Economics

IN FOCUS

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Why Corporate Canada Will Surprise on the Upside in 2014

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Regardless of how bullish or bearish you are, it is clear that neither the consumer nor the government will be able to provide the Canadian economy with any meaningful lift in the coming year. Once again, Canada is finding itself in the familiar position of what's happening elsewhere will be the key factor dictating the country's economic fortune.

And if we are right, 2014 will be a year in which both the US and global economies will surprise on the upside. In the past, without fail, such an environment led to a rebound in capital spending by Canadian corporations. What largely determined the pace of the improvement in business investment was not only the speed of the US recovery but, as important, the level of readiness of firms to elevate spending.

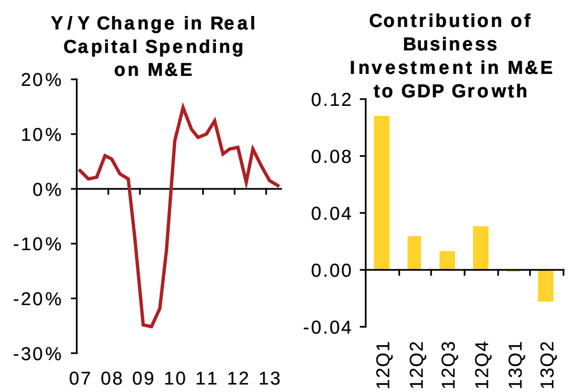
In this context, our measure of corporate strength suggests that Canadian corporations have never been in a better position to respond to the upcoming shift in US demand.

Are They Ready?

Canadian corporations are able but unwilling to increase investment. That has been generally the complaint CEOs have been hearing from the Bank of Canada recently. True, business investment has slowed dramatically over the past six months, hardly rising on a year-over-year basis and currently contributing negatively to overall growth (Chart 1).

Chart 1

Corporate Spending Has Softened Notably



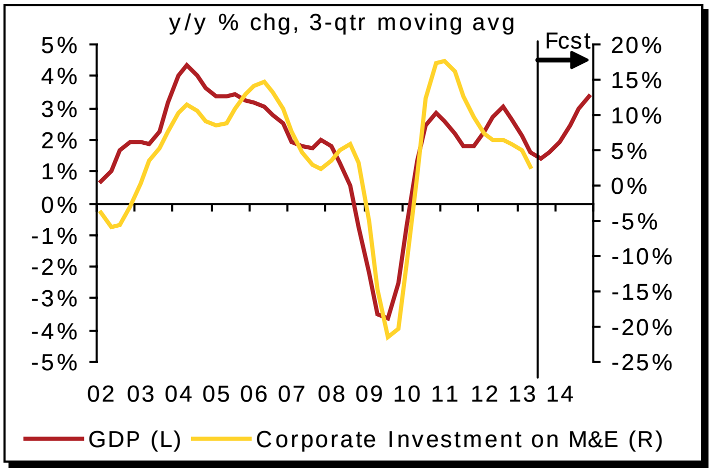
Source: Statistics Canada, CIBC

But things are starting to change. 2013 should be seen as a transition year between something bad and something better. We see the US economy expanding by 3.2% in 2014—more than double the projected pace of 2013, and the global economy, led by continued improvement in Europe and China, growing by 4% vs. 3% in 2013. One need not be an economist to conclude that such an environment is positive for a small open economy such as Canada.

And historically, corporate Canada responded positively by picking up the pace of capital spending (Chart 2). On average, one-percentage-point change in US growth has led to a full three-percentage-point change in capital expenditures by Canadian corporations.

