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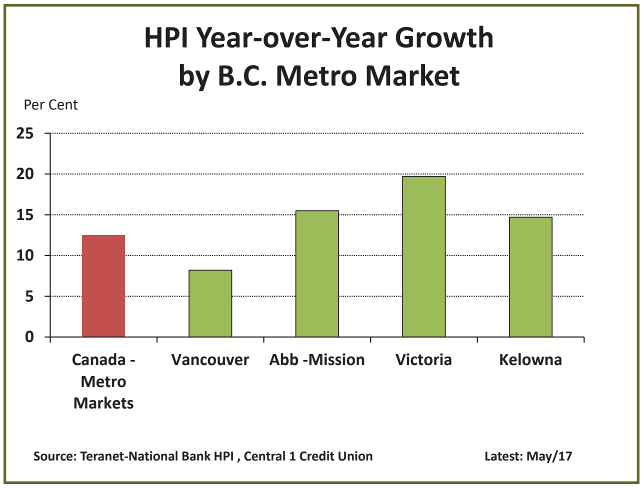
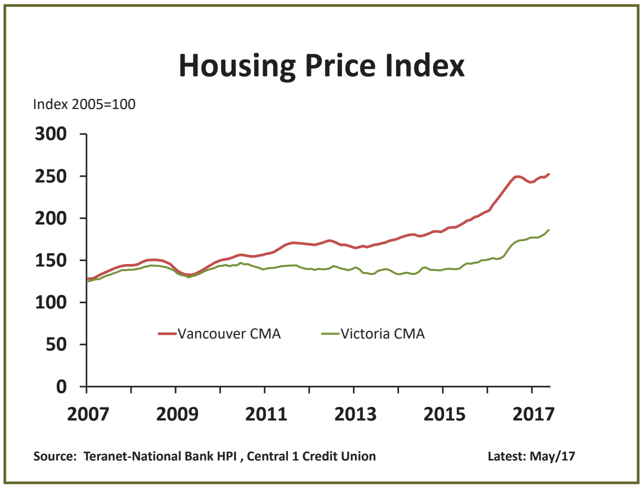
HIGHLIGHTS:

- Housing prices in B.C.'s largest urban areas picked up steam in May
- Lumber production lost momentum during the first quarter
- Manufacturing sales kept pace with the national gain in April with a 1.2 per cent advance from March





B.C. home prices jump in May

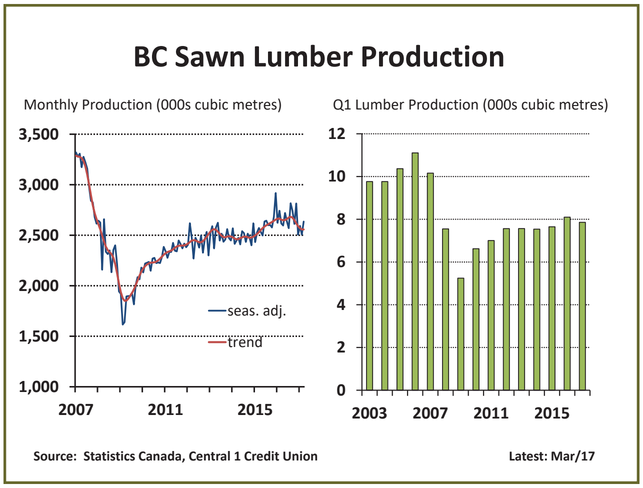
Housing prices in B.C.'s largest urban areas picked up steam in May, according to the latest Teranet-National Bank Home Price Index. Appreciating values reflect the economy and population-induced demand, low interest rates, and tight housing supplies across major urban areas. For the most part, monthly gains in B.C. markets were in line with or exceeded the Canada-wide metro market monthly gain of 1.6 per cent.

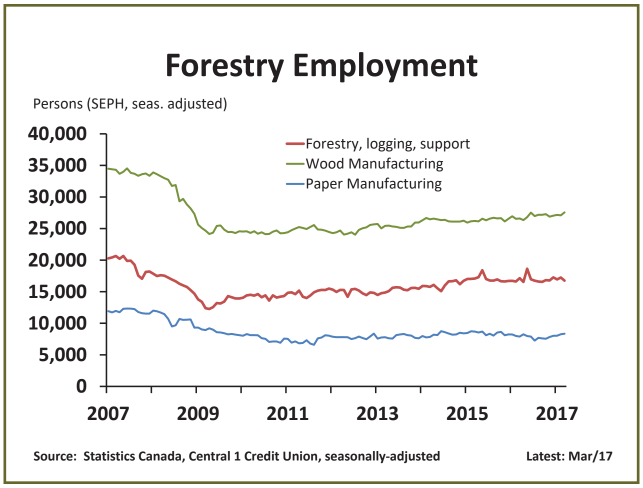
Victoria remained a provincial and national housing market hotspot with the index value accelerating nearly 2.5 per cent from April, driving a year-over-year gain of nearly 20 per cent to a record high. While methodologies and datasets are different, with the Teranet index being a repeat-sales index, growth in the capital region was consistent with the constant-quality index generated by the local real estate board.

