ECONOMIC & FINANCIAL OUTLOOK

Several Central Banks Grow Impatient and Signal Further Interest Rate Hikes

HIGHLIGHTS

- Interest rates have risen over the past month as central banks have become more hawkish. The lack of progress in slowing economic activity and cooling inflationary pressures has seen the Bank of Canada move off the sidelines and the US Federal Reserve eye an even higher terminal rate. That's pushed interest rates higher across sovereign yield curves.
- The eurozone has already posted two consecutive quarters of real GDP declines, and previous interest rate hikes will likely result in further contractions in the coming quarters. The United Kingdom has avoided a recession so far, but its economy is also expected to deteriorate further. Japan is now also seeing rising prices. But inflation is non-existent in China, where a faltering economic rebound is the main concern.
- The US economy continues to grow for now, with modest real GDP growth forecast for the second and third quarters of 2023. But between the 500 basis points' worth of rate hikes delivered by the Federal Reserve since March 2022 (with another expected in July), the impact it's had on mortgage rates, tighter credit conditions and the global economic slowdown, sooner or later economic activity will take a hit. Real GDP is forecast to fall in the final quarter of 2023 and into 2024.
- The Canadian economy continues to best the forecasts of economists. Real GDP growth in the first quarter of 2023 was just the latest example, hitting 3.1% annualized, well above the Bank of Canada's forecast of 2.3%. But we don't expect the strength to last. Even though Q2 2023 real GDP growth is shaping up to be around 1.5% or maybe even better, the strength in the quarter is likely to be front-loaded. We expect growth to weaken further through the second half of the year and into early 2024.
- In Quebec, slower population growth than in the rest of Canada is providing less support to the economy, which has been weak since the start of the year. So far, strong consumer spending has managed to keep Quebec's economy afloat, but it's on fragile footing. Our scenario predicts a period of real GDP contraction lasting into early 2024.

CONTENTS

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NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

RISKS INHERENT IN OUR SCENARIOS

While inflation is showing signs of slowing, it remains high around the world and sticky in some countries. It's prompted central banks to announce further rate hikes and signal that more are still to come, after which they may keep rates higher for longer. The effects of monetary tightening, including the lagged effects of earlier rate hikes, could prove to be a bigger drag on growth than expected. Breaking points may be tested, with unforeseeable spillover effects into other sectors. If things get more difficult for the global economy, Canada could see weaker exports and a sudden worsening of terms of trade. Diplomatic tensions between the US and China, as well as between China and Canada, could lead to additional trade restrictions. Higher unemployment and interest rates could also mean a bigger housing market correction in Canada. Although the recent turmoil in the US banking sector has eased, if it returns, it could spell much tighter credit conditions for all economic agents, aggravating existing challenges. Some US financial institutions could see their ratings downgraded and their borrowing costs go up. The financial turmoil could also spill out over the US border. A deeper economic slowdown could result in more bankruptcies and sharper price corrections in a number of asset classes. From a currency standpoint, if the global economy deteriorates sharply, risks are tilted more to a rapid appreciation of the US dollar, especially against the currencies of countries considered more economically and financially fragile. That could increase some vulnerabilities and spark foreign debt crises. Also, the potential for disruption from extreme weather events is increasingly difficult to ignore, adding to an already uncertain macroeconomic environment.

TABLE 1
World GDP growth (adjusted for PPP) and inflation rate

	WEIGHT*	REAL GDP GROWTH			INFLATION RATE		
%		2022	2023f	2024f	2022	2023f	2024f
Advanced economies	**38.7**	**2.7**	**1.0**	**0.8**	**7.1**	**4.5**	**2.4**
United States	15.7	2.1	1.5	0.7	8.0	4.1	2.5
Canada	1.4	3.4	1.7	0.3	6.8	3.7	2.2
Quebec	*0.3*	*2.8*	*0.4*	*0.3*	*6.7*	*3.9*	*2.1*
Ontario	*0.5*	*3.7*	*0.0*	*1.0*	*6.8*	*3.3*	*1.9*
Japan	3.7	1.0	1.0	0.7	2.5	2.6	1.4
United Kingdom	2.3	4.1	0.2	0.3	9.1	6.7	2.8
Eurozone	11.9	3.5	0.3	0.6	8.4	5.5	2.4
Germany	*3.3*	*1.9*	*-0.5*	*0.5*	*6.9*	*6.2*	*2.7*
France	*2.3*	*2.5*	*0.4*	*0.4*	*5.2*	*5.4*	*2.6*
Italy	*1.8*	*3.8*	*1.0*	*0.6*	*8.2*	*6.1*	*2.4*
Other countries	4.2	3.0	0.8	1.4	5.8	4.5	2.3
Australia	*1.0*	*3.7*	*1.6*	*1.4*	*6.6*	*5.6*	*3.1*
Emerging and developing economies	**61.3**	**3.8**	**3.6**	**3.9**	**8.4**	**8.3**	**5.3**
North Asia	26.8	4.0	5.6	5.2	4.1	3.7	3.4
China	*18.6*	*3.0*	*5.7*	*4.9*	*2.0*	*1.8*	*2.4*
Personal savings rate (%)	*7.0*	*7.0*	*5.8*	*6.2*	*6.7*	*5.2*	*4.8*
South Asia	5.1	5.4	4.2	4.5	4.8	3.9	2.8
Latin America	5.8	3.4	1.5	1.9	9.1	5.7	3.9
Mexico	*1.8*	*3.0*	*2.0*	*1.9*	*7.9*	*5.1*	*3.8*
Brazil	*2.3*	*3.0*	*1.2*	*1.5*	*9.5*	*5.9*	*4.1*
Personal savings rate (%)	8.1	1.0	0.9	2.2	27.0	17.0	11.0
Russia	*3.3*	*-2.1*	*-0.3*	*1.1*	*13.8*	*5.5*	*4.8*
Other countries	15.5	3.9	1.9	3.1	10.4	17.7	9.8
South Africa	*0.6*	*1.9*	*0.4*	*1.6*	*7.0*	*5.7*	*4.7*
World	**100.0**	**3.4**	**2.6**	**2.7**	**7.9**	**6.9**	**4.2**

f: forecasts; PPP: Purchasing Power Parities, exchange rate that equates the costs of a broad basket of goods and services across countries; * 2021.
Sources: World Bank, Consensus Forecasts and Desjardins Economic Studies

FINANCIAL FORECASTS

Interest rates have risen over the past month as central banks have become more hawkish. The lack of progress in slowing economic activity and cooling inflationary pressures has seen the Bank of Canada move off the sidelines and the US Federal Reserve eye an even higher terminal rate. That's pushed interest rates higher across sovereign yield curves. But not all indicators of financial conditions are showing signs of tightening. Stock prices have been rising and credit spreads have been narrowing. Those moves are inconsistent with the efforts of central banks to rein in financing conditions. As a result, absent some catastrophic event, both the Bank of Canada and US Federal Reserve seem likely to raise rates at least once more. The recent Canadian dollar appreciation has been mostly due to narrowing interest rate differentials with the US.

