Economic Insights

April 10, 2014

Springs and Summers

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A new season is upon us, and the early budding of spring economic data has leant hopes to our view that most of the winter's chill in US growth was due to unseasonable weather. That will be critical for Canada, where a leaner manufacturing sector and a cheaper currency could support exports if domestic demand is lacklustre (see pages 8-11), although an energy-focussed West continues to have better growth prospects (see pages 6-7).

But are economic springs going to give way to Summers? If former Treasury Secretary Larry Summers is right, a good second quarter still leaves the US, Canada and the industrialized countries, headed for "secular stagnation". He notes that in the last cycle, a mortgage and housing bubble didn't overheat the US or European economies, but was necessary to get to full employment. Growth in tech sectors that doesn't require much capital spending (leaving businesses sitting on cash), a shift in activity to emerging markets with undervalued currencies, and trends in demographics and savings behaviour, in his view are factors contributing to that bleak assessment.

Summers places emphasis on the use of ramped-up debt-financed infrastructure spending as an alternative to another bubble as a way of getting the US back on track. But maintaining a lower path for interest rates, and for Canada, keeping its more competitive exchange rate, will also be key.

Had US housing and mortgage regulators not been asleep at the switch, a mortgage blow-up wouldn't have been the inevitable result of low rates in the last cycle. The absence of a Canadian mortgage debacle in 2007-09 demonstrates that. Indeed, by holding back the tides in housing, rates could have stayed lower for longer in the last cycle, which for the US, would have supported spending, kept the greenback at a more favourable exchange rate, and left more capital to be allocated to investment rather than housing. Similarly, in Canada, ensuring that the rate differential with the US stays narrow enough to keep the Canadian dollar at a level competitive for exporters will allow the economy to tolerate the end of the housing boom.

So while we see a path out of secular stagnation, Summers still has a valid point. Emerging markets continue to generate pools of excess savings, capital spending remains lacklustre in western economies, and demographics will slow potential GDP growth. If we don't turn to larger fiscal deficits, monetary policy will have to provide enough of an offset to those drags on growth.

" the neutral rate...... will be more than a full point lower than the 4% fed funds rate the Fed's FOMC currently envisages."

Our analysis shows that both in the US and Canada, the neutral rate, where we're likely to pause at full employment, will be more than a full point lower than the 4% fed funds rate the Fed's FOMC currently envisages (see pages 3-5). Unlike the Fed, Stephen Poloz has already come to that conclusion. That won't prevent a bond market sell-off as we approach the first hikes in 2015, but it will make the latter stages of that sell-off a buying opportunity, and a more gentle climb in rates will be a plus for equity multiples.

http://research.cibcwm.com/res/Eco/EcoResearch.html

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MARKET CALL

- The Canadian dollar has recouped some lost ground recently, although we still see risks of some short term weakness as US Q2 growth could handily top Canada's pace. But a firming CPI as the year progresses will position the Bank of Canada to roughly match the US on rate hikes in 2015, and an improved goods trade balance should also be supportive. Still, there's limited room for a much firmer loonie, as in influencing the currency by setting rates, the Bank will be cognizant of the need to lean on exports as a source of growth.

- We extended our forecasts into the first half of 2016. While expecting higher yields through 2015, we see the Bank of Canada surprising markets with a pause on rates in 2016 and the Fed doing so after one more hike, helping bond yields recoup some lost ground. Relative to past cycles, the path for rates to get to and sustain full employment will be atypically shallow (see pages 3-5).

- Elsewhere, the timing for rate hikes will be even more drawn out. The Eurozone still has a massive output gap, and Japan will want to tighten up on fiscal policy long before it moves on interest rates. The euro would be weaker than our forecast if the ECB actually pulled the trigger on QE or other extraordinary measures, but if they didn't do so at a 0.5% inflation rate, it's hard to see what would prompt them into action.

INTEREST & FOREIGN EXCHANGE RATES

		2014				2015				2016
END OF PERIOD:		**8-Apr**	**Jun**	**Sep**	**Dec**	**Mar**	**Jun**	**Sep**	**Dec**	**Jun**
CDA	Overnight target rate	1.00	1.00	1.00	1.00	1.00	1.25	1.50	1.75	1.75
	98-Day Treasury Bills	0.91	0.90	0.95	0.95	1.05	1.20	1.45	1.70	1.70
	2-Year Gov't Bond	1.08	1.10	1.40	1.60	1.85	2.20	2.40	2.50	2.40
	10-Year Gov't Bond	2.47	2.65	2.85	3.00	3.10	3.35	3.45	3.55	3.25
	30-Year Gov't Bond	2.99	3.05	3.35	3.50	3.55	3.60	3.65	3.70	3.50
U.S.	Federal Funds Rate	0.10	0.10	0.10	0.10	0.10	0.25	0.50	0.75	1.00
	91-Day Treasury Bills	0.03	0.15	0.15	0.15	0.20	0.40	0.60	0.85	0.95
	2-Year Gov't Note	0.37	0.40	0.65	0.85	1.00	1.40	1.65	1.85	1.90
	10-Year Gov't Note	2.68	2.95	3.10	3.25	3.30	3.55	3.70	3.80	3.50
	30-Year Gov't Bond	3.56	3.80	4.00	4.10	4.15	4.25	4.30	4.40	4.25
Canada - US T-Bill Spread		0.88	0.75	0.80	0.80	0.85	0.80	0.85	0.85	0.75
Canada - US 10-Year Bond Spread		-0.21	-0.30	-0.25	-0.25	-0.20	-0.20	-0.25	-0.25	-0.25
Canada Yield Curve (30-Year — 2-Year)		1.91	1.95	1.95	1.90	1.70	1.40	1.25	1.20	1.10
US Yield Curve (30-Year — 2-Year)		3.19	3.40	3.35	3.25	3.15	2.85	2.65	2.55	2.35
EXCHANGE RATES	CADUSD	0.93	0.89	0.92	0.93	0.93	0.93	0.93	0.93	0.91
	USDCAD	1.08	1.12	1.09	1.08	1.08	1.07	1.07	1.08	1.10
	USDJPY	102	105	105	104	103	102	101	100	105
	EURUSD	1.38	1.36	1.31	1.28	1.26	1.27	1.30	1.32	1.29
	GBPUSD	1.67	1.64	1.61	1.59	1.58	1.59	1.61	1.63	1.61
	AUDUSD	0.94	0.88	0.86	0.86	0.88	0.90	0.91	0.92	0.93
	USDCHF	0.88	0.90	0.94	0.97	0.98	0.98	0.96	0.95	0.99
	USDBRL	2.19	2.20	2.14	2.33	2.45	2.53	2.65	2.70	2.70
	USDMXN	12.98	12.80	12.75	12.82	12.85	12.90	13.15	13.21	13.20

Jump, But How High? The Outlook for Overnight Rates

Avery Shenfeld and Peter Buchanan

The direction is clear, but just how far will US overnight rates climb in the years ahead? If Janet Yellen was schooled by a recent speech by her Canadian counterpart, the answer might be less than the FOMC currently expects.

