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ECONOMICS DIGEST

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Canadian current trends update.

▲ The 1.3% increase in GDP in Q1 was a bit softer-than-expected.

▲ May employment unexpectedly fell 7.5K following a 1.1k drop in April.

▲ Retail sales rose 0.6% in nominal terms in March — marking a third straight monthly gain.

▲ Housing starts dropped to 196k in May, down almost 10% from 217k in April and the first sub-200k reading in a year.

▲ The improvement in the nominal trade deficit to $1.9 billion more-than-retraced a surprisingly large deterioration to $3.9 billion in March from $2.7 billion in February.

▲ All items inflation edged back down to 2.2% year-over-year in April after having increased to 2.3% in March.

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Financial markets…

One of these things is not like the other

This weekend's G7 leaders' summit will be a tense affair. The group is already being referred to as the 'G6-plus-one' after the US treasury secretary was censured by his counterparts at an earlier meeting of the club's finance ministers. The latter expressed their "unanimous concern and disappointment" over the Trump administration's protectionist trade policies. Their rebuke came shortly after Canada and the EU's exemptions from steel and aluminum tariffs were allowed to expire. With Japan already facing the same levies, all three are readying retaliatory measures against the US. China, while not part of the G7, would likely second their concerns. Just when it looked like progress was being made in tariff negotiations, the US administration renewed its threat to impose levies on $50 billion of Chinese tech imports. All of these moves might simply be negotiating tactics as Trump seeks more advantageous trading arrangements for the US. But tit-for-tat measures risk devolving into a broader trade war that could weigh on all of the economies involved. This comes at a time when most of the G7 is seeing activity pick up following a slow start to the year. How tariff talks evolve could be key to whether Q2's momentum is sustained over the second half of 2018

While Trump will certainly be the odd one out, he won't be the only populist at the table. He is joined this time around by Italy's Giuseppe Conte, a nonpartisan political freshman who became prime minister just days ago. He takes over following a fractious period in Italian politics. Concerns about a constitutional crisis, or fresh elections that would hand even more power to populist parties, had investors off-loading Italian bonds in favour of safe havens like German debt. An eventual solution helped spreads come down from recent highs. But investors continue to shy away from Italian debt thanks to some controversial economic proposals by the new governing parties, which could run afoul of European budget rules. We think the near-term threat to Italy's economy is less significant than some might fear, and an 'Italexit' scenario remains unlikely.

Canada's economy also picking up after a slow start to 2018

Canada's economy hit a soft patch in Q1 with GDP growth slipping to just 1.3%, Consumer spending and housing, stalwarts of the current cycle, accounted for much of the loss of momentum. The slowdown in housing has proven more persistent than anticipated, suggesting higher interest rates and more stringent qualifying requirements are restraining and not just shifting the timing of sales. Consumer spending, on the other hand, is expected to pick up going forward. Recent moderation in consumer credit points to rising interest rates having an impact on household spending, but we think a solid labour market and rising wages will partially offset that headwind. A recovery in retail sales in the last two months supports that thesis. With consumers getting back in the game, we think overall growth will rebound to an above-trend 2.4% pace in Q2. March's GDP release showed the economy had good momentum heading into the current quarter, with a 0.3% monthly increase building on February's 0.4% gain.

Bank of Canada changing its tune…

As expected, the Bank of Canada left monetary policy unchanged at the end of May. But the meeting was hardly a non-event, with some notable changes giving the policy statement an unexpectedly hawkish tone. The Governing Council's mantra has been that they would be "cautious" in future adjustments to monetary policy, but that key word was left out of May's statement in favour of a "gradual" approach to tightening. Their bias was also strengthened by noting "higher interest rates will be warranted" without adding "over time" as they have in the past. And surprisingly there was no mention of maintaining "some monetary policy accommodation" over the medium term. That last change seems to be a significant deviation from earlier indications that the policy rate is likely to remain below the BoC's 'neutral' range of 2.5-3.5% for some time as the economy faces headwinds from trade uncertainty, competitiveness issues and high household debt.

The bank also sounded a bit more sanguine about trade uncertainty in May. In his progress report, Deputy Governor Leduc rehashed some of the points from an earlier speech by Senior Deputy Governor Wilkins on embracing uncertainty. The message—that policymakers need to take uncertainty into account but can't be paralyzed by it—suggests the bank won't necessarily sit on the sidelines amid tariff threats and protracted trade talks.

…but July isn't a done deal

While the Bank of Canada is no fan of forward guidance, their change in tone seemed to signal a near-term rate hike. But monetary policy remains data dependent, so a number of upcoming releases will have to cooperate for rates to move higher on July 11 as we expect. We've already seen some evidence that the economy picked up momentum heading into Q2, and we think April's GDP data will reinforce that. The bank's next Business Outlook Survey will also be key. Policymakers were encouraged by the recent improvement in investment and services exports. A positive signal from business on investment intentions and foreign demand—even in the face of trade uncertainty—would reinforce the BoC's tightening bias.

The bank's more hawkish policy statement was issued just days before the US waived Canada's exemption from steel and aluminum tariffs. The Canadian government is responding with tariffs on a variety of US imports that will take effect in July. Will these tit-for-tat measures derail a planned rate hike? We don't think so at this stage. The bank won't have been blindsided by the tariffs as an extension of Canada's exemption, which was tied to progress in Nafta negotiations, looked unlikely at the time of their policy meeting. And while the steel and aluminum industries are likely to feel some pain, the overall impact on Canadian GDP and exports should be contained.

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Special reports…

Housing market activity remained weak in May as spring season fails to lift off

- Canada's housing market is taking longer than we anticipated to shake off the stress-test lull in activity. Home resales were still weak in May, slipping marginally by 0.1% from April. Vancouver, Toronto and Montreal recorded flat or very slightly rising activity.
- More properties were put on the market in May with new listing rising 5.1% from April, which may support stronger activity in the coming months.

- Demand-supply conditions remain balanced overall in Canada though they softened slightly last month. The softening was more pronounced in Western Canada, where markets such as Calgary, Edmonton, Regina and Saskatoon are currently more favourable to buyers.
- Prices are now rising at their slowest pace in almost nine years. The national benchmark price was up by only 1.0% year-over-year in May. Benchmark prices were below year-ago levels in Toronto, Regina, Saskatoon, Edmonton and Calgary.
- The trio of new mortgage regulation, higher interest rates and additional market-cooling measures in British Columbia is proving to be a tougher challenge than we anticipated. Still, we don't see any evidence that Canada's market is becoming unhinged at this point. We continue to believe that recent developments are mostly positive for the longer-term health of the market despite the ongoing 'landing' being a little rougher than we previously thought.

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