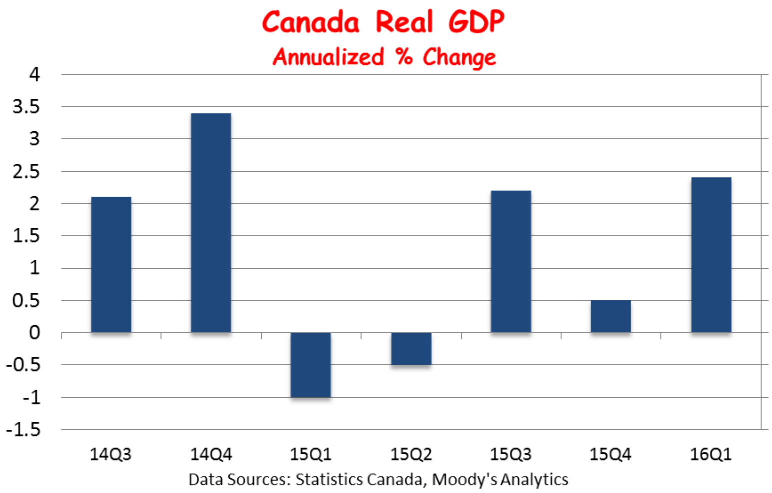
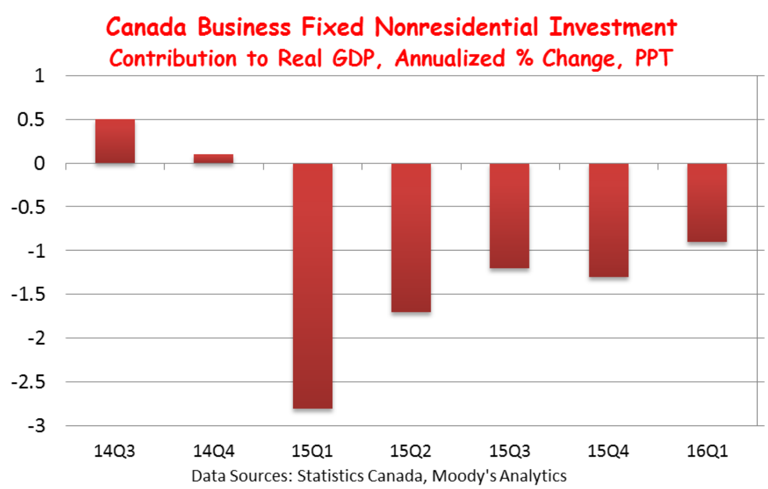
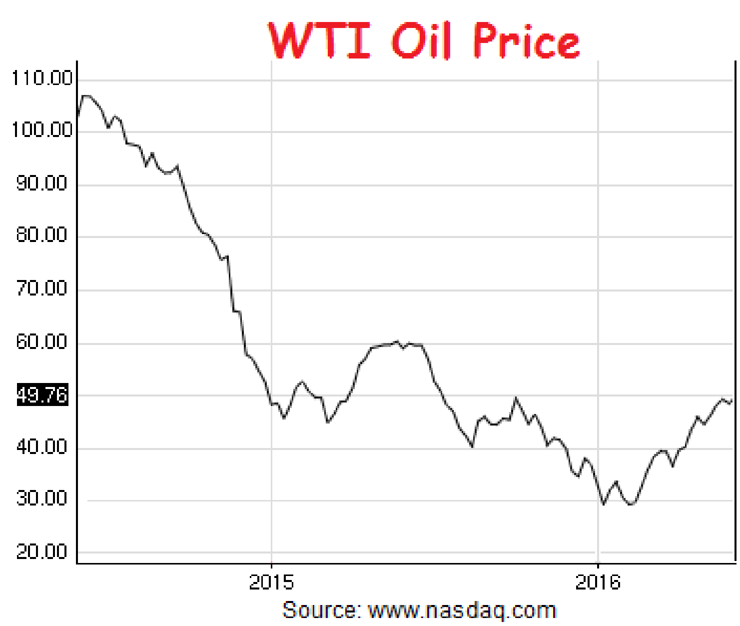
Canada's Economic Outlook







The Canadian economy is struggling. After growing at its slowest pace since 2009 last year, the economy is now facing one of the costliest natural disasters in the nation's history. The devastating Alberta fires have burned over a million acres, including thousands of homes and office buildings; insurance costs alone are estimated to run into the billions of dollars. Meanwhile, the fires have also hurt the nation's key economic driver: oil production. Alberta is Canada's largest oil-producing province, normally producing over half of Canada's total oil output, and the fires resulted in national oil production to temporary drop by around 25%.

