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economic LETTER

OCTOBER 2013

ARE INTEREST RATES ON THE VERGE OF HEADING UP?

When the financial crisis erupted in 2008, the Bank of Canada quickly lowered the key interest rate and injected plenty of liquidity into the financial system to avoid a credit shortage. Since then, the economy has picked up steam, but interest rates have stayed low because production has yet to get back to full throttle.

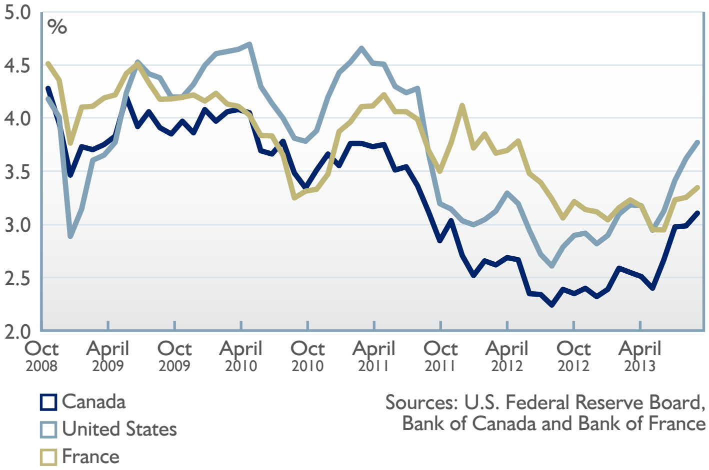
Since the United States was harder hit by the financial crisis than Canada was, the U.S. Federal Reserve (the Fed) reacted by adopting an even more expansionary monetary policy. On top of that, deeming that job creation was lagging and that economic growth was too sluggish, the Fed decided in September 2012 to continue its quantitative easing. Every month, it purchases $40 billion worth of mortgage-backed securities and $45 billion worth of long-term Treasury bonds. The goal of these measures is to keep long-term interest rates low, support the mortgage market and make credit conditions more flexible in order to stimulate the economy.

The Fed did not indicate how long its asset purchase program would last. In June, however, its chairman, Ben Bernanke, declared that if the economic data kept on meeting the central bank's projections, it would be appropriate to slow the pace of asset purchases before the end of the year, and that if economic conditions kept improving after that, the program could draw to a close by mid-2014. Since then, long-term interest rates have started rising, not only in the United States, but elsewhere as well through a contagion effect, in particular in some European countries and in Canada (graph).

Given these events, one might wonder whether the recent rise in long-term interest rates is heralding a general increase in interest rates in the near future. In fact, nothing is less certain. The Fed must exercise caution: if it tightens its monetary policy too hastily, it risks compromising the recovery, especially that of the homebuilding sector, which is still quite fragile. That sector is extremely sensitive to interest rate variations, as may be seen from the housing start data of recent months. Housing starts have lost ground since mortgage rates went up, however modestly. And in Europe, higher interest rates would also be inopportune, given that the zone is barely emerging from a deep recession. Weakening the global economy would have adverse consequences on the United States. ▼

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 October 12. Reliance on and use of this information is the reader's responsibility.

Market yield on 10-year Government Bonds



Sources: U.S. Federal Reserve Board, Bank of Canada and Bank of France

The conduct of monetary policy currently represents an unprecedented challenge for the Fed, as it attempts to control both long-term interest rates (through its asset purchase program) and short-term interest rates (via the key interest rate). It must use a very deft touch to get the financial markets to react the way it wants them to.

In announcing the eventual end to its asset purchase programs, the central bank insisted on the fact that it will need to continue a very expansionary monetary policy for a good while after the asset purchase program comes to an end, in order to achieve its goals of maximizing job creation and keeping prices stable. It also reiterated that the key interest rate would not budge, at least not until the unemployment rate falls back below 6.5%, subject to the condition that inflation expectations are under control. It is reasonable to conclude that it hoped to stimulate a gradual rise in long-term interest rates starting from the end of the year, while keeping short term rates low for a good while longer.

