ECONOMIC VIEWPOINT

Mixed Messages

What the Most Recent Data Tell Us About the State of the Canadian Economy

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Highlights

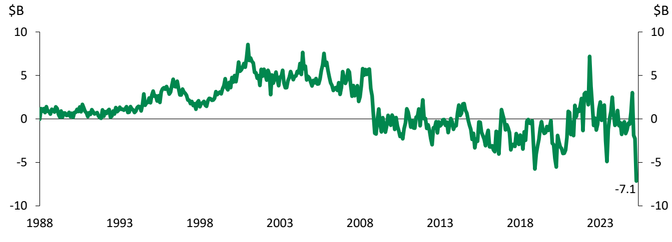
- Canada's real GDP growth is expected to be flat or slightly negative in the next couple of quarters. Declining business investment along with a sharp drag from net exports—driven by strained US trade relations—should continue to weigh on economic activity.
- Household consumption and government spending will likely offer some support to near-term growth thanks to resilient auto sales, ongoing employment gains and post-election fiscal stimulus. However, these may not fully offset the broader economic headwinds.
- Labour market resilience is starting to fade, particularly in goods-producing sectors such as manufacturing. And although slower population growth may limit the rise in unemployment, it will also constrain overall GDP growth. But given that all signs point to continuing durables production in spite of US tariffs, inventories could rise further even as trade activity declines.
- All told, whether the next couple of quarters ultimately qualify as a recession will be for scholars to decide. But what we know for now is that the Canadian growth outlook is pretty bleak because of US tariffs and the ensuing uncertainty. See our June 2025 Economic and Financial Outlook for more information on how our near-term forecast fits into our broader medium-term projection.

With Q1 2025 economic activity now behind us, the true extent of the impact of the US–Canada trade war is beginning to come into view. However, while some recent data clearly illustrate the gut punch of the trade tumult on the Canadian economy, other indicators point to pockets of resilience. In this note, we dig deeper into the numbers so far this year and give a sense of what they mean for the near-term outlook.

No Mo' Trade Flow

Unsurprisingly, net exports have been most visibly impacted by the antagonistic trade policies of the US administration. After a surge in two-way flows in Q1, April saw the largest goods trade deficit on record (graph 1). Bilateral trade in motor vehicles, industrial machinery and consumer goods posted notable declines in the month. And while the deep trade deficit was primarily driven by sharply lower export volumes, real imports dropped in April as well.

Graph 1
Canada's Merchandise Trade Deficit Was the Largest on Record in April 2025
Canada merchandise trade balance



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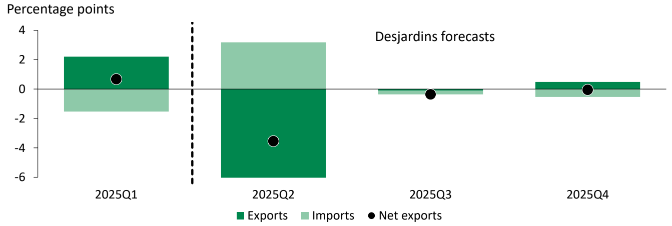
Looking ahead, we don't see a rebound in trade flows in the coming few months. Even if a trade deal is struck, trust is in short supply. The recent further ratcheting-up of tariffs on US imports of steel and aluminum clearly illustrate why. As such, Canadian businesses will likely be reluctant to bet on a return to normal in the trade relationship with the US and will instead seek customers in other markets at home and abroad. Consequently, we expect trade with the US to weaken steadily in the months following the deep retrenchment in April. This recent development points to a substantial drag on real GDP growth from net exports in Q2 and, to a lesser extent, Q3 (graph 2).

Graph 2
Net Exports Should Drag Down Real GDP Growth in 2025

Contribution to real GDP growth from net exports



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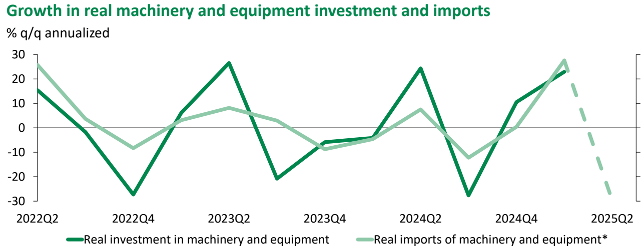
Mind Your Business Investment

Along with the burst in trade with the US in Q1 came a sharp increase in investment in machinery and equipment (M&E) in Canada. The same phenomenon was observed south of the border, as companies tried to get ahead of tariffs. This is expected to reverse in the second quarter as tariffs took effect starting in March, sharply reducing real imports of M&E (graph 3).

