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TD Economics

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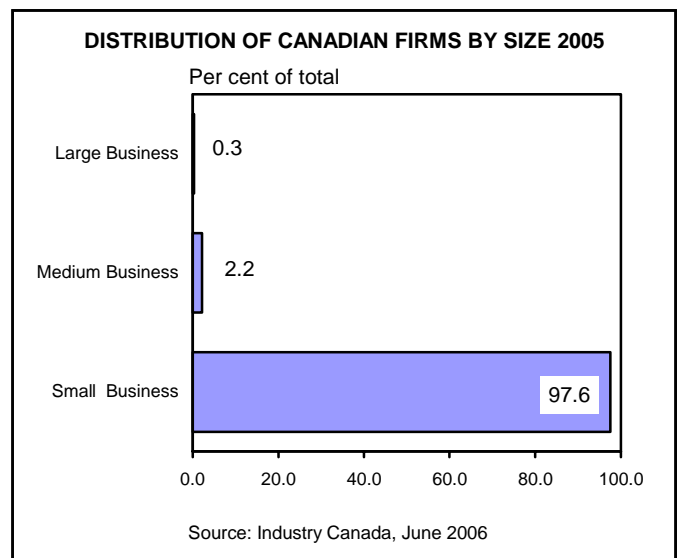
SMALL BUSINESS PROSPECTS REMAIN POSITIVE

More Ties to Domestic Strength, Less Exposure to U.S. Slowdown

Small businesses dot the landscape of every small town and major city. While they are the focal point for many communities, they also support numerous large companies and institutions, ranging from Canada's biggest industrial and financial companies to all three levels of government. It should therefore come as no surprise that the performance of small businesses has a great bearing on the economy as a whole. Nor should it be surprising that the current outlook for the small business sector mirrors some of the broader trends unfolding across Canada's economic landscape. The most notable development expected over the next twelve months is the arrival of a mid-cycle slowdown in the United States. This will likely compound the woes currently faced by small businesses that are tied to Canada's export sector, who have also struggled with the rapid appreciation of the Canadian dollar. By contrast, the expectation of continued strength in Canada's domestic economy will remain supportive for small businesses that primarily cater to the home market. Fortunately, the moderation of economic activity on both sides of the border is expected to be fairly short-lived and real gross domestic product (GDP) in Canada will return to an above-trend growth rate by the end of 2007. To assist in understanding the interplay between small businesses and the broader economy, it is important to understand some of their characteristics, a task we turn to now.

What constitutes a small business?

While some definitions are based on the size of revenues or on ownership status, the most intuitive definition, and the one used in this report, is based on the number of employees. A small business can be defined as employing less than 100 workers while a medium sized en-

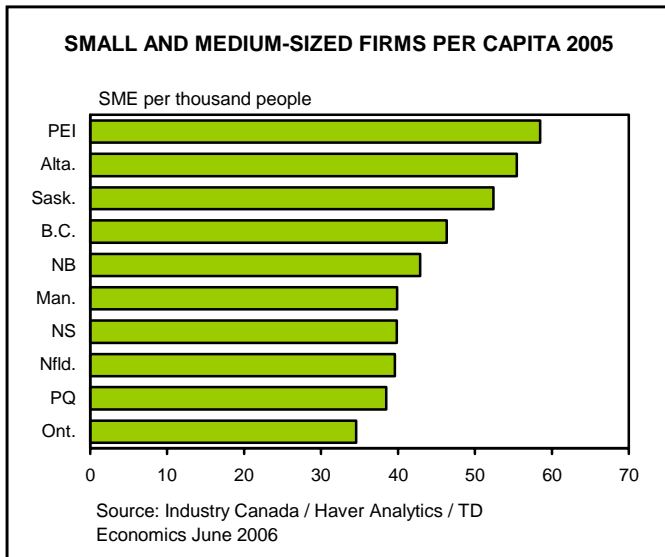


terprise has between 100 and 500 workers on staff. Adding these two groups together to create a category of small and medium enterprises (SMEs) provides the unit of measurement for our analysis.

