



HIGHLIGHTS

- Business investment in machinery & equipment is expected to become a major contributor to economic growth in the coming months.
- Five factors are behind our expectation.
- First, continued growth in corporate profits alongside moderate economic growth in the domestic and global economies.
- Second, high levels of liquidity and strong financial positions among Canadian corporations.
- Third, a continued low interest rate environment and favourable credit conditions.
- Fourth, a host of fiscal incentives including corporate income tax reductions, temporary capital cost allowance measures, the elimination of capital taxes, and the implementation of the HST in B.C. and Ontario.
- Fifth, an elevated Canadian dollar that should hover around parity for at least the next two years.
- In sum, M&E investment should provide a boost to near-term economic growth as the rest of the economy cools.
- Moreover, this is a prime opportunity to build the nation's competitive edge and improve on its abysmal productivity performance.

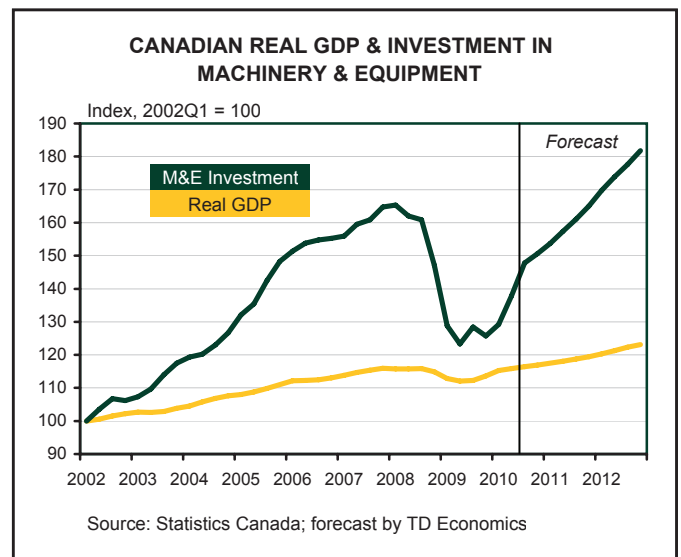
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THE PATH TO ECONOMIC GROWTH IS PAVED WITH MACHINERY AND EQUIPMENT

Introduction

All the stars are lined up for business investment in machinery & equipment (M&E) to be a major contributor to Canadian economic growth in the coming months. Capital purchases by businesses are expected to be ramped up substantially over the next two years on the back of significant improvements in corporate profitability, the continuation of a low interest rate environment, and improved tax incentives. As such, this critical area of Canada's economy, which accounts for roughly 10% of GDP, is anticipated to contribute more than half of real GDP growth over 2011 and 2012.

This new shot in the arm for the Canadian economy could not come at a better time. Households have already begun to moderate their spending and the economy can no longer depend on debt-fuelled consumption, the original poster child for the recovery, in the same fashion that has characterized the recovery so far. Additional headwinds in the form of a weak U.S. demand, the waning impact of fiscal and monetary stimulus, and a housing correction will limit economic growth to



a moderate pace in the coming quarters. Thus, a boost from capital equipment investment will bolster near-term economic prospects and keep the Canadian economy rising at a moderate pace. Moreover, by taking advantage of this prime opportunity to build the nation's productive capacity and sharpen its competitive edge, perhaps Canada can finally improve on its abysmal productivity performance by increasing capital intensity.

