# Economic Insights

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## Economics


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# The Skew in the View

by Avery Shenfeld

Markets are putting very low odds on a Bank of Canada cut through January, too low in our view. It's somewhat understandable in the wake of a rebound in growth in the spring, solid jobs data, and doubts about whether the Fed is prepared to move again.

But what's missing in the market's assessment is the skew in the range of potential outcomes for the Canadian economy. A look at forecasts for 2020 real GDP growth for Canada shows a median outcome of 1.7%, with a mode of 1.8%. Not a bad year at all for this stage of the cycle. That would be roughly in line with the economy's non-inflationary potential, and perfectly acceptable for the Bank of Canada.

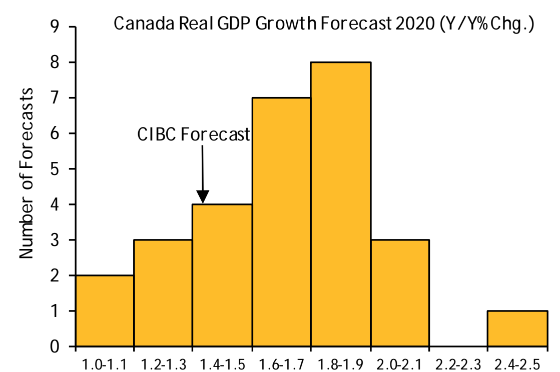
Note, however, that there aren't many forecasts at 2.0% or higher, but there are those seeing a disappointing year of 1.5% or less. The risks are indeed skewed to the downside. Growth of greater than 2% would require a surprising productivity acceleration, given the existing labour scarcity. It would also need a lot to go right in a global economy dealing with trade wars, hot war threats, Brexit ills and, in the US, a lack of available labour.

On the other side, there's plenty of room for downside shocks, particularly through Canada's ties to a slowing global economy. The US-China trade war and frictions between Canada and China could deepen, Europe could fail to deploy fiscal stimulus in the false hope that negative interest rates will finally start working, or Canadian households could get gun shy about debt financed consumption.

For that reason, CIBC's forecast, which we view as the median given upside and downside risks, is for a more tempered 1.4% pace next year. The first signs of that deceleration should be visible by Q4, as we move past a two-quarter rebound from a two-quarter period of near-zero growth last fall and winter.

That will then skew the Bank of Canada's risk-reward calculation in favour of an "insurance" rate cut in either December or perhaps January, a cut that the bond market is not currently pricing-in. Investors should skew their own portfolios to take advantage of that tilt, since there's low odds that the Bank of Canada will be able to turn hawkish in the next few months with so many clouds on the horizon.

***Distribution of 2020 Forecasts***




*Source: Bloomberg, CIBC*

## MARKET CALL

- Our outlooks are unchanged from what we published in our recent issues of Monthly FX Outlook and Forecast. While there have been a few surprises in one direction or another, the third quarter is shaping up to be in line with our prior projections. For both the US and Canada, a roughly 2% Q3 growth pace should be good enough to keep their respective central banks on hold in October, but with the global climate leaving both vulnerable to a more material slowing in Q4 that would prompt a rate cut near the turn of the year.

- The bond market remains priced a bit too aggressively for Fed cuts ahead if, as we expect, the next quarter point ease is the last for this mid-cycle adjustment. That won't be apparent to investors right away, which could have bond yields dipping into the end of the year. But inflation expectations look too low, and we could be moving past the greatest downward pull from European yields should steps towards fiscal stimulus within the Eurozone start to take shape in 2020.

- Its all too quiet in much of the FX space, for good reason. The US dollar and yen have already received much of their "safe haven" benefit, yet other majors don't yet look attractive enough for dollar bulls to throw in the towel. A pass by the Bank of Canada on an October rate cut won't at this point be a market mover, but an ease in December might start to take a bit of the shine off the loonie over the winter.

## INTEREST & FOREIGN EXCHANGE RATES

| | | 2019 | | 2020 | | | | 2021 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **END OF PERIOD:** | | **27-Sep** | **Dec** | **Mar** | **Jun** | **Sep** | **Dec** | **Mar** | **Jun** | **Sep** | **Dec** |
| **CDA** | Overnight target rate | 1.75 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 | 1.75 |
| | 98-Day Treasury Bills | 1.64 | 1.65 | 1.35 | 1.35 | 1.35 | 1.40 | 1.40 | 1.45 | 1.45 | 1.75 |
| | 2-Year Gov't Bond | 1.56 | 1.35 | 1.45 | 1.55 | 1.60 | 1.75 | 1.90 | 1.95 | 2.00 | 2.00 |
| | 10-Year Gov't Bond | 1.34 | 1.25 | 1.30 | 1.50 | 1.65 | 1.75 | 1.95 | 1.95 | 2.05 | 2.05 |
| | 30-Year Gov't Bond | 1.53 | 1.50 | 1.55 | 1.65 | 1.80 | 1.95 | 2.00 | 2.00 | 2.10 | 2.10 |
| **U.S.** | Federal Funds Rate | 1.875 | 1.625 | 1.625 | 1.625 | 1.625 | 1.625 | 1.625 | 1.625 | 1.875 | 2.125 |
| | 91-Day Treasury Bills | 1.79 | 1.75 | 1.75 | 1.85 | 1.75 | 1.80 | 1.90 | 1.90 | 2.10 | 2.25 |
| | 2-Year Gov't Note | 1.64 | 1.40 | 1.50 | 1.65 | 1.80 | 2.00 | 2.05 | 2.10 | 2.30 | 2.50 |
| | 10-Year Gov't Note | 1.68 | 1.50 | 1.75 | 2.00 | 2.10 | 2.20 | 2.20 | 2.30 | 2.35 | 2.50 |
| | 30-Year Gov't Bond | 2.13 | 2.10 | 2.30 | 2.35 | 2.45 | 2.60 | 2.65 | 2.70 | 2.70 | 2.70 |
| Canada - US T-Bill Spread | | -0.15 | -0.10 | -0.40 | -0.50 | -0.40 | -0.40 | -0.50 | -0.45 | -0.65 | -0.50 |
| Canada - US 10-Year Bond Spread | | -0.34 | -0.25 | -0.45 | -0.50 | -0.45 | -0.45 | -0.25 | -0.35 | -0.30 | -0.45 |
| Canada Yield Curve (10-Year — 2-Year) | | -0.22 | -0.10 | -0.15 | -0.05 | 0.05 | 0.00 | 0.05 | 0.00 | 0.05 | 0.05 |
| US Yield Curve (10-Year — 2-Year) | | 0.05 | 0.10 | 0.25 | 0.35 | 0.30 | 0.20 | 0.15 | 0.20 | 0.05 | 0.00 |
| **EXCHANGE RATES** | CADUSD | 0.76 | 0.75 | 0.75 | 0.75 | 0.74 | 0.72 | 0.72 | 0.71 | 0.71 | 0.71 |
| | USDCAD | 1.32 | 1.33 | 1.33 | 1.34 | 1.36 | 1.38 | 1.39 | 1.40 | 1.41 | 1.41 |
| | USDJPY | 108 | 105 | 104 | 103 | 101 | 100 | 100 | 100 | 99 | 99 |
| | EURUSD | 1.09 | 1.10 | 1.12 | 1.14 | 1.15 | 1.16 | 1.16 | 1.17 | 1.17 | 1.18 |
| | GBPUSD | 1.23 | 1.20 | 1.24 | 1.28 | 1.32 | 1.35 | 1.36 | 1.38 | 1.39 | 1.40 |
| | AUDUSD | 0.68 | 0.69 | 0.71 | 0.72 | 0.74 | 0.76 | 0.78 | 0.78 | 0.76 | 0.75 |
| | USDCHF | 0.99 | 0.99 | 0.97 | 0.96 | 0.97 | 0.96 | 0.97 | 0.96 | 0.97 | 0.96 |
| | USDBRL | 4.15 | 3.80 | 3.85 | 3.95 | 3.90 | 4.00 | 3.95 | 3.90 | 3.80 | 3.85 |
| | USDMXN | 19.7 | 19.9 | 20.1 | 20.4 | 20.6 | 20.4 | 19.9 | 19.8 | 19.6 | 19.7 |

