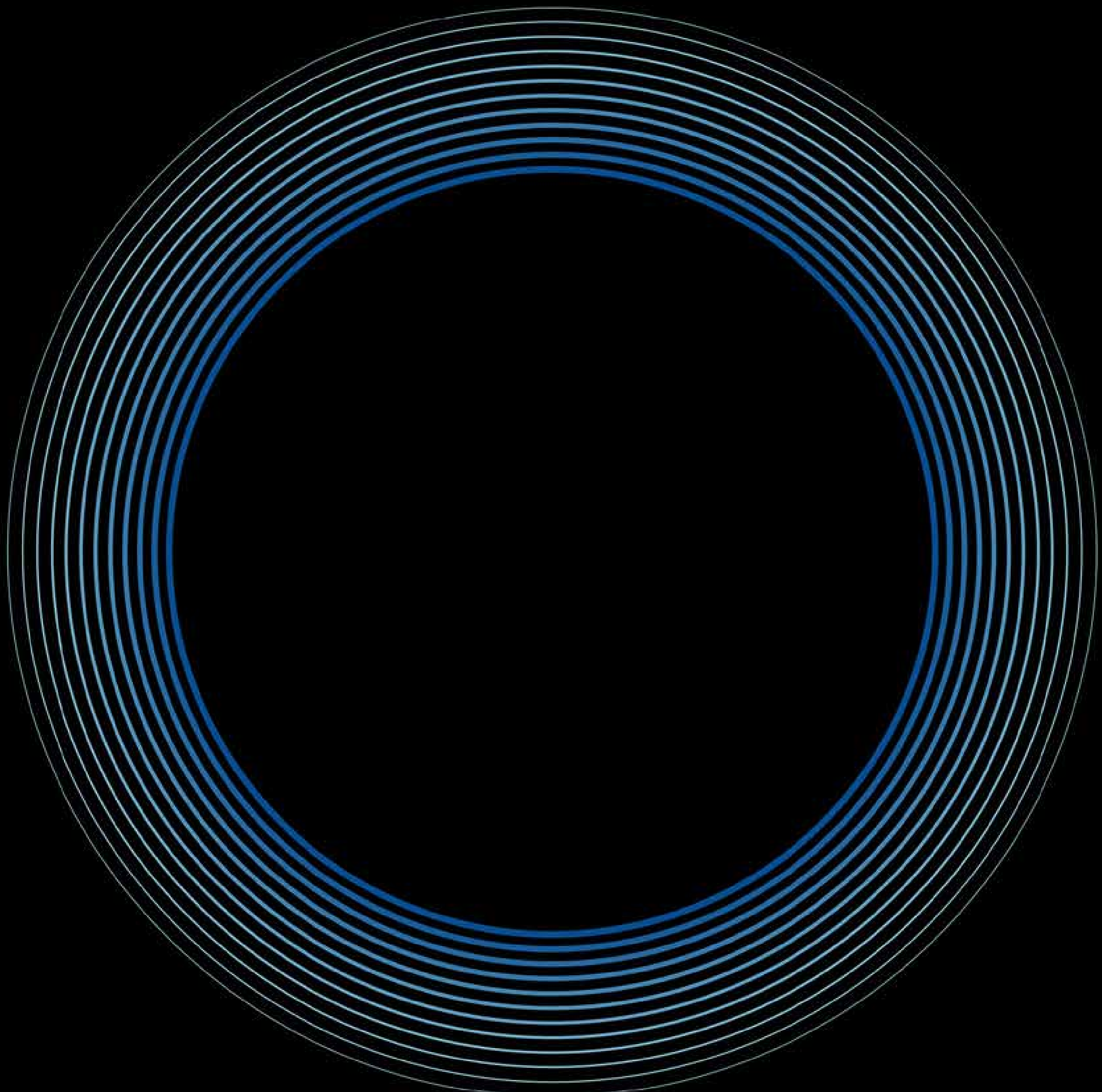


Shake, rattle, and stall

Economic outlook: April 2019

Overview

Since our last forecast round in early January, the global economy has been shaken by some dramatic financial swings alongside emerging evidence of a broad-based slowdown.

