

# In like a lion

Canada kicks off 2010 with a flair. January GDP up 0.6% m/m.

**Canada's economy grew by a greater than expected 0.6% m/m in January. Street forecasts had been looking for a still robust 0.5% m/m (HSBC 0.5% m/m as well). Although optimism was slightly tempered by a downward revision to the December GDP that moved from 0.6% m/m down to 0.5% m/m. That said, Canada is still one of the brightest pennies in the developed world's jar.**

For us, the upside surprise on growth came out of a larger than expected bounce in the goods producing sector. For the forecast, we had penned in a +0.7% m/m rise in the goods sector, well back of the 1.3% m/m that was realized. Both construction (up 1.7% m/m) and manufacturing (up 1.9% m/m with 17 of 21 categories showing gains) bested our expectations by fairly wide margins.

Service producing industries rose by just slightly less than 0.4% m/m in line with our expectations just slightly above that. Services were led by a significant 2.9% m/m jump in wholesale activity which was spot on our expectations. On the down side, financial services were largely flat on the period, well off the pace set in Q4/09. Higher than expected levels of activity in the retail and warehousing categories helped to offset some of the down side associated with the FIREs sector. Overall, the goods producing industries are outperforming service sector industries by a wide margin and providing the bulk of the upside for GDP. This should come as no surprise given that the goods category bore the brunt of the economic recession.

Headline strength in GDP is encouraging although the concentration tends to suggest that there may be some hurdles in replicating Canada's performance in February. Two categories accounted by nearly 65% of GDP growth - manufacturing and wholesale chalked up 38% and 26% of total GDP growth respectively. That being said, the domestic press is replete with stories of a small renaissance in the auto sector with several of the major assembly operations talking about rehiring laid off workers. In total, 2000 rehires are planned over the course of 2010 which can be expected to pay economic dividends going forward when factoring in the additional hiring that will take place upstream in the supply chain. A rough metric suggests that for every assembly job there are between 6 and 7 jobs in the auto sector supply chain.

Yet with the US looking like it is going to consume something along the lines of 11-12mn vehicles a year vs the pre crisis level in the area of 17mn tends to suggest the auto sector cannot be expected to recapture that which was lost to recession and a need to dump excess capacity. In January Statcan points out that motor vehicle production fell by 2.4% m/m. Although looking ahead towards the February GDP report, our expectations are that the significant upside found in both the manufacturing, construction and wholesale categories is unlikely to be replicated. That said Q4 GDP showed us that growth is migrating into the right categories.

For Canada, a balanced economic recovery requires moving clear of a reliance upon public demand and monetary fueled consumer demand and rolling this on over into growth in both business and external demand. And unlike the US economy which grew by 5.6% in Q4, of which 3.8ppt were attributable to the transitory impact of changes in inventories, Canada by contrast, saw inventories knock 0.9ppt out of the 5.0% q/q ann. GDP growth rate. So too has net trade begun to reflect a recovery in external demand, a necessary element of the recovery story, which is now positively contributing to GDP.

From a policy standpoint, the surprising strength in the Canadian economy has fanned the view in markets that the BoC need come back to the fore with rate hikes sooner rather than later. Our forecast continues to look for a September rate hike while some primary dealers are now suggesting that a rate hike could conceivably come as early as April. We however would note that although GDP growth in Q4/09 was brisk at 1.2% q/q (5.0% q/q ann). at the same time productivity jumped by 1.4% q/q. Which is to say that while growth has been remarkably strong, surprising both Bank and street forecasts by a decent margin, it none-the-less has not significantly chipped away at the output gap that exists if both the productivity data and output gap estimates are to be believed. Although that is a big but.

Output gaps are estimated. Really its a number for the history books as we truly won't have good bearing on the level of the output gap until years after the fact. At present the BoC estimates the output gap as running at 3.25%. Higher productivity levels tend to suggest that the economy's potential to grow output may stronger than the BoC estimates for 2010 at 1.5%. Of course as the BoC views everything through its prism of inflation expectations, all of these factors (growth, output gap estimates, productivity and the ability of the economy to grow capacity) affect just when they the Bank, expect that the economy will be expected to close this output gap and by extension, at what point the economy may potentially see bottlenecks and capacity constraints contributing to inflation.

Still, it is a daunting task to look at an economy generating economic growth rates with a 5 handle while at the same time monetary policy is holding rates at the zero bound. Early days of course and there is plenty of room between the cup and the lip yet for spills to happen. There are no perfect numbers in the astrological world of economics and getting a handle on productivity is one of the slipperier eels in the pond. High rates of productivity are what we would expect to see at this stage of the economic recovery, but are unlikely to be a permanent trend, suggesting that the productivity picture is apt to swing around some.

Further to the point, in conjunction with the GDP release for January, Statcan released January employment, earnings and hours worked. In this report, total hours worked for payroll employees increased by 0.3% m/m which, in very loose terms, tends to suggest that January's 0.6% m/m growth in GDP was equally a function of both working smarter (productivity) and working harder (rising utilization).

# Disclosure appendix

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