BDC
Entrepreneurs first

# economic LETTER

JUNE 2014

## A LOOK AT CANADA'S RETAIL SECTOR

The retail industry accounts for 5.4% of Canada's GDP and generates a little over 2 million jobs, i.e. 12% of the country's total employment in 2013. It consists of a very large number of small and medium-sized firms (131,619 in 2012), but the lion's share of business is in the hands of large corporations: in 2011, 66% of retail sales, apart from automobiles, came from the 30 top retailers.

Over the past 20 years, American retailers have gradually captured a growing share of the Canadian retail market. In 2011, half of the 20 leading retailers in Canada had their head office in the United States. And the trend is continuing, with the recent arrival of Target in the Canadian market, and the upcoming entry of other American chains in the apparel sector. American retailers need to expand their market, and Canada represents an outlet with relatively easy access that offers plenty of potential.[1]

The arrival of these new competitors is intensifying the competition in a market where it was already fierce. Moreover, foreign firms do not even have to physically set up shop to do business here any more, since they can do so virtually, through e-commerce. This phenomenon is still very small-scale in proportion to total retail sales (1.5% in 2012), but it is expected to expand in the years to come. In fact, the value of goods and services purchased online by Canadians is increasing at a steady pace: it has reached $18.9 billion, an increase of 24% compared with 2010.[2] The purchases made online are, for the most part, travel arrangements (plane tickets and hotel reservations) and tickets to shows–which are not included in retail trade–but purchases of goods are also increasing. In the electronics and appliance sector, for instance, the percentage of total sales carried out via e-commerce rose from 2.9% in 2011 to 3.4% in 2012.[3]

How is the industry faring in such circumstances? Pretty well overall, but the situation varies from one sector to another. As shown in the table below, some sectors came through the recession better than others. Gasoline stations, whose sales grew by 3.5% per year from 2008 to 2012, recorded a 6.0% average annual increase in their operating profits during that period. Specialty food stores and

1 Most of the information on the structure of the Canadian retail market discussed herein is drawn from *Canada's Changing Retail Market*, Consumer Trends Update, Industry Canada, 2013.
2 Statistics Canada, *Individual Internet use and e-commerce*, 2012.
3 Statistics Canada, *Retail trade, total sales and e-commerce sales, by North American Industry Classification System*.

### Canada

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- > **Moderate employment growth**
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### Key indicators

BDC's Monthly Economic Letter is prepared by the Economic Analysis team from Marketing and Public Affairs and is based on a variety of public sources of economic data. The information in this letter is drawn from data released prior to June 7. Reliance on and use of this information is the reader's responsibility.

liquor shops, whose profit margin, in the neighbourhood of 30%, is the highest of all the retail sectors, also achieved excellent results.[4]

Electronics and appliance stores, and those selling building materials and garden supplies, also performed very well, despite a slump in their sales during this period. They enjoyed average annual growth in their operating profits of 4.6% and 3.5%, respectively. This is due to declining prices of the goods sold: the value of sales did go down, but the cost of merchandise sold fell even more, with the result that profits rose.

Car dealerships did well: their operating revenues grew faster than their operating costs during this period. Lastly, stores selling clothing and accessories and general merchandise stores also recorded higher profits during this period.

Other retail sectors did not do so well. Grocery stores, the second largest sector of the industry in terms of market share and the leading sector in terms of jobs, whose profit margin is the smallest of all the sub-sectors, saw their operating profits fall by 3.7% per year, on average, during this period. Operating expenses other than labour remuneration increased considerably. In the health and personal care products sector, profits are down despite strong growth in sales. It is the sharp increase in labour remuneration in this sector – mainly pharmacists' salaries – that is the cause. For miscellaneous store retailers and furniture and home furnishings retailers, it is flagging sales during the period in question, combined with higher operating expenses, that account for the decline in profits.

