ECONOMIC RESEARCH AND STRATEGY

LAURENTIAN BANK

January 9, 2024

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2024 Economic Outlook

CPI Inflation Outlook – Fragile Inflation Relief, Wage Inflation Catching Up

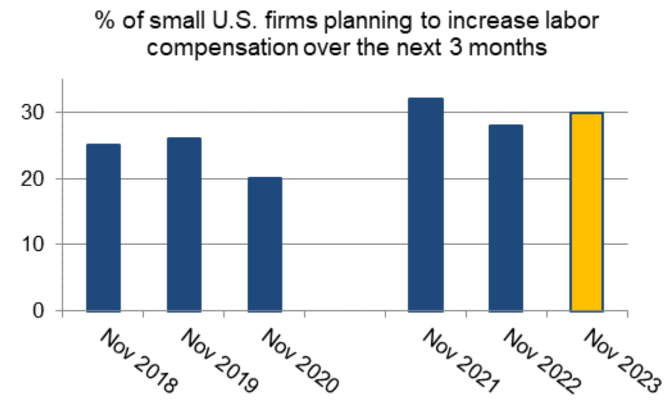
Investors and central bankers are entering the new year with increased confidence regarding CPI inflation. Global CPI inflation has reached an encouraging turning point during the later stages of 2023. It has been colling down across several advanced economies without triggering harsh impacts on the economy and corporate earnings.

The inflation cooling narrative toward 2% central banks' targets will continue to dominate financial markets until a more significant event or theme arises, such as the November 5th U.S. Presidential Elections. The progress in CPI inflation throughout 2023 mostly reflects the loss of momentum in demand and improvements in supply chain disruptions. The latter is evident in the NY Federal Reserve global supply chain pressure index residing in disinflationary territory. Furthermore, producer prices, a leading input of CPI, are not increasing anymore. Price levels associated with goods CPI, excluding food and energy, have mostly attained stability.

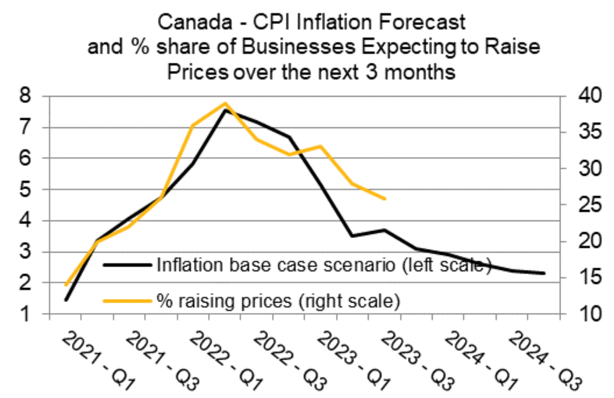
Unfortunately, the relief is incomplete. First, the global energy transition will remain inflationary until the critical minerals rush leads to more deposits and additional supply in the future. For example, the world's largest lithium reserve in Nevada, USA unveiled last September was a step in the right direction. Second, the interconnected behavior among companies, consumers and workers fueling CPI inflation is not entirely back to normal. The inflationary psyche of economic agents will remain difficult to completely dislodge during 2024 in our view. Too many firms still want to increase prices, about a quarter of them in both the U.S. and Canada. But who can really blame them for implementing price hiking strategies to boost corporate earnings given that NY Federal Reserve 1-year (3.4%) and 3-year (3.0%) median consumer inflation expectations are higher than in the past?

The breakdown of the U.S. and Canadian CPI baskets continues to show stickiness in services CPI inflation. One unresolved issue relates to the intertwined dynamics between wages and prices. As the International Monetary Fund appropriately pointed out in a research paper released last September, historical prolonged periods of elevated CPI inflation lasting more than three years occur when wage inflation is uncontained. Additionally, staff at the Federal Reserve of Cleveland indicates that the current surge in wage growth mostly reflects the pass-through effects of high inflation rather than low unemployment. The ongoing wage inflation surge stems from workers aiming to recuperate purchasing power losses incurred during the CPI inflation balloon of 2021, 2022 and 2023. As such, 2023 stood out as the highest number of days lost by U.S. workers due to strikes since the early 2000s. Various U.S. and Canadian surveys note that HR departments offered an average wage base increase of approximately 3.5%-4% in 2024. Hence, it would not be realistic to anticipate 2% CPI inflation in 2024 even if unemployment rises in both the U.S. and Canada. Furthermore, major wage settlements contracts signed in 2023 have an average duration slightly exceeding 3 years. This long contract duration will likely pose challenges in achieving 2% CPI inflation even in 2025 and 2026. Consequently, we refrain from stating that elevated wage inflation is “transitory”.

