Economics

Economic Insights

August 5, 2014

Patient Poloz vs Gentle Janet

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An impressive drop in the jobless rate, but a less than impressive trend in real output. That's the picture that emerges looking back at the US economy, not only in the first half of 2014, but really over the full period of this recovery. The jobless rate has fallen faster than employment has grown, due to temporary cyclical and more lasting demographic forces squeezing the growth rate in the available labour force. Output gains have been dented by the failure of productivity to resume its pre-recession trend.

How does this schism between jobs and real GDP play out for the Fed? It's a double edged sword. Since one half of its "dual mandate" is to attain full employment, more rapid progress on that front cuts towards an earlier first rate hike by the central bank. The glut of part-time workers still seeking full-time jobs implies that there's still more labour market slack than meets the eye (see pages 3-5), but Janet Yellen's Fed won't wait until all the slack is gone before moving off an emergency-style zero overnight rate.

In light of the job gains, we're advancing our call for a move to an even quarter-point funds rate to March 2015, having previously projected a Q2 hike. The calm in the bond market won't survive that realization for long.

But slower trend GDP at the same time leans towards fewer Fed hikes over the coming years, so a jump in bond yields in 2015 could represent a buying opportunity. As we derived earlier, the statistical relationship between the neutral rate and potential GDP growth suggests a mid-cycle US funds rate of only 2½%. That won't be the peak (at some later stage, the Fed will be in a tightening stance), but it's still lower than the Fed's 3¾% medium term call.

For the Bank of Canada, the US jobs-GDP gap also cuts two ways. An earlier than expected hike by the US would allow the Bank to raise Canadian short rates here without fear of excessive C$ strength.

But Governor Poloz has been clear that he won't see the economy on a sustainable expansion path, justifying monetary tightening, until real exports and related capital spending supplant households as a growth driver. Our own analysis warns that consumption and housing may not be able to hold the fort much longer (see pages 6-8), with some factors behind their recent pace likely to fade.

It's US growth, not employment, that drives Canadian export activity. Softer US trend GDP gains lean against a quick acceleration in Canadian export volumes, which might need some juice from a still-weaker loonie. As a result, we see no reason to move up the timing of the first BoC rate hike, which could be a half year later than the Fed. Patient Poloz will outlast Gentle Janet in the contest to see who blinks first.

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

MARKET CALL

- It's a bit of a broken record. We once again have to trim our near term (September) long rate projections, as the bond market holds in despite momentum in key US indicators. Global risk factors were partly responsible for holding down North American yields, and a temporary stall in equities could do the same for a while. But a healthy second half growth rate for the US, and a tightening labour market, has us holding onto our previous targets for higher yields in 2015.

- At the short end, we're moving up our call for the first Fed hike by one quarter, to March 2015, a meeting that has a new forecast and press conference scheduled. The adjustment takes into account the more rapid pace we've been seeing in payrolls growth. Given a more sluggish trend in jobs in Canada, the fact that rates are already at 1%, and the need to see exports and capital spending take the helm, we're leaving our call for a more patient BoC intact.

- We recommended hedging against medium term C$ weakness at 1.07 on dollar-Cad. The move to a softer Canadian dollar has come a bit sooner than we projected. There could be a pause in that action in the near term, but we see a weaker C$ in 2015 as the Bank of Canada lags behind the Fed on rate hikes.

INTEREST & FOREIGN EXCHANGE RATES

		2014			2015				2016	
END OF PERIOD:		**1-Aug**	**Sep**	**Dec**	**Mar**	**Jun**	**Sep**	**Dec**	**Mar**	**Jun**
CDA	Overnight target rate	1.00	1.00	1.00	1.00	1.00	1.25	1.50	1.50	1.50
	98-Day Treasury Bills	0.92	0.95	0.95	1.00	1.05	1.20	1.45	1.45	1.45
	2-Year Gov't Bond	1.08	1.20	1.50	1.65	1.90	2.20	2.20	2.20	2.30
	10-Year Gov't Bond	2.14	2.40	2.70	2.85	3.10	3.30	3.45	3.35	3.20
	30-Year Gov't Bond	2.68	2.90	3.20	3.40	3.50	3.55	3.60	3.50	3.45
U.S.	Federal Funds Rate	0.10	0.10	0.10	0.25	0.50	0.75	1.00	1.25	1.25
	91-Day Treasury Bills	0.02	0.10	0.15	0.40	0.60	0.85	1.10	1.35	1.25
	2-Year Gov't Note	0.48	0.60	0.80	1.05	1.40	1.65	1.85	1.95	1.90
	10-Year Gov't Note	2.50	2.75	3.10	3.30	3.55	3.70	3.80	3.65	3.50
	30-Year Gov't Bond	3.29	3.50	3.80	4.10	4.25	4.30	4.40	4.30	4.25
Canada - US T-Bill Spread		0.90	0.85	0.80	0.60	0.45	0.35	0.35	0.10	0.20
Canada - US 10-Year Bond Spread		-0.36	-0.35	-0.40	-0.45	-0.45	-0.40	-0.35	-0.30	-0.30
Canada Yield Curve (30-Year — 2-Year)		1.59	1.70	1.70	1.75	1.60	1.35	1.40	1.30	1.15
US Yield Curve (30-Year — 2-Year)		2.81	2.90	3.00	3.05	2.85	2.65	2.55	2.35	2.35
EXCHANGE RATES	CADUSD	0.92	0.93	0.92	0.91	0.89	0.88	0.88	0.87	0.87
	USDCAD	1.09	1.08	1.09	1.10	1.12	1.13	1.14	1.15	1.15
	USDJPY	102	103	103	103	102	101	100	100	100
	EURUSD	1.34	1.31	1.28	1.26	1.27	1.30	1.32	1.32	1.34
	GBPUSD	1.68	1.68	1.65	1.64	1.65	1.68	1.69	1.67	1.68
	AUDUSD	0.93	0.91	0.90	0.88	0.87	0.89	0.91	0.92	0.94
	USDCHF	0.91	0.93	0.96	0.98	0.98	0.96	0.95	0.95	0.95
	USDBRL	2.26	2.35	2.48	2.56	2.52	2.53	2.45	3.20	3.28
	USDMXN	13.20	12.85	12.70	12.85	12.90	13.05	13.13	13.15	13.18

So Far and Yet So Close: Closing the US Labour Market Gap

Avery Shenfeld and Andrew Grantham

It's all about jobs. The US FOMC long ago abandoned the 6½% unemployment threshold at which it previously said it would think about rate hikes. But under Yellen's leadership, it's even more tied to progress towards full employment as the key benchmark for a monetary tightening.

Today, the US labour market is both so far, and yet so close, to what the Fed needs to see. Far in the sense that, measured correctly, there is still substantial slack that stands in the way of an inflationary wage-price spiral. But close, since hiring is taking giant leaps, not small steps, in the right direction. And we don't need to close the whole gap to launch a tightening cycle, judging by the lessons of 2004.

