



Economics

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Corporate Canada— Adjusting To The New Mix

by Benjamin Tal

Even to the casual observer it is clear that this cycle is far from normal. The recession was triggered by unconventional forces, and the nature of this recovery is different than any other recovery. The new mix of economic growth, in which corporate Canada will have to mitigate the impact of a softening household sector and more restrained governments, will largely determine the trajectory of the Canadian economy in the foreseeable future. So far, it appears that corporate Canada is up to the challenge, but it will take further adjustments to maintain its new role.

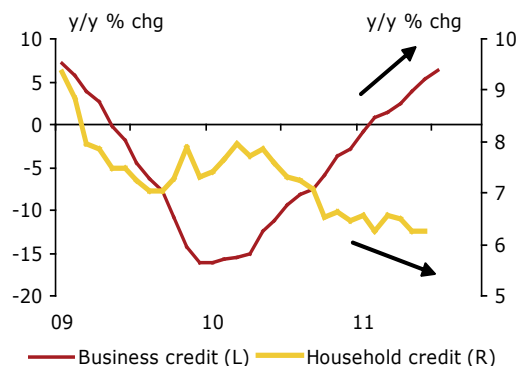
Business-Led Recovery

Faced with an elevated level of debt, households are on a clear downscaling trend, with real consumer credit expanding at its slowest pace since the early 1990s—

leading to a notable deceleration in overall consumer spending during the first six months of the year. At the same time, corporations are more than willing to take advantage of historically low interest rates to finance an ever-growing appetite for business investment (Chart 1). No wonder then that despite its relatively small share of total economic activity, business investment is emerging as the true pioneer of the current economic recovery (Chart 2).

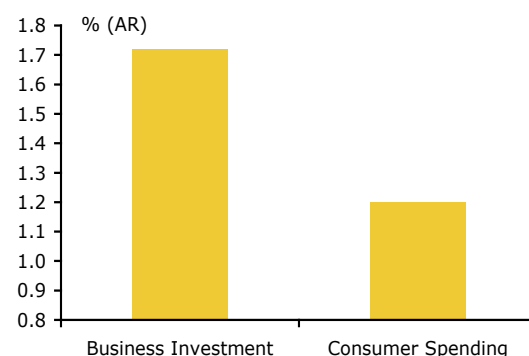
But how can corporations continue to expand while everything else around them is softening? With real exports to the US almost flat over the first half of the year, can Canadian businesses afford to continue their spending spree? A quick glance at Chart 3 shows that beyond current cyclical developments, there is a more structural change in the relationship between capital

Chart 1
Business Credit is Accelerating While Household Credit is Decelerating



Source: Bank of Canada, CIBC

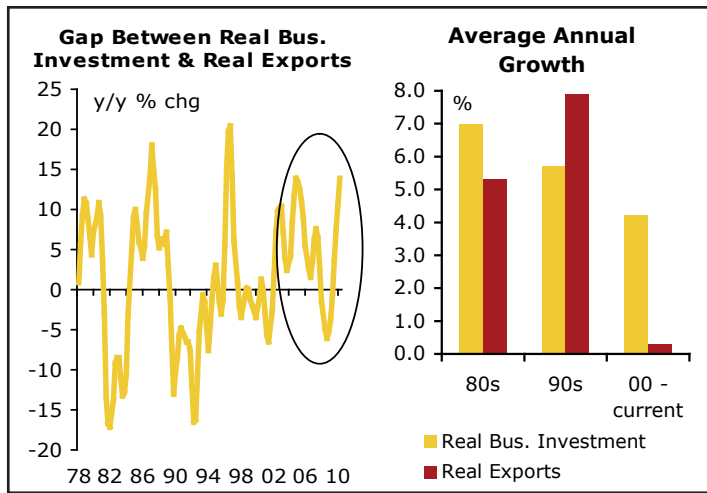
Chart 2
Contribution to GDP Growth Over the Year Ending June 2011



