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FORECAST

June 16, 2020

Economies, Start Your Engines! But Watch for Yellow Flags

by Avery Shenfeld

An NBA shutdown just before a scheduled tipoff told North Americans that their world had radically changed; the restart of auto racing was among the first signs of an economic renewal. But the revving of the engines was picked up only on TV, with nobody in the stands, a reminder that life isn't yet back to normal.

Similarly, what will sound like a full-throated restart of North American economic engines this spring and summer will leave us a long way from the checkered flag of full employment. We see the jobless rate in the US and Canada sitting roughly 3% higher than full employment in 2021 (Table 1), a big improvement from where we stand, but akin to a typical recession level.

Guided by health experts, we're not assuming that a vaccine will be widely distributed before late 2021, which would still be a record-breaking achievement. The need to limit crowds until then will leave some businesses shuttered, and others operating with reduced capacity.

Those missing jobs will in turn weigh against a full recovery in consumer goods demand, exports, and capital spending, particularly if subsequent waves of fiscal stimulus offer less of a boost to incomes. US states will soon have to tighten up on spending if Washington doesn't ride to their rescue.

Overseas, the news has been so far, so good, as relaxing health restrictions hasn't triggered large flare ups. Europe has moved away from austerity and every country fending for itself fiscally. Economic activity, however, hasn't come roaring all the way back, even in Asian countries that achieved very low levels of infection before paring restraints. Moreover, many EM countries have yet to see the peaks of their Covid-19 outbreak.

US Covid restrictions are coming off. That looks prudent in many states, but riskier in the likes of Florida, California, Arizona and Texas, where the number of currently active cases has yet to ease off. Even if a national second wave doesn't show up, regional outbreaks could see state governors slow any further relaxation of restrictions. Reported illness outbreaks could also engender local consumer caution and disrupt workplaces. That could see US Q4 economic growth decelerate from Q3, and similar risks will leave the economy well shy of full employment next year.

Canada's economy has roughly tracked the forecast we laid out in mid-April, and provinces have been careful about easing Covid-related constraints in hotspots like Toronto and Montreal. But the restraints that will remain after the first wave and consumer caution will leave a substantial output gap through 2021, and impact global demand for Canadian energy and manufactured goods.

Table 1

FORECAST SUMMARY

(% Change Except Where Noted)

CANADA	2019A	2020F	2021F
GDP at Market Prices	3.6	-6.2	7.6
GDP in $2007	1.7	-7.1	5.7
Consumer Price Index	1.9	0.7	1.9
Unemployment Rate	5.7	9.9	8.4
Current Account Balance (C$ Bn)	-47.0	-65.6	-62.4
Pre-tax Profits (net Operating Surplus)	-0.1	-40.9	27.7
Housing Starts (K)	209	173	199
UNITED STATES	**2019A**	**2020F**	**2021F**
GDP at Market Prices	4.1	-5.0	7.6
GDP in $2009	2.3	-6.2	5.5
Consumer Price Index	1.8	0.9	2.1
Unemployment Rate	3.7	8.9	7.0
Current Account Balance (US$ Bn)	-498	-560	-682
Pre-tax Profits (with IVA/CCA)	0.0	-36.0	31.2
Housing Starts (K)	1,295	1,255	1,364

Table 2

INTEREST AND EXCHANGE RATE FORECAST

		2020			2021				2022	
END OF PERIOD:		**15-Jun**	**Sep**	**Dec**	**Mar**	**Jun**	**Sep**	**Dec**	**Jun**	**Dec**
CDA	Overnight target rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
	98-Day Treasury Bills	0.18	0.25	0.25	0.25	0.35	0.35	0.35	0.50	0.75
	2-Year Gov't Bond	0.28	0.35	0.35	0.35	0.40	0.40	0.65	0.50	1.00
	10-Year Gov't Bond	0.49	0.70	0.75	0.80	0.85	0.85	1.25	1.35	1.50
	30-Year Gov't Bond	1.01	1.30	1.20	1.30	1.40	1.50	1.80	1.60	1.65
U.S.	Federal Funds Rate	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.125
	91-Day Treasury Bills	0.16	0.20	0.20	0.25	0.25	0.30	0.50	0.45	0.75
	2-Year Gov't Note	0.18	0.25	0.25	0.30	0.30	0.35	0.55	0.50	0.80
	10-Year Gov't Note	0.67	0.70	0.80	1.00	1.10	1.25	1.45	1.35	1.55
	30-Year Gov't Bond	1.41	1.45	1.55	1.70	1.75	1.85	2.20	2.05	2.10
Canada - US T-Bill Spread		0.02	0.05	0.05	0.00	0.10	0.05	-0.15	0.05	0.00
Canada - US 10-Year Bond Spread		-0.17	0.00	-0.05	-0.20	-0.25	-0.40	-0.20	0.00	-0.05
Canada Yield Curve (10-Year — 2-Year)		0.21	0.35	0.40	0.45	0.45	0.45	0.60	0.85	0.50
US Yield Curve (10-Year — 2-Year)		0.48	0.45	0.55	0.70	0.80	0.90	0.90	0.85	0.75
EXCHANGE RATES	CADUSD	0.73	0.72	0.72	0.73	0.72	0.72	0.71	0.71	0.72
	USDCAD	1.36	1.39	1.38	1.37	1.38	1.39	1.41	1.40	1.39
	USDJPY	107	105	103	101	100	100	99	98	97
	EURUSD	1.13	1.14	1.15	1.15	1.16	1.16	1.17	1.18	1.19
	GBPUSD	1.25	1.25	1.28	1.30	1.32	1.33	1.34	1.37	1.39
	AUDUSD	0.68	0.66	0.66	0.66	0.66	0.67	0.68	0.69	0.71
	USDCHF	0.95	0.95	0.94	0.95	0.95	0.95	0.95	0.96	0.96
	USDBRL	5.16	5.30	5.10	5.00	5.20	5.00	4.80	4.80	4.50
	USDMXN	22.6	21.0	22.0	21.0	20.5	20.5	20.0	19.5	19.0

