ECONOMIC VIEWPOINT

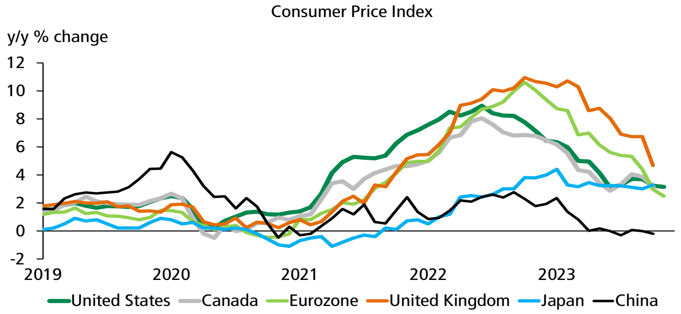
2023 Year in Review

Inflation Continued to Ease as the Effects of Rate Hikes Worked Their Way through the Economy

After peaking in October 2022, **inflation has come down in most major economies around the world** (graph 1). In the G20, year-on-year inflation fell from 9.5% in September 2022 to 5.7% in October 2023. One of the key factors behind this slowdown in price growth is lower energy prices, while core inflation has proved harder to tame. That said, there have been some notable improvements. In the United States, goods prices have plateaued but services inflation continues to run high. This is also the case in Canada, which has experienced a similar trend of slowing inflation this year from the decades-high pace of 2022. It also benefited from having the slowest pace of inflation among major advanced economies (ex. Japan) in 2023. And the trend looks to be Canada's friend, as the most recent price data show a cooling in the broad group of underlying inflation measures the Bank of Canada looks to.

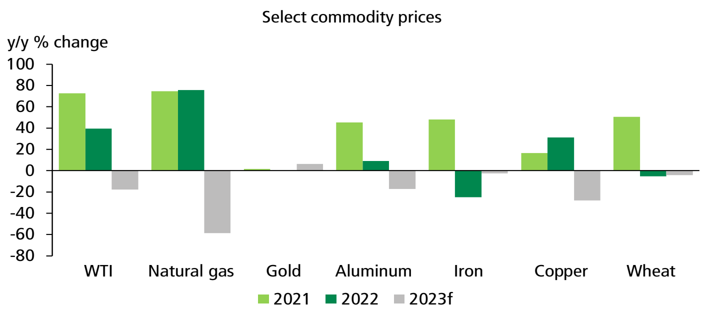
After two years of growth, **prices for several commodities fell in 2023** (graph 2). Broadly speaking, these declines were due to a stabilization of global supply and the deterioration in economic conditions, particularly in the manufacturing sector. Gold bucked the trend, however, with its annual average price growing at 6.5%, as investors flocked to the safe-haven asset in the face of uncertainty and high inflation. Meanwhile, OPEC+ tried to minimize oil price declines by cutting production, but their efforts were undermined by weak demand and a lack of market confidence that the revised target will be met.

GRAPH 1
Inflation Has Come Down Substantially



Sources: Datastream and Desjardins Economic Studies

GRAPH 2
After Two Years of Growth, Several Commodity Prices Fell in 2023



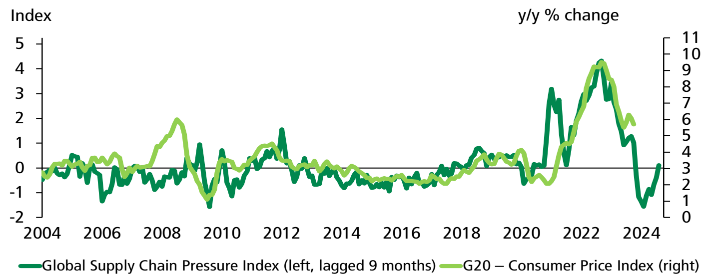
Sources: Datastream and Desjardins Economic Studies

Another factor that helped ease inflationary pressures is the **recovery of supply chains around the world**. The pandemic caused major disruptions to global trade fluidity, resulting in a sharp deterioration in 2021. While the Federal Reserve Bank of New York's Global Supply Chain Pressure Index started to soften in 2022, it didn't return to the historical average until 2023, when it even dipped below the long-term trend (graph 3). The improvement has already affected goods prices and suggests that inflationary pressures on them will continue to ease in the short term.

