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CIBC's Benjamin Tal on interest rates, home prices and the No. 1 risk to the economy

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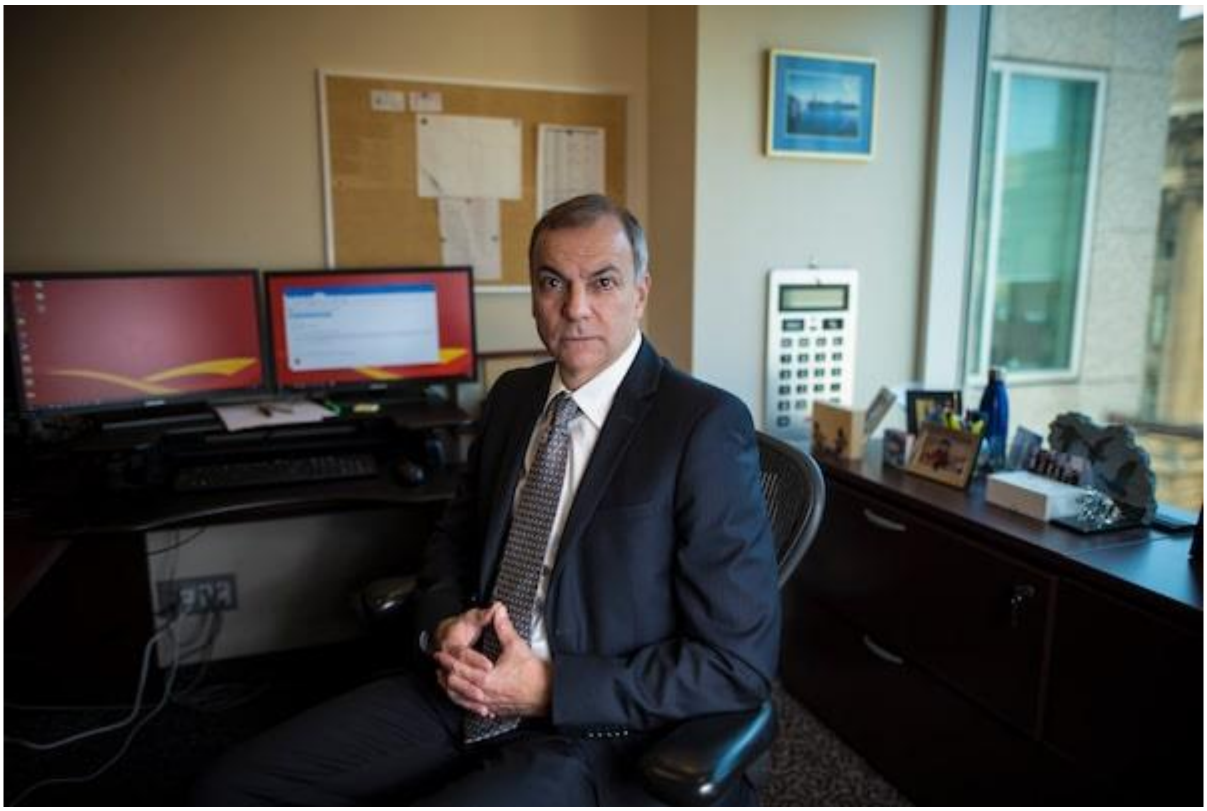

Benjamin Tal, the Deputy Chief Economist of CIBC World Markets Inc., sits in his Toronto office on June 7, 2019.TIJANA MARTIN/THE GLOBE AND MAIL

The Bank of Canada's policy rate is a key focus for the investment community, given the impact of higher interest rates on businesses and individuals. Investors are trying to predict when the first rate cut may occur and where the policy rate might settle.

The central bank's monetary policy decisions are data-dependent, so to get a sense of where inflation, wage growth, the labour market and economic conditions may be headed, The Globe and Mail recently spoke with CIBC Capital Markets deputy chief economist Benjamin Tal.

The market is confident disinflation will continue, with rate cuts expected to begin in the second quarter. What do you see as the future path for interest rates?

I think that the market is right to assume that the Fed and the Bank of Canada are done raising interest rates.

