TD Economics

Special Report

October 20, 2008

2009 T0 PROVE TESTING TIMES FOR SMALL BUSINESSES

October 19th to 25th is small business week, which provides an opportunity to spotlight the importance of small scale enterprises and pay tribute to entrepreneurs. At this time each year, TD Economics issues an economic outlook with the emphasis on the implications for small and medium enterprises (SMEs). Regrettably, the news is not upbeat. No one wants to be the bearer of bad news, but businesses need a pragmatic assessment and the reality is that the next twelve months are likely to prove difficult for many firms.

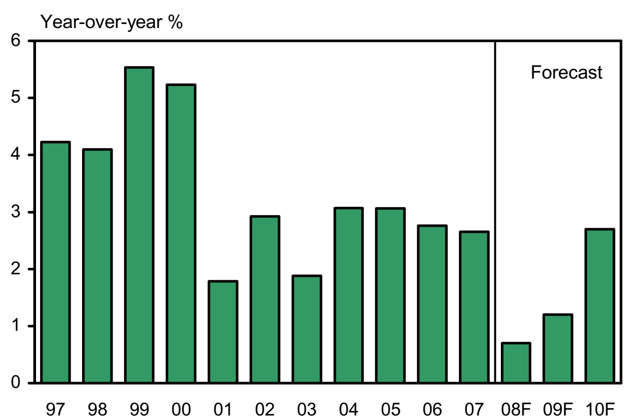
HIGHLIGHTS

- 2009 likely to prove a difficult year for many businesses
- Canada in a slump that will produce slower economic growth across the country
- Key challenge will be weaker revenue growth due to declining exports and softening domestic demand
- Lower energy prices and less tight labour markets provide a partial offset
- Economic prospects should improve in late 2009 and throughout 2010

Canada in an economic slump

The Canadian economy has stalled. After contracting in the first half of 2008, a short-lived rebound in the Canadian economy during the third quarter is expected to be followed by little, or virtually no, growth until late 2009. The more challenging economic times will also be felt across the country. Central Canada is expected to fare worse than the national average and is at greatest risk of experiencing a recession. Atlantic Canada will be close to the national average, while the economic boom in Western Canada is rapidly drawing to a close. There are three important drivers to this macroeconomic outlook.

CANADIAN ECONOMIC GROWTH



Source: Statistics Canada, Forecast by TD Economics

Global downturn bodes badly for exporters

First, Canada is being hit by a negative external shock. The global economy is headed for a mild recession, with particular weakness in a number of Canada's major trading partners. The coming fragility in the world economy has also led to a sharp correction in many commodity prices. This is a double blow for Canada's export sector, since the implication is a lower volume of exports and at reduced prices.

International financial crisis has domestic implications

A second dimension to the external shock is that the global recession is partly due to the fallout of an international financial crisis. There was a credit bubble in the early part of this decade, which simply means too much money was chasing higher returns and it led to excessive increases in real estate prices and the value of financial assets in many countries. The worst of the imbalances was in the United States, where an acute housing bubble formed on the back of extraordinarily poor quality mortgage loans. When it burst, the fallout on the financial system was severe. But, this has not been just a made-in-America event. Many other countries, particularly in Europe, also experienced a credit bubble. Now the bubble has deflated and it is creating considerable pain in global financial markets and the world financial system.

Canada participated in the credit excess. Real estate prices between 2002 and 2007 rose at an average pace of 10% per annum – when the historically sustainable pace is closer to 4%. Canadian households also ramped up their debt levels relative to their income to finance the real estate boom and their consumption of other goods and services. Despite these trends, Canada managed to avoid the worst of the credit problems experienced abroad. The debt accumulated by households was in products that had a lower risk profile than some of the instruments that become popular elsewhere. Canada's major lenders also pursued much more conservative lending practices than many of their international counterparts and avoided many – but not all – of the dangerous financial products that had been embraced in the U.S. and Europe.

As a result, the credit crunch of the last 15 months has been largely an external shock to the Canadian financial system. For example, the financial losses have been concentrated in financial products backed by U.S. mortgages or have been the result of a global repricing of financial assets due to a reassessment of risk. The damage to the world financial system is also hampering Canada. Specifically, international financial institutions have been less inclined, or less able, to lend to one another and this has raised the cost of borrowing to all financial institutions – including those in Canada.

