LAURENTIAN BANK SECURITIES

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FALL ECONOMIC OUTLOOK

Plausible Characteristics of the Upcoming Canadian and U.S. Recession

The synchronous, fast-and-furious tightening in financial conditions orchestrated by central banks looking to prevent a high inflation regime at the cost of near-term economic damage is the main market theme. Led by the U.S. Federal Reserve, more than 20 central banks have been increasing policy rates this year according to the World Bank, the largest single factor contributing to the fading global economic momentum and major decline in asset prices.

The fast run of inflation-focused central banks into restrictive territory will be deep enough to predict at the very least a shallow recession in North America, stifling corporate earnings below current 2023 expectations and increasing unemployment during the next 6-12 months.

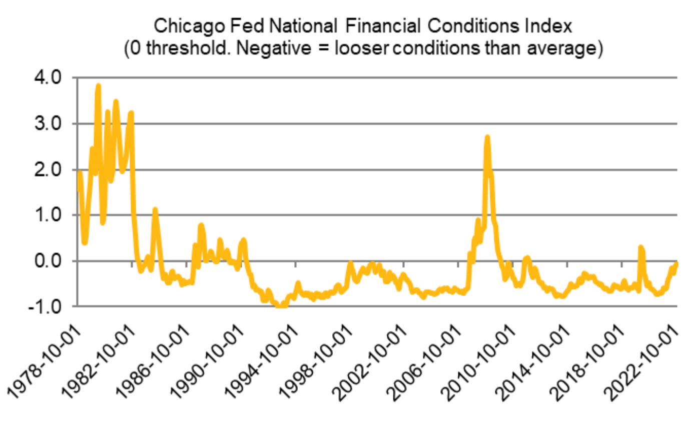
For the first time since Volker's inflation squeeze in the early 80s, investors note the absence of a pre-emptive pause in monetary hiking, or turnaround in policy rates, before the economic downturn begins. At least, broad measures of financial conditions, such as the U.S. Fed Chicago Financial Conditions Index, are not restrictive enough however to call for a deep recession at this point (see chart). Nonetheless, several leading indicators on our recession dashboard have recently turned red. Soon will be the end of what should be remembered as a very short, and volatile, business cycle. In terms of timing, the recession in North America is poised to begin imminently, before the Holiday Season, or at the latest in early 2023. In terms of length, the long adjustment phase of companies and households to higher financing costs points to a recession lasting at least 3 quarters in both Canada and the U.S.

Besides central bankers front-loading policy rates, other factors deteriorating financial conditions consolidate our recession call. For instance, U.S. banks have been tightening their credit standards for commercial and industrial loans according to US Federal Reserve surveys. The safe-heaven investor behaviour reinforcing the DXY generates longer-than-usual capital outflows from emerging markets, especially from USD-debt international borrowers and countries importing in USD. We cannot dismiss that 2022-23 marks the largest break on the global fiscal easing pedal observed since the 1990s, as reported in the World Bank September Outlook. And, unfortunately, the price of war taking the form of global energy and food access problems are not over. The extent of the upcoming energy rationing in Europe will have to be watched closely. Despite this geopolitically induced inflation source, central banks' policy rates would still elevated today, looking to calm down the global and domestic demand excess caused by the overly stimulative macro-policies of 2020-21 and pandemic-led shutdowns.

