

THE REAL ECONOMY

WINTER 2023



 CANADA EDITION

TIGHTENING FINANCIAL CONDITIONS
PRESSURE ECONOMY

RSM'S ECONOMIC FORECAST SEES
A SLOWDOWN, THEN STABILITY

HOW CITIES CAN RE-IMAGINE EMPTY DOWNTOWNS

THE BATTLE FOR RETENTION:
WHAT DO WORKERS WANT?

THE POWER OF BEING UNDERSTOOD
AUDIT | TAX | CONSULTING



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TIGHTENING FINANCIAL CONDITIONS PRESSURE ECONOMY

BY JOSEPH BRUSUELAS

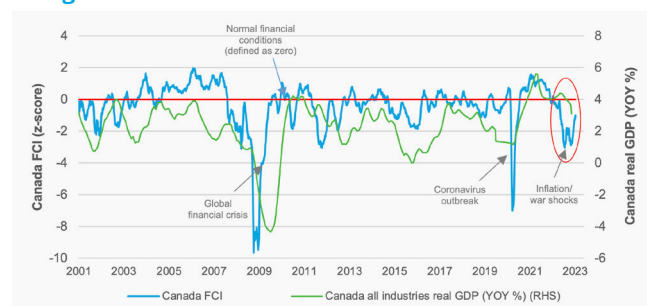
Tightening financial conditions are hurting the Canadian economy to the point where the rising risk of a recession and a housing contraction much larger than anticipated cannot be discounted.

Although we expect the Bank of Canada to raise its policy rate to a peak of 4.75 per cent by the middle of the year, after that the central bank will most likely use a lift-and-hold policy that will keep financial conditions tight.

Over the past year, the Bank of Canada has increased its policy rate from 0.25 per cent to 4.25 per cent to tame the highest inflation rate since the oil crises of the 1980s. These tightened financial conditions are expected to crimp consumer and business investment, cooling the economy.

We offer some insights into what to expect in Canadian financial conditions.

RSM Canada Financial Conditions Index and Canada real GDP growth

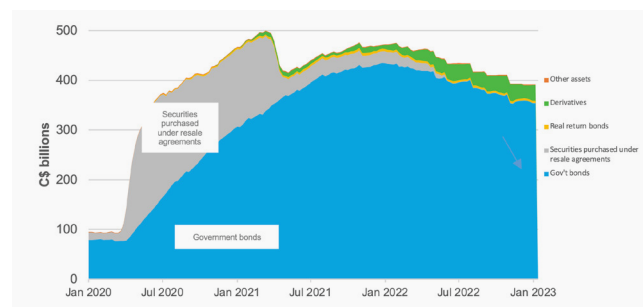


The Bank of Canada adopted quantitative easing ...

The Bank of Canada followed other central banks during the pandemic when it purchased long-term government securities to maintain bond market liquidity and to pressure long-term interest rates lower. It's a strategy known as quantitative easing.

As the recovery from the pandemic took hold in 2021, the Bank of Canada began reducing its holdings of those securities.

Bank of Canada holdings of assets WEEKLY BALANCE SHEET BY TYPE OF SECURITY THROUGH NOVEMBER 2022



... but did it work?

It's debatable if the increase in bond purchases during the pandemic dampened Canada's long-term interest rates during the pandemic.

It's debatable if the increase in bond purchases during the pandemic dampened Canada's long-term interest rates.

Although we expect the Bank of Canada to raise its policy rate to a peak of 4.75 per cent by the middle of the year, after that the central bank will most likely use a lift-and-hold policy.

After all, there wasn't much room for interest rates to fall. Long-term rates had already declined to 1.5 per cent before the pandemic, only to fall below 1 per cent in 2020.

In 2022, though, the Bank of Canada shifted gears and began reducing its holding of government bonds. Ten-year yields over this time have increased upward of 195 basis points.

So while quantitative easing may not have had a significant impact on interest rates, recall the dual purpose of central bank purchases. The injection of liquidity kept the financial sector flush, prevented a bond-market freeze up and reduced the chance of an economic collapse—no small feat during a pandemic.

