OBSERVATION

TD Economics

April 25, 2014

CANADIAN INDUSTRIAL OUTLOOK: GOODS SECTOR TO TAKE THE DRIVER'S SEAT IN 2015

Highlights

- The industrial outlook for the Canadian economy is mixed over the 2014-15 period. In 2014, both the goods-producing and service sectors are likely to expand at just over 2%. However, we expect a changing of the guard to occur in 2015, as the goods sector turns in a markedly improved output performance. In contrast, service sector output is likely to continue to expand at a steady but modest pace of just over 2% next year.
- Within the goods-producing sector, improved manufacturing and forestry activity, as well as sustained growth in oil and gas production will support activity this year. At the same time, a decline in the agricultural sector and minimal growth in construction output will work against total production. In 2015, real GDP growth in the goods-producing sector should accelerate to 3.3%, led by rising activity across most major categories.
- Outperforming service sector industries will be those that have stronger ties to foreign demand. As such, improved performances in the accommodation and food services, wholesale trade and transportation and warehousing sectors will boost economic activity in the near-term. However, government restraint and a continued caution among consumers will likely keep service sector output in check.

Near-term prospects for Canada's major industries are mixed. Both the goods-producing and service sectors are likely to expand at just over 2% in 2014. However, this moderate growth environment at the aggregate level masks large variations in performance across industries. Within the goods-producing sector, improved manufacturing and forestry activity, as well as sustained growth in oil and gas production will support activity. At the same time, a decline in the agricultural sector and minimal growth in construction output will weigh on production this year. The service sector will be boosted by improved fortunes in the accommodation and food services, wholesale trade and transportation and warehousing sectors. However, government restraint and a continued caution among consumers will likely keep service sector output in check.

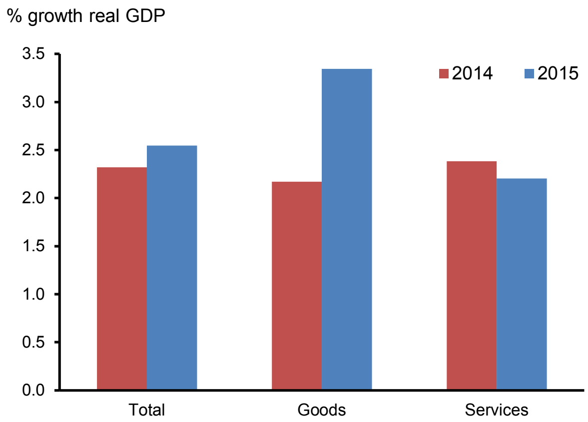
Looking ahead, we expect a changing of the guard to occur in 2015, as the goods sector turns in a markedly improved output performance led by rising activity across most major categories. In contrast, service sector output is likely to continue to expand at a steady but modest pace of just over 2%, reflecting similar growth dynamics to 2014.

Goods-producing sector to follow exports' lead

A strengthening in the external landscape is expected to foster better fortunes for the goods-producing industries, especially the manufacturing sector – though much of that strength will manifest itself in 2015. Following a weather-related slowdown in late 2013 and early 2014, U.S. real GDP growth is expected to gain a step over the remainder of the forecast period, with real economic growth averaging about 3% per year. A weaker Canadian dollar will also add fuel to Canadian goods exports. TD Economics

Derek Burleton, VP & Deputy Chief Economist, 416-982-2514
Jonathan Bendiner, Economist, 416-307-5968

CHART 1: INDUSTRIAL OUTLOOK BY SECTOR



Forecast by TD Economics as at April 2014.

projects that the Canadian currency will fall to around 85 US cents by mid-year, before rebounding to 90 US cents in late 2014 and into 2015. In comparison, the Loonie stood at parity as recently as early 2013.

Within the manufacturing sector, prospects across industries vary. The wood, machinery, chemical and primary metals industries all show scope to demonstrate the greatest near-term strength. However, the auto assembly industry is expected to post moderate declines over the forecast period. The winding down of the GM plant in Oshawa, a misalignment between the types of autos manufactured in Canada and demand seen in the U.S. as well as rising competition continue to act as a hurdle for the industry. The petroleum and coal and paper industries also face a challenging outlook (for a deeper dive on the prospects of the manufacturing sector, please see our recent report The Curious Case of Canada's Manufacturing Sector).

