Fasten your seat belts.

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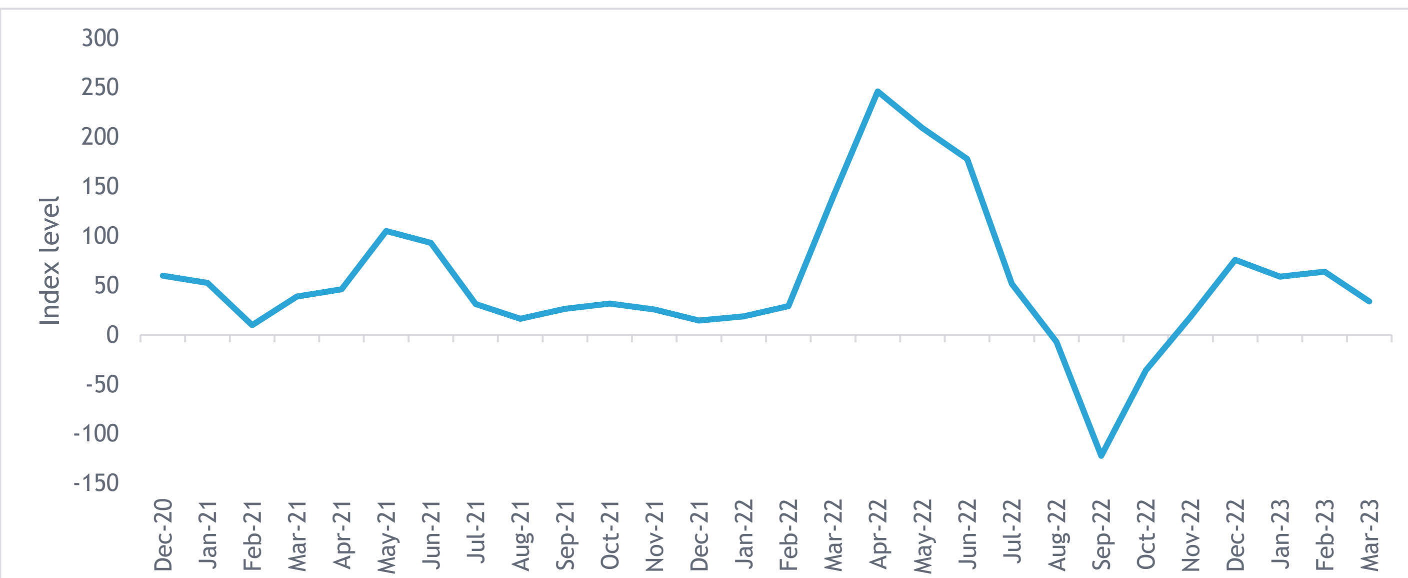
The Canadian economy continues to face significant but not insurmountable challenges. While persistently high inflation remains a substantial concern, recent reports have shown improvements. With this, and following a significant Bank of Canada interest rate hiking cycle, the odds of a recession have increased. Even though SEI believes any recession is likely to be fairly moderate, investors should probably keep their seat belts fastened.

We observed at the start of 2023 that "the challenges facing Canada's economy are significant but not insurmountable," and that still seems to hold true at the start of the second quarter. While there are certainly challenges, there's been some good news as well, and economic data on balance has been surprising to the upside since November 2022, as shown in Exhibit 1.

