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Economic Update

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Highlights

- Finance Minister, Jim Flaherty announced on February 16th, tighter lending standards for mortgages, to take effect April 19.
- Home sales in Canada are up close to 60% from a year earlier with average home prices up nearly 20% year over year.
- Jobless rates in both Canada and the U.S. continue to fall, signalling an employment recovery is beginning to take root.
- Canadian retail sales rose 0.4% in December, led by a 3.3% increase at general merchandisers.
- January housing starts in both Ontario and Quebec top 110K, accounting for nearly 60% of all new homes built in Canada.
- The CAD has retraced its losses experienced earlier this month as Crude, the nation's largest export, surpasses \$80 per barrel and gold sits near \$1,115 per ounce.
- Japans GDP rose at an annual pace of 4.6% in the fourth quarter of 2009, while the Eurozone's Q4 GDP gained a mere 0.1%

Bank of Canada

- Overnight rate 0.25%
- Last: Jan 19, hold
- Next: Mar 2, hold *forecast*

U.S. Federal Reserve

- Federal funds rate 0%-0.25%
- Last: Jan 27, hold
- Next: Mar 16, hold *forecast*

Bubble Talk: Canada's Hot Housing Market

There has been much speculation that the risk of a housing bubble developing in Canada may be on the brink if the market continues to remain as hot as it is. Finance Minister, Jim Flaherty announced on February 16th, tighter lending standards for mortgages, stating that while the housing market appears to be stable and there's no solid evidence of a bubble, the changes are vital to "help prevent negative trends from developing." The standards, to take effect on April 19th, are such that borrowers must use the five-year fixed-mortgage rate to calculate borrowing capacity. Further to this, the maximum amount a homeowner can refinance their mortgage to retain equity has been lowered from 95%, to 90% of the value of the property, and lastly, non-owner occupied properties will require a minimum down payment of 20% as apposed to the current 5% minimum.

To sum up Canada's housing market, January's existing home sales were reported down 2.8% from December, although home sales were still up close to 60% from a year ago, albeit, from their recession dampened levels. Building permits are on the rise, increasing 2.4% in December, and remaining 32.6% higher than December 2008, while housing starts were up 5.8% in January. Furthermore, average home prices rose 19.6% year over year, its fourth monthly increase.

So, does this look like the making of a housing bubble? Senior Economist with BMO Capital Markets, Michael Gregory lays out three criteria to consider when analyzing any potential bubble pattern. The first being, prices rise rapidly to relatively high levels. Secondly, asset demand is energized by high and rising prices (speculative buyers), and lastly, asset turnover is being strengthened through credit growth (borrowing / refinancing to buy assets).

First off, home prices in Canada do appear to be rising rapidly. The average home, costing 19.6% more than a year earlier has resulted in prices hitting their highest levels relative to incomes and rents since findings were recorded in 1980. Many argue, this measure may be skewed based on the actual asset mix, but it is still safe to say that relative home prices are historically high.

Could people be purchasing property based on the notion that market values will continue to rise and the market is driven by speculation? It is important to answer this based on the current market conditions, as the unique environment and many other factors are fostering demand.

The most important factor that many see as driving the buying frenzy is the current and expected cost of borrowing. Mortgage rates are at historic lows, and with the third quarter fast approaching, mortgage

rates are widely expected to increase. Further to this, the harmonized sales tax, to take effect July 1, 2010 in both Ontario and British Columbia will cause sales of higher priced new homes and transactions associated with the sale of both new and existing homes to incur larger overall costs. Additionally, the recent changes to mortgage insurance eligibility rules will further spur demand, as Canadians take advantage of the current borrowing rules.

Lastly, is asset turnover strengthened through credit growth? In a housing bubble, flipping and speculative activity increases, which is reflected in a surge of mortgage credit. In the current environment, this is not the case. Current mortgage growth is roughly half of what it was at its peak before the global financial crisis.

All in all, there is no doubt prices are high, relative to incomes and rents but the expected pace of appreciation is questionable as the markets are making up many of the gains previously lost due to the recession. Furthermore, the catalyst behind the recent activity appears to be anticipation of higher costs as apposed to higher prices, while overall residential mortgage credit growth appears to be contained. Apart from relatively high prices, it does not appear that Canada is plagued by the classic "bubble" signs.

