Economic Commentary

central 1

Highlights:

- COVID-19 shock triggers a short, severe recession
- Economic recovery in base scenario to begin in the fourth quarter of 2020
- Shape of the epi curve will determine recovery's timing

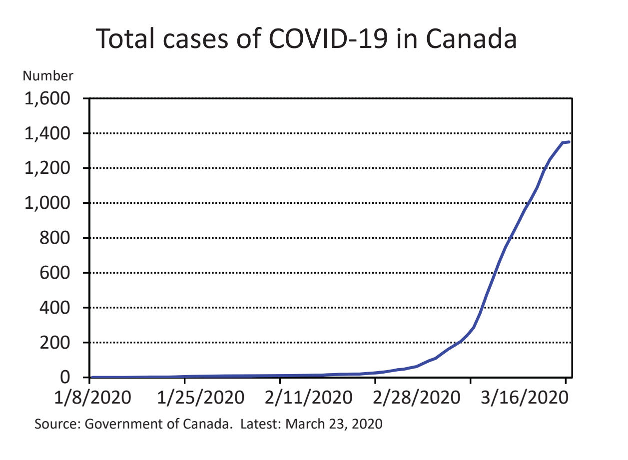
A short, sharp, and severe recession is coming to the global economy and Canada due to the COVID-19 pandemic shock event. This recession is unlike any seen any in the post-war era, or indeed, the past century.

Containment measures to stop the spread of this virus are causing major disruptions to economic activity. Consumer spending is down sharply in many sectors including travel, tourism, and trade. Closed borders, cancelled conferences, sporting events, and other people gathering activities are adding to the economic toll. Affected businesses are laying off staff, reducing open hours, or shutting down. The oil price war between Saudi Arabia and Russia is another blow to Canada's economy.

A synchronized global economic recession is playing out and having a huge impact on financial and commodity markets. China's economy, which was beginning to emerge from its slowdown and was growing around six per cent, is facing a near term contraction. The U.S., Europe, and most other countries and regions are encountering the same economic conditions.

Policymakers are scrambling to address and mitigate the economic disruptions and financial disturbances. Monetary authorities have, or will in Canada, cut their policy rate to the zero lower bound and have implemented various credit and liquidity facilities to keep those markets functioning and not cause economic damage. Fiscal authorities have stepped up their efforts and are announcing spending and income support measures to individuals and businesses.

One benefit of the 2008-09 financial crisis is that policymakers learned to react quickly and forcefully.



However, these policy measures will not offset economic losses and avoid a recession, rather they will mitigate the damage and set the stage for the recovery phase and future growth.

The shape of the recession and subsequent recovery will largely depend on the shape of COVID-19's epidemiological (epi) curve. In Canada and in most countries, the epi curve is in the acceleration phase. How long it remains in this phase depends on the success of containment measures – quarantines, lockdowns, border restrictions, business shutdowns, stay-in-place, social distancing, working from home, closing schools and other institutions, and limits on crowd size. Some of these measures are intended to remain in effect through April and possibly into June. If this does not 'flatten the curve', more stringent containment policies would be implemented.

Once the epi curve is in the deceleration phase, normal activity may not fully resume. A measured relaxation of containment policies is the likely scenario rather than a wholesale lifting. This is a global pandemic with countries, and regions within countries, on different epi curves, which calls for a considered approach. Canada's most important trading partner and next door neighbour, the U.S., and its epi curve will have a large influence on the return to our normal economic activities.

The second blow to Canada's economy is the oil price war and lower commodity prices in general due to the coronavirus global recession. Prices for Western Canada Select are below $10 as of this writing, well below breakeven costs for oil sands producers. Capital

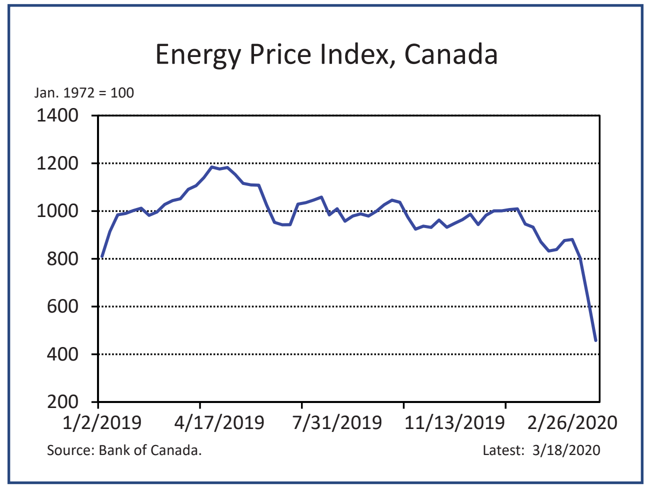
expenditure plans are being cut under these market conditions and the short-term market outlook is poor with prices remaining low. How long the Saudi-Russia stalemate continues is anybody's guess, and the longer it lasts, the greater the hit to Canada's oil patch and to U.S. shale and other swing producers.
Graph energy price index

