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ECONOMIC VIEWPOINT

Canadian Household Finances: What's Next for Budgets and Balance Sheets?

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As the rapid run-up in asset values during the pandemic starts to reverse, Canadians are wondering what's next for their finances. We expect income growth to remain robust in the face of rising interest rates, buoying consumption. At the same time, the savings rate should gradually trend lower while still remaining elevated relative to pre-pandemic levels. But net wealth is likely to be a bigger concern for most households. Because liabilities tend to be stickier, falling asset prices erode net wealth. This dynamic is projected to persist through 2022 if home and other asset prices continue to decline. Delinquencies are also projected to rise. However, most Canadian households should weather this correction. With the Bank of Canada likely to begin cutting interest rates before the end of 2023, asset prices are ultimately expected to stabilize.

It's been a tough couple of years for Canadian households. The COVID-19 pandemic threw working arrangements into disarray, leading to job losses and massive government transfers to shore up incomes. This drove up home and other asset prices, as well as inflation. Surging employment, job vacancies and wages soon followed.

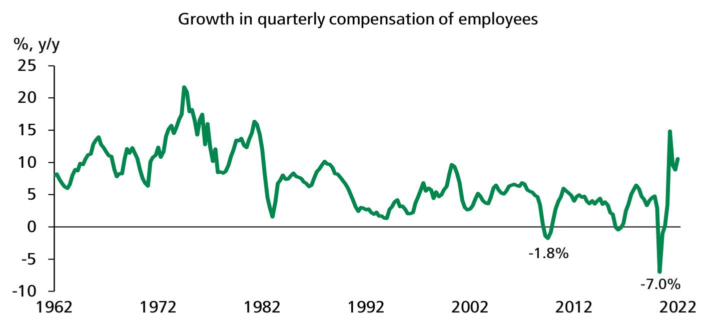
But cracks have begun to show in the pandemic recovery recently as interest rates have risen globally. Households are left wondering what's next. In this note, we'll quickly recap where Canadian household finances stand and how they got here, then dig into the outlook for household budgets and balance sheets over the next couple of years. But buckle up. It may get a little bumpy.

The State of Canadian Household Finances

In the decade leading up to the pandemic, household income and home prices were rising steadily, supported by robust employment and wage gains. Then came COVID-19. Employment dropped like a stone, particularly in client-facing service sectors. Compensation of employees fell sharply as a result, posting the largest annual decline on record in 2020 (graph 1).

To bolster household incomes, governments stepped in aggressively to fill the void. Fiscal transfers to households increased by around 50% to over $350 billion in 2020 and remained elevated throughout 2021 and into 2022, though they've been declining steadily (graph 2 on page 2). In the depths of the pandemic, these transfers replaced lost household income and then some, allowing household consumption to rebound quickly (graph 3 on page 2). And with many services inaccessible for public health reasons, these income gains were poured into goods purchases, compounding the sharp acceleration in global goods demand and inflation we've seen for more than a year.

GRAPH 1
Employee compensation fell more in 2020 than in any other year on record



Sources: Statistics Canada and Desjardins, Economic Studies

But not all this income windfall was spent. Savings increased at a record pace as many households set some of it aside for a rainy day. Deposits and holdings of financial assets rose substantially

NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.
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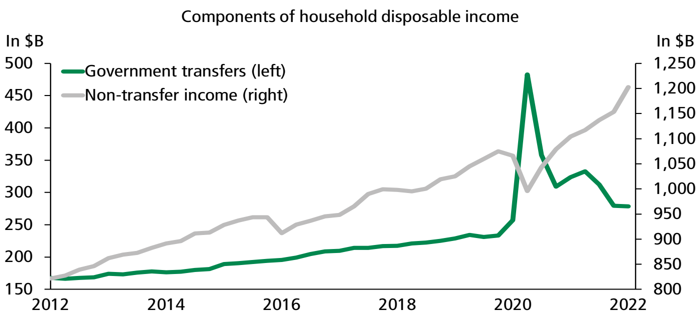
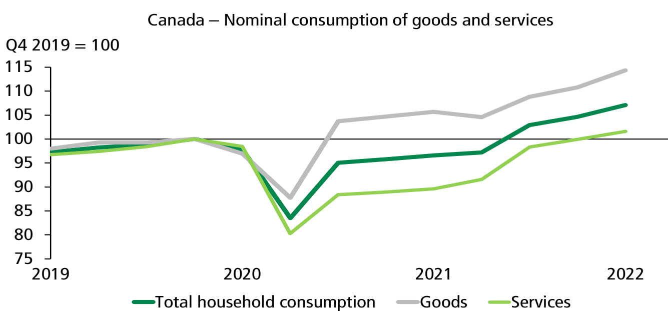
GRAPH 2
Government transfers supported household incomes in the pandemic



