

RBC ECONOMICS | RESEARCH

Canada/Ontario Economic Update: Living with Uncertainty

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Global growth backdrop looks solid

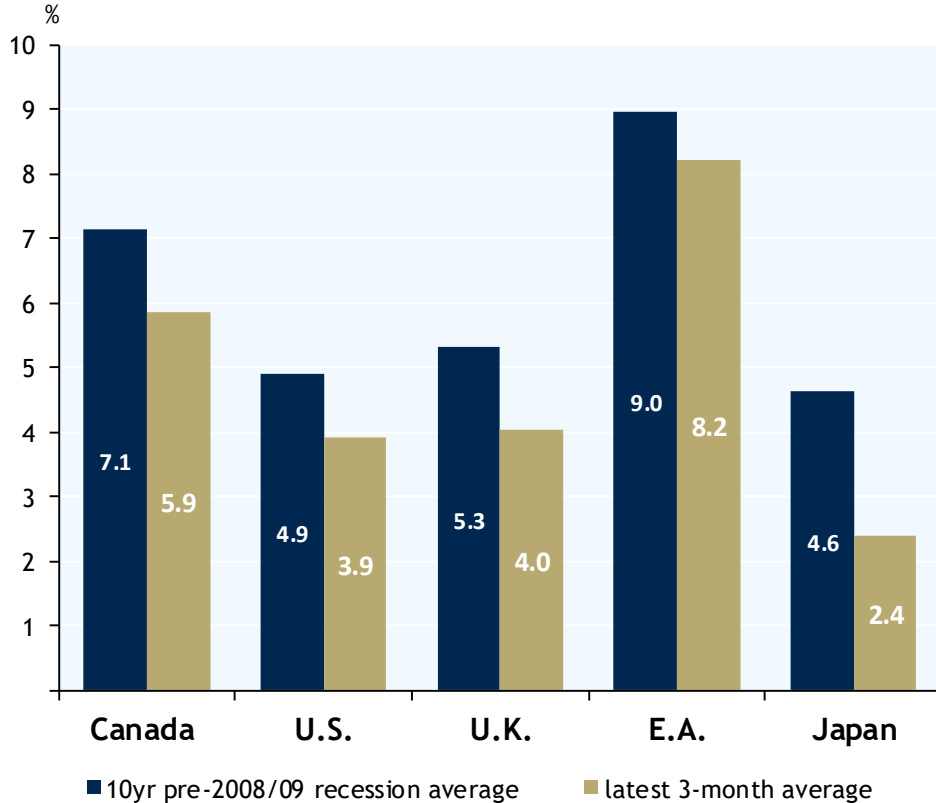


Source: International Monetary Fund, RBC Economics Research

- Some softening in UK, Euro area in H1/18, but probably weather related
- US economy looks very strong – supported by fiscal stimulus

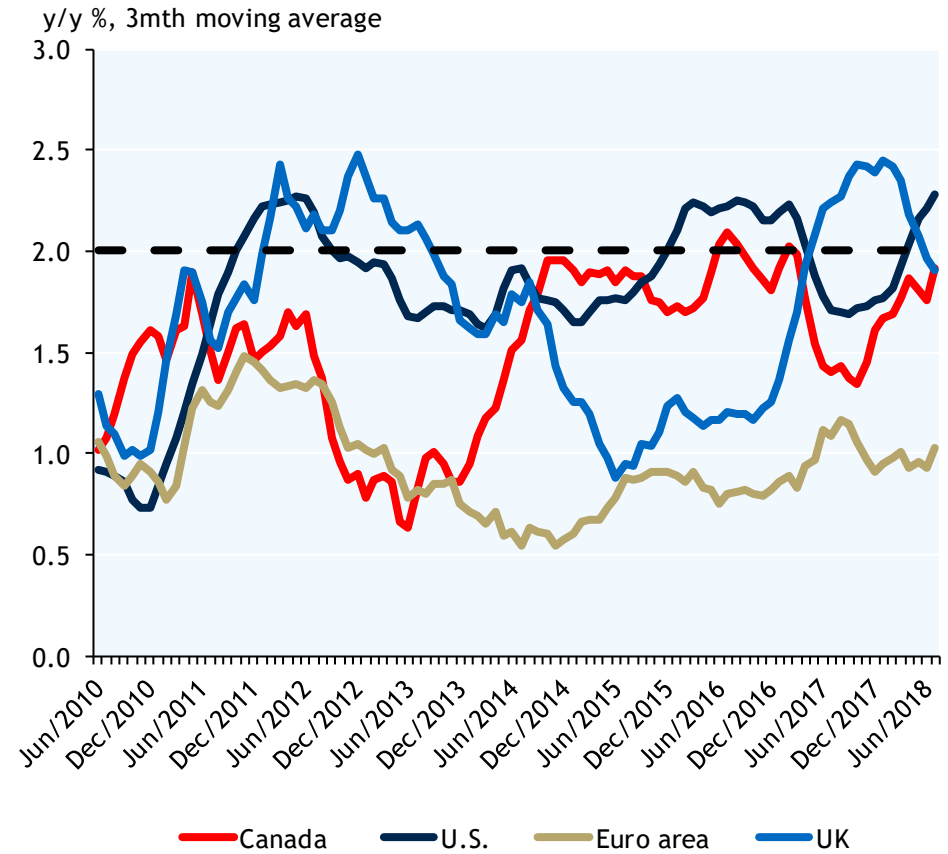
Global economic recovery 'mature' – rates moving higher.

Unemployment rates: Now vs Then



Source: Haver, RBC Economics Research

Advanced Economy 'Core' Inflation

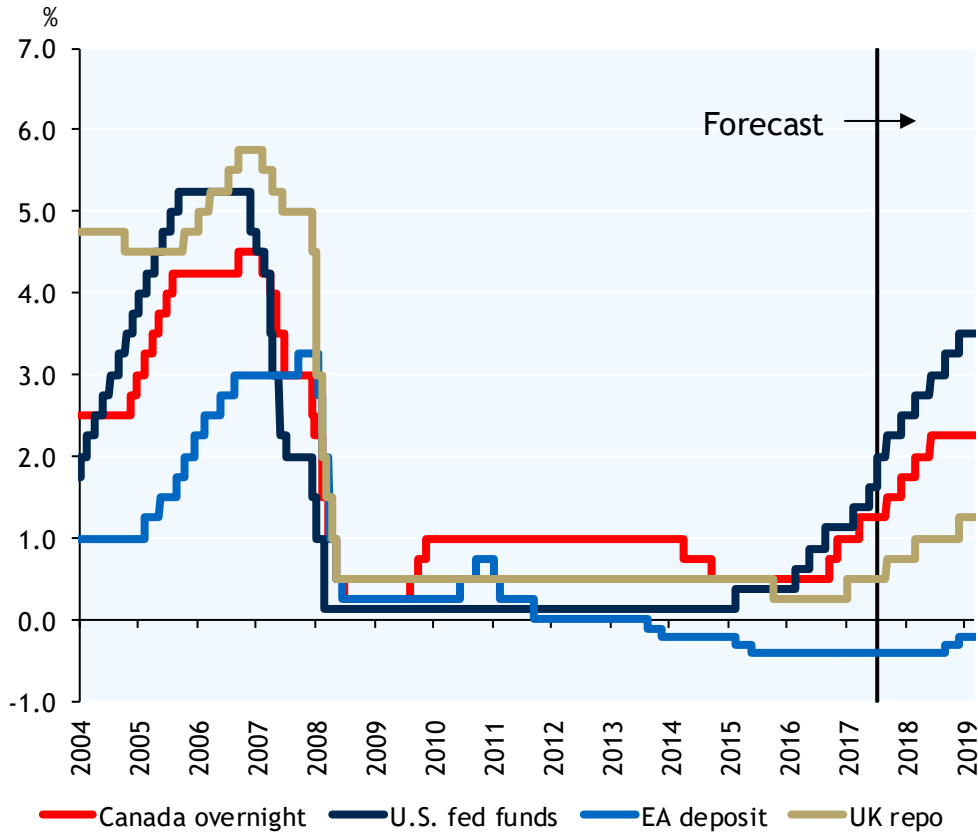


Source: Haver, RBC Economics Research

- Developed economy urates below pre-recession averages
- Central bank focus has shifted to withdrawing rather than adding new monetary policy stimulus

