*[title graphic: CIBC Q2 2023 economic outlook]*

Bob Frentzel:

*[graphic: Bob Frentzel, Co-Head and President, CIBC US Commercial Banking]*

Hello everyone. I'm Bob Frentzel, Co-Head and President of US Commercial Banking for CIBC. Welcome to our second quarter economic outlook discussion. I'm pleased you have chosen to join us as we tackle topics relevant to your business. We have the first quarter to reflect on, today's challenges to consider and the months ahead to plan for. Whether you are facing a decision about financing, supply chain issues, expansion, or just trying to forecast for your company, there's a lot to process! To get us started, we're thrilled to have CIBC Chief Economist Avery Shenfeld speaking to us today. After Avery spends some time recapping and analyzing the business environment, we will be joined by two of our commercial banking relationship bankers, Alison Reinke and Stephanie Vlamis, for a Q&A session that will cover a variety of questions that our clients are asking right now.

Before Avery begins, I want to take a moment to address the recent stress in the banking industry. First, the Fed and the Treasury have done a very good job helping to stabilize the financial markets. Second, CIBC is a strong, well-capitalized bank with high levels of liquidity. We have a diversified business and a robust balance sheet. Third, and most importantly, the team has worked together for 25 years with a proven track record of helping our clients adapt to the market conditions. We remain steadfast in our support for you and are committed to working closely with you to help keep your ambitions on track. Now, let me turn it over to Avery to get us started.

Avery Shenfeld:

Good afternoon.

*[graphic: Avery Shenfeld, Chief Economist, CIBC Capital Markets – Has with CIBC since 1993 – Winner of the Dow Jones Market Watch forecasting award – Awarded for forecast accuracy on the US and Canadian economies by Bloomberg Markets – Ranked as one of the top Canadian economists by "Institutional Investor"]*

I'm happy to be here with CBC's Commercial Banking clients to talk about where we're headed in the US economy. It's obviously a bit of a topsy-turvy world right now, and it's not one without risks. In fact, if you ever go to the gym and your trainer tells you no pain, no gain, that's the message that we have in terms of bringing inflation down. It takes some economic pain in order to get inflation back in the bottle and down to the 2% level that the Federal Reserve wants to see by next year. But what's encouraging is that we're making some significant progress on inflation before we've even seen that much of a slowing in the economy. And that really owes to the fact that if we look at the US economy today, it's not really that overheated relative to where it was in 2019.

The unemployment rate hasn't really been materially lower than it was in 2019. So, a lot of the inflation we've seen was the result of the war in Europe, the supply chain shocks that emanated from the pandemic, and some of those factors are cooling and bringing inflation down. Now, it's still true that from the Federal Reserve's perspective, core inflation measures, measures that strip out things like gasoline prices are still too hot. And the labor market is still too tight so that wages are rising a bit too quickly relative to what we'll need to see to get inflation all the way back to 2%. So, some slowing in the economy is in order. And in fact, our view is that over the balance of this year, we really won't see any material economic growth. The economy will be hovering between growth and recession, but likely not seeing a full-blown recession, because it doesn't appear that that's what's actually necessary to get inflation back down to 2%.

As I said, we've already seen some good progress on that front. It does appear that wage rates are cooling a little bit. Workers are becoming more available, not necessarily because the unemployment rate has moved up, but because more Americans are back participating in the workforce again. Particularly for those under 55, we see a full return to labor force participation. So, these are all encouraging signs that relative to what we went through in the early '80s or the early '90s, the last couple of times inflation was running well above where the central bank wanted to see it, we're not going to have to see nearly that sort of economic pain to get it down the rest of the way.

What it does mean however, is that the Federal Reserve is still looking for a bit of a stall in growth and a rise in unemployment to be satisfied that not only will inflation come down this year, but stay down in 2024. And that means that they're unlikely to provide any relief from the interest rate pressure that they've been imposing on the economy over the last year or so. In fact, the Federal Reserve is still considering whether they need to bump up rates another quarter of a percent and watching very carefully to see how the banking system performs in order to judge whether that's necessary. But financial markets are looking for some interest rate relief. We've seen bond yields come down anticipating that the Federal Reserve might cut interest rates this year. And from CBC's perspective, that's probably a bit of wishful thinking on the financial market's part.

As I said, the slogan at the gym is, "When you're trying to build muscle mass, it's a case of no pain, no gain." And to bring inflation down, we first need to go through a few quarters of negligible economic growth, see an upward tilt in the unemployment rate before the Federal Reserve is going to give the economy some interest rate relief. I do think that that's coming, but it will be a 2024 story after we've gone through this slowing period and after we've seen inflation come down more materially than it has so far. For different sectors of the economy, this is going to be a different sort of environment. We do expect to see some pressure on commercial real estate. We do expect to see the housing market decelerate in the face of high mortgage rates. And we expect some very cyclical parts of the economy, particularly discretionary goods spending that was very heated during much of the pandemic, continue to slow.

