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Current trends...

Big drop in GDP, but the worst be may be over

▲ Moderation in the pace of monthly GDP declines and a sizeable drawdown in inventories suggest that the first quarter may represent the worst of the downturn. This, in turn, augurs well for declines in quarterly GDP to ease in the second and third quarters, with positive growth returning by the fourth quarter.

▲ Canadian labour markets returned to shedding jobs in May after a brief respite in April, with employment falling 41,800. However, the 67,200 cumulative decline in jobs in March-May is much less than the 232,000 drop in the previous three-month period.

▲ Retail sales rose again in March for the third consecutive month. However, these recent increases have not been strong enough to offset the sharp declines in the fourth quarter.

▲ Housing starts showed welcome signs of improvement in May, rising to 128,400 annualized from April's 117,600. The pick-up is in line with our forecast for a stronger second half of the year for starts. We expect housing starts to

average 141,000 in 2009 overall.

▲ The trade balance fell to -C\$0.2 billion in April after a C\$1 billion reading in March. We expect net trade to make a negative contribution to GDP growth during the second half of this year as import demand rises more quickly than exports.

▲ The downward trajectory for the headline inflation rate picked up speed in April and, with the big monthly increases in energy prices last summer unlikely to be replicated this year, we anticipate that the inflation rate will slip into negative territory in the months ahead.

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Financial markets...

Risky business

Investors thought they heard the death knell for global recession in May and increased their appetite for risk, shying away from government bonds and buying equities, commodities and currencies except the U.S. dollar. As a result, the global stock market index we watch increased by 12.2%, oil prices rose 34%, while non-energy commodity prices hit their highest level since November. We agree with the consensus that the global recession began to lose momentum in the second quarter but still expect another round of negative growth rates to be reported before the global economy starts expanding in the second half of this year.

U.S. economy's first-quarter drop sets stage for better news ahead

▲ The revised first-quarter U.S. GDP report showed a slower pace of decline at 5.7%, down from the fourth quarter's 6.3% drop.

▲ The sizeable drawdown in inventories in the quarter means that any pick-up in demand will need to be satisfied by new production.

▲ After-tax corporate profits rose unexpectedly, which augurs well for the sharp contraction in business investment to slow.

▲ We project that the U.S. economy contracted at an annualized 2.8% in the second quarter but anticipate a return to positive growth by the second half of the year, with a 2.9% contraction in U.S. GDP in 2009 overall and a 2.1% increase in 2010.

Canada's economy took a dive in Q1 but suffered less than thought

▲ Canada's real GDP contracted by a sizeable 5.4% annualized rate in the first quarter, but the decline was smaller than expected with the consensus (and RBC) looking for 6.5% drop. It was the marked slowing in the pace of decline in February and March that saved the economy from a more pronounced downturn.

▲ Going forward, with the level of inventories having been drawn down in the first quarter, any revival in demand will be met by new production. To that end, the report gave encouragement to those looking for Canada's economy to work its way out of recession later this year.

▲ RBC's forecast is for the economy to regain its footing in the third quarter with the second quarter's projected decline of 3.2% being softer than the first quarter's 5.4% drop. For 2009 overall, we expect the recession to reduce real GDP output by 2.4%, with a forecast of a 2.5% increase in GDP in 2010.

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New economic forecasts...

Sun peeking out from behind the dark clouds

▲ The global economy posted a sharp decline in early 2009; but leading indicators hint that the worst has passed.

▲ Recovery is unlikely to take hold until late 2009, with momentum building in 2010.

▲ Extraordinarily low interest rates and government stimulus to lift economic activity.

▲ U.S. economy still staggering but showing some signs of life.

▲ Housing market recession looks as though it is in the final stage.

▲ Moderate rebound in U.S. consumer spending ahead as households repair their balance sheets.

▲ U.S. recovery will be modest compared to history.

▲ In the first quarter, Canada's economy posted its largest single-quarter contraction since 1991.

▲ Broad-based declines highlight the impact of global recession and the financial market crisis.

▲ Bank of Canada keeps options open to increase monetary stimulus beyond holding the policy rate at its lower bound.

▲ Inflation rate heads below zero, although it will likely rise again later this year.

▲ C\$ rally sparked by increased risk appetite and a turnaround in commodity prices.

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Provincial outlook...

Has the storm passed?

Our updated provincial forecast acknowledges that many provincial economies "took it on the chin" late last year and early this year, resulting in 2009 growth being widely revised down. The severity of the global recession and painfully slow pace of improvement in the financial crisis caught up with Canadian households and businesses, which have been clearly rattled by the flood of ensuing bad

news – plant closures, bankruptcies, cancellations of investment projects, bailouts of prominent global financial institutions and automakers, and surging unemployment.

The latest available data point to a moderating pace of both job losses and declines in real GDP in Canada, seen as evidence that the worst of the recession is likely behind us. Similarly encouraging signs are emerging in the United States, where an expected turnaround in economic conditions later this year will be a key prop helping Canada pull out of recession.

Improved commodity markets are anticipated to re-ignite capital expenditures by businesses in Canada. This will be supplemented by relatively aggressive public sector spending on infrastructure. The most recent budget season almost universally brought significant measures to stimulate provincial economies, primarily in the form of increased spending on public infrastructures but also, in some cases, tax cuts and other fiscal incentives – Alberta being the lone exception, preferring to hold the line on spending. The magnitude of those measures in the current fiscal year ranges from 1.2% of GDP in British Columbia to 3.1% of GDP in Manitoba and Newfoundland & Labrador — although it is inherently difficult to disentangle precisely stimulus measures from spending that would have occurred otherwise.

Given that construction projects usually take some time to get under way – despite a keen emphasis on “shovel-ready” initiatives – and span many months or years, we expect that the greatest impact will be felt in 2010 in the majority of provinces. The benefit this year will primarily be to attenuate the negative forces weighing on provinces.

The price to pay for this public spending binge is the return of government budget deficits. Collectively, provinces are projecting to run deficits totaling almost \$29 billions this fiscal year, including a recent adjustment in Ontario to account for higher-than-expected financial assistance to troubled automakers. Only Saskatchewan and Manitoba, the two best economic performers, will remain in the black. Even Alberta is projecting its first budget shortfall in 15 years. While running deficits during times of economic crisis is not a cause for alarm, the challenge will arise once the economy is back on its feet. The stimulus will need to be unwound and budgets balanced, which is rarely an easy task. This means that fiscal policy will turn restrictive over the medium term.

The greater weakness early this year has prompted us to downgrade our provincial real GDP forecasts across the board for 2009. Worst hit among provinces is Ontario where motor vehicle manufacturing has crumbled, as plants are being shut down (both temporarily and permanently) in reaction to collapsing auto sales in North America. This has had reverberations across the province’s manufacturing and other sectors, and has weighed on confidence.

For Newfoundland & Labrador, we are now allowing for a greater negative impact from lower mineral production and rapidly moderating output at maturing offshore oil fields. We have also raised our estimate of the economic toll coming from the slide in commodity markets since last summer and the accelerated downturn in housing construction in Alberta, British Columbia and Quebec (where troubles in the aerospace industry have also appeared).

Nonetheless, three provinces are still expected to grow this year – Saskatchewan, Manitoba and Nova Scotia – although barely so. These provinces continue to benefit from growth drivers (mainly capital spending) with sufficient force to overwhelm weaker elements. All other provinces are projected to contract.

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