A two-handed look at the economy.

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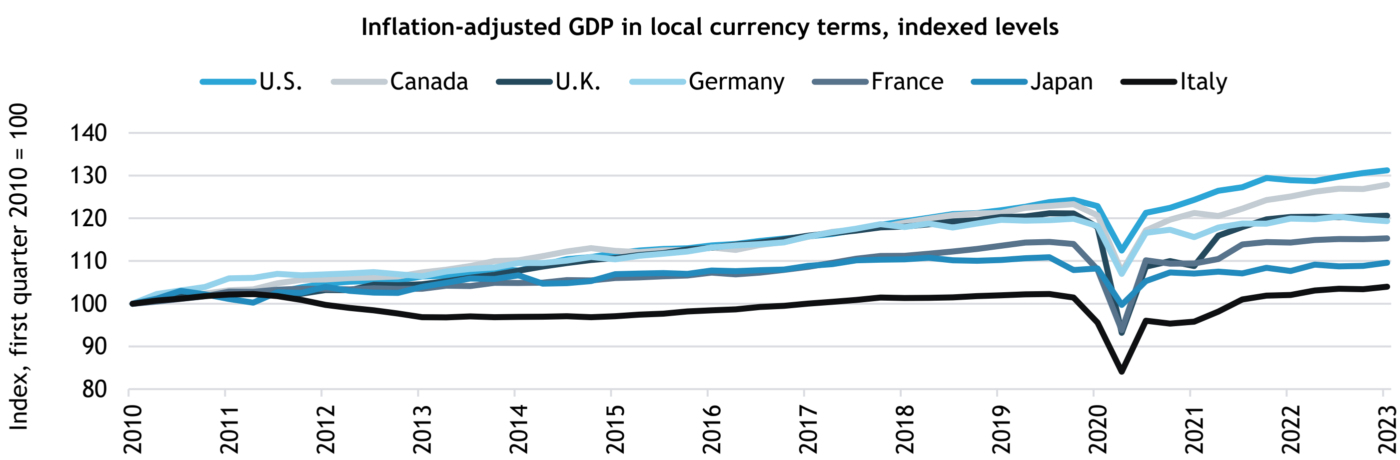
When it comes to the Canadian economy, businesses, consumers and investors are faced with a confusing array of cross currents right now. Economic activity and the labour market have remained on solid footing, but the manufacturing sector continues to struggle, the Bank of Canada is once again hiking rates, and there are other notable risks to the outlook. In environments like these, the timeless principles of sound portfolio design and effective diversification may prove especially useful.

Former U.S. President Harry Truman is reported to have asked for a one-armed economist so he would no longer have to listen to his advisors express their views in terms of "on the one hand, but on the other hand." While the story may be apocryphal, the sentiment is understandable and no less applicable today, given the confusing cross-currents at work in the global and Canadian economies. These domestic cross currents persisted through the second quarter of 2023, keeping Canadian businesses, consumers and investors on edge. On the positive side, economic growth was solid even when adjusted for inflation, the labour market remained quite healthy, and there were signs that inflation may finally be easing meaningfully. However, soggy leading economic indicators, a manufacturing recession, and renewed Bank of Canada (BOC) rate hikes, alongside longstanding concerns about household debt levels and the potential for a downturn in housing activity, tempered any enthusiasm.

On the one hand, Canada's economic performance remained quite solid among advanced economies, as shown in Exhibit 1.