The nature of the upcoming expansion will dictate that, even at full employment, US rates will have to be lower than in past cycles, in both real and nominal terms. Similarly, Canadian overnight rates could end up reaching a plateau at surprisingly low levels. If so, that has implications for investors in longer-term bonds as well—not enough to be bullish just yet, but opening up buying opportunities in 2015 if the market overshoots.

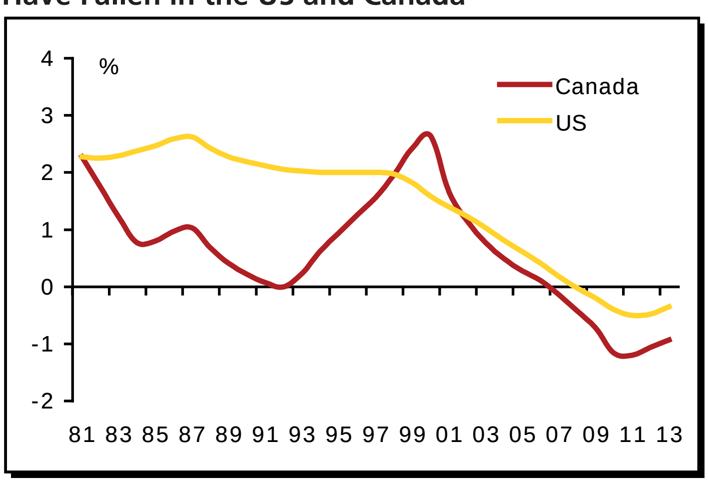
Professor Taylor, Meet Professor Wicksell

Despite rumours to the contrary, economists don't always disagree. At the latest Fed meeting, there was near unanimity in projecting that the first rate hike will come in 2015, and that longer term, the fed funds rate will settle at 4%.

The 4% rate, which at 2% inflation would represent a real rate of 2%, is simply the usual Taylor rule assumption. It sets that benchmark at the level at which an economy growing at its non-inflationary potential will neither speed up nor decelerate. Research, however, suggests strongly that this "neutral" rate is instead time-varying, judging by actual data on growth and inflation over the decades.

Chart 1

Real Neutral Short-Term Policy Rates Have Fallen in the US and Canada



Source: OECD Working Paper #1081, Nov 2013, CIBC

Recent OECD estimates—based loosely on a model developed by the Fed—suggest that the real neutral rate in the US has ranged from negative (through periods of headwinds to growth) to roughly 2½% (Chart 1). Even looking only at periods where the output gap was zero, there are wide variations.

Similarly, Canada's neutral real rate has seen substantial swings, accentuated potentially by the fact that the exchange rate plays a major role in monetary conditions. In fact, the OECD estimates put Canada's current real neutral rate well below that stateside. If correct, that would imply that, particularly prior to the recent correction in the loonie, monetary conditions in Canada have been even tighter on a relative basis versus the US than the 1% gap in overnight rates implied.

Writing a century ago, economist Knut Wicksell argued that whether an interest rate would be stimulative depended on its relationship to returns on capital; rates lower than the marginal productivity of capital would encourage faster investment spending, and inflation. Variations in the MPC would mean variations in the neutral rate.

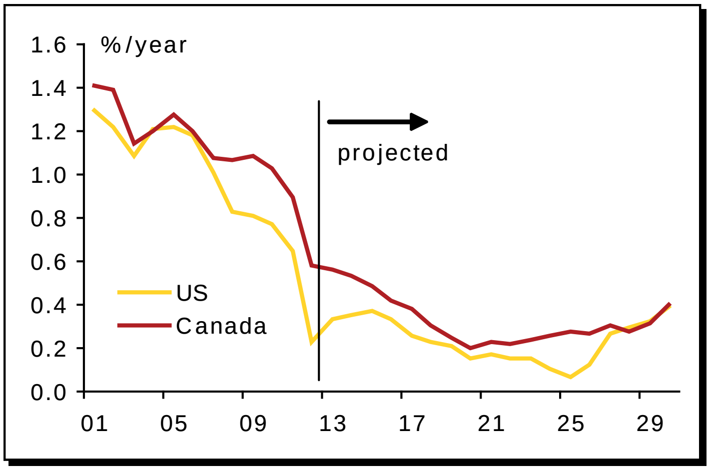
While subsequent growth theory models refined that view, his conclusion still resonates: if growth opportunities are structurally weaker than in the past, so too will be the neutral rate of interest. Neo-Keynesian models also note that if savings are higher than in past periods at any given interest rate, it would also require a lower neutral rate to spur enough investment spending to absorb them and maintain full employment. In advancing his "secular stagnation" argument, former Treasury Secretary Larry Summers has also argued that this implies a reduced equilibrium real interest rate.

Governor Poloz, Meet Chair Yellen

In a recent speech, Bank of Canada Governor Poloz turned to these Wicksell-type arguments to maintain that the neutral rate ahead would be sustainably lower than it has been in the past. He cited slower gains in productivity and labour force growth as implying a lower non-inflationary real growth rate, and in turn, a lower neutral rate.

Chart 2

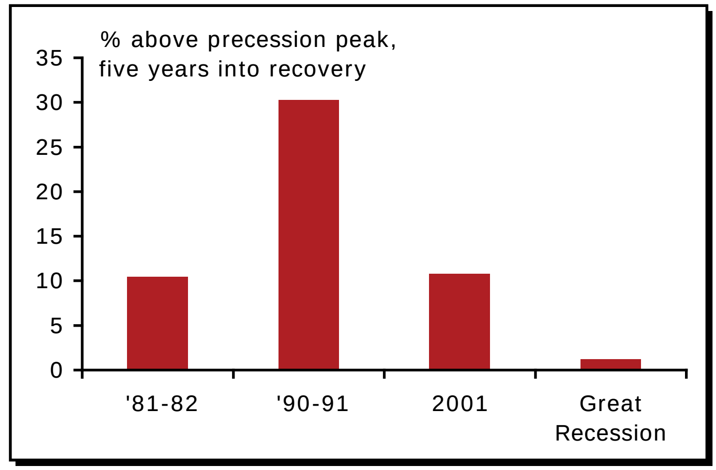
Expected Halving in Working-Age Population Growth



Source: Statistics Canada, US Census Bureau, CIBC

Chart 4

Recovery in US Capital Spending Has Lagged Past Recoveries



Source: BEA, CIBC

Janet Yellen and her team at the Fed should be taking heed. Both Canada and the US are headed for substantially slower growth in the working-age population, decelerating to less than half the pace seen in the last expansion (Chart 2). Unless productivity soars, the pace of potential (non-inflationary) real GDP growth will decelerate.

