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CIBC

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Parting Company

by Avery Shenfeld

Global this, global that. While the world's economies are no doubt hitched to the same wagon, forecasters can overstate the degree to which related economies, or financial instruments, move together. Almost nothing has a 100% correlation, and divergences in the data are more common than you think.

We see a number of ways in which, amidst a global slowdown that leaves no country completely unaffected, there will still be some parting of the ways. Many of the largest economies in Europe, including Germany and the UK, look recession bound. But as recently as 2012, the Eurozone went through a recession without infecting North America.

This time, China, by Chinese standards, is in a slump as well. But President Trump's offer to aim at a partial "Phase I" trade deal, presumably with some tariff relief, provides some light at the end of that tunnel.

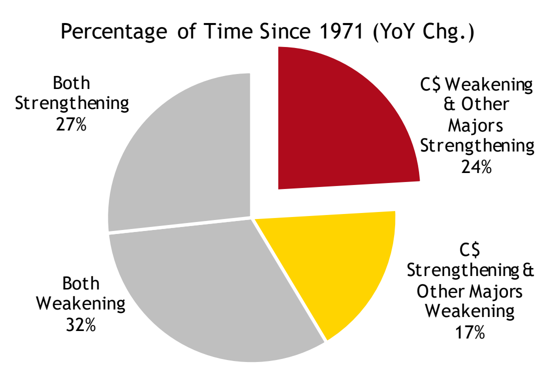
Canada and the US have parted company to this point on interest rates, with the Fed easing while the Bank of Canada stands pat. But we've had such out of phase periods often. The Bank of Canada tightened on its own in 2010, and then eased on its own in 2015. The Fed could now be on hold for the coming year, having brought rates to more stimulative levels, but Canada's central bank might not be as quiet.

If, as we expect, Governor Poloz delivers a lone quarter point cut in early 2020, that will be as much aimed at steering the currency off an appreciating course. It might not look that strong against the US dollar alone, but our analysis shows that its overall strength against its competitors in the American market and abroad has been sufficient to see the country continue to bleed market share (see pages 3-5).

A rate cut in a crowded field of rate cuts might not do much in foreign exchange markets, but adverse trade balances can also bring about an overdue softening in the loonie. At the same time, diminished safe-haven flows if trade tensions ease could see other majors in the DXY index regaining lost ground against the US dollar next year.

Forecasts often rely on the idea that the Canadian dollar and other majors rise and fall as a pack against the US dollar, but nearly half the time, the Canadian dollar charts its own course (Chart). Look for it to part company from the euro, sterling and other majors in 2020.

C$ and Other Majors* vs. USD



DXY Components Ex-Canada

MARKET CALL

- We haven't had to do any major surgery to our interest rate outlooks, as the economic backdrop looks about where it did a month or two ago. The Bank of Canada isn't blind to the risks that the global slowdown will prompt an undue slowing in Canada, but after two strong job gains with on-target inflation, we're sticking with January as the most likely date for a quarter point easing from the BoC. We'll need some softer jobs and growth data to convince the central bank that an insurance easing is warranted.

- The bond market remains priced a bit too aggressively for Fed cuts ahead if, as we expect, October's move represented the final one in this mid-cycle easing. While Q4 growth will look softer, that would actually be the first quarter of below potential growth in the US, and one that the Fed anticipated in its three rate cuts to date. The lagged impacts of that easing, and some progress on a partial trade deal by early 2020, would cement the case for the Fed to remain on hold through 2020, with bond yields moving higher on that disappointment versus market expectations for a further ease.

- The US dollar could be the monkey in the middle next year, gaining ground on the Canadian dollar (which didn't participate in the weakness seen in European majors), but slipping against many other DXY components. These developments will be responding to trade flows and the reversal of earlier safe-haven flights to the USD rather that rate differentials.

INTEREST & FOREIGN EXCHANGE RATES

		2019		2020				2021	
END OF PERIOD:		**30-Oct**	**Dec**	**Mar**	**Jun**	**Sep**	**Dec**	**Jun**	**Dec**
CDA	Overnight target rate	1.75	1.75	1.50	1.50	1.50	1.50	1.50	1.75
	98-Day Treasury Bills	1.66	1.65	1.35	1.35	1.35	1.40	1.45	1.75
	2-Year Gov't Bond	1.58	1.45	1.35	1.60	1.60	1.75	1.95	2.00
	10-Year Gov't Bond	1.49	1.30	1.25	1.45	1.65	1.75	1.95	2.05
	30-Year Gov't Bond	1.66	1.55	1.50	1.65	1.80	1.95	2.00	2.10
U.S.	Federal Funds Rate	1.625	1.625	1.625	1.625	1.625	1.625	1.625	2.125
	91-Day Treasury Bills	1.59	1.55	1.55	1.60	1.65	1.70	1.90	2.25
	2-Year Gov't Note	1.63	1.50	1.60	1.65	1.80	2.00	2.10	2.50
	10-Year Gov't Note	1.80	1.70	1.75	2.00	2.10	2.20	2.30	2.50
	30-Year Gov't Bond	2.28	2.15	2.30	2.35	2.45	2.60	2.70	2.70
Canada - US T-Bill Spread		0.06	0.10	-0.20	-0.25	-0.30	-0.30	-0.45	-0.50
Canada - US 10-Year Bond Spread		-0.31	-0.40	-0.50	-0.55	-0.45	-0.45	-0.35	-0.45
Canada Yield Curve (10-Year — 2-Year)		-0.09	-0.15	-0.10	-0.15	0.05	0.00	0.00	0.05
US Yield Curve (10-Year — 2-Year)		0.17	0.20	0.15	0.35	0.30	0.20	0.20	0.00
EXCHANGE RATES	CADUSD	0.76	0.76	0.75	0.75	0.74	0.72	0.71	0.71
	USDCAD	1.32	1.31	1.33	1.34	1.36	1.38	1.40	1.41
	USDJPY	109	105	104	103	101	100	100	99
	EURUSD	1.11	1.10	1.12	1.14	1.15	1.16	1.17	1.18
	GBPUSD	1.29	1.23	1.28	1.31	1.34	1.36	1.38	1.40
	AUDUSD	0.69	0.69	0.71	0.72	0.74	0.76	0.78	0.75
	USDCHF	0.99	0.99	0.97	0.96	0.97	0.96	0.96	0.96
	USDBRL	4.02	3.80	3.90	3.95	3.90	4.00	3.90	3.85
	USDMXN	19.2	19.9	20.1	20.4	20.6	20.4	19.8	19.7

Canadian Dollar: Too Strong for its Own Goods

by Avery Shenfeld, Royce Mendes and Katherine Judge

The Canadian dollar might look cheap to those with memories of parity, but for exporters, it's not cheap at all. That's been evident in the country's lackluster trade performance, and digging into the details of sluggish exports, part of the story is that we need to pay more attention to the loonie's value against currencies other than the US dollar.

