

# Commodity Collapse: Hammer to Fall

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The record fall in commodity prices has barely begun to reverberate across the Canadian economy. The staggering 48% plunge in the CRB in little more than four months from its mid-year peak has been so abrupt that few indicators have even hinted at much impact yet. Certainly, financial markets have reflected the move, with the Canadian dollar arguably overcompensating for the drop and the TSX's relative performance crumbling since that point. But, the so-called real economy has only just begun to feel the effects. We have been calling for a Canadian recession since early October and would note that many Canadian results are still being flattered by the vapours of the first-half rocket ride in resource prices. In fact, much of Canada's relatively robust performance on a wide variety of fronts so far this year can be directly traced back to the commodity boom. With the boom quickly turning to bust, look for Canada's outperformance to rust.

**CHART 1  
BACK TO REALITY**

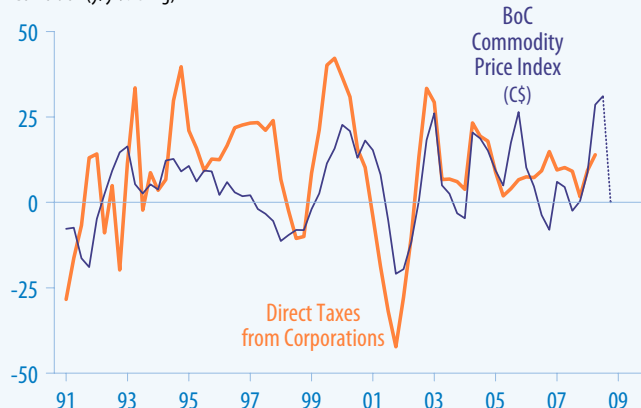
Canada (C\$-terms)

Bank of Canada Commodity Price Index



**CHART 2  
GOVERNMENTS WILL BE PINCHED**

Canada (y/y % chng)

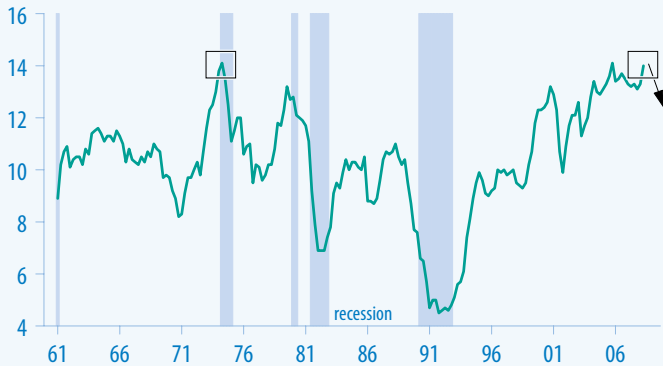


The massive drop in the loonie will partially insulate the impact—the currency has tumbled 25% from its all-time high hit a year ago—as the resource price decline in Canadian dollar terms has been blunted. For instance, recent prices are down only moderately from average levels in 2007 and 2006 (*Chart 1*). But even in C\$ terms, commodity prices are off 35% from the mid-year peak (based on the Bank of Canada's index), and there is little sign that they have reached bottom just yet. Here are a number of areas that could more fully reflect the collapse in commodity prices in coming months:

- 1) **Government revenues:** Nationwide government revenues have been paced this decade by commodity-related windfalls in corporate income tax receipts and royalty payments in some provinces. The combination of a rapidly deteriorating economic outlook and plunging commodities threatens a broad-based return to deficits in many jurisdictions. At the federal level, we estimate that Ottawa is headed for a budget deficit of \$6-\$7 billion in FY09/10 even if they do nothing new to stimulate the economy. Most resource-producing provinces based their budgets on conservative energy price assumptions, and still had room to spare before fading into deficit. However, with underlying growth slowing as well, there will undoubtedly be a few more provinces joining Ontario in the deficit camp next year.
- 2) **Corporate profits:** One area of revenue that will truly take a hit will be corporate income tax receipts (*Chart 2*).

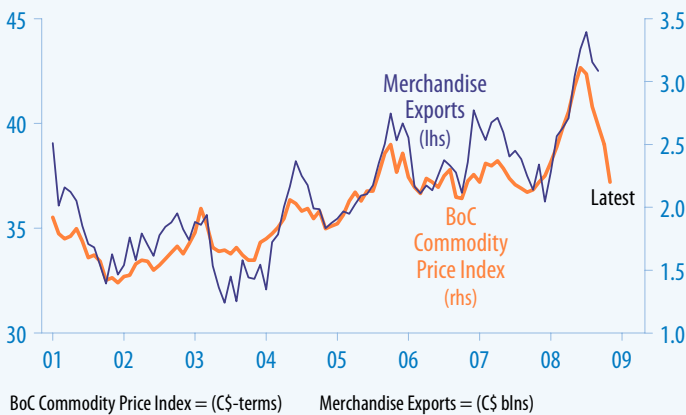
**CHART 3  
ONLY ONE WAY TO GO**

Canada (% of GDP)  
Corporate Profits



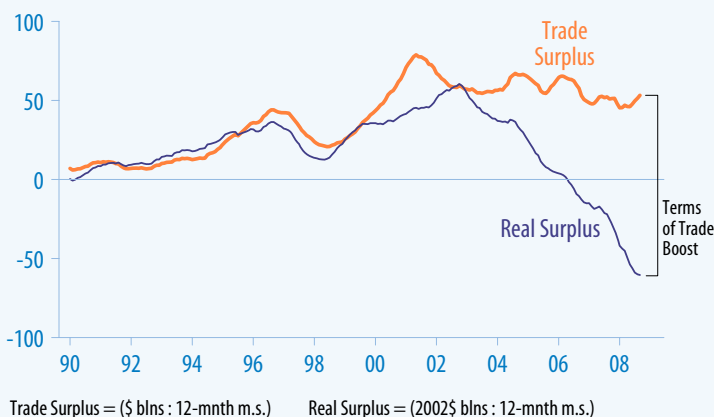
**CHART 4  
TIMBER! EXPORTS SET TO TUMBLE**