# Provincial Outlook: Shuffling the Deck

by Andrew Grantham

The Canadian economy has performed broadly in line with our expectations in recent months, with the slow patch at the start of this year being followed by a strong pick-up in the second quarter. As such, our Canadian forecasts for this year and next are very similar to those we were assuming back in the last provincial article in May.

However, that doesn't mean no change for the provincial forecasts as well, with some shuffling of the deck necessary (Table 1). Most importantly, quarterly figures released by the province suggests that Quebec has remained a hotter hot spot than previously anticipated, while in contrast Canada-China trade tensions appear to be having a bigger impact on Saskatchewan and Manitoba than previously assumed.

## Momentum in East Beats West

Our momentum indicators for the provincial economies (based on nine monthly data series) tell a similar story currently to the one at the start of the year – namely that Western provinces are struggling to live up to their previous growth rates, while many Eastern provinces are growing faster than their average since 2002. The clear exception to that remains Newfoundland & Labrador, although even here there has been some improvement.

However, even within the central and western parts of Canada, there have been shifts in momentum. Monthly data have started to improve slightly in BC and Alberta, suggesting for the latter that the economy should avoid a negative year for growth despite the mandated production cuts in the oil sector. In contrast, our indicators have worsened somewhat in Manitoba and Saskatchewan (Chart 1).

Digging deeper into the components, the worsening in Manitoba appears to be largely a reflection of slower employment growth versus that seen at the start of the year, rather than any weakening in real economic activity. Indeed, Manitoba is one of only three provinces (along with Alberta and PEI) for which the labour-market related components of the momentum indicators have been running weaker than the activity ones (Chart 2). As such, we've only made a slight downward revision to the 2019 GDP forecast for the province.

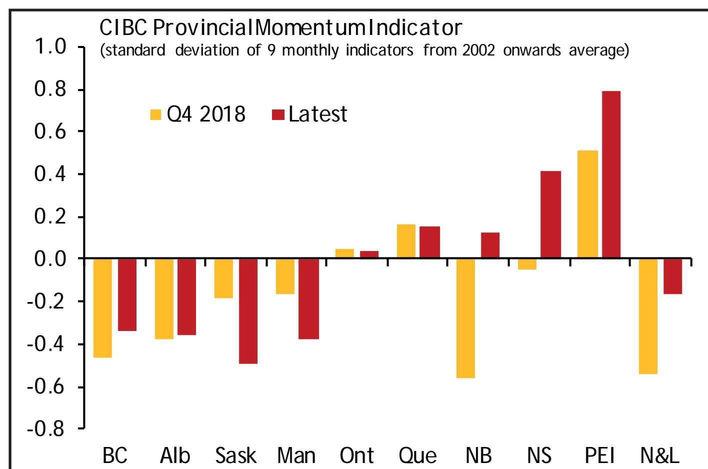
For Saskatchewan, the worsening of the overall indicator has reflected mostly slowdowns in export, wholesale and retail trade. Some of that could be due to an even greater impact from Canadian-Chinese trade tensions than previously anticipated. Indeed, looking at the change in exports to China as a proportion of provincial GDP, the hit for Sas-

| | Real GDP Y/Y % Chg | | | Nominal GDP Y/Y % Chg | | |
|---|---|---|---|---|---|---|
| | 2019F | 2020F | 2021F | 2019F | 2020F | 2021F |
| BC | 1.8 | 2.0 | 2.4 | 3.9 | 4.0 | 4.4 |
| Alta | 0.5 | 1.8 | 2.5 | 3.1 | 3.7 | 5.1 |
| Sask | 0.2 | 1.3 | 2.1 | 2.4 | 3.2 | 4.4 |
| Man | 1.4 | 1.5 | 2.0 | 3.4 | 3.5 | 4.0 |
| Ont | 1.7 | 1.3 | 1.6 | 3.8 | 3.3 | 3.6 |
| Qué | 2.4 | 1.6 | 1.8 | 4.4 | 3.6 | 3.8 |
| NB | 1.1 | 0.6 | 1.0 | 3.1 | 2.6 | 3.0 |
| NS | 1.6 | 1.0 | 1.0 | 3.6 | 3.0 | 3.0 |
| PEI | 1.7 | 1.0 | 1.3 | 3.7 | 3.0 | 3.3 |
| N&L | 1.9 | 0.0 | 0.4 | 4.2 | 1.9 | 2.8 |
| **Canada** | **1.6** | **1.4** | **1.9** | **3.7** | **3.4** | **4.0** |

*Sources: CIBC, Statistics Canada, CMHC*

*Chart 1*

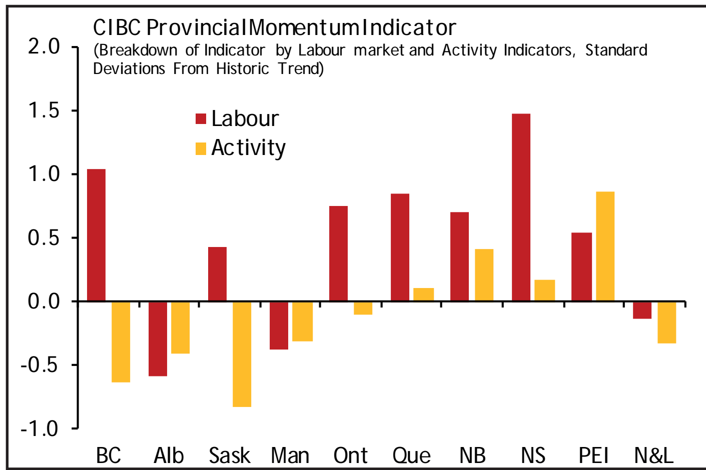
**Western Provinces Are Trailing Their Post-2002 Trend**