Source: Statistics Canada, CIBC

<http://research.cibcwm.com/res/Eco/EcoResearch.html>

Chart 3
Business Investment Outperformed Exports During Last Cycle



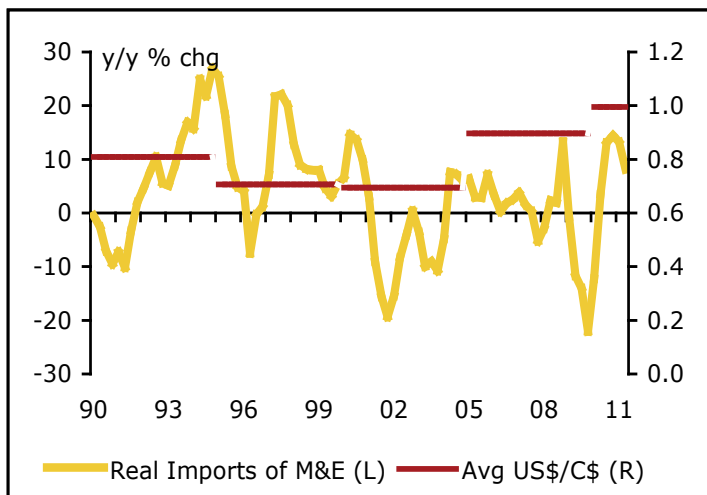
Source: Statistics Canada, CIBC

spending and exports to the US. Growth in business investment outperformed growth in exports to the US for 30 out of the past 36 quarters—by far the longest duration of outperformance on record (Chart 3, left). And while real exports to the US hardly changed over the past decade, business investment managed to grow by an average annual rate of more than 4% (Chart 3, right)—again a record performance gap.

Tapping Into New Markets

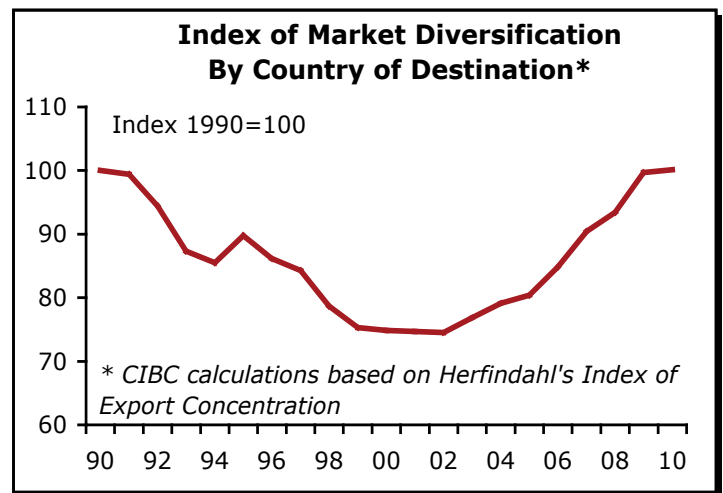
While the strong Canadian dollar might have played a role here, one should not overstate its direct contribution to

