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Canada's overheated economy losing momentum

Economic outlook | June 2023

Introduction

After a year of volatility, the Canadian economy has proven surprisingly resilient as strong population growth, tight labour markets, high commodity prices, and the delayed impact of rising interest rates have all helped to sustain growth. While this has set the stage for a period of relative economic calm heading into the summer, signs of slowing growth are emerging on several fronts.

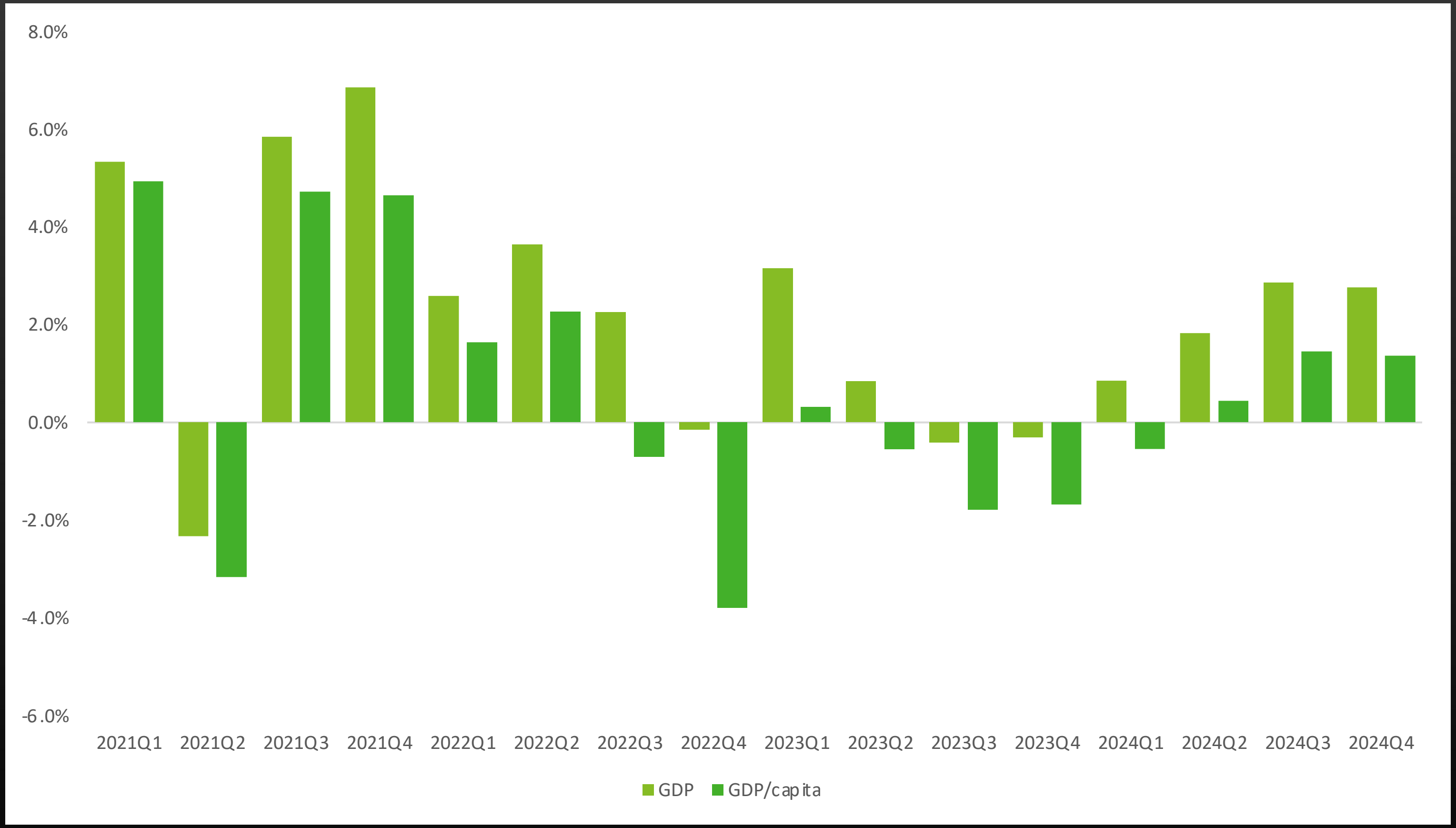
Real GDP growth surprised on the upside in the first quarter, expanding by a very strong 3.1%. Similarly, labour markets continued to fire on all cylinders, adding 231,000 jobs in the first three months of the year. The GDP gain to start the year was driven by an outsized increase in January. Growth was soft in February and flat in March, pointing to a slowdown in momentum heading into the second quarter of the year. The same pattern was observed in the labour market. January job gains clocked in at 150,000, but over the next three months they slowed to an average monthly pace of 33,000 before contracting in May. Job losses in May were concentrated in young workers, who are likely to be first to be let go by companies looking to trim staff costs (although, given the volatility of labour market statistics, this could also be a one-time blip).

