SPECIAL REPORT

TD Economics

May 3, 2017

Q1 AND DONE? ASSESSING CANADIAN GROWTH STURDINESS

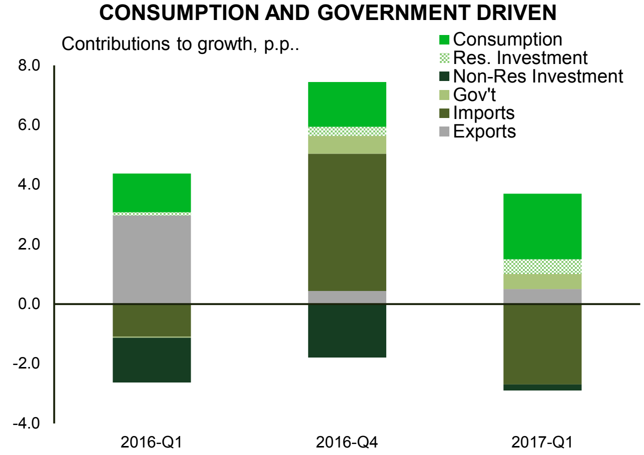
Highlights

- 2017 should get started on the right foot, with Q1 growth tracking 3.4% q/q annualized. There have been a number of false starts in recent years, but a broadening of growth drivers across industries suggests that the Canadian economy is increasingly finding its legs.
- Residential investment has been an important driver of growth, but its share of economic activity is at an all-time high and growing headwinds suggest it is topping out.
- Fortunately, government spending will provide a near-term backstop to economic growth, while a nascent recovery in business investment is becoming increasingly evident. All signs point to a resumption of the much-delayed rotation of economic growth drivers.
- The path forward is riddled with risks. The longer housing markets remain ebullient, diverging from fundamentals, the larger the risk. Moreover, recent trade-related protectionist action and rhetoric from the U.S. administration may yet weigh on business sentiment.
- As such, the Bank of Canada will likely take a cautious approach, looking for confirmation that the growth rotation is durable. It is not expected to begin raising its policy interest rate until next year.

The Canadian economy is poised to tear out of the gates in 2017. The current tracking on first quarter growth sits at 3.4% (quarter-on-quarter, annualized). This would mark the strongest performance since 2014. Canadians can be forgiven for feeling a sense of economic déjà vu. A similar narrative developed last year, albeit with a somewhat less dramatic expansion of real GDP growth of 2.7% in the first quarter of 2016. However, that healthy start quickly gave way to softness. The Albertan wildfires made matters worse, but even absent their impact, growth would have averaged just 1.3% over the second and third quarters, leading to an accumulation of economic slack.

Will the dash forward in first quarter growth this year give way to economic doldrums again? In some respects, the answer is yes. It is not reasonable to expect the strong pace of first quarter growth to persist given unusual strength in areas such as consumer spending on durable goods, and we expect quarterly growth to trend around a more modest pace of about 1.9% as the year progresses. However, there is a key distinction occurring within the growth profile this year relative to last year. At the beginning of 2016, much of the strength was driven by exports (Chart 1). What had appeared to be a solid upswing in foreign demand ultimately proved fleeting and 2016 as a whole recorded the worst Canadian export performance in six years.

CHART 1: CURRENT GROWTH MORE CONSUMPTION AND GOVERNMENT DRIVEN



Source: Statistics Canada, TD Economics. 2017Q1 figures are latest tracking.

Brian DePratto, Senior Economist, 416-944-5069

This time around, GDP data is showing significantly more breadth among the growth-drivers at the industry level (Chart 2). This dispersion of industrial growth is a good sign that the economy is moving towards a stronger and more durable footing than what was witnessed last year.

To be sure, even absent the wildfire impacts, growth in 2016 would have disappointed our expectations. Although the wildfires shaved around 0.3 percentage points from growth, soft out-turns in exports and business investment had an impact of a similar magnitude, leaving the final growth figure for the year well below initial expectations. Per Chart 2, the disappointment appears to have been related to the relatively narrow base of growth. Given its centrality to the growth outlook, the importance of achieving the broader growth narrative discussed in this report cannot be understated – and of course neither can the risks.