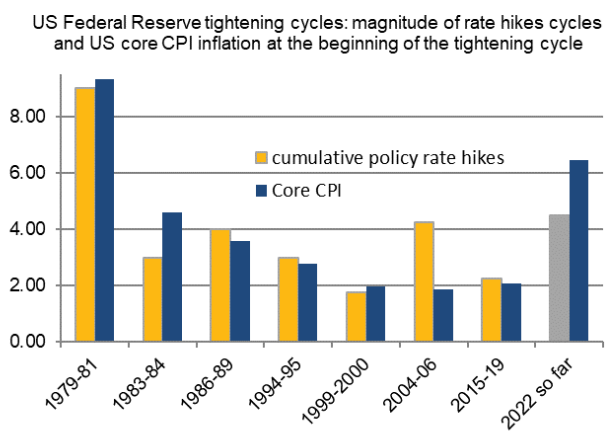
Furthermore, this year has been marked by an unfortunate juncture taking the form of market liquidity deterioration, as highlighted in the October IMF Financial Stability Report. The situation unusually worsened when the UK government came up with the idea of financing tax cuts through a surge in Gilt supply. The consequent massive loss in Gilt value triggered margin calls. UK pension funds scrambled to sell assets in reaction to the unexpected 200+ basis points surge in UK bond yields. Somehow, unconventional global QE led to unconventional risk taking by pension funds looking to eventually pay retirees on defined benefits. But we assist to a reduction of the G4 central banks' balance sheets, totaling more than $US2T so far this year according to Yardeni Research. This switch from QE to QT, combined with derivatives, amplifies financial markets losses. All in all, this matter was another shoe to drop from our perspective of dealing with higher interest rates. A recent European Central Bank study reveals a 25% international spillover effect of Gilts fluctuations on the North American bond market.

Surrounding our fragile base case U.S. and Canadian economic scenario are risks tilted to the downside. First, monetary policy makers could miscalculate the right stance to hammer CPI inflation. The peak effect of a 100-basis points interest rate shock on real GDP of advanced economies usually occurs 3-to-4 quarters later, ranging between 0.3pp and 0.5pp according to some models. But there is uncertainty surrounding the exact timing and cumulative impact in terms of magnitude due to higher and uneven leverage than before, on top of the unclear nonlinear, or psyche-driven, impact of jumbo rate hikes on economic agents' behaviour. Also, monetary policy paths in the largest economies could diverge or lead to unusual actions, as it is the case in Australia with the RBA low 2.60% policy rate and last week's Japan FX intervention as the BoJ has a difficult time to keep rates low. A global, coordinated USD devaluation does not appear in the cards following the 4th G20 Finance Ministers and Central Bank Governor Meeting held in Washington mid-October. Also, commodity supply shocks driven by climate disasters or geopolitical shifts might cause inflation to persist for longer. The global tightening in financing conditions could trigger widespread distress in emerging market debt and among companies with weaker balance sheets involved in the corporate bond market. A resurgence of COVID-19 might further stunt economic activity. A worsening of China's property sector crisis could spill over to the domestic banking sector and weigh heavily on the country's economic momentum, with negative cross-border effects. Also, geopolitical fragmentation could impede trade and capital flows.

On the positive side, there are elements that could brighten the outlook. New funding support from advanced countries to the World Bank could open the floodgates to lending for emerging markets struggling with the energy and food bill. The 2023 rotation of FOMC voting members could tilt the balance in favor of the doves recognizing the danger of going too far on the terminal policy rate and loss of competitiveness triggered by the USD appreciation. Exhaustion on the battlefield and growing vulnerability could bring Russia and the West to some agreement at some point in time, easing the supply energy and food access problem.



Source: Federal Reserve of Chicago



Source: World Bank, June 2022 Outlook

Remarks on the –Possibly Rapid– CPI Inflation Cooling and Fed/BoC Pivot

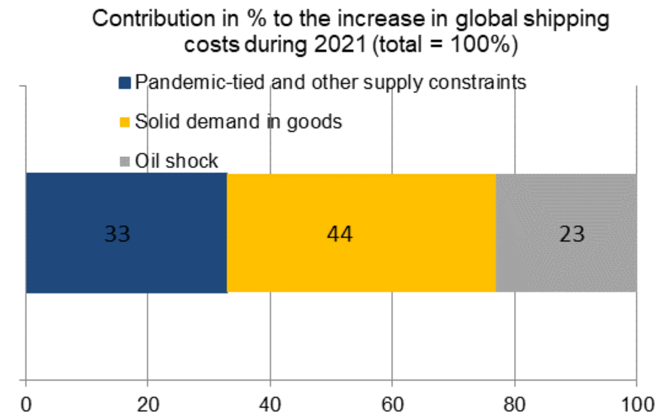
Among all the complex dynamics exposed above, let us comeback on the crucial global monetary tightening phase orchestrated by the U.S. Federal Reserve. More precisely, how much more monetary tightening is in order? The answer resides essentially in the near-term path of global, U.S. and Canadian CPI inflation.

