Energy-hit growth won't stop the Bank of Canada hiking later this year

Turbulence in the energy sector looks set to drag Friday's fourth quarter Canadian growth figure lower. Global risks are building too, but there are still some reasons for optimism on the outlook this year

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Tumbling oil prices and production difficulties hit Canadian growth late last year

It is fair to say Canada's 2018 growth hit something of a peak in the second quarter. The third quarter story wasn't necessarily bad either (2.0% quarter on quarter, annualised), but given fourth-quarter growth will reflect the increasing difficulties in the energy-sector, figures won't be great. We forecast a slowdown to 1.4% QoQ, annualised in data due on Friday.

The root cause of the damage is a mixture of the late-2018 decline in oil prices and the weakening in Canadian oil differentials over much of the year. Pipeline constraints restricted export flows, leading to large inventory builds in the domestic market, which weighed on Western Canada Select significantly more than global benchmarks. The weakness in Canadian differentials saw the province of Alberta announce mandatory production cuts for producers towards the end of 2018, which has since led to a strengthening in Canadian differentials.

The New Year has seen global oil prices regain some poise, but the impact of the production cuts will continue to be a drag on economic growth this year. More broadly, manufacturing fell for three consecutive months at the end of 2018 and business confidence dipped, which likely reflects the more uncertainty picture for global growth. This latter point may see investment dip back the fourth quarter growth numbers.

That said, we still view the economic slowdown to be mild, not major.

Away from energy, there are positives for the economy

Trade developments between the US and China have recently taken a slight turn for the better as the 1 March US tariff increase on Chinese goods deadline was pushed back. There's a long way to go, but if a more permanent resolution can be found, the outlook for US growth still looks fairly reasonable. The solid US consumer backdrop and healthy jobs market isn't likely to fade anytime soon, which is good news for Canadian exports. Better news on trade would also likely help oil prices, reinforcing our commodities teams' view that Brent Crude and WTI should edge higher throughout this year and next.

Canada's labour market is also showing signs of strength. January saw wage growth finally pick-up (see here), and we don't expect this to just be a one-off. Business surveys have recently suggested that firms view labour availability as an increasing constraint on production, which would point to further upside in wage growth over the coming months.

These points bode well for both domestic and foreign demand, as well as sentiment generally, and is why we think the manufacturing sector looks better than the numbers suggest.

A rate rise from the Bank of Canada this year looks likely

The Bank of Canada will also be keeping a keen eye on the severity of any housing market downturn, trade developments between the US and China, as well as oil prices. If these downside risks don't materialise, we expect the central bank to hike once (if not twice) this year. The next move is most likely to come in the third quarter, allowing time to see how the Federal Reserve acts over the next few months.

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