ECONOMIC & FINANCIAL OUTLOOK

Not a Painful Recession, but a Painfully Slow Recovery

By Jimmy Jean, Vice-President, Chief Economist and Strategist

The year 2023 has witnessed turbulence in the banking sector, dashed expectations for a reopening-driven economic surge in China, and only marginal improvements in underlying inflation across several countries. The economic response has varied. Despite the Federal Reserve's more aggressive rate hikes, there is growing optimism for a successful soft landing in the United States. Conversely, China's economy has stumbled, and the various challenges it's facing appear difficult to resolve in the near term. Meanwhile, the euro area, which began the year with optimism, now faces the prospect of an impending contraction in real GDP.

In this complex environment, one constant factor continues to influence our assumptions: high interest rates will continue to impact the global economy. This holds true for the US, where the pool of excess savings sustaining consumer spending is nearly exhausted. Combined with other pressures like high real interest rates, resuming student loan payments, tightening credit conditions, and a hiring slowdown, we can't put too much faith in a soft landing scenario. We maintain a mild recession as our base-case scenario.

The tide appears to be turning swiftly for the Canadian economy. We have now entered the period of peak tightening effects, having entered the 18th month since the tightening cycle began. The economy's weakness is undeniable, especially considering the accelerating trend in demographic growth. Real GDP per capita showed a 2% year-over-year contraction as of Q2. Meanwhile, the unemployment rate started to rise in May, and with growing labour market slack, we anticipate further increases.

Adding the persistent drag from mortgage renewals, we expect Canada to enter a mild recession around the turn of the year. That means interest rates won't be higher for too much longer. By next March, we anticipate the Bank of Canada will deem the supply–demand rebalancing process well entrenched enough to warrant some monetary policy relief. However, achieving the 2% inflation target won't likely happen before the end of 2024, preventing the BoC, like most central banks, from injecting substantial monetary stimulus as in prior downturns.

With higher borrowing costs and lingering inflation concerns limiting fiscal policy's ability to support the economy, there will be little stimulus fuel to propel a rebound. While the next recession might not be excessively painful, we should brace for a sluggish recovery.

CONTENTS

Jimmy Jean, Vice-President, Chief Economist and Strategist • Randall Bartlett, Senior Director of Canadian Economics
Benoit P. Durocher, Director and Principal Economist • Royce Mendes, Managing Director and Head of Macro Strategy
Hélène Bégin, Principal Economist • Tiago Figueiredo, Associate – Macro Strategy • Francis Généreux, Principal Economist
Lorenzo Tessier-Moreau, Principal Economist • Hendrix Vachon, Principal Economist

Desjardins Economic Studies: 514-281-2336 or 1-866-866-7000, ext. 5552336 • desjardins.economics@desjardins.com • desjardins.com/economics

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

Although inflation has come down, it remains above the target range in many countries. Central banks still can't declare victory, and several are leaving the option of further hikes on the table. Even if the status quo prevails, there's also the risk that central banks will keep interest rates higher for longer. The impact 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 on other sectors. The situation in China is worrying, as growth remains muted, deflationary signals are spreading, and the property market is once again raising red flags. If things get more difficult for the global economy, Canada could see weaker exports and a sudden worsening of terms of trade. Higher unemployment and interest rates could also mean a bigger housing market correction in Canada. Many borrowers will be in for a shock when the time comes to renew the low-interest mortgages they took out during the pandemic. In the United States, consumer spending could slow more significantly than expected as excess savings diminish and student-loan payments resume. The effects of the banking turmoil we saw in early spring could continue to be felt, spelling much tighter credit conditions for all economic agents and aggravating existing challenges. More financial institutions could see lower credit ratings and higher borrowing costs. A deeper economic slowdown could result in more bankruptcies and steeper price corrections in a number of asset classes. From a currency standpoint, if the global economy deteriorates dramatically, risks are tilted more to a sharp appreciation of the US dollar, especially against the currencies of countries considered more economically and financially fragile. This could increase some vulnerabilities and spark foreign debt crises. The risk of a new federal shutdown in the United States could also destabilize the outlook. Finally, we can't rule out the possibility of more volatility from extreme weather events that are adding to today's already uncertain macroeconomic environment.

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

	WEIGHT*	REAL GDP GROWTH			INFLATION RATE		
%		2022	2023f	Q2	2022	2023f	2024f
Advanced economies	**38.7**	**2.7**	**1.4**	**0.9**	**7.1**	**4.6**	**2.5**
United States	15.7	2.1	2.2	1.0	8.0	4.1	2.5
Canada	1.4	3.4	1.1	0.0	6.8	3.9	2.6
Quebec	*0.3*	*2.6*	*0.4*	*0.1*	*6.7*	*4.0*	*2.4*
Japan	3.7	1.0	1.9	0.9	2.5	3.0	1.7
United Kingdom	2.3	4.3	0.4	0.4	9.1	7.3	3.0
Eurozone	11.9	3.4	0.5	0.7	8.4	5.5	2.5
Germany	*3.3*	*1.9*	*-0.2*	*0.4*	*6.9*	*6.0*	*2.6*
France	*2.3*	*2.5*	*0.7*	*0.7*	*5.2*	*5.1*	*2.5*
Italy	*1.8*	*3.8*	*0.7*	*0.5*	*8.2*	*6.0*	*2.3*
Other countries	4.2	3.0	0.9	1.4	5.8	4.5	2.5
Australia	*1.0*	*3.7*	*1.5*	*1.2*	*6.6*	*5.6*	*3.2*
Emerging and developing economies	**61.3**	**3.8**	**3.4**	**3.7**	**8.4**	**8.1**	**5.8**
North Asia	26.8	3.9	5.0	4.7	4.1	3.1	3.2
China	*18.6*	*3.0*	*5.0*	*4.3*	*2.0*	*0.8*	*2.0*
India	*7.0*	*7.0*	*5.7*	*6.2*	*6.7*	*5.1*	*4.7*
South Asia	5.1	5.4	4.0	4.4	4.8	3.6	2.7
Latin America	5.8	3.7	2.1	1.8	9.1	5.1	3.9
Mexico	*1.8*	*3.9*	*2.6*	*1.7*	*7.9*	*4.7*	*3.9*
Brazil	*2.3*	*3.0*	*2.3*	*1.5*	*9.5*	*4.9*	*4.0*
Eastern Europe	8.1	1.0	1.5	2.1	27.0	17.6	13.0
Russia	*3.3*	*-2.1*	*1.0*	*1.2*	*13.8*	*5.4*	*4.8*
Other countries	15.5	3.9	1.7	3.0	10.4	18.1	11.3
South Africa	*0.6*	*1.9*	*0.2*	*1.5*	*7.0*	*5.9*	*4.9*
World	**100.0**	**3.3**	**2.6**	**2.6**	**7.9**	**6.8**	**4.5**

