TD Economics

Special Report

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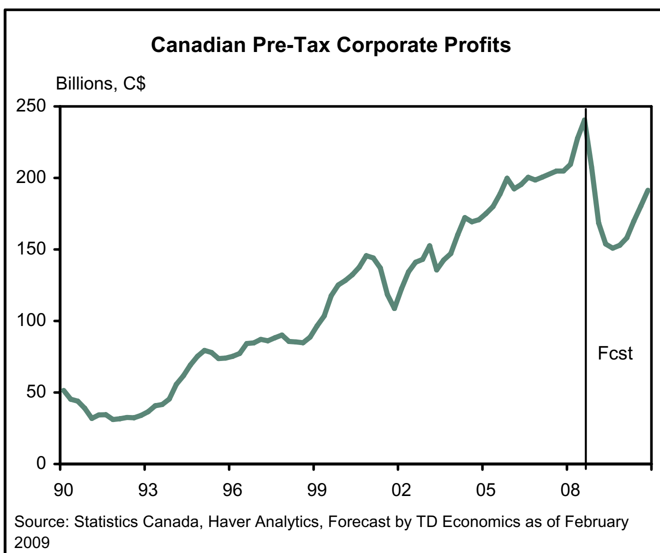
CANADIAN PROFITS TO FALL BACK TO 2003 LEVELS IN 2009

HIGHLIGHTS

- **Pre-tax corporate profits are expected to decline roughly 30% in 2009, placing profits back at 2003 levels.**
- **While domestic and foreign demand typically have the biggest and most direct influence on profits, the massive downdraft in commodity prices has an outsized impact on our profits outlook.**
- **However, by the end of 2010, a recovery in demand and commodity prices is expected to result in roughly a 20% rebound in profits (Q4/Q4), returning them to 2005 levels.**

Plummeting stock markets, tumbling commodity prices and reports of financial hardships among corporations leave no question that the heydays of Canada's corporate profit boom are in the past, but less clear is how long profits will be down and out. This is an important question from an economic standpoint because movements in profits generally impact the wages of workers with a 3-to-4 quarter lag. Likewise, a turnaround in profits will help heal government coffers, through an increase in both corporate and personal tax receipts.

Canadians are just beginning to feel the effects of weakened profits after a near-seven year boom that began in 2002. By the time 2009 is tallied, we believe before-tax profits will have retreated by roughly 30%, marking the largest pullback in a single year since the data commenced in 1961. Although corporate profits are expected to be on the mend at the tail-end of this year, as the domestic and global economies stabilize, the recovery isn't likely to be vigorous and by the end of 2010, the level of Canadian profits are expected to have returned to only 2005 levels.



Source: Statistics Canada, Haver Analytics, Forecast by TD Economics as of February 2009

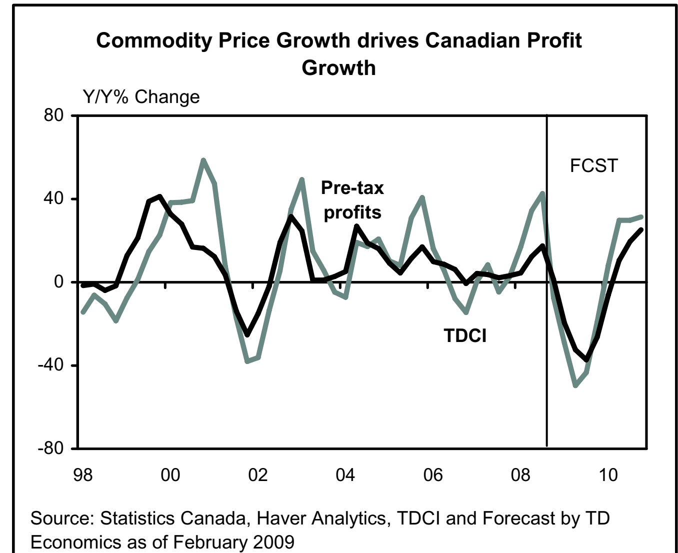
What are the forces at work? Our model explores 4 key influences: energy and non-energy commodity prices, foreign and domestic demand for corporate goods and services, wage costs, and financing costs. Naturally, these influences do not operate in isolation, as the strength of foreign demand has a direct influence on commodity prices, but the model attempts to look at each separately. While domestic and foreign demand typically have the biggest and most direct influence on corporate profits, the massive downdraft in commodity prices that first took hold in late 2008 has an outsized impact on our profits outlook.