REAL GROSS DOMESTIC PRODUCT (GDP)
Annual average per cent change

	98-07	2006	2007	2008F	2009F	2010F
CANADA	**3.3**	**2.8**	**2.7**	**0.8**	**1.3**	**2.7**
N. & L.	5.0	3.3	9.1	0.3	1.2	2.5
P.E.I.	2.6	2.6	2.0	0.5	0.9	1.8
N.S.	2.7	0.9	1.6	0.9	1.1	2.2
N.B.	2.8	3.0	1.6	1.2	1.4	2.1
Québec	2.7	1.7	2.4	0.5	0.9	2.4
Ontario	3.4	2.1	2.1	0.3	0.8	2.7
Manitoba	2.6	3.2	3.3	2.2	2.3	2.4
Sask.	2.0	-0.4	2.8	3.4	2.8	2.7
Alberta	4.0	6.6	3.3	0.8	1.8	2.5
B.C.	3.0	3.3	3.1	1.5	1.5	3.6

F: Forecast by TD Economics as at Oct. 2008
Source: Statistics Canada / Haver Analytics

AVERAGE EXISTING HOME PRICE
Per cent change

	2006	2007	2008F	2009F	2010F
CANADA	**11.1**	**11.0**	**-2.1**	**-4.0**	**1.1**
N. & L.	-1.2	7.0	13.5	5.4	3.7
P.E.I.	7.0	6.4	3.7	2.7	3.0
N.S.	5.9	7.3	3.2	3.5	3.2
N.B.	5.2	7.7	5.3	0.5	3.4
Québec	5.1	7.3	4.2	-1.5	1.9
Ontario	5.9	7.6	-0.6	-3.8	2.5
Manitoba	12.2	12.6	12.5	4.6	3.2
Sask.	7.6	32.0	30.9	-5.2	-1.7
Alberta	30.8	24.8	-2.5	-6.0	0.9
B.C.	17.7	12.3	3.0	-6.8	-2.5

F: Forecast by TD Economics as at Oct. 2008
Source: Canadian Real Estate Association

Domestic economy cooling down

However, we can't blame developments abroad for all of the Canadian economic weakness. A third key element of the outlook is that the domestic Canadian economy is moderating. For the past four years, domestic demand had shot ahead at a strong annual pace averaging 4.3 per cent, when a slightly below 3% pace is the long-run trend. The rapid domestic growth was characterized by booming real estate, remarkably strong consumer spending and robust gains in business investment and government outlays. At some point it was bound to run out of steam, and that is precisely what is playing out right now.

Real estate activity is retreating with sales declining and resale home prices dipping in many parts of the country. The correction is mild compared to the U.S. experience and represents a pullback after excessive strength that made affordability a problem. The implication is that residential building and construction employment will be a drag on economic growth in the months ahead.

Consumer spending is also slowing. The housing correction means that demand for big-ticket home-related items (like furniture and appliances) will be lower. Weaker economic times are also likely to lead to slower personal income growth and dampen consumer confidence, leading to a period of tighter wallets.

Similarly, business confidence is being eroded by the signs of the economic slowdown, in Canada and abroad. Meanwhile, projections of corporate profit growth have been scaled back. This inevitably results in a softer profile to business investment. Meanwhile, expectations of tighter fiscal balances are likely to produce a similarly weaker profile to government outlays.

The bottom line is that exports are expected to contract in late 2008 and the first half of 2009, while domestic demand growth slows to a below-trend rate of 2.3% in 2009.

