Canada’s economy returned to growth in May…

Canada’s economic output shrank by an unprecedented 18% between February and April, nearly four times the peak to trough decline during the 2008-09 recession. But the economy started to claw its way back in May (GDP rose 3% according to StatCan’s preliminary estimate) and recent activity indicators point to further improvement in June. Retail sales reportedly increased by 19% in May (retracing about 40% of the previous two months’ declines) and our own consumer spending tracker suggests card spending nearly returned to year ago levels by mid-June. Auto sales have also rebounded sharply, with June’s unit sales more than tripling from April’s low. New cars aren’t the only big ticket purchase Canadians were more willing to commit to—home resales started to pick up in May and were at or above year-ago levels in some major markets in June.

A quick start to the recovery, particularly on the household side, reflects some pent up demand after health restrictions limited Canadians’ ability to go out and buy anything but essentials (online sales have unsurprisingly flourished). Government support for households—$53.5 billion in CERB payments through the end of June, and billions more in tax credits and child benefits—has also helped shore up income in the face of significant job losses. CERB payments were recently extended by 8 weeks, meaning those that started making claims in mid-March will continue to receive benefits until the end of August.

…but don’t extrapolate that trend

While the early recovery has been swift, we think demand will remain soft over the second half of the year due to low business and consumer confidence and ongoing physical distancing. That will mean still-challenging labour market conditions, and reliance on less generous EI payments for those whose CERB benefits have run out. And while some consumer-facing sectors have seen a solid rebound, business confidence generally remains subdued. The Bank of Canada’s Business Outlook Survey showed a sharp downturn in overall sentiment in Q2, with many firms cutting capex plans, and hiring intentions remaining muted. In a separate CFIB survey, more than 40% of small business respondents still characterized their general business situation as “bad”. Nearly as many expect to reduce full time employment in the next 3-4 months. Exporters are feeling the pinch, too—EDC’s trade confidence index fell to a record low in Q2 with both sales and new business opportunities slowing sharply.

Fiscal support comes at a cost

Fiscal support measures have prevented a more severe economic downturn—the government estimates GDP would have fallen by more than 10% in 2020 without its interventions—by providing a helping hand in the early stages of the recovery. The price tag has been substantial, though. Finance Minister Morneau announced the federal budget deficit is expected to come in at $343 billion, or 16% of GDP, in 2020-21. That largely reflects nearly $230 billion in stimulus measures (including an expanded wage subsidy program) and a $71 billion revenue hit, the majority of which is due to lower tax receipts. The unprecedented shortfall will push federal debt above $1 trillion, or 49% of GDP.

Citing the pandemic’s heavy toll on government finances (both federal and provincial), Fitch downgraded Canada’s credit rating to AA+ from AAA in June. Other ratings agencies still give the country’s debt a top-tier rating, though we expect further downgrades will follow. Market reaction to the downgrade was muted with GoC yields remaining at all-time lows. The Bank of Canada’s QE program is helping to contain borrowing costs—at its current pace, the bank’s purchases (including regular purchases at auction) will equate to more than 85% of bond issuance this year. Lower public debt charges were about the only positive news in the government’s fiscal update.

New BoC governor sounding less optimistic

Outgoing BoC Governor Poloz ended his term with relative optimism, noting that the economy was still tracking the “best-case scenario” laid out in the bank’s April MPR. But his successor, Tiff Macklem, isn’t sounding as cheery. In his first speech as governor, Macklem warned “the recovery will likely be prolonged and bumpy, with the potential for setbacks along the way.” While re-opening should support near term job growth, and consumer spending will be boosted by pent up demand in the “recovery” phase, Macklem noted that not all jobs will come back and lingering uncertainty will result in weak demand over a more gradual “recovery” phase. With demand expected to recover more slowly than supply, excess capacity in the economy is likely to keep inflation below the Bank of Canada’s 2% target. Our forecast assumes CPI ex food and energy, which fell to just 0.6% year-over-year in May, will only reach 1.6% by the end of 2021.

The upshot is that some of the monetary policy support launched by the BoC since March will need to remain in place for an extended period. While improved market functioning means liquidity providing programs are seeing less demand, government bond purchases are continuing at a steady pace. The central bank’s guidance remains that large scale asset purchases will continue “until the economic recovery is well underway”—a commitment that we think will see QE extending well into next year. Rate hikes remain off the table throughout our forecast horizon.