Canada has not been immune to the economic moderation, with growth stalling at the end of 2018. A sharp rebound is unlikely: the Canadian economy is expected to exhibit sub-par growth over 2019 and 2020, leaving it highly vulnerable to any negative shocks.

In the wake of the late-2018 correction in global equity and commodity markets, we argued in the Deloitte report Dark Clouds bring rougher seas (January 2019) that investors had become too pessimistic. Financial markets were increasingly pricing in a global recession despite the fact a slowdown was more likely. Sentiment did turn, with equity markets rallying in January and February.

While financial market performance has been strong so far this year, the same cannot be said about economic data: it has been a steady flow of negative news. Global economic expansion and trade is clearly weakening, with the slowdown apparent in both developed and emerging markets. The economic news at home has also taken a turn for the worse. After a weak third quarter, Canada’s economy stalled altogether at the end of last year. As we argued in previous forecast reports, heavily indebted consumers and real estate could not continue indefinitely to be the engine of growth. As it turned out, consumer spending growth slowed sharply in the second half of 2018 alongside residential investment, which declined in all but one quarter last year.

The hope was that exports and business investment would pick up the slack to become the new drivers of growth, but this rotation failed to materialize in the last two quarters. Some of the drag stemmed from the energy patch, as lower oil prices hit investment. The softness was more widespread, however, with the pullback in business investment relatively broad based.

Worse still, all the growth in the fourth quarter came from inventory accumulation, which looks like it was unintentional and reflected unexpected weakness in demand. Inventories at manufacturers and wholesalers are near or above their record levels, with firms likely to work down their inventories in the coming quarters and dampening economic growth in the process.

The R word: unlikely but not impossible

The Canadian economy slowed from 3.0 percent in 2017 to just 1.8 percent last year, and had little momentum heading into 2019. Growth is unlikely to bounce back substantially in early 2019 as drag from residential investment and cautious households weighs on growth. Business investment should pick up, but the weak global backdrop and decelerating US economy will keep the gains muted. Accordingly, the Canadian economy is now projected to grow by a weak 1.3 percent this year and fare only a slightly better 1.5 percent in 2020. The weak outlook should keep the Bank of Canada on hold and the Canadian dollar weak.

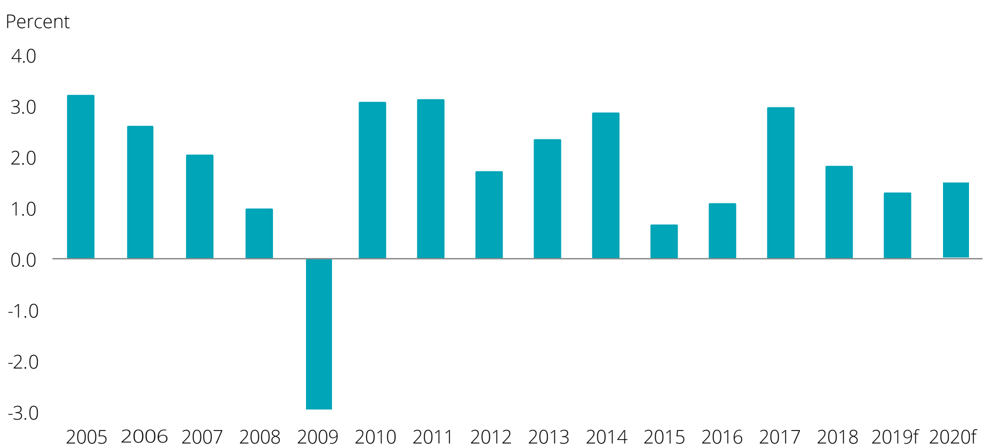
While the base case forecast is one of continued, albeit modest, economic growth, the slowdown will further fuel speculation about the dreaded R word (recession), particularly given that the last recession was a decade ago and that there are a host of new risks, such protectionism, BREXIT, and global imbalances created by the exceptionally low interest rate environment in recent years.

