Forecast

September 4, 2014

Economics

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Stuck in the Middle With You

by Avery Shenfeld

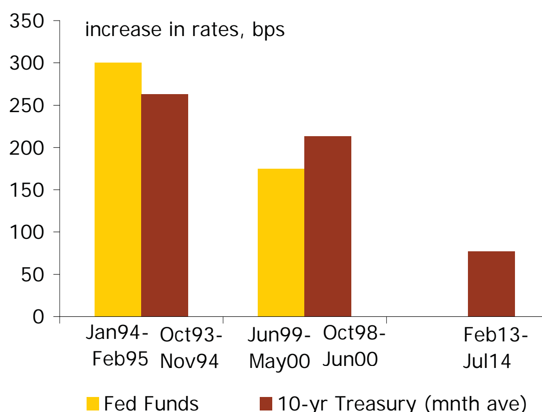
Investors and economies share something in common these days: both are suffering from split personalities. Bonds have rallied as if the global economy is coming apart, stocks have climbed as if all is well. Both can find support for their cause in different regions around the world.

After some disappointments in 2014, it's tempting to say "wait until next year", but more likely, 2015-16 will see global growth still stuck in a middling 3½% range, with Canada and the US each a bit under 3% in 2015. If that doesn't sound particularly exciting, don't worry—financial markets will have plenty of excitement, since Treasuries have a long sell-off ahead, judging by what happened in two previous mild tightening cycles (Chart 1).

The US should crank out enough decent quarters to make further headway on its output gap and bring an earlier-than-expected turn in monetary policy. We don't need full employment to justify a move off a zero rate policy designed for emergency use.

Chart 1

Bond Yields Surge Even in Mild Fed Tightening Cycles



Source: CIBC, Haver

In Canada, neither housing nor consumption funded from a falling savings rate can be the permanent drivers of growth, so all eyes will be on capital spending and exports. The market's response will be less about getting 2½% growth to close the output gap, than about the policy backdrop needed to do so.

Where the Surprises Lie

In the US, the slower potential GDP in this cycle is narrowing labour market slack without spectacular output numbers, bringing forward the date for the first few Fed rate hikes. Broad measures of labour market conditions are not yet in rate hike territory judging by historical cycles. But gaining 200K jobs a month will get us there soon.

Even a dove like Yellen has promised that the Fed won't wait until wage and price inflation are in evidence before nudging the US off zero. Look for a move to an even 25 bps for the funds rate by March 2015, reaching 1.25% a year from now (Table 2).

That's not very aggressive, but cooler heads never prevail in bond land as we approach and then see the start of a tightening cycle, even one that proves to be mild. While we are off the 2013 low yields, the typical response to even a mild tightening cycle

Table 1

FORECAST SUMMARY

(% Change Except Where Noted)

CANADA	14Q2A	14Q3F	14Q4F	15Q1F	15Q2F	2013A	2014F	2015F	2016F
Real GDP Growth (AR)	3.1	3.2	1.9	2.8	3.1	2.0	2.3	2.7	2.3
Real Final Domestic Demand (AR)	3.0	2.2	1.6	1.6	2.3	1.4	1.4	2.0	1.8
All Items CPI Inflation (Y/Y)	2.2	2.0	2.3	2.2	1.8	0.9	2.0	2.1	2.3
Core CPI Ex Indirect Taxes (Y/Y)	1.7	1.8	2.0	2.0	2.0	1.2	1.7	2.1	2.0
Unemployment Rate (%)	7.0	7.0	6.8	6.7	6.6	7.1	6.9	6.6	6.5

U.S.	14Q2A	14Q3F	14Q4F	15Q1F	15Q2F	2013A	2014F	2015F	2016F
Real GDP Growth (AR)	4.2	2.7	3.1	2.8	2.8	2.2	2.1	2.9	2.4
Real Final Sales (AR)	2.8	3.1	3.2	2.8	2.9	2.2	2.0	2.9	2.5
All Items CPI Inflation (Y/Y)	2.1	2.1	2.7	2.5	2.0	1.5	2.1	2.2	2.2
Core CPI Inflation (Y/Y)	1.9	1.9	2.1	2.3	2.3	1.8	1.9	2.3	2.1
Unemployment Rate (%)	6.2	6.1	6.0	5.8	5.8	7.4	6.2	5.7	5.6

Table 2

INTEREST AND EXCHANGE RATE FORECAST

		2014		2015				2016			
END OF PERIOD:		27-Aug	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec
CDA	Overnight target rate	1.00	1.00	1.00	1.00	1.25	1.50	1.50	1.50	1.50	1.50
	98-Day Treasury Bills	0.93	0.95	1.00	1.05	1.20	1.45	1.45	1.45	1.40	1.45
	2-Year Gov't Bond	1.09	1.20	1.65	1.90	2.20	2.20	1.95	1.85	1.95	2.00
	10-Year Gov't Bond	2.01	2.20	2.70	3.00	3.05	2.80	2.75	2.70	2.75	2.80
	30-Year Gov't Bond	2.58	2.75	3.40	3.50	3.55	3.35	3.25	3.20	3.25	3.35
U.S.	Federal Funds Rate	0.10	0.10	0.25	0.75	1.25	1.25	1.25	1.25	1.25	1.50
	91-Day Treasury Bills	0.03	0.10	0.40	0.60	0.85	1.10	1.35	1.25	1.20	1.40
	2-Year Gov't Note	0.51	0.60	1.05	1.60	1.80	1.70	1.65	1.65	1.70	1.90
	10-Year Gov't Note	2.38	2.60	3.10	3.60	3.45	3.25	3.25	3.30	3.35	3.45
	30-Year Gov't Bond	3.14	3.35	3.65	4.15	4.10	3.70	3.65	3.70	3.75	3.80
Canada - US T-Bill Spread		0.90	0.85	0.60	0.45	0.35	0.35	0.10	0.20	0.20	0.05
Canada - US 10-Year Bond Spread		-0.37	-0.40	-0.40	-0.60	-0.40	-0.45	-0.50	-0.60	-0.60	-0.65
Canada Yield Curve (30-Year — 2-Year)		1.49	1.55	1.75	1.60	1.35	1.15	1.30	1.35	1.30	1.35
US Yield Curve (30-Year — 2-Year)		2.63	2.75	2.60	2.55	2.30	2.00	2.00	2.05	2.05	1.90
EXCHANGE RATES	CADUSD	0.92	0.92	0.89	0.85	0.85	0.86	0.85	0.87	0.87	0.86
	USDCAD	1.09	1.09	1.12	1.17	1.18	1.16	1.17	1.15	1.15	1.16
	USDJPY	104	105	104	106	108	108	107	105	106	107
	EURUSD	1.32	1.28	1.26	1.26	1.27	1.28	1.29	1.31	1.32	1.34
	GBPUSD	1.66	1.65	1.65	1.67	1.67	1.66	1.64	1.65	1.65	1.66
	AUDUSD	0.93	0.90	0.88	0.87	0.86	0.87	0.88	0.90	0.91	0.93
	USDCHF	0.91	0.95	0.97	0.97	0.97	0.96	0.96	0.95	0.95	0.93
	USDBRL	2.26	2.48	2.56	2.52	2.53	2.45	3.20	3.28	3.35	3.40
	USDMXN	13.08	12.70	12.85	12.90	13.05	13.13	13.15	13.18	13.23	13.29

would tack on another 100 bps to 10-year rates by mid-2015. Canadian bonds should outperform but will track much of that move. The US dollar will be the big winner among currencies, as interest rate differentials vs Europe and Japan widen much more than now priced in.

