# Questions? We've Got Answers

## Addressing Issues Impacting the Economic and Financial Outlook

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Optimism that the U.S. Federal Reserve will achieve a soft landing has increased among forecasters and financial markets. A welcomed cooling in some inflation metrics has been met with economic resilience, alleviating the worst fears among some analysts that a recession is at hand. The Canadian economy has also refused to buckle, fueling the Bank of Canada's belief that further rate hikes were needed to tap down the consumer demand impulse. But, the journey is not over. Core inflation metrics within both countries are far off the desired 2% mark, leaving the door open that central banks may not yet be done on the rate hike cycle. We explore these themes in our latest list of questions, while tackling topics on the Chinese economy, commodities, the U.S. Dollar, and housing markets.

### Questions & Answers

1. What's the implication of China's abrupt slowdown to the global outlook and inflation?
2. Is the commodity market oversold and are the risks shifting to a rebound?
3. Is the recent U.S. dollar weakness the start of a larger trend?
4. With inflation easing in both the U.S. and Canada, how long will peak interest rates remain?
5. Is Canada's recent economic resilience just due to population growth?
6. What does the intersection of population growth and higher interest rates mean for Canada's housing market?
7. How much longer can Canadians keep spending in the face of lofty debt loads?
8. Is it true that contracting U.S. gross domestic income predicts a recession, even though GDP is expanding?
9. Why is U.S. investment showing unusual resilience in a high rate environment?
10. Are higher rates having any effect on U.S. consumers yet?
11. Are we seeing a turn in labor markets in the U.S. and Canada?

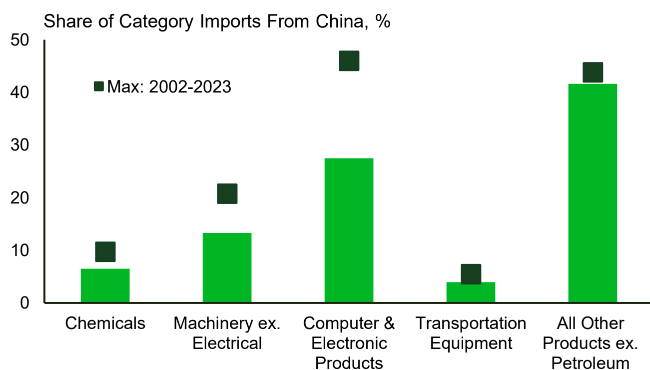
## Q1. What's the implication of China's abrupt slowdown to the global outlook and inflation?

China's disappointing growth performance in the second quarter doesn't move the needle on our global outlook for the second half of the year. A slowdown was already embedded in the outlook, as the post-lockdown burst of activity gave way to persistent structural drags, such as the effects from the government's determination to reduce leverage in the real estate sector. The only aspect of surprise was that the fillip to growth petered out faster than expected, and combined with downward revisions to 2022 data, caused an 80-basis point downgrade to China's 2023 GDP growth or equivalent to a global hit of 15 basis points.

This downgrade could yet be challenged if policymakers move to stimulate the economy. In July, the Politburo showed some wavering in prior commitments. A debate has emerged towards firming up consumer spending, supporting critical industries, and cleaning up local government debts. Markets have responded positively, but the implementation leaves a bit to be desired. Policies are being rolled out in a piecemeal fashion. At the time of writing, tax cuts for small businesses and an extension of tax breaks for EV purchases had been announced. In a conciliatory effort towards the real estate sector, looser rules for first time buyers have been floated, with one provincial capital already taking steps independently. These moves are likely insufficient to meaningfully buoy consumer confidence, which has been cut to the bone.

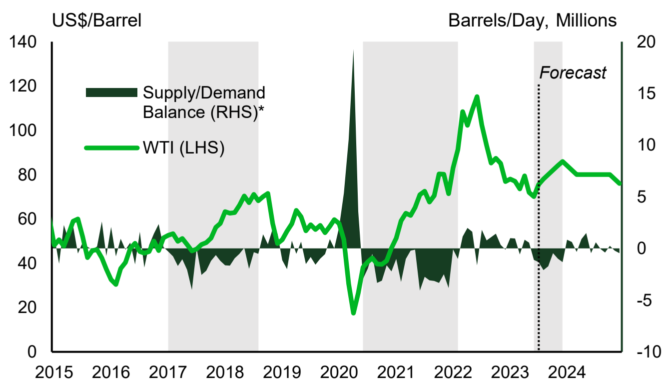
When it comes to China's influence on global inflation, it looks to be more diminished. This is partly due to its slower growth trajectory, but also a reflection of geopolitical tensions that have deliberately diversified manufactured goods supply chains away from China (Chart 1). In fact, geopolitical factors will maintain a wide reach on global price pressures in the coming year, such as OPEC's ongoing supply restriction of crude oil, and Russia's renewed blockage of Ukrainian grain exports on downstream food prices. China's poor economic performance relative to market expectations has, for now, mitigated a proliferation of broader global price pressures.

