

# BDC's MONTHLY ECONOMIC LETTER

November 2009



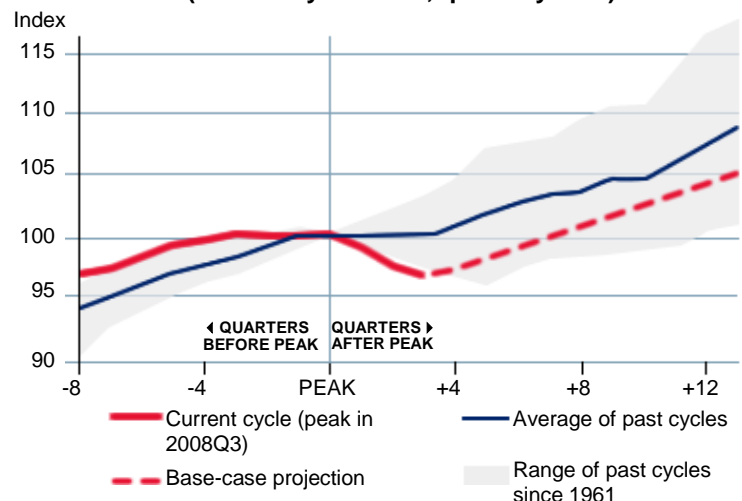
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## Canadian Recovery is Underway

- According to the Bank of Canada's October *Monetary Policy Report*, recent indicators point to the start of a global economic recovery, but significant fragilities remain.
- The Bank notes that a recovery in economic activity is also underway in Canada. This resumption of growth is supported by monetary and fiscal stimulus, increased household wealth, improving financial conditions, higher commodity prices, and stronger business and consumer confidence.
- However, the Bank expressed concerns that heightened volatility and persistent strength in the Canadian dollar are working to slow growth and subdue inflation pressures. The dollar's current strength is expected, over time, to more than fully offset the favourable developments since July.
- Given these factors, the Bank now projects the Canadian economy to grow by 3.0% in 2010 and 3.3% in 2011, after contracting by 2.4% this year. This is a somewhat more modest recovery in Canada than the average of previous economic cycles.

**Comparison of Canadian real GDP across business cycles  
(Peak of cycle = 100, quarterly data)**



Sources: Statistics Canada and Bank of Canada

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## Canada

- Canadian economy sheds 43,200 jobs in October
- Canadian real GDP contracts in August
- Retail sales rise 0.8% in August
- Manufacturing shipments drop 2.2% in August

## United States

- Federal Reserve slightly more upbeat
- U.S. economy loses 190,000 jobs in October
- Q3 real GDP growth signals end of U.S. recession
- Manufacturing index surges to 55.7 in October

## Canada: Credit Markets

The Bank of Canada's October *Monetary Policy Report* states that Canada's overall financial conditions continue to improve and to be more favourable than those in most other advanced economies.

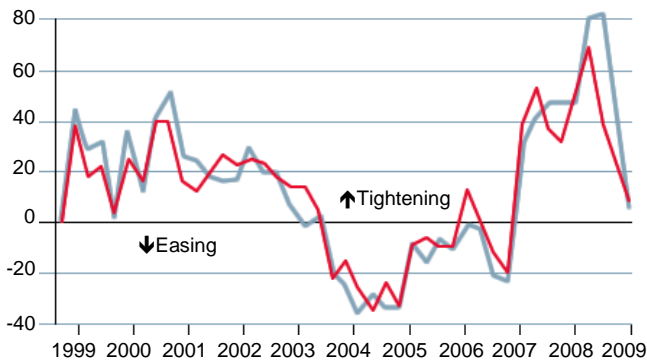
The Bank also notes that funding costs for Canadian banks remain at very low levels and that, unlike other advanced economies, Canadian consumers can readily obtain credit.

In contrast to household credit, business credit has been very weak recently, registering a modest decline in the three months to August. Sluggish business credit mainly reflects the weak outlook for business investment and the constrained availability of credit.

