The Globe and Mail – May 14, 2024

RBC economist predicts two percentage points of BoC rate cuts in a year, with home price gains to follow

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RBC economist Carrie Freestone says she expects the Bank of Canada to begin to cut interest rates in June, with a 25 basis point decrease.

The Bank of Canada will be cutting rates sooner and more aggressively than the U.S. Federal Reserve, according to RBC economist Carrie Freestone. She forecasts that by the third quarter of 2025, cuts to the Bank of Canada's key lending rate will total two percentage points, compared with just 75 basis points of easing by the Fed.

The Globe and Mail recently spoke with Ms. Freestone to discuss her predictions, implications of a widening interest rate differential, and what she sees as the most concerning economic data point.

In April, the Bank of Canada increased the neutral range to between 2.25 and 3.25 per cent, up from between 2 and 3 per cent. Is there a risk that this range may continue to increase? (The neutral rate is the rate at which

the central bank's monetary policy is neither stimulating nor restricting economic growth.)

We're not expecting the neutral range will be nudged higher and higher. Having said that, we think that neutral is likely higher than it was ahead of the pandemic because the macroeconomic backdrop looks a lot different than it did in the 10 years preceding the pandemic.

Is the Bank of Canada on the verge of making a policy error by maintaining a restrictive policy?

I think it's important to highlight that there's a real difference playing out right now between what we're seeing in Canada and the U.S. and the macroeconomic backdrop that helped inform our view, which is that the Bank of Canada and the Fed will be on divergent paths going forward.

We expect the Bank of Canada will go ahead with a 25-basis point cut in June, but we're expecting the Fed will go ahead with their first cut in December.

The inflation data out of the U.S. has been a lot stronger than in Canada. We've seen over the past few months, a larger share of the U.S. basket of consumer goods has been reporting price growth above 2 per cent. I think we're going to have to start to see a material slowing in inflation, which we do expect will happen but we think it'll take some time. We also expect to see additional months of labour market softening before the Fed feels that they're in a position that they can go ahead and make that move. We think it will likely take until December for the Fed to have sufficient evidence that they can go ahead and make that first cut.

This year for the Fed, we have a 25-basis point cut in December and then next year, we have one 25-basis point cut in Q1 [first quarter] and one 25-basis point cut in Q2. And that's all we have so far. So, we only have 75-basis points of cuts priced in right now – a significant divergence from what we're expecting with the Bank of Canada.

In Canada, we already have sufficient evidence that things are trending in the right direction. We think the Bank of Canada will go ahead with a 25-basis point cut in June. We have 100-basis points worth of cuts this year. We have 100-basis points worth of cuts next year. We think that by Q3 of next year, we'll be sitting at 3 per cent and that is probably around where neutral is, depending on the macro data next year.

I think there's a lot of speculation as to whether or not the Bank of Canada has to wait until the Fed goes. That is not our expectation because the economic data are very different. In Canada, growth was certainly strong in January, but it's looking like the back end of the first quarter won't be as strong as the beginning of the year. Inflation is coming down. On a three-month moving average annualized basis, the Bank of Canada's preferred measures, CPI-trim and median, are within their target range.

With that in mind, we think that we're at the point where the Bank of Canada will start to cut and we think that's going to happen in June. If they were to hold for a lot longer, then that could be a concern that they would be making an error and holding for too long – but that's not our base case.

If this does play out as you are forecasting with the Bank of Canada cutting the overnight rate sooner and faster than the U.S. and there is this widening gap between the policy rates, how far can the gap widen before having major negative implications for the Canadian economy?

That's a question that we're getting asked a lot, specifically, we're getting a lot of questions about the Canadian and U.S. dollar.

The Canadian dollar is going to be weaker and that's just because of those divergent rate scenarios.

Our forecast for the Canadian dollar comes from our Global FX strategy team and they've revised their forecast. Previously, we had one Canadian dollar equal to 76 U.S. cents at the end of this year. Now, it's 75 U.S. cents, so a little bit weaker. We previously thought at the end of 2025, one Canadian dollar would be worth 78 U.S. cents and now we're at 75 U.S. cents.

There are a lot of questions about whether or not this will prove to be inflationary because of higher import costs, but we don't expect that this will fuel inflation.

More than half of consumer spending in Canada is spending on services rather than goods. When it comes to the goods sector, we import from a variety of countries, not just the U.S. The U.S. only accounts for about 35 per cent of consumer imports. The other 65 per cent of consumer imports comes from outside of the U.S.; 20 per cent of consumer goods comes from China.

Overall, we think we are less exposed than you might think and we really don't think that is going to lead to broader inflationary pressures in Canada. That's not our base case.

I would say the wildcard would be geopolitical conflicts and higher energy prices. That's something that could prove to be inflationary for Canadians.

What's your baseline outlook for the Canadian economy?

We're expecting 2.5 per cent quarter-over-quarter annualized growth in Q1. Then, Q2 and Q3 will be a little bit softer at 1.4 per cent in each quarter, and by Q4, we have growth picking up to 1.8 per cent and we think that'll continue through Q1, Q2 of 2025. The back half of 2025, in Q3 and Q4, things will be a little bit stronger. Overall, on an annual basis, we have real GDP of 1.3 per cent in 2024, and a little bit stronger at 1.8 per cent next year.

As a team, we like to look the per capita trend because on a per capita basis things have been weak since mid-2022. Even though Q1 is looking pretty strong on a quarter-over-quarter annualized basis, it's looking like we might be on track for seven consecutive quarters of real per capita declines. So, even though things look strong overall, this is very much a story of strong population growth in Canada and it has been for quite some time. Even though we're saying 2.5 per cent in Q1 looks really strong, on a per capita basis, it's either going to be flat or likely slightly negative. Canada's population growth numbers have distorted the GDP numbers over the last year and a half.

