Post-Shuffle Economic Update

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Prime Minister Justin Trudeau extensively shuffled his cabinet on July 26th. His stated goal is to have the strongest team in place to face what he called on numerous occasions “consequential changes/ moments/times” (you can read StrategyCorp’s analysis of the shuffle here). Responding to media questions, Prime Minister Trudeau highlighted the potential for a global economic slowdown and the challenges associated with affordability, inflation, rising interest rates and housing.

Talking to the media with other members of the Prime Minister’s economic team, the Deputy Prime Minister and Minister of Finance, Chrystia Freeland, indicated that the “government is very, very focused going forward on the economy”. As part of this, the government intends to focus on the affordability challenge as well as job creation and economic growth. More details on some of the measures to achieve these objectives are presumably to come in new mandate letters.

Shortly after the shuffle, Statistics Canada released new gross domestic product (GDP) data that provides the economic backdrop for the return of parliamentarians to Ottawa on September 18th for what promises to be an interesting fall sitting. This brief looks at the state of the Canadian economy as the new cabinet begins its work and the different parties prepare for the fall.

Economic Growth

Despite significant uncertainty, the Canadian economy has managed to fend off negative growth since the start of the year. Real GDP by industry increased month-over-month (MoM) for a fifth consecutive time in May 2023. It was up 0.3 per cent from April (Statistics Canada, 2023a).

At a more granular level, the data shows that the real GDP of most industries has been seesawing in the last year. Only two sectors have consistently posted positive GDP MoM growth in the last 12 months: health care and social assistance and the broader category of “other services (except public administration)” under the North American Industry Classification System. On the flip side, it should be noted that the agriculture, forestry, fishing and hunting sector has now recorded eight consecutive MoM decreases since September 2022.

Statistics Canada (2023a) also released preliminary GDP by industry estimates for the second quarter of 2023. It anticipates on aggregate a quarter-over-quarter (QoQ) increase of 0.3 per cent, which translates to an annualized rate of 1 per cent. While positive and therefore pushing any possibility of a recession further into 2023 or 2024, the second quarter data is lower than what was recorded in the first quarter (0.7 per cent QoQ for real GDP by industry). It is also lower on an annualized basis than recent GDP forecasts from the Bank of Canada (1.8 per cent for 2023 or, for the second quarter, 1.5 per cent at QoQ percentage change at annual rates) (Bank of Canada, 2023, p. 9).

The anticipated second quarter numbers show that GDP growth is slowing after a stronger than expected start to 2023. Given the increasing pressure generated by the Bank of Canada's monetary policy tightening, we are unlikely to see any kind of major rebound in the third quarter.

