BANK OF CANADA
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Business Outlook Survey

Results of the Autumn 2016 Survey | Vol. 13.3 | 7 October 2016

The autumn Business Outlook Survey *provides some signs of improving business prospects, as resource-related activity appears to be gradually bottoming out and foreign demand is providing steady support to firms' sales expectations.*

Overview

- Firms believe that resource-related activity may be bottoming out following two years of hardships. The outlook for exports remains supportive, although expectations for US economic growth have trended down.
- Both investment and employment intentions improved, with cuts tapering off in the resource sectors. Plans to increase investment are more widespread among service-oriented firms and often involve smaller-scale expenditures on information technology.
- Capacity pressures are roughly unchanged. Against a backdrop of still-substantial slack, indicators of labour shortages moved up.
- Indicators of both input and output prices point to limited pressures due to diminishing exchange rate pass-through and intense competition. Inflation expectations edged down and are largely concentrated in the lower half of the Bank's inflation-control range.
- Credit conditions point to a marginal easing.

Business Activity

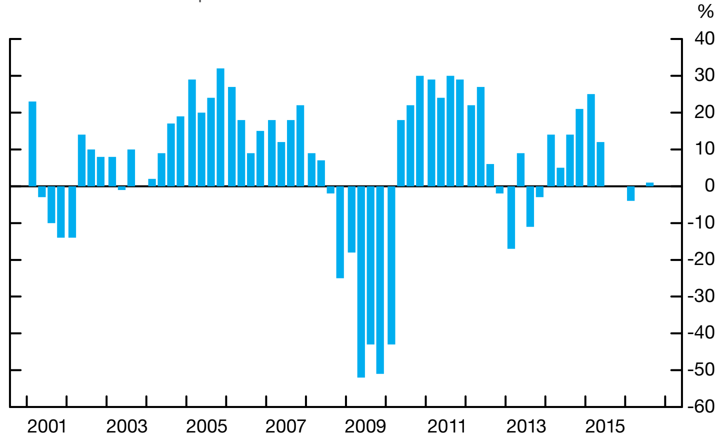
Similar to recent surveys, the balance of opinion on firms' sales growth over the past 12 months is close to zero, suggesting that sales growth has been flat (**Chart 1**). Sales expectations for the next 12 months improved modestly from the weak level in the summer survey (**Chart 2, blue bars**), largely because they stabilized among businesses exposed to the resource sectors. Firms' views that sales growth should accelerate are supported by better indicators of future sales, such as advance orders and sales inquiries (**Chart 2, red line**). Respondents often associated the improved outlook with their own efforts or with a shift in strategy, sometimes in an attempt to offset

The *Business Outlook Survey* summarizes interviews conducted by the Bank's regional offices with the senior management of about 100 firms selected in accordance with the composition of the gross domestic product of Canada's business sector. This survey was conducted from 18 August to 13 September 2016. The balance of opinion can vary between +100 and -100. Percentages may not add to 100 because of rounding. Additional information on the survey and its content is available on the Bank of Canada's website. The survey results summarize opinions expressed by the respondents and do not necessarily reflect the views of the Bank of Canada.

Chart 1: Sales growth stabilized over the past 12 months…

Balance of opinion[a]

Over the past 12 months, did your firm's sales volume increase at a greater, lesser or the same rate as over the previous 12 months?



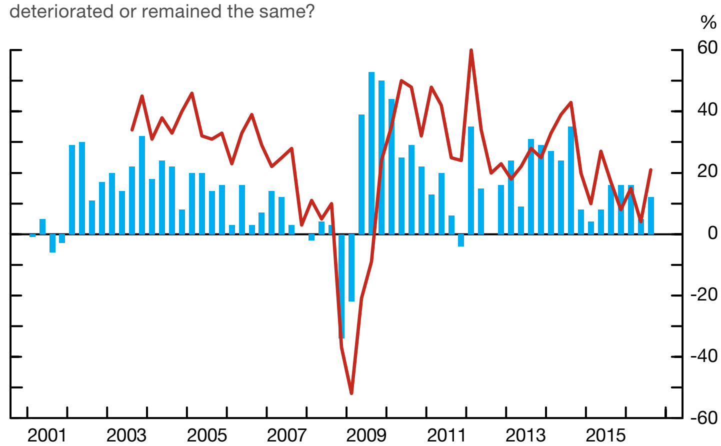
Greater: 42% Same: 17% Lesser: 41%

a. Percentage of firms reporting faster growth minus the percentage reporting slower growth

Chart 2: …while sales perspectives for the next 12 months improved modestly

Future sales (balance of opinion)[a]: Over the next 12 months, is your firm's sales volume expected to increase at a greater, lesser or the same rate as over the past 12 months?

