Energizing Non-Energy Investment

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Nowhere is the dramatic decline in crude prices more visible than in capital spending. Energy-related investment lost one-third of its might in 2015, with more cuts coming. And when oil prices recover, don't expect a quick turnaround in energy CapEx as the correlation between price and Canadian spending is probably much lower than it was in the pre-shale era.

Other sectors will have to step up to the plate, and it's starting to happen. Relatively large scale infrastructure spending will carry some of the weight. A more balanced spending distribution, free of the crowding out effects of energy investment, along with an appropriately valued dollar should also work to raise the CapEx intensity of non-energy sectors.

Natural Resource Impact on the Economy—Not as Large as Perceived

Ask any foreigner about the Canadian economy and the first image is of a country that is defined by its natural resource sector. Yet, the sector employs only 6% of all Canadian workers and, even in 2012, accounted for just 16% of economic output, down from 20% five years earlier. Not only are those figures lower than many assume, but they were also on a clear multi-year downward trajectory even before the oil price shock (Chart 1). And those estimates are based on a broadly based definition of natural resources–one that reaches beyond the materials taken from the ground to encompass value-added manufacturing production (factory production whose inputs constitute a large share of raw materials).

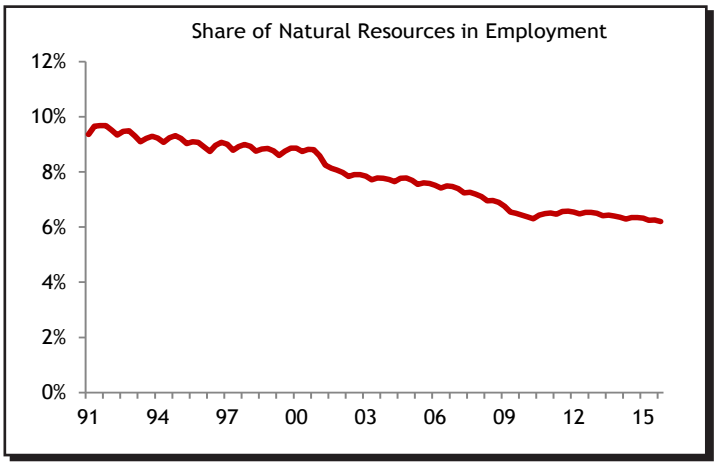
Zooming in on 2015, the 29,000 jobs lost in the natural resource sector, while painful in Alberta, shaved only 18% from the national jobs-gain figure during the year. Although the fall in oil prices had a more significant effect on nominal output, it only cost the economy 0.3 percentage points in real terms—not trivial but hardly a calamity (Chart 2).

Resources Energized Capital Spending

The real impact of the natural resource sector was on capital spending. The magnitude of the decline in the energy space dwarfs any changes in the spending that firms in other sectors were planning for 2015 (Chart 3). No doubt influenced by the oil patch's importance in aggregate investment, Statistics Canada has released actual figures (as opposed to intentions) for energy sector capital spending earlier than usual. With data for 2015 in

Chart 1

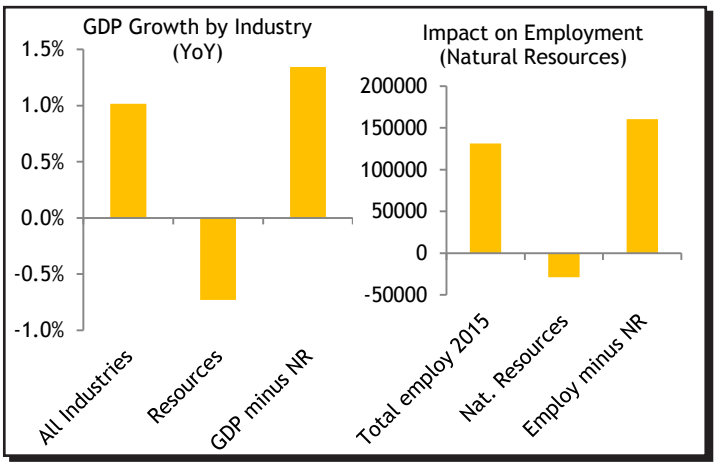
Natural Resources: Direct Role in the Economy Not as Big as You Think