Canada



**CHART 5  
TRADE: SOFT UNDERBELLY**

Canada



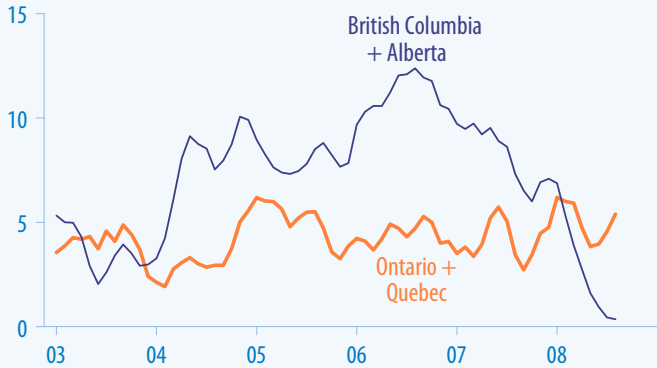
Profits as a share of GDP were at an all-time high in Q2, thanks to peak resource prices, matching the highs last reached in 1974 following the first spike in oil prices (Chart 3). We estimate that the steep drop in commodity prices would alone carve total Canadian corporate profits by more than 10% in 2009 from this year's level, with further downside risk clearly looming.

- 3) **Business investment:** As earnings drop, so too will capital spending. Business investment is normally the most cyclical component of spending, and this cycle will likely prove little different. Statistics Canada reckons that every \$1 of output in the resource sector generates an additional 69 cents of GDP output, so a falloff in activity will spread more widely. Oil sands investments are already set to drop by 20% next year to \$16 billion, according to the Canadian Association of Petroleum Producers. In addition, conventional drilling and exploration activity is also expected to fall heavily alongside the halving in energy prices.
- 4) **Employment:** The mining and oil & gas industries have added nearly 70,000 net new jobs (a 50% increase) since the start of the decade. As well, related construction jobs have boomed, helping drive payrolls in the sector to an all-time high as a share of total employment (7.3%). Both look set to weaken markedly in the year ahead, unwinding much of Canada's heavy-duty outperformance on the jobs front (+1.3% y/y in Canada versus -0.7% y/y in the U.S.), and pushing the unemployment rate above 7% next year.
- 5) **Trade:** Export receipts will be hit by both sliding U.S. volumes and the steep pullback in commodity prices (Charts 4 and 5). This will swamp any positive impact of a lower Canadian dollar on exports. The current account balance is headed for a deficit of \$10 billion in 2009, versus a surplus of around \$16 billion this year. Admittedly, we also looked for a deficit at the start of this year, but that projection was blown off course by the surprising spike in commodity prices in the first half of the year. Since that time, underlying trade volumes have deteriorated heavily, U.S. demand for our products looks even weaker, and commodity

**CHART 6**  
**REGIONAL DIVIDE TAKES ON NEW MEANING**

Canada (3-mnth m.a. : y/y % chng)

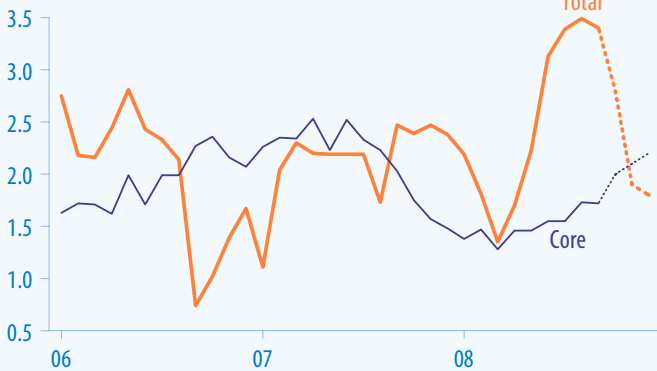
Retail Sales



**CHART 7**  
**CPI: LOOK OUT BELOW**

Canada (y/y % chng)

Consumer Price Index



prices have more than reversed course. Thus, a slide into current account deficit appears inevitable.

- 6) **Regional imbalances:** The recent flow of events is definitely not good news for Ontario's outlook, especially the harrowing drop in U.S. auto sales. But at least there are some positive by-products for central Canada, notably the weaker loonie and the plunge in energy costs. However, recent developments are unambiguously bad news for Western Canada, which had already been showing some signs of cooling even prior to the commodity collapse (*Chart 6*). Simply put, the previously gaping regional growth divide is set to narrow, as the downturn in resource prices hits Western Canada hard. Part of the reason Ontario slipped into have-not status was due to the boom in government revenues in resource-rich provinces. Accordingly, Ontario's new-found status may not last as long as widely assumed.
- 7) **Inflation:** Next week will show a hefty drop in October's headline CPI inflation, and another steep decline is likely in November's report next month. From a recent peak of 3.5%, overall CPI inflation could easily be below 2% by year end, and could drop below 1% by mid-2009, even with the plunge in the Canadian dollar (*Chart 7*). This will provide a boost for consumers, although any help will be overwhelmed by sagging employment. Meantime, core inflation will show a temporary bump as the deep parity-related discounts of a year ago fade away. However, core inflation is also set to fade as 2009 wears on amid much weaker underlying economic activity.

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