TD Economics

Questions? We've Got Answers

Addressing Issues Impacting the Economic and Financial Outlook

August 14, 2024

What a difference a quarter can make. Financial markets have done a 180 relative to our prior Q&A. From focusing on the risks of persistent U.S. inflation and punting out rate cuts largely into 2025, to now worrying that the Fed is behind the curve and has not cut fast enough! Globally, other G7 central banks are already on the move despite stubborn services inflation among some — a reminder that the rate cut process will involve some guess and test. We argue that the U.S. economy remains resilient and the Sahm-old labour market rules need context. We also discuss the potential risks to international trade from campaign promises in lead up to U.S. elections. Canada's economic fortunes are also addressed. The economy continues to look better on the surface due to population growth that defies gravity (yet again). However, this isn't likely to get in the way of the Bank of Canada cutting interest rates at a steady pace at each meeting this year. The one thing that could slow them down is a strong revival in housing demand.

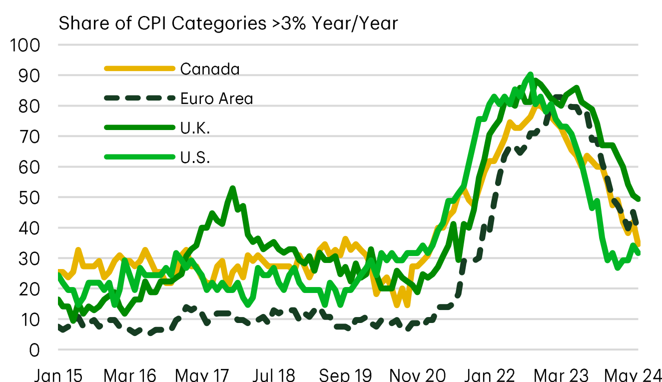
Questions & Answers

1. Is the global cooling in inflation going according to plan?
2. The global interest rate pivot has begun, will central banks take the stairs or the elevator?
3. What is the outlook for currencies and will King USD maintain its reign?
4. With market fears mounting, what is the U.S. economic outlook on the eve of the election?
5. Should we be worried about the cooling in the U.S. labor market?
6. When will lower interest rates provide relief for U.S. housing?
7. How might the 2024 U.S. election affect international trade?
8. What about Canada's economic outlook in the near term?
9. When will strong Canadian population growth cool and how will it break out across provinces?
10. Is Canadian business dynamism suffering from long COVID?
11. Has our Canadian housing outlook changed now that the BoC is cutting rates?

Q1. Is the global cooling in inflation going according to plan?

For the major central banks looking to tame inflation – the European Central Bank, Federal Reserve, Bank of Canada and Bank of England – price pressures have cooled largely in-line with expectations. More importantly, the declines are not solely driven by food and energy prices. The share of categories with prices running above 3% year-on-year (y/y) has stepped down significantly in the past year (Chart 1).

Chart 1: Inflation Breadth Narrows



Source: BLS, Stat Can, Eurostat, ONS, TD Economics. Last Observation: June 2024

Leading the good news has been the rapid unwinding of price inflation for physical "stuff". Excluding food & energy, goods prices are contracting on an annual basis in the U.S. and Canada (-1.7% y/y and -0.5% y/y, respectively), are flat in the UK, and are registering modest gains (+0.6% y/y) in the euro area.

However, the road ahead might be bumpy as prices for services have shown persistence. On an annual basis, services prices are running at 5% in the U.S. and Canada, and even hotter in the U.K. at 6%. The euro area has the best performance, and yet that is holding at a still hefty 4%. What's more, only the U.S. has shown a notable improvement in the near-term trend, where the three-month annualized change has ticked down to 3%. In all other jurisdictions, near-term momentum leans to the upside.

