ECONOMIC VIEWPOINT

What to Watch Out For in 2022

Post-Pandemic Progress… We Hope!

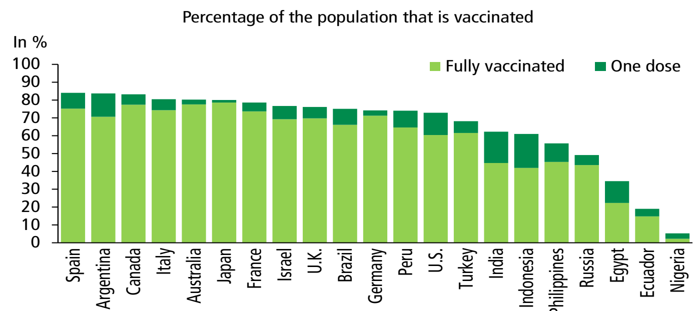
We kick off the new year with a review of key issues that could affect the economy and the markets.

The COVID-19 pandemic is still one of the highest risk factors for the economy. First, the emergence of the Omicron variant is a reminder that vaccines cannot completely protect us against the spread of the virus. Second, the uneven vaccination rollouts around the world are a major issue (graph 1), because the virus goes on spreading and mutating in areas where people are not protected. New variants could also threaten the vaccines' effectiveness. Government authorities in the developed countries are already expending considerable efforts to get a third dose to boost the vaccines' effectiveness. Promising new treatments may be added to the arsenal of weapons available to fight this pandemic.

We should see greater economic normalization in 2022. Broken down by sector, the economy recovered at different rates in 2020 and 2021, mainly due to significant differences in the health measures each sector deployed (graph 2). This has resulted in imbalances, particularly in sector labour demand. Despite government assistance measures, some businesses may suffer permanent effects, potentially pushing up the number of bankruptcies. This means that the pandemic may cause a loss of capacity that could take several years to recover. Governments will have to keep a close eye on this situation.

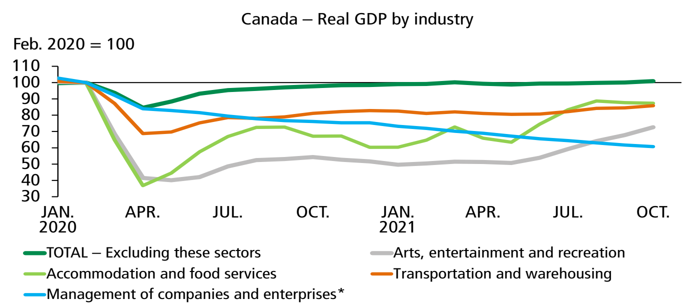
Inflation should calm down in 2022. Both the Federal Reserve (Fed) (graph 3 on page 2) and the Bank of Canada (BoC) are making that prediction. That being said, there may be some surprises along the way. Supply chain problems could hang around longer than expected. Businesses could pass on greater cost increases to their customers. Employees, in turn, may demand higher wages to offset their reduced purchasing power, thereby fuelling a vicious circle in

GRAPH 1
Emerging economies lag behind in vaccination



Sources: Our World in Data and Desjardins, Economic Studies

GRAPH 2
The recovery varies by economic sector



* This sector difficulties resulted from the fact that the pandemic halted strategic and organizational planning in some companies.
Sources: Statistics Canada and Desjardins, Economic Studies

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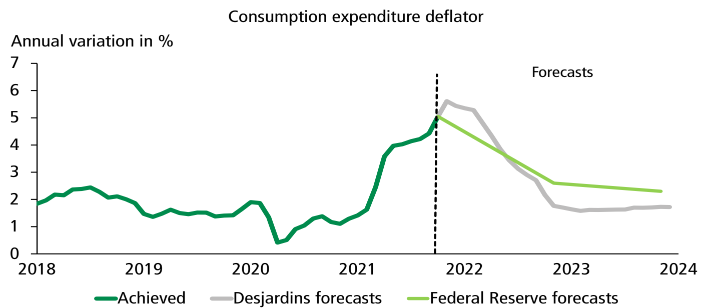
which inflation would remain high for longer. On the other hand, a simple stabilization of prices will help to curb the annual variation of consumer price indexes. Prices could drop for some goods that were particularly affected by supply chain problems, especially in the motor vehicles sector if the international supply problems get worked out. That could bring inflation closer to 2% by the end of 2022.

