Audio file

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Transcript

Hi, this is Beata Caranci with the Quarterly Economic Update.

Now this title will ring familiar with parents who've endured long road trips with the kiddos, and the question is usually followed by how much longer? You can't be faulted if you're starting to feel a little impatient on this very long economic road trip.

The share forecaster is calling for recession crossed 50% last August and that is marked the longest period in which a recession has been predicted but failed to show up. A number of banks, not us, had recession calls placed for the first quarter of this year and those calls have subsequently been bumped to the second quarter or later. So, when US regional bank failures took center stage, the most asked question from clients was whether this would finally produce that recession or offer no path to a soft landing.

So, I'm going to forego a discussion on the global outlook where our view hasn't changed from the last quarter and spend the time diving into the most relevant domestic issues. And part of that means that in order to answer the question on the timing of a recession, we have to first dive into labor market dynamics, which certainly don't leave an impression of an imminent doom. And then specifically for Canada, it has a unique complexity related to the population surge that is not just altering how we identify risks, but also the degree of slack in the labor market and even the end point on the neutral interest rate when we get to the other side of this business cycle.

Starting with the risk that the banking terminal has imparted to the credit cycle. This graph gives a snapshot of three key messages. First, so far there's not a signal of a broader systemic banking stress that risks the 2008 style hard landing. It's fair to say that markets have drawn comfort from the quick response by the Fed, FDIC and Treasury to reinstate liquidity facilities and deposit backstops. The S&P 500 is up about 7 to 8% this year. The Triple B corporate yield has eased by over 50 basis points in the last couple of months and this is reflected by our financial stress index that is returned to neutral levels.

Second, although this risk is unlikely to replicate a 2008 hard landing, it can certainly persist as a rolling risk over many months. Right now, regional banks are being questioned on liquidity and investor confidence, but that can broaden into lending and credit risks if unemployment rate rises more than expected. So, it's not surprising that some are drawing parallels to the late two late 1980s savings and loan crisis. Clearly, we're in a different economic and regulatory environment, which limits direct comparisons. However, the parallel relates to smaller sized institutions and the slow burn nature that can follow a crisis moment.

And, then the third takeaway is that given regional banks punch above their weight in lending, particularly on business lending, any resulting tightening and lending standards will hit business investment the hardest. And our updated baseline forecast will reflect that outcome, but not solely because of recent events. This train was already pulling out of the station long before regional bank issues. It's going to be difficult to distinguish how much credit tightening will be related to the banking crisis versus the natural course of events that comes with a high interest rate environment, which automatically impacts risk tolerance, bank funding costs and collateral values. And there's measurement uncertainty related to markets having lessened their policy expectations in place of an expectation of tighter credit conditions. Between March and today, there has been an 80 to 90 basis point reduction in market expectations of where the policy will be by the end of 2023.

Meanwhile, the Feds measurement of credit conditions has flatlined. This is shown by the black dash line on the right, where they proxy financial conditions beyond just the policy rate to include public and private borrowing rates and spreads. It shows that conditions have leveled off, neither tightening since the banking turmoil, nor loosening as markets withdraw rate hike expectations. So adding up all the cross currents were landing in the same spot with credit conditions today, then, if no crisis had occurred. In terms of market expectations for the policy rate, you can see on the left that we have a substantial gap to those expectations cutting as early as September after hiking in May is a very short time period historically for the Central Bank to make a U-turn absent convincing data that we are headed for a very hard landing. And that benchmark is hard to achieve with today's starting point on inflation being double the Fed’s target. And with job demand still outpacing available workers.