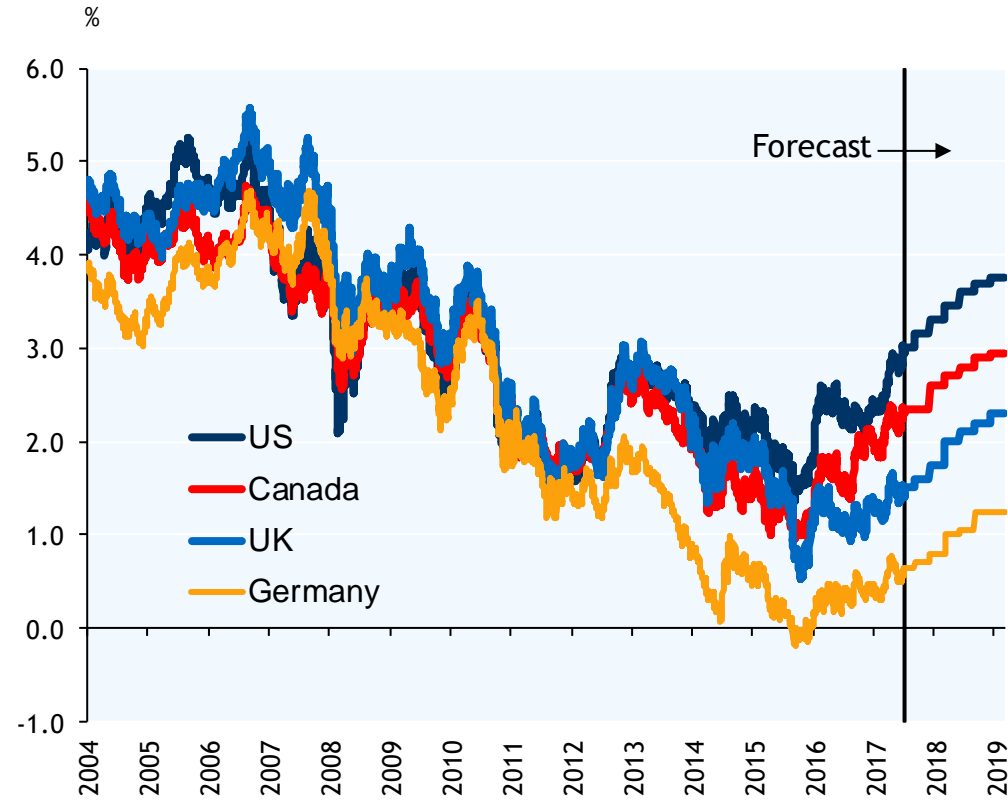
Central banks easing off the accelerator

Global Central Bank Policy Rates



Source: Haver, RBC Economics Research

10-year Government Bond Yields

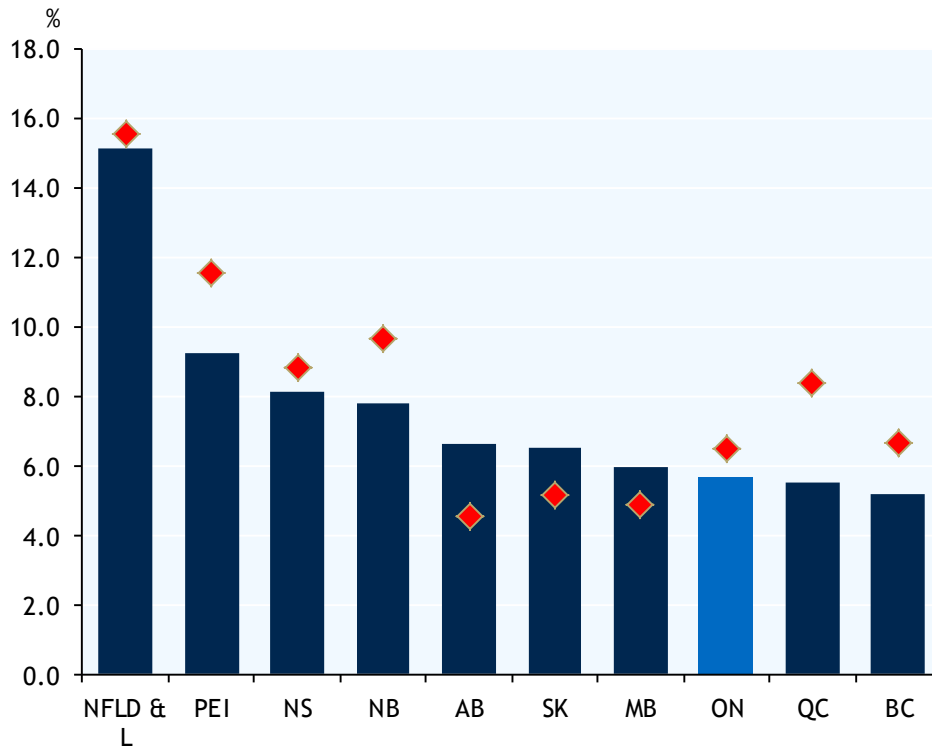


Source: Haver, RBC Economics Research

- Adds up to decade-long sale on debt gradually coming to an end – ‘gradually’ the key word
- Faster in the U.S. because of 1) stronger economy, and 2) un-needed fiscal stimulus

