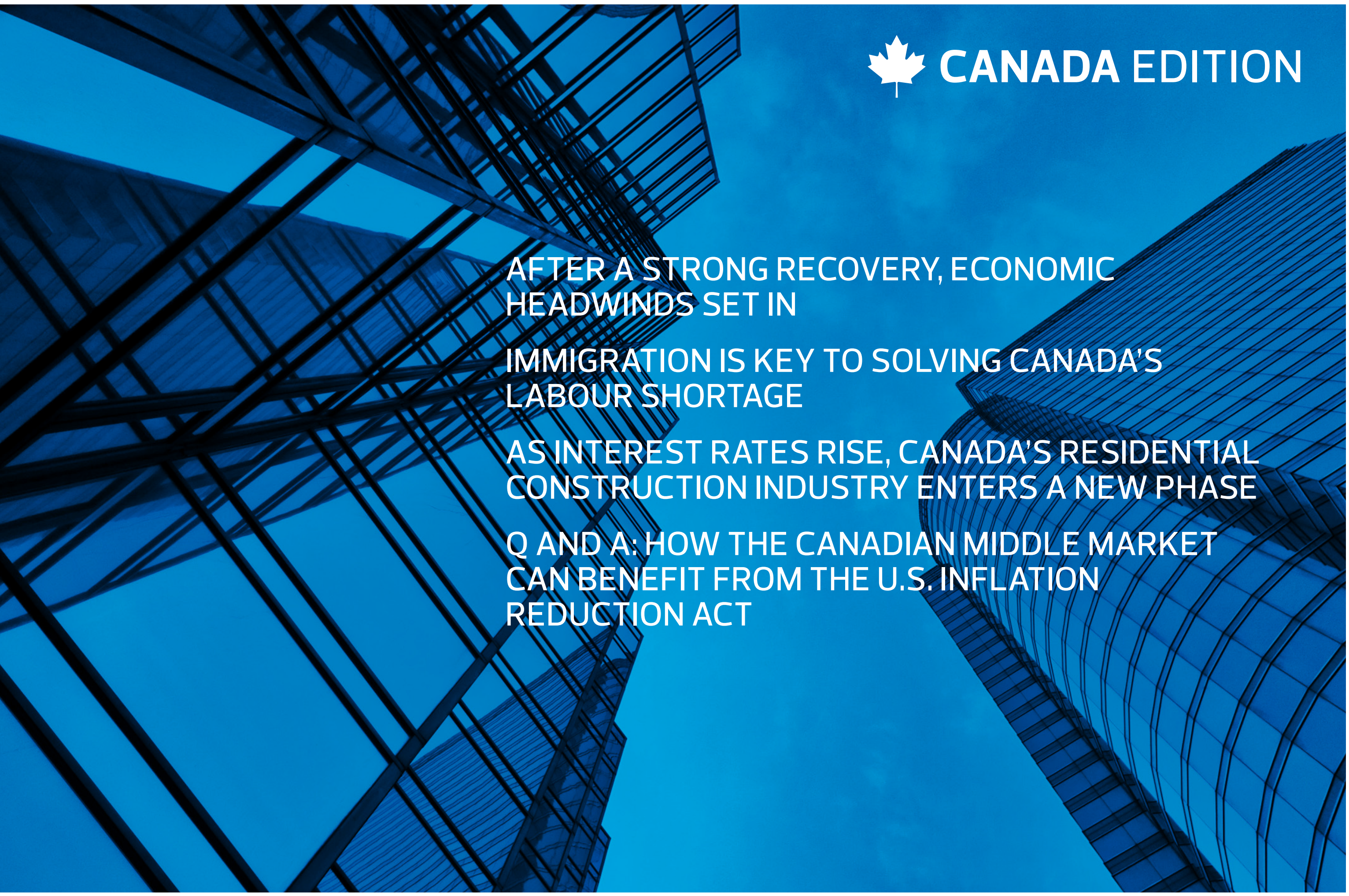
THE REAL ECONOMY

FALL 2022



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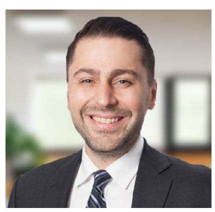

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TABLE OF **CONTENTS**

AFTER A STRONG RECOVERY, ECONOMIC HEADWINDS SET IN

BY TU NGUYEN

The Canadian economy has had a robust recovery from the lockdowns of the pandemic as pent-up consumer demand and generous government spending have fueled growth.

