Canada

- **Canadian economic growth continues to rely heavily on consumption and housing activity, but we—finally—see early signs that the sources of this growth are beginning to broaden to include contributions from business investment.**
- **Following a robust Q1, real GDP growth in 2017 is projected to hit 2.7%, well above the 2.0% we foresaw at the beginning of the year. Some of this demand is likely being pulled ahead from 2018 and we expect growth to slow to 1.9% next year as activity pivots to more balanced and sustainable contributions from investment and trade, as well as increased public infrastructure spending.**
- **We remain sanguine about the likely impact on Canadian economic activity of trade policy uncertainties emanating from the US despite the occasionally overheated rhetoric coming from Washington.**

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GREEN SHOOTS OF BROADENING GROWTH

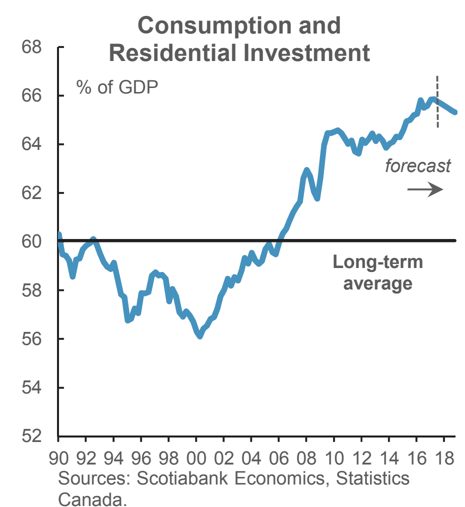
Canadian GDP stormed ahead to an unexpectedly quick pace of 3.7% q/q in Q1. Economic activity continued to be led in a lopsided fashion by consumer demand and residential investment, but Q1 also provided some tentative evidence of a strong pick-up in business investment. This incipient broadening of the sources of private-sector growth at the same time as public infrastructure spending is set to move ahead underpins another mark-up in our growth projections for 2017 to 2.7%, roughly double the Bank of Canada's estimate of Canada's potential. If realized, this would be the highest annual growth rate since 2011's 3.1% and it would make Canada one of the fastest-growing countries in the industrialized world. Some of this demand is likely being pulled ahead from future periods and we anticipate a marked deceleration next year: we have shaved our projection for 2018 growth from 2.0% to 1.9% reflecting our expectation that Canadian economic activity will continue its shift to a more durable mix of sources in the years ahead.

A STILL BULLISH CONSUMER

Domestic growth remains heavily—too heavily—dependent on households: real consumer spending and residential investment growth clocked in at a more than 5% annualized rate in the first three months of the year, the strongest quarterly performance in almost a decade. The two sectors combined now account for a record 66% share of GDP (chart 1). Yet, at the same time, the sources of Canada's growth are starting to diversify: in April our diffusion index on the components of Canadian GDP reached its highest level since 2013 (chart 2)

Confidence, incomes, and spending are being buoyed by a robust labour market and historically low interest rates. Job gains this year have averaged almost 30,000 each month, the strongest pace of hiring in a decade (chart 3). The jobless rate is testing a cycle-low 6.6% (or just 5.5% when measured according to the US methodology that produces the current 4.3% unemployment rate south of the border), at the same time that the prime-age employment-to-population ratio is

Chart 1



Sources: Scotiabank Economics, Statistics Canada.

near all-time highs (chart 4). Recent job gains have been overwhelmingly dominated by full-time paid positions spread increasingly broadly across sectors and regions—a testament to improving business sentiment.

Wealth gains are providing additional support, especially in housing where the lack of interest deductibility provides an incentive for Canadians to pay down mortgages and build equity more quickly than their American counterparts. Surging home values have generated over CAD 300 bn in increased household net worth in the past year alone. Assuming a conservative housing wealth effect of 5 cents on the dollar, rising home equity is contributing upwards of a percentage point to the underlying trend in consumer spending. Big-ticket purchases are major beneficiaries, with motor-vehicle sales and expenditures on home renovations at record highs.