Another indicator of looming weakness is the recent increase in consumer insolvencies. The rise in insolvencies is being driven by consumer proposals, legally binding agreements that extend the time individuals have to pay off their debts, reduce the amount they owe to creditors, or both. In March 2023, consumer proposals were up by almost a third from last year, reaching a historically high level, a sign that households are being increasingly strained by the high interest rate environment. Consumer proposals did fall in April but remain elevated and up nearly 30% from last year.

Introduction (cont'd)

Despite the signs of slowing growth, the economic outlook has improved relative to what we expected in the spring. That being said, the fundamentals expected to suppress growth have not improved. The economy cannot escape the impact of high inflation and the most rapid tightening in monetary policy in decades without slowing. A continued surge in immigration will keep growth from falling substantially but will not keep real GDP from declining by a modest amount in the second half of this year. In fact, in per capita terms, we are looking at a more significant drop in output as households continue to adjust to a high interest rate environment. Overall, we expect real GDP to expand by 1.3% this year before slowing to a pace of 1.0% in 2024. In per capita terms real GDP is expected to fall 1% this year and contract another 0.4% in 2024.

Real GDP growth



Source: Deloitte; Statistics Canada

Fiscal and monetary policy

Fiscal and monetary policy

Monetary policy will continue to be guided by the outlook for inflation, which is determined by the balance between demand and supply in the economy. Given the economic strength observed at the beginning of the year, the Bank of Canada has expressed concerns about inflation becoming sticky. Indeed, inflation ticked higher in April and core inflation measures remained elevated. Against this backdrop, the Bank surprised markets with a 25-basis-point hike in their policy rate when they met in June. The Bank's next rate announcement is scheduled for July, and we now expect them to hike its policy rate to 5% to reinforce the message that they remain laser-focused on returning inflation to its 2% target.

Our assessment is that the additional rate hikes are being targeted at consumer inflation expectations to ensure that households don't expect inflation to remain high indefinitely. High inflation expectations trigger demands for higher wages and cause businesses to raise prices to accommodate higher salaries, something called wage-push inflation. When looking at the recent inflation data, we can see evidence that inflation is already starting to cool—inflation excluding food was 3.6% in April, a substantial decline from its peak of 8.0% last June.

