Canada's economic momentum to gain an inch, not a yard in 2017: TD Economics

TORONTO – A challenging year will be followed by one marked by only slightly better outcomes in 2017 and a wider band of uncertainty related to U.S. policy, says TD Economics in the December edition of the *Quarterly Economic Forecast*.

TD Economics predicts that real GDP will expand by 1.8% in 2017, up from this year's estimate of 1.4%. "There has already been a groundswell of uncertainty, which should be directly felt in hiring and investment plans," notes Beata Caranci, Chief Economist. She projects roughly 100,000 net new jobs will be created over the course of 2017, which will reflect a step-down relative to past years.

Benefits of government spending should start to come through

2016 has been a tough year for economic growth in Canada. Not only did the year start on a weak footing amid severe oil price and market volatility, but the Alberta wildfires in May delivered another blow. Fortunately, the subsequent rebound offers a strong hand-off heading into 2017, with Canadian momentum tracking around 3% (annualized) during the second half of this year.

"Just stopping the bleeding of the past few years will help boost Canada's economic trajectory. This can be seen most clearly in terms of business investment, which subtracted nearly a percentage point from the 2016 economy-wide tally," notes Caranci. Signs of stabilization (particularly in the resource sector) provide a welcome break. Even a modest rebound would lift a significant headwind from the economy in 2017 and 2018. The recently agreed OPEC oil production cuts should send oil prices into the US$55 to $60 per barrel range in the coming year, helping support a recovery in business capital spending.

That the pick-up in growth stems in part from a 'bottoming-out' of investment, rather than a meaningful expansion, helps explain the lacklustre outlook for job gains. Despite this, consumer spending is expected to continue along its recent modest path, although a compositional shift is expected. "As consumers begin to de-lever, we are likely to see a shift from debt-financed big ticket items towards non-durables and services spending" said Caranci.

Further supporting the economy will be government spending, expected to add 0.5 percentage points to growth in 2017. More than half of this boost results from federal Budget 2016 spending commitments. "As we expected, there was little evidence of a fiscal boost in 2016, but all indications are that 2017 and 2018 will benefit" remarked Caranci. Rounding out the economic drivers is trade, where recent wild swings are expected to give way to modest export expansion, helped along by stronger U.S. demand.

Uncertainty elevated post-election

The outcome of the U.S. presidential election has emerged as a risk to the economic outlook. In the absence of specific policies and timelines, TD Economics has chosen not to incorporate any arbitrary assumptions into the forecast. Caranci notes, "the risks stemming from potential U.S. policy changes are two-sided: much of the post-U.S. election dialogue in Canada has been on the potential for trade protectionist measures to negatively impact exports and send the loonie lower. But, the flip side is that the bark may be worse than the bite, since Canada is not the intended target. Should that be the case, U.S. tax reform measures that boost investment and consumer spending south of the border would succeed in lifting demand for Canadian exports. It is conceivable that Canada develops a stronger trade relationship with the U.S. over the long run, helping to recoup some of the lost ground in market share. But, until we see what side the coin lands on, U.S. policy uncertainty could act as a near-term constraint to business capital spending."

Within the Canadian labour market, the muddy picture is likely to manifest through sub-par employment growth and the potential for a continued shift in the hiring mix towards part-time employment. This will be on top of other shifts likely to be underway in the economy. The rapid rise in longer term interest rates since early October combined with new mortgage regulations are likely to contribute to a slowing of a red-hot housing sector, particularly in Toronto.

"A further complication to housing would be a further run-up in bond yields," remarked Caranci. "We don't expect yields to rise significantly from current levels in the coming months, but if we're wrong, the real estate market adjustment would certainly deepen."

Bank of Canada won't follow the Federal Reserve

Economic conditions in Canada remain highly divergent from the U.S., and as such the Bank of Canada is unlikely to follow the Federal Reserve's lead in pushing monetary policy rates higher. Rather, a tone of 'constructive dovishness' is expected, with the Bank of Canada communication to continue to remind investors of the persistent murky landscape alongside the remaining sizeable economic slack. TD Economics does not expect the Bank of Canada to move up its policy interest rate until early 2019. However, should the Bank of Canada's hand be tipped before then, the more likely outcome would be a cut.

Ultimately, a more even distribution of the sources of growth should materialize in 2017. At the same time, the heightened level of uncertainty means that the range of plausible outcomes around this forecast has grown wider. As a result, caution is likely to remain the watchword for Canadian businesses in the coming quarters.

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