However, the financial markets reacted sharply to the announcement of a possible scaling back of asset purchases: long-term interest rates spurted abruptly. At the September press conference, Chairman Bernanke dampened expectations by stating that fears that the quick tightening of financial conditions observed in recent months might slow down growth were one of the reasons why the monetary policy committee decided not to go ahead with tapering its asset purchases. The Fed will no doubt be very cautious in its future communications, so as to temper the markets' zeal.

In short, a generalized hike in interest rates is not on tomorrow's agenda. Moreover, when the rates do go up, they will probably do so in a gradual and moderate fashion. The majority of the members of the Fed's monetary policy committee are forecasting that the key interest rate will reach 1.0% by the end of 2015 (keep in mind that it currently stands at a range of 0% to 0.25%), and none of the members anticipate it starting to rise before 2015. In Canada, forecasters think that the key interest rate will stay unchanged at 1.0% until the middle of 2014 at least. In short, Chairman Bernanke's statement in June has cracked the door open to a near-term interest rate hike, but the door will not be sprung wide for a good while yet. ■

CANADA

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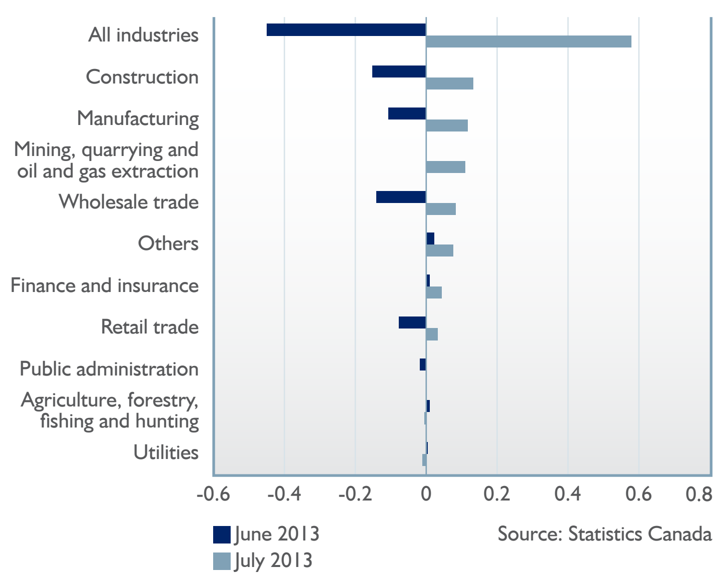
The most recent indicators argue in favour of modest economic growth in 2013, as expected. Real GDP and employment are continuing to grow, but at a moderate pace, and activity in the housing sector is slowing, as anticipated. Growth should accelerate in the next few quarters as economic activity in the United States firms up; however, that could be delayed if the U.S. Senate and the government fail to quickly reach an agreement about the budget and the debt ceiling.

Real GDP growth rebounds

After a pullback of 0.5% in June, real GDP by industry rebounded in July with a gain of 0.6%. Production made headway in all the sectors in which it had lost ground in June: construction, manufacturing, wholesale trade and retail trade (graph). Production in the mining and oil and gas extraction sector, which was flat in June, also made good progress in July. Forecasters are still calling for 1.7% real GDP growth in 2013, which implies quarterly growth rates slightly above 2.0% in the next two quarters. ▼

Main sectors' contribution to the change in gross domestic product (June 2013 and July 2013)



Source: Statistics Canada

Employment expands moderately

The creation of 23,400 full-time jobs, together with the loss of 11,500 part-time jobs, gave us a modest gain of 11,900 jobs in September. The unemployment rate dipped by two tenths of a percentage point, reaching 6.9%; this is the first time since December 2008 that it has stood below the 7.0% mark. The lower unemployment rate is the result of a shrinking labour force, particularly young people between the ages of 18 and 24 who searched for jobs in smaller numbers than in the previous month. Employment has been growing steadily since the beginning of the year, but at a more moderate pace than last year.

