



Inside...

Executive summary

..... 1

Structural challenges & opportunities

..... 2

Continued consolidation 2

Small business restructuring 3

Interpreting liquidity 4

Forecasts for business finance

..... 5

Business lending 5

Long-term financing 7

Business deposits 7

Credit quality 8

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Outlook for North American business finances

Recent developments in U.S. business banking markets provide an abundantly clear warning to Canadian business bankers of how abruptly their own market could change course. Rapid liquidity redeployment has swung U.S. corporations away from record net surpluses of internally generated funds towards net funding needs that are being met by backing into short-term lines, but at the same time issuance conditions have worsened. U.S. liquidity redeployment has also bled business deposits dry and killed off issuance activity at the same time that business investment trends have softened. Slower profit growth and robust merger and acquisition (M&A) activity have been among the culprits. The overall result is that key supports for credit quality have weakened somewhat. Canada is not yet experiencing such developments, but the danger is there, particularly given a much higher starting point on liquidity hoarding by businesses.

In Canada, our near-term cyclical forecasts call for a continued gentle deterioration in credit quality driven by the lagged effects of higher debt servicing costs, a slowdown in profit growth and continued debt growth. This deterioration takes the industry off the best credit quality conditions in many years but still leaves behind generally sound quality conditions. Canadian loan origination trends should remain favourable for most small, mid-market and capital market borrowers into 2008 as businesses continue to require net working capital financing chiefly driven by inventories. Excess liquidity will, however, continue to constrain long-term financing while posing risks of a sharp, U.S.-style slowdown in current accounts growth through liquidity redeployment.

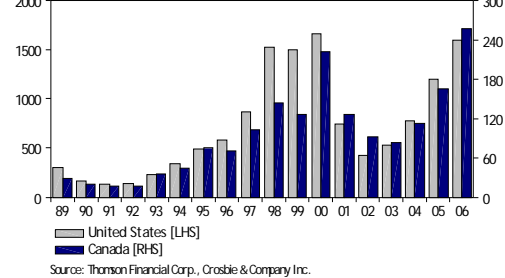
In a longer-run sense, Canada's business community is facing a unique confluence of forces leading to a major restructuring that carries significant implications for different borrower-size categories. The focus within the Canadian market is on gradually building economies of scale and scope, which is being manifest in numerous ways. First, small and medium-sized enterprises (SME) continue to shift gears away from the 1990s-style focus on rapid rates of start-ups and job creation towards consolidating further upstream and addressing their productivity challenges. Second, Canada's public companies are for sale like no other country in the world. A globalized M&A boom is partly behind this trend, but the real issue is the country's inability to grow firms from a SME base to larger publicly listed firms with greater economies of scale and financing capacity.

Taken together, these themes mean that the long-run sweet spot in financing activities may well lie in the middle market. As SMEs consolidate and move upstream, they will carry the greatest potential for acquisition financing, advice

CHART 1

Merger & acquisition activity

Value of announced merger deals (\$billions, local currency)

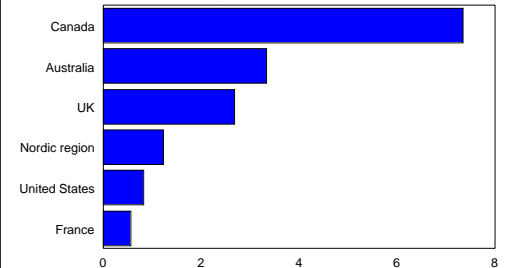


Source: Thomson Financial Corp., Crosbie & Company Inc.

CHART 2

Public company targets

value of public targets as % of stock market capitalization, 2006

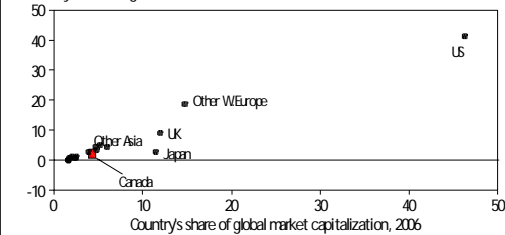


Note: Nordic region includes Sweden, Finland, Denmark, Iceland
Source: Thomson Financial, MSCI Barra, RBC Economics Research

CHART 3

M&As are proportionate to the size of a country's stock market

country's share of global M&A deal values, 2006

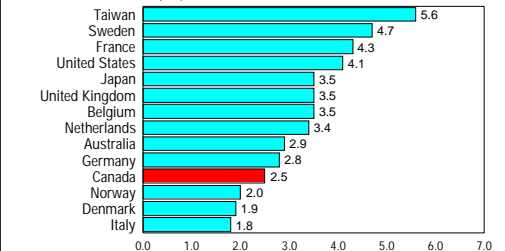


Source: Mergers and Acquisitions Review (Q1 2006), Thomson Financial, MSCI Barra Global Capital Markets Yearbook 2006, RBC Economics Research

CHART 4

Productivity growth

average annual growth in manufacturing output per hour worked, 1979-2005



Source: U.S. Bureau of Labour Statistics, RBC Economics Research

on succession planning and general lending opportunities. The best thing policymakers can do is to reduce policy distortions that drag out this transition.