The long and potentially bumpy road back to full employment runs somewhat counter to the optimism being reflected in capital markets. That seems particularly true for the Canadian yield curve, which alone among major developed markets, is priced as if there's a chance that the Bank of Canada will lead others in restarting a tightening cycle in late 2021 (Chart 1), one factor behind the ability of the C$ to rally with others that have gained against the greenback.

That's at odds with our output gap forecast, and we expect the Bank of Canada's coming outlook will show enough slack through 2021 to obviate the need for tighter policy. If anything, fiscal policy will tighten first as emergency relief programs are withdrawn, and provinces and municipalities move to contain budgetary red ink next year. We also don't expect core inflation measures to show any sustained upside pressure, given ample labour market slack.

If the market doesn't get that message from Bank of Canada language, look for the central bank to reinforce it by shifting asset purchases to the affected part of the curve (i.e. out to five years) or even adopting yield curve control. That should weigh against a further climb in yields in the near term, and also lean against the Canadian dollar.

Given the quicker than expected rebound seen in oil, and the reduced global enthusiasm for the US dollar, we see less C$ weakness than in our prior forecast. But the last thing the BoC wants to see is premature pricing in for higher rates pushing the loonie to export-denting levels, or a climb in five-year mortgage rates before the economy needs it. The Fed for its part, will be more concerned about the long end, given the role that 30-year mortgages play in its market. Further out, of course, the bond market will begin to price in a hotter post-vaccine economy in 2022, pulling long yields higher in anticipation of a tightening cycle that's for now very distant (Table 2).

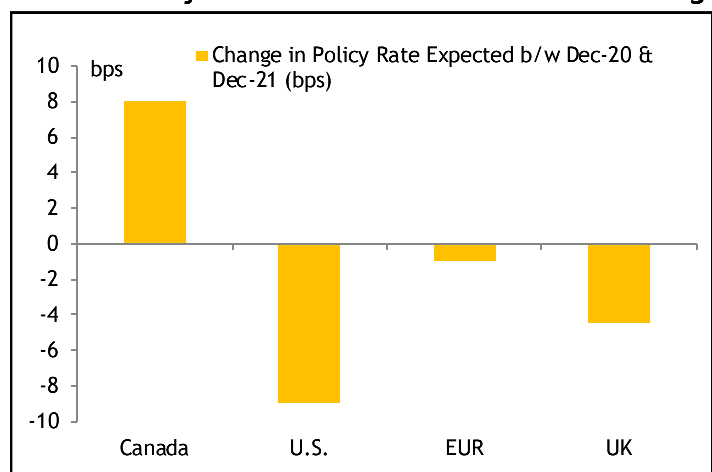
The rebound in equity markets has been grounded in three fundamentals: progress in fending off the first wave of Covid-19, a belief that earnings beyond the next couple of years would be largely unaffected by today's health troubles, and sharply lower interest rates lowering the discount rate on those more distant future earnings.

That said, the market is now vulnerable to a stall or a partial pull back, with flare ups in case counts and earnings disappointments being the two most likely triggers. Historically, it takes many quarters after the end of recession for earnings per share to regain their prior peak (Chart 2). That not only includes the time waiting for output to recover, but also reflects softer margins, and EPS dilutions during the downturn due to additional debt or share issuance, the absence of share buybacks, and insolvencies that transfer corporate assets to creditors.

The bond market seems less worried about the risks that companies will be forced into bankruptcies than in March, but spreads remain wider than pre-crisis, even with central bank intervention. Downside risks have indeed diminished, but the virus could still cause yellow flags to come out and force a deceleration in some regions, and the most impacted sectors still have a long road ahead before profitability returns. But at least we're on that road back.

Chart 1

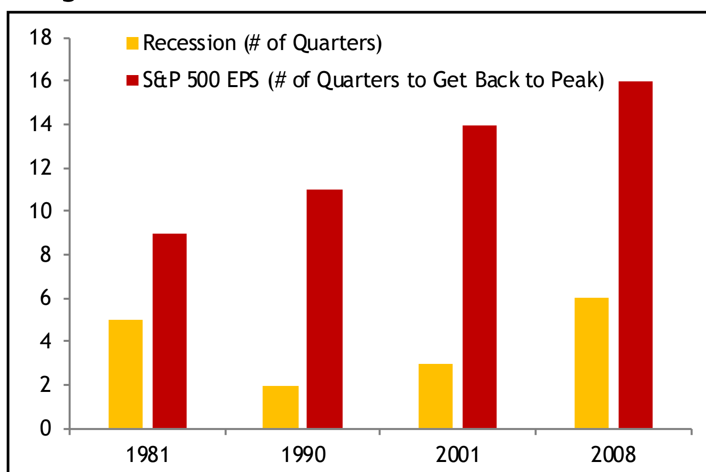
Market Oddly Assumes Canada Will Lead in Hiking



Source: CIBC FICC Strategy

Chart 2

Long Wait For EPS to Recover Post Recessions



Source: Haver Analytics, CIBC

US Outlook: Risky Business

Andrew Grantham and Katherine Judge

The US recession officially started in February, and on a number of indicators, it already appears to be over, with the recovery underway. That would make it the shortest recession in history. However, with the unemployment rate having touched almost 15% in April, it's also the deepest since the Great Depression.

