Canada's Economic Resilience Continues

- **Canada's economy rebounded in June…**
- **…after transitory weakness during lockdowns**
- **Serial upside surprises to BoC expectations continue…**
- **…but talking through them now risks greater rate risk in 2022**

CDN GDP, m/m % change, SA, May:
Actual: -0.3
Scotia: -0.3
Consensus: -0.3
Prior: -0.5 (revised from -0.3)
June 'flash' guidance: +0.7

The Canadian economy is on the rebound and continuing to surpass the Bank of Canada's expectations. As the economy reopens, we are likely to see continued strong growth accelerating from the pace being tracked for the quarter that is behind us.

While May GDP met expectations with a dip of 0.3% m/m and April was revised down to -0.5% m/m (from -0.3%), the weakness during the second wave restrictions isn't the surprising part of it all.

What is somewhat surprising is the magnitude of the early guidance on June GDP. StatsCan says the economy rebounded by 0.7% m/m at a seasonally adjusted non-annualized pace. Given the dip in hours worked during June and the mixed observable readings on the economy during June a preliminary estimate of 0.7% growth is encouraging.

The agency also said that preliminary guidance points to an expansion of 2.5% q/q in the second quarter (0.6% q/q non-annualized). See chart 1 for the quarterly pattern.

Step back and spend a second to appreciate what's going on here. The pandemic has been terrible for too many in terms of the health consequences, although with vaccines this has become more of a self-imposed risk to most hold-outs. The job market is still recovering but is likely to make much further progress over the second half of this year.

Nevertheless, through second and third waves of COVID-19 cases, Canada's economy hardly collapsed. Far from it. The worst thing you can say is that there were minor retreats in a couple of months but they did not translate into sustained quarterly hits as activity simply got punted into subsequent periods. We've seen powerful and sustained growth for four consecutive quarters now and with more powerful growth likely ahead as the economy more fully reopens.

Taking into consideration how the quarter performed and how it transitioned toward Q3 indicates 'baked in' annualized growth of 1.5% q/q in Q3 before we even begin to get any hard data on Q3. As Q3 data rolls in we'll only add to this tracking in favour of growth that is likely to turn out to be several orders of magnitude higher than what is presently baked in.

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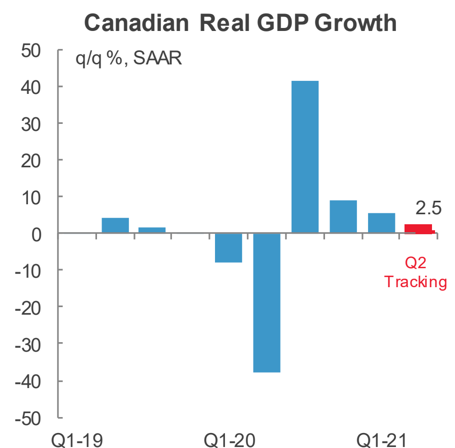
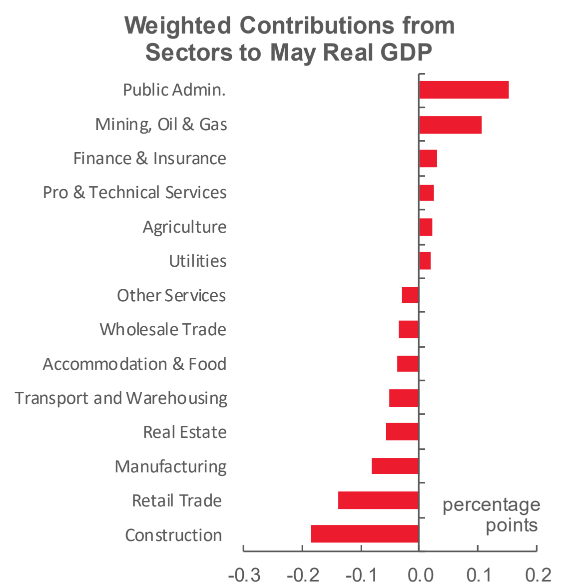
Chart 1



Sources: Scotiabank Economics, Statistics Canada.

Chart 2



Sources: Scotiabank Economics, Statistics Canada.

What this means is that we continue to see serial positive surprises to the Bank of Canada's forecasts. They have generally been rather large surprises. In the January MPR they forecast Q4 would expand by 4.8% q/q SAAR and then contract by 2.5% in Q1, but the economy actually advanced by +9.3% in Q4 and another +5.6% in Q1. The Fed's cautious optimism on resilience through the second wave was correct and the BoC was too negative. Now we're getting slightly firmer Q2 growth at 2½% than they anticipated in the July MPR (2%) after lowering their estimate only because of the massive upside surprise to their Q1 forecast. Overall, the sum total is a massive cumulative upside beat to their forecasts for growth over Q4-Q2.

DETAILS

Chart 2 shows the weighted contributions to growth by sector of the economy during May. The -0.3% m/m dip in May was mainly due to construction and retail sales which makes sense in lockdowns. Still, 8 of 14 sectors were lower and manufacturing also played a modest role in driving the dip. The only material upsides were in mining/oil/gas and the public sector which of course is largely immune to lockdowns.

The qualitative guidance for June indicates gains in retail, accommodation and food services, manufacturing and mining/energy, but contractions in construction and wholesale trade. They don't break down the actual numbers for June in the flash reading, but the verbiage is quite constructive by way of breadth.

