SPECIAL REPORT

TD Economics

May 21, 2015

SWINGS IN OIL AND GASOLINE PRICES CLOUD RETAIL OUTLOOK

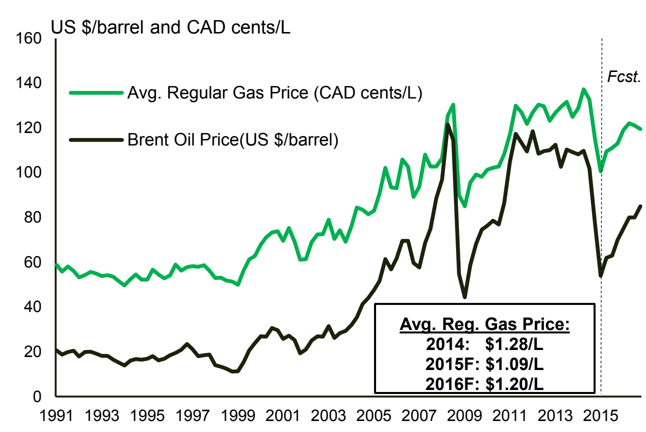
Highlights

- Despite the recent bounce in crude oil prices, the collapse in prices last autumn is still rippling through the retail environment this year through a slowdown in household income and a lower average price at the pumps. As a result, retail sales growth is expected to slow from 4.6% last year to 2.9% this year. As oil prices continue to grind higher into 2016, retail sales are expected to advance by a more normal 3.6% next year.
- We forecast that gasoline prices are likely to average $1.09/L in 2015 and $1.20/L in 2016 compared with $1.28/L in 2014. Due to this volatility in prices, gasoline stations are expected to record large sales swings which will drag down the overall retail sales performance this year and provide a boost the year after. As such, judging the overall sales performance from the headline retail sales growth rate will provide a misleading snapshot.
- The ongoing pass-through effects of the decline in the Canadian dollar over the past six months are bound to translate into higher prices for many imported goods this year. As such, ex-gasoline sales growth is likely to hold up decently in 2015, at around 4.5%. But this performance is likely to come at the expense of tighter profit margins. Next year, these trends are expected to reverse. As the pass-through effects ease, gasoline prices rise, and consumers purchase fewer new vehicles, ex-gasoline sales growth is likely to decelerate to around 3%. At the same time, retailers are expected to enjoy somewhat fatter margins.
- On a regional basis, oil-producing regions are expected to bear the brunt of the slowdown in economic activity and see a significant cooling in consumer spending growth this year, while non-energy exporting regions are expected to benefit the most from a lower loonie and an improving U.S. economy.

Canadian retailers have not had an easy ride over the last few years. Amid a backdrop of modest economic growth, retailers have had to cope with the entry of foreign retailers and increased competition from e-commerce.

Looking out over the near-term, an environment of volatile oil prices is muddying the picture for retailers. Notwithstanding the recent bounce in crude oil prices, the drop in WTI prices during the fall and winter has led to a trimmed outlook for Canadian economic growth. Second, while lower gasoline prices on average this year will leave consumers with more money in their wallets, the benefits of these savings will be muted. That partly reflects the fact that prices for many imported goods, due to past depreciation in the Canadian dollar, are likely to rise and thus erode roughly all of these savings.

CHART 1: GASOLINE PRICES TO GRIND HIGHER, BUT TO REMAIN RELATIVELY LOW THIS YEAR



Source: MJ Ervin and Associates, Haver Analytics. Forecast by TD Economics.

Admir Kolaj, Economic Analyst, 416-944-6318

Given these crosscurrents, we expect retail sales growth to moderate considerably from 4.6% in 2014 to 2.9% this year, before rising to 3.6% in 2016. Further, the relatively downbeat sales performance expected this year and the rosier profile of 2016 mask some important diverging trends. Sales at gasoline stations will detract from growth significantly this year, while contributing robustly the year after. Sales excluding those at gasoline stations are expected grow close to the historical average in 2015, at around 4.5%, while likely recording a more moderate gain of around 3% in 2016.