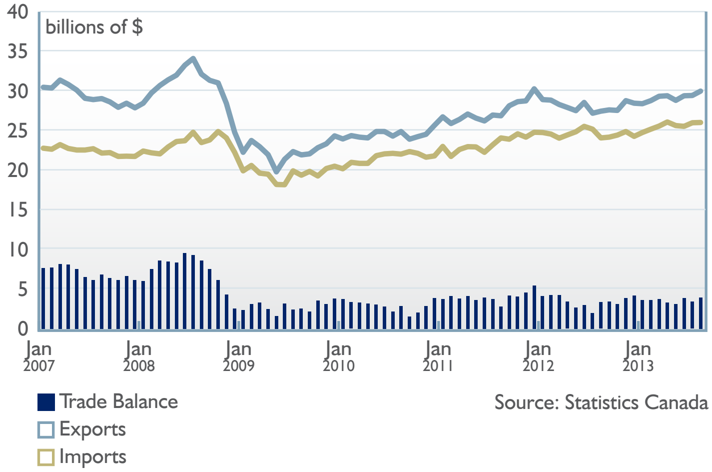
Housing starts and home sales head up

Housing starts increased from 183,964 units in August to 193,637 units in September; this represents growth of 5.3%. In urban centres, starts of multiple-unit homes surged by 5.9%, while those of single-family homes ticked up by 1.4%. Meanwhile, home sales rose in August, by 2.8% compared with the previous month and by 11.1% compared with August 2012. They had dropped in August of last year due to the tightening of mortgage rules, so the rebound in August of this year was anticipated. The recent hike in fixed mortgage rates also gave sales a boost, with buyers rushing to finalize their transactions in fear that rates would keep rising further. Despite the recent boom, the Canadian Real Estate Association is still expecting home sales to be lower in 2013 than they were in 2012.

The trade deficit widens further

After a 1.7% slump in July, exports rose by 1.8% in August. However, imports grew at a faster pace of 2.1%, causing the trade deficit to expand, from $1.2 billion in July to $1.3 billion in August. Energy products and transportation equipment (aircraft and automotive vehicles) led the upturn in imports, while energy products, metal products and non-metallic mineral products made the largest contribution to the increase in exports. Canada's trade surplus with the United States spurted up, from $3.4 billion in July to $4.0 billion in August, but it is still below where it stood before the recession. The value of Canadian exports to the United States has actually gradually risen since the recession, but the value of imports from the U.S. has outpaced it (graph). ■

Canada Exports, Imports and Trade Balance with the United States



Source: Statistics Canada

UNITED STATES

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The economy had been gradually getting back on track in recent months. Unfortunately, the political impasse that currently holds the country in its grip, due to the conflict between the Senate and the government surrounding the budget and the raising of the debt ceiling, could hold this recovery back. We can only hope that the negotiations currently in progress will quickly reach a successful conclusion.

No employment statistics

No job statistics were released because federal offices were closed due to the absence of an agreement between the members of the Senate and the government on the budget and the raising of the debt ceiling.

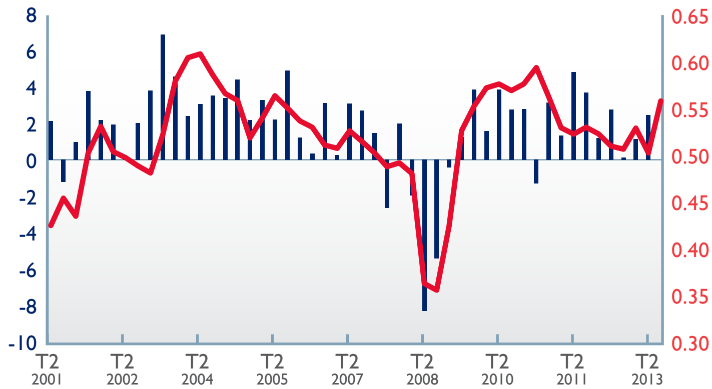
Housing starts stagnate, but the real estate market remains very active