What lies ahead for Canada's retail industry? Will it benefit from the expected acceleration in economic growth in Canada in the years to come? The probability is that retail sales growth will also accelerate, but, as we have seen, more sales do not guarantee higher profits. With competition intensifying in many sectors, it is increasingly difficult for retailers to raise their prices to expand their revenues. At the same time, the depreciation of the Canadian dollar means a higher cost of goods sold for retailers who import their merchandise, putting them in a very tight spot. In many sectors, the challenge will be to reduce operating costs. In this industry, as in many others, increasing productivity is key. ■

**Data on Canadian retail trade, by sub-sector**

| Retail sub-sectors | Market share (%) | Profit margin (2012, %) | CARG* in sales 2008-2012 (%) | CARG in profits 2008-2012 (%) |
|---|---|---|---|---|
| Gasoline stations | 12.7 | 6.7 | 3.5 | 6.0 |
| Specialty food stores and liquor shops | 5.2 | 28.2 | 3.5 | 5.3 |
| Electronics and appliance stores | 3.2 | 5.3 | -0.7 | 4.6 |
| Building material and garden equipment and supplies dealers | 5.8 | 3.9 | -0.5 | 3.5 |
| Motor vehicle and parts dealers | 22.5 | 2.4 | 2.8 | 3.4 |
| General merchandise stores | 12.4 | 5.2 | 3.5 | 2.5 |
| Clothing and clothing accessories stores | 5.6 | 7.4 | 2.5 | 1.3 |
| Miscellaneous store retailers | 2.4 | 5.5 | -0.4 | -0.7 |
| Sporting goods, hobby, book and music stores | 2.3 | 4.0 | 1.8 | -1.2 |
| Health and personal care stores | 7.2 | 3.8 | 3.3 | -1.8 |
| Grocery stores | 17.5 | 1.8 | 1.8 | -3.7 |
| Furniture and home furnishings stores | 3.2 | 4.0 | -1.0 | -3.8 |
| **Total retail trade** | | **5.0** | **2.3** | **2.7** |

CARG = Compound annual growth rate
Source: Statistics Canada

4 The profit margin is calculated as follows: (operating revenues – cost of goods sold – operating costs) / operating revenues.

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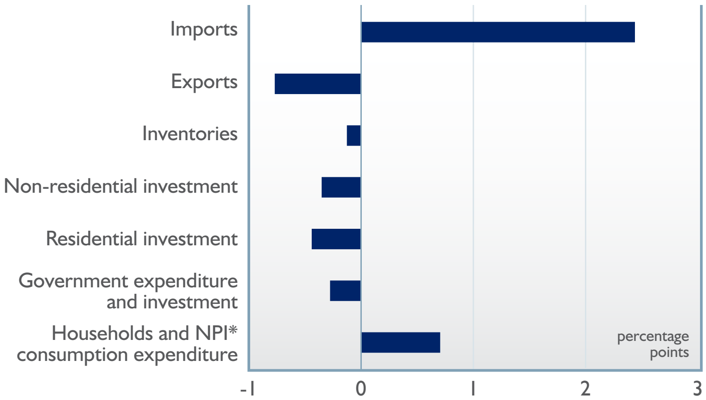
The national accounts data show that demand, both domestic and foreign, was limp in the first quarter. This is no doubt partly attributable to the exceptionally harsh winter, which slowed economic activity in many parts of North America. On the other hand, the job market situation is a source of concern, especially in the eastern part of the country, where employment has lost ground in the past 12 months. Hopefully, the anticipated acceleration in growth south of the border and a weaker Canadian dollar should stimulate the Canadian economy in the months ahead.

## Sluggish real GDP growth

Real GDP grew by a mere 1.2% in the first quarter of 2014 compared with the previous quarter (all rates are expressed in annualized terms). Of the main components of GDP, only consumption – which rose by 1.2% – and imports – which fell by 7.2% – contributed to output growth (Graph). Exports declined by 2.4% compared with the previous quarter, residential investment by 6.3%, non-residential investment by 2.6% and government spending and investment by 1.1%. In fact, were it not for a substantial drop in imports, real GDP would have declined by 1.2% in the first quarter. No doubt the unusually long and harsh winter adversely affected economic activity in the first quarter, but it is difficult to estimate the magnitude of that effect. We should see some rebound in growth in the second quarter, however.

**Contributions to annualized quarterly percentage change in real GDP, first quarter 2014**




* Non-profit institutions

Source: Statistics Canada

## Moderate employment growth

The loss of 29,100 full-time jobs was more than offset by the gain of 54,900 part-time jobs, with the result that total employment expanded by 25,800 jobs in May. The unemployment rate rose by one tenth of a percentage point, reaching 7.0%. Over the past 12 months, employment has risen by 85,500, but all the gains were in part-time work, since full-time employment pulled back by 26,700 during the period. Furthermore, job growth has been uneven across the country: it was strongest in Saskatchewan and Alberta over the past 12 months, while most of the other provinces reported declines (Graph).