Sources: Statistics Canada and Desjardins, Economic Studies

GRAPH 3
Goods consumption skyrocketed while services have barely recovered



Sources: Statistics Canada and Desjardins, Economic Studies

as a result. With households looking for opportunities to invest these excess savings, home prices surged as Canadians fanned out far and wide in search of more space during COVID-19 lockdowns. Many Canadians also bought second homes.

As Canadians were taking on more mortgage debt, they paid down consumer debt as well. Household liabilities therefore didn't rise at nearly the pace that asset values did. Consequently, total household net wealth increased dramatically during the pandemic, not just in absolute terms but also as a share of nominal GDP and household disposable income.[1]

When this is all tallied up, Canadian households began 2022 in a very healthy spot. Despite the phase-out of emergency government transfers, household income is rising quickly thanks to a very tight labour market. Consumption has also remained brisk even in the face of sustained high inflation as Canadians have tapped into their substantial savings to enjoy services that were largely inaccessible during the pandemic. Meanwhile, the savings rate has come down from its record peak but remains elevated compared to its pre-pandemic average. And household wealth remained robust at the start of the year even as housing and equity markets began to roll over as a result of tighter monetary policy.

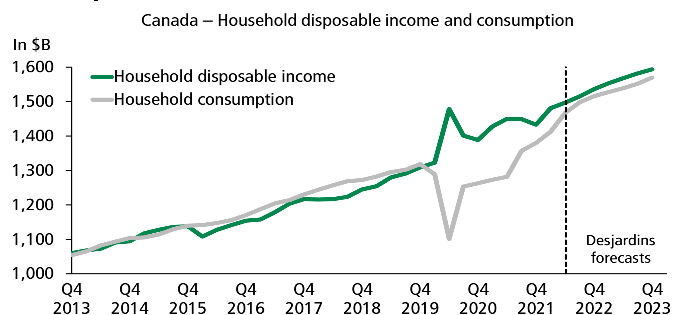
The Outlook for Canadian Household Finances

Now that we know where Canadian household finances stand and how they got here, the key question is: What can Canadian households expect going forward? This requires a more thorough look at our forecast for Canadian household income, spending, savings, assets, liabilities and, ultimately, net wealth—because they all play a role in the health of household finances. They also influence one another to varying degrees and are impacted by rising interest rates around the globe.

Outlook for Household Income

Looking ahead, government transfers will continue to decline toward their pre-COVID trend over the next couple of years. However, we think the labour market is in a healthy enough position to absorb this loss of income. Employment growth has been very strong in the first half of 2022. And while we expect hiring to moderate somewhat as rising interest rates mute economic growth, we anticipate that job gains will remain in positive territory. But possibly more important given the current high inflation backdrop, we anticipate average weekly wages to continue to post solid gains as workers look to recoup some of the real income losses incurred in 2021 and 2022. This should help to ensure that nominal household disposable income advances at a healthy pace of around 4.5% on average annually in 2022 and 2023 (graph 4). That said, on a quarterly basis, we expect growth in household disposable income to gradually moderate to a more typical pace over the forecast. This will happen as the effects of the pandemic fade in the rear view, the labour market loosens as economic growth cools, and inflation takes less of a bite out of real wages. At the same time, growth in real household disposable income should turn positive this year but still increase at a modest pace as inflation remains high.

