Economics | Forecast / Outlook Reports

Economic Analysis of Ontario

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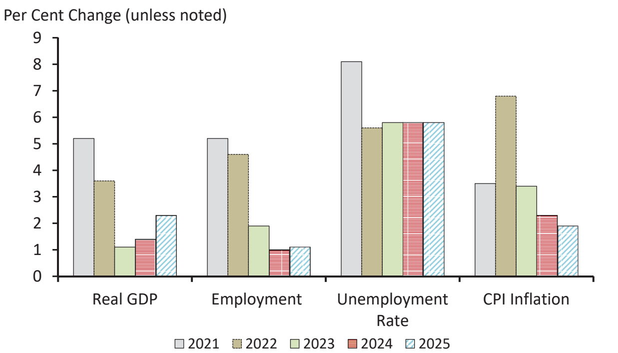
central 1 Economics

Ontario Economic Outlook 2023-25

Ontario's economy is forecast to slow this year in line with the broader economic backdrop. Following a solid 2022 where the province aligned closely with national performance, gross domestic product (GDP) growth is forecast to slow to 1.1 per cent and comparable to levels observed in the early 2010s as tighter monetary policy conditions and declining real income over the past year weigh on growth, while business investment and trade is tempered by a broader slowdown in growth. While we anticipate a recession to be avoided, Ontario will experience a modest period of lower economic growth through 2024, weaker housing starts and a modest uptick in the unemployment rate. That said, the initial conditions of a tight labour market and elevated savings are anticipated to ensure any downturn is mild.

Ontario economy stalls as higher interest rates bite



Source: Statistics Canada, Central 1

Key macro themes

Economic themes have shifted almost weekly in a volatile start 2023. Financial markets have ebbed and flowed with the conflicting pressures of economic data and banking sector stress. Global economic output continues to rise, helped along by China's re-opening. Inflation remains excessive with headline year-over-year growth still above 8 per cent for the G20 economies, and even higher amongst all OECD (Organisation for Economic Co operation and Development) nations. Stubbornly high inflation and a labour market that refused to cool even as rates propelled higher drove the early-year drumbeat of U.S. Fed promises to aggressively hike rates further, but resolve has been tested by the financial instability concerns and regional bank failures.

Interest rate expectations have oscillated and pared from early year highs due to U.S.-related events. In a sign that the rapid rate tightening finally broke something in the system, several regional U.S. banks failed following an outflow of deposits and losses on financial assets. However, the failure and deposit run of Silicon Valley Bank and others was more likely driven by bank-specific factors related to poor risk management, concentration risk, and portfolio duration that is unlikely to have long lasting systemic impacts. Backstops from the Fed and Treasury have stemmed contagion but added uncertainty slows credit growth and has lowered expectations for the Fed's terminal rate from that preceding the bank failures and risks of a more pronounced recession.

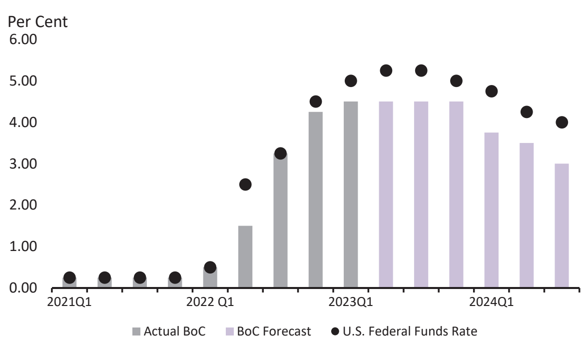
Economic signals remain mixed but a slowdown in activity has yet to fully materialize with the long and variable lags of monetary policy still winding through the economy. The U.S. economy expanded by 2.6 per cent in Q4 (and 2.1 per cent for 2022 as a whole) but slowed to 1.1 per cent in Q1 on weaker investment and inventory drawdown. While housing remains heavily constrained by higher interest rates, and the technology sector has stumbled badly, labour markets remain tight including another solid increase in non-farm payrolls in March and an unemployment rate that dipped to 3.5 per cent. These figures do not capture recent banking sector woes, and markets and forecasters (including the Fed) expect a significant slowdown in the back half of this year including the prospects of a hard landing, although ongoing economic momentum is leaning against this narrative. Markets are anticipating the Fed Funds rate to top out in a range of 5-5.25 per cent which cuts in the back half of this year. This marks a lower terminal rate than priced earlier this year, although we expect the market to be disappointed by the timing of rate cuts given as inflation remains more persistent and elevated than expected and the labour market remains strong.

