Canada

NORTHERN STAR (FOR NOW…)

- **In contrast to the US, Canadian growth is accelerating sharply going into the second quarter, following a solid gain in domestic demand to start the year.**
- **Fast, and accelerating, population growth, and remarkably strong employment growth are providing a solid underpinning to consumer spending and the housing market.**
- **Positive export data suggest that the ongoing strength in domestic demand will be buttressed by net exports in the second quarter, and possibly beyond.**
- **Canadian inflation is at the Bank of Canada's target, in sharp contrast to the US, where it has moved away from the Fed's objective. This gives the BoC room to keep rates on hold if inflation remains on target.**
- **Downside risks remain important and are all linked to US-centric developments, with worries about US trade policy ongoing despite the pause with China.**

THE OUTLIER

Recent Canadian developments stand in sharp contrast to events in much of the rest of the world. Whereas US growth is clearly decelerating, Canadian growth is on an upswing, with recent indicators pointing to a very sharp rebound from a somewhat sluggish start to the year. Canadians appear to be, for the time being, largely insulated from the broader malaise facing the global economy as consumer and business confidence has improved sharply in recent quarters, owing to strong sales and job creation (chart 1). While there are a number of factors suggesting that the growth rebound observed will persist through 2020, there is a risk that a divergence between Canadian and US outcomes may not last.

Underlying much of the strength in activity has been a remarkably strong job market, where job gains so far this year have already outstripped those in 2018 by a wide margin (chart 2). Canadians are benefitting from strong hiring and rising wage growth that together helped boost consumption growth to 3.5% q/q saar in 2019Q1, more than double the rate of the two preceding quarters. Small- and medium-sized businesses continue to cite shortages of skilled and un/semi-skilled labour as the factors that most limit their ability to increase sales or production, but firms are still managing to hire. Year-on-year average wage growth is now running at 3.8%, well above inflation and two full percentage points higher than late last year. Although household debt burdens and debt-service ratios are high, consumer sentiment has rebounded. Household credit growth has steadily accelerated from the second half of 2018, driven by a revival of residential lending as Canadians have adjusted to the tighter qualification standards instituted under 2018's B-20 reforms, and a continued rise in population growth (to its highest rate in over 15 years).

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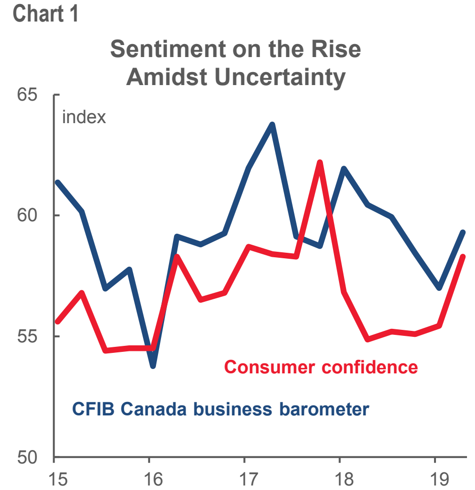
Canada	2017	2018	2019f	2020f
Real GDP (annual % change)	3.0	1.9	1.4	2.0
CPI (y/y %, eop)	1.8	2.0	1.9	1.9
Central bank policy rate (%, eop)	1.00	1.75	1.75	1.75
Canadian dollar (CADUSD, eop)	0.80	0.73	0.78	0.80

Source: Scotiabank Economics.

Chart 1

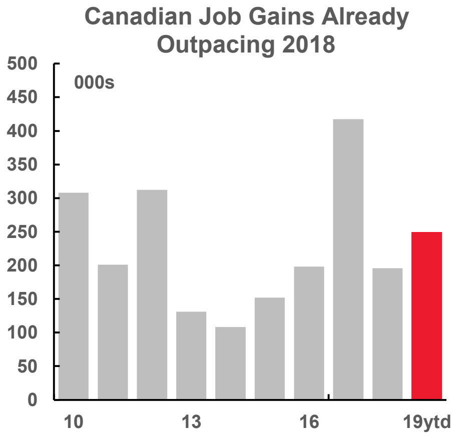


Sources: Scotiabank Economics, CFIB, Nanos Research Corporation, Bloomberg.

Much of the weakness in housing markets appears to be behind us now as the impact of the B-20 reforms and a range of provincial and municipal measures designed to cool housing markets wane. The very simple fact is that with rapid population growth, housing supply has not kept up with demand in much of the country. In the most expensive markets of Toronto and Vancouver, a clear shift in household purchasing patterns is visible, as families rotate from the single-family home market to more affordable townhomes and condos. This is likely to continue as a natural response to affordability challenges in these cities. Prospects for housing markets remain generally good: household income is rising, jobs are plentiful, supply remains generally constrained, and longer-term mortgage costs have fallen by 30 basis points so far this year given the decline in global yields.

