Scotiabank

GLOBAL ECONOMICS

SCOTIA FLASH

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Contributors

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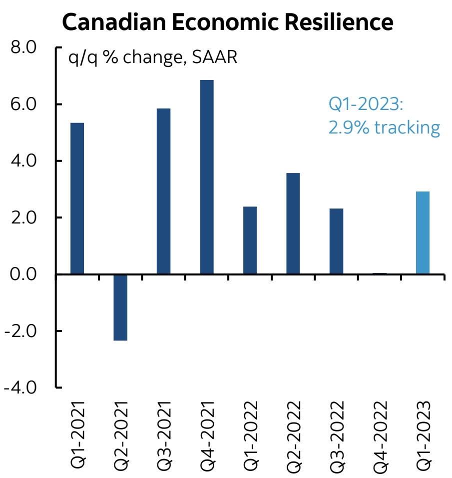
Chart 1



Sources: Scotiabank Economics, Statistics Canada.

Chart 2

Sources: Scotiabank Economics, Statistics Canada.

Why GDP Matters to BoC Observers

- **GDP growth is outpacing BoC expectations…**
- **…as Q1 sharply rebounds with evidence of positive momentum into Q2**
- **Markets may be betting that accidents will drive easing…**
- **…but the fundamentals picture doesn't support this**
- **Powell's preferred inflation gauge remains sticky…**
- **…which also favours continued Fed tightening…**
- **…although it's a long road to the FOMC's May meeting**

Canadian GDP, m/m % change, SA, January:
Actual: 0.5
Scotia: 0.7
Consensus: 0.4
Prior: -0.1
February guidance: 0.3%

Canada's economy is rebounding from all of the temporary drags that drove overreaction to Q4 softness. On net, the economy over Q4 and Q1 is outpacing the Bank of Canada's forecasts and continuing to showcase trend resilience. The figures are a combination of one-part fresh and one-part stale in terms of significance to the outlook.

That's because while on the one hand they may count for relatively little in a world focused upon forward-looking considerations, on the other hand it says that the economy is not yet anywhere close to creating material disinflationary slack. Ditto for the labour market. By corollary, barring a severe liquidity event in global markets, the fundamentals part of the equation to what drives monetary policy considerations does not lend itself to supporting market pricing for rate cuts and the Canadian front-end remains too dear in my view.

DETAILS

GDP was up 0.5% m/m in January which was a touch stronger than most expected, but more important is the fact that preliminary guidance for February pointed to another gain of 0.3% m/m.

Based upon those readings and assuming flat March GDP only in order to focus the math upon the effects of what is known so far results in Q1 GDP tracking of 2.9% q/q SAAR (chart 1). February's growth was very broadly based including expected rebounds in some of the sectors that were temporarily held back by distortions late last year (chart 2). Distortions that included the shut Keystone flows given a spill south of the border, two train derailments that disrupted the transportation sector and halted the flow of products to other sectors, and more adverse weather than usual that disrupted travel.

That's on a production basis and there are strong caveats. Caveats that are more tilted toward the upside.

For one thing, alt-data is showing that March could get a strong lift from services given tracking of measures like Open Table restaurant attendance and air travel as previously observed (chart 3). That means that Q1 GDP could grow by over 3% using production-based accounts.

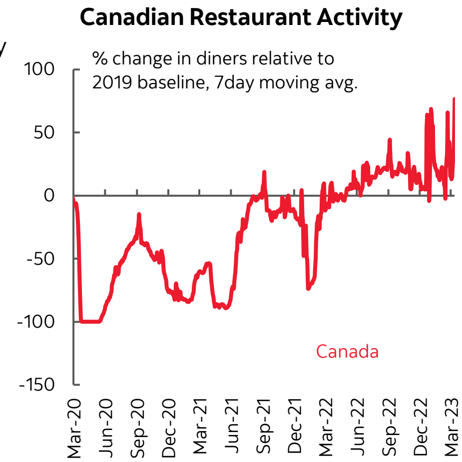
The other caveat is that what the BoC and private forecasters predict is expenditure-based GDP which also considers *how* higher sales and output were achieved by considering net trade—and hence how much activity did or did not leak out of GDP through imports—and inventory swings. Q4 saw a 40+ year record high inventory drag effect on GDP as inventories lopped multiple percentage points off of growth. Some but not all of that was offset by imports, but on net the two factors were a material drag on Q4 GDP. Q1 is likely to moderate this effect which could add further upside not well captured in production-based GDP.