TABLE 2
Summary of financial forecasts

END OF PERIOD IN %	2022		2023				2024			
(UNLESS OTHERWISE INDICATED)	Q3	Q4	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Key interest rate										
United States	3.25	4.50	5.00	5.25	5.50	5.50	5.25	4.75	4.25	3.75
Canada	3.25	4.25	4.50	4.75	5.00	5.00	4.75	4.25	3.75	3.25
Eurozone	1.25	2.50	3.50	4.00	4.25	4.25	4.00	3.50	3.00	2.50
United Kingdom	2.25	3.50	4.25	5.00	5.50	5.50	5.25	4.75	4.25	3.75
Federal bonds										
United States										
2-year	4.26	4.54	4.15	4.55	4.25	4.00	3.75	3.50	3.10	2.90
5-year	4.08	3.97	3.62	3.90	3.75	3.60	3.40	3.15	2.95	2.90
10-year	3.80	3.83	3.48	3.70	3.55	3.45	3.35	3.25	3.15	3.10
30-year	3.76	3.94	3.66	3.85	3.70	3.55	3.45	3.35	3.25	3.20
Canada										
2-year	3.79	4.06	3.74	4.55	4.25	4.00	3.65	3.30	2.90	2.60
5-year	3.32	3.41	3.02	3.70	3.55	3.30	3.10	2.85	2.65	2.55
10-year	3.16	3.30	2.90	3.40	3.25	3.10	3.05	2.95	2.85	2.80
30-year	3.09	3.28	3.02	3.25	3.10	2.95	2.90	2.85	2.85	2.75
Currency market										
Canadian dollar (USD/CAD)	1.38	1.36	1.35	1.33	1.35	1.37	1.33	1.30	1.28	1.28
Canadian dollar (CAD/USD)	0.72	0.74	0.74	0.75	0.74	0.73	0.75	0.77	0.78	0.78
Personal savings rate (%)	0.98	1.07	1.09	1.09	1.07	1.06	1.08	1.11	1.12	1.13
British pound (GBP/USD)	1.12	1.20	1.24	1.27	1.24	1.22	1.24	1.28	1.30	1.32
Yen (USD/JPY)	145	131	133	140	135	130	125	120	115	112
Stock markets (level and growth)*										
United States – S&P 500	3,840		Target: 3,850 (+0.3%)				Target: 4,100 (+6.5%)			
Canada – S&P/TSX	19,385		Target: 18,500 (-4.6%)				Target: 20,000 (+8.1%)			
Commodities (annual average)										
WTI oil (US$/barrel)	95 (80*)		76 (74*)				84 (85*)			
Gold (US$/ounce)	1,800 (1,815*)		1,910 (1,870*)				1,740 (1,670*)			

f: forecasts; WTI: West Texas Intermediate; * End of year.
Sources: Datastream and Desjardins Economic Studies

Overseas

The Eurozone Is Already in a Mild Recession. Will Other Economies Follow Suit?

FORECASTS

The eurozone has already posted two consecutive quarters of real GDP declines, and previous interest rate hikes will likely result in further contractions in the coming quarters. The United Kingdom has avoided a recession so far, but its economy is also expected to deteriorate further. And the Bank of England will have no choice but to continue tightening monetary policy to bring down high inflation. Japan is now also seeing rising prices. But inflation is non-existent in China, where a faltering economic rebound is the main concern. Global real GDP is expected to grow by 2.6% in 2023 and 2.7% in 2024.

COMMENTS

The world economy is slowing, especially production and trade of goods. The primary supply chain pressures have eased significantly. The manufacturing PMIs of most major economies are now below 50, the dividing line between economic growth and contraction. And the global goods trade has also been flat. These factors are sending the price of several commodities lower. Despite the Organization of the Petroleum Exporting Countries and its partners (OPEC+) cutting oil production again, crude prices have fallen recently amid fears that a recession will slow global demand for oil.

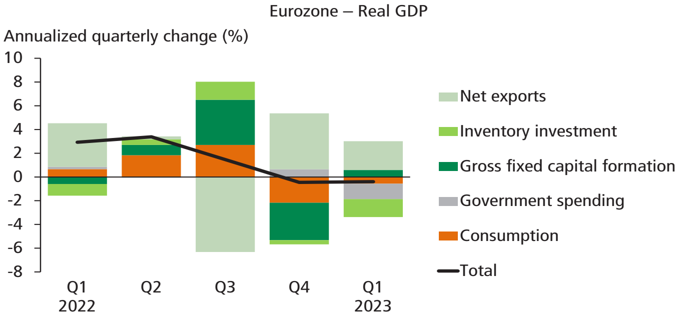
The eurozone is already in a technical recession. Germany led the euro area's real GDP lower by an annualized 0.5% in the fourth quarter of 2022 and 0.4% in the first quarter of this year (graph 1). These are relatively modest declines, but they reflect the challenges facing the European economy. Improving services PMIs suggest better growth in the second quarter, but higher interest rates and tighter credit conditions could mean more drops in real GDP ahead. Eurozone inflation stood at 6.1% in May, well above the European Central Bank's target.

We'll have to keep an eye on Germany, which had the weakest real GDP reading in the G20 in the first quarter (graph 2). Germany also has lower business and consumer confidence than other countries in the eurozone (graph 3 on page 5).

Meanwhile the UK economy continues to dodge a recession, posting two straight quarters of 0.5% annualized real GDP growth. But the UK economy is struggling, with monthly production prints often coming in lower. And inflation is out of control. The three-month annualized change in core CPI was a whopping 12% in April (graph 4 on page 5). That means the UK economy will have to slow further or possibly even contract to contain price growth.