Bank of Canada holdings of government bonds and 10-year bond yields



Source: Federal Reserve; Bloomberg; RSM US

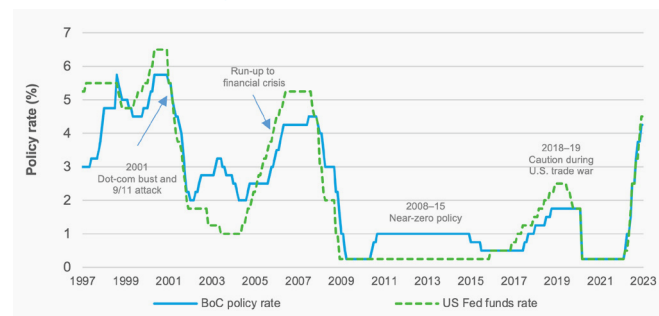
The bond market sell-off

More recently, there has been a sell-off in the Canadian bond market. Why?

We can start with the like-mindedness of the monetary authorities in the advanced economies, especially the Bank of Canada and the U.S. Federal Reserve.

Although their monetary policies were not in lockstep, the Bank of Canada and the Fed quickly pushed overnight rates last year from virtually zero to 4.25 per cent and 4.5 per cent, respectively, with expectations for further rate hikes if inflation remains persistent.

Bank of Canada policy rate and the Fed funds rate



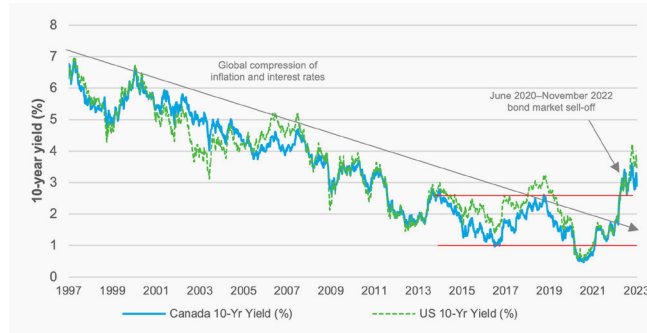
Source: Bloomberg; RSM Canada

U.S. and Canada have a connection ...

Long-term interest rates are determined by expectations of the policy rate and investor compensation for the risk of holding a security over its maturity. We should expect 10-year government bond yields to move together if the monetary policies and risk assessments of two interconnected economies are in sync.



Canada and U.S. 10-year government bond yields

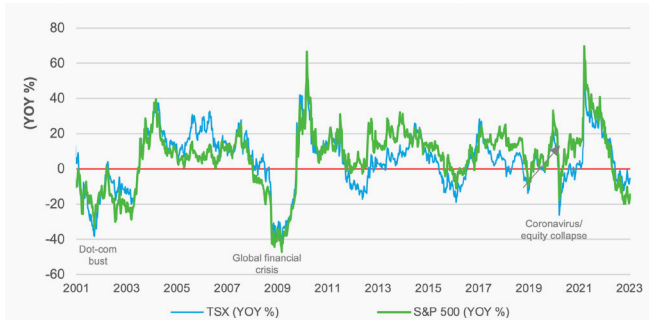


Source: Bloomberg; RSM Canada

... and that extends to equities as well

It's not just the bond market. The trend and level of equity market returns of the major Canadian and U.S. stock exchanges are synonymous, suggesting the co-dependence of corporate profitability.

Yearly returns of the Canadian and U.S. equity markets



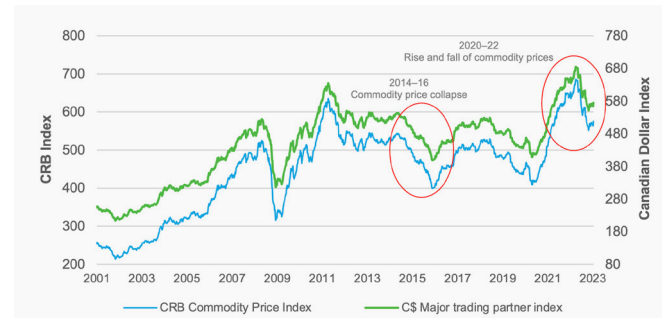
Source: Bloomberg; RSM Canada

There is a difference between the countries, though ...

If there is a difference between U.S. and Canadian financial markets, it is in the currency market.

