The Canadian Economic Debacle

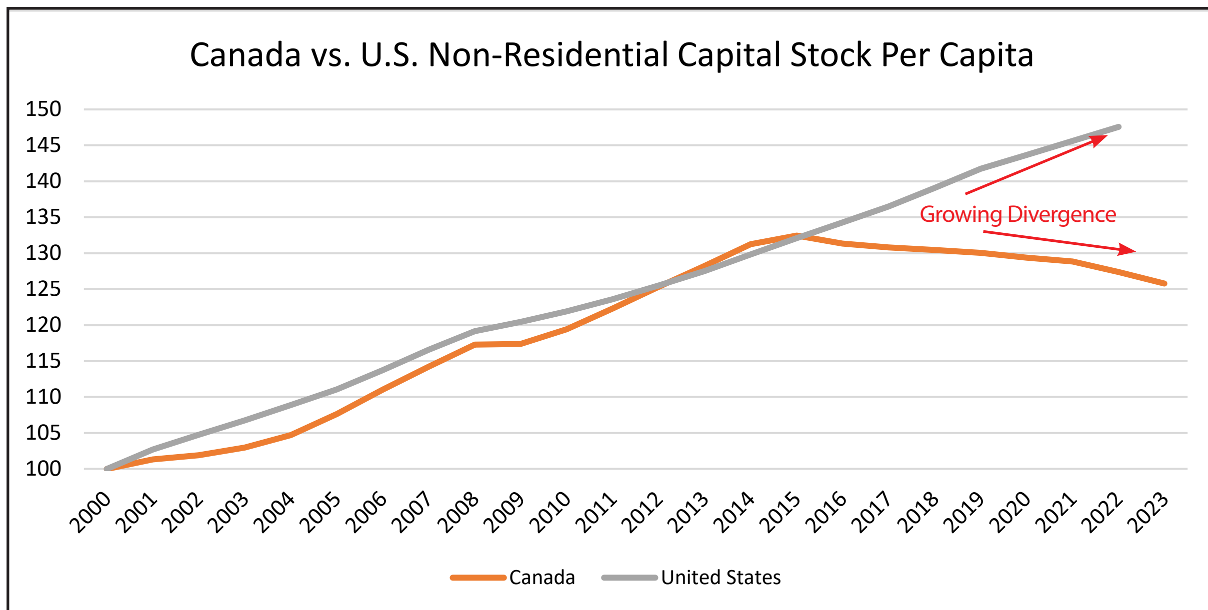
Over the last few years, most Canadians should have noticed a clear divergence of our economy versus the U.S. What's most worrisome is this divergence is expanding and accelerating at a faster pace.

For instance, last month (link) we wrote about how much worse the giant housing affordability issue will get for Canadian homeowners, because of the higher renewal mortgage rates through 2024-2025 and 2026. In the U.S., most mortgage borrowers have a 30-year fixed mortgage so they have been unaffected by the rise of interest rates creating an important divergence between our two economies.

Unfortunately, Canadians face another big challenge created by what we believe are some of the bad policies in Canada. The Canadian GDP per capita has shrunk 5 quarters in a row. In particular, the Canadian GDP per capita was down about 4% annualized in the third quarter. The National Bank chief economist explains it pretty well in their memo titled **"the population trap."**[1] Click here to read.

"I'll put it bluntly: We've fallen into the population trap," said Stéfane Marion, chief economist at National Bank of Canada. An increase in the standard of living is no longer possible because "you don't have enough savings to stabilize your capital to labor ratio."[2]

The pain of our population trap can be best shown with how our non-resident capital stock per capita has barely increased in 11 years, while the U.S. is up 18% in the same timeframe. The large divergence started around 2015 and is getting worse, very fast, which should worry all Canadians.



