CANADA QUARTERLY ECONOMIC OUTLOOK | FIRST QUARTER 2024

What might “less bad” mean for investors?

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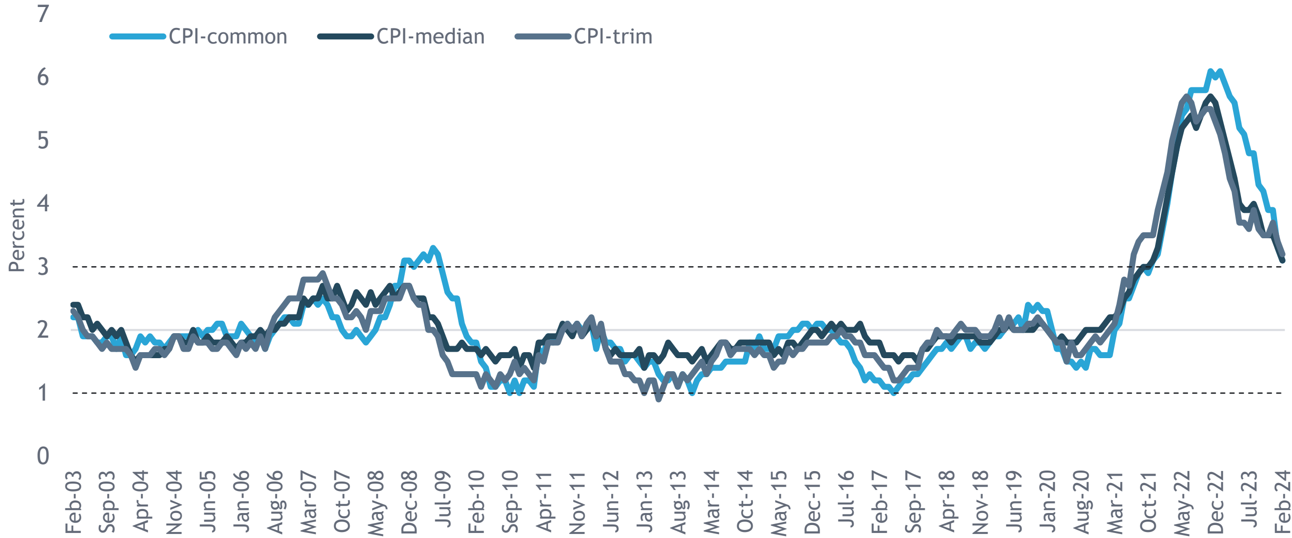
Although SEI has expressed concerns about the Canadian economy in recent quarters, we also observed that an economic downturn would be unlikely to prove either deep or prolonged. Positive surprises in recent measures of economic activity, although not indicative of robust growth, have signaled things may have stabilized enough—or are at least sufficiently “less bad”—that a recession could be avoided altogether. As in many other advanced economies in the first quarter, Canada’s labour market was still strong, equity markets were buoyant, bond yields rose, government budget deficits attracted concern, and the Bank of Canada resisted cutting interest rates contrary to market expectations at the start of the year. So what might a “less bad” economy mean for investors?

At the end of the first quarter, the Canadian economy found itself in a situation similar to many other advanced economies—albeit with a few uniquely Canadian wrinkles, such as immigration dynamics and household debt levels. Although there were ongoing signs of softness in new housing and business investment, overall economic activity and sentiment held up better than consensus expectations, while inflation continued to trend down.

Inflation data could be considered the most encouraging of the lot, given that, as of February, it had descended to a level just outside the upper end of the Bank of Canada’s (BoC’s) target range of 1% to 3%, as shown in Exhibit 1 on the following page. Measured over shorter time frames, the news is even more encouraging. For example, on an annualized basis, three-month moving averages of CPI-median and CPI-trim were both below 2.5%. As noted in our global quarterly outlook, Canada has been outperforming other countries in terms of getting domestic inflation under control.[1]

[1]See Exhibit 2: Mission not accomplished in SEI’s First Quarter 2024 Economic Outlook Part 2, “Sticky inflation + stubborn central banks = spirited markets.”

