# Special Report

**Derek Holt** 416.863.7707
derek.holt@scotiabank.com

## The BoC And The Great Canadian Non-Recession

**The country is not in recession in any meaningful or broadly defined way at this point, and we believe that the BoC should not and will not cut next week.** A dovish bias has merit, but it is likely premature to give up on the rebound story and court the substantial risks associated with further rate cuts. Whether a cut happens or not, we're likely to see higher short-term market rates emerge as current pricing for BoC policy moves over multiple future meetings is very rich as indicated by our fixed income strategist Roger Quick. This note expands upon the arguments that were provided here.

### *Mixed Readings On The Economy*

There are two ways of defining a recession. Canada may be just barely meeting one definition but probably only temporarily so, and is not at all meeting the sounder definition with what we know now.

The more popular definition is marked by back-to-back quarterly declines in GDP. The economy contracted by an annualized 0.6% rate in Q1 and may well have contracted by a similar amount in Q2 but with most data for May and June still pending. Note that **when this definition of recession has been met in the past, it has typically been marked by vastly larger and longer-lived quarterly percentage declines such as in the early 1980s, early 1990s, and 2009.**

The second less popular but more informative definition looks at a broad array of economic indicators on the theory that **GDP growth provides an incomplete picture**. This is the approach taken by the official arbiter of US recessions, the National Bureau of Economic Research. So where do other Canadian readings stand?

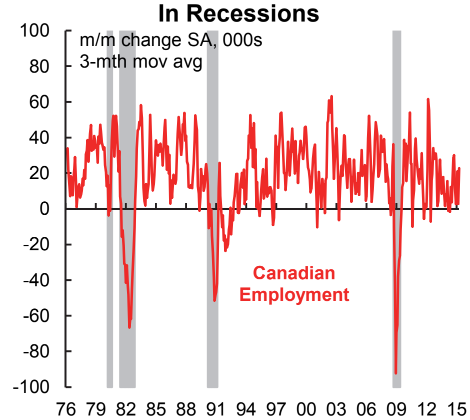
Canada has created 102,000 jobs since the start of the year and almost 200,000 jobs over the past year during which oil prices slid. The unemployment rate lags recessions but employment losses are usually fairly coincidental to falling GDP. A large disconnect has now emerged between the measures (chart 1). Will a trend toward job losses arise in future? Maybe, but during past periods of sharp oil price declines we would have seen a jobs hit by now (chart 2). The rate debate should wait for at least several months to see if this happens.

Housing markets remain on fire. House prices are climbing to new all-time record highs (+8% y/y across Canada; 7% in Toronto and 11% in Vancouver) and home sales continue to climb higher and higher. Vehicle sales are trending at elevated heights. Retail sales volumes have been volatile since December but the trend is resilient.

Financial markets and business finances are not consistently showing signs of recession. Yes, corporate profit growth has dramatically softened especially in the resources sector but that may bottom with the Q2 earnings cycle. The curve is not inverted with about a one hundred point positive spread between 10s and 2s. Credit growth continues to come on strong including in the business sector of late. The inventory cycle is not ringing alarms which suggests low risk that bloated inventories can prompt strong production cutbacks (chart 3).

On balance, if these are the criteria by which to make a recession call then — while we'd prefer something better — we'll take it. Instead, however, we'll call this the Great Canadian Non-Recession. GDP

Chart 1




Source: Scotiabank Economics, Statistics Canada. Shaded bars represent recession periods.

**Scotiabank Economics**
Scotia Plaza 40 King Street West, 63rd Floor
Toronto, Ontario Canada M5H 1H1
Tel: 416.866.6253 Fax: 416.866.2829
Email: scotia.economics@scotiabank.com

growth is perhaps being temporarily disrupted by the worst and typically concentrated effects of the drop in oil prices, a harsher-than-usual winter and spillover effects on North American supply chains of the strikes that crippled west coast ports in the US. The net benefits of lower oil prices and currency depreciation coupled with an already evident US rebound may not have been given enough time to lift GDP growth in other regions of the country.