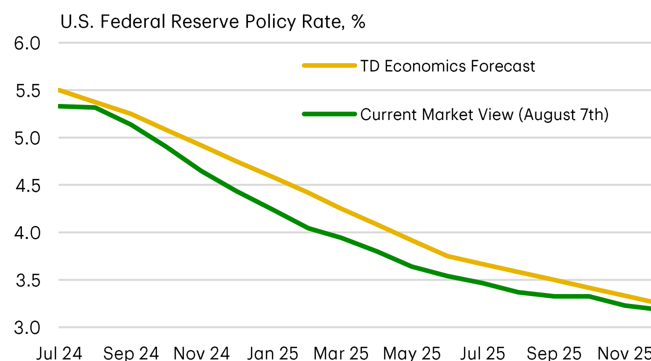
With all central banks having either cut, or about to cut in the case of the Fed, the key question is whether this recent lift in services inflation will be a temporary blip, or limit the amount of relief central banks can deliver. This means that central bankers will remain highly data-dependent in their approach rather than relying on forecast models. Any renewed pressure on prices will be considered within the context of any loosening in labour market conditions that typically precede an easing in service prices.

Q2. The global interest rate pivot has begun, will central banks take the stairs or the elevator?

This answer depends on who you ask. Market pricing for all major central banks indicate a preference to use the stairs, with gradual 25 basis point rate cuts through the next eighteen months (Chart 2). The exception is the Federal Reserve, where disappointing employment data in July led to rampant market speculation that the first cut will be a doozy at 50 basis points in September. Since the Fed is last to the exit door, markets fret that they have fallen behind the curve and will be in a greater rush to normalize interest rates.

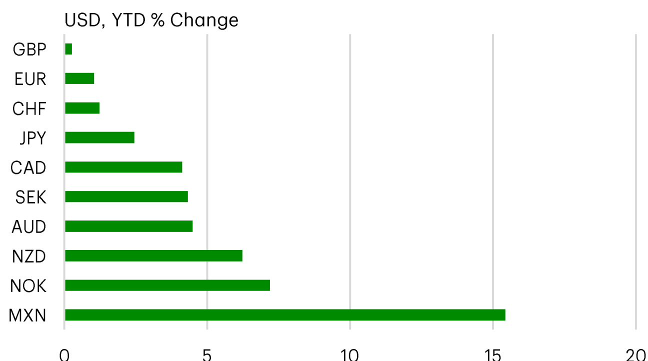
This threat caused U.S. Treasury yields to tumble 40 to 50 basis points in the final week of July and start of August. While we think cooler heads will prevail at the Fed, markets will need reassurance that the economic path is a slowdown and not recession. Only the incoming data will provide that proof point, meaning that every downside miss on consensus can inject more than usual volatility. One thing is for sure, the economy has lost its bouncy step as the long and variable lags of rate hikes finally make a mark. From our perspective, this economic slowdown is a necessary condition to underpin confidence at the Fed that inflation is under control and the process of lowering interest rates can commence. So far, the fundamentals do not predict an economy headed towards recession (see question 4). Provided that remains the case, we anticipate the Fed will take the stairs in lowering interest rates by 25-basis points per meeting starting in September. This would leave the policy rate at 4.75% by end-2024.

Chart 2: Central Bank Policy Rate Expectation Are Coming Down for 2024



Source: Bloomberg, TD Economics.

Chart 3: The U.S. Dollar is Still Up Versus Major Currencies this Year



Source: WSJ, TD Economics. Data as of August 6th, 2024.

We have greater certainty on the outlook for the pace of rate cuts for the Bank of Canada given that it has already established a trend over the last two months. The policy rate is already 100 basis point below its U.S. counterpart, and the Bank of Canada has set a precedent of cutting rates by 25 basis points in back-to-back meetings. This creates a higher bar to alter the course. We expect that the BoC will match the Fed's pace over the rest of 2024, with a quarter-point cut at each of its next three announcements. This will bring the policy rate to 3.75% by year end – a significant amount of easing from the 5.0% level just a few months ago.

Q3. What is the outlook for currencies and will King USD maintain its reign?

The U.S. dollar trade weighted was on an incredible run over the first half of 2024 (up around 5% on a trade-weighted basis) (Chart 3). The relative strength in economic performance caused markets to anticipate a widening in spreads to peer countries, which proved correct until July.

The recent Fed pivot (see above) has caused the U.S. dollar (USD) to depreciate by around 3% since the start of July. Much of this has been against the Japanese Yen, which has climbed approximately 10% over the past month, as that central bank carves a different path of finally raising interest rates. Other countries that have also been caught in the upswing are the euro, Swiss franc, and Singapore dollar. As for Canada, the loonie has largely sat on the sideline, trading sideways to the USD and depreciating against peers. This reflects the offsetting impact of falling energy prices. This lack of direction for the loonie is expected to persist going forward, with offsetting influences keeping the currency within its current 72 to 76 U.S. cent range.

