BDC's MONTHLY ECONOMIC LETTER

Entrepreneurs first

SEPTEMBER 2010

Canada

> Real GDP growth slowing
> Employment down slightly, unemployment up slightly
> Housing starts still dropping
> Trade deficit widening
> Retail sales volume still trending up

United States

> Real GDP growth slowing
> Weak job creation numbers, unemployment still high
> Double-dip in the housing market
> Industrial production picking up again slowly but surely
> Gap between Canadian and U.S. key interest rates widening

The United States: should we be concerned about a double-dip recession?

The slowdown in economic growth in the United States is raising doubts about the sustainability of our southern neighbours' recovery. After a quick surge to 5.0% in the fourth quarter of 2009, real GDP growth slowed to 3.7% in the first quarter of 2010 and second estimates put growth in the second quarter at 1.4%. Some analysts are afraid that the American economy is falling back into a recession. How do things really stand?

In fact, most of the figures indicate that the economy should continue to grow but at a slower pace than projected. Industrial production is gradually regaining the ground lost during the recession and had recovered half its losses in June. The July ISM report indicates that the manufacturing sector is still expanding. Business investment jumped in the second quarter, fuelling hopes that the private sector is ready to take over from the public sector in supporting growth in the coming quarters. However, the housing sector, which was hardest hit during the recession, is struggling to recover. Housing starts, as well as new and existing home sales, which were stimulated by the home buyers' tax credit program, have resumed their negative trend since the program has expired.

Consumption is growing but only moderately: in the face of the prevailing uncertainty Americans are being prudent and are saving and paying off their debts rather than spending. In addition employment, which supports consumption, is lagging and the job numbers do not confirm the recovery. Even ignoring the layoffs following the completion of the census, job creation remains weak in the private sector and unemployment is still high.

Overall, therefore, the indicators point to moderate growth. Forecasters have revised their projections downwards but do not think the American economy will fall back into a recession. The Federal Reserve expects real GDP growth in the United States to be 3.0% in 2010 and 3.5% in 2011. At 2.9% and 3.0% respectively, the Bank of Canada forecasts are slightly lower and very similar to the Consensus numbers of 2.9% and 2.8%. In light of the most recent data, however, we can expect these forecasts to be revised downward again.

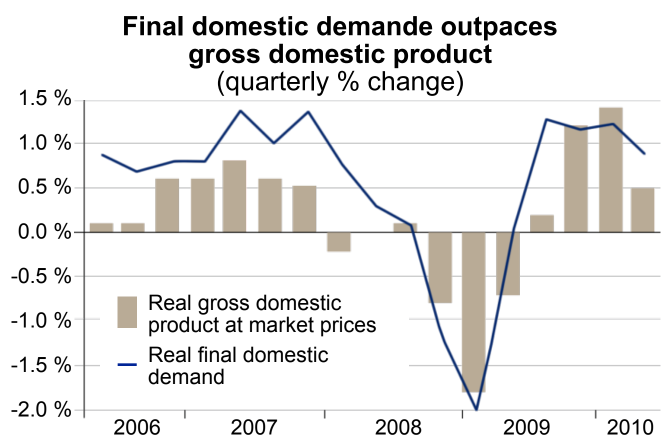
Canada

Canada

The economy has recovered nearly all of the jobs and production lost during the recession. GDP growth slowed in the second quarter, mainly due to the strength of imports, but domestic demand remained quite strong. The real estate sector is also slowing, as expected. The job market is holding up. Unfortunately, our neighbours to the south are not doing quite so well, which will no doubt affect our economy in the coming quarters.

As expected, real GDP growth slowed in the second quarter

Real GDP growth slowed from 5.8% in the first quarter to 2.0% in the second. Despite this slowdown, the results are generally positive. Domestic demand is still strong; investments and imports of machinery and equipment continue to post strong gains, which suggests that businesses are working on improving their productivity. Consumers are being cautious and saving more. The housing sector is losing steam, as expected. There was strong growth in imports, which reflects the strength of domestic demand and explains much of the slowdown in real GDP growth in the second quarter. We can expect economic growth to be moderate by the end of the year; persistent weakness in the U.S. economy will likely hobble exports and could shake the confidence of Canadian businesses and consumers, inducing them to limit their investments and consumption.



