THE REAL ECONOMY

SUMMER 2023

THE POWER OF BEING UNDERSTOOD
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RSM

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CANADIAN ECONOMIC OUTLOOK: DEFYING EXPECTATIONS

BY TU NGUYEN

The Canadian economy has displayed remarkable resilience this year, defying expectations of a downturn.

In our updated economic forecast, we have lowered Canada's recession probability over the next 12 months to 60 per cent from 75 per cent.

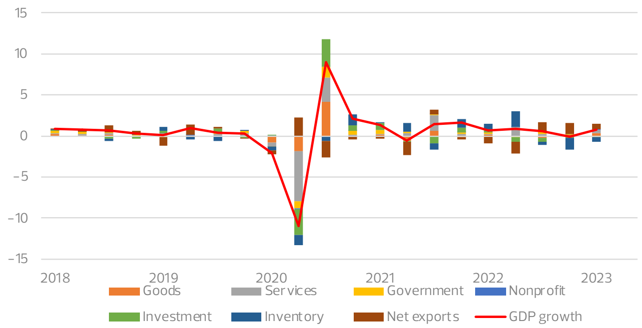
A 40 per cent probability of a soft landing is nontrivial thanks to strong labour demand, healthy consumer spending and a housing market that is still robust. These factors are in part fuelled by Canada's ambitious immigration policy as well as healthy household savings from the pandemic.

Inflation has declined to 2.8 per cent, the lowest among G7 countries. The decline is an encouraging sign that a rate peak is in sight for the Bank of Canada.

While the Canadian economy will muddle through the rest of the year with slower growth, we believe Canada will avoid a recession this year.

In our forecast, the economy will expand by 0.4 per cent in the third quarter and remain steady in the last quarter, with a slowdown continuing into the first half of next year.

Contributions to GDP growth (per cent)



Source: StatCan; RSM Canada

MIDDLE MARKET INSIGHT

Inflation has declined to 2.8 per cent, the lowest among G7 countries. The decline is an encouraging sign that a rate peak is in sight for the Bank of Canada.

The housing market is on solid ground after a brief lull at the beginning of the year as demand continues to outpace supply, leading to high rental and purchase prices despite high interest rates.

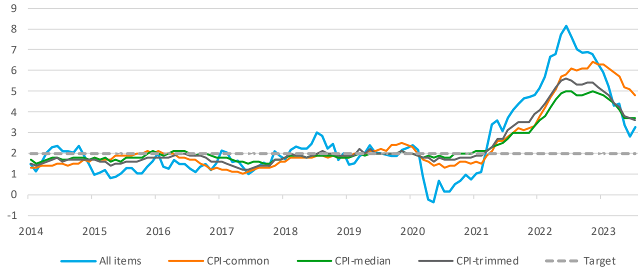
That said, a major exogenous shock risks sending food and fuel prices upward and pushing the economy into a recession.

