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# What We Think……

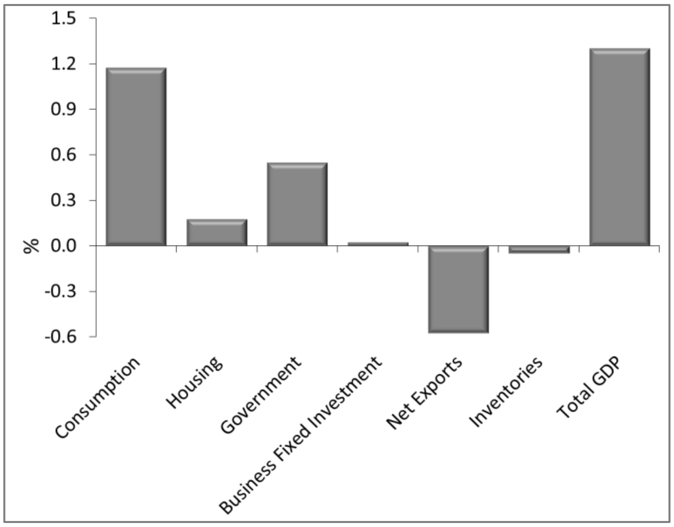
## Canada: Out-of-sync But For How Long?

It might be baby steps, but then again that may only be what is needed to set Canadian consumer balance sheets on the right track. Canada's government has taken some noteworthy policy steps to deal with some of the fiscal imbalances facing Canadians, at a time when a majority of *advanced economy* governments have been noteworthy for their disengagement. Perhaps it is the memories of Canada's own fiscal woes during the mid-1990's or the more recent debacle south of the border that have motivated the government to be pro-active. More likely it is Canada's relatively good economic environment and strong banking sector that has permitted such a response. Of course, most of Canada's peers are facing more significant economic growth hurdles that make political action difficult, if not impossible.

We believe that the economic and fiscal realities that have allowed Canada and its policy-makers to be out-of-sync with other advanced economies, Australia and parts of Scandinavia notable exceptions, are unlikely to persist. A slow-down in the domestic economy will mean that the government will find dealing with the deficit more challenging. Canada has one of the lowest Debt to GDP numbers amongst its peers, but its Deficit to GDP is still significant at 4.5%. Real GDP growth in Canada has averaged 1.20% for 2009-12, outpacing U.S. growth of 0.83% and Eurozone growth of -0.34% (including IMF projections for 2012), and has allowed Canada to maintain relatively low debt to GDP. If, as we expect, Canadian growth continues to slow, Canada's deficit and debt to GDP will be much harder to control, as tax revenues can be expected to decline and demand for government services likely continue to increase.

While many governments have chosen or been forced to rely heavily on their central banks to tackle economic and fiscal problems, the Bank of Canada has been noticeably inactive. To be sure, Governor Carney has paid lip service to deteriorating consumer finances and the lack of corporate capital investment, but as for active policies, the Bank has remained on the sidelines. (The biggest controversy surrounding Governor Carney has mostly been about the nature of his next job.) In what has been a relatively healthy Canadian economy, the Bank has defaulted to a traditional inflation-fighting role. In fact, officially, the Bank of Canada has maintained a tightening bias on the basis of its perception of a declining output gap. However, in reality, the Bank has been on hold for the last 24 months, repeatedly extending its time frame because of events largely outside of Canada. We believe that the Bank of Canada will surprise many with an about-face that will indicate its next rate move is down and not up.

**Figure 1 – 4 Year Average GDP Growth Contribution**




*Source: Bank of Canada Monetary Policy Reports & Lorica Investment Counsel Inc.*

Why will growth slow? The primary drivers of the Canadian economy since 2008 have been domestic consumption and housing. Figure 1 provides a breakdown of contribution to growth from the different sectors. In terms of employment, consumption and housing have contributed 24%[1] of job growth since 2008, surpassing all other sectors, save health care, by a significant margin. However, as spending has soared so too have consumer debt levels; see Figure 2. Prior to the U.S. housing bust, Canadians had far better

1 Consumption and housing is made up of Statscan categories from CANSIM 282-0009: Occupations in art, culture, recreation and sport; Sales and service occupations; Trades, transport and equipment operators and related occupations.