These really are unusual times, and as the recovery continues it will become more apparent that what we are recovering towards isn't a full return to normalcy, as still-high infection rates in some parts of the country and the risk of a second wave in others will slow the pace of reopening towards the end of this year and into 2021, unless faster progress is made on a treatment or vaccine.

Risk…Reward?

Relative to other countries, the US approach to social distancing in order to reduce the spread of COVID-19 has been less strict, particularly recently regarding the speed of reopening. Based on the relationship between globally available mobility data and the daily infection rate, the US currently is not only well above trendlines seen in other countries, but even its own trendline based on figures from earlier in the crisis (Chart 1). This should mean that the US economy sees a smaller drop in GDP during Q2 and possibly a quicker initial rebound than some others. However, it also increases the risk of a "W" shaped economic recovery, if social distancing measures have to be put back in place in at least a few states.

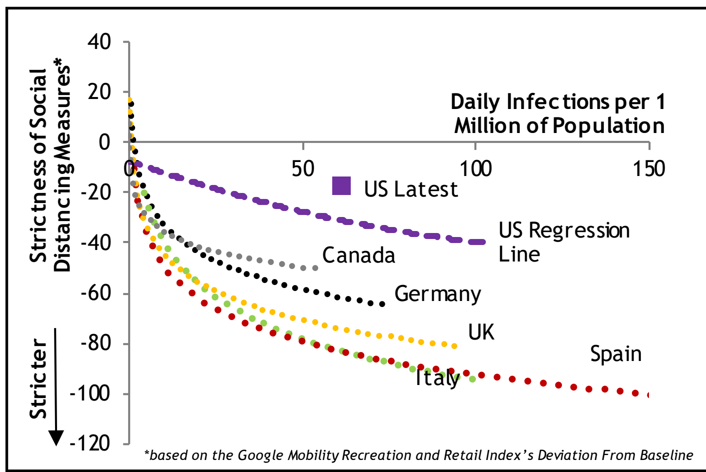
Table 1

US FORECAST DETAIL

(real % change, s.a.a.r., unless otherwise noted)

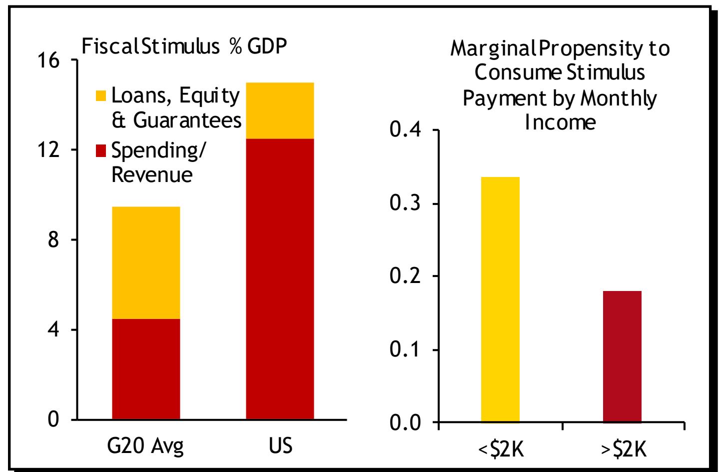
	20:1A	20:2F	20:3F	20:4F	21:1F	21:2F	21:3F	21:4F	2019A	2020F	2021F
GDP At Market Prices ($Bn)	21,535	18,804	20,379	20,726	21,151	21,626	22,241	22,603	21,428	20,361	21,905
% change	-3.5	-41.9	37.9	7.0	8.5	9.3	11.9	6.7	4.1	-5.0	7.6
Real GDP ($2009 Bn)	18,975	16,600	17,910	18,103	18,381	18,710	19,133	19,319	19,073	17,897	18,886
% change	-5.0	-41.4	35.5	4.4	6.3	7.4	9.4	4.0	2.3	-6.2	5.5
Final Sales	-3.6	-41.6	31.6	5.2	6.3	7.5	9.4	3.9	2.2	-5.9	5.3
Personal Consumption	-6.8	-39.1	39.3	6.1	6.6	7.9	10.5	4.0	2.6	-5.3	6.8
Total Govt. Expenditures	0.8	-8.3	3.8	3.7	0.3	0.4	0.6	0.5	2.3	0.2	0.9
Residential Investment	18.5	-26.2	36.8	6.2	6.7	5.3	4.9	4.3	-1.5	4.6	6.8
Business Fixed Investment	-7.9	-59.9	26.6	7.3	12.0	14.7	17.5	6.4	2.1	-15.0	6.3
Inventory Change ($2009 Bn)	-67.2	-49.7	77.4	41.8	40.1	36.5	36.3	37.1	67.0	0.6	37.5
Exports	-8.7	-57.8	29.8	17.7	11.2	10.3	8.2	6.3	0.0	-12.8	6.7
Imports	-15.5	-31.5	24.3	17.1	8.6	8.6	8.7	4.2	1.0	-8.6	8.5
GDP Deflator	1.4	-0.5	1.8	2.5	2.1	1.8	2.3	2.6	1.8	1.2	2.0
CPI (yr/yr % chg)	2.1	0.3	0.5	0.8	1.2	2.4	2.4	2.3	1.8	0.9	2.1
Core CPI (yr/yr % chg)	2.2	1.2	0.8	0.9	0.9	2.0	2.3	2.4	2.2	1.3	1.9
Unemployment Rate (%)	3.8	13.1	9.9	8.9	7.5	7.4	6.8	6.3	3.7	8.9	7.0
Housing Starts (AR, K)	1,487	1,087	1,247	1,198	1,253	1,320	1,410	1,472	1,295	1,255	1,364