1. Structural challenges and opportunities

There are three particularly relevant structural themes influencing our business banking forecasts before turning to the cyclical drivers at play. How historically high levels of corporate liquidity will continue to be managed is an issue that will be addressed in the context of how it influences markets in both countries.

But, first, consolidation trends are worth exploring in both markets. It is certainly no secret that both Canada and the United States are in a merger and acquisition (M&A) boom. Canada just set an all-time record for M&As in terms of the raw number of deals and on a total deal value basis (chart 1). The United States fell just shy of the tech-laden record set in 2000. Whether this will continue and the related implications are key issues governing the outlook for business finances.

We think it will continue more in Canada than in the United States, but at a less aggressive pace with the M&A peak being behind us. The classic drivers of M&A activity are still strongly aligned. High corporate liquidity is a double-edged sword in providing cash war chests to be used or picked off by cash-hungry competitors. Still, low debt-to-equity ratios provide room for capturing interest tax shield effects in a decent overall economic climate. Enhanced foreign competition and relatively high energy prices for industrial users create further incentives to cut costs. In Canada, competitive pressures brought on by a high currency reinforce these consolidation effects. Also, record-high profit-to-GDP ratios in both countries face downward pressure and, hence, cost cuts.

Most of the consolidation focus will be on Canada where the composition of growth opportunities within individual borrower-size segments may be fundamentally shifting. The first sub-theme is the impact on the upper tier of the market before considering the forces that are reshaping SME markets.

1.a. Canadian consolidation and the impact on the upper tier

Canada is now witnessing the acquisition by foreign firms of a very disproportionate share of its public companies (chart 2). Further, foreign acquirers bought publicly and privately listed firms equal to about 18% of domestic stock market capitalization last year. Big cross-border M&A transactions also make headlines stateside, but are less prevalent compared to a much larger market and even in absolute terms. This likely speaks to a lack of depth in Canadian public markets. Proof of this is the fact that Canada's share of global M&A deals is actually a touch smaller than its share of global stock market capitalization, but the market is in line with the global relationship between these two variables (chart 3).

Why is this happening to Canada and is it a source of concern? The 'why' part is easier to address. Elevated commodity markets are one factor, and Canada has many of the natural resources that the world wants. Further, foreigners may see value in Canadian companies by way of underutilized potential reflected in one of the poorest long-run productivity growth performances in the industrialized

world (chart 4). Indeed, the evidence shows that foreign-owned manufacturers in Canada operate at higher levels of productivity and invest more than domestically owned manufacturers. Much higher corporate liquidity in Canada than in the United States also creates attractive targets across many industries.

Whether or not to be concerned can be addressed from three angles. First, we can't simply look at one-way deal flows. It is still the case that, on net, more Canadian firms buy foreign firms than *vice versa* (chart 5). However, in net value terms, more Canadian firms have been snapped up by foreigners — principally non-U.S. — in each of the past two years. So, studies that look at very long-term trends in this measure totally ignore a potential recent shift in the market - and one that may actually become accentuated by questionable efforts in the recent Federal budget to end interest deductibility on debt used to acquire shares of foreign affiliates. Second, if foreign firms see synergies or untapped value in corporate Canada, then let the market work. In a third sense, however, we would argue that there should be concern about the country's inability to grow a deeper pool of top-tier global corporations. Larger firms operate at higher levels of productivity, invest more and spend more on R&D — all pluses for long-run living standards, which have gone down by one-sixth compared to the United States in the past quarter century. What to do about it is explored further in the next section. The outcome, however, is that financing opportunities related to top-tier Canadian firms face retention risks that may well challenge Canadian investment dealers in the home market as growth drivers shift towards private equity and mid-market financing.

1.b. Canadian small business consolidation pressures

Another angle that is likely to shape business financing markets and related services in the years ahead is ongoing evidence that the consolidation being witnessed in Canada is not simply confined to relatively large, publicly listed firms. In fact, the lion's share of the wave of consolidation goes totally unreported by the mainstream business press; the vast overwhelming majority of deals across almost all industries during last year's record volume were valued at under \$100 million (charts 6, 7).

This is not likely to end any time soon. Small and medium-sized businesses are shifting onto a different growth stage.¹ The 1990s were all about rapid small business creation driving rapid gains in self-employment at high-cost firms that suffered from weak productivity. This is one of the few areas in which demographic analysis is useful since business formation rates tend to peak when people are in their 40s and 50s and this relationship is stable over long periods (chart 8).² As boomers moved into this age bracket, they fed rapid start-up rates. Now that they are moving beyond this age bracket, the emphasis is shifting to a consolidation and succession agenda. This suggests that business start-up rates will remain relatively soft compared to last decade's peak. Macroeconomic drivers have also changed. In earlier periods, the powerful combination of cheap energy, plentiful labour, and currency depreciation benefited small busi-

¹ "Small and medium-sized businesses driving productivity gains," RBC Economics Research, October 2006.

² "The pros and pitfalls of applying demographic analysis to the financial services industry," RBC Economics Research, March 2007.