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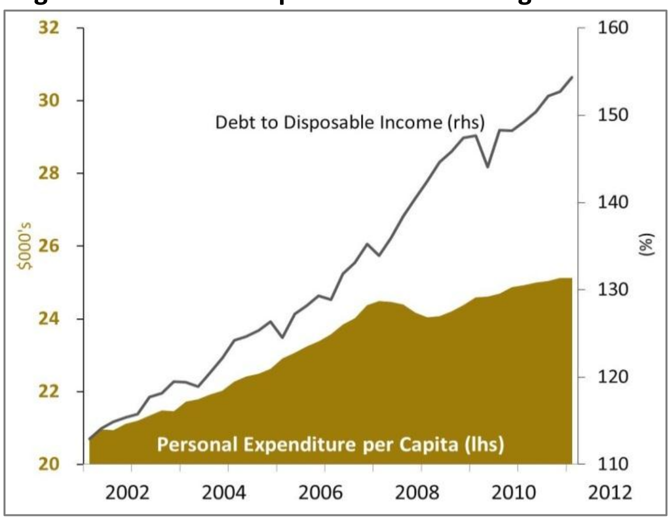
debt fundamentals than our American neighbours. However, this also meant that Canadians could be far more responsive to aggressive monetary policy – clearly something not possible in the U.S. The deterioration of Canadian consumer debt fundamentals has not been lost on Canadian policymakers, but with Canadian monetary policy handcuffed by the easy policies of the Bernanke Fed, the Bank of Canada has been relegated to the sidelines.

**Figure 2 – Personal Expenditure vs Leverage**




*Source: Statistics Canada & Lorica Investment Counsel Inc.*

The *macro-prudential* policy changes in the mortgage market (shortening of maturities and raising down-payments for government insured mortgages) that were designed to begin repairing consumer balance sheets, will continue to have a negative impact on growth. Although the cumulative effect of *macro-prudential* rule changes since late 2008 had already impacted the housing market, the most recent changes have had the most significant impact on prices and volume of sales, especially at the higher end of the market. In addition, there has been an increase to the supply of single family homes and the inventory of unsold condominiums has also begun to build. We don't anticipate any more policy moves, and in fact would be surprised if there wasn't some amount of criticism levelled at the most recent policy changes, made on behalf of a decelerating housing sector.

We admit to having underestimated the resilience of the Canadian housing sector in the past, but that was when both consumer fundamentals and affordability were more favourable. That is not the case today, so we are convinced that the housing slowdown is real, and that housing and related consumption will now play a less significant role in Canada's growth.

The secondary driver of the Canadian economy since the 2008 has been commodities. Fortunately for Canada, developing demand from emerging market economies and persistent Middle East supply issues have offset the decline in demand from advanced economies. Canadian oil exports have benefitted as energy prices have remained relatively high. Natural gas has been more complicated as discoveries in the U.S combined with new fracking technology have hit local prices. The metal sector, an important component of Canada's exports, has suffered as prices have been weak. Forest products have provided some support as lumber volumes and prices have benefitted from the housing market improvements in the U.S. Overall, we expect less contribution to the Canadian economy from the commodity sector going forward – the recent move of the Bank of Canada Commodity Price Index which has trailed the move of the broader S&P Goldman Sachs Commodity Index supports this view.

Finally, manufacturing cannot be counted on to make up the slack created by a decline in consumption. Since 2008, 89,000 jobs have been lost in Canada's manufacturing sector, and there is nothing to suggest that a rebound is imminent. Depending upon where you stand the Canadian dollar has been either a casualty or beneficiary of the easy monetary policies of advanced economies. Manufacturing has certainly been a casualty as shown by the historical trend in exports plotted against the currency (inverse) in Figure 3. The stories of manufacturing renaissance, to combat higher transportation costs and take advantage of slack labour markets, are taking place (although less than advertised) in the U.S., but not in Canada. Manufacturing-rich provinces such as Ontario and Quebec have felt the pain of lost jobs and the higher burden on social services.

