

ECONOMIC VIEWPOINT

Canada: No Real Signs of a Recession

Still, Growth Should Continue at a Moderate Pace

The growth of the Canadian economy has noticeably slowed in recent months. As in other parts of the world, this is intensifying the concerns associated with a possible recession in Canada, where uncertainty remains high, especially with respect to the trade tensions. However, the recent change in the economic and financial indicators is reassuring for Canada. Even if some of the indicators have slowed in recent months, their levels remain, for the most part, quite distant from those seen during past recessions. Under these circumstances, the most likely scenario is that the economy will grow moderately in the quarters ahead. The situation will nevertheless have to be watched closely in the coming months.

The concerns associated with an economic slowdown have risen significantly throughout the world in the last few months. Fears of a recession have even resurfaced and attracted the attention, in particular, of the financial markets.

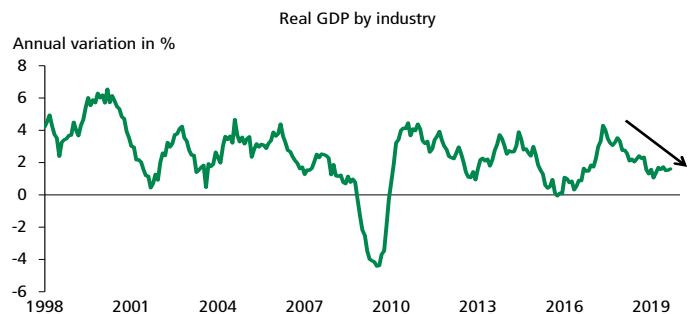
It goes without saying that Canada, with an economy that is fully open to global trade, can't avoid these fears. The global trade war, the uncertainty surrounding the ratification of the new free trade agreement between Canada, the United States and Mexico, as well as the crude oil transportation restrictions are massively affecting the country's economic growth. Consequently, international trade has struggled somewhat, and non-residential investments are experiencing difficulties, as many companies are hesitating to invest under the current circumstances.

Moreover, economic growth in Canada has decelerated over the last few months (graph 1). Will this slowdown continue in the months ahead? Do we need to fear an economic recession? To answer these questions, this *Economic Viewpoint* presents an overview of the most useful economic and financial indicators to analyze the growth cycles of Canada's real GDP.

Recessions Are Rather Rare

In contrast to other areas around the world, especially the United States, no organization is tasked with officially recording the start and end dates of the Canadian economy's growth cycles. According to the theoretical definition, a technical recession occurs when real GDP contracts during two quarters in a row. Based on this criterion, Canada has had six technical

GRAPH 1
Canadian economic growth is weaker



Sources: Statistics Canada and Desjardins, Economic Studies

recessions since 1962 (which corresponds to the beginning of Statistics Canada's data). The most recent technical recession occurred in the first half of 2015, when Canada was hugely affected by the difficulties in the energy sector (graph 2 on page 2).

Still, this definition is too simple. A real recession has a number of consequences and is felt in many areas of the economy. Therefore, the criteria have to be expanded. In Canada, the C.D. Howe Institute launched a committee tasked with analyzing the business cycles of the Canadian economy. According to their methodology, a slowdown is defined as a recession if there is a pronounced, pervasive and persistent decline in aggregate economic activity. Based on these stricter criteria, technical

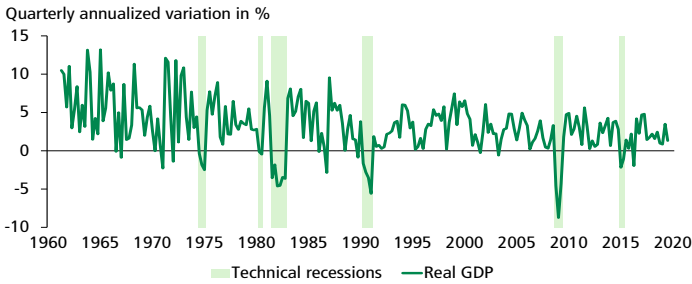
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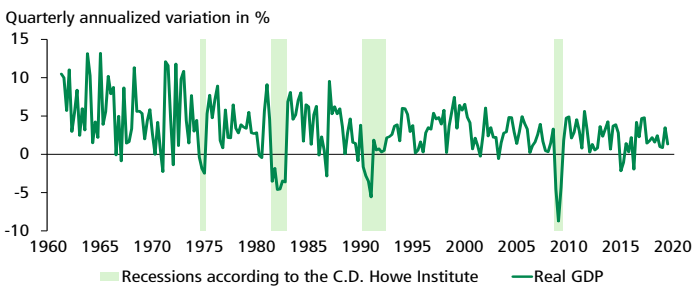
GRAPH 2
The last technical recession occurred in 2015



Sources: Statistics Canada and Desjardins, Economic Studies

recessions outnumbered the recessions identified by the C.D. Howe Institute (graph 3). Moreover, the technical recession of 2015 was not selected by the C.D. Howe Institute, for the Canadian economy's decline was not pervasive enough (the problems were mostly concentrated in the energy sector).