Housing has been a strength, but is becoming a weakness

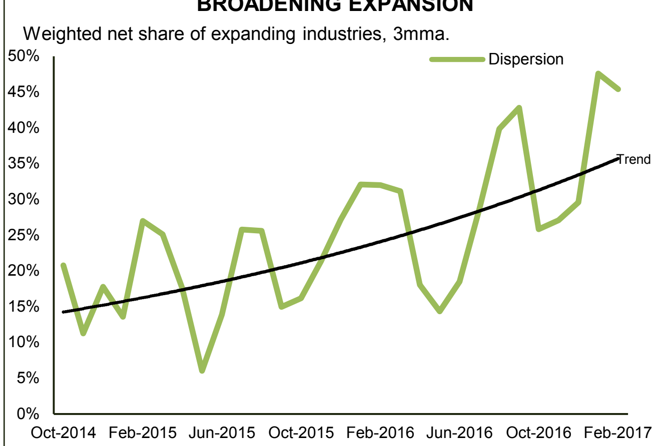
In broad terms, residential investment in Canada tends to be a solid driver of economic growth. More recently however, housing activity is turning into more and more of an economic risk. To be sure, construction and real estate helped provide support to Canadian growth in recent years as other sectors dealt with shocks, but this has also meant that since 2014, roughly 40% of economic growth has been the result of housing, despite this sector representing between 8% and 10% of overall output (Chart 3). This outperformance is unprecedented outside of an economic downturn. When it comes to the share of residential investment in economic activity (a slightly different way of measuring the impact), the outsized growth has pushed it to a new high, above previous peak reached in the late-1980s (Chart 4).

There is not one Canadian housing market, and much of the strength in recent years has been concentrated in the Greater Vancouver and Greater Toronto areas. This can be seen in the provincial employment data (Chart 5). Although slightly below the national figure, construction employment in Ontario stands at an all-time high, while residential investment as a share of GDP has just breached its 1989 peak. In British Columbia, a peak was reached in 2007, but the construction share of employment remains well above both historic levels and the national average.

What's next for housing?

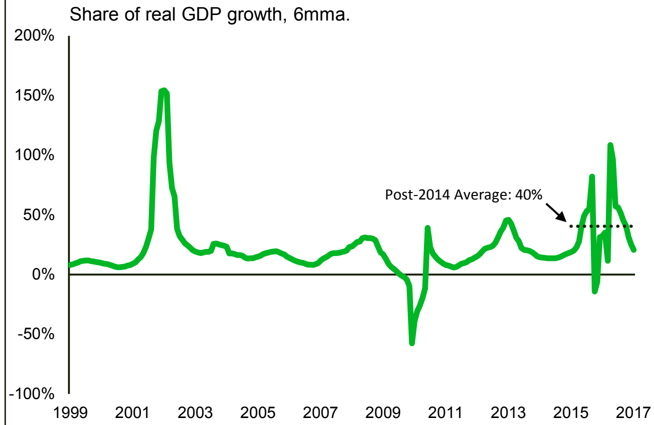
Residential investment in Canada may be looking toppish, but that doesn't mean it must necessarily be at a top. During the pre-recession period, residential investment in

CHART 2: RECENT DATA HAS SHOWN A BROADENING EXPANSION



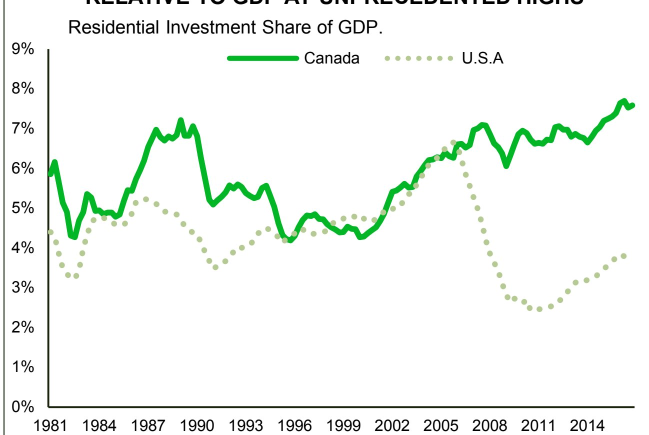
Source: Statistics Canada, TD Economics.

