Economic Research - Canadian Forecast

The Monthly Monitor

July 2009

Carlos Leitao, Chief Economist & Strategist
514-350-3000 – LeitaoC@lb-securities.ca

Sébastien Lavoie, Economist
514-350-2931 – LavoieS@lb-securities.ca

Subscription: Martine Bérubé
514-350-3006 – BerubeM@lb-securities.ca

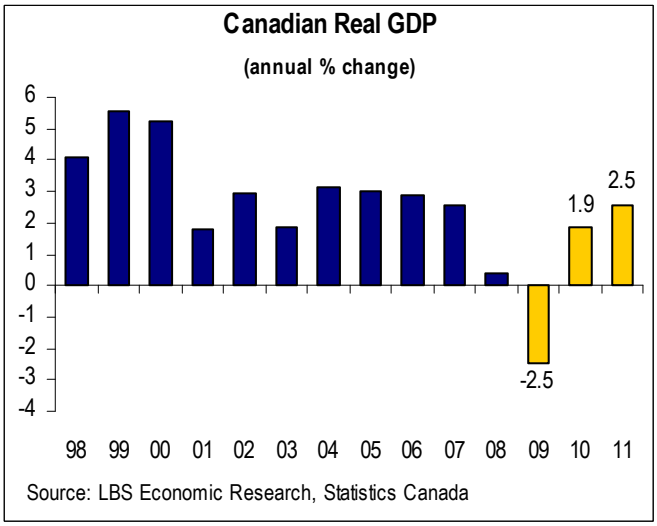
Sébastien Lavoie
Economist

Without a New Impetus, Look for Modest Economic Growth in Canada

In June's edition of the *Monthly Monitor*, we highlighted that balance sheet adjustments for both businesses and households and slower private credit growth will lead to slow economic growth in the US.

In July's edition of the *Monthly Monitor*, *LBS Economic Research* details its latest Canadian economic forecasts. As we know, spillover effects from the global recession at home reached its climax last winter: Exports and imports plunged in tandem with faltering external demand; Businesses trimmed payrolls and investments; Households cut spending and saved money.

Then, "green shoots" blossomed during the spring, signaling that the worst is behind us. We estimate the pullback in Canadian real GDP during the second quarter (-3.2% annualized) was not as draconian as in the first (-5.4%). The country will return to positive growth before year-end, in the fourth at the latest. That said, what matters the most is not the precise date at which the recession will end, but rather the form the expansion will take during coming years.



Put simply, how is Canada likely to perform after the expected 2.5% contraction in real GDP for this year? *LBS Economic Research* forecasts a more modest pace of expansion than what we've seen in other post-recession periods. There are several reasons for this, which we highlight in the following sections of this *Monthly* Monitor. Firstly, our exports are unlikely to rebound to "normal" levels due to the rebalancing currently taking place in world demand. The global macroeconomic picture will not be as beneficial for Canada as in the past.

More precisely, Canadian businesses, particularly manufacturers, will no longer be able to count on their old recipe for success: a combination of a cheap loonie and excess consumerism by US households. Fortunately, Canada is endowed with abundant natural resources. The shifting of global demand towards emerging markets will benefit our natural resources sector and terms of trade. However one should not expect that Western Canada will experience another boom like it did during the years 2000.

Domestically, private deleveraging from households will be necessary. In addition, we forecast the unemployment rate to stay high as well as the savings rate. Consumption growth is still poised to recover modestly in 2010 because of the stimulative stance of monetary policy. On the business side, firms still need to reduce inventories, which will drag down real GDP growth considerably in the upcoming quarters.

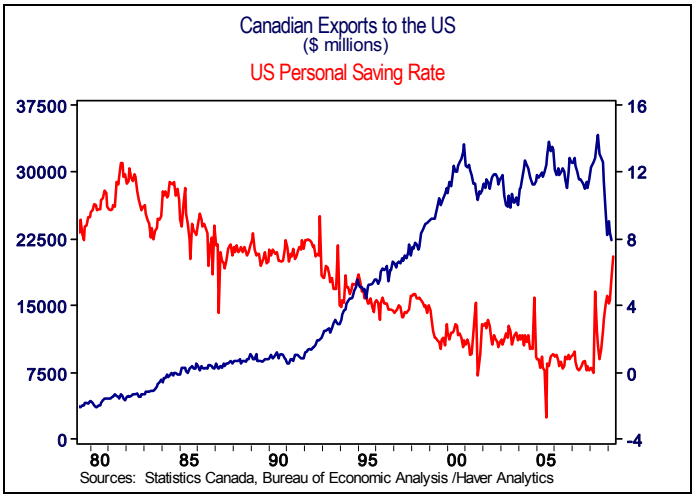
We are thus ruling out the possibility of a robust "V" shaped recovery accompanied by a rapid rise in inflationary pressures. We forecast real Canadian GDP to expand at a pace of 1.9% in 2010 and 2.5% in 2011, a far cry from the 3-4% experienced in the late 1990s. In fact, Canada's economic expansion will likely stay in the 2-2.5% range until a new impetus for growth is found. Historically, long periods of economic prosperity were always driven by major key events:

