TD Economics

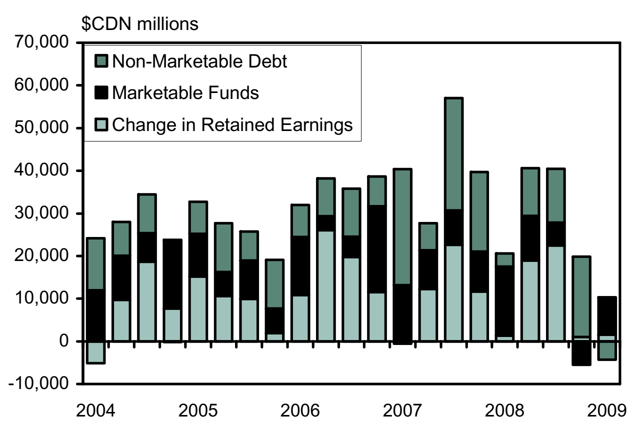
Observation

June 4, 2009

CREDIT FLOWS IN THE FIRST QUARTER OF 2009: DEMAND FOR CREDIT EASES AS ECONOMY PLUNGES

Given the severe deterioration of Canada's economy during the first quarter of 2009, the slowdown in new borrowing by Canadian households and firms over the quarter was to be expected. The somber business outlook and falling capital investment certainly point to lessened demand for business credit. Nonetheless, while non-financial corporations' (NFCs) total new borrowing certainly slowed, the revitalization of bond and equity market served as an important release valve during this quarter. This eased some of the re-intermediation pressures that had been witnessed during the fourth quarter of 2008, when financial markets had seized and NFCs turned increasingly to banks to supply additional funds. For households, mortgage borrowing slowed significantly, as did consumer credit. This picture fits the drop in homebuilding, house prices and house re-sales during the quarter, as well as retreating retail sales.

NON-FINANCIAL CORPORATIONS' SOURCES OF NEW FUNDING



Source: Statistics Canada

HIGHLIGHTS

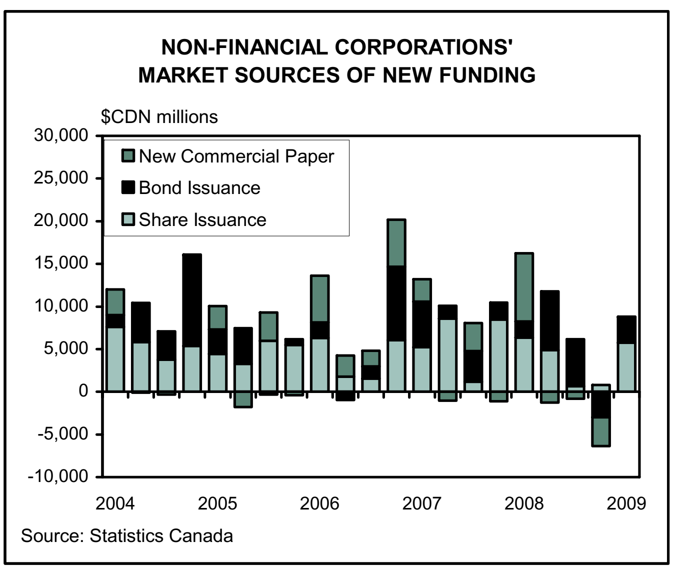
- Access to financing through equity and bond markets improved during Q1/2009. However, securitized forms of credit continue to contract steeply.
- Diminished demand is now the main source of slowed credit growth, with households delaying purchases and firms battening the hatches in the midst of the downturn.
- Even with mortgage rates at historical lows, household borrowing slowed during Q1/2009, owing to an over 50% reduction in the pace of mortgage growth, consistent with diminished home construction and sales.
- Non-financial corporations are facing financing pressures from dampened profits, but elevated inventories-to-sales ratios suggest diminishing future demand for new inventory financing. With existent machinery sitting idle, new investment will continue to slow.

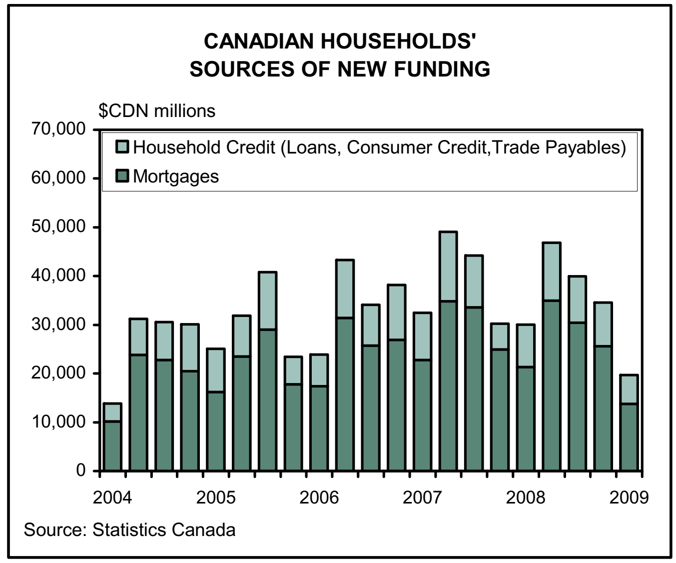
Slowed homebuilding and a "Shift to Thrift" reduce household borrowing

