Economic Insights

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Be Careful What You Wish For

by Avery Shenfeld

Economics

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Federal policymakers are sending a message to Canadians: cool it. Concerned over soaring debt and house prices, Ottawa undertook several rounds of tightening in mortgage insurance rules. Governor Carney has joined in, hinting at rate hikes, even if not needed to contain inflation, if Canadians don't get off their borrowing binge.

The prophets of doom have been quick to declare Canada fated for a US-style crisis, with household defaults taking the economy down for the count. That rests on a simple comparison of aggregate debt-to-income data that is too simple to be correct.

A rain of insolvencies is not in the forecast for Canada, owing to some marked differences in the credit scores of those carrying the debt, and the extent to which it has been doled out to marginal borrowers (see pages 9-11). When it eventually hits, the next recession will see greater than normal credit losses, but unlike the US, we won't see a spike in defaults trigger that recession.

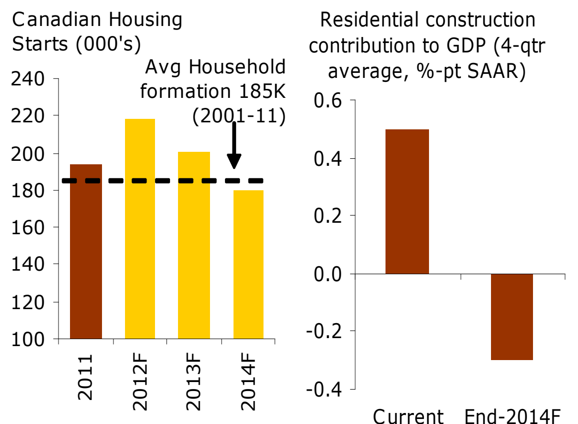
But that doesn't mean that the economy will get off scot-free. Even without a near-term move on interest rates, a slowing trend in the housing sector looks inevitable. Already, the combination of lofty prices, and reduced access to insurance on mega-mortgages to cover them, has seen resale activity drop 15% from year-ago levels, with house prices hitting a plateau.

That will have significant consequences for the ability of the household sector to carry the economy on its back. A 5% per year drop in house prices, for example, would shed roughly a half-point off GDP growth through its wealth effect on consumer spending, given historical sensitivities.

The shift in the volume of construction will be even more consequential. If, as we expect, homebuilding returns to levels aligned with the longer term trend in household formation, taking starts from the 220 thousand per year range today to 180 thousand by 2014, there will be a near 1% adverse swing in the direct contribution of homebuilding to GDP growth (Chart), before allowing for any multiplier effects.

So Ottawa has to be careful what it wishes for. In 2013 an economic acceleration looks unlikely absent a new source of growth to fill in housing's gap. That makes it even more urgent that the global economy is healthier come 2014, when the full bite of a housing slump on domestic activity will be felt. Until that's a sure bet, policymakers will be cautious about pouring more cold water on the housing sector through further changes in mortgage insurance or higher interest rates.

Less Building Activity Will Dent Growth



Source: StatCan, Conference Board, CIBC

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

MARKET CALL

- The Bank of Canada held on to its tightening bias, expressing stronger concern over rising household debt. However, the policy statement and subsequent MPR press conference suggested they view those hikes as less imminent, and we continue to expect the first move coming in early 2014.
- That does not mean, though, that markets won't start pricing in the possibility of rate hikes further out, which would be supportive for the C$.
- Ongoing uncertainty regarding global growth could keep bond yields lower further into 2013 than we previously envisioned. Any move by the Fed to supplement their MBS purchases with Treasuries once the Twist program finishes at year-end could put further downside pressure on long-term yields stateside.

INTEREST & FOREIGN EXCHANGE RATES

		2012		2013				2014
END OF PERIOD:		**30-Oct**	**Dec**	**Mar**	**Jun**	**Sep**	**Dec**	**Mar**
CDA	Overnight target rate	1.00	1.00	1.00	1.00	1.00	1.00	1.25
	98-Day Treasury Bills	0.98	0.95	0.95	0.95	0.95	1.20	1.45
	2-Year Gov't Bond	1.09	1.10	1.20	1.35	1.40	1.65	1.75
	10-Year Gov't Bond	1.80	1.80	2.00	2.25	2.55	2.60	2.65
	30-Year Gov't Bond	2.39	2.40	2.60	2.85	3.00	3.10	3.10
U.S.	Federal Funds Rate	0.18	0.10	0.10	0.10	0.10	0.10	0.10
	91-Day Treasury Bills	0.11	0.10	0.10	0.15	0.15	0.15	0.15
	2-Year Gov't Note	0.29	0.30	0.30	0.35	0.40	0.45	0.45
	10-Year Gov't Note	1.72	1.65	1.85	2.15	2.45	2.55	2.65
	30-Year Gov't Bond	2.88	2.65	2.90	3.20	3.40	3.65	3.70
Canada - US T-Bill Spread		0.87	0.85	0.85	0.80	0.80	1.05	1.30
Canada - US 10-Year Bond Spread		0.08	0.15	0.15	0.10	0.10	0.05	0.00
Canada Yield Curve (30-Year — 2-Year)		1.30	1.30	1.40	1.50	1.60	1.45	1.35
US Yield Curve (30-Year — 2-Year)		2.59	2.35	2.60	2.85	3.00	3.20	3.25
EXCHANGE RATES	CADUSD	1.00	1.03	1.02	1.00	1.00	1.02	1.03
	USDCAD	1.00	0.97	0.98	1.00	1.00	0.98	0.97
	USDJPY	80	80	78	77	76	76	76
	EURUSD	1.30	1.31	1.28	1.26	1.25	1.28	1.31
	GBPUSD	1.61	1.61	1.58	1.58	1.57	1.61	1.63
	AUDUSD	1.04	1.00	0.98	0.97	0.96	0.99	1.03
	USDCHF	0.93	0.92	0.95	0.96	0.98	0.98	0.95
	USDBRL	2.03	2.02	2.02	2.04	2.07	2.05	2.08
	USDMXN	13.06	12.50	12.85	13.05	13.30	13.38	13.48

Assessing Long-Term Growth in Canada's Provinces: Surmounting the Fiscal Challenge

Warren Lovely and Emanuella Enenajor

Provincial economic imbalances have become as Canadian as maple syrup or universal health care. Truth is, regional disparities are ingrained in Canada's economic fabric, and volatility in cross-provincial performance is today no more pronounced than in prior decades.

Canada's regional divergence could get worse before it gets better. Long-term growth dynamics are challenging provincial fiscal sustainability, complicating efforts to level the fiscal playing field and risk intensifying political fissures. But there's an apparent remedy to looming provincial fiscal stresses, one rooted in history.