In turn, as Poloz notes, so too will the neutral overnight rate. Robert Solow's classic growth model concluded that in equilibrium, the real interest rate will equal the long term real growth rate. But the relationship also holds empirically. In the US for example, there has been a strong correlation between the IMF's measure of potential growth and the OECD's estimate of the neutral fed funds rate (Chart 3).

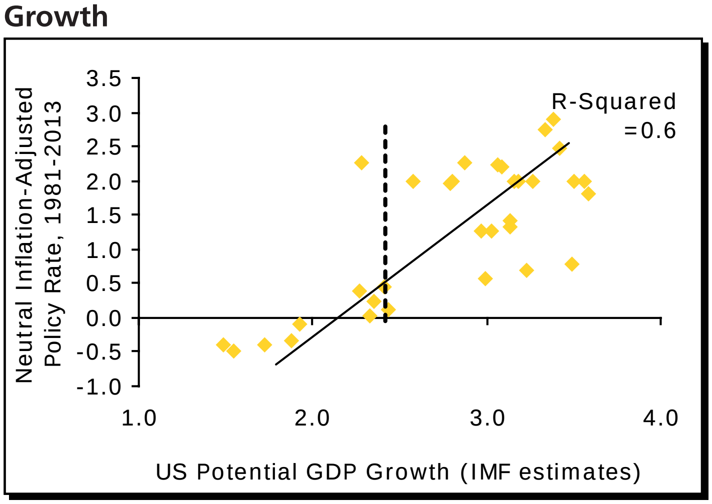
Higher ROEs suggest US returns on capital have been rising, mimicking the profit share of GDP. That seems at first blush to sit oddly with the tenets of the Wicksellian approach, but the discrepancy may be more apparent than real. What matters is not average profitability, but returns at the margin. Capital spending hasn't been particularly brisk in either the US (Chart 4) or Canada in this cycle. That suggests businesses see less of a payback from the last dollar spent.

A contemporary, macro modelling approach, focussing on rates being set to bring savings at full employment into line with capital spending, also supports the persistence of lower-than-normal policy rates in the coming expansion. Insofar as spending goes, uncertainties coming out of an unusually harsh recession may be restraining firms' "animal spirits"—a normally important driver of economic recovery. While such headwinds could ease over time, the capex drought could also reflect more persistent structural factors. It, in part, lines up with a rising trend for non-financial corporations to accumulate cash, not just in the US and Canada, but in Europe and Japan as well.

On the savings side, we are starting to see a trend climb in savings rates in both the US and Canada, despite very unrewarding interest rates. Presumably, that trend will accelerate when rates head higher. But the big imbalance is still a global one, with a massive glut of savings being built in emerging market countries like China and India

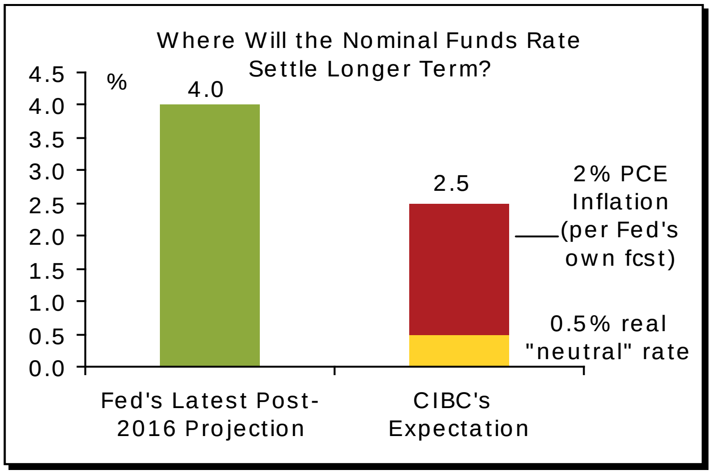
Chart 3

Neutral Policy Rate is Closely Related to Potential Growth



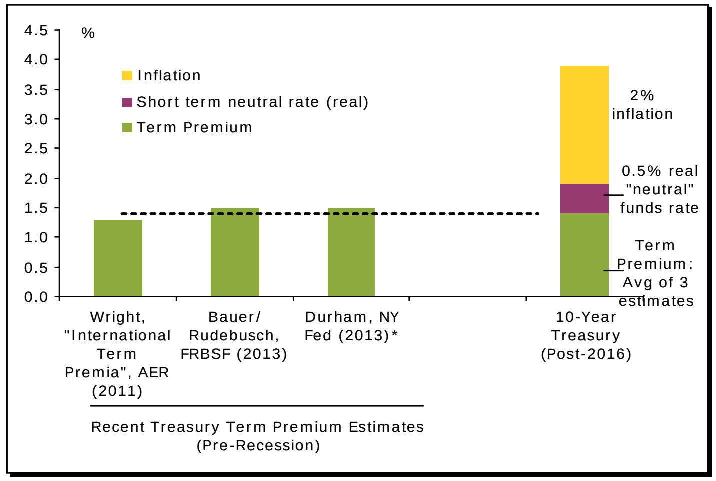
Source: OECD, CIBC

Chart 5
US Neutral Rate is Well Below FOMC Forecast



Source: FOMC, CIBC

Chart 6
Lower Neutral Rate Implies Ten-Year Yields to Remain Below 4%



Source: CIBC studies cited

which boast national savings rates of 25-50%.

The Neutral Fed Fund Rate: Bond Implications

So if the FOMC's forecast of a 4% long-term funds rate (or 2% real rate) is too high, what rate might instead be appropriate? Applying the historical relationship between potential GDP growth and the neutral rate, we estimate that the new long-term neutral rate could be only 0.5% in real terms, or a nominal rate of 2.5% (Chart 5).

That might seem low, but it's in line with the OECD model's estimate of the neutral rate back in 2005. If so, long before it gets to its 4% funds rate forecast, the Fed will find growth decelerating to potential, and will be pushed into a pause.

In Canada, the exchange rate has enough influence to complicate estimating the neutral overnight rate, giving the importance of overall monetary conditions in a small open economy. Nevertheless, slowing potential GDP, along with high household debt levels that will increase the sensitivity of spending to rate hikes, both suggest that a nominal rate below 3% might be the longer-term neutral rate today.

