Economic Trends

August 2022

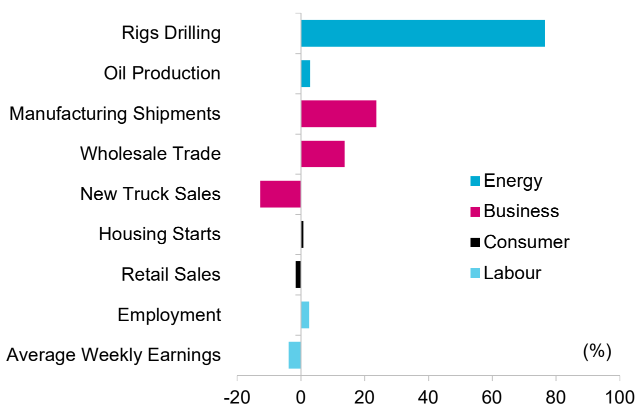
This month's Economic Trends is taken from the Economic Update of the 2021-22 First Quarter Fiscal Update and Economic Statement, released on August 31, 2022.

Overview

The economic landscape has changed significantly since *Budget*. Russia's invasion of Ukraine in late February and resulting disruptions and sanctions against Russia have propelled energy prices. This has boosted revenues and activity in the energy sector. Business output has also seen strong growth amid robust demand and prices. The Alberta Activity Index, a measure of provincial activity, is up 6.2% year-to-date (YTD), led by energy and general business activity (Chart 1).

CHART 1: YTD STRENGTH LED BY ENERGY AND GENERAL BUSINESS INDICATORS

Year-to-date growth in Alberta Activity Index by components, May 2022



Source: Alberta Treasury Board and Finance

Soaring commodity prices and ongoing supply disruptions, however, have exacerbated inflationary pressures for businesses and households, not just in Alberta but globally. Central banks in Canada and around the world have raised interest rates at an aggressive pace in order to quell inflation. The combination of high inflation, faster interest rates hikes and geopolitical instability has dampened the global outlook and increased economic uncertainty. These factors are weighing on consumer sentiment and spending on goods in Alberta. However, a strengthening labour market, pickup in population growth and pent-up demand for services from the pandemic are supporting household activity.

After growing an estimated 5.1% in 2021, Alberta's real gross domestic product (GDP) is now forecast to grow 4.9% this year, down from 5.4% at *Budget* (Chart 2). The downward revision reflects expectations of softer growth in real consumer spending and residential investment. Even so, real GDP is expected to fully recover from the COVID-19 downturn and surpass the 2014 peak for the first time this year. Moreover, incomes – as measured by nominal GDP – are forecast to grow 24% in 2022, significantly higher than *Budget*. This will boost provincial government revenues.

CHART 2: OUTLOOK STILL SOLID DESPITE SOFTER GROWTH IN HOUSEHOLD ACTIVITY

Year-over-year growth in selected economic indicators, 2022

Source: Alberta Treasury Board and Finance
*Unemployment rate is forecast level

Real GDP is forecast to grow at a solid clip of 3.2% in 2023. Energy prices are expected to moderate as global growth decelerates, but will remain supportive of activity. Business investment will benefit from easing cost pressures as uncertainty wanes and oil prices stabilize. While consumer spending and housing starts are forecast to moderate further next year with the impact of higher interest rates and fading pent-up demand from pandemic, they will continue to be buoyed by solid growth in population, employment and household incomes. Alberta's households are well positioned, enjoying the highest per capita incomes, lower cost of living and lower overall taxes in the country.

Energy prices elevated amid volatility

Oil prices have swung widely and increased substantially since *Budget* following Russia's invasion of Ukraine in late February. The resulting disruptions and sanctions against Russia stoked fears of supply shortages as global demand continued to recover from the COVID-19 lows. West Texas Intermediate (WTI) surged to over US$120/bbl in early March before giving back most of the gains in recent months. Renewed COVID-19 lockdowns in China and a slowing global economy have dampened the outlook for demand. These factors are expected to weigh on oil prices in the second half of the year, but low inventories and tight global crude supplies will provide some support. WTI is forecast to average US$92.50/bbl in 2022-23, US$22.50/bbl higher than *Budget*.

