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Economic Research - Canadian Forecast

The Monthly Monitor



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LBS Economic Research

Carlos Leitao
Chief Economist
514 350-3000
leitao@lb-securities.ca

Sébastien Lavoie
Assistant Chief Economist
514 350-2931
lavoies@lb-securities.ca

Marie-Claude Guillotte
Economist
514 350-2925
guillottemc@lb-securities.ca

Emir Coskun
514 350-2941
coskune@lb-securities.ca

Subscription:

Martine Bérubé
514 350-3006
berubem@lb-securities.ca

Stéphanie Fortin
514 350-2952
fortins@lb-securities.ca

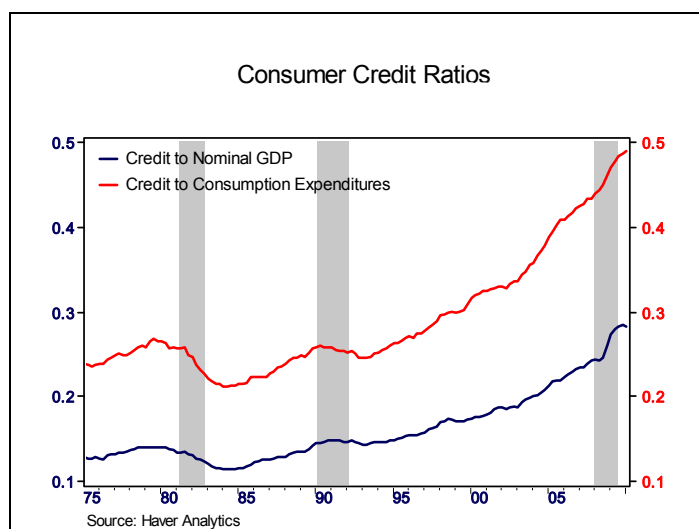


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SECURITIES



Canada's economic recovery is losing steam

The Canadian economy is entering a transition phase. Households have responded to the expansionist policies, thereby quickly boosting economic activity. Extremely low interest rates have encouraged Canadians to rely on credit more than income to finance their spending, generating a marked increase in their debt in relation to disposable income. It is therefore not surprising that consumer credit in relation to consumer spending rose during this recession, whereas it decreased during the previous two recessions.



We think that, in the future, households will be less avid for credit, for several reasons: indebtedness is already quite high; interest rates will no longer be extremely low; and the value of assets will not increase as quickly as it did in the past. Accordingly, households' contribution to the recovery is expected to decline in the next few quarters. We are forecasting a lull in the housing market and some moderation in consumer spending between now and the end of the year. Next year, we will see cutbacks in government investments as the stimulus plans—another major component of the recovery so far—draw to a close.

Despite a smaller contribution by households, more indebted governments and an increase in risks that could perturb the stability of the financial system, we are ruling out the possibility of a double-dip recession in this country. Other factors will be gaining ground, thus contributing more to the expansion.

