ECONOMICS | RESEARCH

ECONOMICS DIGEST

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Current trends...

Canadian economy still robust

▲ Canada's economy grew at a 2.9% annual rate in the third quarter, only moderately slower than the 3.8% second-quarter pace and first-quarter 3.5% increase. The strength in the third quarter came from the domestic economy, which has been the mainstay of Canada's economic growth during the past several years.

▲ Job growth beat expectations once again in November, with 42,600 jobs created, trouncing forecasts for an 8,000 job gain. The job market has generated 388,200 new jobs so far this year and the pace of wage gains has accelerated strongly from the tepid 2.3% average increase in the first quarter to the 4.2% average pace in October-November.

▲ Retail sales fell 0.2% in September for the third time in the past four months, largely driven by a 1.3% drop in sales by new car dealers. The decline in real retail sales and the only modest increase in manufacturing shipments in September point to moderating GDP growth in the month.

▲ Housing starts were essentially unchanged in November, coming in at a 227,900 annualized pace compared to 227,600 in October. The average level of housing starts activity year-to-date has been the highest since 2004. Our forecast assumes that starts will trend lower, eventually averaging a little above 200,000 in 2008.

▲ The merchandise trade surplus widened to $3.3 billion in October as exports inched lower by 0.5% and imports dropped 2%. After shaving 4.8 percentage points from third-quarter economic growth, drag from the trade sector and slower domestic demand will slow GDP growth again in the fourth quarter.

▲ Canada's core inflation rate moved to its lowest level since April 2006 in November, and held below the 2% target for the second month running. The all-items inflation rate will likely remain above the Bank of Canada's 2% target in the near-term, but continued discounting by Canadian retailers will keep the core rate below the 2% target.

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Financial markets...

More rate cuts coming from the Fed and Bank of Canada

▲ The ongoing turbulence in financial markets is affecting the outlook for U.S. and Canadian economic growth. U.S. real GDP growth is expected to slow to a pace of 1% to 1.5% over the next three quarters, while Canada's economy gears down to grow at less than a 2% pace, much slower than the 3.4% average rate in the first three quarters of the year.

▲ This has led us to revise our interest rate forecasts downward. We now expect the U.S. Federal Reserve to lower the Fed funds rate by a further 75 basis points to 3.75% over the next three meetings. This is a change from the 25 basis points of easing in our previous forecast.

▲ The combination of slower U.S. growth, volatility in global financial markets and moderating inflation rates saw the Bank cut the overnight rate by 25 basis points in December, and we expect another 25 basis-point rate cut in January. A month ago, we expected the Bank to cut the overnight rate by only 25 basis points.

▲ Our expectation that the trade drag will continue to be substantial in coming quarters and that domestic demand will slow as the tightening in credit conditions takes a bite out of household and business spending means that the Bank will edge the policy rate lower in early 2008 as the economy shifts into a lower gear.

▲ U.S. third-quarter GDP growth was revised up to a 4.9% annual rate from an already-robust 3.9%, implying that the economy had solid momentum as the tightening in credit conditions hit.

▲ The deepening in credit market tightening and persistent financial market volatility mean that households and businesses are likely to remain nervous and risk-averse heading into 2008. We expect that the U.S. economy will eke out a growth rate of 1.5% in the first half of next year.

▲ In this environment, the Fed will likely put inflation concerns on the back burner and focus on mitigating the downside risks to the economy. The Fed will likely lower the funds rate by a further 75 basis points; this, combined with a government-led program to limit future mortgage defaults should be enough to stave off a recession and support stronger growth in the second half of 2008.

Policy action to produce stronger growth in the second half of 2008

▲ Both the Canadian and the U.S. economies are expected to reaccelerate around mid-year 2008 as the lagged effects of the rate cuts revitalize household and business spending, the U.S. housing market recession eases and financial market turbulence ends.

▲ Our forecast is for the U.S. economy to grow at an average 2.5% pace in the second half of 2008, much faster than the 1.5% average pace expected in the first six months of the year. As the downside risks to the economic outlook recede, the Fed will begin to pare back the amount of monetary policy stimulus, with 50 basis points of rate increases pencilled in for the final half of the year.

▲ The expected rebound in the U.S. economy in the second half of 2008 will remove some of the downside risk to Canada's economic outlook and will limit the drag from the trade sector by bolstering export demand. The Canadian dollar is also likely to slowly give back some of its 2007 gains, setting up for the economy to grow at a rate more in line with its potential.

