ECONOMICS DIGEST

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Canadian economy gears up...

- The December GDP report showed a 0.5% gain.
- Data shows an upward underlying trend in employment with the economy generating an average 38,200 jobs per month in the three months ended February.
- Despite a 0.2% decline in December, the volume of retail sales rose an annualized 5.1% in the fourth quarter.
- Pace of housing growth to continue for remainder of 2011.
- The deterioration in January's trade balance resulted from a $1.9 billion jump in imports indicating strong domestic demand.
- The core inflation rate calculated by the Bank of Canada held steady in January although on a seasonally-adjusted basis, core prices increased by 0.1%.

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Financial markets...

Global economy facing down risks

Investors are navigating through murky waters once again as the reality of strengthening economic activity faces off against the risks emanating from geo-political events, Europe's ongoing sovereign-debt issues and increasing inflationary pressures in some emerging markets. The key question is whether to focus on the actual data reports that confirm that the global expansion is well underway or the odds that the combination of high oil prices and unsteady growth in some countries will derail the economy's momentum. To date, the risks have only had a limited effect on investors' risk appetite causing a hiccup in the world stock market performance and tempering the rise in global government bond yields.

Implications of higher oil prices

We incorporated higher oil price assumptions into our macro forecasts resulting in a 0.2 percentage point (pp) increase in our projections for the headline inflation rates in both Canada and the United States, although this did not lead us to change either our growth or core inflation profiles. A sustained upward move in oil prices would have an effect on our growth forecasts such that for each 10% increase in the price of oil, our U.S. real GDP forecast would fall by 0.15 pp. For example, should oil prices double from about $100.00 today to $200.00 and stay there for the remainder of the year, our 2011 GDP forecast would be cut by 1.5 pp to about 2%. In Canada, higher oil prices are a mixed blessing, with oil producers reaping the rewards while oil consumers see costs rise and exporters face softer U.S. demand. As such, the overall effect on Canada's growth is estimated to be about one-quarter of the effect it would have in the Untied States.

Now that's what we are talking about!

Canada's economy kicked it up a notch in the final quarter of 2010 with annualized real GDP growth of 3.3% following an upwardly revised 1.8% rise in the third quarter. The main surprise in the fourth quarter report was the strength in consumer spending, which combined with a sharp increase in net exports supported the above-consensus gain. The strong consumer and export demand resulted in a sharp draw down in inventories, which is likely to be followed by higher production in the quarters ahead as stock levels are rebuilt. The improvement in Canadian export growth occurred as the U.S. economy showed signs of renewed vigour. Expectations that

U.S. growth will accelerate further in 2011 augur well for Canada's trade sector to make a solid contribution to the expansion while the economy transitions from relying heavily on consumer spending to business investment.

Bank of Canada is waiting to be convinced

The Bank is unlikely to stay on the sidelines for long if the data continue to show that the economy is maintaining its upward momentum. The economy solidly outperformed the Bank's forecast in the final quarter of 2010 and December GDP's 0.5% monthly gain sets the course for another quarterly outperformance relative to the Bank's 2.5% projection. The strength in the recent data has increased the likelihood that the Bank will upgrade its economic outlook in the April update. Faster growth risks a quicker closure of the output gap than in the Bank's baseline forecast and core inflation rising to the 2% target ahead of schedule. Having said that, the risks to the world economy from geo-political events and elevated debt levels mean that the Bank is unlikely to make any quick moves that risk destabilizing the economy. The Bank still needs to be convinced that the stronger momentum will continue. Our forecast is that the economy will record another solid gain in the first quarter of 2011 of 3.7% and will grow by 3.2% over the entire year, well above the Bank's current 2.4% estimate. The risk to the Bank's current outlook is skewed to the upside, and we maintain our call for the overnight rate to rise by 100 bp in 2011 with the first hike expected in May. Our outlook for 2011 is little changed although we now expect the Canadian dollar to be slightly firmer over the forecast period, and as indicated, assume a later start date for the Fed's initial rate increase. Against this backdrop, we trimmed back the amount of tightening that we expect from the Bank of Canada in 2012. Our updated forecast is for an overnight rate of 3.0% at year-end 2012, down from 3.5% in our previous forecast.

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Macroeconomic forecast…

Settling into the next phase: from recovery to expansion — the next stage begins

- World economy is performing solidly despite a myriad of risks.
- Central banks are examining the effect of the recent rise in oil prices on the outlook for inflation.
- Forecasts for U.S. growth are marching higher.
- The U.S. labour market has started to improve, but it will be a long haul for the unemployment rate to move down to more 'normal' levels.
- Canada's economy sparked up in late 2010 laying the groundwork for sustained above-average growth.
- Inflation in Canada is expected to remain quiescent.
- The Bank of Canada's forecast is well below RBC's as policymakers err on the side of caution.
- Our view is that the data will prove sufficiently strong to move the Bank back into tightening mode late in the second quarter of 2011.

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Provincial forecast…

Broad-based provincial growth on track

- Provincial economies are facing a period of sustained growth, albeit still modest for the most part.
- Strong global commodity markets will have particular implications for resource-producing provinces such as Saskatchewan, Newfoundland and Labrador, Alberta and British Columbia.

- 2011 will see provincial recoveries being sustained, receiving support from continued growth in capital investment spending.
- Private investment is slated to grow faster than public investment in all provinces except Saskatchewan, Quebec, Ontario and Manitoba, although public sector increases in some of these provinces reflect higher planned spending by crown-owned utilities.
- With recent data coming in roughly as expected, we made few changes to our forecasts in this *Provincial Outlook*.
- In terms of real GDP, the bulk of our modifications focused on 2010, although we boosted growth for Newfoundland and Labrador to 4.5% in 2011 from 3.8% previously to reflect stronger than expected capital spending intentions in the province (taking down the 2012 rate as payback) and somewhat downgraded Saskatchewan to a still vigorous rate of 4.9% from 5.3% amid added caution surrounding the anticipated rebound in agricultural production.

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Housing markets…

Owning a home became a little more affordable in Canada at the end of 2010

- Housing affordability improved modestly for the second consecutive quarter in the fourth quarter of 2010.
- Homeownership costs were lowered by small decreases in the five-year fixed mortgage rate (posted) during October and November of 2010 amid minimal home-price appreciation (even outright declines in certain local markets).
- At the national level, the RBC Housing Affordability Measures fell depending on the housing type between 0.4 and 0.8 percentage points in the fourth quarter (a decrease represents an improvement in affordability).
- The improvement in affordability in the last two quarters is likely to be short lived.
- Canadian financial institutions raised posted mortgage rates for the first time since November 2010—by 0.25% to 5.44% in the case of the five-year fixed term.
- Given our expectation that the Bank of Canada will resume its rate hike campaign this spring (adding 100 basis points to the overnight rate this year and a further 150 basis points in 2012), borrowing costs are set to climb further still in Canada in the next two years.
- The effect of higher interest rates will be partly offset by rising household income amid a sustained economic recovery and job creation.
- The era of rapid home-price appreciation of the past 10 years has likely run its course overall in Canada, and we believe that we have entered a period of very modest increases. The recently announced changes to mortgage rules by the federal Minister of Finance will, at the margin, contribute to that slowing of activity.

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