Economics

FORECAST

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Eyeing What Comes Next, Next

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For financial markets, and monetary policy, it's not what comes next that matters. It's what comes next, next.

Over the coming year, if we pull back from the brink of a trade war, both the US and Canada will be close enough to full employment, and have enough momentum, to deliver what just about everyone now expects: further growth in corporate profits, a hint of pressure on wages and core inflation, and some increases in central bank interest rates. That's pretty much built into today's asset prices.

With population growth picking up, there's even a bit of elbow room to raise our prior 2019 forecast for Canadian GDP by two ticks to 1.8%, without jeopardizing inflation (Table 1). That room for non-inflationary growth is yet another reason for the Bank of Canada to hike only once next year (Table 2), along with a lot of household debt coming up for resetting, and, as identified in recent BoC research, the challenges posed by a not-very-competitive export sector that has struggled even with a 1.30 dollar-Canada exchange rate.

That's the story for next year in a nutshell. But asset values at the end of 2019 will be guided by what's in store for 2020. For that next, next year, the growth surprises look tilted to the downside, even if, as we expect, the world's major economies keep their heads above recessionary waters. US fiscal policy will turn from a brisk tailwind into at least a modest headwind, shaving 1½% points off GDP growth (see pages 4-6). In Canada, the lagged impacts of higher interest rates will show up as more households get through their mortgage renewals. Come 2020, both the US and Canada could post sub-1½% growth.

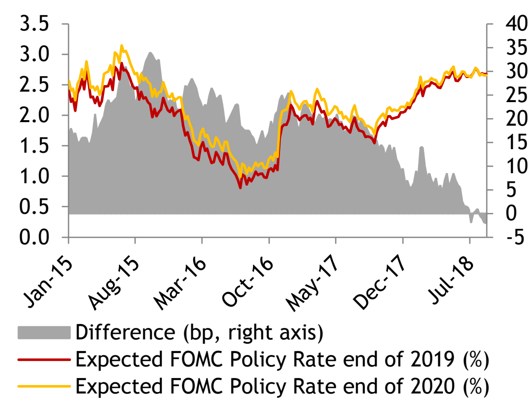
Globally, by 2020, Europe will be feeling its own monetary tightening, emerging markets will be a mixed bag at best, while China could again be pulling back from debt-funded infrastructure spending that will be an unsustainable stop-gap for growth in the near term.

Monetary Policy Over the Horizon

Our practice is to give central banks credit for having at least as much foresight as we can claim. That's why after hiking once a quarter in 2018, we see the Fed adding only 50 bps in 2019, even if core inflation drifts a bit higher.

Markets have dropped expectations for 2020 Fed hikes (Chart 1), but we shouldn't be

Chart 1
Futures See No Fed Hike in 2020



Source: Bloomberg, CIBC

Table 1

FORECAST SUMMARY
(% Change Except Where Noted)

CANADA	2016A	2017A	2018F	2019F	2020F
GDP at Market Prices	2.0	5.4	**4.2**	**4.1**	**3.1**
GDP in $2007	1.4	3.0	**2.0**	**1.8**	**1.3**
Consumer Price Index	1.4	1.6	**2.4**	**2.0**	**1.9**
Unemployment Rate	7.0	6.3	**5.8**	**5.8**	**6.1**
Current Account Balance (C$ Bn)	-65.4	-63.3	**-64.3**	**-56.2**	**-57.1**
Pre-tax Profits (net Operating Surplus)	-1.9	19.9	**4.6**	**6.4**	**4.0**
Housing Starts (K)	198	220	**205**	**188**	**176**

UNITED STATES	2016A	2017A	2018F	2019F	2020F
GDP at Market Prices	2.7	4.2	**5.3**	**4.5**	**3.2**
GDP in $2009	1.6	2.2	**2.8**	**2.2**	**1.4**
Consumer Price Index	1.3	2.1	**2.6**	**2.5**	**2.0**
Unemployment Rate	4.9	4.4	**3.9**	**3.6**	**4.2**
Current Account Balance (US$ Bn)	-433	-449	**-475**	**-517**	**-526**
Pre-tax Profits (with IVA/CCA)	-1.1	3.2	**7.6**	**5.5**	**3.5**
Housing Starts (K)	1,177	1,208	**1,282**	**1,271**	**1,212**

Table 2

INTEREST AND EXCHANGE RATE FORECAST

		2018		2019				2020	
END OF PERIOD:		**5-Sep**	**Dec**	**Mar**	**Jun**	**Sep**	**Dec**	**Jun**	**Dec**
CDA	Overnight target rate	1.50	1.75	1.75	2.00	2.00	2.00	2.00	2.00
	98-Day Treasury Bills	1.54	1.70	1.75	1.80	1.95	2.00	1.80	1.70
	2-Year Gov't Bond	2.05	2.30	2.35	2.45	2.45	2.50	2.30	1.80
	10-Year Gov't Bond	2.24	2.55	2.65	2.75	2.75	2.70	2.70	2.35
	30-Year Gov't Bond	2.25	2.50	2.60	2.85	2.80	2.80	3.10	2.75
U.S.	Federal Funds Rate	1.875	2.375	2.375	2.625	2.625	2.875	2.625	2.375
	91-Day Treasury Bills	2.13	2.25	2.35	2.55	2.65	2.80	2.60	2.25
	2-Year Gov't Note	2.65	2.90	3.00	3.20	3.20	3.30	2.90	2.60
	10-Year Gov't Note	2.90	3.10	3.30	3.45	3.45	3.35	3.10	3.00
	30-Year Gov't Bond	3.07	3.25	3.40	3.55	3.60	3.60	3.45	3.45
Canada - US T-Bill Spread		-0.59	-0.55	-0.60	-0.75	-0.70	-0.80	-0.80	-0.55
Canada - US 10-Year Bond Spread		-0.66	-0.55	-0.65	-0.70	-0.70	-0.65	-0.40	-0.65
Canada Yield Curve (10-Year — 2-Year)		0.19	0.25	0.30	0.30	0.30	0.20	0.40	0.55
US Yield Curve (10-Year — 2-Year)		0.25	0.20	0.30	0.25	0.25	0.05	0.20	0.40
EXCHANGE RATES	CADUSD	0.76	0.76	0.76	0.78	0.76	0.75	0.76	0.77
	USDCAD	1.32	1.32	1.31	1.28	1.31	1.34	1.32	1.30
	USDJPY	112	110	108	106	105	104	102	100
	EURUSD	1.16	1.18	1.20	1.23	1.25	1.28	1.30	1.30
	GBPUSD	1.29	1.30	1.35	1.39	1.42	1.46	1.50	1.51
	AUDUSD	0.72	0.74	0.75	0.76	0.77	0.78	0.79	0.80
	USDCHF	0.97	0.97	0.96	0.94	0.94	0.92	0.91	0.89
	USDBRL	4.13	4.10	4.25	4.30	4.05	3.90	3.95	4.05
	USDMXN	19.4	19.4	19.1	18.9	18.8	19.5	19.4	20.3

surprised if Powell has to ease 50 bps in 2020, even with no recession at hand. That's not as bold a call as it may sound. Both the 1980s and 1990s expansions saw mid-cycle eases from the Fed as it adjusted policy in the face of temporary slowdowns (in 1995) or an equity retreat (in 1987 and 1998), and renewed rate hikes after growth or markets rebounded. Rates were of course higher in those cycles, but not relative to where the neutral rate stood.