The third component of bond yields—beyond the real short term rate and expected inflation—is the term premium, what investors demand for assuming duration risk. Estimates suggest that has fallen in the last decade or two for a number of reasons. One is reduced uncertainty about inflation. The heightened inverse correlation between stocks and bonds may also have encouraged some investors to hold more bonds for hedging purposes.

Several recent studies suggest the term premium embedded in 10-year Treasury yields was about 1-1½% in the middle of the last decade (Chart 6)—before the Great Recession's onset, and yield curve distortions, stemming from the Fed's unconventional remedies for an uncustomarily sick economy. The US economy had little if any spare capacity then—much as we expect in two-three years' time.

What do these three factors imply in the medium haul for Treasury yields? If the Fed calls time-out at a funds rate of 2½%, in line with our current expectation, and term premiums revert to pre-recession norms, with the economy operating at comparable utilization levels, 10-year treasury yields should top out in the 3½-4% range this cycle (Chart 6, again). That's about 100-150 bps below the last decade's peak. Canada's higher credit rating and lower government debt should warrant slightly lower yields here.

To summarize, it's not a bullish call for bonds just yet. Even if overnight rates see a protracted Fed pause at 2.5%, the bond market in 2014-15 might not yet foresee that surprise, and will overshoot. To bond players, rate hikes are like potato chips: once you eat the first one you go through the whole bag. After climbing sharply next year, bond yields could be reversing course in 2016 as central banks take an early breather on hikes. That in turn could create a buying opportunity for fixed income investors from the middle of next year on.

Provinces vs States Redux

Warren Lovely and Nick Exarhos

Think tanks and media outlets have once again taken to comparing the fiscal health of Canadian provinces to US states. Ontario vs California remains a favoured pairing, pitting two large and fiscally challenged jurisdictions against one another. Such appraisals are less than flattering to Ontario, but miss the fundamental point; as rating agencies and bond investors should know, states and provinces aren't peers. To compare one to another in isolation is folly.

We're inclined to look past comparisons of Ontario to California, focusing instead on growing imbalances between the federal and provincial levels of government, and from one province to another. These are the more relevant comparisons, where yawning performance gaps can and will move markets.

Provinces Have Long Carried Heavier Debt Burden

A recent Fraser Institute study declared that Ontario's bonded debt was nearly twice as large in dollar terms as in California—a gap that was more than five times as wide when scaled to population or GDP. While this may strike some as novel, historically Canadian provinces have carried considerably more debt than US states (Chart 1).

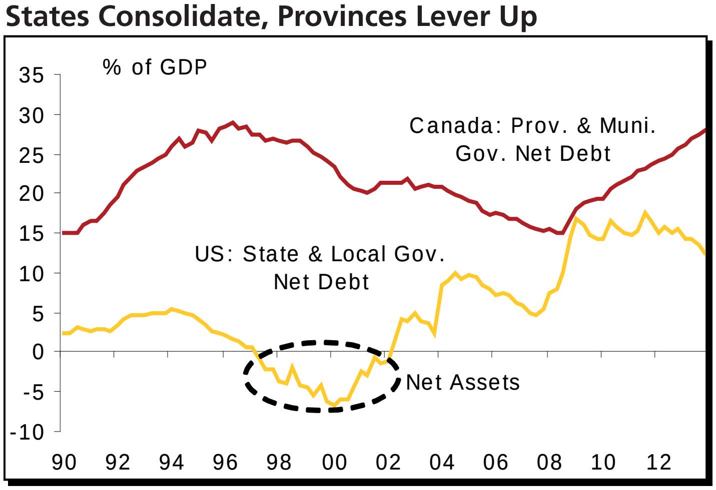
More interesting is the trajectory for relative debt burdens. US state and local governments have begun to repair balance sheets while provincial indebtedness (in aggregate) continues to race higher. As a result, earlier pressure on certain state credit ratings has subsided. California earned a couple of rating upgrades last year, while Ontario's credit rating remains under threat heading into a pivotal budget. State CDS levels have plumbed post-recession lows, while provincial spreads have faced greater resistance (Chart 2).

Economic fundamentals are playing a role. Having generally underperformed Canada during the recession and early stages of the recovery, the US is set to lead advanced-economy growth in the years ahead. Canada will be stuck in a lower gear, burdened by overleveraged consumers and a housing sector destined to cool. Here's hoping Canada's beleaguered manufacturing sector finds its footing and makes a larger contribution to growth in the years ahead (see pages 8-11).

And consider fundamental differences in the division of powers between the various levels of government in the two countries, and the more active role played by the provinces in providing social services. Given primary constitutional responsibility for health care, education and social services, provinces are endowed with greater fiscal flexibility, including sovereign-like taxing powers, an unchecked ability to run budget shortfalls and free rein to borrow in capital markets. Balanced budget laws lack real teeth in Canada, with a number of provinces running larger shortfalls and pushing back deficit-reduction timelines in the face of disappointing growth. US states, in contrast, exhibit less fiscal flexibility; they're generally prohibited from running operational shortfalls, must clear higher hurdles when it comes to raising taxes and face

Chart 1

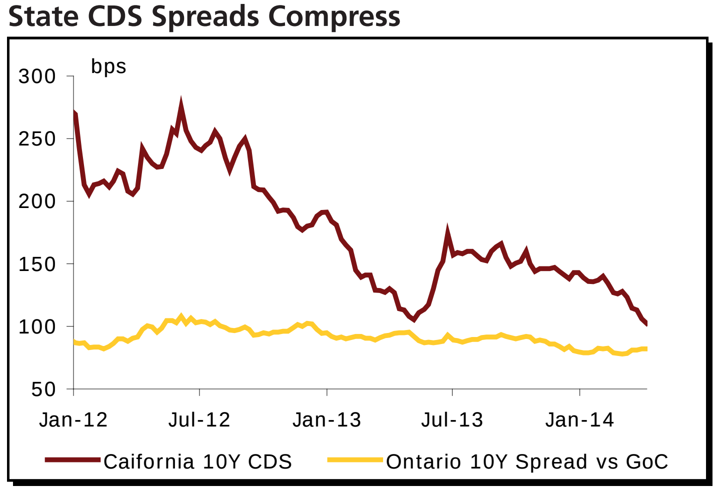
States Consolidate, Provinces Lever Up



Source: CIBC, StatCan, FRB

Chart 2

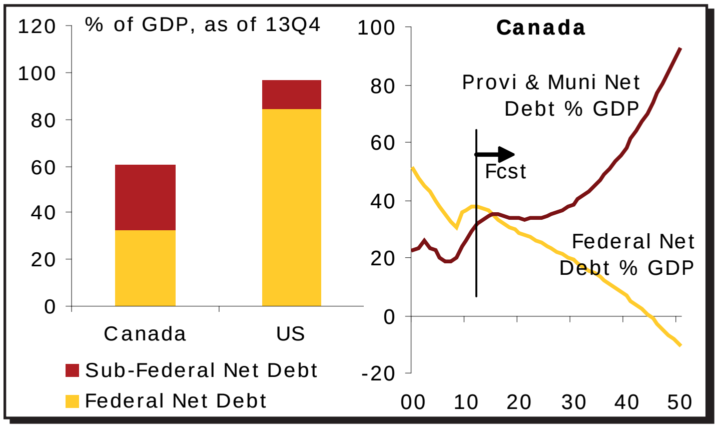
State CDS Spreads Compress



Source: CIBC, Bloomberg

Chart 3

Canada Less Indebted (L); Provinces Account for Larger Share of Canadian Debt (R)



Source: CIBC, StatCan, FRB, PBO

more binding constraints on issuing debt. The obvious result: the provincial sector accounts for a larger share of government debt in Canada, whereas the vast majority of US public sector debt can be traced back to Washington (Chart 3, left). Again, this is nothing new.

