

# PERSPECTIVE



## Can Quebec Businesses Remain Optimistic for Much Longer?

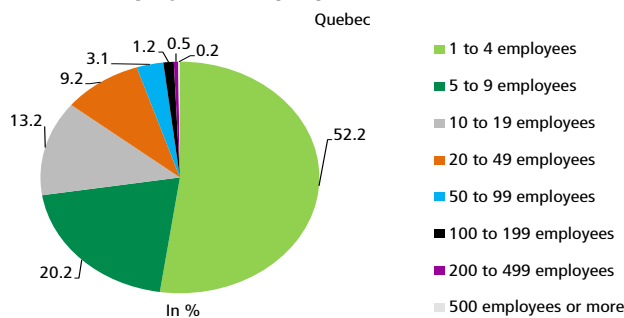
The business confidence indexes have been sitting at high levels for some years now. The uncertainty surrounding the renegotiation of the North American Free Trade Agreement (NAFTA) from 2017 to 2018 may have caused entrepreneurs to waver somewhat, but it did not cause their optimism to flag. What is this optimism based on? Can it continue for a long time to come? Everything depends on what is meant by “a long time.” A review of the factors likely to influence the good or bad luck of Quebec companies will help to see things a little clearer and a little further down the road.

### A Quick Overview

According to Statistics Canada, Quebec had 258,676 companies with employees in June 2018. It would be more accurate to refer to establishments, as this is the term used in Statistics Canada’s Business Register. For example, a company with ten branches would be considered as having ten establishments. More than 50% (52.2%) employed 1 to 4 people (graph 1). If you add up all those with fewer than 50 employees, you would see that they represent about 95% of the total. This proportion was practically identical to that seen in Canada as a whole and in Ontario during the same period. It’s impossible to deny that it’s an SME world.

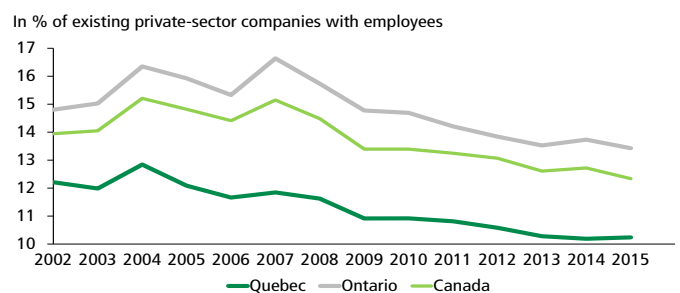
One way to measure the strength of the business sector is to compare the emergence of new companies with those already active. Between 2006 and 2015 (the most recent year), this ratio dropped (graph 2). Following the recession, economic growth was good, but not exactly bustling. This may explain, in part, the slower pace at which companies were being created. An aging population and labour force, as well as a drop in their respective growth rates, may also help to explain this situation. The extremely high number of jobs available due to the increasing number of retirees and the labour shortage also provided a wide variety of career choices. High school, college and university graduates, as well as workers already hired, may have been less inclined to launch their own business.

**GRAPH 1**  
Quebec had 258,676 establishments in June 2018, of which more than 50% employed 1 to 4 people



NOTE: Due to rounding, the total may not be equal to 100.  
Sources: Statistics Canada and Desjardins, Economic Studies

**GRAPH 2**  
The proportion of newly created companies is declining



Sources: Statistics Canada and Desjardins, Economic Studies

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NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.  
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The decline in the number of new business start-ups is a phenomenon that was noted not only in Quebec, but also in Ontario and in Canada as a whole. In 2015 in Quebec, the start-up rate was 10.2% compared to 13.4% in Ontario and 12.3% across Canada. This ratio had been sitting at 11.8%, 16.6% and 15.1% respectively in 2007, just prior to the recession. Since the early 2000s, the rate peaked in Quebec in 2004 (12.8%), whereas the rate in Ontario, and in Canada as a whole, reached its highest level in 2007. Since 2002, the spread between Quebec and Ontario has seesawed. Nonetheless, there has been no indication that this gap has worsened over time.

