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CANADA UPDATE

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A MILD RECESSION AS RESILIENT CONSUMER SPENDING PARTIALLY OFFSETS THE ENERGY SECTOR'S CORRECTION

The energy sector downturn cuts demand for construction services and manufactured capital equipment

Canada slipped into a mild recession in 2015 as resilient consumer spending partially offset the blow from low oil prices. Real GDP contracted at a 0.5 percent annual rate in the first two quarters of the year, and labor market indicators weakened soon after: Employment insurance claims rose in mid-2015 and the unemployment rate rose in the fall and winter months, reaching 7.2 percent in January 2016. The downturn in the energy industry, which accounts for only about 2 percent of Canadian employment and 10 of real GDP, rippled out to drag on manufacturing and construction output as new exploration and production projects were delayed or cancelled, and demand for capital equipment weakened. Solid growth in consumer spending offset this drag, keeping real GDP growth positive for the year. Canadians spent 7.1 percent more in nominal terms on motor vehicles and parts in 2015 than 2014, and 5.7 percent more on home furnishings. In addition, the weak Canadian dollar encouraged them to cut foreign travel and shopping day-trips to the United States, amplifying the boost to Canadian growth from consumer spending. Prior to the release of the fourth quarter GDP report, real GDP growth for the full year of 2015 looked to be about 1.2 percent as measured by the expenditure accounts, or less than 1.0 percent in the production accounts (See Chart 1).

With little sign of the global glut of crude oil abating, Canada will continue to face headwinds from the energy industry's falling production, exports, and capital expenditures in 2016. The drag from low oil prices in 2016 may be even larger than in 2015 since energy companies' financial hedges, which some companies used to sell products above market prices in 2015, will mostly expire. However, Canada will also likely see stronger growth in domestic consumer spending in 2016 than in 2015, as

CHART 1: CANADIAN BUSINESSES SHARPLY CUT CAPITAL SPENDING AS OIL PRICES FELL

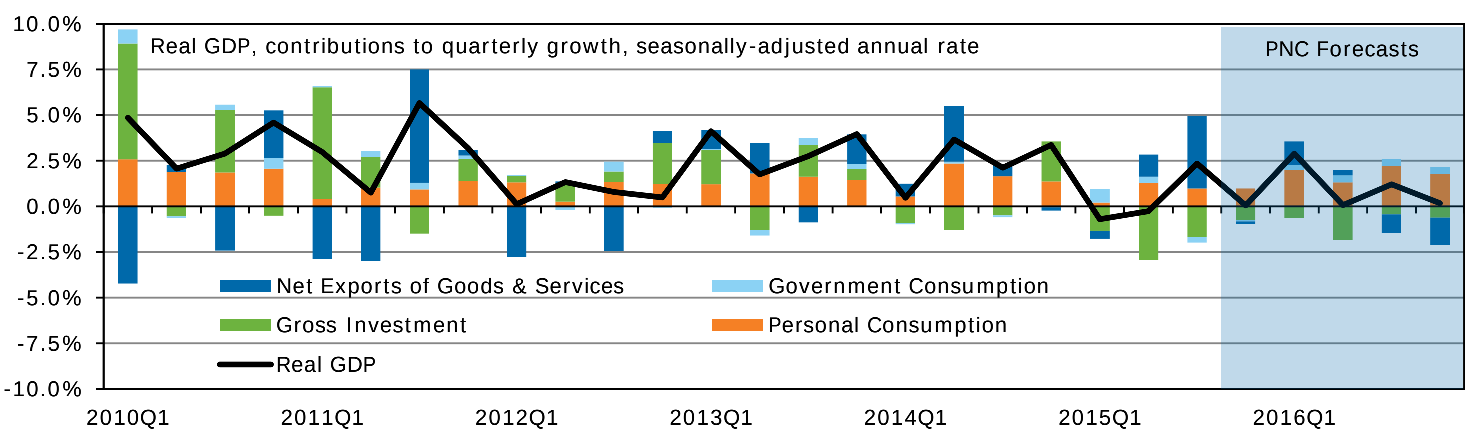


Chart sources: StatCan, CEIC, The PNC Financial Services Group

Consumer spending and a highly competitive exchange rate cushion the blow from low oil prices

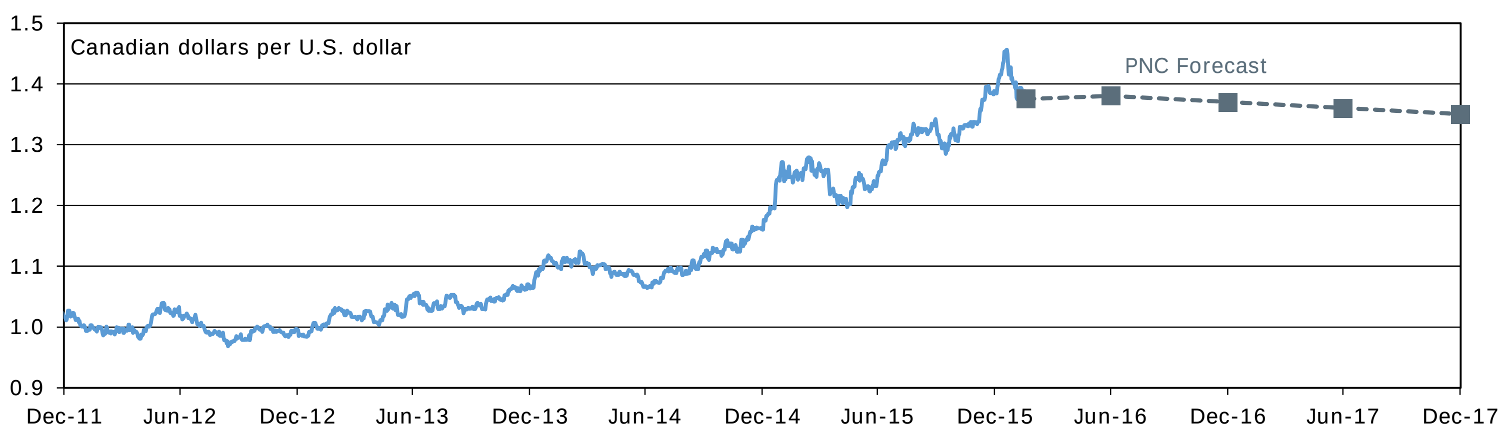
consumer spending gradually responds to lower interest rates and the weaker Canadian dollar. Unlike in the United States, 2016 will likely be a better year than 2015 for Canadian manufacturers as well, since the extremely weak Loonie is dramatically boosting the export competitiveness of Canadian manufacturers. The Government of Canada's plan to run a modest fiscal deficit should also help support domestic demand. Real GDP growth will likely hold steady at a modest 1.2 percent in 2016, before stronger growth in non-resource sectors helps real GDP growth accelerate to 1.7 percent in 2017. If so, the late 2015 and early 2016 increase in Canada's unemployment rate should give way to an improvement in the labor market over the remainder of 2016, lowering the unemployment rate to 6.9 percent by the end of this year and 6.6 to 6.8 percent by the end of 2017.

