Whither Spending?

The Drivers of Lacklustre Canadian Consumption

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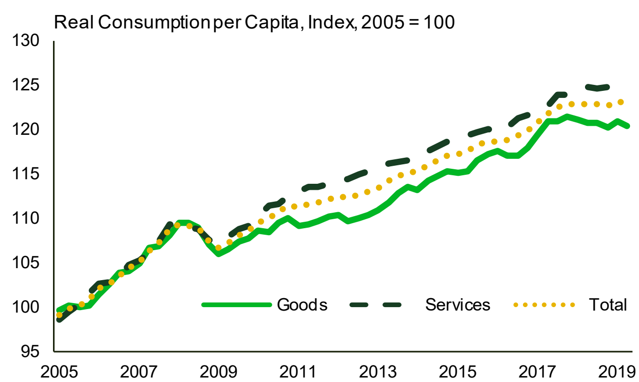
Highlights

- Canadian consumer spending growth has been muted of late despite strong fundamentals in the form of healthy labour markets and low borrowing costs.
- Three key domestic factors are to blame: policy-induced softness in housing markets in recent years, what appears to be sated demand for motor vehicles, and still-challenged household balance sheets.
- These three factors are likely magnified in a global backdrop of heightened economic policy uncertainty.
- Housing markets may have come back to life, but the impact of past developments, alongside the other factors augur for a subdued pace of consumer spending, and by extension, GDP growth over the medium-term.

Let's start with a hypothetical question. Consider an economy with 1.4% annual population growth (fastest in the G-7), that is producing new jobs at a robust rate (25K jobs per month or 1.6% y/y) that are largely full time in nature. Also imagine a job market where wage gains are trending north of 3% (enough to send the most recent quarterly read of incomes to a nearly 7% annualized pace). Oh, and lastly, add on relatively low borrowing costs that have moved steadily lower since the year began, and a housing market that has seen six straight months of rising sales activity and prices. What would you expect household spending in that economy to grow at? This is of course a trick question – all those statistics describe the trends over the last year and half in the Canadian economy. Yet despite these healthy fundamentals, spending growth has been tepid. Total real consumer spending gains have been trending at a sub-2% rate or just 0.5% in per-capita terms. Beneath this already soft trend is a weak split – spending on goods has effectively flatlined from 2018 onwards, falling on a per-capita basis (Chart 1).

Why has Canadian consumption lagged the strengthened fundamentals (and healing housing markets), and will it pick up? The answer comes down to a hang-over of sorts from recent years' events – three in particular. The first is the impact of macroprudential housing policies that slowed activity in this sector markedly in in recent years. The second: the end of a long uptrend in per-capita auto sales that appears to have left demand satiated. And third, still-challenged household balance sheets. This report examines each of these factors in turn, finding that only one – household balance sheets – is likely to fade soon. This means that for the foreseeable future, both the soft overall trend is likely to continue, and are why our Quarterly Economic Forecast includes only modest consumer spending growth.

Chart 1: Household Spending Flatlined Post-2017, Goods the Culprit



Source: Statistics Canada, TD Economics

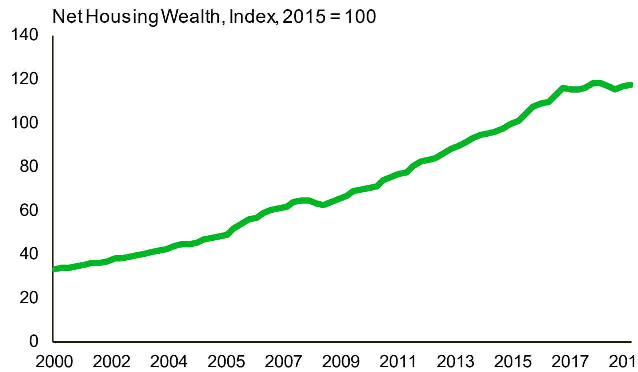
Housing getting its legs back

Almost as impressive as the job market performance has been Canada's housing markets over the past few months. After a string of policy-induced shocks, housing markets – particularly resale activity – has come back to life. Unit sales were up roughly 13% year-to-date in August (Chart 2), bringing the average sale price up 6.2%. Even the beleaguered Vancouver market has shown green shoots in activity on the heels of dramatic drop in sales activity over the past few years. Canadian housing starts have averaged 210k, above their five-year average of 201k despite being dragged lower by this year's cold February.

