ECONOMIC VIEWPOINT

What To Watch in 2023

It Will Get Worse before It Gets Better

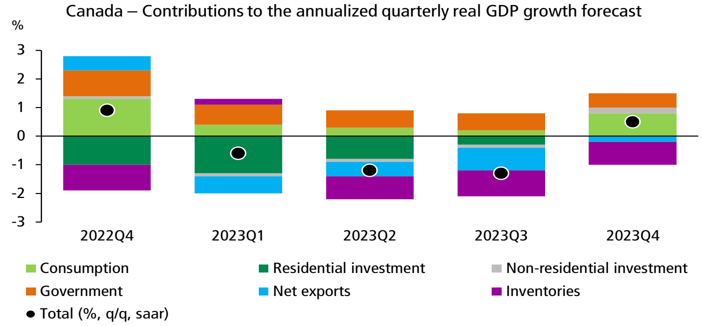
Between the fallout from the higher cost of living, stubborn supply chain issues, China's economic woes, declining household wealth and, most importantly, monetary tightening by the major central banks, a worldwide recession is expected in 2023. **The severity of the economic contraction is likely to vary by country and may diverge from our baseline scenarios.** In the United States, we expect a fairly modest decline in real GDP, but a soft landing with no official recession—or a more severe contraction—cannot be ruled out. As a result, we'll be keeping a close eye on the US labour market and how the Fed reacts.

Similarly in Canada, policy tightening by the Bank of Canada will continue to weigh on housing and consumer activity as well as the labour market in 2023. Growth is expected to contract in at least two quarters of the year as a result (graph 1).

In Quebec, the recession appears to have already begun, with annualized real GDP declining 1.9% in the third quarter of 2022. If the downturn continues over the next few quarters, a recession will be a certainty. The 0.5% drop in real GDP in September bodes ill for the fourth quarter. The contraction of economic activity is already fairly widespread in most business sectors and will persist in the short term. We expect things to improve near the end of 2023, but real GDP will be negative for the year as a whole (graph 2).

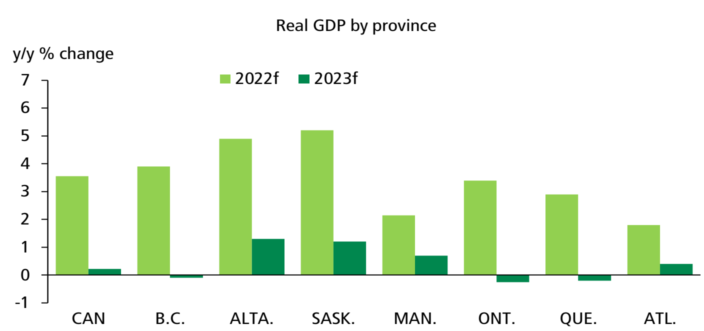
After falling precipitously from its February 2022 peak, **the Canadian housing market is likely done correcting for the most part.** Activity should instead grind gradually lower as a growing number of households renew their mortgages at much higher interest rates. While new listings should rise, we anticipate that households will mainly opt to reduce consumption as opposed to selling their home. But there will be wide variability in outcomes across and within provinces. Ontario and British Columbia have led the adjustment so far. The baton is now expected to be handed off to the Maritime provinces, which benefitted significantly from people leaving central Canada during the pandemic. Meanwhile, the Prairie provinces have

GRAPH 1
Economic weakness should be increasingly broad based in 2023 in Canada



Source: Desjardins Economic Studies

GRAPH 2
The effects of the recession will be felt in all regions of Canada



f: forecasts
Sources: Statistics Canada and Desjardins Economic Studies

outperformed the rest of the country, and this is expected to continue.

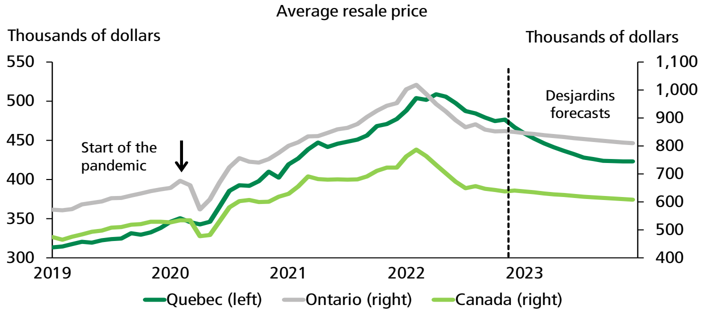
Quebec's housing market will also continue to deteriorate in 2023. Prices will correct further and are expected to be about 15% off their spring 2022 peak by the end of 2023 (graph 3). The initial decline in average prices in 2022, which was mostly due to falling demand, will be followed by a second wave this year. Housing inventory will increase more quickly, and demand will sag even more. Indeed, certain parts of the province could see a shift to a buyer's market in 2023, which will prolong the price correction.

