Quarterly Commentary

July 2024

Oh, Oh Canada!

As neighbours to the large and somewhat imposing US-of-A, it can be easy for us Canadians to lose some perception of the boundaries between our two great nations. This can be true in the sense of media, popular culture, trade, trends, etc. Indeed, at times, it can feel we know more about what's going on within the borders of our Southern neighbour than we do our own country. Perhaps nowhere is this more true than business media. Most media outlets feed a constant stream of data focused on U.S. markets—the S&P500 is up, the Dow is down, Jerome Powell said 'cut', Elon Musk Tweeted (do we still call it Tweeting?). Though market data is often misconstrued as economic data, the same is often true there—we seem inherently aware of the condition of the US economy, while the Canadian economy can be somewhat of an afterthought.

When it comes down to it, despite the close relationship between our two countries, we remain two fundamentally separate economies, with challenges unique to our respective governments, businesses and populations. These differences have been increasingly highlighted of late, with data over the past several months in particular pointing to a rapid softening of the Canadian economy. Our team has been monitoring this closely since 2022, and had previously conveyed our concerns in prior letters regarding Canadian growth, productivity, and debt (both personal and government) in the face of rising interest rates. Our expectation was the rising cost of servicing high household debt-loads would place significant strain on the average Canadian, which would result in a considerable slowing of economic activity. Combined with productivity numbers that have been shockingly low, record government deficits, and grocery/energy bills that defy even the very elevated inflation figures of the past two years, the cracks have increasingly started to show in Canada. Amidst such cracks, the fundamental differences between our economy and that of the U.S. become ever clearer.

Below we dive deeper into the details of some of these challenges and the outlook moving forward. Though there are some brighter lights, the majority unfortunately skew towards much slower economic growth in Canada looking forward.

GDP

The most-watched barometer for any economy is Gross Domestic Product (GDP). Broadly, GDP measures the total value of goods and services produced by a nation. April provided a flicker of hope, with industry-level GDP surprisingly advancing 0.3% month-over-month. That number retreated to 0.1% in May. Overall, business activity has been declining in Canada since mid-2023, as indicated by monthly Purchasing Managers' Index (PMI) data remaining in contractionary territory in both manufacturing and services since that time. Looking forward, TD Economics is forecasting a slowdown in Real GDP Growth as we move into Q3 2024, followed by a rather anemic growth outlook for 2025. All the factors discussed below affect GDP in different ways, but all, unfortunately, point to a less productive economy looking forward.

TD Economics GDP Outlook

Economic Indicator	2024				2025			
	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Real GDP	1.7	2.0	1.2	1.3	1.5	1.6	1.7	1.9

Interest Rates

Interest rates are a function of Bank of Canada's (BoC) target Overnight Lending Rates. This is the policy benchmark rate used by the BoC to broadly control the cost of borrowing in the economy. Banks and other lenders use this benchmark as the basis for their prime lending rates. Likewise, investors (being lenders of capital) also base their return expectations on cash and other fixed income products on this rate as well. Higher interest rates result in higher borrowing costs for users of capital (whether personal, business or government), and higher returns on capital demanded by lenders. Many loans, including variable-rate mortgages, Home Equity Lines of Credit (HELOCs), and consumer loans (such as auto loans) are based on the benchmark rate plus some additional, predefined spread which aims to compensate the lender for the risk of default.

There are many factors the Bank of Canada takes into consideration to determine interest rates. Current inflation rates, future inflation expectations, labour markets, and economic activity are some of the primary inputs. The outlook for these factors, the time-value-of-money, and the return demanded by lenders over certain periods, are expressed in the yield curve.

As we all know, inflation has been stubborn and difficult to bring down. The BoC has remained very focused on returning inflation to their 2% annualized target rate since hikes began in early 2022. However, rising rates have very real impacts on the amount of money required to service debt, and the availability and desire of businesses to take on new debt to finance growth. This can lead to a reduction in demand for goods and services, which can subsequently result in a decrease in labour demand as businesses look to cut costs. This is of course the overall goal of higher rates to begin with; slow demand to reduce prices and thus inflation.

The effects of monetary policy are inherently hard to control, however. Keep rates too high for too long and central banks risk hurting consumers and business too much. Rates that are too restrictive can push unemployment rates too high and reduce business activity too much, and can therefore push the economy into recession. In markets with higher debt loads, like Canada, higher interest rates would be expected to affect such dynamics sooner and to a larger degree. Although it may have taken longer to materialize than expected (for reasons discussed further below), labour markets and economic activity in Canada have begun to slow significantly faster than the U.S. Indeed, the Bank of Canada became the first developed nation to cut interest rates on the back of the recent hiking cycle, cutting their overnight lending rate by 0.25% on June 5th. They have since followed up with a second cut on July 24th. Looking forward, bond markets are pricing in at least one more cut in Canada before the end of 2024. Meanwhile, the U.S Federal Reserve (the 'Fed') has yet to cut once, and the outlook for cuts remains much more muddied.

