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Canadian outlook: stronger growth, stickier inflation

Resilient Canadian consumers will keep growth stronger, inflation stickier, and policy tighter in the coming months. But the central bank's hiking cycle should eventually tip the economy into recession by the turn of the year.

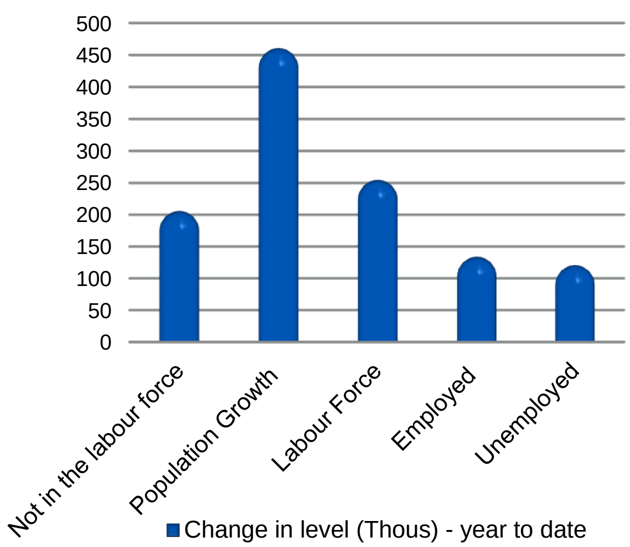
Key Takeaways

- The Canadian economy remains resilient, for now, despite a softer outturn in July jobs growth. This followed a very strong report in June and the pace of monthly GDP has improved in recent months.
- While strong immigration flows have improved the supply of labour, they have also boosted demand within the economy, with consumption growth very robust in Q1, at 5.7% quarter over quarter annualised.
- The net of these two effects suggests that imbalances remain in the Canadian economy, with the BoC's preferred measures of inflation moving sideways.
- In light of this, the BoC has returned to the table with consecutive hikes in June and July.
- But headwinds are coming. Nearly 500bps in cumulative tightening, increasing mortgage costs, and large debt burdens will likely weigh on Canadian consumers in H2.
- Businesses will also face higher costs of capital and tighter lending standards, weighing on investment. This private sector retrenchment should pull the economy into recession at the turn of the year.
- Therefore, we think the BoC may well have finished its hiking cycle. But the bar for a September hike is low if resilience persists and inflation continues to move sideways.

Employment a little softer in July

The Canadian economy lost 6,400 jobs in July, following strong jobs growth in June. Stronger population growth due to immigration flows, meant that labour supply growth impacted the ability of these newcomers to find new jobs, leading to a tick higher in the unemployment rate to 5.5% and slight decline in the participation rate to 65.6%.

Figure 1: Strong population growth drives higher employment and unemployment despite people leaving the labour force



Source: Haver, July 2023

But a higher population adds to excess demand in the economy

While improving supply dynamics in the labour market, immigration inflows have also been contributing to a stronger outturn in consumer spending, which increased 5.7% in annualised terms through Q1.

Monthly GDP data suggests that this momentum has waned a little through the second quarter with goods industries softening sharply in May while services improved.

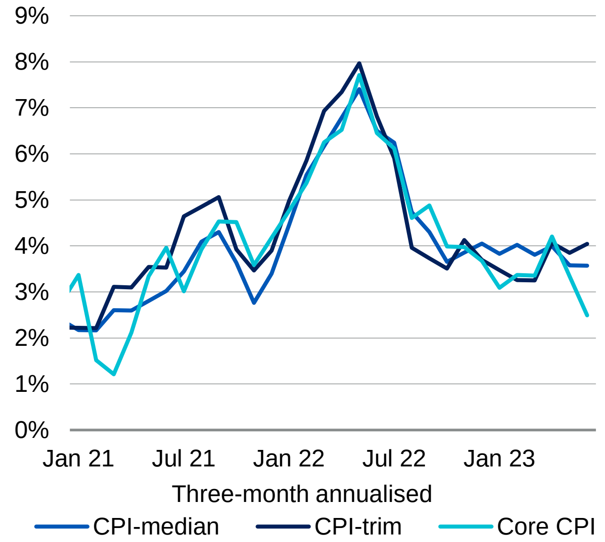
Inflation continues to move sideways

Headline price pressures softened in recent months given drags from energy and food prices. But core inflation remains sticky as the tight labour market keeps wage growth above rates consistent with the Bank of Canada (BoC)'s inflation target range of 1%-3%.

