September 30, 2020

Canada's Uneven Recovery Is Losing Momentum With Downside Risk

- **July's solid GDP gain met expectations…**
- **…but August's growth was soft…**
- **…given hours worked, housing and manufacturing readings**
- **Three-quarters of the pandemic hit to GDP has been recovered…**
- **…and it has only taken four months to do so**
- **A full recovery by early 2022 is likely delayed by a second wave**
- **Spare capacity likely to persist until 2023, inflation pick-up to lag...**
- **...counselling a prolonged BoC rate hold and a lengthy period of balance sheet expansion with feasible yield targets**
- **The recovery remains hugely uneven across sectors**

CDN GDP, m/m % change, SA, July :
Actual: 3.0
Scotia: 3.0
Consensus: 2.9
Prior: 6.5
August guidance: 1%

Canada's economy grew in line with earlier guidance provided by Statistics Canada for the month of July, but August flagged some evidence of emerging downside risk even before second wave considerations are factored into the outlook. On net, the Q3 recovery is probably tracking considerably faster than the BoC had anticipated in its last round of forecasts back in July. Nevertheless, the recovery to date remains very uneven on a sector basis. Markets generally shook off the releases.

The preliminary guidance that August GDP grew by 1% was disappointing. That's because what little information we had to help track growth that month was looking pretty strong. Hours worked were up by 2.9% m/m, housing starts soared by about 7% m/m and existing home sales were up by about 6% m/m as Markit's manufacturing PMI climbed by 2.2 points to 55.1. Recall that GDP is an identity expressed as hours worked times labour productivity, with the latter defined as GDP per hour worked. Thus, a 2.9% jump in hours worked should have meant GDP grew fairly quickly unless productivity slipped, in turn due to softer economic activity. Well, apparently it did.

To help further inform this argument, StatsCan said that "Most sectors continued their growth trajectory in August with the exceptions of retail trade and public administration which pulled back marginally." They don't provide colour on the magnitude of growth across 'most sectors' but it's probably materially cooler. The remark on retail indicates that consumer momentum slipped.

So where do we stand on net at this point in the recovery? Chart 1 provides the answer. After the initial 18% drop in monthly GDP from February to April, we're now only about 5.8% lower as at July. That's a pretty swift rebound in just three

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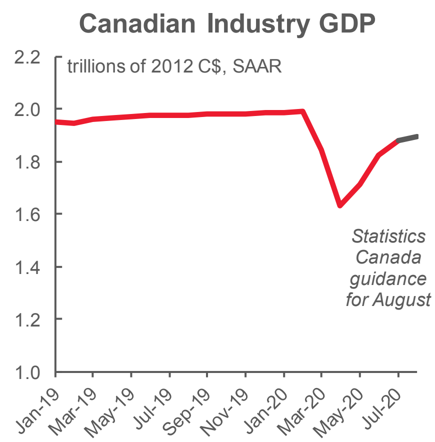
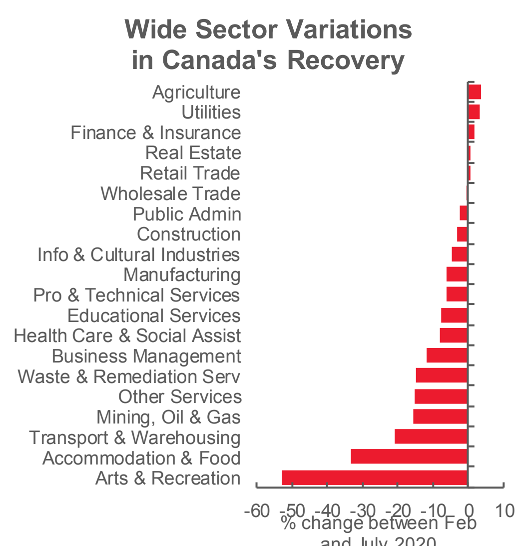
Chart 1



Sources: Scotiabank Economics, Statistics Canada.

