Navigating uncertainty, at home and abroad.

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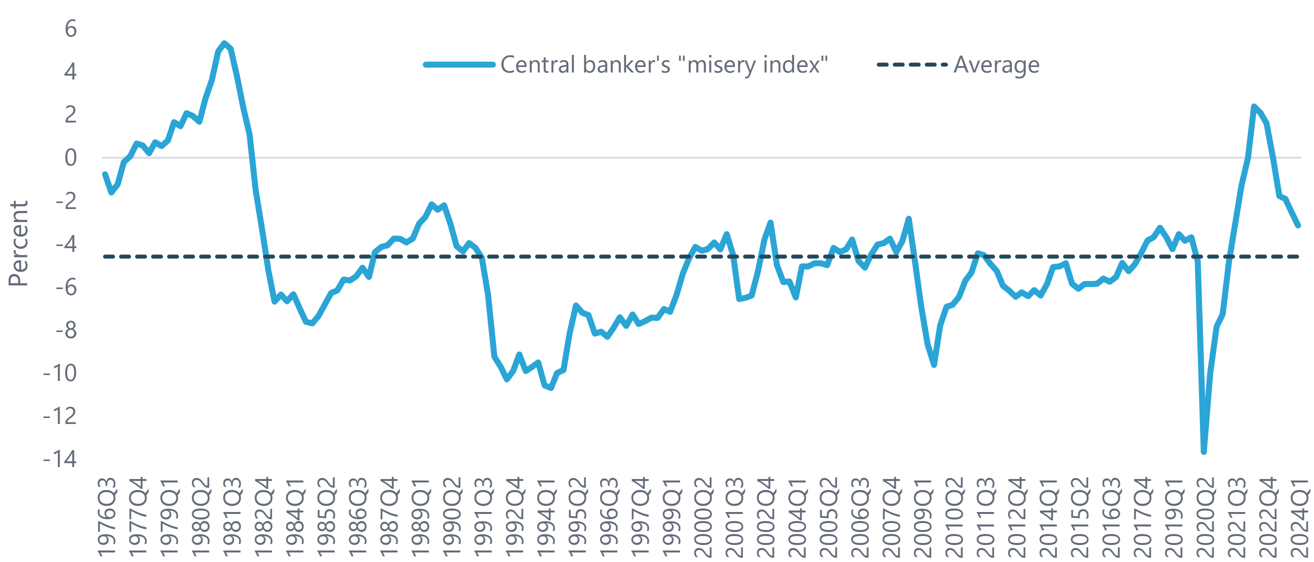
SEI has been cautioning investors that Canada's economy could be in for some tough sledding. Although growth hasn't been gangbusters, recession fears have so far proven unfounded. While both business and consumer sentiment remain depressed, neither has fed into actual economic behaviour to a degree sufficient to cause recession. We've also pointed out that, for a smaller, open economy such as Canada's, the domestic outlook often depends heavily on what's happening outside its borders. This is an observation that recent Bank of Canada research has confirmed in some interesting ways, and we'll take a brief look at some relevant data and research for investors.

Perhaps the most noteworthy news of the second quarter was the Bank of Canada's (BoC) decision to cut its target interest rate by 0.25% to an annualized rate of 4.75%. It was the first BoC rate cut since 2020, and the first among G7 central banks in this cycle. However, as has proven to be the case for multiple central banks, monetary policy easing has fallen far short of what markets expected coming into this year. The COVID and post-COVID eras have been challenging for central bankers. As higher inflation began to take hold a few years ago, we developed a tongue-in-cheek "central banker's misery index" to illustrate just how challenging those conditions were[1]. The misery index for the BoC is shown in Exhibit 1. While inflation has certainly improved over the last two years, the pressures faced by BoC Governor Tiff Macklem and his colleagues are still above historical norms.

