Canadian Factory Sector Bucking the Global Trend of Contraction This Year

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December 9, 2019

Highlights

- While global manufacturing is mired in a deep contraction this year, Canada's factory sector has remained in expansion mode.
- This resilience relative to its peers appears to be partly owing to a solid overall U.S. demand picture. Inventory building and outperformance in some of the big-ticket sectors where demand can be choppy have also provided support to aggregate activity.
- As these areas of transitory support cool somewhat, we forecast manufacturing output and sales to be flat-to-slightly-down in 2020. Hiring looks set to slow substantially from this year's gains.

A steep downturn in global manufacturing activity has been a key story in 2019. Growing trade policy uncertainty, slowing demand in China, and a cyclical slowdown in advanced economies have all conspired against manufacturing and sent growth in world trade volumes to its lowest since the financial crisis.

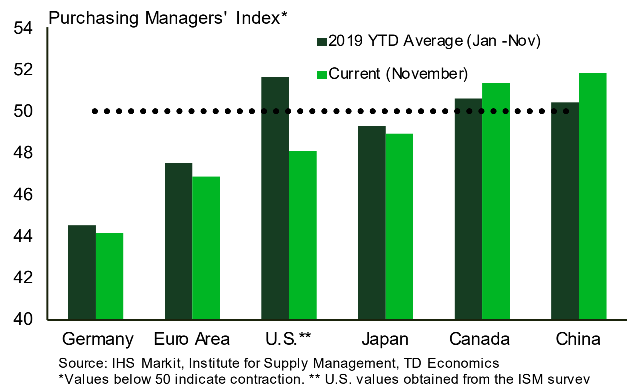
Canada's manufacturing sector – whose struggles over the past few decades have been well-documented – has not been immune to these headwinds. Yet, the sector has managed to buck the trend of contraction, at least so far this year.[1] Comparable data on manufacturing sentiment across major countries provide some evidence in this regard. The PMI surveys compile data across a range of indicators, including current production, new orders, inventories, and employment, with any reading above 50 consistent with expansion. At last count, Canada stood slightly above the 50 mark. This was above the readings seen in most of its major counterparts (Chart 1).[2]

Most indicators pointing to modest expansion

This picture of expanding activity is backed up by key factory metrics. For instance, business confidence in the sector is hovering above the all-industry average (Chart 2). Table 1 shows that, while evidently slowing, Canadian factories have still managed to eke out modest gains in real output this year (through September). This was underpinned by gains in 12 of the 18 industries.

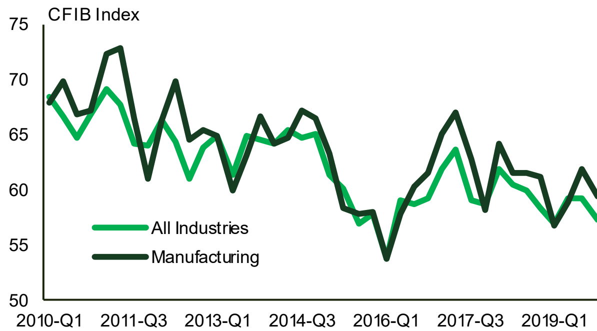
Digging into the details, outperformance was seen in consumer, machinery, non-metallic minerals, and fabricated metals categories. The latter two were likely supported by demand from construction activity. The transportation sector saw positive, if modest

Chart 1: Manufacturing Sentiment Still in Contraction in Most Major Economies



Source: IHS Markit, Institute for Supply Management, TD Economics
*Values below 50 indicate contraction. ** U.S. values obtained from the ISM survey

Chart 2: Small Business Confidence in the Sector Is Not Flashing Any Warning Signals



Source: CFIB, TD Economics. Last data point is a snapshot of Q4 based on October and November data.

Table 1: Key Manufacturing Indicators for Canada*			
	2014-2017	2018	2019 YTD**
Real GDP - Manufacturing	1.8	2.5	0.4
Food	3.1	3.6	1.8
Wood	3.6	-2.1	-7.8
Paper	2.0	-1.6	-8.9
Petroleum	1.8	-3.2	-6.3
Chemical	3.1	4.2	2.6
Non-Metallic Minerals	2.0	4.0	4.0
Fabricated Metals	-1.1	7.5	6.1
Machinery	2.2	6.0	4.1
Primary Metals	1.1	3.1	-6.5
Transportation	1.1	1.0	0.7
Nominal Shipments	2.6	5.4	0.9
Durable	4.2	3.5	1.7
Non-Durable	1.0	7.5	0.0
Real Shipments	1.6	2.1	1.4
Durable	1.7	1.5	1.2
Non-Durable	1.4	2.7	1.6
Employment - SEPH	0.1	2.9	2.3
Employment - LFS	0.1	0.2	0.4

* Annual average % change unless otherwise noted ** Year-to-date Year/Year % Change (Jan-Sep), except for LFS employment ,where YTD data is through November

gains, lifted by notable strength in aerospace and motor vehicle shipment volumes. At the other end of the spectrum, weaknesses in the primary metals, wood, and paper sub-sectors remained. These categories were impacted by tariffs and trade uncertainty, weakening global demand, and challenges in B.C.'s forestry sector.

