EXPORT FORECAST OVERVIEW

Global Export Forecast – Consumer Losing Momentum

1.0 Executive Summary

When it comes to global slowdowns, events rarely unfold smoothly. In mid-summer, the global economy was still humming along, and it looked like the forecasters were once again underestimating world growth. Central banks around the world were on inflation watch, and it looked a lot like a repeat of the early 1970s – rapid global growth, capacity problems aplenty and inflation. How quickly things changed in August. Almost overnight, subprime became both street language and an adjective for crisis, 2007 style. And in a radical about-face, central banks were pumping liquidity into the system on a daily basis.

A bolt out of the blue?

Headlines around the world created the impression that the August turbulence came from nowhere. But this U.S.-centered event was in the works for some time, and the surprise is that it didn't happen sooner. And it was a well-worn slowdown indicator, the U.S. housing sector, that reacted first. Official interest rate hikes that began in June 2004 ended two years and 425 basis points later, exposing excesses in the U.S. housing market that had been building for five years. The outcome? A recession-style plunge in key U.S. housing indicators that sparked a surge of mortgage defaults. Financial service firms around the globe are already reporting big losses, and the defaults have yet to run their course.

Contagion or containment?

When economic slowdown spills into financial markets, fear of contagion is never far away. For the moment, the recent actions by central banks have quelled those fears. In fact, many market watchers are seeing an end to this turbulent interlude in a matter of weeks. Optimists almost always surface at this point in the economic cycle, with stories of how different things are this time – a soothing message of hope that almost invariably disappoints.

Undoubtedly there have been significant changes to the structure of the global economy since the last big slowdown. Just the same, it is hard to imagine that the current housing slowdown will not spread to the broader economy. With home equity no longer the stash of spare cash it has been for the last five years, U.S. consumers have already reined in spending significantly. Moreover, employment growth has weakened and confidence is waning. Long the engine of the economy, consumers are now a burden – over the coming 12 months, U.S. consumer spending growth is expected to be a drag on the rest of the economy.

Not just a U.S. phenomenon

It is equally hard to believe that a U.S. slowdown will not spread to the rest of the world. At 20% of world GDP, the U.S. economy has been a growth engine for at least the last decade. And consumers are 70% of the U.S. economy, its most important trade link with the rest of the world. At the same time, technology and increased trade have knit global economies together more closely than they have ever been. Like cyclists in a tight race for the finish, the world's economies are crowded together, and when one slows, the whole pack feels the effects.

Initially, the slowdown looked lop-sided, confined to U.S. borders. This prompted talk of a world economy decoupled from the U.S. malaise, able to continue cranking out rapid growth. But weakness has traversed oceans. Markets in Europe are more vulnerable to slowdown than was previously thought. European consumers, shocked by developments in global financial markets in the summer, are now spending at a slower pace. At the same time, Japan's recovery has been short-circuited by consumer retrenchment.

Emerging markets not immune

Emerging markets will also be affected. True, the economic numbers are still looking quite good, but in time the cracks are sure to show. Despite the significant economic deepening that has happened since the last major global slowdown, emerging markets' domestic economic base has not yet matured to the point that it can sustain growth independently. Even the large, fast-growing markets like China and India do not yet have this capacity. Recent studies underline the continued strong linkages between emerging markets and demand from the developed world. But the impact of slower world demand will not be instant. It will likely be 2008 before slowdown shows up in the data, and even then it may be masked by increases in inventory.

Financial market turbulence caused ripples in emerging markets, and as creditors re-evaluated positions, interest rate spreads widened. While the moves in some cases were large, the more dramatic moves were confined to a small group of the riskiest markets. For the most part, rate increases were far more modest than in past episodes. Why? Well, the slowdown is still in its infancy. But more importantly, emerging markets have in general adopted stronger fiscal and monetary policies, and accumulated reserves to increase resilience in periods of downturn. So while current headwinds affect overall growth, emerging markets are expected to fare relatively well during the global economy's soft spot.

Recession? Not likely

Normally, the U.S. housing market slowdown we are seeing would lead to a recession. And in recent weeks, the likelihood of a U.S. recession has risen to about 50:50. At this point, it is difficult to say whether the U.S. will teeter into recession, or narrowly avoid it as in 2001. Much depends on confidence, which is fickle at the best of times, and prone to rapid change. But there are good fundamental reasons to believe that the economy will only slow, and then revive in 2009. The U.S. economy has harnessed the forces of globalization so well that productivity growth has remained unusually strong at a late point in the cycle. That has preserved liquidity, which has kept investment strong, and allowed for non-inflationary wage acceleration as resources grew thinner. And the weaker greenback has been a boon for U.S. exporters. Although job growth has slowed, economic growth suggests that modest employment growth can be sustained during the downturn – no outright decline, as in normal recessions.

At present, the U.S. is the planet's most recession-prone economy. In the absence of a recession in the U.S., it is unlikely that the world economy will experience one. In fact, as growth slows and competition intensifies, the process of globalization is likely to intensify, deepening trade linkages and broadening the reach of global supply chains.

The effect at home

To date, Canadian economic numbers have been surprisingly strong. In contrast to our southern neighbours, our housing market is still on a high and consumers are still happily spending. Even with the strong dollar, exporters have hung in there, managing to eke out small growth even in certain sectors that are more exposed. But in a strange twist, slower global growth will actually bring needed relief to exporters.

Strength in the global economy has ignited demand for oil, base metals and now agricultural products – commodities that Canada specializes in. Prices have skyrocketed, and have taken our dollar with them. And as the dollar has risen, speculators have nudged it higher. At current levels, the loonie is a huge threat to near-term exports. Fortunately, slower world growth is expected to cut demand for commodities. Along with increased supplies, this tempered demand is expected to bring prices back down swiftly, although to higher average levels than in the past. This is expected to lower demand for our currency – we expect to see it below 90¢ U.S. by the end of 2008.

Even so, total exports will just manage to grow in 2008. Key price gains have put exports on track to increase by 3.7% this year, but for 2008 growth will be more than halved to 1.5%. Consumer goods, automotive products and base metals will weigh down overall growth next year, the effect of weaker U.S. and global demand. The forestry sector and service industries will also be weak performers. On the upside, the agri-food, fertilizer and energy industries are all expected to post strong growth in 2008.

Reflecting the outlook, Canadian export diversification is expected to continue in the forecast period. For 2008, exports to the developed world are expected to rise by less than 1%. In contrast, export growth in emerging markets as a whole is projected at 11%.

Is the turbulence over?

The global slowdown is still in its early stages. Weakness is only just spilling into other developed markets, and will take time to infect emerging markets. Judging by past episodes of turmoil, we will likely see more turbulence in the coming months. But all told, we don't expect the extent of turmoil seen in the mid- to late-1990s, or the wild fluctuations seen in certain emerging markets in the 1980s.

The bottom line

Preparing for slowdown is never pleasant. It rarely happens in exactly the same way and for the same time span as in the past. We can take solace that on balance, the world has a more sound structural platform than in the past, and should get through the weak spot without a major pile-up. And sooner than you think, we will all be back to worrying about the tricky side of a rebound: shortages, capacity constraints and looming inflationary pressures.

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