TD Bank Financial Group

TD Economics

Observation

September 2, 2009

CREDIT FLOWS IN THE SECOND QUARTER OF 2009

Data on financial flows for the second quarter of 2009 showed a moderation in borrowing by households and a contraction in borrowing by non-financial corporations (NFCs). While mortgages and household credit were boosted in the second quarter from their slow-downs in the first quarter, the flows were nonetheless tepid relative to previous years. This improvement reflected an alleviation of pent-up demand for housing following two quarters of very depressed sales, with second quarter home-buyers being lured by lower prices and very attractive mortgage rates. On the business side, NFCs' overall financing remained positive in the second quarter, thanks to a relatively high share of retained earnings. However, for NFCs' external sources of funds, borrowing from non-market sources shrank while funds from market sources expanded strongly. In aggregate, firms appear to have shifted away from non-market debt towards long-term market debt or equity issues as conditions in these markets have improved. Diminished production and draw-down of inventories point to diminished demand for short-term business credit.

Household borrowing rebounds but on moderating trend

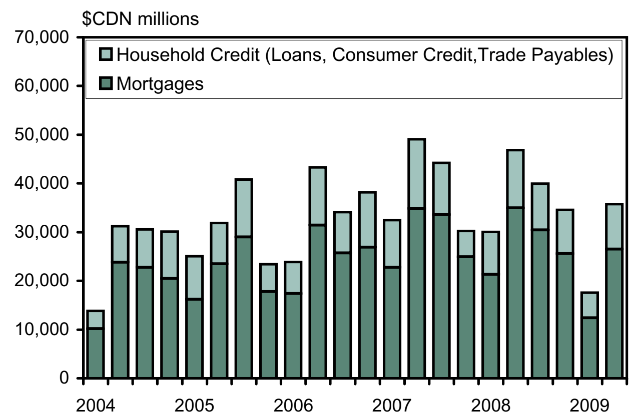
Household borrowing returned to life in the second quarter, but remained subdued relative to history. The re-emergence of household borrowing primarily owed to demand for mortgage credit and consumer credit secured on real estate. From Bank of Canada data, mortgages originated by banks comprise approximately three-quarters of outstanding mortgage credit.

Home-buying was surprisingly robust in the second quarter: on a seasonally-adjusted basis, sales of existing homes were 114,000 in Q2/2009 compared with around

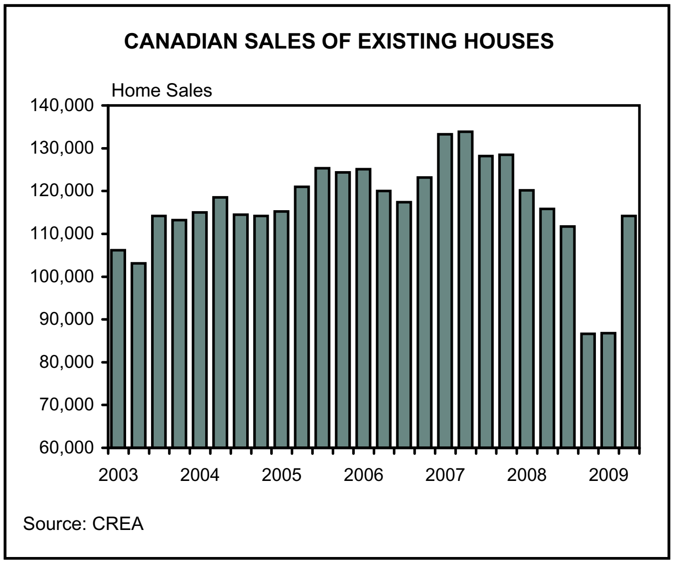
HIGHLIGHTS

- **Households borrowed extensively through mortgages and consumer credit as home-buying in the second quarter rebounded to a surprisingly strong pace.**
- **With conditions on equity and bond markets further improving during the second quarter, non-financial corporations locked in long-term financing and repaid credit lines, which had been used extensively in Q4/2008.**
- **While profits were down, firms cut dividends and retained a heightened share of earnings.**
- **Demand for short-term forms of credit is falling as firms draw down inventories – a trend which we expect to continue as inventories further contract.**

CANADIAN HOUSEHOLDS' SOURCES OF NEW FUNDING



Source: Statistics Canada



87,000 in Q1/2009 and Q4/2008. However, nation-wide sales remain below the 116,000 pace of Q2/2008 and their historic high of 133,000 in Q2/2007. Nonetheless, sales definitely improved in the second quarter, boosting mortgage borrowing. As well, renovation activity was up in the second quarter and additionally boosted demand for home equity lines of credit (HELOCs).

