TD Economics

Piecing Together The Puzzle

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Agenda

1. Is the U.S. still exceptional?

Pressing on this theme first laid out in February, is there evidence of persistence and its manifestation within other corners of the market, like the repricing of interest rate cuts along with chatter on how much central banks can diverge?

2. New kid on the block - U.S. immigration

In past presentations, we've explored aspects of exceptionalism related to resilience among households and business investment. Now there's a new part of the narrative. A re-estimation of immigration figures gives another piece of the puzzle behind why America has experienced less interest rate sensitivity.

3. How much policy divergence can central banks stomach?

This is a question more directed at the Bank of Canada, due to the close economic ties south of the border. Divergent economic drivers, including within inflation, suggest Canada will need to go-it-alone on cutting interest rates this summer.

U.S. Still Firing On All Cylinders

This chart reaffirms the exceptional narrative is alive and kicking in the U.S. before economic models narrow the gap in 2025 relative to other regions due to tighter monetary conditions and other factors.

One of these is a narrowing of the fiscal growth impulse as more time passes from three large bills that all occurred within less than 12 months (between 2021 and 2022). The Infrastructure deal, the IRA, and the CHIPS & Science Act are still going to be growth-positive in future years, but that initial burst in activity naturally fades with time.

The dots on this graph show that relative to the forecast three months ago, most major regions have been upgraded along with the U.S., but not enough to close the performance-gap.

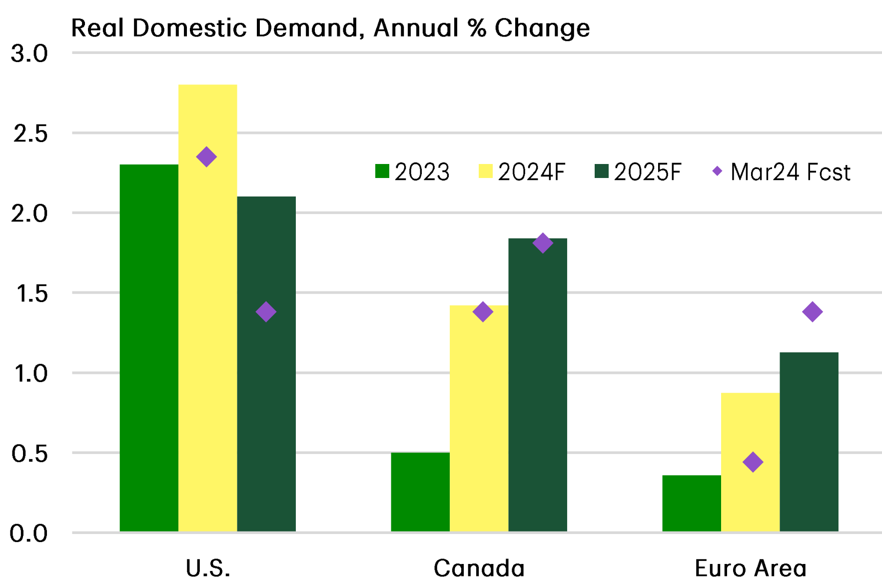
We'll get to Canada shortly, but in the case of Europe, GDP growth in the first quarter was about double market expectations, and broadly represented across countries. Granted both GDP and domestic demand are still moving at a snail's pace, but any forecast upgrade is welcomed for this region.

Not shown on this graph is China, which also turned in a better performance in the first quarter. However, this came from a resurgence in exports rather than domestic demand drivers.

There is a sense that the U.S. is a rising tide lifting all boats.

In the case of Canada, last year ended with real GDP advancing by only 1% (q/q annualized). Had it not been for U.S.-driven net trade, the Canadian economy would have reached a technical recession.

The opposite is true for America. As the largest consuming nation, imports were riding high at 7% in Q1 alongside flat exports, reflecting what happens when the U.S. economy sprints while the rest of the world walks.



Note: *Domestic demand includes consumption expenditures & gross capital formation.
Source: Bureau of Economic Analysis, Statistics Canada, Eurostat, TD Economics.

Is The Magnitude Of U.S. Outperformance Unusual?

The answer depends on the region.

The green boxes are the historical maximum and minimum spreads between each region's real GDP and the U.S. — i.e. negative means underperformance to the U.S.

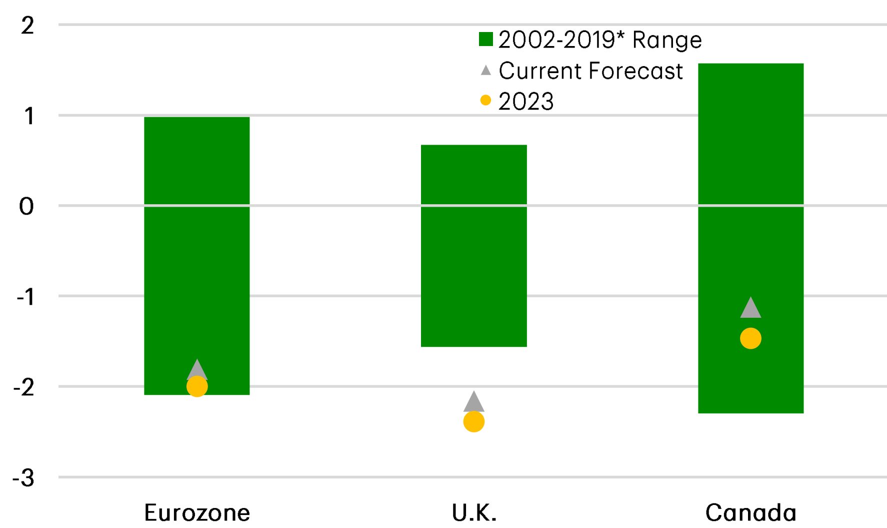
The two dots show that each region was sitting at the bottom end of their historical performances last year, and a similar outcome is forecasted for this year. The UK is an outlier in forming a new bottom, but keep in mind Brexit has shifted the sands under potential GDP for that country.

Canada is actually the best placed among these, sitting more securely within its bottom quartile.

Historically, this degree of growth-divergence has not lasted longer than two years for these regions, although Europe's sovereign debt crisis came close. This means that if there's persistence in this magnitude of outperformance beyond 2024, then it would truly represent a period of exceptionalism for the U.S.

