Markets Ignore Solid Canadian GDP, Hot U.S. Inflation, But May Have Overreacted to Trump

- **Canada's economy was strong in December and January…**
- **…better than feared in February and March could extend gains…**
- **…as four quarters of solid growth matched a more upbeat narrative than consensus…**
- **…but what follows faces downside as Trump takes down global growth**
- **US core inflation was hotter than expected with details the FOMC won't like**
- **The sources of income growth explain why DOGE cuts are failing so far…**
- **…and how making them work would slam Trump's base**
- **UofM sentiment revised lower, inflation expectations revised higher**
- **Fed-speak is turning increasingly hawkish**
- **Markets treated the releases as statistical artefacts amid forward-looking risks**
- **Trump pledged to meet Carney—if PM—but not for weeks after looming tariffs**

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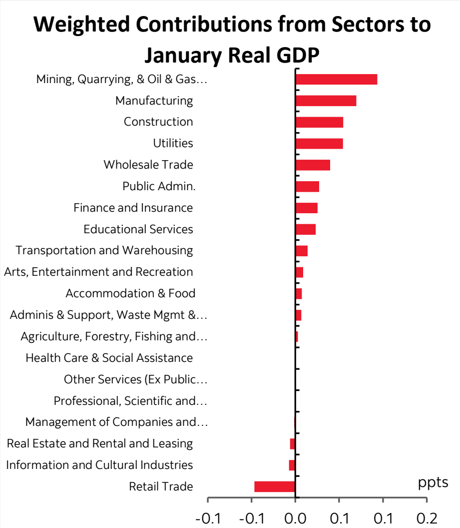
Canadian GDP, m/m % change SA, January:
Actual: 0.4
Scotia: 0.4
Consensus: 0.3
Prior: 0.3 (revised from 0.2)
February 'flash' GDP guidance: "essentially unchanged"

Canada's economy was doing rather well before Trump came along.

GDP grew by 0.4% m/m SA in January which was a tick above Statcan's earlier guidance and the consensus estimate while matching mine. The surprises were on the two shoulders of the January data that were both stronger than expected.

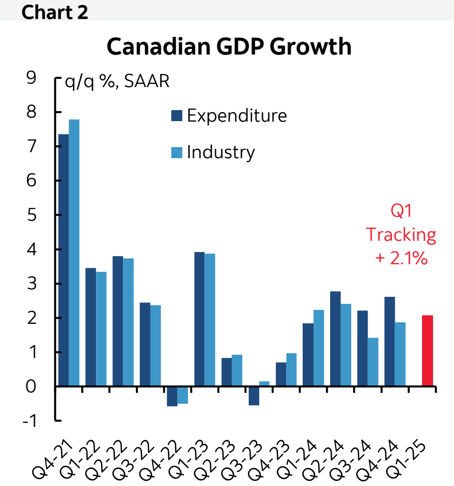
Chart 1 shows a breakdown of the weighted contributions to GDP growth in January by sector. The only notable soft spot was retail as the GST/HST cut on limited items ended at mid-month. There was high breadth to the strength.

Chart 1



Sources: Scotiabank Economics, Statistics Canada.

Chart 2



Sources: Scotiabank Economics, Statistics Canada.

2024 Ended Stronger than Previously Understood

On one shoulder we have December GDP that was revised up a tick to 0.3% m/m and therefore the economy was stronger to end 2024 than previously judged. That makes the January beat all the more impressive in that otherwise a higher jumping off point for December GDP might have made it tougher to get strong growth in January. There were no other revisions to prior months.

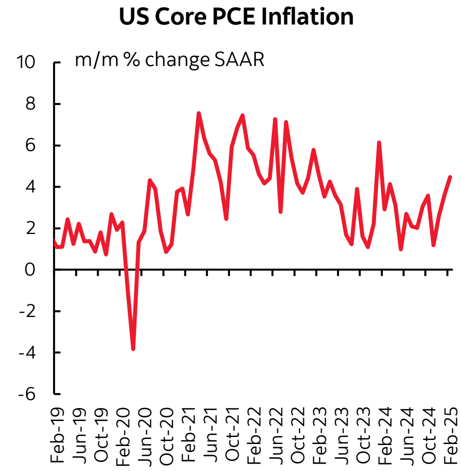
February GDP Was Better than Feared

On the other shoulder is that while I had been concerned about the risk of a decline in February, Statcan instead guides that GDP that month was "essentially unchanged." That surprised me because most of the other data we can track was pointing to a drop, not least of which the relatively large 1.3% m/m SA decline in hours worked that I'll come back to.

What drove February's gain? It's unclear because Statcan only provides loose verbal guidance around its flash estimates sans detailed numbers, but here's what they had to say:

"Increases in the manufacturing and finance and insurance sectors were offset by decreases in the real estate and rental and leasing sector, the oil and gas extraction subsector and the retail trade sector."

Chart 3



Sources: Scotiabank Economics, BLS.