**Chart 1: China's Role in U.S. Manufactured Goods Imports Recedes**




Source: Census Bureau, TD Economics.

**Chart 2: Oil Market Deficit To Put Upward Pressure on Prices**



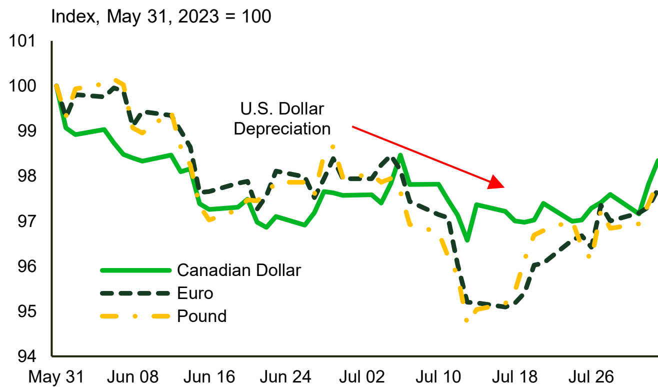

*Shaded areas represent sustained oil market deficits. Source: OMI, TD Economics.

## Q2. Is the commodity market oversold and are the risks shifting to a rebound?

The short answer is yes. Commodity prices are building some tailwinds, after struggling to find direction over the first half of the year. Previously, commodity prices were restrained as recession risks in major advanced economies dominated hopes of a robust recovery in Chinese activity. Now, risks are tilting slightly to the upside, as the worst of those recession fears fade, combined with some tightening in supply-side factors for a select group of commodities. Bloomberg's Commodity Price Index has risen for two consecutive months and is up 6% since the broad selloff late last year.

A shift in sentiment has been notable in crude oil markets. As of June, crude oil balances flipped into deficit territory, which is expected to deepen over the remainder of the year. On the supply side, Saudi Arabia extended its unilateral production cut, adding to other voluntary curtailments by some OPEC members that will remain in place until the end of 2024. On the demand side, global demand is faring much better than previously expected. This combination of events has caused global oil inventories to decline, and we expect WTI prices to embark on a further modest rally over the remainder of the year before moderating into next year as markets return to better balance (Chart 2).

**Chart 3: U.S. Dollar Strengthens After Recent Weakness**




Source: Wall Street Journal, TD Economics. Last observation: Aug 2nd, 2023.

Elsewhere, wheat prices have been volatile. Recent estimates point to ample supply from major producers, but Russia's decision to terminate the Black Sea grain deal last month has reinfected uncertainty on global supply. Moreover, future production yield may face difficulties from sustained above-average temperatures and a lack of precipitation. On demand, attention will shift to China, which is the world's largest wheat importer.

China also still carries a high influence on industrial metals, where its manufacturing decline and property sector woes have led to mixed results on prices. China's surging imports of aluminum amid domestic supply shortages and depleted inventories should provide a lift to prices. Copper and nickel markets, usually the most sensitive to Chinese developments, face a more uncertain path forward as concerns around near-term Chinese consumption collide with brighter longer-term prospects around the global energy transition.

## Q3. Is the recent U.S. dollar weakness the start of a larger trend?

The U.S. dollar has backtracked to its lowest level since April 2022 (Chart 3), as a deceleration in employment and inflation trends boost confidence that the Fed is nearing the end of its rate hiking cycle. At the same time, central banks in Europe are expected to remain in tightening mode due to less progress on curtailing inflation. A marginal compression in interest rate differentials has manifested in a lower dollar. However, we don't think the recent weakness is the start of a longer-term trend. The greenback should maintain support given its likely economic outperformance to peer countries and its safe-haven status.

For instance, the economic challenges in Europe are mounting. An economic slowdown has been underscored by plummeting business loan demand which is already at an all-time low despite the passthrough of the interest rate hike cycle still in its early stages. Weaker economic growth prospects relative to the U.S. should spell near-term downside risk for the euro against the dollar.

