TD Bank Financial Group

TD Economics

Topic Paper

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CANADIAN ECONOMIC AND SMALL BUSINESS OUTLOOK

The Canadian economy has been delivering a lacklustre performance since the fourth quarter of 2004, with real GDP advancing at below a 3 per cent annualized pace. However, this headline result masks considerable strength in the domestic economy, which has left the economy operating at close to full capacity and sets the stage for the Bank of Canada to begin raising interest rates, likely as early as on September 7th.

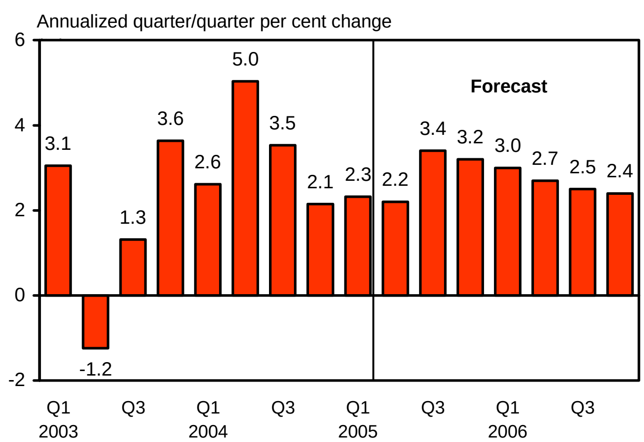
Strong domestic demand…

Consumer spending has been rising at a solid pace, fuelled by low interest rates and favourable labour market conditions. High levels of corporate profits, elevated rates of capacity usage and the need to increase international competitiveness have all been a powerful catalyst to business investment, with outlays on machinery and equipment rising at a double digit pace. Residential construction has also been strong. After expanding rapidly in 2003 and 2004, the pace of residential construction appears to be moderating, but it remains at a remarkably high level of activity. The strength in new and resale housing markets has contributed to consumer spending by boosting demand for consumer durables (like furniture and appliances) but also by raising household wealth through climbing home prices. Consequently, while overall real GDP has increased at a moderate pace, domestic demand has been booming, increasing by an annualized 4.4 per cent in the final three months of 2004 and by 6.3 per cent in the first three months of 2005.

…but weakness in export-oriented manufacturing

But the news has not been all positive. The main factor holding back the economy has been weakness in the manufacturing sector, largely brought about by the lagged fallout from the past appreciation in the Canadian dollar. Although the currency has virtually treaded water this year, the dramatic appreciation vis-à-vis the U.S. dollar since 2003 has taken a powerful toll. As of July, manufacturers had slashed 106,000 positions over the prior year. However, the weakness in exports seems to be gradually abating and there is good reason to believe that the adjustment process should be largely completed in the second half of 2005. As the effects of the currency shock wanes and amid strong economic growth south of the border, we look for the Canadian economy to improve, with economic growth picking up to above the 3 per cent mark in late 2005 and early 2006.

CANADIAN REAL GROSS DOMESTIC PRODUCT (GDP)



Forecast by TD Economics as at June 2005; Source: Statistics

Rates headed modestly higher

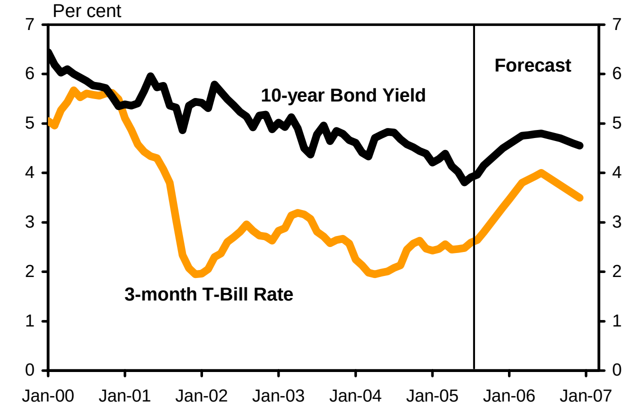
This firming in economic growth, especially among larger businesses, augurs for a gradual rebalancing in monetary policy. Although inflation currently remains in abeyance, the Bank of Canada will be concerned about the risk of price pressures building over the next 18 to 24 months. Estimates of the output gap suggest that there is very little slack available in the economy. This can be seen in the low rate of unemployment and the high rate of capacity usage. Moreover, Canada's recent poor productivity performance suggests that any acceleration in growth could lead to some price or wage pressures. Consequently, the Bank stated in July that "some reduction in the amount of monetary stimulus will be required in the near term", which led markets to expect a 25 basis points rate hike at the September 7th fixed announcement date (FAD). Regardless of the precise timing, the Bank will surely take a gradualist approach to tightening monetary policy, and the improvement in economic conditions is expected to result in the overnight rate being lifted to 4.00 per cent in early 2006. This represents a significant 150 basis point increase in short-term rates, though it should be stressed that it still leaves rates, both in nominal and real terms, at historically low levels.

Outlook for second half of 2006 less bright

So, the economy is expected to fare well in the near term and interest rates are expected to increase only modestly, which constitutes a relatively positive outturn. However, there are storm clouds on the horizon that make us less optimistic about prospects in the second half of next year. It is evident that the U.S. economic expansion has considerable momentum, but it is also clear that a number of major economic imbalances have developed that are directly related to the sustained low interest rate environment experienced over the past couple of years.

