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Comment on Recent Financial Markets Pressures and Risks to the U.S. and Canadian Outlook

In the U.S., the recent financial market turmoil is occurring despite some tentative indications of a turn for the better on the economic data front. The July U.S. payroll employment report came in stronger than expected rising 117K in the month which was up from upwardly revised average gains the previous two months of 50K. The U.S. July unemployment rate also unexpectedly fell to 9.1% though that largely resulted from a drop in the labour force. It is the case that to sustain downward pressure on the unemployment rate you are going to need to see even greater strength in U.S. employment growth above 150K. Encouragingly, the strength in job gains in July was relatively broadly based. As well, jobless claims have continued to trend lower in the current month which augurs well for August U.S. payrolls to strengthen further relative to July.

This improvement in labour markets comes alongside indications that motor vehicle production was rebounding in July and thus provided additional support to the widely held forecast that activity was poised to rebound over the second half of this year. Recent declines in gasoline prices are also helpful in terms of freeing up more funds for household spending outside of energy needs.

However, the recent financial market turmoil and the downgrade of U.S. government debt by S&P has presented a clear risk to this base case forecast of a strengthening in growth over the remainder of this year. With respect to the debt downgrade itself, there has been considerable speculation of such as the size of the recently announced deficit reduction package got progressively smaller to assure passage of the debt ceiling increase. However, the greater risk of the downgrade is that it continues a string of setbacks to the economic recovery including concerns about European sovereign debt, supply chain disruptions that resulted from the Japanese earthquake and tsunami and a recent significant downward revision to U.S. growth late-2010 and early-2011. There is the risk that the debt downgrade represents the proverbial "straw that broke the camel's back." As confidence about a rebound in economic activity sinks ever lower, businesses may move onto sidelines refraining from hiring and investing while households limit spending. More immediately this has put, and could continue to put, further downward pressure on equities as a lower stream of earnings is factored into pricing. This in turn would deliver a further deflationary shock to the system. Developments over the next couple of weeks will be telling as to how deep are these concerns and how much pressure on equity markets is sustained. Our current forecast assumes U.S. growth this year of 1.9% with activity rebounding to 2.9% in 2012. Indications of sustained weakness in equity markets would imply not only faltering confidence but more seriously a negative shock to household net worth that would imply downward pressure on growth the remainder of this year and next.

In response to the recovery stalling, or worse, reversing course, further stimulus would be needed. From the Fed this could well prompt the reassurance to maintain it sizeable balance sheet unchanged for an "extended period" or potentially to a specific date such as "at least through mid-2013" as it recently did with respect to its fed funds target. As well, there is always the option for another round of asset purchases, so-called QE3. With respect to fiscal policy though it has been often mentioned that there is currently no appetite for another round of fiscal stimulus, a near-term rise in the unemployment rate could yet prompt a change in heart. A further cut to payroll taxes had been discussed in some initial discussions to raise the debt ceiling and may yet get resurrected. However, what may be the root cause of the recent financial market turmoil is concern about too high debt levels both by governments and households in the face of modest economic growth. Thus the current financial market pressures could benefit from fiscal authorities, both in the U.S. and Europe, opting for a more forthright and aggressive program to reduce the public sector debt. Any additional tightening should be implemented in the medium term to avoid restraining near-term growth. With respect to the private sector, a helpful initiative in the U.S. may be to ease the high mortgage debt encumbering still too many households.

With respect to the Canadian economy, currently conditions remain solid domestically. This is the case despite negligible, and possibly declining, growth in the second quarter as most of the pressures appear to be transitory. Labour markets seem to be holding up better than in the U.S. even in the wake of a modest gain in July employment, with the unemployment rate continuing to trend lower.

However, external factors related both to the European and U.S. fiscal problems present risks to the Canadian growth outlook going forward. These developments have the potential to weigh on both Canadian exports and commodity prices that have been fuelling both production and investment. Our current forecast assumes growth this year and next of 2.7% and 2.8%, respectively. However, if the financial market pressures are not contained, and equity markets continue under pressure the risk to the outlook is for weaker growth.

In terms of the possible policy response in the face of weaker growth, the stronger fiscal position in Canada presents less need for aggressive fiscal restraint. However, Canadian household debt remained high through the last recession which would be made more onerous in the face of greater economic weakness. As a result, the Bank of Canada is expected to keep policy highly accommodative with even the option to reverse earlier hikes if conditions warrant. With respect to the Canadian dollar, weaker global growth would put further downward pressures on commodity prices which would pressure the C$ lower. This would provide some stimulus to areas of the economy such as manufacturing.

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