The Bank of Canada could eschew an ease in 2020 given the lack of a similar fiscal tightening in store in Canada, and the likelihood that it will have already lagged the Fed on hikes in 2018-19. Even if a NAFTA deal is realized, our lack of export success in the past two decades suggests that keeping the exchange rate in check will be a necessary, and perhaps not wholly sufficient condition to weaning Canada's economy off housing and debt-financed consumption.

While the Canadian dollar doesn't have much upside, other major currencies have room to run against a US greenback whose days of dominance are numbered. For currency markets in 2019, the story will also be about looking ahead to 2020, when Europe and Japan will be pulling back from maximal monetary stimulus, while the Fed will be going the other way.

For the bond market, it's not quite clear sailing at the long end of the curve. Trillions in bonds held by central banks will ultimately have to be refinanced in the public market as the Fed unwinds its balance sheet, and later the ECB and Bank of England follow suit. But 10-year Treasury yields could fall back to 3% in 2020 as the Fed reverses course. A modest half sell-off in bonds over the next four quarters will open up a buying opportunity, not a run for the hills.

Equities are Still Cyclical Assets

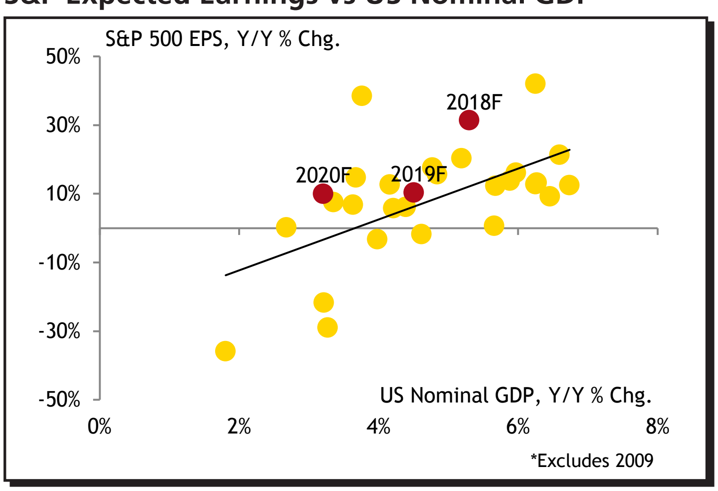
Equity markets have support in the near term from ongoing economic growth and the benefits to margins from what are still soft wage gains. Bond yields are higher than they were a year ago, but don't yet pose much competition for the investment dollars of yield seeking investors. But as we move later into 2019, equities could be challenged by slowing expectations for 2020 earnings, which in the S&P 500 consensus look a bit high relative to our nominal GDP call (Chart 2). That's been true in 2018, but this year's earnings have been lifted by major corporate tax cuts.

The resource-weighted TSX will have to contend with the typical correction seen in that sector as global growth eases. Commodity prices have a substantial correlation with global growth—not surprising, but worth remembering as we head into a deceleration (Chart 3).

Yes, a Fed ease in 2020 will be a plus for stocks. But looking back on prior mid-cycle eases, that only comes after a period in which growth concerns either stall or pull back equity prices, waiting for the central bank to ride to the rescue.

Chart 2

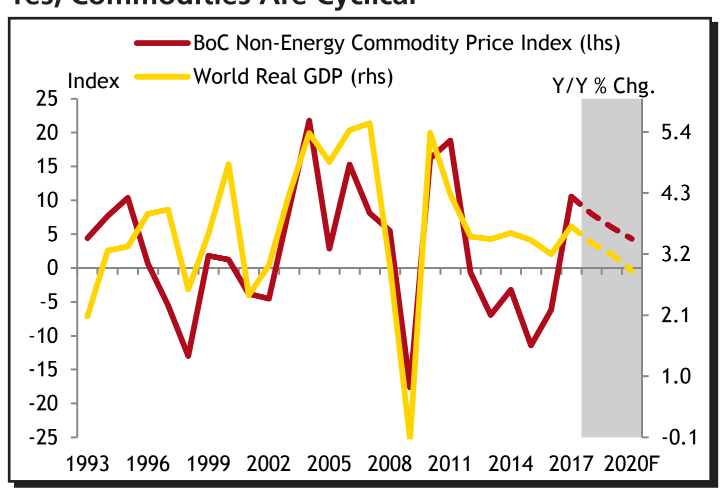
S&P Expected Earnings vs US Nominal GDP



Source: Bloomberg, BEA, CIBC

Chart 3

Yes, Commodities Are Cyclical



Source: Bank of Canada, Bloomberg, CIBC

US Economy: An Outlook With 2020 Vision

Benjamin Tal and Katherine Judge

The US economy does not display any of the imbalances that in the past led to a dramatic softening. Short of an unforced error linked to trade, there is nothing in the cards that will stop the Fed from continuing to hike a further 50 bps this year. So far, Chairman Powell's life has been relatively easy. But by mid-2019 the Fed is likely to face slightly elevated inflation but visible concerns about growth ahead. Growth will trump inflation, suggesting a slowing pace to rate hikes next year and a mid-cycle easing by 2020.

Does Danger Lurk in an Inversion?

The 4% growth seen in the second quarter is probably the strongest reading we will see for a long time. But there is plenty of room below 4% to justify the Fed's current hiking trajectory. Most indicators are consistent with continued strong growth, and the only real nuisance is the flattening yield curve and the noise around it regarding a recessionary risk.

Are we worried? Granted, shrugging off the message from the yield curve is risky business. Bernanke did it in 2006—blaming technical distortions (sound familiar?). But there is a big difference between a flat curve and an inverted curve. Predicting inversion is as difficult as predicting a recession. Second, as illustrated in Chart 1, the 2-year—3-month spread has also been a reliable predictor of recessions and it is not currently flashing a warning sign, with its slope not distorted by earlier QE (Chart 1).

