Questions? We've Got Answers
Addressing Issues Impacting the Economic and Financial Outlook

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Inflation in advanced economies has made notable progress in recent months, enabling central banks to shift their warnings of potential interest rate hikes to dialogue around the timing for cuts. On the economic front, the U.S. remains a stark outperformer to peers. Despite geopolitical risks, and high borrowing costs, it continues to impress, buoyed by remarkable productivity. This is out-of-step with other countries where growth has cooled markedly. Canada is no exception to this pattern, but domestic inflation has not capitulated as much as other regions, creating a challenge for the Bank of Canada. We explore these themes in our latest list of questions, while tackling other topics such as the ongoing risks from commercial real estate, highly indebted Canadian consumers, and renewed housing demand on both sides of the border.

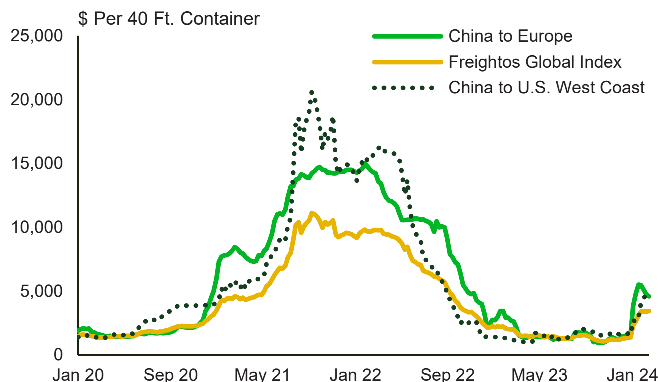
Questions & Answers

1. How are geopolitical risks impacting global growth, inflation risks and commodity prices?
2. What is behind divergent inflation outcomes between the U.S., Canada and the euro area?
3. How are central banks viewing divergent outcomes on their potential policy path?
4. Will a resurgence in housing demand run afoul to central bank rate cut intentions?
5. How will the recent changes to Canada's immigration policy impact the economy?
6. How is U.S. fiscal policy expected to impact growth?
7. What is going to slow the U.S. economic juggernaut in 2024?
8. Where do the risks stand for U.S. commercial real estate?
9. Does Canada carry similar risks in CRE?
10. Canada's soft landing feels hard. How will the economy get its groove back?

Q1. How are geopolitical risks impacting global growth, inflation risks and commodity prices?

The escalation of Israel and Hamas tensions to surrounding regions continues to re-route ships away from the Suez Canal, and around the Cape of Good Hope to mitigate the risk of attacks. The diversion has pushed up container freight rates between China to Europe by roughly four-fold since October, while doubling shipping rates from China to the U.S. (Chart 1).

This means that supply chains are starting to elongate once again, and prices pressures are manifesting. However, the magnitude of the shipping shock is still a fraction of the pandemic era dislocations.



There's also an offset coming from disinflationary forces at China's factories limiting producers' need to pass on further price increases. This means that although the disinflationary forces among goods products may soon be on a short leash within CPI metrics, China's influence helps limit the extent to which a tailwind can build to lift global inflationary pressures.

In addition, oil prices have largely shrugged off the potential for supply disruptions amid geopolitical turbulence. WTI has traded tightly between $70-75/barrel (bbl) for most of the last two months, suggesting little risk premium is built into prices. That said, should events translate to a physical removal of supply from the market, an oil price move to the upside is inevitable. In the coming months, prices should be primarily driven by fundamentals. Most notably for the outlook, key drivers include expectations for robust demand, the extent to which U.S. shale production slows, and OPEC+'s compliance to voluntary production cuts. Our inflation outlook incorporates an uptrend in oil prices back towards $80/bbl in the back half of the year.

For industrial metals, the outlook is contingent on the demand picture – particularly China. New stimulus aimed at expanding investment in infrastructure and manufacturing could provide a lift to prices, but the upside is likely capped by the broader slowdown in industrial production and manufacturing. Despite weakening demand in 2023, inventories for key metals remain at historic lows, helping to keep a floor under prices.