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

Central bankers believe that interest rates will need to stay higher for longer, but that doesn't mean we'll see further rate hikes in Canada or the US. Instead, officials are signalling that rate cuts won't be in the cards for some time. We continue to expect the Bank of Canada and the US Federal Reserve to keep rates on hold for the remainder of this year, although central bankers will likely keep the door open to further rates hikes if needed. Quantitative tightening will also continue to tighten policy even as rates are left on hold. Rate hikes are expected to have a more pronounced effect on economic growth going forward, and we expect the Bank of Canada to begin cutting rates at the end of Q1 2024. In the US, rate cuts are likely to begin Q2 of next year as the US economy has proven to be more resilient.

TABLE 2
Summary of financial forecasts

END OF PERIOD IN % (UNLESS OTHERWISE INDICATED)	2022		2023				2024			
	Q3	Q4	Q1	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Key interest rate										
United States	3.25	4.50	5.00	5.25	5.50	5.50	5.50	5.00	4.50	4.00
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	4.50	4.50	4.50	4.00	3.50	3.00
United Kingdom	2.25	3.50	4.25	5.00	5.50	5.50	5.50	5.25	4.75	4.25
Federal bonds										
United States										
2-year	4.26	4.54	4.15	4.94	4.70	4.20	3.80	3.50	3.10	2.90
5-year	4.08	3.97	3.62	4.12	4.30	4.00	3.50	3.20	2.95	2.90
10-year	3.80	3.83	3.48	3.81	4.20	3.90	3.50	3.25	3.15	3.10
30-year	3.76	3.94	3.66	3.84	4.25	3.90	3.60	3.35	3.25	3.20
Canada										
2-year	3.79	4.06	3.74	4.58	4.50	4.10	3.70	3.30	2.90	2.60
5-year	3.32	3.41	3.02	3.68	3.90	3.70	3.20	2.90	2.65	2.55
10-year	3.16	3.30	2.90	3.26	3.75	3.55	3.20	2.95	2.85	2.80
30-year	3.09	3.28	3.02	3.09	3.50	3.30	3.05	2.85	2.85	2.75
Currency market										
Canadian dollar (USD/CAD)	1.38	1.36	1.35	1.32	1.36	1.37	1.35	1.32	1.30	1.30
Canadian dollar (CAD/USD)	0.72	0.74	0.74	0.76	0.74	0.73	0.74	0.76	0.77	0.77
Euro (EUR/USD)	0.98	1.07	1.09	1.09	1.07	1.07	1.08	1.11	1.13	1.14
British pound (GBP/USD)	1.12	1.20	1.24	1.27	1.25	1.25	1.27	1.31	1.33	1.34
Yen (USD/JPY)	145	131	133	144	145	136	128	120	117	115
f: forecasts; 1 annualized basis. Sources: Statistics Canada, Institut de la statistique du Québec, Canada Mortgage and Housing Corporation and Desjardins Economic Studies										
f: forecasts; * annual change; 1 annualized basis; 2 before taxes; 3 excluding food and energy. Sources: Datastream and Desjardins Economic Studies	3,840		Target: 4,100 (+6.8%)				Target: 4,300 (+4.9%)			
Canada – S&P/TSX	19,385		Target: 18,500 (-4.6%)				Target: 20,000 (+8.1%)			
Commodities (annual average)										
WTI oil (US$/barrel)	95 (80*)		77 (78*)				82 (85*)			
Gold (US$/ounce)	1,800 (1,815*)		1,920 (1,880*)				1,740 (1,680*)			

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

Overseas

The Global Economy Is Deteriorating, Particularly in China

FORECASTS

There are still several signs that the global economy is slowing. Among the advanced economies, Japan and the United States are holding up, but economic activity is starting to weaken in Europe and the United Kingdom. The situation is even more worrying for China, where signs of a slowdown are mounting. Inflation is continuing to cool everywhere—albeit unevenly—but the recent increase in oil prices isn't helping. Global real GDP is expected to rise by 2.6% in 2023 and 2024.

COMMENTS

Global economic growth remains sluggish and uneven from region to region. This is particularly evident when we compare the world's two largest economies: the United States and China. While the US is holding up relatively well amid aggressive rate hikes, China's economy is disappointing. The eurozone seems to be stalling, and real GDP is expected to contract soon.

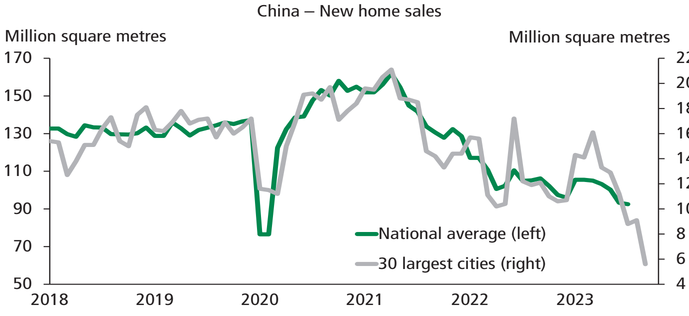
This uneven global climate is reflected in commodity prices. While lower prices of several commodities such as industrial metals suggest the economy is slowing, high oil prices indicate the opposite. However, while recent oil price increases are more attributable to OPEC+ production cuts than higher demand, the latter has held up well in recent months.

China's economy is facing acute, complex problems, and we have downgraded our real GDP growth forecast accordingly. The property market remains bogged down, and new home sales have dropped 43% from their April 2021 peak (graph 1). However, the government is increasing support (cutting interest rates and down payments for first-time home buyers). These measures could help the situation in the coming months. However, confidence in the real estate market remains weak, and it may take time to rebuild. Structural factors such as population decline will also continue to curb demand. In addition, local governments are saddled with debt, which limits their ability to act—and, the central government's. There has also been a decline in foreign direct investments in China. Some sectors will probably recover eventually, but these gains won't erase the underlying problems that are hobbling growth.