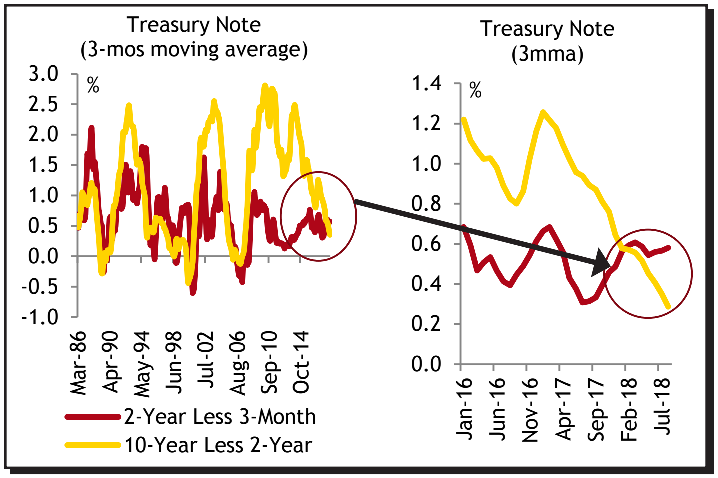
Table 1

US FORECAST DETAIL

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

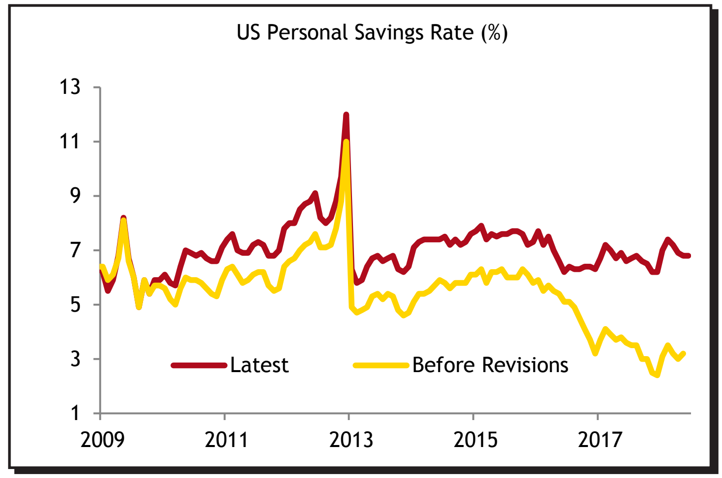
	18:1A	18:2A	18:3F	18:4F	19:1F	19:2F	2017A	2018F	2019F	2020F
GDP At Market Prices ($Bn)	20,041	20,412	20,692	20,926	21,131	21,326	19,485	20,518	21,442	22,131
% change	4.3	7.6	5.6	4.6	4.0	3.7	4.2	5.3	4.5	3.2
Real GDP ($2009 Bn)	18,324	18,515	18,650	18,740	18,825	18,919	18,051	18,557	18,961	19,222
% change	2.2	4.2	3.0	1.9	1.8	2.0	2.2	2.8	2.2	1.4
Final Sales	1.9	5.3	2.0	1.9	1.8	2.1	2.2	2.8	2.1	1.4
Personal Consumption	0.5	3.8	2.8	2.3	2.1	1.8	2.5	2.5	2.2	1.6
Total Govt. Expenditures	1.5	2.4	2.2	2.2	0.5	0.8	-0.1	1.5	1.2	-0.9
Residential Investment	-3.4	-1.6	1.0	2.8	1.7	1.2	3.3	0.7	1.3	-0.3
Business Fixed Investment	11.5	8.5	7.3	6.3	2.7	4.4	5.3	7.6	4.8	3.5
Inventory Change ($2009 Bn)	30.3	-26.9	17.5	19.6	19.5	17.7	22.5	10.1	17.2	16.1
Exports	3.6	9.1	1.9	2.9	2.3	2.6	3.0	4.9	2.9	1.9
Imports	3.0	-0.4	9.4	8.2	2.6	2.1	4.6	5.0	4.0	2.0
GDP Deflator	2.0	3.2	2.6	2.6	2.1	1.7	1.9	2.4	2.3	1.8
CPI (yr/yr % chg)	2.2	2.7	2.8	2.8	2.5	2.5	2.1	2.6	2.5	2.0
Core CPI (yr/yr % chg)	1.9	2.2	2.4	2.5	2.3	2.5	1.8	2.3	2.4	2.2
Unemployment Rate (%)	4.1	3.9	3.8	3.7	3.6	3.5	4.4	3.9	3.6	4.2
Housing Starts (AR, K)	1,317	1,254	1,268	1,290	1,292	1,301	1,208	1,282	1,271	1,212

Chart 1
Yield Curve: Conflicting Signals



Source: FRB, CIBC

Chart 3
US Households Have More Savings Than Previously Thought

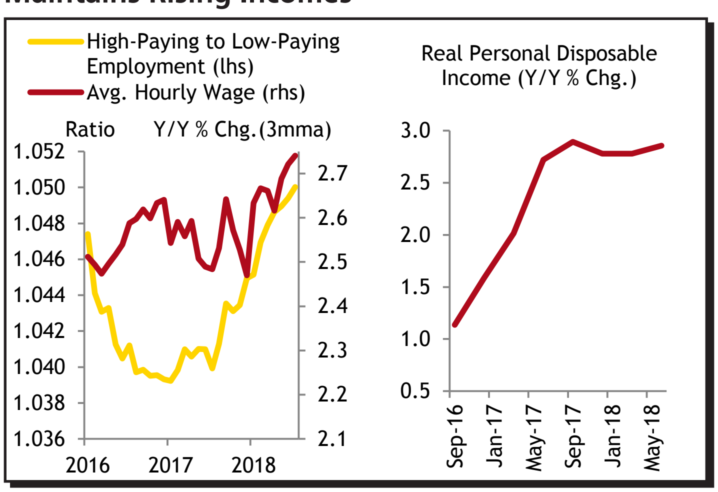


Source: BEA, Bloomberg, CIBC

The Here and Now

It's looking good. The consumer is strong, thanks in part to a tighter labour market. The broader U-6 unemployment rate is at a 17-year low and a favourable shift in the composition of employment to higher-paying jobs is starting to show up in wage growth (Chart 2, left). That, along with tax cuts, has allowed real disposable incomes to continue to grow despite a pickup in inflation and higher energy prices this year (Chart 2, right). Add to the mix the positive revisions to the savings rate (Chart 3), and you have a recipe for continued robust household consumption in 2019.

Chart 2
Healthy Wage Growth, Better Job Composition Maintains Rising Incomes



Source: BLS, CIBC

Soft Spots

That said, there are some early signs of fragility. Housing starts have lagged lately, and leading indicators including permits and pending home sales have also dipped, leading us to nudge our 2019 housing starts forecast lower.

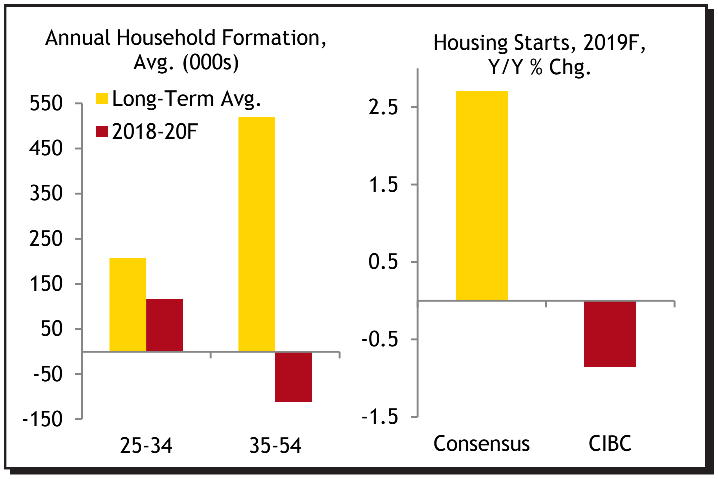
Although household formation has risen in recent months, robust home price growth has priced many potential homeowners out of the market, resulting in a rise in months' supply of homes on the market. That trend doesn't look set to reverse soon, either, as builders' costs have been amplified by tariffs on steel, adding to cost pressures resulting from a scarcity of land and labour. With mortgage rates slated to rise in the coming quarters, housing market prospects have dimmed on the consumer side, reflected in a move lower in purchase intentions for homes. Fundamentals, including slower household formation in the core first-time homebuyer population also suggest that longer term housing market demand could be at stake (Chart 4).