Bank of Canada to hold

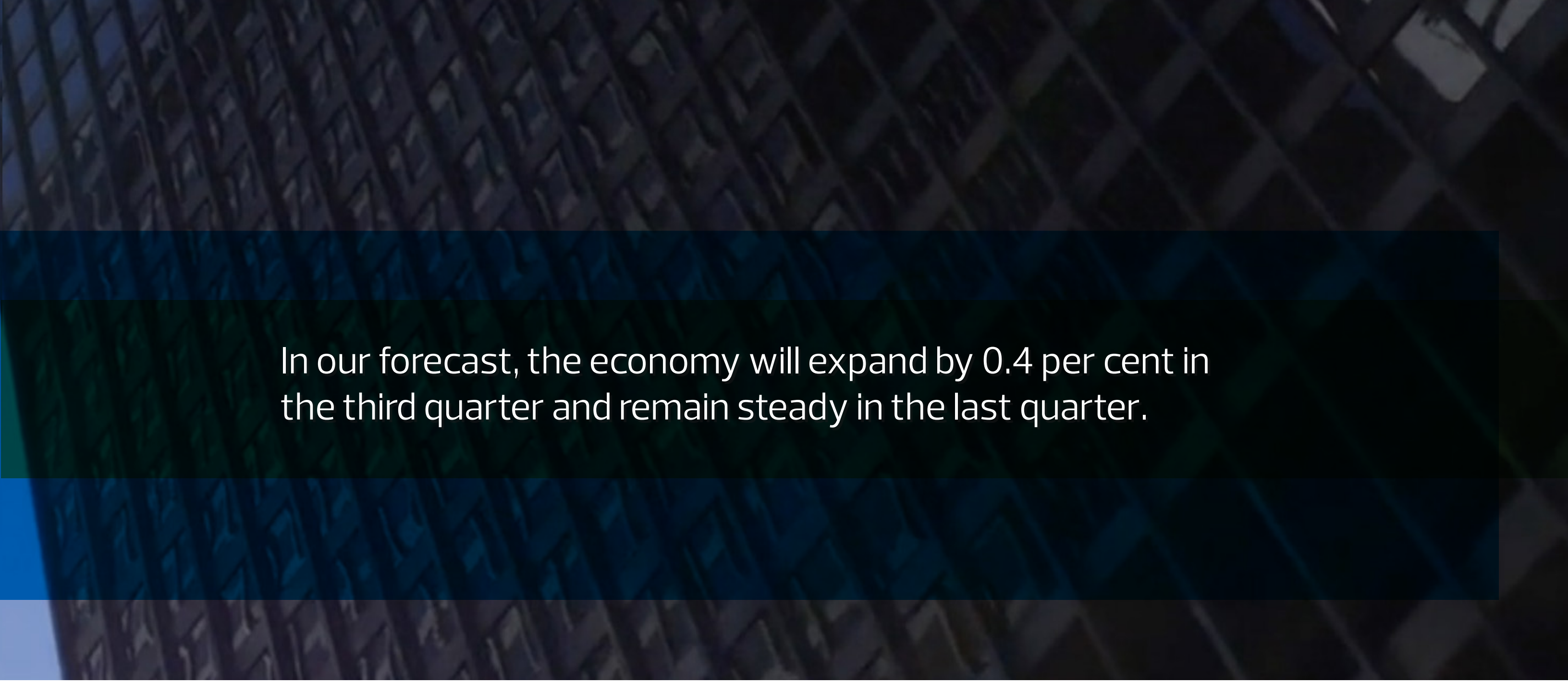
Falling inflation and signs of cooling labour demand might be enough for the Bank of Canada to hold its policy rate at 5 per cent. However, one more hike is possible if emerging data tells a different story.

One can breathe a sigh of relief with headline inflation now below 3 per cent. The decline has occurred much faster than anticipated, thanks to lower energy prices.

Consumer Price Index (per cent)



Source: StatCan; RSM Canada



In our forecast, the economy will expand by 0.4 per cent in the third quarter and remain steady in the last quarter.

We have lowered Canada's recession probability over the next 12 months to 60 per cent from 75 per cent.

Despite trending downward, core inflation measures have remained sticky because of the high prices of services. In addition, businesses still plan on raising prices faster than before the pandemic.

Data on gross domestic product and jobs could send mixed signals during the year's second half as the economy absorbs a series of temporary shocks such as strikes and forest fires.

The Bank of Canada will closely monitor core inflation, labour demand and consumer spending as it tries to walk the fine line to restore price stability while not over-tightening.

Regardless, the Bank of Canada's first rate cut will not come before next year's second quarter.

One reason is that the central bank is keen on taming inflation expectations among consumers and businesses alike. Officials will want to see inflation remain low for an extended period before slashing rates.

On the flip side, sustained higher rates translate into higher borrowing costs for businesses, which hurt business investments, especially in high-risk sectors such as tech.

Immigration fuels economic growth

Immigration has played a pivotal role in helping Canada avoid a recession by not only adding to the labour supply but also boosting consumer demand.

MIDDLE MARKET INSIGHT

The Bank of Canada will closely monitor core inflation, labour demand and consumer spending as it tries to walk the fine line to restore price stability.