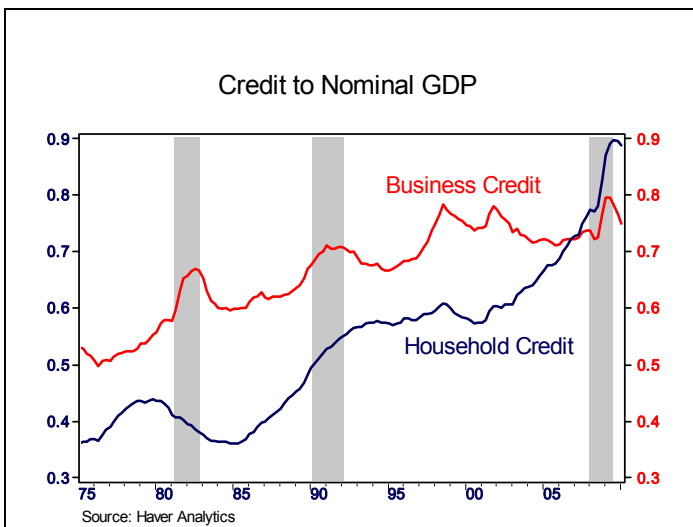
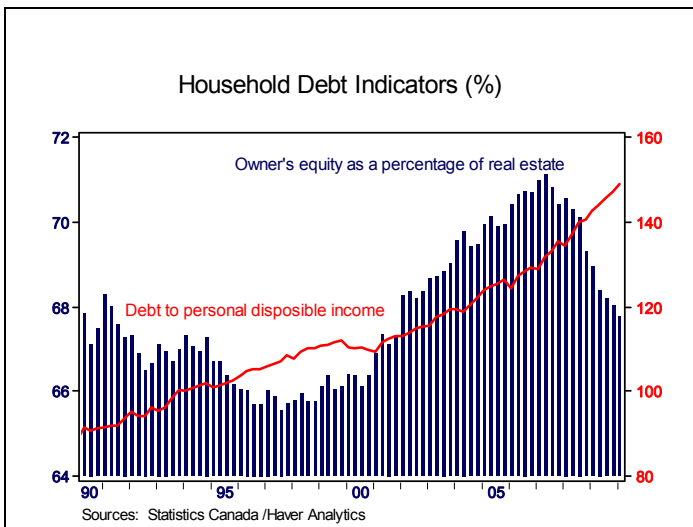
Although they have been timid up to now, profitable companies are in a good position to revive private investment. Those that export abroad should benefit from the global recovery, even though it looks like it will be uneven. All things considered, real GDP growth in the coming quarters should diminish at an annualized quarterly pace below 3%, that is nearly half of the growth recorded in Q4 2009 (4.9%) and Q1 2010 (6.1%). In terms of annual change, *LBS Economic Research* forecasts that growth will reach 3.3% this year and 2.5% next year (see tables at the end of this report).

Higher debt, interest rates and taxes will dampen consumers' enthusiasm

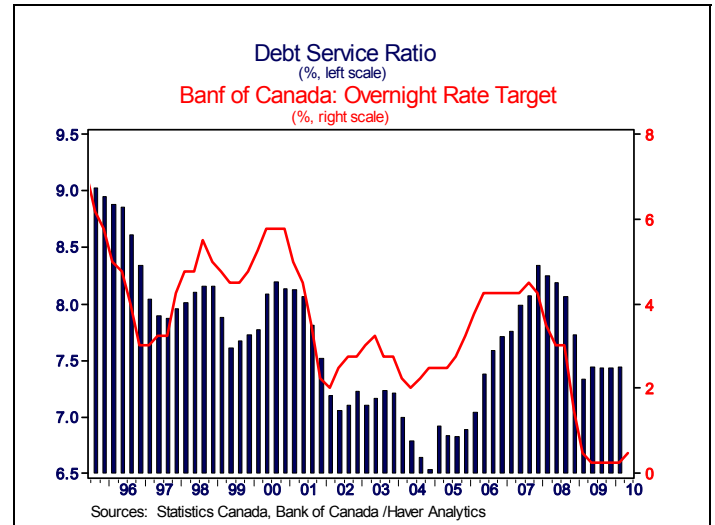
Let's start with the key component that accounts for nearly two-thirds of the GDP: consumer spending. Since the end of 2009, thanks to the expansion of credit, consumer spending has managed to exceed the former peak of Q3 2008, whereas the record employment level of that quarter is not likely to be matched until Q3 2010. Even though disposable income will increase at a slightly faster pace in 2010 (3.5%) and 2011 (2.3%) compared with 2009 (1.7%), that will not be enough to offset the other factors dictating a moderation in spending, i.e. the higher level of debt, interest rates and sales taxes. In this situation, the glory days are behind us as far as growth is concerned. Consumer spending will make a smaller contribution to growth: 2.5% (annualized q/q) or thereabouts in the second half of 2010. In 2011, growth in consumer spending will trail that of real GDP, a situation that has not happened since 2000. In fact, it will probably lag behind growth in employment income by the end of Q3 2010, even though the latter is expected to accelerate.

