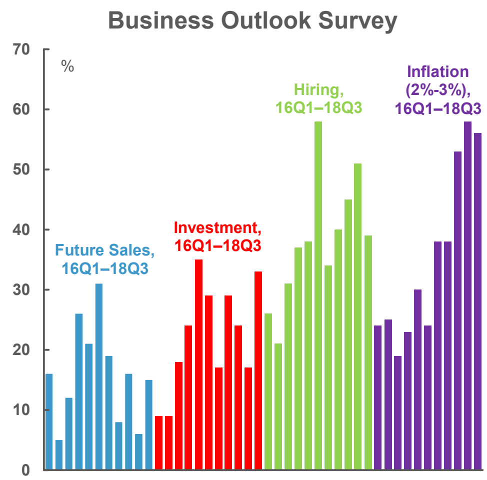
Canadian Businesses Signal Risk Of Overheating To The BoC

- Businesses were delivering a hawkish message to the Bank of Canada even before the NAFTA/USMCA agreement was signed on September 30th. That's the broad conclusion to be derived from the BoC's latest Business Outlook Survey (here). Canada's two year yield jumped by just over 2bps and CAD appreciated by just over one-third of a cent versus the USD following the release. NAFTA was clearly of tertiary significance as businesses reported that they face serious capacity pressures and labour shortages that are motivating aggressive investment plans and rising inflation expectations notwithstanding trade policy uncertainty. A weak report would have been ignored on NAFTA concerns, but a strong report like this one is all the more amazing because it reflects opinions before businesses had any improved certainty toward the trade and investment regime. The chart below demonstrates the core survey results.
- I maintain that the BoC missed an opportunity to hike at the September 5th meeting and arguably should have seen through the effects of NAFTA uncertainty while focusing more upon long brewing pressures facing an economy that is operating at or beyond its capacity limits across a broad array of measures. Regardless, in the here and now, Canada does not need a negative real policy rate along with other major markets that either have slack and/or materially lower inflation and/or ongoing policy uncertainty such as Brexit. As a consequence, an October hike should be a slam dunk. Further, there is arguably some catching up to be done; our updated forecast that was released this morning foresees a doubling of the overnight rate by 2020Q1 from 1.5% at present.
- Investment intentions soared on capacity constraints. The balance of opinion of those increasing investment versus those decreasing investment almost doubled versus the summer survey. The net percentage of firms that are expanding investment now sits at its third strongest level since the survey began in 2008. That says that businesses were more focused upon capacity constraints than NAFTA uncertainty which has been a marketing theme of mine for a while. In fact, at issue is why the BoC has tended to argue there is evidence of investment being impaired by NAFTA uncertainty. I've been much less convinced by that argument as 2018H1 investment was strong and this survey's responses tend to pour cold water on the weak investment plan hypothesis.
- One year forward sales growth expectations improved. The net percentage of survey respondents signalling that they expect a faster rate of sales growth over the next twelve months exceeded those expecting slower sales growth by 15 percentage points. That's about two and a half times higher than the prior quarter.
- Hiring plans remain strong but somewhat less so than the prior survey. The net percentage of firms planning to increase employment over firms planning to decrease employment over the next twelve months sat at 39% versus 51% in the prior survey. Again, note that this is a net percentage and so a strong balance of opinion favours higher employment.

CONTACTS

Derek Holt, VP & Head of Capital Markets Economics
416.863.7707
Scotiabank Economics
derek.holt@scotiabank.com



Sources: Scotiabank Economics, Bank of Canada.

- Yet again, firms are reporting serious capacity pressures. 56% of firms are saying they would have difficulty meeting an unexpected increase in demand, usually due to capacity pressures and labour shortages. This measure has been averaging at the highest during the history of the survey over the past two quarters.
- Firms are reporting more intense labour shortages. The intensity of labour shortages that measures the net percentage of firms saying that labour shortages are more intense hit an all-time record high.
- 56% of firms expect inflation to be in the upper half (2–3%) of the BoC's 1–3% inflation target range over the coming year. Inflation expectations are at risk of becoming unmoored in the business community.
- Further to the competing influences on business investment intentions, Box 1 in the BOS survey link asks businesses to rank the drivers of investment intentions. The number one reason given is domestic demand followed by sticking to a long-term strategy. Export demand lands at number three, but is clearly only asked of export-oriented firms in an economy where exports are about one-third of GDP. Among the biggest impediments to investment, regulation and taxes outweigh uncertainty over their businesses derived from multiple sources. That's a significant message to public policy makers; with NAFTA uncertainty having subsided, businesses are saying that regulation and taxes should be next.

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