Given expectations for a gradual decline in interest rates, what could this mean for the housing market?

We're in a situation where affordability conditions are exceptionally weak in Canada so that has been an impediment to resale activity. We expect resale activity will pick up mid-year once the Bank of Canada starts cutting.

I think the lack of affordability has kept prices down in many major markets in Canada. Having said that, we think the price correction has probably largely run its course.

This year, we have resale activity up 9.2 per cent year-over-year. In 2025, we expect it'll bounce back 16.1 per cent. This is a function of people getting back into the market as rates fall.

How about home prices?

We have prices still weaker this year. They were down 2.6 per cent in 2023. For 2024, we think prices will down another 1 per cent year-over-year and up 3.1 per cent year-over-year in 2025.

What is RBC's consumer spending tracker and what consumer spending trends are you seeing from this tracker?

We use an anonymized aggregated sample of transactions completed by RBC credit and debit cardholders and we look at where spending is going. We use it as a proxy for retail sales activity in Canada because retail sales data, in general, comes through with a pretty significant lag. We publish a report once a month. Right now, I have data up until April.

If we look at retail sales, excluding motor vehicles, they were much stronger in April. Most of that growth was driven by home related purchases, sporting goods and clothing sales, which is something that we would typically see ahead of the summer season in the spring. Our data is seasonally adjusted, but having said that it's not surprising that we are seeing a rebound in that type of spending. Home related spending was on home furnishings, renovation materials, and garden supplies as well and it ticked materially higher for the first time in a year. Actually, a third of the uptick in overall April spending could be explained by building materials spending. So, it looks like people are starting to spend on home improvement. That's interesting to me because discretionary goods sector spending was weak for quite some time. So, the month of April, we did start to see it pick up.

Once we adjusted for inflation, strength in real spending was broad-based. There were increases across almost all spending categories, the exceptions were grocery spending as well as gasoline sales.

For the first time this year, we saw spending on discretionary goods ramp up alongside discretionary services spending and spending on essentials. We haven't seen discretionary goods spending rally since 2023. Also in April, this was the second consecutive month where we saw spending on hotels rebounding and restaurant spending ticked up a little bit as well.

Overall, I do want to be cautious as one month doesn't make a trend.

We saw a little bit of a more optimistic labour market report last Friday. We thought that we would have a slight uptick in job numbers, but it was significant, and the unemployment rate held steady. Consumer spending in April looks a little bit stronger. We expect consumer activity will improve in the back half of this year. The question is whether that will continue into Q2, that wasn't in our base case, our base case was for Q2 consumption to be a little bit weaker than Q1. I would be hesitant to change that based on one month of spending.

Our base case is for the Bank of Canada to start cutting in June but after a more positive labour market report and also this consumer data that's stronger, once we get StatCan retail sales we will have a better idea, but there is more risk now than there was before that the Bank of Canada will push that first cut a little bit later than June.

What trend do you believe may transform the global economy in the next five, 10 years?

I think about risks. We're in a situation where Canada's population is drastically aging, many advanced economies are experiencing the same trend. I think how we address aging population is going to be a huge question.

The trend that could come out of that could be further adoption of new technologies, like embracing AI to replace labour shortages.

In terms of immigration for labour replacement, what the future is for Canada's immigration policies, that's something that we're thinking about a lot.

When you say you're thinking about immigration a lot, what conclusions are you coming to?

There are challenges with immigration in the sense that we've had extremely strong immigration over the last few years and higher demand for housing squeezes affordability further. We’ve seen a lot of public policy in recent months to curb the pace of immigration.

The concern is in the absence of immigration, we’re facing some cost challenges with an aging population because we’re going to have rapidly higher health care costs. The government’s going to be on the hook for more OAS payments, and we’re going to have a smaller base of taxpayers.

So, my conclusion is that we still have to encourage immigration. We have to make sure that we’re targeting the right skill sets. I think we do a very poor job in Canada of matching immigrants’ skills to occupations that are open. We’ve seen that with a significant number of job vacancies in the skilled trades. We don’t have enough construction workers to build the homes that we need to build. We have immigrants coming in with credentials to be doctors and nurses who have to reskill and get their designations all over again to practice here.

My conclusion would be that immigration is absolutely essential to replace some of the labour that we’re going to lose from Canada’s aging population, but we have to do a better job at making sure that people are filling the right occupations and we’re not doing well with that unfortunately.

What’s the most concerning economic data point to you?

Canada’s productivity numbers.

One of the things we’ve been looking at is just how drastically Canada is lagging the U.S. If we look back to the late seventies, our output per hour worked was about 90 per cent of that of the U.S. So, only a 10 per cent differential. As of 2022, that’s fallen to 70 per cent, a 30 per cent differential.

If we look at wage growth adjusted for inflation, so real wage growth, historically, this has moved in lockstep with productivity. So, if we’re in a situation where productivity growth gets weaker or even stagnates that obviously paints a grim picture for wage growth moving forward.

And that’s the only way that we’re really going to see wage growth is if we see an increase in productive capacity. We could see wage growth through labour shortages, but that’s not necessarily the wage growth we want to see because that type of wage growth can be inflationary. We want to see wage growth from higher productive capacity where we see supply meeting elevated levels of demand arising from higher wages – and that’s a huge challenge. That’s probably one of the most concerning data points I would say.