Canada 'back to reality' as economy contracts

By David Parkinson

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Canada's economy took a surprise step backward in August, the latest and strongest evidence yet that the growth surge of the first half of the year has given way to a much more stunted second half.

Statistics Canada reported Tuesday that real gross domestic product fell 0.1 per cent in August from July on a seasonally adjusted basis, the first decline in 10 months. The reading disappointed economists, who had estimated that the economy had eked out modest growth of 0.1 per cent in the month.

The dip comes on the heels a July GDP report that showed essentially no change. Taken together, the two months paint a picture of an economy catching its breath after a blistering few months of growth. GDP expanded at a 4.5-per-cent annualized rate in the second quarter, the strongest quarter in nearly six years.

"The two-month lull in activity pounds home the point that the frothy growth of the past year is over and done," Douglas Porter, chief economist at Bank of Montreal, said in a research note. "The run of amazing Canadian economic data is officially over, with growth coming back to reality in hurry."

But even though the weak August result suggests that growth was something less than 2 per cent annualized in the third quarter, economists believe that economic expansion remains on track in the second half of the year, albeit at a more moderate pace.

"One should be careful in not getting too gloomy on Canada's softened growth in the third quarter," said Bank of Nova Scotia economist Derek Holt, who estimated third-quarter growth at just 1.5 per cent annualized in light of the August decline. "After 4.5-per-cent growth in the second quarter … what did you expect?"

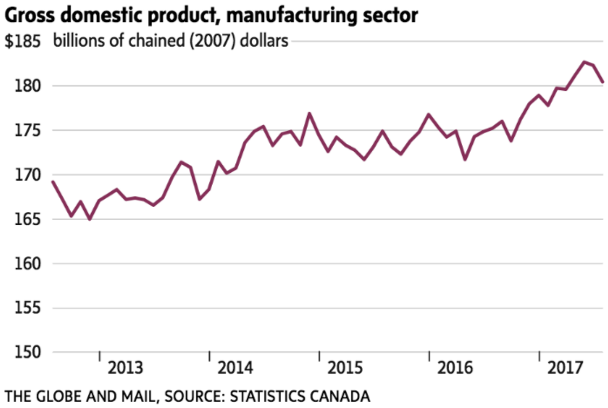
Economists also noted that the August setback wasn't reflective of a broad-based slowdown, as 12 of 20 major industry sectors showed growth in the month. The overall result was weighed down largely by declines in manufacturing and in oil and gas extraction, both of which were slowed by temporary maintenance shutdowns.

"With much of the third-quarter weakness seemingly down to temporary factors, and growth still tracking above potential, there is no reason for Canadians to worry," Brian DePratto, senior economist at Toronto-Dominion Bank, said in a research report.

The goods-producing side of the economy contracted 0.7 per cent, its second straight setback. Goods output was weighed down by a 5.2-per-cent slump in conventional oil and gas and a 7.3-per-cent plunge in chemical manufacturing, the sharpest single-month drop in 20 years. Both sectors were slowed considerably by maintenance shutdowns.

But the larger services side of the economy grew 0.1 per cent, its 17th straight month of expansion. The gain was led by the wholesale sector, up 0.4 per cent, while the real estate and finance-and-insurance sectors each grew 0.2 per cent. But retailing fell 0.4 per cent, its second straight decline following several months of strong growth.

Economists still believe that the economy will likely grow at something near a 2-per-cent pace in the second half of the year, with growth expected to pick up somewhat in the fourth quarter after the third-quarter lull. Last week, the Bank of Canada estimated a third-quarter growth rate of 1.8 per cent annualized, accelerating to 2.5 per cent in the final quarter of the year.



Still, the August GDP report's confirmation of a relatively sluggish third quarter should support the Bank of Canada's recent cautious stance on further interest-rate increases, following its two rate hikes in July and September.

"The moderation of growth and still-mild inflation will be welcome by a Bank of Canada intent in delaying interest-rate hikes for as long as possible," National Bank of Canada senior economist Krishen Rangasamy said in a research note.

Indeed, most economists don't expect another rate increase until January at the earliest, and possibly not until next spring, as the central bank weighs the slower growth pace, still-below-target inflation, and the emergence of risks to growth in 2018 from new mortgage regulations and the uncertain North American free-trade agreement negotiations.

"My bias [is] that the BoC is on a prolonged hold, and more so because of question marks hanging over the 2018 economy than a [third] quarter it can't do anything about anyway," Bank of Nova Scotia's Mr. Holt said. "Only time will help to inform those risks."