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Canadian Resilience May Be No Different This Time

Over the past year, we have steadily telegraphed a story of Canadian resilience in the face of an adverse terms of trade shock (i.e., the plunge in commodity prices since mid-2014). We dubbed our story throughout 2015 as the Great Canadian Non-Recession stance. The core thesis was that recession worries were being exaggerated and the economy would bounce back albeit along a volatile path. Subdued trend growth would likely remain intact and other classic signs of recession would remain absent. This view has only strengthened with time especially as early growth readings roll in this year. The country is not out of the woods yet amidst myriad domestic and external risks, but such risks have failed to inflict the kind of harm that has been feared. The purpose of this note is three-fold: to provide a reminder of what happened to a variety of indicators during past meltdowns in commodity prices; to track how the story has been evolving this time around with implications for future developments; and to conclude with financial market implications.

Resilience During Past Commodity Shocks

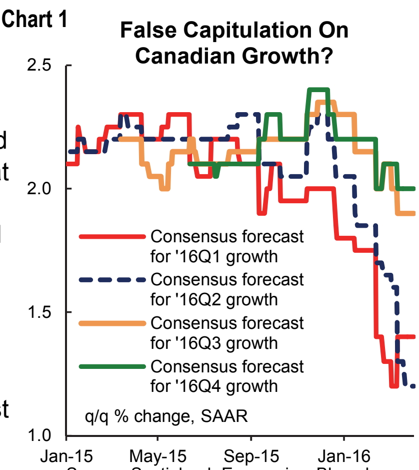
Five past periods of comparable percentage declines in energy prices carried one thing in common by way of the knock-on effects across a variety of indicators: the effects were temporary, and while not inconsequential, they were often modest especially after controlling for other deep challenges like the 2008-09 global financial crisis.

Charts A1-A8 in the appendix track GDP growth, headline CPI inflation, core CPI inflation, job growth, hours worked, housing starts and home sales in the six quarters leading up to the trough in oil prices (time t=0) during past cycles and the twelve quarters thereafter.

There is no denying that weak commodities can drag down regional economies that are more weighted toward resources and that there can be spill-over effects elsewhere, but it takes a disciple of the Rorschachian school of economics to see a clear pattern of steady gloom emerging across this wide variety of nationwide indicators. The point isn't to argue against the notion that growth can be negatively impacted by a commodities downturn; but it's one thing to point to the effects at the margin and another wholly different matter to imply that other offsetting forces won't be operative.

Those risks cut both ways in the current cycle. Yes, this time is about a global commodity supply overhang that may take longer for the resource producing regions to adjust to, but that is more beneficial to the non-resource regions than the typical collapse in global demand that played a larger role in past commodity sell offs. Yes, housing markets are inflated and household indebtedness is high. On the flip side of the risks, however, is that unlike periods such as coming off the housing and leveraged excess of the 1980s, deep fiscal austerity in response to acute pressure from markets and rating agencies, as well as adjusting to the NAFTA agreement have no Canadian parallels this time around.

Chart 1



Source: Scotiabank Economics, Bloomberg.

Resilience Evidence From This Cycle

Indeed the evidence from a variety of indicators drawn from this cycle almost two years into the commodities downturn is not as yet materially different from the macroeconomic effects of past commodity shocks.

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Growth: Canada is on track to record its third straight quarter in the black. Current tracking based on January GDP and the Q4 hand-off assuming a flat February and March to focus on the effects of what we know has growth in the 3.7% q/q annualized ballpark for Q1 which would be the strongest quarter in almost five years. Not even at the peak of the energy boom before the collapse was such growth registered. Even mild dips in GDP as the rest of Q1 data unfolds could leave growth in the 3% range. This stands in stark contrast to the consensus capitulation on growth this year that unfolded around the turn of the year (chart 1). Panic set in just before the sun broke through the clouds it would seem. This concern always exaggerated the role of the resource sector and understated the offsetting benefits of lower commodities and concomitant currency depreciation. Energy — including direct *and* indirect effects — was 15% of the economy and all resources were about 20% of the economy (again including indirect effects) before the commodity downturn, leaving 80-85% of the rest of the economic outlook generally intact. That pattern has been volatile but 2.4% growth in '15Q3, 0.8% in '15Q4 and this kind of upside in '16Q1 is an encouraging trend that more than reverses the very mild dips of -0.9% in '15Q1 and -0.4% in '15Q2.

