Economics
IN FOCUS

January 22, 2024

Canadian consumer spending: The good, the bad and the (potentially) ugly

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Canadian households have been spending more to buy less. On a per capita basis, nominal spending has been above its pre-pandemic trend, with consumers having to pay higher prices for essentials such as food. However, that has left less money for discretionary purchases, and in volume terms per-capita spending is well below its pre-pandemic trend and falling (Chart 1). So where to from here?

The good news is that the recent sluggishness in real consumer spending doesn't just reflect the impact of inflation, but also greater prudence among households, particularly younger ones, when it comes to saving. The bad news is that the decline in per-capita consumer spending already nearly matches some prior recessions, and is starting to affect employment in impacted industries.

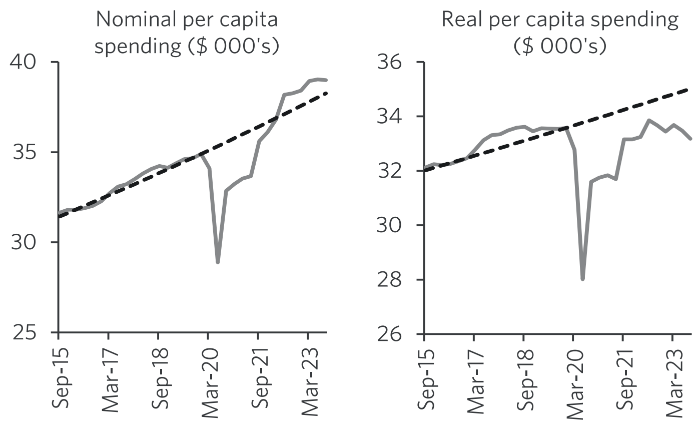
The potentially ugly news will start in 2025 if the Bank of Canada fails to cut interest rates enough to soften the blow from mortgage renewals for those households refinancing their pandemic home purchases. Not just because interest rates are much higher, but also because these homeowners have on average seen less income growth than those who bought earlier.

The good

For all of the talk of high inflation and interest rates weighing on consumer spending, the good news is that the recent sluggishness has also been the result of greater prudence among households when it comes to saving. After reaching just 0.6% of income in 2018 and then spiking during the pandemic years, the savings rate appears to have settled into a range of around 5% recently. The increase in the savings rate relative to its pre-pandemic average is responsible for roughly half of the underperformance in per-capita spending (Chart 2).

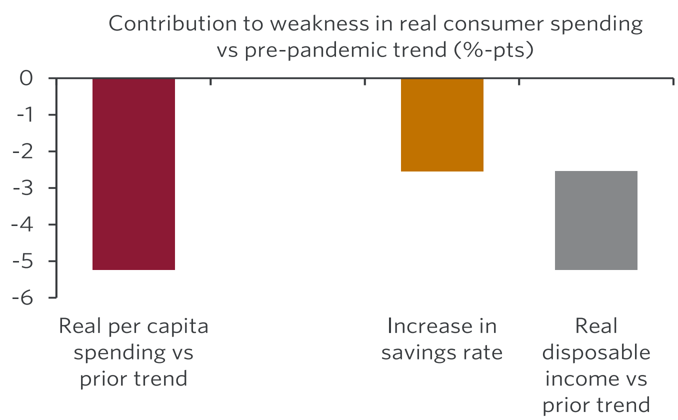
A breakdown of exactly who is saving more also provides some potentially good news in terms of future financial stability. Comparing against a pre-pandemic average, we find that it is younger Canadians in the 35 and under or 35-45 age groups who are spending less of their income, and thereby saving more

Chart 1: Households are spending more (L) to buy less (R)



