FCC Economic & Financial Market Update

2021 Q1

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Outlook

The rollout of the COVID-19 vaccines is creating optimism for the Canadian and global economies. However, a full recovery will depend on the removal of restrictions. Monetary and fiscal support will remain very important to the health of the Canadian economy and its recovery. GDP is expected to grow by 4.7% in 2021, led by the rebound in service industries. Inflation is expected to come in at 1.7% for 2021. Expect higher inflation in industries like food and construction. The Bank of Canada (BoC) overnight rate is expected to remain unchanged in 2021 at 25bp.

GDP

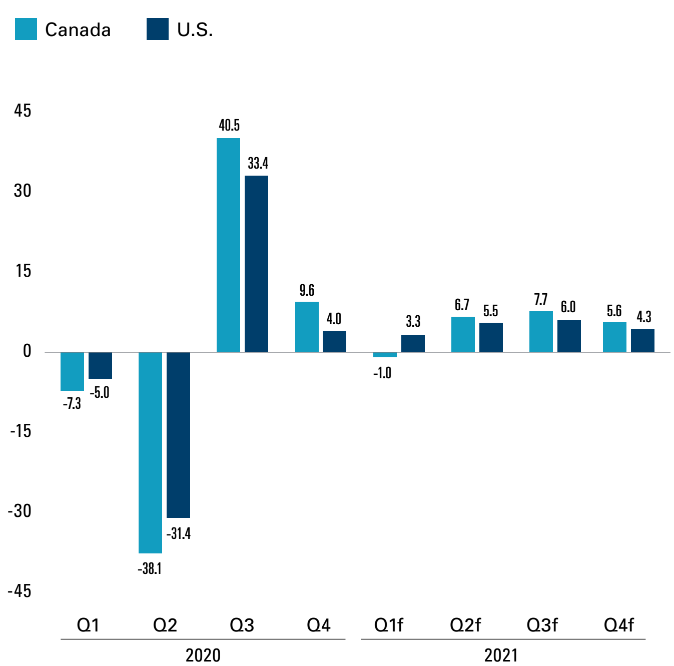
GDP will decline in Q1 2021 due to COVID-led economic restrictions. The consensus forecast calls for economic growth to pick up steam in Q2 and finish the year 4.7% higher year-over-year (YoY). A lot hinges on a successful rollout of vaccines and the re-opening of the economy. A full recovery in which GDP reaches the level observed before the pandemic is expected in early 2022.

Service sectors, tourism, travel, and oil industries are expected to lead growth as social distancing rules ease and global oil demand increases. U.S. GDP growth in 2021 is expected to slightly outpace that of Canada, especially if President Biden's economic aid package goes through.

The aggressive fiscal and monetary stimuli have put a subset of Canadian households in a better position, which is projected to assist growth. Canadian consumer debt fell while savings increased in 2020 as leisure spending declined and the Canadian Emergency Response Benefit (CERB) assisted those in need. There are strong signs of pent-up demand, which could benefit the Canadian foodservice sector and tourism once unleashed.

Figure 1: Q2 quarterly GDP growth could be very strong

Quarterly real GDP quarter-over-quarter percent change
Seasonally adjusted at annual rates



Source: Bloomberg

Table 1: Foodservices led the year-over-year dollar decline in 2020 GDP

Industry (millions)	YoY $ change	YoY % change	% of total decline
All industries	-108,397	-5.4	-
Foodservices and drinking	-8,975	-29.7	8.3
Ambulatory health care	-7,735	-14.1	7.1
Oil and gas extraction	-7,186	-6.3	6.6
Air transportation	-7,135	-72.3	6.6
Administrative and support services	-6,355	-14.1	5.9
Food and beverage stores	710	3.8	-0.7
Non-store retailers	911	21.3	-0.8
Federal government public administration	986	2.0	-0.9
Crop production	2,662	8.6	-2.5
Real estate	5,722	2.4	-5.3

Source: Statistics Canada

Central Bank Policy

Interest rates and core inflation

The Bank of Canada (BoC) and the U.S. Federal Reserve have indicated that their policy rates will continue to be near zero until 2023. No surprise, then, that we forecast the overnight rate to remain at 0.25% throughout 2021. The yield curve has steepened over the previous weeks providing optimism around the economic rebound. The five-year yield that can be used as a proxy for mortgage and financing rates moved up but remains historically low (Figure 2).

