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Canadian Economic Outlook

May 19, 2003

The weakening US economy, sharp appreciation of the CAD, and SARS will debilitate the Canadian economy more than expected this year.

In general, indicators of the Canadian economy over the past month still point to respectable performance in 2003. Monthly gross domestic product (GDP) by industry grew 0.2% in February, while January was revised upward to 0.5%. The index of leading indicators rose 0.2% in March and is up 4.7% over the previous year. In April, the Ivey index, although lower, came in at 54.2 still indicating growth. The housing market is very strong with housing starts up 7.7% over the previous year in April to reach 207,800. Building permits, a leading indicator of housing activity, were up 6.6% in the first quarter compared to the first quarter last year. However, there are some reasons for concern. Indicators of the US economy continued to deteriorate over the past month. There are increasing signs that weakness in the North American economy, in combination with a strengthening Canadian dollar (CAD), are beginning to take their toll on the manufacturing sector. In addition, it appears that the outbreak of severe acute respiratory syndrome (SARS) in the Toronto area, although now contained, will have a negative impact on the economy in the second quarter.

Technical factors explain most of the weakness in recent economic indicators.

As expected, some indicators weakened in the past month, but much of this can be attributed to temporary factors, such as bad weather, the Iraq war, and the SARS outbreak. Retail sales in February rose by a very strong 1.5% to a new record; however, these sales were almost entirely driven by the automotive sector. An anomalous surge in new motor vehicle sales in February and higher gasoline prices caused spending on gas and autos to jump 4.8% in one month. Excluding gas stations and motor vehicle dealers, retail sales fell by 0.2%. In April, the economy shed 19,000 jobs, and unemployment rose to 7.5%. However, again the headline number is a bit deceptive since health care and accommodation and food services (the two areas most affected by the SARS outbreak) accounted for most of the job losses. Excluding these sectors, employment increased by 16,600 jobs. Also, job quality improved as full-time employment (including losses due to SARS) grew by 10,700 jobs. Over the next month, some indicators might continue to weaken, especially retail sales as gas prices and new vehicle sales fall, but these should not be a cause for concern.

Growth in the manufacturing sector is slowing due to a higher CAD and weaker US economy.

In March, manufacturing shipments rose by a robust 1.4%, and even excluding volatile petroleum and motor vehicle shipments, shipments rose by a moderately positive 0.3%. Nevertheless, in the Business Conditions Survey, manufacturers expect to lower production in the second quarter. Manufacturers reported expected declines in all areas: orders, backlog, inventories, and employment. Global uncertainty and the appreciation of the CAD were cited as reasons for this deterioration.

Canadian Forecast Summary

	History		Forecast→				Annual Data			
	02Q3	02Q4	03Q1	03Q2	03Q3	03Q4	2001	2002	2003	2004
Real GDP, % Change, SAAR	3.6	1.6	2.5	2.4	3.7	4.2	1.5	3.4	2.8	3.5
% Change, Year Ago	4.2	3.9	3.0	2.5	2.6	3.2				
CPI, SA, % Change, Year Ago	2.3	3.8	4.5	3.3	2.3	1.8	2.5	2.3	3.0	1.8
BoC Core CPI, % Change, Year Ago	2.4	2.8	3.1	2.4	2.1	2.2	2.1	2.4	2.4	2.1
			End of Period				End of Period			
Bank Target Rate, %	2.75	2.75	3.00	3.25	3.50	3.75	2.25	2.75	3.75	5.00
3-Month Treasury Bill Tender, %	2.8	2.6	3.1	3.2	3.6	3.8	2.0	2.6	3.8	5.0
10-Year Benchmark Bond Yield, %	4.9	4.8	5.1	4.7	4.9	5.2	5.4	4.8	5.2	6.0

