After second quarter contraction, green shoots emerge: TD Economics

TORONTO – Looking back over the past six quarters, the Canadian economy has barely budged. Real GDP is up a meagre 0.5% over that entire period. A strong rebound is playing out in the third quarter in part related to one-time factors. However, we've been fooled before, so what matters most is a continuation of momentum beyond that quarter, says TD Bank Financial Group's Chief Economist, Beata Caranci, in the September edition of the *Quarterly Economic Forecast*.

TD Economics is predicting that real GDP will rebound by roughly 3% in the third quarter, before settling back to just under 2% in the fourth quarter of this year and in 2017-18. This will put an end to the recent period of stagnation, but still reflects a modest growth profile that will not compel the Bank of Canada to adjust interest rates in either direction.

Economic rotation to resume

A key source of the near-term rebound is the return to more normal levels of activity following the May wildfires in Alberta. The outlook for improved growth is also underpinned by an expected pickup in non-commodity exports, the bottoming of the business investment cycle, as well as federal fiscal stimulus.

After a disappointing performance in the first half of the year, non-commodity exports are forecast to resume growth, with July's trade numbers offering optimism. At the heart of the rebound is feedthrough from a solidifying pattern in U.S. demand and stabilization in global growth. However, consistent with a muted global outlook, export growth will be modest when compared to historic norms.

"Canada's much-anticipated economic rotation away from debt-fuelled housing towards non-commodity exports hit a wall in the first half of the year, but there are early signs that the setback was temporary " said Beata Caranci. "Green shoots are emerging in the higher-frequency data, and a broadening of U.S. demand beyond their consumer base should provide near-term support to Canadian exporters."

With oil prices expected to remain in the $55 to $60 range in 2018, the bulk of new investment will take place outside of the commodity sector. There is traditionally a strong link between rising exports and Canadian business capital spending, but TD predicts that this effect will be comparatively modest and lagged, not materializing until the second half of 2017.

"Disappointing business investment trends has been a global story post-crisis," notes Caranci. "Amid various uncertainties and headwinds, the upcoming U.S. election being one, many businesses become incented to take a wait and see approach."

Government spending provides a boost as adjustments occur

Budget 2016 brought sizeable new spending commitments, the effects of which are now beginning to be felt. The Canada Child Benefit cheques began reaching household pocket books in late July. Representing an increase relative to the payments it replaces, a modest one-time boost to consumer spending in the third quarter is expected. More important are commitments to infrastructure spending.

It will take time for these to translate into economic activity, with the majority of the impact expected in 2017 and 2018.

Key housing markets to cool

Recent run-away price gains in the large housing markets of the Greater Toronto and Vancouver regions have been supportive of net worth and consumer spending. However, this is starting to come to an end, with activity in Vancouver slowing, even before the new foreign buyer tax was implemented in August. TD Economics expects activity in both markets to moderate in 2017 and 2018 due to increasingly stretched valuations, but Vancouver will see the larger adjustment. Prices in Vancouver are forecast to fall by roughly 10% from their current levels, while the Toronto market should experience a leveling off in prices in the coming years due to affordability erosion.

Just as rising housing wealth has supported household spending in past, the cooling of major markets is expected to contribute to a gradual deceleration of consumer spending through 2017 and 2018. Noted Caranci, "in the past year, both consumer spending and household debt accumulation has continued to run ahead of overall economic activity. This is an unsustainable trend that we do not foresee continuing in 2017-18, especially in light of our expectation of softening housing trends."

Bank of Canada unlikely to move rates

The Bank of Canada is not expected to move its policy rate from its current accommodative level any time soon. In fact, TD Economics has pushed back a rate hike in its forecast to early 2019 in light of the stalled economic rotation and the setback related to disappointing growth in the first half of the year. In the meantime, TD Economics sees the risks around the policy rate as tilted to the downside until further confirmation of a recovery in exports materializes.

South of the border, the case for further interest rate increases has risen. Generally solid economic figures in the U.S. are making it increasingly probable that the Federal Reserve will raise rates by year-end. The divergence in U.S. and Canadian monetary policy will help maintain downward pressure on the loonie, in turn supporting export competitiveness. That said, upward movements in U.S. bond yields are likely to have some upward pull effect on Canadian medium-to-longer term yields in the coming quarters.

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