On that score, a too-strong Canadian dollar is playing into a weakening US market share for products bearing the maple leaf emblem. That sets the stage for the Bank of Canada to trim interest rates early next year to prevent a further Canadian dollar appreciation, and for the Canadian dollar to weaken next year even as other majors regain some of what they've lost against the greenback.

Not as Weak as it Looks

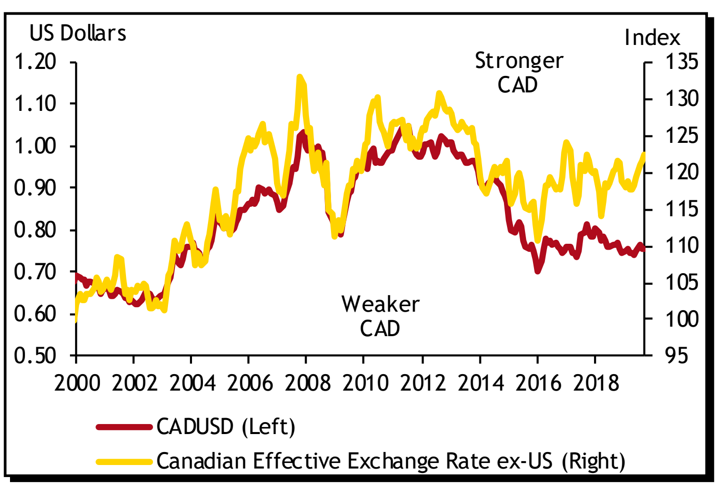
Sure, the Canadian dollar isn't anywhere near its glory days of late 2007, when nominal exports were boosted by peak oil prices, and is well off its run near parity when the Bank of Canada pushed rates up in 2010 while the Fed had years of easing ahead. Note, however, that its trade weighted value against non-US dollar majors, while off its peaks, has appreciated in the last few years (Chart 1), and is in the upper third of its trading range since 2000.

That matters because Canada competes for market share in the US with a host of other countries. From Mexican, European and Japanese car plants, to Scandinavian paper mills, to Brazilian aircraft factories, Canada in some cases faces tough competition from others vying for import share, rather than just from American suppliers.

Moreover, an increasing slice of Canada's exports to the US are actually competing for share in markets in third countries. More than 12% of Canada's exports are in the form of supplies to US industries that then export the finished product elsewhere, up from roughly 8% in 2005 (Chart 2). Remember that those US producers are facing an uphill battle in external markets owing to the elevated level of the American dollar. That has implications for Canadian plants selling steel to Midwest vehicle makers, or components for American machinery.

Chart 1

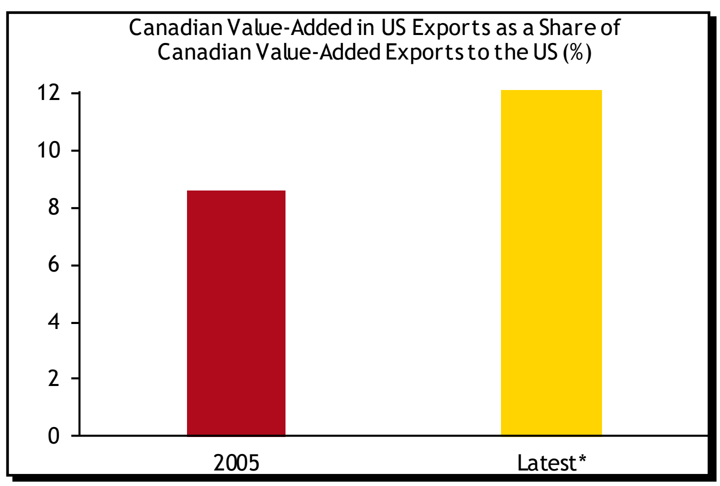
Canadian Dollar Not That Cheap Against Non-US Competitors



Source: Haver Analytics, CIBC

Chart 2

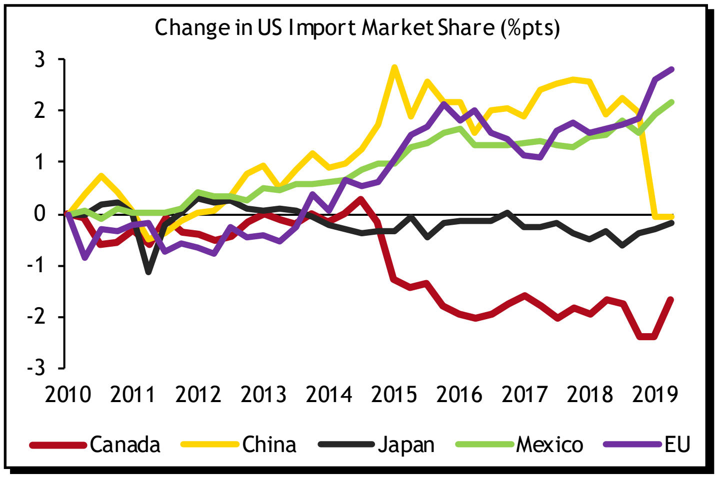
Canadian Exports to US Increasingly Bundled Into US Exports



Source: OECD, CIBC

Chart 3

Canada Has Lost Share of US Imports



Source: Haver Analytics, CIBC

That's not just or even largely an energy story. Sure, oil doesn't fetch what it used to in nominal terms, and America's own production is eating into its import needs. But Canadian oil volumes crossing into the US have grown at the same rate since 2010 as in the prior decade (Chart 4), with the squeeze being felt by other suppliers.

But while Canada's share of US oil imports has therefore climbed by 12% since 2000, in just about every other key sector it has suffered from a trend deterioration in its role in America's imports (Chart 5). In autos, other capital goods and food products, Mexico has been the big winner. The EU has picked up share in non-auto consumer goods, while China has been the big winner in non-energy industrial goods.

Mexico's win has been aided and abetted by its currency's move against the others. Since 2010, It has depreciated by more than 20% against the currencies of other countries it competes with in the US, weighted by their share of US imports (Chart 6). The pound has been the other slider, while at the other end, the yen has soared against the currencies of others targeting the US market.