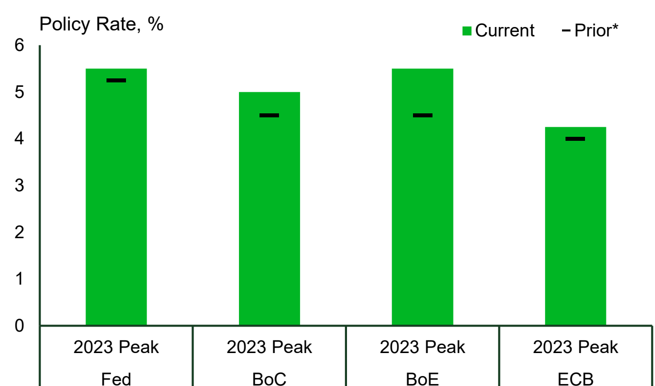
The Canadian dollar (CAD) also looks set to extend the trend of near-term weakness against the greenback. Rising oil prices help place a floor under the CAD but do not deliver the impulse to the currency as in the past, particularly with the U.S. now a net-energy exporter. Heightened global uncertainty and U.S. economic outperformance should also limit the loonie's ability to advance over the next year.

## Q4. With inflation easing in both the U.S. and Canada, how long will peak interest rates remain?

If we told you a year ago that U.S. headline inflation would go from 9% year-on-year (y/y) to 3% y/y today without any net job losses, you'd probably expect the Fed to be cheering that result. Even though that's exactly what happened, the central bank has kept its pom-poms locked away. This is because the drop in headline inflation isn't likely to persist. While the headline reading has fallen on the back of falling energy prices, underlying core measures signal that future inflation will be stuck above 3% for some time. U.S. core PCE inflation has already remained above 4% y/y for almost two years! The Bank of Canada (BoC) is in the same boat, with its measures of core inflation stuck at an average of 3.8% y/y.

What's a central bank to do? Raise interest rates higher than previously expected and commit to keeping them elevated for longer. On the first part, both the Fed and the

**Chart 4: Central Banks Probing Higher Rates**




*Prior is May 2023 estimate. Source: Fed, BoC, BoE, ECB, TD Economics.

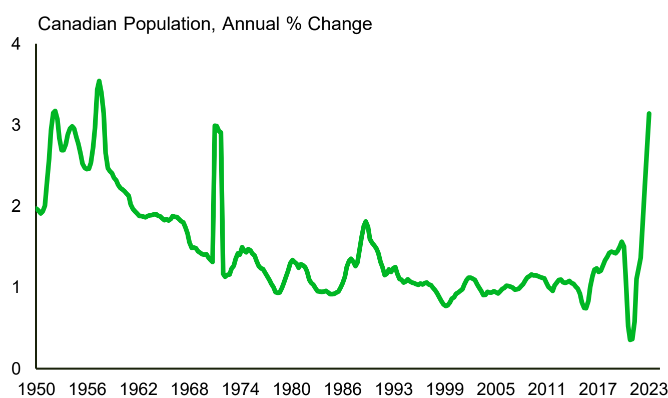
BoC raised rates to new heights in July (Chart 4), testing what the economy can bear to sustain a downtrend in inflation. It was only three five months ago that the Federal Reserve thought the peak policy rate would be 50 basis points lower. One year ago, a peak rate of 4.6% was believed to do the trick. So, it's certainly possible we're not yet at the end of the road, but can at least see where the pavement ends.

This next step requires "tough talk" to ensure yields don't prematurely decline and re-inject demand into the economy before core inflation sustains a downtrend. Our research (see Dollars & Sense) shows that the peak in interest rates typically coincides with fading consumer spending momentum. As we show in our economic forecast, this is more of a late 2023/early 2024 story, which means that the opportunity to start cutting interest rate cuts is most likely to occur in the spring of next year. However, when that moment arrives, it's unlikely that the speed of the rate hike cycle that saw 50- to 75-basis point jumps will be paralleled on the way down. They central bank will likely move in a more cautious, measured fashion.

## Q5. Is Canada's recent economic resilience just due to population growth?

Canada's surge in population has garnered global attention. The 1.2 million person increase over the last year equates to a growth rate not seen since the combined immigration and baby boom of the 1950s (Chart 5). To what extent did this "pop" in population (see report) help to catapult Canada's GDP growth to the top of the G7 leader board? A lot. Working through the arithmetic, the 3.2% quarterly growth in population led to a massive 3.4% quarterly boost to the Canadian workforce. In turn, this rippled into a near-6% annualized increase in consumer spending in the first quarter, that was not nearly as impressive when calculated on a per capita basis. Those figures showed that more cautious spending behaviour was completely masked by the sheer number of people spending.

**Chart 5: The Population Surge Continues**




Source: Statistics Canada, TD Economics.

