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Economic Research - Canadian Forecast

# The Monthly Monitor



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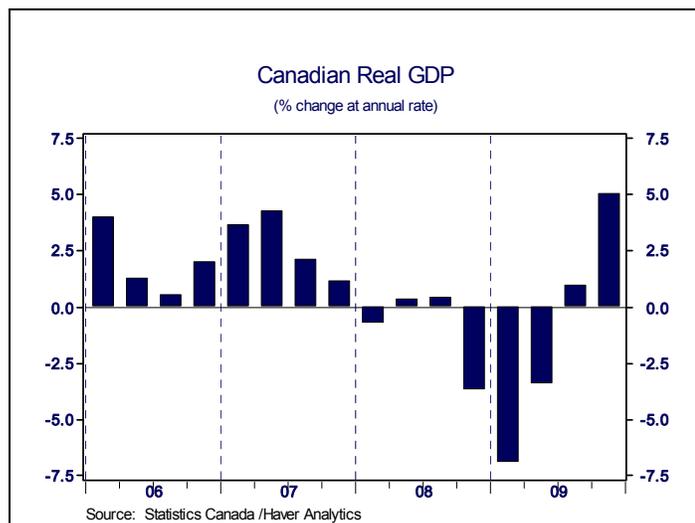
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## Canadian Economic Outlook 2010-11: Growth to Shift into a Lower But More Sustainable Gear

The recovery is taking hold firmly. The Canadian economy advanced at a sizzling pace of 5.0% (annualized) during the last quarter of 2009. Its strength rests far more than usual on successful accommodating fiscal and monetary policies. Exceptionally low interest rates have boosted durable goods consumption, home renovations, existing home sales and residential construction. In addition, government recovery plans have firmed up both public spending and public investment. The Olympics too, provided a nice push that started off the year on a positive note.



Though far from perfect, the Canadian economic recovery is starting to grow roots. This year, governments are trying to make sure that it continues. But, over the medium term, the economic expansion cannot rely solely on excessively expansionist fiscal and monetary policies. If that were to happen, Canada would eventually pay the price, through heavy public and private sector debt levels. Thus, the most probable scenario is that the Canadian economic expansion will continue within a mild normalization process of macroeconomic policies, without putting the recovery in jeopardy. Firstly, we see the Bank of Canada starting to remove part of the accommodative monetary stance in July, in order to respect its mandate of keeping inflation near its 2% target. Secondly, governments will disengage next year in order to bring down their deficits.

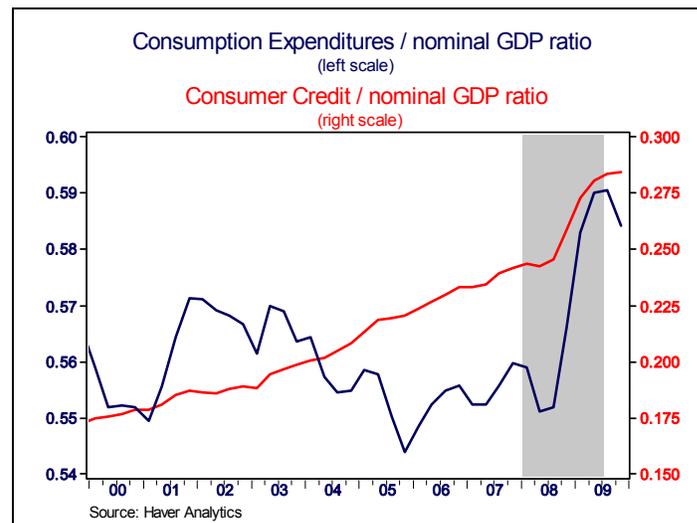
The positive effect of highly expansionist macroeconomic policies will thus gradually dissipate. The result will be slightly slower growth in household demand and government spending, which so far have been key economic drivers. *LBS Economic Research* has been predicting since last year that the current expansion cycle will be moderate, with real GDP growing below the 3% level in both 2010 and 2011.

And, despite the Canadian economy's stronger than expected burst out of its recession, we continue to think that growth will continue at a declining pace, not an accelerating pace. We forecast real GDP growth at 2.8% during 2010 and at 2.5% in 2011. On a quarterly basis, real GDP growth will be slightly higher than 3.0% (annualized) in each of the first two quarters, and will slip back under 3.0% during the second half of the year, and closer to 2.5% throughout 2011. Although we are projecting slightly slower growth next year, it will be more balanced among all sectors than it has so far: consumption will continue to advance soundly, supported by improving job market conditions and the healthy balance sheets of households; Furthermore, business investment, which has been a missing piece in the puzzle so far, is expected to contribute more to the expansion; Export volumes will advance modestly, reflecting a timid US economic expansion and a loonie flying close to parity.