For larger corporations, the situation has improved over the past few months, as indicated by the strong issuance activity in the Canadian corporate bond market. Borrowing costs for Canadian businesses have fallen further in recent months, mainly as a result of the drop in corporate bond rates.

In October, the Bank of Canada's *Business Outlook Survey* (BOS) and *Senior Loan Officer Survey* (SLOS) both showed credit tightening was less prevalent in the third quarter of 2009 but credit conditions remain tight, especially for smaller companies, which continue to face a challenging environment.

**Price and non-price lending conditions:  
Balance of opinion from Senior Loan Officer Survey**



Source: Bank of Canada

- Non-price
- Price

## Canadian Economy

### Canadian economy sheds 43,200 jobs in October

- The Canadian economy lost 43,200 jobs in October, erasing September's 30,000 gain, and the unemployment rate rose to 8.6%, retracing most of September's easing. The net job losses were entirely in part-time workers and most of these net layoffs occurred in service industries where retail and wholesale trade shed 31,000 jobs. Overall hours worked declined by 1%, with the strongest decline in hours suffered by the goods-producing industries. The report points to lingering uncertainties and ongoing restructuring pressures. Despite the job losses, the three-month trend in employment is still positive, pointing to a recovery, but given the slack in the economy, job gains will be modest in the fourth quarter and the unemployment rate will continue to rise.

### Canadian real GDP contracts in August

- The Canadian economy contracted by 0.1% in August. Much of August's weakness can be attributed to a 1.9% contraction in mining and oil and gas extraction activity. Meanwhile, manufacturing was down 0.7% as exports fell for the month, largely owing to an appreciating Canadian dollar and soft foreign demand. These declines were largely offset by strength in the domestic economy. Construction activity was up 0.2%, the first increase in over nine months, while retail activity was up 0.3%. Finance, insurance and real estate activity remained strong for a seventh consecutive month, largely benefiting from an active existing housing market. While economic activity should bounce back in September, the strong Canadian dollar and mild U.S. recovery will continue to weigh on the export-oriented manufacturing industry, dampening prospects on the potency of Canada's third quarter rebound.

### Retail sales rise 0.8% in August

- Retail sales rose 0.8% in August. Rebounding automotive expenditures accounted for the bulk of the monthly uptick, with rising pump prices fuelling a 3.9% increase in gas sales and new vehicle purchases up 2.2%. Retail sales of home-related goods fared strongly in August, with sales of building supplies and furniture on the steady mend. This assuredly owes to the strong pace of home resales and related household borrowing that we have observed in the past months. Although still well below year-ago levels, the trend for sales growth remains firmly positive, pointing to a continuing recovery in Canadian consumer expenditure. Rebounding consumer spending is being propelled by the strength in housing-related expenditures. The relative strength in consumption is happening while exports decline, showing a greater reliance on domestic demand to sustain recovery during the near term. Looking forward, consumption should build steadily as incomes improve and households gain confidence.

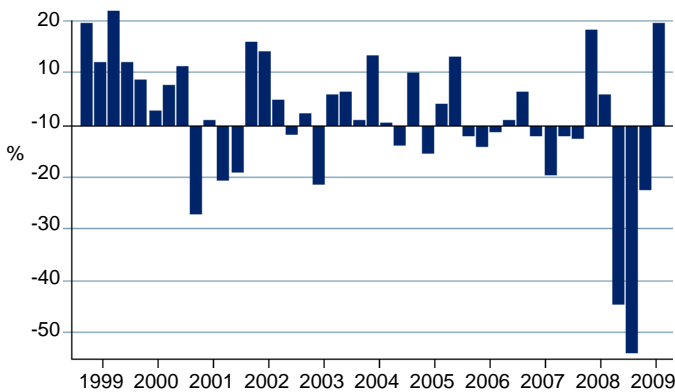
### Manufacturing shipments drop 2.2% in August

