FINANCIAL INDUSTRY MONITORING SERVICE

July 2008

CHART 1

C$ business bank loans - Canada

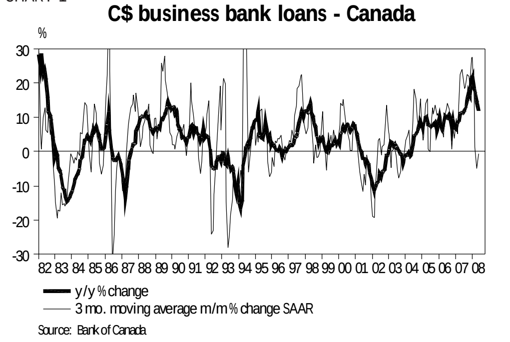


CHART 2

Business borrowing and working capital financing requirements

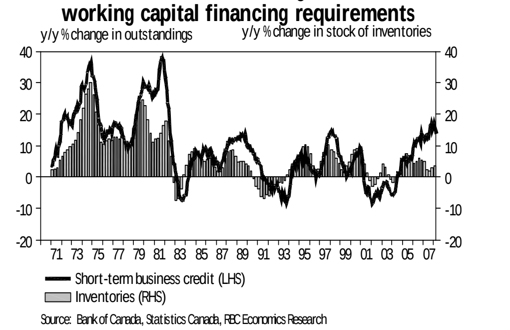
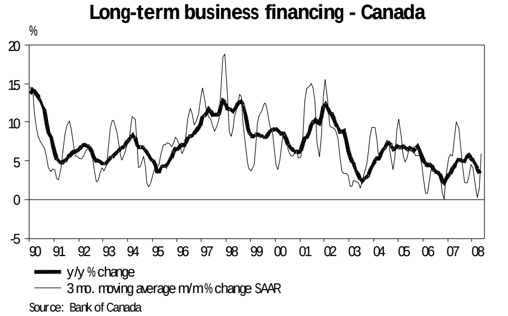


CHART 3

Long-term business financing - Canada



Jimmy Jean
Economist
416-974-6525
jimmy.jean@rbc.com

Canada-U.S. business and household banking markets — Mid-year review

The extraordinary surge in short-term business lending at the end of last year clearly demonstrates how businesses managed to cope with tumultuous financial markets. The credit crisis dried up liquidity on credit markets, spreads rose through the roof while volatility was surging on stock exchanges, all making for extremely unfavourable conditions for the issuance of debt and equities. Yet, while long-term financing was severely hit, short-term lending boomed in both Canada and the United States to levels not seen since the 1970s. Equally impressive was the way this boom defied any sort of economic fundamentals at the time that would have called for such a ramp-up.

As asset-backed commercial paper (ABCP) was severely disrupted, companies turned to banks for financing. However, this alone cannot explain the massive acceleration. Another part of the explanation lies in the move away from capital market financing to short-term bank financing despite potential asset-liability mismatch issues. Another reason was a strong incentive to build up liquidity reserves against future possible shortfalls similar to the experience of the 1980s and 1990s recessions. However, economic fundamentals are now taking the lead again, and these recent trends are already reversing.

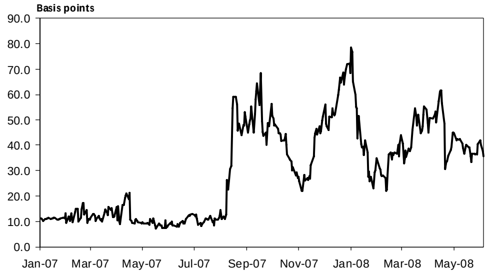
Canadian business markets: Short-term lending to slow

Through the end of 2007 and the beginning of 2008, Canadian-dollar denominated loans at banks surged to reach the highest rate of growth since 1982 (chart 1). Part of this reflected the collapse of the ABCP market as some liquidity back-up lines of credit were used. Still, the decline in commercial paper outstanding (C$1.4 billion between June and October 2007) was small compared to the increase in bank loans (C$6.6 billion during the same period), meaning that this was not the only driver of Canada's lending boom. The traditional close link between short-term business financing and inventory investment appears to have broken down (chart 2). The last two times that short-term financing overshot inventory investment in similar fashion (1979-1981 and 1988-1990), the economy went into a recession and lending tanked.