GRAPH 3
There were fewer recessions based on the C.D. Howe Institute's criteria



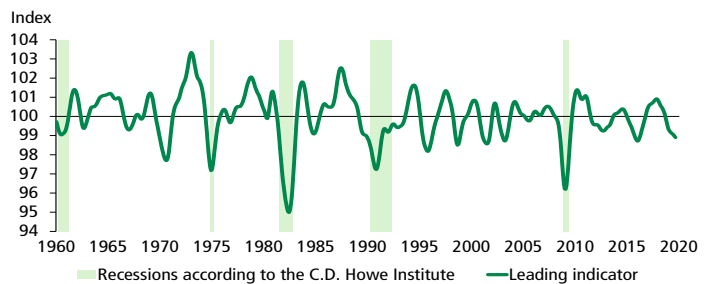
Sources: Statistics Canada, C.D. Howe Institute and Desjardins, Economic Studies

With that, it must be said that recessions are rather rare in Canada. According to the C.D. Howe Institute, only four recessions have been recorded since 1962. With so few recessions, it becomes difficult to accurately predict a recession by highlighting the points they share in common, especially as the causes and consequences can vary from one recession to the next. Yet the way in which some economic indicators change can sometimes help to pick out the telltale signs of a possible recession. Still, this kind of analysis runs up against another challenge in Canada, namely the limited number of economic and financial indicators. Additionally, their history is often too short and doesn't cover enough recessions to have an exact idea of how they evolved during these periods. Below are a few indicators that have caught our attention in this regard.

Some Useful Indicators

One of the most useful data for analyzing economic cycles in Canada is obviously the leading indicator compiled by the Organisation for Economic Co-operation and Development (OECD). It recently fell below the 100 mark, which indicates that growth should be below its trend in the months to come (graph 4). Nonetheless, this result is not enough to conclude that growth will slow enough to plunge the Canadian economy into a recession. Moreover, the indicator had fallen more markedly during previous recessions.

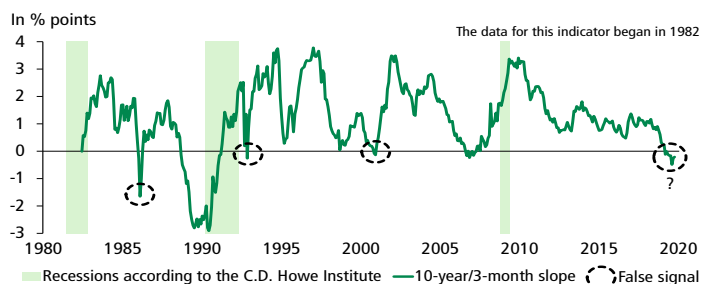
GRAPH 4
OECD leading indicator for Canada



OECD: Organisation for Economic Co-operation and Development
Sources: OECD, C.D. Howe Institute and Desjardins, Economic Studies

Another indicator that's been in the spotlight in recent months is the slope of the yield curve. The spread between Canadian 10-year federal bonds and 3-month Treasury bills has significantly narrowed to the point of entering negative territory (graph 5). The same observation applies to the spread between 10-year and 2-year federal bonds. A yield curve inversion is often considered a telltale sign of a recession. Nonetheless, graph 5 shows that false signals are often associated with a yield curve inversion. A slightly negative spread, as is currently the case, is not always followed by a recession. That said, the current

GRAPH 5
Spread between Canadian 10-year federal bond yields and 3-month Treasury bill yields

