

# Canada: Shrinking surplus is no shrinking violet.

## Trade surplus (Mar) drops from CAD1.2B to CAD300mn

**The Canadian dollar was up around 3.4% over the course of March, and many will be inclined to wag their fingers at the drag associated with persistent strength in the currency. Rather than sweat the currency, we would point to the blooming growth in trade volumes as the pollen fertilizing the Canadian economic recovery. In our mind, expanding global growth trumps North American dollar parity.**

Canada's headline trade surplus for March collapsed back from February's C\$1.2bn down to a paltry C\$300mn in the current report. The median had been looking for C\$1.6bn while our own forecast at C\$1.0bn was still well off the mark. Yet for us, the key to this report isn't the headline surplus that the market tends to focus on but rather what is taking place underneath with regards to trade volumes. On this front we continue to draw economic encouragement. In March, export volumes jumped by a robust 2.3%/m.

True, this was trumped by an even bigger 3.5%/m rise in import volumes but in terms of overall economic activity, we feel it is preferable to see a marginal decline in the trade surplus on the back of rising overall trade volumes than a rising trade surplus on the back of declining trade volumes. For a small open economy like Canada's, an active border means an active economy. And from this standpoint, today's trade report is a significant win. Yes, the Canadian dollar was up in March, rising about 3.4% vs. the USD, which hit dollar exports (so too did declining prices for energy- nat. gas) once they are repatriated back to CAD for reporting purposes. And it is here in the story that is told by persistently rising trade volumes where we see the importance of the trade story and its policy implications.

When is a down side event risk and upside event risk? When it no longer represents a down side event risk.

Recall that the BoC continued to suggest in its April monetary policy report that cited "the persistent strength of the Canadian dollar, Canada's poor relative productivity performance, and the low absolute level of U.S. demand will continue to act as significant drags on economic activity in Canada." We would point out that at the same time the Canadian dollar has been steadily gaining ground on the USD (from May 2009 through to the end of March, CAD is up 23% vs the USD) export volumes over the same May to March period have expanded by 15.4%. This tends to suggest to us that the key determinant for trade and specifically exports isn't the value of USDCAD but rather, whether or not the US economy is growing or shrinking. After all is said and done, the US economy remains Canada's primary economic attachment point to the global economic story.

To be certain, exporting into the US has become some what less profitable given the exchange rate but none the less, despite the currency, has continued to expand in volume terms. And when considering Canada's overall improved terms of trade (albeit having slipped over the past two months) it tends to suggest that exporting is still a pretty good business for Canada. From a policy standpoint, it suggests that the BoC concerns for the absolute level of US demand and persistent strength in the Canadian dollar may be somewhat misplaced. Of course what we don't know is just how much weight they actually attach to these two particular event risks and to what extent they influence policy.

The details.

Underneath the headline trade surplus, the dollar value of exports declined by -0.7% m/m while at the same time the dollar value of imports rose by 2.0% m/m, knocking C\$900mn out of the surplus. Again we reiterate the point that we would focus on the profile for trade volumes rather than necessarily worrying too much about the pricing changes. And while exports to the US declined by -2.5% given that the currency is up by 3.4%, it would tend to suggest that indeed export volumes into the US are continuing to grow.

Looking beyond the 49th parallel that defines the US Canadian border, exports to the EU jumped by nearly 14% m/m. This is on top of last month's 5.0% m/m increase. Although this is offset by a near 20% jump in imports out of the EU.

From a categorical standpoint, exports of energy declined by -6.6% (natural gas exports dropped another -10% m/m while petroleum and coal products were down -16% m/m). At the same time that energy exports were melting away, imports for the same jumped by 10.1% led by crude. Increased imports of crude may be related to the run up in refinery activity ahead of the summer driving season and or possibly a function of blending lighter crude with heavier domestic blends as Canada fills a major pipeline into the US (one would be surprised how much crude it takes to fill a line).

The auto sector was in a bit of a funk in March with exports down -0.9% m/m while imports dropped by -5.8% m/m. But this feels more like moderating lull rather than something untoward. Although passenger car exports declined by -0.7% m/m, the dollar value of these exports are still running near to the recent highs. So too are auto parts exports on a dollar basis running close to recent highs. And of course there were some transitory shutdowns in February that may have played a little havoc with the supply chain.

Metal exports held in nicely considering the massive gains struck in February. Copper ores declined by -26% m/m, but this was following a 82% jump in February. Nickel ores down -11.5% m/m following 268% m/m jump in February. Zinc ores jumped by 267% m/m in March. Nickel and alloys +36.8% and precious metals +47% filled out the metals picture. By and large, the 4.7% rise in the industrial materials export category was led by the near 50% m/m jump in precious metal exports.

Of course there are two sides to every story. Statcan points out that precious metals accounted for 2/3s of the gain in imports. Could it be the gold minted in Canada is being turned into European jewellery for sale in Canada. If it is the case, not great situation from the standpoint of value added and productivity. Forestry exports jumped by 3.0% m/m as crude wood products jumped 75% after having fallen by 41% in February. No housing renaissance south of the border just yet given but rather some smoothing out of previous volatility.

Net, net, the report is again better than the headline surplus would suggest based upon what we see with regards to volume sales. All in all, not a bad report following on the heels of what we thought was a virtuous trade report in February.

So why do we care so much? The importance of the recovery in external demand that is highlighted by the evolving trade picture to the Canadian economic recovery story cannot be underestimated. In that we are seeing trade volumes on the rise at the rate they have been is very encouraging. Of course the caveat lector throughout much of this recovery over the last year has been the return to near US dollar parity in March and April. While the currency has been run up the pole and hung as one of the primary culprits behind the plunge in external demand, we would put forward that a growing global economic pie is more important to Canada's external demand picture than the valuation of the Canadian currency. And today's report seems to bear that out. So too does it suggest that the economic and monetary weight attached to dollar parity may necessarily need to be reduced.

# Disclosure appendix

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