SPECIAL REPORT

TD Economics

June 25, 2015

# CANADIAN EXPORT SECTOR POISED TO STEP ON THE GAS

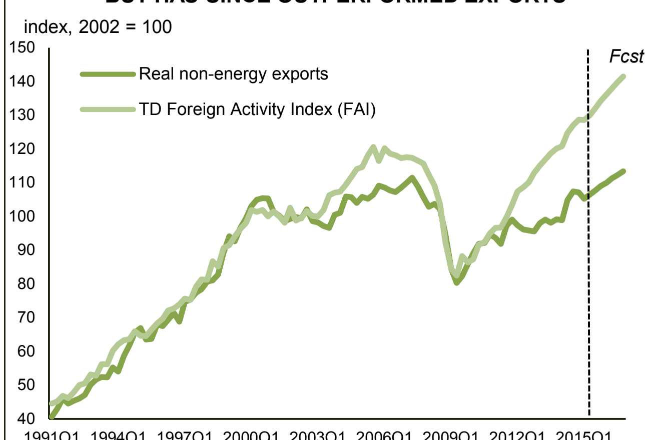
## Highlights

- The sharp decline in oil prices over the past year has led to a pull back in profits and investment in the energy sector, and called into question the future drivers of Canadian economic growth.
- We believe exports will step up and fill a large part of this void. Indeed, the low Canadian dollar and resurgent U.S. and European demand should provide the right conditions for export growth.
- But not all sectors are expected to receive the same boost. This can be chalked up to both cyclical and structural factors.
- Cyclical factors such as the value of the loonie and renewed growth in foreign demand, as proxied by TD's newly developed Foreign Activity Index, are forecast to boost growth in most sectors.
- Only the auto sector looks to be hobbled by persistent structural weakness. With Mexican auto production having surpassed that of Canada starting in 2010 and all newly-announced investment going to Mexico and the U.S., Canadian automotive won't be a key driver of exports.

The trajectory for Canada's trade balance is becoming increasingly significant as the nation's growth driver. The household debt cycle is in a late stage and weaker income growth prospects make consumer spending less likely to carry the day as the main economic accelerator (see our June 2015 Quarterly Canadian Economic Forecast). The recent slump in investment in the oil patch has undermined what has been a key economic underpinning for much of the past 15 years. This places more emphasis on exports to take a leader position, otherwise Canadian economic momentum risks being stuck in low gear. In theory, the landscape is working in favor of this outcome, due to a strengthening U.S. economy and softer loonie. In practice, export growth has underwhelmed in the past three quarters.

There are two influences at work. The first is cyclical in nature. Exports have been batted around due to one-off factors south of the border like poor weather that depressed auto exports in the first quarter, and lingering data distortions related to past railway bottlenecks affecting agriculture shipments. These influences won't persist going forward. The second is more deep-seeded, reflecting a structural shift in the type of exports that will need to carry the day for Canada. TD's newly developed Foreign Activity Index (FAI) estimates foreign demand growth based on our expectations of key external economic indicators (see Box 1). However, a rebound in the FAI in the coming months will not generate the growth impulse to Canadian exports that we've seen in the past (Chart 1). The culprit largely stems from motor vehicles, which are set to post little or no gains despite red-hot American demand. Challenges

CHART 1: TD FAI PERFORMED WELL UNTIL 2012 BUT HAS SINCE OUTPERFORMED EXPORTS




Sources: Statistics Canada, TD Economics.

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CHART 2: TRADE HAS GONE FROM SURLUS TO DEFICIT ON WEAK EXPORT GROWTH


Source: Statistics Canada.

related to competitiveness and penetration within the U.S. and other key export markets will hold overall export gains below their potential.

Stepping into this gap, growth will be more heavily tilted towards electrical products, industrial machinery, and metals and minerals, as well as forestry and chemical products. Likewise, exports of services – notably tourism and commercial services – will carry greater prominence. These sectors will allow exports to more closely track foreign activity over the next 12-18 months, but they won't have the thrust or scale to close the gap that emerged in 2012. Nonetheless, Canadian real non-energy export growth is likely to run a healthy average annualized clip over the final three quarters of 2015 and 4.3% in 2016 (Table 1). With exports forecast to outstrip imports over the next couple of years, Canada's trade deficit is likely to narrow after surging to a 5-year high of 2.6% of GDP in the first quarter of this year.

