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FORECAST

January 18, 2018

The Energizer Bunny

by Avery Shenfeld

We enter 2018 in the midst of an expansion that's akin to the Energizer Bunny: it just keeps going and going. With inflation unlikely to dramatically overshoot targets, no central bank is going to err on the side of hiking rates enough to seriously jeopardize the outlook, and no other major shock is at yet visible.

But like the battery in your aging cell phone, that doesn't mean that growth can't be less powerful ahead. While consensus forecasts have been ramping up growth outlooks for 2018, global growth is more likely to steadily decelerate, from 3.6% in 2017, to 3.3% this year and 3.1% in 2019.

China has already taken its foot off the monetary policy gas pedal. The uber-dovish talk we've heard from the ECB ignores that it has seen enough of an improvement in the broadest measures of unemployment to start hiking by early 2019, if not sooner. The US has room to beat its 2017 results for one year, and the recent tax bill will fuel some of that bump. But by 2019, the barriers of full employment will loom, and the cumulative impact of Fed tightening will have growth running below 2%.

In Canada, prime-age employment and capacity use rates both depict an economy that already has minimal slack. In that sense, the recent Business Outlook Survey almost certainly has it wrong in predicting that growth in the next four quarters will be faster than in the prior four. Monetary policy will be aimed at holding growth to closer to 2% than the prior year's 3% pace, with a further slowdown come 2019 to keep inflation at bay (Table 1).

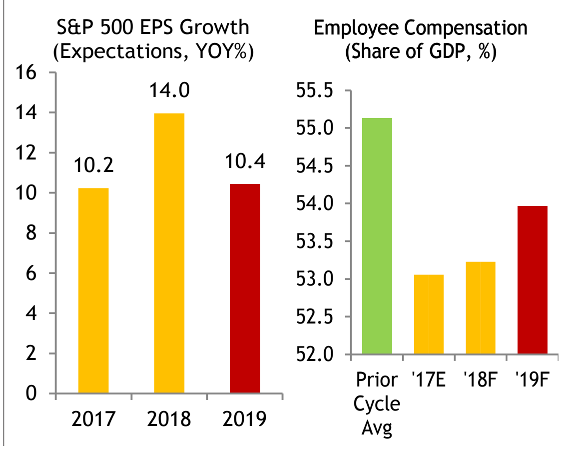
Equities Get the Best News First

For financial markets, none of this should come as a huge surprise. But in equities, it's not clear that investors are pricing in the related deceleration in earnings growth, particularly for 2019 (Chart 1). Wage gains in a tighter 2019 job market could also start to take a bite out of margins.

Buybacks fueled from repatriated foreign earnings and greater after-tax earnings in 2018 will help stocks gain ground, and a long cycle with tame interest rates is also one that helps justify generous multiples for stocks. But the pace of gains will be held back as investors reassess their medium-term assumptions, and as a further lift in commodity prices looks less likely in the face of a softer global pace.

Chart 1

US Earnings Consensus: Too Rosy for 2019 Given Slowing Growth and Wage Squeeze



Source: FRED, CIBC

Table 1

FORECAST SUMMARY
(% Change Except Where Noted)

CANADA	**2015A**	**2016A**	**2017F**	**2018F**	**2019F**
GDP at Market Prices	0.2	2.0	**5.2**	**4.3**	**3.7**
GDP in $2007	1.0	1.4	**2.9**	**2.1**	**1.6**
Consumer Price Index	1.1	1.4	**1.6**	**2.1**	**2.1**
Unemployment Rate	6.9	7.0	**6.3**	**5.7**	**5.6**
Current Account Balance (C$ Bn)	-71.5	-65.4	**-64.8**	**-59.0**	**-58.5**
Pre-tax Profits (net Operating Surplus)	-7.5	0.6	**9.4**	**4.4**	**3.5**
Housing Starts (K)	194	198	**221**	**195**	**178**
UNITED STATES	**2015A**	**2016A**	**2017F**	**2018F**	**2019F**
GDP at Market Prices	4.0	2.8	**4.2**	**4.9**	**4.1**
GDP in $2009	2.9	1.5	**2.3**	**2.5**	**1.9**
Consumer Price Index	0.1	1.3	**2.1**	**2.1**	**2.4**
Unemployment Rate	5.3	4.9	**4.4**	**3.9**	**3.7**
Current Account Balance (US$ Bn)	-435	-452	**-441**	**-504**	**-568**
Pre-tax Profits (with IVA/CCA)	-1.1	-2.1	**4.9**	**10.3**	**4.7**
Housing Starts (K)	1,107	1,177	**1,205**	**1,267**	**1,279**

Table 2

INTEREST AND EXCHANGE RATE FORECAST

		2017	**2018**				**2019**	
END OF PERIOD:		**17-Jan**	**Mar**	**Jun**	**Sep**	**Dec**	**Mar**	**Jun**
CDA	Overnight target rate	1.25	1.25	1.25	1.50	1.50	1.75	1.75
	98-Day Treasury Bills	1.18	1.20	1.25	1.45	1.45	1.75	1.70
	2-Year Gov't Bond	1.75	1.85	1.90	2.05	2.05	2.10	2.10
	10-Year Gov't Bond	2.16	2.20	2.30	2.40	2.35	2.45	2.40
	30-Year Gov't Bond	2.33	2.45	2.55	2.65	2.70	2.75	2.80
U.S.	Federal Funds Rate	1.375	1.375	1.625	1.875	2.125	2.125	2.375
	91-Day Treasury Bills	1.44	1.40	1.60	1.80	2.05	2.20	2.30
	2-Year Gov't Note	2.04	1.90	2.10	2.30	2.50	2.45	2.55
	10-Year Gov't Note	2.56	2.55	2.70	2.80	2.90	3.00	3.10
	30-Year Gov't Bond	2.83	2.95	3.25	3.35	3.40	3.40	3.50
Canada - US T-Bill Spread		-0.26	-0.20	-0.35	-0.35	-0.60	-0.45	-0.60
Canada - US 10-Year Bond Spread		-0.40	-0.35	-0.40	-0.40	-0.55	-0.55	-0.70
Canada Yield Curve (30-Year — 2-Year)		0.58	0.60	0.65	0.60	0.65	0.65	0.70
US Yield Curve (30-Year — 2-Year)		0.79	1.05	1.15	1.05	0.90	0.95	0.95
EXCHANGE RATES	CADUSD	0.80	0.78	0.75	0.76	0.76	0.78	0.78
	USDCAD	1.24	1.28	1.33	1.32	1.31	1.28	1.29
	USDJPY	111	111	110	108	107	106	106
	EURUSD	1.22	1.21	1.22	1.23	1.25	1.23	1.23
	GBPUSD	1.38	1.31	1.31	1.34	1.38	1.38	1.40
	AUDUSD	0.80	0.80	0.82	0.83	0.83	0.85	0.86
	USDCHF	0.96	0.95	0.95	0.94	0.94	0.96	0.96
	USDBRL	3.22	3.35	3.30	3.45	3.51	3.60	3.45
	USDMXN	18.6	19.2	19.4	18.8	18.6	18.3	17.9

That said, although bond yields will drift higher, they still won't represent a huge gravitational pull for investors to shift out of equities relative to historical norms. Neutral rates are likely much lower than they were in past cycles, capturing greater leverage (and therefore interest sensitivity) as well as a diminished appetite for capital spending in most major developed economies. It takes lower yields to get enough capital spending to absorb global savings these days.