Finally, beneath the national averages, expect to see significant variation on a regional basis, with oil-producing provinces underperforming the rest of the country until a more significant recovery in oil prices materializes in 2016.

2014: A good year, but not as good as the headline suggested

Last year, retailers sold more goods and at higher prices than in 2013. Nominal sales grew at 4.6%, in line with the two-decade historical average. This was the best growth performance recorded since the initial rebound from the recession in 2010 and was achieved despite a significant slowdown in sales at gasoline stations toward the end of the year.

However, scratching beneath the surface reveals that the strong performance was largely concentrated in autos. Sales at motor vehicle and parts dealers, which made up almost a quarter of overall sales, grew by a very healthy 7.1%. Sales at core retailers (excluding autos and gasoline) grew by a more modest 3.6%, below the historical average of 4%.

Just as important, the average operating profit margin of retailers took a significant step back in 2014, falling from 3.4% to 2.9% - the lowest level in a decade (Chart 2). Put together, these details imply that the overall story in 2014 was not as rosy for retailers as the headline improvement in sales suggested.

The economic fundamentals are soft

When it comes to determining future retail sales, several factors must be taken into account. Chief among them are income, wealth, borrowing levels, consumer confidence and the value of the Canadian dollar. The volatility and uncertainty surrounding energy prices adds another layer of complexity over these many moving parts.

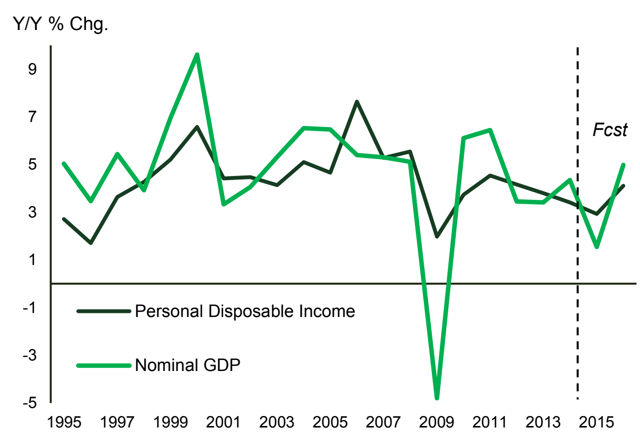
By reducing the outlook for overall Canadian economic activity, the slide in oil prices since peaking at around US$106 per barrel last June will likely result in a deceleration in personal disposable income growth to around 3% in 2015 – the slowest non-recessionary pace of growth since 1996 (Chart 3). As the recovery in oil prices since the spring likely becomes more entrenched and WTI heads up to US$70 per barrel on average next year, personal disposable income growth is likely to improve to around 4% in 2016.

This oily tale unfolds at a time when household imbalances are highly elevated. The debt-to-income ratio is hovering around 165%, with overall debt standing at $1.8 trillion dollars. High debt burdens remain an important limiting factor on consumer spending growth over the medium term. Although the rate of debt accumulation has slowed down significantly in post-recession years, a recent uptick

CHART 2: THE RETAIL PROFIT MARGIN TOOK A STEP BACK IN 2014

Source: Statistics Canada.

CHART 3: DISPOSABLE INCOME TO GROW AT SLOW PACE IN 2015



Source: Statistics Canada. Forecast by TD Economics.

– predominantly in consumer debt – has led to a modest re-acceleration in overall household leverage. On the plus side, the current low interest rate environment is helping keep debt affordable and is supportive to underlying spending. And the broad consensus expects the Bank of Canada will keep its overnight rate at an ultra-low 0.75% until the latter part of 2016, when gradual increases are anticipated. Still, as market interest rates likely begin to increase gradually in the coming months in anticipation of a higher central bank rate, household debt service payments are expected to nudge higher.