Graph 3
Machinery and Equipment Investment and Imports Will Likely Both Decline in Q2 2025

Growth in real machinery and equipment investment and imports



* Includes real imports of industrial machinery, equipment and parts; electronic and electrical equipment and parts; motor vehicles and parts; and aircraft and other transportation equipment and parts. Estimate based on real imports of machinery and equipment data through April 2025 and assuming no change in May and June 2025.

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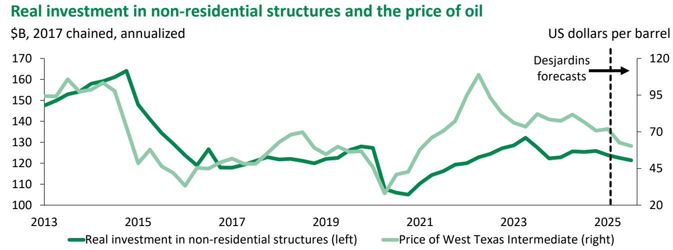
Due to trade uncertainty and lower oil prices, investment in non-residential structures is also expected to fall in the second quarter (graph 4). And the third quarter isn't looking much better. That after investment in non-residential structures took a turn for the worse in Q1.

Graph 4
Investment in Non-Residential Structures Should Fall Along with Oil Prices

Real investment in non-residential structures and the price of oil



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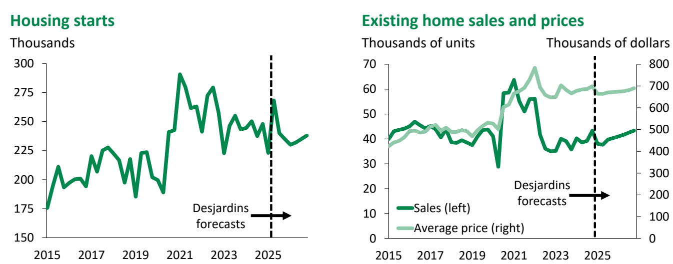
Where Has All the Residential Investment Gone?

Net exports and business investment may be among the few expenditure categories dragging down headline real GDP growth in mid-2025. After a sharp drop in the first quarter, the ownership transfer costs component of residential investment will probably follow quarterly sales data lower again in Q2 (graph 5). Indeed, despite the 225 basis points in interest rate cuts by the Bank of Canada, housing market activity in Canada has slumped recently. We suspect this reflects a sustained lack of affordability against a backdrop of economic and labour market uncertainty. However, we're of the view that existing home sales likely reached a bottom in April, and that May's rebound may be the start of a gradual trend higher. In contrast, surging housing starts recently should boost new home construction in Q2. But we expect this rebound will be short lived, and that lower construction activity through the remainder of the year should weigh on residential investment.

Graph 5
Housing Starts and Sales Are Likely to Move Differently in 2025

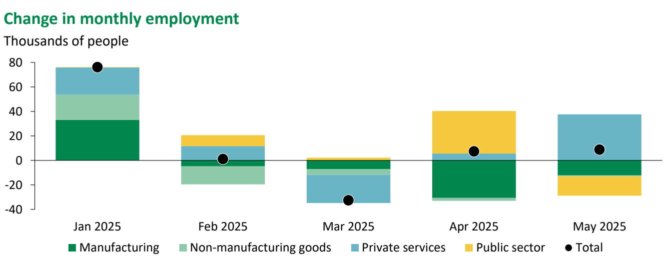


Canada Mortgage and Housing Corporation and Desjardins Economic Studies

The Labour Market Has Largely Shrugged Off the Trade War So Far

Jobs data through May were expected to reflect the weakness in trade flows. But to some extent they have bucked the trend, showing a net increase in jobs in both April and May. Looking through the rise and subsequent fall in public sector hiring around the federal election, private sector employment has largely held up. Mind you, that can mainly be chalked up to hiring in private services. In contrast, goods sector employment has moved lower in every month since January, in large part due to job cuts in manufacturing (graph 6). Employment in non-durables manufacturing seems to be the primary culprit, returning to mid-2024 levels in May 2025 following a sharp run-up in hiring at the end of last year. In contrast, durables manufacturing employment has continued its steady decline since peaking in early 2024. This is in line with seasonally adjusted auto production data through April, which have been broadly flat, suggesting cars are still rolling off Canadian assembly lines in spite of the tariffs. Taken together, these indicators point to the manufacturing sector showing some clear weakness, likely because of the trade spat with the US. But the decline has been more muted than might have been expected and isn't yet spreading to the rest of the economy.

