TD Economics

Questions? We've Got Answers

Addressing Issues Impacting the Economic and Financial Outlook

November 27, 2024

Investors must feel like 2024 has given them whiplash, as expectations for interest rates turn on a dime from one quarter to the next. The Trump trade is the latest catalyst, as the incoming administration's policies are perceived as inflationary, leading markets, and ourselves, to reduce the number of fed rate cuts expected. We have also downgraded growth for the U.S. economy next year but have leaned against incorporating the full scope of campaign promises. Uncertainty on timing and scope is high, as well as the potential for some offsetting measures. However, policy moves on tariffs and immigration are both likely to weigh on the domestic economy in the near-term via effects to consumers and businesses.

In Canada, big shifts have already been implemented on immigration and mortgage rules, and now governments have stepped in with sizeable consumer stimulus, which will boost growth next year. Perhaps this was foresight for the tariff threats now confronting Canada, with President Trump announcing a 25% tariff coming into force upon his inauguration in January. The silver lining is that Canada has a window to begin negotiations to circumvent this outcome. There's $3.6 billion in goods and services flowing between these countries every day, with 30 U.S. states having a trade interdependency with Canada. While the threat is large, we presume Canada will have some success with advance negotiations, otherwise both countries risk stagnation in a tit-for-tat tariff war of this magnitude. In the meantime, the Canadian economy is gaining momentum on its own dynamics and the Bank of Canada will remain motivated to cut interest rates. The loonie will continue to face hardship under trade-war rhetoric, which creates some hardship for companies reliant on imports and investment.

Questions & Answers

1. How will a Trump administration and Republican sweep change our U.S. forecast?
2. Financial markets had a strong reaction to the Trump sweep. Is our outlook for Fed policy and bond yields likely to shift?
3. What are the anticipated impacts on the U.S. consumer?
4. Where does this leave the prospects for U.S. housing?
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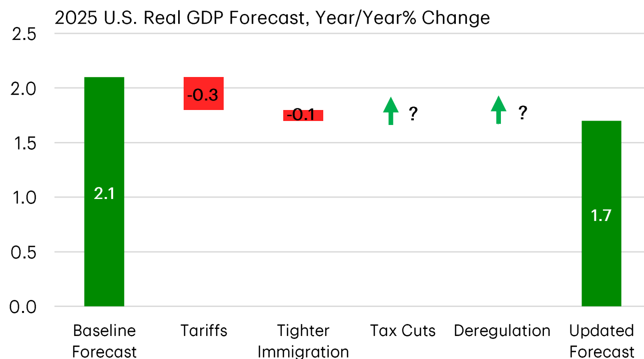
8. How will the Bank of Canada respond to policy shifts?
9. How will federal policy changes play out for Canadian housing?
10. Are Canadians still teetering on the edge of the mortgage renewal cliff?

Q1. How will a Trump administration and Republican sweep change our U.S. forecast?

We expect some of the first policy moves of the incoming Trump administration to be on increased tariffs and reduced immigration. Both will weigh on growth. Assuming campaign promises are partially implemented, we have downgraded our forecast for real GDP growth from 2.1% to 1.7% for next year (Chart 1). President-elect Trump's campaign agenda was focused on four key pillars: tariffs, taxes, immigration, and reduced regulation. Arguably the most significant, and immediate, economic policy change will be higher broad-based tariffs. Our analysis finds that if Trump's administration fully implements rhetoric from the campaign trail (i.e., tariffs of 60% on China, 10% on all other trade partners), it would create a mild stagflationary shock for the U.S. economy. This is not something any new administration wants, particularly during their first year in office. Even so, Trump has already come out swinging on tariff threats, with an impromptu announcement of escalation of 25% tariffs on Canada and Mexico, while upping the ante on China by an additional 10%.