Chart 1
US Physical Distancing Measures Less Strict vs Other Countries



Source: Google, Bloomberg, John Hopkins University, CIBC

Chart 3
Fiscal Stimulus Above Average (L), Bigger Bang For Buck if Focused on Lower Income (R)



Source: IMF, Columbia University, Census Bureau, CIBC

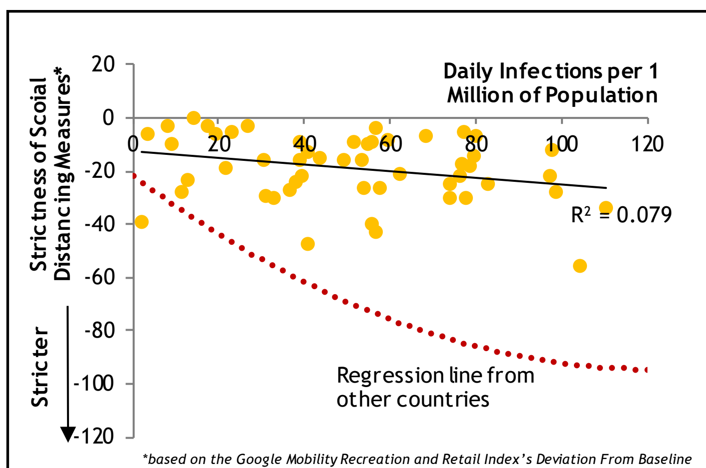
Such actions seem more likely, and maybe even inevitable, when looking at the current relationship between infection rates and the openness of different states (Chart 2). The problem is — there isn't a relationship, with some states posting next to no deviation in mobility scores despite having very high infection rates. Moreover, all states but one are witnessing higher mobility trends versus the baseline than those seen in other countries. The only state that isn't is Hawaii — where mobility is being reduced by the lack of inward tourism.

The Fiscal Building Blocks

If the risk pays off, however, and the US sees only isolated flare ups in case counts as the recovery goes on, the economy should be able to rebound faster than other developed economies. The policy response by the Federal Reserve and Congress is also helping to lay the foundation for the recovery.

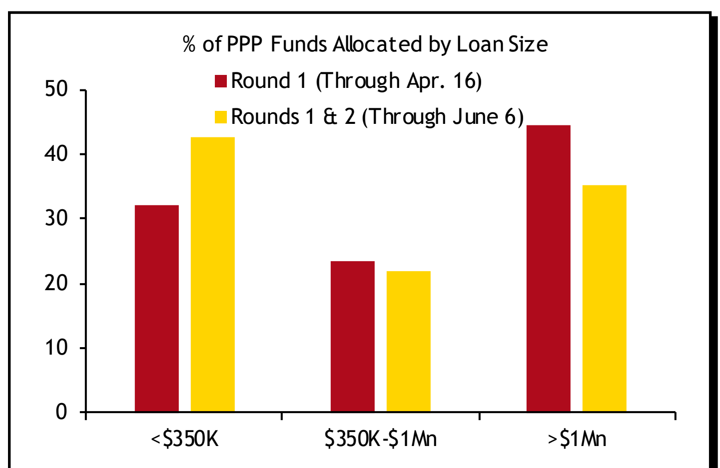
In terms of fiscal stimulus, the US response hasn't been the largest or most timely seen among G20 countries. However, it has been larger than average (Chart 3 left), and has recently become more targeted towards the households and businesses that have the greatest need for support. Earlier rounds of stimulus sent checks to many Americans that didn't really suffer hardship, and who wouldn't have had the same propensity to spend the extra money relative to lower income persons or those that lost jobs (Chart 3, right). Early stimulus efforts

Chart 2
State Infection Rates vs. Mobility Trends: No Relationship



Source: Google, Bloomberg, John Hopkins University, CIBC

Chart 4
Smaller PPP Loans Reflect Shift Towards Smaller Businesses



Source: SBA, CIBC

also ended up supporting larger businesses by more than was intended. However, more recently, the stimulus has become better focused, particularly when it comes to uptake of the Paycheck Protection Program for small businesses (Chart 4).

While the US economy is likely to see further fiscal stimulus through the channels of direct support to households and businesses into 2021, we expect government spending beyond that to be materially weaker as pressure on state and local governments to balance the books mounts. The federal deficit is poised to climb to over 15% of GDP in fiscal 2020, before scaling back in 2021 as labor market gains offset the need for as robust government support.

The decisive actions taken by the Federal Reserve not only helped calm financial markets, but they also have an even greater chance of supporting activity on Main Street (or at least the suburbs near Main Street) than in prior recessions. Previous downturns have often been characterized by financial excesses in the lead-up, which limited the ability of low interest rates to boost activity in the rebound. The 2008/09 financial crisis is a prime example of that. However, this time around, as states have been allowed to reopen, not only have households been able to refinance mortgages at a lower rate (Chart 5, left), but we have also seen applications for home purchases rebound quickly as well (Chart 5, right).

