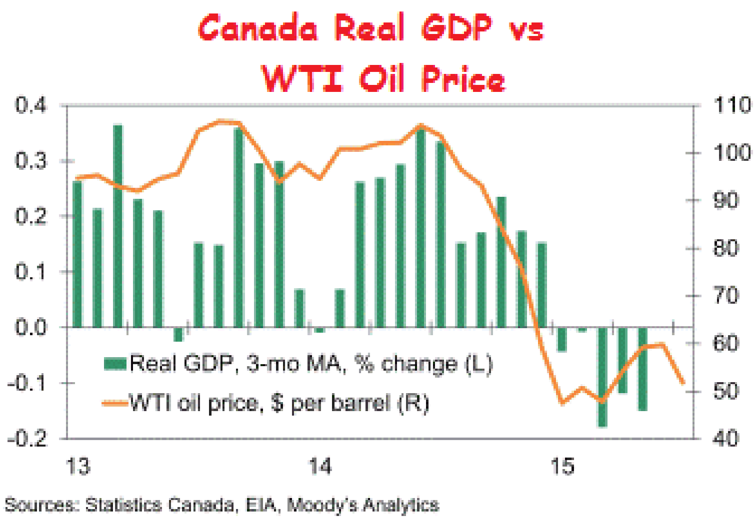
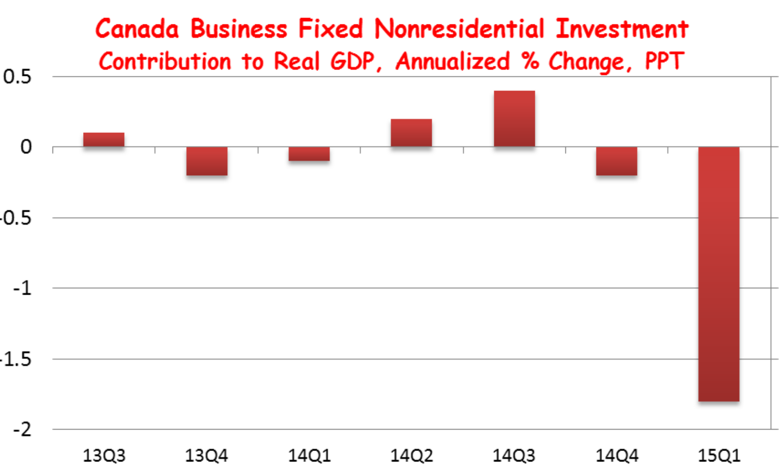
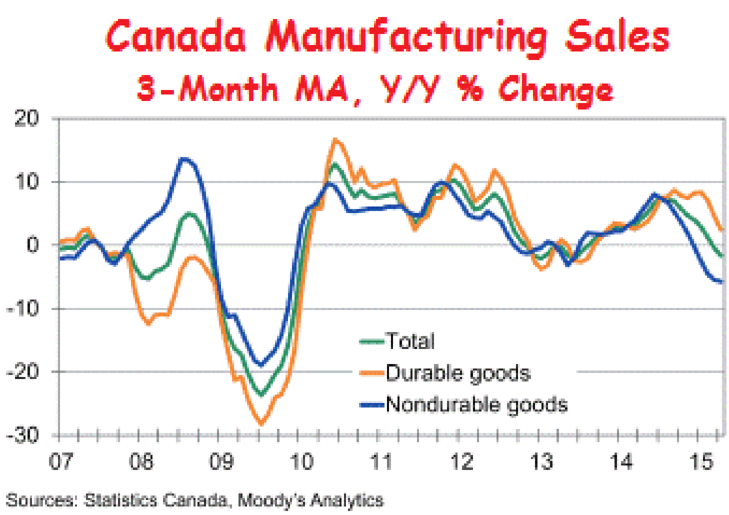
Canada's Economic Outlook



