

Recovery: Are We There Yet?

Douglas Porter, CFA, Deputy Chief Economist

Financial markets have shown a flicker of doubt on global recovery prospects in recent weeks, following nearly three months of a one-way trip north for asset prices. The TSX, the Canadian dollar and commodity prices have all taken a big step back after about five steps forward from the March lows (*Chart 1*). A correction after that strong run could be viewed as healthy; even with the partial retracement, there is little reason for policymakers or investors to lose their nerve at this stage. We continue to believe that conditions are falling into place for the economy to bottom out in Q3 and begin a recovery before the end of the year, much as we have been saying for the past four months. However, there is little doubt that the recovery is likely to be subdued by past standards—even with the depth of the current downturn—and the recession could quietly end with a whimper, rather than a bang.

The reassessment of recovery prospects is entirely understandable, given that signs of a turnaround so far have been almost exclusively in financial markets and sentiment indicators, and not in the hard economic data. But that is absolutely standard fare in the early stages of a turning point—partly because sentiment has to turn before spending, and partly because the hard economic data are lagged (especially in Canada). For instance, much was made of the surprising dip in Canadian retail sales in April, as a sign that the economy was still struggling heavily. Yet, we already have a decent read on many May indicators, including solid home sales but weak auto production. As well, steady gains in consumer confidence right up into June suggest that a turn in spending may be nearly at hand (*Chart 2*). On the production side, Chrysler will be back up on stream by the end of this month, and GM hopes to also exit bankruptcy by next month, which could provide support for Q3 output. Finally, the mountain of fiscal stimulus is about to start affecting the data a bit more forcefully in the months ahead after the (understandably) slow pickup on infrastructure spending.

Still, there are clearly new hurdles emerging for the recovery, on top of the lingering global banking crisis and the pressing need for repair in U.S. household balance sheets. To wit, rising gasoline prices and a back-up in long-term mortgage rates pose new challenges for the consumer. However, even with

CHART 1
PAUSE THAT REFRESHES?
2009

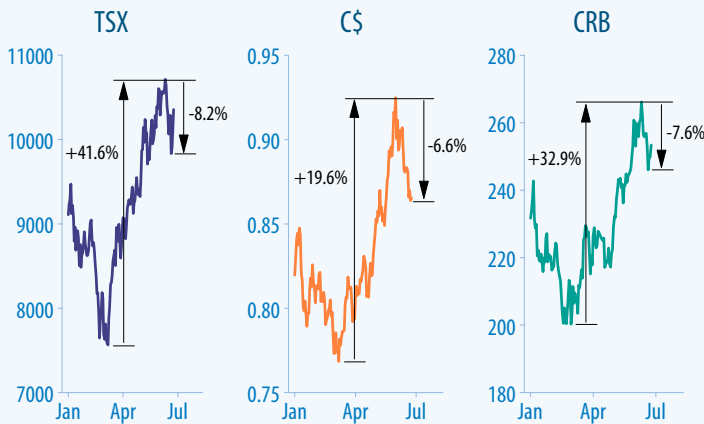


CHART 2
CANADIAN CONSUMERS PUT ON A HAPPY FACE

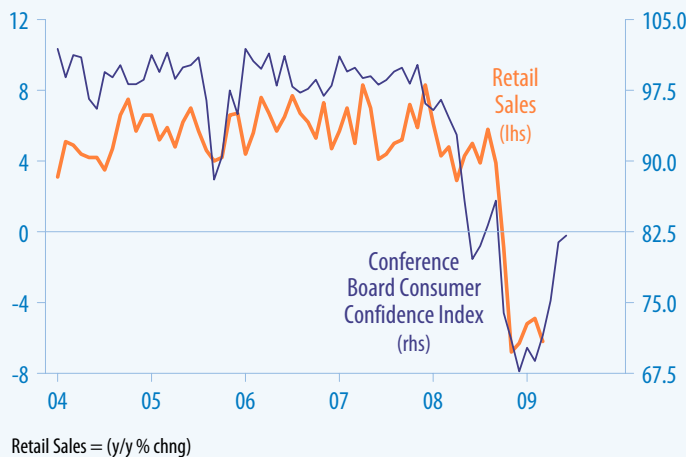


CHART 3
GASOLINE PRICES: USUAL SUMMER HEAT

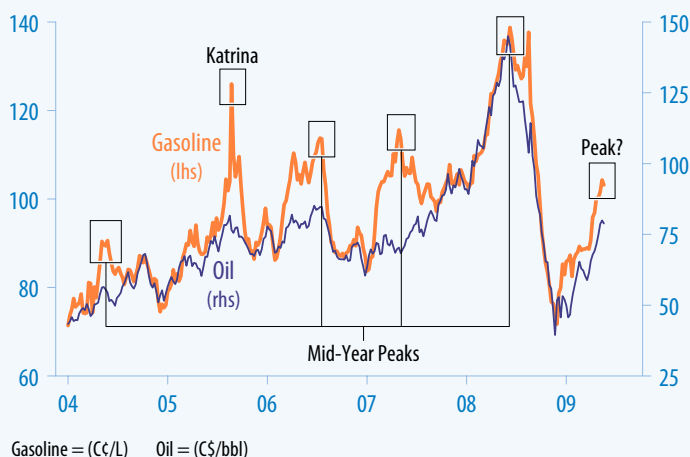


CHART 4
MORTGAGE RATES: AS LOW AS THEY CAN GO?

