Too soon to say Canada's manufacturing sector has rebounded

By David Parkinson
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The on-again, off-again resurgence of Canada's manufacturing sector just might be on again. But after so many false starts, how can we be sure that this latest growth spurt is the beginning of that elusive sustainable upswing that the economy so sorely needs?

Maybe when we see the jobs. Which, unfortunately, is not yet.

Canada's manufacturing sales for August, released Tuesday, did indeed impress: Up a seasonally adjusted 0.9 per cent from July, much better than economists' consensus estimate of 0.3 per cent. And the gain came without any help from higher prices, as volumes were up 1.2 per cent.

The August strength also came despite a sizable drag from motor vehicle makers, whose seasonally adjusted sales were down 2.2 per cent in the month – a function of summer maintenance shutdowns at some plants that would usually take place in July. Excluding the auto makers, manufacturing sales were up 1.3 per cent.

This marked the fourth gain in the past five months for sales at Canada's factories, during which time sales have risen a cumulative 2.5 per cent. It's not a massive number, but given the rough ride the Canadian economy endured during that time with sputtering exports and the Alberta wildfires, it has been an encouraging little stretch.

Of course, it's noteworthy that, even with these gains, monthly sales have only clawed their way back to the levels seen at the beginning of the year, and the August figure was down 1 per cent from a year earlier. While weaker prices have hurt (reflecting the impact of a higher Canadian dollar on the value of export sales), volumes were up a relatively tepid 1.3 per cent year over year. The bounce-back in sales still looks more like digging out of a hole than climbing to new heights.

A clearer sign of momentum in the manufacturing sector will come when businesses decide they need to start hiring. That will be a critical indicator of the true underlying strength that economists have been waiting to see from the sector, which is such a big part of the non-resource side of the economy that experts are counting on to lead Canada's recovery.

When the factories start hiring, it will be strong evidence that those businesses are feeling the need for more human resources to meet their customers' growing demand, and are confident that more demand growth is on the way. Such hiring, in turn, would be a precursor to increased capital spending to expand production capacity, a critical cog that to date has been largely missing in Canada's fitful economic recovery. That's the brass ring.

But the sector isn't there yet. The latest jobs figures, for September, show that manufacturing employment is essentially flat over the past four months, and is nearly 40,000 jobs below its end-of-2015 level. Employment has inched up in each of the past three months, another encouraging sign; but both the level of employment and pace of growth suggest employers aren't ready to jump in with both feet.

There remains good reason for manufacturers to be hesitant, as evidenced by some of the August numbers. Even as monthly sales have shifted higher, the demand coming down the pipeline slipped over the summer. Both new orders and unfilled orders have fallen in each of the past two months. For a sector that has been burned before by upturns that fizzled out, that's justification for caution.

With that in mind, it's notable that the sector hasn't overbuilt its stockpiles. Total inventories dipped 0.5 per cent in August. The inventory-to-sales ratio (a figure that represents how many months it would take to exhaust inventories) declined to 1.39, its lowest since January. That suggests either that demand is eating into existing supplies, or that manufacturers haven't been cranking out enough to keep pace with sales – either way, it's positive for future output growth. The more that ratio works its way lower, the more it will indicate that pressure is building for factory owners to hire and expand.

In the near term, the continuation of manufacturing's solid run added to the evidence the Canadian economy had a strong third quarter, after contracting in the second quarter. Economists now believe that real gross domestic product expanded at an annualized rate of north of 3 per cent in the third quarter, and perhaps close to the Bank of Canada's July forecast of 3.5 per cent. It may bode well for the central bank's update of its quarterly economic forecasts, which will be published on Wednesday in the bank's quarterly Monetary Policy Report – although Tuesday's release of the manufacturing data probably came too late to influence the central bank's calculations.

The key in the Bank of Canada's economic update, though, isn't in the third quarter that's already in the books, but rather in the momentum it implies for the quarters to come. And for the solid third quarter for both manufacturing and the broader economy to mean anything, it's going to have to continue into the fourth quarter to translate into the hiring and spending that will really get this ball rolling.