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FEATURE

Canada

Continued economic growth in a risky world

Craig Alexander

Growth has returned after two quarters, but the pace of expansion will be modest in the months to come and is vulnerable to global risks. This is an opportunity for businesses and executives to consider potential actions should economic conditions shift.

Overview

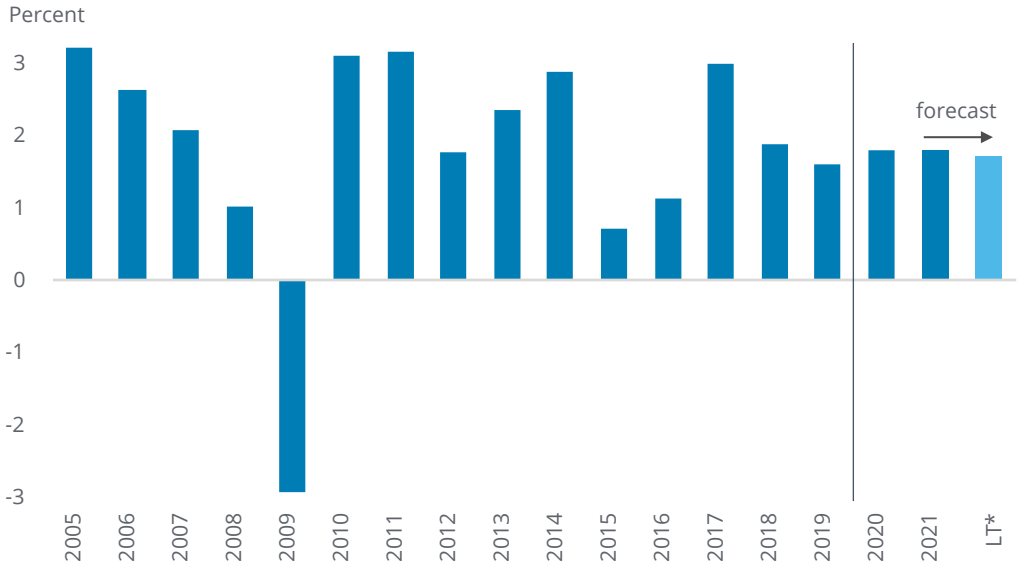
Global financial markets have been on a roller-coaster ride in the three months since our last economic outlook, with recurrent recession chatter accompanied by escalation of geopolitical uncertainty. Previously existing risks, such as the trade dispute between the United States and China and a chaotic Brexit, have been joined by political unrest in Hong Kong and mounting tensions in the Middle East. Economic information has been less volatile, and the main themes remain intact. The global economy is continuing to gradually slow, but the weakness remains limited to the manufacturing sector. Nonetheless, while the softness did not spread to other sectors, it broadened geographically, with more regions experiencing a manufacturing contraction.

Despite the rocky global environment, the Canadian economy managed to post a stellar quarter of growth, expanding 3.7 percent[1] in the second quarter (figure 1). However, most of the strength is related to a rebound from two prior quarters of virtually no growth. Abstracting from the quarterly volatility reveals a more subdued picture, with the trend pace of growth three times slower.

FIGURE 1

Real GDP growth

Despite global economic uncertainty, the Canadian economy grew 3.7 percent in Q2



* LT denotes the long-term or equilibrium rate of growth of the economy, currently estimated to be approximately 1.7%.
Source: Statistics Canada. Forecast by Deloitte Economic Advisory, as of September 2019.

Looking ahead, we expect the Canadian economy to grow around 1.5 percent in the second half of this year, yielding an annual figure of 1.6 percent for 2019. Growth is expected to improve slightly over the subsequent two years, fluctuating around our estimated long-term potential pace of 1.7 percent in 2020 and 2021. Despite low unemployment, inflation has remained in abeyance, leaving the door open for the Bank of Canada to join the club currently easing monetary policy. This group, which currently comprises the Federal Reserve and 21 other central banks, has expanded rapidly in recent months, flipping global monetary policy from gradual tightening mode to relatively broad-based easing.