Don't Judge the Labour Market Book by its U-Rate Cover

Notwithstanding the July uptick, the tumble in the unemployment rate to 6.2%, from 7.3% only a year ago, has been impressive. There are, however, three other reasons why some say you can't judge the labour market book by its U-rate cover.

Not all of the drop in participation has been demographic. Relative to 2007, there are 1½ million more Americans counted as "out of the labour market" but who say they would work if jobs were available. True, more than 600K of these additional marginally attached workers are over 55 (Chart 1), and might retire before they land a job. But there's still slack in the additional 900K in prime age and youth cohorts, with history suggesting some will return as we cross below 6% unemployment.

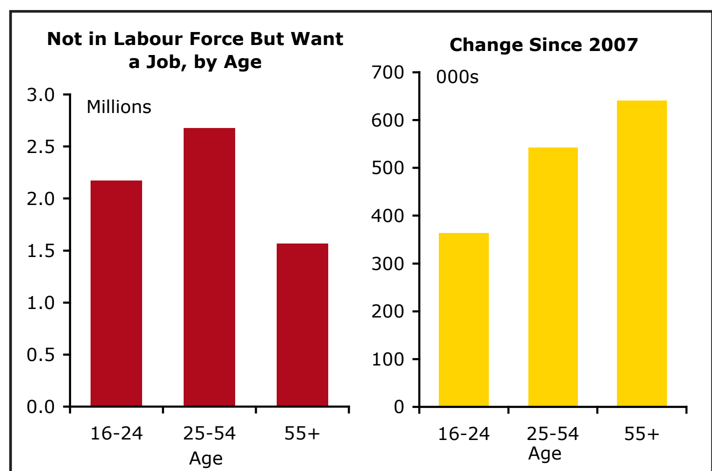
More numerous are the 7½ million who are counted as employed because they have a part-time job, but who say they would work full time if such a job was in the offing. While improving, the share of the labour market stuck in part-time jobs for economic reasons is still well above its pre-recession level (Chart 2).

We found that adding these involuntary part-timers to the unemployment rate creates a measure of economic slack that has a stronger correlation with real wage inflation. And wage growth doesn't typically take off until the combined measure is sub-10% of the labour market (Chart 3). We've got some ways to go there. While today's headline jobless rate is in line with some tightening cycles (Chart 4, top), the Fed has never initiated a tightening cycle in the last half-century with the jobless + involuntary part-time rate above 10½% (Chart 4, bottom).

Hawks bring out a third issue that leans towards earlier wage pressures. More of today's jobless have been out of work for a half-year or more. Have they lost so much

Chart 1

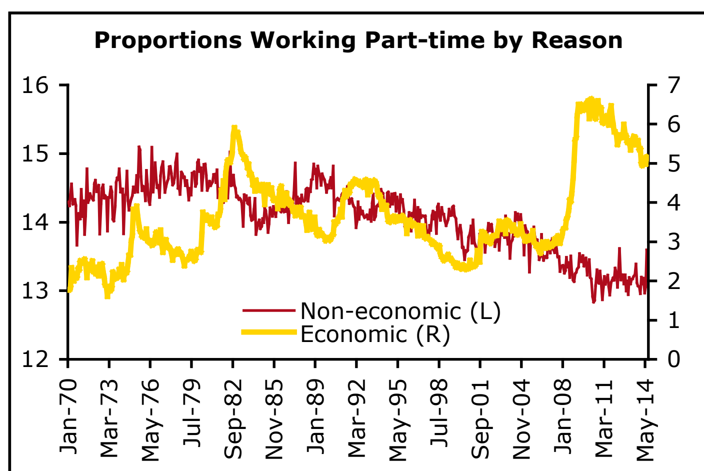
Older Generation a Small (L) But Important (R) Proportion of Marginally Attached



Source: BLS, CIBC

Chart 2

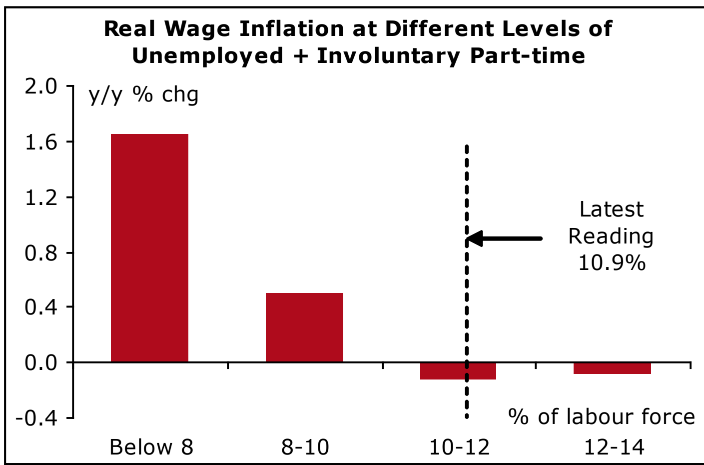
Working Part-time for Economic Reasons Rather Than by Choice (% of Labour Force)



Source: BLS (adj for '94 definition change), CIBC

Chart 3

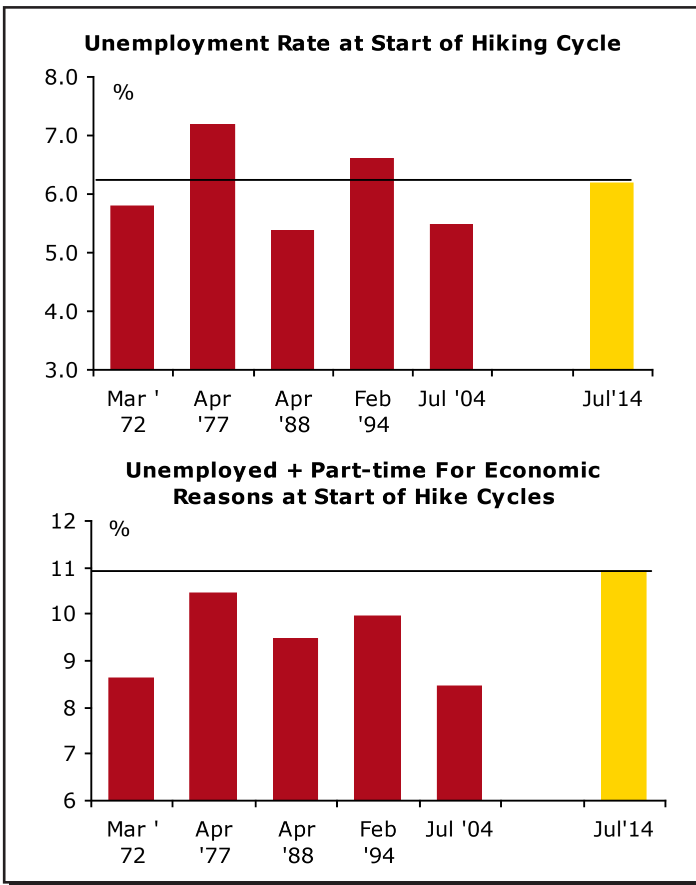
Under-employment Needs to Fall For Real Wages to Pick Up



Source: BLS, CIBC

Chart 4

Unemployment Signals Fed Could Act Now (T); Under-employment Doesn't (B)



Source: BLS, CIBC

skill and employability that their existence doesn't hold down wage inflation? While a Brookings study argued that was the case, a Fed research paper cast doubt on that finding by examining regional data."[1] For her part, Yellen has come down firmly on the side that the long-term unemployed are a buffer against wage inflation.