The main factor behind this moderation is the ballooning debt: total household debt in relation to GDP stood at 94% in Q1 2010. Prior to the recession of 2008-2009, that ratio was 82%. The same holds true for debt in relation to disposable income, which shot up from 137% to 149%. This increase in debt does not pose any major problem, as long as the value of assets also gains ground, which has been the case so far. However, if the value of housing stops increasing and interest rates rise, the equity that households have in their most valuable asset could be severely affected. Moreover, forecasts of fairly moderate growth in the financial markets indicate that the appreciation of financial assets may slacken. That, combined with the stagnating value of real estate assets, could reduce the wealth effect that is the increase in demand for consumer goods triggered by the rising value of real estate assets or of securities.





It could quickly return to the level of 2007 (8.0%) or even surpass it due to the increase in the prime rate but, more importantly, to the fact that it has not fallen at the same pace as the key interest rate, as was the case in 2001 (see graph). This is another indication that the debt load is heavier, and consequently interest payments will be too. To meet this increase in the proportion of income allocated to debt repayment, Canadians will inevitably have to save more. We estimate that the savings rate will have to climb to around 4.0%—4 cents for each dollar of disposable income—before households will be able to accelerate their spending, and that will not happen during the period of our projection, i.e. between now and the end of 2011.



Another factor is the tax hikes that governments will impose to absorb their budget deficits. These will also contribute to reining in consumers' fervour. First of all, on July 1, the provincial sales taxes in British Columbia and Ontario will be harmonized with the federal goods and services tax (GST), and the provincial portion of the HST in Nova Scotia will be raised by two percentage points. Then, in January 2011, the Québec government will increase its QST by one percentage point. All told, the net impact of these measures on Canadian households between July 2010 and June 2011 represents approximately \$2.5B less in their pockets. To that amount we must add the health contribution, which will subtract \$180M from Quebecers' budgets this year and \$575M next year. In short, even though it has been proven that value-added taxes are less damaging to wealth creation than other forms of tax, such as personal income taxes, the fact remains that consumer spending will have to absorb this fiscal shock. Actually, there is some uncertainty on this point. To begin with, it remains to be seen to what extent the impact of the lower input costs for Ontario and BC companies due to the tax harmonization will be carried over to the prices that consumers pay. Secondly, other indirect tax increases are a possibility after 2011.

Furthermore, households—especially those holding variable credit—will be keeping a close watch on upcoming decisions by the Bank of Canada, which started its interest rate normalization process on June 1. The popularity of lines of credit and variable rate mortgages is undeniable: the proportion of lines of credit in consumer credit has doubled, from 30% in 2000 to 60% in 2009, while the proportion of variable rate mortgage loans soared from 8% to 25% over the same period. This means that a greater proportion of households will see their monthly payment obligations rise as the Bank of Canada proceeds with interest rate hikes. We believe that it will do so in 25 basis point increments at each of its upcoming meetings, reaching a total of 1.50% by the end of 2010. This means that by that time, the prime rate will rise to 3.50%. Consequently, the debt service ratio (which expresses interest charges in relation to disposable income) will increase, since income growth will probably not keep pace with the higher interest rates. That ratio has been fairly stable since Q2 2009 (7.4%), i.e. during the period of the Bank of Canada's conditional commitment.