Even though the stars seemed aligned for strong growth in 2023, **China's hopes for a robust recovery were quickly dashed**. The country's economy is being held back by a sluggish property market (graph 4), high local government debt and pandemic-related changes in Chinese consumer behaviours. These factors, combined with an unfavourable global economic environment, caused Chinese inflation to soften and even slide into negative territory. The government has responded with various stimulus measures, but these initiatives aren't addressing the core issues as they're designed to generate short-term gains at the expense of long-term ones. China now faces the threat of Japanification, with an economy that could stagnate or even contract.

Central banks had to introduce **further rate hikes in 2023 to reduce inflationary pressures**. In Canada, the most recent increase was in July and since then the overnight rate has held steady at 5.0%, its highest level since 2001 (graph 5). Short-term bond yields also soared to 20-year highs. Although rising interest rates put the squeeze on borrowers, they were welcomed by investors. Conditions became more encouraging for borrowers toward the end of the year, as several bond yields started to come down and lower inflation resulted in retreating investor expectations for future central bank policy tightening. Some central bankers have shifted to more neutral messaging in recent weeks.

GRAPH 3
Supply Chain Pressures Eased Considerably, Helping Bring Down Inflation

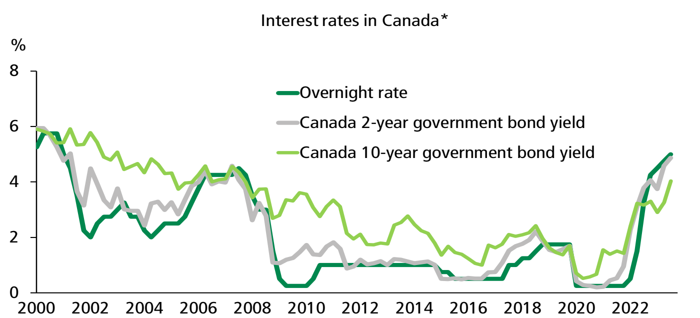


Sources: Federal Reserve Bank of New York, Organisation for Economic Co-operation and Development and Desjardins Economic Studies

GRAPH 4
China's Property Market Continued to Struggle in 2023

Sources: National Bureau of Statistics of China and Desjardins Economic Studies

GRAPH 5
Canada's Overnight Rate Reached a 22-Year High



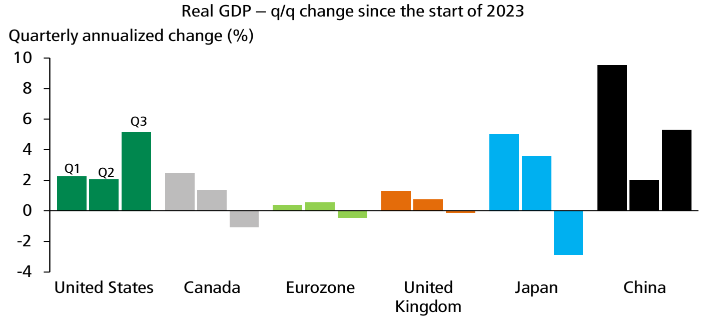
*Data for end of quarter
Sources: Datastream and Desjardins Economic Studies

The cycle of interest rate hikes, which began in 2022 worldwide, has clearly had economic impacts. Monetary tightening aims to reduce inflation by curbing demand. The real estate market, which is particularly sensitive to interest rate fluctuations, cooled in several countries. This was followed by slowdowns in real consumption and business investment. **Several countries saw their real GDP growth decline** (graph 6), but many nonetheless avoided falling into a clear-cut recession. The US economy in particular has been surprisingly resilient so far.