Closing in Fast

It's tempting to jump to the conclusion that Fed hikes are still a long way off. But slack can disappear in a hurry with hiring heating up. One meeting prior to beginning an aggressive tightening cycle in 2004, the Fed minutes described the labour market as having "considerable slack" with wage gains only "moderate."

We warned six months ago that the US unemployment rate was likely to drop much faster than consensus or Fed expectations (see "US Unemployment, How Low Can It Go?" February 2014 Economic Insights). But even relative to our projection, progress has been surprisingly swift, particularly given that real GDP growth missed on the downside.

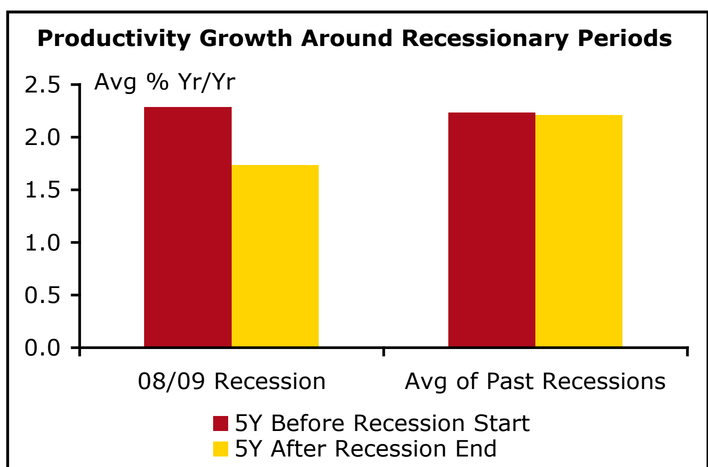
In part, the ability of the economy to rush to full employment amidst unexciting GDP growth reflects the labour force dynamics discussed above. Some of that is temporary, and will rebound as some prime-age and youth start looking again. Most of it reflects the now well-trodden territory of demographics—weaker growth in the working-age population that will permanently slow potential GDP ahead.

But we've also had surprisingly soft growth in output per hour. Labour productivity has dropped during recessions as businesses retain excess staff for a while, but five years hence, it typically has rebounded to pre-recession growth rates. Not so in this cycle (Chart 5). That could be attributable to a slower track for business capital investment relative to past cycles, even in the face of brisk profit gains.

It remains to be seen whether that driver of potential growth remains on such a slow track ahead. But for now, slower potential growth implies an earlier attainment of full employment.

Chart 5

Productivity Hasn't Lived Up to Pre-recession Pace Thus Far



Source: BLS, CIBC

The Jobs are Already There

In the short term, there's another reason to expect the jobless rate to continue to head lower. The jobs are already there. Or at least, the job openings. While there are always unfilled positions, the ratio of openings to hiring is well above historic norms (Chart 6, left).

If we filled enough of the openings to take the ratio to hiring to the historic average, that alone would drop the jobless rate to 5.7% (Chart 6, right). Since openings are evident in a wide range of sectors and regions, rather than narrowly concentrated, there do not appear to be skill or geographic barriers to making progress on that front over the balance of this year.

Indeed, many businesses are already using the stop-gap approach of working their existing employees longer hours (Chart 7), a remarkable development given the atypically high number of part-time workers. The good news is that these extra hours are showing up in higher paid sectors, so if they presage more permanent hiring, it will bring a much needed income boost.

The Spin

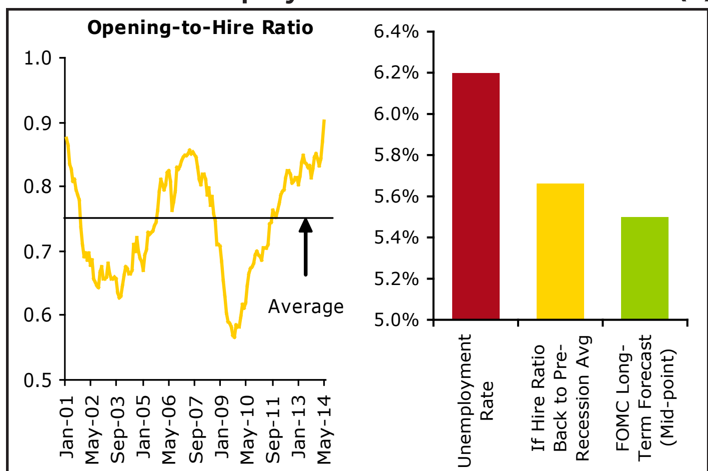
Look for the official unemployment rate to drop to 5.8% by early 2015. That will also likely be accompanied by progress in getting those part-time workers into the full-time jobs they seek, and at least a flatting out of the participation rate. Wage rates might still be tame as we enter 2015, but the Fed has often initiated a tightening cycle ahead of seeing the whites of a wage spiral's eyes.

For now, Janet Yellen has every incentive to spin the data the other way. The Fed learned its lesson on a too-early mention of tapering in mid-2013; open mouth operations can tighten financial market conditions much earlier than desired. But we're moving up our forecast date for the first rate hike to March 2015 (from Q2), and as it did on the tapering warning, the bond market will likely overreact at some point to that approach of bad news.

Note: (1) Krueger, Alan, et al (2014). "Are the Long-term Unemployed on the Margins of the Labor Market?." Brookings. Compare with Kiley, Michael T (2014). "An Evaluation of the Inflationary Pressure Associated with Short- and Long-term Unemployment". Fed Res Bd. Working Paper.

Chart 6

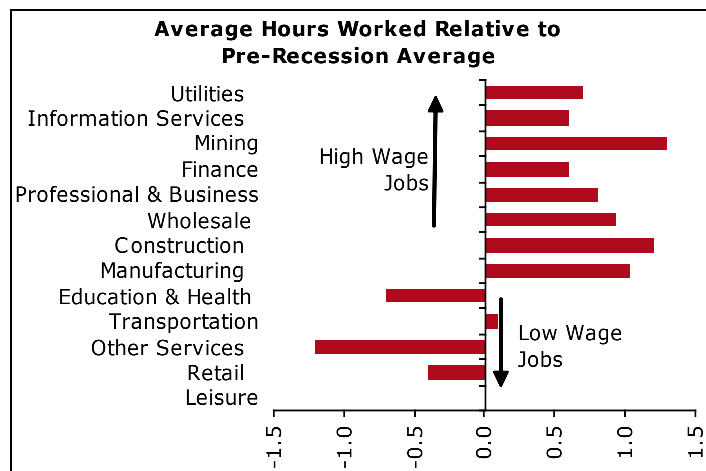
Openings Not Resulting in Hires (L), Otherwise Unemployment Would be Lower Still (R)



Source: BLS, CIBC

Chart 7

High-paying Sectors Working Staff Harder Than Pre-recession



Source: BLS, CIBC

How Long Can Consumers Hold the Fort?

