



## Economics

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*"Best bets are that Bernanke's team will seek no exit from low rates until 2012."*

## No Exit

by Avery Shenfeld

Canada's central bank is now two steps down the road to normalcy, having gingerly raised overnight interest rates, while deliberately talking down expectations of further hikes in order to keep other yields low for now. Just as similar language after a June rate hike didn't prevent a follow-up move in July, this month's Bank of Canada statement would be consistent with further quarter-point steps in September and October.

South of the border, the Fed is talking about how it might exit from its even more dramatic stimulus efforts, which saw both a move to near-zero overnight rates and quantitative easing (QE) that bought Treasuries, MBS and shakier private assets.

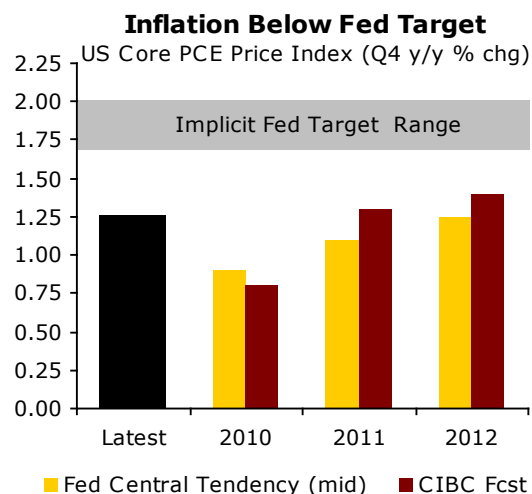
But even *talking* about an exit strategy looks like a misplaced effort. Bernanke's testimony on Capitol Hill devoted several paragraphs to how the exit from QE might take place, and gave but a one sentence nod to the possibility that more, not less, stimulus might be needed. Odd, since the Fed's own forecast shows inflation running below its informal 1.7-2.0% target over the entire forecast horizon, and full employment not attained over that same period. The Bank of Canada would certainly be considering more stimulus if it projected below-target inflation that far out. It may simply be that the FOMC doesn't yet have enough doves on board to broach that subject, but the new appointees coming in could tip the balance.

As the data have rolled in, mostly of the disappointing variety, we've been reconsidering just how long it will be before the Fed could step away from maximal

stimulus. Even under Obama's gradualist proposals, fiscal policy will be a huge negative for growth for the US in the next two years (see pages 7-9). Current American indicators don't spell any significant probability of a double-dip recession (pages 4-6), but they can't capture that fiscal wall ahead.

Given that picture, our earlier projection for even a modest tightening by the Fed in the second half of next year now looks premature. Best bets are that Bernanke's team will seek no exit from low rates until 2012.

Fiscal policy might move off its tightening warpath. Congress already backed away from an earlier posture that would have let extended unemployment benefits lapse, and legislators now talking like tigers on deficits could become pussycats favouring stimulus in the face of continued high joblessness in 2011. If not, look for Bernanke's team to consider entering new rounds of QE next year, rather than hunting for the exit door.



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

## MARKET CALL

- More growth disappointments, more reason to continue to push back the timing of a turn to Fed tightening. The Bank of Canada didn't move until the jobless rate was closing in on 8%, so even a less patient Fed could be waiting until Q1 2012. That will to some extent depend on where Washington ends up in the wide range of fiscal tightening scenarios that are still on the table (see pages 7-9). We've also pared back our expectations for a sell-off in Treasuries over the forecast horizon.
- Can the Bank of Canada continue to go it alone? History says "yes," particularly with a much narrower output gap than what the US faces. Still, we see a pause in rate hikes at 1.25% (or, a bit less likely, 1.50%), as growth slows later this year. A pick-up later in 2011, in a lagged response to continued low interest rates globally, should see a resumption in hikes after a couple of quarters. Canada's yield curve at this point prices in an unrealistically dovish near-term central bank view, so we still see a flattening bear market for bonds.
- The Canadian dollar should gain some momentum on two more rate hikes this year, given that they are not fully priced in. Thereafter, a pause in rate hikes, and the lack of momentum for commodities in a moderate global growth environment, will see the loonie revert to range trading. We see the euro giving back some of its latest gains if upcoming data doesn't look quite as rosy as what we've just seen, but have softened the degree of that dip versus our last forecast.

## INTEREST & FOREIGN EXCHANGE RATES

		2011						
END OF PERIOD:		26-Jul	Sep	Dec	Mar	Jun	Sep	Dec
<b>CDA</b>	Overnight target rate	0.75	1.00	1.25	1.25	1.50	1.75	2.25
	98-Day Treasury Bills	0.64	1.15	1.05	1.15	1.50	1.80	2.20
	2-Year Gov't Bond	1.62	1.75	1.85	1.90	2.35	2.75	3.00
	10-Year Gov't Bond	3.24	3.35	3.65	3.85	3.90	3.90	4.00
	30-Year Gov't Bond	3.78	3.85	3.90	3.90	4.00	4.10	4.25
<b>U.S.</b>	Federal Funds Rate	0.22	0.20	0.20	0.20	0.20	0.20	0.25
	91-Day Treasury Bills	0.15	0.15	0.15	0.15	0.15	0.15	0.20
	2-Year Gov't Note	0.62	0.70	0.75	0.80	1.00	1.25	1.50
	10-Year Gov't Note	3.03	3.05	3.25	3.30	3.50	3.65	3.75
	30-Year Gov't Bond	4.06	4.10	4.15	4.20	4.40	4.45	4.50
Canada - US T-Bill Spread		0.49	1.00	0.90	1.00	1.35	1.65	2.00
Canada - US 10-Year Bond Spread		0.21	0.30	0.40	0.55	0.40	0.25	0.25
Canada Yield Curve (30-Year — 2-Year)		2.16	2.10	2.05	2.00	1.65	1.35	1.25
US Yield Curve (30-Year — 2-Year)		3.44	3.40	3.40	3.40	3.40	3.20	3.00
<b>EXCHANGE RATES</b>	CADUSD	0.97	0.99	1.01	0.93	0.97	1.01	1.02
	USDCAD	1.03	1.01	0.99	1.07	1.03	0.99	0.98
	USDJPY	87	89	91	90	89	87	87
	EURUSD	1.30	1.25	1.25	1.27	1.29	1.31	1.34
	GBPUSD	1.55	1.52	1.53	1.56	1.57	1.58	1.60
	AUDUSD	0.900	0.910	0.920	0.920	0.930	0.940	0.950
	USDCHF	1.05	1.08	1.07	1.07	1.06	1.06	1.05
	USDBRL	1.77	1.76	1.75	1.74	1.73	1.71	1.70
	USDMXN	12.7	12.5	12.5	12.3	12.2	12.0	12.0

