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TD Economics

Observation

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GROWING SIGNS THAT A REBOUND IN GLOBAL TRADE FLOWS MAY BE NEAR

One impact of the global recession that caught markets off guard was the abrupt and dramatic collapse of global trade flows at the end of 2008. The level of nominal exports in China, the U.S., and Canada remains 25%, 32%, and 43% below their respective peaks – October 2008 for China, July 2008 for the U.S. and Canada. While we will likely not fully recoup the ground lost over the next year, there is growing evidence to suggest we will see a much needed rebound in the growth of global trade flows before the end of this year.

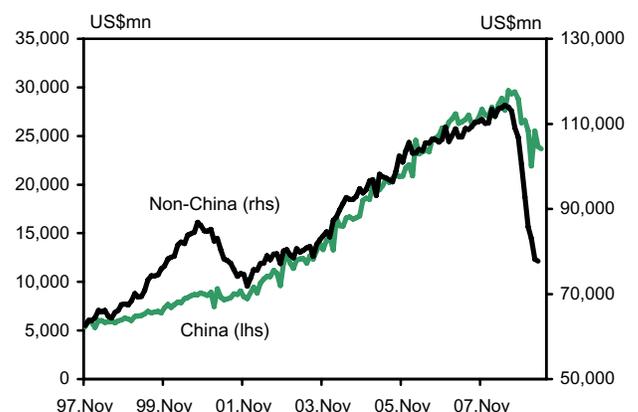
At the root of this growing upside risk is evidence to suggest that U.S. imports are well below where they should be to support even the prevailing subdued pace of business and consumer activity. There are also early signs that the decumulation of business inventories in the U.S. has reached a bottom. The pessimism that led to slashing inventory levels in the U.S. over the last six to nine months looks to have simply been overdone in hindsight. If the normal historical relationships hold – and with the striking improvement in credit conditions over the last three months we see no reason to expect they won't – a rebound in U.S. imports is likely over the second half of 2009, even with lingering frictions likely to remain in credit markets for some time.

And if the U.S. is importing, someone, somewhere is exporting. The prime candidates here are China, Canada, and Japan given their large U.S. trade connections. This demand would spread further throughout the global supply chains and help provide yet more support to the ongoing global economic recovery over the next six months, though we caution that maintaining that momentum through 2010 would still be a challenge due to the soft labour markets.

HIGHLIGHTS

- **Upside risks are growing that suggest we may see global trade emerge from its slump before the end of this year.**
- **This is fueled by the improving business and consumer activity in the U.S., which has left an inadequate level of inventories.**
- **Even assuming U.S. economic indicators show no further improvement for the rest of the year, this would imply U.S. imports are likely to rise.**
- **In turn, rising U.S. imports would mean rising exports of its trading partners, with China, Canada, and Japan likely the biggest beneficiaries.**

