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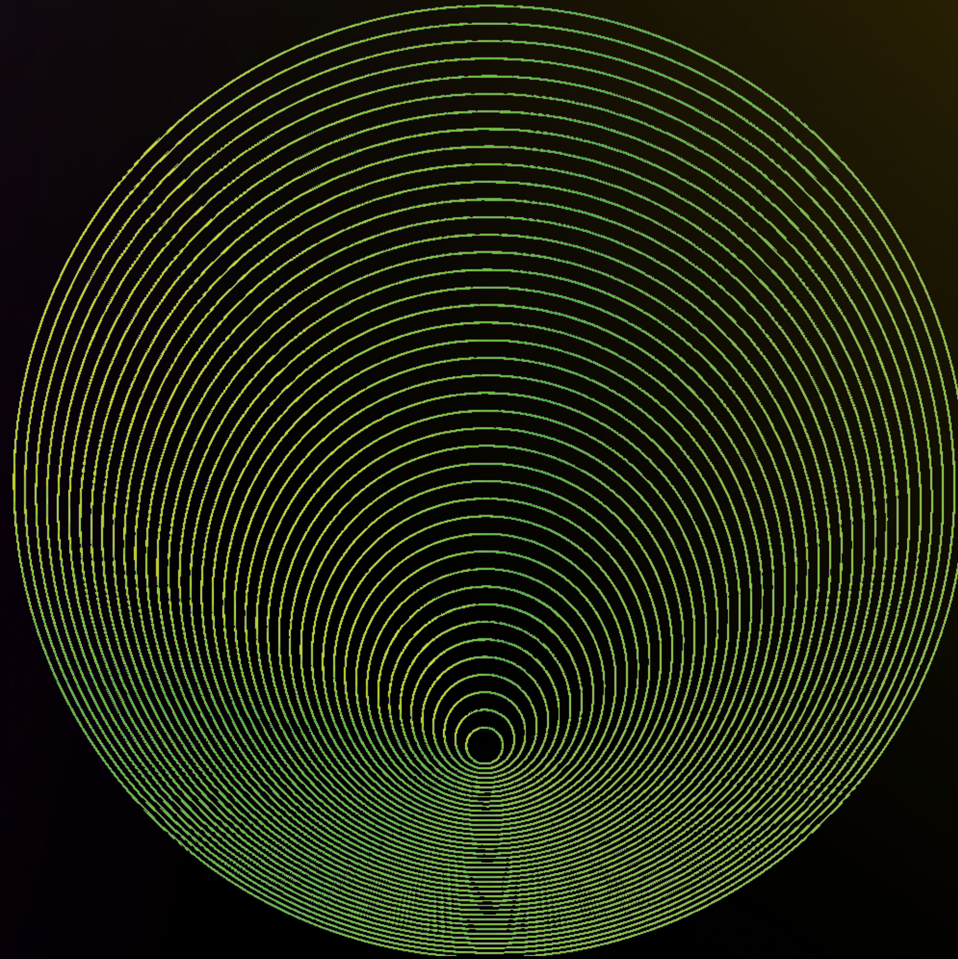


Recession looms due to rising interest rates, changing supply chains

Economic outlook | September 2022

Foreword

by Chief Economist Craig Alexander

The Canadian economy has benefited from very low interest rates since the global financial crisis of 2008-09. That has now changed. The move toward the more restrictive monetary policy necessary to bring down inflation and inflation expectations has happened quicker than we anticipated. Furthermore, we expect the Bank of Canada will now have to push rates well above the target neutral level (2.0% to 3.0%) to bring inflation under control. Add in some supply chain normalization and we expect to see the Canadian economy enter a mild and short-lived recession before the end of the year.

We noted an elevated risk of recession in our last outlook, *Rising interest rates and inflation to slow growth*. What has changed between then and now to shift the scales from a chance to an expectation? Two main factors are behind our recession call: interest rates that are rising faster and to a higher level than expected, and a necessary rebalancing of inventories as supply chains normalize.

In the three months since our last forecast, the Bank of Canada has raised its policy rate by 175 basis points. That brings it up 300 basis points since the beginning of 2022. To put the speed of this increase in perspective, the Bank's policy rate increased by just 150 basis points from the end of the financial crisis in 2008-09 to the beginning of the pandemic in North America in 2020. That means that in the last quarter, we've seen the policy rate increase by more than it did in the 11 years leading up to the COVID-19 crisis. If that sounds jarring, it's because it is; and the markets and the economy are reacting.

