International Commentary — January 10, 2023

Canadian Headwinds Continue to Mount

Summary

- After maintaining a respectable pace of growth through much of 2022, Canada's economy—especially the domestic economy—appears to have lost some momentum in recent months.
- Heading into 2023, the outlook for the Canadian consumer in particular suggests a further downshift in growth may be forthcoming. Amid rapid inflation, real household disposable incomes are falling, which should restrain consumer spending. Rising interest rates should also weigh on the housing sector and broader consumer activity. The outlook for business activity and investment has also become more uncertain. Altogether, we forecast a mild recession in Canada in the first half of 2023.
- With inflation still elevated, we still expect the Bank of Canada of raise its policy rate by 25 basis points to 4.50% at its late January meeting. However, as long as core inflation begins to slow perceptibly in the months ahead, we anticipate that this rate hike will be the last of the current tightening cycle.
- From a currency perspective, we also believe a contracting Canadian economy and end of Bank of Canada tightening could contribute to some underperformance by the Canadian dollar over the short-to-medium term.

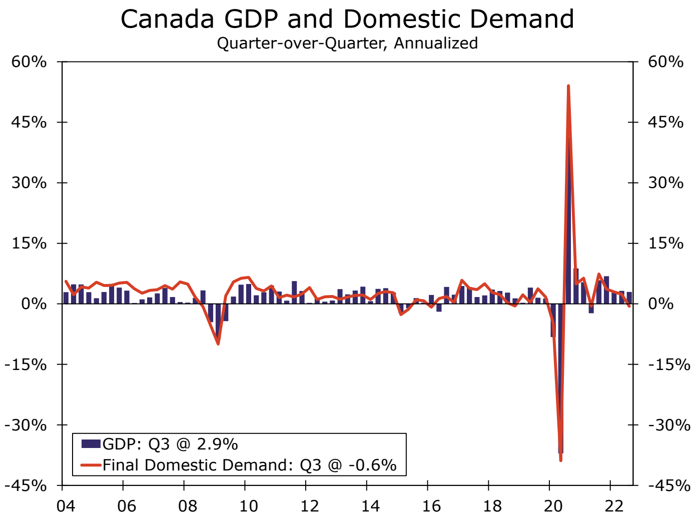
Economist(s)

Nick Bennenbroek
International Economist | Wells Fargo Economics
Nicholas.Bennenbroek@wellsfargo.com | 212-214-5636

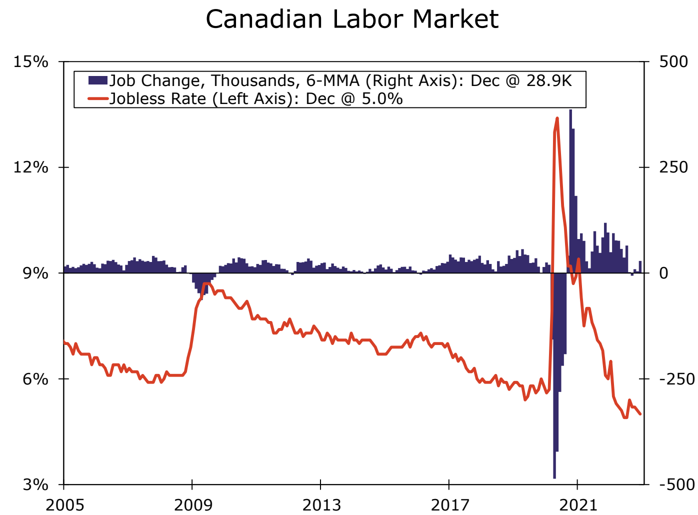
Canada's Economy Shifting Down Through the Growth Gears

Canada's economy maintained a respectable pace of growth through much of 2022, although that momentum clearly waned in the final months of last year and we believe will slow further in 2023. Overall GDP growth was broadly steady near a 3% pace during the first three quarters of last year; however, this pace of growth masked a notable slowing in domestic activity as final domestic demand contracted at a 0.6% quarter-over-quarter annualized pace in Q3. That fall in domestic demand was due to declines in both consumer spending and business investment, declines that we believe could be repeated in the early part of 2023.

Monthly indicators have also pointed to lessening momentum in recent months. October GDP rose just 0.1% month-over-month, with a flash estimate for a similarly small increase in November. Meanwhile, Canadian employment did surge 104,000 in December, driven by a gain in full time jobs, and the jobless rate dropped to 5.0%. That said, the average monthly employment gain was 28,900 in the second half of last year, down a bit from the average gain of 36,800 in the first half of 2022.