U.S. NONPETROLEUM IMPORTS

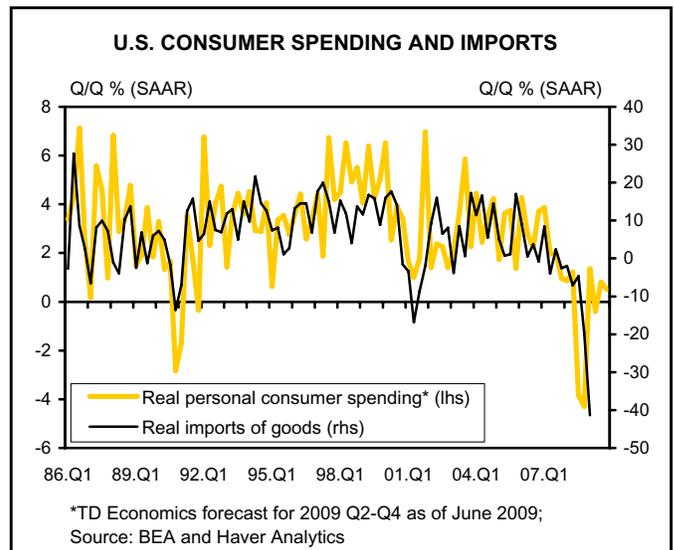
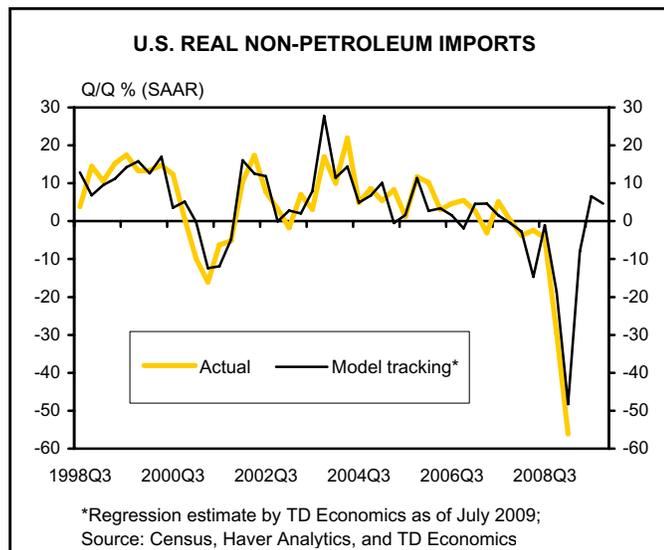
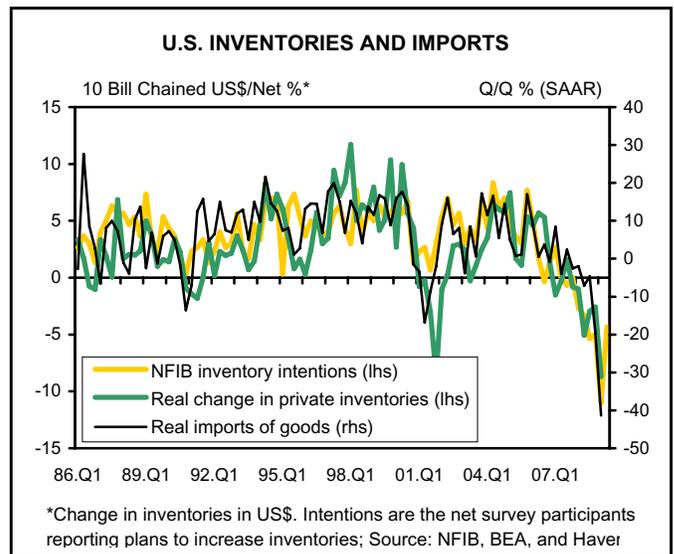
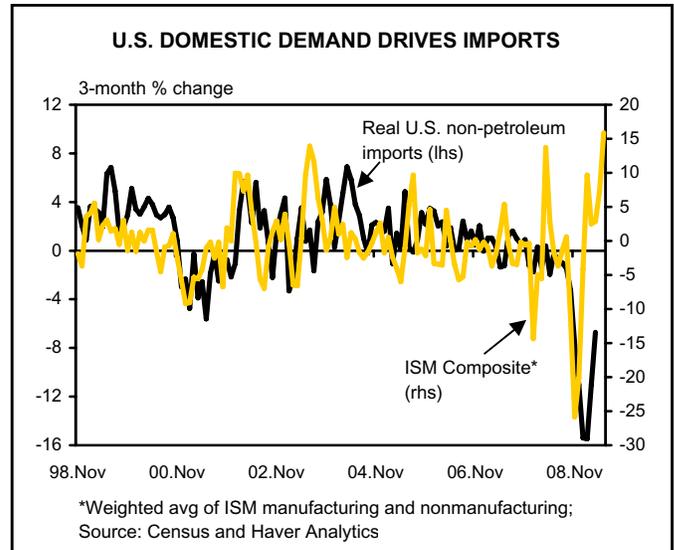


Source: Census, Haver, and seasonal adjustment of Chinese data by TD Economics

The spark to start the fire

Looking at the American side of the equation, U.S. imports go to support both domestic business activity, whether current production or inventory accumulation, as well as consumer spending. If we strip out petroleum for the moment, which fuels the system, domestic business activity – measured here as a weighted average of both the ISM manufacturing and non-manufacturing surveys – is screaming for an imminent rebound in U.S. real non-petroleum imports to the range of a 6-10% annualized growth. The NFIB small business survey of inventory intentions suggests some of this business activity is the result of a change in inventory levels that would add to GDP growth, and which would in part be fueled through imports.