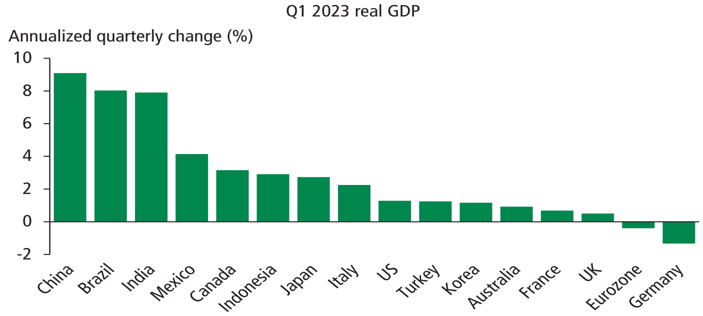
Even Japan—which has long grappled with deflation rooted in business and consumer behaviour—is seeing a surge in inflation. Its consumer price index was up 3.5% year-over-year in April, while the index excluding food and energy hit 4.1%, its highest level since the summer of 1981 (graph 5 on page 5). Unlike other central banks, the Bank of Japan continues to be patient, keeping its key interest rate negative for now. Under these circumstances, the Japanese economy should not suffer too much from

GRAPH 1
The Eurozone Economy Contracted Slightly in the Two Most Recent Quarters



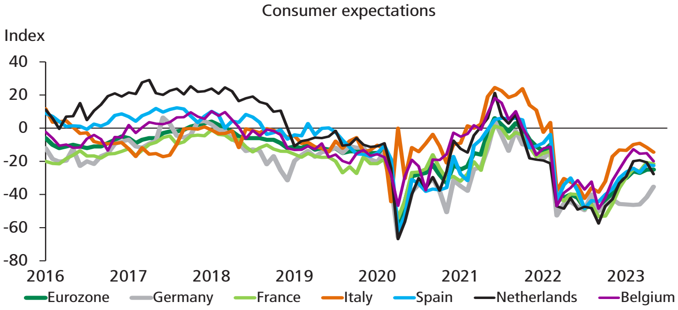
Sources: Eurostat and Desjardins Economic Studies

GRAPH 2
Germany Is One of the Few G20 Countries to Post a Real GDP Decline in Q1 2023



Sources: Organisation for Economic Co-operation and Development, Datastream and Desjardins Economic Studies

GRAPH 3
German Consumer Confidence Is Improving, but Remains Very Low

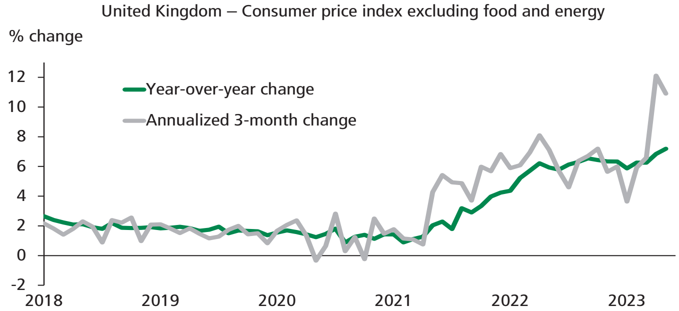


Sources: European Commission and Desjardins Economic Studies

monetary tightening, though the slowing global economy should temper growth somewhat.

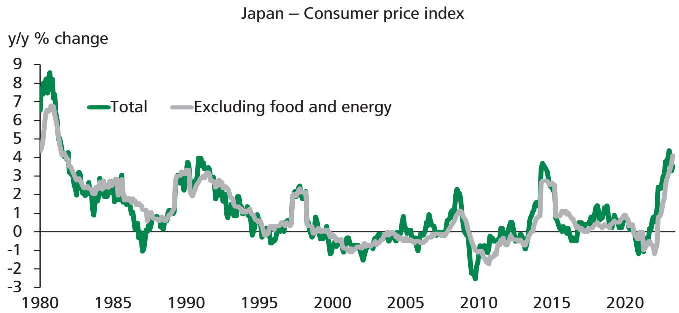
Finally, the Chinese economy seems to be losing steam after rebounding early this year and posting quarterly non-annualized real GDP growth of 2.2%. Although several indicators like industrial production and retail sales are up sharply on an annual basis given last year's lockdowns, they're showing signs of slowing. On top of flagging domestic demand, the real estate market continues to struggle and unemployment is on the rise, especially among young people. Global economic conditions are also weighing on the country's growth prospects. But while China faces a number of challenges, inflation isn't one of them. Since China lifted its zero-COVID policy, inflation fell from 2.1% in January to 0.2% in May (graph 6). As a result, the Chinese government is mulling new fiscal stimulus measures to boost economic growth and help local governments grappling with high debt.

GRAPH 4
UK Core Inflation Is Still Out of Control



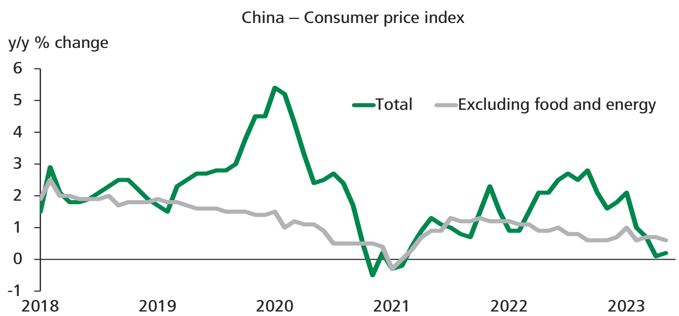
Sources: Datastream and Desjardins Economic Studies

GRAPH 5
Inflation Is Also Up in Japan



Sources: Statistics Bureau and Desjardins Economic Studies

GRAPH 6
Inflation Is Virtually Non-existent in China



Sources: National Bureau of Statistics of China and Desjardins Economic Studies

United States

The Economy Is Resilient, but Fragile at the Same Time

FORECASTS

The US economy continues to grow for now, with modest real GDP growth forecast for the second and third quarters of 2023. But between the 500 basis points' worth of rate hikes delivered by the Federal Reserve since March 2022 (with another expected in July), the impact it's had on mortgage rates, tighter credit conditions and the global economic slowdown, sooner or later economic activity will take a hit, including the labour market. Real GDP is forecast to fall in the final quarter of 2023 and into 2024, helping to bring core inflation and wage growth down. Growth should gradually pick up again later in 2024.

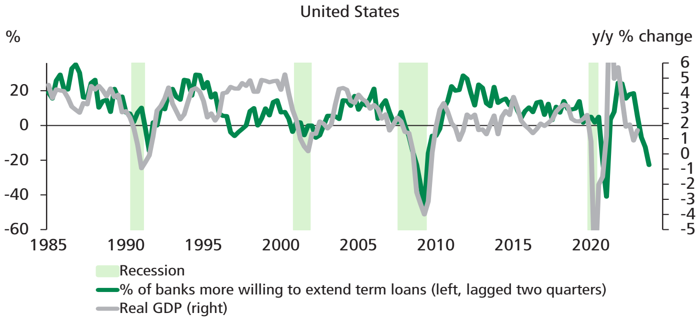
So far, the US economy has managed to withstand the challenges thrown its way. After steep and sudden rate hikes, high inflation eating into incomes and profits, a banking crisis, a debt ceiling crisis and a global slowdown, the economy has come out bruised but not broken. It's even managed to add 1,570,000 jobs since the start of the year. But wage growth and core inflation (which excludes food and energy) are still too high.