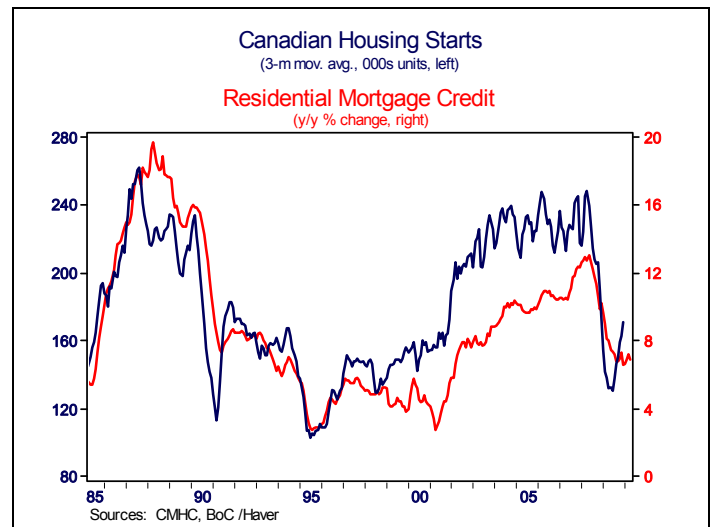
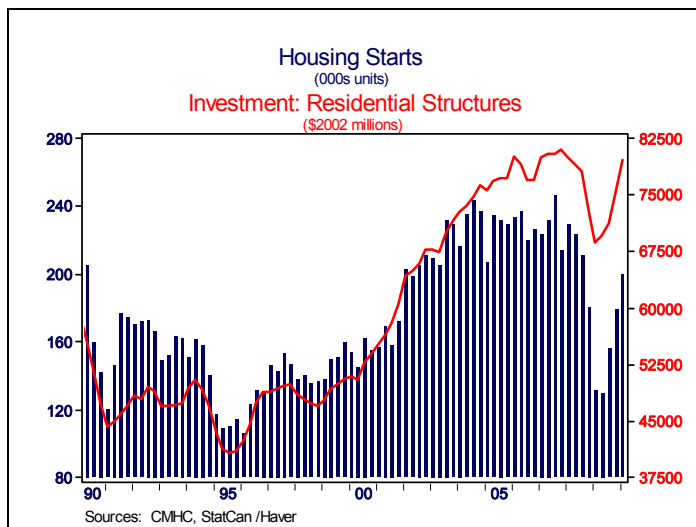


As already announced, Quebec households will feel the repercussions of a second hike in the QST in January 2012; the impact of that on their budgets will amount to \$1.3B per year. And we must not forget that the health contribution will deduct \$945M in 2012. It is also possible that other provinces will follow Québec's example in an effort to eliminate their deficits, by introducing increases in taxation rates within a year.

A lull in the housing market starting this year...

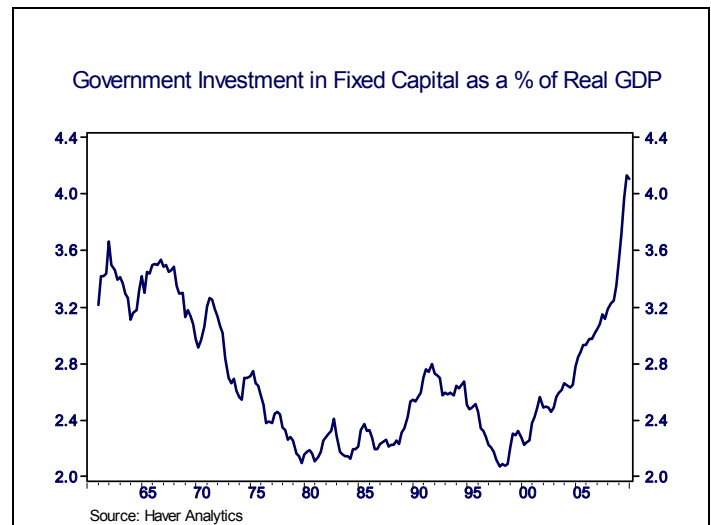
After substantial gains stemming from temporary stimuli such as the home renovation tax credit and exceptionally low mortgage rates, investments in residential construction are likely to drop during the second half of the year (-18% in Q3 and -22% in Q4 2010, quarterly annualized change). In fact, sped-up demand has already started to show signs of waning: resales and housing starts declined by 10% and 6% respectively in May compared with April. Looking ahead, homebuilding investments will reflect more fundamental factors such as the recovery of the labour market, new household growth, and mortgage lending conditions. The latter were tightened slightly on April 19. Finally, as mentioned above, Canadians' household debt will account for a larger slice of their budgets, thereby reducing the money set aside for residential investment.