- Manufacturing shipments declined 2.2% in August following a 5.2% gain in July. August's gains and losses were roughly balanced across the manufacturing sector, with 13 out of 21 industries (accounting for 55% of shipments) in decline. The highly volatile aerospace industry accounted for the bulk



of the monthly pullback, but motor vehicles also eased by 6.3% following a gain of 48.8% in July which was largely attributable to the “cash for clunkers” program. With the U.S. program ending in August, motor vehicle shipments were expected to slip. Shipments of metals also declined after gains in July. Offsetting these declines was a 7.2% gain in petroleum and coal shipments. Substantial inventory drawdowns continued in August, but the decline in sales pushed the inventory-to-shipment (I/S) ratio upwards. The I/S ratio has moderated rapidly since May, after reaching a record high of 1.64 in January, but still remains well above its historical norm. Moreover, the soaring Canadian dollar and a tepid U.S. recovery will continue to hamper Canada’s manufacturing sector. On a positive note, total sales excluding aerospace are up 19.7% so far in the quarter (annualized rate) with one month left to go. This suggests that the sector is in much better shape than most reports would suggest.

**Manufacturing sales less aerospace (q/q, annualized)**



Source: Statistics Canada

### Trade deficit widens to \$2 billion in August

After rebounding the previous two months, the value of Canada’s exports declined by 5.1% in August, primarily due to a 4.4% reduction in export volumes. Imports declined as well, but not as steeply as exports. This resulted in a widening of Canada’s trade deficit to \$2 billion. Machinery and equipment exports experienced the largest drop (-10.4%), erasing the gains posted in July, followed by exports of agricultural and fishing products (-10.3%). Industrial goods and materials fell 3.3%, as volumes were down 6.5%. Exports of automotive products fell by 5.5%, as exports of trucks and other motor vehicles declined 35.1% in August. While exports to the U.S. fell again, the biggest declines were in exports to Japan and other OECD countries. Exports to Japan registered a large drop of 18.3% in August, while exports to the U.S. also contracted by 6.6%. Exports to all other trade partners fell 11.3%. The trade report highlights that Canada’s trade rebound continues to be fragile, despite the strengthening recovery worldwide. Canada’s comparative advantage in commodities provides some support to trade, but a soaring Canadian dollar will continue to be a drag on exports.

### Housing starts drop 4.6% to 150,100 units in September

Housing starts fell to 150,100 units in September following an upwardly revised 157,300 units in August. The drop was en-

tirely concentrated in the urban multiples segment, where starts retreated by 21.4%. This segment tends to be more volatile than the single-family unit segment, because of the size (a single project yields many units at once) and irregular frequency of its starts. Starts of single-detached homes actually increased by a strong 10,000 units in September, or 16.8%, and continue their gradual climb from their low of April. On a regional basis, homebuilding activity rebounded in Alberta, up 12.6% in September, while British Columbia (-16.1%) and Quebec (-17.7%) suffered some steep declines (Quebec’s drop, however, followed two strong monthly gains). Ontario’s 5,000-unit surge from 45,400 to 50,500 units, being as it was concentrated in single-family homes, suggests housing activity will remain strong going into 2010.

## U.S. Economy

### Federal Reserve slightly more upbeat

As expected, the Federal Reserve kept the fed funds rate unchanged at the 0.00% to 0.25% range, and reaffirmed its commitment to keeping the fed funds rate “exceptionally low” for an “extended period”. The economic assessment was upgraded marginally, with the Fed noting that economic activity has “continued to pick up”, which is a slight improvement over the previous statement which stated that economic activity “has picked up”. And in recognition of the recent improvement in consumer spending, the statement noted that household spending “appears to be expanding”, compared to the previous communiqué which stated that spending “seems to be stabilizing”, though it cautioned that spending remains constrained. Given the substantial slack in the U.S. economy, the Fed is unlikely to raise rates until the unemployment rate begins to decline.