*Source: Statistics Canada, CMHC, CREA, CIBC*

*Chart 2*

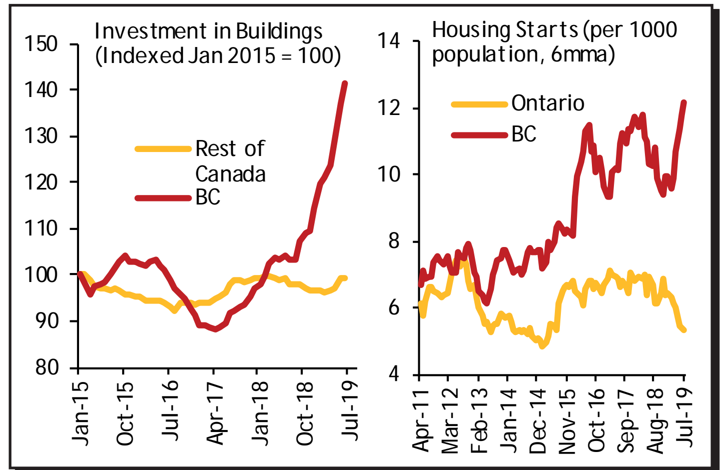
**Labour Market Indicators Running Hotter, Except Man. PEI, Alb.**




*Source: Statistics Canada, CMHC, CIBC*

*Chart 4*

**Non-Residential Construction Surging in BC (L), Housing Starts remain Brisk (R)**




*Source: Statistics Canada, CMHC, CIBC*

katchewan is more than twice as large as the next biggest (Chart 3). Note that for some provinces, notably seafood exporters such as PEI and Nova Scotia, trade with China is still rising and benefitting the local economies.

## BC: Building Company

While our momentum indicator for BC is still indicative of slower than normal growth for that province, it has improved recently. Growth in BC could be close to 2% this year and next, in large part thanks to recent strength in both residential and non-residential investment. Although it won't be until 2021 or later when LNG investment in the province reaches its peak, there has already been a significant pick-up in non-residential construction (Chart 4, left) while housing starts have also been strong so far this year.

The strength in homebuilding is in large contrast to the trend in Ontario, where starts were if anything a little on the soft side earlier this year. Those divergent trends means that BC is building at a much faster rate relative to its population growth than Ontario (Chart 4, right). The question then is if it is too brisk and likely to cool in the years ahead?

The answer for now appears to be no. While we have noted that, on a national basis, newly completed but unabsorbed housing units have been on the

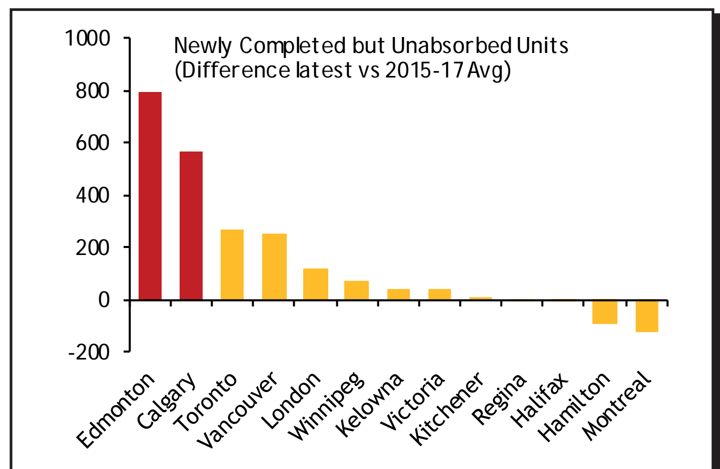
*Chart 3*

**Decline in Exports to China Hurting Saskatchewan, Manitoba**

*Source: Statistics Canada, CIBC*

*Chart 5*

**Unabsorbed Housing Units Rise Most in Alberta, Not BC or Ontario**




*Source: CMHC, CIBC*

rise, a look at the breakdown by city suggests that only a limited part of the increase can be attributed to the major cities in either BC or Ontario (Chart 5).

Instead, the rise in completed but unabsorbed units is primarily owed to increases in Alberta, with Edmonton and Calgary contributing around three-quarters of the total rise.

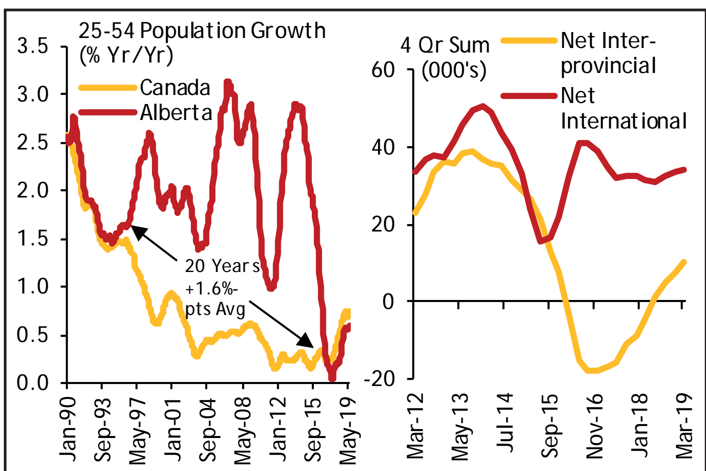
The apparent lack of demand for housing in that province is related to a the fact that Alberta has, at least temporarily, lost one of its advantages over the rest of the country.

For some two decades, up until the oil price correction of 2014, the Albertan economy enjoyed the benefits of strong immigration (both from overseas and inter-provincial) which led to prime-aged population growth averaging more than 1½% above the national average (Chart 6, left).

However, while picking up again recently thanks to a rebound in inter-provincial migration (Chart 6, right), the growth rate of that section of the population is still only in-line with the national average. While overall GDP growth in Alberta will look stronger in 2020 thanks to a rebound in oil production as the mandated cuts are gradually reduced, we don't expect to see a large scale return in oil investment until closer to the completion of key pipelines, which will limit immigration and housing demand.

