Economic Commentary

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Surface pressure: Headline GDP growth soars above expectations, underlying conditions weaken

Like Encanto's Luisa with her strong outward façade, the Canadian economy exhibited headline strength in Q3 that masked pressures under the surface. Headline GDP expanded by an eye-opening 2.9 per cent annualized during the quarter (0.7 per cent q/q), which was far ahead of consensus forecast of 1.5 per cent. This followed a 3.2 per cent expansion in Q2. Despite the strong increase, there were clear signs of significant deterioration in the domestic economy as broader economic drivers weaken. Moreover, national income declined as commodity price drivers retreated.

Headline growth was driven by a boost from international trade and inventory accumulation. Exports jumped 8.6 per cent (annualized), driven by crude oil and agriculture products, while imports fell 1.5 per cent. Meanwhile, businesses continued to add to inventory. This is accretive to growth during the quarter but risks inventory overhang as the economy wanes into 2023.

Under the surface, domestic economic activity was not nearly as strong as consumer spending growth fell and housing contracted. Final domestic demand (FDD) declined at an annualized rate of 0.6 per cent. This was the weakest FDD performance since the early days of the pandemic. Consumers ratcheted back after strong spending in Q2 with household consumption expenditure down 1.0 per cent. Spending on goods ratcheted back, signaling that inflationary pressure, higher interest rates and a weak housing market are curbing spending. Goods-spending fell at an annualized rate of 6.5 per cent led by double-digit declines in durable and semi-durable goods. Services-spending rose 3.8 per cent as consumers continued to return to normal events, tourism and recreational activity. Residential investment fell 15 per cent (annualized), adding to Q2's 31.5 per cent drop, as residential transactions and renovations pulled back. More declines are likely on the way as weak transaction activity triggers declining housing starts in 2023.

In contrast, business investment remained higher with growth in non-residential investment up 11 per cent annualized, which offset a drop in machinery and equipment (7.6 per cent). Government spending was a mixed contributor with consumption up 5.3 per cent but investment down nearly 4 per cent. As the economy slows, non-residential investment spending is also likely to temper into 2023.

While headline GDP rose during the quarter, gross domestic income fell amidst a retrenchment in commodity prices and weaker terms of trade which contrasted with higher consumer prices. The GDP price index fell 1.4 per cent (not annualized), the first pullback since Q2 2020, leading to a drop in nominal GDP of 0.7 per cent. On the income front, compensation of employees decelerated to a 1.2 per cent gain from 1.9 per cent in Q2, gross operating income for corporations declined.

Household disposable income outpaced nominal spending during the quarter lifting the household savings rate to 5.7 per cent in Q3 from 5.1 per cent in Q2.

Despite the strong headline gains, it is safe to say that underlying economic patterns weakened during the third quarter. Preliminary industry-GDP estimates for October point to a flat start to Q4. With higher interest rates still rising and working their way through the economy, growth is expected to stall into the first half of 2023. On the monetary policy front, we expect to see the Bank of Canada remain on a hike tightening path with a 50-bps increase in December but some moderation in domestic economic patterns is likely to signal that we are close to a peak in the policy rate.

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