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Job markets tighten

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The spread of the COVID-19 pandemic in early 2020 set the stage for an unprecedented shuttering of the Canadian and U.S. economies. The lockdowns triggered the most pronounced recessions of the current era[1]. In line with the sharp declines in economic activity, labour markets weakened dramatically and unemployment rates in both countries soared to new highs. The subsequent periods of alternating reopening and closing, which characterized the past two-plus years, resulted in job recoveries that occurred in fits and starts. At the same time, aggressive fiscal and monetary policy stimulus employed during the pandemic were accompanied by global supply-chain disruptions. As the North American economies continue to recover, they now do so against a backdrop of decades-high inflation. Tightening labour markets, coupled with highly visible price pressures, have historically fueled rising wages, which drove consumer prices higher still. Concerns over "affordability" has now reappeared as an economic and political issue for the first time in decades. While a return to the late 1970s era of full blown "stagflation" is not anticipated, taking advantage of professional advice and having a rigorous financial plan can help to ensure that investor goals are achieved in challenging environments.

Economic rebound

The extent of the pandemic-induced global recession is without a modern parallel. Both Canadian and U.S. economies suffered dramatic downturns. As can be seen in the accompanying graph, here at home real gross domestic product (GDP) declined by 8.4% and 37.4% (both annualized) in consecutive quarters, resulting in a cumulative 13.0% drop in the first half of 2020, the sharpest recessionary decline on record. To put this into perspective, output fell, on average, by a cumulative 2.5% during the previous six Canadian recessions[2]. A similar story played out south of the border. The annualized quarterly contractions of 5.1% and 31.2% resulted in a cumulative 10.1% decline in economic output during the first two quarters of 2020. The contraction is unrivalled. Once again, by comparison, real GDP shrank by a relatively modest average of 2.0% during the seven prior recessions. Fortunately, the two economies saw subsequent rebounds that were similarly dramatic. In the U.S., the more rapid re-opening allowed output to reach the recovery point during the second quarter of 2021. At the end of the year, overall activity was a cumulative 3.1% above the pre-pandemic high. Despite a quarterly contraction in the second quarter of 2021, Canada's economic activity did hit a new high-water mark by the end of 2021 with output up 0.1% relative to the pre-pandemic peak.

[1] For the purposes of this paper, the current era dates to 1961, when the oldest, consistent quarterly economic data is first available from Statistics Canada.
[2] Generally, a recession is viewed as two consecutive quarters, or more, of negative growth in GDP.

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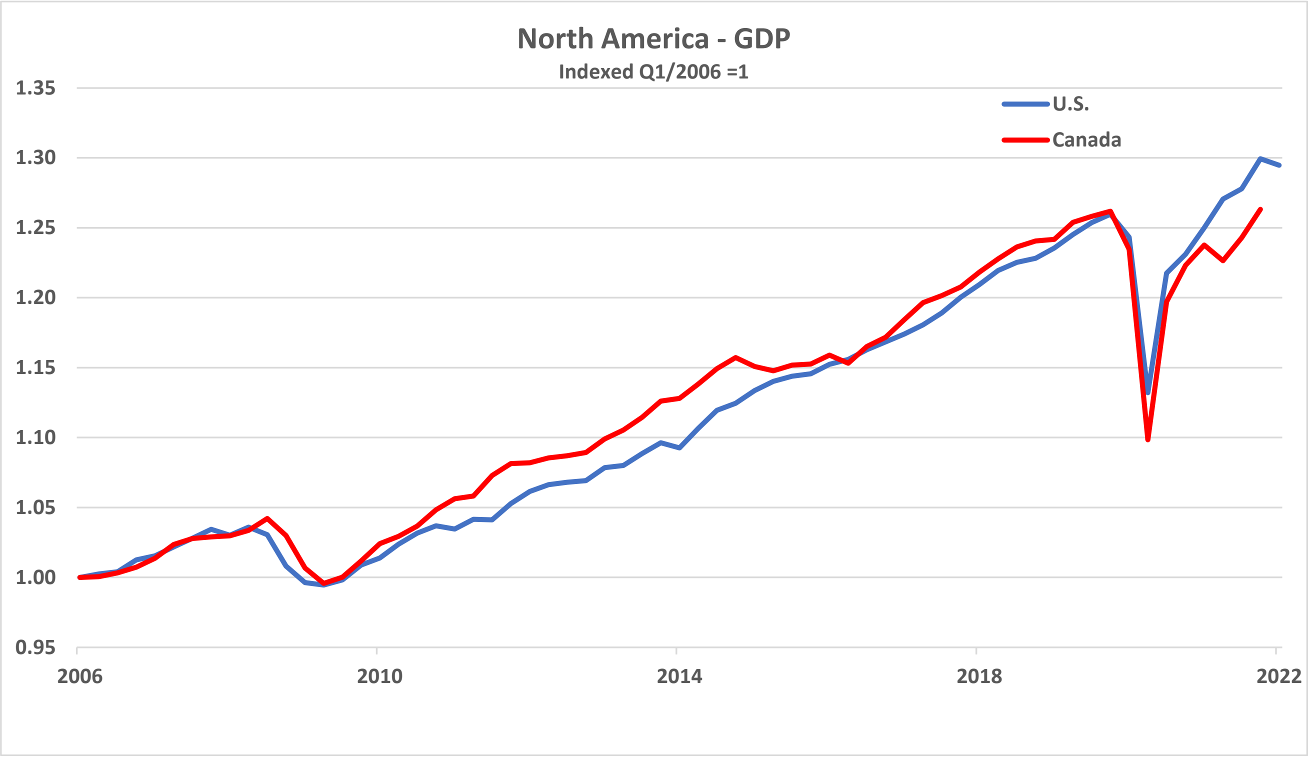