While we don't believe a contraction is the most likely outcome, the possibility cannot be ruled out. With that in mind, there are several things to keep in mind:

- Slowing domestic and global economic growth will affect economic sectors to varying degrees. Cyclical industries, like manufacturing and mining, will face the greatest headwinds, but organizations that better position themselves for the economic shifts can have more resiliency. Some will find that being better prepared than their competitors can create new business opportunities even in difficult times.
- Organizations need to be mindful of the risks but resist the inclination to adopt a recession bias, which may paralyze business decision-making.
- The best way to handle risks is to understand them, plan accordingly, and stay nimble to quickly adapt to changes in business conditions.

Given the prospects for modest growth and continued economic risks, companies should adopt and execute a mantra of adapt, innovate, and overcome rather than let themselves be rattled by the spectre of recession. The economy's sub-par performance also highlights the need for governments across Canada to look for ways to help foster greater economic competitiveness.

Canadian economic outlook (real GDP)



Sources: Statistics Canada, Haver Analytics, forecast by Deloitte

Global developments: financial optimism, economic pessimism

The starkest development over the past quarter is that the financial markets recovery in early 2019 has, somewhat paradoxically, taken place amid a steady stream of gloomy economic reports.

The improvement in financial market sentiment had several causes. The equity market and commodity correction in late 2018 looked excessive, creating buying opportunities. Worries about US-China trade tensions diminished, even though a resolution remains elusive. The central banks of many advanced economies turned more dovish. After hiking rates in December and suggesting more hikes were to come, the US Federal Reserve left them unchanged in January, adopting the mantra of "patience." Across the Atlantic, the European Central Bank, noting the sharp slowdown across much of the Eurozone, pushed out any potential rate hikes and reintroduced measures to promote the availability of credit. Taken together, these factors assuaged investor anxiety and helped risk-asset values recover.

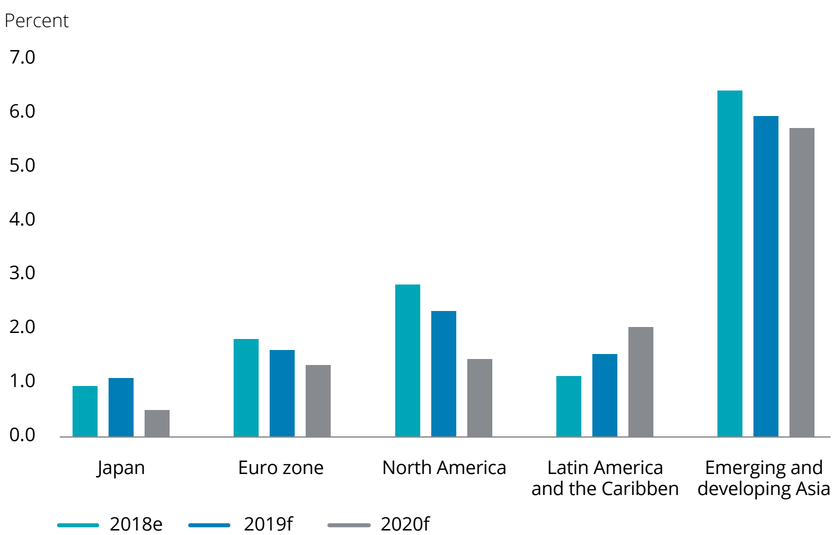
In contrast to the financial optimism, the economic news was consistently negative. Many international institutions, including the World Bank and the International Monetary Fund, lowered their global growth projections. Capital inflows improved in emerging markets, which reduced a source of economic stress, but the pace of economic growth in numerous developing nations is slowing.

In China, the largest emerging-market economy, the pace of expansion decreased in the fourth quarter to 6.4 percent year-over-year, the slowest pace since the 2008-09 financial crisis. Weaker investment and retail sales were part of the story, but the government also acknowledged that the impact of US tariffs was hurting the economy. This led to the government to lower its official growth target range in 2019 to between 6.0 and 6.5 percent. China also announced a number of stimulus measures to help support the economy, which should restrain the slowdown. We expect growth of 6.2 percent this year and 6.0 percent in 2020.

The weaker Chinese economy has spilled over to Japan through softer demand for its exports. Merchandise exports fell by 5.3 percent in January, a third consecutive monthly decline, and are down nearly 8 percent from last year. The weak start to the year follows a solid fourth-quarter performance, when the Japanese economy grew by 1.9 percent annualized. Weakness in previous quarters left the size of the economy unchanged from the previous year, with a softer inflation outlook potentially spurring more stimulus from the Bank of Japan.

