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Economics Group

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Solid Third Quarter Growth in Canada May Not Be Sustainable

The fastest quarterly growth rate in two years is due in part to a bounce-back in oil exports. Although 3.5 percent growth may not be sustainable, there are signs of bottoming in business investment.

More Than Just Post-Fire Bounce, But Not Sustainable Either

Canada's economy grew at an annualized rate of 3.5 percent in the third quarter, which was faster than expected. A bounce-back in exports after wildfires in Alberta temporarily disrupted oil production in the second quarter was a key factor and one that we had been expecting (See "*When the Smoke Clears*," Aug. 31, 2016). The net contribution to GDP growth from net exports was +2.7 percentage points.

It would, however, be an oversimplification to conclude that the strength in the third quarter was entirely a result of oil production coming back online. While it is true that growth in final domestic demand slowed, consumer spending grew at a 2.6 percent annualized rate, which was the fastest clip in a year.

Resumed oil production in Alberta was a welcome development, but the scars from decline in oil prices over the past two and a half years still have not healed. Business investment on machinery & equipment fell as did outlays for intellectual property products. Spending cuts were largest for mineral exploration and evaluation where new investment fell 26.3 percent (not annualized) in the third quarter.

Business investment in Canada has declined for eight consecutive quarters and while we do not anticipate a capex boom on the horizon, there are some signs of a bottoming in business spending cuts.

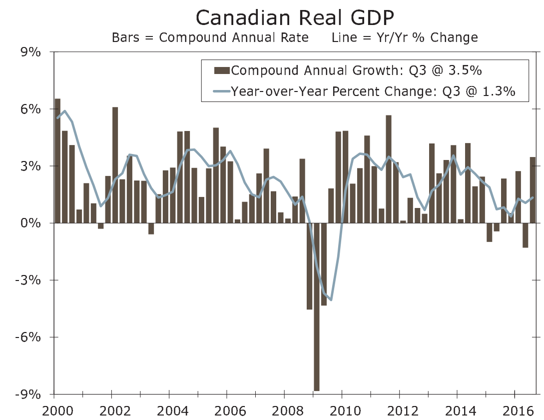
Inventory investment, after three consecutive quarterly declines, increased in the third quarter, resulting in a 1.0 percentage point boost to GDP. The Ivey PMI, a bellwether for manufacturing activity, has been in expansion territory for five straight months.

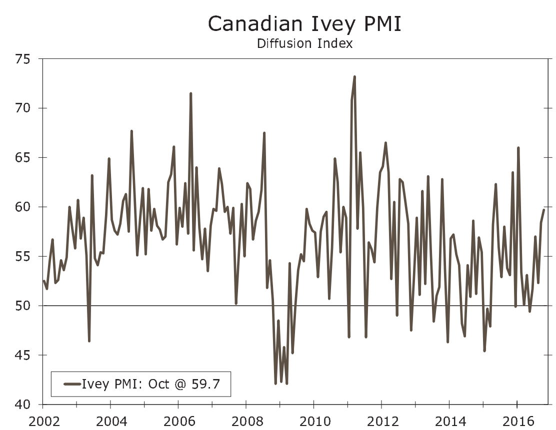
We do not expect that 3.5 percent is a sustainable rate of growth for the Canadian economy at present. An over-levered domestic consumer, pockets of frothiness in home prices, a lack of conviction in business spending and soft global growth are the main reasons why we are forecasting GDP growth of just under 2.0 percent for 2017 and 2018.

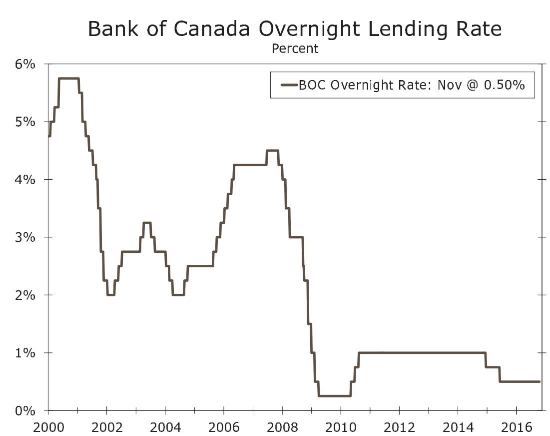
Implications for Monetary Policy

The Bank of Canada (BoC) maintains a somewhat brighter assessment for growth prospects, although in its October Monetary Policy Report the BoC dialed-back its forecast of GDP growth to 2.0 percent in 2017 and 2.1 percent in 2018.

Although the BoC has offered some mixed signals in terms of the future direction of policy, by its own estimate the output gap (the difference between actual GDP and potential GDP) has been negative since 2008. On that basis, we expect the BoC to remain on hold at least through the middle part of next year. With the Federal Reserve expected to raise rates between now and then, our currency strategy group expects continued downward pressure on the Canadian dollar.







Source: IHS Global Insight, Bloomberg LP and Wells Fargo Securities

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