OBSERVATION
TD Economics

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# DESPITE RECENT SETBACKS, BUSINESS INVESTMENT IS STILL POISED TO REVV UP IN CANADA

## Highlights

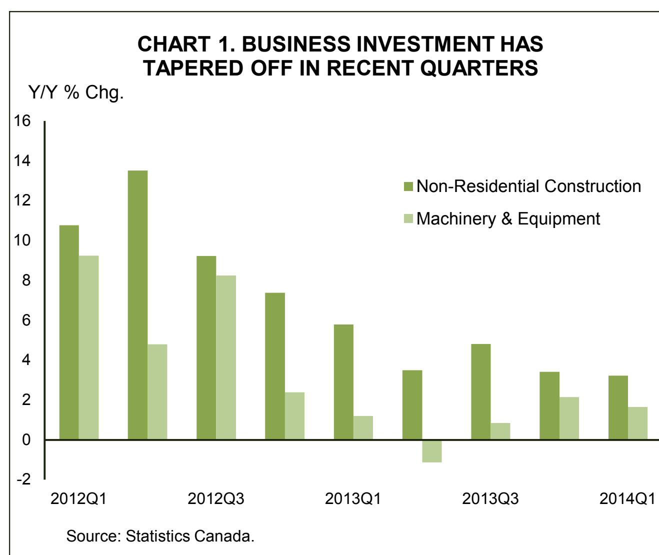
- Business investment in Canada has been disappointing in recent quarters, reflecting an uncertain outlook and hesitation on the part of businesses to invest as a consequence. This is particularly true with respect to investment in machinery and equipment.
- Despite this recent setback, we identify six compelling reasons why capital investment will strengthen over the near term.
- More specifically, U.S. growth is expected to strengthen, pushing up demand for Canadian exports and boosting corporate profits. As a result, firm optimism will continue to increase while capacity utilization will be squeezed further, encouraging companies to invest by taking advantage of their already strong balance sheets and the accommodative borrowing environment that is expected to exist for some time.
- This is good news for Canadian households in the long run, as with stronger business investment, particularly in machinery and equipment, will come productivity gains and ultimately stronger economic, wage, and income growth.

After solid gains out of the gate following the 2008-09 recession, growth in business investment has slowed dramatically in recent quarters (Chart 1). While investment in non-residential structures has played its part in propping up growth, helped along by robust investment in the oil sands, most of the weakness we've seen stems from a lack of investment in machinery and equipment. This is concerning, as it's investment in machinery and equipment that boosts productivity and ultimately economic, wage, and income growth over the longer term.

Despite its recent weakness, TD Economics believes business investment, and particularly investment in machinery and equipment, is poised to pick up over the next couple of years for six reasons.

### Reason #1. A stronger U.S. economy

The first reason for our optimism is the continued strengthening of the U.S. economy. Despite a weak start to the year, largely due to unseasonably cold weather, the economic fundamentals are in place for a solid rebound across the board, with both consumption and investment expected to make gains. As U.S. domestic demand goes up, it should increase demand for Canadian exports, thereby encouraging additional business investment to meet that rising demand (Chart 2).

