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Aerospace Industries—Business Conditions 2004/05

The U.S. Deficit & Political Considerations Rise in Importance

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The expectation of an improving outlook for business through 2004 and into 2005 reported in December 2003, appears to have stalled. This is reflected in the views of the 51 respondents to the *Aerospace Industries Association of Canada's* second quarterly *Business and Employment Conditions Survey*. The key questions about the business, employment and sales outlooks suggest that respondents feel that further improvement is less likely than they did just a quarter ago.

In other words, the improvement that was expected last quarter has occurred or simply not materialized leading to a more pessimistic outlook. This is a key finding and it has troublesome implications for the industry's employment outlook and profitability.

The improvement in overall business conditions, unfortunately, seems to be behind us.

To illustrate, while business conditions in 2004 were seen to be on the upturn by some 67 per cent of our respondents in 2003Q4, this dropped to 61 per cent in 2004Q1. More troubling, the proportion expecting no change rose from 21 to 31 per cent. Similarly, when asked about their outlook for employment over the coming year, the proportion seeing an increase fell from 58 per cent to 31 per cent over the same period; those expecting no change rose from 37 per cent to 53 per cent. Finally, the sales outlook weakened with 16 per cent expecting lower sales compared with 7 per cent last quarter. Better sales were expected by two-thirds of respondents in late 2003; now only 51 per cent expect better sales.

One of the challenges for Canadian Aerospace firms is to grow their businesses with only a small domestic market. The survey attempts to garner a sense of the regions where sales and plant expansion will occur in the coming year. This component will become more robust as further data are collected, but some preliminary comments are in order, keeping in mind that the firms are based in Canada and many are multi-nationals.

The survey again indicates that the United States is seen as the most promising growth market. Forty-two per cent of respondents expect to see their sales growth occurring only in the U.S. Those expecting Canada and U.S. together comprised 9 per cent, while those seeing Canada alone comprised 16 per cent. In other words, fully two-thirds see North

America as their market for growth. This was down about 10 percentage points from the previous quarter largely because the respondents indicated they were looking to other markets. It is too early to tell whether, in fact, businesses are actually going to diversify their sales beyond North America.

Plant expansion remains targeted at Canada for most firms.

Perhaps a more important set of responses relates to the expected growth in physical operations in the coming year. To illustrate the point, one respondent noted:

“New business programs are being affected by the uncertainty of the R&D/Capital government support regime in Canada and the limited initiatives in Ontario . . . (these policies) will play a significant role in . . . the potential addition of new capabilities.”

Forty firms indicated an expansion plan, and Canada remains the most common response with 20 firms planning expansion here, essentially the same as in the December 2003 survey. Those responding that they would expand only in United States changed slightly from 5 to 7 firms over the two surveys, while 5 said both countries. The other responses encompassed a variety of choices with some indication of expansion in Europe being slightly more common—but in the end, 80 per cent look to expand in North America.

The U.S. market is clearly the one with the greatest focus for exports, reinforcing the importance of supportive national relationships between the two countries. This is perhaps why there was a significant increase in respondents indicating that political trends at home and abroad are hurting their business prospects.

The extent to which the Canadian aerospace industry depends on the U.S. marketplace is among the most significant of any Canadian industrial sector. The indication that domestic and foreign political concerns are rising in the minds of respondents is worrisome for the future of business and employment growth in Canada (see Box: **Special Factors Hurt the Business Outlook**).

Note to Readers

This survey was carried out among 107 AIAC members in the second week of March 2004. Fifty-one companies responded, employing some 37,500 employees. This is the second quarterly survey and we hope that the feedback is useful as you adjust your business plans for 2004. As further surveys are completed we will be presenting indices of the key responses to facilitate an understanding of the trends our members are expecting.

We want to thank everyone for responding and hope that the response rate will continue to rise. The next survey will be done in mid-June, 2004. Your Association will be building a database of quarterly results that will enable it to raise the profile of the industry and promote policy change through its regular communications program.

Special Factors Hurt the Business Outlook
The U.S. Deficit & Political Considerations Rise in Importance

The Survey identifies ten factors that can affect the business environment. While respondents could select multiple factors, the most frequently selected negative factor was the “high value of the Canadian dollar”, selected by 43 of 51 respondents, with “foreign political trends” getting 27 responses and “domestic political trends” getting 24 responses. These factors are interlinked.

The previous survey dealt with the Canadian dollar and, since then, not much has changed. Interest rates have been cut once and more cuts can be expected because the negative impact of the high Canadian dollar will become clearer as the months pass.

In fact, this is a key finding of this Survey. Compared with the previous one, a higher percentage of firms indicated the value as a negative factor. This indicator of a change in the mood suggests that companies are now, as time is passing, finding the U.S. \$0.75 Canadian dollar more troublesome. At the moment the outlook is for a currency at about U.S. \$0.74 for the year, compared with U.S. 64 cents in 2002 and U.S. 72 cents in 2003.¹ Little change is expected throughout the next three quarters.

As the Aerospace industry looks to the U.S. to increase its sales, the outlook for business there is critical. Although GDP growth is expected to be about 4 per cent, the catch for aerospace is that the financial state of the U.S. airlines remains weak further delaying their purchases of new aircraft. Further, the U.S. government is deeply in deficit and this could cause the curtailment or downsizing of current military programs and the deferment of new ones.

Given the November 2004 election, there will be little effort to restrict government spending in the short term, but businesses should expect significant restraint to be imposed on military spending over the next few years. The impact on business is illustrated by the F-22 Raptor which is significantly over budget with unit costs expected to be about U.S. \$250 million. This will lead to fewer aircraft being produced and less business than otherwise. Note that some major U.S. programs have recently been cancelled—the latest being the Comanche Helicopter Program, cancelled after spending U.S. \$ 6.9 billion out of a program estimated at U.S. \$39 billion.

It is clear that the U.S. will start cutting its U.S. \$450 billion fiscal deficit. As a result, the military contracting environment can be expected to become tougher, perhaps especially for Canadian-based firms. This is what probably lies behind the response of so many that foreign and domestic political trends are hurting their business.

¹ The forecast data and exchange rate outlook are based on The Conference Board of Canada, Quarterly Canadian Forecast, February 2004.