But having made money in the past by betting the Fed will fall far short of its projected rate hikes, markets might be overdoing their skepticism this time. While tame inflation to start the year could have the doves holding sway in Q1, wage momentum for prime-age workers shows that the Phillips curve is still lurking in the background. PCE inflation should creep close enough to target to satisfy the hawks, and we added a third 25-bp hike to our call for this year due to the stimulus of tax cuts (Table 2).

Longer yields have started to move up, and it's not just the Fed, but Europe, that will drive that pressure. Why were Treasuries so flat until recently? Not because of a drop in US inflation expectations, or recession talk, neither of which was in evidence. Simply put, it's mostly because too many sovereign bonds have been sopped up by central banks. By late 2018, markets will be thinking about an ECB QE unwind ahead, sending US 10-year rates to near-3% levels.

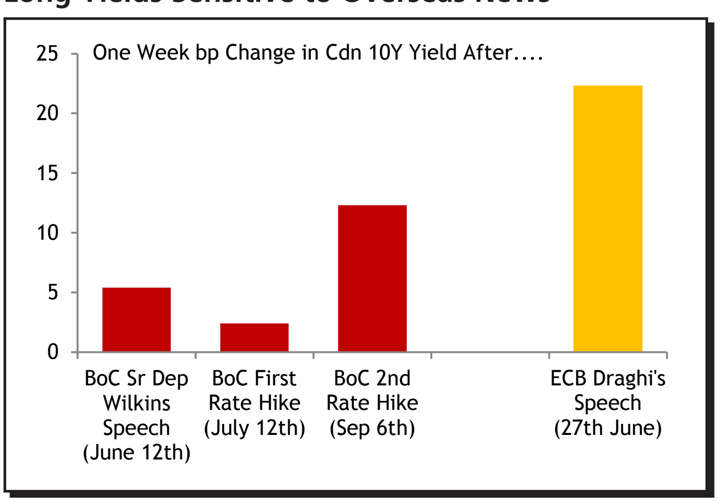
That sensitivity to overseas yields has meant that Canadian 10-year bonds have reacted more in the wake of European news than developments at home (Chart 2). Still, long rates might see less pressure than in the US, because markets appear to be overstating the scope for Canadian central bank hikes, and deficits won't be climbing.

Much of the required easing in growth will instead come from tighter mortgage rules, the drag of previous hikes on indebted households, and the uncertainties for business investment posed by a heightened war of words (and Commerce Department actions) on North American trade policy. If, as we expect, Trump triggers the first step in the NAFTA exit process before mid-year, that could be enough to have the Bank of Canada waiting until early summer before delivering a second (and final) hike for this year.

While skipping a few rate-setting dates won't create that big of a splash in the bond market, it will leave more than a ripple in the foreign exchange pond. A look at trade and capital flows show that the Canadian dollar has been pummeled with a heavy trade and current account deficit, and it's the flow of funds into Canadian debt, rather than real business investment, that has been the offset (Chart 3). Less attractive rate differentials, coupled with fears that the trade deficit could deteriorate further absent a NAFTA accord, could see the loonie sinking rather than swimming, with our forecast targeting a US75-cent valuation by mid-year.

Chart 2

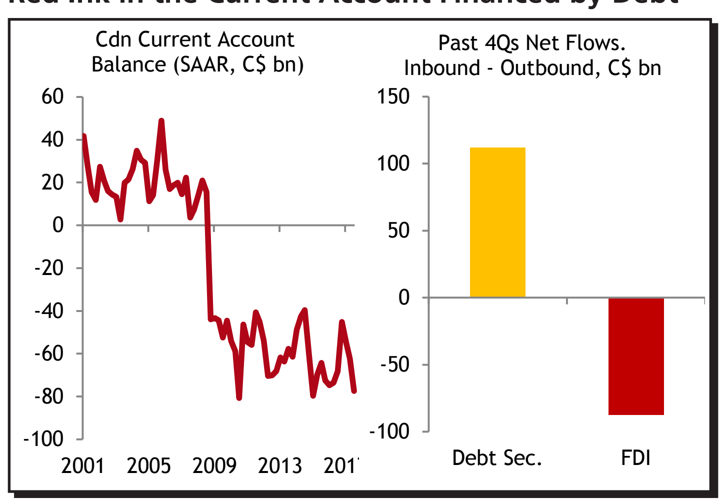
Long Yields Sensitive to Overseas News



Source: Bloomberg, CIBC

Chart 3

Red Ink in the Current Account Financed by Debt



Source: Statistics Canada, CIBC

US Economy: Party On, For Now

Royce Mendes

American households and businesses are on the verge of seeing a material reduction in tax bills, and that's cause for celebration. But, in terms of faster growth, the party can't last too long in an economy that will be closing in on the constraints of full employment.

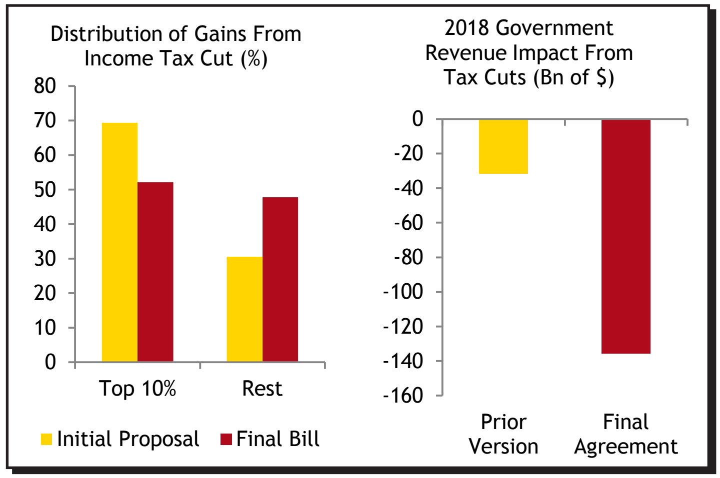
Raising a Glass and Our Forecasts

Relative to what the Senate first passed, the final legislation ended up more broad-based, and pulled forward additional stimulus into the current year (Chart 1), causing us to upgrade our 2018 growth forecast by three ticks to 2.5%.

