TD Bank Financial Group

TD Economics

Special Report

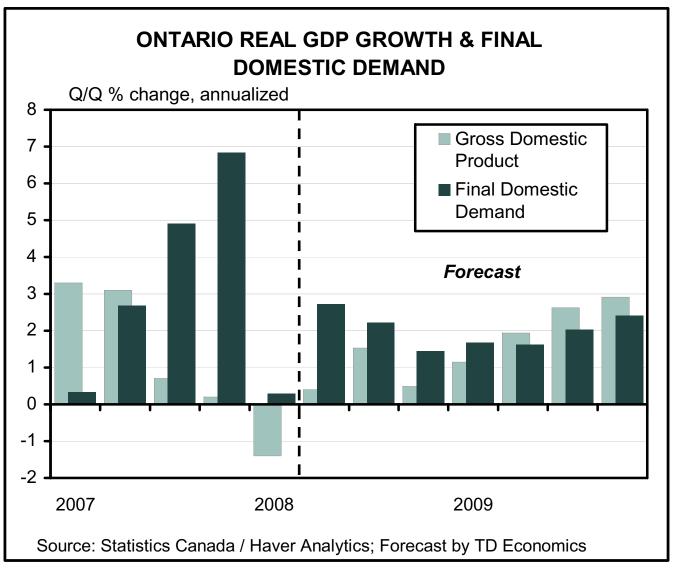
July 30, 2008

ARE THE WHEELS FALLING OFF THE ONTARIO ECONOMY?

Major economic releases out of Ontario in recent weeks have put the province on a heightened state of recession alert. In early July, the Ontario government reported that real GDP contracted by 1.4% (annualized) in the first quarter, bringing the quarterly streak of little or no growth in the province to three. A little over a week later, Statistics Canada revealed the Ontario's job market stumbled badly in June. Other recent developments – such as ongoing concern about the state of the U.S. economy, still-high crude oil prices, a dollar hanging near parity, gyrating Canadian equity markets and building evidence of a softening in resale housing activity – have been fanning the flames of recession worry in Ontario.

The purpose of this note is to look under the hood of Ontario's economy and to assess what the latest developments imply about the economy's likely near term path. Some of the burning questions that we take aim at include:

- Is a recession – commonly defined as two consecutive contractions in real GDP – now a virtual slam dunk?
- How do the most recent developments fit in to TD Economics' outlook for the second half of 2008 and 2009?
- What are the implications of this likely economic track on Ontario government finances?
- Are the current woes temporary or a harbinger of secular decline?



Source: Statistics Canada / Haver Analytics; Forecast by TD Economics

HIGHLIGHTS

- **Ontario is on track to narrowly avoid a second straight negative GDP reading in Q2, but it's too close to call**
- **Regardless of the Q2 GDP outcome, Ontario's economy did not meet a proper recession test in the first half of 2008**
- **The test will come in the coming quarters when job creation begins to falter and domestic demand simmers down**
- **An early-1990s-style economic downturn in Ontario is almost inconceivable**
- **Some of Ontario's current woes are secular in nature**

Q1 report had something for optimists and pessimists

The release of the Q1 *Ontario Economic Accounts* by the government on July 4th provided the most comprehensive and up-to-date picture of the provincial economy. While a quarterly update issued during the dog days of summer typically comes and goes without much of a whimper, this one generated considerable media attention.

For this analysis, we present many of the key historical indicators featured in the *Accounts* in the accompanying