Real policy rates in most countries including the U.S. are still negative but not for long as the monetary policy lag impact kicks in. The rule of thumb of the original Taylor rule says that the real interest rate needs to rise by 0.5 percentage points for each percentage point increase in CPI inflation. The yield on the 5-year TIPS, which incorporates recent and near-term expected changes in monetary policy, has risen by 330 basis points over the past year. According to the Taylor rule, that would be appropriate if inflation had risen by 6.6 percentage points. This is not too far from the 8.2% September U.S. CPI inflation and 6.2% August U.S. PCE inflation figures. However, the U.S. Federal Reserve made the mistake of waiting too long for CPI inflation to surge before starting to tighten in 2022. Accordingly, the front-loaded tightening effort does not appear entirely over according to recent FOMC officials' speeches and media interventions.

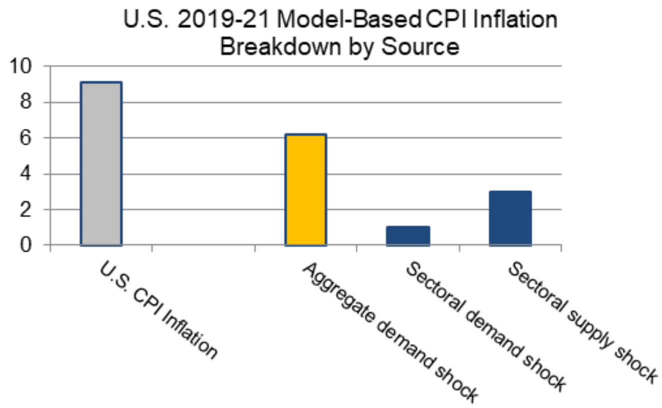
All in all, US CPI inflation current elevated plateau will not last for long in our view. The U.S. real policy rate will move mildly in positive territory during 2023H1, as we've seen in most previous tightening cycles according to the World Bank (see chart). The downward shift in global demand during the upcoming recession is the essence of our prediction of a rapid cooling in CPI inflation, both total and core. Indeed, as the pullback in consumer demand sets in more broadly, the current leveling off in commodity prices will be replaced by outright declines. The U.S. Michigan University survey has been showing for several months diminishing purchase intentions. Americans cite more than before the higher price tag of items and higher interest rates as reasons. Accordingly, sales prospects from companies deteriorate. The intention of companies to build up inventories, which previously exacerbated CPI upward pressures at the worse moment, wanes: companies do not see inventory stocks as too low anymore according to the U.S. National Federation of Independent Business survey.

The root of the problem is mostly demand. And it turns out central banks are good at cooling demand. For instance, a NY Federal Reserve study reveals two-thirds of the hot US CPI inflation figure was basically driven by excessive consumer demand (see chart). Another Bank of England research indicates global excess demand for goods was predominantly driving the shipping rates and CPI inflation in Europe (see chart). In turn, upstream sources of CPI inflation have already cooled down as producers and wholesalers cannot come up with big surcharges. Global container freight rates are down 67% from their peak. This adjustment phase of consumers is observable by the current decline in U.S. monetary aggregates, which usually have a sustained downward impact on CPI inflation lasting for more than one year. A similar dynamic is underway in the U.S. housing market, pointing towards a rapid deceleration in CPI shelter over the course of 2023.

Of course, we acknowledge the existence of structural inflationary irritants on the supply side, such as supply hurdles exposed in the challenging energy transition. Also, China's factory powerhouse is still impaired by the zero-COVID policy. Meanwhile, the BIS highlighted in a September report how semiconductors shortages prevent the build-up in auto inventories to be as solid as for other retail goods. In addition, the global offshoring expansion phase has ended without creating a generalized onshoring era according to the European-based Centre for Economic Policy Research. Thus, we do not expect the NY Federal Reserve global supply chains pressure index to completely go back to normal. The other supply issue relates to ageing population restraining labour force participation. We do not anticipate the structural labour supply problem to fully get resolve because of the upcoming recession, even if it turns out to be deep and very long. U.S. unemployment is poised to increase by 1.0-1.5pp from the current 3.5% level but to stay below the NAIRU estimate of 6.0%-6.5% according to U.S. Federal Reserve staff. Most of the increase in unemployment should occur around mid-2023 once the recession bite on corporate earnings. However, the main driver of the average wage inflation acceleration has been the excess number of job postings allowing Americans to switch jobs. It turns out U.S. job postings are falling fast and voluntary quits are next. Thus, we anticipate market concerns surrounding the wage-inflation spiral to dissipate during 2023. The same story should unfold in Canada where we forecast the 5.2% unemployment rate to edge up slightly north of 6% during 2023.



