TD Bank Financial Group

Industrial Outlook

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TD Economics
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HIGHLIGHTS

- Economic recovery in Canada will be slow, but broad-based growth is expected across both the goods and services sectors
- The manufacturing sector is poised for the greatest gains in 2010-11...
- ...but the cyclical rebound will be muted by a tepid recovery in the U.S. and the high-flying loonie
- Resource output will expand in 2010, but the bounce back will be more pronounced next year
- After rebounding this year, a cooling in the housing market will lead to a contraction in residential construction in 2011
- Services related to trade and manufacturing will outperform in 2010, while public services will slow significantly

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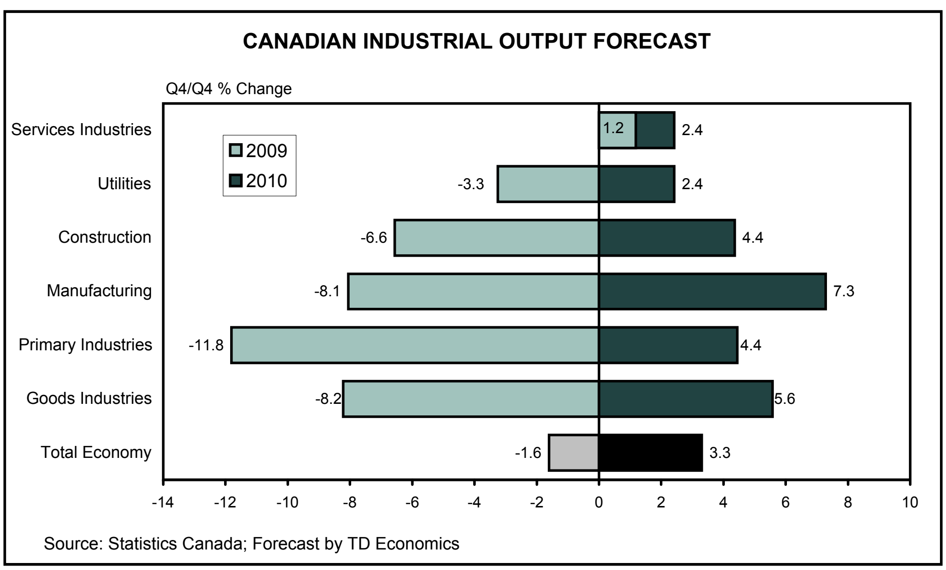
THE LONG WAY BACK

Now that the global macroeconomic and financial shock waves have made their way through the Canadian economy and a recovery is underway, the question now lies in the magnitude and the composition of the bounce back. After contracting by 3.3% peak-to-trough, real output as measured by GDP at basic prices edged up by 0.3% (annualized) in the third quarter of 2009, and is likely to record growth of about 4% (annualized) in the final three months of last year. This momentum will carry through into 2010, but we expect the rebound to have much less vigor than is typical after a recession so deep, with real GDP at basic prices expected to grow by only 3.3% (Q4/Q4) this year.

While we expect to see broad-based growth across both the goods and the services sectors, industries that were hardest hit on the way down are likely to see more upside during the recovery phase. Given that the goods producing sector bore the brunt of the recession, plunging by about 12% since the third quarter of 2008 (compared to a flat performance in the services sector), it is poised for the strongest rebound over the next few years.

The most notable story is the recovery of the manufacturing sector, which we expect to grow at double the clip of the overall economy in 2010-11. The near-term rebound in output should bring an end to an incredible nine straight years of underperformance vis-à-vis all other industries, highlighting the fact that the sector's woes began well before the onset of the recession. But while the sector will outperform overall economic activity over the next few years, the projected growth rates pale in comparison to the rate at which production was slashed during the economic downturn that began in August 2008. As a result, by late 2011, factory production will not only remain below its pre-recession level, but also about 8% lower than the levels seen a decade ago.

Many factors will contribute to this more muted cyclical rebound. First off, the recovery in the U.S. will be quite tepid, as the financial and economic healing



Macroeconomic and Financial Assumptions

- U.S. real GDP to grow by 2.7% in 2010 and 3.7% in 2011 (Q4/Q4)
- U.S. activity index* to grow 6.0% in 2010 and 9.3% in 2011 (Q4/Q4)
- Crude oil (WTI) prices to hover in the US$70-85 per barrel range through 2011
- Natural gas (Henry Hub) prices to remain below US$7 per MMBtu through 2011
- Bank of Canada to leave the overnight rate at 0.25% until Q4 2010, but raise it to 3.25% by the end of 2011
- Canadian dollar to rise above parity in 2010, falling back to only 92 US cents by the end of 2011
- Government contribution to growth via stimulus measures to wane post-2010

