Fidelity Compass

Why Canadian productivity is making inflation hard to beat

Ilan Kolet, Institutional Portfolio Manager

Pamela Ritchie, Host

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Pamela Ritchie: Hello and welcome to Fidelity Compass. I'm Pamela Ritchie. It's no secret that Canada has a productivity issue. In fact, Senior Deputy Governor Carolyn Rogers at the Bank of Canada called Canada's lack of productivity an emergency. While our neighbours to the south are seeing a steady rise in productivity growth, Canada, of course, is lagging in comparison. How is this impacting inflation and what does it mean ultimately for institutional investors? Joining me today to unpack some of the latest market action influencing the Global Asset Allocation team is Fidelity Institutional Portfolio Manager Ilan Kolet. Hi Ilan, how are you?

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Ilan Kolet: I'm great. I'm great. Nice to see you.

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Pamela Ritchie: Nice to see you too. Happy spring. Invite everyone to send their questions in over the next 25 minutes or so. Let's begin a little bit with this comparison because it ultimately goes to the way you're positioned but it also seems to be a head scratcher that goes on and on and on. Why is it that we just have less productivity in Canada than they do in the U.S.?

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Ilan Kolet: That's a great place for us to start. I think what we should maybe talk about is really what is productivity and why it's so important, and then talk about that gap.

I think a lot of people will know productivity is measured as output per hour, output per worker. A lot of people, when they hear the term productivity they think, oh, the workers need to be working harder. That's not really the full story.

Productivity growth, or productivity rather, you can boost it one of three ways. You can have labour deepening so that you can skill-up your labour. You can have capital deepening, which is give the labourers better tools, better computers, fancier robots. You can combine them together in such a way with management that you're really extracting the best from both labour and capital. Those are the ingredients for productivity or productivity growth. The reason we should all care about productivity is for another reason. I'm going to get a little nerdy here, surprisingly.

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Pamela Ritchie: We like nerdy, yeah.

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Ilan Kolet: Productivity is, productivity growth is one of the ingredients to potential economic growth. Potential growth is the rate in which an economy can grow without stoking inflation, in summary. One of those ingredients is strong productivity or productivity. The other ingredient is labour input. The reason that everyone should be in favour of boosting productivity is because productivity plus the labour input equals higher potential growth and that boosts wages, that boosts growth, that makes it easier for central banks to tackle inflation. It's a win for everybody.

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Pamela Ritchie: It's the ball that ultimately keeps the economy humming in the right direction.

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Ilan Kolet: Exactly, exactly. To your point, Pamela, about this gap between Canada and the US, it's really significant. I started at the Bank of Canada over 20 years ago, and at that time there was a research agenda underway to examine the productivity differentials between Canada and the U.S.

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Pamela Ritchie: It was a mystery then too.

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Ilan Kolet: It was a mystery then; it's been a long-standing mystery. It predates me even at the Bank of Canada. This productivity wedge between Canada and the U.S. is a very, very long-standing policy issue. To be quite frank, I don't think anyone has really put their finger on the reason for why productivity and productivity growth has been so weak in Canada. We have some thoughts on what may be the culprit, but the wedge is large.

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Pamela Ritchie: The wedge is large. There's actually a chart that you've brought, let's put that up now because it goes to sort of this discussion obviously and the trajectory of it. It's up now. Yes, there it is. We'll just kind of talk our way through this. It looks pretty stark. It's the yawning jaws and so on. If you had to pick three things ultimately that have seen this flat line and then deceleration what would they be? Give us a starting point.

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Ilan Kolet: Again, there's been a load of research on this. The OECD has done some really interesting work on this. Generally, when I think about some of the three key reasons, I think the third one is the most interesting.

The first one is we have more regulation across industries in Canada which leads to less competition and less competition leads to less business formation and lower rates of productivity. That's the first one.

The second one...it's very hard to measure. There's something that economists think about called dynamism, so economic dynamism. Measures of economic dynamism in the U.S. have picked up recently and in Canada they've been fairly flat. So, dynamism you can measure with things like business formation or start-up formation. You can also measure it with labour mobility. We're getting nerdy again but one way to measure how dynamic an economy is is are people picking up and moving in search of better opportunity? That's kind of dynamism.