The Canadian economy has similarly been resilient. The economy expanded 3.4 per cent in 2022, an unexpectedly strong pace given the news flow surrounding recession risks, rapid interest rate gains and a housing market correction. Growth slowed in Q4 as GDP stalled with some signs that the slowing outlook is curbing business investment. At the same time, data for Q1 shows a swing back to growth. Labour market conditions have remained robust with employment up an annualized four per cent, while industry- GDP tracking a near 2.6 per cent Q1 increase. The economy is proving to be stronger than expected propelled by record population growth which saw over million persons added in 2022. The housing market, while operating in a low volume environment is experiencing price stabilization on low inventory.

Nevertheless, we expect the economy to slow during the latter three quarters of 2023 as higher interest rates and slower global growth curbs export and investment activity. Higher interest rates will continue to bite on consumers. Impacts of higher interest rates on variable rate mortgage have thus far been tempered in part by shifting of share of payments from principal repayment, but mortgage renewals are likely to boost payments for more borrowers going forward, while business investment slows. Housing construction will also decline in response to low resale transactions and poor pre-condo sell through Canadian GDP growth is forecast at 1.3 per cent this year based on the early year pick and average a similar pace in 2024. We do anticipate a significant recession in Canada, although GDP growth could turn mildly negative for a couple quarters. Rapid population gains over the past year and excess savings keep consumer demand modestly positive. The labour market is expected to cool with slowing employment growth and a mild pick up in the unemployment rate.

The Bank of Canada's conditional policy rate pause at 4.5 per cent is forecast to continue through 2023 despite market pricing for a cut late in the year. The Bank can afford to trail Fed rate hikes given high Canadian debt loads and interest rate sensitivity, while inflation and wage growth trends have been constructive and decelerating. That said, headline inflation remains too high, and we expect the Bank to wait until a retreat to near the 2 per cent target to cut. Having been late hiking rates in the recent inflationary episode, it will be more cautious in its decision to cut rates particularly given the strength in labour markets. We forecast a cut in early 2024, and a 2.75 per cent policy rate by year end, before stabilizing at 2.5 per cent in 2025.

Elevated policy interest rates to continues through 2023

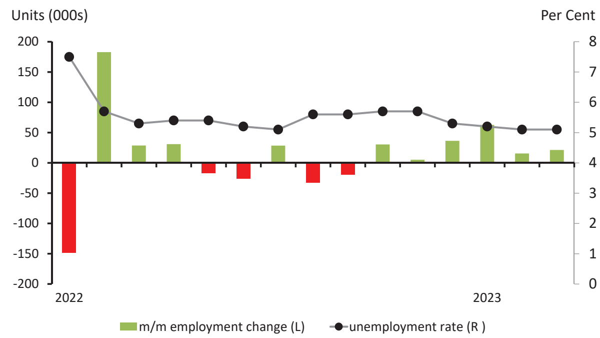


Source: Bank of Canada, US Fed

Ontario

Ontario economic growth was consistent with the broad national picture in 2022. We estimate that GDP grew by about 3.6 per cent following 4.3 per cent growth in 2021. The province has recovered from the pandemic, but the process has been uneven given stricter COVID-19 restrictions early in the pandemic and during the Omicron phase. Annual employment growth reached 4.6 per cent, while the unemployment rate retreated from 7.5 per cent to 5.3 per cent.

