



**Bank
Financial
Group**

TD Economics

Commentary

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CREDIT FLOWS IN THE FOURTH QUARTER OF 2008: REINTERMEDIATION CONTINUES AS MARKETABLE DEBT SHRINKS

The release of Statistics Canada's Financial Flows Accounts for the fourth quarter show an expected slowing of overall credit to Canadian households and firms. With the quarter's annualized contraction in real GDP of 3.4% and looking ahead to another three quarters of weakness, demand for credit was expected to wane. The contractions in certain channels exhibit the turmoil wrought by the credit crunch. Outstanding bonds and commercial paper shrank, demonstrating paralysis in marketable sources of financing. Non-financial corporations' bonds contracted by over \$3 billion – this channel's largest ever quarterly decline. With asset markets in disarray during the fall, non-financial corporations' net share issuance fell to its lowest nominal level since 1971, and the fourth quarter plummet in corporate profits was particularly exaggerated for non-financial corporations, falling an annualized 34%.

HIGHLIGHTS

- **Households' borrowing slows in fourth quarter, as consumers rein in spending and housing market slumps.**
- **Non-financial corporations experienced a steep deterioration of profits and their marketable funds contracted due to the fourth quarter paralysis in bond and money markets.**
- **A strong reintermediation trend is apparent: lending by non-banks shrank but bank loans to non-financial corporations expanded by \$22 billion in the fourth quarter – a historical high in quarterly flows through this channel.**

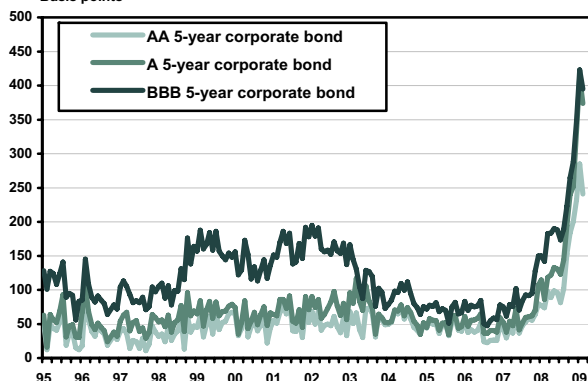
The plummet in corporate profits greatly impairs corporations' ability to draw on internal financing. Picking up some of this slack, bank loans to non-financial corporations increased by \$11.9 billion in the quarter, and rose by \$22 billion for all of 2008 – the greatest annual expansion of bank loans as a percentage of GDP in twenty years.

Falling home sales and waning consumption slow new household borrowing

For households and unincorporated businesses, credit has still grown robustly for the year but the fourth quarter saw its pace slowed dramatically. Arguably, with uncertainty abounding and unemployment on the rise, households are reining in spending. With personal consumption expenditures contracting 0.8% in the fourth quarter, the slowing of consumer credit and loans from their previous fever pitch was expected. Furthermore, the 4.6% Y/Y fall in fourth quarter sales of durable goods flags Canadi-

**CANADIAN CORPORATE BOND SPREADS
WITH 5-YEAR GOVERNMENT OF CANADA BOND***

Basis points



*Monthly data, last plotted Feb 27 2009;

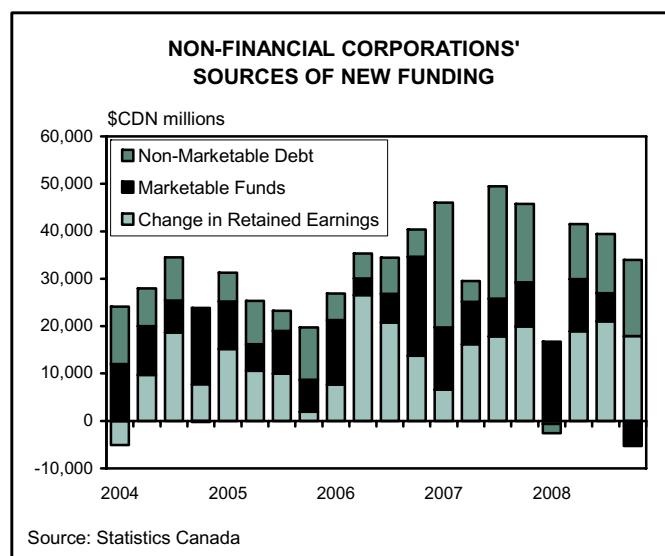
Source: Bloomberg, Bank of Canada, Haver Analytics

ans' diminished spending on big ticket items. Consumer credit grew by \$4.9 billion in the fourth quarter compared with \$6.3 billion in the fourth quarter of 2007. Consumer credit increased by \$31 billion during 2008. Notably, statistics from the Bank of Canada showed 14.5% annual growth in banks' consumer credit during 2008, but consumer credit from non-bank financial institutions only grew 1.5% Y/Y. Even while the pace of consumer credit slowed, banks appear to be the primary source of the ongoing flows to consumers.

