Canada Economic Update

NAB Group Economics

July 2014

National Australia Bank

Summary & Overview

- ***The Canadian economy recorded a moderate 0.3% increase during the March quarter,2014, impacted by weather related disruptions.***
- ***Group Economics is forecasting a 2.3% expansion in 2014, followed by a somewhat quicker 2.5% in 2015. Improved Machinery & Equipment investment, and a stronger contribution from net exports is expected to drive this outcome.***
- ***The Bank of Canada recently released its bi-annual Financial Stability Review. Some of the sources of vulnerability for Canada included: Elevated house prices; High levels of household debt; Canada's high economic and financial dependence on commodity prices; and the strong correlation between US and Canadian 10-year bond yields.***
- ***The Bank of Canada, Canada's Central Bank, is likely to maintain the Overnight rate at 1%, with any rate rise not expected until the second half of next year. The strength, or otherwise, of the Loonie (Canadian Dollar), will impact on its decision making, as the Bank of Canada would like to maintain Canada's export competitiveness.***

Current Conditions

- Economic conditions eased in the 1st quarter of 2014, due to weather related disruptions. The economy expanded by 0.3%, with private consumption activity the key driver. This is well short of the 0.7% expansion recorded in the December quarter, 2013.

- There remain considerable **regional variations**, which is clearly visible when one examines labour market indicators. According to the Statistics Canada, Canada's Statistics Agency, Canada's seasonally adjusted unemployment rate was 7% as at May 2014. The unemployment rate in oil-rich Alberta was only 4.6%; it was as high as 8% in Quebec and 7.3% in Ontario.

- The regional disparity echoes comments in a recent speech delivered by Governor Stephen Poloz on the 28th April in Saskatchewan. In the speech the Governor mentioned that oil producing regions were among the stronger performing in Canada.

- Recent indicators suggest that economic conditions in Canada are expected to improve. The highly watched Manufacturing PMI rose to 53.5 index points in June 2014, the strongest since December 2013 – well into expansionary territory.

- However, any improvement in growth is not likely to be reflected until the second half of the year due to the impact of rising inventories.

Figure 1: Canadian Manufacturing PMI

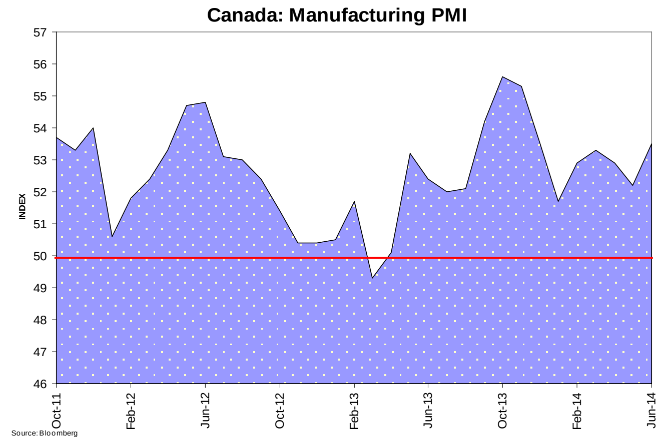
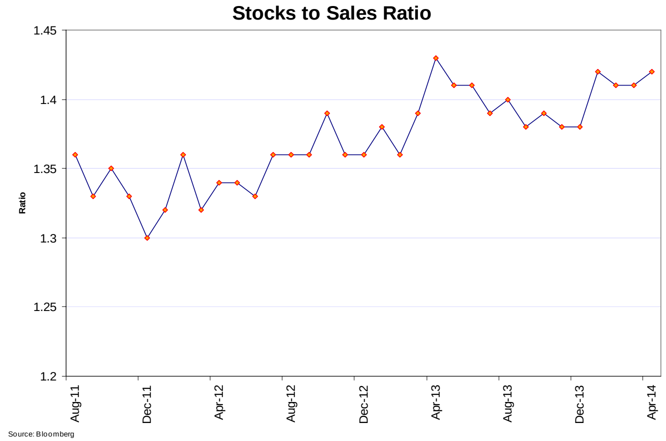