Past experience suggests that firms have a strong incentive to take on short-term debt before downturns to protect their liquidity levels against an anticipated deterioration in their working capital (e.g., write-offs of accounts receivable). We believe that the Canadian economy is still safe from a recession but that there is a high probability that lending growth will falter in the months ahead as the economy grows at a subdued pace. Already, growth in Canadian short-term financing is off the 22% peak recorded in January on a year-over-year basis, having declined steadily to 14.6% as of April.

CHART 4

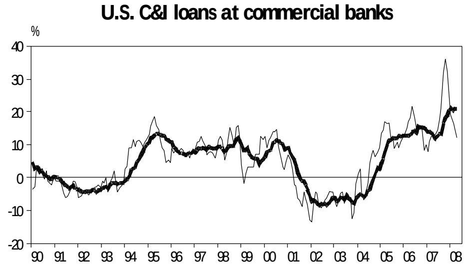
Canada: 3mth deposit rate vs. 3mth OIS swap



Source :Bank of Canada, RBC Economics Research

CHART 5

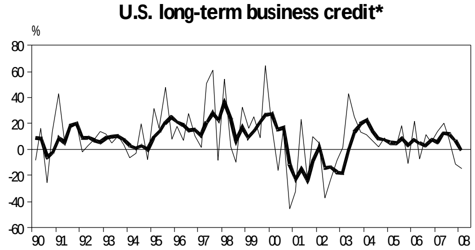
U.S. C&I loans at commercial banks



Source: Federal Reserve Board

CHART 6

U.S. long-term business credit*

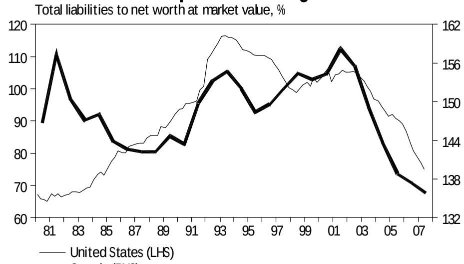


*Includes: bonds, equities, commercial mortgages, and finance company loans
Source: Federal Reserve Board

CHART 7

Corporate leverage

Total liabilities to net worth at market value, %



Source: Statistics Canada, U.S. Federal Reserve, RBC Economics Research

This deceleration is in line with our forecast so far, but the big decline in Canada's inventory investment in the first quarter of 2008 would have normally meant a more substantial decline in short-term lending growth. These two variables are usually well correlated, but the link has faded recently. Even though liquidity levels and leverage measures of non-financial businesses appear healthy (see chart 7), the market drivers that call for more conservatism on lenders' part remain powerful, meaning that this recent episode may well be offset by a period of much softer growth in future short-term financing as short-term credit expansion falls back in line with inventory investment. Based on such a scenario for the latter part of the year, our forecast of 8% growth for short-term credit in 2008 for Canada is on track, although the record spikes earlier in the year convey upward risks.

On the long-term side, financing was affected by market turmoil at the beginning of the year (chart 3); however, some conditions have improved in the second quarter. The commodity-driven TSX broke another record in May, risk appetite has been rising gradually and credit spreads have stabilized (chart 4) as investor sentiment turned less negative. While these conditions have been positive for long-term market-based issuance, downward risks are still alive for the near-term as the North American economy and financial markets prove fragile as evidenced by the latest eruption of market anxiety in June.

As such, the slowdown in stock issuance in Canada tracks our 3% projection, but retreating commodities later this year could mitigate the effect of strong stock markets so far. The late recovery in the Canadian bond market makes our 4.6% year-end forecast very achievable, especially if our expectation of Canadian capital spending to remain healthy proves correct. Overall, our long-term forecast of 3.7% for long-term financing growth in Canada appears sound.