And this is entirely possible if U.S. potential GDP growth is restated higher over time given productivity has been much stronger than peers.

Real GDP Annual % Change Relative to U.S., %-Point Difference



*Non-recessionary periods. Source: TD Economics.

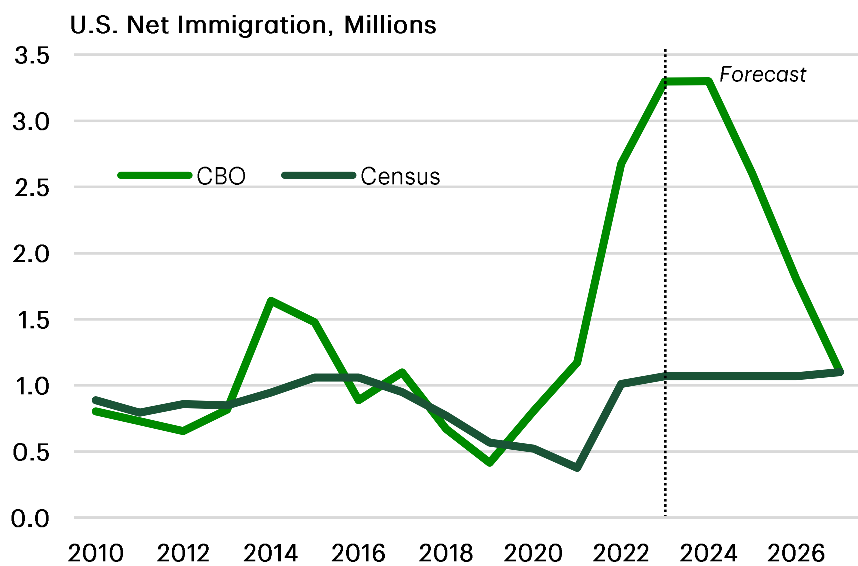
New Kid On The Block…

But there are even more pieces to this puzzle. U.S. population figures have recently come under scrutiny, marking a huge economic development in the past three months.

The Census Bureau estimate is the official immigration statistics that forms the underpinnings for population growth, the labor force and other key variables in the economy. However, the CBO has recently challenged these estimates, implying that the Census Bureau is undercounting immigration by a cumulative error of over 7 million people by 2026!

The largest portion of that divergence reflects a category the CBO has labelled "other foreign nationals", which they derived from data from the Department of Homeland Security. This consists of people who have mostly entered the United States illegally and people who were permitted to enter through the use of parole authority and are awaiting proceedings in immigration court. Among these "missing immigrants" from the official statistics, the CBO estimates that a majority would make their way into the labor force after about 150 days.

For economists, this is a huge revelation that could account for a larger labor force than originally estimated, and be a puzzle piece to help explain why above-trend job growth has not produced significant wage pressures.



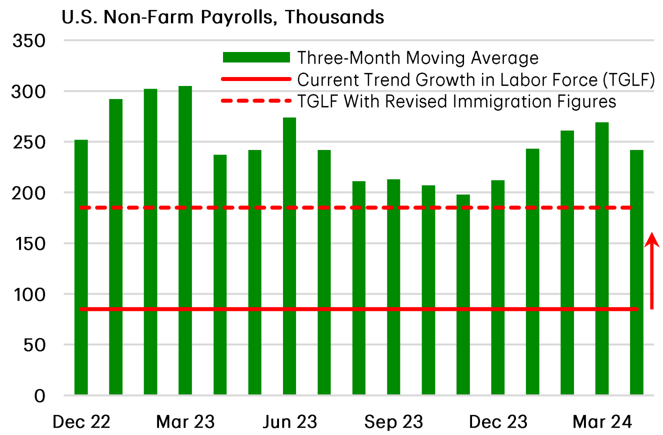
Source: CBO, Census Bureau, TD Economics.

....May Explain How U.S. Job Growth Can Run Well Above Trend

Official labor force participation rates place the sustainable monthly pace in employment growth in the 60,000-140,000 range, indicated by the solid red line in the graph. It was always a head-scratcher on how the labor market could sustain new jobs averaging two times that range without a corresponding escalation in wage pressures.

But if we apply the CBO immigration figures, the absorption rate of the labor force would be lifted to a range of 175,000-200,000. This offers an alternative explanation to U.S. exceptionalism. The labor market is not as tight as economists were led to believe from the official statistics and, therefore, it may not require as much of a rise in the unemployment rate to take heat off inflation.

> In the words of John Maynard Keynes,
> **"when the facts change, I change my mind."**



Source: Bureau of Labor Statistics, TD Economics.

Pros and Cons Of Immigration Surge

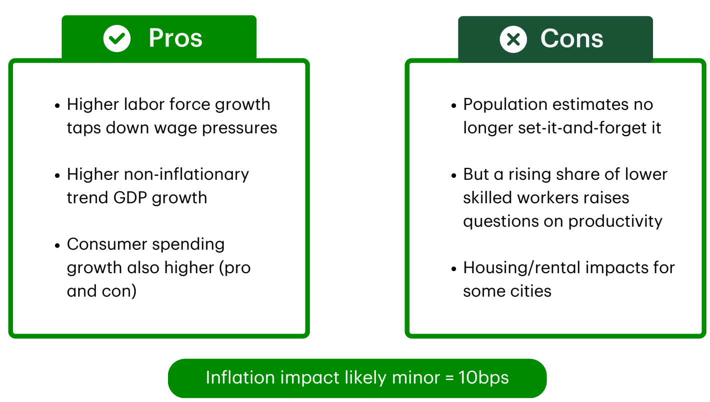
This list should read familiar for those familiar with Canada's strong population growth. The U.S. is experiencing a muted version of Canada. Population growth would still be less than half and spread over a larger geographic footprint relative to Canada's concentration within a handful of cities.

Regarding the last bullet in the "Pro column" on consumer spending, we estimate that the aggregate boost in 2023 could be as much as 20-30 basis points, and that this year will reflect a similar lift.

Over to the right column, everything has a cost. Economists are again in the position of reviewing models in areas that, historically, have been highly predictable and steady, like population growth and its influence on the labor force.

