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ECONOMICS

Avery Shenfeld
(416) 594-7356
avery.shenfeld@cibc.com

Benjamin Tal
(416) 956-3698
benjamin.tal@cibc.com

Andrew Grantham
(416) 956-3219
andrew.grantham@cibc.com

Royce Mendes
(416) 594-7354
royce.mendes@cibc.com

Katherine Judge
(416) 956-6527
katherine.judge@cibc.com

Taylor Rochwerg
(416) 594-7355
taylor.rochwerg@cibc.com

http://economics.cibccm.com

The Math of the Aftermath: Looking Past the Corona Shock

by Avery Shenfeld and Katherine Judge

Having tired of looking at so much gloom, although we'll have more to say on that topic as data roll in, we're already giving thought to what the world will look like when we're past the worst of what the coronavirus can dish out. It will of course miss the presence of the many worldwide victims of the pandemic, and that loss will exceed all others.

A return to normalcy will, in a number of dimensions still be a new normal. The last crisis left behind a changed financial system, a pile of government debt, a long road to full employment, and a cycle in which the new normal for interest rates was much lower. What will the coronavirus recession have wrought when we look back on it years from now?

GDP Path and Neutral Rates

What's unique about this recession is that much of the decline came from mandated closures, so the first leg up should be brisker than usual, albeit after a much starker downturn. Unlike building houses for Americans in the early 2000s who couldn't afford them, which never returned, we'll go back to eating at restaurants and going to an office one day. But after a couple of strong quarters as some sectors reopen, then what?

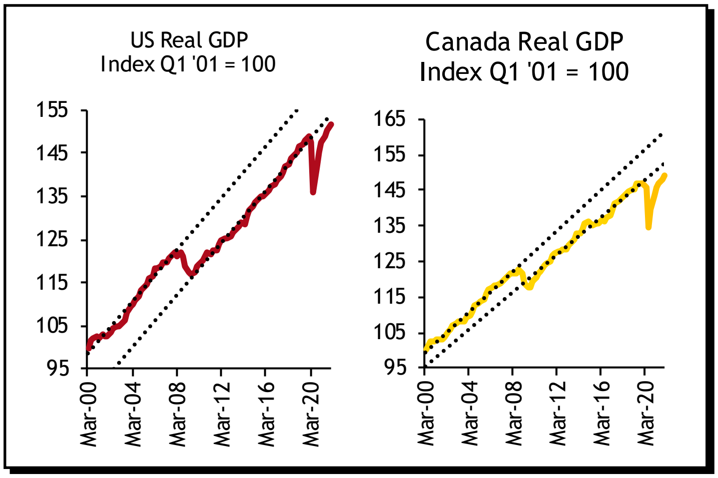
Hopes for a quick return to where we would have ended up pre-virus ignores what we're hearing from epidemiologists and the lessons of past shocks. The experts suggest that until a vaccine or cure is available, some base line level of infection will still circulate in the population (perhaps seasonally), and our exit strategy will be to move from a mass lockdown to aggressive testing, contact tracing, and localized bouts of enforced isolation and workplace shutdowns.

During that period which could extend through 2021, cross-border travel will be at least partially restricted or subject to strict quarantine rules until all countries are on the same page. Large conventions and other mass gatherings might be viewed warily. Not quite happy days are here again. A few sectors that caught negative headlines, including cruise lines and retirement homes, could face lingering reputation issues. Other sectors, including airlines and oil & gas, have simply lost so much demand that even a respectable climb back will almost certainly be a long road.

Even after more typical shocks, economies often struggle to return to the level of real GDP that the prior growth trend would have implied. After the global financial crisis, the US and Canada attained healthy growth rates but left a permanent gap in real GDP versus its 2001-07 trend. (Chart 1) Reflecting that tendency, our base case outlook has the level of real GDP in Q4 2021 still roughly 2% softer in the US and Canada relative to what we had projected at the start of the year (i.e. before the virus hit).