Additionally, short-term inflation expectations remain elevated. These forces likely explain why the BoC's preferred measures of underlying inflation pressures continue to track sideways at a run rate of around 4%.

This adds to our conviction that a recession is required to loosen the labour market enough to quell inflation pressures.

Figure 2: Preferred core inflation measures are stalling around 4%

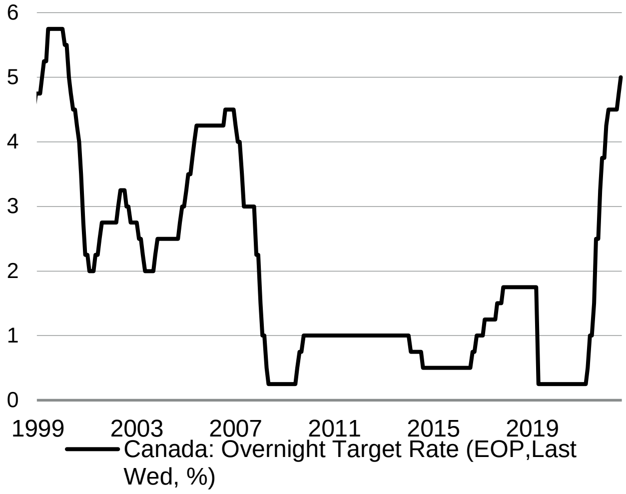


Source: Haver, July 2023

Increasingly tight policy should trigger this downturn

The combination of continued excess demand, a tight labour market and less progress on the inflation front, led the BoC to halt its tentative pause and return to hiking rates consecutively in June and July. This brings the total tightening to 475bps over a 17-month period – one of the fastest and most pronounced tightening cycles in recent history.

Figure 3: Policy has been tightened significantly



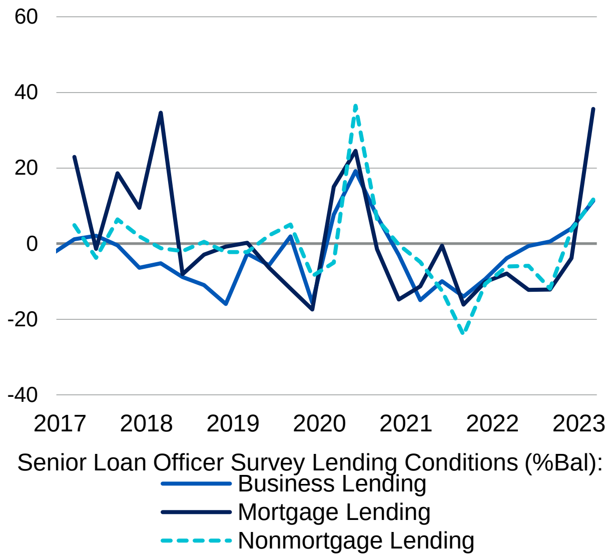
Source: Haver, abrdn, June 2023

There are long and variable lags in the time it takes for monetary policy tightening to be felt, and uncertainties around the point at which policy becomes restrictive i.e., the level of r*. However, research suggests policy should begin to bite after around 12 to 18 months. Idiosyncrasies in the economy post-pandemic, such as large savings buffers, could impact this process, but we still believe this tightening cycle will eventually result in the economy slipping into recession.

Banks are beginning to tighten lending standards

Despite the Canadian banking system being fairly insulated from the recent stresses in the US, policy tightening has already made lending standards more stringent for both businesses and consumers. The sharp rise in lending standards for mortgages is worth watching because this may cause the housing market, which had begun to bottom out, to soften once again.

