FCC Economic and Financial Market Update

2021 Q4

Published on December 2, 2021

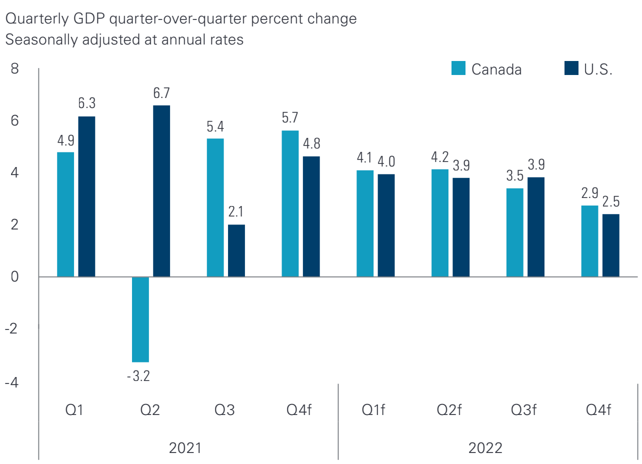
Outlook

Increasing vaccination rates and tactics to reduce the spread of COVID-19 have shown to be effective and economic recovery is now improving. However, the growth outlook for Q4 and 2022 is exposed to downside risks. Months of factory slowdowns and recent floods in B.C. have resulted in supply chain challenges, and labour shortages and inflation proving to be persistent challenges. Canadian GDP growth will be driven by stronger consumer spending in services and oil prices and exports. Inflation will remain elevated to start 2022 before easing back towards 2% at the end of the year. The Bank of Canada (BoC) overnight rate is expected to increase before the end of Q2 2022, followed by two or three other hikes.

GDP

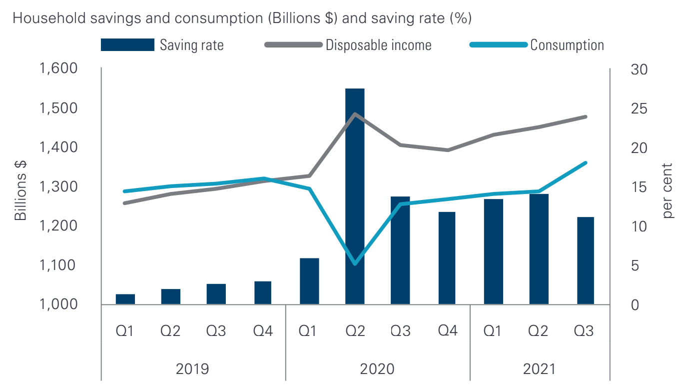
GDP growth in Q3 was 5.4% after declining 3.2% in Q2, and is expected to grow 5.7% in Q4 before lowering to 4.0% in 2022 (Figure 1). Growth in Q3 was fueled by strong consumer spending and exports. The savings rate dipped from 14% to 11% on higher spending, but remains elevated and will support economic activity through the holiday season. The entirety of the $116 billion in additional savings isn't expected to be spent immediately, so there's room for consumption to support growth over the next year. Travel restrictions have eased and should benefit the accommodation and tourism industries. Prices are relatively strong across the agri-food, energy and metals supply chains, resulting in strong exports. However, bottlenecks to and from the Port of Vancouver could impact export growth potential.

Figure 1. GDP is expected to rebound strongly in Q4 before heading to 2-4% in 2022



Source: Bloomberg

Figure 2. $116B gap between savings & consumption



Source: Statistics Canada

Central Bank Policy and Bond Markets

The Bank of Canada overnight policy rate

In October, the Bank of Canada (BoC) ended its quantitative easing program, electing to solely buy maturing bonds and keep their balance sheet stable. Persistent inflation and a tight labour market appear to have shifted the Bank's timeline for its policy rate increase. FCC Economics is projecting that the BoC will implement one rate increase of 25bp in late Q2 2022. We expect two further increases in 2022, bringing the rate to 1.0% at year-end (Table 1). Prime and variable rates should follow in short order.

Table 1. Bank of Canada target overnight policy rate expected to start increasing in late Q2 2022

%, end of period

	2021				2022				Annual		
	Q1	Q2	Q3	Q4f	Q1f	Q2f	Q3f	Q4f	2020	2021f	2022f
Bank of Canada overnight target rate	0.25	0.25	0.25	0.25	0.25	0.50	0.75	1.00	0.25	0.25	1.00

Sources: FCC, Bank of Canada

Inflation and fixed rates

Headline inflation from Statistics Canada was 4.1% year-over-year (YoY) in Q3 and 4.7% in October, led by increases in food, energy and services. Core inflation, which excludes the impact of energy and food, increased 2.9%. Food inflation was 3.8% in October after averaging 1.8% for the first nine months of the year. Energy prices rose 25.5%, largely driven by a 41.7% increase in gas prices.