A reduction in personal tax rates will leave many Americans with extra cash. Additionally, a reacceleration in payroll

Chart 1

Compared to Prior Versions, Tax Cuts More Evenly Distributed (L), And Occur Earlier (R)



Source: CFRB, JCT

Table 1

US FORECAST DETAIL

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

	17:4F	18:1F	18:2F	18:3F	18:4F	19:1F	2017F	2018F	2019F
GDP At Market Prices ($Bn)	19,796	20,014	20,209	20,460	20,703	20,887	19,403	20,347	21,172
% change	6.0	4.5	3.9	5.1	4.8	3.6	4.2	4.9	4.1
Real GDP ($2009 Bn)	17,299	17,377	17,481	17,594	17,689	17,753	17,101	17,535	17,863
% change	3.0	1.8	2.4	2.6	2.2	1.5	2.3	2.5	1.9
Final Sales	3.5	2.0	2.4	2.6	2.1	1.5	2.4	2.5	1.9
Personal Consumption	3.5	2.2	2.7	3.4	2.2	1.8	2.7	2.8	2.0
Total Govt. Expenditures	1.3	0.6	0.4	0.5	0.2	-0.3	0.0	0.6	-0.2
Residential Investment	8.0	3.0	3.5	3.3	2.8	1.2	1.4	2.3	2.1
Business Fixed Investment	5.7	6.9	8.4	10.1	8.5	2.7	4.6	7.2	5.6
Inventory Change ($2009 Bn)	21.9	16.7	17.1	15.9	19.9	19.6	16.9	17.4	16.7
Exports	2.8	2.7	3.1	3.2	2.8	2.3	3.1	2.8	2.7
Imports	3.5	6.8	7.7	10.4	6.9	2.6	3.3	5.5	4.4
GDP Deflator	2.9	2.6	1.5	2.4	2.6	2.1	1.8	2.3	2.1
CPI (yr/yr % chg)	2.1	2.0	2.2	2.2	2.1	2.2	2.1	2.1	2.4
Core CPI (yr/yr % chg)	1.8	1.8	2.2	2.3	2.3	2.2	1.8	2.2	2.4
Unemployment Rate (%)	4.1	4.1	4.0	3.9	3.8	3.8	4.4	3.9	3.7
Housing Starts (AR, K)	1,250	1,245	1,260	1,275	1,290	1,293	1,205	1,267	1,279

growth combined with a pick-up in average hourly earnings will only line consumers' pockets even further.

The boost to disposable incomes will be the driving force behind economic growth this year. It also means that another year of strong consumption readings won't rest on a further dip in the savings rate. There is less scope for that, after the savings rate fell to levels last seen just before the financial crisis.

Household spending, however, won't be the only game in town. The ability to immediately expense certain equipment expenditures, coupled with healthy demand growth, will see business capital spending register its strongest jump since early in the recovery. According to the Penn Wharton Budget Model, capital-intensive companies will see the greatest reductions in their effective tax rates, and are therefore likely to pull forward some spending.

To a greater extent than in the past, that will leak into income for foreigners supplying some of the investment funds, as well as to non-US equipment suppliers. In recent decades, the ratio of equipment imports to the total value of equipment investment has been increasing (Chart 2), indicating that a significant portion of those capital expenditures will be shipped in from abroad, offsetting some of the effects on GDP growth. Notably, the import content of equipment purchases has increased much faster than other parts of the economy.

Dollars, Deficits & Foreign Demand for Them

The pick-up in imports will cause the current account deficit to swell to its widest point since 2008. But don't take that as another nail in the US dollar's coffin. Much of the additional fiscal deficits and/or private investment will be financed by overseas investors chasing higher after-tax returns in the US, adding an extra layer of dollar demand. As a result, while our outlook still incorporates a depreciation against most major currencies, we've actually nudged our US dollar forecasts up a touch.

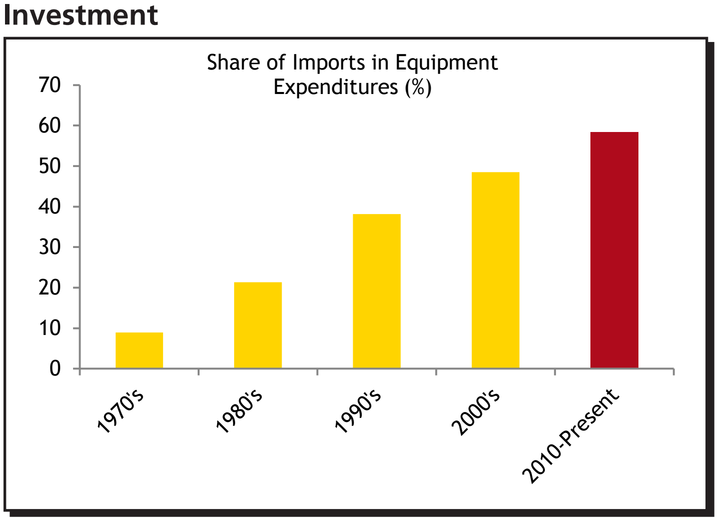
As growth accelerates in 2018, Fed policymakers aren't likely to stand by and watch. We've squeezed in a third rate hike into our projections on the back of our upgraded 2018 forecast. That's in contrast to the market which is only pricing in two full rate hikes for 2018.

We see Fed expectations getting a bump as inflation readings begin to heat up early in the year. The so-called 'transitory' effects of a major price decline in the wireless telecom sector weighed on inflation rates last year, but by the second quarter won't factor into the annual calculation (Chart 3).

More importantly, underlying momentum in inflation has actually been accelerating recently. Over the past six months, the annualized rate of core CPI has been running at 2.2%, providing some comfort to those on the Fed fearing that inflation is showing no progress towards the 2% PCE target.