For example, the U.S. housing market looks decidedly frothy. Indeed, after removing the effect of inflation, home prices in the U.S. are up 41 per cent over the past five years, with the result that housing affordability has fallen to a 13-year low. Even more troubling, the markets look increasingly leveraged and speculative. It is estimated that 42 per cent of first-time home buyers made no down payment last year, while 23 per cent of home sales in a National Association of Realtors survey were identified as being primarily 'investments', which infers that they were speculative purchases.

CANADIAN 3-MONTH T-BILL RATES AND 10-YEAR GOVERNMENT BOND YIELDS



Actual data to: Aug. 2005; Forecast by TD Economics as at August 2005; Source: Global Insight

As the excesses build, there is a greater risk that the U.S. economy will suffer a setback. And, we feel there is a distinct possibility that economic growth may slow next year under the weight of tighter monetary policy, record consumer debt loads, a tapering off in mortgage refinancing activity, an absence of new fiscal stimulus and only modest growth in global demand for U.S. exports.

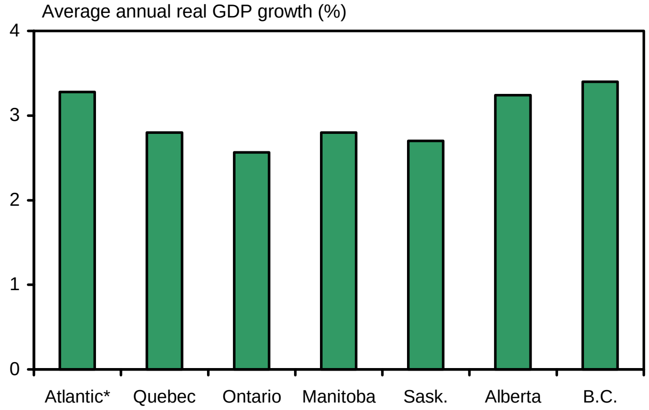
If the U.S. economy does experience slower growth, it will present a new challenge for Canadian exporters. At the same time, the pace of domestic demand growth in Canada may be constrained by a tighter stance to monetary policy by the Bank of Canada, which is expected to dampen interest rate sensitive areas of the economy, such as consumer durables and residential construction. The implication is that the Canadian economy may strengthen over the next 6 to 9 months, but the acceleration could prove short-lived, with real GDP growth slowing once again to below 3 per cent in the second half of calendar year 2006. And, this time the domestic economy will simultaneously shift down a gear.

It should be stressed that we are not expecting a major economic slowdown or a major correction in Canadian housing markets. Indeed, the economy is expected to grow at slightly below a 3 per cent pace for the third consecutive year in 2006. However, it does imply that the peak in interest rates is likely to be at relatively low levels and could occur in early 2006.

Mixed small business performance

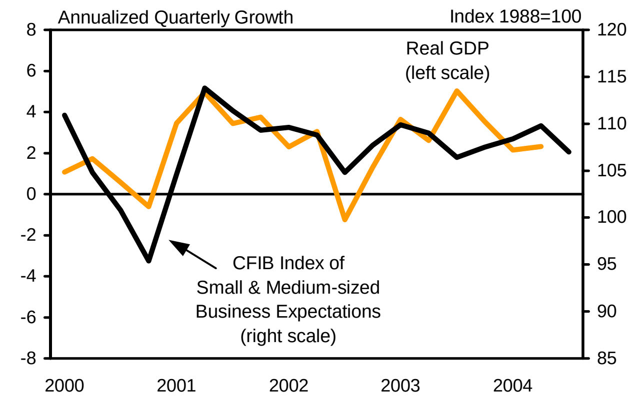
This overall economic and financial outlook has significant implications for the small business sector. Using hiring trends as a proxy for output, small businesses have shared in the weaker than normal pace of economic growth in the first half of 2005. However, despite the broad consensus in financial markets for an improvement in economic conditions in the near term, the prospects for small businesses over the coming 12 months are somewhat uncertain, with many firms reporting declining expectations. This suggests that larger businesses may outperform small businesses in the coming months, which may reflect the better fortunes of export-oriented large-scale businesses in late 2005. However, it should be stressed that while small business confidence may have dipped, it remains at a relatively solid level, suggesting at least a moderate performance in the months ahead. The heavy sectoral orientation of small businesses towards servicing the strong domestic economy bodes well, and small businesses that are plugged into the production processes of large export businesses should benefit from the improvement in the latter. This perspective is supported by healthy hiring intentions reported by small business manufacturers for the coming year.

PROVINCIAL REAL GDP FORECAST - 2006



*Atlantic includes NB, NS, PEI and NL;
Forecast by TD Economics as at August 2005

SMALL & MEDIUM-SIZED BUSINESS EXPECTATIONS



Last plotted: Q2-2005 for CFIB Index & Q1-2005 for Real GDP
Source: Canadian Federation of Independent Business, Statistics Canada. TD Economics

However, a slowdown in the U.S. economy and some moderation in domestic demand growth in 2006 will likely present challenges to the small business sector. Small businesses may be less vulnerable to a slowdown Stateside given their lower export exposure, but small manufacturing firms are still bound to be adversely affected to some degree. Meanwhile, a more moderate pace of consumer spending, a cooling in Canada's housing markets and higher interest rates are likely to temper the prospects for many small businesses.

Once again, it must be stressed that the outlook is not bleak. Indeed, the small business sector as a whole should deliver moderate growth over the next 18 months. Economic conditions are likely to be strongest in the West, where Alberta and B.C. are expected to lead in economic growth, while conditions in central Canada may be less supportive, reflecting the heavier exposure to non-commodity export-oriented industry.

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