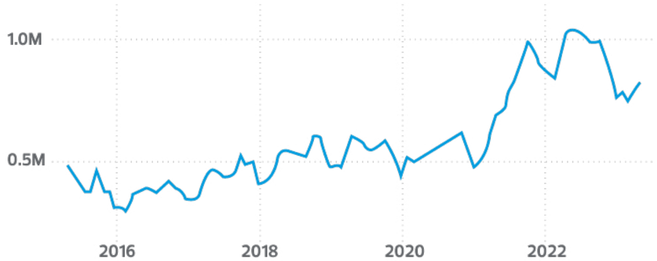
Without immigration, Canada would have a declining population and a shrinking workforce. Instead, Canada now has the highest population growth since 1957 and one of the highest growth rates among the developed economies.

However, immigration is not without its drawbacks, such as straining the already tight housing supply in cities and adding to price pressures. Still, immigration will help the economy overall into next year.

Labour market moderates

Labour demand remains strong but is showing early signs of moderating. The economy added 290,000 jobs during the year's first six months, though most of the concentrated growth was in the first quarter.

Job vacancies



Source: StatCan; RSM Canada

MIDDLE MARKET INSIGHT

The housing market is on solid ground after a brief lull at the beginning of the year as demand continues to outpace supply.

While job vacancies remain elevated above pre-pandemic levels, they have decreased to the lowest level since May 2021. That decline indicates a cooling labour market and is a trend we expect to continue through the year's end.

As an indicator of resilient labour demand, real wages have been growing but could stagnate into next year as the economy slows.

We expect the unemployment rate to creep up to 5.6 per cent by the year's end, which is still below the pre-pandemic average of 5.7 per cent.

When we look at the big picture, businesses are often concerned with the long-term economic outlook beyond the next month or quarter.

To this end, in the long run, a pain point for Canada is its labour productivity, which has flattened and even decreased in recent years.

Canada risks falling behind its peers in the global economy and short-term fixes would not be enough. Instead, it would require an economy and policies that encourage innovation, more openness and less protectionism to ensure long-term prosperity.

Household spending to taper

Consumer spending has been surprisingly resilient, keeping the economy buoyant. But a closer look reveals that consumer spending is likely financed by a drawing down of savings.

Savings from the pandemic have given households a buffer, but this will most likely wind down amid the dual challenges of inflationary pressures and rising interest rates.

At the same time, Canadian households' debt levels have ballooned, standing at 180 per cent of income. According to the Bank of Canada, over a third of mortgage borrowers have seen their interest payments rise, with more to come as more mortgage terms expire.

When households pay more for housing, they have less money to spend on goods and services.

This means monetary policies are working as intended: to cool consumer demand and the economy. Whether or not they can cool the economy without pushing it into recessionary territory remains to be seen.

The takeaway

The data through the end of the year will paint a mixed picture with alternating months of GDP growth and contraction, of job gains and losses. But one thing is clear: the Canadian economy will slow down.

At the same time, solid consumer demand, a robust labour market and strong housing sector are all tailwinds for the economy. Those tailwinds might just be enough to push the probability of a soft landing to 40 per cent, which, if achieved, will be no small feat for the Bank of Canada.

CANADA WELCOMES IMMIGRANTS, BUT THEIR SKILLS ARE UNDERUSED

BY TU NGUYEN

While many developed economies grapple with the challenges of their aging populations, Canada has turned to a bold strategy—using immigration to foster growth.

Immigration is well-known as being central to Canada's economic development. Last year, Canada welcomed 405,000 permanent residents, the most ever in history. This number should reach 500,000 in 2025, according to Immigration, Refugees and Citizenship Canada. That is nearly two million immigrants in four years, a stunning number for a country with a population of 40 million.

So far, the bets are paying off. The economy has skirted a recession as immigrants add to the labour supply and boost consumer demand. Gross domestic product is expected to grow by 1.7 per cent in 2023 and 1.4 per cent in 2024, according to the International Monetary Fund.

But while Canada is great at attracting immigrants, it struggles in using their skills, leaving much unrealized potential on the table.

So-called skill underutilization occurs when employers are not getting the most benefits from workers and talent is not efficiently leveraged.