Canadian labour markets increasingly tight

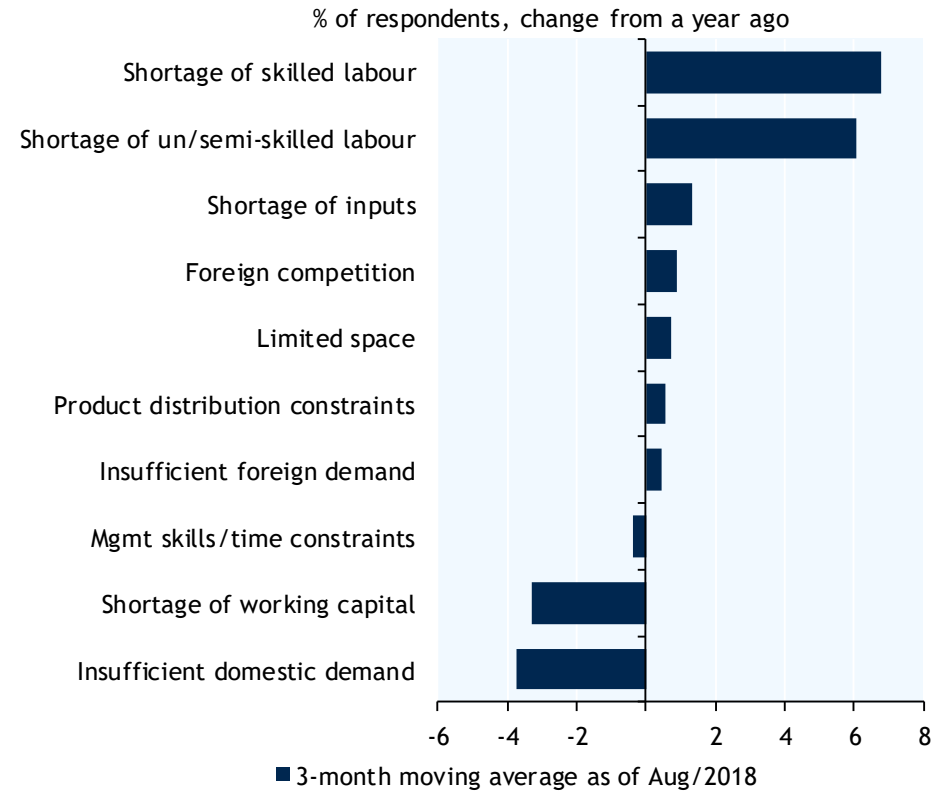
Regional Unemployment Rates



■ Latest 3mth average (as of Aug/2018) ◆ 10-year pre-recession average

Source: Statistics Canada, RBC Economics Research

CFIB: Factors Constraining Production



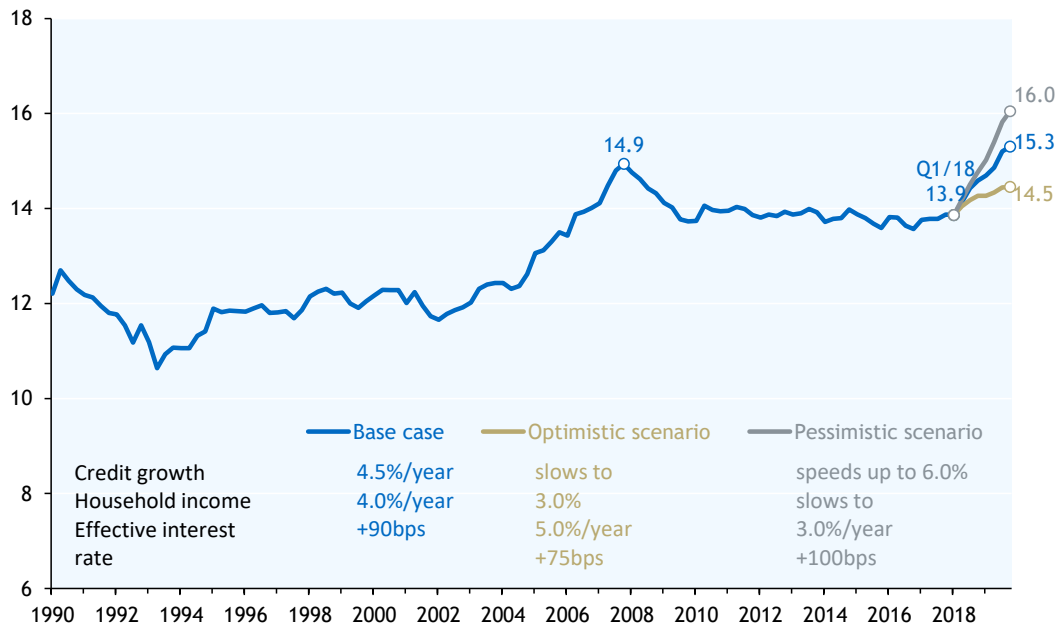
Source: CFIB Business Barometer, RBC Economics Research

- Most provincial unemployment rates low by historical comparison.
- Labour shortages increasingly reported as a constraint on production/sales growth.
- Shortage of skilled labour the #1 cited impediment to business growth – nationally and in Ontario

Debt payments to eat up larger share of Canadian household incomes

Household debt service ratio: Canada

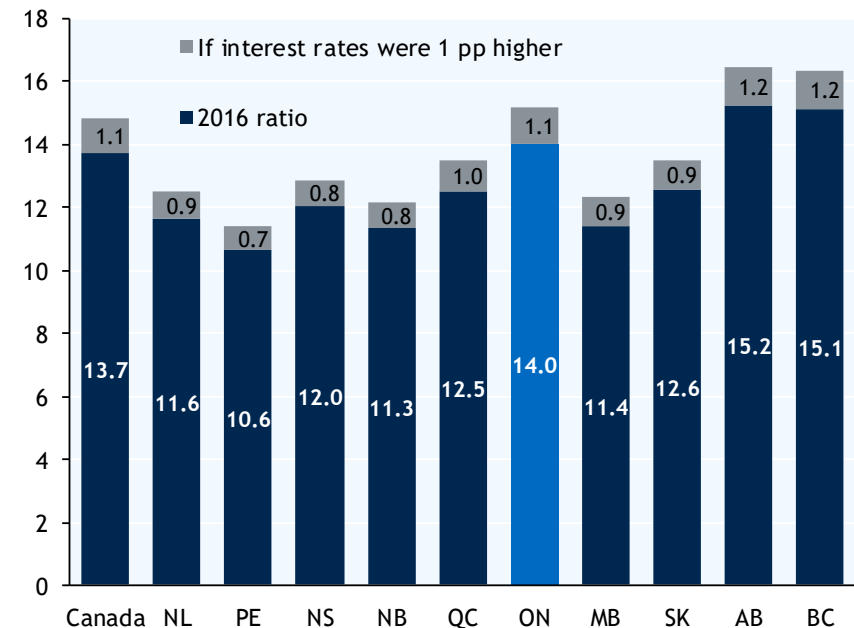
Debt payments as a % of household disposable income



Source: Statistics Canada, RBC Economic Research

Household debt service ratio

Debt service payments as % of household

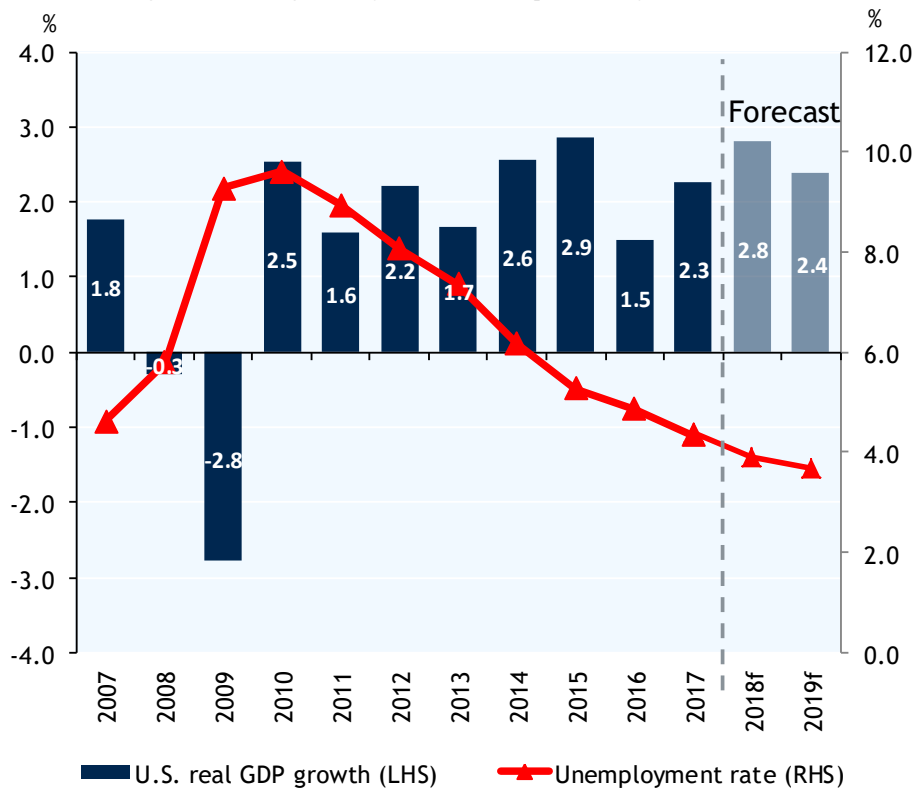


Source: Statistics Canada, RBC Economics

- Higher debt levels mean households more sensitive to rate hikes today – about 60% more sensitive than in the early 1990s
- Regionally, Alberta, Ontario, and BC the most vulnerable
- *Effective rates won't rise overnight, though. Most mortgages fixed rate – not all variable rate mortgages move in lockstep with BoC rates.*
- Household incomes are still rising – wage acceleration still to come

