CIBC
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

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

FORECAST

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Outlook 2014: Give Low Rates a Chance

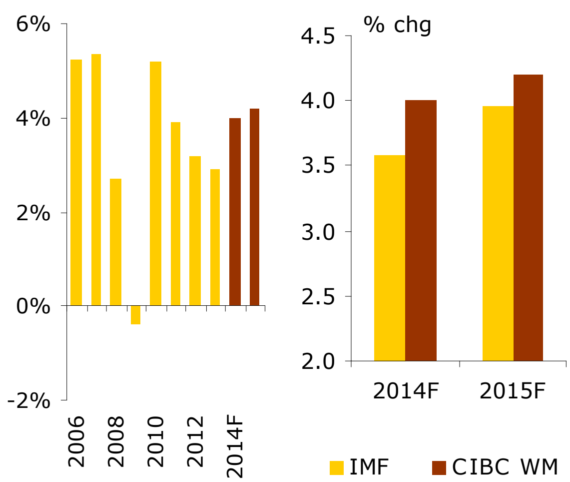
by Avery Shenfeld

Equity markets are sensing it, and this time, they're right. Global growth should finally surprise on the high side in 2014. A year of 4% global growth is hardly spectacular, but will be a point faster than 2013, and a half-point above the last IMF forecast (Chart 1). Canada will need all of that improvement abroad to offset the looming drag from a decline in homebuilding, and a household sector that is tiring of adding debt to fuel consumption (see pages 7-9).

As we discussed a year ago, 2014 was set up for an improvement in growth as the albatross of weighty fiscal tightening that hung over the US and Europe in 2013 would be shed in the following year. That still seems to be in the cards (see pages 4-6 and 10-12). Although a budget deal in the US needs to be completed by mid-January, Congress has lowered its sights towards a modest deal that merely shifts where cuts fall, leaving the overall degree of restraint unaffected from prior plans. While emerging markets have their own story, including some self-inflicted wounds, a rising tide in the developed world will lift EM boats through the link to their exports. The largest of these, China, is already showing improved performance in the latter half of 2013.

Chart 1

Global GDP Growth: Not Spectacular (L) But Better Than Consensus (R)



Source: IMF, CIBC

A Finger in the Dike

Typically, upside surprises in growth bring higher bond yields. But the causation also goes the other way: at a still-fragile point in the cycle, easy monetary policy is a necessary condition for growth to accelerate. Central bankers in North America, Europe and Japan, each in their own way, are going to ask markets to give low rates a chance.

Fortunately, CPI performance affords them the luxury to do just that. Outright deflation seems unlikely, with micro data showing a tendency for individual prices and wages to be resistant to actual declines. But inflation is starting from levels that are below central bank targets in Europe and North America. Economic, demographic and policy changes since the last cycle have made labour markets in Canada less inflation prone than they were at equivalent unemployment rates in past cycles.

Table 1

FORECAST SUMMARY

(% Change Except Where Noted)

CANADA	2010A	2011A	2012A	2013F	2014F	2015F
GDP at Market Prices	6.1	5.8	3.4	3.2	**4.1**	**4.6**
GDP in $2007	3.4	2.5	1.7	1.7	**2.3**	**2.3**
Consumer Price Index	1.8	2.9	1.5	1.0	**1.5**	**1.9**
Unemployment Rate	8.0	7.5	7.3	7.0	**6.6**	**6.2**
Current Account Balance (C$ Bn)	-58.4	-48.5	-62.2	-61.1	**-56.2**	**-53.3**
Pre-tax Profits	31.6	11.3	-4.9	-4.6	**8.6**	**11.2**
Housing Starts (K)	190	194	215	188	**184**	**181**

UNITED STATES	2010A	2011A	2012A	2013F	2014F	2015F
GDP at Market Prices	3.7	3.8	4.6	3.3	**4.9**	**5.3**
GDP in $2009	2.5	1.8	2.8	1.7	**3.0**	**3.0**
Consumer Price Index	1.6	3.2	2.1	1.5	**1.7**	**2.4**
Unemployment Rate	9.6	8.9	8.1	7.4	**6.6**	**5.9**
Current Account Balance (US$ Bn)	-449	-458	-440	-403	**-382**	**-375**
Pre-tax Profits (with IVA/CCA)	25.0	7.9	7.0	4.2	**7.3**	**11.6**
Housing Starts (K)	586	612	783	926	**1,177**	**1,420**

Table 2

INTEREST AND EXCHANGE RATE FORECAST

		2013	2014				2015			
END OF PERIOD:		**9-Dec**	**Mar**	**Jun**	**Sep**	**Dec**	**Mar**	**Jun**	**Sep**	**Dec**
CDA	Overnight target rate	1.00	1.00	1.00	1.00	1.00	1.00	1.25	1.50	1.75
	98-Day Treasury Bills	0.93	0.95	0.95	0.95	0.95	1.05	1.20	1.45	1.70
	2-Year Gov't Bond	1.08	1.15	1.35	1.40	1.50	1.85	2.20	2.40	2.50
	10-Year Gov't Bond	2.68	2.80	2.85	2.90	2.95	3.10	3.35	3.45	3.55
	30-Year Gov't Bond	3.28	3.35	3.40	3.50	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	0.10	0.25	0.50	0.75
	91-Day Treasury Bills	0.05	0.08	0.15	0.15	0.15	0.20	0.40	0.60	0.85
	2-Year Gov't Note	0.30	0.45	0.60	0.80	1.10	1.30	1.55	1.75	1.95
	10-Year Gov't Note	2.85	2.95	3.00	3.05	3.10	3.30	3.55	3.70	3.80
	30-Year Gov't Bond	3.88	3.95	4.00	4.05	4.10	4.15	4.25	4.30	4.40
Canada - US T-Bill Spread		0.88	0.87	0.80	0.80	0.80	0.85	0.80	0.85	0.85
Canada - US 10-Year Bond Spread		-0.16	-0.15	-0.15	-0.15	-0.15	-0.20	-0.20	-0.25	-0.25
Canada Yield Curve (30-Year — 2-Year)		2.19	2.20	2.05	2.10	2.00	1.70	1.40	1.25	1.20
US Yield Curve (30-Year — 2-Year)		3.58	3.50	3.40	3.25	3.00	2.85	2.70	2.55	2.45
EXCHANGE RATES	CADUSD	0.94	0.91	0.92	0.93	0.95	0.96	0.95	0.95	0.94
	USDCAD	1.07	1.10	1.09	1.07	1.05	1.04	1.05	1.05	1.06
	USDJPY	103	102	103	103	102	102	101	101	100
	EURUSD	1.37	1.29	1.25	1.27	1.28	1.28	1.29	1.30	1.32
	GBPUSD	1.63	1.57	1.54	1.57	1.59	1.60	1.61	1.60	1.61
	AUDUSD	0.91	0.88	0.85	0.87	0.88	0.89	0.90	0.91	0.92
	USDCHF	0.89	0.95	0.98	0.97	0.97	0.97	0.97	0.96	0.95
	USDBRL	2.32	2.11	2.08	2.09	2.08	2.15	2.20	2.35	2.45
	USDMXN	12.85	12.65	12.72	12.75	12.82	13.36	13.38	13.40	13.42

In the US, Yellen will keep her finger in the dike, holding back the bearish tide in the bond market, and keeping 10-year rates averaging near 3% for another year (Table 2). Note that "tapering" is already built into market expectations. The FOMC will choose among other options (including changing the criteria for when the funds rate will rise to push off expectations for tightening) to keep yields in check. But if need be, Yellen will taper QE more slowly. Ironically, the more the market believes in the mantra of a dovish Fed in 2014, the more likely the economy will achieve above-consensus growth that will enable Yellen to unshackle the bond market. We still see the Fed lifting the fed funds rate earlier than some might expect, although a lower track for inflation has us pushing back the timing by one quarter to Q2 2015.