But the lower the potential US growth rate, the weaker are incentives for capital spending, and the lower the neutral rate will be. Our research found that with a potential growth rate of little more than 2%, the neutral overnight rate will be only 2.5%. Rates will one day be above that level when the Fed is in a tightening stance, but peak policy rates could still be only 4% or so.

That opens the door for a second surprise for bonds, and a partial retreat for the greenback overseas. The lower neutral rate will be hinted at by a mid-cycle slowing in growth later in 2015, and a significant pause in the Fed's tightening work at 1.25%, with that development allowing for a sizeable relief rally in North American bonds.

Canada's growth track will be similar to its American neighbour's, but monetary policy will show a larger continental divide. We're not at zero, so there's less urgency to begin dialing down the stimulus. But more critically, Poloz wants growth led by exports and capital spending. There's no specific FX target, but a weaker C$, with dollar-Canada in the 1.15-1.20 range, will be a key ingredient in restoring competitiveness and making Canada an attractive place to expand capacity.

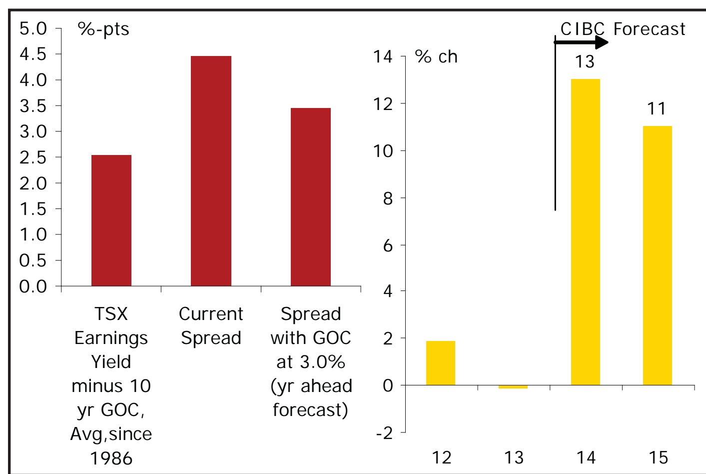
That will be achieved by letting the US eliminate the entire Canada-US short-rate differential before we see even one Bank of Canada hike. A much weaker C$ could then allow the Bank to carry on to a 1.5% overnight rate by year end 2015. But as in the US, a lower neutral rate, coupled with the heightened rate sensitivity inherent in a highly indebted household sector, could generate a moderation in growth that lets the Bank take a mid-cycle pause at 1.5%, a pleasant surprise to bond investors in the medium term.

A More Balanced Equity Market

Late last year, we made a non-consensus call for Canadian equities to outperform their US cousins, pushed by a mini-cycle in resources. At this point, being stuck in the middle for global growth has us less willing to overweight Canada's energy and materials assets, with lumber, tied to US housing, a likely exception. The gap we had identified between US and Canadian valuations has also been closed, making it timely to rebalance to a more neutral stance across sectors and countries.

Chart 2

TSX Attractively Priced Even with 3% GOC Yields (L) ; Earnings Growth to Ease Modestly in 2015 (R)



Source: Bloomberg, Thomson Reuters, CIBC

Equities may not have a huge year ahead as rising rates put some pressure on multiples, but valuations still leave enough of a cushion for higher rates to allow equities to outperform bonds. Today's PE multiple on the TSX is not excessive relative to current and projected bond yields (Chart 2).

Rate hike cycles typically engender greater equity volatility, and it might make sense to add weight to less volatile dividend-oriented stocks (financials, dividend-oriented energy trusts, etc) at the expense of more volatile cyclicals. One might at first blush expect income oriented assets to underperform as central banks tighten, but an index of high quality dividend stocks matched or slightly outpaced overall market performance in the wake of the rate hikes that commenced in September 2004.

Earnings also still have room to run. Our top-down model, which ties key economic indicators (Canadian and US GDP, various resource prices, etc) to bottom-line results, projects TSX Composite earnings growth of 11% in 2015. That's above the historical average, and only a couple of points below the bottom up consensus, which is usually much more bloated before being sobered up by reality as the year unfolds. Bond yields will provide some noisy volatility for stocks, but double-digit earnings gains should still see major indexes close next year at moderately higher levels.

US Growth: Less is More

Andrew Grantham

2014 GDP growth is set to be significantly slower than projected before the year started. Yet the unemployment rate has fallen even more quickly than anticipated, inflation has firmed a little, and the Federal Reserve could be on course to hike interest rates next March.

Confused? We don't blame you. But there is an explanation. Potential growth (i.e. the rate neither too hot to stoke inflation nor too cold to bring about disinflation) has remained noticeably weaker than before the recession hit, meaning that less, in terms of GDP growth rates, can achieve more in terms of unemployment and inflation.

Speed Limit Remains Lower this Cycle

So is the US economy going to be permanently challenged by slower potential growth? One component—labour force growth—certainly doesn't appear to be getting much better, with more baby-boomers set to retire and drop out of the workforce. Even if there are discouraged workers who come back into the labour force, demographics will restrict the rate of growth. It's not just the productive ability of the economy that is different, thanks to an ageing population. Consumer spending is likely to be lower and more focused on areas such as healthcare, than it has in the past (Chart 1).

That means an increase in potential growth will be reliant on productivity gains. Near-term indicators suggest that firms still aren't making the sorts of investments that will improve productivity in the future. Capital spending plans are still extremely low relative to historic averages (Chart 2, left) and less investment is being made on top of what is needed to cover depreciation.

