

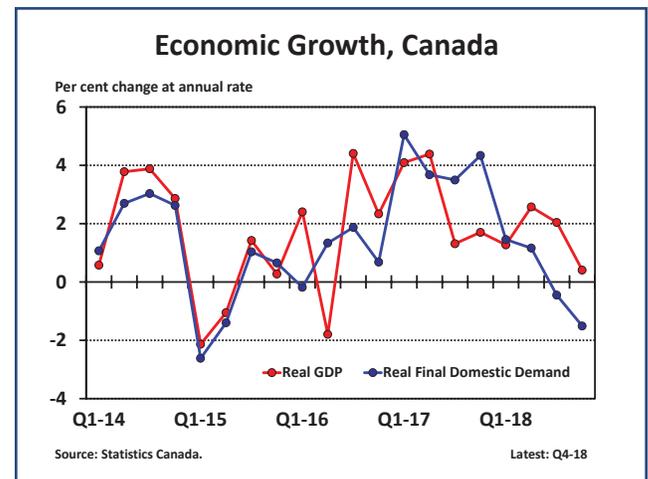
Is Canada's economy slipping into recession?

Recent Gross Domestic Product (GDP) readings on Canada's economy have indicated considerable weakness, and when taken in conjunction with the housing downturn, some observers are calling for a recession in Canada. In addition, some negative external factors are reinforcing this view. Before we examine the recession issue, we will look at recent economic indicators to assess the economy's current position in the business cycle.

The broadest measure of the economy is GDP - and the reading is gloomy. Real GDP growth in the fourth quarter of 2018 approached stall speed at 0.4 per cent annualized. More concerning was the composition of growth in the second half of 2018. Namely, real Final Domestic Demand (FDD) contracted in each quarter and at an accelerating pace. The last time this occurred was during the oil recession of 2015.

Real FDD growth was pulled down by contractions in business and residential investment spending. Household spending slowed during the second half, mostly in durable goods spending, reflecting less housing related activity and fewer new vehicle purchases. The contraction in real FDD is a significant negative sign, and recession fears would be justified should this extend another quarter or more. More information is needed to make a complete assessment of the economic situation.

A scan of current indicators reveals weakness in exports, manufacturing, retail sales and housing starts. One exception is the labour market, notably employment. During the fourth quarter of 2018, employment increased by more than 100,000 persons over the prior quarter and nearly 175,000 in the second half of 2018, according to the Labour Force survey. Payroll employment, from the Survey of Employment, Payrolls, and Hours, increased by 127,000 persons during the second half of the year. These survey results tell a much different story than the GDP data and raises questions about whether Canada's economy is in, or close to, a recession. Or, it could be that employment is a lagging indicator and job losses lie ahead.



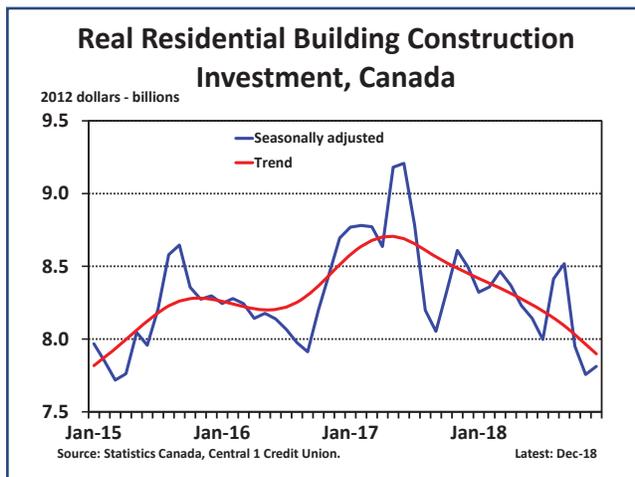
What is an economic recession? The rule-of-thumb of two consecutive quarters of contraction in GDP is insufficient to properly assess whether an economy is in a recession. Business cycle dating bodies¹ use a broader set of key indicators, such as real GDP per capita, real income, employment, industrial production, and wholesale-retail sales, in their assessment of business cycle peaks and troughs. Further, the decline must be significant, broadly based, and last more than a few months². Their cycle dating assessments occur well after the fact. However, forecasters do not have the luxury of time and cannot wait for complete data to make calls.

