Canada's Plan B

by Avery Shenfeld

Economics

Avery Shenfeld
(416) 594-7356
avery.shenfeld@cibc.ca

Benjamin Tal
(416) 956-3698
benjamin.tal@cibc.ca

Peter Buchanan
(416) 594-7354
peter.buchanan@cibc.ca

Warren Lovely
(416) 594-8041
warren.lovely@cibc.ca

Emanuella Enenajor
(416) 956-6527
emanuella.enenajor@cibc.ca

Andrew Grantham
(416) 956-3219
andrew.grantham@cibc.ca

As Europe struggles through a recession and America's economy continues to disappoint, markets are focused on the downside risks to the global economy. So much so, that for some weeks, a small interest rate cut was priced into Canada's yield curve. Certainly, there are reasons for concern, not only in Europe's troubles and more sluggish growth in the US and China, but also in a downside miss in Canadian capital spending (see pages 6-9).

But if growth falters, Canada's Plan B can't depend on monetary policy, given how low rates already are. Trying to squeeze more growth out of housing and debt-financed consumer spending might not be the best option given longer term risks associated with excesses on both those fronts. Instead, the push to growth should come on the fiscal side, which looks particularly compelling right now given record low bond yields.

Governments across the country are already improving their fiscal fortunes by rolling over maturing high coupon debt at today's low rates (see pages 3-5). In our base case, which assumes a stable enough global economy to allow roughly 2% growth in Canada, borrowing needs will drop dramatically.

But if the global picture sours further, borrowing more, particularly at the federal level, and spending more on infrastructure projects, might also represent a way to reduce future deficits and improve growth in the process. For that to be true, we would have to be facing a longer period of economic slack, so that the additional building activity didn't simply accelerate the timetable for Bank of Canada rate hikes and crowd out private projects. So a ramped up pace to government infrastructure projects is really a Plan B if private sector activity falters more materially than we now expect.

How could borrowing more reduce debts and deficits ahead? That arithmetic was spelled out in a recent Brookings paper by Delong and Summers. With real 30-year rates now below the economy's long-term real growth rate, the costs of financing the additional debt will steadily shrink as a share of GDP. Infrastructure spending that adds to the economy's productive capacity will raise tax revenues that will offset the added financing costs.

In other cases, the math is even simpler. Some projects—toll roads, power projects—generate a direct revenue stream for governments that can more than cover the risk-adjusted financing costs. Canada has a number of projects under consideration in the power sector, some of which involve publicly owned utilities where government funding (perhaps supporting a P3) is part of the plan. The dive in interest rates makes those projects look ever more attractive, and getting moving would be even more compelling if slack opens up in the economy.

That suggests that the market's guessing game on the Bank of Canada has been off the mark. Remember that today's 1% overnight rate would already have been an aggressively low real rate in past recessions. Trimming that rate further in the event of an economic shock might be less advantageous than a well-targeted fiscal initiative in the infrastructure space. And in any event, neither renewed fiscal nor monetary stimulus will be needed if, as we hope, policy makers in China, Europe and the US, play their cards well enough to avoid a global recession.

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

CIBC World Markets Inc. • PO Box 500, 161 Bay Street, Brookfield Place, Toronto, Canada M5J 2S8 • Bloomberg @ WGEC1 • (416) 594-7000
CIBC World Markets Corp • 300 Madison Avenue, New York, NY 10017 • (212) 856-4000, (800) 999-6726

MARKET CALL

- Downside economic risks have driven trading in the last quarter, but the next few months could be more of a back-and-forth story. Any bond buying by the ECB or the EFSF/ESM will provide only temporary relief from sovereign debt concerns, and the US is unlikely to see decisive new action on monetary or fiscal policy.

- That leaves currencies and interest rates likely locked in a trading range through September. The Canadian dollar has rebounded nicely, but new doubts on global growth could see dollar-Canada retest 1.04, with the euro potentially retreating through recent lows. But we may have seen the bottom for bond yields for the year if Europe does enough to prevent a severe run on Spanish debt, and if, as we expect, US GDP does not decelerate further in the second half.

- While we don't expect a sufficient policy about-face to accelerate global growth dramatically next year (i.e. no quick use of QE or lighter austerity in Europe, and no move to adopt fiscal stimulus in the US), policymakers could do enough to have markets putting diminished odds on a global recession. That should ultimately take bond yields higher. It should also lead to a diminished safe-haven bid for US dollars.

INTEREST & FOREIGN EXCHANGE RATES

		2012			2013			
END OF PERIOD:		**27-Jul**	**Sep**	**Dec**	**Mar**	**Jun**	**Sep**	**Dec**
CDA	Overnight target rate	1.00	1.00	1.00	1.00	1.00	1.00	1.00
	98-Day Treasury Bills	0.94	0.90	0.95	0.95	0.95	0.95	1.20
	2-Year Gov't Bond	1.09	0.95	1.15	1.25	1.35	1.40	1.65
	10-Year Gov't Bond	1.75	1.60	1.80	2.15	2.45	2.60	2.75
	30-Year Gov't Bond	2.33	2.25	2.40	2.60	2.85	3.00	3.20
U.S.	Federal Funds Rate	0.14	0.10	0.10	0.10	0.10	0.10	0.10
	91-Day Treasury Bills	0.10	0.08	0.10	0.10	0.15	0.15	0.40
	2-Year Gov't Note	0.25	0.25	0.30	0.30	0.35	0.40	0.85
	10-Year Gov't Note	1.55	1.45	1.60	1.95	2.25	2.45	2.60
	30-Year Gov't Bond	2.63	2.50	2.65	2.90	3.20	3.40	3.65
Canada - US T-Bill Spread		0.84	0.82	0.85	0.85	0.80	0.80	0.80
Canada - US 10-Year Bond Spread		0.20	0.15	0.20	0.20	0.20	0.15	0.15
Canada Yield Curve (30-Year — 2-Year)		1.24	1.30	1.25	1.35	1.50	1.60	1.55
US Yield Curve (30-Year — 2-Year)		2.39	2.25	2.35	2.60	2.85	3.00	2.80
EXCHANGE RATES	CADUSD	0.99	0.96	1.00	0.99	0.98	0.99	1.01
	USDCAD	1.01	1.04	1.00	1.01	1.02	1.01	0.99
	USDJPY	79	79	78	78	77	76	75
	EURUSD	1.23	1.20	1.24	1.26	1.27	1.30	1.32
	GBPUSD	1.57	1.52	1.57	1.58	1.60	1.63	1.64
	AUDUSD	1.05	0.97	0.98	0.98	0.99	1.00	1.02
	USDCHF	0.98	1.00	0.97	0.96	0.95	0.95	0.95
	USDBRL	2.02	2.04	2.10	2.06	2.11	2.14	2.18
	USDMXN	13.25	13.15	13.20	13.20	13.20	13.30	13.50

Interest Rates and Bond Supply: Canada's Two-Way Dance

Warren Lovely and Avery Shenfeld

Canada's interest rates and government bond supply are dancing a two-way tango. Low rates will cushion deficits and borrowing requirements, and diminished financing needs ahead will slow the return to normalized long bond yields. Indeed, superior fiscal results could allow the very long end of the Canadian curve to outperform Treasuries even if, as we expect, our central bank tightens ahead of the Fed in 2014.