Closing The Gap

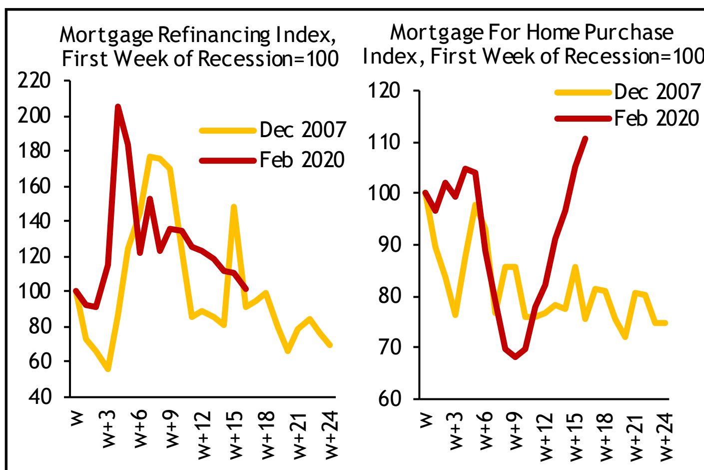
The trends in mortgage applications suggest that of the components of GDP, residential investment should see the quickest rebound. How far that recovery progresses beyond the very near term will, however, be very dependent on how quickly the job market recovers and the unemployment rate falls. Progress here started earlier than expected, with the surprise increase in employment in May's payrolls survey, and could continue to be fairly swift in the near-term if those people identified as on "temporary leave" (just over 80% of recently unemployed as of May) return to their previous jobs. Indeed, if that does happen, the unemployment rate will fall from around 13% to just over 5½%, even assuming that only half of the workers currently misclassified as out of the labour force return to their previous jobs (Chart 6, left).

However, that is certainly a best case, not base case, scenario. Firstly, some of those temporary layoffs will become permanent, particularly for those involved in sectors that are unable to reopen until the later stages of such plans. There is also the likelihood that weak demand resulting from job losses in the most impacted sectors starts to spill over into other areas of the economy. While May's rise in payrolls was a welcome surprise, it was driven entirely by increases in headcount among the sectors most affected by social distancing measures and, therefore, the ones that saw the largest job losses in March and April. Other sectors actually saw mild job losses on aggregate, a sign that second-round effects on the labour market may be materializing (Chart 6, right).

As a result of those factors, we forecast that the unemployment rate even by 2021 will still average around 7%. That's clearly much better than the current rate and the 20%+ mark people were concerned about only a month ago. However, it's still more than 3%-pts above where we were trending before COVID-19 struck. That

Chart 5

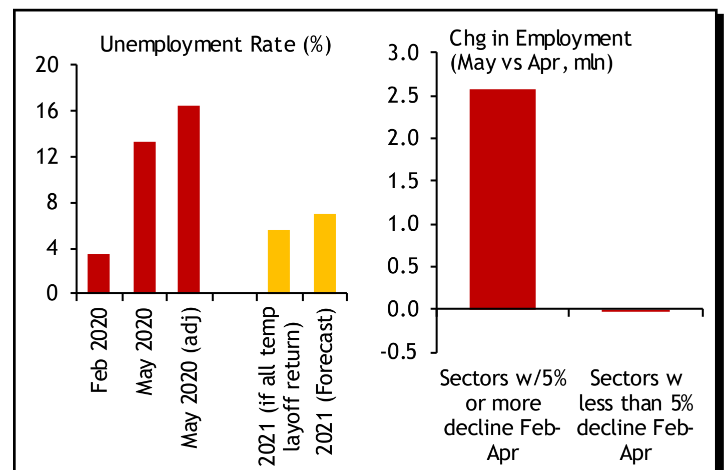
Mortgage Refinancing Pick-up Not Uncommon (L), But Rapid Rebound in Purchases Is (R)



Source: Bloomberg, CIBC

Chart 6

Unemployment Rate Will Fall (L), But Not Fully Recover Due to Second-Round Effects (R)



Source: BLS, CIBC

will slow the recovery in household consumption later in the year, once the initial rebound has happened and government stimulus checks have been spent.

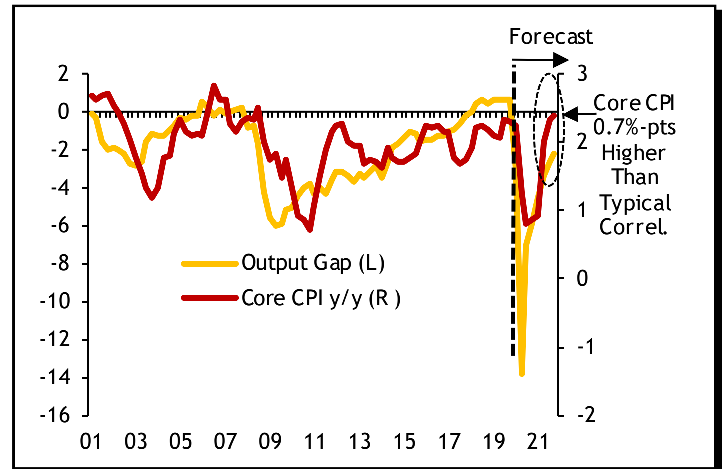
One factor that shouldn't impinge on household spending much, however, is inflation. It is true that inflation will be stronger than what is typically seen after such a large economic contraction and opening up of the output gap, because of business owners passing expenses related to personal protection equipment and safety requirements for staff onto customers. There could also be pressure on import prices as supply chains start to unravel.

However, even after the expected rebound in Q3 GDP, we would still be left with an output gap that's approximately the same size as what was seen at the peak of the last recession — a level typically consistent with lower than 1% core CPI inflation. If inflation were to be between 0.5-1% higher than that historic relationship due to the aforementioned reasons, we would still see core CPI reaching only around 2½% by the end of 2021 (Chart 7).