Similarly, the tracking of U.S. imports against real consumer spending also shows that a return to at least flat growth in imports would be more appropriate even with the below-average 0-1% growth in consumer spending we are seeing now and that we think is likely to continue through the end of 2009. Accounting for the differing impacts of the factors above, our models are suggesting anything between about 3-10% annualized growth in U.S. real non-petroleum imports in both the third and fourth quarters of 2009 is possible. This rebound is based mostly on the lagged effects of the sharp improvements in U.S. economic indicators to date. As well, we make the likely overly cautious assumption that these indicators show no further improvement for the rest of the year – more conservative than our existing forecasts for U.S. GDP would imply. These U.S. imports would be a sign of renewed U.S. domestic de-



mand. Unfortunately, it would be unlikely to change our expectations for the labour market, where we still expect the trend to remain towards monthly net job losses until the middle of 2010. Because of this, it is likely that this rebound would still be followed by a gradual recovery through 2010. It would be important, nonetheless, to see the lifeblood of the global economy starting to flow again.

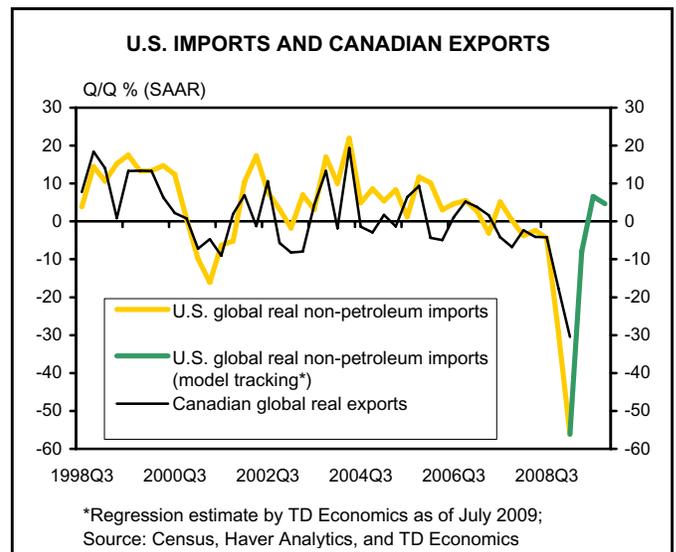
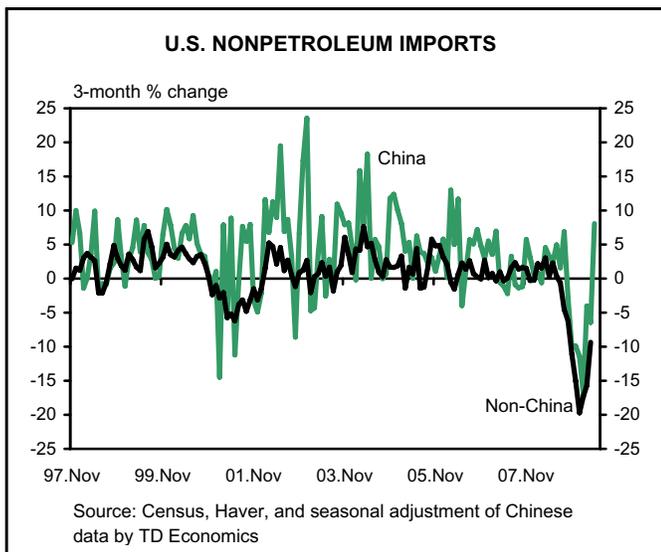
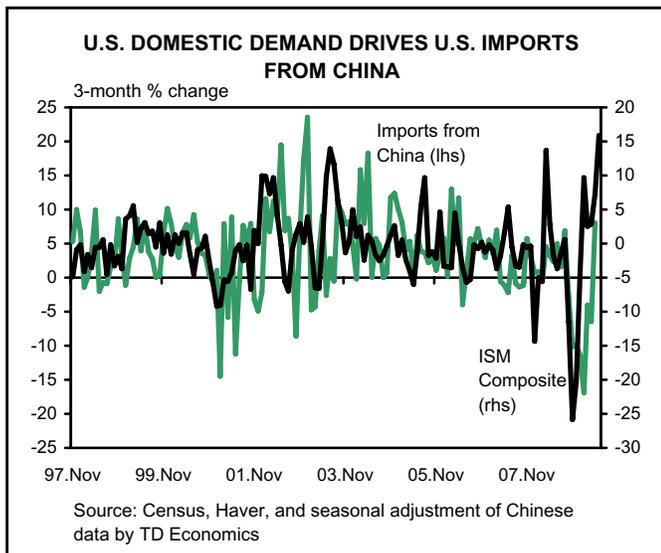
If you import, they will come

