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# Economics Group

Special Commentary

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# Canada's Long Road to Recovery Begins

## Executive Summary

Incoming data suggest the Canadian economy bottomed in April and started to gradually recover in May. While there are lingering uncertainties, progress in containing COVID-19 as well as substantial fiscal stimulus from the Canadian government suggest the economic recovery could persist, and gather some momentum over time.

Given some signs of economic stabilization, the Bank of Canada has begun to pare back the pace of its balance sheet expansion, which could be less of a drag on the Canadian dollar going forward. With some rise also in commodity prices, the medium-term outlook for the Canadian dollar is improving, and we expect the Canadian currency to strengthen moderately over the medium-term.

***The Canadian economic recovery could persist.***

## Canada's Economy Begins to Thaw

After a tough winter for the Canadian economy, during which COVID-19 and the associated lockdown measures contributed to a sharp contraction, the economy showed renewed growth late in the spring. After two large declines in March and April, real retail sales jumped 17.8% month-over-month in May with Statistics Canada saying another large jump is expected for June, while real manufacturing sales also rose 8.8%. There are also encouraging signs from the labor market, which saw cumulative employment gains of 1,242,500 in May and June, and a 17% increase in total hours worked over the same period.

**Figure 1**

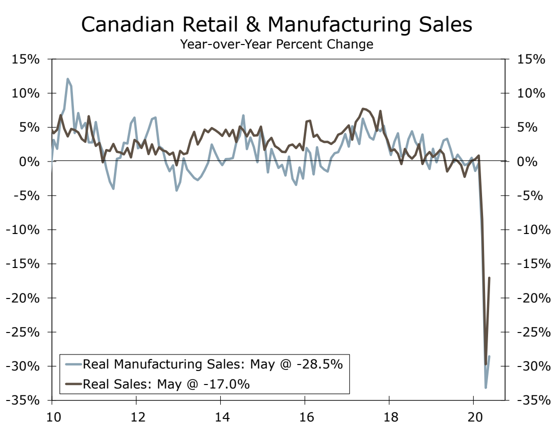
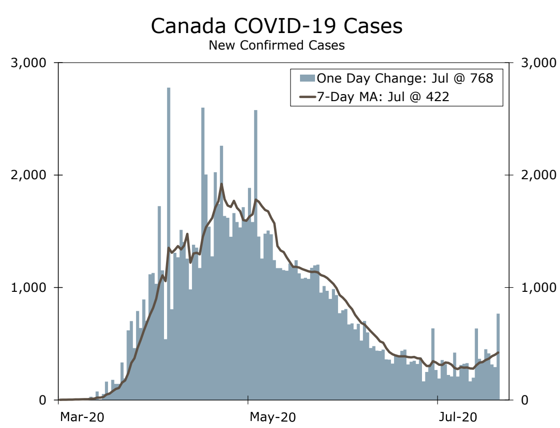



**Figure 2**




**Source: Bloomberg LP, Datastream and Wells Fargo Securities**

The good news that Canada's economy is growing again is tempered by hints that the recovery might not be especially rapid. For example, the rise in May manufacturing sales was met in part by a drawdown in inventories, meaning the increase in output will be somewhat slower. We also note lingering uncertainties in the Bank of Canada's (BoC) Q2 Business Outlook Survey—the past sales balance slumped to -44, the lowest since 2009, while the future sales balance of -35 suggests only modest improvement going forward. Some of these factors are reflected in Statistics Canada's early estimate of May GDP, which anticipates only a 3% monthly rise. In fact, while Canada appears on the path to recovery, the depth of the downturn earlier in 2020 suggests the



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economy will likely be unable to avoid another contraction in Q2, or for the year as a whole. In its latest Monetary Policy Report the BoC projected GDP to decline by 43% quarter-over-quarter annualized in Q2 and by 7.8% for full year 2020—the latter matches our own forecast 2020 decline.

## Further Warming in Growth Likely Over the Summer

On a more encouraging note, we see reason for Canada's economic recovery to strengthen gradually further in the months ahead. First, on the public health front the government has made progress in containing the spread of COVID-19, which should allow for a continued rebound in activity. Over the past week new COVID-19 cases have averaged 400 per day, down from nearly 2,000 cases per day in late April (Figure 2).