Table 1

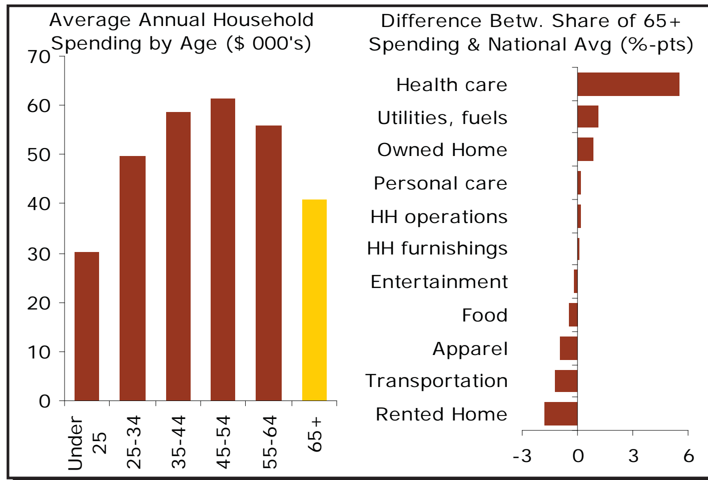
US FORECAST DETAIL

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

	14:2A	14:3F	14:4F	15:1F	15:2F	15:3F	15:4F	2014F	2015F	2016F
GDP At Market Prices ($Bn)	17,311	17,519	17,750	17,962	18,168	18,389	18,587	17,406	18,276	19,098
% change	6.4	4.9	5.4	4.9	4.7	5.0	4.4	3.8	5.0	4.5
Real GDP ($2009 Bn)	15,994	16,102	16,226	16,339	16,453	16,562	16,658	16,038	16,503	16,889
% change	4.2	2.7	3.1	2.8	2.8	2.7	2.3	2.1	2.9	2.4
Final Sales	2.8	3.1	3.2	2.8	2.9	3.0	2.5	2.0	2.9	2.5
Personal Consumption	2.5	2.5	2.9	2.7	2.6	2.9	2.3	2.3	2.7	2.5
Total Govt. Expenditures	1.4	0.1	-0.8	0.8	1.1	1.2	0.5	-0.7	0.5	0.6
Residential Construction	7.2	10.2	11.8	10.0	7.6	8.3	4.9	2.6	9.2	6.2
Business Fixed Investment	8.4	6.4	6.0	6.2	8.7	6.2	5.6	5.9	6.7	4.4
Inventory Change ($2009 Bn)	83.9	69.2	67.7	67.2	64.7	54.4	47.9	64.0	58.6	31.8
Exports	10.1	7.0	5.7	5.0	5.0	5.7	5.0	3.4	5.8	4.7
Imports	11.0	4.2	3.8	6.0	7.0	7.0	4.6	4.2	5.9	4.3
GDP Deflator	2.0	2.1	2.2	2.0	1.8	2.2	2.0	1.7	2.0	2.1
CPI (yr/yr % chg)	2.1	2.1	2.7	2.5	2.0	2.2	2.2	2.1	2.2	2.2
Core CPI (yr/yr % chg)	1.9	1.9	2.1	2.3	2.3	2.3	2.2	1.9	2.3	2.1
Unemployment Rate (%)	6.2	6.1	6.0	5.8	5.8	5.7	5.7	6.2	5.7	5.6
Housing Starts (AR, K)	997	1,071	1,110	1,170	1,250	1,340	1,403	1,026	1,291	1,410

Chart 1

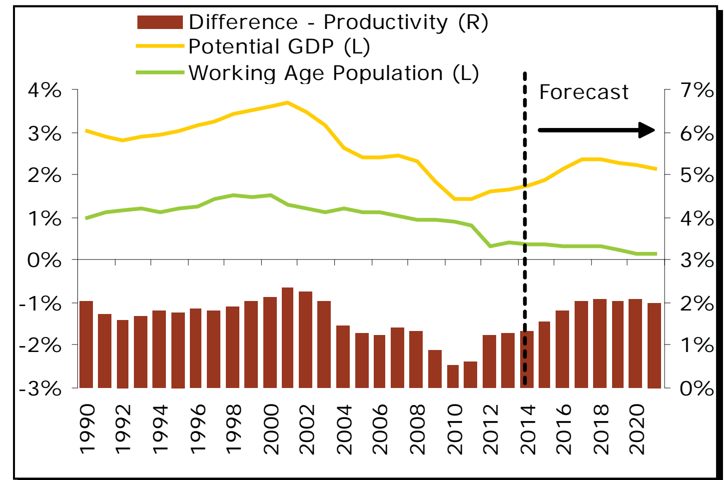
Older Households Spend Less on Average (L), Except Heating and Health Care (R)



Source: BEA, CIBC

Chart 3

Higher Potential Growth Reliant on Productivity Improvement



Source: Census Bureau, CBO, CIBC

True, one earlier restraint on business investment—tighter lending standards from banks to small businesses—appears to be easing its grip. Whereas in recent years financing was becoming more tilted to lower risk businesses, that is starting to reverse again (Chart 2, right), perhaps helped by a record average one-year survival rate of new start-ups. At the same time, the Fed's Senior Loan Officers Survey shows that banks are reporting the sharpest rise in demand for business loans since the end of the recession.

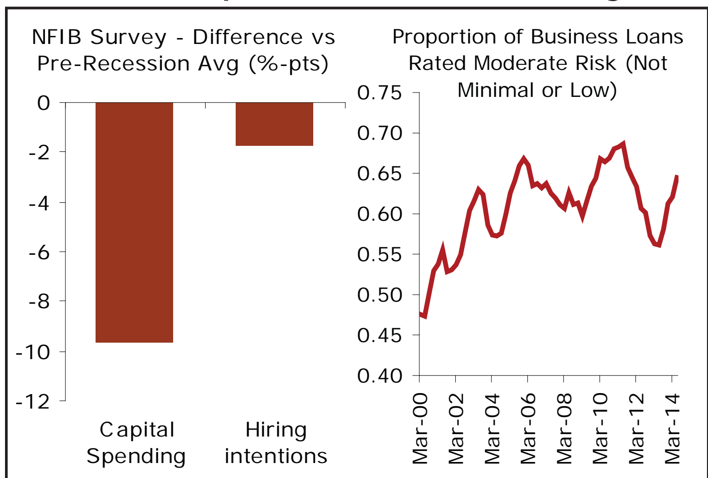
A firming in business investment during 2015 will provide at least some lift to both productivity and potential growth ahead. But thanks to low population growth, the economy's non-inflationary speed limit, at roughly 2%, will still be a full point slower than it was back in the 1990s (Chart 3).

Housing Fails to Crash the Party

The weather took a lot of the blame for the poor start to 2014, but disappointments in the housing market also opened a crack in the foundation of the US recovery. Like the softness in business investment, tighter credit conditions played a role—something which now seems to be easing again and could bolster demand ahead (Chart 4, left).

