Vestcap Monthly Economic Report

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HIGHLIGHTS

The contraction in economic activity in the 1st Quarter in the U.S. and Canada was indeed a temporary event. The U.S. economy is on track to rebound to a real GDP growth rate of almost 3.0% in the 2nd Quarter. We are forecasting stronger growth than that in the 3rd and 4th Quarters. Positive employment news in Canada also points to renewed GDP growth.

Consumer spending has surged in the United States. The monthly increase in May was the largest in almost 6 years. Americans are finally spending their gasoline savings. Personal income growth also remained strong in May for a 2nd consecutive month. Wage income growth has accelerated.

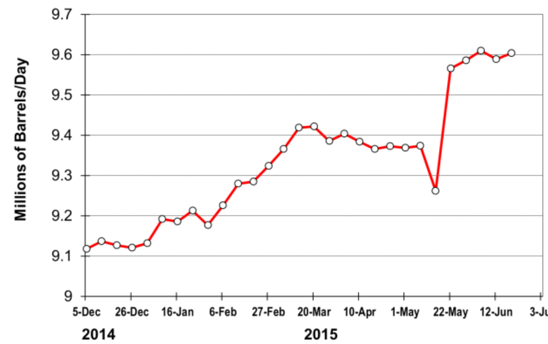
The Fed is in no rush to raise rates. Consumer price inflation remains subdued in the United States. The all-items CPI showed a zero percentage increase over the 12 months ending in May. U.S. consumer prices, excluding food and energy, increased by only 0.1% between April and May. The Fed also wants to see definitive evidence that wages and salaries are growing at a higher rate.

While the employment situation has improved in the U.S., the unemployment rate is still slightly above the full employment range. Job openings are at a record high level but the latest gains have been clustered in a narrow range of industries – retail trade, health care, and professional and business services.

We can expect a big jump in housing starts in the U.S. this summer, and higher levels of construction this fall. Residential permits are giving a very strong message. The latest figures, which are for May, show residential permits in the U.S. running at their highest level since August 2007. Permit issuance increased by 12% from the month before. Construction is expected to make a major contribution to employment growth this summer and fall in both Canada and the United States.

The supply of crude oil has been surprisingly resilient to lower prices. OPEC increased output in May to 31.1 millions of barrels per day – its highest level since 2012. U.S. field production of crude oil rebounded sharply in the week ended May 22nd and has increased since then. Over the 4 week period ending June 19th, U.S. field production of crude oil averaged 9.60 million b/d. This is a y/y increase of almost 14% and is the highest level in more than 40 years.

WEEKLY U.S. CRUDE OIL PRODUCTION



UNITED STATES

Estimates for real GDP growth for the 2nd Quarter have been steadily revised upwards. Total economy growth is now estimated to be almost a full percentage point higher than its long-run average since the economic recovery began 6 years ago. Job growth is providing convincing evidence. It has picked-up again. Payroll employment growth in May exceeded expectations by a wide margin, increasing by 280,000 from the month before. The 4-week moving average for initial unemployment claims remains close to a 15-year low. At the same time, lingering excess capacity in the labor force, soft inflation news and continuing weakness in U.S. industrial sector, mean that the first Fed rate increase could be delayed until December or early 2016. This will keep mortgage rates at low levels and support the U.S. housing recovery. It will also keep Canadian mortgage rates low

CANADA

Exports will have to take on the responsibility of growth leadership but this has not happened yet. May employment figures were a positive surprise though. They indicate a resumption of Canadian economic growth in the 2nd Quarter. There had been worries that the oil shock might produce a 2nd consecutive quarterly decline. Canada produced a net job gain of 59,000 in May. This is a very big number. Private sector employment was the driver. Ontario and B.C. showed near-record job gains. In Ontario, employment increased by 44,000 in May. This pushed its unemployment rate down to 6.5% from 6.8% in April. In B.C. employment increased by 31,000, but unlike Ontario, most of this increase was in part-time work. Ontario is expected to grow by around 2.5%, about the same as last year. Growth in B.C. is expected to be in line with Ontario but many are predicting an outright decline in Alberta's economy.

