The Economy

One year ago, expectations for the global economy were generally positive: a slimmed-down continuation of the reflationary theme experienced in 2020 resulting from pent-up demand, robust fundamentals, and constrained supply. Decent nominal GDP growth of around 6.5% was the consensus for 2022, with a relatively even amount of real growth and elevated, but moderating, inflation driving this forecast. Labour markets were anticipated to tighten further, adding pressure on global central banks to recalibrate highly accommodative monetary policies.

It seems to be an understatement to say that the reflationary elements of these forecasts were realized as global nominal GDP currently looks on track to have jumped by about 9% in 2022. Unemployment rates fell to multi-decade lows while central banks, for the most part, aggressively responded by tightening policy rates. But 2022 delivered a far less favourable growth-inflation mix than expected. Well-documented supply chain shocks pushed inflation dramatically higher and continued to test the resilience of consumers and the broader private sector. Real global GDP lagged forecasts, expanding less than its approximate 1.5% potential. Growth disappointments were spread across the globe as both developed and emerging markets experienced labour market tightening resulting partly from weak labour force growth and low productivity gains.

Even when accounting for these developments, the biggest surprise of 2022 was the dramatic policy pivot that led central banks to increase interest rates at the fastest pace in decades. Very few central banks were able to avoid these actions: even the Bank of Japan, while not raising its policy rate, did allow a higher yield ceiling on its government bonds, moving its formal cap from 25 basis points to 50 basis points for the 10-year bond.

In the first half of the year there was a recognition of the need for urgency in the response to the surge in inflation. The U.S. Federal Reserve (the Fed) led the march towards restrictive policy stances that were designed to ease labour market tightness and to circumvent any nascent shift in inflation psychology. Cumulatively, the Bank of Canada (the BoC) raised its policy rate by 400 basis points in 2022 while also continuing its policy of quantitative tightening.

As we turn towards the new year, the impact of higher interest rates continues to build, and central banks remain on the march higher. The already substantial rise in borrowing costs is clearly depressing housing activity on both sides of the Canada–U.S. border and the sharp rise in the U.S. dollar is not only weighing on U.S. corporate margins but also on economies and companies around the world that fund themselves in U.S.-dollar terms.

There are also increasing signs that credit conditions are broadly tightening. Negative headlines about the financial state of various emerging markets and commodity-importing countries, the vulnerabilities of U.K. pension funds, and the collapse in value of various crypto-currencies are not unrelated – they are a signal that rapidly tightening financial conditions can generate stress in ways that can spill over into the broader economy.

The global growth outlook remains challenged particularly in China as that country continues to deal with its COVID problems, and in Europe as that continent continues to face a natural gas crisis as the winter cold continues. As various business surveys show, weakness in the short term should be concentrated in the goods sector – technology and construction in particular. Given that there seem to be pockets of weakness, the odds of a global recession in the short term are relatively low. The financial conditions drag is already being cushioned by the fading of supply chain and commodity price shocks – global inflation is on track to slow towards 3.5% in the first half of 2023 after it approached 10% in the second half of 2022.

The combined effects of sharply lower inflation and stronger real wage gains should bolster household purchasing power that remains supported by the fading remnants of COVID-era government fiscal largesse. This means that the global expansion will enter 2023 bent but not broken despite the significant regional differences noted above. A consumer-led rebound over the coming months should return North American growth to near its potential pace, while Asia (excluding China) looks to benefit from a boost in service-sector activity. Together, these forces should offset the downdraft from a contraction in Europe and an uncertain outlook for China.

Our forecast for global economic resilience in 2023 is not an endorsement of an economic soft-landing scenario. The

fact that there are long and variable lags in the transmission of monetary policy suggests that the full negative impact is still to be felt. Also important is that the structure of current inflation has likely changed – we expect the worker shortage to continue to increase wages and, combined with an underlying shift in inflation psychology, could limit a drop in inflation that would result from a continuation of positive supply-side developments. The unwinding of 2022's surge in inflation should be substantial but incomplete as 2023 progresses. Global core inflation is likely to remain above most central banks' targets at least throughout the majority of the year.