Source: Datastream and Wells Fargo Economics

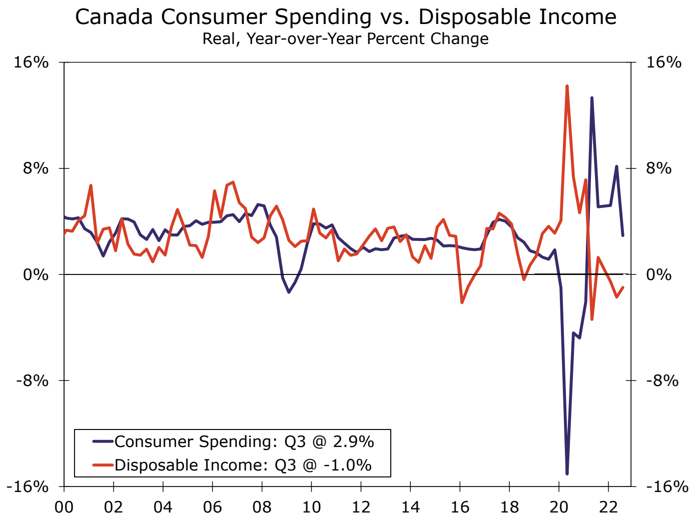


Source: Datastream and Wells Fargo Economics

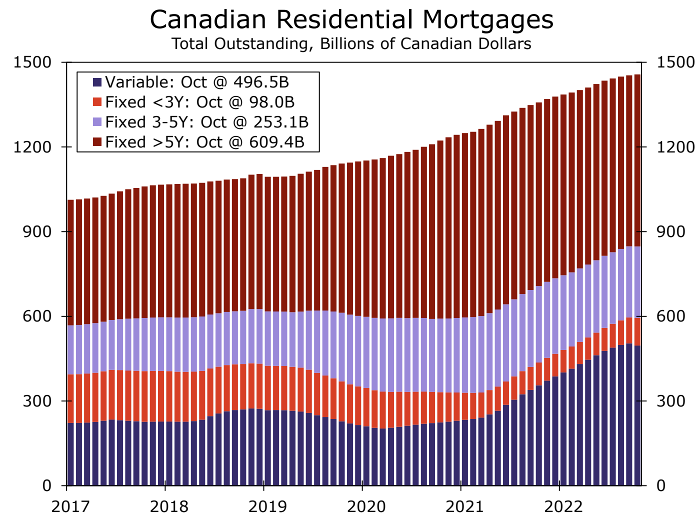
Cautious Consumer to Cool Canadian Growth Further

As we turn the page to 2023, it is the outlook for the Canadian consumer in particular that suggests a further downshift in growth should be forthcoming. While Canadian households have seen their disposable incomes grow in nominal terms, that income growth has not kept up with the pace of inflation. Thus, for the latest available data (Q3-2022), real household disposable income fell 1.0% year-over-year, in contrast to consumer spending, which was up 2.9% year-over-year during the same period. The fall in Canadian household real incomes is likely to keep chipping away at the ability and willingness of Canadian consumers to keep spending in the quarters ahead.

The sensitivity of Canadian household borrowing costs to rising policy interest rates is another factor that clouds Canada's economic outlook. During the pandemic, when borrowing costs were exceptionally low, the demand for variable rate residential mortgages surged. In January 2020, only around 18% of outstanding residential mortgages were variable rate but, given the subsequent surge in demand, that proportion of variable rate mortgage has now risen to 34% of total outstanding mortgages by October 2022. As the Bank of Canada has rapidly raised interest rates during 2022, higher rate have rapidly flowed through into household borrowing costs. Indeed, Q3-2022 saw the debt service ratio for Canadian households rise to 14.0% of disposable income from 13.5% in Q2. That increase was entirely driven by a jump in interest costs to 7.2%, which was partly offset by a drop in principal payments to 6.8%. Not only has the rise in borrowing costs had a chilling effect on Canadian housing activity (existing home sales have fallen in eight of the past nine months, and house prices have fallen for the past five months in a row), but the squeeze on household cash flows could also affect consumer spending more broadly in the months and quarters ahead.