Chart 2

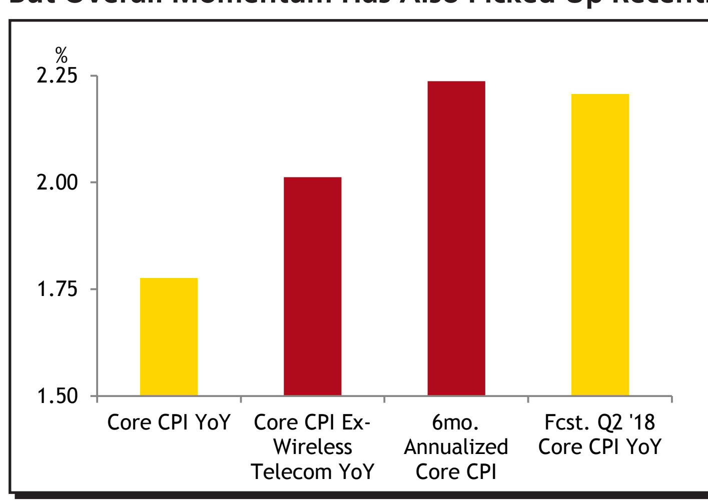
Imports Will Dull the Growth Impact from Capital Investment



Source: Haver Analytics, CIBC

Chart 3

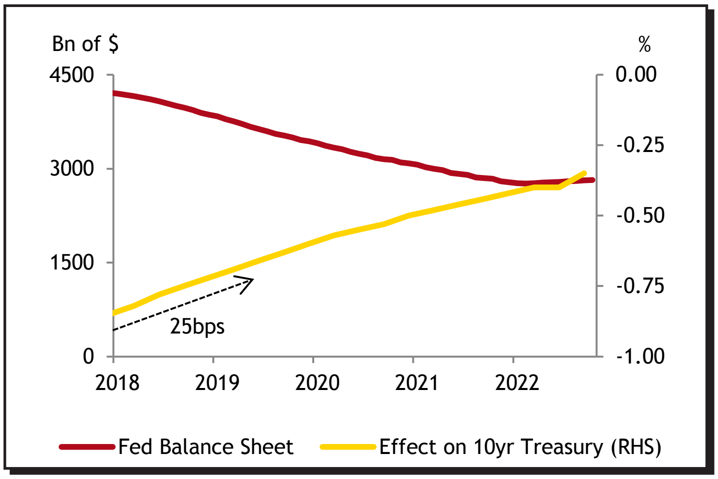
Core Inflation Hotter After Removing Transitory Drag, But Overall Momentum Has Also Picked Up Recently



Source: Haver Analytics, CIBC

Chart 4

Fed Balance Sheet Run-off Forecast to Add 25 bps to 10-Year Yield by End-2019



Source: FRB, CIBC

The combined effects of stronger price pressures, without the drag from large one-off factors, is indicative of a core PCE inflation rate which makes material headway towards its target in 2018. That said, progress after the second quarter will be slow in coming, and will end the year still a tad below 2%.

Turning Down the Volume in 2019

There are still further tax reductions set to kick in for 2019, but the merriment surrounding the economy will fade as the calendar turns. By that time the effects of higher interest rates and tight labour markets will act as a cap on growth.

By the end of next year, with a couple more rate hikes under its belt, the Fed will have both reached its neutral interest rate and shed $800bn of assets from its balance sheet (Chart 4). Policy tightening will be evident across the full yield curve. Fed model estimates suggest that the balance sheet run-off should increase the term premium on 10-year Treasuries by 25bps from today's levels, with a combination of additional debt issuance, stronger inflation, and foreign central bank tightening doing the rest of the work to see yields edge above 3% in 2019.

Look for capital spending to post strong growth relative to the weakness that prevailed for most of the recovery, but still decelerate from 2018 pace. Residential investment should also feel the pinch of reduced tax incentives for mortgage borrowers as well as higher fixed rates, with our forecast that 30-year Treasury yields top 3½% by the second half of 2019.

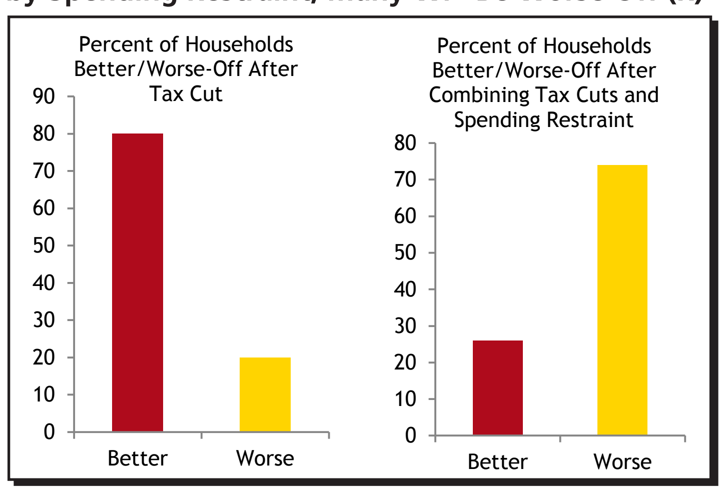
While tighter financial conditions will also provide a headwind to consumer spending, that won't be the only factor that many households will be contending with come 2019. As of this year, a large majority of Americans will benefit from the Tax Cuts and Jobs Act (Chart 5, left). That, however, is likely to change if Republicans can make good on promises to shrink government spending. Assuming the tax cut is fully financed and that each dollar of spending restraint is evenly distributed amongst individuals, researchers at the Tax Policy Center find that a large majority will actually be worse off (Chart 5, right), leaving material gains for only the wealthiest Americans.

Sure, lawmakers might not fully offset the tax cut, but then again restraint won't be evenly distributed, with the lowest income households—those with the highest propensity to consume—bearing the brunt of any slashes to program spending.

With the elbow room for non-inflationary growth being more limited by 2019, one way or another, we will be aiming at a slower growth trajectory than many investors are anticipating. Either fiscal restraint on the spending side will do part of that job, or we will face a somewhat more aggressive Fed next year. Without faster labour force growth, we're not likely to see the US economy trend at any better than 2% growth over the medium term.

Chart 5

Most Better Off After Tax Cut (L), But if Financed by Spending Restraint, Many Will Be Worse Off (R)



Source: Tax Policy Centre, CIBC

Canada: Back Down to Earth

Nick Exarhos and Avery Shenfeld

It reached for the stars in 2017, but the Canadian economy will be back down to earth in the coming year. Simply put, a tight labour market leaves no room for Canada to repeat as the G7 growth leader, not if inflation is to be kept sustainably at bay.

This is still a good news story. Our forecast calls for only a modest inflation uptrend, and we've lowered our projected track for the jobless rate (Table 1). The only question is the extent to which further rate hikes, or other factors, will prompt the necessary deceleration to a more trend-like 2.1% growth rate in 2018, en-route to an advance closer to 1½% in 2019.

We might need fewer rate hikes than now seems apparent to do that job. Business capital spending doesn't have as much scope for a further improvement after the rubber ball bounce the energy sector recorded from its 2015-16 trough. Spendthrift Canadian consumers have better jobs to support their habits, but they could feel a pinch from even modest interest rate settings given their swelled stock of debt. And then there's a war of words, and actions, on trade policy.