- During the 1960s, the Auto Pact allowed free trade in the automotive sector between Canada and the United States and contributed to the rapid development of southern Ontario.
- At the beginning of the 1980s, Alberta benefited from the oil boom.
- British Columbia's rock-solid expansion at the end of the 1980s and the beginning of the 1990s was led by immigration and investments from Asia.
- The North American Free Trade Accord, combined with an undervalued loonie and spendthrift US households allowed Quebec- and Ontario-based exporters to flex their muscles.
- The rise in commodity prices during the years 2000 boosted Canada's terms of trade, leading to massive investments in the energy sector, and an ultra-low unemployment rate.

Unfortunately, some of these pillars lost some luster in tandem with the recession. At the same time, there is no new catalyzing event of this nature in sight that could spark a new lasting period of solid growth. Among solutions discussed, some hope to turn around the country's dismal productivity record. However, this will take time and coordinated efforts by all economic agents, which will not be an easy feat amid the rising debt burden of governments and households. All in all, the big picture is that the Canadian economy, influenced mostly by global macroeconomic factors as usual, is currently traversing a Darwinian period where traditional sectors are restructuring and where no new clusters are big enough at the moment to fully compensate.

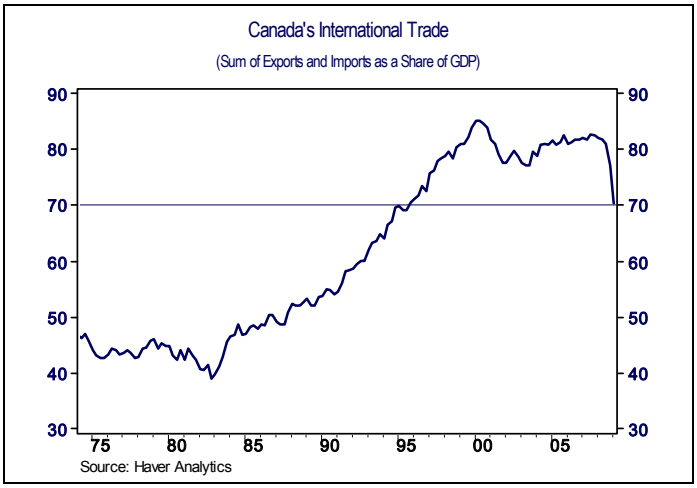
Rebalancing in Global Demand Implies A Profound Transition of Canada's Trade Sector

The following sections detail our view of sub-par growth in the medium-term for Canada. Let us begin with export-oriented businesses. Helped by NAFTA, our exporters were blessed for a long period of time by the weak loonie and spendthrift US households. But since last year, global imbalances are slowly being redressed. As such, we are of the view that the on-going slide in exports, which started in late 2007, is not purely cyclical. The global macroeconomic picture in the future will not be as friendly for Canada as it used to be in the past. We are assisting at the beginning of *"a sustainable rebalancing of domestic demand from deficit countries, such as the United States and the United Kingdom, toward surplus countries, such as China and Germany"*, mentioned Bank of Canada Governor Mark Carney in a speech in June.

