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Transcript

Hi, this is Beata Caranci with the quarterly economic update.

I'll be touching on 3 themes today.

We've been getting a lot of questions about peak growth in terms of whether it's occurred and what does that mean for the economic and monetary cycle.

And for economists, it's a nuanced discussion that draws on the distinction between growth and levels. It's also a concept that's tide into the interpretation of the flat yield curve.

Is that a manifestation of weak economic growth expectations?

And finally, we may recall that last quarter I noted that we were entering this testing phase of the relationship between vaccines and the pandemic. I'll be highlighting some of these developments and the economic interpretation. Let's start with the peak growth concept.

It suggests that if the highest point is already in the past, incremental gains will be harder in order to come by and then this leaves less room for error on any shocks and this is where that flattening of the yield curve could be interpreted as a signal of a mid to late cycle dynamics. So, let's dig into this.

I agree that the first stage of the recovery is behind us. But, disagree that it's cause for alarm or concern for the first reason shown on the slide. As we move forward, there will be fewer times where there's large upside surprises to the data, but that wasn't a sustainable condition to begin with. And then lastly, we have not even begun the journey of policy normalization both on the monetary and fiscal side.

So, when we put these pieces together, it argues that there's still plenty of runways still ahead of this recovery and moving past the point of peak growth does not mean we're moving into a phase of low or no growth.

This slide illustrates the topping out of those growth expectations by the market after a period or analysts chase the forecasts in One Direction. It's now leveling off and being re-calibrated to new developments.

As you know, a big part of those initial upside surprises reflected being an uncharted territory. What would happen when four shutdowns occurred and then again, an uncharted territory when they were removed with all the government supports in place.

Or, were these forecasts have now reached a point where realistically there was only one direction to go in the balance of revisions, but by no means are we looking at low forecast. Market participants still place growth at two to three times the economy potential pace for this year and next. If these figures materialize, it means that the US would be in excess demand later this year.

For Canada, because of the economic shutdowns that took place over the spring, is slightly more delayed and we would be in excess demand position by the first or second quarter of next year.

So keep in mind that for both countries this is a kernel in the context of a policy rate that's still sitting at 0, meaning highly stimulative. When these conditions were last met after the global financial crisis, the policy rate in the US was at 1.75% and in Canada it was 1% and both central banks have long exited QE, which is not the case today.

It's important to contextualize the data and forecasts because annual figures hide the quarterly momentum and the nuances that can unnerve investors. So, this graph shows the contributions to US GDP from the various components of economic activity in the first half of this year, GDP average 6.4%.

Now, this was actually less than expected, despite it being a big number and the disappointment was not due to consumer spending or business investment. Because both of these actually expanded at a double-digit pace, the shortfall was entirely due to a sharp drawdown in inventories, which of course was a function of global supply issues.

There's two points to make on this forecast. First, as we go through the rest of this year, the forecast is stepping down and embeds a gravitational pull back to a steady state with each passing quarter. But, keep in mind, 2.6 growth at the end of this forecast is still above trend. Of course, the margin of error on potential downside surprises is naturally narrowing over time, and that would be a concern if you start to see large downside misses.

The second point reveals that, you know you can see where the risks exists to this forecast. We don't have an ambitious outlook for consumer spending.

The third quarter estimate is 2% for the US, followed by 4% in the fourth quarter. This is why that green bar shows a smaller contribution to growth on that component. We are relying, however, on an improvement in production and inventory levels, as the tension in domestic and global supply chains start to improve. And to that point, this gives an idea of just how low inventories have become in the US, keeping in mind it's not a phenomenon that's unique to the US.

Now, a good chunk of this is related to the auto industry, but not exclusively, and this is why even small movements in inventories can have meaningful impacts on growth because of that low starting point. Also it's often underappreciated that one of the benefits of removing business restrictions is that it shifts people consumption patterns towards services.