There is one question worth asking, even if it is impossible to answer: How many businesses would have been created in Quebec if all the efforts of public administrations, business management schools, educational institutions—from elementary schools to universities—and associations dedicated to promoting and supporting entrepreneurship had not been as significant and as sustained over the last few years?

### The Mood of Entrepreneurs

Most confidence indexes consulted reveal a fairly high level, whereas people might have thought the opposite given the rise in protectionism in world trade, especially in the United States, in recent years. You only have to think of the tariffs imposed on lumber, some types of paper, and aluminum and steel, as examples of this. Let's remember that nearly 75% of Quebec's international exports, and 76% of Canada's as a whole, flow to the United States. Since the beginning of 2018, the increased tension surrounding the renegotiation of NAFTA did nothing to reassure Canadian exporters. In fact, it could have dampened their spirits, but this does not seem to be the case.

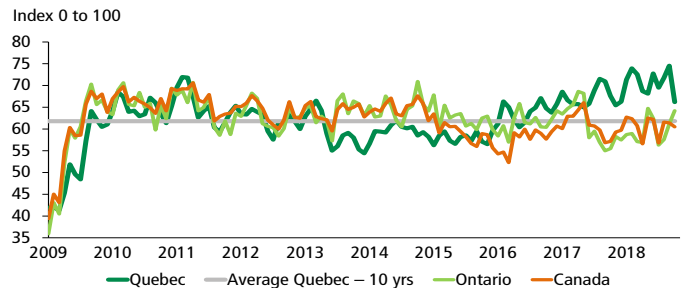
The Business Barometer™ of the Canadian Federation of Independent Business (CFIB) shows that business confidence among Quebec SMEs has continued to rise since June 2017 compared to that of their counterparts in Ontario and across the country (graph 3). It has to be said that, in 2017, Quebec's GDP growth (3.0%) was higher than Ontario's (2.7%).

In addition, since mid-2016, the level of confidence among Quebec SMEs has been considerably higher than the average for the last ten years (61.8%). At 74.5, a record was reached in September 2018 compared to the levels noted since 2008, the year in which the monthly surveys began. Yet, a significant drop is observed in October.

The Conference Board, for its part, looks at the entire country and releases its data quarterly. A reading of the confidence level reveals that the current mark (second quarter of 2018) will not set a record (graph 4). In fact, it is below the average for the last ten years. As the index has changed over the years, it's impossible to deny the impact of the collapse in oil prices at the end of 2014 and the subsequent low prices, which have undermined the optimism of entrepreneurs out west. This has

### GRAPH 3

According to the CFIB, Quebec SME confidence is clearly higher than the average for the last ten years

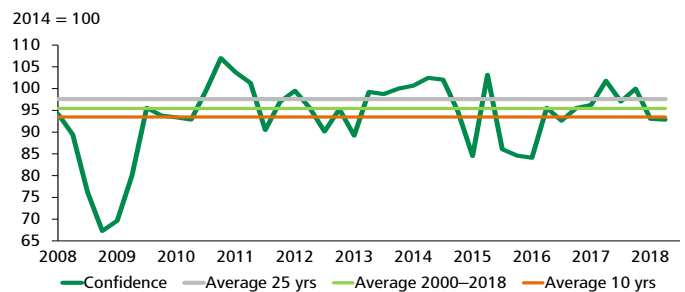


CFIB: Canadian Federation of Independent Business

Sources: Canadian Federation of Independent Business and Desjardins, Economic Studies

### GRAPH 4

According to the Conference Board, Canadian business confidence is slightly lower than the average



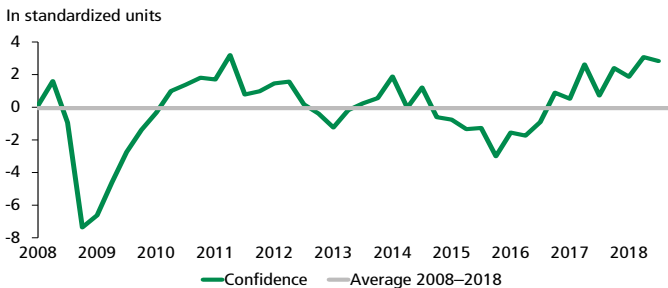
Sources: Conference Board of Canada and Desjardins, Economic Studies

also weighed heavily on the economy overall. The average for the last ten years was affected by the 2008–2009 recession, which has had a greater impact on these ten years than on the average calculated since 2000, or over the last 25 years. This is why it is lower. Nevertheless, despite the concerns raised by the renegotiation of NAFTA (for example, in the automotive sector in Ontario and the aeronautical sector in Quebec), and the disputes surrounding the pipeline projects out west, business optimism has not plummeted, although it has wavered somewhat.