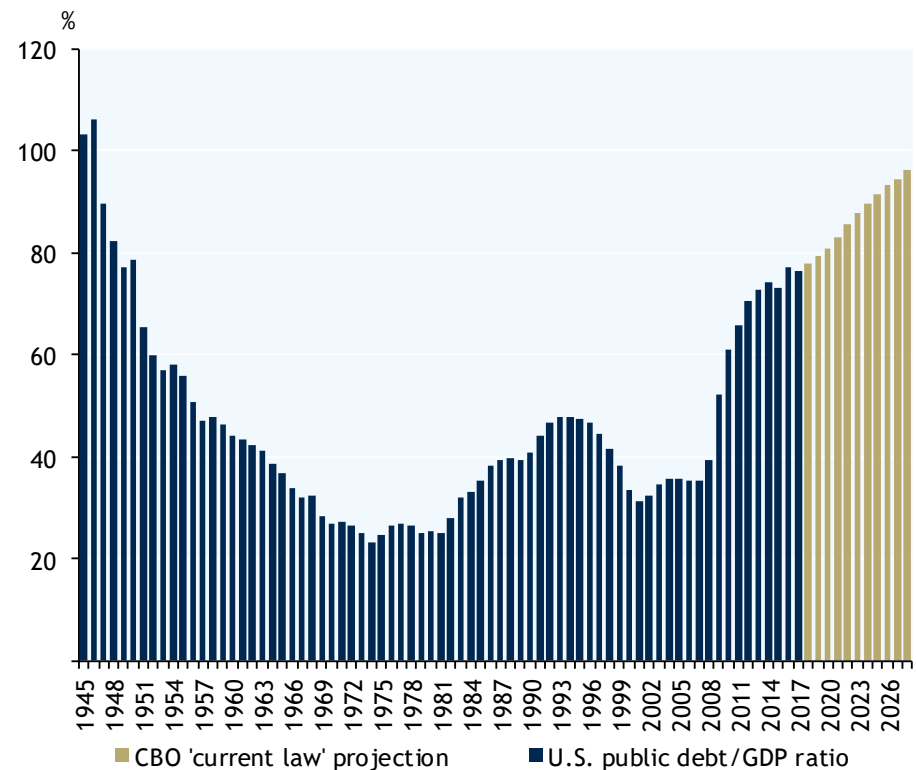
U.S. bucking the slowing trend (by piling on government debt)

U.S. growing beyond capacity



Source: Bureau of Labor Statistics, Bureau of Economics Analysis, RBC Economic:

U.S. Government Debt/GDP ratio



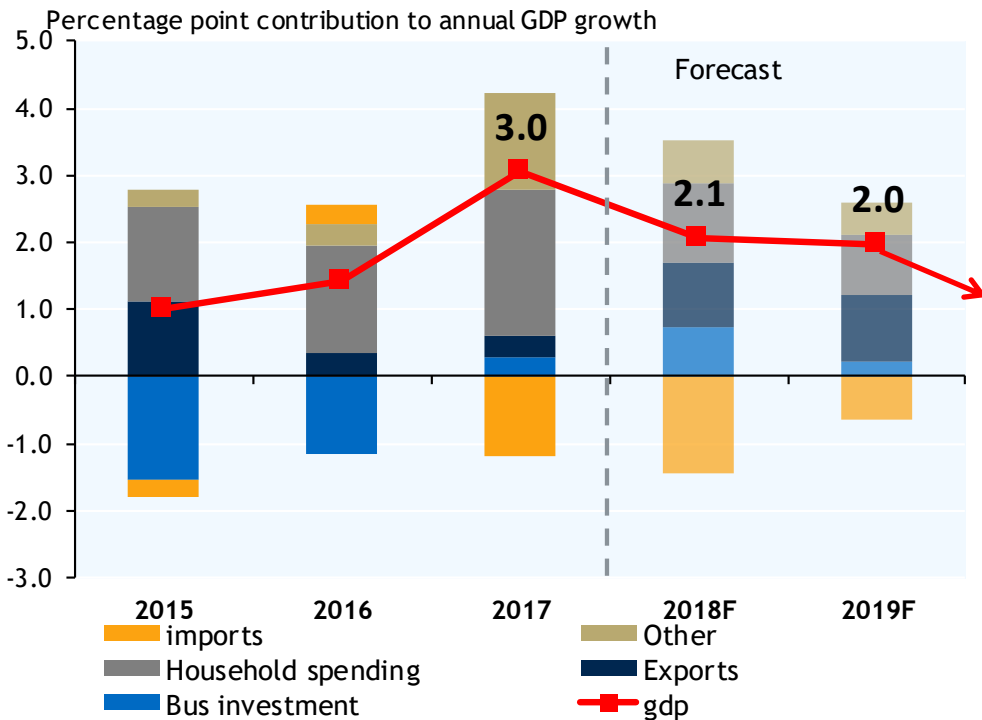
Source: Congressional Budget Office, RBC Economics Research

U.S. economy at or beyond long-run capacity constraints – but budget deficits and debt still rising.

- Debt projected to rise to close to post-WWII levels – not including most of ~\$49 trillion unfunded Social Security/Medicare liabilities.
- Long-term pain but near-term gain.

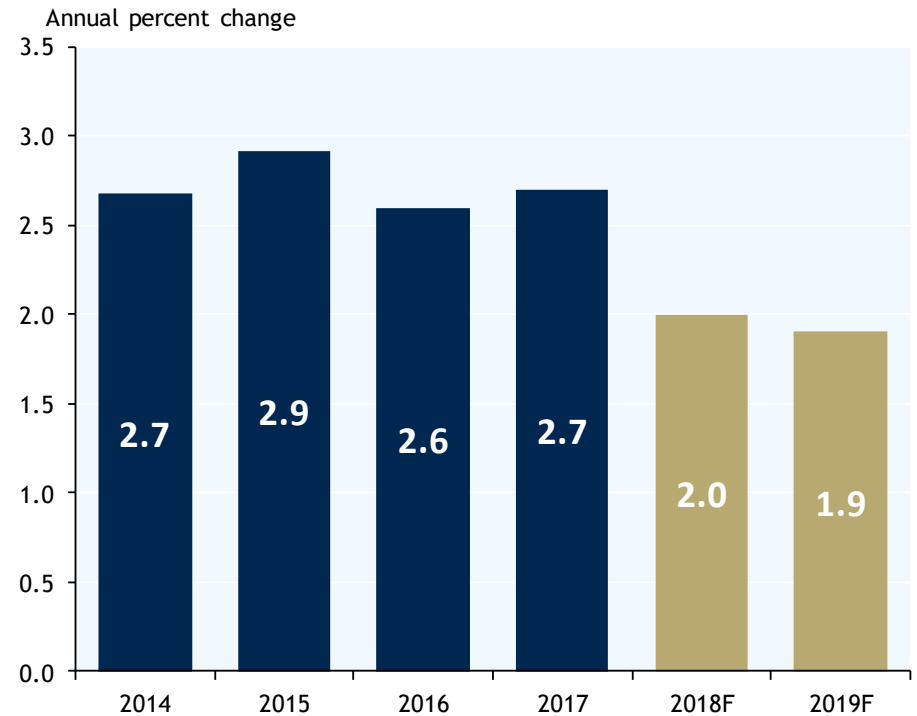
Canadian (and Ontario) GDP growth set to slow further