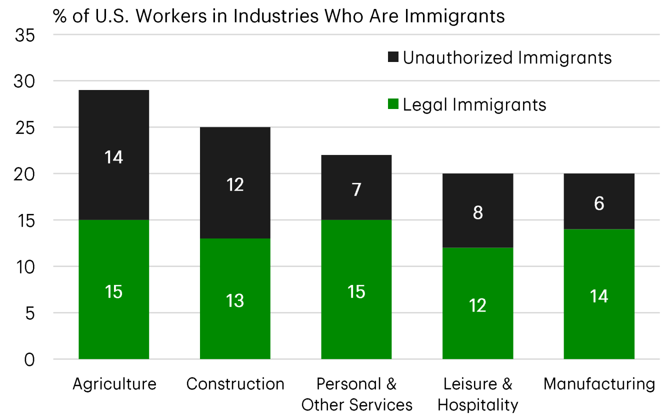
Time will tell on what actually transpires. If the past is any indication, any tariffs implemented would be removed or reduced as countries negotiate and/or amend existing trade deals. But that wouldn't completely mitigate the economic drag, particularly given the high propensity for proportional retaliatory tariffs during that interim period. Business margins and consumers will pay the price, which will result in some erosion of real household incomes. Depending on the size and scope of the tariffs, we estimate that the economic drag could shave anywhere from 0.25-0.50 percentage points (pp) from 2025 GDP growth. However, this estimate was done in the absence of the recent announcement, which would create a much larger economic drag double in magnitude, assuming retaliation by its neighbors.

Chart 1: U.S. Tariffs Are the Biggest Downside Risk to 2025 Growth



Note: Forecast as of November 18th, 2024.
Source: Bureau of Economic Analysis, TD Economics.

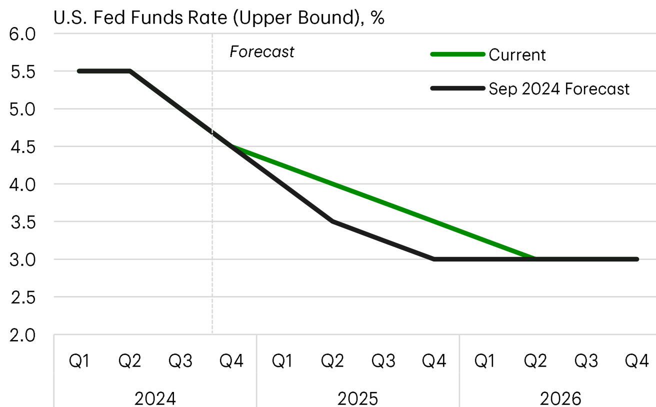
Chart 2: Mass Deportations Would Hit Some Sectors Hard



Source: Pew Research, TD Economics.

Immigration is the other area where Trump has more latitude to act independently and take early action. During his previous term, immigration levels fell from 1.0 million per-year in 2016 to 500 thousand by 2019. Through executive orders, we expect Trump to significantly increase border enforcement, reinstate his "remain in Mexico" policy, and declare "illegal immigration" as a national emergency, which will unlock funds for border wall construction. Relative to our previous baseline, this results in over 2.3 million fewer individuals entering the U.S. by the end of Trump's term. For 2025 alone, it shaves about 0.1 percentage points from growth. Should Trump also follow through with deportations, the economic drag becomes more meaningful and runs the risk of reigniting labor shortages, particularly across industries like agriculture, construction, retail, and leisure & hospitality due to a higher concentration of undocumented immigrant workers (Chart 2).

On the tax side, the first order of business will be to extend the expiring provisions of the 2017 Tax Cuts & Jobs Act. However, this has no impact to our forecast because we had long assumed the sunset clause would not occur. Only an expansion and/or addition of new provisions would result in forecast changes. While Trump has campaigned on several additional tax reductions, these require Congress to pass legislation. Although the Republicans control both the Senate and House, a thin majority in the latter means near-una-



Note: Forecast as of November 2024. Source: Federal Reserve, TD Economics.

nimity among GOP members. This could prove challenging amidst a ballooning deficit. Given the uncertainties of what Congress will agree to pass, we will reserve judgement within the forecast until legislation comes to pass.