Chart 2

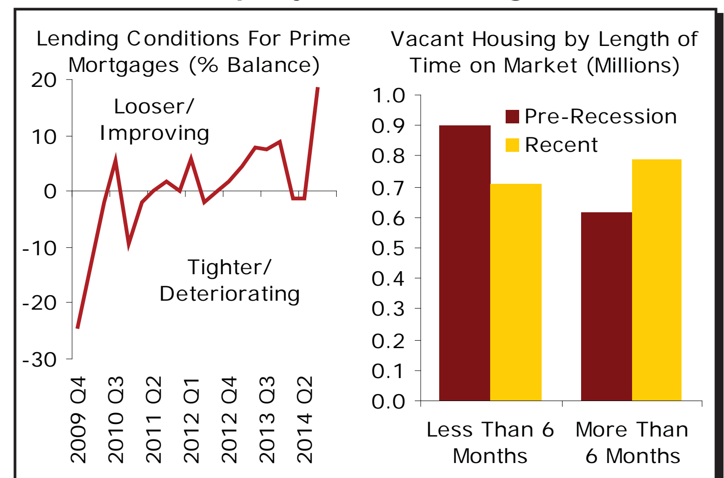
Capital Spending Intentions Low (L), But Lenders Prepared to Take Riskier Bets Again (R)



Source: NFIB, Federal Reserve, CIBC

Chart 4

Mortgage Lending Conditions Improving Again (L), But Stock of Property For Sale Sitting Idle (R)



Source: Federal Reserve, Census Bureau, NAR, CIBC

In terms of resale volumes, and their link to related durables spending, the source of softness partly lay elsewhere. It may seem strange to say just a couple of years after a flood of foreclosed properties was still hitting the market, but supply appears to be as much of a restraint as demand. Months' supply of existing homes is down to pre-recession levels, despite the slower pace of buying. And the supply of quality homes that people may actually want to purchase is likely lower still. A greater proportion of unsold properties are vacant, with many of them languishing on the market for a long time (Chart 4, right).

Part-time Problems

Underemployment—a key concern at the Federal Reserve as it decides when to hike interest rates—also appears to be a headache for homebuilders. With the jobless rate among 20-34 year-olds starting to fall, we suspected that a new wave of home-buyers would be leaving their parents basements.

But that hasn't happened, with young people still suffering disproportionately from both joblessness and underemployment (Chart 5, left), limiting their ability to leave the nest. High levels of student debt could also be limiting young people's ability to branch out on their own, but homeownership rates have continued to fall even among those with no student loan to repay (Chart 5, right).

Looking ahead, these demand fundamentals for housing should brighten in 2015. Dynamics within the US labour market are improving quickly (See *"So Far and Yet So Close: Closing the US Labour Market Gap"*). Job vacancies have risen sharply, and higher paying sectors may be forced into new recruitment with hours of existing staff already stretched. And despite concerns within the FOMC, wages of production and non-supervisory staff have already started to accelerate.

Dissing Disinflation Risk

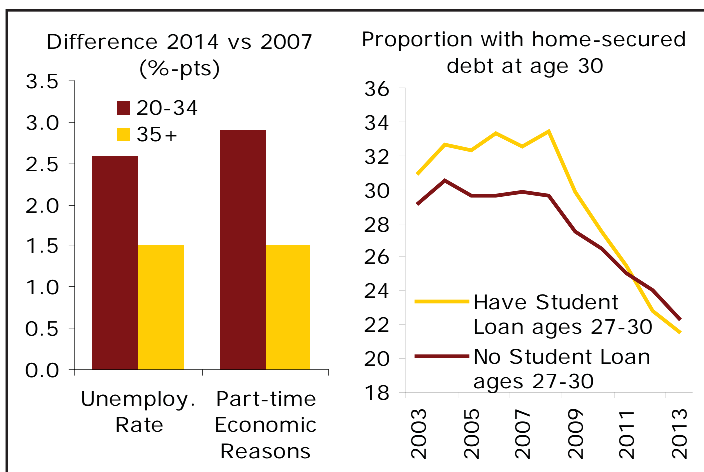
With growth continuing to run ahead of potential in 2015, rates of joblessness and underemployment will continue to fall and the buds of inflationary pressure we have seen recently could begin to bloom. Measures of capacity use in the economy are already consistent with the Fed's target core PCE measure being close to the 2% objective (Chart 6, left), and suggest that inflation will meet that goal in mid-2015 (Chart 6, right).

Stronger business investment and a new uptrend in housing will likely spur better US growth towards the end of this year and into 2015. And even if the GDP pace fails to surpass 3%, it will be far enough above potential to narrow existing economic slack, and justify a move away from full-on monetary stimulus.

That should see the FOMC tapping the brakes early in 2015, raising rates to 1.25% by September. But with a lower neutral rate in this cycle, even that modest first step could engender a temporary cooling in growth, affording the Fed the opportunity for a several quarter pause in rates thereafter.

Chart 5

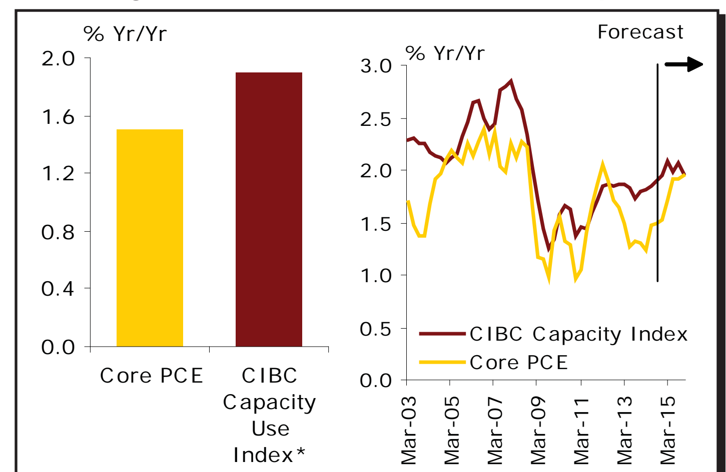
Young People Suffering Most (L), Homeownership Down Even With No Student Loan (R)



Source: BLS, NY Fed, CIBC

Chart 6

Measures of Capacity Use Already Consistent With Near-Target Inflation (L), Which Will Pick Up (R)



** Based on Office Vacancy Rates, Supplier delivery times and Industrial Capacity*
Source: BEA, Markit, CIBC

Canada: Now That The Time's Been Bought

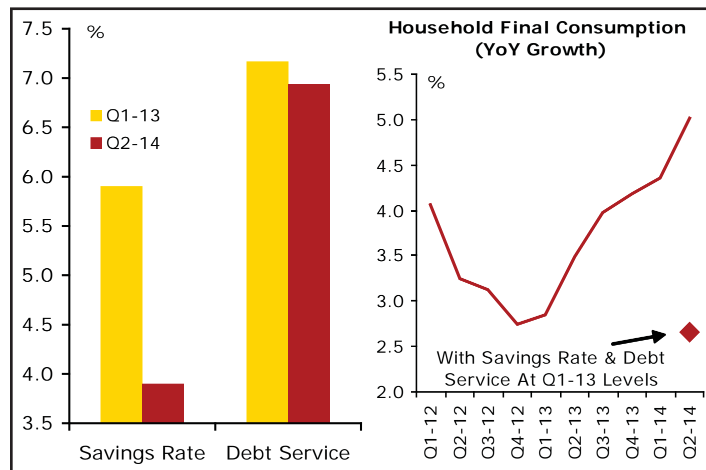
Benjamin Tal and Nick Exarhos

The Canadian growth story is looking rosier than previously envisioned. By now, we're all sick of hearing about the weather, but after slipping in Q1, the economy is set to expand by at least 3% in two consecutive quarters. That in itself should force the Bank of Canada to rethink its forecasts. However, this outperformance vis-à-vis prior expectations was centred on sources of demand that should by now have been flagging, but which were given an extended life by temporary factors.