Altogether, curbing elevated wage inflation is a big hurdle to the return of the past and stable 2% CPI inflation norm, requiring policy interest rates to stay restrictive going forward. We predict U.S. and Canadian CPI inflation to average 2.6% in 2024. Our projection includes a 0.1pp uptick attributed to global climate shocks such as El Niño disrupting global food supply. We also assume no further escalations in tensions Between Israel-Gaza and Russia-Ukraine. We also expect additional oil output from the U.S. and non-OPEC nations offsetting the announced oil supply reductions by OPEC+. In Canada, the weaker consumer outlook logically calls for a faster disinflation trend than in the U.S. However, the chronic housing shortage will keep the Canadian shelter CPI component a positive contributor to Canadian CPI inflation in 2024, in contrast to the U.S. where shelter should become a drag on total CPI by mid-year.



Source: U.S. National Federation of Independent Businesses



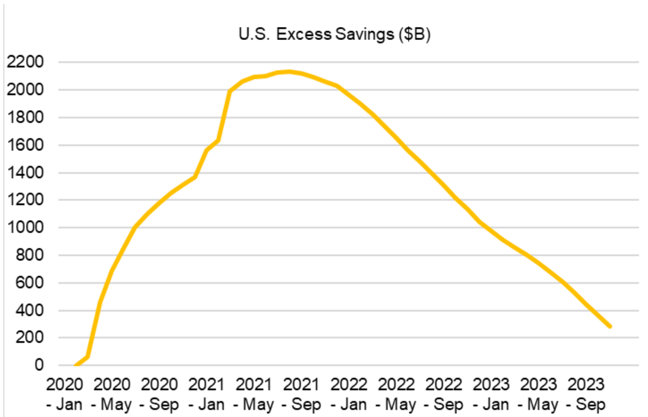
Source: Canadian Survey on Business Conditions, Statistics Canada and LB Economic Research and Strategy

Global Economic Outlook – U.S. Positioned to Outperform Peers by a Smaller Margin

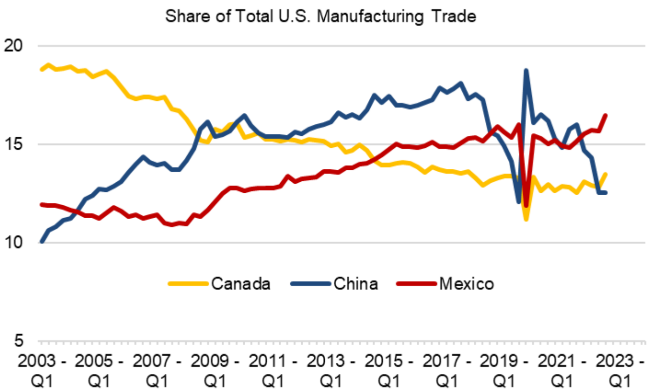
Our base case global and U.S. economic outlook is neither upbeat nor disastrous, a reasonable outcome in this disorderly world. Stark disparities in economic performance prevailed among developed economies and emerging markets in 2023, reflecting various sensitivities to higher interest rates, heightening tensions and global structural shifts. This quasi-ad hoc form of decoupling is expected to persist throughout 2024.

Let us begin with the outperforming US economy. The lock-in effect of 30-year fixed mortgage rates benefiting about 4 out of 5 mortgage holders and stimulative policies from US President Biden remain positive pillars for the 2024 US economic outlook. Higher spending on artificial intelligence, green investments, onshoring, and the US government’s incentives for semi-conductor manufacturing are notably poised to keep non-residential construction activity in the fast lane. Additionally, the median households’ net wealth, up by about 23% since 2020 according to the annual Federal Reserve consumer report, has been contributing to the consumer spending hype. However, the households’ excess savings tailwind will end during 2024: the San Francisco Federal Reserve notes there was “only” US$290B excess savings left as of November 2023, down heavily from the August 2021 peak of US$2.1T.

