Fidelity Connects

China's Path Forward in 2023

Don Drummond, Canadian Economist

Pamela Ritchie, Host

Voiceover: Hello and welcome to Fidelity Connects – a Fidelity Investments Canada podcast – connecting you to the world of investing and helping you stay ahead.

The Bank of Canada has raised their benchmark interest rate by a quarter of a percentage point to 4.5% - the highest it's been since 2007. This is the eighth consecutive interest rate hike for the Bank of Canada, but Governor Tiff Macklem signaled that it might be the last hike of the cycle. One of the most significant announcements made by the Bank of Canada in their policy report is that they are confident in bringing down inflation to target 2% by 2024.

We're joined today by renowned economist Don Drummond to unpack if this timeline is advantageous, and to see what this 25-basis point rate hike means for housing, markets, consumer spending and the real economy.

Don has held several senior roles at the Federal Department of Finance, including Associate Deputy Minister, where he was responsible for economic analysis, fiscal and tax policies. He later served as Senior Vice President and Chief Economist at TD Bank, and is currently Fellow-in-Residence at the C.D. Howe Institute.

One key takeaway today that Don shares with host Pamela Ritchie is noting that inflation has peaked and should continue dropping under 6% year-over-year as we get into this spring. Stay tuned for all of this and more.

Today's podcast was recorded on January 26, 2023, and please note as this was originally presented as a webcast, you'll hear references to a few charts.

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Pamela Ritchie: Welcome back to you, Don. Great to see you. How are you?

[00:02:24]

Don Drummond: I'm very well, thank you.

[00:02:25]

Pamela Ritchie: Nice to see you here. So, what do you think, is pause too strong a word for what they're announcing?

[00:02:32]

Don Drummond: As they say, a conditional pause. It's got a big if in it. If the world unfolds the way they predict it will unfold, the economic and, particularly, the inflation projections they laid out in yesterday's report... then they're pretty clearly done. But, of course, they've left the door pretty wide open that if things don't unfold the way they project them –and they kind of put their finger on what they're really worried about, and that's the stickiness of the service sector inflation– if those inflation numbers don't come down the way they're hoping and predicting, then they're not done. They're going to go again. It is interesting because usually the Bank of Canada's forecasts are complete garbage because you need to know one variable, the interest rate, and they don't give you that. At least this time you can imagine their economic forecasts or projection of inflation are most likely based on the current interest rate prevailing, so at least there's some information content and they seem to think, think, for the moment that should do the trick and move us back to 2%.

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Pamela Ritchie: So, sorry, interest rate prevailing, meaning staying at this point.

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Don Drummond: Stay there.

[00:03:36]

Pamela Ritchie: *[inaudible]* the market, of course, continues... other countries, to price in cuts, basically.

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Don Drummond: I find that really funny because we're getting so much news of people anticipating and building in their outlooks these cuts even six months ago. Whoa, talk about being premature. We're not even at the peak of the cycle; we're not even at that point, at the pause. That, I'm sure the Bank of Canada's not giving one second of thought to that. They want to see the whites of the eyes at 2% inflation before they're doing it. All their worry is on the other side... that inflation is going to prove to ... obviously, they don't want to see a big recession; they don't want a lot of people out of work, but they're more worried about hitting their inflation target than they are about a need to bring interest rates back. I think that's well off into the future.

[00:04:25]

Pamela Ritchie: When you saw the jobs report in December in Canada, most people sort of read that as another rate hike. Right now, we've seen that. Do you think they might have been willing to sort of pause a little earlier, but the data, obviously, came through as it did for jobs.

[00:04:44]

Don Drummond: Even when they released the summary of their meeting minutes, we'll probably never get to what the true conversation was. But I think if we somehow had planted a microphone in the offices of the Bank of Canada a few months ago, they were probably prepared to be done at that point. That was the last thing they wanted to see. Good for 104,000 people who found their jobs, but that's not what they wanted to see. I think they were assuming and hoping more for a flat number, barely a positive. That was just a blockbuster increase. It's funny, talking to Americans, they say, "you realize ... you're normally 10 to 1 ... that's over a million jobs created in the United States. A million jobs, we never have that". And I said, "neither do we". That was a huge increase well into an interest rate cycle and people are worried about recession.

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Well, you know, the labour force survey's one of our biggest site surveys that covers 100,000 people that's well stratified, but it still is a survey; still is a sample. It's got a pretty big standard deviation around the confidence of the numbers. Maybe it wasn't a true measure. Maybe we'll see it unwind in future. When you're in the survey, you stay in for six months so, if there's something unusual about the group that came into December, the number will stay like that for six months and then in six-months' time you can see it unwind.