Residential construction, and, to a greater extent, consumer spending have spurred on the recent strength of the Canadian economy. But as we've indicated in recent research, the growth in household consumption is not being unlocked by sustainable factors, but rather by a significant fall in savings (Chart 1). While the staying power of this trend is surprising, it is buying even more time for the arrival of the future bulwarks of the Canadian economy: exports and investment.

Chart 1

Boost From Lower Savings Rate and Interest Cost to Household Consumption (Update)



Source: Statistics Canada, CIBC

Table 1

CANADA FORECAST DETAIL

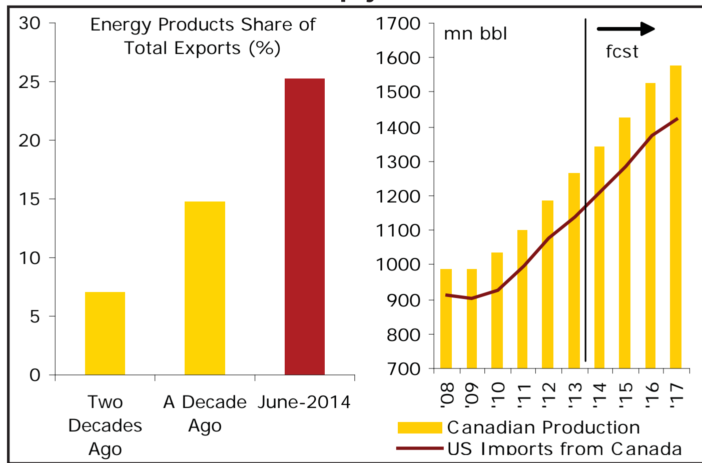
(real % change, s.a.a.r., unless otherwise noted)

	14:1A	14:2A	14:3F	14:4F	15:1F	15:2F	15:3F	15:4F	2014F	2015F	2016F
GDP At Market Prices ($Bn)	1,937	1,956	1,977	1,990	2,020	2,049	2,073	2,093	1,965	2,059	2,156
% change	6.7	4.1	4.2	2.7	6.3	5.8	4.7	4.1	4.5	4.8	4.7
Real GDP ($2007 Bn)	1,716	1,729	1,743	1,751	1,763	1,777	1,789	1,798	1,735	1,782	1,823
% change	0.9	3.1	3.2	1.9	2.8	3.1	2.7	2.0	2.3	2.7	2.3
Final Domestic Demand	-0.2	3.0	2.2	1.6	1.6	2.3	1.9	2.1	1.4	2.0	1.8
Household Consumption	1.7	3.8	2.1	1.8	2.0	2.4	1.8	2.1	2.6	2.1	1.6
Total Govt. Expenditures	-0.8	1.1	1.9	1.8	0.4	0.8	0.5	0.4	0.1	1.0	0.7
Residential Construction	-5.6	11.9	2.9	0.0	-3.2	-3.9	-4.3	-3.0	1.1	-1.2	-2.2
Business Fixed Investment*	-4.2	-0.9	2.6	1.6	4.6	8.1	8.7	8.0	-0.9	4.8	7.1
Inventory Change ($2007 Bn)	14.5	7.1	8.5	8.0	9.3	8.7	7.3	3.9	9.5	7.3	4.1
Exports	-0.7	17.8	6.5	5.3	6.7	6.9	7.1	6.2	5.2	7.1	6.5
Imports	-5.5	11.1	4.2	3.9	3.8	3.7	3.6	3.9	1.7	4.3	4.3
GDP Deflator	5.9	0.7	1.1	0.8	3.4	2.6	1.9	2.0	2.1	2.0	2.3
CPI (yr/yr % chg)	1.4	2.2	2.0	2.3	2.2	1.8	2.2	2.5	2.0	2.1	2.3
Core CPI (yr/yr % chg)	1.3	1.7	1.8	2.0	2.0	2.0	2.1	2.4	1.7	2.1	2.0
Unemployment Rate (%)	7.0	7.0	7.0	6.9	6.7	6.6	6.7	6.6	7.0	6.7	6.6
Employment Change (K)	18	11	44	52	68	58	42	45	121	207	193
Goods Trade Balance (AR, $bn)	7.1	6.6	4.0	2.1	4.0	8.1	10.1	12.6	5.0	8.7	18.0
Housing Starts (AR, K)	175	196	192	184	181	180	180	178	187	180	173

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

Chart 2

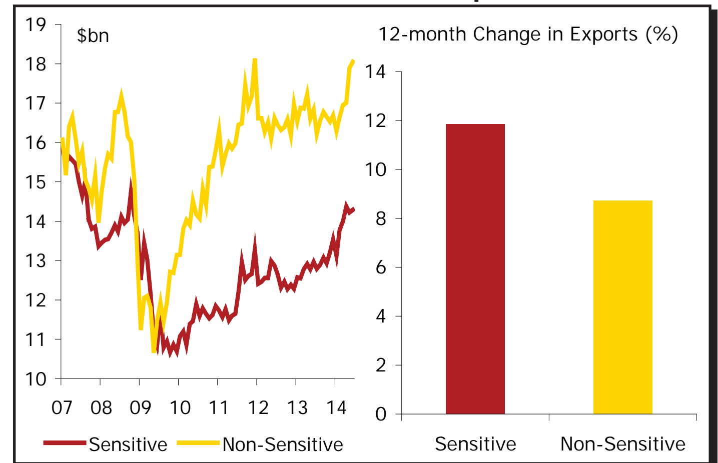
Canada, the Energy Exporter (L); Industry Production Estimates Imply More of the Same (R)



Source: Statistics Canada, CAPP, EIA, CIBC

Chart 3

BOC Defined C$ Sensitive Industries Lagged (L), But Recent Performance Gives Hope (R)



Source: Bank of Canada, Statistics Canada, CIBC

Exports: Signs of Life

Governor Poloz has identified an export wedge, and the indications are that he is unlikely to be forced off of his current policy stance until meaningful work is done in narrowing it.

To some extent, Canada is well-positioned with regard to its export markets. Geography always makes the US key to Canada, but America's outperformance vs. other G-7 countries is enhancing that dependence. In fact, exports destined to the US market are already growing at a near-17% year-on-year pace, while those destined elsewhere are up by just under 11%.

