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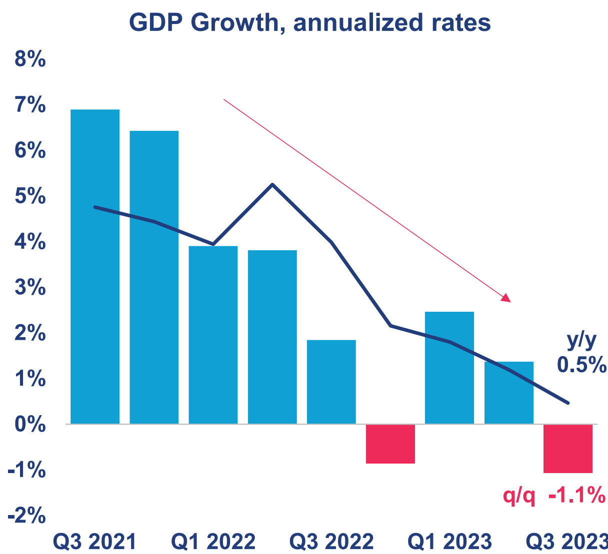
2024 Canadian Outlook

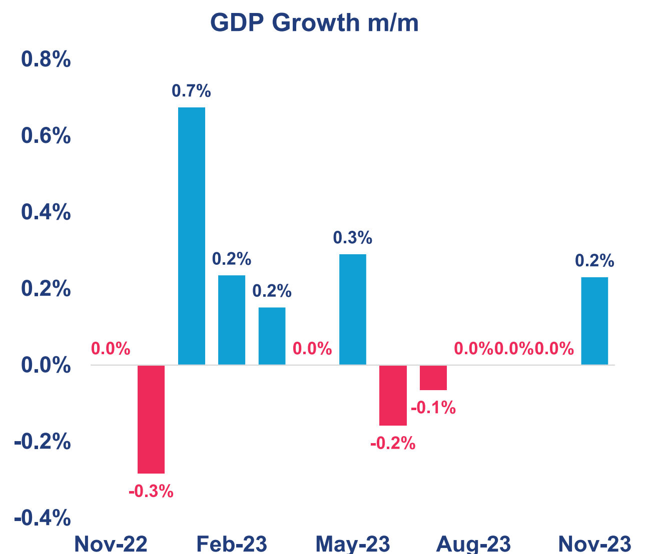
Monetary policy to restrain the economy

Interest rates will remain relatively high through the middle of 2024.

The Bank of Canada (BoC) drove interest rates up to multi-decade highs in 2022 and 2023, raising the overnight rate a total of 4.75% to 5.0% in the course of a year and a half. By comparison, the previous fastest hiking cycle started in 1997 and rose a mere 2.5% over the same amount of time. The rapid interest rate hikes have been successful at slowing inflation, but they have also slowed the economy such that growth in 2024 is likely to be quite weak. Indeed the economy was just bouncing off the bottom in the second half of 2023, posting growth of -1.1% q/q annualized in Q3. On a monthly basis, GDP grew 0.2% m/m in November, but it was the first positive reading after five consecutive months of flat or negative growth.



Source: Statcan, Refinitiv, Allianz Trade



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THE North Report

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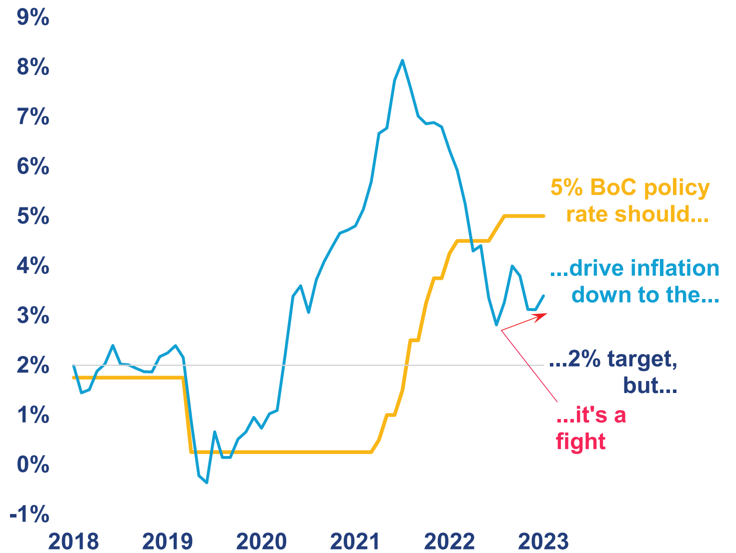
Yet even as the economy slows, the BoC has signaled that it will leave the overnight rate untouched at 5% into the middle of 2024. The BoC does have a good case to stay on hold for some time as inflation is running well above the 2% target. In addition, wage growth is currently running faster than inflation, and labor productivity, which has declined every quarter of the post-pandemic era, has driven unit labor costs to over twice the long-term average. Clearly, there are still inflationary pressures at work, and a continued tight monetary policy will weigh on growth in 2024.