Lastly, the high potential for deregulation, particularly across industries like energy and finance, offers some upside risk to the forecast. However, it is difficult to quantify and is one reason why we chose less aggressive downgrades in other aspects of policy, like tariffs and immigration. We will continue to adjust our outlook as new policies are announced once the new administration takes office. Stay tuned!

Q2. Financial markets had a strong reaction to the Trump sweep. Is our outlook for Fed policy and bond yields likely to shift?

Investors cheered the election of President Trump and the red wave taking over Congress. The S&P 500 is up approximately 5% on hopes that lower taxes and less regulation will be a boon to corporate profits. At the same time, bond yields surged higher on expectations that wider government budget deficits, tariffs, and slower population growth will force inflation higher. Higher inflation expectations have also led markets to pare back expectations for Federal Reserve rate cuts.

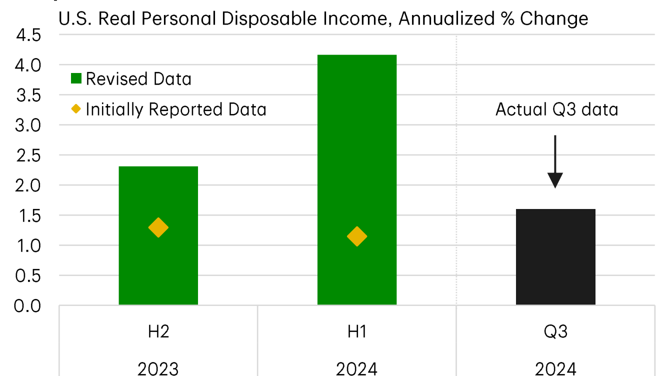
We agree that the Fed will have to tread more cautiously should Trump follow through on his tariff rhetoric. We forecast the central bank will cut by another 25 bps in December and January, before shifting to a pause-cut-pause path thereafter (Chart 3). This means the Fed will get to our 3% neutral interest rate view in the first half of 2026, about six months later than initially forecasted. This will keep bond yields elevated by about 30 bps through next year relative to our pre-election view, tightening financial conditions and cementing the U.S. dollar at its current high level.

Q3. What are the anticipated impacts on the U.S. consumer?

The key policy plans outlined in question 1 would affect consumers in a few ways. In a nutshell, higher inflation reduces consumer purchasing power, compounded by higher interest rates relative to the counterfactual baseline. The impact ripples through demand for loans, such as autos. Lastly, a sharp reduction in the population size relative to our pre-election forecast, further weighs on economy-wide consumer demand. Fortunately, healthy gains in consumer balance sheets due to increased home equity and healthy gains in financial assets provide some offsetting cushion.

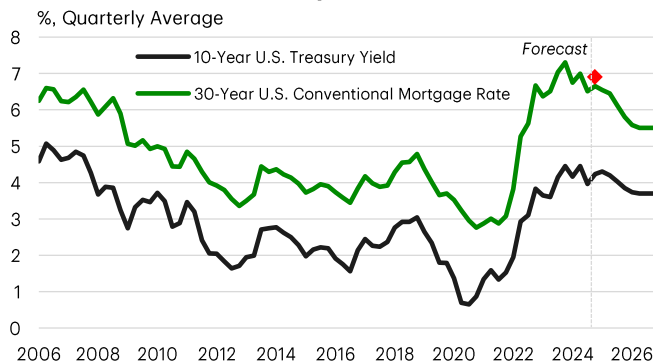
So far, consumer spending has been remarkably resilient, defying our expectations time and time again. Once again, American households in the third quarter put peer countries to shame, with spending accelerating at its fastest pace in a year and a half at nearly a 4% q/q pace – double its trend-pace. Looking ahead to the fourth quarter, we expect spending growth to hold close to 3%, with short-term boost from the clean-up and rebuilding efforts following Hurricanes Helene and Milton.