Exhibit 1: Life has become a bit less miserable for the Bank of Canada

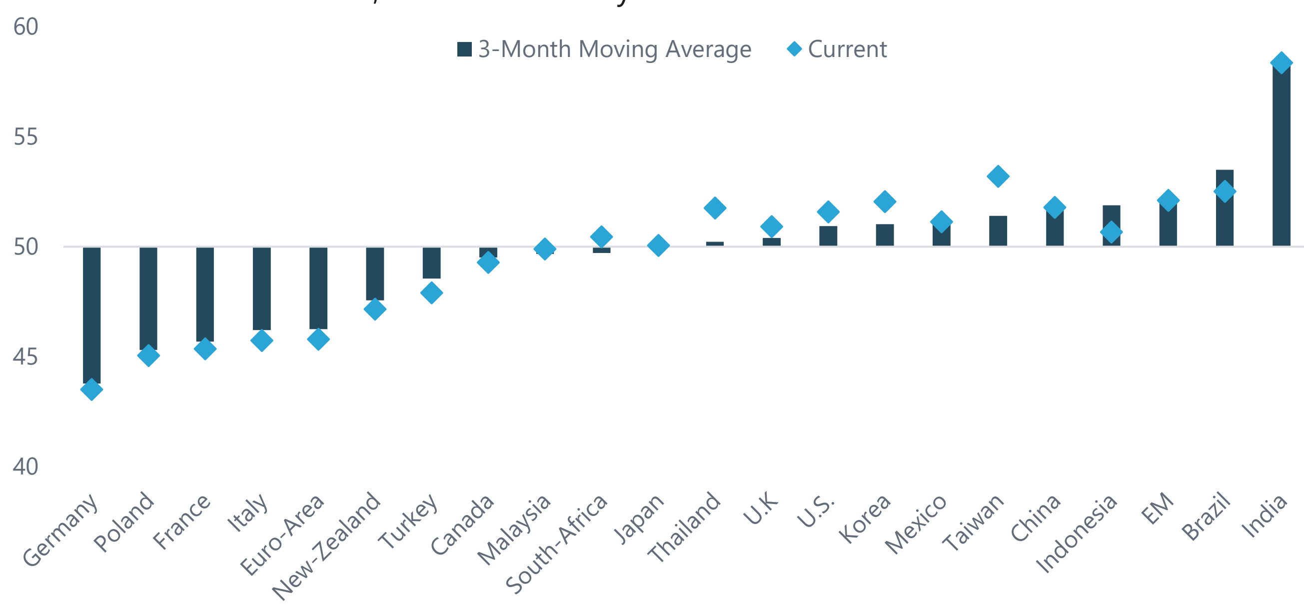


Sources: OECD, St. Louis Federal Reserve. Monthly data from third quarter 1976 through first quarter 2024.

We've also been pointing to poor productivity growth as an ongoing challenge for the BoC, and one of Governor Macklem's colleagues—Senior Deputy Carolyn Rogers—provided a stark warning on this issue in a March 2024 speech when she said, "Productivity is a way to inoculate the economy against inflation. An economy with low productivity can grow only so quickly before inflation sets in. But an economy with strong productivity can have faster growth, more jobs and higher wages with less risk of inflation. That's why I want to talk about Canada's long-standing, poor record on productivity and show you just how big the problem is."[2] Inflation has eased, growth has held up better than expected, and consensus expectations are for an improvement in economic activity as we head into 2025. On the other hand, recent employment data have indicated that the labour market has continued to soften. And looser monetary policy in the context of poor productivity growth means a greater-than-usual risk of inflation reaccelerating, as we pointed out in our fourth quarter 2023 outlook.[3] While markets expect further cuts from the BoC, these uncertainties were almost certainly behind Governor Macklem's press conference recommendation to "just enjoy the moment" as they'll be "taking it one meeting at a time."[4]

Two recent staff working papers from the BoC provide interesting material for thinking about the economic and investment environments. As we have noted previously, for a smaller, open economy such as Canada's, it's important to take account of activity outside the country's borders. Recent surveys show that while sentiment among Canadian manufacturers has been weak and worse than in many other countries, it's still better than some, as shown in Exhibit 2.

