



## Contents

### Current trends

[Canadian current trends update](#)

### Financial markets

[The hurt from red October](#)

### Special reports

[Canada's housing market stays soft in October](#)

## Canadian current trends update

- ▲ Canadian GDP rose a stronger-than-expected 0.1% in August as oil sand production rebounded
- ▲ Employment rose 11k in October as a jump in full-time employment was partially offset by lower part-time employment.
- ▲ Retail sales dropped 0.1% in August with the volumes measure down a greater 0.3%.
- ▲ Canadian housing starts back above 200k in October
- ▲ The Canadian trade balance posted a \$0.4 billion deficit in September — down from a revised \$0.6 billion deficit in August
- ▲ CPI inflation dropped to 2.2% in September year-over-year from 2.8% in August.

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Financial markets...

## The hurt from red October

Concerns about rising protectionism and slowing global growth saw equity markets drop in October. The S&P 500 plunged nearly 7%, its worst monthly performance in seven years. Other global benchmarks saw similar declines, with the MSCI World index down 7.4% in October. Volatility resurfaced with the VIX (volatility index) spiking, though not to the extent seen in the selloff earlier this year. Equities peaked in early October just as the IMF released their latest economic projections. They marked down their global growth forecasts for this year and next amid increasing trade barriers and tightening financial conditions that are seen weighing on emerging markets in particular. Concerns about global growth were also evident in the commodities space with oil prices falling to six-month lows. That's one reason the Canadian dollar hasn't seen much of a boost from the USMCA trade deal.

While the risk-off move saw some intermittent fixed income rallies, Treasury and GoC yields ultimately ended the month higher. That's even as lower oil prices weighed on breakeven inflation rates. A push higher in real yields comes as the Fed and Bank of Canada show no sign of slowing down their tightening cycles. The BoC is now indicating rates need to rise to a neutral level, while some Fed officials have indicated monetary policy will eventually need to become restrictive. That contrasts with Europe, where the ECB isn't likely to raise rates until later next year while the BoE remains handcuffed by Brexit uncertainty. Monetary policy divergence between the US and some of its trading partners saw the greenback gain 2% in October, hitting its highest level in more than a year. Stress on emerging markets from a higher US dollar and rising interest rates was one of the IMF's key concerns in their October outlook.



## Canada's economy keeps up its growth streak

Canada's economy extended its growth streak to seven months with August GDP rising 0.1%. But the increase was narrowly based, led by a rebound in oil production following supply outages in July. Manufacturing, wholesale and retail trade were all lower in the month. Thanks to earlier momentum, GDP is still tracking close to a 2% annualized pace in Q3. Softening retail sales and home-building activity suggest the household sector once again provided less support than in recent years. But we think a further pickup in business investment and another add from net exports provided enough offset to keep the economy growing at a trend-like pace. On net we think GDP growth will average 2% over the second half of the year—a not-too-hot, not-too-cold pace that should please the Bank of Canada given an economy operating at capacity.

## Canadian businesses report growing capacity pressures

The Bank of Canada's latest *Business Outlook Survey* showed another quarter of positive sentiment—and that was before announcement of the new USMCA deal. Even if the survey was a bit stale in that sense, there were still some notable takeaways. A common theme was growing capacity pressures. More than half of firms said they'd have difficulty meeting an unexpected increase in demand. The share of companies reporting labour shortages was at a decade high, and the intensity of labour shortages was near a record in Q3. More than a third of firms surveyed said they intend to respond to capacity pressures by investing and/or hiring over the next year.

The latest CFIB *Business Barometer* also pointed to capacity issues. The share of firms reporting skilled and un/semi-skilled labour shortages jumped higher in October. Businesses say those shortages are the most significant factor restricting their ability to increase sales or production—more than insufficient demand or competitive pressures. These surveys support the Bank of Canada's conclusion that the economy is operating close to full capacity—if not slightly beyond. That should help keep a floor under inflation, and argues for the BoC to continue removing monetary policy stimulus.

## BoC raises rates, drops “gradual” from forward guidance

The Bank of Canada raised rates in October for the fifth time in 15 months. The move was fully expected but Governing Council still managed to surprise markets by shifting their forward guidance. The policy statement no longer indicated rate increases will be “gradual”—a term that markets associated with the Fed's rate hikes at every other meeting. We think Governing Council conversely wants to emphasize that they will be flexible in raising rates, potentially speeding up or slowing down the pace of tightening based on incoming data—particularly how households are handling higher borrowing costs. While their guidance on the pace of tightening is now less specific, the ultimate destination is clearer: they indicated the overnight rate “will need to rise to a neutral stance” to keep inflation on target. The BoC estimates ‘neutral’ is in the range of 2.5-3.5%, well above today's 1.75% overnight rate. That change in language was seen as a hawkish development. Markets are now expecting the overnight will reach the lower end of that neutral range by the end of 2019.

But we aren't ready to change our forecast for next year. Sure, the BoC says monetary policy needs to become neutral, but they didn't give a timeframe for that adjustment. We still think they'll have to be gradual in removing accommodation given household sensitivity to rising rates. Our forecast assumes higher borrowing costs will weigh on the household sector a bit more than the BoC has penciled in next year. As such, we only look for two rate increases in 2019. In our view, it won't be until 2020 that the overnight rate shifts into the central bank's neutral range.

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Special reports...

## Canada's housing market stays soft in October

- The mortgage stress test and higher interest rates no doubt were still top-of-mind for homebuyers in October. Already-soft home resales edged down further by 1.6% from September. The annual rate of increase in benchmark prices was unchanged at 2.3%.
- More than half of local markets saw a monthly decline in resale activity, including Toronto, Montreal, Halifax, Calgary and Edmonton. Vancouver and Winnipeg bucked the trend with modest increases, though in the case of Vancouver the number of transactions remained near five-year lows.
- After rising in the previous two months, new listings fell 1.1% across Canada, which kept the majority of local markets in balance. Montreal was among the few markets where sellers had the upper hand in setting prices.
- Vancouver's benchmark price was up only 1.0% from a year ago, a five-year low point. More buying options have emerged for fewer buyers in the past year—especially in the detached home segment.
- In October, annual price increases were strongest in Victoria (8.5%), Hamilton (6.8%), Ottawa (6.6%) and Montreal (6.3%). The increase in Toronto's benchmark price accelerated slightly to a rate of 2.6% from 2.0% in September.
- Our view is that the prevailing softness in Canada's housing market is the new norm—at least for a while. We expect overall activity to stay in a holding pattern over the coming year and price gains to be limited.

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