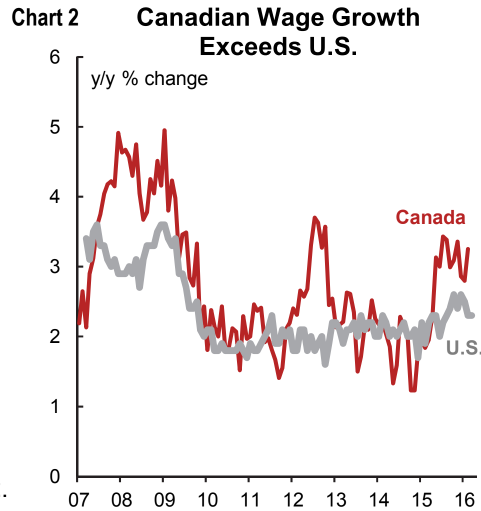
Jobs: Trend job growth has remained resilient in Canada. Since commodity prices began their swoon after mid-2014, Canada has created 232,000 jobs. Over the past year, 118,000 jobs have been created, and over the past six months 31,000 jobs were created. Job growth has slowed in aggregate, while wage growth has sharply accelerated to a pace that is about a full percentage point above the US (chart 2) despite the fact that the US is more likely to be a net beneficiary of lower commodity prices. What's more is that Canadians have never been working more hours in aggregate than they are now.

Business sentiment: When the rubber hits the road and rhetoric gives way to planning a business, what do Canadian businesses think about the future? The Bank of Canada's latest Business Outlook Survey indicates optimism (here). Chart 3 is the result, and it shows that average expectations for 12-month forward sales growth across a diverse array of industries has markedly improved. Plans to hire and invest also rebounded and inflation expectations edged up.

Housing: To say it's on fire is a bit of an understatement. A weaker CAD over the past several years put Canadian real estate on sale internationally, and the Bank of Canada's rate cuts added fuel. Credit growth has accelerated in the wake of the BoC rate cuts and house price gains have sharply accelerated in several regions outside of the energy-affected provinces. While this poses notable risks, they may be more manageable if the economy at home and abroad is on the mend. The view that a household credit quality crisis would emerge was always misinformed given the fundamentally different nature of Canada's mortgage and financial systems. The general absence of strategic defaults and the low risk posed by nonrecourse mortgages (see p.10 here) is a major difference compared to other countries — namely the US — that have had much bigger problems. The relative absence of heavily leveraged vehicles like CDOs (and squared and cubed…) prevented mortgage leverage from being compounded and then viciously reversed if/when the music stops. Explicit guarantees for insured mortgages, and a well capitalized and diversified banking system with multiple funding sources are but two more points on a lengthy list of differences in drawing international comparisons of lending risks.

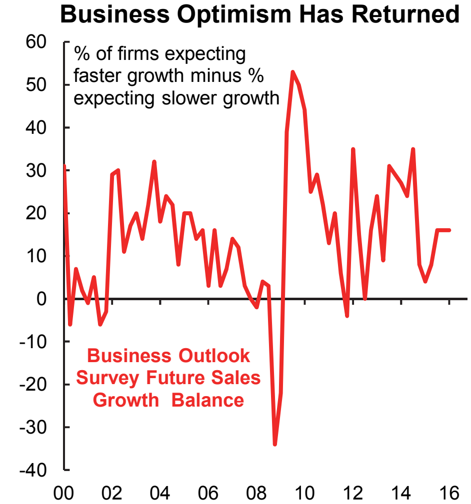
Exports: An encouraging development is that the export side of the picture has shown considerable life for some time now and so has the manufacturing picture. Export volumes have risen in eight of the past fourteen months, four of the past six, and three of the past four consecutive months. In fact, the only months that got in the way of the picture since last summer were probably because of one-off production distortions or the latest that came off very rapid growth over the