A cut in the policy rate is far from assured and would at this juncture be largely symbolic. Easing policy would, at the margin, send the Canadian dollar lower and help support stock valuations. However, the associated moves are likely to be overshadowed by economic developments and commodity price dynamics. Overall, we expect the loonie to average around 75 US cents through the end of next year, helping support Canadian export competitiveness. Having said that, the benefit for net trade and investment will be partly offset by softening in overseas demand and moderation in US economic growth. Business investment will also face headwinds from escalating uncertainty and diminished confidence. And while the stabilization in Canadian housing will be supportive for economic growth, any upside for residential investment and consumption will be limited by elevated levels of household debt.

With federal election weeks away, a natural question is how its outcome factors into the outlook. The simple answer is that it does not. Election platforms are not policies, but rather proposals that may never be legislated even if the party wins. For this reason, they are not implemented in the outlook until they become well-specified and signed into law. Until such time, the status quo of currently legislated policies is assumed.

The bottom line is that economic growth should continue at a modest pace both in Canada and internationally. Importantly, it will be taking place in an environment riddled with risks—the US-China trade spat and disorderly Brexit being top of mind. A scenario where politics further damages the world economy, sparking a global downturn and dragging Canada into recession, is not implausible. At the same time, risks could very well abate, leading to a rebound in economic growth and boosting prices of commodities and stocks. A timely and successful resolution of trade frictions would substantially improve business sentiment and boost trade and investment. An orderly resolution of the Brexit process or its annulment would also improve confidence and lead to improved economic growth in Europe and beyond. While these are merely downside risks that manifested in positive growth by not being realized, it is also important to consider “true” upside risks, such as potential loosening of the purse strings by fiscally sound governments or meaningful structural reforms in economies where growth is restrained by inefficient policies. In this environment, we encourage clients to think through the potential economic scenarios and consider how they would impact their business. Just as there are hazards, every economic and financial outcome also creates opportunities that can be capitalized on by those better prepared to navigate the rapidly evolving economic environment.

Canadian outlook

GROWTH RETURNS WITH A BANG, MASKING UNDERLYING WEAKNESS

As forecasted in our prior outlook, growth returned to the Canadian economy in the spring. After two quarters of virtually no growth, economic activity

increased by a whopping 3.7 percent during the second quarter, blowing past expectations. However, much of the blockbuster gain can be characterized as a mere return to the modest pace of growth prevailing before two-quarter stalling. In fact, despite the second-quarter surge, trend real GDP growth—whether defined in year-over-year or moving-average basis—was around the mid-1 percent mark.

Moreover, details of the second-quarter report portray a far less impressive picture of the economy. Apart for the first increase in residential investment in six quarters, suggestive of green shoots in previously frozen housing, it is a challenge to find a positive element in the report. Consumption, which accounts for the lion's share of economic activity, grew by its slowest pace in seven years, expanding by just 0.5 percent (annualized), implying consumers sat out the second quarter altogether, perhaps focusing on home buying instead.

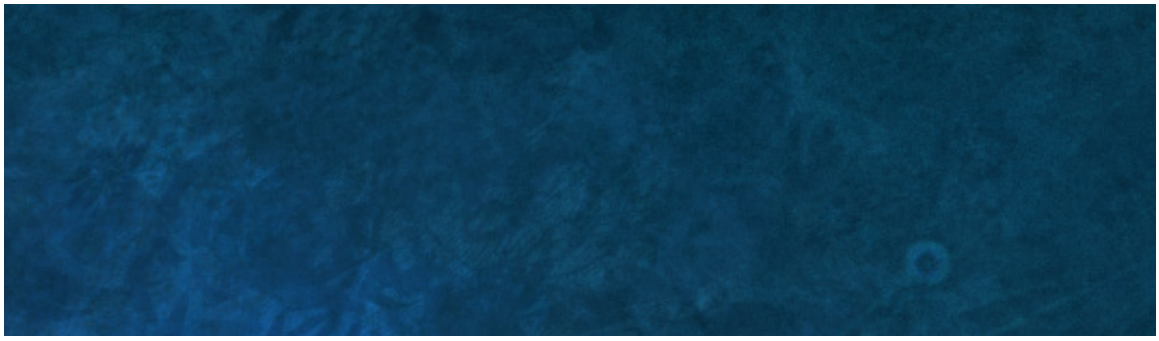
Business capital spending fared worse still. Fixed investment in nonresidential assets declined by 13.3 percent (annualized), with intellectual property the only category exhibiting growth. Spending on nonresidential structures declined for the sixth consecutive quarter, for a cumulative decline of 8.3 percent. This was largely a function of lower capex in mining, and oil & gas sector, already one-third below the pre-2015 peak as the sector reels from low prices and lack of pipeline capacity. Worse still, machinery & equipment spending fell 32 percent, giving up more than the entire prior quarter's exorbitant gain and erasing all the progress since the end of 2017.

