CANADA UPDATE

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AFTER A RAPID UPSWING IN THE THIRD QUARTER, CANADA IS SETTLING INTO A LOW-ENERGY RECOVERY

Canada's real GDP fell more than the U.S.'s in the second quarter

Canada's recovery is underway. Real GDP plummeted 38.7 percent in the second quarter on a seasonally-adjusted annualized basis due to the pandemic, the steepest contraction since the Great Depression. Canadian real GDP fell even more than the U.S.'s in the second quarter, reflecting the Canadian government's stricter shelter-in-place orders. More recent indicators show a recovery is underway. The lifting of restrictions on activity and aggressive fiscal and monetary stimulus (see Chart 1) fueled a rapid upswing in the third quarter. Key housing indicators have rebounded to above their pre-pandemic levels, buoyed by ultra-low mortgage rates, fiscal stimulus, and potentially changing consumer preferences. Retail sales have likewise recovered to above pre-crisis levels. Higher-income households, who have been disproportionately spared from job losses, are spending, and consumers are redirecting disposable income away from restaurants, travel and other services toward goods; these trends are benefiting retailers.

Canada's rebound was initially boosted by C$386 billion (18.4 percent of pre-crisis GDP) in fiscal stimulus which included support for consumers, businesses, specific sectors, and provincial and territorial governments. Additional fiscal stimulus was passed by the government in September mainly targeted at households and businesses.

The energy sector faces severe headwinds

But even after this highly aggressive stimulus, Canada's recovery will be held back by sectors that face particularly severe headwinds like energy. Canada's crude oil benchmark Western Canada Select averaged just $31.15 U.S. dollars per barrel in the third quarter of 2020, down 28.1 percent from one year earlier. Canada's energy sector is likely to face weaker demand growth as the global economy slowly recovers from the Viral Recession and regulatory and

CHART 1: AGGRESSIVE MONETARY POLICY HAS AIDED RECOVERY; FISCAL POLICY HAS SUPPORTED CONSUMER INCOMES

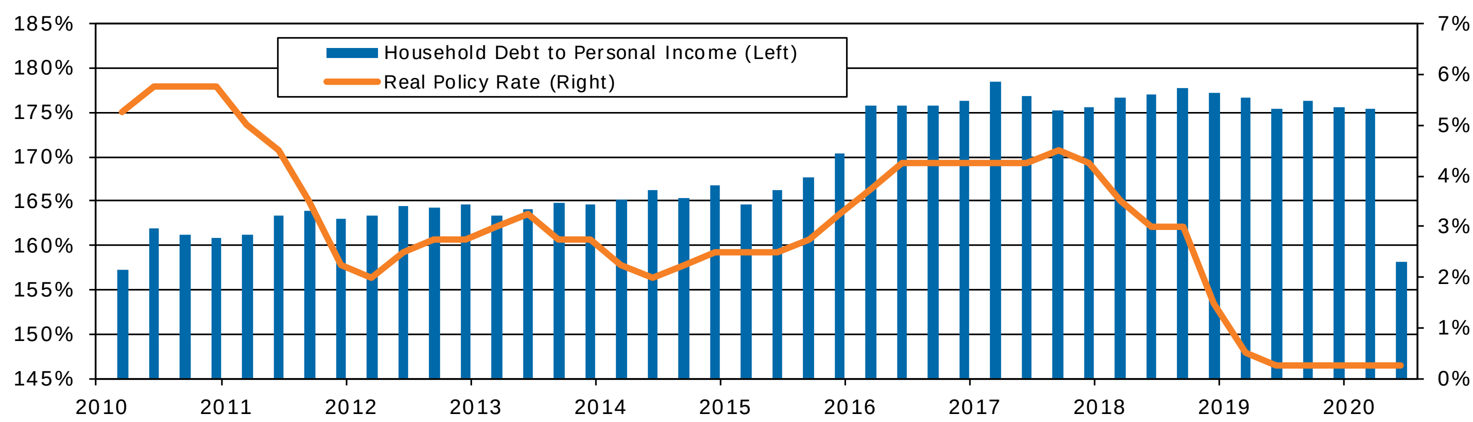


Chart sources: Statistics Canada, Bank of Canada

The Bank of Canada will keep interest rates at the current 0.25 percent level until 2024

technological changes cause renewable energy to take market share from conventional sources. Manufacturing has begun to recover, but manufacturing sales were still 6.6 percent below their pre-downturn level in August. PNC expects the manufacturing sector's recovery to continue in fits and starts as the Canadian economy recovers unevenly from the recession. The drag from these disproportionately weak sectors is reflected in the unemployment rate: it was down to 9.0 percent in September from May's 13.7 percent all-time high, but still well above January's 5.5 percent. After annualized real GDP growth of around 40 percent in the third quarter of 2020, economic growth will continue at a substantially slower albeit still above-trend pace in late 2020 and in 2021; real GDP will only recover to its pre-pandemic level in 2023.