Meanwhile in the eurozone, goods-producing sectors were holding back growth in early 2023, but we're now seeing signs of weakness in services as well. Despite a good tourism season, the services PMIs for the eurozone and its largest economies have fallen below 50 (graph 2). As such, composite indexes that include both the manufacturing and services sectors are telegraphing a decline in real GDP.

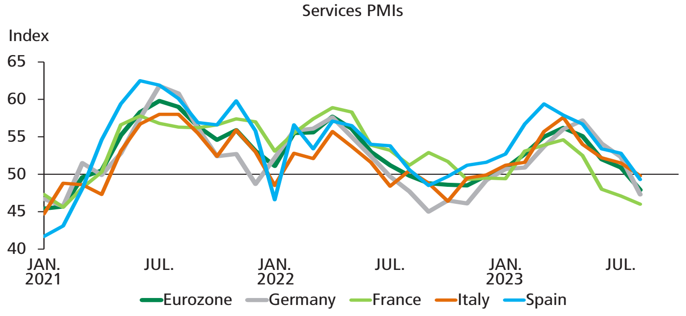
The situation seems particularly difficult in Germany, where ifo business confidence indexes are depressed and consistent with a recession. Germany's manufacturing sector, which is proportionally larger than in most other countries, is of particular concern. Weakness is concentrated in the automotive and pharmaceutical sectors (graph 3 on page 5). After quarterly declines in real GDP in late 2022 and early 2023, the German economy eked out annualized growth of just 0.1% this spring. However, more negative quarters are likely to follow. France is

GRAPH 1
New Home Sales Have Been Declining in China since 2021



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

GRAPH 2
The Services Sector Is Starting to Falter in the Eurozone

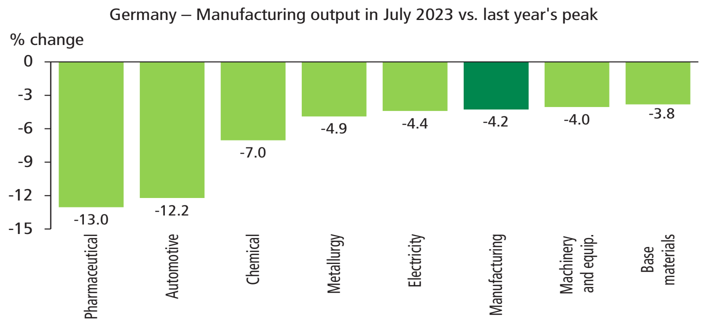


Sources: S&P Global, Datastream and Desjardins Economic Studies faring better so far but will probably ultimately feel the effects of interest rate hikes and suffer the knock-on effects of Germany's problems.

Like the US, the UK has performed slightly better than expected in recent quarters. However, the UK still has some of highest inflation of any advanced economy. Household and business confidence remain low, but above year-earlier levels. In addition, the Office for National Statistics recently upgraded the UK real GDP by 1.8%. Germany has replaced the UK at the back of the pack when it comes to its post-pandemic recovery (graph 4). That said, it's not all good news for the UK economy. Monthly GDP fell sharply in July, and the number of unemployed workers is also starting to increase. Interest rate hikes should sooner or later lead to declines in real GDP.

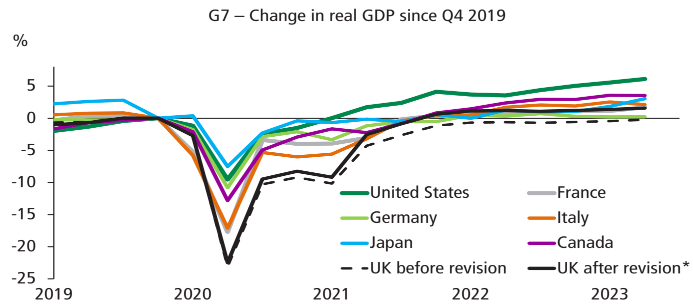
Japan is the only G7 economy that outperformed the US in the first half of 2023. After rising an annualized 3.2% in Q1, real GDP was up 4.8% in Q2. However, the largest contribution to this growth came from net exports, while the other components were rather downbeat, none more so than real consumer spending, which fell 2.5% in the second quarter (graph 5). It remains to be seen if this domestic weakness takes hold, but it's clear that global economic headwinds may hamper the Japanese economy.

GRAPH 3
Germany's Manufacturing Struggles Are Widespread



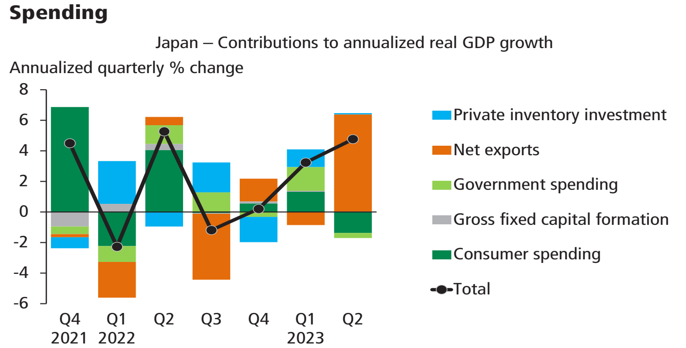
Sources: Federal Statistical Office and Desjardins Economic Studies

GRAPH 4
UK Real GDP Has Been Revised Upwards, Lifting It out of Last Place in the G7



* Using revised data through Q4 2021 and previously published changes starting with Q1 2022.
Sources: Datastream, Office for National Statistics and Desjardins Economic Studies

GRAPH 5
Japanese Real GDP Growth Has Surged despite Lower Consumer Spending



Sources: Cabinet Office and Desjardins Economic Studies

United States

The US Economy Continues to Send Mixed Signals, but a Recession Remains Likely

FORECASTS

The US economy continues to grow. We even expect Q3 real GDP to come in sharply higher on the back of solid consumer spending growth. And employers keep hiring, albeit at a more modest pace. But we still see several signs that real GDP could weaken as the lagged effects of rate hikes ripple through the economy. We expect real GDP to contract late this year and early next year before gradually returning to growth in 2024.