As we have highlighted before, though economic conditions may warrant significant divergence away from U.S. policy, if the BoC moves too aggressively relative to the U.S. in reducing rates, our flailing Canadian currency will continue its downward spiral. For an economy that imports finished goods, this imports inflation as the Canadian dollar loses purchasing power, thereby negating the intended effect of rate cuts. Accordingly, the path forward for rate cuts may not be as straightforward as the BoC might wish.

TD Economics Interest Rate Forecast

Interest Rates	2024				2025			
	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Overnight Target Rate	5.00	4.75	4.50	4.25	3.75	3.25	3.00	2.75
5-yr Govt. Bond Yield	3.51	3.45	3.45	3.25	3.05	2.90	2.75	2.65
10-yr Govt. Bond Yield	3.45	3.40	3.40	3.30	3.20	3.05	2.95	2.85

TD Economics F/X Forecast

Exchange Rate to Canadian Dollar	2024				2025			
	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
U.S Dollar - USD per CAD	0.74	0.73	0.72	0.72	0.73	0.73	0.74	0.75

Consumer Debt Levels

As mentioned above, although it may have taken longer than anticipated, it appears higher interest rates are finally having a negative impact on consumer spending. Canadian's have the highest household debt-to-disposable-income ratio amongst developed economies, totaling approximately 180% for the average household. We also have the dubious distinction of having the highest household-debt-to-GDP ratio when compared to the U.S., the Euro Area, the U.K. and China, at approximately 103%.

High levels of debt amongst Canadians are not a recent phenomenon. The appetite for the single-family home has been strong since the rise of the baby boomer population and has long-been a tenant among Canadians' list of top priorities. Canadians have also been more willing to utilize their homes as piggy banks, drawing on HELOCs to finance various spending needs. A decade of near rock-bottom interest rates and strong demand (both domestic and foreign) in major centers has led to a significant rise in average house prices. Not surprisingly, mortgage debt and other consumer debt (such as auto and credit loans) have ballooned in response. The risks of such significant debt levels and the potential negative effects on economic growth have long been debated, as have the effects of mortgage lending and debt delinquencies on bank earnings. One thing for certain, however, is the quick rise in borrowing costs over the past two years has put stress on highly indebted households and is a situation poised to worsen as mortgage renewals ramp up over the next two years. Delinquency rates on consumer loans are on the rise and are likely to accelerate over the coming years.

More on Housing

High house prices can be viewed as a positive development for existing homeowners. For most Canadians, their home is the biggest contributing factor to their net worth. With net worth rising, homeowners feel at ease to consume goods and continue to travel.

When we compare house prices and rent-to-income ratios, Canada leads countries such as the U.S., Australia, the U.K., Germany and Japan. That said, TD's Wealth Investment Office recently published information gathered from the Canadian Real Estate Association that housing fundamentals point to a balanced market. Inventory (as measured by months of supply at the current rate-of-sale) stood at 4.4 months at the end of May, close to the long-term average of five months. Sales fell slightly and new listings ticked higher in May, resulting in a national sales-to-listing ratio of 53%, slightly below the long-term average of 55%.

In our Q3 2023 newsletter, we had highlighted the gorilla staring us in the face in the form of the upcoming mortgage renewal cycle set to ramp-up in 2025 and 2026. A recent Bank of Canada simulation suggested that even with a 2% cut in policy rates, median monthly payments on mortgages outstanding in February 2022 would increase by 34% between early 2022 and the end of 2027. Without the 2% reduction in policy rates, the median mortgage payment would be set to increase 44% over the same time period. It goes without saying, such an increase would have significant impacts on household balance sheets. Capacity to spend on discretionary items will be reduced significantly, while necessities may be pushed increasingly to credit cards or lines-of-credit. Those without such capacity may be faced with the choice of making a mortgage payment or making their credit card, auto-loan or HELOC payment. With rental rates rising as a result of falling supply, retaining one's home will likely take priority, leaving the potential for consumer-loan delinquencies to grind painfully higher.

On the other side of the house-price dilemma, young individuals and families are increasingly closed-off from the prospect of affording a home. Wages have not kept pace with the rise in house prices, mortgage rates are higher, and, making matters worse, rents are now at levels where saving money for a down payment by choosing to rent is a thing of the past. How this will evolve over the coming years remains to be seen, but the prospect of participating in this great Canadian tradition has become a painfully unrealistic one for many young people.

Labour and Productivity

The Canadian labour market added 26,700 jobs in May, slightly above expectations. However, the combination of a higher unemployment rate and stronger wage growth made for a mixed tone overall. This was vastly below the prior month's addition of 90,000 jobs. The unemployment rate continues to move upwards, now standing at 6.4%, compared to just 4.1% in the U.S. Signs are pointing to a softer hiring environment; people are taking longer to find jobs, with most placement being skewed to the public sector.