Overall, we do not forecast a technical U.S. recession anymore as we did 6 months ago. We project US real GDP growth to reach 1.3% in 2024 versus 2.4% in 2023. Part of this slower pace of economic growth comes the fading positive effect of the post-pandemic catch-up. Furthermore, access to U.S. banking credit is becoming increasingly constrained to both consumers and businesses. There is also rising defaults among leveraged companies stifling economic activity. Without calling it a big wall, a growing number of firms are subject to refinancing debt at higher rates in 2024 and 2025 relative to 2023, particularly in the fragile commercial & real estate sector. At least, a favorable, albeit modest recalibration of policy rates away from current highs should be favorable for earnings of U.S. companies across the board, even firms outside of the so-called Magnificent 7 of the S&P500.



Source: Federal Reserve bank of San Francisco, U.S. Bureau of Economic Analysis



Source: Federal Reserve of Dallas

However, double-digit earnings growth market expectations from analysts on the equity market appear high. Beyond our expectations of a slight loss appetite from consumers, companies' ability to achieve significant growth in corporate earnings will necessitate more prudent management of labour costs, particularly since implementing price hiking strategies is more challenging than 1-2 years ago. With wage inflation remaining high, logic calls for a significantly lower pace of job creation in 2024 to limit total compensation of employees. U.S. unemployment should grind higher to 4.5% by the end of 2024 from the current 3.7% figure. The slower pace of hiring caught everyone's attention in 2023. In 2024, the quit and layoff rate will be a growing factor influencing financial markets and the extent of real GDP momentum loss.

A part of the U.S. outperforming success story lies in its strategic approach, particularly in enhancing the resilience and security of supply chains. Apart from the U.S., Mexico, not Canada, stands out as the primary recipient of onshoring and friend shoring, overtaking China as the largest trading partner with the US. The year 2023 presented significant challenges in China, and the U.S. nearshoring is part of it. From our Western point of view, decoding China's apparent economic opacity makes it challenging to assess precise real GDP growth forecasts. Still, some features are troubling and calls for further underperformance. For example, during the latter half of 2023, China registered its first outflow of foreign direct investment. Furthermore, the Chinese real estate market, constituting a quarter of real GDP, exhibits weakness in smaller cities. Both real estate developers and local governments have higher debt levels. Chinese consumer confidence is in the doldrums, which should keep CPI inflation muted like last year. Its auto industry is stuck with overcapacity given the US made-in-China EV tariff of 25%. On a more positive note, excess household savings remain supportive in addition to a wide range of stimulative measures announced by authorities. All in all, China's structural weaknesses carry more weight in the balance and should contribute to limited, modest base metals price gains as a 180 degrees turnaround from the growing base metals supply gap appears unlikely.

Elsewhere on the planet, the European economy has been hit relatively harder by Russia's invasion of Ukraine in 2022-23, logically opening the door for a slightly better pace of real GDP growth in 2024. However, European Union fiscal deficit rules, including a limit of deficits a 3% of GDP, are back this year after the suspension in place since 2019. Such consolidation should cap real GDP growth near the modest 1% mark in the Euro Zone and should prevent long-term credit downgrades by rating agencies, as the U.S. and China both experienced in 2023. Relative to Europe, Japan should be able to generate a better economic performance again due to low unemployment and more positive domestic traction between wage and CPI inflation. Odds of outperforming equity gains in the Nikkei are nonetheless shrinking as the Bank of Japan is poised to move forward with the end of Yield Curve Control and its negative interest rate policy by mid-year. This contrasts with the consensus view of a mild pivot from other big central banks.

Canadian Outlook – A Long Recalibration Driven by Interest Rates and the Climate Transition

The Canadian economy has been stagnating since mid-year. Outsized immigration gains allowed Canada to escape a technical recession so far, namely a mild contraction of real GDP. The Canadian population soared by 1.25M in 2023Q4 relative to a year ago, with the lion's share being non-permanent residents. In comparison, the US and UK populations advanced by 1.75M and 200K, respectively, during the same period. In our base case scenario, the Canadian economy goes through a soft recession period during the first half of 2024. After expanding at a pace of 1.1% in 2023, we peg real GDP growth to average 0.5% for the entire year as economic activity should gradually gather slight positive momentum later in 2024.