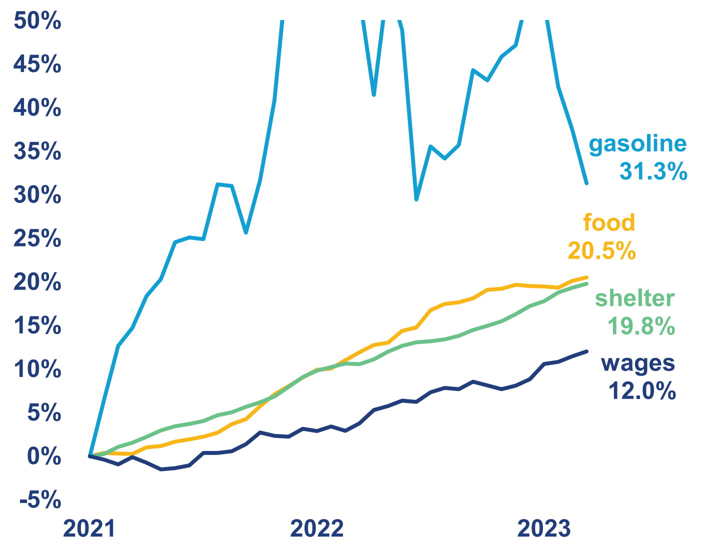
Hypothetically, even if the BoC were to keep the overnight rate at 5.0% through the first half of the year, and then cut four times in the second half of the year to 4.0%, it would still be at the highest since 2008 (ex-Covid) when the BoC raised the overnight rate to slow the housing bubble. Those hikes later drove the economy into recession. The combination of already slowing growth, and continued high interest rates suggests that GDP growth for all of 2024 could be 0.5% to 0.8%.



Source: Statcan, Refinitiv, Allianz Trade

Other fundamentals will drag on the economy.

In addition to high interest rates, there are other fundamentals that will negatively affect the economy in 2024. For instance, even though inflation is slowing, its cumulative effect has wreaked havoc on wage earners. Since January 2021, when inflation started to pick up rapidly, wages have grown a cumulative 12.0%. But the things that wage earners need to live have far outpaced that increase. On a cumulative basis, shelter has risen 19.8%, food has risen 20.5%, and gasoline has risen 31.3%. Clearly wage earners are still underwater, despite recent gains.