Source: Statscan, BEA

What we believe Canada needs to provide, is many fold:

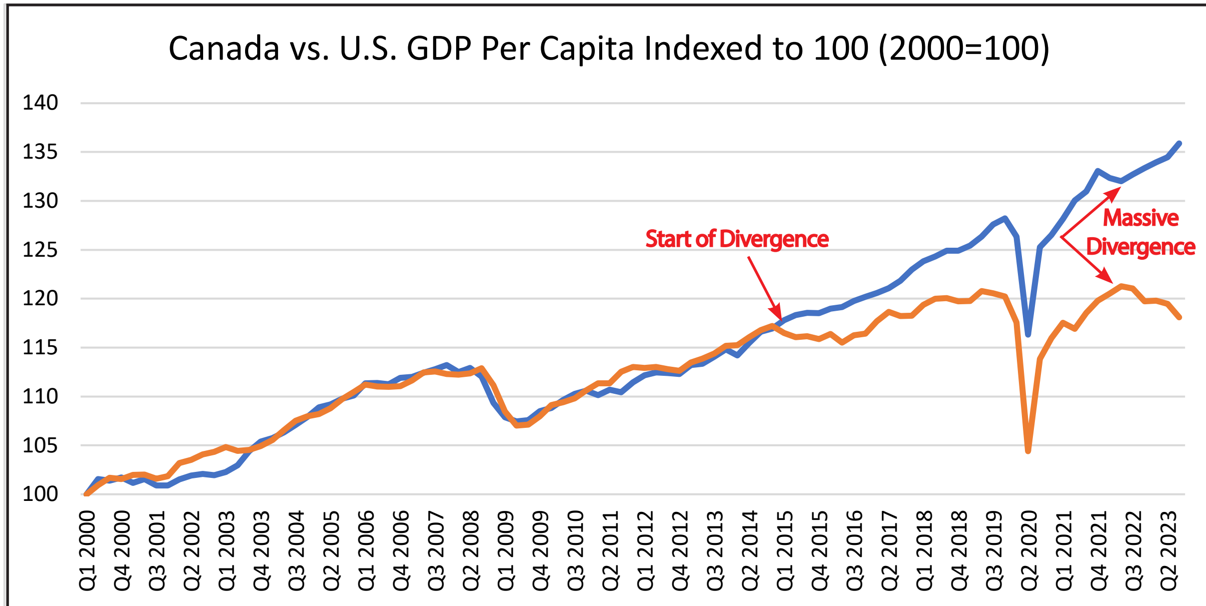
1. A stable investment climate where capital providers feel they are a valued member of society and are not vilified by their government.
2. Reversal of the aggressive increase in taxes of the last many years to incentivize investments thus attracting investors, innovators, and other smart people (Canada is undergoing a "brain drain").
3. Aggressively reducing the regulatory burden – we suggest to read the many articles of Frank Stronach - (more on that later). Check some out here and here.

On top of Canadian economic policies, we know that the Canadian consumer is now over levered in the housing market, which could explain why we are struggling to provide enough non-residential capital for our population surge. Compounding this issue is the low interest rates of the last decade making the current levels feel high (rates are actually not that high if we put them within the long term historic range), further discouraging investment as some areas of the economy need to de-lever their balance sheets.