Chart 2



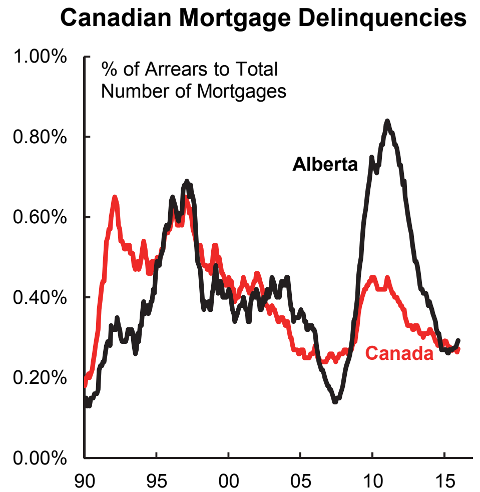
Source: Scotiabank Economics, Bloomberg.

Chart 3



Source: Scotiabank Economics, Bank of Canada.

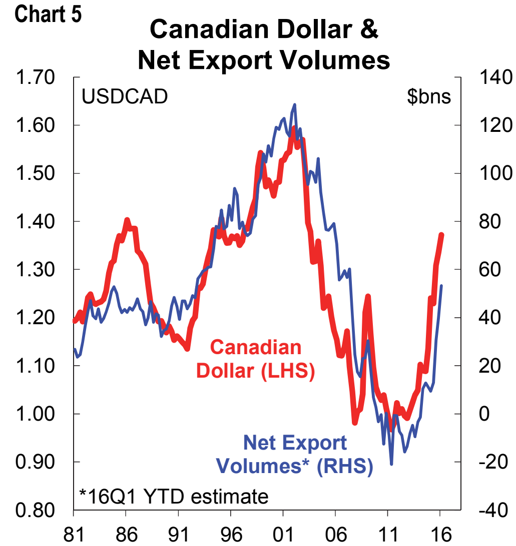
Chart 4



Source: Scotiabank Economics, CBA.

combined two prior months. The view that much deeper currency depreciation may be required to stoke export competitiveness may have been exaggerated since we have a fair amount of data that has pointed upward. Indeed, to her credit, Scotia's Adrienne Warren was right to stand by the assertion that CAD depreciation would eventually work its magic on the trade account by encouraging export growth and discouraging imports with some of this reduced import bill being diverted domestically (chart 5). So far, Q1 is showcasing a massive 15% q/q rise in export volumes at a seasonally adjusted and annualized clip. With March data pending and possible revisions, it's possible that the final Q1 export volume gain will remain in line with current tracking. Canada is likely making market share inroads in the US perhaps as domestic US demand is diverted, but decent trend growth in US domestic demand is also constructive to the Canadian export picture.

Chart 5



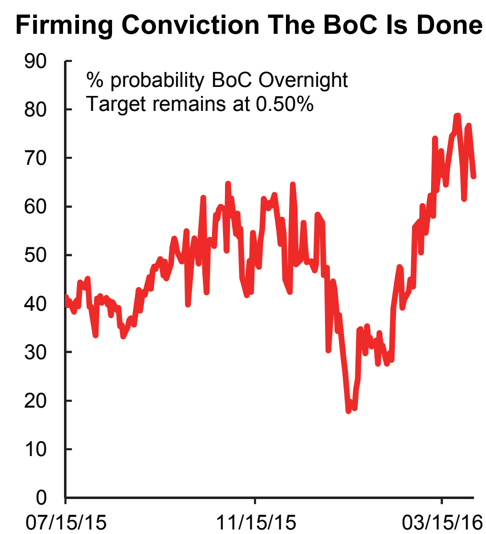
Source: Scotiabank Economics, Statistics Canada.

In all, the economy has performed respectably over the latest three quarters following a relatively brief soft patch over the first half of 2015. A temporary hit to growth was the past norm in response to negative commodity shocks. That soft patch over the first half of last year was also heavily influenced by transitory factors that had nothing to do with the commodity downturn (the reverberating effects of US west coast port strikes, a temporary minivan plant closure in Ontario, forest fires, fire disruptions at refineries, etc.). Almost two years into the commodity plunge, Canada has so far again averted the 'crisis economics' policies that have brought quantitative easing and negative interest rates elsewhere.

Financial Market Implications

This was the big call to be made on Canada and continues to drive our financial market views.

Chart 6



Source: Scotiabank Economics, Bloomberg.

