Economics
FORECAST

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Wait until next year

by **Avery Shenfeld** avery.shenfeld@cibc.com

It's not just the catchphrase for fans of my hometown Toronto Maple Leafs; "wait until next year" is the message for investors and central bankers that have been looking for signs that higher interest rates are going to bring inflation back to target. Yes, price increases have decelerated sharply, but as we anticipated a year ago, that reflects the fact that so much of the earlier spike wasn't attributable to overheated demand. Improvements in supply chains, and slowdowns in China and Europe (see Table 3), are helping to cool global price pressures, as captured in less heated markets for most commodities, shipping costs, and goods prices.

But in the US and Canada, some of the elements that were domestic-demand driven, including brisk wage gains that drive costs and purchasing power, are still inconsistent with a 2% inflation pace. A cure is on the way, however, and further rate hikes would now be overdoing it. Waiting until next year to see the full impacts of prior hikes would be the right call.

Getting all the way to the inflation target, or even close enough to count in horseshoes, will still require some additional labour market slack to cool purchasing power. The surprise in 2023 was that it took a bit longer to get the ball rolling that way, but we're seeing more evidence of labour market normalization each month.

In the US, the spring and early summer have seen the consumer hanging in there for longer, helping to sustain growth. After successive upward revisions, we see real GDP growth for 2023 as a whole at 2.0%, well above the sub-1% pace we expected back in January. That has kept the Fed on the tightening warpath, taking the ceiling on the funds rate to 5.5%, higher than we had thought would be necessary (see Table 5 and pages 5-7).

Still, cracks are emerging, and the US growth trend might not be as rosy as it seems. Real gross domestic income, an alternative growth measure that should equal real GDP, shows the economy having seen a small decline in the first half. A weakening in corporate profits signals a hiring slump ahead, and the cushion of financial assets that earlier fueled consumption has been largely depleted if measured in real terms. The unemployment rate has barely budged, but job vacancies are steadily dropping, leaving employers less desperate to boost wages to staff up, even as others are still paying catch-up increases in unionized sectors.

After starting the year on a decent footing, Canada's more interest-sensitive economy has seen more definitive signposts of a deceleration, one sufficient to push the jobless rate up a half percent since the first quarter. Labour force growth from immigration, and at least some recovery in productivity as supply chains heal further, could continue to push the unemployment rate higher while just skirting an outright recession (see Table 1 and pages 8-10).

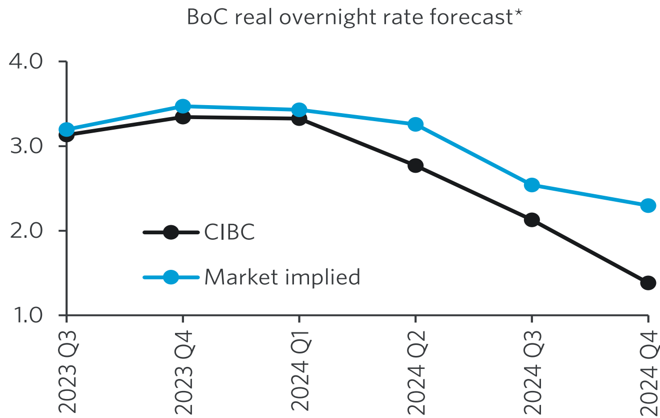
Starry starry night

As the slowdown takes hold, markets will be looking to the stars for answers on when and how far interest rates will retreat. The so called "u-star," the unemployment rate which is neither inflationary or deflationary, is the best guide to "when". We recently estimated Canada's u-star jobless rate to be 5.7%, and look to the Bank of Canada to begin easing policy after a couple of quarters spent above that benchmark, a necessary bit of pain to cool wage inflation. That points to early Q2 2024 for the first rate cut, and a similar exercise suggests that the Fed might be only a month or two later.

Markets have their telescopes more focused on "r star", the real rate of interest (nominal rates less expected inflation) that's neither stimulative nor a headwind to growth. In theory, r* is a guide to where rates are ultimately headed once inflation is on target and the economy no longer needs to be held back.

But for now, r* will not be your Polaris, in terms of navigating the path for policy rates. First, because r* varies too much over the decades, and is best estimated after the economy shows its response to rates that are close to where neutral lies. That

Chart 1: Markets pricing in high real rates through 2024



*Overnight rate minus CIBC forecast for CPI inflation in subsequent 12 months.
Source: Bloomberg, CIBC

has estimates of r* currently looking widely divergent. Second, at least for 2024, if we achieve a soft landing, we're unlikely to get all the way to wherever r* might sit, as economic slack won't require that dramatic a turn in real interest rates.

But we're not totally lost in the wilderness in terms of projecting a likely path for next year's easing, or for where rates are headed longer term. For one, with inflation set to fall, real rates of interest would be climbing in the absence of sufficient rate cuts. The future market's current pricing for Canadian overnight rates looks a bit too hawkish if our forecast for inflation is on the mark, as it would leave real interest rates very high over most of the coming year (Chart 1). That would pose a material risk to Canada's economy in 2025, as households start to renew five-year mortgage rates taken out at the lows of interest rates in 2020.

A faster-than-expected easing process underscores our forecast for lower bond yields in 2024 (Table 4). It also should see the Canadian dollar benefit less from a general weakening in the US dollar as the Fed runs ahead of overseas central banks in paring rates next year.

