Vestcap Quarterly Economic Report

Volume 7, Number 3 March 27, 2015

DON'T WORRY ABOUT THE U.S. ECONOMY

The economic indicators for the U.S. in early 2015 have been underwhelming but this does not mean that we should be worried. The U.S. economy is in a long expansion and is in the midst of a break-out into a higher growth trend.

The latest job-creation numbers provide conclusive evidence. Looking ahead, the outlook is the best since the economic recovery began almost 6 years ago. Average real GDP growth in the U.S. through the next three quarters is expected to be in the high 3% range.

The jobs boom in the U.S. is the strongest since the dot-com days of the 1990's. There have been almost 1.8 million jobs created (1.757 million) over the last 6 months. The job market is running flat-out. The job growth is widespread across regions, industries and income levels.

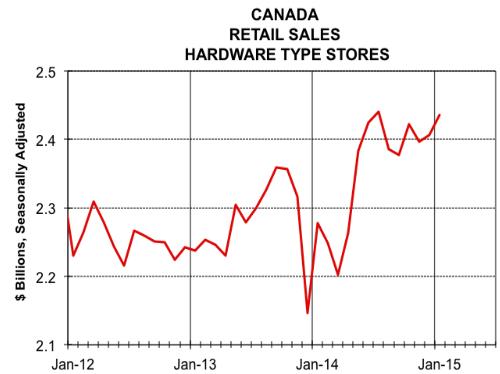
The U.S. unemployment rate is now down to 5.5%, which is the top boundary of what is looked on as the full employment range (5.0% to 5.5%). Over the past 12 months, the number of long-term unemployed is down by 1.1 million.

There is still plenty of slack in the U.S. job market looking at participation rates, involuntary part-time employment and the number of people with only a marginal attachment to the job market. As a result, wage growth has remained stable at a low level of only around 2.0% y/y.

There have been worries that pre-emptive Fed tightening could disrupt the U.S. recovery. However, Fed Chair Janet Yellen has made it clear that future rate increases will be evidence-based and in response to economic strength, rather than forward-looking expectations.

The Fed will be looking at a wide range of indicators in its interest rate strategy. Wages will have a heavy weighting. The Fed is unlikely to raise rates until there is clear evidence that wage growth is accelerating.

Some U.S. retailers (Wal-Mart and the TJX Group) intend to raise wages soon. However, persistently low consumer price inflation will put a low ceiling on future wage increases. Negative price inflation (-0.1% y/y for the U.S. CPI) is fundamentally inconsistent with the Fed's longer-run objective. Persistently low gasoline prices will have a powerful moderating effect on future Fed interest rate decisions. A take-away from the recent Fed meeting is that future rate increases will be small and spread-out.



United States

- Energy savings are being spent
- Leisure/restaurant/home improvement focus
- Energy intensive manufacturing is benefiting
- Oil price impact will help housing recovery
- New single-family home sales are picking-up
- February sales running at a 7-yr high
- Sales reflect move-up (not first time) buyers
- Negative CPI inflation. Latest month -0/1% y/y
- Shale oil production is still moving higher
- Tight oil supply is more resilient than expected
- Means oil prices have not bottomed yet
- WTI could move below $50 per barrel again
- USD strength reflects positive outlook

Canada

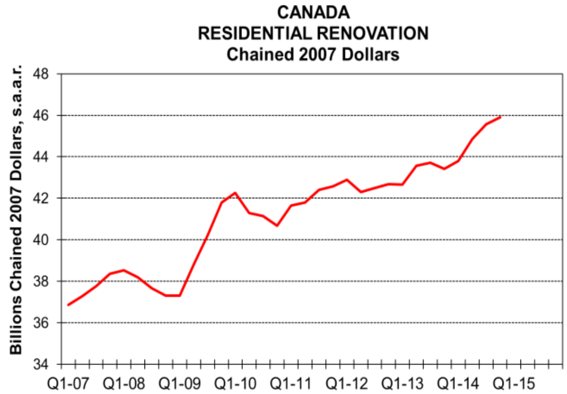
- Oil price hit comes right away
- Benefits less certain; slower to materialize
- Big % cuts (30% range) in oil & gas capex
- Sharp retail sales volume decline since Nov.
- Energy outlook will not stabilize until the fall
- Deflation is taking hold in AB, SK and NL
- ON, BC, QC and MB the new growth leaders
- Real wages are now showing larger increases
- Gasoline savings spent on home improvements
- Retail sales of hardware-type stores picking-up
- National outlook will improve in 2016
- Spill-over coming from U.S.+CAD impact
- Non-energy exports are already picking-up
- Rising U.S. forestry/building materials demand