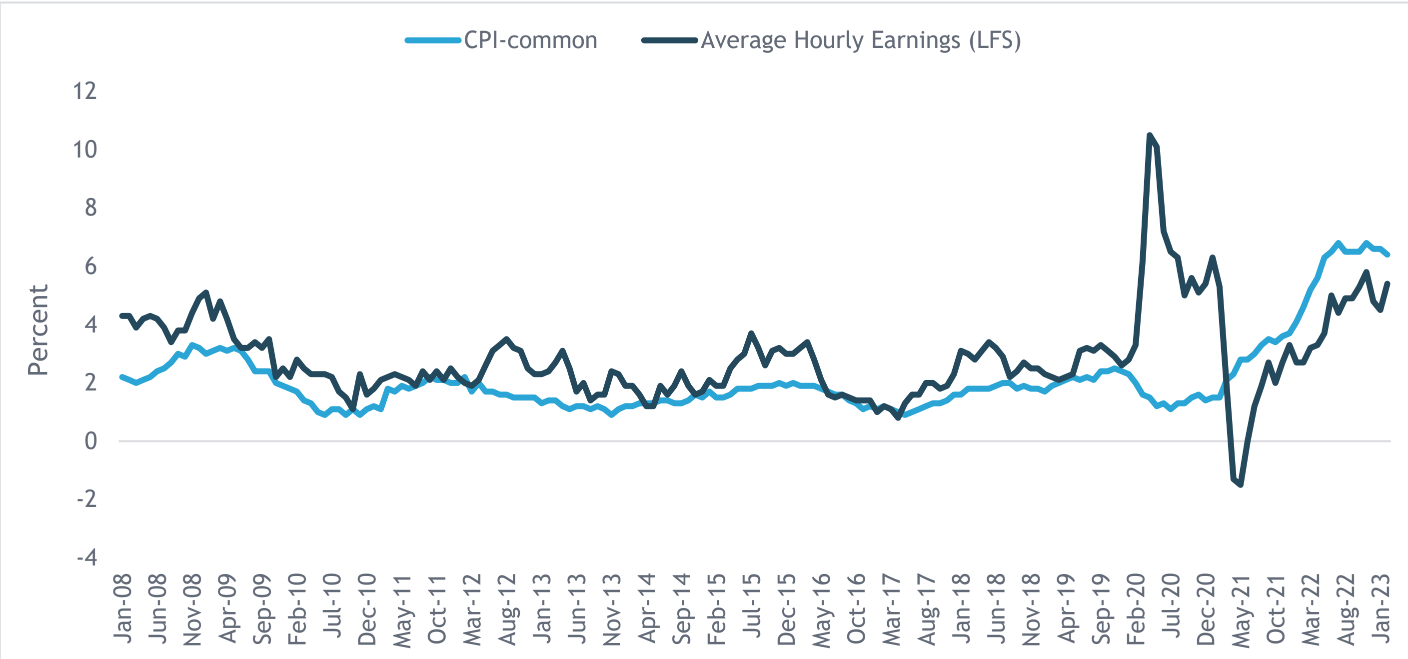
Exhibit 1: Citigroup Economic Surprise Index for Canada



Source: Citigroup, Bloomberg. Monthly data from December 2020 through March 2023.

In fact, some of the challenges facing the Bank of Canada (BoC) and the domestic economy arise from what is essentially good news. The prime example, depicted in Exhibit 2, remains the challenge of still-high inflation associated with a historically low unemployment rate.

Exhibit 2: Wage and price pressures are still uncomfortably high



Source: Bank of Canada. Monthly year-over-year percent changes in consumer inflation (as measured by CPI-common) and average hourly earnings (as reported in the Labour Force Survey) from January 2008 through February 2023.

Another key challenge is productivity growth, a critically important tool in the fight to lower inflation. Unfortunately, productivity has actually been *falling* since the second half of 2020 and is flat relative to where it was at the end of 2018. While lagging productivity can be a normal feature of tightening labour markets, it's not clear from the latest gross domestic product (GDP) report that business investment is going to be sufficient to meet the challenge. Perhaps this isn't surprising given that capacity utilization, as shown in Exhibit 3, is still several percentage points below the level that prevailed before the global financial crisis of 2008 and 2009.

Exhibit 3: Capacity utilization still below 'aughts levels

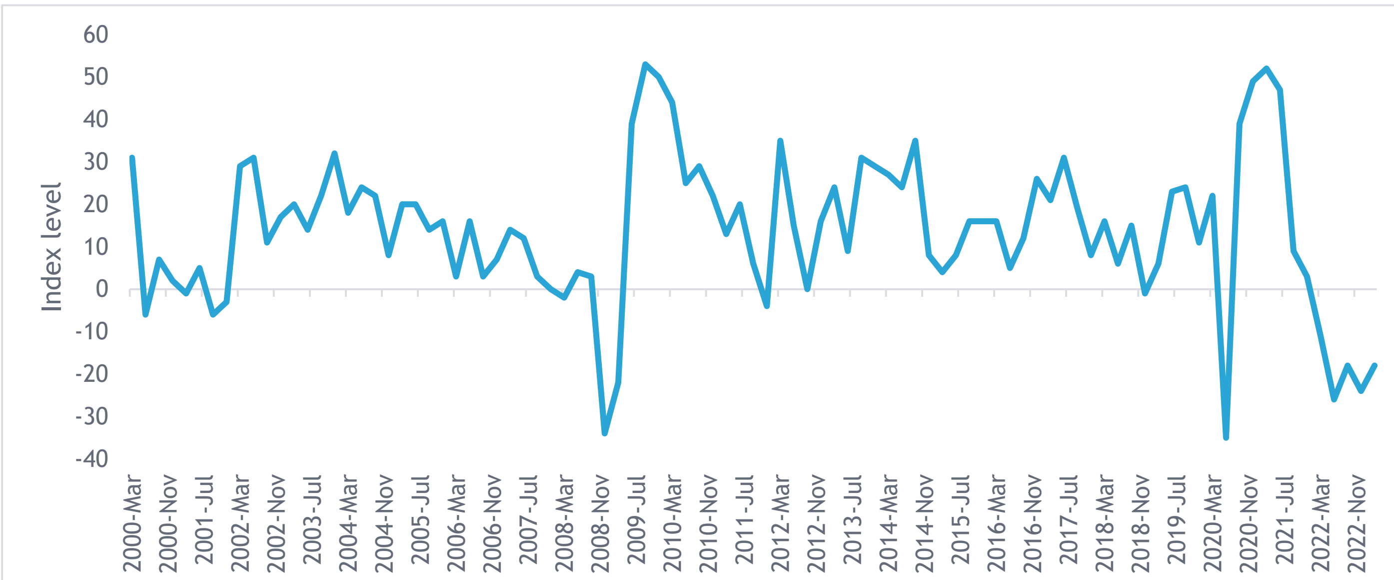
Source: Bloomberg, Statistics Canada. Capacity utilization measured quarterly from the start of 2000 through the end of 2022.

