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Weathering a freeze before the thaw

Economic outlook | January 2024

Introduction

Fashionably late, the economic impact of monetary tightening finally arrived in Canada toward the end of 2023. After a strong start to the year, household spending on goods and services stalled. And although business investment held up longer, spending dropped significantly in the third quarter. The only thing saving the economy from contracting more than the 1.1% registered in the third quarter was a surge in government spending and a modest rebound in residential investment. The final quarter of 2023 is expected to have shown much of the same, with consumer spending and business investment remaining flat and government spending slowing. The only thing saving Canada from an accelerated economic decline is if, as forecast, imports fall.

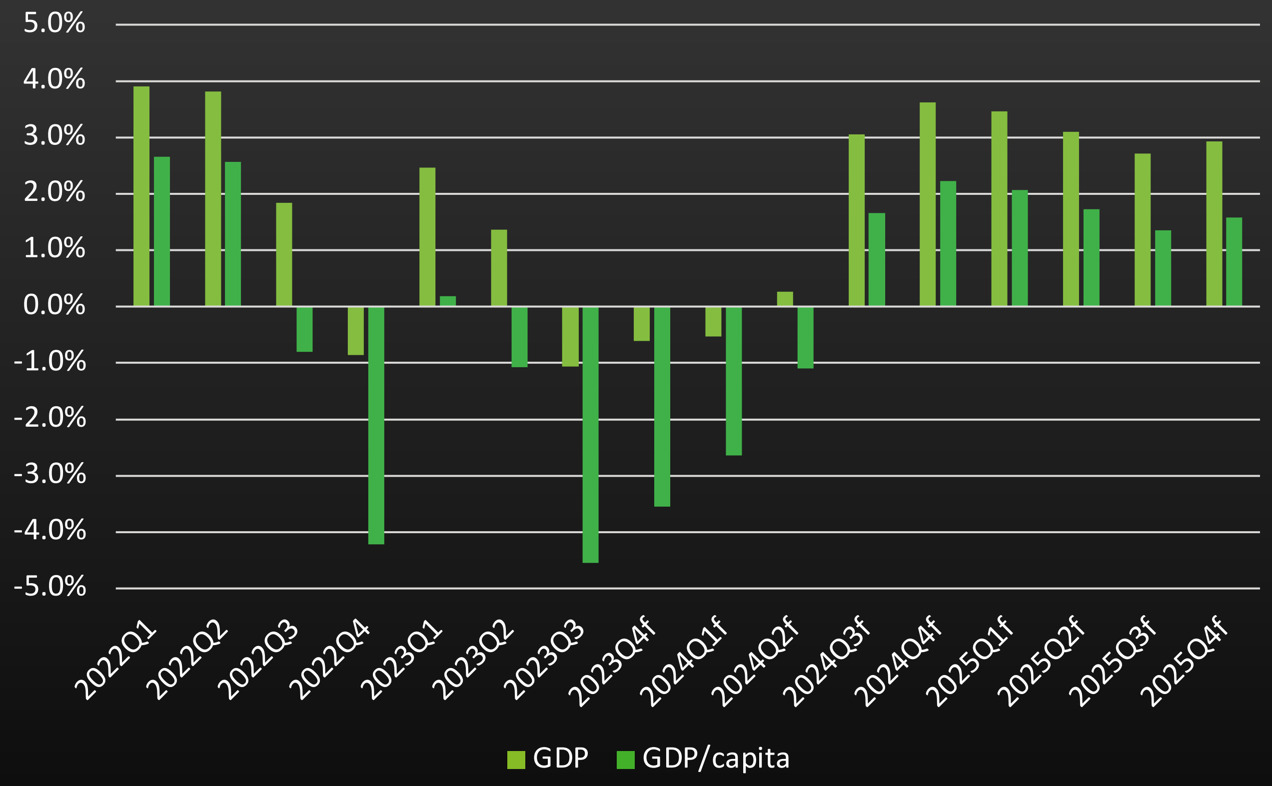
The silver lining of this moribund near-term outlook is that excess slack is building in the economy; as demand continues to trail supply, inflationary pressures will continue to ease. However, a return to the target of 2% inflation will likely take longer because we aren’t seeing much easing of price pressures in the housing market. Typically, higher interest rates would lead to a cooling in housing prices because increased mortgage-carrying costs would deter potential buyers. But a structural housing shortage coupled with strong population growth is leading to continued upward pressure on prices, with rent increasing at its fastest pace in decades and the rapid increase in interest rates pushing mortgage interest costs up by over 30% on a year-over-year basis. The result: housing prices are continuing to post strong growth despite monetary tightening.

