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Mark Noble:
Hello. I'm Mark Noble, Executive Vice-President of ETF Strategy at Horizons ETFs, and welcome to our latest episode of Generation ETFs.

We've discussed quite a bit in past episodes about a potential regime change to the global economy as investors and economic forecasters deal with the most severe rise in inflation in really, more than 40 years. This threatens to reorient the way we think about economic relationships as, very quickly, the long-term regime of low-interest rates, relatively low wages, and global supply chain production are all at risk of becoming unraveled. How governments and institutions react is still a source of debate, as we start to embark on economic conditions that we really haven't seen in more than a generation. There's not really a game plan, in recent years, to be used to understand how we will deal with this from a policy perspective.

Mark Noble:
With us today to discuss what we might expect from both the economy and central banks is Warren Lovely. Warren is Managing Director with National Bank Financial, serving as Chief Rates and Public Sector Strategist within the firm's highly regarded economics and strategy group. Warren joined NBF in 2015, from CIBC, where he'd worked for 15 years in a variety of roles in economic strategy and debt underwriting. Before that, he'd worked for the government of Canada Ottawa, including the Department of Finance. He has a considerable history in terms of understanding how fiscal and monetary policy are crafted in Canada and how policymakers might respond to these challenges we see today, particularly with inflation. Warren, it's a real pleasure to have you here today.

Warren Lovely:
My pleasure, Mark. Thank you for having me.

Mark Noble:
I thought we'd just start with the general health of the Canadian economy. It's a bit of a broader question, but there's a lot to be said about the state of the Canadian economy. Consumers are still in the brunt of inflation. We've seen real estate prices peak, in early March, and late February. Surging commodity demand is providing a little bit of economic boom for some parts of Canada but creating shock at the gas pumps.

Then we also have labour; labour continues to be tight, despite some of these challenges. I'm wondering, where does this all, in your opinion, end up? Do you think that a lot of these macroeconomic factors could be making a strong case for a recession within the next 12 to 24 months?

Warren Lovely:
Well, there's a little bit to unpack there, Mark.

Mark Noble:
Yeah, quite a bit.

Warren Lovely:
Let's just take a step back and think about how the Canadian economy is performing from a high-level perspective. Really, I think it's critical to note that we've sustained a lot of damage during the pandemic. But what has happened, of course, in the last two years, is a very rapid recovery in a lot of the key metrics that economists and central banks are focused on. We've seen real GDP recover substantial ground, [and] really make up what you might call a full recovery. We know that labour markets, hiring, and employment levels have really proven surprisingly robust, getting back to pre-pandemic levels quite quickly. We know that the housing market, as you indicated, has really been on fire, until quite recently.

Warren Lovely:
If you take a step back, from a high-level perspective, here we have a Canadian economy that appears to be operating at quite a high level. It's maybe the case that we've overachieved in some respects, because the concern, the mounting concern, the chief concern now, of course, is that maybe we have too much of a good thing, too much excess demand, too tight labour market conditions, really a shortage of available workers, that's risking a pickup in wages. And, of course, we've got growing and mounting evidence of really extreme inflation. What this is prompting, is a big reaction from central banks.

The worry now is that we've moved very rapidly into a much less accommodative interest rate policy stance here in Canada, in the US, soon in Europe, in England --really across the globe. Central bankers are getting on with rate hikes and getting on with them quite quickly. As a result, we're taking on, and creating, some pretty significant near-term risks for a highly levered Canadian economy.

Mark Noble:
Well, and that just moves into my question about a potential recession because, as you highlighted, it's almost too much of a good thing, but a lot of that, as you pointed out, was driven by fiscal stimulus. And we've had supply chains impact inflation, but a lot of that fiscal and monetary stimulus that we've seen seems to have driven some of these asset price bubbles that have occurred.

I wonder, how quickly does that unravel, though? If you start to meaningfully see an increase in prices, which we've seen, coupled with the dual effect of higher interest rates?

Warren Lovely:
Well, I think this speed factor that you're raising is really a critical element here. Everything has just been happening super-fast. You think about the pandemic; super-fast onset of extreme, in many cases, unprecedented economic weakness, followed by very rapid surprisingly quick recoveries and jobs and consumer behavior and housing markets. We really have been on an accelerated, almost warp-speed timeline in terms of economic evolution. What was interesting is that last year, despite this rapid recovery, central bankers were sitting back saying, "We're still comfortable to keep policy quite accommodative [and] interest rates very, very low because we want to make sure we recover. There may be some inflation risk, but we're confident those will be temporary or transitory." What has, of course, changed now and the big risks that we're getting our heads around and markets are having to come to terms with, is that central bankers woke up late last year to the realization that inflation is not going to be temporary and transitory.