Many immigrants are employed in jobs that require few skills or are underemployed. Over a quarter of immigrants with foreign advanced degrees are working in jobs that do not require them, compared to just 10 per cent of Canadian-born workers, according to data from Statistics Canada.

Underutilization undermines households' earnings and consumer spending, amplifies talent shortages and stunts productivity growth, costing the economy billions of dollars annually.

To achieve sustained economic growth and productivity, Canada needs to address the underutilization challenge.

Immigration: Lifeline of labour supply

An ambitious immigration policy has turned Canada from a country with an aging workforce to a country with one of the highest population growth rates among the Organisation for Economic Co-operation and Development. Immigration also contributes to Canada's having the most educated workforce among the G7 countries.

Around 60 per cent of immigrants come to Canada under economic programs such as Express Entry (EE) or Canadian Experience Class (CEC), according to Immigration, Refugees and Citizenship Canada. New entrants to the country are evaluated on education, work experience, age and language proficiency. As a result, the immigration population is predominantly young and educated with professional work experience.

These demographic characteristics are, in theory, great for the economy. Education and experience lead to higher income, which translates to higher purchasing power.

In addition, educated and experienced workers also tend to be more productive and innovative when employed appropriately. For instance, a senior software engineer with five years of experience would be more productive and capable of innovating than an entry-level engineer. Immigrants, in particular, have been found to contribute to innovation disproportionately compared to native-born workers when given the opportunity.

The problem with underutilization

However, many highly educated and skilled immigrants are not contributing to the economy at the level they could. Many immigrants find they must start over in low-paid, entry-level positions despite having international work experience.

When workers are underutilized, they earn lower wages, which limits their spending power and the economy misses out on productivity.

Underutilization also means that a talent shortage prevails in certain industries, even as immigrants with relevant work backgrounds occupy positions in those sectors, just not in vacant positions that may align with their expertise. This concern holds true for industries ranging from health care to education and professional services.

What's more, underutilized immigrants might feel resentment, leading to low morale and high turnover, both of which are expensive for employers.

On a macro scale, some overlooked workers will even decide to take their talent elsewhere and leave Canada altogether. According to the Institute for Canadian Citizenship, the proportion of permanent residents choosing to become citizens has fallen 40 per cent in the past 20 years to 45.7 per cent in 2021 from 75.1 per cent in 2001.

Nearly a third of young immigrants plan on leaving Canada in the next few years. Talent retention has become an issue on a national scale.

Canada risks losing a sizeable portion of the talent it works hard to attract, which is counterproductive if the goal is to grow and rejuvenate the workforce.

Addressing underutilization

Several avenues could help address underutilization. Streamlining the accreditation process could deploy immigrants where needed faster without them wasting their talent for years while awaiting accreditation.

> MANY IMMIGRANTS FIND THEY MUST START OVER IN LOW-PAID, ENTRY-LEVEL POSITIONS DESPITE HAVING INTERNATIONAL WORK EXPERIENCE.

Alberta, for instance, accelerated the process to license out-of-province nurses faster, resulting in the College of Registered Nurses of Alberta issuing three times the number of permits to internationally educated nurses in three months than the total issued in the past four years.

Employers are currently least likely to consider newcomers when looking to fill vacancies. This process needs to change, as new immigrants represent an essential human resource at a time when the talent shortage costs the economy billions per year and will continue to be a long-term issue.