Global

- Euro Area industrial output is still flat
- Zero y/y Euro Area industrial production growth
- 22 y/y monthly declines in EA industrial prices
- Industrial output picking-up in Germany though
- USD now trading at $1.0875 per EUR
- USD averaged $1.38/EUR in March 2014
- Could still move below parity before summer
- More signs of industrial slowdown in China

ANDERSEN ECONOMIC RESEARCH INC
Tel: 512-243-7823 E-mail: pandersen39@gmail.com Website: www.EconomicKeynoteSpeaker.com

COVER PAGE CHART STORY



Building supply sales are picking-up.

The savings on gasoline are being spent.

They are going into smaller purchases.

Restaurant/leisure spending is a focus.

So is small home improvement spending.

Hardware type retail stores are busy.

They show a solid y/y sales gain.

The dollar value of retail sales at building material and supplies stores is up by 7.3% (Jan y/y).

There was a strong increase in the latest month (between December and January).

Ontario and British Columbia are expected to show the best retail performance in 2015.

These provinces will not experience oil-related job losses.

They will however experience enhanced consumer purchasing power and job gains.

Real wages will increase as gasoline prices cause a drop in aggregate consumer price inflation.

We expect the CPI index to decline soon to close to a zero y/y inflation rate.

Nominal average weekly wages are currently up y/y by 3.4% in B.C. and 2.5% in Ontario.

B.C. has the strongest real wage increase. Its consumer price index is now up y/y by only 0.8%.

As real incomes and employment continue to increase in energy consuming provinces, spending on home repair and improvements will receive a further boost.

Cash savings at the gasoline pumps will translate into spending on paint and home furnishings.

These cash savings are not going away anytime soon. Oil prices will stay relatively low.

Residential renovation spending will therefore be a bright spot in Canada's economy.

New construction will decline in both 2015 and 2016 but renovation is trending higher.

The chart above shows renovation outlays in volume terms, adjusted for inflation, in chained $.

Residential renovation is a big industry in Canada.

In current dollar terms, renovation is currently running at a $52.3 billion annual rate.

That is not far below new housing construction which is currently $58.7 billion annualized.

In nominal terms, renovation in the 4th Quarter of 2014 was up y/y by 10.2%.

In price-adjusted volume terms it was up y/y in the 4th Quarter by 5.8%.

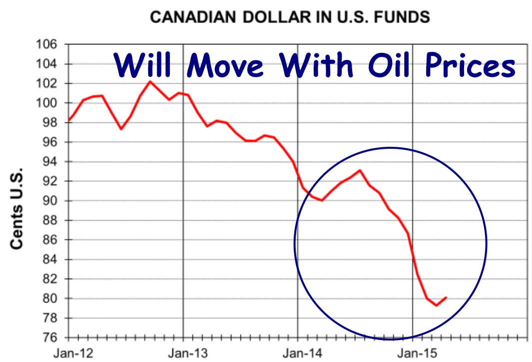
This compares with a price-adjusted y/y volume increase in new construction of 3.6%.

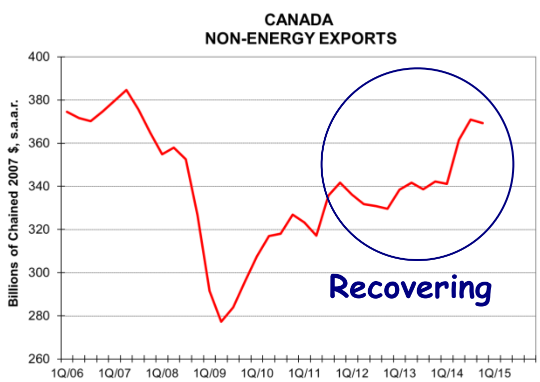
New construction is expected to head downwards in 2015.

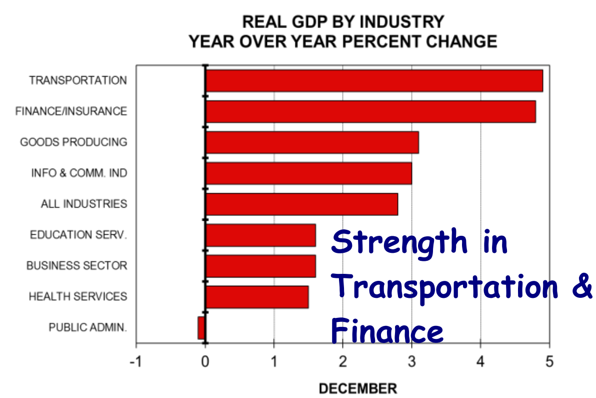
In contrast, residential renovation will continue to be a growth leader in Canada in 2015.