Natural gas prices have also rallied since *Budget*. The war in Ukraine and sanctions against Russia have led to disruptions in global natural gas supply. With Russia supplying less natural gas to Europe, European prices have surged. This has led to a significant increase in demand and prices for ocean-transported liquefied natural gas, which in turn has boosted exports of U.S. liquefied natural gas and pushed prices higher in North America. The Alberta Reference Price (ARP) is now expected to average $5.60/GJ in 2022-23, up from US$3.20/GJ at *Budget*.

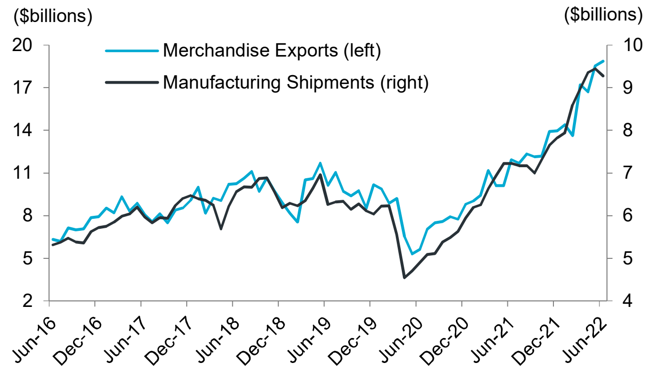
The discount between WTI and Western Canadian Select (WCS) has widened since June. Soaring natural gas prices have increased the cost of processing high sulphur heavy crudes, which prompted U.S. refineries to shift towards lighter grades. The release of sour barrels from the U.S. Strategic Petroleum Reserves has also weighed on heavy oil prices. The light-heavy differential is forecast to average US$19.20/bbl in 2022-23, up US$4.90/bbl from *Budget*. WCS is forecast to average US$73.50/bbl in 2022-23, the highest annual level since the 2015-16 downturn.

Robust corporate profits

Surging business output coupled with a weaker Canadian dollar are lifting corporate profits this year. Net operating surplus – a measure of corporate profits and driver of corporate income tax revenues – is forecast to reach a record high of almost $90 billion this year, up 68% from 2021. This is being driven by business output, which has soared since the start of the year on the back of higher demand and prices (Chart 3). Merchandise exports and manufacturing shipments

CHART 3: HIGHER PRICES SEND BUSINESS OUTPUT TO RECORD HIGHS

Alberta's merchandise exports and manufacturing shipments



Sources: Statistics Canada and Haver Analytics

in the province have risen more than 60% and 30% YTD, respectively. While energy has led the increase, other categories such as exports of chemical and forestry products, as well as food manufacturing sales, have also posted strong gains. A pickup in energy sector activity and expansion in other industries are supporting machinery, fabricated metals, and transportation and equipment. Services have also improved, but the recovery in tourism has been slower than anticipated. Meanwhile, agricultural exports have been hit by last year's poor crop and lower inventories.

Exporters are benefiting from a weaker-than-expected Loonie. Rising global economic uncertainty has increased global demand for the safe-haven U.S. dollar, which has more than offset the support from higher commodity prices. The Canadian dollar is now forecast to average 77.4 US¢/Cdn$ in 2022-23, down from 79.0 US¢/Cdn$ at *Budget*.

