David Rosenberg: The Canadian economy is mired in weak fundamentals and investors are taking note

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The Canadian dollar has broken sharply lower to below 74 cents U.S., back to where it was in late May. But in late May, oil prices (WTI) were US$68 per barrel; today they are near US$80 per barrel. The CRB index was 540 then, and 550 now. So here we have seen the loonie go back to the same level it was three months ago when commodity prices were lower than they are currently.

This speaks to a downgrade of the domestic economy and deservedly so.

We have now seen employment decline in two of the past three months and the workweek basically stagnate in the March-July period. The unemployment rate has climbed 0.6 of a percentage point from the cycle low to 5.5%, a signal that a recession is quickly approaching. June's real GDP printed negative, and the trade picture has recently shifted from surplus to deficit. The once-hot housing market is also showing vivid signs of cooling down. Strip out the +30.6% YoY surge in mortgage interest costs, and headline inflation is running near target at +2.4%, and +2.3% for the core index.

All the while, the Bank of Canada is signaling another rate hike, which is beyond nutty, but sure to be the last of the cycle.

From a big picture standpoint, the Canadian economy is mired in weak fundamentals. The budgetary situation is out of control and there is no serious attempt in Ottawa to promote fiscal stability. There is a false glow attached to a +1.9% YoY real GDP growth rate at a time when the population pace is now running at a 2.4% annual rate, courtesy of the immigration boom. The economy in real per capita terms is contracting by -0.5% on an annualized basis.

The real problem with the local economy is its composition. Too much reliance on consumer spending which has expanded by more than +20% in the past decade. Housing is closer to high-single-digit growth. These are non-productive sources of growth. Business capital spending on both machinery/equipment and plants has contracted10% apiece over the past ten years. Spending is in the wrong areas of the economy in terms of generating lasting positive multiplier impacts.

Get this: there has been zero growth in the productive private sector capital stock over the past decade. That is shocking. It is the product of a government that has lacked the will to use the tax and regulatory system to promote capital investment — it instead focuses on redistributing national income. As such, productivity in Canada is down 1.4% year-over-year and has contracted outright sequentially for four consecutive quarters and in ten of the past eleven.

This is what is missing in Canada, and it is a sad state of affairs because productivity growth is the mother's milk for future economic prosperity. Instead, what Ottawa has done is attempt to camouflage the situation via the most aggressive immigration program since the CPR embarked on "The Rail, from Sea to Sea" transcontinental railroad back in the late 1870s.

This is not to say immigration is a bad thing — not at all. But it does complicate the inflation picture — especially in housing — while the beauty of productivity is that it promotes noninflationary growth and makes the Bank of Canada's job a whole lot easier.