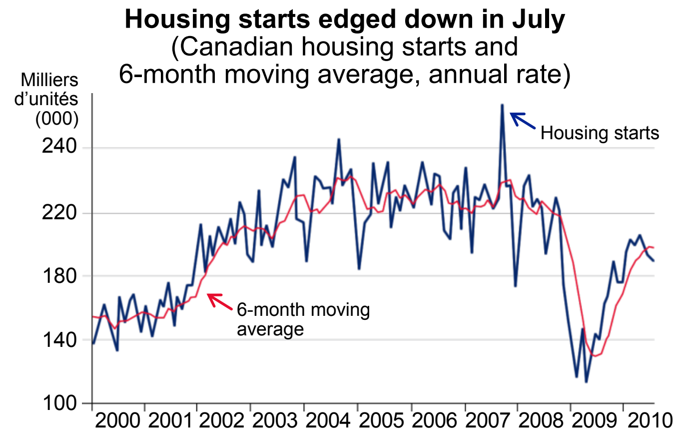
Source: Statistics Canada

Employment takes a break in July, but job market still strong

Employment declined by 9,300 jobs in July. However, this minor dip comes on the heels of substantial gains since the beginning of the year and does not cast doubt on the strength of the job market. Unemployment edged up from 7.9% to 8.0%. The largest losses (65,000) were in educational services. Since job losses of this magnitude rarely occur in this sector, we can assume that the upswing in employment, which began a year ago, will continue in the coming months. The manufacturing sector added 29,000 jobs in July, which is the biggest monthly increase in two years.

Residential construction still slowing, as expected

Housing starts fell 1.6% from June to July to stand at 189,200 units. This is the third consecutive monthly decline. The slowdown in residential construction was expected: the CMHC projects the average number of housing starts to be 182,000 units in 2010 and 179,600 in 2011, levels that are “more in line with long-term demographic fundamentals.” The CMHC also expects that more stringent criteria for borrowers to qualify for government-backed mortgage insurance, coupled with rising mortgage rates, will moderate activity in the housing sector.



Source: National Bank Financial

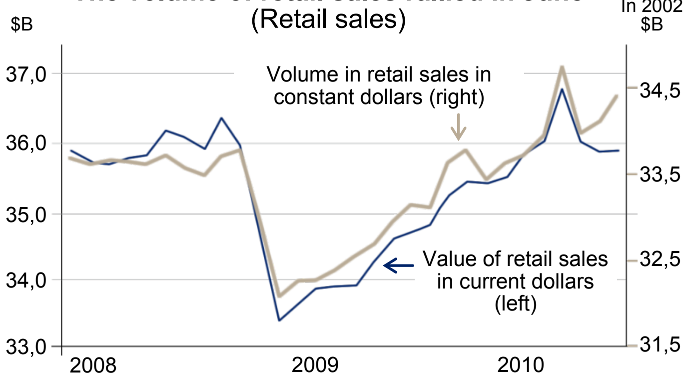
Contribution of the foreign sector to economic growth will be limited

Exports declined 2.5% in June while imports dipped 1.2%, which drove up the trade deficit from $695 million in May to $1.1 billion in June. The largest declines were in exports of industrial products, energy products and motor vehicles. In terms of volume, exports edged down 1.3%, their first decline after six months of increases. Imports contracted mainly in the energy products sector, and especially oil. With slowing growth in the United States and weakness in the European economy, the foreign sector is not expected to make a significant contribution to economic growth in Canada between now and the end of the year.

Retail sales volume continues to trend upwards

The value of retail sales edged up by only 0.1% in June from May, but the volume of sales grew a vigorous 0.9%. The strongest increases were in the electronics and household appliances sector (5.5%), furniture and home furnishings (2.3%), and motor vehicles and auto parts (2.1%), while the most significant decline (-2.7%) was in sales at service stations, where the drop in the price of gas reduced the value of sales.

The volume of retail sales rallied in June
(Retail sales)



Sources: Statistis Canada and Desjardins, Economic Studies

United States

The latest figures indicate that the U.S. economy is recovering much more slowly than expected. No longer propped up by tax breaks, the real estate market plummeted again. Job growth is slow, and consumers are cautious. That being said, production is gradually making up lost ground. Growth is expected to be slow and the risk of another recession, albeit unlikely, cannot be dismissed.