An easing in energy and metal prices would also greatly help lower inflation in 2022. Renewed surpluses in the oil market (graph 4), mainly due to increased output from the United States and the Organization of the Petroleum Exporting Countries and partners (OPEC+) should bring the price per barrel down further. But that is far from certain, since a change in attitude from OPEC+ or insufficient U.S. production could limit or even reverse oil prices. The future of the black gold is also closely linked to that of natural gas. Energy prices could rise further if the European energy crisis gets worse or the natural gas supply cannot be adjusted. The price of metals should go down as supplies are gradually adjusted and the consumption of goods levels out against the consumption of services, easing some of the pressure on the demand side. However, any delays in this rebalancing or extended supply snags may maintain some upward price pressures.

Household finances will have to be watched in 2022. The first year of the pandemic, 2020, had positive effects on household finances in Canada and Quebec. The debt load even dipped, while savings rates peaked. All those improvements were short lived, however. Some indicators started to deteriorate in 2021. The debt load went back up and savings rates edged down in recent quarters (graph 5). That normalization will continue in 2022, since incomes will not rise substantially, and consumer spending will keep going up. Income support programs for households have also become more targeted. The ability of some borrowers to pay their debts will also be affected by the rise in key interest rates starting in 2022. Many households' savings are very high, however, which should offset interest rate increases. On the flipside, inflation will also erode some of the accumulated savings and additional income.

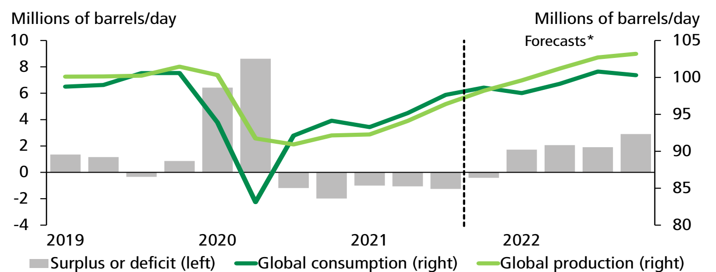
The speed of monetary policy normalization will be one of the biggest issues in 2022. The major central banks have held the line on inflation up to now, but most of them should announce key interest rate hikes in 2022, as the Bank of England did last December. We should point out that the economic situation alone, marked as it is by a significant uptick of activity and significant labour shortages, would be enough to warrant a gradual normalization of monetary policy. With inflation at a multi-decade high and wage pressures accelerating, interest rates will have to be raised to avoid a loss of central bank credibility. The Fed and BoC will try to raise key rates gradually (graph 6 on page 3) while making sure not to rein in the economy too abruptly. However, they may have to take more aggressive steps

GRAPH 3
Inflation should slow down in 2022



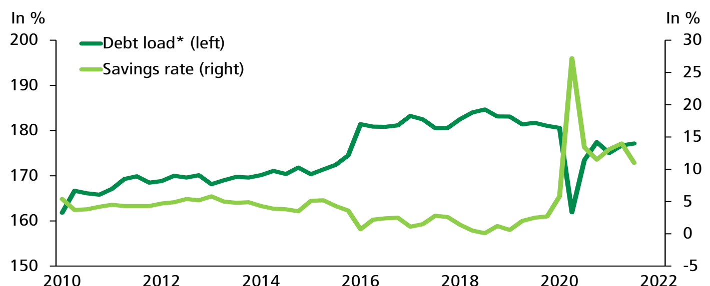
Sources: Bureau of Economic Analysis, Federal Reserve Board and Desjardins, Economic Studies

GRAPH 4
An oil surplus is expected for 2022



* International Energy Agency (IEA) outlook assuming members' compliance with the December 2021 production agreement and the continuation of sanctions against Iran.
Sources: IEA and Desjardins, Economic Studies

GRAPH 5
Household debt loads and savings are edging closer to pre-pandemic levels in Canada



* All debt relative to personal disposable income.
Sources: Statistics Canada and Desjardins, Economic Studies

