



Economics

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"... recoveries are rarely a smooth road, and this one faces a huge speed bump beyond the next couple of quarters."

The Lion and the Lamb

by Avery Shenfeld

Heroic rescue efforts by central bankers and finance ministers have clearly paid off. While those still in the ranks of the unemployed might not see it that way, record low interest rates and huge fiscal stimulus around the globe brought both economies and financial markets back from the brink.

That has the North American economy entering 2010 like a lion. But the fading benefits of these measures, and the lingering hangovers from the past two-years' turmoil, will see us exit like a lamb. An average-looking year for GDP growth as a whole (Table 1) will mask some quite varied temperature readings on a quarterly basis.

There were some disappointments in the pace of growth in the latter half of 2009, but those have left more room for a boost from inventory restocking in the next two quarters. And the rapid recovery in financial markets has had a notable impact on sentiment that has given some support to private sector spending. As a result, we've lifted our first-half growth forecasts materially for both the US and Canada to the 3½% range.

But recoveries are rarely a smooth road, and this one faces a huge speed bump beyond the next couple of quarters. The US will see fiscal policy swing from stimulus to a drag beyond mid-year, just as the quarterly lift from inventory restocking abates. Although job creation will turn positive, household spending will be adjusting to the need for a higher savings rate. Moreover, the banking system will still be licking its recessionary wounds, leaving credit standards tight, particularly if regulators are also moving

to lift capital requirements or trim leverage ratios. All of that could see US GDP advance at 2.8% for the year as a whole, but buried within that will be a mere 1% second half pace, and the growing pressure for fiscal restraint has us cutting our 2011 forecast by a full percentage point to 2.4%.

The US isn't alone in facing a hangover that could restrain growth later this year and into 2011. Europe's banking system has its own walking wounded, with the threat that higher capital requirements will tighten lending standards. Fiscally, we already see a forced march to restraint in the eurozone's periphery (Greece, Ireland) before those economies are strong enough to endure it. Monetary policy could tighten to avoid inflation in core Europe only to prolong recessions in the region's weaker players. Even China is starting to tighten as it balances its need for growth against new concerns over inflation risks and a property market overheating.

The timing of the fiscal and inventory on-off switch for Canada isn't as well defined, nor the pressure for budgetary belt tightening quite as immediate. But if the past two years taught us anything, it's that our small open economy can't chart its own course.

Manufacturing and resources will benefit from the upswing in global growth and inventory rebuilding in the first half, but will subsequently feel the combined pinch of decelerating foreign demand and an overvalued C\$. Solid US growth in the first quarter could see the C\$ retreat temporarily, but jumping ahead of the Fed on rate hikes

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

Table 1

FORECAST SUMMARY						
(% Change Except Where Noted)						
CANADA	2006A	2007A	2008A	2009F	2010F	2011F
GDP at Market Prices	5.5	5.8	4.4	-4.5	5.5	6.6
GDP in \$2002	2.9	2.5	0.4	-2.5	2.3	3.0
Consumer Price Index	2.0	2.1	2.4	0.3	2.0	2.1
Unemployment Rate	6.3	6.0	6.1	8.3	8.3	8.1
Current Account Balance (C\$ Bn)	20.3	15.6	8.1	-41.0	-31.5	-16.5
Pre-tax Profits	5.1	4.1	5.7	-34.5	9.5	15.0
Housing Starts (K)	229	228	211	145	180	185
UNITED STATES						
GDP at Market Prices	6.0	5.1	2.6	-1.4	3.8	4.6
GDP in \$2005	2.7	2.1	0.4	-2.6	2.8	2.4
Consumer Price Index	3.2	2.9	3.8	-0.3	1.7	3.0
Unemployment Rate	4.6	4.6	5.8	9.3	10.2	9.5
Current Account Balance (US\$ Bn)	-803.5	-726.6	-706.1	-410.0	-510.0	-470.0
Pre-tax Profits (with IVA/CCA)	10.5	-4.1	-11.8	-7.0	17.5	9.2
Housing Starts (Mn)	1.8	1.3	0.9	0.6	0.6	0.8

Table 2

INTEREST AND EXCHANGE RATE FORECAST								
		2010				2011		
END OF PERIOD:		13-Jan	Mar	Jun	Sep	Dec	Mar	Jun
CDA	Overnight target rate	0.25	0.25	0.25	1.00	1.00	1.00	1.50
	98-Day Treasury Bills	0.18	0.20	0.60	1.15	1.05	1.15	1.75
	2-Year Gov't Bond	1.33	1.45	1.90	2.35	2.00	2.40	2.70
	10-Year Gov't Bond	3.61	3.65	3.85	3.95	3.75	4.00	4.05
	30-Year Gov't Bond	4.14	4.15	4.30	4.45	4.30	4.35	4.40
U.S.	Federal Funds Rate	0.15	0.15	0.15	0.15	0.25	0.75	1.50
	91-Day Treasury Bills	0.06	0.10	0.10	0.10	0.20	1.00	1.50
	2-Year Gov't Note	0.96	1.05	1.10	1.20	1.35	2.20	2.45
	10-Year Gov't Note	3.79	3.85	4.00	4.15	4.10	4.45	4.45
	30-Year Gov't Bond	4.71	4.70	4.75	4.95	4.85	5.05	5.05
	Canada - US T-Bill Spread	0.12	0.10	0.50	1.05	0.85	0.15	0.25
	Canada - US 10-Year Bond Spread	-0.18	-0.20	-0.15	-0.20	-0.35	-0.45	-0.40
	Canada Yield Curve (30-Year — 2-Year)	2.81	2.70	2.40	2.10	2.30	1.95	1.70
	US Yield Curve (30-Year — 2-Year)	3.75	3.65	3.65	3.75	3.50	2.85	2.60
EXCHANGE RATES	CADUSD	0.971	0.935	0.971	1.020	0.971	0.962	1.000
	USDCAD	1.030	1.070	1.030	0.980	1.030	1.040	1.000
	USDJPY	91	94	93	90	87	86	86
	EURUSD	1.45	1.37	1.38	1.44	1.47	1.48	1.50
	GBPUSD	1.63	1.56	1.58	1.66	1.69	1.69	1.71
	AUDUSD	0.924	0.940	0.925	0.960	1.000	0.990	0.995
	USDCHF	1.02	1.09	1.08	1.03	1.02	1.01	1.00
	USDBRL	1.76	1.80	1.75	1.70	1.68	1.65	1.64
	USDMXN	12.7	13.5	13.0	12.7	12.5	12.3	12.3

could take the loonie temporarily through parity at a time when resource prices won't justify that strength. Fiscal tightening will be in the works for Canada by 2011, and recent upward revisions to provincial deficits in this fiscal year point to a somewhat larger squeeze on growth to get back towards balance.

Patience is a Virtue, But...