Benjamin Tal, Nick Exarhos and Avery Shenfeld

The Canadian growth story isn't following the script. For the last couple of years, the narrative was that an exhausted and heavily indebted consumer would take a break, and a cash-rich corporate Canada would boost capital spending and take the reins of the Canadian economy. The export sector would also fillip growth, spurred on by a turn in global demand.

But, to date, corporate Canada is still reluctant to boost outlays, and households are finding ways to unlock consumption in the face of a mediocre labour market. Though Q1 wasn't a barn-burner, nominal household spending was still up by 4.2% year-on-year (Chart 1, left). Furthermore, its contribution to GDP growth continues to remain in line with its long-term average and Q2 looks poised to see an acceleration. And though autos outperformed so far this year, sales ex-autos and gasoline are also ticking higher (Chart 1, right).

Weak Prices Lent a Hand

It has since started to heat up, but low inflation in the early part of the year played a role in just how much consumers got for their buck. That softer trend in prices—in part a result of the competition that the Bank of Canada often cites—left real retail sales averaging a healthy 3½% pace since early 2014.

But as for how much household consumption bolstered real GDP, prices don't explain the entire story. Though the CPI dropped off at the tail end of last year, the implicit price deflator for all household consumption accelerated (Chart 2, left)—meaning that the consumer's real strength was unlocked elsewhere.

What price trends did change was the composition of the consumption basket. The share of the consumer's budget allocated to health paused precisely because of stalling—and falling—prices (Chart 2, right). That freed up money to be spent on other things for now. But looking ahead, with health prices climbing again, and an aging population tilting consumption in favour of health care, other spending will come under some pressure.

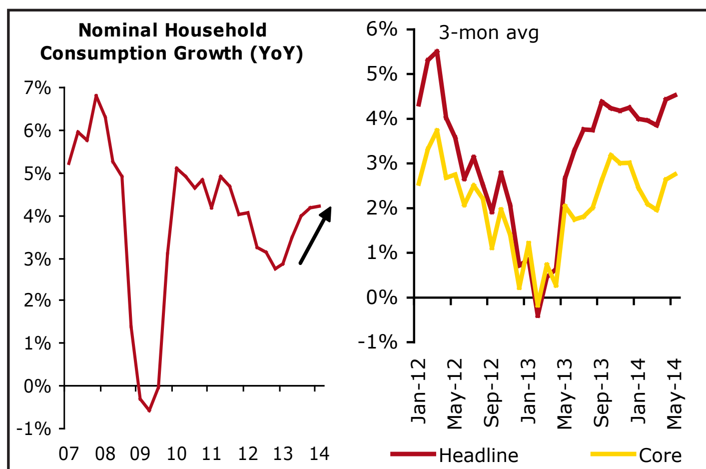
Consumers Overcoming the Labour Market

The strength in Canadian consumption came in the face of a labour market that managed to generate a meagre 6K new jobs per month over the past 12 months—a pace that wouldn't otherwise be enough for consumers to anchor healthy spending on. In fact, real retail sales started to accelerate just as the labour market got stuck in neutral (Chart 3, left).

Furthermore, looking at the difference between growth rates in total compensation and retail sales shows that spending gains are outpacing the gains in Canadians' salaries (Chart 3, right). In fact, nominal net disposable income was up 3.2% year-on-year in the first quarter of this year, decelerating from its 4.2% pace in Q1 2013.

Chart 1

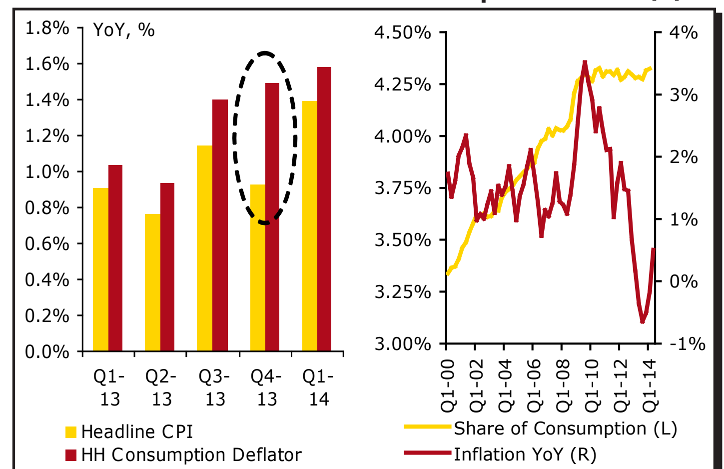
Household Spending Accelerating (L), Reflected in Headline and Core Retail Sales Growth (R)



Source: Statistics Canada, CIBC

Chart 2

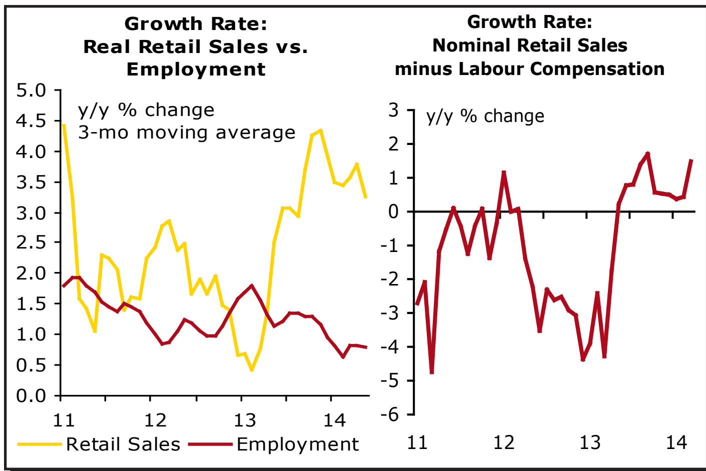
Real Consumption Not Just Driven by Prices (L) Health Care Inflation and Consumption Share (R)



Source: Statistics Canada, CIBC

Chart 3

Real Retail Sales and Jobs Diverge (L), Along with Spending and Wages (R)



Source: Statistics Canada, CIBC

Not Borrowing, But Feeling Good

The natural assumption is that Canadians have borrowed more to supplement weak income gains. But if in the past the consumer used debt to bridge the gap between what's desired and what's affordable, that isn't the case today. Overall household credit is currently rising by just over 4% on a year-over-year basis—the slowest pace of credit expansion since 1995. In fact, that's the slowest pace for credit growth in any non-recessionary period over the past 40 years (Chart 4, left).

What's more, non-mortgage loans that usually finance ongoing consumption are rising by only 2% on a year-over-year basis and have been falling relative to income over the past two years. Credit card balances outstanding have not risen at all in the past year; ditto for the once robust lines of credit. Direct loans are up by 7.5% on a year-over-year basis—mostly due to the near-18% increase in car loans. Note though, that these latter loans are often offered at lower rates than what consumers can get elsewhere and for other purchases, in some way representing a subsidy on the part of manufacturers and dealers. Furthermore, this area of growth is still only a small slice of total consumer credit (Chart 4, right).

