The summer Business Outlook Survey indicates that overall business sentiment is subdued. The boost from foreign demand remains insufficient to outweigh the continued drag from commodity-related activity combined with modest domestic demand.

Overview

- Forward-looking indicators of sales suggest soft business activity ahead, featuring prominent divergences: prospects remain dim among firms hit most directly by the oil price shock, but are more solid outside the affected regions and sectors. Firms in service sectors are generally more optimistic.

- Firms continue to take advantage of business opportunities in foreign markets, supported by US growth, while expectations for sales growth within Canada are more subdued following weak past sales.

- Investment plans remain cautious, with many firms tied to the energy sector budgeting for further cuts. Plans to increase capital expenditures are more widespread among service-oriented firms. Hiring intentions remain modest overall.

- Capacity pressures edged down in light of weak demand. Firms still see substantial slack in labour markets.

- Growth in both input and output prices is expected to stabilize, reflecting competitive pressures and diminishing exchange rate pass-through. Medium-term inflation expectations remain concentrated in the Bank's inflation-control range.

- After a net tightening in the spring survey, credit conditions moved toward an easing.
Business Activity

The balance of opinion on past sales growth reached zero in the summer survey, indicating a flattening of sales growth over the past 12 months (Chart 1). Economic activity in commodity-related regions remains anemic; many firms in sectors such as resources and construction experienced a drop in their sales volumes. Yet, service firms cited more robust sales performance, in part reflecting efforts to refocus their sales strategies and to gain market share.

Chart 1: Firms saw a flattening of sales growth over the past 12 months...

Balance of opinion¹
Over the past 12 months, did your firm’s sales volume increase at a greater, lesser or the same rate as over the previous 12 months?

Greater: 43%  Same: 15%  Lesser: 43%

a. Percentage of firms reporting faster growth minus the percentage reporting slower growth
* Indicates a balance of opinion of zero

Businesses expect a marginal acceleration in sales growth, with the balance of opinion falling to just above zero (Chart 2, blue bars). Indicators of future sales, such as new orders and bookings, improved very little compared with a year ago (Chart 2, red line; see Box 1 for indicators of future sales from both foreign and domestic customers).¹ The moderation in future sales expectations was concentrated among firms in the Prairies, which see few signs of a recovery from the oil price shock. In other regions, steady, albeit modest, domestic momentum is providing support to firms’ sales outlooks. In a number of cases, however, expectations of an acceleration merely reflect the view that domestic sales growth will not deteriorate further or will modestly increase over the next 12 months.

The United States remains an important source of strength in the summer survey, and the majority of firms, including firms in the service industries, expect to benefit from demand south of the border. Growth of export sales is generally expected to accelerate, supported by the past depreciation of the Canadian dollar. For many firms, however, foreign demand is insufficient to offset weakness coming from their domestic customers, and, in some cases, refocusing sales efforts toward export markets is proving difficult. Many firms with an established US customer base anticipate a moderation in foreign sales growth following above-average strength over the past year.

¹ For background information on this series, which is being made available to the public for the first time in the 2016 summer survey, see the “Backgrounder on the Business Outlook Survey Question on Future Sales Indicators,” available on the Bank’s website at http://www.bankofcanada.ca/wp-content/uploads/2016/07/backgrounder.pdf.
While still pointing to an increase over the next 12 months, the balance of opinion on investment in machinery and equipment remains subdued (Chart 3). The main drag comes from firms headquartered in the Prairies, where weak commodity prices continue to depress investment budgets. Overall, modest domestic demand, uncertainty and insufficient foreign demand are key factors holding back investment intentions. While firms judge that the boost to their sales from US growth is lending support to their investment plans, investment intentions are modest for exporters, even those unaffected by commodity prices. Businesses in service sectors continue to benefit from the lower Canadian dollar and are more willing to proceed with investment plans, including expenditures on information technology and expanded operations.

**Chart 2: ...and expect a marginal acceleration over the next 12 months**

Future sales (balance of opinion): Over the next 12 months, is your firm’s sales volume expected to increase at a greater, lesser or the same rate as over the past 12 months? Indicators of future sales (balance of opinion): Compared with 12 months ago, have your recent indicators (order books, advance bookings, sales inquiries, etc.) improved, deteriorated or remained the same?

a. Percentage of firms expecting faster growth minus the percentage expecting slower growth
b. Percentage of firms reporting that indicators have improved minus the percentage reporting that indicators have deteriorated

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**Chart 3: Investment intentions are modest overall**

Balance of opinion: Over the next 12 months, is your firm’s investment spending on M&E expected to be higher, lower or the same as over the past 12 months?

a. Percentage of firms expecting higher investment minus the percentage expecting lower investment
The balance of opinion on employment is positive, with firms generally planning to add jobs over the next 12 months (Chart 4). Yet, hiring intentions remain below post-recession levels and diverge sharply. Plans to reduce staff are particularly prominent among firms in the goods sector, including, for example, construction and manufacturing firms that are part of the energy supply chain. On the upside, firms in service industries, such as consumer and business services and real estate, intend to address capacity constraints and accelerating sales growth by increasing their workforces.

**Chart 4: Hiring intentions remain below post-recession levels**

Balance of opinion\(^a\)

Over the next 12 months, is your firm’s level of employment expected to be higher, lower or the same as over the past 12 months?