### Post-recession trade deficit is a break from history

The narrative of Canada as a trading nation is well established. But, this story is not static. Canada's trade surplus steadily eroded following 2002 with the gradual appreciation of the dollar and the globalization of supply chains. The 2008 recession marked a tipping point that caused Canada to be dethroned as a trade-surplus nation after a fifteen year reign (Chart 2). A trade deficit has since persisted, in part reflecting Canada's comparative advantage of solid domestic demand relative to disappointing foreign demand.

For trade to meaningfully contribute to economic momentum in the months ahead, this deficit needs to narrow, as a demonstration that export growth is outstripping that of imports. This, in fact, started to take root in 2014 alongside a weakening currency and broadening U.S. demand (Chart 3). The trend is expected to continue, but much depends on the performance of the non-energy goods component because it comprises roughly two-thirds of all exports. Energy and services make up the remainder and will also turn up the growth-dial, but ultimately these two export groups do not have sufficient weight individually to propel overall export

**Table 1: Real export growth expected to perform well in 2015-16**

| average annual growth (unless otherwise indicated) | History | | | | Forecast | |
|---|---|---|---|---|---|---|
| | 2002-08 | 2009-13 | 2014 | 2015Q1 | 2015 | 2016 |
| **Real exports** | **0.6** | **1.2** | **5.4** | **-1.1** | **3.2** | **4.2** |
| **Real goods exports** | **0.4** | **1.2** | **6.0** | **-1.8** | **3.2** | **4.1** |
| **Non-energy exports** | **0.1** | **0.6** | **6.0** | **-7.0** | **2.4** | **4.3** |
| *Motor vehicles and parts* | *-2.5* | *2.0* | *2.4* | *-21.4* | *-0.5* | *2.7* |
| *Metal and minerals and products* | *3.3* | *-0.3* | *4.5* | *-16.8* | *5.0* | *5.0* |
| *Consumer goods* | *0.3* | *-0.3* | *6.8* | *-7.8* | *2.8* | *5.3* |
| *Forestry products* | *-3.3* | *-0.7* | *6.2* | *9.1* | *6.5* | *6.0* |
| *Other* | *0.9* | *-1.3* | *7.2* | *4.7* | *2.6* | *3.8* |
| **Energy exports** | **1.5** | **3.3** | **6.0** | **17.9** | **5.7** | **3.3** |
| **Real services exports** | **2.0** | **1.4** | **2.3** | **3.1** | **3.4** | **4.6** |
| *Travel services* | *-2.0* | *-0.5* | *4.6* | *1.2* | *2.8* | *0.8* |
| *Commercial services* | *4.4* | *2.3* | *0.8* | *3.7* | *4.0* | *6.6* |
| *Other services* | *0.6* | *0.2* | *5.8* | *2.9* | *1.9* | *1.5* |

Sources: Statistics Canada, TD Economics.
Note: Quarterly growth rates are presented on an annualized basis.

growth high enough to counterbalance the headwind coming from import growth.

### Outlook for non-energy goods exports is mixed

The first quarter of 2015 represented a low watermark for non-energy goods exports. Weak export performances reflected some temporary factors that hit export demand and slowed production. This included a harsh winter south of the border, a U.S. west coast port strike, and shutdowns among automakers for retooling, among other factors. While only three of the ten non-energy goods export categories contracted in Q1 (in volume terms) – motor vehicles and parts, metal and non-metallic mineral products, and consumer products – these categories represent roughly 50% of the volumes. The gap between the TD FAI and non-energy goods exports widened further as a result.

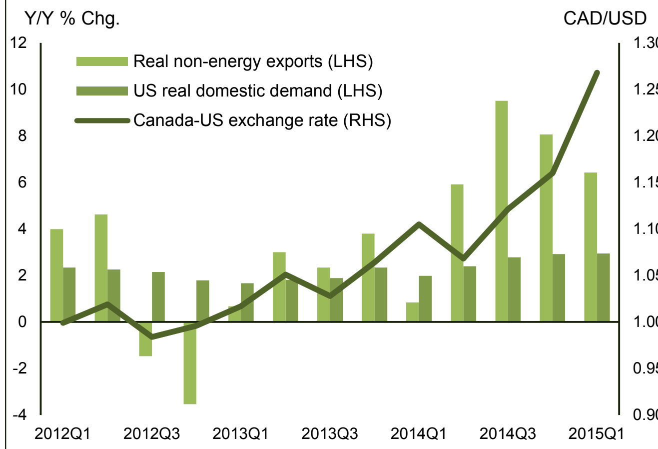
However, this gap is unfortunately not a new phenomenon. It first opened up in 2012 related to structural factors – specific to the auto sector – and has ceased to close in any material way due to the compounded effect of recent cyclical or temporary factors.

