

Canada: Heart like a lion. The skin? Well not quite like a rhino's

Canadian economy checks in with a 6.1%q/q growth rate.

Good show old chap. Jolly good show.

The Canadian economy put on a brave face in the first quarter of 2010, with a q/q annualized growth rate of 6.1%, running just ahead of the median at 5.9%. With much of the data for March in hand prior to the release, it became evident that the Canadian economy was set to log another strong quarter following Q4/09's 4.9% (revised from 5.0%). The month over month GDP data largely spilled out as expected, rising by 0.6%m/m vs. the median at 0.5%m/m.

Goods producing sectors provided much of the grist for the economic mill, as would be expected given that it was this area of the economy that bore the brunt of recession so too is it expected to lead the recovery.

For the month of March, goods producing sectors were up 1.4%m/m (led by extraction industries, manufacturing and construction) whilst service producing sectors comparably languished, growing by a mere 0.3%. For services, wholesale and retail sales led the way, while Olympics related fervor subsided and with it a -5.4%m/m decline in the arts and entertainment categories following a 6.0%m/m surge in the previous month.

The growth profile for the quarterly data continued to reflect a reliance upon the consumer for a good slug of overall economic growth with 2.7ppt of the total 6.1% increase in GDP flowing out of this category. This is a continued reliance upon an area of the economy that is becoming extended and as such, expected to see some significant moderation in the second half of 2010 and on into 2011.

The ratio of total household debt to disposable income is now running at 146.1% and has been accumulating at a rather uncomfortable clip, up from 130.2% from just two years ago. At the same time that credit has been steadily building at near double digit rates on a year over year basis, the growth profile for disposable income has been shrinking. The current rate of growth at 2.5%y/y is down from the previous quarter's 3.5% and is the fourth month in which growth has slid lower. At the same time, the personal savings rate was down to 2.8%. This affords little buffer in the household budget with which to accommodate any changes in the carrying costs associated with those heavy chains of debt that the Canadian consumer has been laboring away at, link by link.

In another measure of consumer servitude Statcan reports that household sector debt service ration stood at 7.44%, up slightly from the previous quarter. Given the popularity of variable rate product amongst Canadian households, both changes to the overall rate structure and the en mass migration over to fixed rate mortgage products that carry with them higher rates, one can expect to see this debt service ratio climb higher in coming quarters.

Indeed, rather than as a function purely related to worries for inflation, and the BoC will say that it sees everything through its inflation prism, it might be the case that the BoC may be driven towards rates hikes out of a concern for the signals it is delivering to the consumer through the maintenance of an ultra loose monetary profile. A monetary profile that is encouraging the Canadian consumer to embrace debt to their growing detriment. In that you can't entirely blame the consumer who is

merely responding to the pricing signals for money. In a market clearing system, reducing the cost of a product whether it be cars or cash, increases its rate of consumption.

On that basis, going forward, the profile of Canadian economy is expected to see the weight of economic growth shift off the shoulders of the consumer and government and on to that of external demand and business investment. On this front there is some encouraging news with business gross fixed capital formation adding around 1.6ppt out of the total 6.1% increase in the economy. But its a mixed blessing. While business investment is rising, it continues to be led primarily by investment in residential structures which jumped by 5.4%q/q in the current quarter (led by new housing construction +11%q/q) just off of the 5.9%q/q from Q4/09. By contrast, total business investment in plant and equipment, non residential structures rose a paltry 0.2%q/q (equipment up 1.8%, non residential structures -1.4%). Early days into the recovery yet, but there is a need to see business investment out side of the residential category recover if we are to talk about a balanced and sustainable long term recovery for the Canadian economy.

It is clear that once the BoC begins to raise interest rates (and we are forecasting a 25bp rate hike at tomorrow's scheduled rate meeting) that consumer interest in housing will begin to wane and so too will one of the chief driver's of economic growth for Canada. So too will the onset of the harmonized sales tax in both BC and Ontario at the outset of July negatively impact the housing market along with administrative changes to the funding of mortgages that come into play in Q2/10.

On that basis, we need to see business investment move from a focus on residential investment on over to investment in non-residential structures, plant and equipment in order for Canada to continue throwing off decent growth numbers through to the end of the second half of the year to replace the expectations for lost growth flowing from housing and consumer consumption.

Net trade is the other area of need. In Q1/10, net trade continued to drag. On the upside, cross border activity ramped up dramatically over the course of the quarter. On the down side, while exports were up an impressive 2.9%, imports were up an even more impressive 3.4% which on a net basis, dragged 1.6ppt out of the headline GDP number. Again, from the standpoint of a long term balanced economic recovery, for a small open economy like Canada's, we will have to see a more balanced trade picture evolve, one that favors an actual net contribution to GDP from trade.

Government spending is also on the wane with growth slowing from a net contribution to GDP of 0.4ppt down from the previous quarters 1.4ppt. A harbinger of things to come when by 2011 government spending is expected to begin to actually drag on GDP as fiscal spending aimed at taking off some of the sharper edges of the recession are wound up. The government has been very specific in saying that fiscal programs will be shut down and wound up by the end of Q1/11.

The economy restocks. Much like the fourth quarter of 2009 was for the US economy all about the inventory, the Canadian economy can thank a good deal of the strength to a concerted effort to restock itself in Q1/10. After having spent the last year steadily de-stocking, in Q1/10 we see the first quarter of restocking with CAD8.2bn added to inventories, contributing 2.8ppt of the total 6.1%. In one sense, Q1/10 was largely a by product of what can expected to be a transitory boost to inventories. Although the stock to sales ratio of 65 days is improved from the previous quarter's 66 days, it remains at the highest level of any quarter between the period Q4 2001 through to Q3 2008 according to Statcan.

There is a reason economists don't get invited to parties.

Once the hoopla surrounding the robust reading on the headline growth rate subsides, there is going to be some effort to discount the strength of the headline economic growth rate as a by product of the inventory correction. So too will there be some hand wringing over the continued reliance upon consumer consumption that cannot continue without causing serious long term damage to the household balance sheet. And while the trade picture has improved markedly (export volumes since

May of last year are up around 15%) it still is not delivering any top side onto the GDP picture let alone relented in tugging growth lower.

Crusty economist stuff aside, it is a great headline report on the state of the Canadian economy. And the reality is that we are richer than we think. Gross domestic income is up a whopping 8.7% in both the current quarter and the past quarter, courtesy of a dramatically improved terms of trade.

But just don't look too hard or think too deeply about the constituents of growth and their ability to keep performing. As is evident to many, the Canadian economy is stealing from its future to pay for growth today. Tomorrow, it is expected that Canada's central bank will be the first G7 country to raise interest rates and with it the carrying costs on a good slug of that debt that Canadian's are carrying will begin the long and inextricable trudge higher.

Disclosure appendix

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