Economic data releases have a reporting time lag and most available releases do not capture the negative impact of the COVID-19 shock on the economy. One release that does is the preliminary, or flash, Purchasing Managers' Index (PMI) reports for March 2020 in select countries such as the U.S., the Eurozone countries, the U.K., Japan, and Australia. These results revealed sharp declines in output, employment, new orders, prices, and future expectations. In some cases, the PMI hit record lows falling below 2008-09 levels or were the weakest since then. Service sector industries were hardest hit, and manufacturing was not spared. Worse results are expected in the April 2020 PMIs.

In China, economic data for February (the first month in which the lockdown began) showed business confidence, industrial production, investment and retail sales have all collapsed. The situation did not improve in March, and China's economy probably contracted for the first time in decades. A quarterly drop around 5 per cent, perhaps as high as 10 per cent, implies an unprecedented decline.

Other evidence comes from unemployment insurance filings and these indicate that a huge surge in unemployment is around the corner. In the U.S., initial claims for unemployment insurance benefits jumped by 3,001,000 to 3,283,000 in the week ended March 21, a record high. News reports on Canada state that nearly one million Canadians applied for unemployment benefits in the latest week. Official numbers will come later. Clearly, unemployment rates will be shooting up when official survey results are released. In Canada, the Labour Force Survey (LFS) for March 2020 is conducted in the second full week of the month and will not capture the fullest extent of the unemployment situation. That will occur in the April 2020 LFS report.

The sudden stop in economic activity is mainly felt in consumer spending. Travel, leisure, hospitality, entertainment, housing, and retail sectors are seeing a meltdown in sales, revenue, and profitability. Table 1 outlines consumer spending categories at high risk amounting to $214.5 billion, or 9.3 per cent, of total consumer spending in Canada during this health crisis. The hit to consumer spending goes beyond this



estimate with sales of autos, furniture, appliances, clothing, and other durable and semi-durable goods falling off. Most consumer spending, except for life essentials, will be considerably down.

Capital investment spending will also be negatively affected during this crisis. A business in an industry hit by the fall in consumer spending or in an export industry facing lower prices and demand, such as in tourism, travel, and energy will be postponing or cancelling capacity expansion plans.

Another sector that faces contraction in the near term is trade. The global economic recession means less demand for Canada's exports from the U.S. and other countries facing similar demand shocks. One positive is that with less domestic demand, imports to Canada also decline offsetting some of trade deficit due to fewer exports.

Scenario forecasting necessary

The shape and duration of the epi curve has a direct bearing on the economic outcome, and given its uncertain path, a scenario approach to forecasting is needed. In Canada's base scenario, cases continue rising in the near-term, peaking in April/May. Containment measures are relaxed in the third quarter and economic activity increases supported by accommodative monetary and fiscal policies.

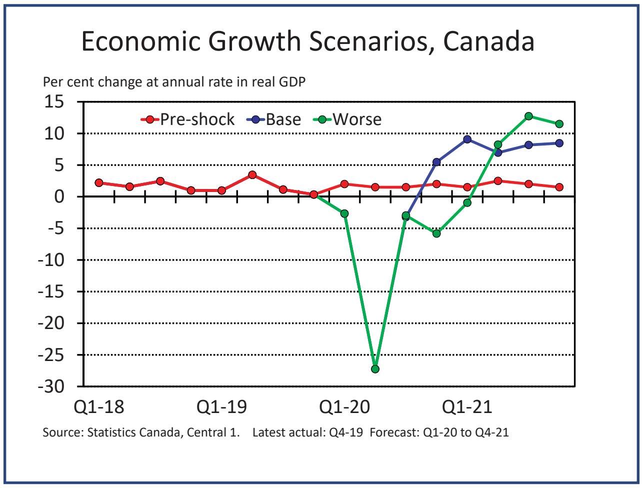
A sharp decline in industry Gross Domestic Product (GDP) during March 2020 will mark the beginning of this economic recession. This forecast has a 1.4 per cent month-over-month contraction occurring followed by a deeper 3.8 per cent drop in April. Smaller monthly GDP contractions are expected in May and June 2020.

