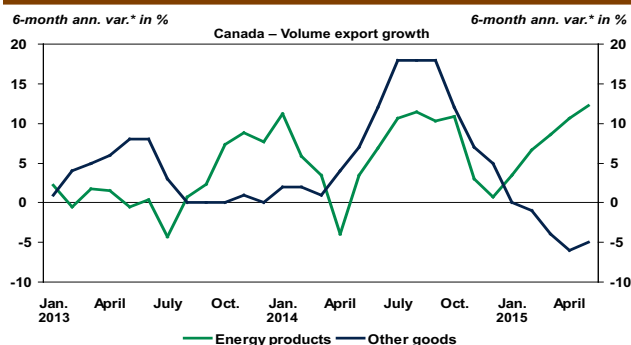


A recession in Canada? What are the implications for markets?

While it has long been accepted that the oil shock would put the Canadian economy to the test in 2015, the impact has proven more severe than expected. So much that in July, the Bank of Canada (BoC) was in the obligation to abandon the optimistic bias it held in the spring, to recognize that the economy was undergoing a “significant and complex” adjustment. Although it refused to characterize the event of recession, the BoC humbly admitted its expectation for a second consecutive contraction in real GDP. This *Economic Viewpoint* compares this cycle’s end with previous one, and discusses some of the implications for financial markets.

With energy sectors occupying about a quarter of their respective economy, Alberta, Saskatchewan and Newfoundland and Labrador were prey to experience recession from the moment oil prices experienced a steep descent such as the one that characterized the second half of 2014. This scenario was part of our assumptions at the beginning of 2015, but it was also understood that the depreciation of the Canadian dollar would trigger a material pick-up in exports, especially for non-energy products such as manufactured goods, metals, or services. On this account, the first half of the year has proven heavily disappointing. Growth in export volumes for non-energy goods not only slowed, but turned negative. Ironically, growth in export volumes of energy products has accelerated (graph 1), although it remains that the price shock has exacted a heavy toll on profitability in the oil patch.

Graph 1 – Trends in export categories went against expectations



* 3-month moving average.
Sources: Statistics Canada and Desjardins, Economic Studies

The inability of other sectors of the economy to pick up the baton from the oil industry was reflected in a string of growth disappointments. The contraction of 0.6% recorded in the first quarter GDP was pitted against a consensus forecast of +0.3%. The 0.9 percentage-point miss to the estimate was the largest in a decade. Given the interference of adverse weather and port labour disputes on U.S. growth, it was difficult to entirely discard the hypothesis that these one-off effects had also restrained Canadian economic activity in Q1. However, monthly GDP estimates only prolonged the sequence of disappointments. In fact, over the six months comprised between November 2014 and April 2015 inclusively, five showed a contraction of GDP including four consecutive ones. The 6-month annualized growth rate of real GDP actually dipped into negative territory in March 2015, a phenomenon that is almost never witnessed outside the context of a recession (graph 2).

Graph 2 – Such contraction in real GDP is rare



Sources: Statistics Canada and Desjardins, Economic Studies

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To make matters worse, it was learned on July 7 that nominal exports had registered a fifth consecutive fall, again, an unprecedented sequence, outside a recession. As we expected, the BoC was forced to respond to the drubbing of bad news. On July 15, it delivered a second rate cut this year, setting its overnight rate at 0.50%.

RECESSION OR NOT?

The word “recession” is heavily charged as it echoes particularly painful episodes, such as the global economic and financial collapse of 2008 and 2009, the agonizing experience of the early 1990s, or the oil shocks of the 1970s. However, two observations are worth making.

First, although a technical recession is considered as two consecutive quarters of negative growth, in both Canada and the United States, the official dating of economic cycles is carried through somewhat deeper research. In Canada, Statistics Canada has historically carried that research¹, while in the United States, the National Bureau of Economic Research (NBER) is known to be the reference in the field. Their judgment has been based not merely on the prevalence of a contractionary GDP sequence, but also on the magnitude of the contraction phase (peak to trough), in addition to the corroboration of conclusions drawn from the analysis of GDP via the analysis of other indicators’ behaviour. For example, the NBER also considers gross domestic income, employment, hours worked, and personal income, to name a few. These nuances made, it must be recognized that the informal rule of two consecutive quarters has proven remarkably reliable historically. In both the United States and Canada, since 1981, no official recession has occurred without two consecutive quarters of contraction. Thorough research is nonetheless useful in dating cycles with precision and identifying dynamics unique to each downturn using broader data.