Chart 2

Capital Spending Dances to the Tune of US GDP



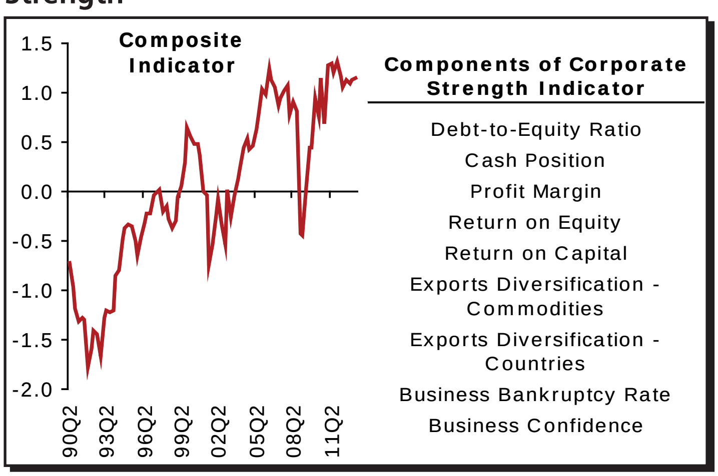
Source: BEA, Statistics Canada, CIBC

But of course, averages do not tell the whole story. The response by corporate Canada is directly linked not only to the speed of the recovery south of the border, but also to its financial position at the eve of that acceleration.

To assess this factor we utilize CIBC's composite indicator of corporate strength, comprising of nine key measures. While softening somewhat recently, the index is still hovering around an all-time high and is almost a full point above its long-term average (Chart 3). That's important since, as illustrated in Chart 4, the higher the level of our index, the more responsive corporate Canada has been to a shift in US demand. A one-percentage-point acceleration in US demand in an environment of relatively low index readings led to less than three percentage points of acceleration in capital spending. That is notably weaker than the four-percentage-point acceleration seen in periods of high index readings. Given the highly elevated level of our index, the ability of Canadian corporations to respond to improving US demand has never been better.

Chart 3

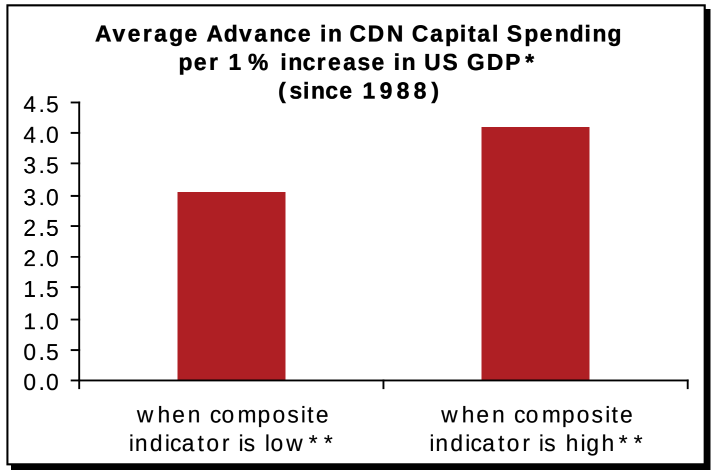
CIBC's Composite Indicator of Corporate Canada's Strength



Source: Statistics Canada, Industry Canada, Conference Board, CIBC

Chart 4

Better Response to US Growth When Our Indicator's Reading is High



* *In an environment of positive US growth*
** *Low reading: >1 STD below average*
** *High reading: >1 STD above average*
Source: BEA, Statistics Canada, CIBC

What's more, this is not a tale of one or two major industries that biased the aggregate results. The index performance is widely based. In fact, improvement in key measures such as cash position and profit margin in recent years actually appears more impressive when the mighty energy sector is excluded.

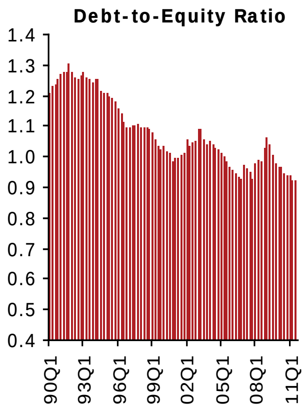
Measuring Corporate Strength

Our composite indicator is based on nine individual indicators. These are normalized with respect to their long-run average and standard deviation, and an unweighted average is taken. While the index is marginally below the highs seen a year ago, it is still a full one-and-a-half standard deviations above its long-term average.