Graphic Source: Moody's Analytics



Data Sources: Statistics Canada, Moody's Analytics



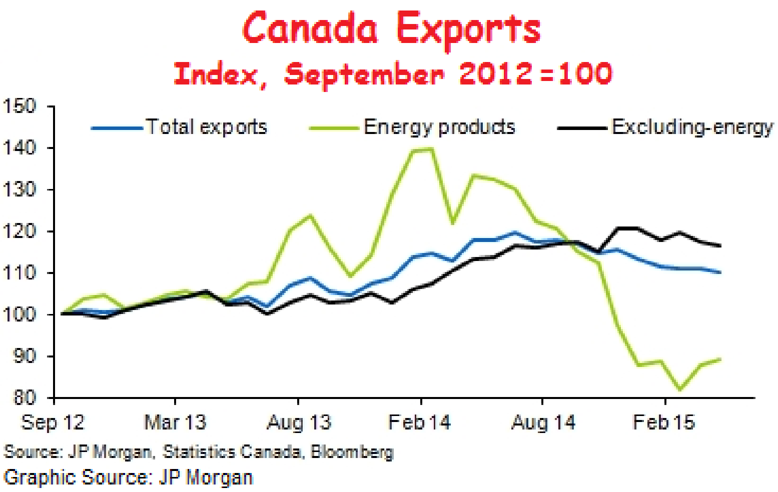
Graphic Source: Moody's Analytics

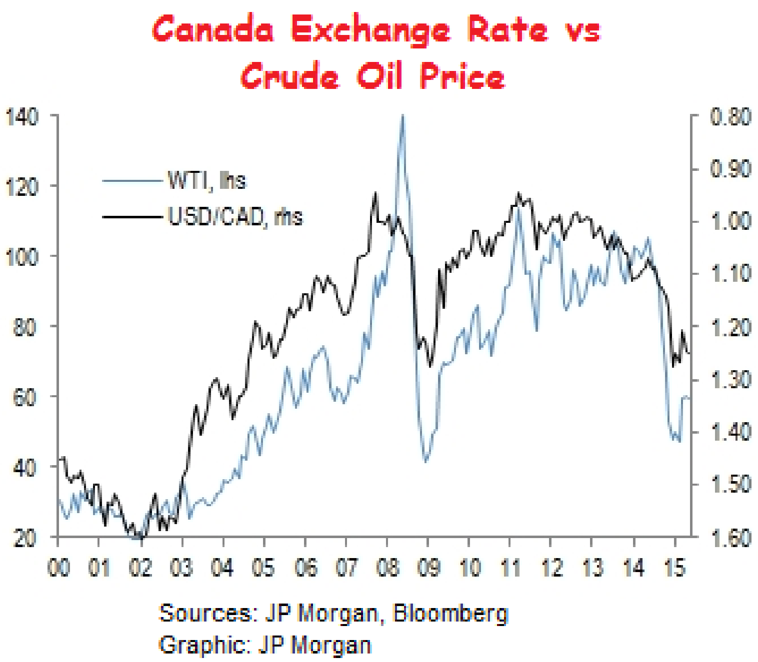
The Canadian economy is struggling. Economic growth has been on a downward trend for over a year and plummeted to negative territory in the first quarter for the first time since 2011. Unfortunately, data indicates that the economic contraction continued into the second quarter, meeting the definition of a technical recession.

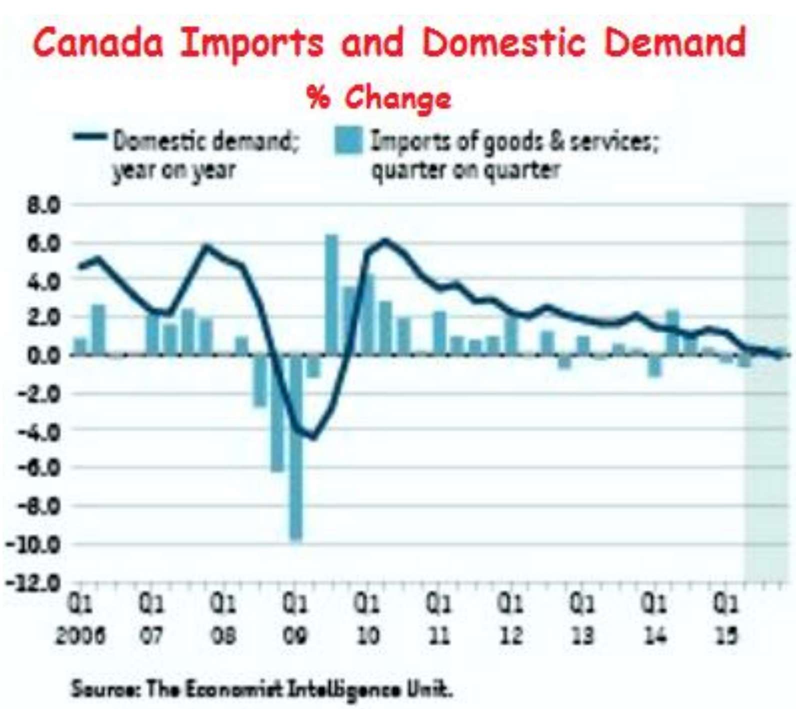
There is hope that improving economic conditions in the U.S. will be a major driver for Canada's rebound. Canada's economic performance tends to lag that of the U.S. by about a quarter and, given the recent economic performance in U.S., growth in Canada is expected to pick up through the rest of the year. Nevertheless, conditions will likely remain weak in the near term, with growth reaching around 1% this year, below its potential.

