Canada

JOB GROWTH TRUMPING UNCERTAINTY

- **The hiring boom rolls on as firms continue to face labour shortages.**
- **Growth should accelerate modestly next year if there is no further increase in trade-related uncertainty. Though risks of a recession exist, we do not think we are headed for a period of protracted weakness. That view could change if uncertainty rises significantly.**
- **Strong population growth will continue to provide human stimulus in Canada, a major differentiator relative to other advanced economies, where population growth is slowing.**

Without question, the most surprising Canadian economic development over the last year has been the resounding strength of the Canadian labour market. More jobs have been created as of August than in all of 2018. Some measures of wages are rising strongly, the unemployment rate is hovering near 45-year lows, there are nearly 600k job vacancies, and Canadian firms continue to report that labour shortages are by far the most important factor limiting production or sales increases. This is set against a global environment tainted by elevated uncertainty, which has led to a retrenchment in global industrial production and trade volumes, along with significant impacts in financial markets.

An immediate consequence of the strength in labour outcomes has been to keep Canadian consumer confidence elevated despite the barrage of worrisome global news (chart 1). This is important in a number of ways. Our recession probability model, which uses information from the yield curve and consumer confidence (in contrast to most yield-curve-based recession probability models), is only pointing to 20% chance or so of a recession in the next 18 months (chart 2). The strength in confidence, which is itself a reflection of underlying dynamism in the labour market, is keeping a lid on recession risks—thus far. Moreover, the resilience of consumer confidence, combined with a fall in mortgage rates and strong employment and wage gains, has contributed to a dramatic turnaround in the Canadian housing market, with sales rebounding sharply through the summer months.

Uncertainty is nevertheless exacting a heavy toll on the Canadian economy. Our macroeconomic model for Canada and the US has been updated to formally include an uncertainty channel. The rise in trade-related concerns and the follow-on impact on financial markets has led to a marked reduction in the level of activity relative to what would have been the case if uncertainty had not increased as much as observed. In the US, the source of the shock, the level of economic activity is expected to be 0.75 percentage points lower at the end of 2019 than would have occurred with less uncertainty (see ***Economic Commentary: United States (October 10, 2019)***). In Canada, the impact is estimated at 0.5 percentage points of output (chart 3) by the end of this year. This is a sizeable economic impact, which of course is being addressed through monetary policy. In Canada's case, absent this uncertainty, we might still be focused on the need for additional interest rate increases, rather than our current call for 50 bps of cuts.

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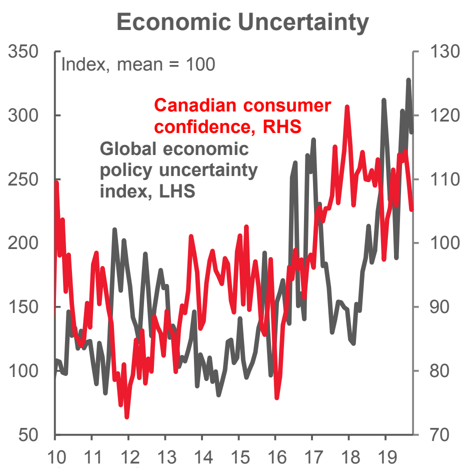
Canada	2018	2019f	2020f	2021f
Real GDP (annual % change)	1.9	1.6	1.8	1.9
CPI (y/y %, eop)	2.0	2.0	1.9	2.5
Central bank policy rate (%, eop)	1.75	1.50	1.25	1.25
Canadian dollar (CADUSD, eop)	0.73	0.77	0.80	0.80

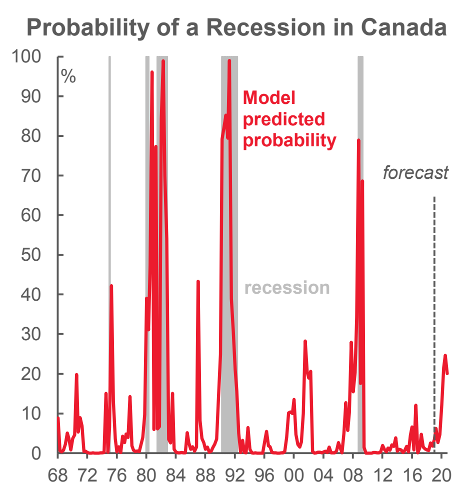
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, PolicyUncertainty.com, Conference Board.

Chart 2



Sources: Scotiabank Economics, Haver Analytics.

