Economic Viewpoint

Desjardins Economic Studies
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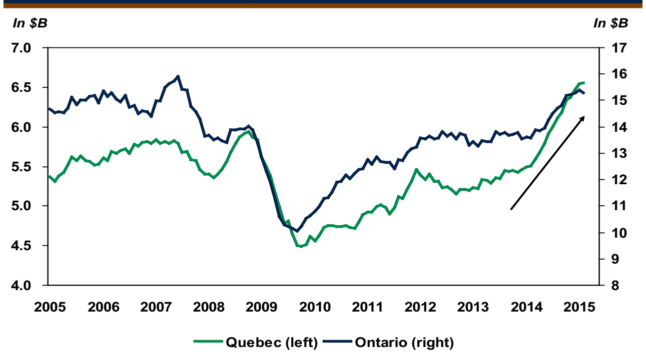
Business investment in Quebec and Ontario: Improvement in sight?

A lot of the hopes that economic growth will accelerate in 2015 are focused on businesses in central Canada. Although the harsh weather disrupted the U.S. economy at the start of the year, it should soon strengthen. Given the weak Canadian dollar, which is oscillating around US¢80, and fact that oil prices have remained low for some time, the situation for non-energy manufacturers is highly favourable. Exports from Quebec and Ontario have grown considerably since last year, but the ripple impact on business investment has yet to materialize. Will the anticipated upswing arrive shortly?

EXPORTS WILL STIMULATE INVESTMENT

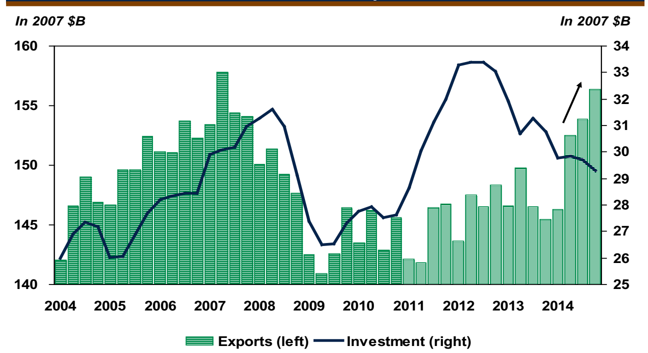
It took Quebec's international exports some time to recoup all of the ground lost during the 2008–2009 recession. They caught up as of last year, however, and since then shipments abroad then posted solid growth (graph 1). Ontario still has a little way to go before it reaches its pre-recession high. The recent weakness in manufacturing sales in both provinces calls, however, for caution. Usually, business investment is closely linked to exports, sometimes with a lag of a few quarters (graph 2). For now, the upswing by investment in non-residential construction has not yet materialized in Quebec, and is on hold in Ontario (graph 3). Imports of machinery and equipment are stable in Quebec, which does not point to a comeback in amounts spent on buying equipment (graph 4 on page 2). What is the outlook for coming quarters?

Graph 1 – International merchandise exports* increased in Quebec and Ontario



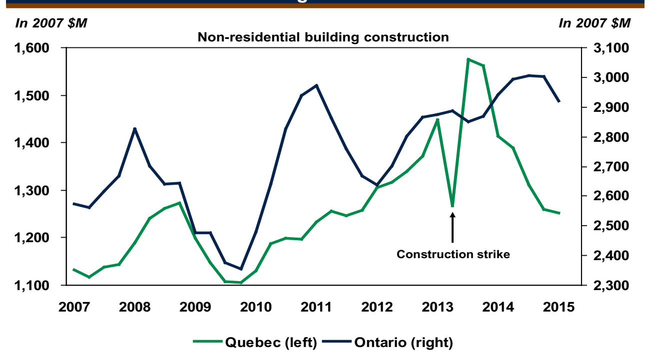
* 6-month moving averages.
Sources: Statistics Canada and Desjardins, Economic Studies

Graph 2 – The rise in exports* in Quebec should soon take business investment up in its wake



* Total Quebec exports to other countries and the rest of Canada.
Sources: Institut de la statistique du Québec and Desjardins, Economic Studies

Graph 3 – Business investment declines in Quebec and flags in Ontario



Sources: Statistics Canada and Desjardins, Economic Studies

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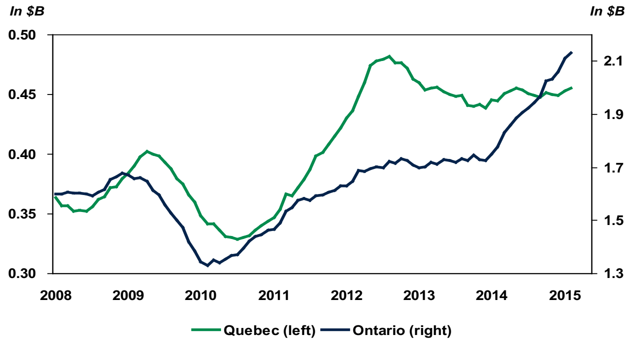
Graph 4 – Imports of machinery and equipment are lacklustre