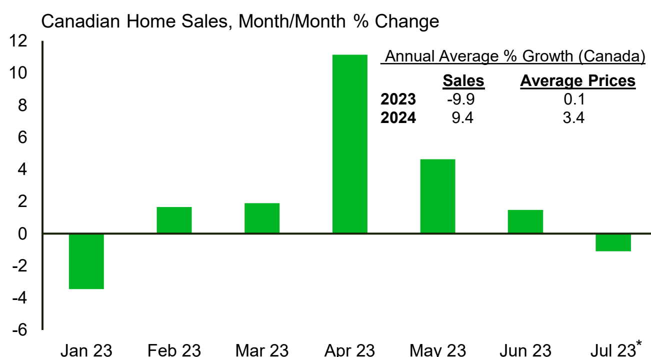
GDP in the second quarter won't look as impressive but that's because several crosswinds hit the economy that even the mighty consumer wasn't able to shield. Since April, there has been a 120k person public sector strike, wildfires that shutdown oil & gas production, and a BC port worker strike that disrupted approximately $11bn in trade. All of these create short-term headwinds to growth. Through it all, spending data have shown resilience. Aside from the influence of population inflows, we must not forget the healthy starting position of existing Canadian households. Pandemic savings are far from depleted, and the Federal government sent out billions last month via the grocery rebate and the enhanced workers' benefit. The labour market is also still in the very early stages of cooling, with much of the rise in the unemployment rate due to strong labour force growth rather than job losses. Workers are now experiencing strong wage gains that are outstripping inflation. This improvement in spending power has been met with discretionary spending in areas of dining out and car purchases, particularly as the latter responds with better inventory levels.

How long can this last? The fall months should bring a turning point that deepens in 2024. Not only is population growth expected to slow next year, this is generally the time period when the lags in interest rate transmission starts to make its presence known. By the end of this year, roughly 47% of mortgages will have renewed to a higher interest rate environment, and by end-2024 that share will sit at 65%. Even if households smooth out their payments by reducing the share dedicated to the principal portion of the debt, caution should still become more entrenched in the household psychology. Auto financing rates have reached as high as 8%, while signs have emerged that subprime debt holders are already struggling, captured by rising delinquency rates.

## Q6. What does the intersection of population growth and higher interest rates mean for Canada's housing market?

Higher interest rates and population growth affect homeownership and the rental markets differently. In the ownership market, short-term dynamics will be governed more by interest rate movements. Our home sales forecast reflects this, as we expect sales to drop by about 5% from their second quarter level in the second half of the year.

**Chart 6: Canadian Home Sales Growth Moderating Amid Higher Rates**




*July is estimated by TD Economics based on data from local real estate boards.
Source: Canadian Real Estate Association, TD Economics.

Price growth, meanwhile, should be roughly flat when measured over the same period. Recent data looks to be already playing this narrative out. (Chart 6).

This might seem at odds with the multi-decade high in population growth, but it typically takes time for immigrant homeownership rates to rise meaningfully. CMHC analysis suggests that homeownership rates for non-permanent residents are generally low, which is the source of the population that has been surging. Instead, this new source of demand immediately impacts rents, which are already skyrocketing. For example, in the GTA, rent for an average one-bedroom condo surged 12% year-on-year in the second quarter. At the same time, higher mortgage rates make it tougher for renters to enter the buyers' market, crowding more people in into rentals. Unfortunately, the lower interest rates that we expect next year are unlikely to be a panacea for sharply rising rents because we estimate it will be accompanied by higher home prices, leaving affordability strained.

## Q7. How much longer can Canadians keep spending in the face of lofty debt loads?

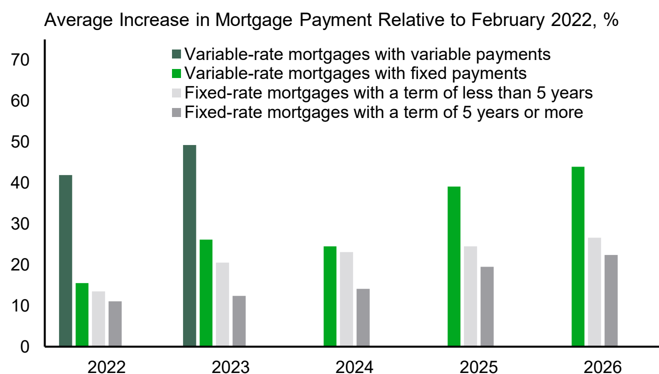
Consumer spending has defied economists' expectations over the past year with booming average real growth of 4% in the four quarters since the Bank of Canada began raising interest rates. Nevertheless, the cumulative impact of the 475-basis-points of rate hikes is starting to catch up with Canadians, and we expect it to weigh on consumer spending through 2024.