Figure 2: Stocks to Sales Ratio



GDP Outlook

- The most recent Business Outlook Survey (Summer, 2014) by the Bank of Canada revealed that businesses reported stronger past sales growth, and expressed optimism for future sales. Credit conditions have also eased.
- They also indicated increased investment in machinery & equipment spending over the coming year, and an increase in hiring intentions, although somewhat less so than in previous surveys.
- With regard to the growth outlook, NAB Economics is forecasting Canadian GDP to increase by 2.3% in 2014, followed by a somewhat stronger 2.5% in 2015. More robust investment activity (particularly in machinery & equipment) as well as an improved contribution from net exports, driven by a strengthening US are expected to be the main drivers of growth.
- Consumption activity will be supported by employment and income growth, but will face headwinds from the high levels of household debt. Residential construction activity is anticipated to weaken due to an expected softening in the housing market. Government spending will also likely be curbed with an increased focus on fiscal consolidation.
- Canada will benefit from both Commodity (primarily energy related) exports as well as non-Commodity related exports, as the US economy gains momentum. Some of the sectors that could benefit, as identified by the Bank of Canada, include: industrial, electronic and machinery equipment; building materials; fabricated metal, plastic and rubber; and pharmaceutical products.

Figure 3: Business Outlook – Future Sales

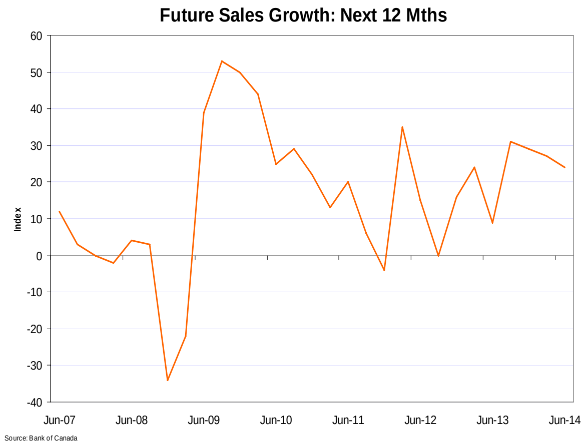


Figure 4: Business Outlook – M&E Investment

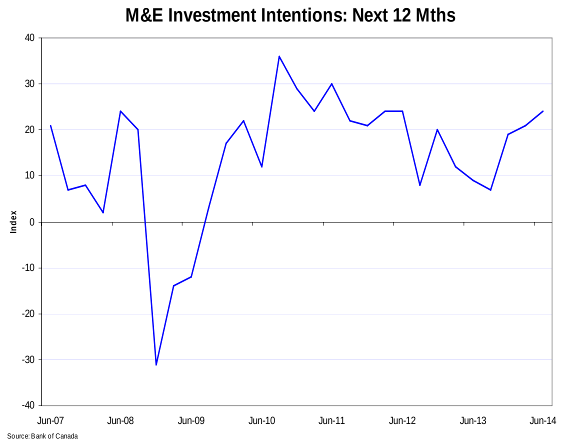
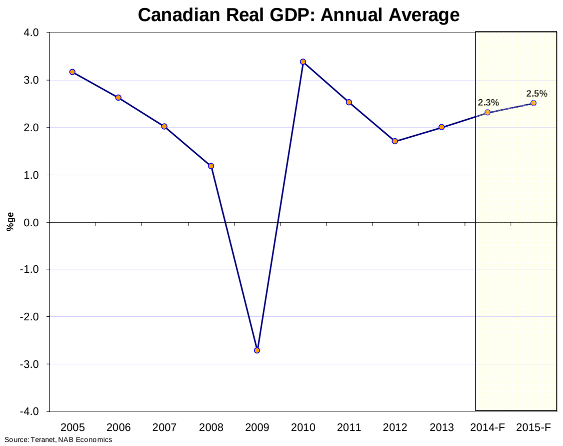


Figure 5: GDP Outlook



Inflation & Exchange Rate

- Over the year to May, 2014, Canadian headline inflation accelerated to 2.3% - above the 2% inflation target; Core inflation (stripping out the 8 most volatile components) was tracking at 1.7%.

