Canadian Quarterly Economic Forecast

Priming the Pump Risks Flooding the Engine

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Canadian Highlights

- Buffeted by risks and entering the mature phase of the economic cycle, Canadian economic growth is forecast to moderate from last year's 3% pace to just below 2% this year and next.
- Consumer spending maintains the support of strong income gains in the near-term. Business investment is expected to hold firm in the face of push and pull factors.
- Rising inflationary pressures support further Bank of Canada interest rate hikes. With external and internal risks elevated however, caution should rule the day. We expect just one more rate hike this year.

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Canadian Outlook - Cruising On Turbulent Waters

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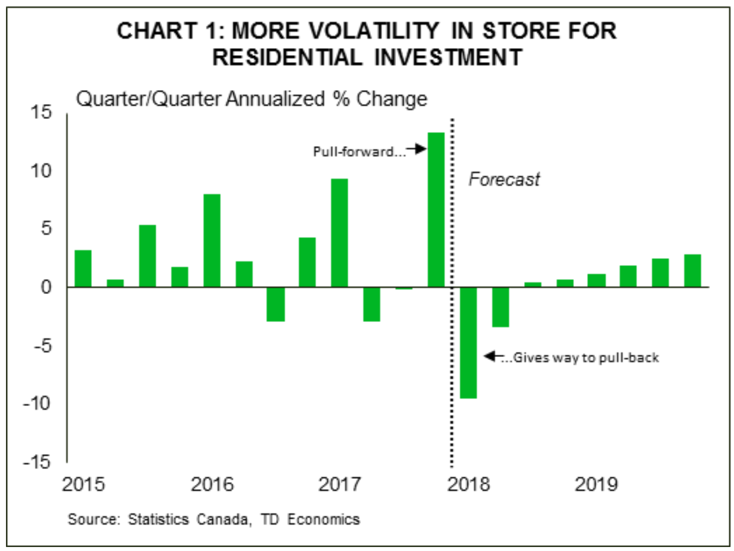
What a year that was. Canada notched up brisk economic growth of 3% alongside impressive job gains in 2017, shaking off the setbacks of the prior two years. A repeat performance in the year ahead is a tall order for a couple of reasons. First, the economy appears to be already operating at slightly above capacity. And second, data reinforces that a meaningful downshift was already underway in the second half of last year. This sets the stage for a return to more sustainable real GDP gains around the 2% mark for 2018 and 2019.



To be sure, there are plenty of headwinds that argue for this downshift. Already-contentious NAFTA talks have now been met with increased U.S. trade protectionism. This is layered on top of a made-in-Canada policy-induced slowdown in the housing market. However, trends in hiring and domestic spending point to an underlying resiliency that leaves a sufficient cushion to absorb headwinds.

The push-and-pull forces of solid domestic spending and gradually rising inflation pressures versus a risk-filled environment will not be lost on the Bank of Canada. Interest rates should continue to move higher over the next few years, but at a pace that will be well shy of our southern neighbour. Widening interest rate differentials will keep the Canadian dollar under pressure in the near term, a development that will help to counter the impact of headwinds in the trade sector.

B-20 changes reverberate in home markets

Canada's housing market came back to life at the end of 2017, with strong growth in residential building and resale activity. This reflected a rebound in activity from earlier regulatory changes, notably Ontario's Fair Housing Plan, that was further exaggerated by anticipation of more stringent mortgage underwriting requirements (B-20).

Pull-forward means payback. Early data suggests that residential investment started 2018 on a back-foot (Chart 1). However, the one-two punch is unlikely to be a knock-out blow. As discussed in earlier reports (See here (https://economics.td.com/canadian-housing-market-regulation-rates) and here (https://economics.td.com/canadian-housing-market-regulation-rates)), two key points should be kept in mind. First, housing is not a single market. Conditions vary by province and city: headline-grabbing changes in conditions in major markets, such as Toronto, are not occurring to the same degree in other markets. Even within volatile markets, there is more to the story – for instance, condo sales have held up relatively better in the GTA/GVA relative to detached homes. Second, while there is certainly no shortage of risks, housing fundamentals remain broadly constructive. Borrowing costs are rising, but so too are employment and incomes. Thus, any near-term adjustment in housing activity is expected to be relatively moderate and concentrated in the first half of 2018.