*Chart 6*

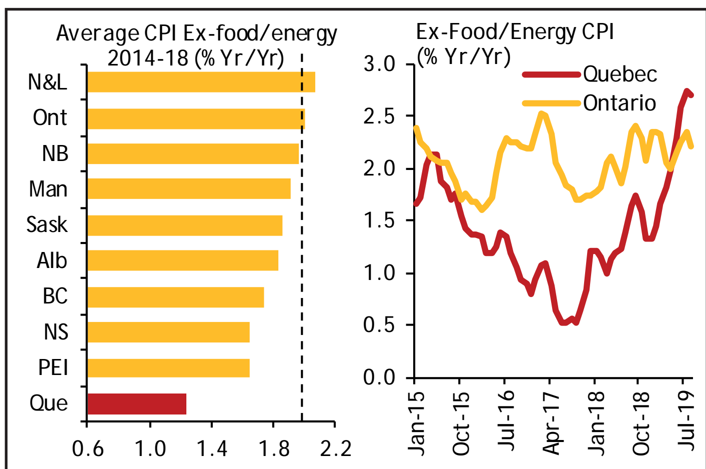
**Alberta's Population Advantage Has Vanished (L), Thanks to Slower Inter-Provincial Immigration (R)**




*Source: Statistics Canada, CIBC*

*Chart 7*

**Inflation Had Lagged in Quebec (L), But is Now Picking Up (R)**




*Source: Statistics Canada, CIBC*

## Quebec Still Bringing The Heat

While we've had to marginally downgrade our forecasts for some provinces, 2019 is shaping up to be an even better year than previously expected for Quebec. Quarterly GDP figures from the Province suggest that it didn't have the soft patch that plagued the national numbers in Q4 2018 and the first quarter of this year. That fact, plus a solid second quarter, leaves Quebec in line to post growth of around 2½% this year.

However, we're starting to see clearer signs that such a pace won't be sustainable. With the unemployment rate now so low, staff shortages are becoming an increasing problem for employers. Meanwhile, capacity constraints also seem to (finally) be showing up in higher inflation. For a number of years, inflation in Quebec has consistently been below the national average (Chart 7, left), but recently it has accelerated and is now above Ontario (Chart 7, right) suggesting that there's not much more room for non-inflationary growth. As such, we expect Quebec to grow only marginally above the national average in 2020 and then slightly below again by 2021.

# Trade Wars: The Test For The Midwest

by Katherine Judge

Growth in Midwestern America continues to lag the rest of the US, with the negative impacts of trade tensions disproportionately weighing on activity. With the adverse effects of trade uncertainty on business sentiment appearing to spread to the household sector, the continuation of trade tensions into early 2020 will further limit economic growth in the region.

That said, a period of cautious household spending has left consumers with a savings cushion for future spending should income growth slow. Over the latter half of 2020, some clarity on the trade front, and an improvement in the global growth backdrop, could start to support a rebound in growth. And while domestic migration trends look less favorable, a continuous stream of international migration to the Midwest has bolstered workforce growth, a potential reason for optimism looking into 2021.

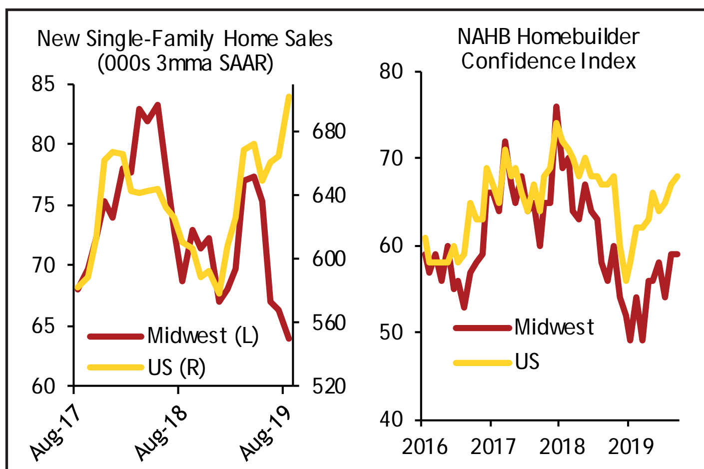
### Rate Cuts Not a Remedy for Midwest Growth Woes

The national economy has started to show signs of responding positively to lower interest rates, with readings on housing market activity having turned a corner in recent months. New home sales jumped in August, and the supply side has also responded, reflected in the pace of homebuilding and building permit issuance, which reached cycle highs in August. However, that positive sentiment hasn't been fully echoed in the Midwest. New home sales in the Midwest have continued to fall since the early summer months (Chart 1, left), and although housing starts have recovered from the bottom reached early in the year, readings on homebuilder confidence suggest a tamer performance from housing starts could be in store ahead (Chart 1, right).

While consumers drove the bulk of growth in the US economy in the first half of 2019, and are poised to do so again in Q3, signs of cautious households extend further than the housing market in the Midwest. The Chicago Fed's index of consumption in the Midwest indicates that household spending has been running below a historically normal rate of growth for the bulk of the period starting in late 2018 (Chart 2, left). That's surprising given the lasting strength of the Midwest labor market, which by many measures, is stronger than in other regions. The job openings rate in the Midwest rose above the national reading in 2017 and remains there (Chart 2, right). Moreover, anecdotal evidence from the Federal Reserve's Beige Book confirms that the Midwest labor market is tight, with employers facing challenges to fill positions of all skill levels. Indeed, the unemployment rate is already well below the trough reached in the previous cycle

*Chart 1*

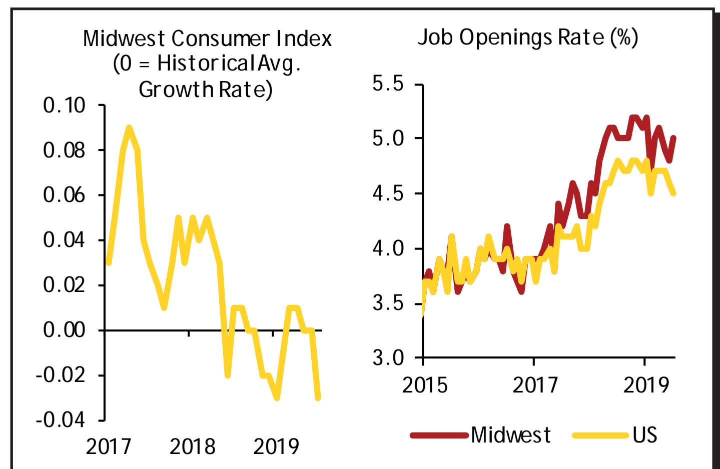
**Housing Demand Not Benefitting from Lower Rates in Midwest (L), And Homebuilders are Less Confident (R)**