When we apply the above definition to the number of firms in Canada, it is clear that SMEs represent the vast majority of companies in this country. In fact, just 0.3 per cent of all firms employ more than 500 workers. While this may seem like an extremely small percentage, it does correspond to nearly 3,000 companies who in 2005 employed an average of 2,000 workers. By contrast, the average SME employed just 7 workers in 2005.

Small business presence greater in Western Canada

As can be reasonably expected, SMEs are fairly evenly distributed across Canada. On a per capita basis, SMEs are most highly concentrated in PEI as well as across West-



ern Canada. On the flip side, the lowest concentration can be found in Ontario and Quebec, owing to the presence of larger manufacturing companies, major financial institutions, and the federal government. The remainder of Atlantic Canada falls in between Western and Central Canada.

Small business present in every industry

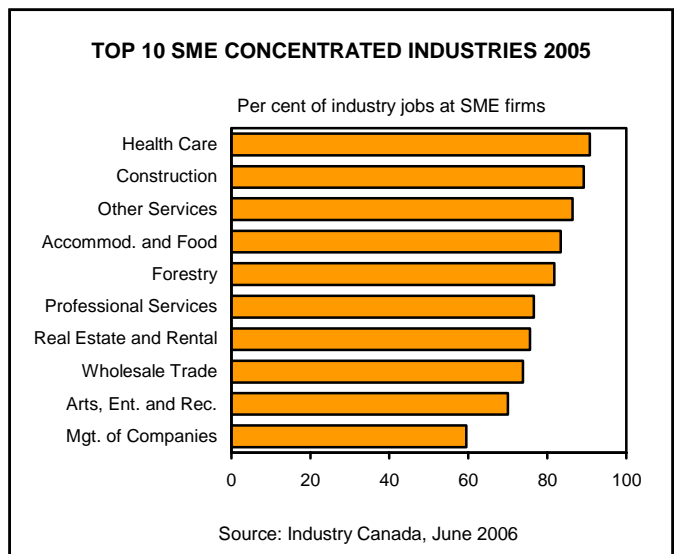
Akin to their geographical distribution, SMEs are also well-represented across Canada's industrial makeup. With the exception of utilities, employment by SMEs represents at least a third of all workers within every industry classification. Over three-quarters of SMEs are in service-producing industries, including health care, accommodation and food, professional services and the catch-all "other services" category. Meanwhile on the goods-producing side, SMEs make up nearly 90 per cent of employment in construction firms and over 80 per cent of the total number of jobs in the forestry sector. Given these high concentrations, it is clear that the economic outlook for the SMEs as a whole will critically depend on the impact that the forecasted macroeconomic trends will have on these individual sectors.

So given their abundance in number and breadth across industries, how important are SMEs to Canada's overall economy? From the perspective of the labour market, over half of all Canadian workers are employed by a SME. And in terms of their contribution to overall economic activity, while Statistics Canada does not produce an official measure, BC Stats has calculated that firms with fewer than 50 employees account for approximately one-fifth of Cana-

da's GDP. A study referenced by the Canadian Federation of Independent Business (CFIB) expanded the definition to include companies employing up to 500 workers and estimated that the SME contribution to GDP increases to approximately 45 per cent of GDP. It is therefore clear that the health of SMEs will have a significant impact on the overall economy.