This has left the Bank of Canada in a difficult position: does it increase rates further to slow price growth in other parts of the economy, risking a deep economic downturn? Or does it look past the stickiness of housing price inflation and trust the current economic slowdown will be sufficient to stabilize prices, with the inflation rate falling to and staying at 2%?

Introduction (cont'd)

We forecast that inflation will settle back on target by the middle of 2025. The Bank is expected to begin cutting rates as soon as the path to 2% is clear, likely in the spring, sparking a recovery in the second half of the year. Real economic growth is projected to accelerate sharply then, resulting in average growth of 0.4% for 2024. The strong gains are forecast to continue into 2025, with the economy posting growth of 3% as consumer spending accelerates and exports benefit from the opening of the LNG Canada export terminal in British Columbia.

Canada's real GDP growth



*f = forecast

Sources: Deloitte; Statistics Canada.

Introduction (cont'd)

Contrary to what we're seeing here in Canada, the economy in the United States has continued to charge ahead—a gain of 2.4% was posted last year as consumers drew down their savings and labour markets remained strong. However, that's expected to have slowed in the last quarter of 2023 and remain flat over the first part of the new year as households reduce their savings and the impact of past interest rate increases hits home. Notably, the country is expected to avoid a contraction in quarterly growth, although overall growth for the year will slow to just 1%. We expect the US Federal Reserve will hold its federal funds rate a little bit longer than the Bank of Canada does, and announce the first interest rate cut only in the third quarter of 2024. As the Fed starts easing rates south of the border and Canada's economy starts to recover, we'll see the loonie rally over the medium term.

Fiscal and monetary policy

Fiscal and monetary policy

While inflation has dropped since peaking in June 2022, it remains uncomfortably high: 3.1%, as of November. Despite an easing of price pressures and clear signs that the economy is faltering, at its last interest rate announcement of 2023, the Bank of Canada maintained its stance that it is prepared to further move interest rates higher if required to restore price stability.

Above-target inflation is being driven primarily by household staples such as shelter and food. While grocery prices have come down across the country, they are still elevated compared to overall inflation. Given the economic slack that's building in the economy, however, we're starting to see price pressures ease in some categories. It's a trend that's expected to continue throughout the year, eventually helping ease inflation back down to 2% by the second quarter of 2025.

The Bank has held the overnight rate at 5% since July 2023. Given the direction of inflation and economic growth, we don't foresee any further increases this cycle. In fact, with inflation coming down, the Bank should be able to start easing **monetary policy** this spring. We expect it will make a total cut of 75 basis points in its policy rate by the end of 2024, and the overnight rate should continue to fall until it reaches its neutral level of 3% by the fall of 2025.

Fiscal and monetary policy (cont'd)

Turning to **fiscal policy**, the Parliamentary Budget Officer estimates the federal government's finances are sustainable despite the fact it has run nine consecutive budget deficits. Borrowing nevertheless remains elevated and fiscal policy is working at cross purposes to monetary policy, with federal government spending on goods and services up by a whopping 18.3% in the third quarter of 2023. The government's carrying costs on its debt will rise over the coming years, with the *2023 Fall Economic Statement* showing that interest payments on the debt will exceed the amount of the Canada Health Transfer, the largest major federal transfer to provinces and territories, in 2024-25. This will weigh on the federal governments' ability to continue increasing its spending, with real government consumption spending easing to 1.9% in 2024. While the deficit will slowly fall, our forecast does not foresee the federal government returning to surplus this decade due to its spending promises.

The provinces are in an even more challenging position. An aging population means that health care systems, decimated by the pandemic, will continue to require more spending year after year. Provincial governments lack the revenues to keep up and are therefore not expected to return to balanced budgets this decade. Nevertheless, their spending to deliver on key programs, including health and education, will continue to support the economy.