**Change in employment from May 2013 to May 2014, by province**


Source: Statistics Canada

## The balance of trade swings from a surplus to a deficit

Exports fell by 1.8% in April while imports were up by 1.4%, driving the balance of trade from a surplus of $766 million to a deficit of $638 million (Graph). The decline in exports is mainly attributable to a pullback in exports of energy products, in particular refined petroleum products which plummeted by 39.5%. Some Canadian refineries undertook maintenance work, which curbed their exports. In real terms, exports contracted by 0.3% and imports expanded by 1.4%.

**Trade Balance**
(January 2012 to April 2014)


Source: Statistics Canada

## Profit outlooks improve

The Conference Board's Leading Indicator of Industry Profitability gained 4 points in April, reaching 108 (January 2007 = 100). A weaker currency, which benefits export industries, combined with the expected upturn in commodity prices, translates into improved short-term profitability outlooks for Canadian industries. The majority of the 49 industries covered by the leading indicator made headway in April. The industries presenting the best profitability outlooks are those that produce goods. The picture for wholesale and retail businesses is gloomier: the weakness of the Canadian dollar raises the cost of their imported inputs and, given the fierce competition that prevails in this sector, they are unable to pass on these higher costs to consumers. ■

# UNITED STATES

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The United States seems to have been even harder hit than Canada by an exceptionally severe winter, as may be seen from the decline in real GDP in the first quarter. That said, the job market situation is improving steadily. Moreover, the housing market is continuing its recovery, and growth outlooks are favourable. Under these conditions, a rally in growth is highly probable in the second quarter.

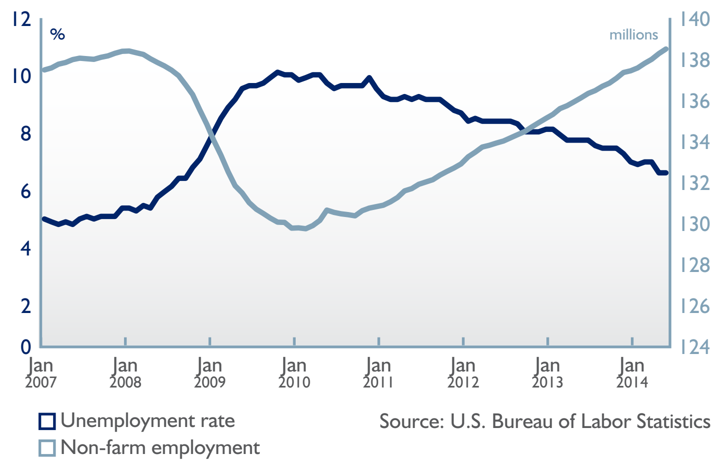
## Real GDP contracts

According to the second estimate by the U.S. Bureau of Economic Analysis, real GDP contracted by 1.0% (annualized) in the first quarter of 2014. The preliminary estimates had pegged growth at close to zero in the first quarter. This change is mainly attributable to the downwards revision to investment in corporate inventories. Keep in mind that some of the weakness in the first-quarter data is due to the adverse effects of a very severe winter, which reined in economic activity in many parts of the United States.

## Employment keeps climbing steadily

Non-farm employment expanded by 217,000 jobs in May and the unemployment rate held steady at 6.3%. The sectors that saw the largest gains in May were healthcare, social services, professional services and business services. There was little change in employment in the manufacturing and construction sectors. Over the past 12 months, the average monthly variation in employment has been 197,000. The unemployment rate is gradually moving nearer to its pre-recession level (Graph). In short, the job market is steadily improving.