A wide body of research suggests a strong link between housing markets and consumer spending. In broad terms, there are two main channels through which this takes place: either directly, via purchases associated with the process of buying/selling a home (such as furniture/furnishings, etc.), or indirectly via what economists call the 'housing wealth effect'– in effect, as home values rise, consumers spend some of this newfound wealth. The former tends to be relatively immediate – indeed, our forecasting models for consumer spending are driven in part by our near-term forecast for housing activity.

Even more important, however, is the wealth effect. Many estimates, including the Bank of Canada's suggest that each dollar of net housing wealth increases consumer spending by about five cents, roughly two years later. That may not sound like a lot, but it is important to remember that the effect occurs for all homeowners – not just those that have recently bought or sold – a sizeable base in a country with a nearly 70% homeownership rate.

Chart 3: Wealth Effect Flattened out in Early 2019

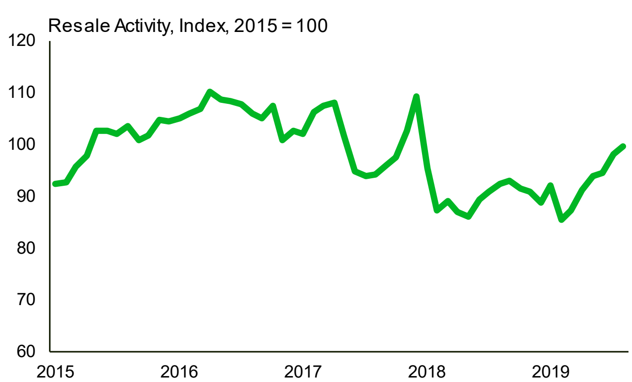


Note: Net wealth defined as market value of household owned land and residential structures, less mortgage debt. Last data point: 2019Q2. Source: Statistics Canada, TD Economics

This channel is thus likely to be the one having the biggest impact at present. While home valuations in some markets such as Quebec have been on fire, net housing wealth on balance across the country has been flat since early 2018, likely sapping an important support for consumer spending in previous years (Chart 3). This is largely by construction, as policy measures, both federal and provincial have weighed on housing activity. Mapping through our estimates of the wealth effect suggests that its impetus to spending more broadly has turned negative over the last six quarters. Absent this drag, nominal consumption spending growth have risen by around 5% to 5.5%, rather than the 3.7% observed.

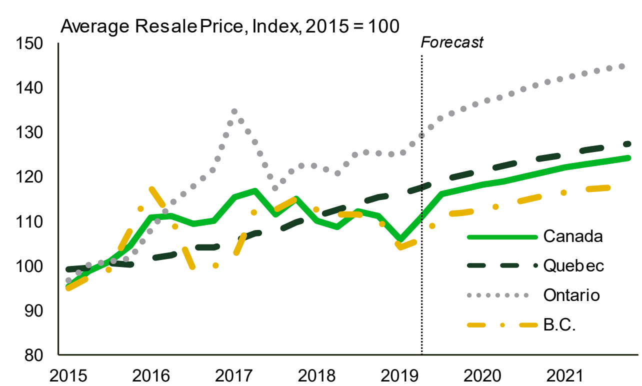
This implies both good and bad news for the spending outlook. The good news is that we expect the recent gradual recovery in housing demand and prices nation-wide to remain in place in the coming quarters (Chart 4). Accordingly, housing wealth should resume its uptrend as soon as