While we've seen stock markets fluctuate as central banks raise rates, from an economic perspective, the early evidence of the impact of rising rates on economic activity has been in real estate markets. Both resale housing volumes and prices are already down significantly from their peak, with further declines in activity expected. High interest rates and inflation are also making life more unaffordable, which is dampening consumer confidence. This will weigh on spending over the coming quarters, putting further downward pressure on the economy.

Furthermore, export growth is expected to slow significantly. While the United States has already seen two back-to-back quarters of economic decline, much of the pinch from higher interest rates has yet to be felt and, as the US economy slows next year, Canadian export growth will cool. One area that's expected to hold up reasonably well is non-residential business investment. Many business leaders are aware that economic growth is set to slow, but they recognize that the slowdown will likely be temporary and that the challenges they're facing now with labour shortages and meeting demand are likely to continue as we emerge from the downturn. We therefore expect to see continued investment, especially in machinery and equipment, despite the slowdown.

We anticipate unemployment will remain low since the labour market is still tight. Yes, employment will dip and unemployment will rise, but the starting point of extreme labour scarcity suggests that this economic slump will not have the typical labour market weakness. This will help mitigate the depth and duration of the downturn.

Foreword cont'd

The inventory impact

While the effects of rising interest rates and high inflation will cause a significant slowdown in growth, they're not enough to cause a recession on their own. What's pushing us into a technical recession—defined in Canada as two quarters of back-to-back declines in real GDP—is a large swing in inventories. Inventories don't often get a lot of attention because they're a small part of the economy. But during the pandemic, we saw supply chain issues emerge as shipments were delayed, shelves became bare at times, and businesses struggled to secure important parts. Inventories fluctuated quite significantly in the past few quarters, and they've soared in the second quarter of this year. A notable portion of this inventory build was in grain, which will drop again after it's exported. As business inventories slowly return to a more normal level, we'll see their contribution to the economy decline. This drawdown acts to depress real GDP and contributes meaningfully to economic contraction.

The United States experienced a similar situation earlier this year when the slowing pace of inventory accumulation pushed its second-quarter GDP growth rate into negative territory. That wasn't a recession. In Canada's case, however, such a scenario likely will be because the inventory swing will happen when the impact of higher interest rates is depressing economic activity.