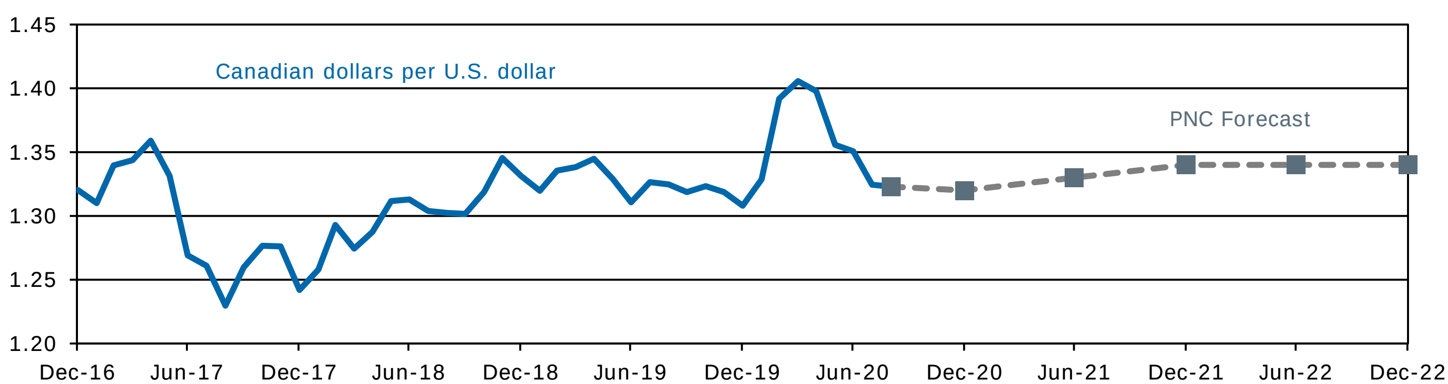
Despite the aggressive fiscal stimulus, inflation has remained muted. Total CPI inflation averaged 0.1 percent per month between April and September, held down mainly by lower prices of gasoline, clothing and footwear, and recreation activities; inflation was near the Bank of Canada's two percent target in February prior to the downturn. The BOC's preferred measures of core inflation—trimmed mean CPI, median CPI, and common factor CPI—were between 1.5 percent and 1.9 percent on a year-ago basis in September.

At the Bank of Canada's September meeting, central bankers committed to hold their policy interest rate at its current 0.25 percent level until inflation reaches the Bank's 2.0 percent target, and to continue with quantitative easing (purchases of long-term government securities to hold down interest rates) "until the recovery is well underway." PNC expects the Bank of Canada to wait until 2024 to raise its policy rate. Structural changes to the global and Canadian economies have slowed inflation after each recession over the last forty years; Canada's recovery will likely need to absorb most of the slack created by the Viral Recession before economic conditions meet the Bank of Canada's criteria for a rate hike.

The Canadian dollar could lose some ground in 2021

PNC Economics expects the Canadian dollar to appreciate modestly through the end of 2020 as financial markets price in a higher probability of additional U.S. stimulus and the global economic recovery gains traction (see Chart 2). However, the loonie is likely to depreciate somewhat in 2021 and 2022 as financial markets recognize that the BOC will hold its policy rate at its current level for longer than financial markets are currently anticipating; financial markets are currently pricing in an increase in the benchmark interest rate in 2022. A resurgence of the pandemic or a stalled economic recovery of Canada's largest trading partner, the U.S., are downside risks to the Canadian economic recovery and performance of the loonie.

CHART 2: LOONIE TO LOSE GROUND IN 2021 AS THE BOC STAYS ACCOMODATIVE LONGER THAN MARKETS ANTICIPATE



Source: Bloomberg, The PNC Financial Services Group