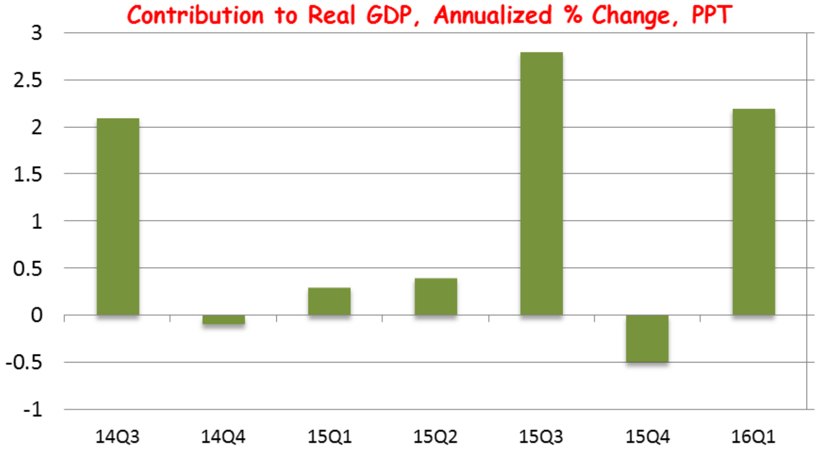
Unfortunately, lower production comes at a time when Canada's oil industry was already struggling on the back of low oil prices. Canada relies heavily on oil export revenues and lower oil prices over the last couple of years have resulted in a significant drop in export receipts. As a result, corporate profits have suffered and businesses have drastically cut back on spending. Weaker investment spending by firms is the main culprit of Canada's slowdown last year.

Although the disruption in Canada's oil production has driven up oil prices, they are expected to drop again once supply returns to normal. Canada's struggling oil sector, along with cooling economic conditions in the U.S., will continue to weigh on business investment and economic growth in the near term. 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 remain weak through the rest of the year. Nevertheless, there is hope that conditions will improve as oil production returns to normal and reconstruction efforts begin. Overall, economic growth for the year is expected to reach around 1.5%, up slightly from 1.2% last year.