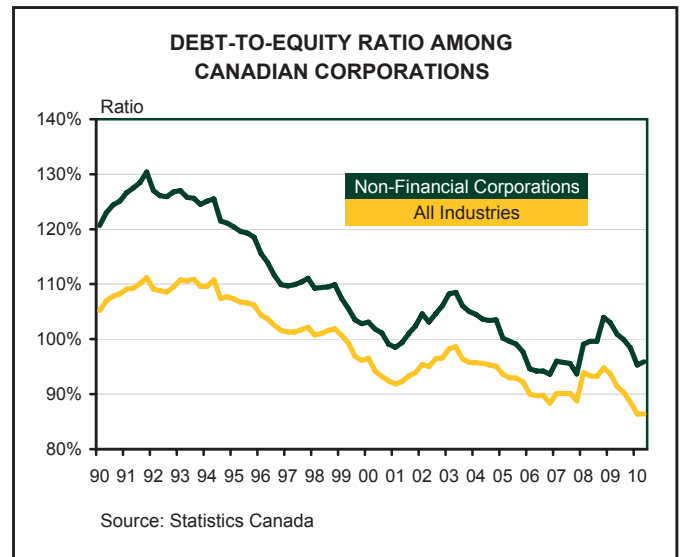
Macroeconomic Environment

In the years leading up to the economic downturn, M&E investment was a key source of economic growth in the Canadian economy. Between 2002 and 2007, growth in M&E was three times as strong as that of overall real GDP growth, underpinned by strong corporate profitability and easy access to capital and credit markets. By the end of 2007, M&E's share of the total economy had risen by almost three percentage points to its highest point on record in those few short

years. So, when global demand went into freefall in the midst of the 2008-2009 downturn, there was a lot to lose. Corporate profits plunged by almost half and businesses saw no reason to build their productive capacity in the absence of any tangible need for it. Thus, M&E investment became moot and suffered a peak-to-trough decline of more than 25% in just five quarters.

Fortunately, the worst is now behind us. Canada has recorded strong economic growth in the past year, erasing all of its recessionary output losses. Thus far, businesses have largely met improving demand and resulting production through increased hiring. In just thirteen short months, the Canadian labour market was able to recover all of the 417,000 net jobs lost during the recession, faster than any other nation in the G7. Thus, with businesses having already hired a substantial number of workers, there is substantial pent-up demand for M&E in order to meet future increases in demand by increasing the capital stock and improving the productivity of that existing labour pool. In fact, this has already been the case. Real M&E investment grew by almost 30% on an annualized basis in the second quarter of this year, after climbing by 11.3% in the previous quarter; moreover, all signs are pointing to a very strong third quarter outcome, as well. However, despite the rebound, M&E investment remains 16.5% below its pre-recession level. So now the significant gap between where M&E spending was and where it is now implies that there is some much needed catching up to do.

Looking ahead, a host of factors will continue to support increased capital spending among businesses, albeit at a more moderate pace relative to what has been recorded most recently.

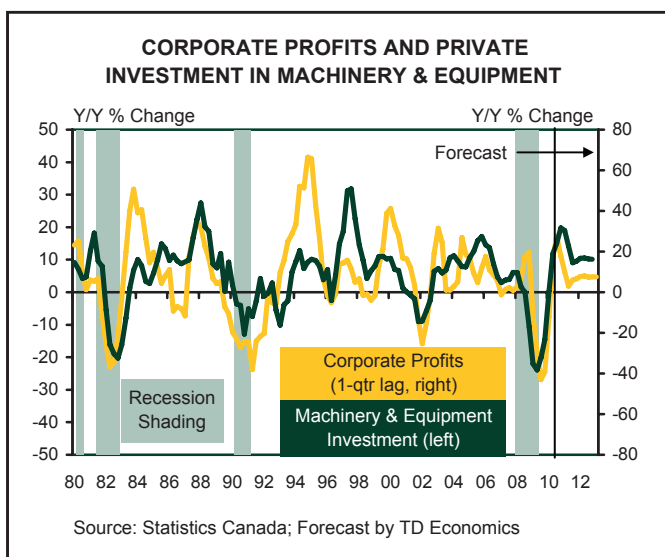


Financial Position of Canadian businesses

First and foremost, corporate profitability is crucial and has been extremely positive in Canada. Over the past four quarters, profits have grown by 29.1% on an average annualized basis and will continue to grow as both the domestic and global economic recoveries persist. We expect average profit growth of roughly 7.0% on a quarterly annualized basis out to the end of 2012. Second, Canadian businesses are currently standing on very strong balance sheets. The debt-to-equity ratio among corporations in Canada is at its lowest point on record at about 86% as of the second quarter of 2010. Implicit in this are two factors. First, equity includes retained earnings, which so far have been largely funneled into deposits and short-term assets in the absence of better investment opportunities. Second, when combined with the recovering state of credit and capital markets, this implies that firms will have a relatively easy time accessing borrowed funds. Hence, the corporate sector is currently extremely liquid; large caches of internally-generated funds are available that could potentially be used to finance new capital spending.