Returning inflation to central banks' targets will ultimately require a material increase in economic slack which implies an increased odds of recession. Timing the next recession is, however, complicated as the ingredients that normally lead to one are not currently in place. To get a material rise in global unemployment rates has usually required tighter monetary policy to be combined with two other factors. The first is tightening financial conditions that, not surprisingly, lead to shocks in the financial sector or to commodity prices. The other is the development of macroeconomic imbalances that simply reflect the maturation of the business cycle. As spending and credit growth expand at the same time that corporate profit margins compress due to increasing wages and slowing productivity growth, households and businesses become more vulnerable to a sharp pullback as financial conditions tighten.

This drag from tighter financial conditions will be powerful in 2023 but should be somewhat offset as the aforementioned supply side shocks continue to fade. Normal late-cycle vulnerabilities related to margin compression, rising leverage, and extended durable spending do not appear to have yet been established globally. Finally, following the expected sharp decline in inflation in early 2023, we expect Europe's energy and China's COVID challenges to ease.

Another consideration that further clouds the outlook is an expected pause in the policy tightening cycle that the Fed and other major central banks have signalled. Looking at the U.S., as inflation there moves lower over the coming months and as its labour market cools, the Fed is expected to take a break at a roughly 5% policy rate, accounting for those lags that eventually surface following a rapid shift to restrictive policy. This pause should not necessarily be considered the end of this hiking cycle, but it could reintroduce some stability in global borrowing rates.

Given the economic uncertainties present at this time, we present four scenarios for 2023 and into 2024:

- **Early 2023 recession:** There are sufficient supports that help avoid a global recession in the early months of 2023, but the risks associated with the tightening of financial conditions and the weakness in Europe and China cannot be overlooked. In this scenario, Fed policy peaks in January and would soon be followed by an easing of monetary policy as global growth contracts and central banks globally have a high degree of confidence that weakening labour markets and fading supply shocks will lower inflation.

- **Late 2023 recession:** A near-term recession is avoided but a mild one is experienced as the year ends. Credit conditions deteriorate and the U.S. dollar appreciates while the purchasing power relief from falling inflation fades while the cumulative weight of previous rate hikes begins to be felt, particularly in the U.S. The rest of the world grows, but at a sub-par pace and a global recession is avoided as a cycle of rate cuts commences, led by the Fed in early 2024 as unemployment increases and inflation drops.

- **Deep recession:** The damage from tight financial conditions is offset by extended consumer resilience and a pause from central banks after the first quarter. The expected fall in inflation following the pause, however, is not realized and is subsequently followed up with another round of rate hikes late in the year. With inflation more embedded than previously thought, the consequences of higher interest rates likely generate a deeper global recession.

- **Soft landing:** This is the scenario where the world avoids a recession. The slowdown in growth in 2022 and 2023, combined with the continued fading of transitory dynamics, allows inflation to slide more rapidly towards 2% without a sharp fall in employment. With inflation receding and growth sluggish but positive, central banks begin to normalize policy rates in the second half of 2023. This outcome would likely pave the way for an extended global expansion.

The second and third scenarios, or one sharing some characteristics of each, appear to be the most likely paths for the global economy in 2023. In the short term, though pressured, consumers remain in adequate shape, employment remains strong, and the full impact of rate hikes have yet to be felt, with a pause in the cycle coming early in 2023. How the first half of the year develops will directly lead to how central banks react later in 2023 and into 2024, with the consequences then becoming clearer.

The Markets

Fixed Income Markets

Both the BoC and the Fed increased interest rates again in the quarter - each one on two separate occasions - with a cumulative change of 100 basis points in Canada and 125 basis points in the U.S. Guidance from each central bank points towards a reduced urgency for more to be done as current interest rates are now considered to be at least mildly restrictive. Further rate hikes have the potential to tip the Canadian and U.S. economies into recession as the full impact from past hikes has yet to be felt in terms of reducing inflation from unacceptably high levels or materially increasing unemployment.

The final quarter of the year saw more volatility across the entire interest rate spectrum as the two-year yield increased again – but by less than was experienced in the third quarter - while the 10-year rate also increased but by only a few basis points. The yield curve remained inverted near historically wide levels as the year drew to a close, a development often seen as a medium-term recessionary warning signal. Market-based inflation expectations increased modestly but remained well below actual inflation levels.