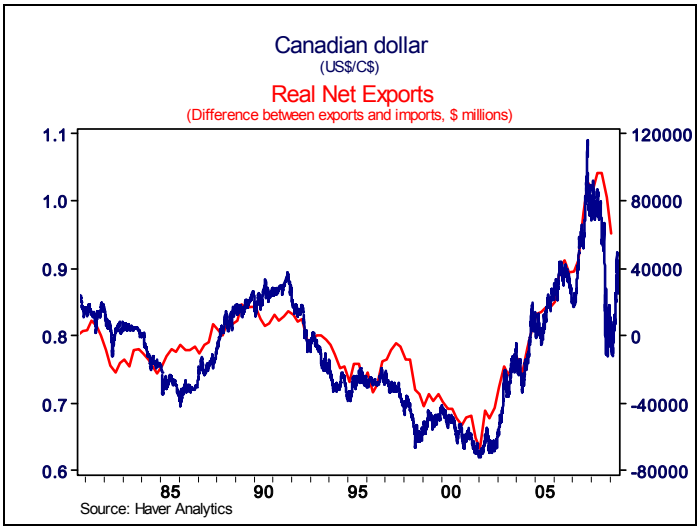


In the United States, this structural rebalancing will be characterized by softer domestic demand. Already, Americans are saving a larger proportion of their disposable income. In May, the personal savings rate was close to 7.0%, the highest figure registered since the early 1990s. One year ago, that rate was zero. We should not be surprised that this increase in savings coincides with the recent slump in Canadian exports. Two other statistics graphically depict the repercussions here in Canada stemming from this behavioural shift in US households: the sum of imports and exports in 2009Q1 was at a 14-year low of 70%; Canada's merchandise trade balance has been close to zero for the last six months for the first time since the mid-1970s.

We are of the view that this growing popularity towards savings is not transitory. The savings rate should remain high in upcoming years as households can no longer count on stock and home price appreciations alone to build up their wealth. Furthermore, Americans may have decided to save money in order to pay for anticipated future tax increases by the Obama Administration, which refers to the Ricardian Equivalence theory.

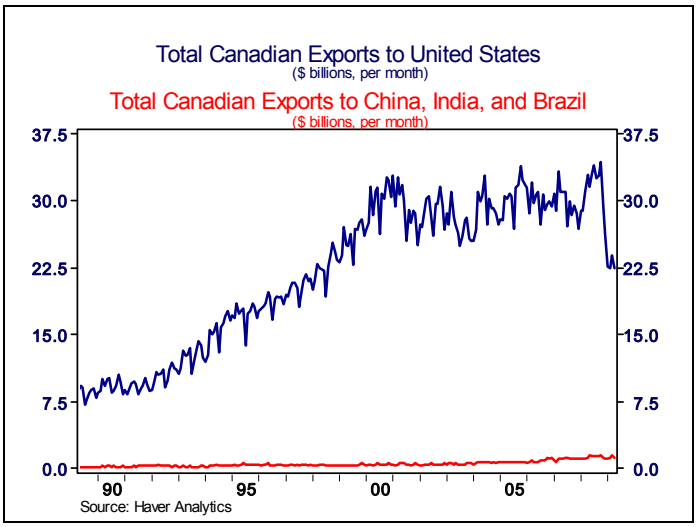


This structural shift means Canadian exporters are unlikely to be able to rely on excess consumerism by US households. On top of that, they should not count on an undervalued currency either. As Governor Carney noted in his mid-June speech: "*…the recent sharp increase in the value of the Canadian dollar, if it proves persistent, could fully offset recent positive developments in financial conditions, commodity prices, and confidence*." Another cause for worry for exporters is the "*Buy American*" clause included in US president Obama's recent $800 billion stimulus package, which could potentially lead to broader protectionism measures. At the moment, we consider protectionism and the recent volatile loonie as two key potential hazards for exporters. These risks could lead us to revise down our forecasts.



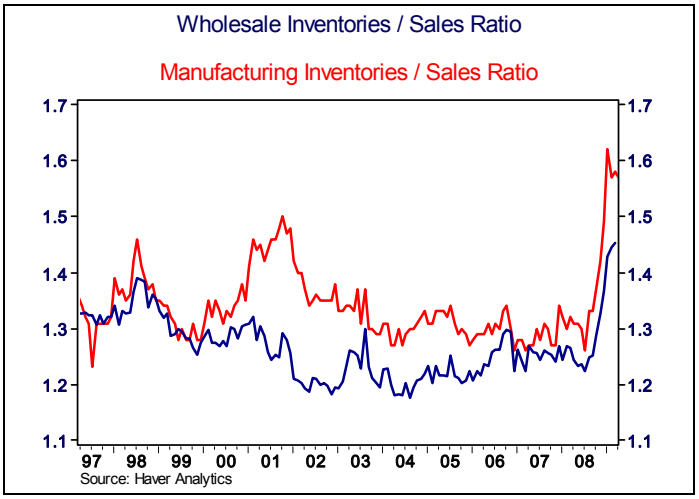
So where does the rest of the world fit in all of this? Could Canada compensate for slower trade with the United States by exporting more elsewhere? Well, not really. Despite a sharp increase in trans-Atlantic and trans-Pacific trade in recent years, no other region in the world can be a quick-fix solution in the short-run and replace the US as Canada's main export destination. Canada's exports to China, India, and Brazil have doubled during the last five years to about $15 billion in 2008, but that is still peanuts compared to the $375 billion exported to America that year. And, although emerging markets continue to generate respectable economic growth, their small per-capita GDP is also a challenge to consider.