Retailers and hospitality services also are getting a boost from strong tourism demand as a relatively weak Canadian dollar attracts a growing number of tourists from abroad and dampens Canadian cross-border trips south of the border. Tourism spending in Canada, adjusted for inflation, increased 5% in the 12 months to 2017Q1, with rising outlays by both Canadian and international travelers.

Looking forward, consumer fundamentals are generally favourable. Consumer confidence and major purchase plans remain strong. Tightening labour market conditions are expected to lead to a pick-up in the currently moribund rate of wage growth. Some lower income households stand to get a hand-up in a few provinces from legislated increases in the minimum wage that should further buttress consumption.

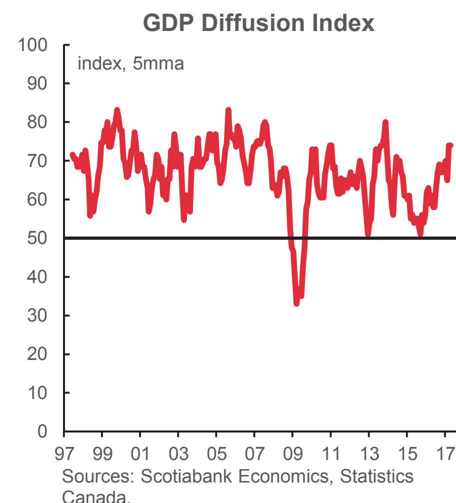
Even so, we continue to forecast a more moderate path for consumer spending as the stimulus from last year's rollout of the Canada Child Benefit fades and housing markets in Toronto and Vancouver become less of a one-way bet. Non-mortgage credit growth has recently slowed, an encouraging sign that households are taking a more cautious approach to taking on more credit given their already record levels of indebtedness. On average, we expect real consumer spending to track real income growth of around 2% in the latter half of 2017 and into next year.

RISING INTEREST RATES, BUT STRONG HOUSEHOLD BALANCE SHEETS

As the Bank of Canada moves to normalize its policy settings, moderately higher interest rates and bond yields pose another headwind to consumer demand growth. A 100 bps increase in the effective interest rate on household mortgage and non-mortgage debt, all else equal, would lift the Canada-wide aggregate household debt-service ratio from its current level of 14.2% of personal disposable income to around 16%—almost two standard deviations above the ratio's 26-year average. The effect would be even more extreme in Toronto and Vancouver, where average debt-service ratios are substantially higher. The additional cost to households to service their loans is likely to dent some discretionary spending.

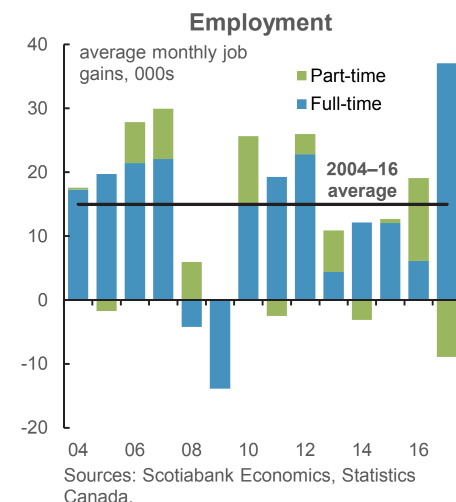
Overall, however, Canadian households have the capability to weather the gradual, though now more imminent, increases in interest rates we expect over our forecast horizon. Mortgage loans account for two-thirds of household credit market debt. The fixed-rate nature of the majority of these mortgages implies that

Chart 2



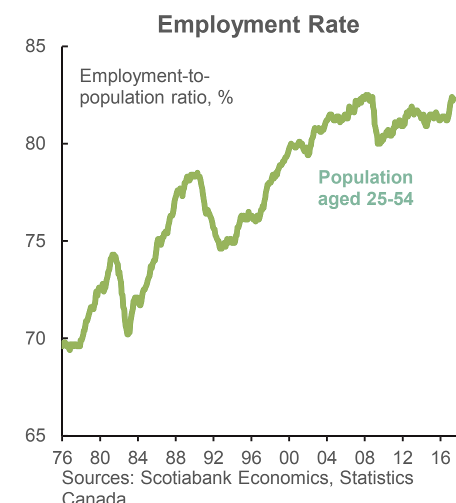
Sources: Scotiabank Economics, Statistics Canada.