For monetary policy, the need for a fiscal tightening and the recession's lingering hangovers suggest that patience will be a virtue in bringing rates back to historical norms. On that score, the Fed's track record is comforting. Washington didn't see any rate hikes until three years after the prior two recessions, and this one was deeper. Bernanke might not want to maintain near-zero rates for that long, and will want to unwind quantitative easing before the mountain of excess reserves threatens to show up in an overdose of lending in the economy. But we're sticking to our view that the funds rate won't budge until 2011.

In Canada, history reveals a central bank with a more itchy trigger finger (Chart 1). After each of the last two major North American slowdowns, the Bank of Canada hiked rates ahead of the Fed, only to have to reverse course when the economy disappointed. Our upgraded first-half growth forecast will likely see something similar, with Carney hiking 75 bps in Q3 (Table 2), only to go back on hold for at least a quarter facing a combination of C\$ gains and weaker growth signals.

But even the first dose of tightening should spark a swing to a bear flattening trend in fixed income markets.

Inflation won't be the problem for the long end. Rather, it's supply. US deficits will remain in the stratosphere over the forecast horizon (Chart 2). It's one thing for America to finance huge deficits when nobody else is borrowing, and when the Fed is buying the lion's share of the net issuance, quite another when the private sector starts to borrow again, and the Fed stands aside.

China might also slow its Treasuries buying if it starts allowing a modest yuan appreciation later this year. Canada's federal/provincial shortfall will still top 6% of GDP in 2009/10, and net provincial bond supply will increase next year given the need to fund capital spending programs. With huge deficits also needing funding in Europe, global bond yields will come under pressure. While outperforming Treasuries for 2010 as a whole, look for 10-year yields to reach nearly 4% in Canada in a flattening sell-off ahead of the first rate hikes, before easing off towards year end.

Judged by the analysts' consensus for more than 25% earnings growth, equity investors may be counting on chickens that will take more than one year to hatch. But the stock market could get a decent year's return in the first six months, when year-on-year earnings comparisons will be against the depths of the recession, macro growth rates will be fairly healthy, and resource prices could still be climbing. While comparable fixed income yields won't be as low as they are today, the gap between TSX dividend yields and those on bonds is very narrow, and expectations for dividend growth in 2010 and beyond should see yield-hungry investors supporting another leg higher for the TSX.

Chart 1
Bank of Canada Tightened Too Early in the Past

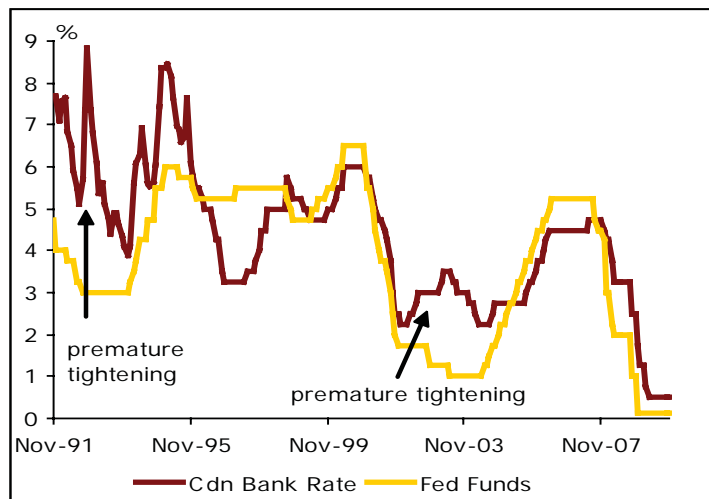
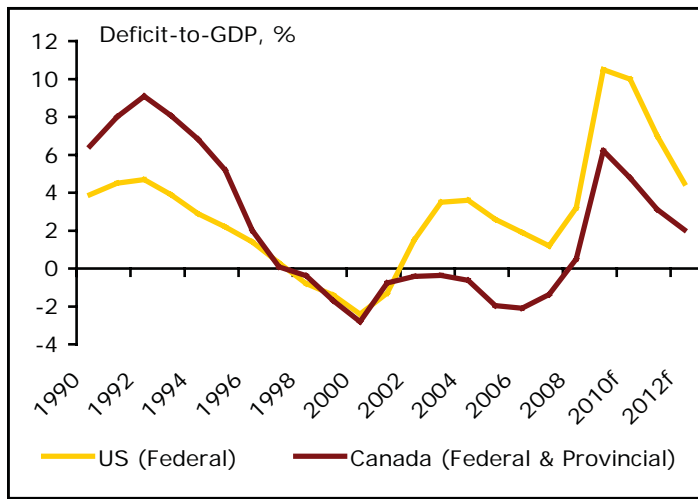


Chart 2
Deficits Remain Elevated Over Forecast Horizon



US: The Winter's Economic Thaw is Unlikely to Last

Peter Buchanan and Meny Grauman

The Great Recession is now history, but the recovery will not be as sturdy as it first appears. Measured from the cycle peak, this latest economic downturn was the deepest since World War II. Deep recessions are typically followed by strong recoveries, but given the recession's heavy toll on the household sector, a still not fully cured financial sector, and the dependence of improvements to date on transitory fiscal stimulus, that long-standing axiom is unlikely to apply this time around.

Aided by massive government outlays, tax stimulus and reduced headwinds from housing, the US economy gradually gained speed over the course of 2009. Some of that strength should carry over into the first half of 2010. But while a double-dip recession now looks unlikely, what will be surprising is how swiftly growth downshifts when support from fiscal pump-priming and restocking vanishes in the second half.

Emergency government stimulus measures added a whopping 3%-pts to third-quarter growth, more than all of the GDP gain. By our calculations, that will slow to about half that amount in the first half of 2010 becoming an outright negative by Q4 (Chart 1). Similarly, the recent economic boost provided by inventories will also wane as quarterly changes decelerate. Thanks to a more service-oriented economy and "just-in-time" management, inventories are much smaller today, as a percentage of GDP, than 20-30 years ago. That means inventory rebuilding will provide some support to growth, but nothing like the huge lift seen in some past recoveries (Charts 1 & 2).