Risky Business for Capital Spending

We were confident Canada would see an acceleration last year, since after two years of slashed plans, business spending in the oil patch has nowhere else to go but up. Indeed, that swing, worth 1%-point of GDP, was much of the 2017 story. But looking at the long-term relationship between crude prices and capital expenditures (Chart 1, left) there's a smaller step up in store for 2018, particularly given the issues being faced on pipeline capacity and the resulting Canada-US pricing differentials.

Table 1

CANADA FORECAST DETAIL

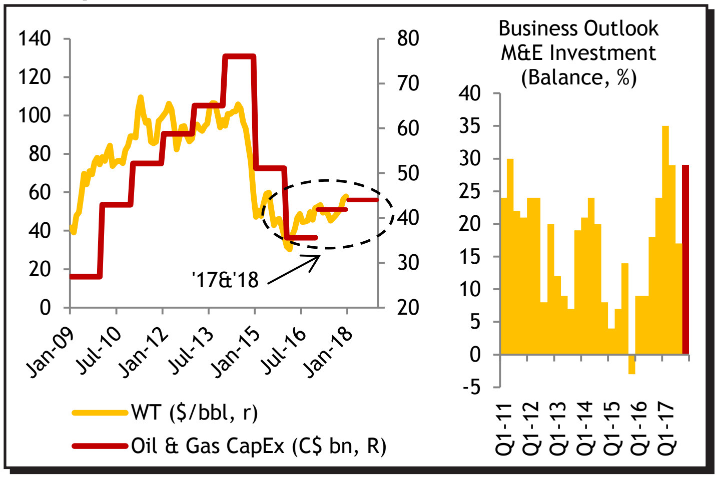
(real % change, s.a.a.r., unless otherwise noted)

	17:4F	18:1F	18:2F	18:3F	18:4F	19:1F	2017F	2018F	2019F
GDP At Market Prices ($Bn)	2,171	2,198	2,221	2,246	2,269	2,289	2,141	2,234	2,317
% change	5.1	5.0	4.3	4.6	4.2	3.5	5.2	4.3	3.7
Real GDP ($2007 Bn)	1,870	1,880	1,890	1,900	1,907	1,914	1,854	1,894	1,924
% change	2.0	2.3	2.0	2.1	1.5	1.5	2.9	2.1	1.6
Final Domestic Demand	3.9	1.9	1.6	1.3	1.3	1.3	3.0	2.5	1.2
Household Consumption	3.6	1.6	1.6	1.3	1.3	1.3	3.8	2.4	1.3
Total Govt. Expenditures	4.5	2.6	2.5	1.8	1.6	1.7	2.2	3.0	1.7
Residential Construction	4.0	2.5	-0.5	-1.5	-0.5	-3.0	2.8	0.6	-2.7
Business Fixed Investment*	4.5	2.3	1.3	1.7	2.2	3.1	1.4	2.9	2.6
Inventory Change ($2007 Bn)	4.4	6.1	5.3	5.5	5.5	5.1	11.0	5.6	5.1
Exports	5.7	2.2	4.0	5.0	3.0	3.9	1.0	2.2	3.7
Imports	2.9	2.3	2.3	2.3	2.3	2.9	3.3	2.4	2.5
GDP Deflator	3.2	2.7	2.3	2.4	2.6	2.0	2.2	2.1	2.1
CPI (yr/yr % chg)	1.8	1.8	2.0	2.4	2.4	2.4	1.6	2.1	2.1
Unemployment Rate (%)	5.9	5.7	5.7	5.7	5.6	5.6	6.3	5.7	5.6
Employment Change (K)	129	105	43	50	53	46	332	329	188
Goods Trade Balance (AR, $bn)	-13.7	-11.4	-8.2	-3.9	-1.2	0.2	-20.1	-6.2	5.1
Housing Starts (AR, K)	230	195	197	194	195	186	221	195	178

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

Chart 1

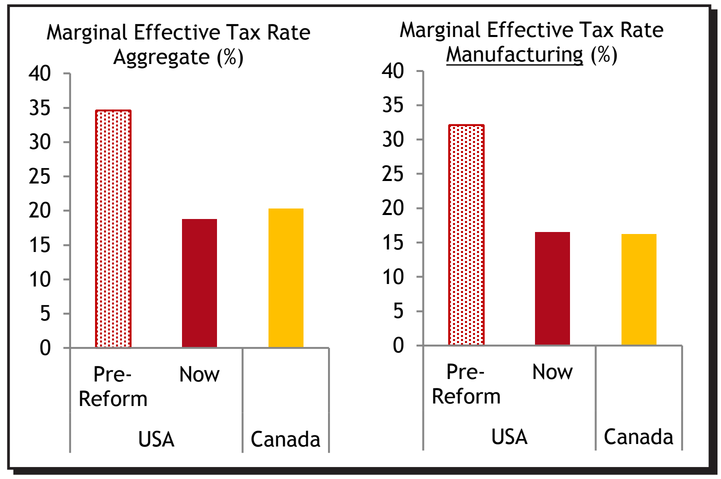
Oil & Gas: Only Modest Upsides for 2018 CapEx (L), Are Optimistic Plans Naïve On NAFTA Risks? (R)



Source: Statistics Canada, Bank of Canada, CIBC

Chart 2

US Reform Erases Canadian Tax Allure



Source: Philip Bazel, Jack Mintz and Austin Thompson, CIBC

Of course, there's also business investment spending in the other 90% or so of the Canadian economy, particularly in the capital-intensive export sector. On the surface, there's reason for hope after so many lacklustre years. Capacity use is hitting typical peak levels, so there's a need for additional space and equipment. Although small business confidence has dipped, the large companies covered in the Bank of Canada's Business Outlook Survey suggested that they are planning to spend more on machinery and equipment this coming year (Chart 1, right).

We're not as sure, however, that these companies, many of which already have operations abroad, will indeed choose Canada for that additional capacity. For one, the noise on NAFTA is about to get greater, with the US likely to at least trigger an official countdown for an exit from the deal. Moreover, the Trump administration has accelerated the launch of trade actions against Canada and other partners, imposing sizeable duties, while Canada has fired back with a broad WTO complaint. When siting a facility to serve the American market, will business see a reason to lean to the US? Indeed, firms responding to the Bank of Canada's Outlook survey are reporting such concerns.

Other policy gaps are making Canada look less attractive. Not to debate their merits, but steep hikes in minimum wages and tougher environmental policies than your key trading partner can play into location decisions. Changes to the US tax code, reducing both the statutory Federal rate and allowing for the immediate expensing of capital expenditures, have erased the earlier tax advantage Canada had in attracting fresh investment dollars (Chart 2).

