

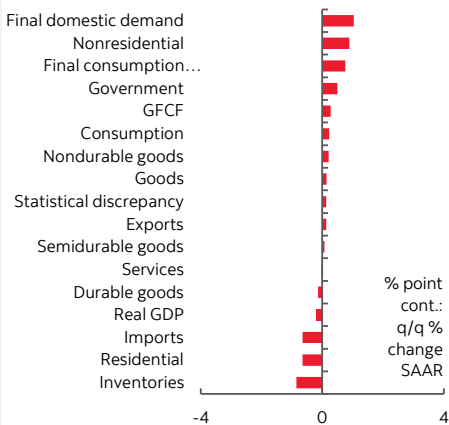
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Chart 1

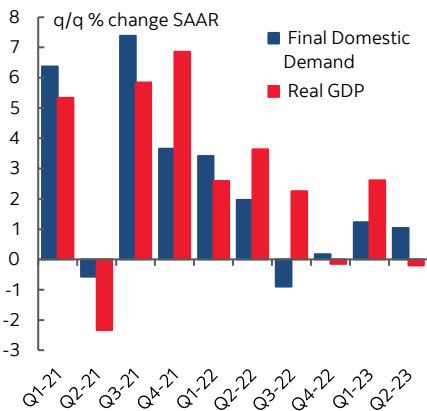
Contributions to Canada's Q2-2023 Real GDP



Sources: Scotiabank Economics, Statistics Canada.

Chart 2

Final Domestic Demand & GDP



Sources: Scotiabank Economics, Statistics Canada.

# Canada's Economy Literally Went Up In Smoke

- Canada's economy put in a weak performance...
- ...principally due to transitory shocks...
- ...as Statcan fingered widespread wildfire effects on multiple sectors
- The shocks went beyond wildfires...
- ...and as they ease, growth should rebound
- The BoC will probably pause next week...
- ...but leave the door open to returning...
- ...as they look through much of the weakness and seek to control market

## Canada GDP m/m % change, SA, June:

Actual: -0.2  
 Scotia: -0.1  
 Consensus -0.2:  
 Prior: 0.2 (revised down from 0.3%)  
**July 'flash' guidance:** "essentially unchanged"

## Canada GDP q/q % change, SAAR, Q2:

Actual: -0.2  
 Scotia: 1.0  
 Consensus: 1.2  
 Prior: 2.6 (revised down from 3.1%).

Canada's latest GDP figures literally read like the sequel to a bad Cheech and Chong movie from the 70s. The common narrative is that they provide evidence that Canada's economy has finally buckled under the weight of rate hikes. That's thin veneer headline commentary in my view. The underlying details point to something that is considerably more robust when controlling for various distortions like the very widespread impact of wildfires, strikes and probably weather as well. I'll go over the implications for the BoC, then the numbers, then how the distortions have impacted them.

## BOC TO SIT THIS ONE OUT

The Bank of Canada has the cover in the GDP data to stay on pause with a hawkish bias on Wednesday. That's because growth came in materially weaker than they had forecast. Ditto for Scotia Economics' last forecast in July (1.7% Q2), my updated guesstimate into today's figures (1%) and the consensus forecast of 1.2%.

It's also because the BoC is likely to lean in favour of going through a full forecast process into the October MPR and evaluate further incoming data between now and then and beyond. They will want to delve deeply into the figures and drivers in order to develop an updated view on how much of the softness may be transitory. I think a lot of it is, but I'd like to see what their army of economists and policymakers think. For now, the BoC must leave the door open to returning with future tightening on the statement bias for three reasons.

- One is that I think this set of numbers has transitory written all over it and we'll probably see signs of a firm rebound into year-end as a multitude of shocks wears off.
- Two is that the BoC needs to manage markets and keep at bay itchy trigger fingers that are inclined to pounce on rate cut pricing prematurely. The usual line here is that history cautions strongly against prematurely declaring victory over inflation and particularly in today's world of widespread structural changes.

- Three is that the BoC has been clear that it is focused upon the multiple influences upon core inflation, inflation expectations, wages, productivity and corporate pricing behaviour. Governor Macklem has also said he needs to see demand growth slow and today's numbers are a step in that direction, but not if we just wind up rebounding from temporary drag effects.

**Q2 GROWTH DISAPPOINTED**

The whole first half performance of the Canadian economy disappointed expectations. Q1 growth was revised down a half percentage point and Q2 GDP was little changed at -0.2% q/q SAAR. That's weaker than the BoC had been assuming by taking Q1 at face value and forecasting 1½% Q2 growth.

Chart 1 shows the key drivers. Inventories knocked 0.85 percentage points off of Q2 growth through lessened investment. Imports subtracted 0.64 percentage points off of Q2 growth. The combined drag from inventories and imports knocked about 1¼ percentage points off of Q2 growth.

One way of controlling for this is to look at Final Domestic Demand that adds up consumption, investment and government spending and hence excludes net trade and inventory effects (chart 2). It was up by 1% q/q SAAR in Q2 which is close to the 1.2% reading in Q1.

Therefore, the economy was not as bad as the headline GDP indicated, but it wasn't great either. Consumption contributed just 0.1 percentage points to q/q annualized GDP growth. Investment added 0.3 ppts to growth as housing investment dragged 0.65 ppts off GDP and this was offset by a 0.9ppt contribution from business investment. Business investment's contribution to GDP growth saw a 0.55 ppt contribution from nonresidential structures and a 0.3 contribution from equipment investment. Government spending added 0.5 ppts to growth and government investment was a flat contributor. Exports added just 0.1 ppts.