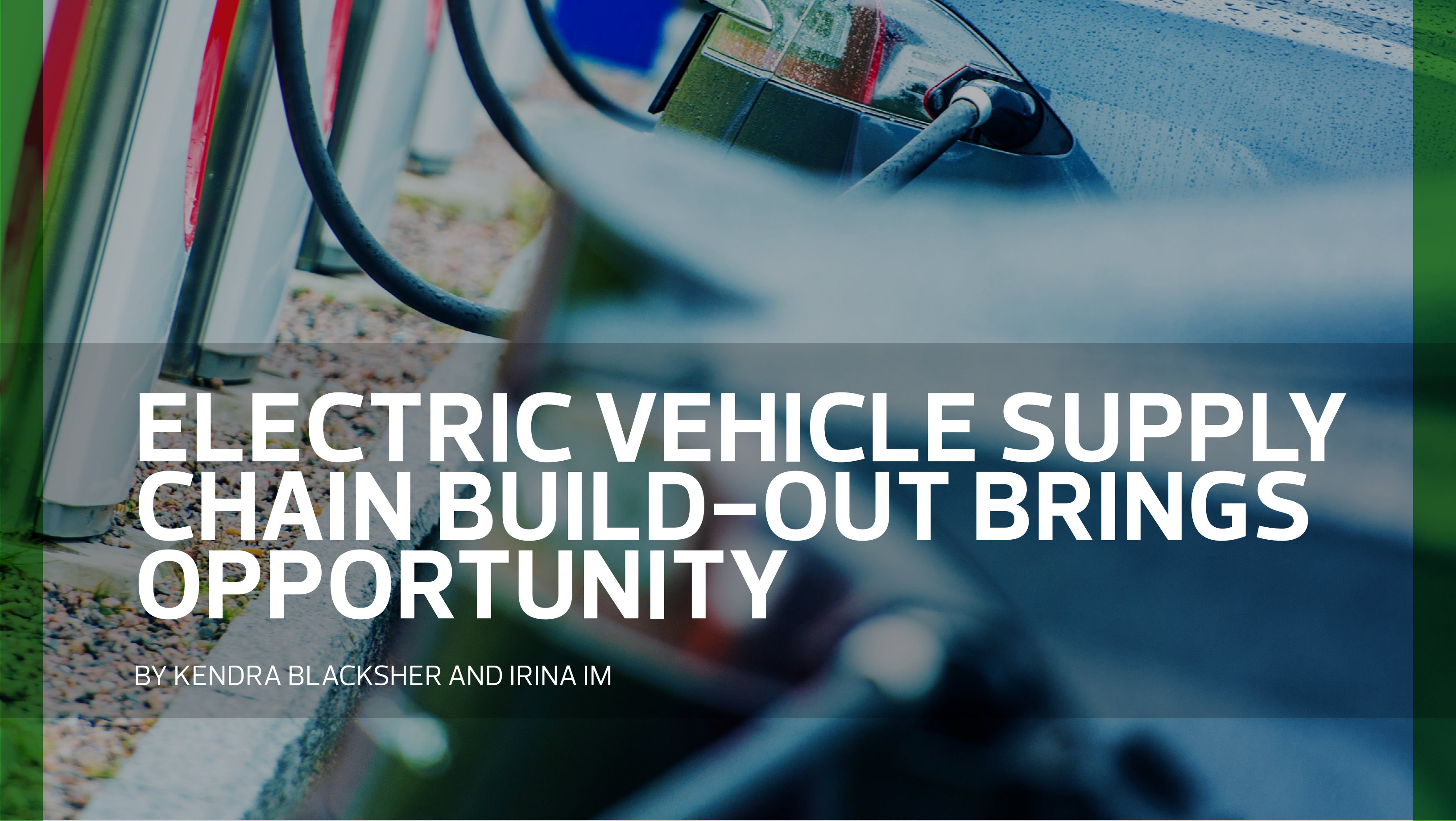
More broadly speaking, investment in research and development would create more opportunities for high-skilled workers in general, enabling productivity growth.

The takeaway

While challenges come with high immigration numbers, such as the housing shortage and the strain on social services and public infrastructure, it would be hard to deny the economic benefits immigration brings to Canada.

However, the underutilization of immigrants prevents the country from realizing its potential long-term economic and productivity growth.

If Canada wants to continue attracting and retaining the best and the brightest, it will need to ensure the skills and education of new immigrants are fully used.



