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

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

Nick Exarhos
(416) 956-6527
nick.exarhos@cibc.ca

What Carney Left Behind

by Avery Shenfeld

He earned global plaudits for managing through the financial crisis, but did Mark Carney's decisions post-recession leave his successor at the Bank of Canada in, as they say in his new country, a spot of bother? As we warned at the time, a hands-off attitude on the exchange rate, alongside foreign central bank intervention, contributed to a serious overvaluation of the Canadian dollar. The country is in reasonable overall shape, but is still struggling to wean itself off home building as a source of growth.

From 2010 through the first half of 2013, safe-haven flows into Canada's triple-A government bonds, and a move by foreign central banks to diversify their reserves by adding weight to Canadian dollars, held the loonie through parity during a weak period for trade balances. Rate hikes in 2010, and on-and-off warnings of further tightening thereafter, also widened the Canada-US spread to encourage such flows. Rather than intervene to neutralize the impact of hot money capital flows on the exchange rate (as the Swiss did), the Bank of Canada tried to offset the impact on GDP growth by keeping interest rates low enough to stimulate housing and domestic consumption.

That was also a period in which, left with excess capacity after the recession, manufacturers were making long term decisions on where to retain plants, and where to shutter them for good. That wasn't only in the auto sector, but in the likes of food processing, locomotives, and steel making. In a speech last September, Stephen Poloz took note of the failure to see any recovery in the net number of firms in the export sector after the steep decline suffered during the recession.

" ...monetary and exchange rate policy traded off more condos for fewer factories, ..."

In effect, monetary and exchange rate policy traded off more condos for fewer factories, and we see the signposts of that in recent data trends. January real exports were likely hurt by weather-related transportation bottlenecks. But even the prior trend was uninspiring, failing to capitalize much on a fairly healthy second-half growth pace in the US.

The latest intentions survey showed that business leaders are planning for almost no growth in capital expenditures. During times of economic improvement, the early survey typically understates actual spending, which gets revised up as the year rolls out. Still, we've reduced our investment spending call enough to pare our 2014 GDP growth forecast by two ticks, to 2.1%. The trimming would have been larger if not for signs that housing construction, including completions of the forest of condos underway, will remain a growth contributor for one more year, contrary to our prior forecast.

Helped by dovish talk from Poloz, the narrowing of Canada-US two-year spreads, and a cooling in the risk aversion that favoured AAA bonds, we now have a more appropriately valued exchange rate. That, and improving commodity prices, will help to bring trade into better balance. But given how infrequently production location decisions come up, the legacy of earlier plant closures will be with us for years to come.

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

MARKET CALL

- We're in the home stretch for Canadian dollar weakness, expecting a run to 1.13 on dollar-Canada in the next few weeks. By June, after a dip in the February data (due in March), we see CPI trending higher again, which, alongside better growth readings in Q2, will quell any talk that the Bank of Canada's next move is an ease and bring some recovery in the loonie over the last half of the year.

- We're throwing in the towel on hopes that the ECB would announce new easing measures that would, as a key benefit, take the euro weaker. We'll need to be closer to Fed hikes, which we still see coming by mid-2015, and which surely the ECB won't be in a position to match, to see the lows in the euro that we previously anticipated for this spring.

- Although in the US it's largely about adverse weather (see pages 3-5), a downgraded story for Q1 growth implies a slightly slower trajectory towards higher bond yields, both stateside and in Canada. We've left our year-end targets unchanged, but don't expect to eclipse last year's peaks in 10-year yields until this fall.

INTEREST & FOREIGN EXCHANGE RATES

		2014				2015			
END OF PERIOD:		**11-Mar**	**Jun**	**Sep**	**Dec**	**Mar**	**Jun**	**Sep**	**Dec**
CDA	Overnight target rate	1.00	1.00	1.00	1.00	1.00	1.25	1.50	1.75
	98-Day Treasury Bills	0.83	0.90	0.95	0.95	1.05	1.20	1.45	1.70
	2-Year Gov't Bond	1.04	1.10	1.40	1.60	1.85	2.20	2.40	2.50
	10-Year Gov't Bond	2.51	2.70	2.85	3.00	3.10	3.35	3.45	3.55
	30-Year Gov't Bond	3.04	3.15	3.35	3.50	3.55	3.60	3.65	3.70
U.S.	Federal Funds Rate	0.10	0.10	0.10	0.10	0.10	0.25	0.50	0.75
	91-Day Treasury Bills	0.04	0.15	0.15	0.15	0.20	0.40	0.60	0.85
	2-Year Gov't Note	0.37	0.40	0.65	0.85	1.00	1.40	1.65	1.85
	10-Year Gov't Note	2.78	2.95	3.10	3.25	3.30	3.55	3.70	3.80
	30-Year Gov't Bond	3.72	3.85	4.00	4.10	4.15	4.25	4.30	4.40
Canada - US T-Bill Spread		0.78	0.75	0.80	0.80	0.85	0.80	0.85	0.85
Canada - US 10-Year Bond Spread		-0.27	-0.25	-0.25	-0.25	-0.20	-0.20	-0.25	-0.25
Canada Yield Curve (30-Year — 2-Year)		2.00	2.05	1.95	1.90	1.70	1.40	1.25	1.20
US Yield Curve (30-Year — 2-Year)		3.35	3.45	3.35	3.25	3.15	2.85	2.65	2.55
EXCHANGE RATES	CADUSD	0.90	0.89	0.92	0.93	0.93	0.93	0.93	0.93
	USDCAD	1.11	1.12	1.09	1.08	1.08	1.07	1.07	1.08
	USDJPY	103	105	105	104	103	102	101	100
	EURUSD	1.38	1.36	1.31	1.28	1.26	1.27	1.30	1.32
	GBPUSD	1.65	1.64	1.61	1.59	1.58	1.59	1.61	1.63
	AUDUSD	0.90	0.86	0.84	0.86	0.88	0.90	0.91	0.92
	USDCHF	0.88	0.90	0.94	0.97	0.98	0.98	0.96	0.95
	USDBRL	2.35	2.20	2.14	2.33	2.45	2.53	2.65	2.70
	USDMXN	13.22	12.80	12.75	12.82	12.85	12.90	13.15	13.21

US Winter Slowdown: Whether the Weather

Andrew Grantham

Bitter cold and snow storms have frozen certain parts of the US economy in Q1. But the key question is whether the weather accounts for all, or at least most, of the slowdown. If it does, better weather in the spring will not just see growth return to its previous trend in Q2, but could also allow the economy to catch up on any activity delayed from Q1.

While commentators have been quick to dismiss a slew of cooler data as weather-impacted, they haven't put their money where their mouth is by adding to forecasts for the second quarter. Even as consensus expectations for first quarter growth have been scaled back, none of that has been added to Q2 (Chart 1, left).