U.S. economic slowdown will spare more SMEs

SMEs are typically thought of as being pro-cyclical, meaning that they tend to react first to changes in economic conditions. As a result, SMEs are a very good bellwether for the overall economy, and although many of the factors that affect their performance are shared by larger enterprises, there are some characteristics unique to SMEs that aid in better understanding and predicting the well-being of the sector as a whole. For instance, when compared to larger firms, SMEs are less likely to directly engage in international trade. An Industry Canada study noted that in 2002, only 1.4 per cent of small businesses exported goods abroad as compared to 27 and 38 per cent for medium-sized and large enterprises respectively. Therefore, SMEs are fairly well insulated from adverse economic developments in the United States. However, many SMEs either compete against imports or support larger firms who themselves engage in international trade, leading to some exposure to foreign demand shocks. With less of an overall focus on international trade, fluctuations in the value of the Canadian dollar are also of less importance to SMEs. A recent survey conducted by the CFIB showed that 51 per cent of firms did not see the value of the Canadian



TD ECONOMICS FORECAST HIGHLIGHTS

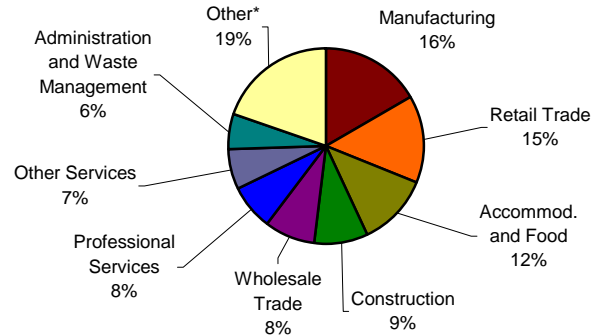
The key theme in our latest Canadian quarterly economic forecast is an export-led moderation in GDP growth in response to an anticipated mid-cycle economic slowdown in the United States:

- U.S. real GDP is expected to grow at an annualized rate of 1.9% in the fourth quarter of this year before recovering gradually through the end of 2007 and into 2008.
- The weakness in the U.S. economy centres on the slowing in the housing market and its effect on consumer expenditures
- The slowing in the U.S. economy will restrain exports in Canada and pull GDP growth below trend for four quarters before recovering through the second half of 2007
- The domestic economy, including the labour market, will continue to perform well, led by healthy consumption expenditures
- While very minor in comparison to the U.S., Canada's housing market will also moderate somewhat in upcoming quarters
- The Bank of Canada will likely respond to the slowing economy by injecting a moderate 50 basis points of stimulus in the first half of 2007
- The slowing in the U.S. economy will translate to a 9% fall in commodity prices (Canadian prices) by mid-2007, which will help keep the Canadian dollar in a trading range of between 87 and 90 U.S. cents

dollar affecting their day-to-day operations.

Placing these observations in context of the current economic environment and forecast (see the accompanying text box for an overview of the latest TD Economics' quarterly macroeconomic forecast), the majority of SMEs are well positioned to escape the detrimental effect of the soaring loonie and the mid-cycle slowdown in the U.S. economy reasonably unscathed. Nevertheless, with 16 per cent of all employees in the manufacturing industry working for SMEs, the U.S. slowdown will be felt for a subset of firms. Indeed, with a CFIB survey noting that 43 per cent of SMEs within the manufacturing sector would prefer a lower dollar, it gives a sense of the proportion of manufacturing firms tied to international trade.

SME EMPLOYMENT BY INDUSTRY



Source: Industry Canada, June 2005

* The Other category is comprised of: Utilities, Mining, Forestry, Finance and Insurance, Informational and Cultural, Transportation and Warehousing, Mgt. of Companies, Arts and Recreation, Real Estate and Rental, and Health Care

Small businesses within the forestry sector will also be affected by the slowing U.S., primarily through the expected declines in the housing market. In fact, this trend has already begun to materialize, as shipments of wood products have fallen by 10 per cent since the start of the year at the same time as forestry exports to the United States have fallen by 13 per cent.

