Scotiabank

GLOBAL ECONOMICS

SCOTIA FLASH

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Contributors

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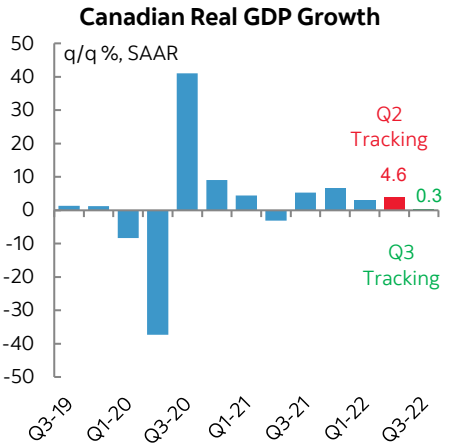
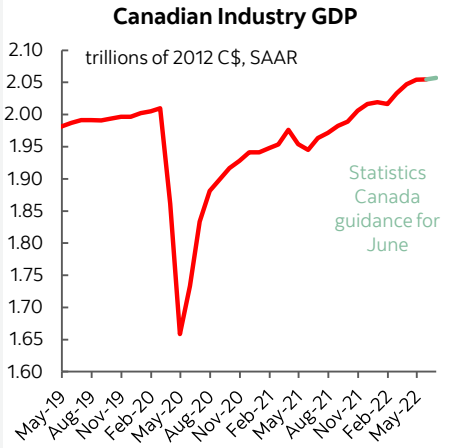
Chart 1



Sources: Scotiabank Economics, Statistics Canada.

Chart 2



Sources: Scotiabank Economics, Statistics Canada.

The Shine May Come Off Canada's Economy in Q3 While US Inflationary Pressures Accelerate

- **While Q1 and Q2 Canadian GDP growth was solid…**
- **…it's hard to get excited by no growth in May and 0.1% in June…**
- **…that bakes in no running head start for the economy in Q3…**
- **…by contrast to the way the math worked in favour of Q1 and Q2**
- **US employment cost and core PCE inflation exceed expectations**
- **Short-term rates rise while USDCAD shakes it all off**

CDN GDP, m/m % change, SA, May:
Actual: 0.0
Scotia: -0.1
Consensus: -0.2
Prior: 0.3
June 'flash': 0.1

Canada's economy performed very well over 2022H1 but may be poised for a moderation into Q3 (charts 1, 2). The way the GDP math works points to a loss of the running head start into Q3 compared to the early advantage that Q1 and Q2 GDP growth enjoyed. With huge cautions given that it's a highly preliminary argument, it may be that the shine is about to come off Canadian GDP growth into the third quarter.

Because US data exceeded consensus expectations (see below), the mildly better than expected Canadian GDP figures were shaken off by USDCAD that barely budged. The US front-end is underperforming Canada's, but in both countries short-term rates moved higher post-data.

CANADA'S Q2 ECONOMY

May GDP was revised up by two-tenths from the preliminary flash reading to now show no growth. Yippee, no growth, but at least it beats a monthly contraction which is what Statcan had initially guided (-0.2%). June's preliminary reading is just +0.1% m/m which is light compared to the huge gain in hours worked that month because goods sector data was generally soft pending further incorporation of more data in the next estimate particularly for lagging services.

The numbers carry positive implications for Q2 but set up a warning around the durability of Canada's economy into Q3.

Using monthly production/income-based GDP accounts points to growth of 4.6% q/q at a seasonally adjusted and annualized rate (SAAR).

Recall that the Bank of Canada had forecast Q2 growth of 4% but that this is based upon expenditure-based GDP. The difference between expenditure-based and production-based GDP can be material in part due to inventory and import leakage effects that stand to be further informed with further Q2 trade and inventory figures. Still, one can probably comfortably say that the Canadian economy is broadly tracking in line with the BoC's expectations after they revised Q2 growth down from 6% in their prior forecast.

…BUT Q3 LOOKS TO BE STALLING

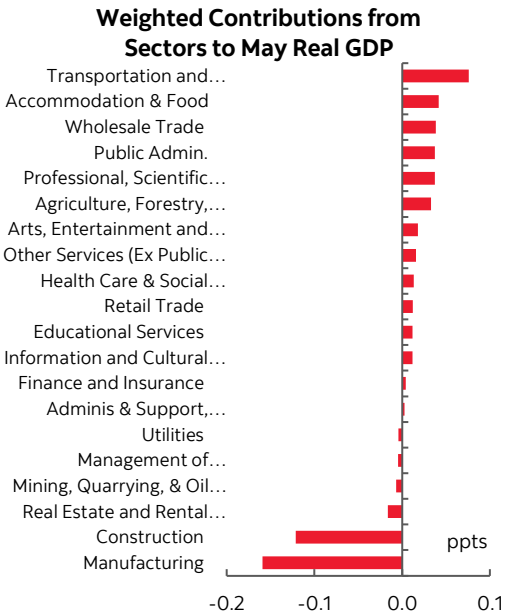
The rub lies in the fact that Q3 has only 0.3% q/q SAAR growth baked in so far and based solely upon how Q2 ended and Q2 average GDP. Before we get any actual Q3 data—starting with next Friday's hours worked and jobs—it's looking like momentum may be

cooling off. Obviously that stands to be informed by Q3 data but the point is that thus far there is no running head start for Q3 GDP based upon the math to this point. By way of comparison, Q1 had 1% SAAR growth baked-in before any Q1 data began to roll in and Q2 had 3% SAAR growth baked in before any Q2 data began to roll in.