GRAPH 4
A confluence of forces should keep earnings ahead of consumption



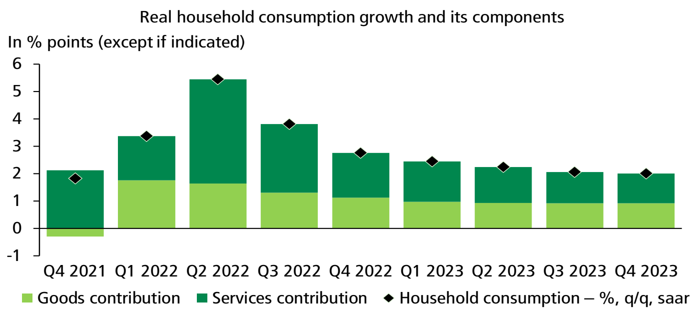
Sources: Statistics Canada and Desjardins, Economic Studies

[1] For more information on the path of household finances in the first year and a half of the pandemic, see: *How Has the Pandemic Affected Canadians' Financial Situation across the Country?*, Desjardins, Economic Studies, *Economic Viewpoint*, November 1, 2021, 5 p.

Household Spending Drivers and Outlook

Despite the expectation that household income growth will remain buoyant, we anticipate the pace of consumption growth to slow after a strong start to 2022 (graph 5). There are a few reasons for this. The first is simply that the tailwind to spending on services as the economy reopens is likely to subside as life returns to normal. That's the good news.

GRAPH 5
Services will help keep consumption growth elevated in the near term

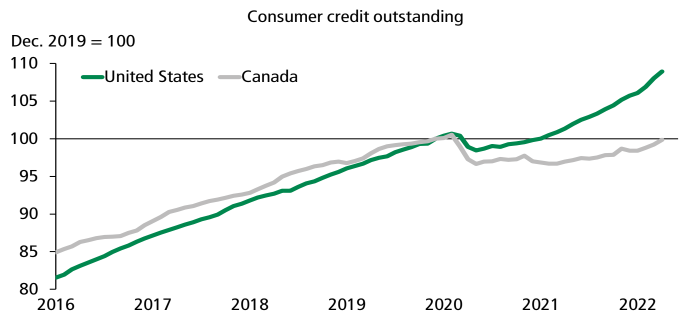


Sources: Statistics Canada and Desjardins, Economic Studies

But there are also less positive reasons for the spending slowdown. The first is inflation. Goods prices are elevated, and inflation is expected to continue to be high into early 2023 as supply chain disruptions persist. Another is that consumption of durable goods such as home appliances and motor vehicles tends to follow the purchase of a home, and the housing market is expected to cool over the coming quarters. The catalyst for the impending housing market slowdown is higher interest rates, which is another deterrent to borrowing for consumption. All told, we're seeing higher prices for consumer goods and services amid rising borrowing costs to pay for them. Add to that, uncharacteristically high demand for goods during the pandemic, and it becomes clear why future demand is likely to moderate.

However, there's an important caveat to this outlook. Consumer credit fell sharply during the pandemic and, despite rising modestly from its Q2 2021 trough, remained 4,8% below its Q4 2019 peak at the beginning of 2022. In contrast, consumer credit has recovered faster in the US, where both COVID lockdowns and government support were removed sooner than in Canada (graph 6). This suggests there may be room for consumers to increase borrowing to smooth consumption going forward. New motor vehicle sales also remain well below their pre-pandemic levels and are still mostly constrained by supply, as was outlined in our recent *Economic Viewpoint*. As more vehicles hopefully become available later this year and next, we expect sales to recover as buyers who've been on waiting lists finally take delivery. This could lead to above-trend growth in consumer credit despite higher interest rates.