For the ECB, QE is seemingly too radical for the gnomes in Frankfurt. The central bankers are likely to look to either another long-term repo (LTRO), or less likely, negative deposit rates, to impress markets with their dovish stance. The transmission channel for that to benefit Eurozone growth will be less through its impact on rates, given still sluggish lending by weakly capitalized banks, than through the exchange rate. Look for euro weakening ahead, as the Eurozone growth surprise that favoured the euro in 2013 gives way to US upside news in 2014. Similarly, the Bank of Japan is determined to keep dollar-yen no lower than 100, particularly in the face of upcoming sales tax hikes that will impair domestic demand, and would do further QE if need be.

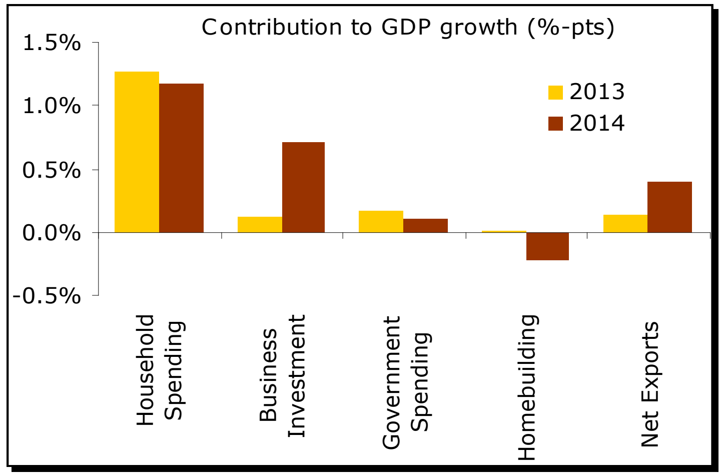
A Phantom Rate Cut

For its part, given concerns over excessive household leverage, the Bank of Canada is reluctant to try to boost activity by cutting interest rates. Moreover, that debt load, and an inevitable cooling in housing starts from unsustainable levels, leaves little room for low rates to drive GDP. Much of any improvement in growth will come simply from the impact of stronger activity abroad, and the resulting lift to exports and capital spending (Chart 2). But Governor Poloz, by tilting the latest policy statement towards more dovish language, has encouraged markets to speculate about rate cut risks. A phantom rate cut, one spoken about but never seen, can in effect ease policy through the exchange rate, as well as by pulling yields lower at the front end of the curve.

As a result, we recently weakened our forecast for the Canadian dollar in 2014 by four cents to a 1.10-1.05 range for dollar-Canada, although we still expect that greater than consensus improvements in the trade balance will see the loonie end the year stronger than it starts.

Chart 2

Business Spending, Net Exports to Increasingly Drive Growth



Source: CIBC, Statistics Canada

Even if the Bank of Canada begins raising rates in 2015, the higher-than-historical levels of household debt imply a much slower trajectory back to "normalcy" for interest rates, as even small doses of higher rates will impose a significant squeeze on spending room. Don't be surprised if after taking rates to merely 1.75% in 2015, we then see a pause at that level to allow the central bank time to gauge the economic response.

Investing for Growth

US equities are hardly cheap given their run-up in 2013, but the Canadian market would appear to have more room to run. Our top-down model, driven by macro variables, points to a 12% gain in corporate earnings for 2014, putting the PE multiple on next year's earnings at about 13½. That's still below the historic norm, and even more attractive if one contrasts it with what are still well-below-normal levels for fixed income yields.

Within the equity market, what hasn't played well in the past few years should now outperform. That includes equities tied to global growth rather than low interest rates, such as base metals and energy stocks. Supply growth stands in the way of another commodities supercycle, but supply increases are already priced in. What's not built in are the upside surprises in demand associated with faster production, construction and transportation activity for the world's economy.

The US Economy: Revving Up For 2014

Andrew Grantham and Peter Buchanan

The US economy has endured a lacklustre recovery, and a large drag from government meant 2013 was the worst year for growth since the recession. But that could be on the verge of changing. With government policy less of a negative, a housing recovery in progress and the shale revolution boosting US energy and related manufacturing, 2014/15 could finally see a real recovery take shape. Look for 3% growth in each of the next two years.

Less Fiscally Challenged

As in other countries, fiscal restraint has taken an economic toll in the US, and an easing of that burden will help to energize growth. The current sequestration path involves a reduction of about $20 billion in discretionary spending this year. Assuming that ongoing budgetary talks do not worsen that burden, the hit to the economy from fiscal drag at the federal and state/local level will ease up by 1.2%-pts of GDP in the new fiscal year. That's one of the largest swings in recent years. And the drag will lessen further come 2015 (Chart 1, left).

Complementing Washington's less harsh fiscal discipline is a parallel easing of fiscal policy at the state level. While all but one of the states have balanced-budget caps, that typically exempts capital outlays. Relative to GDP, state capital budgets have shrivelled by 20% or more in recent years (Chart 1, right). Plugging the resulting infrastructure gaps could contribute significantly to growth going forward.

Despite the cost penalties imposed on larger firms by the start of the employer mandate in 2015, Obamacare is expected to have a positive, albeit modest impact on

Table 1

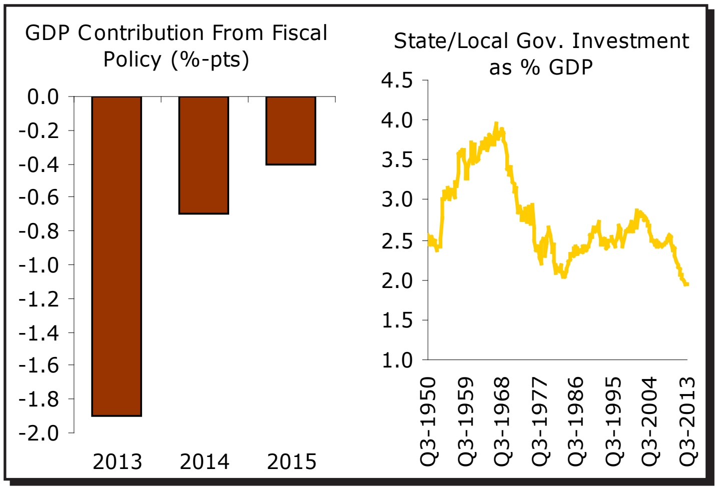
US FORECAST DETAIL

(real % change, s.a.a.r., unless otherwise noted)

