The Economy in 2018—What to Expect

Benjamin Tal

Managing Director and Deputy Chief Economist
CIBC World Markets

Benjamin.Tal@cibc.ca

We recently sat down with CIBC Deputy Chief Economist Ben Tal to gather his thoughts about 2018—its challenges and the opportunities. He offers insights on the health of corporate Canada, the NAFTA agreement, interest rates, the loonie and the housing market.

The current economic expansion is 100-months old—the third-longest expansion in the post-war era. Contrary to the previous expansions, this one's not benefiting from a life-prolonging productivity boom. Nobody is talking about a recession any time soon. However, it's reasonable to suggest that we're closer to the next recession than to the previous one.

Corporate Trends

For its part, corporate Canada projects a secure image with no major red flags. At just under 7%, profit margins are consistent with what we saw in the second half of the past two expansions. This time, those margins are helped by a clear downward trajectory in unit labour costs. This is partly reflected in wages that are remaining tame far deeper into the cycle than textbook models predict.

Business investment is finally in positive territory. While the improvement here isn't as broad-based as the Bank of Canada wants you to think, it represents an important milestone in the current expansion trajectory. However, this improvement isn't financed by so-called "dead money" accumulated by Canadian firms over the years. Cash positions—as a share of assets and GDP—continue to break new records. We have argued in the past that money is not really dead, it simply needed to pave corporate Canada's way to the credit market. That's why we don't expect any material softening in cash positions to finance future improvements in capital expenditures.

Healthy profit margins and elevated cash positions indeed allowed corporations to tap the credit market. However, many have elected to avoid the temptation, with business loans outstanding rising by just over 5% in the past year. This is the slowest pace in six years. Consequently, the debt-to-equity ratio today is now lower than the average seen in the mid-to-late stage of previous expansions.

While the overall position of corporate Canada is all right, the cycle is starting to show some signs of fragility. We expect GDP growth in 2017 to average a strong 3%, most of which was achieved in the first half of the year. We expect 2018 growth to average 2.1% due to some softening in consumer demand and the housing sector. That slowing will limit the need to raise interest rates aggressively during the course of 2018.

> ***"While the overall position of corporate Canada is all right, the cycle is starting to show some signs of fragility."***

The NAFTA Dilemma

Then there's NAFTA, which isn't going well. For the first time, Canadian officials—including the prime minister—have expressed real concern about the possibility that the United States will exit NAFTA. We can suggest until we are blue in the face that the Americans will eventually realize that such a move will cost them dearly. However, it's not really about logic. It seems Trump wants out. While it's impossible to predict how things will unfold, we can guess that at least in the near future, it won't be in a positive direction.

> ***"Two-thirds of small-to-medium enterprises in Canada are telling us that the uncertainty regarding NAFTA is affecting their investment decisions."***

Yes, the U.S. Congress has the power to block the president's attempts to kill NAFTA. Keep in mind that under the constitution, congress also delegates power to the president to act unilaterally on a variety of actions. These include tariffs and other means to address national emergencies, as well as balance of payment and national security situations. With this power, Trump can cause a lot of damage. Already two-thirds of small-to-medium enterprises in Canada are telling us that the uncertainty regarding NAFTA is affecting their investment decisions. Also, the ratio among larger firms is most likely higher.

On Interest Rates, the Loonie and the Housing Market

We're looking at a slowing economy, limited inflationary pressure, NAFTA uncertainty and increased sensitivity to higher interest rates (given elevated level of household debt). These factors suggest that the Bank of Canada will likely take a cautious approach and raise rates only twice during 2018. Also, given that this trajectory would be slower than we might see south of the border, look for the loonie to lose some ground in the new year.

What about the closely watched housing market? There are a few lessons to be learned from recent developments in that space. First, markets are capable of responding swiftly to abnormal market conditions. Second, housing policy can notably impact the movement of the real estate market. Finally, if those policies aren't directed at the core issues facing the market, their impact will be temporary at best.

We're in the midst of an important transition period in the trajectory of the Canadian housing market in general, and Vancouver and Toronto in particular. The level of activity is likely to stabilize and perhaps soften in the coming quarters as markets adjust to recent and upcoming regulatory changes. However, when the fog clears it'll become evident that the long-term direction of the market will show even tighter conditions. The supply issues facing centres such as Toronto and Vancouver will worsen and demand is routinely understated. Short of a significant change in housing policies and preferences, there is nothing in the pipeline to alleviate the pressure.

"We're in the midst of an important transition period in the trajectory of the Canadian housing market in general, and Vancouver and Toronto in particular."

Additional Insights from Ben Tal

- **Watch video: 2018 Economic Outlook**
- **Watch video: The Housing Market: When the Fog Clears**

It's important to consider how economic and market trends can affect your investment portfolio and we can help you with that. ***If you have any questions about these insights, please give us a call.***

CIBC PRIVATE WEALTH MANAGEMENT

CIBC WOOD GUNDY
ONE-TO-ONE INSIGHTS
JANUARY 2018

BITCOIN: REAL CURRENCY OR SPECULATIVE INVESTMENT?