At the end of the day, the population influx is large, but can't be solely blamed for the degree of inflation stickiness that currently exists. Instead, it's another piece of the puzzle falling into place to help us understand how the U.S. economy is defying the odds in a high interest rate environment.

It's not ever just one thing at work but, rather, many overlapping pieces from low household debt leverage to stimulative fiscal policies to re-onshoring activity and, now, to higher immigration flows.

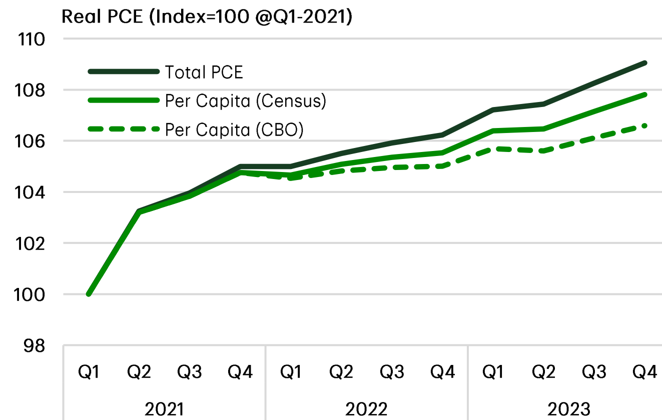


Is Consumer Spending As Strong As It's Portrayed?

And with new information comes new approaches on logic checking. Unpredictable immigration flows require an alternative way of reviewing data to gut-check the impact of interest rates on the consumer. A faster growing population boosts the aggregate consumption figure and can mask underlying trends.

Looking at the data on a per capita basis helps uncover any discrepancies. Doing so reveals a meaningful divergence in consumer spending per capita when applying the official Census data versus the CBO's estimates. Between 2022 and 2023, the pace of spending growth is half that of total spending, and a full percentage point below the Census per capita growth rate.

This tells us that higher interest rates could be leaving a bigger bite on households than we can observe solely with the top-down figure.



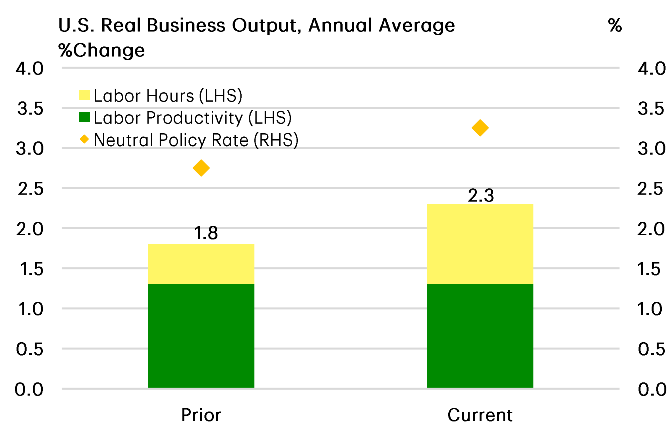
Source: Census Bureau, Congressional Budget Office TD Economics.

Higher Near-Term Potential = Higher Neutral Rate

And it might also help explain the disconnect between the policy rate, which was deemed tight, and the possibility that it might sit at a higher level than originally thought.

On several occasions I've reviewed the persistence of U.S. productivity growth and its divergence from peers that can lend itself to a higher neutral rate. Now we have to also consider that stronger labor hours create another layer of uncertainty on the neutral rate, which is an unobservable variable.

A neutral rate sitting closer to the 3 or 4 percent mark means that a 5.5% policy rate is less restrictive than previously thought, which offers some context as to why central bankers, like Chair Powell, are emphasizing the importance of patience in letting interest rates work on the economy.



Source: Bureau of Economic Analysis, TD Economics.
Note: Forecast is for time period 2024-2026.

Near-Term U.S. Inflation Dynamics Become Unfavorable

This gets us to the other big development since last quarter. After slowing considerably through the second half of last year, progress on inflation stalled earlier this year. The three-month change on core PCE inflation is 4.4%, which is the highest reading in twelve months. The Fed prefers to discuss the 6-month change, shown in the first graph, because it removes volatility. But this too has backed up.

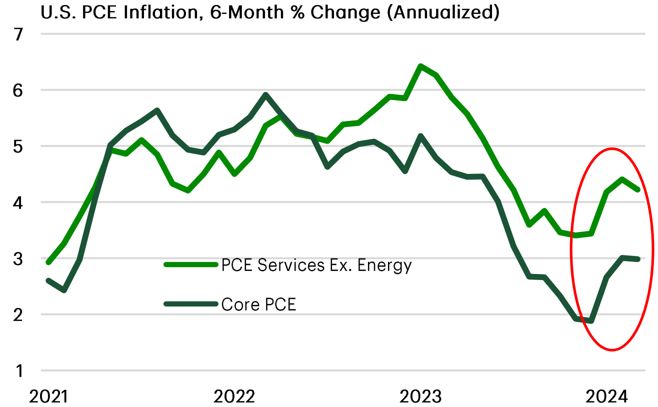
Now the question is why?

Falling goods prices were a major source of disinflation over the past two years, accounting for 80% of the decline in core PCE from its peak. However, that downward influence is stalling out, placing more importance on service prices to step up to the plate.

Unlike goods prices that have a global influence related to supply chains and excess capacity within other countries, service prices are skewed mainly to domestic demand forces. The re-acceleration in PCE inflation has led to a large restatement in our inflation forecast. And it's this development that has punted the timing for the first Fed rate cut from the summer towards the end of the year.

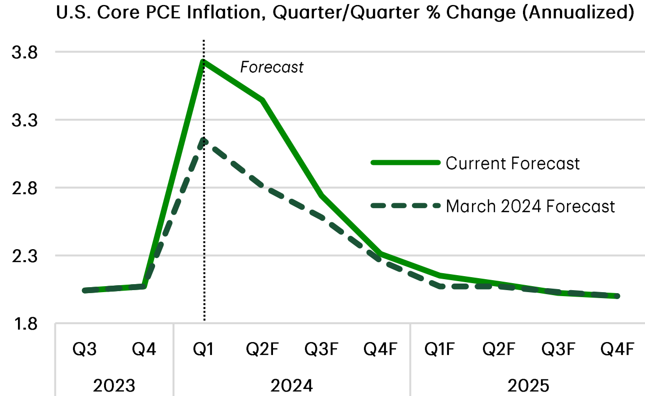
Although markets were highly encouraged by the CPI inflation report for April, that didn't change the math enough to matter. There remains a long lag in getting back to the Fed's 2% target and exemplifies the importance of displaying patience.