## COMMODITIES OUTLOOK

### Commodity Prices: Modest Near-Term Upside As Double-Dip Fears Ease

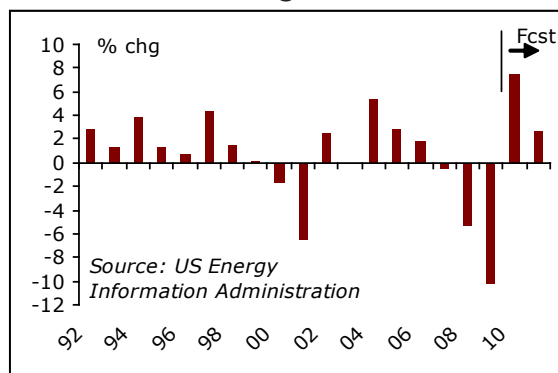
Commodity prices, not surprisingly, have been particularly affected by recovery anxieties, and remain below the spring's peaks even with the recent relief rally. While we've upgraded our forecast for 2010 global GDP growth to 4.5%, that's effectively water under the bridge, reflecting resilient growth in the first half of the year. The road ahead isn't as pretty. While a soft landing in China limits the downside for resource demand there, fiscal austerity will hold OECD growth to a disappointing 2% or less next year.

On a supportive note for gold, unemployment, deflation and double-dip worries signal a longer fuse for central bank rate hikes than we had previously envisioned. That, and the safe-haven bid from smoldering eurozone sovereign debt and banking worries, should see the King of Metals set a new record of \$1300/oz by year-end. Although delayed, the major threat is still Fed retightening. The market's pricing in of that risk will take gold lower by late 2011.

A month ago we trimmed our targets for copper, zinc and the other industrial metals in response to easing although still positive growth prospects and greater risk aversion. Deep cuts in speculative long positions contributed to the correction's vehemence. We are sticking with our above-consensus forecasts for both zinc and copper. China's copper imports have eased modestly, but heavy power grid investments and heightened electric vehicle production should reinforce longer term growth in demand for the red metal there.

Although Henry Hub gas prices have ceded some of the late spring's healthy climb, we believe that the forces are still in place for a further narrowing in the near-record BTU discount to oil over the medium term. Even with non-conventional supply showing traction, total US marketable gas production so far this year is up by only 1.6%, half of last year's rate of increase. After a harsh blow during the recession, natural-gas-weighted industrial production stateside is expected to rise at an unprecedented near-8% pace this year (Chart), bolstering demand. While the BP blowout could have supportive longer term implications for oil, any near-term effects will be trumped by a 6-million barrel/day OPEC supply cushion and demand consequences of a tepid global recovery. Those realities should help to limit WTI spot prices to an average \$80/bbl this year and \$85 in 2011.

Chart  
US Natural-Gas-Weighted Ind. Production



Source: US Energy Information Administration

### Spot Commodity Prices

		Average					
		26-Jul	2007	2008	2009	2010 (f)	2011 (f)
Oil (WTI)	\$/bbl	79	72	100	62	80	85
RBOB gasoline	\$/gal	2.12	2.09	2.49	1.69	2.15	2.25
Heating Oil (NYH)	\$/gal	2.02	2.03	2.86	1.65	2.08	2.20
Natural Gas (Henry)	\$/Mn Btu	4.70	6.97	8.89	3.82	4.90	6.00
Gold	\$/troy oz	1191	695	872	1088*	1300*	1150*
Copper	\$/lb	3.18	3.24	3.16	2.35	3.25	3.15
Aluminum	\$/lb	0.91	1.20	1.17	0.76	0.95	0.85
Nickel	\$/lb	9.20	16.86	9.57	6.69	9.00	8.00
Zinc	\$/lb	0.85	1.48	0.85	0.76	1.00	0.95

\* end of period

# A US Double Dip: Tracking the Odds

Avery Shenfeld and Benjamin Tal

A double dip is to be avoided at all costs when holding a potato chip at the buffet line, and less trivially, when steering economic policy. Even before the NBER has actually confirmed the last recession ended, some are already starting to see the next one on the horizon. Renewed recession risks are drawing rising attention in the media, hitting consumer sentiment, and Google searches for “double dip” references are on the rise (Chart 1), just as searches for “recession” climbed late in 2007. Investors are similarly starting to fret. Although the equity market’s correction is still well within the norms seen during expansions, the AAll bull/bear indicator is back to the levels seen during the recession, and it’s much the same for other sentiment readings from Market Vane and the NAAIM (Chart 2).

But in the modern era, double dips are more often feared than felt. Indeed, if one defines a double dip as a downturn after an expansion lasting less than two years, the only post-WWII US twin dives were the recessions of 1980 and 1981-82. Double dips have also been rare in other major economies of late, although Japan fell into recession in 2000 only a year after it emerged from the “Asian crisis” recession. Prior to the 1940s, however, a more volatile world showed several cases of short-lived expansions that petered out. Few remember that the 1929 start of the Great Depression, for example, followed less than two years on the heels of a US recession that ended in Q4 1927.

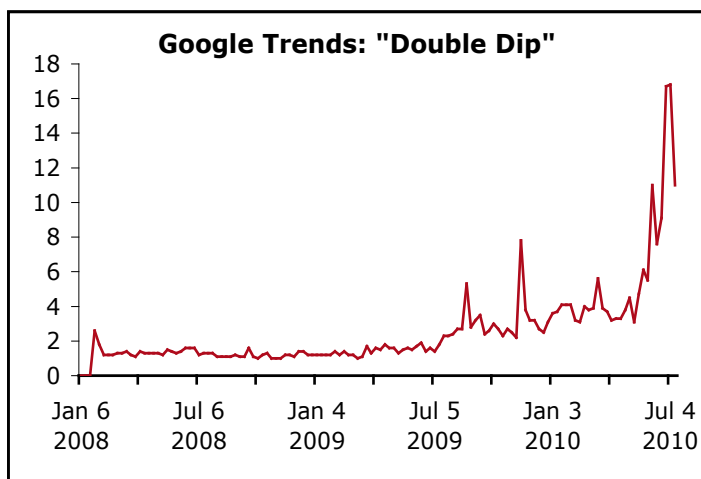
So what are the tea leaves now telling us? Certainly, there are reasons for concern. The economy has been propped up by fiscal stimulus that is now winding down. Job growth has lacked its typical post-recession vigour, leaving a household sector swamped with bad mortgages having few reasons to accelerate spending. The ECRI leading indicator has turned markedly lower.

But there is still a base of ongoing support coming from healthy corporate profits, which typically presage both hiring and capital spending, and a wide-open tap on monetary stimulus. That has us projecting a sharp deceleration in US growth, but not an outright recession, with a similar fate in store for Canada. And thus far, the highest frequency data, taken individually and collectively in a model that tracks recession probabilities historically, comes down on the same side.

