ECONOMICS DIGEST

July 2016

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Canadian current trends update…

▲The April 2016 GDP rises 0.1% followed an unrevised 0.2% drop in March. The overall increase in April 2016 gross domestic product (GDP) was restrained by weakness in non-conventional oil extraction, which dropped by 7.3% in the month.

▲June employment inched down by 700 while 20,900 left the labour force; unemployment rate slips to 6.8%

▲Nominal retail sales rose 0.9% in April, slightly above expectations for a 0.8% .

▲Housing starts jumped to 218K in June, above market expectations for a 190K reading.

▲The trade deficit in May held steady at $3.3B and was higher than the $2.7B expected going into the release. The April deficit was revised up from the previously-reported $2.9B.

▲With the seasonal pressures not quite matching what occurred a year ago, the overall and core year-over-year CPI rates moderated to 1.5% and 2.1%, respectively.

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Financial markets…

Hurry up and wait

Investors awoke Friday, June 24 to news that the UK voted to leave the European Union (EU). As market grappled with what this will mean for the world economy, stock markets dropped, the US dollar popped, and bond yields reached toward record lows. To be sure, uncertainty generated by the UK's decision will have implications for the global economy, and we have revised our forecasts for growth and central bank action in the major markets that we monitor. In the UK, we now expect the Bank of England (BoE) to implement both interest rate cuts and expand its quantitative easing program. We also expect the Reserve Bank of Australia (RBA) to ease by more than we previously anticipated, and our forecasts for rate increases in both Canada and the US have been pushed further into the future. Presently, we expect the European Central Bank (ECB) to stay the course and continue to implement it aggressive easing strategy.

Uncertainty about the global outlook in the wake of the UK decision resulted in a sharp increase in risk aversion. The world stock market index gapped downward by 7% in the first two trading days after the referendum; although by the third day, a recovery in stock markets began. Volatility, as measured by the VIX, surged immediately after the decision but calmed as markets factored in the reality that the UK's exit will be a long process. Markets will be on heightened alert for information about the exit process and sentiment in other member countries regarding any intention to leave the EU. Government bond yields will likely remain under downward pressure in the near term, and given the lower starting point, even when the uncertainty eases and rates begin to rise, we look for considerably lower yields at the end of 2017 than in our previous forecast.

Canada's economy in for a bumpy ride

The focus of the risk facing Canada's economy shifted once the Brexit vote was announced; however, the underlying weights on growth remain in place—the cut to oil production due to the Alberta wildfires and commensurate decline in real GDP in the second quarter. That said, the rise in financial market volatility, steep decline in equity prices, and weakening oil prices led us to revise our forecast for the rebound in activity in the third quarter to 3.6% from 4.0%. The rebound in large part reflects the recovery in oil production and rebuilding in the areas affected. We also revised lower our forecasts for growth in the following quarters such that real GDP is now expected to rise to 1.3% (from 1.4%) in 2016 and 2017 growth is pegged at 1.8%, which is down from 2.0%. Similar to our US forecast, we expect the weaker showing next year to be most evident in business investment, which we project will rise by a tepid 1.8% following two years of massive cutbacks.

How low can you go?

The rout in financial markets shaved 3.2% off Canadian stocks during a two-day period and saw investors make a mad dash for government bonds. The yield on the 10-year bond dropped 22 basis points and was within 10 basis points of its all-time low. The futures market priced in a 20% chance that the BoC will ease policy before the year is finished. We think the market is overpricing the risk of a rate cut and view the mild downward revisions to our growth forecast as adequate accommodation of the downside risk to Canadian growth from this European economic event. That said, uncertainty about the global economy will continue to provide the Bank a reason to maintain its very accommodative policy stance. We now assume no rate change will occur until 2018. Even with the economy projected to grow at a stronger pace in the third and fourth quarters, 2016 will mark another year of sub-potential expansion, thereby doing little to reduce the amount of spare capacity. Despite this, the headline inflation is likely to reach the Bank's 2% target in 2017 as energy prices recover and import prices rise due to the weak Canadian dollar.

Bank of Canada holds steady amid "uneven" rotation in growth

Canada's housing market continues to garner significant attention with home sales on track for a record year and prices rising at a double-digit pace on a national basis. The national aggregates belie diverging regional trends, with Toronto and Vancouver markets extremely hot, cities in oil-producing provinces under downward pressure, while balanced conditions in the majority of the remaining markets underpin activity. Affordability, consequently, is markedly divided, and this condition is likely to persist. In the hottest markets, Toronto and Vancouver, demand for homes will likely remain very strong, helped along by the low level of interest rates. With both these markets facing limited supply and firm demand, we forecast prices to continue to rise rapidly, especially for single-family detached dwellings. Conversely, low rates and balanced conditions in the majority of other markets will keep affordability manageable by stoking sales activity in the second half of 2016.