The Canadian dollar often fluctuates along with swings in the commodity markets. Recent examples include the 2014–16 crash in commodity prices that coincided with the depreciation of the Canadian dollar, the 2020 commodity price hike and appreciation of the Canadian dollar, and finally, the subsequent decline of commodity prices pressuring the Canadian dollar down again in 2022.

Commodity prices and Canadian Dollar Index

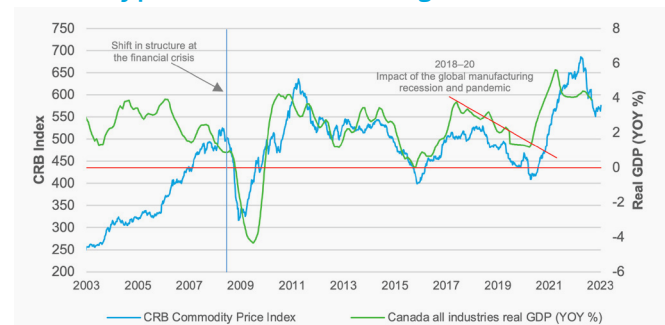


Source: Bloomberg; RSM US

... and this affects Canada's growth

Since 2008, commodity prices have coincided with real GDP growth. We attribute this to the value of the Canadian dollar becoming dependent on commodity pricing. At higher prices of commodities and at a higher value of the Canadian dollar, exports of Canadian commodities add that much more to the value of Canadian economic output.

Commodity prices and Canada real GDP growth



Source: StatCan; Bloomberg; RSM

MIDDLE MARKET INSIGHT

The trend and level of equity market returns of the major Canadian and U.S. stock exchanges are synonymous, suggesting the co-dependence of corporate profitability.

RSM'S ECONOMIC FORECAST SEES A SLOWDOWN, THEN STABILITY

BY JOSEPH BRUSUELAS

Economies respond to financial conditions which are determined by market expectations for monetary policy. With inflation still elevated and demand surging in Canada, we expect the Bank of Canada to continue raising interest rates to cool an overheating economy.

While the Canadian economy may avoid a recession next year, we expect growth will slow below 1 per cent over the next few quarters, well below its capacity.

The economy needs to slow down to rebalance demand and supply, and to relieve price pressures. After that, growth will pick up and the economy will grow solidly.

What else awaits? We offer our outlook for the coming year.

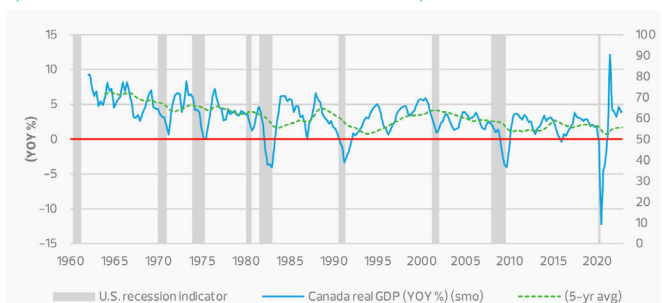
The economy will cool ...

The economy was growing at an average rate of 1.7 per cent per year before the pandemic, only to go into freefall during the pandemic. All that changed in 2021 as the economy roared back following the shutdowns.

Now, the economy is experiencing excess demand. While the price of oil has put a floor under the decline, the combined interest rate and inflation shocks have dented housing, an important sector.

Those shocks will ultimately lead to slower growth. Canadian gross domestic product is projected to decline from about 3.25 per cent growth this past year to just under 1 per cent in 2023 before rising to 2 per cent in 2024.

Canada real GDP growth and U.S. recessions
(YOY % CHANGES OF REAL GDP BY EXPENDITURE)



Source: StatCan; Bloomberg; RSM



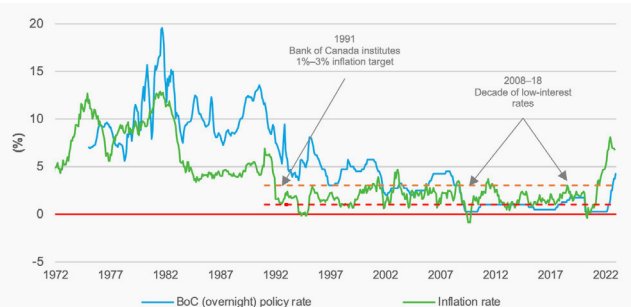
... inflation will ease ...