	13:4F	14:1F	14:2F	14:3F	14:4F	15:1F	2013F	2014F	2015F
GDP At Market Prices ($Bn)	17,012	17,253	17,476	17,724	17,964	18,189	16,775	17,604	18,543
% change	2.9	5.8	5.3	5.8	5.5	5.1	3.3	4.9	5.3
Real GDP ($2009 Bn)	15,853	15,999	16,126	16,270	16,401	16,512	15,734	16,199	16,679
% change	0.9	3.7	3.2	3.6	3.2	2.7	1.7	3.0	3.0
Final Sales	2.3	4.0	3.2	3.6	3.4	2.9	1.6	3.1	3.1
Personal Consumption	2.8	3.3	2.8	2.8	3.2	2.6	1.9	2.7	2.7
Total Govt. Expenditures	-3.2	3.2	-0.3	0.8	-0.8	1.0	-2.1	0.2	0.5
Residential Construction	10.0	10.0	12.0	15.0	12.0	10.0	13.8	11.8	10.4
Business Fixed Investment	4.3	6.0	6.7	6.4	6.0	5.6	2.5	5.5	5.8
Inventory Change ($2009 Bn)	61.9	51.5	51.5	51.5	46.4	41.2	69.3	50.3	37.4
Exports	7.0	5.0	6.1	7.0	5.7	5.0	2.5	5.9	5.7
Imports	5.0	3.9	4.1	4.2	3.8	5.0	1.7	4.2	4.7
GDP Deflator	2.0	2.0	2.0	2.1	2.2	2.3	1.5	1.9	2.3
CPI (yr/yr % chg)	1.3	1.3	1.4	1.7	2.3	2.4	1.5	1.7	2.4
Core CPI (yr/yr % chg)	1.7	1.7	1.9	2.1	2.2	2.2	1.8	2.0	2.2
Unemployment Rate (%)	7.1	6.9	6.8	6.5	6.3	6.1	7.4	6.6	5.9
Housing Starts (AR, K)	980	1,060	1,150	1,220	1,277	1,330	926	1,177	1,420

Chart 1

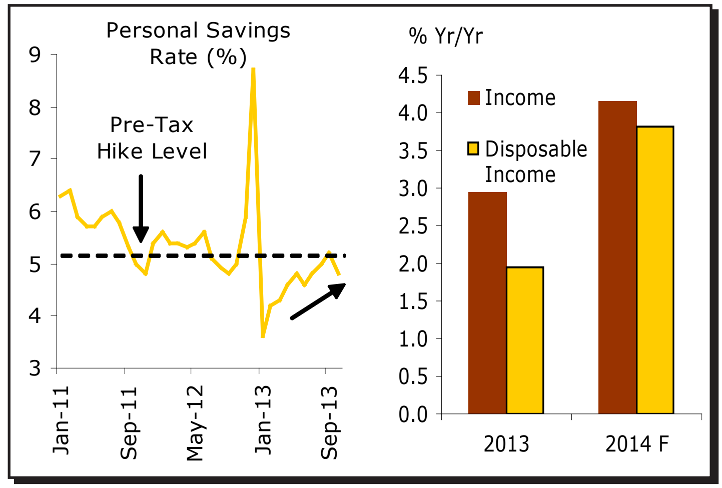
Fiscal Drag Lightens (L), Catch-up Could be Needed on State/Local Infrastructure (R)



Source: CBO, BEA, CIBC

Chart 2

Post Tax Hike Adjustment Almost Over (L), Stronger Income Growth in 2014 (R)



Source: BEA, CIBC

growth. Actuarial projections suggest that extending health insurance coverage to 32 million more Americans could lift health spending by a fifth of a percent of GDP in the next few years.

Spending Power

Higher payroll taxes took a bite out of household incomes in 2013. But having adjusted to this new financial reality, and without such a tax hike planned for 2014, consumers are positioned to accelerate spending again. After a spike in incomes and savings in late 2012 linked to efforts to bring forward income to escape capital tax hikes, the savings rate subsequently slipped. Rather than fully pay for the 2013 tax hike with reduced spending, households initially absorbed some of it by cutting into savings. But frugal spending in Q2 and Q3 has already seen the savings rate recover close to 2012 levels (Chart 2, left). So without the need to recoup savings further, more income will be freed up for spending.

Without a tax hike, and with wages improving, households will also benefit from faster gains in pre- and after-tax incomes in 2014/15 (Chart 2, right). Even though 2013 employment growth appears robust at first glance, many of the jobs added were part-time or in low-paying sectors. But in higher-paying areas, many employees are being worked harder than they were before the recession, and are already starting to get paid for it (Chart 3). Higher wages and additional intakes of staff in those areas should support stronger income growth and spending in 2014.

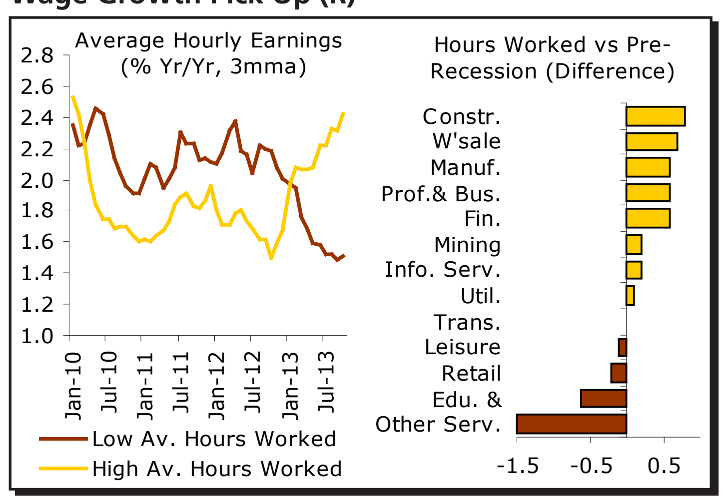
Finding a Home

Consumers will likely spend some of that newfound wealth on furnishing new apartments and houses. Even after levelling off with higher mortgage rates in mid-2013, housing starts, home sales and prices remain on broadly upward trends. And so far that has come with little help from a key demographic—young people.