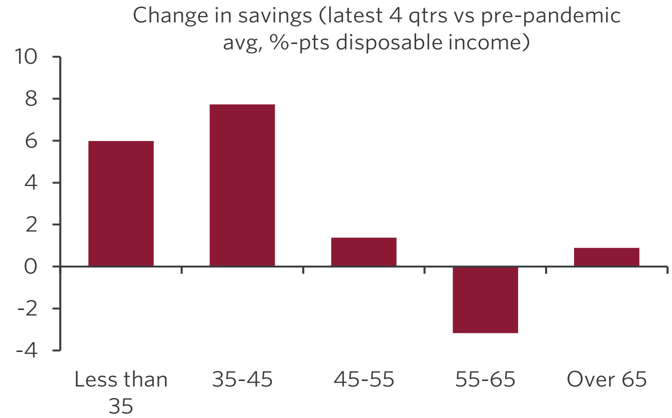
Source: Statistics Canada, CIBC

Chart 2: Increased saving responsible for roughly half of underspending vs. prior trend



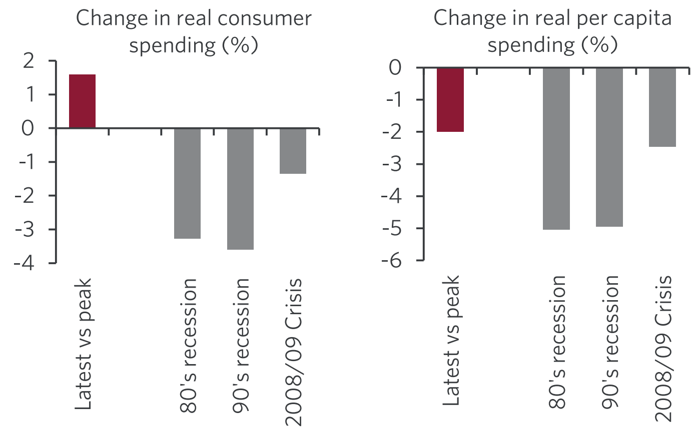
Source: Statistics Canada, CIBC

Chart 3: Younger Canadians have been saving more



Source: Statistics Canada, CIBC

Chart 5: Aggregate spending not close to a recession (L), but per-capita spending is (R)



Source: Statistics Canada, CIBC

(Chart 3). The youngest age group has also seen a sharp drop in their debt levels as a proportion of income (Chart 4).

Admittedly, this newfound prudence may have been imposed involuntarily on some households. For many Canadians aged 35 and under, the sharp rise in interest rates combined with high house prices have made homeownership unachievable, contributing to the decline in debt as a proportion of income and the greater need to save for a potential future downpayment.

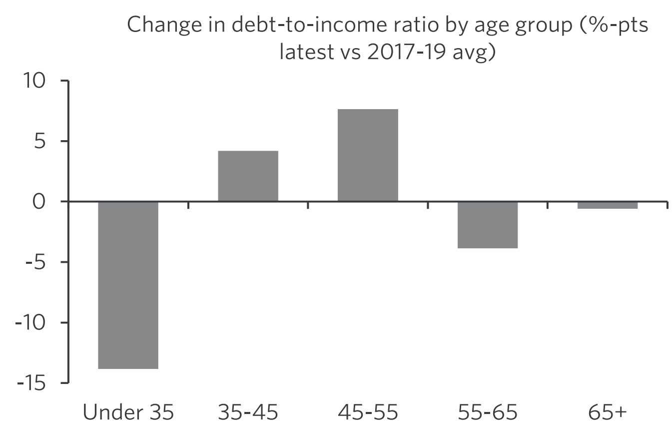
However, a number of households in the 35-45 age bracket would likely have been first-time buyers during the pandemic who will face the greatest financial hit from mortgage refinancing in future years. The increase in savings among this group will therefore hopefully mitigate some of that risk.

The bad

Unfortunately, the increase in savings, alongside the impact of high inflation and rising interest rates, has already resulted in a level of consumer spending that is weaker than many people realise. While aggregate consumer spending has risen by nearly 2% in inflation-adjusted terms since the second quarter of 2022, much of this has been driven by the sharp growth in the population that has increased demand for essentials such as food. In per-capita terms, the decline in consumer spending since 2022 is already approaching levels consistent with prior recessions (Chart 5), and further weakness is expected during the first half of this year.