But now with rising inflation, especially in food and energy prices, and a historically tight labour market, that growth is slowing.

The Bank of Canada, like many central banks around the world, has been aggressively raising interest rates to tame inflation.

But raising rates has consequences. In the best-case scenario, the Bank of Canada would reduce discretionary spending enough to stabilize prices while the economy grows, though at a slower pace.

In the worst-case scenario, economic growth would completely stop as spooked consumers rein in spending, and the economy tumbles into recession.

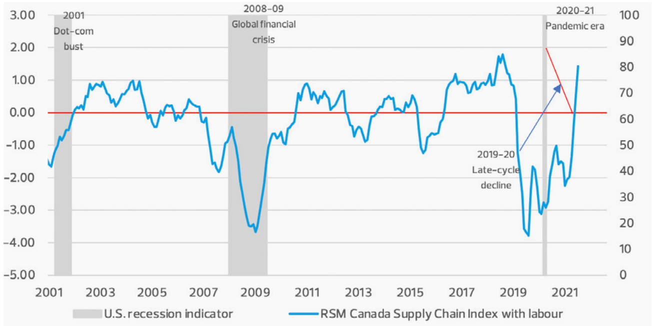
We expect the Bank of Canada to continue its effort to restore price stability despite the costs.

In the coming months, more people will become unemployed, which will present a challenge for low-income households as they try to keep up with the rising cost of living.

Even with these challenges, though, Canada is not currently in a recession, which is defined as a significant decline in economic activity lasting more than a few months.

A rule of thumb frequently cited to define a recession is two consecutive quarters of contraction in gross domestic product. In contrast, Canada's GDP has been growing every quarter since the third quarter of last year, at a rate of 6.6 per cent in the fourth quarter last year, 3.1 per cent in this year's first quarter and 3.3 per cent in the second quarter.

Real GDP growth



Source: Statistics Canada, RSM Canada

But having two consecutive quarters of contraction is not a hard-and-fast definition. Rather, to determine whether the economy is in recession, other indicators need to be considered. These include payroll employment, the unemployment rate, real income and spending, and industrial production.

By most of these indicators, the economy is in a downturn rather than a recession. The unemployment rate of 4.9 per cent remains at a historic low despite the modest decline in job numbers over the past two months.

The industrial sector has been robust as Canadian producers reap the benefits of strong global demand for metals and energy.

But there are elevated risks that Canada could enter a recession early next year after modest growth this year.

The labour market

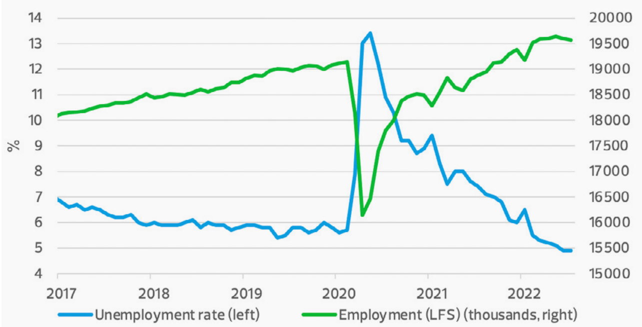
The unemployment rate stands at its lowest level since 1976, giving the Bank of Canada some leeway in normalizing interest rates. That said, if the demand for labour declines, the unemployment rate will creep up.

The economy shed 43,000 jobs in June and another 30,000 in July because of workers leaving the labour force rather than because of layoffs. Job declines came entirely from the services-producing sector, including educational services, and health care and social services.

There are currently more than 1 million job vacancies, mostly in the food and services sector and in health care.

The long-term challenge remains the worker shortage, and Canada relies on immigration rather than natural growth to feed the expansion of its labour force.

Employment and unemployment rate



Source: Statistics Canada, RSM Canada

Inflation expectations

Canadian households and businesses are used to low inflation, which has been at or below the 2 per cent target for more than a decade. Now, with shocks to the global supply chain and geopolitical turmoil, inflation has been elevated for more than a year, rising to the highest levels since the early 1980s.

Though there are signs that inflation might have peaked—it eased to 7.6 per cent in July after hitting 8.1 per cent in June—it will take a while to slow as the war in Ukraine grinds on and the labour market remains tight.

