ECONOMIC RESEARCH AND STRATEGY

LAURENTIAN BANK

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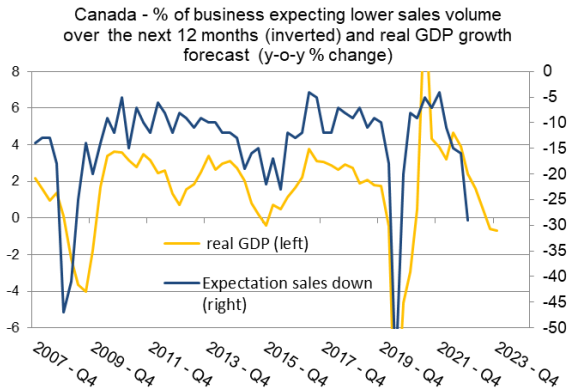
BoC January Decision and Winter Economic Outlook – Walking on Eggshells

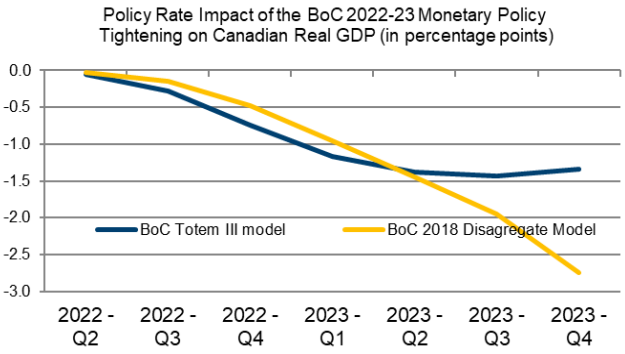
A confluence of adverse events led to ballooning inflation last year. It brought challenging adjustments from consumers, businesses, governments, and central bankers including the Bank of Canada. The BoC lifted its policy rate by 25 basis points to 4.50% this morning. BoC officials plan to pause. This pause is conditional on further inflation moderation. If CPI inflation does not cool down sufficiently, the BoC is prepared to raise interest rates further. We do not think additional hikes will be necessary based on our expectation of a slightly more painful downturn relative to the BoC soft landing scenario. The art of forecasting a high-probability base case economic scenario becomes nonexistent once we add to the mix geopolitical instabilities and global financial vulnerabilities emanating from some emerging markets and highly indebted developed countries.

Mild Recession Coming in North America

Mild, positive domestic demand momentum in North America was registered in late 2022 according to the OECD weekly economic tracker and other high-frequency indicators. In our view, consumers face tougher access to expensive credit and are poised to lose partial support for labour market resilience in the quarters ahead. As for businesses, they temper sales' expectations, try to find liquidities and are less in the mood for M&E capex spending according to three surveys released by the BoC, Statistics Canada and the U.S. National Federation of Independent Businesses. One consequence of monetary tightening and high inflation can be perceived in money in circulation calculated in real terms, already deeply negative year-over-year in the U.S. before the worse comes up. Indeed, the lagged impact of the monetary policy shock on economic activity on both sides of the border should shave close to 1.5pp to real GDP in 2023Q2 and Q3. This points to a mild recession lasting three quarters while the BoC predicts no economic growth.



Source: Bank of Canada, Statistics Canada



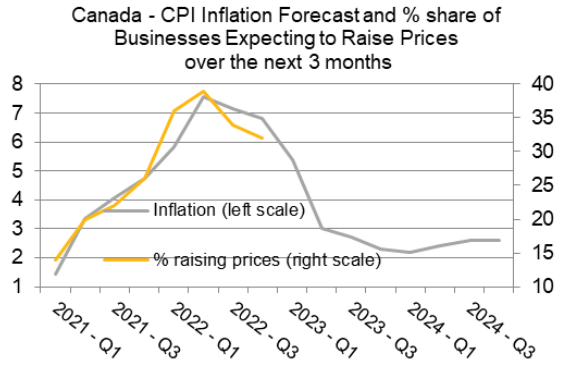
Source: BoC 2018 Disagregate Model (Staff Note 2018-32) and BoC Totem III model (BoC Techinical Report 119 2021), LB Economic Research and Strategy calculations

In tandem with our expectation of a mild economic contraction contrasting with the BoC soft landing scenario staying away from forecasting outright quarterly pullbacks in real GDP, central bankers and bullish market participants should soon find limits of relying on labour market resilience. The BoC mentioned again tight labour market conditions in this morning's statement. However, momentum of the Kansas City Federal Reserve labour market index based on 24 variables has turned negative last November as it usually does several months before a recession. This time, the negative momentum reflects mostly a pullback in hiring, job postings and voluntary quits. We do not see material difference in Canada's job market. Granted, chronic labour shortages will lead some business owners to retain staff. However, even companies with healthy balance sheets are starting to implement cost-cutting measures including staff reductions. We forecast a trough-to-peak unemployment increase of 1.1pp in Canada, from 5.0% last December to 6.1% in 2023H2, less than the 3-4% surge of the 2008-09 and early 1990s recessions.