Given the disparities in reopening plans across states, and the overall faster pace of reopening seen relative to other countries the potential re-tightening of physical distancing measures is a big risk for the US recovery. However, if such a scenario is avoided, with maybe only a brief slowdown in the recovery speed being seen around the turn of the year to offset this risk, the US economy could recover from this crisis quicker than members of the FOMC expect, preventing many of the temporary layoffs seen in the labor market from becoming permanent ones.

Chart 7

Inflation to Track Higher Than Typical For Such a Large Output Gap, But Still Not a Concern



Source: BLS, CBO,CIBC

Canada's Pandemic Recovery: Think Fast Then Slow

Royce Mendes

There seems to be no shortage of advice for how to think about the economic impacts of a pandemic. Some equate it to a natural disaster, others call it akin to a war, and a few even say it's like a doctor putting a patient into a coma.

In reality, a pandemic can only be accurately compared to other pandemics. There are effects on humans, businesses and governments that are unlike anything else, and the impact on the Canadian economy will have its own flavour. A mix of high household debt levels, a reliance on immigration to fuel population growth, and a still-notable exposure to the energy sector mean that the recovery in Canada will look different than those of other jurisdictions.

A Recovery You Can See With Your Eyes

The good news is that the economy seems to have troughed in April, with growth reappearing in May. Unlike most recoveries, it's been incredibly easy to see the early signs of increasing activity. There have clearly been more people walking outside, cars on the road, and businesses with open doors in recent weeks.

That appreciable change led to a big swing in the data. Indeed, the almost 300K jobs created in May represent the most of any one month on record. Assuming all goes according to plan and the virus remains contained, a further relaxation of restrictions, even if limited, will translate into notable growth rates for employment and GDP into the summer months.

Table 1

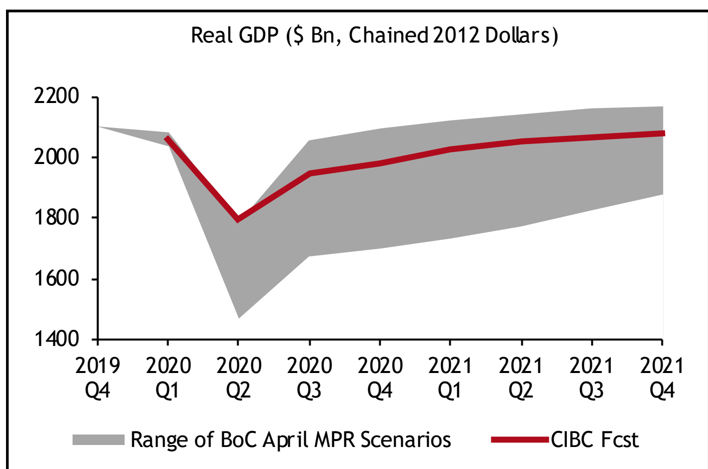
CANADA FORECAST DETAIL

(real % change, s.a.a.r., unless otherwise noted)

	20:1A	20:2F	20:3F	20:4F	21:1F	21:2F	21:3F	21:4F	2019A	2020F	2021F
GDP At Market Prices ($Bn)	2,297	1,974	2,170	2,208	2,276	2,314	2,345	2,373	2,304	2,162	2,327
% change	-6.5	-45.4	45.9	7.2	12.9	6.9	5.4	4.8	3.6	-6.2	7.6
Real GDP ($2007 Bn)	2,057	1,794	1,944	1,977	2,024	2,052	2,065	2,076	2,092	1,943	2,054
% change	-8.2	-42.1	37.7	7.1	9.7	5.6	2.7	2.0	1.7	-7.1	5.7
Final Domestic Demand	-6.0	-36.1	25.6	8.4	10.2	6.3	2.9	2.8	1.3	-5.8	5.8
Household Consumption	-9.0	-39.8	35.1	10.5	11.9	6.9	2.6	2.9	1.6	-6.5	7.2
Total Govt. Expenditures	-2.5	-7.3	7.1	3.4	3.0	2.0	2.4	2.0	1.8	-0.4	2.6
Residential Construction	-0.4	-33.7	8.9	4.1	11.1	8.9	5.3	4.6	-0.6	-4.1	4.4
Business Fixed Investment*	-2.1	-68.2	43.7	15.3	21.6	13.2	4.4	2.9	-0.4	-15.8	7.7
Inventory Change ($2007 Bn)	-2.0	-21.5	14.5	9.8	9.1	7.1	7.5	5.2	15.1	0.2	7.2
Exports	-11.3	-55.4	42.8	13.1	10.9	5.3	4.3	2.8	1.3	-12.2	5.9
Imports	-10.7	-46.3	35.8	13.8	11.6	6.1	5.3	3.6	0.6	-10.0	7.2
GDP Deflator	2.2	-5.9	6.0	0.1	2.9	1.2	2.7	2.7	1.9	1.0	1.8
CPI (yr/yr % chg)	1.8	0.1	0.5	0.5	1.0	2.3	2.1	2.2	1.9	0.7	1.9
Unemployment Rate (%)	6.3	12.9	10.5	9.9	9.3	8.6	8.0	7.7	5.7	9.9	8.4
Employment Change (K)	-282	-2234	1176	327	261	264	193	138	391	-1213	865
Goods Trade Balance (AR, $bn)	-15.6	-51.2	-42.1	-43.3	-42.2	-40.1	-38.0	-35.7	-18.4	-38.1	-44.7
Housing Starts (AR, K)	208	171	147	167	185	201	203	207	209	173	199

