Separate Ways, For Now

A Publication of BMO Capital Markets Economic Research • Douglas Porter, CFA, Chief Economist, BMO Financial Group

ECONOMIC RESEARCH
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United States: Liftoff

- A **reopening U.S. economy is quickly making up ground. Real GDP jumped 6.4**% annualized in the first quarter and will surpass pre-pandemic levels in the current quarter. Consumer spending rocketed 10.7%, as newly-vaccinated shoppers unleashed a torrent of pent-up demand for dining, travel, and just about everything else amid two rapid-fire rounds of stimulus payments. They are far from exhausted, having piled up sufficient aggregate savings in the past year (over $2 trillion) to sustain strong spending even if a good portion is used for debt repayment and investing. The rebate cheques and 1.6 million new payrolls contributed to a record 59% (annualized) jump in personal income in Q1. Nonresidential business spending rose nearly 10%, despite lingering weakness in commercial construction. Even with a mid-quarter snowstorm and regional blackouts, residential construction posted another double-digit gain, with housing starts and new home sales both hitting 15-year highs in March. The two major headwinds in Q1 were plunging business inventories, partly due to chip shortages that led to temporary auto plant closures, and a record trade deficit. The latter reflects strong domestic demand, a Euro Area economy now in recession, and a still-historically strong greenback (though its trade-weighted value is off the record high reached in March 2020).
- Recent April figures and timelier data on credit card spending, retail mobility, indoor dining, hotel stays and air passengers, suggest the **economy's momentum carried into the second quarter**, where we see 8.5% (annualized) GDP growth. Consumer confidence is nearing pre-pandemic highs, while the April jobs report (due May 7) is shaping up to be a blockbuster.
- Passage of the $1.9 trillion **American Rescue Plan Act** in early March, with its $1,400 rebate payments and six-month extension of emergency UI programs, juiced the Q1 recovery. Next up is the President's $2.3 trillion **American Jobs Plan,** with a focus on infrastructure spending, and the $1.8 trillion **American Families Plan**, which is centred around childcare and education. However, both could be slimmed down in Congress and, in any event, the spending measures will be spread over many years and partly offset by higher taxes on corporations and top-income earners. Still, the President's proposals are likely to provide a net boost to the economy in the next decade. The tradeoff is a larger budget deficit, which looks to exceed 7% of GDP next fiscal year, small only when compared with the 16% shortfall expected this year.

Key Messages

The U.S. economy is already reaping big dividends from its speedy vaccine rollout, with the economy accelerating in the first half of the year. It is on track for 6.5% growth in 2021, the fastest in nearly four decades.

Meantime, renewed lockdowns to address a third wave of the virus likely stalled Canadian growth in the spring. Still, a peppy start to the year and an expected sharp rebound when the economy reopens should keep the nation on track for 6.0% growth this year, the most in nearly half a century.

Despite better near-term prospects in the U.S., it is Canada's central bank that is warning of raising rates sooner than previously suggested. While both the BoC and the Fed may wait until early 2023 to raise rates, hefty fiscal stimulus and brewing inflation could advance the timing.

- The **U.S. labour market has kicked into high gear**, with the unemployment rate falling to 6.0% in March and headed much lower according to a recent survey of consumer sentiment. While payrolls are still down 8.4 million since the pandemic began, we expect more than one million to be regained in April alone. Rather than weak demand, it's the supply side that appears to be holding back hiring in some industries, even for lower-skilled jobs. Many companies are having trouble calling back workers or filling new positions, citing virus fears, child-care duties, and expanded UI benefits as obstacles. The participation rate is still almost 2 ppts below pre-pandemic levels, though it should rise as more people are vaccinated, thus supporting job growth and allaying wage pressures. A rising participation rate will also slow the jobless rate's descent, though it should return to the pre-pandemic level of 3.5% by late 2022.

- **Inflation pressures are simmering** in response to massive policy stimulus, surging money growth, booming resource prices, and supply-chain disruptions. The CRB commodity price index is at an 11-year high. Lumber prices have quadrupled in the past year, while copper is at ten-year highs, and wheat and corn prices are also on a roll, flagging higher food costs. Along with semiconductor and other parts shortages, many factories can't find skilled workers. Consequently, more companies are saying they will try to pass higher input costs onto consumers. If enough firms do so, it could sustain the looming spike in year-over-year measures of inflation stemming from low base effects, especially if workers demand higher wages as compensation. While core measures of inflation are far from boiling over, pressures are starting to stir beneath the surface, in areas such as furniture, appliances, and personal care services. Moreover, the hammered travel industry is seeing a reversal in price declines amid rising pent-up demand for flights, hotels and auto rentals. We expect CPI inflation to average 3.0% in 2022, the highest annual rate in a decade. But the risks are squarely on the high-side, especially if policymakers keep pressing on the accelerator and cause the economy's engine to overheat.