GRAPH 6
The recovery in consumer credit has been much slower in Canada than in the United States



* Credit secured by real estate has been excluded from Canadian consumer credit for comparison.
Sources: Bureau of Economic Analysis, Statistics Canada and Desjardins, Economic Studies

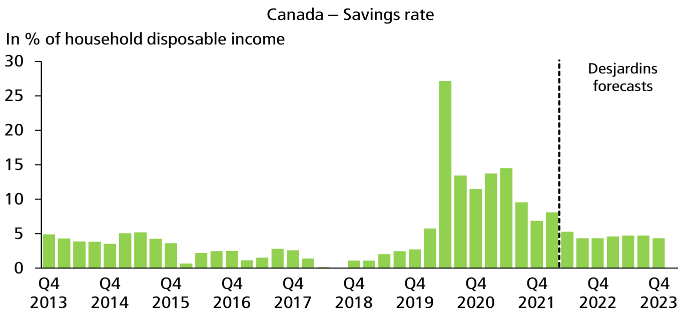
Compare that with mortgage credit, which started 2022 more than 20% higher than it ended 2019, driving aggregate household credit 14% higher over the course of the pandemic. As a result, household credit reached 185% of household disposable income for the first time on record at the end of 2021, although it pulled back slightly in Q1 2022. This leaves households highly indebted as the pandemic gradually comes to a close, suggesting that rising interest rates may act as a brake on the rebound in household borrowing for consumption.

This leads to another area of spending that is likely to weigh on consumption: debt service cost. After falling considerably during the pandemic, the debt service ratio—household debt payments as a share of disposable income—has gradually moved higher. However, it's still below the average of the 15 years preceding the pandemic. But it's also a tale of two types of debt service. While the non-mortgage debt service ratio finished 2021 near its pandemic low, the mortgage debt service ratio ended last year near its pre-pandemic peak—in spite of interest rates remaining at or near all-time lows at the end of the year. This suggests Canadians with large mortgage debt burdens may have to cut back on spending rather abruptly as interest rates rise and their mortgage comes up for renewal.

Household Savings Drivers and Outlook

In our baseline scenario, household disposable income growth is expected to remain robust while consumption is likely to advance at a more modest pace. As a result, the household savings rate is anticipated to move lower only gradually over the forecast (graph 7 on page 4). But while the savings rate may be declining, it's not expected to fall below 4% nationally. This is still high compared to the pre-COVID savings rate and reflects relatively strong earnings growth, weaker demand for new consumer goods, and uncertainty about the Canadian economy.

GRAPH 7
The savings rate is expected to gradually fall but still remain elevated



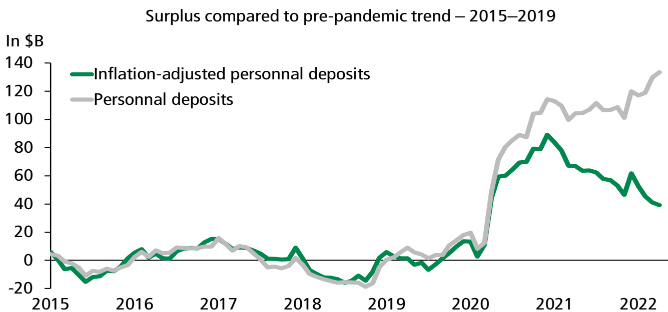
Sources: Statistics Canada and Desjardins, Economic Studies

Household Asset Drivers and Outlook

Although the overall asset picture has been very positive given recent market volatility, important vulnerabilities exist. Asset growth has been mainly driven by valuations in the housing and equity markets, both of which are susceptible to corrections. Traditional savings are also being eaten away by high inflation, causing real deposits to fall quickly.

Excess household savings have largely been accumulated in the form of deposits with financial institutions since the beginning of the pandemic. This led to a phenomenal break from the trend in personal deposit growth, contributing to the build-up of monetary aggregates.[2] We haven't seen this trend begin to reverse yet, and surplus deposits remain elevated and growing, owing largely to income growth. But when we look at deposits in real terms, a different story emerges. Deposits have offered very low returns thus far, so this massive surplus has been losing real value quickly due to inflation (graph 8).