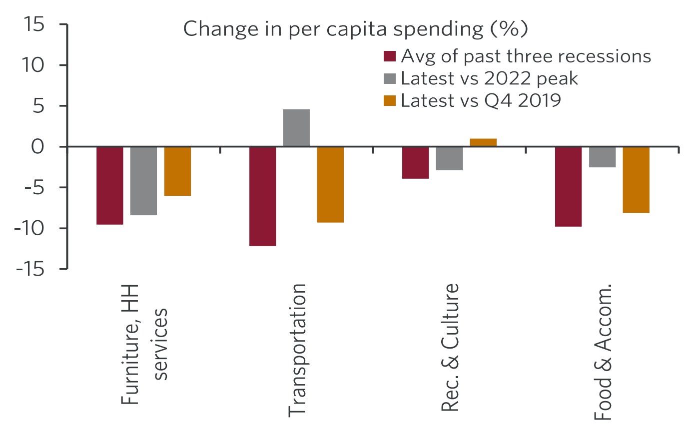
Moreover, the percentage decline in consumer spending since interest rates started to rise is tamed by the fact that consumer spending in a number of interest rate sensitive areas hadn't recovered from their pandemic declines by 2022. Judging spending relative to the second quarter of 2022, transportation (including both car purchases and airline fares) and accommodation & food services both appear unusually strong (Chart 6). However, relative to the pre-pandemic peak of Q4 2019, both areas are seeing declines in per-capita spending that are broadly in-line with an average of prior recessions.

Chart 4: Canadians under 35 have reduced debt as a proportion of income



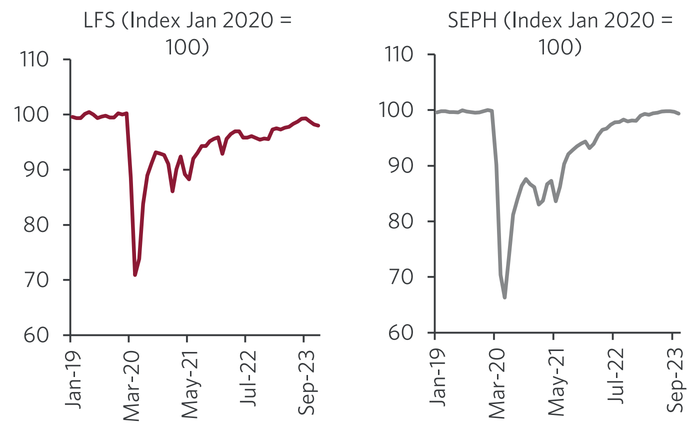
Source: Statistics Canada, CIBC

Chart 6: Per capita spending in some areas even weaker versus 2019



Source: Statistics Canada, CIBC

Chart 7: Employment in retail, restaurants, hotels and other personal services appears to have peaked



Source: Statistics Canada, CIBC

The weak level of consumer spending appears to be bringing lower employment within affected areas, which could become a vicious circle if it persists. Looking at staffing levels within household-facing areas such as retail, accommodation & foods services and other personal services, both the labour force survey and payrolls survey of employment tell a similar story — that aggregate employment in these areas has been trending lower in recent months after only just touching pre-pandemic levels in mid-2023 (Chart 7).

The potentially ugly

Even with per capita consumer spending already depressed, and households saving more in preparation, mortgage refinancing in the coming years could still lead to a potentially ugly result for the Canadian economy. Recent Bank of Canada research showed that if interest rates (not just the overnight rate but also term rates) stayed at October's peaks, the mortgage debt service ratio of homeowners could continue to rise just as quickly as it has in the past two years (Chart 8). That would put further downward pressure on consumer spending, and potentially result in below-target inflation come 2025.

