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economic LETTER

NOVEMBER 2012

INDICATORS TO HELP US PREDICT RECESSIONS

Unlike mathematics or physics, economics is not an exact science. It depends on the behaviour of economic agents (consumers, business owners, government authorities) which changes over time, or according to the circumstances. Certainly there are rules that govern the economy, such as the fact that demand for a product declines when its price rises, but they are not hard and fast. So while two plus two will always make four, the demand for tomatoes can increase even if their price is rising for reasons that alter consumers' usual behaviour.

Therefore, when economists attempt to predict recessions, they rely on indicators that reflect what the economic agents are anticipating. These "leading" indicators are variables whose trends precede that of the GDP. Take home sales, for example. If a household decides to buy a property, that usually means it expects its financial situation in the years to come will be favourable. Consequently, we may assume that if home sales maintain an upwards trend, this is a good omen for economic growth. On the other hand, if the trend reverses itself, that is a bad sign and could mean that a recession is on the way. Stock market indexes also serve as a leading indicator, since they reflect investors' expectations. Generally speaking, after a recession, a sustained rise in stock market indexes heralds an economic recovery.

Obviously, it would be rather dangerous to rely entirely on home sales or stock market indexes to predict GDP trends, as these variables are highly volatile in the short term. To minimize risks of error, it is preferable to rely on a basket of leading indicators, rather than just one. When several indicators move in the same direction for a fairly long period of time, there is a greater probability that they are sending us the right signal. By combining several leading indicators, we obtain a "composite leading indicator." Note that what is important is not the value of the indicator, but how it is changing. A good composite leading economic indicator predicts turning points, i.e. changes in the GDP trend, several months in advance.

For many years, Statistics Canada compiled a composite leading indicator, but it abolished it in the spring of 2012, mainly as a cost-cutting measure. The Macdonald-Laurier Institute has just picked up the gauntlet from Statistics Canada by launching a new, composite leading indicator of the Canadian economy.[1] The creator of the MLI indicator (for Macdonald-Laurier Institute) is Philip Cross, ▼

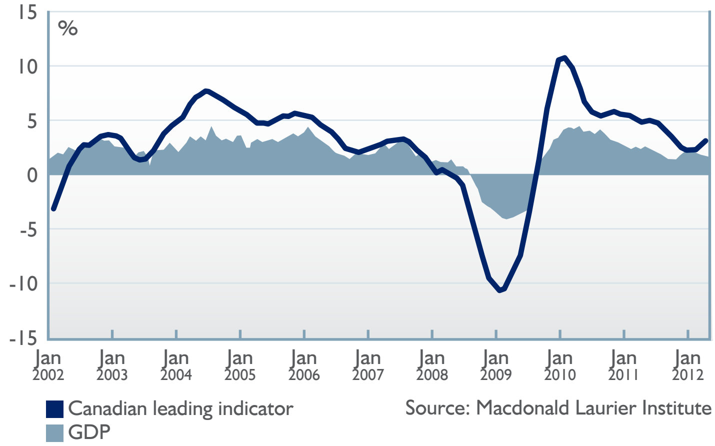
BDC's Monthly Economic Letter is prepared by the Economic Analysis team from Marketing and Public Affairs and is based on a variety of public sources of economic data. The information in this letter is drawn from data released prior to November 3. Reliance on and use of this information is the reader's responsibility.

1 For more information about this new indicator, see the Macdonald-Laurier Institute's publication of October 2012: "Commentary – The Macdonald-Laurier Institute Composite Leading Index for Canada."

an economist who worked for Statistics Canada for over 30 years. Mr. Cross has refreshed Statistics Canada's composite leading indicator by replacing four components that no longer have much predictive power with three others that are more effective (see table). For the period from 1952 to 2012, the old Statistics Canada composite indicator was able to announce recessions 4.9 months in advance, on average. The new MLI indicator sends the alert 7.4 months in advance, on average, which is clearly an improvement. Note that a leading indicator cannot differentiate between a recession and a serious economic downturn, since these two economic conditions are very similar.

