Plenty to like under the surface of Canada’s Q1 GDP report

Canadian GDP rose an annualized 0.4% in Q1, not much better than the previous quarter’s 0.3% gain. The details were much better, though, with domestic demand rising 3.4% following Q4/18’s 1% decline. Surprisingly, consumer spending led the way with households shelling out more on both goods and services. The sharp improvement seemed to defy soft retail sales in the quarter, but is in line with strong job growth and an improving income backdrop. Business investment also shot higher, retracing the previous quarter’s decline. A jump in aircraft purchases was a big factor, though the increase in machinery and equipment spending was broadly based. Some of the pickup in M&E investment came from imports, which surged nearly 8% in Q1. Combined with a drop in exports (mostly in the energy sector), net trade shaved almost 4 percentage points from headline growth. Business capex will come back to earth in Q2 (the jump in aircraft purchases won’t be repeated) accompanied by a corresponding decline in imports.

In addition to solid expenditure details, the trend in monthly activity is encouraging. GDP jumped 0.5% in March, matching the best monthly pace since 2016. The economy was firing on all cylinders—a decline in utilities output after a cold weather-driven surge in February was the only soft spot. We saw a solid gain in services industries (more than 70% of Canada’s economy) where output is up 2.5% from a year earlier. Goods sectors also improved with mining, oil and gas, manufacturing, and construction all posting gains after declining in the previous month. March’s increase shows the Canadian economy had solid momentum heading into the current quarter. We continue to expect GDP growth will rebound to a 2.2% annualized pace in Q2.

As trade tensions rise, BoC staying positive—for now

With the Bank of Canada widely expected to hold interest rates steady and maintain a neutral bias in May (they did both), their latest policy statement was all about tone. The two major developments since their April meeting were improving domestic data and rising global trade tensions (they met after the latest tariff hikes on China but before Trump’s threats against Mexico). The BoC put more emphasis on improving data, noting “accumulating evidence” that the slowdown over the last two quarters will be transitory. That includes strong job growth (suggesting businesses, too, think recent softness is temporary), early signs of recovery in the energy sector, and stabilization in most housing markets. Consumer spending, exports, and business investment were also noted to be improving in the current quarter.

While Governing Council seemed pleased with the economy’s turn for the better, they also said escalating trade conflicts are generating heightened uncertainty. That includes growing US-China tensions and Canada’s own trade issues with China (particularly a ban on some canola exports). But even on the trade file the bank wasn’t overly pessimistic, noting rising odds of CUSMA ratification (again, prior to Trump’s threats against Mexico) and the lifting of US steel and aluminum tariffs. That seemed consistent with their usual refrain that trade risks are both to the upside and the downside.

While trade risks might be two-way, the BoC will have to onboard recent tariff action when they update their forecasts in July. Recall that the previous round of US tariffs and China’s retaliation were seen shaving about 0.2 and 0.5 ppts from US and Chinese GDP, respectively, by the end of next year. The latest round of US tariff hikes, if sustained, might see those impacts nearly doubled. And if the Trump administration follows through on threats against Mexico, the hit would be even larger. So while the BoC maintained that global growth has been evolving as expected, they could be marking down their forecast in July. That would have knock-on effects for the domestic growth outlook, given both Canada’s exposure to the US industrial sector (which is bearing the brunt of tariff increases) and potential weakness in commodity prices stemming from a softer global outlook (something we’re already seeing in recent oil price declines). Markets seem to be more concerned about trade developments than the BoC was in May, and are now pricing in a 25 bp rate cut by the end of this year.