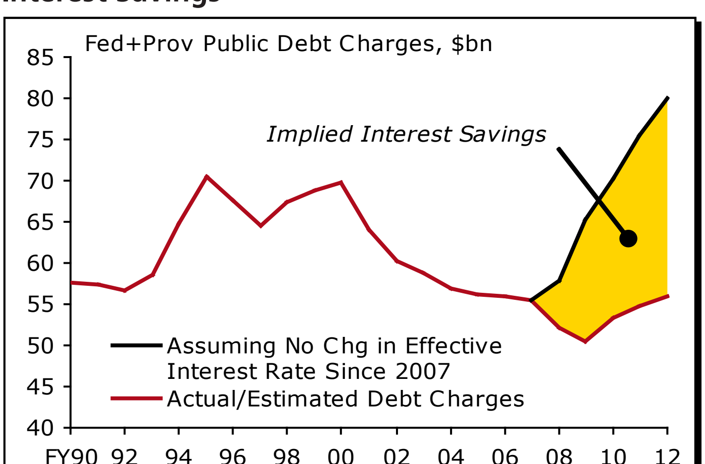
Roll Baby Roll

For Canada's governments, rolling maturing debt into new lower coupon bonds has been a huge blessing. Since 2007/08, a roughly 2% drop in the effective interest rate on their debt has saved Ottawa and the provinces fully $80 bn, including roughly $25 bn in the current fiscal year (Chart 1). Absent those interest savings, Canadian governments would either be much more deeply in the red and presiding over falling provincial credit ratings or would be swallowing even more painful adjustments to taxes and spending to achieve fiscal targets.

Consider that federal debt charges are still almost 10% lower than they were in 2007/08 even though the federal debt burden has climbed by more than 30% or almost $150 bn. Collectively, provincial net debt has shot up at twice that pace, but the aggregate cost of servicing that debt has risen much more modestly, by less than 15%. And today, public debt charges consume less than 8% of provincial revenue, only half the interest burden carried in 2000. Since rating agencies use the debt-service-to-revenue measure as one indicator of financial stability, the debt rollover savings has helped to minimize provincial ratings downgrades in recent years.

Chart 1

Falling Rates Contribute to $25 bn in Annual Interest Savings



Source: CIBC, Canadian governments

While falling rates couldn't prevent deficit overshoots during the recession, the atypical further drop in bond yields during a recovery has been an important factor in allowing Canadian governments to beat deficit targets since then. Last year, aggregate federal-provincial debt service costs ran roughly $3 bn below budget forecasts.

Typically, pleasant interest rate surprises accompany growth disappointments. But while funding rates have swooned, budgets were drawn up with sufficiently conservative growth forecasts. Sensitivities suggest today's tamer rate environment could deliver another $2-3 bn of combined interest savings for federal and provincial governments in 2012/13, relative to a budget plan that was guided by a now-outdated consensus rate call. Add in two other buffers included in some budgets—contingencies in spending and separate forecast allowances/reserves—and there's notable elbow room for Canadian governments relative to spring budget plans.

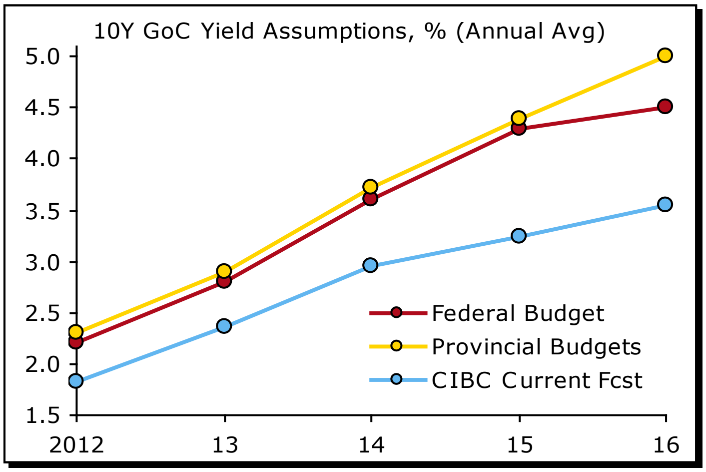
More Savings Ahead

Even if rates start to move higher from here there are still more savings to be realized. Our current interest rate forecast would imply fundamentally lower interest charges over the medium term than current fiscal plans anticipate (Chart 2). From a refinancing perspective, the weighted average coupon on Government of Canada bonds coming due in the next five years isn't high by historical standards, at roughly 2.5%. However, Ottawa's blended long-term cost of funds could end up averaging little more than 1.6% over the coming half decade, barring a dramatic shift in funding mix.

With provincial governments having issued relatively little short-term debt since 2009, their fixed-rate debt coming due in the medium-term generally bears substantially higher average coupons (Chart 3). Manitoba and Ontario both have proportionately more of their debt coming due within five years, with those bonds carrying coupons

Chart 2

Rate Outlook More Benign Than Budget Plans



Source: CIBC, 2012 Fed/Prov budgets

closer to current market levels. Alberta has the lowest coupons on its maturing debt, but the vast majority its borrowing is on-lending for consolidated entities, diluting the rollover impact on provincial budget balances.

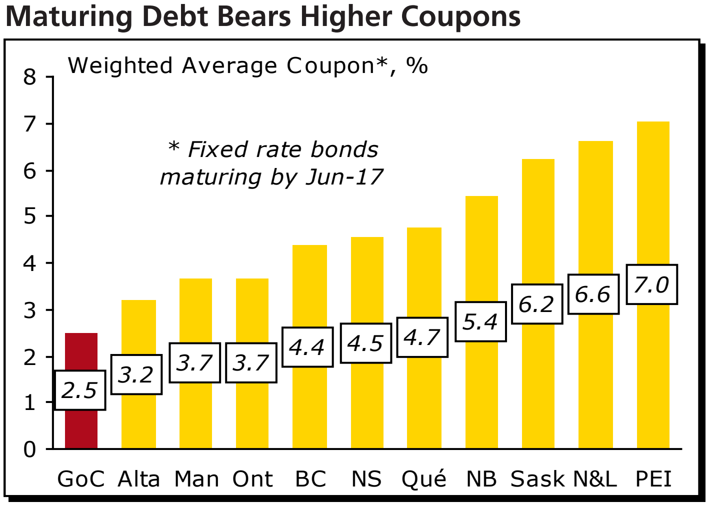
Funding Strategy: Time to Lock In

Tempting as it is for governments to opt for the shortest maturities with the cheapest coupons, its now time to lock in a larger share of funding for longer. While a rapid back-up in rates is hardly likely, today's flat Canadian curve is priced for a very extended period of economic weakness, assuming even fewer rate hikes down the road than our more dovish-than-consensus forecast.