We’re starting to see some small victories when it comes to inflation. The Canadian economy is basically in a per-capita recession, and we have a situation in which economic growth is very close to zero. The only reason why GDP growth is still above zero is because of the population growth.

In the U.S., the situation is a bit different. The economy is relatively strong but inflation is starting to trend downward. Those forces suggest that both central banks are done.

The question is when are they going to cut? To me, it seems that the market is a bit too enthusiastic about the first cut. They are talking about the first quarter or early in the second quarter, maybe April. I think that’s way too early. Both the Bank of Canada and the Fed will have to make sure that inflation is absolutely dead before they cut interest rates. The Bank of Canada would prefer to overshoot relative to undershoot because when you overshoot, you can always compensate by cutting interest rates. When you undershoot you have to deal with inflation and inflation is very difficult to deal with.

One of the reasons why we have seen the rally in the bond market recently is the fact that the market is too optimistic about the Bank of Canada and the Fed cutting prematurely, and I think the market will be disappointed in terms of the timing of the cut.

Overall, we see the Bank of Canada start cutting in the second half of the year by roughly 150 basis points in 2024. The Fed will be cutting in the second half of the year, after the Bank of Canada, by about 100 basis points. The Bank of Canada will continue to cut in the first half of 2025 and the overnight rate that is now 5 per cent will go down to about 2.75 per cent.

How do you see inflation trending?

First of all, we have to realize that there are many measures of inflation that the Bank of Canada is focusing on. Another factor, which is extremely important, is that as opposed to many other countries – including the U.S. – a very important component of inflation in Canada is mortgage interest payments. So, the Bank of Canada is raising interest rates to fight inflation. Higher interest rates are adding to inflation by increasing mortgage interest payments.

And that’s why you like to look at services inflation minus shelter.

Exactly, and that’s something that the Bank of Canada is also focusing on.

I like to remove shelter from the story, especially remove mortgage interest payments. If you remove mortgage interest payments, inflation is already at target.

The IMF anticipates Canada will deliver the strongest economic growth of the G7 nations at 1.6 per cent in 2024. You are expecting GDP growth of just 0.6 per cent in Canada.

I don't understand where their number is coming from. It is way too strong, in my opinion. I don't think the Canadian economy is able to deliver such economic growth given where we are. We are basically operating today at about 0 per cent GDP growth. There is no reason to believe that the first quarter and the second quarter will be significantly stronger than that.

Our forecast is much less optimistic. To give you some numbers, the first quarter will be negative 0.2 or very close to zero. Second quarter will be about 1 per cent, the third quarter about 1.9 per cent, close to 2 per cent, and fourth quarter about 2.2 per cent. I think that the IMF is right about the second half of the year but I think the first half of the year will be weak.

What's your assessment of the Canadian labour market?

I think the way to describe the labour market in Canada is normalizing. The vacancy rate is back to where it was in 2019. If you look at the quits rate, in Canada and the U.S., it's going down.

Over the next few months, we'll see the unemployment rate rise because companies will stop hiring, and, in fact, will start letting people go, as in any economic slowdown. We don't see a disaster. We see the unemployment rate rising from high fives to about 6.3 per cent – about half a per cent. The peak will be in the second quarter of 2024 at 6.3 per cent, and it will remain about 6.2, 6.1 per cent in the second half of the year. It's painful, but not a recessionary story.

What about wage growth?

If you look at the quits rate, if you look at the bargaining power of labour, the unemployment rate trajectory, the labour participation rate, and employment overall, all those forces suggest that wage inflation will start slowing down notably, and that will be a major factor allowing the Bank of Canada to start cutting interest rates.

Turning to the housing market, do you believe home prices may rebound sharply as interest rates fall?

I think the market will start improving when interest rates start falling. I don't see a sharp increase in prices but I do see some improvement.

We have to realize that what's happening now is a very healthy correction in the housing market. The main damage is in the condo space because if you look at detached houses, there is very limited supply and therefore the damage is not very significant, although it's there. But the condo space is definitely slowing down dramatically. Investors are actually selling and investors are 50, 60 per cent of the market. If you look at construction, it's still there because it started two years ago, so the supply is there but demand is not there.

You speak with many chief executives. What dominant themes are you hearing from company leaders?