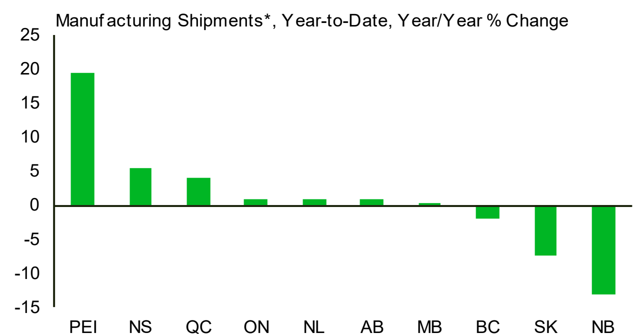
In terms of regional performances, provinces with a heavy presence in the wood and paper manufacturing industries have experienced contractions in nominal shipments this year (Chart 3).[3] These included B.C., and to a lesser extent, New Brunswick.[4] On the other hand, Quebec's strong performances stood out, driven by healthy gains in the transportation and machinery categories. In Ontario, strength in the fabricated metals and transportation industries was partly countered by disappointing growth in primary metals.

One area of surprise has been employment. Both key surveys from Statistics Canada have pointed to increases in jobs relative to last year, although some reversals have started to show in recent Labour Force Survey releases. A jump in wage growth in the manufacturing sector (+7.5% y/y) lends credence to this picture of labour demand strength.[5] Of note, this outperformance of hiring relative to output is not just a story within manufacturing, as other sectors have also recorded similar trends. We have previously noted that this could partly be a function of elevated uncertainty, as companies opt to hire rather than invest in capital to meet near-term demand for their products. Regardless, the gap between activity and employment performance indicators is unlikely to continue.

Reliance on the U.S. provided some counterbalance

A closer look at the overall foreign and domestic demand picture helps to shed some light around the potential drivers of this recent performance (Chart 4). Canadian manufacturing sales are roughly evenly split between those oriented towards the domestic market and those exported.[6] For manufacturing exports, around 80% are destined to the U.S. market. In turn, U.S. demand is proxied by an index that we compiled that draws significantly from the Bank of

Chart 3: Performances Diverged Across the Provinces



Source: Statistics Canada, TD Economics
* Only nominal data is available for the provinces

Canada's Foreign Activity Measure. The measure is heavily geared towards areas that Canadian manufacturing exports are highly sensitive to, such as U.S. business investment, consumer spending, and residential investment.

A few high-level takeaways on this year's drivers are:

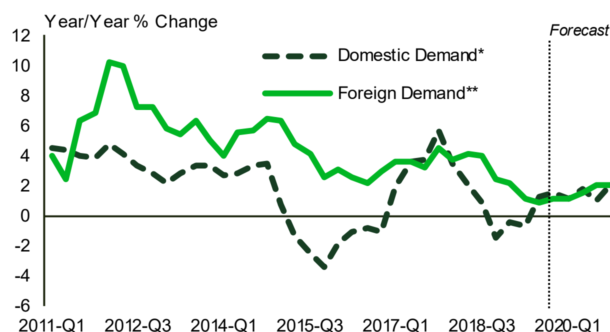
- Canadian manufacturers have not benefitted much from demand at home so far in 2019. Despite positive revisions and a rebound in Q3 of 2019, domestic spending has been subdued for most of the year.
- While foreign activity measures validate the view that external demand has also ratcheted down of late, it has held up a little better thanks to strength south of the border. This was especially notable in consumer sectors.
- A few other factors have also helped support Canadian manufacturing activity in recent months. First, as we discuss in Box 1, Canadian factories have been building inventories. This helped keep real GDP growth in positive territory, and probably partly reflects the impact of heightened trade uncertainty. Second, while gains have been broad-based across industries this year, shipments saw outsized increases in a few big-ticket areas – notably automotive and aerospace - which have flattered the aggregate manufacturing performance.
- The Canadian dollar has been a relatively neutral factor this year, as it has traded virtually sideways within the range of 74-77 U.S. cents.

Where to in 2020?

In broad terms, we see next year's Canadian manufacturing performance as not dramatically different than this year. We would characterize the outlook as flat-to-slightly down.

- Little uptick is expected in global growth or world trade volumes. Even if the U.S. and China manage to reach a Phase 1 trade deal, ongoing uncertainty will remain a dampening force on world demand and supply chains. On the plus side, part of this uncertainty could be partially countered by the potential ratification of the USMCA.
- Chart 4 shows our forecast for manufacturing-related Canadian domestic and U.S. demand. Those measures, too, are expected to run at close to recent pace. In Canada, an ongoing pickup in housing activity will provide some upside to domestic demand in some areas, such as metals. Stateside, the cross-currents of soft investment and decent household spending are expected to remain intact.

Chart 4: Subdued Estimates of Manufacturing-Related Demand in Canada and the U.S.