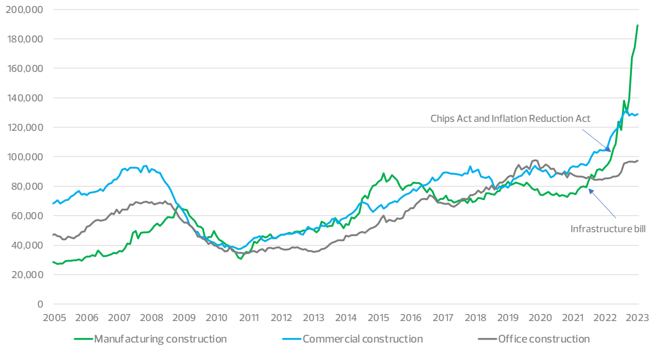
ELECTRIC VEHICLE SUPPLY CHAIN BUILD-OUT BRINGS OPPORTUNITY

BY KENDRA BLACKSHER AND IRINA IM

Despite recent slowdowns in manufacturing and construction, construction spending on new manufacturing plants has surged, doubling over the past year to reach US$190 billion by April 2023, according to Bloomberg data.

This upward trend reflects a renaissance in the manufacturing landscape in North America as new factories sprout across the country and the initial success of the onshoring objectives of U.S. industrial policies. Significant growth is coming from the rising investments in energy transition technologies, semiconductor manufacturing and the build-out of electric vehicle supply chains.

Real construction spending Inflation adjusted, US$ million

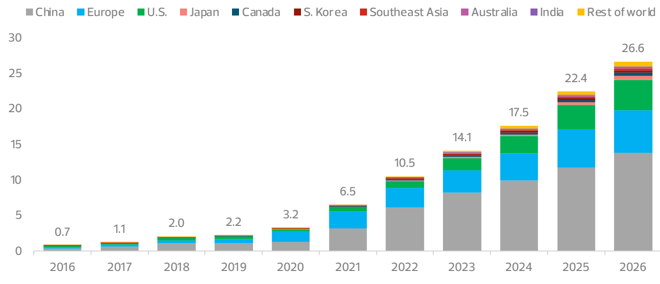


Source: RSM US LLP; U.S. Census Bureau; Bloomberg

The automotive sector's historic transition involves electrification in all segments of transportation, from passenger vehicles to public transportation and commercial fleets. EV sales worldwide are set to surge, rising from 10.5 million in 2022 to an anticipated 27 million by 2026, according to BloombergNEF.

Worldwide passenger EV sales

MILLION UNITS



Source: RSM US LLP; BloombergNEF

This transition is unlocking vast economic opportunities across the entire value chain. In response to these prospects, as well as lessons learned from COVID-19 supply disruptions, many countries are putting EV supply chains at the forefront of their industrial policies. This has initiated a race to attract investments and expedite the build-out of the EV supply, which involves securing critical minerals; onshoring EV production, battery development

and production; and advancing charging infrastructure. The momentum is set to accelerate across North America as the mass adoption of EVs progresses and additional public funding becomes available through the Inflation Reduction Act (IRA) and other similar incentives.

Policy support

To fuel investments from the private sector, the Canadian and American governments have introduced a number of policy tools, including tax credits and incentives at the consumer and manufacturer levels, as well as subsidies, grants and other government funding and loan programs.

Canada

Canada is actively shaping its economic landscape to cater to the evolving EV industry. Governments at both the federal and provincial levels offer billions of dollars in incentives and support programs to attract investments from key automotive and battery manufacturers. These initiatives include investment tax credits for capital spending, subsidies and grants through various innovation funds and programs, government financing and targeted support negotiated directly with original equipment manufacturers (OEMs), battery manufacturers and suppliers. The 2023 federal budget amplified these measures, introducing a 30 per cent refundable investment tax credit for capital investments in eligible property used in clean technology manufacturing and critical mineral extraction and processing.

> The Canadian and U.S. governments have introduced policy tools including tax credits and incentives as well as subsidies, grants and other government funding and loan programs.

Provinces (Ontario and Quebec, in particular) are also fully committed to building out the EV supply chains, luring OEMs and automotive suppliers with lower operating costs, a secure supply of minerals and materials, a developed industrial supply chain, province-funded infrastructure upgrades, effective environmental legislation, easy access to U.S. markets and a highly skilled workforce.