- The rise in the headline rate was driven primarily through higher energy prices, namely gasoline and natural gas. The Bank of Canada is likely to 'look through' the recent rise, which it deems temporary. It cited factors such as the negative output gap, as well as heightened retail competition, ensuring core inflationary pressures remain contained.

- As we move into 2015,and the economy gathers steam and the output gap closes, both headline and core are likely to be around the critical 2% mark, which may prompt a rate rise towards the latter part of 2015. This would entail a rise in the benchmark overnight rate from the current 1%.

- The Canadian dollar has been strengthening of late, driven by factors such as high commodity (mainly energy related) prices, low global market volatility, as well as expectations that the higher inflation outcome could prompt some tightening from the Bank of Canada . The high loonie (Canadian dollar) remains a source of concern to both the Central Bank and Canada's non-commodity exporters, noting the competitive challenges that affect Canadian exporters.

- The strength, or otherwise, of the loonie will be a critical determinant of the timing of a possible future rate rise, as the monetary authorities would not like to scupper Canada's export competitiveness and growth prospects.

Figure 6: Inflation

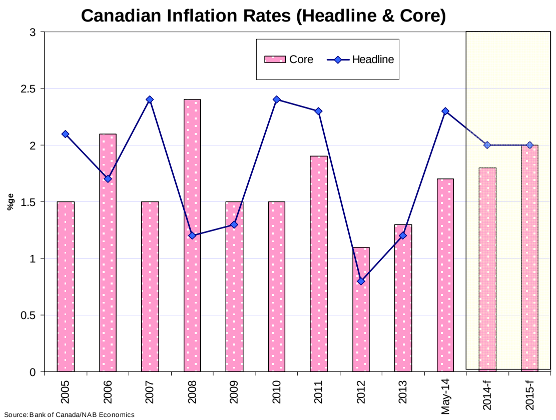


Figure 7: Output Gap

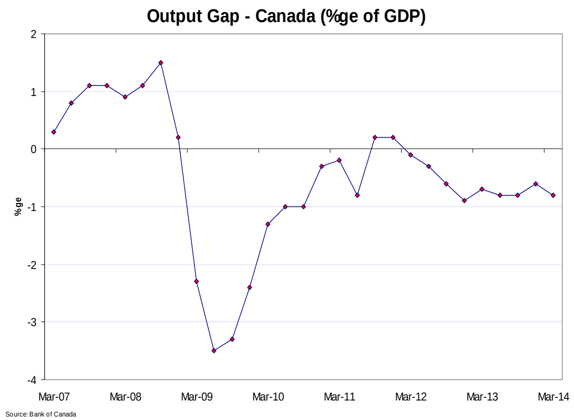
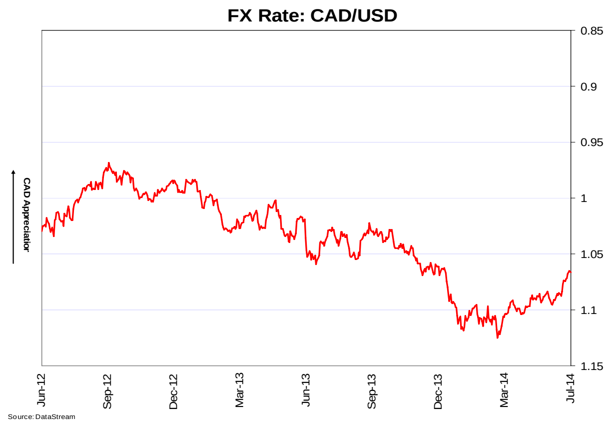


Figure 8: *Loonie* (CAD/USD)



Financial Stability Review: Key Vulnerabilities

- The Bank of Canada released its most recent Financial Stability Review on the 12th of June. It mentioned that the financial system remained sound, with the banking system well capitalised and stable. That said, there were 4 potential sources of vulnerability:

1. The Housing market remains overstretched, and there remain pockets of stress in some segments. That said, a soft landing is anticipated for the housing market.

