

## Economic Research note

# Canada's financial conditions point to rising recession risk

- **Financial conditions have tightened dramatically**
- **Credit crunch and surging CAD lead the tightening**
- **Financial conditions point to risk of recession and core inflation seriously undershooting 2% target**

The JPMorgan Financial Conditions Index (FCI) for Canada has tightened dramatically—almost 170bp since July—and, at -204bp, has turned highly restrictive for both growth and inflation. The FCI is a broad measure of financial conditions that incorporates the Bank of Canada's monetary conditions index (MCI), two measures of money growth, equity prices, the yield curve, and corporate credit spreads. The tightening of the FCI reflects sharply wider corporate spreads in the wake of last summer's credit crunch and a sharply higher Canadian dollar (CAD) as the US Fed has eased while the BoC has remained on hold.

### CAD strength and credit crunch main culprits

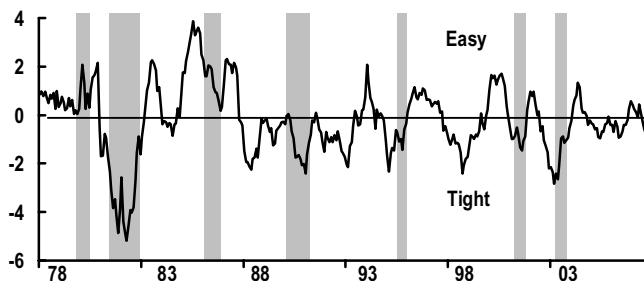
The sharp tightening of the FCI since July reflects tightening of four of the six components of the index (charts, next page). The monetary conditions index, which combines the effect of changes in short-term interest rates and in the trade-weighted CAD, has tightened 266bp since July, mainly reflecting the surge in CAD. The spread between long-term corporate and government bond yields has spiked over 80bp to 188bp, a level that has signaled stalled growth or recession in the past. The yield curve from 90-day commercial paper to 10-year bonds has inverted an additional 68bp since July to -86bp, the most inverted since the 1990-91 recession. The S&PTSX300 held in well through October, but has fallen 6.5% in November to its smallest 12-month gain since July 2003. Among the FCI components, only money supply growth remains supportive. Real narrow money (M1+) growth remains solid at 8.0%o/a, but has slowed from 8.8%o/a in December 2006. Growth of the broad money supply (M2) has also slowed, to 7.7%o/a in September, down from 9.0% in December 2006.

### FCI points to stalling growth, lower core inflation

Financial conditions, which turned stimulative for almost a year after the BoC went on hold in July 2006, have tightened dramatically since July 2007 in the wake of the global credit crunch and a spike higher in CAD. Financial condi-

### Financial conditions index

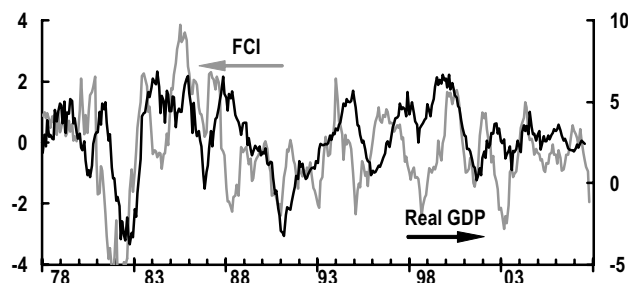
Deviation from average, 1978-99



Shaded areas represent periods of recession or stalled growth.

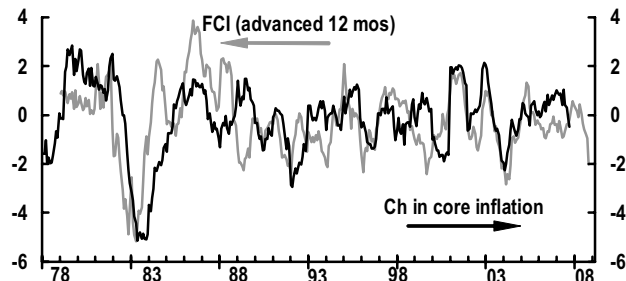
### Financial conditions index and real GDP

Deviation from average, 1978-99



### Financial conditions index and change in core inflation

Deviation from average, 1978-99



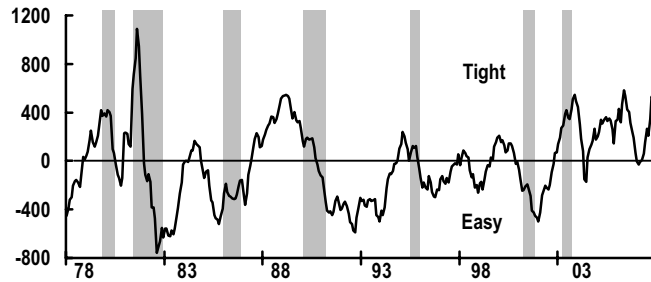
tions have tightened to or beyond levels seen ahead of past recessions or sharp growth slowdowns. The current tight stance of the FCI is consistent with the JPMorgan forecast that real GDP growth will average less than 1%q/q, saar in 4Q07 and 1Q08. The FCI also points to significant downward pressure on core inflation over the coming year. The JPMorgan forecast anticipates that core inflation will fall to 1.5%o/a by 2H07 and the FCI tightening suggests that there are downside risks to this below-consensus forecast. Stalling GDP growth and core inflation moving well below the 2% target will likely require the BoC to cut the policy rate 100bp or more to keep core inflation from falling below the target.