GRAPH 8
Surplus deposits accumulated during the pandemic are being eroded by inflation

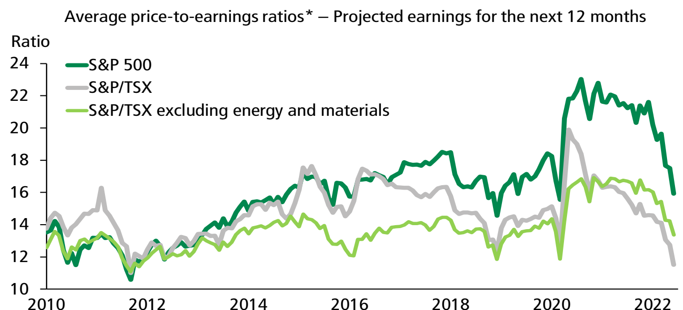


Sources: Bank of Canada and Desjardins, Economic Studies

With historically low real returns on deposits, many households chose to invest their savings in financial markets during the pandemic. This led to two successive years of exceptional growth for equity values, especially in North America. Unfortunately, here too growth in asset values may have been partly inflated by highly expansionary monetary policy. While corporate earnings did rebound strongly from the depths of the pandemic, this didn't justify the late 2021 equity valuations. It's therefore not surprising that much of that value was given back during the recent market correction. Although the S&P/TSX index fared better, Canadian households hold a large share of their portfolio holdings in foreign equities.

Even after the recent drop, risks to equity markets remain tilted to the downside. With the economy slowing down and the possibility of a recession increasing, corporate earnings could take a hit. Even if economic growth remains strong, stock valuations are still relatively high, especially given today's rising interest rates. In fact, the S&P/TSX's low average price-to-earnings ratio is quite misleading. If you take out the energy and materials sectors, both of which are generating substantial earnings at the moment, the average price-to-earnings ratio for Canadian stocks is still above the average seen in the last cycle. This is like the US equities listed on the S&P 500 (graph 9). Add to this better returns on cash and bonds, and investors could continue to snub stocks with low dividends and low growth prospects.

GRAPH 9
Price-to-earnings ratios have fallen from their pandemic peaks but remain high in the United States and Canada



* Last data point as of June 30.
Sources: Datastream and Desjardins, Economic Studies

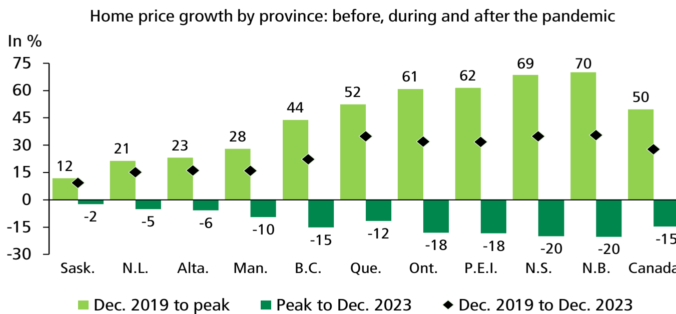
But for most Canadian households, their biggest asset continues to be real estate. And it looks as though economic conditions will be challenging for Canada's housing market over the next couple of years. In two recent *Economic Viewpoints*,[3] we outlined our forecast for the Canadian housing market in some detail. We expect the average price of existing homes in Canada to fall by

[2] One of the most inclusive measures of the money supply in the economy can be computed by adding up all currency in circulation, personal and non-personal deposits in financial institutions, savings bonds and Canadian dollar money market mutual funds. This corresponds to gross M2++.

[3] Canada's Housing Market Correction Has Begun. Is It a Good or a Bad Thing?, Desjardins, Economic Studies, *Economic Viewpoint*, June 14, 2022, 5 p.; Canadian Residential Real Estate Outlook, Desjardins, Economic Studies, *Economic Viewpoint*, June 8, 2022, 6 p.

around 15% nationally from their February 2022 level by the end of 2023 (graph 10). The largest corrections are expected in the Maritimes, Ontario, British Columbia and Quebec, although no province will be immune. That said, we don’t anticipate average home prices will fall below their pre-pandemic level in any province. As such, while the value of household real estate assets will decline, we don’t expect the bottom to fall out of the Canadian housing market.

