Financial markets...

From simmer to boil

Just when we thought US-China trade tensions were at a simmer—with negotiations restarting after a G20 détente—President Trump once again turned up the heat. Unsatisfied with the pace of trade talks, he pledged an additional 10% tariff on all remaining Chinese imports starting in September (i.e. those goods spared from previous tariff hikes, about $265 billion by our count). Financial markets, already disappointed by the Fed’s ‘hawkish’ rate cut the day before, didn’t take the news well, selling stocks and piling into fixed income. The Chinese government’s subsequent move to let the yuan depreciate (USD/CNY rising above the 7.00 mark for the first time since 2008) and the US Treasury’s response (labeling China a currency manipulator) deepened equity market losses with the S&P 500 recording its largest single day decline this year. The risk-off move was also evident in commodities, with oil prices slipping to near-term lows and gold prices hitting a multi-year high.

Demand for safe assets saw US 10-year Treasury yields fall to levels not seen since Trump’s 2016 election win, while German Bund yields dropped to record lows of less than -0.50%. The move was abetted by the prospect of additional easing as central banks try to offset the impact of rising trade tensions. The ECB has signaled that more help is coming—we expect a rate cut in September, and preparations for a new round of QE could be underway. Meanwhile, markets don’t seem to be taking Fed Chair Powell at his word that near-term cuts are just a mid-cycle adjustment—nearly 100 basis points of further easing is priced in for the Fed over the next year. The RBNZ surprised with a 50 basis point rate cut in August (25 bps had been expected) and it looks like the RBA will move again before the end of the year. Solid domestic data have kept the BoC from leaning too far in that direction, but it looks like it’s just a matter of time now before Poloz and Co. join in and lower rates.
Canada’s economic rebound continues to surprise

Canadian GDP growth surprised to the upside for a third consecutive month in May. Average growth of 0.4% since March is the economy’s best three-month run rate in two years. Service industries have posted decent gains over that stretch (retail being a key exception) but it’s the goods sector that has really impressed. Oil and gas output has rebounded as Alberta’s production caps continue to ease, and higher oil prices earlier this year (both globally and in Western Canada) helped support drilling activity. It looks like the energy sector provided a sizeable add to growth in Q2 after acting as a drag in the prior three quarters. The construction sector has also perked up in recent months with the residential side supported by more stable housing markets and robust homebuilding. But it’s decent growth in the manufacturing sector that is most surprising—Canada appears to be bucking the global trend in that regard. No single sector is driving the increase, and growth has been fairly consistent with manufacturing sales excluding transport yet to record a monthly decline so far this year. That trend seems too good to last, though. The all-important US industrial sector has clearly lost momentum and recent PMI readings suggest Canadian manufacturing is also in for slower growth.

Don’t get used to Canada’s trade surplus

Given the strong trend in monthly GDP, we have revised our Q2 growth forecast to 3% from 2.2% previously. It looks like a big chunk of that growth came from net exports—we’re tracking one of the largest quarterly adds from trade this cycle. That reflects Canada’s shift to a trade surplus in May and June, a rarity in the last decade. Agriculture (notwithstanding China’s ban on some imports), energy, and transport equipment all contributed to rising exports, though it was a sharp drop in imports that preserved a surplus in June. In fact, overall trade (exports plus imports) was down year-over-year in June, mirroring the slowdown in global trade flows. Less dynamic global trade could hurt Canada’s export sector, and with the domestic economy holding up fairly well amid slowing global growth, imports are likely to outpace exports. We expect that will be the case over the second half of the year, with the trade balance slipping back into deficit and net exports acting as a modest drag on growth.

Canadian exporters have had little help from the currency, which has been caught in a tug-of-war in recent months. The Canadian dollar rallied from a near-term low of 74 US cents in late-May to more than 76.5 cents in mid-July. That reflected widening in Canada-US interest rate spreads as the BoC remained in neutral while the Fed signaled lower rates. More recently, though, global growth concerns have weighed on both oil prices and the loonie and Trump’s latest tariff threats only exacerbated that move. The Canadian dollar is now back to just above 75 cents, close to its year-to-date average. Unless we see a calming in trade tensions—which would boost commodity currencies and could keep the BoC in neutral for longer—it will be tough for the Canadian dollar to best its highs from earlier this year.

Another quiet (too quiet?) summer from the BoC

With the Bank of Canada maintaining a neutral bias on July 10 (saying current accommodation remains appropriate) and staying silent since then, a policy change in September seems unlikely. But a further increase in trade tensions since July’s meeting—something Governor Poloz flagged as the biggest downside risk to the global and Canadian outlooks—has shifted the conversation to when, not if, the BoC will lower rates. There is precedent for the central bank taking both pre-emptive action (January 2015’s cut) and making a surprise move after a quiet summer (September 2017’s hike). However, with domestic data flow remaining positive, including indications that Q2 growth will come in above the BoC’s forecast, we don’t see Governing Council cutting as soon as September. Our forecast still assumes the BoC will hold off on lowering its overnight rate until January 2020, though risk of an earlier move has increased. Markets are now pricing in roughly 50/50 odds of a cut by October when the central bank will issue fresh economic projections that incorporate the latest trade developments.

Josh Nye
josh.nye@rbc.com

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**Market getting over the stress test**

- **Home resale market warms up in July**: Overall activity in Canada was the strongest since December 2017. Resales picked up 3.5% from June on a seasonally-adjusted basis and 12.6% from a year ago. This is the clearest indication yet that the market is getting over the mortgage qualifying stress test introduced last year.

- **National benchmark price is rising again**: It climbed 0.2% above the year-ago level—the first increase in six months. Tighter demand-supply conditions are providing growing support for prices.

- **Increasingly synchronized recoveries across local markets**: The picture is generally improving in Western Canada with Vancouver recording its largest monthly sales gain (26%) in 26 years in July, and both Calgary and Edmonton posting modest advances. Activity and prices continued to accelerate moderately in Toronto. And trends remain positive in the rest of Central and Atlantic Canada for the most part.

- **Ottawa, Montreal getting hotter**: The persistence of very tight demand-supply conditions keep fueling property values higher and higher in both markets. Any further acceleration could become an issue if it sets off unwanted speculative dynamics.

- **Things could get complicated for policy-makers**: A few more months like July and the housing policy debate in Canada might take a sharp turn—toward a further tightening of rules. This is bound to be a hot topic in the upcoming federal election.

Robert Hogue

robert.hogue@rbc.com

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