GDP Takes a Hit

Our analysis suggests that the harsh winter this year could have subtracted around 0.7-1.0%-pts from the annualized rate of GDP growth in the first quarter of the year. That accounts for almost all of the slowdown to the 1.6% rate we currently forecast for Q1. Simply by not having a weather disruption, second quarter growth would be around 2½%. But adding in activity held over from Q1, and some underlying strengthening of the economy as well, Q2 should easily beat the current consensus (Chart 1, right).

Analyzing periods of below-average winter temperatures and above-average snowfall since 1970 suggests the former has a larger impact on the economy in first quarters—½%-pt versus about ¼%-pt for snowfall (Chart 2, left) compared with the trend over the previous four quarters. Combined, we could be looking at around a ¾%-pt hit.

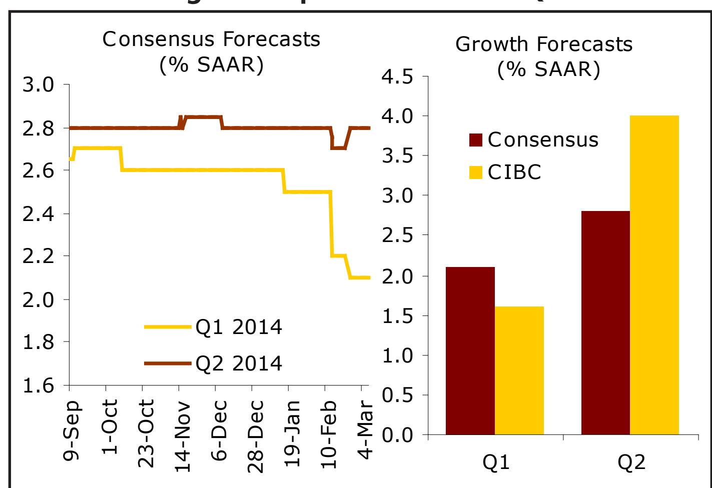
It isn't just whether temperatures are below or above average that counts, though. Regression analysis shows a statistically significant relationship between the divergence of temperatures from seasonal norms, and changes in Q1 GDP growth from the prior trend. Across the US as a whole, the average temperature may only have been about a degree (Fahrenheit) cooler than normal in January. However, temperatures were even more frigid compared to seasonal norms in February. A 2-3 degree divergence for Q1 as a whole would lop off 0.7-1.0%-pts from GDP growth (Chart 2, right).

When cold weather strikes, the impact on GDP usually comes through fixed investment (Chart 3). That may seem strange in light of recently sluggish retail sales figures, but the downturn in spending at the malls is often offset by increased consumption of services (particularly utilities).

In terms of investment, even though construction spending was better than expected in January, housing starts severely lagged building permits, suggesting

Chart 1

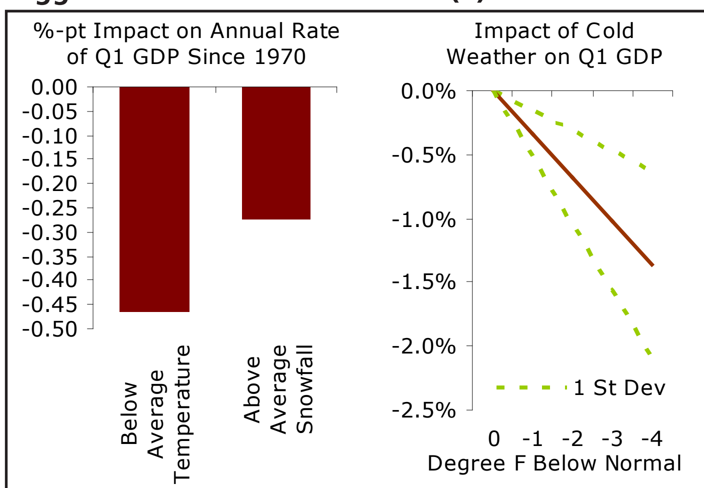
Consensus Has Cut Q1 Expectation, But is Missing the Implied Bounce to Q2



Source: Bloomberg, CIBC

Chart 2

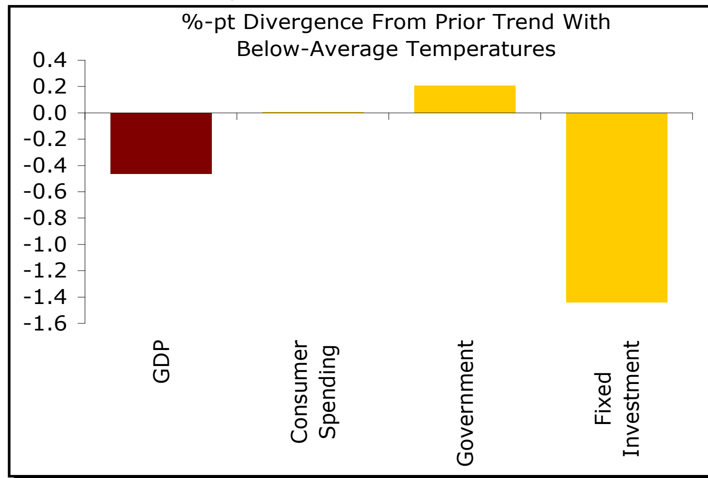
Cold Has Greater Impact Than Snow (L), and Has a Bigger Effect the Chillier it Gets (R)



Source: BEA, NOAA, CIBC

Chart 3

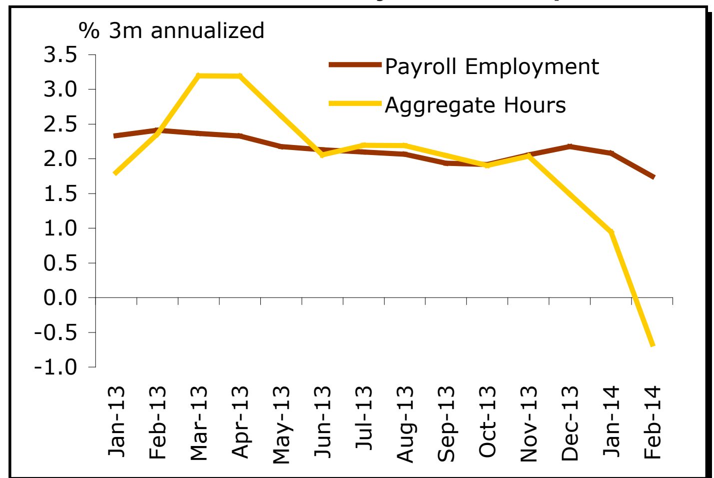
Investment Sees the Biggest Hit From Cold Weather (Average Deviation in Q1 since 1970)



Source: BEA, CIBC

Chart 5

Hours Worked Dive But Payrolls Hold Up



Source: BLS, CIBC

stronger growth to come as the weather improves. The slowdown in homebuilding stems from cold weather making its way further down the Mid-West and into the Southern states, where cooler temperatures could make the difference between breaking ground on new projects or not. The Mid-West and South accounted for virtually the entire slowdown in single family starts during January (Chart 4).