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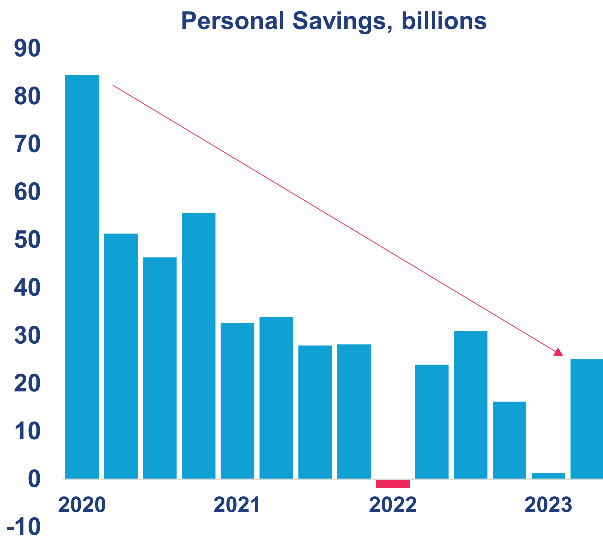
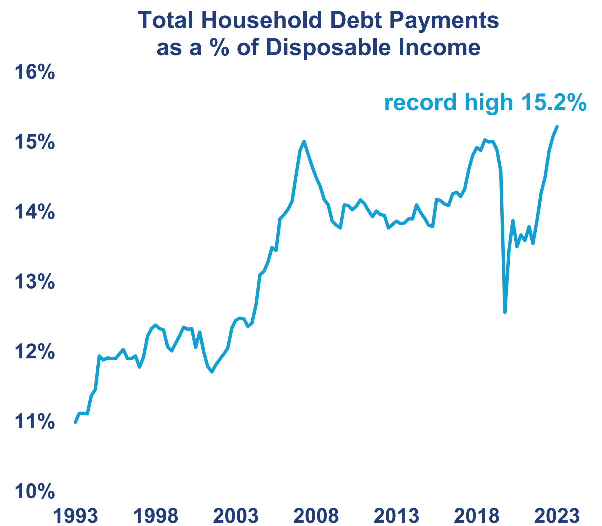
Consumption is also poised to slow. Consumer spending accounts for about 55% of all economic activity in Canada, and consumption requires money to spend in some form or another. Since wages are only now keeping up with inflation, consumers may have to turn to other sources of money. One source could be personal savings, yet savings are dwindling. As a last resort, consumers could turn to credit, but consumers are in a precarious position to do so - Canadians are already paying a record amount of debt service compared to their incomes. In other words, Canadians don't have the financial ability to take on more debt. This situation is again a result of the BoC's aggressive path of interest rate hikes, which has driven credit card rates to record highs and has put the five-year mortgage interest rate at the highest in 15 years. Furthermore, consumer confidence is tepid.



Source: Statcan, Refinitiv, Allianz Trade



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High mortgage rates are just part of the problem that will weigh on the housing market in 2024. Housing prices soared after Covid struck, and although they have fluctuated somewhat recently, they are still 30% to 40% higher than they were before Covid. The combination of high mortgage rates and high prices has resulted in extremely low affordability, and planned property tax increases in 2024 will only make the situation worse. Furthermore, since the BoC started signaling rate increases at the end of 2021, housing activity has plummeted and has never recovered - permits are down 13%, unit sales are down 27%, and the value of residential structures created is down 8%. As a result, housing will continue to be a drag on potential GDP growth in 2024. And in a hypothetical scenario where the BoC cuts the overnight rate by 100 bps in 2024, and the five-year mortgage rate falls 100 bps as well, it would still be the highest in 16 years (ex-Covid), continuing to make housing unaffordable and weighing on the housing market and the economy in general. Finally, since approximately 20% of mortgages need to be refinanced every year, homeowners who borrowed at 3% - 4% a few years ago will face a steep increase in mortgage payments at 6%. Those larger mortgage payments will further eat into consumption.

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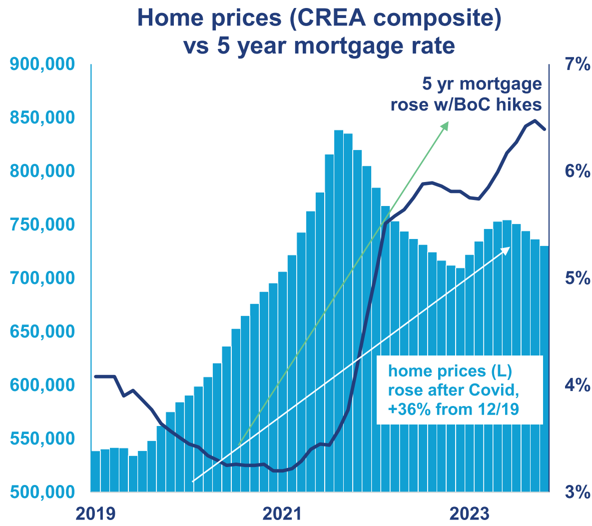
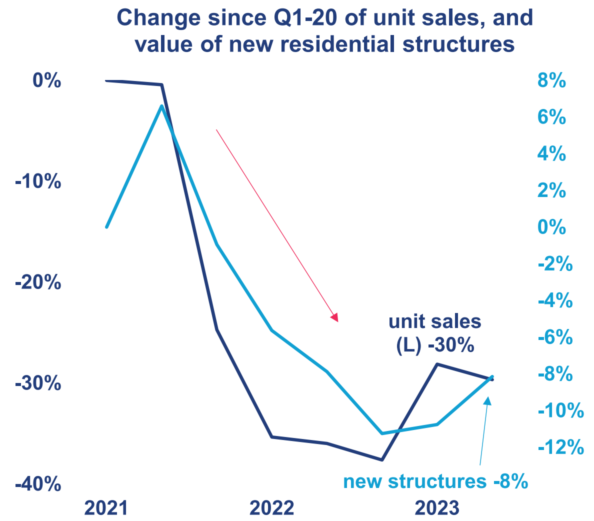