*Exports of motor vehicles and parts weigh on the outlook*

The underperformance of Canadian auto exports relative to U.S. motor vehicle sales is hard to miss in Chart 4. It became particularly pronounced in 2013, and the trend has only worsened. True to form, the American love for cars pushed sales up against record levels. The same did not occur for Canadian auto exports, which remained essentially flat. In large part, this can be chalked up to the yawning gap that has opened up between Canadian and Mexican production, as Mexico's share has increased at Canada's expense (Chart 5). And, there is nothing on the horizon to suggest this trend will ease. All of the announced investment in additional capacity or new plants is occurring in the U.S. and Mexico. Five new plants are scheduled to come on line in Mexico between 2016 and 2019, while there have been ten recent announcements of new or expanding capacity in various states across the United States. By comparison, Canada is not expected to benefit from any investment in new capacity, and is in fact expected to see its production in the auto assembly sector diminish over the next couple of years. Although the outlook for exports of auto parts is less bleak, it too is anticipated to experience more weakness than other export sectors.

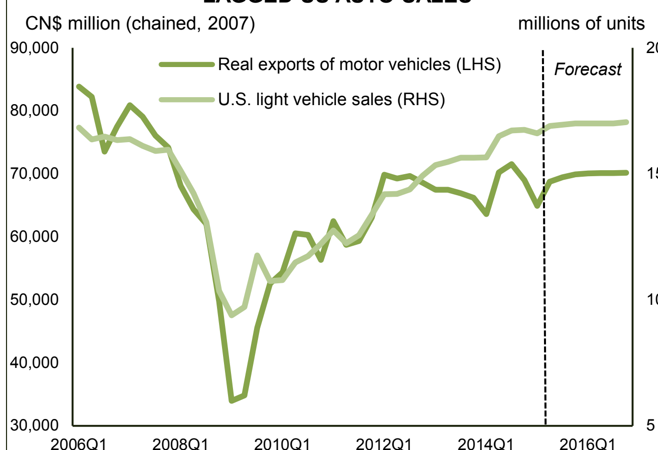
This strong structural headwind will now be met with a cyclical one, as the underpinnings for pent-up auto demand

CHART 3: NON-ENERGY EXPORT VOLUMES STARTED 2014 WITH A BANG



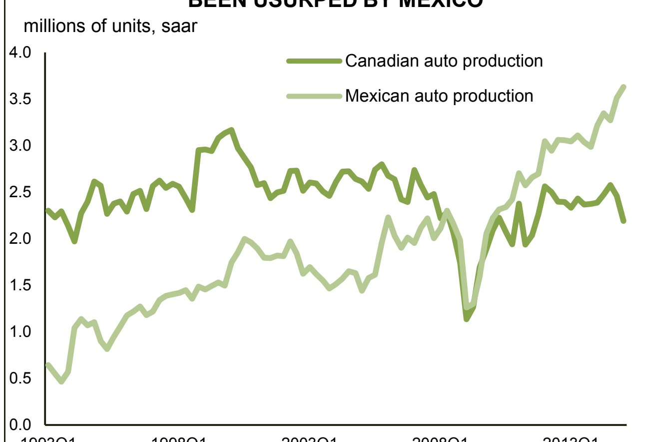

Source: Statistics Canada, Bureau of Economic Analysis, Bloomberg.

CHART 4: MOTOR VEHICLE EXPORTS HAVE LAGGED US AUTO SALES




Sources: Statistics Canada, Autodata Corporation, TD Economics.