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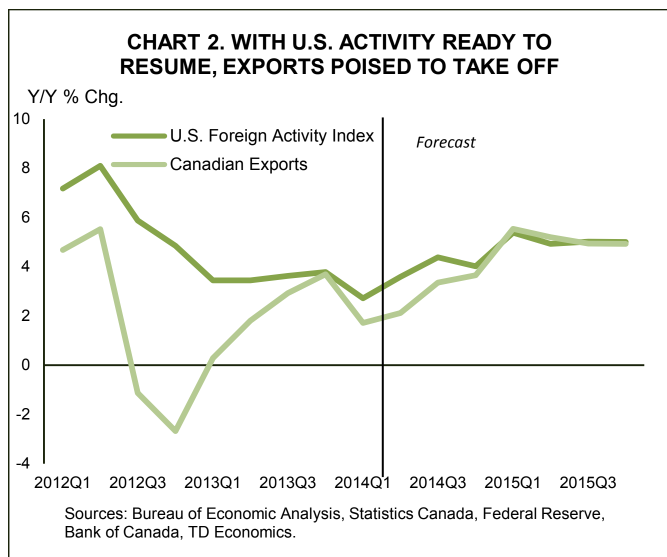
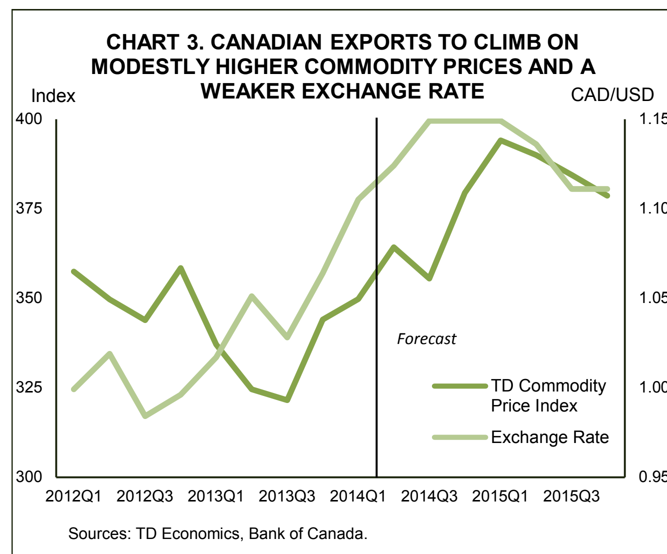
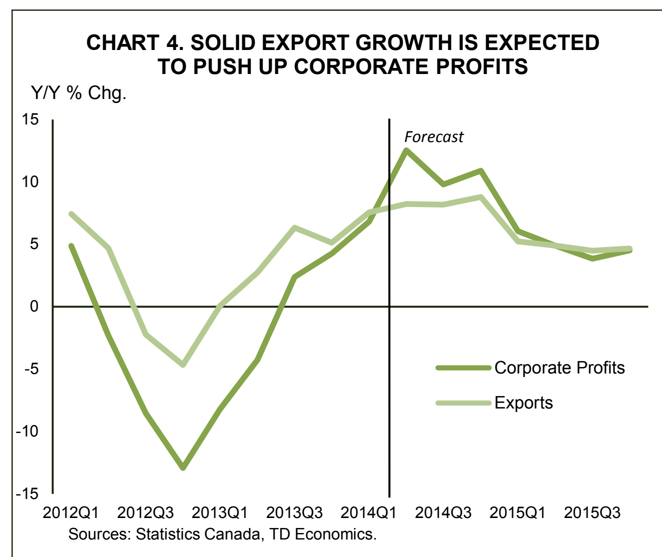



Growing U.S. demand will be supported by other export-friendly influences in the coming quarters. TD Economics expects the Canadian dollar will depreciate further over the course of 2014, to 87 US cents (or C$1.15 per USD), largely reflecting U.S. dollar strength (Chart 3). Furthermore, improving global growth will provide support to resource prices, with most key commodities expected to trade within their recent ranges over the next few years.

### Reason #2. Rebound in corporate profits

The second reason for optimism is the recent rebound in corporate profits. After generally outpacing GDP growth through the recovery, corporate profits declined as a share of GDP from 2012Q1 until 2013Q2 but have since begun to recover. Corporate profits grew by over 25% (at annualized rates) in the first quarter of 2014, underpinning solid growth for the year as a whole.