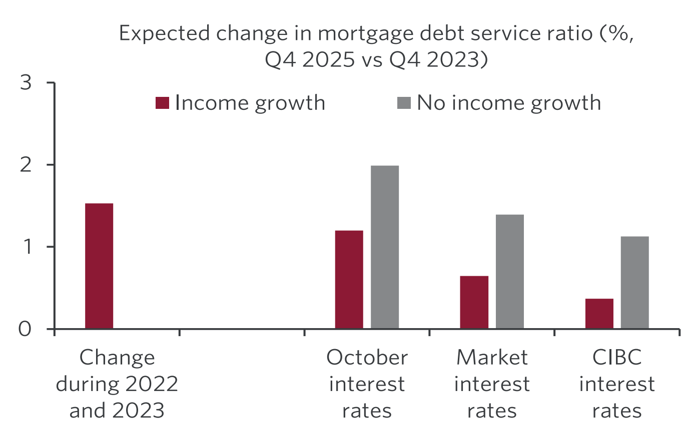
However, based on market expectations for the Bank of Canada to cut the overnight rate gradually to just over 3% by 2026, further increases in debt service costs look much more manageable. That is especially true after allowing for fairly modest income growth of around 2.5% a year.

Our forecast for deeper rate cuts than the market is currently pricing in is based on the expectation that even a further modest rise in debt service costs would be more than needed to slow consumer spending and bring inflation back to target. That's partly because we think that the level of spending is already weaker than many realise. But it's also because we are concerned that homeowners who will be remortgaging in the coming years haven't seen enough income growth to be able to maintain their current spending habits if they face a large increase in mortgage payment.

Statistics Canada data on average household incomes for homeowners with a mortgage suggests that those who bought/refinanced in 2018 or 2019 have seen strong nominal income growth. So, it should be no surprise that up until this point refinancing has been achieved without a dramatic increase in defaults. However, because inflation-adjusted incomes have risen at a weaker pace, even these households may have had to make cutbacks in spending in other areas as their mortgage bills rose. That will become even truer when more mortgages from 2019 and 2020 come up for renewal (Chart 9).

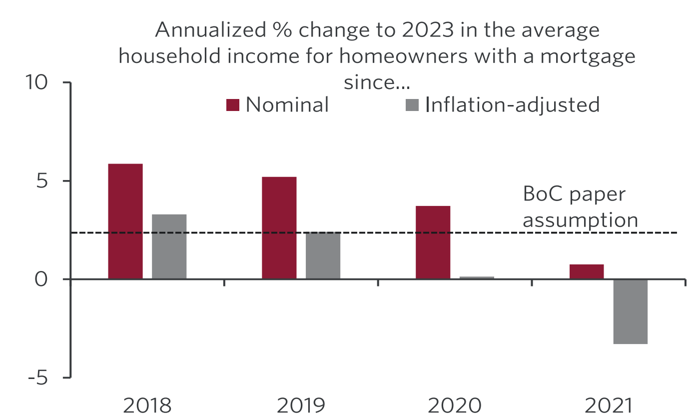
The really ugly story could come next year and beyond if the Bank of Canada does not position interest rates low enough for those households who bought during the pandemic years. Not only did those homeowners purchase at the height of prices and low of interest rates, but they have seen far less income growth on average in both nominal and inflation-adjusted terms than those who purchased earlier. Therefore, if interest rates don't come down far enough, there is still a risk that consumer insolvencies will spike, and the economy falls into a recession.

Chart 8: Further increases in debt service costs should be more modest as long as rates don't return to October peaks



Source: Bank of Canada, CIBC

Chart 9: Assumptions of income growth were conservative for people who bought pre-pandemic, but not during the pandemic



Source: Statistics Canada, Bank of Canada, CIBC

The good, bad and potentially ugly

Consumer spending in Canada is already weaker than most people realise, particularly in per capita terms, and is already bringing weakness in employment within affected sectors such as retailing, restaurants and hotels. That could spark a vicious cycle of even weaker spending and further job losses, while mortgage refinancing remains a risk as households that have seen weaker average income growth since taking out their current mortgage have to refinance.

The Bank of Canada will therefore need to carefully manage cutting interest rates early/deep enough to mitigate these risks. We suspect that this will involve interest rates needing to be lower by 2025 than financial markets currently expect. If the Bank succeeds, we should be able to see a recovery in per-capita consumer spending towards the end of this year and into 2025, with little concern about reigniting inflation.

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