Focus

Feature Article

(Credit) Crunch Time for the Economy?

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The Dark Side of the Boom

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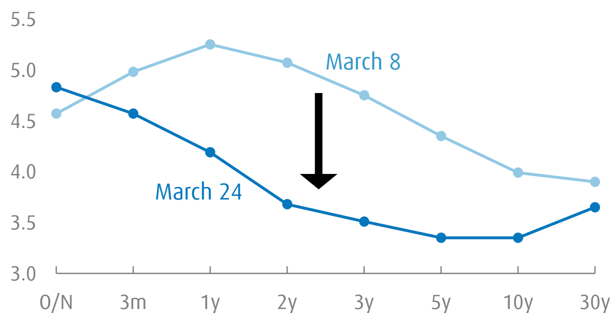
Markets are on the backfoot again amid ongoing contagion concerns from the **rapidly morphing banking sector stresses**. The focus returned to Europe on Friday, with the big German banks coming under the spotlight of sellers. While broader equities are struggling to find direction, bond yields are having no such doubts as they drive relentlessly lower. In little more than the short span of just two weeks, two-year Treasury yields have cascaded down by almost 150 bps. To put such a move in perspective, there have only been two times in the past 35 years that yields have dropped as much as 100 bps in a few weeks—after 9/11 and in the early days of the pandemic—and this episode has gone well beyond those two historic events.

Chart 1
Yield Drop: It's a Hit

United States (percent : as of March 24, 2023, 10:00 am)
Treasury Yield Curve



Sources: BMO Economics, Reuters

The latest typhoon whipped up soon after each of the Fed, the Swiss National Bank, and the Bank of England were comfortable enough with conditions to proceed with as-expected rate hikes this week. Markets now seriously doubt central banks will remain so brave for long; along with Chair Powell's mixed remarks at this week's press conference and no change in the dot plot, the latest flare-up has the market attaching very low odds to any further Fed rate hikes, and is pricing in an aggressive 100 bps of cuts in the second half of the year. We will simply reiterate that the bar for rate cuts is exceptionally high this time—what's different is that the starting point for inflation is 6% in the U.S., 8.5% for the ECB, 5.2% for the BoC, and a towering 10.4% for the BoE.

Whether the central banks blink and then pivot all comes down to how the economy responds to the recent series of events. This week's Focus Feature delves more deeply into that subject, but to this point we suspect the resulting damage isn't enough to drive rate cuts anytime soon. Rough estimates of how much the financial stress translates to Fed tightening run the gamut from 25 bps to more than 100 bps. It's notable that the FOMC's dot plot was almost unchanged from December, suggesting members viewed the coming credit tightening as precisely enough to offset the previously believed upside risks, at least prior to the latest brush fire.

With everyone now looking at history for a guide, and perhaps too much focus on 2008, we'll look even further back. This month marks the 50th anniversary of "The Dark Side of the Moon"; in honour of that landmark release, we'll let Pink Floyd analyze the events of the past three weeks. In the order of the songs:

Speak to Me: Fed Chair Jay Powell was breathing fire at his Senate testimony on Tuesday March 7, warning that rates may need to go significantly higher to corral inflation. His remarks sparked plenty of talk that fed funds could be headed above 6%. Amid the barrage of questions, none were on banking sector stability.

Breathe: The fire-breathing was a bit less intense at the House testimony on March 8, but yields nevertheless rose further on what may well mark the peak for this cycle for maturities from 3 months to 3 years. The Bank of Canada decided that same day to

pause for breath by becoming the first major central bank to move to the sidelines. It now looks like the stay will be long.

On the Run: Soon thereafter, the run on deposits on SVB began and gathered momentum rapidly. Even with another surprisingly strong rise in employment, yields began their historic tumble.

Time: Barely hours after the deep woes at SVB fully came to light, the FDIC was taking over the institution, the second-largest bank failure in U.S. history.

The Great Gig in the Sky: Signature Bank soon became the third-biggest U.S. bank failure, reinforcing market concerns that others could be at risk of expiring.

Money: Treasury, the Fed and the FDIC rapidly rolled out the extensive support package, including the Bank Term Funding Program. The BTFP was tapped for $41.7 billion in the latest week, and in the past two weeks the Fed has lent a total of $339 billion to the banking system. While this may ultimately lift the money supply, at least temporarily, Chair Powell asserted that the latest moves are not QE, since they aren't aimed at stimulating the economy—and borrowers are paying full freight for the funds.

Us and Them: Concerns were not contained to the U.S., with Switzerland hastily pushing Credit Suisse into the arms of UBS this past weekend. While the markets were generally relieved by the shotgun wedding, the (surprisingly harsh) treatment of AT1 bondholders rattled some corners of the market. Equities retained some value while AT1s were knocked down to zero, prompting regulators almost everywhere to state that would definitely not be a pattern elsewhere.

Any Colour You Like: Green, red, black… many markets cannot decide what to do with the mix of banking sector stress but a much tamer profile for future Fed rate hikes. As an example, the S&P 500 is down by less than 1% since the day yields peaked on March 8th, while the Nasdaq is up 4%, and bitcoin and gold have thrived. Meantime, energy is in retreat on prospects of weaker growth, with oil down more than 10%, and the TSX has thus dropped almost 5%.

Brain Damage: Amid the turmoil, some are deeply questioning the wisdom of central banks marching ahead with rate hikes. In perhaps the greatest show of bravery, after probably the most traumatic week ever for the Swiss banking sector, the SNB still pressed ahead with a (rare) 50 bp hike to 1.50% on Thursday. Recall, that key rate had been negative as recently as last summer, as it had been since early 2015. And, in a bit of cognitive dissonance, the Swiss franc has managed to strengthen in the past two weeks, in a true flight-to-safety move.

Eclipse: The question for central bankers, for analysts, for markets—even after the latest series of rate hikes—is still whether the turmoil will eclipse the need to fight inflation for policymakers. St. Louis Fed President Bullard may have put it best: *"While markets are obsessed by the banking stress, the Fed is obsessed with inflation"*.

One statistic that may have been somewhat overshadowed this week by events, but is crucial for the long-run outlook, was the **latest quarterly population estimate in Canada**. In the most recent quarter, the population rose by 0.7% to 39.6 million. In the past year, that marks an astonishing record rise of 1 million (or up 2.7%). In recent years, the growth rate has been skewed by the stop-start of COVID, and the spike in

the past year clearly exaggerates the underlying trend. Still, over the past three years, which would look through the pandemic distortions, Canada's population has grown at a 1.44% annual rate, exactly matching the robust pace in the three years prior to 2020.

A few points on these strong increases: First, the rapid growth is headed in precisely the opposite direction of the U.S., where the population has grown at a 0.5% annual pace over the past three years, or nearly a full point below Canada. Second, all of Canada's economic stats have to be considered in a somewhat different light amid such strong population trends. For example, employment needs to grow by almost 25,000 per month just to keep it rising in line with population trends. And, last year's 2.1% Q4/Q4 rise in real GDP suddenly looks quite soft stacked up against a 2.7% rise in population (i.e., negative in per capita terms). Finally, we have long pushed back against the assertion that the root of Canada's housing squeeze was a supply issue—but if the population keeps growing at anywhere close to 1 million per year, yes you are indeed going to have a shortage of supply, because we just can't build units that fast.