Canada's economy stands out relative to the US and other countries in its elevated sensitivity to interest rates. This partly reflects the heightened level of household indebtedness, resulting from sustained high home prices and rates of homeownership. Canadians also renew their mortgages every five years or less, versus the 30-year terms that are more common in the US. As a result, when interest rates rise considerably, as they have recently, this leaves Canadians particularly vulnerable to higher payments (graph 7). The popularity of variable rate mortgages during the pandemic only made this worse. Households with flexible payments felt the pain of higher short-term rates immediately. In contrast, those with fixed payments were able to avoid the immediate impact of rising rates. When the interest portion eventually surpassed the monthly fixed payment, many lenders allowed borrowers to add the difference to their outstanding principal. Consequently, some homeowners kicked the higher mortgage-payment can down the road in 2023.

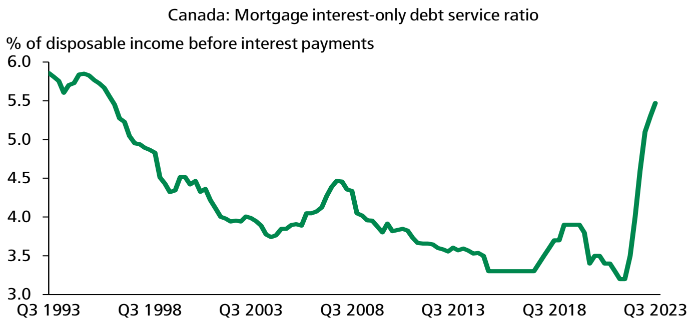
Canada's housing market went through three phases in 2023. First, at the very beginning of the year, most major markets were feeling the cumulative effects of the aggressive monetary tightening campaign that began in 2022. Second, once the Bank of Canada paused rates, buyers flooded into the market, seeking out bargains in an environment marked by sky-high rents and mortgage rates trending lower. The fastest recoveries occurred in and around Toronto and Vancouver—which tend to be most sensitive to interest rates—but gains soon followed in other cities. Third, home sales fell back again when the central bank resumed hiking rates. The weakness began in Toronto, then spread to Vancouver, then became even broader-based, as Calgary and Edmonton—previously resilient to higher borrowing costs given skyrocketing population growth—gave back gains (graph 8). In phase three, listings surged across the country, as many individuals who bought homes in a lower-rate environment struggled with sharply higher borrowing costs.

GRAPH 6
Economic Growth Slowed in 2023, with the US a Notable Exception



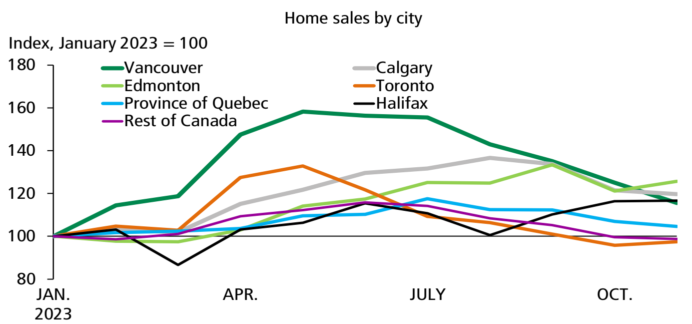
Sources: Datastream, Organisation for Economic Co-operation and Development and Desjardins Economic Studies

GRAPH 7
Canadians Are Spending More to Service Their Mortgages Than They Have since the 1990s



Sources: Statistics Canada and Desjardins Economic Studies

GRAPH 8
Housing Sales Spiked When the Bank of Canada Paused, Then Retreated after Rate Hikes Resumed