As noted in our recent report, there are some good reasons why consumers have defied expectations. Annual data revisions to income and spending revealed a significant upgrade in personal disposable income, lifting growth from a benign 1.1% annualized rate in H1-2024 to a massive 4.2% (Chart 4). Likewise, the savings rate also



Source: Bureau of Economic Analysis, TD Economics.

Chart 5: Mortgage Rates to Trend Lower, But Remain Well Above Pre-Pandemic Average



Note: Red marker indicates a daily mortgage rate of 7%.
Source: Bloomberg, TD Economics.

benefited from a large upgrade, which revealed households were still sitting on excess savings previously believed to have been eliminated. Simply put, the data revisions created a new narrative. Household finances are in a better shape than the original data led us to believe.

However, this hasn't changed the trajectory, despite a higher watermark as the starting point. Savings are still being depleted. In combination with a cooling labor market, income growth is slowing. As such, even prior to Trump's victory, we were expecting the pace of spending to moderate in 2025. Adding in headwinds from higher inflation and interest rates has caused us to shave 0.3 percentage points from consumer spending growth next year. However, we think it'll still put in a good showing at 2-2.5%. Ultimately, American household balance sheets are strong. The amount of home equity has doubled in the last seven years to $35 trillion. Financial asset gains have also been good, with valuations increasing by 30% in the last four years. Wealth in many cases is not as liquid as personal savings in bank accounts and can not be tapped as readily as cash. Still, the wealth effect can provide a tailwind to consumer spending even as excess savings dwindle, particularly if interest rates decline further, making it cheaper for households to tap into their home equity.

Q4. Where does this leave the prospects for U.S. housing?

Significantly eroded affordability has been at the heart of the weak housing recovery for several years. While prospects of lower interest rates had us hopeful that some rebound in housing activity could take hold in early-2025, the recent leg higher in Treasury yields has pushed back on that narrative. Over the past month, the 30-year fixed mortgage rate has increased by nearly 100 bps to 7% or only 30 bps below where it started the year (Chart 5). Unsurprisingly, home sales have mounted no recovery, and remain more than 30% below their early-2022 pre-Fed tightening levels. Over the near-term, we expect that sales will tick a bit lower and stage only a modest rebound in the first half of next year.

Poor affordability has certainly been the biggest constraint on home sales, but limited supply has also been an obstacle. In the face of a multi-decade high in mortgage rates, many "would-be" sellers would face a near doubling in their next mortgage by selling their existing property. This lock-in effect has constrained inventories and supported upward pressure on prices. We don't think the tables will turn until mid-2025, after the Federal Reserve gets another 75 bps in interest rate cuts under its belt and owners are more enticed to list their homes.

But we've been fooled by the housing recovery in the past, and the road ahead is not set in stone. Should interest rates stay persistently higher, it could meaningfully impact the timing and trajectory of the recovery. It's also worth mentioning that even once the Fed normalizes its policy rate, mortgage rates are likely to settle at a level that's nearly 200 bps above 2019 levels. With home prices still nearly 50% higher than 2019 levels, affordability is not returning to pre-pandemic levels. Homeownership will require an increasingly larger share of household's income.

Q5. What are the risks to the global outlook as trade faces greater headwinds?

Tariffs will enact a higher cost of doing business and greater uncertainty to the global outlook. At the core, tariffs are a sales tax on the consumption of foreign goods that raises prices and reduces real incomes on the home front. The direct effect manifests in depressed export activity abroad. The indirect effects layer uncertainty on global investment flows, as decisions about production and supply chains are re-evaluated. Neither avenue boosts growth in the near-term.