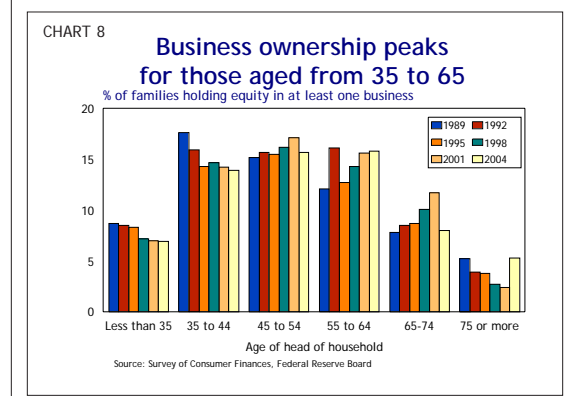
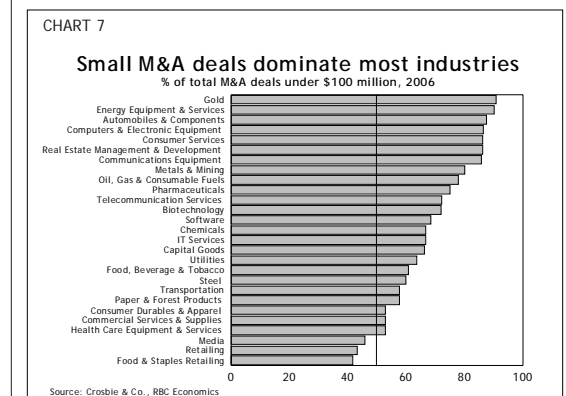
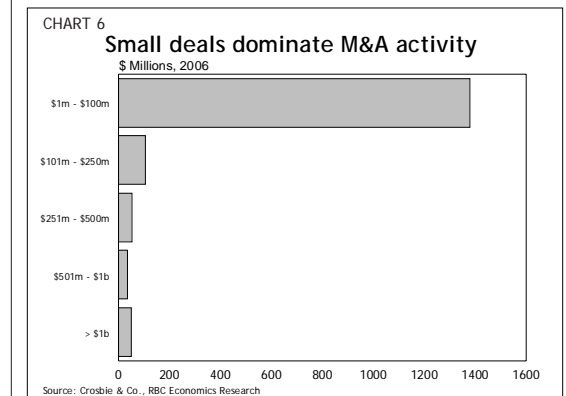
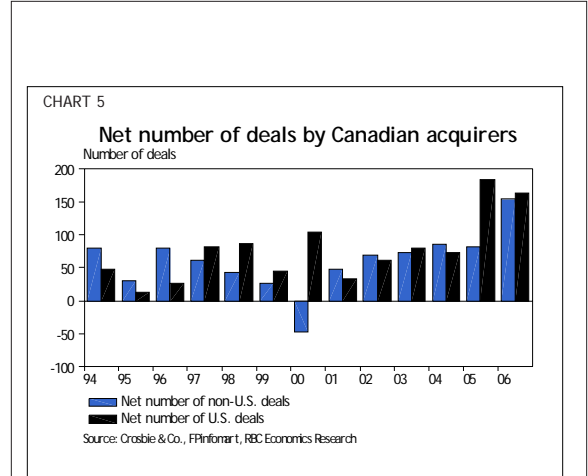


CHART 9
Canadian businesses move upstream

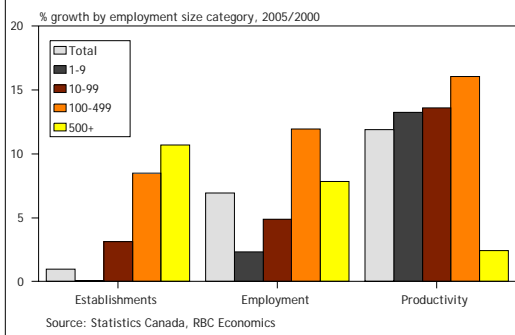


CHART 10
Corporate liquidity

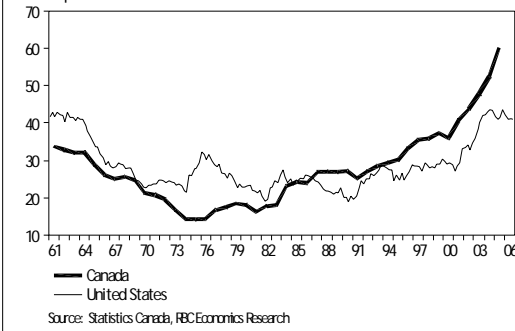


CHART 11
The financing gap at Canadian businesses

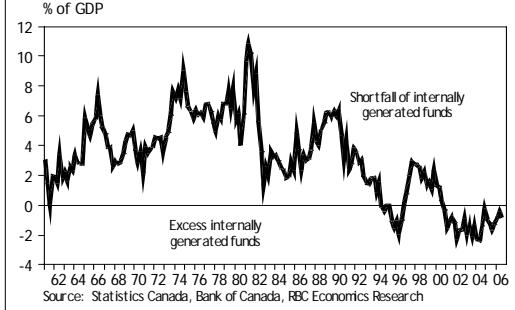
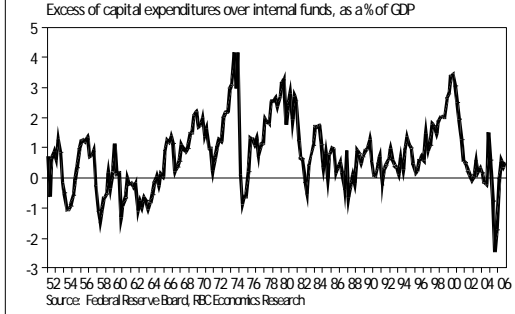


CHART 12
U.S. financing gap for nonfinancial business



ness start-ups. These drivers have shifted. What currency appreciation has done in Canada is cheapen the cost of capital investment relative to labour — since most capital goods are imported from the United States — which disproportionately affects smaller businesses that are more reliant upon labour inputs.

