October 9, 2015

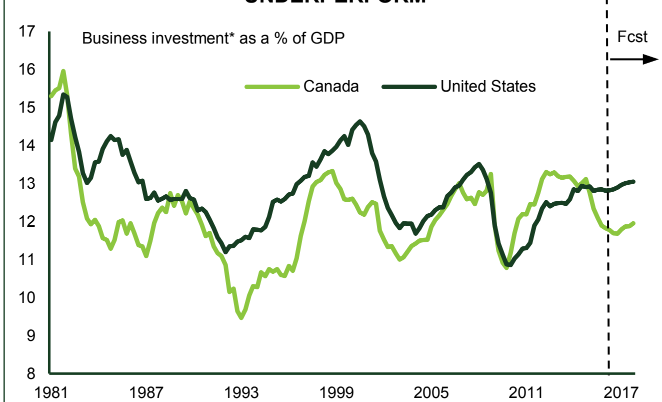
BUSINESS INVESTMENT OUTLOOK: TRADE-BASED SECTORS TO STEP OUT OF RESOURCE SHADOW

Highlights

- Exports and business investment had been counted on to drive Canada's growth going forward, as domestic sources of demand are increasingly tapped out. Unfortunately, the collapse in the price of oil, and weaker commodity prices more broadly, hampers the outlook for capital expenditures within the nonrenewable resource sector.
- With nonrenewable resources having accounted for close to 40% of private sector capital spending since the recession, other sectors are being looked upon to pick up the slack. The investment outlook in 2016-17 is highly tied to sectors that directly benefit from the cyclical drivers of a weaker Canadian dollar and stronger foreign demand.
- This was reaffirmed in The Bank of Canada's Business Outlook Survey, released today. It showed a modest improvement in investment intentions over the next 12 months, with particular strength seen in the manufacturing sector and some service industries. Our findings support this, and we have identified the industries that offer the most investment growth potential include transportation/warehousing, accommodation/food and manufacturing.
- However, there are lags from when an expansion in export activity creates the demand pressures that fuel investment intentions. We should see evidence of business investment recovering in 2016, but we will likely need to wait until 2017 before headline business investment makes a meaningful contribution to growth in overall economic activity.

A key theme in Canada's economic outlook in recent years has been the shift in growth from the consumer and housing, to the export sector and business investment. The consumer, at nearly 60% of the economy, will always be a key economic pillar. But, high debt loads, combined with years of winding down the clock on pent-up demand mean that Canada's economic growth prospects will be limited if other sectors don't step in to fill the gap. We have been on a quest to better understand the risks surrounding this view. In two previous reports (June 2015 and September 2015) we discussed how structural changes partly explain Canada's underperformance in the export sector when compared to measures of foreign demand. Fortunately, cyclical drivers are now in a position to provide a counter influence. The sharp depreciation in the loonie in the past two-and-a-half years alongside strengthening U.S. demand should help fuel export growth going forward. But, those previous reports set us on a course to investigate the growth potential of investment. Canada's investment potential is closely intertwined with developments in the export sector, raising the question as to whether it can be counted on as a reliable thrust to Canada's economic growth

CHART 1. CDN BUSINESS INVESTMENT SET TO UNDERPERFORM



Source: Bureau of Economic Analysis, Statistics Canada, TD Economics.
Business investment includes spending on nonresidential structures, machinery & equipment and intellectual property products.

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prospects.

Concerns were present about the slow pace of investment even before the price of oil was halved over the past year, and investment in the sector ground to a halt. The nonrenewable resource sector (which includes mining and oil and gas extraction) has accounted for close to 40% of private sector[1] capital spending in Canada since the recession. The likelihood that oil prices will remain relatively low hampers the sector's ability to drive growth going forward. This places more of a spotlight on the performance of non-energy exports as a catalyst for stronger investment growth over the next couple of years. In other words, the investment outlook in 2016-17 is highly tied to sectors that directly benefit from the cyclical drivers of a weaker Canadian dollar and stronger foreign demand, like manufacturing, transportation/warehousing and accommodation/food services. However, there are lags from when an expansion in export activity creates the demand pressures that fuel investment intentions. We should see evidence of business investment recovering in 2016, but we will likely need to wait until 2017 before headline business investment makes a meaningful contribution to growth in overall economic activity.