In response, the Bank of Canada has implemented aggressive rate hikes to tackle inflation.

While short-run inflation expectations have climbed, as seen in the wage growth that has deviated from the 2 per cent mark, long-run inflation expectations remain relatively anchored.

At the Federal Reserve's recent symposium in Jackson Hole, Wyoming, the world's top central banks declared that inflation is here to stay and will require forceful actions. Businesses should expect the Bank of Canada to continue raising rates for the rest of the year rather than easing them prematurely.

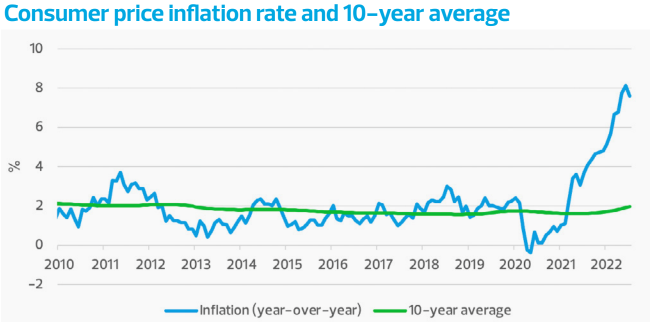
The housing market

In few places is the turn of the business cycle as apparent as in the housing market, which has cooled substantially because of higher borrowing costs. Construction projects are being cancelled or put off. Across the country, listings and home prices are falling, a stark contrast from the overheated market of just under a year ago.

Still, the housing shortage will not be resolved anytime soon; if anything, it will become even worse now as builders pull back. The housing affordability crisis remains as would-be buyers resort to renting and Canadians who fled the cities due to the pandemic now start to return.

Canada still needs to build hundreds of thousands of units to house its people, and once again low-income households are hurt the most in the affordability crisis.

Consumer price inflation rate and 10-year average



Source: Statistics Canada, RSM Canada

Supply chains

The RSM Canada Supply Chain Index turned positive in June, to 0.51, for the first time since before the pandemic and improved to 1.42 in July.

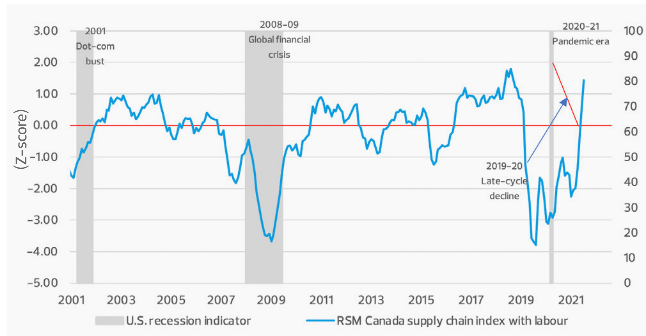
Inventory has finally improved across the board as back-ordered goods from last year arrive. Delivery times and prices have also improved. The increase in inventory is coupled with a slowdown in demand among consumers as they shift spending toward services.

Consumers can expect fewer empty shelves, more abundant inventory and more discounts in the fall as spending wanes.

Still, even with the recent movement toward deglobalization among businesses, the global supply chain remains vulnerable. Another global shock could send the RSM Canada Supply Chain Index back into negative territory. Worker shortages in warehouses, last-mile delivery services and trucking will continue to pose challenges, especially since consumers' embrace of online shopping seems to be here to stay.

That said, for now, the supply chain is healthy, and the RSM index could stay positive over the next few months as producers grapple with too much—rather than too little—inventory.

RSM Canada Supply Chain Index



Source: Bloomberg; RSM Canada calculations

Industrial production

The Prairie provinces have been leading the economy because of strong global demand for energy and rare metals. Industrial production grew by 5.39 per cent on a year-over-year basis in the second quarter, well above the pre-pandemic level, and is expected to end the year on a high note.

As the global markets anticipate a recession and consumer demand slows, industrial production might diminish in subsequent months.

The takeaway

An economic slowdown is not only inevitable amid the tightening cycle and rising interest rates, but it is also needed to combat high inflation. Heading into next year, expect the economy to stagnate if not contract.