The inflation rate surpassed 8 per cent in June but has come down in recent months, although some sectors remain elevated.

Interest-rate sensitive parts of the economy like housing and big-ticket consumer purchases are beginning to show the impact of the increased cost of credit. But the effects of higher rates will take time to sink in.

Expect inflation to fall to 3 per cent by the end of 2023 and return to the 2 per cent target by the end of 2024.

Bank of Canada policy rate and inflation



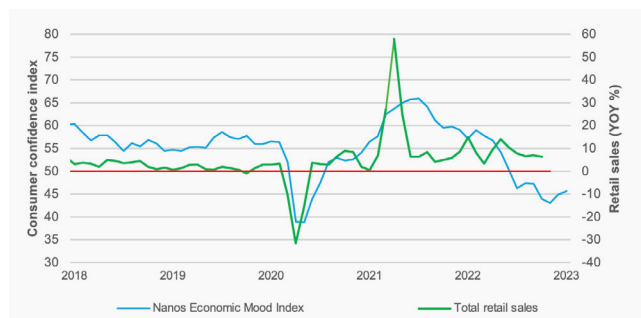
Source: Bloomberg; RSM Canada

... and consumer spending will slow

Retail sales bottomed out during the pandemic along with consumer confidence, only to surge once the lockdowns were lifted. And that growth has continued.

We expect consumer confidence to wane and for retail sales to slow as long as inflation remains elevated. Because the consumer sector is behind much of the economy's output, we expect that to translate into lower GDP growth.

Canada consumer confidence and retail sales



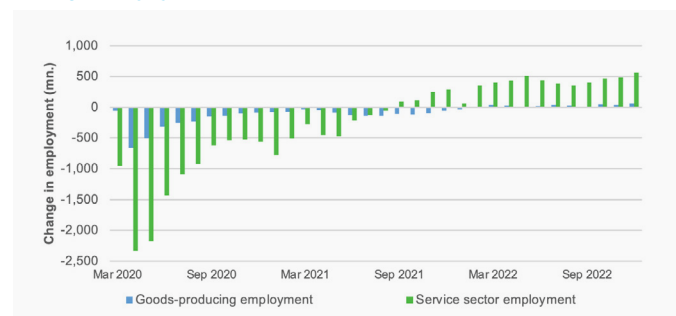
Source: Nanos Research; Bloomberg; RSM Canada

The labour market is tight ...

It took a year and a half for service sector employment to recover to pre-pandemic levels, and then another six months for manufacturers to fully restore their staffing levels.

The service sector comprises 80 per cent of total employment. Goods-producing occupations employ 20 per cent of workers but have knock-on effects that support overall growth.

Pandemic job deficits in the goods-producing and service sectors INCREASE OR DECREASE IN 2020-22 EMPLOYEES RELATIVE TO FEBRUARY 2020



Source: StatCan; Bloomberg; RSM

... which might be the new normal

Canada's economy has undergone a transformation, both in terms of price stability—which is the mandate of Canada's monetary policy—and full employment, which is achievable only within a framework of price stability.

Price stability was achieved decades ago after the Bank of Canada lowered its inflation target in a stepwise fashion and then acted to achieve that goal. Inflation finally fell below 4 per cent in 1991 when the bank adopted its 1 per cent to 3 per cent target range.

Likewise, full employment appears to be redefined every 10 to 15 years. What was once a double-digit unemployment rate is now approaching a 5 per cent equilibrium.

Long-term decline in Canada's unemployment rate



Source: Bloomberg; RSM Canada

Businesses need capital and labour ...

Implicit in the Bank of Canada's focus on price stability is achieving full employment and economic growth. The prerequisites for higher economic output are increases in capital and an increased supply of labour to operate that capital and buy the goods.

Growth rates of Canadian employment and real GDP

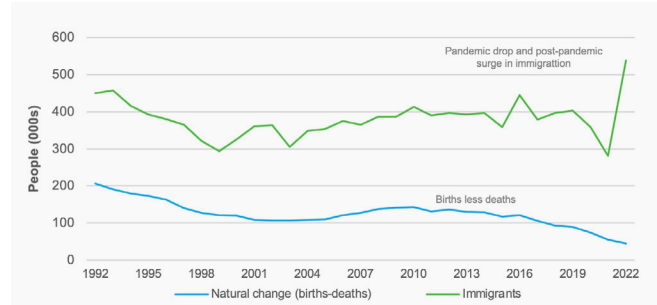


Source: Bloomberg; RSM Canada

... and immigration has helped

But where do the workers come from, especially in a nation with an aging workforce? Canada's population increased by 10 per cent between 2001 and 2021, with much of that increase due to immigration. This had positive implications for the labour force in terms of size and the introduction of new ideas.

