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CIBC's Benjamin Tal was one of the few to correctly predict the BoC's rate moves so far this year. Here is what he's forecasting now

JENNIFER DOWTY || MAY 16, 2024

Major North American equity indexes are at or near record highs. With the earnings season largely behind us, investors will be focusing on economic data and announcements by central banks to provide direction to the markets.

At the start of the year, CIBC's CM-T -2.34%decrease deputy chief economist Benjamin Tal made a bold call counter to the Street's expectations, arguing that the Bank of Canada would not be cutting rates in the spring as the market anticipated. His outlier forecast proved to be correct.

The Globe and Mail reached out to Mr. Tal to get an update on his predictions for economic growth and its key drivers, plus the potential implications for the stock market.

Has inflation, particularly the services inflation less shelter, cooled enough to warrant a rate cut in June?

First of all, I think it's very important to understand what we are talking about when we say inflation.

The inflation target for the Bank of Canada is CPI of between one and three per cent, let's call it two per cent. However, they look at core CPI, which is CPI minus energy and food. They decided that we have to come up with something else, which we call CPIX, which is CPI minus eight components. Then, they decided to come up with other measures, CPI-median, CPI-trim. So, you have five CPI's to focus on.

In addition, how you measure it is also important. In the nineties, the focus was year-over-year. Then people said year-over-year is too volatile, we have to do 3-month moving average year-over-year. Then people said who cares what happened a year ago, we want to know what happens now, so look at month-over-month. But that's very volatile. So, a lot of people started using 3-month moving average month-over-month, or 6-month moving average month-over-month. You have five CPI metrics with six inflation measurements so 30 inflation numbers. So, every time that StatCanada says this is the inflation number, we have to analyze 30 numbers - I call it an inflationary buffet.

The point I'm making here that's extremely important is that the narrative determines the data, not the data determines the narrative. What I mean by that is that in the 30 numbers you can find whatever number you want that is consistent with your narrative.

We have a situation in which the Bank of Canada can justify whatever stance it wants to justify based on the numbers. That's why they justified not cutting in April or March because the CPI-trim rate, the CPI-median rate that they're following were too elevated but other metrics were falling or less elevated.

At this point in the cycle, I'm focusing more on the narrative as opposed to the data.

Let's look at those inflation numbers and go back to your question, "is inflation low enough?" I say absolutely. The trend is there, and in addition, one of the most important factors impacting inflation is interest payments on mortgages. If you take interest payments on mortgages out of the question, core inflation is already below target.

If the Bank of Canada was an AI machine, it would have stopped raising interest rates 50 basis points ago.

The gap between the Fed and the Bank of Canada is now 25 basis points. Usually, it is 75 to 100 basis points because monetary policy in Canada is more effective. We know that because our mortgage structure is different, we have five-year mortgages, they have 30-year mortgages, and we also have more leverage. So, the Bank of Canada does not have to raise interest rates as high as the Fed to get to the same place.

So, either the Fed is undershooting or the Bank of Canada is overshooting and I don't think that the Fed is undershooting, which means that the Bank of Canada, in my opinion, is already overshooting.

At the end of the day, it's a biased bank. You give them two options, recession versus inflation. They will take a recession, which means that they will choose to overshoot. And that's exactly what's happening now.

So, the short answer to your question, inflation is low enough to justify a cut, and I think the first cut will be in June.

I think that the narrative now is that there is enough weakness in the market in terms of inflation numbers, in terms of the labour market, and GDP.

Let's talk about GDP.

First quarter GDP was stronger-than-expected. But, what's important here is the source of the growth. It was not demand, it was more supply, reflecting an easing in the supply chain. And the latest GDP numbers are more consistent with basically zero GDP growth in the second half of this year.

We are in a recession. We are in a per capita recession. In fact, if you look at per capita GDP growth, it's negative and it's approaching rates that we saw in the 1991 recession and in the 2008 recession.

