ECONOMICS DIGEST

November 2017

Contents

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Canadian current trends update.

- ▲ August GDP unexpectedly dropped 0.1% following July's disappointing flat reading.
- ▲ Employment rose 35k in October, the 11th consecutive monthly increase and the best gain since June.
- ▲ Retail sales unexpectedly dropped 0.3% in August following a 0.4% gain in July.
- ▲ Housing starts were stronger than expected in October, rising to 223k from 219k in September.
- ▲ Canada's nominal merchandise trade deficit held steady at an elevated $3.2 billion in September.
- ▲ The year-over-year increase in all items CPI slipped back to 1.4% in October after rising to 1.6% in September.

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Financial markets...

Hiking, fast and slow

The days of rock-bottom interest rates are coming to an end in several economies but that doesn't mean central banks have returned to the relatively consistent, predictable tightening cycles of the past. Take the Federal Reserve—they first raised rates at the end of 2015 but waited a full year before following up with another move. Then after lifting rates at every other meeting earlier this year, the Fed hit pause to begin shrinking their balance sheet. We think they'll get back to raising rates, their main policy tool, in December and look for quarterly increases to resume in 2018. But the committee's 'dot plot' projections show a wide range of views on how much policy should tighten next year, and new leadership at the Fed adds an extra bit of uncertainty.

Meanwhile, the Bank of Canada surprised observers by raising rates in July and September, but just when markets caught up to the notion of a tightening cycle, the central bank tapped the brakes in October. While a tightening bias remains, concerns about Nafta renegotiation and low inflation have markets convinced that monetary policy is on hold into next year. Across the pond, the Bank of England raised their benchmark rate for the first time in a decade but indicated that any additional tightening will be gradual and limited. With lingering Brexit uncertainty weighing on the UK's economic outlook, it looks like it could be 'one and done' for now—we don't see any further moves from the BoE through next year.

Others remain committed to highly stimulative monetary policy. The European Central Bank just extended asset purchases into next year, albeit at a reduced pace, while the Bank of Japan remained firmly on the sidelines with their negative interest rate policy. We're still a ways away from those central banks undertaking their own tightening cycles. But if their global counterparts are anything to go by, the process will be gradual, data dependent, and likely uneven.

Canadian activity geared down in the third quarter

Canadian GDP surprised on the downside in August, slipping 0.1% following a flat reading in July. Growth has clearly come off the boil following an average annualized pace of more 4% over the first half of the year. Current data points to a near-trend increase of 1.7% in Q3. We think the slowdown reflects a more sustainable pace of consumer spending, which would be consistent with a moderation in job growth last quarter. Trade is expected to have been a drag on activity with exports retracing Q2's 10% gain. More encouragingly, business investment likely remained strong with sales and imports of machinery and equipment continuing to post solid gains. Exports and capex will be relied on to return growth to an above-potential pace as contributions from consumers and housing are hampered by higher interest rates and housing policy changes.

Strong economy allows for smaller deficits, more spending

The federal government issued its fall economic statement in late-October, providing an update on the state of finances between official budgets. Thanks to the country's G7-beating growth over the last year, higher government revenues provided a fiscal dividend that could be spent on programs and tax cuts, or saved through smaller deficits. In the end the government opted for a combination of the two, spending about a third of the $46.6 billion in additional fiscal room while still showing $33 billion less in cumulative borrowing over the next five years. There were no big ticket spending items—rather, a few billion dollars went to earlier indexation of Canada Child Benefit payments, support for lower-income workers and the earlier-announced small business tax cuts.

Even with stronger growth trimming the government's deficit projections, there is no return to balance in sight with a $12.5 billion shortfall penciled in for fiscal year 2022/23. A growing economy will help reduce the overall debt burden, with the federal debt-to-GDP ratio expected to trend lower in the coming years. But it is still a bit surprising for the government to refrain from targeting a return to balance, particularly at this stage in the business cycle when government revenues are high, the economy is close to full capacity and pro-cyclical fiscal policy isn't needed to shore up growth. So while there were some positives to take away from the fall update, we would prefer to see a bit more discipline in the form of even smaller deficits and a timetable for a return to balance.

