

Canada

- With a truce in the China-US trade war expected on January 15, the key downside risk to the outlook is largely off the table. As a result, we expect growth of 1.5% in 2020, following an increase of 1.6% in 2019. Activity should be supported by continued strength in population growth and a buoyant (and undersupplied) housing market.
- The Canadian economy experienced a soft patch in 2019Q4, as it dealt with the impacts of the GM and CN strikes, and the effects of a pipeline shutdown. A number of indicators suggest the recent temporary weakness might persist, as employment and consumer confidence fell sharply in the final months of 2019.
- With growth expected to remain below potential, excess capacity should rise, putting downward pressure on inflation. With event and downside risks still high, we believe the Bank of Canada will need to cut interest rates in the first half of the year.
- While a recession is not likely in Canada, the large decline in consumer confidence recently observed increases the odds of a homegrown downturn. Confidence should stabilize around current levels, but a further degradation in sentiment could meaningfully affect the odds of recession.

CONFIDENCE, CONFIDENCE, CONFIDENCE

The Canadian economy slowed sharply in the final quarter of last year reflecting in part a number of idiosyncratic and reversible shocks. These factors include strikes at GM and CN, and the Keystone pipeline outage. The weakness, however, seems broader-based than implied by these one-off events (chart 1). As a result, we now expect the Canadian economy to grow by 1.5% in 2020, slightly lower than the 1.6% expected for 2019. This weaker-than-earlier forecast growth will lead to an increase in excess capacity in the economy which—along with uncertainty remaining high and substantial event risk throughout the year—should prompt the Bank of Canada to cut interest rates by 50 basis points in the first half of the year.

At the moment, we remain reasonably confident that the weakness at end-2019 will be temporary. From a global perspective, trade-related risks are moderating (chart 2). US economic activity remains robust and there are early signs of a recovery in Europe. From a domestic perspective, the strongest population growth in 30 years (chart 3) continues to provide a powerful source of human stimulus to the economy, in the form of workers, consumers, and homeowners. Partly as a result, the rally in home sales activity continues to surprise on the upside, resulting in upward price pressures as homebuilders have been unable to keep pace with the increase in housing demand over the last few years (chart 4). Increases in oil prices and production, flowing from an easing of the curtailment in Alberta, will provide a boost to growth, as will an acceleration of the construction of the LNG Canada project in Kitimat. Firms, despite being less confident about the outlook, continue to indicate that labour shortages are the single most important challenge they face (chart 5).

CONTACTS

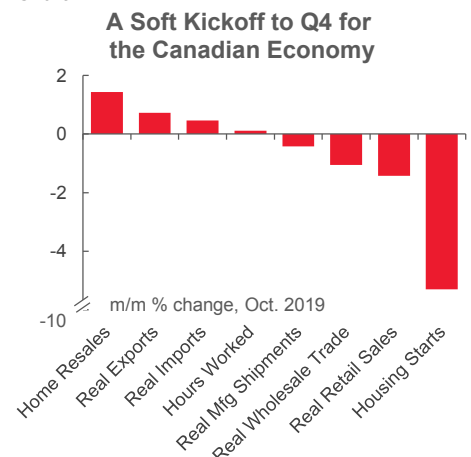
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Canada	2018	2019e	2020f	2021f
Real GDP (annual % change)	2.0	1.6	1.5	2.0
CPI (y/y %, eop)	2.0	2.1	1.8	2.3
Central bank policy rate (% eop)	1.75	1.75	1.25	1.25
Canadian dollar (CADUSD, eop)	0.73	0.77	0.80	0.80

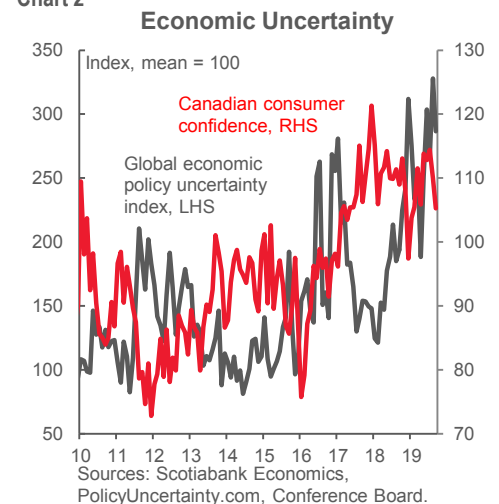
Source: Scotiabank Economics.

