Vestcap Monthly Economic Report

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HIGHLIGHTS

China's growth slowdown and an elevated USD, stemming from a floating yuan and its spinoff effects on other emerging market currencies, is a big negative for all internationally traded commodities – both energy and non-energy.

The yuan devaluation says that China's economy is in trouble and needs help. The Shanghai stock market sell-off is a sharp one if you measure it from its June peak. It is a different matter though if you look back 12 months. The Shanghai composite index was at 2,306 on September 5th, 2014. It is now at 3,160..

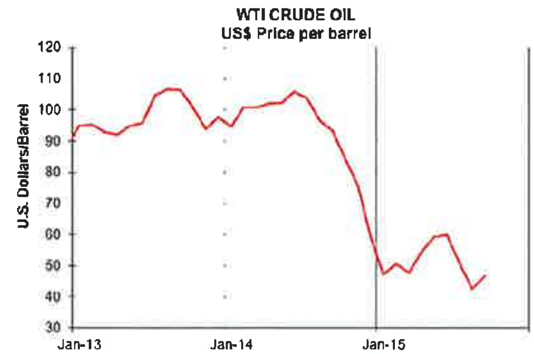
None of these developments mean much for the U.S. economy. America's big exports to China are mainly junk (scrap metal) and soybeans. The stock market sell-off won't is unlikely to derail the U.S. economic expansion. It is not a signal of U.S. weakness or a U.S. recession. It reflects problems in China, rather than in the United States.

Oil producers will keep increasing output as long as the price exceeds the marginal cost of production, which is very low. OPEC production has increased. In addition, re-fracking has destroyed the long-held view that shale oil has a short reserve life.

Cheaper oil reflects supply issues, not weakness in underlying U.S. demand. The growth slowdown in China is behind the stock market sell-off but it is not a systemic global risk. The effect of the Shanghai stock market crash is greatly over-rated. China's stock market is small, has few participants, and is not important for business financing.

The oil price collapse will have a regional impact on the U.S. economy, but as a net oil importer it will benefit consumers and manufacturers. Canada's situation is different. While Canada's economy has contracted for two consecutive quarters, the downturn is attributable to the resource producing regions.

In the rest of Canada, growth has been maintained at a moderate rate through the first 6 months of 2015. Economic activity is actually picking up now in the manufacturing sector. The aggressive interest rate reductions by the Bank of Canada have been a factor pushing the CAD lower, and non-energy exports are beginning to show a positive response.



UNITED STATES

The August U.S. payroll employment report shows a continuing improvement. The increase of 173,000 in seasonally adjusted non-farm payroll employment was less than expected but is still a positive report. August is notorious for big positive upward revisions. The response rate to the survey was the lowest for any August since 2005. It will be higher when the second estimate is released a month from now, and an upward revision is likely. The U.S. job market is moving closer to full employment. The 5.1% seasonally adjusted unemployment rate in August is the lowest since April 2008. Average hourly earnings increased by more than expected. In addition, the number of hours worked per week increased. We are counting on consumer spending and housing construction to produce a solid rate of real GDP growth of around 3.0% annualized in the 4th Quarter.

CANADA

While Canada's economy has contracted for two consecutive quarters, it is still too early to say that it is actually in a recession. Economic indicators do not indicate a broadly-based decline. The weakness is concentrated in oil and gas extraction, energy-related construction and manufacturing. Surprisingly, the unemployment rate in Alberta remained unchanged in August and actually declined in Saskatchewan and Newfoundland. Fortunately, Canada's exports have finally begun to pick-up. Non-energy export volumes now show solid consecutive gains for June and July. Motor vehicles and parts, consumer goods, aircraft and other transportation equipment are driving the export revival. Aggressive interest rate reductions by the Bank of Canada have been a factor pushing the CAD lower, and non-energy exports are now responding. Energy export volumes have held up well and are running above last year's levels.