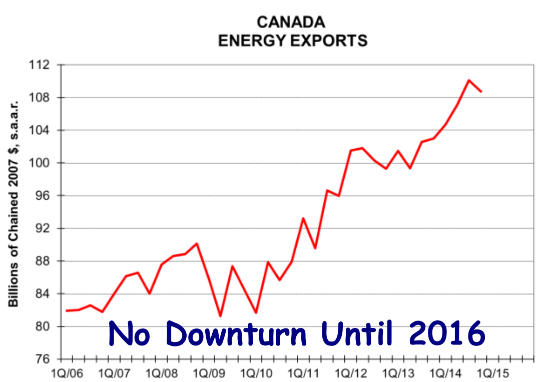
House price appreciation and strong resale housing markets in B.C. and Ontario will provide added support to home improvement. People always repair and renovate when they move.

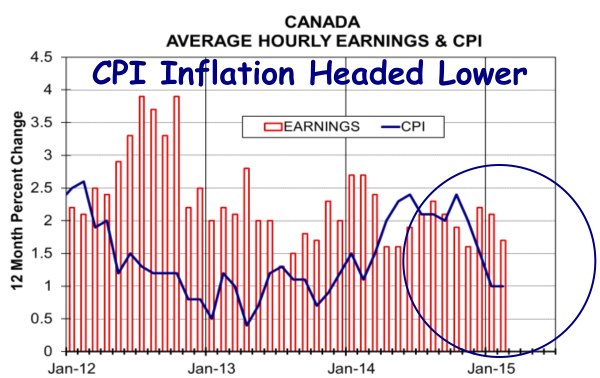
The job market is headed in different directions in the U.S. and Canada. The seasonally adjusted unemployment rate stood at 6.8% in February. It could be well into the 7.0% range by the fall. In contrast the U.S. unemployment rate (5.5% in February) is now at the top end of the full-employment range and is expected to move lower. The sharp decline in oil prices is an unambiguous negative shock for Canada's economy. If the supply of oil continues to outpace demand, it is possible that the price of WTI could move below $50 per barrel again this spring before bottoming and moving back into the $60-$70 range in 2016. Corporate profits have turned down and personal income growth shows a pronounced slowdown. There will be cash savings for motor transport, energy-intensive manufacturing and energy consuming provinces such as Ontario and British Columbia. The CAD has been closely correlated with the price of oil and the lower CAD is also providing a stimulus to non-energy exports. Nonetheless the negative effects on oil producers, their workers and their suppliers come right away. The positive effects come much more slowly and in addition, are more uncertain. Furthermore the higher cost of imported consumer goods associated with the lower CAD will offset a good part of the cash savings on gasoline at the pumps. Capital spending in the oil and gas sector is adjusting quickly. It is expected to decline by more than 30% in 2015. This translates into a decline of more than 10% at the aggregate economy level. Oil industry supply chain links with the rest of Canada will spread the negative impact into oil consuming provinces. The compression in oil-related revenues is also having a dampening effect on the government tax base at the federal level and in oil-producing provinces. Governments are cutting back on spending and are planning tax increases. Real GDP growth will be close to zero in the 1st Quarter and will then gradually accelerate.