While far from a disaster, this outcome would nevertheless undershoot the Bank of Canada's January 2016 forecast for a pickup in real GDP growth to 1.4 percent in 2016. The downside risks to the Bank of Canada's forecasts, as well as very low oil prices, are likely why Canadian interest rates in mid-February imply market participants believed a Canadian policy rate cut was more likely than not by September 2016. These market-implied probabilities likely overstate the likelihood of a Canadian rate cut, since they rely on Canadian interest rates that are being held down by spillover from quantitative easing and negative interest rates in the Eurozone and Japan, as well as risk aversion following the early 2016 sell-off of global stock markets. If Canadian real GDP growth remains positive and the Canadian unemployment rate falls as expected, the Bank of Canada will likely be on hold until the end of 2016. Their next move is more likely a hike than a cut, with the timing either in December 2016 (to match the likely timing of the Federal Reserve's second hike of this year) or in January 2017 at the release of the Bank of Canada's quarterly *Monetary Policy Report*.

The Loonie's weakness discourages the Bank of Canada from easing further

The BoC's reluctance to ease policy further is a reaction to the Canadian dollar's dramatic depreciation in early 2016 to its weakest level since 2003 (See Chart 2). At the BoC's January monetary policy decision, Governor Stephen Poloz cited the risk that a weak currency could push inflation expectations higher as an argument against a rate cut. The sensational media coverage of the spike in Canadian food prices this winter, when the price of a head of cauliflower reached $8 Canadian, must make for unpleasant reading for a central banker. If the Federal Reserve makes two hikes in the federal funds target range as we expect in 2016 and oil prices stay low, the BoC will be pressured to at least hold Canadian interest rates steady to defend the Loonie's value. The Canadian dollar will likely stay quite weak in 2016, averaging just $1.39 Canadian per U.S. dollar this year, but could strengthen modestly in late 2016 and 2017 when it becomes clearer that the BoC's next move is a hike.

CHART 2: LOONIE TO STAY WEAK AS INTEREST RATE HIKES IN CANADA COME LATER AND SLOWER THAN IN THE U.S.



Sources: Bank of Canada, CEIC, The PNC Financial Services Group

Canada Baseline Forecast Table

			2014A	2015P	2016F	2017F
GDP	GDP (Real, Expenditure Approach)	Annual % chg	2.5	1.2	1.2	1.7
	Personal Consumption Expenditures	GDP Contribution	1.5	1.1	1.5	1.9
	Government Consumption	GDP Contribution	0.1	0.2	0.2	0.2
	Gross Capital Formation	GDP Contribution	-0.2	-0.9	-1.2	-0.3
	Real Exports	GDP Contribution	1.6	1.0	0.1	0.4
	Real Imports	GDP Contribution	-0.6	-0.2	0.6	-0.5
Prices	Consumer Price Index	Annual % chg	1.9	1.1	1.6	1.8
	Industrial Producer Price Index	Annual % chg	2.5	-0.2	0.5	1.6
	Newly Constructed Housing Price Index	Annual % chg	1.5	2.3	2.8	2.0
Interest &	Policy Rate	Period Avg	1.00	0.6	0.5	0.9
FX Rates	10-Year Government Bond Yield	Period Avg	2.17	1.47	1.49	1.81
	Exchange Rate, USD per CAD	Period Avg	1.10	1.28	1.39	1.37
	Real Effective Exchange Rate	Period Avg	92.8	84.5	80.5	82.8
Credit	Household Credit	Annual % chg	4.4	5.1	4.7	3.9
	Business Credit	Annual % chg	7.5	8.1	4.9	4.4
Labor	Average Weekly Earnings	Annual % chg	2.6	1.7	1.3	2.1
	Unemployment Rate, s.a.	Period Avg	6.9	6.9	6.9	6.8
Trade	Exports	Annual % chg	10.1	0.2	3.6	5.5
	Imports	Annual % chg	7.6	4.7	-0.6	0.7
Key	Manufacturing Orders	Annual % chg	6.5	-4.2	0.7	3.2
Indicators	Total Construction Permits	Annual % chg	5.1	2.9	5.1	5.8

A = actual, P = preliminary, F = forecast

Sources: StatCan, Bank of Canada, CEIC, Bank for International Settlements, The PNC Financial Services Group

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