Woe Canada?

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Concocting dire scenarios for Canada's economy and financial markets has become a veritable cottage industry among domestic and, more notably, global pundits. Rarely a day goes by without a fresh scare story about the calamitous future for Canada's currency/economy/housing market. This week's drop in the Canadian dollar to near three-year lows has only fanned the flames (*Chart 1*). We first highlighted 18 months ago that, after a sustained period of extreme outperformance, Canada was in for a prolonged spell of underperformance. However, **underperformance does not equal catastrophe**. While we do believe that the Canadian dollar is likely to soften a bit further over the next year, and that Canada will grow more slowly than the U.S. again this year and next, **we flatly reject the extreme negativity of many recent analyses**—which have mooted everything from made-in-Canada recessions, to a Canadian bond bubble, to a housing collapse (the favourite call among the punditocracy), to a deep dive in the loonie.

CHART 1

C$: FOLLOWING THE AUSSIE DOWN UNDER?

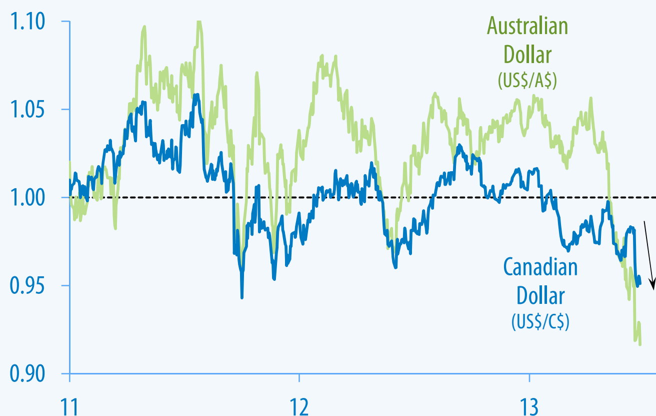


CHART 2

YOU TAKE THE HIGH ROAD...

Without giving too much airtime to the gloom-and-doomsters, the "Sell Canada" narrative in a nutshell is: the housing market is wildly overextended, household debt is at dangerous levels, commodity prices are fading fast, the trade gap is unsustainably large, core CPI is flirting with deflation, the currency is overvalued, productivity is a mess…etc, etc, etc. There is, of course, a kernel of reality to each of these concerns, and those kernels are all solid arguments for why Canada is likely to underperform the U.S. economy over the medium term. Arguably, equity markets have long factored this reality into pricing—after handily topping the S&P 500 for seven consecutive years, the TSX has trailed far behind since early 2011. Not coincidentally, commodity prices hit their nearby peaks in April 2011. Since that point, the TSX has dropped by more than 10%, while the S&P 500 has managed to rise by 20%, a 30 percentage point gap even before taking the currency into account (*Chart 2*). The only other period in the past 20 years when we saw such a mismatch in favour of U.S. equities was in the late 1990s during the depths of the Asian crisis and the heights of the tech boom.

That weak relative stock performance is beginning to affect capital flows, in turn posing an added weight on the currency (*Chart 3*). After shunning foreign markets in the aftermath of the 2008 financial crisis, Canadian investors

CHART 3
PORTFOLIO CAPITAL FLOWS: LESS SUPPORT
Canada (C$ billions : 12-mnth m.s.)

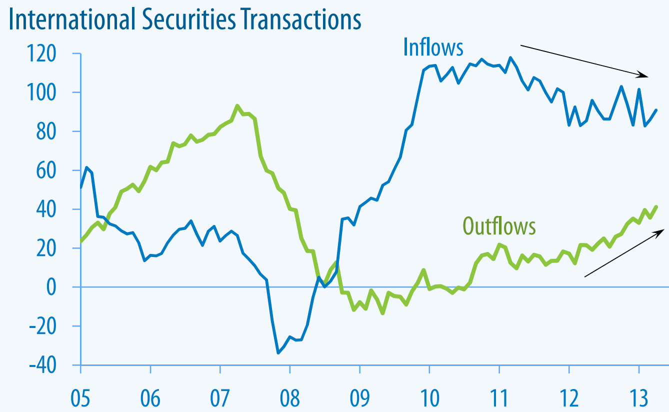
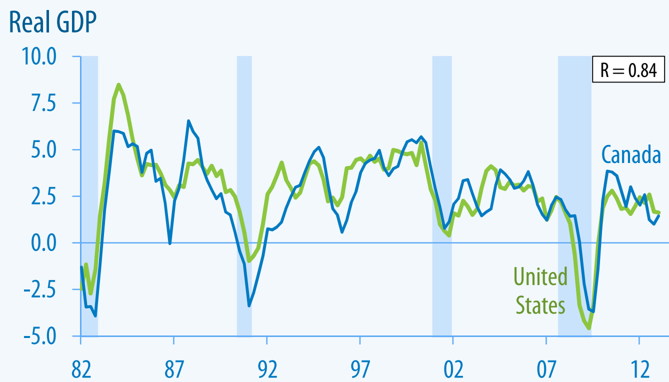
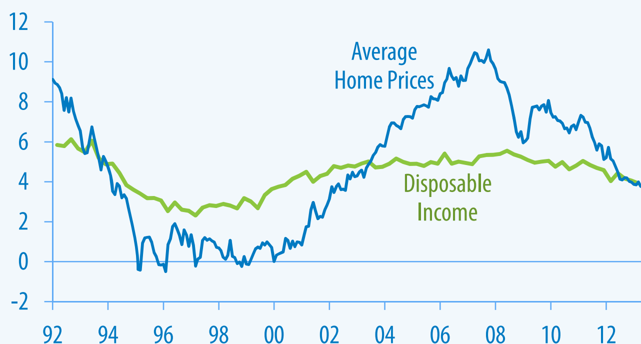