A slowdown in housing, coupled with the bite of 2019 rate hikes, could begin to erode consumption growth come 2020. Already, sales of housing-related goods and building materials are almost flat on the year and early signs of slower credit growth don't bode well for the spending outlook.

But at the end of the day, the key to continued strong growth is business spending. The cut to the marginal tax rate looks good on paper. But will it lead to increased spending? We think that firms will be more than happy to collect extra cash without extra effort, but are more

Chart 4

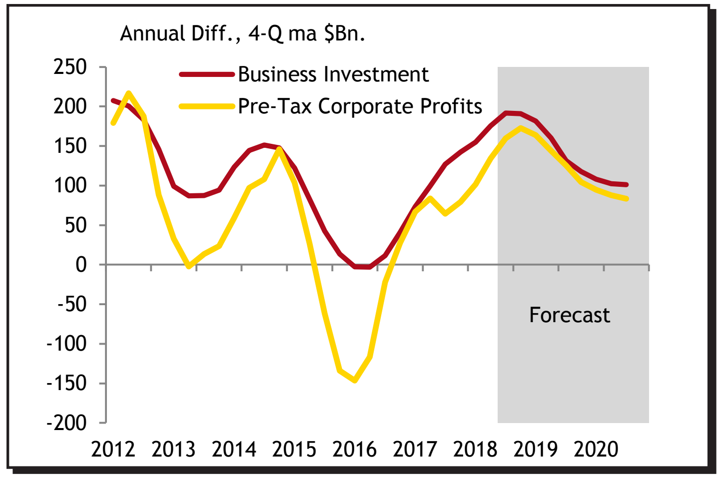
Fewer New Households (L)
Triggers Downside in Housing Starts (R)



Source: Bloomberg, Census Bureau, CIBC

Chart 5

Business Investment Healthy,
But Growth Slows by 2020



Source: BEA, CIBC

likely to follow the signal from pre-tax earnings, before committing new capital. And here the trajectory is consistent with a healthy but not accelerating profit picture (Chart 5). Immediate upfront depreciation may also have pulled forward some capital spending from 2020 into 2018/19.

Fiscal Policy to Become a Drag by 2020

While the overhaul of the tax code may have allowed producers and consumers to reap the benefits of lower taxes this year, come 2020, there should be a reversal in fortunes. The federal government will be grappling with a burgeoning budget deficit that will be dealt with by a reduction in spending. A swing from fiscal stimulus to outright restraint represents a roughly 1½% headwind to 2020 growth using IMF cyclically adjusted data (Chart 6), or nearly 1% using CBO projections.

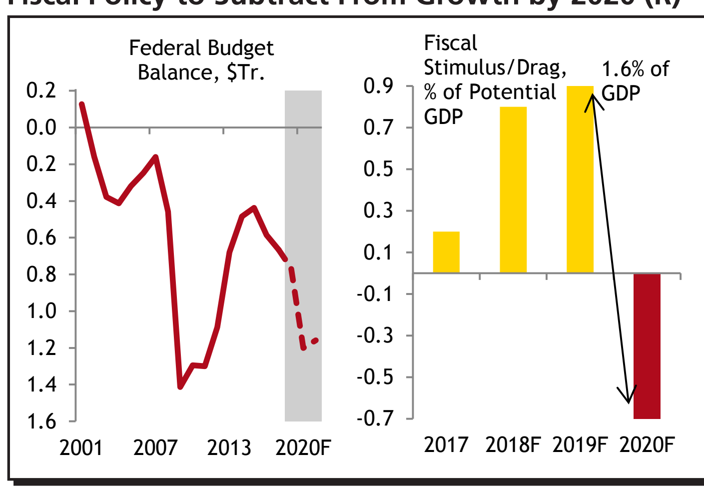
Only a handful of existing federal tax and expenditure provisions are set to expire in 2019 and 2020, which ensures that spending could be reined in in other areas to compensate. Following the midterm elections at the beginning of November, the risk of spending cuts will become more severe if the Republicans maintain control of the House and the Senate, and this includes a possible attempt at healthcare reform. If the Democrats gain control of the House or the Senate, the probability of a government shutdown will increase while the debate surrounding the debt ceiling is reignited. History suggests that a shutdown can shave $2 billion off of GDP per week, which could amount to 0.2%-pts off of a quarter's annualized GDP from a four-week shutdown. Either way, the end of fiscal stimulus will have a material impact on US growth.

Inflation—a Lagging Indicator

Powell was very clear at Jackson Hole: he is paying much closer attention to growth. And if he is willing to raise rates without any overshooting in inflation, he probably will be willing to ease off on rate hikes even before inflation drops below target. By doing so he will not be alone. In both mid-1989 and late 2000 the Fed initiated an easing cycle despite the fact that inflation was not showing any signs of easing. What triggered that courageous monetary act was the realization that inflation is essentially a lagging indicators and that it is more prudent to focus on the slowing trajectory of economic growth. That 20/20 foresight will begin to impact Fed policy as early as next year.

Chart 6

Budget Deficit Still Under Pressure (L),
Fiscal Policy to Subtract From Growth by 2020 (R)



Source: IMF, CBO, CIBC

Canada: A Deal Isn't a Done Deal for Growth

Royce Mendes

Back-and-forth trade negotiations are banner headlines these days, and will be until some sort of resolution emerges. But even if, as we expect, a deal is reached, that won't be a done deal for robust Canadian growth. Other fundamentals will see growth in the economy tailing off to 1.8% in 2019 and only 1.3% by 2020.

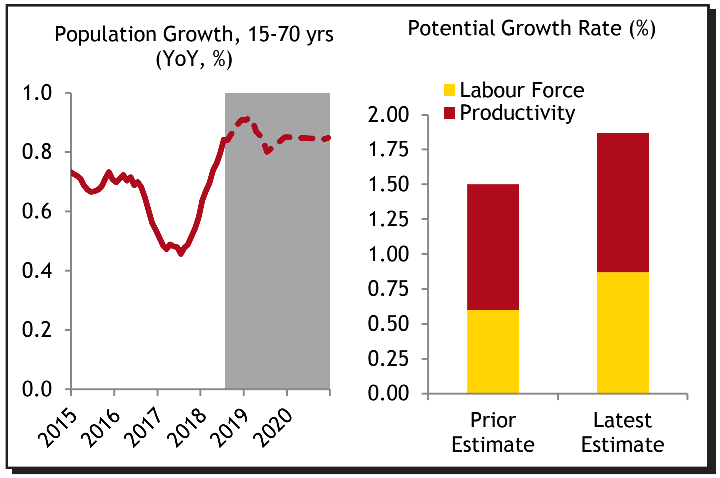
A Longer Runway

The upcoming slowdown is, however, a byproduct of past success. The economy has come a long way since the depths of the financial crisis and subsequent oil price crash, and is now bumping up against its non-inflationary speed limit. The good news is that speed limit appears to be slightly faster than previously estimated.

