Market Commentary

What the Bank of Canada Sees

"The negative effects of lower oil prices hit the economy right away, and the various positives – more exports because of a stronger U.S. economy and a lower dollar, and more consumption spending as households spend less on fuel – will arrive only gradually, and are of uncertain size."

Stephen S. Poloz, Governor, Bank of Canada
London, Ontario
24 February 2015

Each quarter, the Governing Council of the Bank of Canada (BoC) publishes its Monetary Policy Report. This document provides a valuable glimpse into how our central bank gauges the state of the domestic and global economies. The bank will likely base its future actions on the views outlined in the report.

April's report notes that global deflationary pressures continue to dog most economies. The BoC points the finger at a number of culprits. Depressed oil prices and lower commodity food prices have kept core inflation well below target for a number of countries. Although this dip is likely temporary, central banks are uncomfortable with how long it has lasted. Also important are the persistent excess global supply across a broad swath of products and the stubbornly high labour gaps that remain unresolved for so many countries. Modest wage growth is a further indication of labour slack.

The central banks have responded by either continuing to cut interest rates or by introducing additional and less conventional monetary easing. To put this in perspective, monetary easing is occurring across economies that produce more than half of the world's GDP.

The BoC sees similar downward price pressures here at home. Despite some offsets from a lower loonie, gasoline prices have knocked total Consumer Price Index (CPI) inflation down to 1%. That's the bottom of our central bank's inflation target range.

For Canada, the impact of oil's price decline is not just deflationary. The broader negative effects on Canada's economy are more "front loaded" (appearing earlier) than expected. This is spilling over to consumers, who are challenged by lower income and wealth as a result of the lower terms of trade.

The energy sector has slashed capital expenditure budgets. A slow first quarter U.S. economy did little to boost other exporting sectors.

U.S. — Some Steps Forward, One Back

U.S. first quarter real GDP provided a stark reminder that there are still risks in the global economic recovery. A contraction of 0.7% was enough for some observers to question how much time is left in this business cycle. After all, it's been six years since the last recession ended in mid-2009. Clearly, this cycle is maturing.

On the other hand, a number of economic signposts that normally point to a pre-recessionary environment have not appeared yet. One key indicator is the labour market. Non-farm payroll growth has been expanding. An improving labour market signals that an economy is expanding – not contracting. In fact, a typical recession occurs after two years of decelerating payroll growth on average. Labour's share of GDP is still low by historical standards and has only just started to improve. While it is normal for labour to lose share in the early stages of the business cycle, it is also normal for labour to gain share as the cycle progresses. The upturn usually occurs about three years before a recession. If that measure holds true from past experience, a recession isn't imminent.

Consumer confidence, another significant signpost, has remained firmly on the upswing despite some choppiness in recent months. A sharp drop in the consumer mood has typically foreshadowed an impending recession, although there is usually a lag of about a year before that comes to pass.

Housing is one sector in the U.S. economy that has bucked the first quarter contraction trend. Residential construction was the only major expenditure group to improve in the first quarter, jumping 5.0% on an annualized basis. April saw the largest increase in housing starts in 25 years. That result was reinforced by a fourth straight advance in pending home sales (now at nine-year highs). Plus, for the third time in the last six years, new home sales exceeded half a million units. Home prices are up about 6.0%; rents are also up by about 4.0%. This is a positive development from a Canadian perspective. The BoC's Monetary Policy Report said that a sustained expansion in U.S. residential investment is a key catalyst for unlocking a major market for Canada's non-energy exports.

May's U.S. Consumer Price Index data showed that core inflation ticked up to 2.6% on a three-month annualized rate. This four-year high predictably resulted in renewed greenback strength. That's just the sort of signal Federal Reserve Chair Janet Yellen will factor into her decision as she considers when to increase interest rates.

Europe – The Greek Key and the Eurozone's Future

The existential angst continues in Europe – will the eurozone survive? The original intent of creating the euro was to bring eurozone member nations closer together economically and politically as a way of reducing instability. The absence of a fiscal union, however, has left the design of the euro horribly flawed. Without a shared fiscal framework, countries would naturally have to rely on currency adjustments to rebalance the unavoidable growth differentials among member nations. As it stands now, eurozone interest rate or currency policy amplifies the existing economic divergences among countries. That doesn't line up at all with the eurozone's founding intention. The case in point is the debt situation in Greece.

The crisis in Greece is quickly coming to a head. The possibility of a Greek exit has hovered like a dark cloud over the region's fledgling recovery. While the European Central Bank (ECB) has been criticized for its role in the Greek crisis, in fact it has been highly supportive, offering huge loans and accepting junk-rated Greek bonds as collateral. The ECB has also facilitated Greek access to Emergency Liquidity Assistance. Those two types of central bank lending now total over 60% of Greek GDP. In the absence of these two programs, Greece would likely have already exited.