ONTARIO ECONOMIC OUTLOOK																				
Period-Over-Period Annualized Per Cent Change Unless Otherwise Indicated																				
	2007				2008				2009				Annual Average			4th Qtr/4th Qtr		
	Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F	07	08F	09F	07	08F	09F
Real GDP	3.3	3.1	0.7	0.2	-1.4	0.4	1.5	0.5	1.1	1.9	2.6	2.9	2.2	0.3	1.5	1.8	0.2	2.2
Consumer Expenditure	0.6	3.3	3.9	9.3	2.4	1.6	2.2	1.4	1.9	2.0	2.4	2.8	3.6	3.7	2.0	4.2	1.9	2.3
Business Investment	-6.3	8.3	9.8	1.1	-9.7	-2.0	1.2	0.6	0.8	1.2	2.2	2.6	6.4	-0.9	1.0	3.1	-2.6	1.7
Residential Construction	4.3	-2.7	6.3	5.0	-11.7	1.6	1.2	0.0	-2.8	-4.7	-3.9	-2.8	1.6	-1.1	-2.0	3.2	-2.4	-3.6
Government Spending	1.5	0.2	4.9	3.4	3.1	2.8	3.0	2.4	2.6	2.4	2.4	2.4	2.5	3.1	2.6	2.5	2.9	2.5
Final Domestic Demand	0.3	2.7	4.9	6.8	0.3	2.7	2.2	1.4	1.7	1.6	2.0	2.4	3.5	3.0	1.8	3.7	1.7	1.9
Exports	4.2	-4.0	-2.2	-1.4	-16.2	-3.2	0.8	-2.0	-1.6	1.6	3.2	4.5	1.1	-5.7	0.1	-0.9	-5.4	1.9
Imports	-0.5	-3.9	9.6	6.2	-18.6	2.0	1.6	0.8	2.0	2.8	3.2	3.2	2.8	-2.5	2.1	2.7	-4.0	2.8
Change in Non-Farm Inventories ($2002 Bn)	0.9	2.1	6.8	5.6	-0.6	1.2	0.8	1.2	1.6	1.8	2.0	2.2	3.8	0.7	1.9	--	--	--
Pre-tax Corp. Profits	-14.6	-13.6	-4.6	-11.1	4.8	-7.8	-1.6	-4.3	3.2	4.9	10.4	12.6	-1.6	-4.5	2.2	-11.1	-2.3	7.7
% of GDP	11.3	10.8	10.6	10.2	10.3	10.1	9.9	9.8	9.8	9.8	9.9	10.1	10.7	10.0	9.9	--	--	--
GDP Deflator	1.7	2.4	0.3	3.2	2.4	1.6	2.0	2.2	1.4	1.5	1.5	1.7	2.1	2.1	1.7	1.8	2.1	1.5
Nominal GDP	5.0	5.5	1.0	3.4	1.0	2.0	3.5	2.7	2.6	3.5	4.2	4.6	4.3	2.4	3.2	3.7	2.3	3.7
Employment (%)	3.0	0.5	2.2	2.5	2.0	1.5	-1.5	-0.9	0.1	1.1	1.2	1.2	1.5	1.3	0.2	2.0	0.3	0.9
Unemployment Rate (%)	6.5	6.5	6.4	6.3	6.3	6.5	6.8	6.9	7.0	7.1	7.2	7.1	6.4	6.6	7.1	--	--	--
Personal Disp. Income	5.7	-0.2	5.9	4.4	7.4	4.1	0.0	0.8	2.4	2.8	3.2	3.6	4.4	4.2	2.2	3.9	3.0	3.0
Real PDI per capita	2.4	-3.2	5.7	1.7	5.7	1.9	-2.4	-1.7	0.2	0.9	1.4	1.8	2.3	2.1	0.0	1.6	0.8	1.1
Housing Starts ('000s)	66	68	73	65	79	74	72	69	66	68	70	72	68	73	69	--	--	--
Avg. Home Price (y/y)	5.0	5.7	7.3	12.4	4.5	3.8	2.4	1.4	2.4	3.5	3.9	4.0	7.6	2.9	3.5	12.4	1.4	4.0
Industrial Production	3.1	-2.6	-1.5	-5.8	-12.5	-1.5	-0.5	-2.2	-0.8	1.5	2.8	3.2	-1.9	-5.2	0.1	-1.8	-4.3	1.7
Auto Production (y/y)	1.3	-2.4	3.8	5.4	-19.1	-13.0	-1.4	-6.2	-2.5	2.0	3.4	4.0	2.0	-9.9	1.7	5.4	-6.2	4.0

F: Forecast by TD Economics as at July 2008

Source: Ontario Ministry of Finance, Statistics Canada, Canada Mortgage and Housing Corporation, Haver Analytics

