# Tell Me Something I Don't Know

by Avery Shenfeld

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A winter of our discontent, a glorious summer. It's always darkest before the dawn. There's a light at the end of the tunnel. Any one of these clichés befits what the coming year looks like on the economic front. But in terms of market impacts, investors might be asking for something they don't already know, because some form of the bad news first, good news later outlook must already be largely priced into equities, bond yields and currencies.

Sometimes of course, elements of the consensus are on the mark. After all, we are all relying on the same projections from public health authorities that effective vaccination programs will accelerate this spring and summer. We're also incorporating the fiscal stimulus underway in Canada and Europe, and the likelihood that Congress will bump the $0.9 tn fiscal package passed in December to the $1.3 trillion we had built into our early December forecast.

In Canada, a better-than-expected Q4 didn't add to our near-term growth forecast, since it will be offset by a larger contraction in Q1 than we earlier thought, owing to tighter public health restraints. But thereafter, a build up in savings and pent-up demand in the household sector will be the key ingredient in the recipe for a reacceleration after the first quarter. And yes, you've heard that story from us a few months ago, and it's now a common view.

## What the Rates and FX Markets Don't Yet Know

There are still some nuances in that broad story that will shape investor returns. In the very near term, the market isn't pricing in enough odds that the Bank of Canada could undertake a final 10-15 basis point trimming in overnight rates this month. It's been flagged as a possibility in recent BoC speeches, as the Bank reconsiders whether a still-lower rate would be more stimulative.

Squeezing lending margins a bit further might actually work to reduce the flow of credit, but the Bank might think it would lean against Canadian dollar appreciation, and its future drag on exports. The evidence from Australia, where the RBA took a similar step, suggests that it might not be effective on currency sentiment. Threatening a cut, or a longer wait for the first hike if the CAD fails to correct, looks to be a better and more likely tactic.

The BoC is likely to announce this year that it will adopt average inflation targeting in 2022. That would also help convince markets that the Bank of Canada could be more patient than the US in terms of the first hike, a contrast with what's now priced into futures. As a result, we see the C$ bucking a trend that will see the USD losing ground against some other majors, particularly those like the euro and yen that are supported by current account surpluses (Table 2). We've added a few cents of further appreciation to our targets for the euro and others, which has reduced our projections for C$ depreciation over the forecast horizon.

As we look further out, our expectation is that the economic acceleration will be steeper than some forecasts, and importantly those of North American central banks, now expect. The nearly 4% average growth pace

*Table 1*

## FORECAST SUMMARY
(% Change Except Where Noted)

| CANADA | 2019A | 2020F | 2021F | 2022F |
|---|---|---|---|---|
| GDP at Market Prices | 3.6 | -4.8 | 6.8 | 7.2 |
| GDP in $2007 | 1.9 | -5.5 | 4.0 | 5.1 |
| Consumer Price Index | 1.9 | 0.7 | 2.0 | 1.8 |
| Unemployment Rate | 5.7 | 9.5 | 7.9 | 6.2 |
| Current Account Balance (C$ Bn) | -47.4 | -36.5 | -41.5 | -40.9 |
| Pre-tax Profits (net Operating Surplus) | 0.6 | -8.7 | 9.1 | 10.8 |
| Housing Starts (K) | 209 | 215 | 201 | 215 |

| UNITED STATES | 2019A | 2020F | 2021F | 2022F |
|---|---|---|---|---|
| GDP at Market Prices | 4.0 | -2.1 | 6.4 | 6.2 |
| GDP in $2009 | 2.2 | -3.3 | 4.1 | 3.6 |
| Consumer Price Index | 1.8 | 1.2 | 2.3 | 2.5 |
| Unemployment Rate | 3.7 | 8.1 | 5.9 | 4.1 |
| Current Account Balance (US$ Bn) | -480 | -628 | -685 | -676 |
| Pre-tax Profits (with IVA/CCA) | 0.3 | -4.6 | 8.5 | 7.0 |
| Housing Starts (K) | 1,295 | 1,385 | 1,546 | 1,432 |

*Table 2*

## INTEREST AND EXCHANGE RATE FORECAST

| | | 2020 | 2021 | | | | 2022 | |
|---|---|---|---|---|---|---|---|---|
| END OF PERIOD: | | 13-Jan | Mar | Jun | Sep | Dec | Jun | Dec |
| CDA | Overnight target rate | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 |
| | 98-Day Treasury Bills | 0.06 | 0.10 | 0.15 | 0.15 | 0.20 | 0.30 | 0.40 |
| | 2-Year Gov't Bond | 0.17 | 0.20 | 0.20 | 0.25 | 0.30 | 0.45 | 0.60 |
| | 10-Year Gov't Bond | 0.83 | 0.70 | 0.85 | 0.85 | 1.25 | 1.30 | 1.60 |
| | 30-Year Gov't Bond | 1.45 | 1.30 | 1.45 | 1.50 | 1.80 | 1.80 | 1.95 |
| U.S. | Federal Funds Rate | 0.125 | 0.125 | 0.125 | 0.125 | 0.125 | 0.125 | 0.125 |
| | 91-Day Treasury Bills | 0.08 | 0.10 | 0.20 | 0.15 | 0.25 | 0.35 | 0.50 |
| | 2-Year Gov't Note | 0.15 | 0.15 | 0.15 | 0.20 | 0.30 | 0.40 | 0.55 |
| | 10-Year Gov't Note | 1.10 | 1.00 | 1.20 | 1.20 | 1.45 | 1.45 | 1.75 |
| | 30-Year Gov't Bond | 1.84 | 1.75 | 1.90 | 1.90 | 2.00 | 2.20 | 2.25 |
| Canada - US T-Bill Spread | | -0.02 | 0.00 | -0.05 | 0.00 | -0.05 | -0.05 | -0.10 |
| Canada - US 10-Year Bond Spread | | -0.28 | -0.30 | -0.35 | -0.35 | -0.20 | -0.15 | -0.15 |
| Canada Yield Curve (10-Year — 2-Year) | | 0.66 | 0.50 | 0.65 | 0.60 | 0.95 | 0.85 | 1.00 |
| US Yield Curve (10-Year — 2-Year) | | 0.95 | 0.85 | 1.05 | 1.00 | 1.15 | 1.05 | 1.20 |
| EXCHANGE RATES | CADUSD | 0.79 | 0.77 | 0.76 | 0.75 | 0.75 | 0.74 | 0.75 |
| | USDCAD | 1.27 | 1.30 | 1.32 | 1.33 | 1.33 | 1.35 | 1.34 |
| | USDJPY | 104 | 102 | 100 | 100 | 99 | 99 | 99 |
| | EURUSD | 1.22 | 1.24 | 1.25 | 1.26 | 1.26 | 1.25 | 1.24 |
| | GBPUSD | 1.37 | 1.35 | 1.37 | 1.39 | 1.39 | 1.40 | 1.40 |
| | AUDUSD | 0.77 | 0.79 | 0.80 | 0.82 | 0.83 | 0.85 | 0.87 |
| | USDCNY | 6.47 | 6.40 | 6.32 | 6.25 | 6.15 | 5.95 | 5.80 |
| | USDBRL | 5.31 | 5.00 | 4.80 | 4.80 | 4.50 | 4.80 | 4.50 |
| | USDMXN | 19.8 | 19.5 | 20.0 | 20.0 | 19.0 | 19.8 | 20.0 |

we see in the US, and even faster in Canada by 2022 (see Table 1), would see both economies in the vicinity of full-employment before the end of 2022, a year earlier than the Fed now thinks. That will set the stage for the central bank to move up the timetable for QE tapering (starting in 2021) and rate hikes (into early 2023).

The Bank of Canada should see the same upside surprise, but as we noted in a recent In Focus, we're also more positive on the economy's potential growth rate, meaning that an output gap will remain through 2022 (Chart 1), leaving a rate hike to come in 2023, after the Fed's first move so as to not excite loonie bulls.

In the near term, both US and Canadian government bond yields could give back a bit of their recent climb, if confidence in the recovery is shaken by poor first quarter economic news. Further out, a strengthening economy and a paring of QE efforts will send global long rates higher and the yield curve into a steepening.

But not aggressively. True, central banks will be paring back on quantitative easing, reducing the volume of buying as early as April in the case of the BoC, although at first offsetting that by extending the average maturity of what it holds. QE will reduce one factor absorbing fixed income supply, while the private sector will be moving in a similar direction, with businesses drawing down their cash hoards and growing their capital spending, and households trimming savings as they return to travelling, dining out and other services spending.