Risks remain that can push the economy into a recession. The most likely catalyst is Russia's war in Ukraine and its effect on the prices of energy, food and rare minerals. Another potential catalyst is a debt or health crisis in China. These global shocks would undoubtedly spill over into the Canadian economy.

Supply chain timing issues will further distort economic growth. Canadians could continue to face high prices of food, energy and housing, which means deteriorating purchasing power and consumer spending.

IMMIGRATION IS KEY TO SOLVING CANADA'S LABOUR SHORTAGE

BY TU NGUYEN

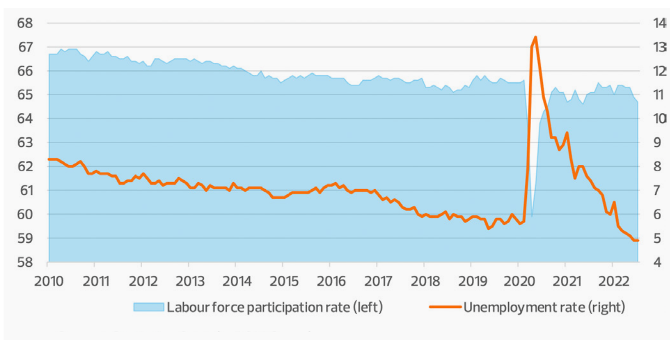
There is no denying it: Canada is experiencing a historic labour shortage. The job market has been running hot for months, with the unemployment rate falling to 4.9 per cent, the lowest on record.

The pandemic and subsequent reopening have been the catalyst. At the onset of the pandemic, workers were laid off, turned to self-employment or retired early. When the economy reopened, organizations were unable to find enough workers to meet pent-up demand for goods and services.

The shortages have hit certain industries particularly hard, including health care, hospitality and food services, and trucking.

Even as the economy shed jobs over the summer, the decline stems from workers choosing to leave rather than businesses needing fewer employees. More than 200,000 people have left the workforce since March, resulting in the labour force participation rate dropping to 64.7 per cent.

Labour force participation and unemployment rates

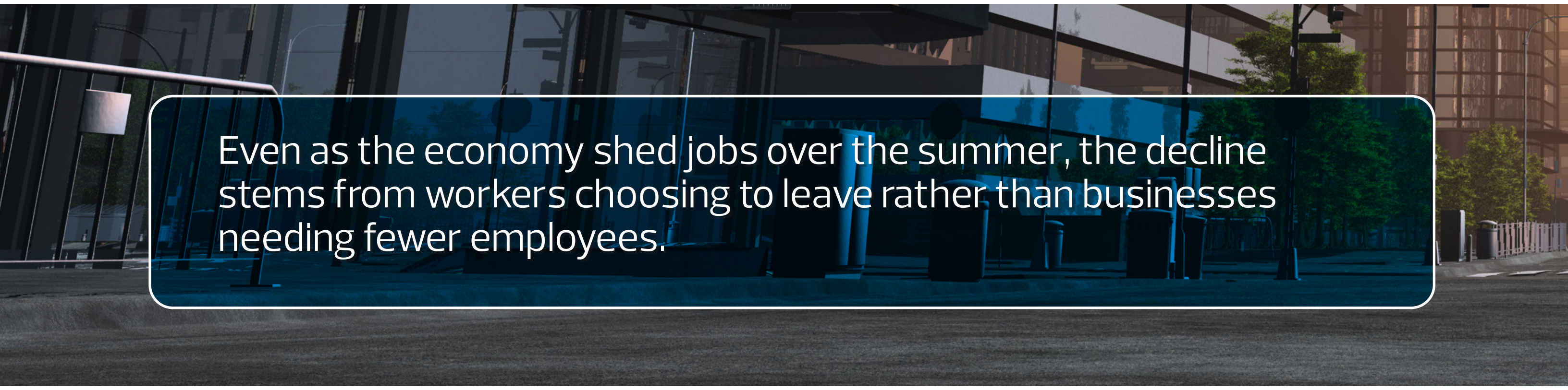


Source: Statistics Canada, RSM Canada

In the long run, the challenge runs deep. A fundamental demographic shift is taking place in Canada as the population ages and fertility rates decline. Combined, this means fewer workers.

In this environment, even when unemployment declines, labour force participation also goes down because people retire, a trend that will not reverse as the population over 65 increases.

Simply put, Canada cannot replenish the labour pool through natural growth.