1 National Bank Financial Special Report

2 Ibid.,

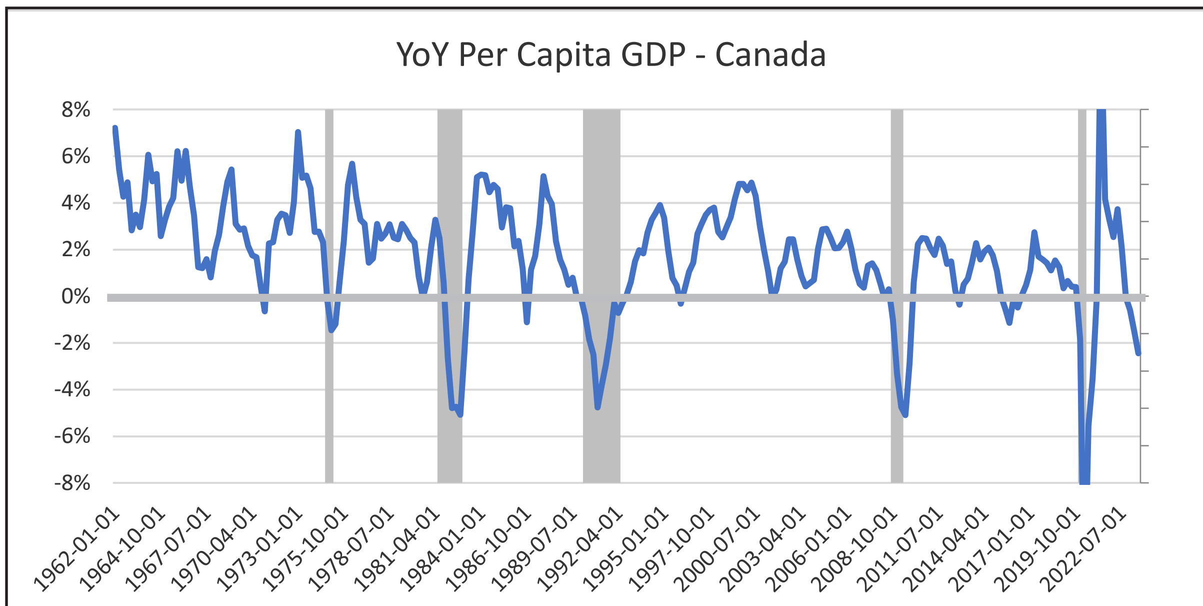
We can see the impact of policy decisions by the **massive divergence** with the United States, where our per capita GDP has been shrinking as theirs has been growing, shown below. Again, that divergence started around 2015.



Source: FRED and Statscan

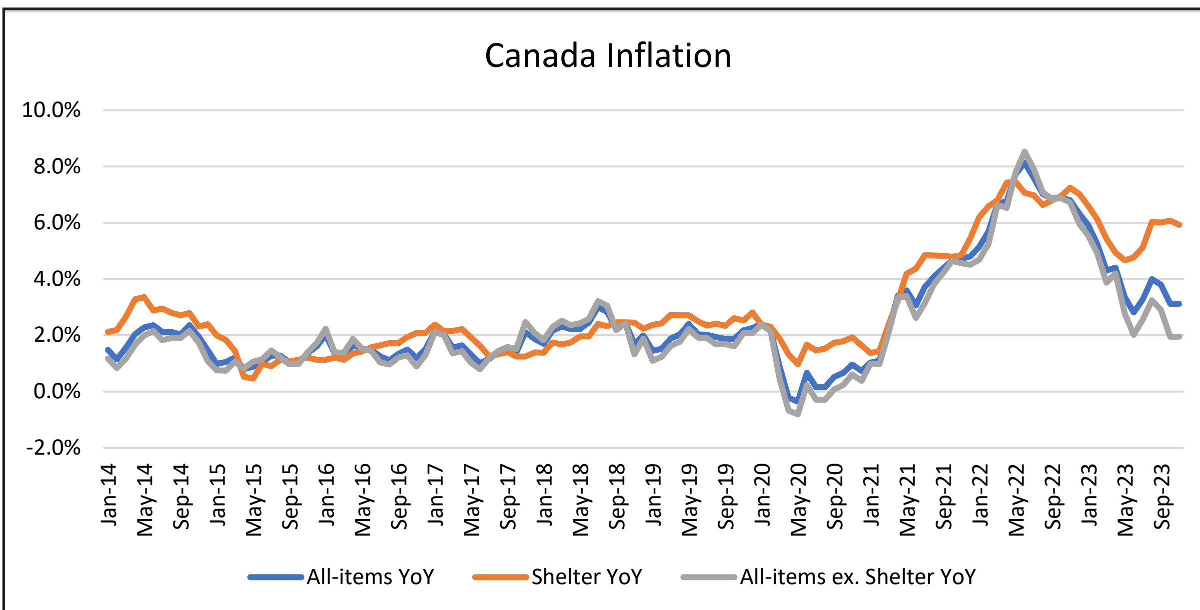
We have barely grown our per capita GDP in the last 8 years, an embarrassing feat. Clearly, something has changed. When we look at the year-over-year GDP per capita, we are obviously in a very bad trend. Historically, Canada has a recession or negative GDP per capita when the entire North American economy is weaker. But this time, our GDP per capita is declining while the USA is growing at a rapid pace (4% annualized last quarter) and incurring big budget deficits for large infrastructure investments, which helps the North American economy.