CHART 3: NEARLY HALF OF RECENT ECONOMIC GROWTH CAN BE TRACED TO REAL ESTATE



Source: Statistics Canada, TD Economics. Note that real estate is defined as residential construction plus real estate services.

CHART 4: CANADIAN RESIDENTIAL INVESTMENT RELATIVE TO GDP AT UNPRECEDENTED HIGHS



Source: Statistics Canada, BEA via HAVER, TD Economics.

the U.S. hit a new all-time high in each of the eight years before its 'true' peak was reached. So then, what is next for Canadian housing?

The deck is stacked in favour of a deceleration in housing activity. Stretched home valuations, the slew of cooling measures introduced in the past 12 months (see our discussion of the most recent measures targeted at Ontario here), and an expected uptrend in borrowing costs will tap the brakes as the year progresses. The expected impact can best be seen in price pressures in the key Ontario and Toronto markets (Chart 6). While double-digit price gains are expected this year – due largely to momentum – average home prices are expected to pull back in 2018. While much of the decline in this metric is likely to be related to the mix of sales, (with activity skewed towards the condo market), it would nonetheless mark the first yearly decline since 2008.

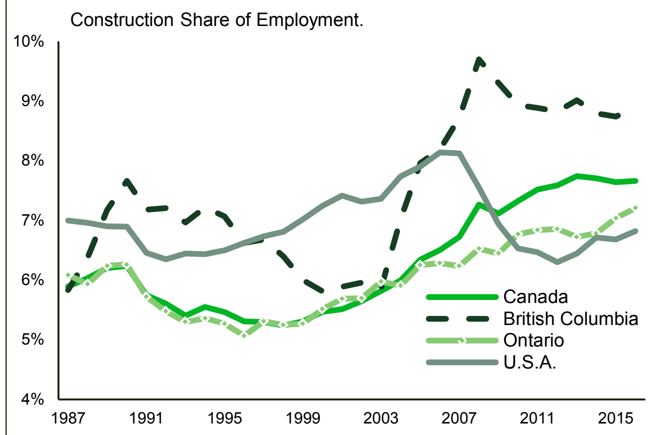
On a national basis, the shift in housing growth should be slightly less pronounced, and there are reasons to be cautiously optimistic regarding some of the harder-hit economic regions of past years. In economics, what goes down typically comes back up. Within the commodity-producing regions, a stabilization of oil prices and a modest resumption of hiring should help buttress housing markets. For Canada as a whole however, residential investment is expected to swing from a source of growth this year to a modest drag in 2018.

If not housing, what?

The dwindling growth impetus from residential investment will leave a hole of sorts in the 'growth balance sheet'. Fortunately, the broadening out of growth drivers that we have begun to see suggests that other parts of the Canadian economy are likely to sustain the expansion going forward.

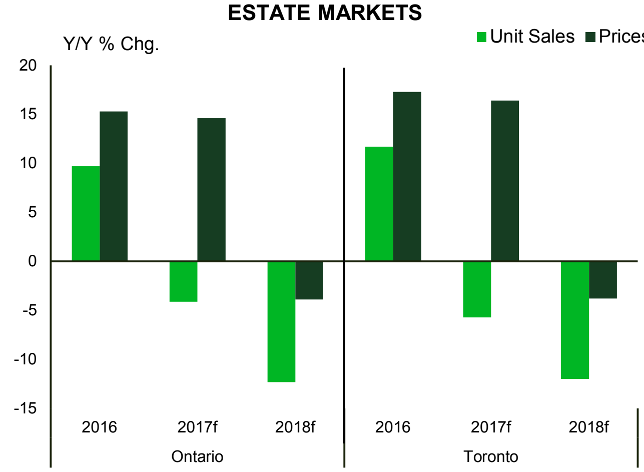
To begin with, the economic impact from fiscal stimulus measures introduced in Budget 2016 were a long time in coming, but are now beginning to be felt in the activity data. The impact should continue to intensify as we enter the traditional construction season across most of Canada. Moreover, the delays in translating spending intentions into action on the ground, alongside additional spending announced in both the Fall Update and Budget 2017, suggest that the impact on activity is likely to stretch into 2018 and beyond. While government spending can't last forever, it is set to have some near term persistence. Government expenditures are forecast to provide a steady backdrop for the economy, adding roughly 0.4 percentage points to output growth this year and next.