Factory slowdowns, mass ordering in preparation for a strong holiday season, and a global movement to replenish depleted inventories led to continued supply-chain bottlenecks. This pushed up shipping rates and left orders delayed or unfilled. Recent data shows a decline in shipping costs, potentially a signal that these issues are easing; however, the November flooding in B.C. has caused additional supply-chain challenges. The strength of consumer spending over the holidays relative to inventories will play a major catalyst for inflation during the first half of 2022.

FCC Economics expects inflation to remain elevated into Q1 2022, given ongoing supply chain challenges and with businesses often waiting until after the holidays to push through cost increases. We're still confident that inflation will subsequently ease towards 2% at the end of 2022.

Table 2. Headline inflation will start to decline to 2% in late 2022

Inflation, year-over-year % change in headline Statistics Canada CPI

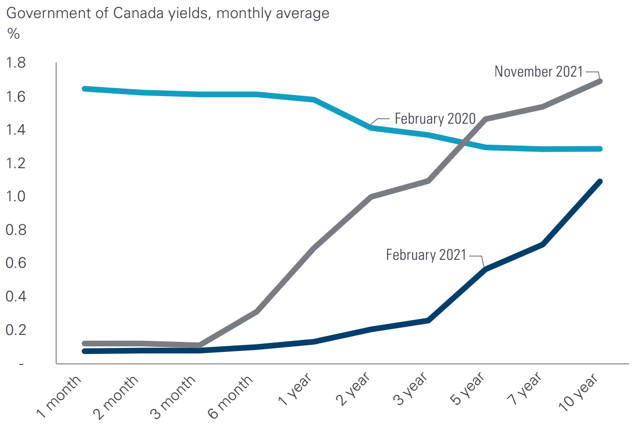
	2020				2021				2022				Annual averages		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4f	Q1f	Q2f	Q3f	Q4f	2020	2021f	2022f
Canada	1.8	0.0	0.2	0.8	1.4	3.4	4.1	4.8	3.9	3.2	2.4	2.1	0.7	3.4	2.9
U.S.	2.1	0.3	1.2	1.3	1.9	4.9	5.4	5.5	5.0	3.5	2.8	2.4	1.2	4.4	3.4

Sources: Bloomberg, Statistics Canada, FCC

Bonds with maturity of five years or greater are now yielding higher interest than pre-COVID. These higher bond yields are increasing long-term fixed lending rates. Short-term yields have also risen, but not as much given short-term uncertainty remaining in the economy and the anticipated timeline for the BoC to increase rates before spring.

Historically low borrowing rates appear to be nearing their end, and businesses should now be in the mindset that borrowing rates will continue to rise.

Figure 3. Long end of the yield curve has steepened above pre-COVID levels



Source: Statistics Canada

Exchange rates and foreign market commentary

USD per CAD

In the fall, the Canadian dollar rose relative to the USD on higher energy prices as economies began to reopen and uncertainty surrounding U.S. debt talks grew. As global supply chain issues get worked out, the Canadian dollar is projected to average 0.787 in Q4 (up 2.5% YoY) and average 0.781 in 2022. Oil price is expected to retreat in 2022, although expansion in output could be limited and push it higher in the short to medium term. A lot also depends on central bank policy. The expectation is that the BoC starts increasing rates ahead of the U.S. Fed, adding additional support to the CAD.

Table 3. CAD projected to decline heading into 2022

Exchange rate, quarterly averages

	2020				2021				2022				Annual averages		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4f	Q1f	Q2f	Q3f	Q4f	2020	2021f	2022f
USD per CAD	0.745	0.722	0.751	0.768	0.790	0.814	0.790	0.787	0.784	0.780	0.775	0.783	0.747	0.796	0.781

Sources: Statistics Canada, FCC

CNY per CAD

Economic growth continues to slow in China. GDP grew 4.9% YoY in Q3, below Q2 growth of 7.9%. Industrial production also fell below expectations, rising 3.1%, as China faced energy shortages and weakened real estate market challenges. The People's Bank of China (PBoC) has increased liquidity into the market to tackle a declining growth rate. Weaker growth and hawkish statements from the U.S. Fed could lead the PBoC to lower the exchange rate to boost export growth.

EUR per CAD

The European Central Bank (ECB) left pandemic stimulus unchanged in October as it remains committed to supporting the economic rebound. The ECB expects inflation to be below its 2% target in 2022 despite inflation currently running close to 4%. According to the OECD, European GDP is expected to be strong in 2022, but below Canada, U.S. and United Kingdom. The ECB's dovish stance has contributed to a lower Euro relative to both the CAD and USD.