More broadly, the rest of the world will not sit idly by while their products are affected. The European Union is discussing targeted retaliatory tariffs. China, conversely, has developed an arsenal of non-tariff measures to be part of their response. These include new laws to

counter sanctions efforts, the ability to target foreign entities acting in detriment to national interests, and export controls on key goods. The extent to which these are deployed will depend on the punitive level of new tariffs and trade barriers. However, China may be reticent to fully implement all these measures, as it's economy struggles to gain traction and it is already the focus of trade disputes with other major partners. The risk of further alienating businesses when investment flows into the country are tapering off is likely to be weighed against the benefits of retaliation. Nonetheless, a full-fledged response could result in shortages of key inputs, delivering a uniquely 21st century supply shock.

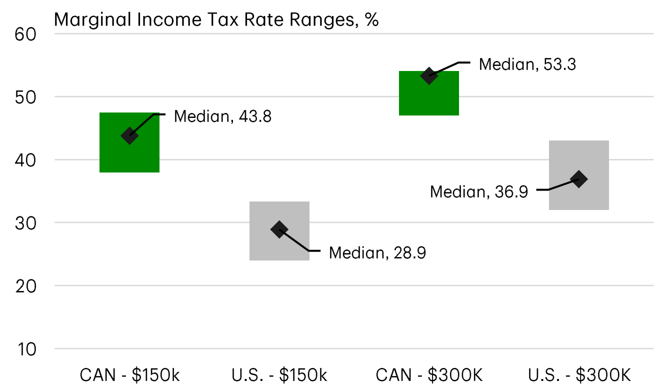
Lastly, in the past year, many nations have gradually shifted to fiscal restraint, trying to offset pandemic era borrowing. This trend could be reversed if growth prospects are materially downgraded. Likewise, governments may feel compelled to provide domestic support to businesses and households to counter the negative effects of tariffs. For instance, Germany's manufacturing sector is already struggling with weak demand and high input prices. The economy has stalled for two years, as government borrowing limits remain in force. The risk of a third year of stagnation could tip the scales towards fiscal spending, and some needed public investment.

Q6. How is Canada's outlook impacted by Trump 2.0 and recent changes in domestic policy?

Canada's competitiveness has already been undermined for several years, evidenced by historically weak productivity. This could be a path for governments to take bolder business-friendly measures to put the country on a better economic path.

Unfortunately, with President Trump already threatening 25% tariffs on Canada, it means greater exposure because the economic trade ties have deepened since the USMCA came into effect in 2020. When the threat on the campaign trail was for 10% tariffs, our research indicated that it would lead to a 5% hit to Canadian export volumes and risk sending the Canadian economy into a period of extended stagnation through 2025 and 2026. The Loonie will remain under pressure as long as tariff-threats remain front-and-center for Canada. It would not be a surprise for the Loonie to push below the 70 U.S. cent threshold if threats become reality, further dampening investment sentiment towards Canada.

Chart 6: Canada's Cost of Living Disadvantage For High Income Earners



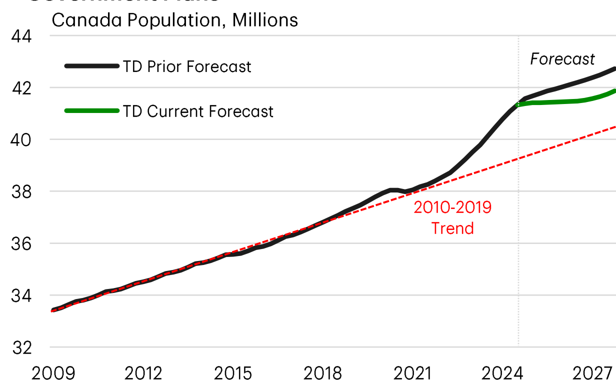
Source: Fraser Institute, TD Economics.

At the same time, U.S. policies that lower corporate taxes, reduce red tape, and favor domestic manufacturing would further compromise Canada's attractiveness for investment over the longer term. This would hinder long-term production capacity and productivity, while potentially resulting in a brain drain of top talent out of Canada and into the U.S.

