TD Bank Financial Group

TD Economics

Special Report

April 4, 2007

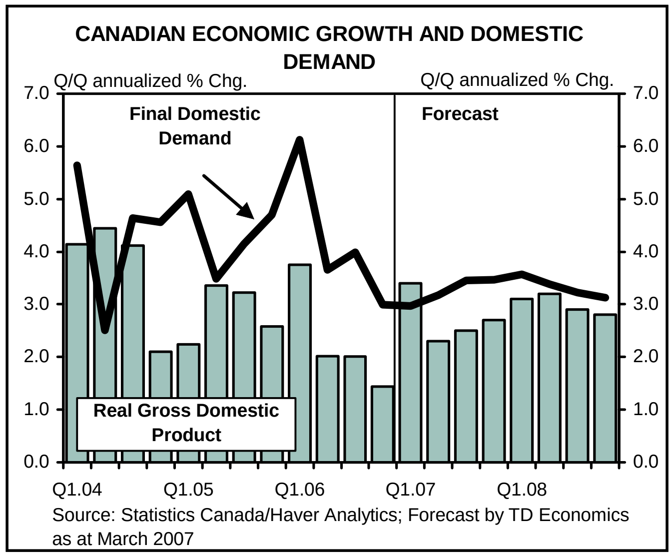
ECONOMIC OUTLOOK REMAINS SUPPORTIVE TO SMALL BUSINESS IN CANADA

- **Economic and financial outlook is positive for domestically-oriented businesses**
- **Export-oriented firms to face headwinds from U.S. weakness, but fortunes will improve in 2008**
- **West to outperform, with regional differences narrowing over time**
- **Interest rates to remain modest**
- **Canadian dollar to stay close to current levels**
- **Challenges from high input costs, tight labour markets and competitive pressures will continue**

Small businesses in Canada are deeply affected by the economic conditions at home and, to a lesser extent, abroad. They are also influenced by financial market developments, particularly borrowing costs and foreign exchange rates. In the following sections, we review the key themes of the economic and financial outlook and flesh out the implications for small businesses. The central conclusion is that the economic and financial climate will remain positive in 2007/08, with some moderation in the west and some improvement in central Canada.

Canadian slowdown masks underlying strength

From a national perspective, the Canadian economy is in the midst of a mild economic slowdown, brought on by the adjustment to a strong currency and the fallout from weakening U.S. demand. Canadian economic growth slowed steadily over the course of last year, with the result that real GDP rose at 2.7% in 2006, down from 2.9% in 2005 and 3.3% in 2004. However, this national picture masked sharply divergent sectoral performances, since the weakness was concentrated in the export-oriented manufacturing sector. Indeed, domestic demand – which encompasses spending and investment by households, businesses and corporations – rose at a strong 4.7% pace last year, which is slightly more vigorous than the prior two years and represents an unsustainable rate of expansion. There was also a major regional dimension, as resource-rich provinces have consistently experienced well above average economic growth.



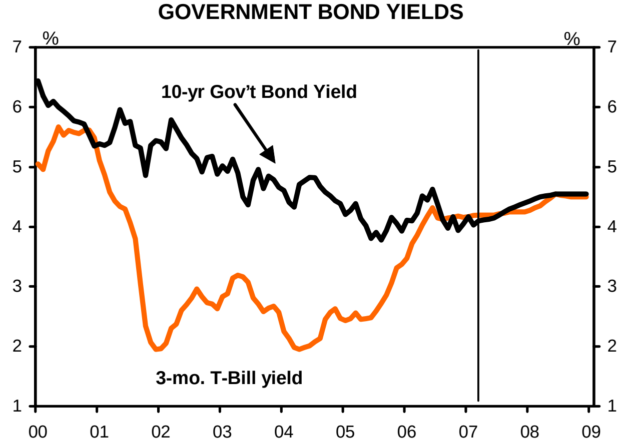
Looking ahead, TD Economics expects the Canadian economy to grow by 2.4% in 2007, representing a sub-par pace of expansion, but the details are again considerably better than the headline. Much of the softness is due to a poor handoff created by weak 1.4% annualized economic growth in the fourth quarter of 2006. In fact, the pace of economic expansion is poised to rebound in first three months of the year and then settle into a 2.3 to 2.7% range for the rest of 2007, before strengthening to an average annual gain of 2.9% in 2008. Domestic demand is expected to remain solid, but moderate to a still-vigorous 3.3% pace of increase in 2007/08, as housing construction and consumer spending lose some steam. However, it must be stressed that the level of activity in housing and personal expenditure will remain high, supported by low unemployment and modest interest rates. Major regional differences in economic performance will persist. The west will continue to lead by a wide margin until manufacturing conditions improve in central Canada, but this is unlikely to occur until the U.S. economy is on the mend – probably in late 2007 or into early 2008. With limited upside to commodity prices and with some moderation occurring in the unsustainable pace of the housing boom and personal spending in the west, the disparate regional economic growth rates will gradually narrow over the forecast horizon. For full details of the forecast, please refer to "TD Quarterly Economic Forecast" available at www.td.com/economics/qef/qefmar07.pdf.