Canada GDP growth forecast



Source: Statistics Canada, RBC Economics Research

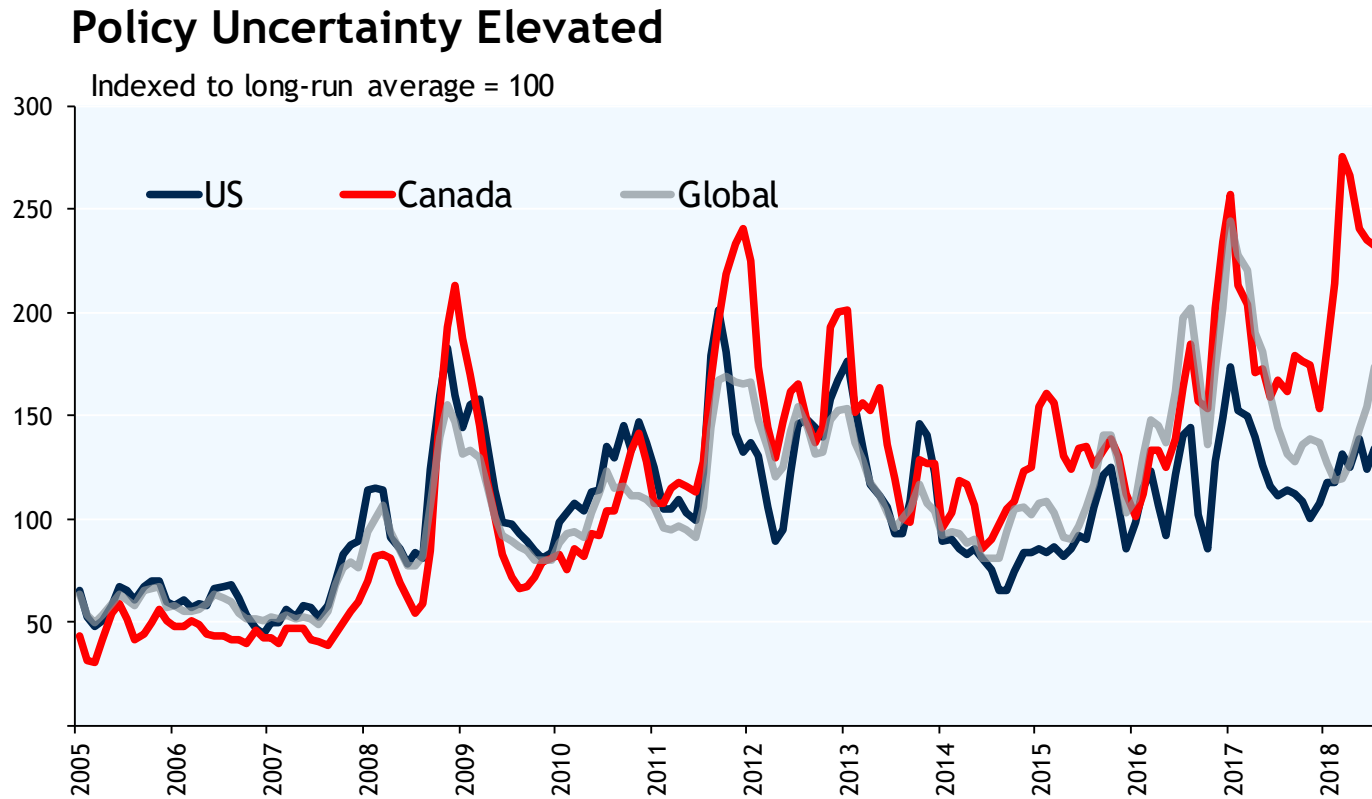
Ontario GDP Growth



Source: Statistics Canada, RBC Economics Research

- Economy running at or beyond capacity already + gradual rate hikes = slower GDP growth (even without U.S. trade risks...)
- 'Potential' GDP growth in Canada probably <2% -- ON a little stronger because of population growth but ON also more sensitive to rate hikes.

Policy uncertainty set to ease, or get worse?

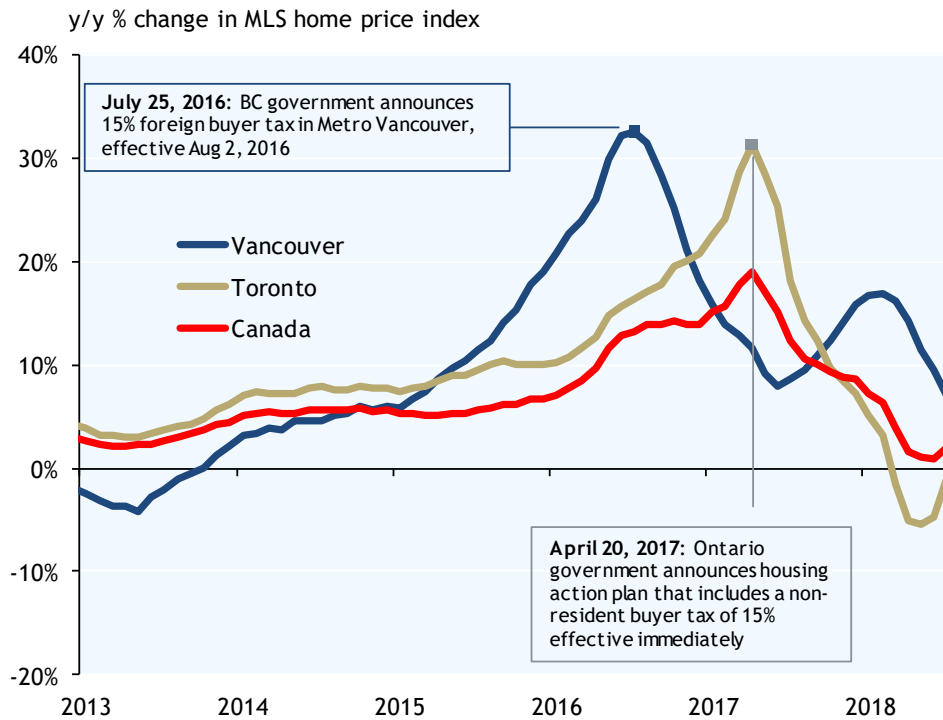


Source: Policyuncertainty.com, RBC Economics Research

- **Uncharted territory on trade and household debt levels.**
- **Means more uncertainty – already likely weighing on business investment but bigger risks to the outlook remain.**

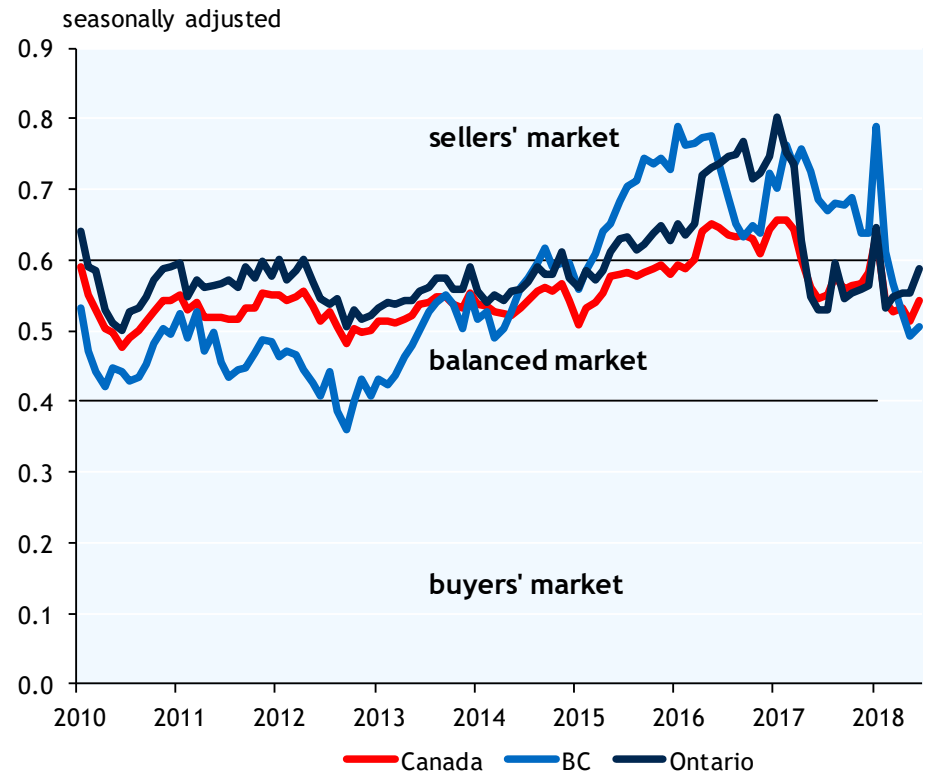
Housing: this is what a 'soft landing' looks like (so far)