By moving back into parents' homes to save money, the proportion of 16-30 year olds who were heads of their own household fell dramatically. Even if that "headship" rate only recovered to long-run averages, 550K new households would be formed (Chart 4, left). With an

Chart 3

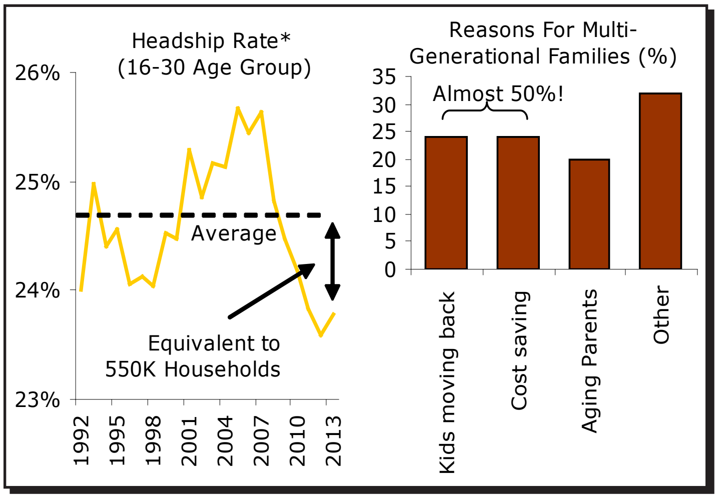
Sectors Working the Hardest (L) are Already Seeing Wage Growth Pick Up (R)



Source: BLS, CIBC

Chart 4

Young People Hold Key For Housing Upturn (L), Multi-generational Living About Saving Money (R)



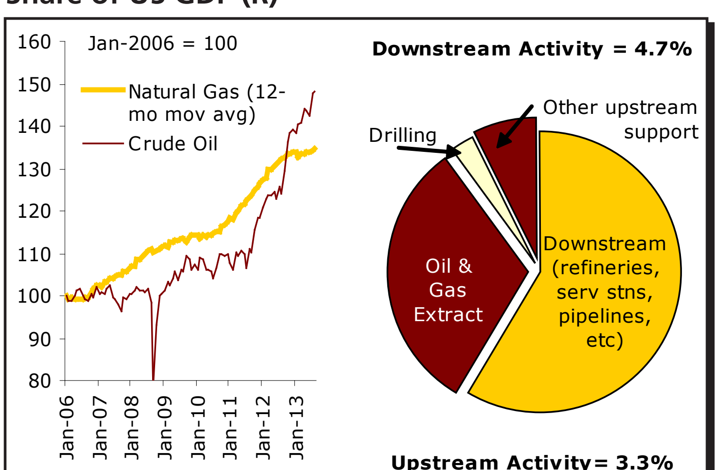
Source: Census Bureau, NAR, CIBC

improving economy limiting the previous need for multi-generational living (Chart 4, right), that trend should begin to accelerate in 2014.

Although Q4 capital spending looks light given recent equipment orders data, business investment is another area that should pick up over the next couple of years. Firms have healthy balance sheets, leaving room to finance investment spending as the clouds lift over the economy. That will include investments in shale oil production, with America set to overtake Saudi Arabia as the world's top crude producer within two years. Some estimates now peg the oil and gas industry's GDP share at nearly 8%, with upstream activity accounting for just under half of that total (Chart 5). That points to as much as a quarter to a half-point lift to growth from that source.

Chart 5

Soaring US Energy Production (L); Share of US GDP (R)



Source: DoE, API, BEA, CIBC, Note: Energy share of GDP includes spillover effects.

Deflation An Unlikely Outcome

Not entirely a surprise given the ample spare capacity still in the economy, inflation has been quite weak in 2013, with the 1.2% annual rate of core PCE not far from 2009/10 lows. Medical care is one key factor, with health cost inflation falling to multi-decade lows.

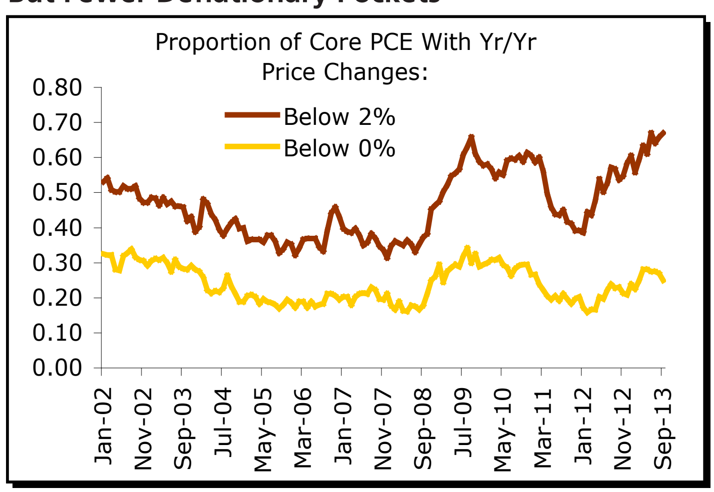
But there are also broad-based disinflationary pressures. Some are asking whether outright Japan-style deflation is now a risk.

The micro data suggest negative core inflation still looks to be an unlikely outcome. The recent drop in inflation has not been accompanied by a material increase in the number of pricing categories in outright decline. Instead, it simply captures a greater share of prices rising by less than 2%, but rising nonetheless (Chart 6). That suggests a downward stickiness in inflation rates near zero, capturing a similar stickiness in wages, where annual changes frequently hit zero but fail to extend to wage cuts. With costs therefore still creeping higher in most sectors, deflation is held at bay.

While inflation should only creep higher in 2014, a year of solid growth should be sufficient to shrink spare capacity enough to bring inflation closer to the 2% target come 2015. That will pave the way for the Fed to nudge up interest rates in Q2 of that year.

Chart 6

Disinflation More Prevalent Than Great Recession, But Fewer Deflationary Pockets



Source: BEA, CIBC

Canada: Better But No Home Run

Benjamin Tal and Emanuella Enenajor

For Canada, 2013 was a year of *déjà vu*. In line with our forecast, it was the second year in a row that the economy tracked a cool 1.7% pace. It was also the second year the Bank of Canada had been warning of potential rate hikes, only to finish the year without making good on that threat. A delayed acceleration in global growth and weak commodity prices hit both exports and business capital investment. Looking to 2014, there likely won't be enough economic momentum to pull the Bank off the sidelines, but with firmer global growth and an uptick in commodity prices, there should be enough help from abroad to get the economy to expand by 2.3%.

Improved Global Conditions Will Ignite Exports and Business Investment

A key ingredient in our Canadian forecast is the expectation that global growth will improve in 2014 and non-energy commodity prices will recoup recent losses (see our recent *Commodities Update*). As a result, exports and business capital spending will lead the pack.