Future rate increases will be determined by the speed of economic expansion and inflation. The CPI-common core inflation (excluding food and energy) was 1.3% in January. We expect to see YoY inflation move near or above 2% in the spring and into summer. The annual consensus for 2021 is 1.7%. Rethinking global supply chains and focusing on buying local will create some local inflation, but effects are not estimated to remain in the long run. Deflationary pressures in services and manufacturing will persist until businesses function near or at capacity.

Figure 2: 5-year government bonds yield remains historically low

5-year government bond yield

Source: Statistics Canada

When the economy fully re-opens, the expansion of consumer spending across industries should alleviate demand pressures in some areas (e.g., home renovations, packaged goods) and provide much-needed demand to others (e.g., accommodation services, salons). This will put us back to an aggregate supply/demand equilibrium that supports stable inflation. The best indicator of true inflation will be in the fall and winter months of 2021, after a full year of stimulus has been realized. Expect the BoC and U.S. Federal Reserve to keep a close eye on core measures of inflation at that point.

Table 2. All-item CPI inflation should rebound but stay below 2% by year end

	2020				2021			
	Q1	Q2	Q3	Q4	Q1f	Q2f	Q3f	Q4f
Canada	1.8	0.0	0.2	0.8	1.0	2.2	1.9	1.8
U.S.	2.1	0.3	1.2	1.3	1.8	2.9	2.3	2.2

Source: Bloomberg

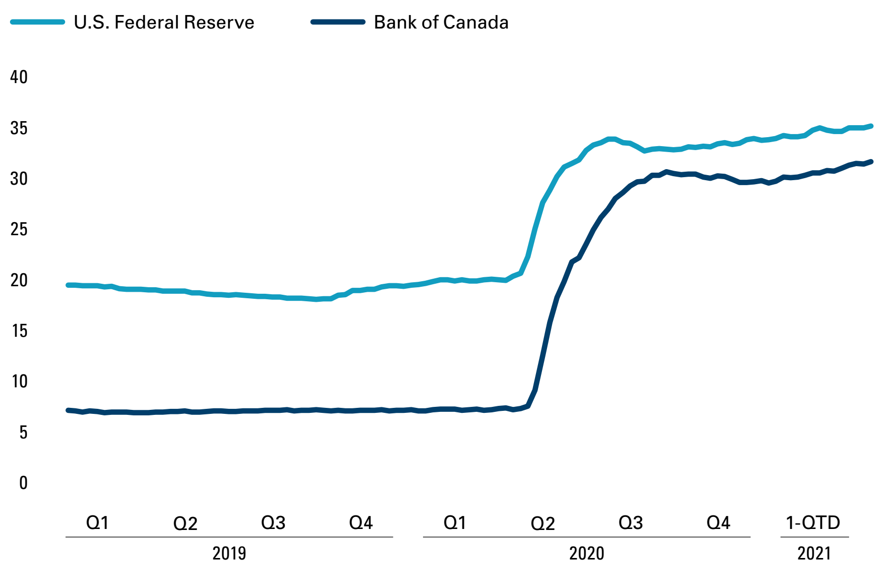
Central Bank asset purchases to be scaled back before a future rate increase

The BoC's and the U.S. Fed's asset purchasing programs have injected capital and thereby ballooned their balance sheets to lessen the blow of the Great Lockdown recession (Figure 3). Canada began the recession in a better position relative to other countries whose use of quantitative easing has continued since 2008-09. We expect that these programs will be halted or substantially reduced before major movements in interest rates. This will be the first sign of a forthcoming rate increase as it would show stability in capital markets and the economy.

