CANADA UPDATE

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A BANK OF CANADA POLICY RATE HIKE DRAWS NEARER AS THE ECONOMY RECOVERS FROM THE OIL DOWNTURN

The headwinds from the energy downturn have dissipated

Canada is back on track. After real GDP growth of less than 2 percent in 2015 and 2016, growth looks set to pick up to around 2.5 percent, or possibly even a little better, this year and the next (See forecast table p. 3). The global energy downturn was a large drag on Canadian nonresidential capital spending, and to a lesser extent on export volumes; it also was a drag on Canadian household incomes since many of the Canadian workers who lost jobs in the resource or manufacturing sector ended up working in lower-paid positions (often part-time ones) in the services sector. But oil prices have stabilized since the second half of 2016 and these headwinds have dissipated. The Bank of Canada's Business Outlook Survey for the spring of 2017 showed the share of businesses planning to increase capital spending in the year ahead was nearly the largest in a decade (See Chart 1). Manufacturers also saw a strong start to the year: They entered 2017 with very low levels of inventories and saw new manufacturing orders jump by double-digits from a year earlier in the spring months. Manufacturing business surveys reported the strongest conditions since late 2013 in the first half of 2017.

Job growth was strong in late 2016 and early 2017

This improved outlook boosted job growth in the second half of 2016 and early 2017. Employment grew at a 2.3 percent annualized rate between August and March, and full-time employment grew even faster, at 2.5 percent annualized. Jobs in the better-paying construction and manufacturing industries rose 1.9 percent, slightly slower than headline employment but a still solid increase. Strong business sentiment and investment intentions and low manufacturing inventories suggest employment in construction and manufacturing will continue to grow in the rest of 2017, adding to prospects for Canadian household income growth.

CHART 1: CANADIAN BUSINESS INVESTMENT INTENTIONS NEAR THEIR HIGHEST IN A DECADE IN EARLY 2017

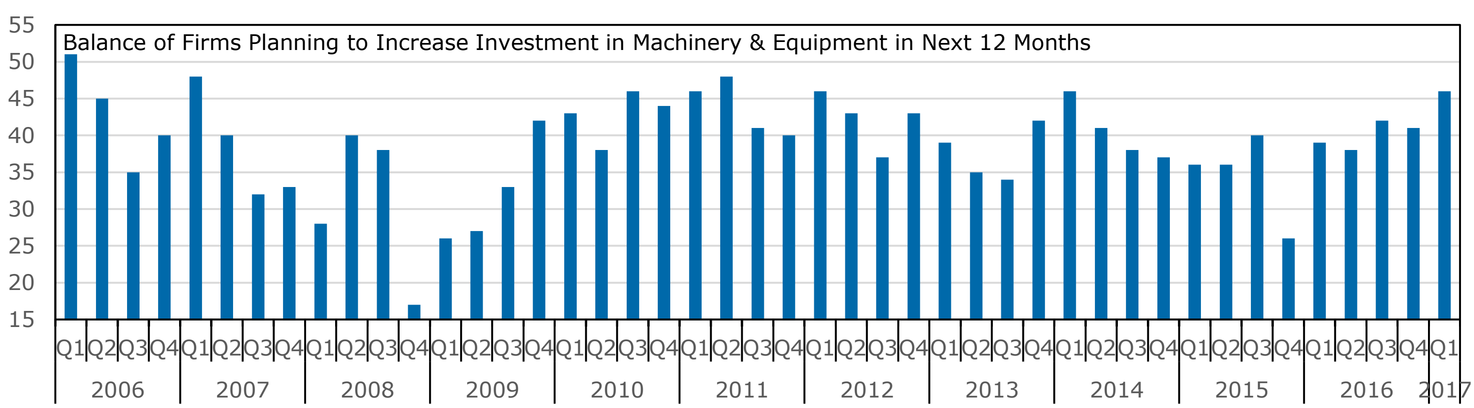


Chart sources: Bank of Canada Business Outlook Survey, The PNC Financial Services Group

Canadian inflation is benign

Inflation looks well controlled and has been trending slightly below the Bank of Canada's 2.0 percent symmetric target. Headline inflation was just below the target in the first quarter, and the BoC's preferred measures of core inflation—trimmed mean CPI, median CPI, and common factor CPI—were between 1.25 percent and 1.75 percent. While the Bank of Canada's sole policy target is ostensibly its inflation target, the BoC in practice targets full employment similarly to the Federal Reserve, since the BoC assumes that slack in the economy—the "output gap"—will tend to put downward pressure on inflation over the medium term.