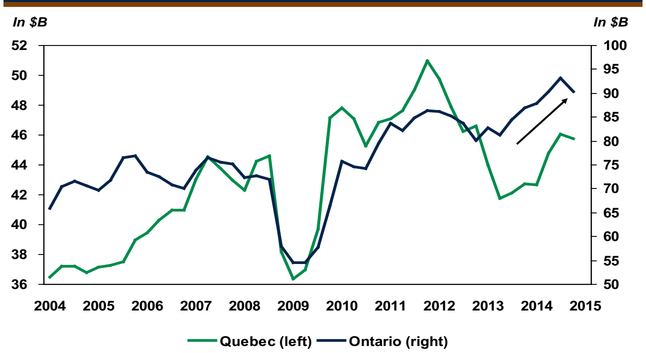


Sources: Statistics Canada and Desjardins, Economic Studies

MANY UNCERTAINTIES PERSIST

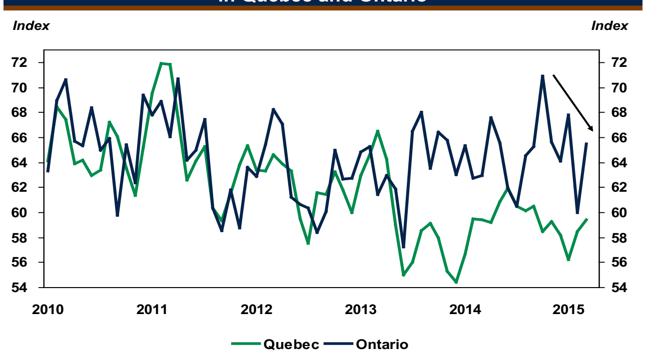
For investment intentions to become concrete, several conditions must be met. Firstly, businesses have to be in a good financial situation. If operating profits keep going up (graph 5), they could be a trigger. Business confidence in the outlook must be high enough for them to go into action. According to the Business Barometer™, the heads of Quebec small and mid-sized businesses (SME) are more confident, but the level remains fairly low (graph 6). In

Graph 5 – Business profits improved in Quebec and Ontario



Sources: Institut de la statistique du Québec, Ontario Ministry of Finance and Desjardins, Economic Studies

Graph 6 – SME confidence is not very convincing in Quebec and Ontario

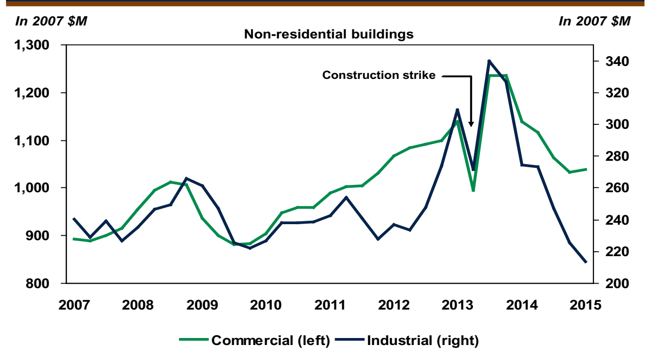


SME: Small and mid-size businesses
Sources: Canadian Federation of Independent Business and Desjardins, Economic Studies

Ontario, although confidence is higher, the last few months have seen it trending down. The uncertainties around energy prices that are shaking Canada's economy, even prompting the Bank of Canada (BoC) to lower its key rates in January, are probably responsible for the climate of caution. The global economy's difficulties are probably another source of concern. The process of repairing the public finances in Quebec and Ontario may also influence how confident businesses are.

The movement by non-residential construction reflects businesses' will to construct new buildings or expand existing facilities. For now, businesses in the trade and industrial[1] sectors remain edgy in Quebec (graph 7). For commercial spaces, the outlook is mixed: the retail trade expansion phase has given way to consolidation, leading to the disappearance of some chains and the closing of less profitable points of sale. Construction of new retail surfaces should therefore be fairly subdued in 2015. The drive to revitalize existing malls will, however, continue to power investment in the commercial sector. New construction of office buildings should take a break in Quebec City and Montreal, as the addition of a few buildings has taken vacancy rates up a little. In the short term, we cannot look for an upswing in commercial investment in Quebec.