Labour market strength persists in early 2023

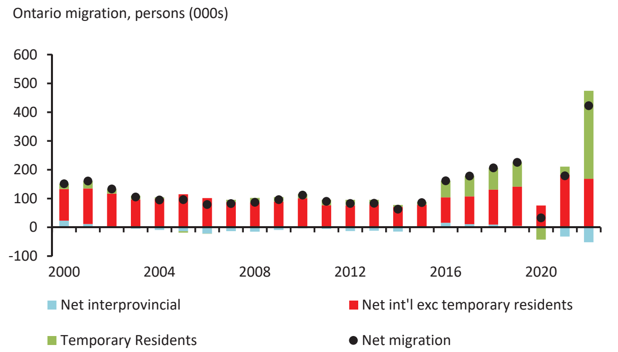


Source: Statistics Canada, Central 1

Early 2023 patterns have remained positive. Employment continued to rise despite economic concerns with continued hiring given a shortage of workers and supported in part by an expansion of the labour force amidst historic levels of immigration. Businesses continue to report a shortage of workers although the acute challenges from 2022 have abated. Key industries driving the growth have included government, knowledge sectors, hospitality, and finance/real estate, although the weak housing market has curbed gains in the latter. Strong population growth and firm labour markets continue to lift consumer spending with retail sales on the rise albeit at slower pace of about 2 per cent y/y alongside robust wholesale demand, while the recovery in services demand remains elevated. Growth in household spending accelerated to six per cent in 2022.

High inflation, which averaged seven per cent in 2022, outstripped wage growth and dragged on real income, but consumer spending continued to rise with a strong labour market and population increases. Like the rest of the country, Ontario recorded a large inflow of newcomers with net population growth of 445,500 persons (3.0 per cent) marking the strongest growth in decades, lifting aggregate spending in the economy and labour supply, but also added further pressure on an already tight rental market.

Ontario net migration surges despite outflow to peer provinces



Source: Statistics Canada, Central 1

The existing housing market, which adjusted quickly over the past 12 months to rapid interest rate hikes and was among the first and few economic casualties in 2022. Sales fell 32 per cent during the year, and while the average price rose 7 per cent on an average annual basis, this masked a near 20 per cent decline from peak. Sluggish housing market activity has continued into 2023 although price levels have shown signs of stabilization if not increase this year. Weakness in the existing housing market and renovation spending were key in cutting residential investment by 15 per cent for the year despite firm housing starts.

Outside of household driven sectors, economic trends have remained positive. Manufacturing continues at a steady pace supported by higher prices and volume. 2022 dollar-volume manufacturing sales rose 18 per cent led by durable goods, with real activity up closer to 5 per cent and with significant gains in transportation equipment, food, and wood products. Strength in the U.S. economy and throughout Canada supported export demand for goods, while improved supply chains added to the recovery. Ongoing recovery in tourist travel has added to the services-sector recovery to support higher spending on hospitality, entertainment, and general spending.

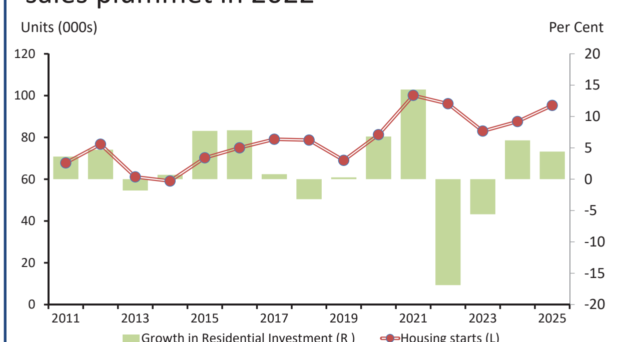
Outlook

Ontario's economy will slow this year and next in a pattern consistent with the national and global economies. We peg provincial GDP growth at 1.1 per cent this year, with a slight bump higher in 2024 to about 1.4 per cent. Ontario lags the national performance, and particularly the Prairie provinces in 2023, reflecting higher sensitivity to interest rates given elevated levels of debt and greater exposure to a slowing U.S. economy. Federal public service strikes, albeit temporary, will provide a mild drag on the economy.

Similar to the broader economy, the economic slowdown will reflect the pass through of monetary policy through consumption and business investment. Consumers are navigating higher debt loads, payment shocks as mortgages renew at higher rates, and inflationary impact on real incomes. Consumer spending growth slows to one per cent before accelerating in 2024 and 2025. Population growth will remain a key support for aggregate consumer spending, although per capita GDP does ease, suggesting deterioration in living standards. Continued wage growth should support spending as general inflation eases through 2023.