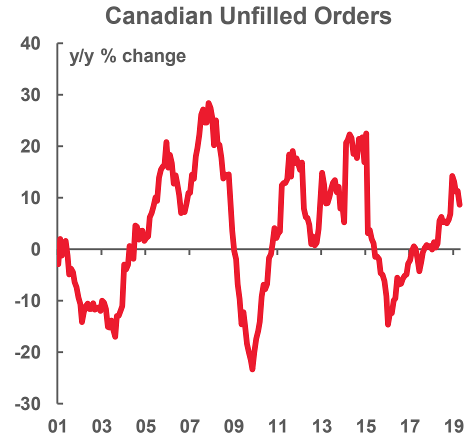
The strength in hiring flows from what remains a generally solid business environment. In many sectors and regions, firms are operating flat-out, with Canada-wide growth in unfilled order books still near the fastet rates in five years (chart 3) and capacity utilization rates remaining at or above long-term averages. Canadian wholesalers saw their strongest two-month gain during March–April in over three years. It appears, however, that the Trump trade battles and uncertainty

Chart 2



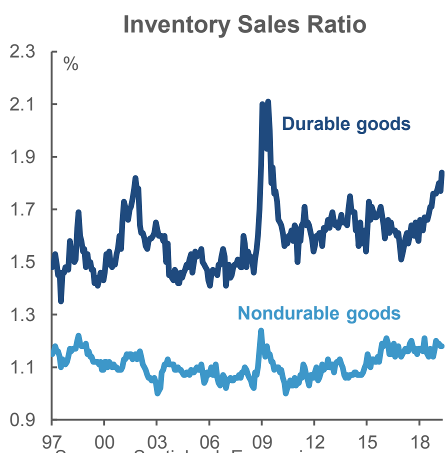
Sources: Scotiabank Economics, Statistics Canada.

Chart 3



Sources: Scotiabank Economics, Statistics Canada.

Chart 4



Sources: Scotiabank Economics, Statistics Canada.

Chart 5

Sources: Scotiabank Economics, Statistics Canada, Netherlands Bureau for Economic Policy Analysis.

Table 1

Quarterly Canadian Forecasts	2018	2019				2020			
	Q4	Q1	Q2e	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic									
Real GDP (q/q ann. % change)	0.3	0.4	2.5	1.5	2.3	2.4	2.0	1.5	1.7
Real GDP (y/y % change)	1.6	1.3	1.3	1.2	1.7	2.2	2.0	2.0	1.9
Consumer prices (y/y % change)	2.0	1.6	2.1	1.8	1.9	2.1	2.1	2.0	1.9
Avg. of new core CPIs (y/y % change)	1.9	1.9	2.1	2.0	2.0	2.0	2.0	2.0	2.0
Financial									
Canadian Dollar (USDCAD)	1.36	1.33	1.31	1.31	1.28	1.28	1.28	1.25	1.25
Canadian Dollar (CADUSD)	0.73	0.75	0.76	0.76	0.78	0.78	0.78	0.80	0.80
Bank of Canada Overnight Rate (%)	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
3-month T-bill (%)	1.65	1.67	1.65	1.65	1.65	1.65	1.65	1.65	1.65
2-year Canada (%)	1.86	1.55	1.47	1.50	1.40	1.35	1.35	1.35	1.35
5-year Canada (%)	1.89	1.52	1.39	1.45	1.40	1.40	1.40	1.40	1.40
10-year Canada (%)	1.97	1.62	1.46	1.50	1.55	1.60	1.65	1.65	1.70
30-year Canada (%)	2.18	1.89	1.68	1.70	1.80	1.90	2.00	2.05	2.10

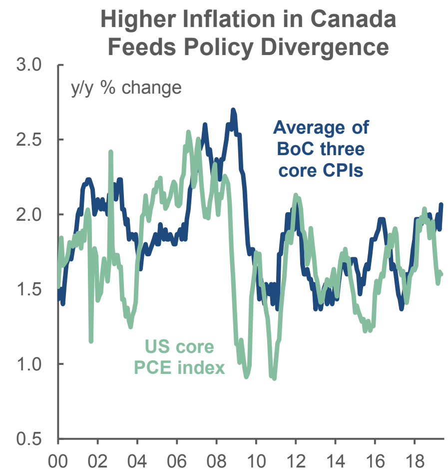
Sources: Scotiabank Economics, Statistics Canada, Bloomberg.

about prospects for the global economic outlook are pushing some of Canada's output into rising stockpiles with inventory-sales ratios still at the highest levels in a decade (chart 4).