Home price growth impacted by policy



Source: CREA, TREB, REBGV, RBC Economics Research

Sales-to-new listings ratio



Source: CREA, RBC Economics Research

- Home resales down sharply early in 2018 as new B20 mortgage lending regulations came into effect
- Listings also down, though, so buyer's haven't gained as much leverage as might have thought
- ~45% of local markets across Canada still 'seller's markets.' ~13% 'buyer's markets' as of July

NAFTA Risks? WTO backstop not so frightening

Key Negotiation Issues

'rules of origin'

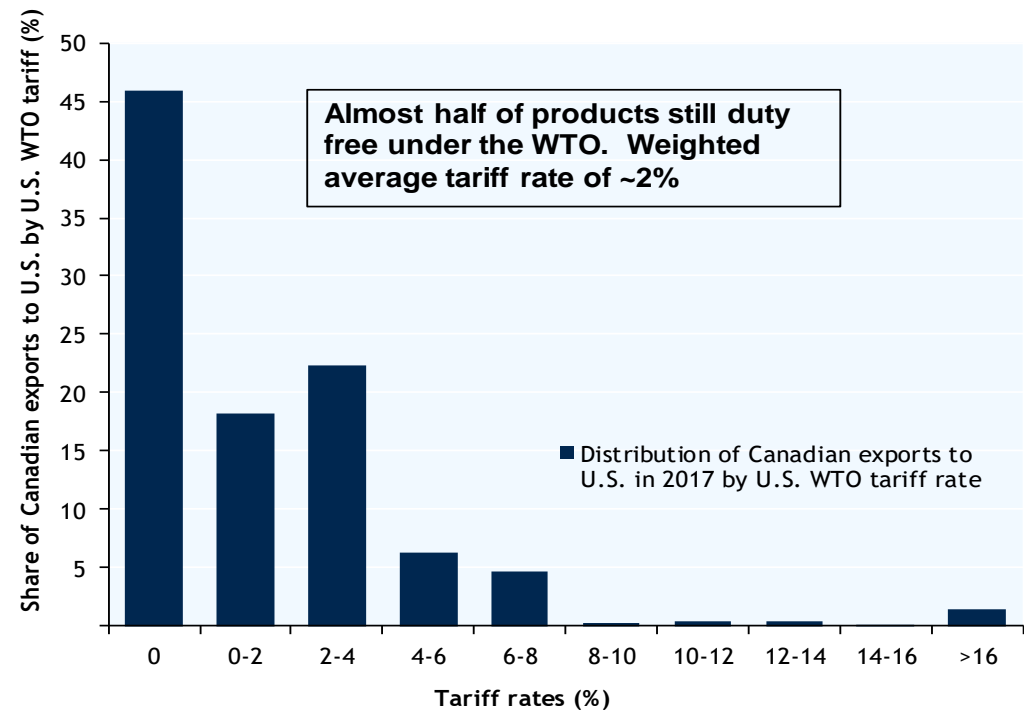
Sunset clause

Dispute Settlement Mechanism (Chapter 19)

Supply management

Government procurement

Canada-U.S. Exports by WTO Tariff rate?



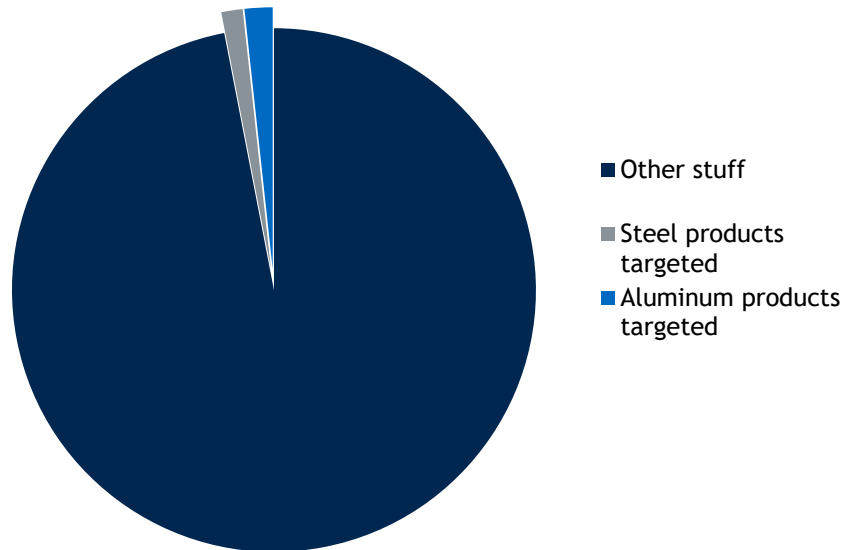
Source: Industry Canada, WTO, RBC Economics Research

- Most likely outcome of NAFTA negotiations is still a new deal – or extended negotiations with the NAFTA agreement essentially remaining in place in the mean-time.
- Don't forget Congress: would have to approve a bilateral MX-US deal – and presumably repeal the legislation that implemented NAFTA.
- U.S. tariffs under WTO are low – ie. NAFTA rip-up not as severe a scenario for Canada as it sounds
- More worrying outcome if U.S. also ignores WTO rules a la Steel/Aluminum tariffs and ongoing Autos section 232 investigation

Auto tariffs would be worse...