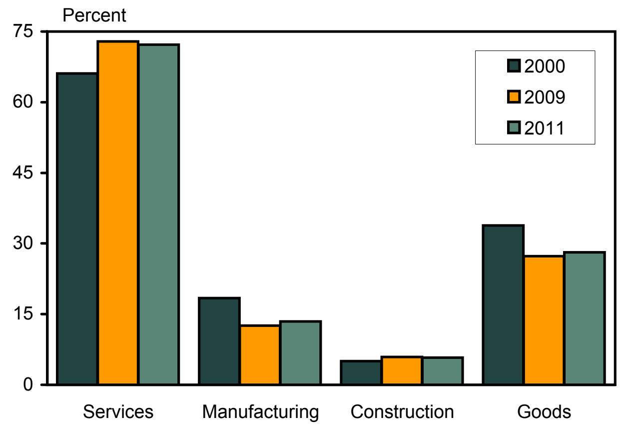
*Index weights U.S. demand and production variables (residential construction, industrial production, auto sales and production, investment in machinery and equipment, personal expenditures and GDP) according to their impact on Canadian exports. Weights used are those generated by the Bank of Canada in its Monetary Policy Report.

south of the border will take some time following such a deep recession. (See the textbox above on macroeconomic and financial assumptions.) What's more, even as demand picks up, some industries will need to work down the massive inventories that have accumulated over the past year before production can sustainably ramp back up again.

Secondly, structural challenges that have been overhanging the sector for the better part of a decade will persist. Notably, the Canadian dollar is likely to rise further in the near term and break through parity, energy prices should remain relatively high and international competition will stay fierce. While much of this competition is from China, the U.S. is also becoming much more cost competitive thanks to the greenback's decline. Case in point is the auto sector, where GM recently announced that it plans to reallocate some production of the next Chevrolet Impala from Oshawa to Michigan, as it will be more cost efficient with the currencies at par.

As such, manufacturing's footprint in the Canadian economy will remain smaller than it has been historically through the upcoming recovery phase. We expect manufacturing as a share of real GDP to rise to 13.5% by the end of 2011 – about 5 percentage points lower than the peak seen a decade ago. Some of this lost share has been picked up by the construction sector, which increased its contribution by a full percentage point since 2000. The rest has been shifted to the services-producing sector, which saw its share of total production hit a record 73% in 2009. These areas will likely see some reversal in relative importance over the next two years; however, much of the gains should remain intact. The trends in output have been mirrored in the job market, with manufacturers employing only 10% of the labour force in 2009, versus 15% ten years ago. This will likely remain the case over the next year or two, as manufacturers work to boost hours and labour productivity during the early stages of the recovery.

SHARE OF TOTAL OUTPUT BY INDUSTRY

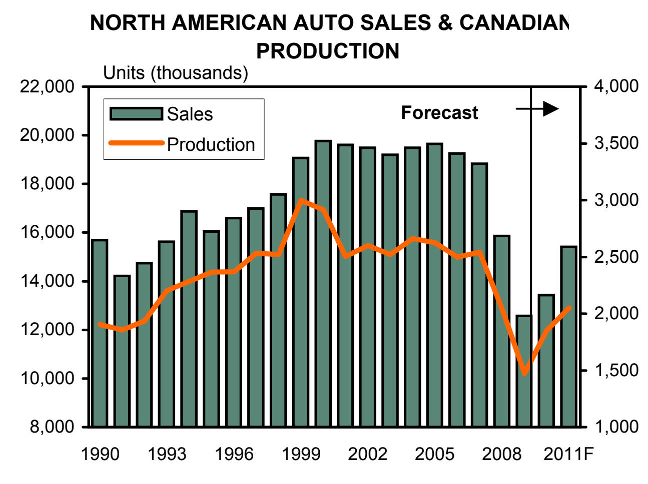


Source: Haver Analytics; Forecast by TD Economics as at January 2010

We now turn to the sector-specific highlights of the forecast. Detailed output changes for 2010-11 are presented in the table on page 5.