- Canada 2 year yields have almost doubled from the lows in January this year. The OIS market probability that the Bank of Canada's overnight rate will end 2016 unchanged at 0.5% has risen markedly (chart 6). We continue to forecast that rate cuts are over and the next move will be upward but not until well into 2017 at the earliest. As time passes, a steeper curve is likely with yields from 2 years through the critically important 5 year rate and outward rising in anticipation of a modest eventual hike cycle.

- CAD has appreciated by about 14 cents (about 10%) versus the USD since the weakest point in January and it has risen against every other cross except the rand. Going forward, Scotia Economics and our crack team of FX strategists jointly forecast CAD to run around the 1.30 USDCAD range over the rest of 2016 and to appreciate by a nickel in 2017.

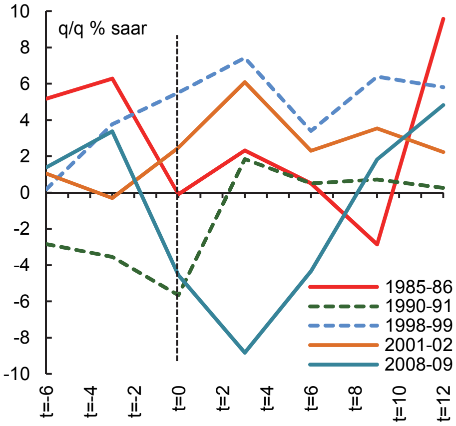
- After a dismal 2015, which major DM stock market index is leading all others so far in 2016? None other than the TSX in USD terms (+7.3%) and CAD equivalent terms (+3%). Each of the banks, energy, materials and industrials segments have participated on a combination of the fundamentals, short covering and lessened negativity toward the currency that put the country's assets on sale internationally. It is possible that such forces keep Canadian equities outperforming.

- We agree with our fixed income strategists that spreads on provincial and Canada housing bonds remain wide relative to the currency entry point, the fundamentals, and the global carry trade in a search-for-yield environment.

- Canada's 10 year inflation breakeven has moved up from 1.16% in January to almost 1½% today. Fundamentals and technicals influence this movement, but markets have sought inflation protection over this period perhaps in recognition of the underlying rationale behind temporary macroeconomic shocks. The case for buying inflation protection over time and smoothed through transitory episodes remains elevated in Canada in our view, versus accepting current pricing as a signal that the BoC will fall well shy of its inflation target for a very extended period of time.

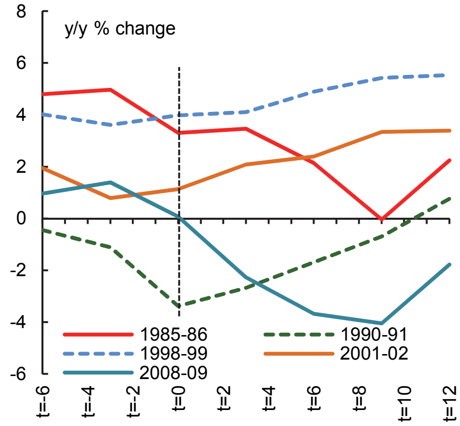
Appendix: Indicator Tracking During Past Comparable Oil Price Shocks

Chart A1
Quarterly GDP Growth



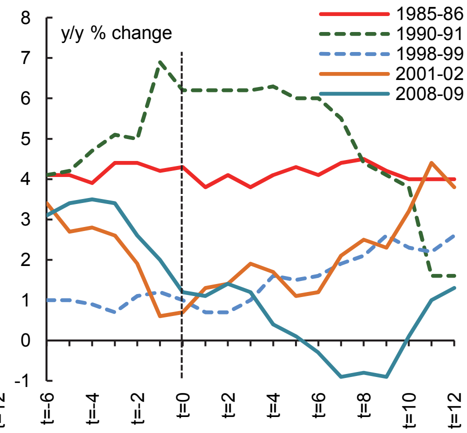
Source: Scotiabank Economics, Statistics Canada.
t=0, lowest WTI price during specified period.