Small businesses have realistic expectations

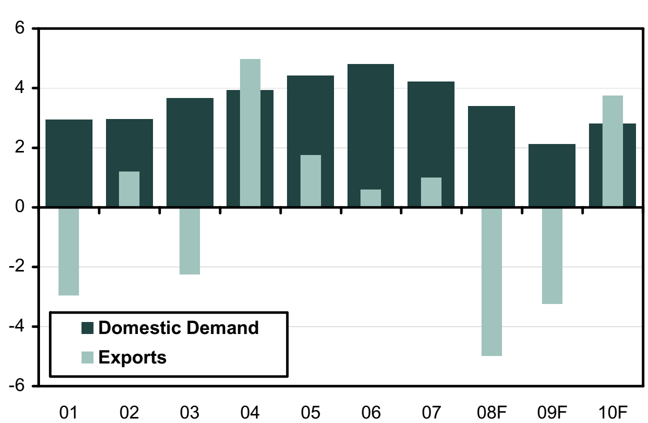
Small businesses in Canada cannot avoid being caught up in the above mentioned macroeconomic trends. Recent surveys suggest that small business owners have already come to this realization.

The Canadian Federation of Independent Business (CFIB) conducts a quarterly survey and publishes a Business Barometer that captures the assessment of SMEs about the state of the economy. Over the four quarters ending in September 2008, the index was trending lower. The index tracks economic growth relatively well and the level in September was consistent with a slow rate of economic expansion. In the wake of the unprecedented financial turmoil in September/October, the CFIB introduced a weekly tracking and the index plunged from 101.8 in the last quarterly report for September to an average of 94.2 in recent weekly tracking for October. This level is lower than during the economic slump of 2001, but was still above the low of 85 recorded during the 1990-91 recession.

Key challenges: some wane, others arise

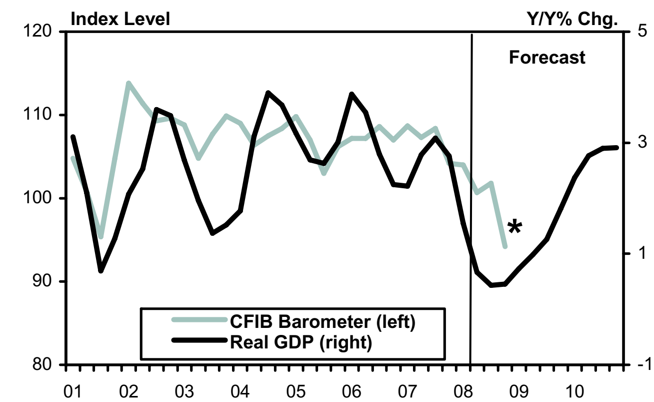
So where will the specific difficulties arise? In September, TD Bank Financial Group conducted a survey of SMEs. Respondents identified five areas of concern, which in order of priority were:

CANADA: EXPORTS & DOMESTIC DEMAND*



*SAAR 2002 chained dollars; F - forecast by TD Economics as at October
Source: Statistics Canada / Haver Analytics

CFIB BUSINESS BAROMETER AND REAL GDP GROWTH



*End point represents an avrg. Barometer between September 13 to October 16
Source: CFIB, Statistics Canada, Forecasted by TD Economics as of October 16, 2008

- Cash flow
- Rising fuel costs
- Currency fluctuations and uncertain economy
- Hiring/retaining talent
- Access to credit

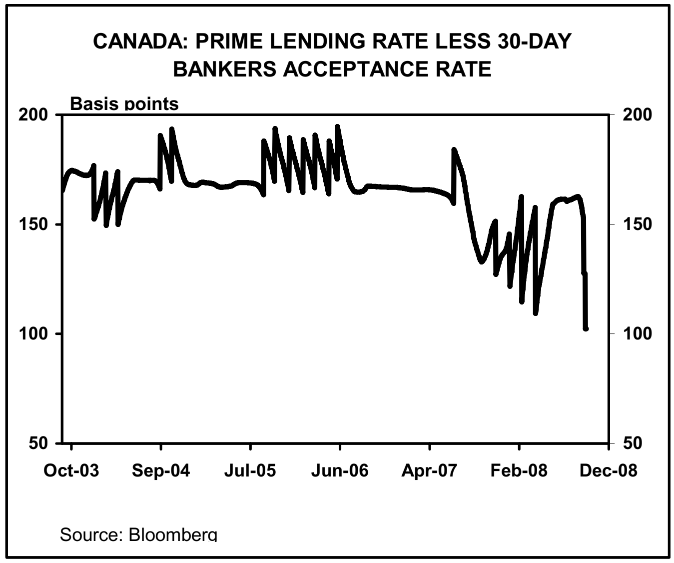
Let's address the outlook for each of these areas