Even a gradualist central bank could raise rates enough in the next decade to make it advantageous to extend the term of issuance. We project that the cumulative interest

Chart 3

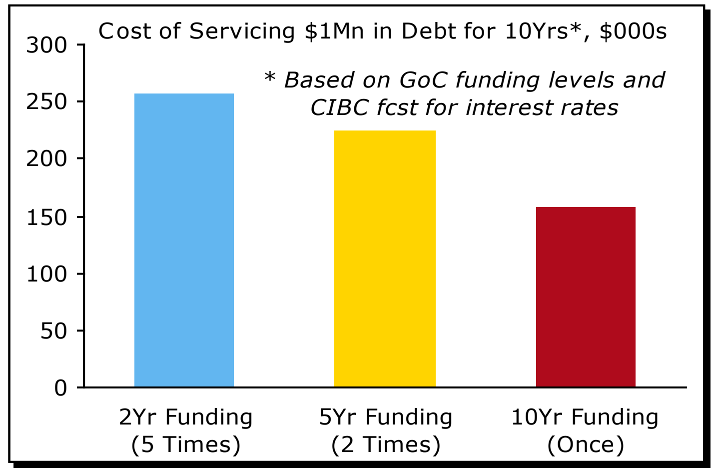
Maturing Debt Bears Higher Coupons



Source: CIBC, Bloomberg

Chart 4

Funding Strategies: An Illustration



Source: CIBC

costs associated with issuing a 10-year bond at today's Government of Canada rate would be barely 60% of what it could cost to roll a series of 2-year bonds (Chart 4).

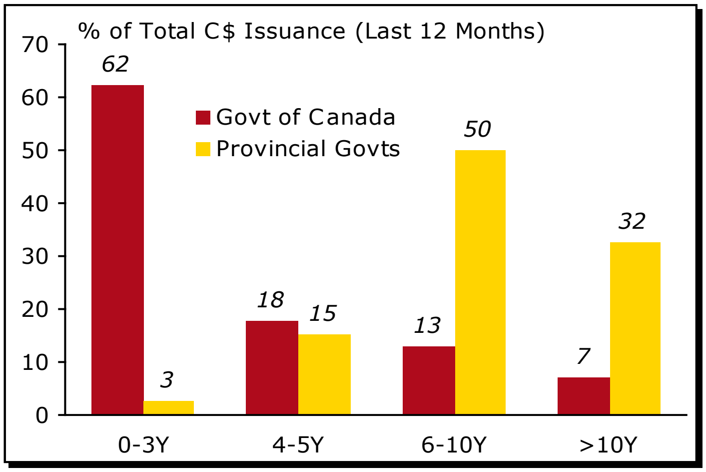
Ottawa has taken note. Its latest Debt Management Strategy signaled a move to lock in a larger share of supply for longer, a message that was subtly reinforced in a June refunding announcement. We estimate that moving some 15% of annual Canada supply from 2s and 3s into longer terms would both save the federal government money over a ten-year horizon and simultaneously reduce the government's annual refinancing risk, a reasonable objective in a highly uncertain global financial environment. Moreover, such a strategy would still allow for fully half of gross Canada supply to be issued in the front-end (2- to 3-years), retaining liquidity in a segment now appealing to a growing pool of international buyers of Canadian dollar bonds.

Provinces have already been more active at the long end, with 10s and longs dominating domestic supply during the past year (Chart 5). That has pushed the weighted average term of new C$ provincial supply to 17 years, in-line with pre-2008 levels and more than three times longer than gross GoC supply. All the provinces have gotten in on the act, although in some cases, a greater reliance on shorter-term US$ issuance has translated into a shorter average term of total supply, including in Ontario.

In hindsight, provinces could have achieved even greater interest savings by issuing a larger portion of their debt in shorter tenors, riding yields lower. But that's water under the bridge. Given CIBC's current interest rate forecast, a funding strategy geared to longer-dated tenors appears

Chart 5

Provinces Lock In, Feds Changing Tune



Source: CIBC, Government of Canada

the way to go. Although more costly immediately, skewing more supply to the long-end should generate net cost savings over a ten-year horizon vs. an alternative, shorter-term strategy. Even a widening in provincial spreads hasn't prevented a plunge in all-in 30-year rates to roughly 3.3% (for Ontario), a bargain relative to last decade's 5% average (Chart 6).

Admittedly, down the hall from those managing government borrowing, those dealing with public pensions faced rising pension costs as the interest rates on their assets tumbled and lower discount rates were applied to future liabilities. But at least relative to the US, Canada's federal and provincial governments are in much better shape. Canada's CPP has amassed a huge pool of assets for which there is no counterpart in the US social security system (where the only "assets" are Treasuries—simply IOUs from future taxpayers). And as we've explored in these pages previously, provincial unfunded pension liabilities are proportionately much lower than those plaguing US states.

Canada-US Spread: Best Bet in Longs

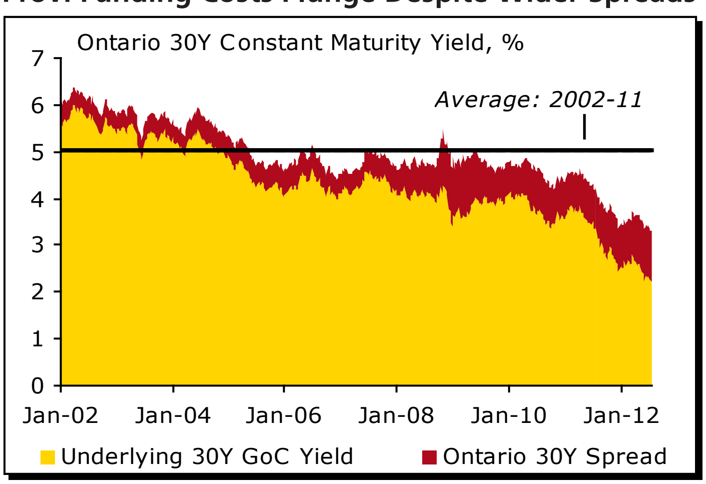
Despite a superior debt and deficit prognosis, short-dated Canadian bonds are likely to underperform US Treasuries. Being much closer to full employment, Canada will see its next rate hikes well before the Fed begins to tighten, even if, as we expect, the Bank of Canada stays on hold until early 2014. At this point, the Canadian curve leaves little room for Bank of Canada rate hikes, even that far out.

In recent weeks, the US long end has been flattered by the market pricing in a third round of quantitative easing, which judging by the impact of the QE2 announcement, might have given 30-year Treasuries a roughly 20-bp benefit, only some of which would spill over into Canadas. But looking further out into 2013, long Canadas could begin to outperform.

At that part of the curve, Canada-US overnight spreads have much less relevance. Using a model that also allows for the impacts of inflation differentials, deficit-to-GDP ratios and net foreign purchases, we find that a 50-bp go-it-alone rate hike by the BoC raises Canada-US 30-year spreads by only 7 bps. But a more rapid fiscal recovery and more favourable net issuance dynamics would contribute to a 20-bp narrowing in spreads, more than offsetting the push higher in Canada's policy rate. So for those playing the curve, consider a box trade that is long Canadas vs Treasuries in 30s but short Canada vs the US in 2s (Chart 7). At roughly -100bps, we view the current entry point as attractive, with 50 to as much as 100 bps of room to move in the coming 12 months.