Commodity slump bites national profits

Doom and gloom gripped the world economic community in 2008, led by a number of high-profile financial insti-

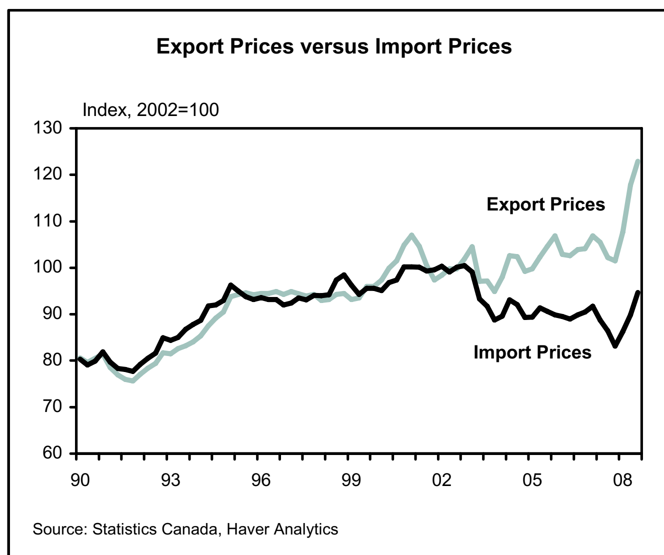
tutions running into trouble. By the third quarter, it was increasingly clear that the Euro region, the U.K and the U.S. were in the grips of a recession. However, someone forgot to tell Canadian corporations of these events, as pre-tax profits experienced a 17% increase in the third quarter relative to the prior year. In fact, profit growth accelerated as the year progressed. One of the key factors was that commodity prices were trending higher until the second quarter, and the unwinding in prices that started in the third quarter was relatively tempered until the final quarter of the year. As a result, nearly three-quarters of the annual increase in Q3 profits still came from the commodity sectors of mining, oil and gas.

But this is hardly new news. The commodity sector was a key driver of profits between 2002 and Q3-2008, as prices pushed higher. Between Q3 2002 and Q3 2008, energy-related commodity prices were up more than 3 fold, while profits within oil and gas industries rose 3 fold and those within mining firms rose 9 fold. In most markets, when prices rise, consumer demand eventually drops off in response. But, demand for commodities is relatively inelastic, meaning that quantities demanded will not change in proportion to price changes. As an example, households can't easily, and cost effectively, switch their heating source from oil to natural gas. Likewise, most companies can't make a quick shift to another energy source in their production and transportation processes. Therefore, when commodity prices rise, with quantities relatively unchanged, revenues for resource based companies largely follow suit. This is why our model estimates that for every one percentage point increase in the TD Commodity Price Index, national profits rise by 0.6 percentage points. However, the same forces are at play when commodity prices tumble. An abrupt drop in global demand has led to a free fall in commodity prices, and from peak to trough, overall commodity prices are expected to fall 50-60% by mid -2009, detracting 30-37 percentage points from corporate profit growth over this time horizon.



Source: Statistics Canada, Haver Analytics, TDCI and Forecast by TD Economics as of February 2009

There are also secondary effects from falling commodity prices on national corporate profits. With the international community recognizing Canada as a commodity-exporting country, movements in commodity prices tend to be reflected in the Canadian dollar. During the 2002 to Q3 2008 period, elements of the Canadian economy benefited from a strong currency that drove export prices up 23% (in Canadian dollars), and import prices down. Although higher export prices meant decreased competitiveness for industries where demand was price sensitive, firms could also purchase inputs from foreign suppliers at lower costs, which helped widen profit margins. For instance, the strong Canadian dollar resulted in a 30% decline in the cost to import machinery and equipment from its 2002 levels, allowing companies to adjust to higher input costs through the replacement of older inefficient equipment with newer, more cost effective models. Since May of 2008, however, the Canadian dollar has depreciated 23% and is expected to average about $0.83 for 2009. In normal times, the quick depreciation of the Canadian dollar and a 6.5% decline in export prices in 2009 would increase the competitiveness of Canadian goods and services on the international market, providing an opportunity to expand trade. But times



