Canada's economy slows; December rate hike seen as unlikely, January a 'close call'

By David Parkinson

November 30, 2018 – *The Globe and Mail*

Canada's economy posted slightly slower yet still-solid growth in the third quarter, but a sluggish end to the quarter and a drop-off in business investment added a note of caution to the near-term growth outlook.

Statistics Canada reported on Friday that real gross domestic product grew 2 per cent on an annualized basis in the three months ended Sept. 30, down from the second quarter's brisk 2.9-per-cent pace. The result was in line with expectation of economists, who had felt the second quarter's strong result was unsustainable, and had seen evidence during the quarter of moderation in Canada's exports and in housing and consumer spending, which are feeling the effects of rising interest rates.

The growth was fuelled significantly by declining import volumes, which boosted net trade. Household consumption and government spending also contributed to growth in the quarter, although both slowed from the previous quarter's pace.

But the quarter ended on a negative note, as month-over-month figures showed that GDP fell 0.1 per cent in September, its first decline in eight months – an indication that the economy lost momentum entering the final quarter of the year.

"The headline may have matched expectations, but the details definitely disappointed," said Toronto-Dominion Bank senior economist Brian DePratto in a research note. "It is hardly an encouraging sign when the bulk of your growth comes from a contraction of imports."

Perhaps more worrisome was an unexpected drop in the third quarter in business investment, which has been one of the key drivers of Canada's economic growth this year. Business spending on facilities, machinery and equipment slumped 7.1 per cent annualized, its first quarter-to-quarter decline in nearly two years. Statscan said the key driver was a drop in spending in the oil and gas sector, which has been battered by falling prices for Canadian crude in the second half of this year.

Economists noted that the third quarter was a highly uncertain time for the business community, as the tense negotiations for a new North American trade agreement came to a head during the quarter. Nevertheless, they said decline in investment was at odds with the Bank of Canada's quarterly business outlook survey, conducted from late August to mid-September – before the new United States-Mexico-Canada Agreement was concluded – which indicated rising investment intentions among businesses, amid growing needs for new capacity.

Bank of Nova Scotia economist Derek Holt suggested the business investment lull may be short-lived, and may merely reflect a pause after a surge in spending late last year and earlier this year. He noted that with the USMCA trade pact resolved and with the federal government's new incentives for investment in its recent fall budget update, some key competitiveness questions weighing on investment have been resolved – at a time when many companies need new capacity.

"For several of these reasons, one might expect an investment acceleration going forward," Mr. Holt said.

Growth in household final consumption expenditures, while still positive, slowed to 1.2 per cent annualized in the quarter – barely half of the second-quarter pace, and the slowest growth since the first quarter of 2016. The slowdown was led by declining durable-goods spending, especially on new automobiles.

“[Interest] rate hikes and mortgage regulations are having their intended impacts in slowing credit-fuelled activity,” said Canadian Imperial Bank of Commerce chief economist Avery Shenfeld in a research report. He noted that in addition to the cooling pace of consumer spending, housing investment declined for the third straight quarter.

With the Bank of Canada’s three interest-rate increases this year showing evidence of tapping the economic brakes, economists are now wondering whether the central bank will slow its pace of rate hikes, amid growing expectations that fourth-quarter growth could be considerably slower than the bank’s forecast of 2.3 per cent.

“The details in today’s [GDP] report are indicative of growth likely slowing further in the fourth quarter, [to] closer to a 1-per-cent rate,” said Paul Ferley, assistant chief economist at Royal Bank of Canada, in a research note. “The slump in oil prices could weigh on activity as well,” he added.

The central bank’s governing council meets next week to make its next rate decision, with the financial markets pricing in only about a 20-per-cent chance that the bank will raise its benchmark rate from its current level of 1.75 per cent. A few weeks ago, the markets saw a quarter-percentage-point hike at the following rate-setting meeting, in January, as a near-lock, but those expectations have been declining as mixed economic data have rolled in and the oil slump has deepened. After Friday’s GDP news, the odds are down to about 60 per cent.

“Today’s [GDP] details reinforce the message that [a January hike] is still a close call, and may well require a marked improvement in oil prices to get there,” said Bank of Montreal chief economist Douglas Porter.