The Bank of Canada (BoC) is also polling entrepreneurs on a quarterly basis (graph 5 on page 3). The analysis revealed that the level of business confidence in Canada did not beat any records during its most recent survey (third quarter of 2018), but it came close. Moreover, the overall index is clearly higher than its average over the last ten years. A rebound began in 2016, when crude oil prices also started to rise (second quarter of 2016).

The BoC detailed some of the components. The sales component for the next 12 months is interesting. Worth noting is that demand from outside Canada appears to please Quebec entrepreneurs, as they expect an even faster rise in export sales next year.

**GRAPH 5**  
**According to the Bank of Canada, business confidence is clearly higher**



Sources: Statistics Canada and Desjardins, Economic Studies

### Elsewhere in the World

Are Canadian, and Quebec businesses in particular, the only ones feeling a little optimistic? In the United States, the small business confidence index of the National Federation of Independent Business (NFIB) has rarely been as high. As for the Institute for Supply Management (ISM – the index of purchasing managers) indexes, the manufacturing component has been growing since September 2016 and, last August, the indicator reached its highest point since May 2004. U.S. companies seem encouraged by the health of their economy, which is supported by government investment, household spending, and tax reform, the main provisions of which took effect at the beginning of 2018. However, nothing indicates that the climate of growth and optimism will continue, given the belligerent trade practices of the last few years.

The business confidence index also remains high in the euro zone. What matters in this case is the Purchasing Managers Index, commonly referred to as the PMI. It has continued to remain fairly steady despite the slower pace of the economy in the first half of the year compared to the six last months of 2017. At the same time, a reduction in the volume of global trade was also noted. Despite the negative trend of these two indicators, the PMI remains in the growth zone. It is currently higher than the pre-recession levels of 2008–2009 and higher than the post-financial crisis level reached as the economy rebounded. Nonetheless, if the picture seems to be rosy, it is less so than at the end of 2017, but there has been no sudden drop.

Recently in China, no change was noted in the trend of the PMIs (manufacturing and non-manufacturing). They remain in the growth zone despite the slower economic growth of its major trading partners to which it exports, especially Europe. As for trade with the United States, the tension is rising due to the current power struggle. The uncertainty is palpable, but discussions are ongoing, which seems to suggest that a negotiated solution may be possible.

This brief overview shows that businesses around the world currently appear to be relatively optimistic.

### Upbeat, but for How Long?

What can sustain the confidence of Quebec companies? In fact, many factors can contribute to maintaining a positive mood among entrepreneurs. Dynamic economic growth is one of them. Added to this is strong household and government spending. The rise in exports and relatively low interest rates are both playing a positive role. Even if rates were raised recently, they are still low compared to the levels that prevailed prior to the 2008–2009 recession. Rising profits are also one of the factors likely to sustain business confidence. However, the past offers no guarantees as to what will happen in the future.

### A Glance at the Upcoming Quarters

The long waiting period surrounding the renegotiation of NAFTA ended on October 1<sup>st</sup>. Preliminary insights into the United States-Mexico-Canada Agreement (USMCA) indicate few upsets for businesses, except for milk, poultry and egg producers. If this agreement eliminates some of the uncertainty, including knowing if access to the U.S. market is still possible without masses of new restrictions, it does not settle everything. In addition, some of the details are still not known.

The Americans were unsuccessful in obtaining an agreement that would be limited to five years. Nonetheless, the USMCA will only remain in effect for 16 years. A review of the provisions is planned after six years, with the possibility of extending the agreement for another 16 years. It's important to remember that NAFTA had no time limit, which leads to the following question: Are 16 years enough to justify a major investment? Yes, for some economic sectors, but is this the case for all types of businesses?

