BC ECONOMIC REVIEW AND OUTLOOK

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B.C.'S OUTLOOK STILL DECENT AS REAL ESTATE BOOM UNWINDS

HIGHLIGHTS

- Global growth is expected to downshift in 2019 followed by a slight pick-up in 2020.
- The U.S. remains on a firm footing, but is also slowing compared to 2018.
- Canadian GDP growth will slip to 1.5% in 2019 due to the difficulties facing the energy sector and the moderation in U.S. economic growth. Consumer spending growth and activities tied to residentially-secured credit will also be weaker, largely because the era of ultra-loose monetary and credit policies came to an end in 2017-2018.
- The Bank of Canada has shifted from a hawkish to a dovish stance over recent months and now appears likely to leave the policy rate unchanged this year.
- We still expect the B.C. economy to grow by more than 2% this year and in 2020 as well. Some economic indicators have improved recently, but the still-unfolding slowdown in the real estate sector means we have left our GDP growth forecast unchanged from last quarter.
- The downturn in housing resales and related consumer spending is a drag on GDP growth. B.C. consumers have tightened their belts and most segments of retail sales have slowed.
- Non-residential construction activity is elevated, helping sustain B.C.'s respectable economic expansion.
- Conditions in the province's export sector are mixed; the weak currency is a plus, but the softer external backdrop is weighing on merchandise exports. On the other hand, tourism and other service exports continue to expand.
- LNG will boost provincial growth this year and provide a bigger lift in 2020.

WORLD GROWTH IS MODERATING

The global economy is cooling. Global real GDP growth is expected to ease to 3.3% in 2019 and 3.4% in 2020, as the effects of tighter monetary policy in some advanced economies, the adoption of more stringent European automobile emissions standards, and uncertainty about trade restrictions and Brexit weigh on trade, investment and confidence. These negative factors are somewhat offset by improving labour markets and, in recent months, by several central banks shifting to a more dovish approach on monetary policy. The projected slowdown in 2019 economic activity is broad-based across most advanced countries as well as China.

U.S. GDP growth remains solid, albeit slower than in 2018 as the effects of earlier fiscal stimulus fade and tighter monetary policy takes its toll. Ten-year U.S. Treasury yields plummeted from a seven-year high of around 3.2% in November to 2.4% in March, putting them on par or slightly below yields on short-dated Treasuries. This could indicate investors expect slower economic growth going forward. British Columbians think of inversion as a layer of foggy cold air trapped in a valley by a layer of warm air, but economists see inversion in the yield curve as much less benign. Sometimes, but not always, flipping to a downward-sloping yield curve can portend an economic slowdown or recession within about a year.[1]

[1] The slope of the yield curve is the difference between long-term and short-term yields for bonds of the same credit quality. The slope summarizes much information about the future state of the economy, inflation expectations and risk premia into a single indicator. Historically, an inverted slope (long-term yields less than short-term yields) tends to predict economic downturns within about a year. However, the slope can shift for several reasons, so its predictive ability has to be interpreted with caution (see Benzoni et al. 2018).

A mitigating factor in this case could be the whipsaw in Federal Reserve (and other central banks') communications in just a handful of months about the pace and extent of interest rate normalization. In the second half of 2018, central banks — especially in the U.S. and Canada — were signaling that the era of loose monetary policy was over, and that several more rate hikes were needed to reach a "neutral" policy rate range.[2] Now, policy rates appear to be on hold and look set to remain below-neutral until better data emerges. At the very least, changes in the yield curve in 2019Q1 are signaling that the risks to the economic outlook are weighted to the downside. (**Figure 1** shows the tumble in 10 year Canadian bond yields).

TABLE 1: **GLOBAL ECONOMIC FORECAST (ANNUAL % CHANGE IN REAL GDP)**

	2018	2019f	2020f
World	3.6	3.3	3.4
U.S.	2.9	2.6	2.2
Canada	1.8	1.5	1.9
Euro area	1.8	1.0	1.2
Japan	0.7	0.8	0.7
China	6.6	6.2	6.0

f - forecast

Source: OECD, IMF (for Canada).

