ECONOMIC AND FINANCIAL MARKET UPDATE

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Canada's economy rebounded in February…

The rebound in Canadian GDP in February was even stronger than expected with a 0.4% increase easily erasing January's disappointing 0.1% decline. Oil and gas output rose as temporary shutdowns eased, though that was offset by further pullback in the real estate industry. Both moves were largely anticipated. Outside of volatility in those sectors, growth was stronger and more broadly-based in February. As with Canada's jobs numbers, these data seem to confirm that the economy's slow start to the year was only transitory. On balance, we think the monthly figures are consistent with the economy expanding at a trend-like 1.8% pace in Q1.

…but spending details are looking a bit soft

While it looks like GDP increased at a trend-like pace in Q1, we think domestic demand made a much smaller contribution to activity early this year. Recall that even with headline growth slowing to 1.6% in the second half of last year, domestic spending still increased at a 4% rate. We are now seeing some payback from that unsustainable strength. Revised retail sales data point to consumer spending slowing sharply. At the same time, housing likely shaved 1/2 percentage point from growth in Q1 after tighter mortgage rules were implemented in January. Business investment also lost a bit of steam to start 2018, though some of that reflected M&E purchases having been pulled forward into late-2017 before a change in emissions regulations took effect.

With the Bank of Canada having raised interest rates three times over the past year, some slowing in consumer spending and housing was to be expected. But the first quarter's drop-off in those sectors looks overstated. Rising debt service costs will certainly take a bite out of households' disposable income but that shouldn't be enough to slam the brakes on spending. Given solid fundamentals of low unemployment, steady job gains and rising wages, we are confident that consumption growth will rebound from Q1's forecasted 1/2% pace. That said, we aren't likely to see anything close the average gains of more than 3% seen last year. Meanwhile, the sharp pullback in Q1 home sales won't be repeated going forward as most local markets appear to be adjusting to higher qualifying rates. Homebuilding activity has also held up fairly well in the face of softer resales, helping to offset some of the decline in real estate activity.

Bank of Canada not in a rush to raise rates

The Bank of Canada left the overnight rate unchanged at 1.25% for a second consecutive meeting in April. Despite the steady decision being almost universally expected, the Canadian dollar still sold off thanks to Governor Poloz's cautious tone. While maintaining a tightening bias, he seemed to put additional emphasis on a number of headwinds including competitiveness challenges, concerns about trade policy, and high household debt. An upward revision to the economy's potential growth rate, which means more room to expand without generating inflationary pressure, was also seen as a dovish development—even as growth forecasts were revised higher alongside.

The meeting provided little clarity on when we might expect another rate hike. Governing Council noted increasing confidence in their tightening bias, but stopped short of signaling a near-term move. That was despite rising inflation and wage growth, and a fairly positive Business Outlook Survey—the latter flagged by Deputy Governor Lane as an "important indicator" ahead of April's decision. We said last month that we still liked the odds of a rate hike before mid-year, but their recent tone doesn't seem to point to a move at May's meeting. Our forecast now assumes just two more rate hikes over the second half of this year, and another two in 2019 (still 100 basis points of cumulative tightening). A continuation of recent inflation trends and a pickup in domestic spending in Q2, particularly in business investment, would boost our confidence that the next rate increase will come in July. Along with the change in our BoC call, we have revised our forecast for the Canadian dollar. We now see it ending the year at 78 US cents (close to current levels) rather than the modest rally we expected previously.