

# WEEKLY COMMENTARY



## Is “Short and Shallow” The New “Transitory”?

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

The forecasting community is split between those expecting a recession and those believing it can be narrowly avoided. But there is a broad consensus around the idea that the slowdown should be relatively mild and short lived. The relevant question is: what’s the risk to this view?

The track record of recessions clearly identifies financial instability as among the most potent factors that could drive a more severe recession, either in terms of the magnitude of the economic contraction, the timing of the bottom or the strength of the recovery period. As a result, markets have been watching closely for any potential “signs of cracks” in the financial system.

True, global financial market infrastructure has been significantly reinforced with macroprudential measures in the wake of the Global Financial Crisis. These have included countercyclical capital buffers for large banks to ensure their resilience to shocks. Stress-testing mortgage borrowers for their ability to withstand higher rates is another example and is proving particularly prescient right now. Higher mortgage rates are a headache for many variable-rate borrowers in Canada. But let’s imagine what would be happening now if more fragile borrowers had been granted mortgages.

The macroprudential measures put in place are not without limitations, however. Smaller balance sheets kept by capital market dealers is the direct result of the more stringent capital and liquidity requirements associated with rules implemented in the middle of the last decade. US Treasury Secretary Janet Yellen recently voiced her concern over the lack of liquidity in the Treasury market, with dealer balance sheets having failed to track the growth in the supply of government bonds.

Until this year, quantitative easing (QE) was helping mitigate those tensions as the Fed absorbed a significant chunk of the supply. It’s rather the opposite in the quantitative tightening

world we’re in today. Various measures of market functioning in the US Treasury market have been sending warning signals. For instance, the volume of Treasuries that primary dealers agree to trade at prevailing bid and ask prices, an indicator of market depth, has been hovering near record lows all year for shorter-dated bonds.

The growth in the size of open-ended investment mutual funds is another area of concern. These funds provide their shareholders with the right to redeem their shares on demand, although some of them are invested in assets that can be illiquid. If for whatever reason redemptions surged, funds would need to liquidate assets to repay investors. This could both depress the value of the assets held by given fund and reduce the value of the assets of other funds. That would in turn give investors an incentive to liquidate their shares across the sector.

A feedback loop is then created, as funds need to sell even more assets. The more illiquid the assets, the bigger the impact on prices. This isn’t just a theoretical risk. Mismatches between the liquidity profile of these funds’ assets and that of their liabilities contributed to the market turmoil of March 2020. In that episode, the hemorrhage was ultimately stemmed only when the Fed and other central banks extended their asset purchases to include corporate bonds.

It was an easy call to make back then since the improvement of market functioning was aligned with monetary policy objectives to support economic activity. Today, central banks are dealing with one of the most difficult monetary policy challenges they’ve faced in decades. As a result, central banks are wary of using rates and balance sheet policies for cross purposes. That constraint means there’s a higher risk of very sudden market moves, with the potential to trigger vicious cycles. Some [solutions](#) have been proposed, including broadening access to the Fed’s liquidity facilities to market participants beyond primary

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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.

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dealers and expanding central clearing. But we don't know whether they will have been implemented before something very bad happens.

Few central bankers seem interested in elaborating on these issues. The Bank of Canada (BoC) did say it was trying to balance the risks of under and over tightening. But the BoC is mostly concerned with domestic debt-related risks. And the BoC isn't the one overseeing functioning in the world's most important bond market. Still, at the beginning of this month, Fed Chair Jerome Powell kept stressing how the Fed didn't want to run the risk of failing to tighten enough. Fed Governor Lael Brainard is among those who have discussed the issue most frequently. She noted in October how "a sharp decrease in risk sentiment or other risk event that may be difficult to anticipate could be amplified, especially given fragile liquidity in core financial markets".

In contrast to most central bankers' rhetoric, various financial stability reports—such as the one from the [IMF](#) and the one from the [Fed](#)—are sounding preoccupied. Central bankers will probably continue to talk tough on inflation in the very near term but the limits on how far they can go are starting to show. This suggests that they are unlikely to ignore ever-louder warnings for very long. Remember that this is largely about tightening financial conditions. The ability to do so in a controlled fashion diminishes the higher rates get and the more dealers need to contend with an amount of supply they don't have the capacity to handle. It also diminishes as the cumulative effect of concerted tightening policies globally causes some sudden and unforeseen liquidations in some investment vehicles.

In short, central banks could cause some significant damage in their quest to break inflation. So far, these tensions—including those in the cryptocurrency space or in emerging markets—have not provoked a "Lehman-moment" but thinking about these risks in a linear fashion might be a mistake. When we get asked how our mild recession scenario could turn out to be a severe one, a negative financial system event comes to mind. Such an event would be the result of central bankers overestimating the financial system's tolerance to tightening, and this possible miscalculation is one of the dominant risks to our outlook.