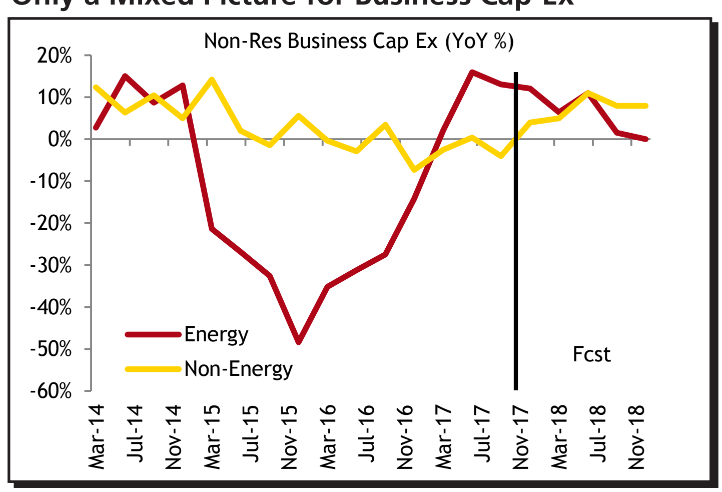
A weaker exchange rate can provide an offset to these competitive shifts, but we'll need a softer hand on interest rate hikes at the Bank of Canada relative to the Fed to make that happen. If, as we expect, the Fed hikes three times this year, that could constrain the BoC to only two hikes. But even then, it takes time for businesses to see a new exchange rate as the new normal. As a result, look for only a modest turn higher in non-energy capital spending to offset what will be a slowing track for oil & gas cap-ex (Chart 3).

Consumers Pinched by Poloz

The Bank of Canada felt confident enough to raise rates in the face of looming NAFTA risks because it was because the labour market tacked on what were remarkable

Chart 3

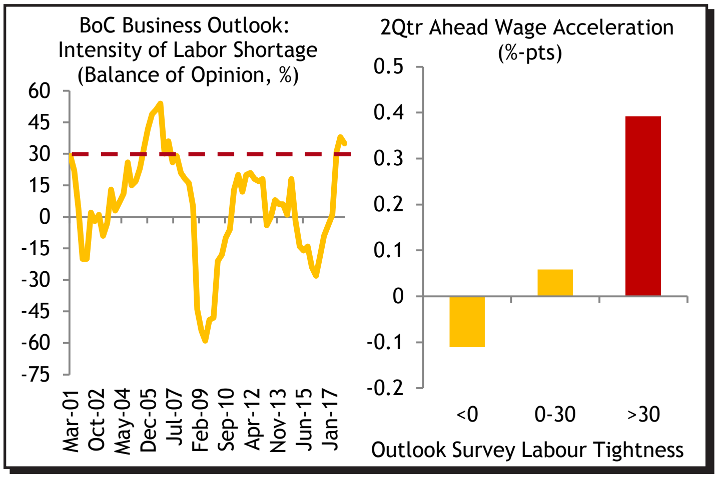
Only a Mixed Picture for Business Cap-Ex



Source: Statistics Canada, CIBC

Chart 4

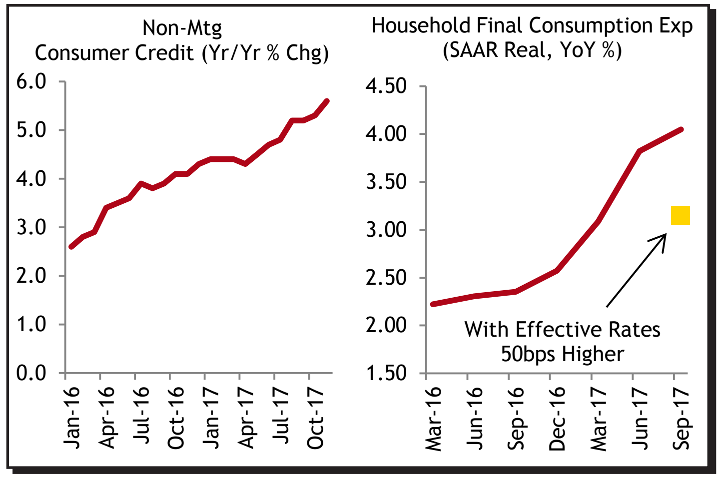
Many Businesses Reporting Labour Shortages (L), A Positive Sign for Wages (R)



Source: Bank of Canada, Statistics Canada, CIBC

Chart 5

Consumers Ramped Up Non-Mortgage Credit (L), Interest Rate Hikes Have Teeth to Slow Spending (R)



Source:Bank of Canada, Statistics Canada, CIBC

gains as we closed out the year. And despite what is beginning to be a quite tight labour market—with the unemployment rate hitting all-time lows in December 2017—there are still signs that many firms are planning on accelerating hiring.

Fortunately for workers, labour market constraints are likely to translate demand for workers into higher paycheques, with an acceleration in wages to around 3% or so, roughly offsetting what will a be a cooling from 2017's 2% track to employment growth. Indeed, the ratio of firms reporting to be facing labour shortages is at stretched levels—those that typically bring with them a meaningful acceleration in wage growth (Chart 4).

While that might only mean a few additional decimal places for pay gains, Canadians will need every bit of it. Even with a strong jobs market, last year's spending still was fueled by even more debt, in this case showing up in an acceleration in non-mortgage credit (Chart 5, left). That helped retailers chalk up a 7% gain in sales in 2017, the backbone of what was a pleasant surprise for consumption overall.

Now households are left with the hangover of those larger credit balances, and a higher interest charge on everything that rolls over into new rates. While rates are rising gently, their impact on consumption won't be as gentle given outstanding debt burdens. If households had to make room to pay the 50 bps in higher rates that we see for the coming year, 2017 real total consumption growth would have been a full percentage point slower than what we observed (Chart 5, right).

The Other Policy Lever

Unlike the US, Canada doesn't have a nation-wide tax cut kicking in for 2017. BC and Québec saw some room to ease up on budget surpluses, but two other large provinces, Ontario and Alberta, are at this point still leaning towards reducing deficits. On the spending side, real government outlays essentially only matched the economy's overall pace.

But the third quarter saw a notable pick-up in government infrastructure activity, perhaps the start of the long delayed spending echo from all the verbal cheering about infrastructure in the 2016 federal budget. It won't match the US tax stimulus in scale, but we've built in a firmer pace for government spending in 2018 assuming projects will be ramping up.

While we still have a national infrastructure deficit to catch up with, the timing no longer suits from a Keynesian stimulus perspective, with many provinces at full employment. It might pay to save more of those rainy day projects for a future rainy day, when the economy is more in need of fresh hiring.

Global Growth: A Struggle to Live Up to The Hype

Andrew Grantham

We saw a golden global growth performance in 2017, one that easily beat expectations set out at the start of the year. This year the bar is higher, with investors expecting an Oscar-winning performance. That may be too much hype for the economy to live up to, and even though our forecasts are far from pessimistic, the steady deceleration we anticipate in 2018/19 would be a disappointment relative to overblown expectations (Table).

