OBSERVATION

TD Economics

August 18, 2016

IS THE ENGINE STALLED OR HAS IT SEIZED? TAKING STOCK OF CANADA'S ECONOMIC ROTATION

Highlights

- Canada's ongoing economic rotation process involves a shift in the composition of growth, away from commodity- and housing-led growth and toward manufacturing and exports.
- This process appears to have stalled in the first half of the year as export volumes pulled back and residential real estate remained a key growth driver.
- The pull-back of exports largely reflects weaker-than-expected growth in the U.S., particularly in business investment. A more positive outlook south of the border should translate into a resumption of export growth, bringing the rotation back on track.
- The Bank of Canada will likely see the delayed rotation as cause for further inaction, holding the policy rate at its current accommodative level for even longer. However, it would likely require a significant negative shock to spur any further monetary easing.

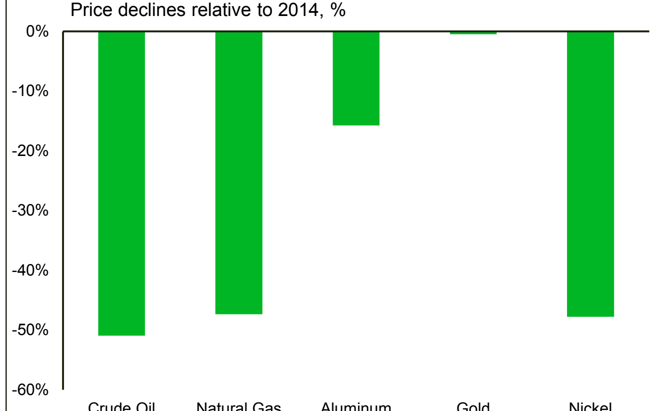
Much has been made of the ongoing 'rotation' of Canadian economic growth that has been precipitated by the dramatic fall in commodity prices from 2014 highs (Chart 1). This rotation has two elements: First, facilitated by an adjustment in the Canadian dollar, a shift in the source of export growth from commodities to non-commodity goods and services. Second, a shift in the composition of domestic demand growth from household consumption and investment (in residential real estate) toward non-commodity business investment.

The first part of this shift is a necessary precondition to the second. A rise in exports is key to absorbing the excess capacity created by the plunge in commodity prices that eventually leads businesses to raise non-commodity-focused investment. The Bank of Canada has repeatedly emphasized that it expects an export-led recovery in manufacturing output as the key to economic rotation and continues to forecast a strong recovery of non-commodity exports. This would represent a return to pre-crisis (2002-2007) growth patterns, with exports leading both manufacturing output and investment higher.

Unfortunately, this growth rotation has shown signs of stalling over the past several months. After strong gains in December and January, export volumes have fallen for the past five months straight. Meanwhile, low interest rates have continued to be a boon to the real estate market, which has single-handedly been responsible for roughly half the growth in real GDP since the end of 2014.

Given the importance of the export story to Canada's economic outlook, it is important to understand the source of the

CHART 1. WEAKNESS IN ENERGY COMMODITY PRICES AT HEART OF ROTATION



Source: Bloomberg, TD Economics.

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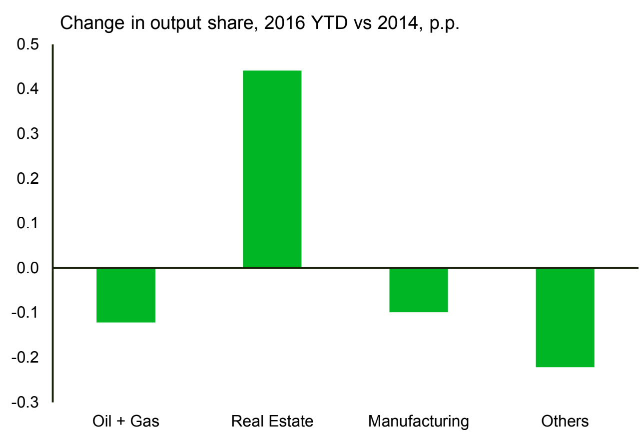
transmission trouble. A quick glance south of the border is all that is required. Economic growth in the United States – Canada's main export market – disappointed in the first half of the year, with growth averaging just 1.0% (annualized). Even more, weakness was concentrated in business investment (an important source of demand for Canadian goods and services), which declined by 2.8% in the first half of this year.

With this in mind, an essential element of the growth transition is a resumption of faster U.S. growth. There are signs that this is already occurring, which should translate into faster export growth and assist in the transition away from household investment towards business investment. But, there are two cautionary notes on this front that temper the speed of adjustment. First, U.S. business investment is likely to expand, but only at a limited pace. With business investment an important driver of Canadian exports, this will likely put a 'speed limit' on Canadian exports. Second, the U.S. presidential election has seen protectionist rhetoric from both major candidates. While we do not anticipate any material change to Canada's trade relationship with the U.S., increased uncertainty in the post-election period may nevertheless weight on business investment intentions.