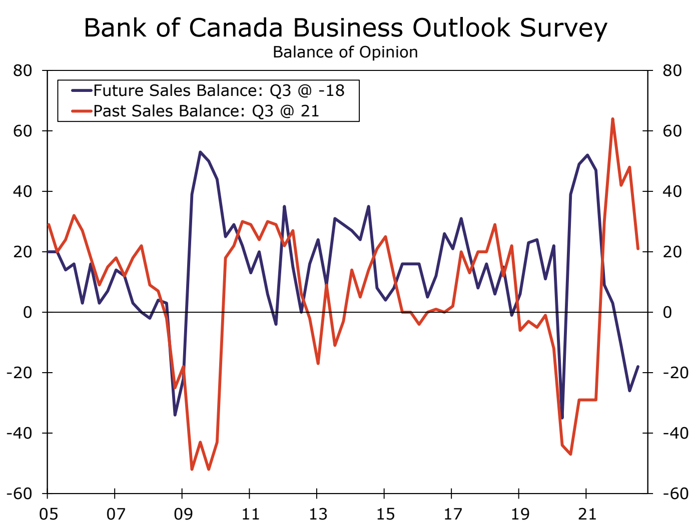


Source: Datastream and Wells Fargo Economics

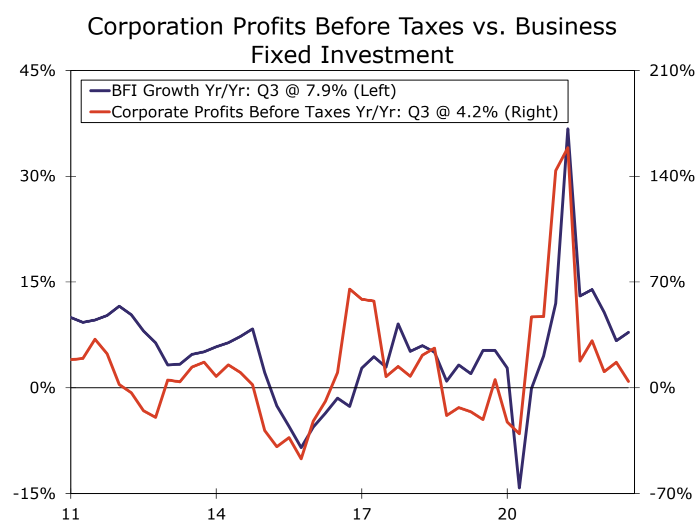


Source: Statistics Canada and Wells Fargo Economics

As the Canadian consumer becomes more cautious, we believe Canadian businesses will also turn more cautious and restrain investment spending. Indeed, signs of this business caution are already apparent. In the Bank of Canada's Q3 Business Outlook Survey, the future sales balance remained subdued at a reading of -18, while the past sales balance also softened to just +21. The third quarter also saw a softening overall trend in growth for corporate profits and business investment, with both now only registering modest single digit gains on a year-over-year basis. The decline in oil prices since its peak in early 2022 is another factor that could restrain business profitability and investment. Altogether, we believe these consumer and business headwinds should continue to weigh on activity, such that **we forecast a short and shallow recession for Canada's economy in early 2023. We expect Canadian GDP to contract in both Q1 and Q2 this year, and anticipate a peak-to-trough GDP decline of around 0.5%.**



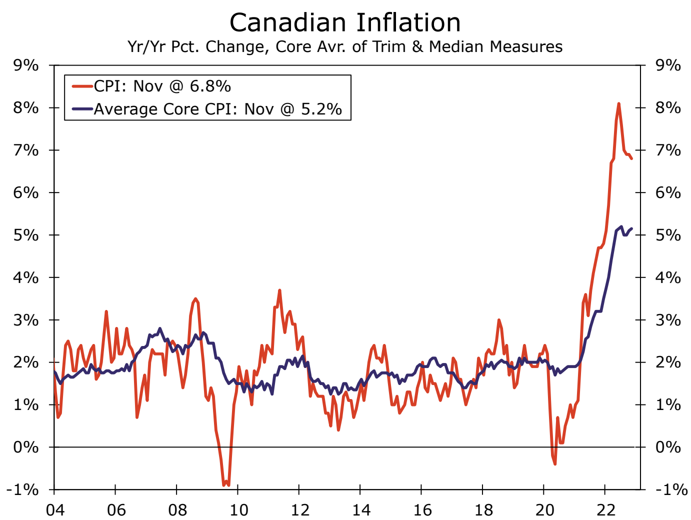
Source: Bank of Canada, Bloomberg Finance L.P. and Wells Fargo Economics