Despite the expected overall pick up in output, longer-term challenges remain in Canada's manufacturing sector. Higher transportation, power and border related costs, as well as capacity constraints, will act as a headwind to the manufacturing sector. Also, Canada's traditionally stronger trade linkages with the northern U.S. states do not align with regions in America that are expected to show the most vigor over the 2014-15 period – especially as it pertains to manufacturing activity. All said, we foresee manufacturing sector real GDP to average 3.5% real GDP growth over the 2014-15 period.

Commodity industry prospects mixed

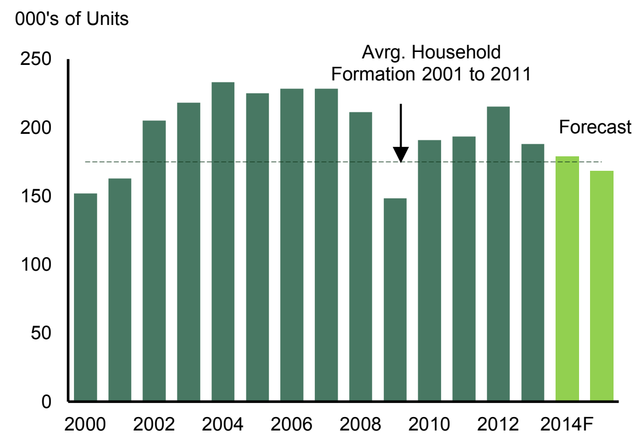
Fortunes across the primary sector are mixed. A bumper crop in 2013, translated into a surge in agriculture sector output (+14.2%). As crop yields likely normalize in 2014, we forecast agricultural sector real GDP to decline 9.4% in 2014. What's more, capacity constraints on Canada's railways have resulted in delays for farmers to get their crops to market. As a result, prices have dipped and will likely detract from farm incomes in 2014. Over the forecast period, we see a reversal in these trends. A return to more sustainable levels of real output are projected for 2015. At the same time, farmers are likely to benefit from some easing in transportation bottlenecks and better pricing. Livestock prices are likely to see particular strength, especially in the hog market, where the outbreak of a virus is weighing on U.S. hog supplies.

With continued solid output returns on past oil sands investments and new pipeline routes running from the U.S. Mid-west to the Gulf coast, Canadian crude oil production is likely to expand at a solid pace at around 5% over the 2014-15 period. WTI prices are likely to trade within the US $93-$98 range over the next 12-18 months, as a number of negative factors (i.e., amply supplied North American market and a strengthening U.S. dollar) and positive factors (i.e., geopolitical risk and strengthening global growth climate) offset each other.

Natural gas output will likely experience renewed growth in 2014, owing to a chilly winter that left U.S. stocks below average (see our recent report Finally Some Good News for Canadian Natural Gas Producers?). However, in light of increased U.S. gas supply, we don't expect this acceleration in gas activity to carry over to 2015. All told, we expect real GDP growth in the oil and gas sector to average a still healthy 4.6% over 2014-15.

In the near-term, we foresee a moderate growth performance (around 3%) in the mining sector (excluding oil and gas). Anticipated price gains in nickel and zinc should prompt increased activity for these base metals. In addition, production will be boosted by a number of mines that will come on-line over the next few years following a sustained period of solid investment in the sector[1]. Counterbalancing gains in these metals will be an expected decline in the price for copper, and a flat outlook for precious metals. Further, with the global potash sector currently in a state of flux, no productions for the industry gains are expected in 2014. In 2015, output is expected to advance as purchasers re-enter the market. Other primary sector activity (e.g., forestry, logging etc.) should see an improved performance on the back of the expected sustained healthy pace of housing starts Stateside and better pricing conditions from a weaker Canadian dollar.

CHART 2: CANADIAN HOUSING STARTS



Source: Canadian Mortgage and Housing Association, Forecast by TD Economics as of April 2014

Construction activity to continue to wane

Construction sector activity is expected to continue to decelerate further in 2014, as a decline in residential construction is matched by a flat performance in non-residential and engineering construction. An overbuilt Canadian housing market and the expected gradual increase of mortgage rates are expected to lead to a decline in residential construction over the next 18 months (see Chart 2). In regards to non-residential and engineering construction, the recent Public and Private Investment survey by Statistics Canada pointed to a slight to decline in non-residential construction sector in 2014. We are slightly more optimistic based on the capital spending plans laid out by a number of provinces during budget season. As such, we expect to see a continued, albeit more moderate, gains in non-residential and engineering construction this year. In 2015, investment in non-residential construction will likely reaccelerate, supported in part by improved growth and profitability among the nation's large exporters.

