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Rethinking the macroeconomic outlook

Speaker Participants

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Presentation

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I'm going to do something I've literally never done before. I've never done this. In the past 10 minutes, I decided to completely change what I'm going to present to you today. And the organizers are what? But I'm up here now. And the reason is because as I was walking in, I had a chance to talk to some of you, and one of you I said, what do you want to hear about today? Do you want to hear about mortgages? You want to hear about rates? And he said to me, I want to hear about the things you can't tell me. That's what he said. I want to know what you're not saying when you get on to stages. So, I think in the spirit of today's theme and being a little bit more creative, that I'm going to tell you all the things I don't say when I get on a stage. Would that work? Can we switch it up a little bit? You're in favor.

Alright! So, let's start with what I was going to say and stretch for 20 minutes. What I was going to say is here's our standard economic outlook. We have economic models that have been tested for 25 years. My economic models tell me we are going to have a Canadian recession probably starting now. We're probably already in it.

The US will probably enter a recession in Q4 of this year, maybe Q1 of next year. We can't figure out the timing. Inflation is going to trend downwards probably to about two and a half percent by the middle of next year. And central banks are going to feel that this recession and this rise in the unemployment rate and drop in inflation is going to be enough for them to cut interest rates starting around the middle of 2024, in Canada and in the United States.

I would tell you that I think we're going to see a more standard easing cycle. So somewhere between 6 to 8 cuts next year. Sometimes controversial, but that's actually standard. That's normally what happens in recessions. And I would talk to you about our long-term forecasts, how we see opportunities, even amongst some of this disruption, some of the asset classes that we like in this environment.

And then typically, I would stand up here and I would show you pictures to prove this point. That's what I normally do. And I typically add in jokes and make a little bit more fun of my husband. And that's usually the standard thing. But I am inspired. I am inspired by what we just heard. And as much as we have a lot of science and models that go into the way we create GDP forecasts.

Often economics gets described as the dismal science, right? I think that in the current environment we actually need more art than science in our outlooks, and we maybe need to start getting a little bit more thoughtful, creative. We need to be a little bit more like Steve and think about the standard ways we're doing things, painting a painting on a wall.

They don't work in this type of environment. We have to flip the script. So, I think what I'm going to do is spend the next few minutes talking to you about all the reasons I'm nervous about the science of economics and where I think things might go wrong. The first thing to say is that almost all of the economic discord is based on standard models that say, well, in the past, when this happened, the next thing happened with a high degree of confidence.

And I got to tell you, all of us chief economists, we get together sometimes. It's super fun. We have great discussions. We almost all have an identical economic model because we all read the same textbooks. We bicker over point 1, point 4, point 2. We never really question whether the standard way we've been doing things is the appropriate way to do things.

The models that I use are not incorporating historically; do not incorporate a lot of the very real and different things that are occurring in our standard, in our now current environment, things that everyone in this room feels every single day. The first one is a very pronounced labor shortage. We all know this, right? How many restaurants have you gone to that are now closed?

Like two days a week because they don't have enough people. I went to Tim Hortons the other day and I had to look up the legal age for working because I was convinced as much a ten year old behind the counter. That's how much shortage. In the United States is very severe, 40% of Americans do not work.40% of Americans do not work. This is not just a post COVID issue. This started declining in 2001. Why aren't they working? There is the highest share of those over the age of 65 in the United States than there has ever been. There's a significant amount of people on disability. Do you know what the number one reason people are on disability in the 1960s was? Heart disease. You know what it is today? Back pain. Back pain. I'm not saying there's not back pain because I've had some back pain that's put me out before.

I'm just saying it's not the same. Incarceration rates, 1% of Americans are incarcerated. One out of 100 Americans incarcerated. And so now if there's a job opening in the United States, you don't even have one unemployed person per open job. You actually have 0.7 people available for every job opening. So, if you're trying to hire that person, you're trying to hire has two jobs to pick from, in fact, right? Now in Canada, we've tried to remedy this. In Canada, the number one reason that businesses on the Business Outlook survey state they can't increase production or retrieve higher profits is because they have a shortage of skilled and unskilled labor.

Now, in Canada, what did we do? We said, you know what we've done in the past that worked really well. We didn't have enough people, so we brought in highly educated people from abroad. This was one of the most intelligent economic policies that any country in the OECD have used for a very long time. It actually helped Canada increased growth, it increased productivity.

Most of those who we invited to come to Canada were highly educated, highly productive, right into the labor force. This is still true. And then our policymakers said that and so that worked really well. What if we expand that policy to the limit and then the policy didn't work so well, Canada bringing a million others into Canada right now.

Again, a good thing for a wide range of factors, but it's created some problems. My husband plays Dungeons Dragons. Yes, he's 40 and he likes to invite his friends over to play. And sometimes he invites six people and then sometimes he says, I invited 20 of the guys and we don't have enough chairs on the kitchen for 20 people to come play.

