# Resilience or Recession?

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## We still lean toward "resilience" in the title question, but with waning conviction

High energy and food costs are eating into consumer spending power and confidence. Fast-rising interest rates are cooling the previous fire-breathing housing market. Even after several upward revisions, we still see upside risks for both inflation and policy rates. Any further bumps higher would almost surely lead to a hard landing. Still, we give the expansion roughly even odds to continue, albeit at a much slower pace and close to stalling at year-end. Support stems from high household savings and pent-up demand for travel, in-person services, and automobiles. Businesses need to invest to expand capacity. But a lot of things must start going right, notably for inflation and the war in Ukraine. Falling lumber and metal prices and easing pandemic restrictions in China are a start, but these are relatively small wins with oil prices still above US$100 a barrel.

## Canada's economy is outperforming most major countries due to its heavy resource exposure

While real GDP grew less than expected in Q1 at 3.1% annualized, this followed 6.6% growth in Q4 and was still above long-run potential. The slowdown reflected a big reversal in exports and a weak start to the year amid pandemic restrictions. However, domestic demand was healthy, led by big gains in residential construction (18.1%) and business investment (9.0%). In addition, consumer spending was solid (3.4%), supported by nearly C$300 billion of extra savings piled up during the pandemic, equal to 19% of disposable income. This will cushion the pain of rising energy and food costs for households, at least for now. Solid monthly GDP figures point to even stronger 4.0% growth in Q2. But that should mark the high point for a while, as interest rates will begin to bite, as is already the case in the housing market. The cost of servicing record household debt could eventually consume more than 15% of disposable income, up from 13.8% in Q4. Due to more aggressive monetary tightening and weaker global demand, **we cut our growth forecast to 3.4% this year and to just 1.0% next year.**

U.S. real GDP shrank in Q1 after surging in Q4. A record trade deficit and cuts in government spending caused most of the damage. However, accelerating business investment and sturdy consumer spending indicated underlying strength, which will help GDP rebound an estimated 1.0% annualized in Q2. **Still, growth is expected to slow to 2.0% this year and to just 0.5% in 2023, well below potential and the consensus view.** Monetary policy is now tightening at the fastest rate in decades, while record gasoline prices are siphoning money from consumer pockets. However, inventory rebuilding may keep the expansion going. As well, a large cache of extra personal savings, about US$2.3 trillion or 13% of disposable income, is helping to sustain spending in the face of rising fuel and foods costs. Even if just a third of the excess savings is used for purchases, it should support demand well into next year. Pent-up demand will also support autos once supply improves.

## Decent growth has led to the best labour market conditions in decades

Canada now has a half million more jobs than at the start of the pandemic, while the jobless rate of 4.9% is the lowest in at least 45 years. Meantime, U.S. payrolls rose 390,000 in May, down from earlier months but still more than double the long-run norm. There are nearly two job openings for every jobless worker in the U.S., and almost one opening in Canada. Despite rapid hiring, the U.S. jobless rate has held at 3.6% for three months due to a welcome upturn in the participation rate. Still, the expected slowdown should push the jobless rate above 4% next year, which will help relieve inflation pressures.

Fast-rising mortgage rates are rapidly **dialing down the heat in housing markets**. Earlier this year, house prices in Canada and the U.S. rose at record rates of 29% year/year and 21%, respectively, mostly in response to excess demand juiced by too-low interest rates. However, more recent data show sales are sliding fast in both countries due to poor affordability, while prices are starting to slip in Canada. Mortgage service costs are approaching 1989 levels in Canada and 2006 levels in the U.S., and recall that neither period ended well. Sales in Canada are likely to slide below pre-pandemic levels once support from

pre-approved mortgages dries up. We expect prices in Canada to retrace a good portion of their past year surge, before resuming a modest upward course amid support from immigration and tight rental markets. U.S. home prices continue to rise amid lean listings, but are expected to level off later this year. The harder that central banks need to fight inflation, the greater the risk of a deeper correction in home prices.

## Inflation risks remain tilted to the upside, even in our above-consensus view

The U.S. and Canadian May Consumer Price Index ("CPI") reports stunned analysts by showing an acceleration in headline and core prices. Annual CPI rates are now expected to peak above 9% in the U.S. and above 8% in Canada this summer, before declining slowly to around 3% at the end of 2023, still above the 2% target. While wage growth remains calm in Canada at just under 4% year/year, U.S. compensation gains are running near 6%. Dismal productivity growth in the U.S. and an outright decline in Canada are also stoking unit labour costs. Energy and food costs show few signs of fading. The high cost of owning a house has pushed rents higher. Falling lumber and metal prices are small wins on the inflation front, with the New York Fed's global supply chain pressure gauge still sky-high, though off its peak.

## The Fed and Bank of Canada are on the fast track to rate neutrality and beyond

The Fed hiked policy rates by 75 basis points ("BPS") on June 15, the most since 1994, following the bad CPI news and an "eye catching" rise in inflation expectations. We expect a similar-sized move in July, and look for the **Fed funds target rate to peak at 3.63% at year-end.** The Bank of Canada hiked rates to 2.5% in July, as it is "prepared to act more forcefully if needed" to prevent high inflation from becoming embedded in expectations with the economy "clearly operating in excess demand". The Bank's policy rate target is expected to peak at 3.50% by year-end, well above the highs reached in the last tightening cycle (1.75%) and somewhat above a neutral range.

## The possible need for even more aggressive monetary tightening to tame inflation is the single biggest threat to the expansion

Downturn risks will rise depending on how far central banks need to take rates above neutral to restore price stability. Recession odds are already elevated given that the Fed has never achieved a soft landing in at least six decades with inflation this high and the unemployment rate and policy rates this low at the start of a tightening cycle. Other things could go wrong, too, such as the war spreading beyond Ukraine's borders, pandemic lockdowns spreading across China, and a more severe strain of the virus infecting the global economy. One thing is clear, the economy's resilience will be tested unless more things start to go right in the year ahead, especially on inflation.

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