September 2024

Bank of Canada needs to step up the pace

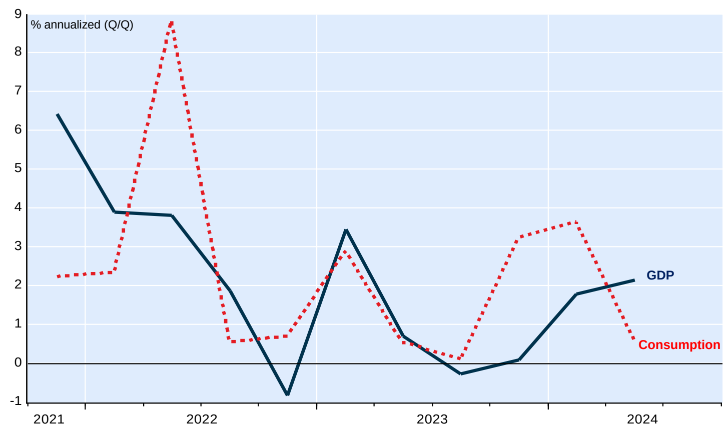
By Matthieu Arseneau, Alexandra Ducharme and Daren King

Summary

- Some forecasters, including the Bank of Canada, had high hopes of an economic recovery and a stabilization of the unemployment rate in the second half of the year, in the wake of interest rate cuts. For several months now, we have been arguing that, although interest rates are starting to come down, monetary policy is far too restrictive for this recovery and stabilization to occur, and recent economic data bears this out.
- With the Canadian economy stagnating in June and July, the 2.8% growth expected in Q3 by the Bank of Canada is now virtually unattainable. As a result, GDP per capita continues its downward trend that began in 2022, illustrating the fact that the economy continues to grow below potential and that excess supply continues to increase.
- Not only do companies seem to have an excess of inventories, they also seem to have an excess of workers. For now, this is limited to a hiring freeze at the macro level, as evidenced by average job gains of just 6K per month over the past three months. Those trying to enter the job market - young people and newcomers - are the main victims of Canada's weak hiring climate.
- With widespread inflation a thing of the past in Canada, we believe the door is wide open for the Bank of Canada to return its policy rate to neutral (between 2.5% and 3.0%) as soon as possible. In the meantime, the damage to the labour market could be greater than necessary. We anticipate economic growth of just 0.9% in 2024 and 1.3% in 2025, which would translate into an unemployment rate of around 7.4% by mid-2025.

Some forecasters, including the Bank of Canada, had high hopes of an economic recovery and a stabilization of the unemployment rate in the second half of the year, in the wake of interest rate cuts. For several months now, we have been arguing that, although interest rates are starting to come down, monetary policy is far too restrictive for this recovery and stabilization to occur, and recent economic data bears this out. While the economy grew at an annualized rate of 2.1% in Q2, slightly ahead of consensus expectations (+1.8%), this was still well below population growth, which stood at 3.2% during the quarter. Not to mention that the overall figure masks obvious weakness on the household side, where spending grew at an anemic pace, while government spending surged.

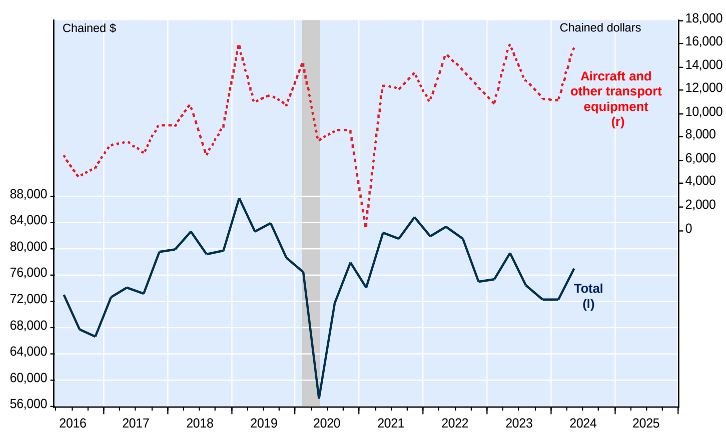
Canada: Consumption anemic in Q2
Gross domestic product and household consumption



NBC Economic and Strategy (Data via Statistics Canada)

Some may have rejoiced at the rise in investment in machinery and equipment during the quarter (+29% annualized), but we doubt this heralds a reversal of the trend. Looking at the data, we see that the aircraft and other transport equipment segment alone accounts for 98% of the total increase. As this component is by far the most volatile, a short-term reversal cannot be ruled out. Of the other eight segments, no fewer than five showed declines in Q2, which is consistent with the most recent Bank of Canada survey indicating weak investment intentions.