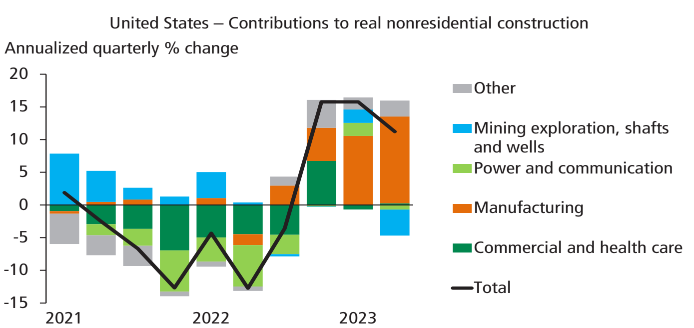
US real GDP expanded at an annualized 2.1% in the second quarter after a nearly identical gain of 2.0% in the first quarter. Since the start of the year, growth has been faster in the US than in most other major advanced economies. Within the G7, only Japan is growing faster. The US economy has also been beating expectations. Not so long ago, it was thought that the cumulative effect of rate hikes would have done more to slow US economic growth by now. But so far, there are few signs of an imminent downturn.

Take the third quarter, for example. Forecasts for Q3 2023 have been revised higher all summer. We now expect real consumption of goods and services to come in stronger. And remarkably given today's high interest rate environment, we're expecting the first positive quarterly print for residential investment since early 2021. We also see private inventory investment and net exports making a positive contribution to quarterly real GDP growth, which could come in around 4% on an annualized basis.

The economy is also getting support from the ongoing shift in the manufacturing sector. The Biden administration's various programs to boost manufacturing have been fuelling nonresidential construction (graph 6) since late 2022. The tech sector has been the biggest beneficiary. But there are signs that the momentum we've seen in recent quarters is starting to wane. Aside from government assistance targeted at a few very specific industries, the manufacturing sector isn't getting much support. The ISM Manufacturing Index remains below 50, and the weak global economy probably won't help goods exports any. Industrial production is also rather sluggish, and manufacturing has added just 23,000 new jobs since the start of 2023 (compared to 307,000 in the first eight months of 2022).

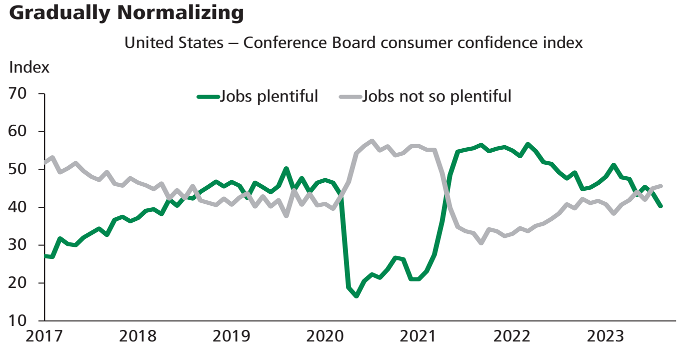
Manufacturing isn't the only sector where hiring has cooled. Although total employment across all sectors continues to rise, job growth has slowed. Over the past three months, payrolls have expanded at half the monthly pace we saw at the beginning of the year. Job openings and quits are down too. And by the looks of the consumer confidence indexes, opportunities are becoming more scarce for job seekers (graph 7 on page 6).

GRAPH 6
US Nonresidential Construction Continues to Rally



Sources: Bureau of Economic Analysis and Desjardins Economic Studies

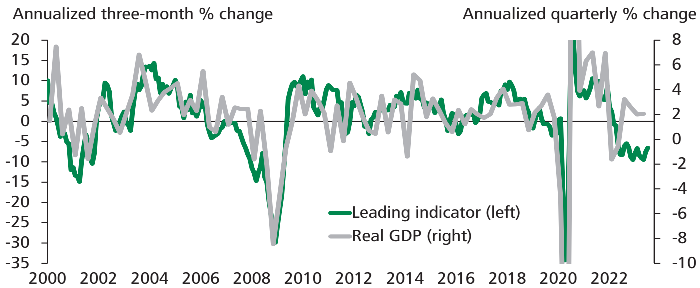
GRAPH 7
Consumer Confidence Readings Suggest the Labour Market Is Gradually Normalizing



Sources: Conference Board and Desjardins Economic Studies

We expect to see more of this in the coming months as the US economy continues to grapple with the effects of higher interest rates, tighter credit conditions, a higher cost of living, smaller savings and a more challenging global economy. Weak consumer confidence, a sharply lower leading indicator (graph 8) and jittery financial markets are all pointing to an economic downturn. We still expect the new year to usher in net job losses and higher unemployment, bringing inflation down further in the United States. Inflation has ticked up recently on higher oil and gasoline prices, but it should start to retreat again soon. Core inflation—which strips out food and energy—continues to decline, but it's taking its time. As expected, the economy will have to slow some more to get inflation back to the Fed's target and keep it there.

GRAPH 8
The Leading Indicator Still Points to Declines in US Real GDP



Sources: Conference Board, Bureau of Economic Analysis and Desjardins Economic Studies

TABLE 3
United States: Major economic indicators

QUARTERLY ANNUALIZED % CHANGE (UNLESS OTHERWISE INDICATED)	2022		2023				ANNUAL AVERAGE			
	Q3	Q4	Q1	Q2	Q3f	Q4f	2021	2022	2023f	2024f
Real GDP (2012 US$)	**3.2**	**2.6**	**2.0**	**2.1**	**4.0**	**-0.6**	**5.9**	**2.1**	**2.2**	**1.0**
Personal consumption expenditures	2.3	1.0	4.2	1.7	3.4	-0.8	8.3	2.7	2.3	0.8
Residential construction	-27.1	-25.1	-4.0	-3.6	3.3	-2.5	10.7	-10.6	-11.6	1.1
Business fixed investment	6.2	4.0	0.6	6.1	1.3	0.2	6.4	3.9	3.0	1.2
Inventory change (US$B)	38.7	136.5	3.5	-1.8	40.0	20.0	-19.4	125.0	15.4	-10.0
Public expenditures	3.7	3.8	5.0	3.3	2.0	1.4	0.6	-0.6	3.3	1.3
Exports	14.6	-3.7	7.8	-10.6	4.3	-1.0	6.1	7.1	2.0	-0.2
Imports	-7.3	-5.5	2.0	-7.0	1.0	-1.1	14.1	8.1	-2.7	-1.4
Final domestic demand	1.5	0.7	3.5	2.3	2.9	-0.3	6.7	1.7	2.0	0.9
Other indicators										
Nominal GDP	7.7	6.6	6.1	4.1	7.4	2.1	10.7	9.2	6.1	3.5
Real disposable personal income	3.2	2.5	8.5	3.3	0.4	-0.3	1.9	-6.2	3.5	0.1
Employment[1]	3.4	2.5	2.5	1.7	1.3	0.7	2.9	4.3	2.3	0.0
Unemployment rate (%)	3.6	3.6	3.5	3.6	3.7	3.9	5.4	3.7	3.7	4.9
Housing starts[2] (thousands of units)	1,446	1,405	1,385	1,443	1,426	1,363	1,606	1,551	1,404	1,434
Corporate profits*[3]	5.5	2.6	-1.8	-6.5	-6.8	-5.5	22.6	6.6	-5.2	1.2
Personal savings rate (%)	3.2	3.4	4.3	4.5	3.7	4.0	11.9	3.5	3.5	3.5
Total inflation rate*	8.3	7.1	5.8	4.1	3.5	3.3	4.7	8.0	4.1	2.5
Core inflation rate*[4]	6.3	6.0	5.6	5.2	4.4	3.9	3.6	6.1	4.8	2.8
Current account balance (US$B)	-891	-865	-877	-880	-865	-863	-831	-972	-871	-839

