

Canada GDP (Q4) an Olympic Silver.

Loonie or a Phoenix? Q4 GDP up 5.0%q/q besting most expectations.

What a difference a year makes. Going into the final quarter of 2008, the Canadian economy was busy downsizing itself at a rate of -3.7%q/q ann. And while the economy entered 2009 like a lamb, it is exiting like an Olympic champion.

Overall, the economy grew in Q4/09 at 5.0%q/q ann best most but the most optimistic forecasts. The market median had been looking for a healthy 4.2%q/q rate of growth and our own slightly more conservative 4.1%. The Bank of Canada's forecast for a 3.3%q/q rise in activity certainly looks conservative by contrast. Yet to be fair, at the outset of the fourth quarter, the BoC forecast at the time was looking downright optimistic given the economy's remarkable ability to disappoint in the early quarters of 2009.

To be certain, Q3/09 which was being billed as the quarter from which the Canadian economy would launch into economic recovery, instead fizzled on the launch pad with an originally reported rate of growth at 0.4%q/q ann. Even with a decent upward revision in the current quarter to 0.9%q/q ann., the report failed to live up to original expectations. On that basis, the upside on today's numbers is all the more impressive. Q4 is essentially the payback for Q3.

While we cheer the greater than expected upside growth on GDP, there are still some notes of caution. We would point to a still heavy reliance upon consumer spending for a good slug of growth. This has been the case through out much of the 2009 recovery whereby the consumer, boosted by cheap money, has provided a decent slug of the GDP growth thereby helping to offset weakness in business investment and particularly a collapse in external demand. In Q3 and Q4/09, the consumer was seen to have contributed 2.3ppt to GDP in each of the quarters. So too would we point to government spending which added 1.2ppt to GDP - a feature the can be expected to continue through 2010 on into 2011.

In order for Canada to embark upon a sustainable path of economic recovery, going forward, we will need see an increasingly leveraged consumer (total household debt to disposable income is running about 142% - a historical high) hand off the economic football on over to growing business and external demand. So too do we know that at some point the contribution to growth coming out of government spending needs to transition from largesse on over to fiscal austerity.

On the upside, some work is being done on that front which suggests we are indeed seeing the laying down of a sustainable economic recovery. It is interesting to note that inventory adjustments continued to detract from overall GDP (-0.9ppt) as businesses destocked in Q4. At some point it can be expected that favorable changes in inventory disposition will start contributing significantly to GDP growth. For now, the 5% growth rate is not a function of changes to inventories as was the case in the US GDP data that saw a large chunk (3.88ppt) of GDP growth related to the transitory effects associated with inventory restocking.

As well, for Canada, the picture on external demand is beginning to give off some favorable notes. In the fourth quarter, net trade actually contributed 1.3%ppt to GDP growth. Trade (external demand) has been an albatross around the neck of the Canadian economy. Lifting this weight off of the neck of the Canadian economy is a large step forward. Indeed, what we learn from today's numbers is that Canada is participating in the global economic recovery - an element that was less than certain in Q3 when net trade was a significant drag on growth.

Net, net, a good finish to 2009 with the economy beginning to hit on the numbers it needs too. Yes the economy appears to be still overly reliant upon consumer spending, but in Q4, the economy is throwing off the signs that it is beginning to transition on over to a more balanced growth profile.

On a monthly basis, in December the economy grew by a greater than expected 0.6% m/m, well ahead of the median at 0.4% m/m and our own forecast looking for 0.44% m/m. The bulk of the upside surprise came out of the goods producing sectors that grew by 1.0% m/m, besting our own forecast for 0.7% m/m. Much of the upside was provided by the mining/oil/gas sectors (+1.6% m/m vs. our forecast for 1.1% m/m) and the utilities (+1.6% m/m vs. our forecast for 0.8% m/m). All sectors save for agriculture and forestry saw decent gains. As the goods sector bore the brunt of economic recession, so too would one expect to see the bulk of the upside surprise to emanate out of these areas.

Service sectors also outperformed expectations rising by 0.43% m/m, besting our forecast for an increase of 0.33% m/m. Wholesale and retail trade both coming in stronger than expected, with associated benefits for the transportation and warehousing sectors. So too did accommodation and food services categories accelerate beyond expectations.

Overall, a couple of upside surprises in the monthly numbers here but generally most of the report played ball with the forecasts.

For the Bank of Canada, while the growth expectations largely outpaced their forecasts on GDP, we still don't believe that the Bank need change its disposition at tomorrow's scheduled rate meeting. The economy is transitioning. Transitioning well in some cases but suffice to say, a good slug of growth remains reliant upon the consumer and government spending (of which the two account for 3.6ppt of the overall 5.0ppt of growth).

However, the significant upside to today's report vs the BoC forecasts, does place increasing weight on what the productivity numbers look like. If there is a commensurate rise in productivity in keeping with the rise in GDP, which would presuppose upward revisions to BoC expectations for potential output growth, then there is not necessarily much to fear from a Canadian economy running into capacity constraints ahead of BoC forecasts.

Still, rising rates of productivity growth would be a significant departure from the past. The onset of the new millennium failed to bring with it new found productivity paradigms for the Canadian economy. Instead, from a productivity standpoint, the last decade has been a lost decade for the Canadian economy that seemed more intent on working harder rather than smarter.

For tomorrow, the BoC's survey data to date has continued to support the BoC pledge to hold rates at 0.25% through to the end of Q2/10. Inflation expectations remain firmly anchored around the BoC's 2% target rate. So too do the responses on capacity constraints continue to suggest that there is ample excess capacity in the Canadian economy so as not to threaten any near term inflation related to bottlenecks in the economy. Still, concern at the BoC will arise if it is the case that the economy fails to generate significant productivity growth. In the absence of any material increases in productivity, it would suggest that the output gap which the BoC estimates at 3.25%, may very well close well ahead of its estimates suggesting the third quarter of 2011 if the economy continues to throw off growth numbers in keeping with the fourth quarter. In turn, this would apply pressure on BoC rate policy and suggest that it need be more aggressive on rates than has largely been reflected in market pricing.

From a monetary policy standpoint, we haven't got to the medal round yet. For the economy, Canada takes the silver. The gold goes to the American's with their 5.9% jump in Q4 GDP. The quality of the win is suspect given the contribution provided by inventory correction. But for today, for Canada, it really just comes down to who owns the game of hockey.

Disclosure appendix

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