United States: Financial and economic challenges weigh on long-term business financing

In the United States, growth in commercial and industrial (C&I) loans jumped 49.6% in the month of September 2007 alone on an annualized basis (chart 5) but has retreated significantly since then. As of May, C&I loan growth was down to only 3.3% annualized. Constrained credit on capital markets, which has caused businesses to turn to banks and liquidity back-up lines attached to asset-backed commercial paper to access financing, has contributed to C&I loan growth levels unseen in 28 years, heightening the risk of short-term lending overshooting our forecast of 7%. These factors are already proving short-lived and we expect further cooling going forward, especially as inventory accumulation is likely to remain on the soft side.

Long-term financing decelerated sharply in the early stages of the crisis (chart 6), with stock issuances taking most of the hit while, on bond markets, speculative-grade issuance bore the burden of the jump in risk aversion. Investment-grade issuance was left relatively intact. Our forecast is still tracking well so far for bonds and commercial mortgages while equity financing will most definitely fall out of the forecast range given recent market developments. In addition, expected soft capital spending will likely emphasize downside risks for issuance in the bond and commercial mortgage segments as well. As a result, it now appears very probable that overall long-term business lending growth will end the year in negative territory.

Business credit quality: Controlled deterioration ahead

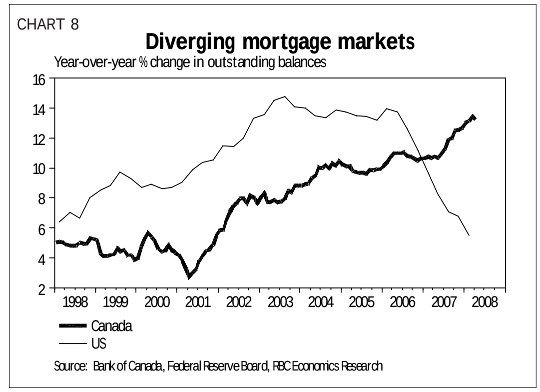
Deterioration of credit quality was already under way in the earlier stages of the credit crisis and the current backdrop featuring higher financing costs, surging commodity prices and subdued demand means squeezed corporate profits and cash flows. In Canada, manufacturers will once again be the big losers, while wholesale and retail trade still benefit from strong spending momentum. In the United States, business exposure to diversified global markets will be a critical factor in preserving credit quality. Despite these challenges, North-American businesses are still much less levered than at the beginning of the decade (chart 7) and high liquidity levels on balance sheets should provide enough ammunition to businesses to get through the soft patch without too much damage.