Much of the current momentum is, however, coming from a single sector. Canada has been leaning more heavily on energy products, now a quarter of its outbound shipments in dollar value, to support exports, investment and economic growth. Estimates from the Canadian Association of Petroleum Producers suggest that black gold's shine isn't likely to fade any time soon. Applying production estimates to their relatively stable historical relationship to exports destined for the US suggests that Canada in 2016 will have exported more than 230 mn additional barrels to America than it did in 2013 (Chart 2).

But energy's growing share also reflects what was, until very recently, lacklustre performance by other exporters. The Bank of Canada identified sectors like forestry products, machinery, aircraft products, and other electronics as key in carrying the next leg of Canadian export resurgence. But its target leadership group has actually trailed other non-energy exporters in the past year.

The larger story is that many non-energy exports historically came from sectors sensitive to the exchange rate. A long period in which the Canadian dollar has been overvalued led to exits of plants from this country, taking out the capacity that would now typically be responding to better news stateside. Until very recently, these currency-sensitive sectors have been notable laggards (Chart 3, left).

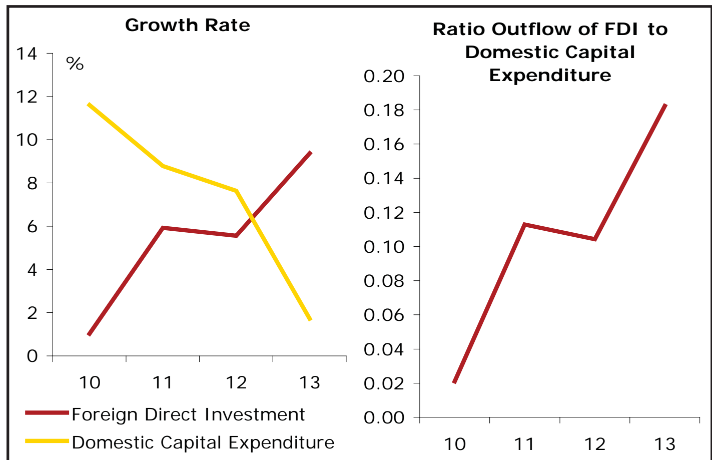
With the loonie off its strongest levels, the past year has seen the first signs of a turn in fortune. Helped by a more competitive exchange rate, and positive price shocks for some products (e.g. foods), the loonie-sensitive group has seen an 11.8% gain in nominal exports in the past twelve months, vs. 8.7% for other non-energy industries (Chart 3, right).

But there is much more to do ahead. There are lags before the full impact of the late 2013 depreciation will be fully felt by existing plants. And we will likely need even more time, and a still weaker exchange rate, to prompt the entry of new production facilities that can start to fill the void left by earlier exits.

Business Investment: Still Waiting

If that gets underway, it should show up in business investment spending. Thus far, after the steepest correction in the post-war period, and an initially strong

Chart 4
Investing... But Not At Home



Source: Statistics Canada, CIBC

rebound, capital spending is well below where it typically should be at this more mature stage of the cycle.

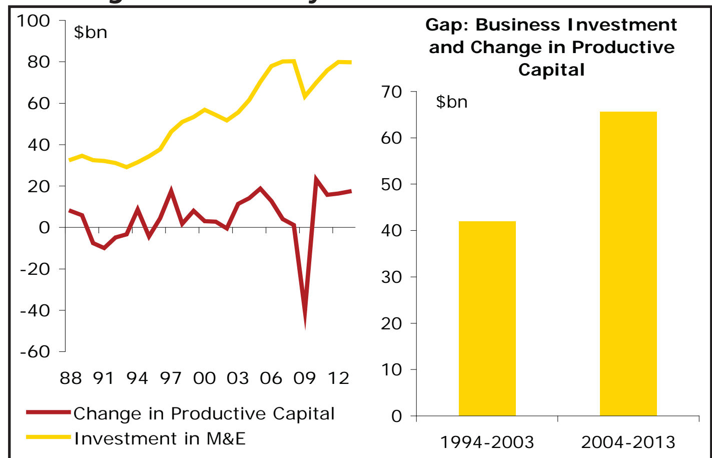
And the issue is not capability. Our business capability index, which uses an array of indicators to measure the ability of Canadian firms to spend, is close to a record high. That suggests that financial limitations aren't the culprit. It's all about the willingness to invest, and here the dismal growth in spending shouldn't be a surprise. Statistics Canada's business intentions survey has been a good predictor of actual activity and the response earlier this year was that CEOs weren't planning to accelerate domestic capital spending in 2014. Evidently, they were more inclined to spend on bricks and mortar or takeovers elsewhere. Foreign direct investment by Canadian companies rose by a record high 9% in 2013—the exact opposite of the decelerating growth trajectory in capital spending at home (Chart 4, left). The ratio of the outflow of FDI to capital expenditure is close to 20%—again a record high (Chart 4, right).

But at one point you have to invest at existing facilities even if you don't want to. The production capacity of the economy is hardly growing, reflecting in part the reduced ability of new investments to increase productive capacity. That is, a growing proportion of each capital spending dollar is now devoted to replacement investments that simply maintain existing levels of production, a trend that is working to widen the gap between investment and the change in productive capacity in the economy (Chart 5). The practical implication is that capital investment must rise much more quickly in order to accommodate both replacement and expansion investments.

And there are now some signs that despite some reservations corporate Canada is about to accelerate spending. The Bank of Canada Business survey identified an upturn in such plans. And if history is any guide, that should signal higher actual spending soon (Chart 6). In fact the BOC index is now at a level that in the past was consistent with real business investment rising by close to 5% on an annual basis.

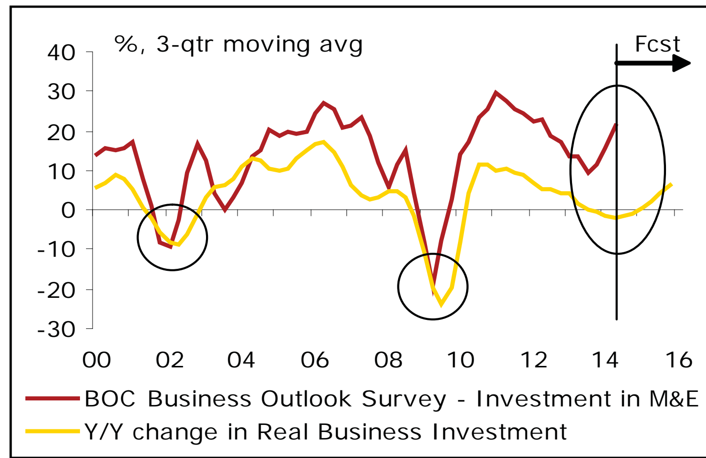
We might end up calling 2015 the year of the rotation. And with the federal government joined by the provinces in imposing less fiscal restraint, growth prospects for the year, and for that of 2016, look to be set on a brighter, and at the same time, more sustainable course. But we'll need continued low interest rates and a cheaper Canadian dollar to get there.

