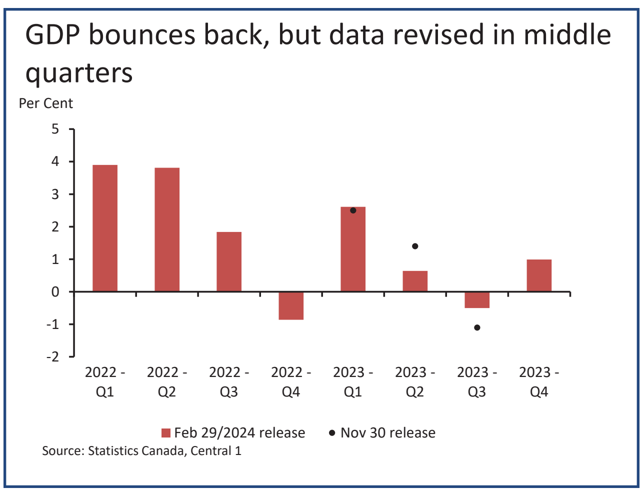
Economic Commentary

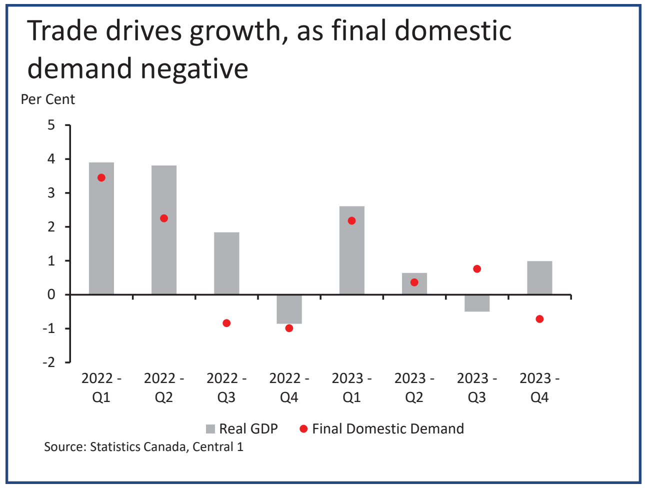
February 29 2024

Economy grows 1 per cent in Q4, but domestic demand slides

Canada's economy managed to surprise to the upside during the fourth quarter, but there is little doubt that the economy continues to weaken as domestic demand falters which should trigger Bank of Canada rate cuts in coming months. Real GDP growth came in at a quarterly annualized rate of 1.0 per cent during the latest quarter compared to a 0.8 per cent consensus. This followed an upward (positive) revised contraction of 0.5 per cent in Q3 (compared to -1.1 per cent in the last estimate) as the Q2 GDP estimate was reduced. Final domestic demand, which excludes international trade and inventory adjustment, contracted 0.7 per cent. On a per capita basis, growth was still negative.



Moreover, the economy exited 2023 with a whimper as industry-output was unchanged in December while the preliminary estimate for 0.4 per cent growth in January is driven primarily by one-off rebounds after public-sector strikes in Quebec which is not the ingredients of sustained expansion. Overall, annual GDP growth was at 1.1 per cent in Q3 from 3.8 per cent in 2022. Nominal GDP rose 6.6 per cent annualized during the quarter.



The details from the latest quarter point to a mishmash of patterns but the drag of monetary policy on domestic demand is clear. Consumer spending growth picked up slightly but remained a stale mild 1.0 per cent from 0.5 per cent in Q3 but owed to a rebound in goods spending after a Q3 contraction and driven by vehicles. Importantly, demand for services slowed sharply to 0.4 per cent, annualized from 2.4 per cent in Q3, which is specifically jarring given strong population growth. Investment took a dive during the quarter across expenditure segments. Residential investment fell 1.7 per cent after a Q3 rebound, while non-residential building investment (-11.6 per cent) and machinery and equipment (-5.7 per cent) added to sharp Q3 retrenchments, signaling the pressures from higher interest rates and the broader cyclical economic slowdown on business activity. Government contributions were also mixed as consumption fell 1.9 per cent while capital expenditure rose 3.2 per cent. As noted, final domestic demand fell by 0.7 per cent, which was the first contraction since Q4 2022.

This domestic weakness was offset by international trade, which was a driver of economic activity with exports up 5.6 per cent and imports down 1.7 per cent. More resilient U.S. economic growth in the U.S. and demand for energy products have lifted growth, as has tourist demand. Inventory adjustments were also less of a drag.

On the income side, unadjusted national income rose a hefty 1.6 per cent (6.6 per cent annualized) which was consistent with Q3. Employee compensation underperformed with growth of 0.8 as corporate net operating surplus (profits) jumped 4.6 per cent during the quarter, marking a second straight quarterly increase. This is in the non-financial space and led by retail and telecommunications. Income is flowing to businesses as wage growth cools in services and falls in goods-sectors. Household net savings were unchanged at 6.2 per cent.

Despite the positive headline surprise for GDP, this does not change our view that a Bank of Canada cut will come soon as the economy cools. March is off the table and April may be too optimistic at this point. That said, the contraction in domestic demand, weaker compensation growth, and negative per capita output growth coupled with the slide in inflation are likely to trigger a cut by as early as June.

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