**Employment and Unemployment Rate**
(January 2007 to May 2014)




Source: U.S. Bureau of Labor Statistics

## Housing starts and home sales rebound

As expected, the housing market, which was seriously held in check by inclement weather in many states during the winter, made up for lost ground in April. Housing starts surged by 13.2%, after a 10% decline in the first quarter of 2014 compared with the previous quarter. April's strong monthly increase comes mainly from the multiple-dwelling segment, where starts shot up by 42.9%. Meanwhile, starts of single-family homes rose by just 0.8%. As far as home sales are concerned, we observed the first monthly increase of the year (1.3%) in April. According to the National Association of Realtors in the United States, sales should accelerate in the months to come thanks to a recent increase in supply. ▼

## Growth outlooks improve

The manufacturing purchasing managers' index, compiled by the Institute for Supply Management (ISM), continued growing in May. Since the low reached in January, the index has gradually improved (Graph). These results would seem to confirm that after a harsh winter, economic activity is getting back on track. Keep in mind that the ISM purchasing managers' index constitutes a good leading indicator, not only of activity in the manufacturing sector, but also of real GDP growth. ■

**Purchasing Manager Index**
(June 2011 to May 2014)


Source: Institute for Supply Management

# INTEREST RATES

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## No change to the key interest rate expected before the first quarter of 2015

On June 4, the Bank of Canada decided, as expected, to leave the key interest rate unchanged, at 1.0%. In the press release that accompanied the decision, the central bank acknowledged that the inflation rate has moved back towards its 2.0% target faster than anticipated, but it notes that global economic growth has proven to be weaker than it had projected in its latest monetary policy report. Among other things, the Bank fears that the U.S. economy may have less drive than it had anticipated. Consequently, it considers that the overall downside risk surrounding inflation is just as great as before. According to the economists at the Canadian chartered banks, the key interest rate is unlikely to head up before the first quarter of 2015 (Table). ■

**Forecasts of the timing and scope of the next move in the key interest rate, according to the chartered banks (percentage points)**

| | 2015 Q1 | 2015 Q2 | 2015 Q3 | 2015 Q4 |
|---|---|---|---|---|
| BMO Capital Markets Economic Research | | | 0.25 | |
| CIBC Economic Research | | 0.25 | | |
| RBC Economic Research | | 0.25 | | |
| Scotiabank Economics | | | | 0.25 |
| TD Economics | | | 0.50 | |
| Laurentian Bank Securities Economic Research | | | | 0.50 |
| National Bank, Financial Markets | 0.25 | | | |

# OIL PRICE

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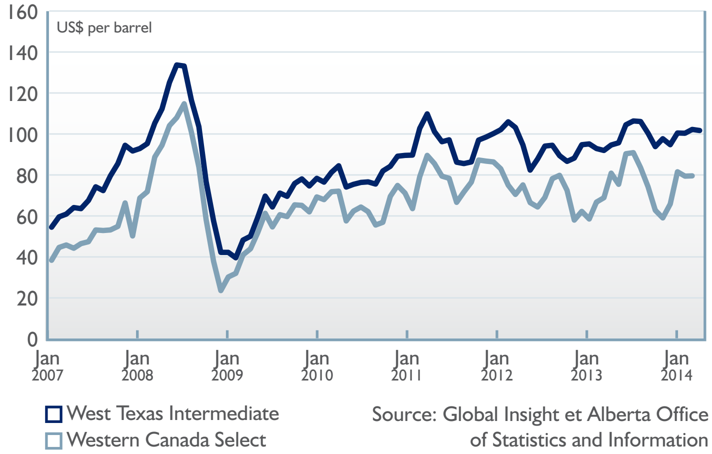
## The price of oil remains high

The price of crude oil, measured by the West Texas Intermediate monthly average, was relatively stable in May compared with the previous month. The price remains high, however, due to a resurgence of violence in Libya and persistent tensions in Ukraine, which are still raising concerns about supply. ■

**Crude Oil Price**
(January 2007 to May 2014)




Source: Global Insight et Alberta Office of Statistics and Information

# CANADIAN DOLLAR

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## The Canadian dollar keeps appreciating

In May, the Canadian dollar appreciated by 0.9% against the U.S. dollar, compared with the previous month. The Consumer Price Index data released in May show that the Canadian inflation rate returned to the 2.0% target in April, far sooner than the central bank was expecting. Consequently, the probability of sooner-than-anticipated monetary tightening rose, which could explain, at least in part, the appreciation of the loonie. ■