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Pamela Ritchie: We're going to put up some charts in a second from the actual report itself, but I just want to ask you, going back to the discussion of cuts and what you think about it, –which I think you've shared– but it certainly plays into what you're seeing in long bond where you're looking at yields years out from here. The market is certainly sending a very particular message that doesn't seem to agree with what you're saying.

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Don Drummond: I find more fascinating the Bank of Canada rate decisions is what's happening to the longer-term bonds. I'll just pick as an example the 10-year Government of Canada bond. It's below 3%. Now, is it half full or half empty? That's over double what it was at its lowest point a couple of years ago, but that's still a very low level. That's the second lowest that they have ever been historically. Even if we were at 2% inflation –and we're nowhere near that– that's barely a positive real rate return at all. In any case, there's not a lot of money to be made from fixed income in terms of that in your portfolio. More than before, but still not a lot.

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But, on the other hand, it indicates at least bond markets are voting that inflation's not going to take off permanently, probably anticipating some softening of the economy, but I think they're looking for the future and thinking, "yeah, the future probably holds lower and stable inflation and therefore we're not going to see at least a continuation of the interest rate increases". To the point, just in terms of these interest rate increases, no one should ever anticipate we're going back to the interest rates we had, as you referred to, the highest interest rates since 2007. When we look back at a long-term history, the abnormality will be how rock bottom low they were. That's not normal. To think the Bank of Canada's neutral estimate was consistent with 2% inflation it's 2 to 3% and, you know, 4.5; it's not that far outside of the range of neutral, so we're not talking about really high interest rates that need to be brought back down.

[00:08:01]

Pamela Ritchie: Fascinating. Let's bring up the first chart here. I think it's looking at inflation easing, or indeed, is still persistent. These are all coming out of the actual report itself. This is the first one. I'll kind of ask you to take us through that. There's Canada, there's the U.S., they obviously started hiking earlier than the other comparatives, the Eurozone and the United Kingdom. I'm curious, just getting to the heart of how you read inflation. There's lots of year-over-year numbers in the report; I'll let you comment on that because I know you have thoughts on that.

[00:08:33]

Don Drummond: Well, I'll just refer to the year-over-year because that's exactly what your chart shows. I think the messages from this chart are twofold: that Canada is far from alone in this; it's affecting virtually every economy in the world. And that's not surprising because the root cause of it, high commodity prices, constrained supply chains, strong demand, are being felt by most of the economies around the world, and that's generating good old-fashioned inflation,

as it did decades ago when those conditions prevailed. The second message, ever so slightly the year-over-year numbers are coming down, albeit unacceptably high. To me, I don't like to look at the year-over-year numbers, and I believe you have a chart that looks at more monthly and the more recent quarterly numbers. They paint quite a different picture than those year-over-year statistics.

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Pamela Ritchie: I think this is the next chart.

[00:09:20]

Don Drummond: Here, we're looking at the monthly data. This is the total CPI, but if you wanted to look as the Bank of Canada and others would be more likely to look at the CPI, excluding food and energy, so the red line. We've been running below a 4% rate of inflation since July of 2022. We're half, you know, 4% is still double the Bank of Canada's target. I'm not suggesting that we should be complacent about that; it's still unacceptably high. But I think if you ask most Canadians what's the rate of inflation, they would say just a little bit above 6% because they always see that year-over-year number being featured. But the month-to-month annualized for half a year now have been running a bit below 4%. This is important in the context of the future as well because the Bank of Canada predicts the rate of inflation will come down to 3% by mid-2023. That might sound heroic if you're in the mindset the current rate of inflation is 6%, but all it takes is a continuation of the recent monthly pattern and it will come down.

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Another way of expressing that is that we had big inflation numbers in March, April, May 2022. And, as we go through those months in 2023, they'll drop out of the year-over-year calculation and then those year-over-year numbers will come down quite sharply. As we start getting into the spring, we'll start to see quite a bit lower inflation numbers. Now, I wish the media would report more on the month-to-month and the quarterly. The Bank of Canada does quite a bit, –even not enough in their cases I would like to see– but it's fun with statistics, if you want. Year-over-year, it's got a lot of historical baggage attached to it and it's telling you more about early 2022 than it is about the last six months.