Traditionally, when Canada hits a rough spell, we would expect to see the Bank of Canada making rate cuts. As we show later, that might end up being difficult to do in the current environment where inflation in Canada might diverge from the U.S's levels. Inflation in the U.S. is expected to decrease (the FED said to expect 3 cuts / the market expects 6 cuts) while we believe it may stay stuck or inflation could even increase in Canada.

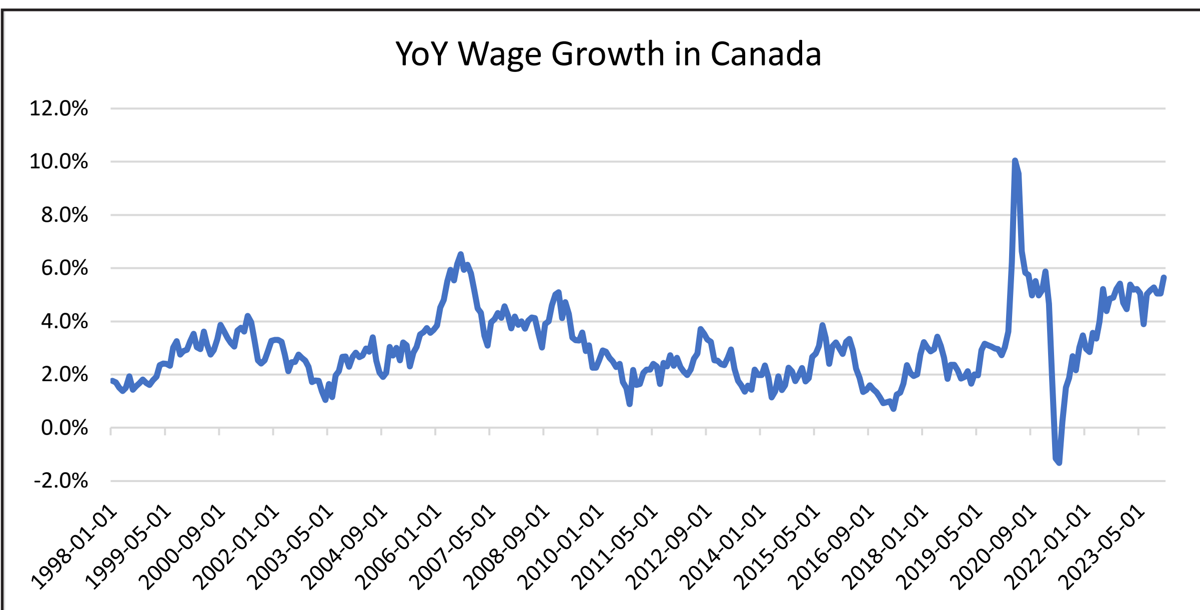


Source: Statscan - grey denotes Canadian recession

What makes it difficult to cut interest rates in the current environment? Wage growth is not abating (latest figures showed that wages were up 5.7% YoY in Canada). Meanwhile, shelter CPI is dragging up our inflation rate. Considering the large housing shortages and record immigration, we predict a large divergence in rents in Canada versus the U.S., where the average rents in the U.S. could be flat to down for 2024 while we see an even higher spike in rents in Canada. We strongly believe that these two items could instill an upward wage price spiral in Canada for at least a few years. If that's the case, it's hard to imagine the Bank of Canada reducing rates aggressively any time soon.