Further out, the biggest constraint on the bond market's room to rally is less about whether the nominal neutral rate is 2.5% or 3%, but where policy rates average in the coming cycle relative to neutral. Bond yields in both the US and Canada were so low in the prior decade because central banks benefited from ultra-low inflation in global core goods prices. To offset that with services inflation and get close to the 2% target, they needed to hold rates below neutral year after year. A more normal cycle, one less impacted by globalization's downward pressure on goods inflation, would see short rates averaging closer to neutral, perhaps in the mid-2% range, which could have 10-year rates sitting closer to 3% on average. Should fiscal policy stay as loose as it has been, that would be a further barrier to as easy a monetary stance as prevailed in the prior cycle.

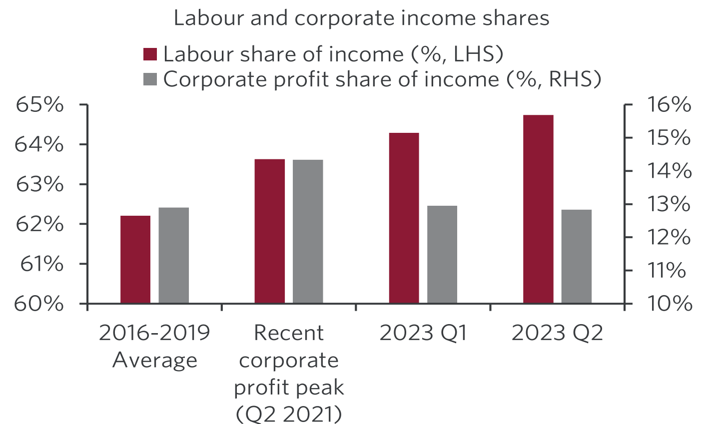
Will stocks wait until next year?

Equity markets got off to a strong start in January, but have largely moved sideways since then, particularly in a lagging Canadian market, but also in much of the US market other than a few tech darlings. Here too investors may end up waiting until next year, as two headwinds stand in the way of a material rally just yet. The rates story should look better in 2024, but for now, stocks face a lot of competition from high yielding short-term deposits, while peaking 10-year bond yields are imposing a higher discount factor on future earnings.

The other headwind is operating on those future earnings, posing a threat of downward revisions to 2024 expectations that we'll need to get through in the next couple of quarters. Corporate pricing power is cooling faster than wages, as workers play catch-up and benefit from what is still a tight labour market. Financial institutions have also seen profits soften. The result is that the profit share of US national income is being squeezed out by a climbing labour share (Chart 2). While wage growth should moderate in the coming year, for now, profits will be growing more slowly than revenues. The latter will also be cooling on the combination of a deceleration in both volumes and prices, each of which are impacted by a slowdown in nominal GDP growth.

That said, investors who wait for next year should be rewarded, as both bonds and equities should see better returns once the Fed and the Bank of Canada are in an easing stance. Indeed, a turn of fortune in the bond market could come even earlier if, as we expect, a slowing North American economy in Q4 starts to bring long yields down. Reduced pressures from wage gains as labour market slack opens up, as well as lower interest costs, should allow earnings per share growth to pick up later in 2024. Unlike sports fans, who are often disappointed when the team that failed to deliver in the prior year does so again in the current season, this waiting game should have a payoff.

Chart 2: US profits squeezed by rising labour share



Source: BEA, CIBC

Table 1: Canadian forecast summary (% change except where noted)

Variable	2022A	2023F	2024F	2025F
GDP at market prices	10.9	2.0	2.8	4.3
GDP in $2012	3.4	1.2	0.7	2.1
Consumer price index	6.8	3.9	2.3	1.9
Unemployment rate	5.3	5.4	6.1	5.6
Current account balance (C$ Bn)	-9.1	-24.7	-36.1	-33.7
Pre-tax profits (net operating surplus)	8.4	-22.5	3.4	4.9
Housing starts (K)	263	240	240	260

Table 2: United States forecast summary (% change except where noted)

Variable	2022A	2023F	2024F	2025F
GDP at market prices	9.2	5.8	3.0	3.7
GDP in $2012	2.1	2.0	0.8	1.6
Consumer price index	8.0	4.0	2.4	2.1
Unemployment rate	3.6	3.7	4.2	4.1
Current account balance (US$ Bn)	-968	-810	-834	-836
Pre-tax profits (with IVA/CCA)	7.3	2.2	2.4	3.9
Housing starts (K)	1,551	1,434	1,485	1,581

Table 3: Real GDP growth rates

Region	2019A	2020A	2021A	2022A	2023F	2024F	2025F
World[1]	2.8	-2.8	6.3	3.5	2.6	2.3	2.8
US	2.3	-2.8	5.9	2.1	2.0	0.8	1.6
Canada	1.9	-5.1	5.0	3.4	1.2	0.7	2.1
Eurozone	1.6	-6.3	5.6	3.4	0.5	0.2	1.0
UK	1.6	-11.0	8.5	4.3	0.4	0.1	1.2
Australia	1.9	-1.8	5.2	3.7	1.8	1.0	1.8
Japan	-0.4	-4.3	2.3	1.0	1.9	1.0	1.2
China	6.0	2.2	8.4	3.0	4.8	4.2	4.4

[1] At purchasing power parity.