Resource-Rich Provinces Have the Edge

Natural resource wealth is synonymous with economic and fiscal success. In the past decade, commodity rich regions like Newfoundland & Labrador and Alberta have led growth (Chart 1), as the lift from emerging market demand spurred hiring and investment in the resource patch. Contrast that with Central Canada, where an appreciating currency put the brakes on a once bustling factory sector. Notwithstanding concerns over an emerging market deceleration, provincial growth rankings look to be little changed this year and next (Table 1).

Nominal GDP growth better informs fiscal performance, and the lift from burgeoning own-source revenue in the resource patch enabled debt paydowns and credit rating upgrades. In Ontario, fiscal stress associated with relative economic underperformance has pushed Ontario's credit ratings below the weighted average of the remaining provinces for the first time ever (Chart 2).

Table 1

Near-Term Provincial Growth Prospects

	Real GDP Growth			
Y/Y % Chg	2010A	2011A	2012F	2013F
BC	3.0	2.9	2.4	2.2
Alta	3.3	5.2	3.5	3.2
Sask	4.0	4.8	3.2	3.0
Man	2.4	1.1	2.5	2.3
Ont	3.0	2.0	2.1	1.8
Qué	2.5	1.7	1.4	1.5
NB	3.1	0.1	1.4	1.6
NS	1.9	0.3	1.5	2.2
PEI	2.6	1.1	1.6	1.7
N&L	6.1	2.8	1.3	3.0
Cda	**3.2**	**2.6**	**2.2**	**2.0**

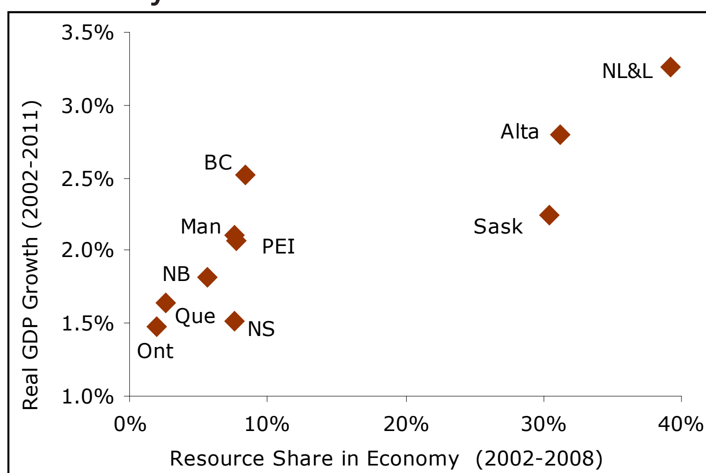
Source: CIBC, Statistics Canada

Deconstructing Canada's Economic Potential

Long-term growth can be expected to track an economy's underlying firepower—growth in the labour force and productivity. Looking back, productivity gains made up for

Chart 1

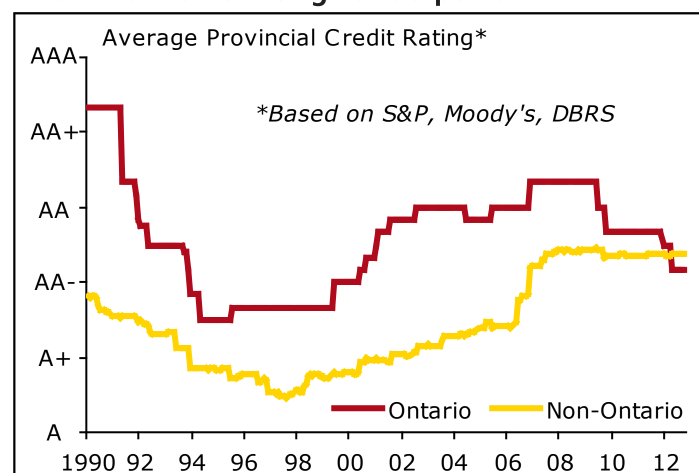
Commodity Producers Lead Economic Growth



Source: CIBC, Statistics Canada

Chart 2

Ontario's Credit Ratings Underperform



Source: CIBC, S&P, Moody's, DBRS

less-abundant labour in the 1990s, while the subsequent decade relied on rising participation in the jobs market to buttress a productivity slump. Since then, Canadian productivity growth has continued to scrape along, while retiring baby boomers depressed the pool of prospective workers. Going forward, demographic trends will heavily influence Canada's regional potential.

Population aging affects Atlantic and Central Canada most acutely (Chart 3, left). While higher rates of immigration could lessen that burden, regions with elevated joblessness will be hard-pressed to attract and retain skilled workers. Ontario has already seen a sizeable drop in its share of national immigration. Today's skilled newcomers are increasingly choosing to put down roots in Alberta, Saskatchewan and Manitoba (Chart 3, right). Inter-provincial migration trends tell a similar story, with net inflows into Alberta and Saskatchewan in recent years.

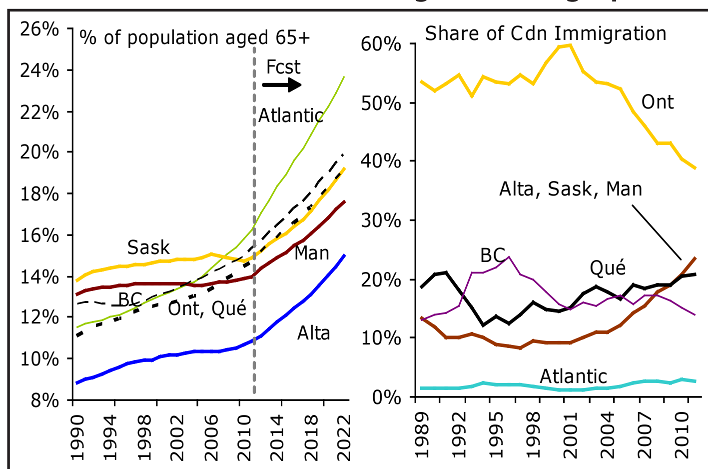
Perspectives on Productivity

Productivity is the other ingredient in determining potential. Constructively, a lofty C$, historically low borrowing costs and a more competitive tax environment could incent Canada's business sector to drive the capital spending needed to spark productivity gains. CIBC's measure of corporate health reveals the financial capacity to support investment, even if confidence is shaky. Efforts to diversify trade also look to be supportive longer term.