Credit Conditions and Interest Rates

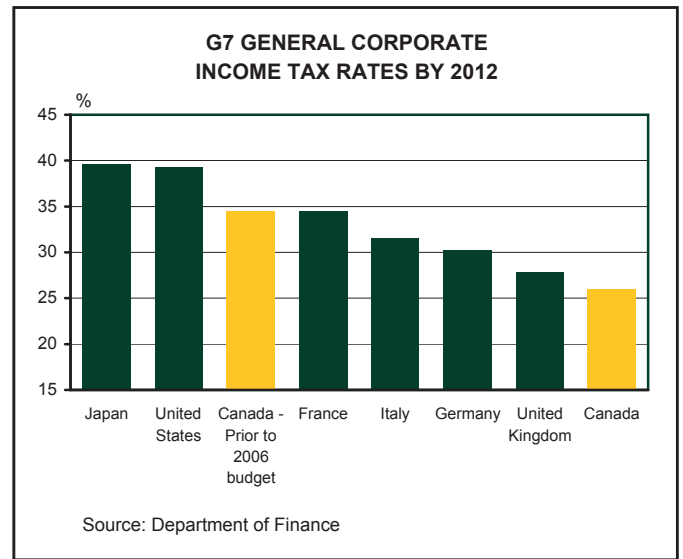
Given that credit is a key source of financing capital expenditures, the favourable interest rate environment expected over the next few years should provide support to investment. The level of the yield curve remains distinctively low and TD Economics expects that the Bank of Canada to stay on hold until after the first quarter of 2011, followed only by a gradual increase. Furthermore, corporate bond spreads have fallen dramatically from their recessionary peaks of about 300-400 basis points, depending on debt



grade, and are currently hovering comfortably around their pre-recession level of 50-150 basis points. So for larger corporations, this implies that debt issuance is relatively affordably. However, even for small and medium-sized enterprises that depend more on bank credit for their financing, the story is just as positive. In addition to low rates, lending standards have been easing for some time. Data from the Bank of Canada's senior loan officer survey indicate that an increasing number of lenders are reporting easing credit conditions and that lending standards are easing in both price and non-price terms. This has been improving for four consecutive quarters now. Moreover, Canada's financial institutions are not hamstrung by impaired balance sheets that the U.S. is currently struggling with. So regardless of size of one's business, debt financing is readily available. And for large corporation, equity financing may also be an attractive option given that rising profits and low interest rates are generally supportive of issuance.

Tax Incentives

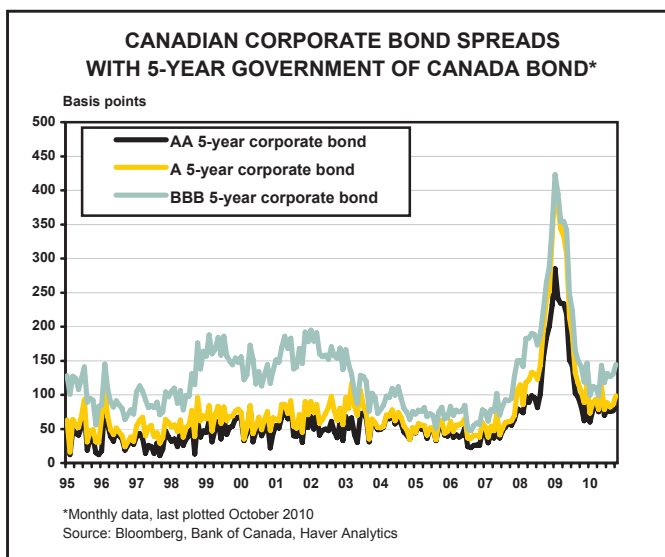
A host of fiscal initiatives are either in place, or are set to be implemented in the coming months to provide an incentive for investment in new capital. To begin, the federal government and a number of provinces have been lowering general corporate income tax (CIT) rates since 2006 in order to incent new investment, raise the competitiveness of Canadian firms and to attract new foreign investment. Further reductions are in the pipeline. By the end of 2012, the federal CIT rate is expected to drop to 15% from its current 18%, while B.C. and Ontario have pledged to reduce their provincial CIT rates to 10% by 2011 and 2013, respectively. New Brunswick was expected to reduce their provincial CIT



rate to 8% by the end of 2012; however, the new provincial government's election platform only included a reduction to 10% by July 2011. In sum, these reductions are expected to result in Canada having the lowest CIT rate in the G7 by 2012.

