

Vestcap Monthly Economic Report

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THE CHINA FEAR FACTOR

Too much attention is being paid to China. Global financial markets have been disrupted by heightened fears of an economic crisis in China. It is experiencing persistent capital outflows, which reflect weak domestic investment returns, caused by industrial overcapacity, declining profitability and worsening credit quality.

Worries about the Shanghai stock market are misplaced though. At current levels, the Shanghai Index is close to its 52-week low, set last August. There is little chance that the sell-off in Chinese stocks could spill-over into the real economy. Holdings are not widely enough held to cause a wealth effect. In addition, China's stock market plays no role in equity financing.

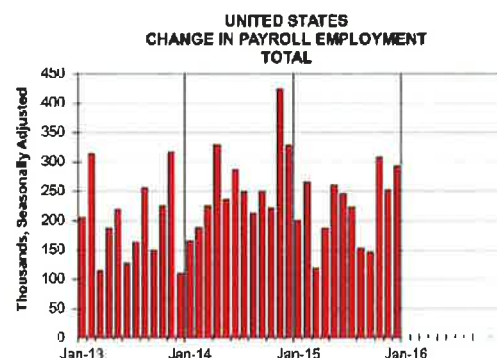
There is no doubt that China is in a major slowdown but its economy is not collapsing. It is a state-controlled system, which can deal with the credit and insolvency risks for property developers, state-owned enterprises and state-owned banks. On the surface, the financial linkages between China and the West are weak. There will not be a spillover into North America and Europe, because China is not very open to foreign investors.

As a result, the global economy is not exposed to losses on Chinese securities or to possible debt defaults. Nonetheless, psychological contagion is another thing. It has definitely reached out to the U.S. and Canada. Bad news from China has been creating a confidence shock for oil, and other commodities, and has also disrupted foreign exchange and global stock markets.

The trade weighted USD is being pushed up sharply by safe-haven flows. In turn, this is causing even more weakness for oil, and other commodities, priced in USD. Copper is now below US\$2.00/lb. for the first time since 2009.

As an oil and commodity producer, Canada gets a direct hit. Alberta and Newfoundland are in recession. Saskatchewan is struggling. The CAD is now trading at 68.59 cents (U.S.). It has not been under US\$ 0.70 since April 2003. The historical low is US\$ 0.6213 in Jan. 2002.

Oil prices will stabilize when the global oil surplus shows signs of growing at a slower rate. This is possible before the end of 2016. Global demand should grow by at least 1.2 MMb/d. A decline in non-OPEC output (2/3 from the U.S.) will partially offset increased OPEC output.



United States

- Job growth measures economic activity
- Employment is more than a coincident indicator
- It also reflects confidence in the future
- It therefore also has leading indicator properties
- If companies are hiring, they are confident
- There is also a consumer confidence impact
- 2015 strongest year for jobs since 1999
- The year ended with solid payroll job gains
- Low oil prices are a net positive for the U.S.
- Overall business investment is moving higher
- Negative impact of USD is over-emphasized
- Low inflation means Fed will delay moving rates

Canada

- Oil shock a net negative for Canada's economy
- Oil-producing provinces now back in recession
- Shock is spreading beyond the resource sector
- Many companies with energy related customers
- Indirect shock effects across regions/industries
- Widespread plans to cut staff across Canada
- Business investment much weaker than in U.S.
- This also reflects regulatory/tax uncertainty
- Focus now on equipment repairs/maintenance
- But U.S. demand & low CAD benefiting some
- Manufacturing shows net employment gains
- Ontario and GTA show employment uptrends
- New home demand still strong in Toronto CMA

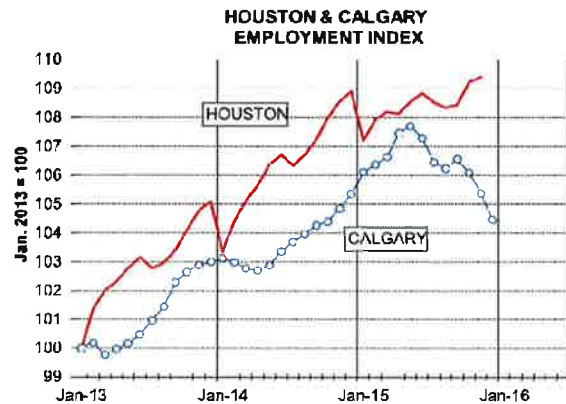
Global

- Trade-weighted USD up 5-1/4% last 3 months
- USD strength putting downward pressure on oil
- Also sentiment-based pressure from China fear
- 2016 global oil inventory build 0.7 MMb/d (EIA)
- This compares with a 1.9 MMb/d build in 2015
- 2016 U.S. crude output to decline by 0.7 MMb/d
- U.S crude oil inventories to peak this spring
- Then to trend lower to year-end 2016 (EIA)
- Yr/yr U.S. inventory declines by Q3 and Q4 2016
- EIA now forecasting US\$38 WTI average in 2016

