



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 Rochweg
(416) 594-7355
taylor.rochweg@cibc.com

<http://economics.cibccm.com>

In Focus

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Coronavirus, Oil and the 2020 Recession: FAQs

by Avery Shenfeld and Benjamin Tal

What are you assuming about the pandemic?

The short answer of course is that we don't know. The number of cases in the US will rise dramatically in the coming weeks as more testing is done, and Canada might be only a bit behind. If taken seriously, social distancing measures that shut down most group activities (schools, entertainment, business meetings), and more working from home might start to flatten the curve of the virus, decelerating but not ending its growth by Q3, judging from what we've seen in South Korea. That might allow for less extreme curtailments of activities by Q4, particularly if there's some success in using anti-virals in reducing morbidity or mortality. But many epidemiologists believe that, with the yet-to-be infected population still without immunity, we'll be living with an ongoing epidemic to some degree, and therefore not a full rebound in all types of activity, until a vaccine can be deployed, which is at least a year out.

Let's get to the point: are we likely on the brink of recession?

Unfortunately, yes. Hit by both the virus and oil markets, Canada and the US are likely to join a growing list of countries facing an economic contraction. We expect to see output dropping in both the second and third quarters in the US and Canada. For the US, the second quarter could be the worst, while in Canada, reductions in activity seem to be a few weeks behind, and we might

end up with a weaker Q3. We're bracing ourselves for annualized declines in the 3% range for Canada in each of the next two quarters. Output for the year as a whole will show no growth in 2020, even with a Q4 rebound, with the US, less tied to oil, only slightly better.

Stern measures—school closures, cancelled events, and so on—will be needed to slow the contagion rate to keep the US and Canada from looking like Italy or Wuhan in the months ahead. Those economies ended up nearly fully shuttered. But even milder forms of social distancing than we needed in those severe hot spots have economic consequences. About a quarter of Canadian consumer spending is in discretionary goods and services that will be pared back if we hunker down in our homes. Stretching out the period in which the disease spreads, while essential in preventing an overrun medical system, lengthens the period in which the economy feels a bite.

Where are these declines going to show up?

Just about everywhere, other than in household essentials, emergency services, and of course, medical services. Exports will be hit by recessions in our trading partners, soft commodities prices, and supply disruptions due to shutdowns abroad. Capital spending will decline as businesses cut costs and reassess capacity needs in everything from airlines to energy. Consumer spending will be disrupted as we hunker

down at home, with a further drag as layoffs take hold. Other companies will see lost hours due to illness and quarantines.

How does this compare to past pandemics?

Our projections are subtracting about 1½% from this year's pre-virus forecast pace, which is still at the moderate end of what economists who have studied past episodes, or modelled their impacts, would suggest. It could, therefore, be worse. SARS didn't send Canada into recession, but it was so severe that those afflicted were quickly in the hospital, and a much narrower contagion was then mostly an issue for health care workers rather than the broad public.

Should we expect to see supply chain disruptions forcing plant closures?

Global trade was in recessionary territory last year, in part due to the US-China trade dispute. Now add a further demand shock and supply chain disruptions for the next couple of quarters.

Some 60% of China's exports to the world are intermediate goods used as inputs by foreign businesses; in South Korea the figure is well over 90%—mostly in electronics. In turn, one fifth of US imports are intermediate goods. The figure in Canada is just under 25%, with industries such as textile, computers/electronics and wood products being heavy users of Chinese intermediate goods.

Disruptions to that chain still lie ahead, as North American companies stocked up ahead of the Lunar New Year break in China, but production restarts there were seriously delayed. Don't rule out Canadian plants running short of US made parts if factories stateside have to quarantine workers.

Longer term, companies might reassess their geographic concentration of suppliers in the wake of lessons learned here, reducing globalization somewhat.

How Big is the Economic Shock from oil prices?

It's worth about a half percent off GDP growth over the coming four quarters, or perhaps a bit less. That's not as severe as we saw from 2014 to 2015 for two reasons. The prior slide started from \$100/bbl oil. Second, as of 2014, energy sector capital spending was more than 3.5% of GDP. We're starting from less than half of that now, so a similar percentage pull back in capital spending won't hit

the national economy as hard. Still, in the oil producing provinces, it's a major setback for output, employment and government revenues.

When would you expect to see a recovery begin, and what will drive that turn?

It's mostly a matter of epidemiology, not economics. Fiscal and monetary stimulus will cushion the downside and protect debtors and leave more spending power to fuel a recovery when it starts. But Canadians won't really be out shopping again, and business confidence won't roar back, until we have the virus under control, a better treatment, or a vaccine. So, our assumption that growth resumes in Q4 is therefore just that, an assumption about progress on some of those fronts here and in export markets abroad.

Unemployment in Canada has been near historical lows. How high will it get in the coming months?

Judging by past recessions, even a short downturn can be associated with a fairly steep run up. For now, we're assuming a peak rate of about 7%, up about 1½% points from where we started. A similar climb will take the US jobless rate to 5%.

The Bank of Canada and the Fed have both cut their overnight interest rate benchmarks. How much further will they go?