Assessing progress to date

Where do we stand in the rotation process? Across the major industrial sectors, only limited progress has occurred (Chart 2). Oil and gas have fallen slightly as a share of output (in volume terms). At the same time, manufacturing has also fallen, as have the other major industries, with one exception: real estate. The real estate sector has become a bigger portion of the economy, up more than 0.4 percentage points in less than two years.

CHART 2. ONLY LIMITED PROGRESS MADE IN ROTATION TO DATE



Source: Statistics Canada, TD Economics.

It is thus difficult to believe that any progress has been made in terms of economic rotation. Indeed, the opposite appears to be the case, given real estate's increasingly large share of economic output.

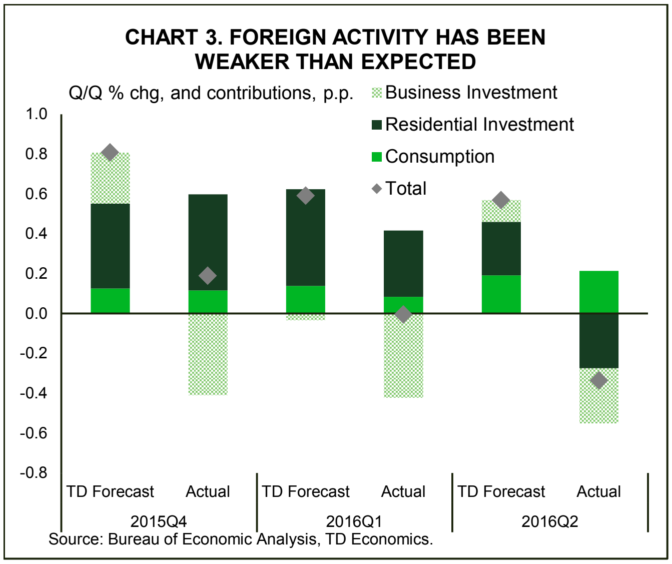
Underscoring the point, even within real estate, strong home price growth has been the key driver. More than 60% of the growth that has occurred since the end of 2014 (when commodity prices dropped and business investment began to decline) has been in the "owner-occupied dwellings" category. This category, in greatly simplified terms, captures the implied value (in rent-equivalent terms) of owned homes. As a result, this in many ways reflects rising valuations, rather than an increase in economic activity in the more traditional sense. As our past research has shown, rising home prices do have positive knock-on effects for consumer spending, but over-reliance on the real estate market is hardly the sign of a healthy economy. Casting an eye beyond real estate, there has been much slower than expected progress towards non-commodity exports and investment as a catalyst for stronger growth. At best, business investment is likely to have bottomed-out in the second quarter of 2016, suggesting that the adjustment to lower commodity prices is beginning to conclude.

Exports excluding energy products have seen healthy growth since the end of 2014, growing at an average annualized pace of 3.3% per quarter. However, the recent five-month trend clocked in at –2% m/m (approximately -5.8% at a quarterly pace), depicting the volatility and fit-and-start nature of this rotation cycle.

Diving deeper into exports

With exports key to both the near- and longer-term rotation process, the disappointing performance of goods exports this year relative to expectations merits closer examination. Past analysis has shown that foreign economic growth, particularly U.S. activity, has been playing an increasingly important role in driving Canadian exports, and this continues to be the case. Updating and expanding this analysis, a strong predictive relationship between foreign activity and exports remains the conclusion even under a multitude of differing regression specifications, sample periods, and other factors.

True to form, the disappointing export performance this year wasn't the product of any fundamental shift in economic relationships, but is attributable to much weaker than



expected foreign demand. As Chart 3 highlights (for the U.S. only, which represents 90% of the foreign activity index), a significant underperformance of U.S. business investment caused the broad index to contract outright in the second quarter. Thus, although competitiveness remains an issue, exporters can take some solace that the recent weakness has been largely beyond their control.

Looking ahead

During the second half of the year, we expect that exports will resume progress towards the economic rotation. The most likely scenario is a resumption of growth in foreign activity, albeit at a somewhat subdued pace. There are a number of reasons to believe this will be the case, despite its recent underperformance:

• U.S. consumer spending is expected to continue its positive contribution, as the fundamentals for household spending remain strong. Employment, average hours and wages have been rising robustly, while price growth has been more modest, setting the stage for further consumer spending;

• U.S. residential investment is on the mend and should accelerate further over the latter half of the year. New and existing single-family home sales reached a post-recession high in June, and demand remains supported by low mortgage rates and accelerating incomes. With the inventory of homes relatively low, all signs point to a likely increase in construction;

• Business investment, the largest component of foreign activity, will likely be modest, but move from negative growth to positive. While uncertainty remains heightened, manufacturing activity has moved back into expansionary territory and the inventory-to-sales ratios have normalized.

