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Transcript

Hi, this is Beata Caranci with the Corley economic update, so I'm going to push the boundaries just a little bit with this presentation. Analysts often point to the resilience of the global economy, and the US is a standout on that narrative. So, I wanted to explore with you whether the US has tripped over the boundary of resilience and moved into exceptionalism.

Which require some permanent defiance of economic laws, and if it has done so, it carries a very different implication for the policy path.

For the US to truly be on a path of exceptionalism, it requires a deceleration of inflation, absent economic pain.

Now, last month, Fed chair Paul said they don't see strong growth as a problem to inflation and winding, which really challenges even the notion of a soft economic landing. Are we in the world of a no landing or some sort of glide path, and if so, how sustainable could it be?

And then there's the Bank of Canada, which is caught in the opposite world of a deteriorating economy and a slow deceleration inflation, perhaps bringing to mind a classic stagflation scenario.

Now we finally caught a break with the January inflation data, surprising to the downside. But one month is not a trend make, and it's definitely not going to be yet enough for the Bank of Canada to take that leap forward in lowering the policy rate to resuscitate the broader economy. My main concern is how long they stay boxed in by high shelter costs, that prevents them from right fitting monetary policy to the performance of the rest of the economy.

So, let's start with an updated graph from last quarter to capture the growth diversions of the US to other countries.

That divergent was expected to narrow in the first half of 2024, and early indications is that is in fact happening, but not to the degree forecasters expected, including us.

So that dashed line I just dropped in over H 2/20/23, is our forecast from last quarter and once again a demonstration of the US outperformance to expectations.

The Dash line over H 1/20/24 is our forecast for the first quarter, which is once again tracking higher than expectations. As you can see in the text box, US GDP growth of 2.3%. this year we'll nearly match last year's pace. This assumes a step down in growth as the year progresses, which you know these days has become a forecast for us given the exceptionalism that continues to be displayed.

As for Canada?

That dashed line shows an economy that underperformed our expectation last year, but this deviation is well within the margin of error and did not alter our 2024 outlaw. And the same is true with other regions in Europe.

So, I'm not mincing words with the title of this slide. Other countries are conforming to model dynamics as the pandemic distortions recede. This means that traditional interest rate dynamics are carrying more predictive power. This is not the case for the US, where the misses on the forecasts have actually become larger, and I've characterized them as embarrassingly large, given the stage of the economic cycle, that should produce more intuitive. So, the gray bars represent the range of analyst views for jobs and GDP growth.

And here's the actual data overshooting even the upper end of people's views. These misses are a standard deviation or more.

So, it makes sense that the US economy is the only one that's still in excess demand, while other nations have moved into economic slack.

And given that the US GDP growth is tracking just north of two per cent in the first quarter, it will take time for this economy to be in a position where supply outstrips demand. This generally requires growth rates, with one handles on them.

We have this within our forecast in the second quarter and beyond, but actually are quite nervous because the US keeps defying gravity. And if you're wondering why Canada shows more economic slack than Europe, that's because Canada's population growth is more than three times greater, and this creates a higher level of potential GDP growth that we have been undershooting.

Now, given how much the US is standing apart from peers, it's less intuitive than all regions are experiencing similar downward movements in inflation, irrespective of the amount of economic slack. This reinforces the belief that the first leg down on inflation was largely related to the unwinding of supply side factors with the healing of the post pandemic recovery.

And the reason people say the second leg down to 2% will be hard fought ground is because it returns to the view that this requires us sinking up of traditional economic dynamics between supply and demand. In other words, some degree of economic sacrifice.

Which brings me to this slide for both the eurozone and the UK economics lack formed so quickly in the second half of 2023 that the three-month trend in their core inflation metrics completely collapsed towards the 2% target.

The US was trending favorably on the three-month trend and looked like it was coming in for a landing until it recently got lift off again.

And then there's Canada, which is a true anomaly. It is in a position of economic slack, and yet had one of the least cooperative inflation dynamics until that little ray of hope came through in the January data.

So, what's going on?

If you look to the right, all the progress on inflation for the US has come on the back of declining prices for goods products like furniture and clothing prices on services haven't budged and actually accelerated in January. This makes sense in the context that the US economy remains in excess demand.