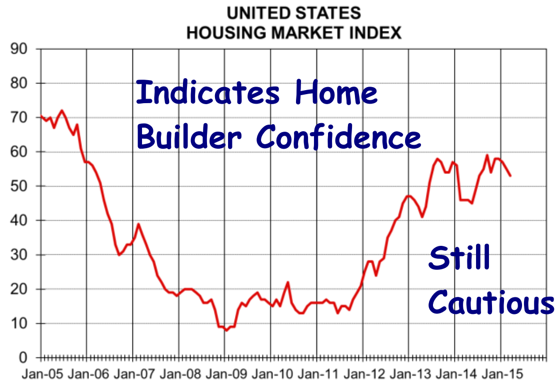


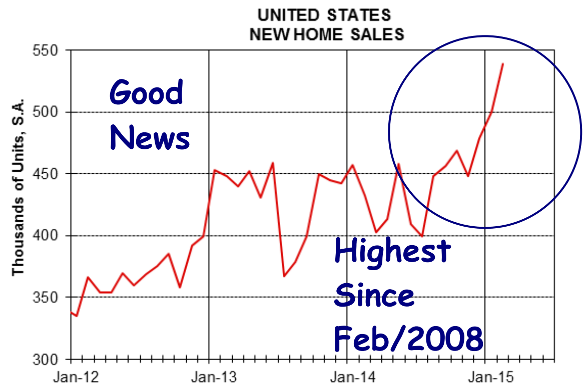


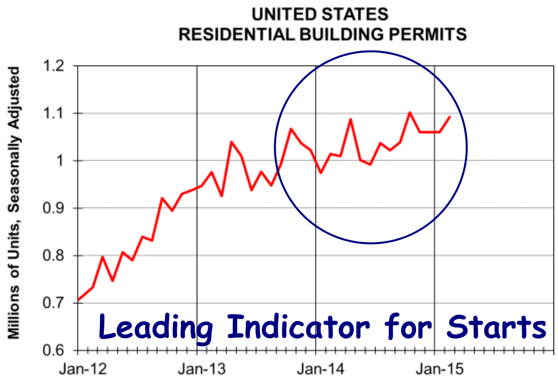


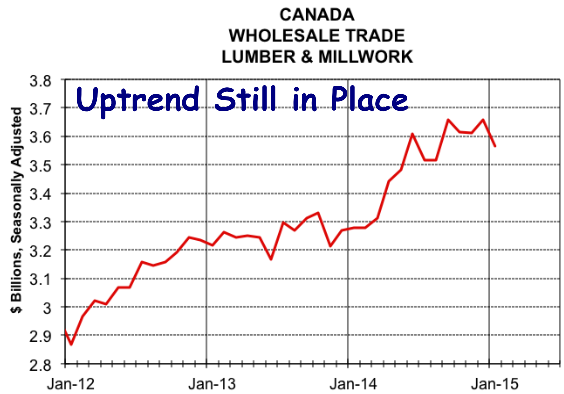


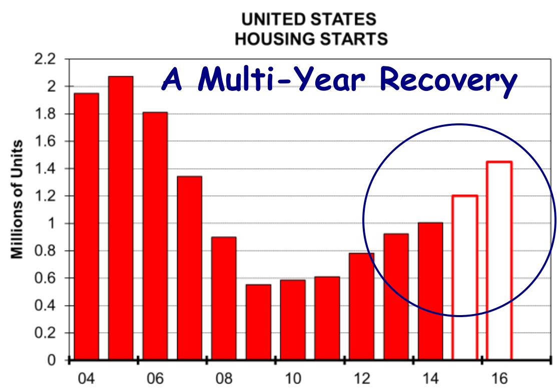
Housing starts are also headed in different directions in the U.S. and Canada. A residential construction uptrend is already in place in the U.S. and it is expected to gain momentum and stretch for another three years at least. In contrast, housing starts have peaked in Canada and are expected to decline over the next two years. The construction outlook for Canada is riskier now as a result of the oil shock. The key issue is what will happen in Ontario and Alberta. Prospects are good in Ontario. A respectable increase in new housing demand is expected, with Ontario housing starts increasing by 3% to 7% from 2014 levels. Housing markets are strong in Toronto and Hamilton and there is no serious condo over-supply. British Columbia will also contribute to gains in housing construction. Market conditions are healthy in the Lower Mainland. Single-detached housing starts in B.C. have been on an uptrend for the last six months. At the other end of the scale, Alberta faces a pronounced decline in housing starts – forecasts range from a 10% to almost a 20% decline. The outcome for Alberta will depend on when and where oil prices stabilize. Our forecast at the national level is more cautious than official government projections. We are calling for 178,000 starts in Canada in 2015 – a decline of 6% from 189,329 last year. In 2016, we are forecasting 174,000 starts. In the U.S., the housing recovery has been slow-paced up to now and driven mainly by multiple-unit rental construction. However, the sharp rebound in new home sales in the U.S. over the past three months points to a stronger phase in the U.S. construction recovery cycle. New home sales in February were running at their highest level in 7 years. Move-up buyers are providing the momentum. First-time buyers are still on the sidelines but should return as job markets continue to improve.