Chart 6

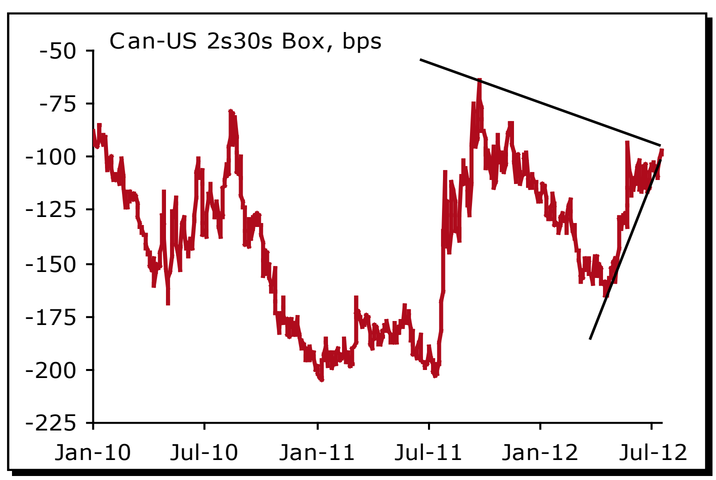
Provi Funding Costs Plunge Despite Wider Spreads



Source: CIBC

Chart 7

Canada-US Box Trade Idea



Source: CIBC, Bloomberg

What Happened to the Rise of the Machines?

Peter Buchanan and Emanuella Enenajor

Business capital spending has been a key engine of Canada's economic revival in recent years, contributing roughly 40% of the rebound in economic output seen since 2009. With exports slowing and consumers showing signs of fatigue, the Bank of Canada, among others, has been pinning its hopes for continued respectable growth on the business sector. That hope has been central to the Bank's still seemingly hawish rate stance. Unfortunately, the roar of booming business investment has sounded more like a whimper in recent quarters, contributing a mere fraction to GDP of what it did earlier in the recovery (Chart 1).

Scratching beneath the surface, while commodity sector-intensive investment in building/engineering structures has continued to make headway, real machinery and equipment outlays have slowed measurably, actually falling in two of the last three quarters, and posting a four-quarter growth rate of only 3% recently—the weakest pace seen since the recession.

The Survey Says…

The slowdown in M&E investment has stumped followers of the Bank's Business Outlook Survey, where gung-ho firms have continued to sound rosy about prospects for future investments. Bullish as the Bank is, the latest strong survey indicators would have it hoping that the recent M&E spending slowdown was just a blip, with firms saying that they are set to ramp up investment spending ahead.

But that may not be the case. A 2011 Bank research paper[1] conceded that its survey question on M&E spending is not the best predictor of future investment, finding that the overall outlook survey was a better guide. Indeed, the future sales expectations of firms surveyed is much more closely correlated with future M&E spending growth (Chart 2), and the sales outlook was not as rosy of late.

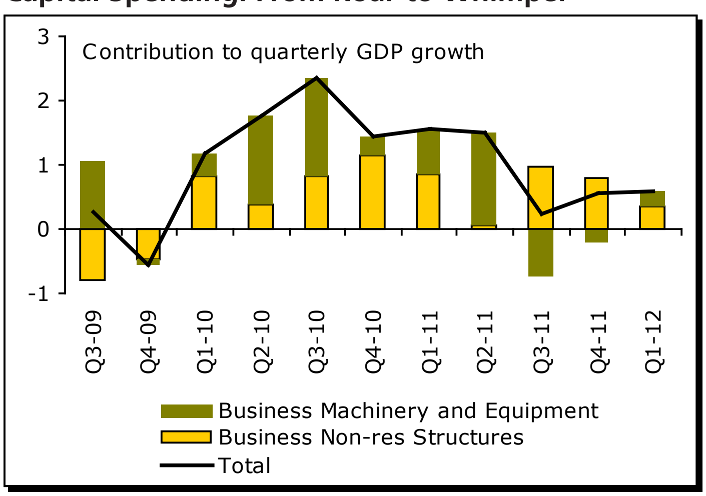
That's not actually so surprising, since firms are only likely to match positive talk on outlays with action if there's money to be made from rising revenues. Also, unlike the question on sales, the M&E investment query refers to levels of investment, not the pace—a subtle difference that blurs the comparison with capital spending growth rates. With cautious sales expectations, the robust annual increases in real business capex of 7-8% that the BoC expects aren't a done deal.

C$ Impacts Not All Positive

Meanwhile, at the broad-brush level, the loonie's climb is a decidedly mixed blessing. While the currency's rise has lowered the cost of imported capital equipment, it has also reduced Canada's appeal as a location for cost-

Chart 1

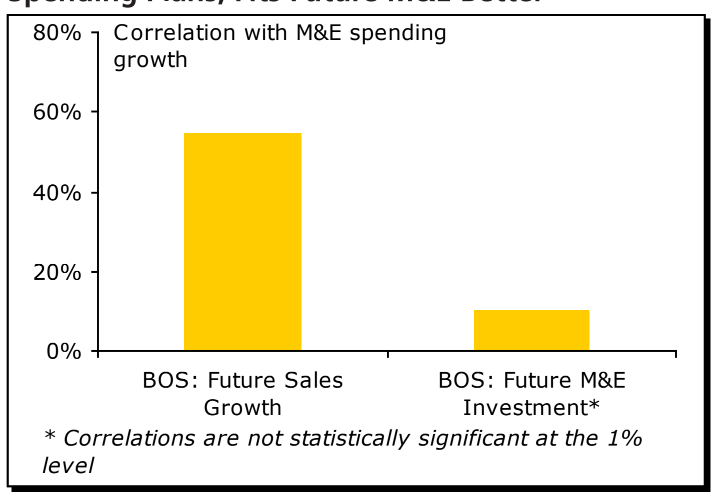
Capital Spending: From Roar to Whimper



Source: Statistics Canada, CIBC

Chart 2

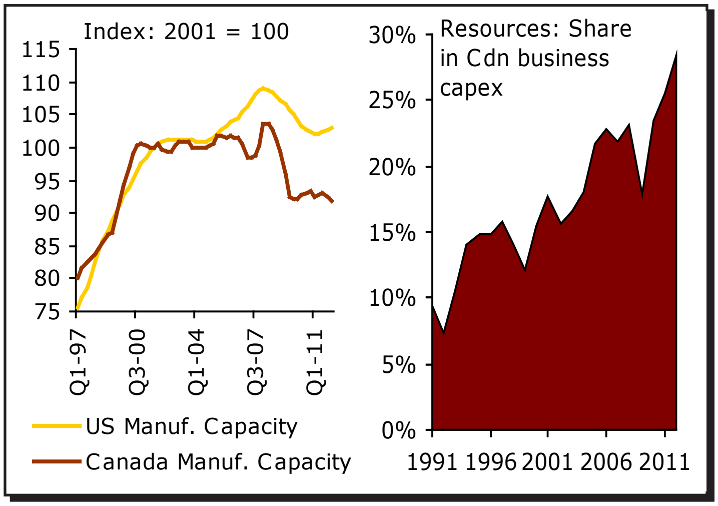
BoC Survey: Sales Expectations, Not Capital Spending Plans, Fits Future M&E Better