Warren Lovely:
That change in thinking at the Bank of Canada, at the US Federal Reserve, really, again, across the globe, and the resulting rapid increase in interest rates that we're now going through, has unsettled markets to some extent. You look at the equity market weakness that we've seen this year. [When] you look at readings of market volatility, and elevated liquidity deteriorating risk measures, in general, are flagging anxiousness [and] anxiety as we contend with these now very rapid interest rate hikes.

So, you're absolutely right. It's the speed of onset monetary tightening. Just the rapid back-to-back-to-back interest rate hikes we're contending with that pose more of a risk. What it means is that we could more quickly overshoot, or more quickly get to the pain threshold for the economy and tip things into, perhaps, a recessionary type environment. or, certainly, an environment of considerably slower growth.

Mark Noble:
My concern -- and I'm curious about your thoughts on this because you've been covering this space for quite some time is there a playbook for the current set of central banks to look at this? In the past, when you go through the readings, whether it's the BOC or the Fed, for years, they have been talking about the 2% core inflation target and employment. If they were using that playbook, then they're not thinking about inflation, maybe to the same degree. I'm wondering, do they have to radically rethink how they approach monetary policy, and is there any experience in doing that? I think Paul Volcker had a good 10 years to digest what was happening with inflation before he decided to go the route he did but we haven't seen this kind of inflation for 40 years.

Warren Lovely:
Great question and prescient observation. Is there a playbook? No, we're writing it on the fly. In the same way, to be clear, we didn't really have a current policy playbook for a pandemic. Not too many people were alive during the Spanish flu. You can, I guess, forgive policy makers and governments, perhaps, in retrospect [of] what may have been an overreaction in terms of providing stimulus to the economy. But, look, it's hard to criticize the policy actions that were undertaken in 2020. I think what we can be a bit more critical of is just the laxness of policy, the kind of ease with which we kept [the] monetary policy in place all through 2021, once we got back to full employment, once inflation really started to get going.

Warren Lovely:
Again, I think to some extent, if you wanted to defend central banks, you'd say, "Well, look. We didn't really have a playbook for recovering from a pandemic." So again, maybe we forgive them. It's water under the bridge. But I think the reality is, maybe that if we look past, past mistakes, what we've got right now is a raging inflation problem, sky-high inflation, that's necessitating a quicker response in monetary policy than we've really ever seen before and not a lot of really good precedent to lean on.

Warren Lovely:
The other thing I think we have to acknowledge, as well, is that it's not just the policy interest rate that we're banging away at. We're also doing some really unique stuff at central banks in terms of balance sheet management. I don't want to get too technical here, but quantitative tightening or shedding of assets at the Bank of Canada, at the Fed, at the ECB, at the Bank of England, and on and on and on, is another rather unique dimension here. What it means is that we've got a couple of streams of monetary policy tightening underway now. Yes, policy rate hikes, the benchmark interest rates moving up, but also balance sheets shrinking at central banks, which are also going to tighten financial conditions, and again, makes this normalization process, if you want to call it that, quite a bit unique and really quite dissimilar with what we've had in the past. This is not your standard monetary policy tightening cycle. It's nothing like what our prior generations would've lived with. It will truly be unique from any type of historical perspective.

Mark Noble:
Again, it's hard to know what to expect on a go-forward basis, because we are treading into the unknown, as you've highlighted, but are there any particular areas of the economy or sectors where you have some winners and losers in this regime? Because I think that's also a key point of debate. What gets impacted by this? Where, as an investor or a forecaster, do I look to see areas creating opportunity, and also areas where I need to be deeply concerned?

Warren Lovely:
Well, let's take a step back. In terms of winners and losers, I tend to put Canada in the winner camp here, just from an international perspective. We'll talk about sectors in a moment but just think about Canada's relative position in today's global economy. I don't want to overplay the

importance of a resource sector or commodity sector here in Canada, but let's be honest, we have an outsized contribution to economic activity from resources in Canada versus a lot of our peers. We also have, I think, a really unique opportunity to substitute for pariah nations here. Substitute for Russian oil and gas, maybe Ukrainian wheat--pick your commodity. We have an export basket in Canada that overlays very nicely with-

Mark Noble:
Uranium, instead of Kazakhstan, right?

