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# Canada Outlook: Forecast Update, Q2 and Beyond

## INTRODUCTION

Normally, an economic crisis warrants a combination of fiscal and monetary policy to stimulate demand and mitigate the damage. The COVID-19 outbreak presents a unique challenge in that an effective public health response is a prerequisite for any of these other measures to truly be effective. To be absolutely clear, by no means would we endorse prematurely abandoning public health measures to reboot the economy sooner. Doing so would unnecessarily amplify the risk of renewing the virus' spread and necessitate that public health measures be re-imposed, prolonging the crisis and exacerbating the economic damage.

# Canada Outlook: Forecast Update, Q2 and Beyond

BY BRENDAN LACERDA

Normally, an economic crisis warrants a combination of fiscal and monetary policy to stimulate demand and mitigate the damage. The COVID-19 outbreak presents a unique challenge in that an effective public health response is a prerequisite for any of these other measures to truly be effective. To be absolutely clear, by no means would we endorse prematurely abandoning public health measures to reboot the economy sooner. Doing so would unnecessarily amplify the risk of renewing the virus' spread and necessitate that public health measures be re-imposed, prolonging the crisis and exacerbating the economic damage.

While grim news abounds, partial data from the government of Canada should provide a glimmer of hope. The public health measures seem to be working. While data for the past week are incomplete, the number of new cases could be slowing (see Chart 1).

This development does not imply that the economic shutdown will soon end. Appropriate caution warrants that several weeks of no new cases will be required before shuddered businesses reopen to the public. Therefore, the Moody's Analytics baseline forecast assumes that economic activity returns to normal in early June.

### Changing assumption

Slight changes in the assumptions for the outbreak's timing and severity imply significantly different results for the second quarter and beyond. The endurance of the shutdown for even a few more months entails more severe labor market dislocations, bankruptcies, worsening credit performance, and a slower recovery.

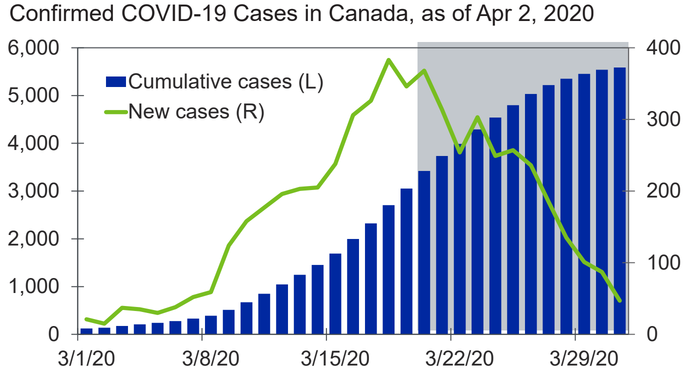
More specifically, the downside S3 scenario assumes that the economy does not re-open until July, just one additional month. But with many businesses trying to keep workers on their payrolls with no incoming revenue, a single month can be the difference between staying afloat and having to shut down permanently. If companies can stay intact and workers are able to return to their old jobs, a stronger V-shaped recovery will take hold.

Alternatively, if these distressed companies disappear, then layoffs will be far greater, and banks will be saddled with defaulted business and consumer loans. This credit crunch sparks a second wave of misery.

As shown by the GDP paths under these alternative assumptions, whether or not business resumes in June implies wildly different forecasts for the second quarter (see Chart 2). The baseline expects an annualized

Chart 1: COVID-19 Case Might Slow

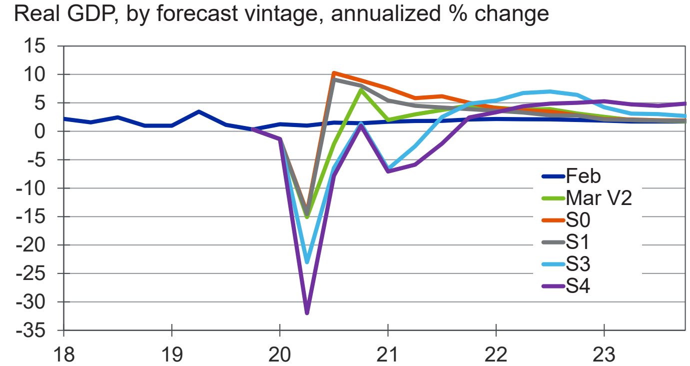
Confirmed COVID-19 Cases in Canada, as of Apr 2, 2020




Sources: Government of Canada, Moody's Analytics *Shaded area is partial data

Chart 2: Economy Sinks Into Recession

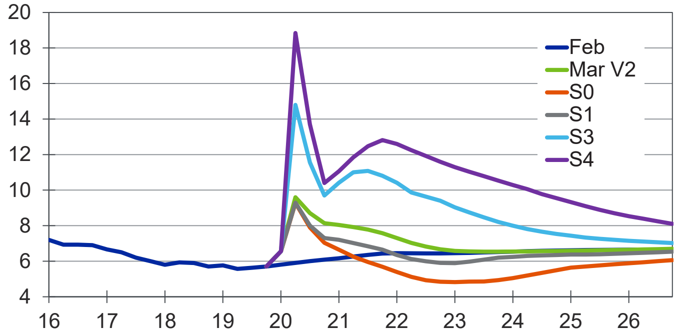
Real GDP, by forecast vintage, annualized % change