Q2 GROWTH APPEARS TO BE SOLID ON DETAILS

It doesn't look like StatsCan is signalling inventory or import distortions to Q2 GDP growth. That's because when I take monthly GDP (based on production) it yields 2.5% q/q SAAR in Q2. That matches StatsCan guidance for expenditure-based quarterly GDP growth of 2.5%. Quarterly GDP differs from monthly GDP tracking because the former incorporates inventory and import leakage effects whereas the production side accounts don't consider this issue of how higher output was achieved or where it went (eg inventory addition or depletion). In plain English (!), this means Q2 growth guidance of 2.5% seems to be quality as opposed to being potentially distorted by inventory and import considerations.

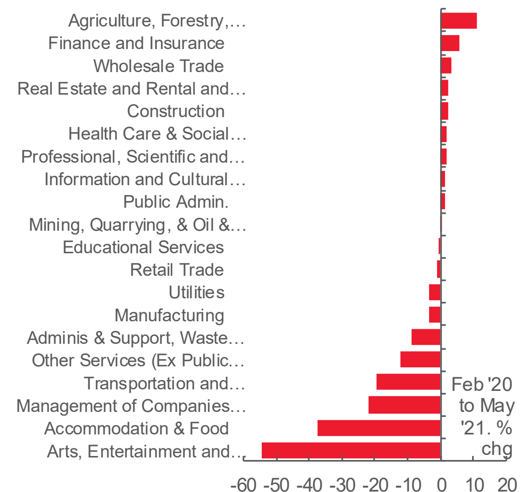
I'm a bit surprised by that. With all of the supply chain issues that are messing up inventories as companies pull in more inputs especially in the import-reliant Canadian economy I would've thought Q2 might have had some of these distortions.

ALMOST THERE!

So where do we stand in tracking the cumulative recovery to date? Chart 3 illustrates the points below.

- GDP is now at 98.5% of where it was in February last year before all of us started aging exponentially;
- the goods sector has fully recovered at 100% of Feb 2020 GDP;
- services are still down 2.1%;
- within goods, ag/forestry/fishing is the biggest winner and is up 11% from Feb'20, mining/energy is 0.5% bigger on net, utilities are down 3.4%, construction is up 2.1% and manufacturing is down 3.5%.
- Within services, wholesale is 3.4% bigger on net, retail is back to being down a bit on net (-1.2%), while transportation/warehousing is down 19.6% yet not the worst. Accommodation and food services are still down 37.5% with arts/ entertainment/rec still down 54.4$ and 'other' services down 12%. Health care is up 2%, professional services (lawyers, accountants etc) are up 1.8%, real estate services are up 2.4% and finance/insurance is up 5.9% on net. IT is also up 1.6% on net.

Chart 3



Sources: Scotiabank Economics, Statistics Canada.

WHERE TO FROM HERE?

Canada may be almost at the point of recovering all total lost GDP, but that doesn't mean growth will necessarily wane. The still massive shortfalls in several service

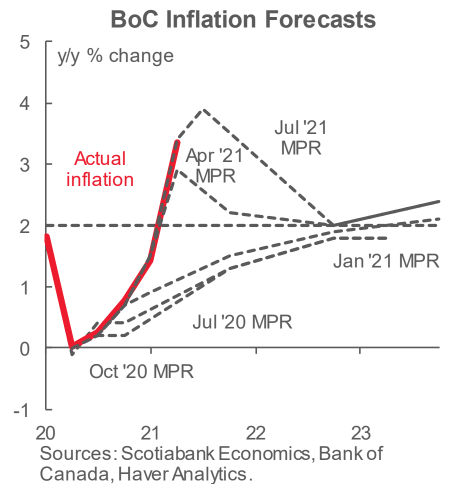
sectors are where the upside sits in reopening economies with relaxing restrictions. Further, simply recovering lost GDP in goods sectors doesn't have to mean they stop growing. In any event, these are distributional issues affecting the composition of GDP whereas a blunt tool like monetary policy should arguably focus upon the broad macroeconomic consequences and leave distributional matters to other policy levers.

What that all means is that Canada is on track to fully recover lost GDP to the pandemic by Q3 and likely shut the output gap measure of spare capacity by early next year if not sooner and given a relatively slow growing supply side. Canada could also meet or surpass the BoC's estimates of slack in the job market as soon as this year.

Given the persistent upsides to the BoC's growth forecasts and to its inflation forecasts (chart 4), there doesn't appear to be a need for emergency levels of monetary stimulus to persist. A dispassionate reading of the inflation drivers would portray them as not just base effect driven but also driven by strong monthly price gains with as many potential transitory upsides to inflation as transitory downsides. Regardless, even the BoC's own forecasts expect a sustained period of inflation slightly above the BoC's target so even its numbers set a limit on 'transitory' talk.

In any event, I would have preferred to see bond purchases end by now and greater guidance to Canadians to expect possibly faster and more numerous rate hikes going forward. Some other central banks in the world are doing so. Policy would still be highly stimulative even if no bonds were still being purchased and even with modest near-term rate hikes. The longer this gets delayed, the more likely it may become that the BoC places itself in a policy straight jacket much like how monetary and fiscal stimulus pulled forward activity with excessive stimulus driven by 2015 rate cuts and subsequent child benefit payments.

Chart 4



Sources: Scotiabank Economics, Bank of Canada, Haver Analytics.

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