Chart 3



Sources: Scotiabank Economics, Statistics Canada.

Chart 4



Sources: Scotiabank Economics, Statistics Canada.

they will be affected only gradually by higher market rates. Given elevated levels of home equity, particularly in areas where house prices have advanced most quickly, many households should be able to avail themselves of refinancing options, if necessary, to lower immediate cash-flow needs. The existing macroprudential requirement that borrowers must qualify for financing at the higher five-year posted mortgage rate has also baked in some financial cushion.

Other balance sheet measures suggest a lower level of financial vulnerability than is inferred from debt-service ratios alone. The household savings rate, at around 4.5%, is in line with its cycle average and could be brought down in response to liquidity needs. Household assets exceed liabilities by a ratio of six to one, providing another potential source of additional funds. Moreover, we anticipate that rising interest rates are likely to be at least partly matched by rising incomes.

HOUSING MARKETS SHOULD REMAIN SOLID

Housing demand remains strong and the chances of a correction remain limited in the face of still-constrained supply in both Vancouver and Toronto, and indications that excess demand is spilling over into other markets such as Calgary, Ottawa, and Montreal. Housing demand in Canada's major cities continues to receive support from high rates of international migration, intra- and inter-provincial migration, strong growth that is converging across Canada's provinces, foreign capital inflows, and still-low interest rates. The increase in rates we now expect from the Bank of Canada during 2017–18 won't meaningfully change this picture: housing starts are forecast to total about 200,000 units this year given the strength of permit demand and the relatively low level of unsold inventory. We already see that efforts to dampen high-end and foreign demand in BC's Lower Mainland appear to have had only a temporary effect, while it's too soon to assess if Ontario's Fair Housing Plan will durably weaken price momentum in Toronto's market without additional measures to increase supply. Overall, we still expect housing to add some 0.3 ppts to GDP growth this year, its largest contribution since 2012.

Low borrowing costs, robust job growth, and solid household formation reinforced by high immigration numbers should remain supportive of housing demand into 2018. Nevertheless, the combination of higher borrowing costs, macroprudential tightening, and strained affordability in Canada's highest-priced markets are expected to lead to some slowing in home sales and house price appreciation in the year ahead. As a result, we expect 2018 to mark the first year since 2009 in which residential investment provides a drag on growth.

MANUFACTURING REVIVAL DRIVING INCREASED INVESTMENT

Firmer demand in the United States—the destination for nearly 60% of overall Canadian manufacturing output—and in Canada lifted Canadian non-automotive manufacturing shipments 8% y/y through April. This represents the best performance in nearly seven years and is double the growth rate recorded from the start of the current economic expansion through mid-2014. We