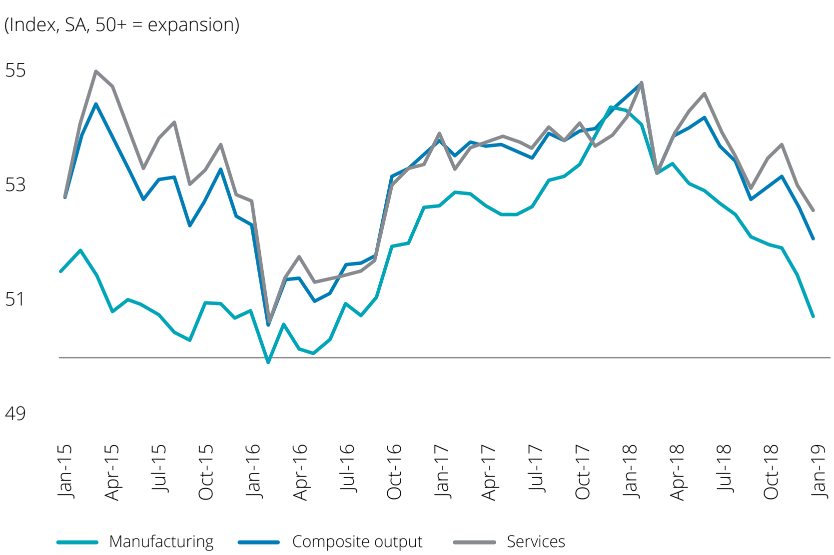
Many international institutions, including the World Bank and the International Monetary Fund, lowered their global growth projections.

Global outlook (real GDP)



Sources: International Monetary Fund, World Economic Outlook Database, April 2018.

Global purchasing manager index



Sources: Haver Analytics, JPMorgan, Markit.

Capital inflows improved in emerging markets, which reduced a source of economic stress, but the pace of economic growth in numerous developing nations is slowing.

The Eurozone economy has also lost momentum. After a 0.6 percent annualized increase in the third quarter, the fourth-quarter gain was only slightly better, at 0.9 percent. Poor external demand for the region's exports was reflected in falling business confidence. Regional purchasing manager indices have softened, implying a substantial weakening of manufacturing activity. The country details are weak. Italy recorded two successive quarters of economic contraction, while Germany's economic expansion stalled outright and expectations for its economic growth have been scaled back. For example, the German government lowered its forecast for 2019 from 1.8 percent to 1.0 percent in January, and further down to 0.8 percent in March.

The UK economy registered growth of just 0.7 percent annualized in the fourth quarter. The Bank of England has reduced its forecast for 2019 to 1.2 percent, down half a point from November. At the time of writing this report, BREXIT remains a significant downside risk to the UK economy, with possible material implications for the global economy.

The US economy continues to deliver a strong performance. After breakaway growth of nearly 4 percent annualized in the second and third quarters, growth slowed in the fourth quarter to a still-strong 2.6 percent annualized. Consumer spending remains robust, supported by a five-decade low unemployment rate and strengthening wage growth. The prospect of diminished economic slack, as evidenced by tight labour markets, was behind the Federal Reserve's tightening cycle. However, the central bank is mindful of the global slowdown and the possible adverse fallout on spending from financial market volatility, prompting it to move to the sidelines for the time being to assess how the economic outlook evolves. Our base case view is that the Fed should remain on hold this year as the US economic expansion loses momentum.

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By the end of this year, the stimulus from the 2018 tax cuts will fade. This comes at a time that US exports are being constrained by a stronger greenback, softer global demand, and any lagged fallout from retaliatory tariffs. Moreover, the diminishing pent-up consumer demand is expected to temper personal expenditure outlays. Consequently, the pace of US economic growth is forecast to slow to well below 2 percent in 2020.