Graph 6
Manufacturing Employment Has Fallen for Four Consecutive Months



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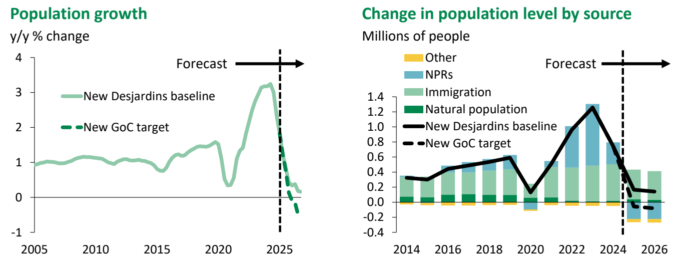
Looking ahead, we think the Canadian labour market is going to weaken but only modestly. Structural changes to the economy due to the trade war could be more prolonged than in prior periods of economic contraction. Sharply slowing population growth thanks to reduced immigration and a decline in non-permanent resident admissions should mitigate the rise in the unemployment rate and decline in the level of employment (graph 7). That said, slowing population growth will weigh down aggregate real GDP gains as well.

Graph 7
Population Growth Is Expected to Slow Considerably

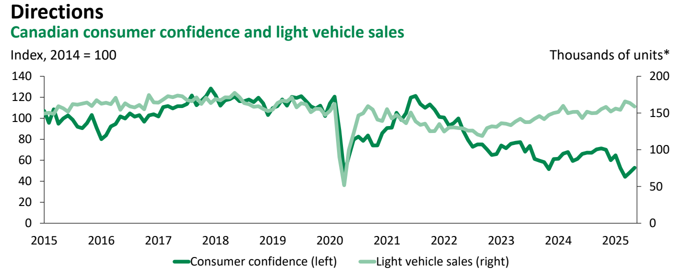


Note: Annual population is presented on a calendar-year basis.
NPRs: Non-permanent residents; GoC: Government of Canada
Government of Canada, Statistics Canada, Bank of Canada and Desjardins Economic Studies

Will Consumers Come to the Rescue?

The lack of a broad-based correction in the labour market appears to have left consumers feeling slightly more confident in April and May. However, consumer sentiment remains near the historic low reached in March 2025. While one wouldn't be blamed for thinking that would translate into weaker auto sales, the opposite has been true since the pandemic (graph 8). Now, stronger purchases of light vehicles are more likely to be associated with lower consumer confidence, possibly linked to the sky-high auto prices that characterized the post-pandemic period. Hence, despite being off their recent peak, auto sales remain elevated.

Graph 8
Consumer Sentiment and Auto Sales Have Moved in Different Directions

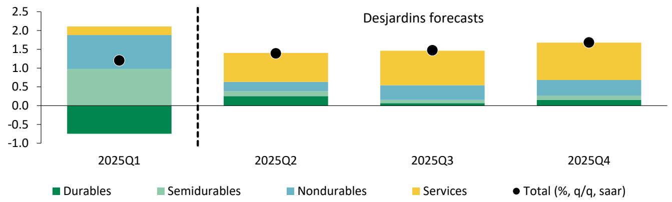


* Seasonally adjusted using Census X12.
Conference Board of Canada, Ward's Automotive and Desjardins Economic Studies

Car purchases make a meaningful contribution to consumer durables spending, which likely means less downward pressure on this expenditure category than previously expected (graph 9 on page 4). Slightly higher consumer confidence probably points to other consumption categories staying afloat in Q2 as well. As such, household consumption is likely to make a modest but positive contribution to growth in the second quarter of the year. We think the same could be true for Q3, further boosted by the planned personal income tax cut coming on Canada Day. However, this anticipated strength also comes against the

Graph 9
Real Consumption Should Move Higher Despite the Uncertainty

Contributions to the quarterly Canadian real consumption growth forecast
Percentage points, annualized rates



Saar: Seasonally adjusted unemployment rate.
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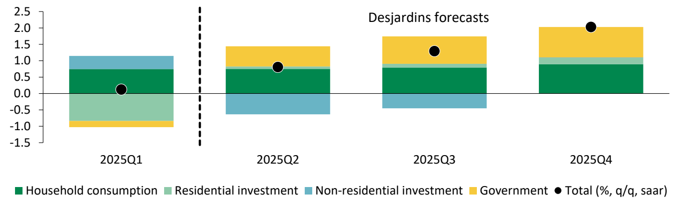
Graph 11
Real Final Domestic Demand Growth Should Stay in Positive Territory

Contributions to the quarterly Canadian real final domestic demand growth forecast
Percentage points, annualized rates



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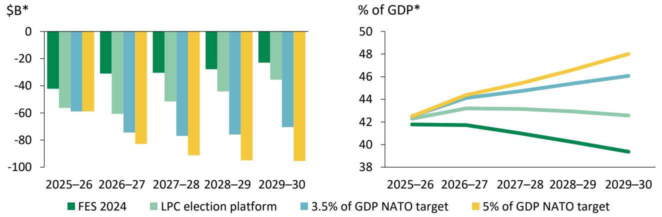
backdrop of mortgage renewals hitting household budgets in 2025 and 2026, providing an offset to this positive news.

