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GLOBAL ECONOMICS

SCOTIA FLASH

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Distorted Softness in Canadian GDP is Down the List of Inflation's Drivers

- **Canada's economy has stalled for two quarters...**
- **...but resilience is avoiding recession despite Mother Nature and striking workers...**
- **...as transitory shocks continue to cloud an understanding of underlying growth**
- **GDP is the least important indicator on the path to October's BoC decision...**
- **...as trend inflation risk remains pointed higher**

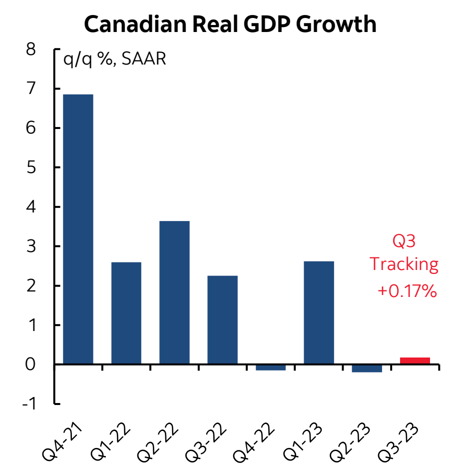
Canada GDP, m/m % change, July, SA:
Actual: 0.0
Scotia: 0.2
Consensus: 0.1
August 'flash': 0.1% m/m

Canada remains mired in a combination of softening underlying growth and transitory shocks all of which is clouding our understanding of what's truly going on in the economy. The outcome is a roughly flat economy in Q2 and so far in Q3.

The Canada two-year yield fell by about 4–5bps in the aftermath primarily on the back of the GDP figures with a small assist from softer than expected core PCE inflation in the US (+0.1% m/m, consensus 0.2%). USDCAD shook off the net effects of Canadian GDP and US core PCE with only minor moves in the currency.

Bank of Canada pricing moved a couple of basis points lower for the October 26th decision but terminal rate pricing over coming months is retaining pricing for a quarter point hike.

Chart 1



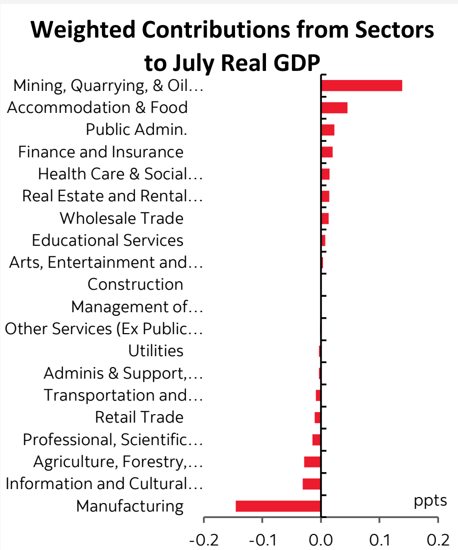
Sources: Scotiabank Economics, Statistics Canada.

THE BANK OF CANADA'S FOCUS REMAINS ON INFLATION MYRIAD DRIVERS

The BoC targets inflation, of course, and not GDP. The BoC probably wishes to see a protracted period of weakness in GDP that would open up material excess capacity as input into its beloved output gap framework for forecasting inflation that in my opinion is of exceptionally little use to forecasting the kind of inflation drivers we face today. Even if we stick to this output gap framework, it's notable that Canada has not yet seriously started to open up excess capacity in the economy.

In any event, GDP is probably the least significant release on the path to the October MPR meeting and beyond. After the BoC's preferred core inflation readings both landed at 5.4% m/m SAAR in August, keys will be the September figures on October 17th, next Friday's jobs and wages, and the BoC's twin surveys of consumer and business attitudes including inflation expectations on October 16th. I'll come back to the path for inflation risk beyond these prints in a moment.

Chart 2



Sources: Scotiabank Economics, Statistics Canada.

DETAILS—TRANSITORY SHOCKS CONTINUE TO WEIGH ON THE DATA

GDP was flat in July and in line with Statcan's preliminary guidance on September 1st, while August grew by 0.1% m/m in today's 'flash' estimate that excludes meaningful details. I thought August might have been stronger, but maybe that just got pushed out to September given very light guidance on the drivers in August.

Using monthly GDP accounts, Q3 GDP is tentatively tracking little changed at 0.2% q/q SAAR following 0.1% in Q2 over Q1 (chart 1). This uses Q2, July's print, August's initial estimate and the assumption that September will be flat which is only made in order to focus the math upon known effects to this point without imposing judgement one way or the other on what may happen in September.

That makes for two consecutive quarters of flatness. The 'nowcast' for quarterly GDP that Scotiabank Economics runs is tracking about 0.5% q/q SAAR in Q3.