Growing Vertical and Horizontal Imbalance in Canada

With Canada's population aging faster than the US, health care costs—which already account for roughly 40% of provincial spending—risk becoming a provincial budget buster as more Canadians turn old and gray.

While Ottawa eyes a return to surplus, a majority of provinces remain mired in deficit. And work by Canada's Parliamentary Budget Officer suggests that, absent corrective measures, provincial net debt will skyrocket as the population ages, whilst the federal government presides over larger and larger surpluses and a growing mountain of net financial assets (Chart 3, right).

Granted, it's always wise to treat long-term fiscal projections with a degree of caution. The basic message is this: Canada may well retain or even build on general government net debt edge vs the US, but under the status quo, provinces will comprise a growing share of public sector debt in this country. Associated supply developments—a glut of provincial bonds vs. fewer and fewer Canadas—are consistent with wider provincial credit spreads, all else equal.

Table 1

Provincial Growth Outlook

	Real GDP Growth				Reference Periods		
Y/Y % Chg	2012A	2013E	2014F	2015F	Pre-Crisis[1]	Recession[2]	Recovery[3]
BC	1.5	1.8	2.4	2.8	3.7	-0.7	2.4
Alta	3.8	3.5	3.8	3.6	4.2	-1.2	4.1
Sask	1.9	3.9	2.4	2.7	2.9	0.3	3.3
Man	2.6	2.5	2.2	2.4	2.6	1.8	2.3
Ont	1.3	1.5	2.0	2.3	2.1	-1.6	2.1
Qué	1.5	1.2	1.7	2.0	1.7	0.6	1.7
NB	-1.1	0.3	1.2	1.7	1.7	-0.1	0.7
NS	-0.1	0.7	1.5	2.0	1.0	1.2	1.3
PEI	1.5	1.4	1.7	1.9	2.5	0.6	1.6
N&L	-4.4	5.9	0.9	0.4	4.4	-5.6	1.9
Cda	**1.7**	**2.0**	**2.2**	**2.4**	**2.6**	**-0.8**	**2.4**

1. 'Pre-Crisis' refers to five-year average annual growth rate for 2003 to 2007

2. 'Recession' refers to two-year average annual growth rate for 2008 to 2009

3. 'Recovery' refers to six-year average annual growth rate for 2010 to 2015

Source: CIBC, StatCan

Ottawa to the Rescue?

If there's a silver lining for the more distressed provinces, it's the potential for a more accommodating federal government in Ottawa, where a surplus era is dawning. How Ottawa chooses to deploy its looming fiscal dividend could be one of the most vital decisions taken by federal policy makers in the coming decade, along with the path for interest rates adopted by the Bank of Canada. The form, scope and timing of future stimulus warrants more attention than it's currently receiving.

Deploying stimulus dollars at the federal level may help narrow the vertical or federal-provincial fiscal imbalance. But barring a dramatically enlarged equalization program, it's hard to see the horizontal imbalances between individual provinces going anywhere.

Quite simply, not all provinces are endowed with equal opportunity. When it comes to economic performance, Canada's resource-rich Western provinces have enjoyed a pronounced edge over Central and Eastern Canada and are armed with superior growth potential ahead (Table 1). Gaps in relative financial performance are even more striking. BC, Alberta and Saskatchewan are already in balance (or very near it), leading to greater success when it comes to arresting an upward drift in net debt-to-GDP. What results is ever greater divergence in credit worthiness between the West and the rest of the country. Gaps in credit ratings will widen, meaning traditional spread relationships between provinces need not apply.

So forget comparisons of Ontario to California. It's more relevant to stack up Ontario vs. Alberta, or Québec vs. British Columbia, or even New Brunswick vs. Saskatchewan, where barring a dramatic shift in course, performance gaps risk proving intractable.

Canadian Manufacturing—Survival of the Fittest

Benjamin Tal and Nick Exarhos

The headline numbers are not pretty. Manufacturing production and shipments fell last year, reversing what was already the most muted recovery on record. An overvalued currency, compounded by the trauma of a deep US recession, has overwhelmed segments of the sector and caused many to question whether there is any future for manufacturing in Canada. But a closer look suggests that a different manufacturing sector is rising from the ashes. Though some failed to survive, many who did are stronger, leaner and more productive. We have identified the industries that, due to their market characteristics and actions taken during the dark days, are poised to outperform in the coming years.

The (Not So) Short-Term Pain

Six years removed from the recession, and Canadian manufacturing is still 10% below its pre-slump level, registering the weakest recovery on record. With both production and shipments falling in 2013, the recovery has lost momentum. Since reaching bottom in mid-2009, industrial production rose by only 10%—half the advance seen south of the border. This performance gap is a clear reflection of the reduced ability of Canadian manufacturing to capitalize on the tailwind coming from the south (Chart 1, left). The gap between the Bank of Canada's US Economic Activity Index and Canadian manufacturing shipments has never been wider (Chart 1, right).

That decoupling is, in large part, due to the dramatic reduction in manufacturing production capacity in Canada. During the past decade, the share of manufacturing in GDP fell from 16% to 12%—by far the fastest pace of decline on record. During the same period, the number of firms in the sector fell by 20% while the number of firms in the rest of the economy rose by 10% (Chart 2, left). There are fingerprints of an overvalued currency all over that picture, with larger firms (which on average are more sensitive to swings in the value of the dollar due to their high propensity to export) seeing their number falling much faster than smaller firms (Chart 2, right).