Interest rates and Canadian dollar are range bound

The macro backdrop suggests that interest rates will remain close to current levels. While the Canadian economy has slowed, it is evident that very little economic slack is being accumulated, as evidenced by the fact that the national unemployment rate continues to hover at close to a 30-year low. Given this situation, the Bank of Canada is unlikely to lower short-term interest rates, unless U.S. economic conditions prove dramatically weaker than assumed in our forecast. At the same time, with inflation likely to remain very close to the monetary authority's 2% target, there will be no urgency to raise rates significantly when national economic conditions firm next year.

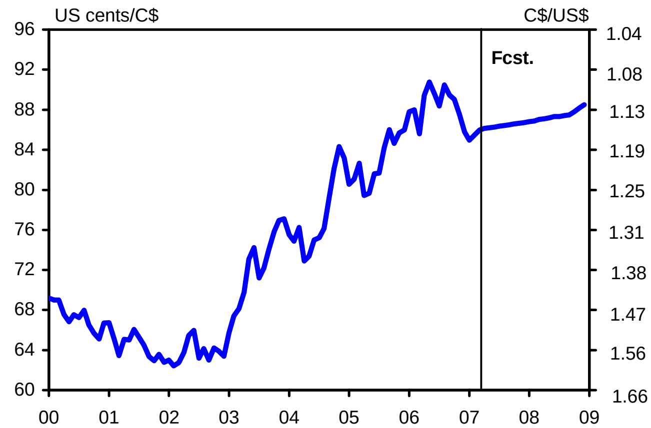
Similarly, longer-term interest rates also appear range bound. Bond markets have already priced in below-trend economic growth in the near term and yields should not decline materially from current levels, but neither should

CANADIAN 3-MONTH T-BILL RATES & 10-YEAR GOVERNMENT BOND YIELDS



Actual data to: Feb. 2007; Forecast by TD Economics as at Mar. 2007; Source: Bank of Canada/Haver Analytics

CANADIAN DOLLAR



Last actual: Feb. 2007; Forecast by TD Economics as at Mar. 2007
Source: Bank of Canada

they climb significantly when economic activity becomes more robust in 2008.

This means that the difference between short-term and long-term interest rates will remain extremely meagre, volatility in interest rates will continue to be low and the level of borrowing costs will continue to be supportive to businesses.

On the currency front, the two dominant drivers of the Canada-U.S. dollar exchange rate are changes in short-term interest rate differentials between Canada and the U.S. and the movement of commodity prices. In terms of the former, interest rates are not expected to change materially in either country. In terms of the latter, the composite TD Commodity Price Index is expected to be relatively flat this year, before rising modestly in 2008. This leads to the assessment that the loonie will remain in a range of 84 to 89 U.S. cents over the 2-year forecast horizon, with a bias to strength late in the period.

Small businesses will benefit from domestic vitality

So, what does all of this mean for small businesses in Canada? Let's run through some of the implications from a sectoral perspective.

Overall, small firms tend to be concentrated in service-related and domestically-focused industries. Health care, professional services, arts, entertainment, recreation and many other service industries should be largely insulated to the near-term weakness in the export sector of the Canadian economy and should continue to benefit from healthy domestic demand. As noted, the pace of domestic demand growth is expected to slip from 4.7% in 2006 to 3.3% in 2007, which will be felt by local businesses. However, the rate of expansion is still quite strong and the trend only represents a shift towards a more sustainable outturn.