There are two cautions here. The quickest one to address is that the economy continues to skirt tail bets that it would slip into recession over Q2-Q3 that some of my competitors have been claiming. Recession avoidance is true just barely for GDP as not even one contraction has been registered thus far, and in any event, a recession call requires more than just back-to-back contractions in GDP. ***In fact, it's a sign of resilience that the economy has yet to contract despite everything that mother nature and striking workers have thrown at it.***

The economy remains stuck in the effects of serial shocks that are at least as important as the effects of monetary policy tightening. Absent such transitory shocks in a very unusual summer there would have been mild growth.

Chart 2 shows a breakdown of GDP growth by sector. For instance, Statcan flagged that manufacturing was the biggest weighted drag on GDP growth in July. They noted that lower inventory formation was a weight and that among the considerations were the effects of the BC port strike that limited product availability, especially sectors like chemical manufacturing.

For another, July's port strike wasn't even the dominant weight against transportation sector GDP. It was a drag, but Statcan noted that:

> "Air transportation (-2.1%) was the largest contributor to the sector's decline in July, contracting for the second consecutive month. Bad weather in the eastern United States over the Canada Day long weekend caused multiple delays and flight cancellations on both sides of the border."

They went on to note that "Water transportation contracted 3.4% in July as the closure of more than 30 British Columbia ports, including Canada's busiest—the Port of Vancouver—impacted the amount of trade that could move by ships. Significant declines in both imports from and exports to countries other than the United States impacted the sector, in particular a decrease in goods coming from China."

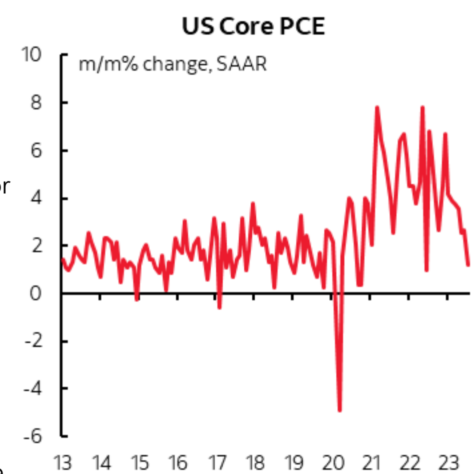
Even August was impacted as Statcan noted oil and gas extraction was a dampener as that sector pulled off the July rebound from wildfires that disrupted activity in June.

Overall we're trapped in the serial shocks story and some of them will persist, such as turmoil in the auto sector. It's just too difficult to weed them out of everything that's going on and these shocks are driving extremely noisy data given wildfires, wetness/weather effects, and strikes aplenty. I remain cautiously optimistic that the economy can still squeeze out modest growth over the duration of the year.

As for the drivers of inflation, they are an awful lot more complicated than simple GDP. Unlike the US (chart 3), Canada has yet to enter a soft patch for core inflation (chart 4). Wages are exploding while productivity is collapsing which is the worst combination of effects in terms of inflation risk. Collective bargaining is much more important in Canada than the US, given that about one-in-three Canadian workers are unionized (versus one-in-ten in the US) and going through aggressive negotiations seeking wage gains far above the BoC's inflation target in the years to come. Inflation expectations remain way above the BoC's 2% target. Immigration is far too high relative to the country's ability to absorb such flows into lean stocks of available housing and other goods and services demanded upon arrival into a new country. Energy prices are skyrocketing as a back-door income lift to Canada's economy and I think food will join in over the winter months, raising pressure not only on headline inflation but also pass through effects into core prices. Fiscal policy is priming the pump once again and with more ahead into Fall updates and Winter budgets. Retailers' inventories are lean. CAD is undervalued.

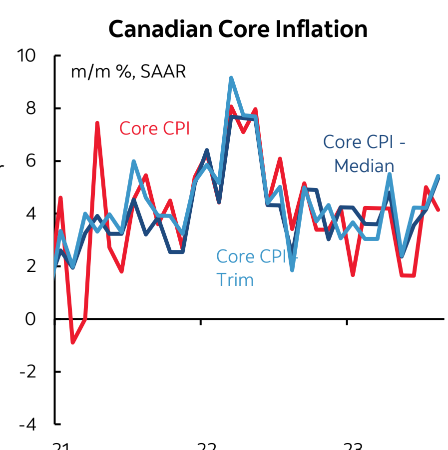
On balance, while we need to be cautious in both directions with respect to reading the GDP tea leaves, I continue to believe that the drivers of inflation combined with elevated inflation expectations put the BoC behind the fight. We have seen periods of time in our country's history when the BoC tightened and maintained a tight stance even as GDP.

Chart 3



Sources: Scotiabank Economics, Bureau of Economic Analysis.

Chart 4



Sources: Scotiabank Economics, Statistics Canada, Haver.