Figure 4: Lending standards are tightening



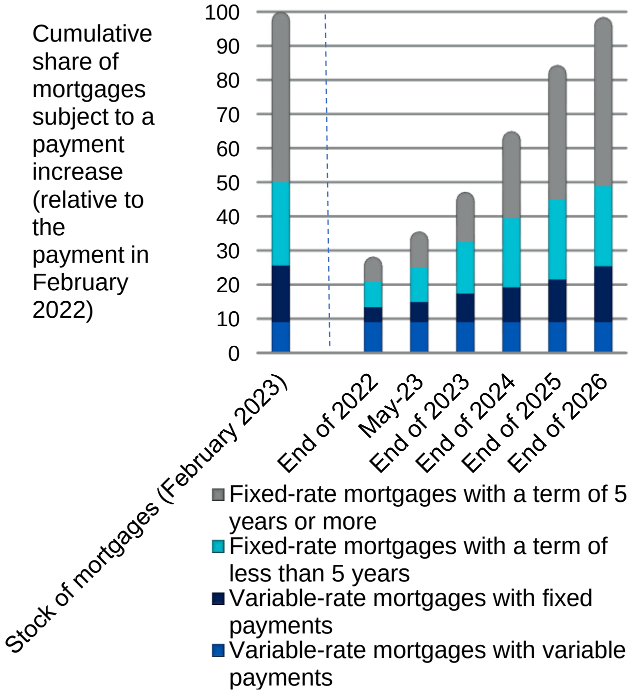
Source: Bank of Canada, Haver, abrdn, June 2023

Households will face increasing mortgage costs

The BoC often references mortgage costs in its communications given these make up a large share of liabilities on the household balance sheet. Recently, the financial system review estimated how likely it is that mortgage costs will increase in the coming years. The speed with which higher mortgage costs are felt depends on how long rates are typically fixed for. The first bar in Figure 5 shows that half of the stock of mortgages in Canada only have rates fixed for less than five years.

For variable rate mortgages, which make up around 9% of the Canadian market, costs are already 49% higher than in February 2022. By the end of 2023, nearly 50% of mortgages will be subject to higher payments, and, over the following two years, this will apply to nearly all mortgages.

Figure 5: Mortgage costs are on the rise

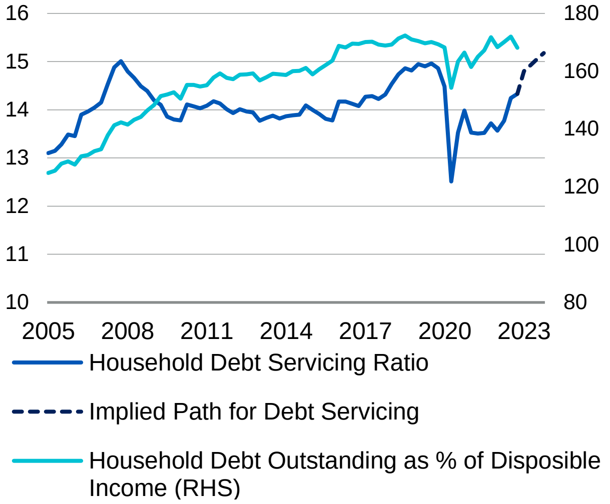


Source: Bank of Canada, June 2023

Since the BoC began its hiking cycle, debt payments as a share of disposable income have risen 1ppt, reaching 14.3%. While this is still below the peak seen in 2008, household debt burdens are larger now, with outstanding debt sitting around 170% of disposable income.

Combining the share of mortgages set to face rising costs with data on mortgage debt payments, we can estimate that debt servicing may increase to 15.2% – surpassing the peak seen in 2008. So, this is clearly one way in which consumers incomes will be depressed, leading to a pullback in consumption in H2.

Figure 6: Debt servicing costs are rising, and debt burdens are historically high



Source: Bank of Canada, StatCan, Haver, abrdn, June 2023

Setting up the conditions for a recession

This household indebtedness in the face of rising rates is one key reason why we continue to expect the Canadian economy to enter a recession. However, with the resilience seen so far this year, we have pushed back the timing of this to the turn of the year. But we do expect to see the economy stall by Q4, with business investment already weak and the housing market likely to re-soften considering the additional policy tightening.

We think, however, that the July hike was likely the last from the BoC this cycle. Should the strength in the economy persist through the summer, we think the bar to a further hike in September is low.

This increasingly tight policy, in combination with our expectations for a recession in early 2024, mean we think inflation will fall below 2% by next year, but this process may take longer. Therefore, we see rates remaining higher for longer, with a shallower cutting cycle than we had previously forecast beginning early next year.

Figure 7: Forecast table

	GDP	CPI	Policy Rate
2023	1.4 (1)	4 (3.7)	5 (5)
2024	-0.6 (1)	1.9 (2.3)	1.5 (3)
2025	2.8 (2.4)	1.9 (2)	1.5 (-)
	(Consensus expectations)		

Source: abrdn, Bloomberg, June 2023

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