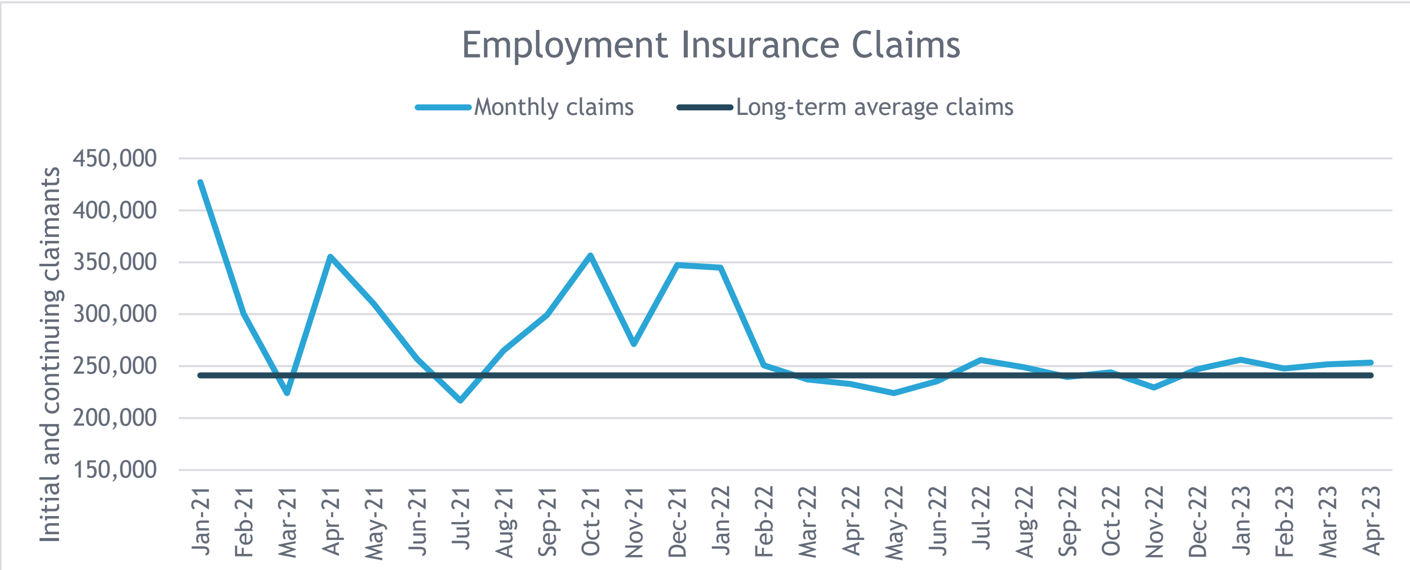
Exhibit 1: Canada's economy performing well



Source: FactSet, SEI.

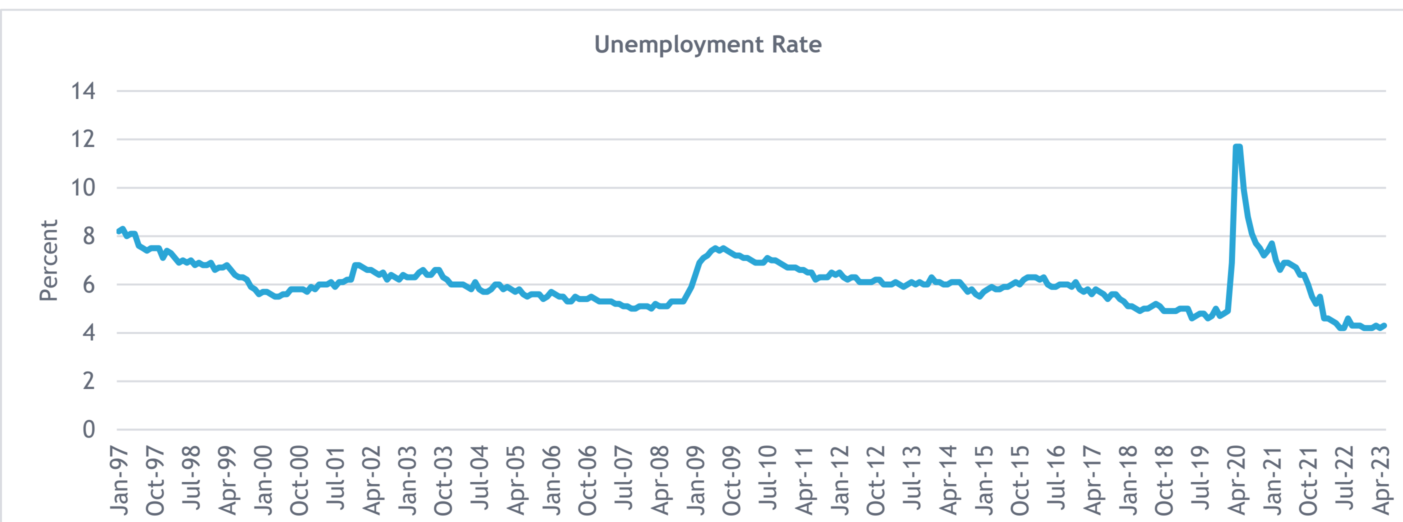
The labour market has also remained quite healthy. Exhibit 2 shows that claims for employment insurance are still well below levels seen during COVID-19 lockdowns and in line with their long-term average, while Exhibit 3 depicts an unemployment rate that is still at historic lows.