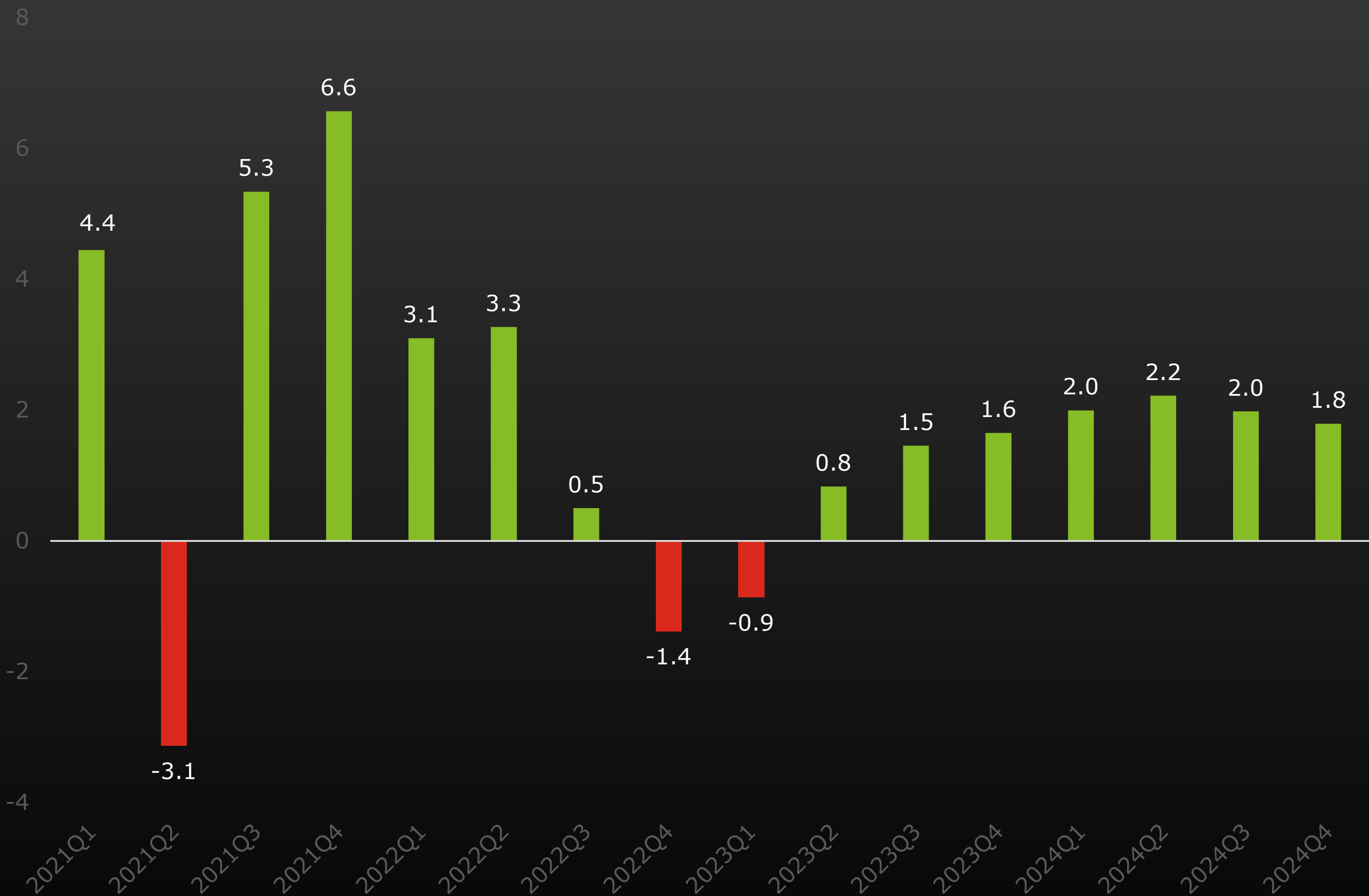
This leaves the economy in an interesting situation. We're expecting to enter a recession, but a recession with an asterisk. In fact, we haven't changed our forecast from the last quarter all that much. A slightly faster pace of monetary tightening to a higher level is pulling forward some of the expected weakness. And the recent unexpected surge in inventories will need to come down as supply chains normalize.

While these factors are enough to tip the scales into recession, the fundamentals of the economy haven't changed much. Tight labour markets, consumers with excess savings, and businesses that need to make investments to contend with labour shortages and international competition will help keep the downturn short and mild, with the economy beginning to rebound in the second half of next year. After eking out a gain of just 0.2% in 2023, real GDP growth is expected to accelerate to an 1.8% pace in 2024 after posting a gain of 3.0% this year.

Fiscal and monetary policy

The Bank of Canada has had a busy year. At the time of writing, it had hiked interest rates at five consecutive meetings, with four of them being oversized increases. The overnight rate went from 0.25% in March to 3.25% in September—a hike of 300 basis points in six months—with more than half of that increase in the last two meetings. With those moves, monetary policy is now in restrictive territory, meaning the policy interest rate is now above the neutral rate (the rate that is neither inflationary nor deflationary, estimated to be in the range of 2.0% to 3.0%) as the Bank aims to rein in inflation.

Inflation has quickly accelerated from impacting a handful of items to becoming broad-based, putting upward pressure on future expectations. With inflation soaring to 8.1% in June before easing back down, the Bank's measures of core inflation averaged 5.3%—well above its 2.0% target. Despite the aggressive pace of tightening this year, it will take time for inflation to return to neutral territory because the full impact of higher interest rates on the economy lag about 12 to 18 months. As such, we don't expect inflation to return to 2% before the end of 2024. This is in line with the Bank's own expectations for price growth.



Fiscal and monetary policy cont'd

It's important to note that the Bank is not done raising rates yet. In September, it gave a clear message that rates needed to move higher. Accordingly, we expect another 50 basis points hike at the next meeting in October, lifting the overnight rate to 3.75%. The question is whether there will be further tightening. The communique in September certainly didn't read like the central bank was setting the stage for a pause in October, but its macroeconomic models are likely giving a similar result to our own: that the combination of the cumulative interest-rate increases, and inventory swings is likely to trigger a contraction.