Source: Statistics Canada; U.S. Bureau of Economic Analysis

Employment recovery

Not surprisingly, job losses in Canada matched the contraction in the economy. A total of three million jobs were lost in March and April 2020. As can be seen in the accompanying graph, the participation rate – the percentage of the working age population that is either working or looking for work – fell to a record low of 59.9% in April 2020. Further, the unemployment rate subsequently hit a record high of 13.4% in May 2020. Since then, the recovery of lost jobs has been anything but smooth. Nevertheless, total employment eventually reached a new high in November 2021. Statistics Canada announced that 302,900 more jobs were added between December 2021 and April 2022. At the same time, the participation rate recovered to 65.3% in the April data. And, as seen in the graph further below, the unemployment rate declined to 5.3%, the lowest level on record dating back to 1976. Comparing to precursor data, this rate is now the lowest since July 1974 (5.1%). Stateside, a record 22 million jobs were lost during the first wave of COVID-19 restrictions. Likewise, by April 2020, the U.S. unemployment rate had jumped to 14.7% and the participation rate had fallen to 60.2%. In the April 2022 report, the U.S. Bureau of Labor Statistics reported that the unemployment rate had fallen back to 3.6%, the lowest rate since February 2020 (3.5%). Similarly, non-farm payrolls stood with a 4.6% annual gain.

