Canada: July GDP contracts by 0.1%

In line with Street expectations.

The July reading on GDP is in line with Street expectations. Much of the surprise was mitigated by comments made yesterday to the media by Finance Minister Flaherty, who noted that the July GDP report could be negative. We had been looking for a slightly better outcome (0.0%). Still, today's outcome is in line with our view that the Canadian economy has moved beyond the first blush of economic recovery and is entering into a growth cycle that will be characterized by incremental increases in output only.

Going into today's number set, markets had been well prepped for a soft report given that the bulk of the data that had been collected to date had pointed to just such an outcome. That said, the market may focus on what could be seen as the transitory impact associated with the onset of a harmonized sale tax (HST) in both Ontario and BC, which negatively impacted the existing home resale market. Industry data pointed to a 6.8%m/m decline in home resale activity, which resonated with an 8.0% decline in real estate agent and broker output. Yet, expectations continue to be that activity in the Canadian housing market is in the process of cooling down after a frenetic level of activity over the past year, which is expected to have cannibalized future sales, a slowdown encouraged by a less-than-certain economic outlook and the onset of what is expected to be a more discerning consumer.

From a policy standpoint, today's report is expected to underscore the uncertainty associated with the economic recovery in Canada on the back of an uneven economic recovery in the US. It should also point to a Canadian economy that continues to underperform the BoC forecasts laid out in the 22 July Monetary Policy Report (MPR). The BoC's base case is set to be revised in October, and we expect to see some downward revisions to its near-term economic forecasts.

As laid out in HSBC's quarterly publication, Emerging elation, Western stagnation, HSBC is looking for the BoC to pause the rate cycle in October. Today's GDP report remains broadly in line with our thesis that looks for the Canadian economy to pull closer to trend growth at 2% as we head into 2011, away from the robust burst of activity that characterized the first half of 2010. Market resolve with respect to the potential for a 19 October rate hike has eroded since the BoC raised rates at its 8 September meeting. Current readings on bank date to bank date OIS are suggesting a 30% probability of a 25bp rate hike at the next meeting.

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Issuer of report: HSBC Securities (Canada) Inc.

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2 All market data included in this report are dated as at close 30 September 2010, unless otherwise indicated in the report.

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