There's light at the end of the tunnel

Economic outlook: executive summary

(Full economic outlook to be released on January 12, 2021)

The Canadian economy likely contracted by an unprecedented 5.7% in 2020 and the second wave of infection will create a weaker start to the new year. Nevertheless, deployment of a vaccine will set the stage for the economy to rebound by 4.9% in 2021.

As 2020 draws to a close, we can finally see some light at the end of the tunnel. Campaigns for COVID-19 vaccination are beginning across Canada and other parts of the globe, signalling a beginning of the end of this tragic pandemic. However, it will take many more months before the vaccines reach enough of the population that our society and economy can begin to truly recover. Until we get there, the country remains in the grips of a deadly second wave of infection. Dealing with the public health crisis has necessitated renewed regional shutdowns and slowed economic growth dramatically from the rebound we witnessed in the third quarter. This is a trend that is, unfortunately, expected to continue in early 2021.

The impact COVID-19 has had on our economy is like nothing in recent memory. Real GDP fell by an annualized 7.3 percent in the first quarter of 2020 and by a jaw-dropping 38.1 percent in the second quarter. The speed of the rebound has also been unprecedented, with growth surging by 40.5 percent in the third quarter.

While the breadth of the impact is unparalleled, what is familiar is the composition of the growth emerging from the recession the pandemic created. As was the case after the 2008-09 global financial crisis, this recovery has been led by household spending, investments in residential real estate, and government stimulus, but this is risky given the high levels of public-sector and household debt. Ultimately, Canada needs to orient growth toward investment and exports.

Nevertheless, our baseline forecast is built on the expectation that household spending will remain key to growth. We expect sharp differences in performance within spending categories. With many personal services and entertainment venues shuttered or operating at reduced capacity, consumer spending on services remains 12.4 percent below its pre-pandemic level. At the same time, household outlays on durable goods and investments in residential properties have soared well above their levels before the crisis.

Another sector that is punching above its weight when it comes to economic growth is the public sector, with federal and provincial government spending continuing to grow and the federal government transferring billions to households and businesses.

Areas of the economy that continue to struggle are business investment and trade, an all-too-familiar narrative. Spending on machinery and equipment has begun to recover but remains depressed, while investments in structures that are dominated by the mining and energy sector have yet to see any resurgence. With global demand still soft, exporters are experiencing a slow recovery.

With lockdowns being renewed across the country in response to rising infection rates, our forecast calls for economic growth to slow to just 2.7 percent in the fourth quarter, leaving the economy down 5.7 percent, or $119 billion, to end the year. The economic soft patch we're in will persist until the second quarter of the new year; when the weather improves and more people are vaccinated, we'll begin to see growth pick up again. Getting enough of the population inoculated to substantially curb the spread of COVID-19 is, however, key to our economic recovery. That means growth next year will be back-end-loaded, given the timing of the national vaccination campaign. As momentum once again begins to build in the second half of the year, we see the economy growing by 4.9 percent in 2021 and 4.2 percent in 2022.

In the meantime, growth will be uneven over the coming quarters. Supported by high levels of savings, households will increase their consumption, but by the second half of next year we'll see spending on goods slow as services spending takes off.

Residential investment is expected to decline in the near term after demand that accrued in the spring was unleashed throughout the summer months. After that temporary cooling, residential real estate growth will resume as low interest rates continue to provide stimulus. Our forecast calls for business investment to grow at a modest pace since the pandemic has decimated corporate balance sheets; it will take years for non-residential investment to return to pre-pandemic levels. Commercial real estate is expected to remain soft until well into the recovery.

With economies around the world contending with the second wave of COVID-19, demand for Canadian exports will remain subdued over the coming months. However, growth in exports of goods and services will begin to pick up again over the course of the second half of 2021.

On the policy front, the Bank of Canada has been explicit with its forward guidance. It will continue with its quantitative easing program for as long as it's necessary to support the recovery. While the Bank is likely to start winding down its bond-buying program in 2021, we don't expect it to increase interest rates until 2023. This is smart, as prematurely reigning in monetary stimulus could cause a setback the economy cannot afford. The substantial excess capacity the economy needs to absorb will keep inflation pressures soft, giving little reason to begin raising rates before 2023.

It's also likely we'll see a change to the Bank's inflation targeting mandate to make it more symmetrical (allowing for periods of below-average inflation to be offset by periods of above-average inflation) next year. This is likely to result in lower short-term rates for a longer period of time.

In November 2020, the federal government presented its fall economic statement which, projected a deficit of nearly $400 billion for the current year. Despite the large deficit, and with the details yet to come, the statement contained a promise of $70 to $100 billion in stimulus to support the recovery over the next three years. We expect this will result in stronger government spending in the second half of 2021. We expect less generous spending by provincial governments, which were in a worse fiscal position heading into the crisis.

> We now find ourselves once again in a recovery that is being fuelled by households and supported by even more generous government outlays than we saw during the financial crisis. However, this time the required rotation to business investment and export-orientated growth is even more important than it was 10 years ago. At the beginning of 2007, Canadian households owed $1.40 for every $1 in disposable income; heading into the pandemic, that had jumped to $1.81.