On this basis, we have been conservative and have assumed that the Bank will pause after October. The forthcoming contraction will reduce some of the excess demand currently boosting inflation and help price growth to come down. With clear evidence that inflation is getting back under control, the Bank is expected to begin cutting its overnight rate in 2024 until it reaches its neutral rate, in an effort to avoid inflation falling below target.

On the fiscal policy front, governments are facing a bit of a tough situation. High inflation has led to a significant boost to nominal GDP and government revenues, and there's a desire in some governments to return some of that windfall to constituents who are feeling the pinch of high inflation. However, governments need to be careful not to offset the work of the Bank of Canada or else interest rates will have to move even higher to blunt the impact of fiscal stimulus.

In our forecast, we assume that governments will be patient in the near term and will save the additional fiscal room they're accumulating to boost their spending and investment in 2023 to help offset some of the weakness in the economy.

Households

A high-inflation, high-interest rate environment is bad news for household spending and residential investment. High inflation eats away at household purchasing power while higher interest rates push up debt-servicing costs, leaving fewer funds for discretionary spending. However, the news on the household front is not all bad. A notable portion of the savings built up during the pandemic remains available and the labour market is expected to hold up relatively well, blunting some of the consumer impacts we would typically expect in an economy experiencing these types of pressures.

On the job front, labour market tightness has been a pressing concern for months. Job vacancies have soared, and the unemployment rate has hit lows not seen in decades. However, there has been a discernible shift in recent months. Employment declined in July and again in August, pushing the unemployment rate up by 0.5 percentage points to 5.4%. Our forecast calls for the rate to continue to trend upward until the second half of next year as employment growth slows dramatically. That being said, it's not expected to go higher than 6.0% despite the economic downturn.

That's due to a few key factors. First, job vacancies remain a concern in various sectors, and the difficulty in finding labour is expected to keep employers from being quick to reduce their payrolls, even in the face of slowing growth. Second, labour supply is expected to remain tight as the retiring cohort of baby boomers continues to put downward pressure on the labour market. Third, the recession we're anticipating isn't expected to be broad-based. Thus, while we'll see declining employment in some sectors, growth in others will help cushion the blow to total employment.

Overall, after increasing by 3.7% this year, we expect employment to grow just 0.8% in 2023. Sectors with weak near-term prospects include wholesale and retail trade, education services, building support and administrative services and information, communications, and cultural services. On the other hand, we expect to see continued strength in professional services and an ongoing recovery in transportation and accommodation services, helping to offset some of the near-term weakness. The unemployment rate overall is expected to peak at 6.0% in the third quarter of next year before starting to come back down. It's worth noting that such an unemployment rate is not much higher than that associated with full employment for the Canadian economy, implying that labour shortages will return as a dominant issue once the economy strengthens.

With prices on the rise, we expect overall consumption spending to weaken in the quarters to come, especially the consumption of goods, where outlays in real terms are expected to be essentially flat this quarter. That is due to declines in durables and semi-durables, which are heavily influenced by the housing market—and as those are expected to remain weak in the near term, growth will remain muted in goods consumption next year. On the other hand, consumer spending on services is expected to continue rising at a slower rate until the end of the year. This is due to pent-up demand as Canadians embrace travel and social outings now that most COVID-19 restrictions are in the rear-view mirror.

Households cont'd

Looking ahead to 2024, the prospect for consumer spending is positive. Decelerating inflation and falling interest rates will allow for an improvement in household finances, helping to boost the consumption of goods. Gains in services will, however, moderate as pent-up demand will have been largely sated by that point. After growing by 5.5% this year, real consumer spending is expected to gain another 2.7% in 2023 before softening to a sustainable pace of 1.9% the year after.

Canada's real estate market continues to exhibit an unusual amount of volatility. After leading the economy out of the COVID-19 recession, the housing market is now helping to lead us into the next recession, since rising interest rates and deteriorating affordability have hit the sector hard. Conditions in the resale market started to turn in the spring, coinciding with the start of higher borrowing costs. Since then, both prices and units sold have fallen significantly. In July, the number of homes sold was down about 30% from the previous July. This affects the real economy mainly through two parts of residential investment: ownership transfer cost investments and renovations.