GBP per CAD

The Bank of England (BoE) left its benchmark interest rate unchanged and voted to continue the current course of bond purchases in their November meeting. Market expectations called for a rate hike, and thus the Pound fell on the news. The BoE stated that inflation in the U.K could reach 5% over the next few months before falling to its 2% target by late 2023. Brexit is causing additional supply-chain bottlenecks and higher domestic prices. The BoE would like to see stronger signals that employment is gaining steam before raising rates, which will likely come on short notice once it happens.

Table 4. Historical currency rates per CAD for CNY, EUR and GBP

Exchange rates, quarterly averages

	2020				2021				Annual averages	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4 to date	2020	2021 year to date
CNY per CAD	5.194	5.118	5.192	5.083	5.120	5.259	5.136	5.128	5.147	5.161
EUR per CAD	0.675	0.655	0.642	0.644	0.656	0.676	0.673	0.696	0.654	0.675
GBP per CAD	0.582	0.582	0.581	0.581	0.573	0.582	0.576	0.589	0.582	0.580

Source: Bank of Canada

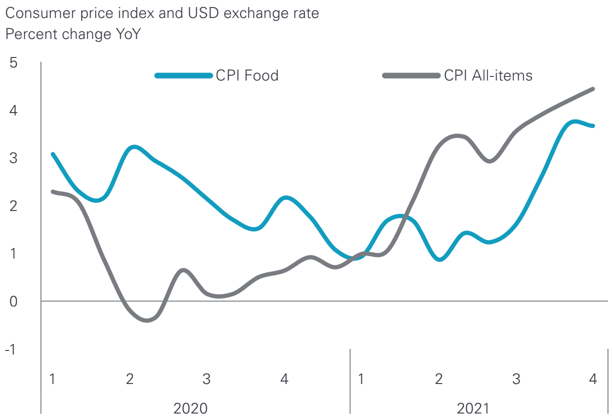
Food inflation

In the second half of the year, food inflation has been rising in response to higher input costs and labour challenges (Figure 4).

Challenging crop growing conditions in large portions of North America and Central Asia have contributed to tighter supplies and higher commodity prices. Low water levels on the Colorado River have forced water restrictions for 2022, impacting crop production. This could put further pressure on imported nut, fruit and vegetable prices in the new year. Livestock prices have also been trending higher than their five-year average in 2021 as the reopening of the economy led to stronger meat demand.

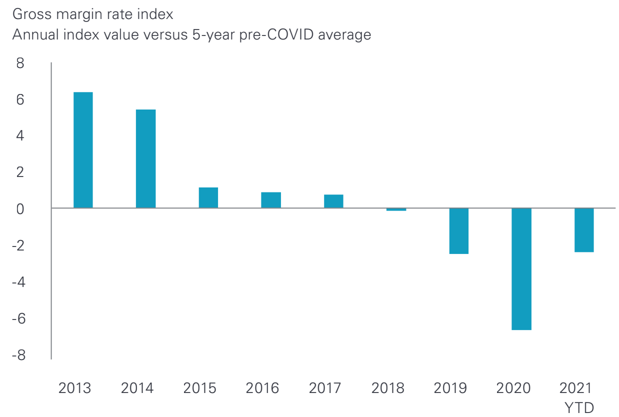
Labour is a top concern throughout the Canadian economy and specifically for food manufacturing. More workers are employed in food manufacturing than before COVID, but businesses still can't keep up with demand, and unfilled orders are trending up 50% YoY. The latest job vacancy report from Q2 was at 5.2%, up from 3.9% during the same period in 2019 and up from 2.8% in 2016. Year-to-date average wages excluding OT are up 4.4%. Production per employee is at record highs; however, the increase in productivity has not offset the higher costs businesses face.

Figure 4. Food inflation has gained steam in recent months



Source: Statistics Canada

Figure 5. Manufacturing margins remain below recent historical levels



Sources: Statistics Canada, FCC

Food manufacturers have passed on a net price increase of over 8.1% YoY through three-quarters of the year, and manufacturing margins are now estimated to be back to 2019 levels. However, they remain below the five-year average (Figure 5). With margins tight, manufacturers will look to pass on any additional costs.

However, there are a few bright spots. Reference prices for some grains, oilseeds and livestock have come down from their summer highs. The loonie has rallied recently, which has also offered relief to food inflation. Canadians rely on the supply of imported food, and the higher dollar softens the blow of higher commodity prices in some areas like fruit and vegetable products, breakfast cereals, sugar, snack foods and coffee.

We believe food inflation will remain elevated for the foreseeable future. As supply chain disruptions and labour challenges ease and the supply of agricultural commodities rebounds, we should record lower food inflation. The difficult question is around the timeline associated with a return to average inflationary pressures.

For more agriculture and food economics insights, visit fcc.ca/Economics

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