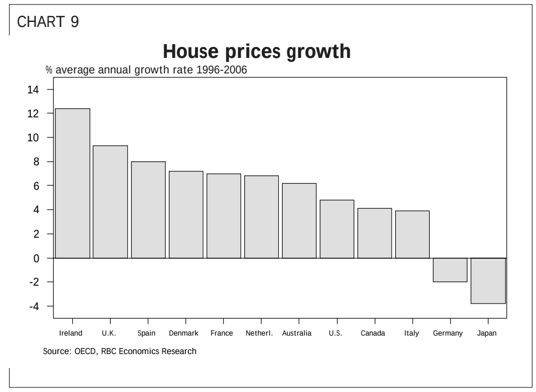
Diverging consumer credit markets

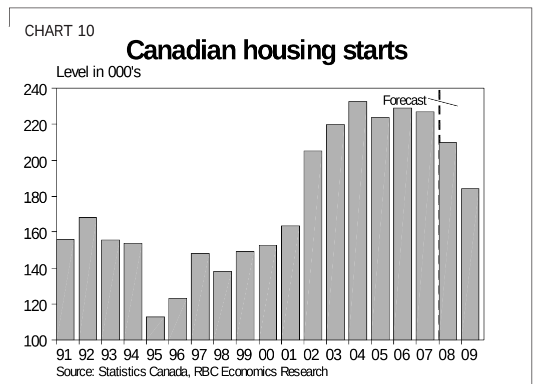
The gap between Canadian and U.S. household debt markets keeps widening as the U.S. housing market pays dearly for past financial innovation excesses, while Canada's market stays on firmer footing, with only the most conservative of innovative products being offered. While there is still room for more innovation in Canada, the effects have been positive so far and have contributed to one of the longest housing cycles in Canadian history, with the number of units started exceeding the 200,000-mark for the past six years. While these levels will likely not be sustained significantly longer because eroding affordability has started to cool the hotter markets, we still don't foresee any danger of a U.S.-style collapse. Canada's lateness in liberalizing its mortgage (and mortgage insurance) market compared to other countries (e.g., Spain, the United States, the United Kingdom) may have helped it to avoid the pitfalls of some of the riskier practices and products. Still, the home ownership rate in Canada is among the highest in the world and, although they have appreciated, house prices have not been inflated to bubble levels on a widespread basis (chart 9).

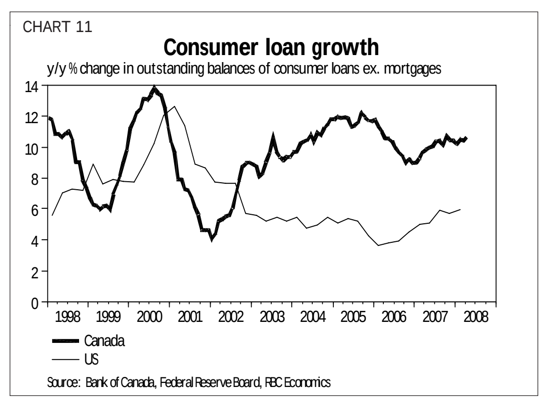
Canadian household credit still buoyant

As a result of recent developments, mortgage credit growth in Canada exceeds our expectations, running at 13.5% on a year-over-year basis as of March. This is the fastest pace in nearly 18 years, even as housing activity in some of the hottest markets is waning. Mortgage growth is, nevertheless, expected to decelerate given the effects of a mildly slowing economy that should cool demand and housing starts (chart 10). Our 9.2% projection for mortgage growth is in line with this scenario. In addition to a healthy housing market, robust consumer spending in Canada is fuelling double-digit increases in non-mortgage consumer loans (chart 11), with very high activity in the personal lines of credit segment, which jumped nearly 17% in April on a year-over-year basis. Here, also, some moderate expected deterioration in Canada's job market will likely curb spending and bring overall consumer loan growth closer to our year-end forecast of 8.5%.









U.S. mortgage financing decelerating markedly

The U.S. case contrasts sharply. Even if the housing market has shown some very tentative signs of bottoming out, talk of a recovery is premature. The culprit remains the increasing number of foreclosures. Attempts at providing loan modification options to troubled borrowers have been modest so far, despite the "Hope Now" initiative. A recent study from the Office of the Comptroller of the Currency (OCC) found that in national U.S. banks, payment plans outnumber loan modifications by a ratio of four-to-one. Loan modifications allow for interest rates and maturity date alterations, whereas payment plans merely help borrowers become current without much change to the loan contract. Meanwhile, the 10.8 months of supply in inventory as of May (chart 12), declining home values, surging delinquencies and faltering consumer confidence make clear that the road to normalcy will be long and arduous.

Growth in mortgages outstanding is still in positive territory as of the first quarter, at 5.6% from a year ago, but the small 3% increase from the previous quarter maintains a decelerating trend that should continue as prospective buyers stay on the sidelines and foreclosures continue to mount. Outstanding mortgages are on track to grow by only 3%-4% during the year, well below our initial forecast of 9% growth. The more widespread effects of the credit crunch have also emphasized the downside risks to our non-mortgage consumer lending forecast, which is now on track to end the year with below 5% gains, somewhat lower than our 8.2% projection.

