



ECONOMIC AND FINANCIAL MARKET UPDATE

August 2018

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Canada's economy impressed in May...

Canadian GDP rose 0.5% in May, well ahead of expectations for a 0.3% increase. Some of the strength reflected reversal of temporary factors that held growth to 0.1% in the previous month. Retail and construction activity both rebounded following weather-related declines and oil and gas output picked up after shutdowns in April. But May's growth was also broadly-based with 19 of 20 industries recording month-over-month gains—the most widespread increase in more than a decade. The strong report raised our Q2 GDP growth forecast to 3%, which would more than double the disappointing increase recorded in Q1. We think the recent pickup reflected a rebound in consumer spending after a soft start to the year, as well as less drag from housing. Exports, which were held down by temporary issues in Q1, also provided significant support (more on that below). Over the second half of the year those sectors will face headwinds from rising interest rates, tariffs and trade uncertainty. We expect GDP growth will be slightly slower on balance with an average increase of just less than 2% in Q3 and Q4. That should keep the economy from pushing too far beyond its longer run capacity—which the Bank of Canada should see as a positive development.

...and the trade deficit shrank in June despite new tariffs

June's international trade report gave us our first look at how US tariffs are impacting Canada's steel and aluminum industries. Steel exports to the US fell by more than a third, while aluminum was less impacted with shipments south of the border falling 7%. But it's worth noting that June's decline follows strong growth between February and May when tariffs were threatened but not yet implemented. So some of the drop-off may simply reflect US purchasers having stocked up in preparation for tariffs. Relative to last year, June's steel exports were down a more moderate 14% and aluminum exports were actually 10% higher. The Bank of Canada has assumed tariffs will lower steel and aluminum exports by roughly 20% over the second half of the year. If that is the case we'll likely see further declines in the coming months.

Notwithstanding lower steel and aluminum exports, June's trade report was quite impressive. Canada's trade deficit shrank dramatically on a broadly-based increase in exports. That capped off a strong quarter for exporters with volumes up a whopping 16% (annualized) in Q2, the strongest pace in four years. We now expect net trade added a full 2 percentage points to Canadian GDP growth in the second quarter.

Another surprise BoC hike in September? We don't think so

An upbeat tone from the Bank of Canada at their July meeting—when they raised rates for the fourth time in a year—improved our confidence that we'd see another hike before 2019. Recent data have also supported that call. When the central bank updated their projections in July their forecast for Q2 GDP to rise 2.8% looked ambitious. But as noted above, May's GDP reported now has us monitoring an even stronger increase. June's CPI report was also firmer than expected with headline inflation running at the fastest pace in more than six years. Upside surprises on growth and inflation have raised the prospect of the BoC hiking rates again as soon as September. That would follow the pattern seen last year when a well-telegraphed rate increase in July was followed by a more surprising move in September.

Will history repeat itself? We don't think so. Back-to-back moves would go against the bank's guidance that tightening will be gradual. Last year was also a somewhat different case as the 50 basis points of rate hikes delivered over the summer could be seen as simply reversing cuts made during the oil price downturn. So even as recent data point to less need for stimulative monetary policy, we think the BoC will be patient this time around and wait until October to raise the overnight rate. Interestingly—and in contrast to the BoC's silence last summer—two panel appearances by Governor Poloz and Senior Deputy Governor Wilkins in late-August offer an opportunity to talk up a September move if Governing Council is so inclined.

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