2. Canadian households are very highly leveraged, despite some slight easing in the ratio of household debt to disposable income.

3. As a commodity exporting country, Canada could be exposed to shocks to commodity prices from a potential weakening in China and/or other emerging markets. This would negatively impact through trade and financial channels.

4. The high correlation between Canadian and US long term rates.

Household finances & House Prices

- Canada's household debt remains elevated: the ratio of household debt to household disposable income is 165.4%. This has eased a touch since September last year, but is still at very high levels.

- The high levels of debt indicate that Canadian households are susceptible to interest rate, income and unemployment shocks, which would exert downward pressure on consumption, as well as increase arrears in the banking system. That said, the current Debt Service ratio remains modest, owing to the low interest rate environment.

- The high level of household debt has been accompanied by a sharp rise in house prices over the past decade. According to Teranet's *Composite 11 Index*, Canadian house prices have risen 130% between 2000 and 2013.

- The outlook for house prices is modest. NAB Economics is forecasting a 3.2% expansion in 2014, followed by a 1% decline in 2015. Multi unit dwellings will most likely fare worse.

- In summary, a soft landing is forecast for the Canadian housing market. The Bank of Canada also subscribes to the view of a soft landing in Canadian housing. This view is given credence by indicators such as the high proportion of Owner's Equity in Real Estate: 69.9%, according to Statistics Canada.

- There remain pockets of vulnerability in Canadian housing. The Bank of Canada has made specific reference to the *Toronto Condominium market*, where supply has run well ahead of demand. This has the potential to generate negative ripple effects across the housing market through influencing buyers' price expectations.

Figure 9: Household debt

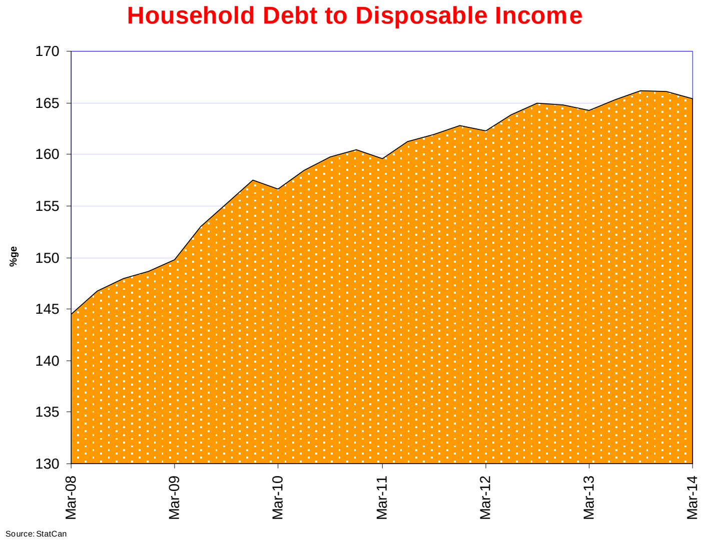
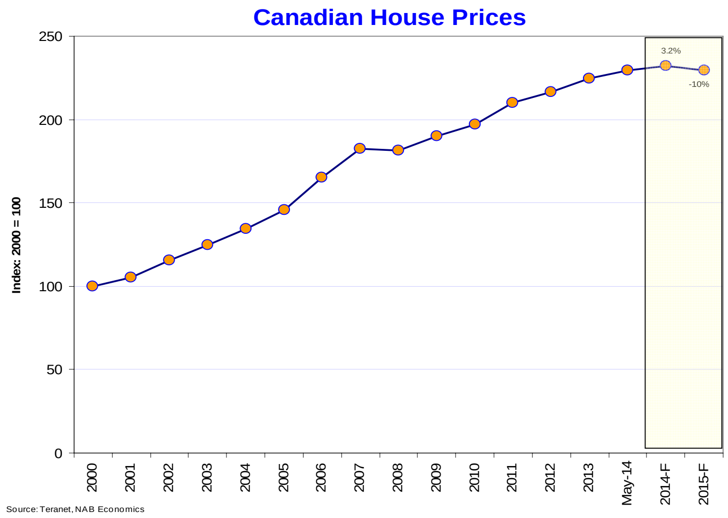


Figure 10: House Prices



External Spillovers: Commodities & US Bond yields

- Commodities have a significant impact on the Canadian economy through trade and financial channels. They account for around 35% of Canada's merchandise exports, dominated by energy-related commodities.

