Talking Points | The latest view on the economy

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UnConventional Wisdom

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As the summer winds down, markets continue to gear higher, with the S&P 500 hitting record highs led by the mighty, mighty tech space. Bond yields got into the act, too, with the 10-year Treasury yield touching a three-month high above 0.75% on the inflation-seeking message from Jay Powell at the virtual Jackson Hole. Even oil took a look at its highest levels since early March, but the run-up in WTI to above $43 had more to do with Hurricane Laura than rising demand. No matter the source, firming resource prices and rising asset markets have also boosted the Canadian dollar above 76 cents, its best level since the opening weeks of the year. Similar forces also lifted the TSX to a post-shutdown high, finding important support by generally better-than-expected Q3 bank earnings.

The **latest batch of economic data was a mixed blessing** for the markets, with more signs of outsized strength in U.S. housing, strong new orders, but stubborn jobless claims at 1 million, and an August slide in one measure of consumer confidence. The high-frequency data suggest that the recovery continues to grind ahead in late August, and an ebbing number of new U.S. virus cases is helping calm nerves (albeit even as cases are rising unnervingly in Spain and France).

The big number for the week was from Canada, perhaps the last major economy aside from Australia to report on **Q2 GDP.** The spring quarter captured the full force of the lockdown across the advanced economies, and **Canada was pretty much squarely in the middle of the pack**. Normally, we report the changes in quarterly GDP on an annualized basis (i.e., if that growth rate was maintained for a full year), but we will focus on the European convention of unadjusted figures for the sake of cross-country comparison, and sanity. Canada's GDP fell 11.5% in Q2, a bit better than the initial flash estimate by StatsCan of -12%. That was roughly in line with the Euro Area average of -12.1%. Printing deeper drops were, in order, the U.K. at -20.4%, France -13.8%, and Italy -12.4%, while hit a bit less hard were Germany at -9.7%, the U.S. -9.1% and Japan -7.8%. (Since you insist, Canada's annualized drop was 38.7%, the U.S. was revised to a drop of 31.7%, while the deep U.K. slide works out to -59.8%.)

The good news, such as it is, is that by all accounts, **these economies are headed for big rebounds in Q3** as nations reopened at varying stages. In some cases, the rebounds will be huge, and Canada looks to be one of those cases. Along with the horrific, although expected, Q2 plunge, it was also revealed that GDP snapped back 6.5% in June and the early estimate for July is another 3% pop. (As an aside, prior to this year, even that seemingly moderate July gain would have been a record monthly advance in GDP—these figures are all absolutely huge.) The three-month string of big monthly increases would leave the level of July GDP already up at a massive 41% annual rate versus the Q2 level. And many, many other indicators are pointing to a mammoth Q3 rebound. Just as one example, the flash estimate on July manufacturing sales was an 8.7% gain, leaving them up a towering 159% above Q2 levels (annualized). As we maintained almost from day 1 of the shutdown, the deep

spring slide in activity has been followed by a rapid rebound in most measures upon reopening.

Two caveats to that upbeat message on the prospects for Q3. First, even with a huge snap-back, the level of output by the end of Q3 is still expected to be about 5% shy of pre-pandemic activity. Putting that in perspective, the peak-to-bottom drop in GDP in the 2008/09 downturn was roughly 5%. Second, while Canada seems poised to blow the doors down in Q3 with something like a 45% surge in GDP, versus around 25% for the U.S. economy in the quarter, it mostly reflects a much weaker starting point. That is, the harder they fell initially, the bigger the bounce. The reality is that because of much more pronounced weakness in Q1 and Q2, Canada is still headed for a bigger annual decline in GDP this year than the U.S. economy.

And that brings us to the punchline. For the first time in more than four months, we are today **revising our estimate on Canadian GDP growth for 2020**. Through the lockdowns and the early stages of reopening, we have held our estimate at a decline of 6%, to be followed by a symmetrical 6% rebound next year. Given the combination of a slightly milder drop than initially expected in Q2 and the better hand-off in Q3, we are nudging our call slightly to a smaller drop of 5.5% this year, but will stick with our above-consensus call of +6% for 2021. It's a roughly similar story for **the U.S., where we nudged up our call for this year by half a point** on the Q2 revision to -4.5%, and look for a 4% rebound next year. In both cases, it's not a big change, but it's **the first upward revision this year by us on Canada, which *is* a big deal**.

There were a lot of big storylines this week in a normally quiet period for markets, including outside of the financial world. Sticking to economics, potentially the most significant development was the semi-expected **adjustment to the Fed's mission statement**, as revealed by Fed Chair Powell's Thursday speech. We dig into the details in Focus, but the main takeaway is that its new flexible average-inflation target and the increased focus on reversing weakness in job markets point to an easier policy for longer. The rubber will really meet the policy road later in this cycle, when the unemployment rate returns to quasi-normal, and the Fed will be slower to begin hiking. That is, they will likely let the economy run hotter for longer late in the cycle.

Market reaction, while generally muted, was to bump up long-term yields, mostly reflecting a slightly higher long-term inflation outlook. However, we would hasten to add that the five-year implied inflation outlook from the TIPS market remains at just over 1.8%; the market is still in "Show me" mode, doubtful that the Fed can generate inflation. That's understandable, given that the core PCE deflator has averaged 1.67% annualized over the past 15 years (and was 1.3% y/y in July).

The Bank of Canada faces a very similar backdrop and may possibly make a similar decision as the Fed in its upcoming new Monetary Policy Framework. While the BoC's official inflation target is headline CPI, curiously it has almost exactly matched the U.S. core PCE deflator since 2005. As of July, it had averaged 1.66% over the past 15 years (and was running at just 0.1% y/y), presenting the BoC with a nearly identical challenge. But before the BoC makes any radical changes, allow us to make **a modest proposal**: Perhaps the Bank could simply revert to aiming to keep inflation within a band of 1%-to-3%, as they did in earlier years of targeting. This by itself allows

inflation to run hot for a spell, without needing pre-emptive action (which the Fed now seems to eschew). And note that in the 15 years up to 2014, and before oil prices collapsed, headline CPI averaged precisely 2.0%. It seems that the Bank had already hit on a perfect formula, so why not simply return to what worked in the past?

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