Chart 2: Home Sales Moving Steadily Higher in 2019

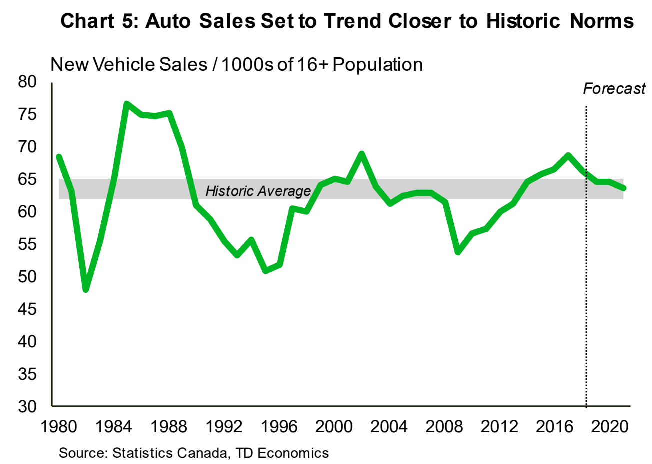


Source: CREA, TD Economics

Chart 4: Canadian Housing Markets Putting Past Shocks Behind Them



Source: CREA, TD Economics



the current quarter. The bad news is that given the lagged nature of the relationship, this moderate tailwind is not likely to be visible in spending trends for at least a few more quarters.

A car already in every driveway?

Even as the direct impact of strengthening housing markets plays into spending, an important component of the overall spending basket is facing its own headwinds. For many Canadians, vehicles are the second largest purchases they'll make in their lifetime, after their home. As discussed in a TD Economics report earlier this year, both auto sales and production have been coming off the boil of late, particularly in Canada. Per Desrosiers Group data, new motor vehicle sales have fallen in 17 of the last 18 months. This is likely due to the completion of a 'catch-up' effect. Auto sales fell markedly during the Great Recession, but, in contrast to past recessions, recovered relatively quickly (Chart 5). The post-crisis uptrend lasted nearly a decade. This length created some signs of over-extension, with sales per population above its longer-term average for the past five years – although still a far cry from the divergence of the 1980s.

There are three persistent trends that suggest that auto sales are likely to continue to tick down in the coming months, though remain historically elevated. First, the service life of motor vehicles continues to improve, meaning, absent a major shift such as electrification, there is less 'need' for replacement vehicles each year, relative to the past. Between 2007 and 2017 (the most recent data available), the average age of the Canadian vehicle fleet rose by more than 15%, to reach 9.7 years (from 8.4 years). This can be seen in the number of cars per population (Chart 6; remember that population growth accelerated quite a bit from 2016 on, making the trend of late more impressive than it might appear).

Second, auto loan amortizations have lengthened significantly in recent years, with 84-month terms increasingly common. This has expanded consumer purchasing power, but at the cost of a longer-time 'underwater' on the purchase, making a trade-in at five years (for example) a costlier proposition. Of course, people can't use the same car forever, but, together with lengthened service lives, longer loan terms stretch out the replacement cycle, moderating near-term demand for vehicles.

More persistent is the third trend: populations becoming both older, and increasingly concentrated in large cities. For urban-dwellers, the availability of substitutes, such as public transit, walking/cycling, taxis/ridesharing, etc. also suggests a lower 'need' for auto ownership and potentially longer replacement cycles compared with their non-urban counterparts.

More than a third of us live in one of the Toronto, Montreal, or Vancouver Census Metro Areas (Chart 7), and this share has been rising over time, up nearly a full percentage point over the last decade. On top of this, these areas remain magnets for new Canadians, driving a larger share of population growth than their shares would imply. To be sure, both older Canadians and city-dwellers still need vehicles, or at least access to them, but again these trends suggest a moderation of demand. For Canadians enjoying