Canada goes from leading to lagging

The contraction in capital spending during the recession was slightly larger in Canada than in the U.S., but the rebound in spending was significantly faster. Business investment in Canada was back at its pre-recession peak three years after the recession, while it took a year longer for U.S. investment to recover. And, up until the first quarter of 2015, business investment in Canada had advanced further beyond its pre-recession peak than in the U.S.

Unfortunately, that is yesterday's news, and our overall assessment is that Canadian business investment growth will lag the United States over the forecast horizon. Even before oil prices collapsed and hobbled Canada's largest source of private sector capital investment, business investment growth in Canada had already started to run out of steam. From 2010-12, investment in nonresidential structures and equipment grew by 12% per year, on average, in real terms. By 2013, spending growth had slowed to a far more modest 2.6%, and to only 0.2% by 2014. This occurred despite a healthy pick-up in exports in that latter year.

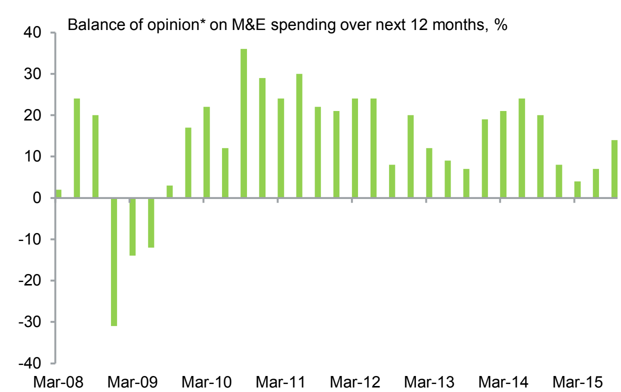
Forecasters, including the Bank of Canada, have long expected a pickup in export growth to feed through to stronger business investment, alongside tightening capacity and improving confidence. So far this has proven elusive. One worry is that after experiencing a multi-year investment boom driven by the resource sector, Canada may be in for a period of weak investment growth (see Chart 1).

Survey says…. 2015 is looking bleak

By any measure you look at, 2015 is shaping up to be pretty dismal for capital spending. Statistics Canada surveys businesses for their capital spending intentions for the year ahead. According to Statistics Canada, the series lines up well with how capital spending comes in at the end of the day. For 2015, this survey suggests that private sector capital spending is set to contract by roughly 6% in 2015, concentrated in the goods sector (-11%). In contrast, spending in the services sector is expected to advance modestly by 2.7%. With the first two quarters now on the books, spending on nonresidential structures along with machinery and equipment has already fallen a combined 6% (on a nominal national accounts basis). In our latest Quarterly Economic Forecast, we detail further contractions on a national accounts basis until the second quarter of 2016, with relatively anemic growth for the remainder of the year.

To not put all the judgement on a single survey measure, we also looked at the Bank of Canada's quarterly Business Outlook Survey (BOS). The balance of opinion (companies who plan to invest more versus those with intentions to spend less) on machinery and equipment (M&E) dropped off dramatically in the winter survey (see Chart 2) reflecting weakness in the resource sector. However, the recently released autumn survey (conducted in late August and early

CHART 2. BOC BUSINESS OUTLOOK SURVEY POINTS TO NEAR-TERM INVESTMENT WEAKNESS



Source: Bank of Canada/Haver Analytics
*Percentage of firms expecting higher investment minus the percentage expecting lower investment.