Similarly, sluggish capital goods shipments hint at soft business investment during the current quarter, but a January rebound in orders suggests a much improved pace to capital spending in Q2.

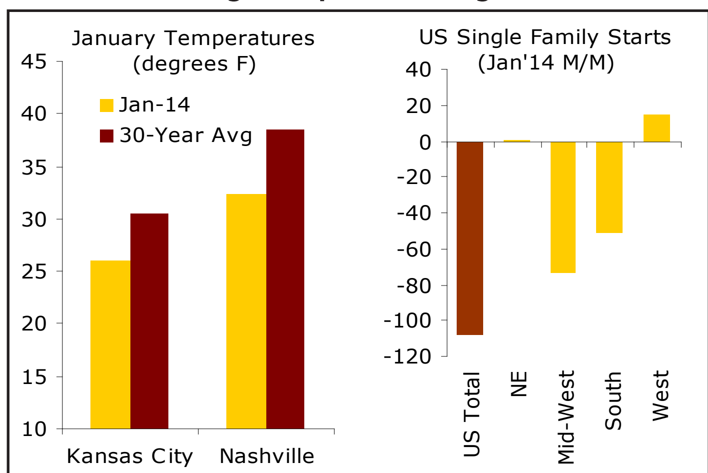
Hiring for a Q2 Rebound

Recent resilience in hiring also makes us more confident of a rebound in growth when spring arrives. The impact of severe weather can be seen in aggregate working hours, which fell marginally again in February and are down on a three-month annualized basis as well (Chart 5). However, given a better-than-expected 175K gain in February, accompanied with modest upward revisions to the prior two months, payroll growth has only slowed marginally.

That doesn't mean employment figures won't also warm up with the weather. In February, some 600K people stated that they didn't work due to bad weather—roughly

Chart 4

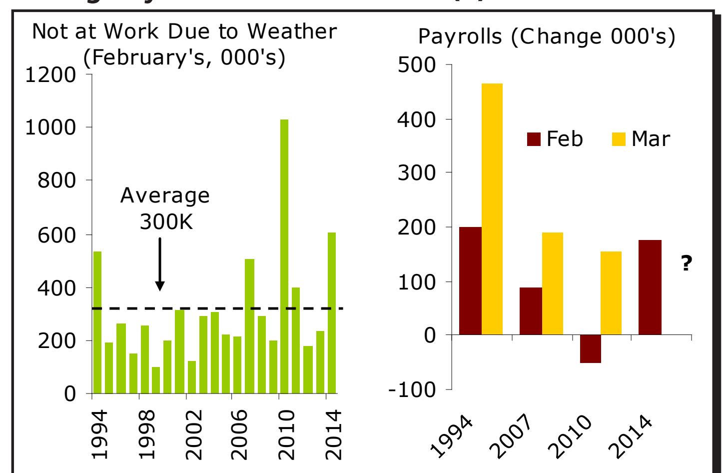
Cold Temperatures in Deep Mid-West and South (L), Result in Large Drop in Housing Starts (R)



Source: Census Bureau, CustomWeather, CIBC

Chart 6

High Instances of Weather Delays (L), Can Signal Strong Payroll Growth to Come (R)



Source: BLS, CIBC

twice the average for that month (Chart 6, left). As they may have been included on company payrolls, that result doesn't affect net hiring directly. Yet, in past instances of high weather-related absenteeism, the March gain in employment has been significantly stronger than that seen in February (Chart 6, right).

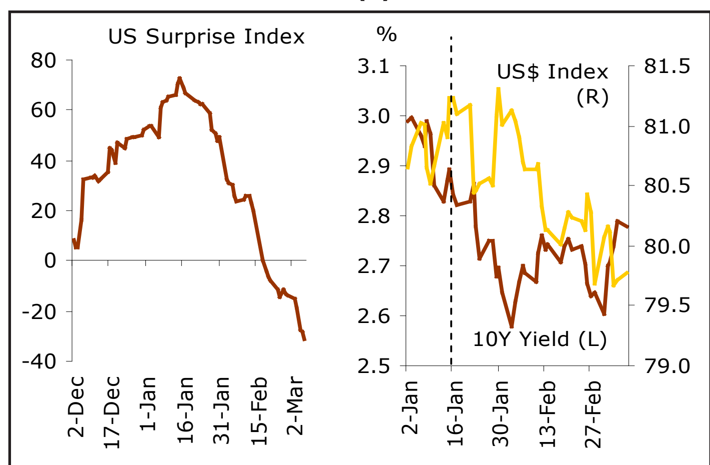
Playing the Rebound

With the consensus not moving up Q2 projections, there is plenty of scope for upside surprises when temperatures warm up. That could have particularly strong implications for those trading US Treasuries and the US$. The 10-year Treasury yield is still some 10 bps lower than it was when the US surprise index peaked on January 15th, while the US$ index is around 1.5% weaker, even after February's robust payrolls report (Chart 7). If bad weather has driven almost the entire slowdown in Q1 GDP, it shouldn't be long until warmer data rolls in and the 10-year yield and US$ are back to at least where they were on January 15th, if not higher.

For consumer-related equities, it is reasonably easy to see from past retail sales data how households typically catch up with postponed purchases once the weather improves (Chart 8, left). However, much of that already appears to be baked into analysts' earnings expectations, with EPS estimates for discretionary consumer goods companies much higher in the coming quarter, even compared with two quarters ago (Chart 8, right). Against less rosy earnings expectations, consumer staples could offer more upside, as even in this area some purchases may have been postponed.

Chart 7

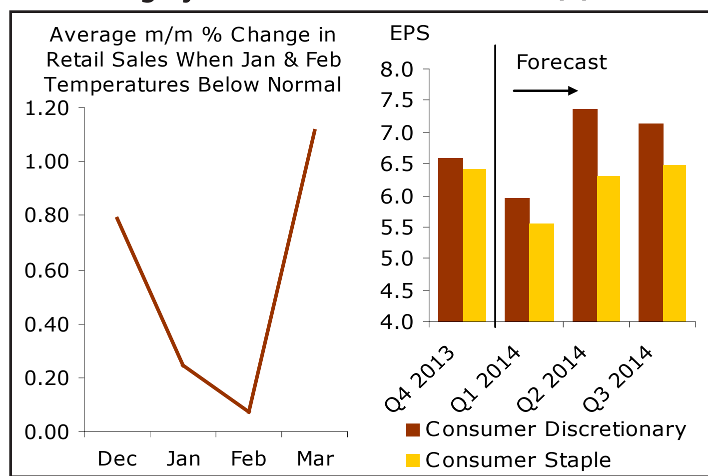
US Surprise Index Has Turned Lower (L); So Have Bond Yields and the US$ (R)



Source: Bloomberg, Citi, CIBC

Chart 8

Retail Sales Often Bounce Back Strongly (L), But That's Largely Baked into EPS Forecasts (R)