CHART 4
NOTHING NEW UNDER THE SUN
(y/y % chng)



U.S. recession periods shaded

CHART 5
WHERE'S THE FIRE?
Canada (6-year trend : % annual rate)



are pouring into global equities and bonds again. Weak domestic returns and a firming U.S. dollar have played a big part in the turnabout, with Canadians investing $41 billion abroad in the past 12 months, the highest since 2007. On the reverse side, Canada continues to attract large inflows ($91 billion in the past year, almost 90% of which was to bonds), but the tally is gradually fading. The net portfolio inflow of $50 billion is roughly half the peak level seen in 2009/10, but is still sufficient to nearly fund the current account deficit.

Here's the case for the defense. The simple fact of the matter is that **the U.S. still exerts a tremendous gravitational pull on the Canadian economy**. Through every kind of weather—depression, war, inflation, commodity boom/bust—the correlation between U.S. and Canadian GDP remains consistently around 0.80 (*Chart 4*). With exports to the U.S. now equal to 23% of GDP, that reality is not going to change abruptly. There has not been a made-in-Canada recession in the post-war era. There was one U.S. recession where Canada just managed to avoid a recession (in the tech bust), but that was a technicality. True, Canadian GDP growth outran the U.S. by a whopping 0.6 percentage points per annum over an 8-year stretch from mid-2003 until mid-2011, and some payback is inevitable. But Canada remains among the most levered to the fate of the U.S. as any major economy; it is simply **inconsistent to be simultaneously bullish on the U.S. outlook and bearish on Canada**.

It's not just GDP growth that looks remarkably similar between the two countries. Job growth has been roughly the same over the past year, the unemployment rates are within half a point, both have current account deficits close to 3% of GDP, and both have core inflation of just over 1%. However, even with a big improvement this year, the U.S. budget deficit is still about 60% larger than the all-government gap in Canada. On the household side, debt/income ratios are converging again between the two countries, with Canada finally receding and the U.S. finally starting to perk up, while Canada's personal savings rate is now roughly double the U.S. level. Meantime, as we have amply made the case elsewhere, Canada's housing market still appears to be cooling almost precisely how the policy

CHART 6

COMMODITY PRICES... DETAILS, DETAILS

(January 2011 = 100)

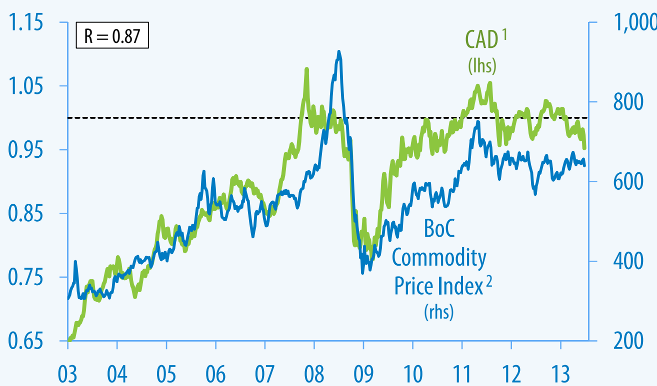
Commodity Price Index

Sources: Bank of Canada, Commodity Research Bureau

CHART 7

LOONIE LESS LOFTY

Canada



1 (US$/C$) 2 (1972 = 100)

doctors ordered. And far from the headline hysteria, Canadian home prices have risen at an entirely moderate 3.7% average annual rate over the past six years, almost precisely in line with the growth in disposable income over that period *(Chart 5).*

As well, another serious thorn in Canada's outlook has been quietly removed in the past six months—the so-called double discount on Canadian oil prices. The gap between Brent and WTI has narrowed below $5/barrel from above $20 earlier this year. As well, Western Canada Select has returned to normal levels against WTI. With oil accounting for almost a 50% weight, the Bank of Canada's commodity price index has actually strengthened so far in 2013 (up almost 5%) even as most measures of global commodity prices have sagged—the CRB is down 5% (*Chart 6*). As a result, the Canadian dollar is now only slightly above its commodity price fundamentals, after flying 10% above fair value earlier this year (*Chart 7*).

Bottom Line: The outlook for Canada counsels caution, not calamity. While we do look for U.S. growth to outperform Canada in the medium term—largely due to the opposite paths for housing—we are fundamentally bullish on the U.S., which ultimately is a big positive for Canada. Similarly, while we expect the loonie to soften somewhat further against the U.S. dollar, we look for it to gain ground against most other major currencies over the next 18 months. Woe Canada? More like, Whoa Canada bears.

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