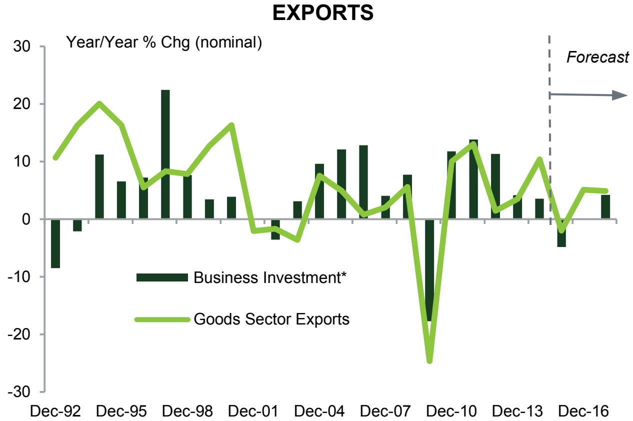
September) showed intentions to increase investment became more widespread, particularly among firms in some service industries and the manufacturing sector. Some exporters with improved margins from a weaker Canadian dollar indicated that they are ramping up their investment spending. While other domestically oriented service sector firms reported plans to modernize facilities or implement new information technologies. These survey results point to a continued modest outlook for M&E spending over the next few quarters, consistent with our own forecast. Since the survey looks at the next 12 months, that prediction holds out to mid-2016.

In broad strokes, our analysis supports this view. The downturn in the resource sector is not fully reflective of the cyclical forces at work elsewhere in the economy. Non-energy exports are expected to be key to propping up growth going forward, due to healthy U.S. demand. This should, in turn, help lift investment in many sectors of Canada's economy, despite the modest overall investment picture. Goods exports have a positive correlation with business investment (see Chart 3), and manufacturing exports have the strongest relationship with capital spending.

Investment outlook varies by sector

However, we can't rely solely on the historical relationship between exports and investment. As our past work on the trade sector has demonstrated, shifts in the global and domestic economic climate can alter historical relationships. It's important to dig a little deeper by looking at other metrics, like corporate profits. This offers some insight into

CHART 3. BUSINESS INVESTMENT LINKED TO EXPORTS



Source: Statistics Canada, Forecast by TD Economics Sept. 2015
*includes spending on nonresidential structures, and machinery & equipment

Table 1. Average Corporate Profit Growth for Key Sectors	2002-07 (avg. y/y % chg.)	2010-13 (avg. y/y % chg.)	Avg last 4 Qtrs (y/y% chg.)
Nonfinancial Industries	11.2	12.7	(3.4)
Manufacturing	7.3	22.3	10.7
Resources*	13.0	18.1	(38.2)
Wholesale Trade	10.8	10.5	(6.3)
Retail Trade	12.8	4.0	6.6
Information & Cultural Industries	22.4	4.7	(2.9)
Real Estate, Rental & Leasing	11.1	15.2	(1.1)
Construction	26.4	10.8	5.7

includes all primary sector activity (mining, oil & gas, agriculture, forestry and fishing)

an industry's financial capacity to invest, irrespective of the near-term economic dynamics. The profit backdrop isn't uniformly bleak (see Table 1), but the overall result is that investment prospects vary quite a bit by sector.

Looking at profits, we forecast investment spending by industry for Canada's largest private sectors. Industries that are highly capital intensive are key to Canada's investment growth prospects, even though they may not look as relevant if judged solely by their size of GDP. Case in point, 90% of private sector capital spending in Canada is accounted for by only half of private sector industries. Not surprisingly, the heaviest hitters are in the goods sector. Mining, quarrying, and oil and gas extraction, and utilities account for more than half of business investment (see Table 3). The transportation and warehousing sector, which includes sectors like rail, trucking, pipelines and warehousing, is highly tied to the goods-producing sector and is also very capital intensive. Finally, the remainder of the primary sector, which includes agriculture, forestry, fishing and hunting is also capital intensive, but is a relatively small sector overall (about 3% of total private sector capex). Our industry-by-industry forecast for capital spending on the 10 largest sectors is shown in Table 2.