U.S. PCE Inflation, 6-Month % Change (Annualized)



Source: Bureau of Economic Analysis, TD Economics.
Laast observation: March 2024.

U.S. Core PCE Inflation, Quarter/Quarter % Change (Annualized)



Source: Bureau of Economic Analysis, TD Economics.

Lag = 14 Months From Actual Rent Costs into Inflation Rent Metric

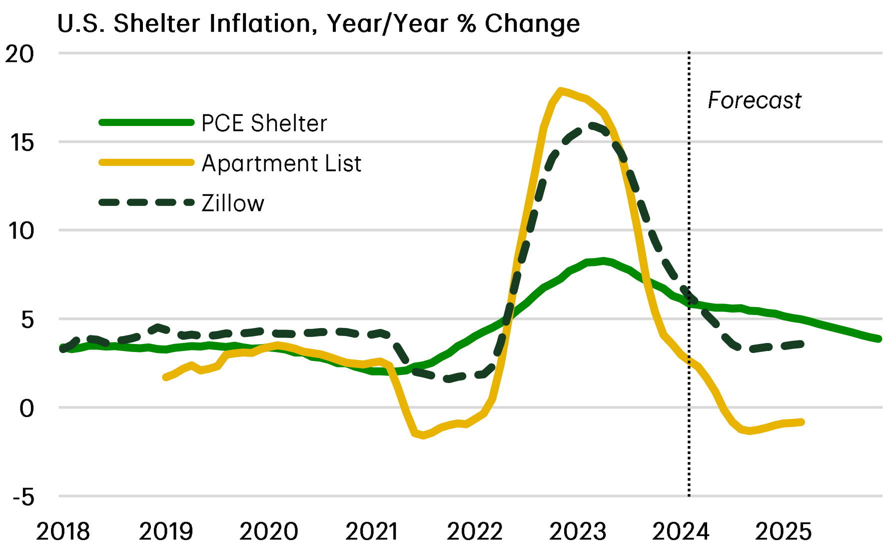
Here's why. There are two key dynamics at play in service costs. One is that prices for non-housing services have accelerated to a near three-year high of 5.6% on a three-month basis. This is not due to a single segment of the economy, many areas are absorbing higher prices such as medical, financial services, and personal services (which includes everything from personal care, to childcare, to accounting services).

This development would be less of a problem if shelter costs, shown in this graph, started to reflect market-based rent movements, because it carries the largest weight in the PCE inflation index at 15%.

As of March, housing was still contributing a full percentage point to core PCE inflation, which is double its pre-pandemic contribution when inflation was running closer to 2%. If this alone would capitulate, there would be sufficient downdraft on core inflation to give the Fed some confidence on re-anchoring at 2%.

But, unfortunately, the transmission lags within shelter are long and could be getting longer with deteriorated housing affordability causing less turnover. One hypothesis on why the transmission lag is longer this cycle is because less rental turnover means that it'll take longer for market prices to build the needed critical mass for downward influence within the inflation index, which is contrary to when it shot up in 2022 on significant turnover combined with accelerating prices.

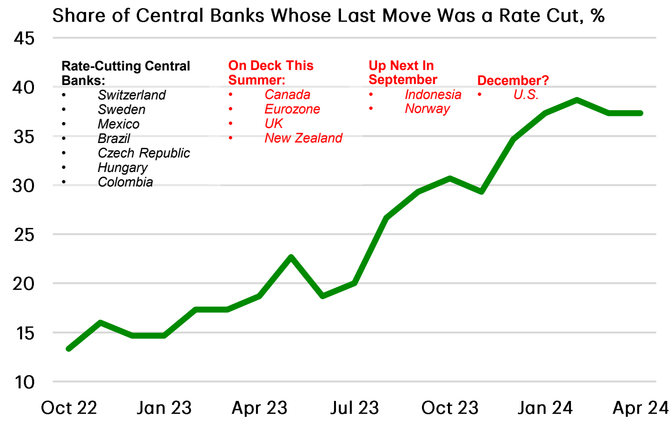
Ultimately, core inflation isn't expected to return to 2% until late-2025, which allows for more normalization in the policy rate in that year once Fed members gain greater confidence in its trajectory.



Note: Both Zillow and Apartment List market based measures of rent have been lagged by 14-months. Source: Apartment List, Bureau of Economic Analysis, Zillow, TD Economics.

Many Central Banks Are Already Cutting Rates

In the meantime, an increasing number of countries have either started cutting interest rates, or are about to cut based on market expectations. This makes the U.S. a notable outlier and reinforces why the greenback has dominated this year.



Source: Bloomberg, TD Economics. Last Observation: April 2024.

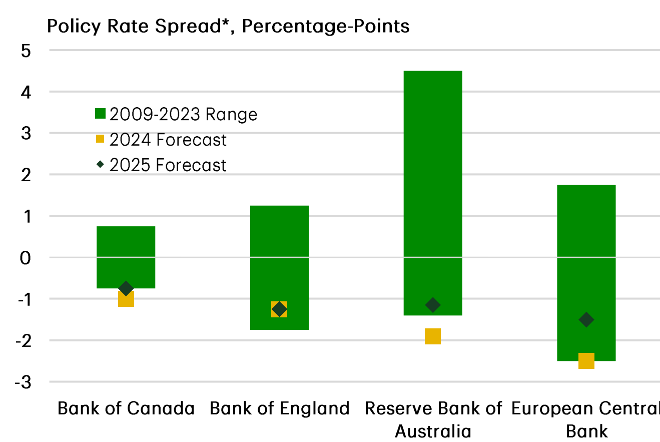
How Far Can Central Banks Move Ahead of the Fed?

And this has created a lot of speculation on how far central banks can stretch from the Federal Reserve to avoid counterproductive pressure on their currencies. This graph captures the high and low spread between the policy rates of the respective central banks with the Federal Reserve over the 14 years before the pandemic.