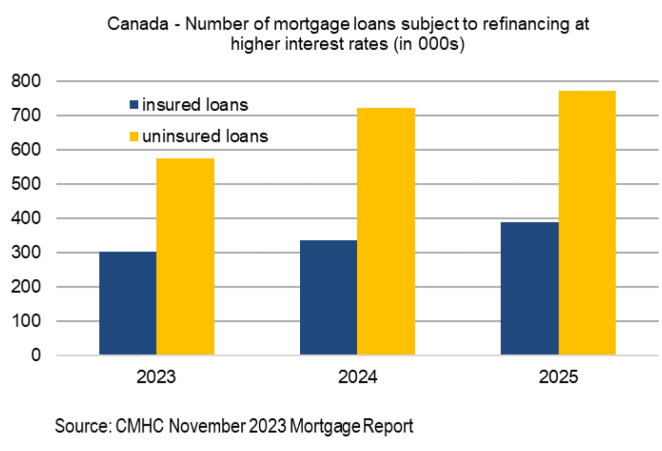
Beside demographics, the main factor driving our scenario relates to the mortgage refinancing cycle, which is about halfway through. The number of borrowers subject to refinancing at higher mortgage rates is larger in both 2024 and 2025 than in 2023. We estimate that mortgage refinancing activity will shave approximately 0.5pp from real GDP growth in 2024 and 2025, even if the Bank of Canada cautiously eases off the pedal. In other words, the recalibration at higher interest rates is a long walk. A very tough restriction period, rather than a traditional recession, appears to be the proper words to describe the state of mind of Canadian consumers. According to the Conference Board index, consumer confidence was at its second lowest level on record at the end of 2023 despite low unemployment.

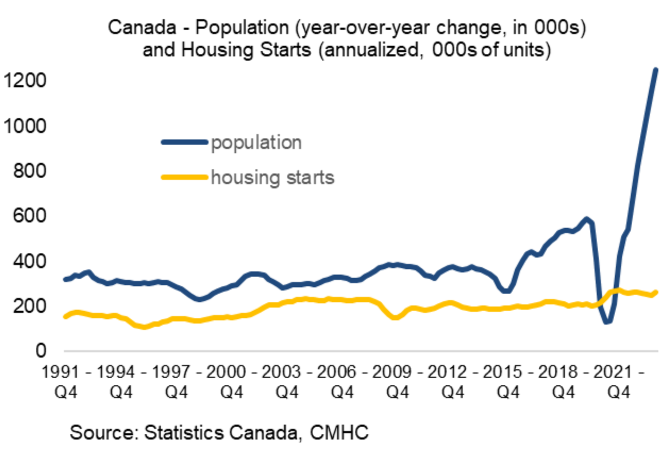
Unsurprisingly, the script has flipped for businesses as well: the Canadian Federation of Independent Businesses (CFIB) survey indicates that companies' main concern is insufficient domestic demand, not labour shortages anymore. Although cost pressures have been moderately abating due to improving supply chains, they remain high according to CFIB and Bank of Canada surveys, creating a challenging profit squeeze for businesses. The spending retrenchment of the average Canadian consumer, combined with persistent input cost pressures, is poised to nurture more negative secondary effects. Both the hiring rate and job postings have been declining. Layoff announcements were more numerous in late 2023, with most becoming effective during 2024. As a result, 2024 will result in a larger gap between labor demand and supply. The rise in unemployment is expected to accelerate during 2024. We forecast the Canadian unemployment rate to average 6.4%, relative to the 2023 Spring low of 5.0% and December level of 5.8%.

Besides the upcoming larger adverse impact of higher interest rates on economic activity, Canada is home to a mixed bag of pros and cons in respect to the global climate transition. The federal government, mostly in partnerships with Quebec and Ontario, took the lead in providing large subsidies to attract multi-billion-dollar EV battery investments in Canada. These investments are poised to bolster non-residential construction activity already showing an encouraging uptrend and keeping the Canadian economy away from a hard landing. Moreover, additional Liquified Natural Gas projects have been approved in British Columbia. At the same time, efforts related to the exploration and extraction of critical minerals in support of global climate pledges continue.