Households and businesses

Households

The outlook for consumer spending on housing and goods and services depends on the future path of interest rates and the health of the labour market. The latest data from Statistics Canada shows that household interest payments on mortgage debt have increased by almost 90% since the first quarter of 2022, when the Bank began raising interest rates.[1] This has driven the household debt service ratio to its highest level since records began in 1990 and has worked to hold back consumer spending over the second and third quarters of 2023. Despite the expected decline in interest rates, homeowners who need to renew their mortgages over the next couple of years will face higher payments. According to RBC, approximately $900 billion in mortgages at chartered banks will be renewed between 2024 and 2026, which will put further pressure on household debt payments and affect their ability to spend.[2]

An important offset to soaring debt payments has been continued strength in the labour market. While job gains have recently slowed compared to the torrid pace observed at the start of 2023, we have not seen a decline in job growth in the three-month moving average. However, with the economy slowing, job vacancies easing, and a potential ceiling on temporary immigration, we don't think the economy will continue to produce huge jobs numbers in early 2024. That means we'll see the unemployment rate continue to trend upward, remaining at or above 6% throughout the year. High immigration to replace retiring workers will translate into a "natural" employment growth that's higher than we're used to, hovering around 50,000 to 60,000 new jobs per month. Wage gains were on pace to remain strong in the final quarter of 2023. We expect to see growth remain slightly above inflation in 2024 as contracts come up for renewal for the first time since the pandemic struck and workers push to get their salaries adjusted to match the inflation we've seen over the past few years.

[1] Statistics Canada, "National balance sheet and financial flow accounts, third quarter 2023," The Daily, December 13, 2023.
[2] RBC Capital Markets, *Canadian Banks: A review of mortgage payment shock*, October 30, 2023.

Households (cont’d)

Taken together, we’re looking at soft job growth in the near term but robust wage gains. And as those wage gains begin to slow toward the end of 2024, job growth will accelerate, providing continued support to income. Overall, household primary incomes are expected to grow by 5.5% this year, down slightly from the 6.4% pace seen in 2023. The growth in disposable income, however, will be constrained by accelerating interest payments; we forecast a gain of just 2.6% this year.

That will make it a tough year for consumer spending despite a continued surge in newcomers. After gaining just 0.1% in the third quarter of last year, real consumer spending is expected to have fallen in the final quarter and to remain muted through the first half of 2024. As interest rates begin to fall, growth will start to pick up in the latter half of the year and remain strong through 2025. The subdued growth in consumption is forecast to be fairly broad-based, with both goods and services impacted by the financial strain facing households.

As for the housing market, a brief period of growth last spring was followed by a decline in home sales that correlated to interest rate hikes in the summer of 2023. The mortgage stress test now requires potential buyers to qualify at a rate of between 7% and 9%, which has lowered the number of people able to enter the housing market. The resale market is expected to rebound this spring alongside rate cuts, helping more people qualify for mortgages and releasing some pent-up demand. Meanwhile, the record population growth over the past two years has boosted the number of households. These factors indicate the housing market is not suffering due to a lack of demand but rather to the lack of affordability. Things aren’t looking rosy on the new-construction front, either. The fear of a recession and high financing costs are driving investors away, so housing starts will likely fall from the near-peak levels seen in the latter part of 2023.

Overall, after two years of decline, real residential investment is expected to gain 2.3% this year. A more robust recovery will have to wait until 2025, when real growth is forecast to reach 5.5%.

Businesses

As households and governments deal with elevated levels of debt and rising debt-servicing costs, Canada's economy needs growth from trade and investment. Unfortunately, their recent performance has not been promising. Indeed, instead of leading the economic charge, we saw real non-residential business investment drop by 10% in the third quarter of 2023 after enjoying robust gains in the first half of the year. The contraction was felt in almost all segments of business investment, but it was particularly acute in aircraft and other transportation equipment.

The weakness is expected to continue in the near term, with virtually no growth in capital spending on non-residential building and machinery and equipment expected in 2024. According to the Bank of Canada's latest *Business Outlook Survey*, Canadian businesses are becoming more pessimistic because of the expected slowdown in demand and sales.[3] To cope, some businesses are planning to slow hiring and some are preparing to invest less in machinery and equipment over the coming year.

Among the different business sectors in Canada, we expect weakness to be most evident in **oil and gas and pipelines**. Estimates indicate that capital spending in this sector experienced its largest decline since 2020 in the third quarter of 2023. With oil prices down sharply from their recent highs and expected to stay close to their current level throughout 2024, investment growth is likely to remain subdued. Further weighing on growth is the fact that the LNG Canada terminal, the largest private sector investment in Canadian history, is nearing completion. We're also seeing work slow on the Coastal GasLink and Trans Mountain expansion pipeline, which will lead to a plunge in capital spending on pipelines this year.