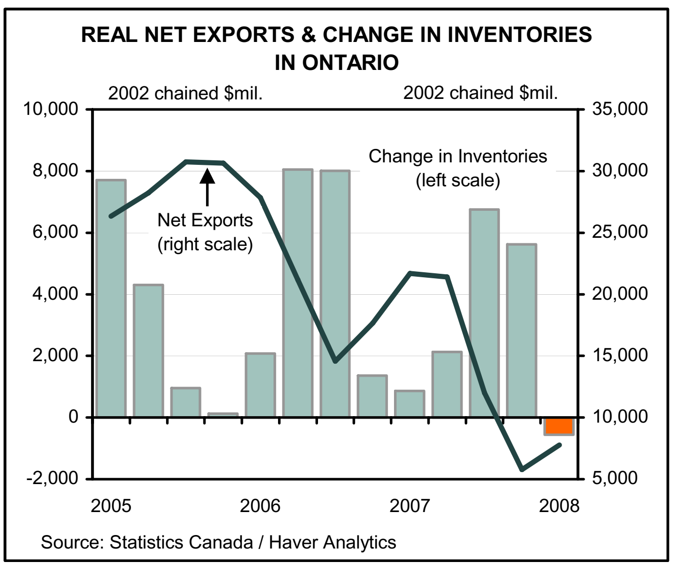
table along with TD Economics' forecasts through Q4 2009. The upper part of the table provides an accounting of GDP, while the lower part includes gauges of incomes, prices, job markets, housing activity and production.

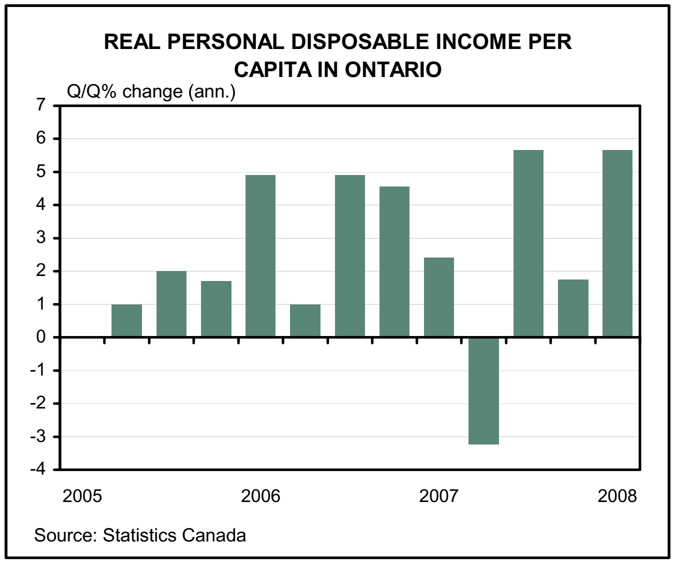
The headline Q1 result – a real GDP *decline* of 1.4% annualized – didn't come as a shocker since we already knew that Statistics Canada had estimated Canadian real GDP at -0.3% in the same period. And Ontario was almost sure to do worse in light of its heavy bent on the struggling manufacturing sector. Nonetheless, the consensus-matching outcome didn't make the report any less newsworthy. In particular, with the further setback, real economic activity in Ontario remains stuck below the level recorded in mid-2007. What's more, the steady slippage in the real GDP profile over the past few quarters conveyed ominous signals about the economy's near-term prospects.

How should one interpret the Q1 numbers? For one, the top-line rarely tells the whole story, so a more balanced assessment involves digging below the surface. A second caveat is that quarterly data are prone to volatility and the impacts of temporary factors which need to be disentangled. And Q1 was no different. Two short-term factors in particular left an imprint on the quarterly performance:

- *A strike in the auto industry* – while the U.S. demand backdrop continued to deteriorate in Q1, the steep double-digit drop in Ontario exports partly reflected a labour dispute at a major U.S. parts supplier. However, given that imports were also affected, the net GDP impact from the strike – which ultimately ended in May – was quite small.
- *Inventory adjustment* – Q3 and Q4 of 2007 featured an unsustainably large accumulation in inventories. (Indeed, without the surge, Ontario real GDP may have very well contracted in the second half of 2007, although a significant share of the stockpiled goods was imported, thus muting the overall effect on growth.) As had been expected, a significant adjustment in inventories took place in Q1, subtracting 1.5 percentage points from the accounting of GDP. This drawdown was consistent with the double-digit drop in imports in the same quarter.

Looking beyond the impacts of these short-term factors, the Q1 GDP report presented a decidedly mixed picture, albeit better than at first glance. From a glass-half-full perspective, consumer and government outlays – which, together, account for more than three quarters of total economic activity – continued to turn in solid showings. In fact, any advance at all in personal expenditure in Q1 could have been considered a feat following the 9% explosion in outlays in Q4 (the fastest Q/Q rate in two decades!). So the 2.4% expansion chalked up in Q1 was consistent with





an ongoing personal spending boom.