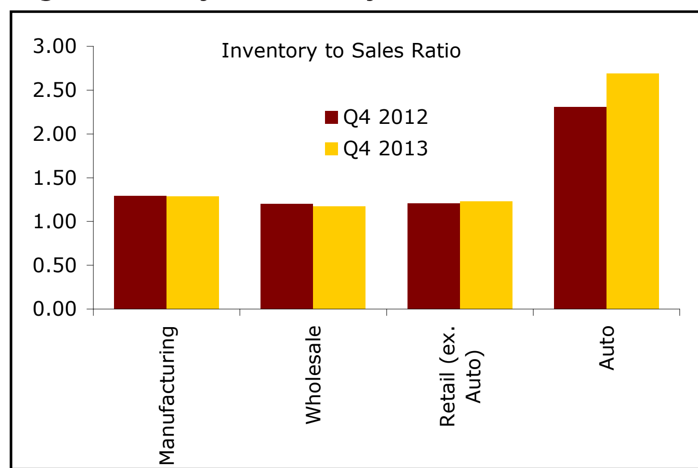
Source: Census Bureau, Bloomberg, CIBC

Of course, there are other factors that could have played a role in slowing the economy. Prime among those is the large degree of stock-building in the second half of 2013, which has led to concern about inflated inventory levels. But even though stock-building won't be as strong going forwards, there is little reason to expect aggressive de-stocking as inventory-to-sales ratios are no higher in most areas than they were a year ago (Chart 9).

While we're far from the first to blame the weather for Q1 weakness, our results point to a much more decisive rebound than the market has priced in. As more seasonal temperatures (hopefully!) return in Q2, and the economy catches up with postponed activity, the data flow will strengthen and second quarter growth could easily surpass consensus expectations. That will have the bond market on its heels again, and support the US$.

Chart 9

High Inventory Levels Only a Problem in Autos



Source: Census Bureau, Wards, CIBC

M&A Outlook: Let's Make a Deal

Peter Buchanan and Nick Exarhos

The urge to merge is back, lending potential support to stocks, if solid gains during the last consolidation wave a decade ago are anything to go by.

The turnaround comes after generally lean pickings for dealmakers in the Great Recession's wake (Chart 1). Deal volumes globally climbed to over $2.2 trillion in 2013 but that still left flows far below the 2007 pre-recession high of $4 trillion. Primarily reflecting a drop in resource transactions, Canadian deal volumes actually fell to $84 billion from $125 billion the year before.

North America in the Driver's Seat

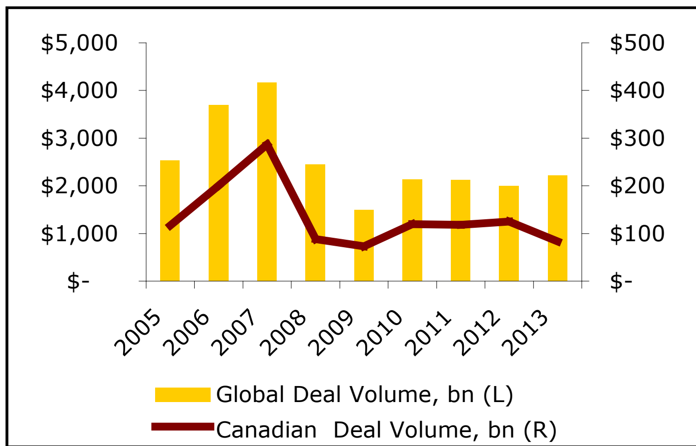
Bearing witness to the turning tide, volumes at the global level are up some 50% on the year so far in 2014. North America appears to be leading that advance (Chart 2), thanks to its more advanced recovery and reduced uncertainty due to developments like the recent US budget pact.

US firms announced well over $300 billion of transactions in January and February, the largest two-month tally since 2000. Although the deal count actually fell modestly, that has been more than offset by a doubling in average transaction size. High profile deals in the social and conventional media spaces and pharmaceuticals are among those drawing front-page attention.

Though down last year, Canadian deals have likewise seen a roughly 30% spike on a year-to-date basis. As noted, the most notable shift in the Canadian deal landscape has been the growing share of communications deals, which at over 20% of volumes last year, doubled its share from its 2007-2012 average.

Chart 1

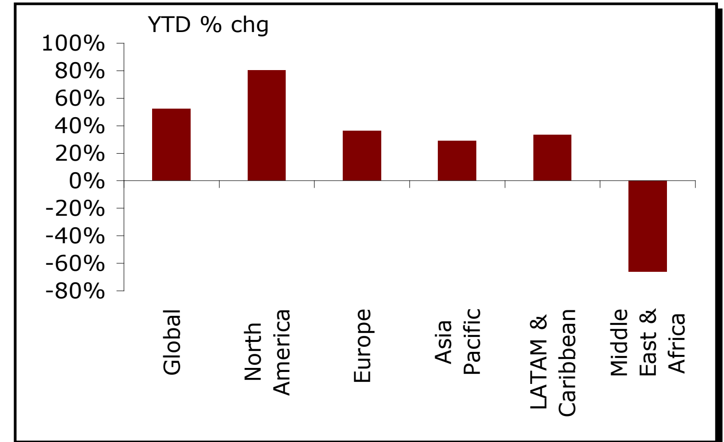
Deal Volumes Have Lagged in Recent Years



Source: Bloomberg, CIBC

Chart 2

M&A Deal Growth by Region in 2014



Source: Bloomberg, CIBC

Although communications, including internet and social media, has been a driver of increased deal activity both globally and at home, it's just one of a number of areas showing signs of a thaw. An appetite for producing and service field assets has helped lift global energy volumes by 80% to nearly $50 billion thus far in 2014. Real estate, pharmaceuticals and travel/accommodation have shown momentum. A double-digit rise in mining deals suggests even that hard hit sector is showing life (Chart 3).

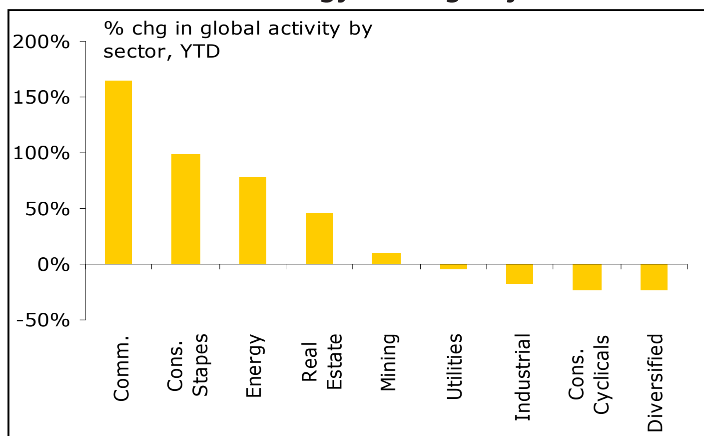
US Acquirers Particularly Active

Looking at longer term origination patterns, the biggest drop-off in activity in the last decade was from Western European acquirers. That slack was largely offset by China. More recently, American firms have padded their acquisitions lead, while China's share has just more or less held its own (Chart 4, left). On the target side, the share of Canadian assets has fallen, though that's likely to reverse itself as interest in resource targets rises in step with commodity prices and the global economy in the next 12-18 months (Chart 4, right).

