Manufacturers build momentum, but face a test as loonie recovers

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Throughout Canada's recovery from the 2014-2015 oil shock, it was taken as an article of faith that the weakening of the Canadian dollar would spawn a resurgence in the country's manufacturing sector. Now, just as manufacturers have begun to consistently deliver on that promise, we may be about to find out whether they can continue to stand tall without a cheap loonie to lean on.

Statistics Canada's manufacturing report showed that sales were up a strong 1.1 per cent month over month in May, on a seasonally adjusted basis. It marked the third consecutive month of gains, and the fifth in the past seven months – during which time sales have risen at an annualized clip of more than 11 per cent. On a volume basis, sales were up an identical 1.1 per cent in the month, and up nearly 8 per cent annualized over the seven-month run.

It's evidence that a reshaping of the Canadian economy in the wake of the oil shock has taken hold, with new leadership emerging to take over from the resource sector as the key source of growth. Economists believe the economy grew by something close to 3 per cent in the second quarter, adding to the 3.7-per-cent surge in the first quarter. And the momentum in manufacturing, and its exports, is a driver of this economic acceleration.

This is what the Bank of Canada envisioned when it started plotting Canada's route out of the oil collapse more than two years ago: a gradual shifting of the country's economic winds away from the resource sector and toward non-resource industries with a heavy export component. The central bank's two interest-rate cuts in 2015 helped facilitate that rotation by driving investors away from the Canadian dollar and speeding the currency's decline – delivering a highly competitive exchange rate to manufacturing exporters.

It took a while for the currency advantage to take hold, but the recent manufacturing and export data suggest it has been working its magic. It's no coincidence that the three-month winning streak for manufacturing sales came during the Canadian dollar's softest patch since early 2016. By May, the currency had lost nearly 4 cents to the U.S. dollar since early February, and was wallowing at a 15-month low.

But the currency story has been been rewritten since May. The Bank of Canada began signalling in early June that it was leaning toward raising interest rates, and followed through with a rate hike on July 12 – indicating, in the process, that there are more hikes to come. The Canadian dollar is already up nearly 7 cents (U.S.) from its May lows; the pivot in rate policy has turned currency traders in the loonie's favour in a big way.

Indeed, it's abundantly clear that the Bank of Canada's rate trajectory has supplanted the price of oil as the focus for currency traders on the Canadian dollar. The loonie's surge has come despite the benchmark crude price falling roughly 10 per cent in the past two months.

What the currency does from here will depend on the timing of further rate hikes – both from the Bank of Canada, and from the U.S. Federal Reserve, which has already raised its own rates several times, but may be about to shift to the sidelines until later in the year. The Bank of Canada looks likely to raise again in the next few months, but after that, the pace becomes less certain, as the central bank gauges the impact of its rate-policy shift and tries to get a better handle on just how close the economy is to absorbing what’s left of its spare capacity. Still, the direction of Canadian rates is unmistakably upward over the next 12 months; it’s not a question of if, but when.

To the extent that a cheap currency has been fuelling manufacturing growth, that effect looks likely to fade in the coming months. And without it, the sector faces some serious competitiveness issues on the global stage – something the Bank of Canada has alluded to many times as the economy has struggled to recover from the oil shock.

And it’s not just a question of trying to compete against low-cost labour in the likes of China and Mexico. National Bank of Canada economist Krishen Rangasamy pointed out in a recent research report that productivity in Canadian factories has grown at only half the pace of U.S. factories in the past two decades; the result has put Canadian manufacturers in a substantial cost disadvantage, one that a weaker currency alone hasn’t been sufficient to offset.

As the benefits of the cheap dollar inevitably fade, the next phase of growth for Canadian manufacturers will require something more: A ramping up of investment in machinery and equipment upgrades that will boost productivity.

In that regard, the manufacturing sales report itself provided an encouraging sign. Sales of machinery jumped 2.2 per cent in May, their fifth consecutive increase, and were up nearly 12 per cent in the first five months of this year. The data lend support to the Bank of Canada’s recent quarterly Business Outlook Survey, which showed that firms plan to ramp up investment this year.

That spending is long overdue; manufacturers have spent years resisting investments as the Canadian economy periodically sputtered and the weak dollar provided a temporary reprieve. If, as it appears, a cycle of business investment is beginning, it can’t come soon enough, to step in for a currency that has already begun to step out.