TD Economics

Economic Outlook Gets Trumped!

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Agenda

1. New government will inherit a strong economy
2. And now the hard work begins... forecasters agree to disagree on outlook
3. Canadian economy also adjusting to domestic policy shifts on multiple fronts

Trump Inherits A Strong Economy

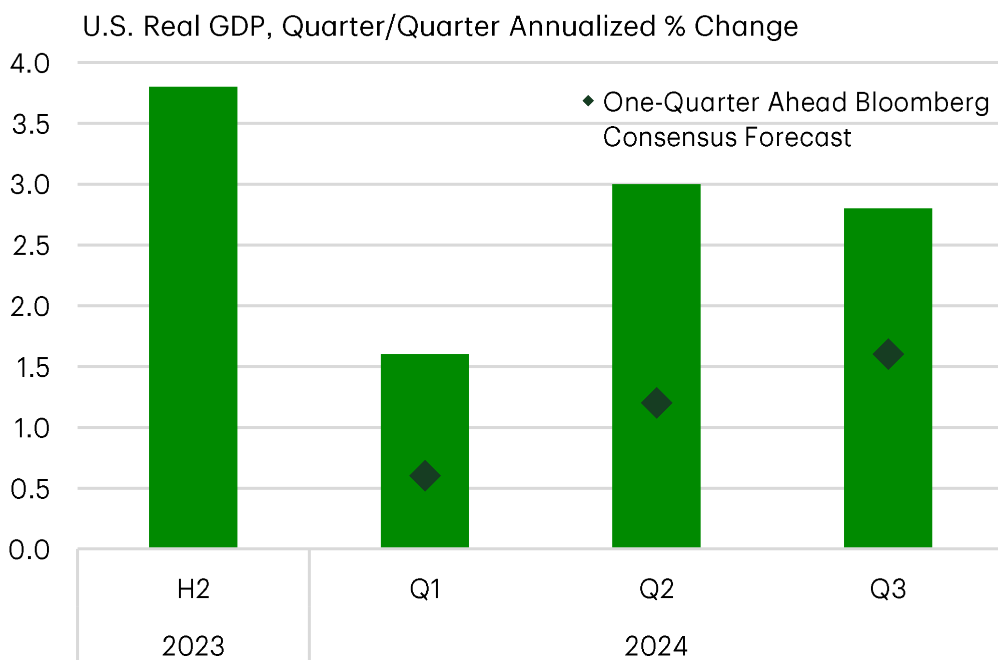
Starting points matter for a new administration, and President Trump will be inheriting a strong economy.

Another way to think of this is that it affords more leeway to implement tariffs and immigration policies to meet key election promises, because there's a cushion to absorb any short-term negative economic impacts.

But the main message of this slide is a familiar one: the U.S. economy keeps beating expectations.

The black dots in the graph represent the consensus for each quarter. The miss to analyst expectations is a full standard deviation or greater than traditional deviations.

The economy is not only outperforming people's expectations, it's doing so by a statistical mile!



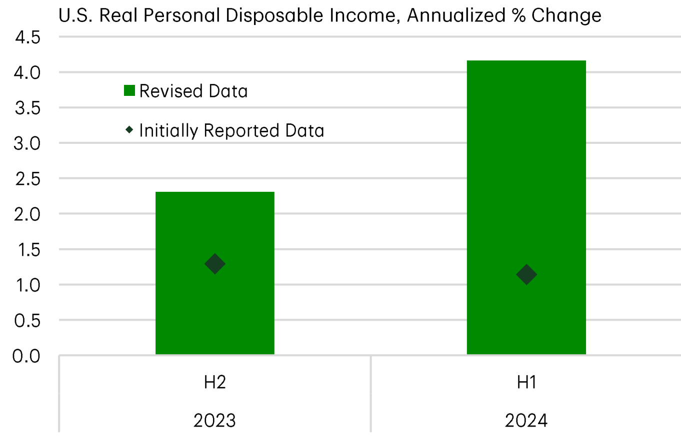
Source: Bureau of Economic Analysis, Bloomberg, TD Economics.

And Data Revisions Revealed Even More Economic Tailwind

Before I throw myself and peers under the bus, one key reason that models and analysts have underestimated is because they were given imperfect information.

Benchmark revisions to after-tax income revealed how it was possible for consumer spending to sustain strength when the initially reported data was telling us that excess savings had all but disappeared. Because it didn't. There was still plenty of savings. There's a big difference in how analysts interpret a 1% gain in real after-tax income in H1 2024 versus an outsized 4%!

Likewise, the savings rate benefited from a large restatement.

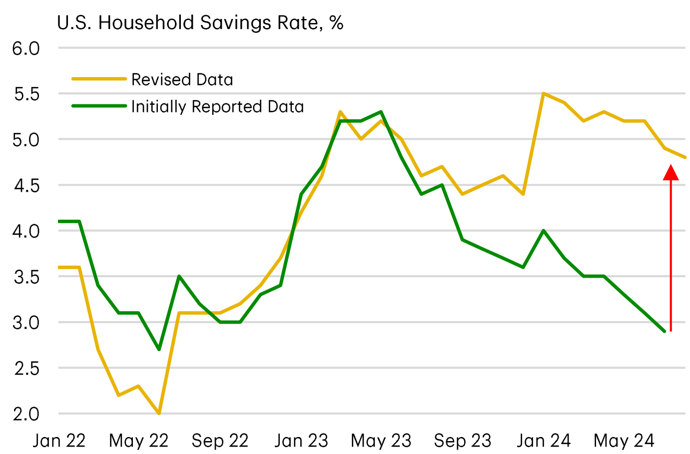


Source: Bureau of Economic Analysis, TD Economics.