Chart 2



Sources: Scotiabank Economics, Statistics Canada.

months. Tack on August guidance and the economy is now less than 5% smaller than just before the pandemic struck and has therefore already recouped about three-quarters of the hit.

As for when we expect the economy to fully recover, well, that's in a bit of a state of flux at the moment. We had previously anticipated that a full recovery in quarterly GDP would likely occur into early 2022. The direction of risks to our forecasts is now more pointed to the downside than previously judged as second wave effects result in rollbacks of reopening plans that are likely to dampen growth in Q4 and through 2021 a bit more than previously expected. That could still mean that GDP levels recover sometime well into 2022. As the supply side continues to expand, however, the output gap is likely to remain open into at least late 2022 and more likely 2023+ in my opinion. Then factor in lagged effects between closing spare capacity and possibly shifting into excess aggregate demand and when inflation may pick up even if the BoC does not embrace overshooting 2%. That means a prolonged rate hold and a balance sheet that is likely to continue to expand throughout 2021 with a principal focus upon GoC bond buying. The BoC may well choose to embrace yield targeting in lieu of purchases across the short-end through the belly of the curve and focus purchases on longer terms. This, however, may require downside risk to average core inflation to emerge to a greater extent than has been evident to date, albeit early to assess the full impact of the pandemic upon prices.

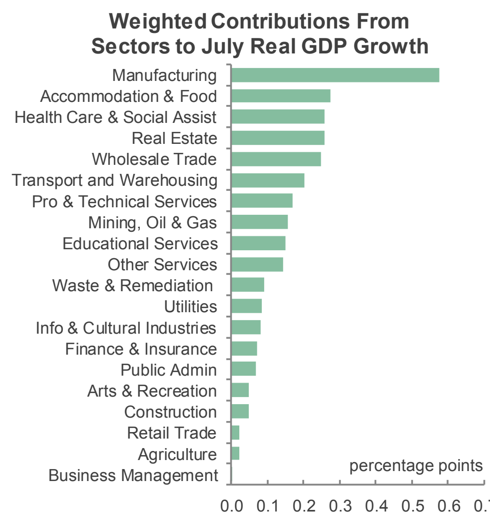
Given that BoC Governor Macklem emphasizes an inclusive recovery, where do things stand in terms of cumulative rebounds by sector? Chart 2 offers an answer at least up to July, since the preliminary guidance for August GDP growth is not broken down by sector.

- A minority of sectors have more than recovered including agriculture, utilities, retail trade, finance and insurance, real estate rental and leasing.
- Wholesale trade has fully recovered.
- Multiple sectors are within 5–6% of a full recovery or less, including construction, manufacturing, information and culture, professional/scientific and public administration.
- The worst laggards are mining/quarrying (-16%), transportation and warehousing (-21%), business management (-12%), waste and remediation (-15%), arts/entertainment (-53%), accommodation and food services (-33%), other services (-15%).

For July itself, the breadth of the 3% rise was high as all 20 sectors gained. The weighted contributions to growth are broken down in chart 3.

After a -38% annualized contraction in Q2, I'm getting Q3 tracking a 45% annualized rebound with two caveats. One is I've assumed September to be flat to focus the math on what we know. Two is that this is using production side GDP that can materially differ from expenditure-based GDP (what the BoC forecasts) often due to inventory and import leakage effects. GDP tracking suggests the economy is rebounding faster in Q3 than the BoC anticipated in its last forecasts back in July. That generally fits the tone of the higher frequency readings. The BoC forecast +31.3% q/q SAAR in Q3 using expenditure-based GDP and we're getting +45% using production-based GDP. Again, the caveat is that inventory and import leakage effects can drive differences between the two concepts and it's feasible that both effects were negative in Q3, so treat evidence of a possibly quicker rebound than the BoC anticipated with some care and keep the focus upon durability in the face of rising downside risk.

Chart 3



Sources: Scotiabank Economics, Statistics Canada.