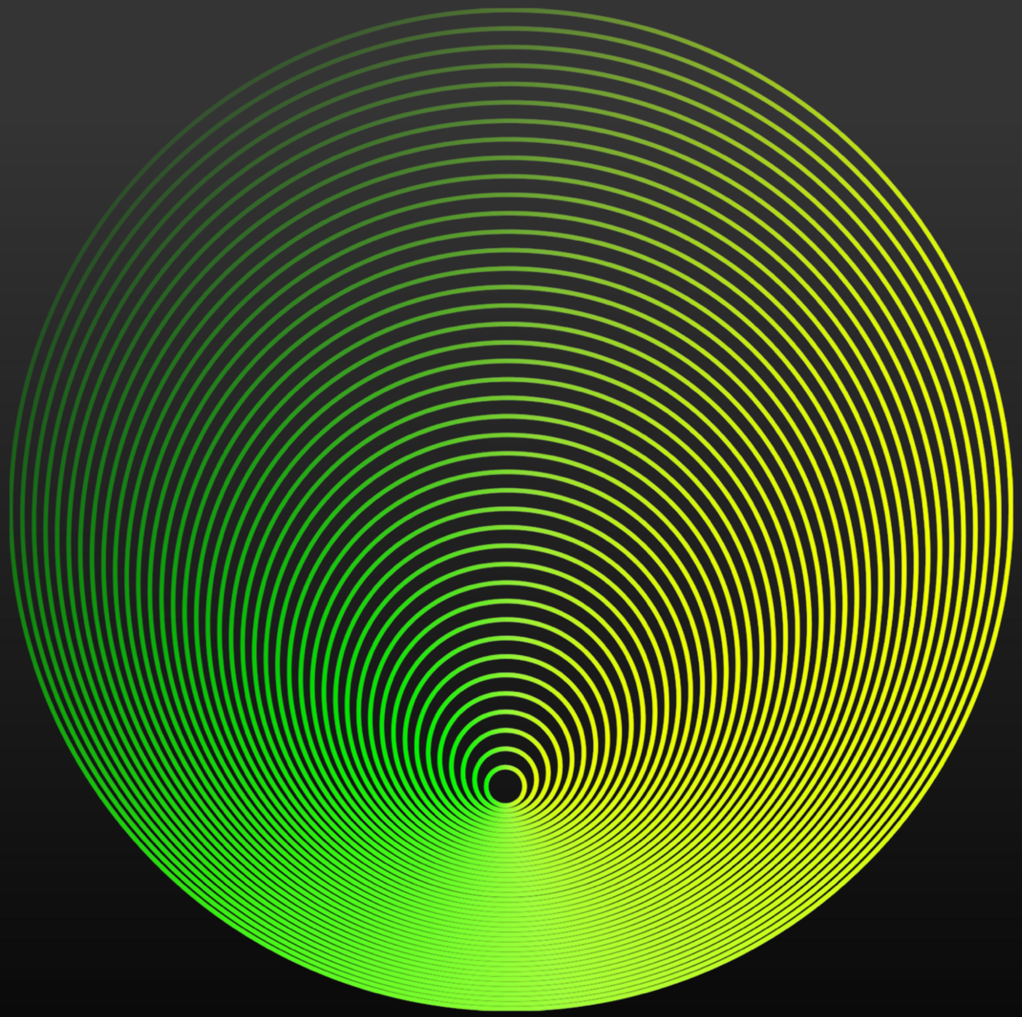
In fact, the largest contributor to inflation pressures in April was rent and mortgage interest costs, which will continue to increase given how much interest rates have increased and the fact that most households have yet to feel the impact of rising rates. In the Bank of Canada's 2023 Financial System Review (FSR) released in May, they've noted that about one-third of mortgages have seen an increase in payments relative to February 2022.[1]

That means that two-thirds have not and therefore, even before this latest rate hike, pressure from mortgage interest costs will continue to trend higher and put upward pressure on inflation.

Given a growing accumulation of evidence that the economy is slowing, our forecast assumes that the July rate hike will be the last one by the Bank of Canada in this tightening cycle. With GDP contracting mildly in the second half of the year and inflation dropping below 3% by the end of the year, the Bank will be in position to start easing its policy in 2024. Indeed, an easing seems implicit in their FSR. The Bank estimates that fixed-rate mortgages renewing in 2025–26 will face a 20–25% increase in average payments. This is much lower than the 49% increase the average adjustable variable rate mortgage holder already experienced before the latest rate hike, suggesting that interest rates will be lower by 2025.

[1] Bank of Canada, Financial system review—2023, May 18, 2023 (accessed June 13, 2023).

