The Only Constant Is Change

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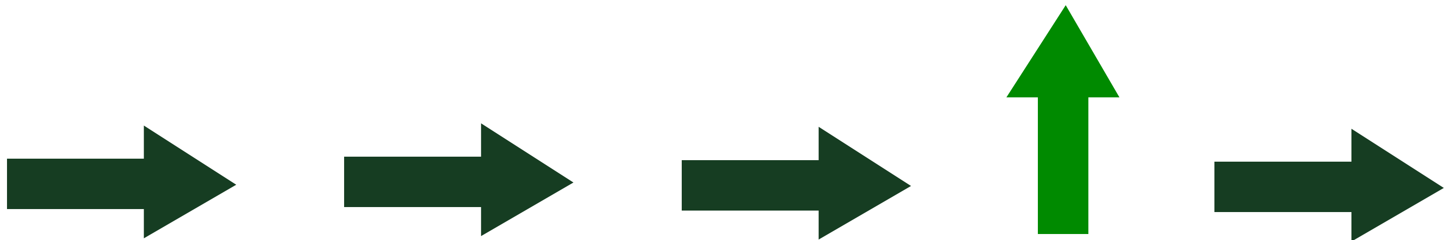


Overview

The 6th century Greek philosopher, Heraclitus, had it right with the idea that nothing is constant but change. He was referring to the universe and life, more generally, but it's an apt depiction of the economy.

After a long period of upside surprises to the economic data, markets are adjusting to a shift in paradigm. Fear moments will dot the landscape until confidence solidifies that the economic path remains a soft landing, and not a hard one.

However, recent developments are not a departure from our forecast. Clear signs of a slowing U.S. economy are a necessary condition for the Fed to cut interest rates, even as markets stay highly attuned to downside data surprises, particularly within labor market indicators.

On Canada, the bulk of the discussion will be on two topics dominating client questions this quarter: housing and productivity. These are intertwined more than many appreciate and can keep Canada at a disadvantage to peers on a longer-term basis, including altering expectations towards a lower neutral interest rate.

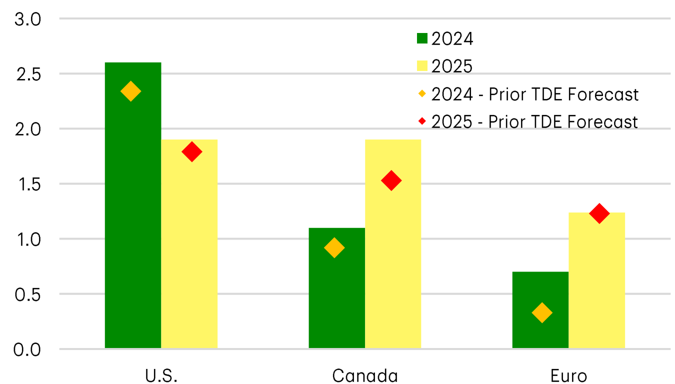
Forecast Evolving Largely As Expected = Growth Convergence

Jumping into the forecast evolution and whether the U.S. is nearing a recession path – this is quite a U-turn in narrative! Our prior discussions have been on U.S. exceptionalism. However, last quarter, I showed that the degree of economic outperformance to peers would need to be sustained for two entire years to truly meet that bar of exceptionality.

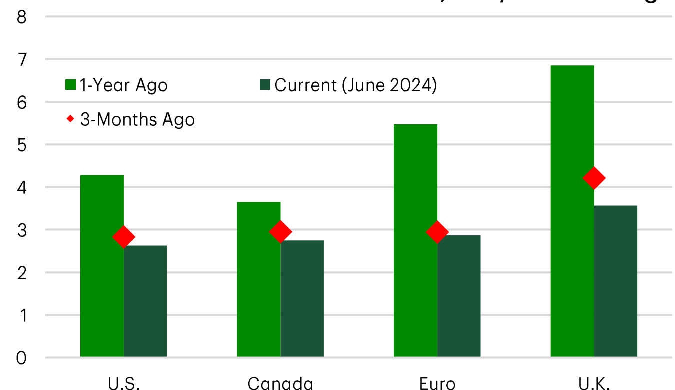
That's because global momentum tends to synchronize through the interconnectivity on trade flows and financial conditions. So although market chatter is rising on recession risks, I think we're just entering the turning point in the cycle that compresses some of the U.S. growth outperformance, but certainly doesn't portray a weak economy.

Our real GDP forecast is tracking 2% for the third quarter, similar to the Atlanta Fed and NY Fed nowcast models. This is not weak growth but is a long awaited return to trend. And relative to last quarter, we modestly upgraded our forecasts, not just for the U.S. but for peer economies.

With economic growth finally synchronizing, the U.S. now really stands out as the outlier in not commencing an interest rate cut cycle. Aside from having the highest policy rate, inflation trends have also synched up to peers. In other words, the minimum necessary conditions are in place for the U.S. to follow peers in cutting. The compression in global economic growth offers reassurance to that narrative.



Note: Prior TDE forecast = March 2024. Source: National Statistical Agencies, TD Economics.



Note: U.S. - Core PCE, CA - Average of CPI-Trim and CPI-Median, Euro & U.K. - CPI ex. Energy, Food, Alcohol, and Tobacco. Source: National Statistics Agencies, TD Economics.

As U.S. Data Surprises Also Flip To The Other Side Of the Ledger

Nobody can blame markets for being jittery, however. Investors are recalibrating expectations to data performance, and pivot points in the economic cycle always feel a bit jarring. U.S. data was consistently to the upside of market expectations until only about three months ago, when the tables turned. No wonder this past quarter has been characterized by large swings in yields, currencies and volatility more broadly captured by the VIX.

Source: Bloomberg, Citigroup, TD Economics. Last Observation: August 13th, 2024.