Source: Statistics Canada, CIBC

Chart 2

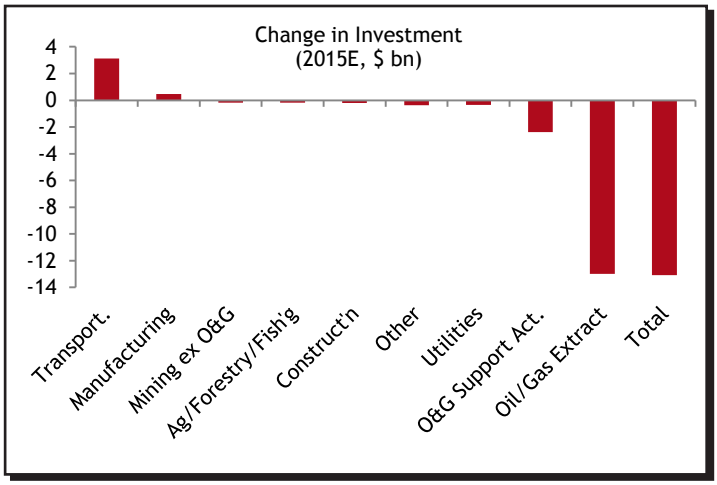
Natural Resources Rocks 2015 Growth, But Not Enough to Sink Economy



Source: Statistics Canada, CIBC

Chart 3

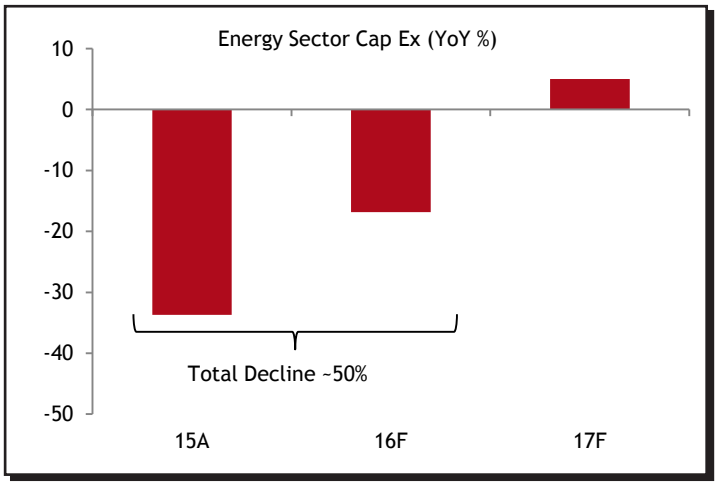
Investment Drop in 2015 Dominated by Collapse in Energy Sector...



Source: Statistics Canada, CIBC

Chart 4

... with Total Investment Halfed by 2016 with Only Modest Recovery Ahead



Source: Statistics Canada, CIBC

the books, we now know that capital spending in the oil patch fell by a thumping one-third—the largest decline since the great recession.

Looking forward, the bleeding should ease, but given further weakness in oil prices at the beginning of the year, and the limited scope for upside before Q4, we expect energy sector capital spending to fall by an additional 20% or so this year. Furthermore, while energy prices are expected to rise toward the $60 mark in 2017, it won't be a smooth ride.

The absence of an old-fashioned swing producer in the market is likely to result in increased volatility in the price of crude, which in turn, will make CEOs more cautious with new investment. Simply put, increased price volatility would work to reduce the correlation between price and investment in Canadian oil sands where projects are large and require significant upfront outlays. Accordingly we expect only a modest advance in spending in 2017 (Chart 4).