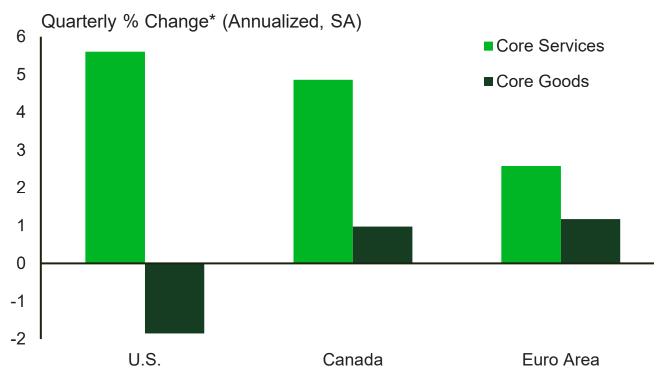
On a different front, tensions have cooled between China and the U.S. after the Biden/Xi summit last November. This has mitigated some of the geopolitical risks to the economy. Overall, the global economy is tracking slightly better than expected in our December outlook, with 2024 global GDP growth expected to register 2.8% (versus 2.6% in December). The largest risks are that the fiscal stimulus in China fails to produce the expected boost to demand or that the U.S. economy finally starts to groan under the weight of high interest rates.

Q2. What is behind divergent inflation outcomes between the U.S., Canada and the euro area?

Through January, the annual change in the Consumer Price Index (CPI) was 3.1% in the U.S., 2.9% in Canada, and 2.8% in the euro area. However, these annual readings mask important nuances. Momentum in price gains has evaporated in Europe, while the same degree of deceleration has yet to be observed in North America.

In the euro area, both goods and services inflation has cooled substantially. The economy has completely stalled since the third quarter of 2022 (+0.04% GDP growth). Traditional economic dynamics have settled in to rebalance demand and supply, and to restore price stability. As a result, fourth quarter price growth has already cooled to roughly 2% (annualized) within both goods and services (Chart 2).

The same cannot be said for the U.S. and Canada. Although Canadian economic growth has steadily evaporated, decades-long housing shortages are coming home to roost. Through January, CPI inflation excluding housing related costs (rent, mortgage interest costs, and replacement costs) has already returned to 1.8% year-on-year (y/y) and is at an even lower 0.6% (annualized) on a quarterly basis. Strip out the same housing factors from the classic core CPI (excluding food and energy) and it advanced only 1.5% (annualized) quarter ending in January. The picture that emerges is of an economy with accumulating slack, not unlike Europe. But, differences in the methodology of the CPI metric within



Canada creates greater distortion from shelter costs, which when combined with a severe supply shortage in the housing market, are going to prop up aggregate inflation for some time to come. It's for this reason that we detailed the related risks of leaving rates too high for too long in a recent report.

Lastly, we come to the U.S. where a resilient economy continues to defy gravity, raising the hopes of an immaculate disinflation. Services inflation has been less cooperative. It continues to chug along, running north of four percent on a quarterly basis. And, unlike Canada, this isn't a housing story. Stripping out the effects of rent and homeownership reveals a quarterly clip of price gains of 5.5% (annualized) through January. Outright deflation in core goods sets the U.S. apart as well, where January prices were down by 1.9% (annualized) on a rolling quarterly basis. Moreover, this print isn't out of the ordinary, in the decade before the pandemic (January 2010 to January 2020) the annual average price growth for core goods was zero. This means that if the downward pressure on goods prices begins to stall out in the face of strong domestic demand and an economy that remains in excess demand, the U.S. is at risk of a re-acceleration of inflation.

Q3. How are central banks viewing divergent outcomes on their potential policy path?