Table 4: Canadian interest rates (end of period)

Variable	2023 Sep 12	2023 Dec	2024 Mar	2024 Jun	2024 Sep	2024 Dec	2025 Jun	2025 Dec
Overnight target rate	5.00	5.00	5.00	4.50	4.00	3.50	3.00	2.50
98-Day Treasury Bills	5.08	5.05	5.05	4.25	3.90	3.35	2.85	2.45
2-Year Government Bond	4.68	4.60	4.40	3.80	3.30	2.75	2.70	2.60
10-Year Government Bond	3.69	3.50	3.35	3.20	3.05	2.90	2.90	2.95
30-Year Government Bond	3.51	3.40	3.30	3.20	3.10	3.00	3.00	3.05
Canada - US T-Bill Spread	-0.37	-0.35	-0.25	-0.70	-0.50	-0.55	-0.55	-0.30
Canada - US 10-Year Bond Spread	-0.59	-0.50	-0.45	-0.40	-0.35	-0.30	-0.25	-0.30
Canada Yield Curve (10-year — 2-year)	-0.98	-1.10	-1.05	-0.60	-0.25	0.15	0.20	0.35

Table 5: US Interest rates (end of period)

Variable	2023 Sep 12	2023 Dec	2024 Mar	2024 Jun	2024 Sep	2024 Dec	2025 Jun	2025 Dec
Federal funds rate (midpoint)	5.375	5.375	5.375	5.125	4.625	4.125	3.625	2.875
91-Day Treasury Bills	5.44	5.40	5.30	4.95	4.40	3.90	3.40	2.75
2-Year Government Note	4.99	4.75	4.60	4.20	3.70	3.10	2.90	2.95
10-Year Government Note	4.28	4.00	3.80	3.60	3.40	3.20	3.15	3.25
30-Year Government Bond	4.37	4.15	4.00	3.90	3.70	3.50	3.45	3.55
US Yield curve (10-year — 2-year)	-0.70	-0.75	-0.80	-0.60	-0.30	0.10	0.25	0.30

Table 6: Foreign exchange rates

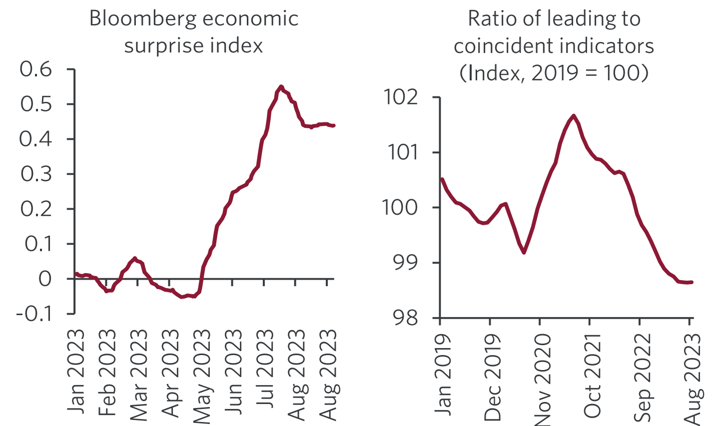
Exchange rate	2023 Sep 12	2023 Dec	2024 Mar	2024 Jun	2024 Sep	2024 Dec	2025 Jun	2025 Dec
CAD-USD	0.74	0.72	0.73	0.75	0.75	0.76	0.77	0.78
USD-CAD	1.36	1.39	1.37	1.34	1.33	1.31	1.30	1.29
USD-JPY	147	144	140	135	125	120	120	118
EUR-USD	1.07	1.05	1.06	1.10	1.13	1.15	1.15	1.16
GBP-USD	1.25	1.22	1.23	1.26	1.30	1.32	1.33	1.34
AUD-USD	0.64	0.63	0.63	0.65	0.66	0.68	0.70	0.72
USD-CNY	7.29	7.45	7.38	7.35	7.30	7.25	7.20	7.10
USD-BRL	4.93	5.20	5.20	5.20	5.40	5.00	5.20	5.40
USD-MXN	17.31	18.00	18.50	19.00	19.20	19.00	18.8	18.5

US Outlook: No buffer

by **Benjamin Tal** benjamin.tal@cibc.com and **Ali Jaffery** ali.jaffery@cibc.com

With every day that passes, the US economy is getting more exposed to the bites of tightening monetary conditions. The buffers that so effectively shielded the economy in the past are deflating rapidly. While growth in Q3 will accelerate, it won't last (Table 1). We expect growth to turn negative in Q4 of this year and to remain below 1% in 2024 as the buffers fade. The unemployment rate will come within ear-shot of 4.5% in late 2024 and inflation should decelerate. Aiming for a soft landing, the Fed should start with rate cuts in mid-2024.

Chart 1: Surprises turn negative (l), with signs of slowing ahead (r)



Source: Bloomberg, Bureau of Labor Statistics, Federal Reserve, University of Michigan, Census Bureau, Standard & Poor's, CIBC

GDP vs GDI

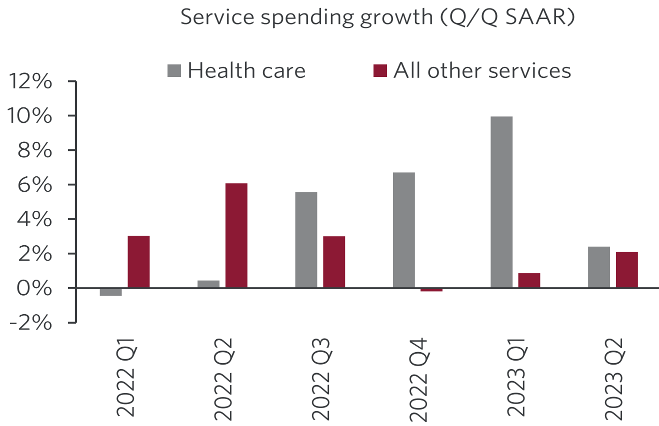
First half GDP growth averaged close to 2% on an annual basis, not bad...that is if you believe the numbers. Gross Domestic Income (GDI) an alternative measure of economic growth (that theoretically should equal GDP) was in fact negative in the first quarter and grew by only 0.5% in the second. The average of the two measures points to an economy that expanded by an annual rate of only 0.7% in the first half of the year.