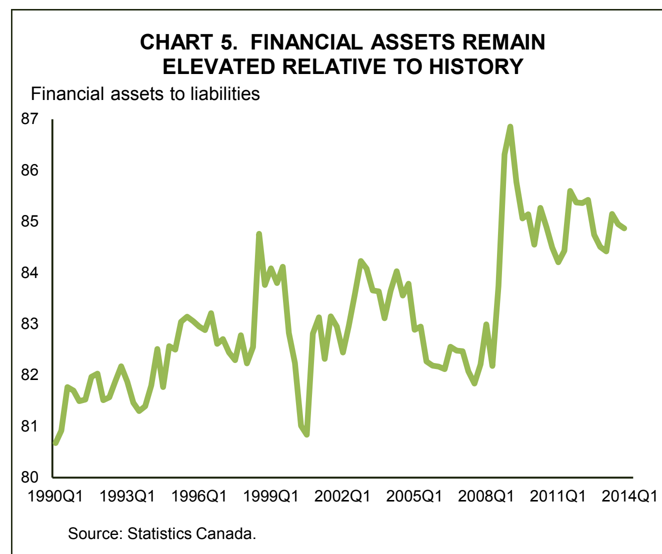


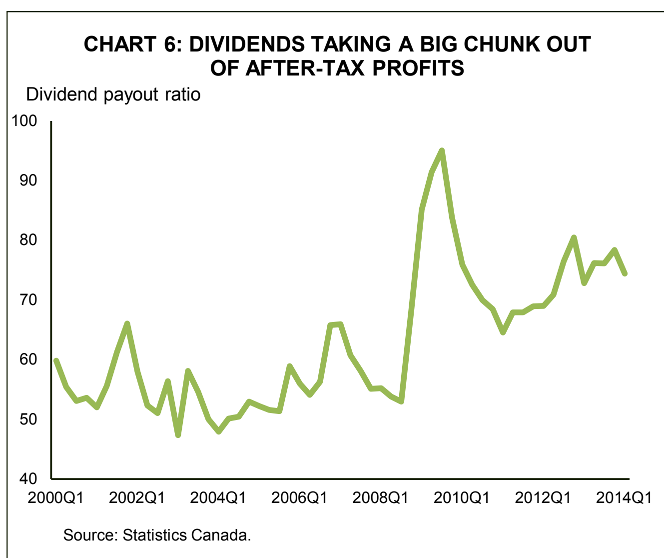



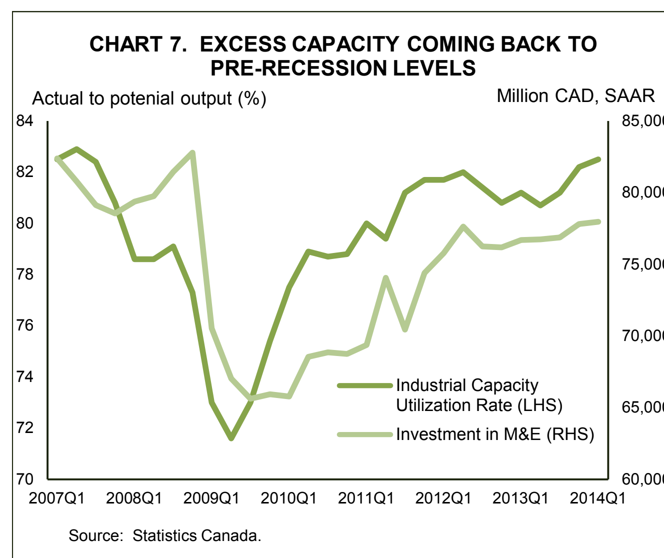

While growth over a few quarters doesn't make a trend, at the very least it suggests the recent weakness in corporate profits appears to have come to an end. Given the strong relationship between exports (as a reflection of foreign demand) and corporate profits, we expect moderate growth in corporate profits going forward (Chart 4). Consequently, as growth in corporate profits tends to lead growth in business investment, we should see investment pick up as corporate profits return to their pre-recession share of the economy.

### Reason #3. Solid corporate balance sheets

Third, the rebound in corporate profits is only going to work to strengthen already solid corporate balance sheets. For instance, the ratio of financial assets to financial liabilities looks to have settled at a new level following the recent recession, reaching near-historically unprecedented levels (Chart 5). This trend is particularly pronounced for






non-financial corporations. The same pattern holds true for cash as a share of total assets, although it continues to remain at a low level. This low debt, high liquidity environment is an ideal launch pad for business investment.

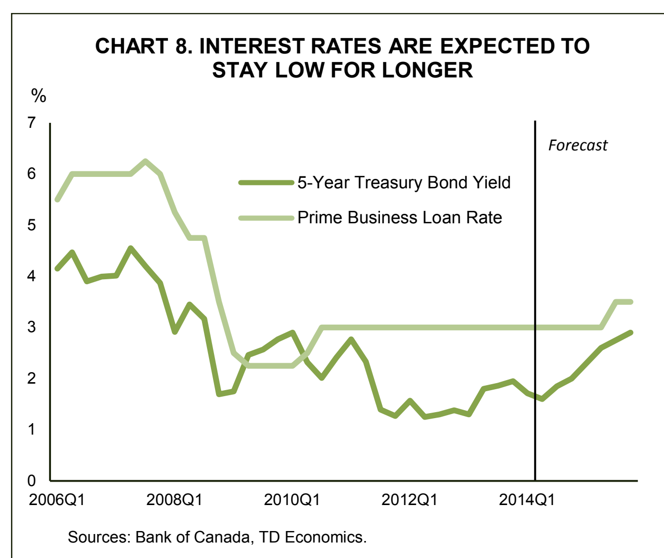
A noteworthy caveat is that, while firms have increased the relative amount of financial assets on their balanced sheets, this may in part have been to ensure their dividend payments were maintained through a period of significant volatility in after-tax corporate profits. As is illustrated in Chart 6, dividends continued to take a large share of after-tax corporate profits through the recovery relative to pre-recession levels. While this hunger for yield is likely to remain strong going forward, the aggregate dividend yield is likely to experience some downward pressure in the coming quarters, due to growth in corporate profits outpacing that of dividends.