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Pamela Ritchie: Which is sort of just the beginning of the rate hike cycle, when it began there. Let's dig into housing here for a second. We'll put the next chart up. This is housing activity that has slowed, certainly. Lots of discussion; everyone knows the discussion about mortgage rates and variable mortgages and so on. We're seeing here, obviously, what the Bank of Canada is putting forth and there is the weakening data. I guess the question that everyone wants to know is, are we about done?

[00:11:41]

Don Drummond: Housing is exactly the same thing as your perception; all depends on what data you look at. What we're being inundated by with the media reports and people in the real estate industry is the decline since the peak, depending on what city you're in. That was *[indecipherable]* February or March of 2022, and that's big, but is that relevant? And what's abnormal? Is the price today abnormal or was the peak price abnormal? I would argue the peak prices were abnormal and unsustainable and people are all focused on the hit to affordability of housing, the rise of mortgage rates, but what about the affordability when the housing prices were at their peak? Yeah, sure, for a while you could get a rock bottom mortgage rate, but in major cities you couldn't buy anything, even a fixer-upper, for under a million dollars. How's that for affordability?

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Pamela Ritchie: Do you then go back to look at where housing either needs to correct to or what the story is? Do you go back to sort of when interest rates went to rock bottom, and we were going back sort of 15 years here? How do you look at that?

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Don Drummond: A bit of a tangent, but just as a footnote, my desperate hope is over the next five or ten years monetary authorities, monetary economists, everybody involved in this will take a good hard look at this monetary experiment; I'll call that. An experiment since the financial crisis of 15 years of hyper monetary stimulus. Did it accomplish anything good? It inflated asset prices and it created an affordability issue. Yeah, you could get a mortgage at a rock bottom rate, but you had to come up with $700,000 and you have these huge mortgages which created an unacceptable degree of risk. My belief is monetary policy should not be deviating from neutral for long periods of time. If there's a problem, you hit it hard, you hit it fast and you go back to a neutral path. You don't end up way from neutral for about 15 years.

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Monetary policy has made two huge blunders that have been very costly. In the mid 2000s, almost all monetary authorities were very sanguine that if inflation was under control, you wouldn't have wild economic cycles. No sooner did they drink that Kool-Aid that we had the biggest one of them all. And it just shows if you don't pay attention on the regulatory side –and here we're talking about the Federal Reserve Board as the prime culprit– if you allow that subprime mortgage market and all these increasing principles on the mortgages that were taken off in California; if you don't pay attention to that you're going to suffer, even if inflation wasn't a problem and interest rates weren't particularly high. So, they blew it then and now I think we've got 15 years of hyper stimulus that in the end didn't accomplish anything, but even if it did for a while, they kept interest rates too low for far too long.

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We have to have this housing price correction, but I don't know about looking back to where we were prior to 2007, maybe just back to where we were in 2018 and 2019. If you look at it from that perspective, the housing prices are still reasonably high. I don't think they'll collapse, and that's the 500,000 number; that's the government's target for new permanent residents. That's a lot of people to be housing in one way or another. Even if they come into an apartment, you still need to buy those units. We are building about 200-220,000 housing starts per year. That's not going to cut it to increase that amount of population.

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Pamela Ritchie: Well, sort of on that point, the question of inflation, do you think that actually will get down to a 2% target or do you think that target actually will change?

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Don Drummond: Oh, it definitely won't change. The Bank of Canada, along with the Government of Canada, just did their multi-year effort they do every five years to evaluate the target. They throw all kinds of darts on the board, on the wall. Should it be lower; should it be a price level target. should it be a different measure of inflation? So far, since the 1990s, they've come back to this 2% within a range of 1 to 3%. But they just recently settled that; that's not going to change for a while. I think it may prove difficult to get back to that. Who knows on the international front. China is coming

out of a fairly firm lockdown, and everybody's focused on their weak growth because of their demographic, but at least in the short term, demand's going to get revised; they'll be travelling again, they'll be increase in aviation fuel and the like. Commodity prices may firm in some ... and 5% wages is going to prove sticky on generalized price increases as well. I think we'll get it. The question will be will we get it at a 4.5% central bank rate or will it take further increases and more economic damage to get it?

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Pamela Ritchie: I want to go to a couple of questions. If you can tell me a little bit about where you see any discussion of a green transition, an energy transition... essentially how it either feeds into inflation or it's coming for our overall economy, perhaps for growth. Discuss how you see this in the near term.