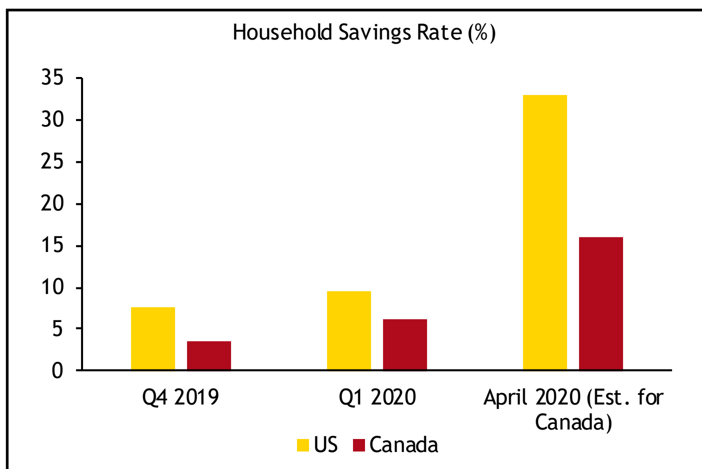
* M&E plus Non-Res Structures and Intellectual Property and NPISH

Chart 1
Economy Appears to Have Avoided Worst-Case Scenario



Source: Bank of Canada, CIBC

Chart 2
Cdn. Household Savings Rate Probably Followed US Higher, If Not All the Way



Source: BEA, Statistics Canada, CIBC

The turnaround means that the economy likely avoided the most severe near-term scenario depicted in the Bank of Canada's April Monetary Policy Report, with the path closer to the central bank's most optimistic scenario in the second quarter (Chart 1). Indeed, we actually expect the labour market recovery to be even faster over the next couple of months than the pace seen in May.

First Out, First In

Looking at the latest labour market report, there were still more than 1 million Canadians who saw their unemployment as only a temporary layoff, almost ten times more than the peak of the financial crisis. That represents some low-hanging fruit. As the economic reopening continues, many businesses that were completely shuttered because they included some non-essential physical interactions will be able to recall many of those workers.

Moreover, Canadian households have likely built up a large stock of savings from staying in their homes in April. Households north of the border might not have seen the same level of increase as their American counterparts who received lump-sum cheques in April, but it will still likely be a sizable increase from the prior trend (Chart 2). That money could be used to satisfy the urge to make a few unnecessary purchases at retailers early in the recovery. As of the first week of June, credit card data confirm that retail spending across a range of categories had already recovered quite nicely, and in some cases, like hardware stores, there had been a notable year-over-year gain. The current rebound in employment and spending likely means that the official recession is actually already over.

Keeping Perspective

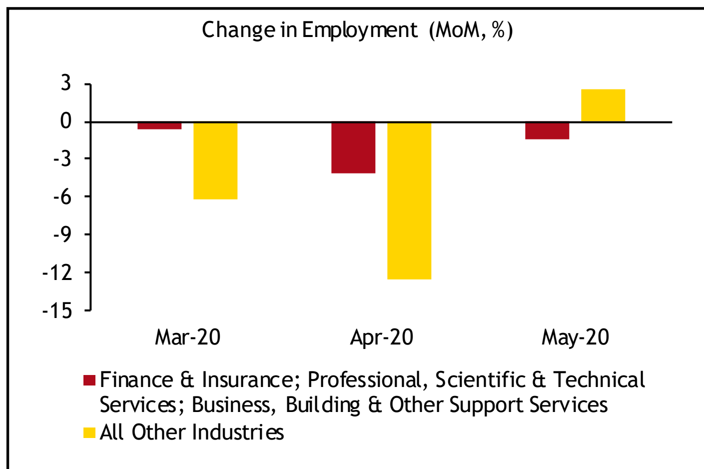
It will, however, be very important to keep perspective. From the severely depressed levels in April, even record-breaking growth will leave the unemployment rate this autumn well above the peak of the financial crisis. Indeed, the May employment gains only represent a recovery of about 10% of the prior declines and absences tied to the pandemic. Even with a million more Canadians either called back to work or finding new places of employment, it would only recoup roughly 40% of the COVID-19-related job destruction in March and April.

The momentum over the summer also seems likely to fade in the fall. For the rest of this year and into next year, many social-distancing measures will need to remain in place. So there's a limit in terms of how much employment and incomes can rebound, even if the demand were present. The need to supress physical contact is expected to last longer than the last time we published forecasts, and in turn weighs on the rebound in 2021.

Furthermore, as of May, there were still large outflows from the workforce, indicating that some businesses that had held on until the early days of reopening, could do so no more. The inflows swamped the outflows adding up to the impressive net job gain, but the inflows were largely in lower-wage employment. Jobs that don't require social distancing, such as office work, were actually still seeing losses (Chart 3).