TABLE 2: **CANADIAN GDP GROWTH (ANNUAL % CHANGE IN REAL GDP)**

Projected Growth Rate	2018	2019f	2020f
Potential GDP	1.5 to 2.1	1.4 to 2.2	1.3 to 2.3
Actual GDP	1.8	1.5	1.9

f - forecast

Source: Bank of Canada January 2019 MPR (potential GDP), IMF (actual GDP).

CANADIAN GROWTH DIPS IN 2019

Canadian GDP growth is projected to slow to 1.5% in 2019 before improving to 1.9% in 2020, the latter being roughly in line with estimates of potential GDP growth (**Table 2**).[3] Contributing to the dip in 2019 are the temporary, mandated oil production cuts in Alberta and excess capacity in the energy sector. The energy sector directly contributes about 11% of national GDP, hence the impact is material. Slower U.S. economic growth will also provide less of a tailwind for non-energy exports.

Canadian consumption and housing-related activities are also softening, largely because the era of ultra-loose monetary and credit policies came to an end in 2017-2018. Households are tightening their belts as the tailwind from leverage-fueled housing equity gains peters out. It is early days in the deleveraging process. Most measures of wage growth are only marginally positive in real terms (i.e. after inflation). It is likely to be a long, slow process for many households seeking to reduce their debt and repayment burdens relative to their incomes.

The Bank of Canada's spring Business Outlook Survey suggests firms are not overly optimistic about an improvement in sales growth over the next 12 months. Firms in the energy and housing sectors expect sales to remain weak or deteriorate further. Firms' investment and hiring intentions "remain healthy outside the Prairies." However, pressures on capacity and binding labour shortages are much less widespread than in recent past surveys. Taken together, the responses are consistent with a cooling in Canadian economic growth in 2019.

Arguably, however, insufficient demand seems a second-order problem for the Canadian economy. The larger, more fundamental problem is the lack of growth on the supply side, mainly due to anemic labour productivity growth. **Table 2** shows potential GDP growth. At best, the Canadian economy can only sustain growth of 1.3-1.5% to 2.1-2.3% per annum without driving higher

[2] A neutral interest rate is the interest rate considered necessary to keep inflation stable and on target with an economy at full employment. At this point (or range), monetary policy has neither an expansionary nor contractionary influence on the economy.

[3] Potential GDP is the product of labour productivity (output per hour worked) and total hours worked. Growth in potential GDP is the natural "speed limit" on actual GDP growth. The economy cannot grow faster than potential GDP without generating higher inflation (except perhaps for a brief period as the economy soaks up any under-employed capital and labour). To stabilize inflation around the 2% target, monetary policy tries to minimize the gap between actual and potential GDP.

inflation. By historical standards, that's a paltry range for economic growth. But right now, it's the best the country can hope for.

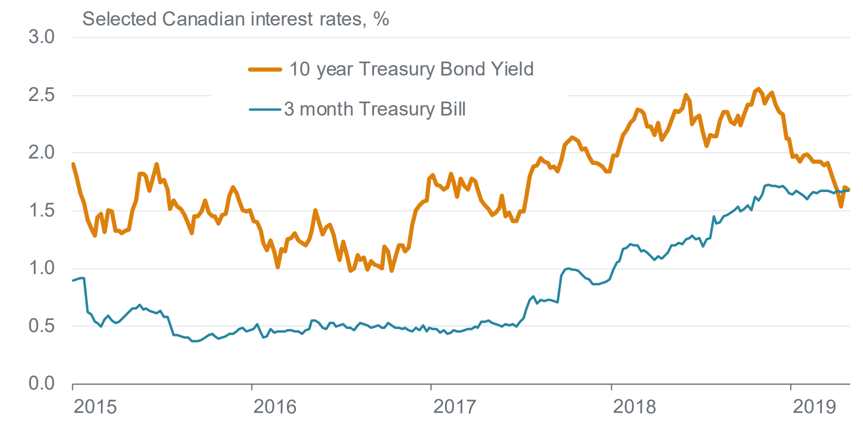
Indeed, from a supply side perspective, Canadian GDP growth appears to be firing on one-cylinder: population growth. Population growth raises GDP, but not GDP per person. The latter is a key measure of living standards. The Canadian economy is getting bigger due to its bigger population, but this is not translating to higher living standards. In fact, recent growth in real GDP per person is close to zero (**Figure 2**). The arithmetic helps to explain why people nowadays seem increasingly skeptical about whether economic growth delivers improved individual prosperity.