Very slowly and incrementally, this means that business opportunities are shifting towards consolidation financing, succession planning and financing growth oriented small and mid-market firms. Witness chart 9. So far this decade, while small businesses are still being created in terms of absolute numbers - in no small part due to vastly preferential tax treatment - the net percentage pace at which they are being created and driving job growth has markedly slowed as firms move upstream. Hence, the pace at which medium- and large-sized firms are being created has gathered steam. Over time, this should also grow the pool of top tier firms and broaden out opportunities for capital markets financing. To speed this up, market friendly public and private policy changes that invest in the removal of barriers that constrain SMEs from moving upstream faster would benefit living standards — since it would likely mean more businesses at higher levels of productivity offering higher wages — and develop more diversified and deeper capital market, mid-market and SME opportunities.

1.c. Interpreting liquidity: The fleeting return of the 'Golden Era'

There is arguably not a single more important factor governing the outlook for business finances than how very high business liquidity is being managed. It is an issue that speaks to expectations about whether the current global M&A boom will continue, the future strength or weakness in short- and long-term origination of financing instruments, expected credit quality and credit pricing.

Economists and bankers are struggling with this issue as corporate balance sheets are in straits not travelled since the so-called 'Golden Era' of the 1950s and early 1960s. Consider some of the evidence. Canadian corporate liquidity is firmly in record territory since as far back as we have data (chart 10). U.S. corporate liquidity has recently come off the highest level since the 1950s and early 1960s and was never as high as in Canada. Profits scaled to the size of the economy are at record highs in both countries. The debt-to-equity ratio has been brought sharply downward in both countries, but particularly in Canada where it still remains very low while the U.S. ratio has backed up somewhat. The net surplus of internally generated funds over investment uses was floating around its highest levels since as far back as we can look. It is now being reined in more aggressively stateside than in Canada (charts 11, 12). Productivity growth in the United States has been the best in decades but is now waning in both countries. The inventory-to-sales ratio is hovering near record lows in both countries, serving to relatively stabilize the economy while reducing costly financing charges. Lastly, low and stable inflation in both eras lowers the opportunity cost of holding cash and reduces incentives to take on debt.

With all of this, perhaps corporate bond spreads were not unsustainably low last year and could have been even tighter. That would have put them more in line with the truly razor-thin spreads of the 'Golden Era' (chart 13). The case for this interpretation has weakened somewhat given recent U.S. liquidity redeploy-

ment. This issue is particularly important to Canadian business financing markets given the much higher degree of liquidity across many industries here than stateside. The surge occurred partly due to rising commodity prices that benefited corporate Canada more than the U.S. corporate sector, but also because of a marked shift in risk aversion and the parking of idle liquidity on Canadian corporate balance sheets, mostly in 2003 before commodity prices really took off. Yes, risks grew or emerged, including C\$ appreciation, rising energy prices and foreign competition, but freezing liquidity cannot go on indefinitely before firms readjust and invest at an even faster clip, higher dividends get paid out, shareholder activism takes over, and potential foreign and domestic suitors start to line up. In our view, Canadian corporate liquidity is still unsustainably high. This is a relative plus for Canadian corporate credit quality, but its redeployment means a weaker support for credit quality stateside. It also means that Canadian companies will continue to be attractive bait in global markets. It is also a factor that is *relatively* constraining financing opportunities in the Canadian market.

The key lies in the speed with which one thinks idle liquidity will be redeployed. Our operating assumption last year was that it would start to be gradually redeployed, but that a rapid reversal was a material risk as has happened in the United States. If we are right about the North American economy reaccelerating through 2007 and 2008, then that should strengthen the forces driving liquidity redeployment on both sides of the border. Among other implications, this raises the risk that funding may well get pricier for lenders.

2. Forecasts for business finances

Beyond the structural and cyclical market influences discussed so far lie more detailed cyclical drivers of product growth and credit quality trends in North American business financing markets that bring it all home.

Each core business financing and deposit product has specific drivers linked to economic developments that are discussed and that go well beyond crude relationships to very aggregated indicators like growth in GDP and population. The latter set of indicators commonly throw off false signals. One of many examples would have been to use weak GDP growth as a planning variable when the U.S. investment bubble popped at the start of the decade, which would have grossly underestimated mortgage prospects as housing and consumer markets continued to perform well, while overestimating business lending opportunities that collapsed.

Detailed forecasts by product for 2007-2011 are presented in tables 1 and 2 for both countries. Further ongoing risks from liquidity redeployment relate to credit spreads. Central banks around the world have been gradually withdrawing liquidity from the markets for some time now with a general upward bias in global short-term interest rates that hasn't been confined to just Canada or the United States in the past two years, but also the end of zero-money in Japan and recent rate hikes in the United Kingdom and Eurozone, with perhaps more to come. This poses a danger to credit pricing given the correlation between financial market volatility and global liquidity growth (chart 14) and has created conditions ripe for sudden swings in sentiment that will continue to be a risk during 2007-08.