After dipping lower in 2017, working-age population growth has reaccelerated, completely driven by a rise in immigration (Chart 1, left). Given current trends and the federal government's higher immigration targets, we see the pace of inflow remaining elevated for the next few

Chart 1

Population Growth (L) Has Increased Economic Speed Limit (R)



Source: Statistics Canada, CIBC

Table 1

CANADA FORECAST DETAIL

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

	18:1A	18:2A	18:3F	18:4F	19:1F	19:2F	2017A	2018F	2019F	2020F
GDP At Market Prices ($Bn)	2,197	2,225	2,246	2,272	2,293	2,314	2,145	2,235	2,327	2,399
% change	3.1	5.1	3.9	4.7	3.7	3.7	5.4	4.2	4.1	3.1
Real GDP ($2007 Bn)	1,878	1,891	1,898	1,907	1,915	1,925	1,856	1,894	1,928	1,953
% change	1.4	2.9	1.5	2.0	1.7	1.9	3.0	2.0	1.8	1.3
Final Domestic Demand	1.7	2.1	2.1	2.0	1.8	1.8	3.0	2.6	1.8	1.4
Household Consumption	1.0	2.6	1.9	2.1	1.7	1.9	3.5	2.2	1.8	1.5
Total Govt. Expenditures	2.8	1.0	2.4	1.6	1.7	1.8	2.6	2.8	1.7	1.6
Residential Construction	-10.5	1.1	2.3	1.1	0.1	-2.3	2.9	0.1	-0.5	-3.2
Business Fixed Investment*	11.5	1.8	2.2	3.2	3.6	4.1	2.5	6.2	3.2	2.9
Inventory Change ($2007 Bn)	15.8	14.1	12.2	11.1	9.2	8.5	13.9	13.3	8.3	6.8
Exports	2.4	12.3	1.2	3.0	3.9	3.4	1.1	3.0	3.7	2.6
Imports	4.2	6.5	1.8	2.3	2.9	2.5	3.6	4.5	2.7	2.5
GDP Deflator	1.7	2.1	2.5	2.7	2.0	1.8	2.3	2.1	2.3	1.8
CPI (yr/yr % chg)	2.1	2.3	2.8	2.5	2.1	2.0	1.6	2.4	2.0	1.9
Unemployment Rate (%)	5.8	5.9	5.8	5.8	5.8	5.8	6.3	5.8	5.8	6.1
Employment Change (K)	3	31	88	56	50	51	337	239	219	169
Goods Trade Balance (AR, $bn)	-34.2	-21.2	-22.1	-19.5	-18.3	-17.2	-24.0	-24.3	-17.5	-21.6
Housing Starts (AR, K)	223	210	194	194	192	189	220	205	188	176

years. As a result, we've modestly upgraded our forecasts for consumption and housing, which has raised our overall 2019 GDP projection by a couple of ticks.

But, the greater supply of potential workers, combined with revised estimates of the capital stock, also mean that the economy has a slightly longer runway before inflationary pressures take flight (Chart 1, right). Recent eye-catching inflation readings are nothing more than the transitory effects of higher energy prices and are set to fade in upcoming quarters (Chart 2). As a result, the Bank of Canada won't need to tap on the brakes any more than the two forthcoming hikes we already had in our forecast. Indeed, from current levels even just a modest rise in interest rates will keep the economy in check.

Time to Pay the Piper

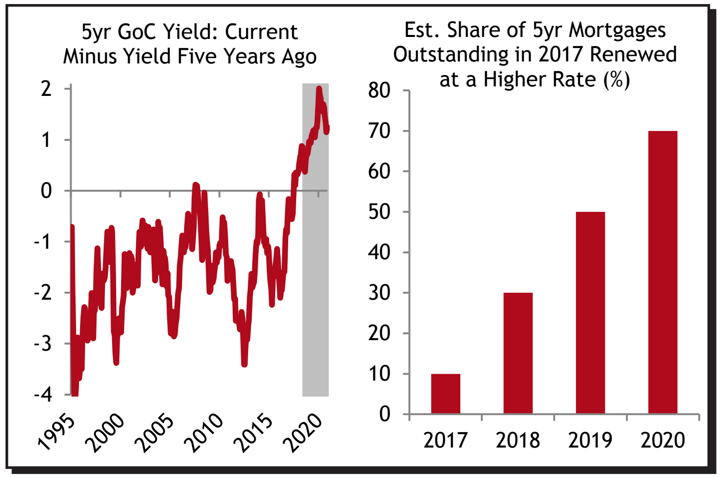
Last year marked the beginning of a new era for Canadian households. For the first time since the early 1990s, interest rates on five-year Government of Canada bonds were higher than they were five years before (Chart 3, left).

With that trend set to continue, we estimate that 70% of households with five-year fixed rate mortgages outstanding at the beginning of last year will have renewed at a higher rate by the end of 2020 (Chart 3, right). Many of those with variable/adjustable or other fixed rate mortgages will similarly be paying more interest on their mortgages by that time.

The sheer magnitude of outstanding mortgage debt means renewals done at higher interest rates will cost

Chart 3

5-yr Yields Now Higher Than Five Years Ago (L), Many Canadians To Feel Pinch by 2020 (R)



Source: Haver Analytics, CIBC

Canadians roughly $8 billion more than they're currently paying, or ½%-pt of disposable income (Chart 4). And that estimate doesn't account for other consumer credit, of which at least some of the $600 billion outstanding will also reset at more expensive levels.

As we've stated before though, that doesn't mean higher interest rates will break consumers' backs. With the unemployment rate expected to hover around 6% over the next couple of years, households in general should be able to service their debt loads. It will, however, leave fewer dollars for discretionary purchases. It also means that Canadian housing, where affordability is already stretched in many places, will become even more costly for many buyers. As a result, both housing and consumption will no longer be able to carry the Canadian economy on their backs come 2020.

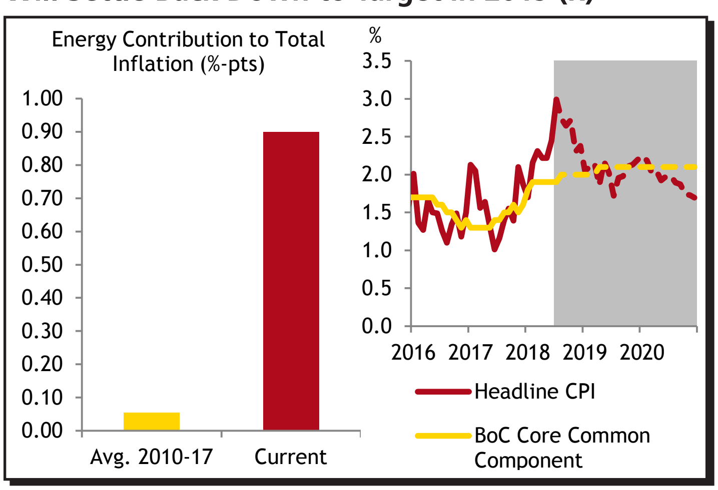
A Slow Rotation

That slowdown is, of course, in part by design. For years now, it's been a goal of policymakers to restrain borrowing, and in the process cool household spending and housing markets. Recent readings on credit growth, debt-to-income ratios and home sales already suggest that the tide has turned. But, the policy twin of that goal, a rotation in demand towards business investment and exports, has yet to materialize on a sustained basis, notwithstanding better export results in Q2.