Leading indicators are useful to all economic agents, as they enable them to take more enlightened decisions. If they know that a recession could soon occur, entrepreneurs and households will be more cautious in their investment and consumption decisions, and government authorities will be able to take preventive tax and budgetary measures. Right now, it would seem that we have nothing to fear: as shown by the chart, the indicator's downwards trend has reversed course in recent months, telling us that Canada should avoid recession, despite the one that has Europe in its grip and the sluggish growth in the United States and Asia. ■

The MLI Leading Indicator, September 2012
(year-over-year percent change)



Source: Macdonald Laurier Institute

Components of the Canadian Leading index

Components that belong to both indices:

- The housing index, which includes housing starts and housing sales
- The money supply, which includes currency outside banks plus all chequable deposits held at chartered banks
- The stock market (Toronto Stock Exchange TSX)
- The average workweek in manufacturing
- New orders for durable manufactured goods

The tree new components of the MLI Leading Index:

- Commodity prices, as measures by the Bank of Canada commodity price index
- Claims for employment insurance
- The Interest Rate Differential, measured by the difference between the prime lending rate charged by chartered banks and the yield on 3-month treasury bills of the Government of Canada

The four components eliminated from the Statistics Canada Leading Index:

- Retail sales of furniture and appliances
- Retail sales of other durable goods
- Services employment
- The ratio of sales to inventory in manufacturing

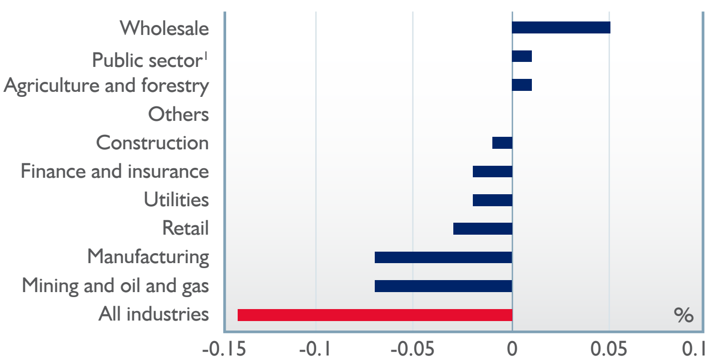
Back

The most recent indicators, particularly real GDP and the trade balance, lead us to think that economic activity was fairly sluggish in the third quarter of 2012. Moreover, the latest Labour Force Survey results, which show feeble employment growth in October, do not bode well for the last quarter of the year. With results like these, it would be very surprising for real GDP growth in 2012 to exceed the expectations of 2.0%.

Real GDP pulls back slightly

Real GDP by industry slipped by 0.1% in August compared with the previous month. Most of the main sectors recorded a drop, but it was mining, oil and gas extraction, and manufacturing that contributed the most to the decline in GDP (Graph). Maintenance shutdowns disrupted mining and oil operations, which partly accounts for the slump in production and allows us to look forward to a rebound in these sectors next month. Having said that, real GDP will have to shoot up in September, by at least 0.4% compared with the previous month, if quarterly growth is to reach an annualized rate of 1.0% in the third quarter of 2012.

Main industrial sectors' contribution to the percent change in GDP, August 2012



1. Education, health and public administration

Source: Statistics Canada

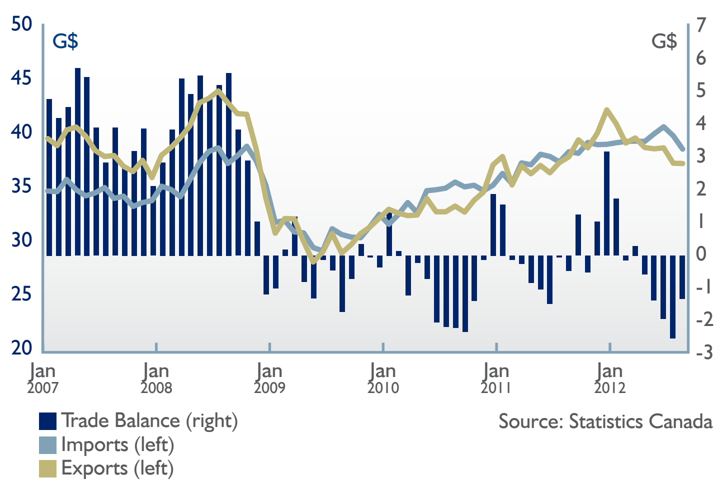
Employment remains stable

After two months of growth, employment stayed practically unchanged in October, with just a slight gain of 1,800 jobs. The unemployment rate held steady at 7.4%. Across the various sectors, the only noteworthy change in employment was a decline in agriculture. The other sectors hardly budged. Across the regions, employment rose in Quebec and in Newfoundland and Labrador. The latter province is enjoying the strongest annual employment growth of all the Canadian provinces, i.e. 3.6% compared with the national average of 1.3%. Employment contracted in British Columbia and Manitoba, but remained fairly stable in the six other provinces.