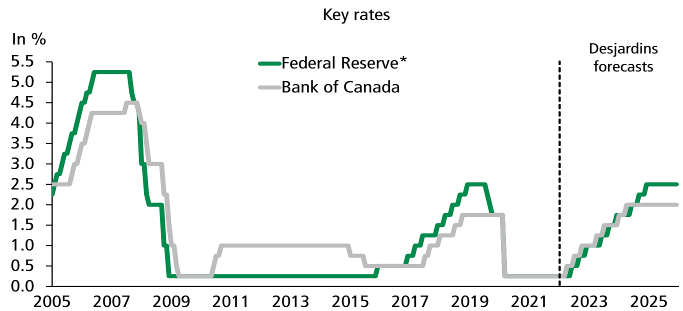
if inflation continues to readily outstrip forecasts and inflation forecasts deviate too far from the 2% target.

The residential real estate market should remain very active until spring 2022. The reinvigorated pandemic and anticipated interest rate hikes should keep demand high in the very short term. Pressure on prices will continue for some time in Canada because market conditions are extremely tight. The supply problems got worse at the end of 2021, with the inventory of homes for sale reverting to last spring's low (graph 7). It will be necessary to monitor whether the rise in mortgage rates and high prices will be sufficient to cool off the residential market. For now, buyers are active even though affordability has already sunk to an all-time low in several census metropolitan areas (CMAs) in Canada, including Montreal, Ottawa and Toronto. The risks of falling prices in 2022 still exist, as several markets are now overvalued.

The labour shortage is likely to remain a problem in 2022. Job growth may not be sufficient to meet business needs. It could even slow down economic growth (graph 8), which will keep upward pressure on wages in 2022. These difficulties are mainly due to demographic considerations. Working age population growth is down, although there may be some improvements on the horizon. International immigration is picking up again and will start to offset the weakness in natural population growth. The labour shortage was also accentuated by the government's pandemic-related income support measures for Canadians, coupled with greater absenteeism. All those factors should wind down in 2022 as the economy and labour markets continue to normalize, especially once the Omicron variant has passed. It remains to be seen whether the effect on business costs could be offset by higher productivity. Business investment intentions appear encouraging, but much remains to be done because Canada is lagging far behind the United States in non-residential investment.

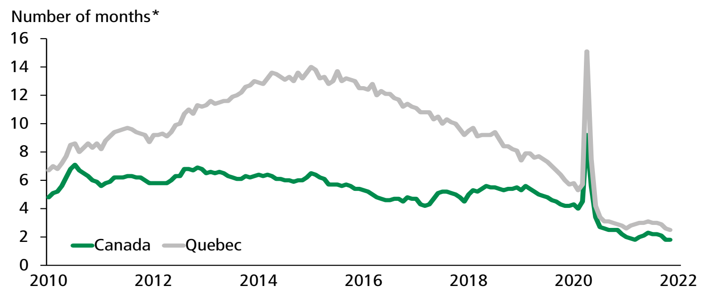
Stock markets could still find it hard to maintain strong growth in 2022. The time for massive liquidity infusions and rock bottom key rates, which was extremely favourable for risky financial assets, is coming to an end and should start reversing gradually. Increased market volatility in the second half of 2021 was the first sign of that reversal. Other factors, like the expected low return on other large asset classes as interest rates climb and consumer demand is strong, will still favour stock markets. The determining factor will likely be profits, and we will have to see whether businesses will be able to maintain high margins despite significant input costs and wages. Given its high valuation (graph 9 on page 4), the U.S. stock market seems particularly vulnerable.

GRAPH 6
Key rates should gradually return to pre-pandemic levels



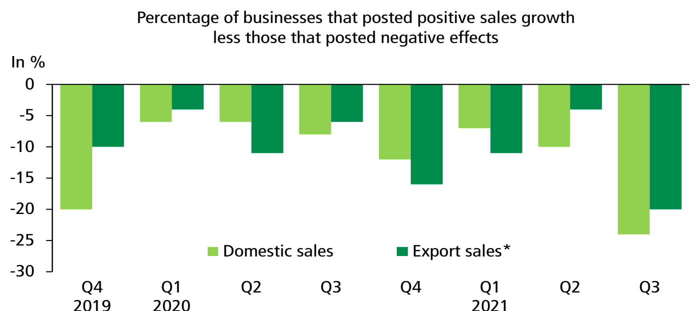
* Upper limit for the federal funds rate.
Sources: Datastream and Desjardins, Economic Studies