The two dots show where this relationship would sit if the Fed punts a rate cut to the end of the year, while others proceed as expected. All regions stretch to the outer part of the recent historical experience. And if central banks follow through with current market expectations, the gap in 2025 would close only modestly.

In our forecast, Canada would have a peak-divergence spread of -125 basis points for only a month if the Fed were to delay until December, and obviously less if they also cut in September as markets have currently priced. That spread would subsequently narrow to 75bps in 2025 provided both maintain a rate cut cycle with an end point for that year of 3.5% for the U.S. and 2.75% for Canada.

Historically, a negative spread of 100 to 125 basis points is sustainable for several quarters, but anything beyond tends to be short lived and would risk sending the loonie below the psychological 70 U.S. cent level.



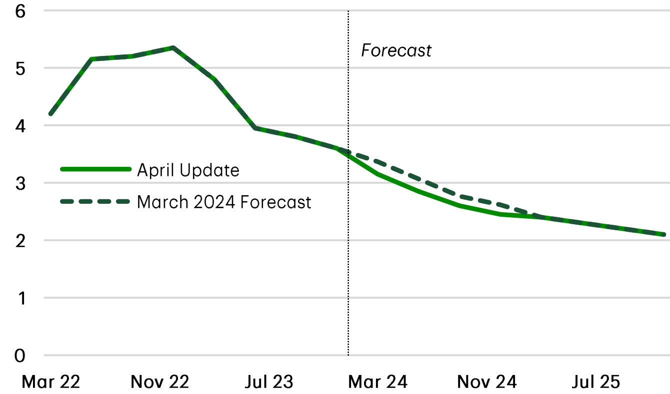
*Difference between listed central bank and Federal Reserve policy rate. Source: Bloomberg, TD Economics.

Canada Gets Favourable Surprise on Inflation

Turning to Canada, here's a glimpse on how inflation is evolving in support of the argument that the central bank can certainly cut interest rates ahead of the Federal Reserve, and by more. Clearly, this is a much different profile on the forecast change relative to the earlier graph shown on the U.S. inflation forecast, which was restated higher.

In the April Monetary Policy Report, the Bank of Canada revised down their total (headline) inflation projection by 20 basis points to 2.2% for year-end, suggesting they have to be a bit careful of an overshoot on the downside given inflation is expected to be treading close to target.

Canada Core CPI, Year/Year % Change



Source: Statistics Canada, TD Economics.

Bank of Canada Core Inflation Measures Falling Fast

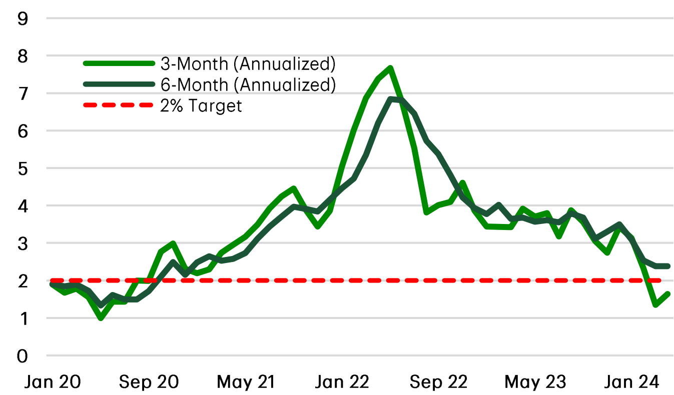
On this point, it appears that Canada's economic slack reached a point that suddenly created a pivot on price pressures.

This graph on the right shows a swift downward trend in the three- and six-month changes. The Bank of Canada would prefer focusing on the six-month due to less volatility, but both are moving in the same direction. Because the central bank has a formal target range of 1 to 3%, the next graph shows the share of items that are still above that upper end. This too is collapsing.

The one similarity to the U.S. is that most of the items above that threshold relate to shelter, which will be slow to change.

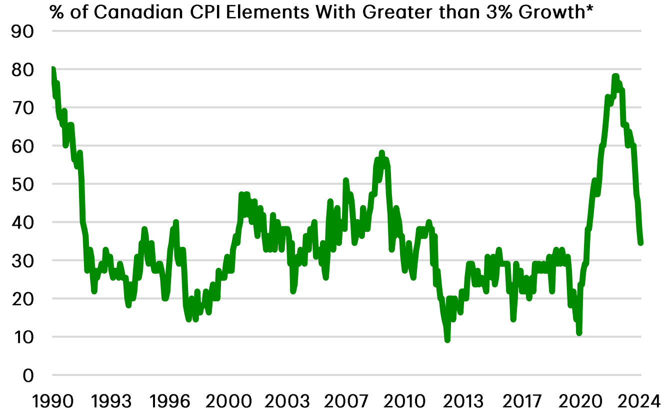
However, there is one fly in the ointment that could either delay a rate cut or slow the speed at which the central bank can normalize interest rates. It came via the April jobs report that had a shock-and-awe moment for markets. That blockbuster report produced 90,000 jobs...hardly a sign of an economy in desparate need of a rate cut.

Bank of Canada Core Inflation Measures*, % Change



*Average of CPI-Trim and CPI-Median. Source: Statistics Canada, TD Economics. Last Observation: April 2024.

% of Canadian CPI Elements With Greater than 3% Growth*



*Year/Year
Source: Statistics Canada, TD Economics. Last Observation: April 2024.

Evidence of Canadian Job Market Slack

But, that April report needs to be placed in proper context. Employer demand still wasn't large enough to drop the unemployment rate, which has risen a full percentage point in one year. This has never occurred absent a recession. That's because over 100,000 people entered the job market in April alone, as labor supply continues to surge on strong immigration flows.

If current trends continue, Canada will have stronger immigration inflows this year than last year despite a recent Federal policy to cap student entry. Because that cap doesn't kick in until September, we may be experiencing a front-running of the system that will be followed by a stronger drop off in the fourth quarter. It might also partially explain why among those 90,000 jobs in April, a massive 40,000 were among youth aged 15-24, where student hiring typically occurs. This was the largest gain since December 2022. Oddly, nearly all of the hiring was among men, which does raise some question on the quality of the data given the unlikely probability of being heavily skewed to a single gender.