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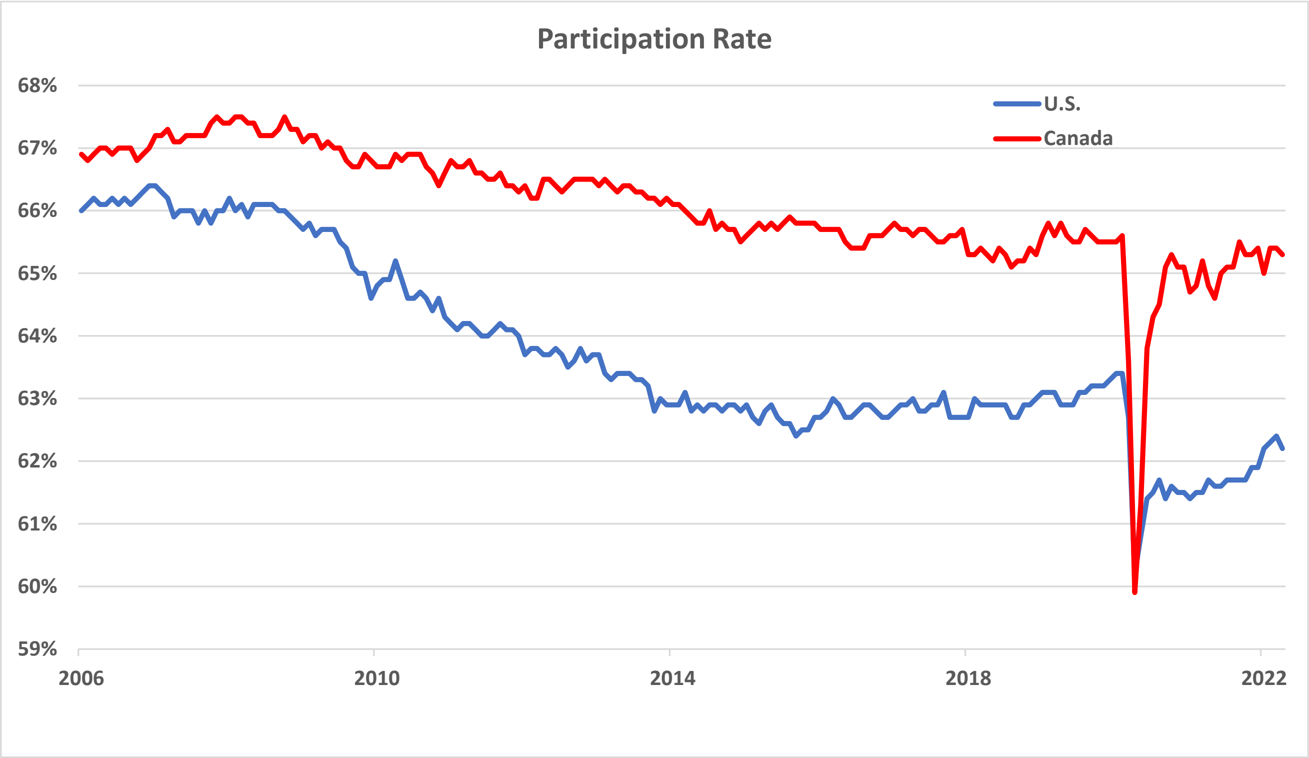
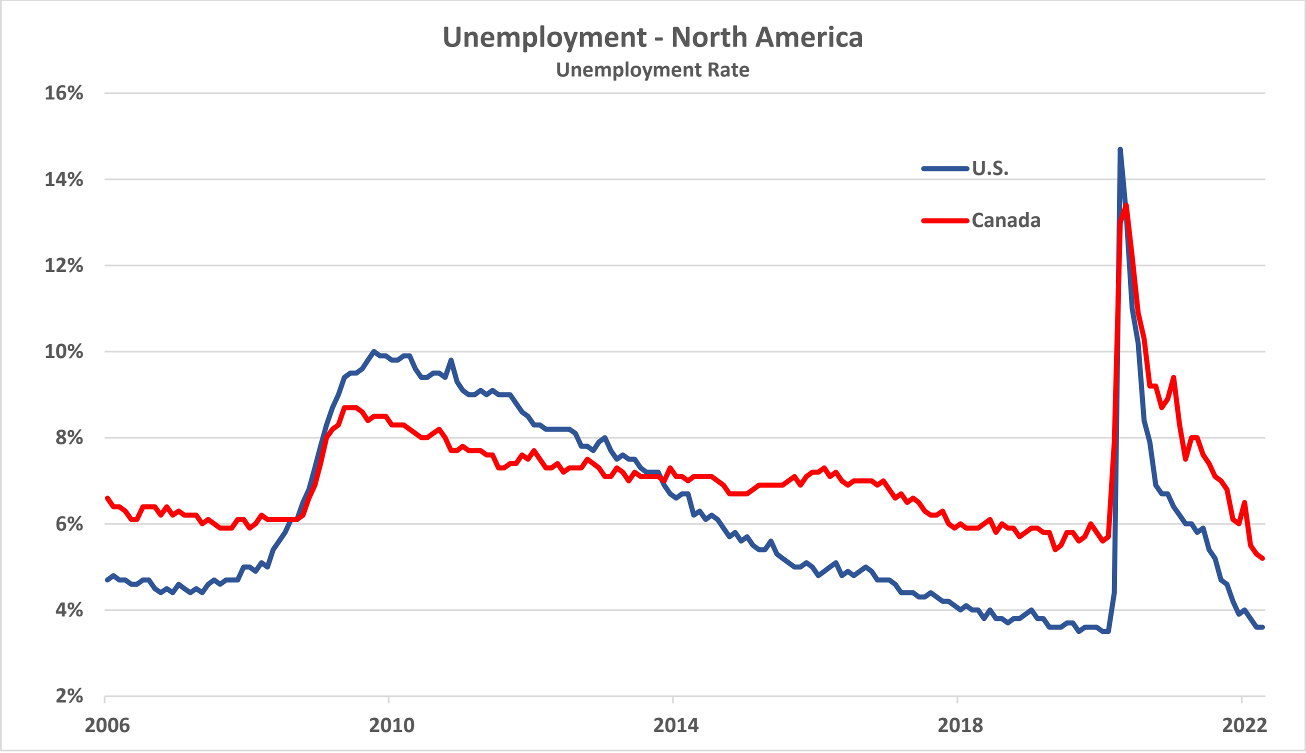