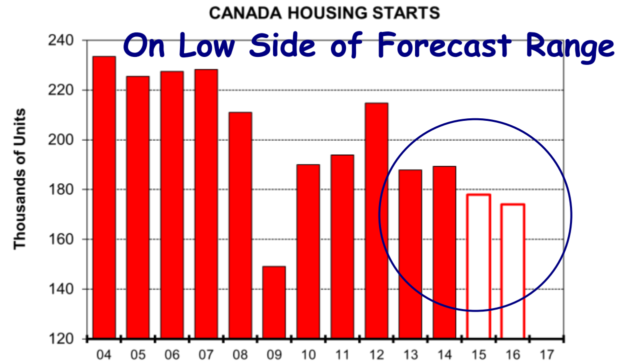




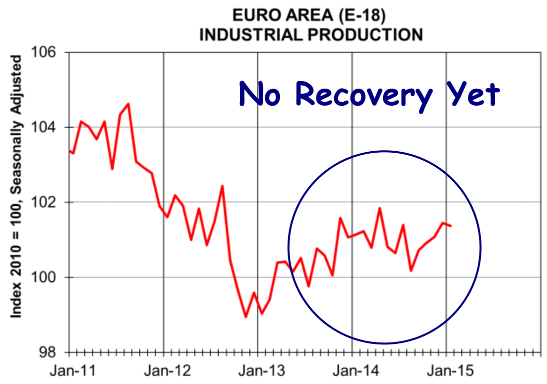


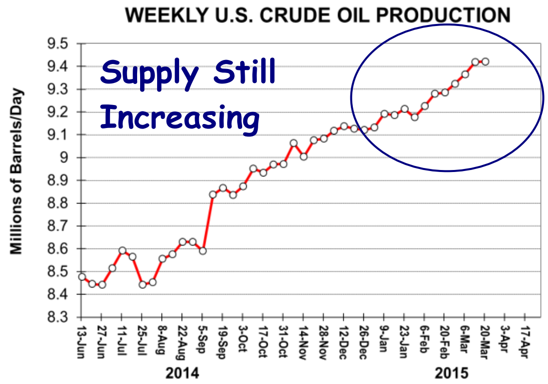


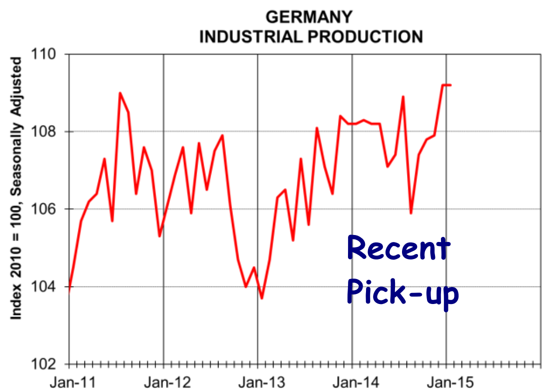


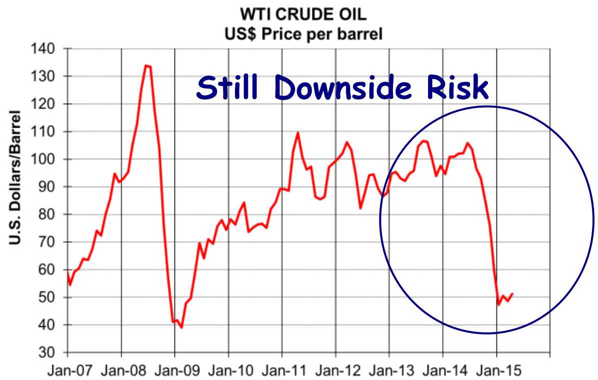


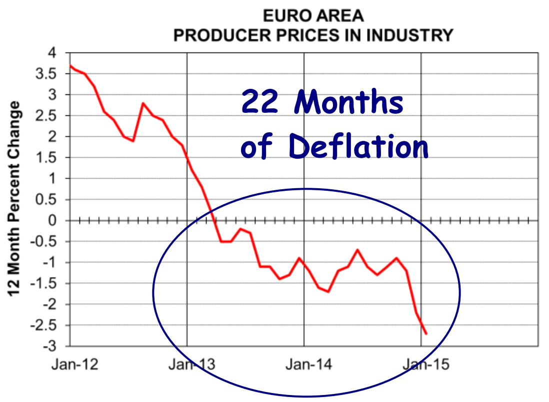
Oil production is still increasing. U.S. field production of crude oil was running at an average of 9.422 million barrels per day in the week of March 20th. This compares with 9.419 million b/d the week before and 9.285 million b/d a month earlier. The oil price will not show a sustained recovery until oil production flattens and begins to decline. Both WTI and Brent have increased in the past week but this reflects other special factors such as the impact of the March 18th Fed interest rate statement, its effect on the USD and also air strikes by Saudi Arabia in Yemen. The increase in oil prices on March 26th was the strongest in a month. It reflected heightened concern that an escalation in Yemen could threaten world oil supplies. The Canadian dollar has been tightly correlated with oil prices since last fall and has temporarily climbed over 80 (cents U.S.). This elevated volatility is obscuring the trends and cycles in commodities and currencies. Looking at the USD first, its downshift against the EUR since mid-March reflects soft economic data from the U.S. and a dovish tone by the Fed. If our forecast of stronger growth in the U.S. in the 2nd Quarter is right, then we can expect FX market psychology to swing around again, pushing the USD higher and providing the Fed with grounds for a rate increase. There is little evidence that the Euro Area is recovering. The latest figures show basically zero growth in EA industrial production over the past 12 months. In addition EA industrial product prices now show 22 consecutive months of y/y deflation. Don't count the USD out. If it moves back onto its uptrend, we can expect more downward price pressure on oil and other commodities. Don't underestimate U.S. shale oil supply either. It has proven to be more resilient than many thought. Other countries such as Canada will also continue to increase oil production in 2015.