Key to that impressive performance is the prudent approach by corporate Canada before, during and after the recession. The debt-to-equity ratio is currently at an all-time low, falling recently below the rate seen before the recession (Chart 5). At the current reading of less than 0.9 this ratio is a full one-and-a-half points below its long-term average. Naturally some sectors have fared

Chart 5

Debt-to-Equity Ratio: A Record Low



	Debt to Equity (2013 as a proportion of long-term avg)
Real Estate, Renting, Leasing	0.56
Agriculture	0.59
Construction	0.61
Retail	0.66
Oil & gas extraction	0.73
Wholesale	0.75
Accommodation & Food	0.80
Transport & Warehouse	0.87
Manufacturing	0.98
Information & Cultural	1.01
Utilities	1.23
Mining (ex oil & gas)	1.40

Source: Statistics Canada, CIBC

better than others in reducing their dependence on debt. The debt to equity ratios in sectors such as real estate and retail are currently less than two thirds of their long-term average and overall debt ratios are now lower than their long-term averages in 9 out of the 12 sectors examined.

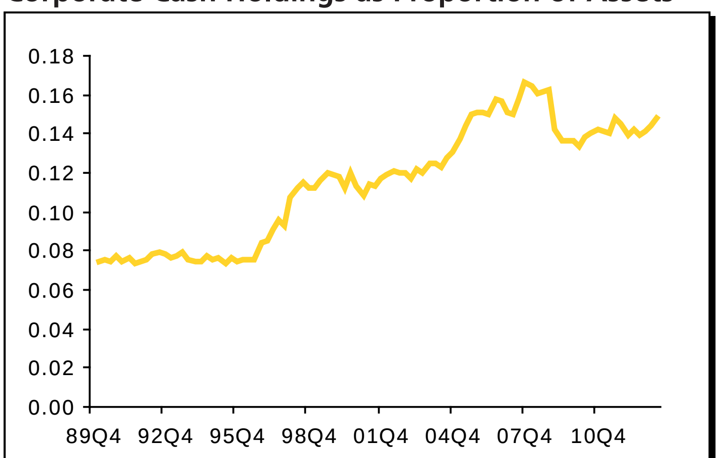
The strong cash position held by Canadian firms is another factor contributing to the elevated level of our index. At more than $560 billion, the cash position is at a near-record high of 15% relative to assets and 28% relative to credit (Chart 6). But as opposed to the popular view that sees this cash as opportunistic money that will be deployed immediately when the light turns green, we see its contribution to corporate strength a bit differently.

The trajectory of the increased cash position is not something new, it is simply a continuation of a long-term trend and in line with prior-cycle normal business practice. The relevant question is really not why Canadian companies are holding onto cash today, but why they moved to such a practice over the prior decade. The trend to a rising cash position started in the mid-1990s when cash as a share of assets was only half of what it is today. But cash should not be viewed in isolation. While businesses have increased the share of assets they hold in cash, they, at the same time, reduced the share allocated to other current assets. Those largely comprise account receivables and inventories, which have been pared to less costly levels through improved logistics, manufacturing integration and better management information systems. In fact, all the increase in the relative cash position in the past two decades was fully offset by the reduced share of inventories in assets. Accordingly we view the elevated cash position as an increase in the relative share of a more productive asset—one that can increase firms' accessibility to lower cost financing.

Another notable example of strength is the current level of business bankruptcies. Regardless of how you measure it, the number of business bankruptcies in Canada is at a record low (Chart 7). Only 3,150 firms declared bankruptcy during the year ending June 2013, 8% below the rate seen in the same period last year, and less than half the average level of the past twenty years. And despite the fact that today there are close to 30% more businesses in the Canadian economy than in the late 1980s, there are 50% fewer business bankruptcies. Accordingly, at only three, the estimated number of bankruptcies per 1,000 businesses is by far the lowest on record.