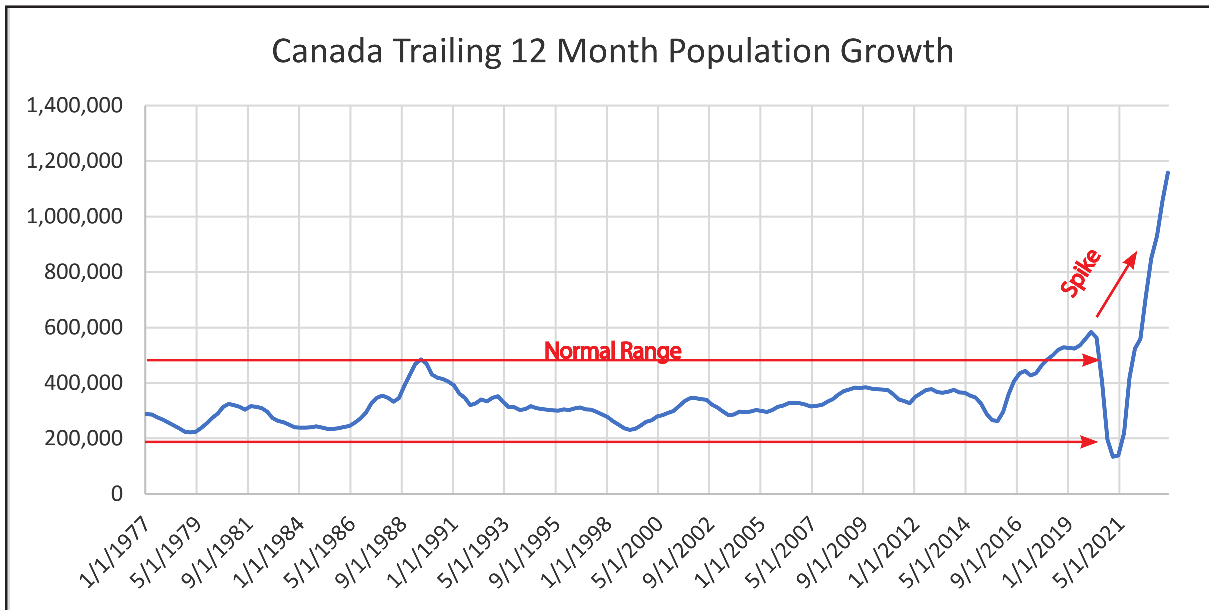


Source: Statscan

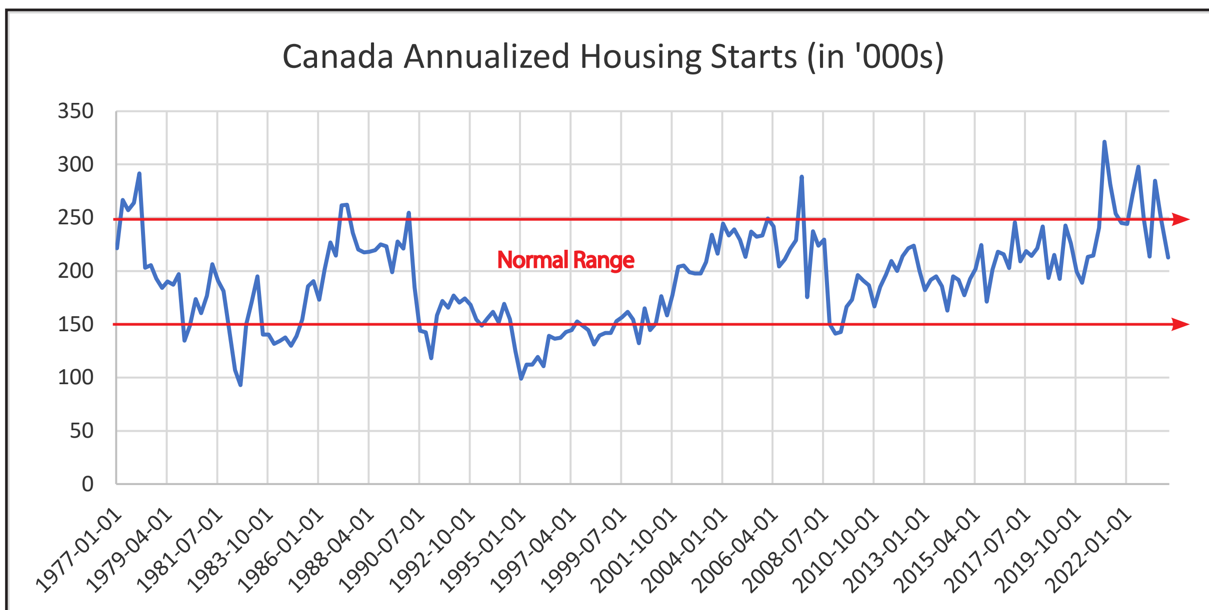


Source: Bloomberg

What many people think they have already seen, but are unprepared for, is that Canadians are about to face an unprecedented jump in the cost of living, as housing costs soar (rent increase or mortgage renewal). As you can see in the below chart, Canadian population has been growing between 200,000-500,000 annually for the last ~60 years before 2019, very consistently. During the same time frame, housing starts have been between 150,000-250,000 annually, a very normalized range. In the last 3 years, we have seen massive upward explosion in population while housing starts have not responded in kind.