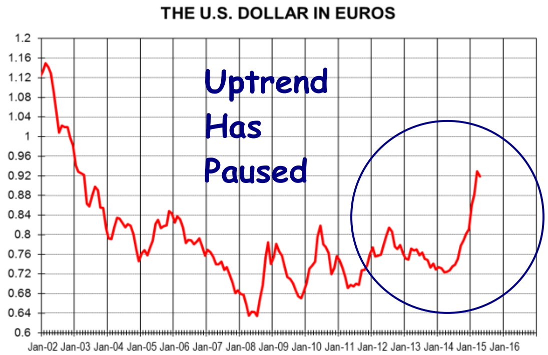




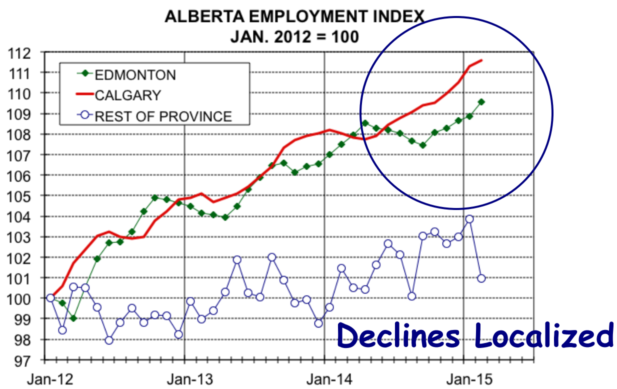


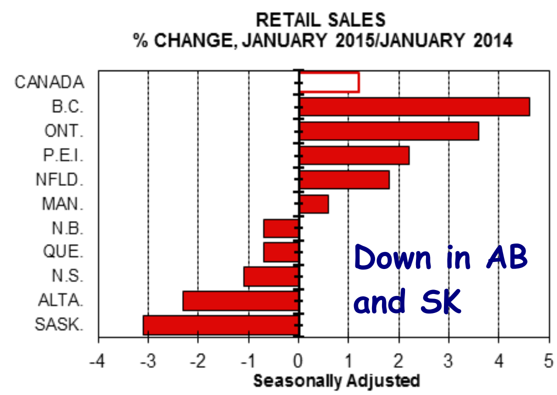


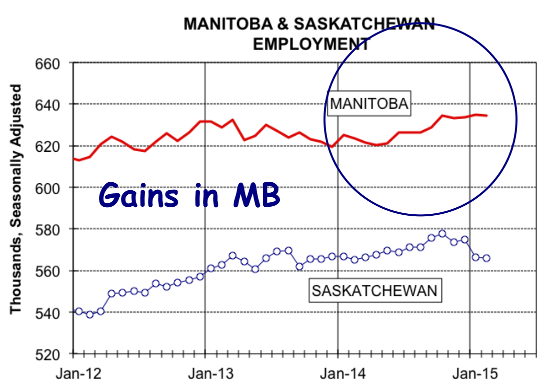


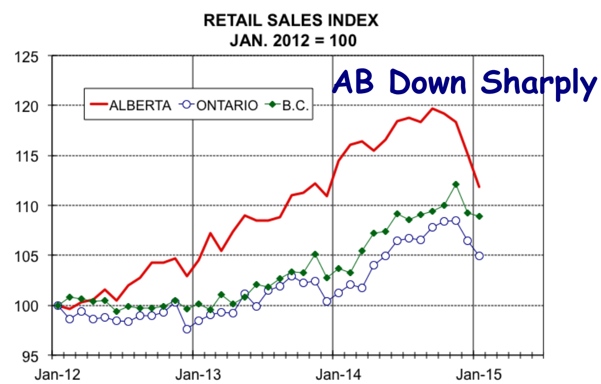


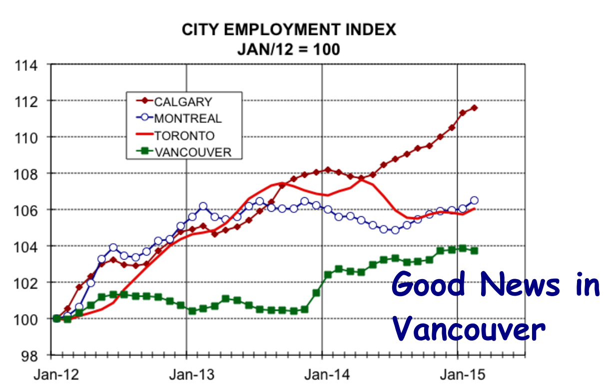
The economic numbers do not yet show how serious the oil price shock will be for Alberta and Saskatchewan. Newfoundland is another matter. A number of indicators point to an economic recession in Newfoundland. In Alberta, the latest employment numbers are holding up well in Calgary and Edmonton. There has been no downturn there yet. There are employment losses in Alberta but they are coming outside of the two main cities. Job losses are more apparent in Saskatchewan. A noticeable downtrend has been in place there since last October. We expect that it is only a matter of time until the indicators confirm a decline in overall economic activity in both Alberta and Saskatchewan. Manitoba is expected to avoid an economic downturn though. It is doing noticeably better than Saskatchewan. Employment in Manitoba has been trending higher since last spring. British Columbia is also performing well. Employment in Vancouver has been moving higher over the past 12 months and its housing market remains strong. Single-detached housing starts in B.C. show solid gains over the past six months. There has also been a noticeable pick-up in new low-rise home sales in the Greater Toronto Area in early 2015. British Columbia and Ontario are now showing the strongest y/y retail sales