GRAPH 10
Home prices will fall, but likely not as much as they rose during the pandemic



Sources: Canadian Real Estate Association and Desjardins, Economic Studies

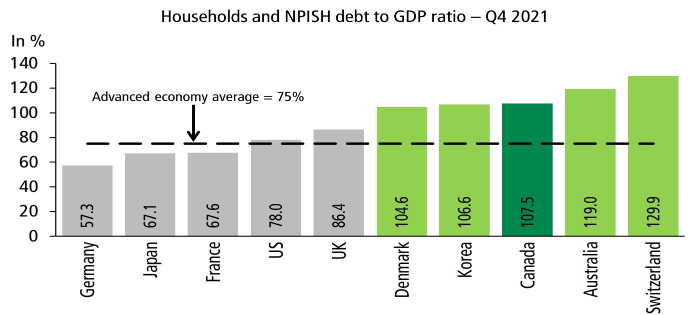
All told, given rising interest rates and a slowing economy, the value of risky assets will remain volatile. But Canadians should at least be able to benefit from increasing returns on bonds and term savings. As inflation moderates, positive real returns on safe assets will make a comeback, helping Canadians to preserve at least a part of their capital.

Household Liabilities Drivers and Outlook

While real estate is the most important asset held by a majority Canadian households, the debt incurred to buy that asset is also their biggest liability. And mortgage debt is huge, accounting for nearly two-thirds of the $2.7 billion mountain of household debt as of Q1 2022. This makes Canada the third most indebted country in the world when it comes to household debt-to-GDP (graph 11). The outlook is brighter for non-mortgage debt, which inched down during the pandemic and remains about 2.2% lower than it was when the pandemic began. However, it still represents a $700 billion liability that will weigh heavily on households as interest rates rise. While the value of assets can fluctuate, debt tends to stick around. Inflation does help reduce the relative importance of debt, but because it leads to higher interest rates, there will be more pain ahead.

Even though housing market activity is expected to slow in coming years, the size of mortgage debt is likely to keep increasing. As we know, growth in mortgage debt is mainly driven by the total size of housing market activity. In order to see a decrease in outstanding mortgage credit, new mortgages issued have to be lower than the principal that is repaid. By

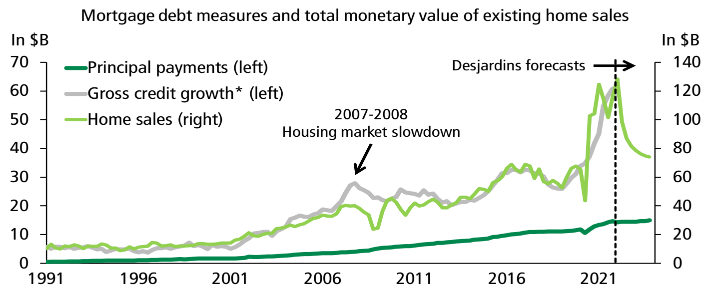
GRAPH 11
Canadian households are among the most indebted in the world



NPISH: Non-profit institutions serving households
Sources: Bank for International Settlements and Desjardins, Economic Studies

adding principal payments to the increase of outstanding credit, we get a measure of gross change in mortgage credit which tracks total new credit issued and the monetary value of home sales quite well in Canada (graph 12). But based on our housing market forecast, even if the total monetary volume of transactions drops significantly, it should keep generating enough new mortgage credit to make up for principal repayments. Furthermore, households tend to repay less on their debt when interest rates rise, as they become more cash strapped as was the case in 2007–2008. This leads us to forecast that, while mortgage credit growth will slowdown significantly in the coming years, it should remain positive unless deeper correction of the housing market occurs.

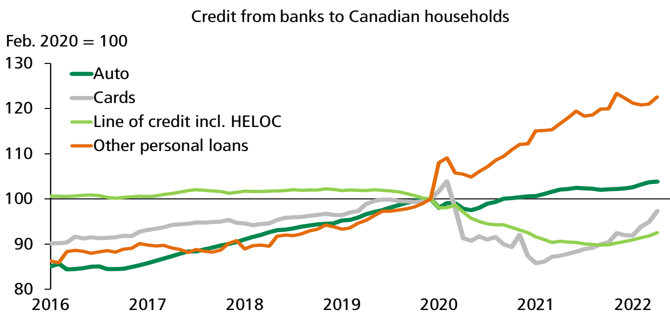
GRAPH 12
Even if housing market activity cools, new credit should more than make up for debt repayment