Simply put, the data revisions created a new narrative. Household finances are in much better shape than the original data led us to believe.

This all works to the advantage of Republicans heading into 2025.

Some economic pain can be absorbed by households with this fatter cushion, particularly when compared to the economies of trading partners that are treading water as their starting point.



Source: Bureau of Economic Analysis, TD Economics.

Trump Policies At A Glimpse

Now let's dive into how this growth-cushion can be adjusted in our forecast.

This is called a waterfall graph. The grey bar on the left is the forecast before the election outcome was known. The U.S. economy was already projected to cool next year with some winding down of the consumer cycle. But at 2.1% GDP growth, it was essentially a return to trend.

As you move to the right on the graph, incremental adjustments are added for each policy assumption on how much it reduces or adds to that original forecast.

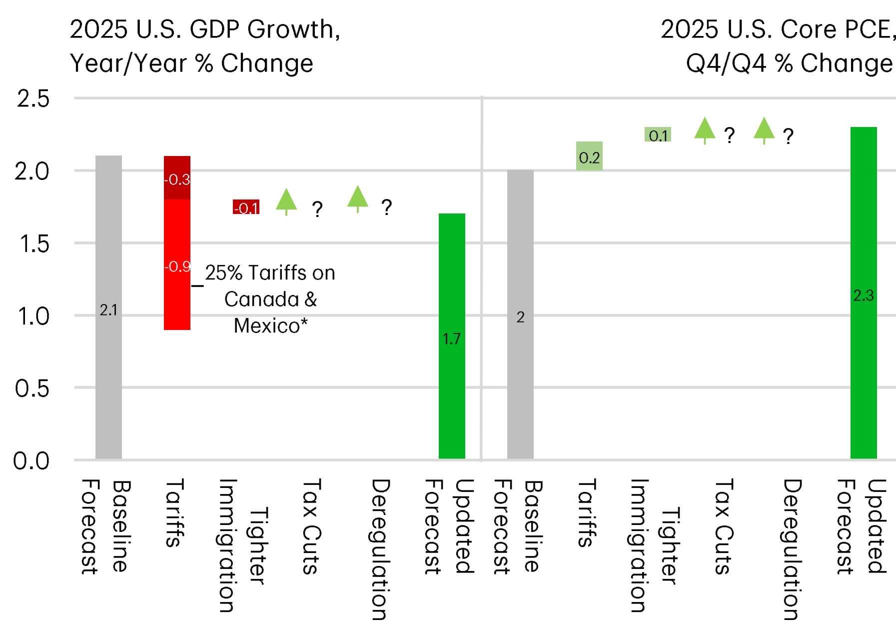
> Tariffs carry a big debate on timing, magnitude, and scope, but there's no debate that it will be the go-to policy tool, as we saw with Trumps recent 25% tariff threat on Canada and Mexico.

So, it's a safe bet to include some impacts as a placeholder in the baseline forecast, even though implementation and timing is not fully known.

This 30-basis point markdown assumes that less than half the tariffs are sustained for one year relative to what we heard during the election cycle. If we went full tilt, it results in economic stagnation, assuming retaliation by trade partners.

That produces a counter-productive and counter-intuitive outcome for an administration that emphasizes how their policies lead to stronger economic growth, stock market gains and lower inflation. And, our hope is that Scott Bessent, nominated to lead the U.S. Treasury Department, will be pragmatic in ensuring the least damage as possible to the domestic economy when tariffs are used to drive a fast deal.

If we embed the tariffs Trump recently announced on Canada and Mexico, and assumed retaliation, then there's an additional economic drag of 90 basis points. The baseline GDP forecast would be revised from 2% growth to a mere 1%. But let's put a pin in that one until we come to the Canadian section.



*Includes retaliation. Source: Bureau of Economic Analysis, TD Economics.

Moving to the right of the graph, there's an estimated 10 basis point hit from immigration policy. Here too there's high confidence of follow-through but, again, differing views on timing, magnitude, and scope.

Here we've assumed stringent border control occurs immediately, but large-scale deportations are slower on lift-off due to greater complexity with execution.

And where you see the question marks in the graph, there's no placeholder on policy within the forecast. This means there's upside potential that could easily return us back to the original baseline of 2% or more. For instance, corporate income tax cuts, alterations to the SALT deduction threshold, and meaningful deregulation that promotes business investment. However, given the very slim majority in the House, which controls this outcome, it's best to take a wait-and-see approach.

The income tax cuts under TCJA were already in our baseline because we never assumed the sunset clause would occur. So, no adjustments are needed unless Congress fails to approve the full suite of income tax cuts.

Forecast Uncertainty Underscored By Large Variation In Peer Views

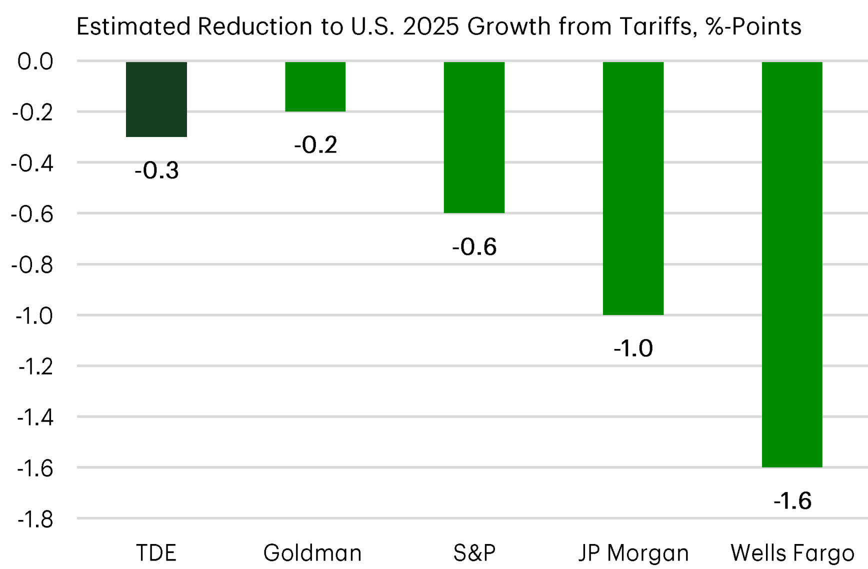
To give you an idea of the degree of uncertainty on forecast estimates, here are peer views on the negative impact to GDP from tariffs.