The gain in manufacturing value-added GDP —despite soft shipments— may be due to front-loading production to be shipped subsequently before tariffs bite. The guided gain in the FIRE sector must have been quite large to offset the other areas of weakness. Or it's also possible that the guidance will be revised when we get the firmer print a month from now. Another possibility is that there are large swaths of the economy that report with long and variable lags like services and resources and so maybe Statcan has better data than is publicly available.

Q1 GDP growth is probably tracking at 2%+ in q/q SAAR terms based upon the soup Statcan presented this morning. All of which is to say that Q1 GDP could be the last of the decent prints after growth of 2¼% to 2¾% in each of 2024Q2, Q3 and q4 and then something similar in Q1 (chart 2). My narrative on Canada's economy rebounding and led by consumption that was more bullish than consensus gloom was working rather well for several quarters until Trump. Now the implications for the BoC are very uncertain going forward as it grapples with growth downsides but inflation upsides.

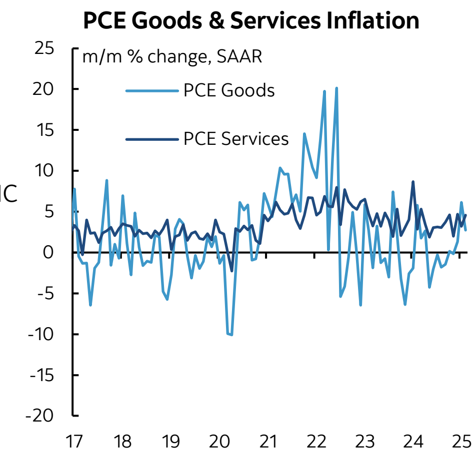
US CORE INFLATION KEEPS THE FOMC SIDELINED

US core PCE inflation was a touch hotter than expected at 0.365% m/m SA, rounding up to 0.4%. At an annualized rate of 4½% that is simply too hot for the FOMC's liking (chart 3).

The details are even more disconcerting to the FOMC and a few more of them sounded hawkish in the aftermath. San Fran's Daly counselled patience but still thinks two cuts later this year are possible. Cleveland's Hammack said there is reason to be 'very' patient. Former Fed official Bullard said the chance of a Fed rate hike is rising.

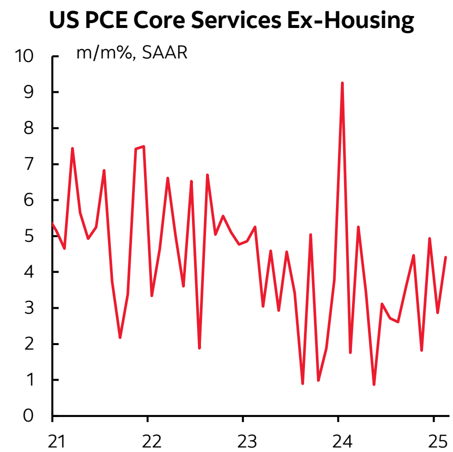
Chart 4 shows that goods inflation eased a bit but remains too warm, while services accelerated.

Chart 4



Sources: Scotiabank Economics, Bureau of Economic Analysis.

Chart 5



Sources: Scotiabank Economics, Bureau of Economic Analysis.

Further, core services PCE inflation excluding housing accelerated to 4.4% m/m SAAR (chart 5). In other words, taking housing out of the picture shows underlying price pressures in the service sector that are simply too warm.

INCOME GROWTH EXPLODED ON BENEFIT PAYMENTS

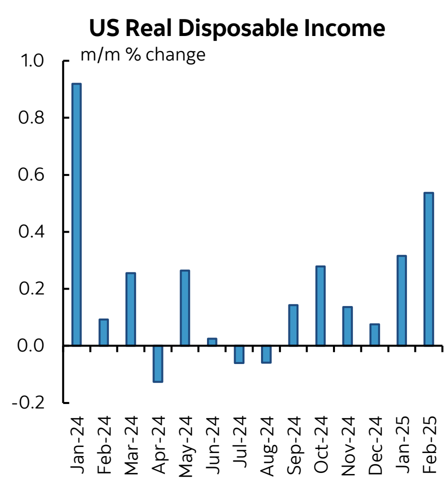
Income growth exploded. February's personal income was up 0.8% m/m which doubled consensus, although partly due to a mild downward revision to a still solid 0.7% in January (0.9% previously). Chart 6 shows inflation-adjusted income growth. In inflation-adjusted terms, personal disposable income was up by 6.6% m/m SAAR.

What drove such income growth? Total compensation was up by 0.5% m/m SA with wages and salaries up 0.4% and benefits up 0.5%. That's solid, but not the fastest driver.

The bigger issue is that transfer payments were up 2.2% m/m SA and mostly due to back-to-back gains of 1.8% in social benefits led by Medicaid and Medicare payments.

Hence why DOGE cuts are not having their effects to date. Trimming workers here and there won't cut it and isn't cutting it. Daily tracking of Treasury outlays shows that spending continues to rise and remains well above prior year levels (chart 7).

Chart 6



Sources: Scotiabank Economics, US BEA.