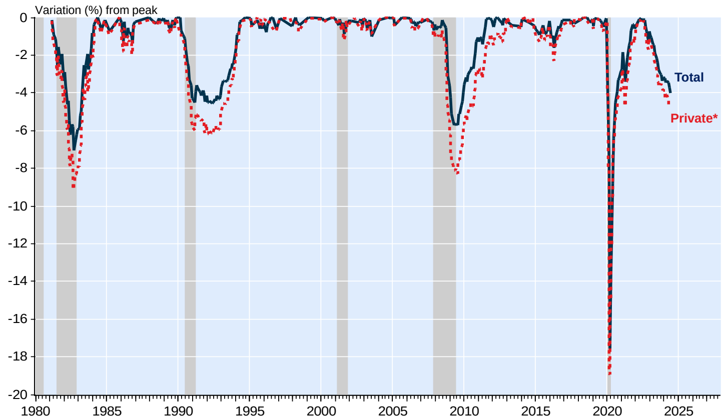
Canada: Is the investment rebound sustainable?
Investment in machinery and equipment (chained 2017 dollars)



NBC Economic and Strategy (Data via Statistics Canada)

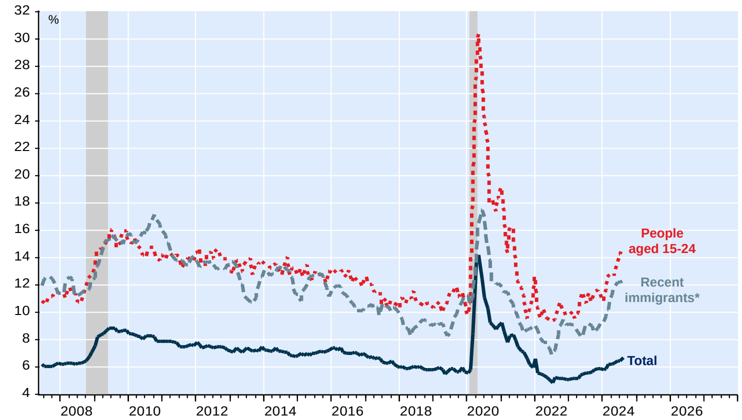
Based on preliminary data for July, GDP per capita continues the downward trend that began in 2022, illustrating that the economy continues to grow below potential and that excess supply continues to increase. The cumulative decline from the 2022 peak now stands at 4.0% in July, which is similar to the cumulative decline recorded during the recession of the early 1990s. The decline is even more marked in the private sector, as was the case in previous episodes of economic weakness.

Canada: GDP per capita continues to plummet
Change since peak in total GDP per capita (last data: July) and private sector GDP per capita (last data: June)



*Private sector define as Total GDP minus education, health and public administration
NBC Economics and Strategy (data via Statistics Canada)

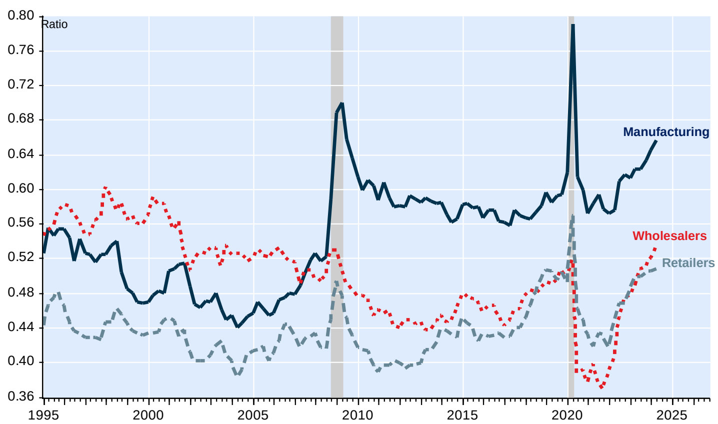
Canada: Sharper rise in unemployment in immigrants and young people
Unemployment rate