The vital, missing ingredient in Canada's macroeconomic growth strategy is labour productivity (GDP per hour worked). Labour productivity growth has been modest over the past decade and shuddered almost to a halt in 2018 (**Figure 3**). The corollary is that even if the temporary demand-side drags on the economy abate, allowing the economy to grow in line with its potential GDP, this would still be an historically feeble rate of growth – especially on a per person basis. There is little prospect of meaningfully higher growth in GDP, GDP per person or workers' real wages without a sustained, material improvement in Canada's labour productivity growth rate.

B.C. WILL CONTINUE TO GROW AT A RESPECTABLE RATE, DESPITE THE UNWINDING OF THE REAL ESTATE BOOM

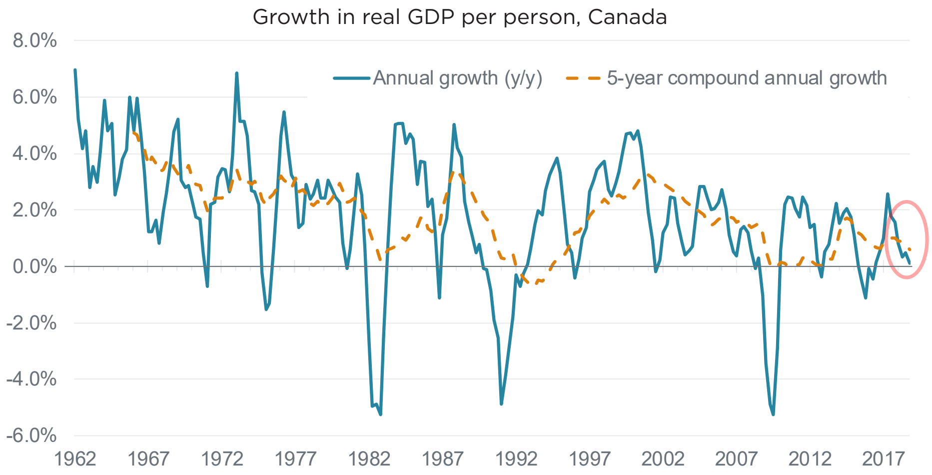
In our previous outlook, we forecast B.C.'s economy to gear down slightly in 2019, but still grow at a respectable

FIGURE 1: **CANADIAN 10 YEAR BOND YIELDS TUMBLE**



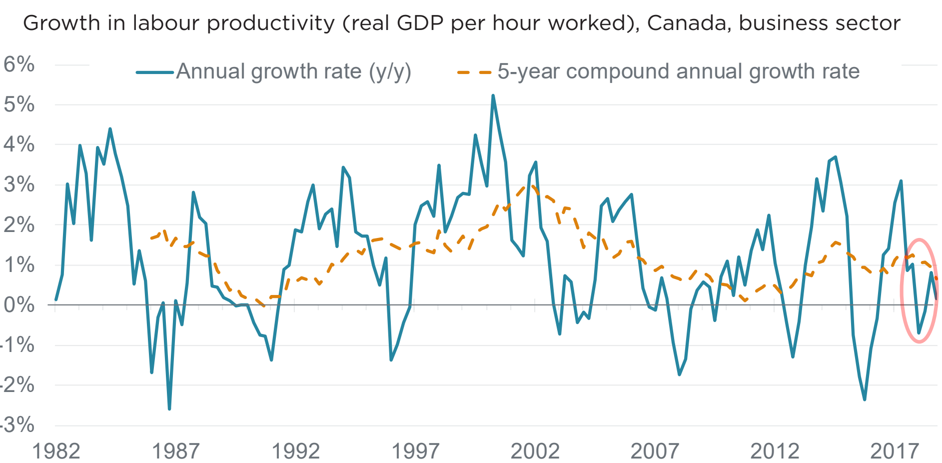
Source: Bank of Canada.