Yearly changes in Canada's population due to natural growth and immigration

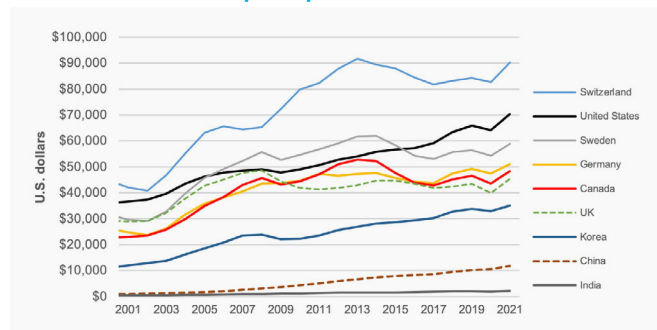


Source: Bloomberg; RSM Canada

In the end, Canada is a powerful draw

People looking for a better life will choose the opportunity offered by high-income economies. Canada's income per capita is among the highest in the world.

Gross national income per capita in selected economies



Source: World Bank; RSM US



HOW CITIES CAN RE-IMAGINE EMPTY DOWNTOWNS

BY JAKE SALPETER

The streets of many major cities these days have a certain Twilight Zone feel: The buildings are there, but many of the people aren't.

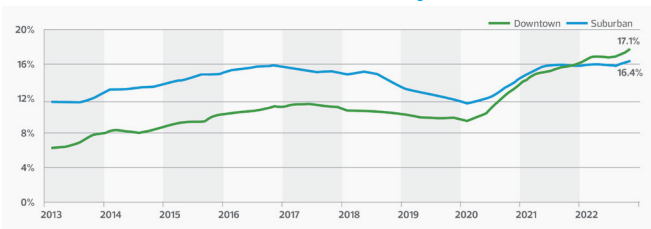
It's been almost three years since the pandemic forced many people to work out of their homes, and many downtowns have yet to recover. Cities and developers are now facing a quandary: What happens to all those empty offices?

It's a particular challenge in high-density cities with expensive real estate and a lack of affordable housing. Toronto, Calgary, New York, Chicago, San Francisco and Los Angeles are all grappling with the prospect of office space that is no longer needed.

Even though Canada is home to three cities with the lowest downtown vacancy rates in North America—Vancouver, Ottawa and Toronto—the national commercial vacancy rate ended 2022 at a high of 17.1 per cent, according to Coldwell Banker Richard Ellis (CBRE).

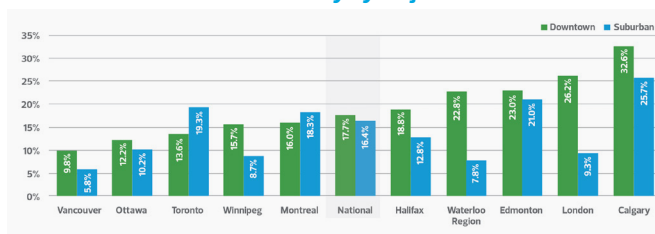
Downtowns in Canada are hollowing out ...

National downtown vs. suburban vacancy rate



Source: CBRE Research, Q4 2022

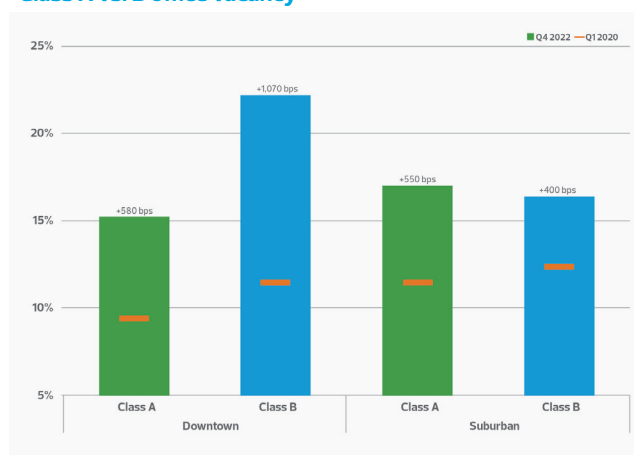
Downtown vs. suburban vacancy by major Canadian market



Source: CBRE Research, Q4 2022

... especially in older, less-desirable buildings

Class A vs. B office vacancy



Source: CBRE Research, Q4 2022

Adaptive reuse

But just as cities face high office vacancy rates, they also face an acute shortage of housing—especially affordable housing. The result is a mismatch in supply and demand.