Our view is akin to Goldman Saks which maintain the full extension of the TCJA, a selection of tariffs applied to countries, alongside some offsetting tax breaks.

Wells Fargo and JP Morgan appear to stand out as highly pessimistic, but that's because both estimates reflect what could happen if a Trump administration delivers simultaneously and immediately on the 60% tariffs against China and 10% against all other countries.

But this is not necessarily what they've baked into their official baseline forecast. It should only be viewed as illustrative of the many possible pathways and scenarios that can be produced.

For instance, Bloomberg Consensus reveals a median GDP estimate for 2025 of 2%.



Source: Published reports from listed institutions, TD Economics.

Mass Deportations Would Hit Some Sectors Hard

Let's now turn to immigration and deportations, and why I've tempered the assumptions relative to rhetoric.

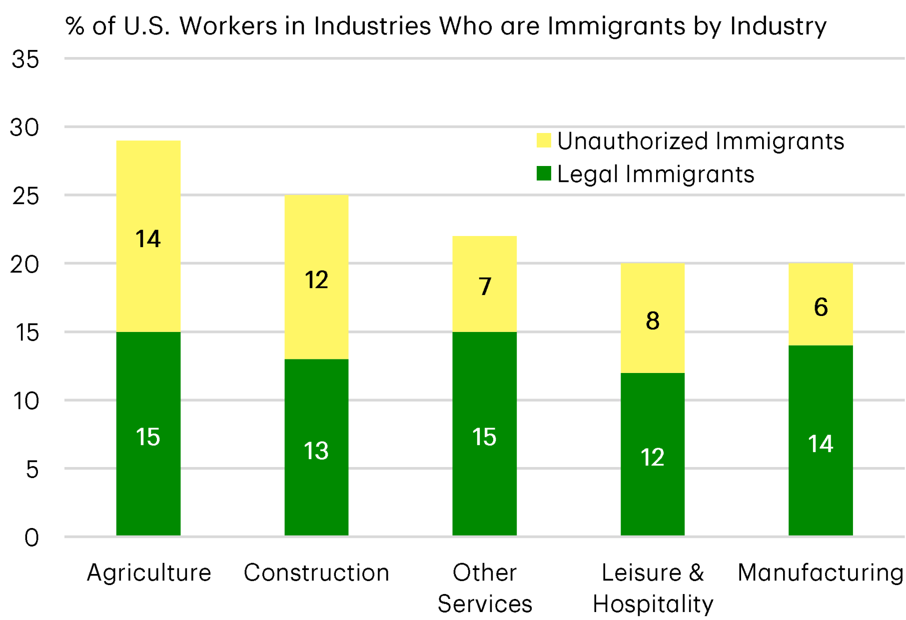
There are some big numbers floating out there on deportations, from 3 million over President Trump's term to as high as 11 million.

Relative to our previous baseline, our forecast has almost 2.5 million fewer individuals entering the U.S. by the end of his term. We haven't included anything yet on deportations because it makes a difference in how entrenched those people are in the labor market. Recently there's been some refinement on the message to target gang members and those with criminal records.

> Should President Trump follow through with mass deportations of 1 million people or more, there is a real risk of reigniting labor shortages in industries with a high concentration of nondocumented immigrant workers.

The agriculture sector is grabbing a lot of media headlines and the Wall Street Journal recently reported that about two-thirds of crop-farm workers are foreign-born, of which almost half (42%) are not legally authorized to work in the country. Basically, when you do the math, that sector has double the undocumented workers relative to what's shown for the agriculture sector, as a whole, in this graph. That data was based on a survey from 2020 and also found that the vast majority of farmworkers have been in the U.S. 15 years or more, and many have children born in America.

The bottom line is that the data hits home on the complexity of the situation and why we must be careful in incorporating bold deportation assumptions within our forecast without clear guidance.



Source: Pew Research, TD Economics.

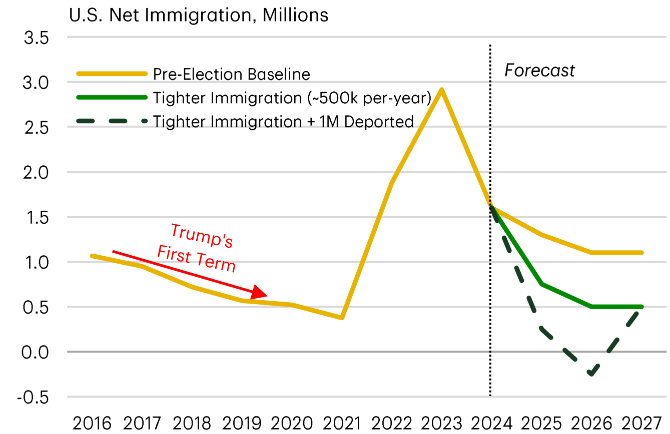
The Highs and Lows Of Immigration Impacts

But it's certainly realistic to believe President Trump will, at the very least, repeat the success of his first term regarding tighter border control, which is the bright green line in this graph. If we made a hard-lined assumption on an additional one million deportations in the coming year, naturally the impact to GDP would be deeper.