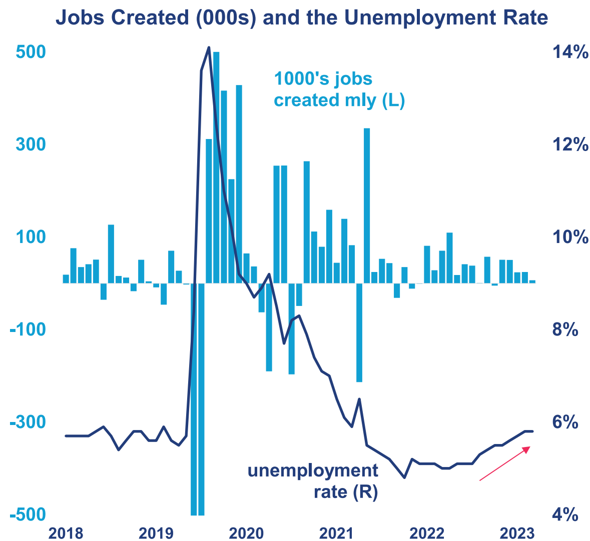
Source: CREA, Statcan, Refinitiv, Allianz Trade



Source: CREA, Statcan, Refinitiv, Allianz Trade

Strong labor market, yet leading indicators are negative.

One bright spot has been the labor market. The economy created an average of 36k jobs per month in 2023, as compared to 20k per month in the 10-year period before Covid, and the unemployment rate is still very low. However, there is some deterioration under the surface. Those strong job gains are starting to slow. The unemployment rate, which is a lagging indicator, has risen rapidly from 5% to 5.8% in just eight months, suggesting that the labor market has already started to weaken. The participation rate and the employment rate, which had returned to pre-Covid levels, are falling. Finally, job openings as measured by Indeed declined by 38% in 2023.



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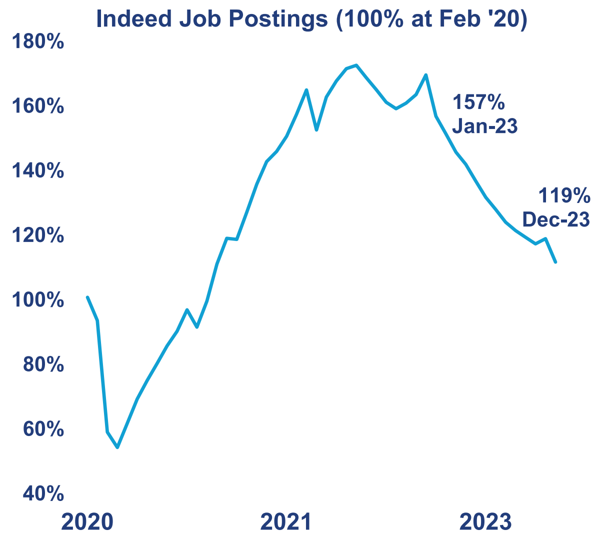