Figure 3. Canadian central bank assets as a per cent of GDP remain below the U.S. level

Central Bank assets as a per cent of Q3 2020 GDP

Annualized constant prices



Source: Statistics Canada, Federal Reserve, Bank of Canada

Exchange rates

USD per CAD

The Canadian dollar is projected to average $0.793 in 2021 (Table 3), declining slightly in the second half of the year after peaking in Q2. The current strength in the Canadian dollar is really about weakness in the U.S. currency. Future currency movements will depend on Canada and the U.S.'s ability to re-open their economies and optimize both the vaccine rollout and the level of stimulus spending.

A full economic opening will increase demand for oil supporting the CAD, but the expectation that OPEC countries will eventually increase supply could put downward pressure on prices. Under these conflicting dynamics, oil prices are expected to see little average quarterly change, generating little movement in Canadian dollar value.

Table 3. Canadian dollar estimated by FCC to average $0.793 in 2021

	2020				2021			
	Q1	Q2	Q3	Q4	Q1f	Q2f	Q3f	Q4f
USD per CAD	0.745	0.722	0.751	0.768	0.789	0.797	0.795	0.793

EUR per CAD

It will be important to monitor Europe and North America's recovery as investors continue to seek high returns by increasing positions in riskier European markets. Lockdowns in Europe continue to limit economic upside, with projections dimmer than those for North America.

GBP per CAD

With the U.K. on pace for a full vaccine rollout by summer, there's optimism across the Atlantic for a quick recovery and a strengthening pound. Underscoring this optimism, the Bank of England has indicated that it won't rush to negative interest rates. While double-dip recession fears have been put aside when Q4 2020 GDP growth was reported as positive, GDP in Q1 2021 is likely to decline. And significant uncertainty remains about future relations between the U.K. and the EU.

JPY per CAD

The CAD recorded gains relative to the yen in the second half of 2020 (Table 4) as investors moved to commodity-heavy currencies. The future of this rally will largely depend on the price of oil. The Bank of Japan increased its growth forecast in its January update and left its policy rate at -0.1%. Internally the bank will be discussing ways to scale back its control of the yield curve. Doing so in the current environment may fail to prop up the economy and could put downward pressure on rates and the yen.

Table 4. Historical currency rates per CAD for EUR, GBP and JPY

	2019				2020				2021
	Q1	Q2	Q3	Q4	Q1f	Q2f	Q3f	Q4f	1-QTD
EUR per CAD	0.662	0.665	0.681	0.684	0.675	0.655	0.642	0.644	0.648
GBP per CAD	0.578	0.582	0.614	0.589	0.582	0.582	0.581	0.581	0.573
JPY per CAD	82.86	82.17	81.31	82.34	81.10	77.64	79.67	80.18	82.14

Commodity cost pressures mounting

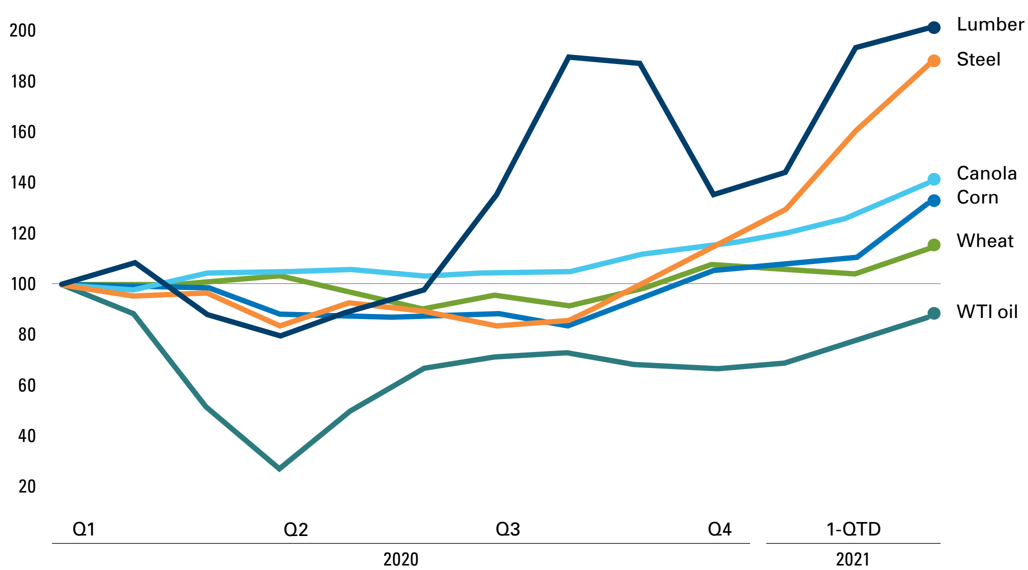
At the forefront of commodity price inflation is a surge in Chinese demand, with imports of metals and agricultural commodities rising over 10% in 2020 YoY. Domestic steel production was cut to lessen their carbon footprint and import restrictions were eased. For agricultural commodities, the trade deal with the U.S. and the rebuilding of the hog herd increased corn and soybean imports in a year with tight global supplies. The increase in ag exports to China is expected to remain strong in 2021.