CHART 5: CANADIAN AUTO PRODUCTION HAS BEEN USURPED BY MEXICO




Source: Automotive News.

| Table 2: Changing Shares of Canadian Exports | | | |
|---|---|---|---|
| % of total real exports* | History | | |
| | 2002-08 | 2009-13 | 2014 |
| **Real goods exports** | **85.7** | **84.4** | **85.1** |
| **Non-energy exports** | **69.5** | **65.4** | **65.6** |
| *Motor vehicles and parts* | *14.6* | *12.0* | *12.5* |
| *Metals and minerals and products* | *12.3* | *13.4* | *13.7* |
| *Consumer goods* | *9.7* | *9.2* | *9.1* |
| *Forestry products* | *8.1* | *5.9* | *5.9* |
| *Other* | *24.8* | *25.0* | *24.3* |
| **Energy exports** | **16.2** | **19.0** | **19.5** |
| *Crude oil* | *7.3* | *10.1* | *11.8* |
| *Natural gas* | *5.8* | *5.1* | *4.0* |
| *Other* | *3.1* | *3.7* | *3.7* |
| **Real services exports** | **14.3** | **15.7** | **15.1** |
| *Travel services* | *3.3* | *3.0* | *2.8* |
| *Commercial services* | *8.2* | *9.9* | *9.6* |
| *Other* | *2.8* | *2.8* | *2.6* |

Sources: Statistics Canada, TD Economics. * Chained 2007 dollars.

in the U.S. is steadily weakening. Any way you slice it, the growth impulse to Canadian exports coming from foreign auto demand won't be strong. With motor vehicles and parts making up nearly 20% of non-energy goods exports, it's clear why this structural change in market demand has loosened the link between Canadian non-energy exports and the TD FAI. It automatically places more onus on other export sectors to step on the gas pedal in order to propel growth.

*Metals and minerals on the mend*

One sector that can help in this endeavor is metals and minerals. It is the other heavy-weight within the non-energy goods exports sector with a 20% share (Table 2). Unfortunately, here too growth in export volumes lagged the TD FAI in 2012 and has since struggled to keep pace. However, unlike the auto sector, this underperformance is more cyclical than structural in nature. It can be largely tied to weakness in Europe, the destination for roughly a quarter of these products. Indeed, growth in both the euro area's real GDP and metal and mineral exports contracted in 2012. And the U.S. economy – the destination to about half of Canada's exports of metals and minerals and products – didn't provide enough of an offsetting boost over this period either. But, good news is on the horizon. Both major economic regions are showing renewed economic vigour (see the U.S. and Global Quarterly Economic Forecasts), and this critical cyclical driver will support a resurgence of metals and minerals exports in the order of 5% over the next two years. Put another way, growth in this sector will roughly match that of the TD FAI (5.3% annually, on average), preventing the gap between the measures from widening noticeably.

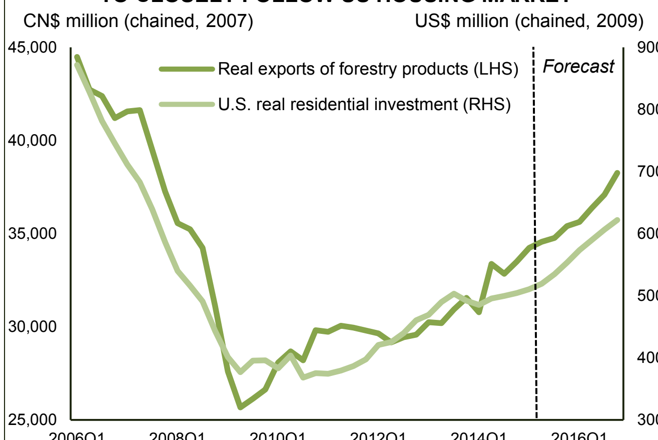
*Consumer goods to push higher*

Real exports of consumer goods also lagged behind the TD FAI in the early post-recession period (2010 through 2012). This was due to a toxic combination of lackluster economic activity in both the U.S. and Europe, and a high-flying loonie that crimped Canada's competitiveness. However, this sector has since been partly to credit for improving the relationship between exports and the TD FAI by more than pulling its weight with average annual growth well over 6% in 2013 and 2014. The trend was briefly interrupted by an 8% decline in Q1 2015 on soft U.S. demand, but it's already making a convincing comeback. We expect to see increased momentum for consumer product shipments this year, marking another sector that will likely keep pace with the TD FAI. Not only will the share of consumer products relative to total non-energy exports rise, but it will offer a counter influence to the underperformance coming from auto shipments.