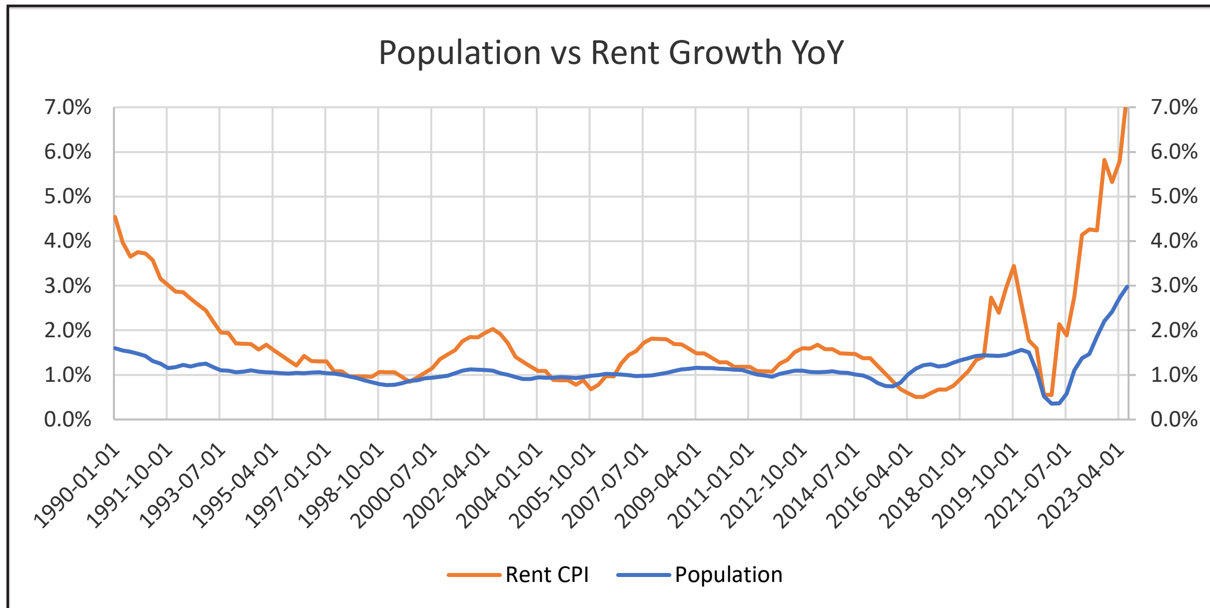


Source: Statscan



Source: Bloomberg

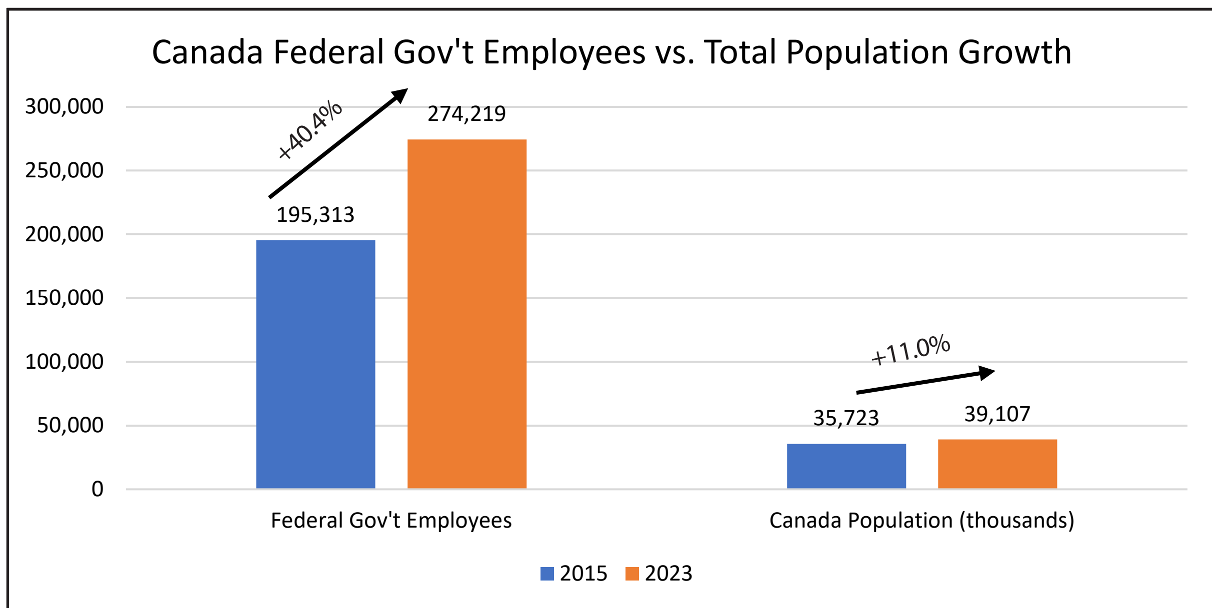
Last month we talked about the soaring cost of housing considering how interest rates have moved. What we think is already showing itself and could simply get worse, is the cost of apartment rents in Canada. As you can see in the below chart, Canadian rent is moving with the growth in population, a remarkably simple concept considering more demand (population) and minimal change in supply means the future for renters is looking bleak.



Source: Statscan

<u>What is not captured in the above is that multiple provinces have rent control in place which puts downward pressure on rent growth contrary to what a free market would show (in other words, inflationary pressures are higher than the official data)</u>. Consider for a moment how painful the situation would be for the average consumer if it were not for rent control. We believe an easy prediction to make right now is that one political party in Ontario will propose rent freezes with landlords not being able to mark to market rental rates on turnovers. <u>Without a supply response from the housing development sector, we are unsure how housing affordability will improve</u>. We saw during the COVID 2020 lockdowns when population growth materially slowed (international students leaving), that rent growth collapsed.

Added to all of the above, we consider the expansion of the Canadian federal government to be no laughing matter. For a country that struggles with productivity and is said to require large foreign temporary workers, it is shocking to see so many resources being sucked up by our federal government. Total federal government employees are 40%[1] higher than at the end of the 2015 fiscal year, which compared to the general population is only up 11% in the same time frame.[2]