Starts of single-family homes climbed by 7.0% in August, while starts of multiple-unit homes plunged by 9.4%. For a few months now, the trend in housing starts, measured by their six month moving average, has ceased to head upwards. It has even reversed course in the multiple-unit segment (graph). On the other hand, the resale market is still very active. In fact, home sales rose by 1.7% in August to reach their highest level in six and a half years. According to the chief economist of the National Association of Realtors, higher mortgage rates impelled buyers to close their transactions. However, activity might decelerate in the coming months due to a shrinking inventory of homes for sale, which limits choices in many regions, the higher mortgage rates which make properties less affordable, and tighter restrictions on mortgage lending which limit access to home ownership for many potential buyers. ▼

Business confidence continues to improve

The purchasing managers' index in the manufacturing sector, compiled by the Institute for Supply Management (ISM) and a good indicator of business confidence, is up again, from 55.7 in August to 56.2 in September. This brings the quarterly value of the index to 55.8, its highest standing since the second quarter of 2011 (graph). The new orders component has lost ground but is still high, at 60.5. The other main indexes are up, in particular that of employment which has gained 2.1 points to reach 55.4. The ISM reports that the comments made by entrepreneurs participating in the survey were generally positive and optimistic about accelerating demand and improvement in the business climate. ■

Purchasing Manager Index in manufacturing sector and change in Real GDP



Real GDP (quarterly change)
PMI manufacturing

Source: U.S. Bureau of Economic Analysis, Institute for Supply Management

INTEREST RATES

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No change in sight for the key interest rate

The Bank of Canada will make its next monetary policy decision on October 23, but no one is expecting a change in the key rate which has stood firm at 1.0% since September 2010. All the more so since the Senior Deputy Governor of the central bank, Tiff Macklem, announced in a recent speech that the Bank was going to revise its forecasts of Canadian economic growth in the last two quarters of 2013, downwards. The expectations of an upturn in Canadian exports that were factored into its economic scenario proved to be overly optimistic. The Monetary Policy Report, which will be released at the same time, will contain all the details of the Bank's economic projections. ■

OIL AND THE LOONIE

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The price of oil declines while the loonie remains stable

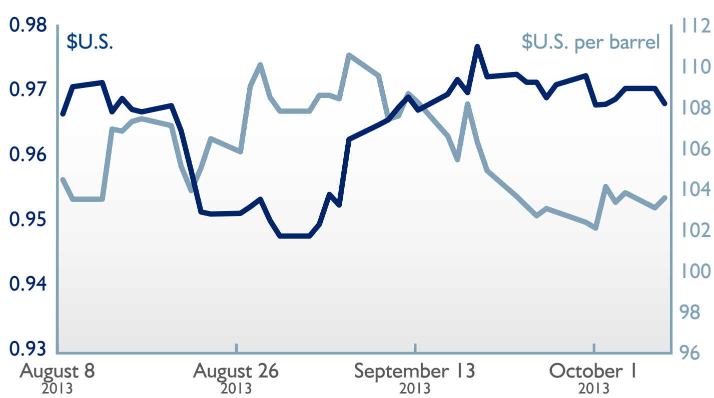
The price of crude oil is still high, but it has dipped in recent weeks. Persistent uncertainty surrounding the budget and the raising of the debt ceiling in the United States–which is jeopardizing the economic recovery in that country and, consequently, global economic growth–and the expected increase in American oil inventories, are the main causes of this slump. Some easing of tensions in the Middle East have also contributed to lower crude prices. As for the Canadian/U.S. dollar exchange rate, it has remained stable, hovering around US$0.96. ■

Exchange Rate and Crude Oil Price
(September 2009 to October 2013)

U.S. – Canada Exchange Rate
Crude Oil Price

Source: Global Insight

Exchange Rate and Crude Oil Price
(September 8, 2013 to October 8,2013)