Moreover, while foreign activity remains the key determinant, a weaker exchange rate will remain a support to exports. Much of the boost to exports from past depreciation has likely already fed through, but we believe downward pressure on the loonie will persist and, in fact, can intensify, providing some additional support. The U.S. economy is on a trajectory for higher rates, and Canada is not. Markets have been complacent on this notion in recent months, but as it becomes reinforced by the data and signals from the Federal Reserve, the Canadian dollar will come under pressure (as will the currencies of other major trading partners, such as Mexico). Even if this remains modest, as we expect, it will nevertheless provide some support to exports.

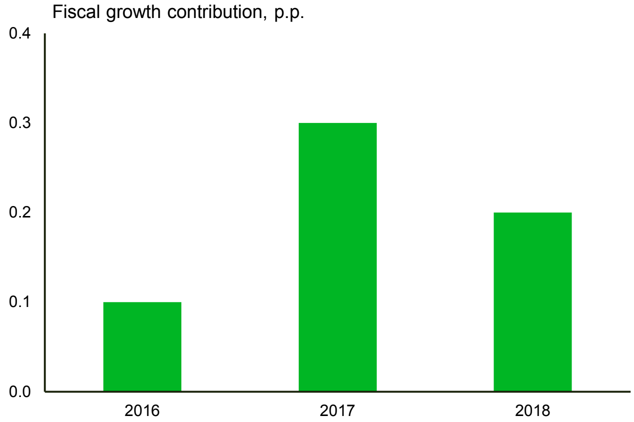
In contrast to the cyclical forces at work on the export side, the opposite is true for a continuation of strength in housing/real estate. In fact, we anticipate an eventual modest price correction as we approach 2018. The impetus provided from past downward movements in interest rates will fade, while a number of macro-prudential measures will further weigh on activity. The end result should be a housing market share of economic activity more in line with historic experience. However, this will be a drawn out process, likely to take several years to occur.

Growth drivers rotating, but at a slower speed than historically

An important element to keep in mind is that even with a successful rotation of economic activity, the overall growth rate of the economy will not return to historical norms. The economy's rate of potential growth (or 'cruising speed') is declining due to population aging and weak productivity growth. On top of this, economic frictions resulting from the reallocation of resources in the rotation process will also slow things down. The result is near-term growth in the 1.5% to 1.8% range – sufficient to absorb excess capacity, but only gradually. Fortunately, near-term growth will receive a further boost from the federal fiscal stimulus announced in the 2016 budget.

Fiscal stimulus will be increasingly felt as budgeted spending begins to translate into economic activity. Some limited boost is already in place with the new Canada Child Benefit providing modest additional support in the form of increased transfers to households. The biggest fiscal impact is yet to come however, as infrastructure spending should start showing up in GDP over late-2016, ramping up in 2017

CHART 4. FISCAL STIMULUS SUPPORTS GROWTH OVER COMING YEARS



Source: TD Economics.

(Chart 4). This stimulus will help keep the overall pace of economic activity elevated, offsetting some of the deceleration in growth associated with economic rotation (and the frictions associated therewith).

From the Bank of Canada's perspective, the pause in the economic rotation in the first half of this year is likely to result in rates held at their current low level for even longer. Holding the policy rate at 0.50% for the foreseeable future will help support the rotation and eat up economic slack through stronger growth. A case may be made for a further reduction of the interest rate, particularly if export growth fails to materialize. However, a cut would likely be of small benefit. It would push the loonie lower, but our research has shown that this has become a less important channel for exports, resulting in a limited impact. While it may reduce business borrowing costs, encouraging investment, rates are already quite low, and demand and confidence in the outlook are the more important drivers – and likely not to be meaningfully impacted by lower rates. At the same time, a rate cut could push already frothy housing markets even higher, increasing the risk of a larger eventual correction. As a result, absent a significant negative shock, the likelihood of further Bank of Canada easing remains small.

Bottom Line

The rotation of growth in Canada stalled in the first half of the year, and this certainly lends concern to the outlook. The fact that the underperformance in exports reflects an unanticipated weaker U.S. economy encapsulates just how tethered the Canadian outlook is to U.S fundamentals.

There is good evidence that momentum accelerated in the U.S. heading into the third quarter and consumer spending remains an area of particular note. Growing foreign demand, alongside some downward pressure on the loonie, should support a resumption of export growth, bringing the rotation process back on track. Export growth is expected to provide some eventual impetus to non-commodity business investment, but that impact is unlikely to be begin to flow through meaningfully until 2018. Further supporting growth will be federal fiscal stimulus, the bulk of which will be felt in economic activity in 2017 and 2018. Patience is a virtue, and Canada's growth prospects will be tested in the coming months. For the Bank of Canada, the pause in the rotation process is most likely to result in a policy rate held at its current level of 0.50% even longer than previously thought.

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