In the Financial System Review, the Bank of Canada noted an increased vulnerability to the financial system given the heightened housing market activity and commensurate rise in household debt. Government policies aimed at addressing these risks are underway with the Finance Minister pledging to conduct a "deep dive" into conditions in the housing market to determine what, if any, policies should be implemented to reduce the risks associated with the elevated levels of debt on household balance sheets further.

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Special reports…

Home resales in Canada (finally!) slow down in May… but not prices

• The long-awaited cooling of Canada's housing market may be finally at hand. Home resale activity eased for the first time in five months in May 2016. The Canadian Real Estate Association (CREA) reported this morning that resales in Canada fell 2.8% in May to 544,500 units (seasonally adjusted and annualized) from April's all-time high of 560,300 units. Resales were still up solidly by 9.6% compared to a year ago.

• The encouraging news was that some of Canada's hottest markets led the decline. While the majority of local markets experienced a slowdown in May, the bulk of the monthly decline occurred British Columbia (down 4.9% from April) and Ontario (down 2.4%). Home resales fell for a third-consecutive month by 4.8% in the Vancouver area and by 7.7% in the Fraser Valley. Activity was little changed in the Toronto area (up by 0.4%) but fell in many other local markets in Ontario including Ottawa, Windsor and London.

• Activity improved slightly for a fourth-straight month in Calgary (with resales rising 1.6% from April); yet, it remained markedly weaker (down 11.3%) than it was a year ago.

• Elsewhere across the country, a number of markets recorded sizable monthly declines, including Halifax (-7.2%), Saskatoon (-6.7%) and Winnipeg (-3.8%). Regina (up 2.5%) and Montreal (up 1.2%) were among the few exceptions registering increases.

• The supply side continued to contract with new listings falling 3.2% in Canada, which reflected further widespread declines across local markets (including in Toronto, the Fraser Valley, Montreal, Calgary and Edmonton). New listings rose slightly for the second consecutive month in the Vancouver area.

• Despite the slowing in resales, home prices continued to rise strongly in Canada in May. The composite MLS Home Price Index (HPI) in fact further accelerated to an annual rate of 12.5% from 10.3% in April and 5.3% in May 2015. Of particular concern are the parabolic trajectories in Greater Vancouver and the Fraser Valley where the annual rate of increase in the MLS HPI has reached 29.7% and 31.7%, respectively. The Toronto area also showed an acceleration in the rate to 15.0% in May from 10.7% at the start of this year.

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Special reports…

Canada and U.S. June 2016 Auto Sales

Canada New Motor Vehicle Sales

Canadian auto sales bounced back in June after slipping to a lower (albeit still elevated) pace in May. Sales were up 7.4% in the month from a year ago according to industry reports. Our estimates suggest that total vehicle sales (including heavy vehicles) on a seasonally adjusted annualized basis rose to a 1.97 million unit pace in June after falling to a 1.92 million unit rate in May. That earlier reading marked the slowest sales pace of the year so far but was nonetheless only modestly below the record-setting 1.94 million average sales rate in 2015. Year-to-date sales have averaged 2.00 million units per month in 2016. We continue to expect that pace over the first half of the year is too strong to be sustained; however, the moderation we expect going forward is limited by the ongoing resilience in labour markets to weakness in the oil & gas sector and the persistence of low interest rates which now look likely to be lower for longer given uncertainty surrounding the fallout of the UK 'Brexit' vote in June. Our forecast assumes sales in 2016 will total 1.96 million units to outpace last year's total and mark a fourth consecutive annual sales record.

U.S. Light Vehicle Sales

In the U.S., light vehicle sales dropped more-than-expected in June, falling to a 16.6 million unit seasonally adjusted annualized rate (according to U.S. Bureau of Economic Analysis) from a 17.4 million reading in May. The June result pulled the year-to-date average down to 17.1 million units, marking a slight slowing relative to the record 17.4 million units solid in 2015 as a whole. Employment growth has softened in recent months; however, offsetting growth in wages has left household incomes still growing at a respectable rate and interest rates are still historically low. Indeed, the softening in auto sales has been somewhat at odds with overall consumer expenditures which, based on data to-date through May, are on track to rise at an average 2.8% pace per-quarter over the first half of the year which would mark the fastest first-half gain since 2006. We expect the underlying pace of employment growth will remain slower than the average 200K-plus increases in 2015 and 2014 but reflecting supply factors (shrinking labour market slack and slow growth in the working age population) rather than demand issues that implies offsetting growth in wages. On balance, we expect the household income backdrop will remain solid which alongside historically low interest rates will prompt higher vehicle sales going forward. We look for auto sales to total 17.5 million units in 2016 as a whole to modestly exceed last year's total.

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