Chart 1



Sources: Scotiabank Economics, Statistics Canada, CMHC, CREA.

Chart 2



Offsetting some of these positives, household finances remain stretched, as debt service costs are at record highs. This no doubt accounts for some of the weakness in consumption growth over the last year, and will likely work to hold back consumption growth this year. Business investment was held back in 2019 by concerns about the China-US trade war and the associated risk of recession. While business investment should rebound in 2020 given the very evident labour shortages and attenuation of trade-related risks, the most recent data on imports of capital goods as well as readings of business confidence suggest firms will remain cautious in deploying capital early in the year.

Taken together, these factors suggest that growth should recover from end-2019 weakness through 2020, but remain below our estimate of potential growth (1.7%) for the year. As a result, the output gap, a key determinant of inflation, is expected to widen as excess capacity builds in the economy.

There are nevertheless clear risks to the downside. Looking through the temporary shocks hitting the fourth quarter, there are chances that the weakness observed at year-end may be longer-lasting than generally assumed. Job market dynamics shifted in the quarter, and wage growth moderated. Perhaps most importantly, measures of business and consumer confidence dropped quickly through the later months of the year, despite an evident cooling of global trade tensions and uncertainty. While economic conditions don't merit further declines in confidence, the speed at which confidence has fallen could indicate additional declines are forthcoming. If this were to happen, we would need to downgrade our outlook further. Equally importantly, consumer confidence is an important determinant of recession risk in our probability model. The drop in consumer confidence witnessed in December increased the odds of a recession in Canada to about 35%, despite a steepening of the yield curve. A further drop of the same magnitude, which we do not expect, would lift the probability of a recession significantly. Clearly, much hinges on the evolution of consumer confidence.

Table 1

Canada	2010-18	2018	2019e	2020f	2021f
	(annual % change, unless noted)				
Real GDP	2.2	2.0	1.6	1.5	2.0
Consumer spending	2.6	2.1	1.6	1.6	1.9
Residential investment	2.7	-1.5	-0.7	3.6	2.4
Business investment	2.4	1.8	0.2	3.7	3.5
Government	1.2	3.4	1.8	1.6	1.8
Exports	3.6	3.1	1.9	1.4	2.5
Imports	3.9	2.6	0.6	2.0	2.7
Nominal GDP	3.9	3.9	3.2	3.3	4.2
GDP Deflator	1.7	1.8	1.5	1.8	2.1
Consumer price index (CPI)	1.7	2.3	2.0	2.0	2.0
Avg. of new core CPIs	1.9	1.9	2.0	2.0	1.9
Pre-tax corporate profits	5.8	2.5	-0.2	0.9	2.0
Employment	1.2	1.3	2.1	0.9	1.0
Unemployment rate (%)	7.0	5.8	5.7	5.8	5.8
Current account balance (CAD bn)	-58.4	-55.5	-44.5	-47.3	-43.9
Merchandise trade balance (CAD bn)	-13.0	-22.1	-18.9	-26.9	-27.5
Federal budget balance (FY, CAD bn)	-19.4	-19.0	-14.0	-26.6	-28.1
percent of GDP	-1.0	-0.9	-0.6	-1.1	-1.1
Housing starts (000s)	200	213	209	205	203
Motor vehicle sales (000s)	1,809	1,983	1,922	1,915	1,915
Industrial production	2.7	3.1	-0.8	1.0	1.8
WTI oil (USD/bbl)	74	65	57	59	64
Nymex natural gas (USD/mmbtu)	3.39	3.07	2.53	2.39	2.63

Sources: Scotiabank Economics, Statistics Canada, CMHC, Bloomberg.

