WATCH: Derek Burleton discusses the Return of the Oil Shock (June 2026 Client Presentation) – Transcript

00:00:00

I'm Derek Burleton, Deputy Chief Economist, TD Bank Group, with an economic update.

The big turn of events since our last official forecast in March is the prolonged conflict in the Mid-East and disruption in global energy markets.

The title of this presentation, Return of the Oil Shock, refers to this being the latest in a string of oil crises, at least five or six since 1990.

So we do have a bit of a playbook on how to assess the impacts.

Having said that, no two oil shocks are exactly the same.

And this one is being widely viewed as historic, with as much as one-sixth of global oil supply and one-fifth the world LNG having been affected.

00:00:39

One other note before jumping in, this is being recorded on June the 10th.

Despite some narrowing in key differences over several rounds of talks, US and Iran have not yet been able to reach a deal, leaving oil flows through the strait effectively choked off.

00:00:56

Logical starting point is our current thinking around oil prices and their likely path forward.

As you can see, forecast price adjustments have been in one direction as the war has dragged on longer than expected.

The green line corresponds to our baseline view for WTI. It's the second line from the top.

We expect prices to stay at their current levels of around $90 per barrel right through the third quarter of 2026, then to gradually recede back to the low 80s by year end.

This assumes some form of a peace deal gets reached in the coming weeks, even if it's likely to be shaky.

00:01:32

It may take prices to rise even higher in the near term to push the US and Iran back to the negotiating table.

The baseline forecast does allow for some near-term price upside.

A key point is that even under this optimistic scenario, we don't get back to pre-war views on oil prices until 2027 at the earliest.

00:01:52

If we're wrong, it's more likely that the oil path proves higher.

Under our prolonged higher price scenario, which is the black line, we have prices holding at close to $100 per barrel right through year end, which could happen if reopening of the strait takes longer and oil flows are slower to normalize.

00:02:10

I'll soon circle back on what this means for our global growth outlook, but I'll first lay out a bit more of the context.

00:02:19

This heat map shows that not all regions are facing the same exposure.

The darkest shading is concentrated in Asia, where the vast majority of Mid-East exports head.

In terms of share of Asian country needs, I'd single out India, Thailand, Korea, and then Japan as the most vulnerable.

00:02:36

Turning west, most countries in Europe have considerably lower direct exposure.

Only about one-fifth of oil and LNG needs to the Eurozone come from the Gulf.

One commodity where reliance is higher is jet fuel, which is why we've been hearing quite a bit about flight cancellations in recent months.

00:02:54

Turning to the U.S. and Canada, they enjoy light shading, reflecting their very low direct exposure and status as net energy exporters.

Any hit to growth in those countries will largely play out more indirectly through 30 to 40% shocks in the price of gas, diesel, and jet fuel.

00:03:13

The global economy has been weathering the shock reasonably well so far.

The "R-word" has been resilience.

Here I show the latest manufacturing purchasing managers index data for developed markets through May, which if anything points to faster growth in the first few months of the war.

Service PMIs for major economies are not as strong, but they have also been holding up fairly well.

00:03:37

A number of factors are helping to buffer growth impacts so far.

The starting point on global inventories of oil and refined products was very healthy heading into the conflict, allowing for drawdown.

Indeed, China, which is the largest oil importer in the world, has been reducing import demand recently as it relies on domestic stockpiles.

00:03:57

On fiscal policy response, governments in Asia, Europe, and Canada have temporarily suspended gas taxes, capped prices, and or implemented other measures to soften the hit on consumers.

00:04:08

And another is the AI boom, which has helped to blunt impacts on economies beyond the U.S., like South Korea and Taiwan.

This resilience is reassuring, but it's still in early days.

Impacts on consumption and growth can lag by at least a quarter or even longer.

00:04:23

Perhaps more importantly, some of these demand supply buffers will start to run thin.