Source: Statistics Canada; U.S. Bureau of Labor Statistics



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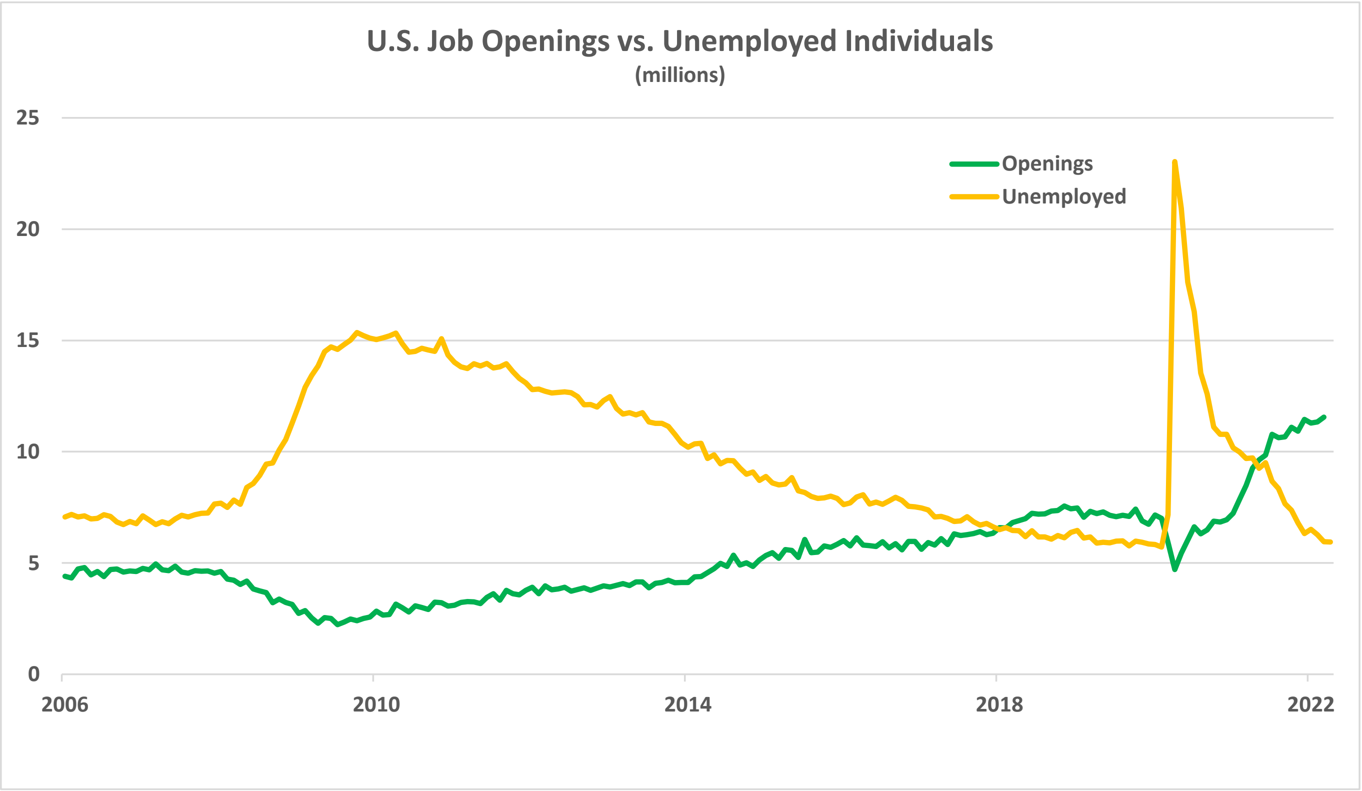
Source: Statistics Canada; U.S. Bureau of Labor Statistics