Despite these positive storylines tied to global decarbonization, the mountain to climb for Canada is steeper than in other economies. First, carbon emission intensity, based on TSX corporate earnings or on a per capita basis, is unambiguously higher than in other developed countries. The federal government is pressing forward with a new cap on GHG emissions in the Canadian oil & gas sector and ambitious EV targets, at a time when doubts about carbon capture are mounting. Second, the small, open Canadian economy thrived during the old days of the Great Moderation and expanding free trade, in contrast to today's heightening geopolitical tensions and escalating protectionism. Third, as we cited earlier, Mexico, rather than Canada, is primarily benefiting from nearshoring with the U.S. due to its cheaper labour costs, particularly in the manufacturing sector. Additionally, anemic productivity is not likely to change overnight unless the adoption of AI for companies becomes broad-based. Furthermore, alongside these considerations, tight global oil conditions resulting from OPEC+ oil cuts are not as beneficial for the Canadian dollar relative to the US greenback as they once were during the 2011-12-13 period. This loss of appetite for the Canadian currency comes from the supply-induced nature of commodity shocks and the U.S. oil shale industry improving horizontal drilling efficiency. The latter has driven American oil production to new highs in 2023. Altogether, the long climate transition, global political disorder contributing to supply shocks weakening merchandise trade fluidity and challenging adaptation to higher interest rates do not point to a steady appreciation of the Canadian dollar relative to the US greenback. USDCAD could test the 1.38-1.40 range when the Bank of Canada signals before the U.S. Federal Reserve the eventual pivot. The combination of these shorter-term business cycle factors and structural trends also points to a mid-single, annualized digit growth return for the TSX market.

Of course, we deliberately left the most critical domestic issue for last: the housing affordability crisis. Housing starts are at dynamic levels, nearing an annualized pace of 260K units. The pace of residential construction could have been better without higher interest rates hindering homebuilders' intentions. We estimate the housing construction shortfall of 2023 at approximately 100K units relative to household formation reaching 360K, an excessively large gap poised to occur again this year. We do not forecast a major drop in home prices nationwide considering other factors besides demographics, including the tight rental market. The Canadian average monthly rent of $2.1K is 8% higher than a year ago according to Urbanation, setting a higher floor for the pricing of the homeownership market. In addition, developments charges paid by property developers to cities are increasing, either stifling homebuilding or prompting builders to pass on the costs to buyers. These factors run counter to efforts aimed at fostering more inclusive and affordable housing, including the sales tax relief for new residential rental properties announced by the federal, Ontario and B.C. governments. Also, listings on the resale market have crept moderately higher during the last year. Very few homeowners intend to put their homes up for sale according to the Canadian survey of Consumer Expectations released by the Bank of Canada. Sales-to-listings ratios have even entered buyers' territory in a few selected markets, including the GTA. Overall, we refrain from calling for an outright, large depreciation in home prices amid the structural supply deficit, the younger immigration cohorts today compared to the 1990s, and unemployment remaining far from the distressed levels.



