TD Economics

Special Report

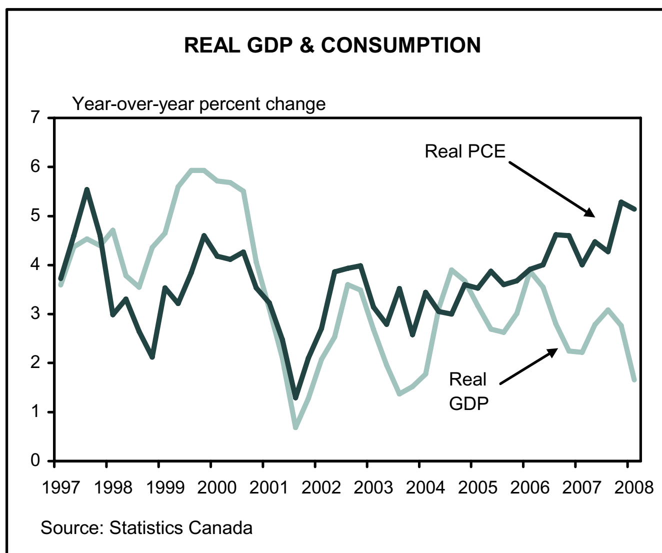
July 2, 2008

CANADIAN CONSUMERS TO GEAR DOWN THEIR SPENDING

Since 2005, there has been a clear divergence in consumer spending and overall economic growth. Households have been spending almost like drunken sailors over the past couple of years, which provided critical support to the economy when the export-oriented manufacturing sector had been suffering under the weight of a strong currency and flagging U.S. demand. The central question is whether consumers can keep tipping pints or whether a hangover is in store. Based on the prospects for the key drivers of personal expenditure, a strong case can be made that the purse strings will be tightened. Weaker labour market conditions, slower income growth, cooling housing markets and softer wealth accumulation all point to a more moderate pace of consumer outlays. However, a major retrenchment should be avoided, as spending growth slows from a booming above 5% year-over-year rate in early 2008 to a much more subdued 2.6% rate in 2009.

HIGHLIGHTS

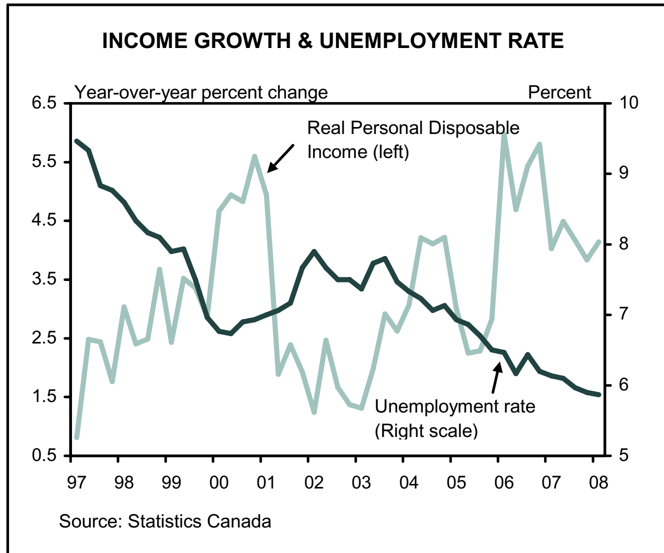
- **Consumer spending has been booming in recent years, but it is poised to slow in the coming quarters.**
- **After rising 4.5% in 2007, real personal expenditure is forecast to advance 4.0% in 2008 and 2.6% in 2009.**
- **The cooling in personal outlays will reflect softer job creation, a modest increase in unemployment rates, a slower rate of personal income growth, weaker wealth gains, slightly higher interest rates and a cooling in real estate markets.**
- **While the trend will be towards weaker consumer expenditure growth, the level of spending should remain solid. Consumption will remain supportive to the economy, but it will not be the engine of growth experienced in the past.**



Catalysts for spending

Several factors fuel personal expenditure. At the most basic level, purchases have to be made from current income or from past savings. The source of personal income growth is employment (i.e. people can move from unemployed to employed or increase their hours worked) and compensation (i.e. wages and salaries or government transfers). Savings are the income from the past set aside for future purchases and any income generated by that savings through asset appreciation. In other words, spending can come from increases in personal wealth from rising real estate prices and realized capital gains on other investments.