From the glass-half-empty perspective, two pockets of domestic spending that had been in overdrive throughout most of 2007 – notably, business investment and homebuilding – suffered significant setbacks. As such, final domestic demand stalled in Q1, although it remained up a brisk 4% on a year-over-year basis.

The news on income generation in the Q1 *Accounts* also shone a somewhat brighter light on the economy's performance. Underpinned by further job creation and wage gains in early 2008, personal after-tax income – in both absolute and in *real per-capita* terms – soared. Indeed, this latest snapshot provides a good explanation for the staying power of household spending in Q1 despite soaring gasoline prices. Rising wages, along with upward pressure in other input costs, had contributed to lower business profit margins throughout 2007. However, corporate profits managed to rebound slightly in Q1, providing support to the modest expansion in nominal GDP.

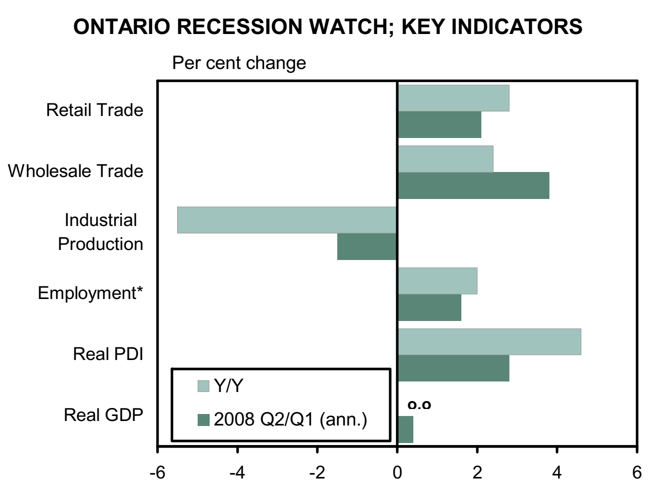
Negative print on Q2 not a done deal

With one negative quarter in the books, the report fuelled even more chatter about the likelihood of recession, narrowly defined as two straight quarters of declining real GDP. Based on Q1 developments – together with preliminary readings on Q2 from a host of monthly indicators on retail trade, international exports et cetera – it appears that Ontario may have narrowly averted this fate in the first half of 2008. TD Economics' base-case estimate for the April-June period is +0.4% annualized, although admittedly it wouldn't take much to pull the GDP reading below water. Monthly numbers on exports and auto production point to a further drag from net trade in Q2, while consumer-oriented indicators augur a moderate bounce back in final domestic demand. Within the construction sector, a pullback in non-residential activity likely went head-to-head against a rebound in homebuilding from its dramatic slip in Q1. Perhaps most importantly, the inventory correction meaningfully reduced the risk of a further contraction in economic activity in the April-June period.

When's a recession a recession?

Despite the widespread use of the simple two quarter recession rule, economists generally embrace a more sophisticated definition along the lines of that adopted by the U.S. National Bureau of Economic Research (NBER). According to the NBER, recessions involve more than a 2 or 3 quarter drop in real GDP, but "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales." This broader notion would distinguish a period of profound economic softness with one where GDP falls victim to a temporary hit. For example, in mid-2003, Ontario real GDP fell for two straight quarters due to SARS and the Ontario power blackout. Yet under the surface, the economy remained fundamentally healthy, setting the stage for a rebound in growth once the impact of those temporary factors waned.

Fast forward to Ontario's current situation. Even if the provincial economy did in fact record a further decline in real GDP in Q2, the other NBER conditions – with the exception of industrial production – were not met. Real income changes have been anything but recessionary, while real wholesale and retail trade activity has continued to expand. Above all, employment rose by 1.5% (annualized) in Q2, leaving the year-over-year reading at a healthy 2%.



*Actual, all others estimated by TD Economics in real 2002 chained dollars
Source: Statistics Canada / Haver Analytics

The ongoing resilience of most of these key indicators can be chalked up the nature of the weakness in real GDP. The softness thus far has been so highly concentrated in one sector – net trade – that it has failed to infiltrate Ontario's core domestic economy. What's more, although the auto- and forestry-based markets across the province are visibly struggling, the more diverse metropolitan centres of Toronto and Ottawa (which, together, account for more than half of the province's total economic activity) have remained relatively immune.