Even as the economy shed jobs over the summer, the decline stems from workers choosing to leave rather than businesses needing fewer employees.

Immigration as a solution

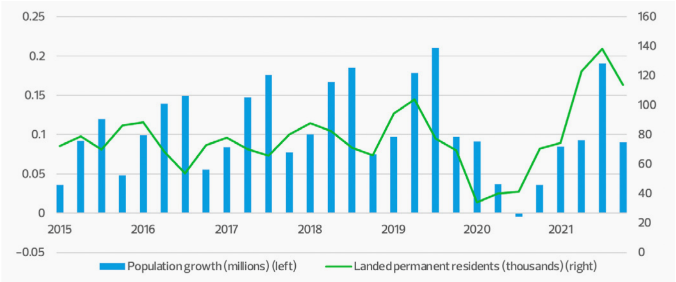
Part of the answer lies in immigration. Already, whatever growth has come in the millennial and Gen-Z workforce has been because of immigration. This is not lost on policymakers, who have already devised several economic pathways and outlined ambitious goals for bringing in more than 400,000 immigrants per year between 2022 and 2024.

And the benefits of immigration go beyond merely solving the worker shortage. Immigrants have been shown to increase labour productivity, something Canada cannot afford to ignore as labour productivity in Canada might fall to last among countries in the Organisation for Economic Co-operation and Development in just a decade.

But having an open immigration policy alone is not enough to address the long-term labour shortage.

First, the majority of recently landed permanent residents are already living and working in the country, so the 400,000 target does not represent the true number of people coming from abroad.

Immigration and population growth



Source: Statistics Canada, RSM Canada

Even those already living and working in Canada are often unable to fill the gap of demand for labour despite being qualified and having relevant work experience.

Employers are sometimes hesitant to hire workers if they do not have Canadian work experience and can be quick to dismiss workers with experience abroad, which only narrows the available pool of experienced hires.

More important are the barriers from government and industry associations. Certain professions, including the ones where shortages are most pressing, require licensing to practice.

For professionals trained abroad, the road to accreditation to practice in Canada is fraught with red tape, designed to stop and discourage rather than facilitate.

As a result, Canada faces a conundrum: While severe shortages persist in certain industries, workers fully qualified to fill these vacancies are often forced to sit on the sideline.

> For professionals trained abroad, the road to accreditation to practice in Canada is fraught with red tape.

The example of health care

Health care is a place where this need for workers plays out most clearly. In May, there were 143,000 vacancies in health care, up 20 per cent from a year prior. In July alone, 22,000 health care workers left the field despite strong demand.

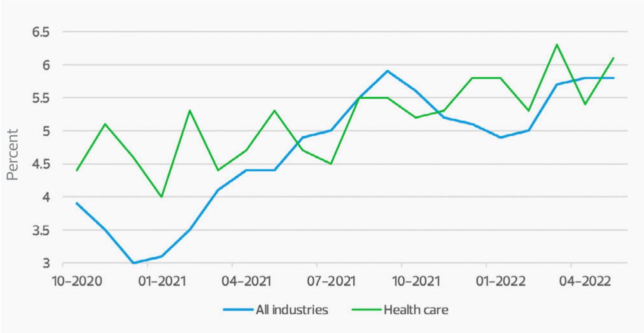
MIDDLE MARKET INSIGHT

In May, there were 143,000 vacancies in health care, up 20 per cent from a year prior. In July alone, 22,000 health care workers left the field despite strong demand.

The pandemic laid bare the crumbling health care system: long waits, delayed routine care resulting in serious conditions as patients were left untreated, and the temporary closure of emergency rooms because of a lack of staff. They are all symptoms of an acute shortage of workers.

Yet the accreditation process for nurses and doctors trained abroad is inefficient. The registration process for internationally educated nurses to work in Canada can take years. Doctors educated and having practiced outside Canada must redo their entire residency program, which takes years, in addition to passing Canadian medical exams, to obtain their license.

Job vacancy rate in health care



Source: Statistics Canada, RSM Canada

The Great Resignation in health care has had far-reaching consequences. As health-care workers quit because of burnout, their departure intensifies pressures on the remaining workers, who in turn become burned out and are also driven to quit.