The first quarter of 2023 marked the largest quarterly increase in the aggregate debt service ratio (DSR) – the share of total disposable income allocated to paying existing debt. At 14.9%, it has leapfrogged over the pandemic low of 12.5%. This is the highest level since 2019, and it is expected to expand by at least another percentage point before levelling off in 2024. Put another way, since the BoC started raising rates, Canadians are paying $37 billion more to service their debts, and we estimate a further increase of $44 billion by the second half of 2024. This cumulative increase amounts to almost 6% of consumer spending (as of 2022), and so consumers will need to divert spending away from other areas. This is a key reason why we expect consumer spending growth to be below 1% in 2024.

However, these are economy wide figures, and the cost of servicing debt at higher rates is much disproportionately imposed on the roughly 40% of households with mortgages. An average household with debt will see a nearly $3,000 increase in yearly payment by the end of 2023 and more than $4,000 by the end of 2024. We are still in the preliminary stages of the impact of rate hikes on consumption.

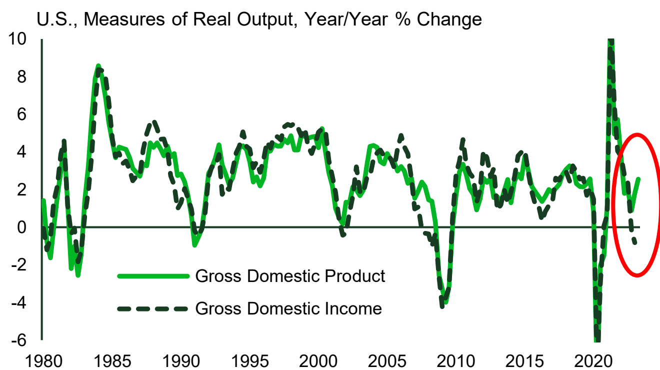
As shown in the Bank of Canada's analysis in Chart 7, the wave of mortgage renewals will have a cascading effect on borrowers. Among them, Canadians with variable-rate mortgages with fixed payments will see the biggest impacts going forward, placing them at a higher risk on the default spectrum. (Those with variable payments have already absorbed the lion's share of their increased payments). With payments fixed, these borrowers may not have mortgage installments increase until renewal, and the step-up could be substantial (Chart 7). Given the mortgage stress tests in place since 2018, most borrowers should be able to adjust to higher rates. But if a borrower's financial circumstances have worsened, such as in the case of a job loss, the risks rise on falling behind on scheduled loan payments. This is why the Bank of Canada has to embed caution in avoiding an overshoot on tightening policy. An unexpected overshoot in unemployment is the biggest determinant of delinquency rates.

**Chart 7: Bank of Canada Estimates of Mortgage Payment Increases**




Source: Bank of Canada Financial Stability Report (June 2023), TD Economics.

**Chart 8: Gap Between GDP & GDI Widens to Largest Margin on Record in Q1**




Source: Bureau of Economic Analysis, TD Economics.

## Q8. Is it true that contracting U.S. gross domestic income predicts a recession, even though GDP is expanding?

Resilience has been commonly used to describe the U.S. economy over the past year – and for good reason. Despite being over a year into the most aggressive Fed tightening cycle in multiple decades, the economy still grew by 2.2% (annualized) over the first half of this year, which also happens to also be at or equal to trend growth is a few ticks above trend growth. And based on more recent data, Q3 is again tracking close to 2%. At this rate, even if Q4 were to flatline, the economy would produce a 2023 growth rate that matched last year's gain of 2.1%!

However, the parallels between this year and last end there. 2022 got off to a rocky start, with GDP contracting in each of the first half of the two quartersyear. This was the initial catalyst that ignited market jitters that the U.S. economy was already in a recession, despite the Fed being very early into its tightening cycle and inflation continuing to reach new multidecade highs. At the time, we had argued that GDP was likely overstating the degree of weakness in the economy, particularly given that alternative measures of economic output such as Gross Domestic Income (GDI) were still pointing to a modest expansion. Today, the story has flipped. Despite GDP recording a string of solid gains, GDI has contracted for two consecutive quarters. The exclamation mark comes when we compare GDP and GDI on a year-on-year basis, which showed the gap between the two widening to the largest margin on record in Q1 (Chart 8).