Source: Bank of Canada, Statistics Canada CIBC

Chart 3

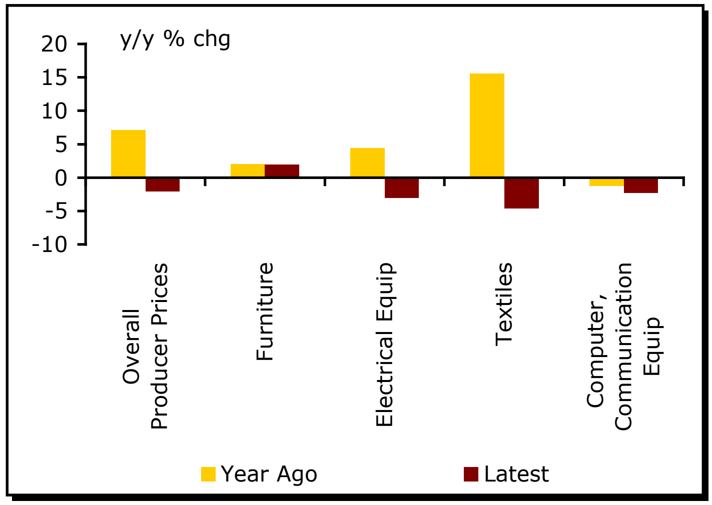
Canada's Declining Manufacturing Capacity (L); Resource Investment Takes Centre Stage (R)



Source: Statistics Canada, CIBC

Chart 4

China: Growing Capacity Glut Drives Factory Price Deflation



Source: NBS

sensitive factory investment, a fact well illustrated by the notable decline in Canada's share of North American manufacturing plant capacity in recent years (Chart 3, left).

That erosion, which has come notwithstanding the boost to overall capital spending from new energy and resource mega-projects (Chart 3, right), could well continue, given the multi-year time lags in many plans. Many of the plants now operating in the auto, metals, electronics and other sectors were put in place when the C$ was worth 80 or even 70 US cents. Moreover, Canada has to compete these days not only with a revitalized US manufacturing base, but a plethora of offshore players, each hungrily vying for market share. With global growth slowing and prices falling for products from textiles to computers in the likes of China (Chart 4), it looks increasingly as if the world has too much rather than too little manufacturing capacity. That's another reason that added factory outlays may not put a great deal of wind into the economy's sales.

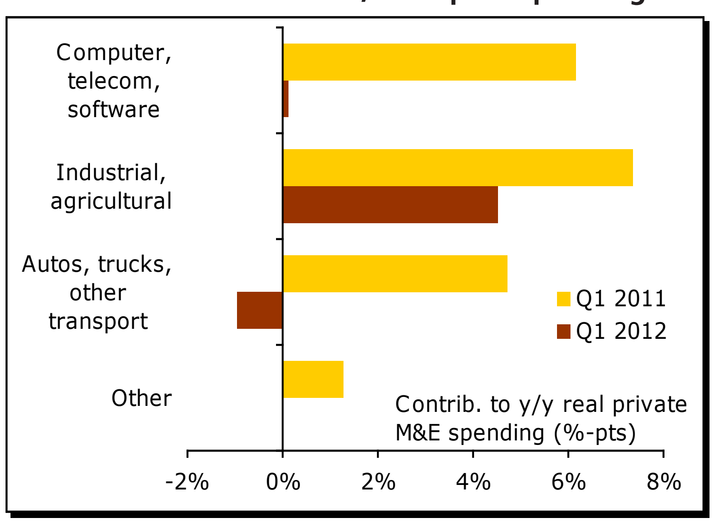
Problems at Home, Problems Abroad

Some have chalked up the recent investment slowdown to pervasive global "uncertainties", to use a popular catchword. But drilling down into the data, there appear to be other factors at play. In the past year, Corporate Canada wasn't slashing spending on drilling rigs and bulldozers. Instead firms were cutting back on smart phones, PCs and software (Chart 5)—the sort of investments needed, in fact, to narrow the persistent and troubling north-south productivity gap.

Tech companies reporting on both sides of the border have cited a challenging global environment for the sector, so it's not surprising to see demand for their products in Canada come up short. Transitory factors, like the wait for new products from key Fortune 500 software and cell phone/computer makers, may be temporarily crimping demand here as elsewhere, but there's a reason to suspect that more enduring, secular trends are also playing a role. Beyond business climate uncertainties, that includes the tamping down on hiring and investment expenditures in the Finance, Insurance and Real Estate sectors (Chart 6).

Chart 5

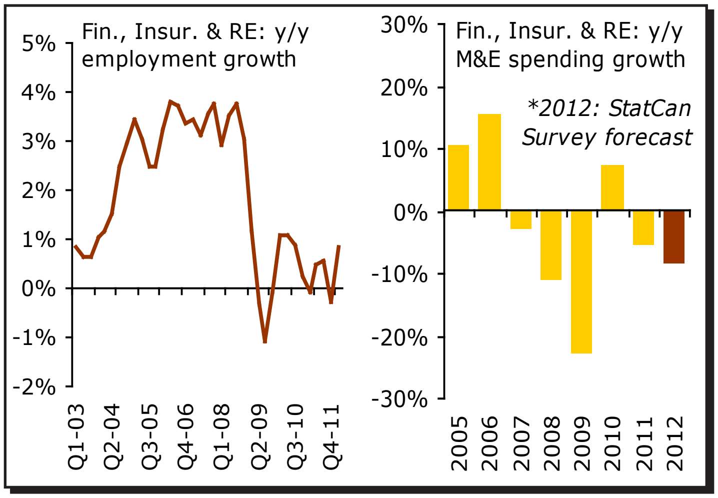
Canadian Firms Slow Tech, Transport Spending



Source: Statistics Canada CIBC

Chart 6

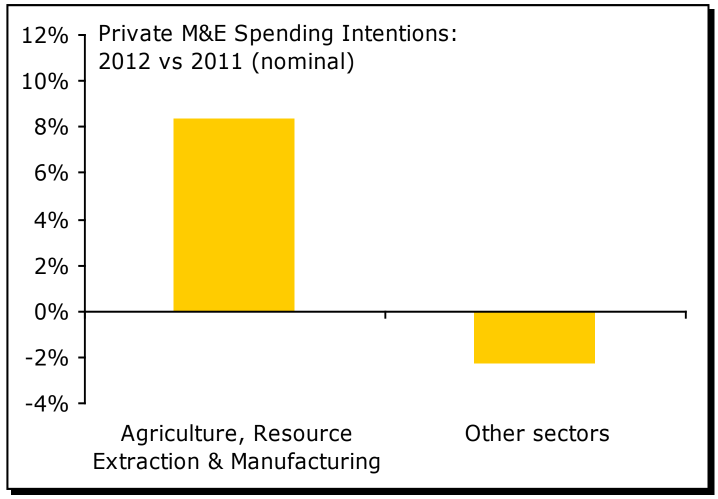
A Key Buyer of Tech, Software Pulls Back



Source: Statistics Canada, CIBC

Chart 7

Domestically Focused Firms Remarkably Cautious on M&E



Source: Statistics Canada, CIBC

That sector buys roughly 30% of all information, communications technology (ICT) M&E. Banking challenges globally and decelerating household credit demand, means the needle may not move much any time soon in pushing financial institutions in Canada to ramp up purchases of smart phones and software.