Canada's productivity gains will have a pronounced regional tilt. In Alberta, oil sands investments are bearing fruit, thrusting the province from a productivity laggard to a leader in years to come. Mineral and hydro projects could support long-term productivity gains in

Chart 3

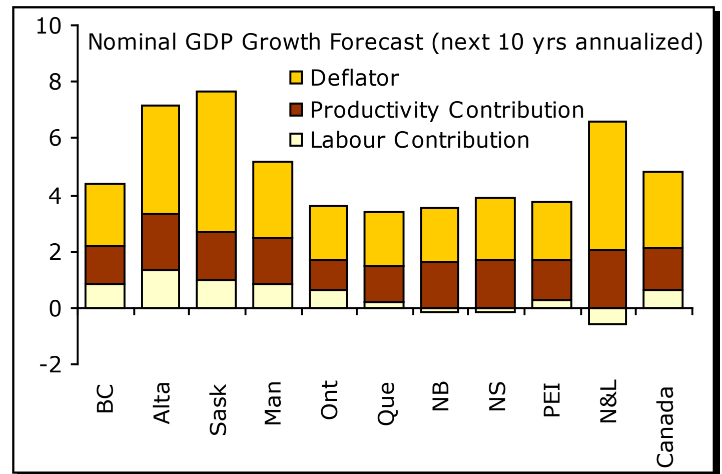
Central, Eastern Canada Losing on Demographics



Source: CIBC, Statistics Canada

Chart 4

West Still Best in Decade Ahead



Source: CIBC, Statistics Canada

Newfoundland & Labrador, although the province looks hard-pressed to repeat its earlier sizzling productivity record. Nova Scotia is set to enjoy a productivity boost associated with shipbuilding and other capital projects. Meanwhile, resurgent US demand over the next decade should benefit manufacturers—an industry concentrated in Central Canada and one boasting relatively hearty productivity growth.

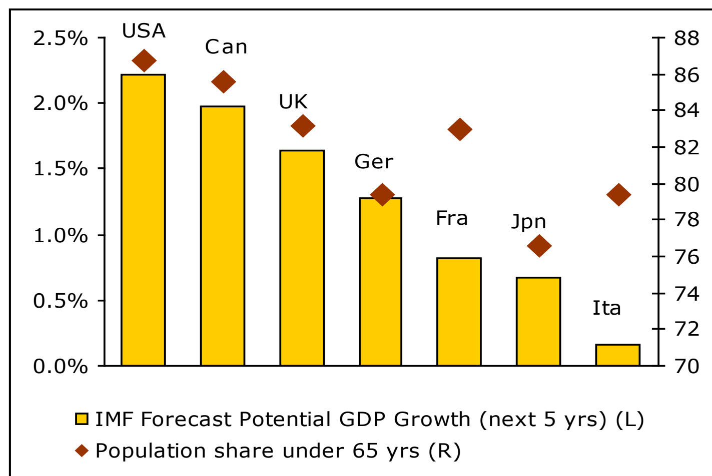
All told, Canadian productivity growth is seen accelerating to 1.5% in the coming decade, a view echoed by the Bank of Canada. Enhanced productivity gains alongside 0.6% average annual growth in the labour force implies a non-inflationary cruising speed of 2.1% for the country as a whole—largely in line with the actual pace of growth seen in the past decade. Potential growth tops the national average in all four provinces to the west of Ontario (Chart 4, Table 2). In Central and Atlantic Canada, however, potential hovers closer to 1½%. Differences in industrial composition and terms of trade effects mean the gap in long-term nominal GDP growth between the West and the rest will be even more pronounced.

Living with Muted Growth

From an international perspective, Canada's potential for economic expansion is enviable, reflecting a relatively higher share of working age individuals (Chart 5). Still, the regional growth dynamics outlined above suggest some provinces could be hard-pressed to grow out of deficit. Provincial own-source revenue growth averaged 7-8% during the last two serious periods of fiscal consolidation, but will likely be only half as fast across much of Central and Atlantic Canada in the coming decade.

Chart 5

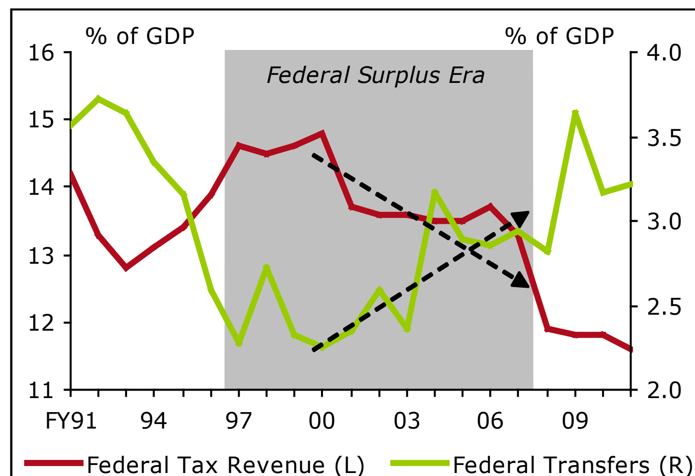
Canada's Growth Could Top Most G7 Peers



Source: CIBC, IMF, World Bank

Chart 6

Federal Cyclically Adjusted Budget Balance



Source: Finance Canada

Reflecting sober economic and demographic realities, simulations by Canada's budget watchdog—the Parliamentary Budget Office (PBO)—show aggregate provincial indebtedness spiraling higher longer term. Separate analysis conducted by Marc Joffe for the Macdonald-Laurier Institute suggests a surprisingly high risk of default in Canada's provinces in 20 or 30 years time, although the author's underlying assumptions make for overly alarmist reading.

Existing provincial deficit reduction targets should still be achievable in the near term, given a firm resolve on spending restraint. After all, low rates are bolstering debt affordability and federal transfers remain supportive, with equalization aiding underperforming jurisdictions. In general, near-term fiscal consolidation is a strategic priority for most provincial governments and opposition parties.

In the near term, Ottawa is understandably focussed on eliminating its own deficit on schedule, and is reluctant to cut taxes further to make room for provinces to hike theirs, or increase transfers at a faster pace. But longer term, it may have room to do just that. Finance Canada's own long-term fiscal projections show large surpluses piling up. For its part, the PBO pegs Ottawa's room to cut taxes or increase spending at 1.4% of GDP or about $25 bn in current dollars. That's nearly enough to transfer the remaining 5%-pts of the federal GST to the provinces. Alternatively, much of Ottawa's corporate income tax take could be transferred to the provinces without jeopardizing long-term federal fiscal sustainability. On the spending side, $25 bn could effectively double annual health transfers to the provinces. It's also more than one and a half times what Ottawa sends to the so-called "have not" provinces via equalization, although any dramatic bolstering of this program risks fanning inter-provincial tensions.

