Quiet Counsel

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Investment Outlook

Canada's Complex Adjustment

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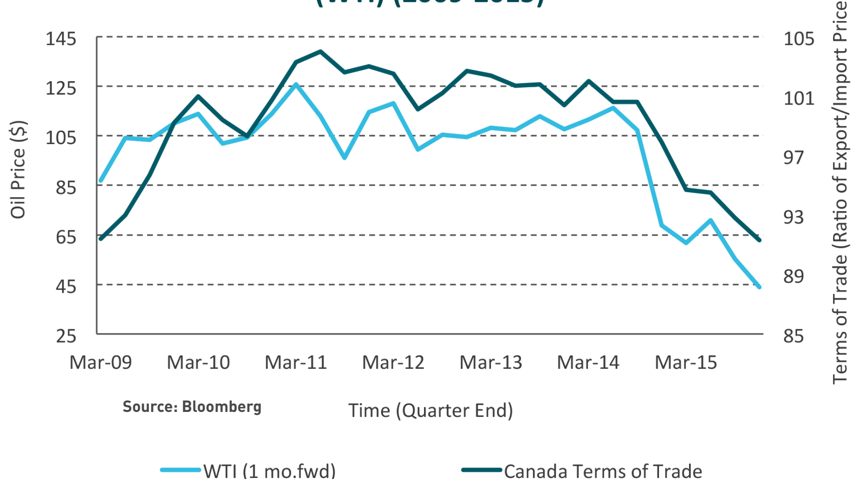
The decline in commodity prices that began in 2014 triggered a significant restructuring of the Canadian economic landscape. Given that commodities represented 9.7% of Gross Domestic Product (GDP) in 2015, the evolution, pace and extent of this restructuring will have broad implications for near term growth and the long term composition of the Canadian economy. The graph below illustrates how the 60% decline in oil prices since mid-2014 has directly reduced Canada's terms of trade, the ratio of the country's export prices relative to its import prices. This shift is noteworthy from an economic perspective, because the improvement in terms of trade was a significant driver of Gross Domestic Income in the ten years prior to the fall in oil prices.

Quarterly Tems of Trade vs. Price of Oil (WTI) (2009-2015)



Source: Bloomberg

As with past commodity shocks, the Bank of Canada (BoC) is paying close attention to this recent downdraft. Recent policy forecasts and commentary by the BoC's Governing Council highlight the significance of this adjustment and its importance in guiding monetary policy decisions. In its published research and public appearance transcripts the BoC has directly cited, or implicitly made reference to, several national metrics they are following to gauge the progress of this complex economic adjustment, which include:

- Energy Sector Capital Expenditures
- Employment by Sector and Geography
- Household Incomes and Spending
- Canadian Dollar Exchange Rates, Exports & Business Investment
- Business Outlook Survey and Firm Creation
- US Housing Market Strength

To assess the impact of lower commodity prices on the broader economy, researchers at the BoC used a five year forecast horizon to model the implications of current commodity prices relative to 2014 peak prices.

Their analysis suggests the economic restructuring will be felt through two distinct transmission mechanisms and play out in three phases extending into 2020.

Phase 1

Restructuring of Resources Sector

The first transmission mechanism is the sectorial and geographic redistribution of investment and labour away from the commodity sector. This shift coincided with the drop in oil prices and is expected to last through to the end of this year. The reduction of capital expenditures in the Energy sector has been dramatic, with 2015 investment falling $28 billion, or 35%, and 2016 investment expected to fall $50 billion, or 60%, short of the 2014 peak. The magnitude of this decline is evident when compared with the Liberal Federal Government's infrastructure stimulus spending of $4 billion. Broadly speaking, the reduction in Energy sector capital expenditures is expected to result in its contribution to national business investment declining by 15%.