### U.S. economy loses 190,000 jobs in October

The U.S. nonfarm payrolls declined a further 190,000 in October, bringing the number of jobs lost so far to 7.3 million. The unemployment rate surged to 10.2% from the 9.8% the month before, and is now at its highest level since 1983. Despite the job losses, the details of the report were somewhat encouraging, with the total net revisions of 91,000 jobs being added to the previous estimates. There were declines in employment in the goods-producing sector (-129,000) and the services-producing sector (-61,000), though the business services sub-component posted a gain of 18,000 jobs. Total private sector employment declined a further 190,000, while the public sector employment was unchanged. Going forward, there are obvious signs that U.S. labour market conditions are continuing to improve, albeit at a slow pace. Business spending on equipment & software rose 1.1% in the third quarter, the first increase since the onset of the recession. This is a positive development that heralds an improvement in labour market conditions.

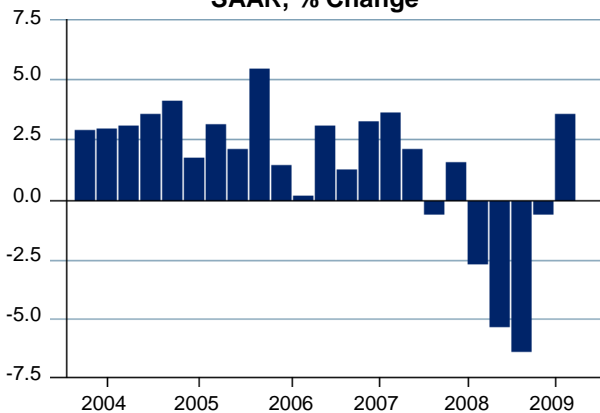
### Q3 real GDP growth signals end of U.S. recession

The U.S. economy posted its first quarterly gain since Q2 2008, advancing by 3.5% in Q3 2009. Moreover, the U.S. Bureau of Economic Analysis revised its estimate of second-quarter GDP upwards and now reports a contraction of only 0.7% annualized. The details of the report were fairly strong. Outside of the surge in durable goods expenditures, which



was bolstered in large part by the “cash for clunkers” program, spending on non-durable goods rose by 2% in the third quarter, suggesting that some positive momentum is beginning to build in consumer spending, outside of the fiscal support. Final domestic sales also grew sharply, rising by 2.5% in Q3. The report suggests that the U.S. economy is slowly emerging from the deep economic recession and is beginning the economic recovery process. However, with the significant fiscal and monetary stimuli providing the main impetus for this sharp rebound, GDP growth in the coming quarters is expected to be less robust as their impact wanes.

**Real Gross Domestic Product SAAR, % Change**



Source: Bureau of Economic Analysis

### Manufacturing index surges to 55.7 in October

- The U.S. ISM manufacturing index surged to 55.7 in October, its highest level since April 2006. The details of the report were strong, with 13 out of 18 manufacturing industries reporting growth. There were big gains in the production sub-index, which rose from 55.7 to 63.3, its highest level since mid-2006, while the employment sub-index rose above 50 for the first time in over a year, rising to 53.1 from 46.2. New export orders rose marginally to 55.5 from 55.0, while new orders declined for the second straight month, falling to 58.5 from 60.8, though it remains well above the 50-threshold. Overall, the report suggests that the U.S. manufacturing sector picked up considerable steam in October and confirms the recent improvements seen in the various regional indicators. Looking forward, the strength in manufacturing is pointing to further upward momentum in U.S. economic activity.

### Durable goods orders rise 1% in September

- U.S. durable goods orders rose 1% in September. There were strong gains in orders for defence goods, which rose a sharp 10.0%, while transportation orders rose 1.1%. Core capital orders, which exclude transportation and defence orders, was bolstered by the 7.9% surge in orders for machinery which is the biggest monthly gain in this indicator in over a year and was the fifth monthly increase in six months. This suggests that U.S. businesses are beginning to slowly rebuild their capital stock in anticipation of the rebound in demand for their products. Orders for primary metals (+ 0.3%) were also up, while orders for electrical equipment (-0.9%) and computers and electronics (-0.2%) were lower. And with shipments

rising by 0.8% and inventories declining by 1.0%, the inventory-to-shipment ratio dropped to 1.77 from 1.80 and is now at its lowest level since November last year. Overall, the strength in core capital goods orders, and in particular the sustained growth in machinery orders, is very encouraging for the state of business expenditures in the U.S.