In addition, the Canadian housing market has picked up some steam in recent months, largely reflecting strength in the important Toronto and Vancouver markets. Elsewhere, sales activity and price gains are considerably more moderate, while markets hit harder by the oil price weakness – notably Calgary and Edmonton – record declines. As interest rates likely rise, Canadian home sales and price gains are expected to cool over the next few years. As such, the boost to house-oriented retail spending and the positive wealth effects that stem from higher home prices will continue to provide some support to spending this year but are likely to be fade noticeably in 2016.1

Lastly, lower gasoline prices will provide some support to non-gasoline retail sales this year by keeping more cash in consumer wallets. We estimate that the average Canadian household is likely to save around $600 at the pumps in 2015. Conservatively, this does not take into account additional savings from other types of fuels which are also likely to see lower prices on average (i.e. heating oil). On the other hand, a slide in the Canadian dollar from as high as 93 US cents in 2014 to the 80-85 US cent level continues to place upward pressure on prices of many goods with high import content (and some services). Looking ahead, expectations of higher U.S. interest rates are projected to keep the loonie under bouts of downward pressure in the coming months, before the currency rebounds back to the 85 US cent level towards the end of 2016. We estimate that the resulting currency pass-through effect is likely to cost the average Canadian household around $600 this year, thereby eroding roughly all of the benefits of lower gas prices.

2015-16: Headline growth to mask important trends

Ultimately, the economic fundamentals point to a moderation in spending growth over the next two years. Retailers are already anticipating more challenging times ahead. For instance, according to the CFIB, small and mid-sized retail confidence has plummeted to the lowest level in almost three years, on a 3-month moving average basis.

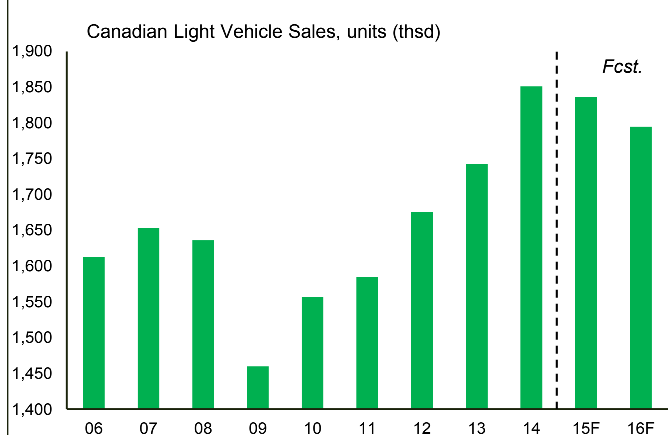
Real sales to see continued deceleration in growth

The slowdown in growth of volume (i.e., real) sales is not likely to be as abrupt as that of the overall value (i.e., nominal) sales. We expect real retail sales growth to decelerate by about 1.1 percentage points, from 3.5% in 2014 to 2.4% in 2015. This is in line with a moderation in real economic activity this year that will be concentrated in oil-producing regions.

Apart from sales at gasoline stations, the slowdown in real retail sales is likely to be reflected in a few key categories of big ticket items. Housing-related retail spending accounts for a sizeable 10% of non-gas related spending. Consistent with our medium term view on housing, home-related retail spending will continue to be underpinned by low borrowing rates and should turn in a good performance this spring. However, sales in this key segment are poised to simmer down over the next few years, especially as the red-hot Toronto and Vancouver markets come down to earth.

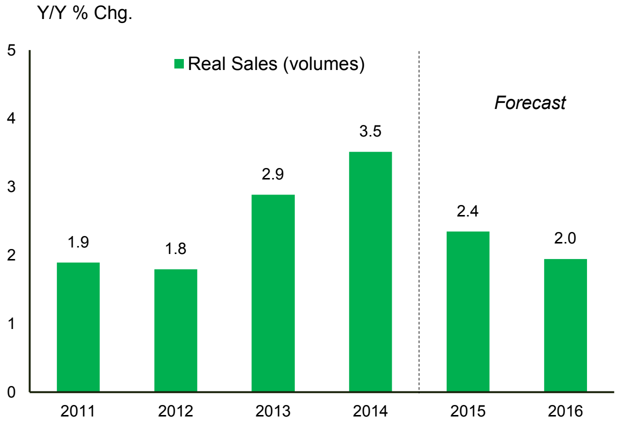
Another major subcategory that is expected to see some softness over the next two years is new vehicle sales. Car sales have grown consistently over the past few years, reaching a record of 1.85 million units sold last year. Looking ahead, many of the same factors that point to an eventual moderation in housing activity, such as high debt levels, are also likely to play out in trends of other big ticket items such as cars. What is more, with vehicle ownership rates