Although we can't precisely measure the cross currents of policy expectations and the impact on banking conditions, the federal senior Loans Officer survey did show that 46% of lenders reported tightening standards for commercial industrial loans in the past quarter. This green line shows the feedback already taking place on equipment investment with a lag. Tightening lending standards also typically temper hiring and that leg is about six months, so a couple more points here. Credit conditions have not reached peak levels of previous recession cycles but are certainly trending unfavorably. Most estimates point to about a 40-basis point hit to economic growth from tighter lending conditions over a one-year period. Second, it's important to not describe lending as a single market. Long before any bank failures, credit conditions had already swiftly tightened on various commercial real estate loans. Unlike CNI, which is shown in this graph, over 60% of institutions have tightened lending conditions on CRE credit, which is actually mirroring the characteristics already of past recession cycles. The dynamics and correlations are compelling enough to warrant a downgrade to our investment expectations.

I mentioned earlier business behavior was already pulling in that direction under the higher cost of capital and economic uncertainties. Effectively what we've done is already taken a trajectory and added in more caution related to what we're seeing in terms of business lending conditions. Now for reference, our peak to trough forecast on investment is not of the depth of past recession cycles. So, it still fits a view of either a soft landing or shallow recession. One reason is related to the transportation sector. In 2001 and 2008 recessions showed two investment areas that tend to get hit the hardest on the down cycle. And these are transportation and industrial equipment. However, it's less likely in this environment that transportation will offer as much of an economic drag as past cycles given the persistent underinvestment in the sector. The retooling in response to electrical vehicles and the re onshoring movement related to geopolitical and climate transition pressures. Even so, you'll probably hear more people describe the weakness of this cycle as being business lead, which is reasonable given we already can see that the investment data is unfolding in that direction.

And then the other side of the narrative is the more limited leverage held by households relative to past cycles further supported by better starting points on savings and job demand. And the graph on the left shows that we are not getting an indication that consumers have capitulated to high interest rates. The first quarter produced nearly 4% growth in consumer spending. Now a lot of that momentum occurred early in the quarter it made us wonder if consumers had put away their wallets. But then here we are again April, we see another big pop and spending. So, this sharp up and down pattern has become par for the course these days. It's more common to have months of huge spends followed by withdrawal and subsequent months, and then you know hit the repeat button on the pattern. The moral of the story is that we must exhibit caution and having a knee jerk reaction when a weak month is reported in the statistics.

Now the graph on the right captures the source of the surprise in consumer behaviors, which is their persistence to spend on goods products. It is not normalized back to trend after a big deviation during the pandemic. So, this is where we tend to be underestimating the momentum. Now going to drop-in service. Ending and this has been slow to return to trim, but again this has been expected because you can't get back lost haircuts and vacations. So that real surprise continues to be unwillingness of to spend on goods and part of that is reflected in things like car purchases as supply increases where we know there's still pent-up demand. But also, their spending patterns in areas like recreation products which would include TV's which were readily available during the pandemic. At the heart of this resilience is still the theme of excess savings. Which should be whittled away by the end of the year, but there's a new twist coming into focus.

Stronger labor income growth has come back into scope, and it's actually now outpacing inflation. In other words, household purchasing power is improving, so the graph on the right is showing how real incomes have performed in the months leading up to recessions, reflected by t = 0 as the start of past recessions. So, during the period when people were facing a loss of purchasing power within their income, excess savings and increased credit usage bridged that gap and that seems to have bought them enough time for now for them to catch up and exceed inflation growth. This is happening against a backdrop where demand is starting to slowly feed back into the housing market. US existing home sales appear to have found a bottom, and that's helping to stabilize prices shown by the three month change in the green dash line. Now, but we're either at or near a peak in the policy rates, the movement in mortgage rates are not one directional. Home demand is exhibiting a pattern of increased sensitivity to changes in price, whether it's in the home price itself or the lending rate. For instance, a 1% pullback in the 30-year mortgage rate between early November and February was followed by a double digit rebound in sales in February, then an upswing in the mortgage rates that month led to a subsequent decline in activity.

