OBSERVATION

TD Economics

October 29, 2013

CANADA'S CORPORATE PROFIT SLUMP

Highlights

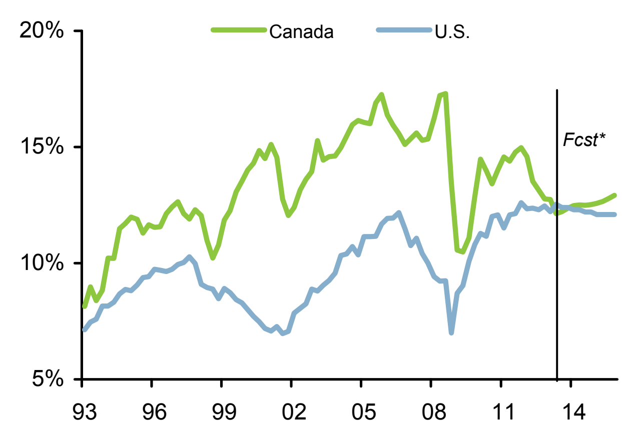
- Looking at profits, corporate Canada is in a slump. The recent decline in corporate profits both in level terms and relative to GDP is the worst outside of a recession since the tech bubble burst.
- The worst of the weakness has been concentrated in a few key sectors like manufacturing and resources. Moreover, profit performance has not necessarily lined up with real output in each sector, as other influences such as commodity prices and inflation are at play.
- Looking ahead, the profit performance should stage a modest improvement over the coming quarters, led by the export and resource-oriented sectors. Overall we see a return to high single digit gains, reversing the downtrend in the profit-to-GDP ratio.

Any way you slice it, corporate Canada is in a slump. Corporate profits have declined in five of the past six quarters and are now 16% below their post-recession peak in late 2011. This decline is not as bad as during the last recession, but it is approaching the performance Canadian firms saw during the U.S. downturn in 2000-2001. That is also the last time corporate profits as a share of nominal GDP was this low outside of a recession.

This weakness has been reflected in the performance of Canada's equity markets, which have vastly underperformed the United States since the lows seen in October 2011. Canada's corporate profit picture versus the U.S. has also deteriorated (see chart).

Apart from equity markets, a tougher profit environment has had implications for business' capacity to invest. Growth in spending on machinery and equipment has dropped dramatically since earlier in the economic recovery, and actually declined in the first half of 2013. Moreover, there is no hard evidence yet that the mood in corporate Canada is about to turn around. The Bank of Canada's latest Business Outlook Survey showed that uncertainty regarding future demand continues to weigh on firms' investment decisions and near-term capacity planning. Clearly this is a phenomenon of importance to Canada's economy and begs a few key questions. How widespread is the weakness in corporate profits? Is this an output story? How much are other factors at play (i.e., prices, higher wages/expenses)? Finally, when is Canada expected to pull out of this slump?

CORPORATE PROFITS AS A SHARE OF GDP



Source: Statistics Canada/BEA; *Fcst by TD Economics as at October

Profit weakness widespread, but losses in key sectors

Relative to the period of healthy growth prior to the last recession, corporate profit growth in Canada has been weak recently. While both the non-financial and financial industries have seen profit growth ebb, nonfinancial industry weakness has been far more pronounced (see table). On average over the past six quarters, non-financial corporate profits have fallen by 6.0% year-on-year. The table highlights the performance of the largest industries, which in total account for more than three-quarters of corporate profits over the past 10 years. The figures show that all sectors have seen their profit growth slow dramatically

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Average Corporate Profit Growth for Key Sectors	2002-07	Past 6 qtrs
	(y/y % chg.)	
Nonfinancial Industries	11.2	(6.0)
Manufacturing	7.3	(13.8)
Resources*	13.0	(30.4)
Wholesale Trade	10.8	3.3
Retail Trade	12.8	0.5
Information & Cultural Industries	22.4	8.9
Real Estate, Rental & Leasing	11.1	7.2
Construction	26.4	4.2
Finance and Insurance Industries	15.4	10.3
Depository Credit Intermediation	16.7	5.9
Secur/Comm Contracts/Oth Finl Invmts, etc	16.7	5.5

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

compared to the pre-recession period. But, losses over the past six quarters have been concentrated in manufacturing and the resource sector.