Whatever the real number is, it will get worse in the coming quarters. The Bloomberg surprise index, which until recently was trending upward, has lost considerable momentum in recent months (Chart 1 left). And this is the here and now. More

Table 1: US Forecast detail (real % change, s.a.a.r., unless otherwise noted)

Indicator	23 Q2A	23 Q3F	23 Q4F	24 Q1F	24 Q2F	24 Q3F	24 Q4F	2023F	2024F	2025F
GDP at market prices ($Bn)	26,799	27,141	27,258	27,461	27,661	27,842	28,047	26,932	27,753	28,776
% change	4.1	5.2	1.7	3.0	2.9	2.6	3.0	5.8	3.0	3.7
Real GDP ($2012 Bn)	20,387	20,513	20,484	20,526	20,563	20,580	20,619.1	20,417	20,572	20,904
% change	2.1	2.5	-0.6	0.8	0.7	0.3	0.8	2.0	0.8	1.6
Final sales	2.2	2.1	-0.5	0.8	0.7	0.3	0.7	2.5	0.7	1.6
Personal consumption	1.7	2.9	-0.6	1.1	0.7	0.1	0.6	2.3	0.8	1.3
Total government expenditures	3.3	2.0	0.6	0.7	0.8	0.8	0.5	3.2	1.0	0.6
Residential investment	-3.6	7.6	0.7	0.4	1.5	2.3	3.1	-11.0	1.7	3.5
Business fixed investment	6.2	-0.1	0.2	-0.5	0.2	-0.1	1.5	2.8	0.4	2.9
Inventory change ($2012 Bn)	-1.8	20.1	15.1	15.6	18.0	21.0	22.9	9.2	19.4	18.1
Exports	-10.6	-1.3	0.4	1.2	1.4	1.0	1.4	1.4	0.0	3.3
Imports	-7.0	2.0	1.2	1.0	1.2	0.8	1.4	-2.4	0.7	1.8
GDP Deflator	2.0	2.6	2.3	2.2	2.2	2.3	2.2	3.7	2.3	2.0
CPI (yr/yr % chg)	4.0	3.3	3.1	2.8	2.4	2.3	2.0	4.0	2.4	2.1
Core CPI (yr/yr % chg)	5.2	4.3	3.8	3.1	2.5	2.4	2.1	4.7	2.5	2.1
Unemployment rate (%)	3.6	3.9	3.9	4.0	4.1	4.3	4.4	3.7	4.2	4.1
Housing starts (AR, K)	1,443	1,453	1,454	1,460	1,480	1,490	1,510	1434	1485	1581

Chart 2: Healthy growth



Source: Bureau of Economic Analysis, CIBC

importantly, the ratio of the leading indicators index to the coincident index is falling like a stone to levels not seen since the great recession (Chart 1 right). What's more, the San Francisco Fed's new and improved financial conditions index is now at a level consistent with the largest upcoming drag on growth since the financial crisis.

The consumer will chill

A big chunk of that upcoming slowing will come from the consumer. The recent strength of consumer spending was not exactly broadly-based, with healthcare accounting for almost half of the growth since late 2022 (Chart 2). The strong job gains in recent quarters were tied to an increased access to employer-linked healthcare benefits, allowing a "catch-up" on missed appointments. That process is diminishing and will exhaust itself by the end of the year.

Excluding health spending, consumption growth has been modest at best and will get even weaker. Excess savings have been shielding the consumer for a while but at the current rate of decline, that important buffer will be deflated by the end of the year – exactly when no less than 40.5 million people will have to resume payments on their student debts (as per the debt ceiling agreement). Their squeeze on spending power will mean an estimated drag on GDP growth of 0.2 to 0.5%-points next year.

And that's in addition to an already rising consumer debt service burden. While households are not as rate-sensitive as they were in the carefree years heading into the Financial Crisis (chart 3 left), you really don't want to use that level as a benchmark. In fact, current rate sensitivity is 15% higher than it was in 1990s and 1980s. And that sensitivity has been on the rise lately due to rapid debt accumulation during COVID (chart 3 right).

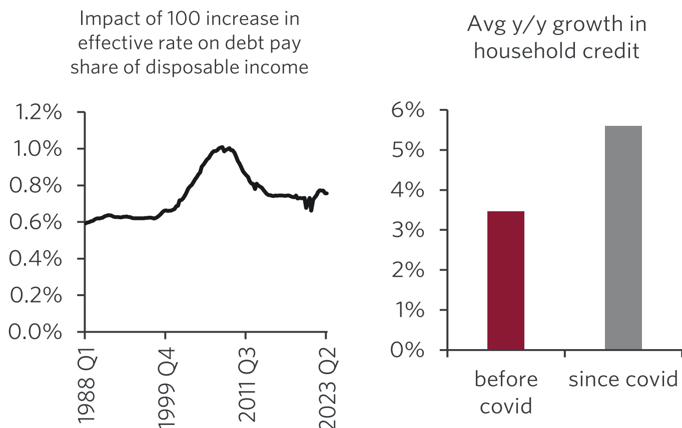
Fiscal cushion

Fiscal policy has also been another buffer of support for the economy in 2023. The Congressional Budget Office (CBO) recently revised its deficit projections for FY2023 and now expects about an extra half trillion dollars of spending to be flowing through the economy. That has likely already ended up as additional income and spending power and has played a role in the solid consumption and investment readings so far. While this fiscal cushion won't go away based on the CBO's past projections, it will not act as an additional stimulus in 2024 and 2025.