The impact extends to every part of the economy. A crumbling health care system translates to more sick people. When workers or their family members get sick, workers have to take time off, cut back on hours or even quit their jobs. This worsens the labour shortage across the country, and no single industry is immune.

The takeaway

A recession will not magically solve the chronic worker shortage. While the service industry might see the shortage ease as demand for labour slows, doctors and nurses train for years before they can practice. For this reason, a recession will not translate to an influx of health care workers. Neither would the privatization of health care, as a quick look at the United States shows.

To tackle the challenge of labour supply, treating and compensating workers well to improve retention would be a start.

But government, industry associations and organizations need to go further and streamline the accreditation process so that workers educated abroad can fill much-needed roles in Canadian society.

Only then can Canada hope to have meaningful growth in labour supply and productivity.

AS INTEREST RATES RISE, CANADA'S RESIDENTIAL CONSTRUCTION INDUSTRY ENTERS A NEW PHASE

BY TU NGUYEN

In response to rising inflation, the Bank of Canada began a series of aggressive rate hikes this year, bringing its policy rate from an effective lower bound of [0.25% to 3.25%](). One of the industries hit hardest by rising interest rates has been construction, and the resulting slowdown now threatens to make Canada's housing shortage more acute.

But for savvy developers, this does not mean that activity needs to come to a halt. A government-financed program is helping expand the supply and make it more affordable.

Rising rates cool construction

For some time, businesses have been dealing with the dual challenges of rising inflation and the central bank's campaign to raise interest rates.

Rising rates mean that money is no longer easy to come by, as it was at the beginning of the pandemic when the rates of borrowing were below inflation. Now, with rates rising, business borrowing and spending will decline.

The construction industry is particularly sensitive to rising rates because it is highly leveraged, and projects of all types are financed using borrowed capital.

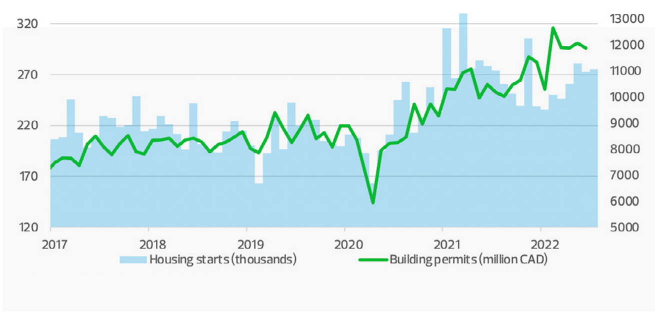
For example, the construction industry lost 20,700 jobs in April and another 3,000 in May, despite the red-hot labour market. Most other industries gained jobs.

Residential construction, while staying well above the pre-pandemic level, has cooled from the last year's high as real estate prices began to fall.

MIDDLE MARKET INSIGHT

The construction industry lost 20,700 jobs in April and another 3,000 in May, bucking the trend in a red-hot labour market where most other industries gained jobs.