CANADIAN ECONOMIC RELEASES

Trends

<i>Employment; Unemployment rate</i>	Jan 43.0k; 8.3%	Dec -2.6k; 8.5%	Nov 79.1k; 8.5%
<i>Headline; Core CPI (annualized)</i>	Jan 0.1%; 2.0%	Dec -0.3%; 1.5%	Nov 0.4%; 1.5%
<i>Housing starts (annual units; monthly change)</i>	Dec 186.3k; 6.8%	Dec 174.5k; 10.1%	Nov 158.5k; 0.7%
<i>Real GDP (quarter to quarter change)</i>	Q3-2009 +0.4%	Q2-2009 -3.4%	Q1-2009 -6.1%

Employment rose by 43,000 in January and the unemployment rate fell to 8.3%. As a result, the country gained almost three times as many jobs as expected in January, led by part time positions for youth, pushing the unemployment rate down to its lowest level since September. Full time employment rose by 1,400 while part time jobs surged by 41,500. Ontario itself, accounted for more than half the gain with an improvement of 30,300 jobs. Further to this, average hourly wage growth decelerated to 1.8% in January from a year ago, compared with 2.4% in the previous month. It was the slowest pace of wage growth since June of 2003. Many economist believe that the gain is very much in line with the moderate economic recovery that exists in North America.

Consumer prices rose in January at the fastest pace in more than a year, bringing inflation close to the Bank of Canada's target and adding pressure on policy makers to raise interest rates. Prices rose 1.9% in January from a year earlier, surpassing expectations and reaching its highest levels since November 2008, due to rising automobile ownership costs. The monthly inflation rate in January was 0.3%. The so called core inflation rate, which excludes gasoline and other volatile items, rose 2.0% on an annual basis compared with 1.5% the previous month, led by the gain in new car prices. On a monthly basis, the core rate was 0.1%. According to the governor of the Bank of Canada, he believes core inflation has shown "stickiness", "probably due to wage gains".

Housing starts increased to the highest level in more than a year as builders began work on more single-family homes, as reported by the CMHC. Starts rose to a seasonally adjusted annual pace of 186,300 as compared to 174,500 units in December, their fourth consecutive monthly gain. Cheaper borrowing costs have continue to spark growing demand for homes, helping the country's economy recover from its first recession in 17 years.

Manufacturing shipments advanced 1.6% in December to \$43.0 billion, as gains in factory sales continue to remain strong. The gains in factory sales were mostly concentrated in the transportation equipment industry. This was the sixth increase in overall manufacturing sales in second months and the highest level since December 2008. Gains in the aerospace product and parts, the motor vehicle and the petroleum and coal product industries were largely responsible for December's increase.

Retail sales rose in December and further supporting the central bank's view consumers are recovering from the country's first recession since 1992. Retail sales rose 0.4% to \$35.3 billion, led by a 3.3% increase at general merchandisers such as department stores. Consumers are key to the country's economic recovery this year, with the BOC estimating they will account for more than half of a 2.9% expected expansion. The gain in retail sales followed a revised 0.5% decline in November, initially reported as a 0.3% decrease. December sales rose 6.7% from a year earlier. It is believed that Novembers warm weather caused some consumers to postpone purchases of clothing and footwear until December. Excluding car and parts dealers, retail sales rose 0.4%. Excluding the entire automotive sector, which also strips fuel sales, a mere 0.1% increase was realized.

Real GDP grew at a 0.4% annualized rate as the Canadian economy grew in the third quarter, a significant improvement after three consecutive quarterly declines. Consumer spending provided a strong support to real GDP which reflected a surge in purchases of autos, which supported a 9.8% annualized gain in spending on durable goods. Government and fixed investment also rose, further supporting the gains recorded by real GDP. Although GDP has moved into positive territory, the modest gain comes short of the Bank of Canada's 2.0% expectation.

U.S. ECONOMIC RELEASES

Trends

<i>Employment; Unemployment Rate</i>	Jan -20k; 9.7%	Dec -85k; 10.0%	Nov -11k; 10.0%
<i>Headline; Core CPI (annualized)</i>	Jan 2.6%; 1.6%	Dec 2.7%; 1.8%	Nov 1.8%; 1.7%
<i>Housing starts (annual units; monthly change)</i>	Jan 591k; 2.8%	Dec 557k; -4.0%	Dec 557k; -4.0%
<i>Real GDP (quarter to quarter change)</i>	Q3-2009 +2.8%	Q2-2009 -0.7%	Q1-2009 -6.4%

Non-farm payrolls unexpectedly lost 20,000 jobs in January, supporting the Federal Reserves forecasts that a labor market recovery will take time, making it more likely interest rates will stay near zero for the next six months. However, the unemployment rate unexpectedly dropped by 9.7% in January as manufacturers added to payrolls for the first time in three years. More than half a million Americans found work, helping push the jobless rate to the lowest level since August. This appears to contradict the net decline in payrolls of 20,000, however the construction industry, as well as state and local governments continue to cut back. All in all, it will continue to be a slow process but the labor market is indeed starting to make progress.

