

Canada: GDP (Q2) at 2.0% q/q ann disappoints.

But it is a digestable disappointment.

Canada's economy grew at a rate of 2.0% q/q ann. in the second quarter. A considerable deceleration from the 5.8% q/q ann (revised from 6.1%) clocked in Q1/10 and well back of the market median at 2.5%. Our just slightly more pessimistic forecast was looking for 2.4%. On a month over month basis, the economy grew at a rate of 0.2% in keeping with the market median and above our forecast for a rate of 0.1%.

Although the headline GDP number has disappointed expectations, the underlying story is somewhat improved from the breakdown that made up the 5.8% q/q ann in Q1. Indeed, what we are seeing is what looks like the very necessary hand off from a reliance upon consumer and government spending on over to business investment.

While business investment contributed 1.9ppt to GDP in Q1, the bulk of the growth was driven by investment in residential structures. In the second quarter, business investment has swung around from investment in residential structures on over to heavy spending on plants in equipment which jumped by around 14% q/q ann., the fastest rate of growth since 2005.

On the down side, the external demand picture is a bit of an albatross. Net trade knocked -4.4ppt off the top of GDP. While we are encouraged by the fact the exports have continued to grow in the second quarter, up 1.5% q/q (the fourth consecutive gain), import growth swamped whatever growth showed up in external demand. Overall imports rose by 3.9% q/q on the back of an 8.7% q/q rise in machinery and equipment imports. Again, this is what one may conceivably have expected given that business investment was ramping up in Q2 and Canada tends to source capital equipment from overseas producers. Outside of net trade, consumption, government, business investment and inventories all contributed positively to GDP.

Inventories were up again contributing around 2.2ppt to the overall GDP growth. The restocking phase is of course a transitory economic event that is not expected to persist. Nor is the contribution coming out of government which contributed 0.3ppt to the headline GDP. Fiscal stimulus comes to an end in Q1/11 but is likely to begin dragging on GDP before then as stimulus spending begins to wind down.

Consumer spending slowed, it needs to. And not unexpected as the blush of the Olympics in the first quarter and the ending of the home renovation tax credit in Q1 faded. The drum beat of higher interest rates also may have curbed some of the consumers enthusiasm. Yet for too long Canada has been leaning on the consumer for support - support that has largely resonated through the housing market which has cooled demonstrably. In return for their support, consumer debt levels have ballooned with the total household debt to disposable income having accelerated dramatically over a period of time during which the overall cost of money cascaded lower.

In Q2 we find a break in the trend to rising household borrowing. Over the quarter, Canadian households borrowed CAD91B vs the CAD102B reached in Q1. Going forward we would expect to see continued moderation in consumer behavior as the interest rates cycle advances and administrative changes in the real estate market combine to moderate activity activity in that sector.

Looking at the economy in terms of goods producing and service sector industries, the lion's share of the output gains went to goods producing sectors which expanded by 1.9% while service sector output rose by 0.1%. Given that the recession nearly entirely fell on the back of declining goods output one would expect that the bulk of the recovery would be found here as well.

Given that GDP grew at a rather sedate 2.0%q/q ann, one wonders about all those extra hands pulling on the levers of the economy in the second quarter. Recall that nearly 230K jobs were generate by the economy in the second quarter. Yet one wonders what they were all doing with their time and the limited contribution to GDP that was made. Suffice to say, it points to a rather disappointing picture on productivity in Q2.

Net net, there is a better picture underneath the headline disappointment courtesy of the drag associated with net trade which pulled 4.4ppt off the headline. With final domestic demand running at around 3.6%q/q ann, which is back of the 4.8%q/q in Q1 (a brilliant quarter from a growth perspective), is really not such a bad outcome after all.

Disclosure appendix

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