The transfer cost investments measure the expenses associated with real estate transactions, such as broker fees. In 2021, that component increased by over 20% in real terms. But with activity quickly falling, the sector is set to give back those gains, with a 21.5% decline expected in 2022 and another 14.4% drop next year. The other component, renovations, tends to accelerate when rising home prices and high sales create an incentive for people to make investments in their home prior to listing. With prices and volumes retreating, we expect to see real renovation spending decline by 1.9% this year and another 4.8% next year.

On the new-construction front, there has been lots of discussion about the need to increase housing supply to alleviate affordability concerns. However, the rapid rise in material prices has led to a sharp increase in housing prices and that, combined with higher mortgage rates, will lead to a slowdown in new home construction in the near term. This is expected to be temporary, though; housing starts are likely to increase once again after the cyclical slowdown, given our strong population growth.

Business

Canada's trade sector has been bolstered by high commodity prices during the first half of 2022, with surging oil prices in particular helping to drive strong export growth. However, with oil prices trending down from June to August, we expect slower merchandise export growth in the third quarter because the energy sector remains a key component of trade. Not all sectors are facing an imminent slowdown; agriculture is expected to post strong growth as inventories of wheat and canola are shipped out of the country.

Looking into 2023, we expect to see a deceleration in both import and export growth. The weak value of the Canadian dollar combined with a slowdown in consumer spending will weigh on imports, although some of this weakness will be offset by continued business investment. Export growth will also slow because of the emerging weakness in the United States and China, key destinations for Canadian exports.

Next year's deceleration is expected to be more widespread due to the soft demand in key markets. On the services side, gains are expected to continue despite the slowdown in overall economic growth as strong pent-up demand for travel continues to buoy activity. As Canadians re-embraced international travel, imports of services are expected to grow by 16.8% this year. Another 11.8% increase is expected in 2023. Canada's tourism sector will not be left out of the return to more normal, with service exports forecasted to grow by 8.7% this year and another 11.6% next year, helping to offset some of the weakness on the goods side.

During the pandemic, companies slashed their capital expenditures (capex) budgets. We saw only a modest recovery in 2021, when total economic growth was being fuelled by housing and consumer spending. But in recent months, we've seen a notable pickup in spending. This has been driven by several factors. Demand in the economy has been red-hot of late and rising profitability has provided businesses with both the means and the motive to invest in their operations. Further, the tight labour market conditions provide additional incentive for businesses to invest in productivity-enhancing equipment, essentially swapping out labour for capital where possible.

Lastly, business investment is still in the recovery phase. Such investment has been chronically weak for years—to the point where the capital stock was declining—and then the sector experienced the largest decline during the pandemic across major GDP categories. This means that stronger growth is needed to offset previous weakness. These three factors taken together will help business investment remain one of the faster-growing components of GDP in the near term. Overall, we expect real investment spending on structures, machinery, and equipment to increase by 10.2% this year and 6.0% in 2023.

Outlook by province

With the downturn in economic growth being driven mainly by households, all provinces are expected to experience a sharp slowdown or outright decline in economic growth next year. The severity of the downturn will depend on the composition of each province's economy and what type of compensating factors will support growth in it. We know that, on an aggregate level, the largest impact will come from the housing sector and, therefore, the state of provincial housing markets will be a large factor in the outlook. In addition, the phase of the economic recovery in which each jurisdiction was before the latest slowdown is influencing its forecast. Some energy- and agricultural-producing provinces, for example, were still recovering from the pandemic recession and were expected to post strong growth both this year and next to bring their economies back into equilibrium. Other provinces were already operating at capacity and experiencing more modest output gains; the downward revision to growth will push them into a mild recession.

Many provinces experienced rapid gains in housing sales and prices over the past few quarters. Now we're seeing sales fall across the country as the housing market retreats, although the size of the slump varies considerably. Newfoundland and Labrador, Manitoba, and Saskatchewan are seeing the smallest decline in activity while British Columbia, Ontario, and Quebec are experiencing more significant drops.