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Pamela Ritchie: Have we had moments of that over the course of the Canadian economic story? You think through the supercycle, they [crosstalk].

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Ilan Kolet: Right. We all remember the direct flights from Newfoundland to Alberta, to parts of Alberta. There was, I would say, some anecdotal evidence around dynamism but it's much more prevalent in the US where it's not uncommon at all. The third one I think is perhaps the most important one, especially over the last 15 years, and that is productive capital being diverted away from the formation of a new business or capital expenditure and into an unproductive asset, namely housing.

In English, what this means is if your plan was to open up a new shop and take on the risks of opening up a new coffee shop or a new restaurant or a new small or medium-sized business, instead you can just divert that capital into buying and flipping condos or just buying condo assignments, you know that that line has consistently gone in one direction for the last 15 years and so capital has really been diverted, into unproductive housing assets.

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Pamela Ritchie: Shouldn't the situation that we're in right now stop that? I mean, it has to an extent. You can see people struggling. We expect this story to continue for the next few years. Is that enough to just spark that element of the productivity issue?

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Ilan Kolet: The way that we're positioned and the way that we think about this, we think that productivity spark is just much more likely to happen in the U.S. That chart that we were looking at showed capital expenditure normalized to several years ago and the growth rate of that in the U.S. versus Canada. Capital expenditure is what we think about as CapEx, non-residential business investment in the national accounts for both Canada and the U.S. I think it's 40% higher than it was 10 years ago in the U.S. and it's almost 20% lower than it was 10 years ago in Canada.

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Pamela Ritchie: How much of the CapEx right now, today, yesterday, the last several months? We're talking about AI. Companies are loading up. We've spoken to certain managers who are managing on a growth in technology companies. If you're not doing it, you're going to be in trouble. Is Canada doing that?

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Ilan Kolet: It's very, very early days. It's very hard to see. It's even hard to see, in fact, in the U.S. In aggregate we know that business spending, CapEx in the U.S. has been quite strong over the last 10 years and has been quite weak in Canada. Part of the issue in Canada is included in that CapEx number in Canada is capital expenditure in oil extraction. That is down 50% since 2014. That used to be a third of CapEx; it's now less than 10%. It's a much smaller share of the pie in Canada and it's been a consistent drag on growth for many, many years.

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Pamela Ritchie: The positioning that you've spoken to us about before ultimately has been leaning into the U.S. equity side of things. Take us there. We know the story of the dollar, it has a lot to do with the overall macro picture right now. Your positioning has worked well. Are you going to stick with it?

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Ilan Kolet: Nothing is preordained, to borrow a Mark Carney line. What I would say about the positioning is we thought, around September, October of last year we started to do some deep research with our research teams in Boston around the productivity dividend. We thought to ourselves, what if investments in Artificial Intelligence or investments in clean technology or even sort of blowing up the standard 9-to-5 work environment and us optimizing our home and work a little bit better, is leading to a higher stall speed for the U.S. economy. If the stall speed of the U.S. economy is higher, if potential growth — again, remember productivity is higher, potential growth is higher — if the potential growth rate of the U.S. economy is higher than what we think it is that means inflation can continue to slow, the labour market can remain at a low unemployment rate, GDP growth can print higher, earnings can be revised higher, and equities can do well.

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This is a checklist for what you'd want to see. In October when we did this research, that's when we deployed our cash position into an overweight to U.S. equities. We didn't really do the same in Canada. In Canada, we are cautious on Canada. There's still plenty of equities in our Canadian, in our funds and those managers can still boost the performance by beating their benchmarks but we're more cautious on Canada really because of elevated rates of debt intersecting higher borrowing rates that we think could potentially lead to a bit of a pullback in consumer spending. The last thing I'd mention there is it's interesting, in January of this year, we presented this potential growth productivity thesis in a room of about 1,000 people at the convention centre here and I could see people in the crowd rolling their eyes.

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Pamela Ritchie: What month was this?

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Ilan Kolet: This is in January.

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Pamela Ritchie: Because they just thought maybe no.

