Financial markets...

New highs, new lows

Policy uncertainty reached new heights in August (at least according to one US index) and bounced around equity markets in the process. Last month saw the S&P 500’s three largest daily declines of the year as investors reacted to fresh volleys in the US-China trade war. There was a glimmer of hope in early-September, though, as the two sides agreed to a new round of talks. And for all the escalation in trade tensions throughout August, the S&P index is just 2% off its late-July record highs. While equities saw plenty of ups and downs, fixed income markets moved in one direction last month. 10-year US Treasury yields dropped by an eye-watering 50 basis points in August (to near-record lows), German and French yields plumbed deeper into negative territory, and even Italian 10-year borrowing costs fell below 1%. Despite less-dovish central bankers, those moves spilled over into Canada and the UK. Even with some retracement in September, yields across developed economies remain well below where they started the year (and the summer, for that matter).

A decline in longer-term interest rates flattened, and in some cases inverted, yield curves. That dreaded precursor of an economic downturn led to no shortage of recession talk. It’s worth noting that yield curve inversion needs to be sustained for several months to really flag a slowdown, and even then the lag can be a year or longer. Investors are still trying to disentangle whether we should start the recession countdown or if this time is different. One thing that’s clear is financial markets are signaling slower growth ahead, and the need for easier monetary policy. Some central banks have been more obliging than others. The Fed remains committed to a mid-cycle adjustment and looks likely to cut rates again in September. The ECB is about to unveil a new easing package that we think will include its first interest rate cut in more than three years. But the BoC was defiantly neutral in September, saying it will set monetary based on domestic conditions, not what other central banks are doing. The BoE also sounds reluctant to lower rates as it continues to grapple with Brexit uncertainty.

For other economics reports, go to http://www.rbc.com/economics/
Making sense of the latest Canadian GDP figures...

Canadian GDP rose an annualized 3.7% in Q2, coming in well ahead of expectations. That’s the strongest increase in two years but the good news ended there. Consumer spending grew at its slowest pace in seven years, which as the BoC pointed out, is hard to square with a 7% annualized increase in aggregate household payrolls in the quarter. Business investment returned to a downward trend, posting the fourth (and largest) decline in the last five quarters. The combination of slower consumer spending and less investment saw overall domestic demand decline in the quarter. So where did all that GDP growth come from? Net exports added a whopping 5.5 ppts to growth—the second-largest contribution in the last two decades.

What to make of these messy (and sometimes contradictory) details? We think it’s best to look through quarterly volatility and focus on the first half of the year as a whole, which tells a more coherent story. Consumer spending growth has picked up slightly this year, reflecting a strong labour market, rising wages, and less pressure on debt service costs thanks to lower rates. Housing activity has shifted from a drag last year to a very modest add so far this year with the resale market adapting to policy changes and getting help from declining borrowing costs. Business investment continues to slow, partially due to a further decline in oil and gas capex, but with global uncertainty likely hampering spending by companies outside the energy industry. International trade added to growth over the first half of 2019, but less so than last year, and mostly due to a combination of rising energy exports and weaker imports. Non-energy exports haven’t done much of the heavy lifting over the last year.

...and what it means for H2/19

That context should help explain our growth forecasts for the second half of the year. Consumer spending and residential investment will remain less of a headwind than in 2018, as long as the labour market continues to support household incomes. But business investment will likely once again be held back by concerns about US trade policy and the health of the global economy. Net trade is likely to be a more neutral force—energy exports won’t provide endless support, and a global manufacturing and trade slowdown doesn’t inspire confidence in non-energy exports. All told, we agree with the BoC’s assessment that GDP growth is likely to be slower over H2/19 than the 2.1% average pace seen in the first half of this year. Our forecast is for average gains of 1.6%, which would be slightly below the economy’s longer-run trend. Further escalation in the US-China trade dispute (or a greater-than-expected impact on the US economy from the latest round of tariff hikes) remains a key downside risk to the outlook. But that is balanced somewhat by the Canadian economy’s recent, unexpected strength and the potential for consumer spending and housing to get a bit more of a boost from lower rates than we have penciled in.

BoC defiant in its neutral bias

We were expecting a dovish tone from the Bank of Canada in September given escalating trade tensions (identified as a key risk to the global and domestic outlook) since its July meeting. But the central bank sounded surprisingly neutral, giving no direction regarding future policy moves and simply reiterating that the current degree of accommodation remains appropriate. It did note that the US-China trade conflict is “weighing more heavily on global economic momentum” than assumed in July, and that global developments and their impact on Canada’s economy will receive “particular attention” when its forecasts are updated in October. But the BoC sounded rather reluctant to follow its dozen or so global peers that eased policy over the summer. In fact, in its economic progress report, the bank emphasized that it will set monetary policy based on domestic conditions, and that the Canadian economy is close to full capacity and inflation is right on its 2% target. That good starting point, along with monetary policy that’s already slightly accommodative, gives the central bank a buffer against negative external developments. The BoC’s defiant attitude trimmed the odds of a rate cut later this year, and a move next January (our assumption) is seen as a 50/50 prospect.
Special reports...

**Market recovery in full swing in August**

- **Home resales rise for a six-straight month**: The cumulative gain since the February trough is 16.6% and rising. In August, resales were up 1.4% from July on a seasonally-adjusted basis. This further tightened demand-supply conditions (ever so slightly) at the national level with the sales-to-new listings ratio (0.60 in August) at the threshold of a sellers’ market.

- **National benchmark price picks up momentum**: Its y/y rate of increase accelerated from 0.2% in July to 0.9% in August. The benchmark rose at an annualized rate of 7.5% over the past three months.

- **August was a good month for the majority of local markets**: There were further signs of early-stage recovery in Vancouver, Calgary and Edmonton (though prices were still down year-over-year). Activity approached more normal levels and prices continued to accelerate modestly in Toronto. Ottawa and Montreal set new record highs for the month (once again). And conditions remain reasonably positive in most of Atlantic Canada.

- **Ottawa prices escalating at close to a double-digit rate**: The national capital, along with Montreal, have been the two hottest housing markets in the country this year. Very tight demand-supply conditions will continue to drive property values higher in the near term.

- **Market outlook improves**: The drop in mortgage rates this year along with still-solid job prospects and strong population growth are setting the stage for the housing market rebound to continue into next year. We have boosted our forecast for home resales and prices this year and next.

Robert Hogue
robert.hogue@rbc.com

Click here for full report