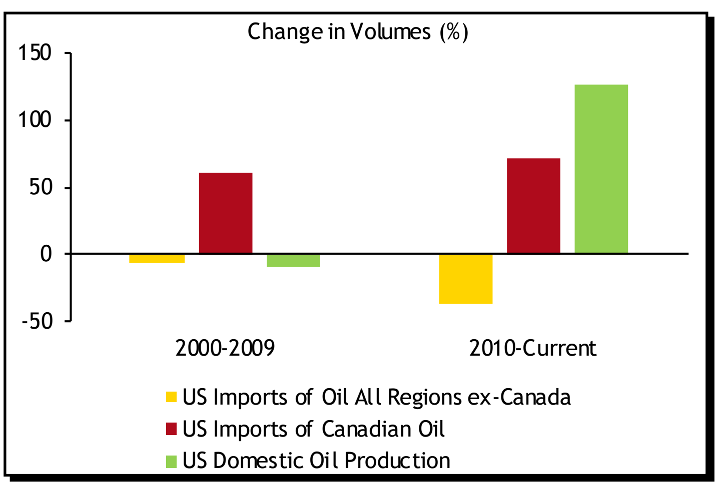
Shedding Share

Where should the loonie be? At least based on trade fundamentals, it still looks too strong for the country's own goods. Canada's share of US imports tumbled sharply after 2014 (Chart 3). While, as we shall see, that largely reflected a plunge in oil prices, the Bank of Canada would have hoped that the invisible hand of markets would have taken the Canadian dollar weaker so as to create an offsetting lift to other exports. Instead, Canada's US market share has simply continued to slip.

Note that the Canadian dollar has been largely unchanged against the pack of exporters to the US since 2010. But remember that those 2010 levels had been lifted by surging oil prices, taking the currency to overvalued levels in terms of Canada's competitiveness in non-oil trade. The failure of the currency to give up ground now that oil fetches levels below half of its previous peaks has left

Chart 4

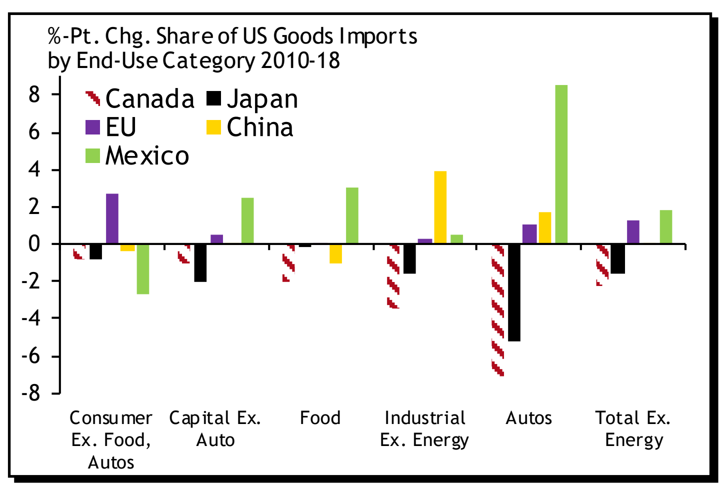
Canada Has Gained Share in US Oil Imports...



Source: EIA, CIBC

Chart 5

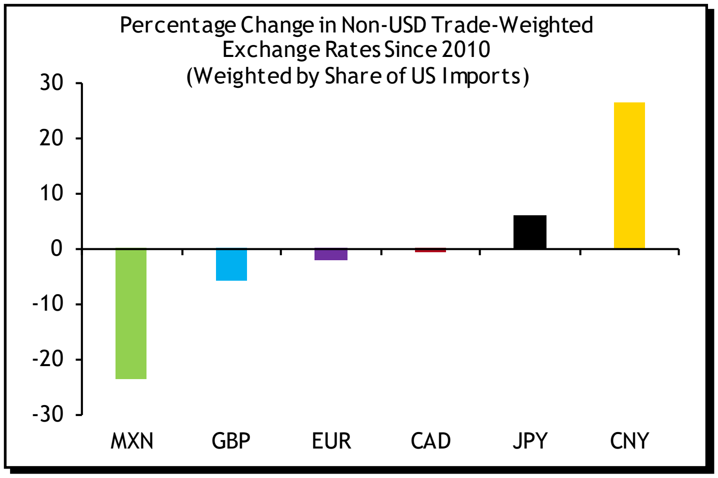
...But Lost Share Everywhere Else



Source: BEA, CIBC

Chart 6

C$ Has Not Weakened Against Other Competitors Despite Much Lower Oil Price Environment



Source: Haver Analytics, CIBC

exporters of other products with the legacy of a Dutch disease exchange rate. To reduce the steady flow of red ink in trade, Canada either needs a stunning reversal of its competitiveness, or more likely, a weaker exchange rate against its US and overseas competitors.

Monetary Policy and FX Implications

Canada's export woes were tolerable during a period in which the country drove towards full employment on the back of housing construction and credit-fueled consumer spending. But not forever. As the Bank of Canada looks to steer the economy along that full employment path, it will likely need to deliver a token rate cut early in 2020 to signal to markets that it's prepared to do what it takes to prevent an even stronger loonie ahead. It's going to need that to get more juice out of exports and related capital spending, as it often forecasts.

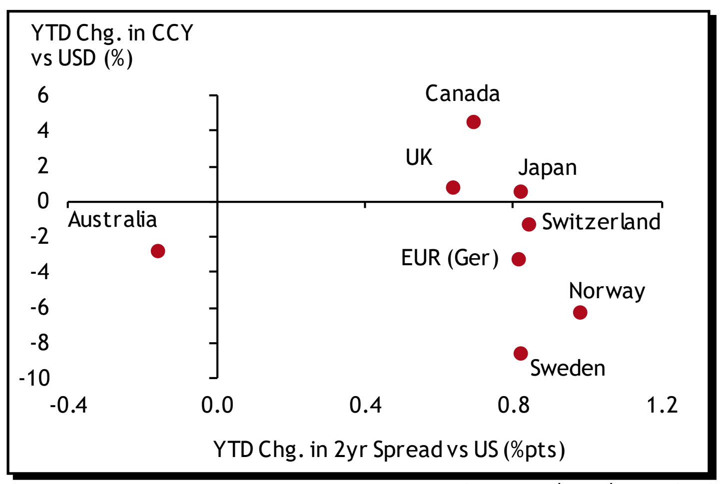
Longer term, trade balances do matter for exchange rates, not just capital flows tied to interest differentials. Indeed, changes in 2-yr rate differentials have not been at all decisive in steering currency trends this year (Chart 7). A trade and current account deficit can only be covered if foreigners constantly add to Canadian dollar holdings at a given exchange rate. We've identified that in contrast to the view that the loonie is "cheap", it's anything but in terms of its impacts on exports, just as the US dollar is in turn overvalued against some of its overseas competitors like the pound and the euro.