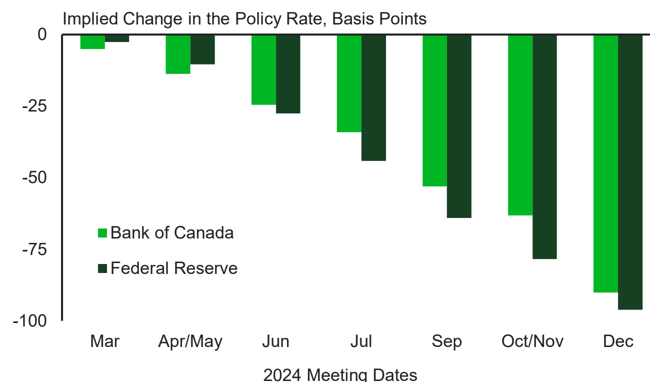
With investors eagerly awaiting the start of central bank rate cuts, both the Fed and BoC have been preaching patience on timing. In the case of the Fed, their preferred core inflation measure – the core PCE deflator – has shown more progress than its CPI counterpart partly reflecting a larger weighting on (declining) goods prices. Under our baseline assumption that goods prices have some more room to fall, core PCE inflation should continue to grind lower to the mid-2% y/y range over the next few inflation reports. While this sounds great, this easing in inflation has come at a time when the U.S. economy has accelerated. The economy grew at a 4.9% quarter-on-quarter (q/q) annualized pace over the summer and barely 'slowed' to 3.3% q/q to close 2023. The first quarter GDP estimate is tracking again near 2%. This is not an economy that is anywhere near excess supply conditions.

Normally, a forward-looking Fed would foresee a higher risk of demand-fuelled inflation, which would prevent them from easing. But Fed Chair Powell has recently communicated that a strong economy may not stand in their way if inflation can continue its downward journey. For this to happen, it would suggest supply side adjustments remain the main driving force of recent disinflationary dynamics and/or America's outperformance in productivity persists to offer a well-timed counterinfluence to demand-push pressures. One thing is for sure, more time is needed to observe dynamics, particularly after a disappointing CPI report for January that reminded investors that this last leg down on inflation will not be a straight line. The Federal Reserve needs to be convinced beyond a shadow of a doubt. The beginning of a rate cut cycle is still in the cards, but the timing will remain hotly debated. We deem the likely opportunity to be around mid-year

The exact opposite dynamics are unfolding for the BoC. The Canadian economy has struggled to tread water since last spring. Total consumer spending has flatlined even with population growing by around 3%. The labour market has also slowed. Cyclical industries have added next to no jobs since last August, while employer demand for workers has effectively normalized to pre-pandemic levels. Yet, even with this weak domestic picture, the Bank of Canada is boxed in with core inflation stuck above 3%. On a three-month basis, the BoC's preferred inflation rates are running more than double that seen south of the border. With higher inflation but a weaker economy, the BoC too is unwilling to open the door to rate cuts.

Despite the difference between the situation facing the Fed and BoC, both have been communicating a similar outlook for policy. The policy rates are at their peak, but don't expect a rate cut in the immediate future, ruling out a decision at the March meeting. After that point, it's an open field, as central banks are hesitant to telegraph too far in advance given the uncertainty of the data. Investors are settling in at around mid-year, which is still reasonable (Chart 3). However, we deem the bigger discussion to be had is not on the precise start date of a cut-cycle but on the speed of

Chart 3: Sticky Canadian Inflation Has Markets Expecting Fewer Rate Cuts



Note: Data as of Feb. 20th, 2024. Source: Bloomberg, TD Economics.

descent. On this, we judge 100 basis points by year-end is within the realm of possibility for the U.S. if inflation remains cooperative. If so, the Fed can achieve an easing of its policy stance while maintaining rates in restrictive territory to mitigate risks of a flare up in inflation.

For the BoC, they will need to decide how much policy can lean against shelter costs, which they have already noted publicly is largely outside their sphere of influence due to its structural imbalances. They also need to manage the other side of the risk. High household debt has pushed up prices for mortgage payments, while consumption is receding from other areas of the economy despite strong population growth masking this pain. Per capita consumption has contracted for four of the last five quarters. While we think the BoC will eventually look past tailoring monetary policy too much to shelter's outsize influence, they are not yet ready to signal this shift. This means that the Federal Reserve and the Bank of Canada may be on the same rate-cut schedule for completely different reasons. Of the two, Canadians will be absorbing the bumpier landing.