Still, as is apparent from our forecast profile, the broader definition of recession is probably going to be put to the test in the coming quarters. The argument has been for some time that domestic spending and exports can follow diametrically different paths in the short run, but a sizeable gap can't last forever. Nor can the equally large schism witnessed between real GDP and job creation persist. And given that the conditions in the U.S. export market are expected to remain soft until the second half of 2009, this convergence is more likely to take place by way of a weakening on the domestic front.

Cracks forming in Ontario's job market

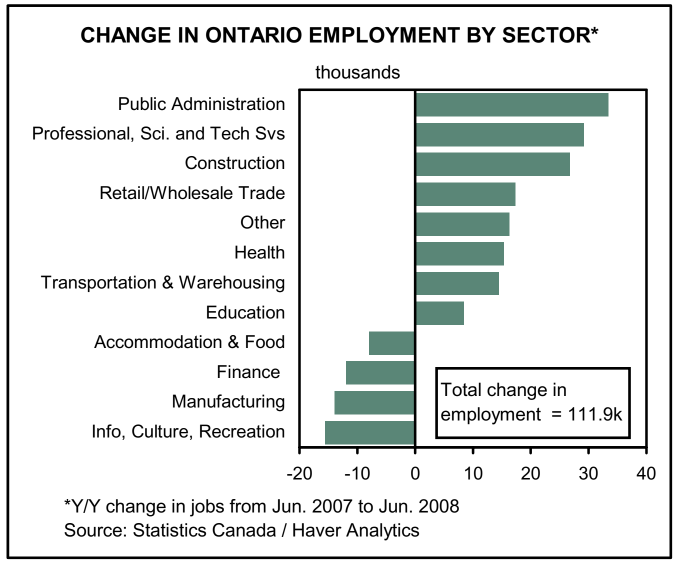
June employment numbers served up the most convincing evidence yet that Ontario's job market may have started to succumb to the pressures emanating from outside the province's borders. Employment retreated by 24,000 total jobs in the month, although that headline tally concealed an even larger 46,000 drop in full-time positions. The jobless rate rose by 0.3 percentage points, to 6.7 per cent, while the increase in the median hourly wage slowed from 4.2% to 3.8%.

As shown in the table, we anticipate further bad news in Ontario's employment pipeline over the next 18 months, with the jobless rate moving above 7% and personal income growth essentially stalling. Indeed, a closer look at the job stats by sector reveals a growing vulnerability in the job market. The manufacturing and the tourism-oriented service industries (i.e., accommodation and food & information, culture and recreation) have remained the most significant weak spots in Ontario's labour market over the past year. Employment in the financial services industry has also been grinding lower since the eruption of the global credit crisis last summer. And while most other sectors have been rising to take up the slack – including professional services, wholesale and retail trade and transportation services – the aggregate job creation figures conceal the fact that some 90% of the total net new jobs recorded on a year-over-year basis have been concentrated in only two sectors: government and construction.

Looking ahead, it is unlikely that these two areas will be able to continue to pull beyond their weight. The outlook for the non-residential construction sector remains positive, particularly as funds booked for infrastructure in previous provincial, federal and local government budgets are spent. But recent data on the resale housing market indicate that the province's over-heated housing sector has begun to simmer down. Housing starts continued to defy gravity in the spring of 2008, as condo projects got started this spring. But, in all likelihood, starts activity has peaked. And as we discuss on page 7, the slowing economy will not be lost on government coffers going forward, limiting the extent of further public-sector hiring.