After slumping earlier this year, a rebound in oil prices means the energy sector should also be less of a drag on the economy than previously expected. Western Canada Select oil prices have recovered above US$30 per barrel while, at least through April, oil and gas activity was making only a small negative contribution to overall GDP growth (Figure 3). It is possible that investment spending may be hampered to some extent, with Canada's oil and gas rig count having fallen sharply since late February, although overall, there is less concern around the oil sector outlook than earlier this year.

**Figure 3**

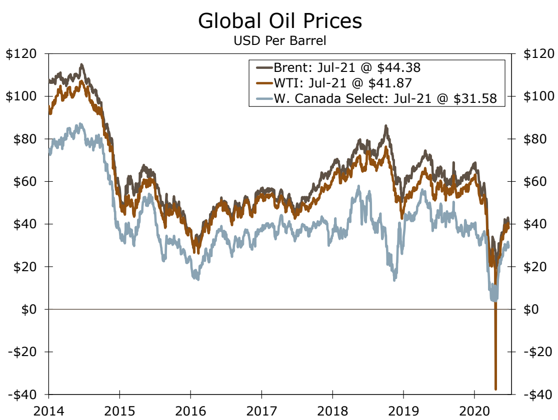
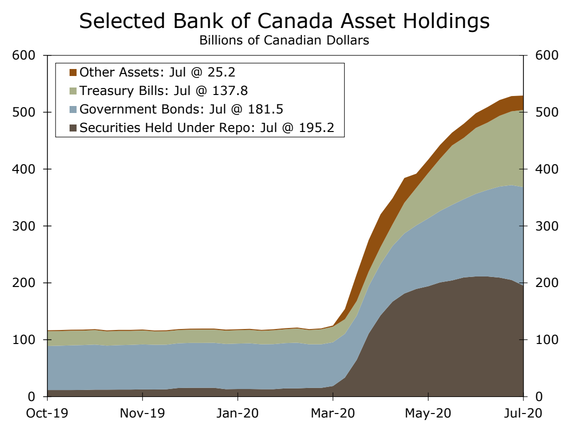



**Figure 4**




**Source: Bloomberg LP and Wells Fargo Securities**

***The fiscal response from the Canadian government should help sustain growth.***

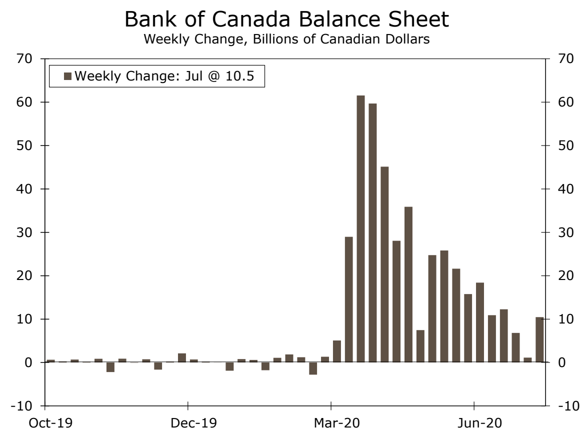
Moreover, another factor that should help sustain growth in the months ahead is an impressive fiscal response from the Canadian government. Among the wide range of fiscal actions were income replacement measures, including the Canada Emergency Response Benefit and Canada Emergency Wage Subsidy. Federal and provincial governments have granted deferrals on taxes, fees and customs duties, while businesses have also had access to loans through federal programs. In terms of the COVID-19 response, in its Economic and Fiscal Snapshot released in early July the government projected C$256B in direct support measures from federal and provincial governments, and C$123B in revenue deferrals. Separately, around C$600B of liquidity support measures were also made available to businesses. As a result of its fiscal actions, the federal government budget deficit is projected to widen from C$34B (1.5% of GDP) in fiscal 2019/2020 to C$343B (15.9% of GDP) in fiscal 2020/2021. While that will see federal government debt rise sharply to 49% of GDP by the end of 2020/2021, those debt levels still compare reasonable favorably on an international basis.