Indicators of future sales (balance of opinion)[b]: Compared with 12 months ago, have your recent indicators (order books, advance bookings, sales inquiries, etc.) improved, deteriorated or remained the same?



Future sales: Greater: 42% Same: 28% Lesser: 30%

Indicators of future sales: Improved: 46% Same: 29% Deteriorated: 25%

a. Percentage of firms expecting faster growth minus the percentage expecting slower growth

b. Percentage of firms reporting that indicators have improved minus the percentage reporting that indicators have deteriorated

weakness in their traditional markets. Only a few firms foresee a tangible boost to their near-term outlook from federal stimulus spending, while some do not expect to benefit until later, noting that spending has yet to hit the ground.

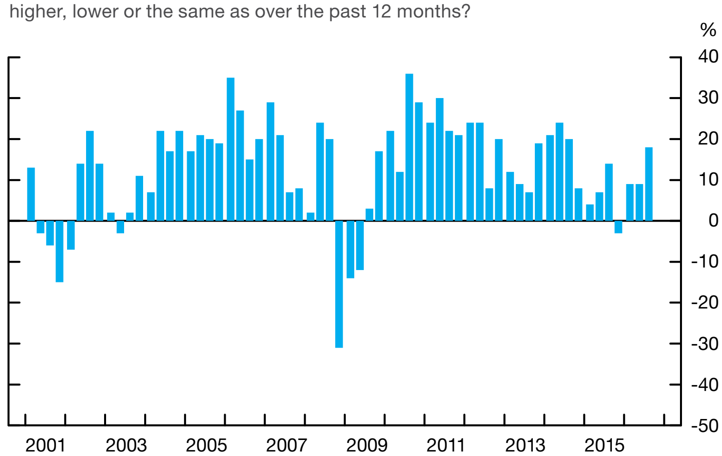
Many resource-related firms, such as those in oil and gas or mining, sense that activity has hit bottom. Given the relatively stable commodity prices in recent months, businesses now cautiously believe that sales will no longer fall or will increase modestly (see **Box 1** for a discussion of the evolving impact of weaker commodity prices and a lower dollar).

The outlook for exports remains supportive, as foreign sales are expected to gain momentum over the coming 12 months. While indicators of future sales have improved from a year ago for both domestic and foreign customers, export perspectives continue to be more positive than views about domestic conditions. The United States remains the main driver of positive prospects for exports, although businesses tend to expect US growth to be slow overall. This view is often related to the climate of uncertainty around the outcome of the presidential elections in November. In this context, some firms noticed a recent soft patch in demand for their products and services from clients south of the border.

Following a period of subdued investment intentions, the balance of opinion on investment in machinery and equipment rose in the autumn survey (**Chart 3**), although the scale of investment appears limited overall. Firms approaching capacity limits due to firming demand for their products are more likely than others to plan expansions. Intentions to increase investment are also more prevalent among firms in service industries, which often referred to projects related to information technology, whereas intentions among manufacturers are weak. At the same time, while growth in foreign demand does not always prompt higher capital expenditures among the exporters surveyed, several plan to spend more on research and development. Following two years of hardships, firms in the Prairies and in resource-related industries are starting to see an end to cuts in investment budgets.

Chart 3: Investment intentions moved up…

Balance of opinion[a]
Over the next 12 months, is your firm's investment spending on M&E expected to be higher, lower or the same as over the past 12 months?