The situation feels fragile. Consumer and business confidence are sitting at recession-like levels, and there are other signs of trouble set to return. Interest rate rises may have got a quick reaction from the housing market in 2022, but the full effect of monetary tightening has yet to hit the rest of the economy. That should come in the second half of 2023. The credit situation will also remain a concern. Although March's banking sector drama was short-lived, banks are still tightening their credit conditions, and their reluctance to lend will end up impacting the economy sooner or later (graph 7).

So far it's primarily business loans that have been affected by tighter credit conditions, particularly since the Silicon Valley Bank collapse. The ISM indexes suggest that we're not in a particularly business-friendly economic environment right now, particularly for manufacturers, with the ISM Manufacturing index coming in at just 46.9 in May. The index's new orders and backlog of orders components fell to a respective 42.6 and 37.5, levels not seen since the 2008–2009 recession, if you overlook the first few months of the pandemic (graph 8). Things seem less dire on the non-manufacturing side, but at 50.3, the ISM Services index is approaching the tipping point that signals a contraction. That said, manufacturing output has so far been faring better than what the ISM data would suggest. The automotive sector appears to be benefiting from fresh investment in electric transportation since the Biden administration introduced the Inflation Reduction Act.

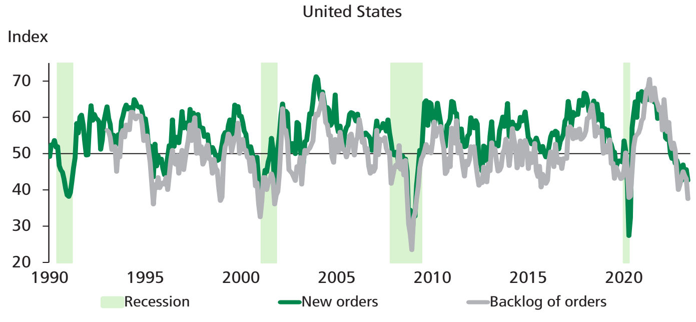
Despite low consumer confidence, households have been benefiting from a strong labour market. Falling energy prices, and food prices that have just started to come down, are good news for consumers, giving a boost to real incomes. We expect to see relatively good growth in real spending for Q2, coming in at around 2%, and a slightly smaller gain in Q3. After that, the

GRAPH 7
Reluctant Lenders Don't Bode Well for Economic Growth



Sources: Federal Reserve Board, Bureau of Economic Analysis, National Bureau of Economic Research and Desjardins Economic Studies

GRAPH 8
Some Components of the ISM Manufacturing Index Are Low, Consistent with an Imminent Recession



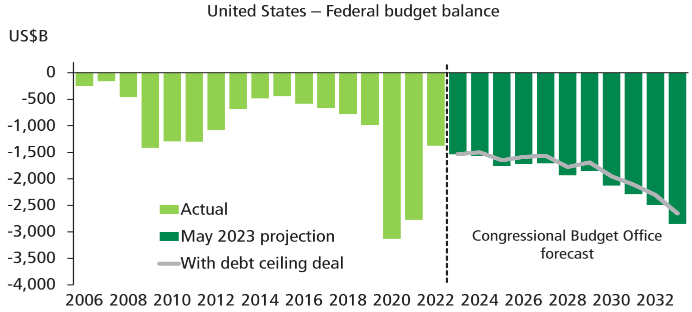
Sources: Institute for Supply Management, National Bureau of Economic Research and Desjardins Economic Studies cumulative effect of rising interest rates, tighter credit conditions and a slower pace of job creation should start to show up in consumer spending. And there are signs that the tide may be turning for the labour market, with job openings down since last year, an increase in mass layoffs and unemployment claims starting to rise.

The US federal debt ceiling standoff is now behind us. Last-minute negotiations produced an agreement that will stave off any more problems until 2025, after the next presidential election, in exchange for fiscal concessions, including short-term caps on non-military discretionary spending followed by modest increases. The details of the agreement don't really change the public finances picture (graph 9), but we could see government spending contribute less to real GDP growth over the next few quarters.

With several factors set to slow or even reverse economic growth, will it be enough to bring inflation down to target? Goods-related inflation has already slowed considerably, barring a few bumps along the way, mostly due to used car prices. It's services inflation, excluding energy and housing, that has the Fed needing to step in to slow things down. We think that what we're forecasting will be enough to bring inflation closer to the central bank's targets.

GRAPH 9

The Debt Ceiling Deal Didn't Significantly Alter the US Federal Government's Fiscal Outlook



Sources: Congressional Budget Office and Desjardins Economic Studies

TABLE 3

United States: Major economic indicators

QUARTERLY ANNUALIZED % CHANGE (UNLESS OTHERWISE INDICATED)	2022		2023				ANNUAL AVERAGE			
	Q3	Q4	Q1	Q2f	Q3f	Q4f	2021	2022	2023f	2024f
Real GDP (2012 US$)	**3.2**	**2.6**	**1.3**	**1.6**	**0.7**	**-0.7**	**5.9**	**2.1**	**1.5**	**0.7**
Personal consumption expenditures	2.3	1.0	3.8	1.9	1.2	-0.5	8.3	2.7	2.0	0.6
Residential construction	-27.1	-25.1	-5.4	5.4	0.0	-5.9	10.7	-10.6	-11.0	0.2
Business fixed investment	6.2	4.0	1.4	2.6	-0.4	-1.6	6.4	3.9	2.2	0.7
Inventory change (US$B)	38.7	136.5	6.9	45.0	5.0	-15.0	-19.4	125.0	10.5	-26.2
Public expenditures	3.7	3.8	5.2	2.1	2.0	1.4	0.6	-0.6	3.1	1.2
Exports	14.6	-3.7	5.2	-7.5	0.0	-1.0	6.1	7.1	1.5	-0.6
Imports	-7.3	-5.5	4.0	3.0	-1.3	-2.4	14.1	8.1	-0.7	-1.6
Final domestic demand	1.5	0.7	3.3	2.2	1.1	-0.6	6.7	1.7	1.7	0.7
Other indicators										
Nominal GDP	7.7	6.6	5.4	5.0	4.2	1.8	10.7	9.2	5.6	3.2
Real disposable personal income	3.2	2.5	7.8	1.5	0.7	-1.0	1.9	-6.2	3.0	0.1
Employment[1]	3.4	2.5	2.5	2.1	1.3	0.2	2.9	4.3	2.3	0.0
Unemployment rate (%)	3.6	3.6	3.5	3.6	3.8	4.0	5.4	3.7	3.7	5.0
Housing starts[2] (thousands of units)	1,446	1,405	1,382	1,474	1,380	1,313	1,606	1,551	1,387	1,384
Corporate profits*[3]	5.5	2.6	-2.8	-6.5	-5.5	-4.6	22.6	6.6	-4.9	2.5
Personal savings rate (%)	3.2	3.4	4.2	4.6	4.5	4.4	11.9	3.5	3.5	4.2
Total inflation rate*	8.3	7.1	5.8	4.1	3.5	3.0	4.7	8.0	4.1	2.5
Core inflation rate*[4]	6.3	6.0	5.6	5.3	4.8	4.2	3.6	6.1	5.0	2.8
Current account balance (US$B)	-876	-827	-860	-901	-894	-884	-846	-944	-885	-858
Personal savings rate (%)										

