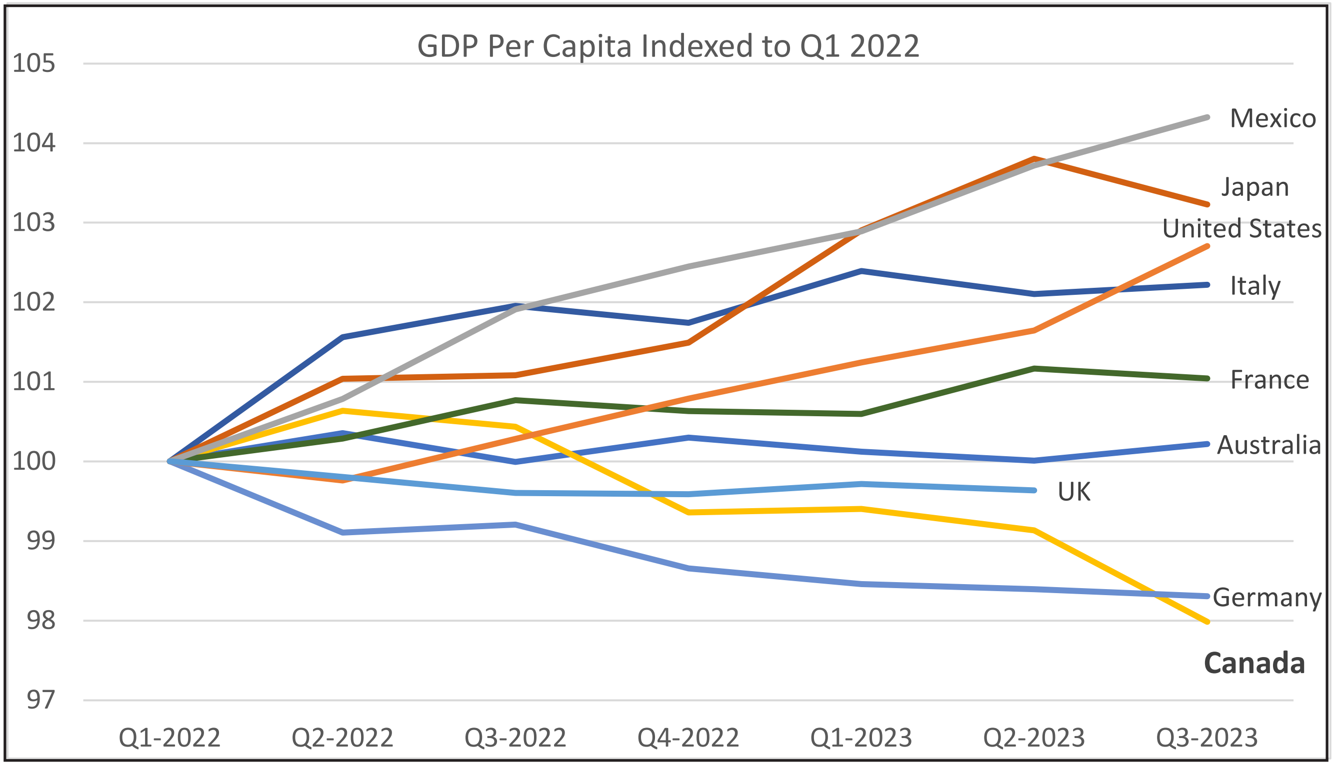
The Canadian Economy Divergence is getting worse and fast

We wrote in our December 2023 letter about the divergence of our Canadian economy compared to the U.S. Unfortunately, this divergence is intensifying and getting worse. The consequences, if the trend continues, are dire and will impact the return of different types of stocks, bonds, and other assets. Therefore, we pay close attention to our Canadian economic data. Still, there are too many people that are unaware or don't appreciate how it will impact all of us at one point. It's not because we were/are a rich country that we will stay a rich country forever. For example, take a look at Argentina (which is getting a lot of headlines with their new president Javier Milei). 100 years ago, the country had a GDP per capita close to the same amount as Germany and since then, a lot of economic potential has been destroyed. **The economy is not a "zero-sum-game".**

To come back to our country, just last month (March), Canada lost 2,200 jobs despite the large increase in the population. More people should normally create more demand in the economy, therefore more jobs. Unfortunately, Canada continues to shrink on a "per capita basis". The economies of Canada and the U.S. are going in opposite directions and the divergence is increasing.