Q4. Will a resurgence in housing demand run afoul to central bank rate cut intentions?

The move lower in borrowing costs in the fourth quarter of last year drove a stronger than expected uptick in housing activity in both the U.S. and Canada. However, given Canada's issues with shelter inflation mentioned above, this is a thornier issue for the Bank of Canada, than it is for the Fed.

In Canada, home sales are outpacing our prior forecasts by a considerable margin in the first quarter. Favourable weather likely also played a role. The upcoming spring selling season could be robust if the BoC does shift to an easing stance in monetary policy. We saw these dynamics take hold last spring. The BoC's "conditional pause" on the policy rate through March, April, and May led Canadian home sales to jump 17%, while average home prices went up 7%.

A hotter-than-expected housing market feeds directly into GDP through residential investment and can stoke consumer spending as well. What's more, home prices and rents feed directly into the Canadian CPI via the shelter component, and this category accounts for a heavy 30% of the basket, compared to only 15% for the Federal Reserve's preferred inflation measure.

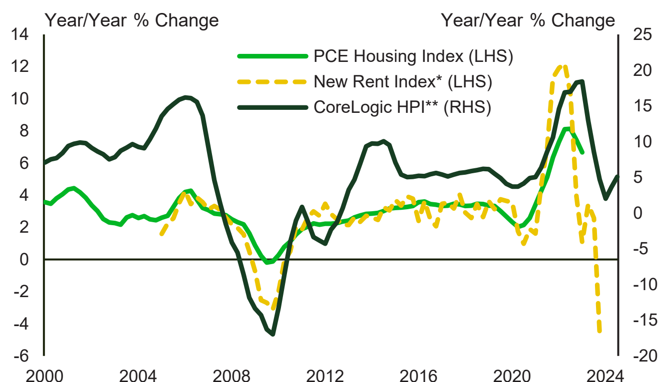
As previously mentioned, shelter inflation is now the single largest contributor to Canadian inflation. We and the Bank of Canada think that inflation can ease towards the 2% target over time, even with sticky shelter costs. However, stronger-than-expected housing market activity risks delaying rate cuts and/or the speed at which they're delivered.

Waiting for shelter inflation to become well behaved (especially if housing markets heat up again) before adjusting policy raises the risk of imparting too much damage on the rest of the economy. On the other hand, Canadian inflation expectations are also influenced by shelter costs. What's certainly the case is the Bank has a difficult communication challenge ahead when it ultimately decides to ease policy.

The U.S. housing market saw pending home sales shoot higher by 8.3% in December – a move that signalled a pickup in housing demand to cap off the year. Although the moderate backup in long-term yields and mortgage rates in recent weeks has likely leaned against this budding strength, the risks are elevated that once the Fed starts to cut interest rates, housing activity could swiftly rebound.

Even so, there's an air pocket for the Fed to navigate. Current U.S. shelter dynamics have reflected some relief from a softer rental market, which feeds through with a notable lag to inflation metrics by several quarters (Chart 4). Mapping this inflation component against home prices (which over the long-run tends to influence rents) yields a similar result. This suggests that shelter inflation growth has further room to cool before it begins to reverse course again through the tail-end of this year. This "wave effect" in how lags feed through offers the Fed a window to cut interest rates even in the event of a hot spring housing season. However, it's also a key argument on the "go slow" approach to easing monetary policy. FOMC members expect only 75 basis points in cuts this year, which is half of what markets were expecting a month ago. Like the Bank of Canada, the intricacies of shelter inflation will present a communication challenge for the Fed too.

Chart 4: U.S. Shelter Inflation Has Further to Cool



*3-Quarter Lead. **6-Quarter Lead.
Source: Bureau of Economic Analysis, CoreLogic, TD Economics.