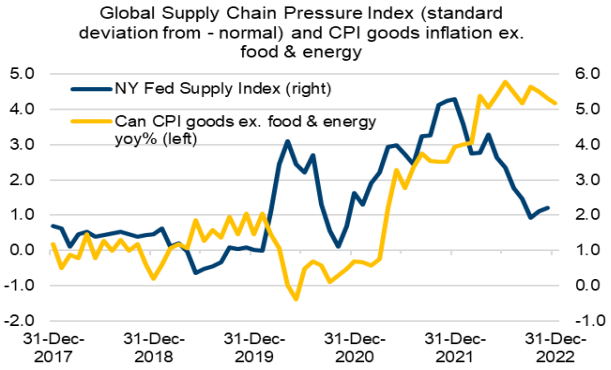
CPI Inflation — Rapid Moderation but Not Low Enough

In addition to the ongoing pullback in domestic demand observed in North America, China's easing of its COVID policy will ease a portion of the global supply-driven inflation problem, particularly for goods CPI excluding food & energy. China's dormant economy had one of its worst years ever in 2022 with real GDP growth close to 3%. In today's new Monetary Policy Report, the BoC upgraded China's 2023 real GDP growth from 4.9% to 5.4%. Chinese households' preference towards less-liquid deposits may prevent a massive acceleration in economic growth this year according to the Peterson Institute for International Economics think-tank. Accordingly, China appears on a path of a gradual consumer recovery and should shelter North America from a severe recession. While we assume the Chinese relaxation of COVID restrictions to generate a net disinflationary effect, a surprising soaring acceleration in China's economic momentum could imply tighter conditions in global commodity markets, one concern BoC Governor Tiff Macklem mentioned during his press conference this morning. This is one good reason for the BoC to stay cautious and communicate a conditional pause today. Monitoring China's population mobility and consumer confidence will be key.

Throw in improving inventories at the manufacturing-retail-wholesale levels, the 2022 Russian war base effect and delayed downturn of housing conditions on CPI shelter, and CPI inflation in both Canada and the U.S. should cool down fast during the first half of this year below 3% in our view. In other words, the intertwined cyclical easing of inflationary pressures and partial improvement in global supply impairments are poised to temper both demand- and supply-driven inflation forces. Already, as of last November, the demand-driven PCE inflation segment faltered completely, while the supply-driven portion was less painful than before according to San Francisco Federal Reserve staff calculations.



Source: Canadian Survey on Business Conditions, Statistics Canada and Canadian Chamber of Commerce



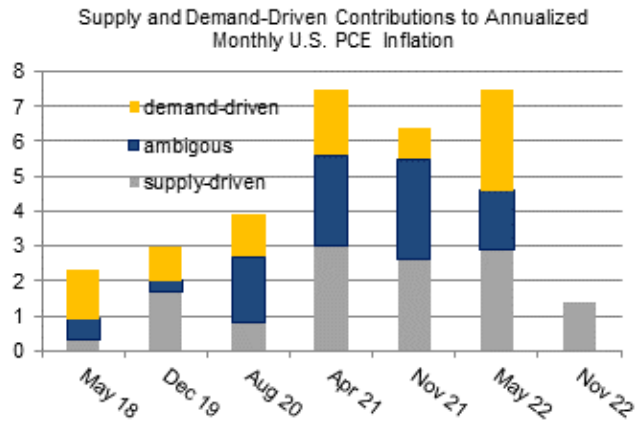
Source: New York Federal Reserve, Statistics Canada