Source: Indeed, Statcan, Refinitiv, Allianz Trade

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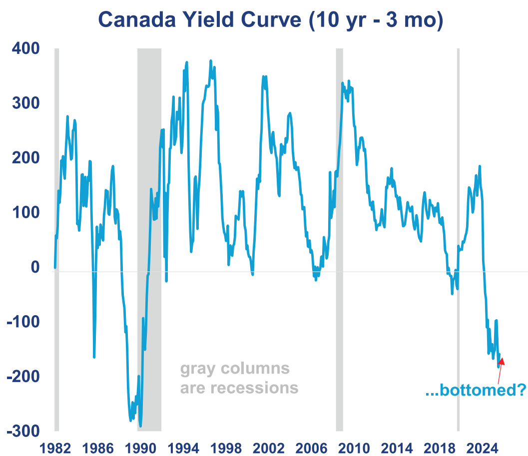
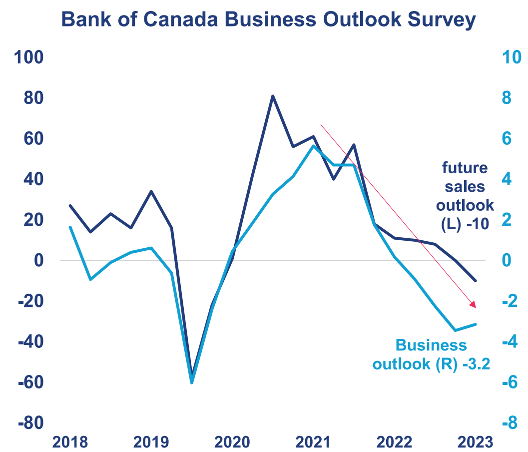
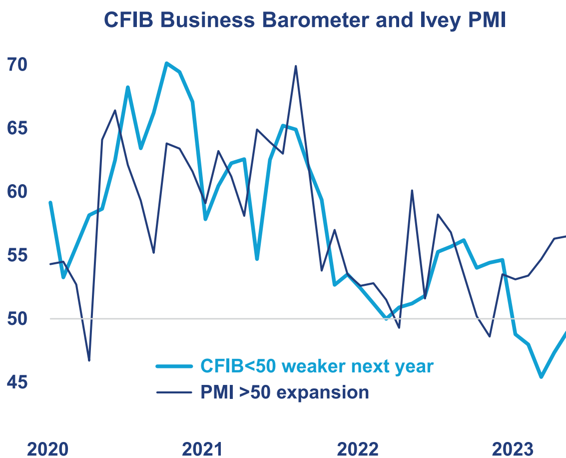
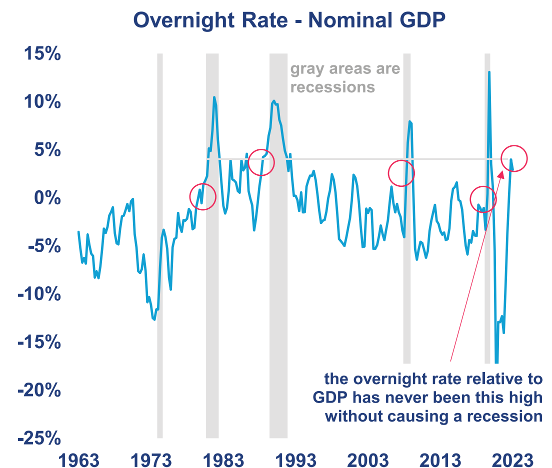
Leading indicators signal a slowdown.

The fundamentals slowing the economy are reflected in most leading indicators. For instance, the yield curve remains deeply inverted but does appear to have bottomed out, which is typical as weakness approaches. The BoC's Business Outlook survey indicator has been negative for four consecutive quarters and now is well into contractionary territory. Respondents to the BoC survey said the outlook for future sales growth has fallen to -10%, the lowest of the post-pandemic era. A remarkable 47% of the respondents said that the effects of monetary policy are "just beginning" while 8% said the effects of not begun yet, but they expect them to. The Canadian Federation of Independent Business (CFIB) Business Barometer survey is also showing weak expectations of future business performance. The survey's gauges of business performance over the next three and 12 months were well into contractionary territory for the last quarter of 2023 although they are now improving. One of the few leading indicators which is positive is the Ivey Purchasing Manager's Index (PMI). It remains in expansionary territory above 50 where it has been for virtually all of the three and a half years since the Covid recovery began. Finally, note that the overnight rate relative to GDP is at a level that has always been associated with a recession.









Source: Statcan, Refinitiv, Allianz Trade

The Canadian economy is likely to put in a weak performance in 2024, with overall GDP growth of less than 1%. The already slowing economy will continue to be pinched by relatively high interest rates, with leading indicators confirming an oncoming slowdown.

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