Sources: Statistics Canada, Moody's Analytics

## Chart 3: Unemployment Poised to Soar

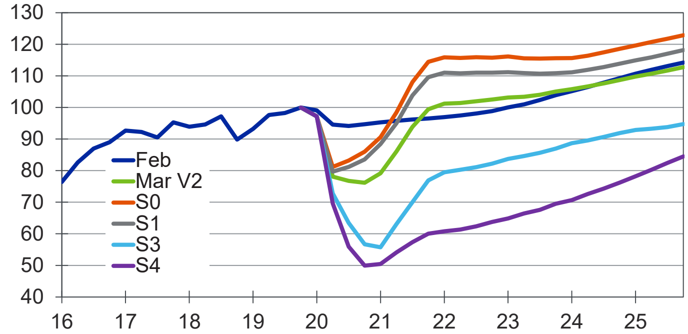
Unemployment rate, by forecast vintage, %




Sources: Statistics Canada, Moody's Analytics

## Chart 4: Equity Prices Shudder

S&P/TSX composite index, by forecast vintage, 2019Q4=100




Sources: SIX Financial, Moody's Analytics

contraction of about 15%. Under the S3 scenario, the loss balloons to nearly 25%. When trying to decipher the myriad of forecasts reported by different financial institutions and economic advisors it may seem that there is significant disagreement. However, as these scenarios demonstrate, it is crucial to look beyond the headline numbers and understand the detailed assumptions that underpin those calculations.

### Labor market

The same holds true for the labor market. The Moody's Analytics baseline forecast projects that unemployment peaks at nearly 10% in the second quarter. This figure represents the quarterly average. Monthly figures for April and May will exceed this level, but with workers returning in June, the jobless rate begins to come back down. If the layoffs extend through the second quarter, unemployment will soar to about 15%, as is the case in the S3 scenario (see Chart 3).

The severity and duration of the pain in the second quarter has significant implications for the ensuing periods, namely whether the first wave of this crisis spawns a second wave of economic malaise. Because the COVID-19 pandemic is unique in recent history, no exact benchmark for comparison exists. However, the Great Recession does provide a useful historical episode for understanding the evolution of the current crisis.

The last recession started as a downturn in the U.S. housing market. The damage was initially modest, but as mortgage defaults surged the financial system became infected and a credit crisis ensued. The collapsing banking system poured fuel on the fire, spreading and amplifying the recession across the globe.

Whether or not history repeats shapes the variation across the scenarios in the second half of 2020 and 2021. In the baseline the recession lasts through the third quarter and unemployment hovers near 8% before more robust growth takes hold in the second half of 2021. In the S3 and S4 downside scenarios, a credit crunch causes further deterioration in GDP and employment in early 2021. A slow U-shaped recovery unfolds as hiring resumes only slowly.

### Equities and commodities

The same features are displayed in the alternative scenarios for equity and commodity prices. In the baseline scenario, equity prices do not experience significant further declines. Instead they muddle through 2020 as the tide turns against the virus. As the outlook begins to improve in early 2021 and business revenue revs back up, the stock market rebounds (see Chart 4).

In the alternative scenarios, the credit crunch invokes further rounds of declines. Under the S3 scenario, equity prices suffer a peak-to-trough decline of about 45%. Even with modest growth it takes years for the stock markets to recover their previous highs.

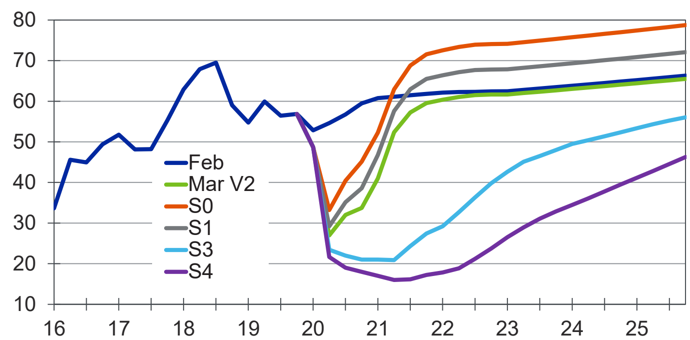
With commodities, demand is key. Lost demand is playing a larger role in energy price moves than the supply dispute between Russia and OPEC. Under the baseline, as workers begin commuting again and airlines resume flights, oil prices start to record sustained gains in late 2020 and early 2021. But with the economy remaining shut down longer in the alternative downside scenarios, commodity prices remain depressed for a considerable time (see Chart 5).

