

Canada's Lopsided Recovery

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The overwhelming consensus view is that the emerging North American economic recovery will be substandard, largely owing to a chastened U.S. consumer. The only serious challenge to this view seems to be to the downside—many fret that the economy risks falling back into the dreaded double-dip after the inventory bounce and fiscal stimulus fade. On the flip side, seldom is heard an encouraging word about the upside risks, even though financial markets had been shouting from the hilltops that growth prospects were gaining momentum. Perhaps singed by the past year's searing economic and financial trauma, few dare listen to the markets' siren call, even though those markets did an excellent job foretelling the deep global recession.

While Fed Chairman Bernanke and Bank of Canada Governor Carney have effectively declared the recession over, they too have sounded starkly cautious on the recovery's strength. Yet, leading indicators in the U.S., Canada and the broader OECD have increased sharply in recent months, consistent with a normal, healthy recovery. For instance, Canada's leading index has surged from March's low, pointing to near-term annualized GDP growth of about 5% (Chart 1). One caveat is that some of this bounce in leading indicators is driven by the equity markets' surge. However, that's not the only factor—the rise in the S&P 500 has accounted for only a quarter of the rebound in the U.S. leading index from its March low. (The steep Treasury yield curve has made a much bigger impact.) But while leading indicators usually offer a reliable reading on GDP growth prospects, some of their most serious misfires in recent years have been in overestimating the strength of recoveries.

In Canada, there are solid grounds for a reasonably robust rebound in domestic spending. Even with July's retreat, real retail sales have risen 4.6% a.r. since the start of the year. Auto sales were never as hard hit as they were stateside, and have been mounting a consistent recovery from last December's lows (Chart 2). Ditto for consumer confidence. While Canadian households have not been paragons of thrift in recent years, they did not get as overextended as their U.S. counterparts, and thus face a much less prolonged period of retrenchment. As well, job losses were roughly half as deep in Canada versus the U.S.

CHART 1
CANADIAN LEADING INDICATORS: STRONG LIKE BULL

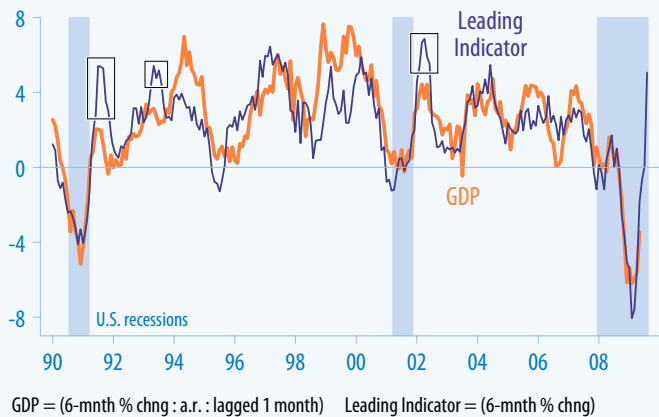


CHART 2
CANADIAN SPENDING HOLDS UP

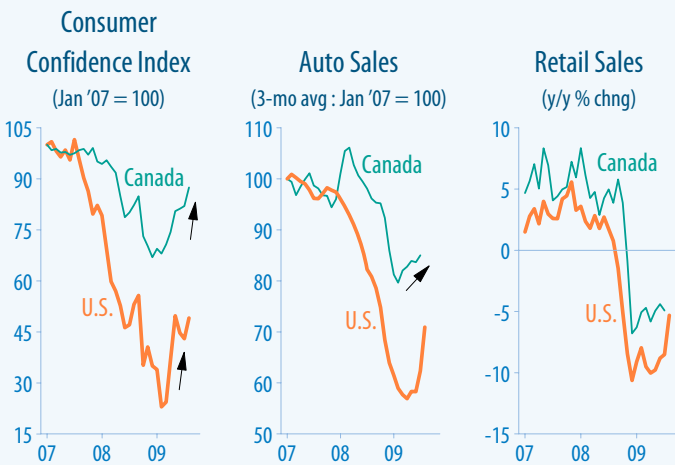


CHART 3
HOUSING: CANADA'S AMAZING ABOUT-FACE

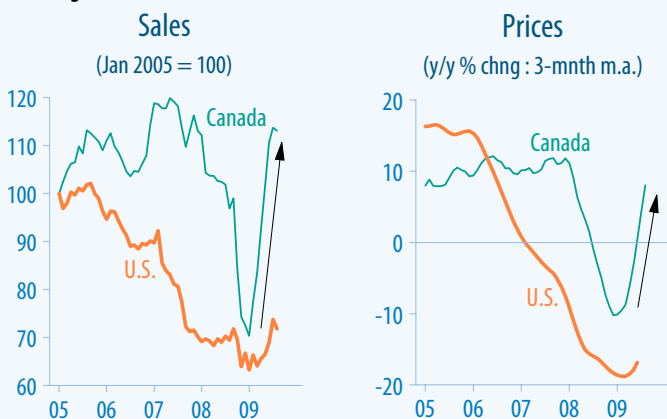


CHART 4
GDP: SERVICE IS LOUSY, GOODS ARE WORSE

Canada (y/y % chng)