Second, all provincial and federal general corporation capital taxes will have been eliminated by 2011. Capital taxes in Canada are a direct deterrent on investment as corporations were taxed based on the total capital held, such as equity and debt, each year. The federal government eliminated their general capital tax in 2006 and pushed for every province to do the same. As of today, only two provinces have not done so. Ontario was third to last, eliminating its tax as of July 1 of this year, while Quebec and Manitoba remain the last to do so, both pledging to eliminate their tax by end of the calendar year.

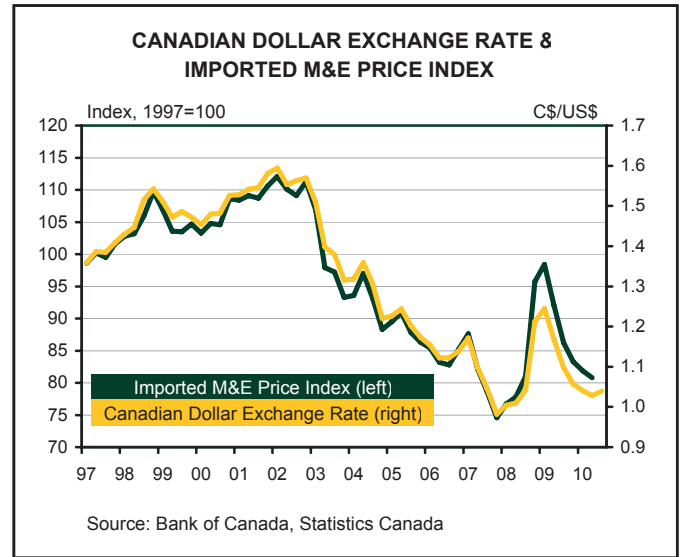
Third, and not unrelated to the two discussed above, the federal government has put forth a number of capital cost allowance (CCA) initiatives in recent budgets regarding a variety of capital goods. Capital cost allowances permit businesses to claim a portion of the depreciation on capital equipment and non-residential properties. Thus, changes in the rates at which capital depreciates effectively changes its cost over its lifetime by allowing businesses to claim a larger or smaller portion of that depreciation. In 2009, the federal government implemented a temporary 100% capital cost allowance for computers bought after January 27, 2009 and before February 1, 2011 and an extension of the 50% straight-line accelerated CCA rate for M&E investment in manufacturing and processing industries, originally implemented in Budget 2007, to the end of 2011. The CCA rates for computer equipment, non-residential buildings, and



natural gas facilities were also raised permanently in 2007 to better reflect the useful lives of those assets.

Lastly, the recent implementation of the harmonized sales tax (HST) in British Columbia and Ontario acts in a similar fashion to business income tax reductions in that they allow firms to retain more of their earnings. Income tax reductions are quite simple in that they lower the tax burden faced by firms; HST, on the other hand, is slightly more complicated in that it reduces the amount of tax cascading by allowing firms to claim the full amount of sales tax paid on intermediate inputs. Prior to its implementation, firms in the two provinces would only be able to claim the federal sales tax (GST), not the provincial sales tax (PST), paid on goods used in their production processes. Thus, final goods sales would be subject to something of a double tax in that a portion of the taxes paid by businesses on intermediate inputs would be taxed again when passed onto the consumer. By allowing firms to claim the full amount of tax paid, tax cascading is eliminated and savings can either be retained or passed onto consumers; in either case, resulting in a more efficient allocation of resources. In Ontario, the HST was met with little opposition; however, the implementation in British Columbia generated vehement resistance and with the recent resignation of the premier, it is possible that the HST will be revoked.