Canada's economy stalls in Q4 but does not derail

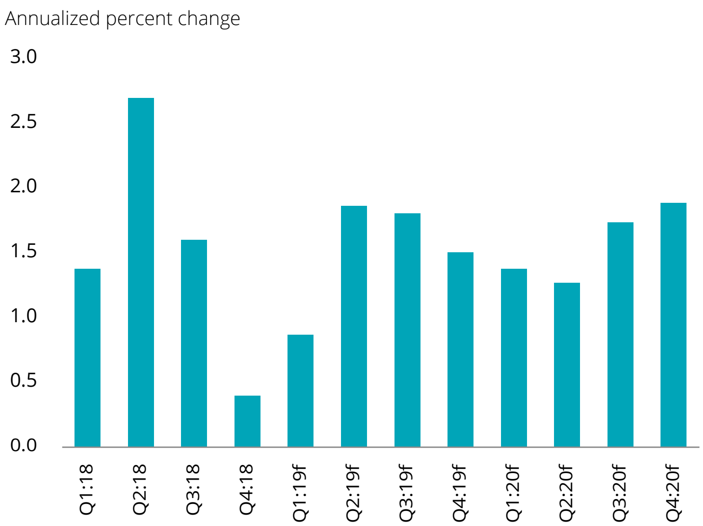
The Canadian economy stalled in the last quarter of 2018, with real GDP increasing by a mere 0.4 percent annualized in the final three months of the year. Were it not for a buildup in inventories, the economy would have contracted by an annualized 1.1 percent. The weakness was broadly based across sectors during the quarter. Moreover, real GDP declined 0.1 percent in December, creating a weak handoff into 2019.

Investment was a key source of disappointment in the fourth quarter. Residential investment plunged an annualized 14.7 percent, following a 5.5 percent decline in the prior quarter. Overall, residential construction activity declined in all but one quarter last year and is down 7.5 percent from a year ago. Real estate activity was down sharply in existing home markets last year due to tighter mortgage qualification regulations, higher mortgage rates, and increasing household debt service costs, with the softness spilling over to new housing.

Non-residential investment was another source of weakness, with a 15 percent annualized drop in structures and a 4.8 percent decline in machinery and equipment investment. After contracting in the third quarter, some reprieve was expected in the final three months of the year. Alas, this was not the case. While the drop in oil prices in late 2018 was a blow to investment in the energy patch, the decline in business investment was much broader, apparent in many industries.

Residential investment plunged an annualized 14.7 percent, following a 5.5 percent decline in the prior quarter.

Canada economic growth (real GDP)



Sources: Statistics Canada, Haver Analytics, forecast by Deloitte.

The volume of exports edged down 0.2 percent but imports fell 1.1 percent, echoing the weakness in domestic spending.

Unlike the first half of 2018, household spending did not help the economy much. With a mere 0.7 percent annualized increase in the fourth quarter, it was the weakest showing since the recession. This is consistent with our prior view that heavily indebted consumers would temper their spending, particularly on categories sensitive to interest rates such as autos and big-ticket housing-related items. Outlays on durable goods fell 2 percent in the fourth quarter, marking a third consecutive contraction. Spending on services was more resilient, continuing to advance at a 2-percent pace.

Net exports contributed slightly to economic growth, though not in a favourable manner. The volume of exports edged down 0.2 percent but imports fell 1.1 percent, echoing the weakness in domestic spending. Removing exports from the picture, final domestic demand has declined for two quarters in a row—the first time since early 2015.

As noted earlier, the $13.2 billion increase in inventory investment kept the economy afloat in the fourth quarter. However, it appears the accumulation was not desired. Inventories are already at high levels relative to sales, suggesting that de-stocking is in store in the coming quarters. This will hinder future economic growth.