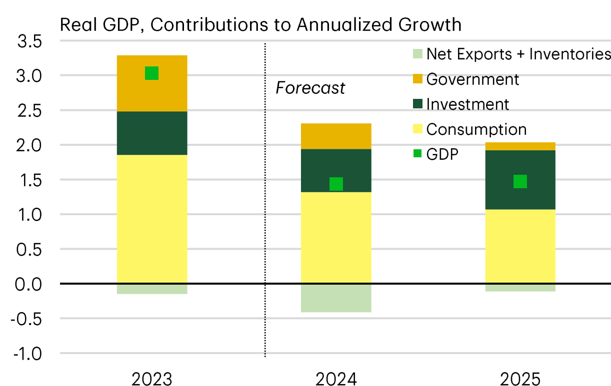
We think the greenback could well be in for a reversal through year-end if market focus shifts back to geopolitical factors and flight-to-safety trades kick back in, to the benefit of U.S. dollars. One such event is what happens with the U.S. election. Does it open the door to a rehashing of trade disputes, the potential for tax cuts, and greater uncertainty for America's peers? Even if the Fed cuts rates aggressively, investors may seek the shelter of King Dollar once again.

Q4. With market fears mounting, what is the U.S. economic outlook on the eve of the election?

Markets are not completely in left field to worry about the downshift in U.S. momentum, but nothing in the data foretell a stalling out. So far, the data reinforce an expansion that has downshifted from fourth gear into second.

The 4% annualized expansion through the second half of last year has decelerated to a trend-like pace of 2% in H1-2024 (Chart 4). However, this shouldn't be interpreted as bad news. It provides validation that the 'long and variable lags' of restrictive monetary policy are finally starting to tighten their grip on the economy – a necessary condition to wring out the last bit of inflationary pressure and open the door for interest rate cuts.

Chart 4: The U.S. Economy Is Downshifting



Source: Bureau of Economic Analysis, TD Economics.

Nearly half of the slowdown is attributed to cooler consumer spending, which shouldn't come as a surprise. With the tailwind from excess savings exhausted, consumers have increasingly relied on debt to fund spending. Earlier in the recovery, households were able to easily absorb these higher debt loads as an exceptionally tight labor market supported strong gains in real incomes. Now that the job market has turned a corner (see Question 5), real disposable income has slowed accordingly.

Even as spending has started to come to heel, it's still outpacing income growth. This cannot be sustained indefinitely. The share of income that households are dedicating to servicing non-mortgage debt is quickly closing in on levels last seen during the 2008 financial crisis. And delinquency rates across most consumer lending products have risen above pre-pandemic levels and are continuing to trend higher. All of this points to a return to thrift, which means consumption patterns should better align to income growth in the coming quarters.

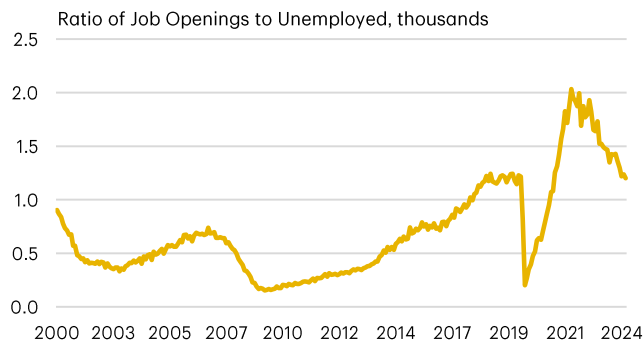
But not all areas of the economy are bending under the weight of higher rates. Business investment has gained momentum through the first half of this year. Part of the strength has been due to a pick-up in equipment spending, which shot up by nearly 12% annualized in Q2 thanks to a 450% surge in aircraft purchases. While this is unlikely to be repeated, further investments directed to semiconductor manufacturing alongside sustained strength in software spending are likely to keep business investment growing at an above-trend pace.

The U.S. economy is slowing, but not buckling, following last year's breakneck pace. This carries the markings of a true 'soft landing' that is allowing inflationary pressures to gradually drift lower. While current polling suggests the outcome of the election could go either way, one thing is looking more certain: the candidate who wins the White House is likely to inherit a resilient economy.