FIGURE 2: **GROWTH IN GDP PER PERSON HAS STALLED DUE TO ANEMIC PRODUCTIVITY GROWTH**



Source: Statistics Canada.

FIGURE 3: **LABOUR PRODUCTIVITY GROWTH HAS STALLED**



Source: Statistics Canada.

2.2% pace. The anticipated moderation reflects a slowing in domestic economic activity, largely centered in residential real estate but also spilling over into consumer spending more broadly. At the time, many current indicators were weakening, so we characterized the risks to the outlook as being firmly on the downside.

There have been no developments in the first quarter of 2019 that prompt us to alter our overall outlook. Some recent indicators, including job figures, are showing signs of improvement. If it were not for the sharp downturn in the residential real estate sector, this might have caused us to nudge our growth projection upwards. But, the near-term outlook for real estate remains unsettled and the market is likely to continue sliding this year. While it now looks like policy interest rates are not headed higher anytime soon, which provides some relief for the real estate market, both federal and provincial government policies implemented to curtail hitherto exuberant demand are having their intended effect.

Our previous forecast factored in LNG Canada proceeding with its massive $40 billion investment to construct its Kitimat LNG plant along with associated pipelines. The project, now in the early stages of construction, is the reason why we expect B.C.'s economy to grow just over 2% rather than under 2% this year. While the outlook for 2020 is more difficult to gauge given the uncertainty around the global economy and the local real estate sector, the ramping up of LNG construction combined with a weaker Canadian dollar will continue to support B.C.'s traded industries and points to a slight overall strengthening in 2020.

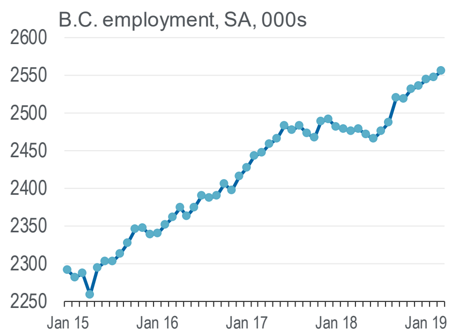
TABLE 3: **B.C. ECONOMIC OUTLOOK (ANNUAL % CHANGE UNLESS OTHERWISE INDICATED)**

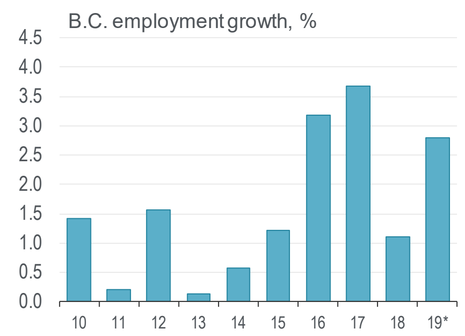
	2017	2018	2019f	2020f
Real GDP	3.8	2.3e	2.2	2.4
Employment	3.7	1.0	2.0	1.2
Unemployment rate (%)	5.1	4.7	4.4	4.6
Housing Starts (000 units)	40.1	41.0	36.0	37.0
Retail sales	9.0	2.0	4.0	3.9
B.C. CPI	1.7	2.7	2.3	2.1

f - forecast e - estimate

Source: Statistics Canada and BC Stats; BCBC for forecasts.

FIGURE 4: **STRONGER JOB GROWTH AGAIN**





* year-to-date (Jan-March). Monthly data are seasonally adjusted.