The labor market tells all

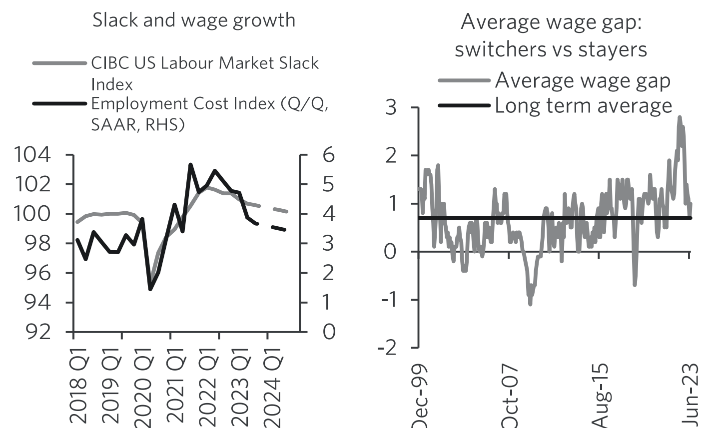
With the drastic improvement in supply chain conditions putting notable downward pressure on goods inflation, all eyes are now on sticky services inflation. Since wages account for no less than 80% of costs in the service sector, it's useful to get a sense of where wage inflation is heading. We combined three leading indicators of labor market conditions (the unemployment rate gap, the quits ratio, and the vacancy-to-

Chart 3: Rising rate sensitivity (l), on higher household debt (r)



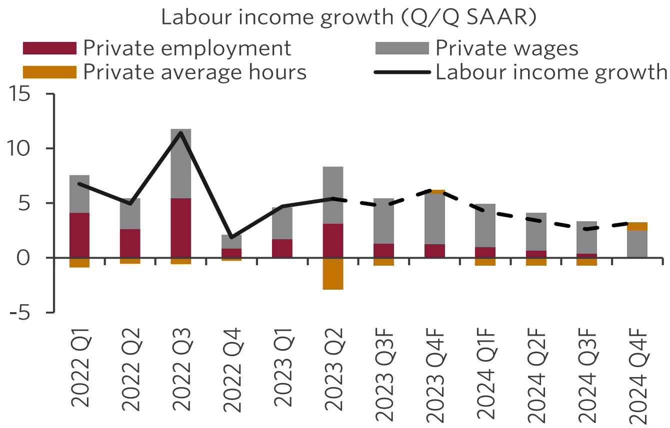
Source: Federal Reserve, CIBC

Chart 4: Job market normalizing (l), job switchers no longer being rewarded (r)



Source: Bureau of Labor Statistics, CBO, Federal Reserve Bank of Atlanta, CIBC

Chart 5: Slowing income growth



Source: Bureau of Economic Analysis, CIBC

unemployment ratio) into a single measure to extract an overall signal of excess demand/slack in the job market.[2]

And the signal (Chart 4, left) is clear. Excess labor demand peaked around early 2022 and is now pointing to softer wage growth going forward. Other leading wage measures are consistent with that signal. The wage gap between job leavers and stayers has gone back to its pre-pandemic average (Chart 4, right) as firms no longer offer an above-average premium to attract new workers.

The process of job market normalization will continue in the coming quarters. But the slowing is unlikely to generate recessionary conditions and is likely to be gentler than in the past, given that only a third of jobs now are in interest rate-sensitive sectors.

Slower wage growth combined with a continuation of more temperate job gains means labor income growth will be squeezed despite the moderating impact of easing inflation (Chart 5). Labour income growth should dip from its current pace of around 5% to about 3% by the second half of next year, which is below the pre-pandemic range.

Productivity: An emerging buffer

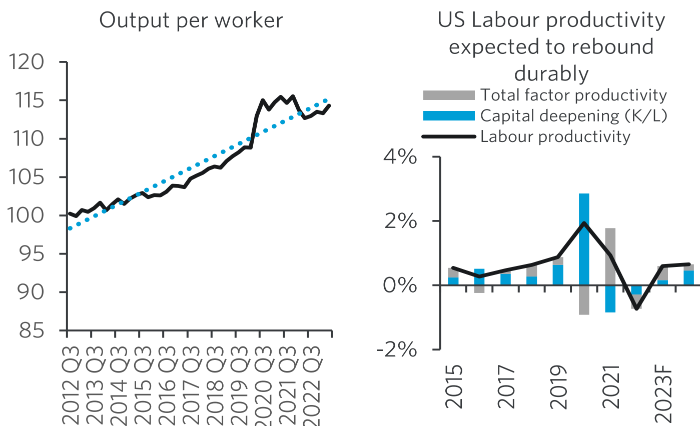
Now for the good news. The recent resurgence of productivity growth is a new buffer, but the kind that the Fed will welcome. While the higher cost of capital and rising wage inflation put downward pressure on profit margins, productivity is back to its pre-COVID trend (Chart 6).

Trends such as deglobalization, just-in-case inventories, and a demographically tight labor market will continue to put downward pressure on margins, forcing firms to lift productivity by accelerating capital spending. Business investment growth has been strong in 2023 and should moderate in 2024, but we expect it to come back strongly at around 3% in 2025, led by equipment and productivity-enhancing investment, including software and R&D. We expect capital deepening to account for two-thirds of labour productivity growth in 2024 to 2025.

The buffers shielding the US economy from high interest rates are receding, leading to a notable softening in the pace of economic growth and price pressures in the second half of the year and into 2024. While the economy will be seeing the white in the eyes of a recession, we suggest that a combination of a relatively gradual deceleration in demand and a healing of supply should work to keep the economy above water – just barely.