While home-buying has so far stayed robust through the third quarter, we expect the pace to wane during the autumn. Given the depressed sales in the previous two quarters, the Q2/2009 home-buying largely absorbed pent-up demand. As well, home-buyers have certainly been attracted by low mortgage rates, and low prices have also likely "brought forward" some future home-buying. Housing starts stagnated further during the second quarter, falling to 127,000 (SAAR) from 139,100 (SAAR) in Q1/2009 and 217,600 (SAAR) in Q2/2008. There are fewer new houses in the pipeline, and we anticipate a pace of home-building around 130,000 units during 2009 and 2010, owing to the over-building during the housing boom. Mortgage demand will cool as the pent-up demand eases.

As well, personal spending on motor vehicles improved in the second quarter – albeit marginally – and financing of auto purchases bolstered consumer credit flows from the previous quarter.

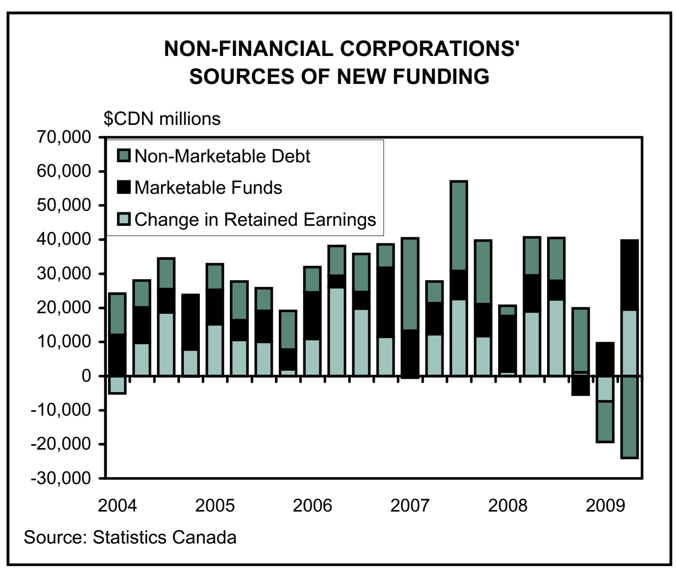
A low interest rate environment has encouraged borrowing, but new credit flows to households remain below their former pace. Household borrowing in the year-to-date remains much lower than in previous years. Given the need for highly indebted households to rebuild their net worth and the much tempered outlook for new housing, we expect the moderating trend to continue.

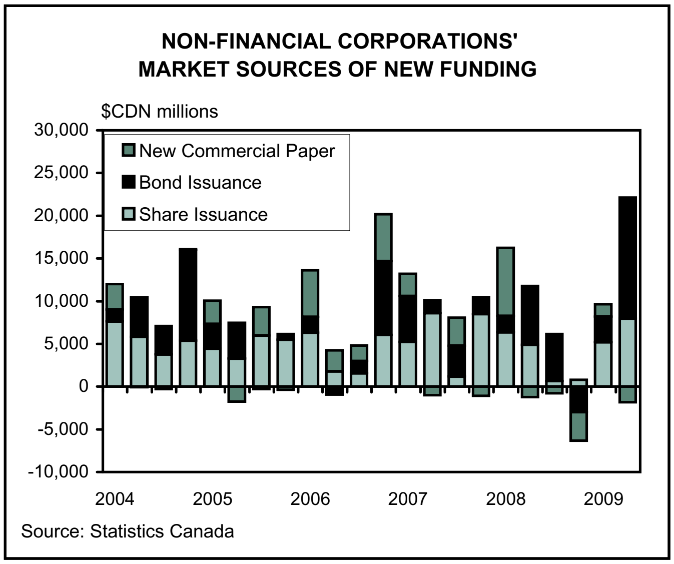
Firms stash cash and tap markets for new funds

Total new financing for NFCs rebounded in Q2/2009; however, excepting the weakness in the previous two quarters, was still lower than in any other quarter since 2003. While NFCs have retained an increased share of earnings, their external sources of financing contracted in the second quarter. Net issuance of equity and bonds rose strongly. However, non-market debt contracted steeply. Borrowing from banks and other institutions both declined substantially, and credit through trade accounts also contracted sharply.