That sounds like a recipe for an even steeper sell off in the bond market, until you factor in what governments will be doing: borrowing less than they did in 2020. While this is a global story, the US picture tells a thousand words (Chart 2). Less excess saving by the private sector, and reduced Fed asset accumulation, could readily be countered by smaller deficits, even assuming a ramped up fiscal stimulus package.

Where that could break down is further out in the forecast horizon, if Washington enacts a mega-infrastructure bill that lifts deficits sharply in 2023. But at that point, the economy will be strong enough to weather the impact of higher yields.

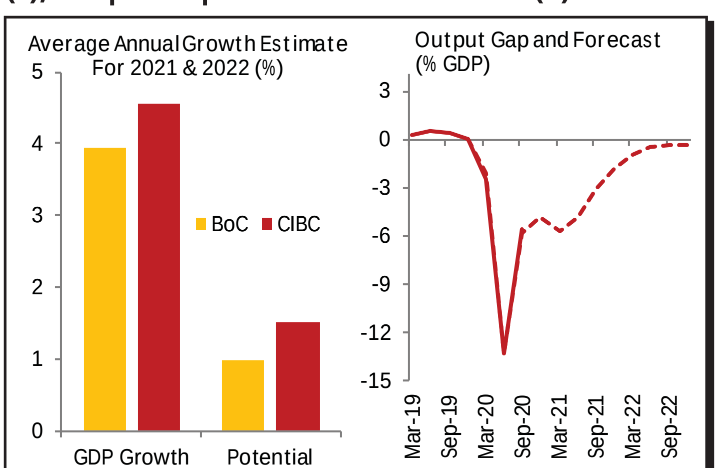
**Is There Anything Stocks Have Left to Cheer?**

The equity market has already built in expectations for an earnings rebound, further growth in the tech giants that led 2020 gains, and for interest rates to remain low enough to make dividends look attractive over bond coupons. So what can drive returns that investors don't already know?

In some cyclical sectors, our call for upside surprises in growth later this year and in 2022 will add to projections for an earnings recovery relative to what's now priced in. But for the most part, stocks should be able to at least creep higher in 2022 because good news for the economy will mean bad news for bond returns. Remember that those holding bond ETFs haven't yet felt much pain, as lower running yields on new issues were offset by capital gains when rates fell. It's actually the first stages of a climb in yields, when capital losses will start to accumulate, that could be the prod to keep funds flowing into equities. Light requirements for new capital spending in what is now a services-leaning market, the competition from private equity, and a return to share buybacks will keep the net supply of new issues on the lean side.

*Chart 1*

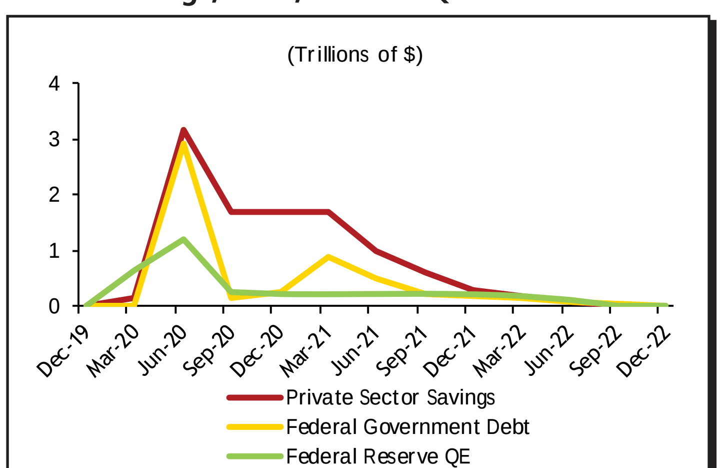
**GDP Growth and Potential Both Top BoC Forecasts (L), Output Gap Closes At End of 2022 (R)**




*Source: Statistics Canada, BoC, CIBC*

*Chart 2*

**Excess Savings, Debt, and Fed QE Due to Pandemic**




*Source: FRB, BEA CBO, CIBC*

# US Economy: The Three Questions

Benjamin Tal and Katherine Judge

Every economic forecaster these days must address three questions: How bad will the winter be? How strong will the second half of the year be? And how much scarring (long-term damage) will the economy have to endure following the double-dip Covid recession?

A key input for any attempt to tackle those questions is the speed of vaccine distribution. We have no reason to question what we hear from the authorities, and therefore assume that by the third quarter of the year, the majority of Americans will be vaccinated, and the economy will be ready to take off.

## The Winter

It's shaping up to be a lackluster start to the year for the US economy, as the continued surge in Covid cases is forcing further curtailments of activity, leaving fewer options for many Americans on which to spend fresh stimulus checks. Consumer spending likely retreated in December, and could have fallen further in January. With a dismal start to the year, even a pickup in activity in February and March won't be enough to prevent a decline in the first quarter, with real GDP set to drop at a 1.1% annualized pace. That decline would have been notably worse if not for the $900 bn fiscal package passed in December, as the fading of the CARES Act had become

*Table 1*

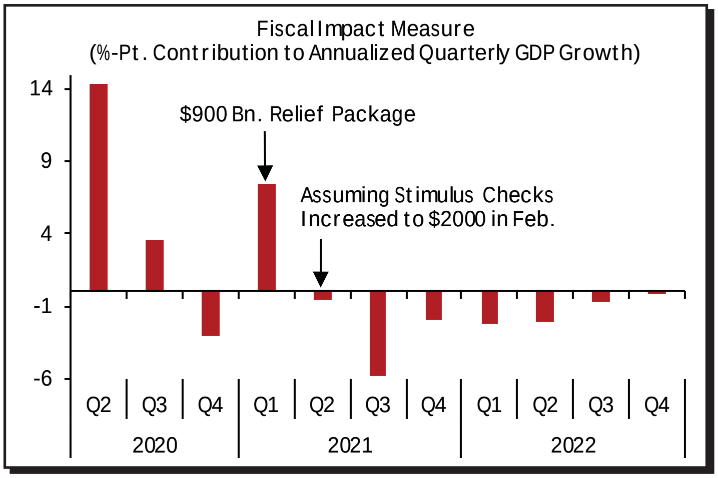
**US FORECAST DETAIL**

(real % change, s.a.a.r., unless otherwise noted)

| | 20:3A | 20:4F | 21:1F | 21:2F | 21:3F | 21:4F | 22:1F | 2020F | 2021F | 2022F |
|---|---|---|---|---|---|---|---|---|---|---|
| **GDP At Market Prices ($Bn)** | 21,170 | 21,680 | 21,755 | 22,060 | 22,538 | 22,988 | 23,297 | 20,983 | 22,335 | 23,712 |
| % change | 38.4 | 10.0 | 1.4 | 5.7 | 8.9 | 8.2 | 5.5 | -2.1 | 6.4 | 6.2 |
| **Real GDP ($2009 Bn)** | 18,597 | 18,905 | 18,853 | 19,033 | 19,334 | 19,585 | 19,726 | 18,454 | 19,201 | 19,899 |
| % change | 33.4 | 6.8 | -1.1 | 3.9 | 6.5 | 5.3 | 2.9 | -3.3 | 4.1 | 3.6 |
| **Final Sales** | 25.9 | 3.5 | 2.0 | 3.2 | 5.4 | 5.3 | 3.5 | -2.9 | 3.6 | 3.6 |
| **Personal Consumption** | 41.0 | 3.2 | -0.9 | 3.0 | 6.7 | 6.2 | 3.2 | -3.8 | 3.9 | 3.7 |
| **Total Govt. Expenditures** | -4.8 | 2.3 | 1.0 | 0.4 | 0.6 | 0.5 | 1.2 | 1.3 | 0.4 | 1.0 |
| **Residential Investment** | 63.0 | 28.9 | 34.9 | 7.2 | 7.1 | 5.8 | 3.2 | 5.7 | 19.6 | 3.8 |
| **Business Fixed Investment** | 22.9 | 10.8 | 7.5 | 2.8 | 4.7 | 5.6 | 5.7 | -4.1 | 5.9 | 4.6 |
| **Inventory Change ($2009 Bn)** | -3.7 | 142.1 | -2.7 | 26.9 | 76.2 | 77.9 | 49.2 | -57.4 | 44.6 | 57.5 |
| **Exports** | 59.6 | 18.0 | 12.5 | 7.2 | 4.4 | 5.0 | 7.4 | -13.1 | 7.4 | 5.8 |
| **Imports** | 93.0 | 22.2 | 7.1 | 2.9 | 4.5 | 4.4 | 4.3 | -9.6 | 10.3 | 4.1 |
| **GDP Deflator** | 3.5 | 3.0 | 2.5 | 1.8 | 2.3 | 2.8 | 2.5 | 1.2 | 2.3 | 2.4 |
| **CPI (yr/yr % chg)** | 1.2 | 1.2 | 1.7 | 2.9 | 2.3 | 2.5 | 2.5 | 1.2 | 2.3 | 2.5 |
| **Core CPI (yr/yr % chg)** | 1.7 | 1.6 | 1.6 | 2.5 | 2.0 | 2.2 | 2.3 | 1.7 | 2.1 | 2.3 |
| **Unemployment Rate (%)** | 8.8 | 6.8 | 6.9 | 6.3 | 5.5 | 5.0 | 4.6 | 8.1 | 5.9 | 4.1 |
| **Housing Starts (AR, K)** | 1,432 | 1,545 | 1,572 | 1,520 | 1,566 | 1,525 | 1,480 | 1,385 | 1,546 | 1,432 |