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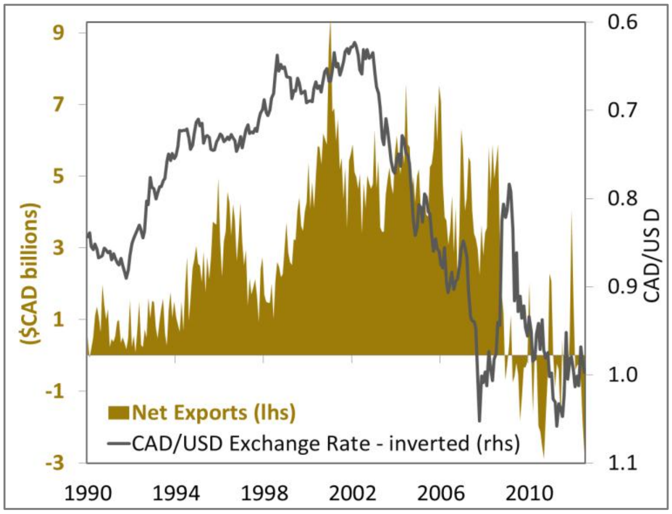
**Figure 3 – C$ vs. Net Exports (Canada)**

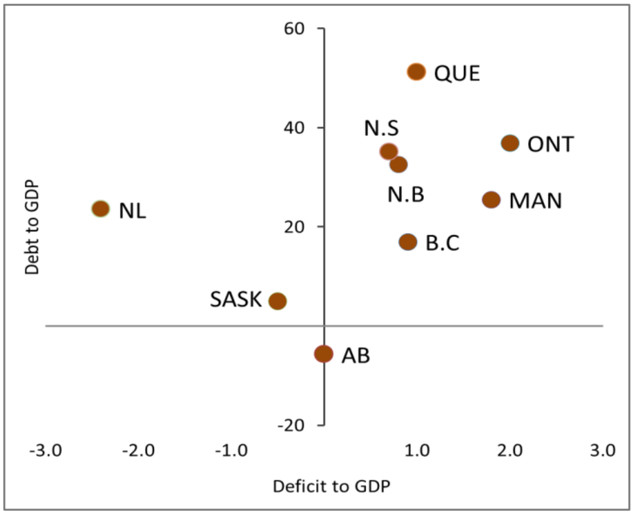



*Source: Bloomberg, Statistics Canada & Lorica Investment Counsel Inc.*

As for the service sector, there are some bright spots – technology and health care to name a couple. However, as with commodities services are also a mixed bag. Parts of the private sector are expanding and hiring, while other parts are maturing and declining through attrition. More germane than private sector services is the state of government services. At the provincial level, many governments have significant deficit and debt problems – notably Ontario is suffering under the weight of a bloated deficit and Quebec under the weight of a sizeable debt load. See Figure 4. Provincial spending, which makes up 54% of all government spending, can only decline and consequently will have a detrimental impact on domestic growth.

In general, we don't believe we are at a point in time, where Canada can rely on the global economy to offset a domestic economy that is getting back in-sync with other advanced economies. Yes, we have commodities that the developing world, notably China, finds attractive, but emerging market economies are not immune to the problems facing the U.S., Europe and Japan. As long as the global economy continues to be dragged down by problems in advanced economies, we don't expect Canada to be able to rely on outside economic forces to maintain the growth rates of the last few years.

**Figure 4 – Provincial Debt and Deficit to GDP**




*Source: RBC Economics Research & Lorica Investment Counsel Inc.*

We expect central banks to maintain their aggressive easy monetary policies, and we believe the Bank of Canada will eventually get back in-sync with its peers. See Figure 5. The Bank has been on the sidelines and has convinced many investors of the hawkish case for its next move; see the sidebar for OIS probabilities. We don't believe their conviction in this regard, but understand that a hawkish stance has served their purposes well – over-leveraged consumers have not needed any more encouragement to borrow. But we expect that the Bank's next interest rate move will be down, but only after there is enough evidence of a broader slow-down. Unlike the U.S. and the U.K., the Bank has room to move lower, removing any need for quantitative easing.

In July, 10-year Government of Canada yields hit an all-time low of 1.58%. Since then, yields have bounced higher and now sit at around 1.8%; U.S. 10-year Treasury yields are lower at around 1.7%. However, the Canadian and U.S. yield curves present a slightly different picture. U.S. overnight rates are at rock bottom: 0-25 basis points, and will be held there for an extended period – through mid-2015. Canadian overnight rates are at 1% with around 25% probability of an increase next year. Also, U.S. Government long-term yields, at 2.85%, have suffered under the weight of poor U.S. fiscal fundamentals and are higher than long term Government of Canada yields at 2.4%.

