Canada's near-term economic outlook brighter, as housing risks shifted further into the future

TORONTO – 2016 was marked by significant challenges to the Canadian economy, but all signs point to an improved pace of growth says TD Economics in the March 2017 edition of the *Quarterly Economic Forecast*.

TD Economics has upgraded its near-term forecast, predicting a 2.3% expansion of real GDP in 2017, up by half a per cent from the December projection. For 2018, the projected expansion has also been nudged higher, to 1.9%. "Our upwardly revised near-term forecast is partly a function to recent signs of momentum and a better starting point. The other key development has been in housing, where sizzling strength in the GTA has driven a significant upgrade to our price and construction forecast," notes Beata Caranci, Chief Economist.

Real estate supports an improved outlook, but is moving away from fundamentals

Canadian real estate is a tale of many markets. Some, such as Vancouver, have been cooling off, while others across the country are seeing mixed performances. An exception is the Greater Toronto Area, where price growth has accelerated at a blockbuster pace in recent months. While a lack of good quality data remains an issue in pinpointing the sources of strength, the market increasingly appears to be fuelled by speculation, rather than fundamentals. Remarked Caranci, "It is hard to square the circle of the speed at which prices are rising in Toronto with pure market fundamentals. That said, barring an unanticipated shock, there appears to be little that will stop the Toronto housing juggernaut this year other than ongoing affordability erosion. History has shown us that momentum can persist past fundamentals for some time."

An upgraded outlook for residential investment supports 2017 economic growth both through its direct impact, as well as knock-on effects on consumer spending. The pace of the purse is forecast to remain healthy in 2017, helped by spending in areas such as furniture and other household items. As 2018 approaches, however, headwinds to both spending and real estate will intensify. Stretched affordability and rising borrowing costs are expected to precipitate a gradual deceleration in the Toronto and within overall Canadian real estate markets.

Oil and gas back in the driver's seat

Although the evolution of housing markets is expected to create a moderate headwind to household spending next year, the consumer is expected to remain the backbone of the economy. In addition, government stimulus dollars budgeted last year should translate more meaningfully into economic activity, and business investment is forecast to turn the corner.

Perhaps more interesting is what the growth outlook implies for Canada's key industries. In a sea-change from 2016, the fastest growing sector is expected to be oil and gas, helped by a bounce-back in production, and modestly improved investment intentions. Stronger U.S. demand is likely to translate into improved output in for other goods producers, with the notable exception of the automotive industry, impacted by the schedule closure of a major production facility later this year. Consistent with the momentum in housing markets, the real estate and construction industries are forecast to perform well, with the latter further helped by federal infrastructure spending.

No shortage of risks

Despite an upgraded near-term outlook for the Canadian economy, uncertainties remain significant. In addition to the vulnerabilities surrounding the potential for a housing market correction, all eyes in Canada will be on upcoming NAFTA renegotiations. The new U.S. administration has suggested that its concerns around trade imbalances are not focused on Canada, but 'tweaks' to the trade relationship still need to be defined and business investment sentiment may soon reflect that uncertainty.

Also concerning are potential changes to the U.S. tax code. Proposals for border adjustments have a clear negative implication for Canadian exporters, including the transportation equipment, machinery, and chemicals industries. "Economic theory suggests that the U.S. dollar should appreciate in response to a border adjustment tax, but the risk is that when the rubber hits the road, the adjustment may be incomplete, or take time, leaving Canadian exporters in the lurch." warns Caranci. The risks are not one-sided, however. Fiscal policy led resurgence in U.S. growth, particularly in business investment, could take Canada along for the ride, accelerating the Canadian growth rotation process.

Bank of Canada happy to stay on hold

A stronger pace of economic growth will be welcomed by the Bank of Canada but is unlikely to spur any near-term action. With the presence of sizeable economic slack, there are little fundamental inflationary pressures at present. As such, the Bank of Canada will be happy to stay on hold through 2017 and well into 2018, wary of acting too soon and pushing the nascent growth rotation off course. This has the added benefit of allowing interest rate differentials vis-à-vis the U.S. (where a string of policy interest rate increases are expected) to weigh on the Canadian dollar, providing some additional support to Canadian exports. Eventually today's economic slack will be absorbed, and inflationary pressures will begin to emerge, kicking off a tightening cycle. This process is expected to begin in late 2018.

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