While NFC net profits rebounded from the previous quarter, they had fallen to their lowest level since 2002 in Q1/2009. So far, net profits in the year-to-Q2 are at their lowest level since 2004. In aggregate, dividends were slashed substantially in the second quarter and NFCs retained a high share of their net profits (60%).

However, external sources of financing witnessed a further contraction in the quarter. In aggregate, firms appear to be locking in longer-term forms of market-based financing, with a strong rebound in net share issuance and the highest quarterly pace of net bond issuance ($14 billion) since 2001. Certainly the improvements in corporate bond spreads and in equity markets have encouraged the revival of issuance. In contrast, NFC commercial paper (CP) contracted by $1.9 billion during the quarter, demonstrating declining demand for short-term credit. CP spreads have dropped from the elevated levels experienced during the turbulent autumn of 2008, but did remain high against

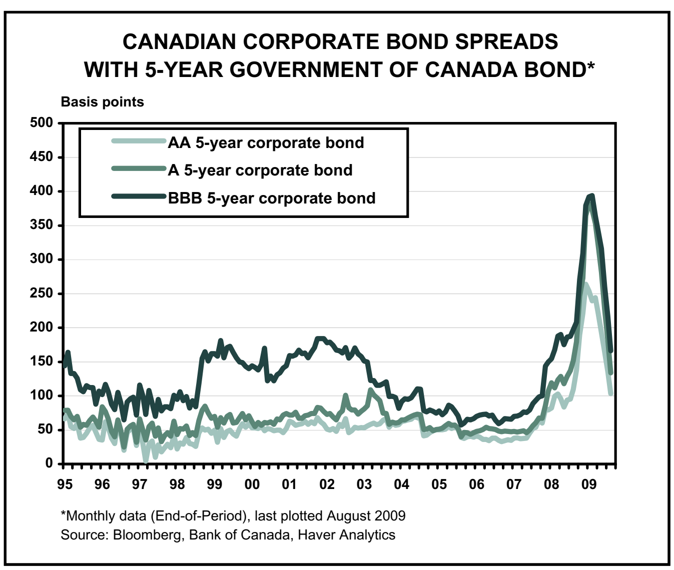




pre-2007 history during Q2/2009.

Consistent with the decline in demand for short-term borrowing, non-market sources of debt have contracted. Bank loans and other loans have both declined. Flows of bank loans notably were at high levels in Q4/2008 as larger NFCs in particular, facing unfavourable conditions on open markets, drew on bank-provided credit facilities. The decline in bank loans in Q2/2009 partially represents repayment of these funds as firms shift to longer-term debt, equity issuance and retained earnings.

Notably, NFCs' mortgages resurged in the second quarter after a tepid first quarter. From Bank of Canada data, banks accounted for all of the second quarter growth in non-residential mortgages, offsetting the decline in non-residential mortgages from non-bank institutions.



Trade credit also contracted steeply by $6.1 billion – its greatest recorded quarterly contraction and its second quarter of decline. The slide reflects the rapid draw-down of inventories, but likely also the increasing expectation for "cash on the barrelhead" by suppliers. Other liabilities – representing accrued interest, interest receivable or payable and prepaid expenses – also declined on the quarter.

A "new normal" for borrowing?

While households took advantage of low house prices and attractive mortgage rates during the second quarter, the continuing contraction of the Canadian economy weighed down business borrowing.

Looking ahead, household borrowing is likely to moderate. Home-buying and renovation activity was very strong in the second quarter; but the dampened pace of home-building and the strained household balance sheet point to recent borrowing as an alleviation of pent-up home-buying and a "bringing forward" of future demand. The pace of mortgage borrowing and consumer credit should moderate during the fourth quarter.