Consequently, we predict that housing starts will fluctuate between 150,000 and 160,000 units (annualized) over the next five quarters. That level is similar to what was seen in 2001 and represents a 40% contraction compared with the record of 246,200 units observed in Q3 2007. However, we must not jump to the conclusion that the Canadian housing market is on the verge of undergoing a severe correction as happened in the United States. The historic low of 530,000 housing starts recorded south of the border in Q1 2009 represented a 75% decline compared to the peak of Q1 2006.



...and in government spending next year

As for government spending, it will further stimulate economic growth in 2010 through the continuation of stimulus plans. Most governments' capital investments will remain high until Q2 2011, when the austerity era will begin. At that point, they will be brought back down to levels closer to those seen before the recession. In addition, governments are getting ready to do more with less by cutting back on program expenditures to keep its annual average rate of growth below the revenue rate for several years to come. In the end, it would not be surprising to observe a pullback in spending on goods, services and fixed assets in Q2 2011 (-2.7%) followed by very tepid growth in the years after (see the latest issue of the *Provincial Monitor* published at the beginning of June 2010 for more detailed information).



Unclogging of business investment

Other sectors of the economy will be called upon to step up to the plate, to compensate for the loss of vitality in consumer spending, the downturn in housing spending and the imminent start of a long period of fiscal austerity.

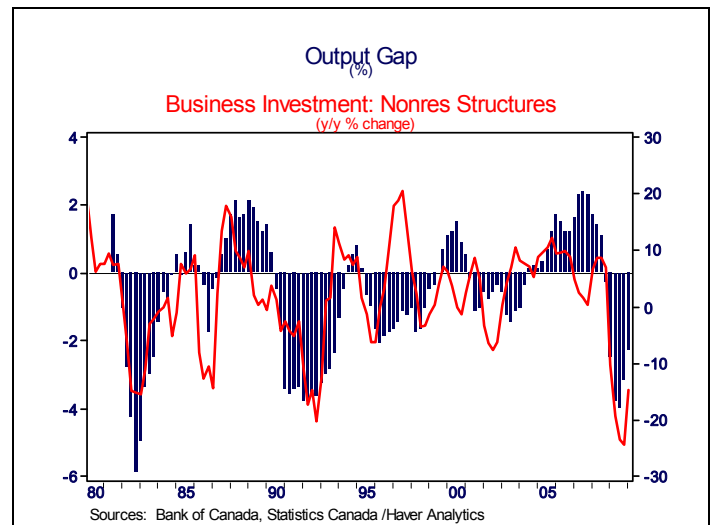
One of those sectors is business investment. Despite favourable balance sheets, companies cut back on their total investment spending more than usual during the 2008-2009 recession, compared with previous recessions. They exercised great caution when faced with extraordinary financial events. And as is usually the case during the recovery period, businesses take their time before making any substantial increase in their investments. Yet, they must do so first and foremost to improve their productivity and competitiveness, while favouring in turn a more balanced recovery. There are a few signs that business investment is on the verge of picking up.

First of all, having become profitable again in Q3 2009, boasting profit growth of nearly 10% compared to the low of the previous quarter, businesses are now in a better position to expand their investments. During the 1991-1992 recession, it took approximately four quarters of profit growth before we saw any concrete recovery in investments.