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Ilan Kolet: Exactly. I could see people rolling their eyes. It's fascinating, you know people are rolling their eyes, maybe some are right now, but it's fascinating to actually see people roll their eyes at what you're saying. When I thought about it, I thought, what do those eye rolls mean? I think they mean that this sounds too good to be true and it's never happened in the past. The pushback to that...

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Pamela Ritchie: What? U.S. equities are on fire? I mean, that's happened in the past.

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Ilan Kolet: I mean this productivity expansion. My pushback to that is it has happened in the past. In the mid to late '90s with the advent of the internet, we knew something was changing. We knew business processes were changing. We couldn't quite see it in the data, but something was happening. The recession models we were using at the time were flashing red, but we never got that recession in the mid to late 90s because the stall speed of the economy was higher than what it had been for many years. Of course, we know what earnings and equities did in the mid- to late-90s.

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Pamela Ritchie: Meaning it could handle it.

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Ilan Kolet: Exactly, exactly. It can handle it without stalling or without igniting inflation which would lead to monetary policy tightening which would lead to a slowing in growth.

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Pamela Ritchie: Tell us about the consumer here, the inflation story here. Let's come back to what consumers have been struggling with which is obviously on the debt side, we know what that is. On the inflation side, I think we mostly know. Is it getting better? We're expecting maybe a cut from the Bank of Canada in June. Maybe, we don't know. Is this the inflation story sort of coming down and we can afford to cut perhaps?

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Ilan Kolet: I think the motivation or the impetus to cut or to normalize, they wouldn't even call it cut, to normalize rates or normalize monetary policy is very different in the U.S. than in Canada. Let's talk about the good. In the U.S., if you had asked me six months ago, when will the Fed begin rate normalization I probably would have said in the middle part of this year.

Remember, both the Fed and the Bank of Canada have told us that they're going to be data dependent. At the time, the data suggested that probably in the middle part of this year was the right time to begin normalization in the U.S. But the data has pushed back a little bit. What I mean by that is the underlying inflation data in the U.S. for the last three months consecutively has moved sideways. That stubborn profile of inflation that we thought would happen has actually emerged. Now, there has been a tremendous amount of progress on the rate of inflation both in Canada and the US. I think they will recognize that when we hear from them this week, but it has probably pushed off the start of normalization maybe by a month or two.

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What I would caution, though, is anyone who claims with certainty that they will begin cutting on this date, they don't know. To be quite frank, nor does the Fed. In Canada it's a little bit different. In the U.S., the motivation for normalizing rates really comes from. ... We might be in the midst of a productivity expansion. We don't want that flame to get any bigger because it might stoke more inflation, but we don't want to put it out. Productivity cycles happen two or three times in our lifetime. They're very rare to achieve. If I'm at the Fed, you don't want to be unnecessarily restrictive for too long and run the risk of squashing that productivity boom.

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Pamela Ritchie: You're speaking to lots of people here who have lots of money to look down the road a little further. Maybe this is the crisis now. I don't know, we're talking about it a lot. Seems like certainly a national conversation. If it's not a crisis it's definitely there. If you're willing to think that the cost of capital in a couple of months in June might be a little bit less, and things look not great right now, would you think about for the long-term making some moves soon? I mean, this is kind of a question for your audience here today. If those rates come down for a couple of different reasons and we get through whatever we have to get through here in this country, does Canada look better on the other side? You can pick the time horizon here.

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Ilan Kolet: It's possible it looks better. What are the tailwinds? The potential tailwinds are, normally in the medium to long run immigration boosts growth. If you remember at the start of the conversation I said potential growth, if you want to increase the stall speed or the potential growth rate of an economy you have two ways to do it: productivity or labour input. Now, the labour input is a potential silver lining in the medium- to long-run. You'll notice I really carefully said medium to long run, that squishy horizon that we don't [crosstalk].