Weaker economy could impact SME cash flow

The main challenge from a cash flow and uncertain economy perspective will come from weaker revenue growth. The economic outlook is consistent will only meagre gains in profits. While large-scale businesses make up the lion's share of national profits, small and medium enterprises are found in virtually every sector of the Canadian economy and they will be affected by the same revenue trends. SMEs do tend to be less export-oriented than large enterprises, and exports are expected to be the greatest source of weakness. At face value this could mean that small businesses outperform their larger export-oriented brethren. But, this likely overstates the case, since many SMEs sell to exporters or sell to local economies that are heavily reliant upon to fortunes of local export-oriented firms. And, the weakness will not be solely on the export front, as the domestically-oriented firms will feel the impact of the softer growth in domestic demand. On a national average basis, SMEs are likely to experience modest income growth of around 3% in the coming year.

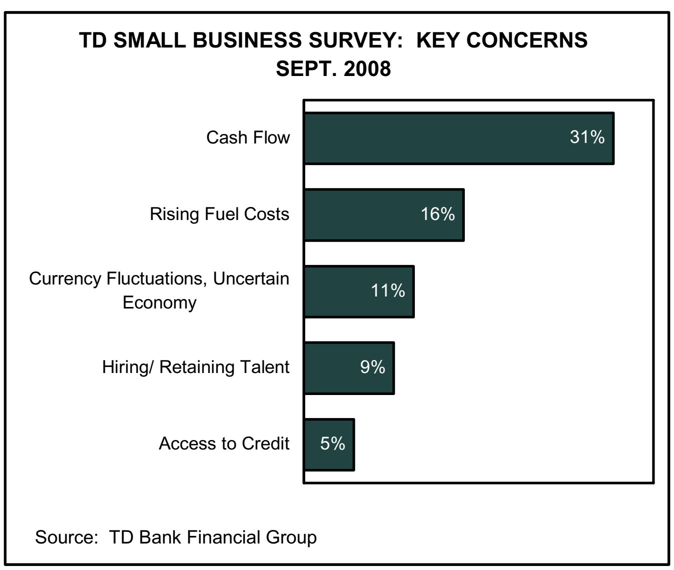
Loonie flies lower

In the TD survey, currency fluctuations were tied to economic prospects and foreign exchange movements are a concern for many small businesses. In the September CFIB survey, 30% of SMEs reported that they prefer a lower Canadian dollar and 27% prefer a stronger Canadian dollar – so the impact on the SME sector is largely a wash, but for individual firms it could be very important. TD Economics expects that loonie to return to above 90 U.S. cents next year. The Canadian dollar fell sharply in the fall of 2008 in reaction to the correction in commodity prices and in response to a global flight to U.S. dollars during a period of financial turmoil. Commodity prices will not recover their losses in the months ahead, but the U.S. dollar is likely to decline when financial conditions stabilize, providing renewed support to the loonie.



Credit conditions tighten

One of the recent concerns raised by small businesses has been access to credit. This is natural given the extreme distress present in the global financial system and the stories about the dramatic decline in banking lending in the United States. In Canada, there is some evidence that credit conditions have tightened. The Bank of Canada Senior Loan Officer Survey showed that 47% of respondents reported tighter pricing and 53% indicated tougher non-pricing aspects of lending. It is critical to recognize the difference, however, between the U.S. and the Canadian experience. In many cases credit is not available in the U.S. at any price, which is why there had been a massive government intervention in the banking sector, with the U.S. Treasury injecting more than US$1 trillion to get lending flowing again. In contrast, credit is available in Canada to businesses, although the cost of funds may not be as attractive as in the early part of this decade. This is why the Canadian government response has been far more subdued. For lenders that pursued prudent practices in the past there has been no need to dramatically tighten up on loan conditions. And, this can be observed from the fact that tightening observed in the Bank survey is only slightly greater than the experience in 2001.