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Don Drummond: I guess, as I look out to the future, monetary policy being successful is the biggest criteria for a successful economy. And I worry about that, given the blunders leading to the financial crisis, given this inflation experience. They've got to figure out what they're supposed to do, which is basically not much. I would just like to see the Bank of Canada, the Federal Reserve Board lounging in their desks with their feet up and just letting things go, not constantly trying to stimulate the economy. They've done in the past that comes out bad.

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Pamela Ritchie: Why do they do that?

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Don Drummond: I think they thought they could make life better, and who wouldn't want to have even more employment? Remember, Alan Greenspan in the mid-2000s famously said they were going to probe the level of potential output. Well, they probed it all right and it jumped back at them and created a huge problem. Tiff Macklem kind of said the same thing, right? He basically said, "we're going to keep the stimulus on just to see how high employment could go". Well, that didn't turn out too well either. They've got to be rock solid. They haven't been rock solid in the past. If we're going to have a good future, that's got to sort out. How we choose and integrate the 500,000 immigrants is going to be critically important. We've got to stop the saying, "we need more immigrants to stimulate economic growth". That surely is not the objective. Why would we be any better if we just double our economy? It's our incomes per capita. Immigration could lead to higher incomes per capita, but it won't if it's not done well. So, we need a lot of work on that front.

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And then the transition to net zero. And all you need to know about that is we're a carbon intensive economy. We've got bad marks on both sides. We're carbon intensive and we're light on clean growth technology. Our starting point isn't good. I hasten to add as most emphatically as I could, this is not an argument for not driving to net zero. Better to have a rocky road to net zero than to burn up as toast. We've got to do it, but it's not going to be easy. We've got a government that is putting out the desire to do it. They've indicated the heavy lifting is going to be done by a carbon tax going $170 by 2030. We're in 2023, we've never been told how it's going to go and when it's going to go. I find that shocking and totally unacceptable. If the carbon price is going to be doing the heavy lifting, why do we feel we need to match every single green growth subsidy coming out of the United States? They've chosen the intervention, the subsidy route, instead of the carbon price. We shouldn't be doing both. But how are those going to mix?

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What I find frustrating from the Government of Canada… you'll get an 800-page document of the budget that talks about the economy; says almost nothing about the environment and then you'll get a 300-page document on the environment that almost says nothing about the economy. They're together, the economy and the environment. We're never going to make the environment goals if we destroy the economy because there will never be a political and a public will to do it. They have to be linked. But I'm not sure sitting here in 2023 exactly what our strategy is and how the different pieces are supposed to fit together. They've really got to create a certainty, like when is that carbon price is going up? How is it going to be affected?

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Pamela Ritchie: Well, you start to see… I mean, I was just reading something actually out of the New York City, I think it was in the Post, but on taking a look, you know, the pensions for various cities in the United States and around the world, this is happening… sort of leaning on those that they invest in to really come up with dates on when they're going to see some of these transition things happening, and from the city perspective because they want to make sure that they are invested properly. It's pension funds for people in the city. I mean, you do see lots of weight being thrown around. Do you see less of that right now?

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Don Drummond: I see a tremendous attention from the corporate world, but an incredible confusion. I can't really think of any operation that doesn't today need to figure out what their cost structure is going to be in 2030. If you're running a public transit, what kind of fuel do you buy? If you're a corporation, what technology do you place? Where do you place your production? How can you do that when you don't know what the policy course is going to be? The flavour from the corporate sector for the longest time is like, don't do anything; don't use the carbon tax. But it's matured beyond that. I think there's an acceptance we have to do this, but they're telling, "we want to know how and when so we can adapt to it". I don't think they have the information they need to do that. I'm hoping this budget will enlighten everybody on that. Don't know. We'll have to see on that point.

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Pamela Ritchie: While we're waiting to see on that front, what do you see for commodities? There's a little bit of a of a pause there on that kind of development. Do commodities, for instance, oil exports from Canada, continue? How do you see that leaning into a Chinese opening?

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Don Drummond: I think we're definitely going to see a slowing in world growth. We've typically seen 4 and even 5% growth in the world economy as being normal, led by China. Clearly, in the next year just for the cyclical slowdown, but for some of these structural things, the demographics of China, we're going to be much slower than that. I think it'll probably cause a further reversal. We've seen commodity prices come down tremendously in the last couple of months and they'll probably come down further than that. Let's not forget, Canada's commodity base is still going to contribute to the Canadian economy, and they are making remarkable changes in terms of their own emissions. They're not disappearing any time overnight. I think they will still be around, and they'll be vibrant, but they'll be unrecognizable from what they are today, and they'll be different form. A lot of the oil and gas companies are under renewables right now. Same general field but a very different production mix.