2 We create a common measure of labour market slack by extracting the first principal component of these series, which explains 87% of the variance across the three measures.

Chart 6: Productivity back to normal (l), decomposing labor productivity (r)



Source: Bureau of Economic Analysis, Federal Reserve Bank of San Francisco, CIBC

Canadian outlook: A stumble, not a tumble

by **Andrew Grantham** andrew.grantham@cibc.com and **Katherine Judge** katherine.judge@cibc.com

The Canadian economy is starting to stumble under the pressure of higher interest rates, with GDP contracting slightly in Q2 and expected to be lackluster over the next three quarters as well (Table 1). However, a tumble into a deep recession could still be avoided if interest rates start to be gradually reduced in 2024, before the largest risks from mortgage refinancing hit in 2025 and 2026. The fact that inflation has already eased, and should move closer to the 2% target during the first half of 2024, keeps the hope of a soft(ish) landing intact.

Sluggish spending

Apart from a temporary surge at the start of this year, consumer spending has already been fairly sluggish. While the 1.6% year-over-year increase in real consumption seen in the second quarter doesn't appear weak at first glance, that's within the context of a later full reopening of the Canadian economy compared to others, meaning that services spending was still in recovery mode over part of that period. Moreover, a 3% year-over-year increase in the population over the same time period means that real per-capita consumption is already declining.

That underlying sluggishness in spending has come despite the fact that many homeowners have not yet been exposed to higher interest rates. As more households refinance mortgages at higher interest rates, consumer spending will remain pinched. By how much depends on how quickly interest rates start to come down.

So far in 2023, the average household will have seen monthly payments increase by about 12% upon a refinancing of a five-year fixed rate mortgage. That appears to have been enough to restrict spending growth somewhat, but not by enough to bring a slump in consumption or a rush of houses being dumped on the resale market.

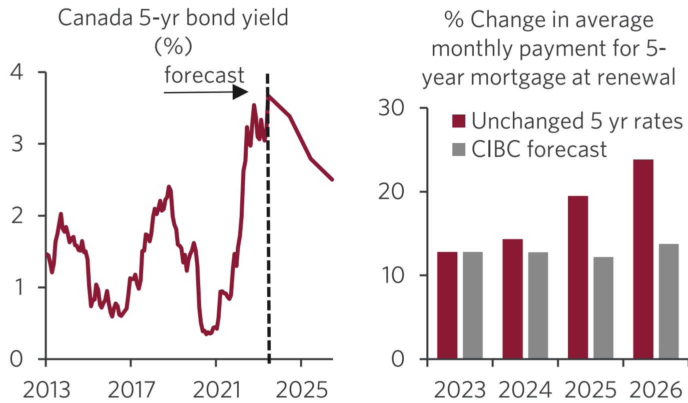
However, if interest rates were to stay around current levels, the refinancing hit would grow, and reach around 25% by 2026 as households that bought during the low rates of the pandemic start to refinance. The hit for those on variable rate mortgages

Table 1: Canadian forecast detail (real % change, s.a.a.r., unless otherwise noted)

Indicator	23 Q2A	23 Q3F	23 Q4F	24 Q1F	24 Q2F	24 Q3F	24 Q4F	2023F	2024F	2025F
GDP at market prices ($Bn)	2,826	2,849	2,872	2,881	2,897	2,931	2,961	2,838	2,917	3,042
% change	2.7	3.4	3.2	1.2	2.2	4.9	4.1	2.0	2.8	4.3
Real GDP ($2012 Bn)	2,199	2,201	2,208	2,203	2,210	2,220	2,231	2,202	2,216	2,262
% change	-0.2	0.4	1.2	-0.7	1.2	1.8	2.0	1.2	0.7	2.1
Final domestic demand	1.0	0.2	1.0	-0.3	1.4	2.2	2.3	0.6	0.9	2.3
Household consumption	0.2	0.5	1.1	-0.8	1.2	1.7	2.1	2.1	0.6	2.0
Total government expenditures	2.0	0.5	1.2	1.4	2.8	3.4	2.2	1.0	1.8	2.5
Residential construction	-8.2	-5.2	-2.0	-2.0	-2.0	2.0	3.2	-13.6	-2.0	2.2
Business fixed investment[1]	8.9	0.9	1.5	-0.8	0.5	2.1	3.0	3.1	1.3	2.8
Inventory change ($2012 Bn)	11.1	9.7	13.9	12.0	12.0	10.2	9.2	12.7	10.9	10.3
Exports	0.4	2.8	0.9	1.6	2.4	1.6	2.4	5.3	1.7	2.3
Imports	1.9	1.5	2.6	2.0	2.8	1.8	2.6	-0.4	2.2	2.8
GDP Deflator	2.9	3.0	2.0	2.0	1.0	3.0	2.0	0.8	2.1	2.2
CPI (yr/yr % chg)	3.5	3.7	3.3	3.2	2.4	1.9	1.7	3.9	2.3	1.9
Unemployment rate (%)	5.2	5.6	5.9	6.2	6.2	6.0	5.8	5.4	6.1	5.6
Employment change (K)	80	54	34	20	84	119	120	454	245	399
Goods trade balance (AR, $bn)	-24.5	-24.1	-28.8	-32.9	-35.2	-33.5	-32.0	-18.5	-33.4	-34.5
Housing starts (AR, K)	249	248	239	235	236	241	247	240	240	260