Outlook: weak Q1, then better growth

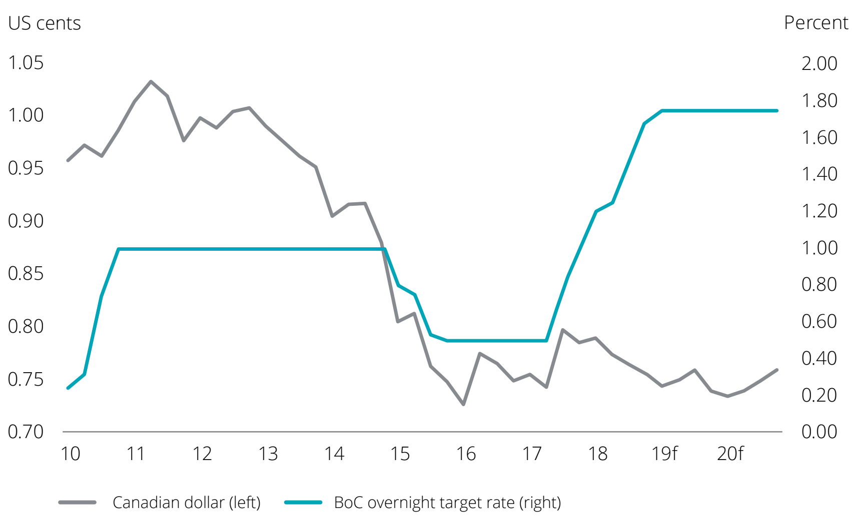
Where does the economy go from here? The contraction in residential and business investment may spill over into early 2019, but it's unlikely to be sustained. Moreover, the fundamentals for consumer spending—highlighted by low unemployment and rising income—should support higher outlays. The recent economic slowdown is also likely to keep the Bank of Canada from raising interest rates further. This will arrest the increase in household debt service costs, support real estate, and keep a lid on the Canadian dollar. In other words, economic growth should improve but a sharp rebound is unlikely.

While consumption expenditures and non-residential investment are expected to improve in early 2019, further declines in residential investment and inventory de-stocking will likely offset the gains. As such, growth in the first quarter will accelerate but the pace will remain sub-par, at close to 1 percent. As drag from residential investment diminishes and inventory stockpiles are reduced, the pace of economic expansion is projected to then strengthen to around a 2-percent pace later in the year.

While this marks an improvement, the pace is well shy of a typical rebound as heavily indebted consumers continue to moderate their spending and home-buying activity. Non-residential investment should also pick up, but the weakness in the global economy and continued risks related to the United States-Mexico-Canada Agreement (CUSMA) ratification, US protectionism, and global retaliation may weigh on business confidence. A weak Canadian dollar will support Canadian export competitiveness, but slowing global trade and world demand growth will limit the gains. The cooling in US economic growth is also likely to restrain the gains in Canadian exports.

All told, the Canadian economy is expected to grow at a sub-par 1.3 percent in 2019 and 1.5 percent in 2020. This is below the economy's long-run sustainable pace of expansion, which is estimated at around 1.7 percent given the prospects for labour force growth and labour productivity, and the resulting economic slack should keep inflation under wraps. Importantly, the modest pace of economic growth will leave the Canadian economy more vulnerable to unexpected negative shocks.

Canada financial outlook



Sources: Bank of Canada, Haver Analytics, forecast by Deloitte.

Canadian outlook by region

The provincial picture varies over the 2019-2020 period British Columbia will remain at the top of the provincial leaderboard with economic growth of a bit below 2 percent, but this is a slower pace than its the robust expansion of recent years. Ontario and Quebec will be in second and third position, with growth close to or slightly above the national average. Saskatchewan and Prince Edward Island will be only slightly below the national average.

Alberta and Newfoundland and Labrador will struggle with the fallout from last years' decline in oil prices, which have recovered but are not back to prior levels. The pace of growth in these two provinces will be a bit above 1 percent, but this is disappointing given the painful economic times in 2015-2016 caused by a prior oil shock. Manitoba's economy is low on the provincial ranking, reflecting mine closures and the completion of major construction projects.

Ontario and Quebec will be in second and third position, with growth close to or slightly above the national average.

Meanwhile, demographic pressures from aging baby boomers are particularly acute in all Atlantic Provinces. Indeed, the forecasted growth rates of 0.9 percent in New Brunswick and 1.2 percent in Nova Scotia are favourable when one makes allowances for demographic pressures.

Prepare to mine the silver lining

In conclusion, the base case outlook remains for continued modest growth, but talk about recession risks are unlikely to disappear. The odds of a Canadian economic contraction without a US recession or a hard landing in the global economy are very low. The Canadian economy is integrated into a North American production chain and is tied to global commodity markets. An economic downturn caused by a drop solely in domestic demand is likely to be mild. However, a significant downturn could materialize should weakening domestic conditions coincide with a significant external shock.