Table 1 — Quarterly Canadian Forecasts

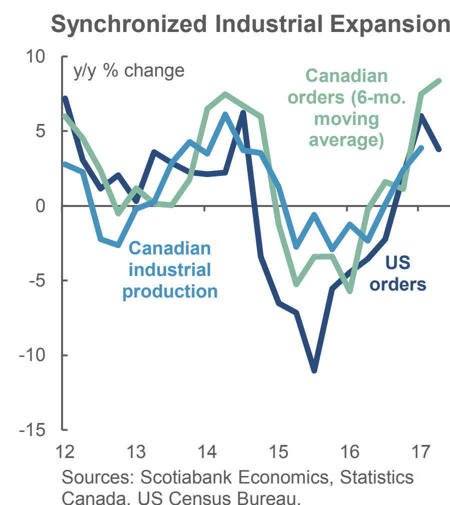
	2016				2017				2018			
	Q1	Q2	Q3	Q4	Q1	Q2e	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic												
Real GDP (q/q ann. % change)	2.8	-1.4	4.2	2.7	3.7	2.5	2.2	2.0	1.9	1.8	1.7	1.6
Real GDP (y/y % change)	1.3	1.1	1.5	2.0	2.3	3.3	2.8	2.6	2.2	2.0	1.8	1.8
Consumer prices (y/y % change)	1.5	1.6	1.2	1.4	1.9	1.5	1.7	1.7	1.7	1.9	2.1	2.1
CPI ex. food & energy (y/y % change)	1.7	2.0	2.0	1.8	2.0	1.5	1.5	1.6	1.7	1.7	1.9	1.9
Avg. of new core CPIs (y/y % change)	1.8	2.0	1.8	1.7	1.6	1.3	1.2	1.3	1.4	1.5	1.7	1.8
Financial												
Canadian Dollar (USDCAD)	1.30	1.29	1.31	1.34	1.33	1.30	1.30	1.28	1.28	1.27	1.25	1.25
Canadian Dollar (CADUSD)	0.77	0.77	0.76	0.74	0.75	0.77	0.77	0.78	0.78	0.79	0.80	0.80
Bank of Canada Overnight Rate (%)	0.50	0.50	0.50	0.50	0.50	0.50	0.75	1.00	1.25	1.25	1.25	1.25
3-month T-bill (%)	0.45	0.49	0.53	0.46	0.55	0.71	0.90	1.10	1.30	1.30	1.25	1.25
2-year Canada (%)	0.54	0.52	0.52	0.75	0.75	1.10	1.20	1.30	1.35	1.40	1.45	1.50
5-year Canada (%)	0.68	0.57	0.62	1.11	1.12	1.39	1.50	1.65	1.75	1.85	1.90	2.00
10-year Canada (%)	1.23	1.06	1.00	1.72	1.63	1.76	1.85	2.00	2.10	2.25	2.40	2.50
30-year Canada (%)	2.00	1.72	1.66	2.31	2.30	2.15	2.20	2.40	2.50	2.60	2.70	2.80

expect this solid performance to acquire additional momentum in the latter half of 2017, especially since order growth has accelerated to a double-digit year-over-year rate and is outpacing production gains (chart 5). The backlog of unfilled orders at Canadian plants is also at record highs for the current expansion, pointing to a continuation throughout 2017 of the strong industrial performance that has emerged so far this year. In fact, industrial activity has picked up significantly in Canada in recent months, and is now in the forefront of growth among G7 countries.

Historical evidence indicates that industrial orders in Canada tend to follow developments in the United States, but with greater volatility. However, looking at a historical series of the six-month moving average of Canadian manufacturing orders it becomes clear that major trend reversals in Canadian new orders occur around the same time as south of the border. This implies that continued solid gains in industrial activity are likely during the second half of 2017, especially since order growth is exceeding output gains in both countries (chart 5 again).

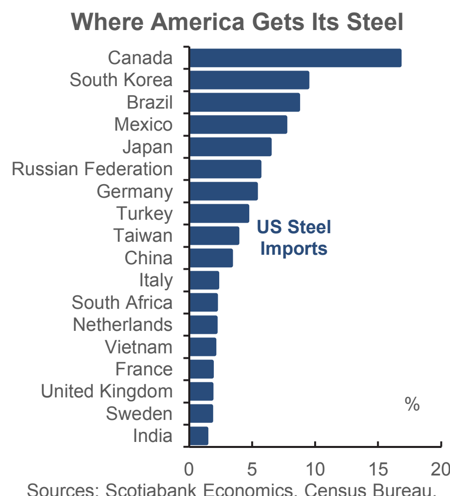
Machinery, computers, and electronic equipment are providing much of the boost to industrial activity in Canada. These sectors account for roughly 30% of overall manufacturing shipments and orders in these sectors have surged nearly 20% year-to-date compared with the same period in 2016. These sectors also have some of the highest export intensities in Canada's industrial sector and they have been operating at full capacity for some time. Economy-wide manufacturing capacity utilization increased by 1.5 ppts in the opening months of 2017, the largest advance over the same period in six years. This should lead to increased capital spending, typically with a two-quarter lag to exports gains in trade-focused sectors. The 13% jump in demand for industrial and metalworking machinery so far this year, the fastest pace since 2011, implies that this investment recovery has started to unfold. If fully realized, this investment would start to reverse the capex hiatus of recent years even as trade policy uncertainties remain unresolved.