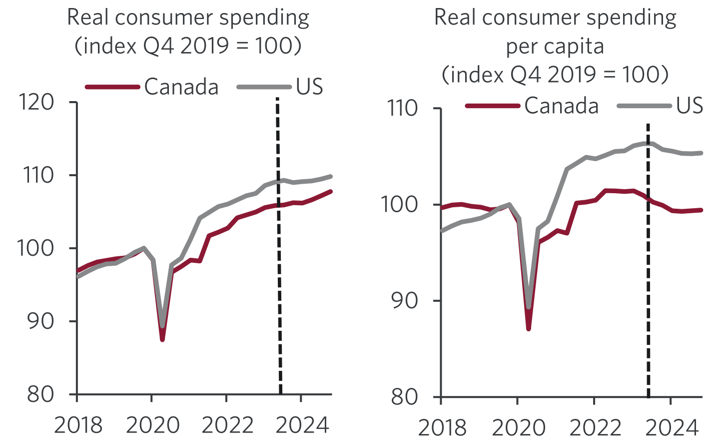
[1] M&E plus Non-Res Structures and Intellectual Property and NPISH.

Chart 1: 5-year bond yields have likely peaked (l), but will remain elevated enough to push up mortgage costs at renewal (r)



Source: Bloomberg, CMHC, StatCan, CIBC

Chart 3: Consumption to continue growing (l), but will sink in per-capita terms (r)



Source: StatCan, BEA, Census Bureau, CIBC

with fixed payments would be even larger. Lower interest rates by the second half of 2024 and into 2025 would help. But even with our interest rate forecast that allows for earlier cuts than current market expectations, a moderate 10-15% increase in mortgage costs would be seen upon refinancing in each year (Chart 1).

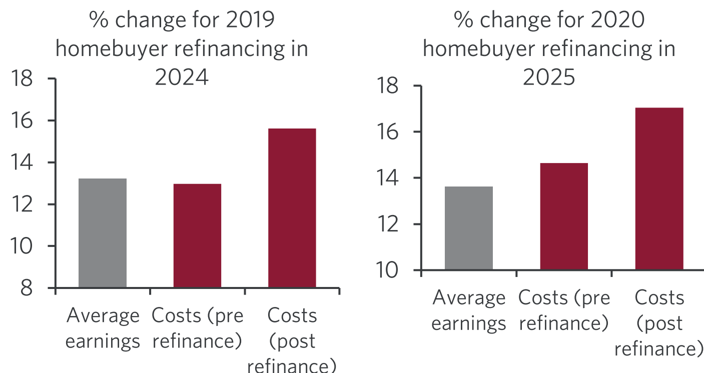
That refinancing cost is likely to continue restricting per-capita consumer spending, particularly given the fact that inflation has outpaced average income growth, and as a result, household finances don't have much flexibility. For a 2019 homebuyer refinancing in 2024, for example, their average earnings have only just kept pace with household costs even after holding mortgage costs constant. Upon refinancing, overall household costs will likely have risen more than earnings for the average household (Chart 2, left). The situation is even worse for a 2020 buyer refinancing in 2025 (Chart 2, right), given how strong inflation has been throughout most of their time as homeowners.

Therefore, even if higher for longer doesn't mean that interest rates stay at current levels past mid-2024, rates in the 2.5-3% range could still mean lower-for-longer consumption growth. That's particularly true in per capita terms, with overall consumption ramping up in the second half of 2024 due mainly to a swelling population (Chart 3).

Excess shifting from demand to supply

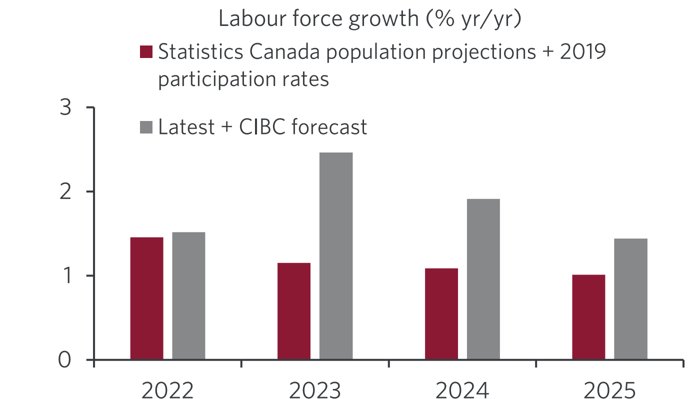
As well as supporting demand through consumer spending and housing, population growth is also adding to the supply potential of the economy. Relative to expectations based around Statistics Canada's 2022 population projections (and assuming 2019 participation rates by age group), the labour force has grown by an additional 1.5% so far in 2023 (Chart 4). Although population growth is expected to slow from this year's torrid pace, it should still be strong enough to support healthy gains in the labour force in 2024 and 2025.

Chart 2: Earnings gains have only matched the increase in household costs since 2019 (l), and are far below that relative to 2020 (r)



Source: StatCan, CMHC, CIBC

Chart 4: Strong immigration adds to the labour supply pool



Source: StatCan, CIBC

We are already seeing signs that the slowdown in demand both domestically and globally is making it harder for the economy to absorb such a big increase in the labour force. The unemployment rate has risen more than a half percentage point from its lows, with the newest immigrants (those in the country less than five years) impacted the hardest, and we expect this trend to continue. Indeed, the jobless rate is now expected to peak above 6%, which would be a level consistent with modest excess supply within the economy rather than excess demand. That will help slow wage growth, as well as inflationary pressures more generally.

