



Contents

Current trends – [Pace of decline in GDP eases up](#)

Financial markets – [Global economy – Prognosis improving](#)

Housing markets – [Improving affordability lifts Canada's housing markets](#)

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Current trends...

Pace of decline in GDP eases up

▲ GDP output fell 0.1% in April, which represented an easing from the 0.3% drop in March and matches the 0.1% contraction in February. These recent declines indicate a marked improvement from the average monthly decline of 0.8% that prevailed from November through January.

▲ June's jobs numbers support the view that the downward momentum in the economy has lessened. In the second quarter, job losses totalled just 13,000, a marked improvement compared to the cumulative first-quarter loss of 272,900 jobs.

▲ May's strong retail sales numbers are expected to help limit the drop in real GDP to 0.5% in May. This is consistent with our current forecast showing second-quarter growth declining 3.2%, at an annual rate, an improvement over the 5.4% contraction in the first quarter.

▲ Housing starts picked up pace in June, coming in at a 140,700 annualized pace. Housing activity looks as though it bottomed earlier this year, with sales activity heating up in April and May on the back of improved affordability.

▲ Falling exports outpaced the decline in imports resulting in a whopping C\$1.4 billion trade deficit in May. We expect the negative contribution from net trade to continue in the second half of this year, with import demand forecast to revive more quickly than exports.

▲ The headline inflation rate moved into deflationary territory in June. However, the downward pressure is narrowly based and largely concentrated in the volatile energy prices component.

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Financial markets...

Global economy – Prognosis improving

The global economy remains in rough shape with data on second-quarter activity showing some improvement but not enough to signal the end of the recession. However, the tenor of economic forecasts has changed and projections are now being nudged up. Even the Federal Reserve in its June policy statement sounded slightly more upbeat, adding emphasis to its view that the economy's contraction is showing signs of slowing. We have not changed our growth profile for the global economy and still look for a recovery to take hold later this year and to build momentum in 2010. We expect central banks to keep monetary policy accommodative and forecast that longer-term interest rates will trade to the lower end of their recent ranges as the recovery proves slower and more volatile than recent price action suggests.

U.S. economic data – Not for the faint of heart!

▲ The U.S. housing market reports perked up a bit in June, suggesting that conditions are stabilizing. Similarly, the ISM surveys substantiated the view that the biggest declines in activity occurred in late-2008/early-2009 with the manufacturing index rising to its highest level since August 2008, while the non-manufacturing index hit an eight-month high.

▲ But, not all surprises have been to the upside. Employment fell by 467,000 in June, a larger decrease than May's 322,000 dip. However, June's decline was smaller than April's 519,000 pace and the 691,000 average monthly drop recorded in the first quarter.

▲ Cumulative job losses (2.1 million in the first quarter and 1.3 million in the second) will keep consumers under pressure in the near-term especially if the unemployment rate drifts higher, as we expect. We have boosted our forecast for the peak U.S. unemployment rate to 10% from our prior call for a 9.7% high.

▲ Overall, we expect that the U.S. economy contracted at a 2.8% annual rate in the second quarter, although recent monthly numbers indicate that the declines in consumer spending and investment activity may be smaller than in our baseline forecast.

▲ For now, the Fed appears content to follow its gameplan of maintaining a loose promise to keep rates low and follow through with the purchases of agency debt, mortgage-backed securities and government bonds.

Canada bumping along

▲ Canada's data landscape has also been bumpy. On the upside, the pace of decline in real GDP slowed in April to 0.1%. But, we see little scope for the improving trend to be sustained. Preliminary motor vehicle production numbers are flagging a deeper decline in May GDP reflecting widespread production shutdowns in Canada following the bankruptcy declaration of Chrysler's U.S. operation.

▲ Looking through the gyrations in the data, we see two things: first, the economy continued to contract in the second quarter and, second, the improvement in the April numbers will likely result in the pace of decline in second-quarter GDP being slower than the 5.4% drop recorded in the first quarter.

▲ Looking further ahead, given the low level of inventories, the prospect of auto production coming back, easing credit conditions and a projected boost from fiscal stimulus, we look for Canada's economy to shift out of recession in the second half of 2009.

▲ While medium-term prospects have improved, the prospect of declining activity near-term will keep the Bank of Canada on guard. We expect the central bank to keep the overnight rate at 0.25% through the end of the second quarter of next year.

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Canadian housing markets...

Improved affordability lifts Canada's housing markets

Housing affordability greatly improved in the first quarter of this year; RBC's affordability measures for all housing types recorded some of their biggest quarterly declines on record (the lower the measure, the more affordable homeownership is). At the national level, the improvement ranged from 2.8 percentage points for standard condominiums to five percentage points for two-storey homes. At the major city level, the decline was as large as 8.6 percentage points (for Vancouver's two-storey homes). This third consecutive quarterly improvement in affordability has reversed much — although not all — of the deterioration that occurred during 2006-2007 when Canada's housing markets reached a boiling point. In most areas of the country, RBC's affordability measures have now returned to, or near, long-term averages, which is consistent with more solid market fundamentals.

Aggressive policy action to shore up confidence in financial markets and jump start the economy is behind much of the improvement in affordability in the past year. The Bank of Canada's rate cutting campaign and the federal government's active support of the mortgage securities market have resulted in meaningfully reducing the cost of homeownership. The decline was accelerated by softening housing prices, especially in the western part of the country, which retraced some of the large gains made during the boom. Monthly payments in the first quarter on a typical detached bungalow (based on the going market value) had fallen by close to 17%

from a year earlier in Canada. Among the major cities, the decline was as much as 24% in Calgary, 22% in Vancouver and 20% in Edmonton.

Such hefty "discounts" on the cost of homeownership provided powerful incentives for buyers to step back into the game. Home resale activity, based on Canadian Real Estate Association data, had plunged during the final quarter of last year and early months of this year as the violent bout of financial flu knocked the broad economy off its feet. With the turmoil in financial markets subsiding (at least partially) and the flow of credit picking up, buyers have indeed returned to the market. Home resale activity has rallied impressively since late winter, erasing more than one-half of the previous decline at the national level (more in some cities). Even more remarkable has been how widespread across all major Canadian cities the rebound has been - every single one of them has enjoyed a resurgence. Property values — which had come under heavy pressure — have recently shown signs of stabilizing in many parts of the country.

While housing markets appear to be generally on the mend in Canada, the road to full recovery still has obstacles. The rise in some mortgage rates in June is a reminder that the sizable improvement in affordability attributable to lower rates is likely behind us and, with home prices stabilizing or perhaps beginning to rise in some areas, further improvement depends on greater gains in family income, which should be supported by an improving economy in the second half of this year.

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