Some of this increased debt issuance will be absorbed by BoC asset purchases, with the central bank also very active in its response to the COVID-19 crisis. In addition to lowering policy interest rates close to zero and expanding its repo operations, the central bank has implemented a range of asset purchases programs including purchases of Canada Mortgage bonds, bankers' acceptances, commercial paper, corporate bonds and provincial and federal government debt. In particular, the central bank has pledged to continue buying at least C$5B of Canadian government bonds per week until the recovery is well underway. So far, since asset purchases began in March, the central bank's holdings of Treasury bills have risen by around C$111B, while holdings of government bonds have risen by around C$105B. Still, with some stabilization in the economic outlook the BoC has reduced the frequency of its repo operations, and bankers' acceptance purchase operations since June (Figure 4).

## Improving Outlook for the Canadian Dollar

In our view the combination of the government's fiscal policy actions, a stabilizing economy and the central bank's most recent monetary policy adjustments, are contributing to an improving outlook for the Canadian dollar.

**Figure 5**




**Source: Datastream and Wells Fargo Securities**

For the BoC, after particularly rapid balance sheet expansion earlier this year, the pace of increase has slowed, such that over the past month the average weekly increase has been just C$7.7B (Figure 5). The slower pace of balance sheet expansion should be less of a restraint on the Canadian dollar going forward.

***The slower pace of balance sheet expansion should be less of a restraint on the Canadian dollar.***

The rebound in oil prices may be a positive for the Canadian dollar over time. More broadly, the BoC's commodity price index—which is heavily influenced by oil prices—is up 85% from its low point in early 2019, and the level of commodity prices suggests, if anything, a mildly positive bias for the Canadian dollar from current levels (Figure 6). We also note the correlation between the Canadian dollar and commodity prices this year has been much stronger than the correlation between the Canadian dollar and interest rates.

**Figure 6**

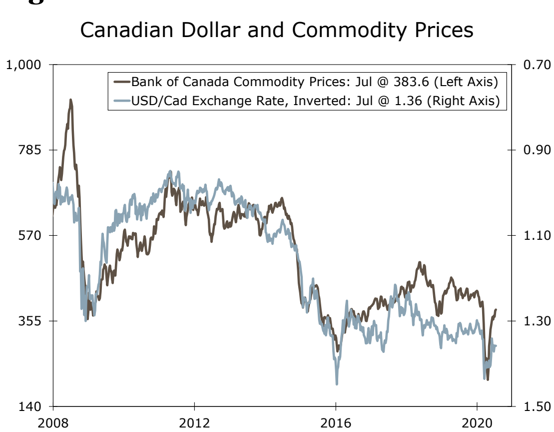
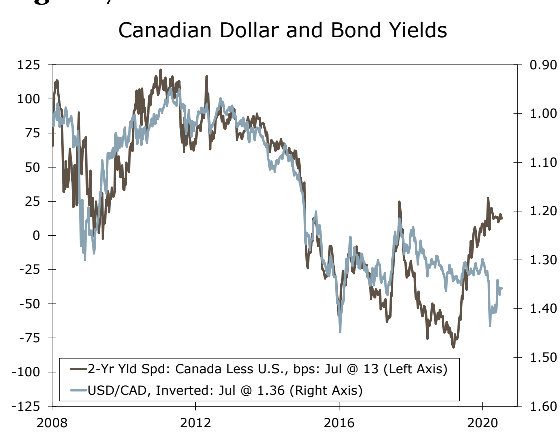



**Figure 7**




**Source: Datastream and Wells Fargo Securities**

***We expect the Canadian dollar to strengthen over the medium-term.***

On that note, we believe those interest rate factors will have a limited influence on the Canadian currency for the time being and that, if anything, that influence could also be a mild positive. Policy interest rates in both the U.S. and Canada are already essentially at zero, and neither central bank appears likely to adjust interest rates for an extended period. While both the Federal Reserve and the BoC have cut interest rates sharply in recent quarters, the interest rate reductions in the United States have been even more substantial than those in Canada. As a result looking at two-year government bond yields, the negative gap between Canadian and U.S. yields that existed until late 2019 has been eliminated, also removing a potential negative for the Canadian dollar (Figure 7). Considering all of these factors, we see scope for, and expect, the Canadian dollar to strengthen over the medium-term.

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