ECONOMIC AND FINANCIAL MARKET UPDATE

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Teasing out the trend in Canada's economy

Canadian GDP fell 0.1% in November as rotating Canada Post strikes weighed on transport activity, adding to an already-soft month for the manufacturing, wholesale and retail sectors. The impact of labour disruptions should have reversed in December, but we think the energy sector stepped in as a new source of weakness. Drilling activity fell 30% toward the end of last year as oil producers responded to lower global prices, sharp discounts on Canadian crude, and production cuts ordered by the Alberta government. With storage levels beginning to normalize and price differentials narrowing, mandatory curtailments are already being eased. But that won't stop lower energy output from exerting a drag on Canada's economy early this year. We are with the Bank of Canada in expecting GDP growth will average just over 1% annualized in Q4/18 and Q1/19.

Much of this soft patch can be blamed on the energy sector or transitory issues, but rising interest rates and regulatory tightening are also having an effect. Last year was the slowest for home resales since 2012 and some markets (particularly Vancouver) have yet to fully stabilize. Meanwhile, retail sales have leveled off with housing-related and rate-sensitive purchases taking a hit. Households can no longer be relied upon to do the heavy lifting—like the Bank of Canada, we view business investment and exports as key contributors to growth this year. That means we're watching closely for any sign of energy sector spillover into the broader economy, or weakness related to slowing global growth and trade uncertainty. Manufacturing sentiment has declined and activity in the sector has been close to flat in recent months—potentially a sign that the rollover in global industrial production and trade growth is hitting Canadian producers. If that trend continues, it would jeopardize a return to at- or slightly-above-potential GDP growth later this year. But as the BoC has been keen to point out, there are two-way risks around trade policy. Any easing in US-China tensions would reduce a key source of uncertainty, and could put the global industrial sector back on an upward trend.

Will the BoC echo the Fed's dovish message?

Recall that the Bank of Canada also softened their tightening bias in early-January, saying they expect interest rates will have to rise to a neutral level "over time" to keep inflation on target. Might they follow the Fed and abandon that forward guidance altogether? We don't think so. Fed funds is now close to most neutral estimates but the BoC's overnight rate remains 75 basis points below its assumed neutral range. And while the Fed wants to see a need to raise rates further, the BoC continues to note that monetary policy must be forward-looking. We expect they'll hold off on raising rates over the first half of the year, watching global developments and the economy's reaction to lower oil prices. But assuming this current soft patch is just a "detour" and the non-energy economy remains near full capacity, we think the BoC will want to tighten policy somewhat further to defend their 2% inflation target. We look for them to raise rates twice over the second half of 2019, leaving the overnight rate at 2.25%—close to where fed funds is today.