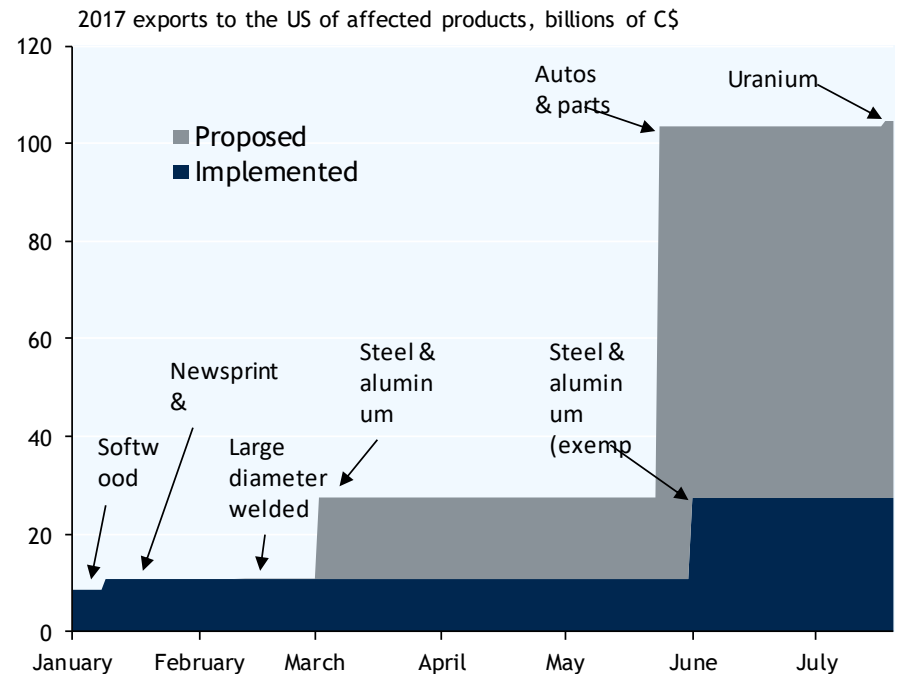
Steel and Aluminum Exports Context

% of merchandise exports



Source: Industry Canada, RBC Economics Research

US tariffs on Canadian exports to-date

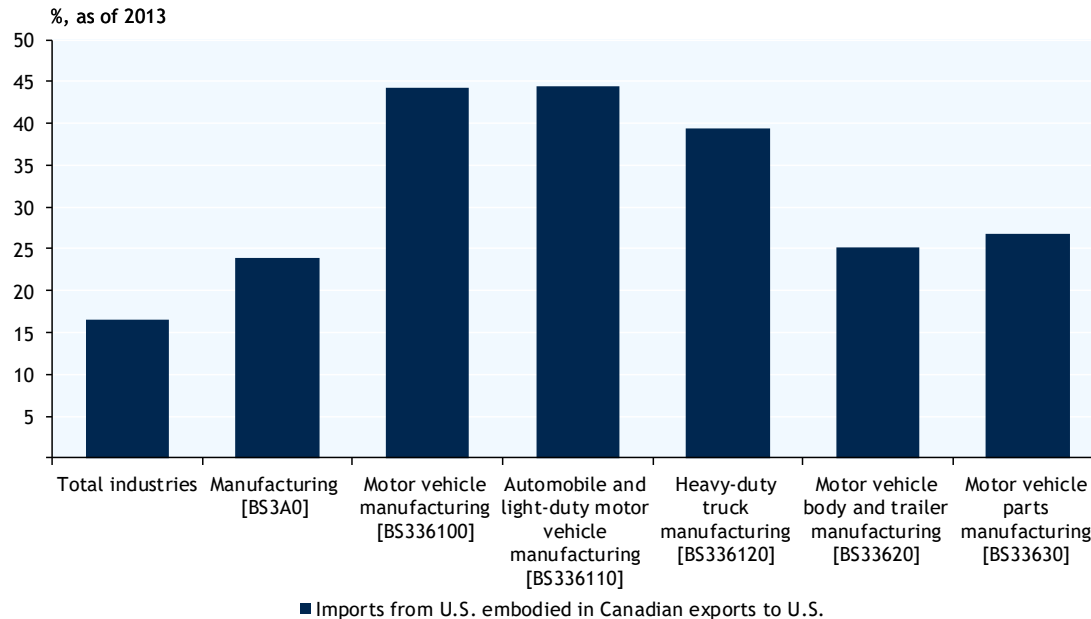


Source: Statistics Canada, Bank of Canada, US Department of Commerce, RBC Economics Research

- Progress in Mexico-U.S. NAFTA negotiations have increased the odds of a 'successful' renegotiation – but sticking points with Canada remain
- 20%-25% auto tariffs that have been threatened would probably be worse in the near-term than a NAFTA tear-up with reversion to WTO tariff levels.

...but don't make any sense – other than as a negotiating ploy

U.S. Import Content in Canadian Exports to the U.S.



Source: Statistics Canada, RBC Economics Research

Top 10 U.S. States by Auto Exports

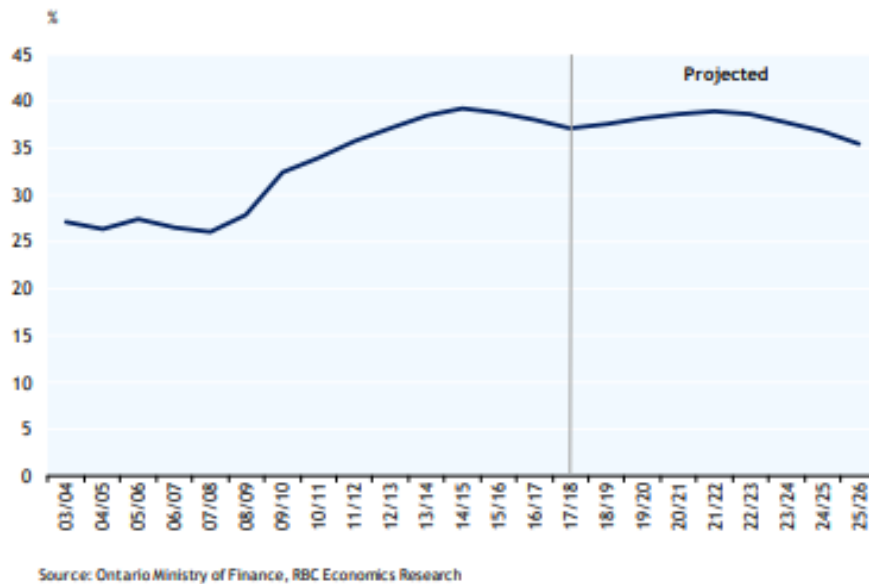
State	% to Canada
Michigan	68.0
Ohio	71.3
Texas	22.6
Indiana	76.2
California	21.5
Illinois	30.6
Alabama	29.6
South Carolina	11.9
Kentucky	78.0
New York	52.0

Source: RBC Economics, U.S. Census Bureau

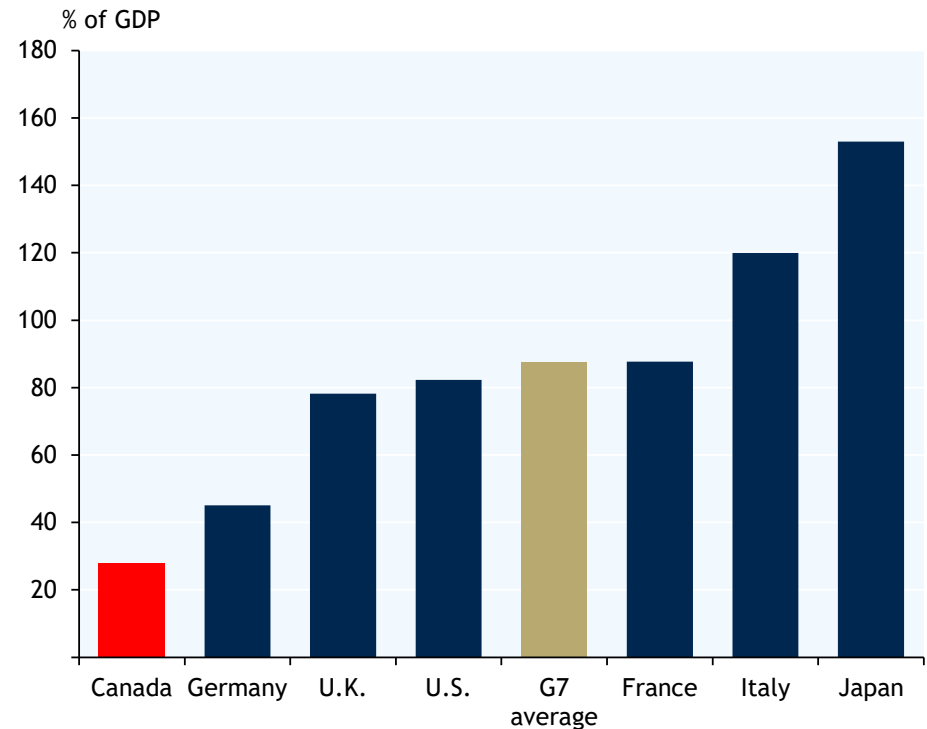
- Accounting for U.S. content used by Canadian auto producers, a U.S. auto import tax on Canada would also act directly as a tax on U.S. exports.
- Canada accounted for the majority of U.S. auto exports for 22 states last year – including important swing states like Michigan and Ohio.
- An unpredictable president means anything is possible but the fact U.S. industry would be hurt by the measures directly makes them less likely – and more likely to be short-lived if actually implemented.