Consumer price inflation rose 2.6% for a fifth straight month, led by higher fuel costs. As a result, the cost of living in the U.S. rose in January less than anticipated and a measure of prices excluding food and fuel fell for the first time since 1982, indicating the recovery is generating little inflation. Excluding energy and food, the so-called core index unexpectedly fell 0.1%, reflecting a drop in new car prices, clothing and shelter. Retailers have reduced prices to lure customers at a time when most employers are reluctant to hire. The broader picture remains one of subdued inflation, and this gives the Fed ample reason to stay on the sidelines until, at least very late in the year.

Housing starts rose in January, as builders broke ground on 34,000 more homes than the previous month. Work began on houses at a 591,000 pace, up 2.8% from a month earlier. Construction of single family houses rose 1.5%, while work on multifamily homes, such as townhouses and apartment buildings jumped 9.2%. Part of the January increase may have reflected warmer weather, compared with the monthly average and colder than average temperatures in December. Building permits also remained strong at 621,000 applications, down from December, however still a sign that the construction industry will continue to show signs of life throughout 2010. The seasonally adjusted rate of 621,000 applications is 4.9% below the revised December rate of 653,000 but is nearly 17% above the January 2009 estimate of 531,000.

The **ISM (Institute of Supply Management) Index** expanded in January for the sixth consecutive month, rising to 58.4%, its highest reading since August 2004 (Readings greater than 50% signal expansion.) The gain reflected increases in orders, production and employment. Factories are stepping up production as stimulus fueled gains in demand and record cutback in inventory boost orders. After massive job cuts in the last two years, some companies are beginning to hire again, laying the groundwork for sustained gains in spending. Manufacturing is growing, and is expected to continue to expand throughout 2010.

Retail sales climbed in January for the third time in four months, signaling the consumer spending recovery that began in late 2009 continues into the new year. The 0.5% increase was larger than forecast and followed a 0.1% drop the prior month that was smaller than previously estimated. Purchases excluding autos rose 0.6%. Retailers continue to drive profits up by keeping stockpiles lean after the biggest household spending slump in three decades. Consumers are still relatively cautious, spending only a portion of their income and not taking on debt.

