Economic Commentary

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central 1 Economics

Canadian economy wilts in Q2 with surprise GDP contraction

Canada's economy disappointed Q2 with a surprise contraction that underwhelmed already modest expectations for Q2 growth as household spending decelerated, housing retraced, and exports tumbled. Expenditure GDP fell at an annualized rate of 1.1 per cent during the quarter following a 5.5 per cent gain in Q1. A deceleration was expected given the effects of the pandemic third wave when public health restrictions ramped up but this was far below the consensus outlook of 2.5 per cent (Reuters).

Statistics Canada's monthly industry GDP estimates were trending at a 2.6 per cent pace including its flash estimate of June activity last month. There were clear unexpected downdrafts to their estimates as April and May estimates were downward revised, and despite a 0.7 per cent bounce in June, quarterly industry GDP came in unchanged from Q1.

The main drivers of slower expenditures included household spending which was flat after expanding 2.6 per cent in Q1. Specifically, goods consumption fell 7 per cent (annualized) due in part to lower vehicle sales, and home and garden products, while higher goods prices crimped demand. Indeed, nominal household spending rose fell only four per cent. Services-growth (7.3 per cent) provided an offset as re-opening activity buoyed demand. Residential investment, which surged for three straight quarters, fell back at an annualized 12 per cent rate as the housing cycle peaked earlier this year. The entirety of this declined owed to a drop in ownership transfer costs (-54 per cent annualized), which more than offset increased new construction and renovation activity.

Adding to this trade winds whipped against the Canadian economy. Exports fell 15 per cent from Q1 while imports held steady. Supply chain disruptions including semi-conductor shortages, have hit vehicle manufacturers particularly hard. On the bright side, business investment in M&E and structures picked up. Inventories were also being rebuilt after a Q1 drawdown.

Comparatively, nominal GDP was up a whopping 7.9 per cent annualized, highlighting the pricing pressures in the economy, and allocation of incomes to higher general and housing prices.

The wild miss in Q2 growth is clearly negative for Canada's growth story. The flash estimate for July industry GDP is for a 0.4 per cent m/m contraction, which would retrace some of June's rebound. While pandemic sensitive sectors will likely expand, early data suggests retail, construction and manufacturing pulled back. A recovery is anticipated in August and September, but given downward revisions and July flash estimate, growth is trending in a range of 3-4 per cent, which is a far cry from our initial estimates of 6.5 per cent expansion. Full year 2021 growth will be cut to just over five per cent.

Weak growth in Q2 and modest Q3 handoff means a delay in the path to full economic recovery. Headwinds persist with the spread of the delta variant and stalling of the re-opening path for the economy. For the Bank of Canada, this latest reading provides more reason to be cautious in its tapering plans and timing of future rate hikes which we still anticipate to come in October of next year. While inflationary pressures are strong the lack of economic traction provides enough reason to stay on the sidelines.

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