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COVER PAGE CHART STORY



Oil is a net positive for the U.S.
Even Houston shows job growth.
This contrasts sharply with Calgary.
Total U.S. payroll job growth is strong.
4th Q job growth averaged 284,000/mo.
It means the economy is performing well.
Jobs are a better indicator than GDP.

Along with 2014, the last 2 years are the best for U.S. job growth since 1999.

This is quite remarkable as there were significant net job losses in 2015 in oil & gas extraction (16,600), mining (15,100), and also in support activities for mining (97,700).

The non-energy part of the U.S. economy is more than making up for these losses.

The sectors making big contributions to December U.S. payroll growth were specialty construction trade contractors, professional and technical services, temporary help services, food services and drinking places, and health care (health care services and hospitals).

Payroll employment in the U.S. in 2015 averaged 141.959 million per month.

It was 2.936 million higher than average monthly employment of 139.023 million in 2014.

This is the largest annual average employment increase since 1999.

In addition, 96% of the payroll jobs created in the U.S. between December 2014 and December 2015 were in the private sector.

This is in sharp contrast to Canada, where private sector job growth has stalled, and only public sector jobs (mainly health and education) show advances.

Employment does a better job of measuring economic activity than GDP, especially in the services and technology sectors.

GDP methodology needs to be updated to accurately reflect how technology is affecting behavior. It is not good at picking up activity in support services, information/digital technology, and business software. GDP tracks transactions. Employment is easier to measure.

The advance GDP release for the 4th Quarter of 2015 will be released on January 29th, and it will tell a different story than the payroll employment figures.

The Federal Reserve Bank of Atlanta's high frequency indicator model estimates that 4th Quarter real GDP growth will be only 0.8% at annual rates.

However the 4th Quarter payroll employment surge suggests that the GDP report is seriously underestimating what is really happening in the U.S. economy.

STRONG JOB GAINS IN THE UNITED STATES
They Indicate that the U.S. Economy is Performing Well
Peter R. Andersen, Ph.D.

THE IMPORTANCE OF THE U.S. JOB NUMBERS: Some economic indicators mean more than others. The recent softness in some of the economic indicators for the U.S., such as industrial production and retail sales, is misleading. Industrial production reflects the energy shock, and only covers 16% of the economy. The retail sales survey does not accurately reflect total spending in real terms. The employment figures are giving a much better indication on what is happening to the U.S. economy.

Employment gains in the U.S., especially in the 4th Quarter, have been much better than expected. The companies that are creating these jobs are responding to what is happening to their business activity, both current and projected. The kind of employment gains that we are seeing is an indication of an elevated level of business confidence.

On the other side of the job market, average Americans are feeling better as a result of a rapidly tightening job market. The risk of layoffs is receding, and there are more opportunities now to upgrade to better jobs. In December, layoffs were running at their lowest level since the recovery began in 2009. In fact, December layoffs were the lowest in 15 years. Job openings are at a historically high level. Job openings remain well in excess of actual hiring. As a result, consumer confidence is upbeat. It is on track in January to show a fourth consecutive monthly increase.

The U.S. will be at full employment this summer. This means that the broadly-defined measure of labor underutilization, the U-6 unemployment rate, will be down to around 9.0%. This is a measure of unemployment that includes those working part-time, who would prefer full-time work, and also people who are discouraged and are not actively looking for work, because they do not think jobs are available. The seasonally adjusted U-6 unemployment rate in December was 9.9%.

WAGE PRESSURE IS STARTING TO APPEAR: While aggregate wage increases remain subdued, they are running well ahead of consumer inflation. Over the 12 months ending in December, average hourly earnings for all employees on private nonfarm payrolls have increased by 2.5%. This would have been higher had it not been for the wage compression underway in the energy sector. There are now pockets of upward wage pressure that are becoming noticeable.