That underscores our call that the Canadian dollar and other majors could begin to part company next year in terms of their direction against the greenback, with dollar-Canada headed for 1.38 even as the euro and pound, for example, recoup some of their recent declines (see Table 1, page 2).

There have been periods of such divergences in the past, and the fact that the Canadian dollar has held firm on an ex-US-dollar trade-weighted basis points to such a corrective move ahead. We'll need it for the good of our goods sector.

Chart 7

No Correlation Between Moves in Rate Spreads and Exchange Rates vs. US Dollar This Year



Source: Bloomberg, CIBC

US Wage Deceleration: A Trick of the Data

by Andrew Grantham

Something spooky has been happening in US wage data recently, with earnings growth apparently decelerating despite the continued reduction of slack in the economy. However, this trend is nothing to be frightened about, and instead just appears to be a trick of the data. As such, we could be in store for either a couple of stronger monthly wage readings, or potentially an upward revision to previously released data, particularly after the likely impact of the auto strike in this week's data fades.

Not an Old Problem

US wage growth finally started to accelerate a couple of years ago, moving out of the 2-2½% range to almost touch 3½% in February. And while employment gains have slowed recently, they have remained on average above the pace of labour force growth. Yet, despite this continued reduction in labour market slack (Chart 1,left), the annual pace of wage growth eased below 3% last month (Chart 1, right).

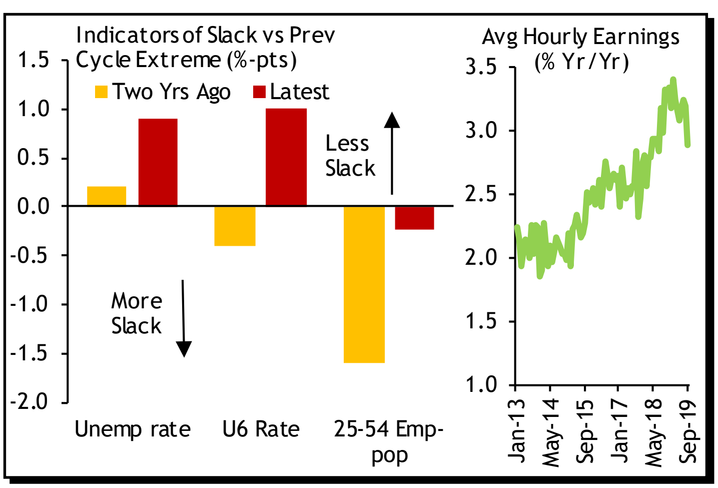
This apparent slowing in wages can't be explained by demographic influences, which we argued a couple of years ago could be reducing the aggregate wage numbers by 0.5%-pts (See Economic Insights, Nov'17). The negative impact of retirees (when high wage earners are replaced by younger, cheaper, workers) has increased only marginally recently (Chart 2, left). Meanwhile, the second aspect, that of low wage growth in the higher age brackets, seems to have improved relative to where it stood a couple of years ago (Chart 2, right).

A Statistical Quirk

Instead, the apparent slowing in wages appears to be the result of statistical quirks. Firstly, if we were using the same headline series we were 10 years ago, we wouldn't even be writing about slower wage growth. That's because wages of production and non-supervisory staff, the series that was used as the headline earnings number before 2007, hasn't shown the same deceleration in wage growth (Chart 3, left). Indeed, wage growth on that measure has held near 3½%, meaning that the gap between the two measures is now the widest since the recession (Chart 3, right).

Chart 1

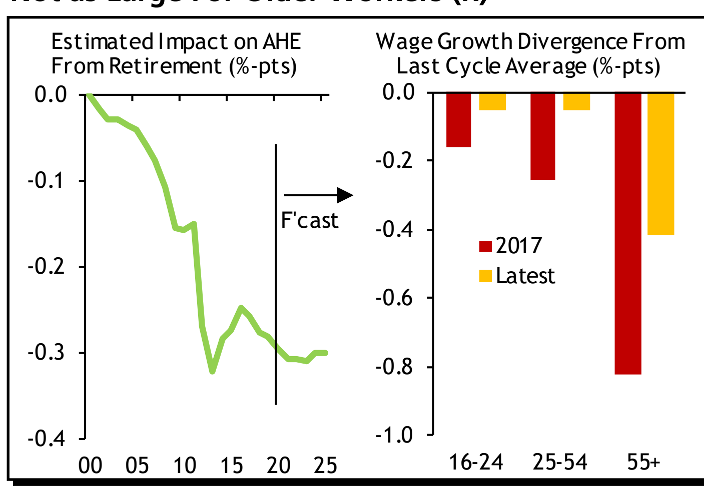
Less Slack (L), But Deceleration in Wage Growth (R)



Source: BLS, CIBC

Chart 2

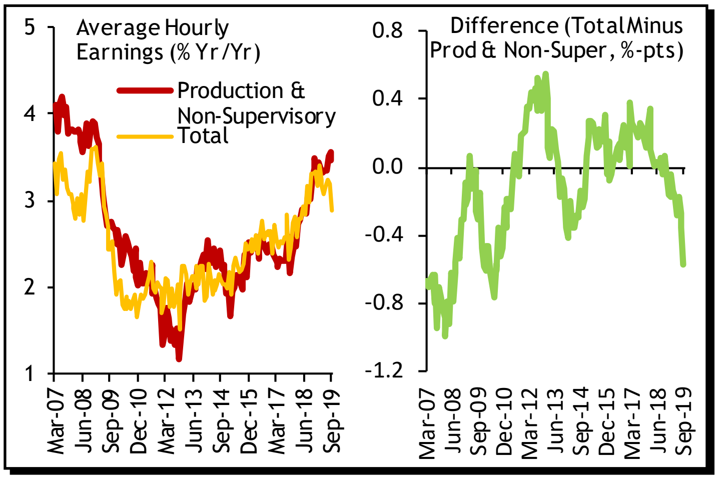
Retiree Impact No Worse (L); Wage Growth Gap Not as Large For Older Workers (R)