Source: Statistics Canada, Labour Force Survey.

The bottom line is that even though a few indicators are a little more upbeat, because of the slowdown unfolding in the residential real estate space we are leaving our 2019 and 2020 real GDP growth projections unchanged and continue to judge risk to the outlook to be on the downside.

B.C. JOB GROWTH STRENGTHENS

The most recent data from Statistics Canada's Labour Force Survey indicates the provincial job market has perked up. The average employment level over the first quarter of this year is up 2.8% over Q1 of last year — a solid gain that is well ahead of the 2% national benchmark. The stronger growth figure for B.C., however, is in part flattered by the weak reading in the first quarter of last year.

Digging below the headline figure, there are some cracks showing in the job market data. Most significant is the fact that employment in the broad goods producing sector is down 4% in the first quarter. Much of this reflects a decline in manufacturing jobs, but the first quarter also saw a year-over-year decline in construction for the first time in almost four years. Given the strength in non-residential building activity, the downturn in new home construction appears already to be weighing on construction jobs.

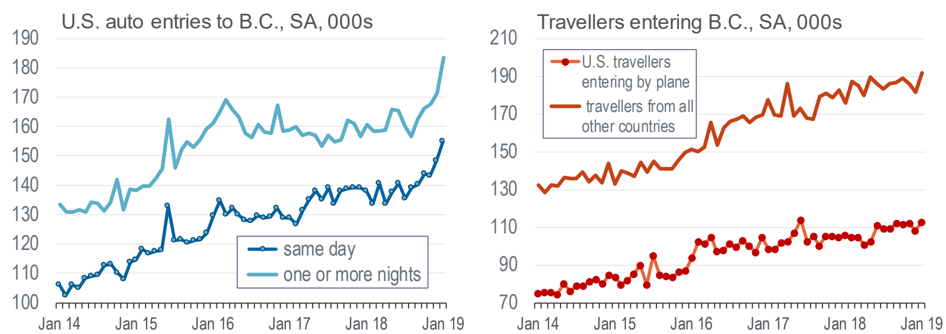
After levelling off in the first half of 2018, job growth in the services sector has again accelerated and increased to 4.8% over the past year. Within this broad category, however, the picture is mixed. The number of people working in the real estate sector has slipped for four consecutive quarters. The pull back in consumer spending is also evident, as employment in the retail sector has also fallen for four consecutive quarters. On the other hand, transportation services, food and accommodation services, professional services and business and support services have all registered solid job gains over the past year. Recent employment data have led us to revise our job growth projection upwards in both 2019 and 2020.

FIGURE 5: **MERCHANDISE EXPORTS EASE IN RECENT MONTHS**

Source: Latest: January 2019. S.A. = seasonally adjusted. 3-month moving average.

Source: B.C. Stats.

FIGURE 6: **TOURISM SECTOR GROWING AS MORE TRAVELLERS COME TO B.C.**



Source: B.C. Stats. S.A. = seasonally adjusted.