Fiscal and monetary policy (cont’d)



A similar story is expected to unfold in the US where persistent inflation will likely see the Federal Reserve raise its target for the federal funds rate another 25 basis points in July after pausing in June. However, a tightening of credit conditions in the aftermath of the medium-size bank failures earlier this year is providing some assistance in easing credit demand, and the rate increase in July should be the last before the Fed too begins easing off next year.

Even with monetary policy in Canada and the US expected to align, the Canadian dollar is expected to lose a bit of steam heading into the third quarter as a weakening global economy supports inflows into the US, helping to boost the value of its dollar vis-à-vis currencies around the world.

Based on the budgets delivered earlier this year, we expect to see little economic support from fiscal policy in the near term despite slowing growth as governments across the country look to either maintain or restore their fiscal balance. Any substantive increase in spending is expected to be targeted at priority initiatives such as providing support to lower-income households and supporting investment to reach our 2030 climate objectives. Combined, real government spending is expected to grow at about 1% per year over the 2023 to 2025 timeframe.

Households and businesses

Households

One of the biggest surprises in recent economic data was household spending. In the first quarter of 2023, real consumer spending increased by an eye-popping 5.7%. That was great news for economic growth but a less attention-grabbing number from the GDP report was that real household incomes fell by 6.5% in the first quarter. That means that the strong household spending at the start of the year was supported by a drawdown in savings and an accumulation in debt. After averaging 5.8% in the last quarter of 2022, the household savings rate plunged to 2.9% in the first quarter of this year, its lowest rate since before the pandemic. Further, data from Equifax shows that consumer credit card balances were up 14.5% year-over-year in the first quarter and that more mortgage holders are missing payments on their non-mortgage debt.[2]

Higher debt, reduced savings, persistent inflation, and increasing interest payments have made it difficult for households to support economic growth even before the Bank of Canada increased interest rates again in June. With the Bank expected to move rates higher again in July, the remainder of 2023 is expected to show real consumer spending remaining essentially flat.

Looking at the components of consumer spending, we expect to see the impact of pinched household finances show up in spending on goods. In fact, spending on goods is expected to modestly decline over the next four quarters, driven by a pullback in interest-rate-sensitive purchases such as vehicles, appliances, and household furniture. Spending on services will continue to grow even with consumer finances under strain, albeit more slowly than during the post-pandemic recovery. Increases are expected in housing services (rent), travel, and health and personal services. Overall, real consumer spending is expected to increase by 2.2% this year and 1.3% in 2024.

Recent data suggests that Canada's housing market bottomed out in the first quarter of 2023. Sales picked up on a month-over-month basis in April and May and prices started to recover, although both remain below year-ago levels. We expect demand to soften in the near term as the impact of additional rate increases bites. Structurally, demand for housing remains very strong in Canada, backed by high immigration and the fact that the large millennial cohort has reached the age where they are most likely to enter the housing market. The underlying strong demand and a shift toward policy easing in 2024 are expected to underpin a rise in residential investment of 3.4% next year following 2023's 9.1% decline.

[2] Canadian Press, "Credit card balances increase in first quarter as mortgage market slows, Equifax Canada says," *Globe and Mail*, June 6, 2023 (accessed June 14, 2023).

Households (cont'd)

Labour market strength supported household spending in the face of higher debt payments and inflation earlier this year. However, the labour market is projected to cool substantially over the rest of this year and push the unemployment rate to 5.6% by year end. The good news is that we do not expect employment to decline, as population is rapidly rising thanks to immigration.

High immigration levels will propel population growth to 2.4% this year—the fastest increase in our population in data going back to 1961.

The number of immigrants to Canada will remain elevated driven by new immigration measures introduced in May, including faster processing of temporary resident visas (TRVs) for spousal applicants, new and dedicated processing tools for spousal TRV applicants, a new open work permit for spousal and family-class applicants, and extensions for open work permits expiring between August 1 and the end of 2023.

Businesses

With global economic growth holding up through the start of 2023, exports have rebounded and are on track to perform better this year than we had previously forecast. One of the key factors leading to an improved trade outlook is the expectation that the downturn in the US will not be as deep as feared a few months ago, with the US economy expanding by 1.1% this year and 0.9% in 2024. Instead, the contraction in output in the second half of this year is expected to be very shallow and, therefore, export growth will slow but not decline over the rest of this year.