CHART 4: CANADIAN AUTO SALES TO SLOW



Source: WardsAuto.com. Forecast by TD Economics.

CHART 5: GROWTH IN REAL RETAIL SALES TO SEE CONTINUED DECELERATION



Source: Statistics Canada, forecast by TD Economics.

stabilizing there appears to be limited pent-up demand for new cars over the next two years (see: Canadian Auto Sales To Downshift From Fifth To Fourth Gear). So while unit sales are expected to remain at elevated levels, we are likely to see a slight contraction in growth this year and an even more noticeable contraction the following year (Chart 4).

The relatively low Canadian dollar is expected to provide some moderate offsetting effects as more Canadians choose to shop within our borders and as more U.S. tourists flock to Canada. For more details on this, please see the box on page 7.

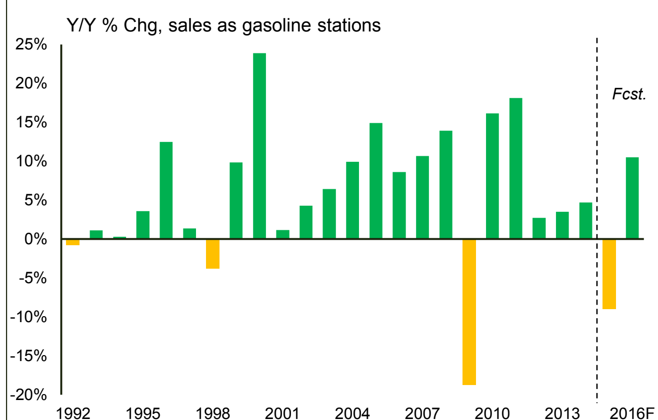
Put together, these trends suggests that the deceleration in real sales growth is likely to continue next year and reach a low point of around 2% - a performance similar to what was recorded in the relatively weak volume years of 2011 and 2012 (Chart 5).

Nominal sales to swing with price effects

Introducing price effects alters the picture significantly. We forecast that nominal retail sales growth is likely to decelerate noticeably this year to 2.9% from 4.6% in 2014. The deceleration in nominal retail sales growth of 1.7 percentage points this year is considerable, but is largely attributed to the significant decline in the price of gasoline. While gasoline and non-gasoline sales have grown in lockstep over the past three years, this has not been the norm over the longer-term. Gasoline price volatility is bound to bring us toward the more familiar territory of diverging growth performances. Based on our Brent[2] oil price projection, gasoline prices should average around $1.09/L over the course of 2015, compared to $1.28/L last year (Chart 1). As such, sales at gasoline stations are likely to contract by close to 9% this year (Chart 6). What is more, gasoline sales make up a considerable share of total sales and represent a relatively inelastic good, meaning consumption doesn't tend to change greatly with price fluctuations (Chart 7). Factoring in the large price swings suggests that the contraction in sales at gasoline stations is likely to detract over 1 percentage point from overall nominal retail sales growth this year.

