Canadian business investment perking up?

Canadian GDP growth slowed as expected in Q3, with a 1.3% annualized increase marking the third sub-trend gain in the last four quarters. But underlying details were firmer than expected with domestic spending rising by more than 3%. Much of the surprise was in business investment which jumped by nearly 10%. That was just the second increase in the last six quarters, and while encouraging, we think it’s too early call this the start of an upward trend in capital spending. Forward looking indicators of business investment remain mixed. The BoC’s Q3 Business Outlook Survey showed a solid increase in investment intentions, but the broader confidence reading (which the BoC says provides a better read on capex) remains subdued. Another survey that focuses more on small and medium-sized businesses shows investment plans have softened, on balance, in recent months.

That said, there is reason to think the drag from oil and gas investment will ease in 2020. Producers’ latest capex plans are mixed but on balance suggest flat to slightly positive spending growth next year. And while the industry continues to await additional pipeline capacity from major projects like Enbridge’s Line 3 Replacement and the Trans Mountain Expansion, a number of measures to increase throughput on existing pipelines and ongoing use of crude-by-rail should provide a bit more egress capacity next year. So even with the Alberta government keeping production caps in place, we think there is scope for investment to edge up from the lows seen in 2019.

Housing rebound comes with more debt

Housing also made a strong contribution to growth in Q3 with residential investment rising at its fastest quarterly pace since 2012. Housing starts were close to a cycle high over the summer and the resale market is now the strongest since late-2017 when buyers rushed to get ahead of new stress tests. Lower mortgage rates (down nearly 1 percent this year despite the BoC holding its policy rate steady) have stimulated demand by making borrowing cheaper and lowering the bar for stress tests. The result, though, has been a renewed pickup in mortgage credit growth, which had slowed to a 17-year low in early 2019, and an increase in the share of highly indebted borrowers. So while a resurgent housing market has helped support GDP growth in the last two quarters, it has also rekindled financial stability concerns.

BoC patience to be tested by sub-trend growth

The Bank of Canada left its policy rate unchanged in early-December, cementing its status as a holdout in 2019 while some 40 other central banks, including the Fed, lowered rates. The BoC sounded more comfortable on the sidelines than in October when it openly discussed a rate cut. In an economic update following the decision, Deputy Governor Lane noted that recent developments gave Governing Council “more confidence” in its October forecasts. The bank also noted “nascent evidence” that global growth is stabilizing but said ongoing trade conflicts and uncertainty are still weighing on activity. Ultimately its upcoming rate decisions will come down to the extent to which external headwinds challenge the household sector’s resilience.

The BoC’s more neutral tone suggests a January rate cut (our previous forecast) is unlikely. But we continue to think persistently sub-trend growth—including lacklustre investment and exports—will test the BoC’s patience and result in a rate cut in Q2. Such a move would provide a bit of relief to highly indebted Canadians, particularly those renewing mortgages in 2020. That said, if recent strength in the resale market persists, the BoC might be reluctant to spur on activity (and increase household vulnerabilities) by lowering rates. Fiscal policy could also give the BoC cause for patience. The government just announced that a promised increase in the basic personal amount (benefiting most Canadian taxpayers, at a cost of about $3 billion next fiscal year) will take effect at the start of 2020, slightly earlier than we expected. If that modest fiscal boost is followed by further near-term stimulus, it might convince the BoC that additional monetary policy support is unnecessary.