

Capital Markets Flash

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Canadian Economic Update
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The Canadian economic setting: A slow but steady recovery

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2012 will mark the third year of recovery for the Canadian economy. On the plus side, employment and economic output have now surpassed their pre-recession levels and forecasts call for steady, but not spectacular, growth over the next few years. Canada's recovery, especially in employment, has been more impressive than most other developed countries, including the US. On the negative side, Canadians are having to adjust to a weaker pace of economic growth than experienced pre-recession and our international competitiveness is being challenged by weak productivity, a strong Canadian currency and weak growth in our major trading partners.

Canada's economic recovery

Although all the numbers are not yet in, it appears the Canadian economy will grow at a pace just over 2% this year, a shade higher than forecast in the July 2012 Capital Markets Flash. As well, 2013 now looks to be slightly stronger than forecast in July 2012, and by 2014 the economy is forecasted to be at full capacity and moving at a decent 2.4% pace. Consumer spending and business investment have shown more spark than earlier expected. Low interest rates have continued to drive spending while commercial construction and energy investment have also been major contributors to growth. Both the federal and provincial governments have pulled back sharply from their stimulus programs of earlier years and are expected to increase spending at a meagre 1% pace in 2013 and 2014. As well, recent changes in mortgage conditions are beginning to cool down residential real estate activity.

Employment has been growing steadily in Canada for more than three years. With growth in the 1% range expected over the next several years, this should bring the unemployment rate back down to the 7%

level. This forecast calls for strong private sector job growth to fill in for very tight controls in the public sector. Slowing labor force growth, resulting from immigration levels in the same range of recent years and an aging of the population, will force us to adjust to employment growth in the 1% range over the next decade.

Historically low interest rates have been a major contributor to our economic recovery. However, easy credit conditions have pushed consumer debt to worrisome levels. In response, the government tightened the regulations on mortgages earlier in the year. As a result, our forecast calls for a falling pace of housing starts in the upcoming years, even in the face of stronger economic conditions over-all.

There is still some excess capacity in the economy, in both factories as well as labor markets. The Bank of Canada does not expect the economy to move to full capacity until the end of 2013. With inflation moving at a pace below this year, the Bank is not expected to begin raising rates until late 2013. However, there may well be steady increases in rates over 2013 and into 2014.

The Canadian dollar has spent most of this year very close to parity with the US dollar and pressures over the next few years seem to be upward. The Bank of Canada will most certainly start their interest rate tightening cycle before the Federal Reserve in the US. This anticipated gap in interest rates in Canada's favor will put upward pressure on the Canadian dollar. Energy prices, specifically oil prices, are also expected to be under steady upward pressure over the next several years as the US, European and Chinese economies strengthen, further adding to optimism for the Canadian dollar.

The recovery internationally

The July 2012 Capital Markets Flash outlined the major direct and indirect ways in which the performance of international economies presented risks to Canada's economic recovery. The US is our major source of exports, real investment and financial flows. Changes in economic conditions in other major countries, particularly China, Europe and Mexico can affect Canada directly as well as indirectly through their impacts on the US economy, exchange rates and commodity prices.

Since our July forecast global financial conditions have improved slightly as a result of aggressive policy actions in Europe as well as the US. However, both growth and financial conditions in Europe remain fragile. The European continent as a whole is in recession with Greece, Spain, Italy and Portugal experiencing the most economic and financial hardship. Germany is the only major European country solidly in recovery. Growth in Europe overall is expected to move slightly into positive territory next year. Growth in China, in the 7.5% range, will be lower this year and next, however it is still very healthy by international standards.

The US economy is expected to continue a slow recovery

The US economy is expected to grow a bit stronger than the Canadian economy in 2012 as well as in the following two years. This is partly because there is more excess capacity to be absorbed in the US. In addition, the US economy will benefit from low interest rates for at least another year, probably right through 2014. Consumer spending and business investment are expected to respond well by 2014. Residential construction is starting to recover and is expected to make an important contribution to the recovery.

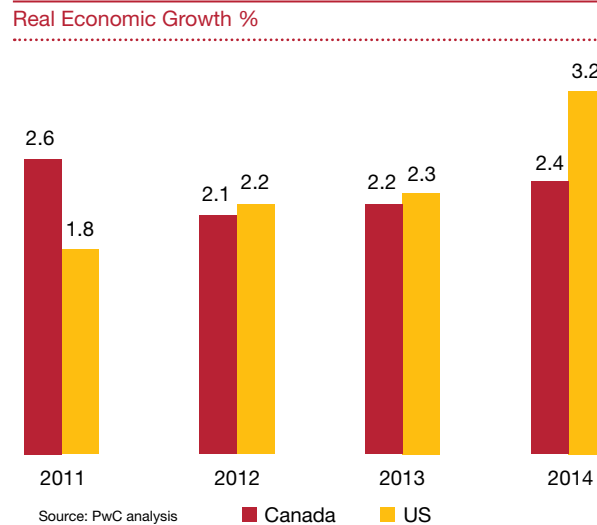
In the recession, layoffs were much more severe in the US than in Canada, with the unemployment rate moving up much more sharply near the 10% level. Employment in the US has not yet regained its pre-recession level as it has in Canada and the unemployment rate in the US, at 7.9%, remains well above that in Canada.