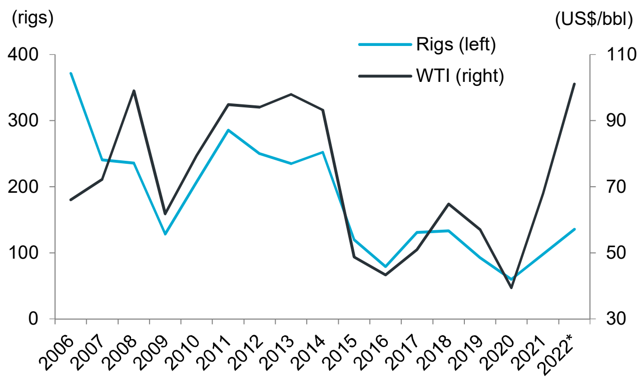
Strong energy investment

Activity and investment in the energy sector have substantially picked up, led by conventional oil and gas. Building on the strong gains in the latter half of 2021, rigs drilling has climbed to eight-year highs since March. Conventional oil production is up 12% YTD and is set to gain further in 2023. Natural gas spending is also benefitting from robust demand and prices. Meanwhile, non-conventional production has risen at a more modest pace as producers focus on maximizing output from existing assets. Overall, oil and gas investment is now expected to rise nearly 35% (or over $8.0 billion) in 2022, up from 27% growth at *Budget*. The upward revision in spending also reflects sharply higher input costs, with growth in real spending up only modestly in the conventional sector relative to *Budget*.

While activity has bounced back, the response from producers has been muted relative to past cycles (Chart 4). Despite soaring revenues, producers have restrained spending to focus on improving their balance sheets and increasing shareholder returns. As a result, reinvestment ratios are extremely low, with some estimates of roughly 30-40% of their cash flow only being reinvested.

CHART 4: INCREASE IN ACTIVITY MUTED COMPARED TO PREVIOUS CYCLES

Rigs drilling and West Texas Intermediate (WTI) oil price



Sources: Alberta Treasury Board and Finance and Canadian Association of Energy Contractors

* YTD through July

Cost pressures to moderate

Cost pressures for businesses have increased significantly since *Budget*, although there are indications that they have peaked. Input costs across the value chain have risen dramatically since the start of the year amid ongoing supply chain disruptions and higher commodity prices. This has affected all levels of production and distribution, and has started to weigh on business sentiment in the province. Non-residential building construction costs in Alberta have soared 15% over the last five quarters, while prices for machinery and equipment in Canada are up around 7%.

There are signs, however, that cost pressures are beginning to ease. In Canada, prices for raw materials and industrial products have retreated due to lower energy and primary non-ferrous metal products. As input costs moderate through next year, growth in non-residential construction costs is forecast to slow from 10% in 2022 to 6% in 2023.

Investment plans advancing

Despite rising costs, companies outside oil and gas extraction are proceeding with investment plans amid solid corporate profits. Real spending on commercial building construction has been strong and is up 21% YTD. Investment in industrial building and engineering construction is also getting a boost from large-scale transportation projects across the province, such as TC Energy's NGTL system and Pembina's Peace pipeline expansion projects. Construction of Travers Solar and other renewable energy projects also continues to progress towards completion, while Capital Power and Cascade Energy power plant conversion to natural gas are also well underway.

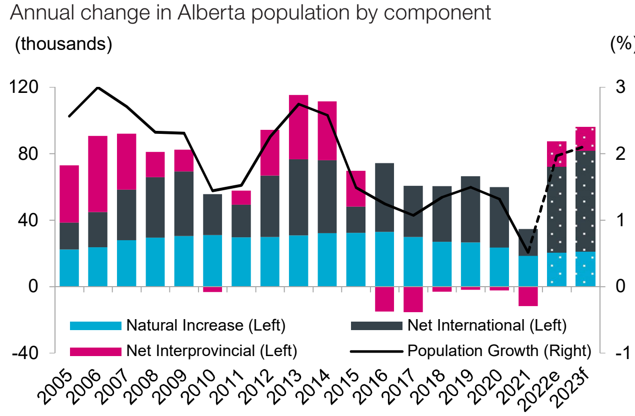
Real non-energy business investment is expected to grow about 900 million (or 4.0%) in 2022, similar to *Budget* expectations. This strength is expected to continue next year as cost pressures ease, with real non-energy business investment forecast to rise 3.3% in 2023.