Private equity's share of acquisitions has fallen from a quarter in the last decade's merger wave to about 15% recently. A parallel change has seen all-cash-deals fall

Chart 3

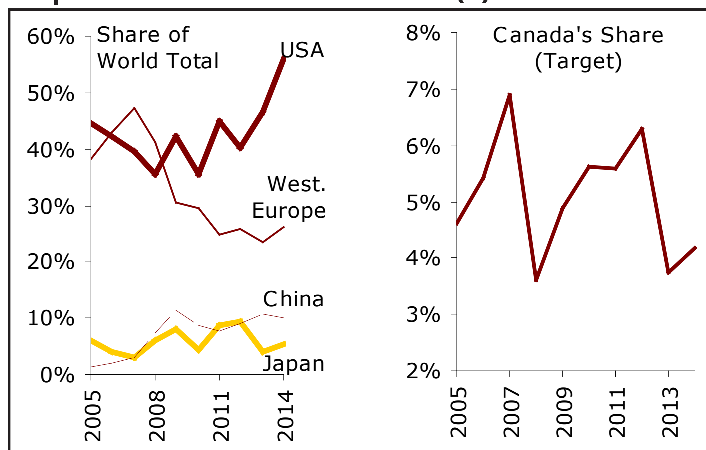
Communications, Energy Among Key Drivers



Source: Bloomberg, CIBC

Chart 4

US Share of Acquisitions Up Sharply (L), Fewer Acquisitions of Canadian Assets (R)



Source: Bloomberg, CIBC

from two-thirds of flows in the decade-ago boom to only 40% of late. With targets being more amenable to accepting acquiring company shares in a strong stock market environment, cash-and-stock transactions have nearly doubled their share. That reflects the benefits to deal financing associated with the healthy equity market backdrop, and also means that acquirers share the deal risk with target firm shareholders.

$4 Trillion Cash Pile, Structural Factors Buoying Deal Flow

What are the next few years likely to bring? Suggesting the M&A turnaround has legs, an examination of the current backdrop highlights shared characteristics with past sustained periods of high-flying M&A activity (Table 1). While Obama's proposed end to favourable carried-interest tax provisions could slow the deal upswing, its passage is still seen as unlikely.

Table 1

Similar Conditions to Past Merger Waves

	1960s	1980s	1990s	Mid-2000s	Now
Dynamic Economic Conditions	×	×	×	×	
Lax Credit Conditions		×		×	×
Booming Equity Markets	×	×	×	×	×
Technological Shock		×	×	×	×
Regulatory/ Policy Shift		×	×	×	×
Buying Cheaper than Building*	×	×			

**Please see Tobin's Q (Chart 5)*

Source: CIBC

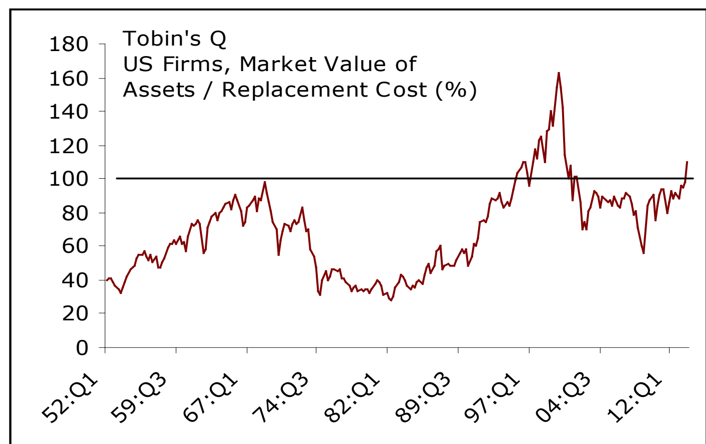
True, one feature of the M&A booms of the 1960s and 80s is no longer present. Back then, stock market valuations were low relative to the replacement cost of the assets. The low Tobin's Q (Chart 5) encouraged conglomerates and others to buy businesses rather than build them. Current valuations leave few such bargains.

But as is now the case, other M&A upswings have been triggered by firm- or industry-specific growth or earnings shocks, making mergers vital to redeploy capital and other resources effectively. Shocks promoting such realignments today include financial sector re-regulation, post-recession consolidation pressures, and patent roll-offs in the drug industry.

Cash levels also suggest more to come in this merger wave. With profits outstripping GDP growth, in many countries, holdings of cash and other liquid assets by

Chart 5

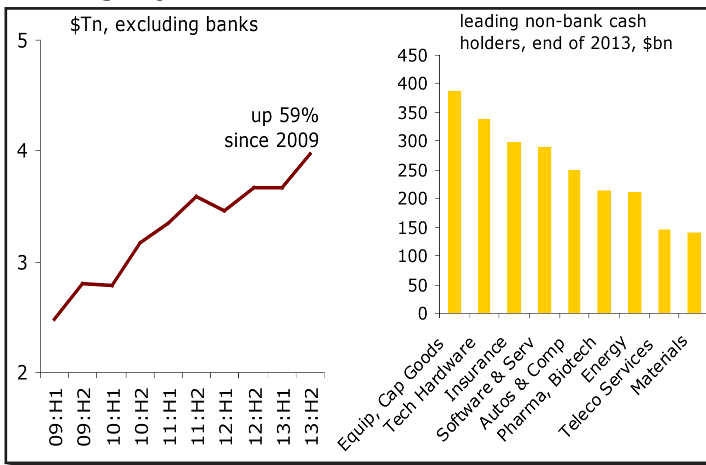
Market Mispricing Not the Main Factor Driving Recent Deal Flow Growth



Source: Fed, CIBC

Chart 6

G7 Corporate Cash Pile Now Tops $4 Tn (L), Largest Holdings by Sector (R)



Source: Bloomberg, CIBC

publicly listed G-7 firms have ballooned by 60% since the recession's end, to over $4 trillion (Chart 6), giving firms an unprecedented M&A war chest. The outsized cash piles of the equipment, IT, energy, auto and health/pharmaceutical segments make them a focal point for dealmaking. Buyout firms have also capitalized on buoyant debt markets, to refinance at a record rate. Alongside that, dwindling low hanging fruit on the cost-cutting side is forcing US firms to explore more options to drive top-line growth.

Is it 1997 All Over Again?

The dot.com bubble ended badly. While the seemingly high prices for some tech acquisitions have sparked fears of a reprise, one metric suggests such fears may not be justified, at least for publicly traded entities. The acquisition premium for new public tech deals has actually been lower than it has typically been in the past.