Although the monetary tightening cycle appears to be drawing to an end, policy rates will remain high in 2023. **The debt burden will be harder and harder for many Canadian households to manage.** There were fewer insolvency cases during the pandemic, thanks to government financial support and relief from financial institutions. However, rising interest rates and discontinued emergency measures have driven the number of consumer proposals higher, and bankruptcies will be close behind (graph 4).

Despite our call for a recession next year, some sectors of Canada's economy face more sanguine prospects. Supported by recovering plant capacity and easing supply chain constraints, automobile production is poised to surge in 2023 following a near 10% increase last year. In Ontario, that should help offset the drag from housing. Peak growth may be behind us in the energy sector, but government forecasts and company financial plans suggest that crude output will continue to rise in 2023. Major project activity—related to natural gas transportation in BC and to potash extraction in Saskatchewan—is also set to continue this year and provide a boost to capital expenditures. Amid market volatility, we will watch for further staff reductions in the technology sector, and whether job losses in financial services will follow those announced in the US. These industries grew significantly during the pandemic and cushioned against losses in other corners of Canada's economy (graph 5).

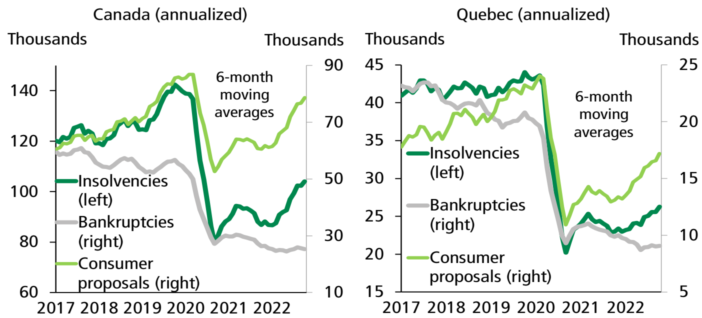
Falling demand at home and abroad will have knock-on effects for the Canadian labour market. Indeed, the unemployment rate is expected to move higher, likely surpassing 7% before the year is out. However, this is not a repeat of past recessions. We anticipate that employment will be flat to marginally higher in 2023 as labour demand remains elevated but the job vacancy rate gradually moves lower toward its pre-COVID average. But with the labour force growing quickly due to substantial immigration at a time when the economy is cooling, the level of unemployment is also expected to rise. Together, this should start to put downward pressure on wage growth in Canada. Labour market weakness should be most pronounced in those provinces where housing plays the largest role in the economy, such as Ontario, British Columbia and the Maritime provinces.

GRAPH 3
Prices will continue to correct in 2023, but remain above pre-pandemic levels



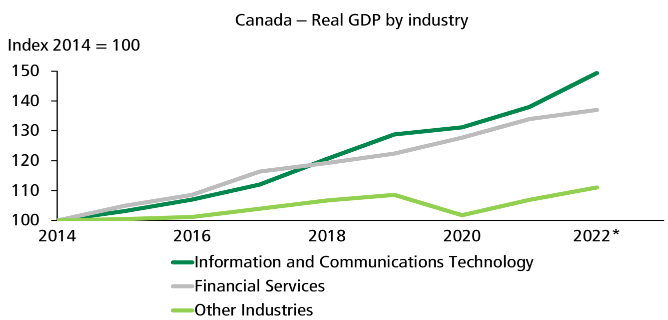
Sources: Canadian Real Estate Association and Desjardins Economic Studies

GRAPH 4
After plummeting at the beginning of the pandemic, consumer insolvency will continue to rise again



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

GRAPH 5
Tech and finance rose during the pandemic in Canada but may now be vulnerable



* Based on data from January to November
Sources: Statistics Canada and Desjardins Economic Studies

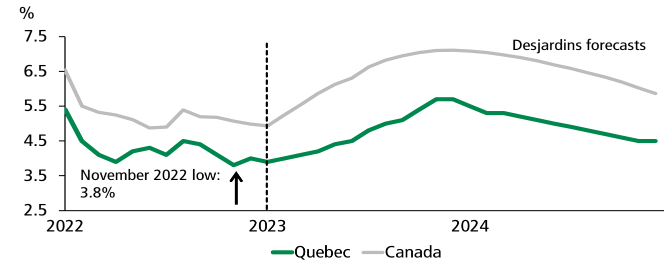
The deterioration of Quebec's labour market will also be limited by structural demographics. However, the labour shortage could ease while the unemployment rate rises gradually to a projected 6% by the end of 2023, far above the low point of 3.8% reached in November 2022 (graph 6). Wage increases should moderate accordingly, especially with inflation expected to ease during the year.