**Q1 REVISED DOWN**

Q1 GDP growth was revised down from 3.1% q/q SAAR to 2.6% now. The main driver of the negative revision was the consumer. Instead of being up 3.2% q/q SAAR in Q1 it now shows a rise of 2.7% which is still very solid. Housing investment was also revised lower to -1.7% q/q SAAR from -1.3%. Inventories are now showing as less of a drag at -1.6 ppts instead of -2.4. Trade figures were left untouched as exports still contributed 3.3 ppts to Q1 growth and imports 0.3. The result is that final domestic demand went from contributing a weighted 2.7 ppts to GDP growth to now contributing 1.2 ppts.

**MONTHLY GDP WAS SOFT**

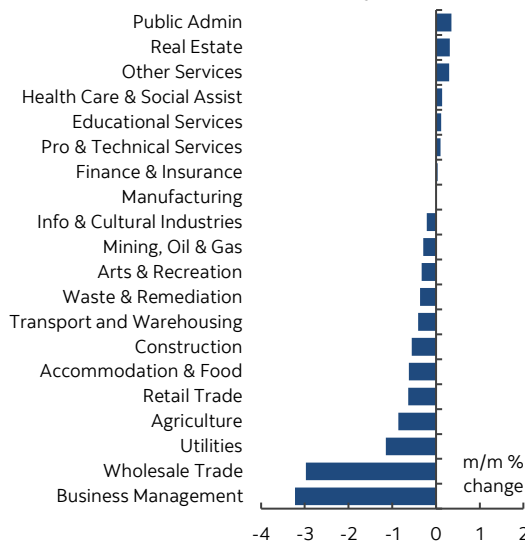
June GDP fell by 0.2% m/m and July's preliminary flash guidance pointed to being "essentially unchanged."

There are no details available for the preliminary July estimate other than verbal guidance that gains in the public sector, finance and insurance and professional, scientific and technical services sectors were offset by dips in manufacturing, transportation and warehousing and construction. Details will arrive on September 29th.

Chart 3 shows the drivers of June GDP by sector and how weakness was widespread. Chart 4 shows the same thing in terms of weighted contributions to GDP growth by sector that account for relative sizes.

**Chart 3**

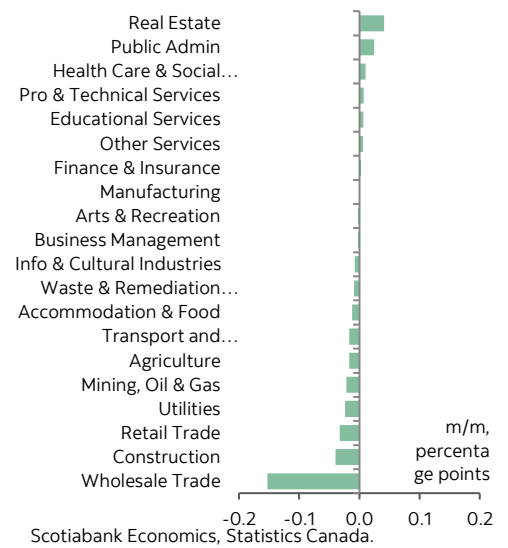
**June Real GDP Growth by Sector**



Sources: Scotiabank Economics, Statistics Canada.

**Chart 4**

**Contributions to GDP Growth in June**



Sources: Scotiabank Economics, Statistics Canada.

**WHAT'S BAKED INTO Q3?**

Q3 has -0.4% q/q SAAR growth baked in thus far. That derived from using monthly GDP figures for Q2 and July and assuming that August and September come in flat solely in order to focus the math upon the known information to date.

September 1, 2023

There are two cautions here. One is that monthly GDP from the production side doesn't capture factors like inventory and import swings that can impact quarterly GDP that is measured on an expenditure basis. Second is that we need to see readings on how the economy performed during August and September while leaving the door open to possibly rebounding.

#### TTTTTTRANSITORY!

Not that word again! Ok but bear with me because I think it's important to argue that much of the recent weakness in the economy is temporary due to a multitude of shocks that will lift and drive a probable rebound going forward. Don't believe me? Read Statcan's write up on June GDP [here](#). I'll rattle off some of their references to the distortions. Suffice it to say that while I expected wildfires to be disruptive to the readings, even I'm amazed at how widespread the cited effects turned out to be.

Wildfires were widely cited as drivers of weakness across sectors.

- Mining and quarrying ex-energy fell 5.7% m/m in June with metal ore mining down 6.7% mainly due to a whopping 35% drop in iron ore mining traceable to wildfire and maintenance effects. Mines in Quebec were shut due to wildfires.
- Wildfires were also cited as walloping rail transportation (-6.6%).
- Even accommodation and food services fell 0.6% m/m in June with wildfire effects on camps and parks cited as the driver. That means tourism-related activity was depressed due to the evacuation orders and the heavy smell of smoke that hung over large parts of the country this summer. That, in turn, likely explains some of the softness in consumer spending including services.
- Oil and gas extraction was up 1.1% in June but only partially reversed the 3.4% drop in May due to wildfires that shut in production.
- The agriculture/forestry/fishing sector fell 3.5% q/q in Q2. Fires were cited as the driver of lower crop production (-4.2% q/q in Q2).
- Forestry and logging output fell 4.5% q/q and fishing/hunting fell 9.8% again heavily due to wildfires.
- Added spending on fighting forest fires lifted support activities for forestry and agriculture by 1.8%.

Other disruptions cited by the agency including technical issues for airlines and staff shortages at airports that dropped that sector's output by 1.2% m/m SA. I would add the likelihood that the BC port strike, flooding on Canada's east coast and other weather effects weighed upon growth. For example, July was the wettest month on record in major cities like Toronto and Montreal and across southern Ontario and that can easily explain some of the softness in homebuilding plus outdoor activities. We will need to go through our own complete forecasting process in order to take into account today's information and determine how much of the weakness was transitory versus indicative of momentum effects.

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