Households borrowing slowed to $13.8 billion in new funds during Q1/2009 compared with $25.6 billion the previous quarter and $21.3 billion in Q1/2008. Sluggish borrowing in mortgages was the main contributor to the reduced pace, as new mortgages increased at half the pace recorded in the previous quarter. The slowing was definitively driven by dampened demand: Despite mortgage rates at record lows, fewer houses were being purchased – sales of existing homes having fallen 27% Y/Y – and houses were transacting at lower prices – nation-wide prices down 9% Y/Y. The value of new house construction also fell 11% in the quarter. In other household credit, consumers reined-in expenditures on durables during the quarter. Nonetheless, overall consumer credit continued to grow – albeit at a much reduced pace. Market aversion to securitization has compelled a pullback in non-intermediated lending. That is, during the last quarters, lenders who had previously packaged their loans into bundled securities found that markets had lost appetite for such assets. Owing to this trend, household credit from non-bank institutions contracted by $1.9 billion during Q1/2009.

Revival of bond and equity markets eases re-intermediation

New financing for non-financial corporations (NFCs) slowed dramatically during the quarter, with total financing having fallen to a mere $6 billion in new funds during Q1/2009 from $14 billion the previous quarter and $20.6 billion in Q1/2008. The weakness originated from smaller corporate profits and a reduced change in retained earnings through which to finance new investment internally. However, external funding sources, and in particular non-market financing, slowed most markedly. Indeed, while market-based sources of funds expanded in the quarter, reversing their contraction during Q4/2008, non-market debt contracted by $4.3 billion. The pullback in "other loans" steepened, contracting by $2.6 billion in the quarter, reflecting the difficulty non-bank lenders are facing in accessing funds and the seizing of securitization markets. While bank loans to NFCs contracted by $2 billion in the first quarter, banks had channeled $15 billion in new funds





to NFCs over Q4/2008 – a 30-year record peak in banks' quarterly NFC lending. Certainly, the rush to bank funds during Q4/2008 reflected borrowers' difficulty in accessing funds in open markets, with corporate bond spreads elevated and equity markets plunging during the fall. The easing of bond spreads since January and bottoming of the TSX has improved market-based sources of funds, with $3 billion in bond issuance and $5.8 billion in equity issuance by NFCs over Q1/2009. The retreat of bank loans to NFCs during the quarter incorporates some of this relief, as firms substitute market debt and repay some of their previous withdrawals from bank-provided credit facilities.

We certainly expect lessened demand for business credit as companies work down inventories in response to the recent surge in inventory-to-sales ratios. We have highlighted these elevated ratios in the manufacturing and wholesale sectors (see "Canadian Inventories are going to be Problematic" March 18, 2009), and the past quarter witnessed the beginning of what we forecast to be an ongoing contraction in levels of non-farm inventories that will continue until the end of 2010. A reduction in inventories implies reduced demand for short-term business credit going forward. However, it should be noted that the involuntary build-up of inventories often drives up demand as the economy enters a downturn. This appears to have been the case during Q4/2008, but by Q1/2009 firms appear to have shifted strongly towards drawing down their existent stock.

In other categories, non-residential mortgages slowed, as would be expected given the 3.8% fall in construction of non-residential structures during the fourth quarter.

Trade credit to NFCs also contracted, demonstrating increased expectation of "cash on the barrelhead" and reflecting suppliers' unwillingness to serve as creditors. The "other liabilities" category includes accrued interest, interest receivable or prepaid expenses.[1] Although this category is not further disaggregated, its contraction reflects a reduced flow that is consistent with the tighter credit conditions faced by firms. Corporate Claims represent advances and issues of debt between associated corporations, and the positive flows represent heightened advances from affiliated entities – potentially reflecting the reduced availability of funds for certain of corporations' subsidiary arms.

"Credit Crunch" fading, but "Real Economy" still contracting

Canada's major financial institutions filled the gap during the credit market tumult of the fall, as spreads widened and the nosedive in stocks made equity issuance unattractive. However, even as credit conditions achieve a "new normal," the driver of credit flows will be demand. The contraction in output during Q1/2009 was likely the most severe that Canada will face during this recession, but the recently improved economic data only show that the rate of decline is moderating and we expect that output will continue to contract until Q4/2009. Even with attractive borrowing rates, facing a grim 2009 of higher unemployment and dampened income growth, uncertain households are likely to delay home-buying and other big-ticket purchases. With falling sales intensifying pressures to draw down current inventories, manufacturers and wholesalers will be increasingly queasy about putting new stock on their shelves. With machinery and equipment going idle and the output gap widening, new business investment will continue to slow until mid-2010. All indicators therefore point to diminished demand for credit – a trend which will continue through 2009. As well, given the risks of consumer and business insolvency, prudent lenders will scrutinize the credit worthiness of potential borrowers. Trade credit will also be constrained as suppliers shun the risk of unpaid bills should their costumers become insolvent. Credit flows should be expected to subside further – at least until the widely postulated "green shoots" are actually firmly rooted.