The profit performance of the resource sector has followed closely in line with commodity prices. The Bank of Canada's commodity price index peaked in early 2011 and fell through much of the next year and a half, driven largely by lower oil prices. This trend hit profits hard, and the bulk of the losses in the resource sector occurred in 2012 (see chart). So far in 2013, generally higher commodity prices have helped drive encouraging growth in resource sector profits, although the sector is still in the red over the past six quarters as a whole.

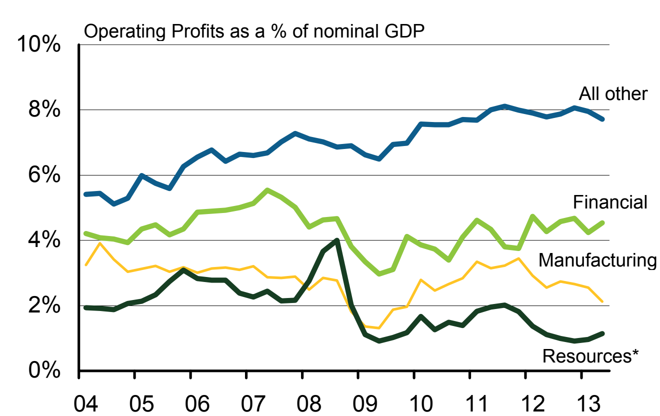
The manufacturing sector has seen the largest losses in absolute dollar terms over the past six quarters. The poor performance in manufacturing is both cyclical and structural. Manufacturing has underperformed so far in the economic recovery in part due to the weakness of the U.S economy, which is its major export market. However, the industry also faces serious competitiveness challenges. Unit labour costs have been rising faster in Canada than in the U.S. since the recession, and this is only partially due to the strong Canadian dollar. Unit labour costs have been largely flat south of the border since the recession, and have risen in Canada even before you adjust for the effect of the exchange rate (see chart). This competitiveness issue is likely part of the explanation why the performance of manufacturing in Canada and the U.S. has diverged recently. Manufacturing shipments in Canada are down in real terms versus last year, whereas in the U.S. they have been growing consistently since the recession.

Profits in more domestically oriented industries have held up better, although they too have seen their pace of growth slow dramatically compared to the pre-recession period. This is due to a combination of more modest domestic growth in Canada versus the 2002-07 period, and intense competition at the retail level, which has led to very limited pricing power in certain industries, constraining revenue growth.

How does this line up with output trends?

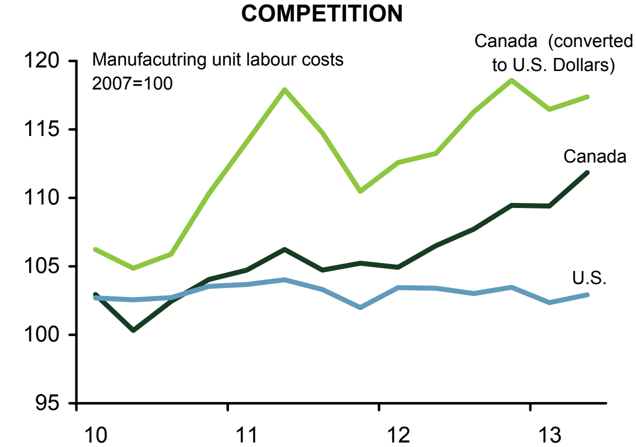
Corporate profits are the difference between revenues and expenses. Revenues are prices times units sold. Output relates to units sold, while profits are affected by product prices and input costs as well. As such, the trends in profits do not necessarily line up with real output in a particular industry. Focusing on the industries which have seen profits decline over the last year and a half, the chart shows that output in most industries has continued to grow in real terms, (i.e. volumes) (see chart). Manufacturing is really the key