* Sum of the increase in outstanding credit and obligated principal payments (yearly average shown).
Sources: Statistics Canada and Desjardins, Economic Studies

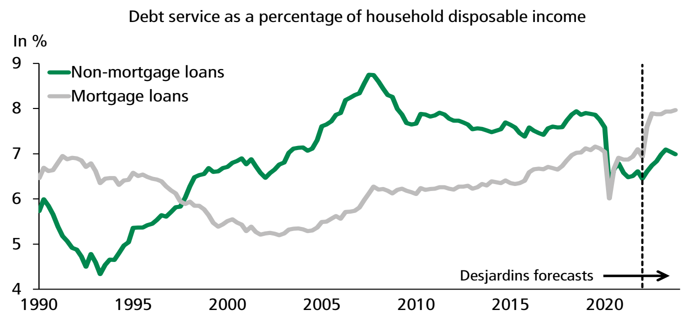
As we mentioned earlier, there’s also still upside risk for consumer credit, which constitutes the bulk of households’ non-mortgage liabilities. For instance, while personal and auto loans have now completely recovered from the pandemic, credit cards and lines of credit both lag behind (graph 13 on page 6). The increase in credit card balances has picked up the pace since the beginning of 2021, driven in part by higher consumer prices. Meanwhile, lines of credit, both secured (e.g., HELOCs) and

GRAPH 13
There is still room for credit card and line of credit debt to grow



HELOC: Home equity line of credit
Sources: Statistics Canada and Desjardins, Economic Studies

GRAPH 15
The debt service ratio is moving up and could reach an all-time high for mortgage loans

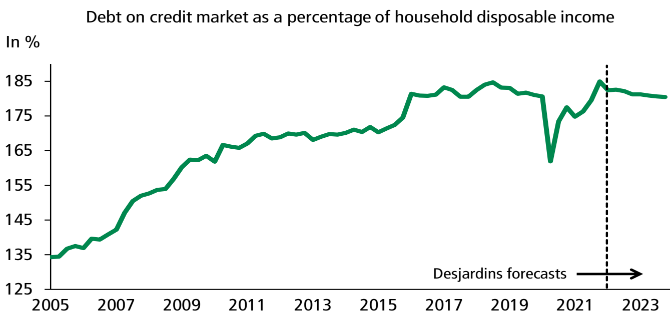


Sources: Statistics Canada and Desjardins, Economic Studies

unsecured are typically used by households when they become more cash strapped. A falling savings rate and rising debt service ratio suggests that the financial situation of some households is likely to deteriorate. As such, stronger consumer credit growth is expected going forward, as many households see their savings shrink and revert to credit to support their level of consumption.

The recovery in consumer credit and continuing growth in mortgage loans could mean that household debt-to-income ratio won't come down any time soon (graph 14). It should gradually inch lower, as the slowing housing market will eventually weigh on overall liability growth. By then, households' mortgage debt service ratio will have reached an all-time high, which could seriously impede housing sector activity and consumer spending thereafter (graph 15).

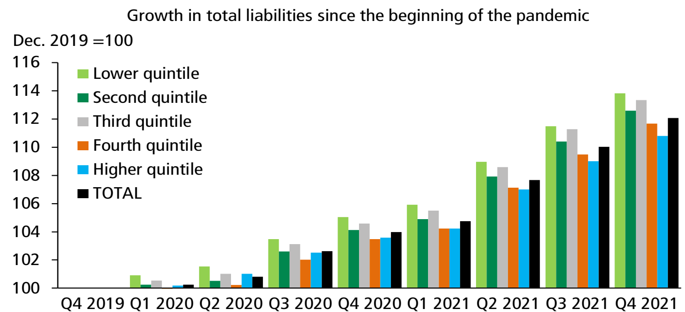
GRAPH 14
Household indebtedness has moved back up and could take time to decrease



