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Economics Group

Special Commentary

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Assessing Canada's Economy and Markets as Trade Clouds Lift

Executive Summary

After months of uncertainty surrounding the eventual fate of negotiations, Canada and the United States reached an agreement late last weekend on a new trade deal, coming together with Mexico to update the original 1994 agreement. Among key provisions in the final deal, arguably most important to Canada's currency and economic outlook is the "soft" sunset clause that ensures up to a 16-year term on the new agreement. This provision removes much of the uncertainty regarding business investment decisions, and should support stronger economic growth, while likely accelerating the Bank of Canada's (BoC) projected pace of monetary tightening, even as concerns may linger about the state of highly-leveraged Canadian households. With continued tightening and higher oil prices, we see potential for the Canadian dollar to gain further versus the U.S. dollar over time.

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Trade Deal Positive for Canadian Growth Outlook

This past weekend, Canada and the United States announced a replacement for the NAFTA trade agreement after several weeks of uncertainty on whether the tentative agreement already reached between the United States and Mexico would be trilateral in nature. The final deal came after both countries reconciled key differences from initial talks, ultimately coming together with Mexico in updating the original 1994 agreement, now called the "United States-Mexico-Canada Agreement."

Key elements of the final deal include (1) giving Canada general immunity from any auto tariffs imposed by the United States, (2) maintaining certain dispute settlement mechanisms and (3) agreeing on a "soft" sunset clause. While auto tariffs have only been floated by the current administration at this point, Canada would be exempt from any tariffs that could go into effect, unless auto exports rise significantly from their current levels. Certain dispute settlement mechanisms that were particularly important to Canada during initial talks were also maintained in the final deal. But arguably most critical to our upgraded Canadian outlook is the "soft" sunset clause, in which the new agreement has up to a 16-year term and the option for review after six years. The United States had pushed for a 5-year sunset clause in initial talks; however, the final timeline helps remove much of the uncertainty surrounding the Canadian outlook that has lingered in recent months.

The new agreement should be positive for the Canadian economy and its currency going forward. Moreover, it could support some transition to business investment and exports—with firms now able to make investment decisions with a greater degree of certainty—and away from consumer spending, something that the BoC had already identified as likely in its latest Monetary Policy Report. The trade deal also has monetary policy implications. The BoC had explicitly factored trade policy uncertainty into its economic outlook, originally looking for the level of business investment to be 2.5% lower by Q4-2020, and with the level of exports 1.2% lower over the same time period. With much of this uncertainty removed, even if this "lost output" is not fully recovered, there is likely upside risk to the BoC's forecasts and projected pace of policy tightening, which we discuss later.

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Digging Deeper, an Investment Pivot Looks Likely

In our view, the trade renegotiations are most meaningful for prospects of stronger business investment.

In our view, the trade renegotiations are most meaningful for prospects of stronger business investment. In recent policy statements, the Bank of Canada has stated that the structure of economic growth should begin to shift, with household spending contributing less to overall economic growth, while exports and business investment should become stronger drivers of the current expansion. But until recently there were few signs that such a pivot is coming to fruition to date. While GDP growth rebounded in Q2 after a sluggish start to the year, business fixed investment remained subdued, growing at just a 1.5% seasonally-adjusted annualized rate, a far cry from the nearly 10% growth rate registered in Q4 last year. Investment sentiment also remained lackluster in Q2, as businesses likely put spending decisions on hold to ride out uncertainty surrounding the ultimate outcome of the trade negotiations.

But looking deeper, several aspects of the evolving business environment could offer more support to business investment in coming quarters. Corporate profit growth in Canada, while slowing recently, remains in positive territory and should still support the ability of businesses to increase investment as trade uncertainty diminishes and investment intentions recover. Capacity constraints in Canada have also tightened recently, with industrial capacity utilization at 85.5% in Q2, up from its cycle low registered of 76.6% registered in Q2-2016. Diminished slack in production pipelines could induce stronger business investment to increase capacity. Production constraints and solid profit growth are signals of upside potential for business investment as the trade policy outlook stabilizes.

Figure 1

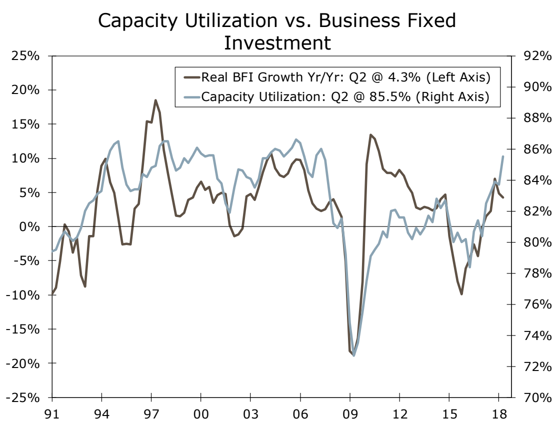
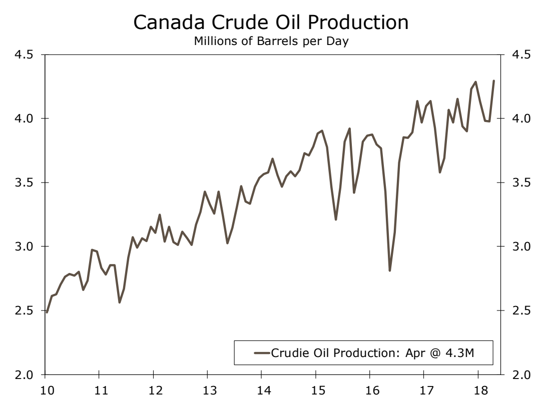


Figure 2



Source: Bloomberg LP and Wells Fargo Securities

One area that could also contribute to stronger business investment in Canada is the energy sector.

