

# Canada: GDP - downside surprise

Net trade and housing drag. GFCF provides some light.

**GDP for the month of September unexpectedly declined by 0.1%*m/m* vs the street median at 0.1%*m/m*. Q3 GDP came in at 1.0%*q/q* ann. which disappointed street expectations at 1.5% and our own forecast at 1.3%. At the core, net trade and housing were the key drags on growth. On the upside, business investment continues to accelerate at a robust clip suggesting that the overall sentiment amongst the economic actors is better than that expressed by the disappointing headline number. And an upward revision to the Q2 GDP (2.0% to 2.3%) is welcome.**

## Facts.

For September's GDP the biggest surprise came in the financial services sector (the largest category in the GDP report) which at -0.0% disappointed our expectations looking for a significant contribution to growth from this category in keeping with industry data out of the real estate sector pointing to a pick up in activity in the home resale market. Without the offset of a significant pick up in financial services, softness in the goods producing sectors (-0.7%*m/m*) dragged monthly GDP into negative territory.

Quarterly GDP is quite a mix of factors and contributors to change. The inventory cycle continues to chug along, providing a net positive contribution to GDP. So too has business investment (GFCF) stepped to the fore, rising by 4.6%*q/q* led by a 6.5%*q/q* rise in investment in machinery and equipment. This is the second back to back rise in business investment of significance that has been unrelated to investment in residential structures and an important component of the recovery process.

Personal consumption is running at 0.9%*q/q*, ahead of overall GDP growth and better than the 0.6%*q/q* seen in the second quarter, seemingly unaffected by changes in BoC rate policy. Of course just as the Bank of Canada began to cycle rates higher, term rates (5-year) in Canada came cascading lower.

On the down side, net trade continues to be the single largest drag on GDP with exports declining by -1.3%*q/q* while imports were up 1.6%*q/q*. So too was the third quarter GDP hindered by a -1.3%*q/q* decline in investment in residential construction as the new build housing market settles back from elevated levels of activity established in the first half of 2010. Recall that in Q4/09 and Q1/10 investment in residential structures averaged slightly better than 5.0%*q/q*.

## Implications.

GDP at 1.0%*q/q* ann. is well back of the BoC forecast for 1.6% made back in October. Yet there is reason to believe that the BoC need not be overly fussed by the disappointment associated with the headline. First and foremost, business investment is growing rapidly. In this the BoC can take some comfort as fiscal stimulus begins to wind down that business investment is coming to the fore.

The down side is that with business investment come imports. Canada does not tend to manufacture capital equipment but rather import it from other jurisdictions aggravating the picture on net trade. That exports declined in Q3/10 is troublesome although understandable in the context of the uneven economic recovery playing out in the US. Canada remains attached at the hip to the US economy as the destination of more than 70% of total Canadian exports. In the absence of a significant pick up

in economic activity in the US, there is unlikely to be a significant pick up in export activity out of Canada outside of a major realignment of Canadian trade patterns. And there is little that Canadian monetary policy can do about that in the near term.

Of course the question on the tip of our tongue is whether or not for Canada, the cycling up of the inventory restocking phase and rapid growth in business investment is capable of sponsoring the broader self sustaining economic recovery that has remained illusive for many of the other developed world economies.

While net trade will improve, it will continue to negatively tug at headline GDP throughout much of 2011. And although Canada experienced a massive pickup in employment growth in the first half of 2010, there has since been an uncomfortable stagnation in the jobs picture in the second half. And what of the consumer? A heavy debt load at the household level is worrying. Following a brief hiatus in Q2/10, total household credit to disposable income is once again on the move rising to 147.3% in Q3/10 up from 143% in Q2, creating what by appearances is an unsustainable trajectory. A trajectory that may very well drag the Bank of Canada back off the sidelines in 2011 in an attempt to moderate consumer behavior (borrow and spend) with higher interest rates.

Against this economic backdrop, both domestic and globally, it remains difficult to envision a scenario in which Canada necessarily experiences robust levels of economic growth going forward. Rather, while having avoided much of the nastiness associated with financial/banking/sovereign crisis, Canada is none-the-less a by product of its developed world environment via its attachment to the US economy. Yes the story can be tweaked higher, but as a small open economy (better than a third of the economy is trade of which more than 70% is reliant upon US markets as a destination) it is going to be difficult for Canada to chart a vastly different course than its peers in the G7.

Bottom line.

While the headline GDP number was disappointing there are encouraging signs (growth in business investment) that suggest the picture on Canada may not be quite as dire as that suggested by this mornings headline number. Looking ahead into the next couple of quarters, our expectation is for the drag associated with net trade to begin moderating as increases in imports crest and begin settling in a lower levels of growth. Data out of the housing market suggest that following a summer lull that saw activity fall off rather materially, that once again activity is picking up, albeit, too late to resurrect September GDP, but none-the-less expected to make a positive impression on fourth quarter GDP. All of which will contribute to a growth profile that while positive, will remain incremental in nature in keeping with the prevailing economic environment.

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