Real GDP growth by province (percent change)

	2021	2022	2023	2024
Newfoundland and Labrador	1.2	2.4	2.1	1.3
Prince Edward Island	6.6	3.4	-0.1	2.5
Nova Scotia	5.8	2.6	-0.5	1.8
New Brunswick	5.3	1.9	-0.5	1.6
Quebec	5.6	3.4	-0.2	1.4
Ontario	4.6	3.0	-0.5	2.0
Manitoba	1.2	4.2	2.3	1.9
Saskatchewan	-0.3	3.5	3.3	2.5
Alberta	5.1	4.7	1.4	1.8
British Columbia	6.2	3.1	-0.5	1.9

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Outlook by province cont'd

On the East Coast, we expect real GDP to contract next year in all provinces but Newfoundland and Labrador, where growth is expected to continue. The economies of New Brunswick, Nova Scotia, and Prince Edward Island weathered the pandemic better than most provinces and were already expecting a softer pace of growth this year, in line with their underlying potential. All three experienced significant housing market gains since the pandemic began and as higher interest rates impact the market and household finances, we expect to see mild contractions in their real GDP next year. Newfoundland and Labrador will continue to post growth into 2023 due to strength in its mining sector and because its housing market isn't declining as fast as in other regions.

We forecast a small decline in real GDP next year in central Canada, with both Quebec and Ontario feeling the pinch of high inflation and rising rates. The decline in Quebec will be buffered by its strong labour market and recovering aerospace sector. Ontario will experience a sharper decline as its housing market undergoes a more pronounced correction, but it will benefit from a rebound in motor vehicle manufacturing, which was sharply curtailed last year due to a shortage of semiconductors.

The economies in the Prairies are expected to hold up better than in other regions. This is partly due to the rebound in growth in the energy sector, where strong prices are propelling oil and natural gas extraction, and the recovery in agriculture following drought conditions last year. After being a growth laggard for many years heading into the pandemic, Alberta is expected to post growth well above the Canadian average in 2023, following above-average growth this year too.

In Saskatchewan, both the energy and non-energy mining sectors are expected to do well as demand increases for potash in Saskatchewan because of the war in Ukraine. The rebound in agriculture will also propel the province to the top of the GDP rankings next year. Manitoba is the only major non-energy producer that is expected to post positive growth next year, since the slowdown in its residential market will be more than offset by the continued recovery in agricultural and utilities output following last year's drought conditions.

After being a growth leader for many years, British Columbia will find itself in an unfamiliar position next year as it experiences the weakest economy in the country. Growth in the province will be negatively impacted as it contends with a housing market correction and declining demand and prices in its forestry and forest product manufacturing sectors.

Final thoughts

At the time of writing, we expect to see the Canadian economy enter a mild but short-lived recession before the end of the year. A swing in inventories is an important part of the reason; the economy is stronger when that effect is removed. Regardless, the economic cycle is turning for Canada. The interest rate shock is causing a housing correction, which will also dampen consumer spending on housing-related purchases. Across the border, that interest rate shock will weaken US demand and curtail Canadian exports. A global slowdown will lower commodity prices and diminish Canadian overseas trade. Business investment might show some resilience, but business confidence will be affected by financial volatility and weakening economic conditions.

It's worth emphasizing that psychology plays an important role in the severity of an economic downturn. The depth and duration of the negative impact on business and consumer confidence will be a key determinant in how the economy performs over the next year. Our assumption is that businesses will see the downturn as temporary and won't slash payrolls and capex budgets, although they might trim them. Likewise, consumers are expected to rely on their high levels of savings and see the recession's slight impact on the labour market as an indication that their finances, while strained, are not in a dire situation. However, if the opposite happens and fear takes hold, the downside to the economy will be significantly greater.

Aside from the risks related to confidence, other factors could lead the economic outlook to deviate from our expectations. The Bank of Canada could be more aggressive with its pace of tightening, leading to a deeper downturn by way of higher interest rates and, in turn, negative impact on consumer confidence. The war is still raging in Ukraine, creating geopolitical unrest and an uncertain economic environment in Europe. Finally, our baseline assumption is that the US economy will slow to 1.0% growth next year, aligned with a soft landing in the United States. Should monetary tightening have a more negative impact on our largest trading partner, we would see a more negative impact on Canadian exports and business investment.