First order impacts of this shift on the national labour market are relatively muted, but will be acutely painful for the commodity producing provinces. The energy sector accounts for only about 1.8% percent of employment and 2.2% of labour hours nationally. However, it is the highest paying sector in the country, with hourly wages and work weeks that are 40% and 25% higher, respectively, than the national average. The high degree of integration between the energy sector and the broader economy in the commodity producing provinces means that energy sector employment losses reverberate through the supply chain and quickly spill over into other industries. As of April 2016, Alberta has yet to recover all the jobs lost since the beginning of the oil price decline, and as the table below illustrates the balance of employment has shifted significantly with goods producers losing over 75,000 jobs and services showing all of the offsetting gains. Despite the relatively muted impact on overall employment levels, aggregate income in Alberta has fallen as services pay 10% below average, while goods producers pay 32% above.

Change in Employment in Alberta
(June 2014 – April 2016)

	Avg. Weekly Wages (April 2016)	Employment (Jobs)
Total Employment	$1,129	-4,300
Total Goods Producing	$1,504	-78,700
Total Service-Sector	$1,015	74,400

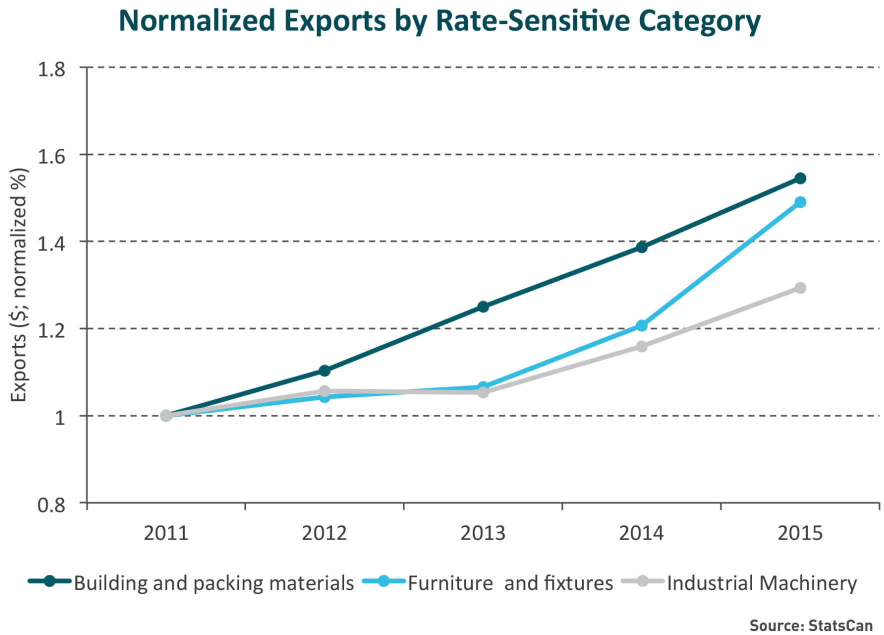
Source: StatsCan

Phase 2

National Impacts of Lower Incomes

The second transmission mechanism is lower consumer spending, which is the result of the lower average incomes highlighted at the end of phase one. The BoC anticipates that the economic impact of lower spending will begin in mid-2016 and continue to suppress consumption through the end of 2017, representing the bulk of the second phase of the adjustment period and the dominant drag on the economy. To put this in context, the decline in oil prices since mid-2014 has reduced Gross National Income by $60 billion, or approximately $1,800 per person.

Given the link between Canada's terms of trade and the value of the Canadian Dollar[1], the BoC is closely monitoring the exchange rate as a potential catalyst to export restructuring. The Canadian dollar has fallen up to 24% relative to the US dollar since June 2014. Estimating that significant currency fluctuations take two years to affect the economy, these impacts are still being felt. With that being said, the chart below supports recent comments from the BoC Governor, Steven Poloz, suggesting that sectors sensitive to U.S. housing are already experiencing upticks as a result of a lower Canadian Dollar.