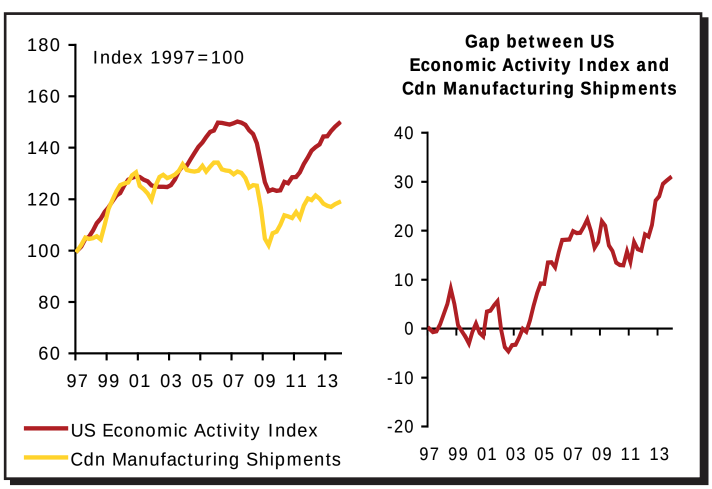
Exacerbating the impact of the rising dollar was the unfavourable regional alignment of Canadian exports to the US. During the recession and in the early stages of the recovery, more than 70% of Canadian manufacturing exports went to underperforming US states (Chart 3). Only recently have we seen an improvement on that front, with those numbers reversing themselves as 70% of Canadian manufacturing exports are now going to outperforming US states—a trajectory that no doubt mitigated the pain.

Perspective

A quick glance at Chart 4 puts the manufacturing saga in perspective. De-industrialization is not a uniquely

Chart 1

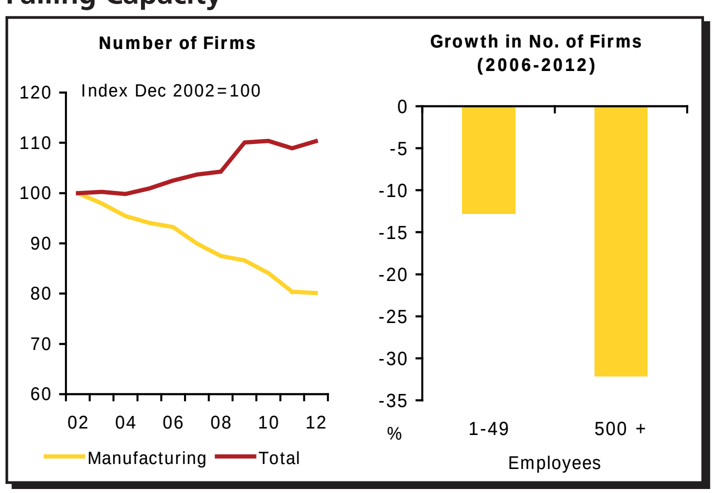
No Lift



Source: Statistics Canada, Bank of Canada, CIBC

Chart 2

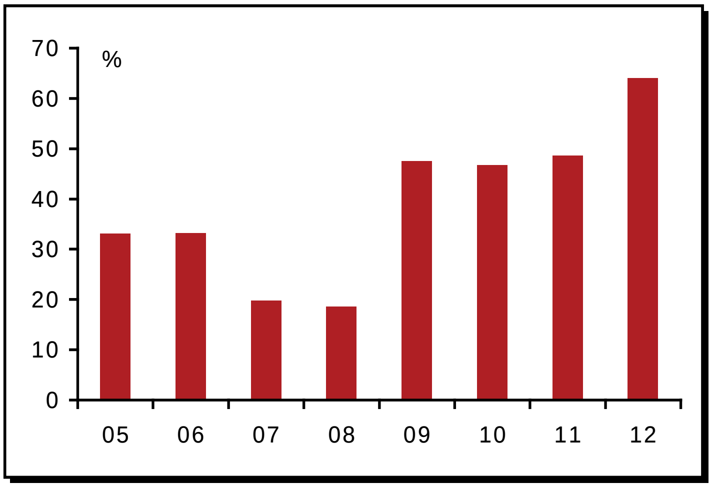
Falling Capacity



Source: Statistics Canada, CIBC

Chart 3

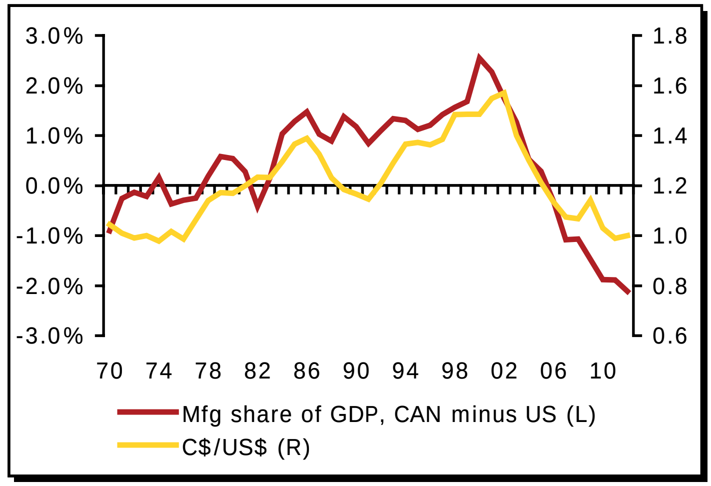
Share of Manufacturing Exports to Outperforming US States



Source: BEA, Industry Canada, CIBC

Chart 5

Can You Spot The Correlation?



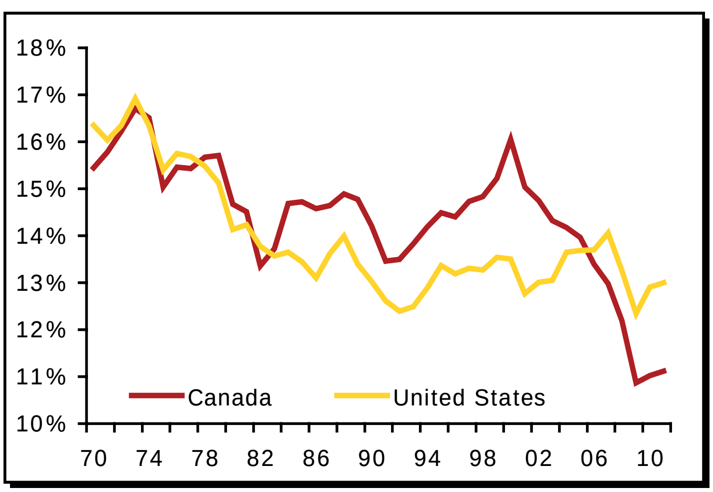
Source: United Nations National Accounts, Statistics Canada, CIBC

Canadian story, but a common reality in the developed world. US manufacturing accounted for 16% of the economy in the 1970s, whereas today it accounts for 13%. But a closer look at the chart suggests that most of that adjustment took place in the 1970s and 1980s. In fact, aside from short-lived cyclical swings, the share of manufacturing in the US economy was relatively stable in the past two decades. The more profound change during that period was the dramatic shift from labour-intensive to capital-intensive production.