But when the U.S. imports, that means someone in the world is exporting. China, Canada, and Japan are the three economies most likely to enjoy the biggest benefit if such a rebound in U.S. imports does materialize. While the U.S./Chinese exchange rate is always a hot-button political topic, it is actually a much weaker driver of bilateral trade flows

than the relative strength of domestic demand in the respective countries. When demand in the U.S. changes, Chinese exports tend to be the first to react within 2-4 months – and we have already seen this. Furthermore, this tends to be followed in the very near term by a pickup in the exports of other U.S. trading partners, such as Japan and Canada. While credit problems have plagued the global economy for nearly two years, the global economy does tend to try and work to repair itself. This appears to be exactly the process that is underway now.

This renewal in global trade flows would likely have differing impacts on headline real GDP growth rates for those impacted. For the U.S., while the arithmetic of GDP accounting says that imports are a negative input, the driver of import growth is growth in domestic demand. U.S. imports would be signs of nascent life in the U.S. economy, and any increase in domestic demand would pose an upside risk to our current U.S. GDP forecasts for -0.5% growth in Q3 and 1.2% growth in Q4, with much of the push likely coming from the change in non-farm inventories.

For China, a rebound in real U.S. imports to the top of our potential range suggests a maximal impact of 20% annualized growth in Chinese exports in Q3 and Q4. The phenomenal pace of Chinese domestic investment is likely to slow over the second half of 2009 as Chinese authorities have already started to remove stimulus from domestic lending. But a resurgent export sector would offset some of this investment slowdown, again increasing upside risks to our forecast for Chinese GDP growth in 2010 of 8.4%.

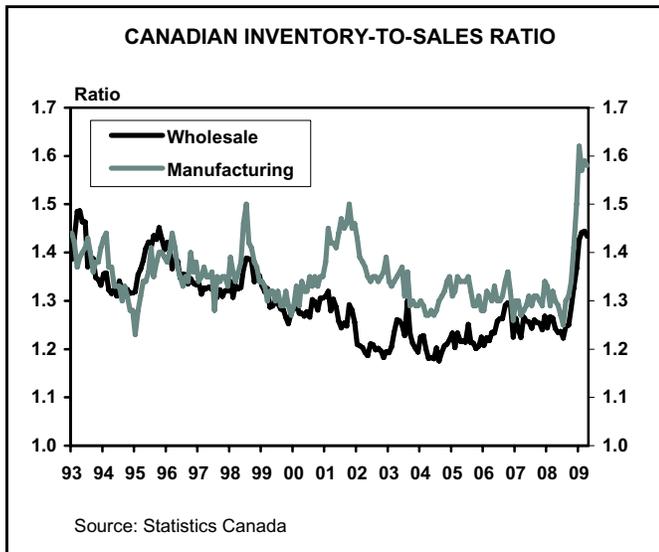


The ongoing inventory overhang would likely mute the impact on Canadian GDP. Rather than having to increase current production as much, Canadian manufacturers would likely use this opportunity to pare back on their high levels of existing inventories. This means that while the stronger Canadian exports – which could be in the magnitude of 3-7% annualized growth in the second half of the year – would contribute to GDP growth, part of this would be

offset by a reduction in inventories. This would still be a positive outcome for Canada as it would alleviate one of the major risk factors we have cited for Canada (see our latest *Quarterly Economic Forecast* here: <http://www.td.com/economics/qef/qefjun09.pdf>). Moreover, given the Canadian recession has been milder than in most other major economies, a weaker rebound would be appropriate.

So, as with our recent report on early signs of a likely rebound in Europe later this year, things are looking up for the global economy (For more, see *Could the Eurozone See the 'Mother of All Rebounds'* here: http://www.td.com/economics/special/rk0609_eurozone.pdf). For the first time in several years, we are seeing the risks regularly build to the upside of the economic forecasts. Certainly downside risks remain, with weak labour markets, spare capacity, and financial issues still to work through on a global basis. But at the same time, it is summer. The sun is shining, birds are chirping, and the global economy is mending.

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