

# Passing the Economic Baton

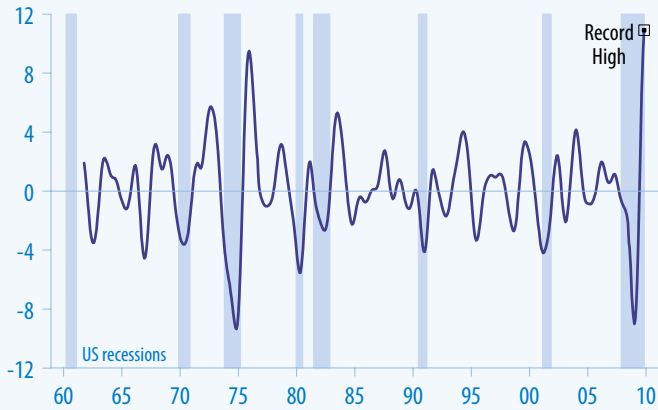
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It's almost an article of faith among the forecasting crowd that the global economic recovery will be sub-par, held back first by ongoing deleveraging in most of the industrialized world, and then later by the need for governments to rein in massive budget deficits. For instance, the latest Blue Chip consensus forecast calls for 2.8% U.S. GDP growth this year, which would barely fill in the hole left by last year's 2.5% slide (the worst single year for the U.S. economy in more than 60 years). Similarly, Europe is only uneasily staggering to its feet, with growth expected to barely top 1% this year after a brutal 4% decline in 2009. And yet, despite quite compelling arguments for caution, global equities and commodity prices continue to roll along, consistent with a much more robust bounceback, and the OECD's leading economic indicator has just reeled off its strongest nine-month rise in 50 years of records (*Chart 1*). What explains this seeming disconnect?

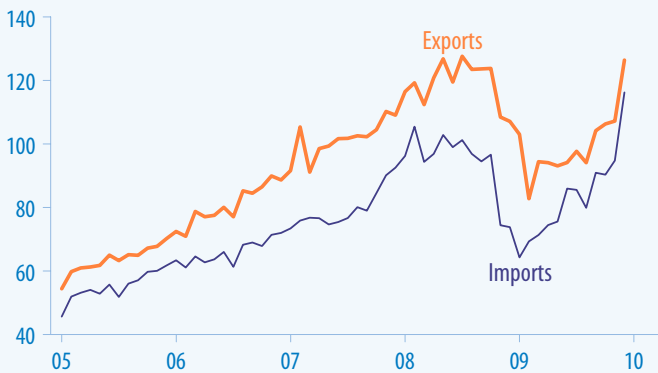
One answer is that, while most industrial world economies are still struggling, many emerging markets have long since picked themselves up, dusted themselves off, and started growing robustly again. While we would not dare call this decoupling, there is certainly some heavy-duty divergence going on. Of course, at the forefront of the emerging market rebound has been China, where the biggest risk at this point appears to be overheating, not a weak recovery. The past week alone has seen two modest steps by China toward a tightening of policy, with somewhat more substantial action likely as 2010 progresses. It is nothing short of astonishing that China managed to churn out growth of more than 8% last year in the face of the deepest global downturn of the post-war era. The country now appears headed for GDP growth of more than 10% this year, thanks to a hyper-competitive exchange rate and the momentum from earlier stimulus measures. December's trade figures revealed that imports have recouped pre-crisis highs, and exports are almost there (*Chart 2*).

In a sense, we are seeing a passing of the baton of economic power from the U.S. to China before our very eyes. Perhaps nothing captures that shift more aptly than the official word that China's vehicle market is now larger than America's (at least temporarily), a crossover that, in fact, occurred early last