The recent agreement reached with the U.S. and Mexico should not obscure the fact that other major trade agreements were recently concluded, including the one between Canada and the European Union. The Comprehensive Economic and Trade Agreement (CETA) came into effect on September 21<sup>st</sup>, 2017, offering preferential access to the European continent. In addition, the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), often referred to simply as the Trans-Pacific Partnership, opens the doors to ten other Pacific Rim countries. This Agreement will enter into force at the end of 2018. These are business opportunities that extend the horizon while helping to reduce the dependency on the United States.

**Imposed Provisions and Making Them Work**

Some of the provisions that can affect business confidence are imposed. This is the case, in particular, with interest rates. After years of very low key rates (graph 6), a hike is inevitable. The rise in rates has already begun and is not yet over if the speed at which the economy is growing and the signals from the BoC are to be believed. Nevertheless, the increase should be gradual between now and the end of 2019. Moreover, the levels estimated for the end of next year are not expected to reach those that prevailed prior to the recession of 2008–2009. That’s one factor that should not slow down businesses too much. Lastly, it is important to note that current rates are extremely low compared to those in effect in the 1990s and 2000s.

Trump administration, a marked drop in Iranian oil production). Whether we like it or not, U.S. economic conditions have an impact on the entire continent.

The mood of entrepreneurs is linked to global trade. For now, the state of the United States–China relationship does not bode well for greater harmony. However, nothing can be taken for granted, and the question remains as to what extent the links with one or the other of the two countries will be strengthened. How much will the clause stipulating that the USMCA partners must be informed of official free-trade negotiations with a country that has a planned economy (like China) negatively impact the flow of goods and services and, at the same time, the prosperity of Canadian companies? Furthermore, the free trade agreements reached between Canada and two major economic blocks (the European Union and the Pacific nations) present new opportunities for Quebec entrepreneurs.

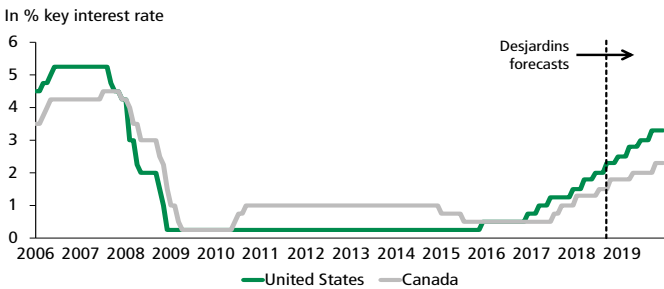
Energy prices, especially that of oil, have a major impact on a number of businesses. Whether it’s for vehicle fleets or heating, prices have undeniably risen over the past year. What will the future bring? For now, our forecasts show WTI prices sitting at less than US\$80 on average, perhaps closer to US\$70 per barrel, for this year and 2019.

What impact will this have on the Canadian dollar? According to our forecasts, the loonie may well remain below US\$0.80 for the coming years. Few factors are favourable to a short-term rise in the Canadian currency: interest rates are rising and will continue to rise slightly faster in the United States than in Canada, Canadian oil prices are not tracking West Texas Intermediate and Brent prices due to the significant restrictions on delivery, and the country’s financial situation is not as enviable as it once was. If the Canadian dollar remains below US\$0.80, this will help to keep Canadian products and services attractive to foreign buyers. However, it would not reduce the cost of imports in any way.

Labour is a factor that could be qualified as being “hybrid.” On the one hand, most of the parameters are imposed “the number of workers in the labour force or the number of graduates, for example”. On the other hand, businesses can make these parameters more “elastic” or “flexible.” By offering on-the-job training or training assistance in the form of subsidized courses, or by setting aside work hours for studying, companies can avoid having to recruit outside their establishment. Internships can also play a role as a “breeding ground for new talent.” Keeping older workers on the payroll longer also helps to amortize the effects of an aging labour force over a longer period of time.