We need to see GDP per capita rising because that's the ultimate measure of the standard of living.

What's your narrative for the U.S. economy?

The U.S. economy is stronger than expected, demand is stronger than expected. The labour market is still relatively tight. There are some clear signs of slowing in the labour market, which is really important. The quits rate is lower than it was in 2019 and job openings are back to where they were in 2019. If you look at the credit to industrial and commercial entities, growth is basically zero. If you look at growth in business investment, although very strong, remember, we have the CHIPS Act from Biden. We've seen a significant increase in spending on non-residential structures. Namely, companies building factories that went up by 30 per cent, which was the number one driver of business investment. Now, it's not going down, but it's staying at the same level, which means that growth is approaching zero. That's another factor slowing down the U.S. economy. So, I see the U.S. economy slowing down, which is actually a good thing.

We're in an environment where bad news is good news. You need to see the U.S. economy slowing down to show that the Fed is winning the war against inflation.

I think what we're seeing now is extremely similar to the soft landing scenario in 1995. In 1993, 1994, the Fed raised interest rates by 300 basis points. Back then, Fed. Chair Mr. Greenspan was chasing inflation that was not really there. Inflation was going down. So, he was chasing the fear of inflation and raised interest rates very quickly by 300 basis points. The economy responded to it but did not crash. GDP averaged about 2 per cent - a soft landing.

Back then, the economy was recovering from a recession. Now, we're recovering from a recession. Back then, the U.S. was the only game in town in terms of GDP growth, the rest of the global economy was slowing down. That's exactly what's happening now in Japan, China, Europe and Canada, which is in a per capita recession. Another factor, which is extremely important is productivity. In 1995, after interest rates went up, one of the reasons why they had a soft landing was due to a surge in productivity - we had the dot-com revolution. Look what's happening now with AI and productivity in the U.S. rising very fast, even faster than back then. And if you look at economic performance it is very similar. All those forces suggest that 2024 should be like 1995.

Now, people say back then the Fed raised by 300 basis points now they've increased by 500 basis points. But I say that 300 back then is equivalent to 500 today because monetary policy back then was more effective. They had more debt back then, and back then there was more debt was in variable rate mortgages. Now, most of it is in the fixed

30-year term. So now monetary policy is not as effective as it was in the past. Therefore, 300 basis points back then is equivalent to 500 now.

What's important here is that after the Fed raised interest rates by 300 basis points between 1994, 1995 and it kept rates there. So, we had interest rates higher-for-longer.

But you're not calling for them to hold interest rates for years.

No, because we think that the five-year rate is too high, but it means that it will not go down to where it was. We believe that interest rates will go down in 2024, 2025 but will remain much higher than they were before the crisis. The neutral rate of interest is higher now than it was before and that's actually very healthy because if there was something that was mispriced over the past 20 years, it was cash. So going back to higher neutral rate is actually very healthy for the economy.

Another factor that is impacting this neutral rate is the fact that although inflation is softening now because of cyclical forces and higher interest rates, I think that the inflationary forces at play are more permanent and more significant.

1995 is giving you an example of a soft landing and higher-for-longer, and we are going to see a version of that today. I call it 1995 deja vu.

In Canada, you have 100 basis points of cuts forecast for this year and 125 for next year. How do your expectations differ for the Federal Reserve?

We see the Fed cutting only twice this year in September and December. We will have three months of the Bank of Canada moving without the Fed. That's assuming that the U.S. economy will slow down, which I think there are many reasons to believe that it will. But, if there is a risk to this scenario, it is the U.S. will continue to surprise to the upside.

So, let's talk about the Bank of Canada. The overnight rate is at 5 per cent now. We see this rate at 2.75 or 3 per cent by the end of 2025. For the federal funds rate, we see the midpoint at about 3.625 per cent by the end of 2025.

Your real GDP forecast currently stands at 1 per cent for 2024 and 1.6 per cent for 2025 for Canada, well below the Bank of Canada's real GDP forecasts of 1.5 per cent for this year and 2.2 per cent for 2025.