It wasn't borrowing, but until recently, elevated confidence and its impact on savings, that provided the fuel. Confidence held up well in quarterly readings even in the face of a challenging jobs market (Chart 5, left), although recent monthly results showed a worrisome retreat.

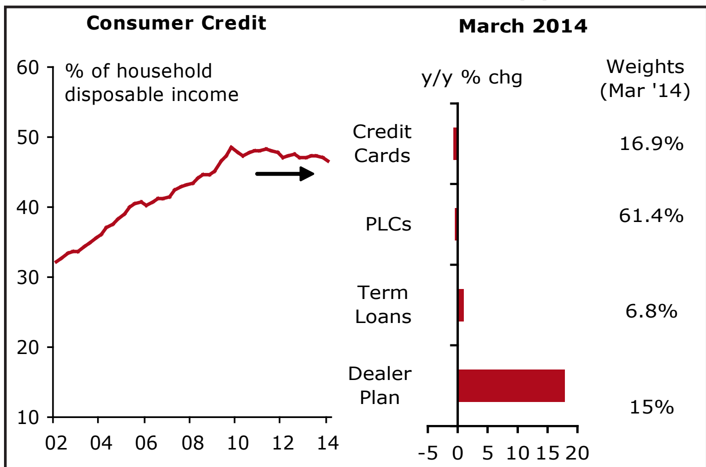
Why were consumers confident up to this summer, when their job prospects were lacking? Weak disposable income gains have been offset by strong increases in net worth (Chart 5, right). Equity markets have been healthy, and home prices continue to advance in real terms.

Thus, sanguine Canadians have stabilized their savings rates at around 5% in 14Q1, a drop from levels seen in early 2013. With the asset side of consumer balance sheets allowing Canadians to reduce how much they squirrel away, more money has been temporarily available for spending.

Falling rates on pre-existing debt—which lowered both the incentive to save and debt-servicing costs—provided consumers with additional sources of relief (Chart 6, left). In fact, interest payments as a share of disposable income fell over the past year by a full percentage point to a record low of 7.1% in the first quarter. Had interest

Chart 4

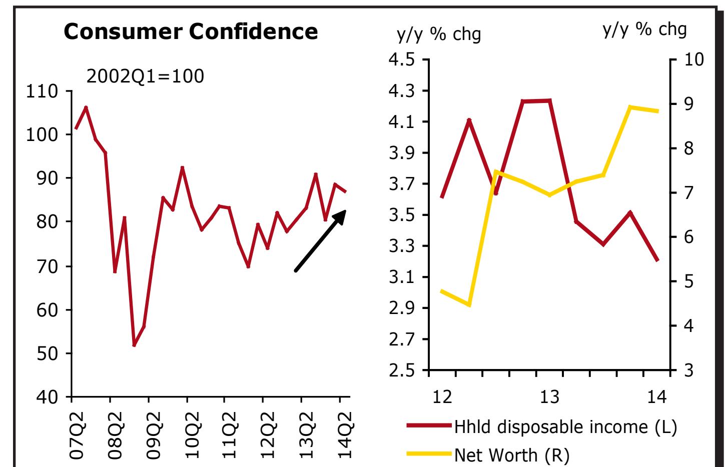
Consumer Credit Flatlines (L), With Notable Growth Concentrated in Auto-Loans (R)



Source: Statistics Canada, CIBC

Chart 5

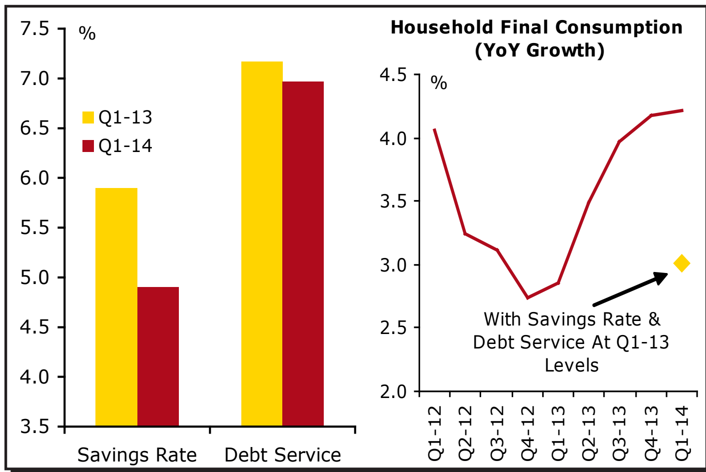
Confidence Riding High (L), On the Back of Net Worth Gains (R)



Source: Statistics Canada, CIBC

Chart 6

Savings Rate and Interest Burden Lower (L); Boosting Consumption Growth (R)



Source: Statistics Canada, CIBC

payments and the savings rate stayed constant since Q1 2013, household consumption would have been around a percentage-point lower (Chart 6, right).

Can't Hold on Forever

The Canadian housing market has had no want for headlines. Investment in residential real estate has been a notable underpinning to Canada's economy, especially as a stronger loonie in the aftermath of the financial crisis helped hollow out export-oriented sectors. The current boom in housing comes as the home ownership rate in Canada has crept steadily higher over the past few decades (Chart 7, left). With the latest reading standing near 70%, a large majority of Canadians are now direct beneficiaries of strength in home prices—a fact already well illustrated in net worth figures.

But you don't need to be a housing bear to see how a higher degree of home ownership can cut the other way on the upside of the interest rate cycle. With housing-related spending standing at almost 30% of the consumption basket (Chart 7, right), there is an increased chance that household consumption will be tested if housing no longer remains a focal point for Canadians.

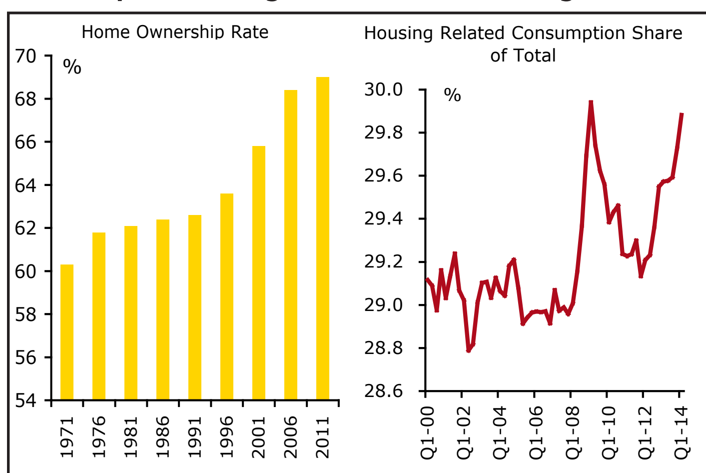
Sure, higher rates might slow or even dent home prices, but a higher concentration of home owners and, given home prices, Canadians carrying larger mortgages, means that higher interest rate hikes in this business cycle will pack more punch. In fact, even though household debt—including the mortgage variety—has been building more slowly recently, it still stands at over one-and-a-half times disposable income.