Better Holiday Sales Belie Still-Weak Fundamentals

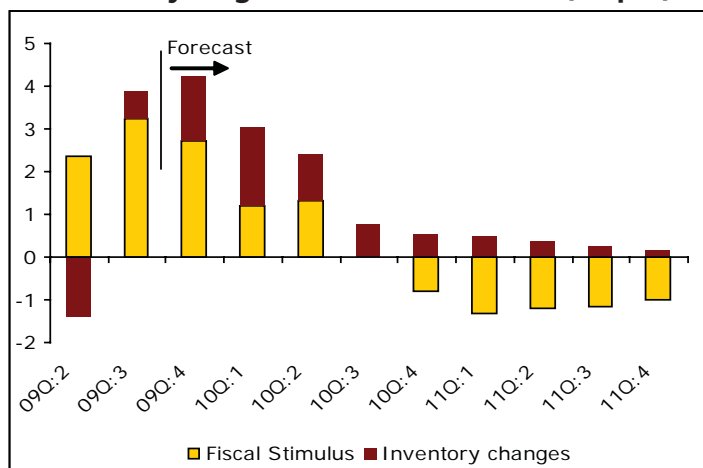
Consumers eased their purse strings a bit this holiday season. Unfortunately, recent increases still leave retail

Table 3

US FORECAST DETAIL											
(real % change, s.a.a.r., unless otherwise noted)											
	09:3A	09:4F	10:1F	10:2F	10:3F	10:4F	11:1F	2008A	2009F	2010F	2011F
GDP At Market Prices (\$Bn)	14,242	14,415	14,594	14,755	14,859	14,949	15,116	14,441	14,246	14,789	15,467
% change	2.6	4.9	5.1	4.5	2.9	2.4	4.5	2.6	-1.4	3.8	4.6
Real GDP (\$2005 Bn)	12,973	13,091	13,221	13,330	13,375	13,399	13,471	13,312	12,973	13,331	13,654
% change	2.2	3.7	4.0	3.3	1.3	0.7	2.2	0.4	-2.6	2.8	2.4
Final Sales	1.5	2.7	2.1	1.8	1.2	0.7	2.0	0.8	-1.7	1.8	2.2
Personal Consumption	2.8	3.2	2.8	2.8	0.7	0.2	1.1	-0.2	-0.5	2.2	1.9
Total Govt. Expenditures	2.7	4.5	4.0	3.1	3.3	1.5	1.6	3.1	2.2	3.7	1.5
Residential Construction	18.9	9.0	1.0	4.0	-3.0	1.5	4.0	-22.9	-20.2	2.8	3.8
Business Fixed Investment	-5.9	-5.1	-2.3	-4.1	-0.4	-0.4	3.5	1.6	-18.3	-3.7	2.2
Inventory Change (\$2000 Bn)	-139.2	-108.8	-48.9	2.0	7.0	8.0	13.0	-25.9	-130.5	-8.0	22.5
Exports	17.8	3.3	2.6	3.0	6.7	5.3	6.4	5.4	-10.6	4.8	5.7
Imports	21.3	3.8	5.0	6.4	4.2	2.6	1.8	-3.2	-14.5	5.3	3.1
GDP Deflator	0.4	1.2	1.0	1.1	1.5	1.7	2.3	2.1	1.2	1.0	2.1
CPI (yr/yr % chg)	-1.6	1.4	2.0	1.3	1.6	1.7	2.2	3.8	-0.3	1.7	3.0
Core CPI (yr/yr % chg)	1.5	1.7	1.5	1.2	1.1	1.2	1.5	2.3	1.7	1.2	2.0
Unemployment Rate (%)	9.6	10.0	10.3	9.9	10.2	10.5	10.1	5.8	9.3	10.2	9.5
Housing Starts (AR, Mn)	0.59	0.56	0.59	0.61	0.56	0.66	0.65	0.90	0.55	0.61	0.79

Chart 1

Contribution of US Stimulus Package & Inventory Chgs to US GDP Growth (%-pts)



Source: CIBC

sales running at only a late-2005 pace. Moreover, that growth has not been underpinned by improving fundamentals. The unemployment rate is still near a 27-year high, and although monthly job losses are now averaging a tenth of what they were running at the height of the recession in early 2009, initial jobless claims are still elevated by historical standards. While we expect payrolls to start to grow again in early 2010, aided by temporary census hires, full employment is a distant hope. The unemployment rate should hover above 10% in 2010, only improving marginally in 2011.

Labour demand sometimes surges after periods of steep job losses, but there is reason to believe that employers will be as cautious about bringing on new workers as they were in the previous two milder recessions. Improvements

in the jobless rate will be hindered not only by a rebound in the participation rate after the steepest drop in 40 years, but by rising average hours, as cautious employers opt for now to extend hours rather than adding new workers (Chart 3, left). And that story has a long way to run. An unusually large number of Americans are working shorter hours because of the recent recession, as evidenced by the record number of those employed only part-time for economic reasons (Chart 3, right).

Real hourly earnings got a lift from falling fuel prices as the recession deepened a year ago, but have stagnated of late. Moving into 2010, sustained job gains should eventually translate into higher income growth. Well over a million new census jobs will also help on this front as well, especially in Q2. However, we continue to expect households to save more of those incremental gains in the wake of the steepest hit to wealth since the Great Depression. Although the monthly pattern has been choppy and affected by government support payments lifting incomes and cash-for-clunkers encouraging spending, the underlying uptrend in the savings rate has it aiming for 6% by the end of 2010.

Even if they don't want to admit to the need to replenish retirement nest eggs, Americans may be forced into a more prudent lifestyle. Credit to the household sector has been plunging (Chart 4, left), and not all of that is because Americans have learned the hazards of excessive borrowing. A banking system that is still carrying a huge burden of non-performing loans (Chart 4, right) won't easily forget those same lessons, and will remain restrictive in lending standards, particularly if regulators tighten capital requirements and leverage limits.

