ECONOMIC COMMENTARY & OUTLOOK

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The Economy

Relative to the mostly dire economic forecasts made a year ago, 2023 turned in a strong all-around performance as inflation fell across most major economies from the peaks experienced in 2022. Importantly, this performance happened without a recession as most developed economies performed better than expected, leading to a growing belief that an economic soft landing has been achieved.

This notion was primarily driven by the much-needed drop in headline inflation (with core rates moderating too, but at a slower pace) that set the stage for a reversal of the recent cycle of aggressive monetary policy tightening. The world's most important central bank, the U.S. Federal Reserve (the Fed), made it clear in December that interest rate cuts were expected later in 2024. Financial markets reacted positively to these developments and enjoyed a strong year of performance, reversing the poor results in 2022 for both stocks and bonds.

Expectations for Europe were low for 2023 and the continent, for the most part, delivered an underwhelming performance. GDP struggled to stay above 0% and lost momentum heading into year-end as third quarter GDP registered a negative result. Being slower than other central banks in beginning its cycle of monetary policy tightening, the European Central Bank (the ECB) had to catch up by raising rates 200 basis points in 2023, compared with 100 basis points from the Fed and 75 basis points from the Bank of Canada (the BoC).

Japan had an interesting year as GDP growth was strong at around 2% and, following three decades of deflation, inflation rose to 3%.

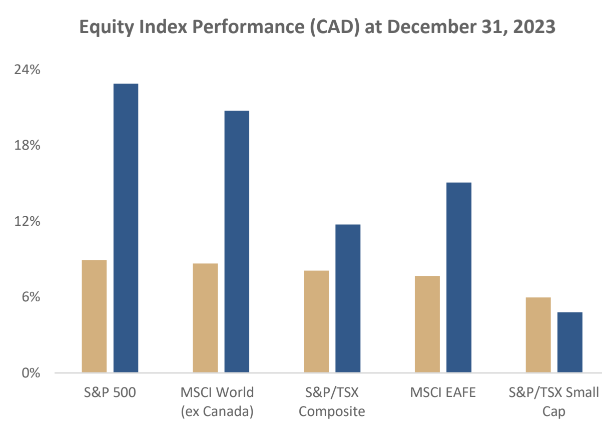
Despite a number of ups and downs in 2023, China managed to mostly meet growth forecasts. Following the end of pandemic lockdowns in late 2022, growth did rebound somewhat and was further helped by the drop in commodity prices and stronger global economic performance. But the ongoing property crisis and a big drop in foreign direct investment driven by government policy uncertainty weighed on the final tally which should register near 5%. Inflation was below most other developed countries - CPI actually fell 0.5% in November - so monetary policy can be supportive if needed.

In Canada, GDP managed to grow by 1% in 2023 but considering that the population grew by 3%, this result was very weak and points to a significant productivity problem.

The Markets

Equity Markets

With very few exceptions, equity market performance was very strong this quarter. Canada's S&P/TSX Composite Index, relatively speaking, had mixed results compared with global peers while the Canadian small-cap index lagged the large cap benchmark. Results in the U.S. were universally good and saw the tech-heavy Nasdaq Composite Index and the small-cap-oriented Russell 2000 Index each outperform the S&P 500 Index. Returns from European equity markets were quite varied in the fourth quarter as Germany almost generated a double digit gain while the gain in the U.K. was only slightly positive. Stock market performance in the Asia-Pacific region was also uneven, exemplified by strong performance from Australia, modestly positive performance from Japan and negative performance from China and Hong Kong.



Source: TD Securities, MSCI

Fixed Income Markets

The final quarter of the year saw a big drop in rates across the entire domestic yield curve in response to falling inflation, slowing growth and an increasing belief that the BoC will soon ease monetary policy. The yield curve steepened although it does remain inverted. Consistent with these developments, market-based inflation expectations fell to their lowest level in almost three years. Reflecting the market's strong appetite for risk, corporate and provincial bonds spreads each narrowed during the fourth quarter.

Currency Markets

The U.S. dollar (USD) experienced a very weak quarter against many major global currencies. The U.S. Dollar Index (DXY), a measure of the value of the USD relative to a basket of U.S trading partners' currencies, fell over 4% in the quarter and was weaker over the past twelve months as well. The Canadian dollar (CAD) appreciated against the USD in the quarter and remains up over the past year. The Fed, signalling a willingness to lower rates, was a primary driver of USD weakness this quarter.

Outlook

Following a year in which the consensus forecast a 2023 global growth rate of around 2% - the actual rate looks to be close to 3% - what should we expect for the upcoming year?

To begin, it will be a year full of elections across a number of countries – the U.S., Taiwan, Mexico, Russia, likely the U.K., and a chance of one in Canada too. Needless to say, geopolitics will be an ongoing potential source of instability throughout the year.

The full impact of interest rate hikes has yet to be felt. In previous commentaries, we noted the reasons why the rate hike effects would be delayed but evidence continues to build that they will ultimately have their desired effect of slowing inflation and the broader economy. In the near-term, however, the prospect of rate cuts suggest that the global economy can grind out modest growth again in 2024 although it is likely to lose momentum as the year progresses.

On a country/regional basis, economic performance should be quite varied. Beginning with the U.S., growth is expected to slow from an above-trend pace in 2023 (around 2.5%) to a below-trend pace in 2024 (about 1.5%). Slower growth and inflation should open the door to interest rate cuts but not until the second half of the year. Though it is an election year, fiscal policy is expected to be less supportive following the big jump in 2023 spending that drove the U.S. federal budget deficit to over USD 1.7 trillion – or more than 6% of GDP. A slowing in employment gains and in wage increases, combined with pandemic savings now being largely spent, will lead to a reduction in consumer spending.

The lagged effects of rate hikes will be felt in Europe for longer than in North America. Demographics continue to be a challenge in Europe and the ongoing war next door in Ukraine adds unwanted uncertainty. Unlike the U.S., growth in the region will be sluggish to begin 2024 but recover somewhat later on. Unfortunately, this means that overall growth will not be much different in 2024.

In Japan, the transition from deflation to inflation led the Bank of Japan to finally prepare to raise interest rates in 2024 at a time when other major central banks will likely lower their rates. This move is expected to slow economic growth in Japan to below 1%.

In China, the outlook for retail sales and industrial production are positive even though export growth is expected to slow once again, leaving economic growth to likely decelerate to a 4% to 4.5% pace in 2024.

What does this all mean for Canada? Clearly the external backdrop appears to be less favourable in 2024 but the biggest challenges for the country are internal, beginning with a heavily indebted consumer sector that continues to grapple with the rapid rise in interest rates. The debt-service ratio hit an all-time high in the third quarter of 2023 and will increase further until policy rates begin to ease. For 2024, growth is likely to teeter on the edge of a recession – at least for the first half of the year. This situation, combined with slowing inflation, means the BoC will be able to cut rates as early as June – ahead of the Fed but ultimately at a similar pace.

Unless otherwise noted, all figures in this commentary are presented in local currency.

DISCLOSURES

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