In contrast, Canada's manufacturing share of GDP rose dramatically in the 1990s. That advance was powered by a tumbling C$ which lost over 20% of its value during that period. The correlation between US-Canada relative manufacturing performance and the value of the loonie is unmistakable (Chart 5).

Chart 4

Manufacturing's Share of Real GDP



Source: United Nations National Accounts, CIBC

Only when the C$ started its march back to, and through, parity at the turn of the new millennium, did the adjustment arrive in Canada. Canadian manufacturing saw a nose-dive—capped off by the Great Recession—from the relatively elevated levels it had seen in the previous two decades.

Perhaps the final destination for manufacturing was the same for the two nations, but a weak exchange rate in Canada provided an important tailwind that forestalled, and even counteracted, the effects of de-industrialization.

Despite having given up the cushion it had built, a more stable—or an even weaker—C$ may leave fundamentals to determine the next chapter in Canadian manufacturing. Whether or not Canada will take advantage of a potential upturn from a base that is the result of a three-decade long consolidation phase will depend on its competitive position.

Competitive Forces

At first glance, compensation costs in Canadian manufacturing appear relatively attractive, with rates averaging below most of its counterparts from the top ranks of the World Economic Forum's Global Competitiveness Report. Though there are sometimes greater differences in particular sub-sectors (e.g. autos, where the Canadian disadvantage is sometimes reported to be in the US$5-10 range), average hourly compensation in Canadian manufacturing was US$37 in 2012, only US$1 greater than wages paid in the US. Furthermore, Canada's tax regime is less punitive on corporations than all of its G-8 peers. It is tied with Germany for the lowest national rate at 15%, and has the lowest average effective tax rate for firms at just over 24% according to PricewaterhouseCoopers. These rates are especially attractive for firms when compared to the US, which imposes a federal rate of 35% that swells further to 46% on an all-in basis for the average firm.

However, when hourly compensation costs are translated into unit labour costs, the trend in Canada is more alarming. Since 1997, Canada's unit labour costs have increased faster than those in the United States, where they have stayed more or less stable. When priced in US dollars, that divergence is even more pronounced with Canadian unit labour costs soaring as the C$ has firmed. A recent depreciation in the loonie, though, helps narrow that chasm slightly (Chart 6).

Increasing unit labour costs mean that hourly compensation in Canadian manufacturing has outpaced its productivity gains while trends in the US signal that both compensation and productivity have increased at more or less the same rate. Indeed, productivity in Canada struggled in the 2000s, increasing only 7% during a period where US manufacturing productivity rose by 25%. However, the trauma of the recession brought on by the financial crisis in the US and an overvalued domestic currency delivered a major wake-up call for many Canadian manufacturers.

While still lagging gains in US manufacturing productivity (albeit at a decreasing rate), output per worker in Canadian manufacturing advanced by more than 9% since 2009—double the pace seen in the productivity of the economy as a whole. There is little doubt that a surging loonie served as a major catalyst for this improvement, with industries more sensitive to fluctuations in the C$ seeing a much better productivity performance (Chart 7). While a good portion of that advance was achieved by reduced capacity in low productivity facilities—the reality is that the shrunken but improved Canadian manufacturing sector has never been better at using the workers it has left.

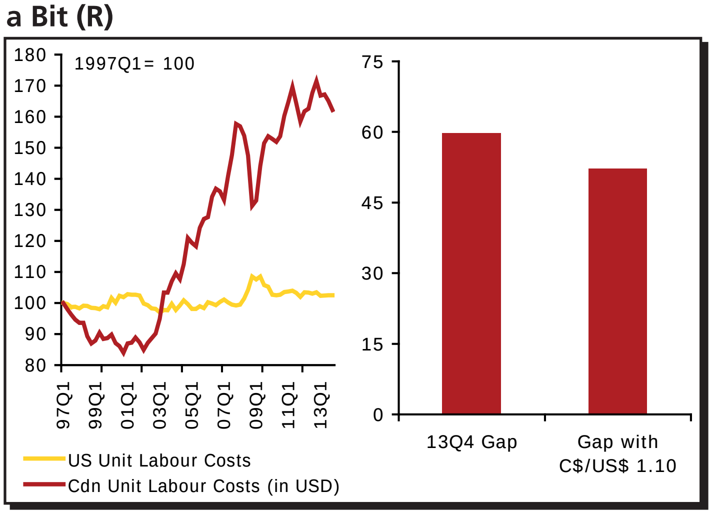
Identifying Opportunities

To uncover the sub-sectors of the manufacturing industry that have best adapted to the discipline imposed onto them from the macro environment, we used some definitive characteristics as filters. After all, prospects for a particular industry will vary notably, based on strategic actions taken since the recession, its sensitivity to changes in the value of the dollar, and its ability to benefit from an improved US economic picture.

More specifically, we have developed a framework based on the following forward-looking indicators: (a) productivity growth since 2009, as a measure of sector dynamism; (b) industry sensitivity to changes in Canadian net exports (i.e. the coefficient of net export),

Chart 6

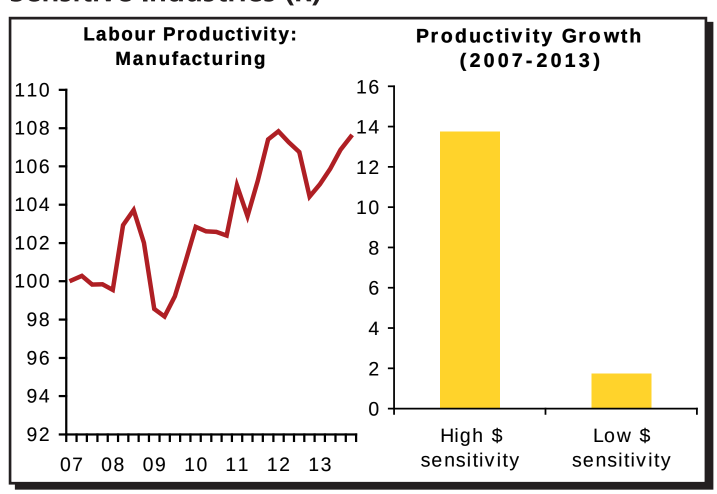
Unit Labour Costs Diverge (L); A Weaker C$ Helps a Bit (R)



Source: BLS, Statistics Canada, CIBC

Chart 7

Labour Productivity Improving (L), Mainly in C$ Sensitive Industries (R)



Source: Statistics Canada, CIBC

as a measure of the direct impact of currency swings on a given industry; (c) foreigners' share of the Canadian market (import penetration), as a measure of the potential gains from reduced foreign competition due to a weaker dollar; (d) Canadian market share of US imports (export penetration); (e) capacity constraints, measured by the deviation of the utilization rate from long term average; and finally (f) the labour share of total production costs.