*Landed 5 years or less ago, 3-month moving average, seasonally adjusted by NBC
NBC Economics and Strategy (data via Statistics Canada)

With the Canadian economy stagnating in June and July, the 2.8% growth expected in Q3 by the Bank of Canada is now virtually unattainable, as it would require an astronomical 0.7% expansion in both August and September. One element that could hold back economic growth is the increase in inventories, which continued its upward trend in Q2. Inventory accumulation has softened the economic blow in recent quarters, but a reverse phenomenon could occur if companies now opt to liquidate their stocks. Whether in the manufacturing, wholesale or retail sectors, the inventory-to-sales ratio appears excessive, resembling levels seen in recent recessions.

Canada: Are high inventories a risk to growth?
Inventory-to-sales ratio



NBC Economics and Strategy (Statistics Canada data)

Companies don't just seem to have an excess of inventories, they also seem to have an excess of workers. No fewer than 13 out of 15 sectors recorded a fall in output per employee between Q3 2022 and Q2 2024, a sign that many parts of the economy are overstaffed. For now, this is limited to a hiring freeze at the macro level, as evidenced by the average increase of just 6K jobs per month over the past three months. Those trying to enter the job market - young people and newcomers - are the main victims of Canada's weak hiring climate.

If we compare the trajectory of the unemployment rate increase in the current episode with that of past recessions, we can see that the youth unemployment rate shows a greater similarity with periods of historical contraction than that of the 25 to 54 age group. The cumulative rise in the current episode is similar to the rise during the 2008-2009 financial crisis. After 26 months of weakness, it is also comparable to the trend observed during the recession of the early 1990s. Unfortunately, we have no confidence in any imminent recovery in the youth job market. Indeed, the vacancy rate in sectors that tend to absorb more young people fell from 6.1% in 2022 to just 3.3% last June, the lowest level since 2017. In other sectors, the number of vacancies is declining rapidly, but remains in line with pre-pandemic levels.

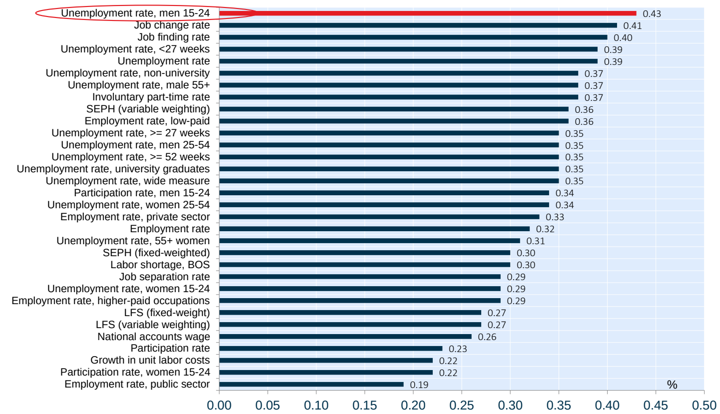
Canada: Disproportionate rise in youth unemployment rate
Increase (p.p.) in the unemployment rate, past recessions (excluding COVID-19)

NBC Economics and Strategy (data via Statistics Canada)

When considering the implications for economic growth and ultimately inflation of a weak youth labour market, it may be tempting to overlook its impact. After all, young people are less productive, earn lower wages and often work part-time. This means that the impact of one less worker on consumption is weaker. However, as we explained in a recent special report (**link**), it would be perilous not to take this into account when analyzing the economic climate. First of all, we can't rule out the current phenomenon being a "canary in the coal mine". It would not be surprising if, after a period of hiring freezes, a wave of layoffs was to occur, affecting all age categories and accelerating wage disinflation. But the implications for inflation may be greater than we think. According to an analytical note by central bank staff published last April (**link**), the unemployment rate of young men ranks first among the 32 labour market indicators identified by the BoC as significant in explaining movements in underlying inflation. It reached 16.3% in

August, the highest level since September 2014 excluding the pandemic, following a 6.5 percentage point rise since its trough in 2022 (compared with a 4.8 p.p. rise for young women).