## The Curve’s Nobel in Forecasting

Markets often have a better nose for recessions than economists. The stock market is too jittery to be a reliable bellwether, with major declines having only a 50% success rate in predicting recessions, and giving five false positives since 1960. A recent study in the *Journal of Finance*<sup>1</sup> found that an equity market liquidity measure has worked better, with a drying up in market liquidity often a telling sign of economic trouble ahead. Indeed,

Chart 1  
Searching For “Double Dip”



Source: Google Trends (Relative Scaling)

Chart 2  
Market Vane Bullish Consensus Stock Index

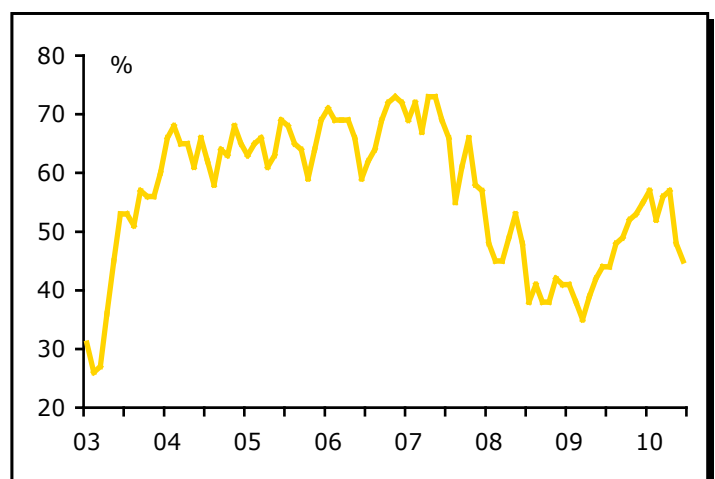
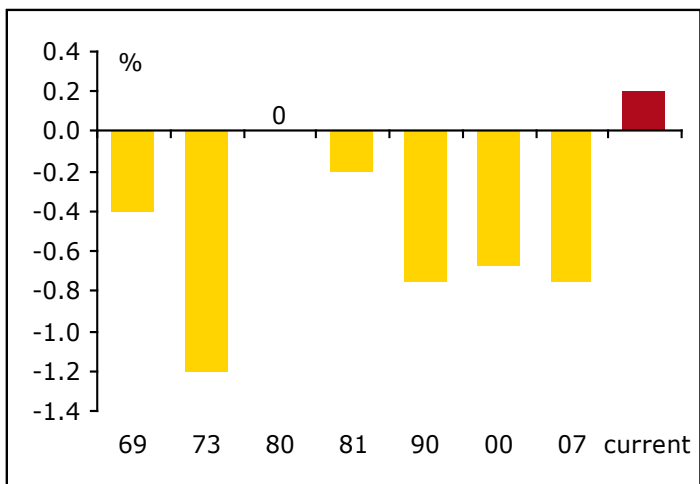


Chart 3

**Liquidity: Deviation From Trend at the Eve of Recessions**



Source: "Stock Market, Liquidity and The Business Cycle" Journal of Finance, March 2010, CIBC

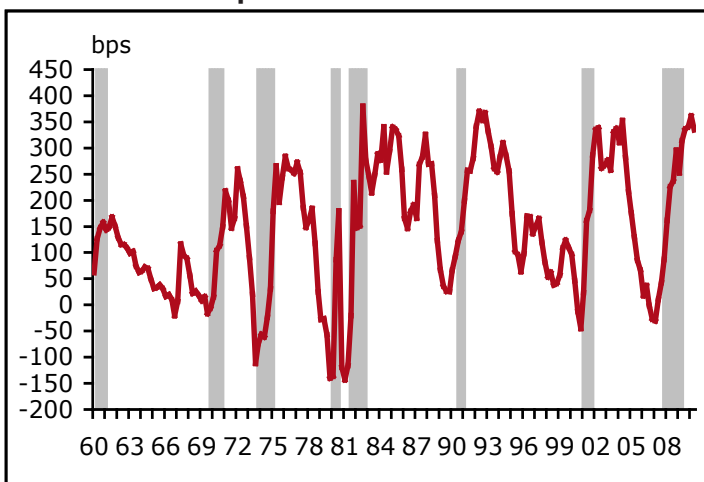
we saw liquidity plummeting at a pace not seen in more than 20 years ahead of the recent downturn (Chart 3). At present, market liquidity isn't sending out the same sort of warning signal.

The bond market also has an enviable track record as a recession indicator. Curve inversions—higher long rates than short yields—often foreshadow a slump (Chart 4), although that too has sometimes signaled downturns that failed to materialize.

Today's curve sounds no alarm bells. Even after the recent rally in US 10s and 30s, the Treasuries curve is much

Chart 4

**Yield Curve Slope and Recessions**



steeper today than it typically is when a recession is coming up in the next few quarters. The Fed's recession probability model, which combines the yield curve and the funds rate, would clearly be very bullish on growth.

That said, we can't really replicate the inversions seen ahead of past slumps. Typically, part of the lead up to recession is a policy tightening that pushes up short rates. The long end of the curve can then invert as investors see a slowdown ahead, and doubt the longevity of the elevated short-term yields. That can't happen now, since short rates are near zero, essentially ruling out a curve inversion. The most the curve can price in is a long wait for an initial tightening, and it's impossible to differentiate whether that is due to expectations of slow growth, or outright recession. As well, the explanatory power of the yield curve has diminished in recent cycles relative to its longer term performance.

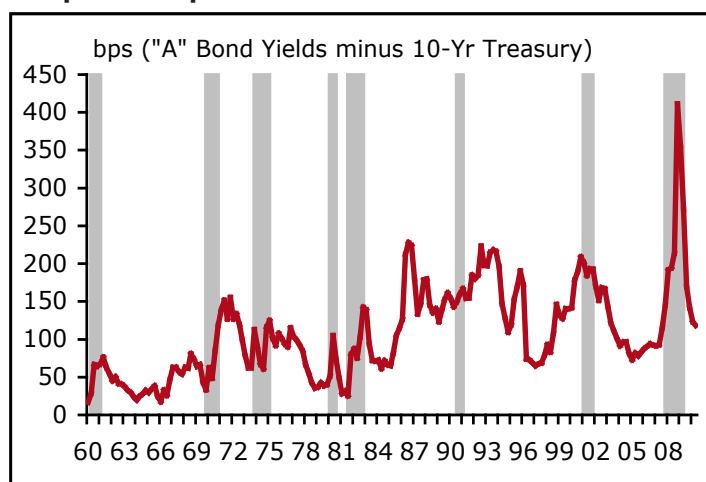
But corporate spreads are another fixed income indicator of where the market's head lies, and here, it's clear that investors are far from pricing in a recession. Ahead of a recession, spreads tend to widen sharply as investors anticipate credit defaults. On that score, while we saw some upward drift as markets eyed the risks emanating from Europe's sovereign debt crisis, spreads remain quite tight by the standards leading up to recent recessions, and don't show the sharp upward trend typically seen ahead of a downturn (Chart 5).