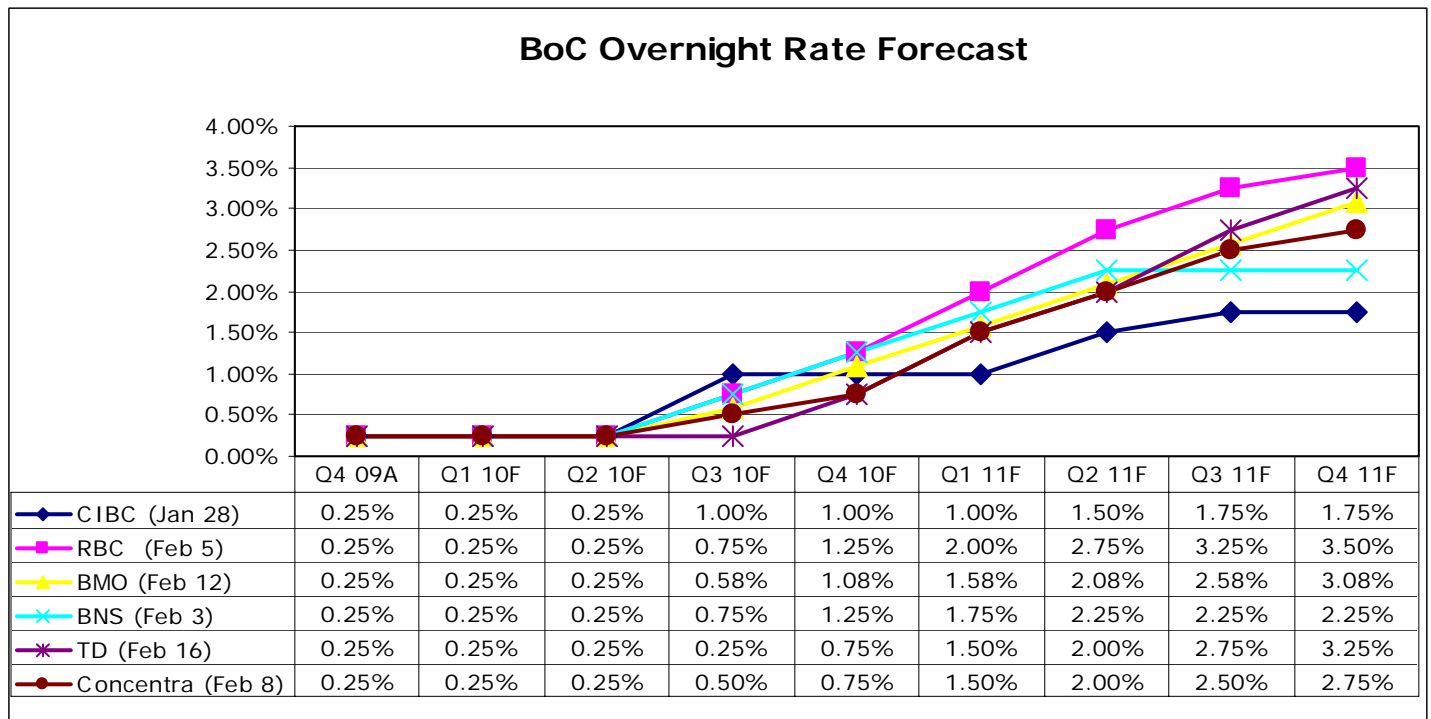
Real GDP resulted in the economy expanding 2.8% annualized in the third quarter, less than government's expectations, reflecting a smaller gain in consumer spending and a larger trade deficit. Smaller increases in spending show that the economy was dependant on government stimulus programs to help dig the world's largest economy out of recession. Growing profits lifted purchases of equipment and software, indicating investment by companies will help make up for smaller gains in household purchases as unemployment remains relatively high.

GLOBAL MARKET

The **Eurozone's**(16 nation) recovery almost stalled in the fourth quarter as waning spending and investment in Germany unexpectedly brought growth in the region's largest economy to a halt. Gross domestic product rose 0.1% from the third quarter, when it gained 0.4%. Furthermore, the recession in Greece deepened, with GDP falling to 0.8% in the fourth quarter after a 0.5% slump in the previous three months. European governments are struggling to contain the fall-out from Greece's budget crisis as they phase out the stimulus measures used to pull the economy out of a recession. As market turmoil pushes bond yields higher across southern Europe, the recovery is in danger of losing momentum. There is fear that Greece's fiscal problems will spread to other countries as Greece needs to sell 53 billion euros' of debt this year, equal to about 20% of its GDP in order to finance the EU's largest budget deficit. All in all Europe's governments face a growing dilemma as they seek to fortify recoveries at a time when rising sovereign debt burdens threaten to halt expansion.

Japan's economy grew faster than economists anticipated last quarter, reducing the risk of falling back into a recession even as deflation intensifies. Gross domestic product rose at an annual pace of 4.6% in the fourth quarter of 2009. Exports led the expansion, aided by a global recovery that prompted manufacturers to raise their profit forecasts. An increase in consumer spending may not last as government stimulus measures fade and households expect prices to keep falling along with their wages. Many economists believe, that the benefits from the global recovery are spilling over into Japan and that the economy will keep recovering even if the government does little to fight deflation.