Chart 2

"Just-in-Time" Economy Limits Support From Restocking

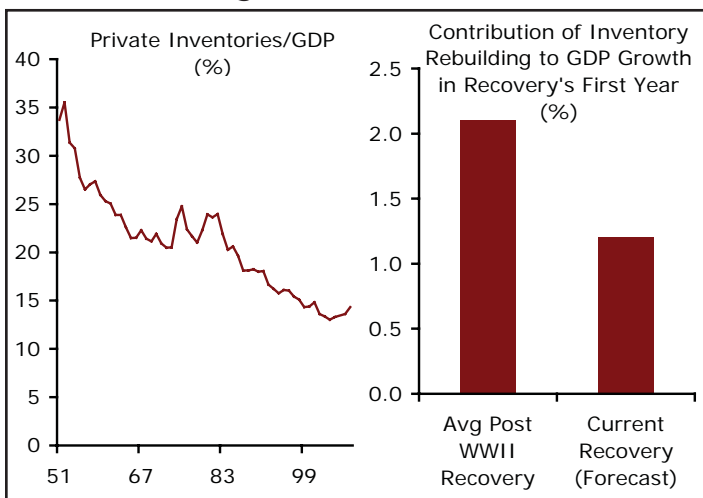


Chart 3

Lots of Room for Existing Workers to Add Hours

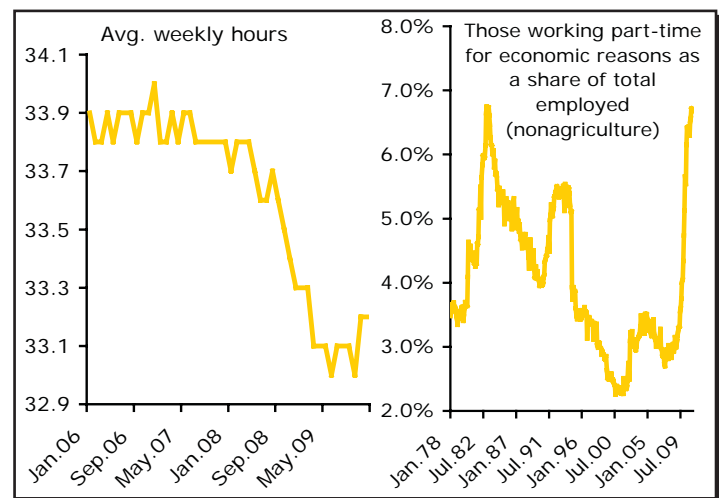
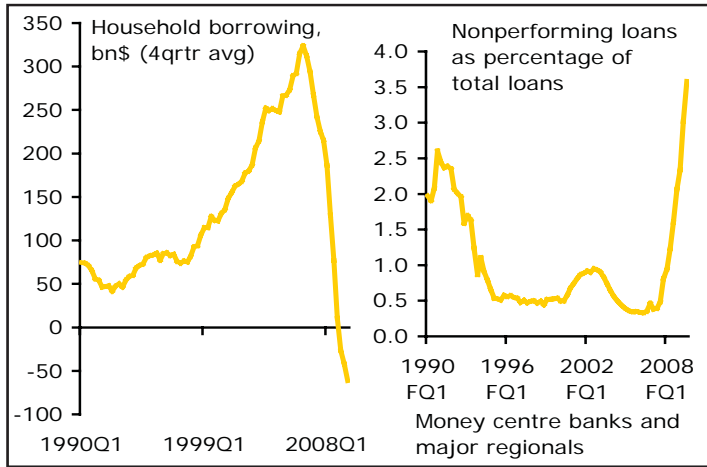


Chart 4

Credit Availability Still Looks Tight



Source: SNL Financial

A Few Glimmers of Hope

Nevertheless, some parts of the US economy could provide upside surprises during this otherwise slow recovery period, limiting the risk of a double dip. Trade weighed on the economy in Q3. But longer term, American factories will see increased market share as they benefit from previous and expected further US dollar depreciation.

Soaring vacancy rates mean that commercial real estate remains a weak link. That sector normally follows a still-depressed housing sector with a year or two lag. But business equipment investment could top expectations in 2010. Outlays have been slashed so savagely that gross spending is now trailing behind depreciation, threatening to result in the first outright decline in that component of the capital stock in over six decades. While households and small businesses are having trouble obtaining financing, the same isn't true of large corporates. Corporate cash flows less investment—the so-called 'financing gap'—reached nearly \$200 billion in the third quarter in annualized terms. The only time internal cash generation covered investment needs better was in 2005, when corporations took advantage of a special tax holiday on repatriated offshore earning.

All of that leaves the economy on track for 2.8% growth in 2010. That's just a third-to-half the pace recorded in the first year after the 1957 and 1975 downturns, the two recessions that come closest to matching the recent one on a peak-to-trough basis. And with fiscal policy poised to turn from a neutral influence later this year to an outright negative, we expect growth to actually lag this year's pace in 2011. Alongside any federal cost cutting,

state governments, many of whom are facing conditions not seen since the Great Depression, will be forced into fiscal restraint by balanced-budget mandates.

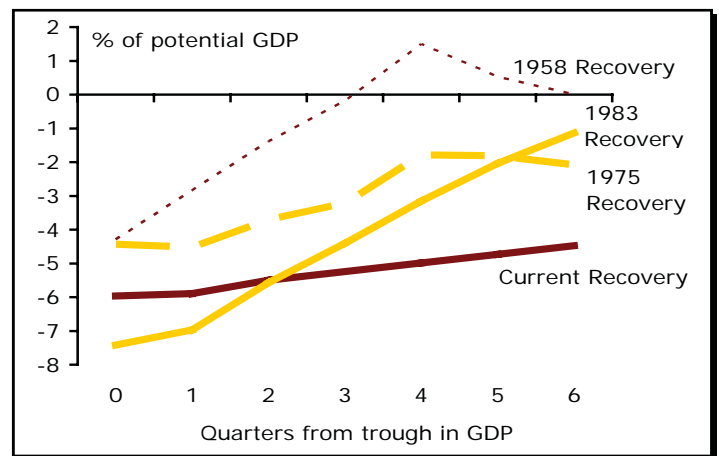
Elevated Joblessness and Low Inflation Will Keep Fed on Hold Until 2011

Bond investors have been quick to price in a potential mid-2010 tightening move by the Fed. However, that ignores the handcuffs placed on inflation by an almost unprecedented large gap between the economy's actual and potential production. That's true whether the extent of the slack is gauged by the unemployment rate's dramatic post-2007 climb, or by the output gap, which will close much more slowly than in past recoveries (Chart 5).

A weak recovery should ensure that inflation remains a sidebar to economic developments over the coming year. Core CPI is off its recent lows, but will trend down again as a temporary surge in vehicle prices normalizes. Shelter costs, the largest single component of the CPI, will become even more deflationary on the back of surging vacancy rates and a still weak housing market. A benign inflation outlook and the prospect of a weaker-than-normal economic recovery will also ensure that the Fed keeps rates on hold at least for another full year, consistent with the timing of previous tightening cycles. While the Fed could still commence unwinding its extraordinary quantitative easing in 2010, any action on interest rates will be put off until 2011. That, however, won't be enough to hold longer yields at bay, given the ongoing flood of government bond financing.

Chart 5

A Lingering, Large Output Gap Will Keep Inflation and the Fed on Hold



Canada: 2010 Pop and Fizzle

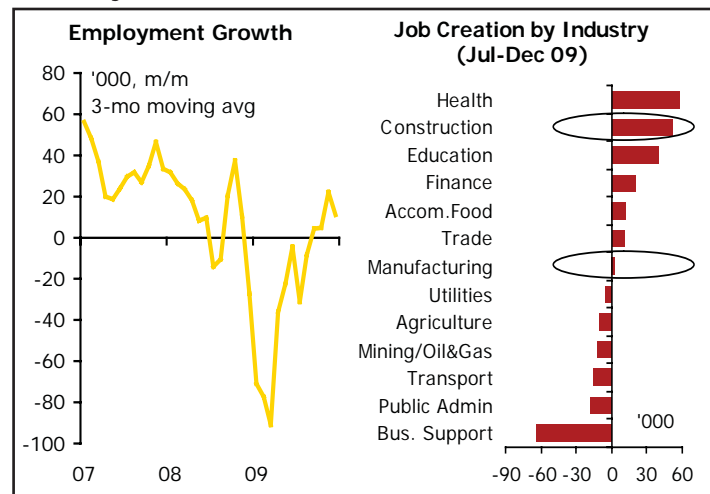
Benjamin Tal and Krishen Rangasamy

No economic recovery goes in a straight line and the current one will be the most non-linear of them all. As in the US, many of the chief drivers of the Canadian recovery will run out of fuel by mid-year, and will give way to sub-par growth in the second half of the year.