Canada's critical minerals mining and processing has also emerged as a priority sector, benefiting from the full spectrum of mineral deposits needed for energy transition technologies, proximity to the U.S. market and the ability to meet sourcing requirements under the IRA. In the 2022 global lithium-ion battery supply chain ranking by BloombergNEF, Canada rose from fifth to second place, surpassing the United States and closely trailing China—a testament to Canada's rich mineral resources, a well-developed mining sector and industrial infrastructure and strong positioning on the environmental, sustainability and governance front.

MIDDLE MARKET INSIGHT

EV sales worldwide are set to surge, rising from 10.5 million in 2022 to an anticipated 27 million by 2026, according to BloombergNEF.

United States

The IRA is arguably the most significant development for the North American auto industry in recent history, setting aside over US$370 billion to combat climate change, with a substantial portion earmarked for EV manufacturing and infrastructure. The IRA strategically ties consumer EV incentives to North American sourcing, incentivizing manufacturers to localize EV and battery production in North America and diversify critical minerals supply chains within U.S.-friendly countries.

In March, the U.S. Treasury Department released guidance on the eligibility for the US$7,500 clean vehicle credit, for which consumers must meet income threshold criteria. From the automakers' perspective, to be partially or fully eligible for the credit, vehicles must undergo final assembly in North America and meet stringent sourcing requirements for critical mineral and battery components.

Sourcing requirements for US$7,500 EV credit

	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
Critical mineral requirement (from North America and Free Trade Agreement countries)	40%	50%	60%	70%	←		80%			→
Battery component requirement (from North America only)	50%	60%	60%	70%	80%	90%	←	100%		→

Source: U.S. Treasury; BloombergNEF

Heavy tax savings for both consumers and automakers will undoubtedly drive demand in the EV market. Under the tax code section 45X credit—which incentivizes manufacturers' domestic expansion efforts—eligible manufacturers can receive up to 10 per cent of project cost reimbursements to produce renewable energy components like EV batteries domestically.

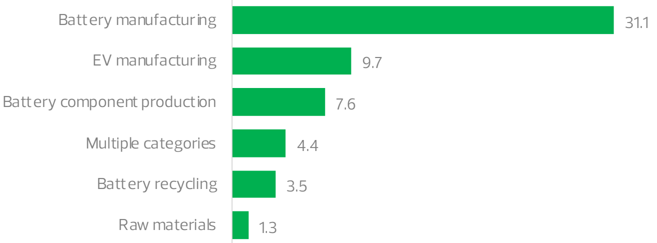
Apart from offering credit and incentives, the U.S. government is pouring billions of dollars in low-cost government loans into funding manufacturers' expensive EV projects. Just last month, the U.S. Energy Department announced an unprecedented US$9.2 billion loan to BlueOval SK, a joint venture between the Ford Motor Company and South Korean battery producer SK On to fund the construction of three battery manufacturing facilities in Kentucky and Tennessee. That follows a US$2.5 billion loan granted to another joint venture project to finance the construction of new lithium-ion battery manufacturing facilities in Ohio, Tennessee and Michigan.

Investments on the rise

Anticipated EV growth and unprecedented government support have already yielded historic investments into the sector. At the end of 2022, Reuters estimated that by 2030, top automakers worldwide will have pumped US$1.2 trillion into the EV sector, which includes batteries and raw material sourcing and processing. And since the IRA passed in August 2022, BloombergNEF estimates new investments of US$57.6 billion in North American EV and battery production as of the end of March 2023, a figure that is continually increasing.

> At the end of 2022, Reuters estimated that by 2030, top automakers worldwide will have pumped US$1.2 trillion into the EV sector.

North America EV and battery investments announced post-IRA
BILLIONS – US$57.6 BILLION INVESTMENTS AS OF END OF MARCH



Source: RSM US LLP, BloombergNEF

In Canada, Ontario is emerging as a powerhouse for the EV supply chain; the province aims to grow its automotive sector to produce at least 400,000 hybrid and electric vehicles by 2030. According to the government of Ontario, from October 2020 to June 2023, the province attracted a staggering US$25 billion from car manufacturers and battery producers. This includes announced investments by Ford (US$1.8 billion), Umicore (US$1.5 billion), General Motors (US$3 billion), Stellantis (US$3.9 billion) and Volkswagen (US$7 billion).