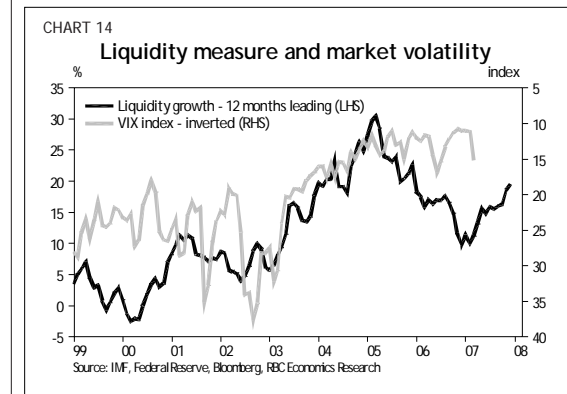
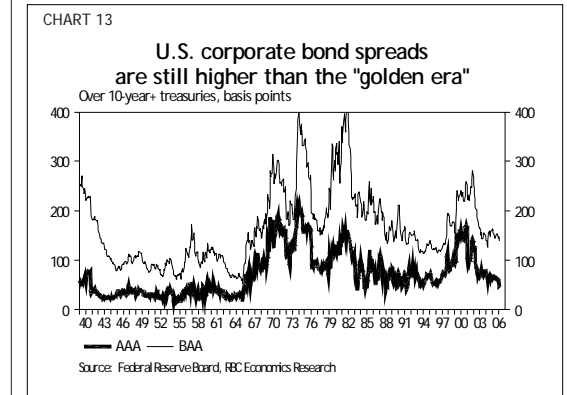


TABLE 1

Outlook for Canadian business banking markets
Year-over-year % change in outstanding industry-wide balance, fiscal-year basis

	2004	2005	2006	2007	2008	2009	2010	2011
1. Total business financing	5.1	7.1	4.9	5.4	5.1	6.0	5.2	5.4
2. Short-term business credit	2.1	8.4	10.9	10.0	8.0	6.5	7.5	7.0
3. Banks	4.4	8.0	11.9	9.0	7.5	7.0	6.0	5.0
4. CS bank loans	7.2	9.6	6.8	7.0	6.0	6.5	4.5	4.0
5. SME loans	1.7	1.8	7.0	5.5	5.0	4.0	2.0	3.0
6. Small bus. loans	1.1	0.3	3.9	4.5	3.5	4.0	3.0	2.0
7. Commercial paper	-13.6	-2.4	-14.0	-3.0	2.5	4.5	5.0	6.5
8. Long-term business financing	6.3	6.6	2.7	3.2	3.7	5.7	4.1	4.6
9. Equities	4.2	2.8	0.5	2.5	3.0	7.0	5.0	6.5
10. Bonds	3.8	4.2	-1.5	4.0	5.0	6.0	3.0	3.5
11. Commercial mortgages	5.4	7.2	6.5	8.0	7.0	6.5	8.0	6.0
12. Lease receivables	15.6	14.5	1.9	3.5	6.0	9.0	10.0	8.0
13. Current accounts	12.1	11.6	13.9	8.5	7.5	8.0	6.0	6.0

2. CS and foreign exchange loans at all intermediaries, commercial paper and bankers acceptances
3. Banks' CS & forex loans plus accept 6. CS loans under \$1 million authorization limit
5. CS loans under \$5 million authorized 7. Issued by non-financial corporations

TABLE 2

Outlook for U.S. business banking markets
Year-over-year % change in outstanding industry-wide balances

	2004	2005	2006	2007	2008	2009	2010	2011
1. Total business credit	8.2	9.2	3.4	5.1	8.5	8.0	8.3	7.7
2. Short-term business credit	0.6	7.9	8.5	9.0	7.0	6.5	6.0	7.0
3. Commercial bank C&I loans	1.5	12.7	15.4	12.0	10.0	6.0	7.0	6.0
4. Long-term business credit	8.8	9.3	3.0	4.8	8.6	8.2	8.5	7.7
5. Bonds	2.1	2.6	5.3	7.0	9.0	7.0	8.5	8.0
6. Equities	11.3	11.1	0.3	3.0	8.5	9.0	9.5	8.0
7. Commercial mortgages	11.5	13.1	12.5	9.5	10.0	8.0	7.0	8.0
8. Finance company loans	1.5	3.1	8.7	4.5	7.0	5.0	3.0	4.0
9. Cash and chequable deposits	6.9	-24.2	-52.4	-60.0	7.0	5.0	4.0	4.0

1. Extended to domestic firms only, except where specified
3. Includes C&I loans to both domestic & foreign firms
Source: Federal Reserve Board, RBC Economics Research

2.i. Business lending

Our base case view is that lending opportunities in Canada and the United States will see some of the fastest growth in years in 2007-08. A low inventory-to-sales ratio and accelerating economic growth should be mutually reinforcing in terms of driving an expansion in net working capital financing requirements at least in sync with sales. Strength in Canadian business investment in machinery and equipment, particularly with matched short- or medium-term economic lives, is also an important driver of short-term borrowing and will be discussed in the context of capital markets funding for longer-term M&E spending. Recent weakness in U.S. machinery and equipment spending is not expected to last.