Chart 5
Running Faster To Stay at the Same Place



Source: Feenstra, Robert C., Robert Inklaar and Marcel P. Timmer (2013), Statistics Canada, CIBC

Chart 6
BOC's Survey Points To Near-Term Acceleration in Business Spending



Source: Bank of Canada, Statistics Canada, CIBC

The Long Haul to Global Recovery

Peter Buchanan

Despite a flurry of negative headlines, the global recovery is continuing. Growth will nonetheless trail our earlier projections, at 3.2% this year, and 3.7% and 3.5% in 2015 and 2016 respectively (Table 1) Monetary policy is poised to shift from its universal pro-growth focus, as economies diverge. The Fed and Bank of England will likely raise rates within the next half year or so, as their job markets firm, with the BOC lagging on somewhat less favourable news. In contrast, the ECB and Bank of Japan will have to deploy fresh stimulus.

Eurozone: Reality Check

Europe was battling growth, deflation and jobless headwinds even before Mr. Putin stirred up a geopolitical hornet's nest. Real GDP unexpectedly stalled in Q2 and inflation at 0.3% remains far below the ECB's near 2% target (Chart 1). Sometimes things are the darkest before the dawn. That may well be the case in Europe, as excessive optimism gives way to overdone pessimism. A belligerent and sullen ex-superpower next door creates risk, of course. But if dangers on that front can be contained, we continue to think 2015 and 2016 could look significantly better than 2014.

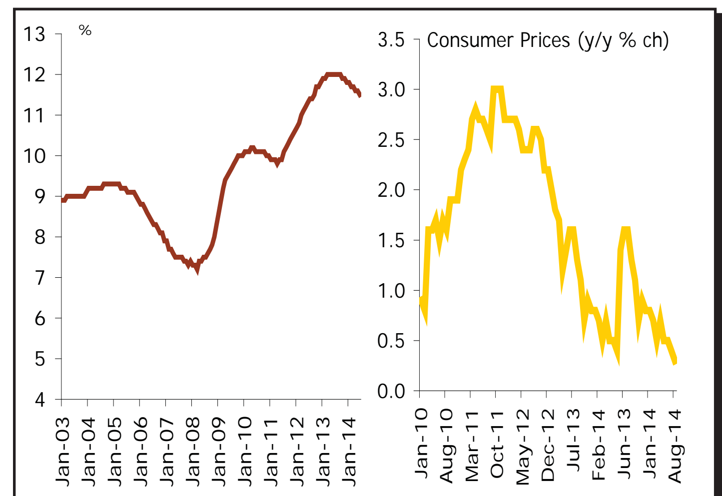
Encouragingly, policymakers are now making amends for earlier, excessive timidity. To bolster growth, the ECB introduced negative deposit rates in June. A new TLTRO facility would funnel as much as one trillion euros of conditional low cost financing, to incentivize bank lending. Future asset-backed buying would help re-liquify lender balance sheets. As we had predicted, those steps are starting to have a visible effect. A further slide in the euro should reduce deflation risks, supporting exports and growth.

In Jackson Hole, Draghi signaled his willingness to do still more in the right conditions to prevent a Japanese-style lost decade—not ruling out US style government bond buying, or full-fledged QE. As in the US, hopes are that cleaning up the banks will also spur lending, with October stress test results a key first step.

Europe's core economies, rather than the periphery, stunted Q2 growth. While Italy and France face deep structural problems, Germany remains fundamentally healthy. Q2's GDP drop there primarily reflected the

Chart 1

Eurozone—High Joblessness and Lowflation



Source: eurostat, CIBC

Table 1

REAL GDP GROWTH RATES

	5 yrs before recession, avg	2011A	2012A	2013A	2014E	2015E	2016E
World*	4.8	3.9	3.5	3.2	3.2	3.7	3.5
US	2.9	1.6	2.3	2.2	2.1	2.9	2.4
Canada	2.6	2.5	1.7	2.0	2.3	2.7	2.3
Euroland	2.2	1.6	-0.6	-0.4	0.8	1.6	1.9
UK	3.3	1.1	0.3	1.7	3.0	2.4	2.2
Japan	1.8	-0.4	1.5	1.5	0.9	1.0	1.3
Brazil	4.0	2.8	1.0	2.5	0.7	-0.6	2.8
Russia	7.5	4.3	3.4	1.3	0.0	-2.0	0.5
India	8.9	7.7	4.8	4.7	5.2	5.5	5.5
China	11.6	9.3	7.7	7.7	7.5	7.0	6.8

** at Purchasing Power Parity*

Source: National statistical agencies, IMF, CIBC

unwinding of a earlier lift to construction from a mild winter. Another factor restraining growth is also poised to lessen. Budgetary austerity will subtract just half as much from growth this year and next as in 2013.

With a third of Europe's natural gas originating east of the Urals, a Russian cut off would cause severe disruption. That's a high stakes card even Mr. Putin might be loathe to play, given the fallout for his own tottering economy—including hard hits to public revenues and the already poor energy investment climate. Russia's 2-3% of the Eurozone's overall exports and 1% share of bank claims (Chart 2) points to limited damage from other recent tit-for-tat sanctions.

All of this doesn't portend Europe's swift return to the fast lane. Even so, our forecast of 0.8% growth for the bloc this year and double that next represents an improvement on recent declines.

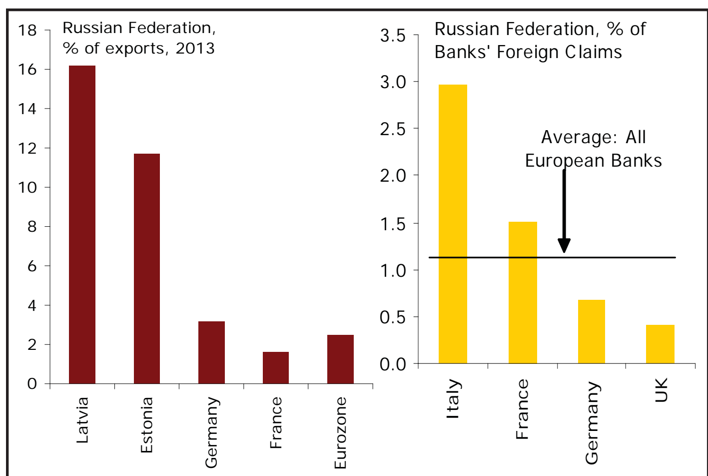
Elsewhere, the UK's economy is poised to lead the G-7 this year, having fully recouped the recession's output losses earlier in 2014. While a debt-ridden consumer and dependence on housing remain risks, we expect GDP to rise by a full 3% this year and above 2% in each of the next two. At 6.4% in July, unemployment is now running significantly below the Bank of England's once inviolable 7% "line in the sand". Notwithstanding that, inflation continues to run below target with a drop in wages suggesting additional room for growth. Although the Bank's message has been inconsistent at times, we expect rates to start rising in the first quarter of 2015.