The trade figures were too highly impacted by abnormal performance in prior quarters. Exports surged over 13 percent (annualized), as crude oil, basic chemicals, and agricultural product shipments rebounded. Somewhat paradoxically, imports decreased 4 percent during the quarter, offsetting half of the first-quarter spike, as aircraft and parts imports returned to more typical levels. The combination was favorable for growth, with net trade alone accounting for more than the entire gain in economic activity. This is true even if we strip the drag from inventory destocking, much of what was related to the decline in imports.

Ascertaining the true pace of economic growth amidst the substantial volatility of GDP can also be done by way of final domestic demand—it strips out the impacts of net trade and inventories and is arguably a better measure of underlying economic health than GDP itself. Distressingly, the gauge, which is seldom negative apart for downturns, contracted outright during the second quarter. While the decline was modest, at 0.7 percent, it is the third one in four quarters. As a result, final domestic demand was a mere 0.3 percent higher than a year ago—the slowest pace of growth since the commodity price collapse of 2015/16.

ECONOMY TO GRADUALLY CONVERGE TO ITS POTENTIAL PACE OF GROWTH

The recent volatility should give way to some stabilization in the pace of growth, as past



imbalances are increasingly cleared. Despite the expected diminished volatility, the pace of growth in the second half of the year is expected to average 1.5 percent. This sub-par performance will be held back by weak global demand and soft commodity prices. A modest acceleration to 1.8 percent is in the cards for next year, as lower interest rates shore up demand internationally and domestically.

Durable goods consumption should particularly benefit from the lower rate environment. However, given the high levels of household leverage, any increase in durables spending will be limited and would take away from less rate-sensitive spending categories. Overall, despite low unemployment and moderate income growth, spending growth will remain modest with many households limiting their accumulation of debt.

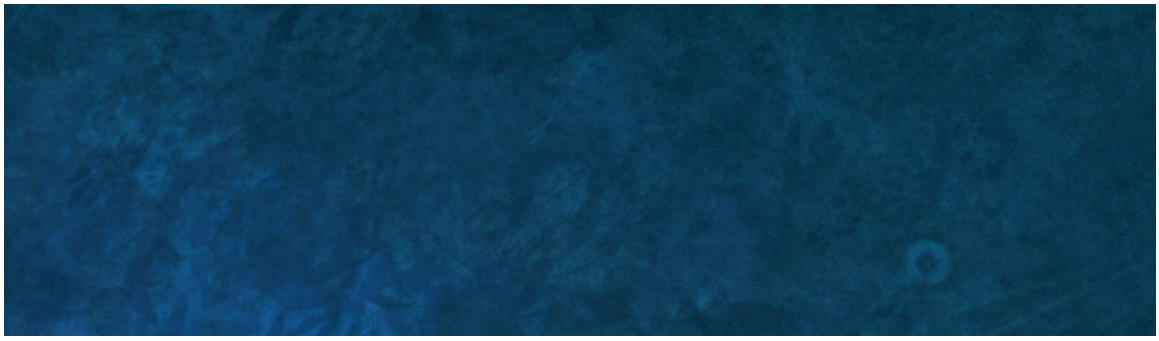
Lower interest rates should also boost residential investment. The housing market appears to have already turned the corner last quarter, removing a key domestic headwind to growth. Lower mortgage rates in an increasingly balanced market for real estate will together act to support the continued recovery in housing—with spending on furniture and appliances likely to benefit.