Transportation equipment spending has also struggled with a few air transport names recently deferring capital and re-fleeting plans. That's offset increases by the rails. While improved global prospects in late 2013 could provide some support, autos spending, heavily skewed towards real estate could continue to struggle if the recent slowdown in the domestic housing resale market persists as we expect.

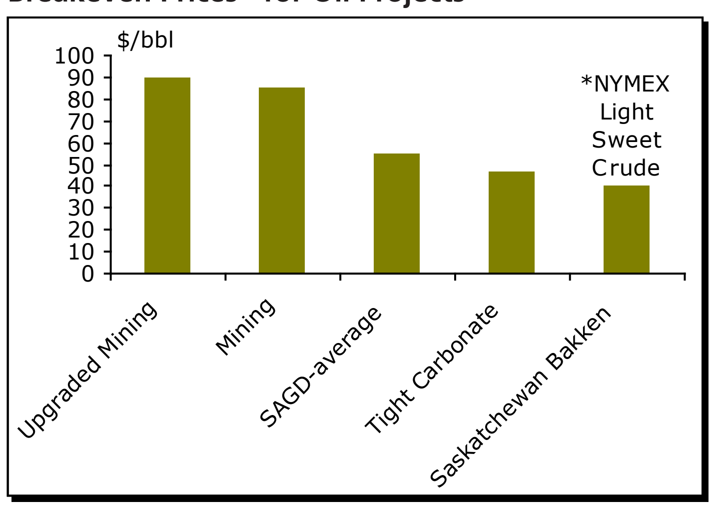
All told, we don't see a sharp bounce back in business M&E spending this year. Firms hinted as much in the latest Private and Public Investment Survey, with nominal gains decelerating to 1% in 2012, led by weakness in the non-tradeables/exportables sectors (Chart 7) —congruent with the latest slowdown. While that could hold back M&E spending, the other important sector of business capex tilted heavily towards resource sector extraction—engineering structures—is facing renewed challenges given energy price volatility.

Unease in the Oil Patch

After remaining steadfastly above $100/bbl through the winter and spring, WTI briefly sank as low as $78 in late June before rebounding to near $90 in July on positive policy developments in the Eurozone and the Fed's apparent willingness to go to the well another time with non-conventional easing. Although we expect oil to recover more of the ground recently lost, a report from CIBC's equity analysts[2] has noted that sustained prices near or slightly below today's level could challenge the economics of some higher cost projects. Based on an assumed 9% return, the average breakeven crude prices for a new mined bitumen project is currently on the order of $85/bbl. Adding an upgrader raises that figure by about $5/bbl. In contrast, *in situ* developments, which use steam to melt the bitumen, have thresholds $20-30 lower and would only be affected if prices fell substantially further (Chart 8).

Chart 8

Breakeven Prices* for Oil Projects



Source: Company reports, CAPP, CIBC

It is worth noting that what is at stake is not so much the ultimate need for Canada's billions of non-conventional barrels, but rather, the time frame for development. Some firms have announced a review of ongoing plans and a slew of upcoming company reports is likely to throw further light on the outlook for investment. Like the US, Canada has reserves of tight or shale oil. Activity on that front along could conceivably offset some though not all of any softening in oil sands activity.

Fundamentals: Balance Sheets Healthy But Profit Growth Stalling

Looking at another investment driver, corporate Canada's balance sheets, in contrast to the household sector's, remain in exceptionally good shape, by almost any measure. The debt to equity ratio for non-financial firms fell further from already near-record lows to less than 54% in Q1, nearly 15%-pts below levels south the border (Chart 9, left).

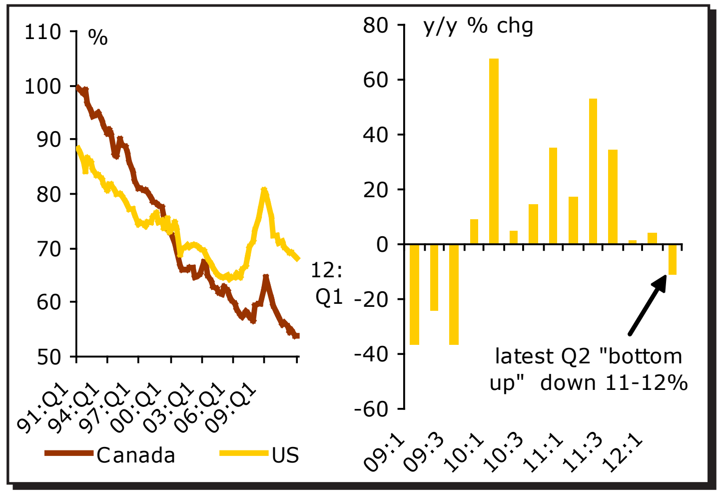
Positive as that may be, things aren't looking as good on the internal funding side. Canada's three year old earnings recovery is showing serious signs of fatigue, as sagging commodity prices and sluggish demand stateside take a growing toll. A sizeable number of TSX firms have missed their earnings targets in recent weeks. Adding to the negative effect of uncertainty on the business environment and investment, index earnings are expected to be down by almost 12% in the latest quarter (Chart 9, right), the sharpest pullback since the recession. Moreover, the decline in earnings performance is being driven by some of the economy's most capital intensive sectors, including oil & gas and the mining sector (Chart 10).

Capital Spending to Walk, Not Run

The downshift in Canada's business investment recovery may not be just a temporary blip, as domestic as well as external economic headwinds conspire to discourage firms from beefing up capital at a hearty clip. While the Bank of Canada has been pinning its hopes for improved growth on business capital spending, that's sector's recent slowdown suggests the arguments in favour of a BoC rate hike could fade. Since investment is needed to support job growth, it's also a reason not to look for job creation to show the vigourous clip seen earlier the recovery.