Finally, we also noted in January that "If the BoC is able to get inflation under some semblance of control, and if economists' projections of a shallow, two-quarter recession prove accurate, we may hear plenty of talk about a 'technical' or 'rolling' recession in 2023 or early 2024 without much in the way of serious or lasting economic damage. That's the hope anyways." That remains the hope as we enter the second quarter, and we have yet to see clear-cut indications of a recession taking hold (first-quarter GDP will not be reported until the end of May).

While inflation is still uncomfortably high on a year-over-year basis, month-over-month readings are a bit more encouraging, and producer price pressures, though volatile, have been easing. Of course, how recently announced production cuts from the Organization of the Petroleum Exporting Countries plus Russia (OPEC+) impact this remains to be seen.

Business and consumer sentiment reports have been quite mixed. Household sentiment is still largely depressed, as seen in Exhibit 4, although this isn't squared easily with healthy consumer activity of recent months and quarters. There's no denying that 2022 was a very difficult year for the housing market, but recent trends in sales and permits have shown improvement while construction starts are still above pre-COVID-19 levels despite worries about high mortgage balances adjusting to higher interest rates. At least one bank CEO believes that mortgage support measures should prove sustainable and effective.[1] Of course, we don't yet know how the recent banking system paroxysms in the U.S. will impact Canadian banks, but it's something economic and market observers will be keeping a close eye on. As for business sentiment, it has seemed weakest among manufacturers of late, although full-year views of sales activity and hiring plans are still relatively optimistic, according to S&P Global.[2]

Exhibit 4: Consumer sentiment still depressed



Source: Bank of Canada, Bloomberg. Monthly data from Bank of Canada's Survey of Consumer Expectations, March 2000 through March 2023.

Facing all of these cross-currents and uncertainties, the BoC remained on hold in March after raising 0.25% at its January meeting. Like many advanced-economy central banks, the BoC has promised to maintain higher rate target for as long as needed to get inflation to more acceptable levels. However—and this is the case for many developed market central banks—markets aren't completely buying it. Rate markets are currently pricing in a BoC interest rate-cutting cycle from the middle of 2023 through the end of 2024. Given that U.S. Federal Reserve (Fed) finds itself in a similar situation, the loonie has been largely range-bound against the U.S. dollar since late 2022.

Of course, Canada's outlook will also be influenced by the global economic environment, where additional cross currents and uncertainties are very much at play. Investors should keep their seat belts fastened.

[1] CIBC CEO Says Mortgage Aid Sustainable for 'Foreseeable Future', https://www.bloomberg.com/news/articles/2023-04-04/cibc-ceo-says-mortgage-aid-sustainable-for-foreseeable-future, last accessed 4 April 2023.
[2] "PMI slips back into contraction territory in March," https://www.pmi.spglobal.com/Public/Home/PressRelease, last accessed 4 April 2023.

Index definitions

The **Citigroup Economic Surprise Index** measures the degree to which economic data is beating or missing estimates.

The **CPI-common** is a measure of core inflation that tracks common price changes across categories in the CPI basket. It uses a statistical procedure called a factor model to detect these common variations, which helps filter out price movements that might be caused by factors specific to certain components.

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