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GLOBAL ECONOMICS

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July 31, 2024

Canada's Economy Remains Resilient, Adding to the Case Against the BoC's Extreme Dovishness

- **Canada's economy remains resilient**
- **Solid Q2 growth is handing off to positive Q3 momentum**
- **So why is the BoC so dovish?**

Canadian GDP, m/m %, SA, May:
Actual: 0.16
Scotia: 0.1
Consensus: 0.1
Prior: 0.3
June 'flash' guidance: 0.1
Q2 GDP tracking q/q % SAAR: 2.2%
Q3 GDP 'baked-in': 0.5%

The shrill cries in pockets of the Canadian consensus for dramatic Bank of Canada policy easing are doing an injustice to a fair portrayal of the health of the Canadian economy. The way they are talking is as if the economy is in recession. They risk pushing the Bank of Canada's already uber-dovish Governor Macklem into committing policy error by easing too much, too soon, and in too cavalier fashion. Throughout the past 2–3 years I have consistently leaned on the positive side of the economy, warning that premature and overly aggressive easing risked reigniting inflation risks. Data continues to support this bias.

Start with GDP. The economy remains resilient (chart 1). GDP grew a smidge faster in May (0.16% m/m SA nonannualized) than Statcan had initially guided (0.1%). Further, whereas I had thought June might face downside risk based on limited readings such as hours worked, it instead grew by 0.1%. There were no material revisions to growth before May.

The only guidance that we get for June GDP is that "Increases in construction, real estate and rental and leasing and finance and insurance were partially offset by decreases in manufacturing and wholesale trade." There are never any numbers provided with the flash estimate for that month, but the fact that Statcan has been providing this starting in the pandemic is welcome from a data freshness standpoint.

This translates into Q2 growth that is tracking of 2.2% q/q SAAR using the monthly income side GDP accounts (chart 2). The expenditure-based quarterly GDP accounts may

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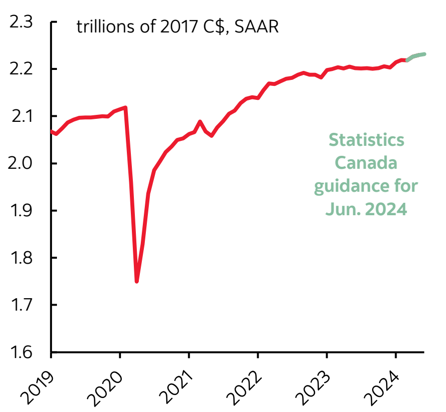
Chart 1

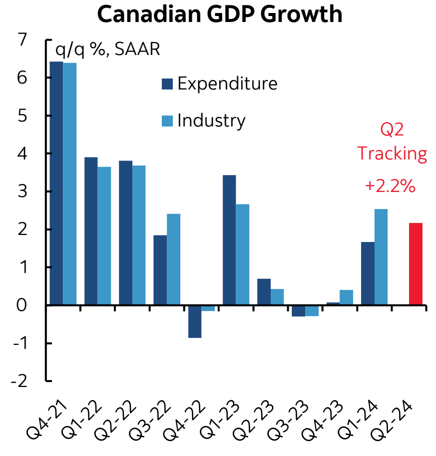
Canadian Industry GDP



Sources: Scotiabank Economics, Statistics Canada.

Chart 2

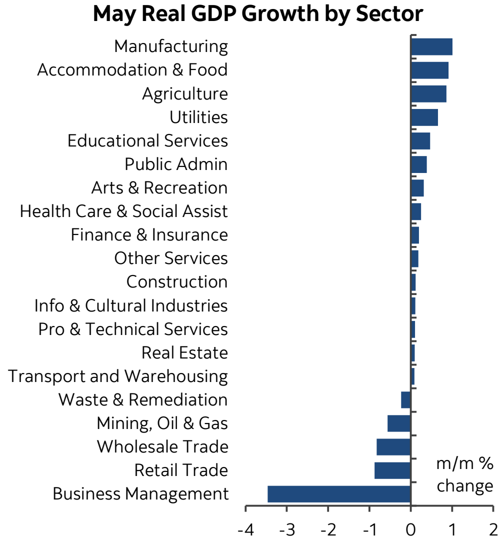
Canadian GDP Growth



Sources: Scotiabank Economics, Statistics Canada.

Chart 3

May Real GDP Growth by Sector



Sources: Scotiabank Economics, Statistics Canada.