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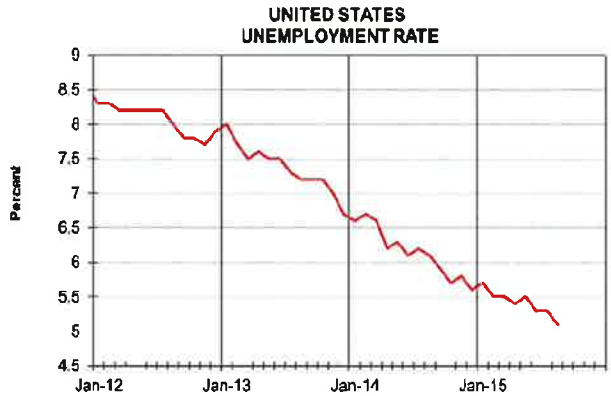
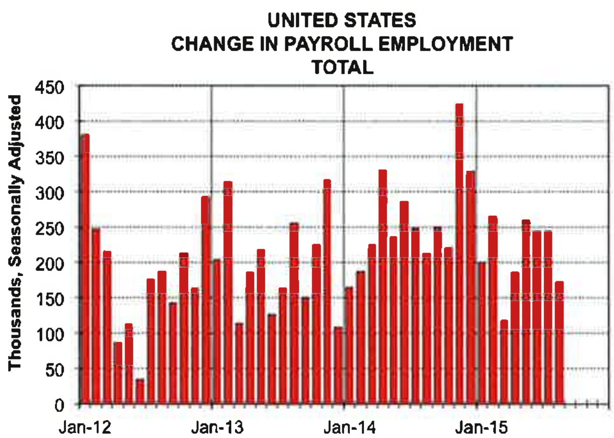
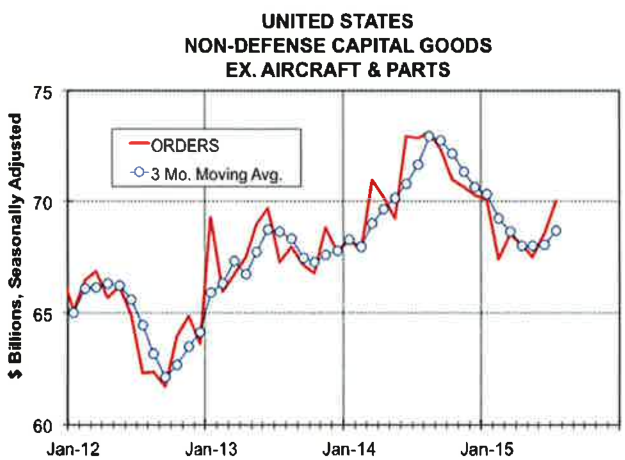
The U.S. expansion will last long enough for Canadian exports to recover. Real GDP growth is expected to accelerate after an inventory related slowing in the 3rd Quarter. Consumer spending will be a driver. July retail sales were stronger than expected. The housing sector is definitely picking-up. July housing starts are the highest since October 2007



The U.S. economy is gradually reaching full-employment. The unemployment rate in August, at 5.1% seasonally adjusted, is the lowest since April 2008. However, given the high degree of stock market volatility, the Fed may decide to hold off from raising rates at its September 16-17th policy meeting. Low energy prices are also feeding into core inflation. The strong USD and low inflation could also cause the Fed to delay raising interest rates.

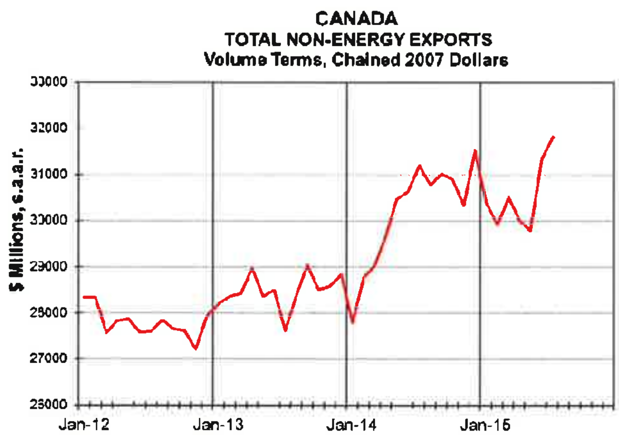


Non-farm payroll job growth in August, at 153,000, was less than expected but an upward revision is likely when the September data is released. Job growth in June and July was revised upwards by a combined 44,000. The 4-week moving average for new unemployment insurance claims is running at a level consistent with job growth of over 200,000 per month.

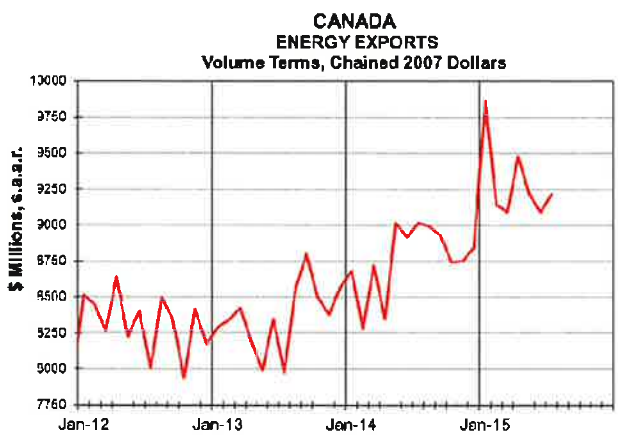


Manufacturers' new order bookings are improving. Total orders increased by 0.4% in July, which was more than expected. The increase in June was also revised higher. Core capital goods orders (excluding defense and aircraft) rose by 2.1%. This was their strongest monthly increase this year. This suggests that business confidence is strong enough for an increase in capital budgets.