Retailers are likely to experience a softer pace of sales, but the moderation will be limited. High rates of employment and continued growth of personal income in excess of inflation will keep Canadians at the malls. Indeed, the national unemployment rate is forecast to remain only marginally above 6%, while real personal disposable income (i.e. after inflation and after-tax income) is forecast to rise by close to 2% annually during the next two years.

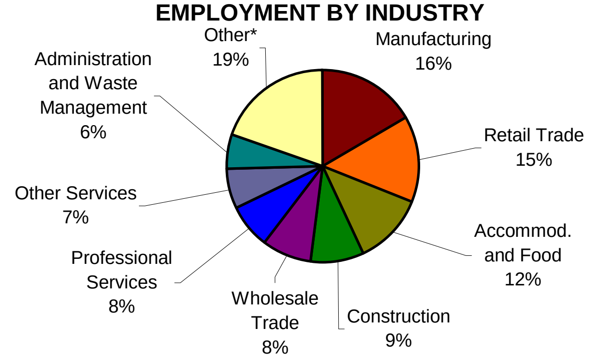
The accommodation and food industry will benefit from a healthy domestic economy, but growth in the sector will be tempered by the impact of the strong Canadian dollar on tourism and could be adversely affected by new passport requirements for individuals crossing the Canada-U.S. border (which are already in effect for air travel and will take effect for ground travel on January 1st 2008).

Construction and real estate will be impacted as housing starts retreat from 228,000 in 2006 to 195,000 in 2008 and resale housing markets cool, with sales declining by 3 to 4% per annum over the next two years. Nevertheless, the level of housing construction and home sales will remain high and demand for real estate services will be solid, as illustrated by the expectation that resale home prices will continue to climb at a national average rate of close to 5%.

Wholesalers and manufacturers will be greatly affected by their exposure to international trade. The outlook is positive for those with significant import exposure, but they will face challenges if they are exporting, or are part of a production-chain of another exporting industry. For example, many small businesses are related to forestry, which is being hard hit by the on-going housing correction in the United States. There are other considerations as well. For example, small and medium-sized businesses related to the auto industry and with strong ties to the North American Big Three assemblers will likely continue to face challenging times due to on-going restructuring in the industry.

These industry observations, particularly for the domestically-oriented businesses, must be balanced by the outlook for the regional economy in which the firms are operating. For example, after PEI, the western provinces of Alberta, B.C., and Saskatchewan have the highest concentration of small and medium-sized enterprises – and these provinces are at the top of the regional growth ranking. The western economies will continue to outperform in 2007-08, but the rate of economic expansion is expected to moderate. Meanwhile, economic conditions in central Canada will be lacklustre in 2007, but generally improving in 2008. Atlantic Canada will have an extremely varied performance. PEI, New Brunswick and Nova Scotia are expected to post modest economic growth in 2007, while Newfoundland & Labrador grows at an above average pace. However, the economic rankings reverse in 2008, as the former three Atlantic provinces deliver significantly better performances.

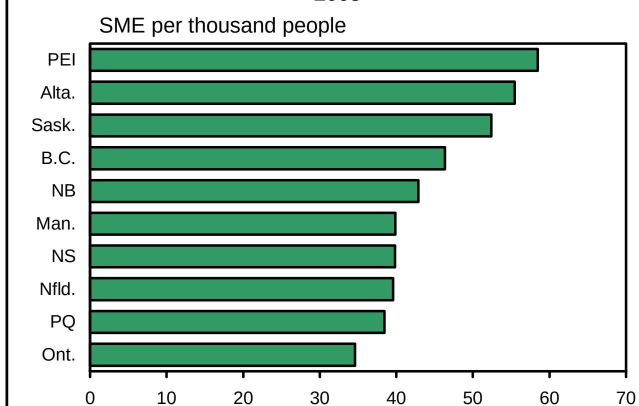
SMALL AND MEDIUM SIZE ENTERPRISE EMPLOYMENT BY INDUSTRY



Source: Industry Canada, June 2005

* The Other categeory is comprised of: Utilities, Mining, Forestry, Finance and Insurance, Informational and Cultural, Transportation and Warehousing, Mgt. of Companies, Arts and Recreation, Real Estate and Rental, and Health Care

