TD Bank Financial Group

TD Economics

Special Report

March 13, 2009

CANADIAN EXPORTS HAVE A LONG WAY TO FALL

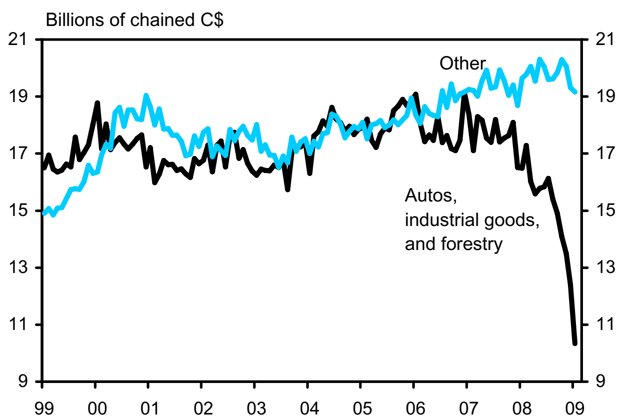
HIGHLIGHTS

- **Real Canadian exports fell by 7.4% in 2008, the second worst performance on record.**
- **Until now, real Canadian exports outside of autos, forestry products, and industrial materials had remained relatively insulated.**
- **However, TD Economics forecasts that real Canadian exports will fall by 11.5% (non-annualized) in the first half of 2009.**
- **This would already exceed the total loss seen over the previous three years or the two-quarter decline of 10.1% seen in the mid-1970s, which was previously the worst such half-year decline.**
- **Moreover, the global capitulation in trade is catching up with Canada and suggests heightened risks of an unprecedented collapse in Canadian exports of up to 20% over the first six months of 2009.**

Net trade has detracted from Canadian economic growth for nine of the last 12 quarters, and only avoided it being twelve straight due to temporary weaknesses in imports, not strength in exports. Exports themselves have now detracted from real Canadian GDP growth since the third quarter of 2007 - six straight quarters. This is now the longest such stretch we have ever seen. The level of real Canadian exports peaked way back in December of 2005, but did almost get back to that level in mid-2007 before once again beginning its descent. From either of those two points, real Canadian exports had fallen by about 9.5% in total by December of 2008. In hindsight, however, that poor performance may turn out to be the opening act to the unfortunate main attraction in 2009.

The decline in real Canadian exports in just the first half of 2009 may exceed - and even double - the decline we have seen over the entirety of the previous three years. It took until mid-2003 for real Canadian exports to finally find their stride following the U.S. recession in 2001. By early 2006, however, a divide began to form. Exports of forestry products began to tail off in early-2006 as the U.S. housing market lost steam, and the auto sector joined in later that year. These declines accelerated, and by early 2008, the auto sector had suffered an additional major hit. By the end of 2008, exports of metals and other industrial materials saw their own precipitous decline, as well. From their peak in January 2006, these three sectors combined (which we will call US3 exports for reasons that will become apparent later) had seen their real value fall by over a third, while the rest of Canadian exports had seen steady growth that totaled 5% over the same period (see chart). So while total real Canadian exports were evenly divided between the US3 and the remaining exports as of Decem-

REAL CANADIAN EXPORTS



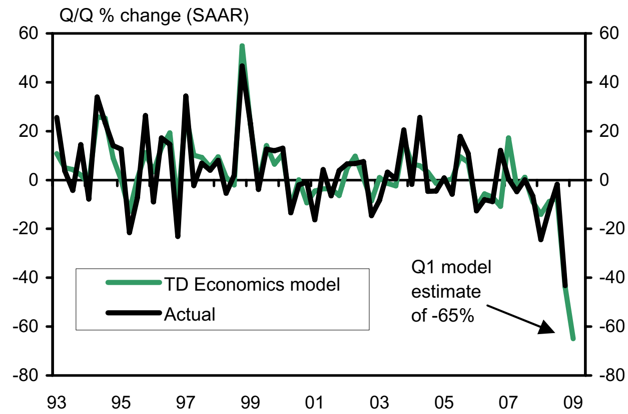
Source: Statistics Canada and Haver Analytics ber 2005, by the end of 2008, the other sectors were 50% bigger than the US3.

The future for Canadian exports seems to suggest those sectors that were already performing poorly will decline even further, while those that had managed to ride out the storm so far may see a precipitous decline. Unfortunately, this would bring Canada into line with much of the rest of the world. Asia, another region with very close trade linkages to the U.S., saw its nominal exports fall by over 20% from its peak in July 2008 through to December, and then fall by an additional 25% in the first two months of 2009 (given preliminary data starting to roll in). Canadian exports generally matched the Asian performance through December, and now the worst may be yet to come.