The reason prices have collapsed so quickly in the euro area and the UK is because there has been capitulation in the prices of services where core services are running at 2.6% compared to 4.6% in the US. What's particularly interesting is that markets are pricing in roughly the same timing and amount of rate cuts no matter the country.

The US rate cut expectation is currently sitting at June, as is the ECB and the BOC, and the BOE oscillate between June and July. This doesn't seem entirely consistent given the different backdrops. Perhaps it's more likely that the European banks cut earlier than markets anticipate, or that the US goes later or by less than markets are expecting.

And we can't dismiss geopolitical risks. The escalation of Israel and Hamas tensions to surrounding regions is pressuring shipping costs by rerouting cargo away from the Suez Canal towards the lengthier route to grow around the Cape of Good Hope. The diversion has pushed up container freight rates between China to Europe by around fourfold since October, and it has doubled shipping rates from China to the US now that uptick looks dwarfed compared to the pandemic period. But these are sizable shifts that indicate an elongation of supply chains is occurring once again. And given that US inflation is solely decelerating on reduced prices for goods products, this development is not good. The disinflation enforces that a benefit to advanced countries may start to unwind.

And this place is even more emphasis on what's happening in this slide. Productivity and inflation are two sides of the same coin. If an economy can produce more with the same volume of inputs, then they succeed in exerting downward pressure on prices. This is the only way to square the circle and how a country can sustain strength and jobs and economic growth, and simultaneously have less pressure on prices. And when it comes to productivity, the US is exceptional to its peers. It's the only country where the average growth of the past four years is still outpacing its historical average.

But, to hold the claim of exceptionalism, the outperformance needs to be sustained. Unfortunately, when Fed Chair, Powell was asked about this, he expressed skepticism and believes that the US will return to where it was pre pandemic. So, let's take a look at what that that looks like.

Powell is referring to this period between 2012 and 2019, where productivity growth averaged just over 1%, productivity shifts have key characteristics during recessions, so that extreme up and down pattern that you see following the global financial crisis is a trademark pattern of every economic shock. Firms prioritize capital investments in the early stages of recovery, and then the dynamic switches to labor force normalization about two years out.

So, we're really focused on what happens to productivity growth three years beyond the shock, which is the pocket we're now in. And unfortunately, history isn't as consistent a guide on this front.

This is the pattern of the 1990s, the era where basically the world came online via the World Wide Web, high speed Internet access, personal computing, power improved. And basically, we ended up with the development of the digital infrastructure. So, today's proponents of AI, transformed of powers, would argue that the future of America., probably looks a little more like this period. However, we just don't know and only hindsight we'll be able to give us this answer.

It's an important area of discovery because the path matters for the trajectory of interest rates. If we are on a higher permanent trajectory, then we estimate the neutral Fed funds rate would be at least three and a quarter and possibly higher. This implies that the Fed has a shorter path on rate adjustments and

can wait longer for embarking on that journey. But if Powell doesn't believe this productivity boost will be sustained by extension. It means that the economy must slow to sustain inflation at 2% and the operative word there is "sustain".

Which seems at odds with one of the biggest areas where we had an adjustment in our forecast for the US, which is the unemployment rate. Now. The graph on the right is Canada and your eyes are not deceiving you, there are two lines plotted, but they are literally on top of each other because our forecast is behaving as expected and requires no adjustment. As for the US, we continue to anticipate some slack to build into the labor market as employers temper demand, but we have less confidence that will come via meaningful job losses.

This means that tight labor force becomes the limiting factor on the extent to which the unemployment rate can rise, and this is the exact opposite story of Canada, where much of the anticipated one percentage point lift in the unemployment rate this year is due to the labor force outstripping job demand by about a factor of 2.

However, and can and we have also built-in a forecast with job losses, which is a little harder to envision for the US because of this next graph.

A big motivator on the US forecast change is related to a very slow normalization in job openings, far slower than what history would guide.

This slide captures the inverse relationship between job openings and the unemployment rate. Economists often refer to this dynamic as 'The beverage curve'.

Here's what it looks like today. Although job demand has come down 2% points, which is more than what we saw in the prior 2 periods, the unemployment rate hasn't budged. And that's an area of true exceptionalism.