The outlook for imports is determined by household spending and business investment intentions. With more modest investment and household spending expected over the second half of this year, import growth is expected to slow toward the end of 2023 and the beginning of 2024. Overall, imports are expected to decline 0.1% this year, with exports projected to increase 5.4%, resulting in net trade making a significant contribution to GDP in 2023.

Business investment in new capacity will be modest this year as firms scale back their capital expenditure plans in the face of high interest rates and softening demand.

The Bank of Canada's latest Business outlook survey indicates that while supply chain issues and labour market tightness are gradually improving, businesses remain concerned about rising costs and potential declines in sales growth.[3] Increasing inflation has led many workers to expect higher wage increases, which in turn raises operational costs. Furthermore, tighter financing conditions resulting from the Bank of Canada's aggressive monetary tightening policies are squeezing businesses' cash flow. On the sales front, many businesses hold pessimistic views about future sales growth due to concerns over a potential recession and reduced household consumption resulting from the rising cost of living. These factors will weigh on business investment outside of the energy sector.

Energy investment faces a different near-term outlook. Indeed, it was robust mining investment that pushed up non-residential business investment in structures during the first quarter. According to Statistics Canada's latest capital expenditures (CAPEX) survey, capital spending in the oil and gas and mining sector is expected to be the primary driver of growth in non-residential business investment in 2023. The Canadian Association of Petroleum Producers also predicts an 11% increase in investment in oil and gas this year, surpassing its pre-COVID level, although that is still far below the 2014 peak.[4]

[3] Business outlook survey—First quarter of 2023, Bank of Canada, April 3, 2023 (accessed June 14,2023)
[4] Canadian Press, "'Feels pretty good': Oil and gas investment in Canada to hit $40 billion in 2023, CAPP says." *Financial Post*, March 2, 2023 (accessed June 14,2023)

Businesses (cont'd)

Despite the near-term boom in oil and mining investment, capital spending on pipeline projects is declining as work nears completion on the Coastal GasLink pipeline and Trans Mountain Expansion project. With no significant new projects on the horizon, investment in pipelines is expected to remain sluggish over the next decade, exerting downward pressure on the business investment outlook.

Overall, given the economic uncertainties, high interest rates, and pessimistic business sentiment, we expect real business investment growth to moderate over the next two years, posting a gain of 1.6% this year and 1.5% next year.

Provincial outlook

Provincial outlook

The improved outlook we are seeing nationally this year has translated into a better outlook for provincial economies. The strongest gains continue to be expected in the Prairie provinces, where natural resources and population gains are driving economic growth. Softer gains are expected out east and in BC, while Quebec and Ontario are expected to grow closer to the Canadian average.

Economic conditions were challenging in Newfoundland and Labrador last year, with the province posting the only decline in output last year. Growth is set to remain subdued this year as the expected restart of production at Terra Nova this spring has been delayed until what is assumed to be later this year, which will help boost output next year. The resiliency we are seeing in household spending will help support tourism to Prince Edward Island this year, as will continued population growth. As household finances adjust to higher debt servicing costs, the tourism sector will be negatively impacted next year, contributing to a slowdown in economic growth. New Brunswick's economy is set to slow this year, driven in part by shutdowns in the mackerel and herring fisheries and more subdued demand for manufactured wood products as the housing market slows across North America. In Nova Scotia, growth is expected to be above the Canadian average, propelled by public sector capital spending plans and robust population growth.

Quebec's economy is expected to grow slightly below the Canadian average, with the economy facing supply challenges that will limit its ability to grow faster than projected. Strong non-residential investment intentions will help buffer the slowdown in sectors sensitive to the global downturn (manufacturing and other goods-producing industries) and those sensitive to higher interest rates (housing and retail sales).