It is important to note that while these increases are not enough to offset the overall loss to the economy from lower Energy exports, they do help mitigate its impact. The permanent restructuring in non-Energy sectors is expected to occur when private sector firms see sustainable increases in export demand and encounter capacity issues requiring capital investment. There is some evidence this shift is materializing in the latest BoC Business Outlook Survey, which shows capacity pressures and investment intentions ticking up. Anecdotal evidence from the BoC also points to firms focusing sales and distribution efforts overseas and away from commodity intensive sectors domestically. However, we remain in the early stages of this restructuring and the decline in the Canadian dollar has yet to translate into a meaningful increase in capital investment. The BoC has also emphasized firm creation as a useful metric to gauge the evolution of business investment, which is expected to remain modest through 2020.

Phase 3

Finding a New Balance

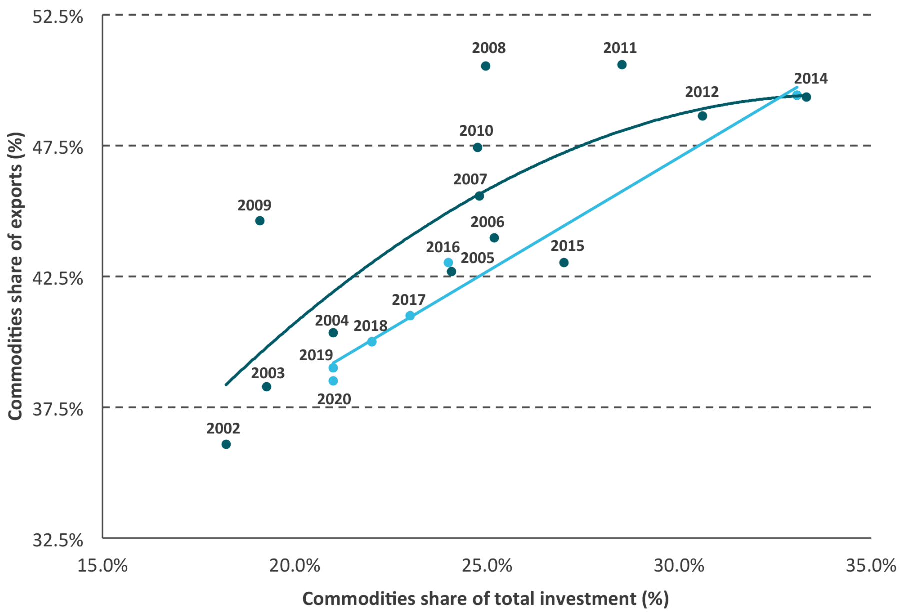
As the economy slowly finds a new equilibrium during the final phase of the adjustment period between 2018 and the end of 2020, the BoC's forecasting models project that the economy will reflect a contribution from commodities closer to the pre-boom era of 2002. As the chart below illustrates, this suggests they will decline from 50% of exports in 2014, to about 40% of exports at the end of 2020.

A reduction in business investment is also expected, with the commodity sector declining from 42% to 27% of total national business investment over the same timeframe. The result being higher proportionate capital investment into non-commodity sectors, with lower potential output. All things considered, potential GDP

[1] **Canadian Dollar at time of writing US$1.29**

will be permanently lower following the final phase of the adjustment period, with uncertainty surrounding non-Energy investment being a significant factor in determining the new level of potential GDP growth. Household incomes are also expected to settle in at a lower level in the final phase of the adjustment period, which will impact both consumption and to a lesser extent housing. There are signs that suggest this adjustment may not be as severe as past commodity cycle downturns, given early indications of increased interprovincial mobility and labour capacity redistribution.

Commodities share of exports, investment over time



Source: StatsCan; Bank of Canada Estimates

Conclusion

With the BoC going to great lengths to reference this complex adjustment process in nearly every recent public appearance, it is high on our radar. The first phase of labour and capital spending adjustments are being felt now, with implications for credit markets. This creates opportunities for us to position into bonds that offer longer term value, but have experienced near term pressure. Lower incomes and spending in the second stage is expected to last well into next year. We feel this has a large impact on when the BoC will look to begin rate hikes. We will monitor the health of the consumer over this period and use that evolution as an input to how we position for potential rate hikes. Finally, the new equilibrium in the third phase will contribute to how we view potential GDP and will have implications for longer term interest rates, and inflation expectations.

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