Exports have been the sore point in Canada's economy recently. While shipments to the US increased in the past year, largely due to rising production of crude oil, languid Eurozone demand and weaker growth in emerging markets saw shipments to the rest of the world fall yet again. Looking ahead, with Canadian petroleum producers eyeing a 7% increase in production and with US growth set to accelerate, we see exports to the US gaining speed. While factory line closures are limiting the upside to auto exports, shipments of other categories including machinery, lumber and metals should improve. Rising growth in the rest of the world, particularly in the Eurozone and emerging markets, should see exports to those regions gain for the first time in three years (Chart

Table 1

CANADA FORECAST DETAIL

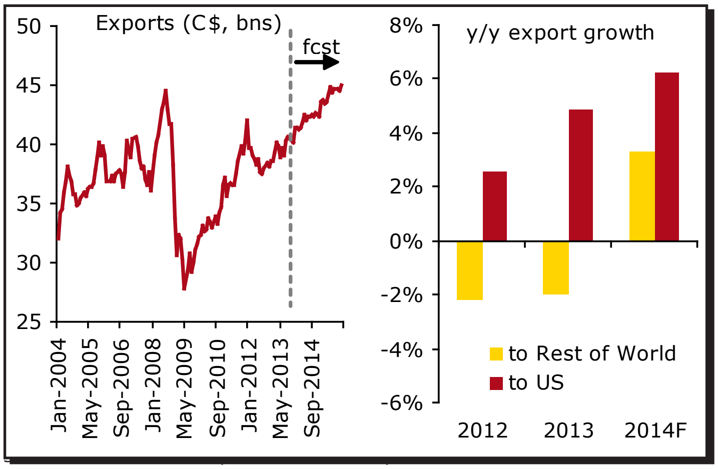
(real % change, s.a.a.r., unless otherwise noted)

	13:4F	14:1F	14:2F	14:3F	14:4F	15:1F	2013F	2014F	2015F
GDP At Market Prices ($Bn)	1,903	1,926	1,945	1,965	1,988	2,012	1,878	1,956	2,047
% change	3.4	4.9	3.9	4.2	4.7	4.9	3.2	4.1	4.6
Real GDP ($2007 Bn)	1,705	1,714	1,724	1,734	1,744	1,755	1,690	1,729	1,769
% change	2.2	2.2	2.3	2.4	2.5	2.3	1.7	2.3	2.3
Final Domestic Demand	1.8	1.9	1.9	1.8	1.9	2.1	1.5	1.9	2.1
Household Consumption	2.3	1.8	1.8	1.7	1.8	1.8	2.2	2.0	1.7
Total Govt. Expenditures	0.3	0.4	0.2	0.5	0.5	0.6	0.6	0.4	0.5
Residential Construction	-2.0	-5.0	-6.2	-5.9	-4.8	-3.0	0.1	-3.2	-3.3
Business Fixed Investment*	4.7	8.6	9.9	9.0	8.6	8.8	1.2	6.6	8.9
Inventory Change ($2007 Bn)	10.1	9.0	8.8	8.4	8.9	9.4	9.0	8.8	7.1
Exports	6.5	6.3	6.3	6.5	5.3	5.3	1.6	5.0	5.7
Imports	4.8	4.1	4.6	4.2	3.9	4.8	1.1	3.4	4.4
GDP Deflator	1.3	2.6	1.6	1.8	2.2	2.5	1.4	1.8	2.3
CPI (yr/yr % chg)	1.1	1.2	1.6	1.5	1.7	1.7	1.0	1.5	1.9
Core CPI (yr/yr % chg)	1.2	1.2	1.3	1.4	1.5	1.6	1.3	1.4	1.6
Unemployment Rate (%)	6.9	6.8	6.7	6.6	6.4	6.2	7.0	6.6	6.2
Employment Change (K)	60	53	56	63	68	69	227	221	241
Goods Trade Balance (AR, $bn)	-6.6	-3.3	-3.5	-3.2	-3.3	-1.1	-8.2	-3.3	-0.4
Housing Starts (AR, K)	195	187	183	182	184	182	188	184	181

* M&E plus Non-Res Structures and Intellectual Property and NPISH

Chart 1

Global Recovery Will Benefit Canadian Exporters



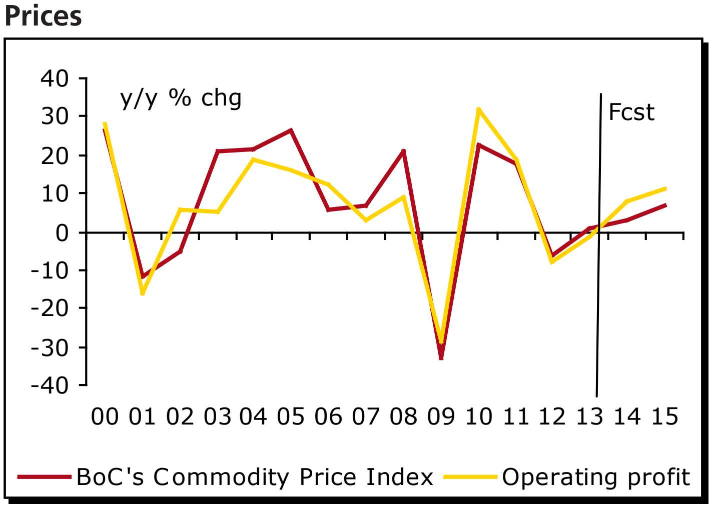
Source: Statistics Canada, CIBC

1). After stripping out price movements, exports could be up by roughly 5% next year—hardly a boom, but enough to help nudge growth forward.

As for capital investment, an improvement there will not be a direct function of extra cash on the balance sheet, which is now a more permanent feature of the capital market. Rather, increased spending will be driven by a revival of profitability. A quick glance at Chart 2 reveals the unmistakable correlation between national accounts operating profits and the Bank of Canada's commodity price index. When commodity prices fell by 6% in 2012, corporate profits declined proportionately. In 2013, flattening commodity prices coincided with a muted profit trajectory. Given that commodity producers account for only 30% of operating profits among non-financial corporations, it is clear that this correlation is largely due to the fact that commodity prices act as a good proxy for the cyclical forces impacting the Canadian economy. Accordingly, and based on our latest commodity forecast, we expect corporate profits to rise by 8% and 11% in 2014 and 2015 respectively.

Chart 2

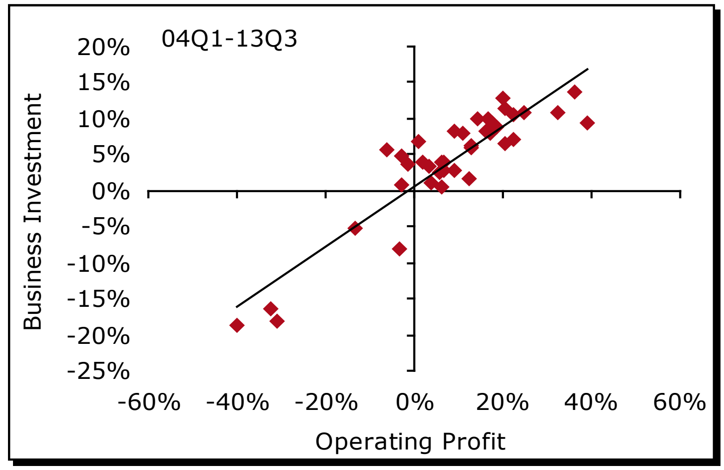
Corporate Profit Dances to the Tune of Commodity Prices