Q5. Should we be worried about the cooling in the U.S. labor market?

Non-farm employment has slowed markedly over the past year, confirmed by a disappointing 114K net jobs in July. However, caution is warranted in reading too much into a single month of data. The labor market is still averaging a healthy 170k jobs per-month over the last three months.

Chart 5: Labor Market Imbalances Are Quickly Normalizing

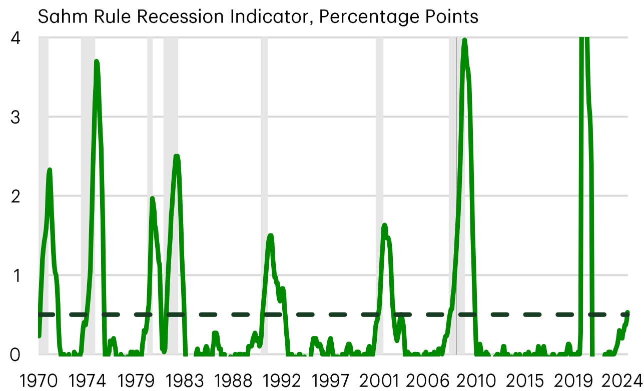


Source: Bureau of Labor Statistics, TD Economics.

Still, it's impossible to ignore the degree of normalization that has taken place. For starters, employment gains have become increasingly concentrated in less cyclical sectors, like healthcare and government. Combined, these two sectors account for 29% of overall employment, but have been responsible for well over half of the jobs created in recent months. Another sign of weakness has been the pullback in temporary hires. Since peaking at nearly 3.2 million in March of 2022, demand for temporary workers has fallen by 15% or a whopping 467k jobs. This statistic has helped fuel market concerns that the Fed is already behind the curve because, in recent history, this magnitude has never happened without a subsequent recession.

However, not all labor market statistics are reinforcing that negative sentiment. The ratio of job openings to unemployed – a metric commonly used to assess the degree of imbalance in the labor market – has significantly receded from its 2022 highs. But it's only closing in on pre-pandemic levels (Chart 5). This period was not defined by a recession, which is why Chair Powell continues to refer to recent trends as a 'normalization' after an unusually long period marked by a breakneck pace.

The same can be said for the share of workers quitting their jobs and the share of small businesses intending to increase hiring over the next 3-6 months. At only 15%, it's near a cyclical low reached earlier this year.



One area grabbing increasing attention is the rise in the unemployment rate through the first seven months of 2024. At 4.3%, the near three-year high is also in stark contrast to its post-pandemic low of 3.4% (reached in April 2023). It's also trending above the pre-pandemic average of 3.7%. This has triggered market chatter on the Sahm rule (Chart 6). According to this rule, if the three-month average of the unemployment rate rises by half a percentage point or more relative to its previous 12-month low, a recession is likely to materialize over the coming months. However, Fed Chair Powell has referred to this as a statistical regularity and not an economic rule. Why? There's some reason to believe that this recession predicator will carry less statistical relevance or a longer lag than past cycles.

The uptick in the unemployment rate over the past year has been more influenced by a larger increase of entrants in the labor force compared to start of prior recessions. So while there's clearly a weakening in labor market fundamentals, the recent upswing is not (yet) a sure-fire sign that a downturn is imminent. That said, firm behaviors on hiring tend to have inertia and can be difficult to influence once a trend is established – suggesting the Fed can't wait any longer to cut rates.

Q6. When will lower interest rates provide relief for U.S. housing?

Our current forecast anticipates that 30-year fixed mortgage rates have already peaked at around 7% and will head lower in the second half of the year, dropping close to 6.0% by year end. Even with prices remaining elevated, this should provide some relief to the U.S. housing market starting in Q3 2024. Monthly mortgage payments on a median priced home are forecast to ease by 6-7% in response to the lower rates between now and the end of the year with our housing affordability index (HAI) rising marginally over the same period, meaning homes would become more affordable. Rates are anticipated to continue heading lower into next year and further improve the situation.