One area that could also contribute to stronger business investment in Canada is the energy sector. Global oil prices have risen over the past several months, and while some pipeline and transportation disruptions have restrained some Canadian specific oil prices, the broader upward trend in global oil prices is generally positive for the Canadian economy. The assurance of open trade with its primary export partner is likely positive for the Canadian energy sector going forward.

Profit growth also looks reassuring for the sector's upward momentum. Oil production remains strong, and operating profits for the oil/gas extraction industry rose a record $357 million in Q2, recording the largest quarterly gain since 1996. Finally, strong economic growth in the United States should also support Canadian growth and investment prospects given the economic ties between the two countries, leading us to see a pickup in overall GDP growth in coming quarters.

But What about the Household Sector?

Tighter capacity constraints and a well-positioned energy sector give us reason to believe that business investment in Canada has room to pick up. But does stronger investment spending have the ability to offset a possible consumer slowdown, stemming from concerns surrounding elevated household debt levels? In the near term, the household sector appears to be faring reasonably well. In examining household balance sheets for Q2-2018, we find that while household debt to disposable income ratios remain high, they have plateaued at around 170%, in part because Canadian households have experienced solid disposable income growth. For example, income growth was around 4% year over year in Q2-2018, helped by continued employment growth and stronger wage growth. That income growth should support consumers' ability to maintain a reasonable level of spending. The saving rate is low, at 3.4% in Q2, and is another sign that consumers are likely using gains in disposable incomes to support spending in the near term, although it is a longer-term cautionary note for the health of the consumer sector.

Figure 3

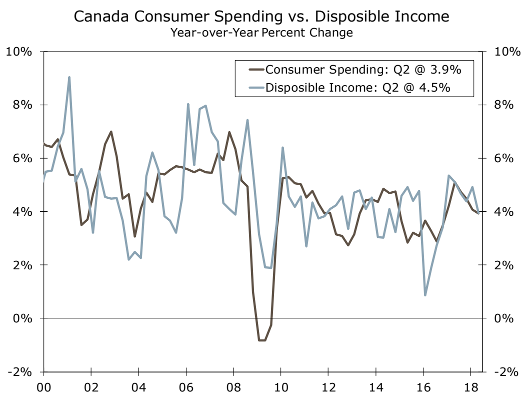
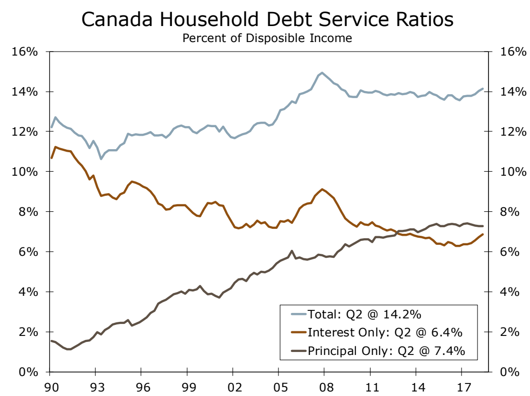


Figure 4



Source: Datastream and Wells Fargo Securities

Another cautionary note are debt servicing costs, which are already high and could rise further as the Bank of Canada continues to tighten policy. There have been initial signs of this pickup, with growth in mortgage interest payments outpacing principal payments over the past few years. That said, rising incomes, a largely stable overall household debt service ratio and interest rates that are still relatively low by historical standards reassure us that consumer spending could hold up reasonably well, even as the central bank continues its tightening cycle.

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Overall, while the consumer sector could slow down, we doubt that slowdown will be especially severe. Combined with the brighter business outlook we have lifted our growth forecast for the Canadian economy, and now see GDP growth of 2.2% in 2019, and 1.7% in 2020.

Bank of Canada Tightening Keeps Going and Going

A more constructive outlook for the Canadian economy has potential monetary policy implications, especially for an economy that is already viewed as operating near full capacity. In its July Monetary Policy Report the central bank estimated that the output gap had essentially been eliminated (i.e. spare capacity within the economy has been absorbed), meaning that a further growth push has the potential to add to inflation pressures.

We now anticipate one more rate hike in 2018, and three rate hikes in 2019.

Even as Canadian headline inflation has eased and wage growth has slowed, core inflation measures have continued to move higher and are slightly above the mid-point of the central bank's inflation target range. Thus with the extra "boost" to the economy, we now anticipate one more rate hike in 2018, and three rate hikes in 2019 (up from two previously) to lean against incipient inflation pressures. With the BoC now seen as keeping pace with Federal Reserve next year, and given firmer oil prices, that change could also be supportive for the Canadian dollar, which we believe can gain further against the U.S. dollar over time.

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