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

The Bank Pauses Rate Hikes as a Recession Looms Large on the Horizon

FORECASTS

High interest rates are increasingly taking their toll on the Canadian economy. Economic activity has underperformed expectations recently, and there is little room for optimism in the near term. Indeed, we expect that the Canadian economy will experience a short, shallow recession in the next year. However, as the economy slows, inflation should gradually converge back to the Bank of Canada's two percent target. This is likely to prompt the Bank to shift from its current holding pattern to cutting interest rates in early 2024.

The tide looks to be turning for the Canadian economy. Now 18 months into the most aggressive rate hiking cycle in a generation, the long-awaited recession looks as though it may not be far off. While real GDP growth fell by a modest 0.2% annualized in Q2, the decline was broad-based. The outcome was also well below the Bank of Canada's forecast (+1.5%) and the consensus of economic forecasters (+1.2%). Growth in prior quarters was marked down as well.

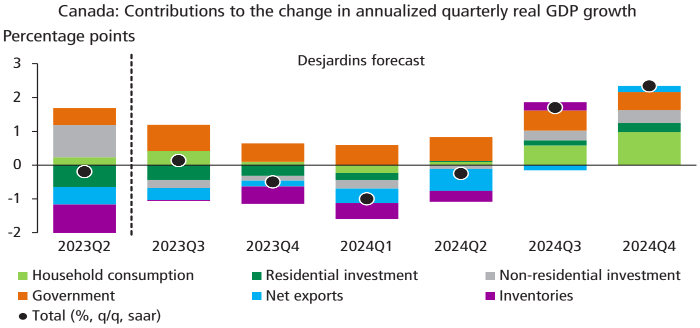
That said, some of the weakness in the second quarter was temporary, resulting from wildfires, strikes and the like. This means we may see a modest reversal of fortunes in the third quarter. Indeed, after a drop in real GDP growth in June and a flat print likely for July, we expect monthly GDP to advance in August and September. As a result, we're projecting real GDP to eke out a slight gain in Q3 (graph 9).

But the trend is not the Canadian economy's friend. High interest costs are weighing on Canadians, raising the cost of servicing debt while driving up consumer and business proposals to above pre-COVID levels (graph 10). This has helped to sour sentiment and sustain concern about a recession in the coming year. As more and more Canadians see their household budgets eroded by higher interest payments, this should act to suppress consumption and investment as they prioritize making mortgage payments over discretionary spending. Indeed, we're expecting residential and business investment to be a sustained drag on economic activity for much of the next year. And the consumer likely won't be far behind, probably pushing household consumption growth into negative territory around the turn of the year.

The Bank of Canada is well aware of the pain high interest rates are inflicting on the Canadian economy. Hence, it decided to keep rates on hold at its September meeting in order to survey the lagged impacts on growth, the labour market and, ultimately, inflation. After resuming rate hikes in June and July to tamp down what looked to be a resurgence in economic activity, the message that the central bank will do whatever it takes to return inflation to its two percent target looks to have gotten through. As such, we're not expecting another rebound in consumer and housing market activity akin to the one that followed the Bank's previous pause.

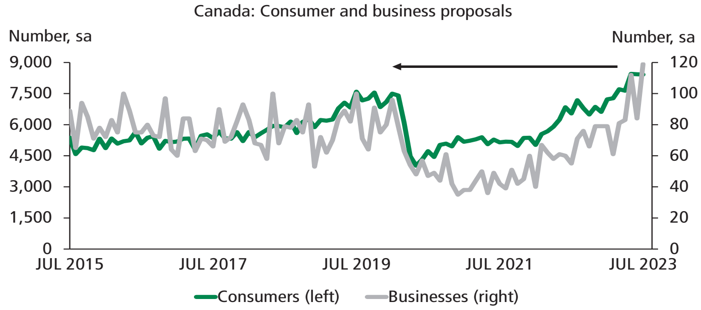
As the economy enters a recession around the turn of the year, we believe this will prompt the Bank of Canada to begin cutting interest rates as early as the end of the first quarter of 2024. By this time, consecutive quarterly declines in real GDP and a

GRAPH 9
Canada's Economy Is Expected to Be in Recession in Early 2024



Sources: Statistics Canada and Desjardins Economic Studies

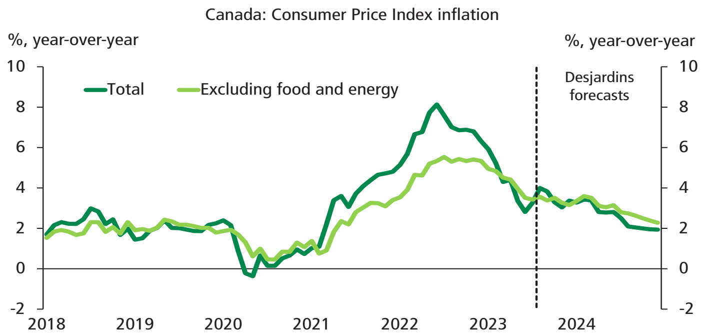
GRAPH 10
Consumer and Business Proposals Have Surpassed Pre-Pandemic Levels



SA: Seasonally adjusted using the Census X-12 method
Sources: Innovation, Science and Economic Development Canada and Desjardins Economic Studies

steadily rising unemployment rate should be accompanied by a marked slowing in underlying inflation (graph 11). This should give the Bank of Canada room to cut interest rates even before inflation has returned to its 2% target, as monetary policy will remain restrictive. That said, rate cuts early next year should be supportive of a rebound in economic growth starting in the second half of the year. But the legacy of high inflation and interest rates will weigh on the Canadian economy for years after they return to more typical levels. As homeowners renew their mortgages, they will continue to come up against much higher monthly interest payments, particularly those Canadians with fixed-payment variable-rate mortgages who have managed to kick the can down the road thus far.