The Fed, a Hawk in Banking Havoc's Clothing

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This week, **the FOMC raised the fed funds target range by 25 bps to 4.75%-to-5.00%**, increasing cumulative tightening to 475 bps. The former is the highest since 2007 (just before the Global Financial Crisis); the latter is the largest since the Fed began targeting fed funds in the 1980s. The move was mostly, but not completely, priced in, with market expectations tainted by recent banking sector turmoil. The implications were noted in the press release: *"Recent developments are likely to result in tighter credit conditions for households and businesses and to weigh on economic activity, hiring, and inflation. The extent of these effects is uncertain"*. The topic permeated the press conference's conversation.

And, for the first time since the tightening campaign commenced a year ago, **the Fed tweaked its forward guidance**. Gone was the eight-times-employed phrase that *"the Committee anticipates that ongoing increases in the target range will be appropriate"*. It was replaced by the phrase that it *"anticipates that some additional policy firming may be appropriate"*. In the presser, Chair Powell said to focus on the words *"some"* and *"may"* in the new phrase versus *"ongoing"* in the old guidance, in the context of rate hikes. The Fed is signalling there's more conditionality concerning further rate hikes given the uncertain impact of banking sector stress and the tightening already in the hopper with its lagged influence on inflation. Another rate hike on May 3 is definitely *"some"* but the FOMC *"may"* also opt to pause. Note that even if the Fed pauses, policy would still, technically, be *"firming"* as quantitative tightening continues. Overall, a clever tweaking.

However, despite the clever turn of phrase, **we suspect the Fed has inherently turned more hawkish along the lines of Chair Powell's recent congressional testimony**. Recall in the wake of that two-day confab (on March 8) the market was pricing in (at the close) more than a 70% chance of a 50 bp rate for this month and a full percentage point of tightening by year-end. For the time being, pending any further escalation of the banking crisis, we reckon **the Fed is viewing these recent developments as a rate hike surrogate**, when more tightening was looking like it was going to be required anyway. Indeed, referring to December's Summary of

Economic Projections (SEP) and its call for 5.125% 2023-end funds rate, Powell said that *"the data in... the first five weeks of the intermeeting period pointed to stronger inflation and stronger labor market, so that pointed to higher rates"* but *"the possibility of credit conditions tightening really offset that effectively".*

Further indicative of a more hawkish Fed mood:

The 25-bp rate hike **decision was unanimous**. We had judged there could have been at least one dissenter advocating a pause owing to banking turmoil and tighter financial conditions.

We assume departed Vice Chair Brainard, arguably the most dovish FOMC participant, was one of the two folks calling for a 4.875% 2023-end funds rate back in December. So, while March's median projection did not change (still 5.125%), the ex-Brainard average projection increased by 4.2 bps. This is equivalent to three participants lifting their forecasts by 25 bps. It appears **the hawks became more hawkish**. Before, there were two 5.625% calls; now, there are three and one at 5.875%.

The median forecast for 2024-end increased by 0.125% with a full quarter-point move just one participant away. So, there's **less expected easing next year**.

Also, in the SEP, the median forecast for real GDP growth (Q4/Q4) was revised down by 0.1 ppt to 0.4% this year and by 0.4 ppts to 1.2% next year. However, core PCE inflation (Q4/Q4) was revised up by 0.1 ppt to 3.6% and 2.6%, respectively. This asymmetry followed December's theme, when the GDP duo was revised down 0.7 and 0.1 ppts and the core PCE pair was revised up 0.4 and 0.2 ppts. The Fed is again **acknowledging the stubbornness of inflation and the necessity of more growth-dampening tightening** to rein inflation in.

Bottom Line: If the FOMC ends up perceiving only minimal impacts of banking stress on credit and financial conditions, we would bet on participants lifting their fed funds forecasts for this year.

As mentioned above, the Fed has been targeting the fed funds rate since the 1980s. Before that, it was **bank reserves** that were targeted (which caused much more volatility in the fed funds rate). Back in those days, the Fed's weekly report on **"Factors Affecting Reserve Balances (H.4.1)"** was required reading. Over the past couple weeks, the publication has gained a new following because this is where the Fed's support measures for the banking system get reported.

For the week ended March 22, the Fed extended another $36.0 bln of credit to the banking system: $37.0 bln was lent to Silicon Valley Bank and Signature Bank to cover their deposits (which is guaranteed by the FDIC) and the Bank Term Funding Program (BTFP) was tapped for $41.7 bln. But discount window borrowing (primary credit) fell $42.6 bln, likely reflecting a shift to the BTFP. Apart from the two mentioned banks, the Fed didn't expand its support for the banking system in the latest week. That's good news.

Since the FDIC, Fed and Treasury announced the collapse of SVB and Signature and the measures to ringfence the fallout (March 12), two reports ago, the Fed's total lending to the banking system has been $339.0 bln: $179.8 bln to SVB and Signature, $53.7 bln via the BTFP and $105.7 bln through the discount window (the $148.3 jump alone

in the week ended March 15 was a record). Meanwhile, according to Bloomberg, the FHLB System issued $304 bln of debt last week, mostly to fund advances to member institutions. As regional and small banks have faced deposit flight and liquidity issues, the Fed (the lender of last resort) and FHLB System (sometimes referred to as the lender of second-last resort) have been filling the void.

Canadian Federal Budget Preview

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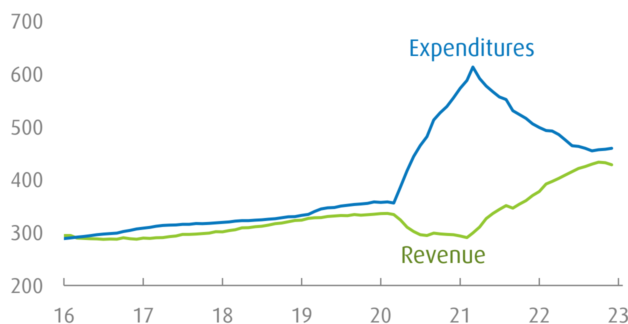
The Federal government will table the **FY23/24 budget on March 28th**, setting out fiscal priorities for the years ahead. In the Fall Economic Statement, Ottawa estimated a $36.4 billion deficit for FY22/23 (1.3% of GDP) and a slightly smaller $30.6 billion shortfall for FY23/24. Those balances reflect a dramatic positive turn from the deep pandemic deficit that weighed in at almost 15% of GDP. Massive temporary spending measures have rolled off and, just as dramatically, the economic recovery and burst in inflation have lifted nominal GDP, incomes and tax revenues.