For firms, after sliding sales resulted in involuntary inventory build-up during the Q4/2008, the rapid cleaving of inventories during the first two quarters of 2008 diminishes the demand for short-term business credit. Going forward, we expect a continuing contraction in inventories. Although sales are stabilizing, inventory-to-shipments ratios remain elevated in the manufacturing and wholesale sectors.

As well, since much production capacity remains idled, we expect business capital investment to continue to slip during the latter half of 2009. Albeit having improved, the balance of opinion for investment intentions is still strongly negative in the Bank of Canada's second quarter Business Outlook Survey. With conditions on open markets normalizing, firms also leapt at the opportunity to issue longer term debt and re-capitalize, and also repaid their credit lines after drawing these extensively during Q4/2008. Extensive issuance of longer-term debt likely reflects a rebalancing away from short-term forms of borrowing rather than new investment intentions. With recovery to be tepid, businesses will be cautious about new borrowing.

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CANADIAN NON-FINANCIAL CORPORATIONS NEW NET FINANCING			
	Total Financing	Change in Retained Earnings	External Sources
New Funds (CDN millions)			
Q2/2005	27,702	10,588	17,114
Q2/2006	38,180	26,050	12,130
Q2/2007	27,706	12,279	15,427
Q2/2008	40,643	18,940	21,703
Q2/2009	15,668	19,518	-3,850
Year to Q2			
2005	60,463	25,775	34,688
2006	70,144	36,896	33,248
2007	67,598	11,762	55,836
2008	61,270	20,236	41,034
2009	5,881	12,145	-6,264
Source: Statistics Canada			

CANADIAN NON-FINANCIAL CORPORATIONS NEW MARKET FUNDS				
	Total Market	Share Issuance	Bond Issuance	New Comm. Paper
New Funds (CDN millions)				
Q2/2005	5,673	3,273	4,191	-1,791
Q2/2006	3,280	1,786	-958	2,452
Q2/2007	9,032	8,605	1,475	-1,048
Q2/2008	10,510	4,872	6,913	-1,275
Q2/2009	20,239	7,950	14,166	-1,877
Year to Q2				
2005	15,716	7,710	7,069	937
2006	16,897	8,087	872	7,938
2007	22,220	13,822	6,855	1,543
2008	26,747	11,218	8,822	6,707
2009	29,901	13,137	17,174	-410
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)							
Q2/2005	11,441	3,283	1,457	4,488	1,686	1,444	-917
Q2/2006	8,850	5,523	1,544	4,194	2,337	1,567	-6,315
Q2/2007	6,395	3,733	-418	3,623	1,567	933	-3,043
Q2/2008	11,193	816	-917	4,407	5,107	5,315	-3,535
Q2/2009	-24,089	-6,964	-4,541	5,069	-3,248	-6,127	-8,278
Year to Q2							
2005	18,972	5,167	2,589	7,264	-111	2,930	1,133
2006	16,351	8,016	2,829	8,802	3,854	6,085	-13,235
2007	33,616	9,979	178	8,733	7,108	7,415	203
2008	14,287	5,438	-1,803	9,816	5,340	7,546	-12,050
2009	-36,165	-8,899	-7,381	6,377	3,495	-8,682	-21,075
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)							
Q2/2005	9566	-387	-2231	1408	8,356	15141	23,497
Q2/2006	8911	529	1156	1224	11,820	19635	31,455
Q2/2007	11456	1592	438	720	14,206	20649	34,855
Q2/2008	9899	2342	-393	74	11,922	23022	34,944
Q2/2009	7643	717	137	758	9,255	17218	26,473
Year to Q2							
2005	15,476	-504	-139	2,352	17,185	22,525	39,710
2006	12,079	1,584	2,103	2,502	18,268	30,601	48,869
2007	17,764	376	627	5,151	23,918	33,694	57,612
2008	15,586	2,234	-455	3,338	20,703	35,533	56,236
2009	11,689	755	984	1,025	14,453	24,388	38,841
Source: Statistics Canada (Financial Flows Accounts)							