GRAPH 11
Inflation Has Peaked in Canada and Is Expected to Keep Slowing



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	Q2	Q3f	Q4f	2021	2022	2023f	2024f
Real GDP (2012 $)	**2.3**	**-0.1**	**2.6**	**-0.2**	**0.1**	**-0.5**	**5.0**	**3.4**	**1.1**	**0.0**
Final consumption expenditure [of which:]	1.5	1.4	2.4	1.0	1.4	0.7	5.4	4.0	1.8	0.9
Household consumption expenditure	*0.3*	*1.1*	*4.7*	*0.2*	*0.7*	*0.2*	*5.1*	*4.8*	*2.1*	*0.3*
Government consumption expenditure	*4.7*	*2.3*	*-3.7*	*2.5*	*3.0*	*2.0*	*6.4*	*2.0*	*0.9*	*2.4*
Gross fixed capital formation [of which:]	-8.5	-3.9	-2.7	1.2	-2.4	-1.5	7.4	-1.5	-3.3	-0.4
Residential structures	*-18.4*	*-9.9*	*-19.1*	*-8.2*	*-4.6*	*-3.3*	*14.9*	*-11.2*	*-13.6*	*-1.9*
Non-residential structures	*6.5*	*11.6*	*8.8*	*9.9*	*-7.2*	*-3.2*	*0.8*	*8.3*	*6.3*	*-1.7*
Machinery and equipment	*-7.8*	*-28.6*	*0.3*	*11.1*	*2.2*	*-0.8*	*9.9*	*7.4*	*-3.8*	*0.3*
Intellectual property products	*-9.6*	*1.2*	*7.5*	*2.6*	*2.8*	*2.1*	*4.0*	*0.7*	*2.0*	*2.2*
Government gross fixed capital formation	*-5.3*	*10.6*	*10.2*	*-0.8*	*2.7*	*2.4*	*0.9*	*2.1*	*3.9*	*2.4*
Investment in inventories (2012 $B)	53.3	24.3	16.1	11.1	10.9	8.1	-4.1	39.5	11.5	5.0
Exports	11.3	2.2	10.2	0.4	-1.2	-1.0	1.4	2.8	4.6	-0.4
Imports	-2.3	-12.6	0.7	1.9	-0.1	-0.4	7.8	7.5	-0.7	0.6
Final domestic demand	-0.9	0.2	1.2	1.0	0.5	0.2	5.8	2.7	0.6	0.6
Other indicators										
Nominal GDP	-2.5	-3.0	3.1	2.7	2.7	0.7	13.6	10.9	1.8	1.8
Personal savings rate (%)	-0.7	5.2	-5.0	6.5	-0.3	-2.4	1.2	-0.4	0.2	0.6
Employment	-1.3	2.2	4.7	1.6	1.2	0.1	5.0	4.0	2.3	0.4
Unemployment rate (%)	5.1	5.1	5.0	5.2	5.6	6.1	7.5	5.3	5.5	7.1
Housing starts[1] (thousands of units)	281	259	223	249	230	215	271	262	229	214
Corporate profits*[2]	15.5	-7.2	-17.6	-30.9	-18.9	-3.0	35.8	8.4	-18.4	11.0
Personal savings rate (%)	4.7	5.8	3.7	5.1	4.8	4.2	10.9	6.1	4.4	4.7
Total inflation rate*	7.2	6.7	5.1	3.5	3.7	3.2	3.4	6.8	3.9	2.6
Core inflation rate*[3]	5.4	5.4	4.8	4.0	3.5	3.3	2.3	5.0	3.9	2.9
Current account balance ($B)	-9.8	-8.1	-3.2	-6.6	-9.0	-11.6	-6.7	-9.1	-30.5	-59.6

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 on Fragile Footing

FORECASTS

While Canada's economy has just begun to show signs of slowing, Quebec's has been weakening for several months. Monthly key indicators are very uneven, and the economic downturn seems to be already underway. High interest rates and sticky inflation are eating into household budgets as the effects of the provincial government's 2022 fiscal stimulus fade. The difficulties are mounting for businesses, which will have a tough time supporting the economy. The situation is particularly acute in the forestry industry, which has been hit hard by wildfires. Our scenario predicts a period of real GDP contraction lasting into early 2024.

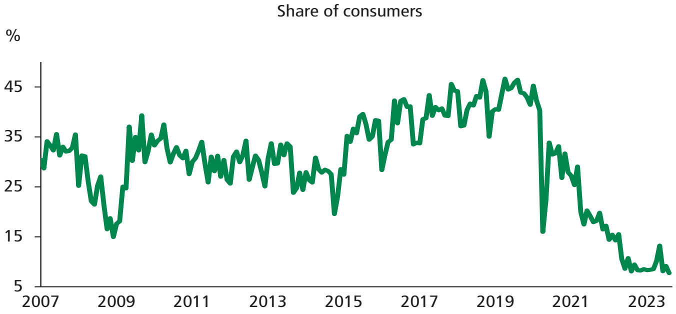
Consumer spending has kept up a good pace until very recently, but cracks are starting to show. Quebec's consumer confidence index continues to weaken and is approaching recession level. In addition, the share of consumers that think it's the right time to make a major purchase has dropped to a 20-year low (graph 12). Sales of durable goods such as motor vehicles, home furnishings and appliances have also declined. Rising interest rates are starting to put a dent in major purchases. We expect this deterioration to continue over the coming quarters as higher interest rates bite harder and the labour market becomes less favourable.

Job creation has been sluggish for a while, but Quebec added 14,800 workers in August. The unemployment rate dipped from 4.5% in July to 4.3% in August, compared to a record low of 3.9% at the beginning of the year. August's solid performance—which came after a few months of disappointing results—isn't enough to change our forecast. Employment is expected to decline in the coming months as real GDP contracts through spring 2024. The unemployment rate will likely rise to between 6% and 6.5% over the same timeframe.

Behind the scenes, there are signs that the labour market is cooling. The number and rate of job vacancies in Quebec have fallen from their May 2022 peaks (graph 13). Businesses are starting to feel the effects of weaker demand. Many are seeing their financial situations worsen, and deteriorating economic conditions could prompt some to reduce their staff. Wage pressures are also easing. Annual average hourly wage growth fell from nearly 7% early this year to around 3% in the summer and is now lower than July's 3.9% inflation rate.