Another implication of the slowdown in the U.S. economy for SMEs is the effect on tourism, including the food and accommodation industry. Indeed, the number of visitors from the U.S. has slowed tremendously in reaction to the flight of the loonie, concerns about border delays, and over the summer months, high gasoline prices. This situation is unlikely to improve once the slowing in the U.S. economy puts a crimp in the travel budget of

U.S. RESIDENTS ENTERING CANADA



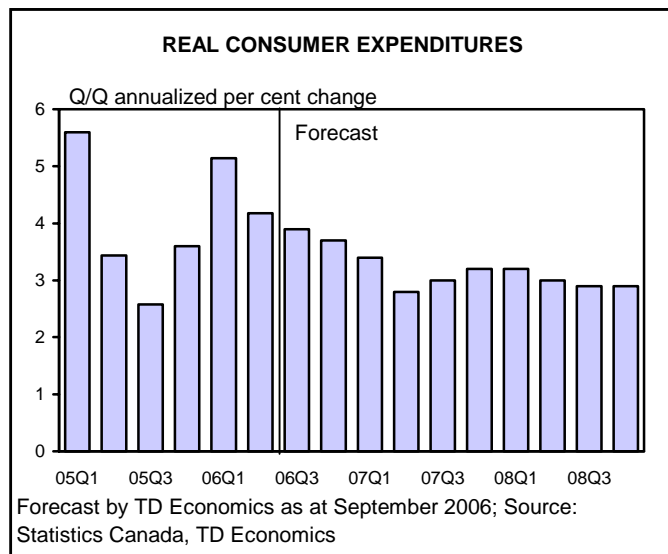
Source: Statistics Canada, TD Economics

American consumers. Fortunately, the slowing in the U.S. economy is expected to be relatively short in duration and economic growth should pickup by the second half of 2007, helping to restore the fortunes of the SMEs directly affected by the slowdown.