To end on a positive note, there are also some upside risks to the forecast. Strong population growth could bring about a faster recovery in the housing market and the high level of household savings could be spent quicker than expected, affecting the outlook for household spending. But with risks plentiful and a recession on the horizon, one of the best ways to plan and act nimbly to changing circumstances is to undertake scenario-planning to understand the implications of different economic trajectories.

Key economic indicators

	2022				2023				21A	22F	23F
	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F			
Real economic activity											
Gross domestic product	3.1	3.3	0.5	-1.4	-0.9	0.8	1.5	1.6	4.5	3.0	0.2
Household consumption expenditure	3.4	5.3	4.4	3.7	3.2	2.5	2.1	1.9	5.0	5.3	3.2
• Durable goods	8.8	-12.0	-0.5	-0.2	0.3	1.0	1.0	1.5	7.3	-0.9	-0.4
• Services	1.5	16.3	4.8	4.0	3.8	3.2	2.8	2.4	5.0	8.7	4.3
Residential investment	7.3	-27.6	-11.0	-9.6	-3.1	-1.7	-0.8	-0.4	15.3	-9.1	-6.5
Non-residential fixed investment	9.0	13.9	15.0	5.9	4.3	4.1	2.5	1.3	2.3	10.3	5.9
• Non-residential structures	12.7	11.1	19.1	6.3	3.6	2.9	0.8	-0.2	-0.3	11.7	5.6
• Machinery & equipment	2.5	19.3	8.4	5.2	5.5	6.1	5.4	3.8	6.6	7.8	6.6
Government consumption & investment	2.8	-1.2	-5.2	-3.7	-2.2	-0.7	0.3	0.8	5.6	0.5	-2.0
Exports of goods & services	-9.0	10.9	11.3	5.2	4.6	3.9	3.2	3.4	1.4	3.3	5.5
Imports of goods & services	-1.4	30.5	4.2	4.1	3.4	3.6	3.2	2.6	7.7	8.7	5.0
Prices											
Consumer price index (y/y)	5.8	7.4	7.5	7.1	6.0	3.9	3.2	2.8	3.4	6.9	3.9
Implicit GDP price index (y/y)	8.8	9.8	8.2	7.0	4.8	1.9	2.6	2.4	8.1	8.5	2.9
Labour market											
Employment	3.2	3.9	0.3	0.2	0.5	0.8	1.3	1.5	4.8	3.7	0.8
Unemployment rate (%)	5.8	5.1	5.3	5.6	5.8	5.9	6.0	5.9	5.4	5.9	5.8

Note: Unless otherwise noted, all figures are expressed as annualized % changes.
Sources: Statistics Canada, Bank of Canada. Forecast by Deloitte Economic Advisory, as of **Sept 12, 2022**.

Financial market indicators

	2022				2023				21A	22F	23F
	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F			
Interest rates (%)											
Overnight rate target	0.33	1.17	2.75	3.75	3.75	3.75	3.75	3.75	0.25	3.75	3.75
3-month T-bill	0.64	1.65	3.26	3.96	3.89	3.83	3.79	3.76	0.15	3.96	3.76
1-year GoC note	1.40	2.58	3.70	4.33	4.23	4.17	4.13	4.11	0.74	4.33	4.11
2-year GoC note	1.49	2.75	3.36	3.88	3.87	3.86	3.86	3.86	0.92	3.88	3.86
5-year GoC note	1.76	2.86	3.13	3.64	3.74	3.80	3.86	3.92	1.34	3.64	3.92
10-year GoC bond	1.92	2.98	3.12	3.58	3.70	3.79	3.88	3.95	1.58	3.58	3.95
Yield curve spread (pp)											
3-month vs. 10-year	1.28	1.33	-0.14	-0.38	-0.20	-0.04	0.09	0.19	1.43	-0.38	0.19
2-year vs. 10-year	0.43	0.23	-0.24	-0.30	-0.17	-0.07	0.02	0.09	0.66	-0.30	0.09
Foreign exchange											
USD/CAD ($C)	1.27	1.28	1.29	1.29	1.28	1.26	1.25	1.23	1.26	1.29	1.23
CAD/USD (US cents)	0.79	0.78	0.77	0.77	0.78	0.79	0.80	0.81	0.79	0.77	0.81

Sources: Statistics Canada, Bank of Canada. Forecast by Deloitte Economic Advisory, as of **Sept 12, 2022.**

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