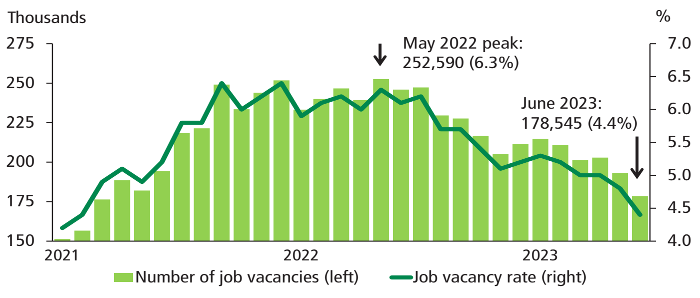
Growth in household income after tax and inflation will give way to a contraction in 2023 (graph 14 on page 11). Faltering wages and less generous government transfers than last year will have a huge impact. Employment is expected to soon start trending lower, and wage growth will continue to slow. Meanwhile, although the Quebec government's (in French only) tax cuts enacted on July 1—a one-point decrease in the first two tax brackets—represent a $1.7 billion windfall for the 2023–2024 fiscal year, this is far less than the government support measures passed in 2022.

GRAPH 12
Not Many Quebecers Think It's a Good Time to Make a Major Purchase, and It's Starting to Show Up in the Durable Goods Data



Sources: Conference Board of Canada and Desjardins Economic Studies

GRAPH 13
Job Vacancies in Quebec: Steep Slide from the Peak

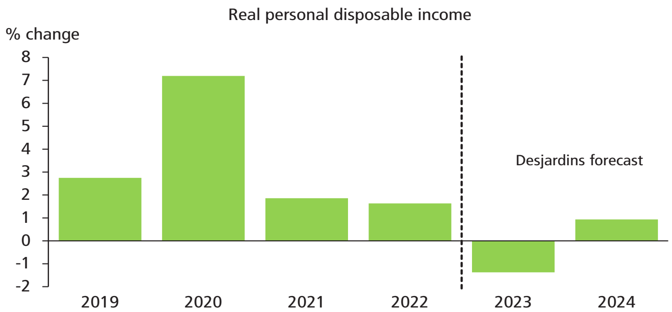


Sources: Statistics Canada and Desjardins Economic Studies

Between the dampening effects of higher interest rates and the decreased purchasing power that will also impact the housing sector, we should soon see a second wave of corrections in the resale market in terms of both prices and sales (graph 15). Housing starts were down about 15% last year and are expected to drop by nearly 40% this year across all market segments.

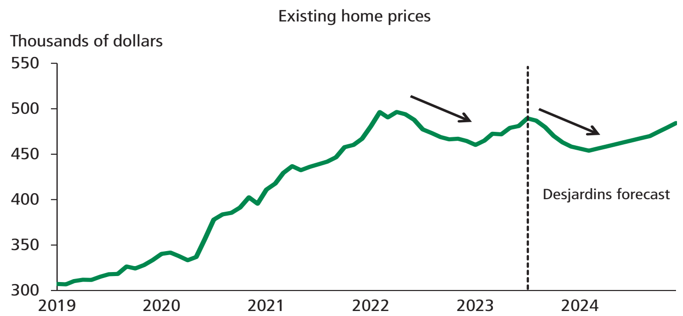
In the purpose-built rental housing sector, high interest rates combined with elevated material and labour costs are jeopardizing the profitability of many projects, which may have to be postponed or cancelled despite urgent demand for rental apartments.

GRAPH 14
Income after Tax and Inflation Will Drop in Quebec in 2023



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

GRAPH 15
Despite the Second Wave of Price Declines Expected in Quebec, Prices Will Remain Relatively High



Sources: Canadian Real Estate Association 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**	**2.6**	**0.4**	**0.1**
Final consumption expenditure [of which:]	-3.3	5.9	3.6	2.7	1.2
Household consumption expenditure	*-5.7*	*5.4*	*4.7*	*3.6*	*1.0*
Government consumption expenditure	*2.0*	*7.3*	*1.5*	*0.4*	*1.7*
Gross fixed capital formation [of which:]	-1.0	7.2	-4.0	-7.5	0.3
Residential structures	*2.8*	*12.9*	*-11.5*	*-15.6*	*0.3*
Non-residential structures	*0.6*	*-1.5*	*1.2*	*-1.8*	*-3.5*
Machinery and equipment	*-15.1*	*20.3*	*1.0*	*-10.7*	*-2.6*
Intellectual property products	*0.1*	*7.1*	*-1.2*	*0.6*	*1.1*
Government gross fixed capital formation	*0.5*	*-3.5*	*1.7*	*1.6*	*4.4*
Investment in inventories (2012 $M)	-6,550	-431	6,442	-1,467	500
Exports	-7.8	2.9	4.2	-0.3	-0.8
Imports	-7.9	6.8	6.5	-0.5	1.3
Final domestic demand	-2.9	6.2	1.9	0.5	1.0
Other indicators					
Nominal GDP	-1.9	11.8	9.6	2.4	1.2
Real disposable personal income	7.2	1.9	1.6	-1.4	0.9
Weekly earnings	7.9	2.9	4.1	2.7	2.1
Employment	-5.4	4.3	3.0	2.1	-0.7
Unemployment rate (%)	8.9	6.1	4.3	4.4	5.9
Personal savings rate (%)	17.4	14.6	11.4	4.8	3.5
Retail sales	0.7	14.4	8.5	3.6	2.3
Housing starts[1] (thousands of units)	54.1	67.8	57.1	35.5	37.0
Total inflation rate	0.8	3.8	6.7	4.0	2.4

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

f: forecasts; * annual change; [1] annualized basis; [2] before taxes; [3] excluding food and energy.
Sources: Datastream and Desjardins Economic Studies

Medium-Term Issues and Forecasts

What It Will Take to Achieve Low, Stable Inflation in the Medium Term

The fight against inflation is taking longer than expected. In Canada, inflation may not stabilize at its 2% target until late 2024. The timing will vary a bit from country to country, and some conditions will need to be met first. The labour market will have to come into a better balance. And aggregate demand will have to stay at or below production capacity. In this regard, the energy transition poses an additional medium-term challenge as it will require more investment and spending in several areas. Geopolitical tensions and the end of globalization as we've known it for 30 years are also problematic as they could hold back efforts to boost global economic potential. It will likely be more difficult to balance supply and demand in the medium term, and we may not see interest rates return to their previous-cycle average on a sustained basis.

