HIGHLIGHTS OF THE WEEK

• WTI crude oil prices hit a fresh 6-year low of US$43 per barrel this week, as markets are beginning to focus on bulging inventories and lack of available storage capacity in the US.

• Manufacturing sales sank 1.7% in January – driven largely by petroleum products. Volumes were down by a more modest 1.0%.

• Retail sales were also down 1.7% in January, due to lower gasoline station receipts. In real terms, sales slid by a still significant 1.2% during the month.

• Lower gas prices continue to weigh on headline inflation, which clocked in at 1.0% y/y in February. However, the weaker Canadian dollar has provided some offset, helping to keep core inflation slightly above the Bank of Canada’s 2% target.

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OIL PRICES CONTINUE TO KEEP THINGS INTERESTING

The impact of lower oil prices on the Canadian economy is becoming more evident with each new data release. However, the current state of crude oil markets suggests the worst is yet to come.

It was a volatile week for crude oil, with prices initially extending last week’s decline – hitting a fresh 6-year low of US$43 per barrel – before rebounding back to US$46 per barrel today on expectations of a further decline in U.S. rig counts. The recent drop in active drilling rigs has helped to stabilize crude oil prices over the last month. However, given the increase in efficiency and productivity in recent years, the drop in rig counts does not have the same impact on production that it once did. Which rigs are being used is now more telling than the number of rigs in use. Indeed, despite falling rig counts, production in the U.S. has shown no sign of slowing down, with output continuing to rise week after week. Meanwhile, inventories are bulging, with the U.S. Department of Energy’s weekly data showing that storage was 88% full last week.

Markets have begun to focus on this lack of storage capacity, which has largely underpinned the recent weakness in oil prices. And, with average inventory builds suggesting that crude oil storage in the U.S. will reach full capacity by mid-May, another leg down in oil prices is likely in the coming months. We expect WTI to average a mere US$42 per barrel in the second quarter, before grinding higher in the second half of 2015 as U.S. production growth finally begins to show some signs of ratcheting down. That said, the glut of oil currently in the market will take time to work down, likely keeping prices below the US$75 per barrel mark over the next 6-8 quarters.

Lower oil prices were a key driver behind the 1.7% tumble in manufacturing sales in January, as sales of petroleum and coal products hit a 6-year low. Moreover, the largest decline was recorded in Alberta, reflecting the 26% plunge in petroleum and coal product sales.

Retail sales also had a poor start to the year, matching the decline in manufacturing in January, thanks in large part to lower gasoline station receipts. In real terms, sales were down by a sizable 1.2%, suggesting weak income growth may be providing some negative offset to savings at the pumps. This poses some downside risk to our consumer spending and overall growth outlook for the first quarter.

Lower gasoline prices also continue to weigh on headline inflation, which came in at 1.0% y/y in February. However, the massive depreciation in the Canadian dollar has provided some offset. In fact, without the currency impact, headline inflation would likely be close to zero, and core inflation would be running significantly below the Bank of Canada’s 2% target (See Canadian Consumer Prices Riding On Loonie’s Wings). In contrast, core inflation has topped 2% for a seventh consecutive month.

As data for the first quarter of the year continues to roll out, the impact of low oil prices on the Canadian economy is likely to become even more pronounced. This is consistent with the Bank of Canada’s and our view that the biggest hit to growth will be during the first half of 2015. With economic growth softening, and core inflation unlikely to drift far from the Bank’s 2% target, there will not be much pressure for the Bank to alter rates in either direction in the near term.