Source: Statistics Canada, Haver Analytics

are not normal with the world economy facing a deep recession. An already failing Canadian export sector can expect more hardship in 2009. In essence, extremely weak global demand will trump improved competitiveness from the currency. Meanwhile, the profit margins for those who rely on imports for inputs will get squeezed from the lower Canadian dollar. The slack in the Canadian economy will ensure that producers and retailers will not have the needed pricing power to pass added costs onto consumers, and will likely have to offer large discounts in order to draw down inventories, putting additional downward pressure on profits.

By 2010, however, we believe the global economy will rebound by 3.2% and this should spur greater demand for commodities. Canada will be in prime position to reap the rewards. An anticipated 24% gain in commodity prices is expected to add about 14 percentage points to profits in that year.

Demand is key

Naturally, the biggest driver of profits is demand, be it domestic or foreign. For a proxy of foreign demand, we used U.S. GDP in our model, which suggests that every 1% increase results in about a 3 percentage point gain in Canadian corporate profit growth. Domestic demand growth has a slightly larger impact on profits, adding about 4 percentage points for every 1% rise.

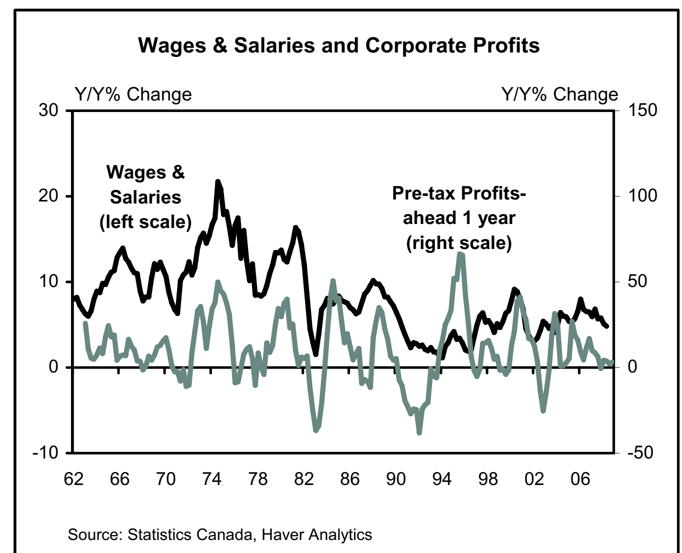
It's not hard to see why U.S. demand has such an outsized impact on the profitability of Canadian corporations, given that exports of goods to that country represent almost one-quarter of Canadian income. And then there are other linkages, such as financial. Historically, Canadian corporations raise about one-quarter of their long term financing in the U.S. market. Given the events of the past year, few people need convincing that economic and financial conditions there have a significant impact on profitability here. With the U.S. economy expected to contract 1.6% in 2009, we believe this will detract about 5 percentage points from Canadian corporate profits.

Canadian corporations won't get any help from the domestic economy either. Domestic demand slowed from an average annualized quarterly pace of 4% over the 2003 to 2007 period, to an average of 1.6% in the first three quarters of 2008. In 2009, the picture darkens, with domestic demand expected to remain flat, the slowest pace since 1991. Therefore, the domestic side of the economy will no longer provide the needed buffer in demand to keep profits afloat, detracting up to 1.2 percentage points from profits in 2009.