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Pamela Ritchie: Let's put up the final chart here from the report. This is looking at the CPI. Inflation is forecast to return to target in 2024. We talked about this earlier, what we might see by midway through this year, but ultimately returning to that target in 2024. Anything here to point out to us that either ... I mean, that's obviously their hopeful direction of travel. Do you see any problems with that?

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Don Drummond: In every Bank of Canada statement, other than perhaps this one, this chart in the statement is absolutely meaningless. The Bank of Canada has a singular target and that's to have 2% inflation. They cannot possibly put out a document that doesn't show at some point them hitting 2% inflation. If they didn't show that, they'd all have to walk out there and mass resign [crosstalk]. Complete failure. But we don't know at what interest rate they get 2%. This time we probably presume it's at the 4.5% policy interest rate. We don't know that for certain, but I think we can be reasonably confident we did that. They could have showed that chart two years ago and maybe they're assuming a 10% interest rate to get it. That's why I said I doubt that, but it just shows you how meaningless the chart is. "2% inflation, yeah, sure, what we didn't tell you is we're assuming we're raising the rates to 10%". At this point I think they believe the 4.5 will be sufficient to get back. But they're worried, obviously. Who wouldn't be worried? And worried, in particular, about the service prices.

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Pamela Ritchie: Australia just printed a 40-year high inflation rate, ss there a warning here for Canada? Inflation can come back.

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Don Drummond: Oh, absolutely. You talk about your cliches, the vicious circle. You've got inflation hit 8%, running at 6%. You've got wage increases at 5%. 5% wage cost without very strong productivity raises unit labour costs; that goes back and raise prices and that's going to create more pressure for the wages. It's hard to break that kind of cycle. Having commodity prices come down would be wonderful. The improvement in the global supply chains... if we could see some peace in Ukraine, for the sake of the people of Ukraine above all else, but for the world economy, that would definitely help as well.

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Pamela Ritchie: Questions coming back to the story of jobs, ultimately. How will the stimulus that is still floating around in the system affect wage inflation? I mean, we've seen that, haven't we? We've seen wage inflation. What do you think about some of the comments and jobs in this report from the Bank of Canada?

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Don Drummond: I think the anticipation over the next 12 months is we'll see a pretty flat profile for jobs which, all-in-in all, wouldn't be that bad. Let's remember; we're at a 5% unemployment rate. We've had the current labour force survey since 1976 and we've never been at an unemployment rate this low. It comes back to a lot of these economic statistics. You look at the change or you look at the level, so even if we have no improvement in employment, let's keep in mind it will still likely have been a high level and even if the unemployment rate edges back up a bit, it's still going to be very low by historical standards. We're normally seeing 6.5 to 7.5% unemployment rates. We probably won't hit that even if we do have this patch of weakness. We'll probably see a weakness; we'll probably see a capping of the wage pressure. I don't think it'll go over the 5% and it'll probably start to drift down from there when we get the better inflation numbers.

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Pamela Ritchie: Great question on currencies, U.S. dollar versus CAD versus EM. It's been quite a story actually in the last six months on the currency front. What do you see going forward?

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Don Drummond: Well, unfortunately, economists have failed a lot in their exchange rate predictions. The one in theory that should work is purchasing parity. We have grosso modo about a 20% productivity deficiency relative to the United States. The economists' infamous statement of everything else equal, we deserve a dollar that's about a 20% discount. We were hanging around there for quite a while, but you've got to note these purchasing power parity predictions have rarely worked very well, anywhere at any time in the world. Now, we get big distinctions and in Canada, largely because of commodity prices. That doesn't seem to be the particular weakness, but this does raise a concern: if the Bank of Canada's on pause, it wouldn't be helpful if the Federal Reserve Board keeps going and going and going because then that would create the negative interest rate differential of Canada and the United States, which would further weaken the value of the Canadian dollar, which would add further pressures to inflation. So, one should hope that, if anything, we would get some firming of the Canadian dollar and add to the disinflation pressures from that. Again, even if the dollar appreciates somewhat, and an exporter might think that's bad, remember, it's a very low level right now. We're way, way away from parity.

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Pamela Ritchie: Oh, that's great. We'll leave it there. Don Drummond, thank you very, very much for taking us through this report, giving your thoughts and putting it into context for all of us. Appreciate your time.

Ending: [00:28:20]

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