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Pamela Ritchie: [crosstalk]

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Ilan Kolet: Exactly, that medium to long run. The reason for that is it takes a while for skilled labour to be absorbed. Skilled labour, when it arrives in Canada there's often a mismatch so that you have someone with two engineering degrees in kind of a low paying, low value-add service job before that skill gets matched appropriately. That could be the situation we're in right now. The amount of immigration over the last few years could potentially be a boost to potential growth, that's two potentials, in the medium to long run. One of the hard things, I think, for policy makers and planners is the volatility that we've had in immigration. We've had none and then we've had a huge amount and then none so that's very hard to plan for.

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The other potential tailwind is commodities coming back. Oil, we know what oil and gold have done, let's say, over the last few months. That should be a tailwind for Canada. The thing is, it's less of a tailwind than it was, say, 15 or 20 years ago because it's a smaller share of capital spending. It's a little bit trickier. What I would say, bringing it back to positioning, we do believe that this productivity dividend, this boost to potential growth is much more likely to show up in the U.S. than in Canada.

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Pamela Ritchie: For the medium- to long-term?

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Ilan Kolet: I would say for the medium- to long-run investor. Again, part of the reason for that is we have 40 years of data that suggests that the productivity expansion really happens vigorously and first in the U.S.

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Pamela Ritchie: None of this seemed to be addressed in the budget that we received a couple of weeks ago. Was it a couple of weeks ago? It feels like it's been a lifetime. In any case, it really wasn't addressed and the answer for that is?

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Ilan Kolet: It's very, very hard. It's exceptionally hard to boost productivity growth. I would say we have decades and decades of budgets that have probably tried to do it and not had much success. It's a bit of a frustrating question when I'm asked, how are we going to do this because there isn't one single thing that we can put our finger on. Again, some of it is almost a cultural difference in risk appetite and risk taking. I mean, I lived in the U.S. for seven years before moving back to Canada, the risk taking of the average entrepreneur I think is just very different in the U.S. than in Canada. Some of that could be a cultural thing but...

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Pamela Ritchie: Small business owners, you want to encourage that, you want to encourage people who are going out there and trying to do something on their own rather than, as you say, perhaps pouring it into a housing market that's ultimately overheated.

Where goes the housing market in Canada and what does it mean ultimately for this economy?

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Ilan Kolet: If I'm being quite honest, I would have thought 475 basis points of tightening by the Bank of Canada would have done a lot more than we've seen. Housing market certainly came to a standstill when the bank was in the process of raising rates, but it's been very, very choppy. Some markets have come back to life, in other markets and in other areas you're seeing sort of price declines. There's evidence to suggest that once the bank begins normalizing rates, which we think will probably be in the middle part of this year which is not that far away at this point, it could be a month or six weeks away, there is a sufficient amount of demand that could flood back into the housing market. I would say...

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Pamela Ritchie: What's more important there? Igniting the housing market or getting people off a falling, crumbling situation?

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Ilan Kolet: Exactly. I think one thing that we should certainly address or recognize with housing is one of the reasons the housing market in Canada was so resilient, quote unquote, resilient, was a huge influx of people which showed up as demand. I think had that boost to demand not shown up in the housing market we would have seen a very, very different picture emerge.

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Pamela Ritchie: With higher interest rates.

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Ilan Kolet: With higher interest rates, exactly. With a giant increase in population, and it's an off-the-charts chart which we can share at some point ... off-the-chart chart?

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Pamela Ritchie: I think that works.

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Ilan Kolet: It really propped up demand. It propped up demand at a time when monetary policy would have normally slowed demand really significantly.

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Pamela Ritchie: Fascinating. What do we do with this idea of sort of a cut may come, what will that do to the economy? Even if we just sort of take ... the idea of a cut coming means that we need it, right? Where will that help, I guess is the question, where might there be something that just takes off because of it, aside from housing?

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Ilan Kolet: Again, it comes back to this idea of the motivation or the reason behind normalization, or cutting. In the U.S. I think, and I'll come to Canada in just a second, in the U.S. I think the Federal Reserve recognizes that they were too late to lift off post COVID. Post COVID they waited and they waited and they waited and then inflation took off and then they did 525 basis points in 18 months.

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Pamela Ritchie: They were behind the curve.

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Ilan Kolet: Right. Every central bank in the world was. I don't think they want to be late on the other side. On the other side, I think, again, we have what looks like productivity growth for the first time in ages. We don't want to put out that fire but we don't want it getting any bigger. Let's normalize rates to keep housing and the consumer and business investment growing at a healthy rate without stoking inflation.

