Global Economic Research

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Special Report:
Volatile Canadian GDP Could Cause Turmoil For BoC Watchers

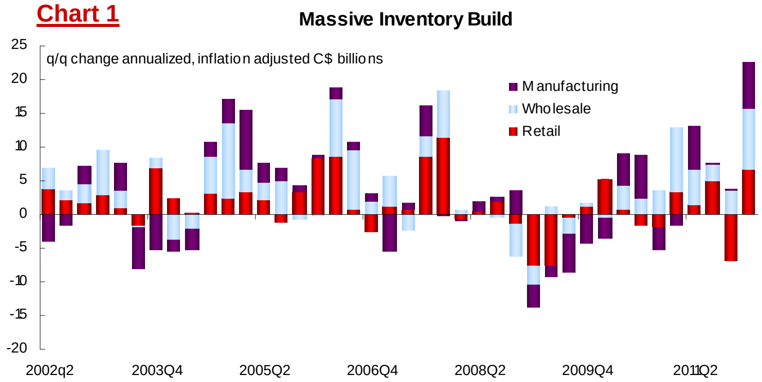
- **The key lies in a massive inventory cycle distortion that would make for an awkward backdrop for the BoC to begin raising rates as early as markets are now expecting.**

Canada could witness one of the largest inventory additions to GDP growth on record when Q1 GDP lands on June 1st. This will put upside risk to our Q1 GDP call that Scotia Economics is revising higher to about 3%. That puts us atop consensus expectations with potentially further upside risks, and above the BoC's 2.5%, but perhaps at the expense of GDP growth in Q2 that we think will come in at half that pace. The implication for markets depends upon how hot money flows interpret the Q1 strength. If they correctly look through the inventory surge to what we are tracking by way of weakness in other components, then the immediate market reaction could push out rate hike expectations. If not, then this is more likely to occur once Q2 growth figures begin arriving since a massive inventory lift in Q1 could point to the risk of a sharply negative inventory and production effect on GDP growth into Q2 or perhaps extended into Q3. Combining the quarters would make for an awkward backdrop for those who believe the Bank of Canada is moving toward a summertime rate hike and imply what should be a profit-taking bias on the trade. Risks to this analysis include the fact that we don't yet have the full quarter's inventory tally since March isn't available as yet, and revision risk.

Measuring The Inventory Build

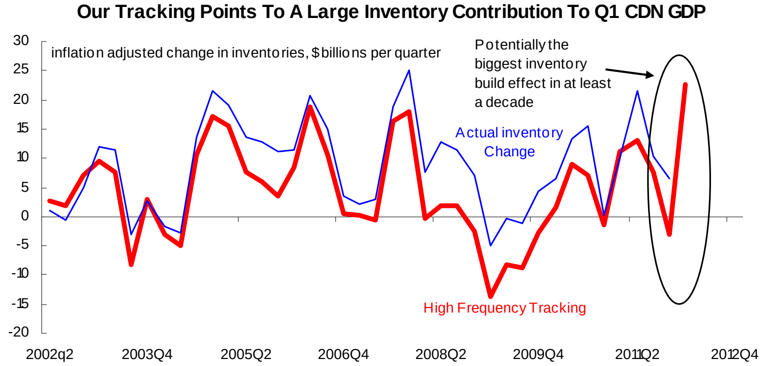
Using updated unpublished monthly inflation-adjusted inventory figures for retailers, wholesalers and manufacturers, we're tracking a pace of inventory building in 2012Q1 that is the strongest quarterly inventory gain since at least 2002 when revised history began. Chart 1 demonstrates how large this effect is tracking in the current quarter by taking the change in inventory balances as at the end of February over the end of December for the latest quarter and comparing that to the full quarter inventory changes over time. This would therefore assume flat inventories in March, leaving room for either an upside or downside surprise. The chart shows that the Q1 inventory accumulation is spread across manufacturers, wholesalers, and retailers. Retail inventories are up by about 12% q/q at an annualized pace in Q1, wholesale inventories are about 13% higher, and manufacturing inventories are about 10% higher. That adds up to total nonfarm inventories climbing by a whopping 12% in Q1 over the prior quarter.

Chart 1



Source: Statistics Canada, Scotia Economics.

Chart 2



Source: Statistics Canada, Scotia Economics.

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Apart from percentage swings, in inflation-adjusted dollar terms, the inventory addition is shaping up to be about $22.5 billion in annualized q/q terms given what we know so far. Our higher-frequency monthly tracking of inventory changes correlates very well with the quarterly inventory changes within the GDP report. That's important because it strongly suggests that our higher-frequency tracking of the inventory side of the picture will be accurate in predicting a large inventory build that is often a last-minute wildcard in the consensus GDP add-up.

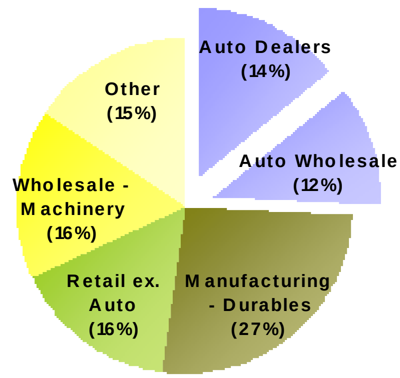
A Diversified Surge In Inventories

At first blush we were tempted to pin the story upon the auto sector given fairly well understood changes in production and inventory levels over the quarter. To be sure, a considerable portion of the inventory accumulation is related to autos; auto dealers account for about 14% of the inventory build within Q1, auto wholesalers account for a further 12%, and auto manufacturers are a considerable portion of the rise in inventories of manufactured durables.