- Additionally, commodities have a strong influence through both equity and debt channels. Commodities constitute 40% of the TSX (Toronto Stock Exchange) Index by market capitalisation. Further, the Big 6 Canadian banks account for about 70% of total Canadian bank loans to the Commodity sector, half of which are to global mining and energy companies.

- As such, shocks to commodity prices emanating from a slowdown in China and/or major Emerging market economies will impact Commodity prices, Canada's terms of trade, as well as growth and income prospects.

- Canada's financial markets are integrated in the global financial system. In particular, there is a high degree of co-movement between US and Canadian 10-year bond yields, with year to date correlation at 94%.

- This close correlation has been noted by both the Bank of Canada, and the IMF, with the latter estimating a *100bp increase in the US term premium leading to a 50-70bp increase in the Canadian term premium.*

- Movements in US bond yields impact on Canadian interest rates, exchange rate and Canada's housing market.

Figure 11: Toronto Stock Exchange: Sectoral Cap

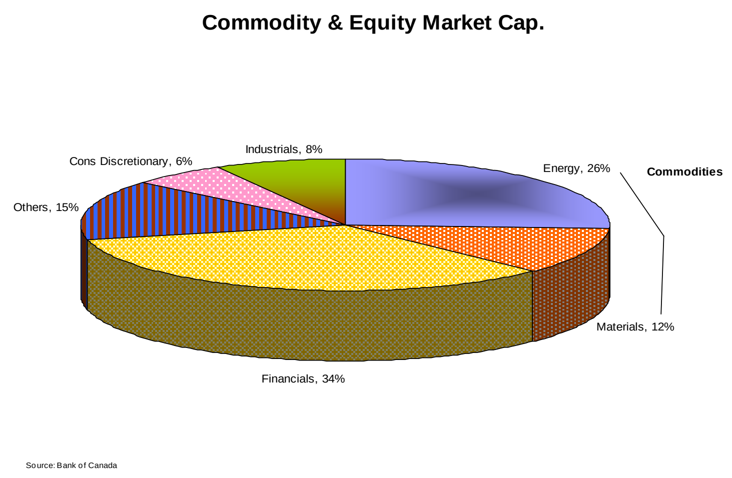
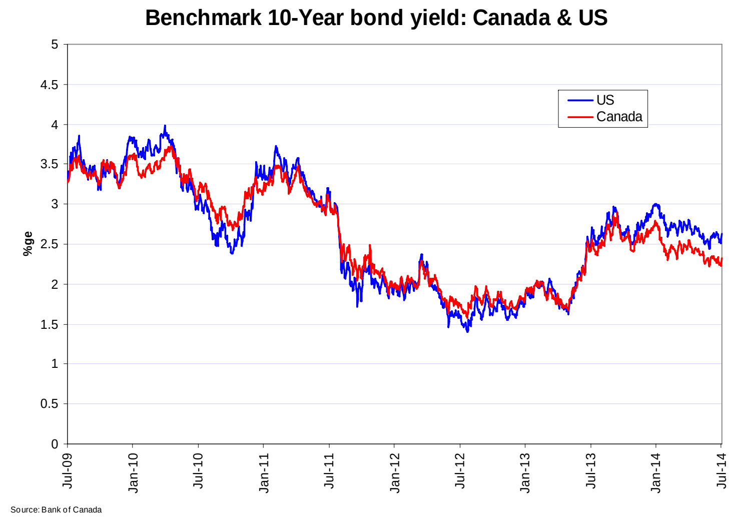


Figure 12: US & Canadian 10-year bond yields



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