A sharp drop in inflation is expected in 2023. We think that inflation will even approach central bank targets by the end of the year (graph 7). Lower commodity prices and widespread relief on supply chain issues will likely drive goods inflation sharply down. Still, many commodity markets, especially oil, will be stuck in a precarious situation, and it won't take much to send prices shuttling in one direction or the other. Service prices might prove more resilient, but the anticipated recession in many countries should help subdue consumption and calm the labour markets. This should be equally true in Canada, where near-term indicators have already demonstrated a significant deceleration in price growth. Diminishing excess demand and a rising unemployment rate due to an impending recession should help to keep a lid on wage and services inflation. When combined with rapidly retreating global drivers of goods inflation, a rapid return toward the Bank of Canada's two percent inflation target by the end of 2023 is likely.

As economic and labour market tailwinds fade on the back of higher interest rates, the outsized revenue surprises that characterized public finances in 2022 will become a thing of the past. Indeed, the risks to official budget forecasts are tilted to the downside. At the federal level, we expected the budget deficit to increase in the 2023–2024 fiscal year. Moribund growth in nominal GDP—the broadest measure of the tax base—will come up against lagged inflation indexation, the rising use of automatic stabilizers such as Employment Insurance and higher public debt charges. In the provinces, which are responsible for health and education spending, there is also a risk that inflation-induced upward pressure on wages will drive public expenditures higher. There is a risk that governments may be tempted to increase transfers further to support households impacted by high inflation. This would have the unintended consequence of keeping inflation higher for longer.

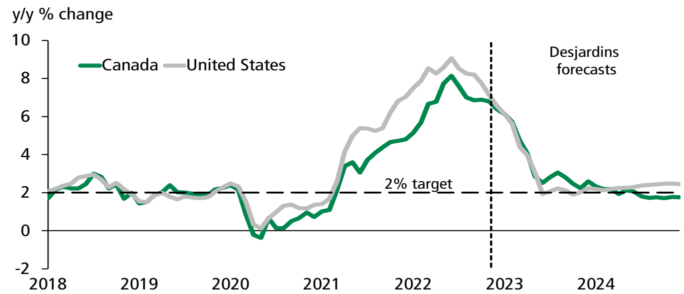
Public finances will also be a hot topic in 2023 in the United States. **The legal debt ceiling has already been reached, and the temporary measures of the US Treasury are likely to be exhausted this summer.** The legal ceiling will therefore have to be raised or suspended, which will no doubt provoke tough negotiations between the White House and the Democratic majority in the Senate on one side and the Republican majority in the House of Representatives (including its more extremist elements) on the other side.

GRAPH 6
The unemployment rate will likely rise in 2023 before gradually coming down in 2024



Sources: Statistics Canada and Desjardins Economic Studies

GRAPH 7
After peaking in 2022, inflation is expected to move closer to central bank targets in 2023



Sources: Statistics Canada, Bureau of Labor Statistics and Desjardins Economic Studies

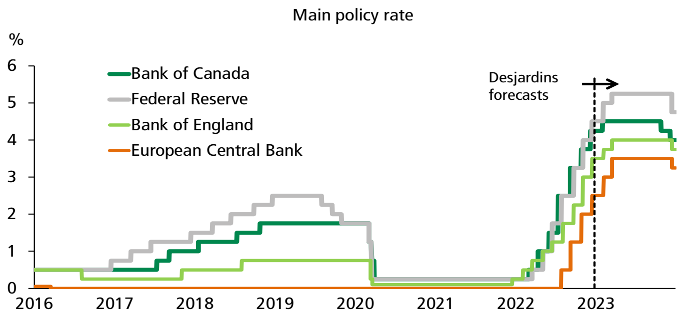
In 2023, far less dramatic policy rate increases await (graph 8). The Bank of Canada could pause its hikes after January's monetary policy meeting if it sees enough indications that inflation will decline. However, it may continue to raise rates if inflation proves too stubborn. The other major central banks, including the US Federal Reserve and the European Central Bank, are more likely to hike rates a few more times in early 2023, albeit much less aggressively than in 2022. With recessions expected in many countries and the resulting disinflationary pressures, we believe that most central banks will have a reason to pause during the year. We may even see the first policy interest rate cuts near the end of 2023 if inflation falls fast enough.

Financial markets are likely to remain very volatile for the start of the year, but then the situation should improve. Lower inflation will be positive for the fixed-income market. Some bond yields have already peaked or started to fall, and this should continue over the next few quarters. The outlook is less encouraging for the equity markets. While US and global stock indexes are set to kick off 2023 at relatively low valuations after a year of losses, listed corporate earnings appear to have peaked, and the outlook for 2023 is starting to lose its sheen (graph 9). The earnings decline could very well continue over the next few months as the economic cycle heads downward. The good news is that a rebound is expected later in the year, as more and more investors start to price in a recovery in economic activity.