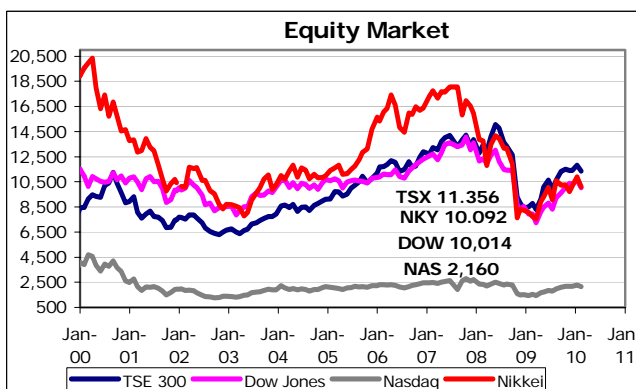
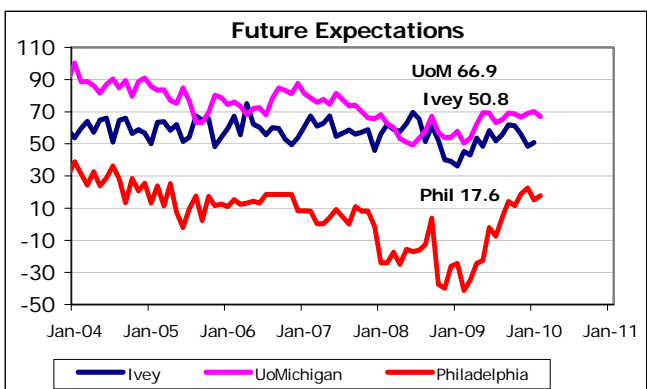
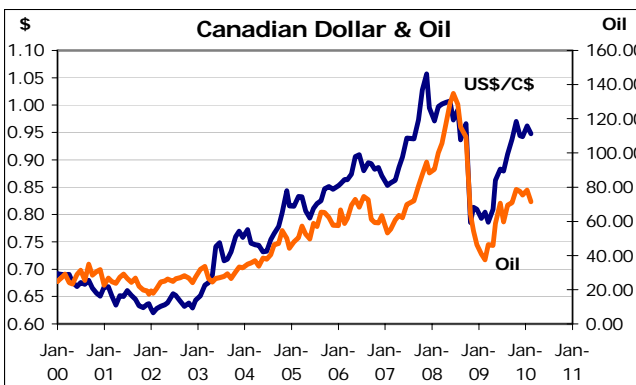
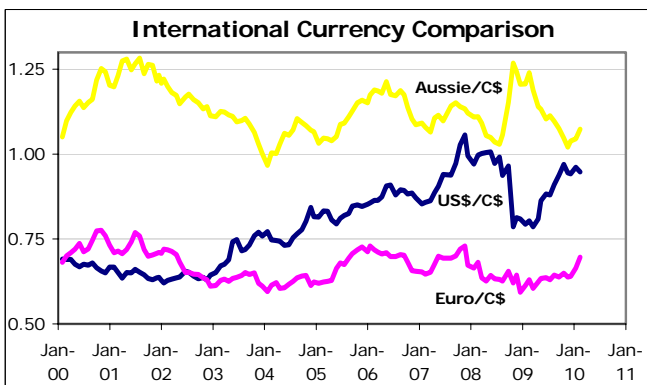
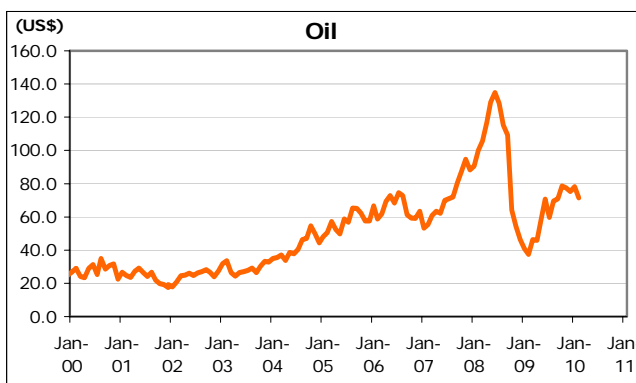
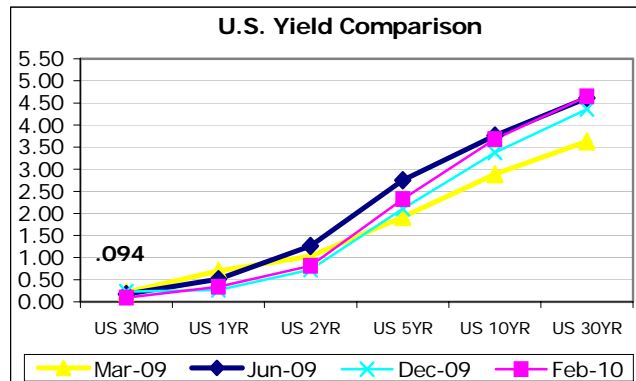
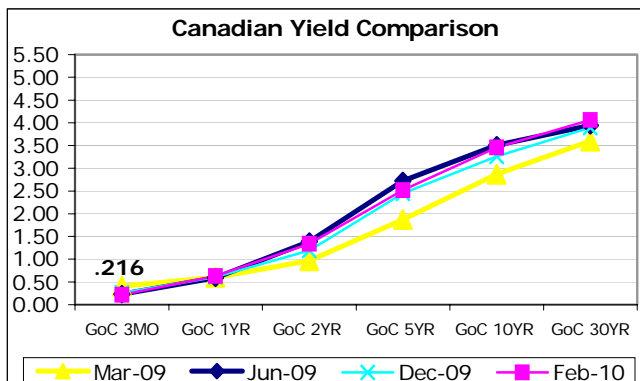
BANK OF CANADA EXPECTATIONS