Source: U.S. Bureau of Labor Statistics

While there are some new figures measuring job openings in Canada, consistent data only goes back to October 2020. Conversely, as can be seen in the above graph, U.S. data clearly shows a fairly typical transition through a recessionary period, similar to that of the financial crisis of 2008/2009. The number of job openings bottomed out at 2.2 million in July 2009. Meanwhile, the number of unemployed individuals continued to rise and then peaked at 15.4 million in April 2010. The improving economy eventually produced an effective “equilibrium” (the number of job openings largely matched the number of unemployed individuals) in February 2018. More recently, these movements were anything but smooth. Nevertheless, the March figures show that job openings stood at 11.5 million and the number of unemployed individuals at 5.9 million. The gap - the 5.6 million more job openings than available workers – is a record for data going back to 2000.

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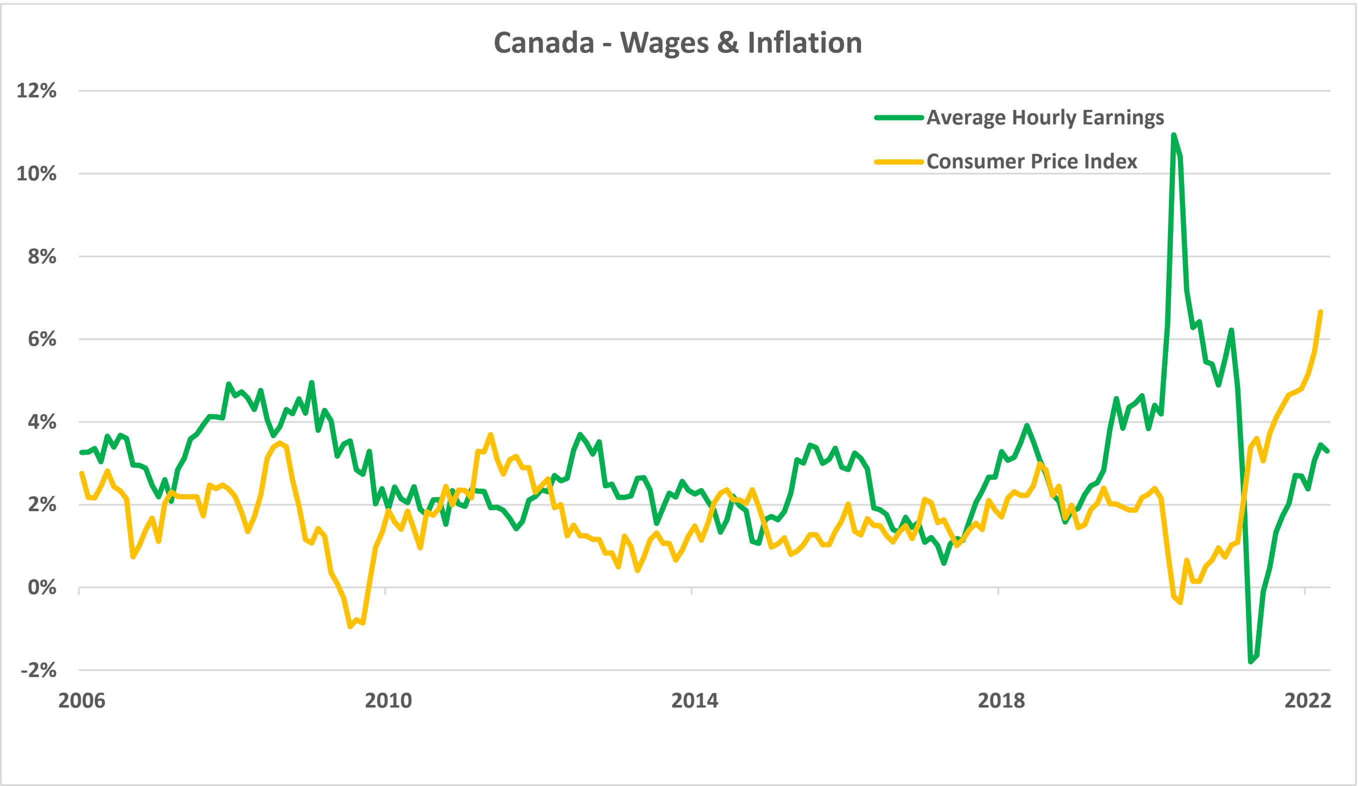
Inflation and wages

