WELLS FARGO

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Sluggish Growth & Subdued Inflation Means More Bank of Canada Easing

Economist(s)

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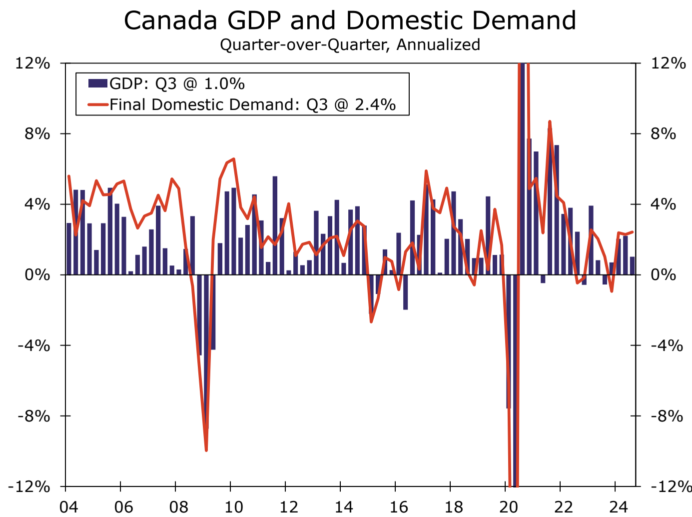
Summary

- Canada's economy appears to have slowed noticeably in late 2024, and prospects are mixed as 2025 begins. The outlook for the household sector is somewhat resilient given firming growth in real incomes, and with interest costs set to decline further in the months ahead. In contrast, sentiment in the corporate sector remains downbeat, while declining profitability could also act as a headwind to business investment.
- Adding to this mixed outlook are increased uncertainties related to U.S. tariff policy and local politics. Our working assumption is that many U.S. imports from Canada may face a tariff of around 5% from the middle of this year. Prime Minister Trudeau's recent resignation should result in a period of uncertainty and transition, even if it eventually leads to a more stable government. These tariff and political uncertainties should offer further headwinds to exports and investment spending.
- Considering the mixed outlook and prevailing uncertainties, we forecast only a modest pickup in Canadian GDP growth to 1.7% in 2025 from an estimated 1.3% in 2024, with the risks tilted toward an even slower recovery.
- Combined with sub-trend growth, contained overall inflation should allow the Bank of Canada to keep lowering policy interest rates at the next several meetings. Domestically oriented inflation is starting to slow more noticeably and, while wages are still elevated relative to productivity, labor cost pressures are also easing.
- We expect the Bank of Canada to cut rates by 25 bps in January, March, April and June, taking the policy rate to 2.25%, which would be at the lower end of the perceived neutral policy rate range. Sluggish Canadian growth, lower Canadian interest rates, and cautious Federal Reserve easing is also likely in our view to keep the Canadian dollar broadly on the defensive over the medium term.

Canada's Mixed Outlook Means Slow Economic Recovery

During the latter half of 2024 and leading into 2025, Canada's economic performance remained respectable, though decidedly mixed across sectors. This mixed performance was clearly reflected in the Q3 GDP outcome, which saw the overall economy grow by 1.0% quarter-over-quarter annualized, although final domestic demand did grow at a stronger 2.4% pace. However, even within the domestic economy there is a clear dichotomy, with the household sector relatively sturdy while the business outlook is somewhat clouded.

Looking first at the household sector, Q3 real consumer spending advanced at a 3.5% pace, while other consumer fundamentals also appeared to be supportive of continued spending, at least in the immediate quarters ahead. Real household disposable income rose 4.8% year-over-year in Q3, the strongest advance since a pandemic-related spike. The household saving rate rose further in Q3 to 7.1% of disposable income, which should offer something of a buffer against a spending downturn. Finally, while household debt servicing costs are still elevated, they have started to trend in a more favorable direction following a series of policy interest rate cuts from the Bank of Canada (BoC). Interest costs as a proportion of disposable income declined in the most recent quarter, while the overall debt service ratio (principal and interest) has fallen for the last three quarters in a row.