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CANADIAN NON-FINANCIAL CORPORATIONS NEW NET FINANCING

	Total Financing	Change in Retained Earnings	External Sources
New Funds (CDN millions)			
Q1/2005	32,761	15,187	17,574
Q1/2006	31,964	10,846	21,118
Q1/2007	39,892	-517	40,409
Q1/2008	20,627	1,296	19,331
Q1/2009	5,997	1,519	4,478
Total for Year			
2005	105,363	37,708	67,655
2006	144,551	68,154	76,397
2007	164,307	46,042	118,265
2008	116,015	43,711	72,304

Source: Statistics Canada

CANADIAN NON-FINANCIAL CORPORATIONS NEW INTERNAL FUNDS

	Net Profit	Dividends	Change in Retained Earnings	% of Profit Retained
New Funds (CDN millions)				
Q1/2005	24,994	9,807	15,187	61%
Q1/2006	31,271	20,425	10,846	35%
Q1/2007	34,931	35,448	-517	-1%
Q1/2008	30,572	29,276	1,296	4%
Q1/2009	21,894	20,375	1,519	7%
Total for Year				
2005	117,947	80,239	37,708	32%
2006	145,050	76,896	68,154	47%
2007	145,774	99,732	46,042	32%
2008	132,124	88,413	43,711	33%

Source: Statistics Canada

CANADIAN NON-FINANCIAL CORPORATIONS NEW EXTERNAL FINANCING

	Total External Financing	Market Funds	Non-Market Debt
New Funds (CDN millions)			
Q1/2005	17,574	10,043	7,531
Q1/2006	21,118	13,617	7,501
Q1/2007	40,409	13,188	27,221
Q1/2008	19,331	16,237	3,094
Q1/2009	4,478	8,803	-4,325
Total for Year			
2005	67,655	30,482	37,173
2006	76,397	41,901	34,496
2007	118,265	39,667	78,598
2008	72,304	26,585	45,719

Source: Statistics Canada

CANADIAN NON-FINANCIAL CORPORATIONS NEW MARKET FUNDS

	Total Market	Share Issuance	Bond Issuance	New Comm. Paper
New Funds (CDN millions)				
Q1/2005	10,043	4,437	2,878	2,728
Q1/2006	13,617	6,301	1,830	5,486
Q1/2007	13,188	5,217	5,380	2,591
Q1/2008	16,237	6,346	1,909	7,982
Q1/2009	8,803	5,750	3,004	49
Total for Year				
2005	30,482	19,167	7,420	3,895
2006	41,901	15,672	10,925	15,304
2007	39,667	23,492	12,437	3,738
2008	26,585	12,684	11,363	2,538

Source: Statistics Canada

CANADIAN NON-FINANCIAL CORPORATIONS NEW NON-MARKET DEBT							
	Total Non-Market	Bank Loans	Other Loans	Non-Res. Mortgages	Corporate Claims	Trade Accounts	Other Liabilities
New Funds (CDN millions)							
Q1/2005	7,531	1,884	1,132	2,776	-1,797	1,486	2,050
Q1/2006	7,501	2,493	1,285	4,608	1,517	4,518	-6,920
Q1/2007	27,221	6,246	596	5,110	5,541	6,482	3,246
Q1/2008	3,094	4,622	-886	5,409	233	2,231	-8,515
Q1/2009	-4,325	-1,977	-2,626	2,422	4,769	-1,412	-5,501
Total for Year							
2005	37,173	4,777	3,537	16,785	340	10,842	892
2006	34,496	8,658	2,813	19,381	9,210	8,938	-14,504
2007	78,598	20,226	-281	18,105	14,510	13,616	12,422
2008	45,719	25,659	-2,276	19,007	8,219	11,526	-16,416
Source: Statistics Canada							

NEW BORROWING BY CANADIAN HOUSEHOLDS							
	Consumer Credit	Trade Payables	Bank Loans	Other Loans	Total Credit	Mortgages	Total New Borrowing
New Funds (CDN millions)							
Q1/2005	5,910	-117	2,092	944	8,829	7,384	16,213
Q1/2006	3,168	1,055	947	1,278	6,448	10,966	17,414
Q1/2007	6,308	-1,216	189	4,431	9,712	13,045	22,757
Q1/2008	5,687	-108	-62	3,264	8,781	12,511	21,292
Q1/2009	4,557	2,384	850	-1,854	5,937	7,832	13,769
Total Annual Flows							
2005	28,476	2,998	1,538	1,613	34,625	51,881	86,506
2006	28,366	62	1,431	8,103	37,962	63,514	101,476
2007	34,365	1,334	935	3,217	39,851	76,269	116,120
2008	30,615	823	2,233	5,518	39,189	73,075	112,264
Source: Statistics Canada (Financial Flows Accounts)							

Endnotes

1 Statistics Canada's glossary for its Financial and Wealth Accounts can be accessed at: http://www.statcan.gc.ca/nea-cen/gloss/financial-financiere-eng.htm