On the housing front, low home sales are expected to continue following last year's plunge. Ontario home price declines have been substantial but remain well above pre-pandemic levels while mortgage rates are significantly higher, meaning affordability remains highly strained. Surprisingly, firm prices reflect insufficient inventories as a strong labour market and rental demand have mitigated broad panic selling despite recent buyers experiencing more severe challenges. The lack of supply is likely to keep home prices elevated, if not fuel some growth, as impatient buyers make the plunge into homeownership maintaining a low volume but high price environment. Many buyers will be shut out of homeownership until interest rates decline. While the existing home market is unlikely to weigh on growth in 2023, we expect housing starts to drop sharply by 15 per cent to 83,000 units, reflecting the lagged impact of interest rates, fewer pre-sale transaction and more challenging environment for rental construction.

Housing starts retreat follows existing home sales plummet in 2022



Source: CMHC, Statistics Canada, Central 1

The export and manufacturing sector recovery decelerate amidst prospects of a U.S. recession and a broader slowdown in global growth which curbs foreign demand. Similarly, tourism continues to rebound but consumers are likely to face greater headwinds from interest rates and affordability challenges which tempers service demand. The slowing export economy is anticipated to curb non-residential private-sector investment offset by major project investment including prospects of stronger mining activity and investments in the green energy sector like the recently announced Volkswagen electric vehicle battery plant. Spending initiatives from the federal government are likely to support public-sector spending and investment.

Labour market conditions have remained tight into 2023 but a slowing economy is forecast to pump the brakes on both hiring and lead to a moderate rise in the unemployment rate as population growth contributes to labour force expansion. The current pace of population growth will remain robust despite slowing from the accelerated pace of both 2022 and 2023, averaging about 1.3 per cent in 2024/25.

Inflation averages 3.4 per cent in Ontario this year and closer to two per cent in 2024 and 2025.

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Terms

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ON Forecast Table

Provincial Forecast

	2021	2022	2023	2024	2025
GDP at market prices	10.3	9.8	3.8	4.1	4.1
Real GDP, expenditure-based	5.2	3.6	1.1	1.4	2.3
Household consumption	4.4	6.1	1.0	0.9	2.2
Government expenditure	6.9	1.8	1.6	1.6	1.2
Government capital formation	0.9	-2.7	3.7	4.0	-0.7
Business capital formation	10.0	-8.2	-2.5	1.8	2.1
Residential structures	14.3	-16.9	-5.6	6.2	4.4
Machinery and equipment	12.8	3.7	3.1	-1.5	-0.4
Non-residential structures	2.3	0.4	-0.2	-0.8	1.5
Final domestic demand	5.9	1.6	0.5	1.4	1.9
Exports	1.3	4.2	2.8	2.0	3.5
Imports	5.7	3.9	0.9	1.1	3.1
Employment	5.2	4.6	1.9	1.0	1.1
Unemployment rate (%)	8.1	5.6	5.8	5.8	5.8
Personal income	5.2	6.4	5.8	4.1	5.0
Disposable income	4.1	5.9	5.6	4.0	5.1
Compensation of employees	9.2	9.3	6.5	4.2	4.5
Net operating surplus: Corporations	13.7	5.6	-9.6	0.9	2.4
CPI	3.5	6.8	3.4	2.3	1.9
Retail sales	9.3	10.9	3.5	3.4	3.8
Housing starts, 000s	100.1	96.1	83.0	87.6	95.3
Population Growth (%)	0.6	2.0	2.1	1.2	1.3
MLS Sales (000s)	270.1	182.9	164.6	186.0	204.6
% ch	18.5	-32.3	-10.0	13.0	10.0
MLS Average Price (000s)	872.7	931.9	845.2	857.9	900.8
% ch	23.6	6.8	-9.3	1.5	5.0
Key External Forecasts					
U.S. Real GDP	5.7	2.1	1.2	1.2	1.8
Canada Real GDP	4.9	3.4	1.3	1.2	1.9
European Union Real GDP	5.3	3.5	1.0	1.5	1.5
China Real GDP	8.1	5.2	4.5	4.0	4.2
Japan Real GDP	2.2	1.0	1.3	1.0	0.9
Canada 3-month t-bill, %	0.1	2.4	4.3	3.2	2.7
Canada GoC long-term Bond, %	1.8	2.9	3.3	2.9	2.8
U.S.-Canada Exchange Rate, cents/dollar	79.8	76.8	76.0	79.0	80.0
Crude Oil WTI USD$ per barrel	68.0	95.0	80.0	75.0	75.0