Wage pressures to continue

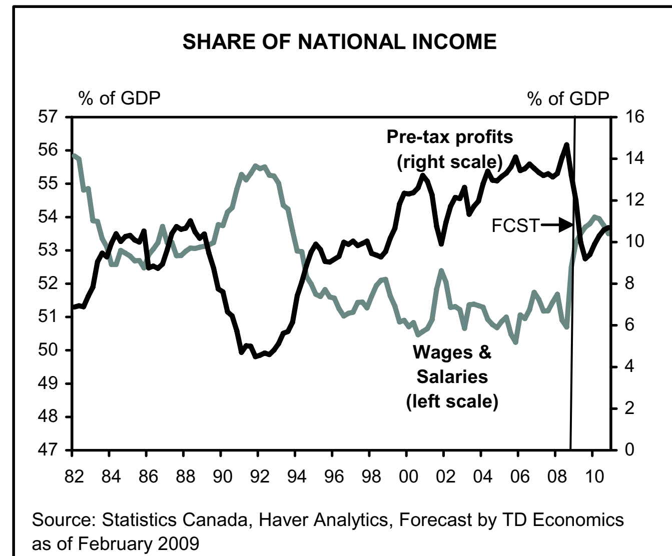
Labour costs generally represent a large proportion of input costs to firms, and as such the model indicates that for every 1% increase in unit labour costs, profit growth declines by 2.5 percentage points. For the most part, labour compensation used in the calculation of unit labour costs reflects wages and salaries. From 2002 to Q3 2008, this total wage bill grew at an average annual pace of 5.5%, outstripping inflation by more than two fold. Corporations were more than able to afford this heady pace of growth because profits were running at an even more robust 9% average annual pace. The 2002-2008 period marked a win-win environment, whereby both profits and total wages made strong advances. However the tide has now turned.

With a recession underway in 2009, we can expect wages to become more of a burden on Canadian corporations, as the wage bill is sticky. This refers to the fact that wage growth does not mirror large upswings in profits, nor does it experience large downswings when profits collapse. Historically, nominal wages do not fall below a 1% annual growth rate. This is because companies are less likely or able to fully adjust wages downwards in economic downturns, in part because of labour union contracts, the cost of severance packages, the fixed costs associated with rehiring when business picks up again and the desire to retain talented and productive employees. Rather, companies are more likely to freeze wages than impose outright wage reductions.



Profit boom to gloom

Since 2002, pre-tax profits have enjoyed robust growth thanks in large part to the commodity boom. Profits have increased at an average annual pace of 9%, outstripping the expansion in national income of 5.6%. As a result, profits as a share of the economy have risen from about 11% in 2002 to almost 15% by the third quarter of 2008. This is 5 percentage points above the historical average. We expect the profit share to rise during periods of a cyclical upturn, but as in many other developed countries the gain was particularly strong. Meanwhile, wages and salaries went from representing 52% of national income at the start of 2002 to 50.7% in the third quarter of 2008.

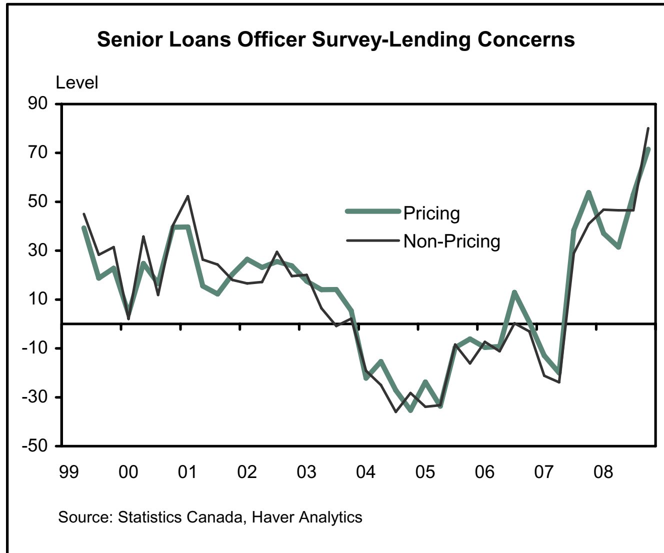


Over long periods of time, the share of wages-to-GDP tends to be relatively constant, but there is a pronounced cyclical pattern with profits being much more volatile than labour income. In a strong economy, profits initially rise as a share of national income, but in time more of the overall income gain goes to labour. In economic downturns, labour income is much more stable than profits, which takes a disproportionate hit and declines as a share of national income. For instance, during the recession mired period of 1989 to 1992, profit growth turned in an average annual pace of -15%; the economy expanded by an average pace of +3.4%; wages clocked in at +4.5%. As a share of national income, wages rose to as high as 55.5%, while profits represented a mere 4.5%, less than half its historical average. In the current recession cycle, we believe the combination of a shrinking economy and the stickiness of wages will cause the latter to once again take a greater share of national income, rising to a peak of 54%. Likewise, because profits are expected to contract at a much deeper rate than the economy, its share will shrink to the lower bound of 9%.