Higher: 42% Same: 34% Lower: 24%

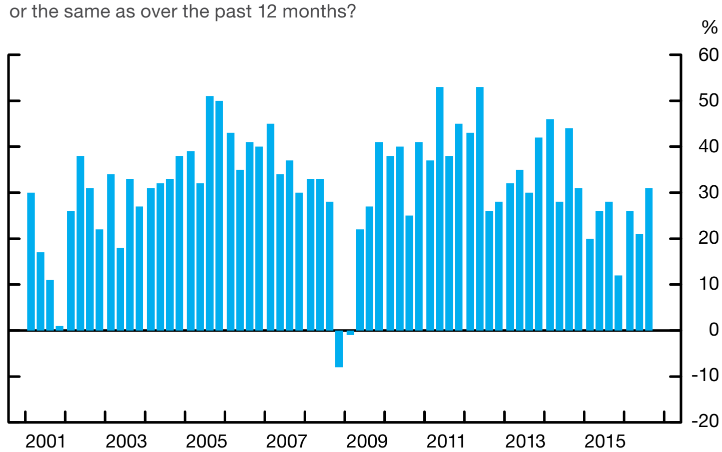
a. Percentage of firms expecting higher investment minus the percentage expecting lower investment

The balance of opinion on employment moved up from relatively low levels in recent surveys, with close to half of the firms surveyed intending to add positions over the next 12 months (**Chart 4**). For several businesses, strengthening demand warranted increases in staff to accommodate expansion plans. Unlike the stark divergences evident in recent surveys, positive employment intentions are now more widespread across all regions and most sectors. Nevertheless, positive hiring intentions in the Prairies merely reflect the fact that fewer businesses expect further cuts. Several firms in Eastern Canada are planning to reduce their workforces because of cost cutting and efficiency gains through software and technology.

Chart 4: …and employment intentions also improved

Balance of opinion[a]

Over the next 12 months, is your firm's level of employment expected to be higher, lower or the same as over the past 12 months?



Higher: 47% Same: 37% Lower: 16%

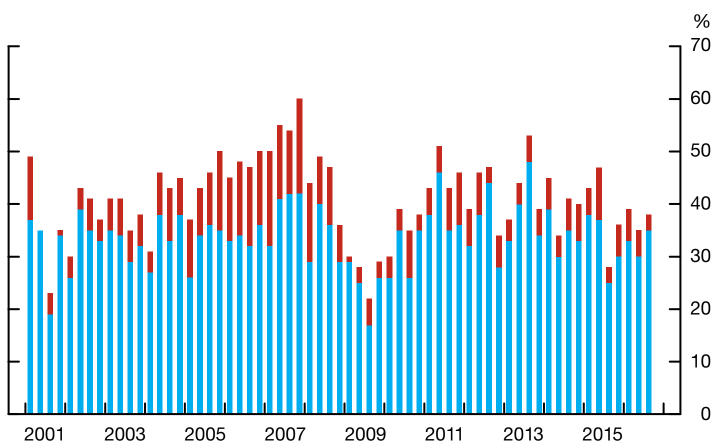
a. Percentage of firms expecting higher levels of employment minus the percentage expecting lower levels

Pressures on Production Capacity

The share of firms that would have difficulty meeting an unanticipated increase in demand is roughly unchanged (**Chart 5**) and is still hovering below the survey average. Few firms cited significant difficulties. Capacity pressures have become more widespread among firms benefiting from weaker commodity prices and the lower dollar, including many exporters. Although more businesses reported that they are approaching capacity limits due to strengthening demand, many would have no difficulty increasing output, mostly because weak past demand has left them operating below normal levels. Firms in the Prairies also continue to report abundant spare capacity as sales volumes remain depressed by the downturn in the energy sector.

Chart 5: Capacity pressures are roughly unchanged…

How would you rate the current ability of your firm to meet an unexpected increase in demand?

