A Brighter Dawn For 2016 Leads To An Upgraded Canadian Outlook: TD Economics

TORONTO – After a difficult 2015, the Canadian economy looks set to record a stronger performance both this year and next. Real GDP growth is projected to reach 1.9% in 2016 and 2.0% in 2017, marking the first upgrade to TD Economics' growth forecast since last spring. Achieving this pace of growth will continue to depend crucially on developments beyond Canada's borders, with exports set to lead the way for near-term growth despite recent strength in the loonie. Providing additional support in 2017 will be the federal fiscal stimulus included in this week's budget.

Canada to outperform U.S. in Q1, but not likely to be a trend

The near term growth prospects for Canada have improved markedly, with strong momentum observed in early 2016. Driving this strength are exports, but solid retail and manufacturing sales numbers also point to an economy that is likely to have bounced back from its weak performance in the final quarter of 2015. With annualized growth of around 3% projected for the first quarter, Canada appears poised to outperform the U.S. when it comes to headline GDP growth.

Adjustment process continues, with slower growth "the new normal"

Although 2016 is expected to start off on strong footing, the underlying theme for the economy remains the ongoing adjustment process to lower commodity prices. TD Economics forecasts that this adjustment process is likely to take several more years to play out. This development along with other influences such as high household indebtedness, an aging workforce and modest expected productivity gains will limit the potential of Canada's economy to expand relative to what has been observed in the past. As a result, looking past the first quarter, average annualized growth of just below 2% appears likely.

According to Chief Economist Beata Caranci, "Canadians need to recalibrate their expectations for the country's near-term performance. Our outlook for growth of about 2% in the coming years might appear lacklustre to many, but when you put it in the context of a longer-term economic cruising speed 1.6%, it is a relatively robust profile."

Soft domestic outlook offset by exports, fiscal boost

Fortunately, as domestic investment and spending struggles, exports appear poised to step into the breach, driving an improved near-term economic performance. Recent data have been reassuring on this front, with strong, broad-based growth in exports in both December and January. Momentum is expected to continue, helped along by the low level of the Canadian dollar. While the loonie has appreciated somewhat recently, some of this strength is expected to fade as the Federal Reserve resumes its tightening cycle, likely this summer, and the level of the exchange rate remains supportive of export growth, particularly when compared with its 2014/2015 levels.

"The long-awaited response from exporters appears to be underway. In a reversal from recent trends, Canada is likely to see a trade surplus this year – a first since 2009," said Caranci.

Looking beyond 2016, government spending is expected to lend a helping hand to domestic growth. The federal budget promised sizeable spending increases, the bulk of which will be felt in 2017.

Caranci notes, "incorporating the federal fiscal stimulus increases 2017 growth by about 0.3 percentage points, helping to push real GDP growth slightly above the 2% mark next year."

Higher unemployment in store, driven by regional differences

Despite an improving growth forecast, Canada's unemployment rate is likely to continue to creep higher over the next few months, before stabilizing at 7.5% in the second half of 2016. For 2016 as a whole, the rate is projected to average 7.4%, up 0.5 percentage points compared with last year. Still, this national figure will continue to hide dramatic shifts in regional profiles. Alberta's jobless rate is poised to hit 8.2%, and Newfoundland & Labrador, Saskatchewan and Nova Scotia are likely to also see sizeable increases. In the remaining regions, unemployment rates are expected to rise moderately or remain steady, as job gains are partially matched by labour force growth.

"One key factor that should help mitigate upward pressure in the national unemployment is increased interprovincial migration, as people in search of work head to those provinces with stronger cyclical growth opportunities, like B.C. and Ontario. Provincial migration flows tend to respond with a lag, but this pattern is already underway," adds Caranci.

Caranci also pointed out that "One limiting factor is that the population base within oil-producing provinces may have become more permanent, evidenced by higher homeownership rates than in the past. Should this turn out to be the case, the national unemployment rate may prove stickier and hold a more elevated levels longer than we're currently predicting."

Canada benefits from the U.S., but cycles diverge

One interesting feature of the outlook is the recent mirror opposite drivers of the relative performances of the Canadian and U.S. economies. Both economies will have GDP performances anchored near the 2% mark over the next two years, but this will mask diverging performances in domestic demand conditions. Typically, domestic spending (the sum of spending by consumers, businesses and governments) tends to move in a similar way between the two countries. The U.S. enjoys significant upside potential for domestic spending that will likely run near the 3% mark, whereas Canada's will be moving at less than half that speed with growth increasingly reliant on external trade. Of particular note, in 2016 slightly more than half of the growth in Canada is expected to be generated by net exports, a trade contribution that hasn't been matched since 1999.

The different stages of the economic cycle and vulnerabilities between Canada and the U.S. go a long way in explaining expected divergences in monetary policy. Canada's upward movement in the unemployment rate contrasts with a solid U.S. job market and building underlying pressures on wages. The Bank of Canada is expected to keep its policy rate on hold through 2017, whereas the Federal Reserve will continue in its tightening cycle – albeit at a slow pace. This should help to keep a Canadian dollar largely range-bound within 73 cents to 78 cents U.S.

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