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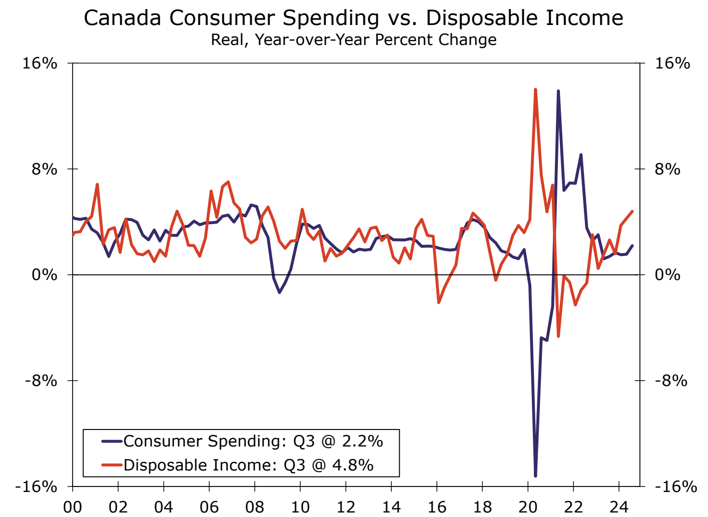

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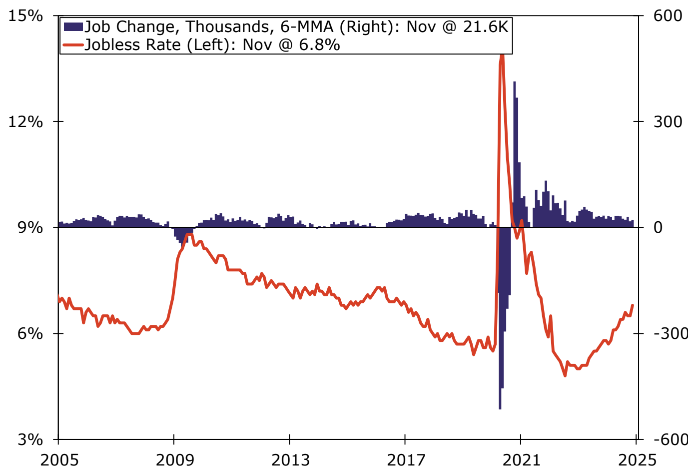
Recent monthly indicators also point to reasonably solid trends in household related activity. From a broader perspective employment trends remain quite solid—including a November employment gain of 50,500—although on the flip-side, the unemployment rate has risen and wage growth has started to slow. Real retail sales were unchanged in October but, following a large September increase, that still leaves the level of October sales 1.1% above its Q3 average. Housing activity also appears to be stabilizing, with housing starts jumping in November and housing permits falling modestly in October; new home prices have also stopped declining. Given the early signs of stabilization and amid a backdrop of falling interest rates, our outlook is for a moderate rebound in housing activity in 2025.

In contrast to the reasonably steady outlook for the household sector, the outlook for the corporate sector remains clouded. Business sentiment remains downbeat, as reflected in the BoC's Q3 Business Outlook Indicator, which at -2.31 remained in negative territory for the seventh quarter in a row. Canada's December services PMI fell to 48.2, slipping below the breakeven 50 level for the first time in three months, another sign of subdued sentiment. Declining corporate profits could also continue to act as a restraint on business fixed investment, which shrank by 3.6% quarter-over-quarter annualized in Q3. To the extent that an uncertain business environment leads to a slowing in employment growth, that could also act as another headwind to overall economic activity.



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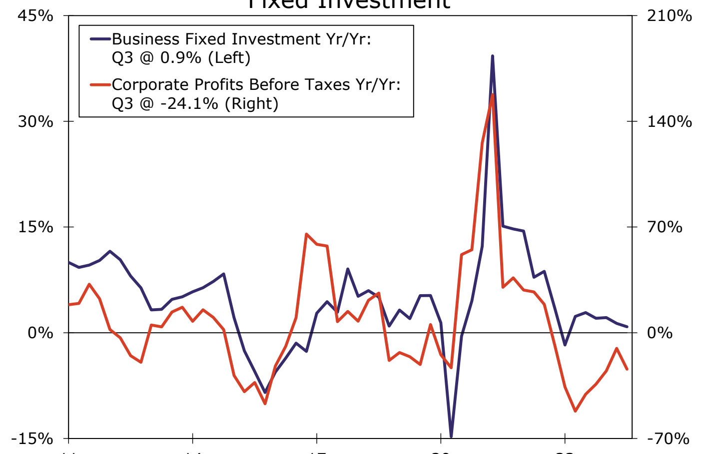

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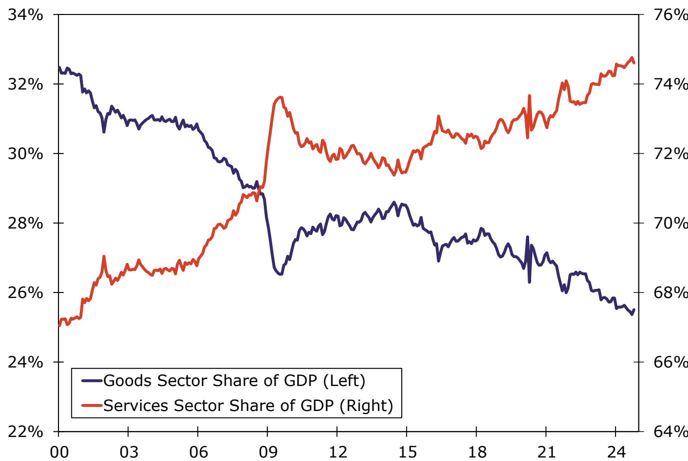
Tariff and Political Uncertainties Increasing