f: forecasts; * Annual change; [1] According to the establishment survey; [2] Annualized basis; [3] Before taxes; [4] Excluding food and energy.
Sources: Datastream and Desjardins Economic Studies

Canada

Trading Economic Serenity Now for Economic Malaise Down the Road

FORECASTS

While the Canadian economy has been outperforming the expectations of forecasters, the recent rate hike by the Bank of Canada is likely to take some wind out of its sails. At least one more hike is likely before the Bank is done. We anticipate the economy to dip into a recession toward the end of 2023 as a result, but it's still likely to be shallow and short-lived. This will help to cool inflation and prompt eventual future rate cuts. But not all households have felt the impact of rate hikes equally. Some variable-rate mortgage borrowers have been able to add higher mortgage interest costs to their principal, thereby extending their amortization period in the process. While this has muted some of the downdraught from higher interest rates in the near term, it risks economic underperformance when those mortgages come up for renewal.

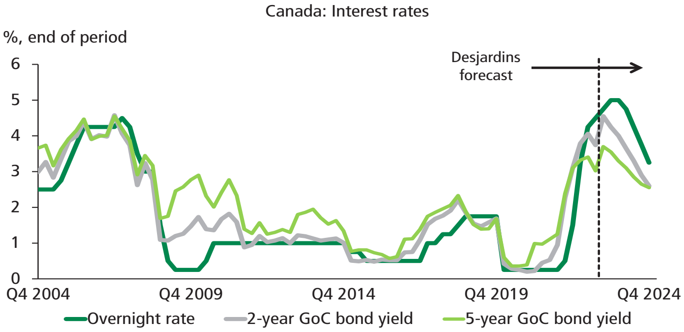
The Canadian economy continues to best the forecasts of economists. Real GDP growth in the first quarter of 2023 was just the latest example, hitting 3.1% annualized, well above the Bank of Canada's forecast of 2.3%. When combined with sustained economic strength in April, including a rebound in the housing market, as well as an upturn in inflation in the month, it was not especially surprising that the Bank of Canada decided to hike the policy rate in June by 25 basis points. This takes the overnight rate to 4.75%, the highest it's been since April 2001 (graph 10). And we expect another 25-basis point hike in July, with the door open to more if the data doesn't cooperate.

But we don't expect the strength to last. Even though Q2 2023 real GDP growth is shaping up to be around 1.5% or maybe even better, the strength in the quarter is likely to be front-loaded. Higher interest rates will take some of the wind out of the sails of the housing market, even if the May data showed that the rebound in April was more than a fluke. Further, Canadians are feeling the squeeze of elevated borrowing costs, with consumer proposals having surpassed pre-COVID levels. Business investment is likely to languish as well, as foreign demand cools, borrowing and input costs stay elevated, and sentiment slumps. Hence, we expect growth to weaken further through the second half of the year and into early 2024 (graph 11).

That said, it won't be your mother's or grandmother's recession. Instead, we expect the downturn to be short and shallow, allowing for the excess demand in the Canadian economy to be burned off. And while we anticipate the unemployment rate to rise, it should largely be the result of the population growing faster than employment. As such, ongoing job and wage gains should keep income growth in the black. That said, a slowing in the economy should also support a sustained cooling in inflation.

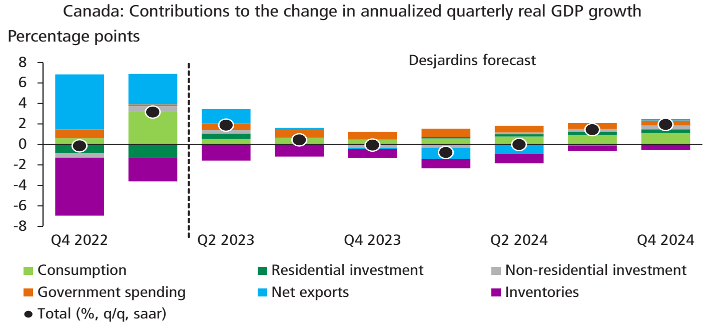
The elevated pace of population growth on the back of heightened immigration has helped to fuel the rebound in the Canadian housing market recently. And it's expected to continue to provide a tailwind going forward. But it's a double-edged sword, as more people chasing after limited housing is pushing up shelter costs and making the Bank of Canada's job more difficult. However, there is a longer-term challenge facing the Canadian economy. As we've written about extensively, some

GRAPH 10
The Bank Is Expected to Hike a Least Once More before 2023 Is Out



Sources: Bank of Canada and Desjardins Economic Studies

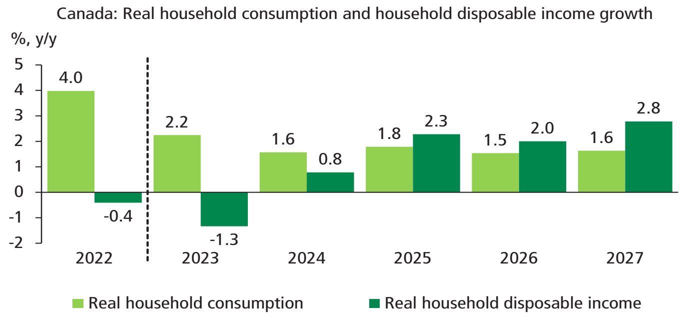
GRAPH 11
We Expect Broad-Based Economic Weakness to Lead to a Recession



Sources: Statistics Canada and Desjardins Economic Studies

Canadian households have kicked the can down the road in terms of contending with higher mortgage costs. Specifically, fixed-payment variable-rate mortgage holders have in some cases been able to add higher interest payments to their principal as opposed to dealing with it today. But they can't escape the impact of higher interest rates forever. Instead of contending with it now, they will need to pay for it in the future, most specifically in 2025 and 2026. We think this will force households to cut back somewhat on discretionary spending, which should cause the economy to slow even as it recovers from the impact of tight monetary policy (graph 12).