**Canada / United States Exchange Rate**
(January 2007 to May 2014)


Source: Bank of Canada

# SME CONFIDENCE

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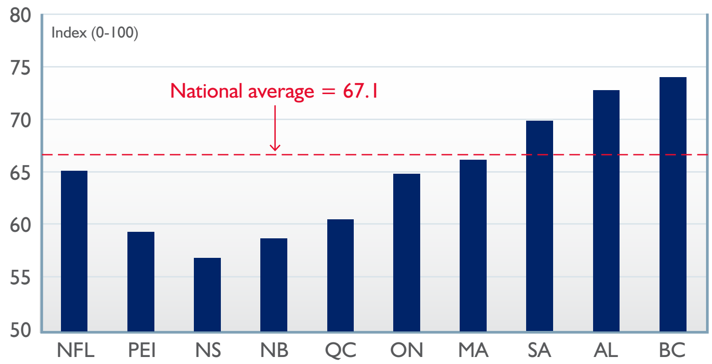
## The confidence of SME owners increases further

In May, the Business Barometer Index compiled by the Canadian Federation of Independent Business rose significantly for the second month in a row. It reached 67.1, its highest level since March 2012 when it hit 67.7. SME owners in the western part of the country are clearly more optimistic than those in the east and the centre (Graph). The percentage of respondents who plan to hire full-time staff in the next three to four months dipped slightly in April compared with the previous month (26.1 % vs. 28.5%), but is still high from a historical perspective (the average between February 2009 and May 2014 is 17.9%). ■

**Business Barometer in May 2014, by province**




Source: Canadian Federation of Independent Business

# BUSINESS CREDIT CONDITIONS

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## Bank credit granted to businesses expands significantly

The credit granted to businesses by the chartered banks expanded by 2.8% in April compared with the previous month. This is exceptionally strong monthly growth: by comparison, the average monthly growth in bank credit over the previous 12 months was 0.6%. April's gain comes mainly from short-term credit (88% of total bank credit), which was up by 3.1% during the month, while long-term credit rose by 0.8%. Thanks to this strong advance, annual bank credit growth is now back on an upwards trend (Graph). ■

**Business Credit from Chartered Banks**
(annual change, January 2007 to April 2014)


# KEY INDICATORS – CANADA

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**Key indicators – Canada**

| | Historical[1] | | | | 2014[2] | | | | Latest | | Forecast | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2010 | 2011 | 2012 | 2013 | Q1 | Q2 | Q3 | Q4 | | | 2014 | 2015 |
| Real GDP (% growth) | 3.4 | 2.5 | 1.7 | 2.0 | 1.2 | | | | Mar | 0.1 | 2.3 | 2.5 |
| Machinery and Equipment Expenditures (% growth) | 10.6 | 8.6 | 5.2 | -0.2 | -5.8 | | | | | | 3.0 | 5.9 |
| Pre-Tax Corporate Profits (% growth) | 61.6 | 16.6 | -8.2 | -0.3 | 50.7 | | | | | | 5.3 | 5.7 |
| Industrial Production (% growth) | 6.0 | 3.9 | 0.9 | 1.9 | 4.7 | | | | Mar | 0.6 | 3.2 | 2.6 |
| Industrial Product Prices (% growth) | 1.0 | 4.6 | 0.6 | -0.3 | 1.7 | | | | Mar | 0.4 | 1.9 | 1.7 |
| Non-Residential Construction (% growth) | 17.3 | 12.9 | 6.9 | 2.2 | 0.4 | | | | | | | |
| Housing Starts (' 000 units) | 192 | 194 | 215 | -13 | 175 | | | | Apr | 197 | 183 | 177 |
| Personal Expenditures (% growth) | 3.5 | 2.3 | 1.9 | 2.4 | 1.2 | | | | | | 2.3 | 2.2 |
| Consumer Price (% growth) | 1.8 | 2.9 | 1.5 | 1.0 | 2.8 | | | | Apr | 0.3 | 1.7 | 2.0 |
| Employment (% growth) | 1.4 | 1.5 | 1.2 | 1.3 | 0.4 | | | | May | 0.1 | | |
| Unemployment Rate (%) | 8.0 | 7.4 | 7.3 | 7.1 | 7.1 | | | | May | 7.0 | 6.8 | 6.6 |
| SMEs Confidence Index (CFIB) | 66.7 | 66.4 | 63.9 | 0.0 | 64.2 | | | | May | 67.1 | | |
| Manufacturers Confidence Index (CFIB) | 68.5 | 67.3 | 66.7 | 63.8 | 64.9 | | | | May | 63.7 | | |

1. Annual growth rate
2. Quarterly growth. at annual rate
3. Month-over-month growth

Sources: Statistics Canada, Consensus Economics and Canadian Federation of Independent Business.