Recent and current data are mixed and are not conclusive to call that a recession is underway. Clearly, there was considerable weakness in the economy during the second half of 2018, and it likely extended into early 2019. However, it is more likely that a housing recession is underway, and possibly, in business investment as well.

Real residential investment spending declined in five of the last seven quarters and the peak occurred in the fourth quarter of 2017. Another measure - monthly real residential building construction investment - peaked in June 2017. The recent high in housing starts was in the fourth quarter of 2017. More importantly, housing sales, a leading indicator of housing construction,

¹ C.D. Howe Institute Business Cycle Council in Canada, NBER Business Cycle Dating Committee in the U.S.

² Often cited as pronounced, pervasive, and persistent declines.



peaked in the second quarter of 2016. Housing sales have downshifted other than in the run-up to the B-20 regulation spike ending in December 2017. Housing price increases eased with a time lag and are no longer rising.³

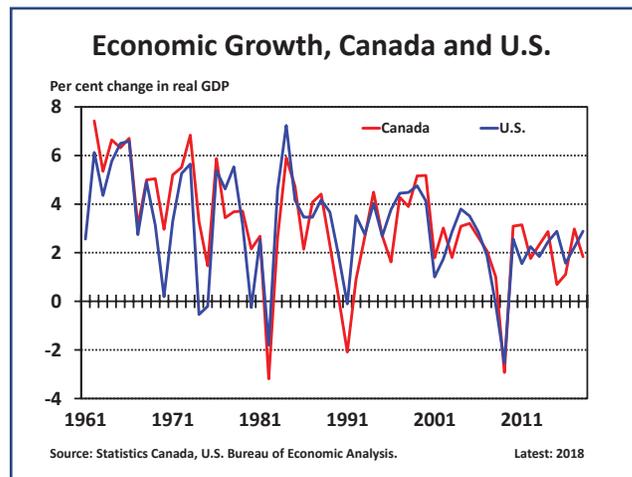
The economy could be in the early stages of a recession if another GDP contraction occurs in the first quarter of 2019. Residential investment will very likely decline, but that may not be enough to pull down overall GDP, nor would it meet the pervasive criterion. Some forecasters are predicting no growth in the quarter, while most see it growing at less than one per cent annualized.

Leading economic indicators for Canada have turned down reflecting 2018's growth slowdown. January 2019's reading continued to slide lower. This indicator has displayed declines previously, without the economy falling into recession and this episode may well be another instance. The main takeaway here is another weak GDP report in the first quarter of 2019 leans to the recession call.

Another leading economic indicator is the yield curve. Historically, the yield curve has inverted (short rates above long rates) before an economic recession. The curve is very flat in Canada and it is partially inverted in the U.S. sending an ominous message. This issue was examined in a previous *Economic Commentary* and it was concluded that these developments did not portend a recession.

Canada's close economic ties with the U.S. economy has resulted in similar performance outcomes. Since 1961, Canada's economy has never been in recession without the U.S. economy falling into recession. GDP growth between Canada and the U.S. is statistically

³ Using the national CREA Home Price Index. Some local markets are seeing rising prices.



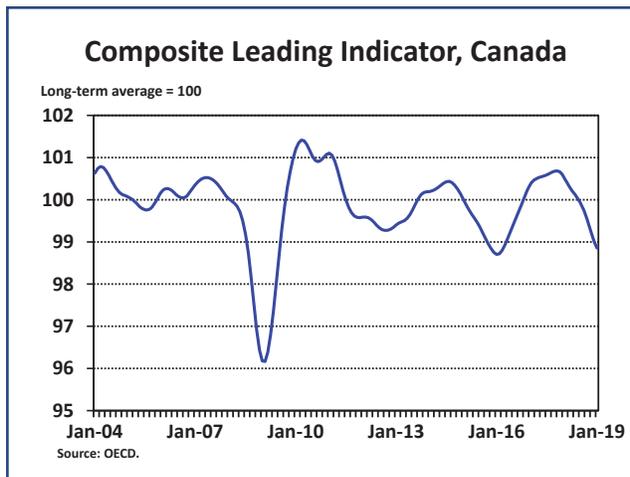
strong, though it has weakened in the past two decades. Nonetheless, it is unlikely Canada's economy would fall into recession without the U.S. economy falling into recession.