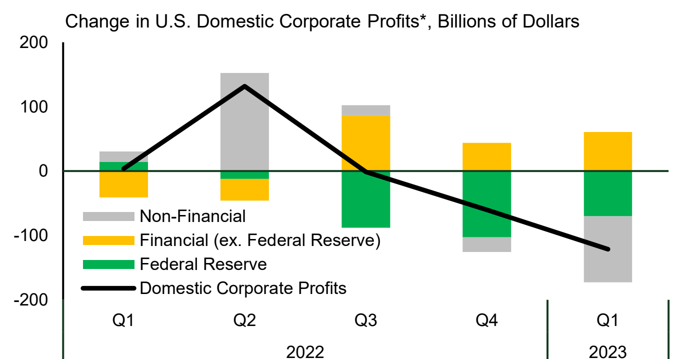
The last time a large gap occurred was immediately prior to the global financial crisis and subsequent recession. Some economists argued that GDI was a better bellwether for an impending downturn. However, this time the sources creating that divergence differ. GDI is declining due to corporate profits, but a hefty amount of that is due to the Federal Reserve incurring massive losses on its QE bond holdings as interest rates move sharply higher (Chart 9). Excluding the Fed, corporate profits would have printed positive in the final quarter of last year and fallen by less than half the amount in Q1. That decline reflected a $103B drop in non-financial corporate profits, which shouldn't be shrugged off. But here too context matters. Profit margins had been running at an unsustainable level over the past two-years and some pullback was inevitable, as the headwinds from softening demand, elevated wages costs and less ability to raise prices intensified. Even after accounting for the Q1 compression in profit margins, they are still hovering slightly above pre-pandemic levels, which likely suggests there's still room to fall.

So what's the takeaway? Neither GDP nor GDI are perfect measures of economic activity, with each having outperformed the other at various points in previous economic cycles. An average of the two is likely our best gauge on the crosswinds of economic activity. That measure shows that growth has been virtually flat in recent quarters, which is a more realistic depiction of where GDP growth is likely headed towards year-end and H1 2024.

## Q9. Why is U.S. investment showing unusual resilience in a high rate environment?

With interest rates at a 22-year high, businesses should be decreasing their exposure to capital good outlays. However, broadly speaking, this does not appear to be the case.

**Chart 9: Federal Reserve Accounts for Much of Recent Weakness in Corporate Earnings**




*Profits have been adjusted for inventory valuation and capital consumption adjustments.
Source: Bureau of Economic Analysis, TD Economics.

After adjusting for inflation, non-residential fixed investment rose by an impressive 4.6% above year-ago levels in the second quarter.

This resilience reflects direct and indirect forces related to federal subsidies for green technology, in addition to delayed post-pandemic recovery trends in the transportation sector. Both influences have persistence that help shield a broader and deeper contraction despite a high interest rate environment.

There are three main aspects to this logic:

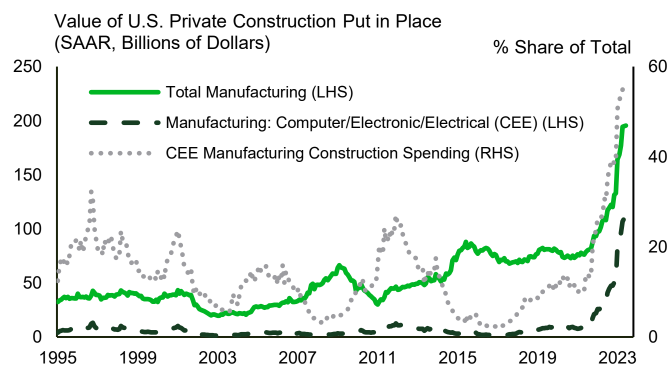
1. The automotive sector is out of sync with the business cycle. Pandemic-related supply chain disruptions prevented automakers from boosting production in response to the exceedingly strong demand in the first half of 2021. Jumping forward to 2023, supply chain disruptions have eased and auto production appears to have normalized, allowing the backlog of business orders to be filled. In the second quarter, investments in light trucks rose 75% quarter-on-quarter (annualized), adding 0.4 percentage points (ppts) to real GDP growth. However, the recovery process remains incomplete. Investments in light trucks are roughly 26% below pre-pandemic levels, suggesting that the recent outsized gains boosting investment growth are likely to continue in the near term.
2. Like autos, aircraft investments are experiencing delayed and outsized post-pandemic growth. The long-term outlook for travel and commercial aviation was highly uncertain during the pandemic, as lockdowns and lingering health concerns weighed on the industry. However, with 2023 travel demand back at pre-pandemic levels, aircraft investments have expanded by 69% year-on-year in the second quarter. This alone contributed 30 basis points to real GDP growth.
3. Federal legislation, notably the Inflation Reduction Act and the CHIPS & Science Act, is providing targeted support. There are numerous provisions that are supportive of the current economic expansion, but the largest investments are related to manufacturing facilities for clean energy, semiconductors, and electric vehicles. Investment in manufacturing structures was up a massive 54% y/y in the second quarter, with most of this strength stemming from new semiconductor and EV battery production facilities. The computer, electronic, & electrical subcategory has seen its share of total manufacturing construction spending grow from 11% in the decade leading up to the pandemic, to 56% in June 2023 (Chart 10). The combined federal and state level subsidies being offered to firms are sufficient in most cases to offset most, if not all, of the rise in financing costs over the past year. The boost to economic activity won't end once the facilities are constructed. Investment will then get a boost through equipment, which usually occurs with a 4-5 quarter lag. In other words, this investment impulse will exist over the medium-term through an increase in manufacturing capacity.