The benefits of the healthier labor markets that we are enjoying in Canada have their obvious benefits in personal incomes and lifestyles. However, the Americans have been able to produce comparable output with relatively less labor, which translates to stronger productivity and more competitive labor costs. As well, the Canadian dollar is expected to remain above par. This means that as the US economy recovers over the next few years, Canadian exporters will have to work very hard to increase their exports to the US.

Forecast for Canada

	2012 Average annual	2013 Average annual	2014 Average annual
Real GDP (YOY %) Growth	2.1	2.2	2.4
Selected Components of GDP (YOY %) Growth %			
Consumer Spending	1.9	2.1	2.3
Government Spending	-1.1	1.0	1.0
Business Investment	7.0	9.0	5.0
Exports	3.0	4.0	4.0
Other Indicators			
Industrial Production (YOY%)	1.0	3.0	4.0
Unemployment Rate %	7.3	7.1	7.0
Inflation (CPI)	1.6	2.0	2.0
Short term Interest Rates (90 day T-Bill) %	0.9	1.2	1.5
Housing Starts (000)	215	190	180
CAN \$ (US cents)	100	102	102

Source: PwC Analysis



Economic impacts of hurricane Sandy

Hurricane Sandy walloped the US east coast from North Carolina to Massachusetts in the final days of October. The principal concern is with the tragic loss of life, irreplaceable personal assets, personal incomes and serious disruptions in living conditions and personal inconveniences. From the economic perspective there was serious damage to infrastructure, specifically roads, bridges, subways, power and port facilities. Most of the destruction of assets was in New York and New Jersey. It will take billions of dollars to replace the public infrastructure, let alone the private housing and businesses destroyed by the water and winds of Sandy.

Much of the private property repairs and replacements will be covered by insurance. However, there will remain significant costs that must be borne by home-owners, some of whom have been victims of the recent layoffs, or business owners still trying to recover from the recession. The public infrastructure will require unexpected financing from federal, state and local governments who were already struggling to balance their budgets.

If there is a bright side to events such as hurricane Sandy they are these. Some of the infrastructure will be replaced with much needed upgrades. Some of the lost business, particularly goods production, lost in late October, will be picked up in the coming months. As well, repair and replacement of damaged infrastructure, housing and business will require a significant amount of spending on furniture, lumber, steel, glass and other building materials. All of this reconstruction will provide a significant amount of unexpected employment for manufacturing and construction workers for several years to come. On net, the losses of GDP and income of 2013 will about be compensated for by the gains in 2014 and 2015.

However, some of the assets will never be replaced and much of the incremental income will be generated just trying to re-establish the assets which were in place pre-Sandy.

Implications of the US Election for Canada

After several years of expensive and heated campaigning, the US was left with the same President, and a Republican House majority and Democratic Senate majority which kept US policy in gridlock over the past two years. However, from the ashes of these remains there are distinct grounds for optimism in Canada.

First, all the concern over the highly publicized “fiscal cliff,” is likely over-hyped. It is certainly the case that if President Obama, working with the opposition Republican House, cannot work out an alternative, several hundred billion dollars of tax increases and spending cuts will automatically come in to effect at the end of the year. This tight fiscal constraint would most likely move the shaky US economy into recession within months. This reduction in economic growth in the US would soon thereafter reduce US imports from Canada, pulling Canada into recession by the end of the year. However, there is virtually no chance that the US will fall over this fiscal cliff. There is also virtually no chance that by year end a substantive longer term solution will be negotiated. All the evidence argues a negotiated postponement of a substantive decision will be reached. The impending recession for 2013 will be averted, the US will continue to “muddle through,” and a substantive economically and politically stable solution will be pushed forward. It will be pushed forward until the US recovery is more solid, or perhaps even pushed forward as long as the 2014 mid-term election.

This is not to say that there won’t continue to be a cloud over the US economic forecast, at least for another year. The forecast in this report, for slow improvement in US economic growth, assumes the above path of the “fiscal cliff.”

Another bright note for Canada from the election was that Michigan voters approved proceeding with a new bridge at Windsor/Detroit, Canada’s busiest trade crossing. While possible legal and regulatory challenges may still arise, this crossing now has the official backing of the US side and will likely begin within a year.

While Mr. Romney sounded like a stronger supporter of the Keystone XL pipeline to carry oil and gas from Alberta through the US, Mr. Obama’s position was not rejection, it was further environmental study and accommodation. That accommodation is now well advanced, including Nebraska voting in a Senator favorable to this accommodation. While environmentalists will continue to pressure the President, Mr. Obama is likely to authorize approval of the full completion of the pipeline in short order.

An aerial photograph of a park with lush green trees and a paved path. Several people are walking on the path, and a small dog is visible. The scene is bright and sunny, with shadows cast by the trees and people. A dark red rectangular box is overlaid on the left side of the image, containing white text.

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We look forward to your call.



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