BoC and Fed officials may find themselves unsatisfied with CPI inflation moving near 2.5% in 2023Q2 as we predict considering inflation usually runs below the 2% target during recession periods. For instance, Canadian CPI inflation dipped into negative territory shortly in early 2009 and hit the 1% mark in late 2001. The BoC projects CPI inflation to fall to 2.6% by 2023Q4, at a slower pace than in our base case scenario. One problem relates to the stickiness in services prices tied to the probably insufficient cooling in labour market conditions, which turns out to be the main upside risk to the BoC MPR scenario. In our view, wage inflation will moderate slightly and remain too high relative to the 2% goalpost. Put differently, U.S. unemployment is unlikely to soar from its current 3.5% level to the 6%-6.5% NY Federal Reserve NAIRU estimate. Furthermore, global efforts to improve shaken global chains resiliency and energy security as noted in the IMF December Finance & Development report are solid factors preventing the return of the soft structural inflationary frictions prevailing before the pandemic. Valuable statistical evidence comes from the U.S. CPI sticky index representing close to three-quarters of total CPI. Based on companies changing prices every 4-5 months instead of every 1-2 months, this index ran above 5% on a 1- and 3-month annualized basis as of last December according to the Atlanta Federal Reserve. Without surprise, it is easier for retailers to adjust prices on the upside than on the downside, and it will be easier for them to cut staff if necessary.

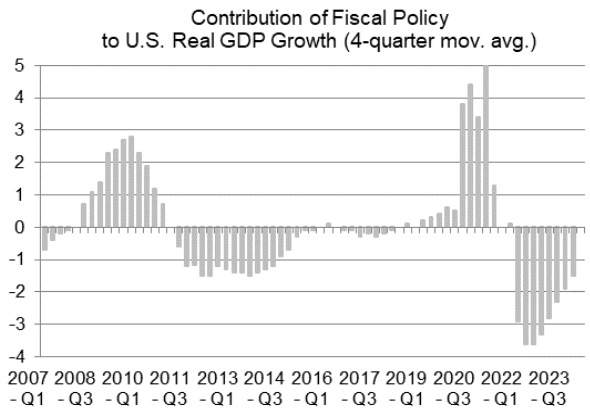
BoC and Federal Reserve Outlook — Long, High Plateau in Policy Rates, No Jumbo Pivot in Sight

Without compelling evidence of sustainable price control in sight, central banks are unlikely to jump soon, nor aggressively, into pivot mode as market pricing currently suggests. BoC officials may succeed in changing the market narrative of a pivot by saying this morning they are ready to hike again if necessary. Instead of pivoting, plateauing at 4.50% for most of 2023 appears the proper wording investors may have to get use to. Any temptation to consider jumbo rate cuts after jumbo hikes, as specific short-term segments of the Canadian yield curve tend to suggest, is ill-advised under the base case scenario of a mild recession. The arrival of one or additional negative global shocks triggering a deep recession would be necessary to shift the narrative in favour of policy rate cuts.

If and only if CPI inflation falls below 3% by mid-year and the recession sets in as we predict, real policy rates should be sufficiently restrictive to embark on a mild pivot to end the year with a 4% policy rate. The overnight rate target could then settle near 3.50% in early 2024. As for the U.S. Federal Reserve, the window of opportunity to hike is narrowing quickly. It has room for two consecutive 25-25bps moves in early February and mid-March, resulting in a terminal policy rate of 5%. From a communication standpoint, it would be extremely difficult for the U.S. Fed and BoC to lift policy rates once the recession becomes an unfortunate reality, contrasting with Europe where inflation runs near 10% and the ECB catching-up with its too-low policy rate of 2% expected to increase closer to 3% by mid-year. Underlying structural inflationary pressures should keep U.S. and Canadian policy rates at their peak terminal levels until at least 2023Q4. For those not convinced, another argument comes from the telegraphed bias of central banks to do not loosen the tight monetary grip like Fed Chairs Miller and Burns did in the 1970s before Volker came in. Combined with renewed hawkishness from Christiane Lagarde at the ECB, and question marks about the future viability of Yield Curve Control at the Bank of Japan in a higher global interest rate environment, the road to the eventual return of a flatter and steeper yield curve in North America could be long and complex.