All Canadian companies and governments will be affected by such macroeconomic conditions. The industries most affected by cyclical changes in the economy include manufacturing, mining, wholesale trade, transportation, and construction. Other industries, such as retail, finance, utilities, and real estate also follow the cycle closely. Industries that are least affected include public administration, health care, and education—but being less vulnerable is not the same as being immune.

This means that each business in every industry needs a good appreciation of how sensitive it is to shifting demand. If the firm is particularly vulnerable, making a plan now about how to deal with the evolution of the economy is advised: being prepared for a challenge is better than being forced to respond in the midst of one. Businesses that are more resilient or better positioned than their competitors to deal with changing economic times can take advantage of business opportunities. And economic and financial volatility has varied effects—some organizations will benefit from a weaker Canadian dollar, while for others it poses a challenge.

Business cycle exposure by Canadian industry

Ranking of Canadian industries
Manufacturing
Mining
Wholesale*
Transportation
Construction
Admin/waste management
Professional services
Retail trade
Other services
Finance and insurance
Information
Agriculture
Utilities
Food and accommodation
Real estate
Arts and entertainment
Education
Health care
Management of companies
Government

High correlation with overall activity

Low correlation with overall activity

Canada: economic forecast

	2018				2019			
	Q1A	**Q2A**	**Q3A**	**Q4A**	**Q1F**	**Q2F**	**Q3F**	**Q4F**
Economic activity								
Real GDP ($2012)	1.4	2.7	1.6	0.4	0.9	1.9	1.8	1.5
Personal expenditure	1.5	1.6	1.3	0.7	2.0	1.8	1.7	1.6
• Durables	0.7	-1.4	-1.8	-2.0	1.9	1.5	1.3	1.0
• Services	2.4	2.7	1.5	2.0	2.1	2.0	1.9	1.8
Residential investment	-9.7	0.6	-5.5	-14.7	-8.0	2.5	1.1	0.5
Business investment	0.8	-0.5	-8.4	-9.5	-1.6	3.0	2.3	1.7
• Non-residential contruction	-2.2	-3.2	-8.0	-15.0	1.2	1.5	2.0	2.0
• Machinery and equipment	22.7	1.3	-14.7	-4.8	1.0	3.5	3.2	1.8
Gov't expenses and investment	1.9	0.9	1.6	-0.6	2.2	2.1	1.9	1.8
Exports	1.0	14.6	3.3	-0.2	2.3	2.3	1.8	0.6
Imports	4.7	5.2	-8.6	-1.1	1.8	2.1	1.7	1.4
Prices								
CPI (year-over-year)	3.3	1.2	2.6	1.1	1.5	1.3	2.2	1.8
GDP deflator	1.9	1.1	2.2	-3.3	2.5	2.0	1.9	1.8
Income								
GDP at market prices	3.0	3.7	4.4	-2.7	3.4	3.9	3.7	3.3
Personal income (year-over-year)	5.1	4.3	3.1	2.7	3.1	3.5	4.1	4.0
Pre-tax corporate profits (year-over-year)	-3.4	4.6	14.9	-16.6	-14.2	-7.1	-3.1	22.4
Labour market								
Employment	0.3	1.0	1.3	2.2	2.6	0.6	0.8	0.4
Unemployment rate (%)	5.8	5.9	5.9	5.6	5.8	5.8	5.8	5.9

* Quarterly data is presented in quarter-over-quarter annualized percent change, annual data is year-over-year percent change, unless otherwise noted.

Sources: Statistics Canada, Haver Analytics, forecasts by Deloitte.