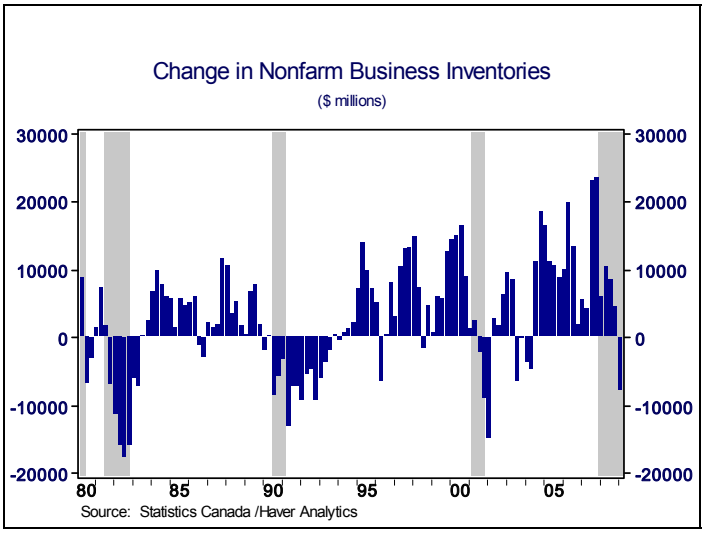
Fortunately, Canada is endowed with abundant natural resource. The shifting of global demand towards emerging markets will at least benefit our exporters of natural resources. However, we should not expect that Western Canada will experience another big boom similar to the 2002-07 period, as a lot of intense capital investment and exploration has been done already.



Businesses: After Hours Worked and Investment, Time to Trim Inventories

The global downturn has forced Canadian firms to slash costs. With Canadian industries rolling at a record low of 69% of capacity during the first quarter of this year, companies will continue to reduce heavily investment in buildings, machinery and equipment. Annual growth in business credit, which has already weakened to just 3.0% in May, is set to stay on this downtrend. On top of investment, businesses were also successful in cutting labour costs. The number of hours worked (-1.8% from quarter to quarter) fell faster than production (-1.4%) during the first quarter of the year. But, in contrast to investment and payrolls, very little has been done on the inventory front: Sales-to-inventory ratios in the manufacturing and wholesale trade sectors are unintentionally elevated. During the 1980s and 1990s recessions, inventories were cut by about $19 billion. They just began to drop during the first quarter of this year. As such, *LBS Economic Research* thinks a major inventory correction is in the cards, which will drag down real GDP growth considerably in the upcoming quarters.