Opportunities for growth

To capitalize on this transition, companies should assess current resource capacity to meet the requirements of the respective tax credits. Companies will need to assess their existing supply chain infrastructure to ensure adequate capacity and availability of resources and assess timelines to ensure component requirements are met in accordance with the transition pace. Collecting and assessing the data needed to meet the incentives requirements could make for a large hurdle in capitalizing on these opportunities.

MIDDLE MARKET INSIGHT

In Canada, Ontario aims to grow its automotive sector to produce at least 400,000 hybrid and electric vehicles by 2030.

Manufacturers that want to take advantage of the incentives and be a first-choice provider for EV consumers eager for tax savings should work with a third party to obtain and analyze data at a level precise enough to capture relevant criteria. That might include data on construction contract labor and battery composition data needed to ensure manufacturing facilities and EVs manufactured therein meet jurisdictional tax credit requirements.

The EV investment frenzy has significant implications for the broader economy and middle market businesses, including immense growth opportunities. The associated manufacturing growth will lead to broad economic benefits, fostering job creation and a circular economy with a widespread positive socioeconomic impact in communities. It will create spillover demand for new products and services across sectors, while also enhancing research and innovation. For middle market businesses, this translates into new market opportunities, particularly in the technology, manufacturing and energy sectors but also in the logistics and service sectors. Given these prospects, it's no surprise that nations are rushing to secure their position in the global EV supply chain.

QUESTIONS AND ANSWERS: THE RAPIDLY EVOLVING STATE OF THE STREAMING INDUSTRY

WITH JUSTIN KRIEGER

Justin is a director within RSM Canada's growing technology, media and telecommunications group and supports the progress of the practice through client development, industry knowledge and relationship management.

Q. What do you see happening in the streaming space now?

A. There is significant saturation in the media industry, making it really hard for companies to grow user counts, especially in the streaming sector. Consumers face more choices for platforms than ever; large media companies are battling an expensive content war, with high competition and the continuous need for new, high-quality entertainment. So, large companies will continue to increase content diversity to deal with that. An example of that is through streaming companies purchasing sports media rights. Another example is through interactive entertainment, such as video gaming.

Q. How is this playing out in sports?

A. Watching live sports is one of the key reasons consumers have stuck with traditional cable packages. Consumers really enjoy watching live sports on television. So, since large streaming companies have large media aspirations and the continued need to battle customer churn and increase content diversity, they have started buying sports rights from the major professional leagues. It's happening with soccer and football, to name two. Many rights deals have expired in the past couple of years and we are seeing a shift to the streaming space that was hard to imagine even five years ago.

Q. What about gaming?

A. This is an area where the change will be profound. Netflix is entering the cloud gaming market with initial testing taking place in Canada and the U.K. Netflix has been involved in the gaming space for a while. But with the move to cloud gaming, they are able to build on their initial expertise of streaming TV shows and movies.

Q. Why is this important?

A. Gaming is already a large industry and will only grow in the coming years. Cloud gaming will play a part as users connect their gaming world to their existing streaming accounts. This change is happening for four reasons. First, streaming services already have a significant user base. Second, streaming companies already have reputable name brands, so customers trust them. Third, the streaming services already have the technology. And last, they have a path to profitability in gaming in that in-game ads, for example, can be a good source of revenue.

Q. Streaming services struggle to turn a profit. What's the path to profitability?

A. At one point, the focus for streaming companies was on user growth. More users could lead to profitability, the thinking went. But as it played out, that's not necessarily the case. The path to profitability is all about striking a balance between retaining users and increasing revenue. Password sharing is one example. When a company places limits on password sharing, as has happened recently, the user count goes way up. Another element is advertising. Streaming services are introducing several tiers of service. So you have one tier that costs less and includes ads and another tier with no ads but costs more. The multiple levels allow the streaming services to develop revenue streams from advertising unavailable to them before. And it gives consumers a choice—ads, no ads or cancelling. It's a winning equation for everyone.

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

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