What can Canada do? There are no easy fixes. Policymakers need to dig deep in controlling what's solely in their domain...domestic policy. Meaningful change in taxes, regulatory barriers, and investment incentives should come into scope. It is no longer sufficient to trim around the edges, as the competitive gap has simply become too large with its greatest trading partner. Canada used to have a tax advantage to incentivize investment, but this has eroded. Taxes and regulatory costs have increasingly been cited in small business surveys as a major input cost constraint. And lastly, personal income tax competitiveness is lacking. The most highly educated graduates are financially better off south of the border (Chart 6). Canada needs to create a compelling case to attract and retain the best and brightest people and businesses, particularly if the Trump administration makes inroads in adopting a merit-based immigration system for skilled workers, cued off Canada's no less.

Instead, governments are again sending cheques to households in Ontario (a total of $3 billion in the New Year) and across Canada in April ($4.7 billion). On top of that, consumers can take advantage of a two-month GST holiday starting on Dec. 14th on products ranging from Christmas trees to toys and restaurant meals. These initiatives are estimated to add 0.3 per-

Chart 7: Stall-Speed Population Growth Under Newest Government Plans



Source: Statistics Canada, TD Economics.

centage points to real GDP growth next year, creating some cushion against the drag from slower population growth and any U.S. tariffs. But, they are a band-aid, and will not fix what ails the economy.

Q7. Canadian population growth: A recalibration or an overshoot?

Americans are not the only ones grappling with immigration. But in Canada's case, it was a deliberate dialing up of population flows that exceeded social capacity and now requires recalibration. The federal government's new immigration plan hits the pause button on population growth. The plan scales back targets for permanent residents (PR) through 2027 and charts the path for a sizeable reduction in non-permanent residents (NPRs). The policy changes were made to shrink the share of NPRs from over 7% of the population to 5% by the end of 2026. It is a dramatic policy shift, but Chart 7 puts the changes into perspective. The level of the population holds well above the pre-pandemic trend. As such, we view this as a recalibration as opposed to an overshoot. It also provides Canada a chance to reorient immigration policy back towards better aligning programs with labour market needs and meeting longer-term skills requirements.

Moving from 3% population growth to stall speed will lead to some negative short-term adjustments for the economy, though the overall impact is likely to be less dramatic than many fear. Slower labour force growth places a lower ceiling on the national unemployment rate. On the consumer spending front, weaker gains in the number of households is projected to be counterbalanced by higher spending per household under lower interest rates. The impact of population changes will be most apparent in the housing market, where the looming negative demand shock will cool but not disappear. The rental market should reflect significant relief in the pace of rent growth (see question 9).

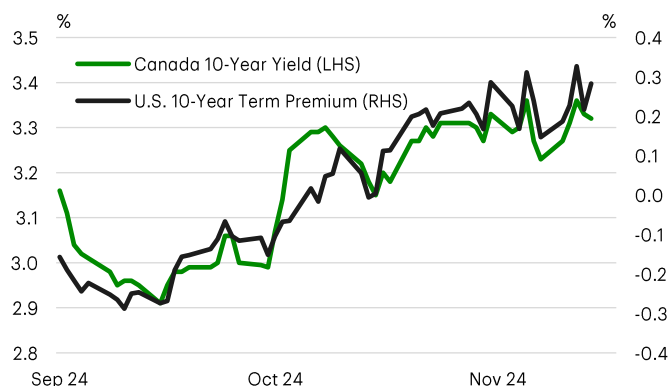
All told, less pressure on housing and infrastructure will reduce inflationary pressures, supporting the Bank of Canada's (BoC) efforts in normalizing its policy rate. Further, reducing access to low-wage temporary immigrants also increases the incentive for businesses to invest in automation, an area that has been lagging the U.S. in recent years. The shift could pave the way for a modest uptick in Canada's productivity growth over the next few years.

Q8. How will the Bank of Canada respond to policy shifts?

So far, the Bank of Canada (BoC) made three 25 bp cuts over the summer, followed by a 50-bps cut in October. Until recently, markets were on the fence about whether the December decision will be another "emergency like" 50 bps or a return to a gradual pace. The latter is edging out the odds, but the broad takeaway is that the BoC is unlikely to halt its rate-cutting cycle just yet, and particularly amidst escalating trade risks that are net negative for economic growth, despite a near-term inflation spike.