Exhibit 2: Worse than most, better than many

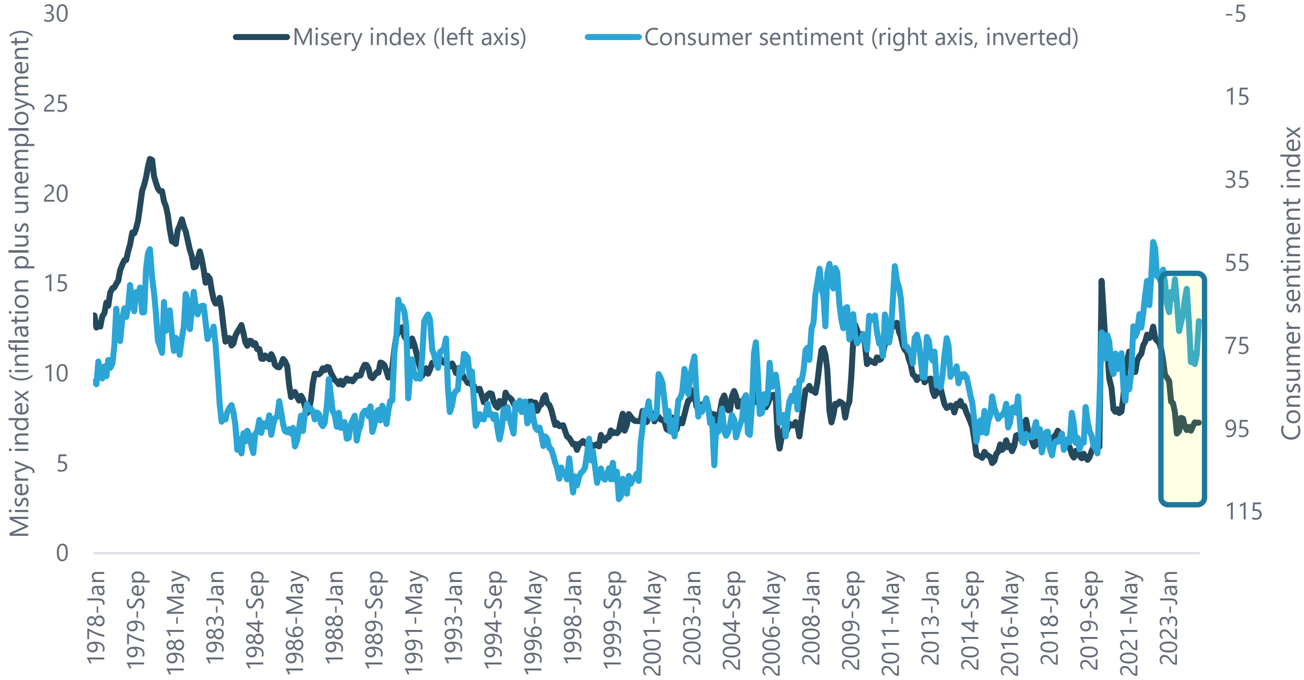


Sources: S&P Global, MRB Partners, monthly manufacturing purchasing managers index (PMI) data from April through June 2024.

Among the countries shown in Exhibit 2, the U.S. is most important (unsurprisingly, given the linkages between its economy and Canada's), as reaffirmed by recent BoC research. An April 2024 BoC working paper found that economic developments in the U.S. have an outsized impact on bond market behaviour in a selection of smaller, open economies (Canada, Sweden and the U.K.), inferring that "U.S. macroeconomic news…is even more important than the respective countries' domestic macroeconomic news" and "is particularly important to explain low-frequency changes in the expectation components of the nominal, real and break-even inflation rates."[5] In March, another working paper proposed a recession-prediction model for Canada that, from a wide range of domestic and foreign variables, selected not only the behaviour of the domestic bond and equity markets, but also the Chicago Federal Reserve's National Activity Index (CFNAI) for the US economy.[6] Yield curve inversion in Canada has been indicating a higher-than-normal risk of recession since mid-2022. Despite a bit of a soft patch in mid-June, the S&P/TSX Index (Index) has been sending a more optimistic signal since last fall. And while the CFNAI diffusion index has been slightly negative for more than 18 months (an indicator that a greater number of components are falling), the overall Index remains in territory consistent with ongoing expansion. Obviously, it's important for anyone with an interest in the Canadian economic outlook to keep an eye on its southerly neighbour. SEI's view is that while we could see some continued softening in its economy, "the U.S. should continue to avoid sinking into recession."[7]

One interesting feature of the U.S. economy—one that it shares with Canada—is that consumer sentiment has been surprisingly weak in the post-pandemic era despite falling inflation and a strong labour market. For example, Exhibit 3 shows the traditional "misery index" alongside the University of Michigan's consumer confidence index (the latter is inverted, so a rising line indicates worsening sentiment). The misery index fell sharply thanks to lower (but still too high!) inflation and a still-low unemployment rate, but there's a notable gap between this index and the latest University of Michigan sentiment measure.