That's where the concept of adaptive reuse—in this case, the conversion of office space into residential housing—comes in.

The economic need is clear, and the market will adapt, said Tuan Nguyen, an economist with RSM. "In the future, offices will be converted into residential properties," he said.

Adaptive reuse offers a way not only to potentially ease the housing shortage, but also to combat climate change as developers make buildings more efficient (think HVAC systems, windows, insulation and heat retention). This trend is being further incentivized by government subsidies for energy and building envelope retrofits; the falling cost of renewable energy is spurring the trend along as well.

At first glance, this seems like the ideal solution. After all, similar recent conversions have worked. In Calgary, for example, the city council committed \$100 million to support conversions. The result was the SNC Lavalin building, the first empty office building to be turned into affordable housing in Canada. Other projects are set to begin.

But it is a difficult process.

The challenges

The most significant roadblock to conversion is the physical structure of an office building. In most buildings, especially older ones, there is limited natural lighting, a single set of bathrooms at the centre of the building, centralized electrical wiring and switches, and a floorplate that can make repurposing the space difficult. These physical limitations make conversions expensive and produce a limited number of apartments.

Added to the challenges of the physical space is the difficulty in obtaining permits and overcoming restrictive zoning laws. Land designated for commercial use might require an arduous process to rezone for residential.

For all of these reasons, it can take years and a lot of money to convert an office building into apartments.

MIDDLE MARKET INSIGHT

In Calgary, the city council committed \$100 million to support conversions. The result was the SNC Lavalin building, the first empty office building to be turned into affordable housing in Canada.

Looking ahead

Still, there are some cities that have succeeded. In addition to the SNC Lavalin building in Calgary, there is the former Canada Life building in Montreal and the Millennium in Chicago, among a host of others scattered throughout North America. Of note is the financial district in New York that benefited from government incentives to convert buildings as firms moved out of the area.

While more successful conversions will drive more market focus toward this type of adaptive reuse, the result is not always going to lead to affordable housing. The success of the project depends on the developer, the location and the project financials. Market costs and dynamics, as well as zoning laws, can make adaptive reuse too expensive.

The takeaway

These barriers all point to the growing need for increased public-private partnerships between municipalities and developers, to help ease the housing shortage and address a surge in office vacancies that is not going away. Municipalities and developers have an opportunity to be economic catalysts to ease zoning laws and create easier pathways for adaptive reuse projects. As these conversions become more common, the market may be encouraged to pursue similar projects and to view buildings as ever-adapting solutions to a rapidly changing world.

Adaptive reuse offers a way not only to potentially ease the housing shortage, but also to combat climate change as developers make buildings more efficient.





THE BATTLE FOR RETENTION: WHAT DO WORKERS WANT?

Facing record-low unemployment, middle market companies have placed even greater emphasis on retaining employees and establishing continuity in a time of frequent change. The pandemic has changed the modern workplace—perhaps permanently—as many organizations adopt remote and hybrid work models. And with trends like quiet quitting and the “great resignation” creating upheaval and stress in personnel departments across North America, it has never been more important to keep existing employees on the rolls.

With the balance of power shifting from employer to employee in a tight labour market, RSM sought to gain perspective from workers. The firm conducted an online survey in the fall of 2022 of over 4,000 workers in both Canada and the United States, split between middle market businesses, which have annual revenue up to \$2 billion, and large businesses. The resulting data provides a deeper understanding of how employees feel about their current employer, their role in the workplace and what factors could build greater satisfaction moving forward.