On a positive note, BHP has approved an additional $6.4 billion in spending for the second stage of its Jansen Potash project in Saskatchewan.[4] This will help offset the decline in pipeline investment, helping to avoid an outright contraction in business investment. Next year is looking better for business investment in general because corporations that accumulated large amounts of cash during the pandemic may simply not be investing so they'll have sufficient reserves in the event of a deeper-than-expected downturn. Given our forecast for a mild downturn, however, we anticipate businesses will invest when confidence bounces back.

[3] Bank of Canada, *Business Outlook Survey–Third Quarter of 2023*, October 16, 2023.
[4] Will McLernon, "BHP commits additional $6.4B to turn Sask. project into 'one of the biggest potash mines in the world'," CBC, October 31, 2023.

Businesses (cont'd)

The near-term outlook on the **international trade** front is no brighter than the investment forecast. Exports posted the largest contraction in over two years in the third quarter of 2023, and we expect this weakness to extend into the first half of 2024. While demand for Canada's energy is anticipated to recover, slowing US consumer spending will weigh on export growth for the next few quarters. The American consumer demonstrated a high level of resiliency in 2023, but with excess savings accumulated during the pandemic now almost exhausted and elevated interest rates continuing to work their way through the economy, we expect consumer spending to continue to pull back. Some cracks are already beginning to show, with delinquency rates on US consumer loans rising to their highest level in over a decade.[5]

This weakening is projected to cut into Canada's exports in 2024, as is a marked decline in several agricultural commodities. Recent estimates published by Agriculture and Agri-Food Canada suggest that exports of all principal field crops are expected to fall by 14.2% year over year in the 2023-24 crop year due to widespread drought across the Prairies.[6] Overall, we project a marginal decline of 0.3% for 2024 before growth resumes at 4.8% in 2025, led by gains in liquified natural gas and oil exports.

Imports will also face headwinds in the first half of 2024 on the back of soft domestic consumer and business spending. As noted earlier, the outlook for both **consumption and machinery and equipment** investment is soft in the near term and will weigh on imports through the second half of the year, when an easing of monetary policy is likely to restimulate consumption and investment demand. This resurgence won't be enough to keep annual import growth positive, however, with imports declining marginally by 0.2% in 2024 before roaring back by 3.2% in 2025 as the recovery picks up.

[5] Federal Reserve Bank of St. Louis, "Delinquency Rate on Consumer Loans, All Commercial Banks (DRCLACBS)," FRED, November 20, 2023.
[6] Agriculture and Agri-Food Canada, *Canada: Outlook for Principal Field Crops, 2023-11-21*, November 21, 2023.

Provincial forecast

Provincial forecast

Following two years of declining GDP due to subdued oil production and lacklustre economic activity, the economy of **Newfoundland and Labrador** is projected to rebound by 1.2% in 2024 and 2.5% in 2025. This comes largely because Terra Nova was set to resume operations by the end of 2023. Increasing oil production will boost economic growth in the province and allow the province to begin recouping the recent losses.

Prince Edward Island is likely going to buck the weakening trend in 2024 thanks to it having one of the strongest population growth rates in the country. Along with relatively low household debt and easing inflation pressure, this will support solid growth in household spending. Furthermore, a ramp-up in construction and a positive outlook for manufacturing will support the economy. At 1.5%, our forecast calls for real GDP growth in PEI to top that of all other provinces this year.

Provincial real GDP forecast (% change)

	2022	2023f	2024f	2025f
Newfoundland and Labrador	-1.5	-0.8	1.2	2.5
Prince Edward Island	3.0	1.8	1.5	3.0
Nova Scotia	3.0	1.3	0.6	3.0
New Brunswick	1.3	1.4	0.5	2.8
Quebec	2.8	0.5	0.2	2.6
Ontario	3.7	1.1	0.2	3.2
Manitoba	3.3	1.3	0.4	3.2
Saskatchewan	6.0	0.9	1.1	3.3
Alberta	5.3	2.6	1.2	3.4
British Columbia	3.9	1.1	0.2	3.1

*f = forecast

Sources: Deloitte; Statistics Canada.