Exhibit 2: Employment insurance claims well-behaved



Source: Statistics Canada. Monthly new and continuing claimants from January 2021 through April 2023. Long-term average calculated from January 1997 through April 2023 (excluding March 2020 through October 2020 due to data limitations).

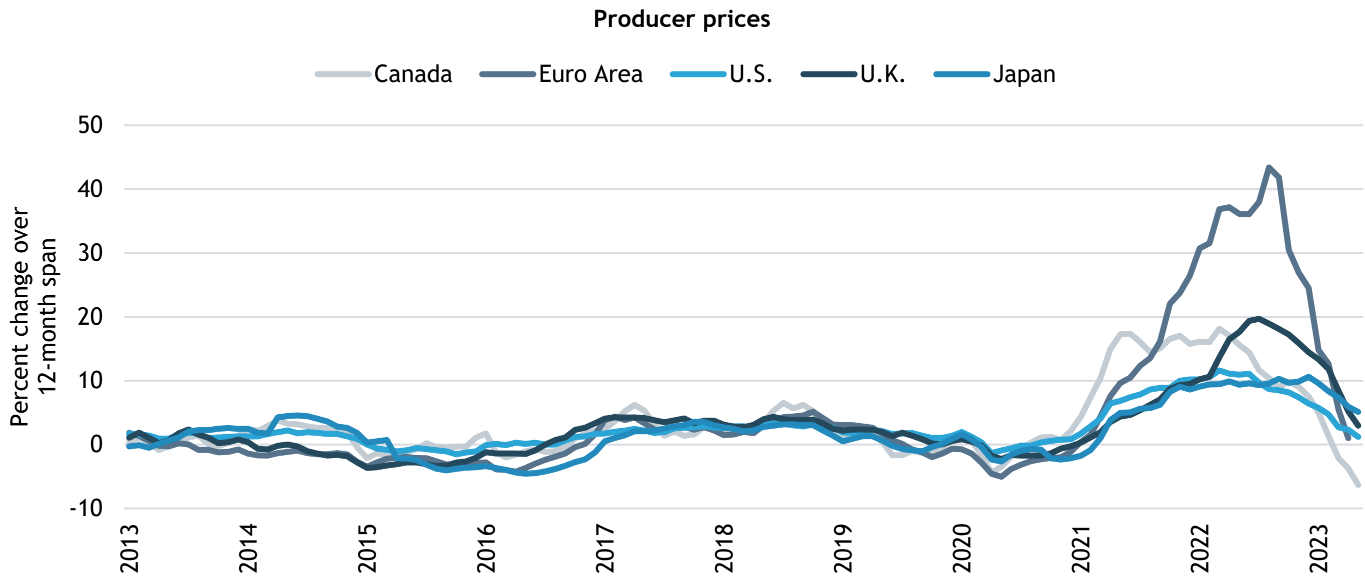
Exhibit 3: Unemployment still at historically low levels



Source: Statistics Canada. Data from January 1997 to May 2023.

Finally, as shown in Exhibit 4, Canada has made some of the furthest progress against inflation among advanced economies, at least for the kinds of industrial or "factory gate" materials captured in producer price indexes.