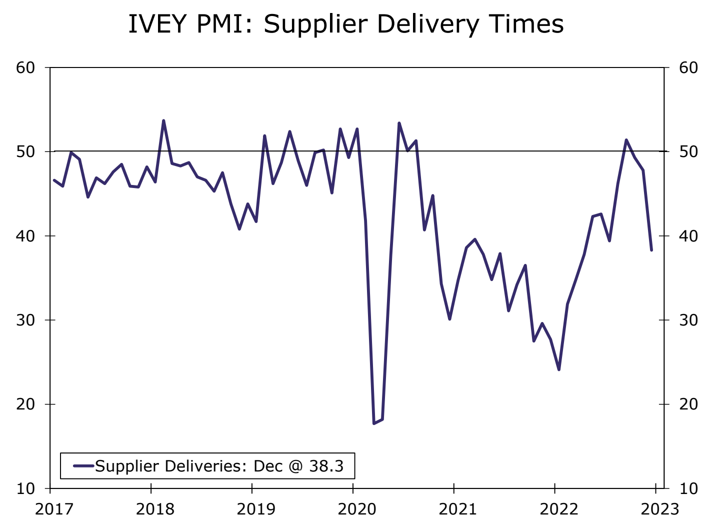
Source: Datastream and Wells Fargo Economics

The Peak is in Sight for Canadian Policy Interest Rates

Purely from a growth perspective, the Bank of Canada (BoC) has arguably already raised interest rates "enough" to engineer a perceptible slowdown in the economy. However, we believe the BoC is not quite done hiking interest rates yet, with inflation still elevated and well above the central bank's inflation target. To be sure, headline inflation has eased to 6.8% year-over-year in November, from a peak of 8.1% in June. However, the BoC is still awaiting more meaningful evidence that underlying price pressures are easing, with its two preferred measures of core inflation quickening slightly to 5.2% in November. **Against this backdrop, we expect the Bank of Canada to rise its policy rate 25 basis points to 4.50% at its late January meeting.** The evolution of these underlying inflation pressures, in our view, holds the key to the end of the Bank of Canada's tightening cycle. On that front, we see some encouraging signs that underlying inflation pressures could soon begin to ease. Supplier delivery times have shortened perceptibly, an indication that there has been a significant improvement in supply chain disruptions over the past several months. A reduction in commodity prices should also restrain broader prices pressures at the margin. At its most recent announcement in December, the Bank of Canada said it "will be considering whether the policy interest rate needs to rise further to bring supply and demand back into balance and return inflation to target." **So long as core inflation begin to slow perceptibly in the months ahead—which is our base case scenario—we anticipate the Bank of Canada's January rate hike to be the last of the current monetary tightening cycle.** From a currency perspective, we also believe a contracting Canadian economy and an end to Bank of Canada tightening could contribute to some underperformance by the Canadian dollar over the short-to-medium term. **Indeed, we see the possibility for some weakness in the Canadian dollar through Q1-2023, and see only a moderate rebound in the Canadian dollar over time. Even acknowledging that risks are tilted toward less Canadian dollar softness than our base case forecast projects (which targets a USD/CAD exchange rate of CAD1.35 by Q1-2024), we still expect the Canadian dollar to be an underperformer among the G10 currencies over the medium-term.**



Source: Bloomberg Finance L.P. and Wells Fargo Economics



Source: Datastream and Wells Fargo Economics

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Economics Group

Jay H. Bryson, Ph.D.	Chief Economist	704-410-3274	Jay.Bryson@wellsfargo.com
Sam Bullard	Senior Economist	704-410-3280	Sam.Bullard@wellsfargo.com
Nick Bennenbroek	International Economist	212-214-5636	Nicholas.Bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	704-410-3283	Tim.Quinlan@wellsfargo.com
Sarah House	Senior Economist	704-410-3282	Sarah.House@wellsfargo.com
Azhar Iqbal	Econometrician	212-214-2029	Azhar.Iqbal@wellsfargo.com
Charlie Dougherty	Economist	212-214-8984	Charles.Dougherty@wellsfargo.com
Michael Pugliese	Economist	212-214-5058	Michael.D.Pugliese@wellsfargo.com
Brendan McKenna	International Economist	212-214-5637	Brendan.Mckenna@wellsfargo.com
Jackie Benson	Economist	704-410-4468	Jackie.Benson@wellsfargo.com
Shannon Seery	Economist	332-204-0693	Shannon.Seery@wellsfargo.com
Nicole Cervi	Economic Analyst	704-410-3059	Nicole.Cervi@wellsfargo.com
Jessica Guo	Economic Analyst	212-214-1063	Jessica.Guo@wellsfargo.com
Karl Vesely	Economic Analyst	704-410-2911	Karl.Vesely@wellsfargo.com
Patrick Barley	Economic Analyst	704-410-1232	Patrick.Barley@wellsfargo.com
Jeremiah Kohl	Economic Analyst	704-410-1437	Jeremiah.J.Kohl@wellsfargo.com
Coren Burton	Administrative Assistant	704-410-6010	Coren.Burton@wellsfargo.com

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