Source: Bank of England, Bank Underground Research, March 2022



Source: NY Federal Reserve, Giovanni, Kalmli-Ozcan, Silva, and Yildirim (2022)

In summary, the cyclical, demand-driven sources of CPI inflation should abate enough to take over structural factors for the time being. We forecast US and Canadian CPI inflation to tumble fast below the 3% mark by mid-2023, sufficient to bring down consumer inflation expectations along the way. The stubborn, stickiness part of CPI inflation should wear off to the point of bringing the U.S. Federal Reserve to contemplate the idea of a peak in policy rates as the recession begins. It will be difficult for Fed Chair Powell, and BoC Governor Macklem, to justify in front of the public policy rate hikes once the recession sets in, leading us to pinpoint the last hikes of this fast-tightening cycle at their respective December policy meetings.

Once possible terminal policy rates of 4.50% for the U.S. and 4.25% for Canada are reached at the end of 2022 (see forecast table at the end), a pause should last a few months before reaching the next leg of the pivot called rate cuts. Central bankers won't declare victory over inflation as easily as investors would like them to. The prudent nature of central bankers leaning in favour of inflation and inflation expectations, in addition to the lag in high-frequency data releases including the CPI, could bring them to communicate eventual policy rate cuts during the recession, at some point during the Winter or Spring of 2023. Then, formal rate cuts could be implemented starting mid-2023. In order words, the full pivot will likely come later than in previous business cycles, contrasting with previous business cycles where the pivot began before or during the recession. If we consider the real, natural short-term policy rate NY Fed estimate of about 0.4%, the so-called r*, policy rates could stand closer to 3.00-3.50% than 4.00% in both the U.S. and Canada by the end of 2023, implying modestly positive real policy rates.

Economic Fog Likely to Harm Market Risk Taking Over the Short-Term Horizon

Besides the upcoming North American recession, the complex mix of adverse factors echoed above makes market timing ill-advised. It should incite investors to privilege a defensive approach for the next 3-6 months ahead. For instance, the share of Americans expecting positive equity returns in the next year is currently lower than average according to the Michigan survey, but this portion of bullish people has been even lower during previous recessions (see chart).

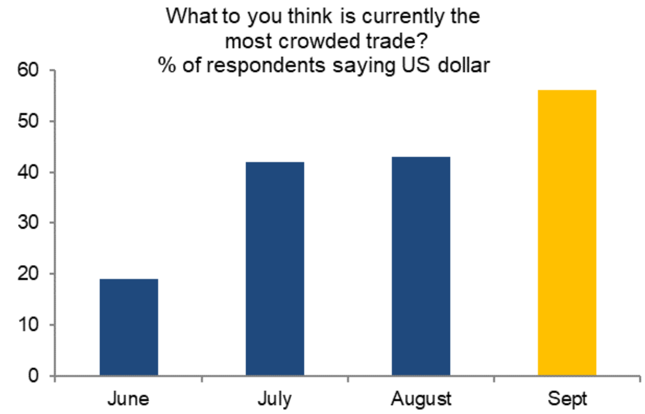
First, in respect to market liquidity deterioration, a low level of depth means that liquidity provision remains fragile due to heavier reliance on sufficiently rapid quote replenishment to meet trading demands without resulting in sharp price moves. This dependence on higher-velocity quote replenishment could pose problem by creating additional market dysfunction. Central banks can generally deal with a liquidity crisis, as we recently observed with the Bank of England, by providing unlimited amounts of money if needed.