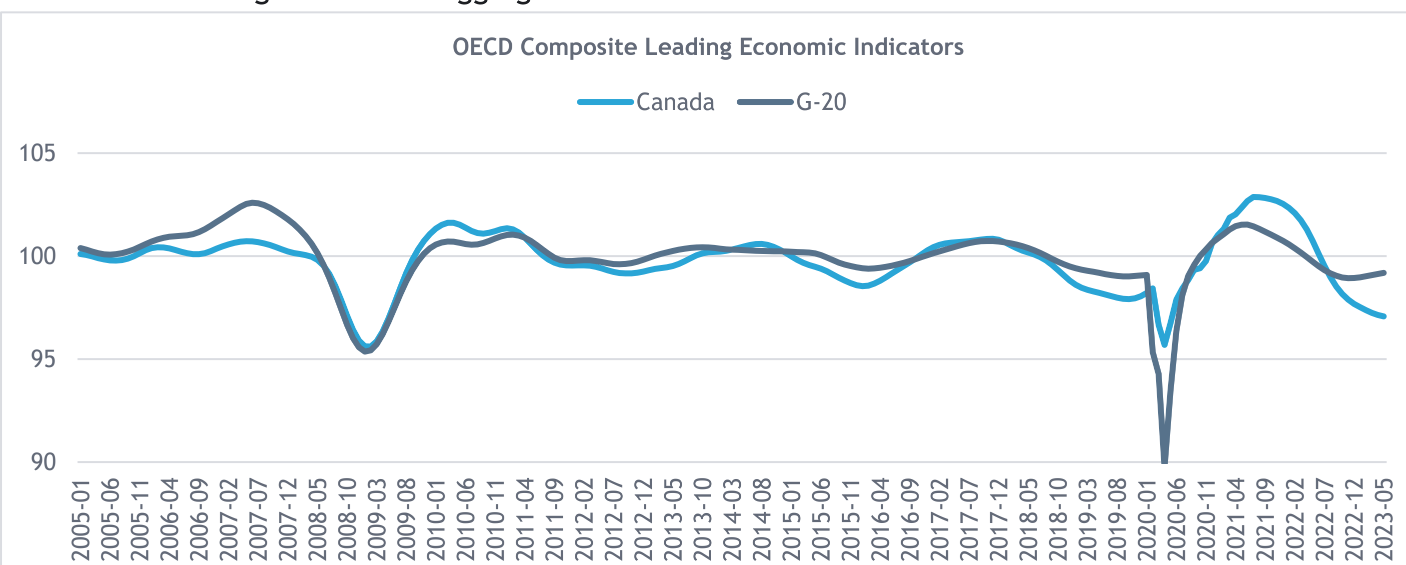
Exhibit 4: Canadian producer prices are falling



Source: FactSet, SEI.

On the other hand (sorry Harry!), Canada's manufacturing sector (like many around the world) has continued to struggle, with the S&P Global Canada Manufacturing PMI® reporting subdued demand and further declines in output and new orders in June.[1] Leading economic indicators are suggesting there may be further trouble ahead for the Canadian economy, as shown in Exhibit 5.

Exhibit 5: Leading indicators lagging



Source: OECD, as of May 2023.

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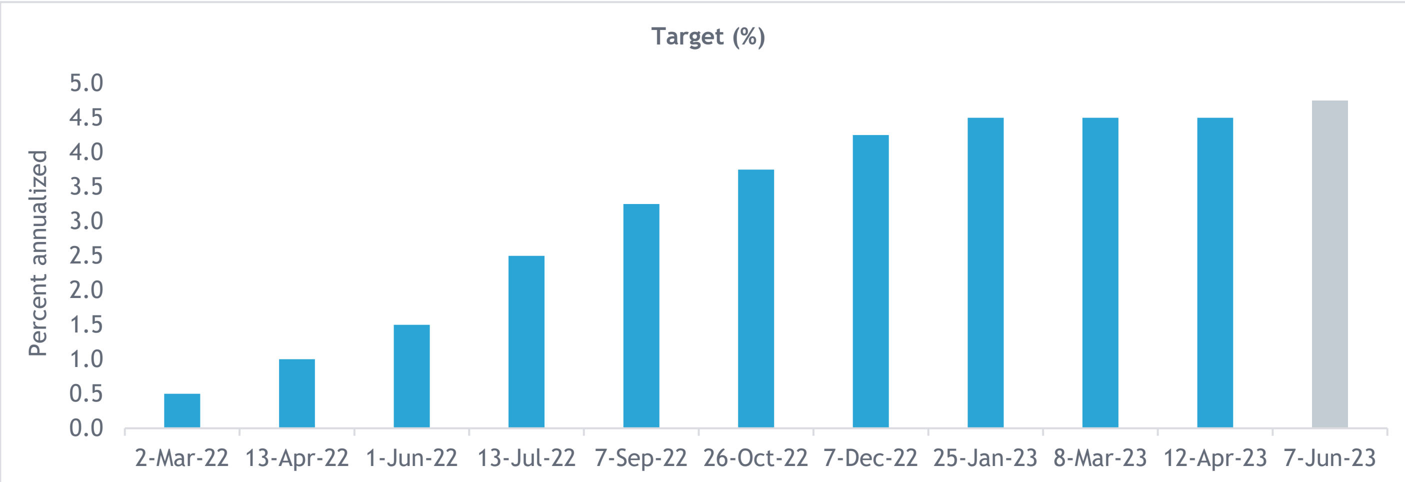
[1] "Canadian manufacturing sector remains in contraction territory," https://www.pmi.spglobal.com/Public/Home/PressRelease/a65b1f8fe8074c86a8f5bb93212e131f, last accessed 5 July 2023.