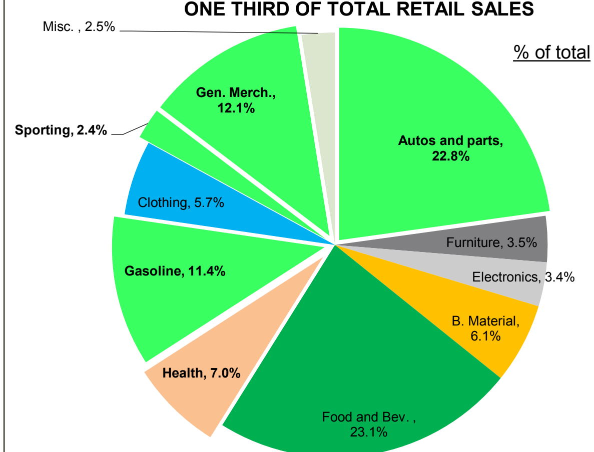
As consumers spend less on gasoline and other fuels this year, they will have the ability to devote more funds toward other items. However, increased spending on other retail products won't be just a matter of choice. Pass-through effects from a lower Canadian dollar are likely to manifest themselves in the coming quarters by inflating prices for many imported goods. For some items, such as food and clothing, prices have already risen substantially in recent

CHART 6: GASOLINE PRICE VOLATILITY TO HAVE LARGE IMPACT ON SALES AT GASOLINE STATIONS

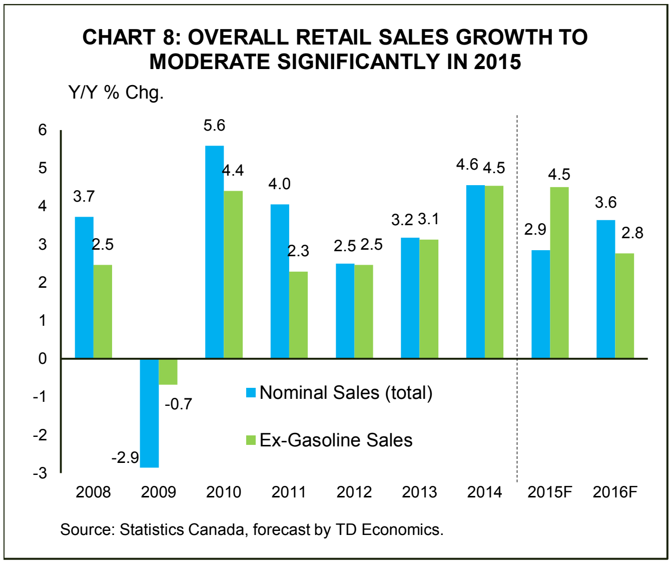


Source: Statistics Canada. Forecast by TD Economics.

CHART 7: AUTOS AND GAS MAKE UP MORE THAN ONE THIRD OF TOTAL RETAIL SALES



Source: Statistics Canada. *2004-2014 average.
Note: Sectors in bright green grew above average last year.



quarters. In a recent report (Canadian Consumer Prices Riding on Loonie's Wings), we estimate that the weaker Canadian dollar could contribute about 0.8 percentage points to inflation in 2015, accounting for 40% of the increase in consumer prices in the year. In this vein, prices of autos and parts could rise by as much as 3 percentage points more in 2015 relative to what would have been the case absent of depreciation in the currency. This means that despite expectations of a slight contraction in unit car sales this year, we are still likely to see positive sales growth for autos and parts, primarily on account of rising prices. Overall, these trends suggest that despite the slowdown in real economic activity, price increases are likely to help buoy growth in ex-gasoline sales this year to around 4.5% - a pace similar to last year (Chart 8). However, this performance is likely to come at the expense of tighter margins as some retailers will not be able to pass on a significant portion of these added costs to consumers.