▲ We are forecasting that the overnight rate will rise to 4.25% in the final quarter of 2008, with market interest rates of 4.25% for the two-year maturity and 4.7% for the 10-year maturity.

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Provincial trends...

East-west provincial growth gap already on a narrowing path

There is now compelling evidence that provincial regional growth disparities likely peaked in 2006. A narrowing in the provincial growth gap is expected to occur amidst what we now expect to be a considerably softer national growth profile in 2008 as an increasingly large drag from the trade sector weighs down economic growth.

Central Canada remains under significant downward pressure, particularly with the renewed strength in the Canadian dollar, elevated commodity prices and an even more prolonged slowdown south of the border. So, the narrowing we expect in the growth gap is not because the growth laggard (Ontario) will pick up pace in the near-term, but rather because the growth leader (Alberta) appears to have reached a cyclical growth peak.

The slowing trend in the west is now apparent across several key sectors, including labour and housing markets, inflation and non-residential activity. Saskatchewan lagged the resource provinces on growth and only started to show signs of a pick-up in 2007. However, the other resource provinces are off their 2006 peaks as house price gains moderate from lofty levels, construction activity cools from recent highs and job growth slows, although it remains at healthy levels. In this report, we track each province's year-to-date performance across these four categories.

British Columbia — Labour markets are holding up with job growth tracking at just above 3% so far this year compared to last year. Wage growth peaked in the early part of 2006 and has since slowed. Renewed downward pressures have hit the economy as a depressed forestry sector has been further restrained by the prolonged slowdown in U.S. housing markets.

Alberta — The province still holds the top spot on growth across many key indicators, but the pace of expansion in many of these indicators has shown clear signs of slowing. Job growth is running at a 5% year-over-year pace, but the rate of wage growth has decelerated. On the housing front, resale activity has been on a slowing path for the last seven months. We expect volatility in these indicators going forward, but the slowing direction of the trend is now apparent.

Saskatchewan — Housing starts are up 65% year-over-year so far in 2007 — by far the strongest growth rate among the provinces. Annual house price growth accelerated in the last four quarters from a low of 5% to nearly 40% in the third quarter of 2007. Job markets are reporting healthy gains and have supported a pick-up in wage growth. But, with house prices growing at 10 times wages, prospective homeowners will continue to be priced out of the market, reducing the demand for new housing.

Manitoba — Manufacturing shipments are up 11% so far this year compared to a year ago — the second highest rate of growth in the country after Newfoundland. Job growth picked up to 2.4% year-over-year in October. Construction, manufacturing and public administration are the sectors currently tracking the strongest year-to-date growth in job gains this year. The unemployment rate is holding close to the 4% mark and is exerting sustained upward pressure on wages.

Ontario — Renewed challenges, including the strength of the Canadian dollar, elevated commodity prices and a slowdown in the U.S. economy, continue to weigh on the province's export-oriented manufacturing sector. Broader economic weakness is showing up across several sectors. Manufacturing shipments are flat, retail sales are soft and have been dragged down by recent weakness in motor vehicle sales, and housing starts are down almost 10%. Strength in the service sector continues to fuel the economy and provide a powerful offset to goods sector weakness.

Quebec — Despite several challenges facing central Canada, the province is tracking fairly well across several key indicators. Year-to-date, manufacturing shipments are up almost 4%, wholesale trade is up 6%, retail sales are up 4.4% and housing starts are up 8%. A generally balanced housing market has been supportive of healthy, but modest, price gains. House prices continue to grow consistently in the 5% to 8% year-over-year range. Healthy job growth has helped push the unemployment rate down almost a full percentage point in the last year from 7.7% a year ago to 6.9% in October.

New Brunswick — Third-quarter job growth was up 3.2% year-over-year — the fastest quarterly pace in three years. A pick-up in job gains has also led to higher earnings growth. Wage growth has been holding above a 4% pace for the last four months and has been on an accelerating path for more than a year. Unlike most of the other manufacturing-oriented provinces, the strength in the province's jobs numbers is actually coming from the goods sector. The agriculture, forestry, utilities, manufacturing and construction sectors are all reporting more jobs so far in 2007 compared to the same period a year ago.

Nova Scotia — Residential construction is slowing and is down 8% so far this year compared to a year ago. Non-residential construction has also been weak in the past few quarters but should benefit next year from the construction start-up of major capital projects. Job markets are holding up better than in 2006, tracking at a 1.3% year-over-year pace so far in 2007. The rate of wage gains is on the softer side compared to the other provinces but is still in a healthy range.