New headwinds have also cropped up. Even with NAFTA still in place, the US has become much more aggressive in imposing tariffs on Canadian exports, a red flag for capital investments north of the border. Similarly, the

Chart 2

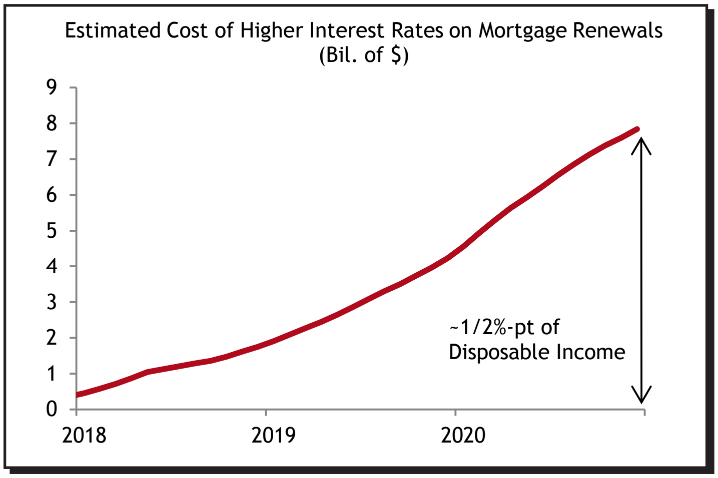
Inflation Overshoot Due to Energy (L), Will Settle Back Down to Target in 2019 (R)



Source: Statistics Canada, CIBC

Chart 4

Mortgages Renewed at Higher Rates to Cost Canadians Roughly $8 bn More



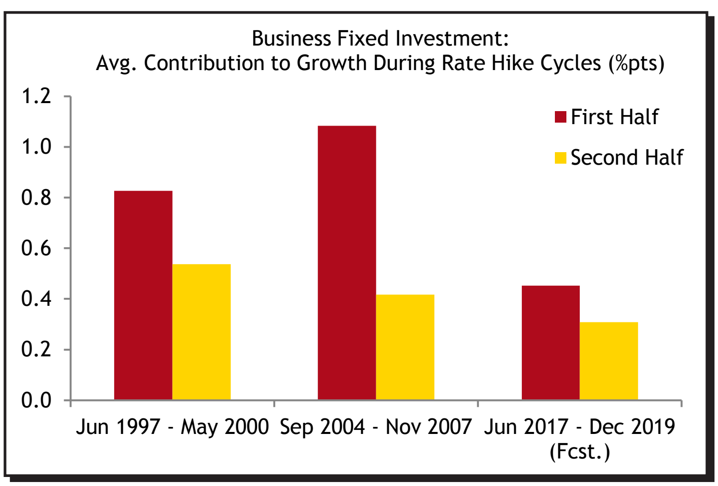
Source: Haver Analytics, CIBC

massive overhaul of the American tax code and regulatory rollbacks on a number of fronts have whittled away at Canada's relative attractiveness as a destination for business investment.

Moreover, past experience shows that growth in capital spending generally slows as rate hiking cycles mature (Chart 5), contrary to the notion that capacity constraints are the dominant factor.

Chart 5

As Rate Hiking Cycles Progress, Capital Spending Growth Slows



Source: Statistics Canada, CIBC

As we've noted before, without healthy business investment, we also can't expect exports to become an engine for economic growth. Last quarter's export surge was nothing more than a flash in the pan, in part due to US buyers front running their own country's tariffs.

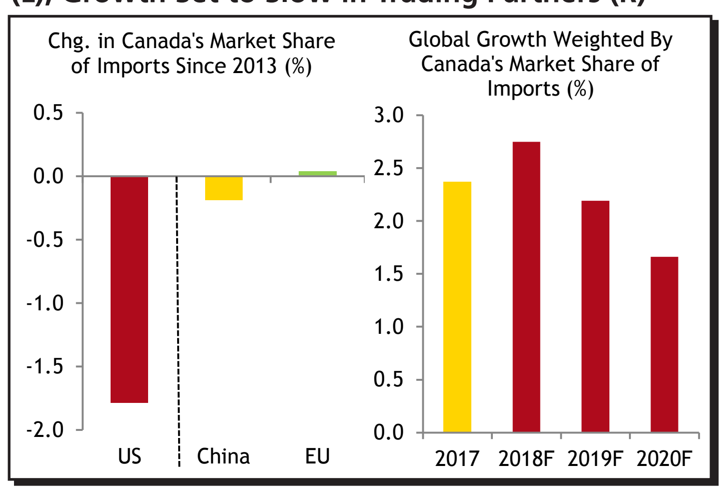
In recent decades, capacity constraints have combined with a poor track record on competitiveness to see Canadian exporters lose market share in the US, without making material ground in other jurisdictions. That's a sad truth that hasn't changed even under the weaker Canadian dollar that has prevailed since 2013 (Chart 6, left).

Even if Canada can somehow stem further market share losses south of the border, or gain ground in other regions, our trading partners are themselves on the precipice of a slowdown in growth (Chart 6, right), reducing the scope for any material uptick in exports. Indeed, the US economy, the destination for three-quarters of Canada's goods exports, is set to see a notable deceleration in the pace of advance (see pages 4-6).

None of that is to say that growth might not look more balanced as we exit this decade, but Canada's export challenges will still limit how much of a monetary tightening the economy can live with. Moderate core inflation, and a central bank that understands the risks inherent in tightening in the face of an indebted household sector, suggest that the Bank of Canada will undershoot consensus forecasts for tightening in 2019.

Chart 6

Exports Lost US Market Share Without Other Gains (L); Growth Set to Slow in Trading Partners (R)



Source: UN, CIBC

The Emerging Global Slowdown

Andrew Grantham

The US aside, most major countries and regions are already starting to see a slowdown in growth following the surprisingly strong 2017. And when the economy stateside slows as well, particularly in 2020 as fiscal stimulus turns into a drag (see pages 4-6), the global pace of expansion could tumble to 2.9%, its slowest since the 2007/8 financial crisis (Table 1).