Investment: Help Wanted

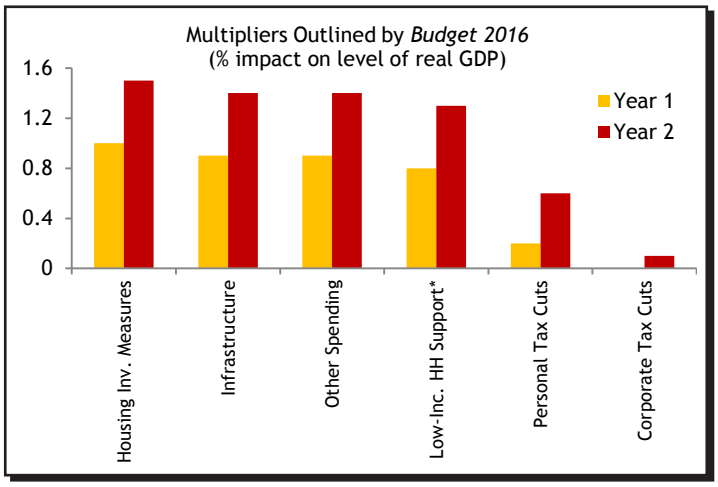
With energy investment not a contributor, we have to look for other candidates to fill the vacuum. The first that comes to mind is of course residential structures given the overall health of the country's real estate sector. Housing starts had a strong end to 2015, which should mean that residential investment will see one or two more decent quarters as initiated projects are seen through to completion.

Indeed, since the end of the recession, this corner of investment has been stronger than what was seen in the US, and we're more likely to see our neighbours to the south play catch-up. Further out, a slowing in housing demand should see homebuilding be a small negative contributor to Canadian growth by 2017.

Seeing the need to stimulate, the Federal government recently tabled a budget that will see roughly $4 bn in annual infrastructure spending over the next few years, and with another billion in the year ahead targeted at affordable housing. It's natural to see why policymakers are aiming spending dollars at these initiatives, with their estimated multiplier effects the highest (Chart 5).

Chart 5

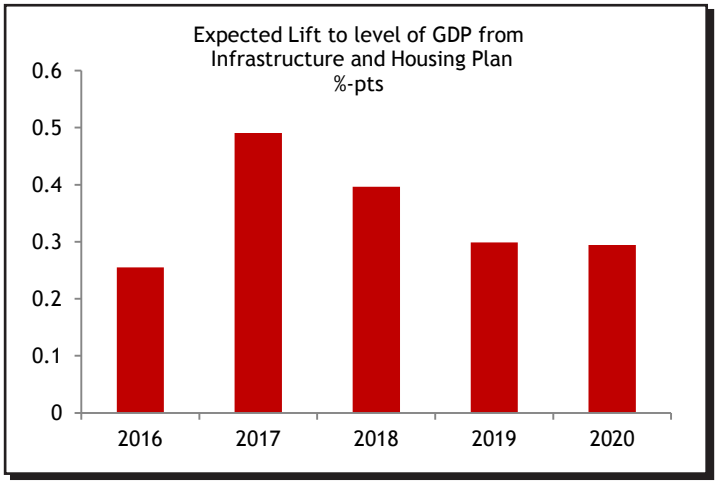
Spending Multipliers Outlined by Budget



Source: Finance Canada, CIBC

Chart 6

Impact on Level of GDP From Federal Infrastructure Spending



Source: Finance Canada, CIBC estimates

Those estimates line up with the analysis the Conservative government compiled in the wake of its own stimulus program after the 2008/09 recession. Given the scope of the spending planned, and our own assumptions for a gradual winding down of money directed toward affordable housing, investment from the government should have the greatest impact next year and in 2018, the lift coming in at just about 0.5%-pts to the level of real GDP (Chart 6). Tax reductions will also give a modest added boost.

But we will need much more than infrastructure spending to fill the void. As illustrated in Chart 7, the Achilles heel of Canadian investment is in the area of machinery and equipment (M&E), where growth has disappointed not only in absolute terms but also relative to the performance south of the border.