Secondly, if it appears that Canada is indeed in a recession, it would have a particular character. All episodes of the kind that Canada has experienced since 1960 were associated with a U.S. recession (graph 3). But far from being in recession this year, the U.S. economy is expected to record growth comparable to that of 2014, which was one of the best years of growth since the crisis. The desynchronization of business cycles is thus largely the result of the shock in the oil sector, whose relative size is much larger in Canada than in the United States. In all likelihood, resilience in other sectors of the Canadian economy, such as services, should enable Canada to get by without too many bruises.

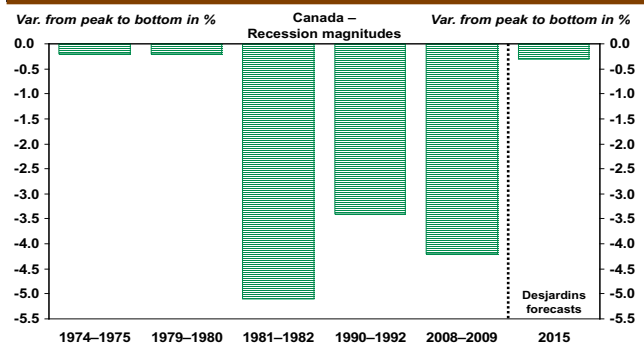
Graph 3 – Recessions in Canada and in the United States since 1960

Date	Recessions	
	United States	Canada
Q4 1969–Q4 1970	✓	
Q4 1973–Q1 1975	✓	✓
Q1 1980–Q3 1980	✓	✓
Q3 1981–Q4 1982	✓	✓
Q3 1990–Q1 1991	✓	✓
Q1 2001–Q4 2001	✓	
Q4 2007–Q3 2009	✓	✓

* Official date of the U.S. recession.
Sources: C.D. Howe Institute, National Bureau of Economic Research and Desjardins, Economic Studies

GDP estimates for the second quarter will be published in September 1st. In our current scenario, GDP is expected to show a decline of 0.5%, before rebounding by 1.8% in the third quarter and 2.4% in the fourth. For 2016, we anticipate 2.1% growth, hence somewhat above the potential growth rate of the Canadian economy. If this scenario is confirmed, the recession of 2015 will have been one of the least painful Canada has experienced over the past 45 years (graph 4). This dovetails with the assumption of a relatively localized recession. Monthly industry-level GDP estimates show the prevalence of a 6-month contraction in eight of 20 sub-sectors, that is 40% of sub-sectors. At the height of the 2008–2009 crisis, 70% of sub-sectors were displaying a contraction over an interval of six months. This proportion had risen to 59% during the recession of the early 1990s and 71% in that of the early 1980s. Although it is not impossible that a higher number of sub-sectors show contractions in coming months, the current circumstances, including the outlook for the U.S. economy, and the larger weight of the less cyclical services sector, make it difficult to envision a propagation of an extent similar to previous episodes.

Graph 4 – Estimating a recession of small magnitude



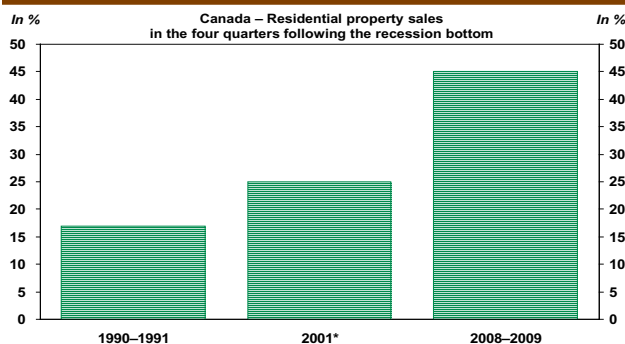
Sources: Statistics Canada and Desjardins, Economic Studies

¹ The Current Analysis department of Statistics Canada, which conducted research on cycles, ceased operating in 2012. This same year, the C.D. Howe Institute created a Business Cycle Council, taking over the expertise.