**Economic Current/Leading Indicators**

Since financial market indicators are perhaps less useful in a near-zero rate environment, it's worth keeping a

Chart 5

**Corporate Spreads and Recessions**



close watch on what the high frequency economic data themselves are saying. Research by J. Stock and M. Watson<sup>2</sup> showed that indicators that use larger numbers of economic series performed better than more narrowly based leading indicators in widespread use. The Chicago Fed's National Activity Index of 85 separate indicators was developed along those lines. Its three-month average, used as a cyclical indicator, continues to show an economy that is advancing at less than trend, but not on the brink of recession.

A possible shortcoming of that index in present circumstances is that some of its components are now a few months old, and so its latest reading would underweight the most recent, and generally disappointing, evidence. The Philadelphia Fed's ADS index, while not nearly as rich an indicator in terms of the number of series it incorporates (only six), has the advantage that it is updated weekly for a change in any of its components, which include weekly claims for unemployment benefits, one of the highest frequency series available. It too, while off its highs, is still above the levels seen at the start of the last two recessions (Chart 6). Note that its recent drop was exaggerated in that it included the rise and subsequent fall in employment associated with the US census.

**CIBC Recession Probability Index**

Still, that downturn in the ADS index suggests that recession risks stateside bear close watching. To help in that task, we have developed a probit model that looks historically at the status of four financial market and economic indicators relative to whether a recession had commenced within two quarters. The Fed's bare-bones

model used only the funds rate and the yield curve slope, but given our concerns about the utility of the latter indicator, we enriched the model by adding credit spreads and the Philly Fed's ADS Index.

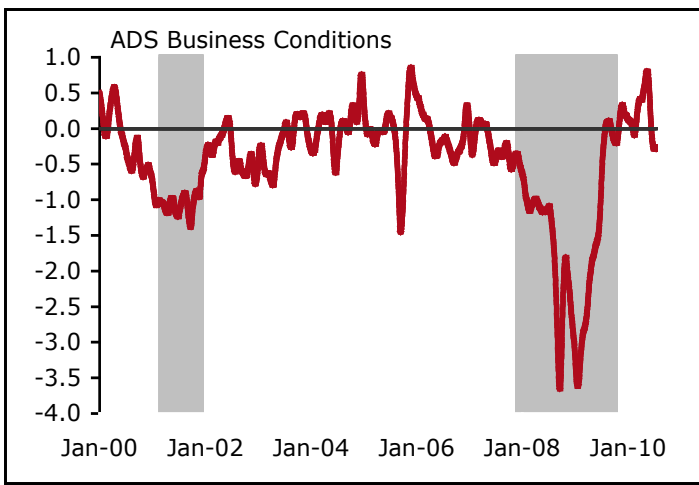
While the long-time scale of the chart makes small leads difficult to see, the model has a strong track record in anticipating recessions (Chart 7), although in the last downturn it was less of a leading signal than a coincident indicator. At present, the CIBC RPI predicts slim odds of a US recession commencing in the next two quarters. While we recognize that the probability estimate is likely understated due to the concerns about the yield curve slope measure noted above, it would still appear to be more consistent with a slowdown rather than a true double-dip recession.

Add it all up, and Seinfeld fans can be comforted in concluding that George Constanza does not yet hold the US economic potato chip in his hands. We're not in material danger of a rude double dip in the next two quarters. But, given the uncertainties, fiscal tightening ahead, and the potential for a slow economy to be vulnerable to shocks, we will keep an eye on our new indicator nevertheless.

Note

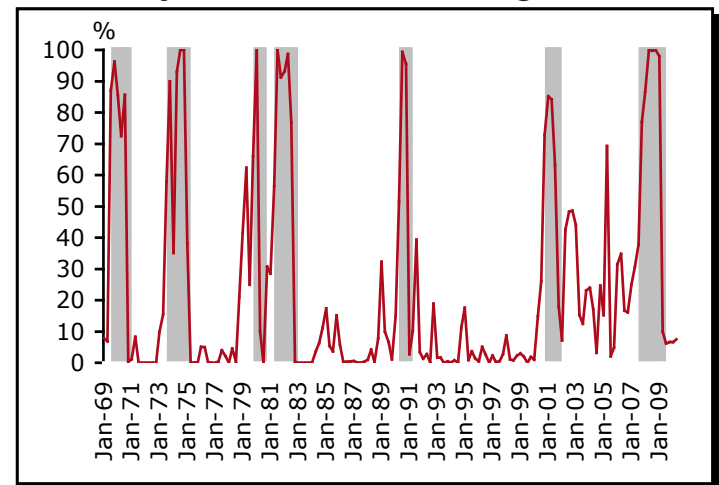
1. "Stock Market Liquidity and The Business Cycle" *Journal of Finance*, March 2010. Liquidity here is defined as a measure of how much stock prices move in response to each volume unit of trade. A high estimate indicates high liquidity (low price impact of trade) and low estimate indicates low liquidity (high price impact of trades).
2. Stock, J.H. and M.W. Watson (2002) "Forecasting Using Principal Components from a Large Number of Predictors" *Journal of the Amer Stat Assoc.* Vol 97.

Chart 6  
**Slow Growth, Not Recession Yet**



\* Zero line equals trend growth Source: Philadelphia Fed

Chart 7  
**Probability of Recession in Coming 2 Quarters**



Source: CIBC based on a probit model

# Sink or Swim Time as Governments Cut Fiscal Support

Peter Buchanan

## To Tighten or Not to Tighten

“We are all Keynesians now” Richard Nixon once said, acknowledging fiscal policy’s role in taming the business cycle. Fiscal activism seemed to be back in vogue two years ago, as governments ramped up their efforts to fight the worst recession in decades. Even though wide output gaps (Chart 1) suggest economic healing has a ways to go, the pendulum of late has been swinging in the opposite direction, as debt-wary governments embrace the new austerity. Fears that a rapid, synchronized unwinding of stimulus measures could plunge the world back into recession have fueled recent ‘double-dip’ anxieties.

Gross debt in the industrial countries—who are under the most pressure to bite the bullet now—is on track to rival GDP for the first time in 2011. Greece’s troubles along with the threat of actions by ratings agencies are pressuring governments to tackle fiscal challenges sooner rather than later. Epitomizing the new mood, government at June’s G20 Summit pledged to cut their deficits by 50% or more by 2013, and stabilize GDP to debt ratios by 2016.