*Chart 1*

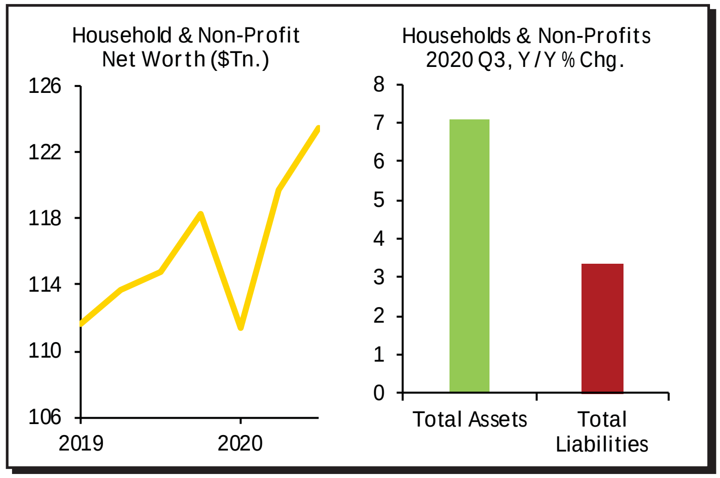
**Fiscal Relief Prevents A Larger Drop in Q1 GDP**




*Source: Brookings, CIBC*

*Chart 2*

**Households' Net Worth Accelerated in Q3**




*Source: Federal Reserve, CIBC*

a drag on growth in Q4 2020. Biden is prioritizing a top-up in rebate checks from $600 to $2000, something that could come to fruition in February, and work to offset most of the drag expected in Q2 from the fading of December's package (Chart 1).

### After the Winter

Key to answering the second question is the shape the US economy will be in on the eve of the recovery. We suggest that that position will be stronger than currently assumed by the market. Behind that assessment is the asymmetrical nature of the recession. The damage is deep but narrow, as the share of households and industries that have been negatively impacted is notably smaller than in any other recession.

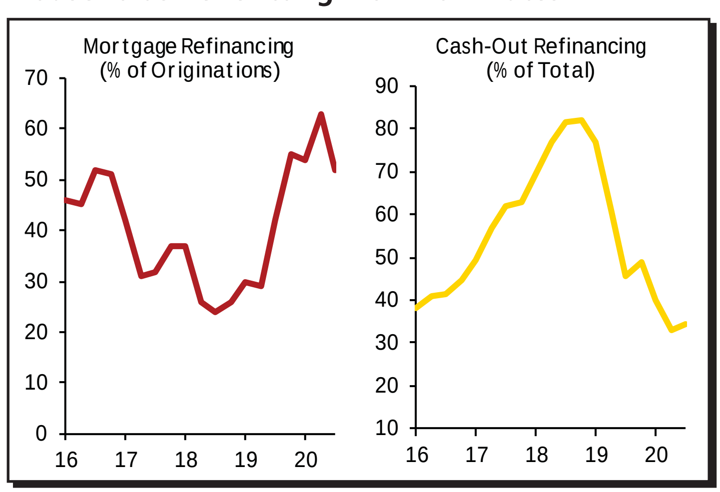
That dichotomy translates into different labor market outcomes based on pay grades, as it's been services that have been disproportionately impacted by social distancing and travel restrictions. Employment in lower-income fields is still about 25% below January levels. In contrast, higher-income employment, which only took a modest hit during the first wave, has fully recovered. While the deterioration has mainly impacted those with the least to fall back on, government support has been crucial in limiting the damage, and helping to maintain the employer-employee link during temporary business closures, which will accelerate the recovery during the re-opening phase.

The unique nature of the recession means that a large segment of the population is in a better financial position relative to the pre-recession period. Most of the decline in spending was amongst middle or high-income households as Covid restrictions and the fear factor dramatically reduced their ability to spend, despite maintaining relatively high confidence and rising income. The resulting excess savings is now estimated at 11% of consumer spending- notably higher than all other major OECD countries but Canada. And that excess saving and pent-up demand will surely rise in the coming months. What's more, the wealth position of households improved notably in Q3 due to rising real estate values, a reduced pace of borrowing, increased savings, and higher stock prices, leading to a 7.6% y/y increase in net wealth (Chart 2).

And if that wasn't enough, many households are in a position to take advantage of historically low interest

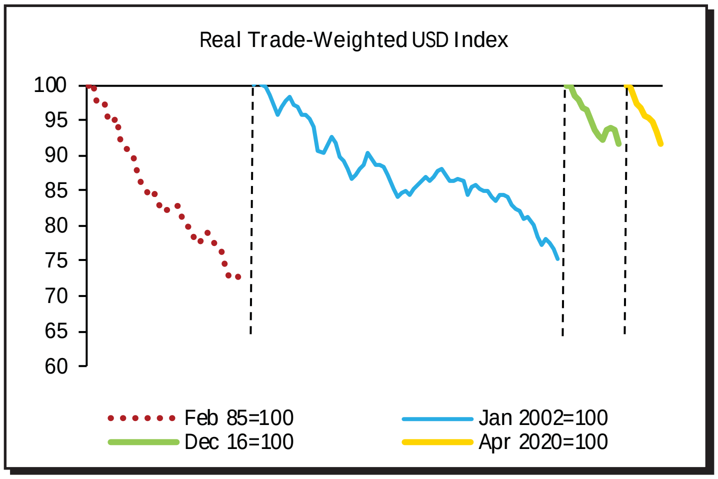
*Chart 3*

**Households Benefitting From Low Rates**



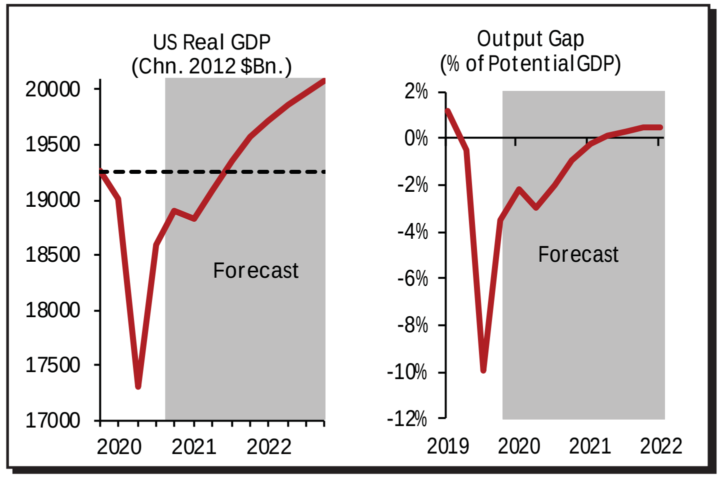

*Source: MBA, Federal Home Loan Mortgage Corporation, CIBC*

*Chart 4*
**USD Weakness Muted at the Macro Level**




*Source: Federal Reserve, CIBC*

*Chart 6*
**Economy On the Road to Recovery in 2021 (L), Output Gap to Close in 2022 (R)**

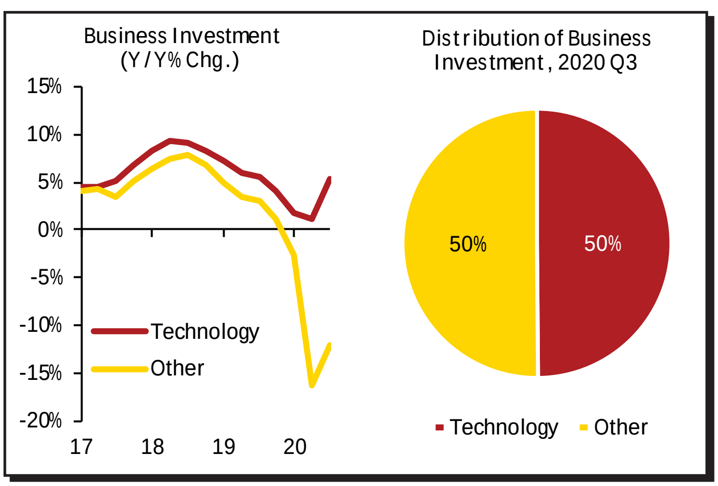



*Source: BEA, CBO, CIBC*

rates. With the sharp decline in the effective interest rate on consumer debt, we estimate that American households have already saved close to $170 bn, or more than half a percent of disposable income, due to lower interest payments. In the mortgage market, lower rates have triggered a wave of refinancing activity, and despite a 13% increase in the value of refinanced property, the share of cash-out refinancing is at the lowest rate in more than a decade (Chart 3).