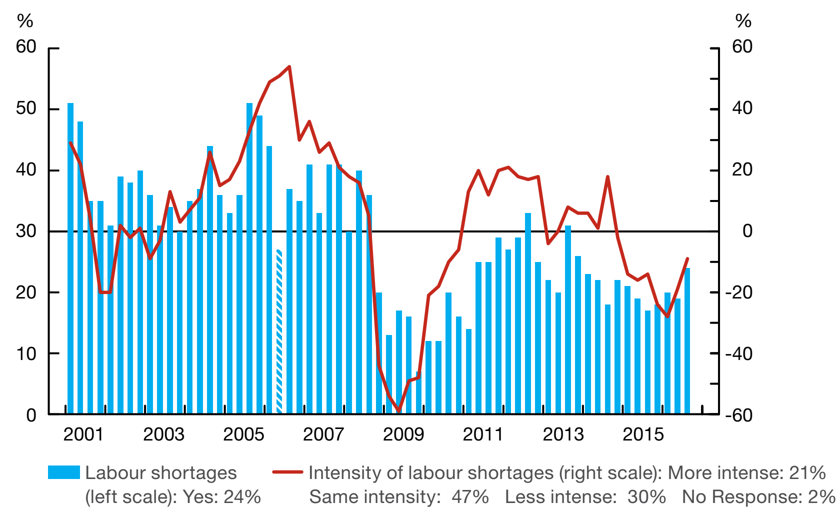


Significant difficulty: 3% Some difficulty: 35%

Although still low by historical standards, both indicators of labour shortages moved up in the autumn survey (**Chart 6**). The results suggest that while substantial labour market slack remains, it may have levelled off. Following several surveys showing little change in the number of firms reporting binding labour shortages, the indicator ticked up in the autumn survey (**Chart 6, blue bars**). On balance, labour shortages are less intense than they were a year ago (**Chart 6, red line**), since firms exposed to the downturn in the oil sector continue to report that labour is readily available. Yet a growing number of businesses operating in industries experiencing gradually improving conditions reported emerging difficulties in staffing positions. Some respondents indicated that replacing skilled staff is difficult as experienced employees move toward retirement.

Chart 6: ...and indicators of labour shortages may have bottomed out

Labour shortages: Does your firm face any shortages of labour that restrict your ability to meet demand?
Intensity of labour shortages (balance of opinion)[a]: Compared with 12 months ago, are labour shortages generally more intense, less intense or about the same intensity?



a. Percentage of firms reporting more intense labour shortages minus the percentage reporting less intense shortages

The summer 2006 results are not strictly comparable with those of the other surveys, owing to a difference in the interview process for that survey.

Prices and Inflation

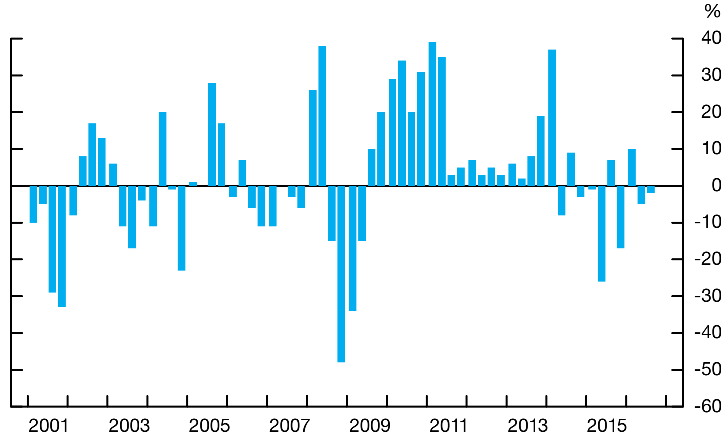
The balance of opinion on input prices increased marginally and, at close to zero, suggests little change in the pace of input price growth over the next 12 months (**Chart 7**). A large majority of the firms surveyed, particularly exporters, source part of their inputs outside Canada, often denominated in US dollars. With the relatively stable exchange rate in recent months, increases due to the past depreciation of the dollar are now largely built into the cost of such inputs, notably in the wholesale and retail trade sectors. Businesses relying on commodity-related inputs reported that they anticipate a flattening of, or modest increases in, their costs.

Output price growth is expected to slow somewhat over the next 12 months, as indicated by the negative balance of opinion (**Chart 8**). Firms often attributed weak price growth to intense competition, as the knock-on effects of the oil price shock have left excess capacity throughout the energy supply chain and beyond. Some affected firms reported having to lower prices

Chart 7: Firms expect stable input price growth over the next 12 months…

Balance of opinion[a]

Over the next 12 months, are prices of products/services purchased expected to increase at a greater, lesser or the same rate as over the past 12 months?