Prince Edward Island — Construction markets on the Island are contracting. Residential construction is down 27% so far in 2007. Non-residential construction has posted double-digit declines on a year-over-year basis for the last four consecutive quarters. The resale portion of housing markets, however, is holding up well, with prices up just above 8% so far in 2007. Healthy housing markets are supporting the consumer with retail sales growing at a greater than 10% year-over-year pace for the last four months.

Newfoundland — Manufacturing shipments are up 24% so far this year — the strongest pace in the country. Construction markets are holding up, although we expect them to soften into next year. Investment in non-residential construction was up 30% year-over-year in the third quarter of 2007. Housing starts are up 5% since the start of the year and resale prices are up about 4%. Retail sales are tracking at 10% year-over-year in 2007, supported by solid wage growth during the last few months.

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City trends

Commercial real estate market momentum poised to soften

The current cycle's momentum in both residential and non-residential real estate markets now appears to have peaked with a slowdown expected over the coming quarters. A combination of stresses will slow the pace of corporate profit growth and contribute to a slowdown in commercial construction markets, including a sharply stronger Canadian dollar, tighter credit conditions that imply slightly greater restraint on business investment in the near-term, a rising cost environment due to labour shortages and higher input costs, and a housing-led slowdown in the U.S. economy that will continue to reduce demand for many Canadian goods and services.

Non-residential investment to slow but not stall

Non-residential investment clocked in a 13% growth pace in 2006. In reaction to strong demand, there has been a substantial increase in the supply of commercial properties that have come to market in the last few years, with the downtown cores of Toronto and Calgary leading the pack. Commercial markets have responded and have recently started to show signs that they are returning to more balanced positions. As this re-balancing continues into 2008, we anticipate a slowdown in the pace of non-residential investment from last year's double-digit growth to something closer to the 6% range in the next two years. However, we are still bullish on public spending prospects, with most provinces expected to get a sizeable capital expenditure lift from the public sector.

Non-residential permits still indicating more strength ahead

The issuance of permits provides a good gauge of forthcoming activity existing in the pipelines. Non-residential permits are up 22% on a year-to-date basis with all three subsectors — commercial, industrial, and institutional and government — posting solid growth in the value of permit issuance. A year-to-date tracking shows that commercial permits are up 27% compared to the same period last year and actual commercial investment is up 20% with growth broadly spread across cities. However, rising costs, increased supply and overall softer economic growth are all expected to contribute to tempering the current momentum in real estate markets.

Land-constrained downtown office markets tight

Office space in the downtown core in many cities has tightened significantly in the last few years. Vacancy rates in many key cities have been trending lower since 2005, with the majority of the drop in vacancy rates reported through 2006. The insatiable oil-linked demand for Calgary office space drove the average rental rate for a downtown Calgary office above Toronto's in 2007, making it the most costly market in Canada. Vancouver's market still lurks behind both Toronto and Calgary on rental costs for downtown space, but on a valuation basis it remains the most expensive. Capacity pressures in Edmonton's market have seen its rents increase aggressively, placing it middle-of-the-pack among major Canadian cities. Saskatoon and Regina are still well below average rental costs despite a significant momentum pick-up in their local economies. These two cities are gradually becoming more expensive but, in terms of affordability, still remain at the low end and are well-positioned for strong investment growth in the year ahead.

Labour and supply shortages fuel a rising cost environment

The persistent strength in the non-residential building construction market has caused the cost of labour and building materials to soar. The largest year-over-year increases in building costs in the third quarter were reported in Edmonton (up 18%), Calgary (up 17%) and Vancouver (up 13%). It was the commercial component of non-residential construction that led the overall pace of increase. The cost environment in cities in central and eastern Canada was more modest compared to the west but still up roughly 5% year-over-year in the third quarter. Wage growth has also been accelerating as labour shortages pose significant challenges to company operations.

Capitalization rates

Vancouver has the lowest cap rate among the big cities, sitting at 5.5%. Calgary is the only other city with a cap rate below 6%. Vancouver has traditionally been an expensive market, but the shift in Calgary's market has been quite dramatic. Regina's cap rate of 8% shows that it still offers relatively inexpensive office real estate on a valuation basis. The remaining major cities hover between 6%-7%. The attractive capitalization rates and low rental costs in Saskatchewan's market will likely draw strong growth into its commercial market in the coming year, while lower capitalization rates in Alberta and British Columbia will restrain the pace of current activity.

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