Chart 4
Real Imports of M&E Not Abnormal Despite a Stronger Dollar



Source: Statistics Canada, Bank of Canada, CIBC

Chart 5
Increased Diversification of CDN Exports

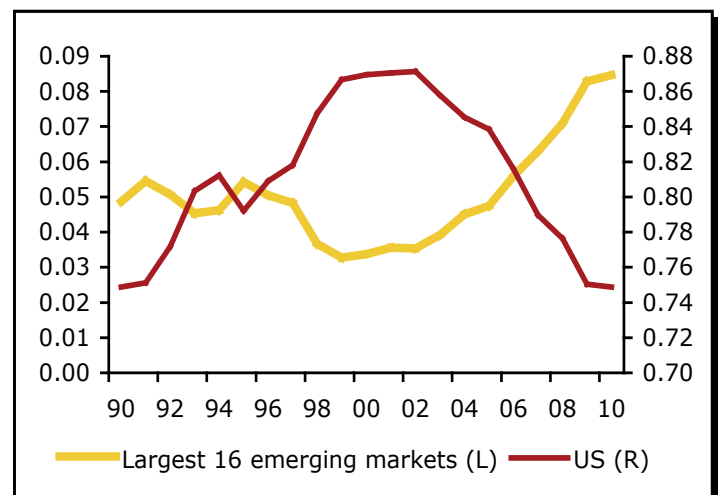


Source: Statistics Canada, CIBC

the surge in capital expenditures. Note that real imports of machinery and equipment are currently rising at roughly the same rate as they did when the value of the Canadian dollar was much lower (Chart 4).

Along with relatively strong domestic demand, it appears that the rise and the sustainability of business investment was helped by increased efforts of Canadian firms to diversify their export base. When measured by country of destination, real Canadian exports are currently 30% more diversified than they were in the early 2000s (Chart 5). And the main catalyst here is the surge in exports to emerging markets and the significant decline in the

Chart 6
Share in Total CDN Merchandise Exports



Source: Statistics Canada CIBC

market share of exports to the US, which is currently back to the pre-NAFTA levels (Chart 6).

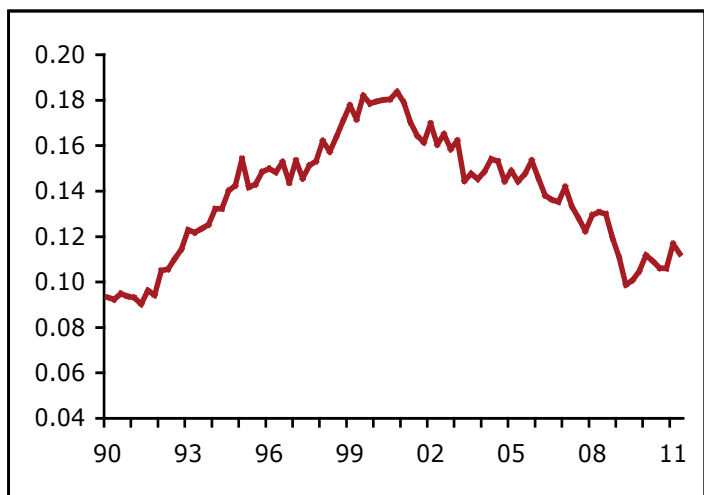
At this rate, the US share of total exports will fall to 60% by the end of the decade, with emerging markets picking up nearly 90% of the gain. Already exports to the US as a share of Canadian corporate sales are hovering around their lowest rate since the early 1990s (Chart 7)—implying a notable reduction in the sensitivity of corporate profits to exports to the US. This sensitivity will continue to decline as Canadian exporters increase their exposure to alternative markets.

While increased diversification means extra cost (and thus investment), it also means an improved bottom line. Academic research on the link between export diversification and corporate profits show that the relationship is highly non-linear. Both extremes (too high or too low levels of diversification) act as a negative for profits with the main improvement seen in the move from the low to medium level of diversification. With exports to the US still accounting for a sizeable 75% of total exports, it is clear that Canada is currently in the optimal stage of its diversification process, with any increase in diversification adding notably to the bottom line.

While corporate Canada is making good progress in diversifying its client list, the same cannot be said about the products that they export—at least not on the surface. The surge in the share of energy exports (in terms of both volume and value) has resulted in a 10 point reduction in the diversification measure of Canadian exports by product. However, this broad measure masks a more

