ECONOMICS DIGEST

February 2018

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Canadian current trends update.

▲ GDP rose 0.4% in November after a surprisingly weak flat reading in October.

▲ Employment plunged 88k in January, bringing an end to an impressive 17-month long streak of gains — the longest such stretch in 17 years — in what is normally a very volatile measure.

▲ Retail sales fell 0.8% in both nominal and volume terms in December.

▲ Housing starts came in a bit stronger than expected in January, holding steady at December's revised 216k annualized pace.

▲ Canada's nominal merchandise trade deficit widened to $3.2 billion in December from $2.7 billion in November.

▲ Year-over-year growth in headline CPI moderated to 1.7% in January from 1.9% in December — but that was still well-above market expectations for a 1.5% increase.

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Financial markets…

Fast times as rates go high

The extraordinarily low equity market volatility seen throughout 2017 ended abruptly in February as the VIX jumped to its second-highest level since the European debt crisis. Losing ground for two consecutive weeks, the S&P 500 entered correction territory falling more than 10% from its January 26 peak. Equity markets in Canada, Europe and around the globe also fell sharply in the past two weeks.

The drop-off in what many feared was an overvalued US equity market seemed to be triggered by rising bond yields. US treasuries sold off sharply to start 2018 with 10-year yields hitting four-year highs by early February. That move was more abrupt than anticipated but reflects a process we expected would unfold. Namely, with the US economy already bumping up against capacity limits and tax cuts set to push demand even higher, inflation risks are tilted to the upside for the first time in recent memory. Stronger wage growth in January seemed to underscore that for markets. With energy prices also picking up, market-based inflation expectations rose to three-year highs and put upward pressure on nominal yields. Investors are also waking up to the reality that the Fed has little reason to slow their tightening cycle amid strong growth momentum and potentially inflationary fiscal stimulus. The promise of increased Treasury supply to finance the tax cuts also played into the bump up in bond yields.

The fixed income selloff wasn't confined to the US as bond yields in Canada, Germany and the UK all trended higher in January. And those moves don't just reflect spillover from the States. The Bank of Canada remains in tightening mode despite Nafta concerns, while positive data in the euro area and UK has investors contemplating an end to ultra-accommodative monetary policy in Europe.

Canada's economy got back on track in November

Canadian GDP growth rebounded to 0.4% in November following a flat reading in October. Goods production jumped as the weight from transitory shutdowns in the auto, energy and chemical manufacturing sectors were reversed. Services growth, which tends to be less volatile, also picked up in November. The increase is more in line with indications of strong employment growth toward the end of 2017. Our forecast assumes GDP growth ticked up to 1.9% in Q4/17 from 1.7% in the prior quarter. That would be slightly ahead the economy's longer-run potential growth but short of the Bank of Canada's 2.5% forecast—a number we were surprised to see held over from their previous projections given a soft start to the quarter.

Housing continued its wild ride at the turn of the year

Canada's housing market went on a wild ride through 2017 and the close of the year was no different. Home sales rose strongly in November and December, hitting a record high on a seasonally adjusted basis in the final month of the year. Homebuyers rushed into the market ahead of a regulatory change on January 1, 2018 that raised the qualifying rate on insured mortgages. Early data for the Greater Toronto Area market—the country's most volatile last year—showed a sizeable drop in sales in January after sales were pulled forward into 2017. When the dust settles we expect regulatory tightening, in combination with higher interest rates, will result in resales falling at a low single digit pace for a second consecutive year in 2018. Price growth is expected to be limited to just over 2% following a double-digit gain last year.

BoC continues to hike despite Nafta concerns

In the month leading up to the Bank of Canada's January meeting, solid economic data and a positive tone from Governor Poloz raised market expectations that the bank would hike rates to start 2018. They didn't disappoint, raising the overnight rate by 25 basis points to a post-crisis high of 1.25%. The central bank kept a fairly balanced tone in announcing their decision, noting recent indicators had generally outperformed expectations while emphasizing caution given risks surrounding the Nafta renegotiation. Their growth forecasts were little changed on balance despite adding a modest downward impact on business investment and exports related to Nafta uncertainty. Even with that drag, stronger contributions from both sectors this year are expected to help offset more modest gains in consumer spending and housing. Growth of 1.8% on a Q4/Q4 basis in 2018 is still slightly ahead of their upwardly-revised 1.6% potential growth rate, implying the economy should continue to bump up against capacity limits this year.

But while product markets are close to full capacity, the bank continued to see signs of labour market slack—though they admitted that has been narrowing more quickly than expected in recent months. Their view partly hinges on wage growth, which despite picking up in the second half of last year, is still running a bit slower than would be expected if labour markets were pushing beyond capacity. The central bank unveiled a new wage measure that stood at 2.2% in Q4/17—below readings closer to 3% in the household and payroll surveys. This new wage reading as well as the bank's labour market indicator both point to a slightly less impressive jobs backdrop than official statistics and will be watched closely as a sign of how the Governing Council sees slack evolving.

While the bank held onto a not-too-hot, not-too-cold view, the reality of an economy operating close to full capacity with underlying inflation near 2% left their tightening bias intact. We think they'll continue raising rates once a quarter this year, pushing the overnight rate up to 2% by the end of the year. How much further they'll go from there is questionable—the bank noted some continued stimulus is likely to be required given headwinds from trade worries and regulatory changes, as well as increased sensitivity to rate hikes. As such, we expect the policy rate will move only marginally higher in 2019 before the bank pauses to assess the impact of past rate hikes.

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Special reports…

Payback time! Canada's housing market quiets down post B-20 changes in January after busy end to 2017

- Both buyers and sellers reacted strongly in January to the B-20 guideline changes. Home resales in Canada fell sharply by 14.5% from December and new listings plummeted by 21.6% on a seasonally-adjusted basis.
- Declines were generalized across the country—providing compelling evidence that tighter qualifying rules for uninsured mortgages had a widespread impact.
- It's too early to tell whether the new rules dampened homebuyer demand permanently or just displaced activity temporarily. We think it's both.
- Benchmark prices continued to slow their pace of increase, easing from 9.2% in December to 7.7% in January. The Toronto area accounted for most of this deceleration. Prices accelerated in Vancouver.
- Interestingly, demand-supply conditions tightened overall in Canada in January because new listings fell more than sales. This was the case in the Toronto, Vancouver and Montreal areas.
- Developments in January are consistent with our view that we've entered a period of payback for transactions brought forward late last year ahead of the new mortgage rule. Our outlook for 2018 calls for a second-consecutive modest annual decline in resales and sharp moderation in price appreciation.

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