To be sure, Ottawa's efforts to ensure its own fiscal sustainability are, in many respects, commendable and beneficial, anchoring attractive borrowing rates for the provinces. But history has shown that the federal government faces intense pressure to cut taxes and boost spending when it starts to run big surpluses (Chart 6). Whatever the form, a transfer of fiscal capacity from Ottawa to the provinces, on par with past federal re-alignments, could be implemented well before provincial debt or interest burdens become unwieldy, forestalling provincial fiscal crises that otherwise stem from muted long-term growth and pronounced demographic pressures.

Table 2

Long Term Potential Growth Estimates

	Actual: 2001-2011 (annualized % chg)			Forecast: 2012-2022 (annualized % chg)		
	Productivity	Labour Input	Real GDP	Productivity	Labour Input	Real GDP
BC	1.0	1.5	2.5	1.3	0.8	2.2
Alta	0.5	2.3	2.8	2.0	1.3	3.3
Sask	1.3	0.9	2.2	1.7	1.0	2.7
Man	1.3	0.8	2.1	1.6	0.9	2.5
Ont	0.6	0.9	1.5	1.1	0.6	1.7
Que	0.8	0.9	1.6	1.3	0.2	1.5
NB	1.6	0.2	1.8	1.6	-0.2	1.4
NS	1.1	0.4	1.5	1.7	-0.2	1.5
PEI	1.3	0.8	2.1	1.4	0.3	1.7
N&L	2.5	0.8	3.3	2.1	-0.6	1.5
Canada	**0.9**	**1.1**	**2.0**	**1.5**	**0.6**	**2.1**

Source: CIBC, Statistics Canada

Commodity Markets: This Time Isn't So Different

Peter Buchanan

Cooling Breezes After a Hot Summer

Weakness in growth and commodity markets go hand in hand. For a while it looked as if central bankers' use of their biggest guns might make this time different. As the effects of those actions have faded, bearish sentiment based on growth and policy anxieties has re-emerged. A none-too impressive US corporate reporting season, fiscal cliff worries and signs of a deeper recession in Europe, notwithstanding the ECB's success in limiting tail risks, have helped to put sentiment back on edge. US Q3 growth, while a touch better, was still unimpressive.

These considerations argue for a more cautious near-term view on a number of key industrially sensitive commodities. Notwithstanding that, we continue to see upside from mid 2013 on, as pro growth measures in a number of countries bear more visible fruit and challenges like the US fiscal cliff are addressed.

Although performance going forward will be conditioned on future prospects, TSX resource stocks have reacted constructively to resource price gains in recent months after sitting out improvements earlier in the year. Gold's QE3-related surge has made materials the TSX's best performing segment in the latest quarter.

Forecast Downgrades Bolster Anxiety

Adding to risk aversion and selling pressure in some areas, the IMF's recent well-publicized forecast cut has spotlighted the global economy's underlying fragility. Although 2014 is likely to show improvement with a 4.1% advance, our latest prediction of a 3.5% gain in global GDP next year means the recovery will struggle for now to match past norms (Table 1). Taking account of inter-country differences in resource-intensity, including Asia's pivotal role in metals demand, geographic growth patterns should nonetheless be more constructive for some key sectors (Chart 1).

Moving to the fore of late have been fiscal cliff related fears. Although we believe that Congress will eventually act to avert disaster, participants may be underestimating the potential for market roiling delays and adverse effects on near-term economic performance. Sixty percent in a recent poll saw legislators simply kicking the can well down the road. China is showing improvement, but may not be on the cusp of a strong, resource-demand-bolstering, 2009-style rebound. September's stimulus package was just a quarter the size of its massive late 2008 prequel, and ordinarily useful "hard" indicators like power demand and freight volumes are not as yet corroborating the improvement shown by some other measures. Fiscal restraint meanwhile will continue to flatten growth and resource demand in austerity-minded Europe.

Table 1

Key Commodity Consumers, Real GDP Growth (%)

	2011	2012(f)	2013(f)
US	1.8	2.2	1.8
Eurozone	1.4	-0.4	0.3
China	9.2	7.6	8.1
World	3.8	3.2	3.5

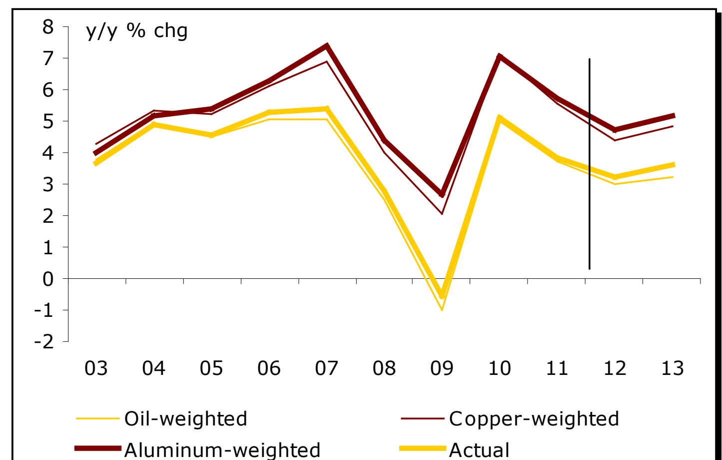
Source: CIBC, IMF

Differing Correlations with the Broad Economic Cycle

For investors, looking at how to divide their dollars, it's useful to know whether price moves, in individual sectors, are driven by broader economic forces—and likely to track other cyclical portfolio assets—or dependent on more sector specific demand and supply dynamics, thereby

Chart 1

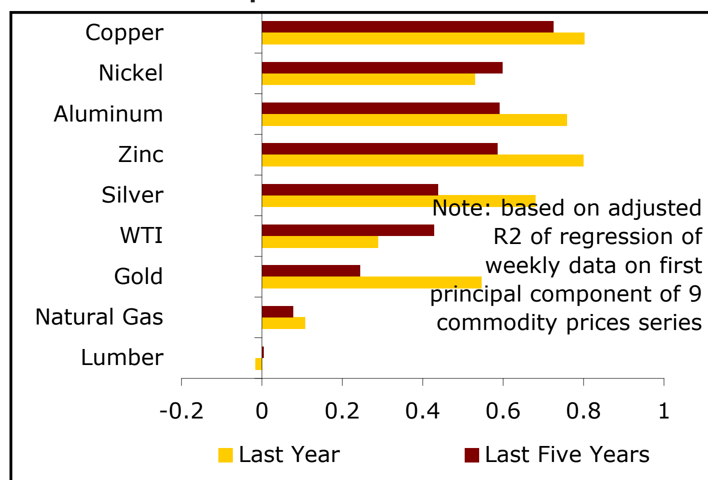
Global GDP: Pattern Will Remain Supportive for Metals



Source: IMF, BP, CRU, CIBC

Chart 2

Proportion of Price Variation Accounted for by Macro vs Sector-Specific Factors



Source: Bloomberg, LME, CIBC

adding useful diversification. To throw some light on this issue, we used a statistical approach known as principal components analysis.