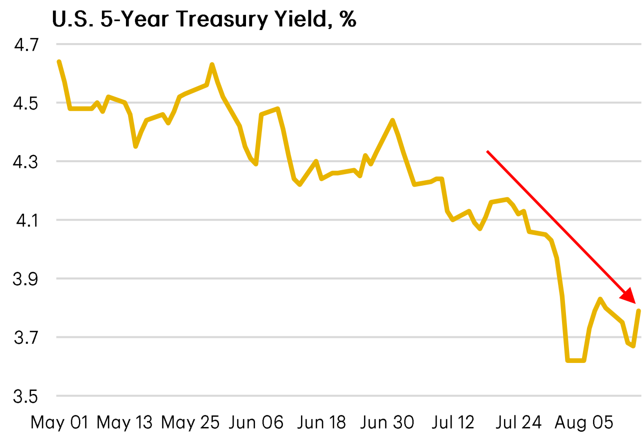
Markets React To Sting Of Disappointing Data

Until confidence builds that a slowdown is not the start of a recession, we could see more days or weeks captured by these graphs. The ongoing guessing game of the Fed's next move will swiftly manifest into yields and the greenback.

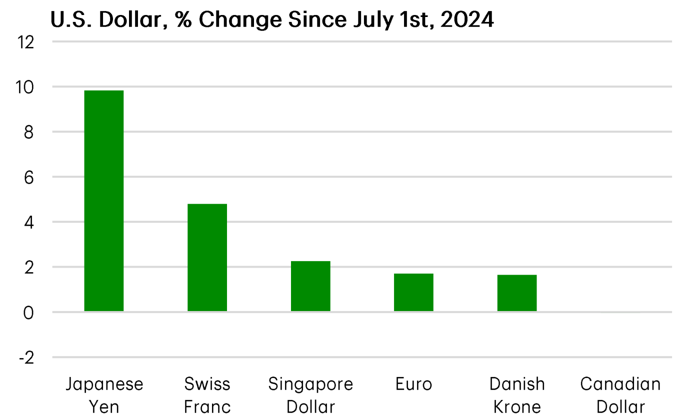
The U.S. dollar had an incredible first half of this year that pushed it up 5% on a trade-weighted basis. In a short period, its value came down 3%, largely on some unwinding of the Japanese carry trade, but not solely. Many other countries have been caught in the currency upswing as views coalesce around greater interest rate spread compression between countries on a more synchronized economic slowdown.

Canada's loonie is the exception. It has traded sideways to the U.S. dollar and depreciated against other peer currencies due to the offsetting impact of falling energy prices. We think there's a good chance offsetting influences will keep the currency within its current 72 to 76 U.S. cent range.

However, trading the U.S. dollar is rarely one-directional. It wouldn't be a surprise if the greenback regained some strength by year-end if market focus shifts back to geopolitical factors and flight-to-safety trades. We don't yet know what the U.S. election will mean for trade disputes, tax cuts, and prior geopolitical commitments made by America's leadership.



Source: Federal Reserve Board, TD Economics. Last Obsevration: August 15th, 2024.



Note: Data as of August 7th, 2024. Source: Bloomberg, TD Economics.

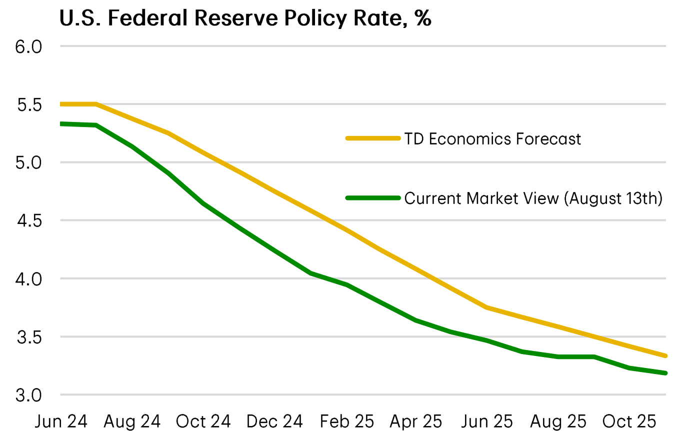
Markets Are All-In On Rate Cuts

In the meantime, markets have priced U.S. rate cuts with some sense of urgency, with 100 basis points by year-end even though there's only three scheduled Fed meetings. Basically, markets are signaling that the Fed is already starting on its backfoot and needs to catch up to avoid a deeper slowdown.

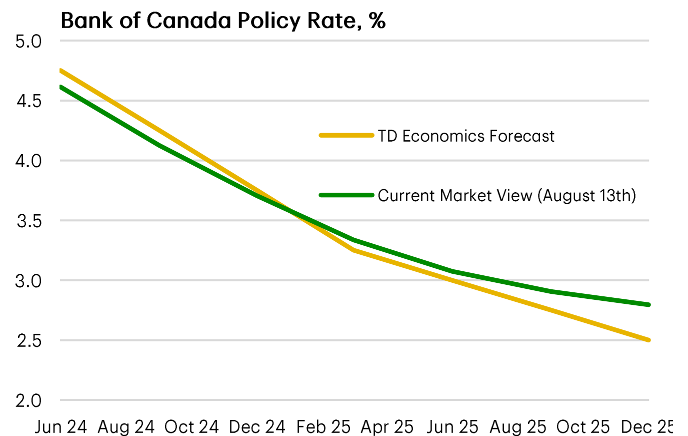
We penciled in an even pace of 25 basis points at each meeting absent a sense of an impending recession. And, from a practical perspective, there's an optics and communication risk for the Fed to start with a 50 basis point rate cut that could trigger even more aggressive pricing across the curve that gets too far ahead of the Fed's assessment of economic risks.