M&E Spending: More from Everyone Needed

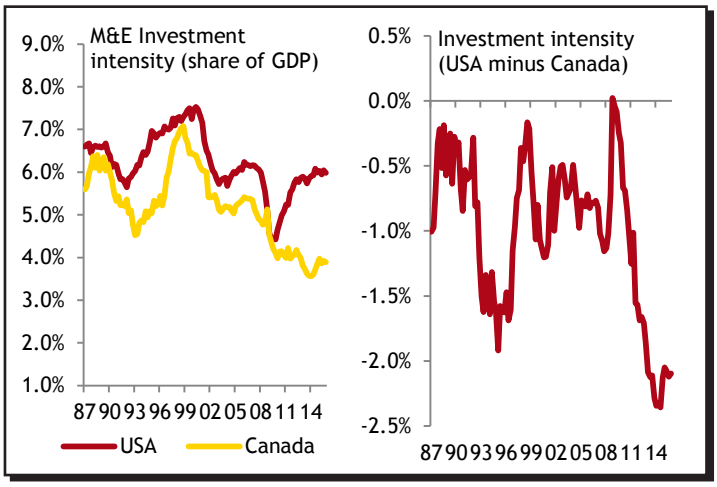
At the current negative 2%, there's a near-record gap between Canadian and US M&E investment intensity (investment as a share of GDP). That reflects the effect of a previously over-valued C$ on plant location decisions and the very strong post-recession recovery in US M&E investment. Note that the dramatic worsening in Canada's relative investment intensity position occurred despite a significant spike in energy investment in the years following the recession. In fact, at no point over the past few decades did M&E investment intensity in Canada exceed that of the US—even at the darkest days of the great recession.

Digging deeper and focusing on non-energy M&E investment, the key question is what's behind the chronic Canadian underperformance in M&E investment intensity. At any given point that intensity gap is a function of two factors: differences in industry structure and differences in within-industry investment intensity. To what extent is Canada lagging due to investment-intensive industries accounting for a relatively smaller share of GDP, or due to industry-specific issues?

Table 1 provides information on non-energy private sector GDP share and investment intensity by industry. Note, for example, that utilities account for a larger share of GDP in Canada, but its impact on the investment gap is partly offset by the fact that investment intensity in the sector is somewhat lower than seen in the US. Ditto for the important construction industry.

Chart 7

Widening Gap: US & Canada Investment Intensity



Source: Statistics Canada, CIBC

Table 1

Investment Intensity by Sector

	Investment Intensity*		Weight in GDP	
	US	Canada	US	Canada
Agri., forestry, fishing & hunting	26.1%	12.8%	1.6%	2.2%
Utilities	20.0%	17.8%	2.1%	3.2%
Construction	6.1%	4.2%	4.9%	10.0%
Manufacturing	9.0%	8.5%	15.5%	14.6%
Wholesale trade	3.9%	2.9%	7.7%	8.0%
Retail trade	4.4%	4.8%	7.4%	7.5%
Transp. & warehousing	15.6%	13.3%	3.7%	6.0%
Information	9.6%	11.8%	6.1%	4.2%
Finance, insurance, real estate	5.9%	3.7%	25.6%	27.6%
Professional and business servi.	1.8%	3.5%	15.2%	7.4%
Admin. & waste management serv.	4.6%	2.9%	3.9%	3.6%
Accommodation & food serv.	4.3%	3.3%	3.6%	2.9%
Other services, except government	3.1%	4.0%	2.8%	2.8%

** investment intensity is the share of sector CAPEX to GDP*

Source: Statistics Canada, BEA, CIBC

Employing a decomposition methodology developed by Statistics Canada, we estimate that close to 60% of the investment intensity gap in the past five years in the private, non-energy space was due to industry-specific factors. To the extent that in the last cycle energy and residential investment worked to crowd out spending in other industries, the coming years should see increased appetite for spending on M&E in the non-energy space.