Graph 7 – Construction is down in all sectors in Quebec



Sources: Statistics Canada and Desjardins, Economic Studies

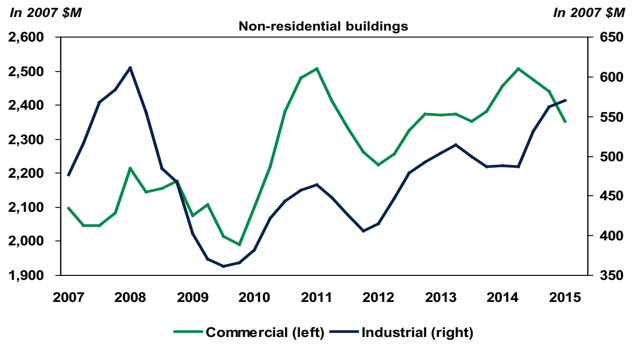
HOPE FOR THE INDUSTRIAL SECTOR

The future looks more promising in the industrial sector. The strong U.S. economy, weak loonie and oil prices provide for a good context for exports. Several industries are now running close to maximum output capacity in Canada, particularly those with the biggest presence in Quebec and Ontario. Transportation equipment (94.1%),

[1] In the Statistics Canada survey on investment in non-residential building construction, the industrial sector primarily includes manufacturing plants and warehouses, whereas the commercial sector is primarily made up of office buildings and spaces for merchants.

wood products (83.7%) and paper products (90.6%) are a few examples. Operating close to full capacity improves plant profitability which, in principle, should favour investment in modernizing or expanding facilities. Given that business profits are on the rise, investment should soon turn around. However, industrial sector confidence will have to firm up before that happens in Quebec. In Ontario, the confidence of SME leaders is seesawing, but the index is higher than it is in Quebec. Commercial investment has ticked down recently, but investment in Ontario's industrial sector has been on an upswing for several quarters (graph 8).

Graph 8 – In Ontario, construction is rising in the industrial sector but falling in commercial

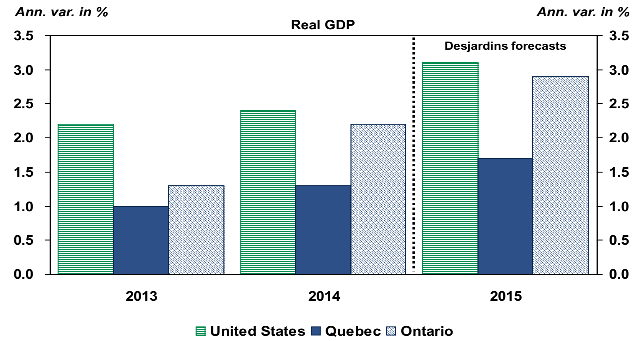


Sources: Statistics Canada and Desjardins, Economic Studies

Despite some positive signals, certain risks persist. According to the BoC's Business Outlook Survey, the energy sector difficulties in oil-producing provinces could pass through to other sectors and other parts of the country. This would make exports to the other provinces especially vulnerable. Although Quebec's international exports are heading up, such exports represent about 60% of total external shipments. The other part goes to other Canadian provinces, which could see more of a slowdown.

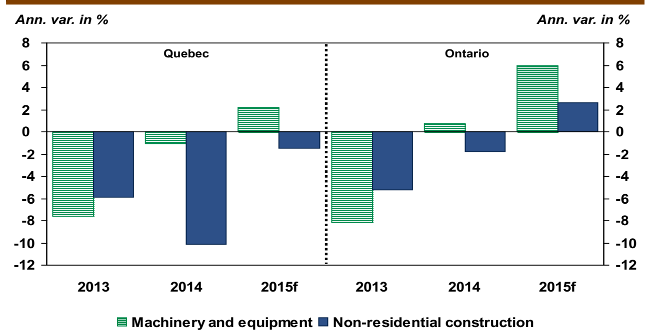
While trade between Quebec and Ontario dominates at the provincial level, exports to other provinces are still sizable. Economic growth will flag in 2015 in several parts of the country, affecting interprovincial exports. Real GDP growth will be faster in Quebec and Ontario this year, thanks to international trade and a gradual acceleration in business investment (graphs 9 and 10). Investment in machinery and equipment should start to rise again this year in both provinces. However, non-residential construction will only see an upswing in Ontario. In Quebec, it is expected to tick down as construction on industrial buildings has not yet turned around.

Graph 9 – The faster economic growth in the United States will have repercussions here



Sources: Datastream, Institut de la statistique du Québec, Ontario Ministry of Finance, Statistics Canada and Desjardins, Economic Studies

Graph 10 – Business investment outlook in Quebec and Ontario



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Sources: Datastream, Institut de la statistique du Québec, Ontario Ministry of Finance, Statistics Canada and Desjardins, Economic Studies

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