



## ECONOMICS DIGEST

September 2009

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Current trends...

**First increase in monthly GDP in 10 months**

▲ Canada's economy contracted at a 3.4% annualized rate in the second quarter, a significant easing in the pace of decline compared to the 6.1% drop in the first quarter. The sizeable decline in quarterly GDP in the past nine months has generated significant slack in the economy, but the increase in June suggests that Canada's recession is nearing an end.

▲ The economy created 27,100 jobs in August, contrary to forecasts for a 15,000 decline. The unexpected rise in employment sows the seeds for economic activity to continue to pick up, aided by the rebound in auto production on the back of rising U.S. demand.

▲ Retail sales volumes rose a strong 0.4% in June following an even more encouraging 0.6% rise in May. The rise in sales volumes in the last two months bodes well for second-quarter consumer spending returning to positive growth.

▲ The pace of housing starts picked up in August, totalling 150,400 at an annualized pace. The pop in resale home sales in July and the 53.2% (annualized pace) rise in starts in July/August augur well for residential construction to support economic growth in the third quarter.

▲ Canada's merchandise trade balance unexpectedly returned to a deficit position in July of C\$1.4 billion from a trade surplus of C\$0.04 billion in June. This represented the second highest deficit on record compared to the C\$1.45 billion recorded in May of this year.

▲ The inflation rate was in deflationary territory again in July with downward pressure coming mostly coming from volatile energy prices. Going forward, we look for the headline CPI rate to continue to be buffeted by energy price movements, while underlying weakness in the economy weighs on core prices.

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Financial markets...

**Recovery watch**

Upbeat economic data dominated in August especially in the United States where the improvement in housing statistics and auto sales stole the headlines. Globally, talk of the end of the recessions in many countries bolstered expectations that the world economy is tracking a course for positive growth in the second half of 2009. We have made upward revisions to our near-term forecasts for Canada and the United States, given the rise in auto sales and production as government programs boosted activity. But will the recovery last once the boost from the auto sector fades? While growth rates may ease up in late 2009 and early 2010 causing markets to reassess the durability of the recovery, we believe that there is enough stimulus in place to support a full-fledged recovery in 2010.

**U.S. economy emerging from worst recession in decades**

- The rise in auto sales, pick-up in industrial production and receding drag from residential construction have led us to revise our forecast for third-quarter growth up to 2% from 1.3%, making the first positive growth rate in the five quarters.

- We look for growth to slow mildly in the fourth quarter to 1.8% as consumer spending on durable goods eases. But, as long as financial markets remain stable, the U.S. economy will remain on a course for recovery.
- Looking forward, we look for the momentum to build in 2010 as most of the fiscal stimulus hits, although the dismal state of household balance sheets will likely restrain the pace of growth compared to past recovery periods. Our forecast is that real GDP will expand by an average 2.2% in 2010 following an expected 2.7% contraction in 2009
- Even with the economy forecast to grow by 2.2% next year, the output gap will remain wide, exerting only minimal downward pressure on the unemployment rate. Against the backdrop of below-potential growth, high unemployment and easing prices, the Fed is likely to hold the Fed funds rate at the current extraordinary low 0% to 0.25%.

### Canada's recession – Running its course

- The hefty 3.4% decline in Canada's second-quarter GDP marked the third consecutive quarter of contracting economic activity; but the slump was more modest than the first quarter's record 6.1% drop and output in June rose for the first time since July 2008.
- The increase real GDP in June suggests that Canada's recession is nearing an end. We forecast real GDP growth of 2% at an annualized pace in the third quarter with a 2.4% gain expected in the fourth quarter and 2.6% in 2010.
- Given that the anticipated gains in the economy in the second half of the year will be modest, only a slight drop in the unemployment rate is expected in 2010. The persistent slack in the system is expected to exert continued, albeit easing, downward pressure on the inflation rate and upward pressure on the unemployment rate into 2010.
- The moderate pace of economic growth and a rising unemployment rate make it likely that policymakers will honour the conditional commitment to keep policy extremely accommodative until the second half of next year.
- The risk to this view is that the economic rebound proves to be much more vigorous than RBC or the Bank of Canada proposes. This would boost the upside risk to the inflation outlook and likely lead to a normalization of rates earlier than in our baseline forecast.

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Housing markets...

### Affordability improvement running out of steam?

Housing affordability improved in Canada for the fifth consecutive quarter during the second quarter. RBC's affordability measures at the national level fell modestly for all housing types — down 0.4 percentage points to 26.9% for standard condominiums and 0.6 percentage points for each of detached bungalows (39.1%), standard two-storey homes (44.4%) and standard townhouses (31.5%). (The lower the measure, the more affordable is homeownership.) This follows the biggest quarterly declines on record in the first quarter when a steep drop in mortgage rates and softening housing prices significantly lowered the cost of homeownership.

The latest improvement in affordability was widespread across the country and housing types. The only exception among major cities was the standard condominium segment in Vancouver, where RBC's measure rose marginally for the first time since early 2008. Ottawa posted some of the largest declines, likely playing catch-up with other cities since it joined the improving trend later than in most areas in Canada. At the national level, affordability has now been restored to pre-housing boom levels (that is, those prevailing in late 2005-early 2006).