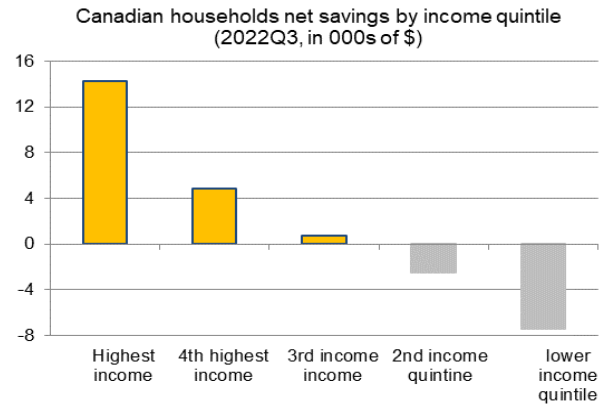
Source: San Francisco Federal Reserve



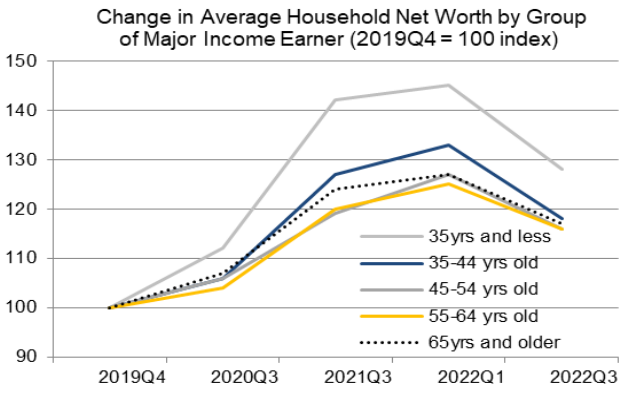
Source: Hutchins Center Fiscal Impact, Brookings

Households — Price Level and Interest Rates Shocks Endure

As for households, the stark contrast with central banks relates to memory. Inflation-targeting central banks will let go the past 2021-22 upside deviations of inflation be bygones. However, bygones are not bygones for households. It will take them ages to make up for the loss of purchasing power. Canadian total CPI jumped 13% between mid-2020 and late 2022. Furthermore, the restrictive interest rate environment will continue to increase the share of disposable household income attributed to debt servicing. Also, households cannot rely on savings as they did in 2020-21. Net savings for the bottom 40% of income earners was 12% lower than in 2022Q3 relative to pre-pandemic according to Statistics Canada. Average net worth by age group is also falling fast, although it remains above pre-pandemic levels. Unsurprisingly, the latest BoC consumer survey shows that almost two-thirds of Canadians are reducing spending and saving more, up from 57% last Spring. Altogether, we refute the bulls' argument saying the imminent return of positive real wage growth will prevent a recession. Put simply, the price level shock and interest rates adjustment restrain the possibility of a solid rebound in economic momentum for 2024. In addition, fiscal policy from Ottawa and Washington is less likely to save the day this time as bond vigilantes worry more than before about public policy easing financed through additional debt issuance. The Hutchins Center, part of the Brookings public policy think-tank, sees a fiscal drag of about 1pp on U.S. real GDP in 2023, reflecting mostly the fading of income support programs.



Source: Statistics Canada



Source: Statistics Canada

Asset Allocation — Perilous Year Beyond Economics

China's COVID policy relaxation, driving part of the USD recent weakness, is going to remove some froth on global supply chains but could surprise on the upside in terms of upward pressures on global commodity markets. However, most underpinning factors point to a recession in several regions of the planet including North America. This being said, it is difficult to come up with solid conviction in respect to the establishment of a base case economic scenario due to the presence of unstable social, geopolitical and financial factors, and a broad lack of cyber and commodity security. Without surprise, the top geopolitical risks for 2023 are more important this year than in 2022 according to the Washington-based Eurasia Group. First and foremost, the think-tank sees Russia calibrating its nuclear threat. Also, a new energy supply concern could emerge from instability in Iran, an unwelcome development considering the Energy International Agency already predicts tight global energy conditions this year. As for the U.S., the newest risk relates to the debt ceiling drama. U.S. Treasury Secretary Janet Yellen could be forced to cut the deficit representing close 5% of nominal GDP through massive fiscal restraint next summer if Congress and the White House do not find resolution in respect to the debt ceiling. The recession would then become severe.

All in all, besides weakness in the North American business cycle pointing toward downward revisions in corporate earnings estimates and favoring defensive positioning within the equity asset class, it appears preferable to wait for a better opportunity to reconsider a less risk-averse mindset when it comes to investing. We are walking on numerous eggshells. There are, after all, rare spots like the economic outlier India that are less negatively impacted by this fragmented, multi-polar world.

Key Economic and Financial Forecasts

	2022	2023	2024
U.S. Real GDP (%)	2.0	0.1	1.1
Can. Real GDP (%)	3.5	0.2	1.2
Can. Unemployment Rate (%)	5.3	5.7	6.0
Can. CPI Inflation	6.9	3.4	2.1
U.S. Fed Funds Rate Target (%, EOP)	4.50	4.25	3.00
BoC Overnight Rate (%, EOP)	4.25	4.00	3.00
5Y Fed Can Gvt Bond Yield (%, EOP)	3.28	2.95	3.10
TSX Index (EOP)	19385	19500	20700
Canadian Dollar (CADUSD, EOP)	0.72	0.75	0.80

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