Canada: September trade deficit widens appreciably to -CAD2.5bn.

Weaker exports into G7 to blame.

Just as August's trade report surprised with its relative strength, September's report is noteworthy for its weakness as the trade deficit widens out to CAD2.5bn from August's revised CAD1.5bn (down from CAD1.3bn). Street expectations had been looking for CAD1.6bn. A wider deficit was led by a 1.7% decline in exports (volumes -2.2%) at the same time that imports rose by 1.2% (import volumes flat).

Categorically, weakness in the export category was led by a decline in the automotive category (-6.6%), the fourth back to back decline. In percentage terms, a -15.9% drop in consumer goods was the largest decline, unwinding a good bulk of the 27% rise in August. The rise in imports was a function of a 5.6% rise in industrial goods and materials, and a 3.2% rise in machinery and equipment. If there is a silver lining to this story it is that imports in these categories could be linked to a continued expansion of business investment in keeping with the theme of economic recovery. In that vein, industrial and agricultural machinery imports were up 5.4%.

On the downside, the yawning trade deficit speaks to the net drag on GDP that will come out of the trade category going forward. Recall that in terms of contribution to growth, net trade knocked more than 4.0ppt off of headline GDP growth in Q2/10. Although the impact of net trade on growth is expected to moderate as we head into 2011, it will continue to significantly pull against growth in Q3/10 GDP. In turn it tends to suggest that the growth profile for Canada in Q3/10 will look incremental at best, and not far removed from the 2.0% seen emanating out of the US.

As it stands, we feel comfortable with our forecast for Canadian Q3 GDP at 2.2%q/q ann. A forecast that we believe has captured the downside associated with net trade over the course of the quarter. Indeed, our outlook for Canadian GDP growth for the rest of 2010 and on into 2011 was in large part predicated on a slow growth outlook for the developed world in general and the US in particular.

Still, much hand wringing will be rent in terms of USD-CAD and its impact on trade. Oddly enough, despite a strengthening in CAD over the course of September, import prices shifted higher. Despite the strength of CAD vs USD, there is a tendency to forget that on the crosses CAD has performed rather poorly and a likely contributor to higher import costs.

But so too will the widening trade deficit be seen in terms of a stronger Canadian dollar as inhibiting exports into the US. On this the picture is less certain. If it were the case that exchange rates were the chief determinant to trade, we feel that the massive revaluation on USD-CAD from 2002 through to 2007 and today would have significantly altered Canadian trade patterns with the US beyond the 82% of total exports Canada was shipping into the US in 2002 to the current level of 72%.

Rather, we think that the outlook for Canadian exports is more importantly a by product of the degree to which the US economic pie is growing. Under the auspices incremental growth only in the US for the next many years, the prospect for aggressively growing Canadian exports into this environment is extremely limited - currency considerations aside. Instead, the key to torquing up Canadian GDP will be its ability to move away from its traditional trade patterns and reorient itself toward the higher growth areas found in the Pacific rim, Latam and Central America.

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Disclosure appendix

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2 All market data included in this report are dated as at close 10 November 2010, unless otherwise indicated in the report.

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