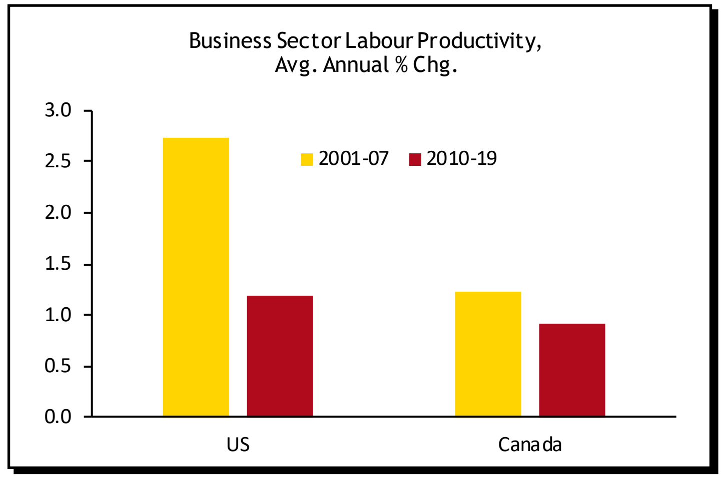
True, part of the shortfall in growth post-2008 reflected an aging North American population that would have slowed growth in any event. But labour markets can also

Chart 1
Recessions Leave Permanent Holes in GDP Path



Source: Statistics Canada, BEA, CIBC

Chart 2
Productivity Growth Slows Following Deep Recessions



Source: Statistics Canada, BLS, CIBC

suffer from what economists call "hysteresis", in which those who are dislodged from jobs lose skills, opt to retire early, go on disability benefits, or are forced to take a position that makes lesser use of their strengths and entails lower output per hour. The short duration of some of the unemployment spells tied to the coronavirus might mitigate some of these impacts, along with government efforts to keep employers afloat so that workers have a former job to return to.

But there are other post-recession headwinds that typically weigh on a full return to trend. A drought in capital spending during the recession, and the tumble in capacity use rates that obviates the need for a quick upturn in new plant and equipment, entails less upgrading to the newest technologies. In the case of recessions that aren't quickly reversed by a return to full capacity use, that can result in a slower pace of productivity growth, just as we saw in the last cycle (Chart 2).

Weaker capital spending plans, and lower trend growth, puts downward pressure on neutral rates of interest. Simply put, it takes a lower rate to get enough capital spending to recycle the savings of the household sector back into the economy. The gradualist road to post-virus full employment, and a low neutral rate, points to a low for long outcome for short term rates in both the US and Canada.

Governments: Weaning Off Stimulus

The scale of fiscal stimulus in both the US and Canada looks set to dwarf prior efforts in both the speed of delivery and its magnitude. With spending constrained during the recession by health policies, its impact will largely be felt in the first few quarters of recovery, as households and companies that received support will be better placed to return to spending and hiring respectively than would otherwise have been the case. The stimulus efforts are in effect aimed at preventing the onset of a protracted depression, and less at buffering the short term shock.

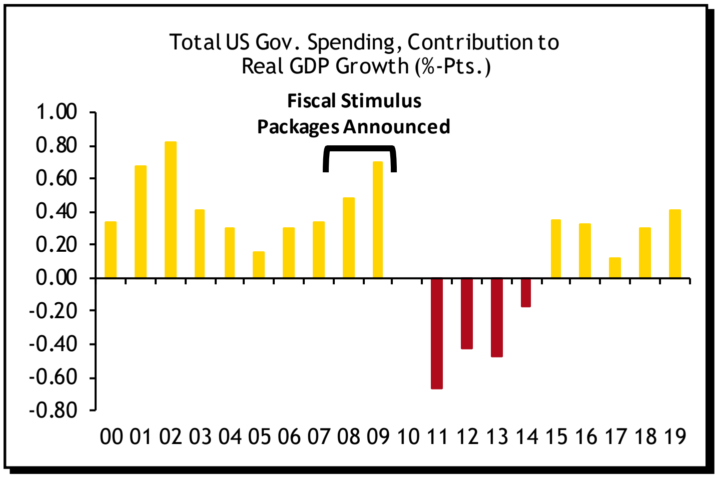
But as we move into 2021 and beyond, what will be the legacy of that fiscal thrust for medium-term growth? The last time we had massive US stimulus, in Obama's first term, Washington was quick to turn back to restraint, as were state and local governments. The result was that US fiscal policy became a protracted headwind for growth (Chart 3). Will we see a repeat of that in Covid-19's aftermath in both the US and Canada?