This rebalancing of demand away from goods helps ease the pressure on supply chains by allowing manufacturers to clear backlogs and restore inventories. Just for context, the pace of spending on goods is estimated to be between 15 and 20% higher than what our models would have predicted in the counterfactual world of no pandemic. So, an easing in sales on this front does not necessarily need to be interpreted as a bad sign of days ahead but, rebalancing from these stratospheric levels. So, while low inventories and supply chains present a forecast risk, there is a duality that this argument because as long as there's steady progress that is made, it becomes a larger net contributor to GDP in the coming quarters. And as you know, supply constraints are, you know, not isolated to the production side.

Labor demand has also been in a tight supply situation. This too should create a positive impulse in the outlook and maintain healthy growth momentum, provided the Delta variant of the virus doesn't completely upend business confidence.

So you know, record job openings offer a foundation of ongoing employment, growth and economic momentum so unique to the cycle, it's that the recovery has not been marked by employers being hesitant to hire, as we saw in the global financial crisis and tech bust. Rather, the cycle is still marked by employers complaining that there's not enough people to hire.

The other factor that lends some optimism that the recovery still has room to run is captured in these leading indicators on manufacturing. You can see that peak growth has occurred with these indicators, but they have also stabilized at very high levels. So, if you focus for a minute on the dark line that shows new orders relative to its history, does it look like it crested? Sure, it's been moving sideways for much of the year, but it's holding high even as producers make headway. Clearing the backlog of orders, which is now just starting to show up.

And I'm going to add in another slide, and the same story holds here. This is now on the service side of the quantum.

Now one caution is that the data in these graphs extend to July, so we'll have a better understanding the degree to which the Delta variant dented these metrics when we get the August and September data.

If the virus was at all material. Here the expectation is for these metrics to come down a bit, but as long as there's a healthy gap above the 50 threshold, it still reflects ongoing growth.

On that front we're scouring the high frequency data to look for cracks in the armor due to the steps of variant you may have seen in the media that the University of Michigan Consumer Confidence Survey sent up a red flare when sentiment returned to the low, seen in the spring of last year. Wherever that particular indicator doesn't actually correlate well.

With consumer spending, you know it's basically the difference of you know what people say versus what we do, but this graph does give some hints that increased consumer caution may be taking hold in the third quarter, especially in those lower VAX states.

It's early days and the overall data isn't compelling in terms of signaling a big downward shift in economic activity, but certainly there's a warning sign there.

I've just dropped in another line showing what the consumer pattern is amongst the higher vax rate. Now, these are seated diners at restaurants, so some measure of confidence and spending. In this chart, we look at five states with the highest vax rates and five at the lowest, where there's this data by open table unseated diner.

There's obviously the lower vax states have recorded a slowdown in recent weeks, providing some evidence of that Delta variant impact on behaviors we have to be a little bit careful though on how we interpret this data because other factors could be at play.

For instance, both metrics show a leveling off in the improvement, since about May now as before Delta really became, you know, a on or hit the radar of Americans.

And then we need to bear in mind that the lower vax states in that South also had fewer pandemic restrictions on businesses and consumers, so there may be less impetus for pent up demand relative to the north where these higher vax rates are now.

Anecdotally, individual airlines are commenting on weaker bookings this month, and some upside in increase in trip cancellations. But again, it's not yet showing in that TSA data of actual air travelers, so there's definitely smoke, but no fire.

Intuitively, it makes sense. There would be some cautious behavior taking hold in the US and in a nod to that risk we are building in some caution into Q3.

But at this stage it doesn't warrant a large downward revision because of all these push and pull forces with the other indicators, so it's likely that Q3 will still show growth in the five to 6% range, which leaves plenty of quick cushion if we get more downside surprises. Another possibility to think of is that we may not see a noticeable effect on the National Statistics but, there may be more bifurcation in growth between states. Those with low versus high vaccination rates and their relative growth pattern.

And if it's any comfort we saw the UK go through a stage of virus cases accelerating and a rise in hospitalizations their econonmy looked like it was pretty resilient through it all within London, there wasn't a collapse in seated dinners at restaurants or people visiting retail establishments.