Many proud employees, but several looking elsewhere

The survey shows that about three-quarters of employees at Canadian middle market and large organizations are proud of their workplace (77 per cent and 75 per cent, respectively), while a greater share of United States middle market employees are proud of where they work (83 per cent) compared to those at larger organizations (78 per cent). However, despite the level of pride employees have in their organizations, middle market employers have greater retention risks.

The pandemic environment forced many companies to adopt a more flexible work environment and the data shows that many employees want that flexibility to continue.

The pandemic environment forced many companies to adopt a more flexible work environment and the data shows that many employees want that flexibility to continue. In fact, Canadian middle market employees are significantly more likely than those working at larger organizations to wish they had more flexibility to set their own hours and schedule (64 per cent vs. 57 per cent). The trend is similar in the United States, with 62 per cent of middle market employees seeking more flexibility compared to 56 per cent of workers at larger companies.

In addition, a fairly consistent number of Canadian employees at middle market and large organizations report actively applying for jobs outside their current company (15 per cent vs. 13 per cent). In the United States, though, middle market employees are significantly more likely than those at larger organizations to report they are actively applying for a new role outside their organization (26 per cent vs. 14 per cent).

“Instead of waiting for your employees to ask you for a raise or a promotion, you can ask them what they need to stay at your company and grow,” commented Marni Rozen, RSM’s human capital consulting leader. “People will generally tell you what they’re looking for, and even opening up that dialogue and letting people know what opportunities are available is a positive step forward.”

The (mostly) good news

While the current environment for talent retention can seem daunting, middle market companies can make the adjustments necessary to address many of the features employees are looking for in the workplace.

Not surprisingly, among those who are actively looking for a new position, salary and benefits are a top theme, according to qualitative data. And while many companies initially responded to staffing shortages by increasing compensation, that may not always be the best response.

“While compensation is obviously important, it is often not the most critical thing,” said Rozen. “It doesn’t necessarily solve the other issues that we’re seeing that employees may find more important, such as flexibility and more autonomy over their schedules.”



The pandemic has changed the modern workplace—perhaps permanently—as many organizations adopt remote and hybrid work models.

MIDDLE MARKET INSIGHT

While talent retention can seem daunting, middle market companies can make the adjustments necessary to address many of the features employees are looking for in the workplace.

In addition, increasing compensation is not always possible. But luckily, many of the additional characteristics employees want in the workplace are not tied to finances, but rather to career development. For example, according to qualitative data, knowledge/skills/opportunity is also a leading theme for U.S. and Canadian middle market employees who are actively evaluating new opportunities.

“From a tactical and people perspective, focusing on career development is a win-win,” said Rozen. “Closing any potential skill gaps is important from a business perspective, but overall development is also what people are seeking. I think people would stay at an organization when they see opportunity ahead of them, they feel like they’re working for something and they see a middle market company investing in them.”

Further, middle market employees were asked about what they have versus what they want at their current job. In both Canada and the United States, the most considerable gaps were with above-market compensation and incentive compensation arrangements. However, just below these gaps for U.S. middle market workers were defined career paths and equity/share ownership.

When asked about the elements of an ideal job, middle market workers in Canada and the United States were once again generally in agreement about what is most important. Employees in both countries believe that work-life balance, support from a supervisor/boss, fulfilling work and the potential for advancement/promotion are the most critical elements of the ideal position. Focusing on or expanding upon any or all of these characteristics presents a key opportunity for middle market organizations to stand out to employees and increase satisfaction.

“These opportunities don’t have to be things that have a large dollar cost,” said Anne Bushman, RSM leader of compensation and benefits. “The survey shows there are many things your employees are likely looking for that are not purely financial. There’s a way to build loyalty through items that are not necessarily all that expensive.”

Considerations for change

Changes to operations will likely be necessary on an ongoing basis to keep middle market employees engaged and satisfied, and therefore encourage more of them to stay with their current company. But in many cases, careful planning is necessary to ensure new processes and strategies align with overall business goals and any potential compliance requirements.

For example, Bushman detailed how taxes could be a compliance concern for any new employee retention strategies. “You need to make sure that you’re not unintentionally increasing a tax cost that you didn’t know was there,” she said. “When you do something completely different—especially when it involves compensation or benefits—you want to go in with eyes wide open about potential costs and tax requirements. It may or may not affect your decision, but it’s just another thing that you must consider upfront.”

Many of the characteristics that employees want in the workplace are not tied to finances, but rather to career development.



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