EXPORT SECTOR EXPANDING AND SUPPORTING GROWTH

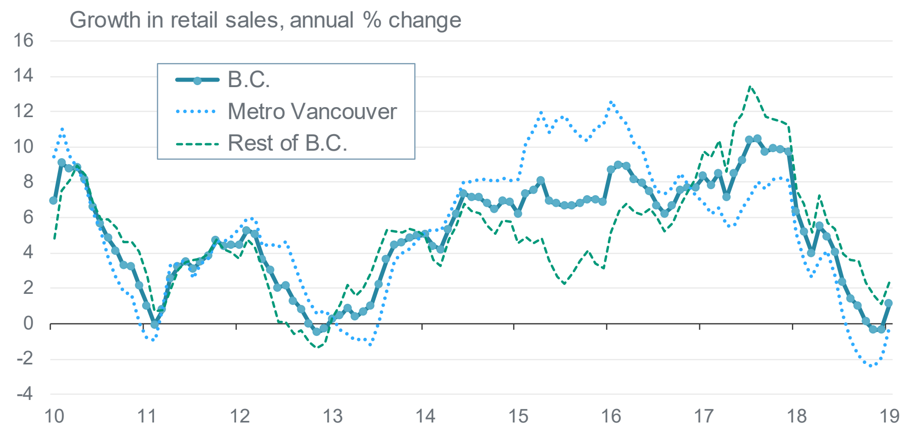
B.C.'s export sector remains in decent shape, even as the global economy gears down. Here a key factor is the weak Canadian dollar, which is supporting growth right across the increasingly diverse spectrum of B.C.'s export base. In the well-quantified goods sector, the total value of international merchandise exports was up nearly 7% in January compared to January of the previous year. This gain follows a similar-sized advance for all of 2018. The year-over-year comparison, however, does mask a levelling off and slight decline in the total value of merchandise exports that emerged over the past six months. Initially, the easing was attributable to some retrenchment in exports to the U.S. But more recently, other key B.C. export markets have also softened.

Meanwhile the various segments of services exports are helping to underpin B.C.'s economic expansion. One of the strongest upswings in recent years is the tourism industry which has grown at a very healthy clip for some time. The number of foreign visitors coming to the province has risen steadily, with an especially large surge in U.S. visitors travelling by car at the end of 2018 and carrying into the first part of 2019.

In addition to gains in the number of visitors, other indicators also point to an ongoing upswing in tourism. Employment in the food and accommodation industry in the first quarter of this year was up a very robust 11% over the previous year. In 2018, room revenue rose in almost all parts of the province. Based on data over the first three quarters of 2018, total room revenue in Vancouver is on track to surge nearly 20%. Whistler and Victoria have also reported healthy gains (26% and 14% respectively). The strong revenue growth is due to slightly higher occupancy rates coupled with substantial increases in average room rates across most regions. Another plus for tourism is the cruise industry, which reported passenger volumes gains of roughly 9% for Vancouver and 6% for Victoria.

B.C.'s film and television sector continues to grow at a healthy pace. The combination of high-quality facilities and a skilled workforce, diverse and desirable locations, the cheap Canadian dollar and the big increase in content created for Netflix and other streaming services is leading to buoyant growth in the film and television production sector.

FIGURE 7: **CONSUMERS STILL TENTATIVE, BUT SPENDING A LITTLE MORE**



Source: Statistics Canada.

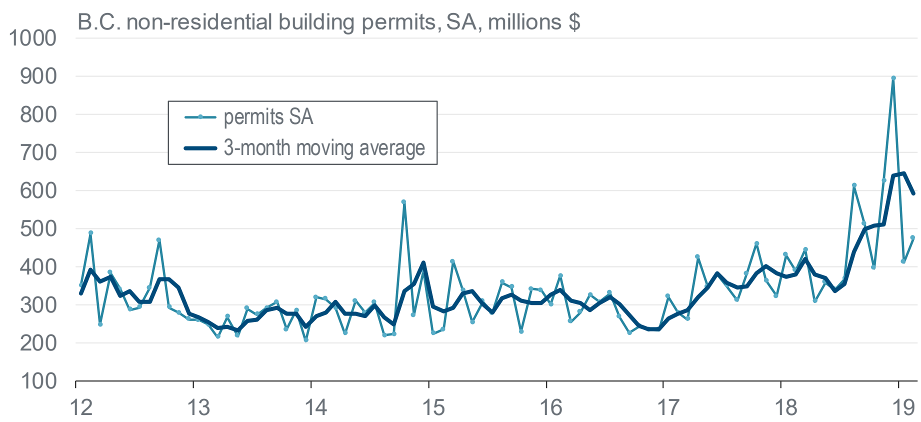
SOME RECENT IMPROVEMENT IN RETAIL SPENDING

The growth in retail sales slowed markedly over the past year. But data as of early 2019 are somewhat more promising, with overall spending growing slightly. The most recent three months of retail spending data (November 2018-January 2019) show total spending across the province edged up 0.6%. The headline sales figure would be stronger if it were not being weighed down by spending linked to housing. Over the most recent three months, spending at furniture stores is down by more than 5% and outlays at electronics and appliance stores are off 3%. Spending at stores retailing building materials and garden equipment also continue to slide, with sales over the most recent three months down 1.6% from the same period a year ago.

