Making sense of the latest Canadian GDP figures...

Canadian GDP rose an annualized 3.7% in Q2, coming in well ahead of expectations. That’s the strongest increase in two years but the good news ended there. Consumer spending grew at its slowest pace in seven years, which as the BoC pointed out, is hard to square with a 7% annualized increase in aggregate household payrolls in the quarter. Business investment returned to a downward trend, posting the fourth (and largest) decline in the last five quarters. The combination of slower consumer spending and less investment saw overall domestic demand decline in the quarter. So where did all that GDP growth come from? Net exports added a whopping 5.5 ppts to growth—the second-largest contribution in the last two decades.

What to make of these messy (and sometimes contradictory) details? We think it’s best to look through quarterly volatility and focus on the first half of the year as a whole, which tells a more coherent story. Consumer spending growth has picked up slightly this year, reflecting a strong labour market, rising wages, and less pressure on debt service costs thanks to lower rates. Housing activity has shifted from a drag last year to a very modest add so far this year with the resale market adapting to policy changes and getting help from declining borrowing costs. Business investment continues to slow, partially due to a further decline in oil and gas capex, but with global uncertainty likely hampering spending by companies outside the energy industry. International trade added to growth over the first half of 2019, but less so than last year, and mostly due to a combination of rising energy exports and weaker imports. Non-energy exports haven’t done much of the heavy lifting over the last year.

…and what it means for H2/19

That context should help explain our growth forecasts for the second half of the year. Consumer spending and residential investment will remain less of a headwind than in 2018, as long as the labour market continues to support household incomes. But business investment will likely once again be held back by concerns about US trade policy and the health of the global economy. Net trade is likely to be a more neutral force—energy exports won’t provide endless support, and a global manufacturing and trade slowdown doesn’t inspire confidence in non-energy exports. All told, we agree with the BoC’s assessment that GDP growth is likely to be slower over H2/19 than the 2.1% average pace seen in the first half of this year. Our forecast is for average gains of 1.6%, which would be slightly below the economy’s longer-run trend. Further escalation in the US-China trade dispute (or a greater-than-expected impact on the US economy from the latest round of tariff hikes) remains a key downside risk to the outlook. But that is balanced somewhat by the Canadian economy’s recent, unexpected strength and the potential for consumer spending and housing to get a bit more of a boost from lower rates than we have penciled in.

BoC defiant in its neutral bias

We were expecting a dovish tone from the Bank of Canada in September given escalating trade tensions (identified as a key risk to the global and domestic outlook) since its July meeting. But the central bank sounded surprisingly neutral, giving no direction regarding future policy moves and simply reiterating that the current degree of accommodation remains appropriate. It did note that the US-China trade conflict is “weighing more heavily on global economic momentum” than assumed in July, and that global developments and their impact on Canada’s economy will receive “particular attention” when its forecasts are updated in October. But the BoC sounded rather reluctant to follow its dozen or so global peers that eased policy over the summer. In fact, in its economic progress report, the bank emphasized that it will set monetary policy based on domestic conditions, and that the Canadian economy is close to full capacity and inflation is right on its 2% target. That good starting point, along with monetary policy that’s already slightly accommodative, gives the central bank a buffer against negative external developments. The BoC’s defiant attitude trimmed the odds of a rate cut later this year, and a move next January (our assumption) is seen as a 50/50 prospect.