Population growth accelerates

Alberta's population growth is expected to pick up with higher levels of net migration. In the first quarter of 2022, net interprovincial migration into Alberta posted its largest first-quarter gains since 2015 and led the country for the second consecutive quarter. Immigrant landings have also ramped up as national admissions set another record and Alberta's share of total immigration has ticked up. Alberta's population is forecast to grow 2% in the 2022 census year, up from 0.5% in 2021 and 1.4% forecast in *Budget* (Chart 5). This pace is expected to continue in 2023. With Alberta having a sizeable Ukrainian diaspora and the federal government indicating that it will accept unlimited numbers of Ukraine refugees, this is expected to provide an additional boost to immigration.

CHART 5: POPULATION GROWTH ACCELERATES

Annual change in Alberta population by component



Sources: Statistics Canada, Haver Analytics and Alberta Treasury Board and Finance; e-estimate,f-forecast

Strong job gains to continue

Momentum in employment is expected to continue in the province, building on the strong job growth in the first half of 2022. The province added over 68,000 between December and July, led by full-time and private sector work. The services sector accounted for most of the gains, with tourism-related industries improving significantly as the economy reopened. With employment yet to recover to pre-pandemic levels in these industries, particularly accommodation and food services, there is further room for growth. Goods sector employment is expected to improve after struggling to gain momentum, supported by the pickup in energy sector activity and construction.

Even with the jobs gains so far, there are still a significant amount of job vacancies in the province. This will support employment growth, which is forecast to rise 5.3% in 2022, up from 4.1% at *Budget*. With the momentum in the services sector and renewed strength in the goods sector expected next year, employment growth is forecast to outpace population growth at 3.1% in 2023.

Labour market tightens further

Employers in Alberta are having a tougher time finding workers. Solid employment growth and lagging labour force participation pulled the unemployment rate down to an eight-year low of 4.8% in July, down sharply from 7.5% in December 2021. The participation rate has pulled back due to persistent weakness among mature workers (aged 55 and over). While more people are likely to enter the labour market in the second half of the year, the participation rate is forecast to average 69.3% in 2022, down from 69.6% in *Budget* and roughly the same as last year's.

Robust job gains and a slower improvement in the participation rate will result in a tighter labour market over the next few years. The unemployment rate is forecast to average 5.9% this year, the lowest annual rate since 2015, before falling further to 5.5% in 2023.

Wage growth to pick up

Despite tight labour market conditions in Alberta, wage growth has been subdued so far this year and has lagged behind the rest of the country. In July, average hourly wages were up 0.7% year-over-year (y/y) in Alberta compared to 5.3% y/y nationally. While this is partly explained by compositional factors – such as the return of lower-paid service jobs and fewer mature and experienced workers (who tend to be paid more) – rising cost pressures and margin compression may also be playing a role. In particular, average wages offered to occupations in manufacturing and utilities remain below 2019 levels, while those in arts, culture, recreation and sports, as well as sales and service occupations, are at new highs.

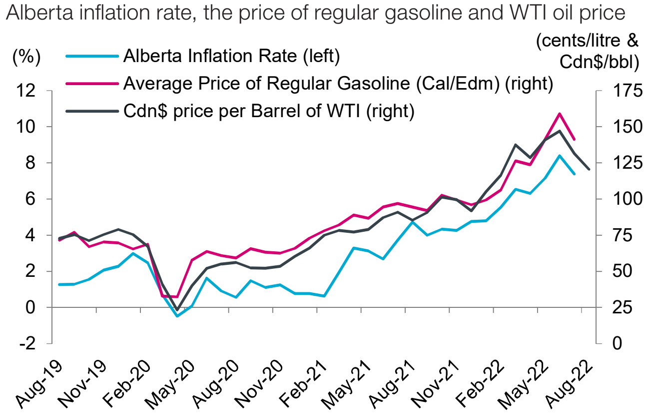
As some input costs ease and uncertainty wanes, businesses are expected to become more responsive to tight labour market conditions. Wages are forecast to rise 2% this year before accelerating to 4% in 2023. With wage growth outpacing inflation, consumers are expected to see real income gains next year.