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Pamela Ritchie: This is in the U.S.

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Ilan Kolet: This is in the U.S. In Canada it's a different story. In Canada, we know that the housing market was on fire 2019, '20 and '21. Most of us have five-year terms on our mortgages which means 2024, which is the year we're in, 2025 and '26, those mortgages are coming up for renewal. There's a wave of renewals with the bulk of them, we believe, coming in 2025.

Growth, well, actually, growth is the wrong word. There's been no growth in Canada in GDP basically since the start of 2023. The level of GDP in Canada since 2023 has essentially been a flat line. The Bank of Canada, I think, is trading off a very dangerous sort of Globe and Mail headline that has a firefighter standing next to a school teacher in front of a for-sale sign because they can't afford the reset on their mortgage. That would devastate sentiment in the Canadian dollar. For the Bank of Canada it's a different calculation than that productivity fire analogy that I mentioned in the U.S. In Canada, we have a huge portion of principal homeowners whose mortgages are coming up for renewal. We've had essentially no growth. We certainly don't have productivity growth and we have a bad record on business investment. We need to normalize rates to not make that any worse.

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Pamela Ritchie: The bookends that you use, and it speaks to the positioning ultimately of the Global Asset Allocation team, the idea that they were late getting off sort of zero and making rates rise and that they don't want to be late on the other side. You don't hear that all the time that that's the reason. Actually, I feel like that's quite different. They don't want to be too late to cut but are there real dangers?

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Ilan Kolet: There really are. In the U.S., for example, there will be 100 years of research based on the COVID monetary policy response. I think it's a very well-recognized fact at this point that central banks were late to lift off. That's one of the reasons that contributed to extremely high, the highest inflation rate in 40 years. I think they want to learn from that policy error, because that was a policy error, I think they want to learn from that policy error and not be excessively restrictive for too long. Again, the way that we should be thinking about rate normalization, and there's a reason I call it normalization and not cutting and it's a bit nerdy...

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Pamela Ritchie: Not just marketing?

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Ilan Kolet: No. If neutral in the U.S. is 2.5 and the Fed is at five the way that they are thinking about it is a movement from 5 to 4 is a move from very restrictive to restrictive. That has a different connotation than growth is weak and unemployment is moving higher, let's cut. That's kind of why I do that differentiation. The truth is, if we are in the midst of a productivity expansion neutral is not 2.5, might be 3.5.

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Pamela Ritchie: I wonder if we just put that chart back up, if you don't mind, just for a second and just have you walk us through, realize why the tilt towards U.S. equities has been there. It's been there since October. Tell us a little bit about ... you're not too far off a 60/40. Is that about right? You're not too far off.

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Ilan Kolet: Exactly. If we use our 60/40 as an example, right now that's about a 64/36.

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Pamela Ritchie: And it has to do with this chart to an extent.

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Ilan Kolet: To an extent, absolutely. Right. We are continually incorporating research, we have a very strong research foundation in everything we do and that decision to deploy our cash position into U.S. equities was very, very deliberate, and it was based on research. Like you mentioned, Pamela, it will always be incremental. The 60/40, it can be a 75/25 or a 45/55 but the moves will always be very deliberate and very incremental.

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Pamela Ritchie: Ilan Kolet, is there any just final word that you want to put in there just for what we're all going to be watching unfold? Quite a busy week on the economic side of things. What are you watching? What should we flag for the next, I don't know, two or three weeks here on the economic calendar?

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Ilan Kolet: For this year in 2024, I'm paying extremely close attention to central bank language and communication. Central banks will take us on a leash to what they want us to think on the day of the decision, and they will inform us with tweaks to language.

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Pamela Ritchie: So we will watch that very, very carefully. Thank you for joining us, Ilan Kolet, joining us here in studio.

Thank you for joining Fidelity Compass. If you've got any suggestions on future topics, guests, please let us know, share your ideas and do stay tuned for more Fidelity Compass webcasts in the weeks ahead. I'm Pamela Ritchie.