The forecasts come with one note of caution. Statistics Canada has been revising the historical data within the capital expenditure by industry survey, such that there is only consistent data on an annual basis going back to 2006. That is not a lot of history to create a robust forecast. To compensate for this, the modelled results from the profit profiles are viewed as one piece to the overall investment outlook and we looked at industry data on profit margins and leverage as an additional logic-check. Industries with positive, elevated or expanding profit margin trends would be expected to attract additional investment. To capture the degree of leverage in an industry, we use liabilities-to-equity. Research from the Bank of Canada has shown that

Table 2. Forecast for Capital Expenditures by Industry	Capex share 2014	GDP share 2014	Capital Spending Growth (%)					Real GDP Growth 2015-17
			2007-14 (avg)	Intentions 2015	Forecast 2016	Forecast 2017	Average 2015-17	
Mining, Quarrying, & Oil & Gas Extraction	38.8	8.5	9.8	-18.7	-4.0	5.0	-5.9	0.8
Utilities	14.7	2.4	9.9	-1.1	11.0	5.4	5.1	2.0
Transportation and Warehousing	10.8	4.2	10.0	13.4	10.0	10.7	11.4	2.6
Manufacturing	7.9	10.6	1.0	2.7	9.3	2.0	4.7	2.5
Real Estate and Rental and Leasing	5.2	12.6	-2.8	4.3	-3.0	-2.9	-0.5	3.1
Information and Cultural Industries	4.2	3.2	3.7	0.9	3.5	2.8	2.4	0.9
Agriculture, Forestry, Fishing & Hunting	3.1	1.6	10.3	-2.8	-1.1	18.0	4.7	1.7
Construction	3.0	7.2	5.5	-3.0	0.7	2.7	0.1	-2.0
Retail Trade	2.7	5.4	0.6	7.7	3.0	-1.0	3.2	2.0
Accommodation and Food Services	2.0	2.1	9.5	1.3	10.0	6.1	5.8	2.4
Wholesale Trade	1.9	5.6	2.6	4.0	5.5	3.4	4.3	3.4
Forecast sample total	94.2			-5.7	3.0	5.2	0.9	

an increase in the debt-to-equity ratio may pose a risk to the outlook for investment growth. Therefore, rising leverage is counted as strike against an industry's investment prospects.

Overall modelled results point to a modest rebound in capital spending in 2016 and 2017 (in nominal terms), contingent on our baseline view of a strengthening in economic growth and a gradual increase in the price of oil beginning in the latter half of 2016. We rank industries based on their investment spending forecast along with profit margin and leverage trends. These are then divided into three categories of positive, neutral and weaker prospects for the 2015-17 period, as shown in Table 3.

The most positive sectors in order of optimism are transportation and warehousing, accommodation and food services, renewable resource extraction and manufacturing. Transportation and warehousing does well on most fronts. Investment intentions are very high this year, and continued strong growth is in line with the cyclical upswing in exports. That combines with high and rising profit margins to lead to a decent overall outlook over the next couple of years. One slight drawback is a steady, albeit mild, rising level of liabilities-to-equity.

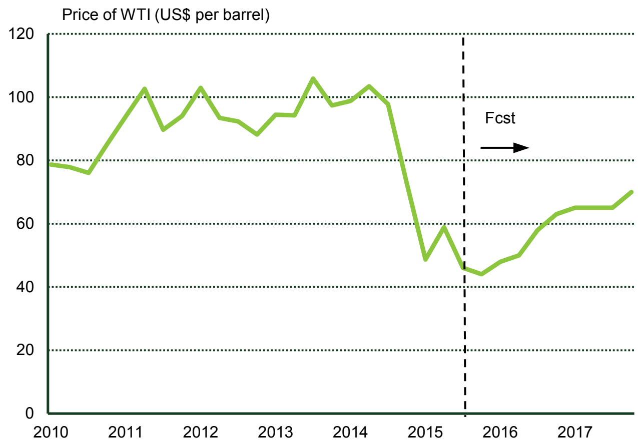
TABLE 3. Investment Prospects for Top Private Sector Industries*	2014 Share % Capex	2014 Share % GDP	
Transportation and Warehousing	10.8	4.2	Positive
Accommodation and Food Services	2.0	2.1	Positive
Agriculture, Forestry, Fishing & Hunting	3.1	1.6	Positive
Manufacturing	7.9	10.6	Positive
Utilities	14.7	2.4	Neutral
Wholesale Trade	1.9	5.6	Neutral
Retail Trade	2.7	5.4	Neutral
Information and Cultural Industries	4.2	3.2	Poor
Real Estate and Rental and Leasing	5.2	12.6	Poor
Construction	3.0	7.2	Poor
Mining, Quarrying, & Oil & Gas Extraction	38.8	8.5	Poor