Chart 2
Level Up: Revenues *and* Spending

Canada (C$ blns)
Federal Government



Sources: BMO Economics, Haver Analytics, Department of Finance

As it stands right now, there is probably some **modest downside risk compared to the projections outlined in the Fall Economic Statement**. While our current call for real GDP growth of 0.7% this year is consistent with Ottawa's fall assumption, nominal growth is tracking slightly weaker, while interest rates are tracking somewhat higher (although the rate backdrop is changing rapidly heading into the budget). These impacts appear modest enough to keep the fiscal path close to what Ottawa laid out in the fall.

What we *will* see: Ottawa will surely lay out a downside fiscal scenario that provides a stress-test of how finances would look in a more significant recession. Finance, and many of the provinces, are making this common practice. The downside scenario presented in the fall update featured a recession-like 0.9% decline in real GDP in 2023, which came with a $52 billion deficit, or $22 billion deeper than the baseline for FY23/24. On the policy front, we're almost certain to see some dedicated spending and/or tax credits aimed at the clean energy sector as a response to the measures in the U.S. Inflation Reduction Act. And, with the cost of living still a major issue, there could be some more highly-targeted relief measures.

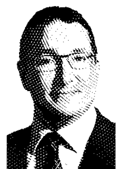
What we *won't* see: Wholesale fiscal stimulus is not the appropriate move at this stage, and the Finance Minister has acknowledged as much in recent weeks. While inflation has shown signs of cooling, the Bank of Canada remains in a dog fight with price and wage pressures, leaving measures like direct support payments (of which we saw more than $10 billion worth last year across the provinces) counterproductive. As such, net stimulus coming out of this budget should be very mild. From a bigger-picture perspective, note that federal program spending over the latest 12 months is running a hefty 26% above pre-COVID levels even after the largest temporary measures have fallen out (*Chart 2*). To be fair, the average price level in Canada is up about 13% over that period, and the population has expanded by another 4%, but

we're still seeing program spending hold above pre-COVID norms in real per-capita terms and as a share of GDP.

What we'll be watching for: The timing of balanced budgets is always a focus, but we've been conditioned to not expect much on that front. That is, look for balanced budgets to remain a token feature of the fiscal plan a number of years down the road. On the policy front, there is always pre-budget chatter about potential tax changes, and this one is no different. Areas like the Alternative Minimum Tax and various tax 'loopholes' targeting higher-income Canadians look to be clearly in play. Other more contentious and wider-reaching areas like the capital gains inclusion rate and top marginal tax rate have been discussed in the media recently, and were part of the NDP platform, but also seem to be perennial members of the pre-budget rumour mill.

All told, and if the provincial budget season is any guide, this could be a relatively stable budget with a few policy tweaks.

What to Watch to Assess the Impact on Canada



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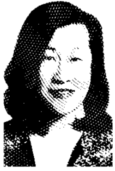
The Canadian economy entered this period of global banking stress with strong momentum. We'll get a check-in with January GDP next week, but it looks like growth was solid to start 2023 (though February appears to have slowed meaningfully). Doug Porter and Sal Guatieri highlight the potential impact on Canada from the banking stress in this week's Feature. **Here are a few data points we'll be watching** to assess the potential impact. This is a time when the lagged release timing of Canadian data can be particularly challenging, but there are some less-followed numbers worth keeping an eye on.

- The timeliest figures come out of the U.S. weekly banking figures. Watch **loan and deposit growth**, as a big pullback in either would be a red flag for activity south of the border and would not bode well for Canadian exports.
- Activity generally takes time to be impacted by U.S. events and tightening credit. Accordingly, look for the **monthly credit** numbers. They aren't any timelier than the activity figures, but if the banking sector tightens credit standards sharply, it should show up there quickly.
- The Bank of Canada's **Business Outlook Survey** could prove useful. The Survey will be out on April 3, and has the potential to provide any early warning signs. The BoC has tended to add questions on whatever topic is trending, and this would be a good opportunity to see if there's been any impact from the stress.
- **Insolvency statistics** are out relatively early (February was out on Thursday) and could signal brewing issues on the consumer or business side.

Additionally, the normal slate of data will be followed, though it will take some time before we can assess if there's any impact from the banking stress. Meantime, monetary policymakers will engage businesses across the country for updates.

Key Takeaway: We're going to be watching the data closely for any signs that the banking stress is impacting the macro backdrop in Canada. The Bank of Canada will be doing the same, which suggests it will keep policy rates comfortably on hold through at least April assuming a deeper crisis is avoided.

Not Yet Time to Batten Down the Hatches



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If it wasn't for the current banking turmoil, I shudder to think how many rate hikes markets would be pricing in… globally. Let's summarize the decisions made after the SVB news ripped through social media at top speed. In no particular order:

- The **FOMC** raised rates 25 bps but considered pausing.
- The **BoE** raised rates 25 bps, a step down in the pace of tightening. Two members wanted to pause, but that had nothing to do with the banking crisis.
- The **ECB** raised rates 50 bps but considered pausing.
- The **Norges Bank** raised rates 25 bps, and gave a head's up that it will go again in May.
- The **SNB** raised rates 50 bps, and said more hikes "*cannot be ruled out*".
- The **BoJ** kept policy unchanged but has, arguably, been on pause for a long, long time. Nothing to do with the current crisis.
- **Banco Central do Brasil** also kept policy unchanged, but the tone was hawkish. The Copom acknowledged the current environment but it "*will not hesitate"* to tighten again if necessary.

Rate hikes are still the order of the day, as central bankers are not letting the turmoil get in the way of their fight against inflation… yet. There were some interesting developments this week from the **ECB**. Over a dozen Governing Council members openly pontificated about the rate outlook and the majority sounded the warning bell for another hike at the May 4 meeting. Although the hawkish sounds were not as loud as they once were (even Austria's ultra-hawk admitted that although he would not rule out three more 50 bp hikes, "*I also wouldn't say that they'll necessarily come either*"), the direction is clear. The ECB is not finished yet. We continue to expect a 25 bp rate hike in May.

The **BoE** clearly cooled down this week. The majority of the MPC all moved together and the seven members backed the 25 bp hike, after voting for 50 bps in the prior two meetings, and 75 bps back in November. But do not take that as a sign that we are at terminal. Governor Bailey seemed to plead with the public this week: "*I would say to people who are setting prices: please understand if we get inflation embedded interest rates will have to go up further*". We continue to expect one more hike (25 bps) in May, as the country still faces double-digit headline inflation. But, there will be one more inflation and jobs reports to factor in before the May 11 announcement. If they show signs of improvement, and if the market uncertainty flares up again, the BoE will seize the opportunity to call it a day.