CHART 5: CONSTRUCTION EMPLOYMENT REFLECTS BROAD HOUSING TRENDS



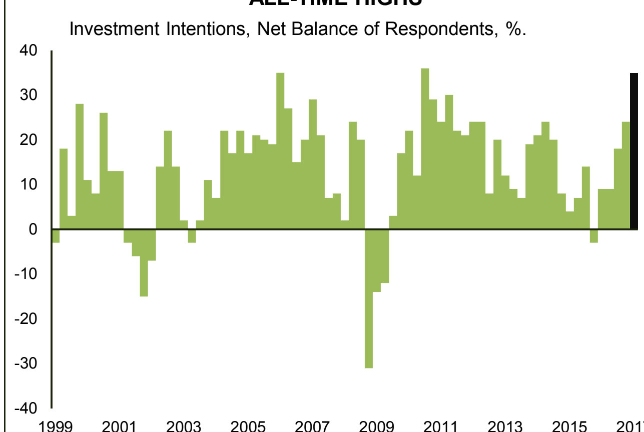
Source: Statistics Canada, TD Economics.

CHART 6: SLOWING EXPECTED IN KEY REAL ESTATE MARKETS



Source: CREA, TD Economics.

CHART 7: INVESTMENT INTENTIONS ARE NEAR ALL-TIME HIGHS

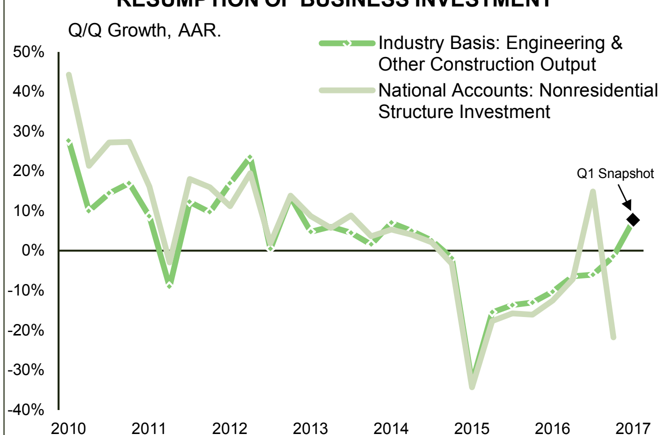


Source: Bank of Canada, TD Economics.

Non-residential business investment is poised to end its more than two year downturn. While only expected to make a modest contribution to growth in coming years, this nevertheless removes a significant drag on the Canadian economy. Supporting this outlook are increasing signs of confidence in a number of surveys. Perhaps surprising, the balance of opinion around future investment in machinery and equipment ticked up to near all-time highs in the Bank of Canada's most recent Business Outlook Survey (Chart 7). This may be a good sign that capacity pressures are building more broadly within the economy to a point sufficient to incent investment, regardless of ongoing political uncertainty south of the border on trade and taxes measures. This was reinforced by recent Bank of Canada research suggesting that the survey as a whole is suggesting a near-term turning point for investment. In addition, among small business, the Canadian Federation of Independent Business' *Business Barometer* has shown an uptick in the number of firms expecting to increase their spending on machinery and equipment.

Encouragingly, the improvement in sentiment has been reasonably widespread. The natural resource sector has seen marked improvement in its perceived outlook, but so too have manufacturing, wholesale trade, and others. Sentiment indicators can only take you so far, and a disconnect can often exist between sentiment and activity. For the manufacturing sector, further encouragement can be taken from capacity utilization data. Both the food and chemical manufacturing sectors were at all-time capacity utilization highs at the end of 2016. Elevated utilization rates were also recorded in the wood product, plastic and rubber product, and furniture industries. All told, the capacity utilization data suggests that pressure to expand operations is starting to build.