Despite this uncertainty, we expect Canadian growth will accelerate modestly, rising from 1.6% this year to 1.8% in 2020. This is in contrast to the US outlook, which may see a sharp reduction in growth rates from this year to next. Several factors account for this:

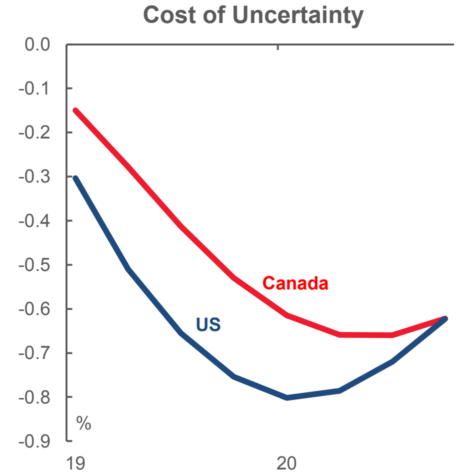
- Canada is experiencing an immigration-led population boom, with population rising at its fastest rate in 20 years. This is in sharp contrast to other advanced economies, including the US, where population growth has slowed. This is giving Canada a dose of human stimulus that other countries aren't benefitting from, while also increasing the pool of available labour for firms in need of workers. Immigrants to Canada have been buying goods and services, and have undoubtedly been supporting housing markets.

- Fiscal policy will likely be slightly more stimulative next year. Announcements to date from the leading parties reflect a mixture of tax cuts, transfers, and spending measures. In all likelihood, the announced measures by the Liberals or the Conservative Party of Canada will add around 0.1 percentage points to growth next year. The exact impact will of course depend on which party wins, what measures they implement and when they take effect. That will be determined in time. For the moment, we are penciling in a boost of 0.1% to growth next year, as the deficit is set to expand under either party.

- Construction of the CAD 40 billion LNG Canada terminal in Kitimat will be in full swing next year, providing a substantial amount of investment, which will meaningfully increase growth prospects in British Columbia and the rest of the country.

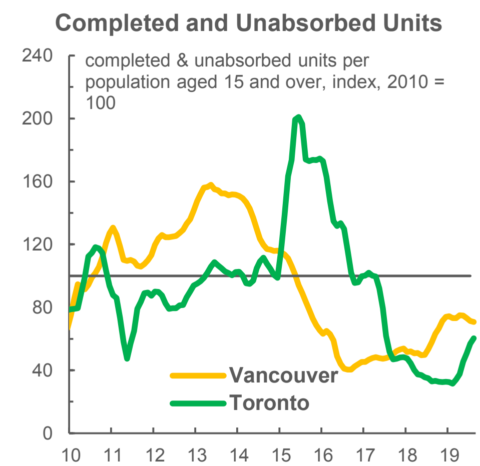
A key area of attention in coming months will be the evolution of the housing markets. The rise in employment, fall in interest rates, and sustained population growth are providing a solid backdrop to national housing markets. Sales activity has picked up dramatically over the summer following a period of generalized weakness that began late last year. We attribute this weakness to the impact of various regulatory changes designed to calm markets and increase the financial resiliency of

Chart 3



Sources: Scotiabank Economics.

Chart 4



Sources: Scotiabank Economics, Statistics Canada.

Table 1

Quarterly Canadian Forecasts	2019		2020				2021			
	Q3e	Q4f	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic										
Real GDP (q/q ann. % change)	1.5	1.2	2.0	2.0	1.4	1.6	2.0	2.1	2.0	1.9
Real GDP (y/y % change)	1.5	1.7	2.1	1.7	1.6	1.7	1.8	1.8	2.0	2.0
Consumer prices (y/y % change)	1.9	2.0	2.1	1.9	1.9	1.9	2.0	2.1	2.2	2.5
Avg. of new core CPIs (y/y % change)	2.0	2.0	2.0	2.0	2.0	2.1	2.1	2.1	2.2	2.2
Financial										
Canadian Dollar (USDCAD)	1.32	1.30	1.28	1.28	1.25	1.25	1.25	1.25	1.25	1.25
Canadian Dollar (CADUSD)	0.76	0.77	0.78	0.78	0.80	0.80	0.80	0.80	0.80	0.80
Bank of Canada Overnight Rate (%)	1.75	1.50	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25
3-month T-bill (%)	1.65	1.40	1.20	1.20	1.25	1.25	1.25	1.25	1.25	1.30
2-year Canada (%)	1.58	1.30	1.20	1.25	1.30	1.30	1.35	1.40	1.45	1.50
5-year Canada (%)	1.40	1.25	1.25	1.30	1.35	1.40	1.45	1.50	1.55	1.60
10-year Canada (%)	1.36	1.30	1.40	1.50	1.55	1.60	1.65	1.70	1.75	1.80
30-year Canada (%)	1.53	1.45	1.55	1.65	1.75	1.80	1.85	1.90	1.95	2.00

Sources: Scotiabank Economics, Statistics Canada, Bloomberg.

households. Those adjustments, while necessary, are clearly in the rear view mirror as the laws of economics assert themselves. Demand remains greater than supply in most markets and inventories are generally low (chart 4). This suggests that housing markets have some momentum going forward, and that affordability will remain a challenge for Canadians in a range of communities. It also suggests that consumer spending will accelerate in coming quarters as these newly purchased homes are furnished or improved.