** Top private sector industries by capex ex. finance and insurance*

Prospects are more neutral for utilities and retail and wholesale trade. The retail sector has had a strong run of capital spending, as many U.S. chains have expanded in Canada since the recession. Margins have also been squeezed recently (as is also the case in wholesale trade), likely reflecting a weaker Canadian dollar and increased retail competition[2]. Operating profits have been weaker than usual in both wholesale and retail trade, muting their prospects. Utilities investment has been very strong in recent years with several large projects under construction. Statistics Canada's capital spending intentions data highlighted weakness this year, and the level of leverage in the sector is also relatively elevated. Canada's utilities sector is highly regulated and tied to government policy, making the outlook for the sector difficult to determine based on economic fundamentals alone.

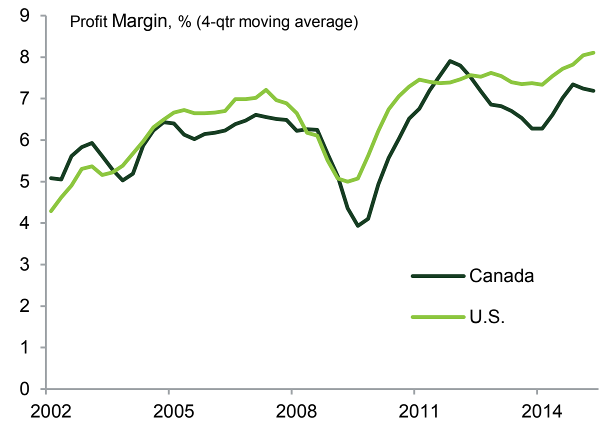
Sectors classified as having weak prospects are information and cultural industries, real estate and rental/leasing, construction and non-renewable resources. Information and cultural industries are hit by weak growth and investment spending this year and further hampered by rising, and historical high, liabilities-to-equity. These influences conspire to offer little growth-impulse to investment going forward. Construction also reflects weak investment intentions this year, and is influenced by an expected slowdown in the housing market next year. The construction sector also includes nonresidential construction, in which the boost from the

CHART 4. OIL PRICES TO RECOVER SLOWLY



Source: Haver Analytics, TD Economics.

CHART 5. CDN MANUFACTURING PROFIT MARGINS LAG THE U.S.



Source: Statistics Canada, U.S. Census Bureau

energy sector is now expected to be a headwind.

The investment-heavy non-renewable resource sector has the most negative outlook given our expectation that the price of oil is likely to remain lower for longer. In particular, the price of WTI (the North American benchmark price for oil) is expected to remain below levels (see Chart 4) where new investment in Canada's oil sands are generally considered profitable, weighing on spending in the sector over the medium term.

Since the non-renewable resource sector is a large source of capital spending in Canada, the overall investment prospect score for private sectors is weak (calculated by a weighted sum of all industry scores). This reality is reflected in our most recent quarterly forecast, where investment spending in real terms barely creeps ahead at a 0.8% pace in 2016, before improving to 5% in 2017 (both growth rates are Q4/Q4).