GDP DETAILS

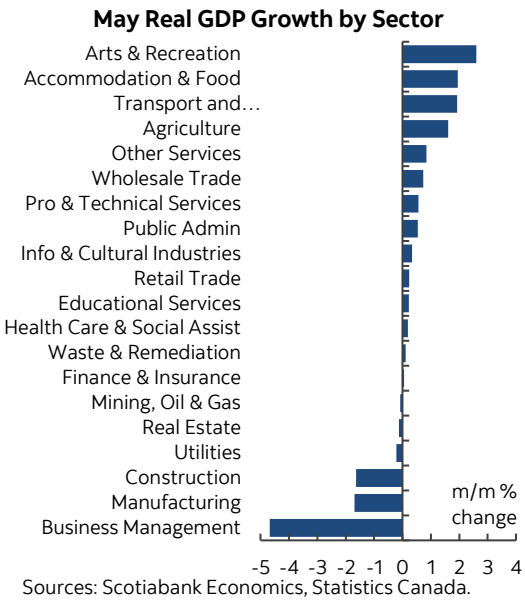
As for details, chart 3 breaks down May GDP in terms of weighted contributions to overall GDP growth. There was fairly high breadth to the gain in May with the only material drags coming from construction (housing) and manufacturing. Chart 4 does likewise in unweighted terms to show raw growth by sector.

Chart 3



Sources: Scotiabank Economics, Statistics Canada.

Chart 4



Sources: Scotiabank Economics, Statistics Canada.

US INFLATION PRESSURES ARE PERSISTING

Think US inflationary pressures are cooling? Think again as that narrative just got a wake up call.

The Fed's preferred inflation gauge is showing no signs of durably letting up. They target headline PCE but use core PCE as the operational gauge that is less volatile and the two measures can tend to converge over time. In practice, the FOMC places greater emphasis upon core PCE.

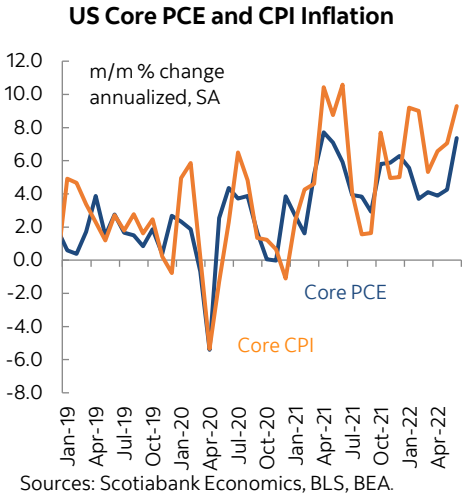
Core PCE inflation was up 0.6% m/m which is consistent with what was implied in yesterday's quarterly figure within the GDP accounts had there been no monthly revisions and there were none. Therefore in theory if folks were doing their homework then there should not have been a surprise today, yet markets were surprised with the USD pushing higher and Treasuries cheapening particularly around the front-end.

That's the hottest reading for core PCE since April 2021 by a whisker. Chart 5 shows the annualized m/m pace. It is a rise that is about double the monthly pace that was being registered from February through May and so in fairness we need more data in order to assess the trend. This is nevertheless a wake-up call that the inflation fight is far from over.

To that effect, also note the Employment Cost Index that jumped by 1.3% (consensus 1.2%) for the fourth consecutive quarterly rise of 1% or more at a non-annualized pace. The drivers were broadly based as wages and salaries were up by 1.4% q/q and benefits were up 1.2%. Growth in private sector compensation is double that of the public sector. See chart 6. Labour cost-push pressures on an all-in basis are supporting broad inflationary pressures.

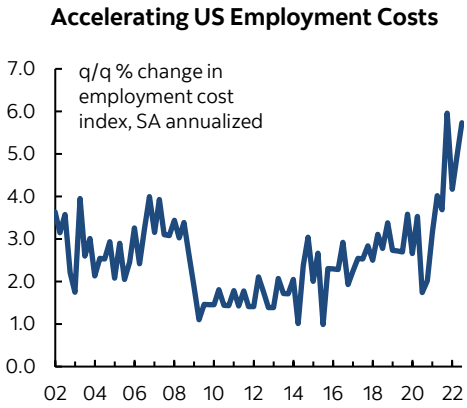
I think that if Fed Chair Powell had to make the September rate call today then he'd remain open to another 75bps move. There is a lot of data ahead before that meeting, however, which will keep markets on heightened alert to data swings. I still think that markets are very prematurely pricing rate cuts next year.

Chart 5



Sources: Scotiabank Economics, BLS, BEA.

Chart 6



Sources: Scotiabank Economics, Bloomberg, Eurostat.