Another auto bailout? Canadian government still with some room to maneuver

Ontario Net Debt % of GDP



G7 Government Net Debt



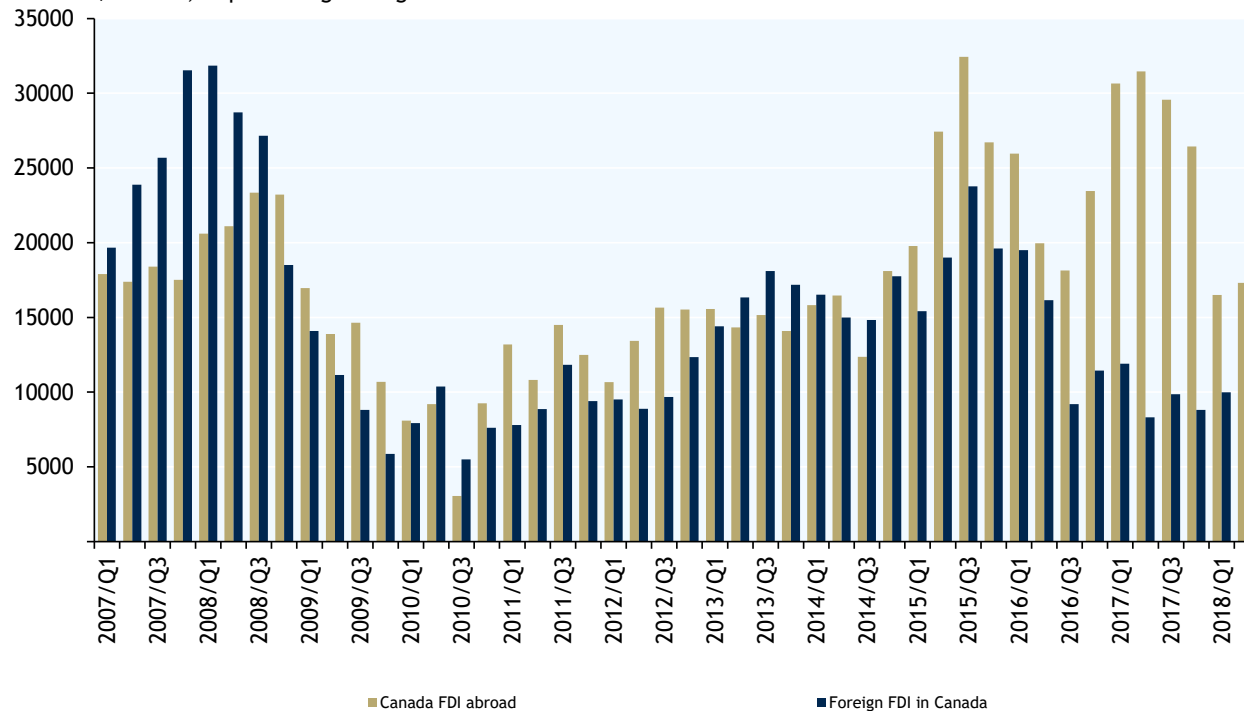
Source: IMF Fiscal Monitor Apr/18, RBC Economics Research

- Deficits still sizeable – but government debt levels enviable compared to other advanced economies...

Loss of 'competitiveness' a concern for businesses

Canada Foreign Direct Investment

\$millions, 4 qtr moving average



Source: Statistics Canada, RBC Economics Research

Canada already was seeing less foreign investment after 2015/16 oil price collapse.

Then:

- **U.S. 2018 tax cuts – Canada's sizeable corporate tax rate advantage eroded**
- **Minimum wage hikes – although impact to-date seems to be limited**
- **Carbon taxation – good or bad, this is a cost that businesses elsewhere don't have to pay**
- **Recent data has looked okay, but still something to watch**

Detailed Canada/Ontario Economic Forecasts

% change unless otherwise indicated

	Real GDP				Nominal GDP				Employment				Unemployment				Housing starts				Retail sales				CPI			
	16	17F	18F	19F	16	17F	18F	19F	16	17	18F	19F	16	17	18F	19F	16	17	18F	19F	16	17	18F	19F	16	17	18F	19F
N.& L.	1.9	2.1	0.2	2.6	2.6	7.7	5.0	6.7	-1.5	-3.7	-0.7	-0.8	13.4	14.8	14.9	14.8	1.4	1.4	1.5	1.0	0.4	2.4	-2.0	1.8	2.7	2.4	1.9	2.5
P.E.I.	2.3	3.1	1.4	1.6	4.0	5.0	3.4	3.7	-2.2	3.1	2.5	0.8	10.8	9.8	9.9	9.7	0.6	0.9	0.8	0.6	7.3	6.3	4.3	3.7	1.2	1.8	2.7	2.7
N.S.	0.8	1.2	0.8	0.8	2.8	3.2	2.7	3.0	-0.4	0.6	1.0	0.2	8.3	8.4	7.7	7.5	3.8	4.0	4.6	3.8	4.7	7.8	2.5	3.3	1.2	1.1	2.5	2.6
N.B.	1.2	1.6	0.6	0.7	3.6	3.6	2.6	2.7	-0.1	0.4	0.4	0.0	9.6	8.1	7.8	7.5	1.8	2.3	2.1	2.1	2.1	6.8	0.6	2.9	2.2	2.3	2.4	2.5
QUE.	1.4	3.0	2.4	1.8	2.7	5.1	4.2	3.8	0.9	2.2	1.0	0.6	7.1	6.1	5.5	5.4	38.9	46.5	47.9	40.0	6.6	5.5	4.2	3.9	0.7	1.1	2.0	2.4
ONT.	2.6	2.7	2.0	1.9	4.3	4.4	3.8	4.0	1.1	1.8	1.4	0.6	6.5	6.0	5.5	5.4	75.0	79.1	76.0	70.0	6.9	7.7	4.6	4.4	1.8	1.7	2.5	2.4
MAN.	2.2	2.8	1.7	1.7	2.3	4.9	3.7	3.8	-0.4	1.7	0.5	0.8	6.1	5.4	6.0	5.9	5.3	7.5	6.5	5.4	3.7	7.8	1.2	4.1	1.3	1.6	2.7	2.5
SASK.	-0.5	2.8	2.2	2.8	-4.0	6.2	7.4	7.2	-0.9	-0.2	0.2	0.8	6.3	6.3	6.2	6.0	4.8	4.9	3.6	4.3	1.5	4.1	1.5	3.4	1.1	1.7	2.7	2.9
ALTA.	-3.7	4.7	2.5	2.5	-4.9	7.9	7.8	7.3	-1.6	1.0	1.8	1.6	8.1	7.8	6.6	6.4	24.5	29.5	28.7	29.0	-1.1	7.1	3.4	5.1	1.1	1.5	2.6	2.2
B.C.	3.5	3.7	2.3	1.9	4.8	6.3	4.5	4.0	3.2	3.7	0.8	0.9	6.0	5.1	4.9	5.0	41.8	43.7	42.1	38.8	7.7	9.3	3.1	3.9	1.9	2.1	2.6	2.3
CANADA	1.4	3.0	2.1	2.0	2.0	5.4	4.7	4.6	0.7	1.9	1.1	0.7	7.0	6.3	5.8	5.8	198	220	214	195	5.2	7.1	3.7	4.2	1.4	1.6	2.4	2.4

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