Summer 2022 economic outlook: Short-term pain for long-term gain

[Midtempo music plays]

[Benjamin Tal, Managing Director and Deputy Chief Economist
CIBC Capital Markets Inc.]

So, if you look at the overall situation, clearly the Bank of Canada is becoming extremely aggressive for a good reason. We have to realize one thing. Although inflation is rising 7%, 8% on its way to 9%, what we have to emphasize is that at the end of the day, this is not about inflation.

[Sheets of Canadian $100 bills being printed. Sheets of U.S. $100 bills being printed.]

That two, three years from now, inflation will be back at 2%.

The issue is the cost of bringing inflation back to 2% in terms of higher interest rates. The Bank of Canada, the Fed, established their reputation, over the past 40 years, as inflation fighters.

[Urban business district with a Canadian flag visible. The U.S. Federal Reserve.]

They are not going to toss it away. So, although people are panicking about inflation, we have to realize that at the end of the day, this is not about inflation. This is about the cost of bringing inflation down to 2%. Therefore, the Bank of Canada has to be aggressive. It's all about inflation expectations. And their nightmare is that expectations will go up the way it was in the '70s.

[Downtown Toronto in the 1970s. The Bank of Canada.]

If you give the Bank of Canada two options: one is inflation expectations rising, the other is that we are in a recession, they will take a recession any time. Their goal is not preventing recessions. Their goal is to prevent you and me believing that inflation is not under control. We expect the Bank of Canada to move to about a 3% overnight rate.

[The Bank of Canada.]

This is a significant increase in a very short period of time. The market is pricing in 3.5%.

[A stock ticker.]

And quite frankly, I believe that the difference between 3% and 3.5% will be the difference between getting it right and overshooting. And overshooting usually leads to a recession. I suggest that there is 40, 45% probability of a recession. And I'm not sugar-coating anything here. That's the way it is. Why? Because inflation is a lagging indicator.

[Midtempo music plays]

[Inflation and recessions]

Inflation is telling you about the past. If you look at the past four or five recessions, inflation peaked─peaked!─six months after the beginning of each recession. But show me the central banker that will resist raising interest rates while observing accelerating inflation.

[Downtown Toronto in the early 1980s and the 1990s. The Occupy Wall Street protests. An aerial view of an empty street.]

And economic recession over the past 40 years, with the exception of the COVID recession, was helped, if not caused by monetary policy error, in which central bankers raised interest rates too much.

That's more or less where we are. We believe that there is still a chance that the Bank of Canada will get it right. Why? Because of the effectiveness of monetary policy. If we are going to get a recession, it would be a very mild recession, reflecting a few things.

[Downtown Ottawa.]

One, the labour market is very tight.

[Laptops being manufactured]

So although it will get less tight, it's starting from a very good position. We know there are help wanted signs everywhere.

[A “Help Wanted” sign. Time-lapse image of a shopping mall]

That's good. The consumer is sitting on roughly $300 billion of excess savings. And that's a good thing. And the housing market is undersupplied.

[Midtempo music plays]

[Housing market outlook]

Clearly, the housing market is slowing down. We know why it went up by 50% over the past two years. It was the abnormality of this recession.

The asymmetrical nature of this recession, with all jobs being lost were low paying jobs. So, home buyers got the benefit of a recession vis-a-vis extremely low interest rates, without the cost of a recession, vis-a-vis a broadly based increase in the unemployment rate.

[A graphic of a large percentage symbol surround by dozens of small model houses that appear to be constructed from paper Canadian flags. An aerial view of a residential neighbourhood.]

We have never seen anything like that. I suggest that we simply felt that there was a sense of urgency to get into the market and people got into the market and accelerated their purchasing activity.

So, we borrowed activity from the future, and the future has arrived. Namely, interest rates are rising and the level of activity is slowing down. And that's extremely healthy. I would not be surprised if you see prices falling by 20%, 25%, maybe 30% in some pockets. However, it means that people who took mortgages in 2020, 2021, they will be exposed later when they renew their mortgages.

[A mortgage being signed and keys changing hands.]

And that's the risk that we are facing three, four, five years from now. And the hope is that interest rates by then will be actually lower that will ease that risk. But the more significant decline will be in the low rise segment of the market.

[A residential neighbourhood. A hyper-lapse image rushing through condo buildings. Aerial views of condo buildings.]

Detached houses where we reach a price resistance level if you wish, and the condo market, although it will slow down, will actually do better.

The rental market, in fact, is going to be inflationary given the fact rent did not rise during the pandemic – it's starting to rise now. We have a situation in which construction costs are rising so quickly, much faster than condo prices, therefore, they are losing money so they are not building.

[Images of construction sites. Several condo buildings. A real estate agent takes a couple through an apartment. A backhoe working on a construction site. Scaffolding on a building.]

Builders, developers they are canceling projects. They are delaying projects because they cannot make money.

So, two or three years from now, when we wake up from this slowdown, prices will rise dramatically.

[A graphic of large dollar symbol surrounded by dozens of small model apartment buildings and houses that appear to be constructed from paper Canadian flags.]

Why? Because we are not building now. There will not be supply while demand will still be there. We're still getting 450,000 new immigrants a year and this number is rising.

[Midtempo music plays]

[Equity market outlook]

Turning to the equity market, in my opinion, a lot of bad news is already priced in. And maybe some overshooting is also priced in, in terms of monetary policy.

[A stock ticker. Exterior images of the Toronto Stock Exchange building.]

Therefore, I believe that if you look at the stock market now, especially Canada, it is relatively cheap compared to where it will be two or three years from now. If you have a time horizon of five minutes, I cannot help you. But if your time horizon is two to three years, I believe that there are some very good opportunities out there, especially in Canada.

[Midtempo music plays]

[This video is provided for general informational purposes only and does not constitute financial, investment, tax, legal or accounting advice nor does it constitute an offer or solicitation to buy or sell any securities referred to. Individual circumstances and current events are critical to sound investment planning; anyone wishing to act on this document should consult with his or her advisor. All opinions and estimates expressed in this video are as of the date of publication unless otherwise indicated, and are subject to change.

The CIBC logo is a trademark of Canadian Imperial Bank of Commerce (CIBC).

The material and/or its contents may not be reproduced without the express written consent of CIBC.]

[CIBC Logo]

[The CIBC logo is a trademark of CIBC, used under licence.]