Exhibit 3: Consumers are more miserable than economists



Sources: U.S. Bureau of Labor Statistics, University of Michigan, St. Louis Federal Reserve. Monthly data from January 1978 through May 2024.

One obvious possibility is that political affiliation might be playing a role, but it's unlikely that this can explain much of the gap as more partisan views tend to flip depending upon which party holds the executive branch. [8] This avenue of inquiry also gets more complicated when you consider that the U.S. Congress has as much influence on the economy as (if not more than) the President. One group of economists revisited U.S. inflation measures in an attempt to analyze the sentiment-misery paradox and found that incorporating interest expense (or consumer financing costs for mortgages and automobiles) into their model could explain a majority of the gap in sentiment.[9] The paper was not a criticism of how various consumer price indexes have changed over time—current methods still tend to do a better job than older ones of separating the inflation signal from price level noise. However, when contemplating consumer sentiment measures, it's important to note that financing expenses may be playing as significant a role as employment and inflation. That's undoubtedly true for Canadian consumers as well.

This leads to a key question that market observers have been asking themselves in recent months: If and when the U.S. Federal Reserve (Fed) finally does follow the BoC's lead on lowering its policy interest-rate target, what effects might that have on consumer sentiment, credit, and activity? And what impacts might the BoC's rate-cutting decisions have on domestic activity? It's anyone's guess at this point. The Fed, the BoC and their counterparts elsewhere have to thread a needle between continued progress on inflation and preventing unnecessary harm to the economy. In other words, while central bankers' misery indexes have retreated somewhat, they're still facing significant uncertainty in the economic outlook and setting appropriate policy. For investors, the best response to this uncertainty is to stay diversified, no matter how much "correlation anxiety" they might feel.[10]

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[1] The traditional "misery index" was created by economist Arthur Okun. It added the unemployment and inflation rates to assess how consumers were faring economically. For the central banker's misery index, we subtract the unemployment rate from the inflation rate, using the (sometimes controversial) rule of thumb that tight labour markets tend to foster higher inflation.

[2] "Carolyn Rogers: Time to break the glass - fixing Canada's productivity problem," remarks to Halifax Partnership, Nova Scotia, 26 March 2024, https://www.bis.org/review/r240326e.htm.

[3] https://intranet.corp.seic.com/sites/IMU/CA%20Documents/23Q4%20Canadian%20Economic%20Outlook-AP-5616045.4.pdf

[4] https://www.bankofcanada.ca/multimedia/press-conference-policy-rate-announcement-june-2024/

[5] Bingxin Ann Xing et al, "U.S. Macroeconomic News and Low-Frequency Changes in Small Open Economies' Bond Yields," Staff Working Paper/Document de travail du personnel—2024-12, https://www.bankofcanada.ca/2024/04/staff-working-paper-2024-12/.

[6] Antoine Poulin-Moore and Kerem Tuzcuoglu, "Forecasting recessions in Canada: an autoregressive probit model approach," Staff Working Paper/Document de travail du personnel—2024-10, https://www.bankofcanada.ca/2024/03/staff-working-paper-2024-10/.

[7] James R. Solloway, CFA, "Settling into the new normal," Quarterly Economic Outlook Second Quarter 2024, https://intranet.corp.seic.com/sites/IMU/CA%20Documents/Second%20Quarter%202024%20Economic%20Outlook_5370260.USAANDCANADA06262024_FINAL.pdf.

[8] See, for example, the Reuters graphic entitled "U.S. consumer sentiment by party affiliation," https://www.reuters.com/graphics/USA-ECONOMY/SENTIMENT-POLITICS/gkvlgqjzxpb/.

[9] Marijn A. Bolhuis et al, "The cost of money is part of the cost of living: new evidence on the consumer sentiment anomaly," NBER Working Paper 32163, https://www.nber.org/papers/w32163.

[10] Bryan Hoffman, CFA, "Correlation anxiety and the reality of diversification," SEI Commentary April 2024, https://intranet.corp.seic.com/sites/IMU/CA%20Documents/240049.19_IMU_Correlation_Anxiety_V3_WEB.pdf.