Real GDP

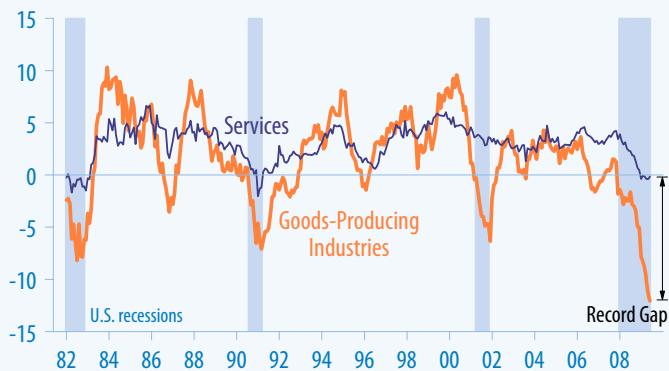
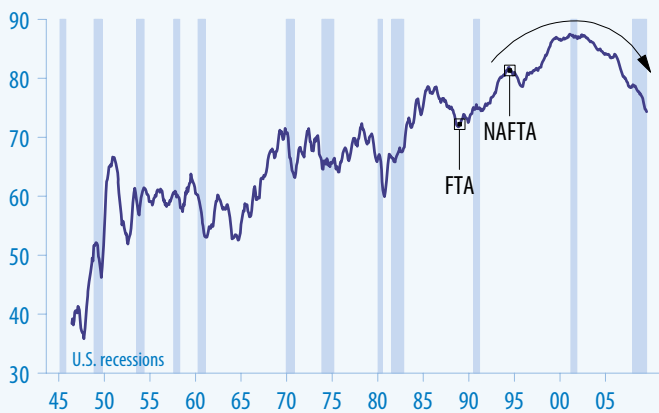


CHART 5
CANADIAN EXPORTS TO U.S.: OVER THE TOP

(% share : 6-mnth trend)



this recession, also casting a less bleak shadow on the spending outlook here.

The relative resiliency in employment played a role in helping Canada's housing market recover Lazarus-like from the early-year depths (*Chart 3*). The rebound in existing home sales and prices, which is showing few signs of relapse, is translating into stronger homebuilding activity. Meantime, government infrastructure spending is only now cranking into high gear, and should provide important support to the fledgling recovery. Business investment is likely to lag the broader economy due to massive existing spare capacity in many industries, which is typical in the early recovery stages. Overall, stimulative monetary and fiscal policies, rebounding financial markets and the recovery in consumer sentiment suggest that almost all systems are go for Canadian domestic demand.

Unfortunately, the missing ingredient for a full-fledged V-shaped recovery in Canada—and it's a big one—is robust U.S. demand. That's not as poisonous as it may seem, since some other cycles were burdened with slow export growth in the early going of recovery (eg. 1975 and 2002). However, it does suggest that Canada's recovery will be lopsided, dependent on domestic spending over exports, and the service sector over goods-producing industries (which are export-heavy). Note that there was a record gap between services and goods industries growth in the year to July, and it will remain wide (*Chart 4*).

Renewed CAD strength, which the BoC highlights as a key risk to growth, will also remain a thorn. However, underlying

U.S. softness is the overriding concern, and increasingly Canada will rely more on sales elsewhere for growth. After a nearly non-stop increase in the dependence of Canadian exports on the U.S. since WWII, the trend appears to have broken decisively at the start of this decade, just as commodities turned higher (*Chart 5*).

Some key implications of Canada's lopsided outlook are:

- 1) Overall growth is unlikely to live up to the gaudy gains in leading indicators or the equity markets.
- 2) With domestic spending reviving and export prospects still dim, the trade deficit could widen further, even with a recovery in commodity prices.
- 3) The nature of the recovery—strong services, weak goods-producing output—is relatively friendly for employment, but bad news for productivity.
- 4) While Ontario may get a near-term bounce from this year's lows, the province will continue to struggle versus the rest of the country with the U.S. consumer hobbled.

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