Building permits and housing starts

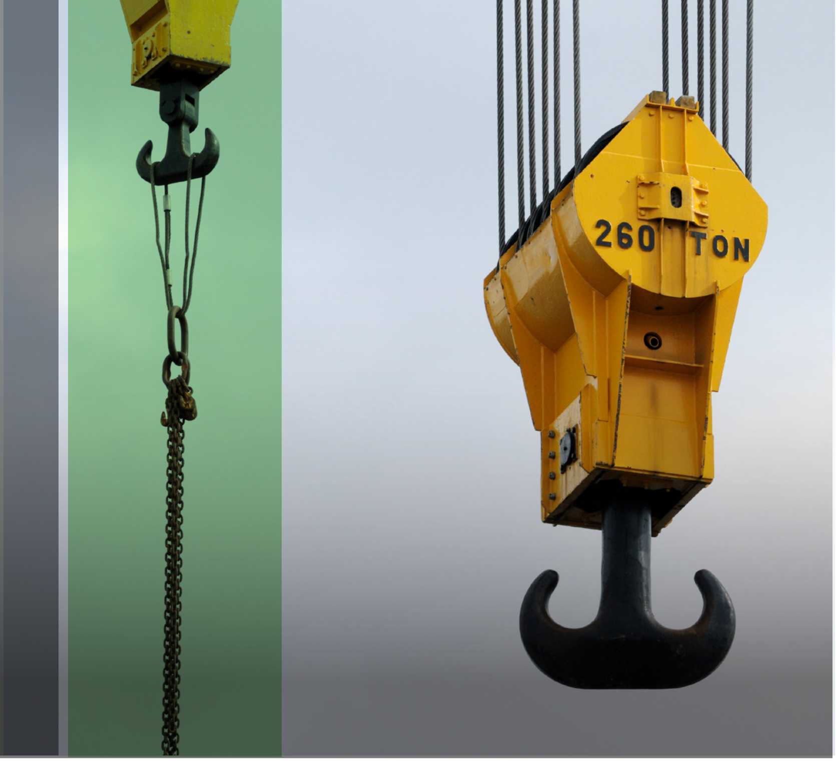


Source: StatCan; Bloomberg; RSM Canada

As the Bank of Canada maintains its hawkish tone to tackle inflation, there will be fewer applications for construction projects. In addition, projects that have already been approved might be delayed or cancelled.

Projects are approved at a certain interest rate and a ceiling rate; the latter adds an extra cushion showing the highest rate at which a project can be funded without additional equity.

When lenders' interest rates rise above the ceiling rate, developers are required to contribute additional equity. If they do not, projects must be put on hold.



MIDDLE MARKET INSIGHT

Rising interest rates, combined with an inflationary environment, threaten to put a lid on construction.

Since many developers do not have this additional money available, new projects that have not started are often cancelled, and even some projects that are under construction could be halted.

Housing supply

While projects of all types—residential, commercial and industrial—are affected, a decline or slowdown in residential construction has serious implications on the economy as a whole.

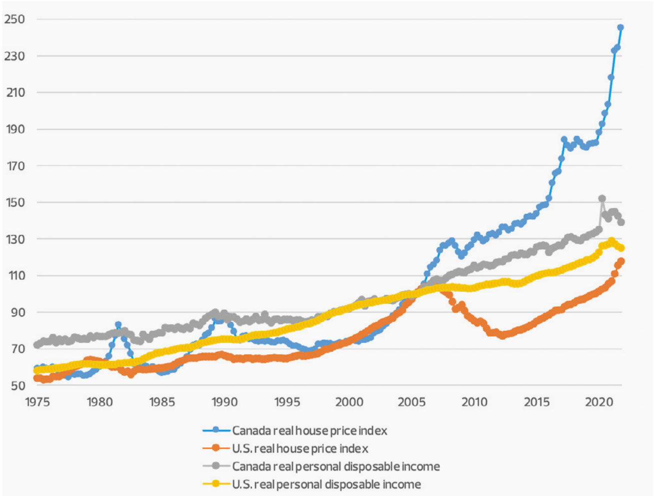
Canada has been dealing with a housing shortage for more than a decade because of underbuilding, and it is one reason for rising housing prices. Indeed, housing prices have been increasing disproportionately in relation to income, and Canada has one of the most unaffordable housing markets in relation to income among the G10 countries.

> Canada has one of the most unaffordable housing markets in relation to income among the G10 countries.

House prices and disposable income, select OECD countries

Source: Federal Reserve Bank of Dallas, RSM Canada

House prices and income



Source: Federal Reserve Bank of Dallas, RSM Canada

Canada Mortgage and Housing Corporation has launched a new mortgage loan insurance program that allows developers to obtain mortgages with more favorable financial terms.

The pandemic, with the Bank of Canada setting the policy rate at the effective lower bound, brought about cheap money and spurred a construction boom that was constrained only by labour and material shortages.

The rising numbers of building permits and housing starts last year promised to add supply to the housing market, somewhat relieving the crucial shortages that have been rampant.

But this is coming to an end. Rising interest rates, combined with an inflationary environment, threaten to put a lid on construction. Given that some approved projects might not proceed as planned, the amount of available housing might be less than the number of building permits and housing starts last year.

This could worsen the housing affordability crisis for Canadians. Even though higher interest rates could cool the housing market, demand for housing remains high as millennials reach the homebuying age, elderly people stay in their homes for longer and new immigrants settle in.

In addition, even though house prices have declined, rental prices show no sign of slowing, especially because even those people who do not purchase a home still need a place to live. As a result, demand for residential housing, including both rental and owned, will most likely increase.