From a macroeconomic perspective, high and distortionary taxes on capital act as disincentives to invest from two perspectives: they act as a barrier to growth, in general, given the tax burden on revenues, but they also raise the cost of capital relative to labour. Prior to these commitments to bring down that cost, Canadian businesses faced one of the highest marginal effective tax rates (METR) on new invest-

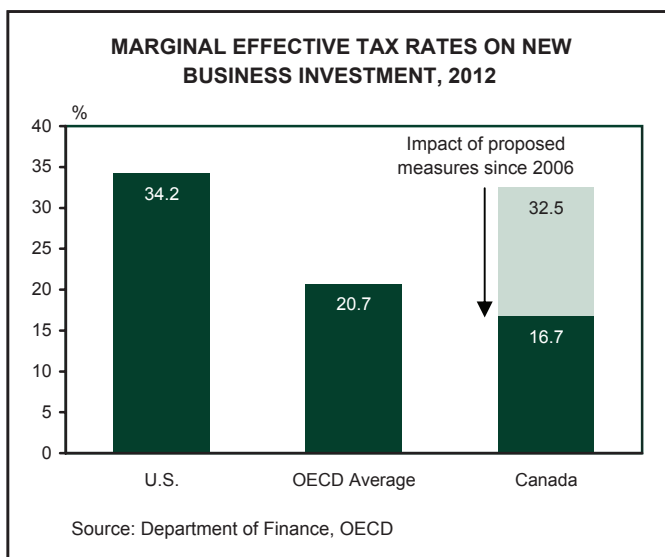


ment in the developed world at 32.5% in 2006. By 2012, the federal government expects the combined federal-provincial METR to fall by almost half to 16.7%, well below the U.S.’ rate of 34.2% and the OECD average of 20.7%. Canada will also have the lowest general CIT rate in the G7 by then. Even if the HST is revoked in B.C., the reduction in the Canadian METR will still be substantial. Thus, these new initiatives will go a long way in not only providing much needed tax relief to Canadian firms, but also to raise the incentives necessary to boost economy-wide capital intensity through increased business investment.

It is important to note that not all of these initiatives have short-term impacts. Corporate income tax reductions and the benefits of HST are slow-moving processes that affect firms over the long haul as they adjust to this new normal. Increased capital cost allowances, on the other hand, will likely have both a short-term and long-term impact, as the immediate benefit of a reduction in the tax burden will likely be funneled into specific capital investment that benefits from the increased capital cost allowances as they are subject to expiry in the near term, computers being a prime example.

Canadian Dollar

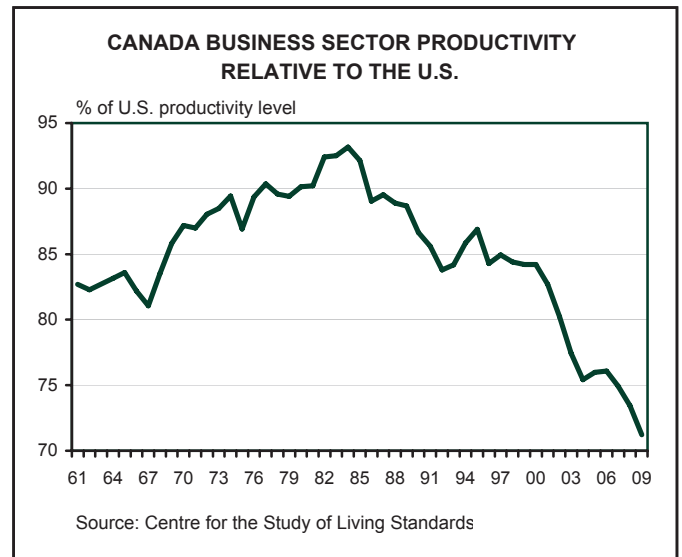
The impact of an elevated Canadian dollar is mostly an advantage for investment, but does have a minor downside. On the positive side, the strong cross-rate between the Loonie and the Greenback lowers the cost of imported machinery & equipment as a large majority comes from the United States or is priced in U.S. dollars. M&E imports comprise roughly two-thirds of all M&E purchases in the country, so the purchasing power of Canadian firms has



risen substantially due to the recent foreign exchange appreciation. However, a rising dollar also detracts from the competitiveness of exporting firms, many of which are big investors in M&E. For example, the manufacturing and mining, oil & gas extraction sectors alone account for more than one-fifth of all M&E investment in Canada and a large majority of firms in this sector are export-oriented. So is the net impact positive or negative? Research from the Bank of Canada has shown that the two opposing factors largely offset each other with regards to exporters. However, for firms that primarily operate domestically, the strong Loonie is undoubtedly a boon. While the volatility in the Loonie's value makes many businesses uneasy, the overall impact should generally be positive. This is already evident in the nation's trade balance. Imports of M&E have recorded stronger gains than every other category of imported goods this year and are up 23% since January. Moreover, this trend is likely to continue given that the Loonie's flight path is largely expected to hover in and around parity over the next two years.