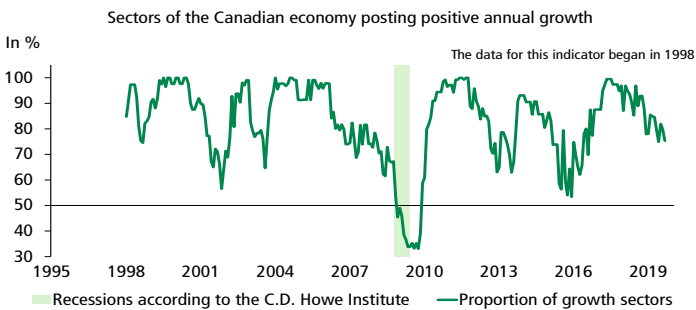


Sources: Statistics Canada, C.D. Howe Institute and Desjardins, Economic Studies

curve inversion has gone on long enough to begin raising some concerns. However, given the many distortions that continue to plague the bond markets due to the quantitative monetary policies put forward by several central banks, it's important to look at the signals coming from the yield curve with a certain degree of suspicion. As a result, the yield curve inversions could happen more often from now on and become a poorer indicator of a recession than in the past. Furthermore, the Bank of Canada (BoC) recently mentioned that the yield curve inversion was a less reliable signal of a recession in Canada, as nearly 40% of the yield curve inversions since the 1960s were not followed by a recession.

Since a recession is usually characterized by fairly widespread difficulties within the Canadian economy, the relative size of the number of sectors of real GDP that are growing is also a good indicator of the Canadian economy's cycles. Clearly, the lower the number, the more widespread the difficulties and the greater the risk of a recession. Well, nearly 75% of the industries posted positive annual growth in September (graph 6). Certainly, this share has gone down a little in recent months, but it still remains relatively high. It's important to remember that the proportion of growing industries had fallen below 50% during the last recession in 2008–2009. It's clear that the current situation is still far from being worrisome.

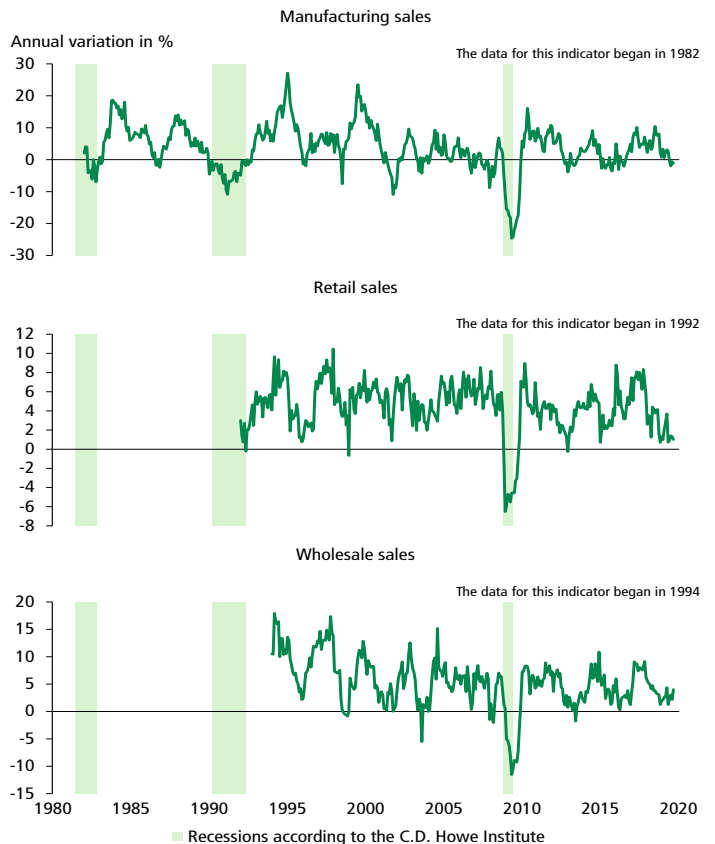
GRAPH 6
The number of growth sectors within the Canadian economy remains relatively high



Sources: Statistics Canada, C.D. Howe Institute and Desjardins, Economic Studies

Several other indicators also posted less sustained gains for the last few months, while maintaining a reassuring level. This is especially the case for manufacturing, retail and wholesale sales (graph 7). Still, the history of this data is fairly short, which makes comparisons with different recessions more difficult. Nevertheless, it seems obvious that these indicators move lower during a recession. Yet, despite the recent slowdown, the annual increase in these indicators is still far from the worrisome level of previous recessions.