The currency market is also expected to remain very volatile this year. Generally, rapid changes in interest rates and the economic climate are major sources of currency fluctuation. If many countries tip into recession, the US dollar should continue to benefit from its role as a global safe haven early in the year (graph 10). Further interest rate hikes in the US should also help the greenback. This may temporarily push the Canadian dollar close to the US$0.70 threshold. Other currencies could prove even more volatile in some emerging countries where capital outflows are often greater in times of economic uncertainty. There are risks that excessive currency movements could further destabilize certain economies, with import prices and foreign debt costs—both often denominated in US dollars—rising faster.

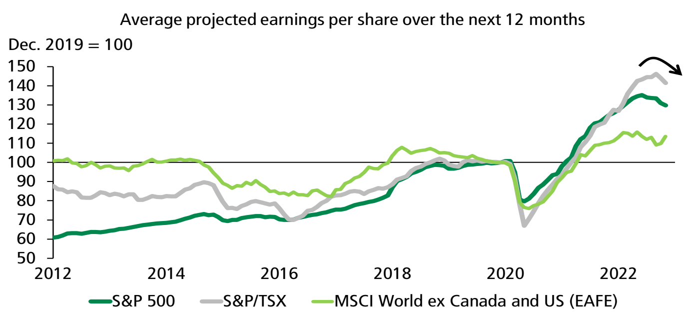
In 2023, will China get stuck or get moving? As the new year dawns, COVID-19 persists and case numbers remain high in China. The government has relaxed certain measures of its often-criticized zero-COVID policy, but the real concern is the human cost of the pandemic's wider spread. One cannot rule out the risk that restrictions are tightened again, especially if the health system becomes overwhelmed. Meanwhile, consumers and businesses alike have been suffering, and the real positive effects of this relaxation on domestic demand are debatable. Demand

GRAPH 8
The BoC may soon pause its hikes



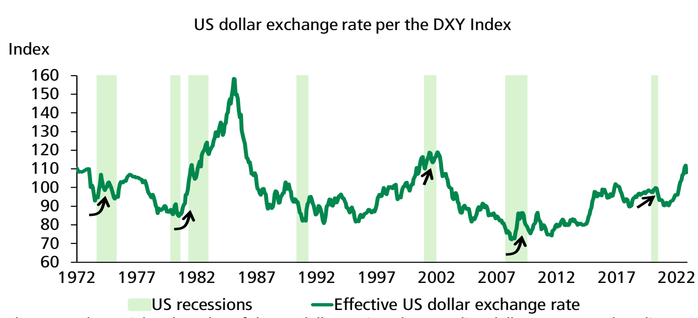
Sources: Datastream and Desjardins Economic Studies

GRAPH 9
Projected earnings are starting to slip



Sources: Datastream and Desjardins Economic Studies

GRAPH 10
The US dollar has often appreciated during recessions

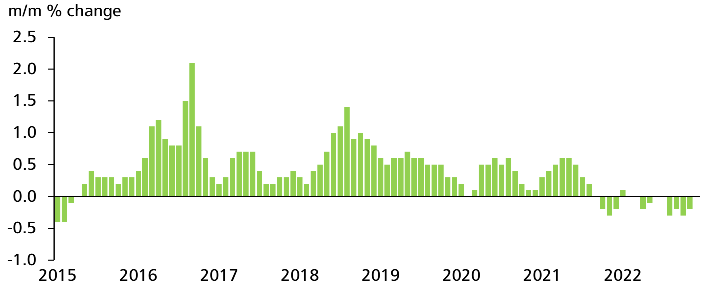


The DXY Index weights the value of the US dollar against the Canadian dollar, euro, pound sterling, yen, Swiss franc and Swedish krona.
Sources: Datastream and Desjardins Economic Studies

will also be further undermined by the real estate market debacle (graph 11). And the Chinese government's political and economic choices—and their repercussions on its industries' productivity—are another question. Another unknown is China's economic potential, which could be hobbled by protectionist attitudes in other countries, first and foremost the US. Relations between these two countries could also be further strained on the subject of Taiwan.

The war in Ukraine will continue to fuel economic uncertainty. The invasion has not turned out to be the quick conflict the Russian authorities were after, and fighting could last well into 2023. Depending on Ukrainian and Russian offensives and counteroffensives, the situation could potentially stabilize and leave more room for diplomacy. However, it would be a surprise if the war's economic fallout were to disappear this year. At the same time, the economic and financial sanctions against Russia—and Russia's reprisals—will probably stay in place. This will continue to be a headwind for European—and even global—economies, particularly if the noose tightens around metals and agricultural commodities, which have so far been spared. Still, the marginal effects could lessen with the passage of time.

GRAPH 11
After years of sustained growth, the average price of houses in China has experienced several declines



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