Source: BLS, Atlanta Fed, CIBC

Chart 3

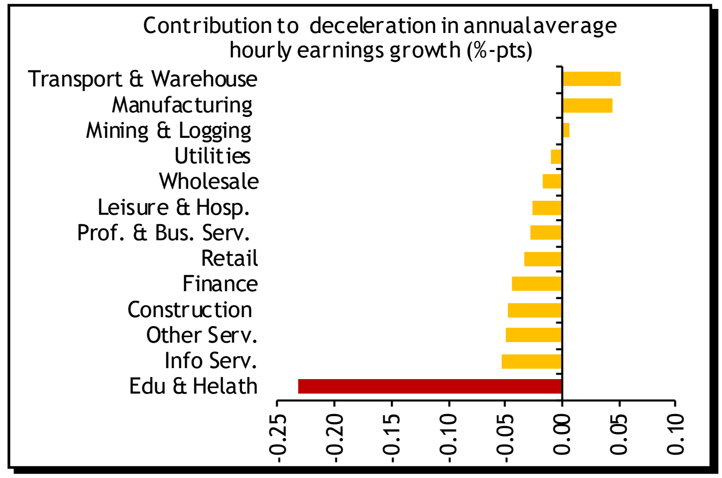
Wage Growth Slowing? Depends on Series Used



Source: BLS, CIBC

Chart 5

Yet Edu. & Health Accounts for More Than Half of Headline Wage Slowdown



Source: BLS, CIBC

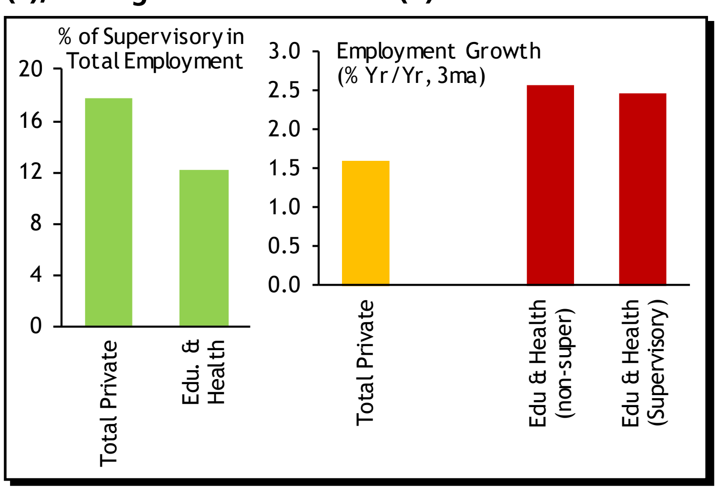
What's more, much of this divergence can be attributed to one sector – education and heath care. Even though the proportion of supervisory staff in this area is lower than the economy-wide average (Chart 4, left), and employment growth of both supervisory and non-supervisory staff in the sector is above the private sector average (Chart 4, right), this area has accounted for around half of the apparent slowdown in headline earnings (Chart 5). To account for the difference between total and just non-supervisory wage growth in the education and health sector, supervisory wages must be down by more than 7% year-over-year.

The good news for policymakers is that wage growth in the education and health sector has had a lower correlation with the output gap than other sectors, particularly recently (Chart 6). Meanwhile, wage growth as a whole has displayed a lower correlation with targeted PCE inflation than in previous cycles.

As such, even if it doesn't bounce back again as we expect, the somewhat slower wage growth shouldn't translate into below-target inflation. However, if the slowdown in aggregate wage growth does prove to be a statistical quirk, a rebound in wage growth will give monetary policymakers another reason to halt their recent easing cycle.

Chart 4

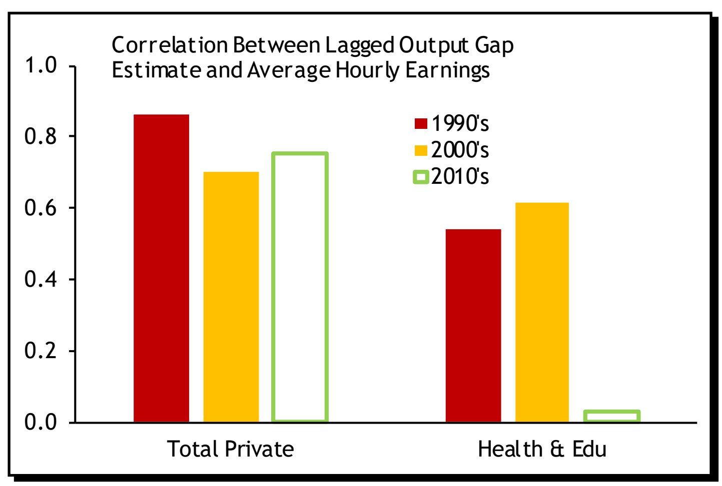
Education and Health Has Low Supervisory Work (L), Strong Recent Job Gains (R)



Source: BLS, CIBC

Chart 6

Health & Education Wage Growth Isn't Following Economic Slack



Source: BLS, CIBC

Canada's Income Problem

by Benjamin Tal

Real disposable income per capita in Canada is currently C$13,000 higher than it was in 1980. In the US, it is US$25,000 higher. What's behind that gap? The answer is complex, but a precondition for any policy initiative aimed at tackling this issue is a clear understanding of the trajectory of the main components that are contributing to this trend. That's what we're trying to do here.

A Brief History of the Gap

Over the past four decades, average real annual disposable income per capita in Canada has risen by 1.3%, notably slower than the 1.9% growth seen south of the border (Chart 1, left). On a cumulative basis, that measure in the US rose 40% faster than in Canada (Chart 1, right).