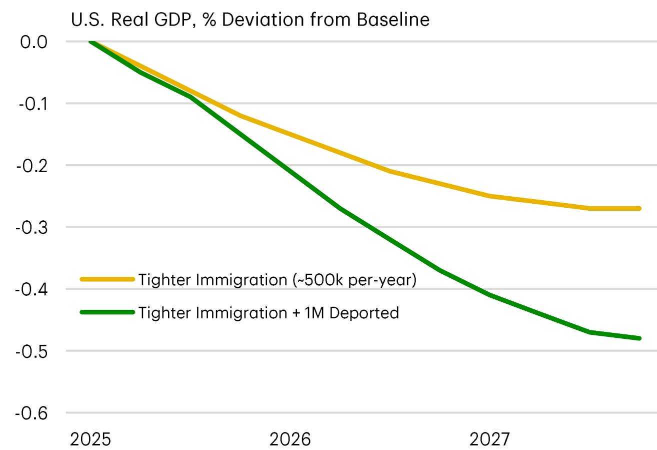
And by extension, the unemployment rate would dip, but not nearly as much as many are suggesting. A low unemployment rate is often viewed as a gauge of an economy's vibrancy. But in this case, it equates to a supply-side shock to the labor force.

However, take a look at how small the numbers are on the left side scale showing a small deviation from the baseline. Some analyst reports emphasis the negative labor force impact. But the unemployment rate is a ratio and there would be some offset from more people domestically needing to be employed, thereby reducing the ranks of the unemployed.

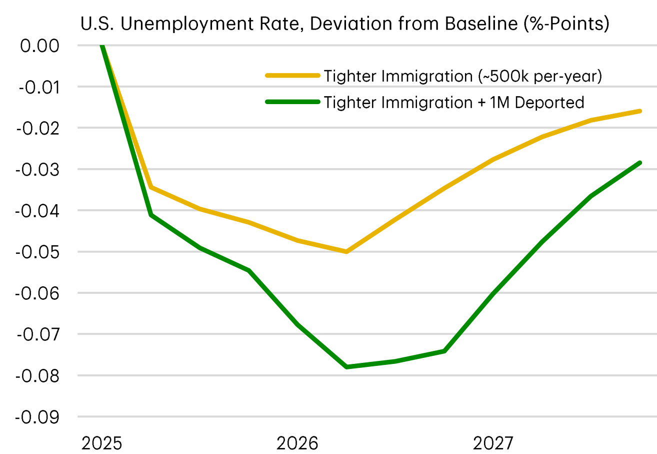
We know companies won't be able to fill all jobs, with people lacking the experience and the appetite for this type of work, which is why the argument that the policy is inflationary still holds. Wages would have to go higher to attract people and product or service supply could be less without a dramatic rise in productivity.



Source: Census Bureau, TD Economics.



Source: Census Bureau, TD Economics.



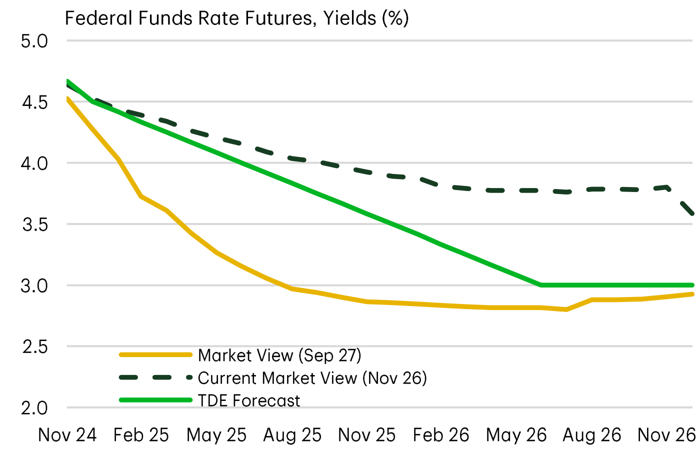
Source: Bureau of Economic Analysis, TD Economics.

Markets Agree Of Slower Reduction In Interest Rates

Yields are one area where markets have agreement.

Although equity markets cheered the election of President Trump and the red wave, bond investors adjusted expectations that larger budget deficits, tariffs, and slower population growth will force inflation higher.

We agree the Federal Reserve will have to tread more carefully and scaled back our rate-cut expectations. The Fed gets to our 3% neutral interest rate view in the first half of 2026, which is six months later than initially forecasted.



Source: Bloomberg, TD Economics.

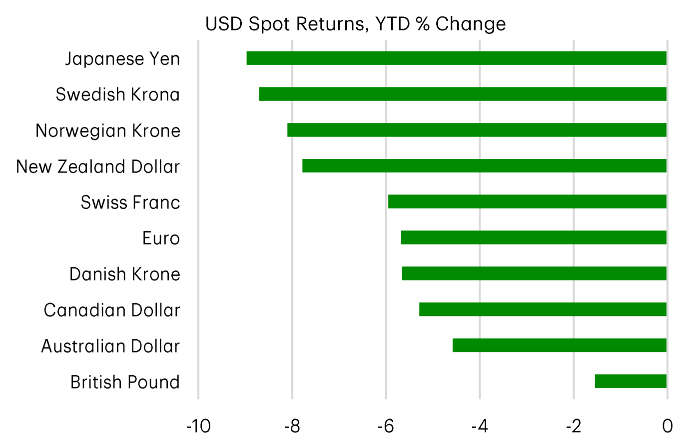
It is in this time-period where we gap to the market view because estimates of neutral have been lifted following the election to be closer to 3.5-4% relative to the market's September view of 3%. It is not unusual for market pricing to show a gap the further out in time, given the high degree of policy and geopolitical uncertainty. However, I'm doubtful a Trump presidency changes a long-term anchor by a full percentage point or, at least, let's see what's to come on deficits and inflation before embedding a dramatic change.