Even so, with limited supply propping up housing prices, a return to full affordability (i.e., the point at which the HAI = 100) remains in the distance. That is the point at which a family earning the median income is able to finance the purchase of a median priced home (assuming 20% down and monthly payments not exceeding a quarter of income). Given our base outlook for mortgage rates, home price and income growth, we expect that this point will be achieved by mid-2027 (Chart 7). Under this scenario, mortgage rates would need to trend near 5 to 5.5%, median home prices would grow at about 3% annually and income would advance by 4.5% annually, which is in line with its historical rate. Interestingly, it would take a more sizeable drop of approximately 300 basis points in mortgage rates, with both income and home prices at their current levels, to return full affordability to the market immediately – a highly unlikely outcome.

Q7. How might the 2024 U.S. election affect international trade?

Regardless of who wins in November, global trade will have to contend with an America that's leaning into industrial policy and self-reliance. The key differentiat-

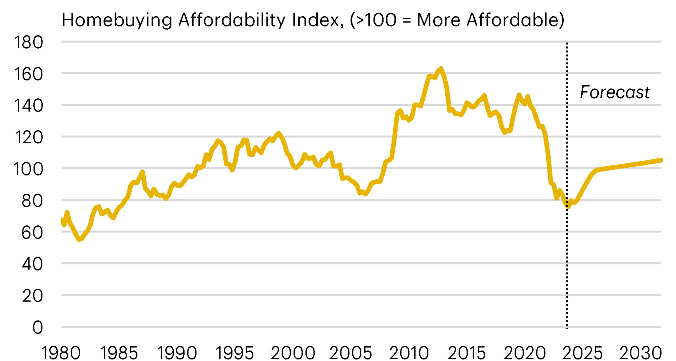
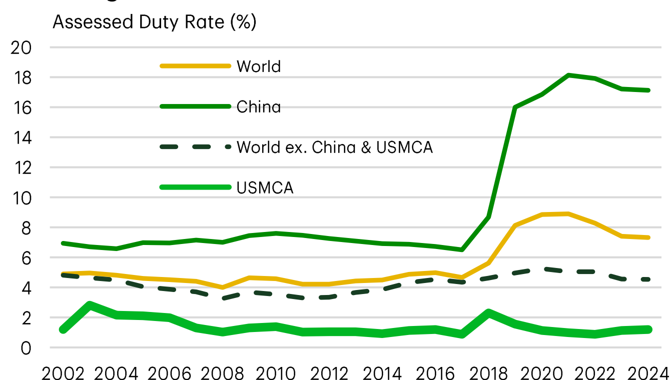


Chart 8: Tariffs on China Persist, Despite Change in Administration



Source: U.S. Census Bureau, TD Economics.

ing factor will be whether the new administration will decide to "go at it alone" or continue to work with allies on strategic sourcing initiatives. The latter scenario represents an extension of the status quo, while the former would likely result in depressed global trade volumes.

First and foremost is the policy stance as it relates to China. Here, there is little relief in sight. The Biden administration imposed further tariffs on China (Chart 8) along with a raft of other non-tariff measures, like restricting access to advanced chips. Irrespective of the election outcome, these initiatives are unlikely to be reversed. The prospect of a Trump Administration also raises the likelihood of a 60% tariff applied to all imports from China, which would likely accelerate the trend we highlighted last winter of trade shifting away from China and towards other economies.

For all other nations, Trump's proposed blanket 10% tariff has raised concerns. The E.U. is reportedly developing a two-stage strategy in response. First to pre-empt the possible tariffs with negotiations, and then to retaliate with targeted tariffs of 50% or more, if necessary. Canada is adopting a similar approach to the E.U. and holding pre-emptive discussions in hopes averting future tariffs. Canada and Mexico are highly reliant on trade with the U.S. and the USMCA agreement will be coming under review in 2026. As such, these countries likely won't want to rock the boat before the election and will likely continue seek solutions through diplomatic means or within the dispute terms of the USMCA agreement. However, as we saw in 2018, the existence of a trade agreement didn't preclude Canada from applying targeted countervailing duties on U.S. products – and the existence of the USMCA is no different. Ultimately, a broad and deep increase in tariffs would dent U.S. real incomes, depressing demand for foreign products. To the extent domestic substitutes exist, these will be consumed and where they don't, foreign goods will continue to flow – albeit likely at a slower pace.