Chart 4

Weighted Contributions from Sectors to May Real GDP

Sources: Scotiabank Economics, Statistics Canada.

deviate somewhat from this estimate upon fuller inclusion of inventory and net trade effects plus potential revisions. Still, tracking around +/-2% growth in Q2, maybe a little above or a little below, is a sign of ongoing resilience. I had thought that the economy was tracking sub-2% growth in Q2 based upon known information until this morning, so to be tracking potentially above 2% is a mildly positive surprise.

Q3 GDP has about 0.5% q/q SAAR growth baked in. By 'baked in' I mean that it's not a forecast. It's a purely mathematical outcome of the way in which Q2 evolved and ended such that we can say that before we get any Q3 data that the economy has a running head start for Q3 growth. Here too I had thought that if June was softer, then we might not have such a running start and would be more dependent on actual Q3 data to keep growth afloat, but now we do. Now we'll just have to see how the actual data evolves around our forecast for continued resilience.

Charts 3 and 4 break down monthly GDP for May in terms of unweighted changes by sector and weighted contributions to overall GDP growth.

How the BoC Might Look At Growth

Now the BoC will look at that and say, ok, that' s nice, but it's at or slightly below the economy's noninflationary speed limit to growth aka as potential GDP growth. Therefore such growth is either maintaining small excess capacity, or slightly widening it since growth is undershooting the supply side's potential.

The BoC says that potential (not actual) GDP growth is 2.4% in 2024. I think they're too high. Nobody can observe potential GDP growth. There is theory around it, but firm estimates are made-up, fabricated, and in my experience typically designed to serve as a forecast plug on a desired narrative. The Governor's narrative is dovish, ergo potential GDP growth is fudged higher. That's my honest opinion.

And yet business investment is weak. Productivity is lousy. And the BoC is applying an overly aggressive translation of population growth into what it means for potential growth by treating any form of growth in population and the labour force as proportionate drivers of GDP. They are not.

With sooooo much of Canada's population growth coming from the non permanent category of immigration, it's hard to see this equal treatment of body-for-body productivity and output potential as a fair assumption. It's a category made up of international students, temporary foreign workers in mostly service seasonal sectors who send paycheques home and take most of the rest with them, and asylum seeker mostly from Syria and Ukraine. They should not be treated as having the same ability to lift the economy's noninflationary speed limit as others including permanent resident forms of immigration and born in Canada from prior generations. And yet that seems to be what the BoC is doing when they revised up potential growth due to aggregate population growth.

So Why is the BoC in Such a Rush to Ease?

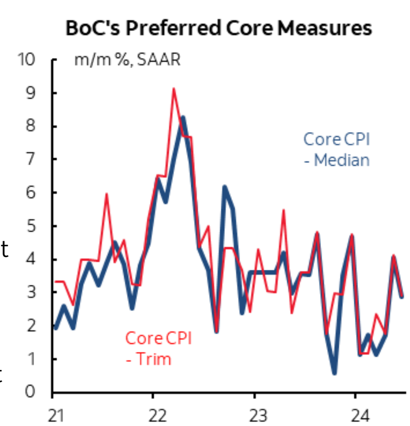
So why is the BoC in such a rush to ease? Why is Governor Macklem speaking about how they're not even close to the limits of undercutting the Fed while signalling total indifference to what happens to the loonie? I can see a rebalancing of the risks from the degree of policy tightening to motivate some cuts, but this Governor sounds like he's super dovish and that may be driving excess in financial conditions.

The economy remains resilient. I've long been in the positive camp on Canada. Wildfires, strikes aplenty, industry one-offs and the large role played by inventory drawdowns in multiple quarters since 2022Q4 made GDP look weaker last year than the economy was in reality. Recession talk was nonsense. It was a textbook time for observing how GDP isn't always the best gauge of what's going on under the hood in the economy.

I then argued you would see a rebound in 2024H1 against the BoC's narrative at the end of last year and in January that H1 would be peak pain for the economy and monetary policy tightening before they revised up H1 growth projections in April. My more upbeat narrative is performing well so far but the BoC has pivoted more dovishly against the data.

The same is true of core inflation. It was soft for transitory reasons over the first four months of the year and has since rebounded sharply to 4.1% m/m SAAR in May and 2.9% m/m SAAR in June (chart 5). Didn't happen, didn't see that, don't want to see that, moving on, all seems to be the BoC's bias despite the caution behind so many false starts on soft core inflation to date.

Chart 5



Sources: Scotiabank Economics, Statistics Canada.

Consumers are handling mortgage resets quite well. Consumption was up by 3% q/q SAAR in each of Q4 and Q1 and will probably mean revert to something at least temporarily softer, but the variable resets have all pushed through and we're now getting variable rate easing.