**CHART 1**  
**FROM GLOOM TO BOOM?**  
OECD Leading Economic Indicator (9-mnth % chng)

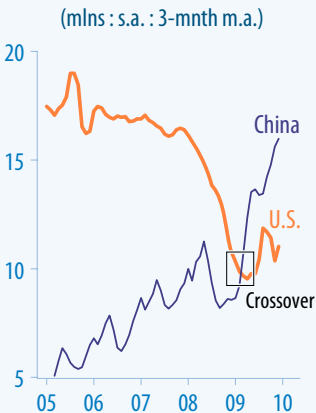


**CHART 2**  
**ALL THE WAY BACK**  
China (US\$ blns : s.a.\*)

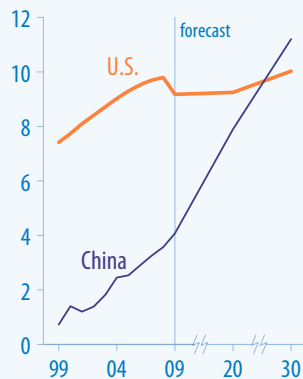


\* by Haver Analytics

**CHART 3**  
**PASSING THE BATON**  
Vehicle Sales (mlns : s.a. : 3-mnth m.a.)



**Oil Imports (mbpd)**



year (Chart 3). While some are blasé about that shift, given the huge population differences between the two nations (China is more than four times larger), the U.S. sold more than three times as many vehicles as recently as five years ago—that is a monumental shift in the historical equivalent of a heartbeat. It is only a matter of time before we see similar sea-changes in other areas. For instance, China’s oil imports last year were almost half as large as the U.S.’s, and we believe that China will be the world’s largest oil importer in less than 20 years (Chart 3 again).

The implications of this passing of the economic baton for Canada are varied. While the U.S. share of Canada’s merchandise exports has steadily eroded since the tech-boom highs of 2000, it is still by far the dominant market with about a 75% share (Chart 4). And while sales to China are sprinting ahead, they still account for only 3% of total exports. In fact, all non-OECD countries now absorb little more than 10% of total Canadian exports—up from 5% at the start of the decade, but not enough to quickly move the needle on overall Canadian growth prospects. Accordingly, we continue to look for Canada to be married closely to U.S. growth trends, with the two again posting almost identical GDP growth rates in 2010. (Note that this will be the seventh year in a row where Canadian and U.S. real GDP growth rates have been within half a percentage point of each other, despite wild swings in commodity prices and exchange rates, starkly different housing markets, and banking systems that are worlds apart in health.)

But while Canada may not benefit directly in terms of real GDP growth from China’s resurgence, it will benefit from the indirect lift to commodity prices. The snap-back from last year’s depths has lifted commodity prices back above the average level prevailing in 2007—shy of the speculative heights reached in 2008, but still quite a strong environment. There may be some legitimate scepticism over just how durable the rebound in demand from China is, but there is little doubt that China is again the prime driver of commodity prices (Chart 5). Not surprisingly then, resource prices and the TSX have become extremely sensitive to any signs that China is preparing to slam on the policy brakes. However, we believe that China is more likely to err on the side of allowing higher inflation rather than cutting off growth too abruptly, and that net policy tightening will be only moderate this year. We are thus calling for a further 5% rise in our commodity price index over the next year, after last year’s powerful rebound, boosting the loonie above the parity bar in 2010.

**Bottom Line:** Forecasts of a modest growth recovery in North America are likely appropriate, given the heavy shackles still holding back the U.S. outlook (with December retail sales a prime example). However, emerging markets are not waiting around for a strong U.S. rebound, and are not encumbered by weak banking systems. In this divergent growth environment, commodity prices can continue to thrive, benefitting Canadian profits and incomes, and ultimately employment and spending.

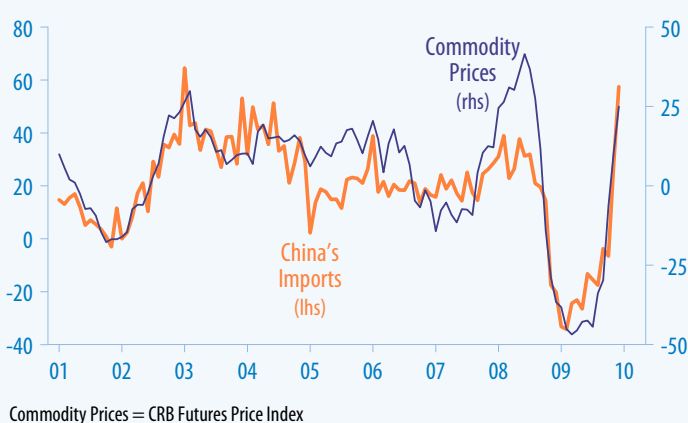
**CHART 4**  
**SHIFTING TRADE TIES**

Share of Canadian Exports (percent : 12-mnth m.a.)



**CHART 5**  
**CHINA DRIVING THE (COMMODITY) BOAT**

(y/y % chng)



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