## Read My Lips

Rhetoric is sometimes only that, but there have been some signs that governments may be likelier this time

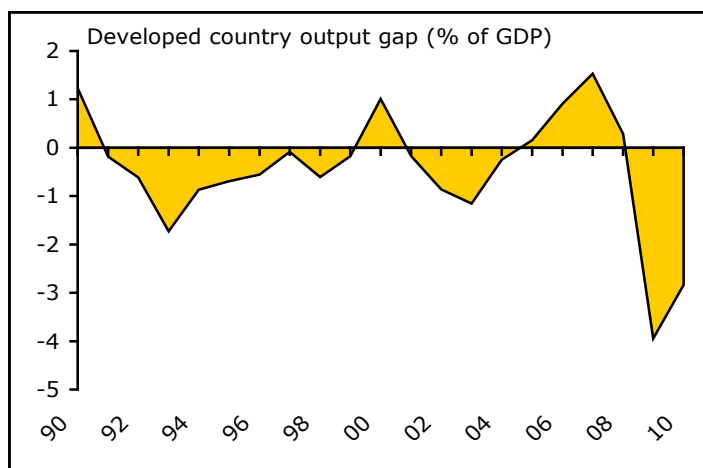
to deliver on promises of fiscal probity than in the past. Britain’s new coalition government served up a more restrictive budget than expected in June, bridging internal policy divisions. Germany’s Angela Merkel has staked her political future on restraint. Although Congress has backed away for now from plans to let supplementary unemployment benefits lapse, fiscal policy will tighten next year—notably if the Obama budget is passed, more radically if it isn’t.

Even if the latest US budget is enacted and the Bush tax cuts for non-wealthy individuals remain in place, fiscal restraint is still likely to take well over 1% out of GDP in the industrialized countries in 2011 (Chart 2). That figure does not include second-order spillover effects.

The US was first off the mark in opening the spending spigot to fight the Great Recession, allocating nearly \$800 billion to the American Recovery and Reinvestment Act (ARRA), enacted by Congress early last year. That followed two not overly successful shots of fiscal caffeine under the Bush Administration. Successful as the ARRA was in moving the economy off dead centre, its fading effect has contributed to the economy’s weaker performance in recent quarters, and will actually turn negative later this year.

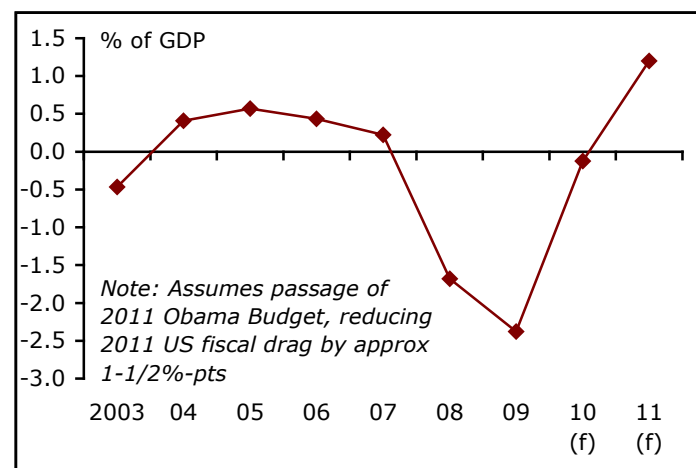
The home ownership tax credit has already expired, and other provisions of the ARRA, including earned-income

Chart 1  
Output Still a Long Way From Full Potential



Source: IMF

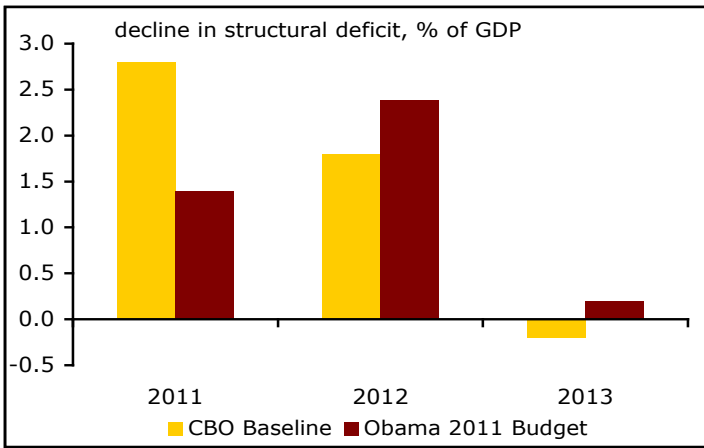
Chart 2  
OECD Fiscal Withdrawals



Source: IMF, CIBC

Chart 3

**US Fiscal Adjustment**



Source: CBO, CIBC

and child tax credits, lapse after this year. If the major provisions of the ARRA are simply allowed to run out in accordance with current law, the economy will face a massive total fiscal withdrawal equal to about 2.8% of GDP, or over \$400 billion in fiscal 2011. That includes the added pressure on state governments for cuts, as the ARRA's \$60-70 billion per year of support from state health and education funding fades into history.

That course is unlikely, since it would almost certainly plunge an economy still labouring under high levels of consumer debt and a shaky-looking housing sector back into recession. Congress' recent decision to retain extended benefits, and the proposed partial extension of the Bush tax cuts, show a wariness to overly hasty fiscal retrenchment. Rather than risk defeat at the polls, chances are that politicians will relent and pass key elements of the 2011 Obama budget. That will not eliminate the coming fiscal reckoning, but it will defer it, softening the reduction in the federal structural deficit from an unmanageable 2.8% of GDP next year, to a still quite notable 1.4% (Chart 3). Note that the 2011 budget proposals would actually add to the fiscal withdrawal in 2012, an election year. Stay posted, consequently, to see what further measures Congress eventually takes to get itself out of that political box.

**Europe's Day of Fiscal Reckoning**

The greatest change in recent fiscal prospects has not surprisingly been in Europe. Even with the added restraint measures announced by governments to placate rating agencies and investors, the headwinds from fiscal policy there will still, on average, fall somewhat short of those

stateside. That burden, however, falls on what is still arguably a more fragile underlying recovery.

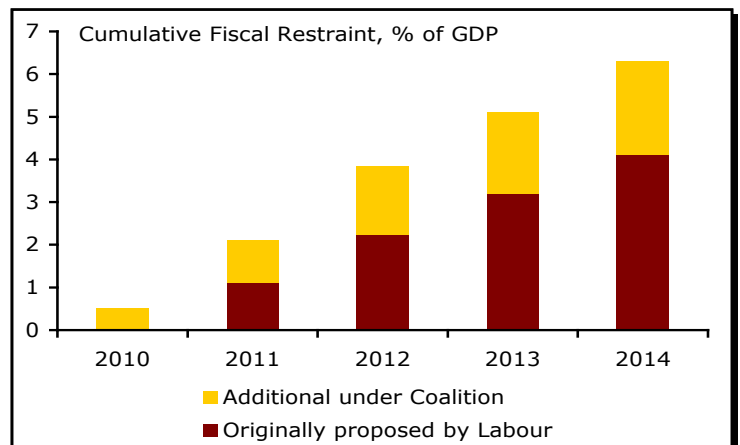
The Budget introduced by Britain's new Chancellor of the Exchequer, George Osborne, implies a fiscal consolidation of 6.3% over the next four fiscal years, roughly half as much again as envisioned by his Labour predecessor (Chart 4). An increase in the consumption tax rate from 17.5% to 20% from January will add over £12 billion to coffers there next fiscal year.