Moreover, **the pick-up in sales activity is leading to a sharp rise in credit growth, which might give pause to the Bank of Canada if, as we believe, it were to seek to provide a cushion to the rise in uncertainty**. For much of the last three years, Governor Poloz has warned of the perils of high household indebtedness. Those concerns are likely to re-emerge, even though household balance sheets generally seem to be in good shape. The most recent data on delinquency rates on credit cards shows a decline in delinquencies relative to last year. Arrears rates on mortgages remain near the lows seen in the last 25 years or so (chart 5). This could all change quickly if the unemployment rate were to increase, but with the pent-up demand for labour currently plaguing Canadian industry, that appears unlikely to occur.

There are nevertheless reasons for concern. Business activity remains solid but inventory levels are at their highest in 10 years (chart 6). This is to some degree understandable given the increase in unfilled orders observed over the last two years, but it does represent a vulnerability if sales were to slow significantly.

Canada is not immune to the vagaries of US trade policy. Some uniquely Canadian factors give us a better cushion to deal with elevated uncertainty than other countries, but the simple fact is that an amplification of policy volatility has the potential to drag Canada down with the US. If uncertainty is kept in check, as we expect, there is a solid case to believe that Canadian growth will increase modestly in 2020 relative to this year.

Table 2

Canada	2000–18	2018	2019f	2020f	2021f
	(annual % change, unless noted)				
Real GDP	2.1	1.9	1.6	1.8	1.9
Consumer spending	2.9	2.1	1.7	1.8	1.9
Residential investment	3.4	-1.5	-1.7	3.1	2.5
Business investment	2.2	2.2	-2.3	3.0	2.3
Government	2.2	3.0	1.6	1.7	1.6
Exports	1.4	3.2	2.7	2.4	2.3
Imports	3.0	2.9	0.9	2.4	2.4
Nominal GDP	4.2	3.6	3.2	3.8	4.3
GDP Deflator	2.1	1.7	1.6	1.9	2.4
Consumer price index (CPI)	1.9	2.3	1.9	2.0	2.2
CPI ex. food & energy	1.6	1.9	2.2	2.1	2.0
Pre-tax corporate profits	0.0	0.5	1.7	3.4	2.0
Employment	1.4	1.3	2.1	1.0	1.0
Unemployment rate (%)	7.0	5.8	5.7	5.9	5.9
Current account balance (CAD bn)	-20.8	-58.5	-35.9	-28.6	-24.5
Merchandise trade balance (CAD bn)	20.6	-22.0	-10.6	-8.5	-8.2
Federal budget balance* (FY, CAD bn)	-4.4	-19.0	-14.0	-19.8	-14.1
percent of GDP	-0.3	-0.9	-0.6	-0.8	-0.6
Housing starts (000s)	201	213	210	206	202
Motor vehicle sales (000s)	1,694	1,983	1,940	1,915	1,915
Industrial production	1.0	3.1	0.9	2.1	1.8
WTI oil (USD/bbl)	62	65	57	55	62
Nymex natural gas (USD/mmbtu)	4.74	3.07	2.61	2.64	2.75

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

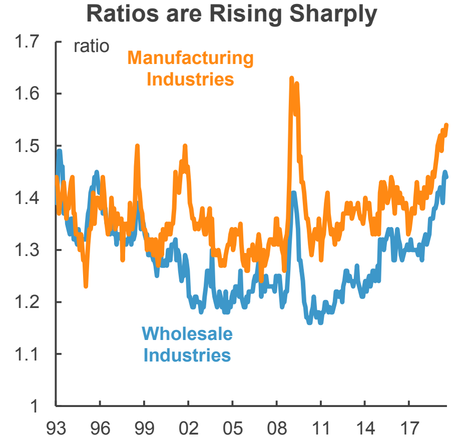
Chart 5

Percent of Arrears to Total Number of Residential Mortgages

Sources: Scotiabank Economics, CBA.

Chart 6

Canadian Total Inventory to Sales Ratios are Rising Sharply



Sources: Scotiabank Economics, Statistics Canada.