Consumption is also affected by changes in the cost of



Source: Statistics Canada

goods and services. When the price of a good falls, households may either purchase more of it (for the same level of expenditure) or purchase the same amount and have more income left over for other purchases. In either case, weaker price gains make households better off. Finally, expenditure is also influenced by the cost of financing current consumption relative to future consumption (i.e. interest rates) and the financial burden of past debts.

Recent fundamentals have been powerful

Based on the above, it is readily apparent why Canadians have had their wallets wide open. Employment boomed in recent years, driving the national unemployment rate to a more than three decade low. The resulting tightness in labour markets led to strong competition for labour, which supported robust personal income growth. Personal wealth has also been rising at a rapid pace, with double-digit average annual percentage growth in both real estate prices and equity valuations from 2002 to 2007. Meanwhile, inflation has been in check. Although energy prices have soared and Canadians have been badly bitten at the pumps, prices for a number of other consumer goods (particularly imported products) have fallen and overall inflation has averaged only 2.1% annually since 2003. The subdued price pressures have allowed interest rates to remain low, and to decline in 2007 and early 2008.

On a national basis, Canadian economic growth has been slowing since 2004, leaving many confused as to how consumer spending growth could accelerate over the same time span. The answer has to do with the difference between real and nominal GDP. When talking about economic performance, economists tend to focus on the growth in real GDP – the volume of goods and services a country produces. But in some cases real GDP fails to fully capture economic well being, particularly when income is growing because of higher prices for a country's exports. National income is measured by nominal GDP. When the difference between nominal and real GDP growth widens, it usually says something about what is happening to inflation – but inflation has not been a problem in Canada. Instead, the difference lately has been a reflection of the fact that Canada has been reaping a windfall of profits on commodities sold abroad at high prices. This strong income growth has been split between corporations and workers, which governments then tax. This income growth has proven to be a boon to consumer spending.

Why? High profit growth encouraged businesses to raise employment and increased the willingness to pay greater wages and salaries. The government tax revenues have encouraged public hiring and spending, and allowed some tax relief. And, as already mentioned, the rise in personal income directly fed through to increased outlays. As a result of the commodity price boom, domestic economic conditions are better explained by nominal GDP growth than the performance of real GDP. It also explains why economic conditions don't feel that bad in most Canadian communities even when the economy contracted

Real Gross Domestic Income (Real GDI)

Another way to capture economic well-being in an environment where rising export prices are contributing strongly to domestic income is to deflate nominal GDP by the change in domestic prices. Economists call this real GDI for real gross domestic income. Real GDI is a best-of-both-worlds measure since it takes away from nominal GDP the growth due solely to rising domestic prices (which do not make Canadians better off) but keeps the increase in income due to greater profits from trade. For large relatively closed economies like the United States, real GDI and real GDP do not tend to differ greatly, but for small open economies like Canada they can and often do. Since 2002 the rise in Canada's terms of trade (the price of Canadian exports relative to imports) has led to annual average growth in real GDI at a booming pace of 3.9% compared to a more subdued 2.7% in real GDP, the latter of which is close to the long-term historical average.

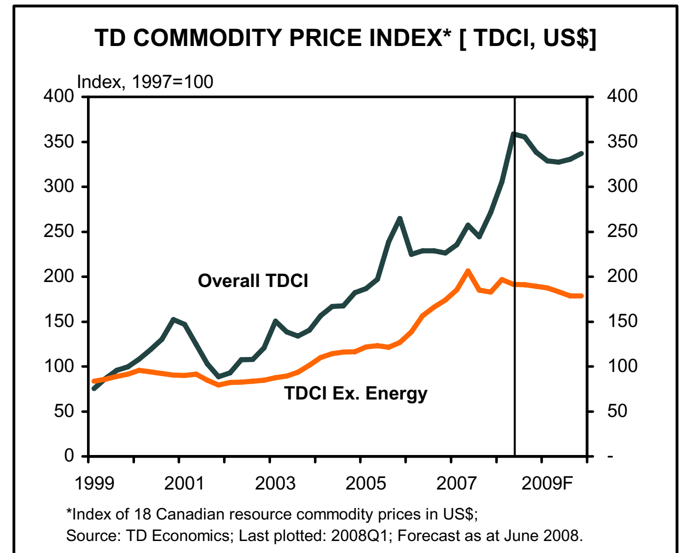
slightly at the start of this year.

