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Economics Group

Special Commentary

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Trade and Housing Weigh on Growth in Canada in Q1

Policymakers at the Bank of Canada (BoC) have long anticipated a pivot to business investment and exports as drivers of Canadian growth. However, this shift remained elusive in the first quarter, as real GDP growth slowed to a 1.3 percent annualized pace from 1.7 percent in Q4 (Figure 1). To be fair, exports did increase during the period, but imports grew more; the result was a drag of more than a full percentage point on headline growth. Higher oil prices in recent months helped boost petroleum exports 9.9 percent (Figure 2). However, growth in non-petroleum exports came in softer. Ongoing concerns about steel tariffs and potential NAFTA changes weigh on the outlook for exports this year.

Real GDP growth slowed to a 1.3 percent annualized pace from 1.7 percent in Q4.

Also contributing to the weaker first quarter print was a slowdown in household spending, which rose at only a 1.1 percent pace—the slowest in three years. Consumption of services rose a solid 2.1 percent on an annualized basis, but goods consumption was essentially flat after increasing for the previous 11 consecutive quarters.

Highlighting our ongoing concerns about the outsized role of residential investment as a share of economic activity, housing investment declined at a 7.2 percent annualized pace, subtracting 0.5 percentage points off headline GDP growth. New mortgage stress measures introduced in January likely contributed to lower resale activity. An analysis by the Bank of Canada indicated that about 10 percent of Canadians who received an uninsured mortgage between 2016 and mid-2017 would not have qualified under the new rules.[1]

Figure 1

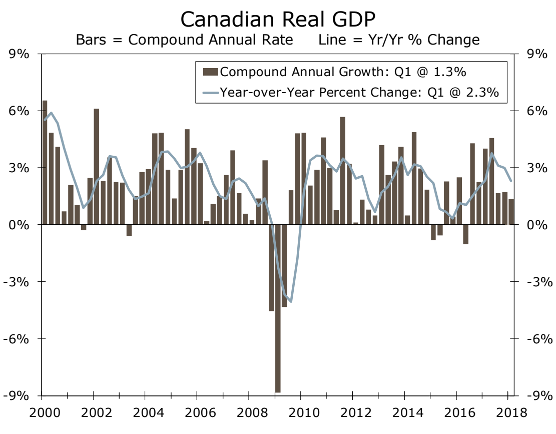
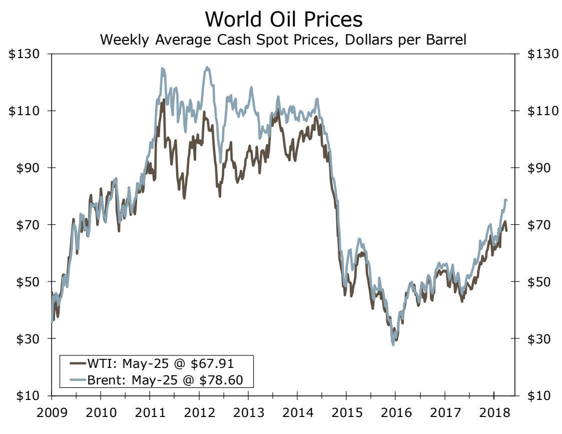


Figure 2



Source: IHS Data Insight and Wells Fargo Securities

For 2017 as a whole, Canadian GDP advanced 3.0 percent, the best year since 2011. However, growth slowed in the second half of 2017 and has now decelerated further to start 2018. We do not expect for this trend to continue. While we have not abandoned our concerns about household debt

[1] **Bank of Canada. "Financial System Review: November 2017."**

Together we'll go far

or the housing market, we expect GDP growth to pick up as the year progresses, enough even for continued normalization of monetary policy.

Positive Outlook from Bank of Canada

The BoC kept the overnight rate at 1.25 percent at its policy meeting yesterday, but expressed a positive outlook for the economy in the press release that accompanied the decision. The BoC remarked that first quarter economic activity "appears to have been a little stronger than expected," and cited more robust exports of goods, solid labor income growth and recovering investment as evidence for improving conditions.

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The May 30 statement from the BoC adopted a moderately more hawkish stance, and potentially signals a faster pace of rate hikes ahead than previously anticipated. However, long-standing concerns about high levels of household debt and unsustainable levels of residential investment remain at play. The household debt service ratio was flat in Q1, but has been increasing consistently due to a combination rising household debt, which now sits among the highest levels in the OECD, and higher interest rates.

Figure 3

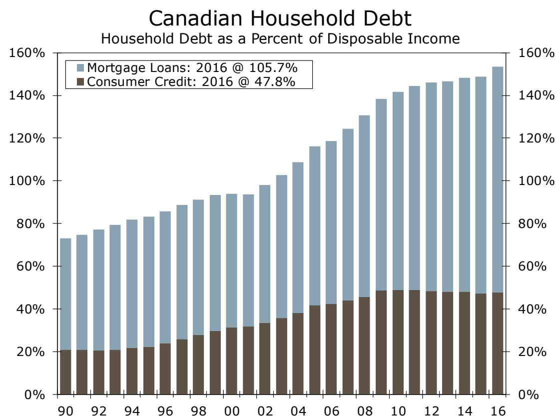
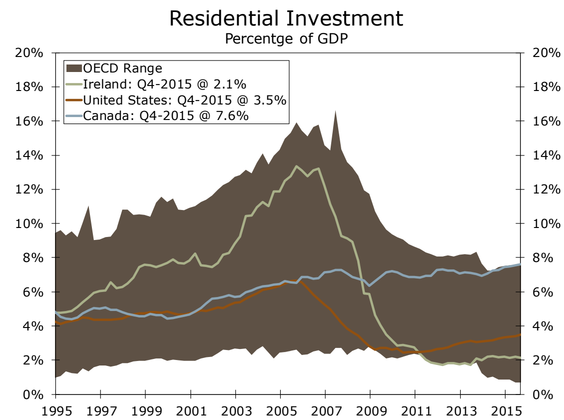