Now Canada’s story is a bit different on timing. The economic growth takes place about 1/4 later, meaning the third quarter, and that's due to a later re opening by a number of provinces that had conducted these hard lockdowns over the spring. In fact, unlike the US which has had continual economic growth for over a year. The monthly GDP data for Canada showed economic contractions in both May and June. Now the high frequency data on this slide shows that July and August look very robust in making up for lost time, and we do expect GDP in that third quarter to advance by roughly 8%.

Obviously, we don't expect that to be sustained in our prior forecast in June. We had built in caution for Canada in the second half of this year, within the job market, because of the country higher tendency to be more reactive to lower levels of infection and hospitalized patients.

And,we will be extending that assumption into the fourth quarter, particularly as the flu season re-enters the picture as a new risk on hospitals and with international travel now loosening up. I also believe that Canada and the provinces, with the exception of Quebec, may be too slow and cautious and implementing restrictions for non-vaccinated individuals with in high-risk activities. Or too quick to remove the mass mandates in the case of BC and Alberta.

So, when you combine that with low hospitalization thresholds, well below their peers, there's a greater risk that a weakening in consumer confidence can materialize in those winter months regarding visiting restaurants or any indoor crowded spaces. And I'll go through this a bit more on the final section.

OK, I'm going to shift gears a bit and go into the financial data.

The Delta variant is certainly having a near term effect on the yield curve by both pushing down yields and flattening the curve. The 10-year Treasury yield dropped about 50 basis points between March and early August, getting as low as 1.17 %, that's clearly not all related to the virus variant because it wasn't yet quite within scope and with Americans, but it certainly was a factor thereafter.

10-year yields have edged up from that low point slightly, but are still fundamentally low relative to the economic progress that's occurred. You know our model projections that factor in assumptions around the term premium, the output gap, the policy path, you know they do place a 10-year treasury at about 2% by the end of this year, which is not particularly high.

But, that may seem heroic in the current context, so a few points to make here. First, history shows that spread volatility during the recovery is not an unusual phenomenon. There's a lot of uncertainty that market participants are still judging in terms of the dynamics of the data and the direction of the central. What makes this period anomalous is that we are seeing a combination of events that would normally conspire to push yields higher, not lower.

For instance, the NBER, which is the official statistical agency that dates recessions, has estimated that this is the shortest recession in history. The recovery has been faster than the priority recessions businesses have responded with increased hiring and double-digit growth and investment, and those complaints of insufficient workers and higher compensation. And we have all these restraints happening on the production side that has lead to inflationary pressures that are the highest since 1990s and then to top it all off in June, the Federal Reserve pulled four of their guidance on the expected timing of the first-rate hike to 2023, and now a consensus is forming within the Fed that QE tapering may commence this year by the end of this year or early next year.

So, I've just listed all seven influences. Any one of these on its own could propel yields higher, let alone all of them rowing in the same direction. So naturally you have to wonder if the bond market is telling us something ominous is on the horizon, but again, we can lean on a history here as a guide which shows that one recovery.

Still, in this testing phase, it's quite common for the yield spread to cycle ahead of central bank communication towards a tightening in monetary policy, and looking at the post global financial crisis period. Yield curve spread oscillated on three separate occasions between 80 and 120 basis points before the rate hike.

1st grade hike was communicated and occurred and I've highlighted one of those periods with that Red Circle on the graph. So, the narrowing was spread or a continuation volatility is not necessarily out of place for where we are.

In the cycle and Central bank communication, eventually the spread does narrow not because the 10 year is low, but because the curve shifts up and the two year rises. As markets reprice expectations on the policy rate and that's the period post taper tantrum in this graph.

However, the level of 10-year yield still seems too low, so the first place an economist you know turns to as a gut check is on inflation expectation and what's being captured in nominal yields. But as this graph shows you lower normal yields are not a function of falling or low inflation expectations. In fact, the opposite has been occurring and the risks are to the other side.

In fact, today's long term inflation expectations are higher than they were post global financial crisis by about 30 to 50 basis points at roughly the same point in time in the business cycle, which reinforces that there's other influences at work.

I'm just going to drop in another graph here, so this graph on the right shows the exceptionality of the low level of real yields. Our forecast only returns real yields to zero in 2022, which doesn't seem like an aggressive assumption. So, if it's not economic momentum or low inflation expectation, pinning down yields that just leads to other influences that are at work.