Source: Statscan and Canadian Federal Government

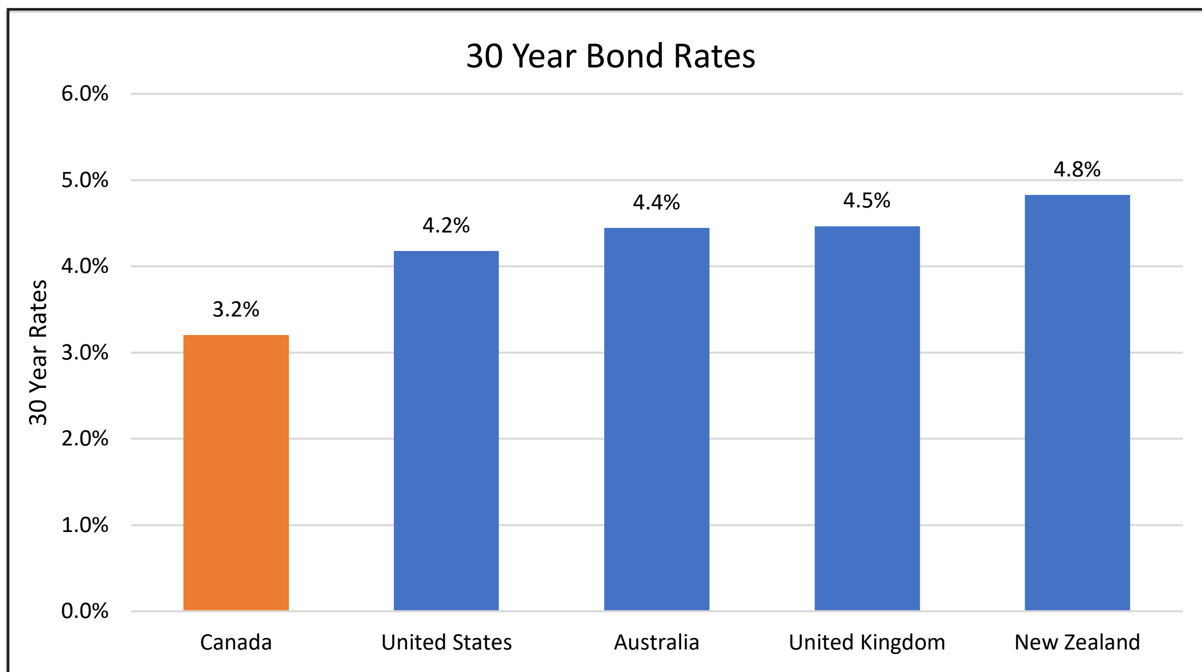
1 https://www.theglobeandmail.com/canada/article-size-of-federal-public-service-swells-to-record-high-according-to/
2 https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=1710000901&cubeTimeFrame.startMonth=10&cubeTimeFrame.startYear=2014&cubeTimeFrame.endMonth=10&cubeTimeFrame.endYear=2023&referencePeriods=20141001%2C20231001

What does it all mean? It feels like we are backed into a terrible corner. Right now Canada is:

- In a recessionary period with respect to per capita GDP
- Inflation is not abating as needed, wage growth is not abating (see wage growth above)
- Housing is unaffordable today, making wage growth more likely, see our last month's letter for that
- However, housing prices falling too fast is bad for the consumer & economy
- Housing affordability not expected to get better (see above)
- Rates cannot come down due to the upward pressures of population growth
- Productivity gains are likely not to come while we rapidly are expanding the bureaucracy with poor incentive structure

Canada is backed into a primed situation for a potential upward inflationary spiral.

While this is all happening, Canada has the lowest long term bond rates in the English world. It makes no sense whatsoever that Canadian rates are so low compared to the U.S. If Canada gets a slower economy with higher inflation rates, we would expect to see a rise in our interest rates across the curve like we had around 1990. If this happens, investment returns in Canada would become dismal and we would clearly underperform the U.S.



Source: Bloomberg, dated as at January 15th 2024

Portfolio Positioning

Considering that we believe Canadian interest rates are too low compared to the rest of the English world, we initiated a new position shorting the 30-year Canadian bonds. Our net exposure to equities remain low as we continue to see the following risks.

1. U.S. markets are already pricing 6 cuts vs 3 indicated by the FED – stocks have rallied strongly on that
2. The US budget deficit is likely to shrink from the high level of 2023 – reduced government spending lowers GDP
3. QT is still ongoing taking about US$100 Billion per month out of the system – the money has to come from somewhere
4. Most investors believe in the soft landing – therefore the hard landing risk is not priced in
5. Chinese economy, the 2nd largest in the world is not doing well
6. U.S. large cap stocks are expensive in relation to historical range
7. Important geopolitical risks are not priced in the markets (Middle East – Ukraine – Taiwan – black swan?)

We believe the world economy will continue to soften gradually as the benefit of COVID policies and the large US deficit reverses. Eventually, markets will discount this eventual recession. Stock indices fall around 30% on average during a recession, therefore we believe the risks remain to the downside.

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As you’re aware our offering memorandum provides that we may cover/sell all stocks mentioned in this report if we feel it is advisable to do so at any time.