Chart 3

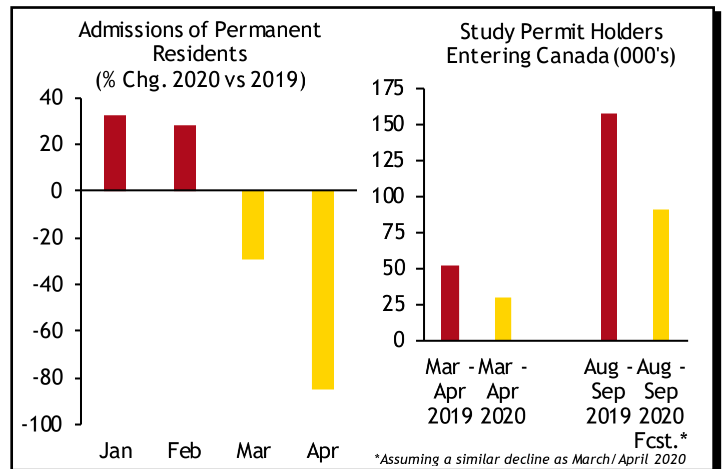
Job Losses Continued in May for Industries Dominated By Office Work



Source: Statistics Canada, CIBC

Chart 4

Immigration Down Dramatically (L); Fall School Term Key to Student Entries (R)



Source: IRCC, CIBC

That's disheartening, since such destruction would seem more long-lasting than the earlier round of layoffs. Those losses also no longer simply represent forced shutdowns, but rather an expectation of an extended timeframe of weak demand. That's contrary to the period of rebuilding which would occur after wars or natural disasters.

Many of the millions of Canadians still receiving the Canada Emergency Response Benefit who were reaching the end of the 16 week maximum in July now seem set to receive an extension. But as some jobs return, governments will be looking to wean both businesses and individuals off of direct aid, redesigning programs to provide incentives for a return to work. While depressed revenues, COVID-related spending, and pressures from provincial and local governments for federal assistance will still keep deficits elevated into 2021, after coming in at roughly 15% of GDP in 2020, one thing we don't see is much upward pressure on bond yields given the offset from the Bank of Canada's asset purchases.

Pre-Existing Conditions

Up until now what's been described could be true of any developed nation recovering from the pandemic. However, Canada has pre-existing conditions which will make fully recuperating in 2021 a challenge.

High household debt levels are an acute risk that has so far not materialized into anything sinister. Mortgage deferrals and income support have been a big part of the reason that there hasn't been a wave of bankruptcies. But, for many of the more than 15% of mortgage holders that were provided relief, payments are set to resume in October.

Our research on the distribution shows that most of the deferrals came from households with high credit scores, suggesting CMHC's dire warnings of a crisis are likely too pessimistic. But, there will still be a rise in defaults from pre-COVID-19 levels on the horizon, particularly if income support begins to wane.

Immigration, unlike the US, had played a major role in propelling Canadian housing markets and spending, but it has also been under pressure, as travel restrictions have essentially hit the pause button on bringing in new Canadians. So far, the data show a 30% drop in permanent residents entering Canada in March followed by a further 85% decline in April (Chart 4, left). The government probably won't try to make up those losses by increasing immigration targets after restrictions are lifted, but the flow should return. Others entering on student visas tend to cluster around the September fall term, so missing the September 2020 start of classes could provide a more lasting hit to population growth well into next year (Chart 4, right).

We've shown before that population growth has represented virtually all of the increases in household spending since the beginning of 2019. As a result, with immigration being held back and the unemployment rate looking set to remain elevated throughout the next year, both housing markets and consumer spending, the

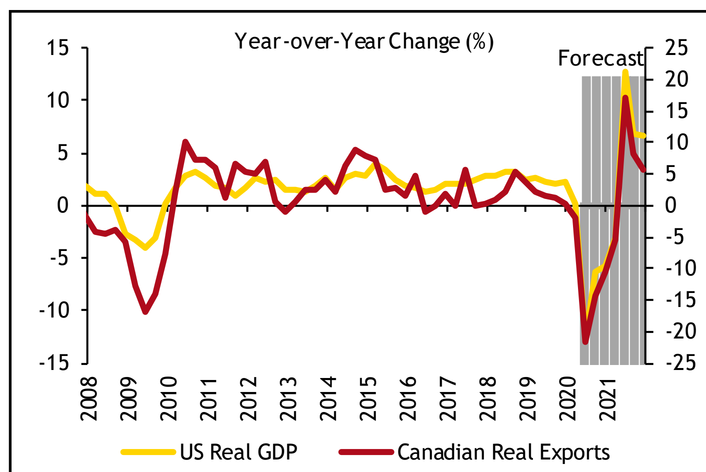
former stalwarts of Canadian GDP growth, will still be limping in 2021.

The Long-Awaited Rotation

Even assuming there isn't a major second wave in the US and reopening happens more aggressively south of the border, it's still expected to take until the end of 2021 for the American economy to climb all the way back. For the US to be underperforming for so long almost necessarily means that Canada's exports will take a sizable hit (Chart 5). As a result, the long-awaited rotation towards non-energy exports and business investment won't be the Canadian economy's saving grace next year.

Chart 5

A Weak US Economy Could Tank Exports, And Not See A Full Rebound in 2021



Source: Statistics Canada, CIBC

Unlike in the aftermath of the financial crisis, there's no emerging economic super-power to prop up global commodity demand either. While oil prices have rebounded recently, it has come only alongside severely diminished global production. The number of oil and gas rigs in Canada stood at just 21 at the end of last week, the same as the prior week and down from 107 a year ago. But the effects of COVID-19 will weigh on the sector even if rig counts can rebound, with cancelled projects curtailing potential production growth years into the future.

Adding up the parts, reveals that neither the sum of the Canadian economy nor the major components of GDP will reach their pre-COVID levels in 2021. Even in 2022, the economy seems likely to be operating with some slack. Unfortunately, there's little policymakers can do to materially accelerate the healing process, with time being the only relevant factor for business formation to fill the gap of companies that couldn't survive. But officials should take a do no harm approach, leaving interests rates at zero for the next few years and austerity for a later date. That might be a different course than in the past, but this is a vastly different environment.

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