Global governments' spending targeted at aging infrastructure could further support lumber and steel prices. Industrial data shows there is enough capacity to meet demand if production ramps up to pre-2020 levels. Oil prices have risen but are expected to remain below pre-2015 highs of over US$90.

Strong commodity prices (Figure 4) and higher labour costs are expected to make their way into the grocery and foodservice sectors. Food inflation is expected to finish the year 3-4% above 2020, keeping trend with the last 12 months, where food prices have increased 1.9% more than non-food items.

Figure 4. Commodity prices on a run since Q2 2020

Index of major commodity prices (January 2020 = 100)



Source: Quandl, Federal Reserve, Statistics Canada

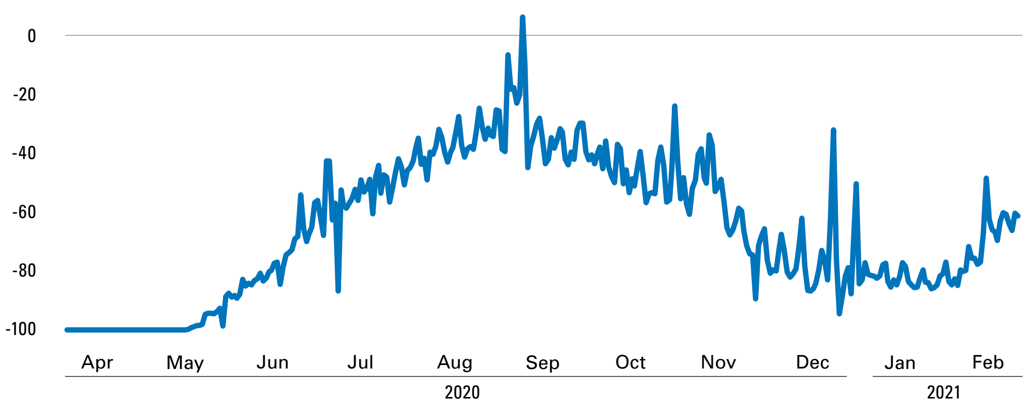
Beverage demand to fuel foodservice growth

Foodservice businesses and businesses whose sales consist primarily of beverages (alcoholic and non-alcoholic) saw the largest dollar declines in Canadian GDP in 2020, falling 29.7% YoY for the first three quarters. The persistence of COVID-19's second wave has caused significant financial strain to the industry. A full rebound will depend on the safe removal of social distancing rules, the number of establishments able to open their doors and the size of pent-up consumer demand. This rebound is not expected until the latter half of 2021, with annual revenues not expected to reach 2019 levels until 2022.

Alcohol represented 20% of pre-pandemic restaurant revenues on average. Restaurants and beverage-serving businesses had the largest YoY decline, suggesting that the resurgence of camaraderie over drinks will provide growth. Expect smaller menu options and appetizers capturing a larger share of consumer dollars (with greater margin opportunities). Breweries, wineries, distilleries and restaurants across Canada will play a part in the good-news buy-local growth story.

Figure 5. Restaurant reservations remain low despite re-openings in some provinces

Canadian foodservice reservations, year-over-year percent change



Source: Open Table

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