Low, Stable Inflation Remains a Laudable Goal

The public is increasingly opposed to raising interest rates to combat inflation, and that's understandable. But not taming rampant inflation would be worse. No one is immune to inflation. It erodes purchasing power, and those with the smallest income gains feel the biggest pain. This could ultimately hurt consumption and lead to stagflation, a period of low growth and high inflation.

For 2025 and beyond, we expect a better balance between supply and demand consistent with stable inflation close to the 2% target. This would mean a softer labour market than we've seen in recent quarters. Job vacancy rates will have to come down, unemployment will need to tick up and wage growth will need to moderate. By our estimates, Canada's equilibrium unemployment rate is around 6.0%. It's a bit lower for Quebec, where the workforce is expanding at a slower pace. Meanwhile equilibrium wage growth is typically equal to 2% inflation plus productivity gains. Canada currently has very low productivity growth, and much more business investment will be needed to see some improvement over the medium term.

The Energy Transition Will Affect Demand

Increased spending and investment to support the energy transition should drive real GDP growth in the medium term. Adapting to climate change will also require spending and investment. In Canada, which has very high population growth, we'll also need to shore up investment in housing and a number of other sectors to meet the needs of our burgeoning populace.

It's hard to predict when all this spending and investment will happen, adding even more uncertainty to medium-term forecasts. We suspect it will stimulate aggregate demand for several years. But surplus demand would create additional inflationary pressures. Some of it could be offset by investments that increase production capacity. But to keep inflation at or below 2%, interest rates will likely need to be higher than they were in the previous economic cycle. We believe Canada's overnight rate will converge to 2.50% in the medium term, with risks tilted to the upside.

A Shift in Globalization

When it comes to future inflationary pressures and interest rates, globalization is a major source of uncertainty. For three decades, globalization helped optimize manufacturing processes and expand access to capital, boosting global economic growth potential and keeping inflation low.

Right now, many countries are looking to reduce their dependence on China. The cost to produce some goods could edge up as a result. And geopolitical tensions are running high amid the war in Ukraine and political uncertainty in Asia and many African countries. So it makes sense not to over-rely on globalization to support the economy and keep inflation low in the coming 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	2.2	1.0	2.4	2.4	2.1	2.1	2.0
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	4.9	5.1	4.8	4.5	4.9	4.6
S&P 500 index (% change)[1]	26.9	-19.4	6.8	4.9	6.3	4.5	4.5	9.3	5.4
Federal funds rate	0.25	1.86	5.20	5.00	3.20	2.95	3.00	1.37	3.87
Prime rate	3.25	4.86	8.20	8.00	6.20	5.95	6.00	4.37	6.87
Treasury bills – 3-month	0.05	2.09	5.20	4.45	2.90	3.00	3.00	1.32	3.71
Federal bonds – 10-year	1.43	2.96	3.85	3.35	3.05	3.10	3.10	2.07	3.29
– 30-year	2.05	3.12	3.95	3.45	3.15	3.20	3.20	2.48	3.39
WTI oil (US$/barrel)	68	95	76	82	82	80	78	65	80
Gold (US$/ounce)	1,800	1,803	1,925	1,740	1,605	1,600	1,600	1,607	1,694
Canada									
Real GDP (% change)	5.0	3.4	1.1	0.0	2.0	1.8	2.0	1.6	1.4
Total inflation rate (% change)	3.4	6.8	3.9	2.6	1.9	2.0	2.0	3.0	2.5
Employment (% change)	5.0	4.0	2.3	0.4	1.8	1.4	1.6	1.4	1.5
Personal savings rate (%)	903	750	450	77	364	289	338	260	304
Unemployment rate	7.5	5.3	5.5	7.1	6.7	6.3	5.9	6.8	6.3
Housing starts (thousands of units)	217	271	229	214	235	241	235	234	231
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	0.76	0.77	0.76	0.77	0.77	0.76
Personal savings rate (%)	0.25	1.95	4.75	4.25	2.50	2.25	2.50	1.18	3.25
Prime rate	2.45	4.14	6.95	6.45	4.70	4.45	4.70	3.38	5.45
Mortgage rate – 1-year	2.80	4.43	7.00	6.50	5.15	5.00	5.00	3.52	5.73
– 5-year	4.79	5.64	6.75	7.10	6.60	6.55	6.65	5.18	6.73
Treasury bills – 3-month	0.11	2.18	4.70	3.90	2.35	2.20	2.50	1.15	3.13
f: forecasts; [1] annualized basis. Sources: Statistics Canada, Institut de la statistique	0.48	2.90	4.20	3.30	2.60	2.70	2.85	1.49	3.13
f: forecasts; * annual change; ** annualized basis; [2] before taxes; [3] excluding food and energy	0.95	2.78	3.55	2.95	2.55	2.70	2.90	1.60	2.93
– 10-year	1.36	2.77	3.35	3.05	2.75	2.80	2.95	1.75	2.98
– 30-year	1.85	2.81	3.20	2.95	2.70	2.75	2.90	2.01	2.90
Yield spreads (Canada – United States)									
Treasury bills – 3-month	0.06	0.09	-0.50	-0.55	-0.55	-0.80	-0.50	-0.17	-0.58
Federal bonds – 10-year	-0.07	-0.19	-0.50	-0.30	-0.30	-0.30	-0.15	-0.32	-0.31
– 30-year	-0.20	-0.31	-0.75	-0.50	-0.45	-0.45	-0.30	-0.48	-0.49
Quebec									
Real GDP (% change)	6.0	2.6	0.4	0.1	1.6	1.6	1.5	1.9	1.0
Total inflation rate (% change)	3.8	6.7	4.0	2.4	1.9	2.0	2.0	3.0	2.5
Employment (% change)	4.3	3.0	2.1	-0.7	1.9	1.6	1.1	1.1	1.2
Employment (thousands)	177	130	90	-30	85	75	50	49	54
Unemployment rate	6.1	4.3	4.4	5.9	5.1	4.3	3.8	6.0	4.7
Retail sales (% change)	14.4	8.5	3.6	2.3	4.5	4.2	4.0	5.7	3.7
Housing starts (thousands of units)	68	57	36	37	46	51	53	55	45

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