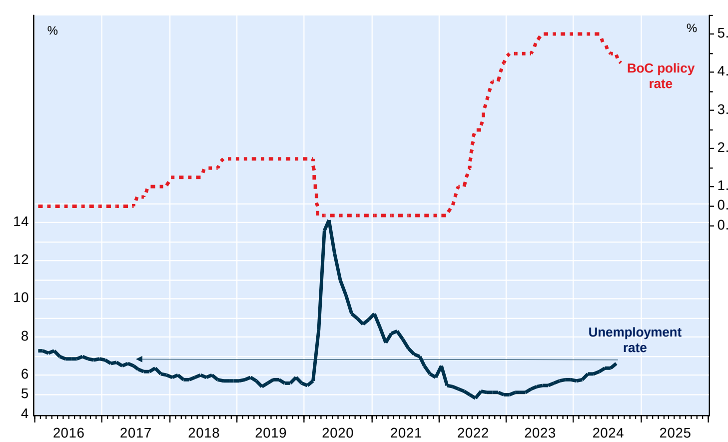
Canada: Youth unemployment must not be overlooked
Impact of a one-standard-deviation increase in variable measures on CPI-Trim



Source: Bank of Canada

Even if we don't limit our analysis to the situation of the youngest workers, monetary policy seems to us to be simply unsuited to the current context, remaining far too restrictive despite the rate cuts announced so far. In August, the unemployment rate rose by two tenths to its highest level since May 2017, outside the pandemic. By way of comparison, the policy rate stood at just 0.5% back then, in stark contrast to today's 4.25%.

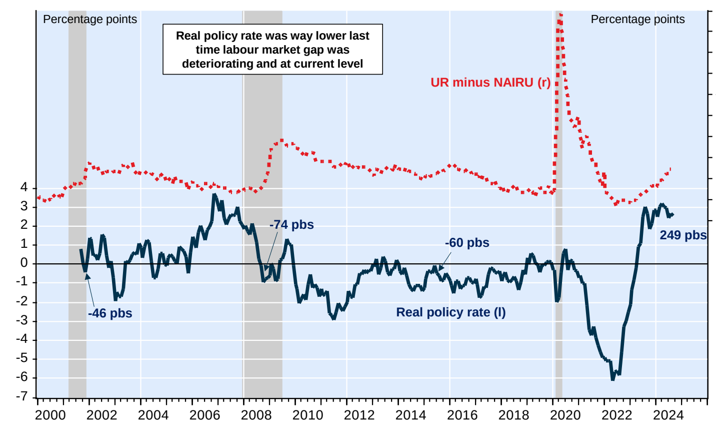
Canada: The policy rate should continue to weigh on the labour market
Unemployment rate and Bank of Canada policy rate



NBC Economics and Strategy (data via Statistics Canada)

An analysis of real interest rates, i.e. adjusted for inflation, leads to the same conclusion. The unemployment rate is now 4 decimals above the non-accelerating inflation rate of unemployment (NAIRU). The last time the unemployment rate was on an upward trend and in this situation, real interest rates were in negative territory, and on average over 300 basis points lower than at present.

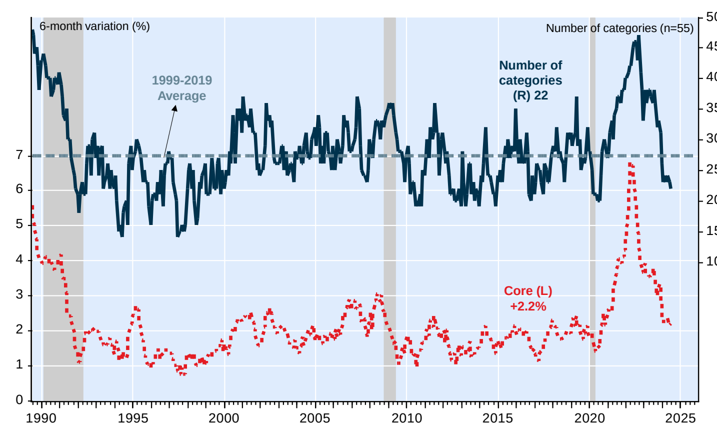
Canada: Real policy rate is overly restrictive given labour market
Labour market gap (UR minus NAIRU) and real policy rate (policy rate minus CPI excl. mortgage cost)