So, a bottom of the market means that we can still expect the market to move sideways due to poor affordability, but there's a low likelihood that we'll see another big step down in activity or prices absence a shock to unemployment. Particularly because it's pretty slim pickings for home buyers on the supply side of the existing home. Now the graph on the right shows that this translates into less drag to GDP from this segment of the economy because the starting position is already low and marking conditions are not necessarily worsening. All this feeds into the notion that a hard landing on the consumer side can be avoided, provided unemployment doesn't go into a tailspin, naturally leading to the question what are we seeing on this front?

These two graphs are among the growing evidence that the labor market is cooling, but it likely feels like the Tim Conway of Job markets for the Carol Burnett fans out there, it's shuffling ever so slowly to the exit door, and it could be a while before it gets there. The number of people filing for unemployment insurance is rising and is above levels that were existing pre-crisis. But we're not seeing a parallel shift in continuing claims suggesting that people are likely succeeding in becoming quickly reemployed. On the right, the share firms hiring has definitely come down, but from stratospheric levels to merely normalized territory, it's certainly not signaling recession.

And where I've just dropped in those red lines, these are the benchmarks of the indicators that tend to occur six months prior to a recession. So, it definitely reinforces that we're still a long way off from that mark. Here too, we can see that job openings are trending down, but are a long way from pre-crisis levels represented by the 100-level dashed line. Just to show how distinctive cycle is job openings have fallen by two and a half million from last year's highs, but the unemployment rate drifted lower. This is completely counter to the beverage curve, which is a long held inverse relationship between job openings and the unemployment rate.

Now this graph on the right was included to decipher if sectors still bearing the brunt of the pandemic are distorting the degree of employer demand for workers. So, we isolated the hospitality, education and healthcare sectors. Doing so shows that they have inflated the overall metric, but there's still quite a bit of excess demand for workers outside of those sectors. Remember, we're just trying to see how long it takes to get to that 100 level, which is the 2019 level, which also was not a recession, we're just trying to get to a normalized environment.

Now this doesn't mean the job market has disconnected from the interest rate cycle. It's a reminder of the slow-moving dynamics and why I'm suspicious of the markets timing on the first rate cut in the September October period, if we haven't even yet seen the first step up in unemployment. So, to return to the question of whether banking terminal has created imminent recession risks, the answer is probably no. And the Fed is going to have its eye firmly on inflation, which has not been cooperating.

Now I showed this graph last quarter with a focus on the three-month trend for the near-term direction, even though the Fed targets the annual rate shown by the 12-month change in this graph. The trend has not been moving in the right direction. Relative to last quarter, it is actually firm, so without progress here and without material weakness in the job market, it would suggest the earliest timing on cuts would be in the first quarter of 2024 provided both metrics show some give by then. Now just as a reminder, because the Fed is starting with the policy rate in excess of 5%, as inflation edges down, the real rate will become increasingly restrictive on the economy. That's the dynamic that opens the window for cuts, but it doesn't argue for a fast reversal unless inflation is really collapsing. And of course, if it's doing that, then we probably have a worse economic outlook on our hands.

I debated including this not knowing what will come of it with each passing day. Last quarter, I mentioned that debt ceiling risks would be on our radar by the summer as the ex-state became known and it came a bit earlier with Janet Yellen identifying June due to tax shortfalls. The timing of the risk has changed, but not the assessment of that risk. It's impossible to judge what an actual default means for the US, particularly in not knowing the duration and scope, but it's universally accepted that it would inject significant turmoil in financial markets and push recession odds to 100%, along with creating longer term ramifications with US Treasury is potentially reflecting a higher risk premium and no doubt creating many discussions across the globe over the safety of U.S. Treasuries.

Now the best-case scenario is that an agreement is reached before the 11th hour to either raise or suspend the debt limit into 2024 or later. The financial and economic implications would be benign in that scenario. The second-best scenario is that they buy time for negotiations by suspending the debt limit until late summer/fall when the regular budget appropriation process occurs. While financial markets would prefer definitive near-term solution, averting an immediate crisis would put jitters at rest for the time being. Perhaps the most likely scenario and bigger concern is that we approach the 11th hour with no deal, and this injects significant market volatility with one and a half to 2 standard deviation moves and possibly more. The natural response would be to say, oh well, that will force a deal and everything will settle back down. Maybe, but this cycle already embeds a high degree of financial sensitivity, and we can't take anything for granted, not knowing where the breaking point may actually be. We can already see markets expressing dissatisfaction even though they're still over a week of grace period.