Export growth will remain subdued, held back by weak demand abroad. While Canada is somewhat shielded from the weakness through its reliance on a resilient American economy, growth in the United States will nonetheless slow next year as it converges to its long-term potential.

Weak global demand will also keep a lid on commodity prices that, alongside elevated uncertainty, hurt business investment. Investment has been a source of serial disappointment for years, with history repeating itself this year with the encouraging surge in the first quarter completely unwinding the following quarter. Still, the story is more nuanced that it would appear. Nearly all of the decline in machinery & equipment investment last quarter was related to the highly volatile aircraft category, which also accounted for much of the first-quarter surge. The remainder of the weakness stemmed from industrial equipment, a category tightly linked to the energy sector. In fact, stripping out energy sector investment portrays a brighter picture of business investment in Canada. Ultimately, the path of business investment will be highly dependent on the commodity price environment and business confidence.

TO CUT OR NOT TO CUT?

The Bank of Canada will face a not-so-trivial dilemma in the coming weeks and will have to carefully weigh all relevant factors before coming to a decision. While we can only speculate as to the bank's updated outlook, assessing the arguments for and against a cut may shed some light on the quandary.



All things considered, a compelling case can be made in both instances (figure 2). This leaves the door open for the bank to ease monetary policy, should the Governing Council deem it needed. At the same time, this also provides scope to keep the status quo should a patient or wait-and-see approach be deemed more appropriate for the economy. Choosing patience does not rule out future cuts should they become warranted. Ultimately, the path of policy will remain highly data-dependent, with developments judged on how, if at all, they are likely to alter the path of Canadian inflation. We have included a quarter point cut in the forecast to reflect the increased downside risks since the last forecast.

FIGURE 2

Arguments galore for both cutting the rates and keeping them unchanged

Standing pat	Token cut
Growth returned with a bang in Q2	Q2 growth boosted by transitory factors
Expansion to continue, albeit at a modest pace	Trend pace of growth closer to mid-1%
Economy continues to pump out jobs	Final domestic demand declined for third time in four quarters
Unemployment at a 45-year low	Downside risks intensifying
Inflation metrics above 2% midpoint	Signaling united front against potential downturn
Robust wage growth	Not cutting would push up loonie
Fed/ECB* cuts already felt on longer-term GoC# bond rates	Not cutting risks further inverting yield curve
Economic impact of a cut likely to be minimal	Neutral rate estimates have been declining
Keeping powder dry with policy rate already low	Preemptive cut may reduce need for later cuts

Note: * ECB denotes the European Central Bank. # GoC denotes the government of Canada.
Source: Deloitte analysis.

Provincial outlook

PROVINCIAL FORTUNES DIVERGE

The recent soft patch encountered by the Canadian economy has not been uniformly distributed across the provinces (figure 3). Despite the global slowdown being limited to manufacturing, Canada's industrial heartland fared comparatively well. In fact, growth in Quebec accelerated to 2.9 percent since late-2018—double the national pace. The Quebec economy will for the third straight year post annual growth near the mid-2 percent mark, benefitting from broad-based growth, with particular strength in housing-related industries and manufacturing, and some of the gains related to the removal of the US steel and aluminum tariffs. Ontario's metal manufacturers will also benefit from removal of tariffs, but provincial growth will trail Quebec due to a cooling real estate market. Housing will subtract nearly 1 percentage point from headline growth in Ontario, with the economy expected to grow by about 1.6 percent this year. Growth across the two economies will converge toward the mid- to high-1 percent range as both approach their potential speed limits next year and beyond.