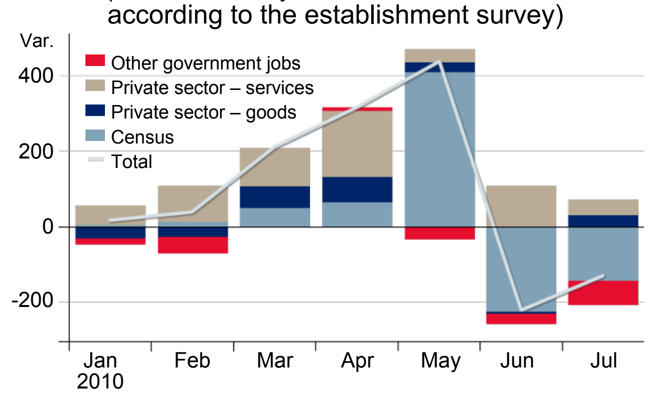
Economic growth will be weaker than expected in 2010

Real GDP growth slowed from 3.7% in the first quarter of 2010 to 1.6% in the second. Private investment, including in the construction sector, grew vigorously while consumption increased at a moderate pace. Growth in domestic demand was hampered by strong growth in imports, which topped 30%, compared to the previous quarter. All in all, the results are not as bad as they might appear since domestic demand was robust. However, the latest economic indicators relating to employment and the housing sector suggest that economic growth will remain weak until 2011.

Employment data slow in confirming the recovery

The layoff of temporary workers hired for the 2010 census again distorted the employment figures, which showed 131,000 fewer jobs in July. The private sector, which gives a more accurate picture of employment trends in recent months, created 71,000 jobs, which is down considerably from the 158,000 and 241,000 new jobs created in this sector in March and April respectively. The gain recorded in July was modest but encouraging, since it was the seventh consecutive increase after two years of almost uninterrupted monthly declines. Unemployment remained unchanged at 9.5%. Overall, the job market continues to make progress, but not enough to clearly confirm the economic recovery.

Slowdown in private job creation
(Jobs – monthly variation in thousands, according to the establishment survey)



Sources: Bureau of Labor Satistics and Desjardins, Economic Studies

No sustainable recovery in the housing market before 2011

After major declines in May and June due to the expiry of the home buyers' tax credit program at the end of April, the number of housing starts recovered somewhat in July to reach 546,000 units, up 1.7% over June. Sales of existing and new homes, however, fell to new lows, plummeting by 27.2% and 12.4% respectively in July. There is still a large surplus supply of homes (new and existing), which is putting a damper on the growth of residential construction. The situation should improve gradually as the job market recovers and demographic changes take hold, but it is clear that we will have to wait until 2011 for the housing market to really take off again.

Industrial production picking up again slowly but surely

Industrial production, which had edged downward in May, resumed its upward trend in June, growing by a vigorous 1.0% over the previous month. Since hitting a low in mid-2009, industrial production has recovered 50% of the losses sustained during the recession. The recovery is slow, but the previous downturn was huge. Even if growth continues at a pace of 1.0% per month, it would take more than six months for production to return to pre-recession levels. However, there is still cause for optimism: despite a third consecutive decline, the ISM (buyers') index indicated that the manufacturing sector continued to make gains in July.

Interest Rates

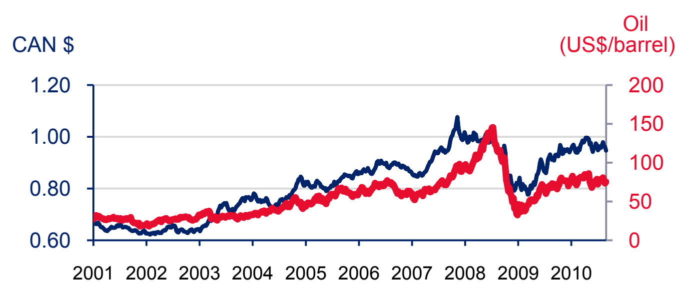
Gap between Canadian and U.S. rates expected to widen even more, although only slightly

On July 20 the Bank of Canada raised its key interest rate to 0.75%, its second consecutive increase. On August 10 the Federal Reserve decided to leave its key rate unchanged, within a range of 0–0.25%. Seeing that the American economy is growing more slowly than expected, the United States central bank prefers to keep its key rate as low as possible so as not to hobble the recovery, especially since credit conditions are still very tight for small and mid-size businesses. With monetary tightening in Canada and the status quo in the United States, the gap between the key rates in the two countries widened. Some forecasters expect the Bank of Canada to raise its rate again on September 8 – which would widen the gap even more – while others think that if the U.S. economy continues to sputter, the Bank of Canada will hold off for a while before hiking the rate again.