Seven of the twelve Federal Reserve Districts report greater wage pressures for skilled workers in a variety of industries, including construction, manufacturing, financial, professional, technology, and health-care sectors. In addition, there are also wage pressures among low-skilled positions. Six Federal Reserve Districts report pressure from state minimum wage increases, and from labor shortages in entry-level positions in banking, retail, and hospitality. As the U.S. approaches full-employment this summer, wage gains are expected to be more pronounced and widespread. This will fuel the consumer recovery.

CHEAP ENERGY IS BOOSTING CONSUMER PURCHASING POWER: The national average for regular gasoline in the U.S. is now down to \$1.88 per gallon. It is running at \$1.67/gallon in Texas. It will probably go lower and stay low in 2016. This compares with a national average of \$3.43 through 2013 and 2014. There is a big impact on consumer cash flow. In essence, the average hourly wage now has much more purchasing power for drivers. Cash savings are estimated (AAA) to have averaged about \$550 per driver in 2015. This amounts to an injection of \$115 billion of additional spending power.

There is more however. There are also savings on home heating costs, as a result of low natural gas prices. The average household heating oil cost during the winter of 2015-16 is estimated (EIA) to be more than \$800 per family lower than in the winter of 2012-13. Warmer-than-normal temperatures throughout much of the U.S. has further increased already abundant inventories of oil and gas, and kept downward pressure on already low energy prices. These savings are particularly important for low-income families, which spend a larger percentage of their income on gasoline and home heating.

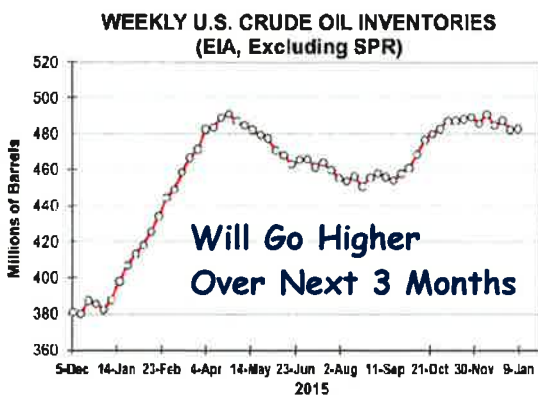
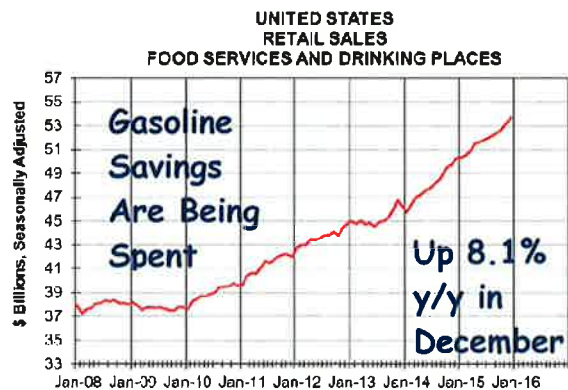
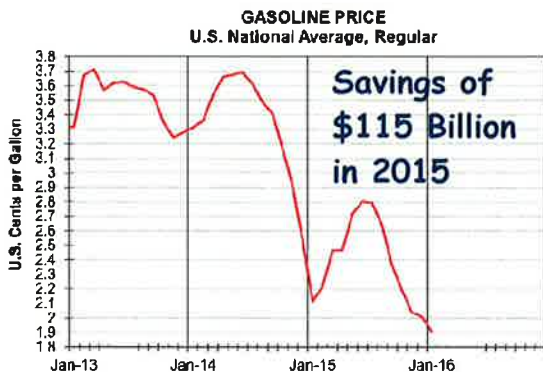
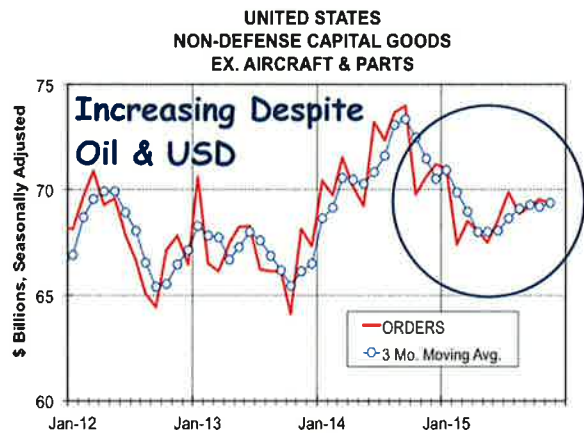
RETAIL SALES REPORTS ARE NOT A GOOD BAROMETER: Americans are responding to cheap energy by spending more on services – eating out, travel and entertainment. The December retail sales report, released this week, shows an 8.1% y/y increase in spending at restaurants and drinking places. However other spending on services (entertainment, tourism and hospitality) is not captured. Gasoline stations are included in the retail sales survey though. Many other retail establishments also sell gasoline. It is not possible to adjust their sales figures, to take out the effect of gasoline. Collapsing gasoline prices therefore give a misleading impression of weakness in retail sales, which are measured in dollars spent.

