CANADIAN ECONOMIC SLUMP TO EASE IN LATTER HALF OF 2015

- Economic growth in Canada has been disappointing in the first half of the year. The first quarter recorded a shallow contraction, and tracking for the second quarter points to another negative print. This morning’s release of May 2015 real GDP by industry helped to firm up this view. And it is this below-expectations performance of the Canadian economy that led the Bank of Canada to cut the overnight rate by 25 basis points in July – the second rate cut this year.

- The weakness has been largely associated with the sharp drop in oil prices that took place during the second half of 2014 and into 2015. Indeed, despite ongoing increases in oil production, support activities for oil and gas extraction has taken a big hit this year, weighing on total output in the sector. However, looking at the monthly GDP by industry data suggests that the weakness is more widespread. TD’s diffusion index has been hovering around the 50 threshold this year (a value above 50 suggests more industries are expanding than contracting), suggesting that industries beyond the energy sector are struggling to gain momentum (Chart 1). Output in mining and energy, manufacturing and construction sectors contracted during the first half of the year, along with several key services industries, including wholesale trade, transportation and warehousing and accommodation and food services (Chart 2). Even job creation, which was a bright spot in the first half of the year, was highly concentrated and largely propped up by Canada’s hot housing market.

- The recent rout in oil prices doesn’t inspire much confidence that energy-sector investment will be a key driver of growth in the future. Indeed, the announcement that Iran will see some relief from sanctions has caused oil price forecasts to generally flatten, with only a very modest recovery expected. Growth tied to the energy sector – particularly on the investment side – will likely remain subdued as a result, driving down non-residential and engineering construction over the remainder of this year. However, the sector should see some reprieve next year as energy prices grind higher, giving overall construction a boost.
The outlook for non-energy industries is much brighter. The latest Bank of Canada rate cut has pushed the benchmark rate down to 0.50%, which bodes well for spending and investment. Canada’s housing market is expected to continue going strong this year, although it should begin to cool next year as the recent spate of price growth has eroded affordability (See Rate Cut not a Game Changer for Canada’s Housing Market). Growth in residential construction and the real estate and leasing industry should follow a similar growth profile. Retail sales are also likely to hold up as well over the next 18 months, as consumers continue to enjoy low borrowing costs.

Another benefit of the recent rate cut has been the sharp depreciation of the Canadian dollar. The loonie is currently sitting at less than 77 US cents – essentially the lowest level in over 10 years. Going forward, the Canadian dollar is expected to continue falling, reaching 73 US cents in the second quarter of 2016 (see Dollars and Sense: C$ and Interest Rate Forecast Downgraded Amid Deepening Oil Slump), and thus providing further support to the export sector. When combined with the anticipated strength in the U.S. economy – where over three quarters of Canadian exports are destined – trade should pick up steam in the second half of this year and into next.

As such, the industries poised for the most growth are those which are tied to the export sector (Chart 3). In particular, increased industrial production in the U.S. should lead to higher demand for manufactured goods – including industrial machinery, chemicals and electrical products – which have been slow to gain momentum. The forestry sector is also poised for significant growth over the next six quarters as the U.S. housing market rebounds from the weather-induced winter lull that started the year and employment gains remain solid. However, while auto production should bounce back during the second half of the year with retooling shutdowns having come to an end, overall production in the sector will remain subdued as automakers have been shifting production elsewhere.

Although it is often overlooked, about 70% of Canada’s output comes from services. The services industries that are linked to the trade sector are also likely to outperform over the next 18 months, particularly wholesale trade and transportation and warehousing (Chart 4). The lower loonie – along with the PanAm Games in July – are likely to attract more visitors to the country, giving the tourism industry a boost. As such, accommodation and food services are expected to be a top performer in the coming quarters. Beyond those sectors tied to the fortunes of the loonie, most services industries are forecast to grow steadily over the outlook.

**Bottom line**

All told, despite a rough start to the year, the outlook for the Canadian economy over the second half of this year and in 2016 is much brighter, with average growth expect to head back toward the 2% mark. We believe economic growth (on a real GDP by industry basis) will rise by roughly 1.3% (annualized) during the second half of the year and average 2.2% in 2016. The manufacturing and export-related industries will get a lift from an uptick in economic activity in the U.S. and the lower loonie, while the domestic sector will also chip in thanks to extremely accommodative monetary policy.