As a rough first cut at a forecast, see charts 15 and 16, which show — ‘new’ economy or not — that inventory investment remains by far the best single forecast driver of growth in total short-term business credit in both countries. While the inventory cycle is notoriously one of the most difficult economic variables to predict, there are three factors that lend support to expanding inventory investment during 2007-08 despite the likelihood of recent weakness. For one, as the economy expands and takes sales revenues upward, firms in growth sectors are likely to want to build inventory buffers. These sectors are likely to dominate as the economy-wide inventory-to-sales ratio sits at rock bottom levels (chart 17). Second, industries related to housing and autos are caught with high or rising inventory levels requiring financing until stabilization in sales and slower production volumes work off inventory excesses. Witness the sharp sectoral differences in inventory-to-sales levels across manufacturers, retailers excluding auto dealers, auto dealers and wholesalers (chart 17 again). Third, on average, most manufacturers are saying that they are comfortable with inventory levels such that inventory growth that is in line with sales is likely (chart 18).

A key issue for lenders is the health of the manufacturing sector in both countries. There is little doubt that labour-intensive sectors facing market share battles in the U.S. import market — such as textiles, clothing, and furniture — face a steep challenge and are likely to continue to shed payroll and downsize. Autos and housing are also likely to weaken further before regaining strength in the latter half of 2007 and into 2008 as renewed growth opportunities emerge.

There is enough strength in other manufacturing sectors to support targeted loan growth. Capacity utilization rates have slipped but remain high, unfilled orders continue to rise, and new orders have been on a volatile but generally upward trend since last fall. Our expectation that the Canadian dollar will soften somewhat — or at least stabilize after the 2003-05 surge — combined with energy prices still being well off their peaks and a resurgent U.S. economy should lead to improved manufacturing conditions. Now, while the sky isn’t falling on all manufacturers, a wise step is the growing recognition that there is money to be made in capturing value chain relationships, including offshoring wholesale operations, in order to exploit and encourage synergies through broader views on who the client is, while offering greater lending diversification over the full cycle. For U.S. manufacturers, the depreciation in the trade-weighted value of the currency and strong global growth should combine with a resurgent, huge domestic market and lower energy prices to drive lending opportunities.

CHART 15

Short-term business credit vs. inventories

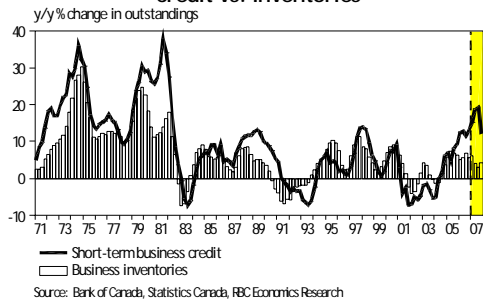
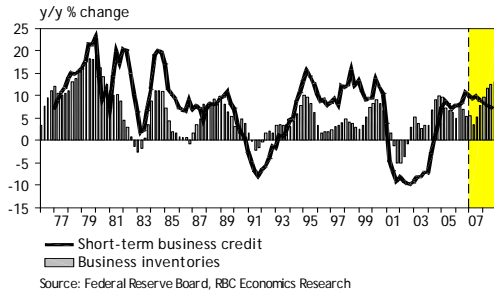
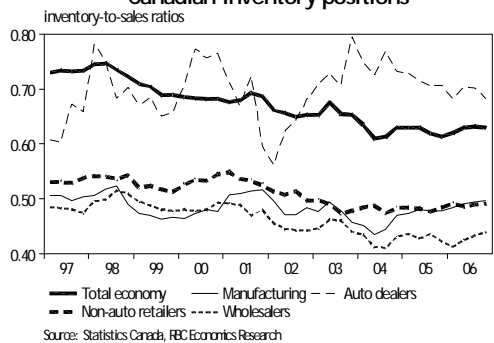


CHART 16

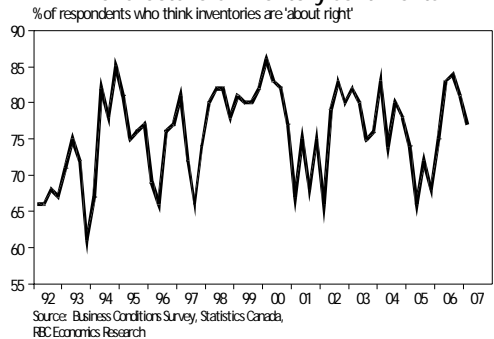
Inventories as a working capital driver of short-term business credit - U.S.



Canadian inventory positions



Manufacturers inventory sentiments



Among other forms of short-term credit, foreign currency loans that grew rapidly in Canada last year are likely to grow more slowly as the currency stabilizes and perhaps retreats a few pennies later this year. Trade financing — more important to the Canadian loan book than the United States — should benefit from an overall expansion of export and import activity combined, particularly the latter which is motivated by a strong currency. The U.S. FX-loan market, however, may well decelerate as a broad-based forecast depreciation in the U.S. dollar against the Euro and yen decreases the attractiveness of FX borrowing. Lastly, while spreads can change rapidly, BAs are likely to continue to be the short-term paper product of choice over CP, thanks to favourable spreads between the products that emerged in the past year in favour of BAs.