Eye popping headlines about peak year deficits will lean that way politically. In the US, the federal deficit could readily top $3 trillion, or 14% of GDP in 2020. Including a proposed $71 billion wage subsidy, Canada's deficit will be approaching $200 billion, or roughly 8½% of GDP. Provinces will, one after another, have to rewrite this year's plans towards a large spike in their collective deficits. It's much the same globally, as no major government has eschewed stimulus or avoided deep revenue hits.

We've been here before. Canada ran a similarly scaled deficit-to-GDP ratio in the 1980s, and fighting world wars produced similar borrowing needs. As in post-war periods, moving past the coronavirus shock will bring

Chart 3

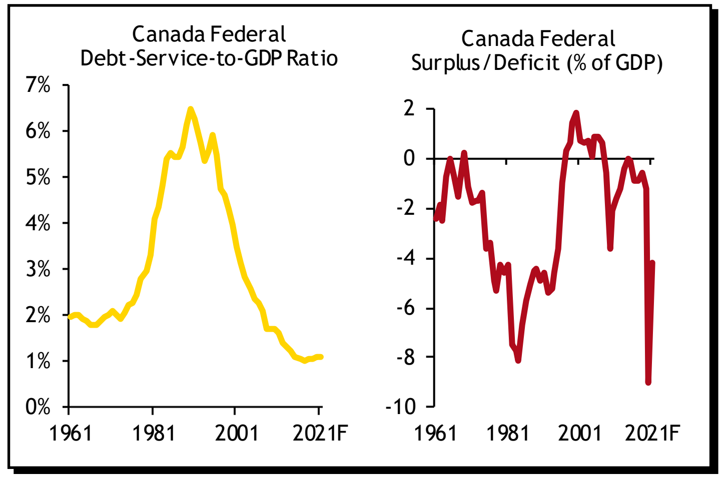
Large Stimulus Packages Can Presage a Drop in Spending Later



Source: BEA, CIBC

Chart 4

Rock-bottom Interest Rates Limit Interest Burden (L), Expected Deficit to GDP Not Unprecedented (R)



Source: Canada Department of Finance, CIBC

deficits down sharply without any need to for active fiscal restraint, as unemployment benefits, for example, drop off with a rebound in employment, and their boost to the economy is replaced by spending from labour income.

Moreover, the right way to measure the associated burden is to look at interest costs as a share of GDP. These billions and trillions of debt are being issued as sub-1% rates. As an example of that, looking at Canada's debt service costs as a share of GDP, even assuming a deficit of $200 bn this year and, arbitrarily, a further $100 bn in 2021, would still leave a manageable cost relative to decades past (Chart 4). Rates on both US and Canadian government debt could move marginally higher as confidence return, but during this high deficit run, will still be not far from multi-decade lows. The massive increase in supply is being offset by both central bank quantitative easing (i.e., bond purchases) and the market's appetite for low risk assets during this period of uncertainty.

This crisis has revealed shortcomings in the capacity of the healthcare system to respond, and that could leave related spending elevated for some time to come. That, and at least some political pressure to return to more modest deficits and debt issuance, could put the squeeze on other spending, beyond the reductions that will happen naturally as those on benefits return to work, or have governments looking for additional tax revenues.

Stateside, which way that goes will largely rest on the outcome of the 2020 election. A Democratic sweep would be likely to see the reversal of tax reductions the Trump administration granted to upper income earners and corporates. Canada's minority government could also be put to an electoral test in 2021, as past history points to a typical two year term.

Unlike the US, which is only now looking at infrastructure as a growth boost, Canada is well down the road on that program. Post 2021, Ottawa might opt to save borrowing room by stretching out those plans, in part because the lack of immigrants this year (or longer) will remove some pressure on schools, transit systems and other assets.

