2023 Economic Outlook – Light at the End of the Tunnel?

[Soft music plays]

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Everybody is talking about inflation. But the reality is that at the end of the day, this is not about inflation.

[Sheets of currency being printed. The Bank of Canada, in Ottawa. The Federal Reserve in Washington.]

This is about the cost of bringing inflation down to 2%, which is the target. The Bank of Canada, the Fed in the U.S., have established their reputation as inflation fighters. They are not going to toss it away. Given a choice between a recession and inflation they will take a recession any day. That's the reality.

[Sources of inflation]

The trajectory of inflation is important here. This trajectory is changing.

[An aerial view of a shipping dock. A person online shops on their phone. An aerial view of a warehouse and shipping center.]

At any point in time, there are two sources of inflation, supply driven inflation and demand driven inflation.

[A full warehouse. Bustling shipping docks. The Bank of Canada building. A timelapse of downtown Toronto.]

What we are seeing more and more, is that the contribution of the supply driven inflation is diminishing, which means that the supply chain is improving, shipping cost is down. And that's actually extremely good, because it means that the Bank of Canada is becoming more powerful in its ability to deal with the situation because more and more inflation is not coming from the outside, but rather from domestic sources which the Bank of Canada can do something about.

[Interest rates]

So, what's the next move?

[The Bank of Canada building.]

The Bank of Canada is now at 4.25% overnight rate. We think it's done. We think that's the end of it. Maybe another 25 basis points if they have to, but we are, basically, extremely close, maybe at the end of the hiking cycle.

The next question, of course, is what's next? When are you cutting? Usually, the lag between the last hike and the first easing move is relatively short. This time we believe it will be relatively long, maybe a year, maybe early 2024.

[The Federal Reserve in Washington. Sheets of currency being printed.]

Why? Because the Bank of Canada and the Fed have to make sure that inflation is dead before they ease monetary policy.

[An aerial image of the Brooklyn bridge in the 1970s. A CIBC branch in Toronto in the 1970s.]

The last thing they want to do is to repeat the mistakes of the 1970s when monetary policy was eased prematurely and led to another wave of inflation, and therefore, the double dip recession of the early 1980s. They would like to avoid that and, therefore, they will wait until inflation is dead before they cut.

And then when they cut by how much? Now, we started this saga at 1.75% overnight rate. We are going to 4.25%, 4.5%. We rest for a year. And then cut––to where? I say about 3%. A full percentage point, maybe more, above the rate we have seen before the crisis.

Why? Because in the background there are three inflationary forces that are putting pressure on overall inflation.

[A low angle view of a Canadian flag in Ottawa. A full warehouse. A woman carries a box of office supplies.]

We are talking about deglobalization. We are talking about Just-in-case inventories that are replacing Just-in-time inventory. And clearly the labour market is much tighter now with vacancy rates in the sky. And the target is the same target, still 2%. So, in order to achieve the same target with more inflationary forces, by definition, interest rates have to be higher and the new neutral rate, about 3%, clearly higher than what it was before the crisis.

[The risk of central bank overshooting]

What's the risk? Overshooting. To the extent that supply chain does not behave. To the extent that we don't see a significant decline in the external source of inflation, that will lead to a situation, in which the Bank of Canada will overshoot, will raise interest rates to 5%, 5.5%.

[The Bank of Canada crest. A person fills out a job application. People sit in a waiting room.]

That will take you to a real recession, with the unemployment rate rising significantly. Every economic recession was helped, if not caused by a monetary policy error, in which central bankers raised interest rates too much.

[The Bank of Canada building.]

At this point of the game, it seems that the Bank of Canada is getting it. They would like to avoid this risk. Basically, stop at 4.25%. That's the main case scenario.

[The Housing Market]

Let's talk about the housing market now. The housing market is extremely sensitive to higher interest rates than in any other time in history.

[An aerial view of houses in Toronto.]

It is slowing down. Is it a correction? Is it a crash? Is it a meltdown? In order to answer those questions, we have to understand what happened to the housing market during COVID. We know that prices went up by 46% in two years. The question is why? The answer is the asymmetrical nature of the crisis. All the jobs that were lost were low paying jobs.

[An empty warehouse. A person reads a layoff notice. Apartment buildings in Toronto. Homebuyers look at listings in the window of a real estate office.]

Young people, renters. That's why rent actually went down during the pandemic.

[A young couple looks at the front door of a house.]

At the same time, homebuyers and even potential homebuyers, their jobs were there. They were assuming their income was there and interest rates were in the basement. So basically, we have a situation in which, if you think about it for a second, homebuyers during COVID 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 street view of a residential neighbourhood.]

There was a sense of urgency to get into the market. So, if you have a sense of urgency to get into the market, you frontload activity. You borrow activity from the future. We are in the future. This is not a freefall. This is not a crash. This is a reallocation of activity over time. We frontloaded activity, now we are resting due to higher interest rates. That's a very positive development. It's not over.

[A “For Sale” sign on a lawn.]

Now, this is the first correction ever, in which the supply resale activity is actually down. Usually, you see supply listings going up when the market is correcting. This is not the case now. Supply is down because people simply are worried about the overall situation, they are not willing to list, and therefore, supply is down by 10% on a year-over-year basis. That's protecting prices from falling further. I believe that will change in 2023 and 2024. We will see supply rising because the fog will clear.

[An aerial view of houses in Toronto.]

But also, some people will be forced to sell given the huge increase in interest rates and the shock that they will experience moving from variable rates to fixed rates or renewing their variable rates. And therefore, I see further downward pressure in the housing market in 2023. However, it's not a crash, it's not a meltdown. It's a very healthy correction.

[An aerial view of houses. A plane lands at an airport. A woman waits for a ride at an airport. A man holds up the Canadian flag. The Ukrainian flag flying over Kyiv. An agent shows a couple a condo]

So, expect to see further declining sales and clearly declining prices, especially in the low-rise segment of the market. At the same time, remember, the fundamentals of this market are still very strong. This year alone, we got 700,000 new immigrants, plus non-permanent residents, foreign students, and people from Ukraine. 700,000. None of them carries his or her house on their back. The demand is there and what's happening to supply? We are *not* building.

[An aerial view of houses in Toronto. The interior of a semiconstructed apartment.]]

One third of activity is being canceled or delayed because of the fact the cost is rising too fast.

So, you don't have the supply coming. The demand is definitely there. You don't need to be an economist to see what will happen two or three years from now. So, the fundamentals of the market, the lack of supply, a lot of demand still there. But at the same time, the market is now adjusting, basically reflecting the asymmetrical nature of this recession.

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