It is unclear how Greece will meet its June debt repayment obligations. Even if a mechanism is found to help Greece in the near term, the country will not be able to get its economy functioning normally without a very material debt write-off. Regular surveys conducted by a German research group suggest global investors are increasingly losing confidence that the eurozone will be able to hold on to Greece. Half expect a Grexit within the year. Yet, financial markets seem relaxed about all this. In a companion survey, the percentage of investors who expect the Greek debt crisis to spread to other countries has actually declined. European banks and exporters have deliberately cut their exposure to Greece at the same time as official exposure through the ECB and governments has increased.

China's Slowdown Continues

The wind has clearly gone out of the Chinese economy's sails. In the first few months of this year, both industrial production and retail sales slipped. This suggests that the slowdown is playing out broadly across the whole economy. Yes, the government has lowered the growth target to 7.0%, but the latest round of interest rate cuts and backstopping local government debt indicate policy makers are quite worried. Many of the more traditional measures of growth strongly suggest that the slowdown is profound: it may even fall short of the government's downsized target.

Can we rely on the traditional yardsticks we used when China's industrial and infrastructure build was booming? Perhaps less so now. This is because numbers like electricity production growth will naturally come in lower as the government moves away from environmentally damaging industries and toward less energy-intensive and higher value-added areas like biotechnology. The same is true for metrics like rail cargo and growth in shadow banking.

The countries most sensitive to a Chinese slowdown fall into three groups. First, the supply-chain economies, especially in Asia, that export intermediate goods to China have become integral to China's production process. Decreasing export demand and declining Chinese competitiveness are already adversely impacting these countries. Second, exporters of capital goods (like equipment and machinery used to produce other goods) have benefited from rapidly expanding demand over the last 10 years or so. If Chinese investment in capital goods slows, they lose. Third, commodity producers like Brazil, Chile, South Africa, Canada and Australia have hugely benefited from the tremendous growth in Chinese commodity consumption. China's waning demand has already contributed to the broad and sharp correction in commodity prices.

Canada's Bank Optimistic

The BoC's policy statement late in May reaffirmed its confidence that an optimistic growth outlook is warranted. The central bank stated that the January rate cut was enough "insurance" against the oil price shock. Despite a very weak first quarter, the bank is sticking to its view that the economy is on track to rebound over the balance of the year.

Most of this confidence is based on the likely assumption that Canada will be able to effectively piggyback on a U.S. recovery, both through improved exports and new capital expenditures in the business sector. It's not certain, however, that this will be enough to offset the expected fallout in oil and gas investment. Even though the price of oil has risen to the $60 range, energy prices still fall well short of key Canadian thresholds to make new projects viable.

While not as closely watched as the NHL playoffs, this month's earnings announcements from the big Canadian banks did not disappoint. All of the big six beat the consensus estimates, with dividend increases coming from Bank of Montreal, National Bank and the Canadian Imperial Bank of Commerce. Strong capital markets revenue, strength in wealth management and improved domestic retail performance all contributed meaningfully to the results. Slightly higher expenses across the group detracted modestly. It is significant that credit provisions remained benign (delinquencies were low and loan charge-offs slight). Investors were comforted by the lack of oil-related issues.

Our Strategy

Key equity markets were mixed for the month; Canadian equity returns were down 1.22% while U.S. equity returns were up 1.29%. In May, the Canadian bond market behaved a lot like it did in April: shorter maturities outperformed mid- and longer-term maturities. Short-term, investment-grade corporate bonds again performed well.

Our investment strategy remains unchanged. We continue to favour equities across most portfolios. This is based on our belief that the U.S. economic recovery is sustainable and will propel the Canadian economy forward. Our fixed income strategy is defensively tilted toward shorter maturities in anticipation of further increases in bond yields. We remain overweight in investment-grade corporate bonds to take advantage of the slightly higher yields those bonds offer.

Throughout May, oil traded pretty much within a $4 band, ending the month just above $60 a barrel. This relative price firmness is somewhat encouraging for Canadian energy companies, though it is clearly too early to conclude that the supply/demand imbalance is behind us. We continue to closely monitor the price of oil and its impact on the earnings of Canadian companies.

The Last Word

April's Monetary Policy Report is encouraging in its conviction that the lower Canadian dollar is directing demand toward non-energy exports and that this process is well under way. The BoC identified key sectors likely to spearhead the advance, including aircraft and parts, industrial machinery and equipment and pharmaceutical products. Exports of services are also showing promising growth.

As this recovery gains more momentum, the report predicts that transportation, wholesale trade, finance, insurance, real estate and leasing should enjoy a spillover effect. Here's the question: will it come quickly enough to offset the energy-sector weakness and sidestep a recession? Until we have enough data to validate the central bank's view, we must simply regard it as aspirational thinking.

Time will tell.

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