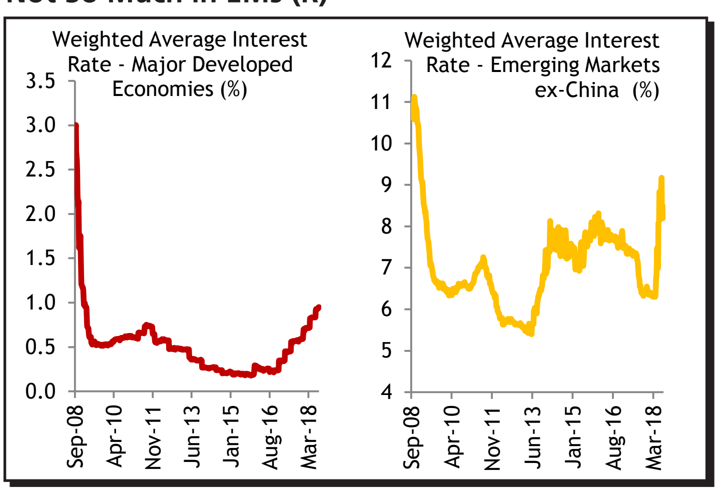
From Emerging to Submerging?

In recent years global growth has increasingly become dependent on emerging markets. Indeed, the ten largest emerging markets have driven more than 50% of growth in the global economy since 2010, with nearly 30% from China alone. That compares with only around one third during the previous cycle, and 17% from China. So the cracks that are starting to be seen in emerging markets should be a concern for investors, not just from an FX viewpoint but also a global growth standpoint.

The efforts made to stem FX depreciations and curb inflation among the most vulnerable emerging markets have their own depressing impact on growth. While interest rates in developed markets are still well below prior-cycle norms (Chart 1, left), recent rate hikes in countries such as Turkey and Argentina mean that, on average, interest rates in emerging markets are much higher than they were a year ago and closer in line with the pre-financial crisis average (Chart 1, right).

Chart 1

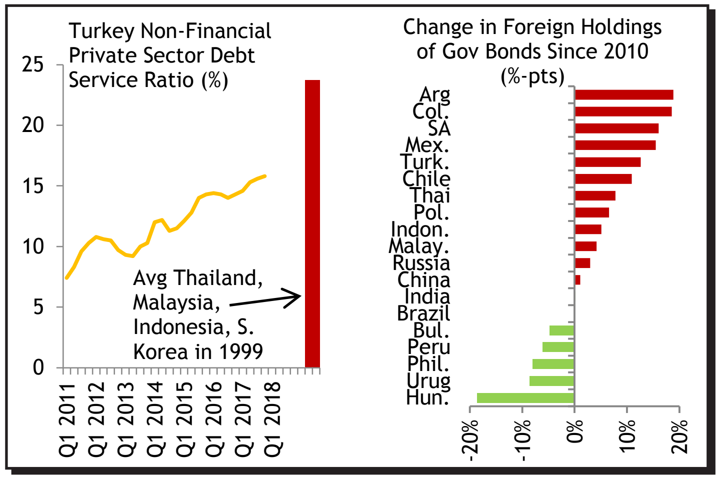
Interest Rates Still Low in DMs (L), Not So Much in EMs (R)



Source: Bloomberg, World Bank, CIBC

Chart 2

Debt Service Costs Rising in Turkey (L), Not all EMs More Reliant on Foreign Investment (R)



Source: BIS, CIBC

That risks slowdowns in consumer spending and business investment as debt service costs rise. In Turkey for example, the private sector debt-service ratio was already on an uptrend, and likely spiked higher in the first half of 2018. Indeed, it could now be converging to levels seen in some countries toward the end of the late 1990's Asian crisis (Chart 2, left).

Of course, not all emerging markets are at risk of a currency crisis. Many have stable governments and some have actually become less reliant on foreign inflows in recent years (Chart 2, right). However, slowdowns could also be seen in emerging market economies even without a currency crisis.

Table 1

Real Global Growth Rates

	5 yrs before recession, avg	2015A	2016A	2017A	2018F	2019F	2020F
World*	4.8	3.5	3.2	3.7	3.4	3.2	2.9
US	2.9	2.9	1.6	2.2	2.8	2.2	1.4
Canada	2.6	1.0	1.4	3.0	2.0	1.8	1.3
Euroland	2.2	1.9	1.8	2.5	2.0	1.5	1.2
UK	3.3	2.3	1.8	1.7	1.3	1.1	1.3
Japan	1.8	1.4	1.0	1.7	1.0	0.9	0.9
China	11.6	6.9	6.7	6.9	6.5	6.2	6.0

** at Purchasing Power Parity*

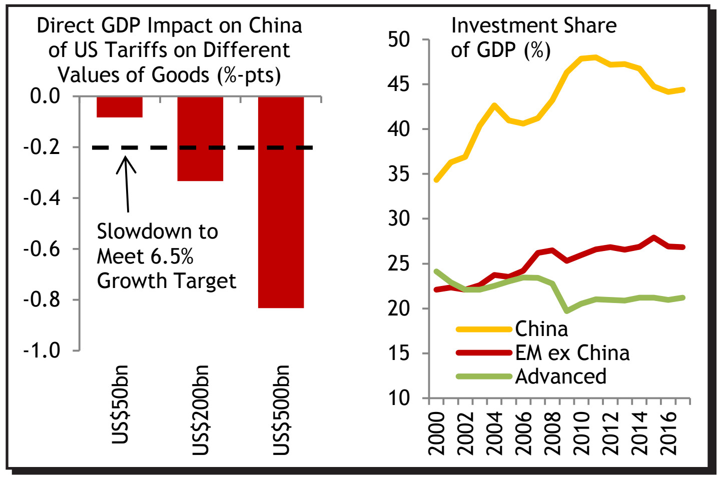
Source: National statistical agencies, IMF, CIBC

Compared to the peak in EM growth around 10 years ago, investment efficiency (ie. the rate of GDP growth compared to investment share) in the space has fallen noticeably. In some countries, such as Indonesia and Colombia, increased investment has been used to maintain previous rates of growth (Chart 3). Meanwhile in others (Russia, China, Turkey and South Africa) GDP growth has slowed even in spite of a higher investment share.

With concerns of over-investment in some countries, and with foreigners less willing to fund such projects, growth will slow in the years ahead. Only in a few cases (Mexico, India, the Philippines) has GDP growth held up even without a higher investment share.

Chart 4

US Tariffs Could Slow China More Than Desired (L), Investment Has Limited Room to Make Up Gap (R)



Source: IMF, CIBC

Fragile China

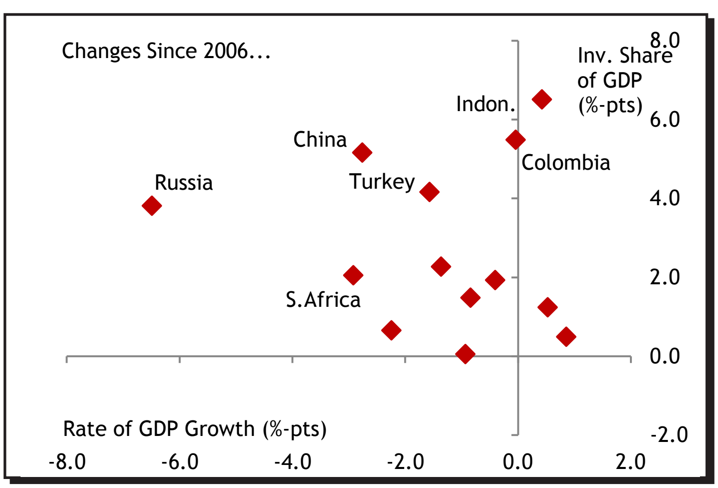
In the case of China, getting less growth from sizeable investments isn't the only reason to expect a deceleration. The continuing trade war with America will also have an impact of growth, even if China isn't quite as dependent on US-destined exports as in the past. Although the initial tariffs applied were small and manageable from a growth perspective, an upcoming further escalation will slow the Chinese economy more than policymakers there are targeting (Chart 4, left).