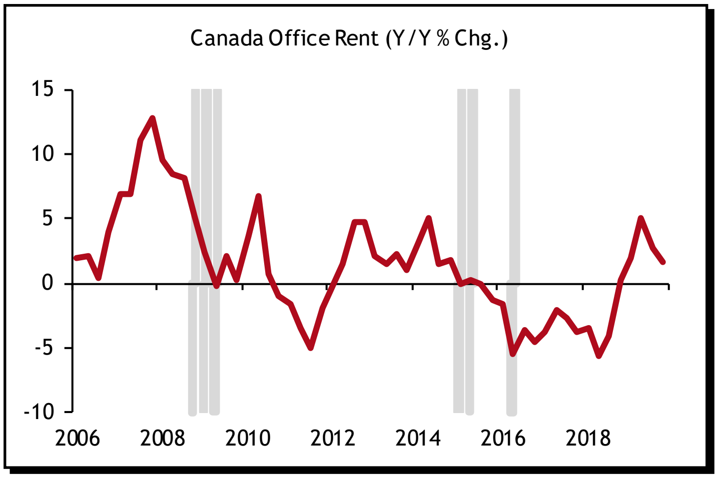
Real Estate

Those same immigrants will also be MIA in the residential real estate market, having earlier been particularly of importance to the rental markets, and in turn to condos that are rented to them by investors. Recent graduates that end up with delayed employment prospects will face a parallel delay moving away from their parents and seeking rental accommodation.

On the supply side, developers could face delays in completing new high rises, but in the Toronto market we were on track for a banner year for such units. Even at a slower pace for supply, the demand hit should mean that now-tight rental markets in cities like Toronto could look much less tight a year from now.

Will the same be true for the office market? Aristotle, who opined that "man is by nature a social animal", must have realized that after working from home for too long. After only a few weeks, the vast majority of our

Chart 5
Office Rent Inflation Weighed Down Following Slower Growth Periods



*Source: CBRE, CIBC *Negative GDP growth quarters are shaded.*

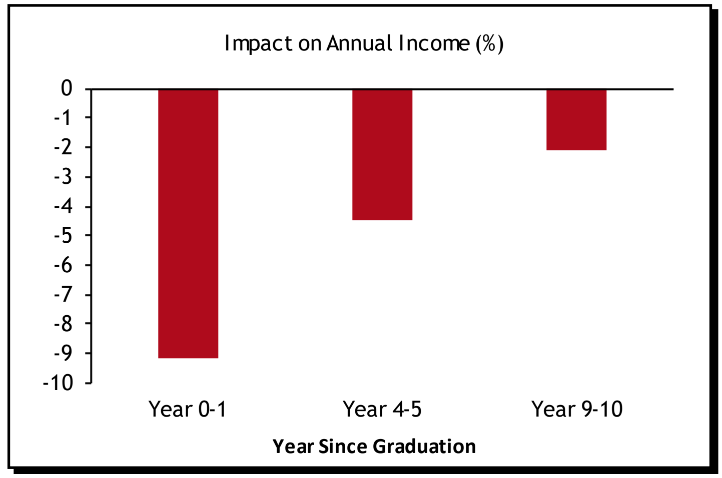
business contacts, all working at home, aren't overjoyed with that prospect. We've had telephones for a century, videoconferencing for decades, and have been wired up to email since the mid- 1990s, but that didn't end business travel or offices.

Still, having invested in the infrastructure necessary for WFH, some employers could opt to make greater use of that option. And we'll have come through a period with fewer start-ups and more business closures, leaving additional slack to be absorbed. The energy-focused Calgary market will add to its prior ocean of empty space. So the new normal could be a lower trend for rent increases nationally, as we typically see in post-recession periods (Chart 5).

Shopping online, and home delivery, has been the big winner during the social distancing saga, and while malls and main streets will open up again, the post-corona world will see some of the temporary tilt to e-tailing remain. Grocery buyers trying home delivery for the first time may not have had the best experience, given that it's been an overloaded channel. But even so, first time users of various online channels are likely to at least retain some usage.