Ontario's economy is benefiting from a slew of new investments in electric vehicles, and the quicker-than-expected rebound in its housing market will help the province post growth of 1.5% this year. However, growth is set to slow into next year as the impact of higher interest rates on the province's heavily indebted households weighs on consumer spending.

Our outlook calls for very similar rates of growth for Saskatchewan and Manitoba over the near term. In Manitoba, strong performance in the manufacturing and agricultural sectors is adding to growth. Further, consumers in the province are less indebted than in other parts of the country, keeping consumer spending growing, albeit at a softer pace than last year. In Saskatchewan, a surge in non-residential investment and plans to increase potash and uranium production are fueling growth, with the province expecting to see yellowcake production almost double this year compared to last year.[5]

[5] Government of Saskatchewan, "Saskatchewan second-largest global producer of uranium," June 13, 2023 (accessed June 16, 2023).

Provincial outlook (cont'd)

Alberta is on track to have the strongest economic growth this year as more people flock to the province and as oil and gas production ramps up. The wildfires that continue to plague the province represent a meaningful downside risk to the projection given that some companies have had to shut-in production. Growth is expected to decelerate next year as highly indebted households soften their spending growth and as weaker global growth lowers the demand for energy commodities.

British Columbia is in for a weak period of growth relative to its recent performance. Households in the province are the most indebted in the country and this will weigh on consumer spending. Further, non-residential investment drove economic gains for years in the province, but as work winds down on major projects such as the Trans Mountain pipeline expansion and the LNG Canada facility, investment will detract from growth prospects.

Real GDP growth by province (percent change)

	2021	2022	2023f	2024f
Newfoundland and Labrador	0.6	−1.7	0.5	1.3
Prince Edward Island	7.9	2.9	1.8	1.1
Nova Scotia	6.2	2.6	1.6	0.8
New Brunswick	5.8	1.8	1.1	0.7
Quebec	6.0	2.6	1.2	0.7
Ontario	5.1	3.6	1.5	1.1
Manitoba	1.7	3.9	1.9	1.7
Saskatchewan	−0.7	5.7	2.0	1.5
Alberta	4.9	5.1	2.1	1.3
British Columbia	6.2	3.6	1.3	1.0

Source: Statistics Canada; forecast by Deloitte

Final thoughts

Final thoughts

The economy continues to surprise to the upside, raising questions about whether the long-called-for recession will materialize. To try to answer that question, it is important to consider the factors that have kept the economy resilient to this point. In 2022, economic growth was a consumer and business investment recovery story. Business investment had a delayed recovery from the pandemic, and growth was front-end loaded then cooled substantially at the end of last year and beginning of this year. Even with high interest rates and concern over global growth prospects, investment is expected to continue to grow over the remainder of this year, albeit at a subdued pace. That leaves the consumer to support growth.

Consumer spending has been a key driver of economic growth for years, supported in part by cheap money and strong population growth. While strong population growth will continue, money is no longer cheap. Households have sustained spending to this point by using savings stockpiled during the pandemic and by delaying principal payments on mortgage debt. But the fact is that mortgage interest payments were up 69.7% in the first quarter, and the ability of debt holders to absorb that increase through reduced principal payments is likely nearing an end as people hit their trigger rates and amortizations have already been extended. With consumer finances under strain, the more likely scenario seems to be a downside surprise to spending rather than an upside surprise.

Our baseline forecast calls for a mild and short-lived recession in the second half of this year. There are, however, important risks to the forecast that could tilt the scales, including more monetary tightening than expected, inflation being stuck higher than forecast, or a deterioration in consumer confidence. On the upside, developed countries could avoid recessions altogether and consumers could shake off the impact of higher debt-servicing costs and continue to spend. At this point, we see the risk balance tilted toward weaker growth, although the possibility remains that a recession in Canada could be avoided altogether.