The Bank of Canada expectations are evenly distributed as 25 basis points at the remaining three meetings. There's more confidence on this view given they have already moved in similar increments in the past two meetings, which establishes a higher bar to alter the course. And the Bank of Canada is already at a starting point that's 100 basis points below the U.S., creating less urgency to 'catch up'.

The bottom line is that all major countries will be in ease mode if the Fed jumps on the rate cut band wagon in September....and then the discussion becomes about how low will rates go?



Source: Bloomberg, TD Economics.



Source: Bloomberg, TD Economics.

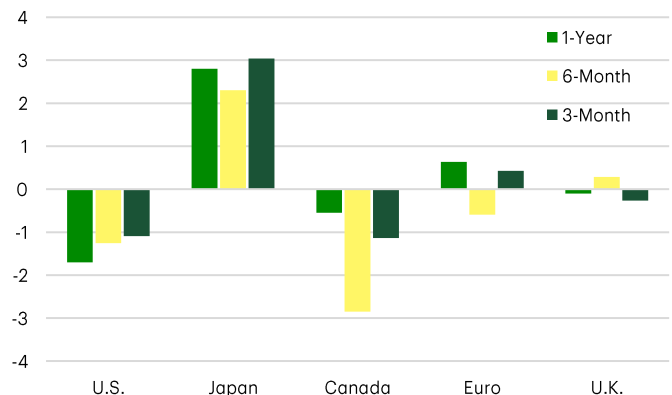
Cutting Aggressively Is A Risky Strategy With Bouncy Inflation

That answer sits in these metrics. During the last two quarters, the rapid decline of prices for physical "stuff" has led inflation lower (referred to as "core goods inflation"). The missing piece on inflation has been a decisive turn in service prices.

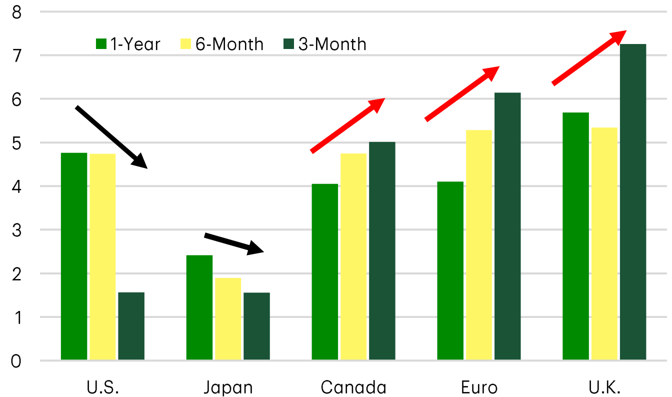
A slow descent is underway, but overall service prices remain universally elevated. In a perfect world, these prices would be expanding a full percentage point less than where it sits today.

Looking at the 3-month trend for clues on future direction, it's been favorable for the U.S., but not for other regions. The exact opposite story played out last quarter when U.S. inflation backed up while other countries benefited from a downdraft. This reinforces that the road ahead is going to be bumpy for service prices because consumer patterns have greater inertia.

So why are central banks cutting at all? One reason is that the share of prices that are rising by 3% or more now represents only 30% of consumer purchases in Canada and the U.S., which is consistent with historical patterns.



Source: National Statistical Agencies, TD Economics. Last Observation: June 2024



*U.S., Canada, Japan - excluding homeownership.
Source: National Statistical Agencies, TD Economics. Last Observation: June 2024

Trump's 2018 Tariffs Had Small Impact on Inflation, But Current Tariff Proposal Won't

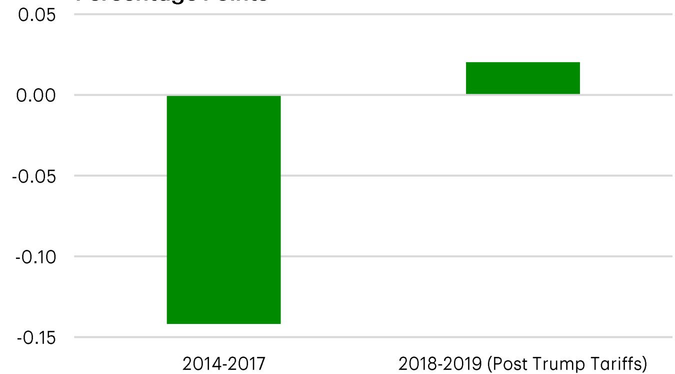
So what happens to inflation if former president Trump is re-elected, and the administration follows through with broad global tariffs, as high as 60% on China and 10% on others?

To understand this, we revisited Trump's past tariff cycle, which was modest by comparison and added about 10 basis points to inflation. It certainly wasn't disastrous, even as countries retaliated with tariffs on American products.

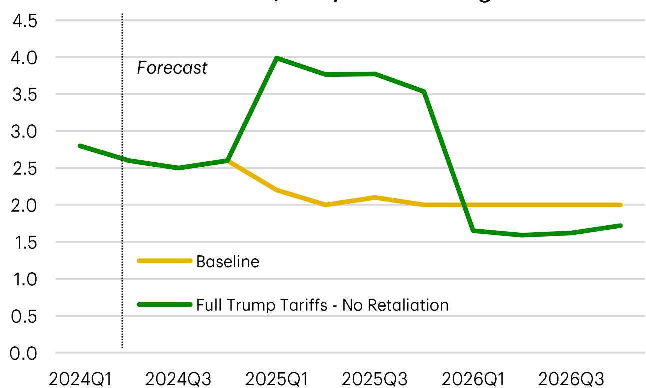
Remember the "great whisky tariff of 2018" by the E.U.? This was a 25% tariff in retaliation to U.S. tariffs on their steel and aluminum. It's a reminder of how isolated the tit-for-tat measures were in the 2018 and 2019 period, amounting to about $80bn in new taxes on products and impacting only 10% of U.S. imports, at their peak.