One derivative of the Covid crisis is the ongoing decline in the value of the US dollar as measured by the trade weighted index, which is down by 8% since February. While that downward trajectory is an important factor impacting financial markets, it is arguably, at this point,

*Chart 5*
**Tech Investment Supporting Overall Business Investment**




*Source: BEA, CIBC*

only a minor US macro story. As illustrated in Chart 4, the current episode of dollar weakness is miniscule relative to those seen in the 1980s or 2000s, and is more akin to what was seen more recently in 2016, which didn't dramatically impact America's trade position or inflation.

Despite USD weakness, import prices are still down relative to the start of the pandemic, while America's trade position has deteriorated even with progress made on Phase One commitments from China. The trade deficit is at its widest level on record (since 1992), but from the perspective of domestic demand and business investment, the story is more encouraging. Two-thirds of the jump in imports of goods, which are up by 8% since February, is accounted for by consumer products, and most of the remaining portion is explained by a climb in inbound capital goods. The latter is a sign that business investment is still relatively strong, boosted largely by strong investment in technological equipment, software, and R&D (Chart 5) .

Accordingly, a challenging few months will give way to brighter horizons into the second quarter, as vaccine deployment will be in full swing by then and some pent-up demand will be ready to be released. That momentum will only grow in the second half of the year, working to bring the level of GDP above its pre-pandemic mark as of Q3, and closing the output gap in 2022 (Chart 6).

### Fewer Battle Scars

Given the above discussion, we are in a better position to address the third question: the risk of scarring. Scarring occurs when weak demand undermines supply potential, weak capital spending damages productivity, credit pressures lead to increased bankruptcies, the growing risk of zombification, persistent resource misallocation, and rising long-term unemployment. That means that beyond a “level effect” on GDP, the gap between actual growth relative to what it would have been in the absence of the virus, widens. Scarring was clearly evident following the 2008/9 recession, but we argue that the abnormality of the current crisis (as discussed earlier) makes it more of an economic event as opposed to a condition, and we therefore do not expect major scarring in the coming years.

# After Pulling Back, A Rubber Band Rebound for Canada

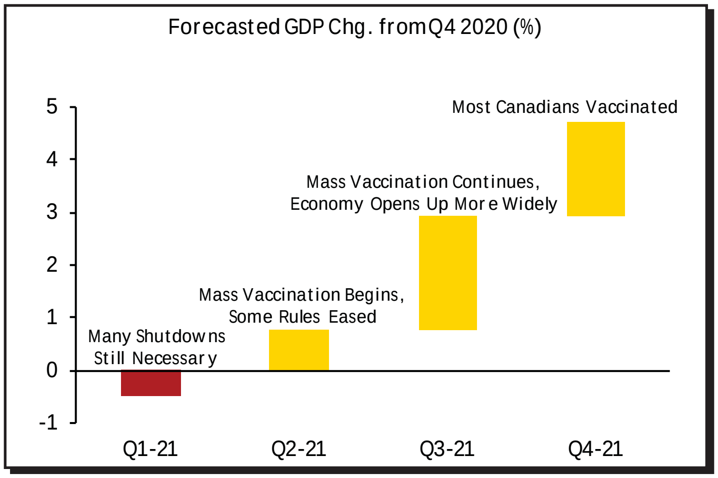
Royce Mendes

The road to recovery from typical recessions can be slow, but the COVID-19 recession is anything but typical. One of the few pieces of good news in 2020 was that in the absence of spiking virus cases during the summer, large swaths of the economy were able to snap back. Not back to prior peaks, but a rebound that was much faster than a characteristic recovery.

So, while the Canadian economy is again faltering under the weight of new infections, there's scope for a sharp rebound to offset those losses as the spread of the virus is expected to slow and eventually disappear later this year. Indeed, while we've been forced to lower our expectations for the first quarter of 2021, much like pulling on a rubber band a bit further, there's reason to believe that it will be made up with a faster bounce back later in 2021 (Chart 1).

*Chart 1*

**Economy To Start 2021 Slow Before Making Strides Later**




*Source: CIBC*

*Table 1*

## CANADA FORECAST DETAIL

(real % change, s.a.a.r., unless otherwise noted)

| | 20:3A | 20:4F | 21:1F | 21:2F | 21:3F | 21:4F | 22:1F | 2020F | 2021F | 2022F |
|---|---|---|---|---|---|---|---|---|---|---|
| **GDP At Market Prices ($Bn)** | 2,235 | 2,280 | 2,283 | 2,314 | 2,374 | 2,429 | 2,475 | 2,200 | 2,350 | 2,519 |
| % change | 55.2 | 8.4 | 0.5 | 5.4 | 10.9 | 9.6 | 7.8 | -4.8 | 6.8 | 7.2 |
| **Real GDP ($2007 Bn)** | 2,003 | 2,026 | 2,016 | 2,041 | 2,085 | 2,121 | 2,147 | 1,986 | 2,066 | 2,170 |
| % change | 40.5 | 4.6 | -2.0 | 5.2 | 8.9 | 7.1 | 4.9 | -5.5 | 4.0 | 5.1 |
| **Final Domestic Demand** | 50.8 | -0.9 | -3.8 | 5.4 | 9.8 | 7.6 | 4.5 | -4.8 | 3.6 | 5.4 |
| **Household Consumption** | 62.8 | 1.1 | -5.3 | 6.0 | 14.0 | 9.4 | 4.6 | -6.4 | 4.6 | 6.3 |
| **Total Govt. Expenditures** | 15.0 | 1.1 | 1.0 | 2.5 | 2.4 | 2.2 | 2.3 | -0.2 | 2.3 | 2.2 |
| **Residential Construction** | 187.3 | -22.8 | -10.1 | 7.9 | 5.3 | 7.9 | 6.3 | 1.5 | 3.8 | 6.1 |
| **Business Fixed Investment*** | 26.6 | 1.3 | -3.6 | 8.8 | 9.8 | 12.0 | 8.3 | -11.3 | 1.1 | 8.2 |
| **Inventory Change ($2007 Bn)** | -36.0 | -2.3 | 1.7 | 7.1 | 9.3 | 6.1 | 6.6 | -17.2 | 6.1 | 3.5 |
| **Exports** | 71.8 | 4.2 | 7.8 | 6.6 | 4.4 | 7.0 | 6.0 | -10.0 | 6.2 | 5.8 |
| **Imports** | 113.7 | 8.6 | 4.2 | 11.0 | 8.3 | 6.6 | 4.7 | -11.9 | 8.8 | 6.5 |
| **GDP Deflator** | 10.7 | 3.5 | 2.6 | 0.2 | 1.8 | 2.3 | 2.7 | 0.7 | 2.7 | 2.0 |
| **CPI (yr/yr % chg)** | 0.3 | 0.9 | 1.3 | 2.5 | 2.3 | 1.9 | 1.8 | 0.7 | 2.0 | 1.8 |
| **Unemployment Rate (%)** | 10.0 | 8.7 | 9.0 | 8.5 | 7.4 | 6.7 | 6.5 | 9.5 | 7.9 | 6.2 |
| **Employment Change (K)** | 1440 | 438 | -95 | 177 | 334 | 272 | 156 | -988 | 785 | 766 |
| **Goods Trade Balance (AR, $bn)** | -35.1 | -37.9 | -36.1 | -30.9 | -37.4 | -35.2 | -30.5 | -34.6 | -34.9 | -31.3 |
| **Housing Starts (AR, K)** | 239 | 224 | 192 | 201 | 203 | 207 | 210 | 215 | 201 | 215 |

* M&E plus Non-Res Structures and Intellectual Property and NPISH

That outlook admittedly relies heavily on a mass-vaccination effort that accelerates to match the expectations of the federal government. And, make no mistake, even such progress would still leave the economy in a hole at the end of the year, with more significant improvements left for 2022. But, the differences between the nature of this recession and others is what will see the path back from COVID-19 as less arduous than the sheer magnitude of the shock to the economy would alone suggest.