Inflation to slowly recede

Price pressures are expected to retreat in the second half of this year after surging since *Budget*. Inflation is beginning to show signs of cooling due to lower gasoline prices and the impact of the provincial electricity rebate program (Chart 6). Despite the moderation, headline inflation still remains high, with core inflation (excluding food and energy) hovering around its 14-year high.

CHART 6: INFLATION HAS BEGUN TO COOL DOWN

Alberta inflation rate, the price of regular gasoline and WTI oil price



Sources: Statistics Canada, Kalibrate Canada Inc., and Haver Analytics

Persistently high and broadening price pressures have forced central banks around the world to increase interest rates at a faster pace, with the Bank of Canada raising its key policy rate by 225 basis points since early March. Slowing demand from higher interest rates, coupled with easing energy prices, are anticipated to dampen inflation in the second half of the year. These trends will be furthered by the government's affordability measures, such as the continuation of the gasoline tax holiday and the realization of the electricity rebate. Inflation is forecast to average just over 6% in 2022 before slowing further to 3.0% in 2023 as base year effects fade.

Spending moderating

Persistently high inflation and rising interest rates have dampened sentiment and household spending. Consumer confidence tumbled in June to levels last seen early in the pandemic recovery. Growth in retail sales excluding gasoline stations has also moderated, with discretionary spending on motor vehicles and renovation-related building materials down YTD through May. Goods inflation has outpaced growth in overall retail sales over the past year, indicating that spending on goods has declined in real terms. This is partly due to the ongoing rotation to services as consumers and businesses adapt post-COVID.

Real consumer spending is now expected to rise 5.3% this year, down from the *Budget* forecast of 5.9%. Despite the softer outlook, real spending is expected to exceed 2019 levels this year. On a per capita basis, spending on services remains subdued and lower than in 2019, while goods spending has fully recovered. Next year, goods spending set to slow significantly mainly due to weakness in durable goods. As a result, growth in consumer spending is forecast to decelerate further to 2.6% in 2023.

Modest housing slowdown

Alberta's housing market is cooling amid higher interest rates. Rising mortgage rates have dampened activity in the resale market, where sales have retreated sharply from the high levels earlier in the year. In contrast, housing starts accelerated to an average of about 42,000 units in the second quarter. Expectations of rising interest rates have prompted many homebuyers to pull forward demand. Low housing inventories along with strong pickup in migration, have also supported homebuilding activity.

Higher interest rates and a pullback in consumer confidence are expected to further moderate activity in the second half of the year. Even so, housing starts are forecast to average 34,600 units this year, up from around 32,000 at *Budget*. Growth in real residential investment, however, will be softer than expected compared to *Budget*, reflecting the shift towards lower-priced, multi-unit dwellings in new construction and a pullback in resale activity. Next year, housing starts are forecast to moderate but remain solid at 33,500 units, buoyed by rising population and household incomes. Alberta's relatively favourable housing affordability will also support activity.

Risks to Outlook

Downside risks to the outlook have increased since *Budget*. Higher inflation and interest rates have increased the risk of a sharp slowdown in the global economy. Weaker global demand could result in a sharper correction in oil prices, which in turn would weigh on energy activity and investment. A slowdown in the global economy would also impact the non-energy sector through weaker export demand. Higher interest rates could also lead to a more pronounced slowdown in housing activity and consumer spending. On the upside, growth in Alberta and the global economy could be stronger if inflation and interest rate increases slow or cease. Oil prices could also be higher if OPEC+ or U.S. production fail to meet demand or if global geopolitical events inflate the risk premium.

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