In contrast, the current proposal would bring the tally to more than $500bn in new taxes, with a high likelihood the countries retaliate. The E.U. is reportedly developing a two-stage strategy to first pre-empt possible tariffs with negotiations, and then, if necessary, to retaliate with targeted tariffs of 50% or more. Canada is thinking through a similar approach.

There's no doubt that a Trump administration would follow through with tariffs, but there's many possible combinations of events, such as what countries can negotiate, how long the tariffs stay in place, and whether carve outs would exist to prevent disruptions to American production.



Source: Bureau of Labor Statistics, TD Economics.



Source: BEA, Oxford Economics, TD Economics.

But in the meantime, here are some conclusions we can rely on:

1. The scale and magnitude would cause a meaningful lift to inflation.

2. Broad and deep tariffs would have the intended outcome of depressing demand for foreign products, but also dent U.S. real incomes.

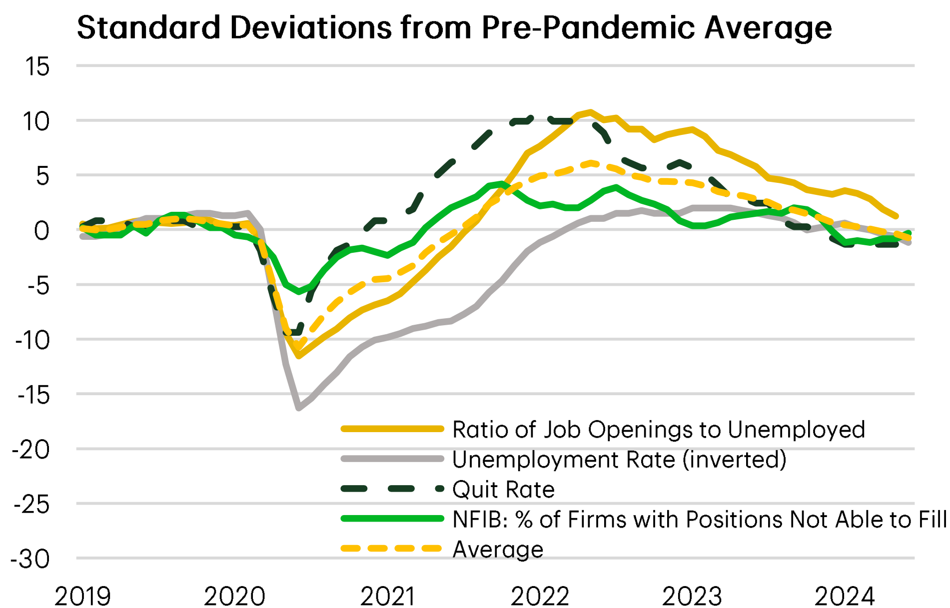
3. The influence on inflation may not stop the Federal Reserve from easing policy, but would likely limit how low they can go.

- For instance, when tariff wars were in full swing in 2019, the Fed still cut by 75 basis points because weaker domestic demand ruled the day.
- The policy rate is at a higher starting point this time, creating scope to the downside. But, getting to our estimate of the neutral rate (3%) could be tough in the absence of very weak domestic demand, which any administration would want to avoid.

Powell Says Labor Market Is Normalizing...Markets Fear The Worst

Turning now to the labor market dynamics that frayed financial market nerves in early August. The July employment data produced 114K jobs – not exactly portraying a falling sky. But that's yesterday's news and all that matters is what the job market looks like in 3-6 months.

On that front, this graph captures a broad set of labor market indicators, which leave no question that a cooler front has rolled onto American shores. Indicators have all normalized to pre-pandemic performances, creating a compelling argument to start adjusting interest rates rather than wait for all the stars to align on inflation. Doing so would risk the need for more aggressive action at a future date if too much slack builds in the economy.



Source: Bureau of Labor Statistics, NFIB, TD Economics.

Fiscal Supports Continue To Boost Business Investment

Now let's look beyond the job market, because there's a lot going right in this economy that helps to provide a counterbalance to market fears. I've been pointing out business investment resilience for about a year now. This is one area that continues to upstage predictions and even gained momentum in the first half of this year.

It's not the only area, so too is investment by all levels of government. State & local governments have spent most of the COVID relief funds, but there's still plenty to come from the Infrastructure Investment and Jobs Act (IIJA). These funds haven't even hit their full stride in economic impact. Recall, this is money allocated to rebuilding roads, bridges, railways, enhancing broadband access, and so forth.

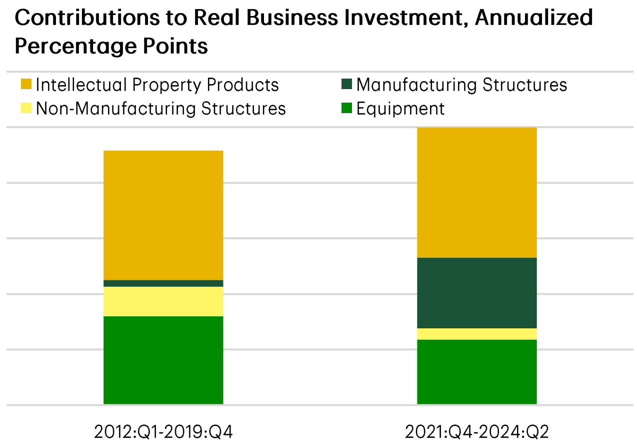
The CBO estimates that those funds will amount to about $60 billion in 2025, rising to about $70 billion in each of the next two years. That compares to $40 billion this year. Irrespective of the next President, repealing these funds wouldn't be easy, it requires an act of Congress. And although Trump has indicated an intention to curtail initiatives, many Republican states are using and benefiting from these funds.