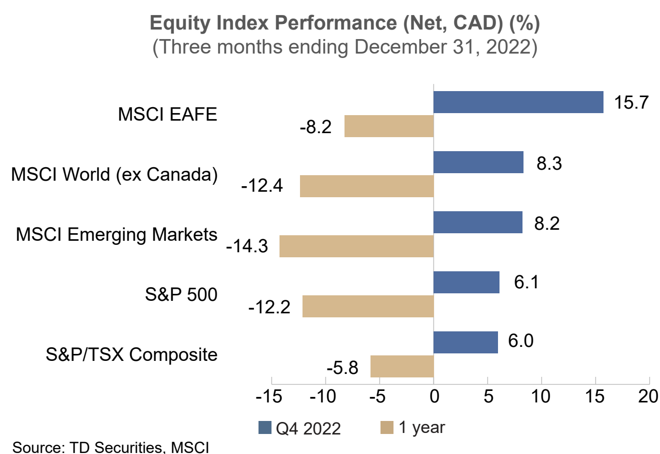
Overall, these market changes, particularly at the front end of the yield curve, are consistent with an expectation of slower central bank policy action to address inflation, but concerns remain about whether this bout of inflation will be slow to normalize over the coming year. Central bankers remain in a challenging position, attempting to moderate inflation while not tipping the economy into recession. The odds of success continue to be low due to the slow pace of inflation moderation.

In Canada, longer-dated bonds generally underperformed shorter-dated bonds in the quarter while corporate bond spreads narrowed modestly. Provincial bond spreads were mostly unchanged. In aggregate, the market returned a small positive result in the quarter following the deep negative returns from the first half of the year. The preferred share market generated another negative return in the quarter.

Equity Markets

Bouncing back from the third quarter's weak performance, equity market returns were almost universally positive in the fourth quarter. Canada's S&P/TSX Composite Index performed reasonably well relative to its global peers while small caps performed even better. Reversing the performance of the third quarter in U.S. markets, the tech-heavy Nasdaq Composite Index, and small-cap-oriented Russell 2000 Index both lagged the broader S&P 500 Index. European equity markets performed very well in the quarter, particularly in Germany. Stock market performance in the Asia-Pacific region remained more varied as Japanese and Chinese equities generated lacklustre performance while markets in India, Hong Kong and Australia performed well.

Equity Index Performance (Net, CAD) (%)
(Three months ending December 31, 2022)



Source: TD Securities, MSCI

Currency Markets

The U.S. dollar (USD) experienced a very weak quarter against most major global currencies as the Fed signalled a slowing in its pace of rate hikes. 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 in the quarter but performed well in the year. The DXY was up about 8% in 2022, nearing a 20-year high.

Similar to other currencies, the Canadian dollar (CAD) gained some ground against the USD in the quarter but remained lower than a year earlier. Even with a lower Canadian inflation rate, an economy more exposed to a global economic downturn, and a central bank policy rate likely to remain below the Fed's policy rate, the CAD benefitted from widespread USD weakness.

Investment Outlook

Despite the continued market volatility, we only made a modest adjustment to our allocations to various asset classes in the quarter given the continued unique environment of sustained weak performance from both equity and fixed income markets. Return correlations were very high in 2022. As an example, the Nasdaq Composite Index was down 33% in 2022 while the long-dated U.S. Treasury bond was down 31%.

The traditional safe-haven role that bonds have historically offered to balanced investors when equity performance is weak was absent in 2022. And even though they have risen to levels not seen in a decade, interest rates remain low, especially relative to current levels of inflation, thus limiting the ability to generate a high real return from bonds.

At year-end, the Canadian bond market's benchmark yield was near its highest level since late 2008. If both inflation and growth rates fall more than forecasted – resulting in an early curtailment of the rate hike cycle - bond performance would likely bounce back from this extended period of weakness. Equity markets would also be supported in this environment of falling growth and inflation, and we continue to believe that equity markets offer better short- to mid-term prospects for performance relative to bonds.

We expect the aggressive tightening cycle will take a pause early in 2023 while North American central banks take some time to assess the impact of their previous rate hikes. We expect that both inflation and growth rates will moderate in 2023. Though a slowing global economy will be almost impossible to avoid at this point, a severe recession can be averted as the challenges and excesses of the past couple of years are worked through.

In summary, we continue to favour exposure to equities overall but have a more neutral outlook on our allocations to Canadian and global equities than in the past. We increased international equities this quarter to a neutral benchmark level and decreased U.S. equities, which remain just above the benchmark level. With credit spreads still at relatively wide levels, there remain opportunities to invest in select corporate bonds and preferred shares as these securities provide an important source of yield in this still low interest rate environment.

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

These views are subject to change at any time based upon market or other conditions and are current as of December 31, 2022.

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