With profit margins in Canadian industry a full two percentage points above their historical average, capacity constraints and the increased scarcity of labour are leading firms to increase capital spending, with outlays on machinery and equipment rising by almost 40% q/q saar in Q1. Survey data point to investment strength for the remainder of the year and we continue to believe the LNG Canada project in Kitimat will be a big driver of business investment this year and next.

The acceleration in investment is occurring at the same time as a pickup in Canadian exports, whose growth has risen sharply since March. We have long held the view that a key factor accounting for lacklustre export performance in recent years had been surprisingly sluggish growth in business investment given high capacity utilization rates. While it is too early to link the upside surprises in export growth to the surge in business investment so far this year, they are indicative that this thesis may hold. Export growth stands in contrast to global developments, which generally point to slower growth as the year has progressed, and stands even more sharply in contrast to global trade flows, which have remained quite sluggish (chart 5).

Chart 6



Sources: Scotiabank Economics, Statistics Canada, Bureau of Economic Analysis.

For the remainder of the year, we expect further export growth to be held in check by a higher Canadian dollar and global trade developments. So far this year, the Canadian dollar is the best performing G-10 currency against the US dollar owing to the rise in oil prices and large drop in US interest rates relative to Canada. We expect further strength in the loonie as the Bank of Canada stands pat in the face of an anticipated rate cut in the US. This will limit export growth. Moreover, global trade uncertainty will remain elevated throughout the year, as President Trump continues to sabre-rattle on the trade front and global growth slows further.

Inflation is effectively at the Bank of Canada's 2% target, as the average of the three measures of core inflation utilized by the BoC is now at 2.1% y/y. This is the highest reading since 2012 despite the likely existence of modest economy-wide excess supply. We expect inflation to remain around 2% over the forecast horizon as the impact of output gap closure and rising unit labour costs is generally offset by the pass-through from a stronger exchange rate. Our model continues to capture the movements in Canadian inflation well.

The performance of inflation in Canada relative to the US (chart 6) is of greater importance. Whereas Canadian inflation is on target, it has generally moved away from the Federal Reserve's target, given the impact of past USD dollar strength, low unit-labour cost growth, and a few temporary factors that drove US inflation down. This should allow the BoC to remain on hold as the Federal Reserve cuts rates to, in part, push inflation higher.

As has been the case for several quarters, **the dominant risks to the Canadian outlook lie beyond our borders.** President Trump's policies are having clear and tangible negative impacts on the US and the broader global economy. While a pause appears to have been agreed-to with China, and the President has backed-off his threat of Mexican tariffs, the US trade deficit is becoming larger which may fuel Trump's affinity for tariffs and damaging trade rhetoric.

Table 2

Canada	2000–17	2017	2018	2019f	2020f
	(annual % change, unless noted)				
Real GDP	2.1	3.0	1.9	1.4	2.0
Consumer spending	2.9	3.5	2.1	2.0	1.9
Residential investment	3.6	2.4	-1.5	-3.6	1.3
Business investment	2.2	2.2	2.2	0.2	5.5
Government	2.2	2.7	3.0	1.6	1.7
Exports	1.3	1.1	3.2	1.7	2.4
Imports	3.0	4.2	2.9	1.5	2.8
Nominal GDP	4.3	5.6	3.6	2.7	4.2
GDP Deflator	2.1	2.6	1.7	1.3	2.1
Consumer price index (CPI)	1.9	1.6	2.3	1.8	2.0
CPI ex. food & energy	1.6	1.6	1.9	1.9	2.0
Pre-tax corporate profits	0.0	20.1	0.5	-4.1	2.1
Employment	1.4	1.9	1.3	2.1	1.0
Unemployment rate (%)	7.1	6.3	5.8	5.7	5.9
Current account balance (CAD bn)	-18.7	-59.4	-58.5	-57.6	-55.9
Merchandise trade balance (CAD bn)	22.9	-23.9	-22.0	-26.1	-28.0
Federal budget balance* (FY, CAD bn)	-3.6	-17.8	-19.0	-11.8	-19.8
percent of GDP	-0.2	-0.9	-0.9	-0.5	-0.8
Housing starts (000s)	200	220	213	202	199
Motor vehicle sales (000s)	1,678	2,036	1,983	1,935	1,915
Industrial production	0.0	4.9	2.9	0.4	1.9
WTI oil (USD/bbl)	62	51	65	56	55
Nymex natural gas (USD/mmbtu)	4.83	3.02	3.07	2.71	2.75

Sources: Scotiabank Economics, Statistics Canada, CMHC, Bloomberg.