- The **Fed** wants inflation to move moderately above the 2% target for some time to compensate for past undershooting. Only time will tell whether that's a wise strategy. It clearly raises the risk of a much larger overshoot. However, if inflation is held in check by long-run forces such as automation, globalization and an aging population, as Chair Powell suspects, then the Fed could achieve its aim of a more inclusive recovery, where even the hardest-hit workers regain employment. We expect policy rates to stay near zero until early 2023, a few months sooner than previously thought. The Fed should then raise rates gradually, assuming inflation stays contained. If not, rates will rise sooner and faster, risking an economic downturn.

- While the **10-year Treasury rate** has steadied in recent weeks after spiking more than 60 bps this year, we expect it to trend modestly higher to 1.75% at year-end and to 2.00% by late next year. From Powell's recent remarks, the Fed likely won't begin tapering asset purchases until much later this year, which should provide near-term support to the bond market.

Canada: Lockdown

- After showing surprising resilience to the second wave of the virus and new restrictions in the winter, **Canada's economic growth is set to stall in the second quarter** in response to aggressive new constraints to arrest a third wave of cases. Thankfully, the hearty rebound at the turn of the year has taken real GDP to within 1.3% of pre-pandemic levels, with the remainder expected to be sopped up by year-end. Based on Statistics Canada's strong flash estimate for March GDP (0.9% m/m), we have upped our Q1 growth call to 6.5% annualized. That's actually a little better than the U.S. rate, despite stricter restrictions in Canada and massive stimulus payments in the U.S., a testament to the economy's ability to partly adapt to the pandemic.

- The same forces pushing the U.S. economy faster—massive fiscal stimulus, pent-up demand, hefty household savings—are **set to drive Canadian GDP skyward in the second half** of the year. The recent federal budget announced another $101 billion of new spending over three years, half of which will hit this year, amounting to 2% of GDP. Meantime, the **housing boom** south of the border (despite rivaling that of the 2006 bubble) is mild compared with Canada, where benchmark home prices rocketed 20% y/y in March and many rural areas are seeing gains of over 30% (and don't even talk about cottage country). Record sales have easily soaked up record listings. How much longer the buying frenzy will (or can) last is anyone's guess. Policy proposals to date (including, a tax on vacant property held by nonresidents and a higher qualifying rate on uninsured mortgages) will have only a modest impact. Eventually, eroding affordability should start clamping down on demand. We do not expect a pullback in house prices, but this assumes the market will cool to more sustainable rates soon; otherwise a correction would be inevitable. Barring a housing downturn or more pandemic trouble, **Canada's GDP is expected to grow 6.0% in 2021 and 4.5% in 2022**, a healthy rebound from last year's 5.4% contraction.

- A **fierce rally in commodity prices is also helping the economy**, likely turning the Q1 current account into surplus for the first time since 2008. While oil prices appear to have steadied near pre-virus levels and close to long-term norms in real terms, that's not the case for most of the other key resources that Canada sells abroad. The Bank of Canada's ex-energy commodity price index has shot up nearly 30% in the past six months to all-time highs. This, along with a recent hawkish turn by the central bank, has pumped the **Canadian dollar** to more than three-year highs above 81 cents US (below C$1.23). The loonie is the top-performing currency this year (not counting the crypto kind). Resource prices are expected to ease moderately as more supply comes online and as consumer spending is diverted toward the service sector. Still, prices should remain supportive, and with the BoC likely to raise rates before the Fed, the loonie looks to have found a higher flight path. **We see it cruising to 83.3 cents at year-end and to 85.1 cents (C$1.175) by late 2022**.
- The **Bank of Canada** recently announced it would start reducing the pace of government bond purchases to $3 billion per week from $4 billion. This wasn't a surprise, but attributing the taper solely to a sharply upgraded economic outlook was (as opposed to concern that the Bank already owns more than 40% of federal supply). The Bank now believes the economy's slack could be absorbed in the second half of 2022 rather than in 2023. Accordingly, we pulled forward the timing of rate liftoff by several months to early 2023. Like the Fed, the Bank is willing to tolerate some upward drift in inflation, as its 1%-to-3% target range affords some flexibility. We see the Bank's three core measures of inflation, currently averaging a tick below 2%, trending modestly higher next year. But, as in the U.S., the risks appear to be all on the upside.