Consensus forecasts for 2018 have risen in lock-step with upgrades made to 2017 (Chart 1, left), while further upward moves in global PMI readings have also added to the general buoyancy (Chart 1, right). However, we've seen plenty of instances in recent years of actual growth readings disappointing relative to what such qualitative surveys suggested. That could already be underway. While growth in a number of key indicators such as industrial production and retail sales remained solid in the back half of 2017, we've clearly moved away from the peaks witnessed earlier in the year (Chart 2).

Even Better than Advertised

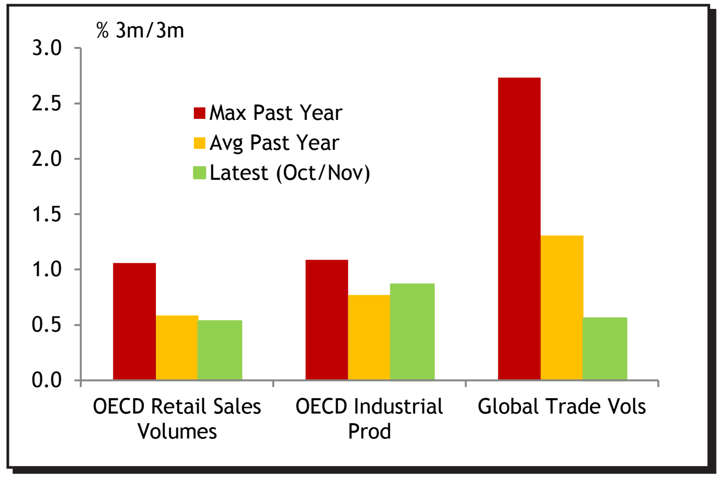
What was already a strong year for official data on global growth in 2017 might have been even stronger if Chinese growth were accurately captured. Two years removed from questioning whether China was actually growing as quickly as Beijing data suggested in 2015, it seems strange to be asking the opposite question. Was the Chinese economy growing even faster than official data had us believe in 2017?

We've shown before that our composite indicator of Chinese growth, which includes factors such as electricity use and freight volumes, had been hitting levels previously consistent with 8-9% GDP growth, not 6.5-7%.

But another way of judging the "real" growth rate in China is to look at how some of its neighbouring trading partners have been faring. Taking a weighted average of

Chart 2

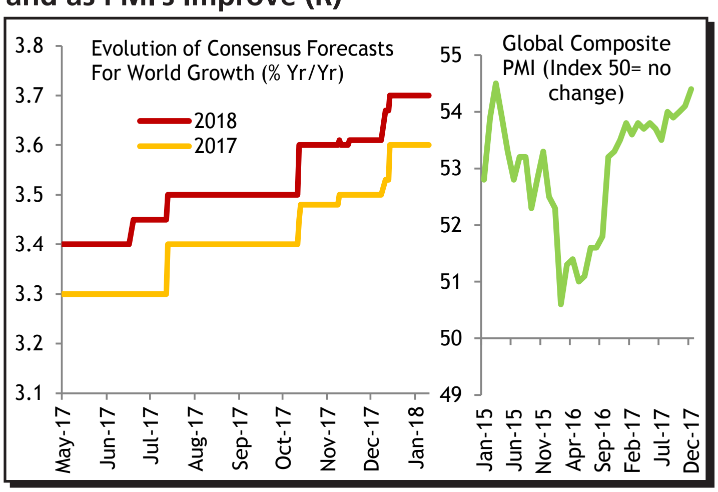
Some Key Indicators Already Off Recent Highs



Source: OECD, CPB, CIBC

Chart 1

2018 Expectations Upgraded in Step With 2017 (L) and as PMI's Improve (R)



Source: Bloomberg, Markit, CIBC

Table 1

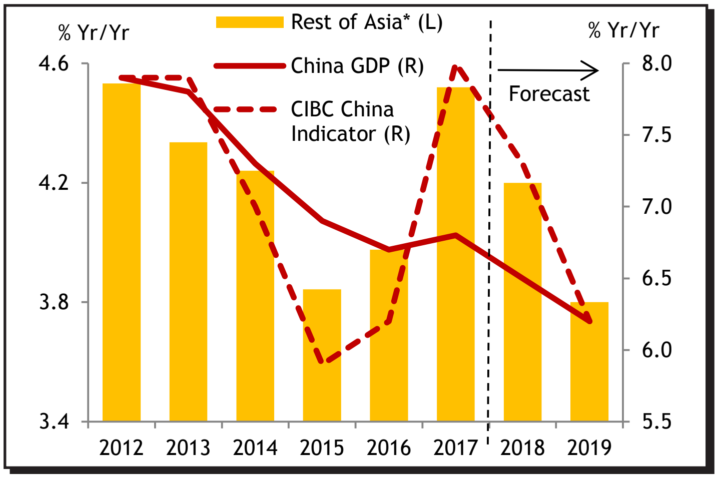
Real Global Growth Rates

	5 yrs before recession, avg	2015A	2016A	2017F	2018F	2019F
World*	4.8	3.4	3.2	3.6	3.3	3.1
US	2.9	2.9	1.5	2.3	2.5	1.9
Canada	2.6	1.0	1.4	2.9	2.1	1.6
Euroland	2.2	2.0	1.8	2.4	2.0	1.5
UK	3.3	2.3	1.8	1.5	1.4	1.3
Japan	1.8	1.4	0.9	1.8	1.3	0.8
China	11.6	6.9	6.7	6.8	6.4	6.2

** at Purchasing Power Parity*

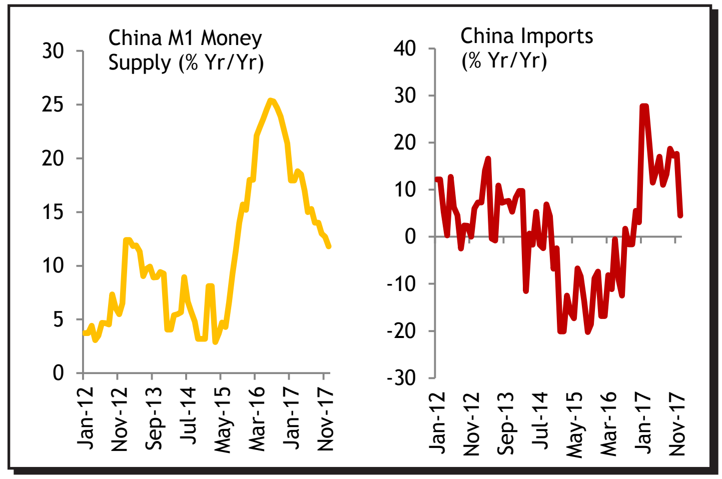
Source: National statistical agencies, IMF, CIBC

Chart 3
China's Neighbours' Growth Hints at Stronger Chinese Economy



Source: National Statistics Agencies, Bloomberg, CIBC

Chart 4
Money Supply Growth is Slowing (L), And Imports Hint at Slower Domestic Demand (R)



Source: Bloomberg, CIBC

growth in eight close trading partners within the region, it's clear that those countries experienced a sluggish period during 2015-16 and then a sharp acceleration last year (Chart 3). That acceleration itself, despite the relatively low weight of those countries in the global economy, added 0.1%-pts to the overall pick-up in world GDP. Add in the stronger growth for China that it hints at, and it's little wonder that 2017 was such a good one for globally sensitive assets.