Chart 6

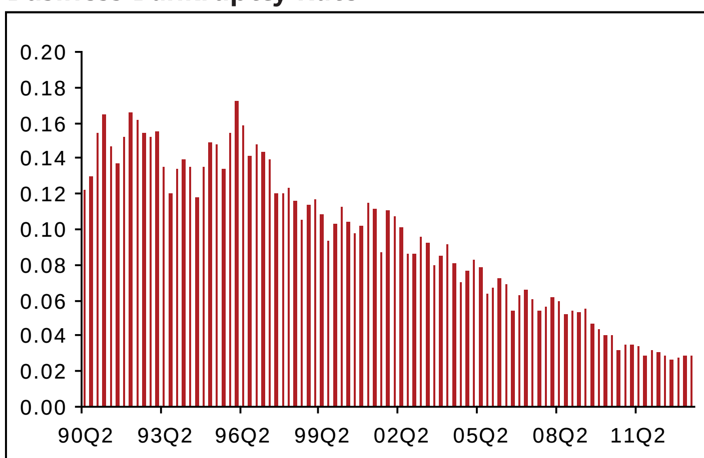
Corporate Cash Holdings as Proportion of Assets



Source: Statistics Canada, CIBC

Chart 7

Business Bankruptcy Rate



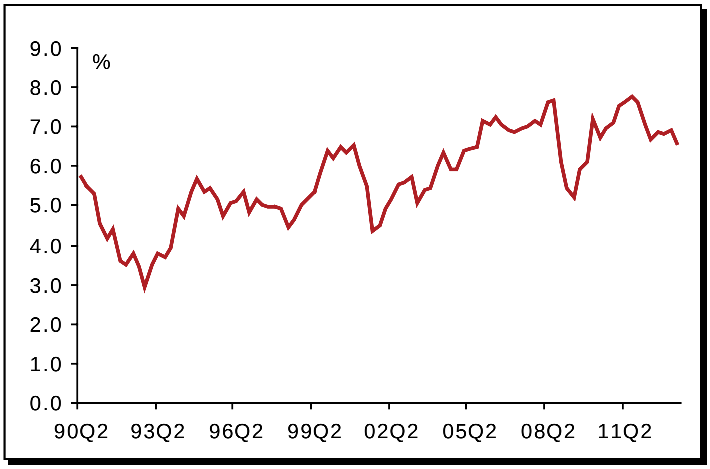
Source: Statistics Canada, CIBC

Other factors however are working to offset some of these positives. Profit margin, while still a full two points above its long-term average, has been trending downward in recent quarters and at 6.5% it is a full point below the level seen a year ago (Chart 8). A similar trend can be seen in return-to-equity which at 10% is two points below the rate seen a year ago, but still roughly in line with its long term average (Chart 9).

Recently, business in Canada has had the ability to step up capital investment but a lack of growth in the domestic and international economies provided little incentive to do so. While it is widely expected that stronger growth in the US next year will have an upside benefit for Canada, what might surprise many is how quickly and significantly Corporate Canada will ramp up spending to capitalize on the long awaited rebound in global demand.

Chart 8

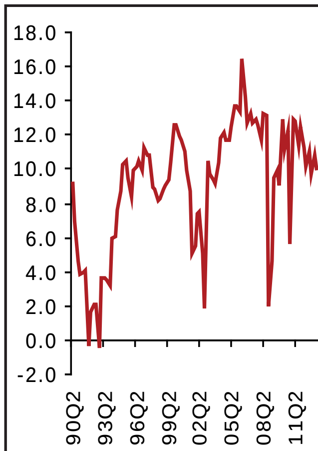
Profit Margin



Source: Statistics Canada, CIBC

Chart 9

Return on Equity



	Return on Equity (2013 as a proportion of long-term avg)
Accommodation & Food	1.9
Information & Cultural	1.9
Transport & Warehouse	1.4
Wholesale	1.4
Real Estate, Renting, Leasing	1.3
Utilities	1.3
Agriculture	1.2
Mining (ex oil & gas)	1.2
Manufacturing	1.1
Retail	0.9
Construction	0.8
Oil & gas extraction	0.2

Source: Statistics Canada, CIBC