The latest report shows a retail sales decline of -0.1% between November and December. Retail sales have increased only once in the last 5 months. On the surface this sounds bad. In price-adjusted real terms, however, consumer spending is advancing. Total consumer spending is estimated to have increased at a 2.2% annualized rate in real terms in the 4th Quarter. It is expected to show annualized growth in the mid 3% range in the 1st and 2nd Quarters of 2016.

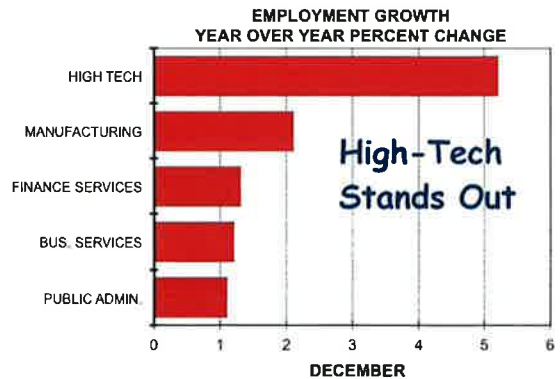
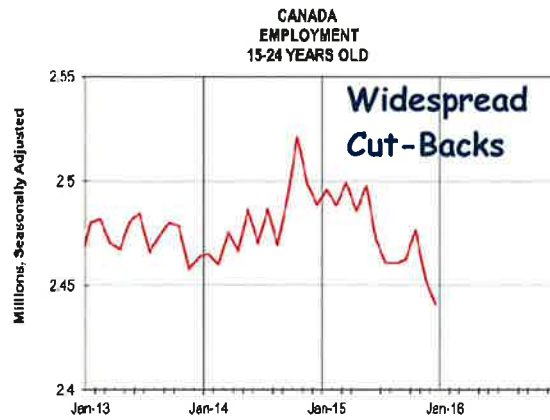
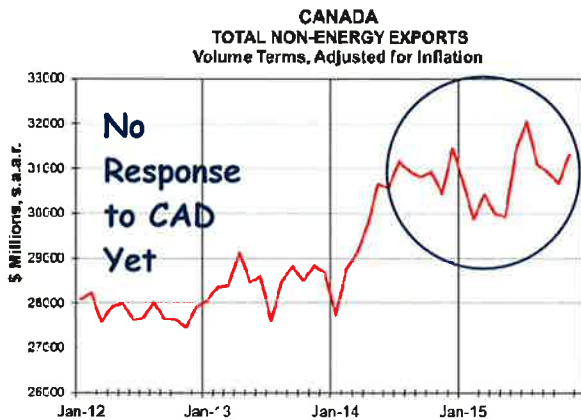
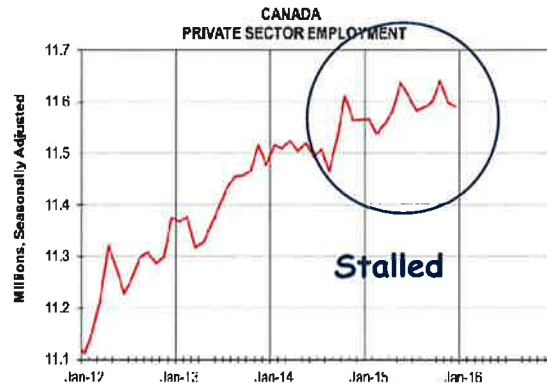
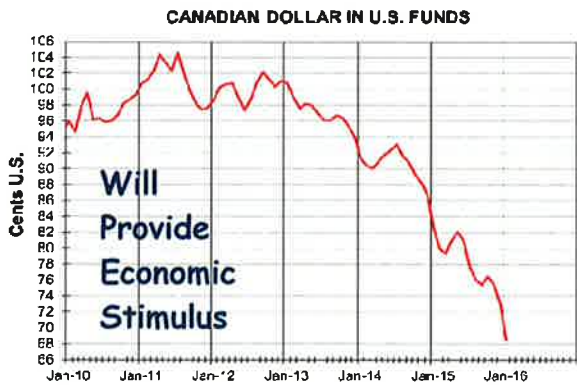
Declining prices are giving a false impression of retailing weakness. Prices are declining for many other consumer goods, as well as just gasoline. Consumer goods prices, excluding food and energy commodities, have shown a string of monthly price declines. This is the direct result of the strong USD, and its impact on prices of imports. It also reflects aggressive discounting by traditional “bricks-and-mortar” retailers, in response to on-line competition. While the retail sales survey attempts to cover online sales, it does not reflect the strength obtained from anecdotal reports.