Warren Lovely:
You got it. You got it. You can do a long list of resource sectors that may stand to benefit. We, of course, know what's happening with those prices and the resulting profitability in those sectors. There, I'd say evidence pretty clearly of winners.

Warren Lovely:
I think another point and, Mark, you touched on this already a couple of times: let's think about the fiscal winnings that we have in this country. This is a non-trivial point. We have in Canada, now, a really tremendous expansion in nominal income, nominal GDP. The income we're generating in this country is flowing in the door fast and furious, and governments are getting to clip a good share of that through taxes and royalties and the like. Let's again state a really important point; governments aren't just saving all that extra revenue. In fact, increasingly what we're seeing is governments turn that extra revenue back to the economy through spending, affordability measures, maybe some selective tax relief, and larger infrastructure programs. Fiscal policy and governments are winners here, clearly. Where, of course, you worry are sectors that are highly, highly leveraged, where you've got a lot of indebtedness accumulated, where higher interest rates bite. Of course, housing is on the front line here. The sector more than anything that we're worried about right now is the Canadian housing market, which again, you talked about economic weights and importance to a national economy. This is a big one. We're subjecting the housing market in heavily indebted Canadian households to some really extraordinary interest rate hikes. Higher interest rates are already showing up and having an impact, leading to a deceleration in housing market activity, as you noted.

Warren Lovely:
This is, I think, the chief area where we're worried and where we need to expect ongoing and, perhaps, significant weakness. The hope, at this juncture, is that we can find some sectors of the Canadian economy that can compensate for an almost certain correction in housing. This is where the profit picture that I mentioned becomes really important because maybe it generates an opportunity for us to substitute away from housing investment, [and] towards business investment. Imagine that. We haven't done a whole lot of that in Canada. There's perhaps an opportunity to do some of that, alongside fiscal policy government spending that I touched on, that could also help spur the economy along, and avoid the hard landing scenario that some pundits have been talking about.

Mark Noble:
If I understand that correctly, you've basically got two different kinds of push-pulls in Canada. You obviously have this extraordinary opportunity of being a politically stable commodity powerhouse, which somewhere the world is going to look to as a leader in these crucial areas. But then you, on the opposite side, we have an extraordinarily highly levered consumer balance sheet, which has primarily been focused on housing over the last decade. But you think the pendulum -- if we see a de-leveraging of the Canadian consumer balance sheet-- do you think there can be an offset from the income we could generate from these "inflationary sectors," let's call them? Is that a realistic assumption?

Warren Lovely:
I hope so, and I believe so.

Mark Noble:
Okay.

Warren Lovely:
Look, the downturn in housing that, as you noted, it's already started. It's already in train, and it's not just in one or two markets. This isn't 2017, 2018 all over again. We didn't have one or two housing markets in Canada, in the last couple of years, that went through extraordinary price gains. It really was broad-based pervasive housing price increases. So, we have a broader national housing market that's going to be subjected to some really extraordinary interest rate hikes. The downturn there, the correction is almost assured. In fact, the Bank of Canada is effectively telling us they want a housing market correction. They're telling you that housing prices are unsustainable high, that there are a lot of attendant-associated financial system risks, and we need to get those risks under control. Hence, the higher interest rate policy that I talked about.

Warren Lovely:
We know we're getting that. The hope here is that we can find these offsets, economic offsets we've dubbed them, to compensate for and pick up some slack. Again, when you look, the most obvious candidates, to me, are business investment spending, of course, in the energy sector and the broader resource sector, but perhaps, outside of the non-resource sector as well, because we know labour is getting a lot more expensive. Maybe there's an opportunity for Canadian businesses to invest in machinery and equipment and IP to drive future growth and meet future demand. We know that governments are supportive. And that is, again, I think a key advantage. We talked about winners and losers. One of the big advantages Canada has had for ages is a government sector that's much more fiscally sustainable than what we see in other parts of the world. Government balance sheets are in a position to support the economy, and we're doing just that at the federal and provincial levels.

I have some confidence that we'll find some offsets. I think we also need to acknowledge, Mark, that while housing is correcting, and it will correct, we still have a Canadian consumer sector that looks to be in pretty healthy shape.