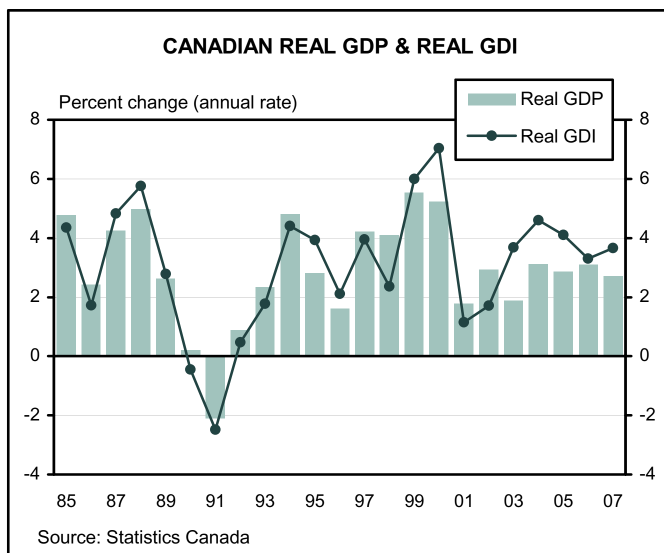
Outlook for spending

The past is the past. The more interesting question is where consumer spending is headed. Let's review the outlook for the major drivers of personal spending. On the personal income side of the slate, the prospects are for a cooling in spending growth.

The pace of job creation at the start of this year was simply unsustainable. While the overall economy actually contracted by 0.3% (annualized) in the first quarter of 2008, job creation continued at a rate of 2.0%. Moreover, over half the jobs created were in Ontario – the province most directly tied to the struggling U.S. economy. A disproportionate amount of job creation took place in the construction and public administration sectors, which are now showing clear signs of slowing. With more modest growth in hiring for domestic-oriented businesses and continued job losses in manufacturing, employment growth is expected to slow to 1.6% in 2008 (down from 2.3% in 2007) and stall at 0.5% in 2009. A slower pace of employment growth will lead the unemployment rate to edge up from its 33-year low of 5.9% in late 2007 to 6.7% by the end of 2009. This still represents a tight labour market that is supportive to spending growth, but the weaker job creation and higher unemployment rate do augur for a moderation in the rate of increase in consumer expenditure.

As mentioned above, rising commodity prices have made an important contribution to rising national income in Canada. Commodity prices and in particular oil prices have continued their rise so far this year, pushing the TD Commodity Price Index (TDCI) in U.S. dollars up 34% year-to-date. Oil prices in particular have seen an incredible gain, reaching a recent high of US$140 per barrel, up from US$95 per barrel at the start of the year. The run up in oil prices has been driven by increased demand from emerging markets, geopolitical risks to supply and a depreciating U.S. dollar. With higher food and energy prices amplifying the pressure on the already beleaguered U.S. consumer and limiting the scope for further interest rate cuts (in both the U.S. and around the world), we remain skeptical about the ability of commodity prices to continue their upward trek. Weakness in the U.S. consumer is unlikely to leave the highly export leveraged economies of emerging markets unscathed; and while they should continue to outperform advanced economies that are more directly impacted by the credit crunch, the developing nations should also see a slowdown in their pace of economic growth.





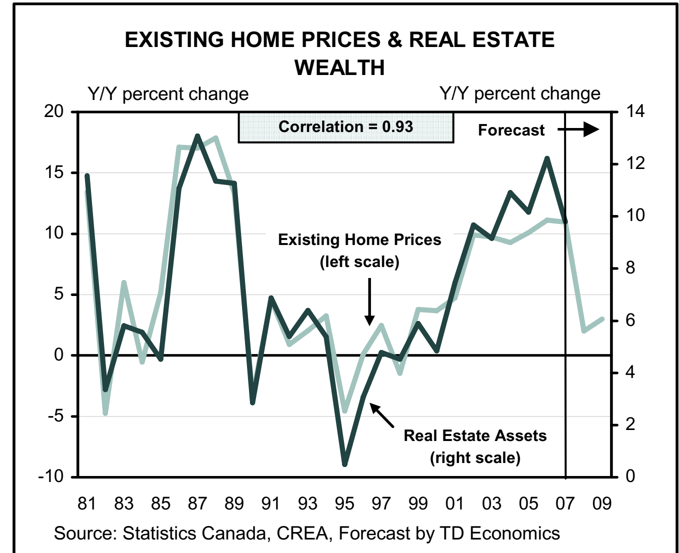
The cooler pace of demand growth from both advanced and emerging markets should alter the demand-supply balance and lead to increased inventories that will eventually result in a retreat in commodity prices. Moreover, the recent and dramatic run up in prices may be in part due to investors looking to hedge against the lower U.S. dollar, which increases the risk of a pullback in commodity prices since the gains were not fully driven by fundamental factors relating to supply and demand. At a minimum, we expect prices to stabilize over the coming months. This has important implications for national income growth in Canada because it is the change in prices that drives growth in corporate profits, personal income and tax revenues. If commodity prices stabilize, or more likely pullback mod-