But there'll likely still be some pockets of growth. Alternative energy as a case in point, lots of government money going to support that sector. But even consumer services, people traveling and so on, I think we're still seeing a bit of relief from the pandemic there in that sector and still more headroom for consumers to spend a little bit on services as they pair back some of the goods consumption. The reward will for all of this pain will come in 2024. We expect some substantial interest rate relief from the Federal Reserve next year. We expect to see the economy reaccelerate, at least in terms of quarterly growth rates over the course of 2024.

Once we put inflation behind us, there will be room to return to economic growth across the economy. But in the here and now, we are expecting a bit of a slowing ahead. And with that, I'm going to turn it back to a couple of our commercial bankers. And I'm bringing in Stephanie and Allison to join me in this conversation on what lies ahead for the US economy.

Allison Reinke:

Hey, Avery. Thank you so much for joining us today.

*[graphic: Allison Reinke,*

Stephanie Vlamis:

It's great to be here. Thanks, Avery. Avery, can you touch on how the geopolitical environment impacts some of the recent trends of onshoring and nearshoring?

Avery Shenfeld:

Some of this might have happened anyway in the sense that manufacturing in some sectors is getting much less labor-intensive. So, if your product is being made by robots, you don't really need to locate it in some far-flung country with low wages. And as well, the disruptions that we saw during the pandemic, I think reminded many businesses that having very far-flung supply chains with lots of individual suppliers all over the world is a risk for business disruption. So, those factors, I think would've already compelled some shuffling of where manufacturing took place. And now we do have geopolitical factors on top of that. So, certainly, in anything tied to defense or even chips, for example, where the government sees a security interest in having that close to home, or at least in friendly countries, we're seeing a bit of a shuffling.

And more broadly, some of the risks factors that we see in Europe from the war there have caused businesses to think about the safety, as well as the cost of their supply chains. Not all this will mean that goods are manufactured in the good old US of A, some of this is going to happen in neighboring countries, in Mexico, in Canada or close allies, and I think it is still far too soon to say they globalization is dead. There are still many products where we're going to continue to rely on very low wage countries abroad in order to hold costs down and produce products at a competitive price.

Allison Reinke:

Staying on that topic a little bit, can you touch on your take on some of the supply chain disruptions and where we are at in the moment with regards to that?

Avery Shenfeld:

The signposts are that things are getting a bit better. One thing you can look at is just the level of inventories relative to sales across the US economy or in retailing in particular. And those inventories are by and large getting back to normal levels. So, there are some exceptions. New vehicles are still in pretty short supply. If you go try to buy one, you're on a waiting list. So, it's going to take I think a fair while to catch up to demand in effect, because the vehicles can leave the dealer lot as fast as they get there, but they are improving. China's end of its lockdown is going to help that. Fewer hours lost due to COVID, even in the US, is helping. So, the untangling is happening, but it still has a ways to go.

Stephanie Vlamis:

So, Avery, with that, we do still have a lot of clients who are importing goods from overseas, particularly from China. So, how should they be thinking about their foreign exchange exposure right now?

Avery Shenfeld:

The US dollar has generally been strong in the last year or so. If you look at it relative to some of its major trading partners, either in Europe, for example, with the Euro or the UK and so on, the fact that the Federal Reserve was hiking rates more aggressively than most other central banks has helped support the US dollar by encouraging capital inflows. And I think as we look out over the next year and a half, once the Federal Reserve is done with those rate hikes, we may find that the dollar actually starts to slip against other major currencies. The US might end up having tightened more than some other countries, might also end up easing a bit earlier on interest rates than some of those other countries, which could see the US dollar begin to weaken. So, for importers buying things, certainly from places like Europe for example, it may pay to do some foreign exchange hedging now in order to protect against some downside for the US dollar.

Allison Reinke:

Thank you. Shifting gears a little bit. With everything going on in the banking industry right now, I'm wondering if you could touch on some of your expectations with regards to any new regulations that might come and how that might impact some of our borrowers access to capital.

Avery Shenfeld:

Well, fortunately, CIBC is a very well capitalized international bank, so we're not sitting ourselves in jeopardy of seeing what's happened to some of the other banks. But it is fair to say that some smaller regional banks have lost deposits. Money has shifted to larger money center banks or globally backed banks, and that will alter the borrowing landscape. There is a bit of an offset here, however. Prior to these banking issues emerging, the Federal Reserve was really on course for several rate hikes. In fact, it would've hiked rates by 50 basis points instead of the quarter point we recently saw, and would likely have carried on with a few more larger rate hikes.

So, the fact that the Federal Reserve has recognized that these banking sector developments will act as a tightening and monetary policy, it's decided that they are a substitutes for some additional rate hikes. So, I guess I could say that for our commercial banking clients, we would've felt pain one way in the form of perhaps more interest rate hikes ahead. We'll see less of that than we would've otherwise. But on the counter to that, money will be a little tighter in the banking system, and therefore perhaps a little tougher to get than would've been the case prior to these banking sector developments.

Stephanie Vlamis:

Thanks, Avery. To touch on that, and you mentioned this in your presentation, how the economy is cutting into a slower period, potentially a little bit of a recessionary environment. I know a lot of our clients, particularly on the asset-based lending side, do rely on their asset values for loan availability. So, how do you see this kind of environment impacting their asset values?