### Is Pent-Up Demand Just A Pipe Dream?

Going on ten months now, Canadians have gone without services that have been either shut down for public health reasons or they have eschewed out of an abundance of caution. Bearish views on consumer behavior, suggest that the recovery in services spending will just barely offset any pullbacks in goods purchases as consumption patterns normalize. But there are serious issues with that line of thinking.

Many households have built up large war chests of cash. That excess cash leaves many Canadians in a position to indulge a bit more than any trends would suggest. Some might go for their first manicure, others might go out for dinner more often they did pre-COVID.

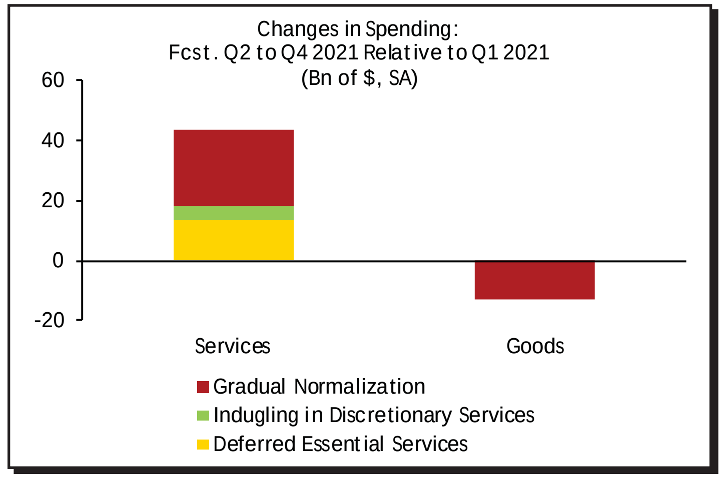
But even that focuses too narrowly on discretionary spending. Something that isn't mentioned much is that surgeries, medical procedures, even just regular health checkups have been delayed until the virus is firmly in the rearview mirror. Much of that is not paid out of pocket and so doesn't rest on Canadians having extra cash and making a decision to spoil themselves. The data show that there's also been deferred maintenance on homes and cars, there have been dental and eye exams missed, and there have been courses not taken at university.

The consumption of all of those deferred services is likely going to be unleashed in a wave, not a trickle. We estimate that the spending deferred because of the pandemic on these essential or near-essential services will have reached nearly $15bn after the first quarter of 2021 (Chart 2).

It's true that some of that extra or bunched-together spending on services will fade heading into 2022. But not all spending is created equally. As we've noted before, for every purchase of services, an equally valued purchase of goods will leak far more dollars out of Canada through imports. Eventually, international travel will again leak dollars out via consumer spending in other

*Chart 2*

**Spending On Services Will Swamp Pullback on Goods Purchases***




*Source: Statistics Canada, CIBC*

** Gradual normalization assumes consumption of services reaches pre-pandemic levels in 2022, while declines in goods spending take it almost back to pre-pandemic levels late in 2021. Indulging in services assumes a faster path back for some discretionary services than gradual normalization. Deferred essential services assumes much of the spending missed is recouped over-and-above normalization.*

jurisdictions, but before that domestic services, and maybe even domestic travel, will reap the benefits of the end of social-distancing measures. So, even just normalizing consumption patterns will help the economy, and by extension job creation, more than just a simple analysis of dollars spent on goods versus dollars spent on services would suggest.

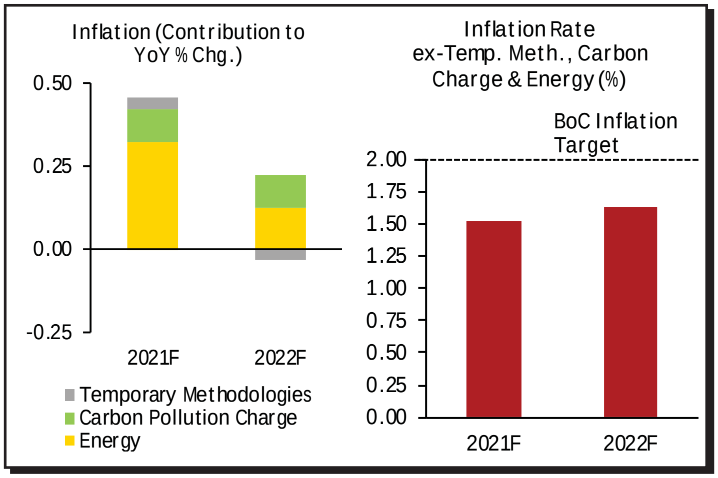
### An Inflation Headache or Head Fake?

In 2021, the economy's capacity will still be suffering from pandemic-related closures as Canada reorients itself back towards a services-driven economy. Capacity constraints combined with that likely wave of spending could create some inflationary pressures, which will be added to increases in measured consumer prices emanating from higher gasoline costs, the increase in the carbon tax and technical adjustments to some of Statistics Canada's methodologies.

There is, however, some good news. The Bank of Canada won't be reacting to 2% headline inflation with higher interest rates, as the central bank will look through many of the temporary or volatile shifts in prices. Gasoline prices are volatile and are often stripped out of underlying price gauges, and the Bank has a long history of looking through such inflation. Even the increase and expected

*Chart 3*

**After Stripping Out Volatile and Temporary Items (L); Inflation Below Target (R)**




*Source: Statistics Canada, Bank of Canada, CIBC*

future increases in the carbon tax don't represent the type of price pressures the central bank would worry about (Chart 3).

While the likely increase in services prices, as a result of a wave of spending at a time when some capacity is still constrained, might garner a bit more attention, even that is likely to be seen as temporary. If new businesses open, or those temporarily closed reopen, at the same pace seen in August and September, the number of active businesses in Canada could approach pre-pandemic levels by the end of the year, supporting job creation along the way (Chart 4). Furthermore, these businesses and jobs are likely to look a lot like the ones that existed pre-pandemic, so workers won't require a whole lot of retraining.

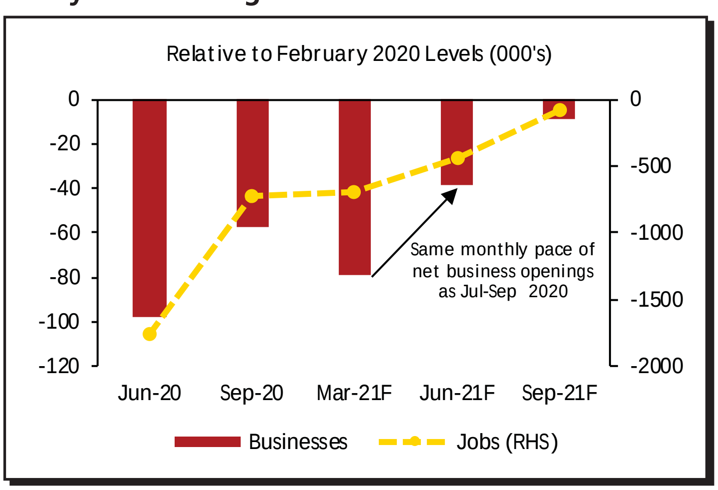
Indeed, restaurants and bars, which were some of the hardest-hit industries during the first wave, saw the number of active businesses in the sector rebound at an even faster pace than average in the summer of 2020 (Chart 5, left and right).

After the 2008-09 financial crisis saw demand crash, many factories that were shuddered never switched their lights back on. Production was moved either overseas or south of the border. However, in this case, that's just not possible. There's no way to outsource an evening out for dinner or a haircut or most of the other services that were knocked down during the pandemic. Ample vacancies in commercial real estate will ease the burden in replacing those businesses that unfortunately failed over the past year.

As additional domestic capacity is restored, temporary factors fade and increased global oil production slows the gains in energy prices, expect inflation to recede back below the Bank of Canada's target in 2022. Growth should also begin to slow around that time, as the idiosyncratic benefits from immunization that caused that earlier rubber band rebound begin to fade. By then, though, the economy should be operating above its pre-pandemic peak, and underlying momentum in the private sector, combined with fiscal stimulus promised by the federal government, should push the economy close to it's potential around the end of 2022. If so, that would call into question the need for further stimulus in 2023, and open up scope to let deficits decline a bit earlier.