Exhibit 1: Consumer price inflation approaching target

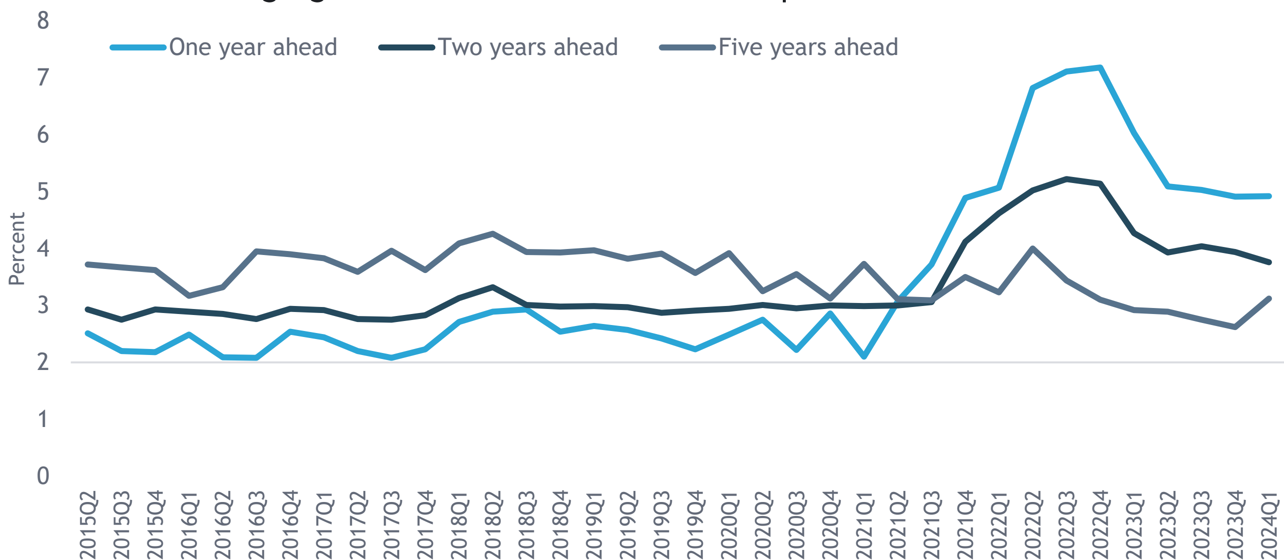


Source: Bank of Canada. Year-on-year change in consumer price inflation (CPI) measures, February 2003 through February 2024. CPI-common is measured using a statistical factor model, CPI-median is based on a weighted median approach, and CPI-trim employs a trimmed mean approach. Dashed lines depict the 3% upper and 1% lower bounds of the BoC's inflation-control target.

However, like most advanced-economy central banks, the BoC has not yet taken enough comfort in the inflation data—or become concerned enough about the economic outlook—to begin cutting interest rates. In Canada and elsewhere, rate markets spent the first quarter toning down end-of-year rate-cutting expectations that SEI believed were far too dovish. The BoC took a wait-and-see approach at its March meeting, with members of the Governing Council agreeing that "they need to see further and sustained easing in underlying inflation," with close attention paid to indicators such as supply-and-demand balance in the economy, corporate pricing behaviour, inflation expectations, and wage growth relative to productivity.

Encouragingly, supply-demand imbalances appear to be improving—although we worry that a rebound in energy prices could cause renewed pressure on headline inflation measures in the quarters ahead. According to the BoC's first quarter 2024 Business Outlook Survey, fewer firms were planning to meaningfully hike prices in the next 12 months. However, the last two indicators—inflation expectations and wage growth relative to productivity—could prove challenging for those hoping to see a BoC easing cycle get underway soon. As shown in Exhibit 2, the most recent BoC Survey of Consumer Expectations found that near-term inflation expectations remained stubbornly high, while five-year expectations—which had fallen to 2.6% in the prior survey—ticked up by half a percentage point, bringing them above 3%.

Exhibit 2: Concerning signals from consumer inflation expectations



Source: Bank of Canada. From Canadian Survey of Consumer Expectations, quarterly data from 2014Q4 through 2024Q1.