Trade deficit narrows

While imports posted a significant drop (-3.1%) in August for the second month in a row (-2.0% in July), exports practically stalled (0.1%), with the result that the trade deficit declined, from $2.5 billion in July to $1.3 billion in August (Graph). Imports were down in all sectors except for energy products, where they rose due to higher crude oil prices. Exports lost ground in many sectors, especially that of industrial goods. Exports of energy products, which also benefited from the higher crude oil prices, advanced for the first time after six straight months of decline. The drop in imports in August and July could point to a softening of domestic demand in the third quarter.

International Merchandise Trade

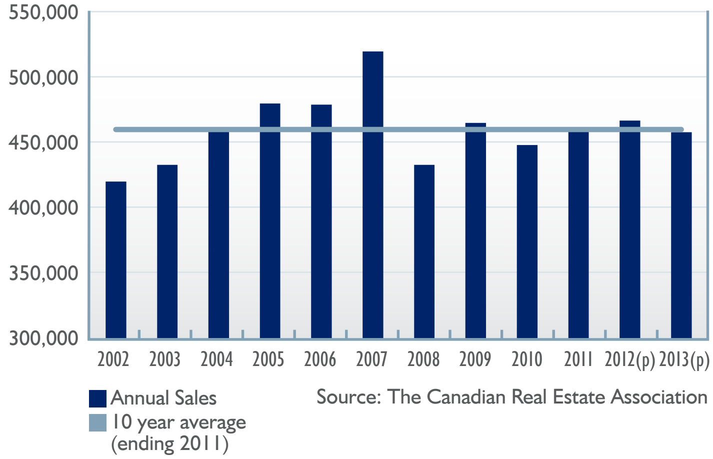


Source: Statistics Canada

Residential construction slows, and the real estate market is more balanced

The number of housing starts fell in September compared with August, from 225,328 units to 220,215 units, but is still far higher than it was in July, when it stood at 209,390. The August surge in housing starts, which was mainly attributable to start-ups of some major projects in the Toronto region, was only partly reversed in September. Sales of existing homes rose by 2.5% from August to September, but were nevertheless down by 15.1% compared with September 2011. The ratio of sales to new listings, which stood at 49% in September, tells us that the resale market is in a balanced state. The Canadian Real Estate Association predicts that home sales will increase by 1.9% in 2012, but will contract at the same pace in 2013 due to tighter mortgage rules and based on the assumption of a hike in interest rates in the second half of 2013 (Graph). ■

Sales Activities, Historical and Forecasts



Source: The Canadian Real Estate Association

UNITED STATES

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Economic activity is gradually getting back on track: employment keeps making headway, the housing market is gradually recovering, and real GDP growth is picking up steam. Having said that, we should not expect any spectacular acceleration in growth in the upcoming quarters. So far, only half of the jobs lost during the recession have been recovered, and it will take quite a while before the housing market regains its energy.

Real GDP growth accelerates slightly

Real GDP growth accelerated slightly, rising from 1.3% in the second quarter to 2.0% in the third quarter of 2012. Consumption, government spending and residential construction contributed to this acceleration, advancing more strongly in the third quarter than in the second; meanwhile, imports lost ground after increasing in the previous quarter (keep in mind that a decline in imports gives a boost to GDP) (Graph). As for non-residential investment and exports, they sank in the third quarter compared with the second. The strength of investment in residential construction, which has continued for the fourth straight quarter, is a good sign. Overall, the real GDP data for the third quarter are in line with expectations and lead us to think that economic growth in 2012 will be around 2.2%, as foretold by the Consensus.

