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Economy in a healthy transition to an investment-fuelled turnaround

Canadians' household debt rebalancing and a weaker loonie are creating an environment in which exports and business capital spending are going in the right direction

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Is the long-awaited rotation from debt-fuelled consumption to exports and investment starting to take shape in Canada? While we are not there yet in exports and investment, some interesting signs are percolating that, to quote the Bank of Canada, "constructive evolution" is under way regarding household balance sheets.

Pundits (yours truly included) have been talking about Canada's high level of household debt for some time. On this front, the latest figures reported by Statistics Canada in the first quarter of 2014 are indicating that things are finally progressing in the right direction. The net wealth of Canadian households is now reaching $7.9-trillion, or $223,200 per capita, an all-time record even after accounting for inflation. Households may be in debt, but their net value has never been this high.

In the first quarter of 2014, household debt increased by only $7-billion, the lowest quarterly increase in four years and, even better, the smallest year-over-year increase since the end of 2001. The bottom line is that the debt-to-assets and debt-to-net-worth ratios have improved, falling to their lowest levels since the second quarter of 2008 at 18.3 and 22.5 per cent, respectively.

The oft-cited debt-to-disposable-income ratio has also fallen for a second consecutive quarter to 165.3 per cent and debt servicing (interest payments on debt as a portion of disposable income) is now at a historic low of 6.97 per cent. In a nutshell, low interest rates continue to make life easy for households. The indebtedness of Canadian citizens is of course still high, but this improvement is nonetheless welcome.

The financial situation of Canadian businesses is also moving in the right direction with company reserves currently at a record $630-billion (equivalent to 12 per cent of their total assets and one third of Canadian nominal gross domestic product). In short, corporate balance sheets are solid and well-stocked in liquidity. By combining this observation with the rate of capacity utilization, which has climbed back up to its historical average, all the elements are in place for a return to investment.

On the exports side of the equation, it seems that the effects from the devaluation of the dollar are being felt earlier than expected (it usually takes six quarters before a lower currency results in volume effects, and we are only three quarters into the loonie devaluation induced by the Bank of Canada).

The latest figures show that Canadian exports have been growing at a faster clip in the last few months (up 7.6 per cent in the first five months of 2014 compared to 6.9 per cent for all of 2013), narrowing the trade deficit to only $152-million in May and pushing the average of the past three months close to zero. Some of this is caused by higher demand south of the border, but we can reasonably guess that cheaper Canadian products are clawing their way back into the competitive mix.

Business investment in Canada has been particularly weak in recent years as the lingering effects of the recession directly hit business confidence, the key ingredient for a return to significant capital spending. We believe that many factors will push Canadian firms to start investing again, the most important being

the combination of an accelerating U.S. economy and a lower loonie, two important elements regarding the demand for Canadian exports and corporate profits.

Companies being flush with cash and spare capacities getting tighter should reasonably lead to more capital spending, especially in an environment of rising demand. The latest **Business Outlook Survey** published by the Bank of Canada on July 7 shows that businesses are facing easing credit conditions and plan to increase investment in the next 12 months (the reading matched the highest in the past three years), although the focus is more on upgrading or replacing existing equipment. All in all, modest signs of improvement but improvement nonetheless.

It is still too early to get bullish again on the Canadian economy. We in fact do not expect growth to accelerate over the next two years, but these burgeoning factors are making us more confident that a healthy rotation of the Canadian economy could be in the cards in the mid-term.

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