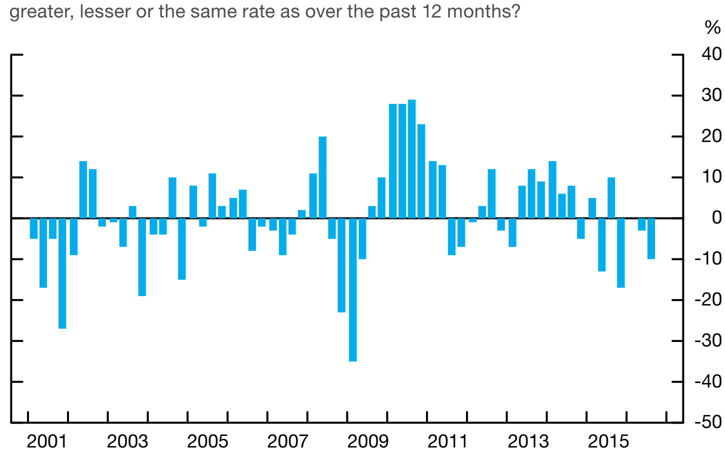
Greater: 28% Same: 42% Lesser: 30%

a. Percentage of firms expecting greater price increases minus the percentage expecting lesser price increases

Chart 8: …and slowing output price growth due to intense competition

Balance of opinion[a]

Over the next 12 months, are prices of products/services sold expected to increase at a greater, lesser or the same rate as over the past 12 months?



Greater: 26% Same: 38% Lesser: 36%

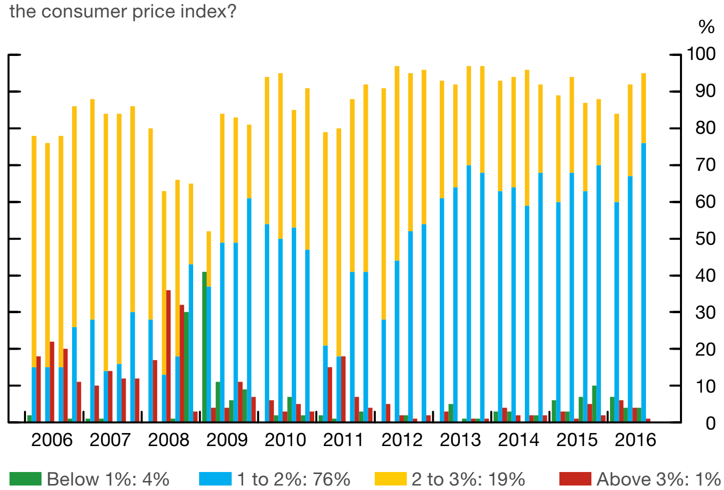
a. Percentage of firms expecting greater price increases minus the percentage expecting lesser price increases

because of their limited bargaining power with customers. Businesses also mentioned less need to pass on higher costs from the lower dollar to their customers. At the same time, while several firms see weak demand as still limiting their ability to raise prices, others believe that firming demand is beginning to add some support to prices. For firms linked to commodities, this perception often accompanied the view that prices will no longer fall.

Inflation expectations for the next two years edged down but remain concentrated in the Bank's 1 to 3 per cent inflation-control range. Despite the modest improvement in many forward-looking indicators in the autumn survey, there is a widespread view among firms that inflationary pressures

Chart 9: Inflation expectations edged down

Over the next two years, what do you expect the annual rate of inflation to be, based on the consumer price index?



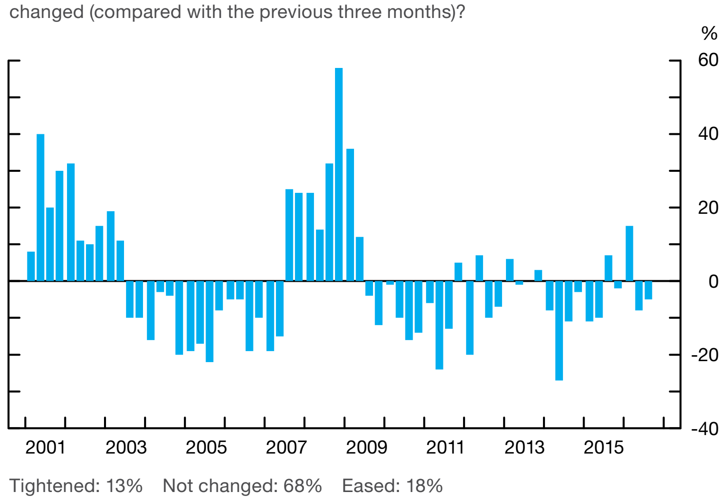
over the next two years will be limited because of sluggish economic growth: the number of businesses expecting total CPI inflation to be in the 1 to 2 per cent range has reached its highest level.