Fortunately, inflation is starting in a good spot, having settled around the 2% target. Unfortunately, rising yields in the U.S. are bleeding into Canada (Chart 8), and the loonie has slumped. Now, new risks are mounting with population growth set to stall amidst the threat of U.S.-imposed tariffs. This may be partly why

Chart 8: BoC Juggling Many Considerations – Importing U.S. Yields & A Lower Loonie



Source: Bank of Canada, FRBNY, TD Economics. Last Observation: November 15th, 2024.

the Ontario and Federal governments unexpectedly flooded households with rebate cheques. Perhaps this reflects a pre-emptive move to shore up confidence and spending, while also taking pressure off the Bank of Canada to cut more deeply and risk exacerbating housing and financial risks.

With governments injecting more stimulus, the Bank of Canada can do a little less. We have removed a quarter-point cut from the forecast with an expectation that the policy rate will come to rest at 2.50% by the end of 2025. However, we are prepared to remove another rate cut from the profile if households spend a greater share of their rebates and tariff threats recede. Rebate cheques tend to be most effective during periods when households are heavily financial constrained, which occurs in recessions with widespread job losses. This is currently not the case. So, we've assumed a large chunk of the rebates (at least 50%) are saved or used to pay down debt. Should the impulse to spend be higher, we will adjust the interest rate profile.

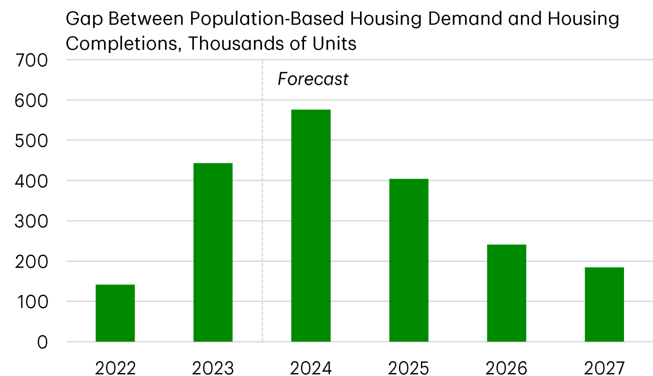
But for now, our forecast maintains a 100 bps spread versus the Fed. This policy rate differential will keep a lid on the Canadian dollar. However, the near-term shifts in the Loonie will be dominated by trade-talk. If President Trump follows through with punitive tariffs once officially in office, the Loonie may revisit sub-70 U.S. cents levels, last sustained two decades ago.

Q9. How will federal policy changes play out for Canadian housing?

In recent months, the federal government has introduced policy changes on mortgage rules and immigration that will provide push-and-pull forces to Canadian housing markets. The impacts will differ within segments of housing demand (i.e. entry into home-buying versus renters).

One change involves loosening rules around insured mortgages, beginning in December. Specifically, first-time homebuyers (and buyers of new builds) will soon be able to stretch their amortizations from 25 to 30 years. Also, the price cap at which a 20% down payment is required will be increased from $1 to $1.5 million. This latter policy should disproportionately lift B.C. and Ontario markets, given their large share of homes priced in that space.

Chart 9: Population Slowdown Unlikely to Eliminate Canada's Housing Shortage

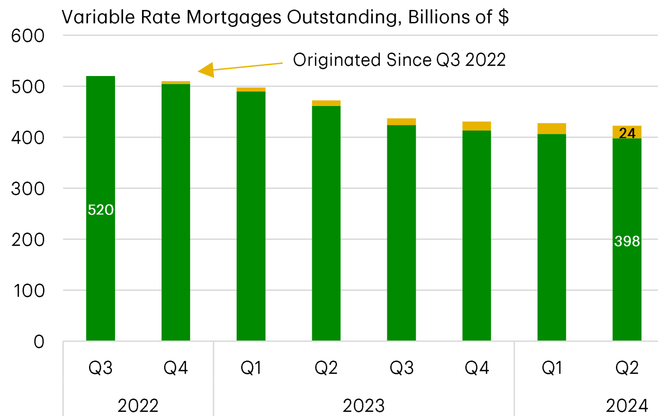


Source: CMHC, Statistics Canada, TD Economics.