Meanwhile, both the Vancouver CMA (1.5 per cent) and Abbotsford-Mission (3.4 per cent) also posted growth, with remarkable strength in the latter. Recent uplift has erased any declines observed in late-2016, with values in both markets tracking above last year's peak. The year-over-year gain in the Vancouver CMA was 8.2 per cent, with weaker than average growth reflecting policy measures designed to cool the regional market in 2016, including additional taxes on luxury homes and the foreign buyer tax.

Price growth in Kelowna reached 1.4 per cent from April, retracing some of the dip since a January peak. Pricing momentum has taken a breather after a robust uptrend in 2016 (26 per cent year-over-year in December) despite sellers' market conditions. High floodwaters in recent months may hold back housing activity and price growth over the next couple months.

Persistence of tight market conditions will continue to lift prices over the short-term, but there are potential headwinds to the market, including policy uncertainty with a new minority govern-





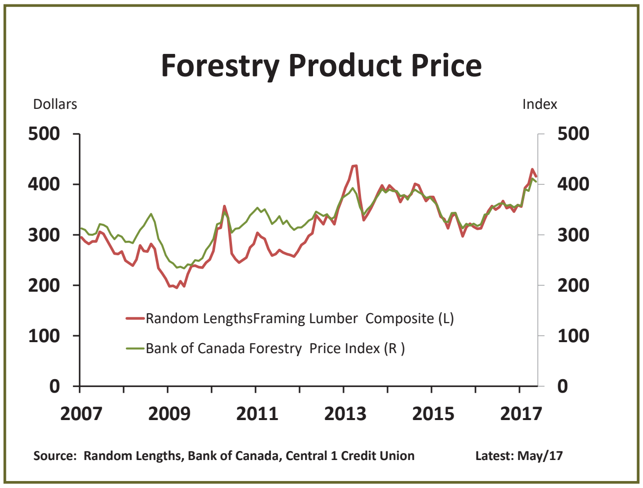
ment, and prospects of demand-constraining taxes. Tighter federal mortgage insurance rules for portfolio insurance that were announced in October are still filtering through the market. The spectre of higher interest rates is also on the table with the U.S. Federal Reserve tightening and potential for the Bank of Canada to move up a rate hike.

Sawmill production flat in first quarter, softwood lumber dispute weighs

Turning to the forestry sector, B.C. lumber production lost momentum during the first quarter to align with a shallow forestry export trend over the same period. Total production reached 2.8 million dry cubic metres in March. While this was one per cent above a year ago, it followed a year-over-year drop of eight per cent in February and a series of significant declines in prior months. Through the first quarter, production fell three per cent.

Declining production since early in the fourth quarter of 2016 has reflected the impact of the expired 2006 Softwood Lumber Agreement (SLA). Specifically, the end of the one-year post-SLA grace period, which allowed free-access to the U.S. market, added greater uncertainty for Canadian producers. While the countervailing duties were only implemented in April, uncertainties about magnitude and degree of retroactivity likely impacted production decisions.

SLA discussions continue and while preliminary countervailing duties on Canadian softwood lumber averaging 20 per cent are already in play, with some B.C. firms paying closer to 24



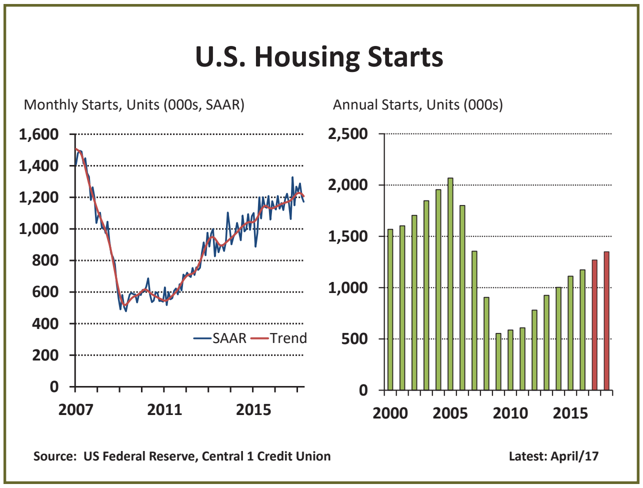
per cent, preliminary anti-dumping duties are still to come later this month. Final duties are expected to be determined late in the year and implemented in January, provided no new deal is reached. We expect them to be in the 20 to 25 per cent range.