More importantly, despite the best efforts of governments to keep their hearts beating, we'll likely exit this slump having seen a wave of brick and mortar retail closures. Others might owe back rent that they will struggle to pay, and end up folding during the recovery phase. The legacy of past recessions shows that refilling these vacant spaces will take time, and thereby put downward pressure on commercial rent inflation for a while.

Chart 6
Impact on College Graduate Earnings of Graduating in a Recession Year*



*Source: Oreopoulos et al. 2012 *Assumes a 5% rise in national unemployment rate.*

Labour Markets

Both Canada and the US entered this downturn with some degree of labour market tightness. While not yet putting material upward pressure on core inflation, wage gains were one factor biting into corporate profit margins and earnings growth. That will all reverse course in a hurry. Oddly, wage inflation will tick up in the first stage of the shock, as average wages will rise given a disproportionate loss of jobs at the lower end of the pay scale in hospitality, retail and other services. But look for ample labour market slack to put downward pressure on wage inflation well through 2021.

For new graduates in particular, the bad luck of finishing school in the year of the virus could have long lived implications on their future earnings path. Delays in getting that first job, and being forced to start further down the ladder, has been shown to impact average wage performance for up to a decade. A study by Philip Oreopoulos of Canadian male college grads found that entering the workforce in a typical recession year not only meant a 9% hit to initial earnings, but left those workers still earning 4.5% less five years out, relative to the path for those ending school in a year when the national jobless rate was 5% points lower (Chart 6).

Supply Chains

The business sector, as well as governments, have seen some of the negative sides to globalization, as both the corporate sector and health authorities struggled to keep the flow of key materials running. It wasn't just about China's reliability, as even nearby suppliers in Italy ended up to be a problem for auto manufacturers in Germany, for example. That comes after a year in which trade wars were another challenge to globalization. How supply chains are altered to reduce both risks would be an article in its own right.

While there will be a rethinking on that front, efficiency considerations are likely to mean that we amend, rather than reverse, decades of globalization. Where feasible, having lined up two or more suppliers in different countries would reduce disruption risks. For critical health care products, having a national stockpile of key items might be more cost effective for smaller countries than developing permanent local supply chains.

Inflation: A Non-Threat Despite QE

Those who lived through massive quantitative easing programs in Japan, Europe and the US surely know by now that they don't entail a flood of money supply growth and an inevitable risk to inflation. Then, as now, central banks engaged in QE because the economy faced the prospect to too little demand, and therefore a risk of an inflation undershoot. Turning the tap off again when the economy gets back to full employment has not proven to be too challenging.

The same will be true for Canada as its central bank launches into what is essentially its first major foray into QE. Expanding balances in the overnight system doesn't actually lead to soaring money supply growth; it's really more about keeping rates low and credit flowing during a period in which markets might not function well enough to do that.

Inflation will, of course, tumble during the downturn, helped by rock bottom oil prices, softer rent inflation, and a general surfeit of demand. It will as usual rebound in the recovery, and Canadian real return bonds look to be pricing in too little of that. But there's no reason to believe that QE will lead to a mad surge in inflation tied to an excess of money supply.

Asset Values in the Aftermath

Investors have to think about these longer term issues because, at least in the textbook, it's not this year's earnings that matter, but the discounted value of the stream ahead. The lessons of large major shocks in the past, and likely this one, is that a bear market that's tied to a downturn doesn't reverse in a hurry, as that's also the case for earnings. Not only will huge haircuts and higher insolvency risks have to be priced in for 2020, but markets will also re-asses how much of that will be recouped in 2021.

In the bond market, government and central bank efforts to aid liquidity for corporate issues, add lending capacity in shorter term credits, and in selected sectors, provide bailouts or loan guarantees, should ease spread pressures. In Canada, the interventions have been largely aimed at shorter term paper, but stateside, the Fed's willingness to buy corporate bonds has brought spreads in from their wides. A further narrowing in both countries is likely once news on the virus improves. But just as it won't be a quick ride back to full profitability, we're unlikely to revert to pre-shock spreads over the next couple of years.