We may have at least another month or so of runway before markets become increasingly anxious about a sharp tightening in global energy markets ahead of the peak driving season.

So hopefully we do see a deal and steps to reopen the strait soon.

00:04:43

This chart reveals how we're currently viewing the 2026 global growth outlook.

The punchline, we expect to be marking down our 2026 global growth forecast in the June round relative to March, but not dramatically.

And in China, we see potential for a moderate upgrade on Q1 data strength.

00:05:03

For the US, we've trimmed our growth expectations by a few ticks, but to a still solid rate of just over 2%, thanks in part to the AI investment boom which continues to forge ahead.

00:05:13

Our tracking in Canadian growth this year has been scaled back a bit and will likely be reduced moderately further in the June forecast due to a disappointing first quarter GDP turnout where the economy failed to expand for the second straight quarter.

But the good news there is that growth looks set to rebound starting in the second quarter, which should at least keep it running not too far off 1% rate for the year as a whole.

00:05:37

So not a huge change, but it still masks some important regional and sectoral shifts.

Alberta will get upgraded while oil consuming provinces like Ontario and Quebec will get trimmed.

00:05:48

Now under our higher oil price scenario of $100 per barrel, downside adjustments would be larger as shown by the symbols in the chart, but there again not moving the needle too much for the U.S. and Canada.

00:06:01

What isn't shown here is 2027 outlook, which is when the effects of $100 oil would likely become more visible due to lags.

In that case, US and Canada growth would see larger half or 0.6 percentage point growth downgrades to a pace of around 1 to 1.5% from almost 2% currently, but still think they'd manage to avert a recession.

00:06:25

Needless to say, we'll be closely following a range of timely and real-time indicators to gauge the impacts of the shock.

Indicators of supply chain pressures are on that list.

00:06:35

On the left-hand side, I show container rates, which are important for global consumers since they capture the cost of moving many consumer goods around the world.

The Baltic Dry Index on the right-hand side shows shipping costs for raw commodities and is a good leading indicator of upstream cost pressures.

00:06:51

These indicators are not flashing red, at least yet.

And in the case of container rates, remain quite low.

But we'll be watching for sudden turns in the data.

00:07:01

Where we're seeing larger changes to our forecast is on inflation.

Already, headline inflation has been shooting up globally on 1st order effects through higher pump prices and airline prices.

In May, U.S. headline inflation moved above 4%, which is getting in nosebleed territory.

00:07:17

The bigger question, though, is to what extent we see these headline pressures broaden out to core inflation, since that will dictate responses by central banks and financial markets, which in turn could have knock-on effects to our growth outlook going forward.

00:07:32

The chart on the left-hand side shows how much more favorable Canada's starting position on core prices is relative to the U.S. in the early stages of the war.

I show six-month annualized trends here to capture momentum, and the gap is yawning.

In fact, based on this measure, core Canadian inflation is below the 2% Bank of Canada sweet spot, about half that of the U.S.

That wedge is accounted for by stronger domestic demand in the U.S. and the impact of last year's tariff increases on U.S. consumer prices.

00:08:04

Turning to the right-hand side, you can see where we see core inflation in both countries ending this year.

We've added about 0.4 percentage points to our year-end core inflation estimates to account for the impact of the energy shock on energy-intensive areas like food.

00:08:19

For the US, core inflation moves up to about 3.5% by year-end, where Canada's rises to around 2.7%.

That's significant but not dramatic and maybe less than you might have expected.

One only has to go back to 2022 when core rates of inflation surged to more than 5%.

00:08:35

What will help to contain underlying inflation pressure this time around?

One key assumption that I noted is that we assume oil prices will gradually decline in the back half of 2026.

But perhaps more importantly, the consumer demand picture is quite a bit softer in the current cycle, which will make it more challenging for businesses to pass through price increases.

00:08:58

This chart really drives home that last point.

This is not 2022 revisited.