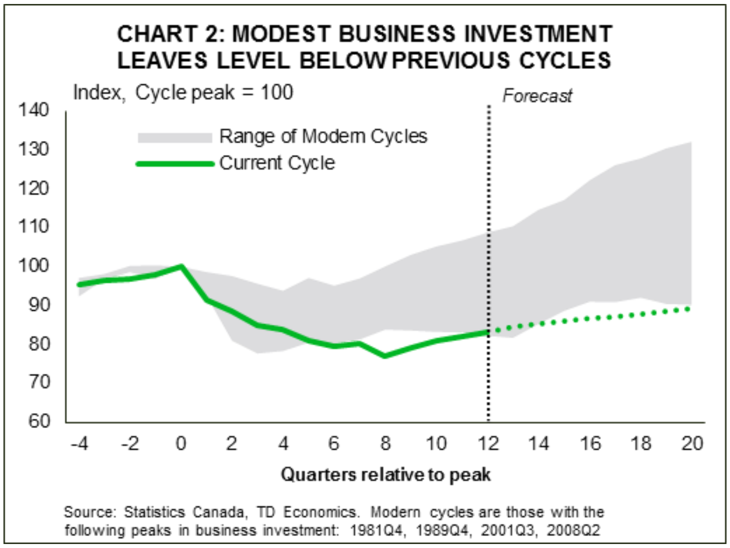
Exports not yet trumped, but new risks emerging

It has been one step forward, one step back when it comes to Canadian exports. The result has been a flat performance since 2015. Recent U.S. policy changes have had mixed implications for the export outlook. On the plus side, tax reforms and stimulus have generated a significant upgrade to the near-term U.S. growth outlook. This, along with a weaker loonie, should translate into increased demand for Canadian goods, particularly in 2019. On the downside, NAFTA negotiations don't seem any closer to resolution, while the U.S. has stepped up specific protectionist rhetoric and actions, including on Canadian softwood lumber, newsprint and more recently, global aluminum and steel imports. The bigger issues of concern stem from potential indirect impacts on market and business confidence, which we will need to watch closely. Our baseline view of modest export growth assumes that Canada-U.S. trade relations do not dramatically deteriorate in the months ahead. But, we also have next to no contribution to GDP growth stemming from net trade over the next two years, on average.

Business investment set to climb, slowly

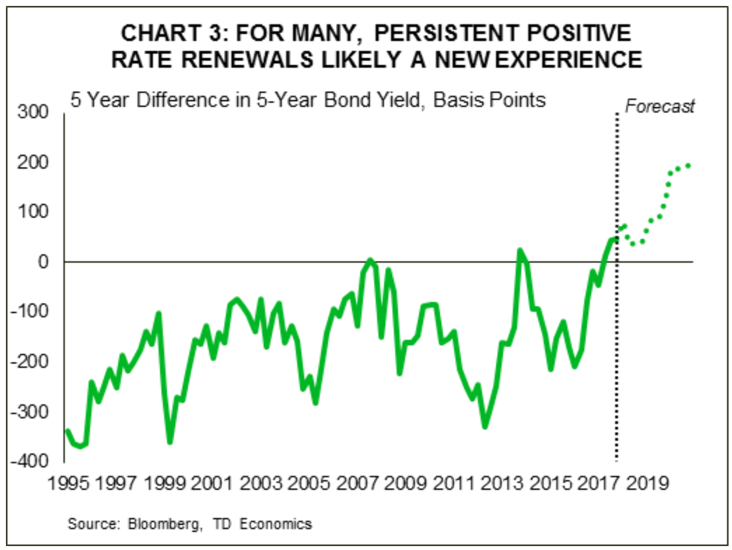
The gyrations of housing markets may have captured the most media and investor attention in 2017, but flying under the radar has been an important resurgence in non-residential business investment. It grew 8.4% last year (Q4/Q4), putting past setbacks in the rear view mirror.

Negative risks tend to steal the spotlight, and there have been no shortages of late. But it is important to remember that the majority of Canadian firms are not export-oriented. These domestically oriented firms are reporting optimism and facing both tight labour markets and capacity constraints. This is a recipe for further investment. There are pockets of weakness to be sure: investment in the energy sector is one such case. And, it is hard to imagine much investment in export capacity at this juncture. But, the net result is an investment profile that balances these risks, proving to be soft from a historical context (Chart 2), and still able to offer an important contribution to economic growth.



Households face rising incomes, borrowing costs

Last year saw roughly a full percentage point chopped off the national unemployment rate as employment grew at the fastest pace in 10 years. Tightened labour markets have translated into rising wages, with gains in the 'employee compensation' component driving household incomes up more than 4% last year. At the same time, households remain highly indebted and borrowing costs have begun to rise, as measured by the five year government bond yield, a useful proxy for contracted mortgage rates (Chart 3).



Income gains have been outpacing borrowing costs. With disposable income set to grow 5% this year, this trend should continue. The result is a bit of a sweet spot: modest spending growth alongside an uptick in savings. As we move into 2019, however, borrowing costs will play a more limiting role on spending: interest rates are projected to continue their gradual ascent, and as mortgages come up for renewal, more and more households will face increased borrowing costs – in many cases for the first time. Thus, while the near-term outlook for consumer spending is constructive, over the longer term, a deceleration to below historic norms remains most likely.