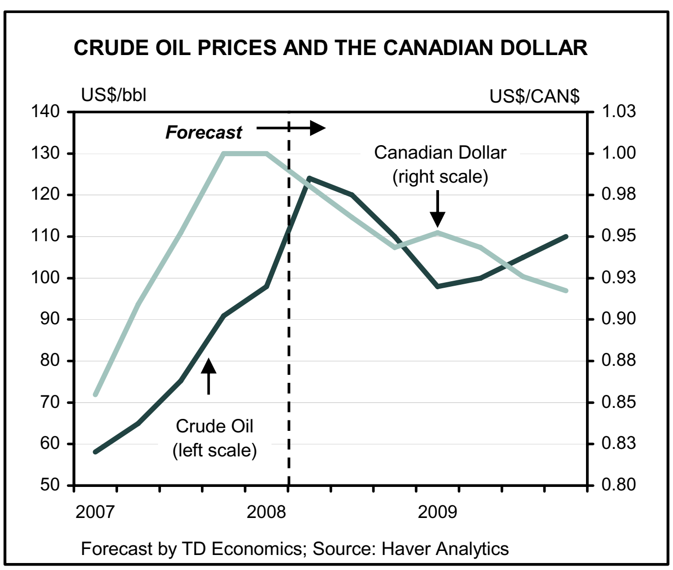
Broad-based slowdown expected

The slackening in job market conditions is likely to continue into 2009, putting a damper on personal incomes and household spending activity in the coming quarters. Within the business sector, prospects for investment are not as negative as that implied by the dramatic pull-back registered in Q1. In fact, in the July 2008 *Bank of Canada*



Quarterly Business Outlook Survey, a higher number of firms in Central Canada indicated an intention to raise machinery and equipment (M&E) spending in the near future for "reasons related to restructuring". Still, with corporate profits likely tracking downwards, gains in overall business investment are expected to be minimal.

While consumers and businesses confront more challenging conditions, some offsetting relief will stem from a likely pull-back in crude oil prices to about US$100-110 per barrel by late 2008. The Canadian dollar is also likely to ease in tandem, to 95 US cents and 92 US cents in Q4 2008 and Q4 2009, respectively. TD Economics expects that the Bank of Canada will keep its overnight target rate at a reasonably stimulative 3% until midway through next year, before bumping it up to 3.75% in late 2009.



Ontario's first recession since the early 1990s?

In sum, TD Economics expects Ontario to eke out some slight real GDP growth this year and next, but the margin between expansion and contraction in the forecast is razar thin. Moreover, the projected general softening in domestic and labour-market conditions in the near term will push Ontario closer to satisfying a broader definition of recession than any time since the early 1990s.

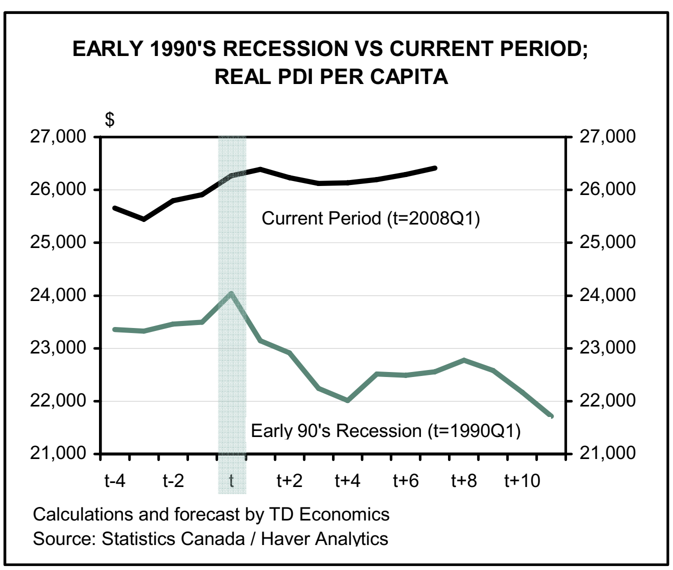
The use of the R-word tends to be avoided, and for good reason. Yet economic expansions followed by recessions are inevitable components of any business cycle. The fact that Ontario hasn't fallen into recession in 15 years (twice the traditional 7-year cycle) can be attributed to a number of positive structural developments over the past few decades, including improved provincial and federal fiscal policies, stable inflation, low interest rates, booming trade with the U.S. following NAFTA and an increasingly diverse economic base. But, these factors have made cycles longer and less volatile, not eliminated them entirely.