Chart 9

Non-Financial Debt/Equity Ratio (L); TSX Earnings Growth Stalls (R)



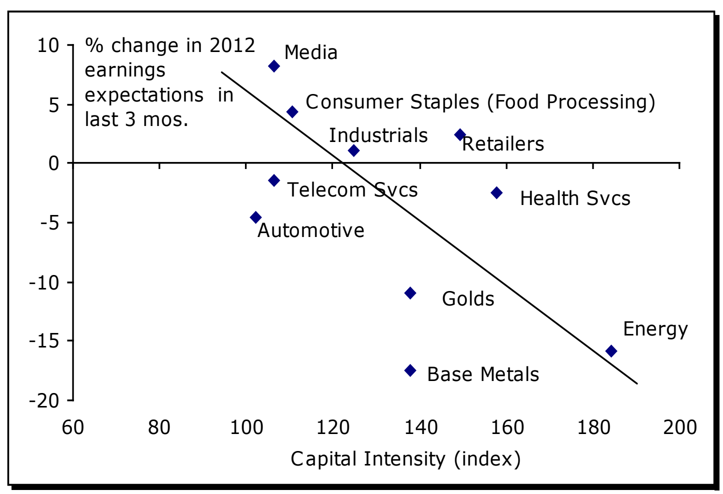
Source: Statistics Canada, Bloomberg, FRB, CIBC

[1] *Pichette, L. and Rennison, L. 2011. "Extracting information from the Business Outlook Survey: A Principal-Component Approach." Bank of Canada Review (Autumn): 21-28.*

[2] *North American Light Oil Facing Structural Change, July 2012*

Chart 10

Earnings Slowing the Most in Capital-Intensive Sectors



Source: Bloomberg, Statistics Canada

US Housing: Beyond Bricks and Mortar

Benjamin Tal and Andrew Grantham

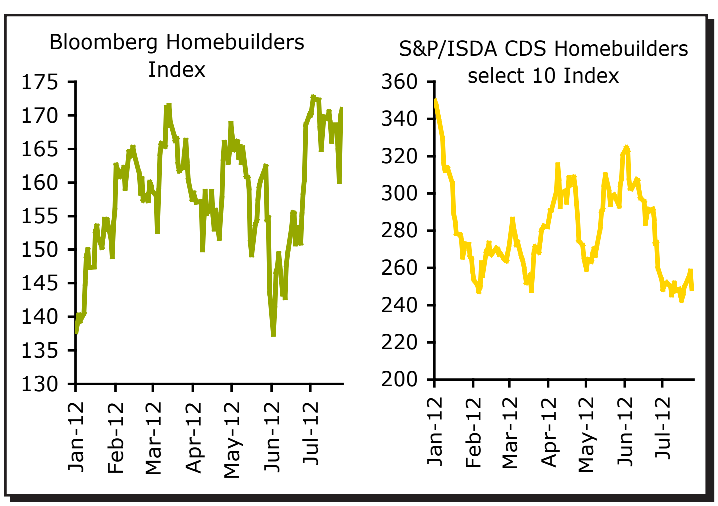
With more than 20% of mortgages remaining underwater, the US housing market remains a long way from functioning normally. As a result, any comparisons with the bubbly pre-recession period are irrelevant. What is relevant is the direction and rate of change. In that respect we may have seen a turning point, with housing starts, new and existing home sales, as well as renovation activity all higher than a year ago.

And markets have taken notice. Homebuilders' stock prices are up more than 20% year-to-date, compared to a sub-10% advance in the S&P 500. Meanwhile, credit default swaps are noticably lower (Chart 1).

The direct impact of this upturn on the US economy is clear, with residential construction contributing an average 0.3%-pts to GDP in the first half of 2012. However, the indirect effects are potentially more important and feed through with a lag. Should housing starts continue to recover modestly as we expect (to 820K in 2013) that would typically support a 50K intake in construction payrolls. Even more significantly, a recent leap in renovation activity would typically be consistent with contractor employment around 300K higher than current levels (Chart 2, left). While a combined 350K staffing increase over the next few years would only offset a fraction of the 2.2 mn construction jobs lost since 2006, it would be a marked improvement on the broadly flat trend seen recently, and provide some support to household incomes and spending.

Chart 1

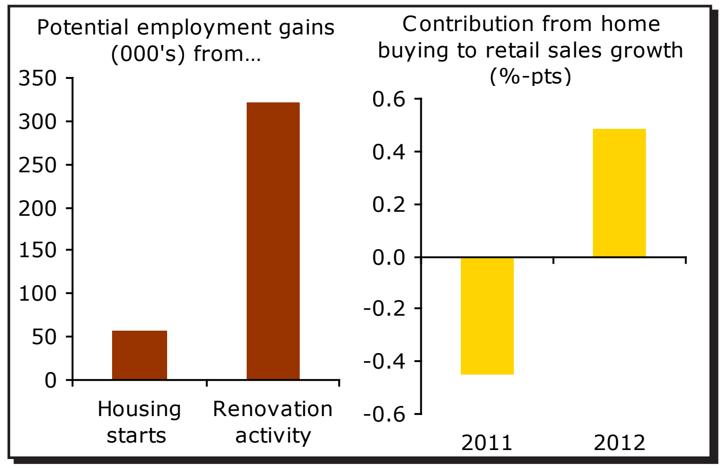
Markets Already Recognizing Improving Housing Trends



Source: Bloomberg, ISDA, CIBC

Chart 2

Housing Upturn to Support Employment (L) and Consumer Spending (R)



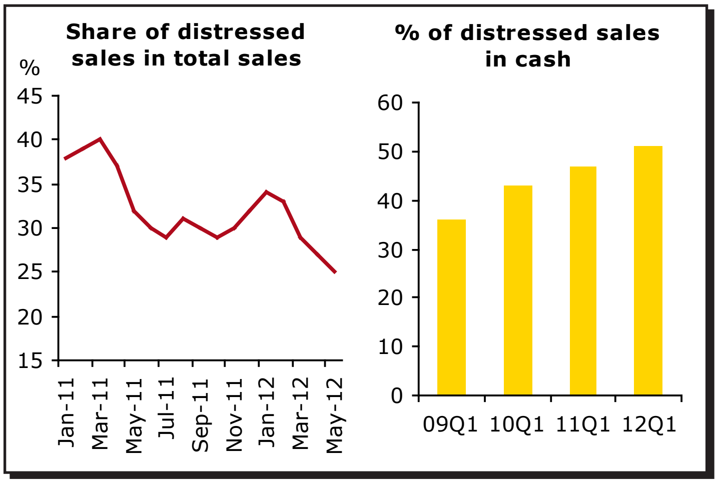
Source: BEA, NAHB, CIBC

And spending is something people tend to do more of when they move. Indeed, the NAHB previously showed that buyers of old homes spent twice as much on furnishings, appliances, etc. over a year than those who stayed put. Buyers of new homes spent nearly three times as much. With new and existing home sales higher than a year ago, such spending should be a minor positive for future retail sales (Chart 2, right).

Housing wealth will also begin to support spending should recent encouraging news on home prices continue. In assessing turning points for house prices, data precision is crucial, and here the widely used Case-Shiller index has major disadvantages. Not only is there a one or two month lag until closing, and then another month until records are made available, but due to the sample size a three-month moving average is used. Therefore, the index can easily have a 5-6 month lag, making other indicators such as those from the FHFA and Corelogic potentially more timely. These are already showing annual increases in home prices, whereas the Case-Shiller index remains in the red.