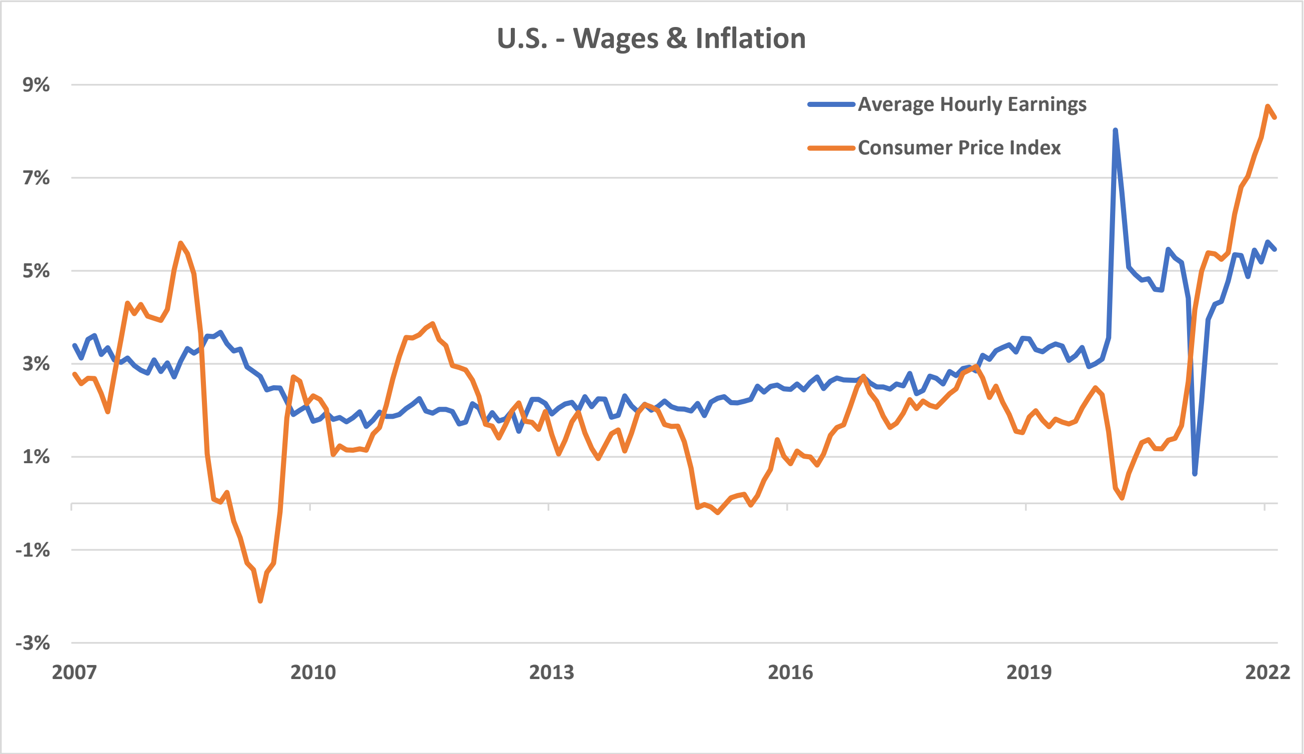


Source: Statistics Canada

Statistics Canada reported that, on a monthly basis, its consumer price index (CPI) rose 1.4% (seasonally adjusted) in March 2022, following a 1.0% gain in February. The March advance was the largest increase since January 1991 (2.6%), when the goods and services tax was first introduced. The March 2022 gain pushed the annual inflation rate to 6.7%, the largest increase since January 1991 (6.9%). Much of the recent movement in the overall CPI reflects the price of energy components, which tend to flow through to all other components in the index. Diminished worldwide investment in traditional energy development projects over the past several years, coupled with increased demand and the conflict in Ukraine, have pushed oil prices sharply higher in recent months. Historically, as Canada boasts the third largest oil reserves in the world[3], this energy price move would have been accompanied by a rising Canadian dollar, which would offset at least some of the inflationary pressures. However, the loonie has fallen over the past twelve months. The CPI data show that gasoline prices stood with a 39.8% year-over-year advance in March 2022. On April 1, 2022, the federal government raised the carbon tax on gasoline by 2.2 cents to 11 cents per litre. This will be reflected in the consumer price data when the April figures are released in May. Not surprisingly, rising inflation and an improvement in the labour market have been accompanied by some gains in wages. Still, average hourly earnings stood with an annual increase of just 3.3% in April, which is less than half of the prevailing inflation rate. Like Canadian workers, their U.S. counterparts also see a vast rift between inflation and wage growth. As can be seen in the following graph, American workers

[3] **U.S. Energy Information Administration.**

saw an annual gain of 5.5% in average hourly earnings during April. This is well below the 8.3% inflation rate posted for the same month. For workers in both Canada and the U.S., increased mobility and rising inflation will mean increased focus on wages as new labour contracts are negotiated.