I think the two main issues are labour shortage and interest rates.

First of all, they look at their ability to attract talent. That's a major challenge that is facing the Canadian economy.

And second is interest rates and the trajectory in the future because high interest rates are really hurting, no question about it.

What you see is the No. 1 risk to the economy?

Geopolitical issues that nobody can predict – that's a risk.

The other risk is that inflation will be stickier than expected and that risk has two options. One is service inflation. The consumer will be stronger than expected. Pent-up demand will be stronger than expected. People will continue to spend, inflation will reaccelerate. That's something that will lead to higher interest rates and that will lead to a recession. The other is renewed supply chain pressures due to geopolitical events.

And what is one word or sentence that you think will best describe 2024?

Normalization.

Consumer spending is an important driver for economic growth. The household debt-service ratio climbed to a record high of 15.2 per cent in the third quarter. At the same time, the household savings rate is holding up at 5.1 per cent in the third quarter. What's your assessment of Canadian household wealth and how do you see it going forward?

One big thing happened during COVID and that's the accumulation of excess savings - $165-billion. The Bank of Canada was raising interest rates while the consumer was using excess savings to basically sabotage the Bank of Canada and continued to spend.

However, if you look at the excess savings now, it's approaching zero. Now, the consumer is much more exposed to the pain of higher interest rates. That's the reason why we see the economy slowing notably in the first half of 2024, as it slowed in the latter part of 2023.

I think that one of the reasons why the savings rate is holding is because if you know that the reset of mortgage payments is coming, what are you going to do? You're putting money aside, preparing for this shock of increasing payments due to higher interest rates. That's why it's so crucial that the Bank of Canada starts cutting interest rates in 2024 because the main shock will be in 2025, 2026, that's five years from when interest rates were extremely low in 2020, 2021.

Corporate balance sheets are quite healthy. In a report that you published last month, you state that cash represents nearly 8 per cent of assets for Canadian companies. Do you believe this may lead to more M&A activity in 2024 or dividend growth? What will be the main outcomes?

First of all, we have to look at other aspects beyond cash, and that’s profitability. I think the way to look at it is that profit margins are going to face downward pressure over the next few years. I believe that over the past 20, 30 years, profits were relatively easy because of globalization, because of just-in-time inventory, because of the labour market. Today, those forces are going into the wrong direction, putting downward pressure on profit margins.

Now, one of the reasons why companies were not investing in any significant way is the fact that profits were easy, so there was no motivation to invest. Today, investing is basically a necessity as profit margins will be under pressure. I think cash is going to be necessary to compensate for the lack of profit growth and therefore dividend increases will be limited.

A report that you published in December noted that since the pandemic TSX earnings margins have increased to 12 per-cent, on average, the highest level looking back over the past two decades. Now, you’re talking about profit margins coming down. Is that going to be negative for the stock market? Should investors be concerned?

I think that investors should be more aware of profit and earnings expectations. I think that to the extent that the market is not scaling it down, that will be problematic.

So you’re saying it’s a negative backdrop for the Canadian stock market?

I think that there will be two forces.

Low interest rates clearly will be helping, that is already in the market and led to some improvement in the stock market. This optimism can be reversed in the near future.

Profit margins will face some difficulties over the next year or two or three.

Those forces suggest that the stock market will go back to quality. You need quality and dividend-paying stocks. I think that’s where the focus will be.

What sectors do well ahead of rate cuts by the Bank of Canada?

Interest-sensitive sectors. For example, you may be surprised to hear that construction will do fine. Utilities will do fine. Even manufacturing will do fine, benefiting from the lower dollar.

Do you see the Canadian dollar relative to the U. S. dollar remaining range-bound in the low- to high 70-cent range?

I think that the bias would be for a weaker Canadian dollar over the next few months, reflecting the fact that interest rates in Canada will be falling faster than interest rates in the U. S.

In 2024, we see the Canadian dollar trading a bit lower than where it is now or staying more or less where it is, but the bias is lower. 2025 is the year where we see a recovery in the value of the Canadian dollar as the U. S. dollar will be facing downward pressure and the gap in interest rates between the Fed and the Bank of Canada will shrink.