*Source: Census Bureau, NAHB, CIBC*

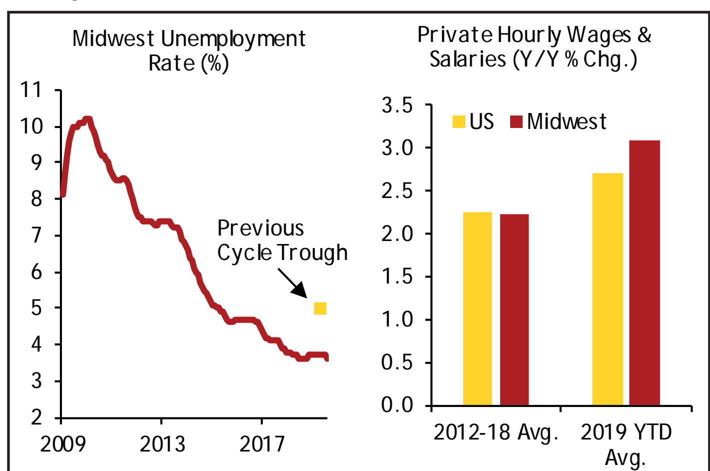
*Chart 2*

**Consumers are Spending Cautiously (L), Despite Jobs Being Plentiful (R)**




*Source: Chicago Fed, BLS, CIBC*

*Chart 3*
**Unemployment Rate Remains Low (L), Seeing Compensation Growth Accelerate (R)**




*Source: BLS, CIBC*

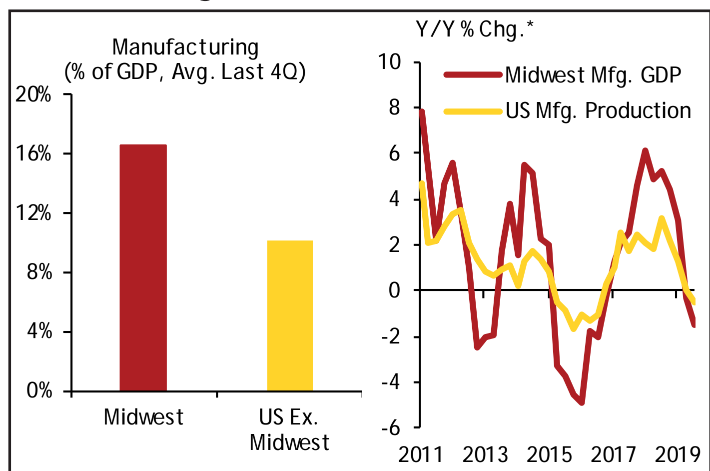
(Chart 3, left), which has seen growth in the hourly wages and salaries index for private industry jump, widening the gap with the rest of the US (Chart 3, right).

Still, despite most of the ingredients for a healthy household sector being in place, consumers remain cautious. That could be a byproduct of a more marked deterioration in the production side of the economy, instilling uncertainty in the region about the state of the job market ahead.

### Tariff Fallout Taking a Toll on Midwest

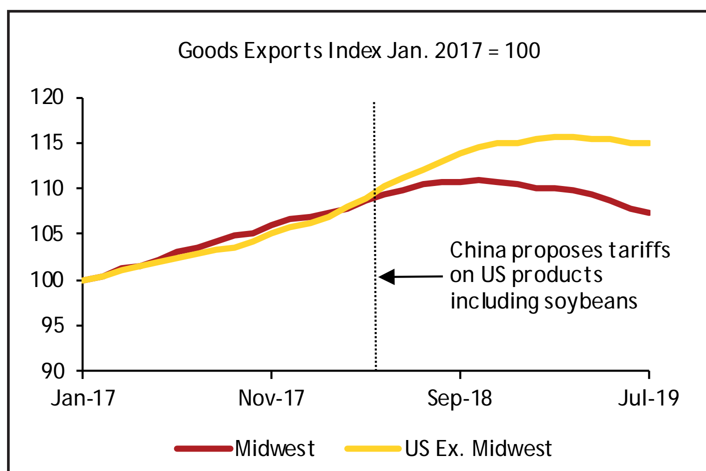
Manufacturing remains a cornerstone of the Midwest economy, accounting for the single largest share of GDP.

*Chart 4*
**Midwest Economy More Exposed to Manufacturing Slowdown**




*Source: BEA, CIBC*
**US data ends August 2019, Midwest data for Q2 and Q3 are CIBC estimates based on Chicago Fed surveys.*

*Chart 5*
**Midwest Exports Hit Harder by Tariffs**




*Source: Census Bureau, CIBC*

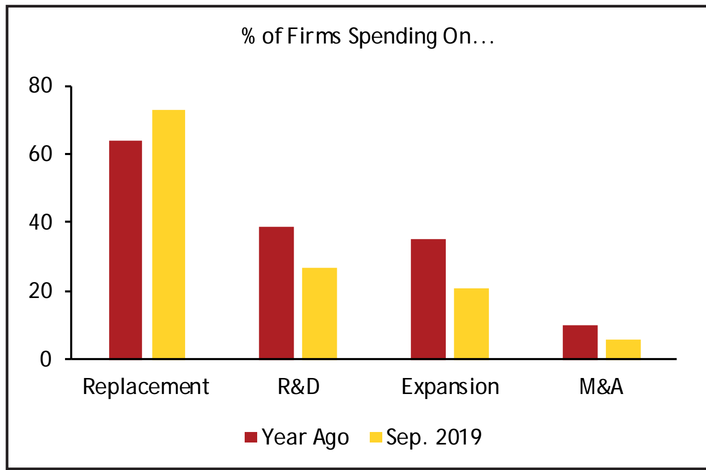
Unlike in other areas of the US, manufacturing as a share of the Midwest economy remains relatively high (Chart 4, left). That has exposed the region more to the slowdown in that sector that is underway across the US, a reflection of trade uncertainty and slower global growth. Indeed, supply chain uncertainty, and inputs to production that are subject to tariffs, have caused manufacturers to slow production (Chart 4, right).

China's initial announcement of tariffs on a list of US goods in April 2018 also added pressure on the region's farm sector. The inclusion of soybeans, a staple of Midwest farms, prefaced the downturn in Midwest exports (Chart 5), which were more acutely impacted than those elsewhere in the US. Although China has exempted some farm products from tariffs recently, the volatile nature of trade talks will continue to weigh on sentiment. With the persistence of trade tensions likely extending into 2020, growth in Midwest export sectors is likely to remain constrained.

Survey evidence from the Chicago Fed also suggests that the impacts of trade uncertainty will extend into the future. Without the addition of capacity, production, and therefore export growth, will be capped going forward. And according to a Chicago Fed survey, current capital spending in the Midwest is tilted more towards replacement and maintenance, rather than expansion (Chart 6), relative to a year ago.