OK, so let's switch to Canada. The GDP growth profiles between the two countries are not significantly different, shown by the black dots. And I'm just going to pop in right now. It's important to note that the impact of the Alberta wildfires are not reflected here for Canada. There will be volatility injected into the quarterly pattern, but it may not influence the actual annual figures. It's estimated that about 2 to 4% of oil and gas production is being disrupted, and when that's happened in the past with Slave Lake or Fort Mac, it takes about 20 to 60 basis points off GDP in that period but then GDP pops back up in the subsequent months as production ramps up.

Now in terms of the composition of growth between the two countries, it does bear differences for 2024, even though 2023 looks strikingly similar, and I think where we really get some deviation is on the government side and the contribution to growth in Canada being so much greater. And that came out of what we saw in the federal and provincial budgets this year. We've applied a more moderate view on Canadian consumption due to the higher leverage not due to worse job and income fundamentals relative to the US. In fact, arguably those fundamentals are stronger in Canada, but doesn't solve for the fact that households are going to be facing more income pressure and supporting loan payments that causes some substitution away from consumption. As an example, Canadians will have to dedicate more than five percentage points more of their after-tax income to supporting debt payments relative to their American counterparts. However, if I'm hazarding a guess on where we could get it wrong in the forecast, this is probably it.

Consumption can prove more resilient given the backdrop on labor, Government supports, still high savings and the fact that households have coped so far pretty well with the higher interest rate environment by smoothing out the payment shock with longer amortizations. So, let's dig into some of these items. While US political parties come to blows on spending, that's clearly not an issue for Canada. Across the country, governments benefited from unexpected revenue windfalls relative to last year's expectation. And likewise, they're spending profiles have risen, and I'm showing you here budget to budget season, but even the short time period between the fall economic statements and the budget period, there was an additional 25 billion added in spending measures or about 1% of GDP. So, this will be a counter influence on any weakening and Growth Dynamics elsewhere in the economy, and it's little wonder that government spending is one of the biggest contributors to our 2024 GDP growth outlook. Budgets had a heavy focus on healthcare and climate transition initiatives, which arguably are necessary, though we could certainly debate the amounts they were still so-called inflation relief measures that ruled out of budgets this year amongst the provinces and federal government, but they were scaled down from prior commitments.

Regardless, when all the pieces are added together, whether policies are necessary or not, doesn't alter the fact that in a high inflation environment and tight job market, this could alter the timing to normalize inflation and interest rates relative to the counterfactual world. So, you take that and then combine it with what we recently saw in the housing markets, and it makes me a little nervous that we could be underestimating the momentum and Canadian consumers in our forecast. Now timing the bottom of the market was largely as we had expected, but not the subsequent string. Existing home sales rebounded 11% in April, and it was broadly distributed among eight of the ten provinces. Just like in the US, for home buyers jumped on a drop in mortgage rates we saw Canadians do the same, but with much stronger results.

Since January, the biggest market shifts have occurred in Ontario, BC and Alberta on a combination of strong sales and a weak showing in listings. The market has tightened back up to seller's market for most provinces, which is typically at a ratio above 60. It's possible that improving marketing conditions will bring more sellers into the spring and summer markets to ease supply pressures, but that's unlikely to raise the large deficit relative to fundamentals new listings are starting from a 20 year low nationally.