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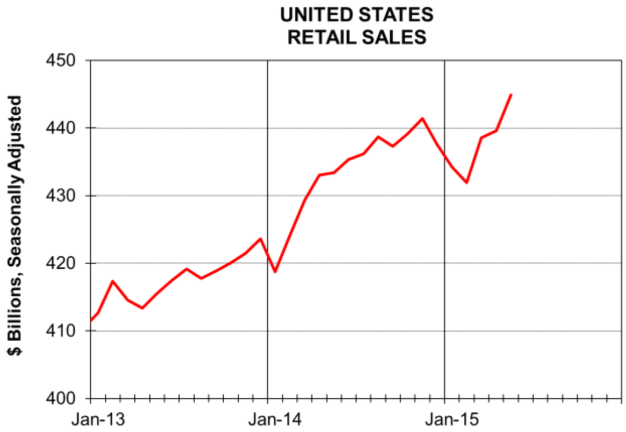
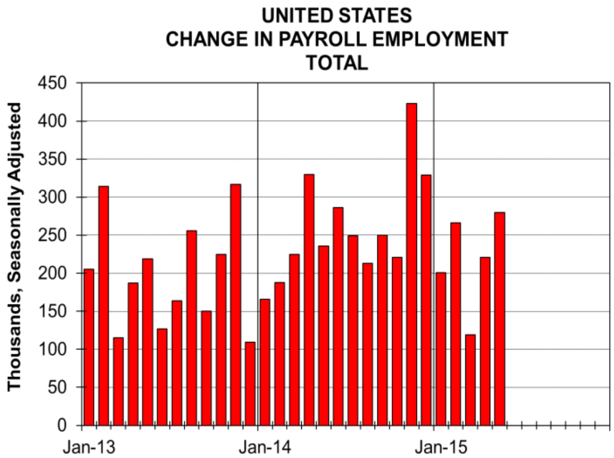
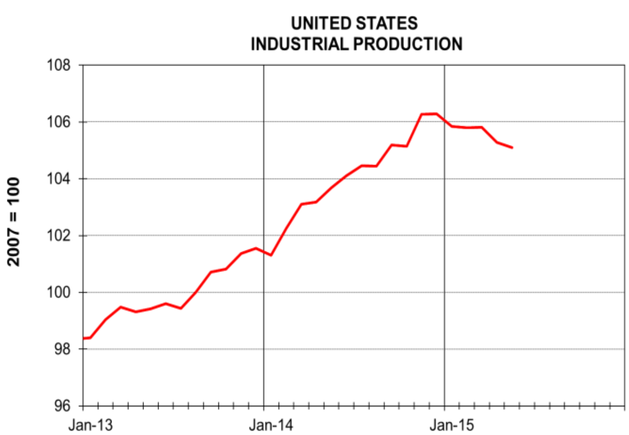
Consumers and home building are behind the pick-up in overall U.S. economic activity. Consumers now have a more upbeat view of household finances. Along with motor vehicle dealers, building materials/supplies and clothing stores showed noticeable gains in May. Over the past 12 months, restaurants/bars and sporting goods stores are retail sales leaders. Americans are spending their windfall on lower gasoline prices. In addition, home sales are now improving.



Total retail sales provided a positive surprise in May, increasing by a hefty 1.2% from the month before. As a result, the longer-term uptrend has been restored. Motor vehicle sales increased strongly in May to 17.8 million units at annual rates – the highest in almost 10 years. This indicates a willingness to make big-ticket discretionary purchases.