THE RECOVERY COULD UNDERWHELM

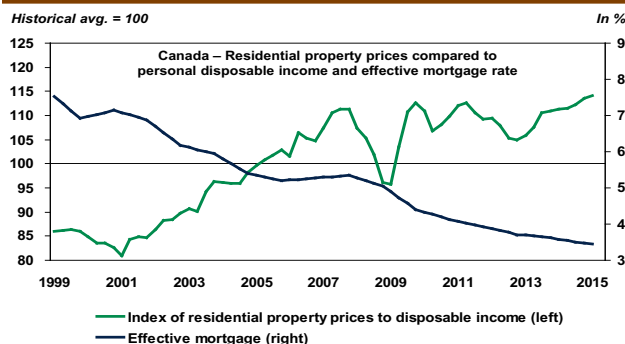
Some features of the current environment, however, suggest that the recovery may be somewhat slower than in previous episodes. Some of the levers on which Canada could count in times of stress might prove less effective today. The BoC has certainly reduced its policy rates by 50 basis points this year but they had been kept at very low levels since the 2008–2009 crisis. Recall that during the crisis, the BoC lowered overnight rates by 425 basis points. In 2001, Canada has narrowly averted recession but fears of the moment had led the BoC to deliver 375 basis points of cuts. Given that the transmission of rate cuts to the economy works predominantly through the credit channel, especially mortgage credit, strong rebounds in home sales have been observed during the recovery phases of these cycles (graph 5). In the present case, one can be sceptical of the ability of limited eases to generate more than a marginal reaction in real estate activity. Mortgage rates were already at unprecedented lows and the appreciation of residential properties in recent years implies that the housing market is now very expensive as a function of disposable income (graph 6). Not to mention the question of whether an extension of the Canadian household debt cycle would be desirable, after an expansion that has relied so heavily on credit.

Graph 5 – Economic recoveries have tended to feature robust real estate activity



* U.S. recession bottom. Sources: Canadian Real Estate Association and Desjardins, Economic Studies

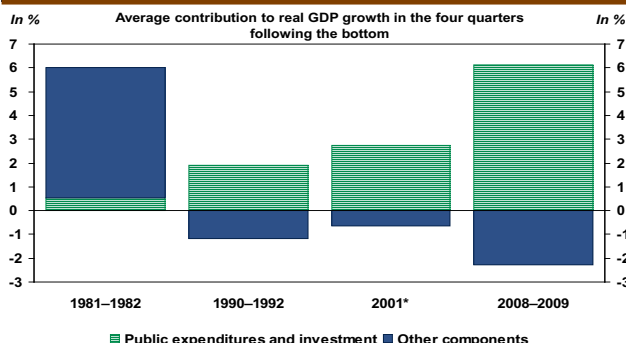
Graph 6 – Rates have been low for long, and affordability has eroded



Sources: Canadian Real Estate Association, Statistics Canada and Desjardins, Economic Studies

The contribution of government spending is another source of uncertainty. If monetary policy seems to be running out of steam, Canada by contrast enjoys considerably flexibility from the standpoint of fiscal policy. The federal government had announced a return to a balanced budget this year. Some provinces such as British Columbia and Saskatchewan heralded slight surpluses, while Quebec was slated to balance its budget. Disappointing growth could compromise some of these ambitions but it remains that a considerable consolidation effort has been carried out in recent years, providing Canada with an enviable level of flexibility to reinvigorate the Canadian economy, as has been done successfully in the most recent downturns (graph 7). However, one can hardly expect a prompt response, notably in the context of a federal election this fall. The localized nature of the problem is also likely to inhibit any sense of urgency on the part of governments.

Graph 7 – Government stimulus measures have played an increasingly large role in recovery phases



* U.S. recession bottom. Sources: Statistics Canada and Desjardins, Economic Studies

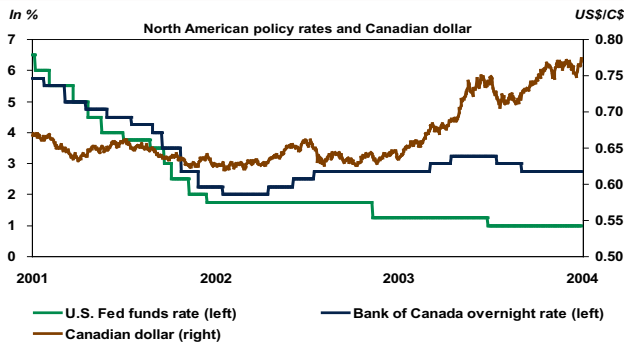
MARKET IMPLICATIONS

By virtue of the forward-looking nature of financial markets, the Canadian recession scenario is already heavily priced in. Thus, as is usually the case, the Canadian dollar has depreciated significantly against the U.S. dollar. The depreciation also reflects in good part the fall in oil prices that has occurred in the second half of 2014. Although oil prices have a tendency to fall sharply during global recessions, the peculiarity of the current context lies in the fact that it is the oil price decline itself, stemming from a supply shock as opposed to a global recession, that is the source of Canada’s economic woes. This property of the current cycle necessarily implies a desynchronization of monetary policies, a rare phenomenon.