Chart 5



Sources: Scotiabank Economics, Statistics Canada, US Census Bureau.

Chart 6



Sources: Scotiabank Economics, Census Bureau.

FISCAL: MORE SPENDING, BUT SMALLER DEFICITS

Across all levels of government, current and capital spending is still projected to contribute about 0.4 ppts to real GDP growth in calendar 2017 and 2018. With respect to Ottawa's forecast deficits for FY18 and FY19, we now expect Canada's real GDP and GDP price deflator to come in higher than the projections used in the federal Budget last March, building on stronger-than-anticipated federal revenues in fiscal 2016-17 (FY17). Consequently, federal deficits in FY18 and FY19 are now expected to average close to CAD 20 bn, excluding the government's CAD 3 bn adjustment for risk, which improves upon the CAD 25 bn shortfalls previously anticipated. This reinforces our expectation that the federal accumulated deficit, even with the risk adjustment included, should stabilize at just over 30% of GDP over the next two years.

While the mix of federal spending may shift with events, such as the compensatory measures recently announced for softwood lumber producers, the overall levels of spending are assumed to remain as programmed in the March federal budget. Infrastructure spending is picking up, but risks remain that it may continue to be delivered more slowly than planned, particularly for Phase 2 of the federal government's plan, which has always been expected to ramp up in FY19.

For the majority of Provinces, forecast surpluses or curtailed deficits should, by FY19, result in net debt increases that largely reflect stepped-up capital outlays rather than operating deficits.

EXTERNAL RISKS REMAIN, BUT APPEAR LESS ACUTE

We remain relatively sanguine about the risks facing Canada from changes in US trade policy. The 18 May letter from US Trade Representative Lighthizer to Congress informing of the US administration's intent to re-open NAFTA outlined a fairly benign set of

priorities for negotiations and gave further credence to our expectation that the agreement will be 'tweaked' and modernized, rather than revolutionized or ripped up. With formal talks set to begin in late-August, all three NAFTA member governments have launched consultative processes with their national stakeholders to identify their negotiating priorities. Incentives are broadly aligned to bring the talks to a smooth conclusion. Nevertheless, neither Canada nor Mexico face pressure to cut a deal at any price, and if negotiations are not concluded by the end of 2017, campaigning for the July 2018 Mexican Presidential elections would likely delay an end to the talks well into late-2018.

The concurrent dispute over softwood lumber should have limited impact on the Canadian macroeconomy—the sector accounts for only about 1% of Canadian GDP—but may have specific effects on individual producers and their communities. The US residential construction industry needs every Canadian log it can get. Absent a new Softwood Lumber Agreement that imposes quotas to cut Canada's roughly 30% share of the US market, the costs of the preliminary duties imposed by the US government on Canadian softwood imports should, in the main, fall on US consumers rather than Canada's exporters.

A trade probe against China and other exporters of low-cost steel into the US market that was launched in April by President Trump is due to deliver its findings any day now. The probe was justified on grounds of "national security", but the US's five largest suppliers of steel, which together account for nearly half of all US steel imports, are all American allies: Canada, South Korea, Brazil, Mexico, and Japan (chart 6). In contrast, China provides only about 3.5% of US steel imports, making it the 10th largest supplier to the US, in part because Chinese steel is already subject to a variety of penalties that have slowed trade. While Canada is the most exposed of any country to a US effort to impose tariffs or quotas on all steel imports, the likelihood of any such move is reduced by the inevitable backlash it would produce from several of the US's major allies.