Avery Shenfeld:

I think it's very dependent on which sector, what the assets are, the quality and so on. So, when the economy slows, we will, for example, see some companies end up with more inventories perhaps than they had planned or would like, and they need to keep a close eye on that. There will be other sectors where asset values are marked down because profitability doesn't look as strong. So, again, that could cut into credit availability. And it just reminds businesses that this is a time in the business cycle where it pays to keep an eye on leverage, keep an eye on credit needs. Don't get too overextended as we come into this slowdown.

We at CIBC want to work with our clients to make sure that we not only get through this slowdown, but come out in healthy shape on the rebound. And our bankers are ready and willing to talk to clients about what they can do to really brace themselves for this slower period, keep their books in reasonable order through it and emerge on the other side as a winner in the US economy.

Allison Reinke:

Thank you. Touching on the interest rate environment that you had discussed in your presentation, can you talk on some of the tips you have for our clients to manage through some of this interest rate exposure?

Avery Shenfeld:

So, we are in a period where the Federal Reserve is unlikely to meet market expectations for rate cuts as early as the market is opening. So, in fact, if anything, term interest rates, which came down as markets started to bet that the Federal Reserve might cut interest rates a bit sooner, they could move back higher in the near term. So, be ready for that to some extent. But I do think it's true that if we can put our lens further out into 2024, once inflation is tamer, once we've gone through this slow patch, the Federal Reserve will be willing to provide some interest rate relief. So, lower term borrowing costs may well be available when we get into 2024, and businesses should be thinking about that as they make their plans in terms of the timing, interest rate hedging, and so on, to consider the prospects for rates to come up a little bit in the near term on term rates, but then later into 2024, perhaps be down again as the Federal Reserve actually starts cutting interest rates.

Stephanie Vlamis:

In your presentation, you touched a bit on some of the different industries that might feel the slowness, while some might remain somewhat strong. So, can you just elaborate on how this kind of slow period or potential recession would be different than ones we've seen in the past?

Avery Shenfeld:

Our hope is certainly that it'll be milder than some of the ones we've seen in the past. People's memories are from the recession that followed the great financial crisis, which wasn't so great for anybody. That was actually quite a severe recession. And of course, the very brief recession that we had when COVID first hit was an extremely deep downturn, albeit one that didn't last very long. If you look back, there are other periods where we've had a bit of a slow patch that didn't end up being a full-blown recession. I think that's closer to what we're thinking of here. So, that's the good news, that for the economy as a whole, we don't believe it's necessary for the Federal Reserve to do what it did in the early 1980s or even the early 1990s in terms of really beating up on the economy in order to get inflation down.

But that said, when the economy even stalls, when we even have a few quarters of say zero growth, that means that half of the economy is actually in a recession. And people who are listening know who they are. They know which sectors, whether they're in a sector that tends to get hit a lot when interest rates are higher. So, it's the interest sensitive sides to the economy, and it's the more cyclical sides of the economy that tend to feel the brunt of it. So, we have seen, for example, a steady slowing and housing starts. Construction is still very active because we're busy completing all the houses, and condos and apartment buildings we started six, eight months ago, but a slowing in the construction sector is coming there.

I think one of the sectors that maybe has a longer road back to health is the office sector. And that's really because this work from home is not going away. Even hybrid workers are still only putting in two, three days a week in the office. And as leases come due, companies are going to rethink how much space they need. So, this could take a while to unfold across the economy. It'll be different in different local markets, but there's certainly going to be a longer period there, I think, where owners of these buildings are going to struggle to find tenants and perhaps face lower rents as a result of that.

Allison Reinke:

Thank you, Avery. My last question is, a lot of my clients are focused on the M&A environment, and just wondering how you envision the remainder of 2023 playing out for M&A activity.

Avery Shenfeld:

There could actually be some interesting opportunities here. So, we're seeing it, for example, in the energy space where some of the big oil companies are shopping for some of the companies in the shale fields and so on. And I think that, if anything, a bit of a squeeze on access to capital for some businesses is what creates opportunities for businesses that have a lot of capital, have a lot of equity built up to actually buy assets on the cheap during an economic slowdown. Not necessarily getting a quick windfall on those assets, but rather positioning themselves for the next business expansion to follow in 2024 and beyond, where they'll have purchased assets at a reduced valuation and benefit from that.

So, I would certainly for well capitalized companies that have built up equity or a lot of retained earnings, this could actually be a very interesting shopping period in the M&A space. I think that's all the time we have for today. So, thank you, Allison and Stephanie for some great questions, and thanks to our clients for tuning in and listening. If you do have follow up questions, please feel free to reach out to your CIBC relationship manager. We'd like to help you think through these issues and how they affect your own businesses. Have a great day.

Bob Frentzel:

Well I first want to thank Avery and Stephanie and Allison for that insightful Q&A session. Appreciate all the work you did to prepare and to all of you that joined us today, I hope you found this insightful. And again, if you have any questions, don't ever hesitate to call your relationship bankers and those that you know at CIBC. Have a terrific day. Thank you.

[closing graphic: CIBC "Ambitions made real"]
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