Back then, job markets were drum tight as reflected by historic job vacancy rates.

Now vacancy rates are on the loose side.

Consumers were embarking on revenge spending four years ago, helped by massive excess savings, which is not the situation currently.

00:09:20

As I noted, the U.S. is facing a larger challenge than Canada on underlying inflation momentum.

But we are seeing signs that upward momentum on prices from last year's tariff increases is starting to roll over, which is well timed since it will provide a nice counterbalance to higher energy-related pressures going forward.

00:09:39

What will this mean for our forecasts and central bank policy rates?

As they typically do, market expectations on interest rates have not wasted any time moving in response to hawkish communications by central bankers.

For the Fed and the Bank of Canada, we've seen year-end pricing and overnight rise move up.

00:09:56

In the case of the US, by as much as 75 basis points.

For Canada, closer to 25 to 30 basis points.

And that's generated growing yield differentials across Canada and the US that have put the Canadian dollar on its back foot recently.

00:10:10

For the Fed, cuts that were priced earlier this year have been removed and there is now fully a full hike price by year end.

For the Bank of Canada, which left rates stable at this week's meeting, there is now one hike price by year end.

Though as you can see, at one point, there were as many as three rate increases assumed in the market.

00:10:31

Turning back to the Fed, which meets next week, these are not certainly ideal conditions for the new Fed chair to take the reins at the FOMC.

Trump wants him to reduce interest rates, but the data in coming months simply won't accommodate easing.

Even if Warsh wanted to, it's highly unlikely he would be able to secure the votes.

00:10:50

Our group still sees scope for a few more interest rate cuts south of the border to bring rates down to neutral, but the earliest now appears to be the first half of 2027 when inflation begins to normalize.

00:11:02

For the Bank of Canada, which left its setting unchanged at the latest rate decision, we haven't moved off our view that it will remain on hold for the foreseeable future.

What will prevent market expectations from an increase materializing in Canada's ongoing softness in the job market and the likelihood that core inflation remains within its 1% to 3% target range?

00:11:23

Based on stable short-term policy path and our baseline view on oil price, we do expect 2 to 10 year bond yields on both sides of the border reversed about half of their post-war run up of between 40 and 70 basis points by the end of this year.

With US yields likely to fall by more than Canada, we should see the Loonie gain some moderate traction going forward.

00:11:45

Back to the what if question.

Under our higher oil price scenario, hikes by both central banks would certainly be in play, particularly in the United States, given that we'd expect higher, more persistent inflation relative to our baseline.

00:11:59

Let's circle back to the U.S. consumer.

Spending resilience will be tested by higher costs, but we do expect some key tailwinds on income to soften the blow.

00:12:09

On the left-hand side, we estimate drivers on average to face a higher gasoline bill of around $500 this year, but for many Americans, that will be more than countered by tax savings under the One Big Beautiful Bill.

Another potential area of relief is a temporary halt on the U.S. federal excise tax, but that may face an uphill battle in Congress.

00:12:30

Despite this favorable math, it's going to be a challenging period for lower-income Americans, whose spending and sentiment are highly tied to the price of gas, food, and other essentials.

Put another way, the K-shaped dynamic in U.S. consumer spending is only going to get worse.

00:12:46

Also, as we show on the right, the low aggregate personal savings rate stateside is leaving less financial flexibility than it has in the last several years.

For now, we've trimmed US real consumer spending growth forecast in 2026 to under 2%, marking a significant step down from last year.

00:13:06

Turning to Canada, government policies will also do some work to cushion the blow from higher energy costs and potentially food costs.

On the left-hand side, the temporary federal tax holiday is helping to blunt the impact of gas price increases on the consumer.

And on the right-hand side, the federal government's recent announcement that it would be enhancing its grocery benefit will deliver around $300 on average to households this year.

00:13:30

In terms of forecast changes, a real consumer spending outlook for Canada has not been significantly impacted by the oil shock thus far.