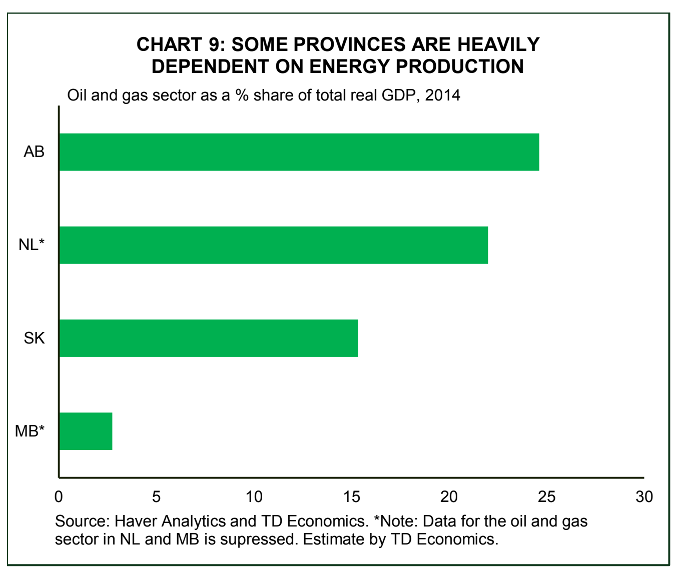
In 2016, based on the assumption that oil prices recover, we expect the price of gasoline to reverse course and average around $1.20/L. Consequently, sales at gasoline stations are expected to grow robustly in the low double digits, thereby contributing over 1 percentage point to overall nominal sales growth next year. This will help propel overall sales gains to 3.6%. Nevertheless, allocating more funds towards gasoline will mean less spending on other items. In addition, the currency pass-through effects are expected ease in 2016 as the loonie likely gains some ground. Coupled with expectations of a further contraction in auto unit sales and a contraction in existing home sales, these trends suggest that ex-gasoline sales growth is likely to moderate to around 3% in 2016. On the flip side, retailers are expected to see some fattening in profit margins.

Provincial sales forecast

The growing dichotomy in economic growth performances between the oil-rich and other regions will also be reflected in retail sales. As it stands, the oil and gas sector holds significant weight in the economies of Alberta, Newfoundland and Labrador, and Saskatchewan (Chart 9). Low oil prices will affect the bottom line of energy companies and are expected to translate into weaker hiring. As such, employment growth in both Alberta and Saskatchewan is forecast to decelerate sharply in 2015 and weigh on disposable incomes. Meanwhile, employment in Newfoundland and Labrador is expected to outright contract this year.

Furthermore, over the course of 2015, house prices in oil-rich provinces are now expected to fall between 2% and 3%, resulting in negative wealth effects. On these premises, consumer confidence has taken a significant dive in the Prairies (Chart 10). All told, retail sales are likely to contract slightly this year in Alberta and Newfoundland and Labrador, while we expect Saskatchewan to record only moderate gains (Table 1).

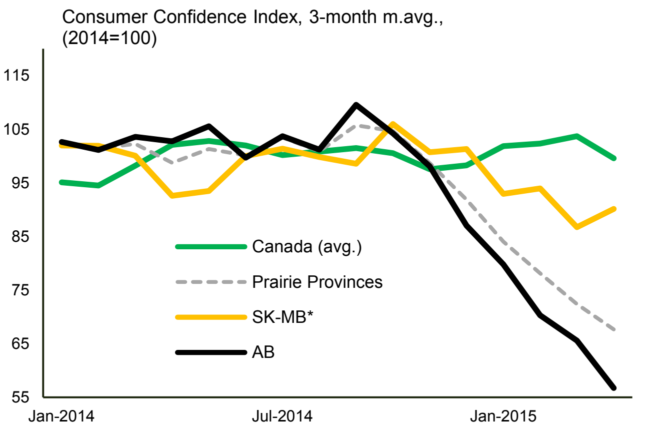
On the other hand, prospects appear to be more promising for other regions. Expectations of a resurgent U.S. economy and a low Canadian dollar, not to mention lower fuel costs, bode well for non-energy exporters. Meaningful upticks in employment are presently only evident in Manitoba and to a lesser extent in Quebec. But it is likely only a matter of time before output gains translate into a stronger



employment picture for non-energy exporting economies. Additional tailwinds, such as low borrowing rates, also bode well for spending in these provinces. Taking everything into account, the top spots for sales growth this year are likely to be captured by British Columbia and Ontario. Additionally, sales growth is expected to hold up decently Manitoba and Quebec, while the Maritime provinces are likely to record more moderate gains.

Next year, assuming a recovery in oil prices, economic prospects are expected to improve for oil-producing regions as employment, incomes and confidence rise. As such, we are likely to see a rebound in spending in oil-rich provinces, with the exception of Newfound and Labrador which is likely to record only moderate gains based on expectations of a continued weakness in employment. Meanwhile, the strength in economic growth and spending is expected to carry over in 2016 for most non-energy producing provinces.