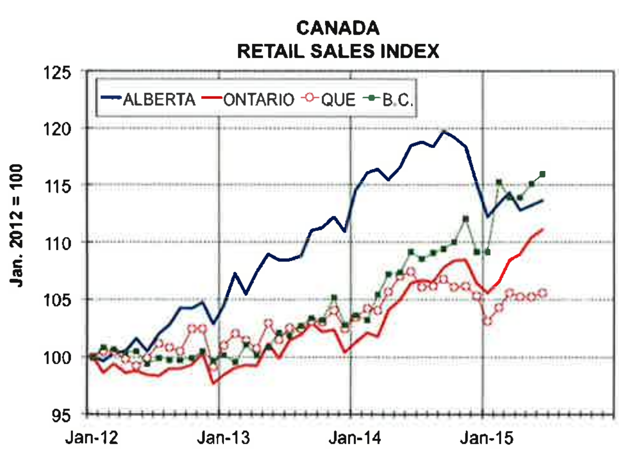
There is evidence this summer that economic activity is actually picking up in the manufacturing sector. Wholesale trade is trending higher and manufacturing sales have stabilized, pointing to an improvement in economic conditions in Ontario and Quebec. Provinces such as Ontario, Quebec and British Columbia will also benefit from the effect that low oil prices are having on consumer purchasing power.



In price-adjusted volume terms Canada's non-energy exports have finally begun to pick-up. This reflects the decline in the CAD against the USD as well as an improving U.S. economy. Export sectors that should be particularly sensitive to the decline in the CAD are heavy trucks and buses, clothing and textile products, furniture and fixtures, and building and packaging materials. Also expected to benefit are tourism, pharmaceuticals, aerospace and fertilizers.

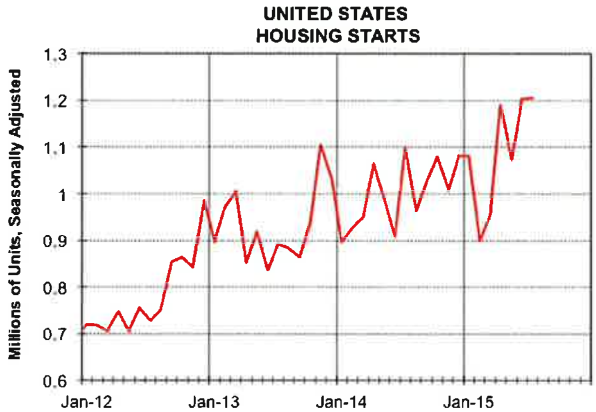


There is a bad news/good news mix in Canada's energy sector. There is no relief in sight yet for oil prices. They still have significant downside risk. Energy exports are doing surprisingly well though. They are holding up in volume terms and are running well above 2014 levels. However, resource related business investment is plunging. Investment in the oil & gas sector could contract by about 40% this year. Firms in the non-energy commodity sector are also making big reductions in capital outlays.

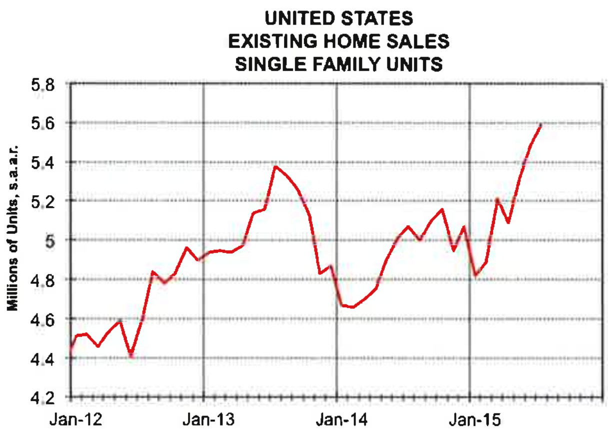


Consumer confidence remains high in Canada's oil consuming provinces. Retail sales are performing well in Ontario and British Columbia. Growth in wage income outside of oil & gas extraction and the mining sector is still running at rates of increase seen before the oil price crash. Sales of existing homes and new motor vehicles in oil- consuming provinces are up from last November, when the oil downturn was just getting underway.