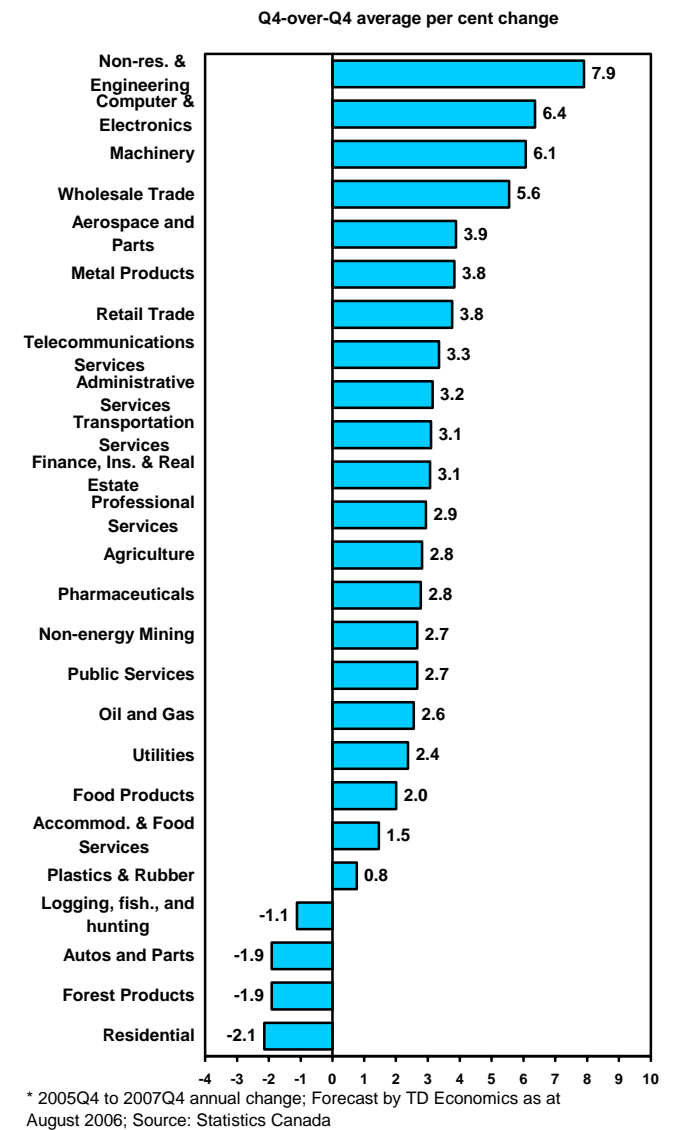
Domestic economy will remain supportive

Another characteristic of SMEs relative to larger firms is a greater sensitivity to trends in Canadian consumer spending. This reflects a high concentration of SMEs in industries that primarily cater to households and individuals such as retail trade, real estate services, and other professional services. Furthermore, the level of interest rates has a larger role to play for SMEs than for larger companies since their financial structure tends to be based on mortgages, lines of credit and other loans. In the current context, both of these forces are favourable for SMEs. As noted in the text box on page 3, one feature of the economic forecast is a healthy growth rate for domestic demand over the next two years. As a result, while the trade sector will weigh on overall GDP growth, consumer spending is expected to hold up well, providing continued support to SMEs. Meanwhile, lending rates have reached their cyclical peak at a level that remains fairly low by historical standards. Going forward, the Bank of Canada is expected to keep rates on hold for the rest of the year before injecting a modest 50 basis points of monetary stimulus over the first half of 2007, giving SMEs an additional boost.

One of fundamental sources of support for the Canadian consumer has been the housing boom, which through appreciating home prices has dramatically increased house-



PERFORMANCE OF CANADA'S INDUSTRIES IN 2006-07*



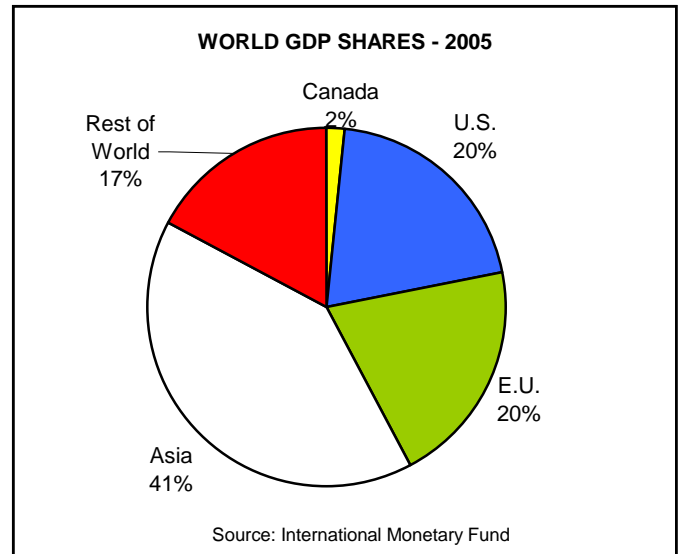
hold wealth, allowing for greater consumer expenditures. However, we do not anticipate this performance to continue and instead expect some degree of moderation in housing activity in the quarters to come. While the forecast decline pales in comparison to that expected in the United States, it will nevertheless have a negative impact on the construction and real estate industries, both of which have high concentrations of SMEs. Nevertheless, offsets from investment in non-residential projects and continued momentum in Western Canadian housing markets will limit the severity of any pullback in overall construction activity.

Another source of support for small businesses has been favourable fiscal positions of the federal and provincial governments. An expanding civil service has increased the demand for support services provided by small enterprises. Over the next year, Canada's solid overall fiscal position is likely to remain intact, providing additional support to SMEs. Furthermore, tax rates on small business income have been recently lowered across several provinces and stand at very low levels when compared to other countries. This comparative tax advantage will continue to stand them in good stead.