In our scenario, the Federal Reserve (Fed) will have hiked rates twice by the end of the year, while by contrast, the BoC will have cut twice in 2015. One has to go back to 2002 and 2003 to trace such extent of divergence. It was then the reverse; between April 2002 and April 2003, the BoC raised

rates five times for a total of 125 basis points of tightening, while the Fed continued to lower Fed funds rates, bringing them from 1.75% in early 2002 to 1.00% in mid-2003. In response, the Canadian dollar strengthened by 25% over 2002 and 2003 (graph 8). Since early 2015, the dollar has depreciated by more than 10% despite the fact that oil prices have mostly kept in a range from US\$40 to US\$60. Monetary policy divergence has thus played a key role in the behavior of the Canadian dollar.

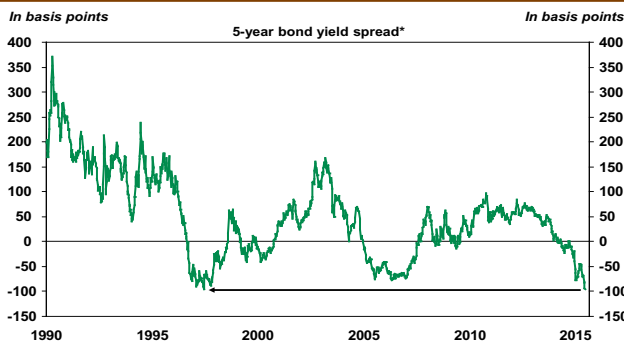
Graph 8 – In 2002 and 2003, diverging monetary policies contributed to the strengthening of the Canadian dollar



Sources: Bloomberg and Desjardins, Economic Studies

This is reinforced by interest rate spreads. The difference (Canada minus United States) in rates on 3-month T-bills, which tends to influence the Canadian dollar, has compressed to 38 basis points, after keeping in the neighborhood of 100 basis points since the crisis. Note the even more dramatic spread compression in the bond curve: the 2-year spread is at its lowest level since 2007, while in the 5-year horizon, the spread has reached its lowest since 1997 (graph 9). Similar finding for spreads at the 10-year horizon, currently in the surroundings of -80 basis points.

Graph 9 – The 5-year spread has reached a low dating back to the late 1990s



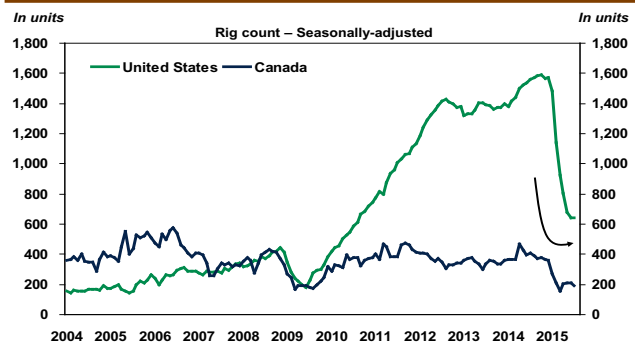
* Canada minus United States.
Sources: Bloomberg and Desjardins, Economic Studies

It is not impossible to imagine further spread compression in the near term. While most forecasters, including

ourselves, expect rate increases to begin in September in the United States, markets remain deeply skeptical. According to futures contracts on Fed funds, the eventuality is anticipated with an implied probability of only 40%. If the commencement of policy normalization in the United States proves a “surprise” for the markets, a high-magnitude reaction in the United States could encourage further declines in yield differentials, and by extension continuing depreciation of the Canadian dollar. In this context, it is less difficult to envision a scenario where the Canadian dollar touches the US\$0.75, even absent new easing gestures by the BoC.

As a matter of fact, additional spread compression is much more likely to be the consequence of events in the United States, as opposed to decisions in Canada. First, if our hypothesis of a low-magnitude technical recession is validated, the BoC will gladly step to the sidelines and elect to maintain its overnight rate at 0.50% for a prolonged period. Already some recent signs of stabilization in the oil rig count suggest that capex contractions in the oil sands might begin to diminish in intensity (graph 10). If this trend is accompanied by an external sector taking the appropriate path dictated by U.S. economic growth, the BoC will count on a few good reasons to camp on its position. Second, from an operational perspective, the liquidity issues that already plague the Canadian repo market could be exacerbated by an overnight rate brought down to 0.25%. And third, cutting to this level might compel the BoC to unveil a game plan for the use of non-traditional tools. There is reason to believe it will resist as much as possible making use of methods that might raise a number of practical challenges in Canada, in addition to delivering uncertain results (see box on page 5).