Employment

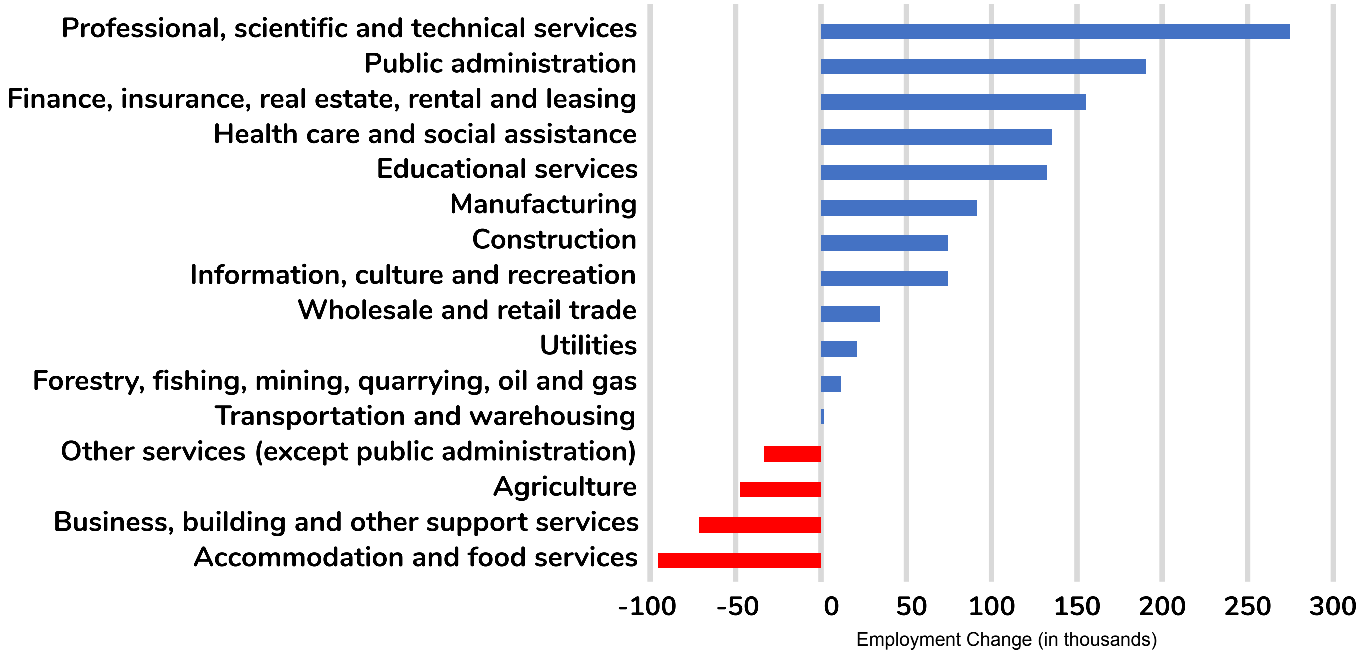
The enduring and somewhat surprising strength of the Canadian labour market has been one of the biggest economic stories of 2023 so far. As of June, year-over-year (YoY) employment was up 2.4 per cent on a seasonally adjusted basis. On a monthly basis, employment experienced a small dip in May (minus 17,300), the first since August 2022. The unemployment rate grew from 5 per cent to 5.2 per cent in May (Statistics Canada, 2023b).

This prompted discussions within economic and policy circles around whether the much-anticipated labour market slowdown had begun. However, the June numbers showed the ongoing resilience of employment as it rebounded by 59,900. The unemployment rate did however increase another 0.2 per cent to reach 5.4 per cent as more individuals looked for work according to Statistics Canada (2023c). This is the highest rate since February 2022.

On aggregate, employment is significantly up compared to before the pandemic (5 per cent compared to February 2020). However, certain industries have been struggling to get workers back and remain below pre-pandemic levels. This is the case for sectors such as accommodation and food services, business, building and other support services as well as agriculture and "other services" (see Figure 1). Notably, employment in accommodation and food services sector is still almost 100,000 below where it was before the pandemic. While job vacancies have steadily decreased across the economy, this sector continues to record the highest job vacancy rate (7 per cent in May compared to 4.3 per cent for all industries).