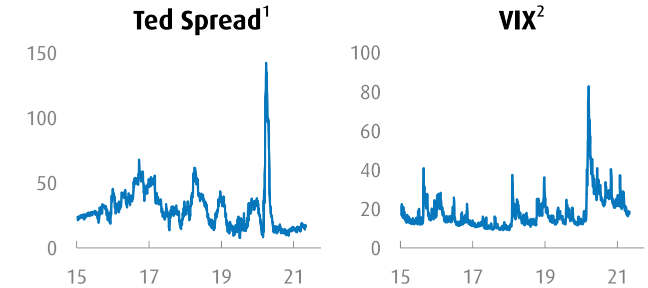
Forecasts

		2021				2022				Annual		
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2020	2021	2022
CANADA												
Real GDP	(q/q % chng : a.r.)	6.5	0.0	9.0	6.0	5.0	3.0	2.5	2.5	-5.4	6.0	4.5
Consumer Spending		0.6	-2.6	10.4	5.5	6.3	3.6	2.6	2.8	-6.1	3.4	4.9
Business Investment (non-res.)		4.2	2.7	11.4	13.0	11.2	6.6	5.4	5.0	-13.1	2.2	9.0
Consumer Price Index	(y/y % chng)	1.4	2.7	2.7	2.6	2.5	2.7	2.5	2.4	0.7	2.4	2.5
Unemployment Rate	(percent)	8.4	8.3	7.0	6.5	6.4	6.1	5.8	5.6	9.6	7.5	6.0
Housing Starts	(000s : a.r.)	308	225	245	223	223	228	227	223	219	250	225
Current Account Balance	($blns : a.r.)	15.7	10.7	4.9	0.8	-4.2	-9.8	-15.8	-22.4	-42.7	8.0	-13.0
Interest Rates		(average for the quarter : %)										
Overnight Rate		0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.25	0.25
3-month Treasury Bill		0.08	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.44	0.10	0.10
10-year Bond		1.32	1.55	1.55	1.60	1.65	1.70	1.75	1.85	0.89	1.50	1.75
Canada-U.S. Interest Rate Spreads		(average for the quarter : bps)										
90-day		3	4	0	0	0	0	0	0	7	2	0
10-year		0	-8	-13	-14	-15	-15	-15	-15	0	-9	-15
UNITED STATES												
Real GDP	(q/q % chng : a.r.)	6.4	8.5	7.5	4.5	3.8	3.1	2.6	2.3	-3.5	6.5	4.3
Consumer Spending		10.7	8.4	7.5	4.4	4.2	3.6	2.9	2.6	-3.9	7.6	4.5
Business Investment (non-res.)		9.9	9.5	8.9	6.2	5.5	3.2	2.5	2.4	-4.0	8.7	5.3
Consumer Price Index	(y/y % chng)	1.9	3.6	3.2	3.2	3.0	2.8	2.7	2.6	1.2	3.0	2.8
Unemployment Rate	(percent)	6.2	5.5	4.8	4.4	4.1	3.8	3.7	3.5	8.1	5.2	3.8
Housing Starts	(mlns : a.r.)	1.61	1.68	1.66	1.67	1.67	1.68	1.69	1.70	1.40	1.65	1.69
Current Account Balance	($blns : a.r.)	-800	-879	-923	-958	-969	-983	-996	-1014	-647	-890	-990
Interest Rates		(average for the quarter : %)										
Fed Funds Target Rate		0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.38	0.13	0.13
3-month Treasury Bill		0.05	0.05	0.10	0.10	0.10	0.10	0.10	0.10	0.37	0.05	0.10
10-year Note		1.32	1.65	1.70	1.75	1.80	1.85	1.90	2.00	0.89	1.60	1.90
EXCHANGE RATES		(average for the quarter)										
US¢/C$		79.0	81.1	82.3	83.1	83.6	84.1	84.5	85.0	74.6	81.4	84.3
C$/US$		1.27	1.23	1.22	1.20	1.20	1.19	1.18	1.18	1.34	1.23	1.19
¥/US$		106	110	109	106	105	104	104	103	107	108	104
US$/Euro		1.21	1.20	1.19	1.18	1.18	1.19	1.19	1.20	1.14	1.19	1.19
US$/£		1.38	1.39	1.40	1.41	1.41	1.41	1.42	1.42	1.28	1.39	1.42