Applying our forecasts for Canadian rates to the historical relationship they have held with interest costs suggests that Canadians will soon be faced with paying 100 basis-points more in interest on existing debt by the first quarter of 2016 (Chart 8, left). Those higher rates would mean close to $18 bn dollars more in interests costs at today's debt levels (Chart 8, right). That figure represents over 1.5% of current household consumption.

How long can consumers hold the fort? Not long. Confidence has started to slip, and the savings rates is vulnerable to a climb ahead. So far, the consumer has allowed the economy to buy time while the corporate sector sat on its hands. But though July auto sales were impressive, the clock is ticking on the arrival of the hoped-for but yet to be realized rotation to business spending and exports.

Chart 7

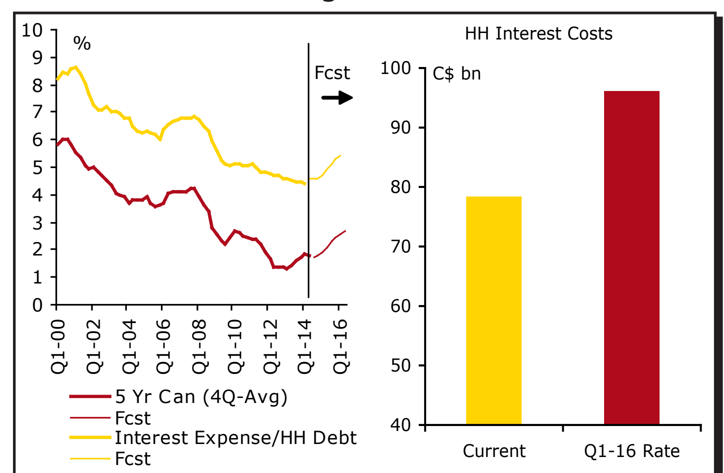
Canadian Home Ownership Up (L), Related Consumption a Large Share of Total Budgets (R)



Source: Statistics Canada, CIBC

Chart 8

Rates to Rise (L) Putting a Dent in Wallets (R)



Source: Statistics Canada, CIBC

Stocks: Time for a Little Defense

Peter Buchanan

It's summertime and the livin' is easy. The TSX has bested other major equity markets this year en route to reclaiming record ground, while earnings growth last quarter was the best since 2012, based on the estimates.

Despite July's bumpy end, North American markets have now gone two years without a full-fledged correction. While that doesn't clearly indicate one is pending, Warren Buffet's famous dictum, about being fearful when others are greedy, is worth keeping in mind.

Long Term Positives Still In Place

No picture, though, is entirely black or white. Some long term positives are reasons why a summer "tune up"—taking some money off the table, upping defensive exposure—appears more sensible than all-out, radical de-risking.

Foremost among these is the gradually improving economic environment. The US economy clearly disappointed earlier in 2014. Growth, nonetheless, appears to have turned the corner, with Q2 performance coming in well above consensus, and we expect GDP to track above 3% in the second half. Canada and Europe are also expected to fare moderately better in the second half (Chart 1), with recent indicators confirming stabilization in China.

Despite concerns in some quarters, earnings also appear to be holding up decently this side of the border, as noted. Energy is expected to account for the bulk of the dollar increase in Q2's TSX earnings firepower, with an over 40% year-on year rise aided by strength in both oil and natural gas and tighter spreads. Still, the gains there are only part of a broader positive story. The industrials, base metals, IT and health care sectors are also expected to do materially better, with earnings growth in eight of ten TSX groups surpassing the comparable S&P 500 segment (Table 1).

Third is monetary policy. While the Fed was still singing the labour market blues as July ended, US policy rate increases could start by March 2015. Despite the fears of some, the reality is that the early stages of rate hike cycles haven't ordinarily been toxic for stocks. In fact, equities have risen in the first year of all but two of nine Fed tightening cycles in the last four decades.

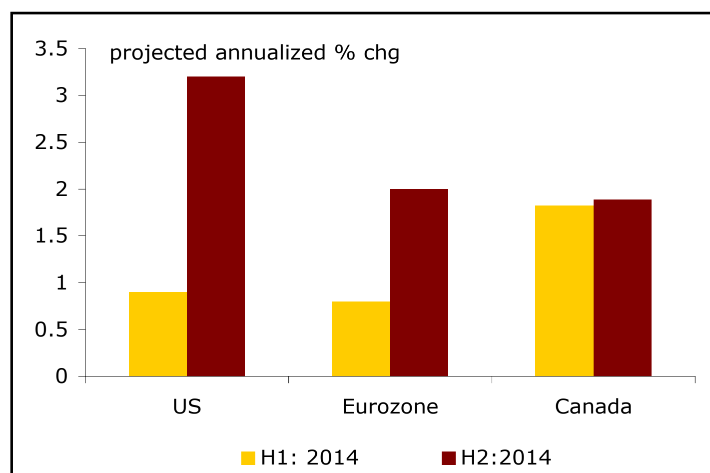
On a further potentially constructive note, inflation appears to be picking up modestly in both the US and Canada. The Goldilocks rule applies here. A 2-3% pace has been the friendliest for stocks historically—enough to lift margins without incurring aggressive central bank pushback (Chart 2).

Sabre Rattling or the Guns of August Again?

What could throw things off kilter? One threat is geopolitics. Iraq, the world's seventh largest oil producer, is reeling, and fraught relations with Russia have revived

Chart 1

GDP Growth: A Warmer Second Half



Source: Statistics Canada, BEA, Eurostat, CIBC

Table 1

TSX Composite & S&P 500 Earnings Growth by Sector, Recent Quarters

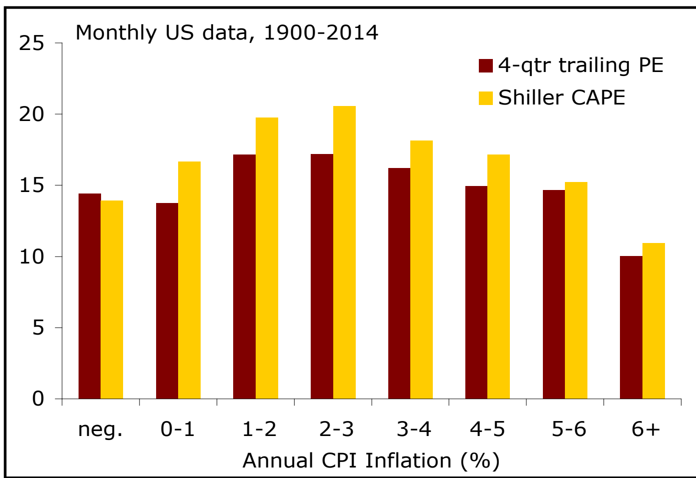
	TSE Composite				S&P 500
	13:Q3	**13:Q4**	**14:Q1**	**14:Q2***	***14:Q2****
Energy	31.1	-6.3	46.2	**42.0**	*7.6*
Materials	-34.9	-44.4	-44.5	**-20.1**	*10.3*
Industrials	2.2	3.8	8.5	**28.0**	*5.9*
Cons Discretionary	7.4	-3.3	15.7	**12.1**	*6.8*
Cons Staples	1.4	-14.9	7.5	**6.9**	*3.0*
Health Care	53.3	89.9	53.9	**52.9**	*8.1*
Financials	17.4	1.0	10.2	**7.8**	*-3.6*
-Banks (10)	7.6	6.4	6.9	**4.3**	*-7.4*
-Insurance	59.1	9.2	11.2	**22.2**	*-2.3*
Info Tech	28.4	-64.7	-12.0	**25.3**	*14.6*
Telecom Svcs	1.7	-13.5	2.5	**4.3**	*11.1*
Utilities	0.2	30.6	-2.7	**2.2**	*-1.1*
All Sectors	9.4	-6.0	10.2	**13.3**	*6.0*
-ex resources	13.0	1.0	9.9	**11.0**	*5.6*