This shows how much our forecasts need to be adjusted with the stronger jump off. we thought prices would flatten the second quarter and then turn up in the third quarter. But the second quarter is already tracking a massive 9% gain. The forecast impact is significant for the year as a whole, even though we fade the speed of the recovery in the outer quarters due to poor affordability. We still end up with a 12% gain fourth quarter over fourth quarter in prices instead of a small contraction. Now some of this is compositional shifts in demand because this is average prices and demand has been leaning towards single family homes for the past few months, it's lifting the aggregate price measure. However, we can gut check this against the MLS Home Price Index, which is a more like for like measure and it too has been rising for two consecutive months, telling us that the collective data is suggesting broader momentum is picking up even when we consider shifts and demand preferences. By the way, all of this is occurring with a small change in mortgage rate mortgage rates of about 40 basis points. Unlike the bigger move in the US, so there's more going on here than meets the eye.

So, this is the other piece of the equation. There's a lot of pressure coming from the demand side that's starting to grab a lot of attention. After a pandemic lull in immigration, 2022 had a banner year with a million people swing in population on a combination of immigrants and non-permanent residents who entered for work, school and other reasons. Now, permanent residents made-up about 60% of that swing. And even though in January this year they were banned from buying residential property for two years, there are plenty of exemptions for those on a valid study or work permit, as well as other exemptions. The bottom line is that people need to live somewhere, so even placing pressure on already tight rental market squeezes pressure back into homeownership prices for others. The immigration strength looks to be continuing in the initial months of 2023 and we, we may again be on or exceed the trajectory of the high growth scenario.

The large influx of the population is broadly represented across the country and will keep tension on housing demand and prices, particularly Ontario, which is absorbing a larger share of the population than its typical representation. From a policy perspective, this is a huge challenge for the Bank of Canada. They don't control this demand influx but must respond to the economic and financial risks it creates. Too much price appreciation could pull them off the sidelines in favor of more rate hikes, or at the very least, forestall the timing of rate cuts. The consumer is king in the economy and a persistence and stronger housing demand feeds into retail sales, renovation activity, wealth, and can even reignite higher inflation expectations. People associate high home prices and deteriorating affordability with high inflation in general. So, while the housing rebound is not unique to Canada, since we're also seeing the dynamics play through in the US, the magnitude of the strength is certainly very Canadiana.

The rapid influx of population and rising immigration targets force a rethink on the steady state from everything from housing demand to employment growth to even the neutral level of interest rates. Which we estimate will be about 50 basis points higher in Canada. That means that in that Goldilocks state of stable inflation and economic growth, the bank of Canada would have to run a neutral interest rate closer to about 2 1/2 percent rather than 2% absent some corresponding surge in productivity. But that hasn't been Canada's forte for the past decade. This graph on the left captures our estimate for housing demand with the new population forecast relative to what the run rate on demand would have been under the prior lower immigration targets and inflows. For the next two years, we estimate that this demand could average around 280,000 units each year across Canada. This compares to a pre pandemic run rate that was about 60,000 lower each year.

Considering the population growth is colliding with pressures on construction and a high interest rate environment, Canada could fall short of supplying almost a quarter million units during this period. This shortage means little relief in housing affordability and regionally, the gap between new supply and demand requirements would be largest in Ontario, followed by the prairies and then the Atlantic regions. These triangles show the past completion rate of housing, which falls well short of where the new marker is for demand. The solution is not a function of building faster, supply will always adjust slower in response to demand flows. So, governments really need to be more thoughtful on the absorption rate for population growth that realistically would not heighten inequality and pressure on social systems.

So why is the government permitting this degree of population flows? Canada's labor market has benefited tremendously since last spring. Monthly job growth has averaged around 40,000 per month, compared to 20,000 trend over the 2010 to 2019 period. Now that 20,000 monthly trends used to be considered sustainable, but not anymore. With Canada's ability to track and integrate so many more new Canadians, the steady state for job growth has leveled up closer to a run rate of about 35 to 40,000 per month. For an economy with 700,000 unfilled job vacancies, this has been a boom for employers. It also helps limit the pass through on wage pressures, which are already elevated. And likewise, the unemployment rate has been stable at about 5% for the past four months. Had the labor force not expanded as it did, we'd be looking at a 4% handle on it.