Risks

Our outlook for business investment is mainly predicated on the need for additional capital in order to meet rising demand. However, there are downside risks. Uncertainty regarding global and domestic demand may cause firms to delay new investment until the economic recovery is more entrenched. Industrial capacity utilization yet remains below its pre-recession level, meaning that if firms do not perceive the inevitable increase in demand as any larger than the excess capacity available, then they may, again, delay additional investment. This uncertainty is further

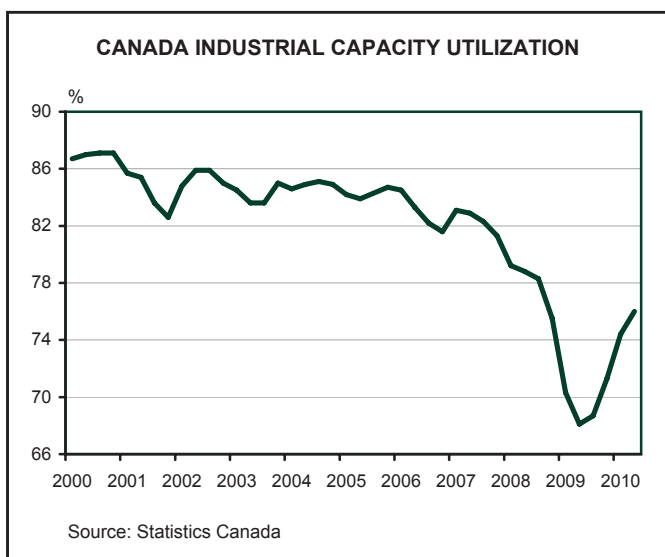


exacerbated by the current volatility in the Canadian dollar, as discussed above.

So, the question is: how optimistic are businesses that they will need to expand capacity? According to a variety of data sources, things are starting to look brighter. The latest from the Bank of Canada's business outlook survey indicates that 46% of firms in Canada have plans to invest more in the coming year than in the past year. In particular, the heavy hitters in investment are showing substantial increases in investment intentions. According to Statistics Canada's private and public investment intentions survey, firms in the mining, oil & gas, utilities, manufacturing, and transportation & warehousing sectors – all of which account for nearly half of all non-residential investment done in Canada – intended to increase investment by more than a combined \$8 billion from their 2009 levels.

The Productivity Debate

Hopefully, this emerging trend in M&E investment will provide a partial solution to the productivity challenge that has plagued Canada for the last decade. Since 2000, business sector productivity growth has averaged just 0.7% annually, less than one-third of the 2.5% average growth rate in the United States. Andrew Sharpe of the Centre for the Study of Living Standards has estimated that business sector output per hour was just over 70% the U.S. level in 2009, down from 84.2% in 2000. A primary source of the overall productivity gap lies in the substantial difference in attitudes towards information & communications technology (ICT) investment, one of the key sources of productivity improvements in service-based economies such as Canada's and the United States'. Andrew Sharpe has also estimated





that, on a per worker basis, the stock of ICT equipment is just 45.4% that of the U.S. as a result of less ICT investment. Thus, a boost in M&E investment, particularly on the ICT side given the temporary 100% CCA for computers, will hopefully trigger an inflection point in the nation's bid to improve its productivity record as this is one of the most persistent and significant public policy issues of our time.

Conclusion

There are a number of headwinds facing Canada's economic outlook – Canadian households are becoming increasingly cautious as debt levels reach record heights, U.S. demand remains notably weak, monetary and fiscal stimulus

impacts are waning, and the housing sector is moderating. On the other hand, these headwinds mask the underlying trend that demand growth, albeit moderate, remains solid. The challenge during these atypical times is to look past this uncertainty and take advantage of the low level of borrowing and wholesale funding costs, the gainful tax incentives, the continued improvements in profitability, and the elevated Canadian dollar in recognition of this. Ultimately, we anticipate a robust performance in M&E investment growth ranging from 8-12% on a quarterly annualized basis over the next two years and this is expected to account for close to half of economic growth in 2011 and 2012.

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