CHART 10: CONSUMER CONFIDENCE HAS FALLEN SHARPLY IN ALBERTA



Source: Conference Board of Canada. As at April 2015. *Not available separately.

Table 1: PROVINCIAL RETAIL TRADE FORECAST
Annual average per cent change

	2012	2013	2014	2015F	2016F
CANADA	2.5	3.2	4.6	2.9	3.6
N. & L.	4.5	5.0	3.4	-0.2	1.5
P.E.I.	3.2	0.8	3.3	2.8	3.4
N.S.	1.0	2.9	2.3	2.0	3.6
N.B.	-0.7	0.7	3.8	2.5	3.7
Québec	1.2	2.5	1.7	3.3	3.8
Ontario	1.6	2.3	5.0	4.1	3.9
Manitoba	1.3	3.9	4.3	3.0	3.7
Sask.	7.4	5.1	4.6	0.2	2.8
Alberta	7.0	6.9	7.5	-0.2	3.3
B.C.	1.9	2.4	5.6	4.2	3.6

Source: Statistics Canada. Forecast by TD Economics.
Note: Along with the February 2015 release, seasonally adjusted data were revised back to January 2011 and unadjusted data were revised back to January 2014.

Bottom Line

The post-recession environment has been relatively challenging for Canadian retailers, as sales have generally grown moderately and the profit margin has retreated. Last year, for the first time since the rebound of 2010, sales grew at a faster pace than the historical average. Yet, the details revealed a less rosy picture than the headline numbers suggested.

Looking ahead, swings in oil prices pose a new set of challenges for retailers as prospects for economic growth in Canada have been scaled back. While considerable uncertainty remains as to how oil prices will evolve, we expect them to recover gradually over the next 1-2 years, but to remain relatively low.

On a regional basis, we are likely to see big variations in performances depending on the local economy's exposure to oil production. Oil-producing regions are expected to bear the brunt of the slowdown in economic activity and see a significant slowdown in consumer spending growth this year, while non-energy exporting regions are expected to benefit the most from a lower loonie and an improving U.S. economy.

Although consumers are likely to save substantially from lower gas prices this year, a falling loonie is likely to erode roughly all of these savings as prices for some services increase and as retailers try to pass on the increased costs of products with high import content. Not all retailers will be able to pass on these added costs to consumers and this is expected to weigh on retail profit margins.

All told, we forecast that sales growth is likely to moderate significantly this year to 2.9% and improve next year to 3.6%. However, judging the overall retail performance from these headline growth rates will provide a misleading snapshot. That is because sales at gasoline stations are expected to swing wildly, around the low double digits, over the next two years. Removing these effects inverts the picture for the remaining retailers, with ex-gasoline sales growth likely to hold up decently in 2015 but trail behind the headline the year after.

Admir Kolaj, Economic Analyst
416-944-6318

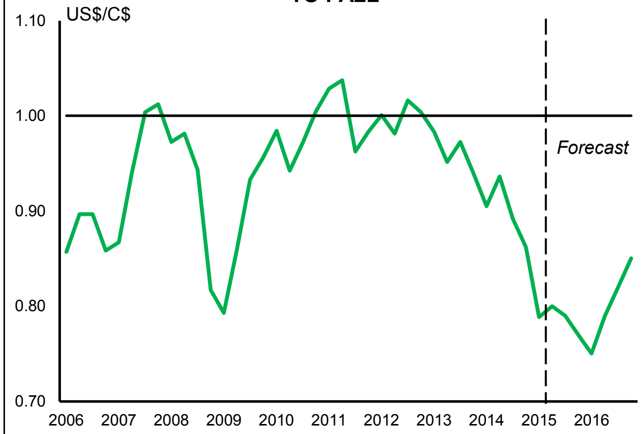
The Loonie From A Retailer's Point Of View