Also, the National Communist Party Congress just ended in China. The NCCPC, which takes place every five years, is the highest-profile event in China's political calendar, providing a forum for leadership and constitutional changes. China's economy, the second largest in the world, is in a tailspin. The recent trend of this large net importer of commodities is obviously not supportive for the TSX stock market. China's property market, which over the last 10 years contributed about a quarter of real GDP growth, melts down. Foreign investment falters. China's zero-tolerance approach to COVID has crippled consumer demand and stalled domestic businesses. It remains to be seen if further consolidation of President Xi's power could lead to a broad confirmation of structural policy settings, shift back the focus to a steady acceleration in economic growth by supporting industries and demand, loosen COVID policies and find ways to stabilise the property market.

Closer to home, another source of potential short-term financial market volatility looms: the November 8 US midterm election. According to recent polls, Republicans are expected to make gains in Congress and control both Houses, setting up a scenario favored by many investors because it would split the government now controlled by President Joe Biden's Democratic party. Historically, a divided U.S. government has been more favorable for equities than when Democrats control both the House of Representatives and the Senate along with the presidency. But this possible shift of power in Washington should not materially changed by itself the current sour investor sentiment.

All in all, there could be several hiccups during the recession period. Fundamentally, the fragile environment should continue to fuel the bearish sentiment that has been perceived in various ways, including in the Bank of America investors monthly survey: overweight cash, a position that could be sustained if the currently elevated CPI inflation falters soon; underweight equities as the grim economic outlook takes over. Furthermore, the risk of a deep recession may prevent investors from favoring corporate credit over equities. As for bonds, central and subnational governments in the U.S. and Canada are likely to act more prudently given the lesson learned from the major UK policy mistake. One conclusion from our deep analysis of the Canadian fiscal update season so far is that most Provinces set aside buffers and secure higher-than-expected revenues for potential tougher economic days. This may favor a more sustained bid into government bonds. As for the Canadian dollar, sour investor sentiment fueling the USD was previously the main driver behind the depreciation earlier this year according to the BofA survey (see chart). But more recently, it was more the deteriorating global commodity outlook and market expectations that the U.S. Federal Reserve will end up with a policy rate slightly higher than in Canada that drove the USDCAD depreciation lately. With global commodity prices expected to pullback further as the recession sets in, the USDCAD should be under further depreciation pressure until 2023H2, moving a notch closer to 1.40 (see forecast table at the end).

Source: University of Michigan Survey



Source: BofA Global Fund Manager Survey

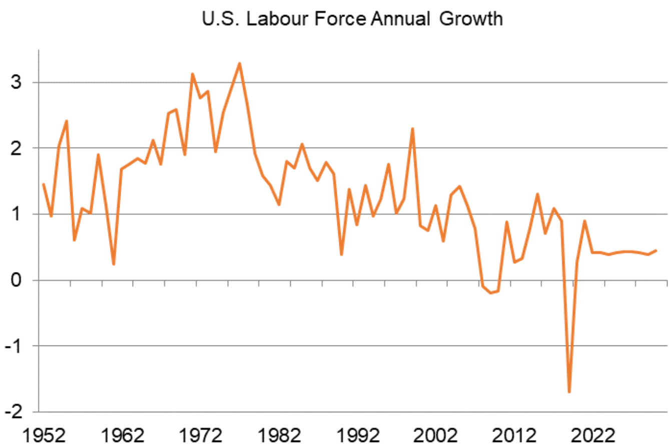
Glimpses on the –Possibly Slow– Economic Recovery Post-Recession

Our final words go to the more appealing flip side of the story: short-term economic damage is the price to pay to restore CPI stability … and to restore a more positive environment for investment returns. If our crucial call that central banks can engineer a sustainable cooling of inflation, stagflation fears will return in the genie bottle. In a way, the current streak of quarterly heavy losses in balanced portfolios, and upcoming recession, is the lesser of the two evils because the alternative appears worse: a long era of high inflation eroding corporate margins, preventing growth in earnings per share and ultimately reducing real returns on investment.