Conventional Mortgage Rates – Canada (percent)

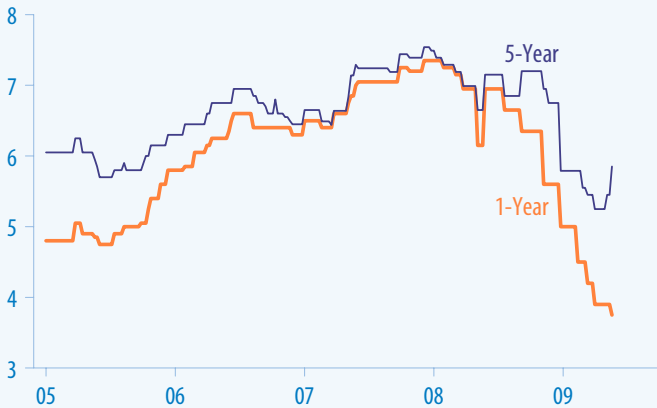
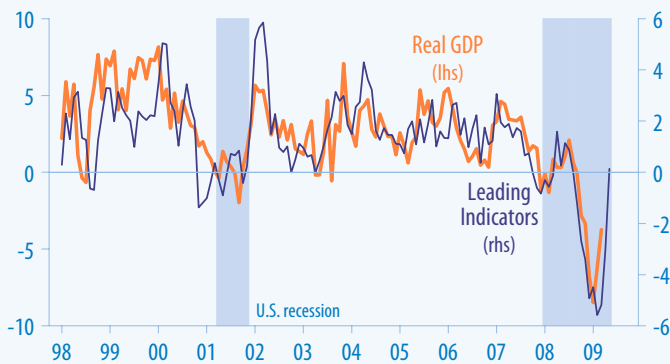


CHART 5
LEADING INDICATORS: WAITING TO EXPAND
Canada



Leading Indicators = (4-mnth % chng) Real GDP = (3-mnth % chng : ann.)

TABLE 1
AFTER U.S. RECESSION ENDS: CANADA ONE YEAR LATER

U.S. Recession Trough	Cdn Real GDP (%)	Cdn Employment (%)	Cdn Jobless Rate (ppts)	CRB Futures (%)	TSX (%)	CAD (%)	Cdn Overnight Rate (bps)	10-Yr GoCs (bps)
Mar. 1975	+4.9	+5.8	+0.1	+8.2	+6.5	+1.5	+313	+121
July 1980	+3.9	+3.6	-0.4	-7.7	+2.6	-4.9	+1062	+429
Nov. 1982	+6.2	+3.7	-1.8	+16.1	+38.2	-0.9	-245	-24
Mar. 1991	+0.8	-0.6	+0.6	-3.7	-2.4	-3.0	-268	-63
Nov. 2001	+3.5	+3.5	-0.1	+21.3	-11.5	+1.4	+14	-2
Average	+3.9	+3.2	-0.3	+6.8	+6.7	-1.2	+175	+92
Median	+3.9	+3.6	-0.1	+8.2	+2.6	-0.9	+14	-2
Our Call *	+2.5	+1.0	-0.1	+10.0	+8.0**	+10.0	+33	+66

* Growth from 2009Q3 to 2010Q3 **TSX Projection from BMO Equity Research

the run-up in pump prices from the lows of late last year, they are still down more than 20% from a year ago. This looks like an instant replay of the distinct seasonal pattern of recent years—six months up, followed by six months down (*Chart 3*). In four of the past five years, pump prices have peaked right around mid-year (the exception was the Katrina spike in 2005), and we may very well be at the turning point for this year, unless specific supply factors cause oil to bubble further.

Similarly, the significant back-up in bond yields has put upward pressure on long-term mortgage rates, posing a threat to the nascent recovery in housing (*Chart 4*). Again, even with the spring rise, rates are still well below year-ago levels and short rates haven't budged (and aren't expected to until mid-2010). Moreover, recent doubts on the recovery have let the steam out of bond yields—10-year Treasuries are down 50 bps from their peak— showing the self-correcting nature of long-term rates. While rising bond yields may blunt the recovery, they won't thwart it.

Overall, the weight of evidence continues to tip in favour of growth resuming before the end of the year. Canada's index of leading indicators posted one of its largest gains on record in May, and has now managed to rise since January. This is consistent with a flat performance for GDP in the near term (*Chart 5*). To date, the upturn has been driven primarily by a narrow base of stock prices and home sales, but we look for more indicators to move into the positive camp through the summer.

Assuming the U.S. recession does end by the autumn, we expect Canada to essentially move in lock-step, and have looked at how the Canadian economy fared in past U.S. recoveries (*Table 1*). Growth in output and employment is projected to be markedly slower than a typical recovery, although not quite as weak as the 1991/92 performance (when Canada was grappling with even bigger structural change, the GST and fiscal restraint). The jobless rate usually recedes a tad in the first year of recovery, but not always, and it has only fallen sharply once (in the robust 1983 rebound). Notably, on almost all the major financial market indicators, the main message is that there are no hard and fast rules in a recovery. In fact, the median recovery has seen little perceptible change in these markets, often because they have moved long before the economy actually turns (most notably for stocks).

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