WHY IT MATTERS TO THE BOC

That matters because the BoC had projected q/q SAAR GDP growth in Q1 of just 0.5% in its January MPR after it overestimated Q4 growth with a 1.3% q/q expansion instead of the flat reading we got. On net, the BoC's GDP forecasts for the two quarters combined face upside and may continue to do so if the above point on March GDP offering an attractive hand-off into Q2 proves to be valid. We'll see, as all the harder data lies ahead.

What that means is that the economy is not making the BoC's expected progress toward opening up disinflationary slack. At least not yet. Postponed. Again. And again. And again. And on both sides of the border.

Chart 3



Sources: Scotiabank Economics, OpenTable.

Markets are pricing a quarter point BoC rate cut by September or October of this year and smaller probabilities of a cut before then that have been tamped down from recent peaks. I don't dismiss the risk of accidents driving market turmoil while nervously awaiting how developments like political dysfunction in the US debt ceiling fracas might cast a pall over summer, but accidents are not a foundation for a forecast and at least thus far the tools at the hands of regulators and central banks have been sufficient to contain the flares that we have observed to date.

Setting aside a forecast bias based upon accidents happening and being mishandled or overwhelming liquidity management, the fundamentals don't support cut pricing. In my view, central banks are likely to set a higher bar against easing than market participants who think every soft bump and wiggle should drive a pile on into the front-end. In my view, the plague that has beset front-end traders from day one at the embryonic stage of debating hike timing continues to hold them in its grip. The plague that has driven thinking that they can't possibly hike because gosh that might damage growth when that's the point. The plague that what kept inflation low in the past must always hold in future. The plague that drives thinking that all it would take is a handful of weak readings to driver central banks toward an abrupt turnaround.

POWELL'S PREFERRED INFLATION GAUGE REMAINS STICKY

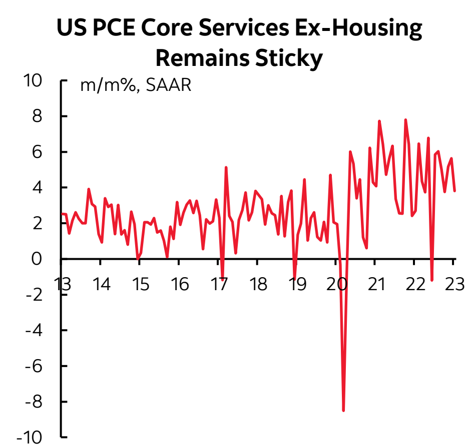
On the other side of the border, Chair Powell emphasizes that the measure of inflation he is watching most carefully is PCE core services (ex-energy services) and excluding housing. It serves as a proxy for underlying momentum in service sector inflation as other gauges like housing inflation are likely to weaken in lagging fashion to market-based measures.

This measure was up by 3.8% m/m SA at an annualized rate in February. As chart 4 shows, this remains relatively sticky around the average of the past couple of years. It is not yet posting enough material progress toward slowing back to the Fed's 2% PCE inflation target.

The main reason for why headline PCE at 0.3% m/m was a touch weaker than CPI at 0.4% was because of the much lower weight that PCE puts on shelter. Shelter was hot in CPI but chopping its weight in half in PCE relative to CPI knocked about 0.1 m/m off PCE. The reconciliation of all of the other differences in CPI and PCE yielded negligible other drivers.

In my view, the core PCE data should do nothing to alter expectations for another 25bps hike from the Fed in May. Onto payrolls next Friday and another round of inflation prints. Today's positioning swings are just noise in the meantime.

Chart 4



Sources: Scotiabank Economics, Bloomberg.