The following sections of our revisited Canadian outlook provides more detailed portraits of household consumption, housing, governments, business investment, and exports. Forecasts are available in the table at the end of the report.

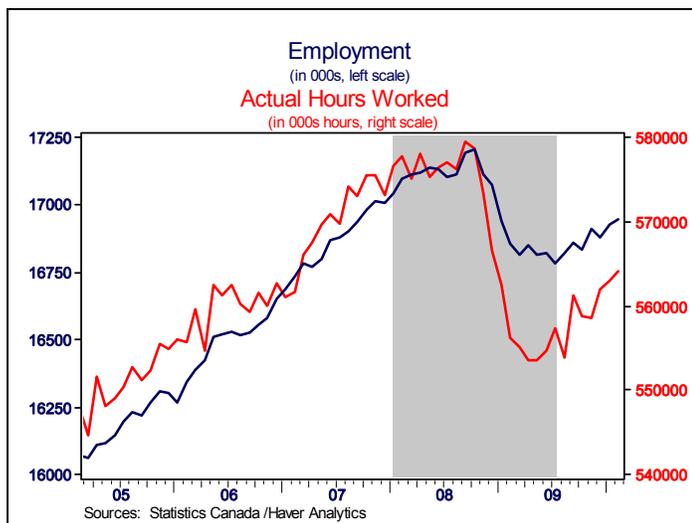
### A Moderate Slowing in Consumption Growth

With the delicate return towards a less stimulative monetary policy, the pace of growth in household demand, which so far has been the key driver of the economic expansion, is expected to weaken slightly during the coming quarters. As pent-up demand and pull-forward demand will cease to be major underlying factors, consumption growth will rest more on fundamentals such as labour market conditions, households' balance sheets, and consumer confidence.



These three factors all signal respectable consumption growth going forward. More precisely, consumer confidence has bounced back to pre-recession levels and the average household net wealth increased to approximately \$173,000 during the fourth quarter. Although Canadians have taken on a lot of new debt, this has been balanced out by the appreciating value of their financial and residential assets.

Also, job market conditions will continue to improve slowly during upcoming quarters although nowhere near as favorable as they were between 2006 and 2008. Even if total employment rose by a net 159,000 posts since the beginning of the recovery, it remains well below (260,000 jobs) the October 2008 peak, just before the global financial crisis took hold. During the recession many businesses were reluctant to let go of qualified staff, so they cut work hours instead. As a result, companies are not hiring massively during the recovery. As economic activity ramps up, firms are mostly giving their existing employees back the hours cut when things were slow. As such, we estimate it will take at least another year before total employment returns to its October 2008 peak. Furthermore, when private sector employers do take on new staff, they usually start out by recruiting temporary workers. These workers in general earn considerably less (16% in 2003 according to Statistics Canada) than permanent workers do. Lastly, the strong loonie, which is forcing exporters to keep labor costs low so they can remain competitive at the global scale, also plays against a V-shaped recovery in employment. Altogether, these elements set the tone for a moderate increase in disposable income in 2010 and 2011. The unemployment rate should gradually drift below the 8% mark this year, though it will remain above the 6% rate seen between the end of 2007 and the beginning of 2008.

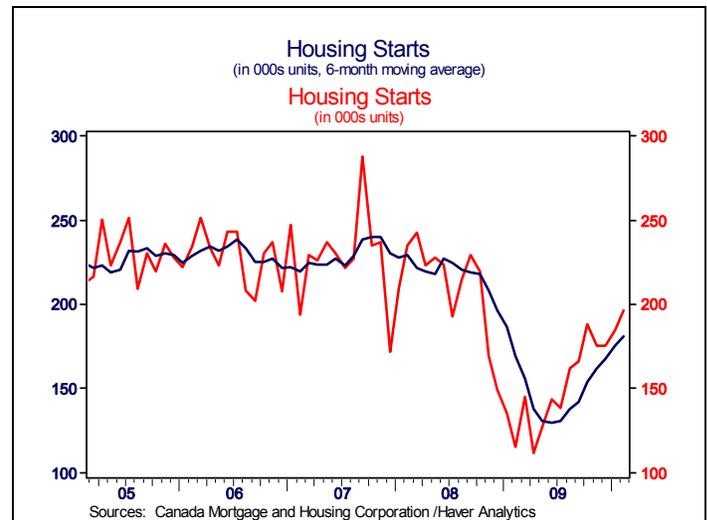


### Residential Investment: A Strong Pullback in the Cards

The residential investment boom – including existing home sales, construction and renovation activity – got stretched last year, thanks to stimulative macroeconomic policies. Going forward, look for residential investment to be a drag instead of a boon on GDP growth:

- The successful federal home renovation tax credit ended on January 31st.
- Mortgage loan applicants will have to meet slightly stricter lending criteria starting on April 19th.

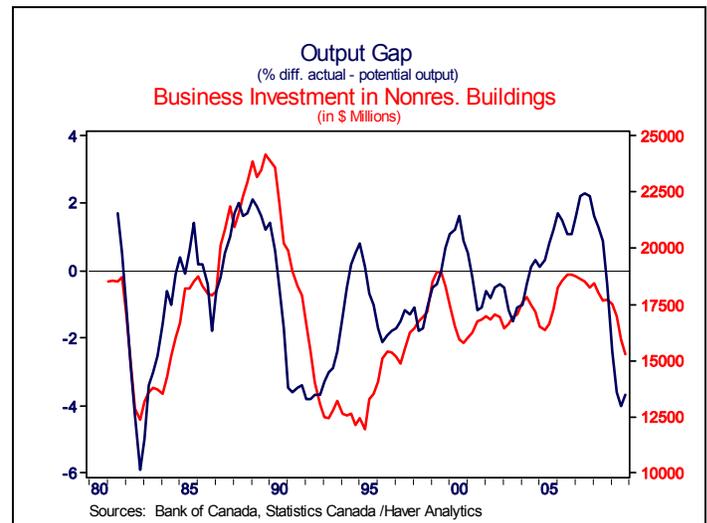
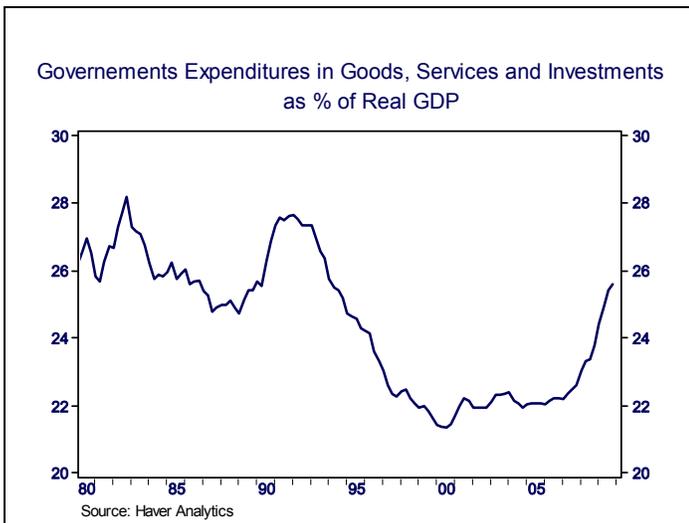
- Demand for new homes has been temporarily spurred by the provincial sales tax harmonization in British Columbia and Ontario (which will take effect in July 2010), as buyers rush to avoid paying extra taxes. Real estate promoters have helped by advancing production. During the second half of the year housing starts will fall, towards the annual rate of 150,000 units.



Further, the release of pent up demand for existing homes, which saw renewed glory days last year, started to abate. According to the Canadian Real Estate Association, the number of existing homes sold fell by 3.2% m/m in January and by another 1.5% m/m in February. This is likely the beginning of a long descent since pull-forward demand is set to also wane once the exceptionally low interest rates period draws to a close during the second half of 2010. All of the above factors will combine to push down residential investment activity during 2010 (-1.6%), followed by a sharper decline in 2011 (-9.4%).