The main culprit of Canada's slowdown is weaker investment spending by firms. Canada is the fourth-largest exporter of oil and lower oil prices over the last year have resulted in a significant drop in energy export receipts. Consequently, corporate profits have dropped by an annualized rate of almost 40%, causing businesses to drastically cut back on spending. Unfortunately, lower sales in the energy sector have had ripple effects throughout the Canadian economy, with manufacturing sales experiencing a sharp downward trend since mid-2014.

While oil prices began to make a turnaround at the beginning of the year, tepid global economic conditions resulting from uncertainties in China and Greece have led to yet another downturn in oil prices. This will create further weakness in corporate profits and prevent business investment and economic growth from recovering in the near term.



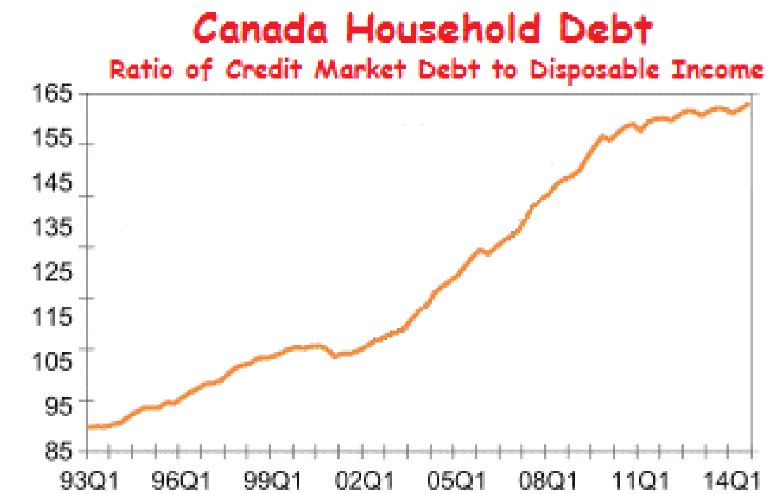




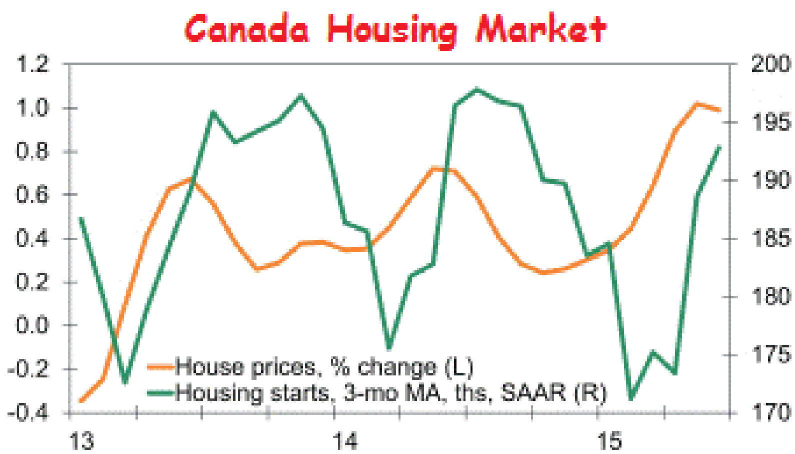
Contrary to the energy sector, Canadian nonoil exporters are benefiting from lower oil prices due to their impact on the U.S./Canada exchange rate. Given that a large portion of Canada's foreign currency reserves are earned through the export of oil, which is priced in U.S. dollars, a decline in the price of oil reduces Canada's U.S. dollar reserves and the value of the Canadian currency against the U.S. dollar. As such, lower oil prices over the past year have resulted in a significant depreciation of the Canadian loonie and lifted nonoil exports growth by increasing the price-competiveness of Canadian exports.

