

TD's chief economist on the year ahead and what might be the largest surprise to investors

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Beata Caranci, Chief Economist and Senior VP at TD Bank Group. Tijana Martin/The Globe and Mail

In 2022, soaring [inflation](#) and [aggressive rate hikes](#) by the [Bank of Canada](#) contributed to losses in the markets. Looking to the year ahead, it will be the impact of these higher rates on inflation and the economy that will influence how markets perform.

After TD Economics published its latest economic forecast this month, I spoke with Toronto-Dominion Bank

chief economist Beata Caranci, who shared her views on inflation and monetary policy, as well as the labour and housing markets.

There is concern that while inflation will decline, it may remain "sticky" and well above the Bank of Canada's target. However, TD is forecasting inflation will return to the upper end of the Bank of Canada's target range of between 1 and 3 per cent by the second half of 2023. What gives you this conviction?

It's predicated on weaker consumer spending that in turn is a reflection that there's quite a bit of risk related to ongoing debt service in Canada.

Over all, we're still looking at wealth being higher today than it was pre-pandemic. So there's still a cushion there. But it's hard to deny that household debt levels are high. On top of that, the interest-rate increases that we've seen this year really don't affect the overall national balance sheets until next year. Every quarter, more people will be renewing mortgages, elevating the share of income that will need to be dedicated to servicing debt. We got a glimpse in the third quarter that more households are putting money into interest payments versus principal. And that trend is going to become amplified as we get into next year.

We also have a cooling in the labour market in our forecast. Those two dynamics are what gets you to that inflation profile.

When we last spoke in the summer, you forecast the overnight rate would peak at 3.25 per cent. In 2022, the Bank of Canada ended up hiking the overnight rate seven times to 4.25 per cent. Consequently, do you believe the Bank of Canada has made a policy mistake and tightened too much?

It's an interesting question because it goes back into why they have to go

higher than we originally thought – and they thought, too – and that's because the economy has been more resilient than we were expecting. Consumer spending came in very resilient in the second quarter, the job market is very tight, wages are rising so that's why they're hiking.

You can't mark it as a policy mistake until we get to the other side of it. You only know that answer retrospectively.

You believe the Bank of Canada will hike rates for the final time on Jan. 25, taking the overnight rate up to 4.5 per cent. With an end of the tightening cycle in sight, the focus is shifting to when the Bank of Canada will start lowering rates. In your forecast, you have the first rate cut occurring in the fourth quarter of 2023, bringing it down to 3.75 per cent, and dropping to 2.25 per cent by the end of 2024. It seems like a very swift reversal.

It goes back to the expectation that we will have a consumer that will be contracting in the second half of next year, an unemployment rate that will be rising, and inflation that will be giving some convincing signs that it's moving back towards their target of 2 per cent.

One of the conditions you're talking about is consumer spending contracting. Yet, we have such strong wage growth, and when people have more disposable income, a tendency is to spend. We've seen wage growth of over 5 per cent in the last six months. What are your wage growth expectations?

Well, to get inflation to move back toward 2 per cent, you're usually talking about a wage growth environment that's around 3 per cent.

The Bank of Canada will eventually get the outcome they want. It's just a matter of how high they have to go on the interest rates.

When I look at the labour market, and you touched on this, it's been so strong with the unemployment rate at 5.1 per cent in November, close to its record low of 4.9 per cent. So help me understand why wage growth will decline to 3 per cent when we have such tight labour market conditions?

Because in our forecast we have the unemployment rate rising about 1.5 percentage points and that corresponds to about 100,000 in job losses, putting some slack and caution back into the markets.

So if you look at job levels, the number of employed people in Canada relative to pre-pandemic, they're up about 2.7 per cent, almost 3 per cent.

In comparison to the U.S., job levels are only up about 0.7 per cent relative to pre-pandemic. We hired at a much faster and greater rate than what we saw in the U.S., which suggests that there could be more job losses in Canada when the economy cools. You couple that with the interest rate risks on debt, and that would suggest we could cool down quite a bit next year.

We've had some really big gains in the professional area, public administration, finance, insurance and real estate, so those are sectors where the jobs might be a little bit more vulnerable.

The spread between the Canadian two- and 10-year government bond yields is steeply inverted, which has historically been a strong predictor of a recession. How do you interpret what the bond market is telling us?

The two- and 10-year spread is reliable in terms of its prediction, but not in terms of its timing, and it doesn't account for what the future may hold.

If you have the central bank starting to cut the overnight rate next year because it is seeing economic weakness and inflation coming down, it could

take away that dynamic. So it really depends on that future policy state as well – how fast the central bank reacts.

When we last spoke in the summer, you forecast a 50-per-cent chance of a soft landing and a 50-per-cent chance of a shallow recession. Have those probabilities changed?

I would say if you look at our forecast, we have a rising unemployment rate; that is consistent with an economy that gets characterized as being in a recession. Our labour market forecast would suggest a recession, mild by historical context, because the unemployment rate is only up 1.5 percentage points, as opposed to between two and four percentage points that would characterize a deeper recession.

Your forecast of declining rates starting in the fourth quarter of 2023 would ease pressures in the housing market. The national average home price in Canada peaked in February and has now erased more than half of its gains realized during the pandemic. Do you believe we are close to a bottom? What is your outlook for the housing market?

We would say that we're about two-thirds of the way through the correction and we think the bottom in the market will occur around the first quarter of next year, maybe second, and the reason is because we're already seeing some dynamics that are levelling off. The magnitude of declines in the last few months are getting less and less, we've seen some stabilization in the amount of sales, and we're not seeing listings jump up, which would be an indicator that households are under financial stress. So there's some stabilization dynamics starting to come through. That's why we think we're probably near the end but that assumes that the Bank of Canada meets our expectation that there is only one more hike left.

Another point on this is that a weak economy would not support a strong

rebound. While we may be close to a trough forming, the market could move sideways during the rest of the year.

I noticed in your report that TD Economics has forecasts for commodities. What are the key takeaways?

The first half of next year is probably not going to be great for the global outlook. But once you hit a recovery phase, which for China is going to come through for sure in the second half of next year, Europe probably as well, you should see some strengthening come back in certain commodities.

I think we'll see some strength come back in oil prices and China will be a motivator there. They are a big consumer of commodities in general, obviously oil, but also base metals. Their zero-COVID strategy really depressed demand. I think the first quarter is going to be a bad quarter for them due to illnesses and workplace disruptions, but thereafter you may see quite a pop in growth. They have the ability to be a swing factor on the demand side for commodities as we get into next year.

Yes, I see that TD forecasts the price of WTI (West Texas Intermediate) crude oil will bounce back to US\$90 a barrel by the end of 2023.

I have one final question for you. What might be the largest surprise to investors in 2023?

The largest surprise is that inflation comes down faster than we're expecting because everybody's bias right now is that it's sticky.

This interview has been edited and condensed. An extended version is available online at [tgam.ca/inside-the-market](https://www.theglobeandmail.com/investing/markets/inside-the-market...id=IwAR1tS_82vslrqwWwjOAFktoMRr0zfGBH1PXcFtezheRIfTktvyWM6-NT5rc).

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