Bank of Canada: the dove is in the details

After two consecutive rate hikes over the summer, a less hawkish tone from Governor Poloz and crew trimmed the odds of a follow-up move in October. Market expectations were vindicated with the Bank of Canada holding their benchmark interest rate at 1%. The bones of the policy statement and updated projections weren't all that dovish—the economy is operating close to capacity, above-trend growth is expected to continue and thus "less monetary policy stimulus will likely be required over time." But there was little evidence of the urgency that saw policymakers rush to raise rates in Q3. While maintaining a positive view on the economic outlook, Governor Poloz noted risks surrounding Nafta renegotiation, as well as uncertainty about how highly-indebted households would respond to the bank's recent tightening.

The theme of uncertainty was even more prevalent with regards to the inflation outlook.

The bank investigated whether technology and globalization are weighing on inflation, and while finding little evidence that structural factors are at play, policymakers fell short of dismissing those issues entirely. Governor Poloz also noted that, even though businesses are running near full capacity, there is still some slack in labour markets to be absorbed that is preventing wages from growing faster. The bank thinks productivity-boosting business investment will provide a bit more room to grow without generating inflationary pressure. And thanks to a stronger currency, policymakers now see inflation remaining below their 2% target well into next year. Their audible concerns about the inflation outlook further reduced market expectations for near-term rate hikes and pushed the Canadian dollar 1% lower. We agree that it looks like the bank will be a bit more patient in removing accommodation but continue to think a near-capacity economy calls for higher interest rates. Our forecast now assumes the BoC will remain on the sidelines for the next couple of meetings before resuming a tightening cycle in the second quarter of 2018. A slightly slower pace of hikes prompted us to lower our Canadian dollar forecast, with the currency now expected to dip to 75 US cents early next year before recovering as the BoC resumes raising rates.

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Special reports…

It was all about continuity in October for Canada's housing market

- The Fall home-buying season is uneven across Canada but activity continues to recover overall.
- October was quite a busy month in Vancouver and Montreal, and saw a third-straight monthly gain in home resales in Toronto.
- Calgary and several other Prairie markets remained stuck in a soft patch.
- Price pressures eased further at the national level, primarily reflecting cooler conditions in Toronto.
- There continues to be limited downside risks to prices in the near term because the majority of local markets—including Toronto—are in balance.
- More stringent qualifying criteria facing borrowers of uninsured mortgages by January 1, 2018, is poised to affect the outlook for the coming months.

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Special reports…

Canada and U.S. October 2017 Auto Sales

No (significant) signs of slowing in Canadian October Auto Sales

Canadian light vehicle sales rose 6.3% from a year ago in October according to industry reports. That makes 9 out of 10 months this year to-date in which sales have been stronger than last year's total. Our estimates suggest that sales on a seasonally adjusted annualized basis (and including heavy vehicles) moderated to 2.09 million units in October. That was down from 2.11 million in September but still well-above what was already a fourth consecutive all-time sales record 1.98 million units sold in all of 2016. Interest rates have inched higher in recent months but household income growth has remained solid. Job growth posted its 11th consecutive gain in September — the longest such streak since March 2007 — and consumer confidence measures are back at pre-2008/09 recession levels. Broader indicators have been pointing to a slowing in growth in the economy overall from the outsized pace of improvement from mid-2016 to mid-2017. We expect, though, to a still modestly 'above-trend' pace that should generate further improvement in labour markets. Financing costs are also likely to continue to grind gradually higher but remain quite low from a historical perspective. Ultimately, we expect auto sales will remain solid going forward but at a pace down from what we continue to view as an unsustainably strong level in 2017 to-date.

U.S. light vehicle sales solid again in October

U.S. light vehicle sales dipped in October but to a still-elevated 18.0 million unit pace after hitting a new cycle-high 18.5 million in September. September sales were in part boosted by delayed sales after Hurricane Harvey disrupted sales activity in late August. The October numbers should have provided a 'cleaner' read but may have also gotten a marginal boost from the replacement of damaged vehicles both from Hurricane Harvey and Hurricane Irma in September. Auto sales have generally been somewhat disappointing in the U.S. so far in 2017. Even with stronger sales the last couple of months, sales are tracking a decline in the year for the first time since 2009. Overall consumer spending and income growth has been solid, but the share spent on motor vehicles has remained historically low. Distortions from severe weather mean stronger auto sales numbers over the last couple of months should probably be taken with a grain of salt. Nonetheless, we expect a solid household income backdrop, supported by ongoing improvement in labour markets, and still low financing costs will result in sales moving modestly higher in 2018 from the 17.1 million units on pace to be sold in 2017.

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