Talking Points

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The latest view on the economy

April 26, 2019

Loonie Tunes: What's Up, BoC?

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Bonds say inversion, and bears say recession
Trump says trade war, and Xi says weak yuan
Inversion, recession, trade war, weak yuan
Let's call the whole thing off.

With profound apologies to the Gershwins, but Friday's surprisingly springy 3.2% annualized rise in Q1 U.S. GDP puts a rather large punctuation mark on the many gloom-and-doom calls at the start of the year. While the details were considerably less flashy than the gaudy headline—and, of course, bonds rallied on the low core inflation reading—the reality is that **the U.S. economy has also grown 3.2% in the past four quarters**. Aside from a brief period in early 2015, that pace hasn't been topped in the past 13 years. No doubt, inventories flattered the Q1 figure, but final sales managed a 2.5% gain (as we had expected) and are up a sturdy 2.7% y/y. That's despite being weighed down by a government shutdown, a global slowdown, a trade war, and some pretty awful weather. **We continue to look for GDP growth to cool through the rest of this year**, but the Q1 figures show we are **a long way from recession**. And with the Fed taking its foot off the brake and hopes still high for a U.S./China trade deal, near-term risks are fading.

In stark contrast, **the Canadian economy is expected to actually perk up as we move through 2019** after a tough start to the year—at least according to the central bank's latest forecast. Perhaps the single biggest surprise in this week's quarterly Monetary Policy Report was the BoC taking an axe to this year's growth call, chopping it to just 1.2% from 1.7%. In one fell swoop, the Bank has gone from above to below consensus (the latest is at 1.5%, where we reside). Recent surveys suggest that this puts the BoC among the bottom decile of forecasters for this year. However, the Bank claims that much of the big downward revision reflects the carryover from a surprisingly weak showing around the turn of the year, including their dismal call of just 0.3% growth for Q1 GDP (we're at 0.7%, and won't see those official stats for another month). But they also are quite cautious on Q2 at just 1.3% growth. After that, the Bank looks for growth to pick up to the 2%-to-2.2% range through the end of 2020—which actually puts them at the high end of forecasters for next year (at a 2.1% average, while we are at 1.7%).

That pronounced upward swing in Canada's GDP forecast over the next year was just the most debatable of **a number of key takeaways** from this week's interest rate announcement. Here are some of the most important:

Bias removed: The rate decision itself held little drama—the BoC is incredibly clear that it is on a prolonged pause, barring some kind of shock—but made it official by **removing the lingering mild tightening bias**. In the press conference, Governor Poloz explained that the bias had been meant *"to remind people what policy normalization could look like"*, but that was no longer needed. In an ensuing interview, Poloz opined that **rates could still be hiked *"sometime down the road"*…**

presumably, the long, and winding road. We are quite comfortable with our call of no change in the overnight rate through 2020.

Neutral trimmed: Each April, the Bank reassesses its estimate of the neutral interest rate, or the long-run norm, and chose to trim it a quarter ppt to 2.25%-to-3.25%. That implies less headroom for any further rate hikes, i.e., those hikes far down the road. Our only quibble would be that they should have gone another step down; in fact, it wouldn't be that radical to believe that the current 1.75% overnight rate may already be in the zone of neutral. The conventional wisdom is that neutral must be positive in real terms, so it can't possibly be below the 2% inflation target. However, note that **since early 2001, the average overnight interest rate has been a snick below average inflation** (1.85% versus 1.86%… *hey, I said a snick*). That's 18 years with a negative real overnight rate, so yes neutral may very well be below 2%.

Potential growth unchanged: Each April, the Bank also revisits the estimate for potential GDP growth, and there was some thought that the recent surge in population (1.4% y/y) and the labour force (+1.7% y/y) may provide a boost. Sadly, **what more workers have giveth, less productive workers have taketh away.** Labour productivity has been a damp squib recently (with almost zero growth in the past four quarters), holding the view on potential GDP growth precisely stable at 1.8% for this year. In fact, with the labour "input" expected to calm slightly, the Bank shaved its estimate of potential for the next two years by a tick—albeit still averaging 1.8% in the 2020-22 period.

Output gap boosted: With no significant changes in potential growth, that means that the slowdown in actual growth in the past two quarters has left the economy further from full capacity. The Bank now sees the economy operating somewhere between 0.25% and 1.25% away from full potential as of Q1. In semi-plain English, that means it would take a full year of growth of about 2.5% to close the gap and get the economy back up to capacity. Unless and until that happens, it's pretty tough to see the Bank considering rate hikes again.

Unimpressed by oil: Accentuating the "on-hold" view, the Bank downplayed oil's recent revival. While lifting the assumption for global prices by $10 (to $60 for WTI; it's back below $63 as we speak), the Bank declined to make a call on WCS. Instead, the MPR flatly stated that Canadian production was *"anchored by transportation capacity"*. While technically correct, the bounce in prices will eventually support incomes and government revenues, if not confidence, in the oil-producing regions. Of course, **the Canadian dollar has also been completely unimpressed by the rebound in oil**, with the currency barely up since the first days of 2019 even as WTI has jumped 40%, and further cut by the Bank's dovish remarks this week. But that seeming disconnect can be partly explained by the fact that **non-energy commodities have been heading south** of late, dragged down especially by sagging lumber and canola prices.

Unimpressed by fiscal stimulus: The Bank's assessment of this year's round of budgets was that whatever Ottawa and a few key provinces (mostly B.C. and Quebec) added, Ontario removed. We don't fully agree with that analysis. Note that Ontario's latest estimate of program spending for the current fiscal year is almost identical to that projected in last year's budget by the prior government, and the deficit is also considerably larger. Meantime, Ottawa essentially spent the bulk of its revenue windfall of the past year, so we judge the overall thrust of policy to have been slightly stimulative this year. By itself, that explains much of the gap in our respective GDP growth calls. As an aside, today's latest monthly budget figures show that Ottawa's revenues continue to top all expectations, up a whopping 8.5% in the first 11 months of FY18/19 (versus a 6.7% estimate in the Budget).

More constructive on housing: After fretting about how long it was taking housing to stabilize for much of the past year, the Bank sounded a bit more upbeat. The adjustment in Vancouver, in particular, and perhaps Toronto may have a bit further to run, but Poloz noted that many other large markets are *"seeing solid activity"*. The Bank looks for residential construction to start adding to growth again by 2020. Zero debate from us, and it's a drum we've been pounding for a while. In fact, **we also are expecting a lighter hit to growth from housing than the Bank this year**, another reason **we are less downbeat overall on the growth call for 2019**. Today's high-side surprise on U.S. GDP offers a morsel of support for that view.

One other post mortem… there's nothing like viewing Game 7 in hostile terrain for Leafs fans—downtown Montreal, surrounded by instant Bruins supporters. In the Year of the Upset for the NHL, the one series that naturally went absolutely according to script was Boston/Toronto. After all, the Leafs have yet to beat the Bruins in the playoffs in my life-time, so why start now? There's only one thing left to say about the Leafs… Go Raptors!

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