	2020				2018A	2019F	2020F
	Q1F	**Q2F**	**Q3F**	**Q4F**			
Economic activity							
Real GDP ($2012)	1.4	1.3	1.7	1.9	1.8	1.3	1.5
Personal expenditure	1.5	1.5	1.7	1.8	2.1	1.5	1.6
• Durables	1.0	1.2	1.3	1.4	1.1	0.3	1.2
• Services	1.7	1.7	1.9	2.0	2.6	2.0	1.8
Residential investment	0.4	0.5	0.8	1.0	-2.3	-5.0	0.7
Business investment	1.0	1.0	1.9	2.0	0.3	-2.4	1.6
• Non-residential contruction	1.0	1.1	2.0	2.1	-0.9	-3.3	1.6
• Machinery and equipment	1.0	1.2	3.0	3.2	5.8	-1.5	2.0
Gov't expenses and investment	1.6	1.6	2.0	2.0	2.7	1.4	1.8
Exports	0.5	1.5	1.7	2.1	3.3	2.5	1.2
Imports	1.2	1.4	1.6	1.8	2.9	0.1	1.5
Prices							
CPI (year-over-year)	1.0	1.7	2.3	2.2	2.2	1.4	1.7
GDP deflator	1.0	1.0	2.6	2.6	1.7	1.1	1.6
Income							
GDP at market prices	2.4	2.3	4.3	4.5	3.6	2.5	3.2
Personal income (year-over-year)	3.6	3.2	3.3	3.7	3.8	3.7	3.5
Pre-tax corporate profits (year-over-year)	9.8	0.1	0.4	7.5	-0.4	-1.5	4.2
Labour market							
Employment	0.3	0.4	0.6	0.6	1.3	1.5	0.5
Unemployment rate (%)	6.0	6.0	6.1	6.1	5.8	5.8	6.1

Canada: financial forecasts

	2018				2019			
	Q1A	**Q2A**	**Q3A**	**Q4A**	**Q1F**	**Q2F**	**Q3F**	**Q4F**
Interest rates								
Overnight rate %	1.20	1.25	1.47	1.69	1.75	1.75	1.75	1.75
3-month T-bill %	1.10	1.26	1.59	1.64	1.65	1.67	1.69	1.67
2-year government bond %	1.77	1.91	2.21	1.86	1.75	1.77	1.79	1.77
5-year government bond %	1.96	2.06	2.33	1.88	1.80	1.87	1.92	1.87
10-year government bond %	2.09	2.17	2.42	1.96	1.85	1.95	2.02	1.95
Yield curve								
10-year–3-month %	0.99	0.91	0.83	0.32	0.40	0.58	0.76	0.55
10-year–2-year %	0.32	0.26	0.21	0.10	0.10	0.18	0.23	0.18
Canadian dollar								
USD/CAD	1.26	1.29	1.31	1.32	1.34	1.33	1.32	1.35
US cents	79.06	77.45	76.51	75.68	74.50	75.00	76.00	74.00

* Historical data is period average, forecasts are period end.

Sources: Statistics Canada, Haver Analytics, forecasts by Deloitte.

	2020				2018F	2019F	2020F
	Q1F	**Q2F**	**Q3F**	**Q4F**			
Interest rates							
Overnight rate %	1.75	1.75	1.75	1.75	1.69	1.75	1.75
** 3-month T-bill %	1.65	1.66	1.65	1.67	1.64	1.67	1.67
2-year government bond %	1.70	1.77	1.80	1.77	1.86	1.77	1.77
5-year government bond %	1.75	1.87	1.90	1.87	1.88	1.87	1.87
10-year government bond %	1.80	1.95	2.00	2.05	1.96	1.95	2.05
Yield curve							
10-year–3-month %	0.30	0.49	0.61	0.75	0.32	0.55	0.75
10-year–2-year %	0.10	0.18	0.20	0.28	0.10	0.20	0.35
Canadian dollar							
USD/CAD	1.36	1.35	1.33	1.32	1.32	1.35	1.32
US cents	73.50	74.00	75.00	76.00	75.68	74.00	76.00

Concluding remarks

The last few months have been a bit of rollercoaster, with the global economy shaken by some dramatic financial swings and evidence of a broad-based slowdown emerged; Canada's own economic growth sputtered and has an anemic year ahead. Businesses and governments cannot immunize themselves from economic and financial cycles. The key to remaining healthy is to understand the risks and their implications.

Since the Great Depression, the Canadian economy has experienced 12 economic cycles. Its governments and businesses have weathered them all and thrived, with the economy expanding and supporting a rising standard of living. The current economic outlook may look more challenging and business down-cycle risks do exist, but it is important not to develop a recession mindset. Remember instead that economic challenge can be a good motivator for innovation and change.

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