Deal premiums for a spectrum of segments reveals some interesting patterns (Table 2). Premiums in the energy sector have been near their historical averages globally in the last year. Premiums for utilities and non-energy resource producers have been relatively high relative to the past. Seemingly generous premiums for the mining sector, though, may be more a testament to still-depressed share prices, and the need for radical restructuring, including mergers in some cases, to unlock shareholder value.

Beyond ample cash piles and firming resource prices ahead, other factors also point to the potential for a further acceleration in M&A activity, affecting the

Table 2

Global Deal Premiums by Sector

Sector	Last 4 Qtrs	Average, 2002-date	Difference
Technology	26.9	31.4	-4.5
Communications	22.5	30.7	-8.2
Basic Materials	42.2	30.7	11.5
Consumer Non-Cyclical	20.0	29.2	-9.2
Energy	27.9	27.0	0.9
Financial	24.0	26.2	-2.2
Consumer Cyclical	28.5	23.5	4.9
Industrial	16.0	23.1	-7.2
Utilities	20.0	7.8	12.2
All Sectors	**25.6**	**27.6**	**-2.0**

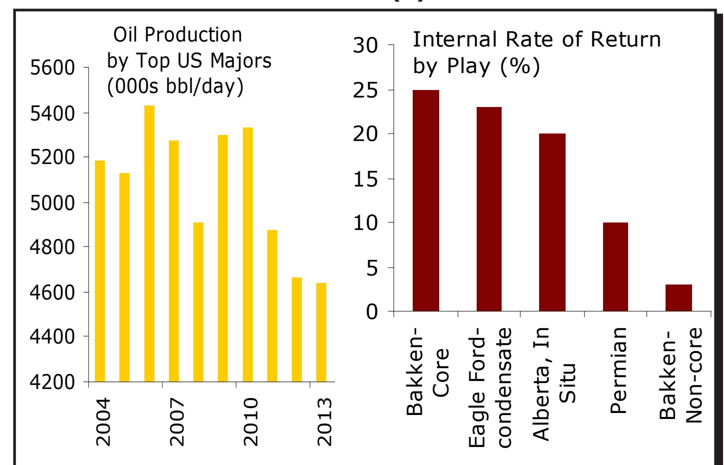
Source: Bloomberg, CIBC

TSX's largest sectors. Notwithstanding expanding US oil output, oil production by the largest American players has stagnated (Chart 7, left), leaving them pressured to seek growth by acquiring producer assets. Despite perceptions, returns on oil sands' in situ developments compare favourably with US tight oil deposits (Chart 7, right). Mining deals are showing some signs of a turnaround, and consolidation pressures there are likely to continue. Pressures for new revenue streams and cost savings in drug pipelines will continue to drive deal flow in the pharmaceutical sector.

The last decade's feverish resource spree saw some legendary Canadian resource names on the auction block. The lift from that episode to a number of key TSX sectors added as much as 7% to market cap*. Even if the activity this time doesn't reach quite the same feverish pitch, a pick-up in buyout activity is another potential source of market support. That's one of several reasons for thinking the TSX could fare better this year after finishing well back in the G-7 pack in 2013.

Chart 7

Oil Production by Three Top US Majors (L), Canadian In Situ Attractive (R)



Source: company data, S&P, CIBC

* *see May 17, 2007 Monthly Indicators, "New Wave Mergers"*

Less for More: Canada's Retail Outlook

Avery Shenfeld and Benjamin Tal

Canada's retail sector is in flux, on just about every front. Mergers have boosted enterprise size of domestic players with the aim of improving buying power and scale efficiencies, but competition is heating up from US-based entrants, in department store goods, groceries and looking ahead, the luxury category.

What do macro fundamentals have in store for stores for 2014? A complete U-turn from what we saw last year, in which retailers moved greater volumes as consumers' purchasing power benefited from softer inflation. The next two years will see a gradual upturn in inflation, in part a reflection of a weaker Canadian dollar, but also capturing higher energy costs and a tobacco tax hike. So quarterly growth rates will see a trend towards selling less for more: higher prices, but leaner growth in real volumes.

Mediocre Wallet Growth

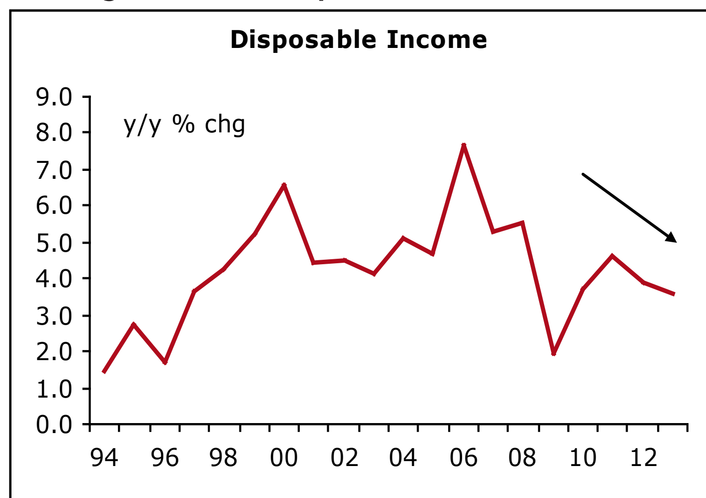
One constant from last year to this one is that household wallets will be improving at what can only be described as a mediocre pace. In nominal terms, disposable income growth has been slowing, rising by only 3.6% in 2013— the weakest non-recessionary showing since 1996 (Chart 1), capturing generally lacklustre wage and employment gains in 2013. Improvements on that front aren't likely to be seen until 2015, when tighter job markets should generate some labour bargaining power. Typically, average hourly wages don't climb at anything above 3% unless the output gap has been closed.

The big winners in the retail space have been at the bargain end, and income patterns explain some of the appeal of dollar stores. Increasingly, whatever wage gains there are have been tilted to a select group of higher-paid sectors (Chart 2, right), leaving the median worker with leaner improvements. The average wage in the past year rose 2.5%, but the median wage climbed only 1%. That extends a pattern going back more than a decade, in which the ratio of the average to the median wage has been eroding (Chart 2, left).

Those backing the upcoming boom in luxury store square footage should like that tilt, but they still risk disappointments in the size of that segment relative to where it sits on their more familiar US turf. Despite a rising trend in inequality over prior decades, both pre- and after-tax income in Canada is not nearly as unevenly distributed as it is stateside. As of 2010, a US tax-filer had to earn $359.4K to be in the top 1% of Americans. The corresponding figure for Canada was only $201.4K.