Recap

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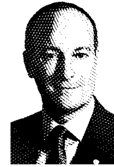
*Indications of stronger growth and a move toward price stability are **good news** for the economy.*

	Good News	Bad News
Canada ▪ BoC Minutes suggest policymakers are comfortable keeping rates steady ▪ Loonie weakens along with oil prices	**Consumer Prices** slowed to +5.2% y/y (Feb.) —a 13-month low **Retail Sales Volumes** +1.5% (Jan.)—but StatCan estimates nominal sales fell 0.6% in Feb. **Mortgage Credit Growth** slowed to +6.5% y/y (Jan.) **New Housing Price Index** -0.2% m/m (Feb.) —helps the inflation picture **Population** +1 mln y/y (Q4)—largest on record **New Motor Vehicle Sales** +8.8% y/y (Jan.) **Province of Saskatchewan** is projecting a $1 bln surplus (FY23/24) **Province of New Brunswick** expects budget surplus to narrow to $40 mln (FY23/24)	**Manufacturing Sales** -2.8% (Feb. A) **Wholesale Trade** -1.6% (Feb. A) **Province of Ontario** is projecting a small $1.3 bln deficit (FY23/24) **Province of Quebec** is projecting a $1.6 bln deficit (FY23/24) **Province of Newfoundland & Labrador** is projecting a small $160 mln deficit (FY23/24) **Province of Nova Scotia** is projecting a $279 million deficit (FY23/24)
United States ▪ FOMC hikes 25 bps; signals end of increases may be nearing ▪ Markets gyrate amid banking sector turmoil ▪ Credit conditions tighten	**Core Durable Goods Orders** +0.2% (Feb.) **Existing Home Sales** +14.5% to 4.58 mln a.r. (Feb.) **New Home Sales** +1.1% to 640,000 a.r. (Feb.) **Initial Claims** -1k to 191k (Mar. 18 week) **Current Account Deficit** narrowed to $206.8 bln (Q4)	**Chicago Fed National Activity Index** -0.19 (Feb.)
Japan ▪ Yen strengthens on flight to safety	**Consumer Prices** slowed to +3.3% y/y (Feb.)—but core-core hit fresh 41-yr high of +3.5% y/y **Department Store Sales** +20.4% y/y (Feb.) **Manufacturing PMI** +0.9 pts to 48.6; **Services PMI** +0.2 pts to 54.2 (Mar. P)	
Europe ▪ BoE hikes 25 bps and signals it is not done ▪ SNB raises rates 50 bps despite Credit Suisse fallout ▪ Norges Bank hikes 25 bps; signals another increase in May	**Euro Area—Services PMI** +2.9 pts to 55.6 (Mar. P) **Euro Area—Trade Deficit** narrowed to €11.3 bln (Jan.) **Germany—Producer Prices** -0.3% (Feb.) **U.K.—Producer Prices (Output)** -0.3% (Feb.) **U.K.—Retail Sales (incl. Fuel)** +1.2% (Feb.) **U.K.—Rightmove House Prices** +3.0% y/y (Mar.) **U.K.—GfK Consumer Confidence** +2 pts to -36 (Mar.)	**Euro Area—Manufacturing PMI** -1.4 pts to 47.1 (Mar. P) **Euro Area—Consumer Confidence** -0.1 pts to -19.2 (Mar. P) **France—Retail Sales** -4.3% y/y (Feb.) **Germany—ZEW Survey** -15.1 pts to 13.0 (Mar.) **U.K.—Consumer Prices** jumped 1.1% or 10.4% y/y (Feb.) **U.K.—Manufacturing PMI** -1.3 pts 48.0; **Services PMI** -0.7 pts to 52.8 (Mar. P)
Other ▪ Banco Central do Brasil holds rates at 13.75%, despite pressure from President Lula calling for a cut		

(Credit) Crunch Time for the Economy?



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"Recent developments are likely to result in tighter credit conditions for households and businesses and to weigh on economic activity, hiring, and inflation. The extent of these effects is uncertain." — FOMC Statement, March 22, 2023

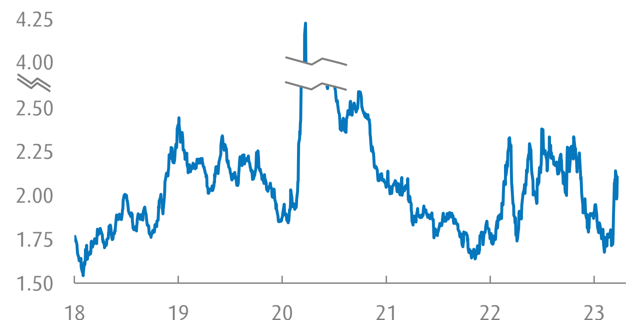
The banking sector stress in the past two weeks has clearly ratcheted up the risks for the broader economic outlook. At a minimum, it will reinforce the ultra-aggressive central bank tightening of the past year. Quantifying the impact in these early days is next to impossible given that: a) no one can say for certain whether the squall will soon blow over or intensify; and b) the transmission of financial system strains to the economy is imprecise. On balance, we suspect the **turmoil will tighten lending conditions notably in the U.S. and Europe (and less so in Canada and Australia)**, cutting into already-softer capital spending trends, and denting what had been a resilient consumer. We have been in the mild recession camp for the past six months on the North American economy for 2023, and will freely allow that it was beginning to look like an overly dour forecast—until now. The combination of the near-record rate hikes of the past 12 months and a moderately tighter credit backdrop **points to a contraction in the economy in the coming quarters**, though the ultimate depth and duration will revolve around how long the current turmoil persists.

United States

The banking stress will affect the U.S. economy via three channels—**credit, confidence, and conditions** (financial). Credit is about to get scarcer and more expensive. Loan growth was already slowing due to higher rates and tighter standards, but the trend could gather pace. Credit spreads have widened in the past two weeks, led by financial firms, though they are far removed from past blowouts (*Chart 1*). According to the American Bankers Association, credit conditions for consumer and business loans improved in Q1, but remain poor even *before* the latest financial stress. Smaller regional banks that are losing deposits will be forced to curb lending; while larger lenders may not plug the gap if they fear a recession. Smaller banks (outside the top 25 by assets) accounted for 41% of total bank loans in February and 70% for the commercial real estate sector. The office segment could take another body blow, with property values already down 25% from a recent peak (*Chart 2*). Rising bank funding costs could translate into higher loan rates for businesses and households. **Small business confidence is already at recession levels and could sag further**, depressing investment and hiring.

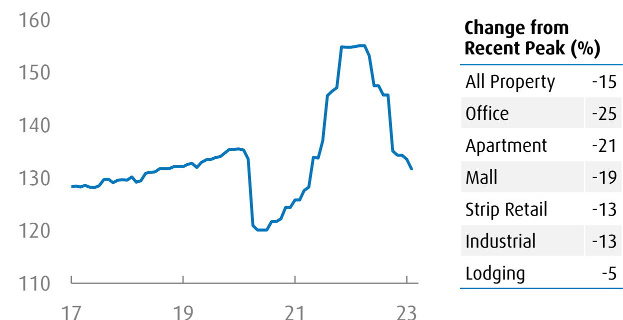
The impact on financial conditions is harder to pin down. Despite the slide in bank shares, equity markets have held up fairly well. The Chicago Fed's measure of **financial conditions tightened only modestly in the two weeks to March 17** (*Chart 3*). While conditions had weakened materially in the past year, they are looser

Chart 1
Credit Spreads Up... but Not Away
United States (ppts : as of March 23, 2023)
15+ year A-BBB Corporate – 10-year Treasury Spread



Sources: BMO Economics, Haver Analytics, ICE/BoA Merrill Lynch, FRB

Chart 2
Out of Office
United States (Aug. 2007 = 100)
Green Street Commercial Property Price Index



Sources: BMO Economics, Haver Analytics, Green Street Advisors

than normal and not yet tight enough to cause a severe downturn.