For business cycle from a business cycle perspective, this means that it's possible to have an economy producing something like 10 to 15,000 jobs every month and still have a rising unemployment rate because the pace of job absorption would be insufficient relative to the growth in the labor force. And that's a really big departure from what we've seen in the past. This natural leads into the question of how Canada's inflation can be doing better than the US if a population surge has the natural dynamics of placing price pressures on products and services. Part of the answer comes down to differences in methodologies. Both countries have experienced a downdraft in goods prices as supply chains loosened and commodity price pressures eased. Of course, there are nuances like the US having had a stronger run up in new and used car prices last year that's coming down now and base year effects are leading to a stronger downdraft in the US.

Both countries are facing sticky price pressures when it comes to services, but again, Canada is slightly on the lower side partly due to recent policies like daycare subsidies that are not market driven and there's also been less price pressures on recreational services where the US shows stronger demand for those services. But the main reason for the differences is service costs due to shelter costs, which explain roughly 2/3 of the Canadian US gap this year. This is the largest component of service costs and it's only now starting to level off in the US due to very long lags and incorporating market data like falling rent pressures.

In contrast, in Canada, shelter costs are measured differently, which results in a faster transmission of price pressures through housing replacement costs and mortgage interest costs. So, what does this all mean? Given differences in measurement in lags, Canadian inflation trends may simply be ahead of the US by six months or so, and we're really not in that much of a better inflation cycle in the US. This point can be quickly reinforced given the resurgence of Canadian housing demand, the sustainability of a downtrend in shelter cost could prove limited. Getting price pressures to return to 3% will be less of a challenge than returning to the 2% mark as the cross currents start to wane. We got a glimpse of this in the April inflation report where we saw a broadening of price pressures across goods and services and with time other influences will come into play. For example, the outsized drop in childcare costs this year will not be a downward influence next year on inflation.

So, if housing is simultaneously heating up, population growth is pressuring broader demand and government spending remains strong one can envision a situation where inflation gets stuck at a higher level. This would require more growth, sacrifice to calm pressures. In other words, all roads lead back to the necessity for labor markets lack. And that's why we haven't changed our view that the unemployment rate will need to rise by 1 1/2 percentage points. And actually, we have more conviction that this is the necessary condition to resolve the tension. The timing is the only thing in question with employment data still showing resilience. And it's also possible the Bank of Canada's pause won't be sustainable, and they'll have to come back into the market.

Now the population flows to inflation could be less of a threat if Canada was producing stronger productivity, but that is definitely not the case. Surveys by the Conference Board and Bank of Canada are also showing that an increasing share of people are reporting negative sentiment around their financial conditions. That's not that unusual, given that we're in a high interest rate environment, but it also seems a bit at odds that strong spending patterns are still occurring against high household leverage. So, what these two graphs reinforce is that this is really a numbers game of the sheer size of the population that's creating more output. But not necessarily transmitting to better living standards or individual outcomes and all of these dynamics can forestall progress on inflation expectations.

The Bank Canada survey metrics show inflation expectations are bending, but still far off the mark on where they like them to be. If this improvement starts to stall out, they may need to drive a harder bargain with interest rates meaning take them higher. This is why so much hinges on the evolution of the job demand as a catalyst to re-anker inflation. So relative to last quarter, we're still roughly in the same place on the outlook with the data being resilient and turning into too much of a good thing in the past three months, the data has revealed more on government initiatives, more on population flows and more on the housing rebound.

The Bank of Canada may yet have to press higher in interest rates to find that point of inflection where demand shows greater sensitivity and that creates a risk of an overshoot. I can certainly vision their patient patience running short in the next couple of months if job demand doesn't reset convincingly or if inflationary pressures keep broadening out. Meaning that April's data developments become reinforced as a trend and not a one-time data plan.

So, I'll stop there, thanks so much for sharing your time.