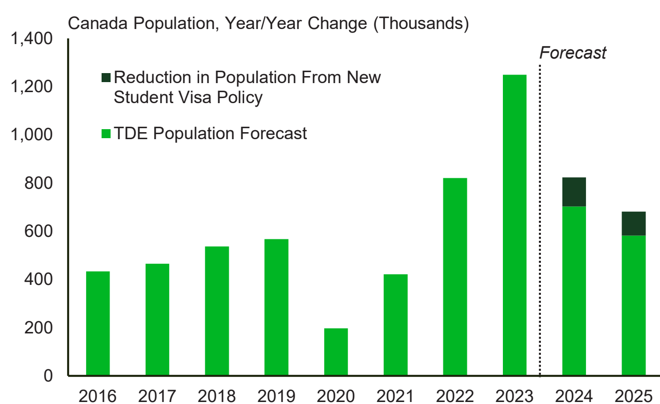
Q5. How will the recent changes to Canada's immigration policy impact the economy?

In 2023, Canada's population grew by a staggering 2.8%, or roughly 1.1 million new people. This supercharged growth goes a long way in explaining how Canada's domestic economy has managed to stay afloat during the Bank of Canada's historic tightening campaign. For its part, immigration helped fill labour force gaps, boost employment, and prop up aggregate spending. Now, the "too far, too fast" pace of growth has created imbalances, pressuring housing affordability, fueling rapid rent gains and stretching the nation's public services capacity. To tackle these challenges, policymakers have put in place a series of measures to curb the historic inflow of migrants.

In November 2023, the federal government released the details of their 2024–2026 Immigration Levels Plan. In that document, targets around permanent residents were left unchanged at 485k and 500k, respectively for 2024 and 2025, with a 500k target tacked on for 2026. The Plan puts a greater emphasis on drawing in high-skilled workers, who are expected to account for nearly 25% of all permanent newcomers this year, up from around 18% in 2023.

More recently, the federal government imposed an immediate cap on the number of international study visas. The targeted reduction, pegged at 35% or 220k fewer study approvals compared to last year, would keep the total pool of international students effectively flat over the next two years. While the full mechanics of the program need to be worked out by the provinces, population growth is now on track to decelerate at a slightly faster rate as a result of the new policy (Chart 5). The cap on international students will also alleviate some pressure on rent growth, although it doesn't offer a full solution (see report).

Chart 5: Canada's Population Growth Set To Decelerate



Source: Statistics Canada, TD Economics.

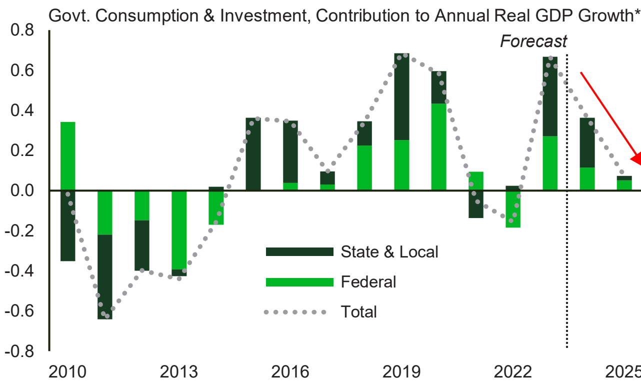
The non-permanent resident channel, mostly consisting of work and study permit holders, has contributed the most to Canada's ballooning population count. The government is now mulling the idea of curbing the country's dependance on temporary foreign workers through a review of the program. No further details are available at this time, but program changes could further take the heat off the structural challenges within the economy's housing and social fabric.

All said, the government appears to be more vigilant about finding the right balance with Canada's population growth, while retaining the need for immigration (see report). These measures will go some way in restoring balance in the Canadian economy.

Q6. How is U.S. fiscal policy expected to impact growth?