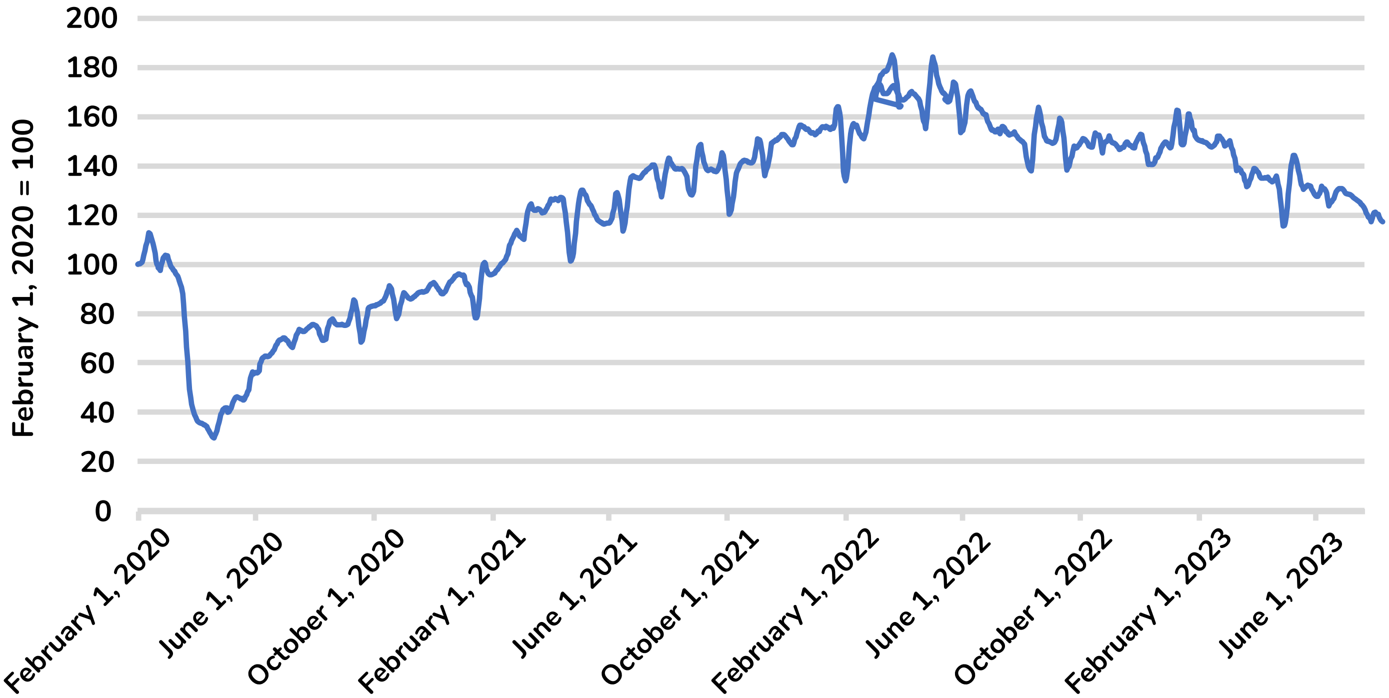
While headline labour market numbers are strong, we are seeing employers adjusting to changing economic conditions and uncertainty. Beyond job vacancies steadily easing, the number of job postings has been declining since reaching record highs in early 2022. Indeed's data for new job postings in Canada highlights this trend in Figure 2.

Figure 1: Employment Change by Sector Compared to Pre-Pandemic Levels
(June 2023 versus February 2020)



Source: Statistics Canada (2023d).

Figure 2: New Job Postings on Indeed
(Indeed Job Postings Index, seasonally adjusted)



Source: Brendon Bernard (2023, July 21).

Inflation and Affordability

For a little over two years, inflation levels were above the Bank of Canada's target range of two to three per cent. After growing 8.1 per cent YoY in June 2022, a level not seen since 1983, consumer price index (CPI) growth started its slow decline. A year later, inflation was finally back within the expected range for the first time, clocking in at 2.8 per cent in June 2023. This was in part due to lower gasoline prices compared to June 2022 when it hit the $2 per litre mark. Excluding variations associated with gasoline, June CPI YoY growth came in at 4 per cent according to Statistics Canada (2023e).