Manufacturing poised for greatest gains

Within the manufacturing sector, all industries are expected to expand over the next two years with the sole exception of aerospace (in 2010) – which was last to fall victim to the recession and should continue to pare back output this year. Although the 3% (Q4/Q4) contraction in auto and parts production in 2009 may not seem so bad, output has dropped by over 45% since the end of 2007, making it the hardest hit industry over the past two years. Furthermore, the sector managed to draw down its inventories to historically low levels during the third quarter of 2009, thanks to the "Cash for Clunkers" program in the U.S. and a slew of incentives that boosted auto sales. These two factors combined lead us to believe that the auto sector will be at the top



Source: WardsAuto.com; Forecast by TD Economics as at Jan. 2010

of the leader board this year, with a 17.5% (Q4/Q4) jump in production. However, once stockpiles are replenished – likely by mid-year – production growth is likely to taper off, as demand for autos, although improving, will remain on the weak side in historical terms. Indeed, as we show in the chart above, North American auto sales are likely to reach only 15.5 million units in 2011 – 22% below the peak seen in 2000. As a result, the pace of growth in auto sector output is likely to slow to only 4.5% in 2011.

Meanwhile, the plastics and rubber sector will benefit from the increase in auto production, and the machinery and metal products industries is also set to advance at a healthy clip over the next two years, in line with an ongoing recovery in industrial production in the U.S. Food products has been an outlier, in keeping with its recession-proof billing. As such, its share of total manufacturing has risen from 9.8% in 2007 to 12.6%, and its share of overall GDP has edged up to 1.6%. Given the resilience seen during the recession, growth in the food processing sector will be more moderate as the recovery unfolds, underperforming the rest of the manufacturing sector this year and next.

Primary sector to pick up steam in 2011

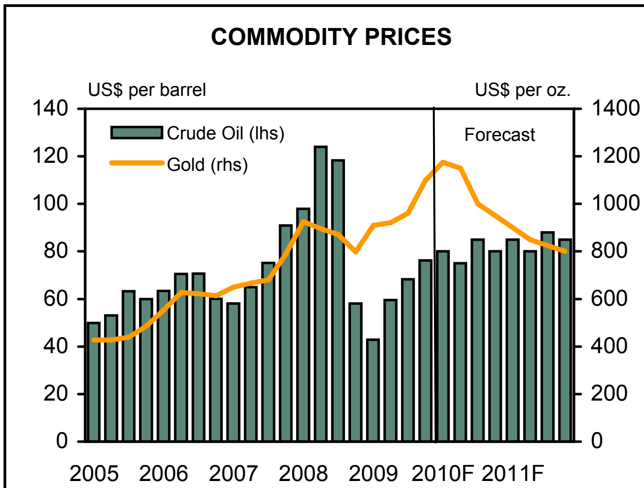
Although most commodity prices have bounced back from the lows seen in 2009, only modest increases are expected for 2010-11. A slow recovery in global demand, persistent excess supply in several markets, and gains in the U.S. dollar later this year as markets look ahead to future rate hikes by the Federal Reserve will limit the upside in U.S.-dollar commodity prices We expect energy prices to hold in recent ranges, at roughly half the peaks seen in 2008. Metal markets have already priced in much of the recovery news, and gold prices are likely to head lower. (For details on our gold price outlook, see *Gold Prices: Has the Rally Run out of Steam*, available on our website.) With a number of markets currently facing a supply glut, the bulk of the rebound in the primary sector will likely occur in 2011 rather than in 2010, once markets are more balanced.

Forestry and logging is the only resource sector that will experience a larger bounceback in output this year, since producers have managed to slim inventories, and are keeping supply in line with demand. This is also the sole primary sector that we expect to recoup the losses brought on by the recession by the end of 2011. However, it is worth noting that the industry has been in a structural decline which will likely continue post-recovery.

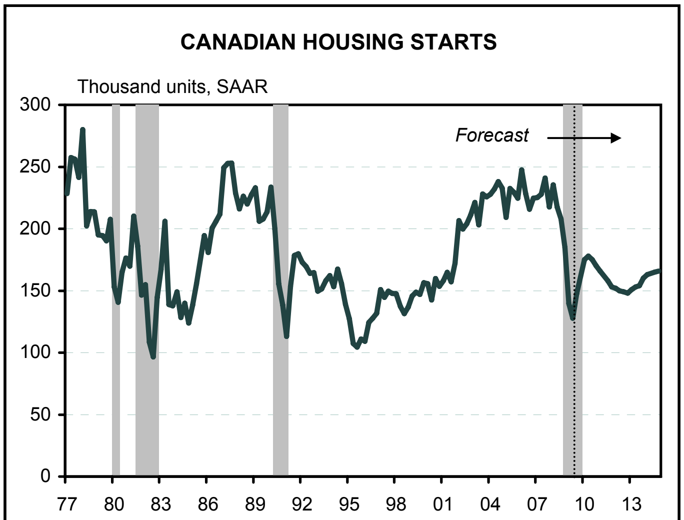
Construction a mixed bag

The Canadian housing market has been surprisingly strong over the past six months, spurred largely by rock bottom interest rates. But much of the strength has stemmed from the existing home market, where sales have not only recovered fully from the recession, but have surpassed the previous peak set in 2007. Average prices have also recouped their losses, and are expected to rise by a further 9-10% in 2010.