### Stimulus

Policymakers have made clear that they will provide unprecedented stimulus. The baseline and scenario forecasts incorporate all measures that had been announced as of March 27. This includes the Bank of Canada's policy rate cut to 25 basis points. The bank has also announced a series of extraordinary measures: (1) expanded term repo facilities,

## Chart 5: Oil Prices Plunge

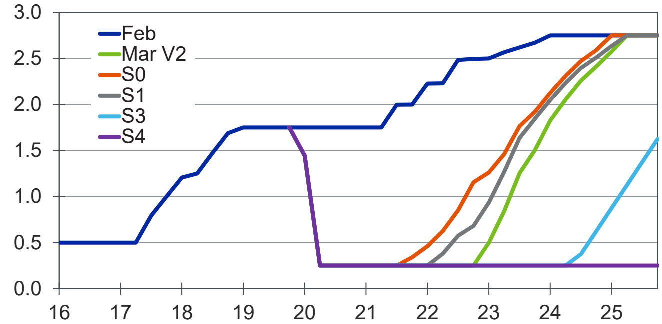
West Texas Intermediate, by forecast vintage, US$ per bbl




Sources: EIA, Moody's Analytics

## Chart 6: Bank of Canada Deploys Stimulus

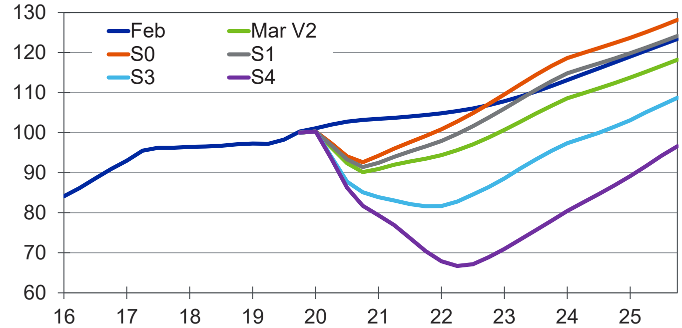
Policy rate, by forecast vintage, %




Sources: Bank of Canada, Moody's Analytics

## Chart 7: House Prices Tumble

RPS house price index, by forecast vintage, 2019Q4=100




Sources: Statistics Canada, Moody's Analytics

(2) government bond buybacks and switches, (3) purchases of Canada mortgage bonds and bankers' acceptances, (4) purchases of provincial money market instruments, (5) yield curve control, buying government debt of all maturities on the secondary market to the tune of C$5 billion per week until the "economic recovery is well underway," and (6) a Commercial Paper Purchase Program.

Incorporating these unorthodox measures into the model presents challenges. To do so we assume that these measures minimize public and private credit spreads.

### No quick BoC pivot

Given the Bank of Canada's forward guidance, Moody's Analytics does not expect that the bank will pivot on rates until the first quarter of 2023, when unemployment has returned to 6.5%. Under the S3 scenario, normalization does not begin until more than a year later in mid-2024 (see Chart 6).

The forecasts also include the approximately C$100 billion package proposed by Prime Minister Trudeau. We anticipate that the package will be successful at addressing the economy's short-term challenges, but more stimulus will likely be needed. Fortunately, the Canadian federal government has significantly more fiscal space than most advanced economies. However, the fiscal position of the provinces is much less healthy, and they will likely require assistance.

The forecast does not presently include any additional fiscal stimulus. Given the wide array of forms that future fiscal stimulus could take, our general approach is to include only such measures until policymakers have clearly outlined their size and composition.

Reduced interest rates will not save the housing market. Our previous analysis has shown that the health of the labor market is the dominant factor determining the direction of house prices. By our estimates the elasticity between unemployment and house prices is about four—that is, a 1-percentage point increase in the unemployment rate causes house prices to fall by 4 percentage points.

Through savings and government-funded income support, the initial second-quarter spike in unemployment is not the relevant factor in determining the decline of house prices. Rather, with unemployment settling around 8% in the second half of 2020, the trend jobless rate will be around 2.5 percentage points above its prerecession level. Thus, in the baseline scenario house prices suffer a peak-to-trough decline of about 10% (see Chart 7).

In the S3 scenario, trend unemployment in 2021 holds around 10.5%, a 5-percentage point increase. Therefore, house prices tumble about 20% before bottoming out.

### Recession unavoidable

Last, we should note that even in the upside S0 and S1 scenarios recession is unavoidable. Barring some miraculous pharmaceutical remedy or quick vaccine, the public health measures appear to be the best tool to defeat the outbreak. These actions will require that the economy remains in shutdown for most of the second quarter. The variation in the forecast scenarios reflects the ambiguity surrounding the outbreak's timeline, the extent to which it evolves into a credit crisis, and whether policymakers can implement the appropriate stimulus to mitigate the fallout.

## About the Author

Brendan LaCerda is an associate director and senior economist with Moody's Analytics. Brendan serves as the lead analyst for the Canadian economic forecast. His primary responsibilities also include the development and improvement of country forecast models. His research is primarily focused on international macroeconomics, healthcare and fiscal policy. Before joining Moody's Analytics, Brendan worked as a senior economist with IHS Global Insight's U.S. Macroeconomic Service. Brendan received his PhD in economics from the University of Virginia. He pursued his undergraduate education at the London School of Economics and the University of Notre Dame, where he graduated with a BA in economics and mathematics.

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