Opportunities remain

But it is not all doom and gloom. Earlier this year, Canada Mortgage and Housing Corporation (CMHC) launched a new mortgage loan insurance program that allows developers to obtain mortgages with more favourable rates and financial terms.

In exchange, housing projects need to set aside a certain portion of units as affordable housing. In addition, they must abide by more stringent energy efficiency and accessibility requirements than if their mortgage came from a bank.

Applying for a mortgage with CMHC could help developers secure financing that they would not be able to obtain elsewhere under the rapidly rising interest rates.

Second, it could help lower the cost of capital for developers in an inflationary environment.

Third, building housing projects that are energy efficient, accessible and affordable could help developers improve their performance in meeting the environmental, social and governance criteria set out by CMHC.

Will this new program be successful? In New York City, known for its lack of affordable housing, mixed-income programs with part of the mortgage coming from the New York City Housing Development Corporation have achieved moderate success.

Additionally, Canada's federal and provincial governments have targeted affordability in the past. Now there are opportunities to create new housing that is affordable, accessible and energy efficient.

The takeaway

While there might be less housing built overall in the next couple of years, the proportion of affordable housing that is also climate-friendly and accessible could increase as more developers turn to CMHC for financing.

Last year saw an uptick in construction that could add much-needed stock to the supply of housing, but as building and borrowing become expensive, the shortage will continue.

As projects become more challenging, developers need to realize opportunities to secure financing. In addition, sometimes strategies that lower costs and increase project viability end up helping bring the projects to life, creating situations that benefit the government, developers, and buyers and renters.

QUESTIONS AND ANSWERS:

HOW THE CANADIAN MIDDLE MARKET CAN BENEFIT FROM THE U.S. INFLATION REDUCTION ACT

With Alex Kotsopoulos

A conversation with Alex Kotsopoulos, RSM Canada partner

The Inflation Reduction Act, or IRA, recently enacted in the United States includes significant incentives to foster the growth of renewable energy. Canadian businesses, including those in the middle market, stand to benefit greatly from the legislation. RSM's Alex Kotsopoulos, a partner in RSM Canada's environmental, social and governance advisory practice, discussed what Canadian businesses can expect.

Q: How will the IRA affect the Canadian economy?

A: The IRA as a whole, and in particular those provisions that relate to climate change, is very beneficial to Canada's economy. That benefit is not only because of the degree of integration between the Canadian and U.S. economies but also because of the specific provisions in the act. One example is the electric vehicle tax credit. That's going to apply to vehicles built in America and that have more than half their mineral content in the batteries sourced from a U.S. trading partner like Canada. Given Canada's mineral resources and the importance of the mining sector, this provision will give a big boost to the Canadian economy.

More broadly, though, the act provides some certainty on where companies can hang their hats from an economic development perspective. It's a clear signal to the market. Of course, Canada has long sought to develop industries that can service the clean energy transition. But the act says more clearly than ever that clean energy is where we need to be.

Q: What other sectors stand to benefit?

A: The mining sector and manufacturing sectors within the Canadian economy will benefit. Those sectors provide the products and the equipment necessary to facilitate the clean energy transition. Think of industries like solar panel manufacturing, or the companies that make the instrumentation for smart grids. Canadian industry is fundamental to the green energy transition in the United States.

MIDDLE MARKET INSIGHT

The act provides some certainty on where companies can hang their hats from an economic development perspective.

Q: How does the act change Canada's economic policy?

A: Canada has had a pretty robust climate change strategy for some time. But what has been less developed is the economic plank of that strategy—the opportunities that can come from servicing and developing clean energy industries. How can we use this legislation to scale up? That's the message being sent to businesses.

Q: How can middle market companies take part in this transition?

A: Middle market companies are a vital part of the Canadian economy. A lot of the companies that are going to be servicing the demand in the United States and Canada are middle market companies. So it's important for them to invest accordingly, to add capacity so that they can serve the demand that is to come. The IRA was a big moment. This is the first time that the United States is committing such a substantial amount of money to meet some of its climate change objectives. We're talking hundreds of billions of dollars over the next 10 years, and that's just the government. So middle market companies have a significant opportunity. Those Canadian companies that have the capability, the technology, the products and the services are going to be well-positioned.

> The Inflation Reduction Act as a whole, and in particular those provisions that relate to climate change, is very beneficial to Canada's economy.

For more information on RSM, please visit **rsmcanada.com**.

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