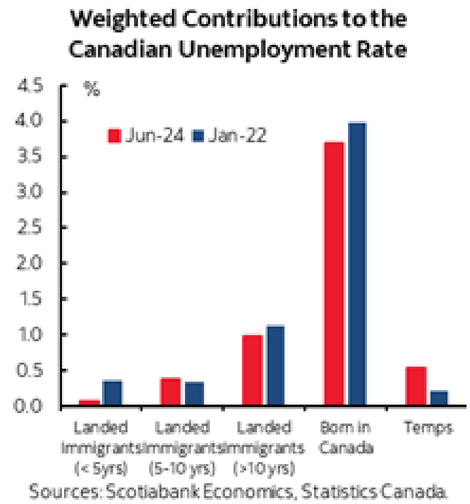
Canada 5s are dear imo, so the flow through to the popular fixed rate mortgage benchmark is helping the folks with fixed resets. Consumer bankruptcies remain rock bottom, so do 90-day plus mortgage arrears, and banks' provisions for mortgage loan losses have gone from nothing when rates were dirt cheap to average despite some of the awful reporting on the issue.

Jobs are strong. The prior month's flatness was a youth summer job effect distorted by the massive surge of temps (nonpermanent residents) who are the ones who have driven all of the rise in the UR (chart 6). Canada's problem is that it is taking on too many.

Wage growth is accelerating in real terms (chart 7) and is sticky at higher m/m SAAR levels in nominal terms (chart 8).

Productivity blows (chart 9). Accelerating wage gains while productivity sinks is an unwelcome combination of inflation risks. Maybe it will pick up in future as the BoC predicts, but they've made that prediction before and keep pushing it out. Besides, sustained productivity gains are needed, not just one-offs if population growth is cooled should the Feds and provinces tamp down non permanent immigration.

Chart 6



Fiscal policy is still adding to growth ages after its usefulness expired. Fiscal plans into an election year with the Libs/NDP polling so badly are a one-way easing bet. Tell me of a government anywhere that is polling as badly as Trudeau, Singh and Freeland that spends less into an election year when they so desperately cling to the perks of power. Tell me of one such government that doesn't spend more. Vote grabbing is likely to be the focus and with that Canada risks further fiscal easing alongside potentially further monetary easing. The mere risk of such an evolution of the risks should at least make the BoC's rhetoric sound more careful notwithstanding their practice (in public at least…) of only reacting to fiscal announcements after the fact.

Chart 7

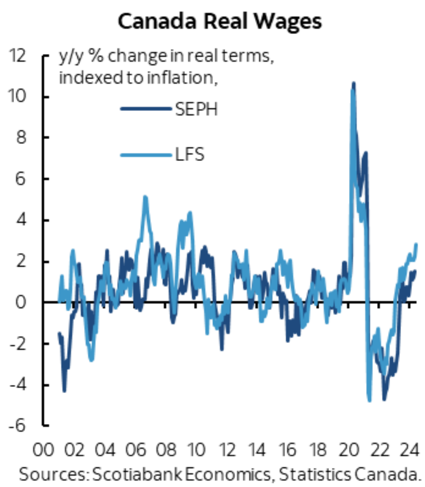
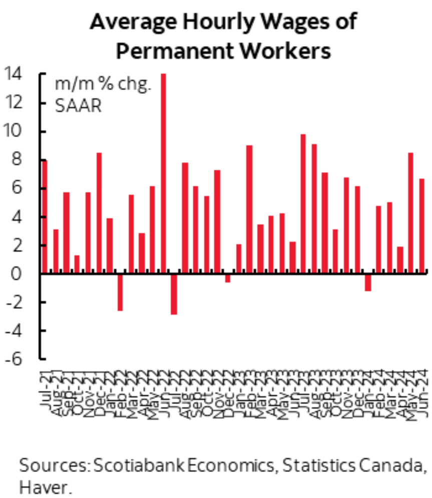


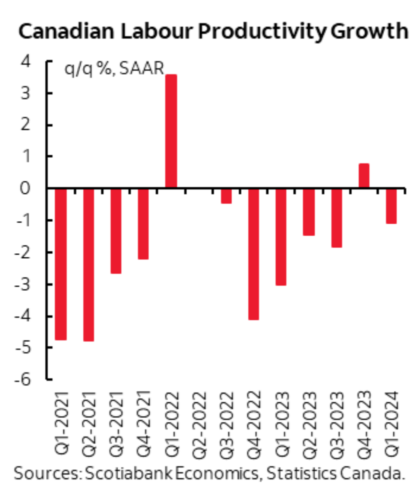
Chart 8



Immigration remains wildly excessive and thoroughly mismanaged. Housing shortfalls were deep before the pandemic and have only intensified. Shelter ex-mortgage interest is a quarter of the basket and faces structural upward pressure. Economists aligned toward serving only real estate interests are screaming rate cuts. Gosh, wonder why. Their arguments lack balance. At worst, they are blatantly misleading by saying only mortgage interest is driving inflation when that isn't even included in the BoC's preferred core inflation measures and never has been during the whole pandemic and even before. That is professionally irresponsible.