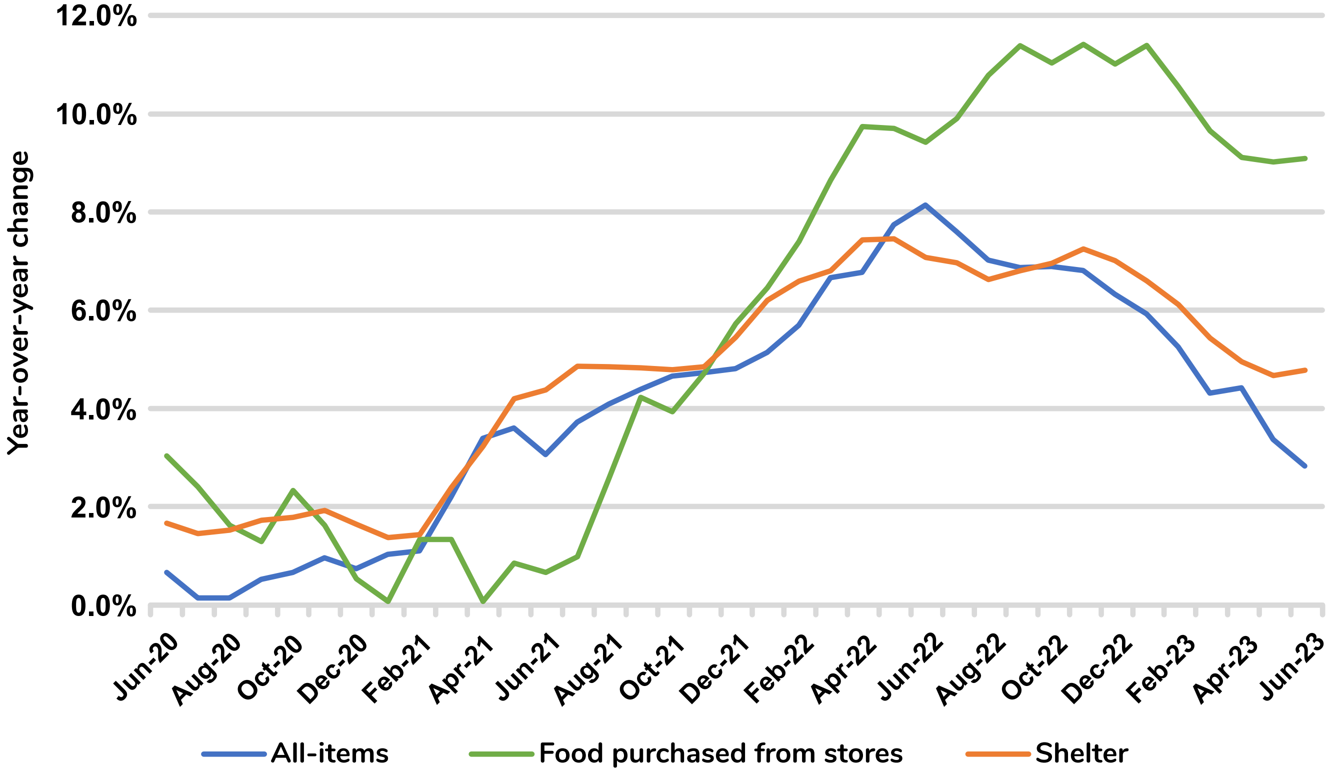
Unfortunately for households, food inflation remains stubbornly highly compared to headline numbers. Grocery prices were up 9.1 per cent in June 2023 (see Figure 3). If we go back to before the pandemic, the price of food purchased at the store increased by 21.9 per cent since February 2020.

Shelter, which includes both rent and mortgage interest costs, was still high at 4.8 per cent in June. This is driven in great part by significantly higher mortgage interest costs (up 30.1 per cent year-over-year) caused by the aggressive monetary policy tightening efforts of the Bank of Canada.

After a small pause in March and April, the central bank resumed its hawkish stance and increased interest rates in June and July. This brought the Bank of Canada's policy interest rate to 5 per cent. The prime rate was up to 7.2 per cent.

As monetary policy takes time to make its way through the economy, the June decision surprised economists and market watchers who had expected the Bank of Canada to exercise caution before implementing another rate increase. The next rate decision is scheduled for September 6th, which makes the July CPI data expected on August 15th extremely important. Should inflation stay under the three per cent mark, it would likely provide reassurance to the central bank that conditions are stabilizing, especially as real GDP data for the second quarter is expected to be lower as well.

Figure 3: Consumer Price Index: Year-Over-Year Change for Selected Categories



Source: Statistics Canada (2023f).