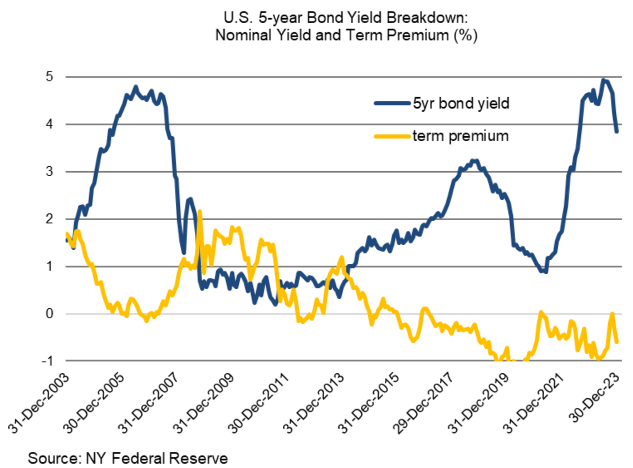


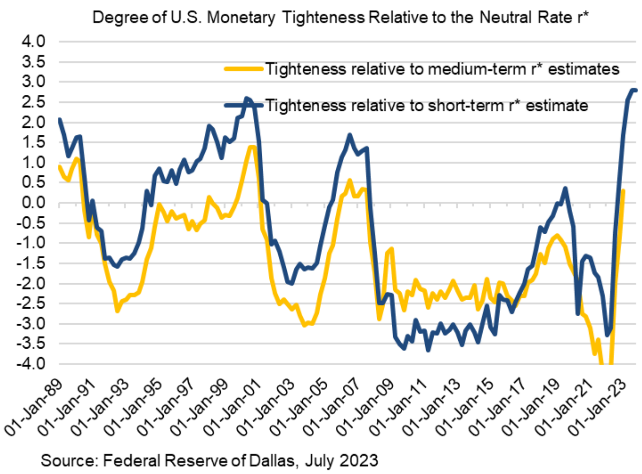
Interest Rates Outlook – Patient Central Bankers, Agitated Bond Vigilantes

Disinflation observed among several countries and Federal Reserve December dots showing 3 possible policy rate cuts by the end of 2024 have crystalized a market relief in late 2023 taking the form of equity gains and lower bond yields. But, after dropping the inflation ball in 2021-22, central banks will not make the mistake of celebrating prematurely. We expect the Bank of Canada and U.S. Federal Reserve to be cautious about the speed and scale of policy rate cuts. Markets should not foresee large policy rate cuts on the way down, contrasting with the urgent sense among central bankers that led to jumbo policy rate hikes of 50bps+ on the way up during 2022.

In Canada, one trigger point should be compelling evidence that total CPI inflation will firmly cool down further while it reaches approximately 2.5%-2.7%. Another green light for the pivot will flash when the two core CPI measures, core-trim and core-median, keep falling and clearly cross the 3% mark on a 3-month annualized basis. These goal posts may move during the first half of 2024. We pinpoint the first 25bps BoC policy rate cut in June, followed by similar 25bps incremental moves at the four meetings held during the second half of the year. This will leave the overnight rate target at 3.75%, avoiding an overtightening situation as ongoing disinflation continues.

At the U.S. Federal Reserve, further cooling bringing down total U.S. CPI near 2.5%-2.7% and unemployment rising slightly in the 4.0%-4.5% range should ideally be supportive to begin a prudent pivot a few months before the November 5th U.S. Presidential Elections. The growing complicated matter for Fed Chair Jerome Powell in 2024 relates to the slower uptrend in unemployment restrained by the softer expansion of the labour force, up about 1.7% in 2023 versus 2.3% in Canada. Relative to six months ago, we scaled back on the number of Fed funds target cuts that may occur in 2024 due to the outperforming U.S. economy. We forecast the Federal Reserve to begin its pivot in September at a pace of a quarter of a point and to last until the first half of 2025. We expect the upper bound of the Fed funds rate target to move gently to 4.75% by the end of 2024 and 4% in 2025H1.





The cautious easing path relative to the forceful hiking cycle implies that investors should at best expect less inversion of the Canadian and U.S. yield curves, based on the policy rate versus the 5- and 10-year bond yields. Growing evidence of peaking policy rates has already led to some relief based on the bond rally observed on the curve in late 2023, fitting with past periods between the last Federal Reserve hike and the first policy cut. Thus, in 2024, there appears to be a limit to the scope of further declines in interest rates, particularly since bond vigilantes, or governments' steady fiscal easing, are structurally pulling rates up. Bond vigilantes started to make a comeback with Liz Truss' fiscal mistake in the UK in 2022 and gained ground ever since. They are poised to stay front and center in 2024, as odds appear very low for a sudden return of fiscal tightening regardless of the outcome of the key upcoming UK and US elections. The U.S. credit downgrade from AAA by Fitch last August reflected the excessively unsustainable fiscal path in Washington, notably depicted by a federal debt-to-GDP ratio trending up and surpassing levels of WWII. The U.S. term premium, estimated by the NY Federal Reserve, is not deeply negative anymore. DBRS also downgraded the UK's long term credit outlook to AA a year ago and China to A last November. At the same time, central banks are no longer absorbing large excess government bond issuance as during the 2020-2022 period due to Quantitative Tightening (QT). In the U.S., QT has lowered the Federal Reserve's balance sheet by 14% since its summer 2022 peak, and consequently drained the amount of excess cash reserves in the US banking system. Liquidity appears thinner amid the flaring spikes observed in the repo market in late 2023, requiring continuous vigilance of the U.S. short-term funding market in 2024.

