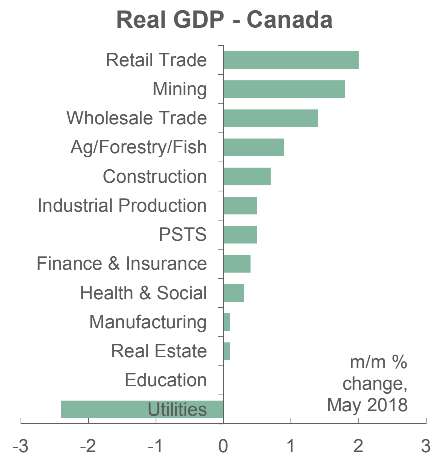
Canadian GDP Points To BoC Hikes Still Being Underpriced

Canada, GDP, m/m % May:
Actual: 0.5
Scotia: 0.4
Consensus: 0.3
Prior: unrevised from 0.1

- This is a very strong report that I think both the currency and rates complexes are ignoring to their peril. In fairness, however, there are a number of headlines operating on the currency around a similar time frame such as softer than expected US inflation but news of kick-started US-China trade negotiations. Talk about not seeing the forest for the trees. The Canadian two year yield is marginally higher and perhaps offers a cleaner post-data read but I continue to think the rates complex is seriously underpricing the BoC. With basically one hike priced into the OIS curve over the next year, too many market participants risk getting caught flat-footed on BoC hike risk yet again. With what is known to date, the BoC would hike in September in my opinion and yet only a trivial handful of basis points of a 25bps hike are priced at present.
- Overall, the BoC will like this further evidence that the economy rebounded from transitory softness. That fits their narrative and ours. The output gap shut in Q2 and they are behind price pressures with negative real rates whether using backward y/y CPI or shaky RRB inflation expectations or survey evidence. This economy doesn't need negative real rates. It doesn't need as easy financial conditions as we have in CAD, high yield, credit spreads etc. NAFTA developments are moderately constructive at the margin but our operating assumption remains that it will be 2019 before a deal is reached and passed in all three legislative assemblies. In the meantime, markets are trading volatile tweets, not fundamentals. One has to tailor monetary policy to the hand that is being dealt by an economy that is performing well and much better than the doomsayers had thought. The economy is now slipping marginally into excess aggregate demand conditions amid rising price pressures. The short-term rates market and CAD are sharply underestimating the BoC in my opinion.
- My simple regression model of monthly GDP had been on the fence with a forecast of 0.4–0.5% GDP growth. I held it back because of uncertainty over the unobservable components namely the ongoing production disruptions in some sectors. Those unobservables mostly came in strong for now.
- Breadth was very strong. 19 of 20 sectors advanced with utilities the only exception as weather patterns returned closer to seasonal norms. In weighted contribution terms, the biggest contributors were mining/oil/gas extraction, retail, wholesale and construction in that order.
- Quarterly growth tracking is exceeding the BoC's already aggressive forecast. Recall that in the July MPR the BoC forecast 2.8% GDP growth in Q2. That was relatively aggressive compared to consensus. Kudos where it seems to be deserved! There are two ways of estimating this tracking:
    - Using monthly GDP figures from the income/production side of the economy, Q2 GDP growth is tracking 3% in q/q seasonally adjusted

CONTACTS

Derek Holt, VP & Head of Capital Markets Economics
416.863.7707
Scotiabank Economics
derek.holt@scotiabank.com



Sources: Scotiabank Economics, Statistics Canada.

and annualized terms. That's assuming a flat June GDP estimate in order to focus upon the effects of what is known by way of the Q1 hand-off and the first two months of Q2. It could fall by 0.2% m/m in June and tracking would still get 2.8% growth. The usual caution is that this is using monthly income/production side GDP. The BoC's forecast is for expenditure based GDP which factors in import leakage and inventory effects that the raw production side wouldn't consider.

  - However, on an expenditure basis CDN GDP basis, Scotiabank Economics figures that growth is tracking 3.2%. Therefore, both the income side tracking of 3% and the expenditure side tracking of 3.2% exceed the BoC's forecast. The BoC may dismiss a month here and there due to distortions as the 'bumps and wiggles' as Poloz puts it. They won't look past the quarter overshoot of what was already among the highest forecasts within consensus when the BoC made it. While nailing the underlying components is another matter, the fact that GDP growth is exceeding the BoC's already aggressive forecast is what matters by way of more rapidly shutting the output gap and now moving into slight excess aggregate demand than what the BoC had anticipated. That puts them even more behind the curve.

- StatsCan is rightly putting a fair emphasis upon weather. There is no need to tell anyone in Canada about what happened to Spring that was awol in many parts of the country at least at first, but the rebounds in retail, construction, food/drinking establishments, building materials, autos etc were likely in part driven by the lagging arrival of nicer weather compared to normal seasonal adjustments. That speaks to a) ignoring prior softness, b) not viewing May's gain as durable, but c) looking to the trend as Poloz does with his 'bumps and wiggles' dismissal of short-run data. The point that should carry the takeaways is that the one-and-done doomsayers had thought that the Canadian economy would crumble this year. It hasn't. It is again among the fastest growing economies anywhere and proving adept at handling higher nominal policy rates.