Finally, we continue to see limited immediate risk to Canada from US tax reform. While it is entirely possible that a border adjustment tax will continue to feature in Congressional discussions, we see little chance that it will be enacted. There is a somewhat higher probability that some form of agreement on corporate tax cuts could be reached, which, combined with carbon pricing measures north of the border, could put Canada's businesses at a competitive disadvantage over the longer term.

Table 2 — Canada

	2000–15	2016	2017f	2018f
	(annual % change, unless noted)			
Real GDP	2.2	1.5	2.7	1.9
Consumer spending	2.9	2.3	3.0	1.8
Residential investment	3.8	3.0	3.6	-1.4
Business investment	2.7	-7.8	-0.3	3.2
Government	2.2	1.8	2.0	2.0
Exports	1.3	1.0	1.8	3.7
Imports	3.1	-0.9	2.1	2.7
Nominal GDP	4.4	2.1	5.2	3.9
GDP Deflator	2.2	0.6	2.4	2.0
Consumer price index (CPI)	2.0	1.4	1.7	1.9
CPI ex. food & energy	1.6	1.9	1.7	1.8
Pre-tax corporate profits	3.9	-4.5	25.0	5.0
Employment	1.4	0.7	1.5	0.9
Unemployment rate (%)	7.1	7.0	6.6	6.5
Current account balance (CAD bn)	-13.9	-67.0	-47.8	-37.4
Merchandise trade balance (CAD bn)	28.2	-26.0	0.0	7.5
Federal budget balance (FY, CAD bn)	-2.9	-1.0	-22.0	-24.5
percent of GDP	-0.2	0.0	-1.1	-1.1
Housing starts (000s)	199	198	202	190
Motor vehicle sales (000s)	1,639	1,949	2,000	1,980
Industrial production	0.5	-0.3	3.8	1.5
WTI oil (USD/bbl)	64	43	51	53
Nymex natural gas (USD/mmbtu)	5.09	2.55	3.10	2.95

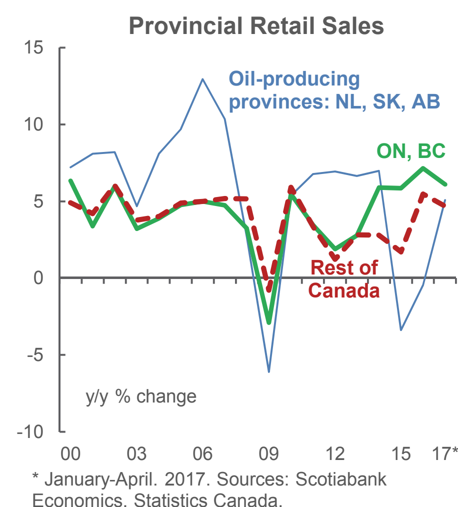
The Provinces

SOLID REGIONAL EXPANSION SEA TO SEA

- **Output, employment, and incomes are revised higher across Canada for 2017, followed by more moderate gains in 2018.**
- **For the fiscal year just completed, a combined surplus for the seven net oil-consuming Provinces is expected for the first time since fiscal 2007–08 (FY08).**

Mirroring this year's stronger forecast expansion are y/y increases to date in private-sector paid employment in seven provinces, with full-time positions climbing in six jurisdictions. British Columbia is leading provincial private-sector job creation for the second consecutive year, followed by sizeable gains in central Canada, leading to stronger weekly wage growth for these provinces after their tepid 1.1% wage hike in 2016. Alberta, aided by post-wildfire reconstruction, and Saskatchewan are starting to recoup some of the 88,000 full-time positions lost from Q2 2015 to Q4 2016. In 2018. Annual unemployment rates in central Canada, Nova Scotia and PEI are expected to be lower than their 2007 rates entering the recession, even with the anticipated easing in job creation next year.