Chart 3

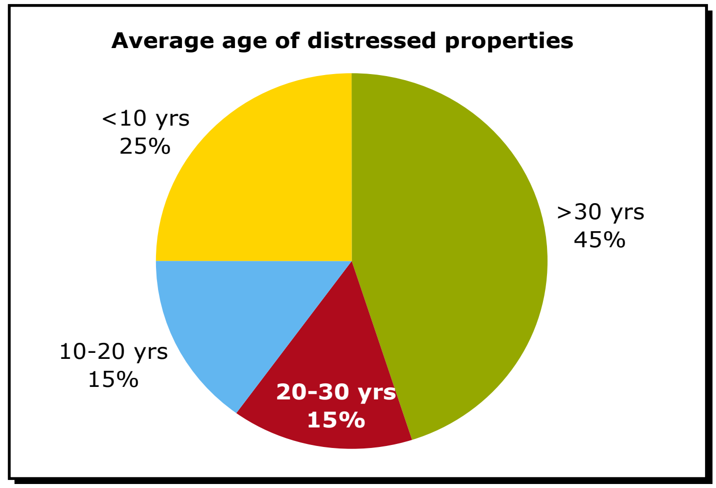
Distressed Sales a Lower Share (L), Bought by Cash-paying Investors (R)



Source: NAR, DataQuick, CIBC

Chart 4

Distressed Properties Mainly Older and in Need of Restoration



Source: NAR, DataQuick, CIBC

What's more, asking prices are also edging higher, with Trulia's Price Monitor showing a 0.8% increase for the second quarter. Rising asking prices tend to signal a second stage in the price recovery. Even trends in distressed sales, which played an important role in house price declines, are showing some improvement. From the peak, distressed prices fell 40%, with non-distressed prices down 25%. However, the discount on distressed sales has narrowed, and they are now accounting for a smaller proportion of the market (Chart 3, left).

But it is the fact that investors are now buying big into the rental market that is potentially the most significant trend. They are being attracted by the prospect of capital gains but also by a strong rental demand, with vacancy rates of 8.6% the lowest since 2002, and increases in rent outstripping inflation. Investors now account for some 20% of total residential sales, with approximately 70% of those purchases made in cash. That means a record high 25% of total residential sales, and 50% of distressed sales, are now cash purchases (Chart 3, right). That trend will only be exaggerated by the government's REO-to-Rental Program, selling batches of residences to investors on the basis they hold them as rental properties for at least three years.

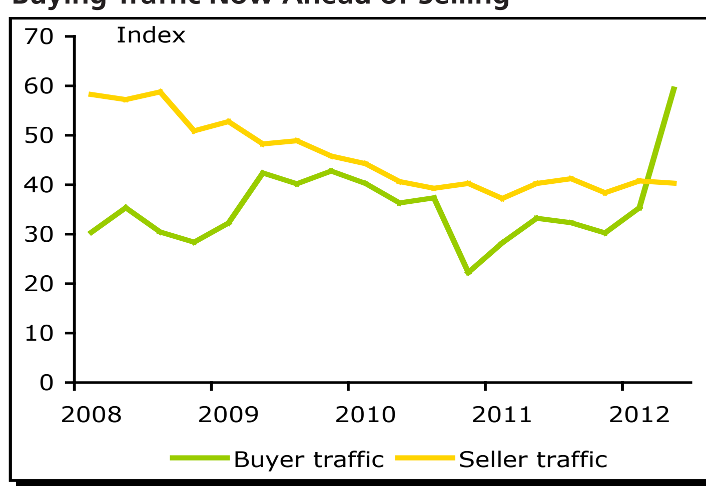
That provides further benefits to the economy. As investors tend to purchase distressed property in need of work, renovation activity could see an additional boost—particularly as the stock of distressed property is biased towards older homes (Chart 4). As already discussed, increases in renovation activity could have a significant impact on employment in the construction sector, with even present levels generally consistent with 300K in additional headcount.

These positive trends mean that, for the first time since the market turned prior to recession, buying traffic is outpacing selling (Chart 5). Therefore, the modest recovery in US housing could continue, with latest dip in the new and existing home sale data only pauses in an overall uptrend.

There is no doubt that the housing market recovery will be a slow process, with activity and prices remaining extremely depressed compared with bubbly pre-recession levels. But, the trend improvements seen recently, producing modest contributions to growth through a number of channels, not just in bricks and mortar, could sum up to a significant positive for the economy. That would prove timely, as earlier engines of the US recovery appear to be sputtering.

Chart 5

Buying Traffic Now Ahead of Selling



Source: NAR, CIBC

ECONOMIC UPDATE

CANADA	12Q1A	12Q2F	12Q3F	12Q4F	13Q1F	13Q2F	2011A	2012F	2013F
Real GDP Growth (AR)	1.9	2.3	1.7	1.9	2.1	2.2	2.4	2.1	2.1
Real Final Domestic Demand (AR)	1.3	1.1	1.8	2.4	2.5	2.4	3.0	1.6	2.3
All Items CPI Inflation (Y/Y)	2.3	1.6	1.4	1.8	1.8	1.9	2.9	1.8	2.1
Core CPI Ex Indirect Taxes (Y/Y)	2.1	2.0	2.0	2.0	2.1	2.1	1.7	2.0	2.0
Unemployment Rate (%)	7.4	7.2	7.2	7.2	7.2	7.1	7.5	7.3	7.1

U.S.	12Q1A	12Q2A	12Q3F	12Q4F	13Q1F	13Q2F	2011A	2012F	2013F
Real GDP Growth (AR)	2.0	1.5	1.6	2.3	1.5	1.7	1.8	2.2	1.8
Real Final Sales (AR)	2.4	1.2	1.8	2.7	1.7	1.8	2.0	2.0	2.0
All Items CPI Inflation (Y/Y)	2.8	1.9	1.6	2.1	2.0	1.9	3.2	2.1	2.1
Core CPI Inflation (Y/Y)	2.2	2.3	2.2	2.2	2.2	2.1	1.7	2.2	2.0
Unemployment Rate (%)	8.3	8.2	8.2	8.2	8.2	8.2	9.0	8.2	8.2

CANADA

May GDP, set to be released shortly after we go to print, could come in at 0.3%, enough to see GDP growth in the second quarter tip the scales at 2.3%. That's a few ticks weaker than we initially expected, owing to a softer-than-anticipated start to the quarter. The near-term profile for inflation looks a bit less aggressive that our earlier forecast, given a sideways trend in energy prices. However, rising food prices could add some upside to CPI come 2013.

UNITED STATES

US growth eased to a tepid 1.5% pace in Q2, and recent disappointments in retail sales and core capital goods orders suggest little chance of significant acceleration in Q3. Only due to an upward revision to Q4 2011 is 2012 growth now projected at 2.2%, slightly above our previous estimate. Growth rates for the second half of 2012 are lower than we previously estimated. The recent spike in corn prices should feed through to consumers later this year and into 2013, leading us to raise our CPI forecast by two ticks.