The three Cs will challenge the three pillars of resilience. Long after the final stimulus cheques were sent out in 2021, consumer spending has been buttressed by excess savings, pent-up demand for deferred services, and stunningly strong job growth. That's why we see just a shallow downturn. In fact, after the latest upswing in jobs and spending, we started to doubt whether the economy would shrink at all. Post-turmoil, however, even if extra savings and pent-up demand are likely to last for the remainder of the year, **hiring will take a hit,** undercutting consumer confidence and spending. In addition, **demand for big-ticket items, such as homes and autos, could be held back by tighter credit**. While home sales may have bottomed, the recovery could be delayed given that mortgage rates are still well above 6% and new applications have fallen back to cycle lows.

It's too early to judge how much the banking stress will weigh on the economy—it depends on how long it lasts and whether it spreads. The Fed's initial stab was to modestly lower its GDP growth outlook, though its view for this year (+0.4% over four quarters) is still somewhat firmer than ours (-0.2%). For now, we suspect **the turmoil will largely offset prior upside risks, preserving our call for a shallow downturn around mid-year**.

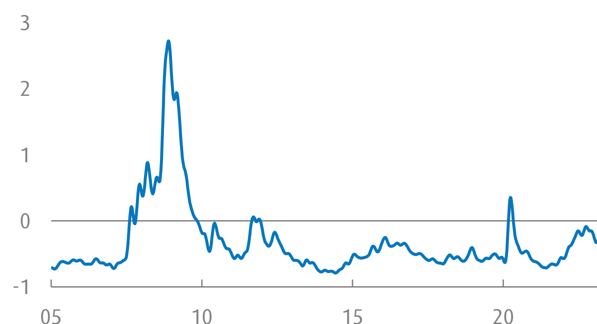
On the plus side, **consumers could see some inflation relief**. By depressing oil prices, the financial turmoil could lead to more savings at the pumps. It has already dampened inflation expectations, with one implied Treasury metric hitting a two-year low (*Chart 4*). If workers expect slower price increases, they could rein in wage demands. And, businesses might face a tougher time passing cost increases to customers.

Chart 3

Tighter, but Not Tight

United States (positive = tighter than average)

Chicago FRB National Financial Conditions Index



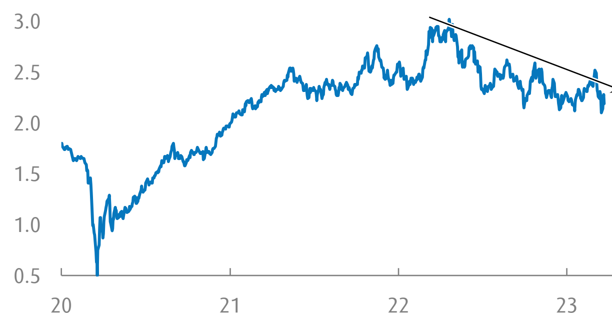
Sources: BMO Economics, Haver Analytics, Federal Reserve Bank of Chicago

Chart 4

Destressing about Inflation

United States (ppts : as of March 23, 2023)

10-year Nominal Treasury Rate minus 10-year TIPS Rate



Sources: BMO Economics, Haver Analytics, Federal Reserve Board

Canada

While Canada's relatively strong financial sector has largely stayed out of the recent fray, **it doesn't mean that the domestic economy will emerge completely unscathed**. Almost no one would compare this episode with 2008, but we can still glean lessons from that traumatic series of events. At that time, Canada was widely recognized as having the healthiest banking system in the world, yet credit conditions still tightened markedly amid the waves of uncertainty, triggering an equally deep downturn in capital spending and the broader economy (*Chart 5*). The added hit from much weaker exports and commodity prices led to a 4% y/y drop in real GDP in the four quarters after Lehman Bros. went under, actually slightly exceeding the decline in U.S. GDP over the same period. (Where Canada really shone was on the recovery out of the deep downturn.)

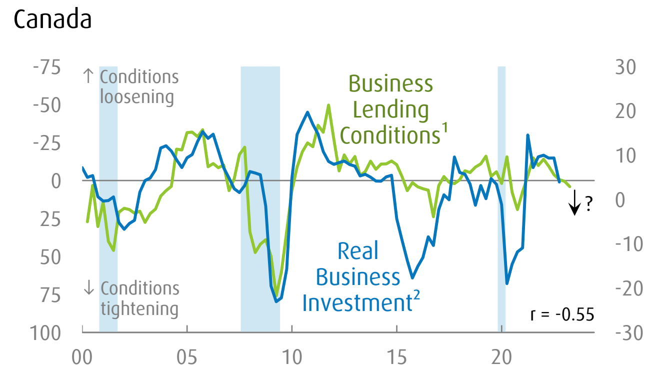
According to the BoC's Senior Loan Officer Survey, **business lending conditions were slightly on the tighter side of normal in Q4**. Most of that somewhat tighter landscape was on the price side, while nonprice conditions were in fact a bit looser than typical. Capital spending had already begun to lose pep late last year—one of the main reasons GDP growth stalled in Q4 was a surprisingly soft 5.5% drop in business investment after three quarters of solid recovery. From the perspective of borrowers, the BoC's Business Outlook Survey reported a notable tightening in conditions (*Chart 6*). While not nearly as tight as in 2008, it's among the biggest moves in the 23-year history of the survey—and that was before the events of the past two weeks. Not surprisingly, the same survey shows that business plans to boost capital spending have faded fast from very strong levels.

Lending to households, and consumer spending in general, tend to be less susceptible to shifts in credit conditions and more dictated by moves in interest rates and employment. Still, financial market turmoil and the spillover to credit conditions can undercut confidence and spending. While admittedly an extreme example, consumer spending turned on a dime in late 2008, and fell heavily for two quarters. The BoC's loan officer survey only began tracking household lending conditions in 2017, so there's not much history. Still, we know that conditions tightened sharply at the start of the pandemic, especially for nonmortgage consumer loans, but then quickly backed off (*Chart 7*). At the end of last year, mortgage lending conditions were seen as roughly normal, while they were a bit tight for nonmortgage loans, particularly on the nonprice side.

The main point is that even with a relatively strong and stable banking sector, credit conditions may still tighten somewhat amid the turmoil in other economies. In other words, **Canada is not an island**. And, businesses were already reporting that credit conditions were tightening in the lead-up to recent events, with some preliminary signs that households were also facing a somewhat stricter backdrop. Any further tightening will reinforce the 425 bps of policy rate increases over the past year, and —as for the U.S.—raise the odds of an outright downturn in the broader economy in the coming quarters. At the same time, this would bring forward the point at which the Bank of Canada could begin to take its foot off the brakes, especially with inflation beginning to relent.