** blended consensus*

Source: Bloomberg, CIBC

Chart 2

The "Goldilocks Rule"—Stocks Like a Whiff of Inflation



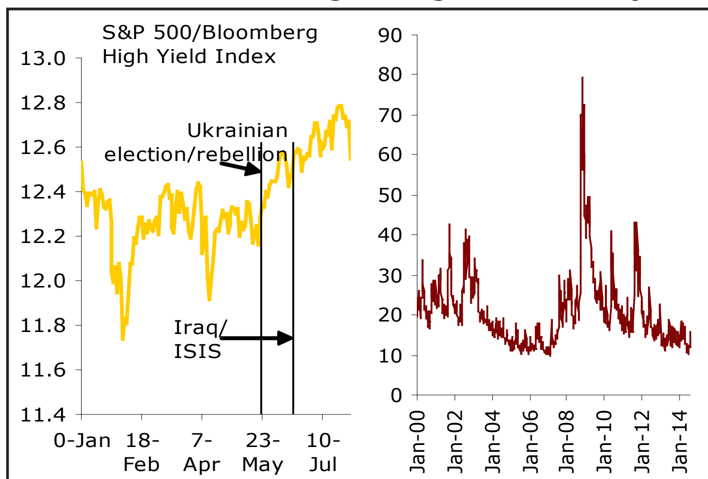
Source: R.J. Shiller, CIBC

Cold War memories. Even as Treasuries have rallied and high yield spreads have widened, equities have remained relatively well bid (Chart 3-left). What should worry stock investors most is not the stock market's reaction to heightened geo-tensions, but rather the lack of a sharper one. The record, or near-record, lows of both the VIX and put-to-call ratios contrast with past crises (Chart 3-right). Monetary policy shifts, moreover, have often lifted volatility in the past, a potentially even larger risk this time as central bankers grapple with the how and when of reducing record stimulus.

Profits sway or buoy share prices, primarily to the extent improvement is unanticipated. Although we expect continued decent growth, a difference—vs a quarter or two ago—is that appreciable short-run improvement is already largely priced in. Our earnings model is projecting a near-consensus 13% rise in TSX operating earnings this year (Chart 4). While Canada may have a bit more low hanging productivity fruit than the US, the reality is that margins in both countries are not low by historic standards, limiting prospects for sharp improvement (Chart 5, Table 2).

Chart 3

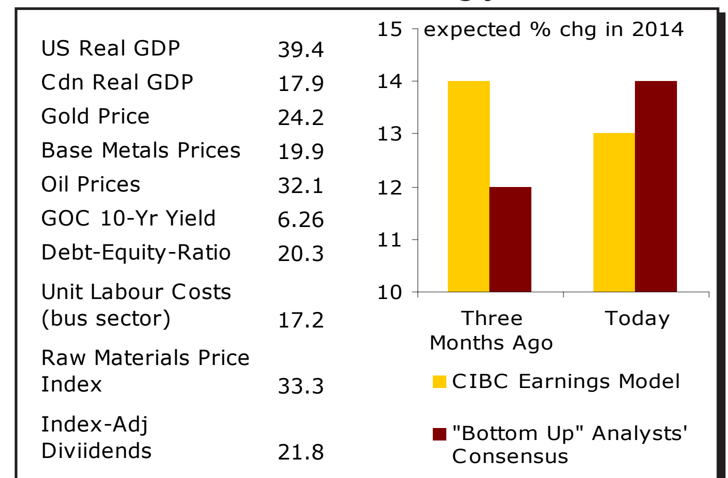
Stocks Have Been Outperforming Other Risk Assets (L), VIX Still Signalling Low Anxiety (R)



Source: Bloomberg, CBOE, CIBC

Chart 4

TSX Earnings Model Components and Weightings* (L), Better 2014 Results Increasingly Baked In (R)



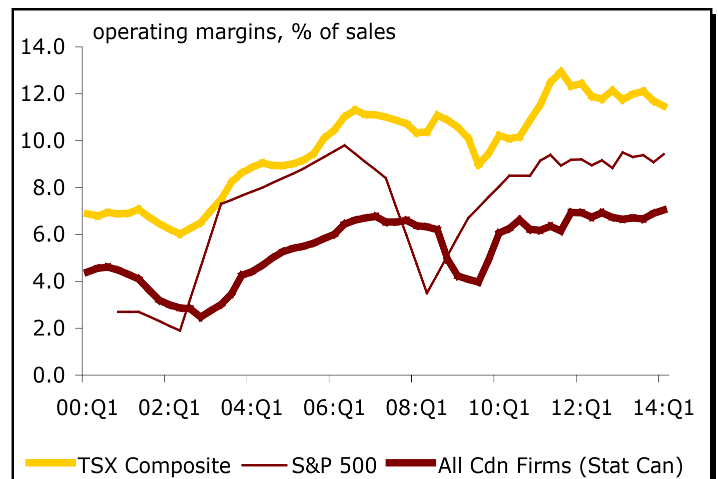
** based on standardized regression coefficients Source : Bloomberg,CIBC*

Canadian Valuation Discount Has Largely Disappeared

Though more reasonable than at some past market tops, valuations aren't cheap, lastly, with forward PEs for both the S&P 500 and TSX, in the 15 ½ -16 range, a point or so above historical averages. While the TSX's outperformance vis-à-vis the S&P 500 year-to-date has stemmed from strong profit growth, it has also reflected

Chart 5

Profit Margins High by Historical Standards



Source: Statistics Canada, Bloomberg, CIBC

Table 2

Profit Margins by Sector, 2014

	TSX Comp.	Improving/De-teriorating	S&P 500
	%		%
Railroads	22.35	+	17.81
Hotels, Rest. & Leisure	13.82	+	11.48
Diversified Telecom	12.23	+	8.36
Drug Retail	10.78	+	3.73
Chemicals	10.73	-	9.46
Real Estate Mgment & Dev	9.07	+	5.33
Paper/Forest Prod	8.08	+	6.31
Media	8.02	-	11.53
Oil, Gas, Other Fuels	7.92	-	7.34
Auto Components	4.74	+	5.86
Multi Line Retail	3.92	-	4.40
Airlines	1.06	+	6.80

Source: Bloomberg, CIBC

somewhat greater multiples expansion (Chart 6-left) cutting into an earlier, appreciable north-south valuation gap. Earlier in the year, the TSX's forward multiple was about 5% cheaper than the S&P 500. Adjusting for differences in sector weightings, cap size and other factors, we estimated the typical Composite member was nearly 10% cheaper than its S&P 500 counterpart per dollar of forward earnings. That's discount is all but gone now (Chart 6-right).