Federal fiscal policies have been a key ingredient in the U.S.'s outperformance over the past few years. These policies included trillions of dollars in pandemic-related economic stimulus in 2020 and 2021, in addition to the more recent landmark legislations of the Infrastructure Investment and Jobs Act (IIJA), the CHIPS & Science Act, and the Inflation Reduction Act (IRA). All three of these bills have resulted in massive amounts of public and private investment despite a rapid rise in interest rates. While the initial stimulus impulse from these packages has partially receded, each is expected to continue to provide support to economic growth as work continues on the associated projects.

However, new federal spending measures are expected to be limited in 2024 as Congress targets discretionary spending caps in the yet-to-be passed annual budget. A provisional agreement between Congressional leaders would see defense spending grow by roughly 3%, while non-defense spending would be flat, consistent with the limits agreed with in the Fiscal Responsibility Act (FRA) of 2022. However, the federal government is currently funded under a continuing resolution that runs through early March, the third such one passed since the fiscal year began in October. Failure to pass the 2024 budget by April 30th will trigger automatic spending cuts legislated by the FRA, including a 1% cut to defense and non-defense discretionary spending. While this represents a modest risk to the economic outlook, federal expenditures are expected to see slower growth moving forward regardless, although the FRA cuts would accelerate the decline (Chart 6).



*Percentage Points. Source: Bureau of Economic Analysis, TD Economics.

In addition, state and local government (S&L) spending growth has also been elevated. State budgets have been bolstered by the $350 billion State and Local Fiscal Recovery Funds set out in the 2021 American Rescue Plan Act. These funds must be allocated by the end of this year and spent by the end of 2026. S&L spending has also been boosted by the projects related to the same federal bills mentioned above (IIJA, CHIPS, IRA). The competition to attract the related private sector investments has further pushed up S&L spending, creating another tailwind that will take time to recede.

Q7. What is going to slow the U.S. economic juggernaut in 2024?

The U.S. economy roared through the second half of last year, causing analysts, including ourselves, to have an embarrassing degree of forecast miss. Growth in the second half averaged 4% and the October-December period marked the sixth consecutive quarter that economic growth either met or exceeded its long-run potential growth rate, despite the federal funds rate remaining well into restrictive territory.

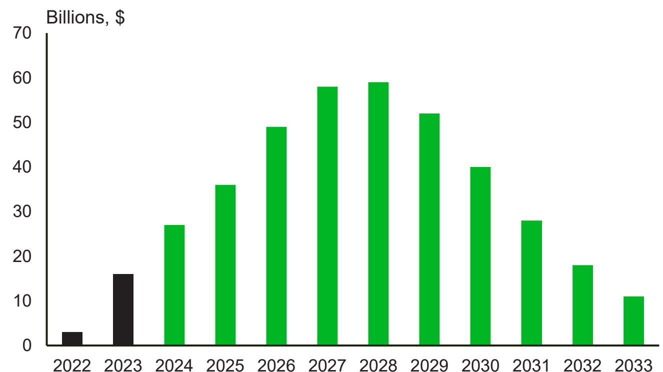
Consumer spending has been a key catalyst, even as excess savings have become increasingly depleted, and millions of borrowers have resumed regular student loan repayments. The ongoing strength can be traced back to the robust labor market and ongoing gains in real household income. Falling gasoline prices and easing food inflation have also provided a tailwind, by freeing up some additional cash which has ultimately filtered into stronger discretionary spending.

As outlined in question 6, state & local government (S&L) has also been punching above its weight – adding 0.4 percentage points to growth in 2023 (see Chart 7). This spending push could very well extend over the coming years, particularly given that COVID relief funds will need to be designated for specific uses by the end of fiscal 2024 (and deployed by the end of FY2026). In addition, authorized funds through the Infrastructure Investment & Jobs Act (IIJA) have only recently translated to shovels in the ground (Chart 7).