Table 2

Quarterly Canadian Forecasts	2019		2020			2021			
	Q4e	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic									
Real GDP (q/q ann. % change)	0.2	1.6	1.7	1.6	1.9	2.1	2.2	2.3	2.2
Real GDP (y/y % change)	1.5	1.7	1.2	1.3	1.7	1.8	1.9	2.1	2.2
Consumer prices (y/y % change)	2.1	2.3	2.0	2.0	1.8	1.7	1.8	2.0	2.3
Avg. of new core CPIs (y/y % change)	2.1	2.1	2.0	2.0	1.9	1.9	1.9	2.0	2.0
Financial									
Canadian Dollar (USDCAD)	1.30	1.28	1.27	1.26	1.25	1.25	1.25	1.25	1.25
Canadian Dollar (CADUSD)	0.77	0.78	0.79	0.79	0.80	0.80	0.80	0.80	0.80
Bank of Canada Overnight Rate (%)	1.75	1.50	1.25	1.25	1.25	1.25	1.25	1.25	1.25
3-month T-bill (%)	1.66	1.55	1.25	1.25	1.25	1.25	1.25	1.25	1.30
2-year Canada (%)	1.69	1.50	1.35	1.30	1.35	1.40	1.45	1.45	1.50
5-year Canada (%)	1.68	1.45	1.35	1.35	1.40	1.45	1.50	1.55	1.60
10-year Canada (%)	1.70	1.55	1.45	1.50	1.50	1.55	1.60	1.70	1.75
30-year Canada (%)	1.76	1.65	1.60	1.65	1.75	1.80	1.85	1.95	2.00

Sources: Scotiabank Economics, Statistics Canada, Bloomberg.

Chart 3

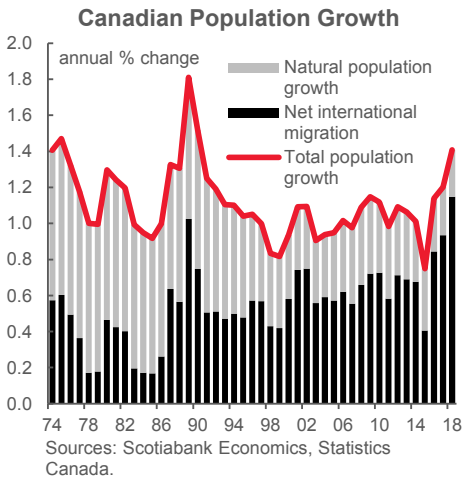


Chart 4

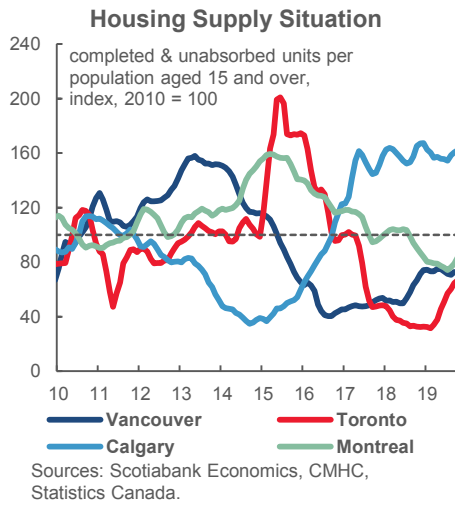
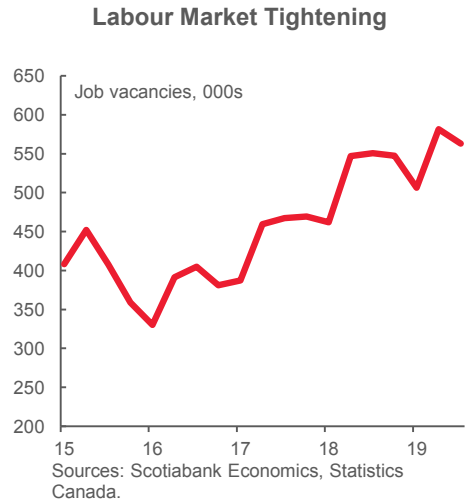


Chart 5



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