*Chart 4*

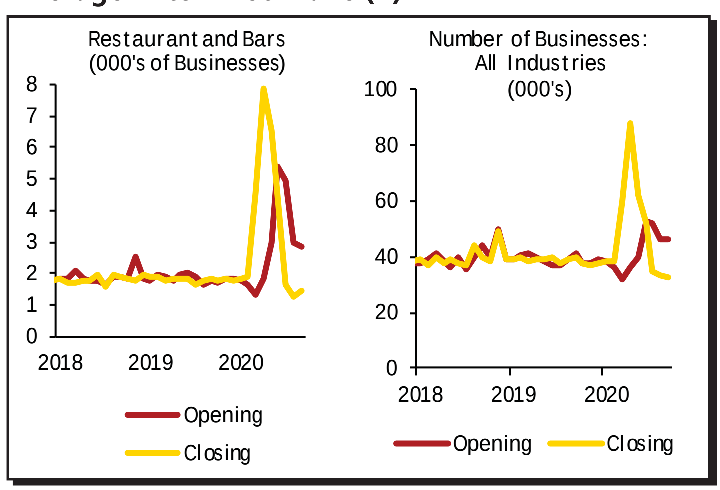
**Number of Businesses Snapped Back Last Summer, Likely To Do So Again This Summer**




*Source: Statistics Canada, CIBC*

*Chart 5*

**Restaurants and Bars Bounced Back Faster (L) Than Average After First Wave (R)**




*Source: Statistics Canada, CIBC*

# Global Growth: Awaiting The Recovery's Second Wave

Andrew Grantham

Most major economies, particularly those in the northern hemisphere, are enduring a second wave of virus infections and the resulting economic impacts from physical distancing measures. As a result, the recovery in many countries has slipped into reverse, and near-term economic forecasts have been downgraded.

However, with vaccinations having now started, and the pace of those picking up in recent weeks, we can still look forward to a second wave of the economic recovery, starting later this year and continuing into 2022, which will bring strong GDP growth rates in most areas (Table 1).

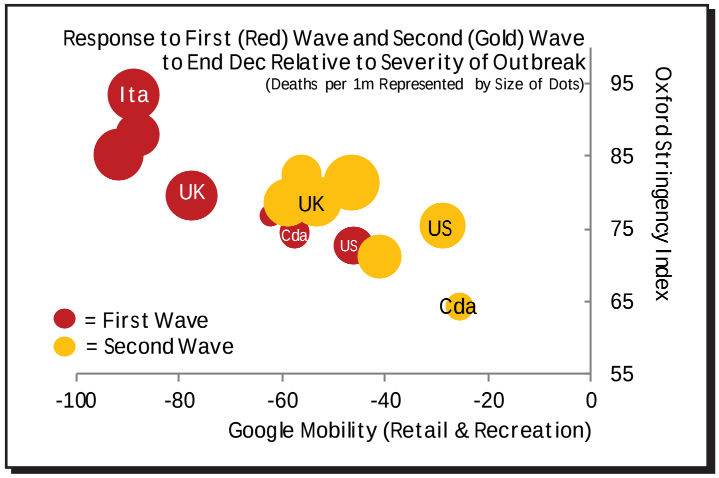
## A Resurgent Virus

Before that resurgence in the recovery, however, more economic pain will be felt in the near term from the resurgence of the virus. Over the autumn, case counts surged in most parts of the northern hemisphere, resulting in physical distancing measures being re-imposed in many countries.

Judging by measures of lockdown strictness, including Oxford University's severity index and Google mobility data, it's clear that most countries attempted to use a lighter touch to tackling case numbers than in the spring (Chart 1). It also appears from the greater gap in mobility statistics relative to the severity index that public adhesion to lockdown rules hasn't been as high as it was in the March/April 2020.

*Chart 1*

**Lighter Response to Second Wave at End 2020**




*Source: University of Oxford, Google, CIBC*

But health outcomes, and the economy, will pay for autumn's laxity in the first quarter of 2021. Case counts have surged in the UK as a new variant of the virus took hold, remain elevated in the US and continued to creep up in Canada (Chart 2). That's resulted in even stricter measures having to be applied since the New Year, particularly in those aforementioned countries, which will take a bite out of Q1 GDP.

The good news now, relative to where we stood last spring, is that there is light at the end of the tunnel in the

*Table 1*

**REAL GDP GROWTH RATES**

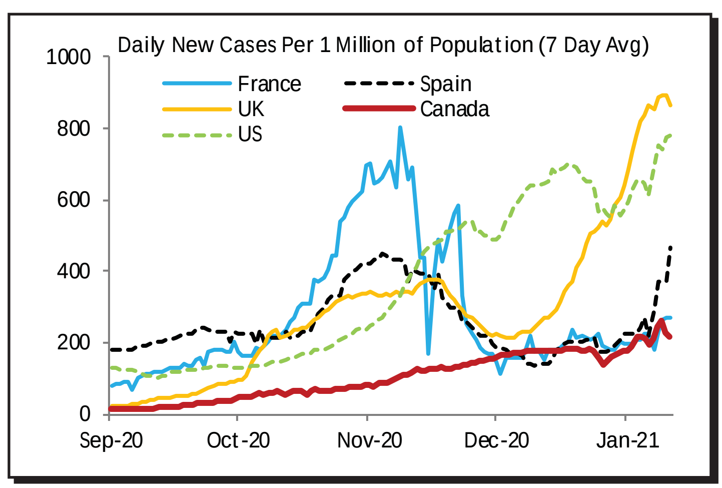
| | 2017A | 2018A | 2019A | 2020F | 2021F | 2022F |
|---|---|---|---|---|---|---|
| World* | 3.8 | 3.5 | 2.8 | -3.3 | 5.1 | 4.5 |
| US | 2.3 | 3.0 | 2.2 | -3.3 | 4.1 | 3.6 |
| Canada | 3.0 | 2.4 | 1.9 | -5.5 | 4.0 | 5.1 |
| Euroland | 2.4 | 1.9 | 1.3 | -7.2 | 3.9 | 4.3 |
| UK | 1.7 | 1.3 | 1.3 | -11.3 | 4.7 | 7.4 |
| Australia | 2.4 | 2.8 | 1.9 | -3.0 | 3.0 | 3.4 |
| Japan | 2.2 | 0.3 | 0.7 | -5.3 | 3.3 | 2.0 |
| China | 6.9 | 6.7 | 6.1 | 2.0 | 8.4 | 5.6 |

** at Purchasing Power Parity*

*Source: National statistical agencies, IMF, CIBC*

*Chart 2*

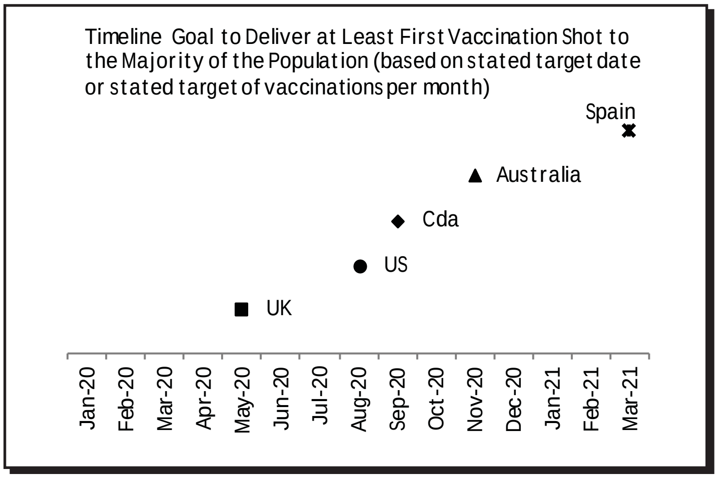
**Partial Lockdown Measures Thus Far Haven't Been Effective in Some Areas**




*Source: Bloomberg, CIBC*

*Chart 3*

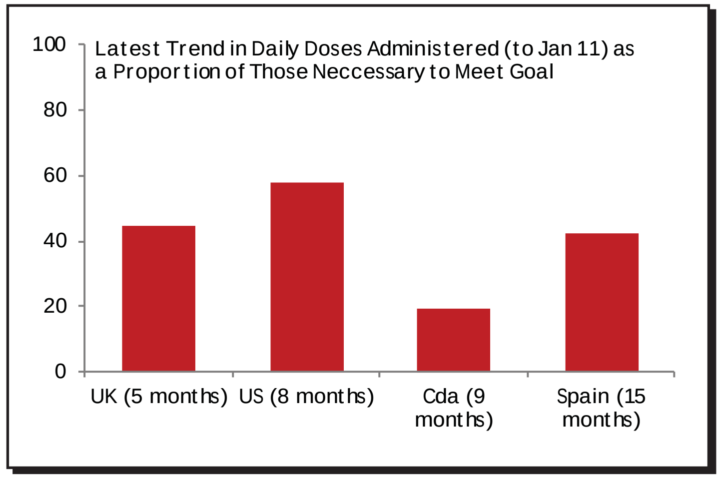
**Vaccination Goals Could See Discrepancy Between UK and Rest of Europe**