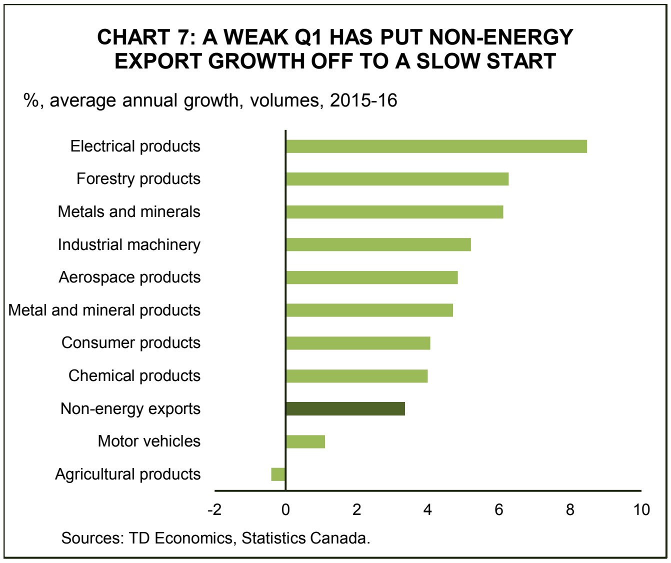
*Forestry products make a comeback*

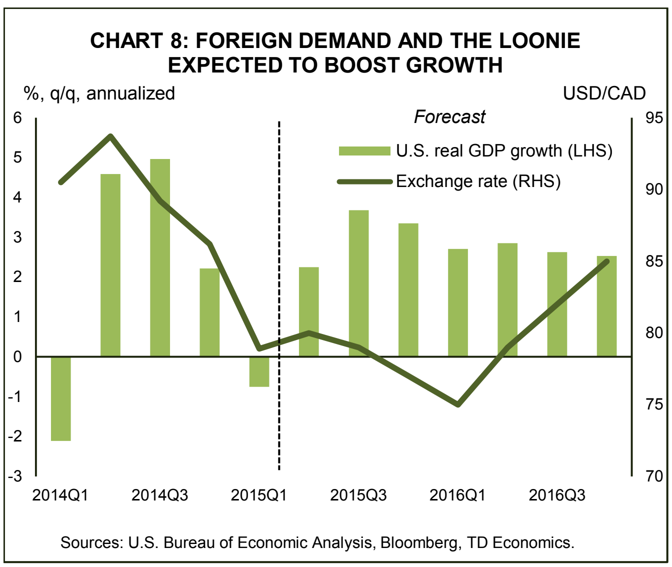
Also falling into the camp of having close U.S. ties is the forestry industry. It has been a victim of both structural and cyclical influences. The lackluster recovery in the U.S. housing market, combined with dwindling demand for newsprint, has ensured that the post-recession recovery in forestry

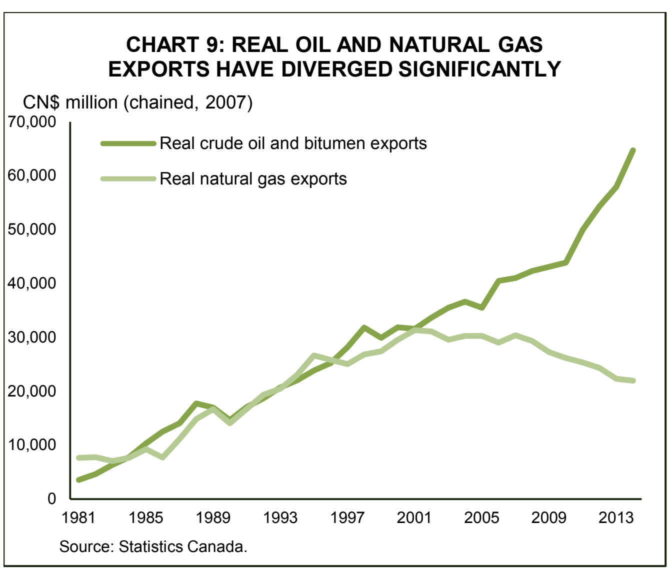
**CHART 6: EXPORTS OF FORESTRY PRODUCTS TO CLOSELY FOLLOW US HOUSING MARKET**




Sources: Statistics Canada, Bureau of Economic Analysis, TD Economics.




exports has remained modest (Chart 6). Nonetheless, growth in 2015 and 2016 should gain momentum alongside renewed residential investment stateside.[1] Starts of single-family dwellings – a lumber intensive sector – are expected to post double-digit advances over the next two years.