U.S. – Canada Exchange Rate
Crude Oil Price

Source: Global Insight

SME CONFIDENCE

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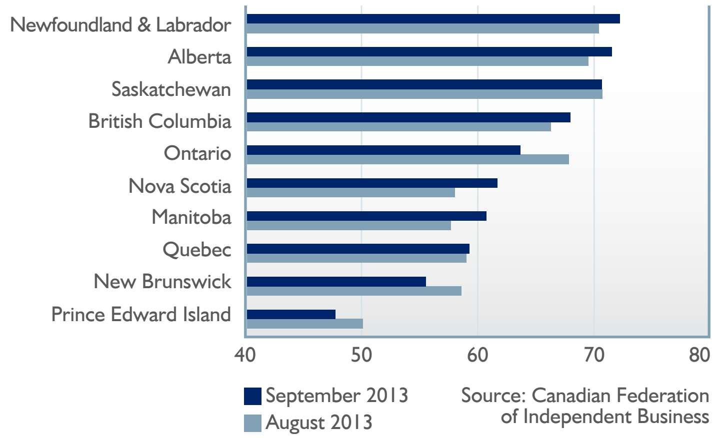
SME owners are a bit less optimistic

In September, the Business Barometer Index compiled by the Canadian Federation of Independent Business (CFIB) lost nearly all the ground it had gained in the previous month. At 64.5, it is nevertheless relatively high compared with the results seen since the spring of this year. With indexes above the 70 mark, Newfoundland and Labrador, Alberta and Saskatchewan are still the front-runners, while Prince Edward Island, New Brunswick and Quebec, whose indexes are languishing below 60, are pulling up the rear. The other indicators of the CFIB survey (hiring intentions, the general state of business health, price and wage hikes and investment spending) have remained relatively stable compared with the previous month.

Business Barometer



BUSINESS CREDIT CONDITIONS

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Credit conditions continued to ease

The credit conditions facing businesses are still good. According to the Bank of Canada's Senior Loan Officer Survey, those conditions continued to ease during the third quarter of the year. According to the Business Outlook Survey, they were unchanged from the previous quarter; however, survey respondents declared that it was relatively easy to obtain funds. In August, short-term credit granted to businesses by the chartered banks rose by 3.5% compared with the previous month, while long-term credit climbed by 9.6%. Year over year, growth in bank credit is still high, at 12%.

Business Credit Conditions
(balance of opinions, %)

KEY INDICATORS – CANADA

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Key indicators – Canada	Historical[1] 2009	2010	2011	2012	2013[2] Q1	Q2	Q3	Q4	2013[3] Latest		Forecast 2013	2014
Real GDP (% growth)	-2.7	3.4	2.5	1.7	2.2	1.7			Jul	0.6	1.7	2.3
Machinery and Equipment Expenditures (% growth)	-21.2	10.6	8.6	5.2	-0.1	-2.1					1.1	4.9
Pre-Tax Corporate Profits (% growth)	-45.4	61.6	16.6	-8.2	9.6	-32.6					-5.2	4.8
Industrial Production (% growth)	-11.0	6.0	3.9	0.9	4.2	-2.3			Jul	1.0	0.5	2.1
Industrial Product Prices (% growth)	-3.5	1.0	4.6	0.6	4.2	-1.1			Aug	0.2	1.1	1.8
Non-Residential Construction (% growth)	-19.4	17.3	12.9	6.9	1.5	-2.8						
Housing Starts (' 000 units)	148	191	193	215	175	190	191		Sep	194	183	173
Personal Expenditures (% growth)	0.3	3.5	2.3	1.9	1.3	3.8					2.1	2.1
Consumer Price (% growth)	0.3	1.8	2.9	1.5	1.6	2.0			Aug	0.0	1.1	1.8
Employment (% growth)	-1.6	1.4	1.5	1.2	0.8	1.3	0.8		Sep	0.1		
Unemployment Rate (%)	8.3	8.0	7.5	7.3	7.1	7.1	7.1		Sep	6.9	7.1	7.0
SMEs Confidence Index (CFIB)	57.7	66.7	66.4	63.9	64.9	61.3	64.8		Sep	64.5		
Manufacturers Confidence Index (CFIB)	56.0	68.5	67.3	66.7	65.6	58.3	65.4		Sep	64.1		

1. Annual growth rate
2. Quarterly growth, at annual rate
3. Month-over-month growth

Sources: Statistics Canada, Consensus Economics and Canadian Federation of Independent Business.