Source: Statistics Canada, CIBC

Chart 3

Projected Profit Trajectory Implies Acceleration in Capital Spending



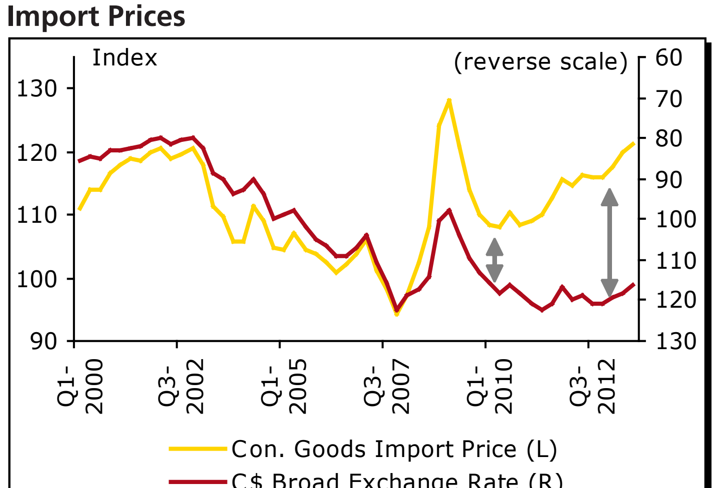
Source: Statistics Canada, CIBC

If history is any guide, this improvement in profits should lead to a 5-10% increase in annual capital spending in the coming two years (Chart 3). Already, we have seen a spate of announcements that have given a green light to earlier-delayed projects in the oil patch.

While greater capital spending will leak into higher imports, overall, we don't see import growth as a significant impediment to progress in net exports. On

Chart 4

Consumer Import Growth Will Be Limited by High Import Prices



Source: Statistics Canada, CIBC

average a one percentage point acceleration in business investment in machinery and equipment leads to an estimated 1.2% acceleration in the volume of M&E imports. That increase in imports will be partly offset, however, by our expectation that consumer-related imports, which account for close to 30% of total goods imports, will soften somewhat in the coming year. In addition to a generally soft pace for consumer spending, the recent acceleration in import prices (well beyond what the Canadian dollar can explain) (Chart 4) could help hold back import growth in 2014.

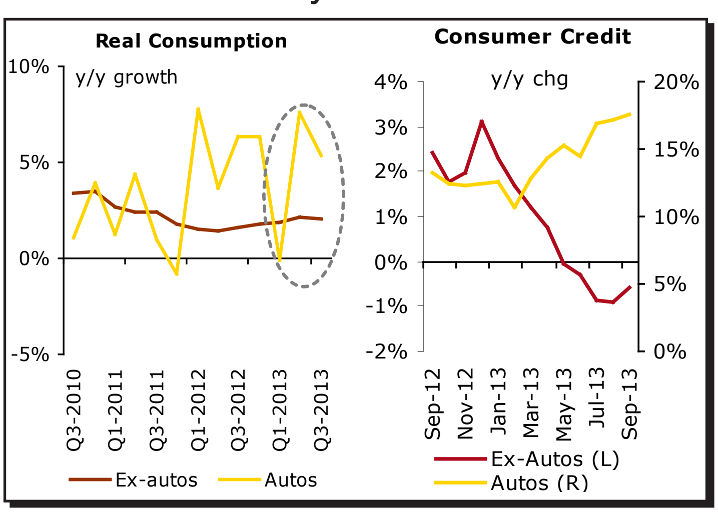
Don't Count on the Consumer and Governments

And just as net exports and business investment are set to accelerate next year, consumer spending could head down a less promising path. Subdued inflation has helped Canadians stretch their earnings power in spite of relatively weak wage growth. On net, that has seen consumer spending actually accelerate in 2013. But that lift to spending may not last for very long. Ex-autos real consumption growth has been roughly unchanged in the past two years, and it's been volatile auto demand that has accelerated, pushing up the overall pace of household spending. But there's a risk that consumption growth could cool in 2014 as autos demand softens after an outsized pick-up in 2013 (Chart 5). Note that a key factor driving the acceleration in auto demand has been rising credit, despite the broader trend of subdued economy-wide consumer credit.

Another factor that might soften consumer spending is our expectation that the savings rate will rise during the course of 2014, largely due to the diminishing impact of the real estate wealth effect on consumer spending. We estimate that over the past year the real estate wealth

Chart 5

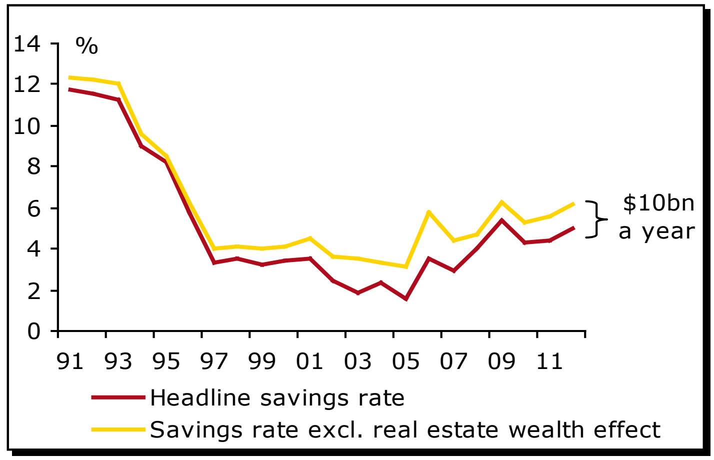
Auto Sales Financed by Loans



Source: Statistics Canada, Bank of Canada, CIBC

Chart 6

Real Estate Wealth Effect Reduces Savings Rate by a Full Percentage Point



Source: Statistics Canada, CIBC

effect single handedly cut a full percentage point from the savings rate (Chart 6), with consumers building *de facto* net wealth positions via higher house prices rather than outright savings. With real estate prices likely to track no better than flat, this important dis-saving mechanism will diminish.

And don't look for the public sector to compensate for that weakness. Unlike Canada's neighbour to the south that has taken an active approach to cutting public spending, Canada has been more gentle in pruning its fiscal largesse. Real government spending has grown over the past year, but at a sub-1% pace that has tracked well below the tempo of the last decade, seeing the public sector continue to gradually shrink as a share of the overall economy. Budget releases in the spring should provide a clearer picture of the trajectory of Canada's austerity-lite approach. But with some provinces acknowledging challenges in reaching budget targets in light of weaker-than-expected growth and tax revenues, a continued modest approach to fiscal restraint is in the cards for next year. That could see government spending growth tracking roughly in line with the past year's moderate pace.

Add it all up, and Canada's economy is yet again waiting for a helping hand from abroad to push growth forward in 2014. Business spending and exports should accelerate, but with consumer spending, homebuilding and government outlays all set to underwhelm, growth of 2.3% in 2014 will trail the US pace. Fortunately, for investors, the Toronto index is heavily tilted towards stocks levered to global growth. The improved pace abroad could still see Canadian equity markets playing catch-up to those south of the border.

Global Recovery: Picking Up the Pace

Peter Buchanan and Andrew Grantham

There has been no shortage of false dawns in recent years, as the world struggles to find its feet after a brutal, financially induced recession. Though it's hardly high noon just yet, changes on the fiscal side and recent better-looking data suggest the global economy is finally poised to move back onto firmer terrain. Growth rates of 4.0% in 2014 and 4.2% the year after (Table 1) would represent the best back-to-back increases in nearly a decade.