Provincial forecast (cont'd)

Last year we saw **Nova Scotia**'s economy contend with depressed housing market conditions, falling manufacturing sales, and stagnant retail spending. With these headwinds continuing into 2024, we expect to see growth moderate to a pace of 0.6% in 2024. Still better than the national performance, the primary driver of growth is the substantial population increase, which will support a rebound in household spending and more domestic demand, which will incentivize business investment to meet that demand.

A steady inflow of newcomers is also supporting **New Brunswick**'s economy. The province has a low debt burden, too, implying the higher interest-rate environment will not impact consumers to the same extent as we're seeing in other provinces. Economic growth is forecast to outpace the national rate in both 2023 and 2024, although it will trail its Atlantic peers, which are benefiting from even stronger population growth.

It was a challenging year for the **Quebec** economy due to massive wildfires, high interest rates, a sharp increase in the cost of living, and large labour strikes; it's expected to post the second-softest provincial growth rate in 2023. With the economy starting the year still contending with several of these challenges, we've lowered our forecast for Quebec. We predict it will grow by just 0.2% in 2024—half the pace of the Canadian economy.

Like the national economy, **Ontario**'s started 2023 strong and then fizzled. Consumers there have the second-highest debt load relative to income, and that has led Ontario to post the weakest growth in retail sales among all provinces last year. Feeble consumer spending will continue into the first half of this year, as will the malaise in its housing market. On the bright side, the NextStar Energy EV battery plant is set to begin operation in July 2024, which will give a boost to the province's manufacturing sector—but not enough for provincial growth to reach the national average.

Provincial forecast (cont'd)

Manitoba's economy held up well in 2023. As of November, it had the lowest unemployment rate in the country at 4.9% and in October, its inflation dipped to 1.9%, below the Bank of Canada's 2% target. However, as the global economy slows in 2024, we expect the province's manufacturing sector could be in for a rough ride and households to pull back on spending, although the construction of various investment projects will provide an offset. Overall, Manitoba's growth is expected to be relatively subdued through 2024, at 0.4%.

After leading the provincial growth charts in 2022, we expect Saskatchewan will have fallen to near the back of the pack for 2023 with growth of just 0.9%, with dry growing conditions weighing on crop production. The downturn in the potash industry also dragged on growth as it faced increased competition from a rebound in Russian potash exports. However, as commodity markets settle in 2024, we expect to see a rebound for potash. We expect this, combined with the start of BHP's stage 2 expansion of its Jansen potash project, to push growth to 1.1% in 2024—more than double the national average.

Buoyed by a revitalized energy sector and strong population growth, we expect that **Alberta**'s economy finished 2023 on a high note, with annual growth coming in at 2.6%. Looking to this year, we expect growth to moderate to 1.2% as elevated interest rates weigh on household finances, given the province's relatively high debt to disposable income ratio. Nonetheless, an anticipated ease in monetary policy in the second half of the year and increased oil production in anticipation of the opening of the expanded Trans Mountain pipeline should provide solid tailwinds to growth. If further delays in completing the pipeline occur, growth in the energy sector is unlikely to be as robust.

After major forest fires and port strikes shook **British Columbia** early last year, we forecast economic growth will have fared better than predicted, coming in at 1.1% for 2023. This is mainly due to strong housing activity and consumer spending. Growth will lose momentum this year because, with the highest household debt levels in the country, the impact of high interest rates will hit the province hard, causing a sharp slowdown in consumer spending. The winding down of construction of the massive LNG Canada facility will also drag down business investment.

Final thoughts

Final thoughts

As 2024 begins, the major wild card in the economic outlook continues to be interest rates and how households and businesses manage high borrowing and debt-servicing costs. While our baseline forecast shows that policymakers will be in a position to ease rates beginning this spring, it's widely accepted that we won't see a return to the ultra-low interest rates of the decade leading up to the pandemic. That means that even with some relief, interest rates will continue to have a negative influence on spending and investment decisions in 2024.

The good news is that Canada's robust population growth will fuel domestic demand, although tempered by the possibility that if labour market conditions deteriorate more than expected, household demand could remain depressed for longer. That's the key risk to this outlook. While our baseline forecast expects the economic recovery to begin unfolding in the second half of this year, the ability of households to manage their higher debt-servicing costs and the actions they take to maintain their spending will ultimately decide the timing and magnitude of the recovery.