Confirming conventional belief, copper showed the strongest relationship to broad "demand" forces (i.e. the general macroeconomic cycle), natural gas and lumber the least (Chart 2). That suggests some exposure in these latter areas can be an important, source of diversifiable risk, or alpha, in a larger resource portfolio. While gold has shown a greater tendency than in the past to track other commodities, the opposite applies for oil, a not altogether surprising finding, given the recent impact of supply disruptions specific to the sector, like Libya's revolution and more recent Iranian sanctions. Interestingly, copper, silver and oil have all risen a bit more than broad changes in the economic environment would suggest, nickel and zinc a bit less (Chart 3), although care should be taken in interpreting these results, given that supply side developments have had some effect as well.

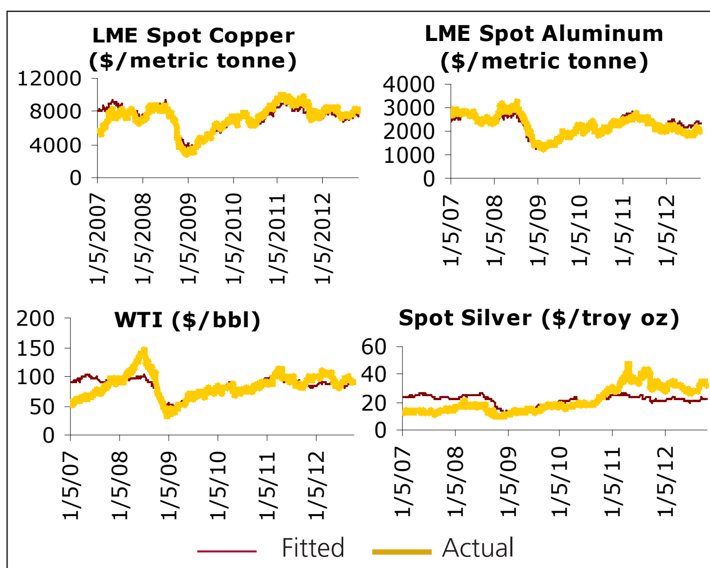
Gold Most Near-Term Upside, but Longer-Term Risk

Looking more specifically at developments and prospects in number of key sectors,

Gold/Silver Gold has risen by from \$200-400 on each of the Feds three QE announcements. The combination of a possible year-end extension of the current \$45 bn/month treasury buying plan, purchases by other central banks and institutional and fiscal cliff anxieties could provide modest additional support in the next 4-6 months. Notwithstanding that, we see lower prices 1-2 years out. Inflation remains contained in industrial countries, and is

Chart 3

Actual Price vs PC Model Prediction, Various Commodities



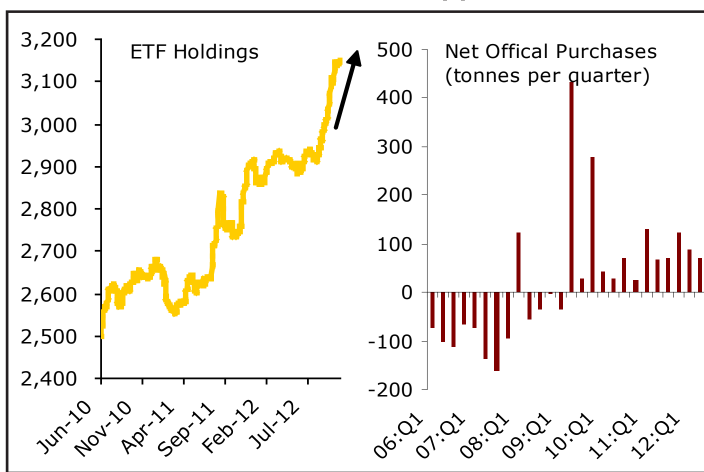
Source: CIBC

subsiding in the emerging markets, limiting demand for a traditional hedge. More Eurozone jitters could work to the normally inversely correlated US dollar's favour in 2013. Narrowing trade surpluses in some countries like China may also crimp growth in their reserves, slowing demand for gold as a central bank asset (Chart 4).

Base Metals Metals-related equities rebounded along with gold in late summer. Base metals are twice as sensitive to the macroeconomic environment as other resource prices (Chart 2 again), and particularly at risk consequently to ongoing downbeat data, although longer haul we continue to see emerging market demand, rising mine costs and other structural factors as supportive. Local debt and rekindled house price inflation fears will

Chart 4

Gold: Two Recent Sources of Support



Source:Bloomberg, WGC, CIBC

likely keep China from using the same sledge hammer tactics to re-energize growth this time, as in 2009. Inventory levels remain high for aluminum, nickel and zinc, leaner for copper. Even with cyclical developments weighing, a modest continued 2013 supply deficit also warrants a more constructive view on the latter metal. In contrast, rising supply from recently commissioned production could restrain nickel.

Oil Prices appear to have modestly outrun fundamentals earlier in the fall. Increased supplies from Iraq and Libya have failed to fully counter cuts by several other producers, including Iran. We nevertheless expect that concerns about the economy and resulting demand softness will continue to help offset elevated Middle East geopolitical risks. WTI should average $95/bbl in 2013, as the subdued growth backdrop, vehicle restrictions by China's main cities, and rising US fleet efficiency levels hold global oil demand growth to a sub-1% pace, with pipeline constraints keeping North American prices below key international benchmarks.

Natural Gas Record generator fuel substitution, cooling demands of a torrid summer and an expected cold start to winter saw Henry Hub prices hit an 11-month high of $3.50 in early October. Cutting into the earlier daunting supply overhang, low prices and the expiry of "play or lose" provisions in many lease contracts has seen the active natural gas rig count drop to 13-year lows in recent months. Although markets are tightening, the positive response of supply to renewed price momentum and risk of losing cost-sensitive generation customers limits the upside for prices, which we see averaging $3.50 and $3.75/Mm Btu in the next two years.