With house sales nation-wide down over 30% Y/Y and average resale prices having fallen nearly 10% Y/Y, the slowing of mortgage growth is no surprise. Mortgage growth slowed considerably with \$15 billion in net new mortgages compared with \$20 billion in the previous quarter and \$19 billion in the fourth quarter of 2007. Households' bank loans declined by \$426 million on the year – this category's first annual contraction since 1991. However, households obtained a robust \$3.9 billion in new other loans over 2008. Households' total new borrowing was thus down from 2007 but still at a historically strong level for the year.

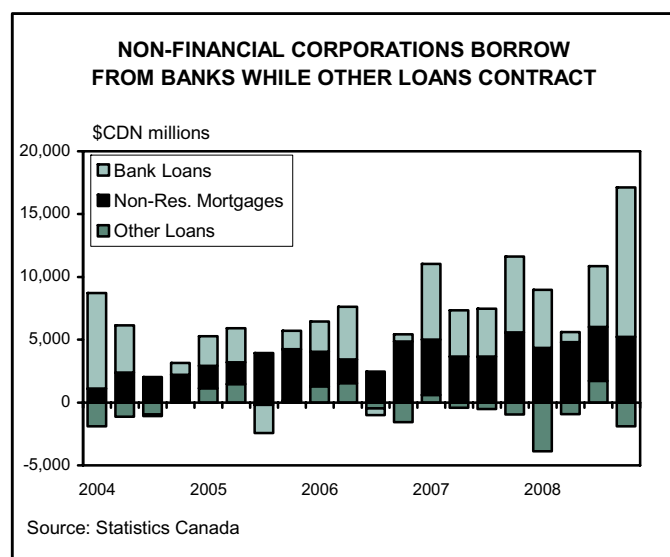
Non-financial corporations' bonds contracted and profits shrunk but bank loans surged

Non-financial corporations' net new financing slowed substantially in the fourth quarter, dampening new funds for the year to pre-2006 rates. Credit flows during the fourth quarter exhibit the strong reintermediation trend. Indeed, new bank loans appeared to be the sandbags on the levees, shoring aggregate borrowing against contrac-



tions in other financing channels. The quarter's flows show the drought in equity markets, the downturn in profits, paralysis in bond and money markets, and deleveraging by non-bank lenders. Marketable funds contracted by \$5.3 billion in the quarter – the consequence of a 38-year quarterly low in quarterly equity issuance, the largest net contraction in bonds on record, and ongoing shrinkage in commercial paper. The extreme contraction of bond markets is unsurprising since Canadian corporations' bond spreads remain at historical highs and Canadian non-financial corporations gross bond issuance has plummeted – particularly in issues of new debt on foreign markets.

However, non-financials' non-marketable debt increased by \$16 billion in the fourth quarter. The expansion of non-financial corporations' bank loans by \$11.9 billion in the quarter represents a historical high in flows through this channel. On the year, bank loans to non-financials have expanded by \$22 billion – the highest-ever annual flow. In contrast, loans by other financial institutions saw their greatest-ever annual contraction, shrinking by \$5 billion. Continuing extension of non-residential mortgages in the fourth quarter also propped up non-marketable borrowing. Since non-residential construction slowed considerably in the fourth quarter, these new non-residential mortgages presumably represent a strong growth in secured borrowing by non-financial corporations on existent properties. From Bank of Canada statistics, banks provided 43% of the 2008 growth in non-residential mortgage credit while 25% owed to Insurers and 32% to Credit Unions and Caisse Populaires.



Non-financial corporations' other liabilities – which include accrued interest, interest receivable or payable and prepaid expenses – contracted by \$18 billion through 2008. In contrast, non-financials' new credit through trade accounts remained relatively robust, slowing to \$2.4 billion on the quarter but still \$12 billion in net new flows for the year. Despite the turmoil, suppliers still remained willing to extend credit and immediate cash-on-delivery had not yet become the rule.

Credit Crunch takes its toll

While core financial institutions continue to prop up credit growth, credit conditions will not return to normal until corporations can again secure marketable debt at reasonable

spreads. As the economy contracts over the next three quarters and nominal income also shrinks, corporations' will have diminished profits on which to draw. Even with corporations retaining a higher share of profits, the change in retained earnings decreased considerably during 2008. With equity markets in a slump, share issuance is prohibitively costly. Firms will increasingly turn to intermediated sources of credit. Bank loans to non-financial corporations have expanded impressively as non-banks continue to deleverage. However, banks cannot fill the gap entirely. Although Canadian firms continue to successfully access new funds in aggregate, financing through bond and money markets must regain some traction.