Canada has seen some similar trends, with two EV battery plants under construction in Ontario, a battery materials production facility being built in Quebec, and several automotive manufacturing facilities undergoing upgrades for EV production. Canada is also seeing upstream investments in critical mineral production, such as Rio Tinto's expansion of aluminum production in Quebec. The investment story in Canada is like the U.S., with subsidies bridging the financing gap.

## Q10. Are higher rates having any effect on U.S. consumers yet?

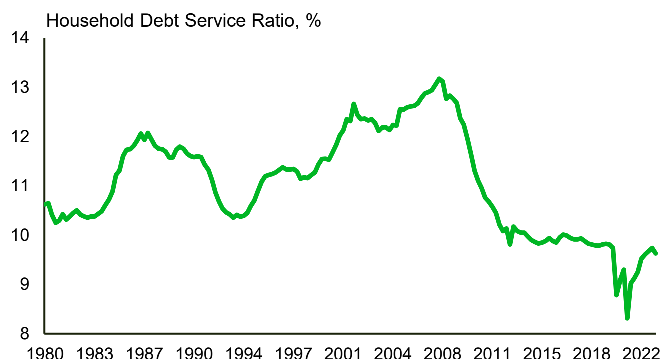
There are three primary elements which have combined to blunt the impact to consumers of the higher rate environment. First, American households deleveraged after the Global Financial Crisis and now have relatively low

**Chart 10: Federal Subsidies Boosting Manufacturing Construction**



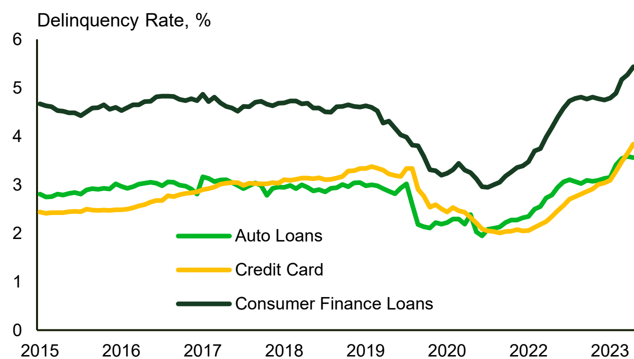

Source: U.S. Census Bureau, TD Economics. Last Observation: June 2023.

**Chart 11: Household Debt Service Burden Still Relatively Low**




Source: Federal Reserve Board,TD Economics.

**Chart 12: Consumer Loan Delinquency Rates on the Rise**




Source: Equifax, TD Economics.

debt service burdens to weather rising rates (Chart 11). Second, the prevalence of longer-term fixed-rate debt is also dampening the impact of the central bank's rate hikes. Consumers have locked in lower rates on many existing debts (primarily mortgages and auto loans), so the impact of rising rates will only feed through gradually via new debt or as existing debts are renewed. Finally, households also have higher net worth coming out of the pandemic, which can help cushion the impact from higher borrowing costs.

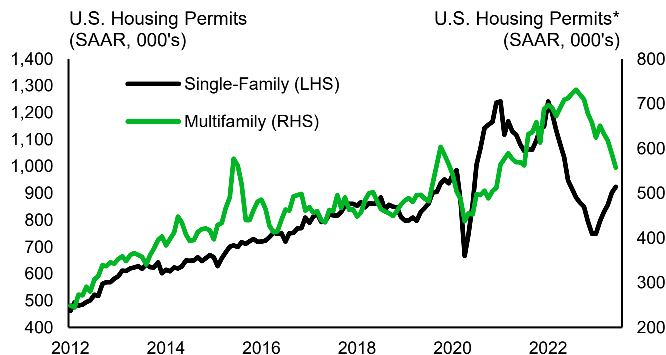
That said, there is evidence that higher interest rates are starting to leave a mark. Delinquency rates on consumer loans have been trending up in the last few months. This is reflected in both rising credit card delinquencies and other loan categories, such as installment and single payment plans. Total delinquent balances for auto loans at 3.6% also reflect a 50-basis point increase since the start of the year (Chart 12). At the same time, loan demand is declining, as some would-be auto buyers step back from the market. Although the level of delinquency rates is not ringing any alarm bells, it must be true that household financial strain is taking hold on the margin given it's occurring alongside strength in wages and jobs. A more telling picture will emerge after October, as the restart of student loan payments will add additional pressures to borrowers and may cause delinquency rates to rise further.