Various U.S. leading economic indicators are not flashing recession, only a mild slowdown. Real GDP growth in Q1-2019 is forecast to less than 1.5 per cent annualized, down from 2.6 per cent in the last quarter of 2018. The federal government shutdown, poor winter weather, and sliding exports, due in part to Trump's policies, are expected to depress growth. A growth rebound to 2.5 per cent annualized is widely seen for the following quarter.

Similarly, a growth rebound is expected in the second quarter after a weak first quarter of 2019. Alberta's oil production cut of 325,000 barrels per day (bpd) beginning in January was eased by 100,000 bpd in response to higher prices and lower inventories. Further reductions are likely. Poor weather this winter created some pent-up activity, which will materialize in the spring and summer and boost growth. Exports are expected to rise under the low loonie and firming global growth and commodity prices. The wild card is business investment.

Recessions usually develop when significant economic imbalances are present, and a trigger event sends the economy into a contraction phase. In Canada, the most oft-cited imbalance is household debt, which hit a record high at 176.3 per cent of disposable income in the fourth quarter of 2018. A high debt level does not cause a recession, rather, it is a vulnerability for the economy and exacerbates the downturn, should a recession occur.

A related concern is interest rate resets. Mortgage debt incurred when rates were low will be refinanced at higher rates, which could result in some borrowers



unable to support higher payments. The extent of borrowers in this difficult position is not large and will not cause a recession because the quality of borrowing has improved, rates are higher by less than one percentage point, household incomes are higher, and the main cause of default is unemployment, which brings us full circle to the recession trigger.

Recessions in Canada are usually caused by external events ranging from geopolitical crisis, a recession in the U.S. and or in major economies, a plunge in commodity prices, and fiscal, monetary, or industry policy measures by key government bodies, such as the U.S. Fed over-tightening.

Economies are usually in a growth phase and spend little time in recession. For example, in the post-war era, the U.S. economy has been in recession only 15 per cent of the time and only 13 per cent for Canada. The U.S. economy has not had a recession since 2008-09 and its current expansion phase is approaching the duration record. After June 2019, it will break the record. Canada's last recession was also in 2008-09 and was caused by the recession in the U.S. and European economies due to their financial crises.

With the U.S. the largest economy in the world and Canada's largest trading partner, it is the main interest here. No U.S. recession during 2019 is expected by most forecasters, nor signaled by leading indicators, however, beyond 2019 recession odds increase to around 20 per cent, though few forecasters are calling for one. A slower U.S. growth phase— trend growth below two per cent—will likely play out in 2020 and 2021. Fiscal tightening to deal with the large federal budget deficit will be one factor restraining growth. Further tariffs imposed by the U.S. would be another.

The top recession risk is U.S. trade policy. The U.S.-China trade dispute and the U.S. threat to impose tariffs on auto imports generates a high level of uncertainty and could seriously harm the global economy if there is no satisfactory resolution. Another concern is a geopolitical flare-up turning into a recession trigger if it involves key global actors or disrupts oil supply.

Recession odds for Canada are probably greater than 20 per cent, and this will increase if the bout of weakness does not reverse soon. Based on leading indicators and on prospects for improved U.S. and global growth in the near term, a reversal is likely. This recession scare will not be this last one for this cycle - at some point, Canada's economy will fall into a recession due to external events.

Canada's medium-term economy prospects are modest to moderate growth. Economic growth is seen slowing from 1.9 per cent in 2018 to average 1.6 per cent annually during 2019 to 2021. The Canadian dollar will be range-bound and modestly appreciate when oil prices rise. Low interest rates in Canada will play out in this environment.

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