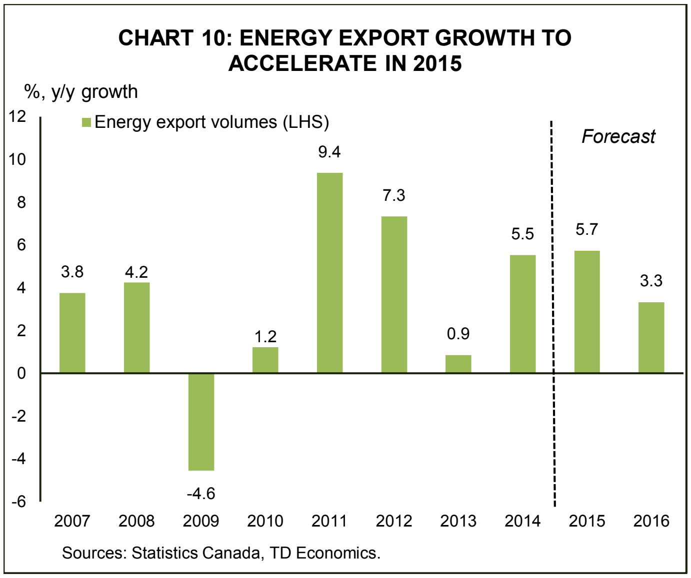
*Remaining export categories to post strong advances*

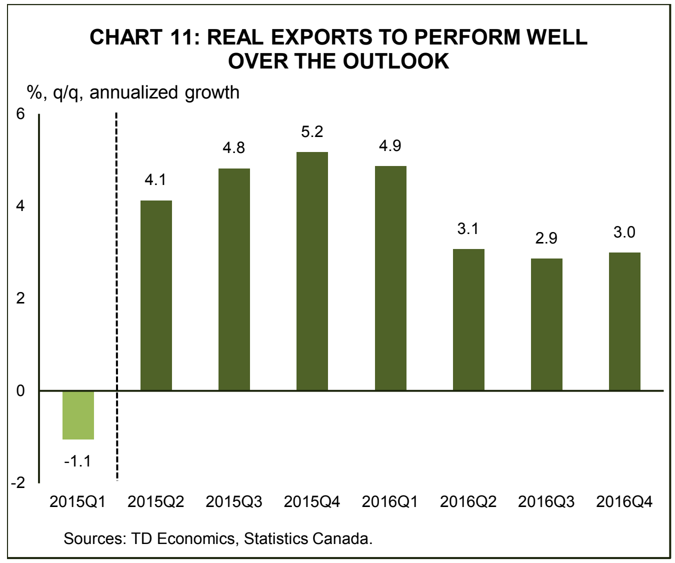
The remaining non-energy goods export categories are all expected to be at or near the top of the leader board over the next couple of years, with the notable exception of agriculture (Chart 7).[2] These include real exports of electrical, aerospace and chemical products, as well as industrial machinery. Generally closely linked to U.S. industrial production, the external conditions are ripe for growth resurgence in these export sectors (Chart 8). So, the key take-away message is that once you strip away the auto sector, the growth prospects of the remaining non-energy export sectors are positive and set to either maintain or accelerate in momentum.

**Growth in energy export volumes should remain solid**

Up until now, the discussion has been concentrated on non-energy exports, since this aggregate provides the broadest insight into the growth potential and health of Canada's export sector. However, no discussion on exports is complete without touching on Canada's flagship energy industry. This industry is particularly sensitive to the whims of American demand, as demonstrated in the first quarter of 2015. A cold snap across the eastern U.S. seaboard caused natural gas shipments to soar, and real energy exports posted the strongest quarterly pace since Q1 2012. However, that was a one-time cyclical blip, and going forward the structural drivers take over. And the structural trend has been toward a reduced role for natural gas exports in light of shale gas development south of the border (Chart 9).

Looking ahead, outside of some volatility expected in the near term, oil and natural gas prices are likely to recover gradually over the next couple of years. Thanks in large part to the strength of Q1, energy export volumes in 2015 are forecast to grow by nearly 6% – closely matching the growth in 2014 (Chart 10). But the advance in real exports of oil volumes, in particular, could slow, reflecting continued high inventories as well as the impact of recent cuts to capital expenditures in the energy sector. These factors are expected to cause growth in real energy exports to decelerate toward 3% in 2016. This puts projected growth in energy export volumes in line with our modest forecast for oil production growth in 2016, in the 3-5% range. Although Canadian oil




exports are likely to be sustained due to Canada's key role in the North American market for heavy crude oil, the impact of shale extraction on natural gas exports is a cautionary tale. And, while the dust has yet to settle on the recent decline in oil prices, the North American oil industry has permanently changed in the past five years.