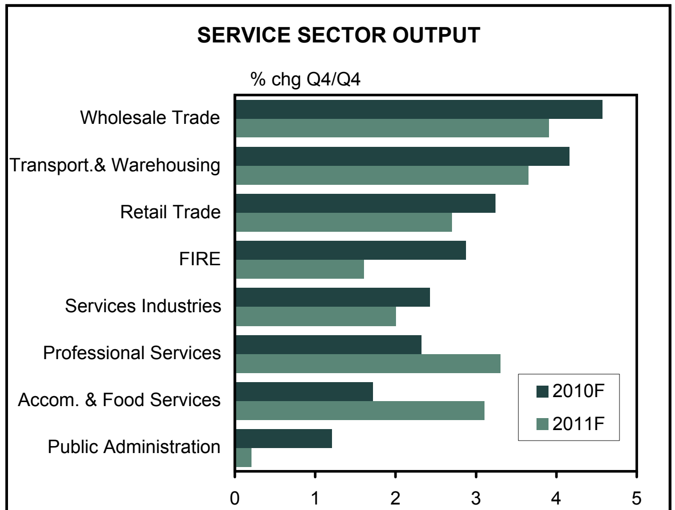
Only part of this exuberance has spilled over into the new home market, bringing homebuilding activity to over 165,000 starts in the fourth quarter – well above the levels seen at the start of 2009. This momentum is likely to carry through into 2010, though we don't expect the strength to persist past the first half of the year. As a result, residential construction should resume a weakening trend by mid-year, with new home starts falling through 2011. As well, if the federal government allows the Federal Home Renovations



Source: Haver Analytics; Forecast by TD Economics as at Dec. 2009



Source: CMHC. Forecast by TD Economics as at Dec. 2009.



Source: Statistics Canada; Forecast by TD Economic, Dec. 2009.

Tax Credit to expire as planned in February 2010, renovation activity would be dampened.

The non-residential sector typically lags the rest of the economy during a recovery as businesses wait to make investments until the rebound is well-entrenched. Engineering construction activity fuelled by government infrastructure spending will remain a bright spot in the non-residential sector in 2010, but is likely to slow in 2011. In the commercial sector, high downtown office vacancy rates, which have increased nationally, from 6% to over 9% since the second quarter of 2008, will continue to put a damper on activity. On balance, the non-residential sector is poised for moderate growth over the next few years. Nonetheless, the outright contraction in residential construction means that the construction sector as a whole will lag behind all other industries in the second half of 2010 and in 2011.

Moderate growth in store for services

Over the course of the recession, the performances within the services industries have been mixed, although 2009 should see modest overall growth of 1.2% (Q4/Q4). Much of the sector's strength in recent months has stemmed from services related to the red-hot housing market, such as finance, insurance and real estate. Public services, including public administration, healthcare and education also expanded in tandem with government stimulus spending. But looking ahead, the strength in these services industries will likely ease as the housing market loses steam and deficit-challenged governments begin to rein in spending. We expect both of these sectors to underperform next year after decent momentum carries them through 2010.

Services industries with the most upside during the recovery stage are those linked to trade and the top growth performer, the manufacturing sector. These services include wholesale trade and transportation and warehousing. Retail trade will also fare well, supported by strength in the domestic market. In fact, after sliding 8.4% peak-to-trough, the retail industry has come a long way, as it is already back to pre-recession levels in volume terms. But consumer indebtedness will hold back consumer-oriented industries, such as retail trade, especially as short-term interest rates begin to rise in late 2010 and in 2011. In fact, only two service industries are expected to enjoy a quicker pace of growth next year: food and accommodation, and professional services. Both of these sectors tend to follow business activity, which should pick up some steam next year during the latter stages of the recovery. On net, growth in the services sector will be much more modest than historical norms of 3-4%.