## Components of Canada's financial conditions index

These six components are expressed as deviations from their 1978-99 means, are normalized for standard deviation, and are equally weighted in the financial conditions index. Shaded areas represent periods of recession or stalled growth.

### Monetary conditions index

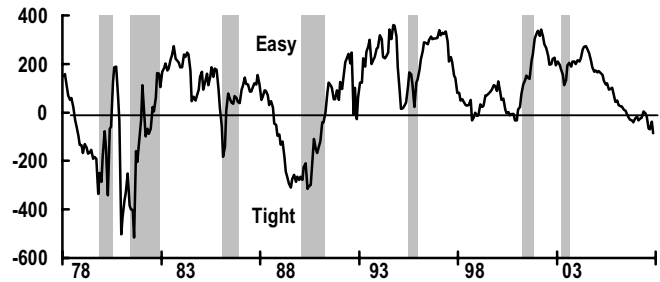
12-month change, bp



With the Bank of Canada on hold and the Fed easing, appreciation of CAD has caused monetary conditions to tighten 290bp since August, and 620bp year to date.

### Yield curve

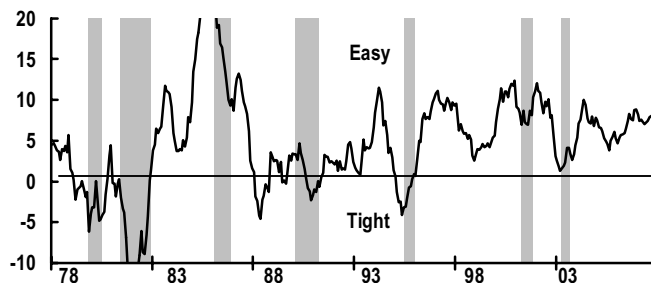
Spread between 10-year bond and 90-day commercial paper, bp



The yield curve inverted further to -86bp, as the 90-day commercial paper rate rose 10bp while the 10-year bond yield fell 58bp since July.

### Real M1+ money supply

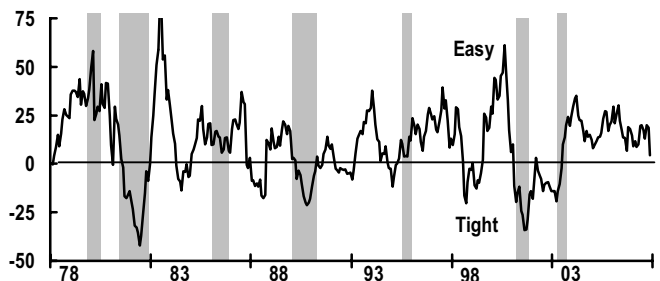
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Growth of real M1+, a good leading indicator of real GDP growth, remained strong at 8.0%oya in September (latest data), but down from 8.8% in December 2006.

### Toronto Stock Exchange 300 Index

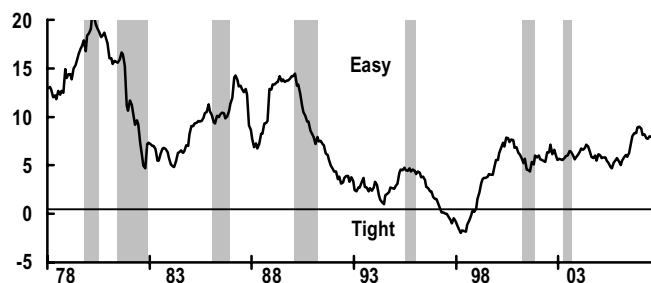
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After hitting a record high in July, the TSX300 has fallen 9%. It is still up 4.5% oya, but that is the smallest 12-month increase since July 2003.

### M2 (gross) money supply

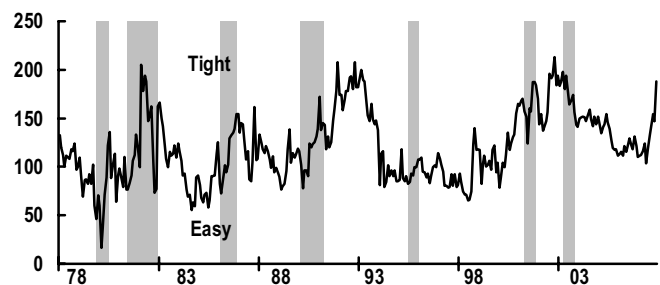
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Growth of the broad money supply, M2 (gross), a good leading indicator of inflation, slowed to 7.7%oya in September (latest data), down from 9.0% in December 2006.

### Corporate bond yield spread

Spread between long corporate bonds and 10-year Canadas, bp



The long-term corporate bond spread, at 188bp, has jumped over 80bp since July. Corporate spreads at current levels have signalled recession or stalled growth in the past.