ECONOMIC AND FINANCIAL MARKET UPDATE

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Canada's economy also had a slow to start the year…

Canada's economy unexpectedly stumbled to start the year with January GDP falling 0.1%. The shortfall relative to our forecast (and consensus call) for a 0.1% increase largely reflected a pullback in non-conventional oil and gas extraction—due to transitory maintenance shutdowns—that shaved 0.2 percentage points from monthly growth. A less surprising decline in the real estate sector as new housing regulations slowed resales also trimmed 0.1 ppt from headline growth. Absent those two factors, the rest of the economy recorded a more trend-like pace of growth. While we await early activity data for February, our expectation is that growth will rebound as energy sector shutdowns reverse. The same won't be true for real estate, with sales having fallen again in February. That decline was less acute, however, and won't provide the same headwind it did in January. All told, we have lowered our Q1 GDP growth forecast to 1.6%. That would represent a fairly sizeable shortfall (for the second consecutive quarter) relative to the Bank of Canada's 2.5% projection.

…but inflation continues to tick higher

While recent growth figures have disappointed relative to the central bank's forecast, inflation has surprised to the upside. The Bank of Canada's three core CPI measures have continued to grind higher and are now averaging 2%—a rate seen only a handful of times in recent years. These year-over-year rates will likely pick up further in the near term as two of the core measures are tracking closer to a 2.5% annualized pace over the past six months. Some of the increase can be attributed to Ontario's minimum wage hike, which has been passed through to a number of expenditure items—most notably food purchased from restaurants and child care and domestic services. But our calculations suggest Ontario has only accounted for half of the recent increase in inflation—punching only slightly above the province's weight in the overall CPI basket.

Wage growth is also picking up—both in Ontario, due to a higher minimum wage, and in a number of other provinces where labour markets are tight. The Bank of Canada has highlighted four wage measures it tracks. The two for which data is available early this year suggest hourly pay is rising slightly faster than 3%. That rate doesn't exactly suggest inflation is about to surge, but is certainly more consistent with a multi-decade low unemployment rate than the pace of wage growth seen through much of last year.

Markets are less confident in a near-term rate hike

Odds of another near-term rate hike have likely been influenced by trade policy developments and central bank communication. The Trump administration's initial proposal on steel and aluminum tariffs, which would have applied to Canada, had the BoC point to growing trade uncertainty in their March policy statement. A subsequent carve-out for Canada and a number of other allies reduced direct trade risk, though Trump's subsequent announcement of tariffs on $50 billion of Chinese imports means the threat of a global trade war hasn't gone away. On a more positive note, negotiators seem to be making progress in Nafta talks. The US is backing away from some of their more contentious demands in an effort to wrap up negotiations in the next month or two—or at least have an agreement in principle.

But while the key headwind of Nafta uncertainty might be easing, markets aren't rushing to price more tightening by the central bank. Some of that likely has to do with a more dovish tone from Governor Poloz. In a recent speech, he floated the idea that monetary policy needs to remain accommodative to encourage investment and attract more people into the labour force. However, remarks from other Governing Council members were more neutral and consistent with the BoC's tightening bias. On balance we don't think recent developments preclude another rate hike before mid-year, though odds of a move in April have certainly diminished over the past month.