Forecasts continue to only be as long as 2010, with more dramatic increases being built into projections. Overall, the trend remains that rates will be on hold until the third quarter of 2010, with a more pronounced turnaround expected in 2011. RBC, once again, remains the most aggressive in terms of the turn around, with a 1.50% hike built to span Q1 and Q2 2011.

Note: BMO averages the quarterly rate reductions, versus stating it at a particular point in time.

MARKET TRENDS



PROVINCIAL HIGHLIGHTS

	Employment <i>January</i>			Unemployment <i>January</i>			CPI (2002=100) <i>January</i>		
	Value (Thousands)	% Change (Period)	% Change (Year)	Value	% Change (Period)	% Change (Year)	Value	% Change (Period)	% Change (Year)
Canada	16,900.0	0.3	-0.1	8.3	-0.1	1.0	115.1	0.3	1.9
British Columbia	2,280.5	0.5	0.6	8.1	-0.2	1.8	112.2	0.3	0.7
Alberta	1,987.6	-0.4	-1.6	6.6	0.0	1.9	122.3	0.3	1.7
Saskatchewan	519.8	-0.4	-0.2	4.7	-0.1	0.5	117.5	0.3	1.6
Manitoba	612.4	1.4	1.0	5.4	-0.4	0.8	114.3	0.1	1.7
Ontario	6,557.7	0.5	-0.2	9.2	0.0	1.1	114.5	0.4	1.9
Quebec	3,864.6	0.2	0.4	8.0	-0.4	0.1	114.0	0.0	2.2
New Brunswick	364.5	-0.2	-0.9	9.3	0.4	0.5	115.4	0.8	3.9
Nova Scotia	447.0	-1.1	-1.4	9.8	0.2	0.9	116.9	0.5	3.1
Newfoundland	218.6	0.6	1.5	14.9	-0.3	0.3	116.5	1.1	3.2
P.E.I.	71.7	0.7	5.3	9.9	-0.9	-2.2	118.7	0.5	4.0
	Retail Trade <i>December</i>			Manufacturing Shipments <i>December</i>			Housing Starts <i>January</i>		
	(SA, \$ millions)			(SA, \$ millions)			(SAAR, thousands of units)		
	Value	% Change (Period)	% Change (Year)	Value	% Change (Period)	% Change (Year)	Value	% Change (Period)	% Change (Year)
Canada	35,298.9	0.4	6.7	43,000.0	1.6	-0.1	185.6	5.8	37.0
British Columbia	4,630.4	0.1	8.7	2,689.8	-2.3	-9.8	27.5	19.6	88.4
Alberta	4,742.4	1.8	0.7	4,737.6	0.7	-3.9	23.6	9.1	61.2
Saskatchewan	1,186.8	0.9	5.2	904.5	0.9	0.8	6.3	46.5	215.0
Manitoba	1,280.1	0.3	6.0	1,184.2	5.0	-9.1	5.1	54.5	64.5
Ontario	12,542.1	-0.2	8.4	19,768.0	2.3	1.1	55.5	1.8	23.9
Quebec	8,113.5	0.7	6.3	11,120.0	0.2	-1.0	55.4	6.3	25.1
New Brunswick	856.8	2.0	8.2	1,357.9	13.0	34.6	5.2	62.5	36.8
Nova Scotia	1,053.4	-0.7	10.1	751.6	-1.5	4.9	2.7	-10.0	12.5
Newfoundland	614.1	-1.2	8.0	394.4	11.1	11.6	3.6	-5.3	-16.3
P.E.I.	118.7	0.5	4.0	109.5	1.9	10.9	0.7	-30.0	16.7

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