We believe that the economy will slow down more significantly because some of the growth that we have seen until now reflected supply chain growth, which will not repeat itself. We think that the consumer is weaker-than-expected. Remember that we still have 50 per cent of mortgage holders who will be refinancing their mortgages, which is going to be a major shock to the economy and we lead to higher savings rates. I think the labour market is even weaker than perceived. All those forces suggest that the economy will be weaker than the Bank of Canada suspects. I think that the Bank of Canada will have to revise its forecast downward.

In your 2024 outlook report on the housing market, you discuss how prices for detached homes have jumped 40 per cent since pre-covid and condo prices are up 30 per cent. In the report, you said, "we expect the downward pressure to get worse before it gets better," expressing near-term caution with more listings putting pressure on home prices, particularly for condos. Have we seen the worst yet?

That's exactly what happened over the past six months or so. The condo market is a shadow of its former self, especially if you look at the presale activity and pre-construction activity - it's absolutely dead.

We have seen the worst for the detached segment of the market because there is not enough inventories. But what we're seeing now in terms of condo supply is we have a lot of condos that are being completed now. But we don't see condos that are starting because developers simply cannot presell. The way it works is you presell, then you get the financing, and then you start working. Presale activity is basically zero, which has major implications. The condo space is now relatively weak and it will remain weak for the next six months or so until you clear the market. There will be downward pressure on prices or at least they will stabilize, they will not rise in any significant way. So, there will be a growing gap between detached houses and condos.

However, the fact that we are not building now, looking out two years from now, three years from now, interest rates will be lower, demand will be there.

With pre-construction activity down, there's not going to be supply in a couple of years, so prices will rebound. Correct?

Exactly. This is not really a forecast, this is almost a given.

How do you view the housing market in cities versus satellite cities or suburbs?

We have seen a very strong growth in the suburbs over the past few years no question about it, reflecting the working from home environment.

I think that the supply/demand mismatch is a major issue. We were very vocal about doing something about the demand side, especially with non-permanent residents. I think that the move by the government recently to cut the number of non-permanent residents from 6.5 per cent of the total population to 5 per cent is a huge step in the right direction that will slow population growth from 3 per cent to about 1 per cent, 1.5 per cent, which is more normal and more reasonable because what we have seen in terms of population growth over the past year was simply unsustainable by any stretch of the imagination. Government policies are attacking demand, we also have to work very hard on supply. We're not even close to where we should be.

What is the potential impact on home prices in cities versus satellite cities?

I think that cities are becoming totally unaffordable and people will have to migrate to satellite regions and that's where demand growth will be strong. I think that the price gap between core cities and satellite cities will shrink.

Have we seen the worst for the depreciating Canadian dollar versus the U.S. dollar?

The market is a forward-looking mechanism so the fact that the market is now expecting the Bank of Canada to move ahead of the Fed, this is already priced into the value of the Canadian dollar. That's why we're talking about the Canadian dollar stabilizing, basically reaching a bottom at about 72, 71 cents.

The S&P/TSX Composite Index is flirting near a record high. Do you believe we may be in a stock market bubble with valuations not supported by economic fundamentals, especially when you forecast GDP growth in 2024 of just 1 per cent?

There is no question in my mind that there will be some downward pressure on profit margins over the next year and the market has to adjust for it, that's a negative for the stock market, in general.

There is also the uncertainty regarding the election in the U.S. When it comes to Trump, we're talking about trade, we're talking about taxes, and we're talking about regulations - that might get the market nervous.

What do you think might be the next surprise to the market?

More of a risk is that the U.S. will not be cutting as quickly and as much because the economy is relatively strong. That's a risk and that will put the Bank of Canada in a very difficult position because the Canadian economy will require lower interest rates.

What do you see as the number one risk for the U.S. economy?

I think that the number one risk is that inflation will be sticky, and it will be stronger than expected.