The headline GDP numbers for Q3 were disappointing, but they masked strong momentum in the domestic economy. Final domestic demand rose at an annualized pace of 4.7% in the quarter, capping off the strongest six-month period in any initial post-war recovery. That momentum clearly reflects the recent improvement in the labour market which, beyond the volatility of the monthly figures, is showing a clear upward trend (Chart 1, left). While health and educational jobs are being created in large numbers, these categories are not “recovery makers” or major cyclical forces. What traditionally carries or destroys a recovery are the construction and

Chart 1

Labour Market Improves with Some Support from Cyclical



Source: Statistics Canada, CIBC

Table 4

CANADA FORECAST DETAIL											
(real % change, s.a.a.r., unless otherwise noted)											
	09:3A	09:4F	10:1F	10:2F	10:3F	10:4F	11:1F	2008A	2009F	2010F	2011F
GDP At Market Prices (\$Bn)	1,525	1,555	1,587	1,609	1,619	1,635	1,664	1,600	1,529	1,612	1,718
% change	3.3	8.0	8.5	5.7	2.5	3.9	7.4	4.4	-4.5	5.5	6.6
Real GDP (\$2002 Bn)	1,283	1,294	1,307	1,317	1,322	1,328	1,338	1,321	1,288	1,318	1,358
% change	0.4	3.5	3.8	3.1	1.5	1.9	3.3	0.4	-2.5	2.3	3.0
Final Domestic Demand	4.7	2.5	3.5	3.0	2.7	2.4	2.3	2.6	-1.5	3.0	2.5
Personal Consumption	3.1	2.6	2.5	2.5	2.2	2.1	3.0	3.0	0.1	2.5	3.0
Total Govt. Expenditures	7.9	4.6	5.9	4.5	6.2	4.8	1.2	4.8	4.1	5.5	1.5
Residential Construction	8.1	6.0	5.0	4.0	-3.0	0.0	2.0	-2.7	-8.4	4.2	1.6
Business Fixed Investment *	4.2	-3.9	3.2	2.3	0.8	0.3	1.0	0.2	-14.6	-0.1	2.5
Inventory Change (\$2002 Bn)	-5.8	-4.4	-2.7	-0.8	0.0	0.1	1.9	12.2	-7.5	-0.8	6.4
Exports	15.3	9.6	14.8	12.9	1.9	1.2	12.1	-4.7	-13.9	8.5	9.9
Imports	36.0	6.7	13.3	12.4	5.5	2.8	9.1	0.8	-13.7	11.3	8.7
GDP Deflator	3.1	4.2	4.5	2.5	1.0	2.0	4.0	3.9	-2.0	3.0	3.5
CPI (yr/yr % chg)	-0.9	0.8	1.7	2.1	2.5	1.7	1.7	2.4	0.3	2.0	2.1
Core CPI (yr/yr % chg)	1.6	1.6	1.9	1.8	1.8	1.6	1.7	1.7	1.8	1.8	2.0
Unemployment Rate (%)	8.6	8.6	8.3	8.2	8.3	8.4	8.3	6.1	8.3	8.3	8.1
Employment (m/m avg, K)	4	11	34	34	16	10	17	7	-20	22	30
Goods Trade Balance (AR, \$bn)	-14.8	4.6	3.8	6.4	0.6	-3.0	0.6	46.9	-3.0	1.9	6.8
Housing Starts (AR, K)	148	166	177	180	181	182	183	211	145	180	185

* Machinery & Equipment plus Non-Residential Structures

manufacturing sectors, and here the non-linear nature of the current recovery will be most evident.

Housing Stall Will Weigh on Growth

Construction jobs are playing a major role in supporting the current recovery in the job market (Chart 1, right). While many will argue that government infrastructure spending is behind the revival of the construction sector, the reality is that more construction jobs march to the tune of house prices (Chart 2, left).

But as we found in our recent analysis (see December 2009 *Economic Insights*) house prices are already overshooting. Facing an increased supply this spring, and higher mortgage rates down the road, real estate values could level off in coming months and even decline in some of the now-hot markets. As a result, the current wave of hiring in the construction sector will give way to more subdued job growth in this sector in the second half of the year, particularly since first-half activity will have been boosted by builders running ahead of the July 2010 implementation of sales tax reform in Ontario and British Columbia.

But flattening housing prices will have an additional negative impact beyond construction employment cutbacks. According to the Bank of Canada's estimates, consumers spend 5.7 cents yearly out of every dollar increase in the value of their homes. Note that this housing wealth effect is significantly more powerful than the wealth effect associated with rising stock prices. Housing wealth is much more broadly distributed across income levels than stock wealth and its impact on consumer spending is much more immediate. The negative wealth

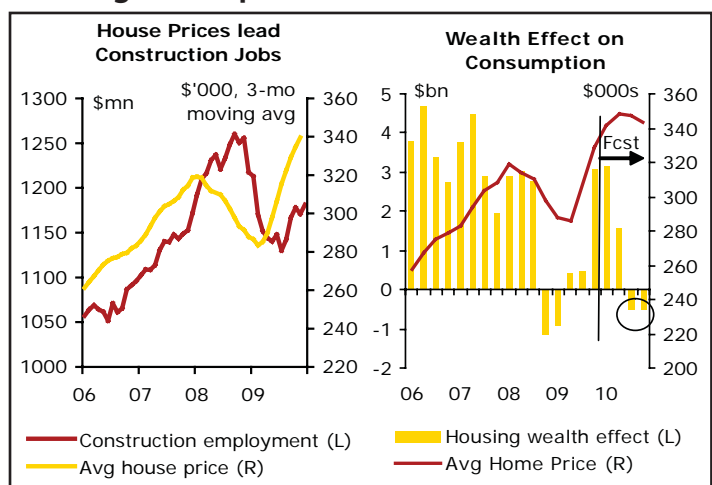
effect seen early in the recession clearly had a negative impact on spending, but the current recovery will see a cumulative increase in the wealth effect of close to \$10 billion by mid-year—an amount equivalent to one-fifth of the projected increase in overall consumer spending in 2010. But with house prices flattening or potentially falling in the second half of the year, that important boost to consumption will evaporate (Chart 2, right).