That doesn't mean we're set for a further acceleration in 2018. Chinese authorities, likely knowing that the economy has been running on the hot side, are already taking steps to cool things down. Loan growth has slowed, bond yields have risen and the rate of increase in the money supply has abated (Chart 4, left). And if recent import data are any indication, that may now be showing up in slower domestic demand growth (Chart 4, right). While we still see China growing in the 6-6½% range in each of the next two years, that would feel like a fairly significant deceleration compared to 2017 if last year was understated.

ECB Preparing to Test the Breaks

The Eurozone will join in the effort to cool growth by the end of this year. After Canada, the Eurozone was the biggest surprise of 2017. With growth in the region of 2½%, it was around ¾% above expectations at the start of the year. And given the momentum we saw towards the end of 2017, we've also raised our expectation for growth in 2018 to 2%. That may not seem particularly strong, but given poor demographic trends in Europe that would still be at least 1%-pt above potential and enough for the unemployment rate to keep falling.

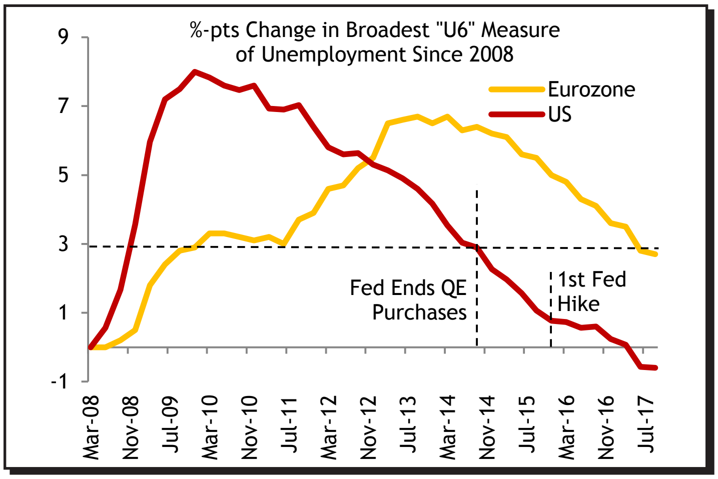
It would also be enough to see further reductions in stimulus from the ECB, driving a more material slowdown in growth come 2019. Having already halved the pace of its asset purchases, bond-buying is likely to come to an end in September. Then the question shifts to whether rate hikes will come "well past" the end of asset purchases as the ECB now asserts, and what that phrase actually means. We've already seen hints from ECB members that the committee is thinking about tweaking such language.

Bringing forward the start of policy tightening could also be justified by comparing the Eurozone experience to that of the US. Similar to the US, the Eurozone saw its widest "U6" measure of unemployment (which also includes marginally attached and involuntary part-timers) climb by some 7%-pts before peaking. Now it is less than 3%-pts higher than it was before the financial crisis—a point by which the US had already ended its QE program (Chart 5). If the ECB is late in ending QE relative to the Fed's track, the gap between the end of asset purchases in Europe (presumably September) and the first rate hike shouldn't be as long as that seen stateside.

The trend of monetary policy becoming slightly less accommodative will also be seen in Japan, contributing to the deceleration in growth expected there. If anything, with less slack in the economy than the Eurozone, a deceleration in Japan could come sooner.

Chart 5

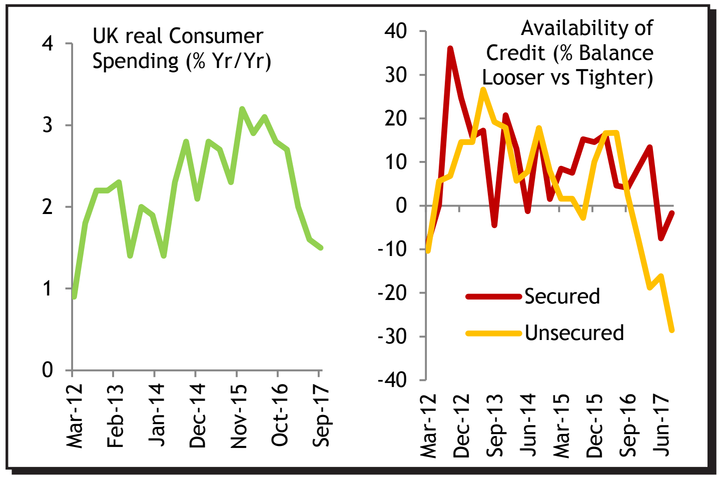
Is the ECB Already Behind the Fed's Policy Tightening Path?



Source: BLS, ECB, CIBC

Chart 6

UK Consumer Spending Slowing (L), And Credit Conditions Will Get Tighter (R)



Source: ONS. BoE, CIBC

UK: Don't Forget About Brexit

The central bankers won't take all of the blame for the slower growth that's already visible in the UK. While performing much better than had been expected in the immediate aftermath of the Brexit vote, much of the growth was driven by debt-fueled consumer spending sparked by the Bank of England's response in loosening policy. However, that response also contributed to the sharp depreciation in sterling and the resulting run-up in imported goods prices.

That's now starting to weigh on real consumer spending (Chart 6, left) just as the Bank of England is beginning to withdraw stimulus and banks are reporting tightening credit standards (Chart 6, right). All of that bodes poorly for the UK economy going forwards, particularly with some business investment likely to be delayed by continued uncertainty regarding just what the final Brexit deal will look like.

Our forecasts for global growth in 2018 and 2019 are far from pessimistic. Indeed, barring an upside surprise in productivity, they are about as good as it can get given that we are at a stage in the economic cycle where fewer large countries have significant slack. However, given the hype heading into the year, even a modest slowdown would be considered a disappointment. That would have implications for how high bond yields rise, and how much more steam there is in the equity market, particularly in global cyclical stocks. It's also a primary reason why we're expecting a pull-back in some key commodity prices from current levels.