In an environment where household debt levels are high, house prices are no longer rising and providing a tailwind of collateral gains through housing equity, and interest rates are around 80 basis points higher than two years ago, it is not surprising to see spending on big ticket items soften. Spending at B.C. auto dealers is off 3.7% year over year.

On the other hand, outlays for less discretionary items have grown. Sales at food stores are up slightly, while spending at clothing stores grew 9% in the most recent three-month period compared to the year before.

FIGURE 8: **NON-RESIDENTIAL CONSTRUCTION SURGES**



Latest: January 2019. SA = seasonally adjusted.

Source: Statistics Canada.

NON-RESIDENTIAL CONSTRUCTION IS A GROWTH DRIVER

Following a late-in-the-year jump, the value of non-residential building permits returned to more normal levels in January of this year. The spike, however, was large and points to strength in the province's non-residential construction sector. In the final quarter of last year, the value of non-residential permits soared by 70% and, as evident in the accompanying figure, shot well above trend. Commercial building permits, which doubled from year ago levels, were the main reason for the spike. In contrast, industrial permit values were essentially flat. Institutional and government permits were up 50% over the same period. While this is good news for the sector and the provincial economy more generally, the construction industry is running at capacity and building costs are rising. Escalating building costs are straining public sector budgets for capital projects and may begin to prompt private sector projects to be postponed.

FIGURE 9: **HOUSING STARTS REGAIN SOME LOST GROUND**

* 3-month moving average. Latest: March 2019. Seasonally adjusted annual rates.

Source: Statistics Canada.

...WHILE THE UNWINDING OF B.C.'S RESIDENTIAL REAL ESTATE BOOM IS A DRAG ON GROWTH

The biggest downside risk to the B.C. outlook is centred around residential real estate. Real estate activity has slowed dramatically and is likely to continue sliding over much of 2019. The steepest downturn has been in the Greater Vancouver Real Estate Board where resales (i.e. the rate of turnover of the established housing stock) have fallen by 31% to their lowest level since 1986. Meanwhile, the average MLS transaction price across Metro Vancouver is down 7.7%.

A similar downturn is unfolding in the Fraser Valley Real Estate Board region, where March resales were off 27% compared to March of the previous year. In other parts of the province, the picture is mixed. Resales are down in the Victoria region by a more moderate 8%, accompanied by small price declines. In the Central Okanagan, which encompasses the Kelowna region, resales were off 15% in March compared to the same month in 2018. The decline is resales activity implies less financing, home inspections, legal work, renovation spending and weakening in some categories of retail spending.

Housing starts have cooled over the past year. Population growth has edged higher in the province as the federal government ramps up immigration levels, partly offset by continued negative net interprovincial migration. Demographic demand should help keep housing starts at a reasonably high level over the medium term. In the near term, however, higher interest rates, tighter mortgage finance conditions and cooler house price growth are likely to see housing starts take a breather after several years of robust activity.

SUMMARY

Absent some indication that the real estate sector is bottoming, we have little reason to upgrade our B.C. outlook. As we said when the sector was booming, it was a major factor underpinning B.C.'s strong economic performance. The opposite now holds: the sharp downturn in activities tied to residential real estate and credit are a significant drag on economic growth. Some other indicators have improved, but overall the picture remains mixed. Still, some strengthening in retail spending, solid non-residential construction activity and a decent outlook for the province's export sector means there is little reason to cut our growth projections for 2019 or 2020. We continue to closely monitor non-residential construction activity, which is running at elevated levels.

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