This rather mixed outlook takes shape, in our view, prior to even considering key risks to the Canadian economy, the most prominent of which is the threat of tariffs from the United States. During the U.S. election campaign, President-elect Trump proposed a 60% tariff on all imported goods from China, as well as an across-the-board 10% tariff on goods imported from all other countries. Separately and more recently, Trump floated a 25% tariff on imports from Canada and Mexico, citing concerns around the flow of illegal drugs and undocumented immigration into the United States. While we don't think all of these tariffs will go into effect, we doubt Canada will fully avoid tariffs either. For now, our working assumption is that around half of Trump's initially proposed tariffs will go into effect around the middle of 2025, which would equate to approximately a 5% tariff on imports from Canada from the middle of the year.



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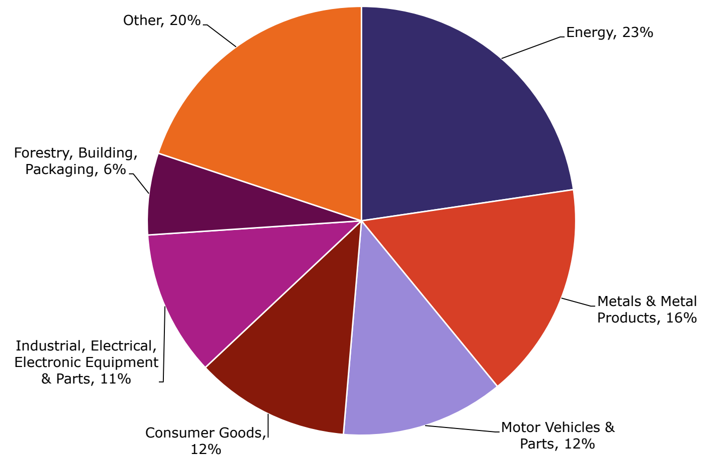

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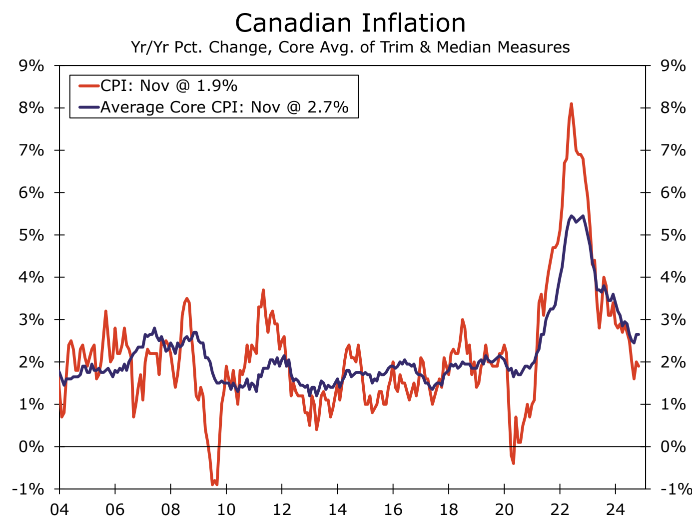
To some extent, the shifting composition of the Canadian economy since the turn of the century could mitigate the negative impact on Canadian growth. The goods sector currently accounts for 25% of the economy, down from around 32% in 2000. Over the same period, the service sector's share of the economy has risen to around 75%, from 67%.Even with this shift, however, Canada's exposure to the U.S. economy is still sizable, with around 76% of total merchandise exports destined for the United States. And perhaps except for energy—which accounts for around a quarter of Canada's merchandise exports—most other Canadian export categories appear to be candidates for the imposition of tariffs.

Should tariffs go into effect as we expect, the negative impact on exports and business investment would act as a potential further headwind to economic growth.