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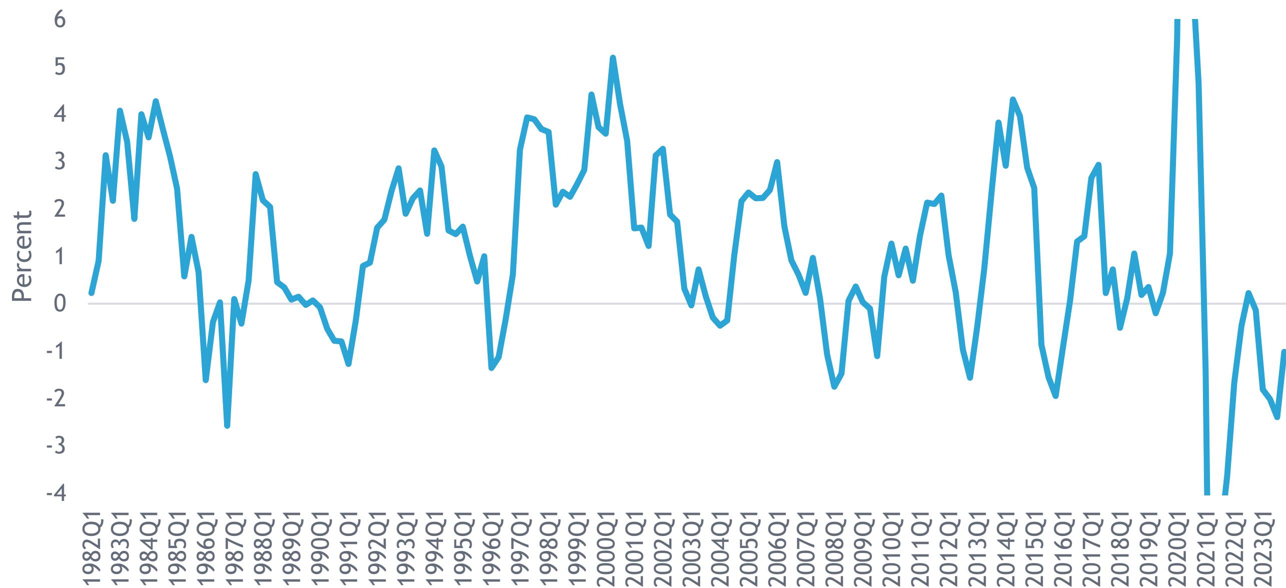
Meanwhile, as noted in our global Quarterly Economic Outlook, wage growth in 2023 was well above pre-COVID levels in Canada as well as several other advanced economies,[2] and in Canada's case, this has occurred against a backdrop of *declining* productivity in recent years (Exhibit 3). While we should note that productivity can be difficult to measure with precision in services-heavy economies, to the extent it provides a reasonable approximation of underlying trends, it's something the BoC has to remain concerned about.

Exhibit 3: Declining productivity adds to inflation concerns



Sources: Statistics Canada, SEI. Year-on-year change in quarterly labour productivity. Vertical axis shortened to remove distortions caused by COVID-related volatility in 2020-2021.

A turnaround in productivity growth would certainly help the inflation outlook and give the BoC more room to cut interest rates. But while Canada's southerly neighbour has been enjoying upside productivity surprises of late, the catalysts for a similar dynamic at home are not yet clear. Business investment has been lackluster, and according to the latest Business Outlook Survey, "Businesses are moderating their investment plans in response to high borrowing costs, persistently weak demand, and easing capacity pressures. In this environment, fewer firms feel the need to expand. Instead, more businesses are focusing their investment on maintaining existing capacity." That's hardly a recipe for a productivity revolution. Perhaps generative artificial intelligence and large language models will provide some support as they become adopted more widely. Meanwhile, proponents of immigration argue that population growth can foster innovation and thus greater productivity; however, these are likely to be second- and third-order effects that take time to unfold, possibly across multiple generations.

Given immigration's ongoing importance to the Canadian economy and some recently announced changes, a further word on the matter is in order. The net economic effects of the federal government's strong immigration push in recent years (Exhibit 4) are widely believed to be positive, as immigrants have likely provided some measure of labour market relief, added to consumer activity and contributed to pent-up housing demand. The housing aspect may be a double-edged sword however, as shelter price inflation has been the largest contributor to official price measures in recent quarters (Exhibit 5). This may have been a motivating factor behind Immigration Minister Marc Miller's March announcement that the government would seek to lower temporary residents to 5% of the population from over 6%. While this decision certainly won't undo the government's ambitious immigration targets of roughly half a million permanent residents each year through 2025, it may have some interesting marginal effects on consumer activity, the labour market, and housing in the years ahead.

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[2]See Exhibit 3: Labour markets provide no reason for inflation optimism in SEI's First Quarter 2024 Economic Outlook Part 2, "Sticky inflation + stubborn central banks = spirited markets."