Chart 1

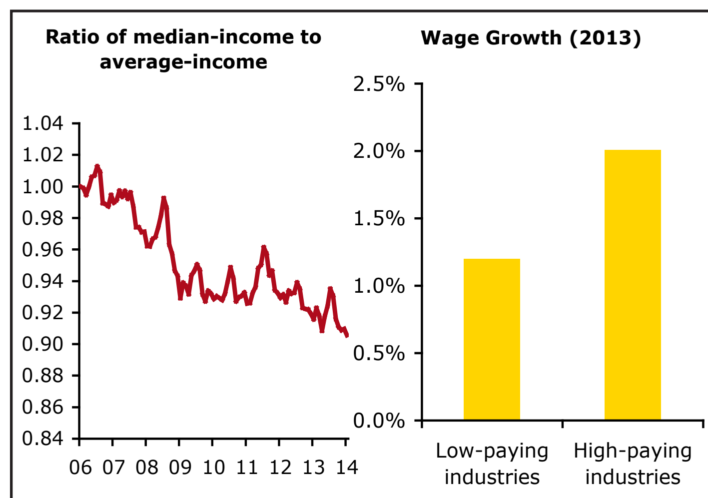
Slowing Growth in Disposable Income



Source: Statistics Canada, CIBC

Chart 2

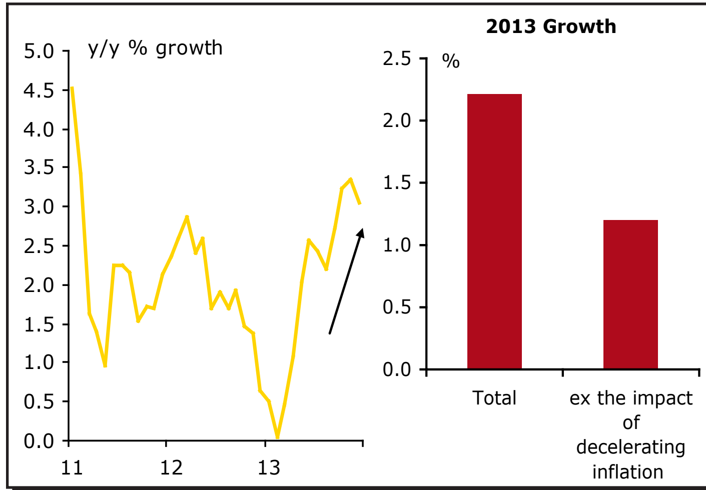
Income Distribution: Less and Less Normal



Source: Statistics Canada, CIBC

Chart 3

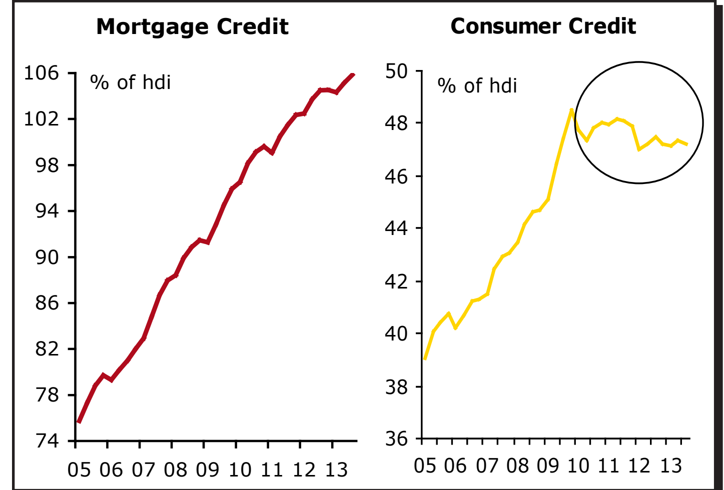
Real Retail Sales (L) Boosted by Lower Inflation (R)



Source: Statistics Canada, CIBC

Chart 4

Consumer Credit Stalls, Only Mortgages Growing



Source: Statistics Canada, CIBC

Disinflation Dividend Ends

Despite lacklustre income growth, Canadians had a lift to spending power in 2013 from a drop in inflation (Chart 3, left). That was even truer on store shelves than it was in the overall consumer basket, as the chain-price index for retailing showed even more disinflation than the more services oriented CPI. But for that drop, real retail sales growth would have been much weaker (Chart 3, right).

Looking ahead, the disinflation dividend is about to disappear. The 12-month inflation rate remains low, and could dip to only 1% in February as an unseasonably large monthly change in February 2013 drops out of the figure. But look for inflation to climb over the balance of the year, reaching 2% by mid-2015.

Several factors are at play in that outlook. Some of the low inflation trajectory in 2013 may have been due to simply noise in the data, as the core CPI tracked below where other inflation drivers typically would position it. While retail competition remains intense, particularly in the grocery aisle, the one-off impacts of new entrants should dissipate through the year. The earlier drop in the C$ should add about 0.3-0.4% to CPI by year end, based on the results of our modelling of historical pass-through impacts. Squeezing margins, competitive pressures in some sectors will limit the ability of retailers to pass on all of their cost-of-goods increases to their customers.

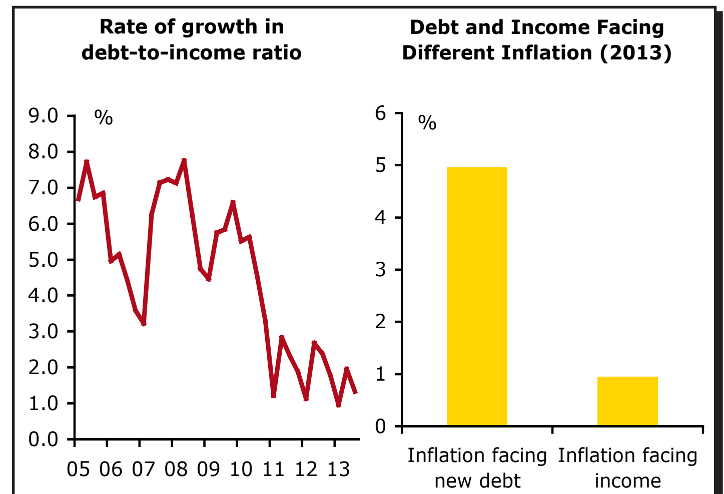
To Spend or Save?

Having earlier run up balances in lines of credit and other non-mortgage debts, Canadians have been listening to those advising more caution, with growth in consumer credit hovering near the lowest pace in more than two decades.

Despite all the fear mongering about rising debt/income ratios and profligate behaviour in a low rate environment, the debt burden climb in the last two years has been largely a story of soft incomes and mortgage credit, not borrowing for consumption (Chart 4).