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NEW BORROWING BY CANADIAN HOUSEHOLDS							
	Consumer Credit	Trade Payables	Bank Loans	Other Loans	Total Credit	Mortgages	Total New Borrowing
New Funds (CDN millions)							
Q4/2004	7,101	-673	-8	3,184	9,604	10,885	20,489
Q4/2005	5,566	1,621	-20	-1,849	5,318	11,511	16,829
Q4/2006	8,145	-2,707	2,602	2,422	10,462	15,973	26,435
Q4/2007	6,365	2,614	-1,152	1,117	8,944	19,784	28,728
Q4/2008	4,984	-1,117	306	430	4,603	15,587	20,190
Total Annual Flows							
2004	26,656	-6,445	840	7,501	28,552	48,624	77,176
2005	26,976	2,564	835	1,104	31,479	56,258	87,737
2006	31,114	2,608	2,394	6,421	42,537	67,119	109,656
2007	34,908	2,949	16	3,723	41,596	80,189	121,785
2008	31,440	777	-426	3,915	35,706	71,470	107,176

Source: Statistics Canada

CANADIAN NON-FINANCIAL CORPORATIONS NEW NET FINANCING			
	Total Financing	Change in Retained Earnings	External Sources
Q4/2004	23,630	7,725	15,905
Q4/2005	19,727	1,953	17,774
Q4/2006	40,379	13,755	26,624
Q4/2007	45,765	19,961	25,804
Q4/2008	28,671	17,891	10,780
Total for Year			
2004	105,159	31,006	74,153
2005	99,568	37,708	61,860
2006	136,953	68,733	68,220
2007	170,805	60,586	110,219
2008	123,765	57,196	66,569

Source: Statistics Canada

CANADIAN NON-FINANCIAL CORPORATIONS NEW EXTERNAL FINANCING			
	Total External Financing	Marketable Funds	Non-Market Debt
Q4/2004	15,905	16,104	-199
Q4/2005	17,774	6,716	11,058
Q4/2006	26,624	20,914	5,710
Q4/2007	25,804	9,307	16,497
Q4/2008	10,780	-5,287	16,067
Total for Year			
2004	74,153	45,174	28,979
2005	61,860	31,359	30,501
2006	68,220	44,148	24,072
2007	110,219	39,372	70,847
2008	66,569	28,379	38,190

Source: Statistics Canada

CANADIAN NON-FINANCIAL CORPORATIONS NEW INTERNAL FUNDS				
	Net Profit	Dividends	Change in Ret. Earn.	% of Profit Retained
Q4/2004	25,588	17,863	7,725	30%
Q4/2005	31,680	29,727	1,953	6%
Q4/2006	33,078	19,323	13,755	42%
Q4/2007	33,915	13,954	19,961	59%
Q4/2008	30,525	12,634	17,891	59%
Total for Year				
2004	99,593	68,587	31,006	31%
2005	117,947	80,239	37,708	32%
2006	143,876	75,143	68,733	48%
2007	129,447	68,861	60,586	47%
2008	137,663	80,467	57,196	42%

Source: Statistics Canada

CANADIAN NON-FINANCIAL CORPORATIONS NEW MARKETABLE FUNDS				
	Total Market	Share Issuance	Bond Issuance	New Comm. Paper
Q4/2004	16,104	5355	10630	119
Q4/2005	6,716	6500	615	-399
Q4/2006	20,914	6053	9335	5526
Q4/2007	9,307	8491	1930	-1114
Q4/2008	-5,287	213	-3116	-2384
Total for Year				
2004	45,174	22,542	19,978	2,654
2005	31,359	20,167	7,297	3,895
2006	44,148	15,672	13,172	15,304
2007	39,372	23,492	12,142	3,738
2008	28,379	14,084	10,771	3,524

Source: Statistics Canada

CANADIAN NON-FINANCIAL CORPORATIONS NEW NON-MARKETABLE DEBT							
	Total Non-Marketable	Bank Loans	Other Loans	Non-Res. Mortgages	Corporate Claims	Trade Accounts	Other Liabilities
Q4/2004	-199	927	190	2,018	2,207	856	-6,397
Q4/2005	11,058	1,475	148	4,083	1,430	3,683	239
Q4/2006	5,710	577	-1,557	4,856	2,058	4,296	-4,520
Q4/2007	16,497	6,033	-950	5,580	772	902	4,160
Q4/2008	16,067	11,894	-1,896	5,232	1,543	2,473	-3,179
Total for Year							
2004	28,979	12,153	-3,771	7,542	6,444	5,769	842
2005	30,501	4,319	2,537	11,571	340	11,842	-108
2006	24,072	6,659	813	11,956	9,210	9,938	-14,504
2007	70,847	19,583	-1,281	17,297	14,510	13,616	7,122
2008	38,190	22,159	-4,976	18,678	8,219	12,026	-17,916

Source: Statistics Canada

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