All of this leaves the impression that the U.S. economy is immune to higher interest rates, but it's more likely that the lags are just longer in this post-pandemic cycle. From the consumer standpoint, spending growth is now outpacing income by a wide margin, leaving households increasingly reliant on consumer credit – as evidenced by rising credit card utilization rates. With excess savings for low-to-middle income households largely exhausted, consumer spending is running on fewer growth-impulses. Headwinds are also persisting from tight lending standards, elevated interest rates, and there's also the potential for political uncertainty related to the election to weigh on near-term business investment. But even with these headwinds, U.S. growth is still expected to expand by 2.3% this year – nearly matching 2023's rate of expansion. This annual average growth is flattered by a strong hand off from 2023, with growth expected to slow to 1.5% by the end of the year (on a Q4/Q4 basis). But even this pace will far outstrip its peers, which means the global theme of American exceptionalism will remain intact for at least another year.

Q8. Where do the risks stand for U.S. commercial real estate?

Higher interest rates have not been kind to Commercial



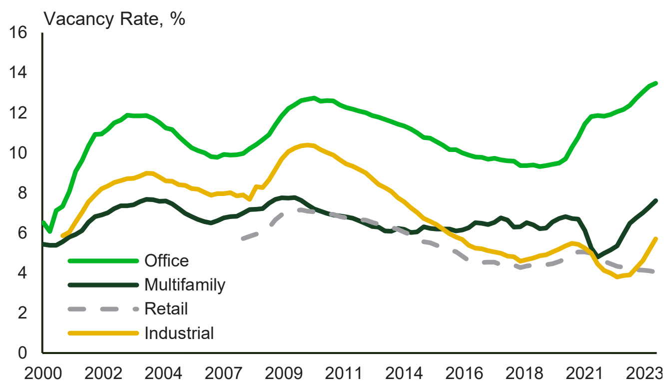
Note: CBO Projection as of February 2024. Source: CBO, TD Economics.

Real Estate (CRE), with deal activity drying up and property values, especially those for the office sector, trending lower. At roughly $540 billion per year in 2024 and 2025, the volume of CRE loan maturities is expected to remain elevated, but relatively steady compared to last year. But the ongoing deterioration in overall market fundamentals points to a potentially bumpier road ahead. CRE remains a long tail risk within the forecast. It will continue to take time to play out with the likelihood of rolling flare-ups within certain financial institutions. But it's not believed to have a deep reach into undermining financial stability that would upset the broader economy.

So far, the delinquency rate of all CRE loans issued by banks in the U.S. stands at 1.1%, much lower compared to prior periods of stress such as the GFC, but it still exhibits a noticeable upswing recently. CRE weakness continues to be centered around the office market, where the vacancy rate has risen to an all-time high. CMBS loan data shows that the delinquency rate of loans backed by office properties has risen sharply over the past year, to 6.3% in January from 1.9% a year ago. The other main CRE sectors are generally better positioned to withstand the pressure of maturing loans in a higher interest rate environment, but rising vacancies in the industrial and multifamily space could bring about more signs of stress (Chart 8). On the plus side, prospects for a further move downward in longer-term yields, and a relatively resilient U.S. economy, should help limit the fallout.

Roughly half of the loans slated to mature over the next few years have been originated by the banking sector. As has been well publicized, some smaller regional banks are more exposed to CRE debt, and potential losses related to these loans can cause financial difficulty for these institutions. But, their exposure to the weakest corner of CRE – the office market – is more limited. In addition, once factoring in nonbank players in the CRE lending space (i.e., Life insurance companies, CMBS etc.) the overall exposure and perceived risks tied to the smaller banks is much lower. Meanwhile, larger banks are better capitalized to handle the stress. These are all elements that should serve to limit risks, or the systematic nature of that risk within the broad economy. Speaking on this issue recently, Fed Chair Powell agreed, noting the potential for some smaller banks to 'close or be merged out', but stated that that CRE risks present a 'manageable' problem for larger banks, and that there isn't much risk of a repeat of 2008.