The bottom line is that the economy is still experiencing a one-two investment punch, through both private and public sector spending initiatives. However, we are weeks away from an election that will force forecasters to revisit views once the new administration and composition of Congress is known.

Markets will be attuned to how well Congress will address deficits and debt. To not do so risks yields embedding a higher term premium as political platforms are executed. In turn, this would undermine the cost of capital and investment.

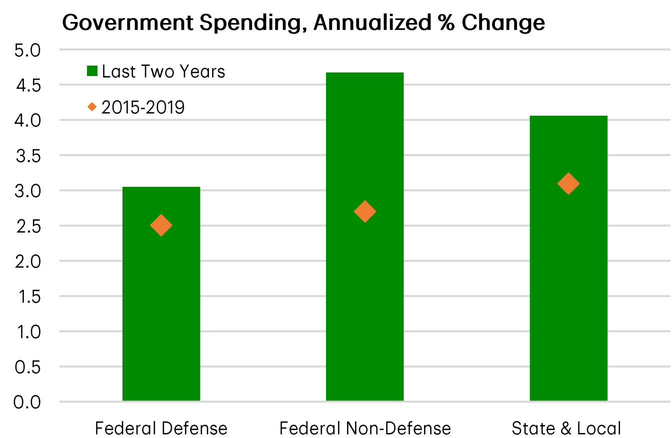
Clients often ask: when will deficits and debt matter in the U.S.? I wish there was a precise answer other than to say: it'll matter when markets say it matters, revealed by punitive financial conditions. This is what it takes to jolt governments into making the hard, and often politically unpopular, decisions.

Contributions to Real Business Investment, Annualized Percentage Points



Source: Bureau of Economic Analysis, TD Economics.

Government Spending, Annualized % Change



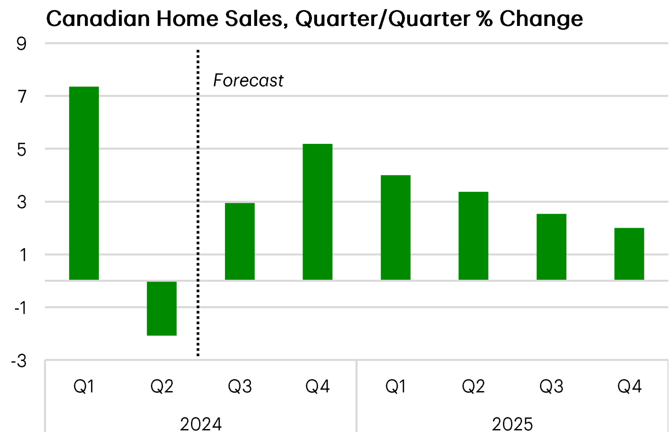
Source: Bureau of Economic Analysis, TD Economics.

Housing Revival Poised to Cushion Canada's Economic Growth

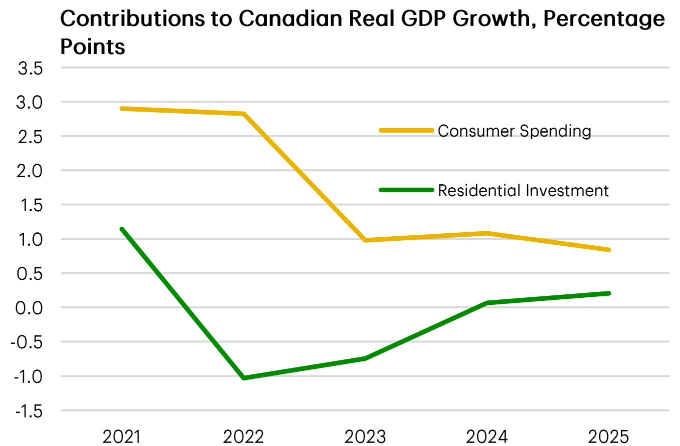
Switching to Canada, let's jump right in with the opposing forces between housing and productivity that are coming to define Canada to foreign investors and domestic clients.

As you saw at the start of the presentation, the economy is trudging along at about 1% this year, which is a function of narrowly missing a technical recession at the end of last year that created a weak hand-off. However, the tables turned in the first half of this year, as the consumer staged a comeback, albeit this likely reflected the feed through of high population growth.

The ultimate message is that the economy did not roll over and is now ripe to build a tail wind on lower interest rates, particularly within the housing sector. On that note, we have upgraded our forecast for housing activity into 2025 due to the swift repricing in bond yields. We should increasingly see the housing sector swing from being a major drag on the economy to a small contributor.



Source: CREA, TD Economics.



Source: Statistics Canada, TD Economics.

Downpayment Gifts Boost Demand And Price By First Time Homebuyers

Lower mortgage rates will help with poor affordability on the margin, but won't reinstate levels seen pre-pandemic. In addition, other dynamics could result in a stronger-than-expected rebound in sales and prices.