### Fiscal Disengagement

Government infrastructure spending, which jumped by 12.9% last year, has also boosted real GDP in the first stages of the recovery. Altogether, government expenditures in goods, services and investments suddenly counts for one-quarter of real GDP, the highest share observed since the early 1990s. After working hard to re-launch the economy last year, the federal and provincial governments plan to maintain their efforts during 2010. As a result, public spending and investment will remain a key pillar of growth until 2011. Then, Ottawa and the provinces will enter a phase of transition, as finance ministers try to get their fiscal books back in order. For example, Ottawa's economic action plan ends on March 31, 2011. Put simply, government-related investment in infrastructure will naturally experience a fallout in the second quarter of 2011. Overall, Ottawa plans to slow annual program spending growth to an average of 0.9% between FY 2011-12 and 2014-15. Other provinces will unveil their budgets soon, but most appear to be opting for restraints on the expenses side to get finances back on track. In short, an era of fiscal tightening will begin soon, leading us to forecast a mere 1.1% growth in government spending in 2011, following robust back-to-back increases of 4.5% in 2009 and 4.9% in 2010.



### Business Investment About to Rise

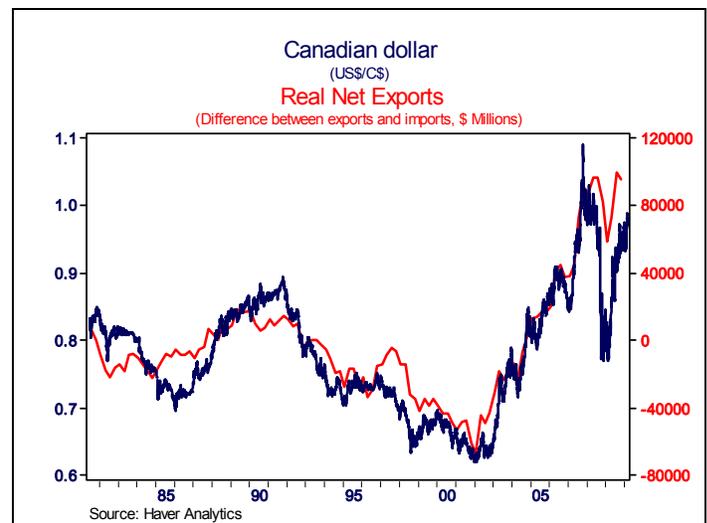
The current economic recovery has so far not been broadly based. Although households have responded to accommodating fiscal and monetary policies, businesses have held off. This is, to a certain extent, quite understandable. During the fourth quarter of 2009, Canadian industries functioned at only 71% of their production capacity. Similarly, actual production remains far below its potential (the BoC's statistical estimate of the output gap is 3.7% for 09Q4). Excess supply naturally implies weak demand for non-residential investment in buildings, which recently hit its lowest level since 1997. Nevertheless, as the economy expands and excess supply gets absorbed, non-residential investment will start to pick up, mostly in 2011. Meanwhile, business investment in machinery and equipment is expected to be somewhat stronger in 2010 and 2011 after cooling off substantially in 2009 (-19.2%). All of the ingredients are in place for a rebound in M&E investment:

- Operating profits have been increasing in most industries for the past two quarters and debt levels are low.
- Credit conditions on the financial markets improved considerably, including the narrowing in corporate credit spreads.
- The strong Canadian dollar, expected to stay close to parity, reduces the cost of imported machinery and equipment.
- A reduction in royalties charged to the oil and gas industry will bring Alberta's tax regime increasingly in line with those in other Canadian and US jurisdictions. This in turn could attract more investment.
- Recent Statistics Canada and Bank of Canada surveys suggest that businesses plan to increase their investment expenses.

All in all, we look forward to see business investment (non-residential and M&E) compensating for slowing public sector investment, particularly in 2011 with almost double-digit growth (+9.1%).

### Exports Will Advance Only Moderately Due to a Strong Loonie and Soft US Demand

It is well known that the Canadian dollar's run-up during the years 2000 and the global recession hit Canada's trade sector hard. During the second quarter of 2009 for example, the volume of exports just barely reached \$400 billion (annualized), their lowest level since 1998. Since the economic recovery began, the rebound in the trade sector has been timid and mixed. Soft growth for exports is in the cards since the strength of the loonie, currently trading at near parity with the US greenback, appears to be more durable than it was the last time that happened back in 2007. Indeed, from an international standpoint, the grass looks greener in Canada than it does elsewhere in several respects: government finances are stronger than in other G-7 nations; the unemployment rate is lower; the country hosts a solid banking industry and some of the world's largest commodity producers; Also, the Bank of Canada's governor Mark Carney appears to be in a strong position to lift the overnight rate in 2010Q3.

