Canada Offers A Lesson On When Not To Over-React To GDP Headlines

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- Growth exceeded expectations in Q2 and June...
- ...but the underlying economy was not as strong as GDP made it look
- GDP overstated weakness in Q1 and overstated strength in Q2…
- …as final domestic demand has been rather volatile
- The BoC may wish to wait to monitor final domestic demand…
- ...but the case for an insurance rate cut remains rooted in future downsides
- The BoC may discount the export tally…
- ...as business investment grinds to a halt in the era of Trump

Canada, GDP, q/q % SAAR Q2, m/m % June:
Actual: 0.2 / 3.7
Scotia: 0.2 / 3.1
Consensus: 0.1 / 3.0
Prior: 0.2 / 0.5 (revised from 0.2 / 0.4)

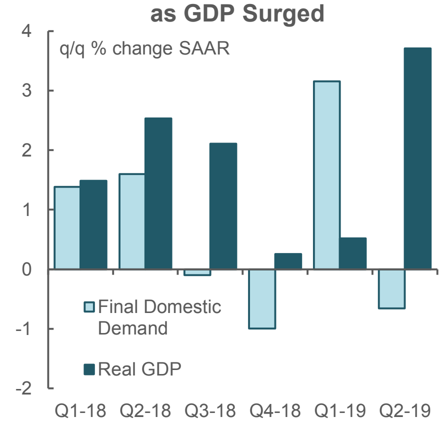
More than anything, this year's GDP figures are providing a lesson on how sometimes GDP can be an imperfect guide to strength or weakness in the economy. Expect the BoC to emphasize this point. Markets didn't react much to the release, as CAD only slightly appreciated and the Canada 2 year yield only ticked higher by one basis point.

While headline 3.7% Q2 GDP growth was on the stronger side of consensus, the underlying details should be faded because apart from exports, the rest of the economy was rather soft. Don't get too carried away with that, however, in that this reverses the opposite dynamic in Q1 when GDP exaggerated weakness in the domestic economy. Overall, a takeaway should be that the economy wasn't as weak as it appeared in the first quarter nor as strong as it appeared to be in Q2 if one were to judge it solely in terms of headline GDP growth.

Regardless, much like how the BoC ignored strong growth in 2014Q4 (2.9%) and 2014Q3 (3.9%) when it cut in January 2015, there remains a solid case for discounting backward readings and looking toward increased downside risks to the global and domestic economies. That, in turn, could well motivate downward revisions to forward GDP growth and delay targets such as the sustained closure of excess supply in the broad economy and sustained achievement of the 2% inflation target.

What stands out in this release is the fact that final domestic demand fell in Q2 and subtracted 0.7 percentage points from annualized GDP growth in weighted terms. Final domestic demand adds up consumption, government spending, residential investment and business investment. Basically, it captures everything other than net exports and inventories in order to give a useful perspective on key sectors in the domestic economy.

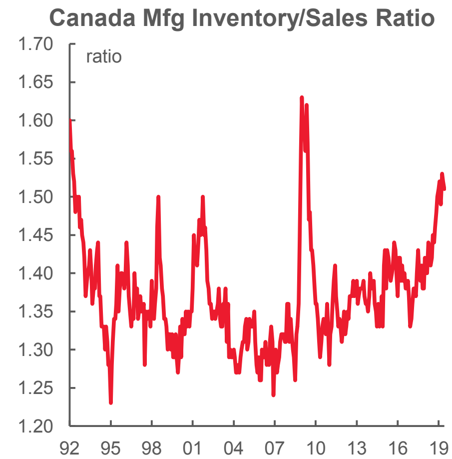
Final Domestic Demand Shrank as GDP Surged



Sources: Scotiabank Economics, Statistics Canada.

One should nevertheless put this in the context of how final domestic demand ripped higher in Q1 and added over three percentage points to GDP growth in weighted contribution terms as the headline GDP number only grew by ½% annualized. See chart 1 for a portrayal of how GDP and FDD can be a) wickedly volatile, and b) often out of sync with one another. Hence, don't over react too much to the volatility in the FDD numbers in that some payback in Q2 isn't a huge surprise after Q1. Still, at the margin, the stalling out in almost everything outside of net trade is a point of concern if it persists. It incrementally informs a perspective that says not all is well in the domestic economy and that not all of the risks are external to Canada, but given the volatility in this reading over 2019 to date, we need more data to have greater comfort with this interpretation. The BoC may well wish to wait to see if this stalling out in FDD truly has legs to it by monitoring incoming data, though this observation does not invalidate the earlier argument about future downside risks.

So what drove growth in Q2? Net exports added a whopping 5.5 percentage points to GDP growth in weighted terms with 4.1 points out of that through a 13.4% gain in gross exports and 1.4 points coming from a 4% drop in imports that in a GDP accounting sense is positive because it means less activity leaks out of the economy.



Sources: Scotiabank Economics, Statistics Canada.

Inventories subtracted 1.1 percentage points to GDP growth in Q2. With elevated inventory levels particularly in manufacturing and at wholesalers, I take that to be constructive in an effort to rein them in. Growth would have been stronger yet if inventories had not been pared back, but again, that's not necessarily a negative at this point in the cycle especially on the manufacturing side of the equation (chart 2). Manufacturers are dealing with the most bloated inventory position since the GFC which suggests a more cautious approach to production decisions going forward.

As for what drove weak final domestic demand, consumption added only 0.3 percentage points to GDP growth in Q2 on an annualized basis. Residential investment added only 0.4 points. Business investment subtracted 1.6 points primarily as machinery and equipment investment subtracted 1.5 points with soft structures investment offering a minor subtraction from growth. That companies don't feel comfortable committing capital budgets in the era of Donald Trump is a nearly universal theme and not one that is likely to go away any time soon. Indeed, the BoC may be concerned about legs to the export picture given that investment is not expanding the capacity to drive sustainable export gains. Government spending added a half percentage point to GDP, again, all in annualized terms.

As for GDP during the single month of June, there are two observations worth making. One is that the way the math hands-off to Q3 bakes in 0.8% annualized GDP growth given the way the quarterly average GDP figures transitioned to enter Q3. Obviously this is assuming nothing about how data unfolds over Q3 but it bakes in a weak starting point.

Second is that breadth to GDP growth was quite good in June. GDP was up in 17 of 20 industries. The country coped with a manufacturing retreat that shaved about 0.15 points off of June GDP. Only transportation and warehousing and 'other' services fell with everything else advancing. The gain was in line with my estimate, but durability remains extraordinarily uncertain into Q3 and beyond.