The Inventory Cycle: A Double-Edged Sword

To a lesser extent than in the US, where the earlier decline was sharper, a recovery in inventories will give a significant but temporary lift to growth. During the worst of the panic in early 2009, inventories were slashed, weighing heavily on GDP growth. Now with businesses starting to see the light, inventories are being cut at a much slower pace. This change means that once again inventories are a positive contributor to GDP growth—a process that will reach its zenith in the second quarter of the year before dropping off in the second half as inventories reach a more optimal level relative to sales (Chart 3). Note that these measures somewhat exaggerate the actual lift to Canadian GDP, due to the heavy import content of retail and wholesale inventories in Canada.

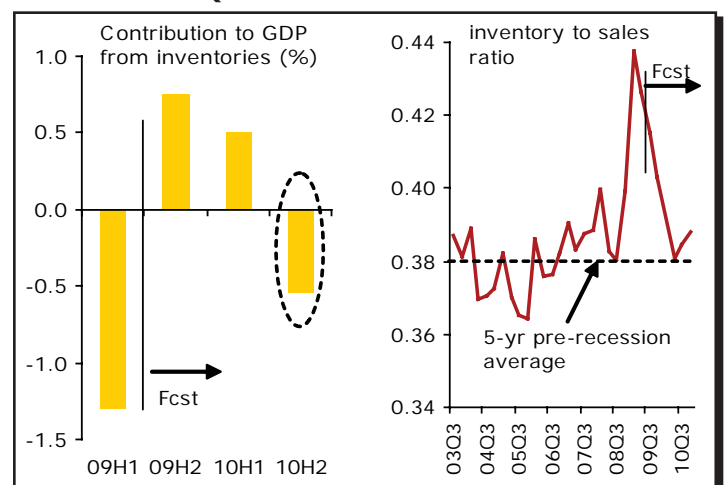
Beyond its direct contribution to GDP growth, the inventory cycle is an important factor behind the swings in factory jobs (Chart 4, left). After shedding over 200,000 jobs during the recession, the manufacturing sector is starting to show signs of recovery with modest job creation in the last six months of 2009. And we can expect further gains in that sector in the first half of 2010 as depleted inventories are replenished. But if history is any guide, those job gains won't be sustainable once

Chart 2
Housing: An Important Economic Driver



Source: CREA, Statistics Canada, Bank of Canada, CIBC

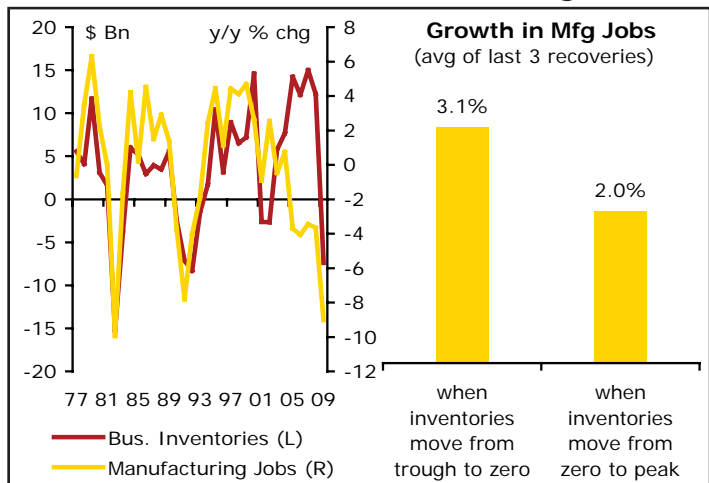
Chart 3
Inventories' Contribution to Growth Will Peak in Q2



Source: Statistics Canada, CIBC

Chart 4

Business Inventories & Manufacturing Jobs

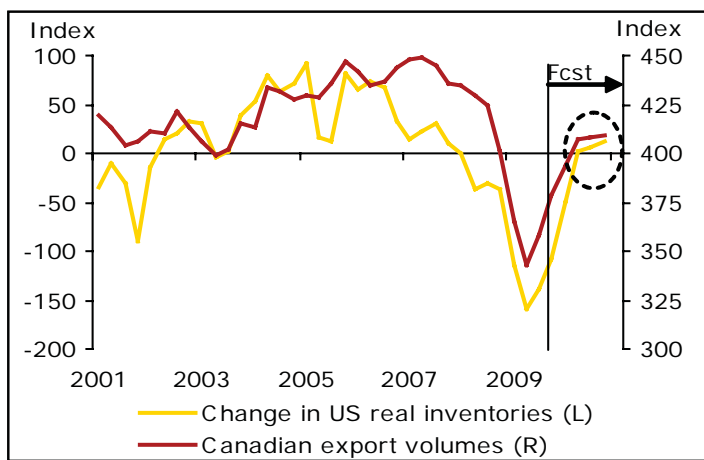


Source: Statistics Canada, CIBC

the inventory refills are completed. Note that in past recoveries the bulk of the factory jobs created were in the early stages of the upturn (i.e. similar to our current situation), when inventories had moved from their trough to zero (Chart 4, right). But once that phase ends (likely in the second half of the year for the current recovery), manufacturing jobs won't be as forthcoming. Note that the historical average 2% growth in factory jobs in that phase is biased upwards because it masks the impact of a NAFTA-related structural change in manufacturing in the early 1990s. In fact, excluding that jobless recovery, all other cyclical upswings have seen manufacturing jobs fall during the more mature stage of the inventory cycle. Given the competitive challenge of an overvalued C\$, this cycle is unlikely to be an exception.

Chart 5

Canadian Exports Dance to the Tune of US Business Inventories



Source: Statistics Canada, BEA, CIBC

Indeed, as important as the domestic inventory cycle is to the shape of the recovery, inventory refills in the US could potentially play an even bigger role. To get an idea of how tied the fortunes of Canadian exporters are to the American inventory cycle, one just has to look at the past decade (Chart 5). The collapse in trade in the recent recession was a result of a massive cutback in US inventories, and the restocking stateside should provide a commensurate bounce back in Canadian exports, something that will lift GDP over the first half of 2010. The outlook for exporters afterwards, however, is less rosy. The completion of US inventory refills, a slowdown of the American economy, and an overvalued Canadian dollar, will cause trade to revert to being a net drag on the economy.

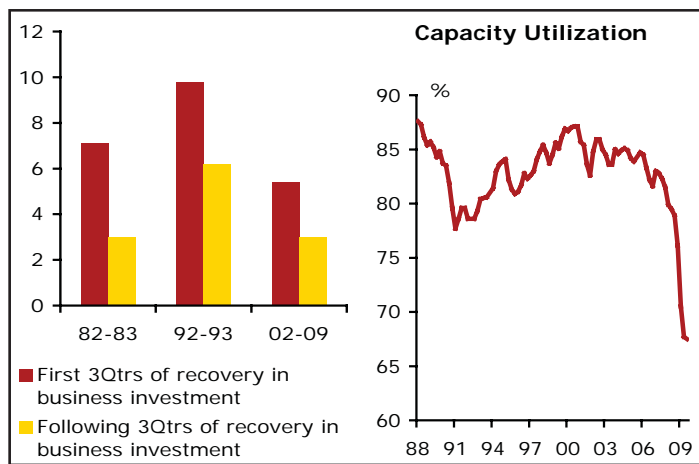
Business Investment Constrained by Capacity Glut

Business investment was strong in the third quarter in line with a normal cyclical trend, as the first wave of investment is mostly replacement investment which is necessary regardless of where we are in the cycle. But the expansion investment that follows is usually much weaker (Chart 6, left) and this time, it will be even weaker given a record low capacity utilization rate (Chart 6, right).