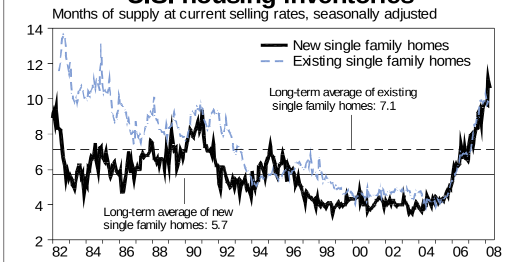
Credit quality deterioration a bigger threat in the United States

Credit quality is much less at risk in Canada than in the United States. This is confirmed by trends in charge-off rates, which decreased again in Canada in 2007 while jumping significantly in the United States. In both cases, bankruptcy rates had been kept in check despite the rising debt-service burden, likely due to the effects of strong non-employment income gains and elevated consumer liquidity providing a thick buffer.

The first quarter of 2008 showed a significant increase in U.S. charge-off rates (chart 13), most likely the spillover effects from mortgage foreclosures. In this context, with the slow speed of implementation of mortgage modification measures, combined with high energy and food prices that make matters worse, the risks of further and faster deterioration in U.S. household credit quality have been heightened. Deteriorating credit quality also holds true for the Canadian consumer, but bankruptcies are still under control (chart 14) given a stronger job market and still lower levels of indebtedness (chart 15).

CHART 12

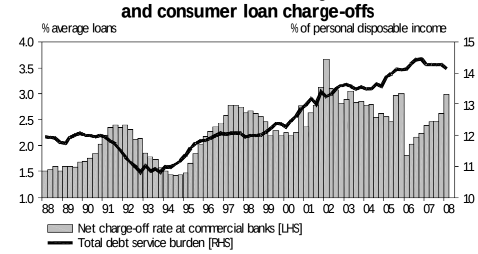
U.S. housing inventories



Source: U.S. Bureau of the Census, National Association of Realtors, RBC Economics Research

CHART 13

U.S. debt-servicing and consumer loan charge-offs



Source: Federal Reserve Board

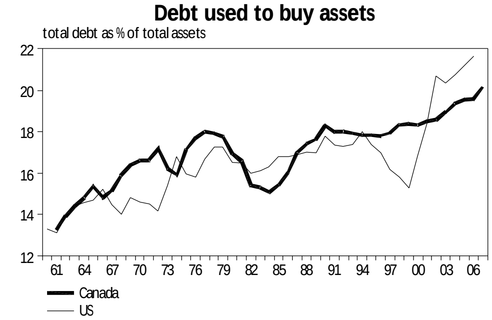
CHART 14

Canadian consumer bankruptcies

Source: Office of the Superintendent of Bankruptcy Canada, RBC Economics Research