And even if the system doesn't break, mistakes could still be made if central banks push tightening beyond certain tipping points. Here in Canada, there are many reasons to believe the economy to be particularly vulnerable if the Bank of Canada acts too zealously. We will look at what that could mean in an upcoming Economic Viewpoint. But the broader point is that whether the "short and shallow" theme ends the same way "transitory" did is really going to be up to monetary policymakers.

# What to Watch For

By Randall Bartlett, Senior Director of Canadian Economics, Tiago Figueiredo, Associate – Macro Strategy, Marc Desormeaux, Principal Economist, and Francis Généreux, Principal Economist

WEDNESDAY November 23 - 8:30

<b>October</b>	<b>m/m</b>
Consensus	0.4%
Desjardins	1.7%
<b>September</b>	<b>0.4%</b>

WEDNESDAY November 23 - 10:00

<b>October</b>	<b>ann. rate</b>
Consensus	570,000
Desjardins	550,000
<b>September</b>	<b>603,000</b>

TUESDAY November 22 - 8:30

<b>September</b>	<b>m/m</b>
Consensus	1.1%
Desjardins	0.1%
<b>August</b>	<b>0.7%</b>

WEDNESDAY November 23 - 4:00

<b>November</b>	
Consensus	47.0
<b>October</b>	<b>47.3</b>

## UNITED STATES

**New durable goods orders (October)** – New durable goods orders were up 0.4% in September, mostly on the back of rebounds in the nondefense aircraft and automotive sectors. Based on order data from Boeing and increases in industrial production in the automotive and aerospace industries, we expect both sectors to drive new durable goods orders once more in October. Orders excluding transportation had a turbulent September and declined 0.5% month-over-month, their worst showing since April 2020. However, we’re forecasting modest growth of 0.1% in October. The new orders component of the ISM Manufacturing PMI rose from 47.5 in September to 49.2 in October. Although it remains under the 50 threshold, this is a positive sign. October’s 0.3% rise in industrial durable goods production excluding motor vehicles is also good news. Orders excluding transportation should climb 0.1%. Overall, we’re anticipating 1.7% growth in new durable goods orders.

**New home sales (October)** – Sales of new single-family homes in September were down 28.1% from their December 2021 peak. Like most other housing market indicators, sales are suffering from the impact of soaring mortgage rates. We also expect a further decline in October. Demand for building permits for single-family homes fell 3.6% in October, extending the downward streak to eight months. Fewer mortgage applications for home purchases and waning builder confidence lead us to expect single-family home sales to drop further from 603,000 to 550,000 units.

## CANADA


**Retail trade (September)** – Retail sales are expected to have increased by 0.1% in September. This stands in contrast to Statistics Canada’s advance estimate of -0.5%. The monthly advance is likely to be roughly evenly divided between more modest gains in both volumes and prices. Pushing prices higher is an upward move in seasonally-adjusted goods CPI. The drivers to retail sales volumes were more mixed in September, however. Unit auto sales and consumer goods imports rose while wholesale trade volumes and retail employment took a step back in the month. But while unit auto sales were up in September, this was more than offset by lower auto prices, leading us to forecast retail sales excluding motor vehicles to advance by 0.5%. Looking ahead, Statistics Canada’s flash estimate for October is projected to come in at around -0.1%.


## OVERSEAS

**Eurozone: Purchasing Managers’ Index (November – preliminary)** – PMIs continue to decline in most European countries. The eurozone’s composite index fell to 47.3 in October, its lowest level since November 2020. This level remains consistent with a slowdown in eurozone real GDP after the (non-annualized) 0.2% increase over the summer. A further drop in the PMI would signal that a contraction is taking hold in the fourth quarter.