It'll become increasingly more difficult to withstand the forces of higher interest rates as "excess savings" dwindle. The nest egg that consumers built up through the pandemic is now lower than TDE's previous estimate. From a peak of just over $2.2 trillion in 2021 Q3 (previously calculated at $2.7 trillion peaking in 2021 Q4), we estimate that households have just under $800 billion worth of excess savings as of 2023 Q2, which is forecast to be exhausted by H2 2024.

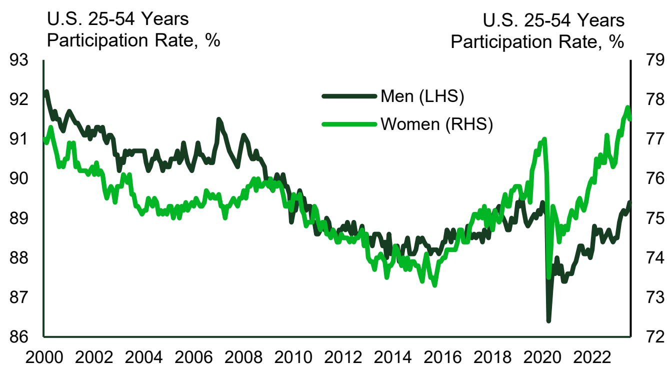
One interesting phenomenon is how the housing market is reacting to a crippling mortgage rate environment. This market was the first to bow down to higher financing costs, but now counter-influences are propping it back up. For the most part, existing homeowners' mortgage rates sit well below today's prevailing rates of near 7%. This disincentive to move and take out a new mortgage at a higher rate is contributing to a lack of churn in resale inventory, which is keeping a floor on prices.

More buyers have pushed into the new home market, manifesting in improved homebuilder confidence, although optimism has been confined to the single-family segment. Multifamily permits have been trending down since the autumn of 2022 (Chart 13). This is consistent with a rise in the multifamily vacancy rate and a record-setting number of units under construction. In essence, the U.S. has a bifurcated market in housing demand, which is expected to persist even under a cooling job market.

**Chart 13: Single-Family Permits Turning Around, Multifamily Permits Heading Lower**




*3-month moving average.
Source: Census Bureau, National Association of Home Builders, TD Economics.




## Q11. Are we seeing a turn in labor markets in the U.S. and Canada?

U.S. job growth continues to moderate on a trend basis, but is still averaging 218k over the last three-months ending in July. This remains above the roughly 100k jobs per month needed to keep the unemployment rate flat in a steady participation environment.

Job openings are also coming off the boil, but here to remain historically elevated with roughly 2.5 million more openings relative to the average of the two-years prior to the pandemic. Initial jobless claims are showing even more stubbornness, trending lower over the past month after having steadily moved higher through H1 2023. Little wonder why the unemployment rate sits only a tick above its 53-year low.

At this point, the major constraint on future job growth is labor supply. Up until now, employers have had the benefit of a surge in the core working age (25-54 years) participation rate, which rose by 1.1%-pts between November 2022 and July 2023. Gains have been seen across both men and women, though the headliner has been the female participation rate reaching an all-time high (Chart 14). Whether or not further inroads can be made remains to be seen.

American women between the ages of 25-54 participate in the labor force at a rate 8%-pts below Canadian women. This suggests significant upside potential for female labor force growth. (There is also a gap for men, although relatively smaller at 3%-pts). Differences in parental leave policies explain a large part of the gap, and that hasn't changed. But the increased shift to hybrid work arrangements has likely been a factor drawing more women into the paid labor force. If the female participation rate moved up by just 2%-pts, that would add 1.3 million workers, or roughly half the 'excess' job openings seen today. However, this would mark a milestone for the U.S. and certainly wouldn't happen in short order. Nor is there any reason to think it will happen, but it does illustrate that the possibility for the labor market to come back into better balance without as large an increase in the unemployment rate, as history would suggest.

In Canada, labor shortages have been far less of an issue given robust population growth, and the labour market is showing more convincing evidence that a cooling is afoot. Since May, the number of workers entering the labor force has swelled relative to the growth in employment demand. In other words, the number of unemployed workers has grown by 123k in three months, lifting the unemployment rate to 5.5% in July, from 5.0% in April. This loosening is also apparent in the number of job vacancies, which have dropped by 250k from the peak last year. These trends are consistent with our expectation that Canada's job market will continue to cool and the unemployment rate will trend towards 6.7% by the end of 2024.

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