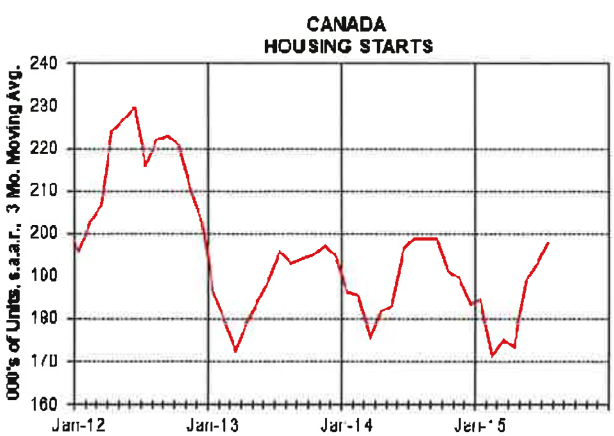
The stock market crash is having a big effect on longer-term interest rates. This will flow directly into mortgage rates in both Canada and the United States. The panic selling of stocks has created a stampede into government bonds. Several of the big Canadian banks have been offering 5-year fixed mortgages at a historically low 2.69%.



The recent advance in U.S. housing starts puts them at their highest level since the U.S. housing recovery began. Single-family starts are now providing important momentum. This category had been lagging behind the recovery in multiple-unit starts, which in the U.S. largely reflects rental, rather than ownership demand. We are forecasting a continuing uptrend in U.S. housing starts.



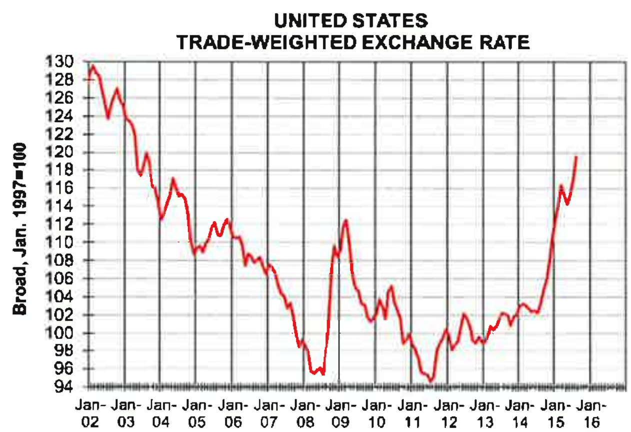
The U.S. housing market has performed well this summer. The existing housing market has continued to tighten. The improving job market, along with low mortgage rates is expected to sustain the upward trend in existing home sales. A majority of loan officers are easing credit conditions for private and government insured mortgages. New home builder confidence has increased to a post-recession high.



Housing starts in Canada have been higher than expected. Single-detached housing starts in Ontario have held up at healthy levels over the past 3 months. Vancouver shows an impressive YTD advance in single-detached housing starts compared to last year. This contrasts with sharp declines in the Prairies. Retail sales at hardware-type stores are a proxy for do-it-yourself renovation and they are in an impressive upturn. The outlook for renovation spending in Ontario and B.C. is positive.

The collapse in oil prices is having spill-over effects on other non-energy commodities. The elevated USD is also having a negative effect on many commodity prices. Commodity-producing emerging market countries are experiencing weaker economic growth. China and the EMEs have been the main source of global economic growth since the financial crisis of 2007-2009. The message is clear – the world economy is in a major economic slowdown.

Copper prices, which are a proxy indicator for China's economy, have plunged to their lowest level since early 2009. There is no doubt that China's economy is still slowing down. The August purchasing managers' index for China was running at its lowest level since 2009. The yuan devaluation gives the message that its economy is in trouble and needs help.



Expectations of Fed interest rate increases have been a major factor pushing the USD to its highest level since 2003. Most other countries, with the exception of the U.K., seem intent on providing more monetary stimulus, not less. The USD is also moving higher in response to concerns about the global economy, international geopolitical risk, and safe-haven capital inflows.

There are mixed signals coming from Europe. Despite continuing GDP growth, industrial production in the 19-member Euro Area slipped below its 1st Quarter average in June. The European Central Bank has downgraded its projections for both growth and inflation. Mario Draghi, President of the ECB, has responded by announcing an extension to its asset purchase program. This has pushed the EUR sharply lower against the USD.