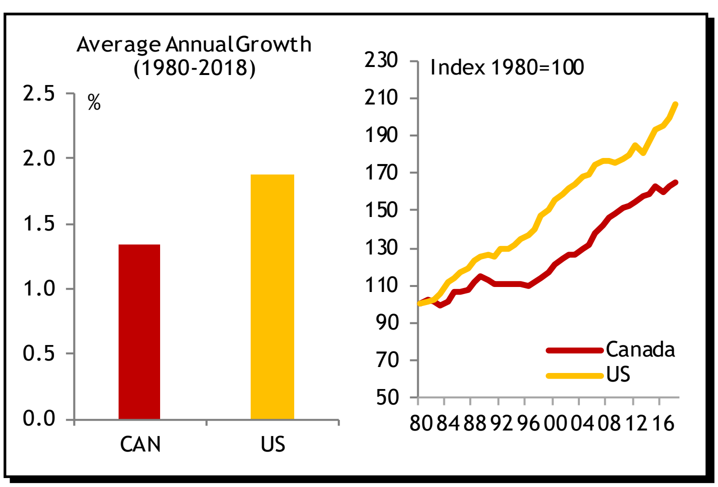
Now, four decades is a long time, and in order to fully appreciate the nature of that gap, we need to examine its trajectory over time. As illustrated in Chart 2, every decade has its own story. The 1980s and its double dip recession saw US income growth outpace Canada's by close to 0.7% per year. But the real break away occurred in the 1990s, as the jobless recovery in Canada resulted in a dramatic widening in the gap, with the US outpacing Canada by an inflation-adjusted 1.5% per year during that decade. The 2000s started with relative stability in the gap, with income in both countries rising roughly at the same rate. But by the latter half of the decade, Canada started to make its move, and the gap began to narrow. That trend was helped tremendously by the impact of the Great Recession on income growth in the US (and the fact that Canada was only a second-hand smoker here). But by 2010, as the US labour market started to recover, Canada's outperformance came to an end.

From this, we learn that over the past four decades, income growth in Canada was able to outpace growth in the US, on a sustainable basis, only 15% of the time—and even that outperformance was helped notably by the fact that the US went through its worst recession since the Great Depression. We also can say that the US's recovery since 2010, which saw the US-Canada income gap widen by 8%, almost completely erased Canada's gains made since the latter part of the 2000s. This means that the gap generated in the 1980s and further in the 1990s remains intact.

This, of course, has important implications. For example, if it were not for that underperformance, Canada's highly watched household debt to income ratio would have

Chart 1

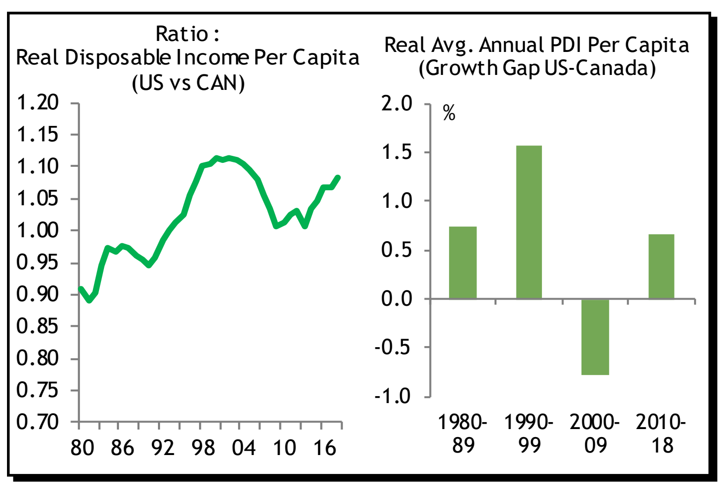
Real Personal Disposable Income Per Capita



Source: Statistics Canada, BEA, Census Bureau, CIBC

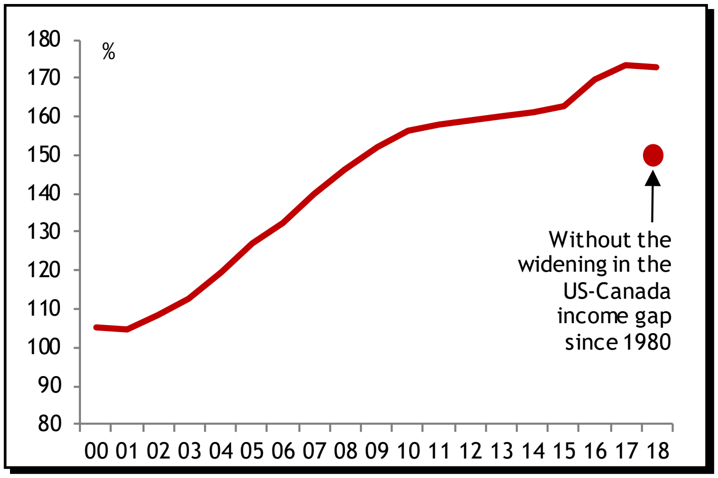
Chart 2

The Gap Over Time



Source: Statistics Canada, BEA, Census Bureau, CIBC

Chart 3
Household Debt-To-Income Ratio: Canada



Source: Statistics Canada, CIBC

been 150%, as opposed to the current reading of over 170% (Chart 3).

Any attempt to try to fully understand the factors behind that underperformance must start with accounting for the sources of that gap. Is it about job creation? Wage growth? Taxes? Investment income? Let's take a look.

The Demographic Factor

Our measure is real per capita disposable income. Let's focus first on the "per capita" part. As illustrated in Chart 4, since 1980, population growth in Canada has outpaced growth in the US, with most of that outperformance occurring in the past decade. That faster population growth accounted for 15% of the widening in the income gap since the 1980s, and no less than half of the widening in the gap since 2010. But that, of course, is not really a good excuse. With that extra population growth, we should have seen proportionally extra income growth, and that obviously is not happening.

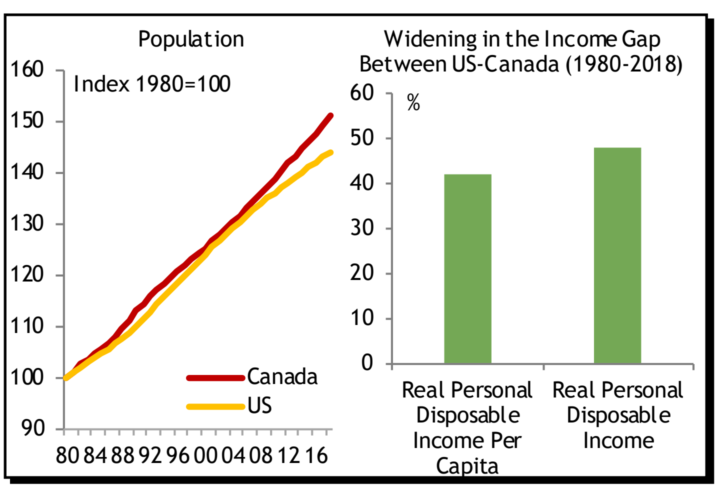
Taxes?

Next, we focus on the "disposable" part. To what extent did taxes and other transfers to governments account for the rising income gap? For obvious reasons, that component in Canada is much larger, accounting for more than 30% of gross income vs 10% in the US. As illustrated in Chart 5, growth in gross income in the US rose roughly at the same rate as net income. At the same time, in Canada, net income rose more slowly. We estimate that the impact of faster rising taxes and other transfers to governments (such as CPP) in Canada have accounted for close to one-quarter of the widening in the gap since 1980[1].