These measures will add a secondary tailwind to a market that's already sprung back to life from lower interest rates and household income resilience. Canadian home sales surged 8% m/m in October alone, marking the third straight month of climbing back up. The government measures will boost demand within a particular segment, such as first-time homebuyers (44% of the market) and those who take out insured mortgages (20% of recent issuances). There is concern that Canadians will return to old habits of escalating debt-to-income ratios that impart financial risks and interest rate sensitivity. In particular, insured borrowers have typically been more prone to bouts of financial stress.

On the flip side, housing demand will have a constraint coming from the federal government's immigration changes (see here). Likely impacts include slower rent growth that reduces the attractiveness of these properties to investors. In contrast, the direct impact on ownership demand will likely be small, given that newcomers largely rent. However, keeping the population steady for a few years will offer an opportunity for builders to cut the sizeable gap between housing completions and underlying demand that opened up from 2022-2024 (Chart 9). This gap is more likely to be narrowed than eliminated. The policy will not, by itself, be a panacea for Canada's housing affordability problem, even if it's a step in the right direction.

Add it all up and Canadian home prices are likely to see an upgrade in our upcoming forecast for 2025 – an 9% annual average gain versus 6% in our September projection. The upgrade would have been larger if not for the back up in yields (Question 2) this quarter and



strained affordability. Canadian home sales, meanwhile, are likely to record a gain of about 15% next year, after an upgraded performance in 2024.

Q10. Are Canadians still teetering on the edge of the mortgage renewal cliff?

Luckily, not. In fact, we anticipated that consumers could withstand the sticker shock of renewing historically low-rate mortgages at decade-high rates. This view was based on detailed estimates of mortgage payments, drawn partially from TD's internal mortgage data and complemented by several key assumptions. A year later, things have gone better than expected. For the balance of Canadian mortgages outstanding at mid-2024, aggregate payments are set to decline by 1.2% in 2025 — a significant easing relative to the 0.5% increase previously expected. This is despite a $75 billion (or 3.5%) increase in household mortgages outstanding.

Two major factors drive this decline. The largest is looser-than-expected financial conditions. While the reductions in the overnight rate were in line with our forecast, actual variable mortgage rates have dropped an additional 42 basis points due to heightened competition among lenders. The second factor is a shift in mortgage composition, which helped households front-load the payment shock. Borrowers have increasingly switched from variable to fixed-rate mortgages, aiming to lower payments or avoid rate volatility. We estimate that of the $520 billion in variable-rate mortgages held at chartered banks at the end of 2022, 14% switched to fixed-rate mortgages or were prepaid (Chart 10).

However, there are still challenges for the consumer. The decline in per capita spending in recent quarters along with rising delinquency rates is testament to the challenges faced by Canadians in the past couple of years. However, difficulties are more concentrated among non-homeowners, as the recent rise in delinquencies is largely driven by non-mortgage credit products – such auto loans and credit cards. In contrast, homeowners continue to demonstrate resilience, with the latest data showing net worth metrics remain well above those of renters.

In aggregate, households have financial flexibility, much of which is the result of borrowers' own efforts. As the year ends, we expect consumption to finish slightly above trend growth. However, the easing interest rate cycle and lower mortgage payments could create an additional tailwind. Indeed, if the savings from reduced sticker shock are funneled into spending, annual average nominal consumption growth could see a boost of up to 1.6 percentage points in 2025, even as population growth moderates. But for now, we forecast real consumer spending of 1.1% for 2025, and recognize the risks are tilted to the upside.

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

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