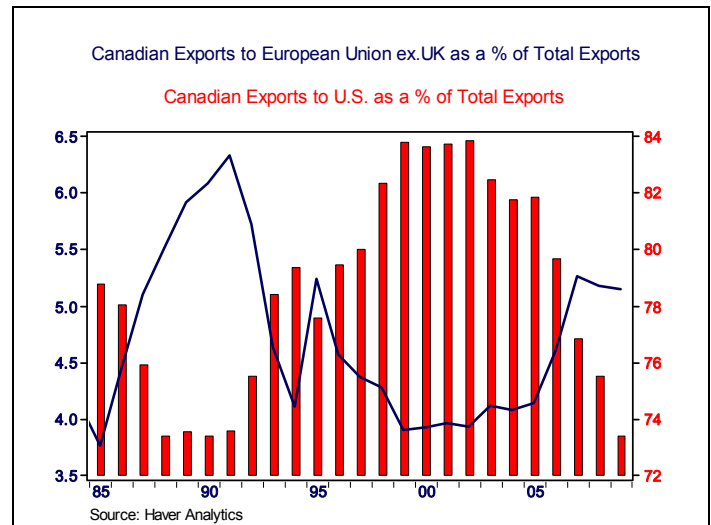
Secondly, the substantial excess supply is being absorbed as the recovery progresses. During Q1 2010, Canadian industries operated at 74.2% of their production capacity, up from 71.3% in Q4 2009 and from the nadir of 68.1% in Q2 2009. As for the output gap, that is the percentage variation between actual and potential output levels, it is gradually closing. It inched up from -3.2% in Q4 2009 to -2.3% in Q1 2010. According to our forecasts, we estimate that this surplus supply will be completely absorbed during the year 2012. In those conditions, investment in non-residential buildings should put an end to its decline of the past six quarters and rebound in the second half of the year. The rally in investments in machinery and equipment, which started in Q1 2010 (7.5%), should accelerate in the next few quarters.

Thirdly, the results of the Statistics Canada survey on investment intentions in the private and public sectors show that private-sector investments will rise in 2010, but stay well below the levels seen in 2008. We should point out, however, that this survey was conducted at the beginning of this year. Since then, greater risks—imbalances, financing, liquidity—surrounding the stability of the system are such that it is now less certain that those intentions will be followed by action. Those risks could delay the release of funds earmarked for investment. We should add that, even with an increase in private investment of nearly 10% in 2011, it will still probably be below the level observed in 2008. Some of the sectors that are most likely to expand their investments are mining, oil and gas extraction. The automotive industry will probably do the same; in fact, GM has already announced investments at its St. Catharines plant to build new transmissions and more fuel-efficient V8 engines.

Fourthly, though it may be a burden for consumers, the HST in Ontario and British Columbia will be in the interest of businesses.



Most companies will be able to claim tax credits on their inputs, to offset the sales tax that they pay on many of their purchases and capital expenditures; this will provide them with considerable savings. In the past, other provinces that adopted the HST, such as Nova Scotia, New Brunswick and Newfoundland and Labrador, saw a surge in business investments. The same will no doubt hold true for private investment in Ontario and BC, which account for approximately 45% of all private investments in Canada.



Fifthly, global growth is on target, though it may be uneven. We are predicting respectable growth in exports, in the order of 9.1% in 2010 and 7.8% in 2011, in particular thanks to the recovery of the American economy, whose growth could reach 3.1% in 2010 and 2.7% in 2011, according to our forecasts. Furthermore, since Europe is not a major trading partner for Canada (just 5% of total exports), the impact of the austerity measures being adopted in some European countries on Canadian exports will be minimal. As for imports, they will be supported by an upswing in investment by Canadian businesses in machinery and equipment, and will therefore climb by 11.3% in 2010 and 5% in 2011.