estly (see chart on prior page), the result would be a slower pace of national income growth going forward. Indeed, Canadian nominal GDP growth is expected to slip from 5.9% in 2007 to 4.1% in 2008 and to 3.5% in 2009.

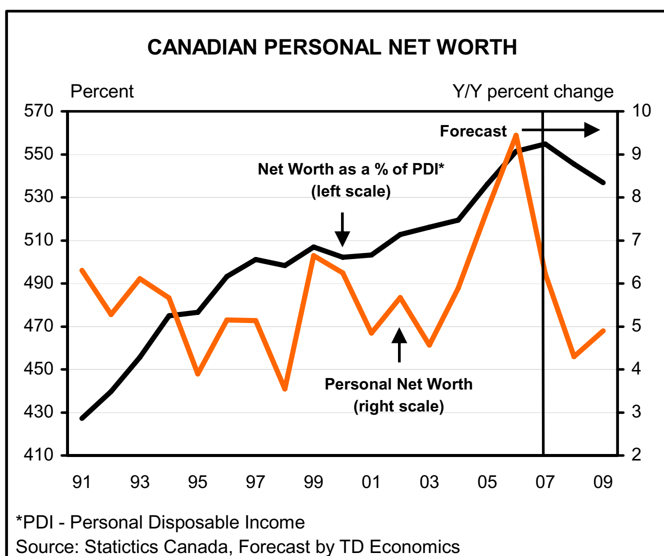
Upside to wealth gains limited

Similar to the outlook for current income, gains in personal wealth are expected to moderate over the next two years. Since 2002, real estate asset growth has been driven by rising prices for existing homes, which have increased on a national basis at 10.2% annually. Prices have risen most spectacularly in markets in western Canada – particularly Calgary, Edmonton and Saskatoon, which at their peak, saw price increases of over 50% on a year-ago basis. But in the past year, price advances have decelerated substantially in the two major Alberta cities, with the latest data showing a modest pull back in prices in both Edmonton and in Calgary. Meanwhile, price gains in Saskatoon reached a peak in June of 2007, some six months after Edmonton, and average prices remain 31.2% ahead of last year's levels. After such high run ups in prices, new listings growth has begun to outpace sales growth, making these markets likely to see significantly slower price growth and a possible price correction. Elsewhere in the country, where price increases have been more subdued, more moderate cooling in the housing market is expected. All told, average prices in Canada should grow by 2.0% in 2008 and 3.5% in 2009.

Growth in financial assets is also set to slow from its breakneck pace of the last several years. The S&P/TSX index started the year down, reaching a low 12% below its 2007 year-end level, as speculation that the U.S. had entered a recession and problems in credit markets led to a broad-based sell off in North American equity markets. Since then the TSX has recovered, advancing nearly 3% year-to-date in late June. However, the gains in Canadian equities have not been broad based and are exclusive to a few outperforming stocks largely related to booming energy and agriculture prices. International equities have also underperformed Canadian stocks, with many major international stock indicies still in negative territory. Equity markets often lead the economic recovery, but signs have increased that this U.S. slowdown is more likely to be shallow and long, rather than deep and short. Assuming a stabilization of commodity prices, or a mild pullback, the outlook is for equities to deliver a single digit return in 2008 and 2009. Accordingly, a diversified investment portfolio – with exposure to cash, bonds and equities – should see growth around 5-7% over the forecast horizon, which falls well short of the returns experienced over the past several years. And with gains in real estate assets growing at a slower pace, personal wealth should grow at a less than 5% annual pace over the coming year. Consumers will still be able to largely tap past gains in personal wealth, but the support to consumer spending should wane with time, implying more modest spending growth ahead. It should also be noted that the cooling in real estate will not only impact household wealth, but it will also tend to dampen demand for housing-related purchases, such as furniture and appliances.