Figure 4



Source: IHS Data Insight, OECD and Wells Fargo Securities

Also high relative to other OECD economies is residential investment as a share of the economy. As Figure 4 shows, residential investment currently comprises a larger share of economic activity in Canada than it does in any other large advanced economy. The 7.2 percent decline in residential investment in the first quarter shows how some retrenchment in this key sector can weigh on growth; it sliced 0.5 percentage points off the headline GDP number for the first quarter. A 3.1 percent uptick in building permits for March suggests a reprieve from the slowdown in coming months. These high-frequency indicators of the housing market take on additional significance this year as we watch how trends in housing can influence the broader Canadian economy.

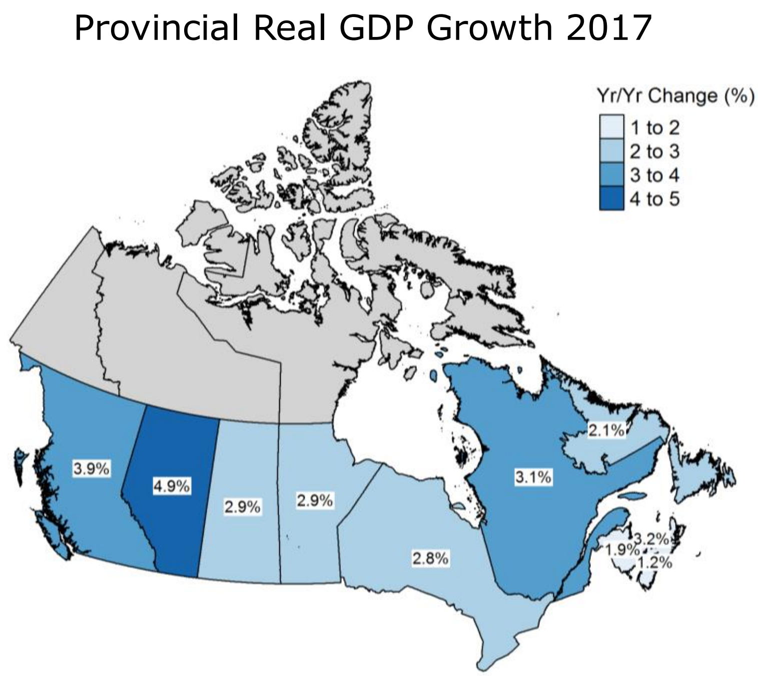
Broad-Based Growth Across Provinces

Real gross domestic product increased in every province in 2017 for the first time since 2011.

Data released at the start of May showed that real gross domestic product increased in every province in 2017 for the first time since 2011 (Figure 5). In eight of 10 provinces, growth in goods-producing industries outpaced service-producing industries, reflecting in part a recovery in the energy sector. Following declines in 2015 and 2016, Alberta's GDP rose 4.9 percent in 2017 (the highest rate among all provinces), with oil and gas extraction and support activities accounting for 50 percent of headline growth. Saskatchewan and Newfoundland and Labrador also saw significant contributions to GDP from oil and gas.

While growing more slowly than the goods sector in 2017, the service sector remained the most important contributor to economic growth in seven of 10 provinces due to its larger share of the economy. In Ontario, the service sector accounted for more than 80 percent of growth, and was boosted by growth in wholesale trade, up 7.1 percent for the largest increase since 2011. Strong wholesale trade activity also helped Quebec's economy grow 3.1 percent overall in 2017, the strongest pace of growth since 2000 for the province. British Columbia (B.C.) recorded the second-highest growth rate of all provinces, after coming in first place the two prior years. The largest contributors to growth in B.C. included transportation, retail and wholesale trade and construction. In both B.C. and Ontario, new regulations governing the housing market weighed somewhat on the real estate line of GDP.

Figure 5



Source: Statistics Canada and Wells Fargo Securities

The Future Looks (Generally) Bright

After starting 2017 on a tear, Canadian GDP growth slowed in the second half of 2017 and the first quarter of 2018. Deceleration in household spending, declines residential investment and slower export growth contributed to the slight downshift in Q1 GDP growth. However, recent economic data support the case for a positive outlook on the Canadian economy, as laid out by the BoC in their most recent policy statement. Higher oil prices and service-sector strength helped lift all provincial economic boats in 2017, putting the country on solid footing from coast to coast. We expect that Q1 will be the weakest quarter for growth in 2018. Nevertheless, we remain wary about risks posed by high levels of household debt, a potential slowdown in residential investment and geopolitical concerns (especially the threat of new tariffs from the United States).

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