GRAPH 12
Consumption Growth Should Follow Real Disposable Income



Sources: Statistics Canada and Desjardins Economic Studies

TABLE 4
Canada: Major economic indicators

QUARTERLY ANNUALIZED % CHANGE (UNLESS OTHERWISE INDICATED)	2022		2023				ANNUAL AVERAGE			
	Q3	Q4	Q1	Q2f	Q3f	Q4f	2021	2022	2023f	2024f
Real GDP (2012 $)	**2.3**	**-0.1**	**3.1**	**1.9**	**0.4**	**-0.1**	**5.0**	**3.4**	**1.7**	**0.3**
Final consumption expenditure [of which:]	1.5	1.4	3.7	1.2	1.5	1.4	5.4	4.0	2.2	1.6
Household consumption expenditure	*0.3*	*1.1*	*5.7*	*0.9*	*1.2*	*0.8*	*5.1*	*4.8*	*2.6*	*1.2*
Government consumption expenditure	*4.7*	*2.3*	*-1.5*	*1.8*	*2.3*	*2.7*	*6.4*	*2.0*	*1.3*	*2.5*
Gross fixed capital formation [of which:]	-8.5	-3.9	-0.9	4.6	0.6	-0.8	7.4	-1.5	-1.8	1.1
Residential structures	*-18.4*	*-9.9*	*-14.6*	*5.6*	*0.5*	*0.2*	*14.9*	*-11.2*	*-9.3*	*2.0*
Non-residential structures	*6.5*	*11.6*	*8.7*	*4.3*	*-1.1*	*-4.2*	*0.8*	*8.3*	*6.1*	*-0.4*
Machinery and equipment	*-7.8*	*-28.6*	*-9.6*	*-0.2*	*-1.7*	*-5.1*	*9.9*	*7.4*	*-8.9*	*-2.4*
Intellectual property products	*-9.6*	*1.2*	*19.3*	*4.6*	*2.0*	*2.0*	*4.0*	*0.7*	*5.0*	*2.2*
Government gross fixed capital formation	*-5.3*	*10.6*	*13.8*	*6.6*	*4.5*	*3.5*	*0.9*	*2.1*	*6.5*	*3.4*
Investment in inventories (2012 $B)	53.3	24.3	12.6	3.9	-2.2	-6.9	-4.1	39.5	1.9	-17.9
Exports	11.3	2.2	10.1	1.4	-0.5	-1.5	1.4	2.8	4.8	-1.4
Imports	-2.3	-12.6	0.9	-3.0	-1.2	-1.2	7.8	7.5	-1.8	-0.2
Final domestic demand	-0.9	0.2	2.6	2.0	1.3	0.9	5.8	2.7	1.3	1.5
Other indicators										
Nominal GDP	-2.5	-3.0	4.2	1.4	1.5	1.7	13.6	10.9	1.7	2.3
Personal savings rate (%)	-0.7	5.2	-6.4	-2.6	2.8	-1.3	1.2	-0.4	-1.3	0.8
Employment	-1.3	2.2	4.7	1.3	0.4	-0.1	5.0	4.0	2.1	0.4
Unemployment rate (%)	5.1	5.1	5.0	5.2	5.7	6.2	7.5	5.3	5.5	6.9
Housing starts[1] (thousands of units)	281	259	223	226	215	211	271	262	219	215
Corporate profits*[2]	15.5	-7.2	-14.9	-21.4	-14.6	-2.4	35.8	8.4	-13.8	5.2
Personal savings rate (%)	4.7	5.8	2.9	2.1	2.5	2.0	10.9	6.1	2.4	1.9
Total inflation rate*	7.2	6.7	5.2	3.7	3.2	2.7	3.4	6.8	3.7	2.2
Core inflation rate*[3]	5.4	5.3	4.8	4.1	3.5	3.2	2.3	5.0	3.9	2.5
Current account balance ($B)	-9.8	-8.1	-6.2	-10.9	-12.7	-14.3	-6.7	-9.1	-44.1	-59.4

f: forecasts; * Annual change; [1] Annualized basis; [2] Before taxes; [3] Excluding food and energy.
Sources: Datastream and Desjardins Economic Studies

Quebec

Quebec's Economy Is Already Showing Signs of Weakness

FORECASTS
In Quebec, slower population gains than in the rest of Canada mean less demographic support for the economy, which has been weak since the start of the year. Real GDP and employment haven't seen the same momentum as in other parts of the country, alongside several other weaker indicators. Residential construction has continued to fall in Quebec, with only a slight rebound in the resale market. Business investment and international exports are also down provincially but holding up nationally. So far, strong consumer spending has managed to keep Quebec's economy afloat, but it's on fragile footing. Our scenario predicts a period of real GDP contraction lasting into early 2024.

Despite high inflation and interest rates, consumer spending is taking some time to slow down. There are several contributing factors that have driven Quebec incomes up and pushed the savings rate above 10%. For one thing, Quebec was the most generous province in terms of household financial support in 2022. For another, the labour market remains tight, with unemployment at 4.0% and rapid wage growth supporting workers' incomes.

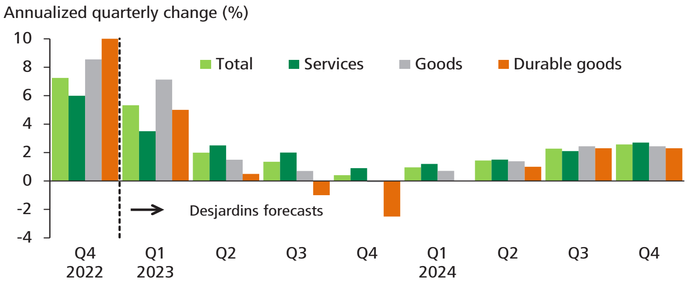
While consumer spending has remained resilient so far, conditions are set to become less favourable over the coming quarters (graph 13). Rising interest rates will put more of a strain on household borrowing capacity, government financial support will be significantly reduced and the labour market, which has already begun losing steam, will start to deteriorate. Quebec's sluggish job gains since the start of the year reflect an economy that has already slowed. We expect an employment downtrend to start soon, bringing the unemployment rate up to 6.0% by early 2024 (graph 14).

Whereas consumers have held up relatively well so far, recession conditions seem to have already set in on the business side. Profits are down and investment has been declining since mid-2022. Challenging conditions are here to stay for the short term and should intensify in the coming quarters. Although several big investment projects have been recently announced in Quebec, the value of building permits in the non-residential sector has been trending downward for several months.