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Key economic indicators

	2023				2024				2022	2023f	2024f
	Q1	Q2	Q3	Q4f	Q1f	Q2f	Q3f	Q4f			
Real economic activity											
Gross domestic product	2.5	1.4	-1.1	-0.6	-0.5	0.3	3.1	3.6	3.8	1.0	0.4
Household consumption expenditure	5.3	-0.1	0.1	-0.1	0.1	0.9	2.2	3.0	5.1	2.0	0.6
• Durable goods	6.0	-2.9	4.0	-1.3	-1.5	-0.6	0.5	1.6	-1.8	2.3	-0.3
• Services	6.9	-0.1	1.4	0.8	0.8	1.6	2.7	3.5	9.1	3.1	1.4
Residential investment	-12.6	-4.2	8.3	1.0	-0.7	3.3	4.7	5.8	-12.1	-9.8	2.3
Non-residential fixed investment	4.2	13.9	-10.1	0.2	0.9	1.0	0.4	0.3	4.0	1.2	0.0
• Non-residential structures	6.3	11.3	-7.7	-0.4	0.4	0.6	0.0	-0.2	6.7	5.2	-0.2
• Machinery and equipment	0.4	18.8	-14.4	1.3	1.6	1.7	1.0	1.1	-0.3	-5.4	0.3
Government consumption and investment	1.6	1.1	6.5	-0.8	1.6	1.4	1.5	1.5	3.3	2.0	1.6
Exports of goods and services	12.1	5.1	-5.1	-1.2	-1.3	-2.4	5.5	6.5	3.2	4.5	-0.3
Imports of goods and services	4.0	4.4	-0.6	-1.6	-0.9	-1.1	1.3	2.4	7.6	0.9	-0.2
Prices											
Consumer price index (y/y)	5.2	3.5	3.6	3.0	2.8	2.6	2.3	2.1	6.6	3.0	2.1
Implicit GDP price index (y/y)	2.2	-0.6	1.6	1.1	1.7	1.2	-0.2	0.5	5.3	1.1	0.5
Labour market											
Employment	4.7	1.6	1.5	1.8	0.6	0.6	1.4	2.6	4.0	2.4	1.2
Unemployment rate (%)	5.0	5.2	5.5	5.8	6.1	6.3	6.3	6.0	5.3	5.4	6.2

Notes: Unless otherwise noted, all figures are expressed as annualized % changes; f = forecast.
Sources: Statistics Canada; Bank of Canada. Forecast by Deloitte Economic Advisory, as of December 15, 2023.

Financial market indicators

	2023				2024				2022	2023f	2024f
	Q1	Q2	Q3	Q4f	Q1f	Q2f	Q3f	Q4f			
Interest rates (%)											
Overnight rate target	4.50	4.75	5.00	5.00	5.00	4.75	4.50	4.25	4.25	5.00	4.25
3-month T-bill	4.48	4.65	5.11	5.03	5.02	4.74	4.49	4.23	4.20	5.03	4.23
1-year GoC bond	4.44	4.71	5.19	5.02	4.96	4.94	4.74	4.52	4.36	5.02	4.52
2-year GoC bond	3.84	4.12	4.75	4.59	4.30	4.00	3.75	3.60	3.93	4.59	3.60
5-year GoC bond	3.16	3.34	4.03	4.00	3.75	3.60	3.50	3.40	3.32	4.00	3.40
10-year GoC bond	3.03	3.08	3.70	3.87	3.75	3.65	3.55	3.45	3.18	3.87	3.45
Yield curve spread (pp)											
3-month vs. 10-year	-1.45	-1.57	-1.41	-1.16	-1.27	-1.09	-0.94	-0.78	-1.03	-1.16	-0.78
2-year vs. 10-year	-0.81	-1.04	-1.05	-0.72	-0.55	-0.35	-0.20	-0.15	-0.75	-0.72	-0.15
Foreign exchange											
USD/CAD ($C)	1.35	1.34	1.34	1.37	1.36	1.36	1.35	1.35	1.36	1.37	1.35
CAD/USD (US cents)	0.74	0.74	0.75	0.73	0.74	0.74	0.74	0.74	0.74	0.73	0.74

Notes: f = forecast. The overnight rate represents the end of the period. All other indicators are quarter averages. Annual figures reflect the end of the period as measured by Q4.
Sources: Statistics Canada; Bank of Canada. Forecast by Deloitte Economic Advisory, as of Dec 15, 2023.

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