Blocked areas mark BMO Capital Markets forecasts

Chart 1
Risk Aversion Abates

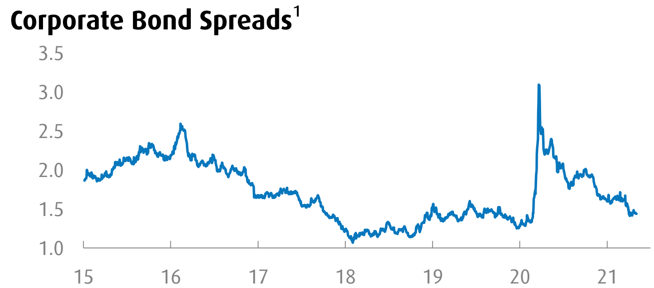
United States (as of May 3, 2021)



[1] 3-mnth Eurodollar minus 3-mnth T-bills (bps); [2] CBOE market volatility index
Sources: BMO Economics, Haver Analytics

Chart 2
Credit Spreads Continue to Narrow

United States (ppts : as of May 3, 2021)



[1] 15-year BoA Merrill Lynch AA Corporate Yield less 10-year Treasury Yield
Sources: BMO Economics, Haver Analytics

Chart 3
Equities Probe New Peaks

(indices : as of May 3, 2021)

Sources: BMO Economics, Haver Analytics

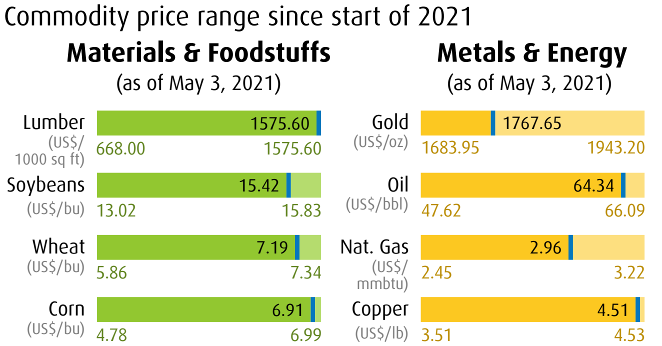
Chart 4
Loonie Firming

(US¢ : as of May 3, 2021)

Sources: BMO Economics, Haver Analytics

Chart 5
Commodities Pricier

Commodity price range since start of 2021



Sources: BMO Economics, Haver Analytics   Line indicates current value

Chart 6
Oil Extends Rally

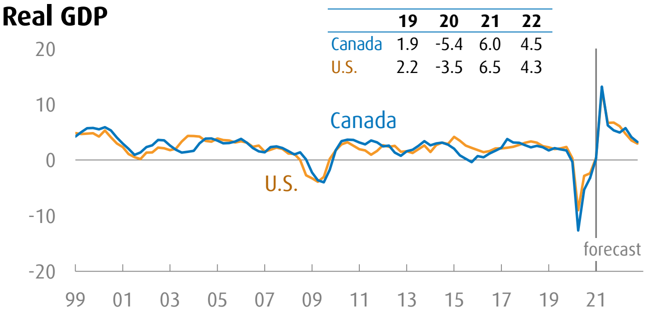
(US$/bbl : as of May 3, 2021)

Sources: BMO Economics, Haver Analytics

Chart 7
Better Year Ahead

(y/y % chng)

Real GDP

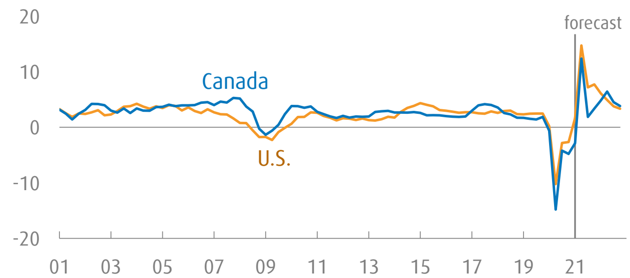


Sources: BMO Economics, Haver Analytics

Chart 8
Consumers Lead Recovery

(y/y % chng)

Real Personal Consumption Expenditures

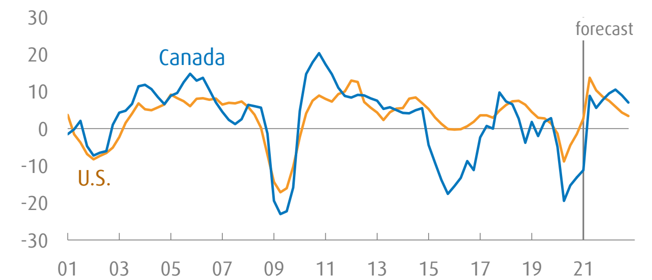


Sources: BMO Economics, Haver Analytics

Chart 9
Business Catching Up

(y/y % chng)