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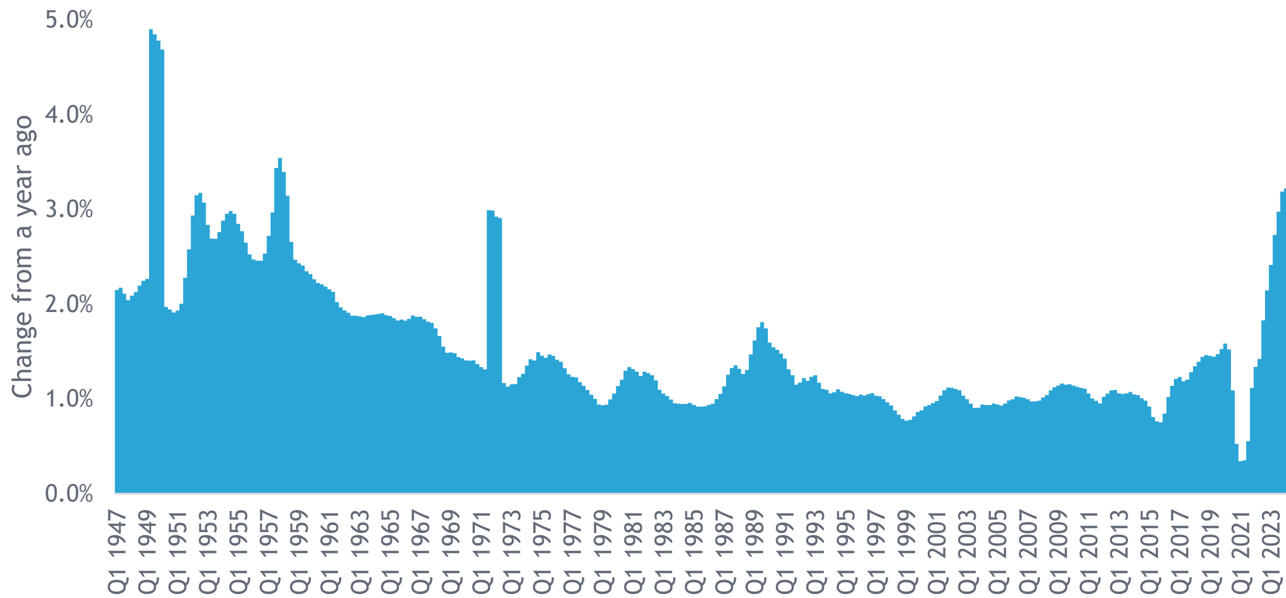
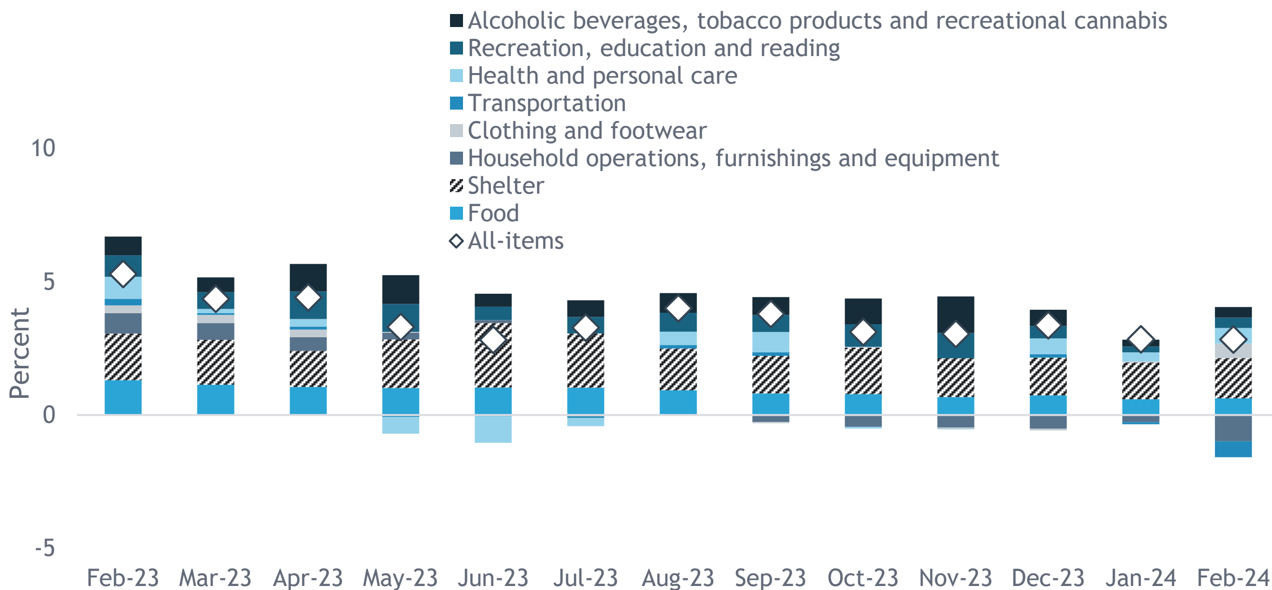
Exhibit 4: Fastest population growth since the 1950s



Source: Statistics Canada, SEI. Year-on-year change in quarterly population estimates, first quarter of 1947 through first quarter of 2024.

Exhibit 5: Shelter prices keeping inflation elevated



Source: Statistics Canada, SEI. Year-on-year change in monthly consumer price inflation, February 2023 through February 2024.

Given this outlook, it makes sense to us that the BoC's Governing Council has adopted a more patient approach than markets expected at the start of 2024. Better—but still weak—data, a potential spring thaw in home sales, and "less bad" business and consumer sentiment could mean that the economy continues to avoid recession in 2024. With inflation still above target, markets now expect a more reasonable 0.75% decrease in the BoC's target rate over the rest of this year. In this environment (as in most!), investors should stick to their long-term strategy, seeking to take advantage of diversification benefits and employing active management where appropriate.

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