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These are the five economic scenarios we may be facing — and they're not as scary as you think

Everyone is talking about a recession, but it isn't the only way the economy might play out

Peter Hodson || Jul 14, 2023

Pedestrians walk past the Bank of Canada in Ottawa. PHOTO BY DAVE CHAN/AFP VIA GETTY IMAGES FILES

I have been lying awake at night and losing sleep over the upcoming recession. No, I'm kidding, I sleep just fine. Recessions are part of the market, and most are very short. Unfortunately, the painful memories of 2008 continue to worry investors. Investors are panicking that high interest rates, high inflation and other economic issues are going to plunge us into a deep, dark economic abyss. Do you need to worry? Maybe, maybe not. Let's look at five possible economic scenarios that might play out. We think, after reading, you might just be able to get a good night's sleep, too.

A 'regular' recession

This is probably the consensus scenario right now. In the past year we have had the most rapid interest-rate-tightening cycle ever, and as rates rise consumers and businesses cut back on spending, and as a result sales and profits decline, and the economy sees some general economic weakness across the board. The stock market declines somewhat as investors price in lower growth and earnings. To this we say, without being facetious, "So what?" A recession is part of the regular economic cycle. It reduces froth, resets valuations and pops some bubbles. But most recessions last a year or less, and for stock market investors they are usually fantastic buying opportunities. By the time a recession is official, the stock market has usually already turned higher. That might be occurring now. So, for any investor with a three-to-five-year time frame, a regular recession should really be a ho-hum event and not cause any sleepless nights.

No recession, but weak growth

This might be just a continuation of the status quo. Right now we are not in a recession, but the economy is lacklustre and not exactly going gangbusters. Some companies are doing well, some are not. Most are experiencing some inflationary cost pressures. Some tech companies are laying off workers, but overall there are tons of jobs available. Unemployment is near a record low. Essentially, this is the scenario of the past couple of years. Despite economists expecting a recession for nearly two years now, business conditions are still what one might classify as decent. It is a great environment for stock pickers. Other than the Mega Seven giant companies in the U.S., many companies' valuations are very reasonable, as all the recessionary talk has set expectations very low. Yet some companies continue to perform much better than expected, and their stock prices have reacted. This is a bit different than 2022, when all that mattered was the inflation numbers. It is a healthier market where fundamentals actually mean something again. This scenario is not great, but we can certainly live with it.

A giant, horrible, gut-turning recession

This is the scenario that's causing nightmares. With U.S. short sellers sending out warnings of a Canadian real estate crash and possible bank failures, this is the scenario that gets the most press. Bad news sells, remember. This outlook is based on the fact that Canadian house prices are way too high (likely true) and that higher interest rates are squeezing all those poor folks that have variable-rate mortgages (likely true). So, this camp believes house prices will collapse as homeowners simply walk away from their homes, as they did in the U.S. in 2008. Bank losses increase, layoffs ensue, profits decline and the stock market plunges. Is this possible? Sure. It has happened before. But, there is a big difference between now and conditions that existed during the Financial Crisis. First, in 2008, North America was losing 400,000 jobs a month. Now, it is creating 250,000. The Canadian job market is unbelievably strong. Generally, when homeowners have jobs, they keep paying their mortgage. They may cut out on other things such as dining out and vacations, but their mortgage payment is the last thing to go. This means we won't likely see a flood of houses hitting the market, and bank losses won't be nearly as bad as they were 15 years ago. Also, the Canadian housing and banking sector is much different than that in the U.S. If you noticed, we had no banks fail in the first half of the year, unlike the U.S., which saw weekly failures in March and April. Second, with mortgage insurance more prevalent in Canada, our housing market is a bit more secure. Overall, we would give the giant recession scenario very low (but not zero) odds of occurring.

A 'full-employment' recession

If you read the section above, you will have noticed that there are tons of jobs available. Can we still have a recession if everyone has a job? Sure, it is possible. Consumers, hearing all the talk about the "upcoming" recession, can simply just stop buying things, choosing to pay down debt instead. Lower sales results in lower corporate profits, and lower GDP generally. What are the odds of this type of scenario? Well, it would take a massive change in consumer behaviour. You can argue all you want about the focus on the materiality of the world, and how keeping up with the Joneses is unhealthy consumer behaviour. But North America, rightly or wrongly, remains a consumer-driven economy. I, sadly, found myself at two different shopping malls this past weekend, in two different cities. Both were absolutely packed with consumers. At Yorkdale in Toronto, perhaps the Canadian shopping mall best known for its expensive stores, I could barely find a parking spot. I didn't even want to be there (I have four kids), but surely lots of people did. So yes, a full-employment recession is a possibility, but we would see it as very unlikely.

No recession and — what's this? — strong growth

Frankly, we can barely find any investor or economist who actually thinks the economy can actually grow in the next couple of years. That's what makes this scenario the most interesting for us as stock market participants. If no one is expecting growth, if it occurs then there could be some very big stock market moves. We do not see why this is not at least a possibility. As noted, jobs are plentiful and consumers are spending. Companies cut costs during COVID and have been reluctant to spend because they hear all the recessionary talk as well. Lower costs, and new technology such as artificial intelligence, can boost profit margins. Interest rates will one day peak, and this will lower finance charges for companies and increase the valuation of future cash flows.

All that employment could lead to pension plans and individuals buying more stocks and improving market valuations accordingly. Lower oil prices and even the end of the Ukraine War could provide a big confidence boost. Is this at all likely? Probably not, but we would at least give this rose-coloured scenario the same odds as some of the other possibilities discussed here. This scenario of course is the most fun and will provide the most upside for investors. For me, at least, it's the one I go to bed dreaming about.