By Luc de la Durantaye, Managing Director, Asset Allocation and Currency Management, CIBC Asset Management

Bitcoin: A type of digital currency in which encryption techniques are used to regulate the generation of units of currency and verify the transfer of funds, operating independently of a central bank.[1]

Bitcoin is a cryptocurrency that uses a blockchain to record and verify transactions. Think of a blockchain as a database or a digital accounting ledger. The Bitcoin software was released in early 2009 by a mysterious creator who went by the name of Satoshi Nakamoto.

A blockchain is decentralized and works on a peer-to-peer framework, without central control or government authority. Once a transaction is recorded, it's almost impossible to retroactively delete or change it.

Let's put aside for the moment many of the practical questions that come up when Bitcoin is discussed such as:

Where do new Bitcoins come from?
Where do I buy Bitcoin?
Can I lose Bitcoin or have it stolen?
Can Bitcoin be counterfeited?
What can I buy with Bitcoin?

This is a complicated but topical subject. As currency managers, here are some of our initial thoughts on Bitcoin.

Is Bitcoin Here to Stay?

When assessing Bitcoin's potential as a currency, it's useful to remember some of the traditional roles that currencies play:

1) Store of Value: Bitcoin has a very short history. This makes it difficult to assess the soundness of its architecture or its ability to act as a store of value in the longer term—it hasn't really been tested. Although it has gained a lot of ground since inception and soared in the past few months, Bitcoin remains full of risks.

Theoretically, anyone could launch a cryptocurrency or new technology that competes with Bitcoin and has the potential to make Bitcoin and/or blockchain obsolete. Other cryptocurrencies already exist (Ether, Monero, Bitcoin cash). However, Bitcoin remains the most popular choice for the moment. Sovereign states might try to prohibit the use of cryptocurrencies as a way to maintain their own monopoly on issuing fiat currencies* and their privilege of seigniorage and the benefits that entails.

2) Means of Exchange: Bitcoin isn't really being used as a means of exchange at this time. Unlike major currencies, the value of Bitcoin is extremely volatile (and therefore highly unpredictable). This makes it very risky to use as a store of value for the future purchase of goods and services. Although Bitcoin had an impressive rally in 2017, it also saw multiple 30%+ corrections. Bitcoin is so volatile that Fortune magazine recently published an article entitled "5 Big Bitcoin Crashes: What We Learned." All five Bitcoin crashes discussed in the article have occurred since 2013!

Until it's more stable and its use is more convenient and widespread, Bitcoin won't be seen as a reliable means of exchange. However, we have witnessed other disruptive technologies that have rapidly changed the landscape once they reach "critical mass" (e.g. the use of Uber as opposed to taking a taxi, streaming or downloading music versus the purchase of CDs).

3) Monetary Policy Instrument: Bitcoin isn't issued by a government. It has no inflation or trade balance data or any other economic fundamentals associated with it on which to base a currency valuation. It's difficult for anyone (including ourselves) to calculate a fair value and determine if the currency is cheap or expensive. Bitcoin holders do not receive interest payments and that makes it more expensive to hold relative to many currencies that do pay an interest rate. The difficulty in establishing a fair value for Bitcoin increases its pricing uncertainty and has led to the large price volatility observed since its creation.

Because of its distinctiveness when compared to traditional currencies, Bitcoin doesn't lend itself well to our investment process, which is fundamentally driven. However, the recent introduction by the Chicago Mercantile Exchange of a Bitcoin futures contract might help it gain more acceptance in the financial community. With a futures contract, banks can "bet" on the price of Bitcoin without holding the underlying Bitcoins. This may bring new or different players into the market who don't want to deal with the complications of holding Bitcoins. But the futures contract will also allow investors to short Bitcoin (bet on the price going down); previously this was difficult to do. Some analysts think this could finally put downward pressure on the price.

The biggest shortfall we can see with Bitcoin (or any of the other cryptocurrencies) is the lack of a large stable "guarantor." Major fiat currencies, such as the U.S. or Canadian dollar, have a government behind them to back their use as the sole means of exchange for that country. Cryptocurrencies lack a major proponent that can be relied upon to sustain and expand their use as a means of exchange.

Our Current Opinion

As currency managers, we're staying on the sidelines for the moment, but will continue to assess the developments in the cryptocurrency world. At this point, Bitcoin seems to be more a speculative phenomenon than a real currency opportunity. However, we're keeping an open mind. Disruptive forces continue to manifest in global politics, business, media and society as a whole. One year ago, the U.S. election proved that "the impossible" can happen. These are interesting times.

[1] https://en.oxforddictionaries.com/definition/bitcoin

** Fiat money is currency that a government has declared to be legal tender, but is not backed by a physical commodity. Examples of fiat currencies are the Canadian and U.S. dollars, euro, Japanese yen.*