That's because it's not just about direction, but also the starting point.

The job opening rate is currently sitting at 5.4%, which is still 2% points higher than the peak of both of the previous cycles. So, the unemployment rate can't rise meaningfully if until at least hits these initial thresholds. And we're still a little way off from that moment.

So why do we still hold to the tenet that the economy will slow in 2024 as each quarter moves forward?

There is some groundwork already being laid.

As time passes, higher interest rates are leaving a mark on household finances, despite solid job conditions. First of all, consumer spending is now outpacing income by a wide margin, leaving households increasingly reliant on credit. And this is evident by the rising credit card utilization rates.

Likewise, the savings rate has plummeted and is below levels observed before the pandemic and then an excess savings for low- and middle-income households is largely exhausted. In addition to millions of households now resuming student loan repayments after a three-year moratorium, payments to the Department of Education have increased fivefold since the Supreme Court decision and the end of forbearance last year. And lastly, as the slide shows rise in delinquency rates suggest some strain is reflected by select households. In other words, the lags from interest rates into the economy are certainly longer in this cycle but have not disappeared completely as time goes on consumer spending

has fewer extraordinary growth impulses to draw from. But again, all this still speaks to either a soft landing and potentially even still, that glide path camp.

That's because there's no sense that a Cliff is in the waiting, and that's why our forecast on consumer spending doesn't reflect a retrenchment and financial markets are quickly adjusting to this reality.

In mid-January, markets had priced 134 basis points in interest rate cuts by year end and by mid-February that stood at about 90 to 100 basis points. Now our view had always been centered on no more than 100 basis points and a later start period for when those hikes would occur towards mid-year. So effectively the markets views and ours have now collapsed onto each other. Remember, the Federal Reserve has only penciled in 75 basis points and cuts this year, so we may still be on the upper end of what's possible given the degree of economic resilience, the lack of capitulation in service prices and the risk that the deflationary benefit of good prices comes to an end under geopolitical risks.

Switching to Canada's inflationary landscape, it actually has several parallels to the US we've seen a significant reduction in the number of products with prices expanding by 4% or more. Although the share is still higher than what we saw pre-pandemic.

And then what, I have just dropped in is at the other end of the spectrum, there is also been a jump in the number of products in deflation and for candidates, even more so than pre pandemic, this is all good news, except unfortunately for Canada, it suffers from a distortion in the measurement of CPI due to a heavier emphasis on shelter costs than pure countries. Higher shelter inflation is the single biggest factor preventing the BOC from achieving its 2% inflation target. Shelter accounts for two-thirds of the products and services rising over 4% within the bank account as preferred core inflation metrics.

This graph shows the manifestation within their preferred trim and medium metrics. So, let's for a moment just take a step back and talk about what's so unique for Canada.

Shelter-cap captures rent costs, as do other international inflation metrics, so there's nothing unusual there, but it differs in two key areas to peer countries. The first is within the inclusion of mortgage interest costs, which is not the case with peers. The second is that the population is 3 times higher than peer countries, and this accentuates the degree of structural housing shortages and related cost push pressures.

Although many people assume the bank account has trimmed inflation, metric removes the influence of shelter because it would be trimmed off at the higher end of price gains, this actually is not the case because it carries too large a weight and still gets captured in their preferred metrics.

In contrast, I just dropped in the CPIX and it used to be the BOC's preferred guidance between 2001 and 2016. It strips out eight of the most volatile price movements that are not representative of what's happening in the broader economy, as well as, it removes taxes and importantly it removes mortgage interest costs. The bank account had unfortunate timing and moving away from this metric as its preferred guidance because if it kept it, rate cuts would likely be occurring. The CPIX already sits at only 2.4%. And now, I'm going to drop in a reconstruction of a metric we've done for Canada, which is using the Federal Reserve's preferred metric, which for them is core PCE inflation. We've recreated that for Canada. It sits at just two points, 1%. In other words, it's already at Target.