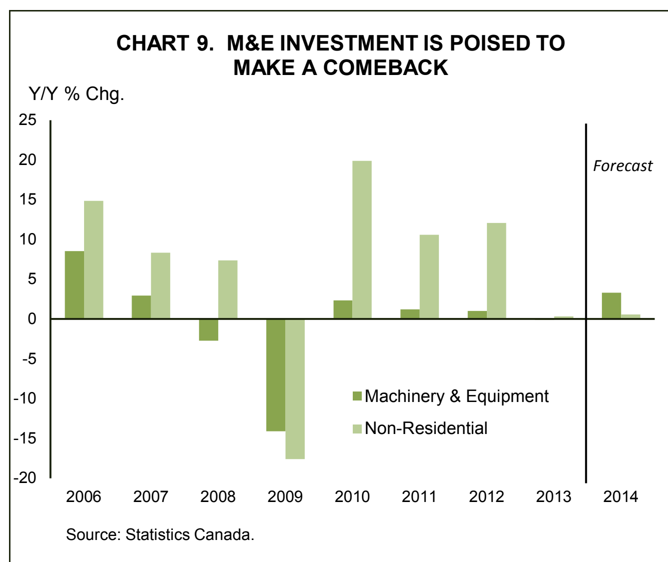
**Reason #4. Spare capacity is shrinking**

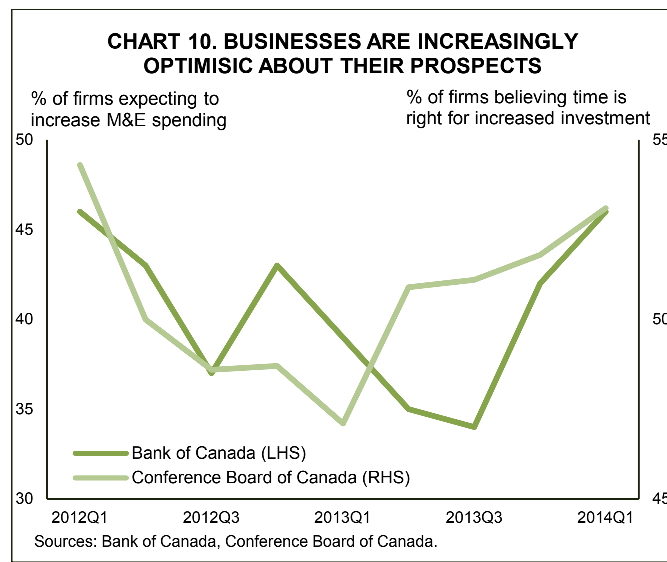
This brings us to the fourth reason for our optimism, which is that shrinking excess capacity may not leave Canadian companies much choice but to invest. Specifically, the total industrial capacity utilization rate, which tracks changes in the level of investment in machinery and equipment, is at its post-recession peak and rising (Chart 7). As a result, given we expect economic growth to accelerate over the near term, it's a safe bet that industrial capacity utilization rates and investment in machinery and equipment will increase along with it.

**Reason #5. Accommodative monetary policy**

The fifth reason for optimism is accommodative borrowing conditions, as persistently low interest rates create a positive environment for borrowing (Chart 8). Indeed, exceptionally low benchmark rates, combined with compressed corporate spreads, have spurred increased corporate borrowing activity so far this year, which tends to be a leading indicator of near-term investment spending. This positive environment for borrowing is expected to continue, with the Bank of Canada not expected to raise interest rates until the second half of 2015. Meanwhile, with long-term interest rates being additionally influenced by U.S. Federal Reserve policy, the continued tapering of the pace of asset purchases can be expected to put only modest upward pressure on long-term borrowing rates through 2015.






### Reason #6. Companies are optimistic

This brings us to the sixth reason business investment is likely to pick up over the next couple of years, which is that companies have indicated they are planning to invest. While prone to significant revisions, the Statistics Canada Survey of Public and Private Investment Intentions is consistent with higher capital spending in 2014. More specifically, companies have indicated that they intend to invest 3.3% more in machinery and equipment in 2014 than in 2013 (Chart 9). In contrast, following a period of solid growth, investment in non-residential structures is expected to be more muted in 2014.

Looking to more recent indicators, business sentiment continues to rise in Canada on the back of stronger prospects for foreign demand and Canadian exports. Indicators from the Bank of Canada's Business Outlook Survey (BOS), Conference Board of Canada Business Confidence Index, and the Canadian Federation of Independent Business' Business Barometer all point to increased optimism for the future among Canadian companies (Chart 10). Business investment is expected to increase as a result of this greater optimism.

### Bottom line

Combining solid corporate balance sheets, improved profitability and shrinking excess capacity with optimistic investment expectations, stronger expected foreign demand and stimulative borrowing conditions, it seems entirely reasonable to expect business investment to pick up going forward. TD Economics expects real business investment will lead real GDP growth over the next couple of years, growing at an average annual pace of 4-5% over the remainder of 2014 and in 2015.

Increased business investment, particularly in machinery and equipment, will be a welcome development in the Canadian economy. As investment increases, so does productivity, and ultimately wages and incomes in the long term. However, it should be noted that as the export sector tends to be more capital intensive, and thus employs proportionately fewer people than many other areas of the economy, the benefits of the export and capital spending intensive expansion likely won't be felt by many Canadians in the near term.

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