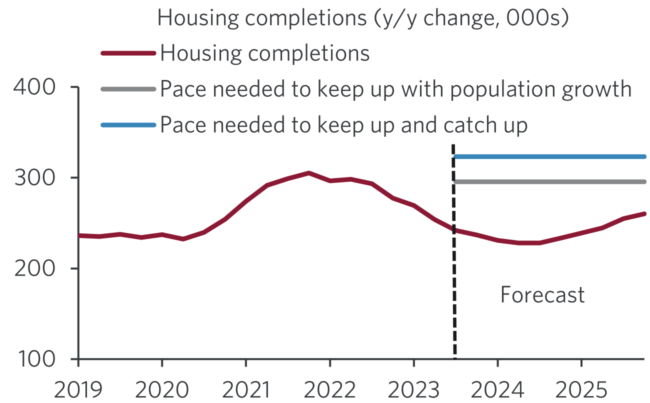
Indeed, the loosening labour market and a slowing economy are already helping to ease inflation. The uncomfortable truth for the Bank of Canada, however, is that they have far less control over some areas of the inflation basket compared to others. Price pressures in service sectors, for example, tend to be more domestically-driven and display a closer relationship with measures of economic slack (Chart 5, left). Inflation has already eased back to its pre-pandemic average in these areas (Chart 5, right) and should continue to soften ahead as slack in the economy opens up.

However, goods prices, which in the past have displayed a weaker correlation with the domestic economy, could cool in the near term, but still settle into a higher trend inflation rate than in the prior cycle. If so, the Bank may need to run the domestic economy slower than it would have done in the past in order to achieve a 2% inflation target.

The Bank also doesn't control the supply side of the economy, and in particular the shortage of housing which is putting upward pressure on house prices (despite high interest rates) and rent. In fact, high interest rates could be making the situation worse, by making new construction more expensive. In order to keep up with expected future population growth, around 290K new homes would need to be built every year (Chart 6).

However, to restore the same ratio of houses to households that was seen in 2017, that number rises to around 330K. These figures are well above the current pace of building, and could be lower than actual housing needs due to the undercounting of non-permanent residents in the official population data. New plans expected from the Federal and provincial governments during the Fall updates will hopefully provide a boost to housing construction, and help limit any further widening of the gap between population-fueled demand and supply.

Chart 6: Housing supply shortfall to remain prominent

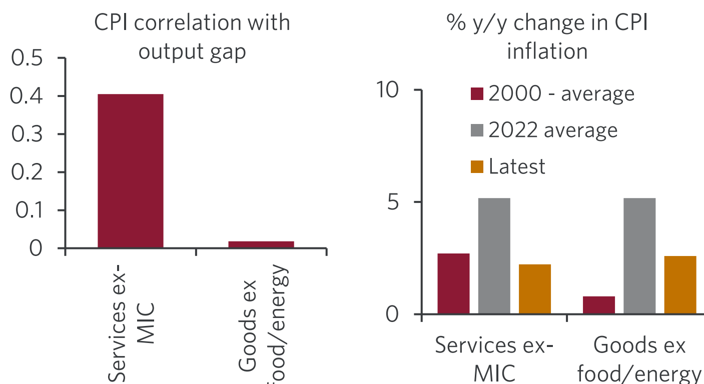


Source: CMHC, CIBC

From an overall inflation point of view, though, the contribution from shelter costs hasn't stemmed mainly from rents or replacement costs but rather the Bank of Canada's own actions, by lifting mortgage interest costs. So while supply constraints in the housing market will mean that rental prices remain a positive contributor to inflation, the overall contribution of shelter to CPI should ease fairly quickly in late 2024 and into 2025 if the Bank of Canada cuts interest rates as we expect (Chart 7).

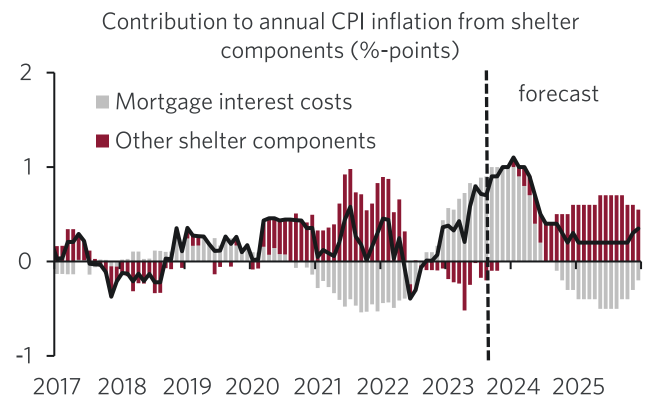
With growth stumbling for the next few quarters, but not tumbling into a deep recession, inflation will likely be at or even slightly below 2% by the end of next year. That would provide some welcome relief to Canadian consumers, enabling per capita consumption to accelerate slightly which, combined with strong population growth, will see a faster pace to real GDP growth during the second half of 2024.

Chart 5: Domestic service costs tied closely to the output gap (l) have subsided, while goods prices still present a risk to inflation (r)



Source: StatCan, CIBC

Chart 7: Inflation contribution from shelter to drop off as interest rates fall, offsetting the impact of increases in home prices



Source: StatCan, CIBC

Contacts:

Avery Shenfeld
avery.shenfeld@cibc.com

Benjamin Tal
benjamin.tal@cibc.com

Andrew Grantham
andrew.grantham@cibc.com

Ali Jaffery
ali.jaffery@cibc.com

Katherine Judge
katherine.judge@cibc.com

FICC Strategy
Ian Pollick
ian.pollick@cibc.com

CIBC Capital Markets
PO Box 500
161 Bay Street, Brookfield Place
Toronto, Canada, M5J 2S8
Bloomberg @ CIBC

economics.cibccm.com

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