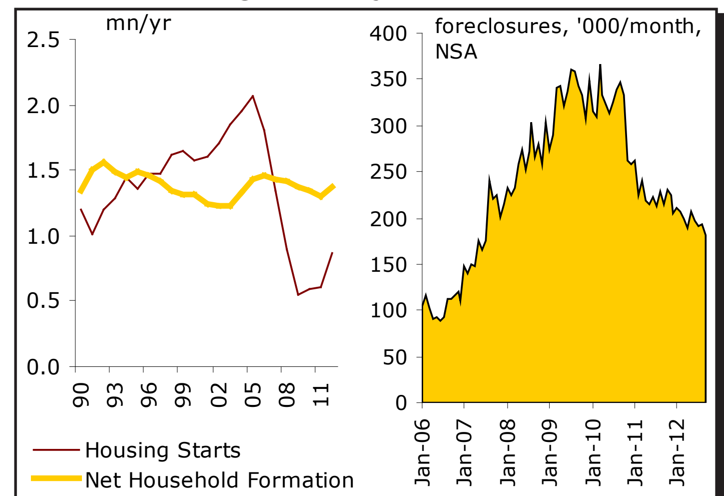
Lumber Prices have moved up further in response to September's four-year high in US housing starts and other signs of recovery in the once troubled sector. Even at current levels, starts are still several hundred thousand units below projected rates of household formation, suggesting further potential upside (Chart 5). Capacity constraints due to recent mill closures and nascent signs of a rebound in China's homebuilding/real estate sector are also constructive.

Potential for Renewed Momentum from Mid-2013

Buoyed by rising emerging market demand and other factors, commodity prices have risen at an average rate of around 8% in the last decade. Although the next 9-10 months could be challenging, we see the potential for renewed broadly based momentum in cyclical areas from mid-2013 on given economic and recent policy developments. Longer term, a new and upcoming tranche of dynamic resource-intensive economies could offset diminished momentum in some of today's BRICs.

Chart 5

Demographics (L), Falling Distressed Supply (R) Will Drive US Housing Recovery



Source: US Commerce Dept, Macroeconomic Advisors, RealtyTrac, CIBC

Table 2

		Average						
		29-Oct	2009	2010	2011	2012 (f)	2013 (f)	2014 (f)
Oil (WTI)	$/bbl	86	62	80	95	95	95	100
Natural Gas (Henry)	$/Mn Btu	3.43	3.82	4.37	3.99	2.65	3.50	3.75
Gold	$/troy oz	1707	1088*	1406*	1531*	1825*	1700*	1600*
Silver	$/troy oz	31.8	16.9*	30.9*	27.8*	31.9	29.8	28.1
Copper	$/lb	3.50	2.35	3.43	4.01	3.65	3.50	4.00
Aluminum	$/lb	0.85	0.76	0.99	1.09	0.91	0.80	0.90
Nickel	$/lb	7.23	6.69	9.91	10.38	7.90	7.25	8.00
Zinc	$/lb	0.81	0.76	0.98	1.00	0.88	0.75	0.80
Lumber**	$/'000 bd ft	307	221	245	255	277	325	350
Potash	$/tonne	435	404	316	412	431	420	450
** end of period*	***1st Futures*							

Source: CIBC

Should We Worry About a US-Style Housing Meltdown?

Benjamin Tal

Every percentage point drop in housing activity in Canada raises the level of trepidation, both at home and among potential foreign investors, about an American-style real estate meltdown. To be sure, house prices in Canada will probably fall in the coming year or two, but any comparison to the American market of 2006 reflects deep misunderstanding of the credit landscapes of the pre-crash environment in the US and today's Canadian market.

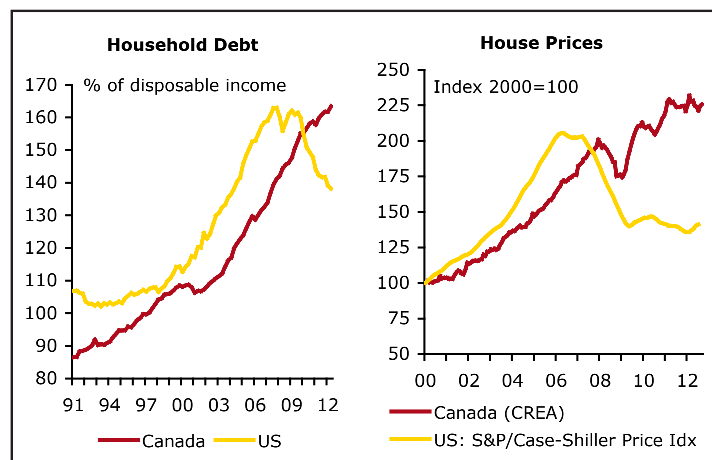
The Bad News

A glance at Chart 1 might cost you a good night's sleep. House prices in Canada continue to defy gravity while the new and improved household debt-to-income ratio is now above the level seen at the eve of the big American crash. No surprise then that the cocktail party conversation of the day is about the possibility that Canada will zig where America has zagged.

And admittedly, some of the lines of defense used to defy those fears are breakable. Many observers point to the extremely low mortgage delinquency rate in Canada as a measure of stability. But as the US experience teaches us, this sea of tranquility can turn into a violent storm overnight. In a short eighteen-month period in 2007-08, the serious mortgage arrears rate in the US surged by more than 300%. Ditto for the claim that the debt-to-asset ratio in Canada has been relatively stable. That was also the case in the US in the years leading to the recession, but it did little to prevent the ultimate crash.

Chart 1

It Doesn't Look Good



Source: StatCan, Federal Reserve Board, CREA, Standard & Poor's, CIBC

Another widely used feel-good assertion is that, unlike the US, Canada (with the exception of Alberta) is a recourse country—a situation wherein lenders can go after borrowers' other assets to pay down a mortgage. However, the reality is that only twelve US states are non-recourse states. What's more, there appears to be no significant difference in housing market performance between recourse and non-recourse states, suggesting that the recourse status of the Canadian market does not provide a full shield from a substantial fall in prices.

But perhaps the most widely used distinguishing claim is that as opposed to Canada, mortgage interest payments in the US are tax deductible, and thus worked to increase the home ownership rate to an undesirable level. This claim can be challenged in two ways. First, there is a growing body of research suggesting that mortgage interest deductibility (MID) played only a minor role in elevating US homeownership. Just over one-fifth of American taxpayers claim MID, and only 15% of them earn less than $50,000 per year. And for those, the average tax saving is less than $175 per year. Simply put, MID primarily benefits those who would choose to own homes anyway while encouraging them to simply buy bigger and more expensive homes. That goes a long way in explaining the fact that the homeownership rate in Canada today is not significantly different than the one seen in pre-recession US.