Indeed, the US economy added 303,000 jobs in March and continues to maintain a low unemployment rate of 3.8% while here in Canada, unemployment took a big leap upward to 6.1%. **On top of it all, despite this weaker job market, wage inflation increased to 5.1% in Canada.**

When you compare Canada to the G7 plus Mexico and Australia, you can see that we are at the bottom of the pack in terms of GDP per capita growth since Q1 2022. Consider that the UK and Europe both have had an energy crisis, plus Canada is in close geographic proximity to the United States and Mexico who are both doing great.

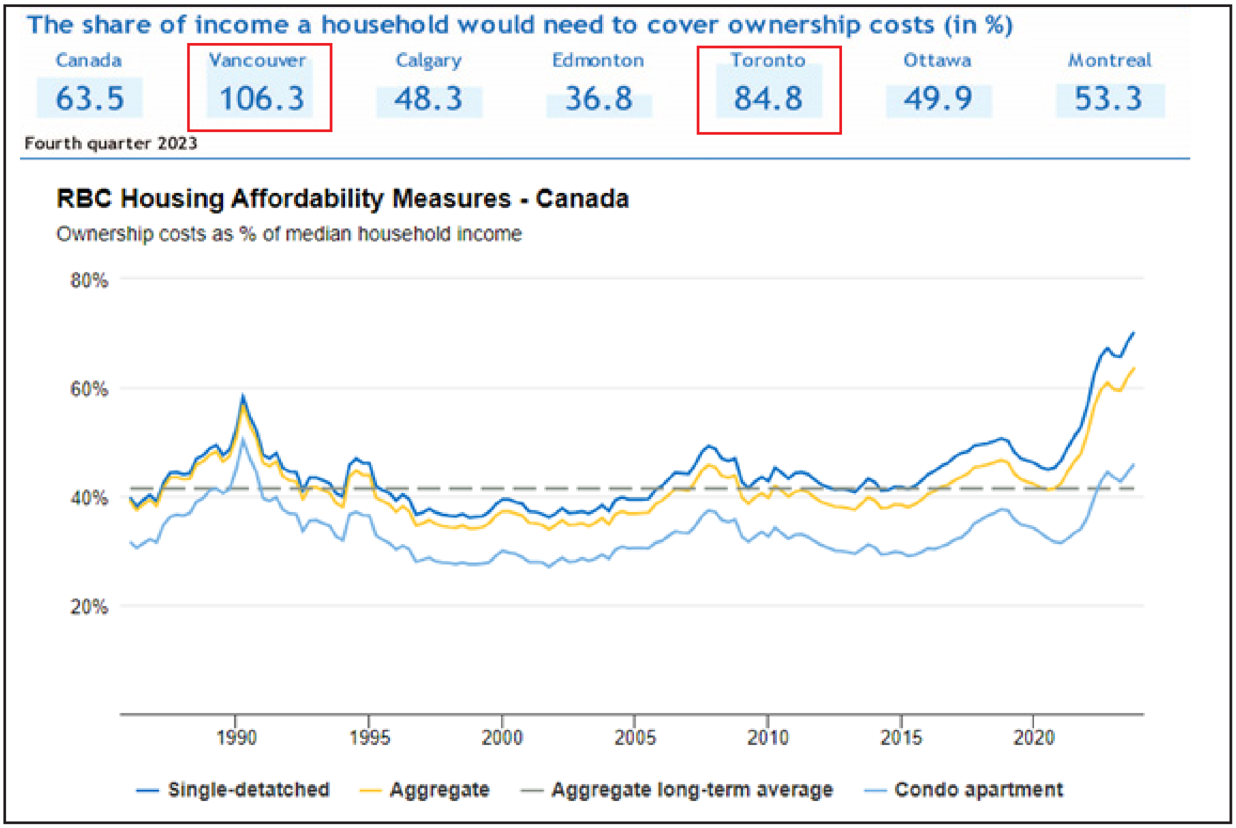


Source: OECD, https://stats.oecd.org/index.aspx?queryid=66948

What is causing this? What are the long-term consequences? What can be done to fix the situation? And if the trend continues, what can investors do?