*Chart 6*

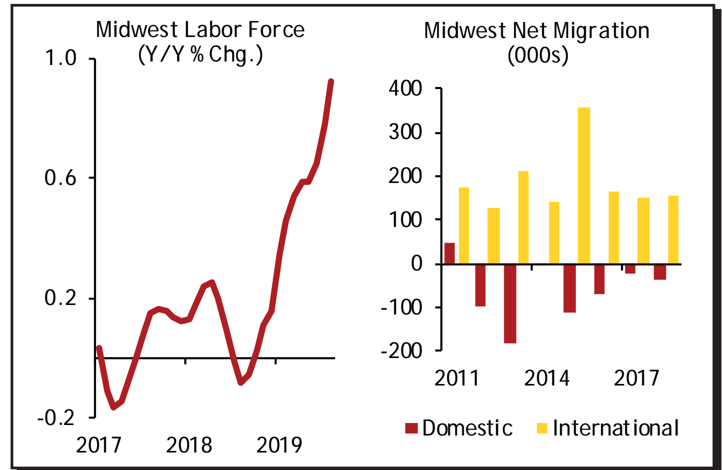
**Current Capital Spending Increasingly Tilted Towards Replacement Rather Than Expansion**




*Source: Chicago Fed, CIBC*

*Chart 7*

**Labor Force Growth Accelerated (L), International Migration Has Bolstered Participation (R)**




*Source: BLS, Census Bureau, CIBC*

## Short-term Pain, Long-term Gain for Midwest?

Near-term growth prospects in the Midwest are clearly clouded by trade uncertainty. And with the potential for the current administration to hold out on reaching a trade resolution, it will take some time for sentiment to recover. However, the approach of the 2020 election will put more pressure on the White House to achieve at least a partial easing in trade tensions. As a result, the Midwest economy is well positioned for a rebound in growth come 2021.

That should be driven by an acceleration in household spending and the resumption of business investment. With employees in the Midwest earning more than in other areas of the US, but spending less, households should be accumulating a sizeable savings cushion for future consumption, should income growth slow unexpectedly.

Higher earnings also appear to be working to boost labor force participation (Chart 7, left). And while domestic migration trends show that there has been a net outflow of Americans from the Midwest during the recovery, international migration has more than made up for that (Chart 7, right). Depending on the outcome of the 2020 election, a reliance on international migration could either be a cause for concern, or a reason for optimism heading into 2021. Still, while labor availability could improve, capacity constraints should continue to see the Midwest somewhat lagging the US until we see a more robust improvement in capital spending in the region.

# Is Monetary Policy Broken?

by Avery Shenfeld and Royce Mendes

After years of mixed results from the most aggressive versions of monetary policy stimulus, some are questioning whether the prevailing wisdom on how low rates lift growth and inflation needs to be upended. A new paper by Harvard's Larry Summers and Anna Stansbury threatens to overturn what's long been conventional wisdom: the lower the policy rate of interest, the faster will be growth and inflation. Instead, they argue that very low rates could either be an outright drag, or less dramatically, not nearly as powerful a lift as once thought.

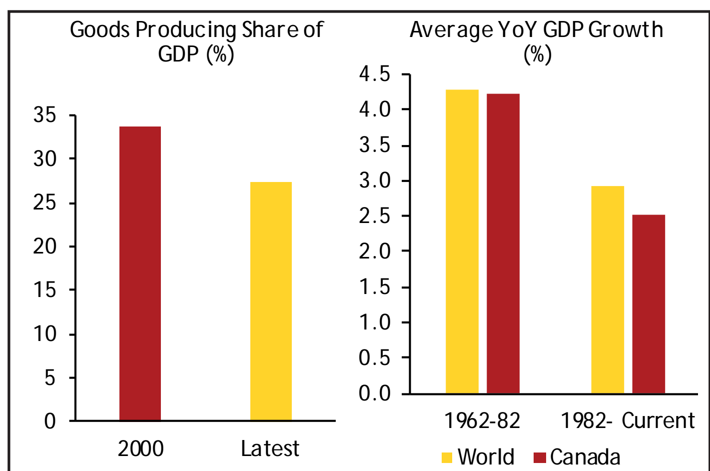
If that view takes hold, it will have major ramifications for both policymakers and investors. The experience in this cycle suggests that monetary policy might well be doing more harm than good in places like Germany and Japan. While the evidence doesn't point that way for Canada, there are reasons to expect that even here, monetary policy will have less power to lift growth and inflation ahead, and implies that long term yields, which might be pricing odds that near zero or negative rates will be occasionally deployed, could be too low.

## Turning Interest Rate Impacts on their Head

There's little doubt that one channel for interest rates to boost growth, and eventually inflation, is still operative.

*Chart 1*

**Economy Is Shifting Away From Heavy Industry (L), Slower Trend GDP Growth Reduces the Need for Capacity Growth (R)**




*Source: Statistics Canada, CIBC*

Lower rates, all else equal, reduce the hurdle rate for business investment spending.

But we at CIBC Economics and others have noted that this link would be weaker than in the past, owing to the lesser economic role played by capital intensive heavy industry (Chart 1, left), and slower trend growth that reduces the ongoing need for capacity expansions (Chart 1, right). With a given rate cut levering up a smaller response from businesses, we can get caught in a trap in which ever lower rates are needed at the bottom of each economic cycle, eventually hitting a wall at wherever the lower bound on rates lies.

Where things get interesting is in the impact of interest rate changes on the household sector's decisions on how to allocate income between current consumption versus savings and future consumption. The conventional wisdom is to assume that at lower interest rates households will opt to borrow more for spending today, and given the lower reward for doing so, save less for future consumption. That captures what economists call the "substitution effect."

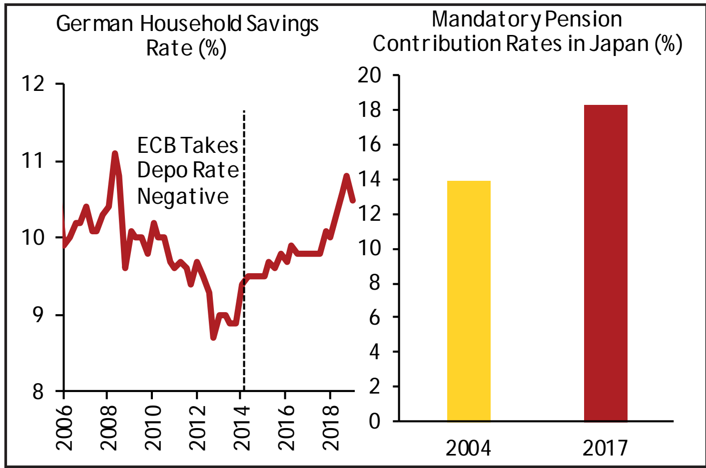
But there's an "income effect" that works in the opposite way. Permanently lower interest rates can reduce one's lifetime consumption path, since for a given lump of retirement savings, one will have a weaker stream of income. Households in their prime income and savings years might opt to increase savings (and reduce spending) when rates fall, in order to make up for that hit to retirement incomes. Younger retirees could slow their dis-savings, spending less of their incomes and assets in fear of not having sufficient interest income in the future.