Greece, where the debt crisis began, unveiled austerity measures totaling €30 billion during the spring. Other Euroland countries have since joined the fray. Germany's structural deficit, at just 2.5% of GDP, is one of the lowest in the eurozone area. The Merkel government, notwithstanding that fact, announced budget balance measures equal to about 2% of GDP on June 7<sup>th</sup>. The steps, including significant benefit cuts, are aimed at cutting the structural, or non-cyclical part of the deficit, to 0.35% of GDP by 2016 (Chart 5), as required by a recent constitutional amendment. Meeting that target will require cuts of 0.5% annually in the deficit in coming years. Other countries are not quite so far along. France, with a significantly higher deficit than Germany, has been moving quietly, out of an apparent fear of political protests, to tighten fiscal discipline.

While all the details of France's plans won't be known until the 2011 budget is tabled later this year, the IMF now estimates that fiscal consolidation will take about four times as much out of eurozone growth next year, as it had anticipated back in April (Chart 6). In terms of another key player, the DPJ's Upper House defeat has dealt a blow for now to plans for an early increase in Japan's 5% consumption tax rate. With Japanese gross

Chart 4

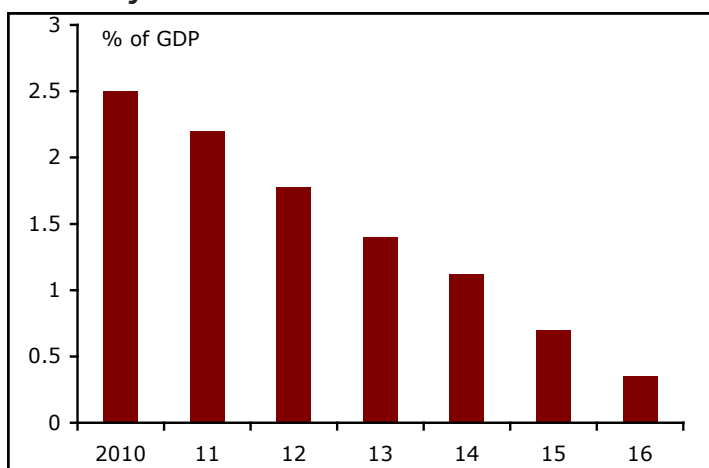
**UK's New Coalition Gov't Hits the Brakes Harder**



Source: Institute for Fiscal Studies

Chart 5

### Constitutionally Mandated Decline in Germany's Federal Structural Deficit



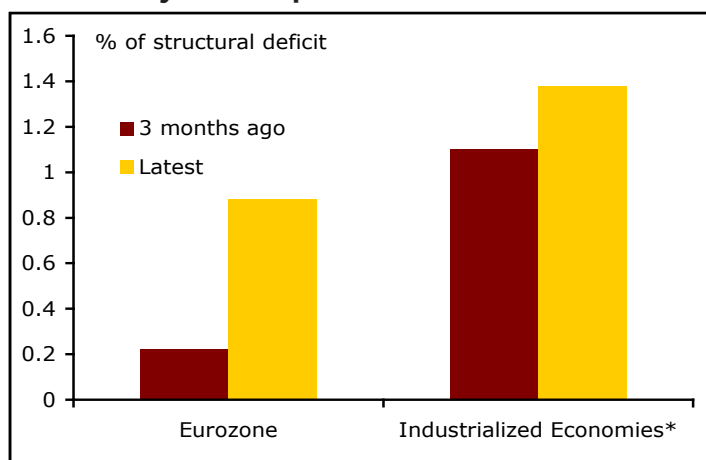
Source: Institut der deutschen Wirtschaft Koln

debt on track to hit a G8-worst 240% of GDP in the next couple of years, the government's polling setback will not permanently derail efforts at fiscal consolidation.

In terms of both the likely consequences, and chances for success, it is interesting to compare planned fiscal adjustments with past consolidation episodes. The pending policy shifts rank high on the scale, although they are not the largest ever. Denmark, for example, lowered its cyclically-adjusted budget gap by 10%-pts in the four-year period between 1982 and 1986, a reduction of 2.5% annually. Greece actually shaved an even larger 10.8% from its primary gap over a five-year period two decades ago, when it last ran into trouble (Chart 7). Canada, no slouch, lopped around 6%-pts from its deficit in the late 1990s. While none of those

Chart 6

### Fiscal Tightening to Weigh More in 2011, Particularly in Europe



Source: IMF

\*Top 20

countries, interestingly enough, experienced a formal recession during those periods, they all relied on currency depreciation to soften the fiscal blow. That's an option clearly unavailable to present-day eurozone members. None, moreover, faced the adverse trade headwinds from a slew of neighbours doing the same thing.

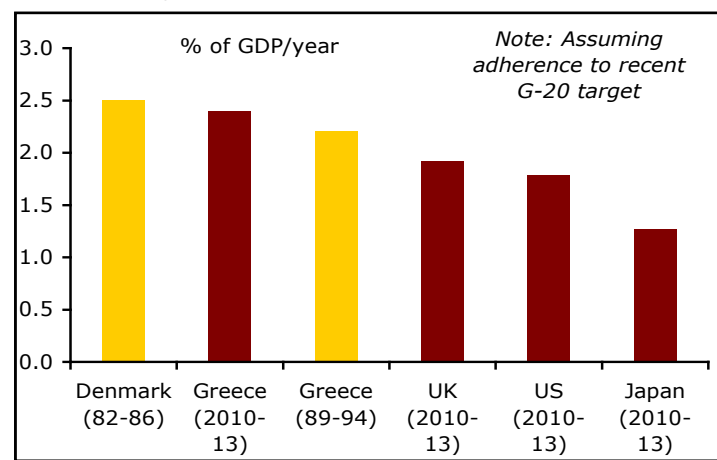
### Monetary Policy, Politics, Should Avert Double Dip

One of the market's fears is that a premature re-tightening of fiscal policy could plunge the global economy, or at least the debt-ridden industrialized part of it, back into recession. There are reasons, however, to think that the likelier outcome may not be another sharp tumble, but a protracted period of lacklustre growth—death by a thousand cuts, in other words. The first is monetary policy. A tauter fiscal stance puts more pressure, on central banks. The latest reduction in our forecast for the short end of the US curve (see page 2) reflects our view that the monetary authorities there, and presumably elsewhere, will respond appropriately, keeping the throttle wide open longer. While avoiding immediate action, Bernanke has indicated, moreover, that he can and will take more aggressive measures to lift growth, if the need arises.

The other mitigating factor is normal political survival instincts. Except in James Dean movies, people don't intentionally drive off cliffs, fiscal or otherwise. The Obama budget will defer some of the effect of fiscal restraint, and if the road ahead looks scary enough, we expect further delaying actions. Some Democrats, in fact, are already reportedly feeling queasy about letting the ARRA tax cuts expire as scheduled. That may not inoculate against a growth downshift, but does make a full-fledged double dip less probable.