During 2009, we believe the income pie is going to shrink by about $50 billion, as the combination of a drop in economic activity and weakness in commodity prices lead to a 3.1% decline in nominal income – the first time on record that nominal income will have contracted. For further details on this issue see TD Economics Special Report, "When the Commodity Boom Goes Bust", December 4th, 2008. Since wage growth is sticky, we believe total wages and salaries will continue to grow at a rate of about 1% this year, a marked deceleration from the pace seen in the prior seven years, but growth nonetheless. The combination of a shrinking economy and rising wages means that the latter will take a greater share of national income, rising to 54% from the 50-51% range today. By extension, Canadian corporations are going to feel the bite in their bottom lines, even as they restructure and shed more than 300,000 jobs during 2009. In 2010, the playing field will shift with profits expected to reflect much improved global and domestic economies alongside leaner expense growth. Once again the improvement in wage growth will lag that of profits, such that by the end of 2010, corporations will take a larger share of the economic pie with profits rebounding by 20% (Q4/Q4).

Financing costs to still impinge on profit growth

The fourth and final influence that we incorporated into our profit model captured financing costs. Although the cost of financing is not a dominant influence in the model, it does help explain the behaviour of profits. It hardly comes as a surprise in the current economic environment that high or rising financing costs constrain profitability by making the cost of day to day operations and business investment more onerous. For the purpose of modeling, we looked at the influence of financing costs via the business prime rate. However, modeling this influence is not an exact science. The prime rate has fallen from 5.75% to 3.00% in the past year, but the problem with modeling this influence is that actual lending rates can cycle around the



prime rate, which also doesn't reflect the cost of bonds, commercial paper funding or non-rate access issues. In particular, the fourth quarter Bank of Canada's Senior Loans Survey showed that 72% of businesses had non-pricing concerns in terms of finding loans, while 80% had pricing concerns. In 2007 those averages were 6% and 15% respectively. Concerns over borrowing are now at the highest level since the survey began in 1999.

This survey speaks to two main issues: access to credit and cost of credit. In terms of the former, data from the Bank of Canada show that chartered banks were increasing credit to Canadian businesses at a strong rate of 13% at the end of 2008, so credit was flowing. However, this only provides a picture of supply. What is not known is whether this rate of growth was sufficient to satisfy demand, especially since many non-banks had significantly reduced credit supply. Interest rate spreads might reflect broader elements of the cost and access to credit. For instance, the spread on 5-year AA corporate bond yields and risk-free government yields has a historical average of about 50 basis points. However, by mid-January of this year that spread rose to over 300 basis points. Risk premiums have risen dramatically, imposing a greater cost on borrowing. As long as economic uncertainty persists on the domestic and global front, the financing environment will reflect this.

So, there are two impacts to consider from higher financing costs. In the near term, more expensive borrowing immediately squeezes the profitability of firms. In the longer term, which is outside the scope of this paper, higher borrowing costs defer or derail investment that would have made a company more productive and competitive. This, in turn, could result in a slower rate of profit growth for many years than otherwise would have been the case.

By the tail end of 2009, the process of global deleveraging and loan losses among financial institutions should subside, enabling more credit to reach the hands of non-financial corporations. This will set the stage for an easier (but not easy) credit environment, as risk premiums on borrowing narrow.

Conclusion

2009 will be filled with challenges for Canadian corporations as a mix of faltering demand, plummeting commodity prices, and a difficult lending environment set the stage for the worst profit performance since the 1990's recession. Our model predicts a profit decline of 29% in the year. However, the model results are subject to statistical error, and more realistically, we can expect to see profits fall anywhere in the range from 23% to 35%, reversing most gains accrued over the last five years. Poor profit performance will encourage corporations to cut costs through employment and reduce excess capacity. Therefore, once foreign and domestic demand begins to recover in the second half of 2009, and commodity prices rebound by 24% in 2010, Canadian firms will be in a position where revenue growth will outstrip expense growth, allowing profits to bounce back by 6-12% in that year (about 20% on a fourth-over-fourth basis).

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