Source: U.S. Bureau of Labor Statistics

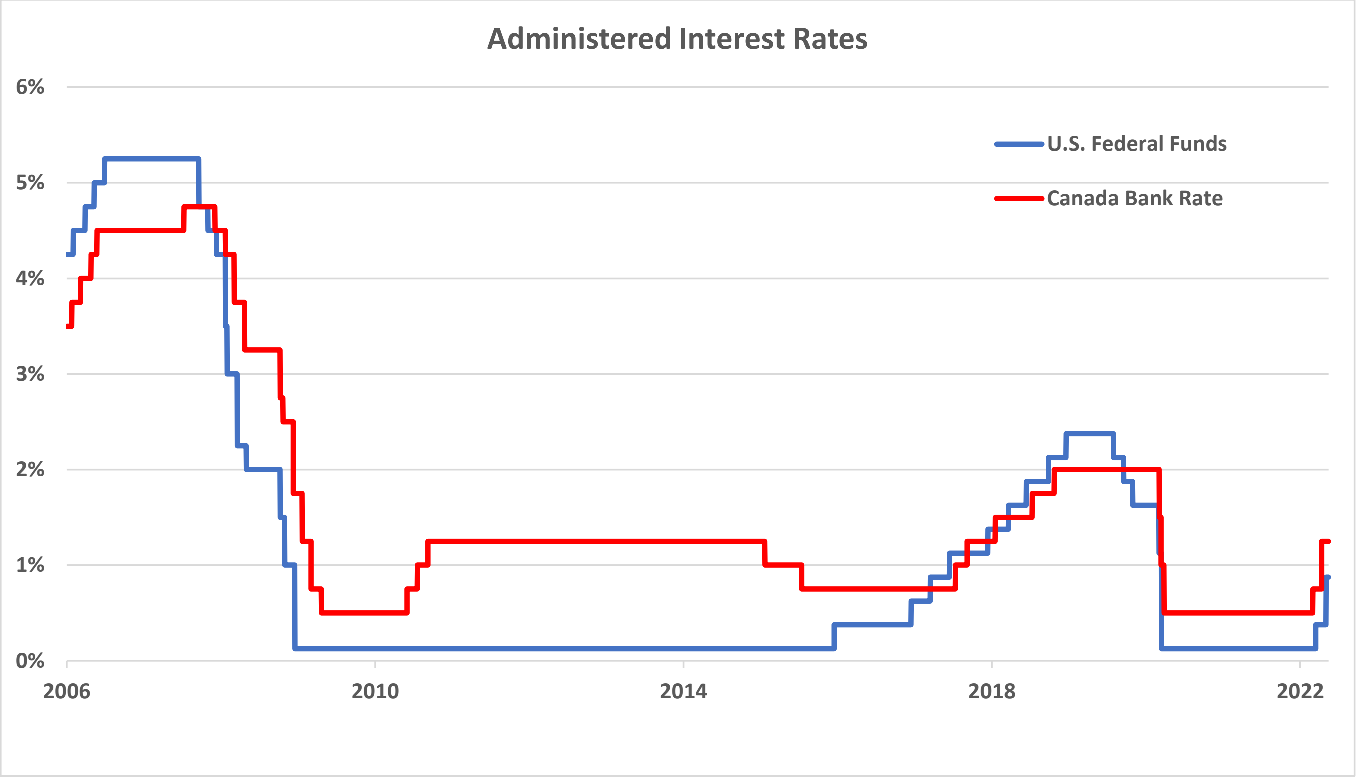
Central bank response

Inflation's steady march higher has revealed a stark contrast from concerns over potential "deflation" that prevailed during the early part of the COVID-19 pandemic. With inflation now running at multi-decade highs, the gaps between the two central banks' targets and real-life price changes have never been as wide. Unsurprisingly, the central banks are now on the receiving end of considerable criticism for failing to maintain their primary mandates. With the separation of actual inflation from targets, the dangerous precedent of rising inflation ***expectations*** is emerging. Accordingly, if workers' inflation expectations are not materially dampened, tight labour markets will reignite wage-driven inflation.

Given the obvious trajectory of inflation, the market was surprised when the Bank of Canada did not raise administered interest rates at their January 2022 policy meeting. At that time, analysts suggested that the delay in raising rates was due to a desire to prevent a move up in the Canadian dollar ahead of any rate action in the U.S. At its March policy meeting, the Bank did announce a 25-basis point (a basis point is 1/100th of one per cent) rate hike. The range for overnight borrowing was set at 0.25% to 0.75% (previously 0.25% to 0.50%). The move also reinstated the 50 basis point range between the deposit rate and the Bank Rate (the

lower and upper limits of the target range). As can be seen in the accompanying graph, this was the first-rate increase since October 24, 2018. At its April 2022 policy window, the Bank announced a further 50 basis point rate hike. The Bank also announced that it was beginning a program of Quantitative Tightening (QT) with bonds from the Bank's balance sheet being allowed to mature without being replaced. This will allow the balance sheet to shrink over time. The last time the Bank raised interest rates by 50 basis points was May 17, 2000, when inflation was only 2.4%.

