

Special Report
Spend Or Save —
Which Way Will The Pendulum Swing In 2006?

February 23, 2006

2005 Was Another Year Of Spending More And Saving Less

By and large, Canadians are a confident bunch. So much so that the pendulum has swung decisively to the 'spend more' side of the arc. Across the country, though more in the west, consumers are keeping shopkeepers happy across a broad spectrum of retail categories.

This attitude is not without some justification. Despite encountering a number of growth-robbing speed bumps in recent years, the Canadian economy has been recession free for 14 years.

Obviously, getting the macro-economic policy environment right at home has played an important role in helping to sustain growth. For example, low inflation and high budget surpluses have fostered a pro-growth climate of low borrowing costs, increased government spending, and more tax relief.

It is not surprising therefore that Canadians, for the most part, adopted the 'spend more, save less' mantra that has become a national past-time south of the border. Canada has become a veritable 'jobs juggernaut', generating new employment opportunities on a consistent basis, even though hiring, just like the overall macroeconomic landscape, has been skewed by the exceptionally robust conditions in the resource-rich west.

Nationally, we've added a whopping 1.7 million net new jobs since the new millennium began, just about half the gains recorded in the United States. Not bad for a country roughly a tenth of America's size, and where manufacturers have trimmed roughly 200,000 jobs since the peak in late-2002, as many export-sensitive firms adjust to increasing overseas competition, as well as a rapidly appreciating currency. An array of sectors — construction, primary, retailing/wholesaling, and most service categories, including public administration — are filling the breach.

Overseas investors are also contributing to the improving tone in Canada. A wave of foreign purchases, primarily into Alberta's burgeoning oil patch, but in real estate across the country as well, are putting Canada on the international investment map. Immigration, primarily into our major urban centres, continues to bolster our longer-term prospects.

Confidence is also benefiting from the ongoing boom in construction. Nationwide, the housing market remains quite buoyant, with starts, sales and renovation activity continuing to move ahead. And just as important, home prices are still on an upswing, contributing to the multi-year increase in household wealth, and allowing homeowners to convert their rising equity values into spending power.

This building boom should persist, with the 'bricks and mortar' now being passed to commercial, industrial and institutional construction. And don't forget that a cash-flush Ottawa, as well as many of its provincial counterparts, are ramping up expenditures on the nation's neglected physical infrastructure, as well as providing additional tax relief.

Canadians are so confident they are now effectively *dis-saving*! By spending more than they earn, they've driven their collective rate of saving into negative territory — an average of -0.4% of personal income in 2005, much like their U.S. counterparts, whose savings rate averaged an equally meagre -0.5% of personal income. Just ten years ago, this measure of savings in Canada averaged a relatively lofty +9.2% of personal income.

Another yardstick is the amount of RRSP contribution room still available to be topped up by Canadians. The latest statistics indicate that contributions for 2004 climbed 4½%, though the total of almost \$29 billion represented only a small fraction of the total room available to eligible taxpayers. Apparently, savings, either tax-sheltered or not, have taken a back seat to spending and/or investments in other non-financial items, namely homes and other properties, and collectibles — art, automobiles and other physical assets — that don't make it into the traditional measurement.

Will 2006 Become A Year Of Spending Less And Saving More?

Canadians are betting that the good times will continue to roll. And they may be right, particularly if they work, reside or primarily invest in the high-growth, resource-rich western provinces. The significant ratcheting up in energy-related investments will keep this region, as well as Newfoundland & Labrador, in the relative fast lane of growth.

But there are increasing risks to this relatively sanguine outlook that could begin to swing the pendulum back to the 'save more' side of the arc.

In contrast to the boom at the opposite ends of this country's topography, prospects for the 'big valley', or the central provinces, are good, but not great. The major population centres in Ontario and Quebec will continue to grapple with the multi-year restructuring of their large manufacturing sectors that is at the epicentre of the global gravitational shift in production to the more labour-cost competitive countries overseas.

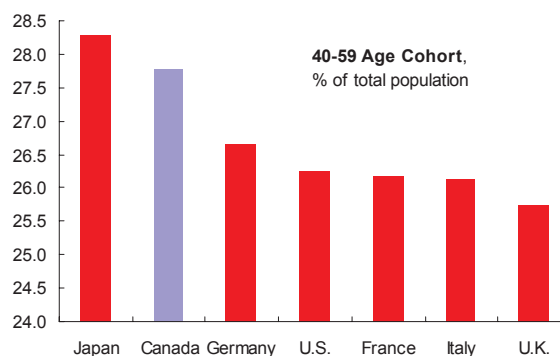
The likelihood of a stronger Canadian dollar will reinforce this momentum, and keep pressure on export-sensitive firms to improve their bottom line performance through strategic, productivity-enhancing investments, mergers & acquisitions and plant rationalization, as well as labour and benefit cost savings. The latter bears watching, since an increasing number of firms are being forced to trim their benefit and pension plans, an especially worrisome development for those workers contemplating retirement.