Furthermore, even if low rates do work to advance spending on housing and durable goods, households who tapped into such opportunities when rates first fell might not be tempted again by a renewed low rate period in the same cycle. An "on sale" sign will only bring the customers into the store for so long before they've fully tapped into what you're discounting, particularly for durable goods and housing.

The bottom line: whether and to what degree rate cuts lift consumer spending and the economy overall is a

*Chart 2*

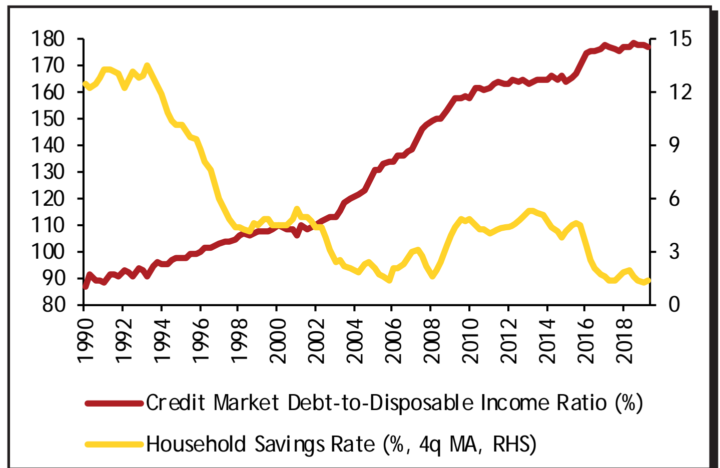
**Low Rates Led To Rising German Savings Rates and Higher Japanese Pension Contribution Rates**




Source: OECD, CIBC

*Chart 3*

**Lower Interest Rates Have Induced The Expected Response From Cdn. Households: Higher Debt and Reduced Savings**




Source: Statistics Canada, Haver Analytics, CIBC

matter for empirical testing rather than an irrefutable conclusion from theory.

### Canadians Borrowed More, Saved Less at Low Rates

Germany and Japan look to be fertile ground to see the sort of adverse impacts that Summers-Stansbury are pointing to. With Germany's aging population getting past their prime borrowing years, we're seeing a rising savings rate and a reduced share of income going to current consumption. In fact, since the European Central Bank introduced negative interest rate policy, the savings rate has moved even higher, suggesting that further reductions could harm more than heal (Chart 2, left).

In Japan, rates have been ultra-low since the 1990s, but the introduction of negative rates in 2014 similarly came alongside an increase in the savings rate and a decline in market-based inflation expectations. Falling yields for many assets has also seen Japanese households forced to contribute more to pension plans (Chart 2, right).

In Canada, the empirical evidence seems clear. While capital spending responded only weakly to low rates, both consumer spending and housing investment received substantial lifts when the Bank of Canada cut rates in the last recession.

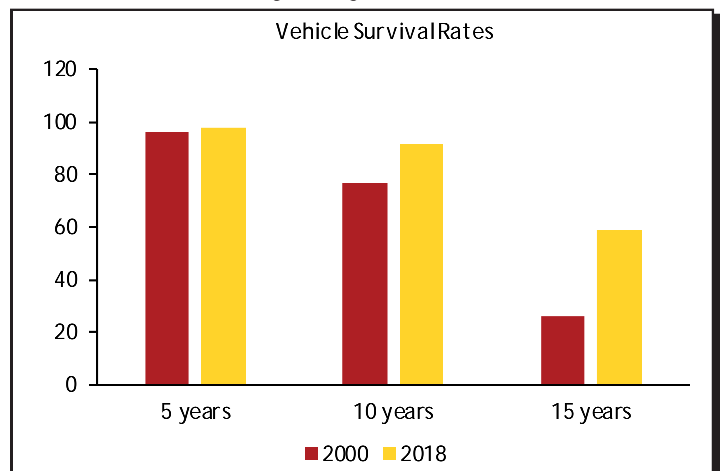
But we might well be in for a weaker response if rates fall again in the near term. After being stalwarts during the recovery by opening their wallets, households' savings rates are now trending around the lowest levels since the early 1960s, and well publicized debt ratios are among the highest in the world (Chart 3), leaving less room for monetary policy easing to incent further spending.

Looking at the fundamentals of the most interest rate sensitive household purchases also suggests that the economy may not be as sensitive to rate cuts in the future. The pace of home building has been running a bit ahead of demand, with completed but unfilled units beginning to climb.

Canadians also don't need to replace their vehicles as often as they did a couple of decades ago (Chart 4). As a result, the share of durable goods consumption in Canadian GDP hasn't really done much despite the rock bottom rates of the current expansion (Chart 5).

*Chart 4*

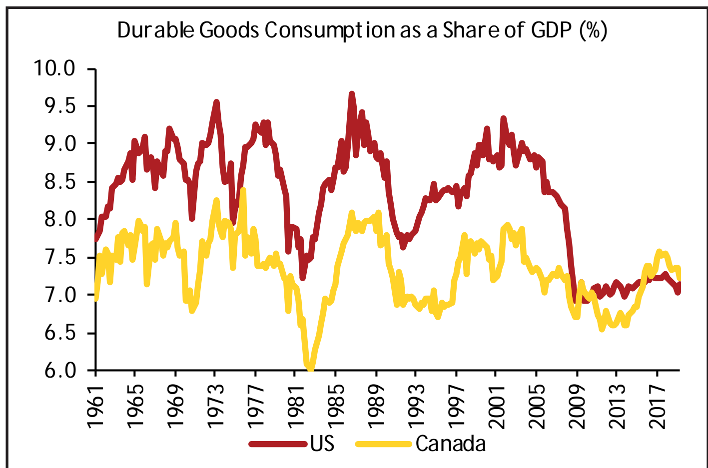
**Vehicles Are Lasting Longer**




Source: Desrosiers Automotive Consultants, IHS Markit

*Chart 5*

**Despite Very Low Rates, Durables Goods Consumption As A Share of Cdn. GDP Hasn't Increased, While It Has Plummeted in the US**




*Source: Bureau of Economic Analysis, Statistics Canada, CIBC*

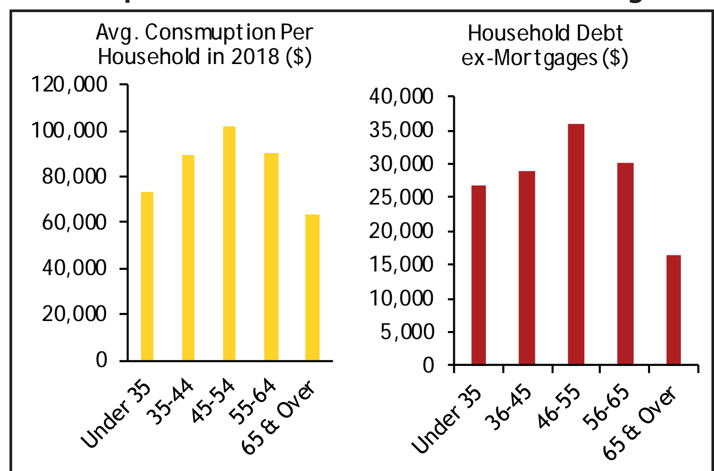
We also have a rising share of Canadians moving past the stage of the lifecycle in which the heaviest borrowing and spending takes place. Both consumption and debt tail off for those reaching 55 and older (Chart 6, left and right).