The Atlanta, Minneapolis, and Dallas Federal Reserve Districts all report a surge in e-commerce shipments, and parcel companies report record holiday-related demand. The employment data also suggest that online retailing is being underestimated by the retail sales survey. December payrolls for the retail sector point to more strength than the retail sales report. There was a hefty 15,100 increase in employment in courier and messenger services between November and December.

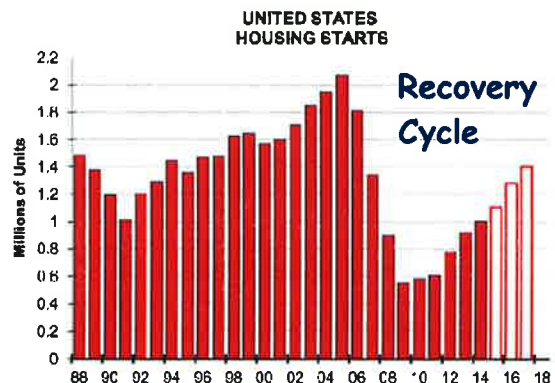
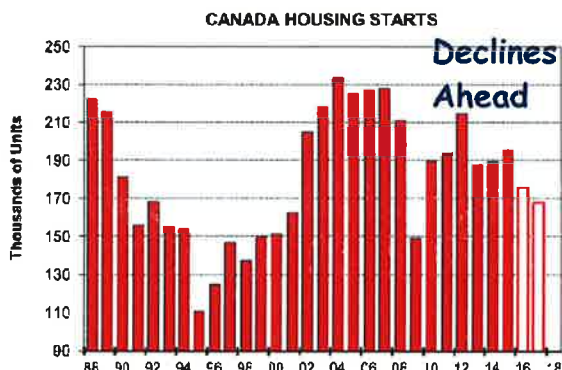
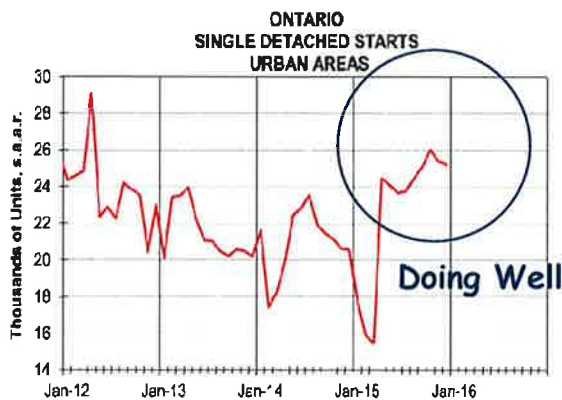
The consensus expectation is for real GDP growth of 2.5% in 2016 in the United States. This would be in line with the estimated 2.4% advance in 2015. While low by the standards of past recoveries, it is still an improvement on the longer-term growth trend of 2.2% since the recovery began in mid-2009. Consensus forecasting is dangerous though. We think that U.S. growth will actually be higher, at about 2.8% in 2016. Looking further ahead into 2017, U.S. growth momentum is expected to be sustained, and to improve somewhat. The real U.S. GDP growth estimate for the 4th Quarter of 2015, which will be published at the end of January, will show a misleadingly weak quarter – an annualized real growth rate, measured from the previous quarter, of less than 1.0%. However, this will reflect the temporary effect of a large reduction in inventory accumulation. Final domestic sales have continued to show respectable growth. Consumer spending has not been as slow as the monthly retail trade survey shows. The GDP report will give a more inclusive and more accurate reading on consumer spending. GDP growth in 2016 will not be distorted by inventory shifts, and will reflect the underlying trend in U.S. domestic demand. Sustained job growth is starting to put upward pressure on wages, which will support consumer confidence and will allow more individuals to qualify for mortgages. Seven of the twelve Federal Reserve Districts report greater wage pressures for skilled workers in a variety of industries. There are also wage pressures among low-skilled, entry-level positions in banking, retail, and hospitality.