Sources: Statistics Canada and Desjardins, Economic Studies

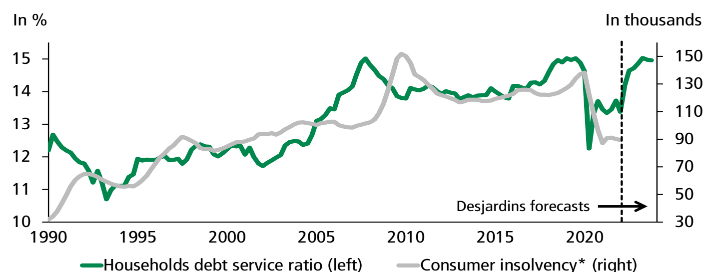
That said, the overall debt service ratio won't look as bad, owing to the relatively smaller share of non-mortgage debt in the total, which is notably more expensive to service. But looking at the debt service ratio as an aggregate doesn't tell the whole story. The distribution of income and liabilities matters too. Unfortunately, that's not very reassuring either. Since the beginning of the pandemic, the bottom fifth of income earners in Canada (known as the lower income quintile) has seen the sharpest percent increase in the size of its liabilities (graph 16). This leaves low-income households particularly vulnerable to an increase in interest rates and falling asset values. Inevitably, high debt levels, coupled with rising interest rates will lead to more consumer insolvency, as has been the case in the past (graph 17).

GRAPH 16
Liabilities have increased more for households with lower incomes



Sources: Statistics Canada and Desjardins, Economic Studies

GRAPH 17
Increasing debt service usually leads to more consumer insolvency

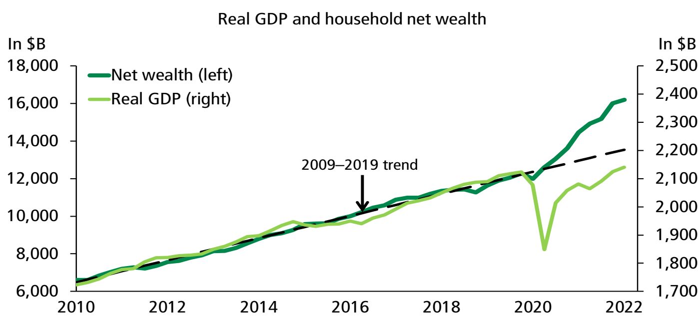


* Annual moving sum.
Sources: Statistics Canada, Office of the Superintendent of Bankruptcy and Desjardins, Economic Studies

Household Wealth Drivers and Outlook

With the value of many assets at risk and liabilities increasing for Canadian households, the outlook for wealth looks bleak. And there is good reason for that. The massive run-up in Canadians' wealth during the pandemic was almost solely driven by easy monetary policy and generous government spending programs. Production has been lower during the pandemic, meaning the supply of goods and services is constrained, while wealth that can be used to buy them is plentiful (graph 18). Left unchecked, such a situation can only lead to even faster inflation, which will in turn reduce the real value of assets, liabilities and wealth.

GRAPH 18
The divergence from trend in household net wealth doesn't appear sustainable



Sources: Statistics Canada and Desjardins, Economic Studies

Central banks are trying to bring inflation back in check while preserving economic growth. This balancing act will mean either erasing some asset value or keeping assets in the form of savings for long enough for production capacity to catch up. Interest rate hikes are intended to have precisely that effect. They lower the value of risky assets, reduce household consumption by increasing debt servicing costs, and keep savings in the bank by offering comparatively better returns on fixed income products and traditional savings.

Conclusion

By the end of this unusual economic and financial cycle, the massive wealth accumulated by Canadian households will most likely have shrunk, at least in real terms. The extent of this reduction, however, remains highly uncertain and will depend on how smoothly the Bank of Canada navigates a soft landing of the economy. The distribution of net wealth will also matter. Canadians with lower incomes and high levels of liabilities will feel the pain before others. And increasing insolvencies in that segment of the population could have far-reaching consequences for the economy, even if overall net wealth remains higher than before the pandemic.

Fortunately, income growth is expected to remain healthy even as inflation decelerates, ultimately turning positive in real terms as the lagged effects of inflation feed into wages and current price growth fades. This should help to buoy consumption and limit loan delinquencies and consumer insolvency. And as the Bank of Canada takes its foot off the brake as economic activity slows, asset values and wealth should stabilize at a level that is more typical of a balanced economy.