NBF Economics and Strategy (data via Refinitiv)

Overall, the latest data from Canada show us that the economy continues to be shaky and too weak to stabilize the rapidly deteriorating labour market. With annual inflation excluding mortgage interest costs already hovering around 2.0% for the past 7 months, and core inflation over the past 6 months essentially at the level targeted by the central bank, we believe the door is wide open for the Bank of Canada to bring its policy rate back to neutral (between 2.5% and 3.0%) as soon as possible. In the meantime, the damage to the labour market could be greater than necessary. We anticipate economic growth of just 0.9% in 2024 and 1.3% in 2025, which would translate into an unemployment rate of around 7.4% by mid-2025.

Canada: Perspective on core inflation
Average of the 6-m chg. in CPI-trim and CPI-median and categories (n=55) that have increased 2% or more



NBC Economics and Strategy (data via Statistics Canada)

Canada – Economic Forecast

Economic Forecast

*(Annual % change)**	*2021*	*2022*	*2023*	*2024*	*2025*	Q4/Q4 *2023*	*2024*	*2025*
Gross domestic product (2012 $)	5.3	3.8	1.2	0.9	1.3	1.0	1.2	1.8
Consumption	5.2	5.1	1.7	1.8	1.1	1.7	1.5	1.4
Residential construction	14.6	(12.1)	(10.3)	(0.8)	1.9	(3.1)	(1.8)	3.7
Business investment	8.7	4.0	(0.8)	(2.4)	0.4	(3.9)	1.2	1.4
Government expenditures	4.6	3.3	2.1	2.4	2.0	1.7	3.1	1.8
Exports	2.7	3.2	5.4	0.5	1.0	4.5	0.0	2.0
Imports	8.1	7.6	0.9	0.3	1.1	2.1	(0.3)	2.1
Change in inventories (millions $)	4,425	55,290	38,900	24,350	24,044	39,514	22,669	25,169
Domestic demand	6.1	2.8	0.5	1.4	1.4	0.8	1.7	1.7
Real disposable income	0.5	(0.1)	1.9	3.0	1.4	2.2	2.1	1.5
Employment	5.0	4.0	2.4	1.6	1.0	2.3	1.3	1.1
Unemployment rate	7.5	5.3	5.4	6.4	7.3	5.8	7.0	7.2
Inflation	3.4	6.8	3.9	2.5	1.9	3.2	2.1	1.9
Before-tax profits	33.2	14.7	(17.4)	(5.7)	1.6	(9.1)	(10.8)	6.5
Current account (bil. $)	0.4	(10.3)	(21.0)	(26.2)	(19.6)	....	....	....

** or as noted*

Financial Forecast**

	Current 9/09/24	*Q3 2024*	*Q4 2024*	*Q1 2025*	*Q2 2025*	*2023*	*2024*	*2025*
Overnight rate	4.25	4.25	3.50	3.00	2.75	5.00	3.50	2.75
Prime rate	6.25	6.25	5.50	5.00	4.75	7.00	5.50	4.75
3 month T-Bills	4.08	3.95	3.25	2.85	2.65	5.05	3.25	2.70
Treasury yield curve								
2-Year	3.04	2.95	2.75	2.55	2.40	3.89	2.75	2.55
5-Year	2.78	2.75	2.60	2.45	2.35	3.17	2.60	2.55
10-Year	3.01	2.95	2.85	2.70	2.60	3.11	2.85	2.80
30-Year	3.12	3.10	3.00	2.90	2.85	3.03	3.00	3.00
CAD per USD	1.36	1.37	1.41	1.39	1.38	1.32	1.41	1.36
Oil price (WTI), U.S.$	70	67	65	65	69	72	65	75

*** end of period*

Quarterly pattern

	Q3 2023 actual	*Q4 2023 actual*	*Q1 2024 actual*	*Q2 2024 actual*	*Q3 2024 forecast*	*Q4 2024 forecast*	*Q1 2025 forecast*	*Q2 2025 forecast*
Real GDP growth (q/q % chg. saar)	(0.3)	0.1	1.8	2.1	0.4	0.5	1.5	1.7
CPI (y/y % chg.)	3.7	3.2	2.8	2.7	2.2	2.1	2.4	1.8
CPI ex. food and energy (y/y % chg.)	3.4	3.4	2.9	2.8	2.8	2.6	2.9	2.3
Unemployment rate (%)	5.5	5.8	5.9	6.2	6.6	7.0	7.3	7.4