So now we have a really big picture on how subjective a 5% policy rate is as the appropriate setting for the entire economy, because the last two metrics argue that the policy rate is already too restrictive. And this is why we penned a paper in January that ran through the math to show this point. Returning to what we saw in January CPI data, if almost two-thirds of elevated inflation was due to shelter costs, then it goes against the very concept of inflation. Inflation requires breadth to reflect economy-wide conditions, and therefore it should not be dominated by a single sector. However, here's the flip side of that coin, the one area in our Canadian forecast that has undergone a large upward revision is housing sales and prices. This is not an area that will easily let up on the inflation metrics, a modest move, lower and boring costs in the fourth quarter of last year was enough to trigger an unexpected jump in housing activity, which, by the way, also occurred in the US. Home sales are outpacing our prior forecasts by a considerable margin. Favorable weather may have also played a role, and it's possible that that winter surge in sales simply pulls forward activity from the spring season, but we just don't know for sure.

What we do know is that the Canadian housing market acts like a coiled spring. Every time pressure is released, it pops right back up because the structural demand and supply imbalances are just too severe.

So, a shift in the BOC monetary policy stance could easily throw more fuel onto this fire, which means that the argument on cutting rates this year and looking past shelter costs is not an argument on bringing rates back to stimulative levels within the economy. It's an argument to right size the policy rate to the entire economy. That's why forecasts call for 100 and at most 150 basis points and rate cuts, despite a weak economy, this leaves a policy rate in a restrictive territory that gives a bit more balance.

And if you think the recent changes in immigration policy will ride to the rescue of the Bank of Canada, in solving for structural housing shortages, think again. This is the magnitude of the changes announced so far, with the targeted 35% reduction of study permit approvals. That's equivalent to about 220,000 fewer students. Population growth would still outpace housing construction by double. And this is our estimate of its impact on rent costs and home sales.

A deceleration and rent are already queued up in the data, but from very high levels and rent tends to decelerate at a gradual or even pace. So, for example from 2019 to 2021 purpose billed rent only slowed from 5% to 3%, even though the bottom completely fell out of population growth during the pandemic. On the right side, the direct impact on sales is estimated to be very low. CMHC data indicate that only 3% of mortgages were issued to non-permanent residents. Now the federal government is hinting at more changes to come on immigration. Mark Miller has indicated an intention to curb Canada's dependence on temporary foreign workers through review of the program, should this occur, it would further help with the adjustment of shelter inflation, but this is an argument that most of the changes would impact the economy in 2025 rather than immediately. In other words, nothing has changed our view. The BOC should start cutting rates this year, but the true act of policy normalization is a 2025 story.

To pull the lens back to the rest of the economy, we are getting clearer signs that job demand is quickly decelerating. All of the downward trend over the past six months is occurring on the back of the private sector and is a critical hint that the backbone of the economy is bending. The industry reach of softening labor demand has been very wide and within highly cyclical sectors that include manufacturing, construction, retail, wholesale, trade, finance, real estate, recreation and accommodation, so quite wide.

And Canadian families are showing more cautious spending, looking at the data with more granularity by breaking it down by income quintile, it shows a clear trend that each successive quarter the spending patterns are being driven by a narrow slice of households at the top quintile.

It's not surprising that that top 20% are holding in, considering that these are families with less, you know, effect from the termination of government pandemic supports and their net income investment has been boosted by higher interest rates and lower debt burdens. But that doesn't speak to the health of the broader economy. Per capita consumption has contracted in four of the last five quarters.

Which brings me to this final slide, the BOC, the Federal Reserve are in the opposite world with their economies, but both carry similar messages to markets. The first is that the policy rate has indeed peaked. The second is that patience is still required, and the last message is that it's realistic to expect some easing in policy this year. But both central banks remain nondescript on the timing or magnitude.

Financial markets are paying attention to this messaging and have meaningfully altered their rate cut expectations, since the start of the year. For the US, expectations have been scaled back to remove nearly two cuts from the path of 2024. For Canada it's gone in the other direction where rate cuts were magnified to reflect a weaker economy and some good news recently on the inflation front.

I think the market has it right. It never made sense to me why the US was priced so heavily, while Canada had the light touch. However, the US still has the bigger burden of proof, it must show that either exceptionalism can be maintained on productivity and its link into inflation, or the economy will have to slow the growth patterns in the one and 1-1/2% range later this year and right now, our forecast reflects the latter.

So, I'm going to leave it there.

Thank you so much for your time.

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