The 2.3% GDP growth projected for 2010 will mask two opposing trends. Boosted by temporary factors such as the inventory cycle on both sides of the border, real estate activity and replacement investment, first half growth will advance at an impressive annual rate of more than 3%. But this euphoric performance will give way to a much more subdued second half which will see growth decelerating below the 2% mark—a performance that will force the Bank of Canada to pause very early in the tightening cycle.

Chart 6

Replacement Investment Provides Only Temporary Boost



Source: Statistics Canada, CIBC

Global: A Two-Speed Recovery

Peter Buchanan and Meny Grauman

After a deep global recession, nearly all of the world's economies have now turned the corner—some quickly, others laboriously. Aided by a colossal dose of monetary and fiscal stimulus, the global economy is likely to expand by nearly 4% this year, decelerating to a pace of 3½% in 2011 as short term factors lifting the US fade and central bank tightening begins to bite in emerging markets like China. That's a percentage-point short of the pace prior to the Great Recession, but still a welcome relief relative to the worst fears of only a few quarters ago.

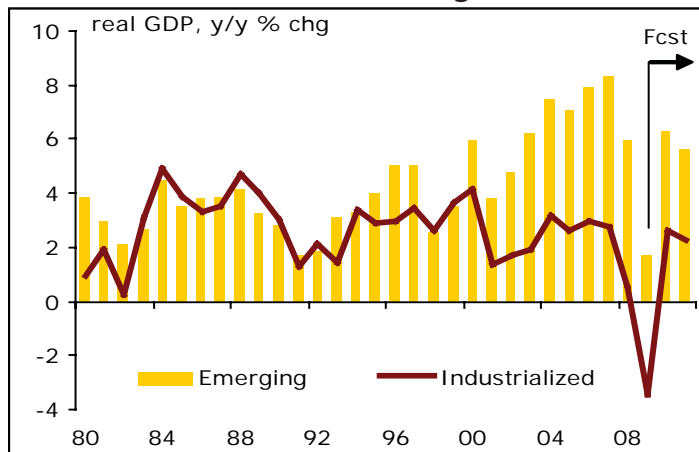
The global average growth pace masks an expected continuation of what has been one of the recovery's salient features: the unprecedented growth gap between the industrialized and non-industrialized economies. Unemployment in the OECD will hit 9% this year, three to four points above pre-recession lows. While weak consumer spending fundamentals will help to keep the OECD recovery from being a barnburner, emerging markets in many cases avoided the full force of the recent financial train wreck. Healthier domestic demand, supported by stimulus measures, is also helping to counter lingering export weakness. Given all of this, we expected those economies to expand by around 6% this year, triple the industrialized world's pace (Chart 1).

Exit Strategies: One Size Doesn't Fit All

A key risk to global growth comes from the pending phase-out of the massive fiscal and monetary stimulus programs instituted to combat the crisis. Policymakers came together a year ago to vanquish what, at the time, looked like another Great Depression, but differing

Chart 1

Emerging Market Growth Edge Will See Earlier Moves to Retighten



economic prospects coming out the recession will ensure that they chart somewhat different courses in the year ahead. Any Fed rate hike is at least a year off, but monetary policy in places like China and Australia is already turning back to restraint. Moreover, OECD public sector deficits will easily surpass 8% of GDP this year (Chart 2), putting greater pressure on industrialized countries to make significant budget cuts over the coming two years, only adding to growth differentials.

Commodity prices never fell quite as low in this recession as in past ones, and have since rallied earlier and more forcefully than during earlier recoveries (Chart 3). While the global economic comeback is still in its infancy, leaving longer term headroom for resources, markets appear to be getting ahead of underlying fundamentals.

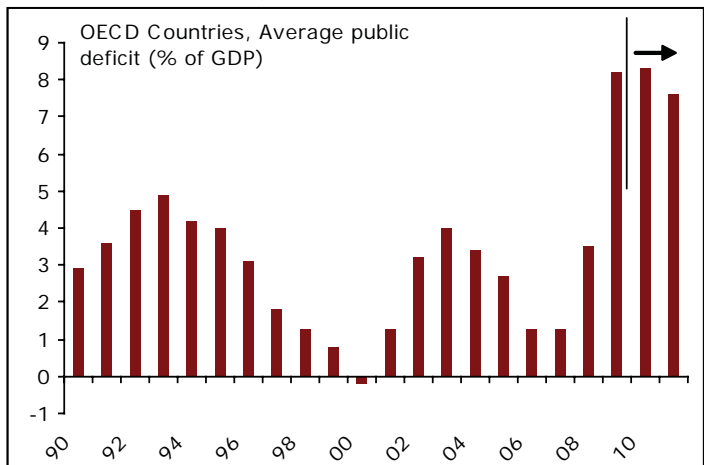
Table 5

REAL GDP GROWTH RATES						
	2006A	2007A	2008A	2009E	2010F	2011F
World*	5.1	5.1	3.1	-1.0	3.8	3.5
Euroland	3.1	2.7	0.5	-3.9	1.5	2.0
UK	2.9	2.6	0.5	-4.5	1.8	1.4
Japan	2.0	2.4	-1.2	-5.3	1.7	1.5
Brazil	4.0	6.1	5.1	0.0	4.0	5.5
Russia	7.7	8.1	5.6	-8.0	3.0	4.0
India	9.8	9.4	7.3	5.5	7.0	6.0
China	11.6	13.0	9.0	8.3	10.2	9.0

*Country growth rates are weighted using purchasing power parities.

Chart 2

Recession's Heavy Fiscal Toll Will Persist



Source: OECD

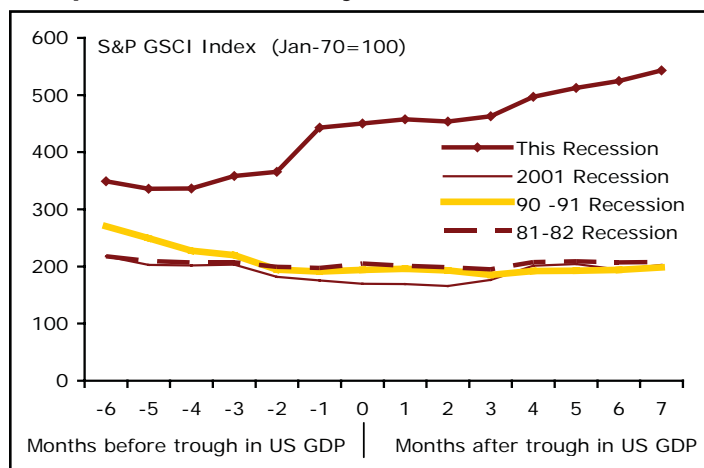
Average resource prices could easily correct by 10-15% later this year as the US slows and key emerging markets like China retighten.