Similarly, in the U.S., the Federal Reserve (Fed) raised administered interest rates by 25 basis points following its March 2022 meeting, the first interest rate hike since December 19, 2018. A further 50 basis point rate hike was applied following the May 2022 meeting. This was the first 50 basis point rate hike since May 16, 2000, before the fed funds rate was set within a range and the actual target, at that time, was 6.50%. Inflation was 3.2%. In addition, following the May meeting, the Fed released its plan to reduce the size of the Federal Reserve's balance sheet (QT) beginning in June. The initial target was a monthly reduction of US$47.5 billion, stepping up over three months to US$95 billion. Given where North American inflation and interest rates were in 2000, market watchers will continue to debate how far the two central banks are "behind the curve". Reversing public perception of easy monetary policy and aggressive fiscal policy will represent a serious challenge for both governments and central banks. For investors, this paints a challenging backdrop.



Source: Bank of Canada; U.S. Federal Reserve Board

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CONCLUSIONS

- North American labour markets are tightening. At the very least, workers will be looking to not lose ground to inflation. With inflation expectations now fundamentally changed, this raises the risk of a wage-driven price spiral.
- Central banks have begun to tighten monetary policy while governments have shown little evidence of any desire to reign in fiscal stimulus. The markets will continue to view the banks as being behind the curve until there is clear evidence that inflation is coming under control.
- For investors, expectations of rising interest rates against the backdrop of multi-decade high inflation can prompt an emotional response. Taking advantage of professional advice during periods of uncertainty can ensure that emotion does not prompt any departures from their financial plan.

For more information, we encourage you to speak to your advisor or visit us at assante.com