TD Bank Financial Group

TD Economics

Special Report

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CANADIAN INVENTORIES ARE GOING TO BE PROBLEMATIC

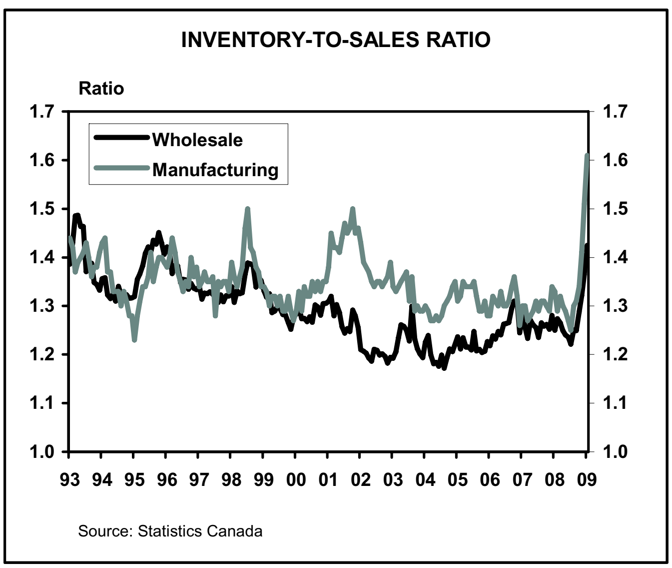
In the past two days, Statistics Canada has released two reports, one on manufacturing shipments and the other on wholesale trade. Most of the media and investor attention has focused on the abysmal performance of January sales within these sectors. In both cases, sales grossly underperformed market expectations, highlighting the quick deterioration in the Canadian economy that started to bear the markings of a recession in late 2008.

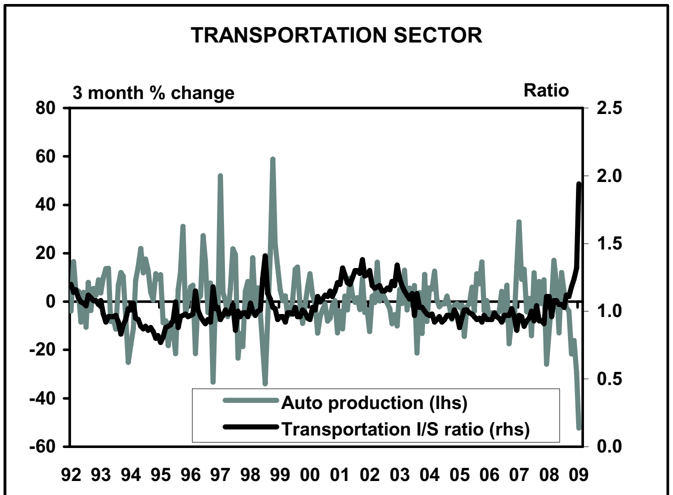
However, the two reports clearly indicate that sales are falling at a faster rate than even producers must have anticipated, because there has been an outsized rise in the inventory-to-sales (I/S) ratios. The manufacturing I/S ratio matches the highest level reached in January 1992 (when the data first started to be recorded), and the 3-month annualized pace of real inventories is rising at an accelerated clip of 6.5%. Although spring is just around the corner, Canadian firms are clearly squirreling away far too much stock. This is going to be problematic for Canada over the next 3-6 months, and perhaps even longer for two reasons. First, in the near-term, if the trend in January is sustained, there will likely be a net accumulation in inventories in Q1, suggesting that it will provide some boost to GDP. Some might deem this positive, since most other economic indicators are pointing to a substantial drag, but this brings us to the second implication. Beyond Q1, there will likely be substantial corrective behaviour among producers to reign in inventories to more satisfactory levels relative to demand. This is an argument for continued heavy job losses and production cut backs in the remainder of the first and second quarters. The near-term upward trend in the I/S ratio was already built in the TD Economics forecast, so recent developments do not alter our Q1 real GDP prediction of -5.8% (annualized). We also built in a declining I/S ratio thereafter, however, there is a risk that it could occur more rapidly than we had been currently anticipating.

Within the details of the I/S ratios, much of the upward push is attributed to an unprecedented climb within motor vehicles. This likely comes as little surprise given the me-

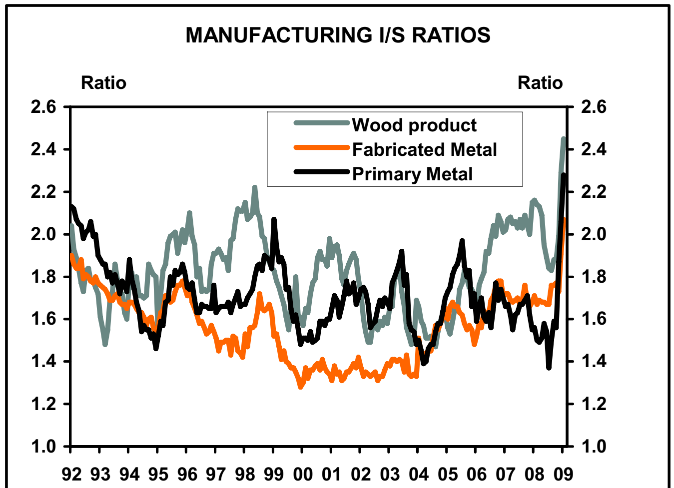
HIGHLIGHTS

- **Rapid rise in inventory-to-sales ratio could prove problematic for Canada.**
- **Although inventories might offer a boost to GDP in Q1, there will likely be substantive corrective behaviour among producers to rein in inventories thereafter.**
- **Inventories in the auto sector are extremely high relative to demand, but it is not the only industry getting caught with unintended build-up.**





Source: Statistics Canada
*Auto production statistics seasonally adjusted by TD Economics



Source: Statistics Canada

dia splash this sector has made in detailing its woes. However, the I/S ratio tells us that the situation has gone from bad to worse for this industry. Motor vehicle manufacturing sales fell 46% in January, resulting in an unintended rise in inventories, to the tune of 37% in that month. This occurred in spite of the fact that production has been cut back by just over half in the past 3 months (Nov-Jan). Clearly, more aggressive action needs to take place to reduce capacity, pointing to a particularly bleak outlook over the next 3-6 months for production and employment. The same story holds on the wholesale side, where the I/S ratio is at more than a decade high.

However, the interesting aspect with both the manufacturing and wholesale reports is that it does not appear that the auto sector is alone in maintaining high inventory levels relative to demand. Ratios are also rising broadly across industries. Within the manufacturing sector, there wasn't a single durable goods industry where the I/S ratio did not push skyward and the ratio is at record levels within the wood, primary, and fabricated metals industries. The wholesale sector is reflecting a similar experience. All told, upward pressure on I/S ratios is not a positive development, and we will be paying close attention to it in the coming months. Inventory levels have officially made our list of downside risks to the Canadian economy.

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