Chart 5
Capital Spending Already Sagging

Canada

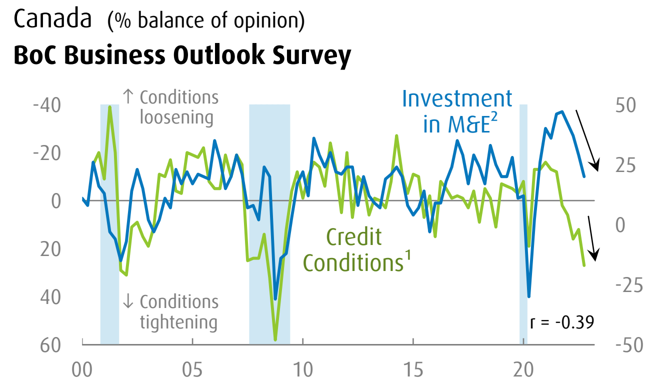


Shading marks U.S. recessions; [1] BoC Senior Loan Officer Survey (lhs : % balance of opinion : adv. 2 qtrs. : inverted); [2] (rhs : y/y % chng)
Sources: BMO Economics, Haver Analytics, Bank of Canada, Statistics Canada

Chart 6
Business Trims the Sails

Canada (% balance of opinion)

BoC Business Outlook Survey

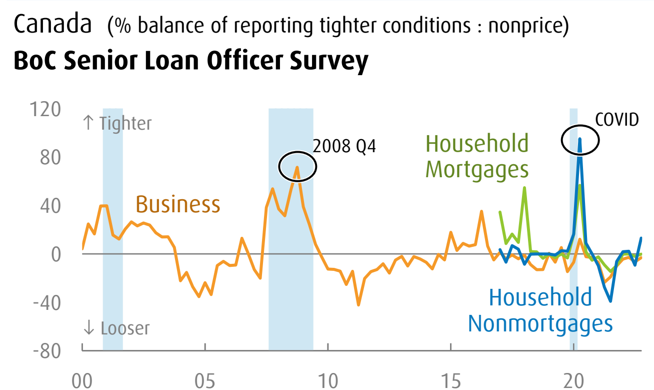


Shading marks U.S. recessions; [1] (lhs : inverted); [2] (rhs)
Sources: BMO Economics, Haver Analytics, Bank of Canada

Chart 7
It's Not About the Price Tag

Canada (% balance of reporting tighter conditions : nonprice)

BoC Senior Loan Officer Survey



Shading marks U.S. recessions
Sources: BMO Economics, Haver Analytics, Bank of Canada

Economic Forecast Summary for March 24, 2023

		2022				2023				Annual		
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2022	2023	2024
CANADA												
Real GDP	(q/q % chng : a.r.)	2.4	3.6	2.3	0.0	1.0	-0.5	-0.7	1.0	3.4	0.7	1.3
Consumer Price Index	(y/y % chng)	5.8	7.5	7.2	6.7	5.3 ↓	3.6 ↓	3.3 ↓	2.9 ↓	6.8	3.8 ↓	2.5
Unemployment Rate	(percent)	5.7	5.1	5.1	5.1	5.0	5.3	5.6	5.8	5.3	5.4	5.6
Housing Starts	(000s : a.r.)	241	271	281	259	235	242	225	220	263	230	220
Current Account Balance	($blns : a.r.)	11.0	22.0	-33.7	-42.6	-36.4	-36.6	-42.5	-44.5	-10.8	-40.0	-45.0
Interest Rates						(average for the quarter : %)						
Overnight Rate		0.33	1.17	2.75	3.92	4.50	4.50	4.50	4.50	2.04	4.50	3.88
3-month Treasury Bill		0.39	1.43	2.91	3.96	4.40	4.45	4.45	4.45	2.17	4.45	3.85
10-year Bond		1.92	2.98	3.01	3.16	3.00	3.30 ↑	3.20	3.05	2.77	3.15	2.95
Canada-U.S. Interest Rate Spreads						(average for the quarter : bps)						
90-day		9	33	16	-22	-40 ↓	-55	-60	-60	9	-54	-52
10-year		-2	5	-10	-67	-61 ↑	-62 ↑	-57 ↑	-52	-18	-58 ↑	-44
UNITED STATES												
Real GDP	(q/q % chng : a.r.)	-1.6	-0.6	3.2	2.7	0.5	-1.0	-1.0	0.8	2.1	0.7	1.3
Consumer Price Index	(y/y % chng)	8.0	8.6	8.3	7.1	5.9	4.5	4.0	3.7	8.0	4.5	2.5
Unemployment Rate	(percent)	3.8	3.6	3.5	3.6	3.5	4.0	4.6	4.8	3.6	4.2	4.7
Housing Starts	(mlns : a.r.)	1.72	1.65	1.45	1.40	1.40	1.38	1.34	1.37	1.55	1.37	1.41
Current Account Balance	($trlns : a.r.)	-1.12	-0.95	-0.88	-0.83	-0.88 ↓	-0.90 ↓	-0.90 ↓	-0.91 ↓	-0.94	-0.90 ↓	-0.92 ↓
Interest Rates						(average for the quarter : %)						
Fed Funds Target Rate		0.21	0.96	2.63	3.79	4.63	5.04	5.13	5.13	1.90	4.98	4.42
3-month Treasury Bill		0.30	1.10	2.75	4.18	4.80	5.00	5.05	5.05	2.08	5.00	4.35
10-year Note		1.94	2.93	3.10	3.83	3.65	3.90	3.80	3.55	2.95	3.75	3.40
EXCHANGE RATES						(average for the quarter)						
US¢/C$		79.0	78.4	76.6	73.7	73.9	73.8	75.1	76.5	76.9	74.8	77.7
C$/US$		1.27	1.28	1.31	1.36	1.35	1.35	1.33	1.31	1.30	1.34	1.29
¥/US$		116	130	138	141	133	133	132	130	131	132	127
US$/Euro		1.12	1.06	1.01	1.02	1.07	1.08	1.09	1.10	1.05	1.08	1.12
US$/£		1.34	1.26	1.18	1.17	1.21	1.21	1.23	1.24	1.24	1.22	1.27

Blocked areas mark BMO Capital Markets forecasts; up and down arrows (↑↓) indicate forecast changes; spreads may differ due to rounding

Canada

Benjamin Reitzes
Canadian Rates & Macro Strategist
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Federal Budget
Tuesday

See Robert Kavcic's Thought on page 6.