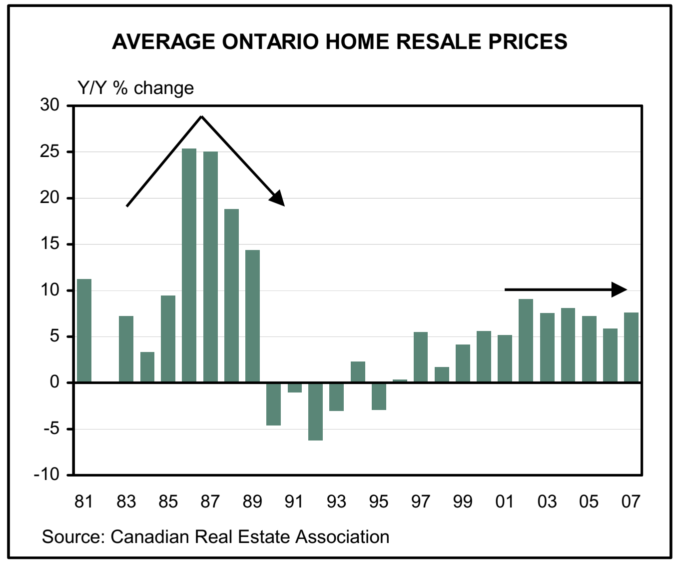
Recessions often conjure up images of mass layoffs, but the hardship they inflict is fully dependent on their depth and duration. Consider the severity of the early 1990s recession in Ontario, which was brought on by the implosion of a domestic housing bubble in the late 1980s, surging inflation, double-digit interest rates, and large government deficits.

- Between Q1 1990 and Q1 1991, Ontario real GDP would fall by about 8%.
- From a peak in Q2 1990 to the trough in Q4 1992, some 350,000 jobs would be lost in the province, accounting for about one in sixteen of the total employment base. Worse still, employment trends would then stagnate throughout 2003.
- Over the course of those four years (1990-early 1994), real PDI per capita fell by a whopping 13%.

In contrast, TD Economics' base-case forecast for the remainder of 2008 and 2009 can be characterized as a period of relative stagnation in Ontario. Admittedly, there are many uncertainties on the horizon, most notably the fortunes of the province's biggest trading partner and auto market south of the border. Yet notwithstanding some of these clouds, it is almost inconceivable that Ontario endures a similar painful outcome as in the early 1990s.

There has been some talk about a potential "bubble" in Ontario's housing market. We remain confident that the housing market can be aptly labeled as an overheated market rather than the type of speculative-driven frenzy that brought down the province's economy in the early 1990s or the United States more recently. In the four years leading up to the Ontario housing collapse in 1990, average resale prices grew by 22% per year. The comparable average annual gain in 2004-07 was about 7%. Despite some evidence of overbuilding in the major urban markets, home inventories in the province have stayed reasonably low and well below levels in the late 1980s. And though inflation measures in Canada have been perking up of late, the likelihood of a dramatic tightening in monetary conditions by the central bank in the current environment seems low.





There has been concern about the future impact of the recent erosion in consumer confidence in Ontario, as households have been bombarded almost daily by bad news in the media, including rising gasoline and food prices, U.S. developments, gyrating equity prices, et cetera. The worry is the weakening sentiment could lead households to cut back spending substantially. However, confidence has proved to be very spotty as a leading indicator of consumption. Until individuals (or their neighbours) are affected directly, consumers are unlikely to dramatically alter their spending plans. TD Economics' projections on labour market activity are consistent with slow personal spending growth, but not an outright retrenchment.

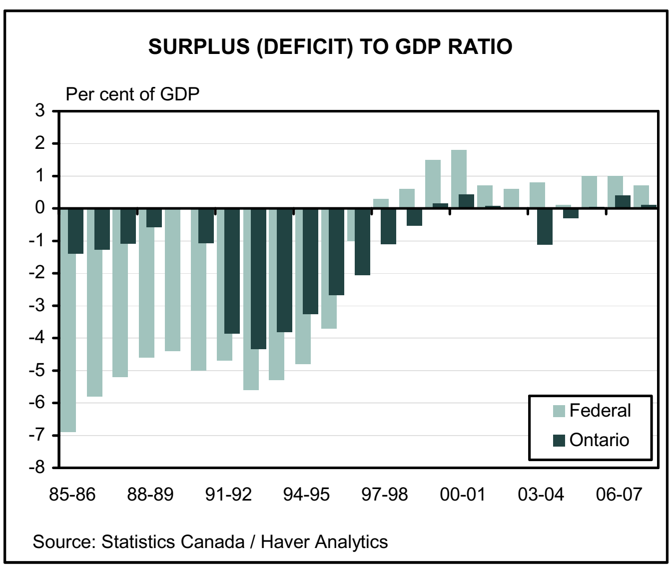
Ontario government to grow significantly in 09-10

Above all, the current fiscal environment should allow the government sector to remain a stimulative force in the economy. The same could not be said for the period leading up to the early 1990s recession when fiscal flexibility was greatly reduced by rising budget deficits and soaring debt-service payments. The measures contained in the 2007 federal and provincial Fall Updates and 2008 spring budgets will help to underpin economic expansions in the coming quarters.