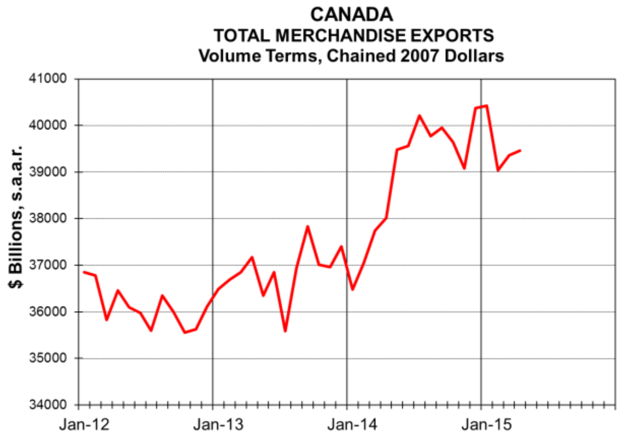


Job growth has picked-up again. Payroll employment growth in May exceeded expectations by a wide margin, increasing by 280,000 from the month before. The 4-week moving average for initial unemployment claims remains close to a 15-year low. The number of job openings increased to 5.4 million in April. This is the highest since the collection of job openings data began in December 2000. However, the increase in job openings is not widespread across industry groups.

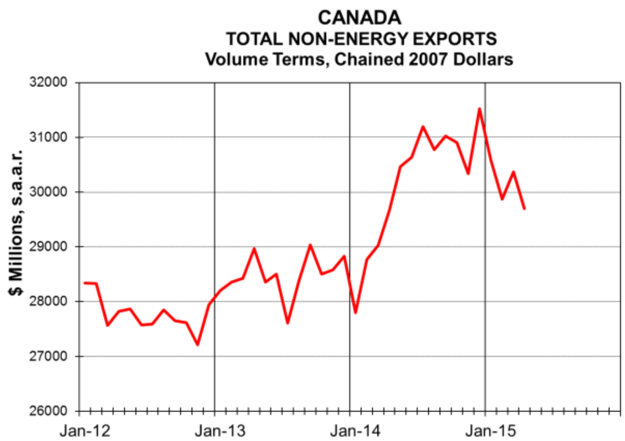


Despite good news from the consumer sector and from motor vehicle sales in particular, industrial production (manufacturing, mining and utilities) has been on a downtrend since December. This could reflect the impact of energy sector cut-backs on demand for equipment and materials. The stronger USD may also be adversely impacting the competitiveness of U.S. manufacturers. Industrial capacity utilization is running 2% below its long term 1972-2014 average,

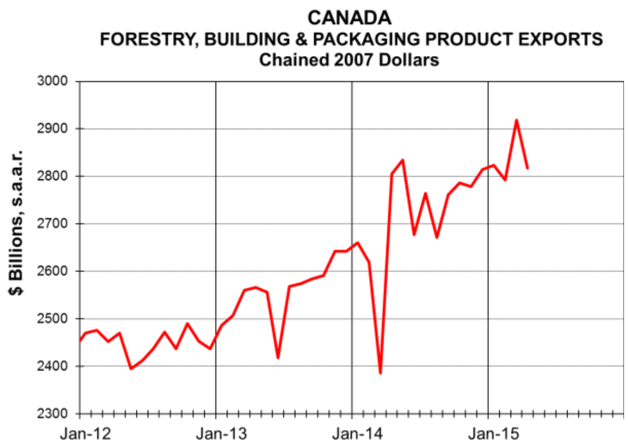
In volume terms, total merchandise exports show no growth momentum at all. The latest monthly number actually suggests a downtrend. The hope has been that Canada's non-energy exports would be revitalized by the combination of lower CAD and the improving U.S. economy. This is supposed to fuel a reawakening in business capital spending and a self-sustaining expansion in jobs, income and output. For now, however, Canada is stuck in the slow growth lane.



Canada's export performance has been disappointing. There has been no volume growth in total merchandise exports since last summer. Canada's energy exports show strong gains though. The latest figures show a hefty 6.6% increase in the number of barrels of Canadian oil exported to the U.S. over the past 6 months. This reflects oil sands project completions but it is unsustainable and is more than offset by weakness in non-energy exports.