U.S. Dollar Bulls Help Offset Tariff Impacts

With bond yields expected to stay elevated by about 30 basis points through next year relative to our pre-election view, it helps cement U.S. dollar strength, given its economic outperformance to peers alongside policies that will incent an inward pull on U.S. investment.

Greenback strength taps down inflationary pressures from tradeable goods, as tariffs are imposed. It's a reminder that policies are not all a one-way road on inflationary pressures, there are some counterbalances naturally created in market dynamics.

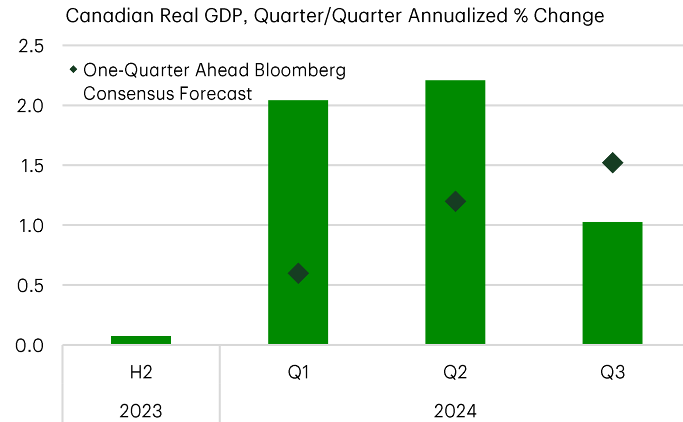
As tariff policies are revealed and imposed on various countries, there will be further near-term upside to the greenback relative to those currencies.



Note: Data as of November 26th, 2024. Spot returns calculated using USD as base currency.Source: Bloomberg, TD Economics.

Canada Regaining Momentum…Will That Get Trumped?

Turning to Canada, similar to the earlier and first slide shown on the U.S, here too Canada's performance beat market expectations until the most recent quarter. But some of that miss is completely deceptive. Consumer spending advanced by an outsized 3.7%, with the "forecast GDP miss" stemming from an inventory swing.

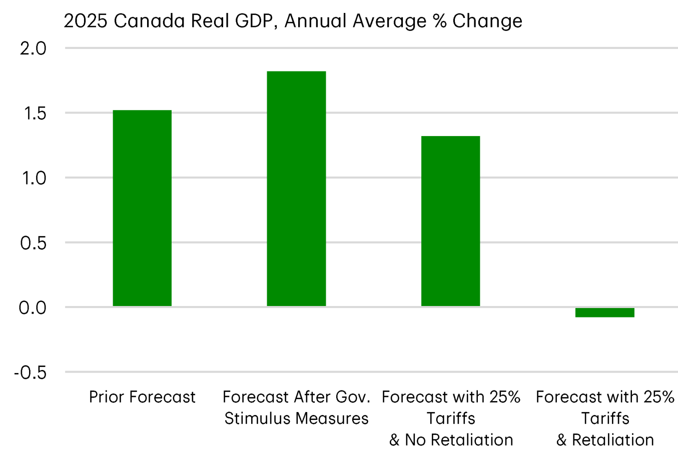


Source: Bloomberg, TD Economics.

However, a key difference between Canada and the U.S. is that that overall economy is expanding by 1-2% versus 3% stateside.

There's good news building in the pipeline, with momentum accelerating into the fourth quarter. Data for September and October reinforced a significant strengthening in consumer spending and housing demand, which should push GDP above 2%.

Let's call this second graph: choose your own adventure.



Source: Statistics Canada, TD Economics.

It shows different outcomes based on the recent unveiling of government stimulus at the Federal and Ontario level versus the potential for follow-through on Trump's 25% tariff announcement.

Starting with the positive impulse to the economy, the federal government's proposed $6.4 billion stimulus package includes a two-month GST holiday for select items and $250 rebate cheques to individuals earning under $150,000. If the government succeeds in passing this measure, those cheques will hit the bank accounts of 19 million people in April. In addition, the Ontario government is sending out $200 rebates, benefiting 15 million people in January.

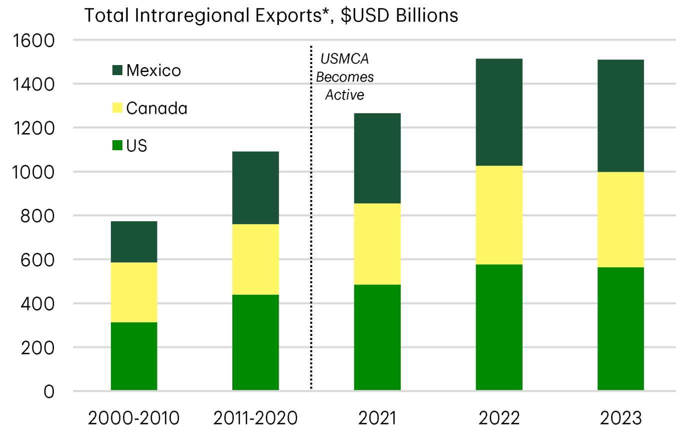
Meaning, some double-income households will receive $900, in addition to the usual carbon rebate cheques that are sent in January and April. That financial windfall has the potential to lift real GDP growth by 30 basis points in 2025. We've assumed only 50% pass through, with the remainder saved or placed on debt paydown. The stimulus impact could be more if there's a higher propensity to spend.

Perhaps governments had foresight of pain to come because the next two bars show the impact to growth under the 25% tariff threat. It would wipe out economic progress should Canada retaliate at an equivalent level. If there's no retaliation, a recession can be skirted.