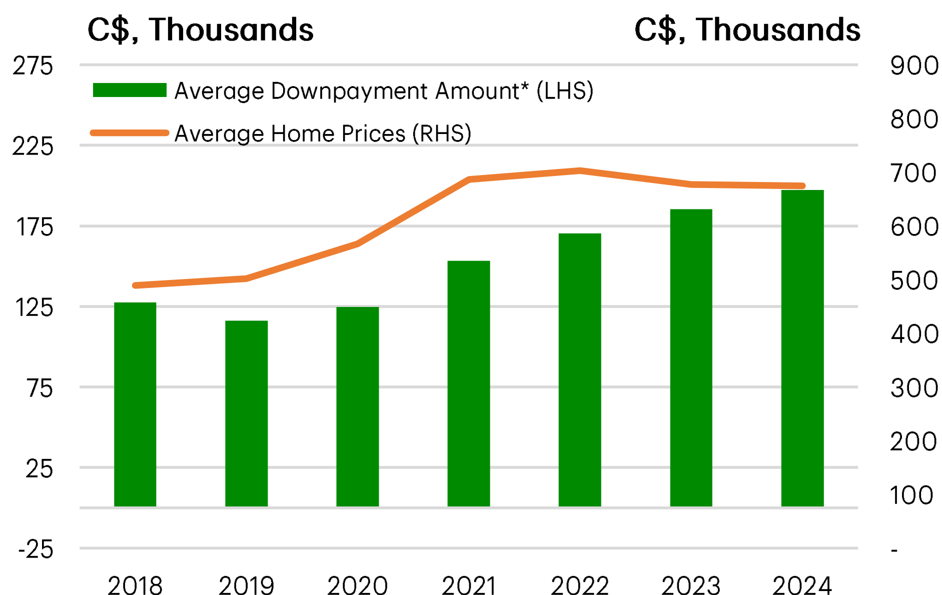
One of those goes back to research we did in 2022 showing how housing acts as a major vehicle of wealth accumulation, ultimately advantaging the children of parents who are homeowners. Those children are more likely to benefit from a wealth transfer that advantages them in becoming homeowners.

This graph shows how much assistance first-time buyers are being given for downpayments. More than one-third of first-time buyers receive gifts, the average age is 32, and those funds have kept pace with home prices. Since 2018, home prices have risen 40% and downpayment gifts have risen 55%.

Therefore, a lot of factors will be competing for the attention of the central bank as they assess the impact of monetary policy on the housing market:

- There's the usual impulse unleashed through lower debt service costs.
- Then there's the added impulse of pent-up demand created by Canada's historic population growth.
- But then there's another powerful impulse from wealth transfers that mitigate the affordability problem for a large share of buyers.
- And finally, there is a demographic push. People aged 30-34 have risen by 12% in the past three years, compared to only 4% in the three years before the pandemic. This is a key age for entry into homeownership

Simply put, the amount of pent-up demand is difficult to measure and could very well be higher than we think.

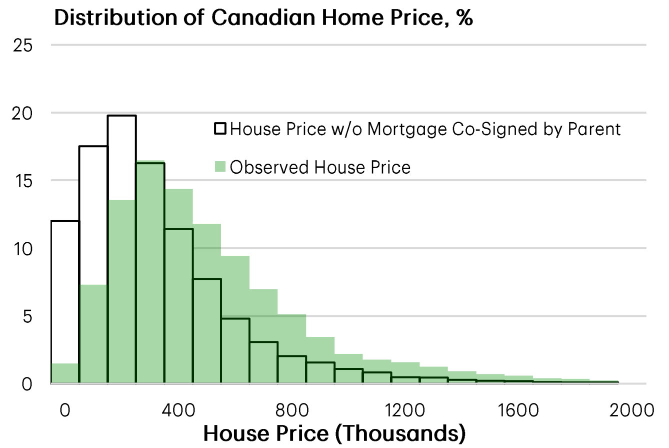


*Average for first-time home buyer applicants who relied solely on gifts for their downpayments. Source: Canadian Real Estate Association, TD Economics.

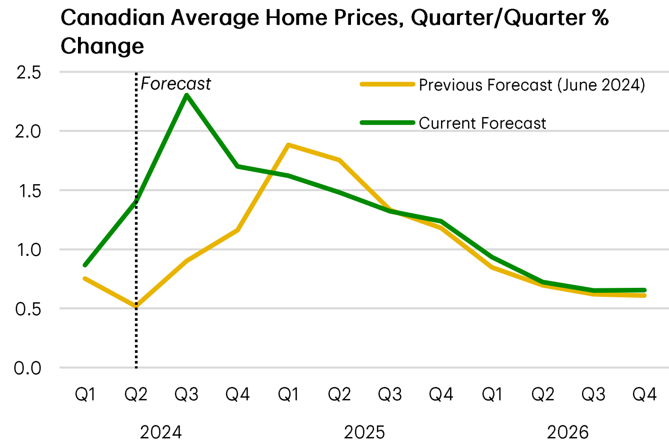
The Coiled Spring That Has Come To Define Canada's Housing Market

How much can the "parental advantage" impact prices? This data is pulled from a working paper at the Bank of Canada that looked at mortgages co-signed by a parent. Among the 11% of mortgages co-signed by a parent, 74% of those homeowners would be constrained to the point of having to purchase a home with the median price 34% lower without their parent's support. This graph on the right shows how the price structure would shift in their absence.

So even though we adjusted our forecast for the front-loaded drop in yields that will pull forward demand, 2025 may still serve up an upside surprise. If this happens, it could limit the BoC's policy stance from returning to our neutral estimate of roughly 2.50%, because it's not as simple as just measuring the direct impulse from interest rates.



Source: Bank of Canada, TD Economics.

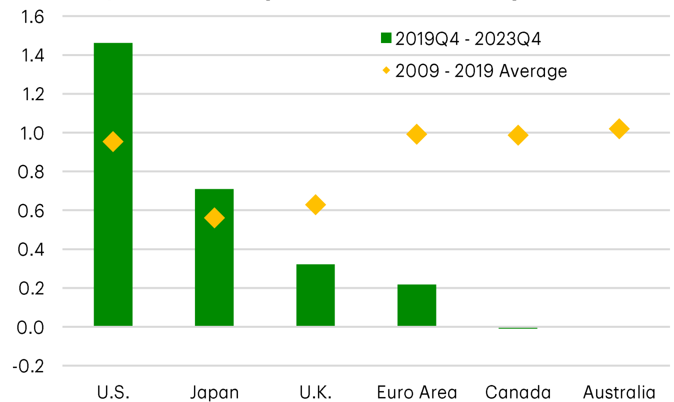


Source: CREA, TD Economics.