"I'm from the Government and I'm Here to Help"

Despite declining in Q1 on shifting pension numbers, government spending is expected to ramp up in the coming quarters as the federal government begins delivering on its election promises. The plan is to run large deficits and rack up substantially more debt in the hope of spurring an economic boom in Canada (graph 10). This should boost both government consumption and investment and provide an offset to the drag from business and residential investment. However, we're skeptical that the plans laid out during the 2025 federal election will translate into the boost in economic activity that is hoped for. (For example, see our recent note on federal infrastructure investment and another on defence spending). But hope springs eternal.

Graph 10
Deficits Could Be Larger and Debt Higher than Currently Planned

Federal budget balance forecasts / **Federal debt forecasts**



FES: Fall Economic Statement; LPC: Liberal Party of Canada; NATO: North Atlantic Treaty Organization
* Defence spending estimates are made on a cash basis, with the assumption that the 2% NATO target will be reached in 2025–26, based on Desjardins Economic Studies June 2025 Economic and Financial Outlook.
Government of Canada, Office of the Parliamentary Budget Officer, LPC and Desjardins Economic Studies

Finally, Final Domestic Demand

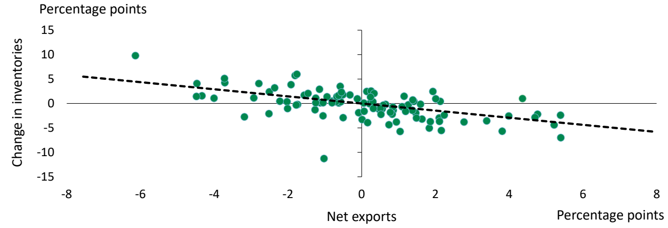
Adding all of this up—business investment, residential investment, consumption and government spending—final domestic demand growth should be weak but remain flat or slightly positive for the near future (graph 11). Indeed, a solid pace of government expenditures and weak but still-positive consumer spending and residential investment should together offset the drag coming from non-residential investment.

What's the Story with Inventories?

But consumption, investment, government spending and net exports don't quite add up to headline real GDP. Instead, inventory accumulation is needed to make the math work. Indeed, inventories are drawn down when imports and domestic production aren't enough to meet demand. On the flip side, inventories accumulate when imports and domestic production are greater than what is required for final domestic demand and exports.

As a result of businesses getting ahead of tariffs, the first quarter of 2025 saw the strongest quarterly contribution to growth from inventories since Q3 2022. This was unusual, as a positive contribution to real GDP growth from trade is typically associated with a drawdown in inventories (graph 12). But these are not typical times.

Graph 12
A Drop in Net Exports Is Typically Accompanied by a Bump in Inventories
Contributions to real GDP growth from inventory accumulation and net exports



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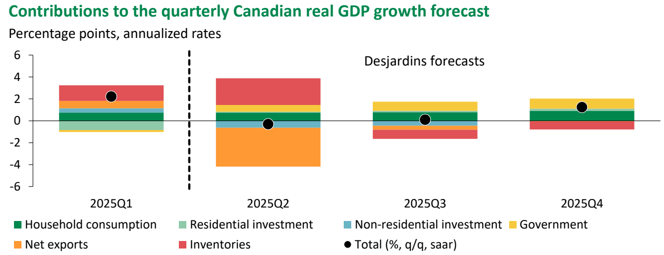
Looking ahead, we believe the sharply lower trade flows that we've seen so far in Q2 2025 will be accompanied by a build-up in inventories in the near term. On average, a drag from trade is typically matched by an offsetting contribution to growth from inventories of about half that magnitude. And with data so far in Q2 suggesting production didn't fall off a cliff in April and May while trade did, inventories likely stacked up in the early part of the second quarter of 2025.

A Bumpy Road Ahead for Real GDP Growth

When our near-term outlooks for final domestic demand, net exports and inventories are combined, the result is a real GDP growth forecast that is flat to slightly negative over the next couple of quarters (graph 13). Whether this ultimately qualifies as a recession will be for scholars to decide. But what we know for now is that the Canadian growth outlook is pretty bleak because of US tariffs and the ensuing uncertainty. And with the Canada–US trade relationship severely strained, possibly irreparably, it's tough to see a surging rebound in economic activity in Canada's future. See our June 2025 Economic and Financial Outlook for more information on how our near-term forecast fits into our broader medium-term projection.

Graph 13
Trade Should Weigh on Growth Now That Tariffs Have Taken Effect



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