The reason for the tighter pricing and availability has to do with an increase in the cost of borrowing to financial institutions. The accompanying chart shows the spread between the Prime lending rate and the 1-month Bankers Acceptance (BA) rate. The Prime lending rate is the benchmark for many loans. The BA rate is the cost to financial institutions of raising cash. In recent months, the Prime lending rate has declined as the Bank of Canada cut rates, but the BA rate has not fallen in tandem. Canada's largest lenders take in deposits and make loans, but the loans are greater than the deposits. The difference must be financed in international markets, which are currently demanding elevated interest rates and impairing profitability. Policy makers in the U.S., Europe and Canada have introduced significant measures to address this problem in an effort to lower interbank lending rates. These actions are likely to be successful eventually, but it won't happen overnight. When the financial strains do subside, businesses should find that credit pricing and availability improves. However, given that the excess credit was the root of the recent financial problems, the availability and price will not return to the lows in the early part of this decade.

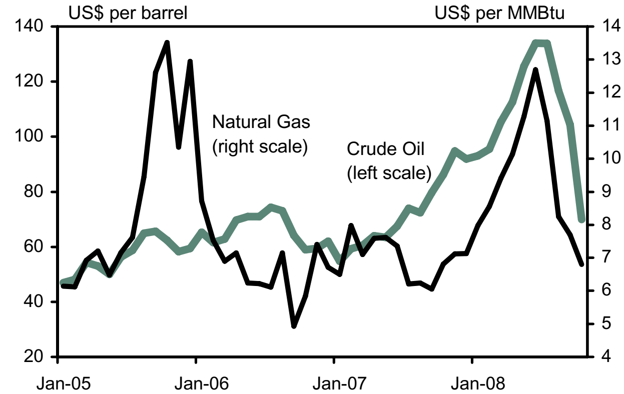
Energy prices plummet, but remain high

Despite all of the difficulties, it is noteworthy that some of the past challenges for SMEs are becoming less pressing. Energy prices have fallen sharply in recent months. Over the past several years a dramatic run up in energy prices caused many businesses considerable distress and boosted production/delivery costs. However, the prospects of weaker global energy demand have now led to a dramatic correction in energy prices, with oil and natural gas falling substantially, and much of the decline will be sustained. The commodity price correction has also not been limited to energy, as base metal and forest product prices have retreated. It should be noted that while the commodity price correction may take some of the pressure off input costs in selected industries, the outturn will hamper profit growth in commodity-related industries or businesses that sell to the commodity sector. Moreover, the level of prices remains elevated – as evidenced by the fact that the pullback in crude oil prices in early October still left the level higher than the average in 2007.

Labour markets to become less tight

Another major concern in recent years has been the excessively tight conditions in Canadian labour markets. Many businesses have encountered difficulty finding and retaining skilled staff at a time that unemployment was at, or near, a 30-year low. Looking forward, Canada's labour markets will slacken. Employment growth is expected to slow from the 2.1% average pace over the last decade to 1.5% in 2008 and a mere 0.3% in 2009, with the pace of job creation cooling across the country. Meanwhile, the national unemployment rate is poised to rise from 6% in 2007 to 6.7% in 2009, and all of the provinces will experience this trend. It should be stressed that this still represents a low rate of unemployment and is supportive to the domestic economy, but it does suggest that businesses may find that hiring and retention will be less of a problem. Corresponding to the labour market moderation, wage and salary growth is also expected to cool to a 3% pace in the coming year – which will still provide workers with income growth slightly above the rate of inflation.

CRUDE OIL AND NATURAL GAS PRICES



Source: Haver Analytics
Last date plotted: October 16, 2008

Conclusion: 2009 a tough year but the tide will turn

The bottom line is that 2009 will likely prove to be a challenging year for many firms. However, it is also important to stress that this is a cyclical event. The external shock from the global economic slump and global financial turmoil will dampen Canada's economic prospects in the coming year. More subdued domestic consumption and a weaker real estate market will also be a headwind in the near-term. Notwithstanding these transitory negative forces, the Canadian economy is fundamentally sound and it will recovery when the depressing factors abate. The Canadian financial system is also stronger than its international counterparts and the Government of Canada has superior fiscal balances than many other nations. When the global economy stages a recovery in 2010 and when the improvement of domestic housing affordability brings buyers back into the market, the Canadian economic cycle will turn, leading to improved fortunes for small and medium-sized enterprises.

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