Warranting greater optimism, monetary policy in the advanced economies will remain extremely accommodative as fiscal policy moves away from the all out restrictive stance that has thwarted a normal-looking recovery so far. Trade volumes are also showing signs of reviving (Chart 1, left). While prospects are more uneven in the emerging markets, the two largest, China and India, are showing improvement. They should continue to contribute disproportionately to global growth and resource demand (Chart 1, right).

Getting Closer to Euro-phoria

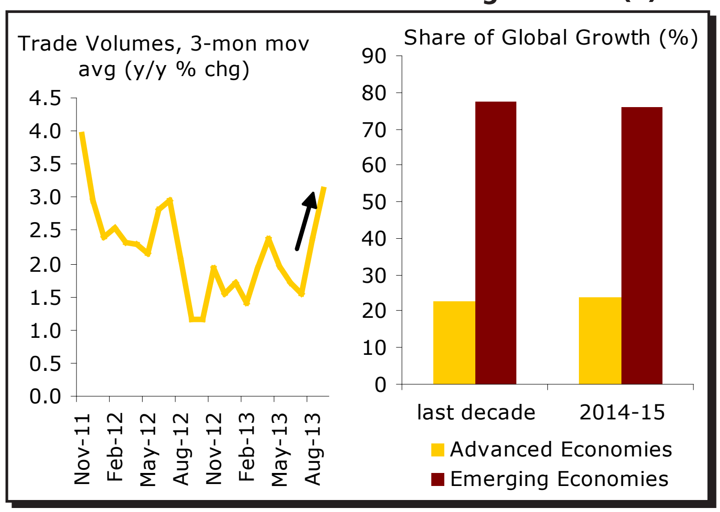
A boost from exports saw the Eurozone economy emerge from recession in Q2 2013, but a strengthening currency has subsequently seen that support wane. Still, we remain relatively optimistic on Eurozone GDP in 2014 and 2015, expecting consensus-topping growth of 1.4% and 1.9% respectively.

Low inflation and high unemployment point to a Eurozone output gap that is wider than even that of the US. The tame CPI should now allow for a more accommodative ECB, which could turn to another LTRO or other easing measures in the coming year. The key transmission mechanism for ECB easing will be its weakening impact on the euro. And it's not just German manufacturers who will benefit. Peripheral countries have started to make progress improving competitiveness, and improvements in their current account positions have not just been a story of lower imports linked to a shrinking domestic economy (Chart 2, left).

As in the US, fiscal policy should be another catalyst for faster-paced Eurozone growth. With countries missing deficit targets no longer being forced to make up the shortfall immediately, fiscal drag will likely be much lower, subtracting less than ½% from growth instead of around

Chart 1

Global Trade Rebounding (L); Resource-Intensive EMs Still Driving Growth (R)



Source: CPB, CIBC, IMF

Table 1

REAL GDP GROWTH RATES

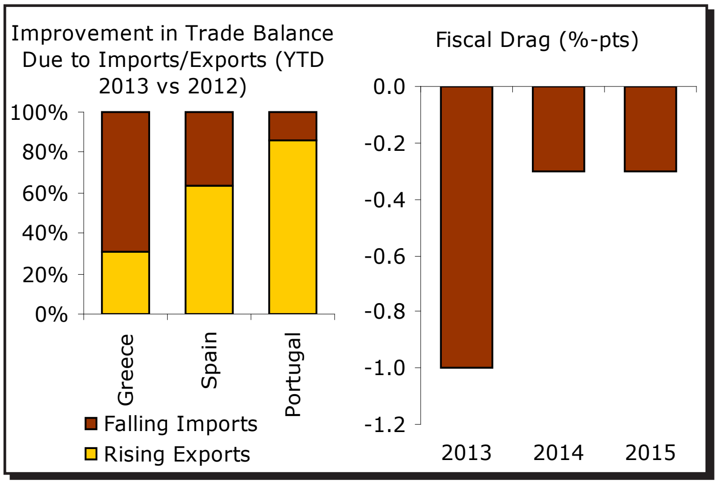
	5 yrs before recession, avg	2011A	2012A	2013E	2014E	2015E
World*	4.8	3.9	3.2	2.9	4.0	4.2
US	2.7	1.8	2.8	1.7	3.0	3.0
Canada	2.6	2.5	1.7	1.7	2.3	2.3
Euroland	2.2	1.6	-0.6	-0.4	1.4	1.9
UK	3.3	1.1	0.1	1.4	2.3	2.0
Japan	1.8	-0.4	1.4	1.6	2.1	1.8
Brazil	4.0	2.7	1.0	2.2	2.4	2.7
Russia	7.5	4.3	3.4	1.5	2.7	2.8
India	8.9	6.3	3.2	3.9	5.3	6.0
China	11.6	9.3	7.7	7.7	8.0	7.8

** at Purchasing Power Parity*

Source: National statistical agencies, IMF, CIBC

Chart 2

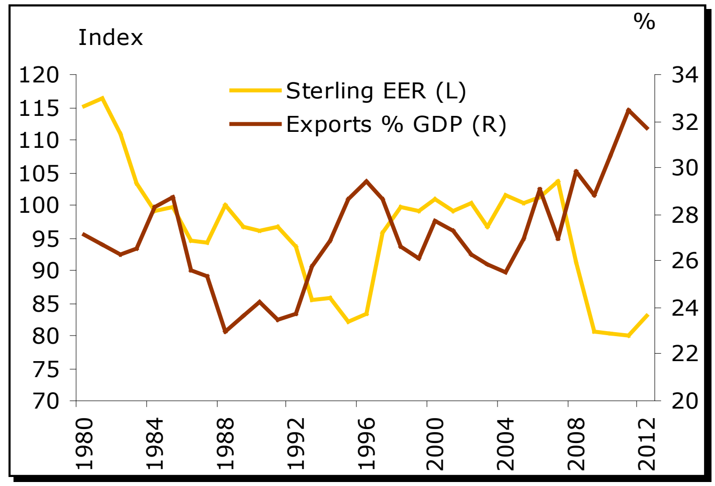
Exports Contributing to Improving Trade Balance (L); Fiscal Drag Easing (R)



Source: Eurostat, CIBC

Chart 3

Share of Exports to GDP Has Risen Since Sterling's Slump



Source: BOE, CIBC

1% as in 2013. That swing accounts for roughly half of the acceleration we expect in Eurozone growth during 2014 (Chart 2, right).

While the Eurozone has emerged from its double-dip recession with something of a whimper, the UK has emerged with much more of a bang. Unannualized 0.8% growth in Q3 2013, following an already better-than-expected showing in Q2, has seen forecasters' frantically revise estimates for the UK economy higher—not just for 2013, but for 2014 and beyond.