Key economic indicators

	2023				2024				2022	2023F	2024F
	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F			
Real economic activity											
Gross domestic product	3.1	0.8	−0.4	−0.3	0.9	1.8	2.9	2.8	3.4	1.3	1.0
Household consumption expenditure	5.7	0.3	−0.1	0.0	1.2	2.1	2.9	3.4	4.8	2.2	1.3
• Durable goods	14.0	−0.1	−2.0	−4.4	−1.7	0.0	1.1	1.7	−2.3	4.1	−1.3
• Services	5.3	0.6	0.5	1.3	2.1	2.8	3.4	3.7	8.6	3.1	2.1
Residential investment	−14.6	13.0	−7.1	−0.3	6.5	5.5	5.7	4.6	−11.2	−9.1	3.4
Non-residential fixed investment	1.9	1.3	1.6	0.6	0.1	2.2	2.2	1.3	8.0	0.9	1.2
• Non-residential structures	8.7	0.6	1.0	−0.2	−1.3	0.7	1.0	−0.4	8.3	5.9	0.0
• Machinery and equipment	−9.6	2.7	2.7	2.1	2.5	4.9	4.3	4.2	7.4	−7.4	3.3
Government consumption and investment	0.6	−0.8	0.8	1.4	0.7	1.0	1.2	1.4	2.0	1.1	0.9
Exports of goods and services	10.1	3.0	0.0	1.4	3.1	3.8	4.6	4.2	2.8	5.4	2.8
Imports of goods and services	0.9	3.2	0.9	2.4	3.0	4.2	3.6	4.0	7.5	−0.1	3.0
Prices											
Consumer price index (y/y)	5.2	3.4	3.0	2.6	2.7	2.5	2.3	2.2	6.6	2.6	2.2
Implicit GDP price index (y/y)	1.4	−1.2	0.4	1.6	1.9	1.9	2.1	2.0	4.1	1.6	2.0
Labour market											
Employment	4.7	0.9	0.3	0.7	1.0	1.4	1.6	1.6	4.0	2.1	1.0
Unemployment rate (%)	5.0	5.2	5.4	5.6	5.6	5.6	5.5	5.5	5.3	5.3	5.6

Note: Unless otherwise noted, all figures are expressed as annualized % changes.
Sources: Statistics Canada, Bank of Canada. Forecast by Deloitte Economic Advisory, as of **June 16, 2023.**

Financial market indicators

	2023				2024				2022	2023F	2024F
	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F			
Interest rates (%)											
Overnight rate target	4.42	4.58	5.00	5.00	4.75	4.50	4.25	4.00	3.75	5.00	4.00
3-month T-bill	4.63	4.68	5.02	5.00	4.73	4.48	4.23	3.97	4.20	5.00	3.97
1-year GoC bond	4.83	4.78	5.20	5.22	4.99	4.78	4.54	4.30	4.36	5.22	4.30
2-year GoC bond	4.30	4.12	4.48	4.57	4.47	4.36	4.23	4.08	3.93	4.57	4.08
5-year GoC bond	3.77	3.52	3.96	4.17	4.21	4.21	4.17	4.11	3.32	4.17	4.11
10-year GoC bond	3.03	3.37	3.78	4.01	4.09	4.14	4.15	4.13	3.18	4.01	4.13
Yield curve spread (pp)											
3-month vs. 10-year	−1.60	−1.31	−1.24	−0.99	−0.64	−0.34	−0.08	0.16	0.37	−0.66	0.53
2-year vs. 10-year	−1.27	−0.74	−0.70	−0.56	−0.38	−0.23	−0.08	0.05	−0.75	−0.56	0.05
Foreign exchange											
USD/CAD ($C)	1.32	1.35	1.37	1.33	1.29	1.25	1.23	1.22	1.36	1.33	1.22
CAD/USD (US cents)	0.74	0.74	0.73	0.75	0.78	0.80	0.82	0.82	0.74	0.75	0.82

Sources: Statistics Canada, Bank of Canada. Forecast by Deloitte Economic Advisory, as of **June 16, 2023.**

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With leaders in macroeconomics, microeconomics, policy and regulatory analysis, economic development, and analytics and modelling, Deloitte's Economic Advisory practitioners have the knowledge and experience to tackle some of the most complex and challenging policy and business issues of today.

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