ECONOMIC AND FINANCIAL MARKET UPDATE

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What, me worry?

The final weeks of summer vacation were anything but quiet as markets were faced with rising geopolitical risk emanating from North Korea and continued political gridlock in the US. A bout of risk aversion toward the end of August saw gold prices breach the $1300 mark for the first time this year, while 10-year US Treasury yields dipped to levels not seen since November's presidential election. The US dollar remained under pressure, particularly against 'safer' funding currencies like the yen and euro. Equity markets generally shrugged off concerns with the S&P 500 near all-time highs thanks to another solid earnings season and decent economic data. That said, August was a bit less calm from a volatility standpoint—the VIX market volatility index jumped higher several times during the month after averaging a record low in July.

Geopolitical concerns and uncertainty surrounding NAFTA renegotiations didn't faze the Bank of Canada. Following a strong upside surprise on Q2 growth, including signs of broadening activity and better-than-expected momentum, the central bank didn't waste any time in further removing some of the "considerable" monetary policy stimulus still in the system. We think they will raise interest rates for a third time later this year, and follow that up with three more hikes in 2018. As for the Fed, we expect they'll follow through on tapering plans with an announcement at this month's meeting that they'll be trimming reinvestment as of October. We also see the European Central Bank beginning to slow their asset purchases next year. Meanwhile the Bank of England, Reserve Bank of Australia, and Reserve Bank of New Zealand aren't expected to follow their North American cousins in raising interest rates steadily next year—we see each of those three central banks holding policy steady through 2018.

Canadian GDP surprised to the upside (again)

Canadian GDP growth exceeded already-lofty expectations with a 4.5% annualized increase recorded in Q2. That is the fastest rate since 2011 and marks a fourth consecutive quarter of above-trend growth—also the best streak in more than three years. As with the previous quarter, Q2's gain was broadly-based but led by another sizeable jump in consumer spending. Household outlays are now up nearly 4% from a year ago, the best pace since consumer spending rebounded following the 2008/09 recession. Strong aggregate income growth, fueled by rapid job gains, has allowed households to open up their pocketbooks without dipping too much into savings. In fact, Q2's 4.6% household savings rate was close to the 10-year norm.

Consumers weren't the only sector supporting growth. Business investment posted another solid increase in Q2 and rose relative to a year ago for the first time since 2014. And net trade added half a percentage point to headline GDP growth as exports rose by nearly 10% after two quarters of lacklustre gains. We think Canada's export sector will continue to be supported by strengthening global growth and trade flows, but a disappointing July trade report indicates we might see a pause in Q3. One piece of the growth puzzle that remained surprisingly absent was government investment. Little change in public investment over the first half of the year is despite more infrastructure dollars flowing from the federal government. We still think that expenditure will show up in the second half of the year, delivering a decent boost to 2017 growth as a whole.

Canada's strong Q2 growth figure overshadowed another solid increase in monthly GDP. Output was up 0.3% in June—well above the market consensus of 0.1%—on the heels of a surprisingly robust 0.6% gain in May. Strong momentum heading into Q3 prompted us to raise our forecast for the current quarter to 2.5% from 1.9% previously. That would represent another upside surprise for the Bank of Canada. Their July forecast called for increases of 3.0% and 2.0%, in Q2 and Q3, respectively.

That prompted another rate hike from the BoC…

The economy's better-than-expected growth numbers led the Bank of Canada to raise interest rates in September for the second time in as many meetings. While odds of another rate hike had improved in the wake of Q2's GDP report, the move still came as a surprise to market consensus—and ourselves. We hadn't heard from the central bank since July, and while their data-dependent forward guidance left the door open to a September hike, we expected they would wait until their growth forecasts were refreshed in October and more Q3 data, including their Business Outlook Survey and further inflation readings, were available. In the event, policymakers saw enough evidence of growth becoming more broadly-based—including the long awaited rotation toward stronger business investment and exports—to warrant some further removal of the "considerable monetary policy stimulus in place." September's 25 basis point rate hike lifted the overnight rate to 1.00%, right where it was before the bank lowered rates in 2015 in response to the oil price shock.

…which we don't think will be the last this year

At present, inflation and wage data are not signaling an immediate need to return to a more neutral monetary policy stance. However, in raising rates at consecutive meetings, the Bank of Canada has shown that the amount of slack in the economy is a key consideration in setting policy. Given outperformance of GDP growth, we think the bank's October projections will show the economy near full capacity in the current quarter. However, with their latest statement noting the bank will be re-evaluating the economy's growth potential, policymakers have some flexibility on that front. In any case, we think limited economic slack, in conjunction with solid growth momentum and "considerable" stimulus remaining in the system, supports the case for another rate hike before the end of the year. We see that move being followed by another 75 basis points of tightening in 2018 as growth slows but remains modestly above trend. Those rate hikes would nearly keep pace with expected moves from the Fed. As such, we don't see policy divergence being a major factor for the Canadian dollar next year, leaving it close to the 80 cent mark through much of 2018. The Bank of Canada doesn't seem overly concerned with currency appreciation, attributing the recent increase to USD weakness and relative strength of the Canadian economy.