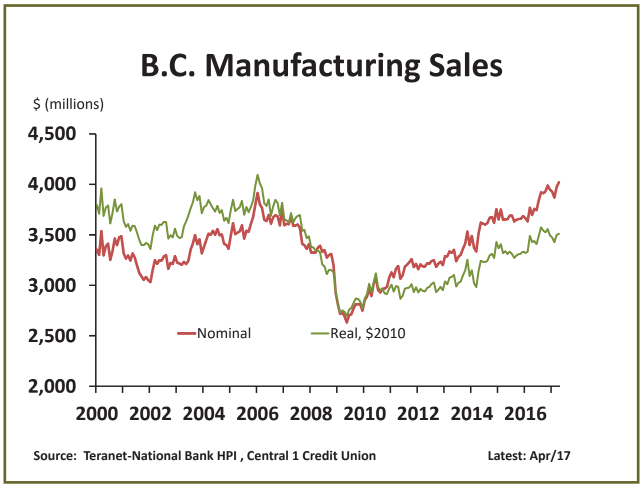
Thus far, the associated labour market has shown few ill effects from the production cuts, with logging, extraction and support employment steady, and higher manufacturing employment counts in both wood-production and paper. However, employment is a lagging indicator of sector production.

We expect the duties to negatively impact production in B.C. and Canada later this year, due to a loss of competitiveness. Small scale and less efficient producers will be less able to absorb the duty. A four per cent decline in direct forestry and related manufacturing employment, or about 2,000 workers, would not surprise as production declines.

That said, a number of factors could provide some offset for B.C.'s lumber sector, namely rising U.S. housing demand and lumber prices. U.S. housing starts are gradually grinding higher, sitting near an annualized pace of 1.2 million units, while renovation spending is also expanding – albeit at a weaker pace in recent months. At the same time, key price composites have shifted higher with the Random Lengths composite index up about 20 per cent since the beginning of the year and the Bank of Canada forestry composite tracking a similar pace. In USD terms, prices are the highest since early-2013 and mid-2004 peaks. Consensus Forecasts survey of economist shows an average U.S. housing forecast of 1.27 million units in 2017 and 1.35 million units in 2018.

The magnitude and timing of price gains suggests tariff expectations and likelihood that duties would be retroactive have been absorbed into the price and passed on to the producer and ultimately the consumer. Rising demand and higher prices will mitigate some but not all the drag on the forestry sector. We anticipate a weak capital investment cycle for forestry, despite higher prices, due to uncertainty surrounding a future agreement and potential for quotas. Adding to this, but unrelated, are supply constraints resulting from the long-term impact of the mountain pine beetle epidemic.





Manufacturing sales expand for second month, prices a factor

B.C. manufacturing sales kept pace with the national gain in April with a 1.2 per cent advance from March to a seasonally adjusted $4.02 billion, a second consecutive gain. Growth contributors included a near 14 per cent increase in primary metal manufacturing and higher sales of paper (7.5 per cent) and solid-wood products (2.3 per cent). These were largely offset by declines in manufactured-food products (-2.6 per cent) and transportation equipment (-19.4 per cent).

April marked a record high for seasonally adjusted monthly manufacturing sales and was the first time that the $4 billion mark was breached. However, adjusted for price levels (using national prices as a proxy), real manufacturing sales were generally in line with the year-long range and still below pre-recession levels by five to 10 per cent.

Year-to-date, B.C. manufacturing sales increased 5.9 per cent, slightly above the national reading, but trailing the major energy-producing regions by a wide margin as higher oil prices lifted sales volumes from a year ago. Gains in B.C. have been a mix of price-induced and real growth in activity. Primary metal manufacturing was up 27 per cent and contributed to about one-third of total manufacturing growth, owing to a ramp up in production following completion of the Rio Tinto aluminum smelter replacement project, while a favourable exchange rate has boosted sectors such as food products. Solid-wood product dollar-volume sales climbed five per cent but as noted earlier, this reflects a surge in prices as lumber production has declined from a year ago. Higher coal prices have likely contributed to higher total manufacturing sales, despite lower production, but data for B.C. was suppressed from manufacturing data.

Going forward, manufacturing growth will slow. Despite a low Canadian dollar and expanding U.S. economy, growth will reverse due to the impact of lumber duties, while production growth in primary metals will crest as Rio Tinto's production ramp up ends.

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