USMCA Has Deepened Relationships

On tariff risk, the economic trade ties have deepened since the USMCA came into effect in 2020 with $3.6 billion goods and service flowing between the countries DAILY and 30 U.S. states with a trade-interdependency. Many American states have a vested interest in preventing a drop in their exports or disruptions to supply chains that would likely create work stoppages.

President Trump singled out border security on illegal migrants and drug trafficking as the basis for the tariffs, rather than unfair trade. For Canada, this could get resolved in a reasonable timeframe if the President doesn't again move the yardsticks, which is always a high possibility.



*Exports from Canada, U.S & Mexico to each other.
Source: Bloomberg, TD Economics. Last Observation: 2023.

It also highlights why momentum was building for Canada to pull away from tri-lateral negotiations with Mexico even before this announcement.

As an example:

- U.S. border control officers had about 24, 000 encounters with people crossing illegally last year from Canada, versus 1.5 million encounters at the Mexican border.

If all else fails on negotiations, Canada has the lowest debt/GDP ratio among the G7, with "fiscal room" to provide financial support domestically to companies and households. However, the government will have to start being more strategic and thoughtful on managing its budget. Those windfall cheques might be better served later in the year if negotiations fail, or perhaps the support would better serve businesses directly impacted by the tariffs to prevent layoffs and price escalation.

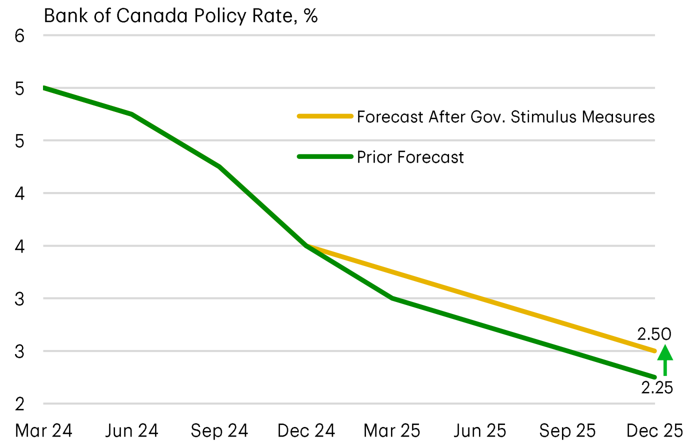
So, I don't want to hit the panic button and we'll adjust forecasts as information solidifies in the next few months. Also, timing matters. A one-quarter shock is immaterial to the forecast compared to tariffs sustained for one year, which is what's reflected in that earlier graph.

Whether a deal is struck on tariffs or not, all roads lead to a higher deficit because of greater spending on border security, defense, technology at borders and so forth. These areas have not been the center piece of the government or of past budgets.

Bank Of Canada Can Do Less Of The Heavy Lifting

If Canada avoids tariffs and we now have governments rowing harder in the direction of stimulus, that implies the Bank of Canada can do a little less.

We are of the view that a quarter-point cut on December 11th would be the better choice, particularly with consumer spending and the housing market coming back to life even before that 50-basis point move in October.



Source: Bank of Canada, TD Economics.

If we don't see tariffs, and the marginal propensity to consume (MPC) from those stimulus cheques turns out to be higher than our estimations, we may need to remove another rate cut from the profile, because the sensitivity of housing demand has been stronger than many have anticipated in the early days of lower mortgage rates.

On the flip side, if we do get tariffs on Canada, the BoC would prioritize the negative impact to economic growth and jobs relative to the transitory inflation shock from tariffs. This means in both tariff scenarios, whether there's retaliation or not, the rate-cut profile in this graph would be lower – my guess is by about 100 basis points in the event of the recession scenario.

Why not even lower? There are many considerations:

First, governments wouldn't stand idly by and stimulus measures would start flowing.

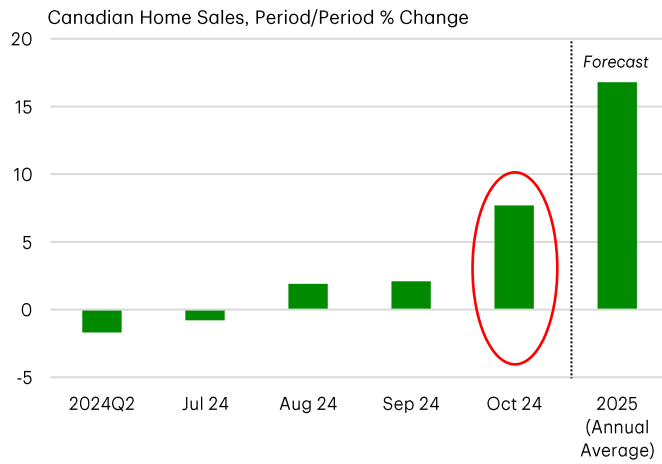
Second, the Bank of Canada has to be mindful of too much widening in the interest rate spread to the U.S. that worsens pressure on the Canadian dollar. Aside from the damaging effect to purchasing power and the ability of businesses to invest, it imparts a secondary path for inflation.

Canadian Housing Demand Is Already Off to the Races!

Now let's look at Canada's favorite sport – the housing market.

Housing demand is highly interest rate responsive in the best of times, and even more so when there's plenty of pent-up demand and insufficient supply. Add to that federal government initiatives to further stimulate demand with extended amortizations and a higher price cap for mortgage insurance. That means next year's home sales will benefit from a strong tailwind.

The October home sales data came out shortly after the Bank of Canada's supersized rate cut, in which they would not have known that the sales data was about to show a massive 8% pop.