### Housing starts little changed in September

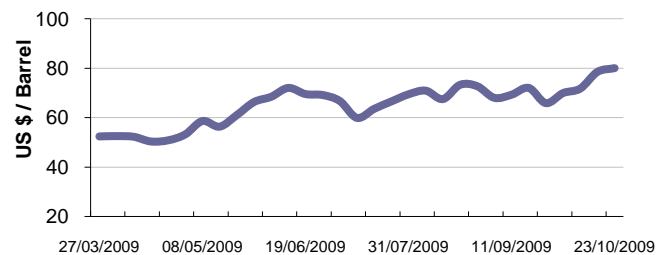
- U.S. housing starts stagnated in September at 590,000 units, barely unchanged from the 587,000 the prior month. While U.S. home prices are finally beginning to rise (with plenty of positive implications for the U.S. economy), it remains considerably less certain whether this will translate into additional construction due to a substantial overhang of inventories. And even as the official inventories are drawn down, it seems that banks and builders may be holding onto shadow inventories that will preclude the need for serious construction activity for quite some time. Single-family starts rose by 3.9% during the month, while the more volatile multi-unit starts were down by 15%. Once again, this report suggests no immediate prospect of a recovery in U.S. housing starts.

### Retail sales drop 1.5% in September

- U.S. retail sales declined by 1.5% in September. The key factor pushing sales lower was motor vehicles sales, which declined by 10.4% as the “cash for clunkers” program ended. Excluding autos, sales rose by 0.5%, while core retail sales, which exclude sales of autos and gas, rose by 0.4%. Encouragingly, most retail spending categories posted gains. There were gains in the sale of furniture (+ 1.4%), gasoline (+1.1%), health and personal care products (+0.8%) and food (+ 0.7%). Sales at general merchandise stores were also up, rising by 0.9% in September. Overall, this was a fairly strong report, and with the broad-based gains in spending, there are growing indications that U.S. consumer spending is beginning to recover. Nevertheless, weakness in the labour market suggests that it will be some time before we can see a sustained pick-up in consumer spending.

### U.S. Dollar Gains Squeeze Oil Prices

- After climbing above \$80 a barrel, oil prices fell in early November to \$76 a barrel as investors appear to be shifting away from the riskier high-yielding returns of oil and equities and into the safe haven of the U.S. dollar. The gain in the U.S. dollar squeezed oil prices lower.

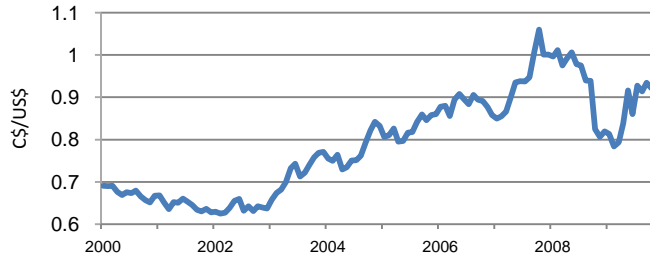


Source: Bloomberg



## Risk Aversion Softens Canadian Dollar

- After surging in early October, Canada's dollar hit a one-month low of 92.8 cents as risk aversion hit Canadian stocks and global commodity currencies.