increases. Retail sales in the Toronto CMA also show impressive y/y gains. In contrast, Alberta and Saskatchewan are showing pronounced y/y retail sales declines. This is expected to be a continuing pattern in 2015. Ontario and B.C. are now Canada's economic growth leaders. They will benefit further from increasing non-energy exports, the stimulus from low mortgage rates and the positive effect of the low CAD on tourism. In Ontario job growth up to now has been concentrated outside of the Greater Toronto Area. The unemployment rate in the City of Toronto has been moving lower recently but this has not been matched yet in the 905 area.

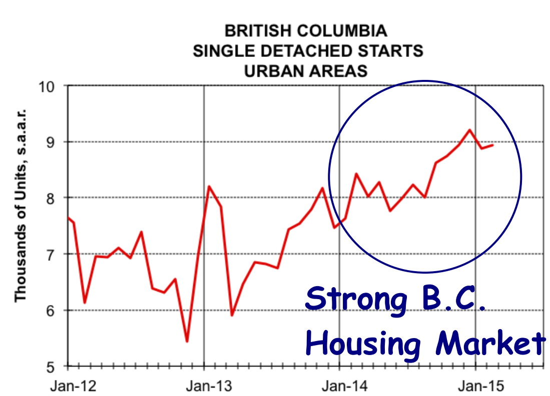












STRONGER U.S. GROWTH THIS SPRING AND SUMMER

1st Quarter Slowdown is Temporary

Peter R. Andersen, Ph.D.

A REPLAY OF 2014: It has been déja` vu all over again. Another severe winter got in the way of the U.S. expansion. The underlying trend – a shift into a stronger growth mode – still seems to be in place though. Last year, a weather shock produced a surprise decline in 1st Quarter real GDP in the United States. This was followed by a strong rebound in the 2nd and 3rd Quarters to growth rates of 4.6% and 5.0%, respectively. This year is shaping up to follow a similar pattern. Real GDP is not expected to show a 1st Quarter decline this year in the U.S. but growth could be under 1.0%. There is always an attempt to adjust economic indicators for seasonal conditions but the adjustment calculations are based on typical seasons.