National Bank of Canada

Provincial Economic Forecast

	Real GDP (% growth) 2021	2022	2023f	2024f	2025f	Nominal GDP (% growth) 2021	2022	2023f	2024f	2025f
Newfoundland & Labrador	1.0	-1.7	-2.5	1.5	2.3	18.5	6.8	-3.1	2.8	2.5
Prince Edward Island	8.4	2.9	2.2	3.0	3.0	14.9	9.3	4.7	5.6	4.8
Nova Scotia	5.9	2.9	1.3	0.7	1.0	10.0	7.1	3.4	2.8	2.9
New Brunswick	5.3	1.1	1.3	0.6	0.8	10.9	7.4	3.5	3.3	2.7
Quebec	6.7	2.5	0.2	1.0	1.0	11.6	8.4	3.7	3.8	3.0
Ontario	5.4	3.9	1.4	1.0	1.3	9.8	9.2	4.3	3.5	3.1
Manitoba	1.3	3.3	1.3	0.7	1.2	9.2	8.6	3.9	3.2	3.1
Saskatchewan	-0.7	6.0	1.6	0.6	1.4	13.9	29.2	2.1	1.9	2.3
Alberta	4.6	5.0	1.5	1.0	1.7	24.9	22.0	-0.8	4.3	2.4
British Columbia	7.1	3.8	1.6	0.6	1.1	15.8	11.0	2.2	3.3	2.7
Canada	5.3	3.8	1.2	0.9	1.3	13.4	11.8	2.8	3.6	2.9

	Employment (% growth) 2021	2022	2023f	2024f	2025f	Unemployment rate (%) 2021	2022	2023f	2024f	2025f
Newfoundland & Labrador	3.6	4.3	1.7	2.8	0.9	13.1	11.2	9.9	10.0	10.0
Prince Edward Island	4.2	5.3	5.7	3.6	2.0	9.9	7.5	7.4	7.9	8.5
Nova Scotia	5.6	3.6	2.7	3.1	1.2	8.6	6.6	6.4	6.6	6.9
New Brunswick	3.2	2.7	3.4	3.0	1.1	9.1	7.2	6.6	7.1	7.9
Quebec	4.4	3.1	2.3	0.5	0.8	6.1	4.3	4.4	5.4	6.2
Ontario	5.2	4.6	2.4	1.4	1.0	8.1	5.6	5.7	7.0	8.1
Manitoba	3.7	3.2	2.5	2.4	1.0	6.4	4.5	4.8	5.4	6.4
Saskatchewan	2.6	3.5	1.8	1.9	1.1	6.5	4.7	4.8	5.4	6.0
Alberta	5.5	5.2	3.6	2.7	1.6	8.5	5.8	5.9	7.2	8.1
British Columbia	6.2	3.1	1.6	2.1	0.9	6.5	4.6	5.2	5.6	6.3
Canada	5.0	4.0	2.4	1.6	1.0	7.5	5.3	5.4	6.4	7.3

	Housing starts (000) 2021	2022	2023f	2024f	2025f	Consumer Price Index (% growth) 2021	2022	2023f	2024f	2025f
Newfoundland & Labrador	1.1	1.5	1.0	1.6	1.4	3.7	6.4	3.3	2.3	1.8
Prince Edward Island	1.2	1.0	0.9	1.3	1.3	5.1	8.9	2.9	2.2	1.9
Nova Scotia	6.0	5.6	7.2	9.0	8.5	4.1	7.5	4.0	2.6	1.9
New Brunswick	3.9	4.7	4.9	5.4	5.0	3.8	7.3	3.5	2.5	1.8
Quebec	69.4	58.2	39.5	49.7	52.5	3.8	6.7	4.5	2.6	2.0
Ontario	100.4	96.1	90.0	82.5	94.5	3.5	6.8	3.8	2.5	2.0
Manitoba	8.0	8.1	7.1	7.1	8.2	3.2	7.9	3.6	1.5	2.3
Saskatchewan	4.3	4.2	4.6	4.4	5.0	2.6	6.6	3.9	1.6	2.1
Alberta	31.9	36.4	35.9	45.8	46.5	3.2	6.5	3.3	2.8	1.6
British Columbia	47.6	46.7	50.6	46.5	53.5	2.8	6.9	4.0	2.6	1.9
Canada	273.8	262.5	241.7	253.3	276.4	3.4	6.8	3.9	2.5	1.9

e: estimate f: forecast

Historical data from Statistics Canada and CMHC, National Bank of Canada's forecast.