Service sector strength also tied to external demand…

The transportation and warehousing, wholesale trade and accommodation and food services sectors are expected to be the top performing service sector industries over the 2014-15 period. Notably, these industries all have strong ties to foreign demand. In contrast, domestically-driven sectors such as retail trade, finance, insurance, real estate and leasing and public services are all expected to record only moderate gains.

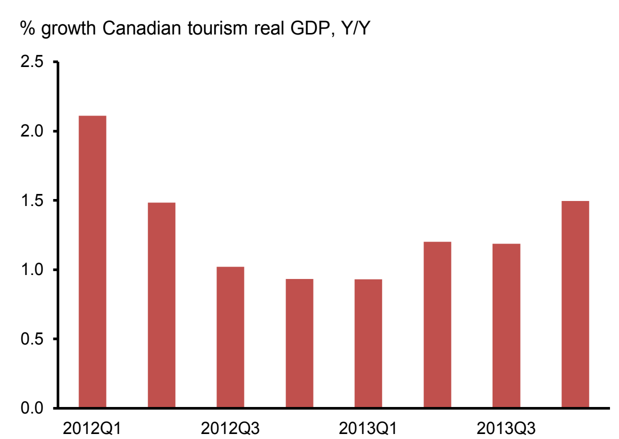
The transportation and warehousing sector will be carried by improved fortunes in rail transportation. Increased industrial production in the U.S. and rising crude by rail shipments all support this brighter outlook. Wholesale trade activity can also expect to see an improved performance on the back of increased manufacturing and export growth, but will be limited by the weaker Loonie, which will cut into import activities.

The accommodation and food services sector has already posted strong showings in recent years, advancing 3.6% in 2012 and 3.1% 2013. Looking ahead, the decline in the Canadian dollar and healthier income gains south of the border should boost cross-border travel activity. Recent activity in the tourism sector supports this notion, with real GDP in the tourism sector up 1.5% (Y/Y) in 2013Q4 – the strongest reading since 2012Q2 (see Chart 3). What's more, major events in Canada such as Charlottetown's 150th anniversary celebration this summer and the Pan Am Games in Ontario in 2015 will provide further support for the sector.

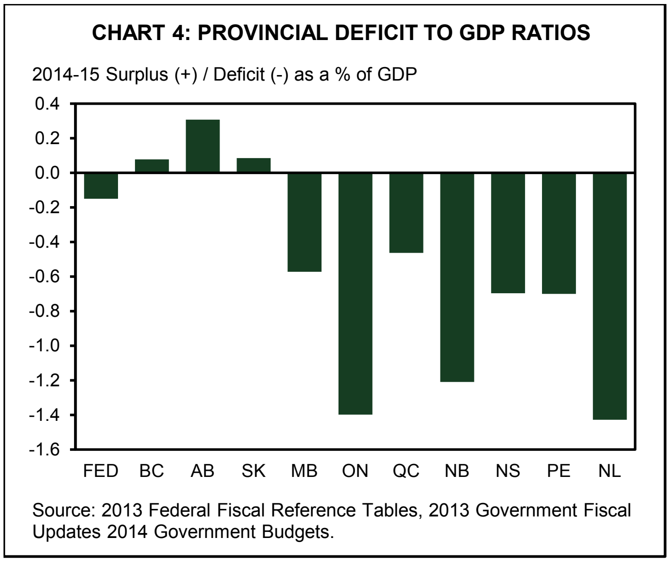
…but will be counterbalanced by reduced domestic activity

Economic growth in the real estate and leasing sector will be subdued over the forecast period. Our expectation for stabilization in the housing market will restrict growth in the near term. Finance and insurance activity will also be constrained by an anticipated pullback in insurance activities following a number of weather-related disasters that struck across Canada in 2013. Retail trade will likely register a moderate performance on account of steady gains by the Canadian consumer. Consumer spending is expected to slow slightly as a tug-of-war is played out between low interest rates combined with decent employment and income gains against the high levels of debt carried by Canadian

CHART 3: TOURISM ACTIVITY STARTING TO PICK UP



Source: Haver Analytics.



households. That said, we do expect interest rates to drift upwards over the next few years.

We anticipate public sector[2] growth to remain paltry over the next few years. More specifically, expect real GDP growth to come in at the mid-1% range as a number of provincial governments remain in deficit positions and the federal government aims to balance the books by 2015-16 (see Chart 4).

From a domestic demand perspective, the professional services industry is expected to outperform over the 2014-15 period. Healthy employment gains and improved corporate profits should translate into a stronger performance for the sector that underperformed in 2013. Within the sector, expect professions tied to the legal and accounting as well as the other professional, scientific and technical services (includes management, scientific and technical and consulting services) categories to lead the way following below-average performances in recent years.