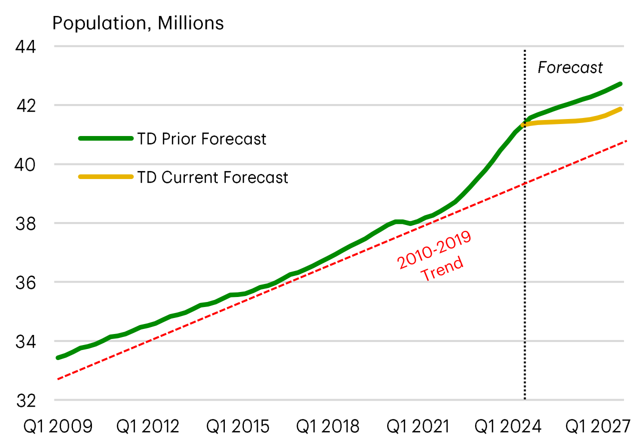
Source: Canadian Real Estate Association, TD Economics.

This forced an upward revision to our forecast, with a sales gain next year of at least 15%. Ontario and B.C. are more likely to post gains of 25%, with price growth of 5-7%. But, keep in mind that the condo market is soft and amply supplied relative to the detached market. Right now, it's the latter driving the gain in sales and prices.

Population Growth To Slow to a Crawl...But Levels To Hold Elevated

Some have argued that recent changes to immigration present a downside risk to housing.

However, as this graph shows, the government is simply hitting the pause button. The population will hold at elevated levels relative to the previous trajectory, shown by the red trend line. The green dotted line captures the new population projection that maintains a significant gap to that trend line.



Source: Statistics Canada, TD Economics.

Slower Population Growth Doesn't Solve for Housing Shortage

Which brings me to these graphs.

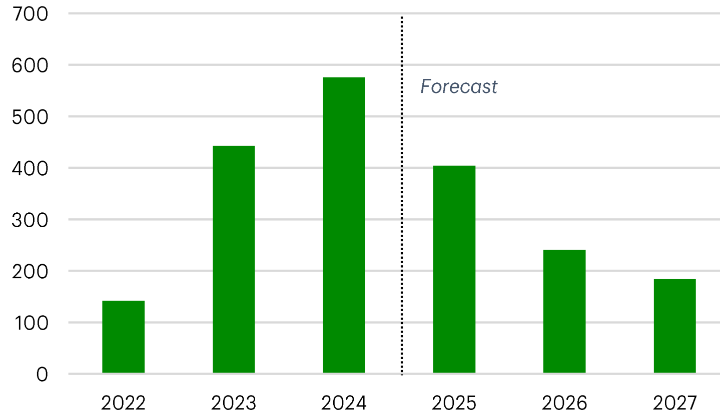
Keeping the population steady for a few years will offer an opportunity for builders to cut the sizeable gap between housing completions and underlying demand. But it won't eliminate the gap.

The impacts of reduced immigration flows should be most apparent in the rental market. In the GTA, rents were already falling in year-on-year terms even before population flows were restrained, because a wave of newly completed rental units is hitting the market.

Industry data indicates that rent growth is also cooling in B.C. and Quebec. There's a strong likelihood that the attractiveness of these units as income-generating properties will be diminished, and weigh on investor demand.

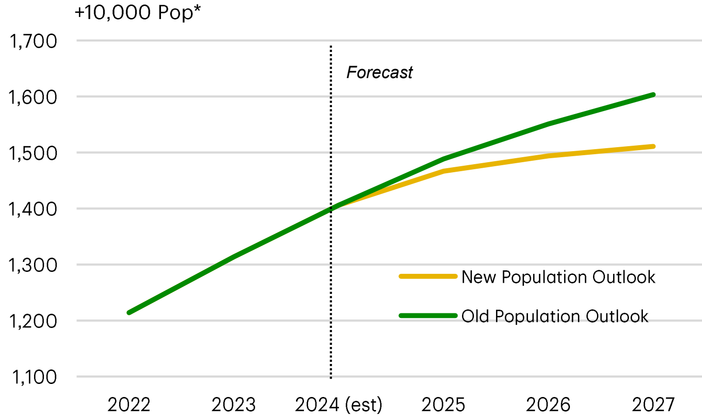
But the direct impact on ownership should be small, given that both non-permanent and permanent residents largely rent when they first come into the country.

Gap Between Population Based Housing Demand and Housing Completions, Canada



Source: Statistics Canada, Canada Mortgage and Housing Corporation, TD Economics

Average Purpose-built Rent, All Canadian Urban Centres with +10,000 Pop*

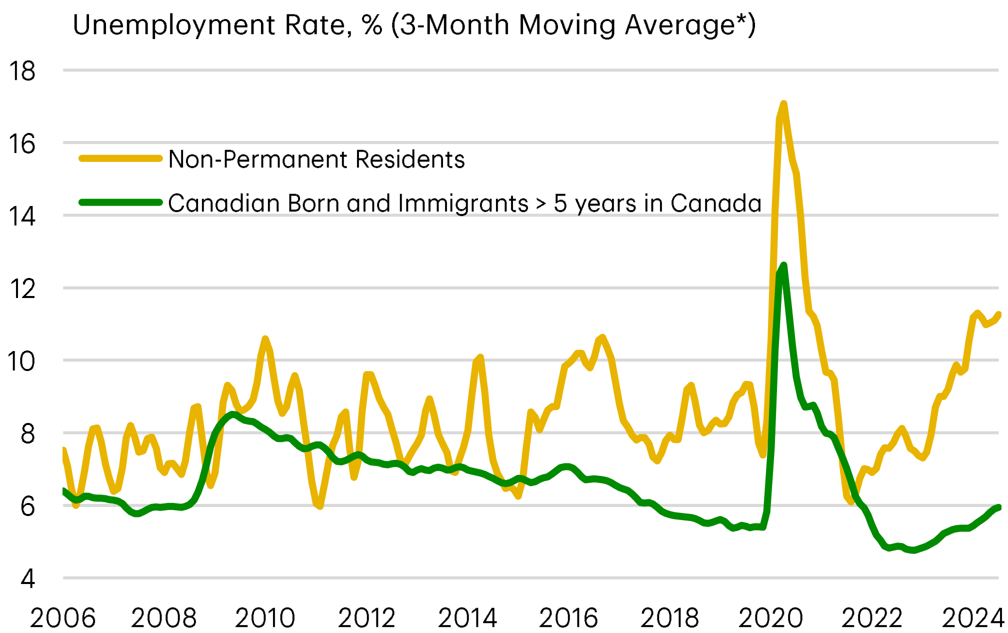


*Row Homes and Apartments.
Source: Canada Mortgage and Housing Corporation, TD Economics.