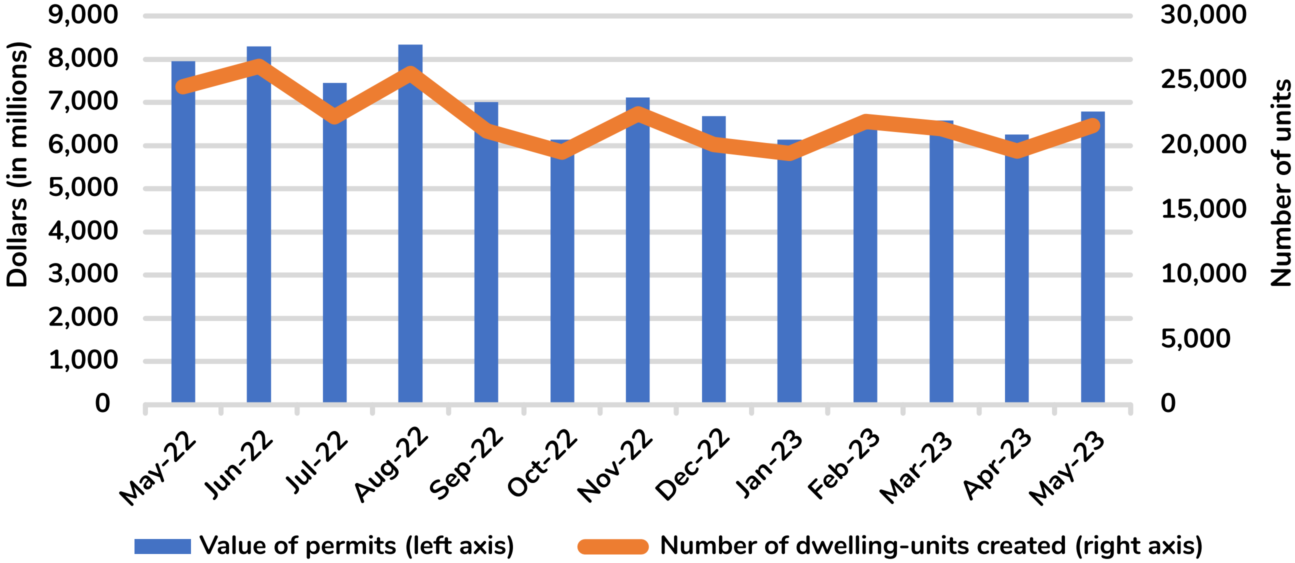
Housing

Rising interest rates tapered housing demand and prices on the ownership side between March 2022 and January 2023. This was short lived as prices started rising again in February 2023 in actual terms. While still down from the peak of March 2022, the actual national average home price was $709,218 in June 2023 (Canadian Real Estate Association, 2023). This was up 6.7 per cent year-over-year. However, it was down 2.7 per cent month-over-month, halting a four-month price increase. Given the Bank of Canada's June and July hikes, it is likely that national home prices will not significantly increase in July as demand adjusts to the new mortgage rates.

As home prices recover and higher mortgage rates reduce the purchasing power of households, the demand for apartments has grown rapidly. Pressure in that market is further compounded by record-high population growth driven for the most part by international migration according to Statistics Canada (2023g). When first arriving to Canada, immigrants are more likely to rent than purchase a property.

Greater demand inevitably translated to higher rent price. The average rent for a two-bedroom apartment in Canada was up to $2,249 in June 2023 (Rentals.ca, 2023). This represented a 10.3 per cent YoY increase. In addition to being expensive, apartments are also scarce in many cities across the country. Canada Mortgage and Housing Corporation (CMHC) estimated that the national vacancy rate for purpose-built rental apartments was 1.9 per cent between October 2021 and October 2022. This was the lowest level since 2001 (Canada Mortgage and Housing Corporation, 2023a, p. 6).

Figure 4: Residential Permits and Dwelling Units Created
(seasonally adjusted)



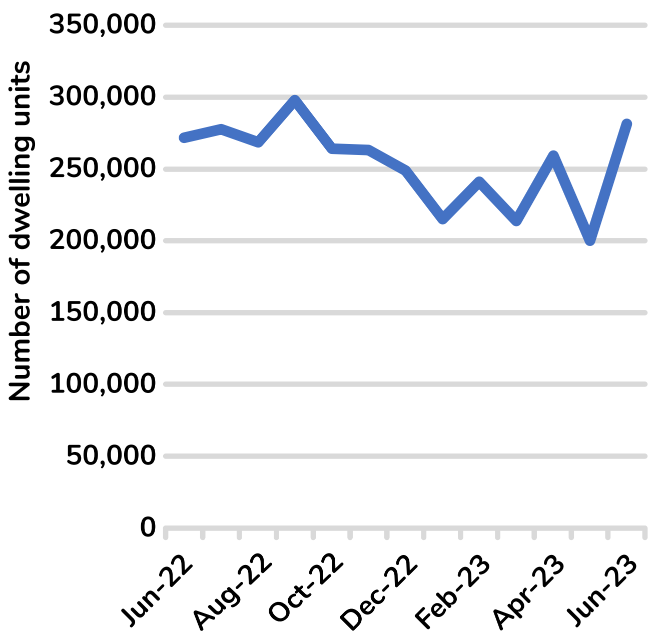
Source: Statistics Canada (2023i).