Structural Risks Deepen In Canada: Declining Productivity Requires Lower Interest Rates

You may now be wondering how this can possibly tie into Canada's weak productivity performance? Let's start with the big picture, where these graphs define the magnitude of the problem.

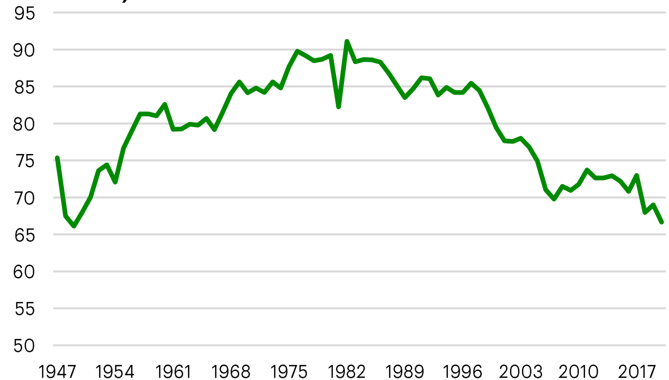
Output Per Working Hour, Annual % Change



Source: Bureau of Economic Analysis, Statistics Canada, Office for National Statistics, Eurostat, TD Economics.

Unfortunately, the word, productivity, suffers from a brand problem. When people hear it, they interpret it as less people doing more work. It becomes a hard sell for policymakers to get Canadians fired up on the concept, let alone to make the necessary financial sacrifices and policy adjustments toward solutions. But healthy productivity defines the extent to which an economy is dynamic, resilient and prosperous. And for ageing populations with public health and pension programs, it is essential to maintaining quality public services.

Relative Labour Productivity (GDP Per Hour in Business Sector) in Canada as a % of United States



Source: Statistics Canada, Bureau of Labor Statistics, TD Economics

So companies investing in Canada need to pay attention, especially if attracting foreign dollars gets harder and especially if a new U.S. administration makes Canada look more politically risky as a place to invest to gain access to deep U.S. markets.

For Canadian workers, they should be paying attention because living standards were lower in 2023 than in 2014, based on GDP per capita. And it's no coincidence that falling real median wages coincides with falling productivity.

That's why even the Senior Deputy Governor of the Bank of Canada said it's time to break the glass on Canada's productivity problem. Never in my career have I had more clients ask about it. The time is ripe for policy makers to get on this. But it could require a structural change in how we grow our economy.

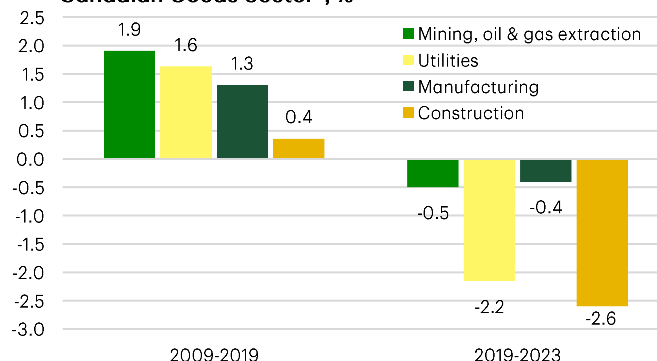
Construction's Declining Productivity Drags on Canada By Drawing In More Resources

A comprehensive TD Economics report on productivity will be coming in about two weeks, but in the meantime, these graphs get to answering the question of "why" the problem has worsened since the pandemic. We're only focused on the last four years, and what happens if this continues for another three-to-four years.

When we break out labour productivity by industry, it's evident that the problem has been broadly represented since 2019 within the goods sector. Many tend to point out the oil and gas sector because it has supported labour productivity in the past due to its high capital intensity. It's been experiencing falling investment and a reduced share of output since the pandemic. With the energy transition, the move away from this sector is likely to continue weighing on productivity growth.

However, a lesser discussed challenge is Canada's focus on construction investment, where productivity is consistently weaker than other industries. This is true not just in the past four years, but through time. It's also not a uniquely Canadian problem. Construction productivity suffers across countries, including the US. But, its effects are amplified in Canada by the disproportionately large amount of resources dedicated to the sector.

There are many factors at play outside of the commonly cited barriers associated with over-regulation and complex permitting processes. One of those is the disproportionate share of very small firms, where one-quarter have fewer than 20 employees. Small firms are slower to adopt new techniques and technologies than larger firms, and may face thin margins that further prohibits risk-taking and the piloting of projects. However, it's a tough sell to promote greater consolidation. Policymakers would have to think thru an incentive structure to reward growth towards becoming larger, which hasn't been the typical focus in Canadian policy.



*Excluding agriculture, forestry, hunting & fishing.
Source: Statistics Canada, TD Economics

Source: Bureau of Labor Statistics, Office for National Statistics (UK), Statistical Office of the European Communities (Eurostat), Statistics Canada, TD Economics

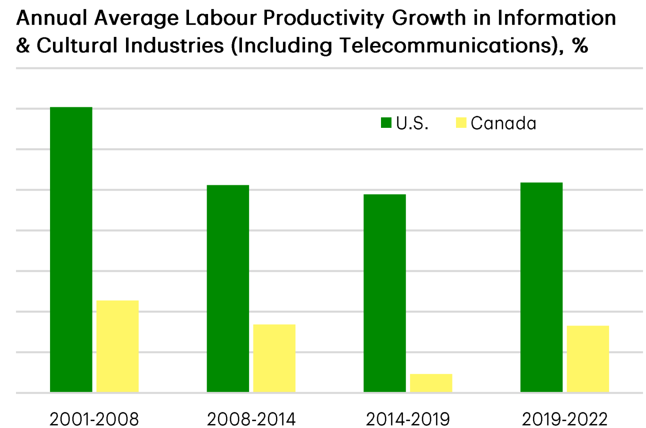
Canada Also Underperforming in High Tech Sectors

At the other end of the spectrum are sectors that are more tech-heavy that support Canadian productivity growth, but to a lesser extent than peers like the U.S., because companies are less represented, with generally smaller scale and scope.