Subscribe to our publications: NBF.EconomicsStrategy@nbc.ca – To contact us: 514-879-2529

General

This Report was prepared by National Bank Financial, Inc. (NBF), (a Canadian investment dealer, member of CIRO), an indirect wholly owned subsidiary of National Bank of Canada. National Bank of Canada is a public company listed on the Toronto Stock Exchange.

The particulars contained herein were obtained from sources which we believe to be reliable but are not guaranteed by us and may be incomplete and may be subject to change without notice. The information is current as of the date of this document. Neither the author nor NBF assumes any obligation to update the information or advise on further developments relating to the topics or securities discussed. The opinions expressed are based upon the author(s) analysis and interpretation of these particulars and are not to be construed as a solicitation or offer to buy or sell the securities mentioned herein, and nothing in this Report constitutes a representation that any investment strategy or recommendation contained herein is suitable or appropriate to a recipient's individual circumstances. In all cases, investors should conduct their own investigation and analysis of such information before taking or omitting to take any action in relation to securities or markets that are analyzed in this Report. The Report alone is not intended to form the basis for an investment decision, or to replace any due diligence or analytical work required by you in making an investment decision.

This Report is for distribution only under such circumstances as may be permitted by applicable law. This Report is not directed at you if NBF or any affiliate distributing this Report is prohibited or restricted by any legislation or regulation in any jurisdiction from making it available to you. You should satisfy yourself before reading it that NBF is permitted to provide this Report to you under relevant legislation and regulations.

National Bank of Canada Financial Markets is a trade name used by National Bank Financial and National Bank of Canada Financial Inc.

Canadian Residents

NBF or its affiliates may engage in any trading strategies described herein for their own account or on a discretionary basis on behalf of certain clients and as market conditions change, may amend or change investment strategy including full and complete divestment. The trading interests of NBF and its affiliates may also be contrary to any opinions expressed in this Report.

NBF or its affiliates often act as financial advisor, agent or underwriter for certain issuers mentioned herein and may receive remuneration for its services. As well NBF and its affiliates and/or their officers, directors, representatives, associates, may have a position in the securities mentioned herein and may make purchases and/or sales of these securities from time to time in the open market or otherwise. NBF and its affiliates may make a market in securities mentioned in this Report. This Report may not be independent of the proprietary interests of NBF and its affiliates.

This Report is not considered a research product under Canadian law and regulation, and consequently is not governed by Canadian rules applicable to the publication and distribution of research Reports, including relevant restrictions or disclosures required to be included in research Reports.

UK Residents

This Report is a marketing document. This Report has not been prepared in accordance with EU legal requirements designed to promote the independence of investment research and it is not subject to any prohibition on dealing ahead of the dissemination of investment research. In respect of the distribution of this Report to UK residents, NBF has approved the contents (including, where necessary, for the purposes of Section 21(1) of the Financial Services and Markets Act 2000). This Report is for information purposes only and does not constitute a personal recommendation, or investment, legal or tax advice. NBF and/or its parent and/or any companies within or affiliates of the National Bank of Canada group and/or any of their directors, officers and employees may have or may have had interests or long or short positions in, and may at any time make purchases and/or sales as principal or agent, or may act or may have acted as market maker in the relevant investments or related investments discussed in this Report, or may act or have acted as investment and/or commercial banker with respect hereto. The value of investments, and the income derived from them, can go down as well as up and you may not get back the amount invested. Past performance is not a guide to future performance. If an investment is denominated in a foreign currency, rates of exchange may have an adverse effect on the value of the investment. Investments which are illiquid may be difficult to sell or realise; it may also be difficult to obtain reliable information about their value or the extent of the risks to which they are exposed. Certain transactions, including those involving futures, swaps, and other derivatives, give rise to substantial risk and are not suitable for all investors. The investments contained in this Report are not available to retail customers and this Report is not for distribution to retail clients (within the meaning of the rules of the Financial Conduct Authority). Persons who are retail clients should not act or rely upon the information in this Report. This Report does not constitute or form part of any offer for sale or subscription of or solicitation of any offer to buy or subscribe for the securities described herein nor shall it or any part of it form the basis of or be relied on in connection with any contract or commitment whatsoever.