So, the value of that chair increases and some of them have to get stools. All that to say, we do not have enough homes, services or goods to actually be able to absorb this population growth. This is not included in our economic models. In fact, even Statistics Canada is having trouble figuring out how the heck do we absorb these numbers? Where are they calculated? Even things like retail sales data in Canada. So, what's happening is a lot of our data looks really good. People say, how can we be in a recession in Canada? There are so much retail sales happening. Well, we increase the population so much; each of us as individuals is buying less. Each of us as individuals is doing worse in GDP terms.

We just increase the population so much. This is not necessarily a good or bad thing. That is not my point. My point is it's not in our economic models. Inflation. Historically, where did the inflation come from? It came from you and I spending too much of our money. That was effectively, is that the theory behind inflation!

If there was too much price pressure, it's because all of us went out and we were buying too many, I don't know, cars, going to restaurants, extending services. This was the traditional way in which inflation rose. So, if you wanted to bring down inflation, central banks would just make us all poor. When central banks say they're going to reduce demand.

They're just saying they want to make us poorer, increase the unemployment rate. That's what's happening. Right? But now we don't have inflation in Canada or the United States because we're all buying too much. We have inflation in Canada and the United States because of a host of new issues. Some of them came from COVID. Some of them were accelerated by COVID.

Geopolitical tensions. The conflict between Russia and Ukraine has massively increased food prices. I got to tell you; President Poutine probably doesn't even know who Governor Macklem of The Bank of Canada, does not care if we hike interest rates, does not solve the war in Eastern Europe. Food prices are rising because of increased severity and frequency of weather events.

Droughts in Brazil, for example, have been very powerful for agriculture. If we hike interest rates in Canada and the United States, it's not going to rain in Brazil; it's not going to work. We're seeing deglobalization trends. Every single one of you who ever took an economics class and I see all of you these textbooks there were even those in the 1930s were advocating for this. Okay.

The basic tenant of economics, we all learned it is that free trade is good. Do you remember this one? There's an island with apples and an island with bananas. When you build a bridge between them and then everyone gets apples and bananas at lower costs. Like one of the standard things, you learn in the econ. Some of you were, like, blocked it out, Frances! Why going back there?

In 2016, we actually started to see that this very powerful globalization force that existed since the 1930s, it started to sort of fade out around 2016. That's when President Trump came into power. That's when Brexit occurred. And so suddenly we started seeing tarifs across the entire world rise and prices started to rise, not because we were all buying too much stuff, but because of decisions made by policymakers that occurred over this time.

And then of course COVID. COVID does not care if we hike interest rates or not. It will still shut down borders and raise the prices of things and our access to it. So, companies are saying, you know what, this is so disruptive, but source goods and materials here at home and even though it costs more, it's an insurance policy against disruptions to my business, that's inflationary.

And it's outside the realm of higher interest rates or lower interest rates. So now in Canada, we have a problem. Some of you might have seen earlier this week that inflation is moving back up. I think that's temporary. Inflation is moving back up because oil prices have surged 30%. Oil prices move 30% because we're all buying too much oil?

No, we've had production cuts in Russia, Saudi Arabia and some really terrible floods in Libya. Bank of Canada hikes interest rates, it's not going to stop floods of Libya. It isn't. So now we're in an environment where the inflation is left in our system in Canada and the United States cannot and is not being cured by higher interest rates.

That's an anathema to the way that our economic system has existed, and it's not in our standard economic models. It's not. So when I say I think inflation is going to go back down to 2, 2 and a half percent next year, it assumes and anyone else who says that is assuming that the inflation in the system is going to respond to these higher interest rates as it goes forward.

And that brings me to the biggest question mark I have about our outlook at all, which is what are central banks going to do? How the central banks respond when the economy falls into recession, but inflation is still high, they have to make a choice.

In Canada, our central bank has one mandate: Control inflation. In the United States, they have two: full employment and price stability. So, they have an out, because the employment rate starts to rise, they can say, Oh, we're going to focus on this one now, but we have to have some really big discussions about what interest rates are made for? Why do we run them? If they don't cure inflation should we be moving them at all?

How many people have to lose their job for inflation to come down by a little bit. This is a new trade off that we haven't had to think about in decades, it's coming forward. So, when we make our forecasts, we assume if interest rates go up, the economy will decline. Our standard models tell us that we will see a recession next year and that central banks will respond to that recession by cutting interest rates.

But maybe they won't. Maybe they won't. Now we're all here because we need to know how to manage our investments. That's my job. I don't get paid to go on TV, although I really think I should, that would be great! No, we get paid based on the performance or my team does based off the performance of our portfolios.

So, it doesn't work for me to come in to work and say, Here's this model! Doesn't work for me to come in to work and go, I don't know. That doesn't work either. So, what do we do? When you don't know when you're operating with uncertainty, I have to pile a little bit of art. You have to make a plan.