For a short period of time, authorities could crank up infrastructure spending again to fill the gap. However, even though the growth rate of investments has been slowing in recent years, that area remains a very high proportion of GDP and there will be concerns regarding just how productive new spending will turn out to be in the longer term (Chart 4, right). As such, by late 2019 and certainly 2020, investment spending may be getting dialed down again even if trade relations with the US remain troubled.

Slower growth in emerging markets is key to our global slowdown story. Indeed, relative to the IMF's recent optimistic projections for a further acceleration in such countries, we're about a full percentage point weaker by 2020 (Chart 5, left). However, the spillover effects from emerging markets onto developed economies are still fairly small, particularly compared to what would happen in the reverse case (Chart 5, right). So even though financial markets could feel some pain of an EM slowdown, there are more fundamental reasons why we expect a deceleration in advanced economies as well.

Chart 3

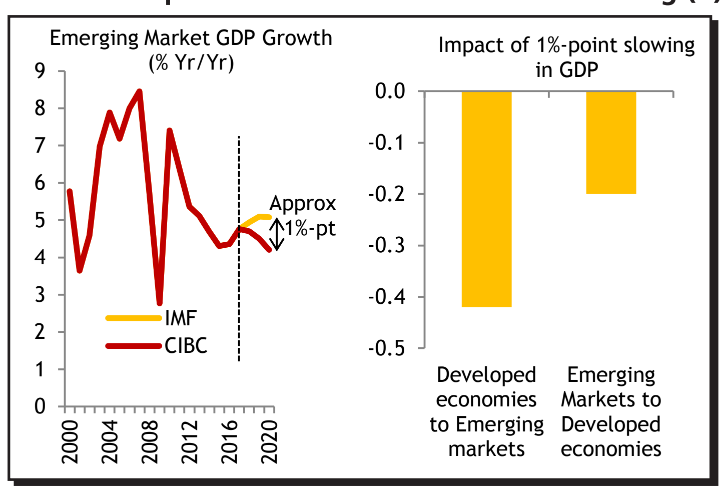
Some EMs Have Been Investing More to Curb Growth Deceleration



Source: IMF, CIBC

Chart 5

EM Growth Could be Well Below IMF Forecasts (L), But GDP Impact on Advanced Economies Not Big (R)



Source: IMF, CIBC

The Potential Problem

With unemployment rates already low or falling, many developed economies are going to see growth limited by demographics. In some areas, demographic headwinds have been countered recently by rising labour force participation rates among older cohorts and/or women. This has been particularly evident in Japan where labour force growth in recent years has vastly outstripped what would have been expected based on working age population growth alone (Chart 6, left).

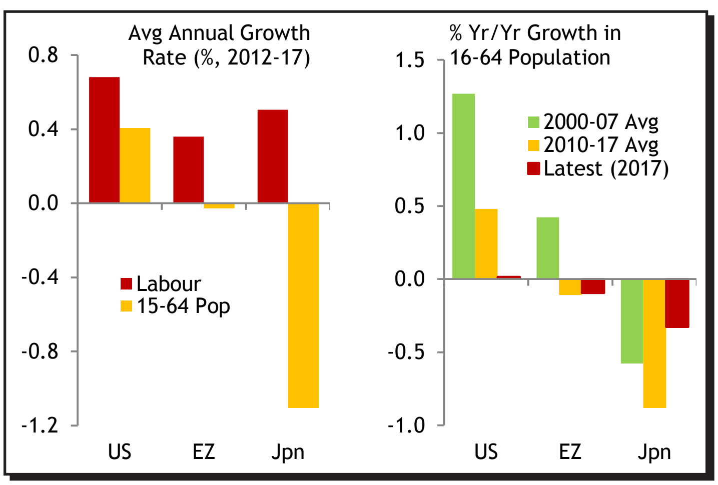
Assuming those trends can't carry on indefinitely, growth rates will start to be capped by the low bar set from working age population growth. Interestingly, though, demographic trends have probably troughed in Japan and aren't expected to get too much worse in Europe. However, the lead the US used to enjoy in terms of working age population growth has pretty much disappeared (Chart 6, right).

An improvement in productivity could help growth going forward, particularly given the fact that in many key areas business investment has finally been a key driver of GDP recently (Chart 7). The main exception is in the UK where, presumably due to uncertainties surrounding Brexit and what the future relationship with Europe will look like, businesses have remained cautious to invest. That's also a key reason why we see the UK economy lagging the Eurozone still in the coming year.

An Emerging Global Slowdown

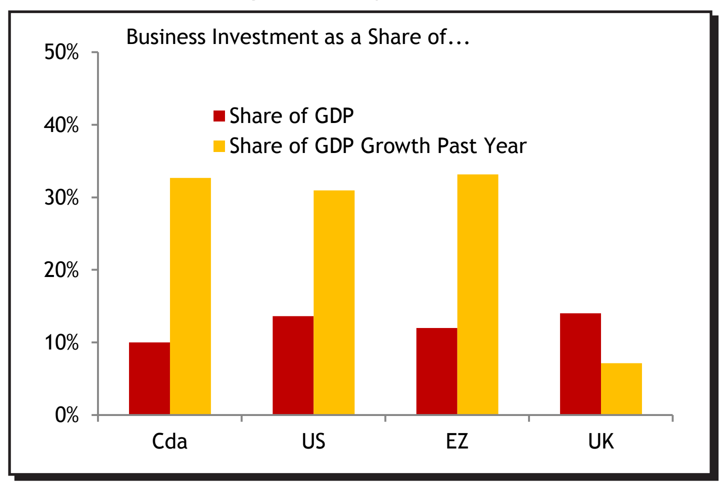
For Europe and Japan, the slower pace to growth in the next two years will reflect the constraints of diminishing labour and product market slack. As a result, that will not stand in the way of an end to ultra-loose monetary policy since inflation could firm somewhat even in the face of a moderate growth pace (see *EZ and Japan: Approaching the End of An Era*, August 2nd). That suggests that overseas major currencies will be winners against the US dollar as the Fed completes its tightening cycle while European and Japanese central bankers are only getting started.

Chart 6
Labour Force Growth Defies Japan Demographics (L), Convergence Seen in Population Growth Recently (R)



Source: OECD, CIBC

Chart 7
Investment Strong Recently Except in UK



Source: IMF, CIBC