This information is only for distribution to Eligible Counterparties and Professional Clients in the United Kingdom within the meaning of the rules of the Financial Conduct Authority. NBF is authorised and regulated by the Financial Conduct Authority and has its registered office at 70 St. Mary Axe, London, EC3A 8BE.

NBF is not authorised by the Prudential Regulation Authority and the Financial Conduct Authority to accept deposits in the United Kingdom.

EU Residents

With respect to the distribution of this report in the member states of the European Union ("EU") and the European Economic Area ("EEA") by NBC Paris, the contents of this report are for information purposes only and do not constitute investment advice, investment research, financial analysis or other forms of general recommendation relating to transactions in financial instruments within the meaning of Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 ("MiFID 2"). This report is intended only for professional investors and eligible counterparties within the meaning of MiFID 2 and its contents have not been reviewed or approved by any EU/EEA authority. NBC Paris is an investment firm authorised by the French Prudential Control and Resolution Authority ("ACPR") to provide investment services in France and has passported its investment services throughout the EU/EEA under the freedom to provide services and has its registered office at 8 avenue Percier, 75008 Paris, France.

NBF is not authorised to provide investment services in the EU/EEA.

U.S. Residents

With respect to the distribution of this report in the United States of America, National Bank of Canada Financial Inc. ("NBCFI") which is regulated by the Financial Industry Regulatory Authority (FINRA) and a member of the Securities Investor Protection Corporation (SIPC), an affiliate of NBF, accepts responsibility for its contents, subject to any terms set out above. To make further inquiry related to this report, or to effect any transaction, United States residents should contact their NBCFI registered representative.

This report is not a research report and is intended for Major U.S. Institutional Investors only. This report is not subject to U.S. independence and disclosure standards applicable to research reports.

HK Residents

With respect to the distribution of this report in Hong Kong by NBC Financial Markets Asia Limited ("NBCFMA") which is licensed by the Securities and Futures Commission ("SFC") to conduct Type 1 (dealing in securities) and Type 3 (leveraged foreign exchange trading) regulated activities, the contents of this report are solely for informational purposes. It has not been approved by, reviewed by, verified by or filed with any regulator in Hong Kong. Nothing herein is a recommendation, advice, offer or solicitation to buy or sell a product or service, nor an official confirmation of any transaction. None of the products issuers, NBCFMA or its affiliates or other persons or entities named herein are obliged to notify you of changes to any information and none of the foregoing assume any loss suffered by you in reliance of such information.

The content of this report may contain information about investment products which are not authorized by SFC for offering to the public in Hong Kong and such information will only be available to, those persons who are Professional Investors (as defined in the Securities and Futures Ordinance of Hong Kong ("SFO")). If you are in any doubt as to your status you should consult a financial adviser or contact us. This material is not meant to be marketing materials and is not intended for public distribution. Please note that neither this material nor the product referred to is authorized for sale by SFC. Please refer to product prospectus for full details.

There may be conflicts of interest relating to NBCFMA or its affiliates' businesses. These activities and interests include potential multiple advisory, transactional and financial and other interests in securities and instruments that may be purchased or sold by NBCFMA or its affiliates, or in other investment vehicles which are managed by NBCFMA or its affiliates that may purchase or sell such securities and instruments.

No other entity within the National Bank of Canada group, including National Bank of Canada and National Bank Financial Inc, is licensed or registered with the SFC. Accordingly, such entities and their employees are not permitted and do not intend to: (i) carry on a business in any regulated activity in Hong Kong; (ii) hold themselves out as carrying on a business in any regulated activity in Hong Kong; or (iii) actively market their services to the Hong Kong public.

Copyright