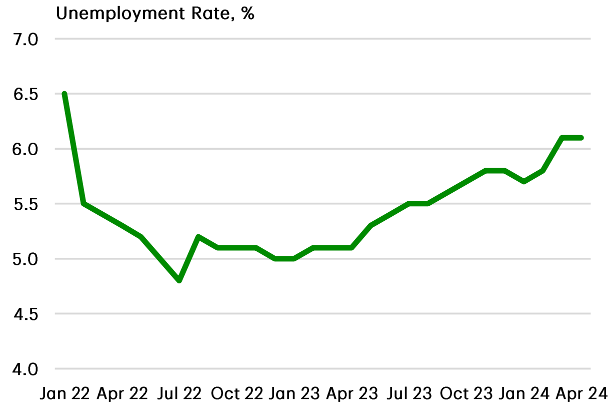
Ultimately, it's doubtful April's data signals a resurgence in job demand.

The second graph shows data from both labor market surveys in Canada to gut check against possible survey bias. The employer-based survey, shown by the solid green line, has a more determined downtrend than the household survey. But neither would materially alter the Bank of Canada's path. In any event, should the central bank wait until the July policy meeting, it will have two more job reports and more inflation data to help with that decision.

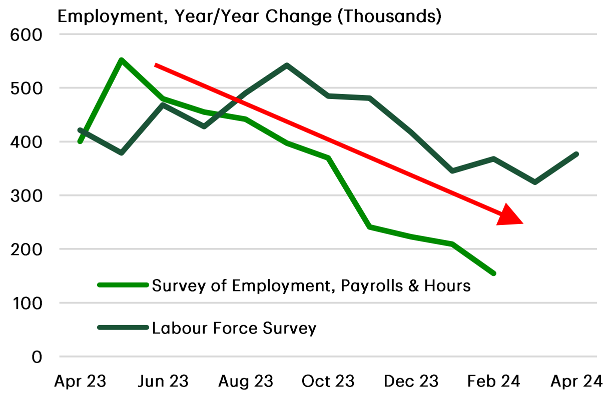
Within that matrix of data, they won't be able to ignore what this third graph is telling us.

Canada has as many people unemployed as what typically occurs at the peak of a recession cycle.

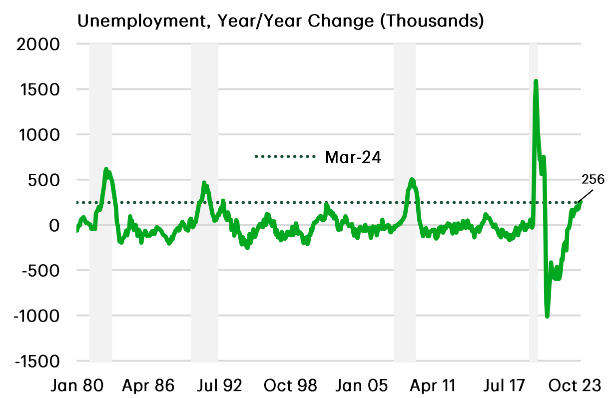
There's no question that labour market slack is building. But at the same time, a train wreck is not unfolding and the central bank can move in a measured way, which is why we expect only 75 basis points in rate cuts this year... provided inflation maintains its current trend!



Source: Statistics Canada, TD Economics.



Source: Statistics Canada, TD Economics.



Note: Grey areas denote recessions.
Source: Statistics Canada, TD Economics.

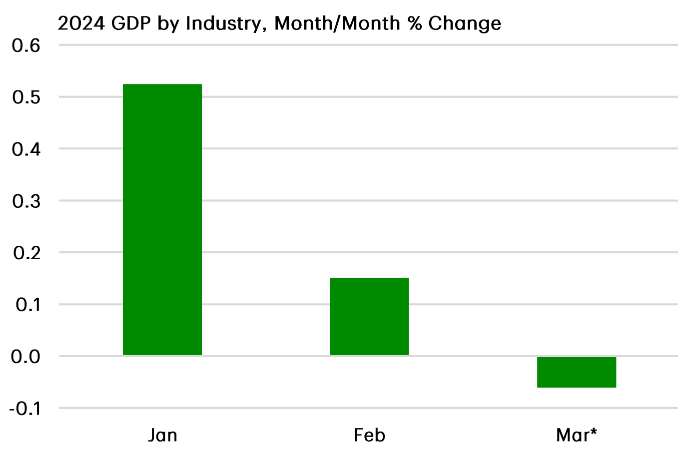
2024 Starts Strong But Looks Like A One-Hit Wonder

Contrary to how Canada's growth prospects have been portrayed up until now, real GDP in the first quarter is likely to surpass that of the U.S., which slipped below 2%. However, be careful when interpreting those headlines. Consumers came out of the gate strong in the quarter, but there's already plenty of evidence that momentum petered out heading into the second quarter.

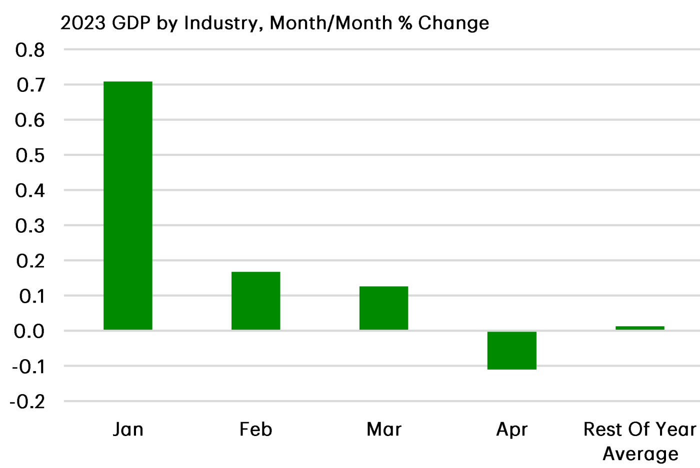
And this pattern appears to follow that of last year, marked by a growth spurt that quickly died out. This suggests there could be some temporary seasonal influences at play in the data.

Once again, historically high immigration flows offer the one caution on this "slowdown" narrative, which could return staying power to consumer spending (and inflation) as people settle into a new environment, even if other portions of the population continue to scale back.