CORPORATE PROFITS SHARES BY SECTOR

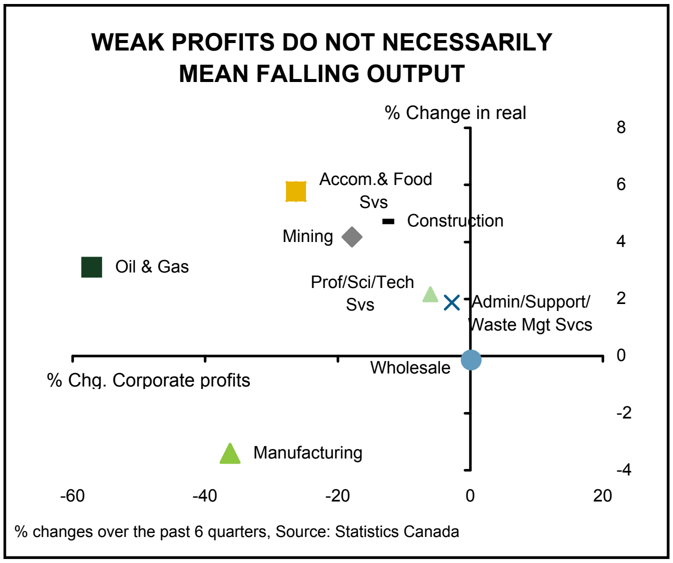


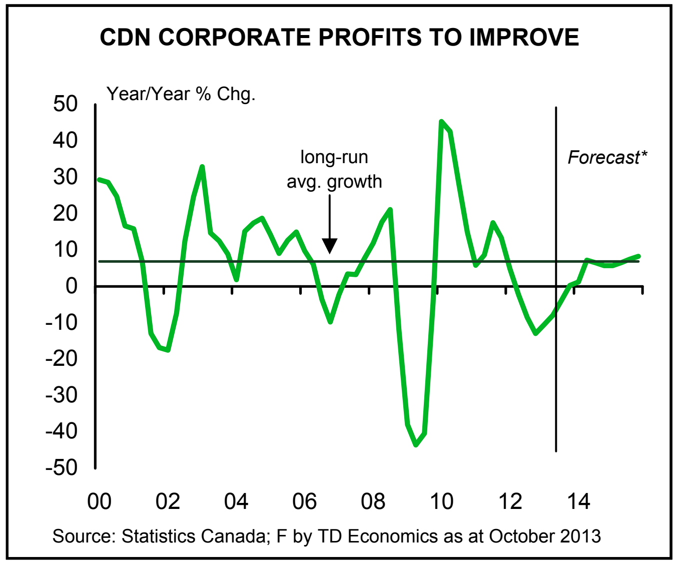
Source: Statistics Canada
*includes mining, oil & gas, and forestry/agriculture fishing and hunting

CDN MANUFACTURERS FACE TOUGH COMPETITION



Source: Statistics Canada





outlier, as both profits and output have fallen. Again, the chart confirms that the resource sector weakness has really been a commodity price story, as the industry has continued to grow its output in real terms.

Is Corporate Canada going to shake off its slump?

Looking ahead, corporate profits do face some cross-currents. Overall, stronger economic growth in the United States next year will help lift U.S. demand and hence profits at Canada's exporters (for more detail please see our latest Canadian Quarterly Economic Forecast). As a result of the government shutdown, U.S. economic growth will be weaker-than-anticipated in the near-term. However, that activity should be recouped next year. Moreover, there has been a decent pick up in the U.S. ISM manufacturing index since the spring, which generally bodes well for Canadian exports to the United States. Commodity prices, broadly speaking, should improve, although further gains are likely to be modest. Inflation has troughed in Canada, and a bit more pricing power going forward should also help corporations' bottom lines. The Canadian dollar is also forecast to depreciate over the forecast horizon, which should lend a hand to competitiveness in the manufacturing sector. Pushing against these forces are a modest slowing in domestic demand growth.

Overall, these forces should help corporate profits stage a modest rebound in the coming quarters (see chart). Annual profit growth should improve to the mid-to-high-single digits year-on-year, essentially in line with their historical average pace, which should be supportive for equity markets going forward. That would leave corporate profits as a share of the economy improving once again, but not regaining their pre-recession levels. Echoing the forecast for growth in the economy as a whole, Corporate Canada should see better days ahead, but not a return to the heydays seen prior to the recession.

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