The current period of uncertainty has generated caution among businesses, particularly as pressures keep piling up. Costs have skyrocketed over the past few years, and steep interest rate hikes have made it more expensive to pay off debt, putting some businesses on shaky financial footing. Insolvencies are way up (graph 15 on page 11), particularly in the sectors hardest hit by the pandemic such as retail and accommodation and food services.

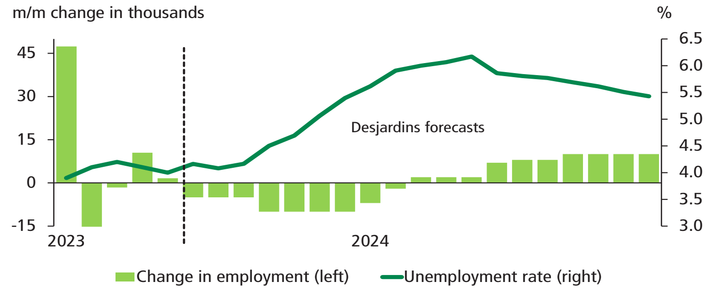
Bankruptcies are also on the rise in the construction industry, which has seen a slump in residential projects. Borrowing costs have become too high for many developers, which isn't helped by the high cost of land, materials and labour. New projects are down significantly across all market segments: single-family homes, condominiums and rental housing. The fall-off in activity is province-wide, affecting most major and mid-sized urban centres. (See our Spotlight on Housing). On an annualized

GRAPH 13
Quebec: Consumer Spending Growth Is Expected to Slow, While Spending on Durable Goods Will Likely Fall



Sources: Institut de la statistique du Québec and Desjardins Economic Studies

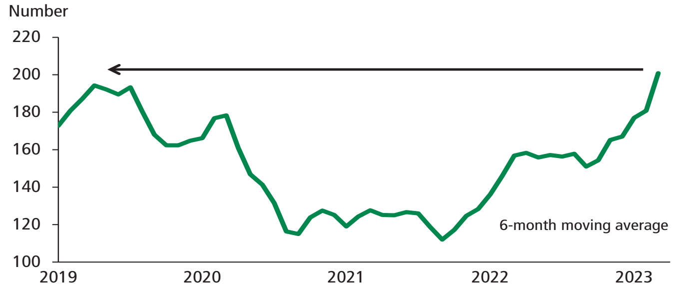
GRAPH 14
The Labour Market Could Soon Feel the Effects of a Moderate Recession in Quebec



Sources: Statistics Canada and Desjardins Economic Studies basis, housing starts fell to nearly 30,000 units in May. We've downgraded our forecast as a result of the weak activity. After declining 15.8% in 2022, housing starts are now projected to fall by at least another 35% this year.

Between difficult business conditions and a fall-off in residential construction, the pace of real GDP growth has already started to slow. The growing problems facing the global economy are also already showing up Quebec's international exports (about 75% of which are to the US), which recorded a decline in Q1 2023. April's power outages and June's wildfires will weigh on real GDP for the second quarter, and the impending slowdown in consumer spending will further strain Quebec's economy. A recession is therefore very likely. A gradual recovery is expected for 2024 as interest rates come down and the North American and global economies start to recover.

GRAPH 15
Business Insolvencies Are Now above Pre-pandemic Levels in Quebec



Sources: Office of the Superintendent of Bankruptcy Canada and Desjardins Economic Studies

TABLE 5
Quebec: Major economic indicators

ANNUAL AVERAGE % CHANGE (UNLESS OTHERWISE INDICATED)	2020	2021	2022	2023f	2024f
Real GDP (2012 $)	**-5.0**	**6.0**	**2.8**	**0.4**	**0.3**
Final consumption expenditure [of which:]	-3.3	5.9	3.6	3.4	1.4
Household consumption expenditure	*-5.7*	*5.4*	*4.7*	*4.1*	*1.3*
Government consumption expenditure	*2.0*	*7.3*	*1.4*	*2.1*	*1.7*
Gross fixed capital formation [of which:]	-1.0	7.2	-4.0	-6.5	-1.2
Residential structures	*2.8*	*12.9*	*-11.4*	*-14.2*	*1.0*
Non-residential structures	*0.6*	*-1.5*	*0.9*	*-5.1*	*-3.0*
Machinery and equipment	*-15.1*	*20.3*	*1.3*	*-9.3*	*-2.1*
Intellectual property products	*0.1*	*7.1*	*-1.3*	*0.0*	*1.1*
Government gross fixed capital formation	*0.5*	*-3.5*	*1.6*	*5.9*	*4.7*
Investment in inventories (2012 $M)	-6,550	-431	6,783	-2,000	500
Exports	-7.8	2.9	4.2	-0.8	-0.1
Imports	-7.9	6.8	6.2	1.0	1.3
Final domestic demand	-2.9	6.2	1.9	1.3	0.9
Other indicators					
Nominal GDP	-1.9	11.8	10.0	2.1	1.8
Personal savings rate (%)	7.2	1.9	1.9	0.7	1.0
Weekly earnings	7.9	2.9	4.1	2.5	2.0
Employment	-5.4	4.3	3.0	2.0	-0.5
Unemployment rate (%)	8.9	6.1	4.3	4.4	5.8
Personal saving rate (%)	17.4	14.6	11.9	7.0	6.1
Personal savings rate (%)	0.7	14.4	8.5	4.3	2.7
Housing starts[1] (thousands of units)	54.1	67.8	57.1	37.0	40.0
Total inflation rate	0.8	3.8	6.7	3.9	2.1

f: forecasts; [1] Annualized basis.
Sources: Statistics Canada, Institut de la statistique du Québec, Canada Mortgage and Housing Corporation and Desjardins Economic Studies

Medium-Term Issues and Forecasts

The Effect of Rate Hikes May Sting for a While

Tackling inflation is going to be a little more difficult over the coming quarters, requiring interest rates to stay higher for longer. The good news is that inflation is expected to be brought back under control at around 2% in the medium term. That said, it would be surprising to see rates come back down to as low as they were over the previous decade. That means borrowers will have to keep adapting, with enduring consequences for the housing market. That's on top of expected structural changes brought on by an accelerated energy transition and the arrival of new and potentially disruptive technology such as AI.

The Ticking Time Bomb of Variable-Rate Mortgages

The economy has been surprisingly resilient over the past few quarters. It would have been safe to assume that Canadian household debt levels and the growing popularity of variable-rate mortgages would cause the effects of monetary tightening show up more quickly in the economy. But that didn't happen.

One reason is a lack of change in variable-rate mortgage payments, something we discussed in a recent Economic Viewpoint. Payments on variable-rate mortgages simply haven't gone up enough to reflect the rise in interest rates. In some cases, payments are no longer covering interest. All these borrowers will need to extend their amortization periods or take the hit of a payment increase and cut down on other expenses. 2025 and 2026 are likely to be particularly challenging as variable-rate mortgages taken out during the pandemic, when rates were at rock bottom, come up for renewal.