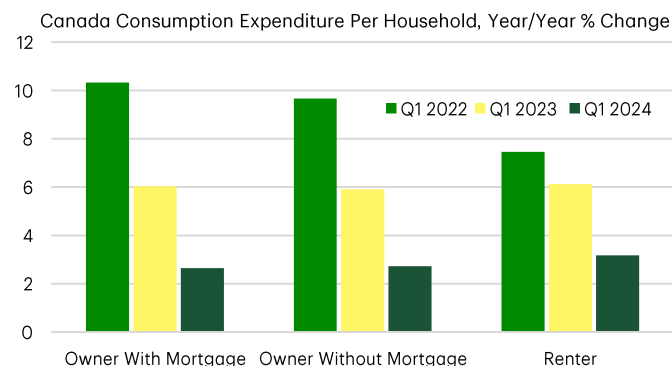
For Canada, the U.S. represents an outsized risk. Canada has increased its reliance on the U.S. as an export partner since the USMCA was established in 2020. The potential for energy products to be subject to tariffs is especially concerning. Energy exports to the U.S. represent roughly 5% of Canada's GDP, a near record share of total outbound trade. This means depressed demand due to tariffs could also materially impact its growth outlook.

Q8. What about Canada's economic outlook in the near term?

The Canadian economy narrowly avoided a technical recession in 2023 and has since shown surprising resiliency over 2024 (final domestic demand was up 2.9% q/q in Q1 2024). The debt-constrained consumer has demonstrated a renewed willingness to spend on 'nice-to-haves' like dining out at restaurants, travel, and entertainment. At the same time, population growth has well outpaced expectations (see more below), which has created a bigger base for spending.

How long this can last is uncertain. New government restrictions on non-permanent residents are intend-

Chart 9: Canadian Consumers Have Tightened Their Purse Strings



Source: Statistics Canada, TD Economics.

ed to curb population flows in the coming months (see question 9), which could act as a headwind for spending. Not to mention that a significant number of mortgage holders will face higher rates at renewal of 200-250 basis points, even with a central bank cutting interest rates (Chart 9).

With consumer spending expected to slow going forward, we are optimistic that a mixture of business investment, government spending, and increased exports could be a counterweight. Whether it be shovels in the ground on new EV/battery plants, the development of purposed-built rentals, or increased oil exports thanks to the expanded Trans Mountain pipeline, there are levers to create a much-needed growth offset.

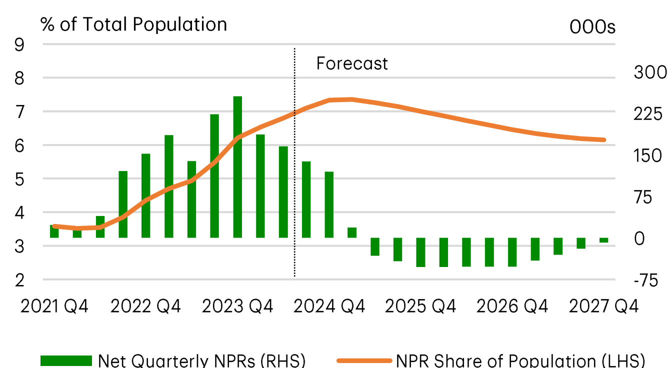
The big risk to this view is related to the outcome of the U.S. election. Canada signed the USMCA deal under the prior Trump presidency, but this doesn't shield it from renewed trade disputes. In fact, this will be of greater importance since Canada has increased imports from Mexico and exports to the U.S. since 2020, while reducing exposure to China. Canada is therefore more vulnerable to protectionist trade policy from the U.S., which could limit the expected GDP offset from Canadian business investment and trade.

Q9. When will strong Canadian population growth cool and how will it break out across provinces?

Canada's population growth is still running hot. But we expect it is nearing a crest, with a more pronounced slowdown in 2025 (1.7%) and 2026 (0.8%) as federal government policy to reduce the share of non-permanent residents begins to take effect. At last count (Q1-2024), Canada's headcount was growing at a breakneck pace of 3.2% year-on-year, matching the quarter prior and growth rates last seen in the 1950s!

