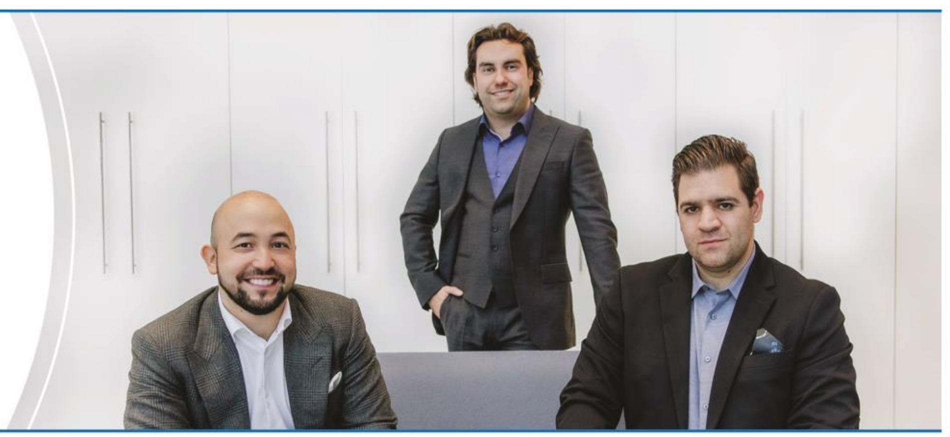
The Wrap Up



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Like a Wrecking Ball

The Bank of Canada surprised half the market on Wednesday by raising its policy rate by 25bps. Anyone with variable interest debt will be letting out some air this weekend as, after several months of pauses, they question how many more rate hikes lie ahead and what it will do to their budgets. We've spent some time focusing on US debt ceiling drama and the AI boom so this week we will highlight the story in Canada.

When measured in GDP, the Canadian economy has flexed its resilience throughout the first half of the year with Q1 growth coming in at 3.1% (vs the Bank of Canada's estimate of 2.5%). Consumption was strong as it rose 5.7%, however, the quarter also saw the savings rate rise at its slowest pace since before the pandemic at 2.9%. The strong consumption today is not without tradeoffs but more on that later. Early GDP readings are also looking quite strong, suggesting growth of 0.2% for the month of April. What we learned from these figures is that at the aggregate level, the economy is still growing at a healthy pace.

One of the less healthy components of Q1 GDP was real estate, with residential investment down 14.6% for the quarter. In all fairness, the real estate sector may have bottomed out in Q1 as recent activity has suggested a pickup in activity, however, the overall state of our real estate market does require further attention: new listings were at their lowest in 20 years even though the population has grown by 25% since then (which means fewer listings per citizen). Affordability is still a cause for concern when measured by mortgage payments as a percentage of household income; this measure has improved recently but is still at the highest level since the early 1990s. What came after that cycle was a period of prolonged weakness on the real estate front, however, we have no guarantees that this cycle will play out similarly.

What makes the trajectory of real estate difficult to assess is the country's commitment to bringing a larger number of new arrivals than in the previous thirty years; this will keep demand elevated. Supply is the other variable that we have to consider in our assessment as it is fixed in the short run. In response to the current housing environment

many have suggested to just build more to compensate. The thing is we have been building more, with housing starts at an all time high (although single-detached homes are close to their lows). Considering the larger population, it makes sense that we are building more units, however we will have difficulty increasing that figure at the moment. Keep in mind that the labour market in the country is tight meaning that it is difficult to find workers that possess the skills necessary to continue building. Available land also plays a factor as cities and provinces would need to increase the available infrastructure in less populated areas to encourage development further out from city centers.

The housing situation in Canada is a particular one which does not have any solutions for the time being. In a way, the housing conundrum is similar to our economic one which is why the Bank of Canada raised rates this week. Time is needed for output (measured in production capacity, number of available workers, inventory, raw materials, etc) capabilities to reach the level of aggregate demand. When demand continues to surprise on the upside, it pushes forward the timeline for supply to catch up and this is where inflation comes from. While inflation is off from the peak levels reached in 2022, it sat at 4.4% in April. It will continue to improve, albeit marginally, while core inflation is proving to be stickier than we would like. Remember that the inflation target is 2% and that even if we reach 3% by year's end, it required the Bank of Canada to embark on a rapid rate hike path to accomplish this. Furthermore, the rate hikes happening when debt levels are elevated, risk having a negative economic impact that can last for many years.

We see the dwindling savings rate and increase in consumer credit as an example of borrowing from the future to get by today. This is not financially healthy and a cause for concern, especially as mortgages and government debt matures in the years ahead and are renewed at higher interest rates. What will happen in the future when debt servicing makes up a bigger proportion of budgets? Already the higher interest rates risk pushing out or outright cancelling new ventures, hurting innovation and economic development. Slower spending by both the consumer and the government would only compound those economic woes. This is an unenviable position and could lead to several years of poor economic performance, an erosion in living standards and knee-jerk political (populist) movements.

Canadians are not entirely helpless and there are measures that they can take to better prepare themselves in the event of a negative economic outcome. The key is to strengthen one's balance sheet; reduce consumption in the short term and use the surplus to fund savings or reduce debt. I fully understand that it is easier said than done when referring to reducing our personal expenditures, however, this is what is necessary. Encouragingly, this is already happening; Costco reported during last quarter's earnings announcement that consumers were shifting from beef to less expensive proteins like poultry and pork. It is unrealistic to assume that people will dramatically change the way they live and spend, hence the more pragmatic approach of compromise and searching for alternatives. For that summer vacation consider Airbnb if hotel prices are too high; maybe frequent restaurants once a week instead of twice and prioritise home renovations by urgency levels (a new roof can't wait while epoxy finish on the garage floor can).

Most importantly, understand one thing, the current economic situation is not the consumers' fault. We do not need to feel bad or guilty for our purchases or our lifestyle. Simply put, the political, economic and social response to the pandemic have put us in this position. While some of the issues we face today began to develop before 2020, the shock of the pandemic brought forth many of these obstacles. The economy just needs time to replace itself and correct some of the policy mistakes that were made; it can either do so with minimal consequence or with larger repercussions. Regardless of the tone of this recap, we are not fearful but we remain cautious as investors and as individuals. We encourage everyone reading, to approach this reality in a similar light. Enjoy the summer, just don't go overboard.

Healthy Distraction

A few months ago, I shared a list by Tasteatlas, that ranked the top cheeses in the world. A few weeks ago, they released a list of the 100 best cities to try local food. Italy was well represented on the list with Florence (1), Rome (2), Naples (4) and Milan (10) all in the top 10. Lima, Hong Kong, Mexico City, Paris and Tokyo round out the top 10 while there are zero Canadian cities represented in the top 100. How is Montreal not on the list but Indianapolis and Louisville are?

Even though I question some of the entries and omissions, the list is a great place to consult for foodies looking for vacation ideas. On the subject of vacation, I have taken my own advice by renting a home on Airbnb and booking a flight using my BMO reward points. Our weekly publications will pause during my vacation and will resume on June 30th.

For those curious, I am headed to Tuscany where I will be a 40 minute drive from #1 on the list (Florence) and I will also spend a few days in Rome, #2 on the list. We were inspired to return to Italy after a rewatch of Anchorman. Ron Burgundy’s inability to understand the expression ‘when in Rome’ made us laugh but also reminded Christina and I of the trip we canceled in 2020.

I assure you that I will come back well rested (and maybe a little heavier) and ready to support our clients as we enter the second half of the year that can unfold in many ways.

Have a wonderful pair of weeks!

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