Between December and April, 411K people entered Canada. This time last year that figure stood at 276K. This could mean a trade-off in growth patterns that are front-loaded in the first half of this year before student caps take effect thereafter to create a fading growth impulse.



*Flash estimate. Source: Statistics Canada, TD Economics.



Source: Statistics Canada, TD Economics.

Is Consumer Spending As Strong As It's Portrayed?

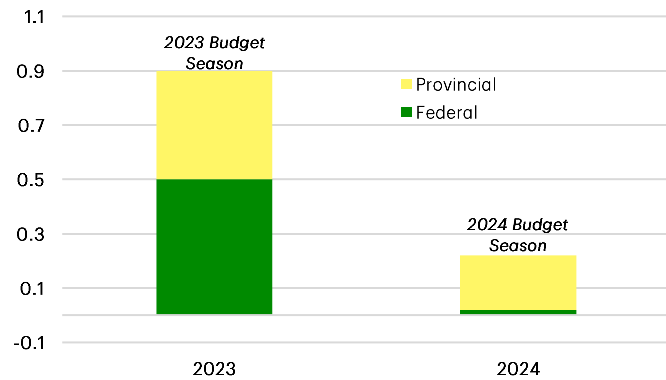
Ahead of budget season, many economists were cringing to see if governments would again complicate the Bank of Canada's job with highly stimulative policies. Governments showed some restraint this time around, but not completely.

The contribution to GDP is estimated to be much smaller this year at 20 basis points from combined provincial and federal budgets, which compares to 90 basis points last year. But at the end of the day, net government outlays are still running faster than economic growth, which can work against the Bank of Canada's efforts to fight inflation with other factors happening in parallel, like strong population growth.

As shown, much of the near-term fiscal push is coming from provincial governments, which have an element of necessity given the pressures of rapidly expanding population. Among the provinces, BC and Quebec showed the largest deterioration in finances, with Alberta at the other end of the spectrum.

Provinces were focused on expanding program spending and large-scale capital investment plans... like transit, healthcare and schools. On the federal side, $53 billion in new spending was largely targeted at housing and health care. Whereas provincial spending is more frontloaded, the federal government has pledged heavy new spending commitments later in the time horizon.

Contribution to Canadian GDP From Federal/Provincial Budget Measures, Percentage Points



Source: Provincial and Federal Governments, TD Economics

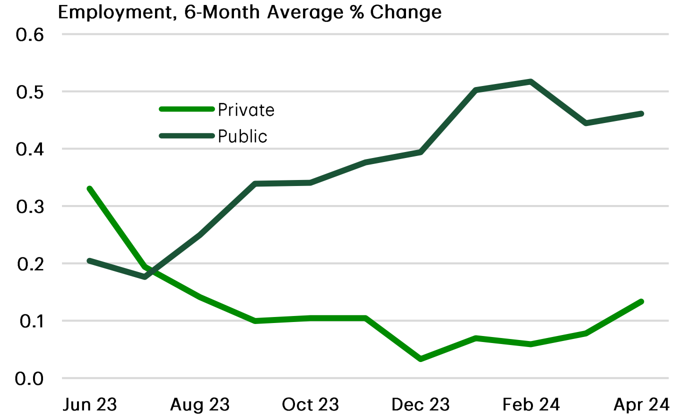
Governments Are The Most Active Employer In Town

However, there's more than meets the eye. There are many direct effects of announced spending in budgets, but also many indirect effects such as the hiring practices of governments. On this, job growth has not only consistently outpaced the private sector, but is also running about 7% higher than if the pre-pandemic trend had been extended. In contrast, the private sector is showing more hesitation on hiring workers relative to its historical reference.

The public sector is a board definition, referring to employees at all level of governments, including a crown corporation, or a government funded establishment such as a school (including universities) or hospital.

But the broader point is that just looking at budget spending underestimates the full effect of governments on the economy, let alone the multipliers that happen within the private sector on infrastructure spending and other items.

Employment, 6-Month Average % Change



Source: Statistics Canada, TD Economics.

Forecast Risk – Housing Pops

And, of course, the Bank must be a little nervous about stoking housing demand. There were many announcements on housing measures in federal and provincial budgets focused in the purpose-built rental space, but these are likely to only add marginally to housing supply in the near-term. Turning a policy into an actual apartment building takes time.

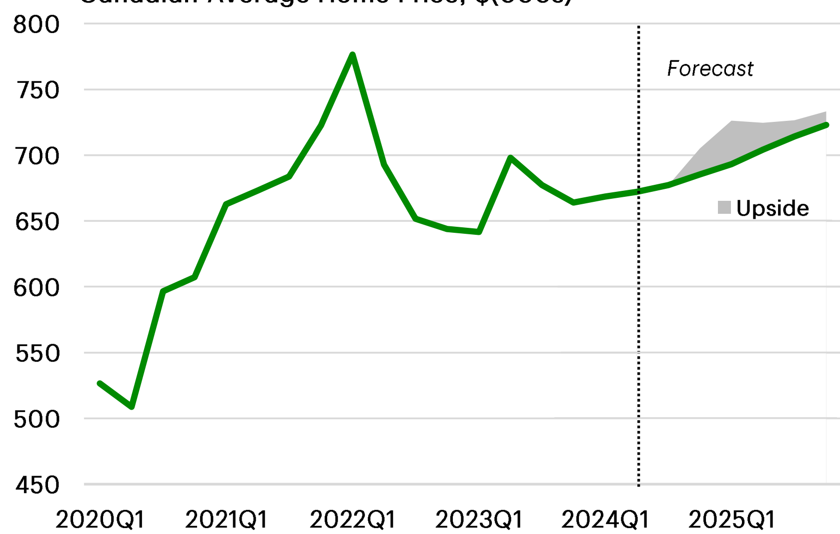
On the flip side, pent-up demand is going to respond more immediately, and we don't know for sure how much exists until the Bank starts cutting interest rates in a market that has been suppressed for over a year despite exceptional population growth.

In the Bank of Canada's consumer survey, it noted that intentions to buy a home in the next 12 months increased since 2023, which they speculate is driven by newcomers who have stronger buying intentions than other Canadians. This occurred despite expectations of solid home price growth and limited availability.

