When it comes to economic growth, what goes down must come up: TD Economics

TORONTO – Canada's economy is expected to turn in a solid rebound from the wildfire-induced contraction in the second quarter. As activity normalizes in the second half of the year, real GDP is expected to grow by 1.3% in 2016, improving to 2.0% in 2017.

Perhaps above all, this outlook hinges on exports rebounding from their recent disappointing performance. In addition to continued solid gains in U.S. demand, this will require the loonie to remain relatively stable and competitive, at around 75-80 U.S. cents. The strong correlation between the Canadian dollar and oil presents some downside risk to this view. Higher oil prices could lift the loonie, but prices are unlikely to reach levels that would trigger a near-term turnaround in oil-related investment.

Similarly, TD's economic outlook is predicated on a gradual unwinding of excesses in the housing market. Supported by low mortgage rates, the housing market has shown little signs of slowing so far this year. Still, given the rate of home price increases, pressures on affordability are increasing and vulnerabilities are rising.

"Fortunately, there are enough tailwinds behind Canada's economy to lift its sails following this most recent setback" says Beata Caranci, Chief Economist, TD Bank Group. "Steadily rising U.S. demand, ongoing accommodation in financial conditions and higher federal infrastructure spending should lead to faster growth trajectory over the remainder of this year and into 2017."

Wildfire impacts likely to be a one-time blip as momentum recovers

Caranci acknowledges that economic reports released over the past few months have given reason for pause. Even before the onset of the Alberta wildfires in May economic momentum in Canada had shown clear signs of waning. Growth in the first quarter of this year was front-end loaded, while February and March saw a cumulative decline over the period. The export sector, which is an area that had been counted on to do much of the heavy lifting on the growth front, has been disappointing, losing steam after surging out of the gate in January.

"The extent of the recent softness highlights a key economic vulnerability in Canada, which is the economy's heavy reliance on one sector – exports – and one market – the U.S. – for growth."

Once the impacts of the Alberta wildfires are taken into account, economic output is expected to fall by about 1% (annualized) in the second quarter. However, what goes down tends to come up. Despite the economy's fragilities, which also include the high indebtedness of households as well as the effects of transitioning away from an economy dominated by resource investment, TD Economics projects economic growth to run at a decent annualized clip of 2.5% during the second half of 2016 and around 2% in 2017.

Beneath the noise, supportive export fundamentals remain

In this quarterly forecast, the outlook for export gains through 2017 have been downgraded in light of the disappointing reversal recorded over the past few months. However, quarterly export growth in volume terms is still expected to average a healthy 4%, or twice the rate of growth of the economy.

"Fortunately, the U.S. economy remains on a steady and solid growth track and should pull many Canadian exporters along on its coat-tails," says Caranci. The loonie is expected to remain at supportive levels, averaging between 75 and 78 cents U.S. in 2016 and 2017.

Households constrained, but still some scope to spend

When it comes to the domestically-oriented areas of the economy, the story remains a mixed bag. Households face growing debt constraints, but underlying conditions continue to point to steady but modest consumption gains. Borrowing costs are expected to remain low and advances in personal income are likely to accelerate and run at a rate slightly above inflation. In the large housing markets of the Greater Toronto and Vancouver regions, strong sales and rising prices are propelling spending and net worth. TD Economics expects demand in these markets to simmer down beginning in the second half of 2017, reflecting increasingly stretched valuations, but only moderately.

As housing activity cools over the medium term, other domestic areas are expected to step up and take up much of the slack. Government infrastructure spending is one area that picks up sharply in 2017, supported by measures in the spring federal budget.

Business investment is expected to remain a soft spot on Canada's economic landscape. Despite crude oil prices finding a firmer footing at around US$50 per barrel and the improvement in global and domestic financial conditions in recent months, a meaningful resumption of activity is not expected until at least 2018. Caranci added: "the glass half full message with respect to investment is that it should cease to be a drag on growth during the second half of 2016, halting a two year period of extreme weakness."

No short-term rate increase in Canada until 2018

Despite the likelihood that Canada returns to a decent growth track in the coming quarters, the Bank of Canada is likely to keep its foot on the accelerator for some time to come, maintaining its key policy interest rate at 0.50% until 2018. In addition, TD Economics sees the near-term risks surrounding rates tilted to the downside in light of the economy's recent weaker-than-expected performance. For the central bank to pull the trigger on a further rate reduction would require growth continuing to run significantly below its estimated trend rate of around 1.5% and/or a severe deterioration in global financial market conditions that dim prospects for future growth.

In contrast to Canadian rate policy, the U.S. Federal Reserve is expected to continue raising interest rates, albeit gradually. This divergence in monetary policy will help keep downward pressure on the Canadian dollar, supporting export competitiveness. Nonetheless, some upward pressure on Canadian longer-term government bonds yields is likely to emanate from south of the border.

Provincial divergences likely to widen

Even before the Alberta wildfires began, provincial growth rates were expected to be widely divergent. Taking the wildfire impacts into account, Alberta is likely to experience a deeper recession this year than TD Economics predicted in its previous forecast. On the other end of the spectrum, B.C. should lead growth over the 2016-2017 forecast period, supported by a diversified economy that continues to benefit from the low level of the currency. Ontario and Manitoba are also expected to grow strongly for the same reasons.

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