Despite these initiatives, workers are rare and, in some cases, there is truly a labour shortage. At the end of Q2 2018, 84,700 jobs were unfilled in Quebec according to Statistics Canada’s surveys. Between June 2017 and June 2018, the vacant job rate rose from 1.7% to 2.4%. During the same period, the unemployed-to-job-vacancy ratio dropped from

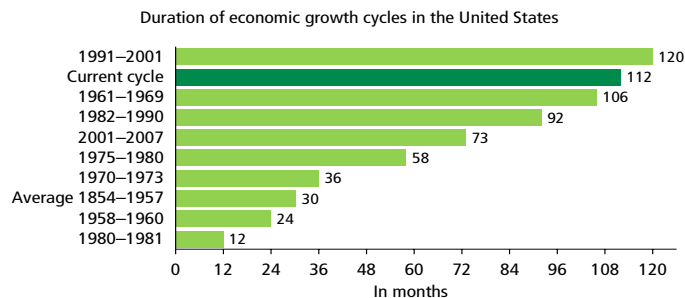
**GRAPH 6**  
Monetary policy tightening continued this summer and further increases are expected



Sources: Datastream and Desjardins, Economic Studies

Economic conditions overall also play a considerable role. Therefore, if the current climate favours business, what can’t be ignored is that the economic cycle that began in July 2009 in the United States has already lasted 112 months. Graph 7 shows that it is the second longest cycle since the United States began compiling GDP data. The record to beat is the 120 months reached between 1991 and 2001. Many risk factors could upset the current situation (e.g. even greater protectionism, geopolitical risks of any kind, the fallout from the policies of the

**GRAPH 7**  
The current growth cycle is already the second longest



Sources: National Bureau of Economic Research and Desjardins, Economic Studies

4.8% to 2.9%. This situation can bring the operations of many businesses to a grinding halt and compromise their growth, something that can weigh on entrepreneurs' level of confidence.

**Internal Factors**

Among the other signs visible for businesses is the industrial capacity utilization rate. However, it is only available for Canada as a whole. This rate has been rising, especially since the second half of 2016. It is true that the recent increase was mostly—but not solely—driven by the mining, oil and gas extraction industry. The forestry sector was the highest of all in the second quarter of this year. This strong industrial capacity utilization rate is an additional indicator of the current business momentum.

As for profits, graph 8 shows that they are rising among Quebec businesses. In fact, this factor should reassure them in their optimism and encourage increased investment in the coming quarters. This situation will require further observation.

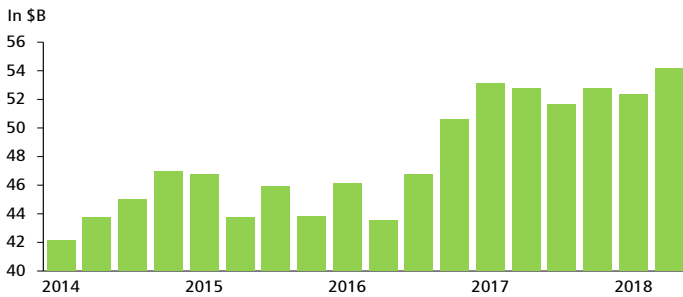
**Confidence: A Combination of Factors**

The level of business confidence hinges on a variety of factors as discussed earlier. Additional factors include the level of inflation, changes in household and government spending or movement in the pricing of the numerous inputs used in production or the delivery of services. However, the parameters covered in this analysis still provide an overview of the main points supporting business optimism.

Generally, a fairly high degree of confidence can be seen throughout Canada and even more so in Quebec. Nonetheless, there are signals that economic and trade conditions are tightening. For example, interest rates are up, international trade frictions are on the rise, the labour shortage is growing, and the current economic cycle may be coming to an end. Should we fear a collapse in business confidence? Not in the very near term if current trends continue unchanged. But let's not fool ourselves: current levels will be difficult to sustain over the long term. As early as next year, we should see the level of confidence decline gradually without plummeting unless the parameters discussed earlier suddenly and irrevocably change.

Joëlle Noreau, Senior Economist

**GRAPH 8**  
**Increased profits for Quebec businesses are expected to continue to support renewed investment**



Sources: Institut de la statistique du Québec and Desjardins, Economic Studies