Chart 7

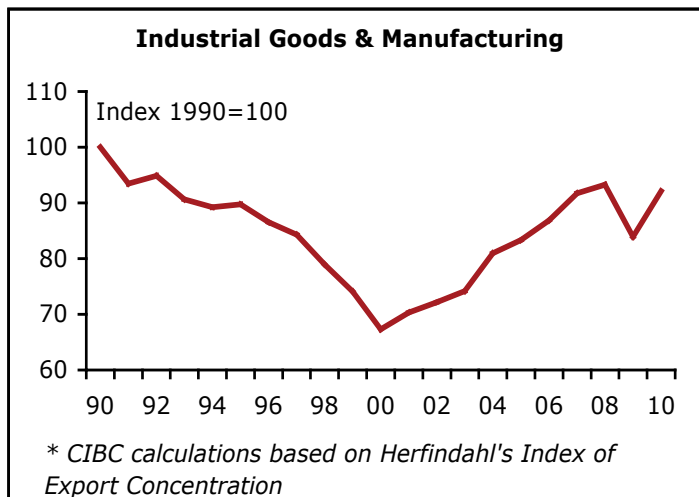
Export to US as a Share of Canadian Corporate Sales



Source: Statistics Canada, CIBC

Chart 8

Index of Market Diversification—By Product*



Source: Statistics Canada, CIBC

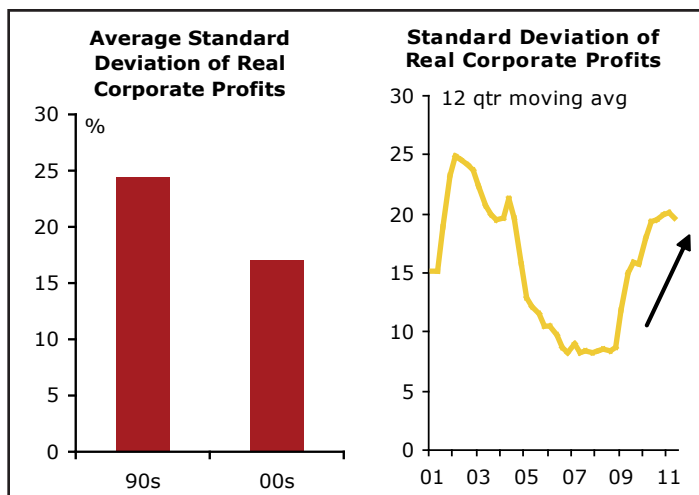
promising trend when one zooms in on manufacturing and industrial products. In this space, when measured by volume, overall diversification has improved by more than 30% over the decade (Chart 8). Key here are sectors that contributed to both product and destination diversification such as wood and paper, chemicals, metals and minerals, agriculture food, machinery and equipment, and aerospace.

Adjusting To The Bumpy Road Ahead

Increased diversification of exports by destination and product is not only necessary to maintain profitability, but also to hedge against increased economic volatility that is

Chart 9

The End of the "Great Moderation"?



Source: Statistics Canada, CIBC

likely to be an integral part of the economic landscape of tomorrow. A glance at Chart 9 clearly shows why the past decade is often referred to as the "great moderation". This period was characterized by reduced volatility in the economy, in general, and corporate profitability, in particular. Key here was the role that increased borrowing played in smoothing our economic variability. As credit is likely to play a lesser role in the new economic mix, the economy will lose its main shock absorber. Other factors that might work to increase volatility in the new economic order are increased sensitivity to interest rate changes due to high household debt levels, and the likelihood is that the post-crisis era will see a slower pace of financial innovation. Look for the recent uptick in volatility (Chart 9, right) to continue in the foreseeable future.

Accordingly, look for corporate Canada to adapt to the new reality by becoming more flexible and responsive. These changes will be characterized by actions such as adapting variable hiring practices, more conservative finance practices, increased use of sales force to identify changes in the marketplace, increased ability to switch product type which, in turn, might require different capital equipment, and a higher capability to change the composition of sales during the cycle.

The post-Great Recession era, and the new mix of economic growth that will define it, could provide corporate Canada with a golden opportunity to restructure itself in a way that simultaneously reduces its dependence on the US economy, and improves its bottom line. Key here will be continued deliberate attempts to diversify export activity by both destination and product with the realization that such an action is no longer a choice but a necessity.

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