The international student population will likely be impacted first, around the third quarter of this year. Historically, a seasonal spike of around 60–100k new study permits are issued in the month of August. Given government policy to implement some guardrails on the amount of study permits educational institutions can issue, we expect the August data to show a significant scaling back in the number of study permits issued in order help stabilize the pool of international students to 2023 levels, as per the policy's guidelines. Ontario, British Columbia, Manitoba and the Maritime provinces should be disproportionately affected by the cap, as 2024 application processing caps will be reduced from the year prior to be in better alignment with regional population shares.

Chart 10: Canada Likely to See A Delay in Getting Non-Permanent Residents to Reach 5% Target



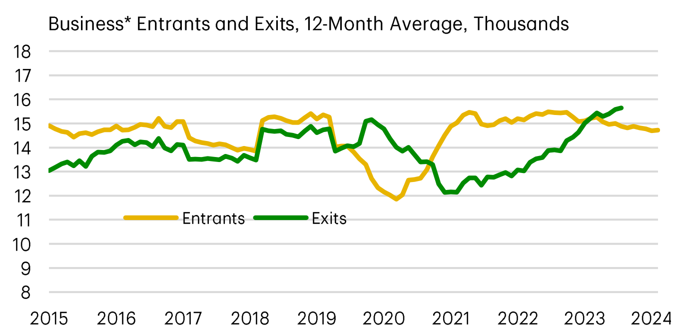
Source: Statistics Canada, TD Economics.

However, it is not certain that the government can deliver on its promise to reduce non-permanent residents as a share of the population to 5.0% by 2027. Since the policy was announced in March, non-permanent resident flows have remained robust, pulling the ratio up from 6.3% to 6.8%. Further, this share will continue to nudge slightly higher in the near-term, potentially delaying when the target is reached.

We expect net non-permanent resident outflows will begin in the first quarter of 2025, after the federal government outlines its immigration levels plan for 2025–2027 in November. This will be the first year that the government will provide non-permanent resident targets. Our forecast embeds a view that between today and end-2027, Canada could see net outflows of non-permanent residents of around 450k, which would put the country closer to its goal, but still around a percent shy of 5%. (Chart 10). The timing of these reductions is important, as it can impact the Bank of Canada's (BoC) policy decisions. For their part, the BoC appears to have some skepticism about whether the federal government will hit its target, projecting Canada's population growth rate to stay more elevated in the medium-term.

Chart 11: Canada's Waning Business Dynamism Needs a Booster Shot

Business* Entrants and Exits, 12-Month Average, Thousands



*Business sector industries except educational services and health care and social assistance Source: Statistics Canada (Table 33-10-0722-01, Experimental estimates for business openings and closures), TD Economics

Q10. Is Canadian business dynamism suffering from long COVID?

The anemic state of Canada's business dynamism in the post-pandemic world certainly points to this diagnosis. Business dynamism is measured by the rate at which firms enter the market, grow, and leave a market. It offers insight into the potential for higher rates of productivity growth, as unproductive firms leave, and more productive firms enter or grow. Unfortunately, Canadian business dynamism has been weakening.

Net business entries—the difference between business entrants and exits scaled by the number of active businesses —has declined since 2023 due to an above-average rate of exits, while the number of entrants has remained close to its historic average (Chart 11). Net exits are not yet estimated for early 2024, but we can back out a conclusion given that there's been nearly an 80% increase in bankruptcies over the first five months of 2024 relative to the same period in 2023. Unless the entry rate picks up significantly, the net entry rate will continue to decline.

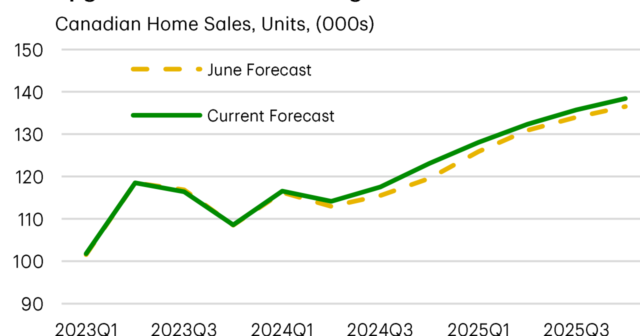
Compared to a similar statistic in the United States, the difference is striking.[1] While both countries saw an above-average boost to net entries in the wake of the pandemic, the recovery was more robust and lasted longer south of the border. By the end of 2022, the net entry rate in Canada had fallen below the pre-pandemic average, while that of the U.S. has surpassed it. Due to U.S. data limitations, we can't compare exits in 2023, but entries and new business applications remain above average. Although Canada's increase in firm exits could be indicative of a delayed process of less productive firms closing, it's too early to see evidence that it has led to broad productivity gains. However, more concerning is the persistently low or declining net entry rate. Deteriorating business growth foretells of a widening gap in business vibrancy between Canada and the U.S.