There's no reason to hold back. This is a rare case where the cause of the shock is fully visible even before it has shown up in the data. With little room to cut, it's important to deliver the cuts you can do in a hurry. So, Canada will get to 0.25% (another 100 bps in total) by no later than June, and the US will also cut a further 100 bps over the same period.

Are negative interest rates or quantitative easing possibilities in Canada?

Governor Poloz has reiterated that, in theory, rates could go as low as -0.5%. But the experience elsewhere suggests negative rates can do more harm than good. A greater fiscal stimulus effort makes more sense if the recession deepens beyond our call. Conventional QE (buying longer Government of Canada bonds) won't do much good given how low those yields already are, but the Bank of Canada could explore other options (some of which might require legislation) to aid other parts of the debt market.

Will lower rates fuel the fire of what had been a strongly rebounding Canadian housing market?

While in the short term, the next few weeks, we might see increased demand due to low rates, soon enough, given our recession call, weaker confidence and greater job insecurity will offset the affordability factor. Accordingly, we expect those two forces to cancel each other out, and see very little change in housing market activity in the coming 2-3 quarters.

What sort of fiscal measures do you expect to see in Canada?

Fiscal stimulus has much more room to lend a helping hand than monetary policy, given the limited room for rate cuts at the start of this downturn. There are automatic stabilizers as more Canadians qualify for employment benefits (with a shorter waiting period), and Ottawa could take further steps to shore up incomes. Those funds might not all get immediately spent, but will help accelerate the recovery once Canadians come out of their virus hibernation. Other steps might include supporting provinces hard hit by either health care costs or job losses, and perhaps measures aimed at reducing business insolvencies in sectors seeing deep, but temporary disruptions. We'll need sums in the tens of billions to be material to Canada's growth rate.

Is this a Buying Opportunity in Stocks?

The past weeks have not been a false alarm. The market is in a process of pricing-in a global recession. For a good reason. While the process is not over yet, if the virus has dealt its worst blow by the third quarter, markets might then look ahead to an economic recovery of some sort in 2021. That could leave room for equity markets to reassess beaten down sectors.

But in the meantime, in addition to taking earnings estimates down, investors need to pay attention to balance sheets, and look for companies with manageable debt loads that can live through a considerable slow patch and emerge in what we hope will be a brighter light next year.

Where will this take the Canadian dollar?

We were already looking for a weaker Canadian dollar over the next two years. That was based on the poor longer term performance of the country's non-energy exports, and the need to have a more competitive exchange rate to allow exports to take some of the burden off housing and consumers in driving growth. Canada's stubborn trade and current account deficit would in the medium term have pushed the currency gradually weaker. Instead, with the dive in oil prices, we took a big step towards our targets in a hurry. A recovery in oil prices next year would lend support, but we still see dollar Canada above the 1.40 level come 2021.

What are you monitoring to see if you need to project a longer or deeper recession?

We would get more worried if China and Korea see a re-acceleration in caseloads as they take decisions that ease up on restrictions on people and business. That would suggest that stern measures will need to be in place for longer, and we'll be worried about the next year's hockey season and next year's economy.

Any rays of sunshine you are looking for to go the other way?

The first results from some drug field trials are expected in April. While anti-virals sometimes only shorten the course of the disease or not work at all, in the case of the AIDS virus (albeit not a close cousin of this one) we turned a fatal disease into a treatable condition.

ECONOMIC UPDATE

CANADA	19Q3A	19Q4A	20Q1F	20Q2F	20Q3F	20Q4F	21Q1F	21Q2F	2019F	2020F	2021F
Real GDP Growth (AR)	1.1	0.3	0.9	-3.0	-3.4	4.9	2.9	2.4	1.6	0.0	1.8
Real Final Domestic Demand (AR)	3.1	0.7	1.7	-1.3	-2.1	3.9	2.5	2.2	1.2	0.7	1.8
Household Consumption (AR)	2.0	2.0	1.6	0.2	-0.6	4.2	2.0	2.1	1.6	1.2	1.9
All Items CPI Inflation (Y/Y)	1.9	2.1	2.0	1.0	1.3	1.6	1.6	1.6	1.9	1.5	2.2
Unemployment Rate (%)	5.6	5.7	5.7	6.4	7.4	7.2	7.2	7.2	5.7	6.7	6.4
U.S.	19Q3A	19Q4A	20Q1F	20Q2F	20Q3F	20Q4F	21Q1F	21Q2F	2019A	2020F	2021F
Real GDP Growth (AR)	2.1	2.1	1.4	-3.2	-2.8	3.2	4.1	3.8	2.3	0.3	2.2
Real Final Sales (AR)	2.1	3.1	1.3	-2.7	-2.3	1.6	4.1	3.0	2.2	0.7	1.9
All Items CPI Inflation (Y/Y)	1.8	2.0	2.2	1.4	1.7	1.9	2.4	2.8	1.8	1.8	2.7
Core CPI Inflation (Y/Y)	2.3	2.3	2.3	2.2	2.0	2.1	2.1	2.3	2.2	2.2	2.3
Unemployment Rate (%)	3.6	3.5	3.6	4.1	5.0	5.0	4.9	4.8	3.7	4.4	4.8

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