Credit Conditions

By a narrow margin, the balance of opinion on credit conditions points to an easing (**Chart 10**). A large majority of businesses saw no change in the terms and conditions for obtaining financing over the past three months. Several firms, such as those selling into solid consumer markets, specified that their good track record or strong balance sheet allowed them to fund their operations at more favourable borrowing rates, terms and conditions.

Chart 10: By a narrow margin, credit conditions point to an easing

Balance of opinion[a]
Over the past three months, how have the terms and conditions for obtaining financing changed (compared with the previous three months)?



a. Percentage of firms reporting tightened minus the percentage reporting eased. For this question, the balance of opinion excludes firms that responded "not applicable."

Box 1

The Evolving Impact of a Lower Dollar and Weaker Commodity Prices

Since mid-2014, oil prices, together with the value of the Canadian dollar, have declined significantly, creating a new economic environment for Canadian firms. From the first quarter of 2015 to the third quarter of 2016, firms participating in the *Business Outlook Survey* were asked how this new environment has affected their businesses and plans. Their responses illustrate how the outlook of firms evolved throughout the complex process of adjusting to this new context.

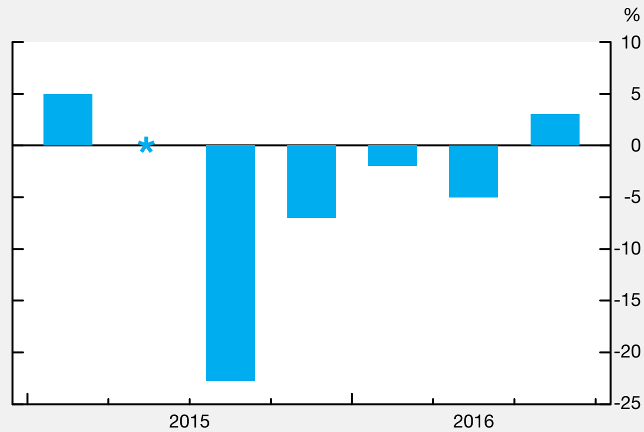
Early in 2015, firms viewed the impact of the new environment as somewhat positive, on balance (**Chart 1-A**), since many were hopeful that they would benefit from a weaker dollar and lower energy costs, and some energy-related firms expected oil prices to rebound. At that time, businesses describing themselves as unfavourably affected were concentrated in the Prairies, frequently in the oil and gas industry and related supply chains, and they described the impact as severe. But, by the second half of 2015, a deeply negative sentiment emerged as the oil price shock spread across all regions and sectors and firms realized that the benefits would take some time to materialize. Firms reported negative indirect and induced effects on demand as consumer and business spending in commodity-producing regions was curtailed. As a group, unfavourably affected firms reported weak or declining past sales and correspondingly muted capacity and labour market pressures. Further, facing limited expectations for future sales growth and tighter credit conditions, these firms often had to cut payrolls, wages and capital budgets to achieve a leaner cost structure and remain viable. This overall negative view prevailed throughout the first half of 2016 as oil prices fell further and expectations of a near-term rebound dissipated. More recently, several resource-related businesses have undergone major restructuring or ownership changes and are now sensing that the worst may be over.

Meanwhile, a core minority of firms have continued to experience favourable but often modest effects throughout this period. While some exporters saw a boost to their sales volumes due to more competitive pricing, the more frequently cited benefit was improved margins on US-dollar-denominated foreign sales. In some cases, these stronger margins were deployed to support growth, investment and employment plans, but in others, they were offsetting higher import costs or weak demand or were used to repair balance sheets. Domestic firms also saw favourable effects from the weaker dollar as Canadian consumers and businesses shifted toward domestically produced goods and—often more importantly—services, helping to stabilize domestic demand. Moreover, while import-intensive firms were initially struggling because of the weaker dollar, their efforts to pass through higher import prices are now mostly complete. These supportive developments, together with a gradual bottoming out of the negative effects of the oil price shock, have lifted the balance of opinion on the impact of the new economic environment to a slightly positive position in the autumn survey.

Chart 1-A: The impact of the new environment has turned slightly positive

Balance of opinion[a]

Would you characterize the impact of lower oil prices and the lower dollar on your business outlook for the next 12 months as favourable, neutral or offsetting, or unfavourable?



a. Percentage of firms reporting that the new environment is favourable for them minus the percentage of firms reporting that it is unfavourable

* Indicates a balance of opinion of zero

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