And it might be happening already. True, the critical manufacturing sector planned for only 2.7% CapEx growth in in 2015 despite a weaker dollar. But economics 101 is not totally off base. This low figures masks the fact that out of the sector's 22 industries, no less than 18 have reported positive growth in spending intensions, and no less than nine industries reported increased intentions to spend by more than 20% (Chart 8).

As a result, the relatively subdued aggregate number does not reflect broadly based weakness but rather negative growth in a small number of relatively larger industries such as food and auto parts. And even here recent export numbers suggest that these may be turning a corner, auguring for a need to invest in capacity ahead, with the Bank of Canada's recent Q1 Business Outlook Survey giving further hope for a turn higher.

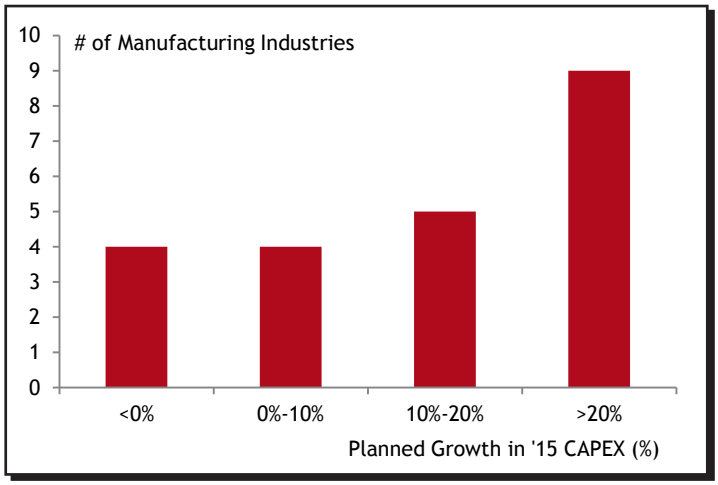
Filling the Gap, in 2017

In fact, our model for non-energy business capital spending, driven by US and Canadian GDP, the Canadian dollar, and our forecast for revenue growth points to a modest turn higher in real investment this year (Chart 9). A rough patch for earnings growth in 2015 was going to dampen the impetus for firms to ramp up investment, but 2017 should see more strength as profits recover and a cheap C$ lifts external demand.

Residential investment is still very strong as low rates have given housing starts further elbow room, and we're likely to see only a slow grind lower over the coming years. After the contributions from private residential and non-residential investment accounted for large fluctuations—both positive and negative—over the past several years, they aren't likely to sway the trend in quarterly growth much over the next two. Taken together with what businesses are slated to spend, look for overall investment to return to being a positive—albeit only modest—contributor to growth next year.

Chart 8

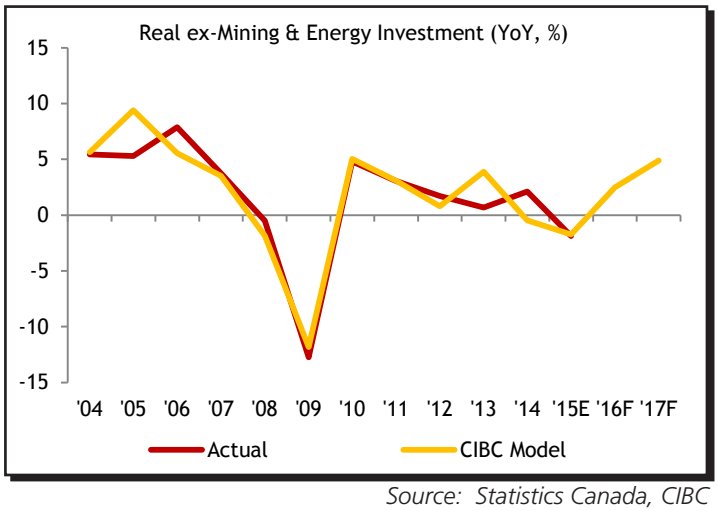
Enthusiasm for Factory Investment More Broadly Based Than Perceived



Source: Statistics Canada, CIBC

Chart 9

CIBC Model Points to Real Recovery in Non-Resource Investment



Source: Statistics Canada, CIBC