ECONOMICS DIGEST
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Canadian current trends update...

- GDP declines in February with decreases in four of the five major goods-producing industries.
- April marked the second monthly increase in employment and boosted the tally of job gains so far this year to 140,000 or an average monthly gain of 35,000 jobs.
- The weakness in February retail sales was concentrated in a sizeable 2.4% decline in motor vehicle and parts sales.
- Following a robust first quarter, Canadian housing starts strengthened even further in April.
- The improvement in the March merchandise trade surplus reflected the weakness in imports outpacing a decline in exports.
- The overall CPI rose at a slightly slower than expected 0.4% in March 2012, thereby matching increases in both January and February.

Dawn Desjardins
dawn.desjardins@rbc.com

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Financial markets...

Forecasts zig; data zag

April brought a round of across the board upgrades to Canadian and US growth projections. The International Monetary Fund (IMF) upgraded its 2012 forecasts by 0.3 percentage points for both countries. The Bank of Canada upped its 2012 Canadian growth forecast, and the US Federal Reserve boosted the range for US real GDP growth by 0.2 percentage points. While this was a step in the right direction, the bottom line is that another year of moderate growth is still in the cards. These more upbeat assessments were overshadowed by a round of weak data reports out of Europe. The first release of UK real GDP showed an unexpected decline; the euro area's purchasing managers' indices slipped again, and the unemployment rate hit an all-time high. Concern about the European economies and a return of financial market stress drove investors into safe-haven markets like US Treasuries, Canadian government bonds, and German bunds. The upgrading of growth forecasts in Canada and US met some resistance following a raft of softer than expected data reports. The first print of US first-quarter 2012 real GDP showed that the economy grew at a 2.2% annualized pace, which was below market forecasts for a 2.5% increase. Canadian GDP proved to be disappointing with the economy contracting by 0.2% in February, which was contrary to expectations for an similar-sized increase in the month. While the headlines gave a jolt to markets, the details of the reports do not suggest that these trends will persist and in fact set up for even stronger gains in the second quarter than we previously projected. All told, we maintain our 2012 growth forecasts of 2.6% and 2.5% for Canada and the US, respectively.

Fed maintains position that policy will stay easy

The Fed left the fed funds target range at 0% to 0.25% in April and reiterated that exceptionally low rates are likely to be needed until late 2014. This conclusion came as no surprise to markets although the mild upgrades to the Fed's near-term economic projections dampened expectations that another round of quantitative easing is in the pipeline. In the quarterly forecast summary, policymakers raised the expected range for 2012 real GDP growth to 2.4% to 2.9% from 2.2% to 2.7%. In turn, the forecast for the unemployment rate edged down to 7.8% to 8.0% from 8.2% to 8.5%. These changes did not constitute wholesale changes to the Fed's baseline view (especially given that the growth forecasts for 2013/2014 were revised lower); therefore, they did not alter our outlook for policy.

Canadian employment jumps; GDP dips

Canada's economic data have been erratic in recent months with the economy unexpectedly contracting in February while the labour market generated a whopping 82,300 jobs in March. To be sure, February's dismal performance reflected a drop in utilities and natural gas output due to warmer than usual temperatures that will likely be reversed in the months ahead. Also weighing on growth were temporary shutdowns of potash and nickel production facilities. These factors are likely to ease, if not reverse, in March although maintenance shutdowns in various oil sand production facilities may limit the rebound. As a result, we expect only a marginal improvement in March GDP with activity likely holding steady. The weakening in February, however, was not sufficient enough to offset the strength recorded in late 2011 keeping the economy on course for a positive growth print in the first quarter of 2012.

BoC to follow a go-slow approach in reducing stimulus

The soft February real GDP report defied both RBC and the Bank of Canada's forecasts for strengthening growth in the first quarter of 2012. Following the release, we revised our forecast down to 1.8%, matching the pace recorded in the fourth quarter of 2011. At the same time, we revised up our second-quarter 2012 growth forecast to 3.1%, expecting that as the shutdowns end and weather returns to normal, we will see a reacceleration in the pace of output gains after a lull in February and March. Correspondingly, we anticipate that any backup in the unemployment rate that occurs because the economy grew at a below-trend rate between September and March will reverse. This is another reason why the Bank of Canada is unlikely to rush to temper the amount of policy stimulus and risk a further weakening in the pace of growth. As a result, we expect that the Bank will maintain the overnight rate at 1.00% until the fourth quarter of 2012 when there should be sufficient evidence of a reacceleration in domestic activity, rising export demand as the US economy picks up, and an easing in global financial market stress.

Dawn Desjardins
dawn.desjardins@rbc.com

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Special reports…

Vancouver's housing market: moderation in store but vulnerable to a harsher outcome

- ▲ Signs of cooling have emerged in the Vancouver-area market in the past year. Since reaching their peaks in the early months of 2011, both home resales and prices declined quite noticeably.
- ▲ With affordability, or rather *un*affordability, having moved off the scale in the past three to four years, the historically volatile Vancouver-area market is undoubtedly under substantial stress. Indeed it is vulnerable to a marked correction.
- ▲ Although such a correction cannot be ruled out, we believe that the most likely scenario is one of a modest price decline, possibly in the order of 7% to 12% from quarterly peak to trough over the medium-term.
- ▲ We expect a more measured decline because: 1) the strong gains in property values from 2009 to early 2011 were overstated by MLS average price data; 2) we find few signs of imbalance between demand and supply at present; and 3) we expect the Vancouver-area market to remain well supported by a fairly favourable macroeconomic environment and strong demographic fundamentals.
- ▲ While there has been a rapid increase in new multiple units under construction in the Vancouver area last year, we do not expect this increase to materially outstrip the market's capacity to absorb the new units at completion in the next year or two.

- Nonetheless, market pressure and risks are likely to intensify in the medium term, when we expect rising interest rates to start to bite more.
- Risks will be further heightened by Vancouver-area valuation's dependence on a strong and steady flow of wealthy foreign buyers and recent immigrants — a phenomenon that is both poorly documented and potentially vulnerable to adverse external shocks.

Robert Hogue
robert.hogue@rbc.com
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Special reports…

Western Canada led provincial growth in 2011

- Western provinces posted the strongest economic growth in the country in 2011.
- The preliminary real GDP by industry estimates for 2011 showed booming activity in Alberta and Saskatchewan with growth rates of 5.2% and 4.8%, respectively.
- British Columbia ranked third with a rate of 2.9%.
- Performance in Central Canada was generally below the national average of 2.6%, while performance in Atlantic Canada was weak except for Newfoundland and Labrador where growth was slightly above the national rate.
- Manitoba, with a rate of 1.1%, was the lone exception among Western provinces showing weaker growth than the national average last year.
- Further recovery in manufacturing contributed to a real GDP gain of 2.0% in Ontario and this occurred despite a small drop in motor vehicle output.
- Heavy investment in the mining sector was a bright spot in Quebec, where the provincial real GDP rose by 1.7%.
- Newfoundland and Labrador stood out in Atlantic Canada with growth of 2.8%, following a very strong gain of 5.8% in 2010.
- Lower fishing activity and a smaller potato crop restrained the pace in Prince Edward Island (1.1%).
- Declining natural gas output and a drop in construction activity created significant drag in Nova Scotia, where growth slowed to just 0.3%.
- An even slower pace of 0.1% was achieved in New Brunswick amid declines in construction, manufacturing forestry and utilities.

Robert Hogue
robert.hogue@rbc.com
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