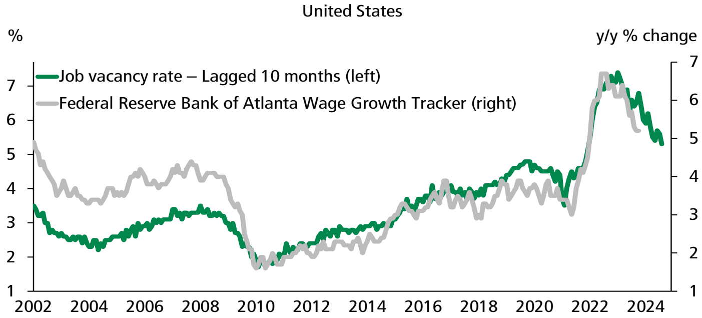
Sources: Canadian Real Estate Association and Desjardins Economic Studies

Labour market dynamics changed in the past year. While it's true that unemployment rates generally remain near all-time lows, **there are signs that labour shortages are easing in many areas that were struggling in 2022**. The US job vacancy rate plummeted and now hovers near pre-pandemic levels, which has led to slowed wage growth (graph 9). Canada's labour market experienced similar developments to other countries in 2023, but with some notable exceptions. Like elsewhere, wage growth remained elevated, the unemployment rate was low but rising and the vacancy rate fell toward the pre-COVID average. **But growth in the labour force dwarfed that of Canada's international peers due to the strongest pace of migration from abroad in a generation**.

Canadian population growth hit a 65-year high in 2023, and that helped support economic and housing market activity. Even more surprising than that strength, though, was the source of those gains. Admissions of non-permanent residents (NPRs)—which include temporary workers and international students—accounted for 65% of population growth last year. Contributions were even higher in Quebec, Ontario and BC (graph 10). Going forward, we think there's a risk that cooling NPR admissions could exacerbate the economic slowdown, as easing labour demand normally lowers use of Canada's temporary worker programs. That said, the federal government's increased use of NPRs to meet its permanent resident immigration targets limits that risk. In a potential downside population scenario, Quebec, Ontario and BC look most vulnerable given their recent reliance on NPRs. By contrast, the Prairies and Atlantic provinces appear less exposed, and relative housing affordability increases their appeal to immigrants and people from other provinces.

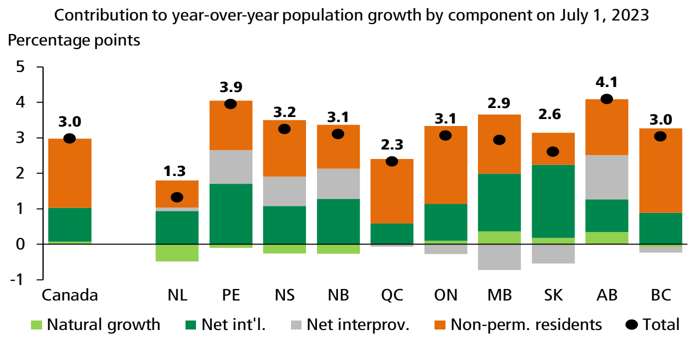
In early 2023, the stock market outlook wasn't particularly rosy. High interest rates and an anticipated economic slowdown resulted in corporate earnings projections being revised downward for the first time since the post-pandemic economic reopening. The S&P 500 index in the United States seemed vulnerable due to inflated valuations of some securities. But then a game-changer emerged: ChatGPT. **The chatbot impressed the world by demonstrating the remarkable capabilities of generative artificial intelligence (AI) and sparked massive investment in the field**. As a result, stocks with more exposure to generative AI significantly outperformed other asset classes, boosting the S&P 500 and NASDAQ indexes in particular. The S&P 500's rebound was only temporarily slowed by the collapse of Silicon Valley Bank and other regional banks in March. Fears proved to be very short-lived, and in the end the event simply confirmed the fact that the Federal Reserve is ready and willing to support the financial system in times of need. The year was nonetheless marked by market volatility, though the vast majority of global indexes posted gains in the fourth quarter after bond yields started falling. Advances in artificial intelligence pushed the S&P 500 and the NASDAQ into a category of their own (graph 11).