So, when I come in to work every day, I say, we're not doing it the way that we used to. We're changing the way we do this. The first thing we're going to do is we're not going to throw out everything. Some people are doing this right now, they're saying the economy is totally different; we're going to throw everything out completely. Nothing's going to work. No, we say what would be true, would be true in a standard environment. And then line by line, and there are 265 lines in my model, we question. We question every old correlation, every old relationship, and we apply a factor to it. We say we don't believe this is a 100% accurate anymore. Let's do some work and on 265 lines, we go each one and we say how are we going to address this?

And what we end up with is a slightly different outlook than what the standard outlook would produce. If I was just using my standard economic model, I didn't make any adjustments to it; it would tell me we're going to a very severe recession, very, very severe recession next year.

But when we apply this factor, when we look at what's different, what we see is that there was a lot of excess savings in the system from those CRB checks and stimulus checks that will mute the recession somewhat. We know that fewer people are going to lose their job because there's a labor shortage. So, companies are still going to let go of people, but less than they have in the past.

We look at this environment and we say, you know what? Manufacturing has been in a recession for eight months, and that's probably because we all bought our fitness equipment. We all bought our computers and our “at home webcams” and we figured out zoom over the course of COVID. I just sold the peloton I bought for 60% off. I used it three times.

Okay. That's a deflation, by the way. But we've been waiting for years to take my little boys to Disney World. Took us this long to be able to get it together. We're still in that post-COVID environment, right? So, the economy is operating differently and therefore, while we say recession. Doesn't look as bad as maybe what the standard models would say.

And yet, even as I say recession, sometimes I talk to you and I say recession and people get really nervous about that word. Here's another thing that I don't usually say. Yeah, we got a call for recessions. What's a recession? It's two quarters of negative GDP with a rise in the unemployment rate and a couple of other small details and boxes you have to tick.

It's a mathematical output. So, you could have a very negative outlook. And instead of it being a -0.1, -0.3, you could have .1 and.3 and we'd effectively be in the same environment. This R-word is way less important than the general story that we're going into, which is a growth slowdown and inflation slowdown and rates that probably move lower, the magnitude of which we can discuss based on words like recession, but that's far less important.

It's big words, soft landing, hard landing. It's just semantic, effectively, it gets headlines, but it's a semantic. It has to do with how your Excel spreadsheet comes up. So, the first thing we do is we question, prior relations, prior correlations, just because something happened in the past, whether it's in your business or whether it's in your portfolio, may not mean that it happens again in the future. We have to apply some subjective, some subjectivity to that.

The second thing we do is use scenarios, and this is something that I advocate to everybody: business owners, institutional investors, retail investors, frankly, I do it in my own life too. We're going to the amusement park. What if this kid's pants gets wet? What if they want this? What if they want the stock? We all do scenarios in our life.

We need to do this more than ever. We need to plan for a central scenario and then we need to say, well, let's not put all of our eggs in that basket. What are some alternate things that should happen? We have to apply these confidence intervals to that type of environment. Really important as we go into an environment of uncertainty.

And the most important thing we do is we remember our timelines and really trying to push this a lot because in a lot of financial media, when I get asked to join financial media, they want to know about jobs number that came out that morning and why are stocks up 1.2% today? This is the big thing. There's so much short-termism and even long-term commentary is focused on things like 3 to 6 months.

That is not practical investing for the vast majority of our clients. I worked for hedge funds. I worked on trading floors. I know what they're doing. But I also know that the sticky money that exists in our system is long-term. I was in California last week and I saw many of our institutional clients and in every single meeting I went into, the first question they would say is, where are you on this recession thing?

And I spent a minute or two and they said, All right, let's talk about the five year outlook. Let's talk about 5 to 10 years, what that outlook looks like, because that's actually where we need to be focused. And our 5 to 10 year outlook is actually really positive. It's really bullish on the asset allocation time. What will we see?

We see that after we come out of this growth downturn within the next 12 months. There are some really interesting things happening. We actually see higher growth. All this AI talk, actually matters. It boosts productivity. It means we can actually grow our economies faster. Inflation, that's above 2% or below 3% can be positive for a lot of our asset classes.

My colleague Eric Menzer is here today. He is a whiz on private markets, on real assets. That asset class is going to do really well in that type of environment or should. If we see slightly higher interest rates, that's great for those of us with fixed income, because for the first time in my career, I don't want to date myself! For the first time in my career I'm actually getting income from our fixed income.

And when we generate five year forecasts, we may get a small decline on the price return, but the income component is larger than it's been since I've been at Manulife, which is almost nine years. So as much as we spend our time today talking about maybe what the next 3 to 6 months or 6 to 9 months looks like, the best thing I can say is turn off the television, focus on five years ahead. Talk to your investment counsellors about what that looks like, because timelines are far more important than a lot of the short-termism that's coming up there. So, I think what we're going to do now, we're going to go to questions, I'm going to have some of my colleagues come up on stage with me, maybe Leslie is going to be coming on board and we can talk a little bit more about this.

I know some of you still want to know about variable rate mortgages. We can get to that as well. But hopefully, hopefully I'm not into too much trouble. Told you a little bit about the things I shouldn't really be telling you. Hopefully, that's useful to you. Thank you.

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