GRAPH 7
There are very few existing properties for sale



* The time required to sell off all properties at the current sales pace.
Sources: Canadian Real Estate Association and Desjardins, Economic Studies

GRAPH 8
A lack of capacity or qualified labour will have a negative effect on the sales of some Canadian businesses

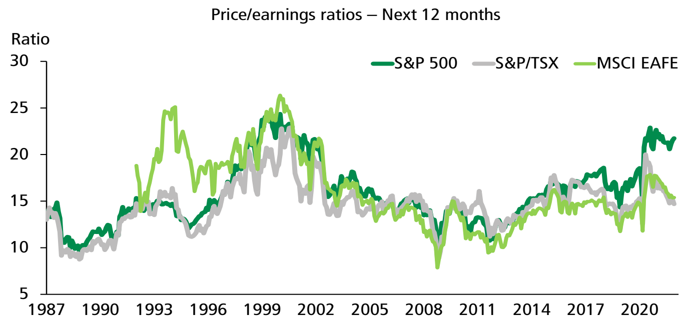


* Percentage of exporters.
Sources: Bank of Canada and Desjardins, Economic Studies

China's economy showed several signs of slowing down in 2021, and that should continue in 2022. There is a real, ongoing risk of more widespread financial disruptions. COVID-19 restrictions, supply problems and a decrease in infrastructure spending are economic slowdown factors that could be significant in 2022. The high prices of energy and the supply problems that forced China's authorities to ration electricity consumption could continue to curb industrial output and fuel anxieties about a more widespread economic slowdown. The housing market problems and the difficulties of Evergrande Real Estate Group, a major enterprise, should continue to affect activity and confidence (graph 10).

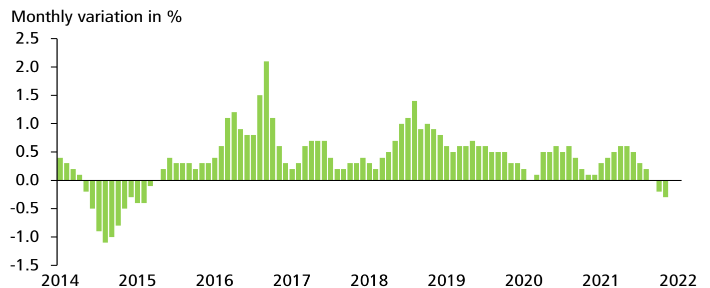
Political or geopolitical uncertainties could damage the economic situation in 2022. Several regions around the world are still diplomatic and military powder kegs. Russia is threatening Ukraine again and has inflamed relations between Moscow and Washington. There is also a harsher attitude toward China over Taiwan and the treatment of the Uyghur people. Price hikes, especially for food and energy, could provoke popular dissatisfaction in emerging countries. Important elections are also coming up this year. November 8 will mark the midterm elections in the United States; a Republican majority in Congress could further undermine the political and economic agenda of President Joe Biden, who is already losing popularity (graph 11) and having difficulty implementing the reforms he has proposed.

GRAPH 9
Factoring in earnings outlook, only the U.S. market seem overpriced



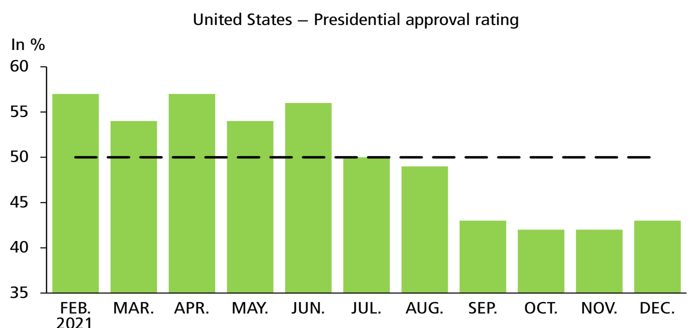
Sources: I/B/E/S, Datastream and Desjardins, Economic Studies

GRAPH 10
The decline in Chinese new home prices breaks a six-year growth record



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

GRAPH 11
President Joe Biden's popularity is waning



Sources: Gallup and Desjardins, Economic Studies