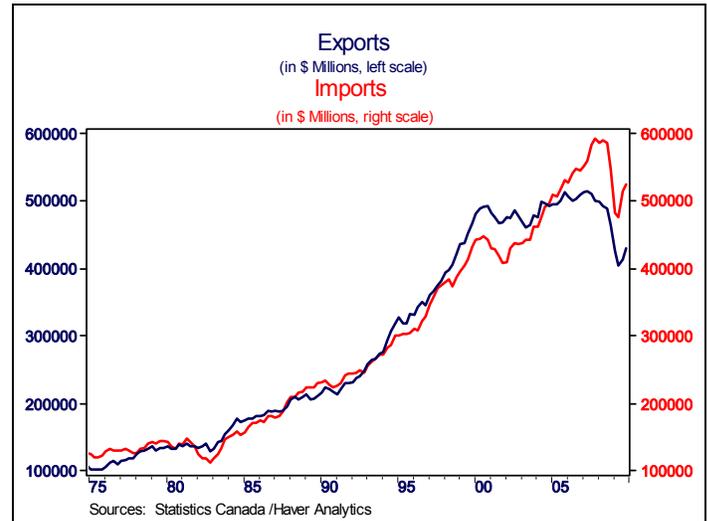


When the loonie marched gradually to parity during the years 2002-2007, exporters slowly adjusted to the strengthening currency by reducing labor costs, increasing the efficiency of their capital equipment and modifying prices. Some were even hoping that the currency would decline and did nothing. Today, the business-thinking of exporters has changed. More exporters seem to understand that it is better to continue operating business with a loonie at par by continuing this long adjustment process. As such, the loonie's most recent surge is unlikely to have as much an impact as the previous one.

But exporters are more than bearing the brunt of an elevated currency. The composition of global demand is also at play. The origin of global growth is not as favorable as in the good old days for Canada's export volumes. During the 1990s for example, the US economy accounted for 35% of world real GDP growth. During the years 2000 that contribution shrank to just 15% and it is likely to stay at that range for the coming few years. Since the United States is our largest trading partner, Canada will not be able to profit to the same extent from the global expansion in terms of export volume – and therefore real GDP – than in the past.

In fact, the composition underlying our US real GDP outlook (3.3% in 2010; 2.7% in 2011) implies a modest pick-up in Canadian exports this year and next. Firstly, the de-leveraging currently underway in US households will continue, meaning automotive and other consumption products export growth below previous cruising speeds. Furthermore US housing starts will likely remain below one million annually over the medium term, keeping the recovery in Canada's forest products sector out of sight.

The outlook is more promising in the materials and industrial goods exports sector, which is being spurred by new signs of life in the US manufacturing sector and the expected increase in investment by US firms. Also, the completion of major projects will soon translate into a continued increase in the volume of oil sands. Altogether, we expect Canadian exports to advance by a moderate 7.5% in 2010 and by 5.0% in 2011. Persistent double-digit growth in export volumes appears to be a pipe dream, until Canada's trade ties with BIC emerging countries are further developed.



