Canada’s energy slowdown continues to ease

Despite rising global headwinds, recent Canadian data have been broadly positive and there is growing evidence of the economy emerging from its Q4/18-Q1/19 slowdown. April GDP was up 0.3%, handily beating expectations for a second consecutive month. Unlike in March, growth was concentrated in the energy sector, which was a major drag on activity over the winter. Some of the increase is likely to be temporary—oil companies ramped up production rather than undertaking usual maintenance, so we should see some give-back in the coming months—but rising drilling activity and further easing in production restrictions suggest the energy sector’s recovery is becoming entrenched.

Canada’s non-energy economy continues to chug along. Housing hasn’t exactly turned from headwind to tailwind like the energy sector, but recent stabilization is encouraging. Consumer spending is also emerging from a winter slump with retail sales up an annualized 3% in the last three months. Other services sectors like wholesale trade, hospitality, and tech continue to expand at a solid rate. Manufacturing has shown some signs of weakness, though not to the extent seen in other economies. While exports jumped higher in May, the increase isn’t likely to be sustained—manufacturing sentiment has fallen sharply amid rising trade tensions and slowing global industrial production. Overall, however, Q2 GDP growth is tracking a 2.2% annualized pace with healthy contributions from both energy and non-energy industries.

Business Outlook Survey better than expected (feared) in Q2

Business confidence fell sharply in Q1: rising trade tensions and a decline in manufacturing sentiment had us concerned about a further slip in Q2. But the BoC’s latest Business Outlook Survey was stronger than expected with overall sentiment moving back above its longer-term average (though only slightly). The future sales indicator posted a solid increase, with foreign sales likely to see modest growth even as firms expect global trade headwinds and uncertainty will restrain exports. In fact, concerns about global trade tensions were less prevalent than expected—among factors restraining sales, capacity pressures and domestic regulation ranked higher than trade policy. With domestic demand remaining supportive, hiring and investment intentions remained slightly above longer-term levels. Overall, the Q2 BOS was about as good as the BoC could have hoped for given global developments during the May survey period.

BoC sounding more concerned about global risks

With a run of positive economic data and a less worrying Business Outlook Survey in hand, we thought the Bank of Canada would come out with a neutral tone again in July. They did maintain a neutral bias—saying current accommodation remains appropriate—but sounded more concerned about global developments than in May. Whereas the last policy statement put an improving domestic economy front and centre, July’s led with rising trade tensions and a deteriorating global outlook. The BoC lowered its global growth forecast this year and next, and said escalating trade conflicts are the biggest downside risk to the outlook globally and in Canada. And while marking up its Q2 growth forecast, Governing Council pointed out that some of the increase will be from temporary factors, and growth is expected to moderate somewhat in Q3. GDP growth was revised lower for 2020, largely due to less contribution from business investment and exports, but is still expected to average around 2%.

Overall, the BoC thinks trade conflicts and uncertainty will reduce the level of GDP by up to 2% by the end of 2021. Given that sizeable headwind, it’s no surprise policymakers were sounding more cautious in July. For now, though, the BoC looks set to diverge from the Fed, holding rates steady while the US central bank cuts. Firmer core inflation in Canada (close to 2% for the last year) and an already more-accommodative stance give the BoC some leeway in that regard. But its latest comments suggest further deterioration in the global outlook, or an increase in trade tensions, would see the BoC joining its global peers in lowering rates. We have penciled in a 25 basis point rate cut in early-2020 that should help take some pressure off the Canadian dollar, which has increased 2.5 cents in the last six weeks thanks to the Fed’s dovish shift.