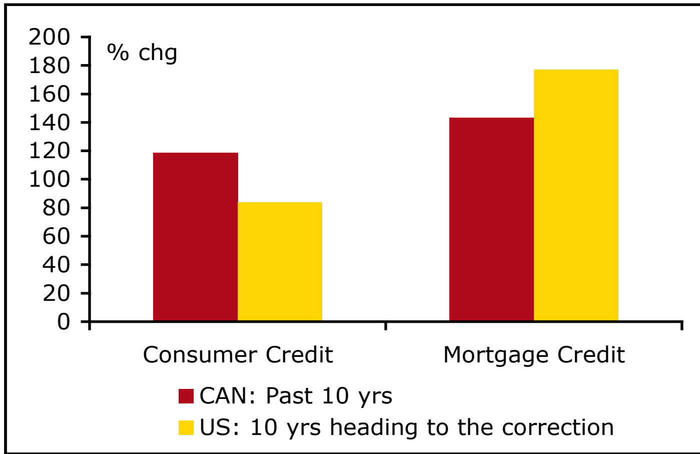
Second, even to the extent that the tax deductibility factor did work to increase mortgage borrowing in the US relative to Canada (say via the average size of mortgages), this growth probably substituted for alternative credit vehicles. No surprise then that when comparing the decade leading to the recession in the US to the past decade in Canada, we find that Americans relied more heavily on mortgage financing while Canadians borrowed proportionally more via non-mortgage loans (Chart 2).

The Good News

Fortunately, the Canadian housing market has more distinguishing attributes that separate it from the pre-crash US market. Yes, the debt-to-income ratio in Canada just broke the American record set in 2006, but as any economist knows, this ratio is more a headline grabber than a serious analytical tool. It compares the stock of

Chart 2

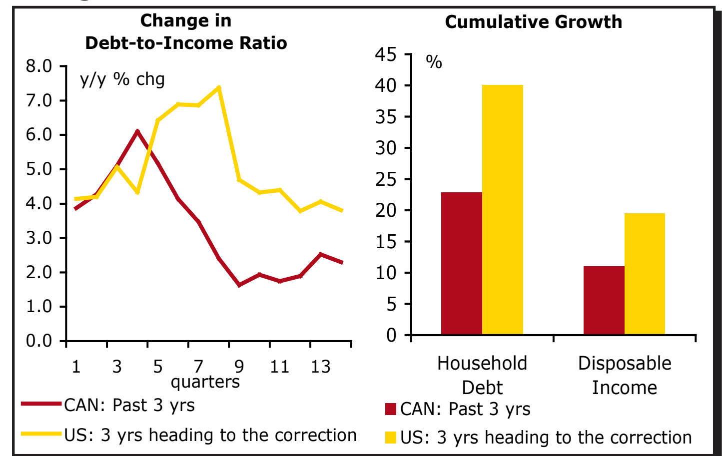
Consumer & Mortgage Credit: Canada vs US



Source: StatCan, Federal Reserve Board, CIBC

Chart 3

Debt-to-Income Ratio in Canada Rising Much Slower Than in Pre-correction US



Source: StatCan, Federal Reserve Board, CIBC

debt to the flow of income, and the latter includes income of households with no debt whatsoever. There is a list of countries with comparably higher debt-to-income ratios, which did not experience anything remotely resembling the recent US experience. And while we should not completely ignore the level of that ratio, perhaps even more important is the speed at which it grows. And here the picture looks a bit less alarming. Comparing the three years heading into the US crash to the past three years in Canada reveals that the debt-to-income ratio in Canada has been rising at half the speed seen in the pre-crash US market (Chart 3).

And that comparably strong growth in indebtedness in the US was no doubt helped by the fact that speculative activity south of the border was much more prominent than what we are currently seeing in the Canadian market. On average, over the past decade, housing starts in Canada exceeded household formation by only 10%—with most of the excess seen in cities such as Toronto and Vancouver. In the US, the gap during the decade leading to the crash was almost 80%.

The Quality Factor

Even more important than the amount of debt is its quality. The distribution of the credit score in Canada has not changed dramatically in the past four years with some increase in the relative proportions of both sides of the risk spectrum. That is very different than the experience seen in the US in the four years heading into the recession. The proportion of the risky category rose by no less than ten percentage points and accounted for 22% of the market.

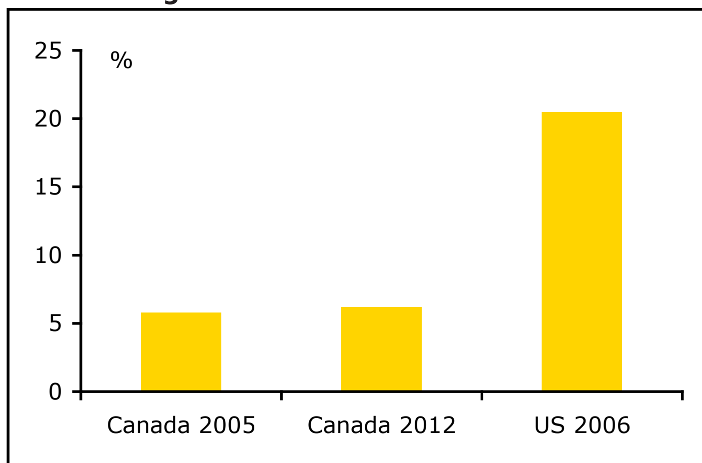
But credit score does not tell the whole story. Many of the troubled mortgages in the US were sold to borrowers with an acceptable credit score. Alt A mortgages, for example, were underwritten to borrowers of good credit quality that did not satisfy the underwriting rules for prime loans because they were unable or unwilling to provide full documentation on their mortgage applications. In 2006, non-conforming mortgages (subprime + Alt A) accounted for no less than 33% of originations and close to 20% of outstanding mortgages. What's more, an astonishing one-third of mortgages taken out in 2005 and 2006, before the drop in prices, were in negative equity position, and more than half had less than 5% equity, making them highly exposed to even a modest decline in prices.

In Canada, the negative equity position is nil, and only 15-20% of new originations have an equity position of less than 15%. Furthermore, we estimate that the non-conforming market is currently at around 7% of mortgage outstanding, up from 5% in 2005 but dramatically below the level seen in the US at the eve of the crash (Chart 4).

And at its core, the US meltdown is a non-conforming story. Average house prices in cities with above-average non-conforming exposure fell by 40% from the June 2006 peak—double the decline in cities with below average exposure (Chart 5). And in the US market of 2006, below average non-conforming exposure does not necessarily mean low exposure, as this category included cities such as Dallas and San Diego with well over 15% in non-conforming exposure. Eradicate subprime from

Chart 4

Non-Conforming Mortgages as a Share of Total Outstanding



Source: CIBC calculations based on Filogix, Financial Monitor and Loan-Performance

the US housing market and, instead of the most severe house price meltdown since the great depression, you get a soft landing.

Sensitivity to Higher Interest Rates

On paper, the fact that a typical mortgage in the US is for 30 years compared to a typical 5-year term in Canada makes Canadian borrowers more sensitive to the impact of interest rate hikes. But the key word here is typical. And in the years leading to the crash, there was nothing typical in the US housing market.