And while falling producer prices illustrated in Exhibit 4 may bode well for the broader inflation picture eventually, demographic and wage pressures could help keep a floor under inflation pressures in more services-oriented areas of the economy. Meanwhile, prices for crude goods such as commodities may be finding a bottom at current levels. With lingering concerns around the inflation outlook, the BOC resumed its rate-hiking cycle after a several-month pause (Exhibit 6).

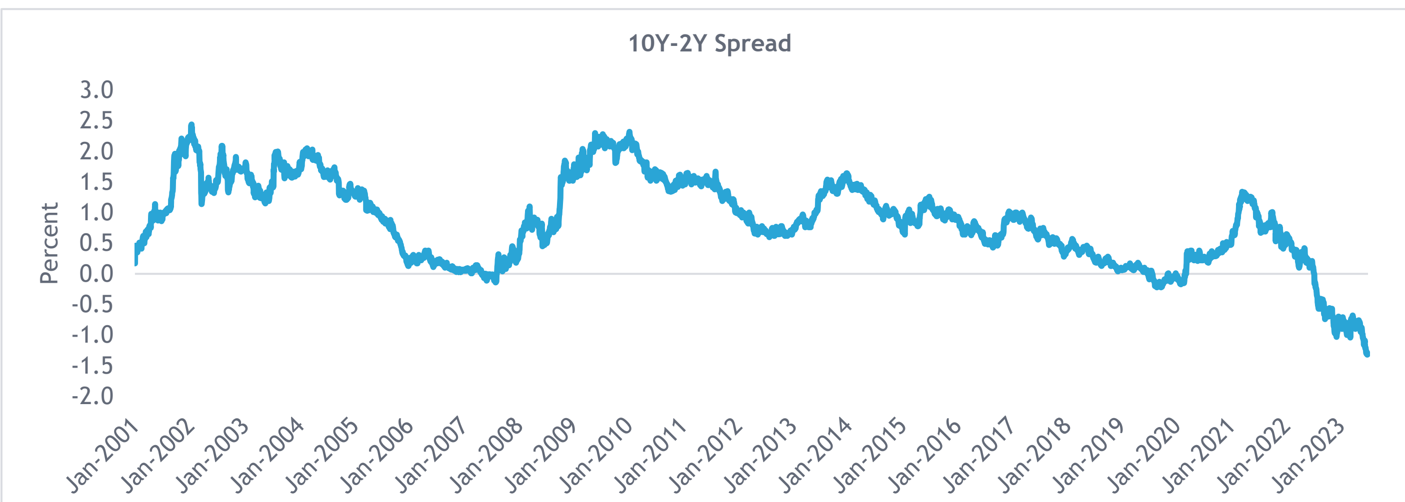
Exhibit 6: BOC gets back to business



Source: Bank of Canada.

This has led to an even more dramatic inversion of the yield curve, as shown in Exhibit 7, which many economists view as a harbinger of recession.

Exhibit 7: A deeply inverted yield curve



Source: Bank of Canada. Difference between the daily yields on 10-year and two-year government bonds from 2 January 2001 through 4 July 2023.

The recession question is obviously the one that's causing anxiety for businesses, consumers and investors. While prevailing consensus seems to be that a recession might start in the back half of this year or in 2024, it's not clear how deep (or shallow) or how prolonged (or short-lived) a downturn might be.

For investors, the name of the game hasn't changed despite the cloudy economic outlook—ensure your portfolio provides an appropriate level of expected risk for your financial objectives and use diversification to your advantage.

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