Bottom line

Canada's rising economic growth tide will play out differently at the industrial level. In-line with our overall outlook, industries more closely aligned to domestic levers of growth are expected to wane somewhat over the forecast period. On the other hand, export-related sectors, such as manufacturing, oil and gas extraction, transportation and warehousing, accommodation and food services and wholesale trade, are forecast to be top performers over the next two years as a weaker Loonie and stronger global demand boost economic prospects within these industries.

CANADIAN INDUSTRIAL OUTLOOK
REAL GROSS DOMESTIC PRODUCT (GDP) BY INDUSTRY*

	Level $billions	Share of Output	Annual Average				Q4/Q4 % change			
			Actual		Forecast		Actual		Forecast	
	2013	2013	2012	2013	2014	2015	2012	2013	2014	2015
ALL INDUSTRIES (GDP)	**1589**	**100.0%**	**1.8**	**2.0**	**2.3**	**2.5**	**1.1**	**2.7**	**2.2**	**2.5**
GOODS INDUSTRIES	**477**	**30.0%**	**1.9**	**1.8**	**2.2**	**3.3**	**0.5**	**2.6**	**2.2**	**3.4**
PRIMARY INDUSTRIES	**157**	**9.9%**	**1.1**	**5.7**	**2.8**	**4.3**	**-0.1**	**6.8**	**1.9**	**4.6**
Agriculture	20	1.3%	1.4	14.2	-9.4	4.1	2.5	15.7	-14.3	10.4
Oil & Gas	107	6.7%	2.2	4.2	4.8	4.4	-0.2	5.4	4.1	4.0
Non-energy Mining	23	1.4%	-3.6	7.0	2.7	3.6	-1.2	6.5	3.6	3.4
Forestry, Logging & Other Primary	7	0.5%	-1.1	3.5	7.7	6.5	-2.2	5.1	9.5	5.1
MANUFACTURING	**167**	**10.5%**	**1.4**	**-1.2**	**2.9**	**4.0**	**-2.5**	**1.5**	**3.4**	**3.9**
CONSTRUCTION	**113**	**7.1%**	**5.2**	**0.7**	**0.1**	**1.3**	**5.3**	**-1.1**	**1.2**	**1.0**
Residential	**36**	2.3%	7.1	-0.6	-0.7	-3.2	5.9	-1.9	1.4	-5.9
Non-res. & Engineering	**77**	4.8%	4.3	1.4	0.5	3.5	5.1	-0.7	1.1	4.3
UTILITIES	**40**	**2.5%**	**0.4**	**4.0**	**2.2**	**2.3**	**4.7**	**3.2**	**1.1**	**3.0**
SERVICE INDUSTRIES	**1113**	**70.0%**	**1.8**	**2.1**	**2.4**	**2.2**	**1.3**	**2.7**	**2.3**	**2.2**
Wholesale Trade	86	5.4%	1.7	1.3	3.3	3.8	-0.7	3.0	3.5	3.9
Retail Trade	86	5.4%	1.7	2.8	2.4	2.4	0.2	4.0	1.5	2.3
Transportation & Warehousing	66	4.1%	1.9	1.3	3.4	3.6	1.0	3.2	3.0	3.4
Information & Cultural Industries	53	3.3%	1.6	1.0	2.5	2.3	1.6	0.8	3.6	1.7
Finance, Insurance & Real Estate	307	19.3%	2.6	3.3	2.5	2.2	2.4	3.5	2.4	1.7
Professional Services	84	5.3%	2.2	1.6	2.7	2.8	1.1	2.0	3.3	2.4
Accommod. & Food Services	33	2.1%	3.6	3.1	3.5	3.2	3.4	2.0	4.9	2.5
Public Services**	303	19.1%	1.1	1.4	1.4	1.4	1.3	1.7	1.4	1.4
Other Services	95	6.0%	0.9	2.1	2.7	1.1	0.0	3.6	1.1	3.6

*Measured in chained 2007 dollars; Forecast by TD Economics as at April 2014. Source: Statistics Canada / Haver Analytics, TD Economics.

**Includes Public Administration, Health Care, & Education Services.

End Notes

1. For example, rising zinc production is expected from Halfmile Lake mine in New Brunswick in 2014. The Totten mine in Ontario, which produces nickel, has already commenced production as of February.
2. Public sector is defined as the sum of the health care and social assistance, educational services and public administration sectors.