Graph 10 – The worst might be behind in the North American oil sector



Sources: Baker Hughes and Desjardins, Economic Studies

OUR EXPECTATIONS

Our financial scenario assumes a floor for the Canadian 10-year bond yield around current levels (1.50%), followed by a very gradual recovery in 2016. On the equity front,

A quantitative easing program in Canada?

The Bank of Canada (BoC) asserts that it has additional tools at its disposal in a hypothetical scenario where it needs to offer support to growth, beyond lowering interest rates to the conventional lower bound. In theory, it could adopt a program of quantitative easing (QE), as did several other central banks. However, the BoC does not play on the same grounds as the Federal Reserve (Fed), the European Central Bank, the Bank of England or the Bank of Japan. The size of the Canadian bond market is relatively small. Canada has less than \$500B of federal bonds and very low net supply at present. Nearly 30% of its debt is held by foreigners, including official reserve managers. These are investors with long-term horizons, and they have in fact increased their holdings of Canadian bonds at an accelerated pace earlier this year. In these circumstances, bond purchases related to a balance sheet expansion policy enacted by the BoC might have some impact on market liquidity.

In this respect, the BoC could take note of the inconclusive experience of Sweden. The Bank of Sweden had launched QE at the beginning of the year but was forced to expand it since, as the response had amounted to little more than a currency trading sideways against the euro through the first half of the year, and minimal spread compression in Swedish yields against German Bunds, right up to early July. This could be the curse of a central bank of a small developed country attempting measures less well adapted to the specificities of a smaller market. Alternatively, the BoC might wish to avoid these complications by joining the negative rate movement, but as pointed out in an *Economic Viewpoint* published in July,² outside an unlikely scenario where the Fed adopted such type of policy, there is little chance that the BoC would go this far.

² Desjardins, Economic Studies, *Economic Viewpoint*, "Negative interest rates: Will Canada be spared?", July 9, 2015, www.desjardins.com/ressources/pdf/pv150709-e.pdf?resVer=1436448862000.

even if it must be recognized that an economy in recession is usually a harbinger of bad news for corporate results, weakness in energy and materials has long been discounted. The S&P/TSX is currently one of the few markets showing a decrease in its index since the beginning of the year (graph 11). Even in Australia, where the economy is also going through the impact of a terms-of-trade shock, not to mention high exposure to a slowing Chinese economy, the stock market index features a gain since January. Bargain hunters may emerge as the Canadian economy gets out of its difficult position but it is clear that a global context

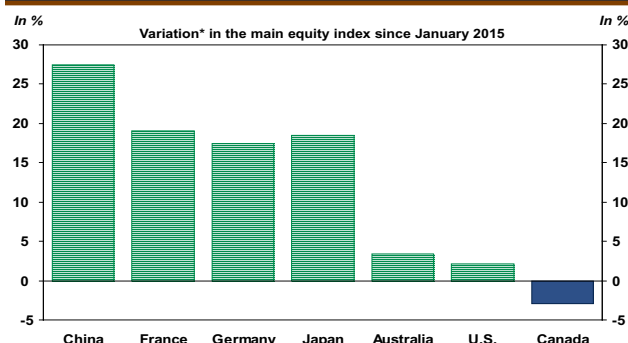
still not conducive to a rebound in commodity prices, will restrain the ability of the S&P/TSX to catch up.

CONCLUSION

Whether formally or informally in recession, the Canadian economy is undergoing a period of great difficulty. However, in all likelihood, it will manage to bounce back relatively soon. The recovery could prove slow, however, especially considering that some of the traditional levers on which Canada used to count in such circumstances are likely to be less effective. While monetary policies in the United States and Canada will continue to diverge, the BoC should be hesitant to venture into uncharted waters, especially since monetary policy normalization in the United States will encourage further declines in interest rate spreads. From this perspective, the currency appears bound to depreciate further, bettering the fate of Canadian exporters. However, Canadian stock market underperformance is likely to prove an enduring theme, especially if global commodity prices maintain their downward trajectory.

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Senior Economist

Graph 11 – The Canadian equity market is one of the rare ones in contraction on a year-to-date basis



* As of July 23, 2015.
Sources: Bloomberg and Desjardins, Economic Studies