Oil, CAN $

Price of oil and Canadian dollar still under pressure

The price of oil, which topped US$80 a barrel at the beginning of August, has since fallen, as recent economic data suggest that the global economy in general, and the United States economy in particular, are growing more slowly than expected. The loonie followed the same course, dropping by 3.1% against the greenback since the beginning of August. The majority of forecasters still expect the price of oil to rise again and the Canadian dollar to appreciate against the American dollar in the medium term, as global demand firms up.



Source: Global Insight

Optimism of small business leaders continues its downward drift

The CFIB Business Barometer Index dipped slightly in July. However, its level of 65.7 still clearly points to economic growth.

Capital expenditures are projected to be lower in the next three or four months, which could indicate that business leaders are expecting interest rates to rise or demand to slow down.

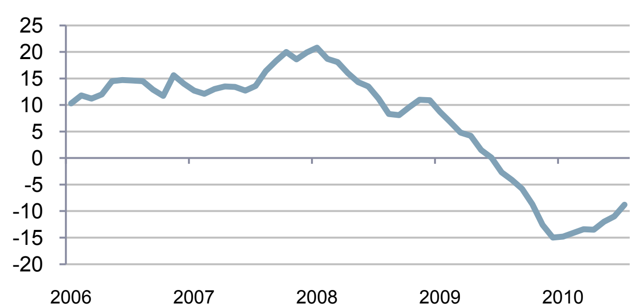
Optimism prevails in the healthcare, information, wholesaling and financial services sectors, while confidence continues to be weaker in the hospitality, construction and agriculture sectors.

The general assessment of the situation by businesses has hardly changed since June: 37% of companies consider it good, 16% poor and 47% acceptable.

Overall, business credit is picking up steam and bank credit is recovering slowly

Much of the growth in overall business credit since the beginning of the year is due to the increase in the issuing of debt securities (bonds and debentures) and shares. Bank credit is still down compared to last year, but annual growth is gradually picking up again (from -15% in January to -9% in July).

Business Credit from Charterd Banks
Annual percentage change



Source: Bank of Canada

KEY INDICATORS – CANADA	Historical				2010				Latest		Forecast	
	2006	2007	2008	2009	Q1	Q2	Q3	Q4			2010	2011
Real GDP (% growth)	2.8	2.2	0.5	-2.5	5.8	2.0			Mar	6.1	3.4	2.7
Machinery and Equipment Expenditures (% growth)	10.2	4.2	-0.9	-20.3	7.5	6.7					5.1	7.7
Pre-Tax Corporate Profits (% growth)	5.7	1.9	8.0	-32.3	39.1	-3.9					22.8	10.0
Industrial Production (% growth)	0.3	0.1	-4.2	-10.0	13.2	8.9					5.8	5.2
Industrial Product Prices (% growth)	2.3	1.6	4.3	-3.4	2.8	1.0			Jan	1.0	0.6	2.5
Non-Residential Construction (% growth)	7.5	6.9	-2.7	-8.5	-5.4	1.0						
Housing Starts (' 000 units)	227	228	211	149	193	202			Jan	189	184	176
Personal Expenditures (% growth)	4.2	4.6	2.9	0.5	4.3	2.6					3.4	2.7
Consumer Price (% growth)	2.0	2.1	2.4	0.3	2.3	-0.9			Jan	1.8	1.8	2.2
Employment (% growth)	1.9	2.3	1.5	-1.6	1.6	4.2			Jan	1.5		
Unemployment Rate (%)	6.3	6.0	6.1	8.3	8.2	8.0			Jan	8.0	8.0	7.6
SMEs Confidence Index (CFIB)	67.3	67.2	56.1	57.7	68.4	66.7			Jan	65.7	3.4	
Manufacturers Confidence Index (CFIB)	66.4	64.5	52.7	56.0	69.7	69.0			Jan	67.7	5.1	
Credit Conditions (Bank of Canada)[1]	-9.8	3.8	32.0	8.0	-1.0	-10.0			Juin	-10.0	22.8	

Sources: Statistics Canada, Consensus Economics, Canadian Federation of Independent Business and Bank of Canada. Annual growth and quarterly growth at annual rate. [1]Business Outlook Survey, balance of opinion on tightened terms and conditions for obtaining financing compared with previous three months. Historical data: annual average of quarterly data.