Chart 7

### Historically Large Structural Deficit Reductions, Past & Projected



Source: CIBC, A. Cinzia & D. Gross, "The European Experience With Large-Scale Fiscal Adjustments", <http://www.voxeu.org>

# North American Autos: Short-Term Gain After Much Pain

Meny Grauman and Krishen Rangasamy

The great recession of 2008-2009 may be behind us, but its impact on the North American economy will linger for years to come. Nowhere is that more evident, than in the auto industry, where the economic downturn proved to be more than just a cyclical road bump, but a full-blown existential crisis.

It's not just the scale of the decline in US auto sales that sets this recession apart (Chart 1); but also the fact that we are unlikely to get back to pre-crisis levels any time soon as households continue to hold back on big ticket purchases, leaving new auto sales running below scrappage for the next few years.

Over the past decade easy access to cheap consumer credit fuelled an unprecedented boom in vehicle ownership in the United States that in many respects paralleled the boom seen in homeownership. After a sharp crash, the real-estate market is a shadow of its former self and, although the downturn in the auto market has been less dramatic, it is also suffering from the same persistent ills.

## The New Normal

Not surprisingly production has downshifted to meet this new reality, with total North American vehicle output falling from an annualized 15 mn in 2007 to less than 12 mn today. Similarly, Canadian vehicle production, which

is highly levered to US demand, has gone from 2.6 to 2.1 million over this same time period, a drop of nearly 20%.

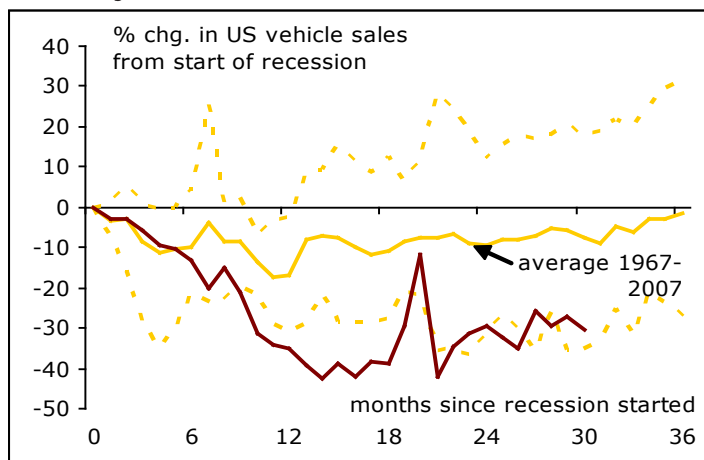
Despite the decline in absolute output levels, Canada has been able to hold on to its share of the North American vehicle market in the face of industry turmoil and much publicized plant closures. However, that has only been possible thanks to Japanese plants, which typically use more imported components, replacing outgoing American ones (Chart 2). What the Canadian auto industry has not been able to do is gain significant market share even as US based production slid from 70% of North American output in 2007 to 65% in 2010. Those gains have instead gone to Mexico, which has seen its own share climb by close to 5-% pts over the past three years to 18% largely due to its own cost advantage (Chart 3).

Given its relatively high labour costs, Canada will have to continue to entice foreign automakers with productivity gains and tax incentives in order to maintain its competitive position in the North American supply chain. To some extent it has been able to already do so, by boosting productivity through this recession. However, those gains have come at the expense of employment, which fell as much during the recession as in the six years preceding the downturn (Chart 4).

Besides the race for market share, a more fundamental challenge for auto producers across the continent will be

Chart 1

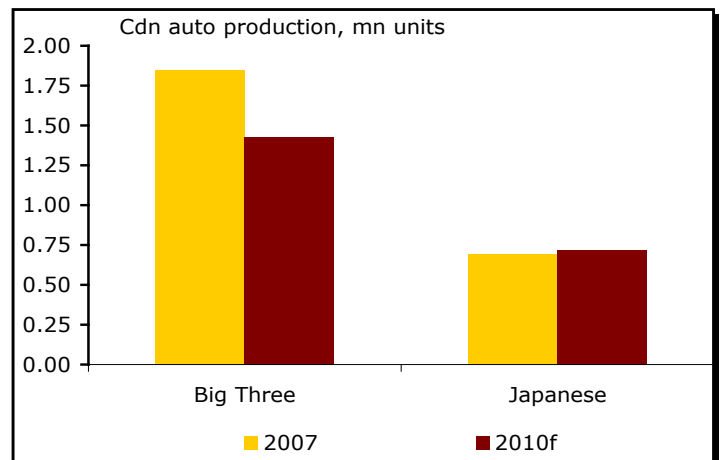
### Recession Has Been More Brutal to Auto Industry This Time



Source: US Bureau of Economic Analysis, CIBC

Chart 2

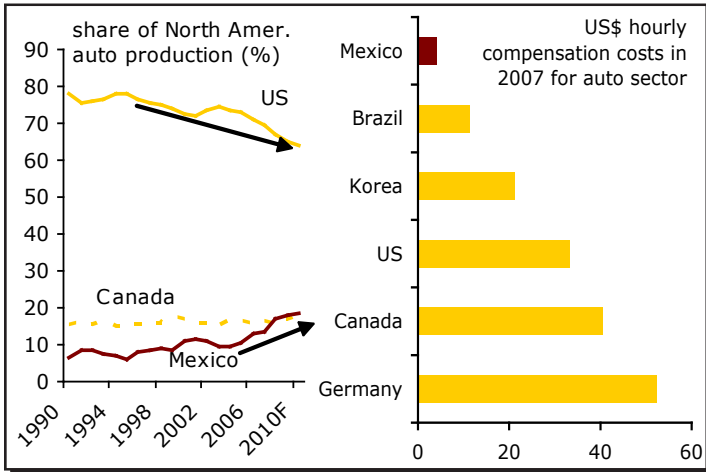
### Canadian Loss in Activity Centred in Big-Three



Source: WardsAuto.com, CIBC

Chart 3

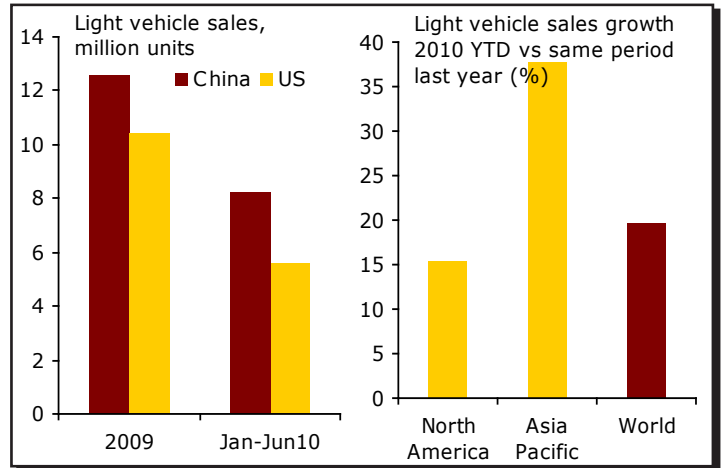
**Mexico's Share of North American Auto Output on the Rise**