But Can Help Ease Unemployment Pressures

On the flip side, the tapping down of immigration flows can help cap the unemployment rate.

Since the start of last year, it has risen 1.5 percentage points, but for non-permanent residents it has jumped about 4 percentage point to an unemployment rate north of 11%. This indicates how oversupplied the labor market suddenly became that ran counterproductive to the purpose of the policy. Non-permanent residents represent only 6% of the labor force but accounted for about a quarter of the rise in the national unemployment rate.

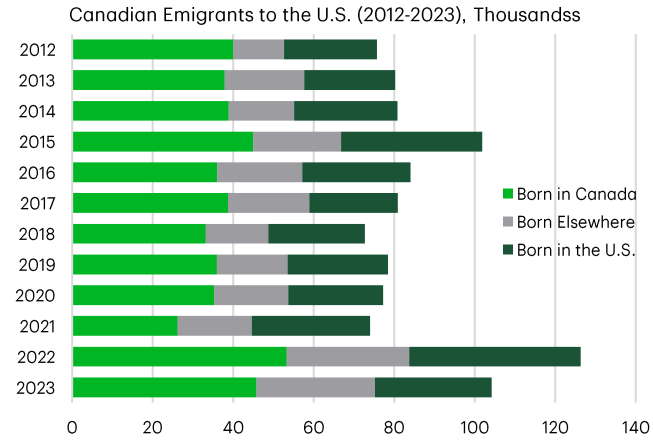


*Smoothed. Source: Statistics Canada, TD Economics.

Are Canadians Voting With Their Feet?

Just as Canada is trying to recalibrate its immigration policy, a new, but old question, is resurfacing with clients. It intensified after the government lifted the capital gains inclusion rate in June followed by the U.S. "red wave".

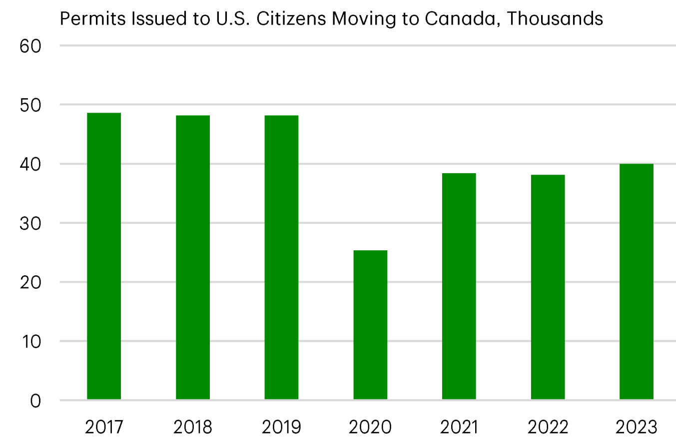
And that question is:
Will Canada experience worsening brain drain to the U.S. of high skilled, high-income earners?



Source: American Community Survey/U.S. Census Bureau, TD Economics.

This became a hot topic in the 1990's when the rise of the tech sector set its sights on Canadian talent. Although the numbers leaving Canada as a share of the total workers was deemed to be small at less than 1%, the pattern revealed an increasing exit of highly skilled workers who were young, well-educated, and well-paid. This was a pivot in the characteristic of migration from the older cohort aged 55+.

Today, Canada is producing one of the worst productivity performances among peers, and the composition of the higher immigration flows in recent years had shifted to lower skilled, lower income individuals.



Source: IRCC, TD Economics.

This graph does show that after a relatively long period of stability in the number of Canadians leaving for the U.S., the last two years have seen a jump that cannot be explained as "catch up" from reduced flows during the pandemic. It bears close monitoring if tax advantages and income opportunities create more pull in the years to come.

On the other side, people leaving the U.S. to enter Canada has downshifted by about 10,000 per year relative to pre-pandemic. However, a word of caution. These data are not directly comparable, because the two countries track the data differently, so it's the patterns that we're focused on.

Summary

I threw a lot at you, so here's a quick summary of key points:

- The Canadian economy is regaining momentum, even before government stimulus comes into force next year.
- This offers a trade-off with fewer interest rate cuts if a tariff war can be contained.
- To get the most out of Canada's immigration policy recalibration, there needs to be a pivot to a higher share of skilled workers, and greater efforts on retention to stop a further swelling in talent leaving for the U.S. Maybe this is an unattainable goal given the large gap in income tax competitiveness, not to mention the lure of earning U.S. dollars alongside better housing affordability. If so, it means Canada has to work harder at backfilling with people from other countries.
- For the U.S., it's hard to estimate policy implications in the absence of clear paths, so we will have to roll with the punches on the forecasts as information is revealed.
- One thing to keep in mind is that anything on deregulation has a long tail, meaning the benefits are unlikely to be immediate, unlike tariffs and changes to immigration policies that have more direct and faster pass through to the economy.

Bottom line, the Fed will have its work cut out, as will every economist!