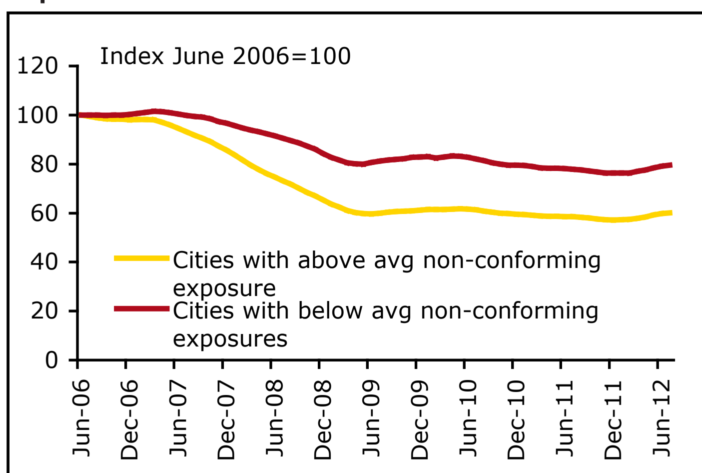
In Canada, borrowers are already curbing their rate sensitivity by reducing the share of variable rate mortgages in new originations to a multi-year low (mainly among more risky mortgages) whereas in the pre-crash US, the opposite was the case (Chart 6). The share of adjustable rate mortgages (ARM) remained elevated until the bitter end, with no less than 80% of non-conforming originations being ARMs.

And those mortgage gymnastics did not end here. The introduction of the teaser rate, a low introductory rate for a period of two or three years that would adjust upward at the end of the initial period, worked to effectively neutralize US monetary policy. Between mid-2004 and mid-2006, the Fed Funds rate rose by more than 400 basis points, but in part due to the impact of the teaser rate, the effective mortgage rate rose by only 30 basis points. The practical implication of that was that when the teaser period expired, millions of Americans felt the full impact of two years' worth of monetary tightening virtually overnight. The reset of no less than $2 trillion of mortgage debt in 2006 and 2007 was no doubt the trigger to the US housing crash. Such a potential trigger does not exist in Canada with mortgage rates likely to rise gradually, allowing borrowers to adjust over time.

In a final analysis, not all is well in the Canadian housing market. Home prices are overshooting their fundamentals, mainly in large cities such as Toronto and Vancouver. The recent slowing in sales activity will probably be followed by price adjustments in many cities across the country. But the Canada of today is very different than a pre-recession US, namely as far as borrower profiles are concerned. Therefore, when it comes to jitters regarding a US-type meltdown here at home, the only thing we have to fear is fear itself.

Chart 5

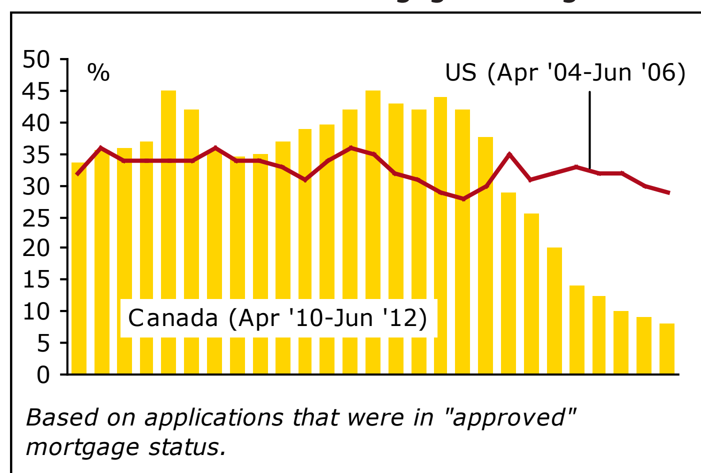
US Average House Prices by Non-Conforming Exposure



Source: CIBC calculations based on S&P/Case-Shiller, Loan-Performance and MBA

Chart 6

Share of Variable Rate Mortgages in Originations



Based on applications that were in "approved" mortgage status.

Source: D+H: Lender Insights' Market Share Report 2012Q2 (broker channel) , Federal Reserve Board, CIBC

ECONOMIC UPDATE

CANADA	**12Q2A**	**12Q3F**	**12Q4F**	**13Q1F**	**13Q2F**	**2011A**	**2012F**	**2013F**
Real GDP Growth (AR)	1.9	1.0	2.4	1.9	2.1	2.6	2.2	2.0
Real Final Domestic Demand (AR)	1.6	1.8	1.8	1.8	2.0	2.7	1.7	1.9
All Items CPI Inflation (Y/Y)	1.6	1.2	1.6	1.6	1.7	2.9	1.7	2.0
Core CPI Ex Indirect Taxes (Y/Y)	2.0	1.5	1.5	1.7	1.8	1.7	1.8	1.9
Unemployment Rate (%)	7.2	7.3	7.3	7.2	7.2	7.5	7.3	7.1

U.S.	**12Q2A**	**12Q3A**	**12Q4F**	**13Q1F**	**13Q2F**	**2011A**	**2012F**	**2013F**
Real GDP Growth (AR)	1.3	2.0	1.8	1.5	1.7	1.8	2.2	1.8
Real Final Sales (AR)	1.7	2.1	1.6	1.7	1.8	2.0	2.0	1.8
All Items CPI Inflation (Y/Y)	1.9	1.7	2.4	2.4	2.3	3.2	2.2	2.4
Core CPI Inflation (Y/Y)	2.3	2.0	1.9	1.9	1.9	1.7	2.1	1.9
Unemployment Rate (%)	8.2	8.1	7.9	7.9	7.9	9.0	8.1	7.9

CANADA

Statistics Canada revisions have pegged growth in recent quarters slightly stronger than previously estimated, although we still see the economy tracking roughly 2% in the coming year as domestic demand peters along, offsetting risks on the trade side. A GDP contraction in August should peg growth in Q3 at around 1%, weaker than our earlier estimate, although an easing of temporary disruptions should see growth accelerate going into Q4. Inflation has recently surprised on the downside, seeing us nudge down our call for the year as a whole by one tick.

UNITED STATES

US consumer spending picked up to support Q3 GDP, and should continue to offset weaker trends in capital investment in the fourth quarter. However, with a surprise jump in government spending flattering the third quarter figures, and Hurricane Sandy possibly shaving a couple of ticks off growth, we expect a mild deceleration to a 1.8% pace in Q4, before fiscal restraint slows growth further in early 2013. Subdued payroll gains may make further declines in unemployment more difficult to achieve, while food prices could see inflation accelerate further in the coming months.

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