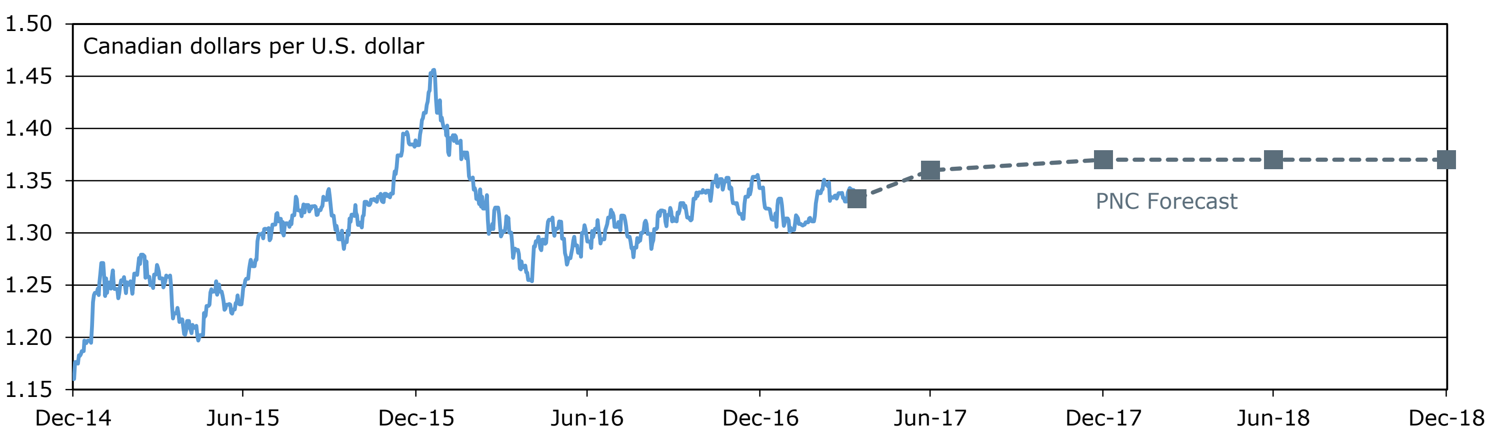
The Bank of Canada will likely raise its policy rate in early 2018, if not sooner

After solid employment and output growth in early 2017, the Bank of Canada in April revised its economic forecasts and now projects the output gap to close by the first half of 2018. This forecast could be used to argue that the Bank of Canada should begin raising the overnight rate target before mid-2017, since monetary policy only acts to restrain inflation after a lag of several quarters. But BoC Governor Stephen Poloz has signaled since taking office in 2013 that after years of false dawns, the Canadian economy must be clearly firing on all cylinders before he is willing to support tighter policy. In the base case, the Bank of Canada will most likely wait until the first quarter of 2018 to make its initial 0.25 percentage point hike to the overnight rate target, which has been at 0.50 percent since July 2015. But if growth picks up in 2017 by as much as recent survey data suggest, the Bank of Canada could make that initial rate hike sooner than in our baseline forecast.

The Canadian dollar could weaken in the rest of 2017 as the Fed hikes US interest rates

Since PNC Economics expects the Federal Open Market Committee to raise US policy interest rates a cumulative 0.50 percentage point between April and December 2017, the premium of US interest rates above comparable Canadian benchmarks looks set to widen over the next twelve months, supporting our forecast for a weaker Canadian dollar in the second half of 2017 and in 2018 than in the first half of 2017 (See Chart 2). There are both upside and downside risks to this forecast. If rising US oil production and inventories put downward pressure on global oil prices, the Canadian dollar could weaken by more than expected. On the other hand, if geopolitical tensions push oil prices higher, or if the US government delays or decides against plans to enact fiscal stimulus, the US dollar could be less strong and the Canadian dollar less weak than in our forecast.

CHART 2: LOONIE TO STAY WEAK AS INTEREST RATE HIKES IN CANADA COME LATER AND SLOWER THAN IN THE U.S.



Sources: Bank of Canada, CEIC, The PNC Financial Services Group

Canada Baseline Forecast Table

			2015A	2016A	2017F	2018F
GDP	GDP (Real, Expenditure Approach)	Annual % chg	0.9	1.4	2.5	2.6
	Personal Consumption Expenditures	GDP Contribution	1.1	1.3	1.3	1.1
	Government Consumption	GDP Contribution	0.3	0.4	0.4	0.4
	Gross Capital Formation	GDP Contribution	-1.4	-1.0	0.5	0.8
	Real Exports	GDP Contribution	1.1	0.3	0.8	1.2
	Real Imports	GDP Contribution	-0.1	0.3	-0.4	-0.8
Prices	Consumer Price Index	Annual % chg	1.1	1.4	2.2	1.9
	Industrial Producer Price Index	Annual % chg	-0.8	-0.2	2.0	0.8
	Newly Constructed Housing Price Index	Annual % chg	1.3	2.5	4.4	5.0
Interest &	Policy Rate	Period Avg	0.6	0.5	0.5	1.1
FX Rates	10-Year Government Bond Yield	Period Avg	1.47	1.25	1.78	1.89
	Exchange Rate, USD per CAD	Period Avg	1.28	1.32	1.35	1.37
	Real Effective Exchange Rate	Period Avg	84.5	82.4	82.8	84.5
Credit	Household Credit	Annual % chg	4.9	5.3	5.7	3.8
	Business Credit	Annual % chg	8.2	5.2	6.3	6.7
Labor	Average Weekly Earnings	Annual % chg	1.8	0.4	1.8	1.6
	Unemployment Rate, s.a.	Period Avg	6.9	7.0	6.6	6.4
Trade	Exports	Annual % chg	-0.7	-0.7	8.4	2.2
	Imports	Annual % chg	4.5	-0.1	0.0	1.4
Key	Manufacturing Orders	Annual % chg	-4.3	0.4	8.0	3.0
Indicators	Total Construction Permits	Annual % chg	0.2	0.9	6.4	7.6

A = actual, P = preliminary, F = forecast

Sources: StatCan, Bank of Canada, CEIC, Bank for International Settlements, The PNC Financial Services Group

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