We highlighted labour productivity in our April newsletter. To recap, a recent study by the Organization of Economic Development ranked Canada 29th out of 38 countries for labour productivity, and very low in the ranks Real GDP per capita. Put simply, Canada's economy needs a significant jolt in productivity, though the prospects for such a jolt in the near-term are not overly likely.

TD Economics Unemployment Rate Outlook

Economic Indicator	2024				2025			
	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Unemployment Rate (%)	5.9	6.3	6.6	6.7	6.7	6.6	6.5	6.4

Market Commentary

Global equity prices posted another quarter of solid gains. The Canadian stock market was mostly stagnant in the second quarter despite attempting to maintain the positive momentum brought on by the Bank of Canada's June rate cut, while U.S. stocks finished the quarter strongly. Despite a brief setback in April, the S&P 500 Index and Nasdaq Composite Index both reached new record highs in Q2, fueled by continued optimism surrounding artificial intelligence stocks.

Meanwhile, a rise in U.S. Treasury yields weighed on bond prices amid rising inflation expectations and higher inflation-adjusted borrowing costs.

U.S. Equities

Growth stocks, communication services, and momentum factors once again powered U.S. equities to the top of the global equity market leader board. The gap between the S&P 500 and its equal-weighted counterpart has reached its widest in 15 years. The spread should come as no surprise considering how much we have heard of the Magnificent 7 this year. Data from the S&P and Dow Jones Indices show a ~10.9% spread in total returns between the two indices in the first half of the year (8.5 vs 19.4%, respectively), raising concerns that a shift in sentiment could derail this year's rally.

Some strategists are noting that the high valuations of tech stocks, reminiscent of those seen during the dotcom bubble, pose market risks if growth expectations aren't met. Excluding Nvidia, the S&P 500's gains would be around 10%; excluding the top seven tech stocks, the gains would total just over 6%.

Canadian Equities

The S&P/TSX Composite Index continued to lag the tech-heavy U.S. market, posting a 4.69% return year to date as of June 28th. It posted a 1.3% loss in the second quarter with nine of eleven sectors being negative. Materials and consumer staples were the only positive sectors during the quarter. Materials have historically performed well near the end of positive economic cycles, while the strengthening consumer staples sector highlights a shift to more defensive positioning.

Fixed Income

The primary investment-grade fixed income indices tracked by our team were mixed in Q2. Canadian investment-grade bonds, as measured by the FTSE Canada Universe Bond Index, were up 0.9% for the quarter. The key global investment-grade bond benchmark was down 1.1%, while high-yield bonds in Canada were up 1.5%.

With weakening data opening the door for further rate cuts by the Bank of Canada, this should be a tailwind for Canadian bond prices going forward.

At the beginning of the year, bond investors in the U.S. wholeheartedly embraced Jerome Powell's December 2023 announcement that the U.S. Federal Reserve expected to cut rates three times in 2024. The market quickly priced in six rate cuts. We have yet to see a single cut in the U.S. this year, though recent speculation has increasingly focused on September as a potential turning point. Our team currently remains skeptical the Fed would cut so close to the November election, given a desire to remain out of the partisan political headlines that would surely follow. This points to the December meeting for a first rate cut, barring major changes in the economic outlook. Whether the Fed can or will wait that long remains to be seen.

Borger Griffiths Wealth Management Portfolio Positioning

In anticipation of slowing global economic growth, we have been shifting portfolios to more defensive positioning, having taken advantage of higher interest rates which now appear to be on a downward trajectory. As interest rates move down, we believe that dividend-paying equities will once again become more attractive to investors seeking tax-efficient cash flow. At this time, we expect to maintain this defensive bias until after the U.S. election, given the potential for enhanced market volatility during the lead-up to the vote. We continue to remain cautious on the forward outlook for the Magnificent 7, having taken some profits on positions exposed to these names. Although presently generating record cash flows, their multiples have nonetheless expanded, and we believe they are currently overvalued; only time will tell the full story.

The Borger Griffiths Wealth Management team thanks you for your business and continued trust in us. We look forward to continuing to work with you and your family as we help navigate your financial journey with deep knowledge, diverse experience, and commitment on your side. If you have any questions or issues you would like to discuss, we would be happy to receive your call. We hope you enjoy a relaxing summer with family and friends.

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Sources: TD Economics, Statistics Canada, Bureau of Labor Statistics, Federal Reserve Bank of St. Louis, TD Wealth Investment Office, TD Wealth Monthly Performance Monitor, BCA Research, The Globe and Mail, Bloomberg, JP Morgan Asset Management
https://economics.td.com/ca-forecast-tables#lt-ca

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