2.ii. U.S. issuance could see relief, but Canadian markets at risk

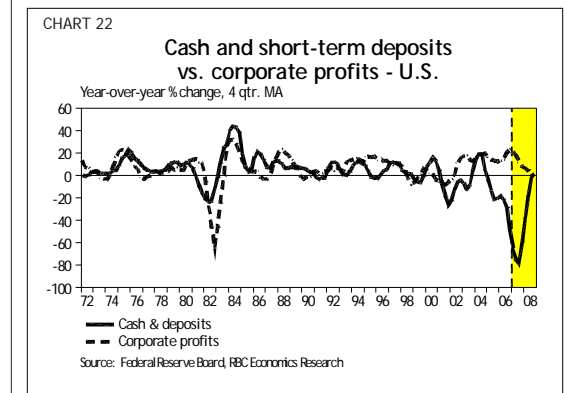
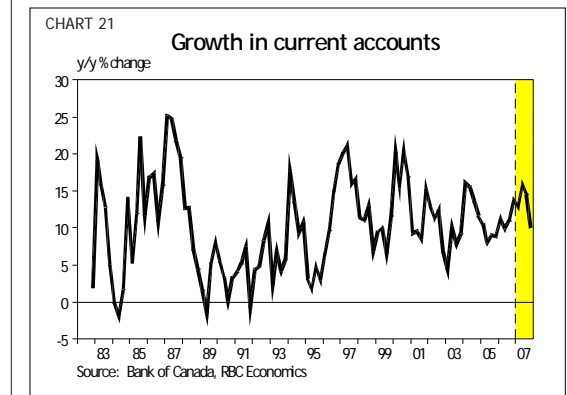
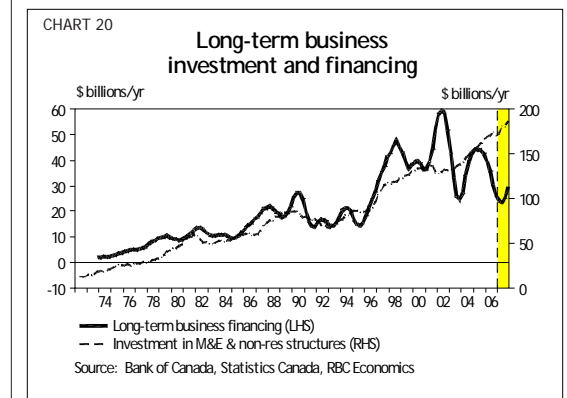
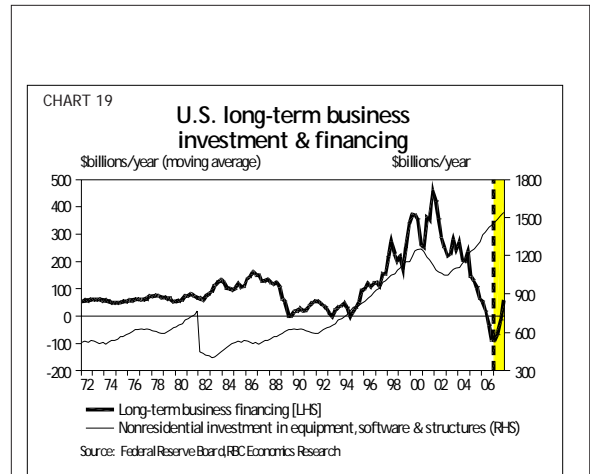
The United States has experienced nothing short of a total collapse in total net long-term product issuance, including bonds, equities, commercial mortgages and asset-based financing products. This is partly driven by recent weakness in business investments in equipment and nonresidential structures (chart 19) and partly by drawing more heavily on cash positions. That should turn around modestly this year for two reasons. First, the economic climate for business investment is expected to improve as the year wears on and into 2008. Capacity utilization rates are high, technological change is rapidly making capital obsolete, scarce labour is causing businesses to meet higher production through capital investments, the U.S. economy should stabilize and balance sheets are still in generally decent shape. Second, the liquidity drawdown that came at the expense of long-term issuance activity has significantly run its course.