Chart 1

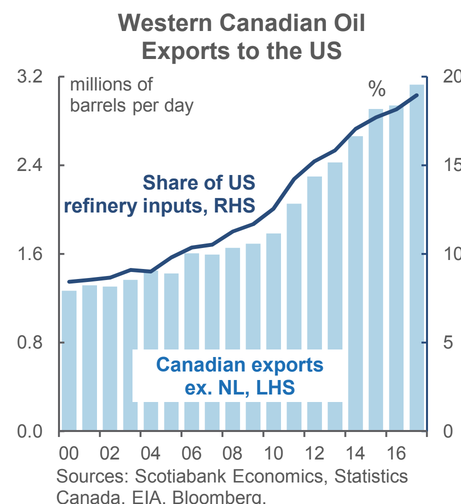


* January-April. 2017. Sources: Scotiabank Economics, Statistics Canada.

Aided by tourism, household income gains this spring are sustaining further healthy retail sales advances for the net oil-consuming provinces, alongside rebounding sales in Alberta and Saskatchewan (chart 1). Contributing to Newfoundland and Labrador's modest y/y sales growth to date this year is the erosion of higher-wage jobs as resource projects near completion. BC and Quebec stand out in 2017 for the relief provided in consumers' health care payments. In 2018, as the six smaller provinces adopt their customized versions of a pan-Canadian carbon price, and fees for public services increasingly reflect full-cost recovery, a greater squeeze is anticipated on the household income available for discretionary purchases.

As new residential construction cools over the next eighteen months despite an upswing in affordable housing expenditures, the planned step-up in infrastructure investment from provincial programmes plus the implementation of Phase 1 of the federal infrastructure plan are expected to provide an important offset. As well, oil & gas investment, whose share of total-industry capital spending was nearly halved to 15% last year, is beginning an extended recovery with an expected increase of over 10% in 2017. After the setback from the 2016 spring wildfires, an uptick in Western Canada's oil exports to the US this year is forecast that will underline the intensifying demand for additional pipeline capacity to markets (chart 2).

Chart 2



Sources: Scotiabank Economics, Statistics Canada, EIA, Bloomberg.

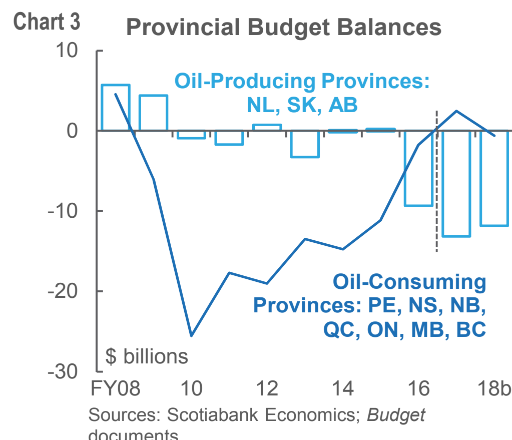
A sustained strengthening in non-energy investment through 2018 is forecast for the majority of provinces, partly in response to expansion in transportation and other activities serving goods-producers and the upswing in hospitality and arts with Canada's 150th celebration. Also critical is the significant digital and IT expansion in several regions and continuing demand for business support services.

REGAINING BLACK INK

For FY17, British Columbia's larger-than-expected final surplus, the substantial black ink indicated by Quebec's monthly data, and Ontario's sizeable deficit reduction point to a combined positive balance of more than $2 billion for the seven net oil-consuming

Provinces (chart 3). For these same Provinces, the upward revisions to calendar 2017 growth are likely to transform the modest combined deficit outlined in their FY18 budgets to an aggregate surplus, albeit smaller than the FY17 balance. For the three major oil-producing Provinces, their combined deficit should begin to narrow in FY18.