*Source: Our World in Data, Local News Sources, CIBC*

*Chart 5*

**All Countries Will Have to Speed Up to Meet Goals**



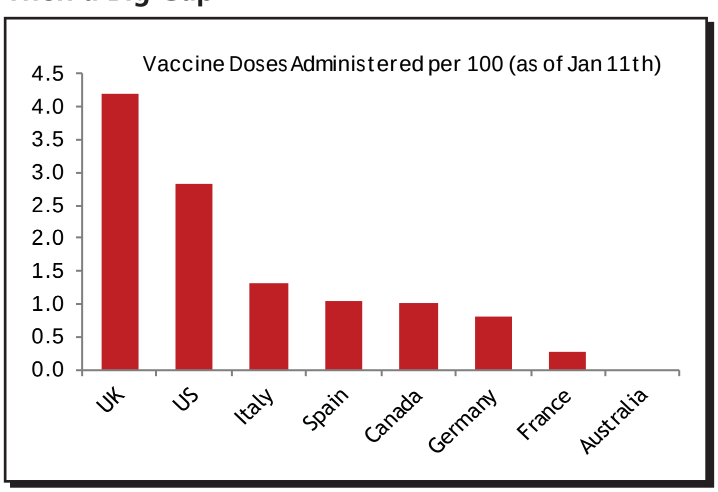

*Source: Our World in Data, CIBC*

form of vaccines. Assuming that current vaccines remain protective against different mutations of the virus, by the end of this year or early in 2022 most countries should be able to allow a wider reopening of their economies and the return to a greater level of social contacts.

However, while it is admittedly early days, the timeline for, and current speed of, vaccination has differed among major economies. None are going to complete vaccinations as soon as early frontrunners such as Israel. But, an ambitious target in terms of vaccinations per week would put the UK on course to have most complete before the summer, with the US slightly behind and Canada setting a goal for the end of September (Chart 3).

*Chart 4*

**Vaccinations: UK Ahead, US Following, Then a Big Gap**




*Source: Our World in Data, CIBC*

Despite being at the center of developing and producing one of the first vaccines to become available, Europe appears to be lagging behind in the vaccination process, both in terms of the goals it has set but also in terms of the number of doses delivered thus far (Chart 4). Note though that in almost all cases the rate of vaccinations will have to accelerate from the current pace to meet the stated goals, particularly Canada (Chart 5).

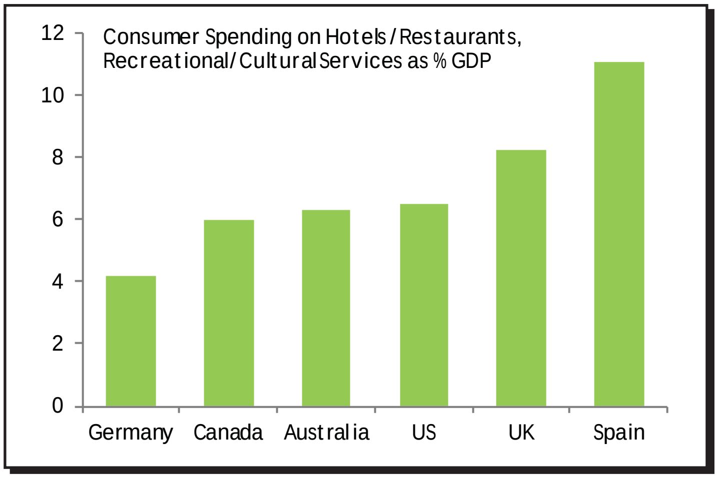
## Euro-skepticism

Delays in vaccinations in one country, or group of countries, relative to others could bring vastly differing economic fortunes over a 6-18 month period. That's particularly true for some parts of Europe. In Spain, for example, even in comparison to the UK, a greater proportion of consumer spending is related to close contact services such as bars, restaurants and recreation (Chart 6). A delay of six months in being able to return consumer spending in such areas from say 60% to 100% of pre-pandemic levels would knock off 2% from the pace of rebound in 2021.

Of course, not all of Europe is as reliant on tourism-related spending as Spain. However, there are still reasons to doubt that the rebound in the euro area will be quite as strong as in other areas. While the degree of fiscal support has been larger than in prior downturns, it has still fallen short of the kind of spending seen in other countries. Income support for households impacted by pandemic-related job losses hasn't been as strong, meaning that the rise in the household savings rate hasn't been as pronounced, particularly when compared to

*Chart 6*

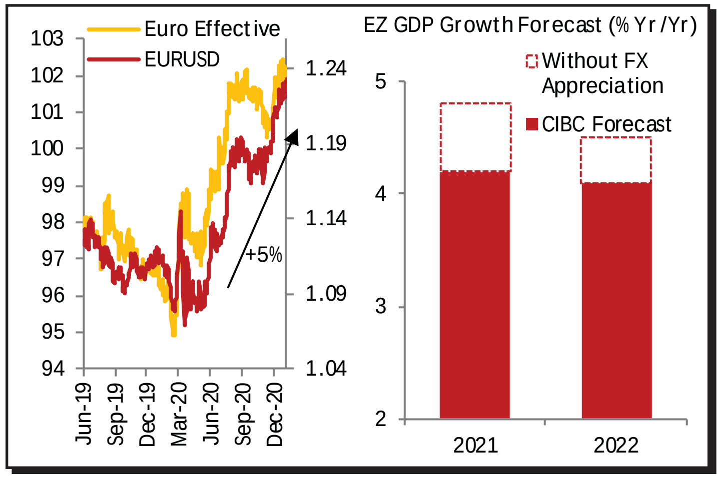
**Some Parts of Europe, as Well as UK, Have Most to Gain from Speedy Vaccination**




*Source: OECD, CIBC*

*Chart 8*

**Euro Appreciation Last Year (L), Will Dampen Growth in 2021 and 2022 (R)**



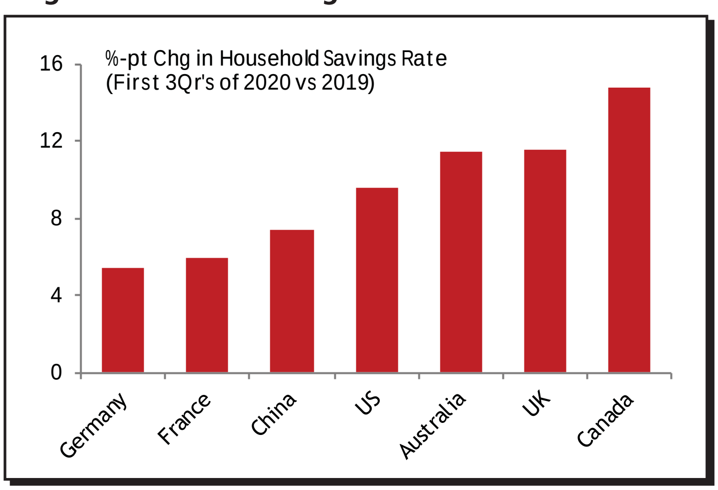

*Source: Bloomberg, European Commission, CIBC*

North America and Australia (Chart 7). The bottom line is that there isn't the same excess savings to be redeployed when service-related areas of the economy are able to fully reopen.

Last year's appreciation of the euro will be a headwind to growth as well. Even though the negative impact will be dwarfed by the benefits of economic reopening as vaccinations finally accelerate, the roughly ½%-pt a year drag we expect in both 2021 and 2022 would be the difference between a slightly above-consensus and marginally below-consensus view on the Eurozone economy (Chart 8).