SMALL AND MEDIUM-SIZED FIRMS PER CAPITA 2005



Source: Industry Canada / Haver Analytics / TD Economics June 2005

Firms have realistic expectations

The general outlook for small businesses in Canada outlined above appears to align very closely with the March 2007 business survey released by the Canadian Federation of Independent Businesses (CFIB). In the first quarter of this year, small and medium-sized firms reported an increase in business conditions, corresponding with our anticipated rebound in Q1 economic growth. Moreover, the headline barometer index has remained in a tight range of

105-110 that has generally prevailed since mid-2002, which is consistent with solid domestic demand. In terms of the outlook, 51% of respondents expected a stronger performance in 12-months time, while only 14% expected a weaker outturn. This fits with our view that the Canadian economy will firm in 2008 and that the moderation in domestic demand will represent a shift from booming strength to robust conditions. As one would expect, business optimism was strongest in B.C. and Alberta; solid in Saskatchewan and Manitoba; modest in Ontario and Quebec; and very mixed in Atlantic Canada. Based on this survey, it appears that small businesses in Canada have realistic expectations about the future.

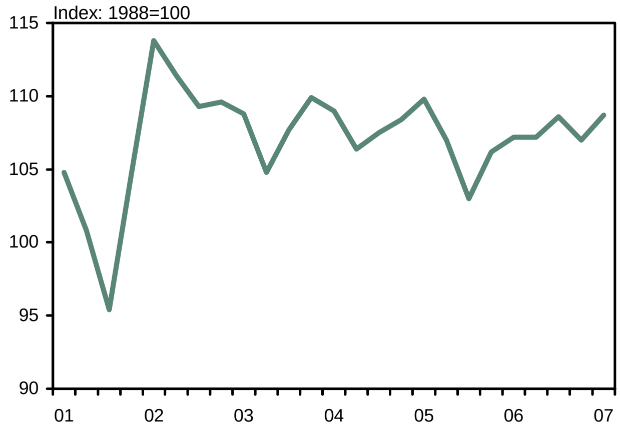
Tight labour markets will remain a challenge

This positive assessment is not to say that businesses don't face challenges. Surveys consistently show that rising input costs are a key hurdle. The good news is that we believe that the upside to energy prices and material costs are limited. The bad news is that there is little chance of a significant pullback either.

Firms also regularly note concerns about wage demands and labour availability. The economic outlook suggests that small businesses will continue to be challenged by tight labour market conditions. The national unemployment rate will stay at close to a 30-year low over the forecast horizon and this is likely to put upward pressure on wages. The situation will be most acute in western Canada. The unemployment rate in Alberta is projected to rise, but remain below 4%, while it is forecasted to stay below 5% in British Columbia. However, this is not just a western story. For example, unemployment in Ontario is forecast to peak at less than 7% in 2007, which is still quite low by historical standards. This is not to diminish the labour market difficulties in some sectors, like manufacturing, but for many other industries the greatest hurdle in recent years has been finding adequate staff with the necessary skills, and this appears likely to continue. However, one should also recognize that the labour market strength has been a major contributor to the recent economic expansion.

Finally, businesses have been challenged by increasing competition from both domestic and foreign competitors. It is difficult to see this changing. In order for firms to succeed, they will need to be nimble and adaptive. Increased investment in productivity-enhancing machinery and equipment could help on this front, and the strength in the Canadian dollar is a positive since it has dramatically reduced the price of imported capital. Moreover, the 2007 Federal Budget allows manufacturers to write-off their investment in machinery and equipment faster, which lowers the cost of capital purchases for small businesses in this sector, and all firms are allowed to write-off computers more quickly.

CFIB QUARTERLY BUSINESS BAROMETER



Source: Canadian Federation of Independent Business

Conclusions

So, challenges are present, but the main themes to the outlook for small businesses are fundamentally positive. First, the economic backdrop should be generally supportive in 2007/08. Small businesses tend to be less export-oriented and this is the sector that is most vulnerable in the near term. The domestic economic expansion will cool a bit over the next two years, but it will remain robust. And, for those small businesses that do export or are tied to other businesses that export, the economic fortunes should improve heading into 2008. Second, there is a huge regional dimension to the outlook, but the differences should narrow with time, with the trend being towards a convergence around healthy economic activity. Third, financial conditions will remain positive, with interest rates remaining at historically low levels. The Canadian dollar will remain strong, but it should not appreciate significantly from current levels.

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