Monthly Real GDP
Friday, 8:30 am

Jan. (e)	**+0.4%**
Jan. P	+0.3%
Dec.	-0.1%

The Canadian economy followed the old saying, "In like a lion, out like a lamb", ending 2022 with a whimper, and starting 2023 with gusto. Manufacturing and wholesale activity surged, while retail sales saw a modest gain, and mining/oil/gas likely rebounded from maintenance-driven softness in the prior month. Construction probably saw some benefit from the mild winter, though housing starts and home sales fell in January. Hours worked also surged to start the year, on the back of the largest non-pandemic job gain on record (even in percentage terms). StatCan's early estimate pegged **January GDP** at +0.3%, but we're a bit more upbeat with our call for +0.4%, driven by the pervasive strength in the data. That would be a very solid start to Q1, and put quarterly growth on pace to handily outperform the BoC's January MPR forecast of +0.5% annualized. The advance February data so far have shown meaningful retracement, and we'll be looking for the flash GDP estimate for a better picture. If the direction holds, it looks like the rebound in Q1 GDP will be restrained after the prior quarter's inventory-fuelled weakness.

United States

Sal Guatieri
Senior Economist
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Personal Spending & Income
Friday, 8:30 am

	Personal Spending	Personal Income
Feb. (e)	**+0.3%**	**+0.3%**
Consensus	*+0.3%*	*+0.3%*
Jan.	+1.8%	+0.6%

Core PCE Price Index

Feb. (e)	**+0.5%**	**+4.8% y/y**
Consensus	*+0.4%*	*+4.7% y/y*
Jan.	+0.6%	+4.7% y/y

After bursting out of the gates on milder weather in January, consumers look to have cooled their jets in February. **Personal spending** likely rose 0.3%, while slipping a tenth in real terms. Although some retail outlets posted solid gains last month, auto dealers and restaurants faced big pullbacks. Still, after January's 1.1% spike, real consumer spending growth likely doubled to around 3% annualized in Q1. Meantime, personal income should decelerate to 0.3% in February amid softer aggregate work hours and hourly wage growth. Alas, there won't be much deceleration in inflation. Last month's CPI highlighted big price gains at restaurants, airlines, and hotels (i.e., travel-related areas still seeing some pent-up demand), with a small offset from lower health care costs. Cheaper natural gas might hold overall **PCE prices** to a 0.4% monthly increase in February, and clip the yearly rate two notches to 5.2%. But core prices look to pop 0.5% after an even larger bounce previously, which should lead to a second straight rise in the yearly rate to 4.8%. That is, core inflation may be moving toward, rather than away from, the earlier cycle high (5.4%). Powell's 'supercore' measure (services less energy and housing) could also leap 0.5%, hauling its yearly rate to 4.9% from 4.6% in January and within earshot of earlier highs (5.2%). The Chair may need to bite his lip given the financial stress, but he won't be happy.

Financial Markets Update for March 24, 2023

		Mar 24 [1]	Mar 17	Week Ago	4 Weeks Ago	Dec 31, 2022
					(basis point change)	
Canadian Money Market	Call Money	4.50	4.50	0	0	25
	Prime Rate	6.70	6.70	0	0	25
U.S. Money Market	Fed Funds (effective)	5.00	4.75	25	25	50
	Prime Rate	8.00	7.75	25	25	50
3-Month Rates	Canada	4.32	4.29	3	-17	9
	United States	4.56	4.34	23	-22	22
	Japan	-0.27	-0.27	0	-13	-9
	United Kingdom	4.26	4.24	2	0	39
	Australia	3.70	3.69	1	19	44
2-Year Bonds	Canada	3.33	3.54	-20	-94	-72
	United States	3.70	3.84	-14	-111	-73
10-Year Bonds	Canada	2.71	2.78	-7	-68	-59
	United States	3.36	3.43	-8	-59	-52
	Japan	0.27	0.28	-1	-23	-14
	Germany	2.11	2.10	0	-43	-46
	United Kingdom	3.27	3.28	-1	-39	-40
	Australia	3.22	3.39	-18	-61	-83
Risk Indicators	VIX	23.7	25.5	-1.8 pts	2.0 pts	2.0 pts
	Inv. Grade CDS Spread [2]	85	87	-1	9	3
	High Yield CDS Spread [2]	517	528	-10	52	33
					(percent change)	
Currencies	US¢/C$	72.56	72.83	-0.4	-1.2	-1.7
	C$/US$	1.378	1.373	—	—	—
	¥/US$	130.48	131.85	-1.0	-4.4	-0.5
	US$/€	1.0753	1.0670	0.8	1.9	0.4
	US$/£	1.222	1.217	0.4	2.3	1.2
	US¢/A$	66.44	66.97	-0.8	-1.2	-2.5
Commodities	CRB Futures Index	257.78	254.66	1.2	-3.5	-7.2
	Oil (generic contract)	68.47	66.93	2.3	-10.3	-14.7
	Natural Gas (generic contract)	2.20	2.34	-5.8	-10.1	-50.8
	Gold (spot price)	1,997.49	1,989.25	0.4	10.3	9.5
Equities	S&P/TSX Composite	19,407	19,388	0.1	-4.0	0.1
	S&P 500	3,935	3,917	0.5	-0.9	2.5
	Nasdaq	11,713	11,631	0.7	2.8	11.9
	Dow Jones Industrial	31,873	31,862	0.0	-2.9	-3.8
	Nikkei	27,385	27,334	0.2	-0.2	4.9
	Frankfurt DAX	14,919	14,768	1.0	-1.9	7.1
	London FT100	7,387	7,335	0.7	-6.2	-0.9
	France CAC40	6,996	6,925	1.0	-2.7	8.1
	S&P ASX 200	6,955	6,995	-0.6	-4.8	-1.2

[1] = as of 10:55 am *[2] = One day delay*

China

Friday March 31

PMI	Mfg.	Non-mfg.
Mar. (e)	**51.8**	**54.3**
Feb.	52.6	56.3

Japan

Friday March 31

Jobless Rate

Feb. (e)	**2.4%**	
Jan.	2.4%	

Retail Sales

Feb. (e)	**+0.4%**	**+5.9% y/y**
Jan.	+0.8%	+5.0% y/y

Industrial Production

Feb. P (e)	**+2.7%**	**-2.1% y/y**
Jan.	-5.3%	-3.1% y/y

Europe

Monday March 27

EURO AREA

Adjusted Private Sector Credit

Feb.	
Jan.	+4.9% y/y

GERMANY

ifo Business Climate

Mar. (e)	**91.0**
Feb.	91.1

UNITED KINGDOM

BoE Gov. Bailey speaks at London School of Economics

Tuesday March 28

FRANCE

Business Confidence

Mar. (e)	**103**
Feb.	103

ITALY

Consumer Confidence

Mar. (e)	**104.0**
Feb.	104.0

UNITED KINGDOM

BoE Gov. Bailey testifies on SVB

Wednesday March 29

GERMANY

GfK Consumer Confidence

Apr. (e)	**-29.3**
Mar.	-30.5

FRANCE

Consumer Confidence

Mar. (e)	**81**
Feb.	82

UNITED KINGDOM

BoE Financial Policy Summary

Thursday March 30

EURO AREA

Economic Confidence

Mar. (e)	**99.8**
Feb.	99.7

Consumer Confidence

Mar. F (e)	**-19.2**
Feb.	-19.1

ECB Economic Bulletin

GERMANY

Consumer Price Index

Mar. P (e)	**+0.9%**	**+7.9% y/y**
Feb.	+1.0%	+9.3% y/y

ITALY

Jobless Rate

Feb. (e)	**7.9%**
Jan.	7.9%

Friday March 31

EURO AREA

Consumer Price Index		Core CPI
Mar. P (e)	**+7.1% y/y**	**+5.7% y/y**
Feb.	+8.5% y/y	+5.6% y/y