We continue to see real spending gains of just over 1% in 2026, thanks to continued steady showing by households so far this year based on data we've had.

And that will be led by high income earners who are benefiting from strong wealth gains.

00:13:55

Demographic trends are having an impact on both the U.S. and Canadian economies, and nowhere is this more evident than in the job market.

We've effectively seen steady declining labor force trends over the past year.

00:14:07

Why is this important?

It means that fewer jobs are needed on a monthly basis to keep the all-important unemployment rate unchanged.

In the US, the so-called run rate of employment growth has been marked down to around 30,000 per month, one-fifth of its pace in 2024.

In Canada, the comparable figure has fallen to 0 from 50,000 in 2024.

00:14:29

One implication is that we need to change how we evaluate monthly job numbers.

Zero or a slight positive can no longer be viewed as an off month.

00:14:37

Looking through the volatility, Canada's labor market has essentially been flat so far this year, which is consistent with a relatively stable, though elevated, unemployment rate of between 6.5 to 7%, where we expect it to remain that way as we move through the second-half of this year.

00:14:54

The US job market has managed to beat the 30,000 run rate bar on average since early 26, consistent with a relatively low jobless rate, one that is only a sliver above its long-term target.

00:15:08

The other implication of no labor force growth is that it will place an even bigger reliance on productivity to drive real GDP gains.

It's no secret that this is where the U.S. enjoys a huge advantage, as can be seen here.

Productivity has been rising at an annual clip of about 2% per year, and expectations are that the U.S. will continue to sustain that healthy rate going forward.

00:15:30

Where there's legitimate reason to worry is around Canada's productivity growth which has averaged a menial 0.3 percentage point per year since 2022.

Essentially, the lion's share of real GDP growth in Canada has come via businesses and governments expanding their workforces rather than improving efficiency.

00:15:48

Now call me an optimist, but I do believe we're at a turning point in Canadian productivity.

If you squint, at the chart, you can see a modest pickup in productivity growth since late 2024, and that coincides with a moderation of labor force and immigration rates.

00:16:06

The last quarter showed a setback.

But that was largely due to manufacturing, where services enjoyed a strong showing on the productivity front.

00:16:15

And looking ahead, we assume growth accelerates broadly in productivity to around the 1 to 1.5% rate over the next few years.

That's not U.S. level, but better.

And that should help to put a floor under Canada's trend or potential growth of around 1.5% annually.

That's only a moderately slower pace than our historical estimate in Canadian trend growth of 1.8%.

Meantime, the US potential or trend rate of growth is expected to hold at around 2.5%, keeping it the envy of the G7.

00:16:46

The US is more the outlier here rather than Canada.

Many traditional factors set the U.S. economy apart, including dynamism, market depth, and leadership in technology investment and adoption.

And more recently, the AI investment super cycle has taken the U.S. productivity performance to the next level.

00:17:03

On the left-hand side, I show the latest impact on the AI build-out on investment as a share of GDP.

We expect it will increase to around 3% by 2027, which will deliver major first and second-order benefits across the U.S. economy.

00:17:18

On the right-hand side, we show our current view on U.S. business investment.

A combination of both AI-related strength and acceleration in non-AI-related spending will drive a near double-digit growth performance in business investment, and that's notwithstanding the impact of the oil shock.

00:17:36

A key driver of productivity upswing in Canada is tied to an improving investment picture, which has long been the Achilles heel of Canada's weak productivity showing.

One positive event that happened with little fanfare earlier this year is that StatCan revised up its estimate of the size of Canada's capital stock in its benchmark revisions.

That upgrade to the amount of capital labor has to work with bodes well for at least some pickup in productivity growth going forward.

00:18:03

And looking ahead, we do expect Canada to end its recent run of investment declines this year.

We're not getting too far ahead of ourselves.