Back to a cautious Bank of Canada

There has been a lot for the Bank of Canada to like in recent data. Overall growth may have slowed in the back half of last year, but domestic demand remained resilient and aggregate incomes continued to rise strongly. At the same time, with a mature business cycle come measures of core inflation that have marched upward and are now just shy of the Bank's 2% target. This creates a sufficient condition for a tightening bias within the central bank. However, the Bank of Canada will continue to look for real-time confirmation in the data that the economy is performing to its expectations. On that note, Q4 2017 GDP growth actually undershot the Bank's expectation marginally, and we believe Q1 2018 will do the same. This should keep the Bank in cautious mode. What's more, with the impact of Federal Reserve hikes expected to generate an implicit Canadian tightening via bond yields (as discussed in our most recent Dollars and Sense (https://economics.td.com/ca-dollar-and-sense)), there is even less impetus to move quickly on the policy rate. Absent a significant near-term shock, only one more hike is expected this year, likely at mid-year, with two more in the queue for 2019. The impact of U.S./Canada rate differentials is a key factor working to hold down our loonie forecast, expected to remain in the 77 to 80 U.S. cent range this year.

Financial Outlook: Powell Takes the Reins

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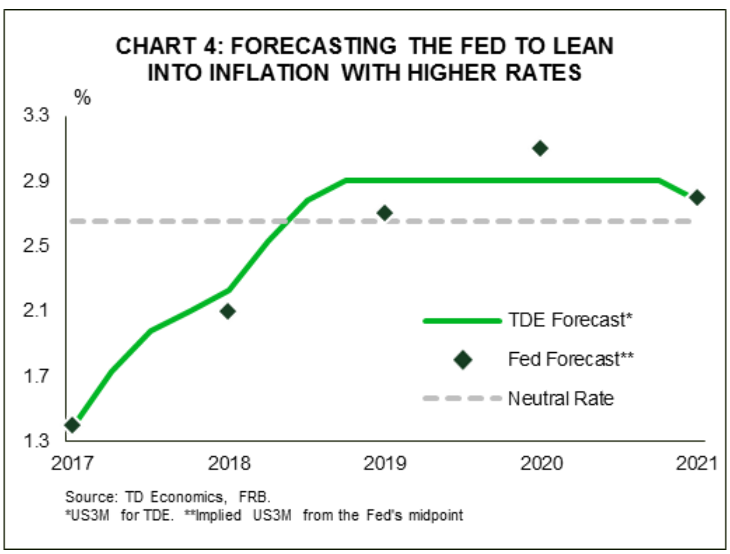
On March 21st, the Chair of the Federal Reserve Board of Governors, Jerome Powell, will announce the first in a series of interest rate hikes under his leadership. This announcement is as guaranteed as an interest rate decision can be – which will bring the upper bound of the fed funds rate to 1.75%. While the interest rate decision is always important, investors will be more focused on how Chair Powell is viewing the evolution of the overall economy given this is his first meeting leading the FOMC.

As we can infer from Powell's semiannual Monetary Policy Report to Congress in late February, he views the economy as performing well relative to his forecast. The one area that is of particular significance is Powell's statement that, since the fiscal spending package, his "personal outlook for the economy has strengthened." There is certainly credence to that view. With labor market pressure visible in strong wage growth and capacity pressures evident in producer prices, a layering on of fiscal policy will only amplify this view.



As is inferred from our federal funds rate forecast and from the Fed's own statement of economic projections, the economy is likely to push into excess demand territory in the next couple of years (Chart 4).

This is what happens when a government turns on the spending taps when the economy is flowing just fine. With capacity constraints beginning to bind, inflation is likely to push higher than the Fed's 2% target. To stabilize inflation around the 2% mark, the Fed would have to raise rates at a faster pace and to a higher level than previously expected. For this reason, there is risk that the Fed will raise rates more than our current forecast of three times this year (markets are priced for exactly three at the time of writing). Higher rates will increase the user cost of capital, mortgage rates, and corporate bond yields, which will act as a drag on the economy, which then helps rein in inflation.

The major consequence of this outcome is that interest rate risk is starting to be embedded in the U.S. Treasury yield curve. The term premium (compensation for the risk that interest rates rise and bond prices drop) has seen a downward slide for 30 years due to the ability of the Fed to stabilize inflation and establish credibility around the 2% target.

But a decade of less than 2% inflation and presence of quantitative easing has pushed the term premium into negative territory. As can be seen in our U.S. economic outlook (https://economics.td.com/us-quarterly-economic-forecast#us), we are expecting inflation to rise above the Fed's 2% target to 2.2%. As inflation pushes higher over this year, we expect the term premium to rise out of negative territory, forcing the US 10-year Treasury yield well above 3% by the end of this year.

With respect to America's peers, underlying inflation dynamics have improved in the majority of advanced economies over the last year, but in most cases are still lagging behind their American counterpart. Layering on the fact that tax reform improves U.S. competitiveness relative to its peers and tariffs incentivize production inside America's borders, discretion from other central banks seems prudent.

A higher relative policy rate and government yields in the U.S. is supportive of the greenback, especially when other major central banks are moving towards caution. Our forecast calls for the currencies of Canada, the UK, and the Euro area to trade with an implicit discount to fair value due to trade risk and policy rate differentials over 2018. We expect this discount to fade over time, resulting in a depreciation of the greenback over the remainder of the forecast horizon.

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