Canada Exchange Rate
C$:US$

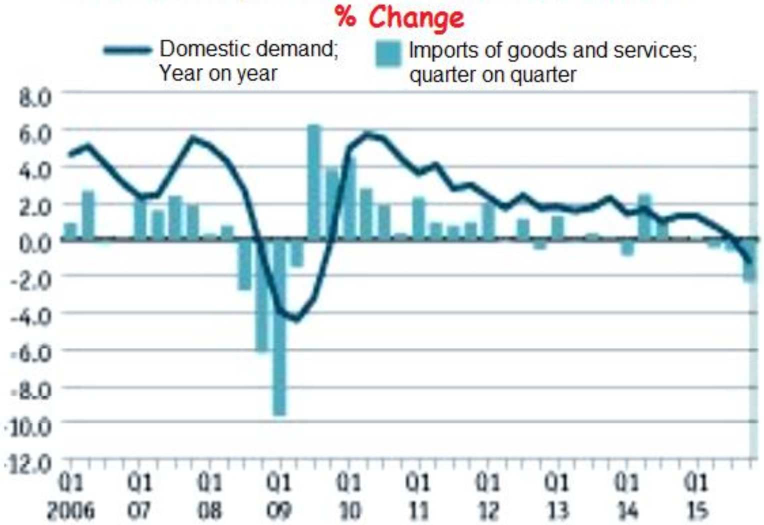
Source: The Economic Intelligence Unit

Canada Exports
Contribution to Real GDP, Annualized % Change, PPT



Data Sources: Statistics Canada, Moody's Analytics

Canada Imports and Domestic Demand
% Change

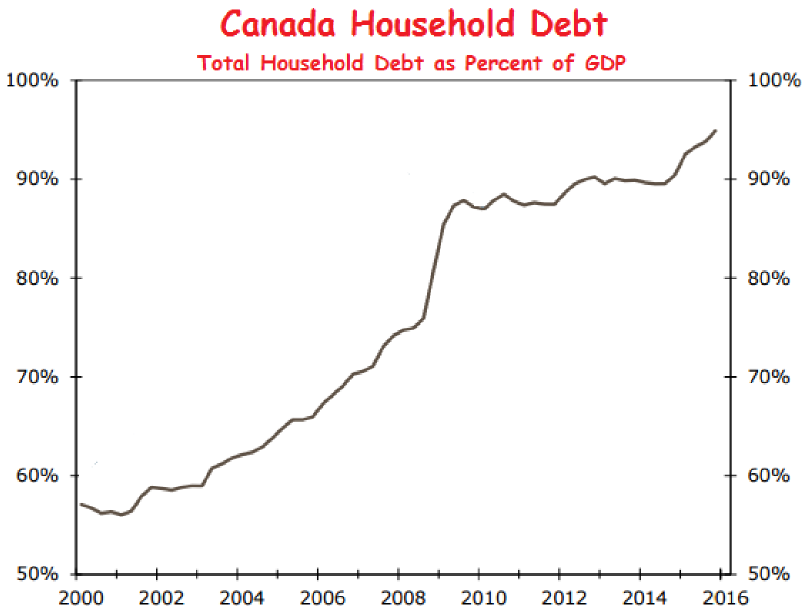


Source: The Economic Intelligence Unit

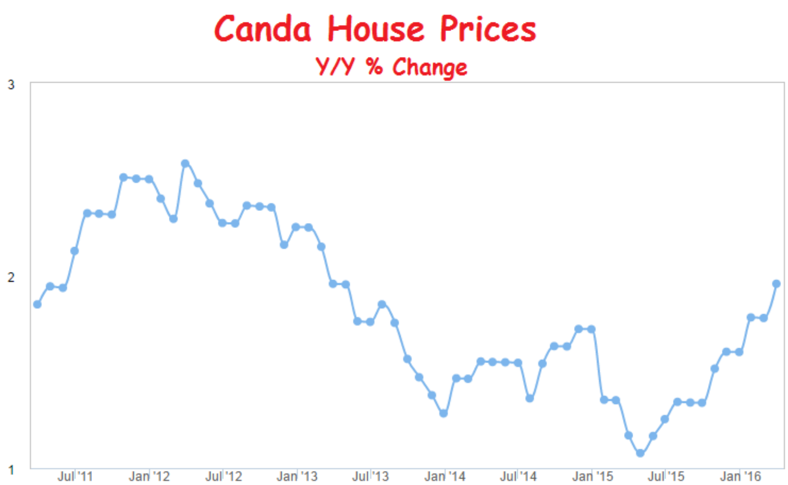
Contrary to the energy sector, Canadian nonoil exporters are benefiting from lower oil prices due to their impact on the U.S./Canada exchange rate. Given that a large portion of Canada's foreign currency reserves are earned through the export of oil, which is priced in U.S. dollars, lower oil prices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

Rising nonoil exports growth has been the primary contributor to Canada's recent economic growth and is the main reason the economy managed to climb out of last year's technical recession. Although exports growth is expected to remain elevated due to the weaker loonie, slowing conditions in the U.S., Canada's principal trading partner, will likely restrict growth in the near term. There is also potential for the negative impact of lower oil prices on Canada's energy sector to outweigh the positive impact on the nation's nonoil exports growth in the near term, especially if oil prices experience a renewed decline.

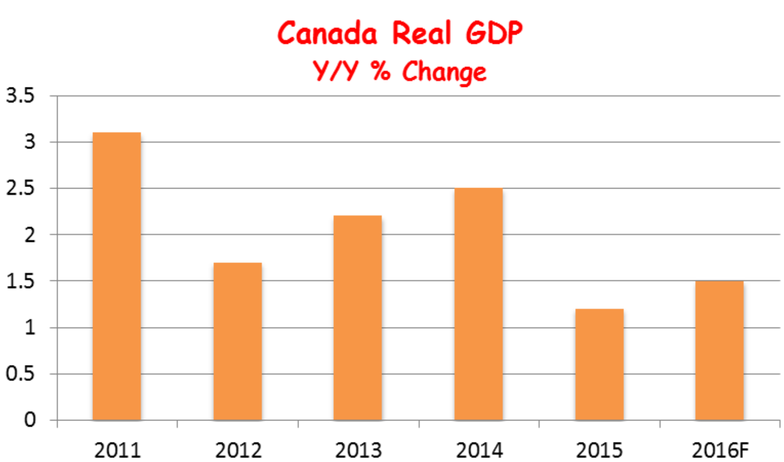
Meanwhile, the weaker loonie and lackluster domestic demand have resulted in Canada's imports growth to drop to negative territory. Although household spending has been a key engine of growth for the Canadian economy during the past decade, the massive amount of spending has resulted in a mountain of debt, causing financially-stretched consumers to retrench. Unfortunately, the situation has been exacerbated over the past couple of years 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 168%, while total household debt as a percent of GDP has reached almost 95%.



Sources: IHS Global Insight, Bloomberg LP and Wells Fargo Securities, LLC



Sources: Moody's Analytics, Statistics Canada



Data Sources: IMF, International Financial Statistics, Economic Intelligence Unit,

Canada's household debt problem is primarily due to rising homeownership; mortgage debt alone 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 eight-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 has kept borrowing costs low by cutting the policy interest rate twice in the past year and a half. While these efforts make mortgage payments more affordable for homeowners, they have also added 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 decline further.

Overall, the Canadian economy is struggling to gain momentum. Lower oil prices will continue to weigh on the nation's energy sector in the near term, preventing a recovery in business investment and production. Although the weak loonie and reconstruction efforts from the devastating Alberta fires will boost growth, cooling economic conditions in the U.S and the negative impact of lower oil prices will prevent significant improvement. Meanwhile, consumer spending will remain restricted as a result of record-level household debt and slowing income growth. Economic growth is expected to reach around 1.5% this year.

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