As the data rolls in around the world, our models for Canadian exports have fallen to the floor. The first two charts here show models for Canadian exports, splitting exports between the suffering US3 and the remaining sectors that continued to grow. Not surprisingly, the US3 show a strong connection with the American economy. U.S. housing starts and Canadian auto production show up in exports very quickly, while the overall performance of the U.S. economy can further influence demand for Canadian US3 exports up to a quarter later. The US3 show very little concern with what goes on in the rest of the global economy. This would explain why they failed to experience any offsets to the U.S. weakness from the global economy, which remained resilient until the tail end of 2008. Interestingly, these areas in aggregate appear to show little concern for the Canadian dollar after accounting for the actual U.S. demand, as well.

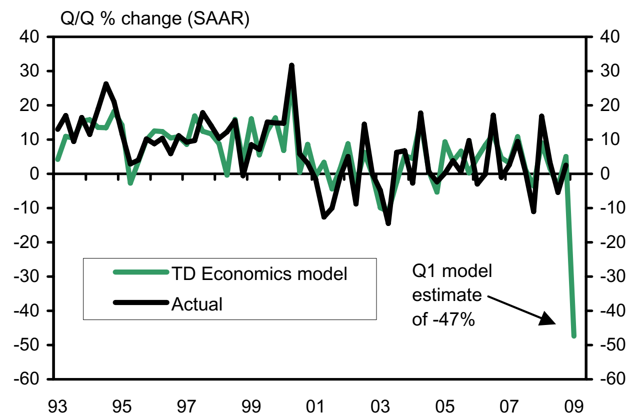
The remaining Canadian export sectors, however, show a much closer connection with the global economy and Canadian dollar, which determines the relative competitiveness of Canadian products. While real U.S. GDP growth is an immediate driver of Canadian exports, and American consumers add to this for a further quarter, it is past global economic growth (excluding the U.S. and weighted by Canadian export shares) which seems to be the major determinant of Canadian growth in these remaining export components. So, while the global economy collapsed in the fourth quarter of 2008, the 73% annualized depreciation of the real Canadian dollar helped to support this sector from the ongoing capitulation of U.S. consumers. But with the Canadian dollar much less of an offset now, and things only haven gotten worse in much of the

REAL CANADIAN US3 EXPORTS*



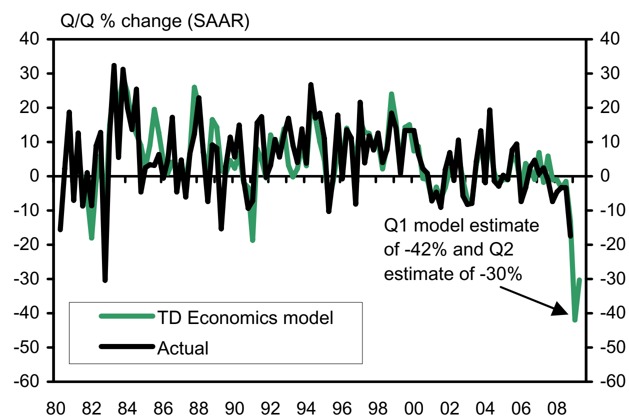
*Exports of forestry products, autos, and industrial materials; Source: Statscan, Haver, and TD Economics estmates as of March 13, 2009

REAL CANADIAN OTHER EXPORTS*



*Excluding forestry products, autos, and industrial materials; Source: Statscan, Haver, and TD Economics estmates as of March 13, 2009

TOTAL REAL CANADIAN EXPORTS*



*Excluding forestry products, autos, and industrial materials; Source: Statscan, Haver, and TD Economics estmates as of March 13, 2009 global economy as we near the end of the first quarter of 2009, the last bastion of hope for Canadian exports may be set for a big disappointment.

While our newest quarterly forecasts released yesterday (http://www.td.com/economics/qef/qefmar09.pdf) expect a 26% annualized contraction in real Canadian exports in the first quarter of 2009 and a 17% contraction in the second quarter, the analysis here does help to explain why we remain rather pessimistic on the prospects for the Canadian economy in the near term. This shock to Canadian trade must undoubtedly feed through even further into Canadian employment and business investment and weigh on domestic demand. All told, the three underperforming export sectors may see their annualized contraction reach 60% in the first quarter, while the remaining sectors could see a 5% annualized growth rate in the fourth quarter become up to a 40% contraction in the first quarter of this year. A separate medium-term model for total Canadian exports confirms this risk, suggesting total Canadian real exports could fall by a 25-40% annualized pace in each of the first two quarters of 2009. At this point, this is a downside risk and not a base case, but we are living in an age where pessimism is prone to be realized, so we thought it prudent to share.

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