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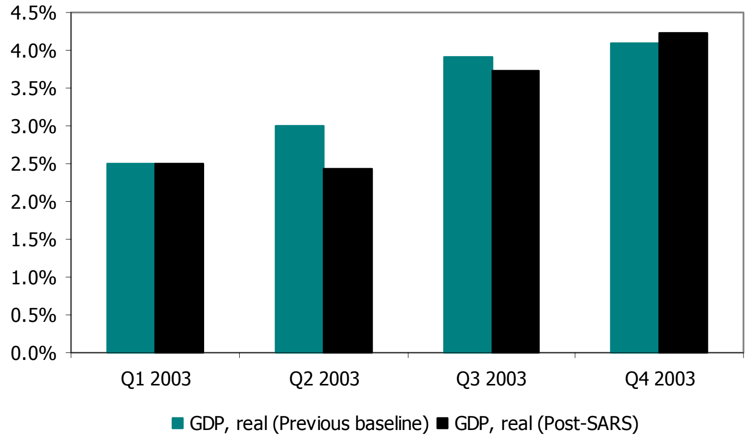
The effects of SARS will be mostly felt in the second quarter, and be partially offset in the fourth.

The effect of SARS on quarterly GDP (SA, annual rate)



Sources: Statistics Canada, Swiss Re Economic Research & Consulting, Bank of Montreal, Toronto-Dominion Bank.

The trade surplus will begin to decline over the next quarter.

The trade surplus grew in March to one of the highest levels in the past two years. However, net unit sales have actually been falling. In the short run, the appreciation of the Canadian dollar causes import prices to fall faster than unit sales increase, lowering the value of imports temporarily. Also, higher energy prices helped to push up the value of exports 5.2% for the first quarter. Falling energy prices, the sharp appreciation of the CAD, and a decline in the US economy will eventually reduce the trade surplus.

SARS will lower economic output this year by about 0.2%.

The economy grew at about a 2.5% pace in the first quarter, but the next two quarters will be weaker than previously expected due to the SARS outbreak. SARS affects the economy directly through a decrease in tourism, health care spending and consumer purchases and indirectly through trade with Asia. According to TD bank, the Toronto area accounts for about 20% of the economy, meaning the outbreak is bound to have a significant impact. Foreign tourists spent CAD 17.8 bn in Canada last year, or about 1.6% of output. According to an end-of-April poll by Ipsos-Reid, 41% of Americans said they would be less likely to visit Canada because of SARS. In addition, consumer spending accounts for 56% of output, so even a small decline in retail activity, as shoppers avoid public places, can have a big impact. Other factors will not have as much of an impact. Trade with Asia accounts for less than 2% of exports, and the Toronto area health care sector, affected by potential patients avoiding health care facilities, accounts for only an estimated 1.1% of the economy. Overall, we expect a decline in health care and consumer spending in the second quarter, but most of this will return in later quarters. However, some travel for this year, especially in the form of conventions, has been permanently lost. Overall, assuming that there are no further outbreaks, we estimate about a 0.2% drop in output for this year due to the outbreak with almost all of the net effect being felt in the second quarter.

The Bank of Canada is currently on hold after recently raising rates. Long-term interest rates will not rise significantly by year-end.

As we expected, the Bank of Canada raised rates by 25 basis points in April. They changed their outlook to a more balanced view, signaling that they will not raise rates at the June 3rd meeting. The Bank is still keen to raise rates further this year, but the sharp rise in the Canadian dollar (up 5% since the last rate announcement), the declining U.S. economy, and slowing inflation will keep them on hold until the third quarter. Interest rates on 10-year government bonds have come down by 35 bp over the past month. This drop has been instigated by a sharp fall in US long-term rates due to lower-than-expected inflation and an announcement by the US Federal Reserve indicating it would be on hold for longer than expected. The fall in US yields added to the interest rate differential, and in combination with the rise in the CAD and Federal fiscal surpluses, fueled a surge in Canadian bond prices. We expect these conditions will keep the 10-year interest rate at year end near where it ended the first quarter — between 5% and 5.5%. This outlook is highly uncertain given the large swings of interest rates from small changes in the outlook for the US economy.