China: Building (Sector) Headwinds

China reached back into its traditional grab bag of infrastructure and other pro-growth measures to deliver

Chart 2

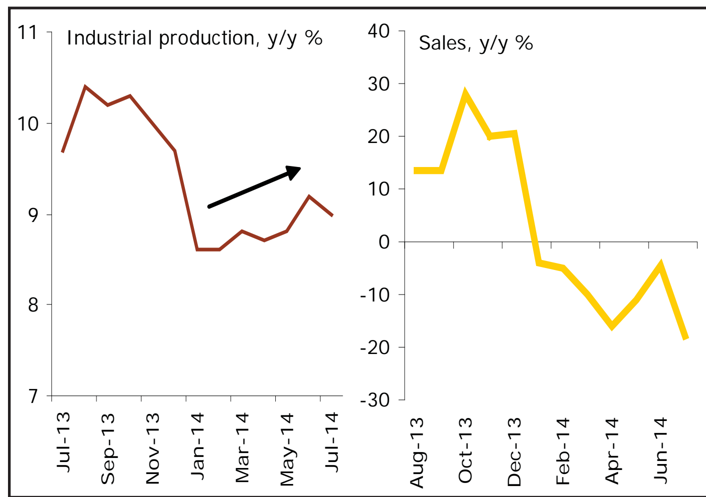
Vulnerability to Russia Limited, Outside Energy



Source: CIBC, IMF, BIS

Chart 3

China: Weak Recent Rebound (L) as Housing Headwinds Mount (R)



Source: NBS, CIBC

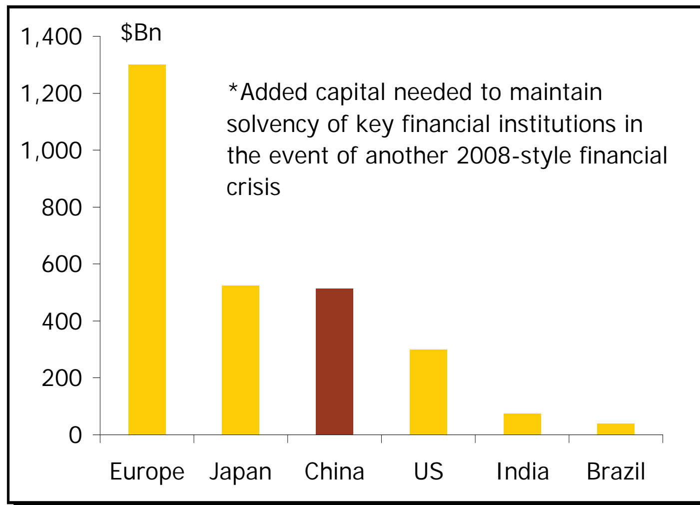
up a mini-stimulus program in April. The economy's reacceleration has been mild at best (Chart 3, left), with assorted indicators underwhelming in July. Further fiscal stimulus and a potential reserve requirement cut should see growth attain the official 7.5% target in 2014. Given a deepening housing slowdown, we've nonetheless pared our GDP forecasts for 2015 and 2016 to 7% and 6.8% respectively.

China's long-running investment-led growth model has entailed costs. Although lending slowed in July, estimates suggest the country's debt to GDP ratio—including shadow banking and other private obligations—has risen to about 250% from roughly 200% earlier the decade. This is not as high as Europe or Japan, but appreciably above most other emerging economies. Modelling at NYU's Stern School placed the potential cost of a financial system bailout at about $500 bn, in the event of another 2008-style global crisis. That's appreciable but not quite as high as a European or Japanese shock—and is less than Beijing's stock of liquid international assets (Chart 4).

Even without such a setback, China's economy faces near-term challenges. Residential investment is over twice as large as in the US, at the height of its boom. July's sharp drop in homes sales (Chart 3, right) and recent home price declines suggest the bloom is coming off the rose.

Despite weakness in housing and other cautionary flags, we see a modest deceleration rather than hard landing as most likely outcome. July's export surge points to a dividend from recent yuan weakness and improvements in markets like the US. Urbanization and social housing construction are supportive for performance, as is

Chart 4
Global Systemic Risk by Country/Area



Source: CIBC, NYU Stern School Volatility Lab, Acharya, Engle and Richardson (2012)

the planned liberalization of the Hukou, or residential registration system. Hukou reform could raise the spending of footloose migrant families by 2500 yuan or more, adding 7% to their consumption, according to recent estimates.

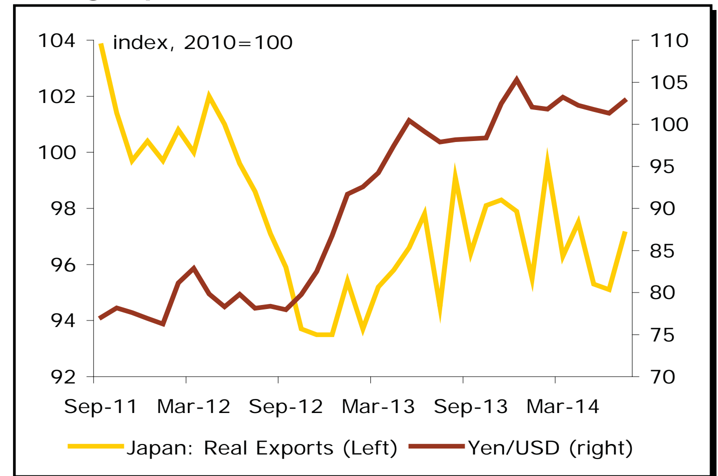
India's new prime minister, Narendra Modi, campaigned on a economic revitalization platform. May's BJP win has raised hopes for a return to healthy performance in what is now the world's third largest economy. The new government has if anything shown a preference for incremental rather than dramatic change. Turning around an economy as large and as beset with structural difficulties as India's is bound to take time. Industrial production has accelerated modestly in recent months. Even a limited restart of stalled infrastructure projects could help nudge growth up to a 5.5% pace in the next two years.

Japan: Now for the Difficult Part

After some early success, Japan's efforts to overcome a lost decade is entering a critical phase, as the government moves from its first two policy arrows—aggressive monetary easing and budgetary pump-priming—to the most promising but also potentially most difficult, structural reform. Q2's GDP dive wasn't unexpected, since April's sales tax hike pulled consumption forward. One disappointment has been the failure of exports to respond to the yen's nearly 25% trade weighted depreciation since 2012 (Chart 5). Given that and other recent developments, we've pared our estimate for 2014 GDP growth to 0.9%, with a slightly stronger performance next year.

The global recovery failed to reach escape velocity in the first half of 2014. Although we expect improvement in the second half, growth in the medium term will nevertheless lag our earlier expectations. Our most recent commodities forecast took down some of our earlier targets for growth-sensitive resource prices. That's one further reason for the Bank of Canada to seek a weaker exchange rate as a lift to exports in non-resource industries.

Chart 5
No Big Export Lift Yet From Yen's Slide



Source: CIBC, Bloomberg, SBJ

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