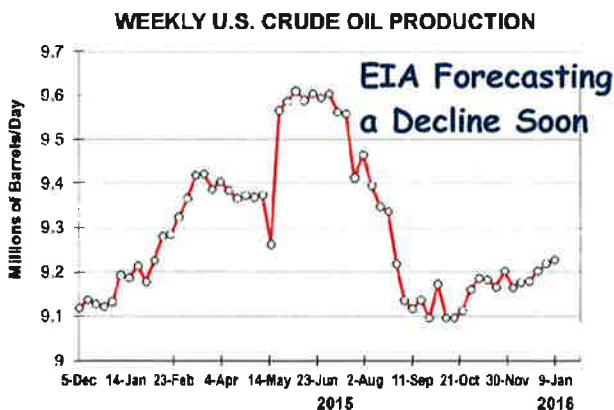
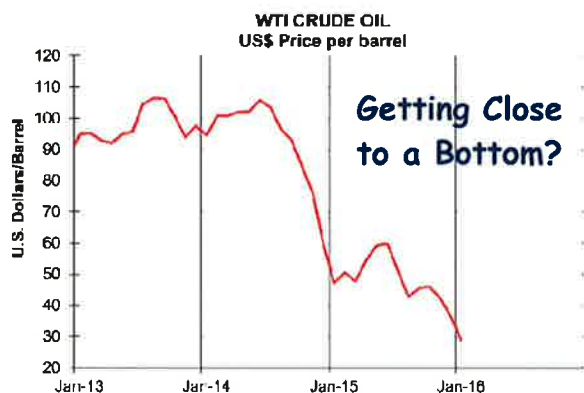
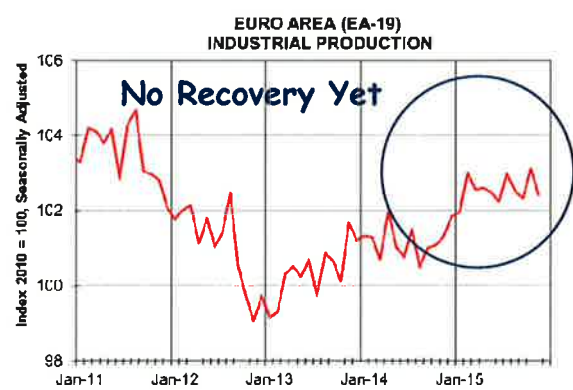
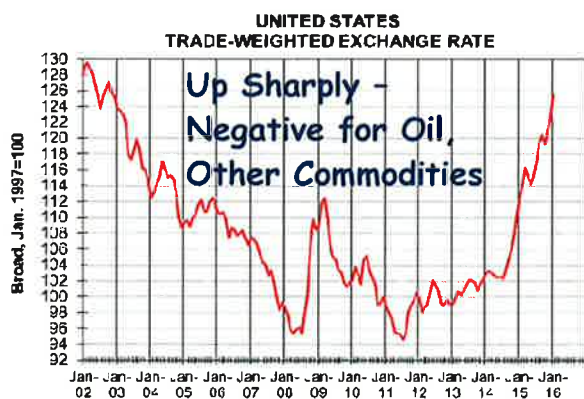
The negative effects from the oil price shock are spreading in Canada, beyond the energy-producing regions and sectors. Many businesses across the energy supply chain are struggling as they adjust to weak demand. As well, non-energy firms, which are exposed to slowing demand from their energy-related customers, or from households in affected regions, are feeling a negative indirect effect on their business. The outlook for business investment in machinery and equipment is the worst since the recession. Many firms are limiting their capital budgets to just repairing and replacing existing equipment. Declining investment intentions are now also evident in non-oil producing regions. Businesses are worried about the strength of domestic demand, regulatory and tax uncertainty, and the outlook for foreign demand. Hiring intentions are down. They are the weakest since 2009. Fewer firms plan to increase staffing. In addition, more companies are planning layoffs. Cuts in payrolls are spreading to the resource-consuming sectors and regions. The focus for many companies is on the need to cut costs and become more efficient. The dramatic plunge in the CAD is making a big difference for non-commodity exporters though. Most price their products and services in USD, and the currency conversion is now giving C\$1.45 for every US\$1.00 of export revenue. They are benefiting from cheaper energy as well. Also there are import substitution opportunities for many domestic firms.



