

Canada's interest-sensitive shoe has clearly dropped

By Warren Lovely & Taylor Schleich

Note: This Market View note is meant to supplement to NBF's detailed analysis of Canada's Q4 GDP release, which can be accessed [here](#).

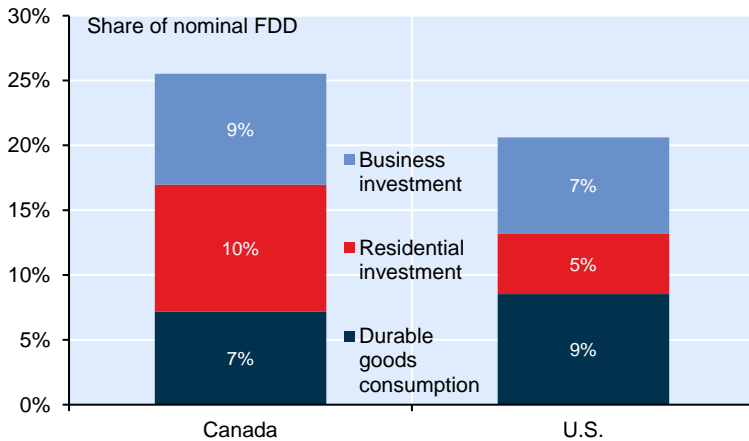
The one-year anniversary of the Bank of Canada's latest monetary policy tightening spree is just around the corner. We're not necessarily about to celebrate the 425 bps of BoC policy rate hikes that have been foisted onto the economy and financial markets since March 2022, but you can bet we're closely examining the fallout. After all, there's plenty at stake for Canada, even more so than in the U.S.

Forgive us if you've seen Chart 1 before. We've used it to illustrate the large(r) share of Canada's domestic economy that could be deemed interest sensitive. We're talking durable goods consumption, residential construction and business investment in machinery/equipment and structures. Collectively, these components comprised just over one quarter of Canada's final domestic demand when the BoC first pulled the rate-hike trigger a year ago. Compared to the U.S.—where policy rates have moved up even a touch more—Canada has more of its economic eggs in the interest-sensitive basket... and has for some time. Indeed, Canada's pre-hike ISD share of final domestic demand was one of the largest on record, being generally consistent with more inflated/elevated household debt levels. With plenty of direct economic exposure and rate hikes in overdrive (vs. prior tightening cycles), it stands to reason we'd be seeing some notable fallout. Enter the Q4 GDP data.

Pouring over the national accounts, it's increasingly clear that interest-sensitive demand has wilted in Canada. Collectively, the three primary components of ISD pulled down real GDP growth in each of the final three quarters of 2022. The drag from (or adjustment to) higher interest rates has been most pronounced in residential construction, where real activity is off an annualized 20% in the past three quarters. The interest-sensitive hickey is larger/uglier than in the U.S. and also stands in noted contrast to the arc Canada traced out during the half dozen prior tightening cycles that comprise the BoC's 'overnight target rate as policy tool' era (i.e., since the mid 1990s). Layer in Canada's relatively more encouraging inflation trajectory—evident in both CPI and PCE—and you have a case for policy rate divergence. More specifically, we see mounting evidence to support a BoC hold, even as the FOMC looks prepared to bang away with another 75 bps of tightening this spring.

Chart 1: Canada has more eggs in interest-sensitive basket

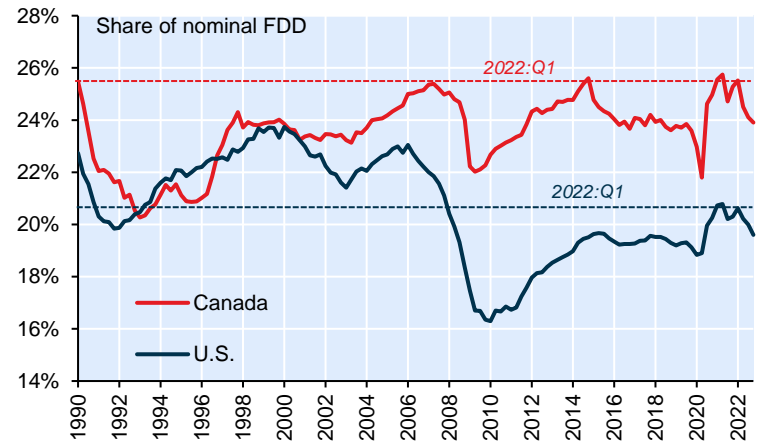
Interest-sensitive share of final domestic demand: 2022:Q1 (i.e., first hike)



Source: NBF, StatCan, BEA | Note: 2022:Q1 was quarter of first BoC/FOMC rate hike

Chart 2: Pre-hike, as much ISD exposure as ever for Canada

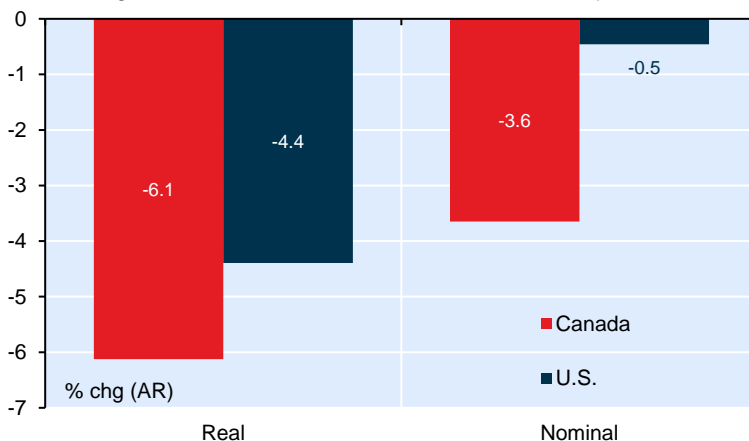
Interest-sensitive share of final domestic demand



Source: NBF, StatCan, BEA

Chart 3: Interest-sensitive demand coming off hard(er)

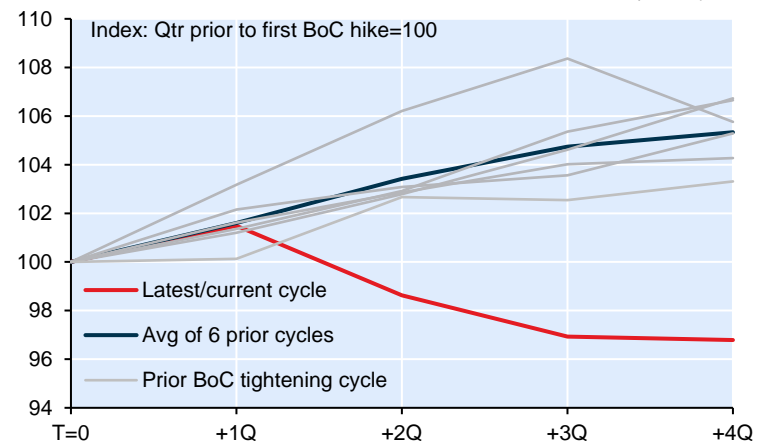
Annualized growth in interest-sensitive demand: Final three quarters of 2022



Source: NBF, StatCan, BEA

Chart 4: No surprise in faster/bigger adjustment this time

Evolution of Canada real interest-sensitive demand: Current vs. prior cycles



Source: NBF, StatCan, BoC | Note: Indexes the level of ISD in chained dollars



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