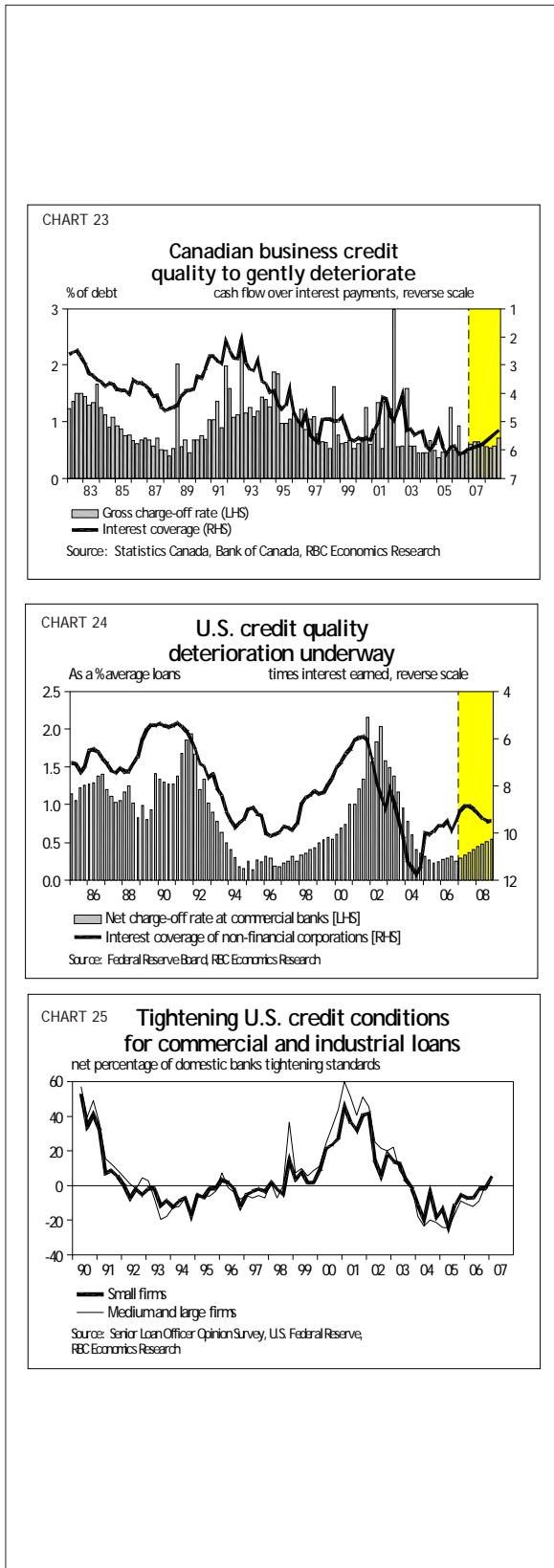
Canadian business investment in equipment and structures will remain a key support to long-term financing (chart 20), especially with the Federal budget's accelerated write-offs for manufacturers - but a gradual degree of liquidity redeployment from high levels will continue to weigh on issuance. The income trust collapse should breathe some renewed life into more traditional vehicles. The commercial real-estate market is offering added support to issuance as this market takes off across North America. This is one reason why growth in commercial mortgages will remain strong. In addition, and beyond commercial markets, Canada is likely to be in a cross-country cap-ex spending boom by decade's end and is already starting to join a global infrastructure funding boom.

2.iii. Business deposits — U.S. warnings for Canadian bankers?

Another year, another flood of business deposits into Canadian banks, which extends a long-standing streak (chart 21). But, warning signs on just how quickly this can change in the current environment of excess liquidity come from the United States, which is experiencing the sharpest drawdown of business deposits and cash holdings since recorded data started in the early 1950s (chart 22).

We have spoken of this risk in both countries for some time now, but the magnitude and speed of the U.S. contraction is surprisingly profound. Business cash and short-term deposits on the books of commercial banks have plummeted from about \$150 billion in the second quarter of 2005 to about \$21 billion today





— an 86% decline in six quarters! This data is highly volatile and subject to revision, but this trend is consistent with other indicators such as the speed of the turnaround in overall U.S. corporate liquidity, the swing away from internally generated cash surpluses towards funding shortfalls and the collapse in net issuance of long-term financing products. It is likely that the U.S. contraction will stabilize and modestly turn around later this year as M&A activity cools somewhat and profit growth comes in at the mid-single digits pace.

In Canada, current accounts growth should moderate, but several drivers will remain intact. For one, growth in corporate profits will remain a support, but at a slower pace than eye-popping figures in the past two to three years. Growth in financing proceeds that are often first deposited and expanding payrolls through ongoing employment and wage growth are added growth supports. The intermediated spread between core lending and deposit products is a key wildcard driver of current accounts. Finally, we've talked liquidity to death, so suffice it to say that the risk of a sudden U.S.-style turnaround is not to be dismissed.

As defined, Canadian current accounts also include healthy forces guiding deposits by provincial governments, other deposit-taking financial institutions, charities, universities, pension funds and other miscellaneous entities.

2.iv. Credit quality still strong, but losing its liquidity support

North American business credit quality is on a path toward marginal deterioration that is likely to continue to unfold during 2007-08, but we will still remain in one of the better environments for overall business credit quality in decades.

After growing by 25% and 15% in 2004 and 2005, respectively, Canadian after-tax corporate profits grew by only about 7% last year and should remain in the mid-single digit environment during 2007-08. Combined with debt growth and the lagged effects of higher short-term interest rates dating back to the start of the Bank of Canada's rate hike campaign in the fall of 2005, this is likely to drive a slight deterioration in interest coverage. In turn, since this is a good leading indicator of charge-offs (chart 23), business credit quality has topped out but should still float within the best levels on record.

A similar story holds true for the United States, but the deterioration in quality is occurring at a faster pace and losing some of its liquidity support (chart 24). As in the household sector, one of the biggest risks is lender over-reaction to deteriorating credit quality. Lenders have been prudent so far in moving off the easiest credit conditions that existed in 2005. Back then, the largest net percentage of loan officers were easing credit conditions on loans extended to all sizes of firms since the Federal Reserve commenced its survey (chart 25). Shifting into modest tightening territory will now result in a more aggressive culling of the marginal credits and higher charge-offs. As in household markets, however, a risk is that of over-tightening lending standards and a self-imposed credit crunch.

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