David Rosenberg: Why the long-term outlook for Canadian stocks is looking rosy (short-term, not so much)

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The Canadian economy faces a challenging path forward, as the impact of higher interest rates is poised to weigh further on a highly leveraged consumer and an overextended housing market. In addition, with global recessionary pressures on the rise, Canada’s export dependency makes it vulnerable to external demand shocks.

But there are also some reasons to be positive: The Bank of Canada’s rate hikes are now on hold, and inflation is showing more signs of going off the boil. Furthermore, the Canadian dollar is cheap by historical standards (leading to improved international competitiveness), and strong immigration flows will serve as a tailwind to long-term growth prospects.

Therefore, while we expect equities to see continued selling pressure because of tighter financial conditions and rising recession odds, we believe long-term investors could use future periods of weakness to add to Canadian stocks, given their attractive valuations. That’s especially so for exporters and companies with high international exposure that stand to benefit from a weak currency.

In addition, in an environment of slowing growth and inflation – as well as a central bank that has moved to the sidelines – we believe long-dated government bonds are an attractive option.

The principal risk for the Canadian economy stems from just how vulnerable it is to higher interest rates. Unlike U.S. consumers, who deleveraged in the aftermath of the Great Recession, Canadians added to their debt load significantly. This dynamic is evident in the respective household debt-to-disposable income ratios: While it sits at 96.4 per cent in the U.S., down from a peak of 129.4 per cent in the recession, it is hovering near an all-time high in Canada, at 168.1 per cent.

Clearly, given this massive debt load, as well as the increase in interest rates, servicing this debt is becoming more of a challenge. The household debt service ratio is back to 14.3 per cent, up from a low of 12.5 per cent in the aftermath of the pandemic. With debt payments taking up an increasingly large chunk of incomes, this means less money available for consumer spending (especially discretionary expenditures).

Beyond the economy’s high sensitivity to interest rates via consumer spending, residential investment (the segment of the economy with the greatest response to changes in monetary policy) is still two standard deviations above its long-term average. From our standpoint, this suggests the housing market will continue to act as a headwind for growth – especially as mortgages are renewed at much higher rates (the typical mortgage term in Canada is five years, compared with 30 in the U.S.). The full impact of this is still to be felt.

Canada’s export dependency is also a clear negative in an environment where the risk of a global recession is very high and rising. Exports account for 34 per cent of GDP in Canada – roughly three times the percentage in the U.S. Therefore, this country is far more susceptible to global developments, so a worldwide economic downturn will be felt more acutely.

But inflation is showing clear signs of rolling over – and at a much quicker pace than is the case in the United States. Indeed, over the past three months, Canadian CPI – excluding food and energy – has grown at an annualized rate of 3.1 per cent, slowing from a peak of 7.7 per cent in May of last year; by way of comparison, over the same period, U.S. core CPI has grown at an annualized pace of 4.6 per cent.

The marked deceleration in Canadian inflation has gone a long way toward validating the Bank of Canada’s recent pause. Alongside a more dovish central bank – vis-à-vis the U.S. Federal Reserve – interest-rate differentials have widened. This dynamic has weighed on the Canadian dollar, taking it to one standard deviation below its long-term average against the greenback. A weaker currency will improve Canada’s international competitiveness and serve as a key source of support for the country’s manufacturers and exporters. There are also likely to be positive long-term growth implications (via capital deepening) from a larger and more competitive manufacturing sector.

Finally, with Canada dramatically boosting its immigration levels – to offset declining fertility rates – the country is likely to see stronger labour-force growth than the United States. By 2025, the annual immigration rate in Canada will be 12.5 per 1,000 residents, quadruple what the U.S. expects. This is another long-term positive for economic growth in Canada, although not without its share of challenges (housing affordability, which is already dire, is likely to become even more of a challenge). Consequently, the extent of the positive growth boost remains to be seen – and will ultimately depend a lot on policy solutions to deal with this population surge (increasing housing supply etc.).

Bottom line: There are good reasons to be negative on the Canadian economy at the current time. But it isn’t all bad news: Inflation has rolled over sharply, allowing the Bank of Canada to move to the sidelines. This has resulted in widening interest-rate differentials with the U.S., taking the Canadian dollar well below its long-term average.

Against this backdrop, notwithstanding the challenges facing the Canadian economy, we believe there are still good opportunities for investors. For starters, the easing of inflationary pressures and slowdown in economic activity – as well as the pause from the BoC – make long-dated government bonds very appealing.

Furthermore, for equity investors, the fact of the matter is there is already a lot of “bad news” embedded in current prices. After all, the TSX Composite Index trades at just 13 times forward earnings versus 18 times for the S&P 500 (whereas they have traded much more in line historically).

As a result, although we believe equities are likely to see continued downside (on tighter financial conditions/growing recession risks), we think the Canadian equity market has decent value for long-term investors.

However, in light of the weakness in the Canadian dollar, and the softness in domestic demand, we would be inclined to screen for companies that derive a high share of their revenues internationally.

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