That being said, even though booming commodity prices and western economies are supporting federal coffers this year – keeping its budget on track – the economic outlook facing the Ontario government has weakened noticeably since the spring. What's more, the Ontario budget didn't leave a big margin for error, projecting balanced budgets in both 2008-09 and 2009-10 after deducting contingency reserves of $750 million and $1 billion, respectively.

In the accompanying table, we compare TD Economics' projections with those contained in the 2008 budget. Growth in nominal GDP (a proxy for the tax base) is poised to come in about 0.5 percentage points under plan in fiscal 2008-09. Using Ontario Finance's simple rule of thumb, each 1 percentage drop in GDP costs the treasury about $700 million, mostly in terms of foregone revenues. This suggests that any negative impact on the books should fall within the government's contingency reserve. And with interest rates coming in below expectations – leading to an offsetting downward revision in debt-service payments in 2008-09 – it was not surprising that Ontario left its year-end budget outlook intact in its first-quarter update.

Still, the fiscal squeeze is poised to grow significantly in fiscal 2009-10. With growth once again underperforming



Source: Statistics Canada / Haver Analytics

ONTARIO ECONOMIC & FINANCIAL ASSUMPTIONS
(Per cent, unless otherwise noted)

	TD Economics*		2008 Budget	
	2008	2009	2008	2009
Real GDP growth	0.3	1.5	1.1	2.1
Nominal GDP growth	2.4	3.2	2.8	3.9
Employment growth	1.3	0.2	1.0	1.1
Unemployment rate	6.6	7.1	6.6	6.5
3-month T-Bill rate	2.4	3.2	3.3	3.8
10-yr gov't bond yield	3.7	4.3	3.9	4.5
CAN $ (U.S. cents)	97.0	93.5	100.0	98.0

* As at July 2008. Source: Ontario Ministry of Finance

budget, the *level* of nominal GDP next year is expected to be about 1.2 percentage points lower than planned, equating to a larger hit of about $800 million. TD's higher unemployment rate projections point to increased cost pressures related to social services, which should be offset to some extent by lower interest rates than currently built into the budget. As noted, the government budget plan in 2009-10 is protected by a $1 billion contingency reserve not to mention various contingencies built into spending plans.

Ontario's secular challenges require a long-term plan

Economic slowdowns tend to drive up pressure on governments to take action to revive the economy. The exercise in the section above highlights the fact that there won't be much scope for the government to take additional measures above and beyond those in the 2008 budget – that is, unless it runs a deficit. The truth of the matter is that there isn't much that can be done anyway about deteriorating economic prospects. On the other hand, if the economy is hit unexpectedly hard – or if revenues come under more pressure than that indicated by the simple rule of thumb – aggressive action should not be taken to reduce the impact on the budget balance. The automatic stabilizers should be allowed to operate.

In any event, the focus of the Ontario government should not be on near-term prospects, but the secular challenges facing the provincial economy that won't be addressed by a cyclical recovery in the U.S. economy. For example, Ontario's weak productivity performance remains a major issue. And while there is a good case to be made that crude oil prices and the Canadian dollar are likely to descend moderately from their current lofty levels, any forthcoming relief on that front is not expected to fully staunch the bleeding in Ontario's manufacturing sector. The competitive threat from manufacturers in lower-cost jurisdictions is one element of the recent "perfect storm" confronting Ontario producers that is unlikely to abate. Meanwhile, ultra-low interest rates and booming housing activity have helped to mask weakness in manufacturing by driving up demand for construction-related products and overall economic activity. However, we don't believe that the province can count on this masking trend for much longer. Nor can we expect construction and financial services to outperform as housing market activity reverts to a more sustainable level.

As such, the Ontario government should take the opportunity to set out a clear, positive strategy to raise the province's growth over the medium to long haul – say 3 to 5 years. This strategic plan could be unveiled in the 2008 Fall Economic and Fiscal Update.

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