Meanwhile, nonoil exports have also been rising due to improving economic conditions in the U.S., Canada's principal trading partner. This trend is expected to continue in the near term as the U.S. growth engine gains momentum and loonie faces additional downward pressure from falling oil prices. Nevertheless, the negative impact of lower oil prices on Canada's energy sector will continue to outweigh the positive impact on the nation's nonoil exports growth.

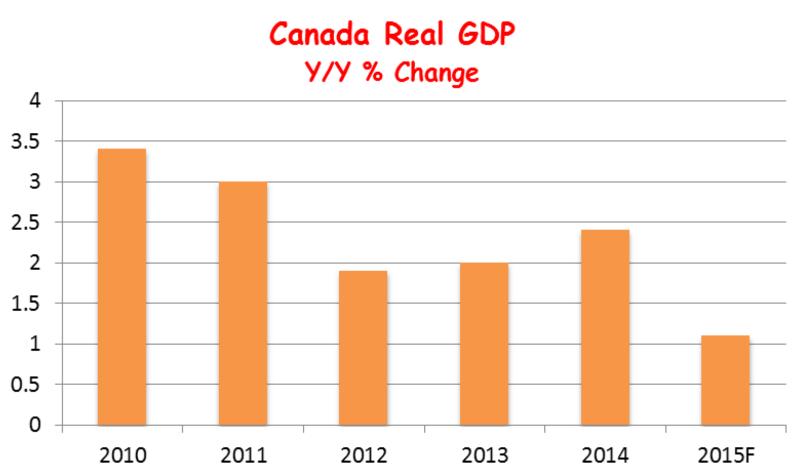
Despite the falling loonie, Canada's imports growth remains weak as a result of lackluster domestic demand. Although household spending has been a key engine of growth for the Canadian economy during the past decade, the massive amount of spending has resulted in a mountain of debt, causing financially-stretched consumers to retrench. Unfortunately, the situation has been exacerbated over the past year due to lower oil prices, which have reduced income growth and made it harder for households to repay their loans. As a result, the ratio of Canada's household debt to disposable income has reached a record high of almost 164%.



Sources: Statistics Canada, Moody's Analytics
Graphic Source: Moody's Analytics



Sources: Brookfield RPS, CMHC, Moody's Analytics
Graphic: Moody's Analytics



Data Sources: IMF, International Financial Statistics, Economic Intelligence Unit, Moody's Analytics

Canada's household debt problem is primarily due to rising homeownership, as mortgage debt accounts for roughly two-thirds of the total debt. Hyperactivity in the housing market during the past decade has driven the median home price to over seven-times that of median family income.

The combination of record-high debt levels and an overinflated housing market has created major concern for the Canadian economy and is now considered the greatest threat to the nation's financial system. The worry is that, if income growth continues to fall, more and more homeowners may begin to default on their debt, leading to a burst in the housing market and financial crisis similar to that of the U.S. during the Great Recession.

To avoid this risk, the Bank of Canada is trying to keep borrowing costs low by cutting the policy interest rate twice in the past year. While these efforts make mortgage payments more affordable for homeowners, they are also adding fuel to the fire, with the red-hot housing market experiencing record-level sales and prices. As such, some sort of housing market correction appears inevitable in the near term if oil prices and income growth continue to fall.

Overall, the Canadian economy is most likely in recession. The renewed decline in oil prices will weigh heavily on the nation's energy sector, preventing a recovery in business investment and production. Although the falling loonie and improving economic conditions in the U.S. will boost growth in the near term, the negative impact of lower oil prices will outweigh these benefits. Meanwhile, consumer spending growth will remain restricted as a result of record-level household debt and slowing income growth. Economic growth is expected to reach around 1% this year, below its potential.