*Chart 7*

**Households in Europe Don't Have the Same Degree of Excess Savings**




*Source: National Statistics Agencies, Bloomberg, CIBC*

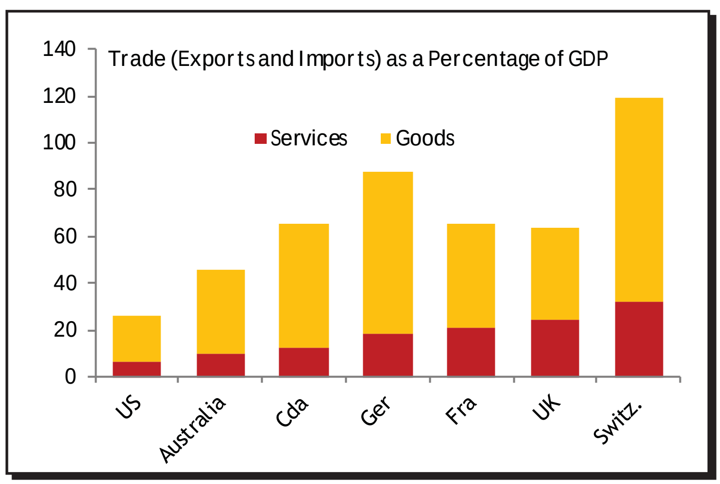
### Rushing For the Brexit

A last-minute rush towards the end of last year saw a trade deal negotiated that would allow the UK to leave the EU without incurring WTO tariffs. That clearly reduced another downside risk to growth, but the trade deal has not been without its critics — in particular those pointing out that it failed to cover any service industries which make up 80% of the UK economy.

However, we are more optimistic. While it is true that the service sector was not covered, and it is a larger part of the UK economy than most, it is not the largest part of the country's trade with other nations (Chart 9). Not many people travel from Calais to Dover for a haircut.

*Chart 9*

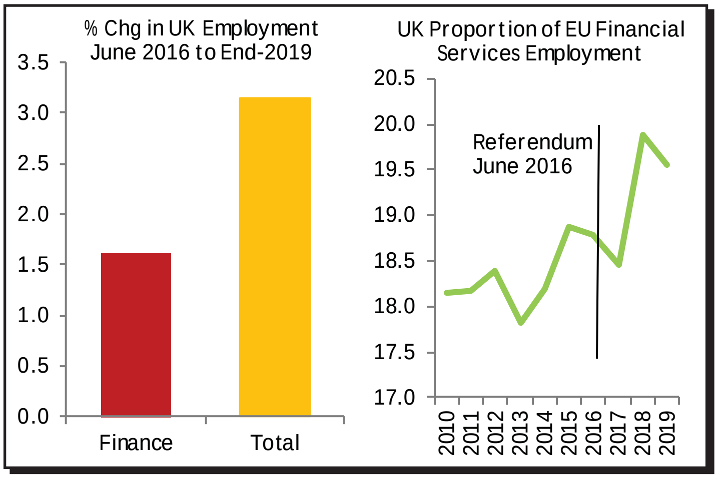
**Even in UK, Most Trade Is in Goods Not Services**




*Source: World Bank, CIBC*

*Chart 10*

**UK Finance Employment Sluggish Relative to Other Sectors (L), But Not Rest of Europe (R) Since Brexit**




*Source: ONS, Eurostat, CIBC*

While trade in financial services is important, as we argued at the time of the Brexit vote, the UK holds important advantages other than its previous EU membership, including a common language when dealing with most of North America. Indeed, even though financial services employment hasn't grown as quickly as other industries in the UK since the Brexit vote, it has actually risen faster than finance jobs elsewhere. As such, the UK has actually, surprisingly, gained share in terms of financial services employment within Europe since the EU referendum (Chart 10).

## The Sun Rose Earlier in the East

Relative to most developed countries in the West, those in the Asia-Pacific region have generally been able to keep virus cases in check much better, resulting in less economic pain in 2020 and the continuation of reopening early this year.

However, that doesn't mean that those countries have nothing to gain from vaccinations, both within their own country and the rest of the world. One notable example of a sector still awaiting liftoff is tourism/travel. With the exception of China, where intra-country travel has fully rebounded, even countries with low case counts such as Japan and Australia have seen only a limited rebound in air travel (Chart 11).

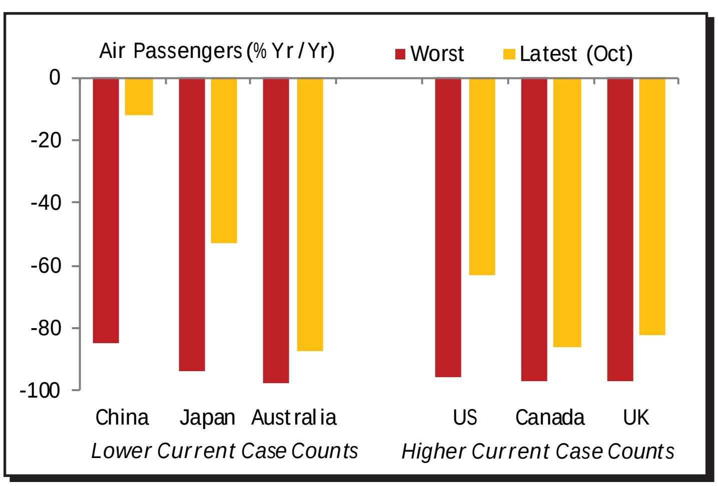
In China there still seems to be a degree of nervousness among consumers (either due to job prospects or potential virus related health concerns) that has seen a more sluggish rebound in retail sales relative to other sectors within China or the recovery in retail sales seen in other countries (Chart 12). A more complete rebound in Chinese retail sales in 2021 and 2022 would not just be a positive for growth in that country but also for the export prospects of other nations.

## What to Expect From the Recovery's Second Wave?

As we've highlighted elsewhere, we are generally optimistic regarding the post-vaccination stage of the recovery and believe that, due to the unique nature of the downturn and unprecedented government support,

*Chart 11*

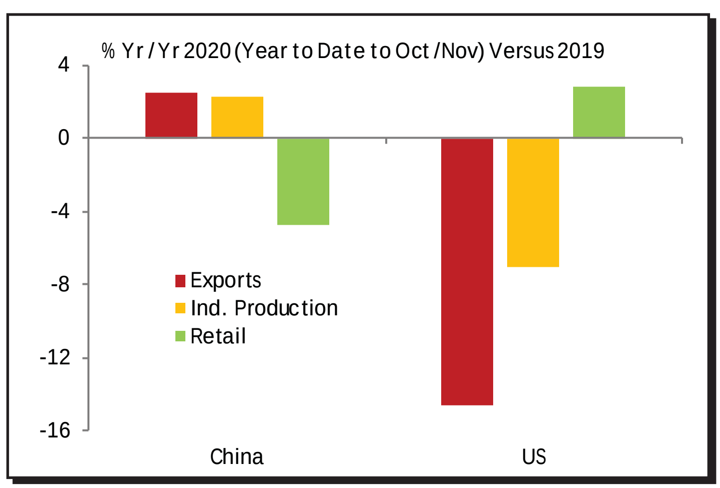
**Air Travel Has a Lot of Room to Recover, Even in Most Low Case-Count Countries**




*Source: Bloomberg, CIBC*

*Chart 12*

**China's Recovery Was Generally Stronger, Apart From Retail Sales**




*Source: Bloomberg, Haver, CIBC*

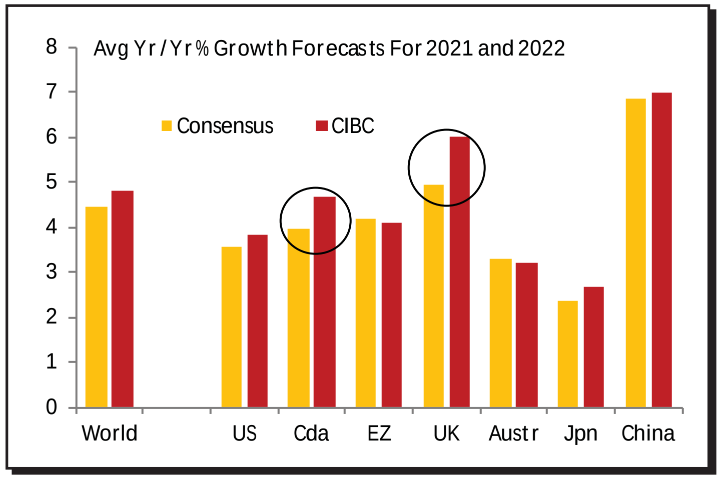
economic activity will return closer to its pre-recession trend than in other downturns (Chart 13).

However, that doesn't necessarily mean that we expect above-consensus growth rates across the board. In Europe, for example, the somewhat more limited level of government support, longer vaccination timeline and FX appreciation means that, in our view, there is less scope for positive surprises. Thanks to consensus forecast upgrades owing to strong growth late last year as Victoria reopened, our Australia forecast is also no longer above the median projection.

Those areas where we see greater upside include Canada, as long of course as the speed of vaccinations picks up, and the UK. In the latter, a speedier vaccination process and less disruption to the economy than most expect owing to Brexit, sees us forecasting strong growth for the UK economy in the second half of this year and into 2022.

*Chart 13*

**Where We See The Biggest Surprises**




*Source: Bloomberg, CIBC*