Following two years of budgets outlining relatively weak revenue gains for the upcoming year, this spring's budgets were more upbeat. Anticipated gains in provincial receipts as FY18 progresses are expected to spur additional programme spending. This should help to narrow existing social programme gaps; but going forward, with economic growth trending lower, increased spending commitments will likely complicate the Provinces' challenge in trimming their net debt burdens back towards pre-recession levels.



Sources: Scotiabank Economics; *Budget* documents.

Table 1 — The Provinces

annual % change, except where noted

Real GDP	CA	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC
2000–15	2.2	2.5	1.8	1.4	1.2	1.7	2.0	2.4	2.1	3.1	2.7
2016p*	1.5	1.9	2.4	0.9	1.4	1.7	2.6	2.4	-1.0	-3.8	3.7
2017f	2.7	-1.8	1.4	1.4	0.9	2.3	2.9	2.3	1.9	2.9	3.0
2018f	1.9	-0.3	1.3	1.2	0.8	1.7	2.1	1.9	2.0	2.3	2.2
Nominal GDP											
2000–15	4.4	5.7	4.3	3.3	3.3	3.6	3.8	4.5	6.0	6.5	4.5
2016e	2.1	-0.1	3.7	2.4	2.5	3.0	4.2	3.7	-3.5	-6.0	5.4
2017f	5.2	2.4	3.1	3.3	2.7	4.4	5.2	4.4	5.1	6.8	5.3
2018f	3.9	2.7	2.8	2.8	2.2	3.4	4.0	3.6	4.2	5.0	4.0
Employment											
2000–15	1.4	1.0	1.2	0.7	0.5	1.3	1.3	1.0	1.3	2.5	1.2
2016	0.7	-1.5	-2.3	-0.4	-0.1	0.9	1.1	-0.4	-0.9	-1.6	3.2
2017f	1.5	-2.6	1.8	0.6	0.6	1.6	1.4	0.9	0.4	1.0	2.6
2018f	0.9	-1.1	0.3	0.3	0.2	0.8	1.1	0.7	0.6	0.9	1.2
Unemployment Rate (%)											
2000–15	7.1	14.3	11.2	8.9	9.6	8.1	7.2	5.1	4.9	4.9	6.6
2016	7.0	13.4	10.7	8.3	9.5	7.1	6.5	6.1	6.3	8.1	6.0
2017f	6.6	14.5	10.1	8.1	8.7	6.3	6.1	5.6	6.1	8.2	5.5
2018f	6.5	14.9	10.0	7.9	8.6	6.2	6.1	5.5	5.9	7.9	5.4
Housing Starts (units, 000s)											
2000–15	199	2.7	0.8	4.3	3.6	44	71	5.1	5.2	35	28
2016	198	1.4	0.6	3.8	1.8	39	75	5.3	4.8	25	42
2017f	202	1.1	0.8	4.1	1.7	41	80	7.2	4.5	26	36
2018f	190	1.1	0.6	3.8	1.7	38	75	5.7	4.5	26	34
Motor Vehicle Sales (units, 000s)											
2000–15	1,639	28	6	48	37	410	624	47	45	216	178
2016	1,949	33	9	54	44	458	807	55	51	220	218
2017f	2,000	31	8	54	42	456	822	59	59	245	224
2018f	1,980	29	7	54	41	450	812	58	60	248	221
Budget Balances, Fiscal Year Ending March 31 (CAD mn)											
2000–15**	-2,917	59	-39	-31	-146	-1,009	-5,215	-84	425	1,746	291
2016	-987	-2,207	-13	-11	-261	2,191	-3,514	-846	-675	-6,442	730
2017f	-22,000	-1,080	-18	41	-231	250	-1,524	-872	-1,289	-10,784 †	2,775 †
2018f	-24,500	-778	1	136	-192	0	0	-840	-685	-10,344	295

* Real GDP by industry at basic prices. ** MB:FY04-FY15; AB:FY05-FY15; SK:FY15-FY18f: ex pension accrual adjustment. † Final FY17; other FY17 & FY18: Provinces' estimates.

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