China: Easing Export Drag Adds to Pressure for Restraint

No country's economic turnaround has been more dramatic than China's. From a near-stall late in 2008, growth has accelerated successively in recent quarters, aided by the second largest stimulus program of any country (after Russia) relative to GDP. Headwinds for the export sector, the major factor restraining growth for much of the last year, have eased noticeably (Chart 4, left), and the latest PMI readings, as well as November's nearly 20% yearly rise in industrial production, suggest that the economy entered the new year with appreciable octane. Real estate investment has accelerated notably,

Chart 3

Commodities Have Rebounded Earlier and Steeper Than in Past Cycles



although national housing prices are still rising at only 6% per year, only a third the pace of the previous US bubble, suggesting that surges in residential prices are less widespread and a smaller macro risk than commonly perceived.

Inflation remains fairly tame at 0.6% on the year (Chart 4, right). But bottlenecks due to strong growth and a further lift to food prices owing to bad weather could see price pressures accelerate. While the political leadership is not yet advocating all out restraint, we expect monetary policy to be tightened more aggressively in the second half of the year as inflation worsens. Even with more vigorous braking, the economy is likely to expand by 10.2% this year and around 9% in 2011.

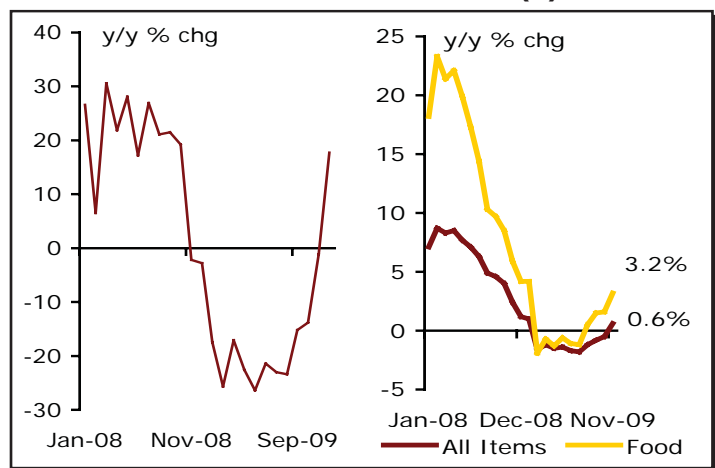
Japan has now reported two consecutive quarters of growth, a singular enough feat for a country long considered Asia's sick man. While the outlook remains subdued, several developments should nonetheless help to prevent a "double dip". For one, the Bank of Japan has stepped up its efforts to flood markets with liquidity, keeping long-term rates down. In particular, early in December the BoJ announced an extension of its previously terminated special corporate lending facility. Secondly, growth in the trade sector is helping to offset weakness in investment spending and residential investment. The net result of those efforts won't be a powerful recovery by any means, but should keep the economy on course for 1.7% growth this year and 1.5% in 2011

Europe: Regional Disparities Persist into 2010

As is the case in North America, we expect the emerging eurozone recovery to be quite weak relative to previous

Chart 4

China's Exports Recovering (L) as Inflation Rebounds From Lows (R)



recessions, and look for significant regional disparities to persist in 2010. To date, the main drivers of European growth have been inventory restocking and the revival in global trade flows, favouring countries with large manufacturing bases and significant export sectors like Germany and France. Meanwhile, once high-flying economies like Spain and Ireland remain grounded, weighed down by a host of structural problems. With world growth on the upswing and the euro giving back some earlier gains, exports should remain an important engine of recovery for the continent in 2010, but that should be tempered by ongoing weakness in domestic demand, that will act as a muzzle on the economy well into 2011.

Eurozone consumer balance sheets may be in better shape than in either the US or the UK, but are still very vulnerable to further deterioration in the labour market as tighter regulation and government-sponsored work-share programs have slowed down necessary adjustments. At the same time, despite the rebound in capital markets, a still-bruised banking sector should stand as a notable speed bump for the business sector, due to its outsized reliance on private lending. Rising business confidence and a recovery in corporate profits should provide some lift for investment in machinery and equipment, but construction will be flat, aside from government sponsored infrastructure projects.

Although the UK has lagged the eurozone in the early stages of this recovery, a more vigorous policy response coupled with a more buoyant consumer sector suggest that Great Britain will outperform the continent in 2010. However, that edge is unlikely to last into next year, as fiscal belt tightening takes on a more aggressive tone in

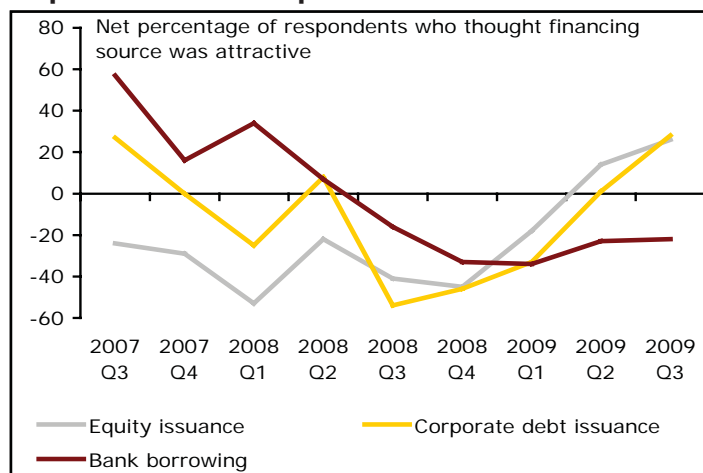
the UK, with the budget deficit coming down markedly in 2011 after peaking at over 13% this year.

While household expenditures have begun to recover after a steep fall, the UK business sector continues to show significant signs of weakness. Business investment has continued to contract, and inventories are still plunging, even though stocks were no more out of line in the UK than in other countries before the recession. As in the eurozone, credit conditions, especially for small and medium size firms that primarily rely on bank financing, will provide an additional drag on investment (Chart 5).

As in Europe, we expect the BoE to begin hiking rates and reversing their aggressive QE measures starting in the third quarter. That will be driven both by signs of improvement in the economy and a narrowing output gap, triggering longer term concerns about inflation.

Chart 5

UK Bank Financing Still Difficult Despite Improvement in Capital Markets



Source: Bank of England

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