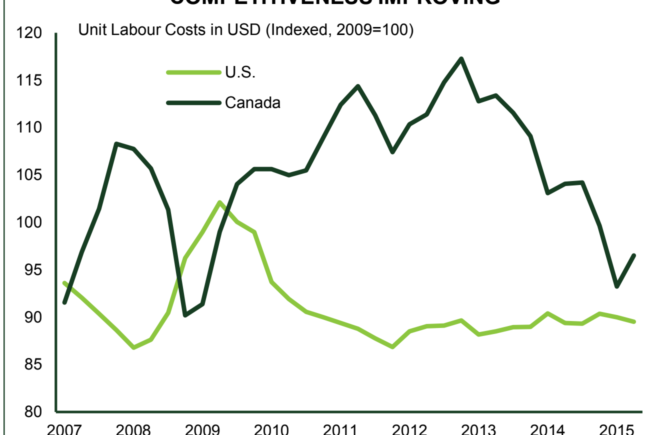
All eyes on manufacturing

One common theme coming across in the data is that the manufacturing sector seems to stand out from the crowd. This is evident in Table 1 marked by nearly 11% profit growth and also within Statistics Canada's capital expenditure survey with 2.7% expenditure intentions for 2015. The latter may sound modest, but is a bright light compared to all other goods-producing sectors, which reported a decline in investment intentions. More importantly, this modest pace of investment growth on the back of unusual weakness in exports in 2015 bodes well for even stronger momentum in 2016 and beyond. Manufacturing will directly benefit from a cyclical rebound in export growth to the U.S. and a weaker Canadian dollar. The lower energy price environment also works to the advantage of this energy intensive sector.

Because manufacturing is a large and diverse sector and is a critical engine behind Canada's investment prospects over the next two years, it warrants a deeper dive. Canada's manufacturing sector accounts for roughly 11% of the economy, and has been going through a long-term adjustment alongside increased globalization of supply chains and appreciation in the loonie over a ten year period.

Since the United States is our biggest trading partner and closest competitor, it is useful to see how we stack up against them on various financial measures of health. Canada and the U.S. have seen improving manufacturing profit margins

CHART 6. CDN MANUFACTURING COMPETITIVENESS IMPROVING



Source: Haver Analytics, TD Economics.

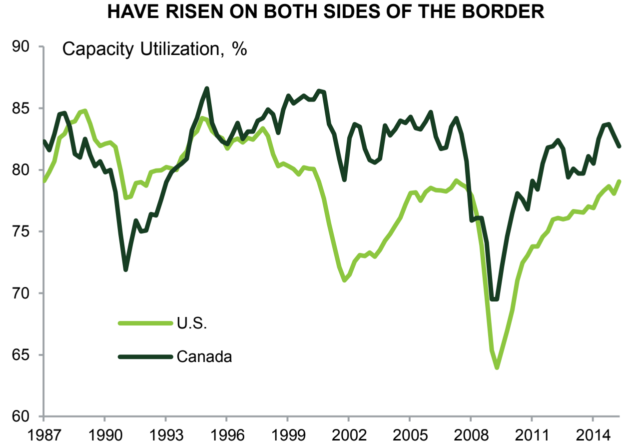
since the recession, but margins in Canada have deteriorated more recently (see Chart 5). In contrast, looking just at growth in operating profits, Canada's manufacturing sector has done a little better than the U.S. in recent quarters. Trends in leverage in Canada and the U.S., as proxied by liabilities-to-equity, have both trended higher post-recession, but the U.S. remains well below its historical level.

Improving profits and margins for Canadian manufacturers also likely reflect the sizeable improvement in unit labour costs in U.S. dollar terms since the Canadian dollar began depreciating a couple of years ago. As Chart 6 shows, Canada's unit labour costs deteriorated dramatically in the days when the loonie hovered around parity with the greenback, while U.S. manufacturers kept unit labour costs in check. While Canada's costs are still relatively higher, there has been a big adjustment that is positive for the sector.

Another potential signal for business investment is increasing capacity utilization rates. As capacity use rises, an industry may start bumping up against production constraints that prompt a firm to invest in new capacity in order to meet demand. Both Canadian and U.S. manufacturing sectors have seen rising capacity utilization rates since the recession (see Chart 7). However, when you look at the level of capacity utilization relative to the historic norm in each country, the United States is further above its historical level, suggesting greater capacity pressures south of the border.

