ECONOMIC AND FINANCIAL MARKET UPDATE

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Canada's economy keeps up its growth streak

Canada's economy extended its growth streak to seven months with August GDP rising 0.1%. But the increase was narrowly based, led by a rebound in oil production following supply outages in July. Manufacturing, wholesale and retail trade were all lower in the month. Thanks to earlier momentum, GDP is still tracking close to a 2% annualized pace in Q3. Softening retail sales and homebuilding activity suggest the household sector once again provided less support than in recent years. But we think a further pickup in business investment and another add from net exports provided enough offset to keep the economy growing at a trend-like pace. On net we think GDP growth will average 2% over the second half of the year—a not-too-hot, not-too-cold pace that should please the Bank of Canada given an economy operating at capacity.

Canadian businesses report growing capacity pressures

The Bank of Canada's latest Business Outlook Survey showed another quarter of positive sentiment—and that was before announcement of the new USMCA deal. Even if the survey was a bit stale in that sense, there were still some notable takeaways. A common theme was growing capacity pressures. More than half of firms said they'd have difficulty meeting an unexpected increase in demand. The share of companies reporting labour shortages was at a decade high, and the intensity of labour shortages was near a record in Q3. More than a third of firms surveyed said they intend to respond to capacity pressures by investing and/or hiring over the next year.

The latest CFIB Business Barometer also pointed to capacity issues. The share of firms reporting skilled and un/semi-skilled labour shortages jumped higher in October. Businesses say those shortages are the most significant factor restricting their ability to increase sales or production—more than insufficient demand or competitive pressures. These surveys support the Bank of Canada's conclusion that the economy is operating close to full capacity—if not slightly beyond. That should help keep a floor under inflation, and argues for the BoC to continue removing monetary policy stimulus.

BoC raises rates, drops "gradual" from forward guidance

The Bank of Canada raised rates in October for the fifth time in 15 months. The move was fully expected but Governing Council still managed to surprise markets by shifting their forward guidance. The policy statement no longer indicated rate increases will be "gradual"—a term that markets associated with the Fed's rate hikes at every other meeting. We think Governing Council conversely wants to emphasize that they will be flexible in raising rates, potentially speeding up or slowing down the pace of tightening based on incoming data—particularly how households are handling higher borrowing costs. While their guidance on the pace of tightening is now less specific, the ultimate destination is clearer: they indicated the overnight rate "will need to rise to a neutral stance" to keep inflation on target. The BoC estimates 'neutral' is in the range of 2.5-3.5%, well above today's 1.75% overnight rate. That change in language was seen as a hawkish development. Markets are now expecting the overnight will reach the lower end of that neutral range by the end of 2019.

But we aren't ready to change our forecast for next year. Sure, the BoC says monetary policy needs to become neutral, but they didn't give a timeframe for that adjustment. We still think they'll have to be gradual in removing accommodation given household sensitivity to rising rates. Our forecast assumes higher borrowing costs will weigh on the household sector a bit more than the BoC has penciled in next year. As such, we only look for two rate increases in 2019. In our view, it won't be until 2020 that the overnight rate shifts into the central bank's neutral range.