With the U.S. leading the way in global interest rates, and the elastic already stretched out between U.S. and Canadian rates, it would not be realistic to hope for a significant drop in Government of Canada's bond yields. Even if Ottawa does not plan to register deficits as gargantuan as in Washington, particularly troubling for the latter considering the U.S. economy outperforms Canada, the Canadian federal fiscal outlook still points to plenty of T-Bills and longer-term bond issuance over the medium-term. All in all, we see both 5s and 10s north of 3.25% by the end of 2024 and beyond.

Risks to the Economic Outlook in a Disorderly World

Heightened geopolitical tensions, human tragedies and climate shocks are contributing to a more fragile global economy and impacting a wide range of commodities. In 2023, there were notably more frequent large daily moves in the equity and bond markets, driven also by serious concerns about elevated inflation among market participants.

As for our 2024 "neither upbeat nor disastrous" economic outlook, it is highly susceptible to swift changes in the narrative due to a mix of predetermined and unexpected events. First, 2024 marks the most significant election year in history, with voters in about 60 countries selecting political leaders shaping policies. In India, where the economy is outperforming, elections will be held in April or May. The UK election is anticipated in the second half of 2024, with the precise date yet to be announced by current Prime Minister Rishi Sunak. Before those, the Taiwan Presidential election on January 13th, and its consequences in defining tensions between the U.S. and China, is unambiguously the largest political event to begin the year. The ruling Democratic Progressive Party, leading in voting intentions, takes a relatively firmer stance toward China compared to the other two political parties in the race, Kuomintang and Taiwan People's Party.

As for the U.S. elections, the most likely outcome is a rematch of Joe Biden versus Donald Trump, although future decisions by the Supreme Court could potentially alter the course of the election race by disqualifying Trump. "Bidenomics", including the Infrastructure and Jobs Act and the Inflation Reduction Act, contributes both to the short-term U.S. economic resilience and structural upward shift in longer-term bond yields. Persistent elevated CPI inflation has been a source of frustration for Americans for an extended period and might not fall sufficiently enough before the Elections from Biden's point of view. Donald Trump suggested a punitive protectionist policy, namely a 10% tariff on all U.S. imports. This, above all else, should be regarded as the largest downside risk to the global and Canadian economic outlook. Despite his unpredictable style, the 2024 version of "Trumponomics" does not include so far corporate income tax cuts like 2017, which fueled market risk taking and bolstered after-tax corporate earnings of the S&P500. Furthermore, as the great think-tank Eurasia Group points out in its new list of top geopolitical risks for 2024, the winner could be decided by just a few voters with the harsh consequence of destabilizing the country.

Besides democratic elections, potential inflation shocks related to a worsening of the wars Israel-Gaza and Russia-Ukraine should remain on the radar of investors, including the most recent increase in global freight rates caused by diversion of merchandises away from the Red Sea. The unfortunate continuous deteriorating path of these two conflicts, combined with possible escalating domestic tensions in the U.S. post-elections, is poised to bring gold prices to new record highs.

In Canada, the most recent trend in resale home market conditions merits further scrutiny in 2024. Some selected resale housing markets have begun to display cracks, including the GTA, where home prices have experienced a moderate depreciation in recent months. If a widespread buyers' market emerges, it could deteriorate households' balance sheets and raise fears of a harder landing.

As for positive risks to the outlook, the lower short-term debt exposure of the U.S. economy could continue to surprise on the upside the way it did in 2023, although this could delay monetary easing at the U.S. Federal Reserve after the Presidential Elections. Additionally, CPI disinflation in developed markets might accelerate and facilitate central banks in pivoting. For example, the inflation cooling reaction to the Federal Reserve tightening is subject to a wide range of possibilities and could be very swift, as researchers pointed out last September using the Chicago Federal Reserve model. Market sentiment could improve if Chinese authorities attempt to spur domestic demand and revitalize the real estate sector through enhanced policies and larger fiscal deficits than 3% of GDP. As for the Canadian economy and the TSX sector, one area where there is room for improvement relates to the better use of AI for sales, marketing, research, and customer relations. According to KPMG, only 35% of Canadian firms currently use AI relative to 72% in the U.S. If AI adoption goes mainstream, it will support the expansion of profit margins and raise odds of getting high-single, or double-digit digit returns for investors exposed to the Canadian equity market.

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