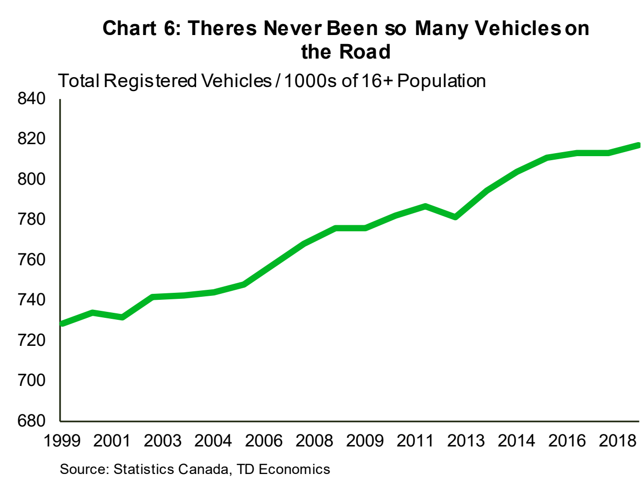
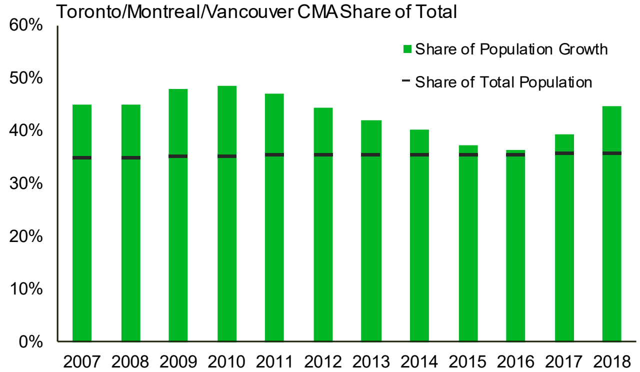


Chart 7: More Than a Third of Us Live in Three Key Cities, and They're an Outsized Draw



Source: Statistics Canada, TD Economics

their retirement years, wear and tear on their vehicles is likely to be lower compared with commuting, lengthening the replacement cycle.

All of this is not to suggest that a dramatic correction in auto sales is around the corner – quite the opposite in fact. The sales data to date is hardly indicative of 'overconsumption' type behavior seen ahead of the 1990s downturn, and both healthy labour markets and favourable borrowing costs should provide a base of support. It is more to suggest that the trend of recent years, of only modest growth in this important part of the consumption basket, should continue. Sales growth in line with or slightly below population growth is the best assumption. Don't expect this sector to accelerate any time soon.

Household balance sheets fragile but healing

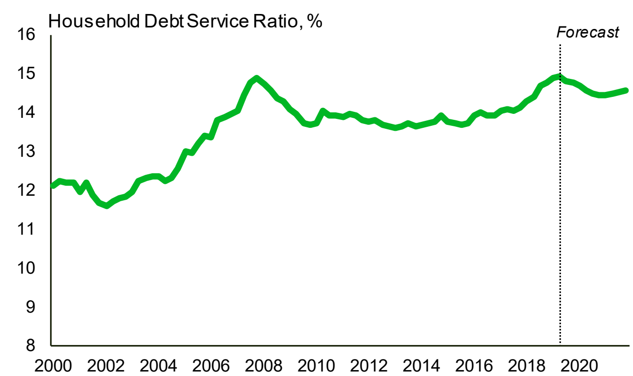
The multi-decade runup of Canadian household leverage appears to have come to an end. While the level is extremely elevated, at nearly 180% of disposable income, recent quarters have seen this ratio level off somewhat as borrowing decelerated in the wake of the slowdown in housing activity and mortgage credit growth and as income growth ticked up a notch thanks to tighter labour markets. But at least until recently, an uptick in borrowing rates in 2017/18 also flipped some key dynamics among households. Prior to 2017, falling interest rates meant that even as relative debt levels climbed, servicing this debt took up a relatively constant share of incomes. The rate hikes of 2017 and 2018 brought this to an end (Chart 8). As rates rose, income growth was more muted, driving the debt service ratio (share of income needed to stay current on one's debts) higher, to an all-time high in the second quarter of 2019.

The impact of this change in direction on consumption is intuitive: spending more of your income on keeping your debts current leaves less money for other priorities. Research suggests that the impact is more than just this immediate cash-flow hit. Research from TD Securities found that a one percentage point climb in this ratio is also associated with a 0.1 to 0.2 p.p. drag on consumer spending a year later.