## *Assessing BoC Cut Risks*

Traders are divided on next week's decision with currently slightly better odds of a pause than a cut priced into OIS markets (a swap contract priced off of expectations for the policy rate after next week's announcement). That rises to about 100% odds by Sept/Oct. Yesterday's Reuters survey showed 12 of 35 forecasters forecasting a cut with the majority still in favour of a hold. **Our hold call does not buy the three main arguments advanced by the cut camp and discussed below:**

**1. The BoC will be concerned about lower oil prices**

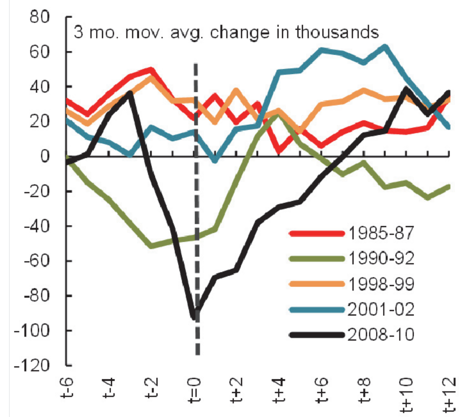
Maybe, but it is important to note that **the BoC's oil price forecast assumptions are not being disappointed.** We've simply come off the recent oil price peaks and markets had temporarily overshot the BoC's assumptions that were based upon the spot prices at the time of doing the forecasts. The BoC's April MPR (its last full forecast) had assumed oil prices would average $55 on Brent, $50 on WTI and $35 on Western Canada Select over the projection horizon. Brent is now about $58, WTI is $53 and WCS is $40.50. Since the BoC's April meeting and its last forecasts, WTI has averaged $58.40, and Western Canada Select has averaged $49.

**2. The BoC will want to weaken the currency**

Possibly, but I'm less sure of that. CAD is testing weak levels for the year while oil prices remain firmer than the earlier low points in Q1/Q2. **The floating currency is absorbing more of the softer oil price effect than was the case in January**.

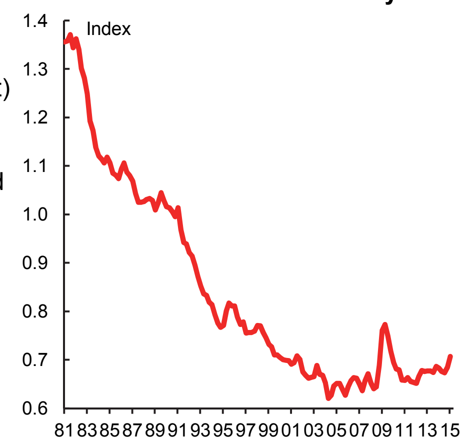
**3. Weak April GDP and May trade data defies expectations of a rebound**

**Chart 2** Job Growth




Source: Scotiabank Economics, Statistics Canada.
t = 0: lowest WTI price during specified timeframe.

**Chart 3** I/S Ratio: Total Economy




Source: Scotiabank Economics, Statistics Canada.

April/May Canadian data may have been partly reflecting hangover effects from a harsh winter and a soft US economy in Q1 and into the start of Q2 whereas the US activity measures really picked up thereafter. So, Canadian data might be following a similar trajectory to that which we have observed in the US but unfortunately the problem here is that the Canadian data notoriously lags the US. If this argument proves correct, then it could be rather ill-advised for the BoC to cut based upon stale data. Further, by StatsCan's own past admissions, much of the trade data on the resources and particularly the energy side of the picture is inferred because it is not available on a timely basis for the first pass before completed industry responses are incorporated into revisions. Cutting now won't change backward data. There remain good reasons to expect better growth.

## *You Can't Re-Load A Spent Bullet*

As for the theory that the BoC can cut now with zero risk and take it back with future rate hikes to offset easing should it prove to be unnecessary, don't be so sure. You can't put the bullet back in the chamber after it has been fired. If cuts further inflame housing, then when we eventually enter the potential soft patch of weakened housing demand it may prove to be very difficult to hike. Giving away cuts now could mean courting more extreme monetary policy action later and with debatable success in a market like Canada especially if the Fed is going the other way. Relying upon further macroprudential policy tools to contain housing risks in a timely manner is set against the mixed success of such measures to date.

It risks feeding weakness if the BoC cuts and accompanies such a move with confidence-sapping guidance. It also risks delaying the rotation of growth sources away from the household sector and toward the investment and export sectors through over-stimulating consumption and housing and setting a low bar for hurdle rate targets and thus biasing the capital-labour ratio consistently in favour of labour at the expense of productivity and hence both profits and long-run living standards of workers. Just as the BoC has been patient in looking through core inflation upsides, it should arguably look through the first half of the year's growth performance.