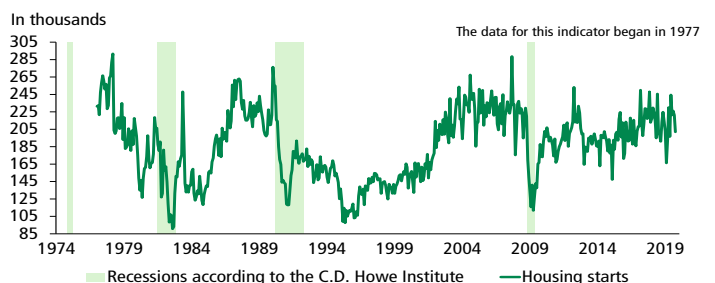
GRAPH 7
Variation of manufacturing sales, retail sales and wholesale sales



Sources: Statistics Canada, C.D. Howe Institute and Desjardins, Economic Studies

In contrast, some indicators paint a very positive picture of the Canadian economy's growth cycle. This is especially true of the data associated with the housing market. Even if there was a difficult period a few months ago, the housing market has recently regained strength. Consequently, the number of housing starts (graph 8) and the increase in existing property

GRAPH 8
Number of housing starts



Sources: Canada Mortgage and Housing Corporation, C.D. Howe Institute and Desjardins, Economic Studies

sales (graph 9) are both relatively high and very far from the worrisome levels recorded during recessions. In addition, the housing market has sent many false signals, with several periods of weakness not necessarily leading to a recession.

No Recession in Sight

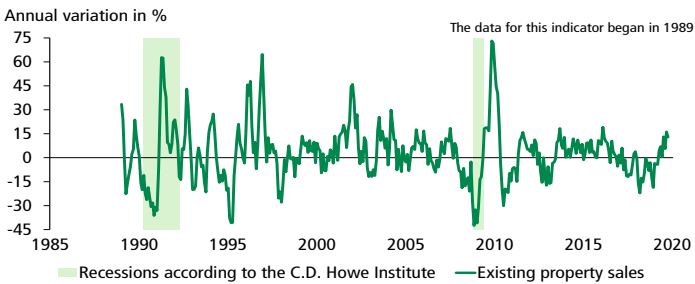
In short, there is no economic or financial indicator currently signalling that Canada could soon sink into a recession. Nevertheless, it is undeniable that economic growth is weaker, as shown by the mere 1.3% (annualized) hike in real GDP that occurred in the third quarter. Moreover, some indicators suggest that this weakness could last for a few more quarters, and this is the main assumption of our current economic scenario.

However, these indicators must be watched closely for any signs of a change in the quarters ahead. Furthermore, the global economic situation could change, which would have serious repercussions on the growth outlook for Canada’s real GDP.

High household debt could also worsen the situation if ever the Canadian economy were to be hit by an external shock. With a high debt service (interest payments and principal repayments), households’ financial leeway is fairly limited, which reduces their ability to withstand any possible unforeseen events. If ever the Canadian economy were to sink into a recession, high household debt could exacerbate the impact. A BoC analysis showed, moreover, that if the current global economic slowdown were to worsen considerably, the high levels of household debt would cause the anticipated reduction in consumer spending to increase by approximately 30%.

Benoit P. Durocher, Senior Economist

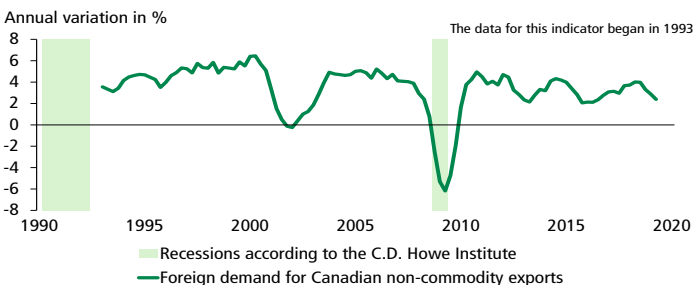
GRAPH 9
Variation in existing property sales



Sources: Canadian Real Estate Association, C.D. Howe Institute and Desjardins, Economic Studies

Lastly, the recent change in the foreign activity index is also reassuring (graph 10). Bearing in mind the importance of international trade for the Canadian economy, it’s easy to believe that a drop in foreign demand could lead to a recession, as happened in 2008–2009. In spite of the trade tensions, the rise in foreign demand for non-energy Canadian exports remains relatively strong.

GRAPH 10
Variation in the foreign demand index for Canadian non-commodity exports



Sources: Bank of Canada, C.D. Howe Institute and Desjardins, Economic Studies