Source: Statistics Canada, CREA, Forecast by TD Economics



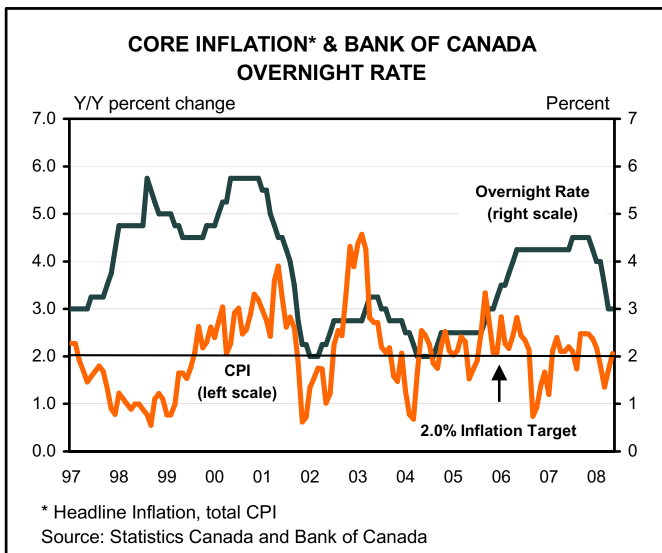
*PDI - Personal Disposable Income
Source: Statictics Canada, Forecast by TD Economics

Prospects for interest rates and household financing

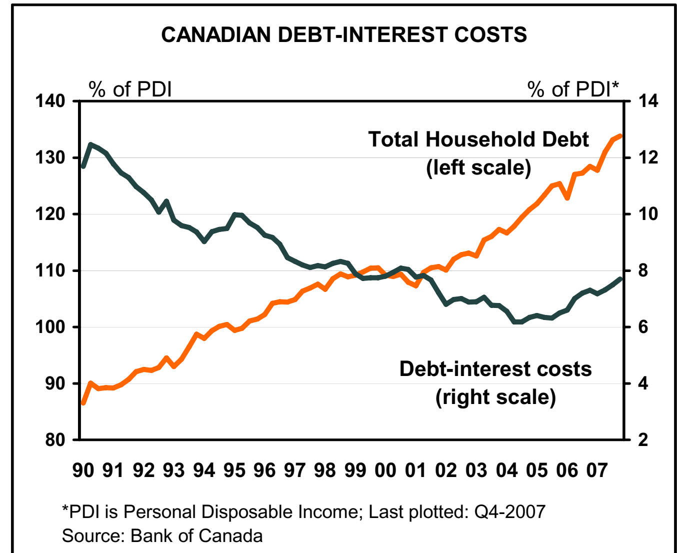
The final piece of the puzzle in the outlook for spending is the prospects for inflation and interest rates. Inflation trends in Canada have been very supportive of consumer spending in the last several years. The rising Canadian dollar has led to lower prices on an array of consumer goods, particularly selected imported products, keeping the overall inflation rate hovering close to the Bank of Canada's 2% target.

Looking ahead, inflation is expected to remain contained. The disinflationary impact of the rising Canadian dollar will moderate, as the currency retreats towards an average level of 93.5 U.S. cents in 2009. However, continued weakness in the U.S. economy that will dampen Canadian economic growth combined with a softening in Canadian labour markets is expected to help limit any price pressures that rise from higher import prices. The pass through from high energy prices to other goods and services prices is a wild card, but the feedthrough has been limited so far and we are assuming that this continues. As a result, headline inflation could jump towards 3% in the near term on the direct impact of elevated energy prices, but it is expected to trend back to an average of 2.1% in 2009. The implication is that consumer inflation should not be a major hurdle to spending growth, but high gasoline and other energy costs are taking a bite out of consumer wallets, leaving less funds for other purchases in the near term.

With respect to financing costs, the prospects are for interest rates to remain quite low, but they are not expected to fall further. In the wake of the credit crunch, the Bank of Canada cut short-term rates by 150 basis points. In June, the Bank signaled that the rate easing cycle was at an end. The good news is that the level of borrowing costs are supportive to consumer spending at the moment, and monetary policy is likely to remain on hold for at least the remainder of 2008. In 2009, the Bank is expected to begin reversing course as economic conditions improve. We expect this to happen in the second half of the year. Regardless of the exact timing, the trend will be towards gradually higher borrowing costs next year, which should act to temper consumer spending on big-ticket items.



