



FCC Economic and Financial
Market Update

2021 Q2

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Outlook

The rollout of the COVID-19 vaccines and the lessening of restrictions create optimism for the Canadian and global economies. GDP is expected to grow by 6.2% in 2021, initially led by commodity exports and higher investments followed by higher household consumption and the rebound in service industries in the latter part of the year. Inflation is expected to average 2.3% for 2021 after peaking above 3% within this quarter. The Bank of Canada (BoC) overnight rate is expected to remain unchanged in 2021 at 25bp before rising in 2022. Beware of rising long-term interest rates as inflationary pressures appear in the economy.

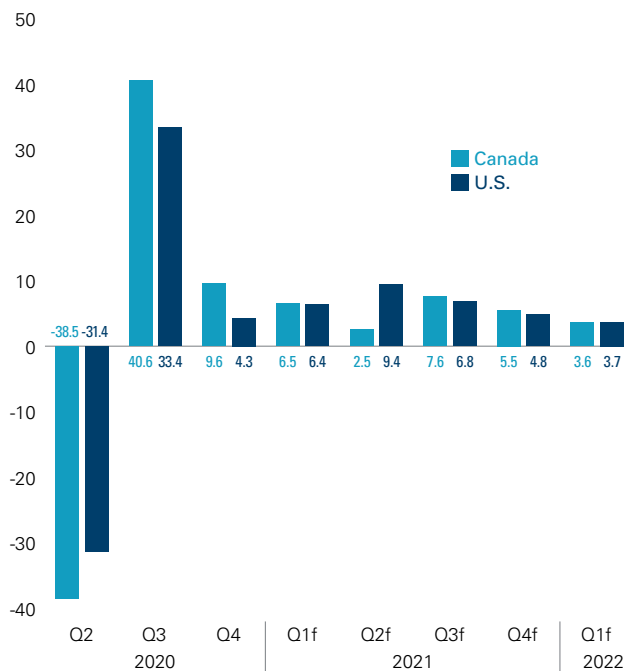
GDP

Expectations for GDP growth have improved, and forecasts are particularly strong for the second half of the year (Figure 1). The consensus forecast calls for year-over-year (YoY) GDP growth of 7.6% in Q3 in anticipation of the economy re-opening. COVID's third wave lowered household consumption expenditures in food services and travel. However, strong commodity prices boosted exports (Table 1). Despite the steep price increases in lumber and steel, the strong real estate market has led to higher investment in new construction as new permits were up 33.7% YTD over 2020.

As the economy re-opens and industrial output reaches pre-COVID levels, the economy will become less dependent on commodities and real estate for growth compared to the first quarter of the year. The aggressive fiscal and monetary stimulus have put a large segment of Canadian households with higher savings projected to assist growth throughout the year. The economy is expected to fully rebound from COVID by the end of the year, growing 6.2% and surpassing the 2019 GDP level.

Figure 1. Second half GDP should be strong

Quarterly GDP quarter-over-quarter percent change
Seasonally adjusted at annual rates



Source: Bloomberg

Table 1. Commodity prices are driving exports up, lifting the economy YTD

Commodity	March 2020 Export (\$ millions)	YoY price inflation	March 2021 Export (\$ millions)	YoY export % change
Wheat	644.5	7.0	906.7	40.7
Canola	647.5	54.8	679.0	4.9
Steel	774.6	120.7	993.2	28.2
Lumber	1,519.4	151.3	2,650.3	74.4
Crude oil	6,682.3	94.0	7,818.1	17.0
Total exports	47,018.5	-	54,072.3	15.0

Sources: Quandl, Federal Reserve, Statistics Canada, CREA

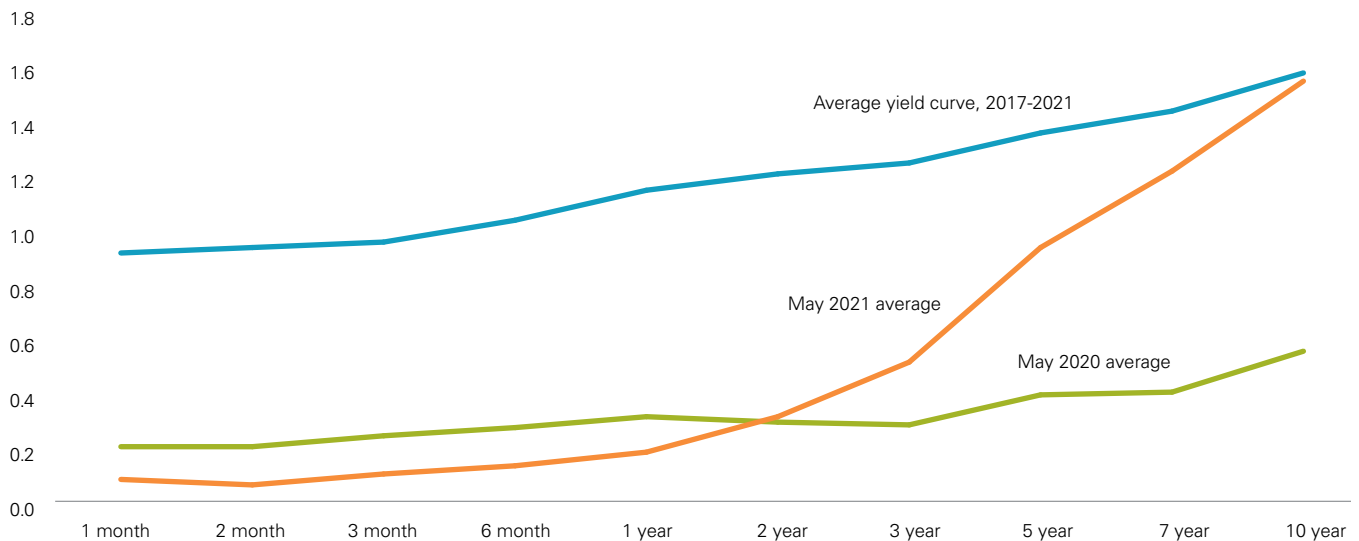
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Central Bank Policy