A depreciating loonie, expected to dip back below 80 US cents by the end of 2015 (Chart A), will help curb cross-border shopping, both traditional and online, since the costs to Canadians will rise. The Canadian dollar has already lost significant ground against the U.S. greenback over the last year and some of these effects have already been felt. For instance, tourism GDP rose substantially over the course of 2014 (Chart B). More recently, same-day Canadian car trips to the U.S. were down 17% on a year-ago basis in March (3-month moving avg.), while car trips of U.S. residents in Canada were up 6% - the strongest growth since the end of 2010 (Chart C). These trends are likely to continue until the Canadian dollar makes a recovery in value, a trend expected to materialize towards the second half of next year. Ultimately, a low-valued loonie will help contain more spending within Canada and bring in much-needed tourist revenue.

But on the other hand, as the value of the Canadian dollar falls, retailers will be prone to pass on some of the added costs of items with high import content to consumers. The current competitive environment in some segments of retail trade will make the passing on of these costs quite difficult for some. While the pass-through effects of a lower loonie tend to add upward pressure on prices, retail competition has the opposite effect. Both are expected to significantly impact inflation in 2015, while their effects are likely to ease next year. However, as the Bank of Canada outlined in their January Monetary Policy Report "It is not easy to separate the impact on prices of pass-through from the effects of retail competition, since both factors tend to affect the same categories of goods with high import content".[3]

At the end of the day, retailers will have to balance out the need to increase prices with the consequent reduction in consumer demand. Market strategy will vary depending on a retailer's goals and ability to absorb exchange rate volatility. For instance, some retailers will be able to absorb some of the added costs with the hopes of preserving or gaining market share over the longer-term. Overall, this is an added pressure that is likely to weigh down retail profit margins this year. Thankfully, lower fuel costs will provide some offsetting effects. For instance, reduced transportation costs this year bode well not only for consumers but also for wholesalers and retailers.

CHART A: CANADIAN DOLLAR HAS MORE ROOM TO FALL

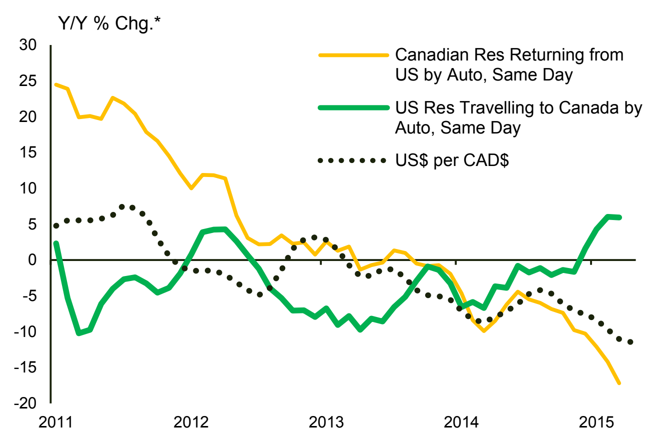


Source: Bank of Canada. Forecast by TD Economics.

CHART B: TOURISM GDP ROSE SIGNIFICANTLY LAST YEAR

Source: Statistics Canada. * Real.

CHART C: AS LOONIE LOSES GROUND, MORE U.S. TOURISTS ENTER CANADA



Source: Statistics Canada, Haver Analytics. * 3-month moving average for all.

ENDNOTES

1. Pichette, L., and Tremblay, D., "Are Wealth Effects Important for Canada?", Bank of Canada, 2003. http://www.bankofcanada.ca/wp-content/uploads/2010/02/wp03-30.pdf
2. "The Brent price is more important for Canadian consumers, since wholesale and retail gasoline prices have tended to move more closely with Brent, even in regions that predominantly refine WTI." – Bank of Canada, MPR, April 2015. http://www.bankofcanada.ca/wp-content/uploads/2015/04/mpr-2015-04-15.pdf
3. Monetary Policy Report, BoC, January 2015, page 11. http://www.bankofcanada.ca/wp-content/uploads/2014/07/mpr-2015-01-21.pdf