* Headline Inflation, total CPI
Source: Statistics Canada and Bank of Canada

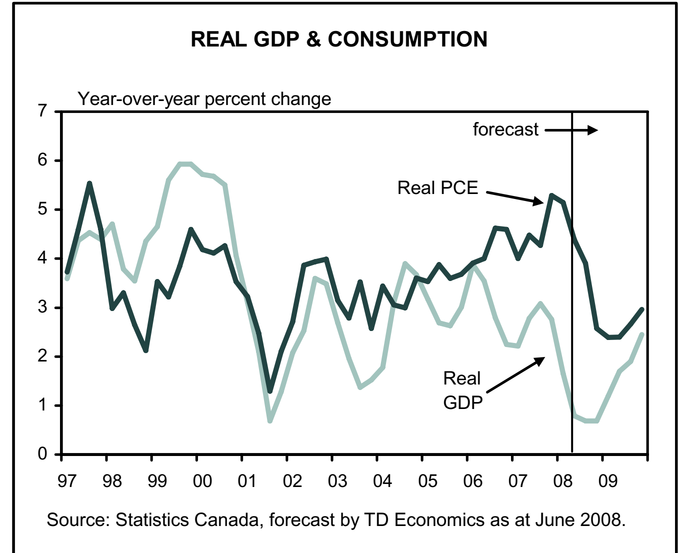


*PDI is Personal Disposable Income; Last plotted: Q4-2007
Source: Bank of Canada

However, the future rise in interest rates should only contribute to a cooling in spending – not lead to a retrenchment. There is no question that Canadian households are carrying historically high debt burdens, but debt service costs are not punitively high at the moment, and assuming the Bank of Canada only gradually raises rates next year the level of debt-interest costs as a share of Personal Disposable Income (PDI) should only return to the levels experienced in the mid-to-late 1990s. Moreover, according to the Canadian Financial Monitor survey, 72% of the debt held by Canadian households is mortgage debt and a further 13% is lines-of-credit, often secured by residential real estate. Since the majority of mortgage debt held by households carries a five year or longer term, the impact of rising interest rates will only occur gradually over time. It would take an aggressive tightening in monetary policy to create a major problem, and the Bank of Canada is very aware of the increased vulnerability of Canadians to higher borrowing costs.

Bottom Line

All of the stars appear to be aligned for weaker consumer spending, but not a major downturn. Canadian consumer spending has been buoyed by strong gains in employment and disposable income and by double-digit capital gains on financial and real-estate wealth. Low inflation, the rising terms-of-trade environment that boosted income, and the strength in the Canadian dollar have all supported spending. Going forward, all of these factors will remain supportive to personal spending, but to a lesser extent, which augurs for a cooling in expenditure growth. In terms of current income, employment growth is expected to slow and the unemployment rate to edge up. Still, with the unemployment rate coming off its lowest level in 33 years, the labour market will remain relatively tight and income growth will slow but not dramatically. Likewise, the past strong performance of both housing and equity markets will continue to be supportive to spending but future gains are expected to moderate. Commodity prices are unlikely to continue to appreciate and may pull back from their recent highs. Still, gains over the last several years are unlikely to be reversed and the level of prices will continue to be supportive of a high level of national income – even if the growth rate is set to slow. Finally, interest rates will remain low through the end of the forecast period, but the trend will be towards higher rates in 2009. With all of these trends in mind, personal consumption is expected to cool from 4.5% in 2007 to 4.0% in 2008 and to 2.6% in 2009. This represents a shift from booming spending growth to slightly below average gains next year.



ECONOMIC VARIABLES IMPACTING CONSUMER SPENDING
Percent change unless otherwise indicated

	2006	2007	2008F	2009F
Income & Employment				
Nominal Gross Domestic Product	5.7	5.9	4.1	3.5
Real Gross Domestic Product	3.1	2.7	1.0	1.8
Real Personal Disposable Income	5.5	4.1	4.5	1.7
Employment	1.9	2.3	1.6	0.5
Unemployment Rate (%)	6.3	6.0	6.1	6.6
Wealth				
Existing Home Prices	11.1	11.0	2.0	3.5
Personal Net-Worth*	10.3	6.4	4.3	4.9
Financing				
CPI Inflation	2.0	2.1	2.3	2.1
Bank of Canada Overnight Rate (%)*	4.3	4.3	3.0	3.8
5-Year Bond Yield (%)*	4.0	3.9	3.5	4.4
Personal Consumption Expenditure	**4.3**	**4.5**	**4.0**	**2.6**

* End of period
Source: Statistics Canada, CREA, TD Economics

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