Fall 2022 economic outlook - Recession on the way?

[CIBC logo]

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[Upbeat music]

[Avery Shenfeld, Managing Director and Chief Economist, CIBC Capital Markets]

There's a Chinese saying, "may you live in interesting times". And these are certainly interesting times for both an economist as well as for investors. Inflation is, of course, running amok. We haven't seen an inflation like this since the early 1980s. And what is concerning investors is that the experience of the early 1980s did not end happily. We had soaring interest rates and a deep recession to take care of that.
We're still hopeful that while a real soft landing is probably out of the picture—in other words, we are going to have to have some economic pain to wrestle inflation back down—that central banks can do that by having two years of minimal economic growth as opposed to an outright deep recession and the central banks are right now still in the process of finding out what interest rate it's going to take in order to get us there.

The Bank of Canada still believes it has a little more to go, but we don't think that rates will get through 4% in either the U.S. or Canada.

[The city of Ottawa. The Bank of Canada. The U.S. Federal Reserve.]

And that does portend a period of slow growth and a tricky period for investors.

Inflation should come down notably in 2023, not only because of slowing growth here in North America, but also because of visible recession risks in Europe, slow growth in China, which are already starting to take the heat off of some of the globally determined prices, particularly for commodities, but for other cyclical goods as well.

[A suburban shipping station. A large shipping boat near a port. Combine harvesters in a wheat field. A combine harvester transferring wheat into a tractor.]

That will help Canada on the inflation front, but it's not going to be a pain-free exercise. We're going to need slower economic growth to get that done, and that includes some pain for the real estate sector. Housing has slowed dramatically in terms of resales.

[A residential housing area. A detached two-storey house. A condo building under construction. Cement being spread onto the ground. Several construction workers pouring cement.]

The next shoe to drop on that will be construction activity will likely slow as condos stop selling as briskly this year, it portends weaker starts for new dwellings next year. And all that is going to mean that the Canadian economy at best is going to hover at growth rates at 1% or maybe even less. It wouldn't surprise us to see a negative quarter here or there as part of the process of weaning economic growth down to a level that brings inflation under control.

[Upbeat music]

[Investment outlook]

What does that mean for investors? Well, it does mean that fixed income investors in terms of short-term yields are getting more of a reward now for their money. Still doesn't look that generous in after-inflation terms. But if inflation comes down next year, it means that interest rate products that are locked in this year might actually offer a reasonable return next year.
In terms of the equity market, this is still not safe hunting right now for the equity investor.

[The Wall Street street sign. The New York city financial district. An outdoor stock ticker.]

It means that risk levels are certainly a bit higher than they would normally be given these economic uncertainties. It means that we need to think about what exposure we want to have to equities relative to our normal levels might be a shade lower. And if there are risks ahead, they're more now on the side of earnings disappointments. The market is braced now for higher interest rates and the impact that that has on equities. So that's part of the risk is already priced in. But what may not be fully priced in yet is the likelihood that with very slow economic growth in both the U.S. and Canada, with imminent recession risks in Europe and slow growth in Asia, that earnings growth also slows to a trickle.

The market right now seems to expect that next year's earnings growth will be similar to this year. Our view is it's likely to come in lower. We're likely to see a couple of years of very slow growth in earnings. And so the equity markets still may have some adjustment to do in the next quarter or two. But if central bankers do manage to do what we said at the outset, which is steer the economy to two years of very slow growth rather than an outright recession, to get inflation under control, that should ultimately build the next leg for an equity rally. When we start to see signs that inflation has in fact been tamed and the risks of a recession are therefore diminished.

So, still a time to certainly rely on professional advice, rely on the expertise of professional investors to help guide you through that process and to think carefully about the weightings of your portfolios across asset classes to ensure that you're not too exposed to some of the downside risks to economic growth that are still very much out there, yet ready to take advantage of the opportunities that will arise as we start to get a better grip on inflation and therefore start to diminish the risks that will need a large scale recession in order to get inflation under control.

[Upbeat music]