CHART 8: INDUSTRY FIGURES POINT TO A RESUMPTION OF BUSINESS INVESTMENT



Source: Statistics Canada, TD Economics

Although timely data on business investment can be quite limited, the data that is available does offer further supporting evidence. Industrial activity in the 'engineering and other construction' sector tends to track business investment in structures quite well, and suggests that this category of investment is likely to turn positive again in the first quarter of 2017 (Chart 8; note that the swings in investment near the end of 2016 were related to the importation of a large module for the Hebron offshore oil project).

All told, there appears reason for at least cautious optimism regarding the future path of business investment. To be sure, expectations for the pace of growth should be tempered, but growth, no matter how modest, will be a welcome change from the past few years. Taken together with the medium-term support from government spending plans, the narrative of an economic growth rotation has begun to re-emerge for Canada.

Business investment far from certain

Our cautious optimism on business investment reflects a pace of growth of just 1.3% over 2017 (fourth quarter over fourth quarter; on an annual average basis, business investment is expected to remain negative owing to softness at the end of last year). This leaves a razor thin margin of error should policy changes south of the border kick the legs out from under Canadian business sentiment. Indeed, President Trump has recently focused his ire in the direction of Canada. Some areas of focus were unsurprising – softwood lumber and the Canadian dairy system have been long standing sore spots in the bilateral relationship. However, more surprising was the President's negative comments on Canadian energy exports (particularly given the recent approval of the Keystone XL pipeline), while the threat of NAFTA repeal remains ever-present.

Actual policy changes, notably the imposition of countervailing duties on Canadian wood product exports, will have a negative impact on Canadian growth, but the impact is likely to be quite limited. (see our recent report) In contrast, there is momentum underway that should work in favour of Canadian exports more broadly, such as good U.S. investment figures, a likely resumption of consumer spending, and the recent softening of the loonie (2017 forecast: +2.2% year-on-year).

Once again, just like with investment, we are not expecting a large contribution to the economy from exports, but the near-term forward momentum already underway is beneficial. It remains to be seen if an elevated level of uncertainty around the future U.S. policy backdrop materializes in the actions of Canadian business leaders. To the extent that it translates into delays or relocation of future investment, it poses a direct risk to rotation of economic growth in Canada. Ultimately, an orderly renegotiation and modernization of NAFTA may prove to be beneficial for all three North American economies (see our earlier report).

Caution the watchword for the Bank of Canada

Although we are seeing early evidence that economic activity is displaying a greater dispersion of growth-drivers than last year, the potential for another head-fake and elevated risks are undoubtedly weighing on Bank of Canada Governor Stephen Poloz. Key to the Bank eventually launching a rate-hike cycle will be in seeing strong evidence of the expansion's durability.

A closure of the output gap (and associated inflationary pressures) that occurs on the back of housing strength may prove to be only temporary. If housing markets enter a period of adjustment, as we (and the Bank of Canada) assume, and other sources of growth can't take its place on a sustainable basis, economic slack and disinflationary pressures will reemerge. Tightening monetary policy into such an outcome would then have been a mistake.

Clearly then, caution is likely to be the Bank of Canada's watchword. As discussed in our most recent Dollars and Sense, policymakers will want to take a wait-and-see approach. Until the durability of growth has been proven, the Bank of Canada is not likely to touch the policy lever. We believe that point will come around the spring of 2018. And, even then, only a gradual pace of subsequent interest rate increases is expected, reflecting the inherent fragility in the rotation process.

Bottom Line

Things are looking up for the Canadian economy. There are good indications that the sources of growth are beginning to broaden, lessening Canada's reliance on real estate and consumer spending as the critical drivers. Although risks abound, notably from south of the border, business investment should become a positive factor for growth this year, adding to the medium-term support provided by government spending. This will allow the rotation of economic growth away from the increasingly overextended real estate sector (and stretched consumers), toward a more balanced growth path. The Bank of Canada is likely to bide its time, making sure that the rotation of growth is truly durable. Once convinced, a gradual tightening cycle will begin next year.