However, this restorative phase of the affordability cycle is likely running out of steam. The two major contributors to the significant improvement during the past year or so — the decline in mortgage rates and the drift down in prices — appear to have reached turning points. After hitting generational lows (in nominal terms) in the spring, some mortgage rates (including those of five-year fixed

mortgages on which the RBC measures are based) rose modestly in the summer. Also, the earlier generalized weakness in property prices has largely dissipated in recent months in most parts of the country — some areas have even begun to register gains again.

While those shifting trends will cease to drive affordability improvements, the next phase in the coming quarters will not necessarily be one of wholesale deterioration with continued expected growth in household income providing some offset. More likely the period ahead will be marked by a certain levelling off in affordability.

This flattening to levels close to historical averages overall is, therefore, not expected to derail the current impressive resurgence in housing activity. After sinking late last year-early this year to the deepest depths in ten years, the number of existing homes sold through the Multiple Listing System has surged by more than 60% through the spring and summer.

Figures in June and July for Canada showed the first year-over-year increases since the end of 2007. In fact, July sales were the best on record for the month. This renewed activity is now drawing down the earlier build-up in properties for sales. The Canadian Real Estate Association reported that total listings in Canada have fallen below year-earlier levels in May, June and July. With the supply of properties for sale diminishing just as demand is bouncing back, any slack in the market is being quickly removed. This is working to heat up prices again in many parts of the country (though not everywhere).

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Special report...

## **Auto sector: The dawn of a new era?**

Battered by the financial and economic crisis, the global auto industry has just gone through its darkest days since the Great Depression. Plunging sales have pushed industry giants over the edge, causing widespread plant closures, employee layoffs and ripple effects throughout the supply chain. Now that Chrysler and parts of GM have emerged from bankruptcy protection in the United States, in a series of "Q&As", this report analyzes what it all means for the auto sector from a Canadian perspective. Here are some key points

### **Q: Are we out of the woods yet?**

**A:** Chrysler and GM have won some significant breathing space, but uncertainty will persist until motor vehicle sales recover meaningfully from recent deeply depressed levels. Equally important is the situation of parts manufacturers, who are still very much on shaky ground (they have been under intense pressure for a number of years). Several large players have filed for bankruptcy protection in recent months in the United States (including Visteon, Metaldyne, Hayes Lemmerz, Noble International and, in early July, Lear) and a host of others are said to be in trouble. Given the symbiotic relationship between the large motor vehicle manufacturers and their parts suppliers, risks in the overall sector will remain elevated until both have returned to health.

### **Q: How has Canada's auto sector changed during this crisis?**

**A:** Changes have been at all levels — corporate, assembly, parts manufacturing, retail distribution, financing.

### **Q: Is this a permanent change in the Canadian auto industry or a cyclical episode?**

**A:** Both. The North American industry had excess production and distribution capacity, primarily among the Detroit Three owing to their protracted market share loss since the mid-1980s. Some culling of capacity had to occur — this is the process now under way. At the same time, the financial and economic crisis, particularly in the United States, destroyed motor vehicle demand. Thus, a large portion of the decline in Canadian motor vehicle and parts production is attributable to the recession/financial crisis. Once the U.S. economy begins to recover, which we expect during the second half of this year, and consumer confidence bounces back more firmly,

and with financing availability and terms improving, U.S. motor vehicle sales should pick up and production in Canada should initiate a cyclical rebound.

**Q: What is the outlook for auto sales and production?**

**A:** We expect auto sales in the United States to rise very modestly during the second half of this year, totalling 10.2 million units overall in 2009, and continue to move higher to 11.5 million units in 2010. This would compare to 13.2 million units in 2008 and an average of 16.6 million in the previous five years. Similarly, in Canada, sales of new motor vehicles are expected to move modestly higher starting in the second half of this year, totalling 1.5 million units in 2009 and 1.6 million units in 2010 compared to 1.7 million in 2008 and an average of 1.6 million in the previous five years. In the medium- to longer-term, the “new normal” for sales in North America is likely to be a little lower than the average of 18.5 million units (perhaps in the 17.5 to 18 million range) recorded in the 1999-2007 period due to a slower projected growth in the driving-age population.

The implications for auto production in Canada is that 2009 will probably be the low point of this cycle — indeed, this will be the worst output performance since 1982. Over the medium-term, annual production rates in Canada could well return to the range of 2.2 million units that has often been achieved this decade. However, moving much above such levels — to, say, earlier peaks of 2.7 million units — would be quite unlikely in light of the reduction in capacity that has just taken place.

**Q: What is the impact of the turmoil in the auto sector on Ontario’s economy?**

**A:** The crisis in the industry has both structural and cyclical components. This means that, as the cycle turns upwards, activity will, indeed, pick up again in the province. Ontario will remain a leading auto manufacturing hub in North America, benefitting from the presence of world-class players, a well-established supplier base, strong skills and expertise, excellent infrastructure and advantageous geographic location. However, growth will be constrained by some loss in productive capacity, mostly on the parts manufacturing side. This is a key reason behind our forecast of Ontario lagging the rest of the country in the recovery. That being said, the resumption of production at the Chrysler plants (idled during May and June while the parent company worked through the bankruptcy procedures in the United States) and other facilities during the summer is likely to produce a certain pop in real GDP mid-year, helping the province move towards positive growth overall during the second half of this year.

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