Finally, the Canadian political backdrop has also become more unsettled. In recent days, Prime Minister Justin Trudeau announced his resignation as leader of the Liberal Party, a development precipitated by events including the resignation of previous finance minister Chrystia Freeland. In this more unsettled environment, New Democratic Party leader Jagmeet Singh said his party would now support a vote of no-confidence in the government. Combined with similar support from the other main opposition parties, the Conservative Party and Bloc Quebecois, that would be enough for a no-confidence motion to succeed. Trudeau will remain in charge until a new Liberal Party leader (who will become Prime Minister) is selected, which will probably occur some time in March; however, an election is likely to take place shortly after. The main opposition party, the Conservative Party led by Pierre Poilievre, currently holds a huge lead in political opinion polls, which would also very likely translate into a majority government. Ultimately, recent developments could lead to a more stable government, and the Canadian dollar's reaction to the Trudeau resignation announcement was initially positive. That said, it's not clear to us that a new leader (or party) will be more effective in dealing with the tariff threat from the United States, and there will by necessity be a period of uncertainty during a transition to a new government. Overall, taking into account mixed economic trends, as well as tariff and political-related uncertainties, we see only a very modest rebound in Canada's economy this year. After estimated GDP growth of 1.3% in 2024, we expect GDP growth of just 1.7% in both 2025 and 2026, and moreover, we view risks as tilted to an even slower rebound in activity.

Contained Inflation Means Continued Bank of Canada Easing

Combined with our forecast for sub-trend economic growth, we believe contained overall inflation trends will allow the Bank of Canada to keep lowering policy interest rates at the next several meetings. With that said, we believe more steady 25 bps increments rather than the 50 bps moves seen at recent meetings are more likely. To be sure, Canadian inflation has ticked slightly higher in recent months. As of November, the headline CPI was running at 1.9% year-over-year, close to the central bank's 2% inflation target, while the average core CPI was running at 2.7%, moderately above the inflation target. Within the details, however, there were some favorable dynamics. As examples, November shelter inflation slowed to 4.6%, and broader services inflation also eased to 3.5%. Other indicators also point to a further moderation of domestically-oriented inflation pressures in the months ahead. In the latest labor market report for November, hourly wages for permanent employees slowed more than forecast to 3.9% year-over-year. And while not as current, the details from Canada's quarterly productivity and cost measures also point some moderation of labor cost pressures. For the latest data for Q3-2024, compensation per hour rose 3.2% year-over-year while unit labor costs rose 3.3% year-over-year. Overall, while wage growth is still somewhat elevated relative to productivity, it is clearly moderating, a slowing trend that should be reinforced by to ongoing rise in the unemployment rate and loosening of the labor market.



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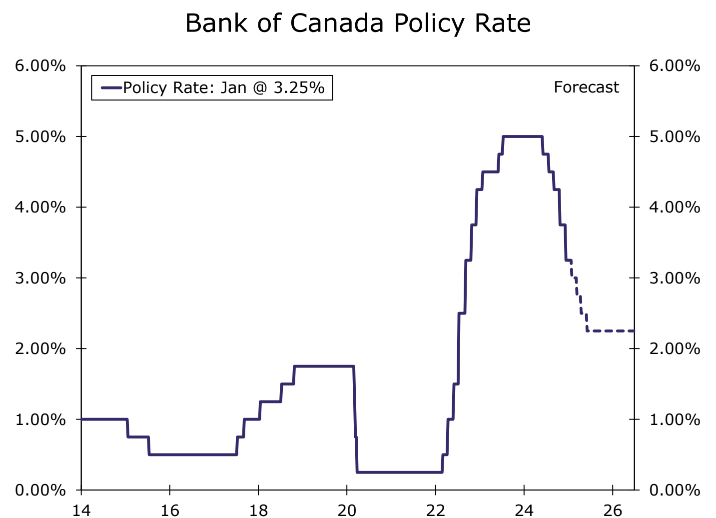

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Taken together, we believe sub-trend economic growth, along with a moderation in domestic inflation and wage trends, will provide the Bank of Canada with the motivation—and the comfort—to continue easing monetary policy in the months ahead. With the current policy rate of 3.25% now at the upper end of the 2.25% to 3.25% range viewed as “neutral” by central bank policymakers, monetary policy is no longer seen as being in clearly restrictive territory. As a result, we expect the BoC to revert to 25 bps rate cuts at the meetings ahead, following 50 bps reductions at the October and December announcements. Still, given sub-trend growth and well-behaved inflation we anticipate the policy rate being reduced to the lower end of that neutral range. Accordingly, we expect the Bank of Canada to lower its policy rate by 25 bps at its January, March, April and June meetings, which would see the policy rate reach 2.25% by the middle of this year. That forecast is slightly lower than the policy rate trough we previously forecast (2.50%) and also well below our forecast trough for the fed funds rate, to a range of 3.50%-3.75%. Sluggish Canadian growth, lower Canadian interest rates, and cautious Federal Reserve easing should in our view keep the Canadian dollar broadly on the defensive over time. We remain comfortable with our forecast for the USD/CAD exchange rate to reach CAD1.5000 by early 2026.

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