But it's not all smooth sailing from here. Low wages and still-elevated inflation continue to restrain disposable incomes, and talk of cooling a housing upturn seems premature given still-low levels of sales and mortgage approvals. Meanwhile a stronger sterling threatens to disrupt the redistribution of growth towards exports, which have risen as a share of GDP since the recession (Chart 3). As a result, there seems less room for the UK to surpass consensus expectations.

China: Trotting into the Year of the Horse

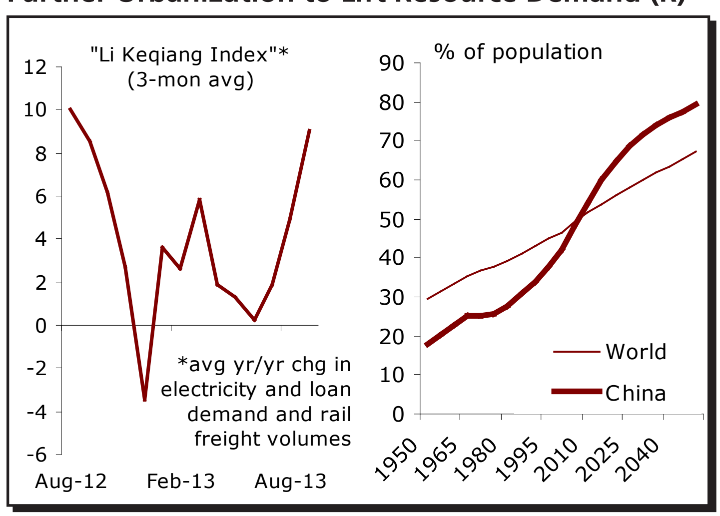
For a decade or more, some observers have argued that the shortcomings and imbalances of China's economy were so acute that growth could grind to a halt. Such concerns were top of mind for the country's leaders when they unveiled an ambitious new reform blue-print in November.

While it may be years before the full effect of those proposals become clear, assorted top-down and ground-level indicators suggest that the economy has re-acquired some speed lately, aided by the summer's mini stimulus program. An index of power consumption, railway freight traffic and new lending—the metrics China's new premier reportedly watches—confirms the economy's pick-up in Q3 (Chart 4, left). Aiding performance, the trade balance has re-widened to an average $27 billion in the three most recent months. The government has also reaffirmed its unwillingness to let growth dip below 7%. At the same time, below-target inflation limits pressure for early monetary re-tightening. Urbanization should continue to support resource demand (Chart 4, right).

China faces greater hurdles than a decade ago, with the working age population now declining and more credit-intensive growth suggesting challenges on the investment quality side (Chart 5). We nonetheless believe underlying

Chart 4

Bottom-up Indicators Confirm GDP Pick-up (L); Further Urbanization to Lift Resource Demand (R)



Source: NBS, UN, CIBC

growth is 7-8%, as opposed to something markedly lower. The supportive policy backdrop and recoveries in overseas markets like the Eurozone should help GDP expand by 8% and 7.8% in the next two years.

Elsewhere, everything that could go wrong has in Brazil, which is likely to see muted 2.4% growth next year. Growth projections have also been trimmed further in Russia. India's economy, as large as those two put together, is nonetheless showing improvement. Real GDP expanded at a near-5% pace on the year in Q3. We expect GDP growth of 5.3% and 6% in the next two years, with spring elections potentially easing obstacles to reform.

Japan: Challenges in 2014

A year ago, Japan's newly elected government introduced Abenomics, with its three arrows of fiscal and monetary stimulus and structural reforms, in a bold bid to jolt the country out of its decade-long stasis. As a key element, the Bank of Japan set an inflation target of 2% earlier in the year.

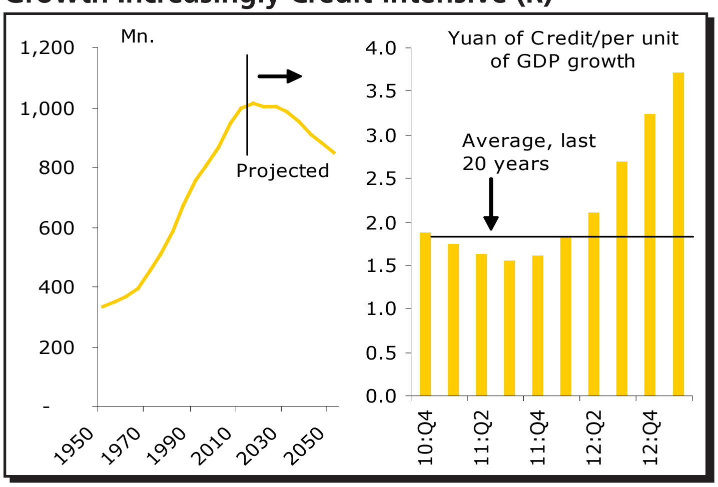
Results initially were encouraging. The economy roared out of the blocks in the first half of the year, with back-to-back four percent quarters. Corporate profits have topped expectations. Signalling a seeming end to deflation, year-on-year core inflation edged back into positive terrain for the first time in a half-decade in October (Chart 6, left).

Notwithstanding that, the economy faces notable challenges in 2014. Neither consumer outlays nor corporate spending is showing traction (Chart 6, right). Glacial 0.1% year/year wage growth heightens concerns about the economy's ability to shoulder April's planned 3%-pt rise in the value-added tax. We expect growth to remain modest, at about 2% in the next two years, even with the added stimulus measures introduced this month and further depreciation of the yen helping exports.

After a challenging few years, the global economy is finally showing signs of moving out of the slow lane, aided by still accommodative or easing monetary and fiscal policy. Progress won't be even. The improving backdrop should nonetheless support exporters and commodity producers in Canada and other countries.

Chart 5

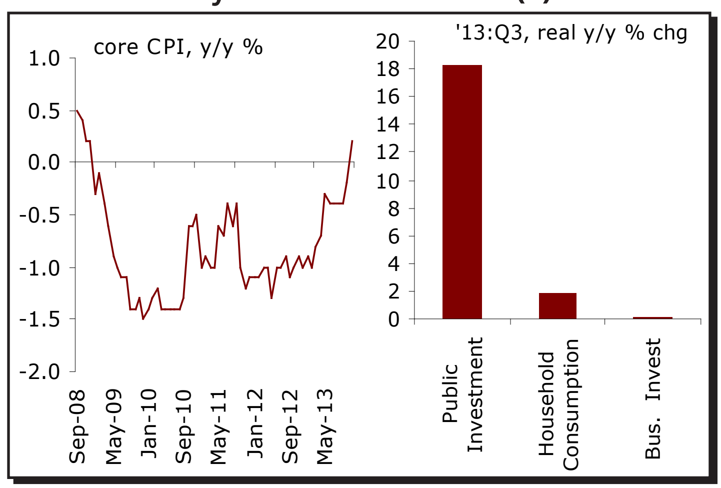
China's Working Age Population Has Peaked (L); Growth Increasingly Credit-Intensive (R)



Source: UN, BIS, CIBC

Chart 6

Japanese Deflation Eases (L); But Its Recovery Needs More Drivers (R)



Source: Statistics Bureau, CIBC