Housing starts have peaked in Canada. They increased in 2015 because of condominium construction in Toronto. Without this increase, national starts would have shown an annual decline. In 2016 the oil price collapse is expected to produce a big decline in Alberta that will push the national starts lower. More oil-related layoffs are in store, and interprovincial workers are returning from the oil patch. The increase in down-payment requirements, which will come into effect in mid-February, will remove buyers from the market. Home sales in Calgary, Edmonton, Saskatoon and Regina are slumping. Home prices in Calgary face double-digit percentage declines. High-rise construction in Alberta will decline as pre-sale commitments evaporate. However, conditions in Ontario and B.C. are much different. Housing activity is expected to remain at a high level in Ontario, where demand continues to outpace supply. The inventory of new low-rise homes in the Greater Toronto Area has declined to a historic low. Toronto area builders could sell and build more homes, if they had an adequate supply of serviced land. There have been a large number of condominium completions in Toronto, but the market has largely absorbed this new supply. The preliminary annual housing starts estimate for Canada in 2015 is 195,500 units. This compares with a baseline demographic need for housing construction in Canada of around 180,000 units per year. We are forecasting declines in annual housing starts in 2016 to 176,000 units, and in 2017 to 168,000 units.



Even in a scenario where Iran boosts oil production by 700,000 bpd in 2016, which is probably too high, global demand growth of somewhere between 1 million to 1.5 million bpd, and declining non-OPEC production, will narrow the gap between global supply and demand. Real gross domestic product (GDP) for the world, weighted by oil consumption, increased by an estimated 2.4% in 2015. The EIA's projections are based on the assumption of weighted global GDP increases of 2.7% in 2016 and 3.2% in 2017. This could be the year where there is a supply response to the oil price collapse. Reduced oil production is possible in non-OPEC countries - mainly in the U.S., but also in the North Sea and in Russia. The depreciation of the ruble vs. the USD has dampened Russia's exposure to low prices though. The EIA is forecasting that U.S. oil production will decline to an average of 8.7 million bpd in 2016, from an estimated 9.4 million bpd in 2015. This would put it back to its 2014 level. It will be a narrowing supply/demand gap, rather than the market staying over-undersupplied, that will shape expectations, and thereby provide a bottom for crude oil prices. They are expected to remain low in 2016, as supply will still exceed demand this year. More crude oil will be placed into global storage, but hopefully not as much as the year before. The EIA estimates that global oil inventory increased by 1.9 million bpd in 2015, for a second consecutive year of inventory building. It is forecasting that inventories will rise by an additional 0.7 million bpd in 2016. After that, the global oil market could finally become relatively balanced in 2017. The EIA expects the first draw on global oil inventories in the 3rd Quarter of 2017, after 3-1/2 years of build-up.



The big drop in the value of the CAD will improve economic conditions in Ontario and British Columbia. Some companies are already experiencing the benefit, which will become increasingly widespread in 2016 and 2017. There is a long list of non-energy industries that are sensitive to the USD/CAD foreign exchange rate. Research by the Bank of Canada shows that we can expect companies in the following sectors to show a strong positive export response – automotive, machinery & equipment, aerospace, pharmaceuticals, fertilizers, lumber, building materials, tourism, heavy trucks and buses, clothing, textile products, and furniture & fixtures. Ontario and British Columbia are well-represented in this list. In the first instance, there will be a price and profit margin effect. Most companies price their exports in USD, and the currency depreciation means that US\$1.00 of export sales now translates into C\$1.45 of Canadian revenue. Some companies have probably hedged at earlier CAD/USD levels, but these hedges will expire. The volume effect on exports will come when Canadian exporters, experiencing improved profit margins, begin to cut their USD prices in order to increase their market share in the United States. In addition, import substitution will have a big positive effect on companies that compete in the domestic market with U.S. imports. The big currency move means that they will increase their domestic market share, as buyers shift to cheaper Canadian-made products.