If we decompose the real yield into 2 main components, it shows that there's a downward trajectory occurring on the expectations of the Fed funds path and the real term premium. Each one of these have a lot of new nuances, but at a high-level shows where the pressure is occurring. Regarding the expected Fed funds rate, the embedded market assumption within the 10-year Treasury yield is for a policy rate of only 1% by the end of 2031. And, for context the Fed's Dot plot has that end point at 2.5%. And that's a really large gap to reconcile. It's fair to say that markets are materially underpricing Fed policy or you know the expectation relative to the Federal Reserve.

At the same time, it's not unusual at this point in time for the store occur because we have not yet received a definitive signal from the Central Bank on the path and timing. The Fed must first communicate their plan to wind down. QE purchases well before markets will reliably interpret the timing and level of the policy rate.

So there's a sequencing of events that needs to occur, and of course a material impact on both the term premium and the expectations for the Fed funds rate is the economic uncertainty being created by this Delta variant. So, I'll wrap up this section by saying yield volatility is common, particularly at this point in the Economic and monetary cycle. At the same time, yields do reflect a low level relative to the economic fundamentals.

And lastly, as the economy continues to expand, the market will re calibrate its Fed funds policy path as the Central bank communication starts to firm up.

Moving to the final section and the big question that lies behind everything I've presented so far, how are economies most likely to navigate the endemic stage? This is a question that really only applies to economies that have benefited from high vaccine access. So basically applying to Europe and North America. A large share of the rest of the world, and in particular emerging markets, remain very much in the pandemic phase.

The WHO estimates that vaccine distribution would be near completion by the end of next year, but with now countries announcing third doses like the US for the entire population, not just for higher risk individuals, this timeline could certainly be at risk.

So you're looking at GDP forecasts within the table to your right, and a comparison to last quarter and the graph on your left offers an illustration of the adjustments made to the forecast since last quarter, and there's two items of note.

The first is that 2021 and 2022, forecasts are still solid figures no matter the region. This is a function of coming off a little base in 2020, with more economies sustaining their reopenings as well as advanced economies as they make steady progress also helps the production and trade cycle of yens.

The second item of note is that the direction of the forecast revisions has been negative. While the outlook is little changed for advanced economies the spread of the delta a variant has hit a large group

of regions very hard, such as the region encompassing Indonesia, Malaysia, the Philippines, Singapore, Thailand.

So the first takeaway message of this endemic phase is that COVID-19 remains the largest risk factor in the forecast and it doesn't matter whether a country has had a high degree of vaccine access or not. It's the largest risk factor for all countries.

The second takeaway of the endemic phase is that the bar has not yet been set. When news first broke of the pandemic last year, various figures were being batted around that herd immunity could be achieved with vaccine thresholds as low as 60% if it's skewed to those who are most at risk of falling out.

Of course, as time has passed, those numbers have changed, as with each variant that comes through. And now we're seeing numbers as high as 90%, and it's not just 90% of the general population, but even getting broken down to geographic distribution be even across the country as well as within age cohorts. So the image on the light offers, third endemic takeaway, which is that systems that work during the pandemic need adjustment and can actually become counter productive during the endemic phase.

And the UK offers some lessons learned here, they have a robust contract and trace system, but they have come up against limitations as the population loses patience with the system and businesses cannot get into a steady state with their operations. So people have started to delete the app from phones because it becomes too disruptive to their day-to-day.

The high frequency at which the test and trace system is indiscriminately placing vaccinated and unvaccinated people into isolation caused pronounced labor and production shortages. The government subsequently pivoted to creating exemptions to the 10-day isolation requirement within certain workplaces, and frankly, it quickly became clear that the stop and go economy is, you know, not a workable model during the endemic phase, especially as government support systems, cannot, you know, be sustained indefinitely.

And this slide gives you a graphical representation of what I just mentioned. The “Pingdemic” was a clever term to describe the UK's of National Health services. Contact and trace app that would ping people to conduct their ten-day isolation period due to proximity to someone who tested positive. And you can see it reached more than a half million people at one point, hence the labor shortages that it created.