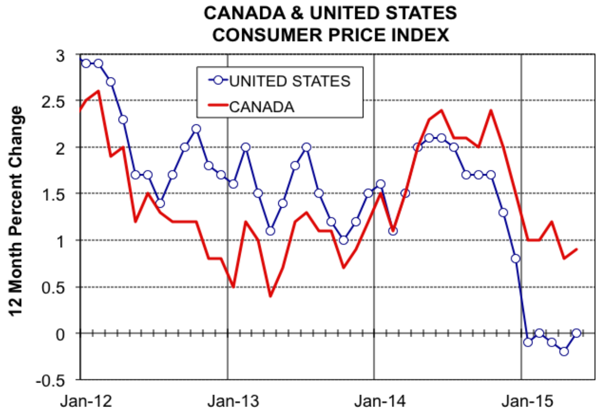


Canada's non-energy exports have been tanking. In volume terms, they have declined sharply over the past 12 months. There are some bright spots but there has not yet been enough support from them to make up for weakness in other non-energy export categories. Even the Canadian auto industry is falling behind. Despite the surge in U.S. motor vehicle sales over the past 3 years, Canadian exports of motor vehicles and parts, measured in volume terms, have been basically flat since 2012.

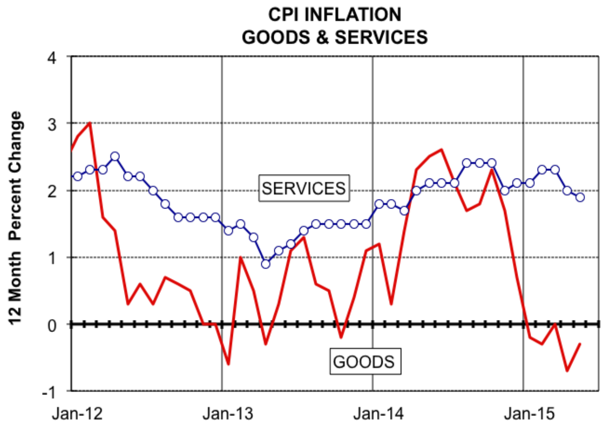


Forestry and building product exports are advancing and so are exports of industrial machinery, equipment and parts. Other non-energy export sectors that are expected to show improved performance soon are fabricated metal products, aerospace, fertilizers and pharmaceuticals.

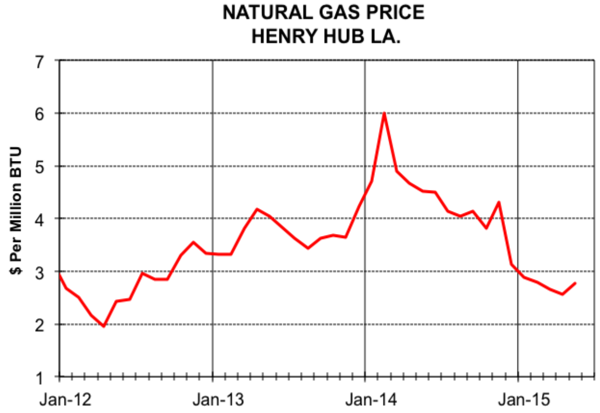
Gasoline prices have moved higher but this reflects isolated outages at West Coast and Midwest refineries. Gasoline prices are expected to decline again soon. Low gasoline prices appear to be here to stay. This will put a low ceiling on the consumer price inflation rate in both Canada and the United States. In addition the strong USD is producing price competition in the United States. Finally, low natural gas prices are producing downward price pressure on electric power prices, chemicals, plastics and a wide range of products.



Both the U.S. and Canada show 12-month increases in consumer prices that are well below official targets. In the U.S., the y/y CPI inflation rate is running at zero. Canada shows a y/y inflation rate of 0.9%. As a result, bond yields have remained at low levels. The current 10-year Government of Canada bond yield is running at only 1.78%. This is 61 basis points below the 2.39% yield on 10-year U.S. Treasuries. These are the rates that drive mortgages. Several major Canadian banks are offering 5-year fixed mortgages at only 2.74%.