Keeping that in mind, we now turn our attention to the relative performance of gross income, and its components.

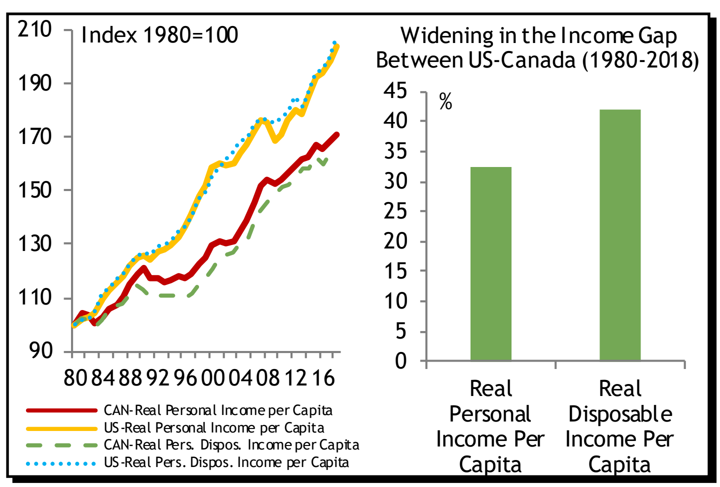
As illustrated in Chart 6, income growth in the US has outperformed income growth in Canada in each and every category. The most important factor here is obviously the performance of labour income, which in both countries, accounts for about 60% of total personal income.

Chart 4
Population Growth in Canada—Faster



Source: Statistics Canada, BEA, Census Bureau, CIBC

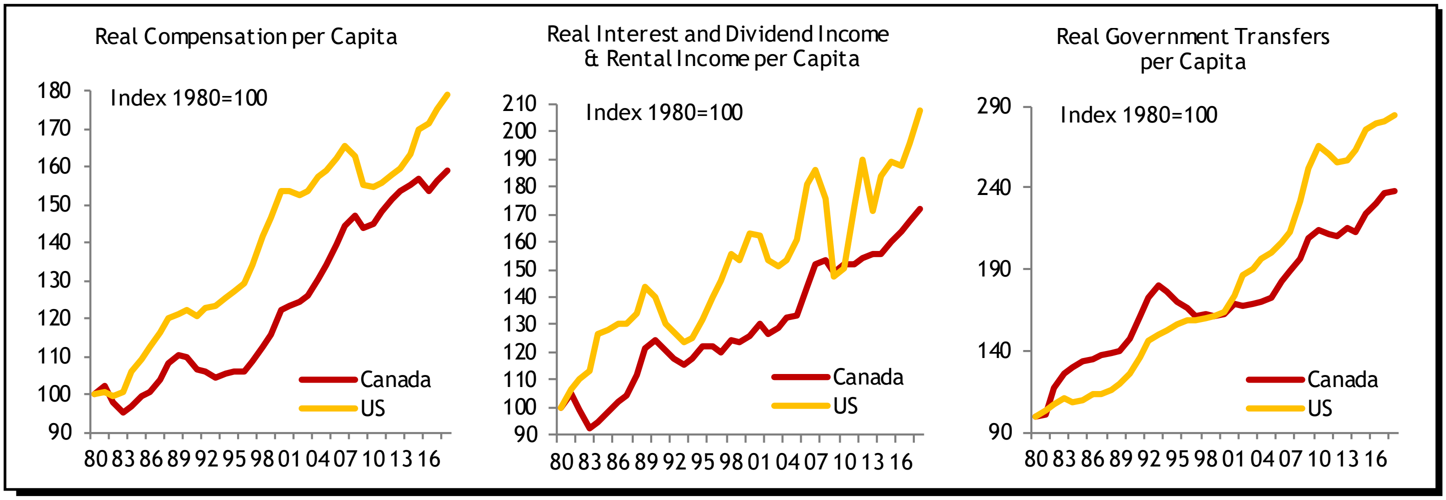
Chart 5
Taxes And Other Transfers Played A Role



Source: Statistics Canada, BEA, Census Bureau, CIBC

Chart 6

Gap Widening in All Income Components



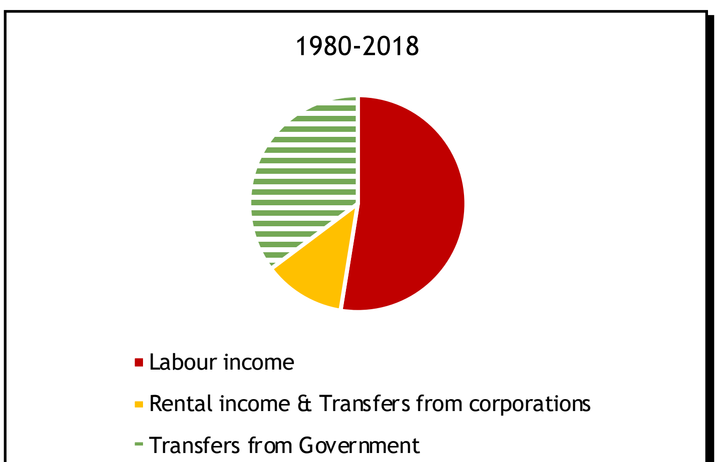
Source: Statistics Canada, BEA, Census Bureau, CIBC

On a per capita basis and adjusted for inflation, this component of income in the US has risen by an annual average of 1.5% since 1980. At the same time, in Canada, labour income per capita has risen by only 1.2%. No surprise—the trajectory here mirrors the trajectory seen in total personal income.

We estimate that the smaller increase in labour market income in Canada accounts for just over 50% of the entire increase in the US-Canada gross income gap since 1980. Lower growth in transfers from governments (in part due to the jump in unemployment insurance payments in the US in the 2000s and mostly during the Great Recession), accounted for 35% of the widening gap, while lower growth in interest/dividend and rental income in Canada accounted for the rest (Chart 7).

Chart 7

Contribution To The Widening US-Canada Real Personal Income Per Capita Gap



Source: Statistics Canada, BEA, Census Bureau, CIBC

What's Behind Labour Income Underperformance?