Jobless Rate

Feb. (e)	**6.6%**
Jan.	6.6%

ECB President Lagarde speaks in Florence

GERMANY

	Unemploy.	Jobless Rate
Mar. (e)	**unch**	**5.5%**
Feb.	+2,000	5.5%

Retail Sales

Feb. (e)	**+0.5%**	**-5.2% y/y**
Jan.	unch	-4.2% y/y

FRANCE

Consumer Price Index

Mar. P (e)	**+0.8%**	**+6.4% y/y**
Feb.	+1.1%	+7.3% y/y

Consumer Spending

Feb. (e)	**+0.1%**	**-3.6% y/y**
Jan.	+1.5%	-3.7% y/y

ITALY

Consumer Price Index

Mar. P (e)	**+1.5%**	**+8.9% y/y**
Feb.	+0.1%	+9.8% y/y

UNITED KINGDOM

Real GDP

Q4 F (e)	**unch**	**+0.4% y/y**
Q4 P	unch	+0.4% y/y
Q3	-0.2%	+1.9% y/y

Other

Tuesday March 28

AUSTRALIA

Retail Sales

Feb. (e)	**+0.1%**
Jan.	+1.9%

Wednesday March 29

AUSTRALIA

Consumer Price Index

Feb. (e)	**+7.2% y/y**
Jan.	+7.4% y/y

Thursday March 30

MEXICO

Bank of Mexico Monetary Policy Meeting

[D] = date approximate

Upcoming Policy Meetings | Bank of England: May 11, June 22, Aug. 3 | European Central Bank: May 4, June 15, July 27

Canada

Monday March 27

Tuesday March 28

Federal Budget

10:30 am — 3-, 6- & 12-month bill auction $18.0 bln (new cash $2.4 bln)

11:15 am — Cash management bond buybacks $0.5 bln

Wednesday March 29

12:30 pm — BoC Deputy Gov. Gravelle speaks in Montreal on "The Market Liquidity Measures We Took During COVID"

Thursday March 30

8:30 am — Survey of Employment, Payrolls, and Hours (Jan.)

Noon — 30-year bond auction $1.5 bln

10-year bond auction announcement

Friday March 31

8:30 am	**Monthly Real GDP**
Jan. (e)	**+0.4%**
Jan. P	+0.3%
Dec.	-0.1%

Ottawa's Budget Balance[D]

Jan. '23	
Jan. '22	-$5.2 bln

United States

Monday March 27

10:30 am	**Dallas Fed Mfg. Activity**
Mar. (e)	**-10.0[c]**
Feb.	-13.5

Fed Speaker: Governor Jefferson (5:00 pm)

11:30 am — 13- & 26-week bill auctions $105 bln

1:00 pm — 2-year note auction $42 bln

Tuesday March 28

8:30 am	**Goods Trade Deficit**	
Feb. A (e)	**$89.9 bln[c]**	
Jan.	$91.1 bln	
8:30 am	**Wholesale and Retail Inventories (Feb. A)**	
9:00 am	**S&P CoreLogic Case-Shiller Home Price Index (20 city)**	
Jan. (e)	**-0.5%**	**+2.5% y/y**
Consensus	*-0.5%*	*+2.5% y/y*
Dec.	-0.5%	+4.6% y/y
9:00 am	**FHFA House Price Index**	
Jan. (e)	**-0.3%**	**+4.9% y/y**
Consensus	*-0.3%*	*+4.9% y/y*
Dec.	-0.1%	+6.6% y/y
10:00 am	**Conference Board Consumer Confidence Index**	
Mar. (e)	**101.3[c]**	
Feb.	102.9	
10:00 am	**Richmond Fed Manufacturing Index**	
Mar. (e)	**-8[c]**	
Feb.	-16	

10:00 am — Fed Vice Chair for Supervision Michael Barr testifies before the Senate Banking Committee

11:30 am — 7-day cash management bill auction $30 bln

1:00 pm — 17-day cash management bill auction $45 bln

1:00 pm — 5-year note auction $43 bln

Wednesday March 29

7:00 am	**MBA Mortgage Apps**
Mar. 24	
Mar. 17	+3.0%
10:00 am	**Pending Home Sales**
Feb. (e)	**-4.0%**
Consensus	*-2.3%*
Jan.	+8.1%

10:00 am — Fed Vice Chair for Supervision Michael Barr testifies before the House Financial Services Committee

11:30 am — 17-week bill auction

11:30 am — 2[R]-year FRN auction $22 bln

1:00 pm — 7-year note auction $35 bln

Thursday March 30

8:30 am	**Initial Claims**	
Mar. 25 (e)	**200k (+9k)[c]**	
Mar. 18	191k (-1k)	
8:30 am	**Continuing Claims**	
Mar. 18		
Mar. 11	1,694k (+14k)	
8:30 am	**Real GDP**	**GDP Deflator**
Q4 T (e)	**+2.8% a.r.**	**+3.9% a.r.**
Consensus	*+2.7% a.r.*	*+3.9% a.r.*
Q4 S	+2.7% a.r.	+3.9% a.r.
Q3	+3.2% a.r.	+4.4% a.r.
8:30 am	**Pre-Tax Corporate Profits**	
Q4 F (e)	**+4.6% y/y**	
Q3	+5.5% y/y	
8:30 am	**Real GDP by Industry (Q4)**	

Fed Speakers: Richmond's Barkin (12:45 pm); Boston's Collins (12:45 pm)

11:00 am — 13- & 26-week bill auction announcements

11:30 am — 4- & 8-week bill auctions

Friday March 31

8:30 am	**Personal Spending**	**Personal Income**
Feb. (e)	**+0.3%**	**+0.3%**
Consensus	*+0.3%*	*+0.3%*
Jan.	+1.8%	+0.6%
8:30 am	**Core PCE Price Index**	
Feb. (e)	**+0.5%**	**+4.8% y/y**
Consensus	*+0.4%*	*+4.7% y/y*
Jan.	+0.6%	+4.7% y/y
9:45 am	**Chicago PMI**	
Mar. (e)	**43.9[c]**	
Feb.	43.6	
10:00 am	**University of Michigan Consumer Sentiment**	
Mar. F (e)	**63.4[c]**	
Mar. P	63.4	
Feb.	67.0	

Fed Speakers: New York's Williams (3:00 pm); Governor Waller (4:00 pm); Governor Cook (5:45 pm)

[c] = consensus [D] = date approximate [R] = reopening

Upcoming Policy Meetings | Bank of Canada: Apr. 12, June 7, July 12 | FOMC: May 2-3, June 13-14, July 25-26

General Disclosures

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