Aggregating these measures, we have produced the ranking illustrated in Chart 8. Sitting atop the ranking, the Wood Products industry has seen strong growth in productivity since the beginning of the recovery, and its net export coefficient is above average. While its import penetration rate is relatively low, the industry is the leader in export penetration to US markets at close to 50%. A clear negative is a relatively high level of capacity utilization. However, with continued growth the industry will likely see a strong pace of investment to meet demand.

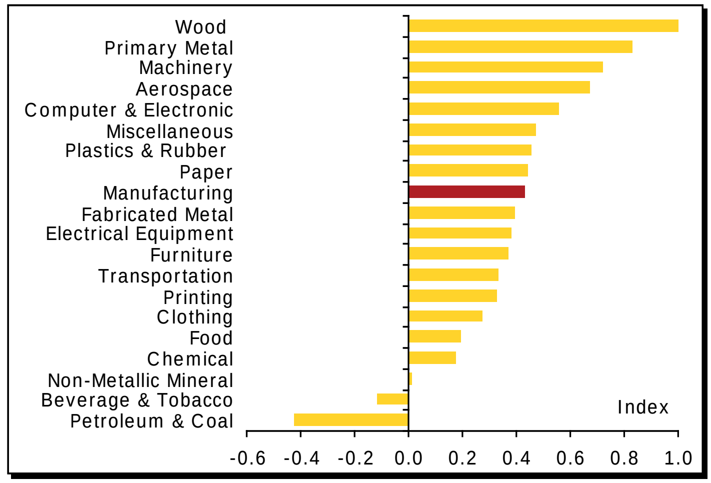
Leading the way in productivity growth since 2009, Primary Metals is well positioned to take advantage of the decline in the value of the dollar thanks to its favourable net exports position. Also helping here is the fact that over half of the domestic market is supplied by foreign sources, suggesting a weaker currency will—at the margin—benefit domestic suppliers. The industry is also well positioned to take advantage of a stronger US economy, accounting for more than 25% of total US imports. At only 2% below its long term average, however, growth might be limited by capacity constraints, a fact that also suggests a stronger path of capital spending in the coming years.

Machinery manufacturing has the strongest net export position in all of the manufacturing sub-industry groups, and with the majority of the current market belonging to foreign imports of machinery, it is best positioned to capitalize on a swooning loonie, driving up the price of imported competition. Despite having registered less than stellar productivity gains since 2009 at a 6.6% improvement, capacity constraints, here too, may mean more capital investment in the near future.

The Aerospace sub-industry group is another that will benefit from a weaker loonie due to its advantageous net exports and import penetration positions. These factors led to it being ranked higher than its Transportation industry

Chart 8

Industries Ranked By Brightest Prospects



Note: Expressed as a share of highest ranked industry
Source: Statistics Canada, CIBC

group parent, which has shown more productivity growth than Aerospace (25% vs. 10%). However, the broad Transportation industry group's productivity gains have been driven by plant closures and capacity downsizing which have hampered its net exports position, which falls behind Aerospace's.

A name surprisingly absent from the top of our rankings is the Food manufacturing industry. In recent years that industry has been a winner, primarily in the domestic market sense, but has had a less impressive net export ranking. Furthermore, because it has fared better than most of its peers, it has not had to increase its productivity as fast as others, marking a slight 2% gain since 2009. Because domestic manufacturing already takes up so much of the Canadian market, it will have to nurture its export markets in search of growth.

Talks regarding large scale repatriation of manufacturing activity to North America are highly pre-mature. But there is no denying that the post-recession leaner and smarter North American manufacturing sector is better positioned to stop the bleeding. US manufacturers can utilize their improved competitive position and brand advantage to continue their advance into the emerging market consumer space. As for Canadian firms, the long and painful adjustment is starting to pay off, with many industries better positioned to take advantage of the weaker dollar to regain positions in US markets and to better integrate into global supply chain opportunities.

ECONOMIC UPDATE

CANADA	13Q4A	14Q1F	14Q2F	14Q3F	14Q4F	15Q1F	2013A	2014F	2015F
Real GDP Growth (AR)	2.9	1.8	2.0	1.7	2.0	2.7	2.0	2.2	2.4
Real Final Domestic Demand (AR)	1.2	1.9	2.0	1.7	1.7	1.9	1.4	1.7	2.0
All Items CPI Inflation (Y/Y)	0.9	1.3	1.8	1.8	2.2	2.0	0.9	1.8	2.2
Core CPI Ex Indirect Taxes (Y/Y)	1.2	1.3	1.5	1.7	2.1	2.0	1.2	1.7	2.1
Unemployment Rate (%)	7.0	7.0	6.9	6.8	6.7	6.5	7.1	6.8	6.5

U.S.	13Q4A	14Q1F	14Q2F	14Q3F	14Q4F	15Q1F	2013A	2014F	2015F
Real GDP Growth (AR)	2.6	1.6	3.8	3.3	3.4	2.7	1.9	2.9	3.1
Real Final Sales (AR)	2.7	3.2	4.0	3.6	3.4	2.7	1.7	3.1	3.1
All Items CPI Inflation (Y/Y)	1.2	1.4	1.7	2.0	2.6	2.5	1.5	1.9	2.4
Core CPI Inflation (Y/Y)	1.7	1.6	1.8	1.9	2.0	2.2	1.8	1.8	2.2
Unemployment Rate (%)	7.0	6.7	6.5	6.3	6.2	6.1	7.4	6.4	6.0

CANADA

After January's bigger-than-expected bounce from ice storm-damaged December, we upped our Q1 real GDP forecast by two ticks to 1.8%. An auto- and energy-led two-way trade rebound brought Canada’s goods trade balance to the black in February—a victory for the swooning loonie. And a hearty March Labour Force Survey dropped our unemployment forecast down a tick for the year. We’ll keep a close eye on housing though, as a few more disappointing starts numbers would leave us without a bridge to the business capital spending that will only arrive in 2015.

UNITED STATES

The thaw following this year’s harsh winter is slowly bringing with it some better US data, supporting our call for a significant rebound in growth during the spring. That has come a little too late for first quarter GDP, which we still see reaching only 1.6%. However, recent acceleration in working hours and expectations for a pick up in consumer and construction spending should set the stage for growth of almost 4% in Q2. Better economic prospects appear to be underpinning a mini-recovery in labour force participation, which while helping growth sees us anticipating a slightly higher unemployment rate this year than we had previously.