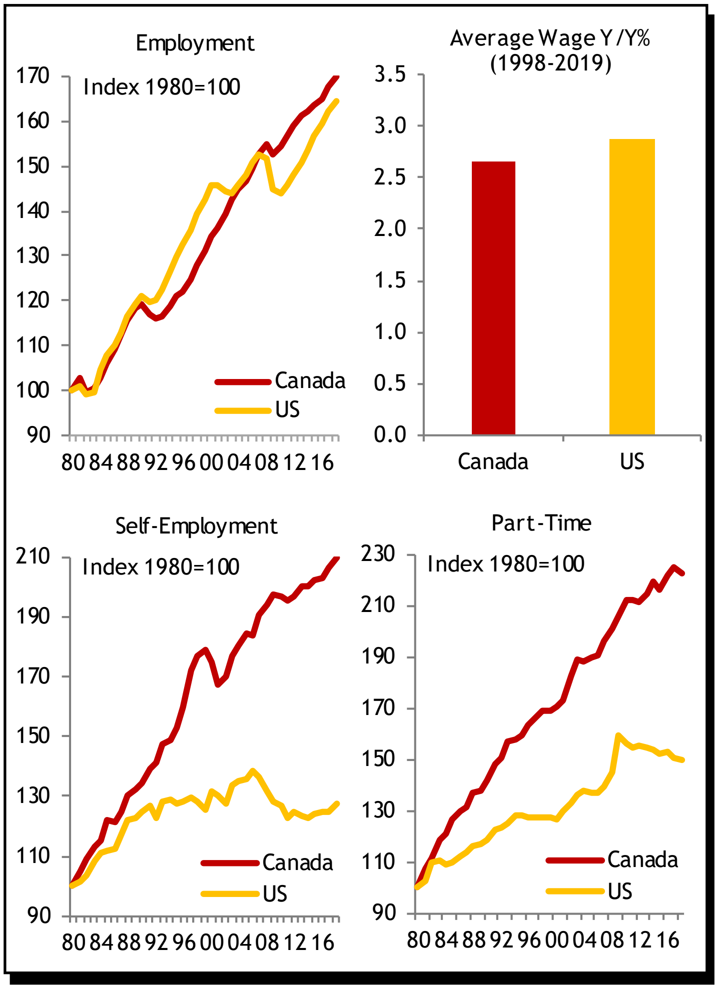
Given the importance of labour income for our story, we can go one step further and look at the factors behind Canadian underperformance here. Labour income comes from three sources: job creation, wage increases and labour composition.

Let's start with job creation. As illustrated in Chart 8, over the past four decades, the pace of job growth on average in the US and Canada was very similar. That suggests that job creation was not a major factor impacting Canada's underperformance in growth in labour compensation during the entire period.

However, real wages in the US rose notably faster, averaging real annual growth of just over 1.2% vs. less than 1% in Canada.

The rest of the underperformance is due to less favourable job composition in Canada, as well as the role of part-time and self-employment in the Canadian labour market. Since the 1980s, part-time employment in Canada more than doubled, while in the US it was little changed. Self-employment has seen a similar divergence. What's more, the vast majority of the increase in self-employment in Canada has been in the form of unincorporated, one-person operations, which on average, earn 75% of the income earned by paid-employees.

Chart 8
Job Markets Performance



Source: Statistics Canada, Bureau of Labor Statistics, CIBC

Putting It All Together

Even putting aside the fluctuations of the Canadian dollar, the US-Canada personal disposable income per capita gap has widened by an inflation adjusted 48% since 1980. One-quarter of that widening in the gap was due to faster growth in taxes and other transfers to governments in Canada. Zooming in on gross personal income, just under one half of the widening in the gap is due to lower growth in rental and interest/dividend income in Canada, as well as faster growth in government transfers in the US. The rest is due to lower growth in labour income in Canada—all of which is due to a combination of slower wage growth and less favourable composition of job creation in Canada.

This analysis does not explore the root economic causes of the widening US-Canada income gap, nor does it discuss relative changes in income distribution. Rather, it provides an accounting framework, which permits a more focused picture of the widening gap. This should result in a better appreciation of the different dimensions of the poorer income growth performance in Canada, as well as the potential effectiveness of policy initiatives aimed at tackling the problem.

Note: (1) It also means, however, that Canada's pension system is better funded.

ECONOMIC UPDATE

CANADA	19Q2A	19Q3A	19Q4F	20Q1F	20Q2F	20Q3F	20Q4F	2019F	2020F	2021F
Real GDP Growth (AR)	3.7	1.4	1.0	1.2	1.4	1.1	1.5	1.5	1.4	1.9
Real Final Domestic Demand (AR)	-0.7	1.8	1.4	1.4	1.6	1.9	1.6	0.9	1.4	1.9
Household Consumption (AR)	0.5	2.3	1.4	1.4	1.6	2.0	1.7	1.7	1.6	1.9
All Items CPI Inflation (Y/Y)	2.1	1.9	2.3	2.5	1.7	2.0	1.9	2.0	2.0	1.8
Unemployment Rate (%)	5.5	5.6	5.7	6.0	6.1	6.1	6.0	5.7	6.1	5.9

U.S.	19Q2A	19Q3A	19Q4F	20Q1F	20Q2F	20Q3F	20Q4F	2019F	2020F	2021F
Real GDP Growth (AR)	2.0	1.9	1.1	1.8	1.9	2.0	2.1	2.2	1.7	2.1
Real Final Sales (AR)	3.0	2.0	1.6	1.5	1.6	1.7	2.2	2.1	1.8	2.1
All Items CPI Inflation (Y/Y)	1.8	1.8	2.0	2.4	1.8	2.0	2.0	1.8	2.0	2.1
Core CPI Inflation (Y/Y)	2.1	2.3	2.3	2.2	2.2	1.9	1.9	2.2	2.0	2.3
Unemployment Rate (%)	3.6	3.6	3.7	3.8	3.9	3.9	3.8	3.7	3.9	3.8

CANADA

There's still no recession in our base-case forecast, but we have nudged down our second half growth rate to take account of oil production lost to extended maintenance activities. And, even with a rebound in that sector already penciled in for Q4, we still see the economy running below its potential during the final trimester. Challenges remain for the exports and capital spending, something that could eventually weigh on core inflation, if as we expect those issues lead to rise in the unemployment rate next year.

UNITED STATES

The US economy decelerated by only a tick in Q3, with growth driven by a solid consumer and a boost from residential investment for the first time in almost two years. And while lower rates will continue to support housing and consumption, the negative impacts of trade uncertainty are apparent in growth readings in the business and export sectors of the economy, and could start to spread more meaningfully to hiring in Q4. But note that Q4 will also have an artificial dent from a US auto strike and the ongoing issues at a major aircraft manufacturer.