So, much like the housing wealth story, we can't look only at near term dynamics. The debt service ratio should begin to fall thanks to a combination of strong income growth, lower interest rates (the discounted five-year mortgage rate has fallen by more than 80 basis points since the beginning of the year), and importantly, an assumption that credit growth remains around the 3.5% y/y mark. But, even with these more positive dynamics, there will be a hangover of sorts from the recent uptick in servicing costs. All else equal, this effect should hold back spending over the remainder of this year and into 2020 by about 0.2 p.p. – hardly a gigantic impact, but still another item on the "slow consumption" checklist.

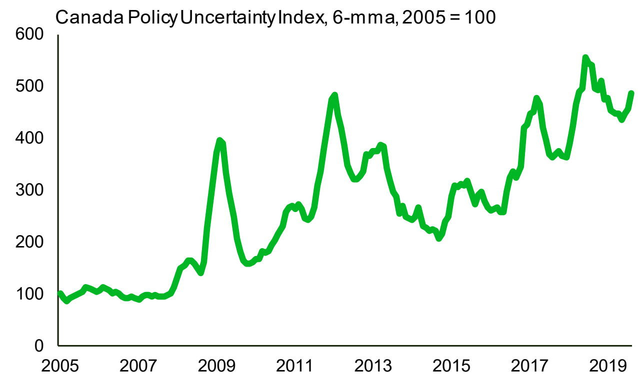
The silver lining is that recent drops in borrowing costs should ease the strain on households as we approach 2021 and beyond. This also highlights the challenge for the Bank of Canada – recent dynamics have underscored just how much high household indebtedness has amplified Canadian's sensitivity to rising borrowing costs. The Bank is well aware of this, referring to it across multiple communication opportunities. This is one reason why, until the relative debt burden shows meaningful improvement, the current level of 1.75% is as high as the Bank of Canada's overnight rate is likely to get.

Chart 8: Some Near-Term Relief in Sight for Household Finances



Source: Statistics Canada, TD Economics

Chart 9: Policy Uncertainty Sitting at All-Time Highs



Source: Baker, Bloom, and Davis (2012); policyuncertainty.com, TD Economics

An uncertain backdrop

Much ink has been spilled on the re-kindling of global policy uncertainty. Indeed, it often feels like every day brings a new headline as various global trade battles progress. This isn't just a feeling – economists have attempted to quantify potential news headline effects via an index of policy uncertainty based on newspaper coverage of current events (Chart 9). The past few years have, unsurprisingly, delivered the highest levels of uncertainty on record, as well as the most persistent.

Simple regression analyses suggest that a 100 point climb in the trend level of policy uncertainty over six months, all else equal, drags retail spending volumes about 0.3 percentage points lower. There is also evidence that not only do consumers react to rising uncertainty, elevated levels (even if constant) also have a corrosive effect on spending decisions. All this to say that, as you'd expect, when the economic backdrop gets uncertain, consumers grip their wallets a bit tighter. Some cautious optimism may be warranted here: U.S.-China talks are ongoing, and it appears that the U.S. and Japan have reached the early stages of a trade agreement. But, on the other side of the coin, the U.S.-China trade conflict has seen more than its share of false dawns, and Europe is still in President Trump's crosshairs. Put it all together and it seems unlikely that this headwind to spending will be dissipating any time soon.

Bottom Line

Many of the key fundamentals point to consumer strength. Net hiring is expected to continue and income gains are projected to hold in a moderate 3-4% range. The interest-rate environment should also remain favourable. But the reality of late has been a tepid performance at best. As this report has shown, a handful of headwinds have conspired to hold back consumer spending. The unfortunate news is that while there are some encouraging near-term dynamics taking place, particularly in housing markets, the overall impact is unlikely to dissipate any time soon. As the saying goes, history may not repeat itself, but it often rhymes. If you sell to Canadian consumers, expect the next few years to feel awfully familiar.