Of course, the further ahead the outlook, the more uncertain the forecast. If interest rates come down lower than expected in 2025 and 2026, borrowers may have an easier time with their mortgage renewals. But with inflation proving stubborn pretty much everywhere around the globe, it's safer to be cautious about interest rate cut expectations.

Wildfires Bring a Reality Check

Quebec and other parts of Canada have been hit hard by natural disasters recently. Torrential winds, ice storms, flooding and now wildfires have made it clear that climate change is here. The coming decade will bring a surge of energy transition investment. Spending will also be needed for adaptation strategies as it's clear it won't be possible to completely avoid the effects of climate change.

Accelerated climate change investment and spending is expected to boost real GDP growth. Incentives for battery production already total tens of billions in Canada alone, and that's just one link in the transport electrification chain. Several other sectors will have major capital needs: needs, including mining, clean power generation and building energy efficiency.

It's difficult to predict a timeline for all this investment and spending, which adds even more uncertainty to the medium-term forecast, including inflation. If productivity doesn't improve, an over-stimulated economy would generate inflationary pressure, which is one more argument in favour of limiting rate cuts in the medium term.

Is AI the Answer to Productivity Prayers?

One major challenge for this decade will be improving productivity, which is currently low in Canada. It's unclear whether climate change investment will help in this area. While it will help bring down certain environmental costs in the long term, it's likely to make it more expensive to produce many goods and services in the short term. On the other hand, other innovations, like artificial intelligence, could help generate significant efficiency gains in a number of sectors. But it's still too early to say how big these gains might be and when they could materialize. And some innovations could have downsides, like negatively impacting cybersecurity. For now, we're keeping our productivity expectations in check, forecasting levels below the historical average over the next few years.

TABLE 6

Major medium-term economic and financial indicators

% (UNLESS OTHERWISE INDICATED)	ANNUAL AVERAGE 2021	2022	2023f	2024f	2025f	2026f	2027f	AVERAGES 2018–2022	2023–2027f
United States									
Real GDP (% change)	5.9	2.1	1.5	0.7	2.5	2.4	2.1	2.1	1.9
Total inflation rate (% change)	4.7	8.0	4.1	2.5	2.3	2.2	2.1	3.6	2.6
Unemployment rate	5.4	3.7	3.7	5.0	5.1	4.8	4.5	4.9	4.6
S&P 500 index (% change)[1]	26.9	-19.4	0.3	6.5	6.3	4.5	4.5	9.3	4.4
Federal funds rate	0.25	1.86	5.20	4.75	3.05	2.95	3.00	1.37	3.79
Prime rate	3.25	4.86	8.20	7.75	6.05	5.95	6.00	4.37	6.79
Treasury bills – 3-month	0.05	2.09	5.15	4.20	2.80	3.00	3.00	1.32	3.63
Federal bonds – 10-year	1.43	2.96	3.60	3.25	3.00	3.10	3.10	2.07	3.21
– 30-year	2.05	3.12	3.75	3.35	3.10	3.20	3.20	2.48	3.32
WTI oil (US$/barrel)	68	95	76	82	82	80	78	65	80
Gold (US$/ounce)	1,800	1,803	1,805	1,740	1,565	1,600	1,600	1,607	1,662
Canada									
Real GDP (% change)	5.0	3.4	1.7	0.3	1.7	1.8	1.9	1.6	1.5
Total inflation rate (% change)	3.4	6.8	3.7	2.2	2.0	2.0	2.0	3.0	2.4
Employment (% change)	5.0	4.0	2.1	0.4	2.0	1.7	1.3	1.4	1.5
Personal savings rate (%)	903	750	416	74	400	342	280	260	302
Unemployment rate	7.5	5.3	5.5	6.9	6.3	5.7	5.5	6.8	6.0
Housing starts (thousands of units)	217	271	219	215	235	241	235	234	229
S&P/TSX index (% change)[1]	21.7	-8.7	-4.6	8.1	7.0	5.0	5.0	4.5	4.1
Exchange rate (USD/CAD)	0.80	0.77	0.74	0.77	0.78	0.77	0.78	0.77	0.77
Personal savings rate (%)	0.25	1.95	4.75	4.20	2.50	2.25	2.50	1.18	3.24
Prime rate	2.45	4.14	6.95	6.40	4.70	4.45	4.70	3.38	5.44
Mortgage rate – 1-year	2.80	4.43	6.80	6.35	5.20	5.15	5.15	3.52	5.73
– 5-year	4.79	5.64	6.75	6.95	6.70	6.65	6.75	5.18	6.76
Treasury bills – 3-month	0.11	2.18	4.65	3.75	2.35	2.20	2.50	1.15	3.09
Federal bonds – 2-year	0.48	2.90	4.10	3.30	2.55	2.70	2.85	1.49	3.10
– 5-year	0.95	2.78	3.40	2.90	2.55	2.70	2.90	1.60	2.89
– 10-year	1.36	2.77	3.15	2.95	2.70	2.80	2.95	1.75	2.91
– 30-year	1.85	2.81	3.10	2.85	2.65	2.75	2.90	2.01	2.85
Yield spreads (Canada – United States)									
Treasury bills – 3-month	0.06	0.09	-0.50	-0.45	-0.45	-0.80	-0.50	-0.17	-0.54
Federal bonds – 10-year	-0.07	-0.19	-0.45	-0.30	-0.30	-0.30	-0.15	-0.32	-0.30
– 30-year	-0.20	-0.31	-0.65	-0.50	-0.45	-0.45	-0.30	-0.48	-0.47
Quebec									
Real GDP (% change)	6.0	2.8	0.4	0.3	1.7	1.6	1.5	1.9	1.1
Total inflation rate (% change)	3.8	6.7	3.9	2.1	2.0	2.0	2.0	3.0	2.4
Employment (% change)	4.3	3.0	2.0	-0.5	2.0	1.6	1.1	1.1	1.3
Employment (thousands)	177	130	86	-22	90	75	50	49	56
Unemployment rate	6.1	4.3	4.4	5.8	4.9	4.1	3.6	6.0	4.6
Retail sales (% change)	14.4	8.5	4.3	2.7	4.5	4.2	4.0	5.7	3.9
Housing starts (thousands of units)	68	57	37	40	51	52	53	55	47

f: forecasts; WTI: West Texas Intermediate; [1] Changes are based on end-of-period data.
Sources: Datastream, Statistics Canada, Institut de la statistique du Québec, Canada Mortgage and Housing Corporation and Desjardins Economic Studies