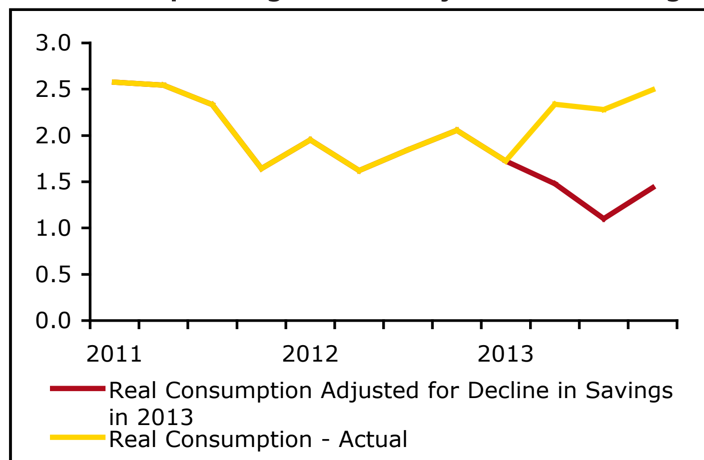
Chart 5

The Problem is in Income, Not Credit Growth



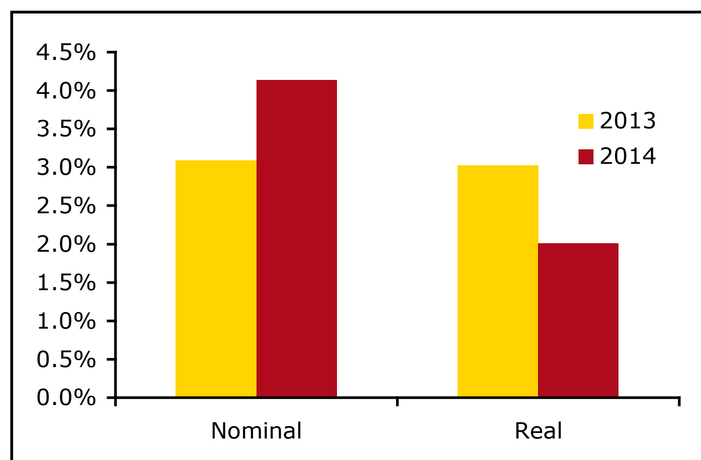
Source: Statistics Canada, CIBC

Chart 6
Consumer Spending Financed by Reduced Saving



Source: Statistics Canada, CIBC

Chart 8
Retail Trade

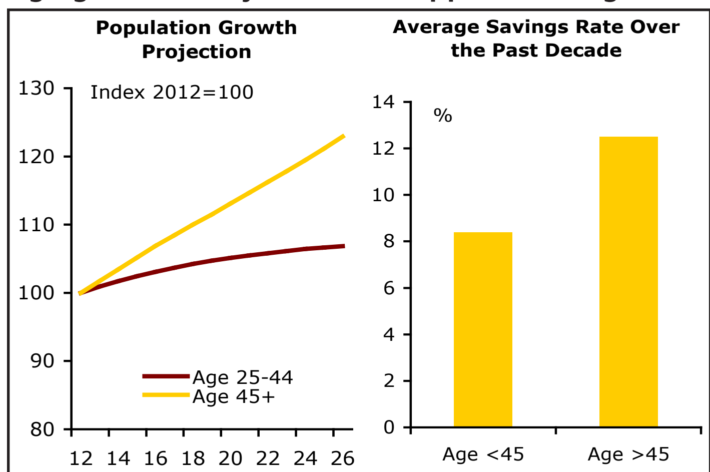


Source: Statistics Canada, CIBC

And much of its recent momentum has been largely a function of house prices, which push up average mortgage size. The inflation rate on housing and other credit financed purchases has been running above the broader rate of inflation in the economy, which tends to be what influences wages (Chart 5). A plateau in debt/income ratios could be achieved by 2015, as this inflation gap shifts, with wages accelerating and house price inflation cooling.

The good news for retailers is that history suggests that consumer credit growth is unlikely to slow any further in real terms without being pushed there by a recession. But savings decisions could still pinch consumption a bit in 2014. The past year saw a pullback in the savings rate, and the higher portion of income devoted to consumption was key to growth (Chart 6).

Chart 7
Aging of the Baby Boomers Supports Savings Rate



Source: Statistics Canada, CIBC

The general trend in savings rates has been very gradually higher since early 2005, and a number of forces could see that trend reassert itself in 2014. Our call for bond yields to drift upwards from current levels would lean in that direction. Aging demographics should also trend towards an upward tilt, given that over 45 year olds, where we are seeing greater population growth, tend to save more than younger Canadians (Chart 7).

One factor holding down savings rates in recent years is that the climb in asset values, both housing and financial, has lifted household net worth, up by more than 7% in the last year. Gains on existing portfolios reduce the pressure to forego consumption. While we expect a reasonably healthy climb in equity portfolios, many households have much of their financial assets in life insurance and pension plans, with the value of housing assets exceeding non-insurance/pension assets by more than 15%. A slower pace to house price inflation this year could also lean towards a slightly higher savings rate.

That will still leave room for nominal retail sales growth to improve by more than a full percentage point in 2014 (Chart 8). But all of that upswing will be due to higher prices, even with retailers absorbing some of the cost increases associated with a weaker loonie. In volumes, look for a slowdown as Canadians await better income growth in 2015 with which to cover the price increases ahead.

ECONOMIC UPDATE

CANADA	13Q4A	14Q1F	14Q2F	14Q3F	14Q4F	15Q1F	2013A	2014F	2015F
Real GDP Growth (AR)	2.9	1.6	2.0	1.7	2.0	2.7	2.0	2.1	2.5
Real Final Domestic Demand (AR)	1.2	1.7	2.0	1.7	1.7	1.9	1.4	1.6	2.0
All Items CPI Inflation (Y/Y)	0.9	1.3	1.7	1.7	2.1	2.1	0.9	1.7	2.2
Core CPI Ex Indirect Taxes (Y/Y)	1.2	1.2	1.4	1.6	1.9	2.0	1.2	1.5	2.1
Unemployment Rate (%)	7.0	7.0	6.9	6.9	6.7	6.6	7.1	6.9	6.5

U.S.	13Q4A	14Q1F	14Q2F	14Q3F	14Q4F	15Q1F	2013A	2014F	2015F
Real GDP Growth (AR)	2.4	1.6	4.0	3.3	3.4	2.7	1.9	2.9	3.1
Real Final Sales (AR)	2.3	3.3	4.1	3.5	3.4	2.7	1.7	3.1	3.1
All Items CPI Inflation (Y/Y)	1.2	1.4	1.5	1.8	2.4	2.4	1.5	1.8	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	6.6	6.4	6.2	6.0	5.9	7.4	6.3	5.8

CANADA

After the strongest quarterly increase in two years, Canada's economy likely slowed to a 1.6% pace in Q1, due to December's handoff, severe weather in some areas and heavy inventories in sectors like autos. We've also pared our full-year growth estimate by two ticks to 2.1%. Although housing could contribute incrementally to growth, a hoped-for turnaround in investment still remains a ways off. Core inflation is likely to regain the BOC's target by year end as the lagged pass-through from the weaker loonie intensifies and some recent transitory negatives fade.

UNITED STATES

Harsh winter weather has dampened growth in the first quarter of 2014, but warmer temperatures should allow the economy to surprise to the upside in Q2 (see pages 3-5). Although it has edged up recently, we still expect the unemployment rate to fall towards 6% before year end—a level that has typically seen discouraged workers re-enter the labour market. Slightly higher gasoline and agricultural commodity prices underpin a modest upward revision to our 2014 CPI forecast.

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