So this graph shows our price forecast by the green line, which reflects modelled outcomes based on affordability metrics and our interest rate profile. But it's hard not to feel a bit sheepish about how the risks may be distributed disproportionately to the upside.

The grey shaded area shows an upside surprise of four percentage points, which is roughly our forecast error when there have been extreme misses in the past. This has only happened three times and one of those was during the pandemic. Ultimately, this gives a glimpse of a potential miss once the Bank of Canada does embark on a rate cut cycle should it unleash significant pent-up demand. Anything that starts to trend towards our upside scenario would give them pause.

Canadian Average Home Price, $(000s)



Source: Canadian Real Estate Association, TD Economics.

Federal Housing Plan: Ambition Versus Reality

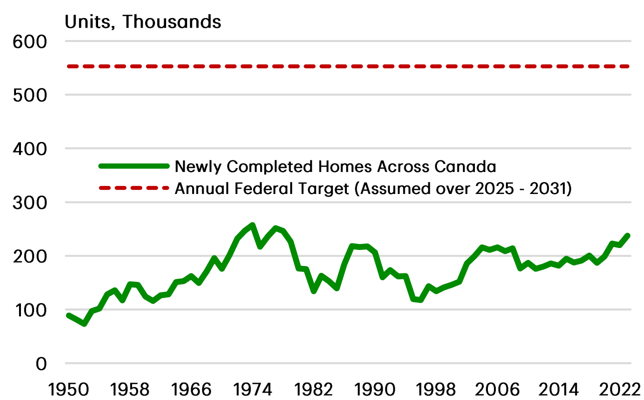
And it's hard not to think the risk is high. Government ambitions to boost housing supply are a tall order.

From the budget, Canada's Housing Plan rolls out measures that industry stakeholders have been desiring for years, like the topping up of funds for the apartment construction loan program, the housing accelerator fund, increasing the accelerated capital cost allowance from 4% to 10% for rental units, and many other measures.

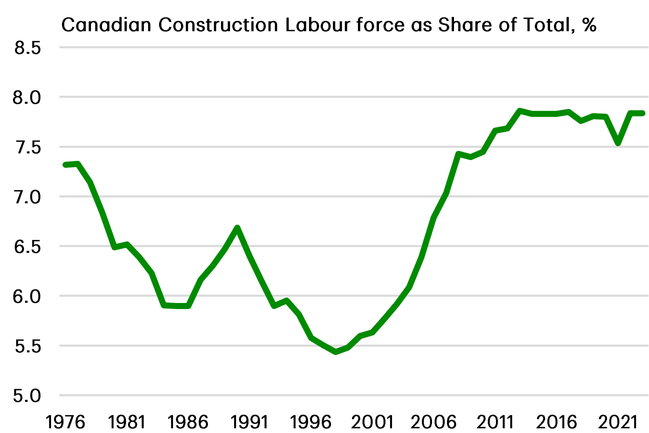
But the industry will continue to face challenges with labour constraints, marked by an aging workforce plus competition for workers from non- residential projects. There's already a high share of workers in this field. Despite this, it struggles on productivity.

Hitting the target for new homes in the federal housing plan implies 550k new housing units completed per year, more than double the historic maximum. The industry is already operating with starts trending at 242K units, which is not far from the all-time high of 270K.

This highlights the risk the Bank of Canada faces, as supply adjusts with significant lags while rate cuts spur immediate demand.



Source: CMHC, Federal Government, TD Economics. * Note that student and/or modular housing may be included in the federal target but aren't included in CMHC's housing starts. **2023 data is estimated by TD Economics.



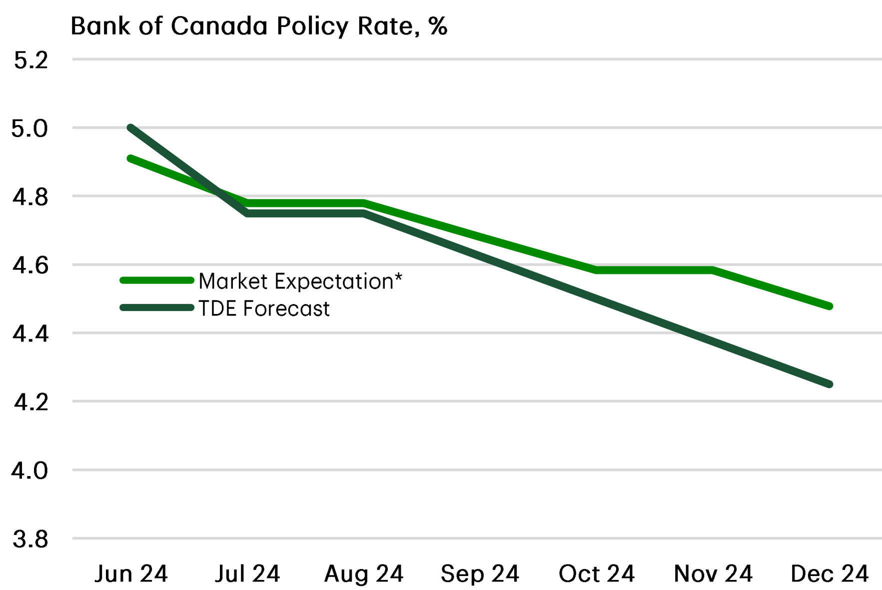
Source: Statistics Canada, TD Economics

Tempered Pace Of Rate Cuts

With all the push and pull factors on the economy, the pace of rate cuts is expected to be slow and measured, and it may not even occur at every meeting. The Bank of Canada could choose to move at every other meeting (12 week increments) to offer more time to observe key data points on inflation, employment and housing…while also casting an eye southward on their U.S. counterpart.

True interest rate normalization remains a 2025 story, where the central bank should have more success in getting the policy rate towards 3% by year end, provided some conditions hold:

1. Inflation does not back up on rising housing demand.
2. The U.S. is also in rate-cut mode.
3. Geopolitical events don't throw another loop in pressuring supply chains…be it wars or tariff escalation, with lots of unknowns still to come on the U.S. election outcome.



*Market Expectation as of May 9, 2024. Source: Bloomberg, TD Economics.