Based on the chart, the 1.5% gains we're expecting in business investment are modest, as uncertainty around CUSMA and other factors will keep many businesses in Canada cautious.

00:18:21

And the Carney government has more work to do to improve the regulatory and tax climate in Canada.

But gains should head in the right direction.

00:18:29

That's what the message from the latest Bank of Canada Business Outlook survey was that showed higher investment intentions, with companies citing boosting productivity as a key objective.

00:18:39

And our investment forecasts may be too cautious.

The federal government continues to focus its efforts on fast-tracking nation-building projects.

The recent fiscal update added the list of tools to work with, including the new Sovereign Wealth Fund that it hopes will move the goal posts on its ambitious target of catalyzing as much as $1 trillion in public and private investment over the next five years.

00:19:01

So far, more than $100 billion in nation-building projects have been referred to the Federal Projects Office, and around 1/3 of those projects have either received funding commitments or already moving forward.

Of that, energy projects dominate the pipeline.

And on that list, a new oil pipeline to the West Coast that is now looking more likely than before after the recent agreement between Alberta and Ottawa.

00:19:23

Our forecast only factors in projects where we have good clarity and we're cautious around ongoing hurdles, such as, for example, the potential for First Nations court challenges.

Suffice to say that to the extent these projects move forward, there is an upside risk to the investment forecast.

00:19:41

I've used the word resilience a few times so far, but also aptly applies to the financial conditions picture.

Despite all of the uncertainty, markets outside of oil and bonds have turned the other cheek.

00:19:52

Equities in particular have hit or been close to new records driven by consensus-beating earnings growth performances, particularly among the MAG 7.

And even as yields have risen on inflation worries, corporate spreads have remained narrow.

00:20:05

Looking at this chart, our financial stress index did worsen in the first month after the conflict started, but has since returned back to pre-war levels.

00:20:16

One thing to note, our financial stress index measures underlying volatility across broad asset classes.

Valuations are not considered, where clearly there have been signs of froth.

Our baseline view doesn't make any heroic assumptions on any swift or sudden increases in financial stress, so this remains a potential downside risk to the forecast.

00:20:37

One market area that has been on the front burner in recent months is private credit.

In the private space, much of the worry surrounds retail investments through business development companies or BDCs.

00:20:49

Money has poured into these vehicles.

Since the pandemic, BDC's assets under management have grown fourfold from around $125 billion in early 2021 to around $450 billion by the end of last year.

That's what's shown in the chart.

00:21:03

This year, rising anxiety in private credit reflects several high-profile bankruptcies linked to private credit, opaque valuations, and illiquidity.

The sector is also troubled by its significant exposure to software companies potentially at risk of AI disruption.

But 30% of direct lending in the space over the past six years has been to software companies.

00:21:24

The result has been a sell-off in publicly traded BDCs and increased redemption requests and non-traded funds.

Now so far, these risks haven't rippled into the broader market conditions, and good reason to believe that systemic risks from the sector are low.

Even if redemption pressures persist, these funds can continue gating withdrawals, gradually selling assets, and winding down funds if needed.

00:21:46

As a share of total financial assets, households have very small exposure, and direct credit and exposure to banks appears manageable.

Having said that, the vulnerability in private credit relates more to potential amplifier of an economic shock, and as a result, will continue to prompt calls for greater supervision and transparency.

00:22:07

In summary, U.S. and Canada's economies remain quite well positioned to absorb the oil shock under most scenarios for oil prices.

This assumes that our reading of financial stress conditions continues to show reasonable resilience.

00:22:21

Inflation rates will rise, but we don't expect major pass through to core inflation under our baseline view.

We expect both central banks to sit tight through year end as they closely monitor economic impacts from the shock.

00:22:35

With labor force slowing, economic growth potential will become more reliant on productivity gains.

The good news is that the U.S. will continue to impress on this front, and we see scope for Canada's productivity performance to gain some traction.

00:22:47

Thank you very much for listening.