Rising costs will remain a challenge

Canadian consumers have also benefited tremendously from a phenomenal performance of the labour market, with the national jobless rate sitting at 30+ year lows. While typically a positive development for the overall economy, Canada's labour market plays a thorny role for the performance of SMEs. On one hand, robust employment growth coupled with wage gains helps support consumers and business activity. However, with labour one of the main input costs facing SMEs, rising wages can have a detrimental direct effect on their well-being. Since SMEs typically have a greater reliance on part-time and youth employment, the legislated minimum wage plays an important role relative to larger firms. On these fronts, the outlook for SMEs is mixed. While the minimum wage has risen by 28 per cent in nominal terms across Canada since 1996, the comparable real increase is moderate and in line with wage increases in the economy as a whole. On a more challenging note, one of the characteristics of the current labour market is that virtually all of the job creation in the last four years has taken place in full-time positions, implying higher wages and increased benefit costs. Furthermore, youth participation in the labour force has also fallen somewhat over the last two years, limiting the supply of available workers and helping contribute to higher wages. Measured on aggregate, average hourly wages for permanent workers has shown a steady increase since the middle of 2003 and are now running at a relatively lofty annual rate of about 4 per cent.

Another cost pressure SMEs have faced in recent years is insurance premiums. Following the equity market implosion and the terrorist attacks on the United States in 2001, insurance firms aggressively increased their premiums for property, casualty, and auto insurance. In 2003



the CFIB conducted a survey of its members and found that three-quarters of firms ranked the increase in insurance premiums as the greatest external shock to their business operations, greater than the Iraq war, Severe Acute Respiratory Syndrome (SARS), Bovine Spongiform Encephalopathy (BSE) and Canada-U.S. trade disputes. Recently, insurance premiums have become less of a concern for SMEs. In the latest Quarterly Business Barometer (released on September 27, 2006), the CFIB noted that firms observed a large improvement in insurance premiums over the last year, in contrast to the previous issue which reported that 52 per cent of firms felt that the value for money of insurance premiums had worsened over the previous 12 months.

Longer-term challenges

Given the expected momentum in the domestic economy and the relatively short-lived slowdown in the United States, the outlook for most SMEs over the medium-term remains upbeat. However, there are two fundamental forces affecting Canada's economy over the longer run that remain both an obstacle and an opportunity for small business: globalization and Canada's aging population.

It is clear that globalization has had a significant impact on Canada's business landscape. Both Canada's exports and imports have increased dramatically over the last twenty years, with an increasing share destined to and coming from countries other than the United States. But, while many have taken advantage of the opportunities pre-

sented by rising trade either by exporting to foreign markets or by importing goods and services for resale or as inputs in a domestic production process, others have taken a passive approach. And, with Canada accounting for only 2 per cent of the world economy and likely to grow slower than the world average, SMEs will find it increasingly difficult to rely on their local markets for growth.

In a 2004 TD Economics report, entitled “Canadian Business Goes Global for Growth” (www.td.com/economics/special/sb04.pdf), which can be downloaded from our website, we identified a number of obstacles to trade that need to be overcome. Among these include a lack of resources, shipping costs, exchange rate uncertainty and difficult customs processes. Above all, SMEs need to overcome a dearth of information or expertise and a perceived lack of financing. On the informational front, there are a number of institutions available to assist small business. Both Export Development Canada (EDC, www.edc.ca) and the Department of Foreign Affairs and International Trade (www.dfait-maeci.gc.ca/) offer a wealth of information designed to demystify many international trade issues.

Furthermore, foreign governments also post trade information online in an effort to attract foreign businesses. To assist with financing, both EDC and financial institutions such as TD Bank Financial Group stand ready to provide funds and assist in managing the risks.

The second fundamental force expected to shape Canada’s economy in the years to come is the effect of an aging population and the role that immigration will play in supporting the labour market. As the baby-boom generation begins to retire, growth in the labour force will begin to slow, especially in the youth component. This will make the staffing requirements of SMEs that much more difficult, adding to the already formidable challenge of adapting to changing demands from a retirement age population. A very potent offset to the aging population is immigration. Many new immigrants to Canada have either started or found work at SMEs in their early years of arrival. This trend will continue to benefit the sector, providing a substantial flow of new workers, contributing to a flexible and adaptable labour force capable of adjusting to the changing face of Canada.

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