# Economic Indicators

Week of November 21 to 25, 2022

Day	Hour	Indicator	Period	Consensus		Previous data
UNITED STATES						
MONDAY 21						
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TUESDAY 22						
	11:00	Speech of the Federal Reserve Bank of Cleveland President, L. Mester				
	14:15	Speech of the Federal Reserve Bank of Kansas City President, E. George				
	14:45	Speech of the Federal Reserve Bank of St. Louis President, J. Bullard				
WEDNESDAY 23						
	8:30	Initial unemployment claims	Nov. 14-18	225,000	226,000	222,000
	8:30	Durable goods orders (m/m)	Oct.	0.4%	1.7%	0.4%
	10:00	Michigan’s consumer sentiment index – final	Nov.	55.2	54.7	54.7
	10:00	New home sales (ann. rate)	Oct.	570,000	550,000	603,000
	14:00	Minutes of the Federal Reserve meeting				
THURSDAY 24						
	---	Markets closed (Thanksgiving Day)				
FRIDAY 25						
	---	---				
CANADA						
MONDAY 21						
	---	---				
TUESDAY 22						
	8:30	Retail sales				
		Total (m/m)	Sept.	1.1%	0.1%	0.7%
		Excluding automobiles (m/m)	Sept.	1.0%	0.5%	0.7%
WEDNESDAY 23						
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THURSDAY 24						
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FRIDAY 25						
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Note: Desjardins, Economic Studies are involved every week in the Bloomberg survey for Canada and the United States. Approximately 15 economists are consulted for the Canadian survey and a hundred or so for the United States. The abbreviations m/m, q/q and y/y correspond to monthly, quarterly and yearly variation respectively. Following the quarter, the abbreviations f, s and t correspond to first estimate, second estimate and third estimate respectively. The times shown are Eastern Standard Time (GMT - 5 hours).  Forecast of Desjardins, Economic Studies of the Desjardins Group.

# Economic Indicators

Week of November 21 to 25, 2022

Country	Hour	Indicator	Period	Consensus		Previous data	
				m/m (q/q)	y/y	m/m (q/q)	y/y
<b>OVERSEAS</b>							
<b>MONDAY 21</b>							
Germany	2:00	Producer price index	Oct.	0.6%	42.0%	2.3%	45.8%
<b>TUESDAY 22</b>							
Euro zone	4:00	Current account (€B)	Sept.	n/a		-26.3	
Italy	4:30	Current account (€M)	Sept.	n/a		-5,259	
Euro zone	10:00	Consumer confidence – preliminary	Nov.	-26.0		-27.6	
New Zealand	20:00	Reserve Bank of New Zealand meeting	Nov.	4.25%		3.50%	
<b>WEDNESDAY 23</b>							
France	3:15	PMI composite index – preliminary	Nov.	49.5		50.2	
France	3:15	PMI manufacturing index – preliminary	Nov.	47.0		47.2	
France	3:15	PMI services index – preliminary	Nov.	50.6		51.7	
Germany	3:30	PMI composite index – preliminary	Nov.	44.9		45.1	
Germany	3:30	PMI manufacturing index – preliminary	Nov.	45.0		45.1	
Germany	3:30	PMI services index – preliminary	Nov.	46.2		46.5	
Euro zone	4:00	PMI composite index – preliminary	Nov.	47.0		47.3	
Euro zone	4:00	PMI manufacturing index – preliminary	Nov.	46.0		46.4	
Euro zone	4:00	PMI services index – preliminary	Nov.	48.0		48.6	
United Kingdom	4:30	PMI composite index – preliminary	Nov.	47.5		48.2	
United Kingdom	4:30	PMI manufacturing index – preliminary	Nov.	45.8		46.2	
United Kingdom	4:30	PMI services index – preliminary	Nov.	48.0		48.8	
Japan	19:30	PMI composite index – preliminary	Nov.	n/a		51.8	
Japan	19:30	PMI manufacturing index – preliminary	Nov.	n/a		50.7	
Japan	19:30	PMI services index – preliminary	Nov.	n/a		53.2	
<b>THURSDAY 24</b>							
South Korea	---	Bank of Korea meeting	Nov.	3.25%		3.00%	
Japan	0:00	Leading indicator – final	Sept.	n/a		97.4	
Japan	0:00	Coincident indicator – final	Sept.	n/a		101.1	
France	2:45	Business confidence	Nov.	101		102	
France	2:45	Production outlook	Nov.	n/a		-8	
Sweden	3:30	Bank of Sweden meeting	Nov.	2.50%		1.75%	
Germany	4:00	Ifo survey – Business climate	Nov.	85.0		84.3	
Germany	4:00	Ifo survey – Current situation	Nov.	93.9		94.1	
Germany	4:00	Ifo survey – Expectations	Nov.	77.0		75.6	
Japan	18:30	Consumer price index – Tokyo	Nov.		3.6%		3.5%
<b>FRIDAY 25</b>							
Germany	2:00	Consumer confidence	Dec.	-39.8		-41.9	
Germany	2:00	Real GDP – final	Q3	0.3%	1.2%	0.3%	1.2%
France	2:45	Consumer confidence	Nov.	83		82	
Italy	4:00	Consumer confidence	Nov.	91.0		90.1	
Italy	4:00	Economic confidence	Nov.	n/a		104.5	

Note: In contrast to the situation in Canada and the United States, disclosure of overseas economic figures is much more approximate. The day of publication is therefore shown for information purposes only. The abbreviations m/m, q/q and y/y correspond to monthly, quarterly and yearly variation respectively. The times shown are Eastern Standard Time (GMT - 5 hours).