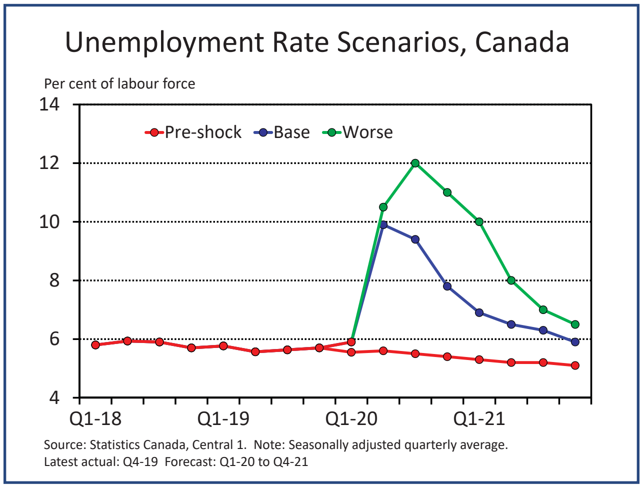
Canada's second quarter 2020 real GDP is shaping up to take a severe hit, plummeting at a 27.2 per cent annual rate, which would be the largest quarterly decline on record. This comes on the heels of a forecast 2.7 per cent annualized contraction in the first quarter of 2020. These two consecutive quarterly contractions qualify as a recession, though not all do, due to the dispersion of the economic losses as well as their depth. Household spending is forecast to decline at annual rates of 1.1 per cent and 10.7 per cent in the first and second quarters of 2020, respectively. Real exports are seen down 1.6 per cent and 12.3 per cent and real business investment spending is off 1.0 percent and 2.9 per cent on the same basis. Government spending is the only sector forecast to post increases during this time.

The base scenario has this recession ending in the fourth quarter of 2020 based on the assumed epi curve. A sharp V-shaped recovery phase is forecast when pent-up consumer demand is released, and trade volumes pick up. Low interest rates will boost housing sales and construction. Growth rates between seven and nine per cent per quarter are expected to backfill the recession's output losses by the end of 2021.

The unemployment rate shoots up to around ten per cent in the near term. Industries most affected are shown in Table 2, though few industries will be spared as the demand shock multiplies through the economy. A recession in the oil patch due to its price collapse is another channel feeding into rising unemployment.

An alternative and worse scenario in this forecast has this crisis persisting into 2021 adding to the economic disruption and encompassing all the large economies. The economic recession continues until the first quarter of 2021. More pessimistic scenarios are possible and include the virus crisis extending into the summer of 2021 or easing during the summer months only to revive in the winter. These scenarios would result in a longer recession phase or a brief economic pick up only to fall back into a contraction. Additional fiscal support measures would be required, and likely





forthcoming, to mitigate some of these losses and the Bank of Canada implementing quantitative easing. The best remedy for the economic recession is to contain the virus as quickly and completely as possible.

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Canada Economic Forecast – Base Scenario

	2019 Q4	2020 Q1	2020 Q2	2020 Q3	2020 Q4	2021 Q1	2021 Q2	2021 Q3	2021 Q4	2019	2020	2021
Real GDP, % ar	0.3	-2.7	-27.2	-3.2	5.5	9.1	7.0	8.2	8.5	1.6	-5.4	4.0
U. Rate, %	5.7	5.9	9.9	9.4	7.8	6.9	6.5	6.3	5.9	5.7	8.2	6.4
Core CPI, % y/y	2.1	2.0	1.9	1.8	1.9	1.7	1.7	1.8	1.9	1.7	1.9	1.8

Source: Statistics Canada, Central 1. Shaded cells are forecasts. ar = annual rate.

Consumer spending categories at high risk, Canada

2019 values	$ bil.	% of GDP
Air transport	16.3	0.7
Other transport	11.3	0.5
Accommodation services	13.6	0.6
Food and beverage services	78.8	3.4
Games of chance	16.8	0.7
Cinemas	1.1	0
Recreational and sporting services	12.9	0.6
Other cultural services	3.5	0.2
Personal grooming services	9.5	0.4
Expenditure by Canadians abroad	50.7	2.2
Total	214.5	9.3

Source: Statistics Canada Detailed Housing Final Consumption Expenditure, Central 1.

Payroll employment in high risk industries, 2019, Canada

Industry	Persons (thous.)	% of total
Air transportation and support	107.4	0.6
Transit and ground passenger transport.	127.6	0.8
Travel arrangement and reservation	37	0.2
Arts, entertainment and recreation	312.2	1.8
Accommodation services	204.1	1.2
Food services and drinking places	1,138.00	6.7
Motion picture and sound recording	54.2	0.3
Personal care services	93.9	0.6
Retail trade	2,007.50	11.8
Wholesale trade	822.8	4.9
Total	4,904.70	28.9

Source: Statistics Canada Survey of Employment, Payrolls, and Hours, Central 1.