Mark Noble:
Yeah. Yeah, it's very strong.

Warren Lovely:
We've got a lot of income growth, and wage growth. We still have some excess savings to draw on. So yeah, I'm not looking for consumer spending to accelerate, but I think the doom and gloom scenario on the Canadian consumer might not be as acute a risk as some believe.

Mark Noble:
Well, I think you've covered most of what we wanted to discuss today. I have one just area that I wanted to hit on, just because I'm curious about your opinion as a rate expert. Obviously, people keep pricing in future rate increases, and we've talked about the reasons and the thinking of the central banks. As you've highlighted, they may go harder and faster than the market may bear. How far is that, in your opinion? There's a second part of this question because there's also a discussion that the market, particularly the capital market, seemed to already be pricing in worst-case scenarios on the interest rate curve, on inflation, and might be doing some of the work that the central banks might be doing. I know that the Dallas Fed chair, a few weeks ago, was saying just exactly that, that the corporate bond market was doing some of his job for him. What are your thoughts there? Where do you think rates potentially shake out in this whole scheme of things?

Warren Lovely:
Well, again, let's acknowledge the obvious, that the rates market globally, and certainly here in Canada, has reacted and reacted forcefully to this change of tone from central banks. If you look at changes in global bond yields, these are extraordinary increases that we've observed on a year-to-date basis. We've re-priced interest rates massively. Across the curve, we've seen, in many cases, doubling of benchmark yields, like 10-year yields in Canada now approaching 3.3% -- really exceptionally high and significant increases, relative to our recent history. The market has moved and has effectively discounted that tighter policy that I talked about. It's now for central banks to validate those expectations. I think they're in the process of validating them. I think we need to be prepared for the Fed, for the Bank of Canada to be banging away and banging away quite forcefully in July, in September, with interest rate hikes.

Warren Lovely:
Again, I think the key question is, by the time we get to the Fall, we're likely to have seen some slowdown in economic activity. Will we have seen a slowdown, or moderation in inflation, to allow central banks to back off? That's still the open question at this juncture.

Mark Noble:
Yeah. Yeah, it is.

Warren Lovely:
I think the farther and the higher we go and the faster we go, the greater the risks are of a harder landing. Maybe, you bring closer the time for when central banks actually have to reverse themselves. We're still hopeful we can achieve a soft landing. We're hopeful that central banks maybe don't have to go to ultra-extreme, truly restrictive levels. But all of that, of course, is going to hinge on getting some relief in inflation. We're not getting that anytime soon, but there's still a hope we could get that before the year is out.

Mark Noble:
And, I guess, the economic data that we start to see trickle in over the next six to 12 months is going to give you a sense of that, right? I mean lagging indicators like employment and things like that, which could be in decline right now, but we really won't know for a few months.

Warren Lovely:
That's right. That's the thing. We're operating, to some extent, with blinders on or incomplete information. Thankfully, in things like housing markets, we have pretty good timely data to help gauge and react in terms of monetary policy, but on unemployment, on inflation, you're absolutely right. Take some time to really understand where things are. When you're moving very rapidly, as we are we're not in anything approaching a steady-state, you sometimes don't know, where the underlying health of the economy is. That's why, in the past, it's sometimes been beneficial to move more deliberately on policy, on interest rates, because it would allow you to assess how things are unfolding. When you go super-fast, hurry-up offense, it's harder to really ascertain where the underlying economy is. That's why I say moving so quickly, moving so aggressively, creates a risk that you overdo it. You get beyond some type of threshold that the economy can bear. That's, again, the problem with unprecedented monetary policy tightening, but that's what we're going to have to contend with for the balance of this year.

Mark Noble:
Well, Warren, this has been fantastic. We're definitely going to have to have you come back if you're open to it because I thought this was a really awesome discussion. I think we don't have a lot of answers here, which is exactly what we're trying to achieve, because this is complex, uncharted territory, but I really do appreciate you taking the time and really providing what I thought, for me in particular, was incredible educational context to what's going on. I think our investors and listeners are really going to enjoy this conversation as they start to think about their portfolio and their investments from a more macro level. Thank you so much for joining us today.

Warren Lovely:
Yeah. My absolute pleasure and I'd be happy to come back anytime. Take care.

Mark Noble:
Okay. Thanks, Warren.