### Services exports likely to plod along

An often overlooked sector of exports is services. While goods represent about 85% of the value of Canadian exports, exports of services continue to play an increasingly important role in Canadian trade. From about 10% of exports 30 years ago, services now represent 15% – just south of the export share of the all-important energy sector. But in contrast to energy exports, services exports have been rising steadily over time, slipping under the radar as a major contributor to Canadian export growth. This parallels the increasing importance of services among advanced economies more generally.

On the cyclical side, services exports also benefited from the positive external conditions in 2014, and this is expected to continue in 2015 and 2016. Building on growth of around 3% annualized in Q1 2015, we are projecting annual growth in real services exports to be in the range of 3-5% over the next couple of years. Taking the lead will be commercial services , which includes exports of financial services, while tourism is forecast to show solid growth in 2015 before decelerating in 2016 on the back of a rising loonie.[3]

### Bottom line

Since the financial crisis, the trade winds have reversed for Canada, pushing us from our historical perch as a net exporter to a net importer. This is the result of export growth that has not kept pace with foreign demand as opposed to our insatiable appetite for foreign products. While structural factors have weighed on specific sectors, such as motor vehicles, exports have also been affected by cyclical spillovers from major trading partners like the U.S. and Europe.

Nonetheless, the rebound in the export sector will ultimately spur investment and employment in the sector. We have already seen promising signs of this development, albeit somewhat masked by the temporary factors holding back U.S. growth in Q1. As a result, we expect total export volumes to advance by 3.2% in 2015, before rising further to 4.2% in 2016 (Chart 11). But, since the TD FAI is likely to increase by an average of 5.3% in each of the next two years, the deviation with total Canadian export growth will persist.

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**Box 1: Constructing the TD Foreign Activity Index**

There has been a great deal of analysis done in trying to understand the drivers of non-energy export growth, particularly by the Bank of Canada. Building on this work, we have developed a TD Foreign Activity Index (FAI) in order to help explain the evolution of Canadian non-energy goods exports. The approach used to construct the TD FAI is similar to that used in the construction of TD's Labour Market Indicator (LMI)[i] and Precarious Employment Index (PEI)[ii]. The TD FAI includes foreign real GDP outside of the U.S. and Canada, as well as real U.S. consumption, residential investment, investment in machinery and equipment (M&E), investment in non-residential structures, motor vehicle sales, and industrial production. Hence, the FAI is tilted more heavily toward economic developments south of the border than elsewhere, which is fitting given the share of Canadian exports shipped stateside.

The TD FAI tracks real non-energy goods exports from Canada well over history, both before and after the 2008-09 recession. However, much like other measures of foreign activity, the TD FAI has recently missed the mark in estimating growth in non-energy goods exports, particularly through 2012 and 2013. The TD FAI also follows total exports well (including energy), but we use it primarily to track the non-energy component given it's a marker for broadening external demand thanks to its inclusion of multiple indicators of foreign economic activity.

i 'One Indicator to Rule Them All: TD Labour Market Indicator Provides Balanced Snapshot of Job Conditions', http://www.td.com/document/PDF/economics/special/Labour_Market_Indicator.pdf.

ii 'Precarious Employment in Canada: Does the Evidence Square with the Anecdotes?', http://www.td.com/document/PDF/economics/special/PrecariousEmployment.pdf.

## ENDNOTES

1 The expiration of the Softwood Lumber Agreement (SLA) in October 2015 is likely to complicate the outlook, as it is likely to encouraging the export of forestry products that have seen their production ramp up recently on account of devastation rendered by the mountain pine beetle.

2 The notable exception is agricultural exports. As with any sector, real exports of agricultural products are not immune to temporary factors. In this case, a backlog of grain shipments through 2013 were finally able to be moved by rail in mid-2014. This was accompanyied by double-digit growth of nearly 70% (annualized) in Q2 2014. Exports have since fallen back to more normal levels, leading to weak growth numbers on an annual basis. But this masks the steady and stable quarterly growth of about 3% annualized expected over the remainder of 2015 and into 2016.

3 Commercial services cover several services such as management, telecommunications, financial services, insurance, commissions on trade, computer services, research and development, professional services, training, health services, audiovisual and cultural services. Payments and receipts for the authorised use of propriety rights such as patents, copyrights and industrial process and designs are also covered by the definition of commercial services.