The spike in Canada's business bankruptcies is another compelling symptom of the lasting impact of the pandemic. The rise in bankruptcies is clearly associated with January's repayment deadline for Canada Emergency Business Account (CEBA) loans and the start of collection of CEBA loans in default. Notably, this surge is driven by industries with the largest share of firms requesting CEBA loans during the pandemic—accommodation & food services, transportation & warehousing, and construction. This suggests that government support measures, or at least the CEBA program, delayed but did not eliminate the financial woes triggered by COVID-related lockdowns. CEBA suppressed the typical number of business bankruptcies during the pandemic period, and these closures are now coming in a wave.

Looking at shifts in business dynamism by industry, three sectors account for 80% of the worsening in business dynamism relative to the pre-pandemic trend. Despite accounting for less than 10% of Canada's GDP these include transportation and warehousing, accommodation and food services, and other services (repair and maintenance, personal and laundry, etc.). If this trend is accompanied by weak or declining productivity, it would suggest that business dynamism is suffering from long COVID.

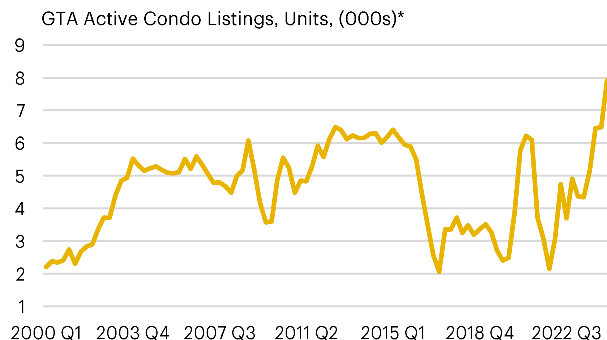
Chart 12: Downgraded Rates Profile Drives Upgraded Canadian Housing Forecast

Canadian Home Sales, Units, (000s)



Source: CREA, TD Economics.

Chart 13: GTA Condo Owners are Trying to Unload Their Properties



Source: CREA, TD Economics.
* Seasonally Adjusted by TD Economics

Q11. Has our Canadian housing outlook changed now that the BoC is cutting rates?

We have upgraded our forecast for housing activity into 2025 compared to the previous view (Chart 12). This is due to the swift repricing in bond yields (see question 2) as markets have pulled forward the timing and magnitude of interest rates cuts on both sides of the border.

It's still early days and the evidence is mixed on how markets are reacting to lower rates. Sales were up nearly 4% month-on-month in June, but preliminary data for July point to some give-back in markets like Calgary, Toronto and Vancouver.

However, there are two other opposing forces acting on the forecast. On the positive side, part of the upgrade to our near-term price forecasts comes from so-called "compositional forces". Pricier properties are outselling their more affordable counterparts, lifting average home prices. We expect this trend to be maintained in the coming months. Note that Canadian average home prices were up approximately 2% during the first half of 2024. In contrast, benchmark prices, which strip away the impact of compositional forces, declined about 2%.

On the negative side, Toronto's stressed condo market will play an important role in shaping overall dynamics. As is stands, active condo listings in the Greater Toronto Area (GTA) are the highest on record (Chart 13). The wave of condo projects completed in recent years has arrived alongside elevated borrowing costs, weighing on the ability of purchasers to close their mortgages. In addition, a rising share of investors are finding themselves cash-flow negative, likely adding to the supply of listed properties. GTA benchmark condo prices declined about 2%, on average, from 2023Q4 – 2024Q2, and further drops are likely required to clear inventories. That said, economic resilience, pent-up demand, solid population growth and falling interest rates should be enough to support positive price growth in the GTA housing market overall. The fact that apartments account for only about 30% of resale activity will also help keep GTA price growth numbers positive in the coming months.

For any media enquiries please contact Debra Moris at 416-982-8141

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