CANADIAN INDUSTRIAL OUTLOOK										
REAL GROSS DOMESTIC PRODUCT (GDP) BY INDUSTRY*										
	Level	Share of	Y/Y % change				Q4/Q4 % change			
	$billions	Output	Actual	Est.	Forecast		Actual	Est.	Forecast	
	2008	2008	2008	2009	2010	2011	2008	2009	2010	2011
ALL INDUSTRIES (GDP)	**1,230.4**	**100.0%**	**0.6**	**-3.1**	**2.8**	**3.0**	**-1.0**	**-1.5**	**3.3**	**2.8**
GOODS INDUSTRIES	**363.6**	**29.6%**	**-2.6**	**-10.1**	**3.4**	**5.2**	**-3.8**	**-8.2**	**5.6**	**4.9**
PRIMARY INDUSTRIES	**84.8**	**6.9%**	**-1.1**	**-10.4**	**-0.2**	**6.0**	**-1.1**	**-11.8**	**4.4**	**6.5**
Agriculture	20.8	1.7%	7.4	-6.6	-1.6	2.2	2.2	-7.0	1.8	0.7
Oil & Gas	47.7	3.9%	-3.0	-9.2	-0.4	6.7	-0.7	-11.4	4.0	8.2
Non-energy Mining	9.1	0.7%	-0.5	-21.4	0.7	8.7	-2.9	-22.6	7.7	10.4
Forestry, Logging & Other Primary	7.3	0.6%	-10.6	-14.5	4.2	9.3	-10.1	-15.0	12.5	7.7
MANUFACTURING	**171.9**	**14.0%**	**-5.7**	**-12.7**	**6.5**	**6.2**	**-7.9**	**-8.1**	**7.3**	**5.9**
Autos & Parts	19.1	1.6%	-22.6	-30.0	28.4	9.2	-31.8	-2.9	17.5	4.5
Aerospace & Other Transport.	7.6	0.6%	9.9	-4.2	-11.4	2.5	7.3	-11.4	-6.9	7.2
Wood & Paper Products	19.9	1.6%	-12.2	-16.6	3.8	8.2	-13.7	-11.0	6.3	9.3
Food Products	18.2	1.5%	1.5	2.5	2.3	2.6	1.7	3.3	2.3	2.7
Chemicals	15.0	1.2%	-2.7	-7.2	7.9	5.0	-4.3	-2.6	5.6	5.1
Plastics & Rubber	7.9	0.6%	-12.8	-16.8	11.5	7.9	-18.9	-4.6	9.0	9.3
Computer & Electronics	7.1	0.6%	0.7	-7.6	11.7	5.0	1.1	-3.6	8.5	5.1
Machinery	13.1	1.1%	-2.1	-20.0	0.3	7.4	-3.9	-23.0	9.0	8.8
Metal Products	25.2	2.0%	-4.1	-22.1	5.9	7.0	-10.0	-17.6	9.0	7.5
Other Manufacturing	38.9	3.2%	-0.3	-4.7	5.0	6.1	2.2	-6.3	7.3	4.7
CONSTRUCTION	**74.5**	**6.1%**	**2.8**	**-5.9**	**1.6**	**3.3**	**1.6**	**-6.6**	**4.4**	**1.8**
Residential	**23.5**	1.9%	0.4	-11.0	2.4	-0.3	-4.0	-8.6	3.4	-1.8
Non-res. & Engineering	**51.0**	4.1%	4.0	-3.6	1.2	4.9	4.3	-5.7	4.8	3.3
UTILITIES	**31.0**	**2.5%**	**-0.9**	**-4.9**	**1.3**	**2.1**	**-4.8**	**-3.3**	**2.4**	**2.1**
SERVICE INDUSTRIES	**869.2**	**70.6%**	**2.1**	**-0.2**	**2.6**	**2.1**	**0.4**	**1.2**	**2.4**	**2.0**
Wholesale Trade	70.7	5.7%	0.5	-6.9	6.4	3.8	-6.7	0.7	4.6	3.9
Retail Trade	75.0	6.1%	3.0	-0.5	5.0	2.7	-0.1	3.1	3.2	2.9
Transportation & Warehousing	58.3	4.7%	0.5	-4.0	4.5	3.4	-1.6	-0.9	4.2	3.6
Information & Cultural Industries	46.1	3.7%	2.0	-0.3	0.6	1.5	1.0	-1.1	1.7	1.5
Finance, Insurance & Real Estate	237.2	19.3%	2.2	1.9	3.5	1.8	0.7	3.5	2.9	1.6
Professional Services	61.0	5.0%	2.4	-1.0	0.8	3.5	1.1	-1.4	2.3	3.3
Accommod. & Food Services	27.2	2.2%	2.5	-2.0	1.2	2.8	-0.8	-1.2	1.7	3.1
Public Administration	70.6	5.7%	2.7	1.9	1.7	0.6	3.3	1.5	1.2	0.2
Other Services	223.1	18.1%	2.5	0.7	0.8	1.6	2.0	0.1	1.2	1.1

*Measured in chained 2002 dollars; Forecast by TD Economics as at January 2010. Source: Statistics Canada / Haver Analytics, TD Economics.