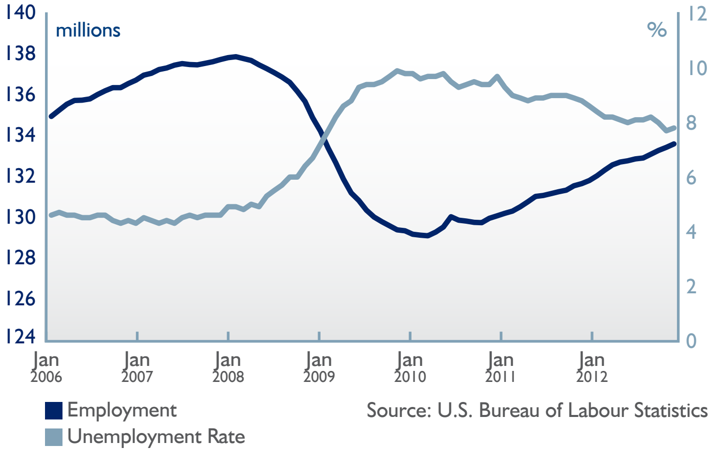
Real GDP and Related Measures
(quarterly change at annual rate)

Source: U.S. Bureau of Economic Analysis

Employment keeps improving

Non-farm employment expanded by 171,000 in October compared with the previous month, and the gains that were recorded in August and September have been revised upwards. The unemployment rate is up slightly, from 7.8% in September to 7.9% in October. In the first 10 months of 2012, the labour market added 157,000 jobs per month, on average, compared with 153,000 in 2011. At this point, a little over 50% of the jobs that were lost during the recession have been recovered (Graph). ▼

Non-Farm Payroll
(January 2006 to October 2012)



Source: U.S. Bureau of Labour Statistics

Housing starts soar, while home sales dip

Housing starts soared in September, posting a 15.0% increase compared with the previous month. Starts of single-family dwellings surged by 11.0% and those of multi-family homes escalated by 25.0%. Building permits also advanced strongly in September, which bodes well for housing starts in the months ahead. In the real estate market, home sales were down by 1.7% in September compared with the previous month, but the median price continued to rise, and inventories contracted. At the current pace of sales, it would take 5.9 months to sell off the existing inventory of homes. Twelve months ago, it would have taken 8.1 months to sell off the inventory at the pace of sales that prevailed back then. ■

INTEREST RATES

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No change expected in short term for key interest rate

On October 23, the Bank of Canada again decided to leave its key interest rate unchanged, at 1.0%. In its October issue of the Monetary Policy Report, the central bank says that it finds that the economy has unfolded as it had projected in July. The economic recovery is continuing gradually in the United States, while Europe is in recession. Growth has slowed in China and the emerging countries, but seems to be stabilizing. The Bank repeated that some modest withdrawal of monetary policy stimulus (in other words, an increase in the key interest rate) will likely be required, to reach the 2% inflation target, but that the timing and degree of any such withdrawal will depend on economic developments and on imbalances in the household sector. As shown by the table, the central bank's projections of Canadian economic growth have not changed much since July. ■

Projection for real GDP growth

	MPR July 2012	MPR October 2012
2012	2.1%	2.2%
2013	2.3%	2.3%
2014	2.5%	2.4%

Source: Bank of Canada, Monetary Policy Report, October 2012

OIL AND THE LOONIE

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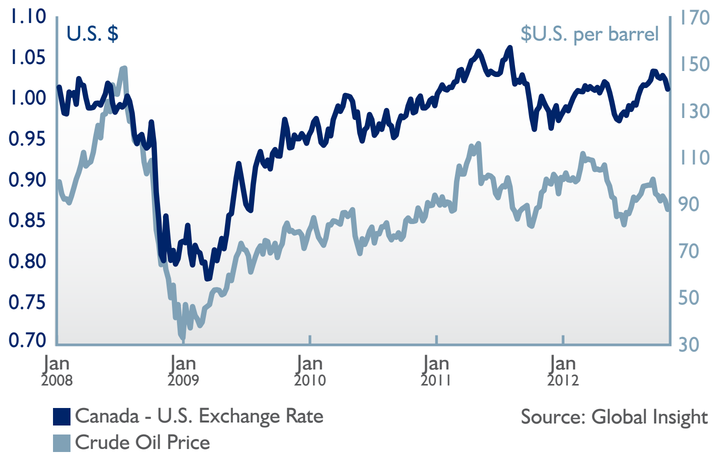
Slump in oil prices; the Canadian dollar dips slightly

The price of crude oil has dropped in recent weeks due to falling expectations of demand for energy in the United States, combined with expanding inventories of oil in that country. The U.S. is ramping up its oil production, mainly thanks to new oil extraction techniques; this is generating a surplus and driving prices down. The price slump was held in check, however, by concerns about geopolitical tensions in the Middle East, which are still acute. The Canadian dollar has stayed relatively stable against the U.S. currency, despite the lower oil price.