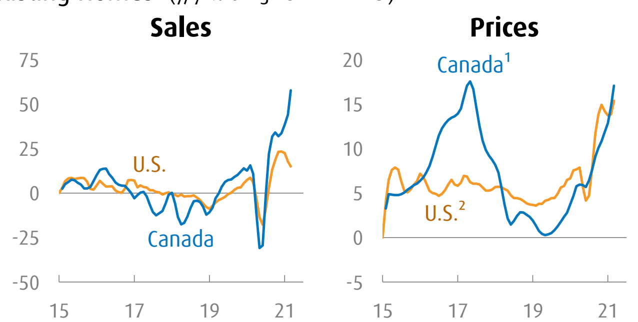
Real Non-Residential Business Investment



Sources: BMO Economics, Haver Analytics

Chart 10
Housing is Heated

Existing Homes (y/y % chng : 3-mnth m.a.)

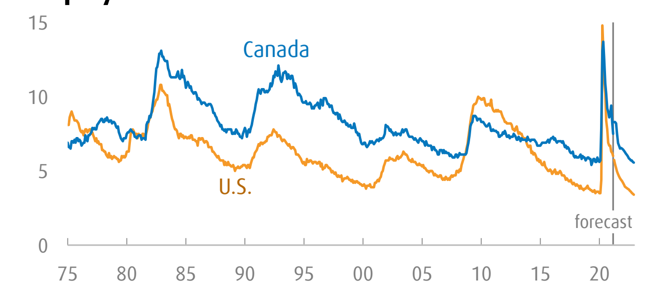


Sources: BMO Economics, Haver Analytics [1] MLS HPI; [2] NAR Median Sales Price

Chart 11
Jobless Rate Easing But Still Elevated

(percent)

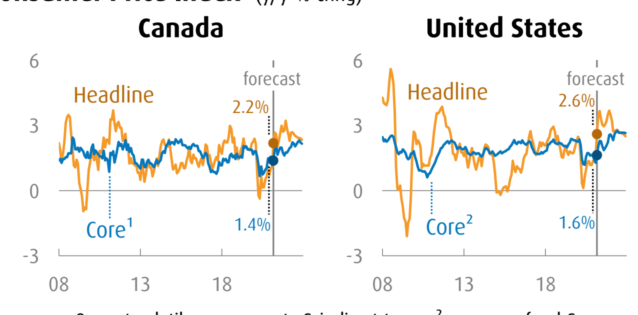
Unemployment Rate



Sources: BMO Economics, Haver Analytics

Chart 12
Inflation Simmering

Consumer Price Index (y/y % chng)

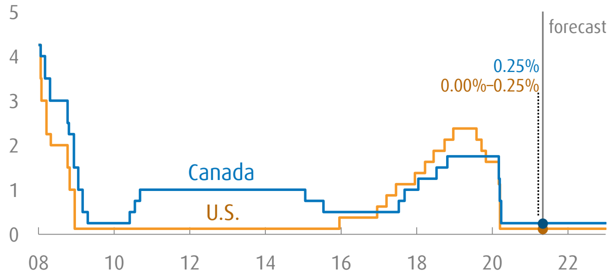


[1] core = ex 8 most volatile components & indirect taxes; [2] core = ex food & energy
Sources: BMO Economics, Haver Analytics

Chart 13
Policy Rates Going Nowhere Fast

(% : as of : May 3, 2021)

Overnight Rate

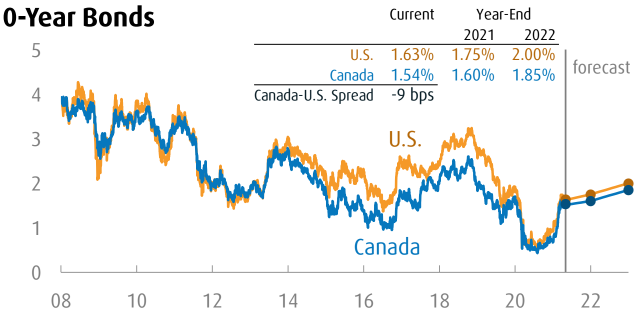


Sources: BMO Economics, Haver Analytics

Chart 14
Treasury Sell-off Should Slow

(% : as of May 3, 2021)

10-Year Bonds



Sources: BMO Economics, Haver Analytics

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