This graph captures the ongoing issues in shipping and logistics globally which are flowing out of various lockdown isolation requirements. Global container prices surged another 50% month over month through July. It's only now starting to ease, but from very high levels, so the endemic phase for our country doesn't mean it can successively avoid policies that lead to labor and production shortages within its own country, let alone the ripple effects created by another country like China and others that are still conducting hard lockdowns as a key tool to infection control. To reinforce this point, this slide shows the differential between producer price growth relative to consumer price growth within various regions.

They all look the same no matter what stage a country has reached on vaccine distribution. And although the US looks to have lower margin pressures, it also has the highest path through to consumer prices amongst these regions. So as long as producer prices are being pressure, this maintains a risk of further pass through two consumer levels even for those countries that are in that endemic phase.

So we know that higher vaccination rates help significantly limit hospitalizations, and this slide shows that getting to that 90% threshold is a long ways off no matter the country, particularly if it needs to be achieved across age cohorts. Now, Canada and the UK closest to that mark, but still a long ways from that goal within younger age cohorts?

The reason I'm showing the national vaccine vaccination rates as of July 1st?

First it is because absolutely UK virus cases we're climbing at this exponential rate, and so I'll just highlight some of their vax rates and the periods compared to Canada. Canada has not relaxed business restrictions to the extent of the UK, and higher has higher vaccination rates, so it offers a bit of hope that we won't suffer the same rise in hospitalizations, or at least to the same degree as the UK but we have to balance that view with this next slide.

This is the hospitalization rate of the UK and Israel as our two leader countries that we have been using throughout the pandemic to help gauge what to expect next. And you can see how hospitalizations have not peaked as high as their prior waves. Whoever Israel achieved this in part by RE imposing their green paths that meant only vaccinated people could get access to indoor credit events.

They also don't light touch on other restrictions. Kim does not have a green pass as a national measure, and even though there have been many recent policy announcements around vaccination requirement.

The execution of these policies still remains ambiguous and are often not coming into effect until October at the earliest, and we know that this virus is no threading the needle early, and decisive action is key, and the UK offers a cautionary tale for Canada, and I'm just going to drop in Canada hospitalization rates right now.

You may recall that last quarter I pointed to Canada very low hospitalization threshold relative to peers. So what's considered low hospitalizations in Israel and the UK would actually equate to Canada peak levels in the priority waves. When hard lockdowns went into effect and even military assistance was requested by two provinces.

So even though can has slightly better starting points on vaccination rates, it doesn't remove the risk that we could be in for another iteration of business restrictions. If quick progress is not made on preventative policies. And that's probably one of the biggest pandemic takeaways that's being observed.

A key economic tool has become the broad emergence of domestic vaccine pass. Sports and vaccine mandates.

Last quarter I had noted that there was a growing implementation of international vaccine passports for the entry into a country and at that time there was only experimentation occurring with domestic vaccine passports. You know, minimal take up with the exception of Israel. But certainly now that's changing and it's evolving into a more acceptable tool if it means not having to close your business.

However, both can the US show a very fragmented approach regionally and so it continues to argue that there could be this multi-phase pandemic period marked by a lot of trial and error.

And then I'll just go to this last slide, closing the presentation with the other tool that's being deployed where governments have failed to provide a, you know, a cohesive regional or national structure corporations have taken the reins and this list just keeps on growing with TD now added to this list so

you know the new normal in the endemic phase is definitely one defined by a strong resistance to a return to business lockdowns and this requires using every means possible.

Those regions that deploy both tools like in New York City, for example, have a better chance of maintaining business operations. And the confidence of consumers to venture into restaurants and other establishments once that winter and flu season arrives, irrespective of the political or ideological lean.

From purely an economic perspective, using every means possible on leveraging vaccine requirements is a preferred.

They'll come towards a more sustainable recovery, while also limiting the strain on government, household and business finances, and this may be more true in the case of Canada than the US because of that difference and their historical reaction functions to the virus. So, I'll leave it there and thank you very much for your time.