This morning's income figures show the mandatory spending numbers are still soaring. Personal income from transfer payments was up 2.2% m/m after 1.8% the prior month. Medicaid was up 1.5% in Feb after 2.2% in January. Veteran's Benefits have grown by 0.7% mm for six straight months. Social security payments were up 0.4% after 2.7% the prior month.

Hence, in order to make meaningful cuts requires slashing entitlements via mandatory spending reductions. That comes at a steep political cost including to Trump's base.

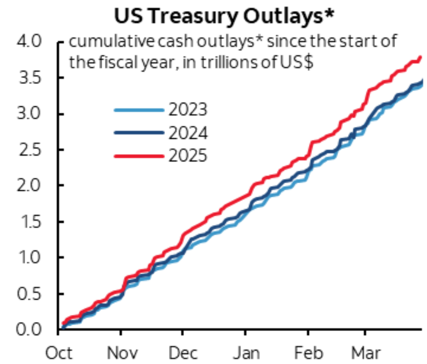
Whatever one thinks about such cuts isn't what matters, although the US is paying the price for not addressing unfunded social security etc ages ago like Canada did in the 1990s with its CPP reforms. The US is paying the price for constantly driving higher deficits with tax cuts while doing nothing to more fundamentally address spending including long term solutions for benefits programs. What does matter will be how Trump's base reacts to slashing their benefits to fund tax cuts that overwhelmingly go to top earners as the extension of the TCJA provisions would do. Trump's overall policy mixture is highly regressive including the fiscal component and tariffs. That's great for upper income folks, but they have limited numbers of votes into midterms. I sense an overwhelming feeling is brewing that will be akin to the feelings of betrayal by the folks who opted for Brexit that goes something like 'we voted for that??'

Despite such income gains, however, US consumers are not spending. Chart 8 shows that real consumption has stalled out over the past two months. In fairness, some of that is likely due to effects like LA fires and harsher than usual weather in significant parts of the country. Some of it is also probably a reflection of sagging consumer confidence that has driven up the saving rate by over a full percentage point in two months from 3.3% in December to 4.6% now.

This last point highlights a challenge to giving tax cuts. If given with one hand while consumers are being spanked by tariffs with the other, then the outcome could mean that tax cuts persistently leak out and are saved amid the uncertainty rather than spent. This odd combination of policies could leave behind bigger deficits with little to nothing to show for them.

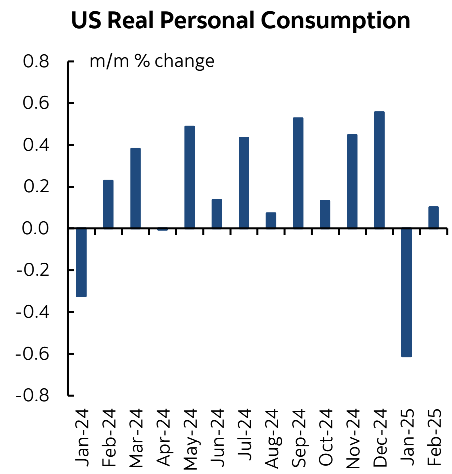
Lastly, US UofM consumer sentiment was revised down to 57.0 from 57.9 for the final March reading entirely on lower expectations (52.6 from 54.2). Inflation expectations were revised up with the 1-year inflation expectations reading now bang on 5% and with the 5–10 year measure up two ticks to 4.1%.

Chart 7



* Operating cash withdrawals, minus debt redemptions.
Sources: Scotiabank Economics, Department of Treasury.

Chart 8



Sources: Scotiabank Economics, US BEA.

My opinion remains that no measures of inflation expectations much matter and the FOMC seeks too much comfort in the longer run market measures as previously argued. Consumers don't understand inflation. Neither do markets. Markets don't have much ability to form expectations over the 5–10 year period which is the measure the Fed prefers. Markets have repeatedly blown it with such measures, like for years thinking inflation was the big problem coming out of the GFC and then in the depths of the pandemic thinking inflation would never come back. Market measures are just traders making blindfolded guesses which is why inflation risk—not fake long-term forecasts—is what should guide policy.

THE TRUMP-CARNEY CALL

Lastly, Trump posted **this** remark after this morning's call with Canadian PM Carney. Looking past the fact that Trump makes the perhaps not unreasonable assumption that Carney will win the election lies what initial media headlines on the post neglected to mention. All they flashed was "immediately" meeting while overlooking the fact Trump said this would occur after the election a month from now!

Unfortunately we have the more pressing matter of next Wednesday and this past week's auto tariffs unless they're on hold and there's nothing to suggest that. More fundamentally, everyone needs to learn their lessons here folks. The oscillating pattern of on, off, on, off, on, off trade developments has been nothing short of a roller coaster. Nothing lasts in markets as the goal posts and comments keep shifting.

And oh to be a fly on the wall. If Trump sounds more constructive, then why? Was it because Trump is suddenly a changed man? lol. Was it because Carney bent the knee? That's doubtful based upon his messaging yesterday. Was it because Carney sounded as aggressive as yesterday and laid out in clear language what Canada would do if Trump doesn't back down? Who knows. Maybe Carney will shed some light.