The Bottom Line
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Canadian Calm in a Turbulent Sea

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Canada's domestic economy has rebounded strongly from the financial crisis and global recession. And, while there are many uncertainties, the recently released fourth-quarter data show growth in Canada at a stronger-than-expected 5% annual rate, held down a bit by inventory depletion. Final sales jumped at a whopping 6.5% clip. Housing, government spending and consumer spending were all strong, with net exports chipping in a small gain as well. Business spending, however, remained weak despite a sharp quarter-over-quarter rise in corporate profitability. Still, the economy is likely to post very solid growth in the first quarter of this year as well.

As we vividly remember, 2009 ended on a far better note than it began. Overall growth for the year was -2.6%, only the third annual contraction in the past 50 years and the second deepest after 1982. The challenge for this year will be for businesses to improve their competitive position with the backdrop of a continued strong Canadian dollar. For that, we need to see investments in machinery and equipment, enhanced technology and processes that will boost our beleaguered growth in productivity. To date, Canadian business has been very cautious, as relatively low business confidence has dimmed the prospects for significant capital spending. While capex plans for this year have improved, they still remain listless, despite the strong Canadian dollar, which reduces the cost of capital equipment.

American business productivity growth has surged this cycle which, along with the greenback's weakness, has reduced the cost of production significantly south of the border. Manufacturing remains among the strongest sectors in the U.S. economy, culling strength from inventory rebuilding, the pickup in demand for business equipment, and firming foreign sales. Ironically, it is reduced inventory depletion and capital spending growth that have driven much of the fourth quarter gains in the U.S., in direct contrast to the continued contraction in capex in Canada, suggesting that there is a good deal less excess capacity than the sub-73% U.S. capacity-utilization rate would suggest. Much of the shuttered industrial space in both the U.S. and Canada is likely obsolete, but why American business is investing heavily in technology while Canadian business is not remains a mystery, especially given the relative strength of the loonie.

The U.S. economy, though growing at an upwardly revised 5.9% in the fourth quarter, appears to have hit a speed bump, as incoming data have been fraught with negative surprises. For example, the latest Conference Board consumer confidence survey plunged,

existing home sales nose-dived again, new home sales fell to a record low, some house price indicators recently declined and unemployment insurance claims, a leading indicator of employment, surged—all very troubling harbingers of things to come. In addition, the level of disposable personal income was revised down for the fourth quarter and fell month-over-month in January.

Canada must tap new markets for our export products to assure greater economic stability and growth in the future. Opportunities are manifest in emerging Asia's outsized economic growth, especially in India and China, which boosts commodity prices and remains a largely untapped market for Canadian products. Growth in these economies is far more intensive in energy and industrial materials usage than in the developed world.

Despite these challenges, Canada looks like a bastion of stability and confidence when compared to Europe, the U.K. and Japan. The debt crisis in Greece and potential contagion to countries such as Portugal, Spain, Ireland and Italy have sent the euro reeling. There is likely going to be little growth in Europe this year, as Germany and France—mired by Greek debt guarantees and faltering growth—will post very meagre growth. The U.K. is also struggling with financial losses, enormous debt ratios and a stumbling recovery. Japan is scrambling to take actions to reduce government red ink without tipping the economy back into recession, mindful of its debt levels approaching nearly twice the size of the economy.

The Bottom Line: While Canada struggles with continued high unemployment and the deficit in our trade balance, most of our problems are caused by the turbulence emanating in the rest of the world. For risk-averse investors, Canada looks like one of the safest of havens.

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