Chart A2
Annual GDP Growth



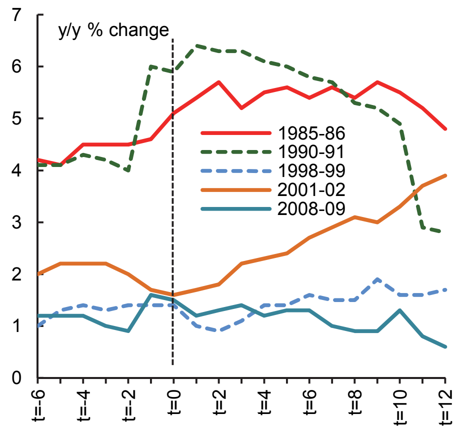
Source: Scotiabank Economics, Statistics Canada.
t=0, lowest WTI price during specified period.

Chart A3
CPI



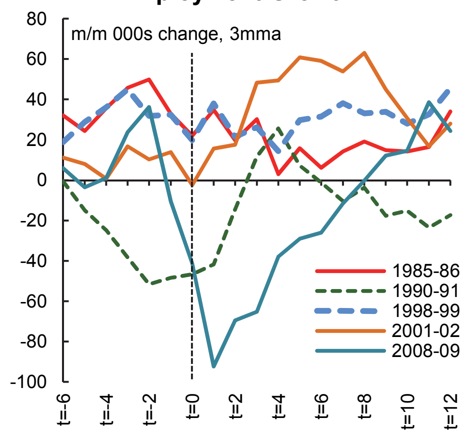
Source: Scotiabank Economics, Statistics Canada.
t=0, lowest WTI price during specified period.

Chart A4
Core CPI



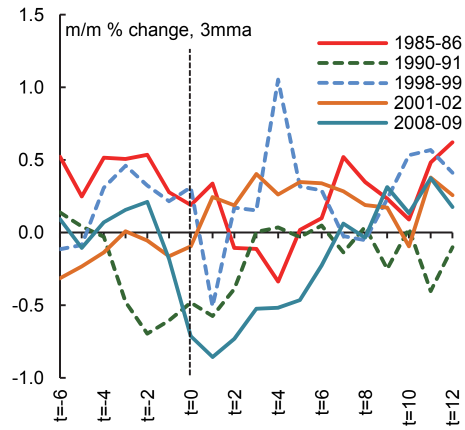
Source: Scotiabank Economics, Statistics Canada.
t=0, lowest WTI price during specified period.

Chart A5
Employment Growth



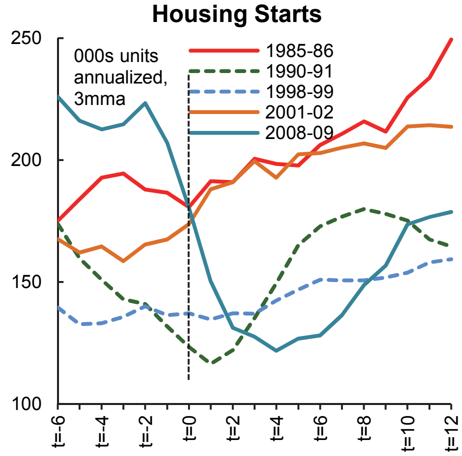
Source: Scotiabank Economics, Statistics Canada.
t=0, lowest WTI price during specified period.

Chart A6
Hours Worked Growth



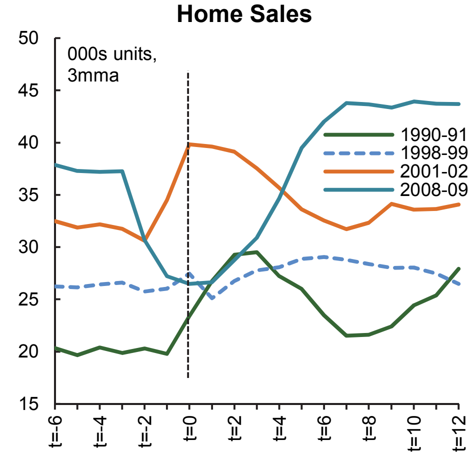
Source: Scotiabank Economics, Statistics Canada.
t=0, lowest WTI price during specified period.

Chart A7
Housing Starts



Source: Scotiabank Economics,CMHC.
t=0, lowest WTI price during specified period.

Chart A8
Home Sales



Source: Scotiabank Economics,CREA.
t=0, lowest WTI price during specified period.