Furthermore, geopolitical tensions including effects on oil prices plus soaring global shipping costs add modestly to inflation risk with inflation expectations still up around the BoC's upper bound of the 1–3% inflation target range (charts 10–12).

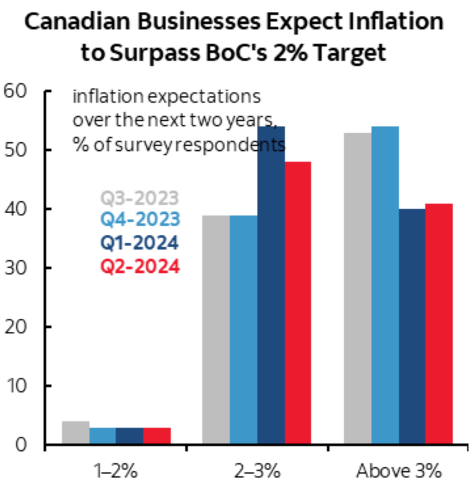
Chart 9



So, Canada. Why exactly are you in such a rush to be the poster child for global monetary easing? Why has a need to be circumspect, careful, and arguably noncommittal to the future path been supplanted by extremely dovish talk from Governor Macklem who should've learned about the perils of overly strong forward guidance in the pandemic? If such a bias proves to be correct, then it's more likely to be because of luck or unforeseen shocks than due to reasoned analysis. I would have thought that after over promising a multi-year period of no rate increases and then reneging on this promise to borrowers in the pandemic that the Governor would have been more careful toward an easing bias now.

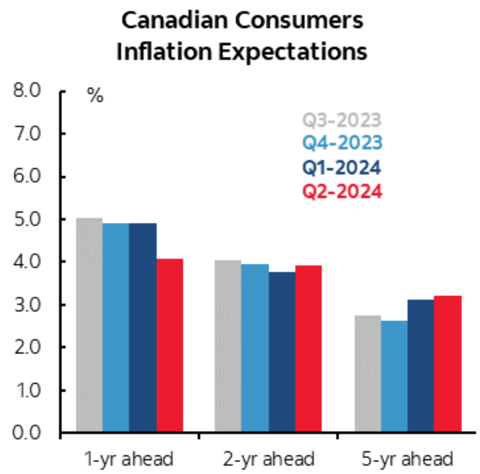
At stake is the fact that markets are believing the Governor. Market sentiment is piling onto Macklem's dovishness in a priced-for-perfection way. Canada 5s are rich at 3.14%. If neutral is anywhere around 2.75%, which is our guesstimate and the mid-point of the BoC's 2.5–3% estimated band, then tack on a term premium and the 5-year bond has gotten on the rich side. It would only be in a vastly more dire scenario for the economy and lower inflation than we are predicting that this would be justified if the policy rate looks to be materially undershooting neutral. Or if the risk of policy error unfolds with the BoC. Time will tell. A half point doesn't cement any outcome, but delivering on the BoC's extremely dovish language has me leaning increasingly toward the latter outcome. Mild easing to rebalance the risks to the inflation target seems appropriate, but going much further is dicey and priced for perfection in the belly.

Chart 10



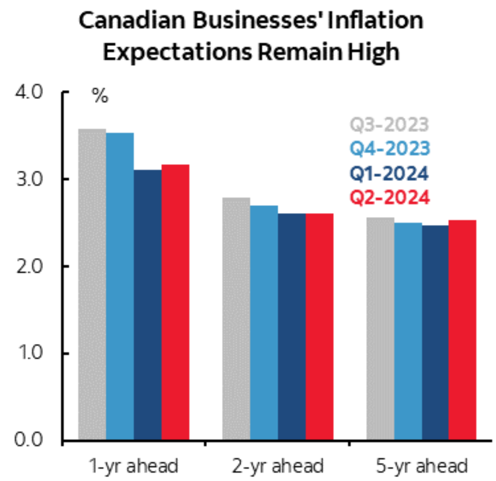
Sources: Scotiabank Economics, Bank of Canada.

Chart 11



Sources: Scotiabank Economics, Bank of Canada.

Chart 12



Sources: Scotiabank Economics, Bank of Canada.