The Bank of Canada (BoC) lowered their weekly bond purchases by 25% to \$3 billion and bumped up the timeline for increasing the policy rate to late 2022 from 2023. No surprises - there is a large consensus that the overnight rate will remain at 0.25% throughout 2021. But inflationary pressures are causing some real concerns in the financial markets. In 2021, the economy is recovering faster than anticipated at the outset of the pandemic, reflected in the steepening yield curve. Long-term rates have increased (Figure 2); however, short-term yields have decreased over the same timeframe. All bond yields are well below their five year average. This is a result of future expectations for growth and concerns around sustained inflation

Figure 2. Government bonds yield remains historically low

Average Canadian bond yield curve over time



Source: Statistics Canada

The all-item CPI inflation was 3.4% in April, and the annual expectation for 2021 is 2.3% (Table 2). We expect to see YoY inflation be around 3% from now into summer before lowering in the fall. The primary driver of higher inflation has been in products manufactured with unusually high-demand materials and limited production capacity because of COVID.

These include energy products (up 32.7% YoY in April) crop products (35.2%), and aluminum products (32.9%). The price increases on these items are large compared to headline CPI. Offsetting these increases are price decreases in cellular services (-17.5%), batteries (-13.6%) and mortgage interest payments (-7.3%).

The number of new businesses coming to market is higher than pre-COVID as people see opportunities with consumer product shortages. This is true for forestry, construction, manufacturing (including food manufacturing), wholesale trade and retail. These new businesses, along with higher output once COVID restrictions end, could put downward pressure on prices. The expectation that consumers shift spending to the service industry will also lower demand for manufactured goods. If supply issues continue into the second half of the year, inflation could run up further.

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Table 2. CPI Inflation will run hot for the next few months

	2020				2021				2022			
	Q1	Q2	Q3	Q4	Q1	Q2f	Q3f	Q4f	Q1f	2020	2021f	2022f
Canada	1.8	0.0	0.2	0.8	1.4	3.0	2.6	2.3	2.2	0.7	2.3	2.0
U.S.	2.1	0.3	1.2	1.3	1.9	3.8	3.3	3.3	2.7	1.2	3.1	2.3

Sources: Bloomberg, FCC

The bottom line is that inflation is likely to be transitory, and prices should stabilize or even lower in the second half of the year. If inflation is not transitory and continues to increase into Q3/Q4, the BoC could be forced to increase rates sooner, and long-term yields and interest rates could continue rising.

Exchange rates

USD per CAD

The Canadian dollar has recently been on a tear. It is projected to average \$0.813 in 2021 (Table 3), declining slightly in the fourth quarter of the year after peaking in late Q2 or Q3. The Bank of Canada lowered bond purchases and signalled an eventual rate increase ahead of the Federal Reserve, boosting loonie optimism. But the expectation is that the U.S. will follow suit with a more hawkish stance in the second half of the year, supporting the U.S. dollar. A lot also depends on the future of oil prices. The current outlook has oil prices beginning to lower in the second half of the year as the initial growth boost wanes, stabilizing the dollar into 2022. In 2022, whoever moves first on increasing interest rates between Canada and the U.S. will determine movement.

Table 3. CAD projected to peak in Q2 or Q3 before declining slightly

	2020			2021				2022				2020	2021f	2022f
	Q2	Q3	Q4	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f			
USD per CAD	0.722	0.751	0.768	0.790	0.815	0.824	0.822	0.820	0.817	0.816	0.814	0.747	0.813	0.817

Sources: Statistics Canada, FCC

CNY per CAD

The CAD recorded gains relative to the Yuan after the BoC announced higher growth projections in April. It has increased slightly in 2021 after bottoming in Q4 2020. The peak of post-COVID growth is behind China for the most part after it posted 18% GDP growth in Q1 (vs -6.8% a year ago). This could further support CAD appreciation, although future growth projections in China still far outweigh Canada's, which should limit upside.