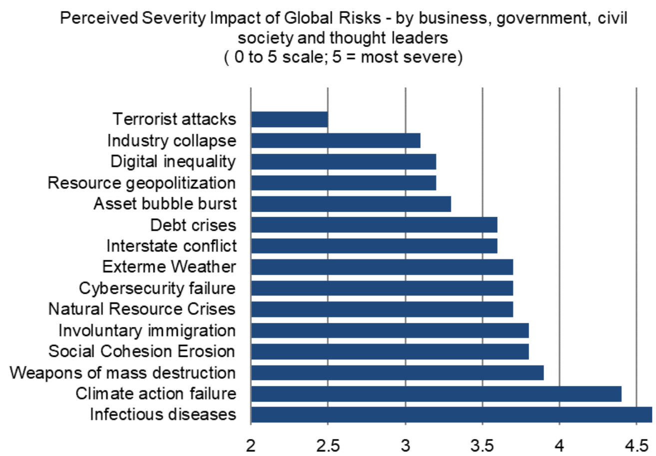
Thus, investors with a longer-term strategic view, and thinking central banks will prevail, should still find comfort in overweighting equities and eventually deploying some of today's excess cash on the side. Similarly, bond investors should be able to lean at some point into longer duration and rethink about a normal steepening of the yield curve. At the same time, in this attempt to provide a flair on how the recovery could look like, we end up with the conclusion that the far-stretched market risk taking and elevated price-earnings ratios of 2020-21 do not appear in the cards. Even if central banks backtrack, real policy rates are unlikely to return deeply in negative territory, far from providing the V-shaped pulse observed in late 2020-21.

The fact that consumers will not be able to catch-up over the 2023-24 horizon for the 2021-22 major loss in purchasing power point toward a slow recovery. While the staying power of the U.S. and Canadian consumers has shown uncanny resilience in previous business cycles, several signs point to the tide turning. The U.S. saving rate has notably dipped to 3.5%, credit card borrowing has risen well above pre-COVID levels, and the pool of excess cash is drying up. Consumers have increasingly relied on their balance sheets to spend, with wage gains not keeping pace with inflation. The longer this situation lasts, the greater the deterioration in household finances become. If the differential from the pre-pandemic saving habits continues to shrink at the same rate that it has over the past three quarters, the excess savings accumulated in 2020-21 by the U.S. consumer will be wiped out by mid-2023.

Another alternative point of view on the eventual recovery leads us to think about labour force and productivity. The U.S. Bureau of Labor Statistics projects a compound annual rate of change of 0.5% for the labour force for the period 2021-31 (see chart). In other words, the marked slowdown in the influx of workers observed in the past will continue. Put simply, the ageing population will continue to restrain the pool of available workers. As for labour productivity gains reaching 1.4% per year on average since 2009, it also marks a slowdown relatively to the above-average 3.2% annual growth of the late 1990s and early 2000s. Innovation and the widespread use of new technologies could reverse the trend. But the bar is high for potentially high productivity gains to more-than-offset a world of prevailing multi-dimensional risks and structural supply impairments (see chart): the multi-polar world is replacing hyper-globalization and contributes to the loss of fluidity in global merchandise trade; the lack of reliable energy in a global climate transition and geologically challenging time stifle activity and lead to social unrest. Overall, the supply limit could lower the threshold at which CPI inflation re-accelerates during the next recovery phase. All in all, combined with unlikely return of the super-friendly Fed's put, these factors should convince investors to do not expect consistent high single- or double-digit annual growth returns in equity markets in upcoming years.



Source: St. Louis Federal Reserve, U.S. BLS Projections



Source: World Economic Forum Global Risk Landscape, Annual Survey 2021.

Key Economic and Financial Forecasts

	2021	2022	2023	2024
U.S. Real GDP (%)	5.9	1.7	0.0	1.4
Can. Real GDP (%)	4.5	3.3	0.0	1.3
Can. Unemployment Rate (%)	7.4	5.5	6.1	6.3
Can. CPI Inflation	3.4	6.7	2.6	2.1
U.S. Fed Funds Rate Target (%, EOP)	0.25	4.50	3.50	3.00
BoC Overnight Rate (%, EOP)	0.25	4.25	3.50	3.00
5Y Fed Can Gvt Bond Yield (%, EOP)	1.26	3.45	3.10	3.20
TSX Index (EOP)	21223	18000	19000	20000
Canadian Dollar (CADUSD, EOP)	0.79	0.72	0.74	0.78

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