## Canada

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

									Annual Average			4th Qtr/4th Qtr	
	2009Q3	2009Q4	2010Q1	2010Q2	2010Q3	2010Q4	2011Q1	2011Q2	2009	2010	2011	2010	2011
<b>Real GDP (%)</b>	<b>0.9</b>	<b>5.0</b>	<b>3.5</b>	<b>3.0</b>	<b>2.7</b>	<b>2.8</b>	<b>2.5</b>	<b>2.0</b>	<b>-2.6</b>	<b>2.8</b>	<b>2.5</b>	<b>3.0</b>	<b>2.3</b>
Consumption	3.7	3.6	2.8	2.8	2.2	2.2	2.4	2.4	0.2	2.9	2.4	2.5	2.4
Business investment	10.1	-8.9	-2.8	5.1	9.7	9.0	10.1	9.4	-17.9	0.1	9.1	5.1	9.1
Non-residential structures	-8.4	-8.5	-4.1	3.5	5.8	7.2	12.0	10.0	-15.6	-3.6	8.6	3.0	9.4
Machinery and equipment	22.8	-9.2	-2.0	6.0	12.0	10.0	9.0	9.0	-19.2	2.3	9.4	6.4	9.0
Residential construction	9.5	29.7	3.0	-19.0	-25.0	-16.0	-4.0	-2.0	-7.4	-1.3	-9.4	-14.9	-1.8
Government spending	9.0	7.4	4.8	2.6	2.2	2.0	2.5	-2.0	4.5	4.9	1.1	2.9	0.4
Exports	12.2	15.4	8.5	8.5	5.0	6.0	4.5	4.5	-14.0	7.6	5.0	7.0	4.2
Imports	36.0	8.9	3.5	4.0	3.0	2.0	4.0	5.0	-13.4	7.3	3.9	3.1	4.7
<b>Current account balance in % of GDP</b>	<b>-4.3</b>	<b>-3.0</b>	<b>-2.1</b>	<b>-1.7</b>	<b>-1.5</b>	<b>-1.3</b>	<b>-1.1</b>	<b>-1.1</b>	<b>-3.2</b>	<b>-1.6</b>	<b>-1.1</b>	<b>-</b>	<b>-</b>
<b>Inflation (%)</b>													
Total CPI (y/y)	-0.9	0.8	1.6	1.4	2.0	2.0	1.9	1.9	0.3	1.8	1.9	2.0	2.0
Core CPI (y/y)	1.6	1.6	2.0	1.6	1.5	1.6	1.8	1.9	1.8	1.7	1.9	1.6	2.0
<b>Unemployment rate (%)*</b>	<b>8.5</b>	<b>8.4</b>	<b>8.2</b>	<b>8.1</b>	<b>8.0</b>	<b>7.8</b>	<b>7.9</b>	<b>7.7</b>	<b>8.3</b>	<b>8.0</b>	<b>7.6</b>	<b>-</b>	<b>-</b>
<b>Employment</b>	<b>-0.1</b>	<b>1.3</b>	<b>1.5</b>	<b>0.9</b>	<b>0.7</b>	<b>0.9</b>	<b>1.3</b>	<b>1.5</b>	<b>-1.6</b>	<b>0.8</b>	<b>1.3</b>	<b>1.0</b>	<b>1.6</b>
<b>Housing starts (000s)</b>	<b>156</b>	<b>180</b>	<b>196</b>	<b>185</b>	<b>150</b>	<b>155</b>	<b>155</b>	<b>165</b>	<b>149</b>	<b>172</b>	<b>161</b>	<b>-</b>	<b>-</b>
<b>Before-tax Corp. Profits (y/y)</b>	<b>-39.9</b>	<b>-14.8</b>	<b>8.3</b>	<b>24.6</b>	<b>17.3</b>	<b>11.5</b>	<b>12.7</b>	<b>13.5</b>	<b>-33.2</b>	<b>15.1</b>	<b>12.2</b>	<b>11.5</b>	<b>10.2</b>

\*Average rate for the quarter or the year.

Forecasts as of March 22nd, 2010

## Main Economic Indicators - Canada

	2003	2004	2005	2006	2007	2008	2009	2010	2011
								Forecasts	
Real GDP -- % change	1.9	3.1	3.0	2.9	2.5	0.4	-2.6	2.8	2.5
Real Personal Disposable Income -- % change	3.9	5.5	4.4	7.3	5.3	5.9	1.8	2.7	3.3
Employment -- % change	2.3	1.8	1.4	1.9	2.3	1.5	-1.6	0.8	1.3
Unemployment Rate (%)	7.6	7.2	6.8	6.3	6.0	6.2	8.3	8.0	7.6
Housing Starts (000s units)	218.6	233.1	225.0	228.2	228.7	211.6	148.8	171.5	161.3
Before Tax Profits -- % change	6.9	16.4	10.9	5.1	4.1	5.7	-33.2	15.1	12.2
Total CPI Inflation (%)	2.8	1.9	2.2	2.0	2.1	2.4	0.3	1.8	1.9
Current Account Balance (\$M)	14650	29837	25903	20333	15607	8116	-41303	-21750	-15000
Growth of real GDP components (%)									
Consumption Expenditures	3.0	3.3	3.7	4.1	4.6	3.0	0.2	2.9	2.4
Residential Construction	5.4	7.5	3.2	2.0	2.9	-2.7	-7.4	-1.3	-9.4
Business Investment	6.9	8.3	12.7	10.1	3.9	0.3	-17.9	0.1	9.1
Government Spending	3.4	2.5	2.6	3.3	3.7	4.8	4.5	4.9	1.1
Final Domestic Demand	3.7	4.0	4.5	4.6	4.2	2.7	-1.8	2.8	2.2
Exports	-2.3	5.0	1.9	0.8	1.1	-4.7	-14.0	7.6	5.0
Imports	4.1	8.0	7.1	4.7	5.8	0.8	-13.4	7.3	3.9
Change in Inventories (\$M)	5770	7701	14223	12122	14990	12241	-4900	2200	1875