Increasing supply across the housing continuum is widely regarded as the only structural and sustainable solution to improve housing affordability in Canada. However, some key housing indicators have not been trending in the right direction due to economic headwinds such as the high cost of financing and ongoing labour shortages in the construction industry. As of May 2023, there were 69,375 job vacancies in construction for a vacancy rate of 5.7 per cent (Statistics Canada, 2023h).

Construction intentions are below the levels recorded up until August 2022, which is when the data took a turn for the worse. This is reflected by the lower value of residential building permits as well as the number of dwelling units created (see Figure 4).

Housing starts have also been down in 2023 after reaching nearly 300,000 dwelling units in September 2022 on a seasonally adjusted annual rate (SAAR) basis (see Figure 5). After dipping to 200,000 units in May 2023, the seasonally adjusted annual rate spectacularly grew by 40.7 per cent MoM to reach 281,373 in June (Canada Mortgage and Housing Corporation, 2023b). The July data will tell us whether housing starts continued their recovery.

Figure 5: Housing Starts
(at seasonally adjusted annual rates)



Source: Canada Mortgage and Housing Corporation (2023b, July 18).

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Commentary: What This Means for the Government (And the Opposition)

How to guide the country through a prolonged period of low economic growth in 2023 and 2024 will be an important question for the new cabinet, government and opposition parties. The elusive “soft economic landing” continues to technically be a possibility as GDP has not contracted this year yet.

As the government pursues this ideal outcome, the Deputy Prime Minister and Minister of Finance stressed her focus on the affordability challenge following the cabinet shuffle. The tools available to help alleviate the negative consequences of high prices on Canadians are relatively limited because of the risk of inflation. The government indicated in the past that it does not want to hinder the ongoing efforts of the Bank of Canada. From a policy standpoint, this means it may continue to prioritize targeted support measures like the enhanced GST rebate (“Grocery Rebate”) as broad-based measures would have a greater potential to inadvertently fuel and/or maintain inflation.

On the industry side, slow growth and recession risks can hurt business investments as firms focus on their core operational activities to navigate uncertainty. This can in the long run have negative consequences on their competitiveness. To that effect, the tax credits related to clean technologies (“clean tech”) in Budget 2023 could potentially help in some sectors, but it remains to be seen if the uptake will be hindered by current economic conditions. Additional measures to maintain business investments might be looked at by the government, opposition parties and stakeholders, but the same risk of generating inflation in the process will need to be factored in.

Given the strength of the labour market, the policy and politics of employment have been mostly related to staffing shortages. Since the pandemic, immigration has been a key pillar of the government’s response to this challenge. However, should the economy enter a recession that leads to unemployment increasing, the long-awaited structural reform of the Employment Insurance (EI) program will once again be a hot policy topic. The shortfalls of the EI system are well-known and were exposed during the pandemic.

Lastly, housing affordability will dominate debates when the House of Commons returns. Canada is facing a difficult situation where high demand (stemming in part from population growth) puts tremendous pressure on supply, thus driving prices higher on both the ownership and the rental side. Making the situation worse, higher interest rates and overall inflation has reduced the purchasing power of households.

The government introduced over the years several measures to support individuals on the demand side such as the Tax-Free First Home Savings Account and the top-up to the Canada Housing Benefit. On the supply side, it has prioritized a program-based approach (usually administered by CMHC). The Rapid Housing Initiative and the Housing Accelerator Fund are two examples. However, given the increasing politics of housing and the fact that every development project is facing significant headwinds (especially purpose-built rental projects), the government will be under pressure to announce additional initiatives. Given its broad availability and the precedent set by the clean tech credit, using the tax system to deliver some housing measures might be considered.

Overall, the Canadian economy has performed above expectations in 2023 so far (forecasts included in Budget 2023 had real GDP growing by only 0.3 per cent this year). Despite its resilience, the economy faces significant uncertainty and challenges, which directly impact Canadian households and businesses. Economic conditions will extensively shape the work of Prime Minister Trudeau’s new cabinet in the coming months. Affordability, housing and low growth are top of mind and will be at the heart of the approach and strategies of all major parties as they prepare for the fall sitting.

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