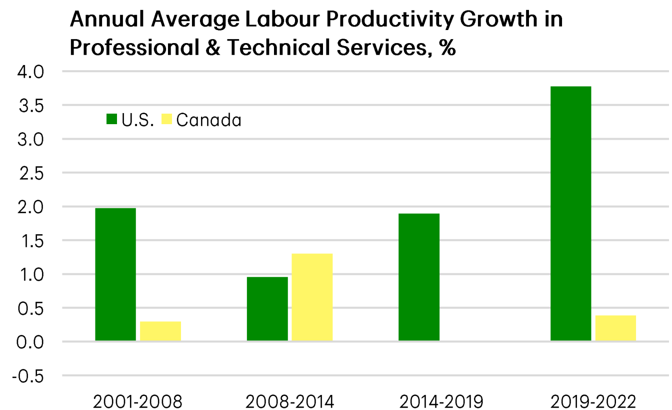
As these graphs show, some challenges are longstanding, like Canada being a laggard in adopting ICT. Not shown in these graph is the one sector that noticeably outperformed its American counterpart over the past decade and through the pandemic: finance.

Canada's current economic construct is geared towards putting more resources into construction over the next five years, which will amplify a weak productivity sector. And it's not clear that the representation of high productivity sectors will improve.

Now the million-dollar question is what this could mean for monetary policy?



Source: Bureau of Labor Statistics, Statistics Canada, TD Economics



Source: Bureau of Labor Statistics, Statistics Canada, TD Economics

What If Financial Assumptions Start To Embed Low Productivity?

The longer weak productivity persists, the less we can explain away aspects as one-time effects or anomalies, and the more likely it gets embedded into financial assumptions.

Our baseline forecast assumes productivity returns to 1% growth over the next three years, even though it's averaged -0.5% over the past three years. If we instead assume it stages only a modest recovery to be flat, it implies lower neutral interest rates and trend economic growth.

And a persistently wider interest rate gap to the U.S. would likely add downside weight to the currency. So this is still hypothetical, but certainly within the realm of possibilities and we will have to start considering this more meaningfully if a convincing productivity rebound doesn't form in next year.

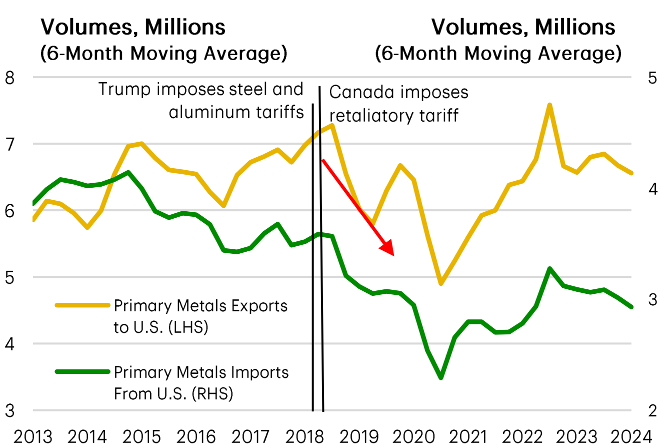
		Baseline	Zero Productivity Scenario
Average 2025-2027	Trend GDP	1.7 - 2.0%	0.7 - 1.0%
	Neutral Policy Rate	2.25 - 2.50%	1.25 - 1.50%
	CAD/USD Equilibrium	76 - 78 U.S. Cents	68 - 70 U.S. Cents

Policy Risks: A Lesson in Tariffs From Trump's Presidency

So that covers some of the structural risks within the economy, and I'll end on the potential for U.S. policy risks from the election outcome to upend the Canadian economy.

Regardless of who wins in November, global trade will have to contend with an America that's leaning into industrial policy and self-reliance. The key differentiator will be whether the new administration decides to "go at it alone" or works with allies on strategic sourcing initiatives.

A Trump administration is a bigger risk for Canadian trade flows given blanket statements on 10% tariffs and interest in revisiting the USMCA when up for review in July 2026 – albeit a Harris administration would also likely seek some alterations.



Source: Statistics Canada, TD Economics. Last Observation: Q1 2024.

Estimates on economic impacts are always going to be dire when there's sudden and large tariff impositions, but there is precedence to check on this logic and the magnitude of effects. Trump's prior tariffs on Canada were on strategic items, like lumber, steel and aluminum. As a result, it didn't have the scale to seriously undermine total trade, but did negatively affect the targeted segments.

This graph shows one of Trump's marquee tariffs of 25% on steel and 10% on aluminum, which were maintained for one year (May 2018-May 2019). During this time, Canada imposed a retaliatory tariff on U.S. steel and aluminum imports.

As the red arrow emphasizes, import and export volumes both moved immediately lower. A rebound didn't occur until the tariffs were lifted, which was subsequently interrupted by the pandemic. This is illustrative that a blanket tariff across many major sectors would replicate this outcome on a larger scale and immediately force mark downs within our economic forecasts. This is further amplified by the fact that since the USMCA was penned in 2020, Canada has increased its trade and, therefore, economic reliance on the U.S.

So to end, let's return to the words: nothing is constant but change. We're about to enter a period of many changes that go beyond just the decisions and the control of central banks and monetary policy.

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