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EUR per CAD

The European Central Bank (ECB) appears adamant to continue providing monetary stimulus until their inflation target is met. It is unlikely a policy change will occur this spring or summer, even if borrowing costs increase worldwide. Europe is now expected to reach COVID herd immunity by July, which has some economists questioning the need for aggressive stimulus. However, inflation and GDP expectations in the eurozone still lag North America, and the European economy is not expected to reach pre-COVID levels until late 2022. A faster-moving Canadian economy could put further upward pressure on the CAD relative to the euro.

GBP per CAD

The British economy is projected to increase upwards of 7.8% in 2021, a pace above both Canada and the U.S. The U.K. central bank is now more hawkish and is more likely to cut stimulus faster, creating optimism for the Pound after years of being down from Brexit. The recent Scottish election won by the Nationalist party has opened the doors for a new separation referendum after last voted down in 2014. The separation is unlikely, but after the Brexit fiasco, any vote at all could have short-term negative consequences on the pound.

Table 4. Historical currency rates per CAD for CNY, EUR and GBP

	2020				2021	
	Q1	Q2	Q3	Q4	Q1	Q2 to date
CNY per CAD	5.194	5.118	5.192	5.083	5.120	5.254
EUR per CAD	0.675	0.655	0.642	0.644	0.656	0.673
GBP per CAD	0.582	0.582	0.581	0.581	0.573	0.581

Source: Bank of Canada

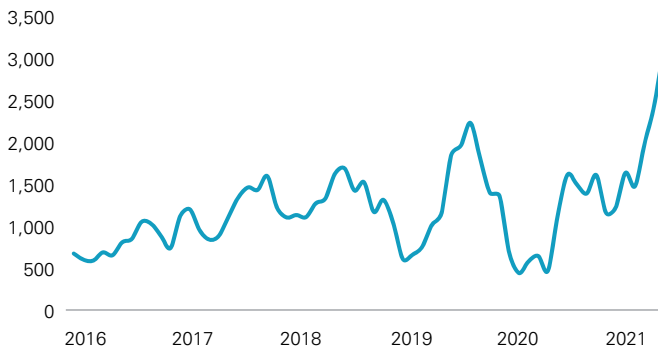
Transportation disruptions over the Pacific will take time to subside

Shipping and transportation frustrations have grown over the past several months, and they will most likely continue into the summer. The Baltic Dry Index, which is a proxy for dry bulk shipping prices, has increased 11.8% YTD as a container shortage has plagued the industry, specifically for those trading with Asia (Figure 3). Just under 10% of all Canadian agriculture and food sales (excluding fishing) came from exporting to Asia in 2020, and losing this revenue stream from shipping disruptions can be frustrating. Chinese manufacturing capacity has surpassed the pre-COVID level, unlike Canada and the U.S., and this is creating imbalances in trade that the North American supply chain is not accustomed to.

The Port of Shanghai is estimated to be over 60% more productive than the Port of Los Angeles without COVID worker restrictions, with workers working 24-7-365. As a result, Asian producers are requesting and paying high costs to get containers and ships back across the Pacific as fast as possible. The per cent of total twenty-foot equivalent units (TEU) containers exported empty from the Port of Vancouver has increased from 25% in Q1 2020 to 43% in Q1 2021 (Figure 4). The amount of time it takes to unload and load a train once it arrives at port has also increased to over five days at times, significantly longer than the Port's optimal threshold of three days. As supply chain disruptions subside in North America, this should alleviate shipping disruption over time.

Figure 3. Sea freight rates are at a 5-year high

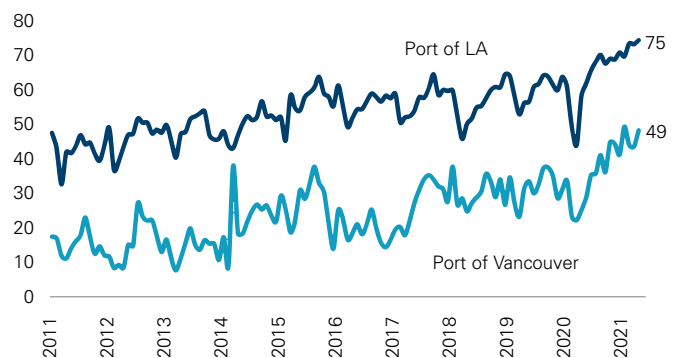
Baltic Dry Index, monthly average



Source: Bloomberg

Figure 4. Empty twenty-foot equivalent (TEU) container exports have been increasing for years

Empty container TEUs as a percent of total exported TEUs



Sources: Port of Vancouver, Port of Los Angeles

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