Cyclicals Pricier After Spirited Run

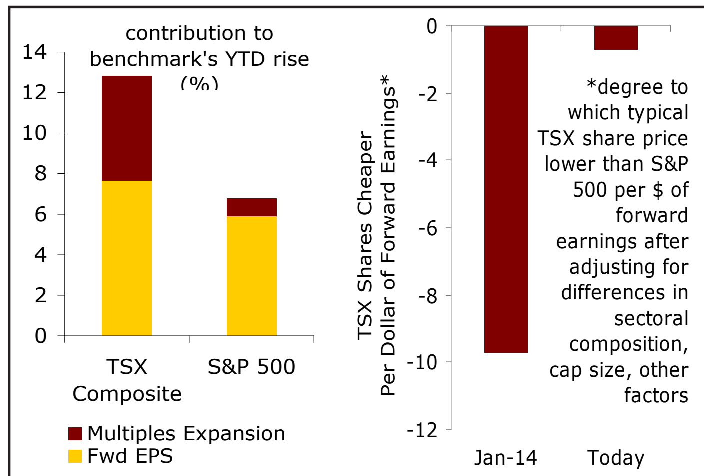
What conclusions should investors draw? Valuations are high enough that the coming few months could see dimished upside, making it timely to take some money off the table. But the longer term positives suggest that any significant correction should be seen as a buying opportunity.

The TSX's year-ago laggards have been winners in 2014. The resource cyclicals have accounted for nearly 60% of the benchmark's advance. After gains approaching 20% in both cases, neither sector is looking particularly cheap. Energy and Materials forward PEs are about 12-14% above their longer-term historic averages. With inflation not overly high, any material easing in geopolitical tensions could also hurt gold and producer equities. Industrials stock valuations are also starting to look pricey.

Valuations in the financial sector, in contrast, aren't significantly above their long term averages (Table 3). Historically, those segments have afforded a degree of protection from market bumps. The so-called "new

Chart 6

Factors Driving North American Rally (L), Canada "Discount" Has Nearly Vanished (R)



Source: Bloomberg, CIBC

neutral" implies a lower trajectory for yields, adding to the appeal of the above-average dividends firms in those sectors pay. A similar positive logic applies to utilities and telecom stocks, although the exposure of the latter to regulatory and technological uncertainty may not appeal to all investors. With debt levels up and job growth trailing levels stateside, Canadian consumers aren't likely to be as important drivers of the economy in future. Affordable consumer sector PEs nonetheless suggest a good deal of downside risk is already baked into prices, with subgroups like auto parts actually more levered to global than domestic demand.

While value, as always, can be found, a more fully priced market will require investors to dig deeper. A less even ride also warrants shifting to a somewhat more defensive posture.

Table 3

TSX Valuation by Sector

	4-Qtr Fwd Earnings	Index Level	Forward PE Current	Forward PE Avg last 15 yrs
Energy	201	3486	17.3	15.4
Materials	104	2403	23.1	20.3
Industrials	127	2326	18.4	16.5
Consumer Discretionary	107	1634	15.2	16.2
Consumer Staples	175	2925	16.7	16.2
Health Care	117	1628	13.9	15.2
Financials	174	2294	13.2	12.9
Info Tech	8	160	19.5	18.4
Telecom Svcs	81	1191	14.7	15.8
Utilities	99	1892	19.0	17.9
TSX Composite	971	15394	15.9	15.1

Note: Indexes as of July 24th close; 4-qtr fwd earnings are proj. 14:Q2 thru 15:Q1

Source: Bloomberg, CIBC

ECONOMIC UPDATE

CANADA	14Q1A	14Q2F	14Q3F	14Q4F	15Q1F	15Q2F	15Q3F	15Q4F	2013A	2014F	2015F
Real GDP Growth (AR)	1.2	2.5	1.8	2.0	2.7	3.1	2.7	2.0	2.0	2.1	2.5
Real Final Domestic Demand (AR)	-0.3	2.8	1.7	1.6	1.6	2.3	2.0	2.1	1.4	1.2	1.9
All Items CPI Inflation (Y/Y)	1.4	2.2	2.3	2.6	2.4	2.0	2.1	2.4	0.9	2.1	2.2
Core CPI Ex Indirect Taxes (Y/Y)	1.3	1.7	1.9	2.1	2.1	2.1	2.1	2.3	1.2	1.8	2.1
Unemployment Rate (%)	7.0	7.0	7.1	6.9	6.8	6.7	6.7	6.7	7.1	7.0	6.7

U.S.	14Q1A	14Q2A	14Q3F	14Q4F	15Q1F	15Q2F	15Q3F	15Q4F	2013A	2014F	2015F
Real GDP Growth (AR)	-2.1	4.0	3.0	3.4	3.2	2.9	2.6	3.0	2.2	2.1	3.1
Real Final Sales (AR)	-1.0	2.3	3.7	3.4	3.2	2.9	3.0	3.1	2.2	2.0	3.1
All Items CPI Inflation (Y/Y)	1.4	2.1	2.2	2.8	2.7	2.3	2.4	2.5	1.5	2.1	2.5
Core CPI Inflation (Y/Y)	1.6	1.9	2.0	2.1	2.3	2.2	2.2	2.2	1.8	1.9	2.2
Unemployment Rate (%)	6.7	6.2	6.1	6.0	5.8	5.8	5.7	5.7	7.4	6.2	5.7

CANADA

We've made only minor changes to our Canadian real growth outlook in the past two months. Q2 growth looks to be a few ticks better, at 2.5%, an upgrade we made as decent monthly gains in May were unveiled. Despite disappointments in the past half year, we're still expecting job growth to pick up enough to renew a downtrend in unemployment. Core inflation is tracking a bit higher, and while we share the Bank of Canada's benign diagnosis of its causes, we see it persisting a bit longer than the BoC due in part to further C$ weakness ahead.

UNITED STATES

After numerous disappointments with Q1, we finally got some good news with the advance release of Q2 GDP, with the 4.0% growth rate that quarter accompanied by upward revisions to the previous three quarters as well. However, even with that, GDP for 2014 as a whole is still tracking a modest 2.1%. Should job openings start to be filled more quickly, the unemployment rate could be below 6% before year-end, but less heat in energy and food prices recently have seen us nudge down our CPI forecasts slightly for this year and next.

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