Borrowing costs are still biased higher. Tighter labour markets and reduced industrial capacity suggests that inflation risks continue to be biased higher, especially with households and businesses confronted by high costs in areas such as energy. While the appreciating Canadian dollar helps to keep a lid on imported costs, the exceptional strength in demand conditions in the high growth sectors and regions of the country will keep Bank of Canada policy on a gradual firming tack.

Banking on continued high economic growth is a high-risk strategy, especially if U.S. consumer fatigue settles in. While Americans appear to be genetically-bred to shop, they are being gradually weaned off of the financial steroids that pumped up their purchases. Ultra-low interest rates are behind them, as are multiple rounds of tax cuts, while energy costs have moved significantly higher. Importantly, the cresting in home price inflation should reduce the equity cash outs that have helped fuel the recent spending boom. A leaner U.S. consumer is likely to emerge, though purchases should still be supported by moderate job and overall economic gains.

The risks to the U.S. economy, and correspondingly its NAFTA partners as well as the rest of the world, could be magnified if the slumping U.S. dollar experiences a hard landing. Whatever the trigger — investor reluctance to continue underwriting America's debt-financed imports, protectionist roadblocks that would alienate its overseas 'bankers', or even a renewed terrorist strike on U.S. soil — a sharply weaker currency would put

Boomers -- Canada's 'Silver Medal' Aging Performance



Source: United Nations

upward pressure on bond yields and downward pressure on interest-sensitive spending. The housing market — the recent wellspring of consumer spending — would become vulnerable.

The 'don't worry, spend more' crowd might have other potential problems. Simmering geopolitical tensions could boil over. Iran's nuclear ambitions have vaulted the Middle East back into the spotlight, because the country borders the Strait of Hormuz through which nearly 90% of the Persian Gulf's crude oil is transited by tankers. Other hot spots, Iraq and Nigeria for example, are also linked to the global oil market. Any meaningful flare-up would have serious implications for global growth and investor confidence.

Another concern is the potential for a broader outbreak of the avian flu. The deadly H5N1 strain already has killed fowl in a reported 14 countries in Asia, Africa, Europe, as well as India, but only a relatively few human deaths have been attributed to the virus around the world so far. While the likelihood of a global pandemic is still questionable low, any meaningful outbreak could have a measurable impact, far beyond the SARS epidemic that enveloped China and Canada in 2003, and the U.S. cattle blockade in the same year due to a solitary case of BSE in Alberta. Any disruption to worldwide trade and travel, small or large, would undoubtedly destabilize global growth and financial markets.

If heightened economic and geopolitical risks don't get Canadians saving more, then it may be left to play the 'demographic' card. Canada is at the 'older' end of international baby boomers, that age group in their prime earning years that can have it all, but not for much longer. Almost 28% of Canadian population is in this key 40-59 age cohort, just slightly below the Japanese rate, but at least a percentage point, if not more, greater than the share in the other G7 nations, including the United States. While this aging process is more of a gradual flow than a seismic shift, the immutable forces of nature — remember, retirement is just around the corner — suggest that Canadians ought to begin saving more and spending less.

The Pendulum Will Eventually Swing Back To Saving

The TSX stock index, heavily-weighted towards Canada's large and diverse commodity sectors, may well post another strong performance in 2006. Earnings remain on a solid growth trajectory, and investor interest remains strong, especially so if foreign investment continues apace. Another favourable year in the real estate market is also likely, particularly in the resource-rich regions of the country.

However, with provincial growth disparities increasing, banking on another year of double-digit returns is a high-risk strategy in an increasingly high-risk world. Accordingly, the pendulum is bound to swing back towards the 'save more' side of the arc with so many factors threatening to take these hot markets off the boil.

What should Canadians do?

First, have a diversified plan that would help to insulate household finances from the potential volatility in various asset markets.

Second, take another look at the outstanding levels of mortgage and personal debt with the aim of reducing the variable and/or non-deductible portion that could be adversely affected by any unexpected upward bump in borrowing costs or downward bump in growth.

And third, a simply pragmatic response would be to save more. Canadians may be able to apply the GST — the *good savings time* — rule. With the new government in Ottawa indicating that it is preparing to reduce the 7% GST by one percentage point in its spring Budget, it might be a relatively easy decision to save the reduced tax burden.