GRAPH 9
US Job Vacancies Are Falling, Easing Wage Pressures



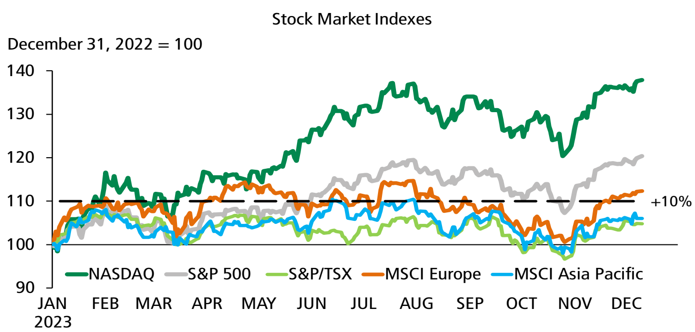
Sources: Bureau of Labor Statistics, Federal Reserve Bank of Atlanta and Desjardins Economic Studies

GRAPH 10
Non-permanent Residents Continue to Drive Population Gains in Canada



Sources: Statistics Canada and Desjardins Economic Studies

GRAPH 11
Stock Markets: Excitement Surrounding AI Pushed the S&P 500 and the NASDAQ into a Category of Their Own

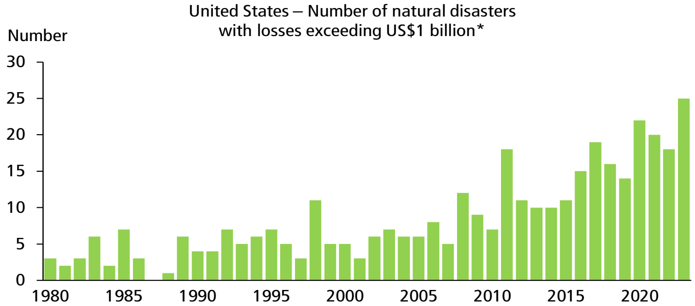


Sources: Datastream and Desjardins Economic Studies

Climate change was a major issue once again in 2023. Around the world, temperatures reached record highs and many global regions struggled under intense heat, drought, violent storms and flooding. In the US, the number of natural disasters rose again in 2023 (graph 12). Hawaii was struck with devastating fires and California was battered by its first tropical storm since 1997. In Canada, several provinces battled forest fires over the summer. Quebec experienced a major ice storm in April as well as heavy rains that affected agricultural production. In addition to hurting the economy and destroying sources of income for many businesses and individuals, these events increased volatility in economic indicators and added complexity to economic decision-making. While decarbonization efforts still fall short of what's needed to achieve net zero by 2050, the implementation of public policies supporting the energy transition accelerated in 2023 with the introduction of investments linked to the Inflation Reduction Act of 2022 in the United States, but also to similar or even competing policies in Canada and Europe.

Geopolitical issues continued to weigh on the economy in 2023. The war in Ukraine raged on and, despite Ukrainian forces making some territorial gains, the situation on the ground remains virtually unchanged from last year. That said, Russian leaders were concerned by the aborted Wagner rebellion in June. In the Middle East, Hamas' terrorist attacks on Israel and the Israel Defense Forces' aggressive retaliation in Gaza have caused widespread outcry, but so far the conflict has only had a modest impact on the global economy. Meanwhile, tensions between China and the US remained palpable throughout 2023, causing a decline in trade between the two countries (graph 13). While issues related to technology trade and Taiwan continue to be points of contention, some of the friction between the two countries eased after Joe Biden and Xi Jinping met in November. Political tensions also ran high in the US after Republicans won a narrow majority in the House of Representatives. There were increased conflicts with the White House (debt ceiling and government funding) as well as between Republican members of Congress.

GRAPH 12
The United States Faced a Record Number of Natural Disasters in 2023



*Most recent data: November 2023
Sources: Datastream and Desjardins Economic Studies

GRAPH 13
US Imports from Mexico and Canada Now Surpass Those from China

Sources: Bureau of Economic Analysis and Desjardins Economic Studies