![Chart 4](BOS - 2016-07 - Chart 4 - EN.indd)

Higher: 43%  
Same: 36%  
Lower: 22%

a. Percentage of firms expecting higher levels of employment minus the percentage expecting lower levels

**Pressures on Production Capacity**

The share of firms that would have difficulty meeting an unanticipated increase in demand edged down and remains below the survey average (Chart 5). Limited capacity pressure was often associated with readily available labour and weak demand, but a few firms also reported that recent investments have expanded their capacity. Firms operating at or above capacity most often referred to physical constraints that limit their ability to ramp up production. These firms reported generally stronger investment and employment intentions to accommodate growing demand for their products.

Both indicators of labour shortages continue to point to substantial labour market slack (Chart 6). The number of firms reporting that labour shortages are restricting their ability to meet demand is almost unchanged in the summer survey and is at a low level (Chart 6, blue bars). In all regions, with the exception of British Columbia, where the outlook is more favourable, businesses judge that labour shortages are less intense, on balance, than they were a year ago (Chart 6, red line). Firms in regions deeply affected by the oil price shock find it easier to staff positions following the sizable layoffs in the industry.
Prices and Inflation

The balance of opinion on input prices fell to just below zero in the summer survey, suggesting that firms anticipate roughly stable input price growth over the next 12 months (Chart 7). With the current level of the Canadian dollar now largely built into the prices of imported inputs, firms expect less upward pressure on these costs. While subcontractors had to substantially reduce their fees in light of weak demand from the oil and gas industry, several businesses indicated that they do not expect further concessions. Many firms also expect a recovery in commodity prices to drive cost growth for commodity-related inputs.
Mimicking the movement of the input price indicator, the balance of opinion on output prices turned marginally negative, signalling that firms expect output price growth to stabilize over the next 12 months (Chart 8). Competitive pressures are expected to put a damper on price growth, particularly for firms struggling for market share in the face of anemic activity in the energy sector. Diminishing upward pressure from the exchange rate also implies slower price growth ahead. But firms also pointed to factors driving an acceleration in price growth, including the recovery in commodity-related costs, such as the prices of oil, fuel and metals that firms plan to pass on to their customers.

**Chart 7: Firms expect roughly stable input price growth over the next 12 months...**

Balance of opinion<sup>a</sup>

Over the next 12 months, are prices of products/services purchased expected to increase at a greater, lesser or the same rate as over the past 12 months?

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**Chart 8: ...and also little change in output price growth**

Balance of opinion<sup>a</sup>

Over the next 12 months, are prices of products/services sold expected to increase at a greater, lesser or the same rate as over the past 12 months?

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<sup>a</sup> Percentage of firms expecting greater price increases minus the percentage expecting lesser price increases.
Expectations for inflation over the next two years are largely unchanged from the previous survey and continue to be concentrated within the Bank’s 1 to 3 per cent inflation-control range (Chart 9). The majority of firms expect total CPI inflation to be in the lower half of the range, citing soft demand conditions and weak energy prices. Nevertheless, some firms anticipate that a rebound in oil prices will feed through to higher gasoline prices and expect that food prices and the low level of the Canadian dollar will contribute to higher inflation.

**Chart 9: Inflation expectations are little changed**
Over the next two years, what do you expect the annual rate of inflation to be, based on the consumer price index?

Credit Conditions
Following a tightening in the spring survey, the balance of opinion on credit conditions moved back toward an easing (Chart 10). Firms reporting an easing often cited improved market receptiveness to new debt or equity issuance compared with the volatile period at the start of the year. While the vast majority of firms characterize credit as easy to obtain overall, reports of a tightening in conditions are concentrated in the oil and gas and related industries.

**Chart 10: Credit conditions moved toward an easing**
Balance of opinion
Over the past three months, how have the terms and conditions for obtaining financing changed (compared with the previous three months)?

a. Percentage of firms reporting tightened minus the percentage reporting eased. For this question, the balance of opinion excludes firms that responded “not applicable.”
Demand from Foreign Customers Is Outperforming Domestic Demand

Since the third quarter of 2003, firms participating in the Business Outlook Survey have been asked about their indicators of future sales, such as order books and advance bookings. Since 2014, firms have also been asked to assess these concrete signs of demand from both their foreign and domestic customers. The results suggest that over the past two years, firms have generally seen more solid indications of demand from their foreign customers (Chart 1-A). Businesses often referred to healthy US demand for their products, in part because the depreciation of the Canadian dollar has allowed more competitive pricing.

In the summer survey, businesses continued to report improved indicators of future sales from their foreign customers, as reflected in the positive balance of opinion (Chart 1-A, red bars), although the measure decreased over the past few surveys. In line with these responses, businesses expect an acceleration in exports over the next 12 months. Several firms have already focused their sales efforts on foreign markets, while others reported plans to enter international markets, in part to offset soft domestic demand. Some exporters also indicated that the above-average growth of foreign demand over the past year will likely not be repeated.

Businesses see little improvement in signs of domestic demand (Chart 1-A, blue bars), with the indicator hovering around zero over the past few surveys. Firms exposed to subdued commodity-related activity along the supply chain continue to struggle. Nevertheless, some firms are experiencing stronger domestic demand. These include firms that are now competing more favourably with imports—in retail trade, for example—since Canadians now tend to shop locally rather than across the border. Several domestically oriented firms also reported benefiting from improving tourism and the strength in some regional real estate markets.

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**Chart 1-A: Indicators of future sales from domestic and foreign customers**

Balance of opinion\(^a\)

Compared with 12 months ago, have your recent indicators of future sales from foreign and domestic customers improved, deteriorated or remained the same?

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\(^a\) Percentage of firms reporting that indicators have improved minus the percentage reporting that indicators have deteriorated. For this question, the balance of opinion excludes firms that responded “not applicable.”