Source: WardsAuto.com, US Bureau of Labor Statistics, CIBC

Chart 5

**Sales Are Picking Up Globally But Bulk of Growth Occurring Outside of North America**



Source: WardsAuto.com, CIBC

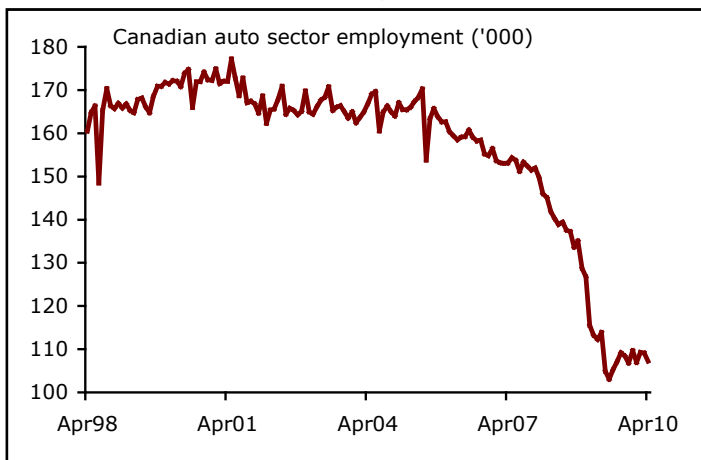
adjusting to the fact that North America is no longer the center of the global vehicle demand. World auto sales continue to climb higher, but that growth is increasingly being driven by demand in emerging markets, especially China, which in 2009 overtook the US as the world's biggest car market (Chart 5). Ontario can no longer claim the location advantage it once held when the most active auto market was just south of its border.

**Near-Term Inventory Boost**

Despite longer term structural challenges for the industry in both Canada and the US, the steep drop in production levels seen in 2009 continues to restrain inventory levels into the recovery. In fact, even when adjusted for a less-than-buoyant sales outlook, current dealer inventory levels are historically low (Chart 6).

Chart 4

**Canadian Auto Sector Payrolls Leaner Now**



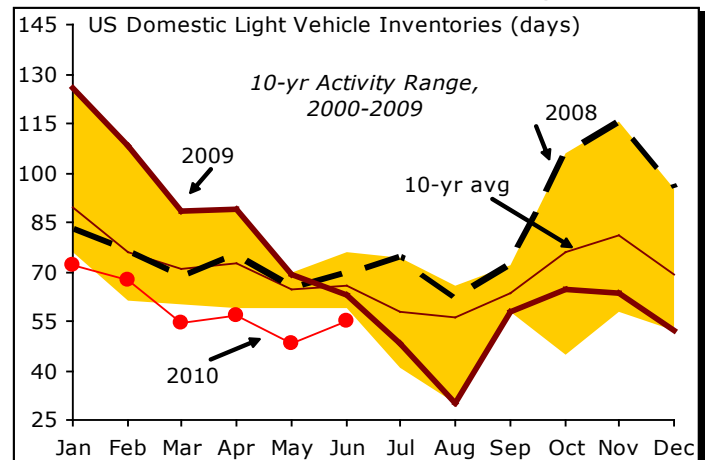
Source: Statistics Canada, CIBC

That mismatch between supply and demand in the US auto market should prove to be a temporary boon for auto production on both sides of the border, but will be tempered by a desire on the part of auto makers to remain conservative in the face of ongoing global economic uncertainty.

The decision by some US plants to forego normal summer retooling in an effort to catch up to demand will likely have an effect on third quarter US real GDP, as upgraded production plans are now up at a seasonally adjusted double-digit annualized pace in Q3. While the revised Q3 production schedule should be much less dramatic in Canada, output here should still get a nice lift during the quarter as busier US assembly plants boost exports of Canadian-made components.

Chart 6

**Inventories Still Below 10-Year Range**



Source: WardsAuto.com, CIBC

**ECONOMIC UPDATE**

<b>CANADA</b>	<b>10Q1A</b>	<b>10Q2F</b>	<b>10Q3F</b>	<b>10Q4F</b>	<b>11Q1F</b>	<b>11Q2F</b>	<b>2009A</b>	<b>2010F</b>	<b>2011F</b>
Real GDP Growth (AR)	6.1	2.6	2.5	1.4	1.7	2.9	-2.5	3.2	2.5
Real Final Domestic Demand (AR)	4.7	5.9	2.4	2.0	1.6	1.9	-1.8	4.3	2.3
All Items CPI Inflation (Y/Y)	1.6	1.4	2.0	1.6	1.7	2.2	0.3	1.7	2.1
Core CPI Ex Indirect Taxes (Y/Y)	1.9	1.8	1.9	1.8	1.7	2.0	1.8	1.9	2.0
Unemployment Rate (%)	8.2	8.0	7.9	8.0	8.1	8.1	8.3	8.1	8.0
<b>U.S.</b>									
Real GDP Growth (AR)	2.7	3.3	2.9	1.0	1.4	2.6	-2.4	3.0	2.4
Real Final Sales (AR)	0.8	3.2	2.7	1.3	1.6	2.4	-1.7	1.8	2.4
All Items CPI Inflation (Y/Y)	2.4	1.8	1.2	1.0	0.8	1.2	-0.4	1.6	1.5
Core CPI Inflation (Y/Y)	1.3	0.9	0.8	0.6	0.9	1.0	1.7	0.9	1.1
Unemployment Rate (%)	9.7	9.7	9.7	10.0	9.7	9.8	9.3	9.8	9.6

**CANADA**

While a slower-than-expected start to Q2 prompts us to lower our forecast for the quarter, we're upgrading our call slightly for the third quarter to reflect the expected additional contribution from exports in the auto sector (see pages 10-11). Overall, that trims our 2010 growth forecast marginally to 3.2%. We're maintaining our call for softer growth in the final quarter and early 2011, anticipating a US-led slowdown coupled with fading fiscal stimulus at home. The resulting deceleration in the labour market should keep the unemployment rate close to current levels through much of 2011. Headline inflation will spike above the Bank of Canada's 2% target due to HST effects in the second half, but the BoC will find solace in a milder core rate, which would warrant a go slow approach to rate hikes.

**UNITED STATES**

A more buoyant inventory outlook has led us to bump up our forecast for third quarter real GDP growth, but we have simultaneously taken down our calls for both Q4 and Q1 2011. Look for the US economy to hit a speed bump as we close out the year, and although we still don't expect a double-dip recession, growth should fall well below trend. Under those conditions, job gains are unlikely to be anything but mediocre well into next year. We had hoped for an earlier turn, but now see the unemployment rate above 9.5% for the bulk of 2011. Meanwhile, consumer inflation is unlikely to turn negative with rents no longer falling, but look for core CPI to stay below 1% into next year.

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