THE WEST COAST DOCK SLOWDOWN: The winter of 2015, like the one before, was anything but normal. In addition, throw in some other special effects such as a West Coast dock slowdown and the collapse in gasoline prices. There were 29 ports from Seattle to San Diego that were affected by the labor dispute. It had a big effect on U.S. exports and was probably more important for foreign trade than the elevated U.S. dollar. Nonetheless, the USD got much of the blame for softness in net exports in early 2015. The delays, work slowdowns and lockouts at the West Coast ports affected about one-quarter of U.S. international trade. A tentative deal for a new contract was reached in February but it will take many weeks and perhaps months to clear the cargo backlog. The end result has been a depressing effect on a number of closely watched U.S. economic indicators. It has obscured the underlying trend in a wide range of industries and the overall U.S. economy.

RETAIL SALES ARE NOT AS WEAK AS THEY LOOK: The collapse in gasoline prices has also confused economic reporting. Gasoline is sold at many retail outlets in the U.S. – at big box retailers, grocery chains and convenience stores. The drop in gasoline prices has pushed the dollar value of total retail sales down sharply. We can take gasoline service stations out of the total retail sales numbers but it is not possible to separate out gasoline sales by other retailers. The gasoline price collapse is making it look like retail sales have softened because they are measured in dollars, rather than in price-adjusted volume terms. You can be sure however, that people are not buying less gasoline because the price is down. The number of gallons of gasoline purchased has been going up, not down. In addition, the cash savings at the pump are being spent. At about $14 per fill-up, the money is going into small purchases such as restaurant meals, leisure activities and small home improvements.

THERE HAS BEEN A BIG WEATHER EFFECT ON THE U.S. ECONOMY: Boston experienced a once-in-a-century winter snowfall this year (110 inches as of March 21st). Buffalo is not far behind at 109 inches. Snow stretched down the eastern seaboard. Dulles International Airport had about double its normal snowfall. The National Oceanic and Atmospheric Administration (NOAA) officially declared on March 5th that 2015 is an El Niño year. Skiers already knew that.

In addition, it was the coldest combined February and March on record in Massachusetts. Pennsylvania, New Jersey, New York, Connecticut and Rhode Island were also hit by winter storm shocks. It was just as cold in the upper Midwest in 2015 as the year before. Ice coverage on the Great Lakes has been far above normal.

At the beginning of March, three of the Great Lakes (Superior, Huron and Erie) were completely frozen over. The ice coverage for all five of the Great Lakes was 87%. This compares with a historical average ice cover for the Great Lakes in early March of 34%. The point is that the data confirm what you have been thinking. It has been a really tough winter. It is a replay on 2014 and it has had a big temporary impact on economic activity. The seasonal adjustment smoothing just did not work. However, there will be a bounce-back in output and spending this spring and summer.

THE UPTREND IN U.S. OIL SUPPLY MAY SOON BE OVER: It is important to remember that low oil prices are good news for the U.S. economy. The U.S is a big net importer of oil and the benefits of low oil prices far outweigh the negative impact on oil producers. The drilling rig count has declined sharply but U.S. oil production has continued to increase through the week of March 20th. It is the least productive and highest cost wells that are being shut-down. The number of drill rigs in North Dakota has declined to the lowest level in five years. Half of Colorado's rigs have been idled since the end of October.

The Eagle Ford oil rig count is down to 135 at last report. In comparison, it was running at about 250 rigs in 2013 and 2014. Productivity per rig is steadily increasing though. In the Eagle Ford, new-well oil production per rig is estimated by the EIA to be running at 680 barrels per day in April. This compares with 660 barrels per day in March and about 500 barrels per day in March of last year. Production from new wells will continue to increase but production from legacy wells is on a downtrend. The net change could turn negative in April or May. This means that the uptrend in total U.S. oil production could come to an end soon. Outright weekly U.S. oil supply declines could be in place by mid-year. This would provide a big psychological boost to both the price of oil and the Canadian dollar. There is still downside risk for oil and the CAD in April but both could show significant rebounds this summer. The CAD has been tightly correlated with the price of oil since last fall.

HOW HIGH COULD THE PRICE OF OIL AND THE CAD GO? Exxon Mobil CEO Rex Tillerson said recently that North American tight oil supply is more resilient than some people think it is. He has been right so far and he will probably continue to be right. Tight oil producers appear to be opting for a defensive strategy of drilling but not completing wells. The completion part of the process involves the hydraulic fracturing and accounts for about 60% of the total well cost. As the oil market tightens this summer and fall, they will be ready to come back on stream with new production relatively quickly. The futures market contango – a spot price of around $51.43 and an April 2016 future price of over $58 is interesting. However, remember that futures prices are not necessarily good predictors of future spot prices if storage is available. A WTI spot price $10 - $15 higher than today could mean a CAD in the mid-80 cent (U.S.) range. A CAD climb above 90 cents would be harder to achieve.