What we haven't seen yet in Canada is the drag on spending seen in Germany and Japan where either private savings rates or pension contributions were lifted to generate sufficient retirement income. While savings rates have indeed risen for those up to 64, that's been offset by retirees savings rate becoming more negative.

Why would retirees facing low interest rates be more willing to spend from their assets? Our hypothesis is that there is a quirk of how savings rates are measured. They are the residual left after subtracting spending from disposable income, but the latter doesn't include capital gains. Huge capital gains on housing and other interest-sensitive assets, helped by a falling rate environment, could for a while be increasing the ability of current retirees to spend liberally. A recent Bank of Canada study documented a sizeable lift to current consumption from wealth extraction from housing.

*Chart 6*

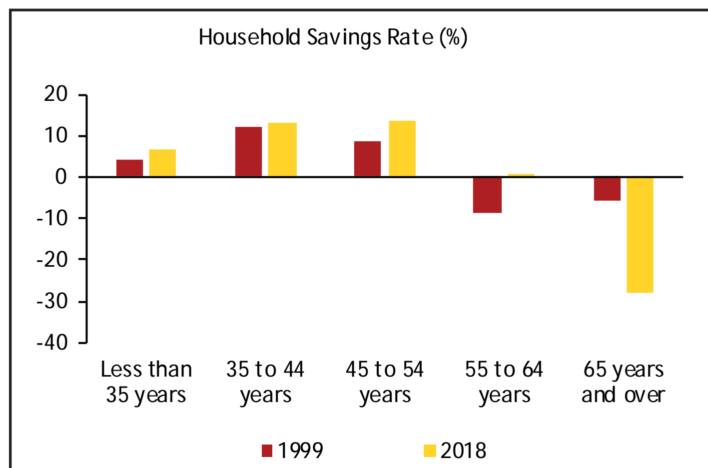
**Consumption And Debt Both Tail Off After Age 55**




*Source: Statistics Canada, Equifax*

*Chart 7*

**Canadians Need to Save More Before Retirement, Retire Later, and Drawdown on Capital in Retirement Instead of Living on Interest Income**




*Source: Statistics Canada, CIBC*

But if rates then plateau at low levels, there's not as much additional juice for asset price inflation. Over time, that will see both individuals and pension funds facing diminished income generating prospects, risking a swing towards saving more and spending less to provide the additional principal. Perhaps that's why we're already seeing younger Canadians move in that direction, with their savings rates climbing since 1999 (Chart 7).

Add it all up, and while low rates helped in the rescue of the Canadian economy in the last recession, they might work less well in the next downturn. The Bank of Canada still talks about the use of negative rates as an option, one that Fed Chairman Powell now has largely ruled out for the US. Fortunately, in Canada, there's a political consensus towards fiscal stimulus in such circumstances.

The failure of Europe to come to the same conclusion, and the poor Eurozone response to ultra-low rates, will be a lesson we'll need to remember. And if we do, today's long term rates, which likely price in some probability of periods of near zero rates in Canada, could be too low if economists start to more broadly question the wisdom of ultra-low policy rates.

## ECONOMIC UPDATE

| CANADA | 19Q2A | 19Q3F | 19Q4F | 20Q1F | 20Q2F | 20Q3F | 20Q4F | 2019F | 2020F | 2021F |
|---|---|---|---|---|---|---|---|---|---|---|
| Real GDP Growth (AR) | 3.7 | 1.9 | 0.9 | 1.2 | 1.4 | 1.1 | 1.5 | 1.6 | 1.4 | 1.9 |
| Real Final Domestic Demand (AR) | -0.7 | 1.6 | 1.4 | 1.4 | 1.6 | 1.9 | 1.6 | 0.8 | 1.4 | 1.9 |
| Household Consumption (AR) | 0.5 | 1.6 | 1.4 | 1.4 | 1.6 | 2.0 | 1.7 | 1.6 | 1.5 | 1.9 |
| All Items CPI Inflation (Y/Y) | 2.1 | 2.0 | 2.3 | 2.5 | 1.6 | 1.9 | 2.1 | 2.0 | 2.0 | 1.8 |
| Unemployment Rate (%) | 5.5 | 5.8 | 6.0 | 6.1 | 6.2 | 6.2 | 6.1 | 5.8 | 6.2 | 5.9 |

| U.S. | 19Q2A | 19Q3F | 19Q4F | 20Q1F | 20Q2F | 20Q3F | 20Q4F | 2019F | 2020F | 2021F |
|---|---|---|---|---|---|---|---|---|---|---|
| Real GDP Growth (AR) | 2.0 | 2.0 | 0.8 | 1.7 | 1.8 | 2.0 | 2.1 | 2.2 | 1.7 | 2.1 |
| Real Final Sales (AR) | 3.0 | 1.8 | 1.6 | 1.4 | 1.5 | 1.7 | 2.2 | 2.1 | 1.7 | 2.1 |
| All Items CPI Inflation (Y/Y) | 1.8 | 1.8 | 1.9 | 2.3 | 1.7 | 1.8 | 2.1 | 1.8 | 2.0 | 2.2 |
| Core CPI Inflation (Y/Y) | 2.1 | 2.3 | 2.3 | 2.3 | 2.2 | 2.0 | 2.0 | 2.2 | 2.1 | 2.3 |
| Unemployment Rate (%) | 3.6 | 3.7 | 3.7 | 3.8 | 4.0 | 3.9 | 3.8 | 3.7 | 3.9 | 3.8 |

## CANADA

Second quarter growth exceeded expectations on the headline, but fell short in the details, adding to evidence that the rebound would be largely temporary. While the current quarter is tracking a roughly 2% advance, the pace of growth is still benefiting at least somewhat from activity returning to more normal levels after a two-quarter period of near zero growth. Following that one-off rebound, we expect to see a deceleration as the drag from soft global conditions takes hold.

## UNITED STATES

Signs that lower interest rates are working to spur housing market activity, and a slight improvement in business investment indicators for Q3, leaves our forecast for that quarter a tick higher at 2.0%. But Q4 looks vulnerable to a much slower pace as softness in trade and related capital spending sparks caution in hiring, and therefore, consumption. Progress on trade and the lagged impacts of rate cuts should see growth rebound thereafter.

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