Chart 8: U.S. Vacancy Rates in Other Key CRE Sectors Heading Higher



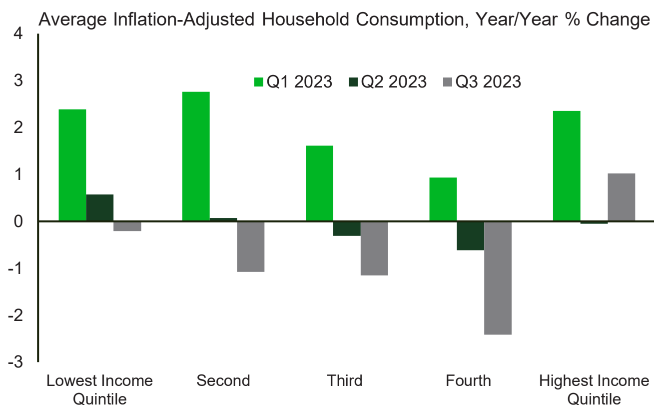
Source: CoStar, TD Economics.

Q9. Does Canada carry similar risks in CRE?

Probably not. Lending exposure to CRE is small, at least for banks, with the Bank of Canada noting that non-residential mortgages account for about 2% of the total value of bank assets. As in the U.S., the Canadian office sector is struggling. However, the number of workers returning to the office is climbing, brightening the outlook a touch. The multi-residential sector is also facing some difficulties due to higher interest rates, but the medium-term outlook is favourable given the prospect of solid population growth and Canada's severe housing shortage. Elsewhere, industrial and retail asset classes are holding up better than the office and multi-residential categories.

More broadly, the U.S. is made up of thousands of smaller, fragmented regional banks, which raises the risk that any given lender could face challenges due to a lack of diversity in its lending portfolio. The recent struggles at New York Community Bancorp are a case-in-point, with the mid-sized lender facing severe difficulties due to its overexposure to commercial real estate. We also saw this early last year with Silicon Valley Bank, who's failure was in part due to overexposure to U.S. treasury bills and too much reliance a struggling tech sector.

Contrast that with Canada, whose lending system is comprised of fewer, larger lenders with more diversified business models and funding sources. The Canadian banking sector captures a more uniform application of strong capital buffers, solid balance sheets and high loan-loss reserves. They are also subject to rigorous liquidity standards set by federal regulators. Other Canadian lenders are more exposed, with estimates suggesting exposure levels of between 5-20% for some larger Canadian pension funds. Unfortunately, data limitations make it tough to tease out how important nonbank lenders are in the non-residential space, making this grey area a risk.



Q10. Canada's soft landing feels hard. How will the economy get its groove back?

While Canada's economy is approaching what economists call a soft landing, for the average consumer it may still feel hard. The Bank of Canada's goal of raising interest rates just enough to slow the economy and reduce inflation — without triggering a recession — does not alleviate the financial pain for many households. The combination of higher levels of household debt and a high-interest rate environment means that, on aggregate, Canadians with debt are paying almost 90% more in mortgage interest and 60% more in non-mortgage interest than before the Bank of Canada began raising rates. That is estimated to cost the average family with debt an additional $2,800 annually in servicing costs by 2024.

An increasing number of Canadians are falling behind on their debt payments, a trend so far largely reflected in consumer debt (i.e., credit cards and loans) rather than mortgage debt. According to TransUnion, the late delinquency rate (over 90 days past due) for credit cards and installment loans has already either surpassed or is very close to pre-pandemic levels. This situation largely reflects the higher interest rate environment, as job losses remain limited. However, as the unemployment rate continues to creep up and personal income moderates, credit conditions are likely to deteriorate further, with families increasingly feeling financial strain.

Consequently, consumers are pulling back on spending. Overall real spending growth is tepid at best and is contracting on a per capita basis. Looking at spending trends across household income quintiles, real spending is declining on a year-on-year basis in all groups except the top 20% (Chart 9). This is not surprising, given that higher-income families' were less affected by the termination of government pandemic support, and their net investment income was boosted by higher rates thanks to a lower debt burden.

We expect these dynamics to continue to play out, despite the temporary boost in spending evident at the end of 2023 (see report). Consequently, we project that personal spending will grow at a sub-par pace into 2025. This will hold down overall GDP growth, with the economy remaining in excess supply though that period.

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