Over half of the picture, however, is not within autos as shown in chart 3 which breaks down the gain in Q1 inventories by sector. Retailers excluding auto dealers also witnessed a sizeable rise in inventories as consumer spending was soft in Q1. Machinery and equipment wholesalers also saw a build-up in inventories as business investment softened. A variety of other sectors account for the rest.

Chart 3

Fairly Diversified Q1 Inventory Build



Source: Statistics Canada, Scotia Economics.

The Rest Of The 2012Q1 Growth Picture

If our tracking up to February stands for the rest of the quarter, then it seems plausible that inventories climbed by about $22.5 billion in inflation adjusted terms and that would single-handedly add almost five full percentage points to GDP growth in Q1. For now, we're playing it more conservatively in assuming inventories rise at about three-quarters of that pace to leave room for inventory revisions and uncertainty over the end-of-quarter March figures, and that would therefore have inventories adding three full percentage points to Q1 growth. In other words, there may be further upsides to our GDP forecast should inventories rise at the tracking rate as opposed to the assumed rate, and assuming that this doesn't come at the further expense of contributions to growth from other demand components.

To this latter point, the stronger-than-expected inventory build in the first quarter should be partially offset by what is shaping up to be a softer-than-expected pace of domestic demand growth. The accompanying table summarizes some of the key indicators we're tracking that affect Q2 growth perspectives.

Consumers, faced with high gas prices, slowing job gains and repeated household debt warnings, have become more cautious spenders. Retail sales volumes in January and February are essentially flat relative to the final quarter of 2011. The monthly retail sales report captures only a subset of consumer outlays, with a notable underrepresentation in services. Even here, however, expenditures may be on the softer side given mild winter temperatures that likely reduced demand for utilities as well as some seasonal household services such as motor vehicle repairs.

Tracking 2012Q1 Growth

NIPA component	Monthly indicator proxy	Latest month	% Growth built-in (a.r.)
Total GDP	Real GDP (by industry)	Jan	1.8
Consumer spending	Real retail sales	Feb	-0.1
Residential investment	Housing starts	Mar	10.2
	Home sales	Mar	1.4
Government expenditures	Real government building construction	Q1	-7.4
Business M&E investment	Nominal imports of M&E	Feb	-5.1
Non-residential construction	Real non-residential building construction	Q1	7.7
Exports	Real merchandise exports	Feb	6.3
Imports	Real merchandise imports	Feb	2.2
Change in inventories	Real manufacturing inventory change	Feb	$6.9 bn
	Real w holesale inventory change	Feb	$8.9 bn
	Real retail inventory change	Feb	$6.7 bn

Source: Scotia Economics

Housing activity remains buoyant, but its contribution to overall growth has begun to fade. New construction picked up in Q1, but the increase was entirely in multi-unit starts which have a relatively smaller GDP impact than single-detached construction. Meanwhile, resale home transactions were essentially flat in the quarter. Renovation expenditures too have slowed in recent quarters, mirroring more moderate home sales and price appreciation.

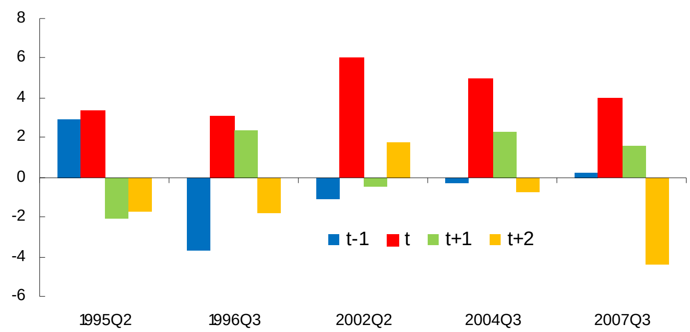
Based on imports of industrial machinery and business equipment, capital outlays in early 2012 are running a bit below fourth-quarter levels. We expect this will prove a temporary slowdown given strong underlying investment fundamentals, including solid corporate balance sheets, a high-valued currency, favourable financing conditions and heightened competitive pressures. Business sentiment surveys (e.g. Conference Board, CFIB) continue to point to strong capital investment intentions, focused primarily on reducing costs and boosting productivity.

Private sector non-residential construction will likely lead domestic spending growth in Q1. Real industrial and commercial construction increased at close to an annualized 8% rate in the January to March period, led by increased spending on manufacturing, storage and utilities facilities in Western Canada. In contrast, government investment in institutional buildings fell for an eighth consecutive quarter.

Net external trade — the balance of exports and imports — may well be the deciding factor for headline GDP growth. Data for January and February suggest real net trade will provide a small positive lift to overall output. However, monthly trade data are highly volatile and subject to significant revisions. Periods of high inventory accumulation are often accompanied by strong import demand, which would provide an offsetting drag on growth.

Chart 4

Comparable Periods Of Large Inventory Gains



Source: Statistics Canada, Scotia Economics.

What About Q2?

History suggests that in the quarter(s) following such a large inventory addition, inventories turn toward being a drag on GDP growth either in the ensuing quarter or the one after that as the pace of inventory stockpiling slows or as inventories get burned off. Chart 4 plots what has happened to inventory contributions to GDP growth in the quarter preceding a build-up in inventories that was comparable to what we think happened in 2012Q1, during the quarter itself, and in the two following quarters. Two of those periods saw a negative contribution to growth from inventories the next quarter, and the other three saw a negative contribution the quarter after. Thus, the payback to 2012Q1 inventory accumulation could land in either of 2012Q2 or Q3, but we think that the sheer magnitude of the Q1 gain this year will make it more likely that inventories drag on GDP growth in Q2. Along with that would be more moderated production gains as firms incrementally shift toward burning off inventory stockpiles.