

Review and Forecast

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CANADA HAS OUTPERFORMED

Canada has lived up to our expectations of an accelerating recovery. However U.S. growth through the first half of 2011 has been much slower than anticipated. In Canada, real GDP growth in the 2nd Quarter appears to have continued to be in line with the 3.9% annualized rate of advance recorded in the 1st Quarter.

In comparison, economic growth in the U.S. has been much slower than expected, averaging only around 2.0% through the first half of the year. It has been held back by economic shocks from the Japanese disaster and spiking oil prices.

American business confidence has remained fragile and has probably been affected by uncertainty over the debt ceiling and the possibility of a government default. Despite strong earnings, favorable profit margins and record levels of cash, U.S. companies have been reluctant to hire.

CANADA'S ECONOMIC FUNDAMENTALS

This contrasting growth performance is partly attributable to the absence in Canada of some of the problems such as housing and state budget cutting that are holding back the U.S. economy. Housing markets avoided the collapse in Canada. The severe budget cuts that are taking place in the U.S. at the state and local government level have also been avoided.

Healthy housing markets have had a big effect on Canada's ability to recover from the 2008-2009 recession. Household wealth and job market mobility have been maintained. In the U.S. negative equity in many family homes has crippled household balance sheets. Frozen U.S. housing markets have prevented Americans from relocating in order to take advantage of job opportunities. The avoidance of distressed housing markets also allowed Canadians better access to credit. In the U.S. the evaluation of housing collateral is still difficult to calculate and household credit availability remains tight.

Canadian provinces are allowed to run budget deficits and finance them with bond issues. This is not the case in the United States. State and local governments are required to live within their means on a current basis. They show a combined job loss of 333,000 over the 12 months ending in June and layoffs are expected to stretch into next year. In comparison, the public sector has been a source of employment growth in Canada. It has actually been a growth leader.

CANADA'S JOB CREATION RECORD

Employment growth picked-up last summer in Canada and stayed robust through the 2nd Quarter. The employment multiplier effect is creating a positive feed-back loop. Job growth has created income which has in turn produced spending and more job growth.

The seasonally adjusted unemployment rate in June 2011 stood at 7.4% - its lowest level since January 2009. The momentum in the job market is concentrated in full-time work. Over the 12 months ending in June, full-time jobs have accounted for 86% of the total employment increase. Business confidence in Canada has been strong enough to generate strong job-creation.

In contrast to the U.S. total employment in Canada is now running well above its previous 2008 pre-recession peak. This is providing important support to consumer and domestic demand. It is also producing a revival in government revenues which are supporting government deficit reduction targets.

DISAPPOINTING U.S. EMPLOYMENT NEWS

The missing link in the U.S. economic recovery continues to be decent employment growth. This is what is needed to produce a self-reinforcing and sustainable recovery. Corporate earnings have been strong but corporations have held back from hiring and have preferred to use their accumulating cash for mergers and acquisitions, dividend increases and stock buy-backs.

There have been some signs of improvement in the U.S. labour market. The payroll service firm ADP reported a sizeable increase in payroll jobs in June and initial jobless claims have recently edged lower. However, the June payroll report showed the weakest employment growth in the past nine months – a monthly increase of only 18,000 payroll positions. This was far below consensus expectations that had been boosted by the previous day's ADP report.

It also showed a disappointing third consecutive monthly decline in temporary help employment and a slippage in the average workweek. These are looked on as leading indicators for full-time hiring. The unemployment rate, which is sourced from a separate survey, remained elevated and actually increased slightly to 9.2%. This job market news indicates that in the 2nd Quarter the U.S. economy was unable to shift from a slow growth recovery to a higher paced and self-reinforcing expansion.

THE U.S. DEBT CEILING

The intention to link the increase in the U.S. government's debt ceiling to matching spending cuts is meant to assure financial markets that America is taking steps to regain a sustainable fiscal condition. Without such a link, the U.S. could run out of international financing room within 10 to 15 years. The awareness of this would surface much earlier, probably before mid-decade. It is expected that these cuts will be from spending growth and will be spread out over the next 10 years. Revenue increases may be part of the package but they are more likely to reflect reductions in tax expenditures rather than actual increases in tax rates. A deal on the debt ceiling has the potential to boost confidence in financial markets.

THE PROSPECTS FOR IMPROVED U.S. PERFORMANCE

There are a number of reasons to expect more positive economic news in the second half of this year. The Greek financial crisis has now eased in response to another bail-out. The European Central Bank and the IMF will facilitate rollovers of Greek government debt. The special factors holding back the U.S. economy this spring will dissipate.

Oil prices appear to have peaked in response to the co-ordinated International Energy Agency move to release strategic oil reserves. The price of West Texas Intermediate crude oil has declined from US\$106.72 per barrel at the end of March to around US\$96 at present. The retail pump price of gasoline has declined substantially from a national average of almost US\$4.00 per gallon to around US\$3.65 per gallon. Same-store retail spending has picked-up in response.

The negative impact from the disaster in Japan has been greater than expected but will turn around when Japanese supply chains are re-established. Japan's economy is now rebounding. Production and sales of autos are expected to recover this fall. In addition the large reconstruction efforts in Japan will be partly sourced in the United States. With the possibility of a U.S. government debt default no longer a threat, U.S. business confidence should improve.

THE GLOBAL ECONOMY

The global economy still performed well through the first half of this year and the global commodity cycle remains in place. The price of copper has increased from US\$4.26 per pound at the end of March to US\$4.40 in early July. China's economy has a strong underlying momentum that has defied official efforts to cool it down. Increases in fixed asset investment and money supply remain very large. The emerging market economies are on a strong growth trend which is highly commodity-intensive. The supply of many commodities cannot keep up with demand.