Source: Statistics Canada, TD Economics
* Canadian domestic demand is calculated as the sum of goods expenditure, business, and residential investment. **U.S. demand proxy

- Where we see downside risks emerging relative to this year relates to the temporary nature of two drivers of growth witnessed so far. Manufacturing inventories are high relative to sales, setting the stage for a potential adjustment in production in the months to come. Furthermore, this year's surprisingly strong performances of the aerospace and auto manufacturing are unlikely to be repeated. Indeed, in autos, there continues to be a gravitational pull of activity south of the border.
- Hiring appears poised for a slowdown. The fact that employment growth has outstripped that of output for most of the year implies falling productivity, which is not sustainable for extended periods. Recent data is already showing a notable moderation in hiring.

Bottom line

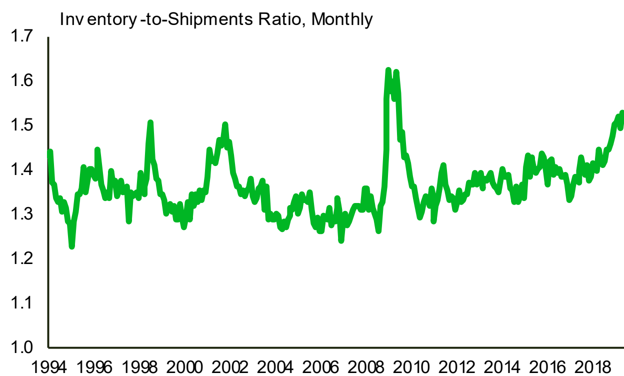
Canada's manufacturing sector has been recording modest output and hiring growth this year - notwithstanding elevated global headwinds and a factory recession globally. Our near-term outlook points to a moderate step down in 2020, in part reflecting a continued benign overall demand picture as well as a partial reversal in some of the temporary factors that have contributed to the recent outperformance.

Box 1: Elevated Inventory/Shipments Ratio Presents Some Downside Risk

The elevated inventory/shipments ratio in the manufacturing sector has been raising eyebrows since last year (Chart 5). An elevated I/S ratio should be monitored, given its potential impacts on future production decisions. This is especially relevant in the case of slowing sales. Taking a closer look, Chart 6 shows the decomposition of the y/y changes in the inventory/shipments ratio. This ratio can increase due to: 1- lower sales growth and/or 2- higher inventory build-up. The decomposition below shows that, for most of 2018 and 2019, sales growth has been working to lower the ratio, as seen by its negative contribution to growth (which is encouraging). Instead, it is the ongoing increases in inventories experienced since 2017 that kept the ratio at its elevated levels.

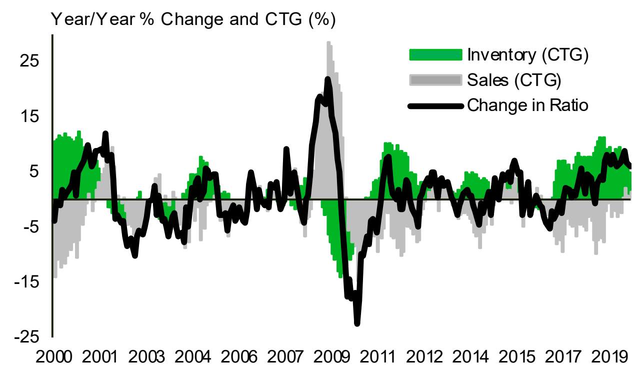
Digging into the details reveals that the sectors driving this inventory build-up include transportation, machinery, metals, and food – most of which are trade sensitive and have high export intensities. We hypothesize that this was likely caused by the elevated levels of trade uncertainty in these sectors since 2018. While not our baseline scenario, if sales don't pick up meaningfully, elevated inventory levels could spur reductions in production, exacerbating the impacts of a slowdown in demand.

Chart 5: Inventory/Shipments Ratio Still Elevated



Source: Statistics Canada, TD Economics. Last data point September 2019.

Chart 6: Inventory Build-Up Is Driving the Elevated Inventory/Sales Ratio



Source: Statistics Canada, TD Economics. Last data point September 2019

Endnotes

1. On a year-to-date year-over-year basis through September, growth has been positive in most inidicators, but has moderated.
2. Canada's PMI dipped below 50 a few times in the summer, but has compared favourably with most advanced economy peers over the year (especially since September).
3. Note that real shipment and real GDP data are unavailable for the provinces. In addition, some industry data may be suppressed at the province-level. We therefore rely on nominal shipments.
4. New Brunswick also had transitory factors impacting its non-durable goods manufacturing due to an explosion in its refinery in the fall of 2018. Note that Quebec has a presence in the wood manufacturing sector, but negative performances are offset by notable strength in other industries.
5. Based on Statistics Canada's Labour Forece Survey (LFS) data in November Data from the Survey of Employment, Payrolls, and Hours (SEPH) also shows a similar increase.
6. Export intensity is around 50%, where export intensity = Manufacturing Exports/ Manufacturing Shipments.

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