Overall, our forecast calls for the COVID-19 economic recovery to mirror the one seen after the 2008-09 recession, minus the resurgence in energy investment we saw a decade ago. After the financial crisis, economists often pointed to the need to shift the composition of growth away from households and toward businesses through higher investments and better export performance.

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In a final comparison with the global recession of 2008-09, the federal government was in decent fiscal shape heading into the financial crisis, with a debt-to-GDP hovering around 25 percent. Its latest estimate is that pandemic spending will push that ratio north of 50 percent.

Simply put, households and governments cannot afford to fully drive the economic recovery this time given their high debt levels. While this might sound like a dire assessment, there is an opportunity for policymakers and business leaders to finally address the productivity and competitiveness underperformance that has held us back for years.

Read the full economic outlook in January 2021.

Key economic indicators

	2019	2020				2021				19A	20E	21F
	Q4A	Q1A	Q2A	Q3E	Q4F	Q1F	Q2F	Q3F	Q4F			
Real economic activity												
Gross domestic product	0.4	-7.3	-38.1	40.5	2.7	2.5	5.8	9.1	5.6	1.9	-5.7	4.9
Consumption expenditure	2.0	-7.7	-36.5	46.0	2.3	3.9	4.1	6.2	3.9	1.7	-4.7	5.0
• Durable goods	-2.3	-31.2	-46.2	262.7	1.9	1.6	1.5	-1.0	1.2	0.0	-4.4	13.1
• Services	3.7	-11.1	-54.1	44.3	7.6	5.2	7.7	13.2	6.7	2.1	-10.5	5.6
Residential investment	-2.9	-1.4	-47.7	187.3	-6.9	-24.8	5.3	3.8	2.7	-0.2	2.8	1.8
Non-residential fixed investment	-5.9	-0.6	-55.1	25.8	1.8	5.1	7.6	11.5	9.4	1.1	-12.6	2.5
• Non-residential structures	1.7	6.9	-49.8	-1.2	1.7	6.9	9.6	14.9	11.1	1.1	-9.4	1.4
• Machinery & equipment	-17.4	-12.7	-63.6	91.8	1.9	2.2	4.2	5.7	6.5	1.0	-18.0	4.2
Government consumption & investment	1.4	-0.3	-12.7	15.0	0.3	5.5	3.1	5.8	4.1	1.7	-0.2	3.9
Exports of goods & services	-4.2	-6.6	-56.7	71.8	2.1	3.1	5.8	9.1	5.6	1.3	-10.1	5.0
Imports of goods & services	-2.9	-9.3	-65.0	113.7	10.9	1.8	5.4	8.2	11.4	0.4	-11.8	7.8
Prices												
Consumer price index (y/y)	2.1	1.8	0.1	0.4	0.4	0.7	1.8	1.6	1.7	2.1	0.4	1.7
Implicit GDP price index (y/y)	3.2	0.7	-0.9	1.6	2.4	3.7	5.3	3.7	2.6	3.2	2.4	2.6
Labour market												
Employment	0.1	-1.5	-11.4	8.6	2.5	1.7	1.0	0.9	0.5	2.1	-5.2	6.0
Unemployment rate (%)	5.7	6.3	13.0	10.0	8.5	7.5	7.1	6.7	6.6	5.7	9.4	7.0

Note: Unless otherwise noted, all figures are expressed as annualized percent changes.
Sources: Statistics Canada, Bank of Canada. Forecast by Deloitte Economic Advisory, as of December 14, 2020.

	2019	2020				2021				19A	20E	21F
	Q4A	Q1A	Q2A	Q3E	Q4F	Q1F	Q2F	Q3F	Q4F			
Interest rates (%)												
Overnight rate target	1.75	1.41	0.23	0.23	0.25	0.25	0.25	0.25	0.25	1.75	0.25	0.25
3-month T-bill	1.66	1.17	0.25	0.15	0.20	0.20	0.20	0.20	0.20	1.66	0.20	0.20
1-year GoC note	1.73	1.19	0.30	0.22	0.38	0.43	0.47	0.49	0.50	1.73	0.38	0.50
2-year GoC note	1.61	1.14	0.31	0.27	0.37	0.41	0.45	0.48	0.50	1.61	0.37	0.50
5-year GoC note	1.54	1.11	0.40	0.36	0.48	0.55	0.62	0.67	0.71	1.54	0.48	0.71
10-year GoC bond	1.51	1.13	0.55	0.55	0.67	0.74	0.80	0.86	0.91	1.51	0.67	0.91
Yield curve spread (pp)												
3-month vs. 10-year	-0.15	-0.04	0.30	0.40	0.47	0.54	0.60	0.66	0.71	-0.15	0.47	0.71
2-year vs. 10-year	-0.10	-0.00	0.24	0.29	0.29	0.32	0.35	0.38	0.40	-0.10	0.29	0.40
Foreign exchange												
USD/CAD ($C)	1.32	1.34	1.39	1.33	1.29	1.29	1.29	1.29	1.29	1.32	1.29	1.29
CAD/USD (US cents)	0.76	0.74	0.72	0.75	0.77	0.77	0.78	0.78	0.78	0.76	0.77	0.78

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