Crude Oil Price and Canada - U.S. Exchange Rate



Source: Global Insight

BUSINESS CREDIT CONDITIONS

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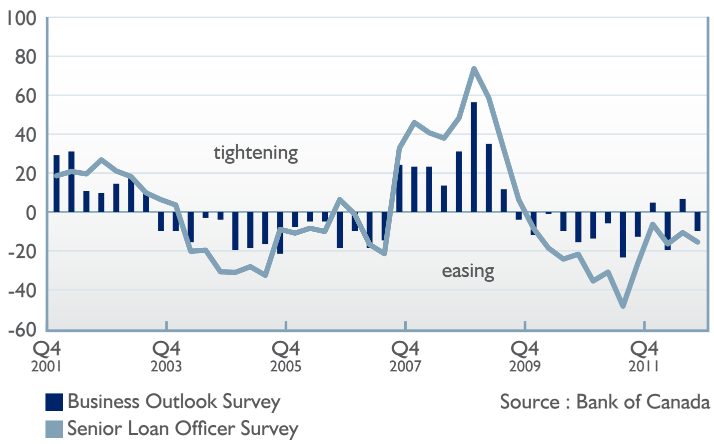
Business credit conditions ease

For the third quarter of 2012, the Bank of Canada's Senior Loan Officer Survey and the Business Outlook Survey (BOS) both reported an easing in credit conditions faced by businesses (Graph). But, according to the BOS, credit conditions remained unchanged in the past three months for the majority of businesses; it was mainly medium-sized and large businesses that reported an easing in their credit conditions. Moreover, credit granted to businesses by the chartered banks continued to show robust growth in September: short-term credit expanded by 19.9% compared with the previous month, while long-term credit rose by 6.1%.

Business Credit Conditions
balance of opinions (%)



Source : Bank of Canada

KEY INDICATORS – CANADA

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Key indicators – Canada	Historical				2012				Latest		Forecasts	
	2008	2009	2010	2011	Q1	Q2	Q3	Q4			2012	2013
Real GDP (% growth)	0.7	-2.8	3.2	2.4	1.8	1.8			Aug	-0.1	2.0	2.0
Machinery and Equipment Expenditures (% growth)	-0.5	-19.5	11.8	12.5	4.0	7.2					3.4	6.3
Pre-Tax Corporate Profits (% growth)	11.0	-33.1	21.2	15.4	-14.0	-17.5					-0.6	4.2
Industrial Production (% growth)	-3.1	-9.5	4.9	3.5	-1.3	1.6			Aug	-0.7	1.9	3.1
Industrial Product Prices (% growth)	4.3	-3.5	1.0	4.6	0.9	0.6	-3.5		Aug	-0.1	0.8	1.8
Non-Residential Construction (% growth)	7.9	-22.2	2.8	13.7	7.4	11.4						
Housing Starts (' 000 units)	211	148	191	193	206	231	223		Sep	225	209	182
Personal Expenditures (% growth)	3.0	0.4	3.3	2.4	0.7	1.1					1.7	2.0
Consumer Price (% growth)	2.4	0.3	1.8	2.9	2.1	0.1	0.1		Sep	0.2	1.8	1.9
Employment (% growth)	1.7	-1.6	1.4	1.5	0.9	2.8	0.4		Oct	0.0		
Unemployment Rate (%)	6.1	8.3	8.0	7.5	7.4	7.3	7.3		Oct	7.4	7.3	7.2
SMEs Confidence Index (CFIB)	56.1	57.7	66.7	66.4	66.3	64.4	61.0		Sep	62.0		
Manufacturers Confidence Index (CFIB)	52.7	56.0	68.6	67.2	69.0	67.2	65.3		Sep	62.8		

Sources: Statistics Canada, Consensus Economics and Canadian Federation of Independent Business. Annual growth, quarterly growth at annual rate and month-over-month growth.