CHART 15

Debt used to buy assets



Source: Statistics Canada

Financial industry trend and forecast overview

Canada

Seasonally adjusted at annual rates	Latest period	Outstandings (C$ billions)	y/y % change	m/m* or q/q % change	Recent trend	FYTD** % change	FY FORECAST % change
Household markets							
1. Household credit	Apr-08	1,236.5	12.3	12.1	Flat	11.7	9.2
2. Residential mortgages	Apr-08	852.1	13.2	12.7	Flat	12.8	9.5
3. Consumer loans	Apr-08	384.4	10.4	11.0	Flat	9.2	8.5
4. Fixed & variable rate loans	Dec-07	153.4	5.9	0.0	Down	-6.4	5.0
5. Credit card balances	Dec-07	76.5	13.3	16.3	Up	19.1	7.5
6. Personal lines of credit	May-08	153.4	17.5	22.5	Up	19.2	17.0
7. Personal deposits	Apr-08	756.4	8.2	11.6	Up	9.8	6.0
8. Banks	May-08	550.3	8.9	12.7	Up	11.0	5.5
9. of which: fixed term	Apr-08	303.2	8.0	6.3	Down	9.1	5.9
10. of which: chequing/saving accounts	May-08	243.9	10.3	19.8	Up	13.9	5.0
11. Mutual fund net sales (C$B hist. nonann.)***	May-08	na	na	na	na	$17.4	$45.0
Business markets							
12. Total business financing	May-08	1,194.8	6.0	3.6	Down	5.1	5.1
13. Short-term business credit	May-08	370.7	11.7	1.8	Down	8.0	8.0
14. Banks	May-08	276.7	14.1	0.3	Down	8.2	7.5
15. C$ bank loans	May-08	182.3	12.0	-1.8	Down	6.6	6.0
16. SME loans	Q1 2008	58.6	4.4	6.1	Up	5.0	5.0
17. Small bus. loans	Q1 2008	29.0	1.7	4.6	Up	2.9	3.5
18. Commercial paper	May-08	13.4	0.0	14.8	Up	48.7	2.5
19. Long-term business financing	May-08	822.9	3.7	4.2	Flat	3.4	3.7
20. Equities	Jun-08	326.5	6.6	5.1	Down	6.5	3.0
21. Income trust units	Jun-08	77.6	-11.4	-10.2	Flat	-12.4	N/A
22. Bonds	Jun-08	279.3	4.8	15.7	Up	6.4	5.0
23. Commercial mortgages	Apr-08	76.6	9.8	11.4	Up	13.5	7.0
24. Lease receivables	Apr-08	33.8	8.2	6.4	Down	8.9	6.0
25. Current accounts	Apr-08	218.6	10.0	26.2	Up	13.4	7.5

United States

Seasonally adjusted at annual rates	Latest period	Outstandings (US$ billions)	y/y % change	m/m* or q/q % change	Recent trend	FYTD** % change	FY forecast % change
Household markets							
26. Household credit	Q1 2008	13,163.9	5.6	3.3	Down	4.9	8.8
27. Residential mortgages	Q1 2008	9,488.2	5.6	3.0	Down	5.0	9.0
28. Consumer loans	Q1 2008	3,675.7	5.5	4.0	Down	4.6	8.2
29. Revolving credit	Q1 2008	2,082.1	6.2	4.5	Down	5.6	9.3
30. Home equity lines of credit	Q1 2008	1,130.8	4.8	2.8	Down	3.7	12.0
31. Credit cards	Apr-08	956.9	7.8	4.5	Down	6.0	6.0
32. Non-revolving credit	Apr-08	1,608.1	5.0	4.8	Flat	4.2	6.9
33. Personal deposits	Q1 2008	5,974.5	4.8	2.8	Down	7.2	5.2
34. Mutual fund net sales (US$B hist. nonann.)***	Apr-08					301.8	400.0
Business markets							
35. Total Business Credit	Q1 2008	20,372.0	0.8	-12.8	Down	-10.9	8.5
36. Short-term business credit	Q1 2008	1,808.6	18.3	16.1	Down	18.4	7.0
37. of which: commercial bank C&I loans	Apr-08	1,489.8	20.9	14.8	Down	18.9	10.0
38. Long-term business credit	Q1 2008	18,563.3	-0.6	-15.1	Down	-13.1	8.6
39. Bonds	Q1 2008	3,592.0	9.5	7.6	Down	8.9	9.0
40. Equities	Q1 2008	10,912.7	-6.7	-27.2	Down	-24.5	8.5
41. Commercial mortgages	Q1 2008	3,589.0	10.8	6.5	Down	8.4	10.0
42. Finance company loans	Q1 2008	469.6	3.5	3.9	Flat	2.5	7.0
43. Cash and chequable deposits	Q1 2008	545.6	9.1	-2.9	Down	-3.4	7.0

*Month-over-month % change with a three-month moving average. **For quarterly data, September 30 is used as a proxy for October 31 fiscal year-end ***11 & 34 are on a calendar year basis. Canadian reinvested dividends are included in mutual fund totals and usually occur in December; U.S reinvested dividends are not. Components presented are non-exhaustive and their sum may not add up to totals presented.

Source: Bank of Canada, Statistics Canada, Investment Funds Institute of Canada, Canadian Bankers' Association, Federal Reserve Board, RBC Economics Research