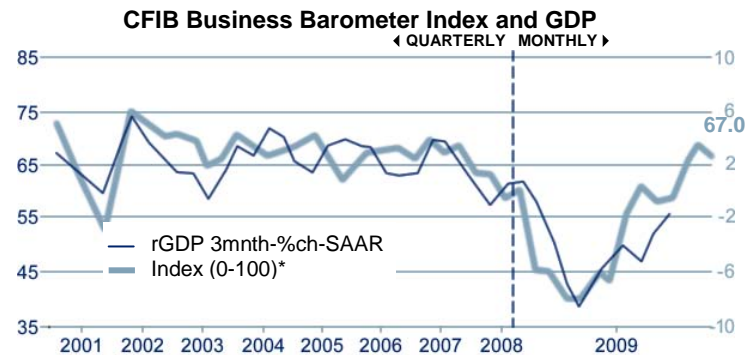
Source: Bloomberg

## SME Optimism Dips Slightly in October

- Following strong improvements through the late summer, business confidence among Canada's small and mid-sized businesses stepped back slightly in October.
- CFIB's Business Barometer Index dropped to 67.0 in October, from 68.7 a month earlier. When mapped against GDP growth, however, this Index level still suggests the recovery is progressing.
- The decline in optimism is almost entirely due to a tempering in expectations among manufacturers and businesses in the personal services sectors—in particular within Ontario and

Quebec, which saw declines of 4.6 and 3.6 points respectively in their indices.

- The rapid rise in the C\$ relative to its U.S. counterpart would likely explain the impact on export-oriented segments of the economy. Nonetheless, this shift only partly offsets the strong improvements in business sentiment through August and September.



Source: Bloomberg

Source: Canadian Federation of Independent Business

\* Index of 50 = equal balance of stronger and weaker business expectations. Note that CFIB's Business Barometer index has been revised as of May 2009. The index is based on the same survey, but is now a weighted average of response scores: 100 for stronger performance, 50 for same performance and 0 for weaker performance.

KEY INDICATORS - CANADA	Historical					2009				Forecast	
	2004	2005	2006	2007	2008	Q1	Q2	Q3	Latest	2009	2010
Real GDP (% growth)	3.1	3	2.9	2.5	0.4	-6.1	-3.4			-2.4	2.6
Machinery & Equipment Expenditures (% growth)	9.3	14.1	10.5	4.4	0.5	-37.6	-16.1			-19.6	1.3
Pre-Tax Corporate Profits (% growth)	17.1	10.9	5.1	4.1	5.7	-30.8	-42.9			-33.8	13.9
Industrial Production (% growth)	1.9	1.6	0.2	0.2	-4.2	-18.6	-15.5			-10.4	2.3
Industrial Products Prices (% growth)	3.2	1.5	2.3	1.6	4.3					-3.3	1.6
Non-Residential Construction (% growth)	0.8	6.8	7.5	6.9	-2.7	-24.1	-17.8				
Housing Starts (' 000 units)	233	225	227	228	211	140	128	148	Sep. 150	140	159
Personal Expenditures (% growth)	3.4	3.7	4.1	4.6	3.0	-0.7	-0.5	-0.5		-0.1	2.1
Consumer Price (% growth)	1.8	2.2	2	2.1	2.4	1.2	0.1	0.4	Sep. -0.9	0.4	1.8
Employment (% growth)	1.8	1.4	1.9	1.9	1.5	-5.5	-1.5	-0.8			
Unemployment Rate (%)	7.2	6.8	6.3	6	6.2	7.6	8.4	8.6	Oct. 8.6	8.4	8.7
SMEs Confidence Index (CFIB)	68.4	66.4	67.3	67.2	56.1	42.3	64.2	64.2	Oct. 67.0		
Manufacturers Confidence Index (CFIB)	70.4	68.3	66.4	64.5	52.7	38.8	64.4	64.4	Oct. 65.4		
Credit conditions (Bank of Canada)*	-10.8	-16.5	-9.8	15.0	32.0	35.0	34.5	25.5	Oct. -4.0		

Sources: Statistics Canada, Consensus Economics and Canadian Federation of Independent Business, Bank of Canada

\*Business Outlook Survey, balance of opinion on tightened terms and conditions for obtaining financing compared with previous 3 months. Figures reflect annual averages.