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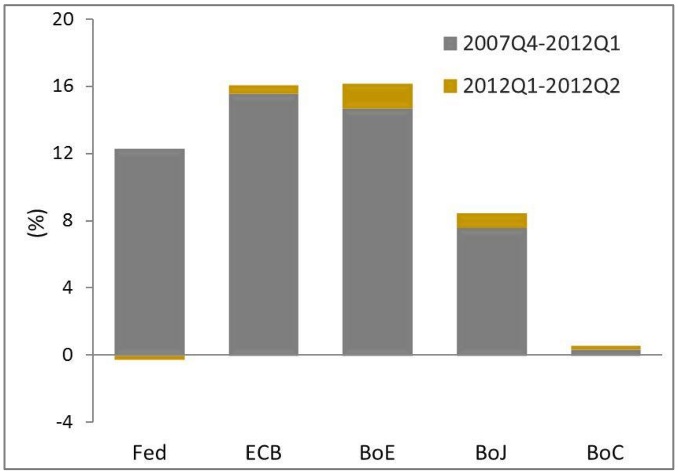
The U.S. Treasury yield curve is much steeper than Government of Canada yield curve, and should remain that way for some time. However, consistent with our view for a lower Bank of Canada rate, we expect the Canadian yield curve to steepen relative to the U.S. yield curve – the Canadian 2-30 years yield curve should steepen by at least 25 basis points over the next few quarters. Such a yield curve shift should present opportunities for active bond investors who are willing to anticipate such changes through duration positioning of their portfolios.

**Figure 5 - Change in Central Bank Reserves**




*Source: Bank of Canada, U.S. Bureau of Economic Analysis; U.S. Federal Reserve; Eurostat; European Central Bank; U.K. Office for National Statistics; Bank of England; Cabinet Office, Government of Japan; Bank of Japan & Lorica Investment Counsel Inc.*

Canada's economy has certainly been resilient in the years since The Great Recession – a well-regulated financial sector, responsive housing market, and broad range of natural resources have combined to keep the unemployment rate among the lowest of advanced economies. Unfortunately what has worked since 2008 will not as easily work going forward – domestic consumption and housing will likely slow. However, Canada as a net exporter of raw materials should continue to benefit from demand coming from emerging market economies. Finally, we would expect the Bank of Canada, which has been safely on the sidelines, to respond to any deterioration in economic fundamentals with more accommodative policies.

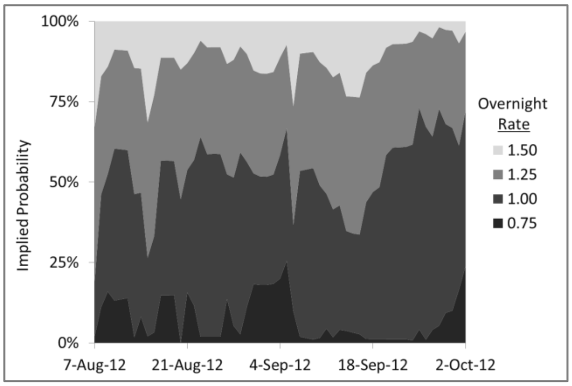
## OIS – Overnight Index Swaps

An overnight index swap (OIS) is an over-the counter derivative in which two parties agree to exchange, or swap, for an agreed period, a fixed interest rate determined at the time of the trade for a floating rate that will vary over time. In this regard, OIS contracts are similar to traditional fixed-floating interest rate swaps. The distinguishing feature of the OIS is that the floating rate is the Canadian Overnight Repo Rate Average (CORRA) over the period[2].

… "If the duration of the swap extends over a FAD [Fixed Announcement Date – Bank of Canada overnight rate], for example, the difference between the fixed rate and the current overnight rate can be used to calculate the market expectations of a future change in policy rates."[3] …

The graph taken from the OIS data indicates market expectations at around 75% probability that the overnight rate in Canada will be equal to or higher than the current 1% rate, one-year out.

**Canada Overnight Index Swap Rate: Implied Probability – 1 Year Out**




*Source: Bloomberg & Lorica Investment Counsel Inc.*

[2] Christopher Reid, Financial Markets Department, "The Canadian Overnight Market: Recent Evolution and Structural Changes", Box 1: "The Overnight Index Swap Market", *Bank of Canada Review*, Spring 2007, pp. 17-18.
[3] Ibid., p. 18.



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