Canada

Period-Over-Period Annualized Per Cent Change Unless Otherwise Indicated

								Annual Average			4th Qtr/4th Qtr		
	2009Q4	2010Q1	2010Q2	2010Q3	2010Q4	2011Q1	2011Q2	2011Q3	2009	2010	2011	2010	2011
Real GDP (%)	4.9	6.1	2.5	2.6	2.3	2.4	2.0	2.9	-2.5	3.3	2.5	3.4	2.7
Consumption	3.9	4.4	3.2	2.5	2.4	2.0	2.3	2.3	0.4	3.5	2.3	3.1	2.3
Business investment	-9.4	2.6	10.5	12.5	10.1	8.7	8.0	9.1	-20.0	1.9	9.5	8.9	8.8
Non-residential structures	-11.4	-5.4	8.0	10.0	12.0	10.0	8.0	7.5	-19.5	-4.1	9.4	5.9	8.4
Machinery and equipment	-8.1	7.5	12.0	14.0	9.0	8.0	8.0	10.0	-20.3	5.7	9.5	10.6	9.0
Residential construction	26.3	23.6	5.0	-18.0	-22.0	-10.0	-4.0	-3.0	-8.2	8.4	-10.2	-4.5	-4.6
Government spending	9.1	2.2	2.6	2.6	2.2	1.8	-2.7	-0.6	5.1	4.7	0.7	2.4	-0.5
Exports	13.8	12.0	11.5	8.0	6.0	7.0	9.0	8.0	-14.2	9.1	7.8	9.3	8.0
Imports	12.4	14.1	8.0	6.0	4.0	4.0	5.5	5.0	-13.9	11.3	5.0	8.0	4.9
Current account balance in % of GDP	-3.1	-2.4	-1.7	-1.5	-1.3	-1.1	-1.1	-1.1	-3.4	-1.7	-1.1	-	-
Inflation (%)													
Total CPI (y/y)	0.8	1.6	1.4	2.4	2.3	1.9	1.9	1.7	0.3	1.9	1.9	2.3	2.0
Core CPI (y/y)	1.6	1.9	1.7	1.7	1.4	1.8	1.9	2.0	1.8	1.7	1.9	1.4	2.0
Unemployment rate (%)*	8.4	8.2	8.1	7.9	7.8	7.8	7.7	7.5	8.3	8.0	7.6	-	-
Employment	1.3	1.5	3.4	1.0	0.9	1.3	1.5	1.8	-1.6	1.4	1.5	1.7	1.6
Housing starts (000s)	180	198	188	150	155	155	165	160	149	173	161	-	-
Before-tax Corp. Profits (y/y)	-12.1	16.8	31.6	23.5	18.2	12.7	13.5	12.5	-32.3	22.2	12.2	18.2	10.2

*Average rate for the quarter or the year.

Forecasts as of June 30th, 2010

United States

Period-Over-Period Annualized Per Cent Change Unless Otherwise Indicated

								Annual Average			4th Qtr/4th Qtr	
	2009Q4	2010Q1	2010Q2	2010Q3	2010Q4	2011Q1	2011Q2	2009	2010	2011	2010	2011
Real GDP (%)	5.6	2.7	3.5	2.6	2.4	2.6	2.6	-2.4	3.1	2.7	2.8	2.6
Consumption	1.6	3.0	2.7	2.0	1.9	1.8	1.9	-0.6	2.2	2.0	2.4	1.9
Private investment	6.7	3.3	10.6	9.6	6.6	8.7	8.7	-17.6	4.3	8.5	7.5	8.7
Machinery and equipment	19.0	11.4	16.0	12.0	8.0	10.0	10.0	-16.6	11.1	10.2	11.8	10.0
Residential construction	3.7	-10.3	6.2	2.0	3.0	3.5	2.5	-20.5	0.0	3.0	0.0	2.7
Government spending	-1.3	-1.9	1.0	2.6	2.7	1.3	1.3	1.8	0.7	1.7	1.1	1.2
Exports	22.8	11.3	8.0	6.8	6.2	5.6	5.5	-9.6	11.5	6.0	8.0	5.5
Imports	15.8	14.8	5.2	5.2	5.3	3.9	2.8	-13.9	10.0	4.0	7.6	3.2
Inflation (%)												
Total (y/y)	1.5	2.4	1.9	1.5	1.2	1.0	1.3	-0.3	1.8	1.4	1.2	1.8
Core (y/y)	1.7	1.3	1.0	0.9	0.8	1.0	1.2	1.7	1.0	1.2	0.8	1.4
Unemployment rate (%)*	10.0	9.7	9.8	10.2	10.0	9.8	9.7	9.3	9.9	9.7	-	-
Housing Starts (000s)	564.7	617	650	665	675	700	725	554	652	725	-	-
Before-tax Corp. profits (% y/y)	30.6	34.0	12.0	10.0	10.0	5.0	7.5	-3.8	15.9	8.1	10.0	10.0

* Average rate for the quarter or the year.

Forecasts as of June 28th, 2010

Marie-Claude Guillothe
Economist