Then again, Rest of Canada—an aggregation of the eight remaining provinces—has underperformed. While quarterly GDP figures are not available for these provinces, it is apparent from other higher-frequency indicators that conditions were weakest in the three energy-producing provinces of Alberta, Saskatchewan, and Newfoundland & Labrador. Economic growth in British Columbia (BC), which topped provincial rankings for years, has all but fizzled out given that the white-hot housing market nearly collapsed. Declining values of real estate assets have weighed on household spending, already under pressure from homeowners saddled with mortgage debt. As a result, the BC economic

FIGURE 3

Provincial growth

The recent softness in the Canadian economy was not uniformly distributed across the provinces

Source: Statistics Canada. Forecast by Deloitte Economic Advisory, as of September 2019.

expansion will slow from 2.4 percent last year to just 1.2 percent this year, before a modest rebound in 2020 as housing conditions normalize. Economic conditions are even grimmer on the Eastern side of the Rockies, where low crude prices and a large discount to global benchmarks weigh on conventional investment and drilling. Oil activity in Alberta was further reduced by mandated production cuts related to limited outbound pipeline capacity. The story also applies in Saskatchewan, albeit to a lesser extent, but the provincial economy faces significant challenges of its own, finding itself caught in the middle of the US-China trade spat by way of a ban on canola exports to China. Both Prairie Provinces will see growth slow to near stall-speed this year, before an acceleration to the 1 to 2 percent range, with the forecast highly susceptible to commodity prices. Low crude prices are also hurting investment in Newfoundland & Labrador, with the provincial economy further undermined by fiscal and demographic challenges. Nonetheless, modest growth should return to the easternmost province this year, after a 2.7 percent contraction last year.

Conclusion

EVEN A DOWNTURN OFFERS OPPORTUNITIES

The main message is that we are in the midst of a global economic slowdown that threatens to weaken Canada's growth prospects. The modest rate of expansion projected in the Deloitte base-case scenario increases the possibility that a negative shock could trigger a turn in the business cycle. What are the implications of such a scenario for Canadian businesses and how should firms respond to this economic environment?

For starters, it is crucial to understand particular business vulnerabilities to a downturn. No two firms will be affected exactly the same. Businesses better positioned to endure the most challenging environments can benefit from a downturn by seizing opportunities inaccessible to competitors. A recent *Harvard Business Review* article notes that 14 percent of publicly traded companies accelerated their growth rate and increased profitability during the last downturn.[2]

There are three types of opportunities to consider during downturns.

1. Financial: Better management of expenses, strengthening of balance sheets, and pivoting spending toward strategic objectives

2. Market: Changing product offerings and/or pivoting to new markets

3. Strategic: Positioning for growth by making structural changes, such as investing in new technology, establishing alliances, seeking mergers or acquisitions, and hiring/developing human capital

In all these cases, leaders need to be mindful of their response and consider market and customer perspectives.

Choosing among these opportunities will require careful analysis of the economic, financial, and business environments in the context of a particular firm. Among the most popular strategies is the typical belt-tightening. However, according to a survey conducted by the Bank of Canada, firms appear to have frequently utilized market and strategic opportunities even in a downturn as deep as the Great Recession.[3]

Leaders need to think holistically in terms of their operational and strategic response. Planning from an offensive position provides the impetus for a rapidly evolving mindset if, or when, a downturn occurs.

The traditional blueprint for planning looks too static for the kind of economic reality we now face.

Dynamic planning, including scenario planning, is a necessary to stay ahead of change and position an organization to quickly resolve challenges or capitalize on opportunities.

So, remain calm and approach planning and risk management from a mindset of opportunity. Start thinking now about potential actions to execute if economic conditions deteriorate. Understand that inaction or drastic nonstrategic belt-tightening in anticipation of a downtown will only make things worse.

Endnotes

1. All GDP growth figures are reported in compound annualized form.
2. Martin Reeves, Kevin Whitaker, and Christian Ketels, "Companies need to prepare for the next economic downturn," *Harvard Business* Review, April 2, 2019.
3. Lori Rennison, Farid Novin, and Matthieu Verstraete, *Firm strategy, competitiveness and productivity: The case of Canada*, Bank of Canada Review, 2014.

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Craig Alexander is the first chief economist at Deloitte Canada. Alexander has over 20 years of experience in the private sector as a senior executive and leading economist in applied economics and forecasting. Most recently, Alexander served as senior vice president and chief economist at The Conference Board of Canada, producing macroeconomic forecasts for the Canadian national economy as well as provinces, territories, cities, and industries. He holds a bachelor's degree in economics from the University of Toronto.

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