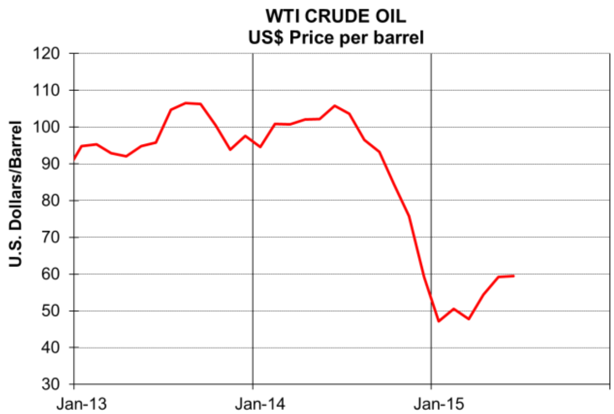


Consumer price inflation in Canada is a mixed picture. Prices of consumer goods actually show outright deflation. This is surprising, given the sharp decline in the CAD. It has made imported goods from the U.S. more expensive. However, there is obviously an offset from price weakness elsewhere. Prices of consumer services are continuing to run at around a 2.0% y/y inflation rate. This stability reflects government taxes and charges and administrative pricing.

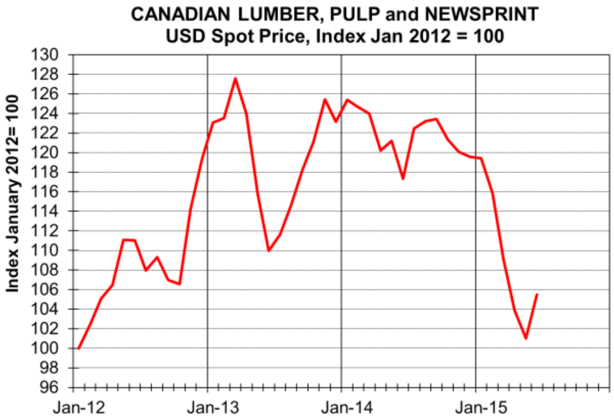


Natural gas prices have a direct and indirect effect on a wide range of other prices. The North American natural gas market appears to be in a long-term oversupply condition. Benchmark natural gas prices are running well below 2014 levels and are not expected to recover for a number of years. As a result, North American manufacturing is expected to have a long-term competitive energy cost advantage with manufacturers in Europe and Asia.

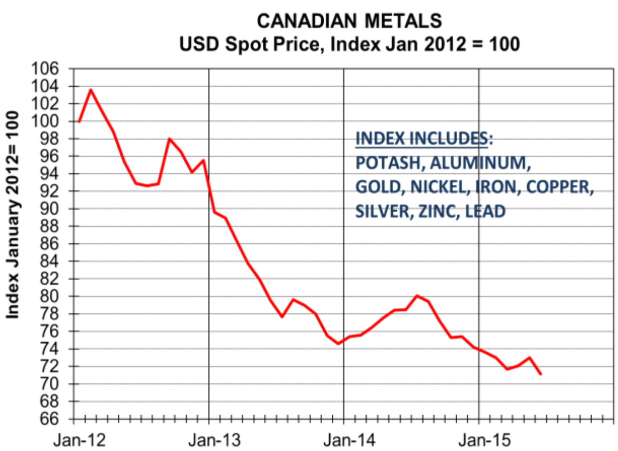
The global oil market remains seriously over-supplied. Brent and WTI oil prices have fluctuated in the $60 to $63 range though. This reflects an embedded risk premium, caused by worries of unplanned supply disruptions in the Middle East and North Africa. There is still an expectation that U.S. tight oil production will decline in July and August. However, recent increases are casting doubt on this. It is beginning to look like lower gasoline prices are here to stay.



There is still significant downside risk in oil prices. This means that there is also downside risk in the Canadian dollar. The CAD has been closely correlated with the price of oil for some time now. The supply of crude oil has been surprisingly resilient to lower prices. Global inventories show steady growth.



Forest product prices have declined over the past 3 months. However, there are now early signs of an upturn. Lumber prices have started to move up again. Residential building permits, which indicate intentions to build, are running at their highest level in the U.S. since August 2007. Multifamily permits are the highest in 25 years.



Commodity prices are a leading indicator for consumer price inflation. With some exceptions, such as lumber, they are pointing to a continuation of a low inflation environment in Canada and the United States. There have recently been further downward revisions to the outlook for world economic growth. Metals prices that are of strategic importance for Canada have been trending downward since last summer.