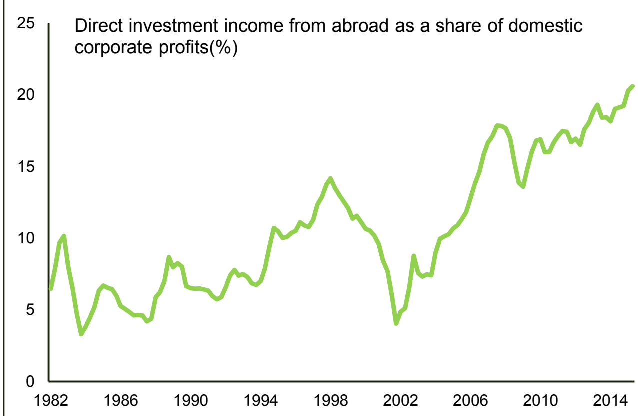
The TD Economics' paper (Failure to Launch) looked at how various manufacturing industries are faring in the U.S. market by looking at trends in their share of U.S. imports. Overall, Canada's manufactured products have lost market

CHART 7. MANUFACTURING CAPACITY USE RATES HAVE RISEN ON BOTH SIDES OF THE BORDER



Source: Statistics Canada & The Federal Reserve Board

CHART 8. INVESTMENT INCOME FROM ABROAD GROWING FASTER THAN DOMESTIC PROFITS



Source: Statistics Canada

share in the United States due to the negative prospects of the relatively large transportation equipment sector, and primary metals to a lesser degree. Within transportation, it is largely the result of motor vehicle manufacturing where Canada has increasingly lost out to competitors in the U.S. and Mexico. Still, there are several industries with positive prospects that offer a clue as to where we are most likely to see stronger investment growth in the future, such as wood products and chemicals.

Canadian firms increasingly invest globally

Although profits, margins and leverage can help us gauge investment potential within industries, it doesn't answer the question of where firms will plan to invest. Another consideration is that Canadian companies may see more attractive opportunities for investment abroad, rather than on home soil. Canadian companies have increasingly engaged in the global economy, as evidenced by the rapid growth of Canadian direct investment abroad. In fact, if you added Canadian direct investment abroad to total nonresidential investment spending in Canada, growth in business investment would have been twice as strong in 2014 as was reported in the national accounts.

Business abroad can also be seen in the steady growth in income from direct investment abroad. When investment income from abroad is benchmarked against growth in corporate profits in Canada (net operating surplus from the national accounts), it is clear that its size relative to domestic corporate profits continues to grow (see Chart 8). Canadian firms are becoming increasingly global, and their investment opportunities are not confined to Canada. Not surprisingly, the most common destination is the U.S, which has received the lion's share of investment over the past 10 years.

The expansion of investment abroad by Canadian firms should not be viewed negatively as driving an investment malaise domestically. It shows that Canadian firms are becoming increasingly globalized in finding the best strategy to expand. But, it does offer one explanation of why borrowing activity by businesses in Canada has been so strong recently, while investment activity has remained more subdued.

The Bottom Line

Canada's energy sector may account for only 10% of the economy, but it has been a heavy hitter over the past decade when it comes to investment spending. Therefore, the relatively grim outlook for spending in the energy sector over the near term casts a long shadow over Canada's investment forecast.

However, we do expect other sectors, particularly those tied to international trade (including tourism) to step out of the shadow of the resource sector slump. Just like we expect the economy to experience a rotation of growth drivers, so too will investment. The industry rotation within investment will take time, but we should see evidence of business investment recovering in 2016, and will likely need to wait until 2017 before headline business investment makes a meaningful contribution to growth. Business investment is highly tied to the performance of exports at this stage of the economic cycle. Therefore, the performance of exports will be closely watched as a key catalyst for business investment.

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End Notes

1. Excludes public administration and health and education, which are largely government-funded in Canada.
2. The Bank of Canada has cited intense retail competition as a restraining factor on inflation in recent years (see latest Monetary Policy Report)