What is causing this?

1. Unaffordable housing: Home prices in Canada are so high in relationship to average household income that we estimate that less than 10% (probably about 5%) of Canadians can afford a house without any family help or already built-up home equity. Regarding this, RBC recently published a thought leadership report demonstrating what home ownership costs as a percentage of median household income in both Vancouver and Toronto is now at ~106% and ~84.8%, respectively. Link



Source: RBC Economics

2. Another factor contributing to higher home values is the substantial increase in the Canadian population. In 2017, temporary immigrants made up 2% of the population. We are now at 7.5%[1]. This is simply the law of supply & demand at work and unless something drastic is done, housing is likely to continue to remain unaffordable for most Canadians.

3. High taxes and competition (ie: the increase in the capital gains inclusion rate): High taxes make it harder for families to save and accumulate the required funds for a down payment (making affordable housing even worse). Given that Canadian taxes are much higher than in U.S. and Mexico, it makes it a lot harder to attract investment and talented people (we probably have a high "brain drain" currently) from Canada which ultimately lowers our economic potential. Let's face the facts as the numbers speak for themselves, you can clearly see Mexico and the U.S. pulling ahead in the chart on the prior page. Canada competes with the USA, Mexico, China and the rest of the world for capital, **the investment dollars will go to the most attractive places and the need for a competitive and stable tax regime along with access to talent is essential to long-term economic growth.**

1 https://globalnews.ca/news/10397176/trudeau-temporary-immigration-canada/

4. Inflation. The massive cumulative inflation we have seen since the end of the pandemic has eroded the purchasing power of consumers: The average rent has increased by 9% in 2023 and 21% in the past 2 years according to rentals.ca's national rent report and we expect an average increase of ~10% again in 2024[1]. For many, wages have not kept up with the cost of rent, mortgage increases, car payments, insurance, food, etc. Therefore, we continue to believe that inflation in Canada will remain high, perpetuated by wage pressures (ie: up 5.1% in March), rent/mortgage increases, and the strong likelihood of a much lower Canadian dollar (and a lower CAD$ will bring the cost of all imports upward creating even more inflation).

What are the longer term (10+ years) consequences if the divergence continues and gets worse?

1. The Canadian dollar could go down to 50 cents or less
2. Brain drain intensifies
3. Higher inflation along with higher interest rates, dropping the standard of living
4. Record bankrupcies

What could investors do (assuming one does not decide to leave the country immediately)?:

1. Invest in companies that have most of their revenues outside Canada
2. Invest in other currencies
3. Invest in foreign stocks, bonds, and other foreign assets
4. Be very selective when investing in companies primarily exposed to Canada

Final Thoughts

Our economy and country should be booming considering the amount of natural resources that we have (water, oil & gas, uranium, base metals, gold, lumber) on top of having the world's largest economy as our neighbour. Furthermore, our population growth is world leading. Consider how attractive our country could be, with a healthy per capita GDP growth profile, if we had the right policies in place.

Portfolio Positioning

Given the increasing evidence of a worsening divergence between our Canadian economy compared to the U.S., we have positioning in the portfolio of companies with a high revenue mix outside of Canada and/or companies with management teams prioritizing organic and inorganic investments outside of Canada. The fund is also net long the U.S. dollar and our short book includes allocations to long-term Canadian rates. Finally, and as always, we continue to prioritize investment opportunities we believe offer a great risk-reward proposition.

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1 https://rentals.ca/national-rent-report

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