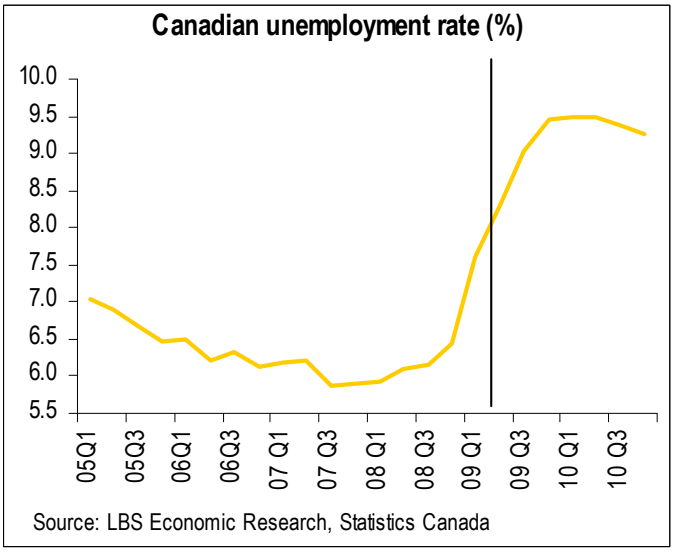




Households: Increasing Unemployment and Savings

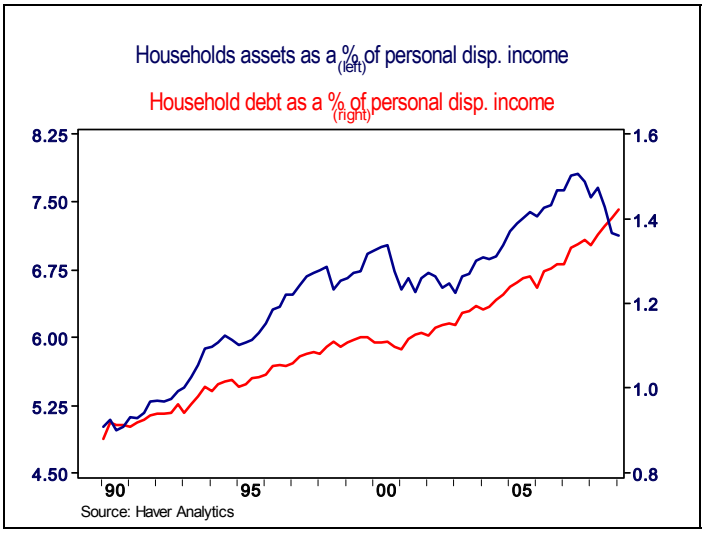
Staff reduction by firms have hit households hard. Labour income fell in 2009Q1 for the first time since 1982. Looking forward, we expect the unemployment rate to stay high even after the recession is over (above 9% during 2010 and 2011) as businesses delay bringing back laid-off employees until they are sure that a recovery has taken hold.

The deteriorating job market is not the only reason underlying the expected pullback in consumer expenditures this year. The $445 billion decline in the value of Canadian household assets between 2008Q2 and 2009Q1 is also part of the equation. As such, Canadians do like Americans: they save a bigger chunk of their income. The savings rate rose during the past year to hit 4.7% by 2009Q1.

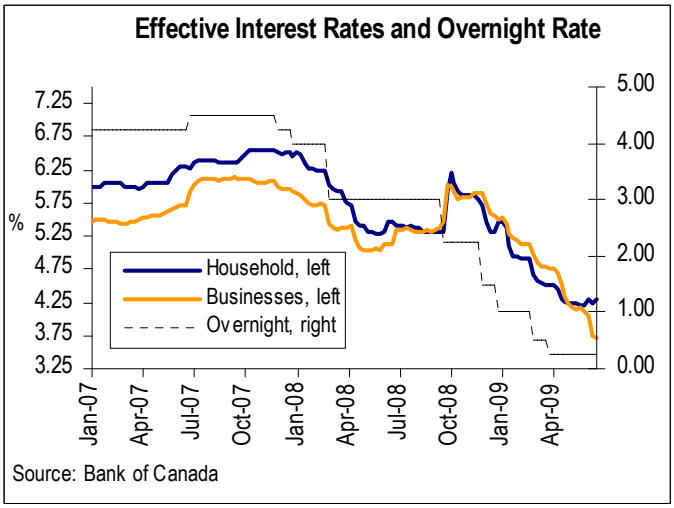


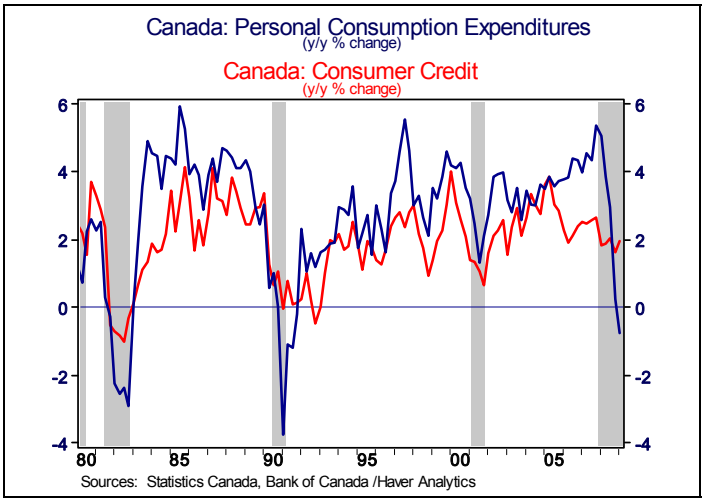
Another piece of the puzzle is the growing financial vulnerability of Canadian households to economic shocks. The sensitivity facing the unemployed is notably worse than it was during previous recessions due to the fact that admissibility criteria to collect Employment Insurance benefits are far tighter.

Only 45% of unemployed Canadians are collecting EI benefits today, compared to between 80% and 85% during the recession of the 1990s. Altogether, these factors were key drivers of the spike in personal bankruptcies and mortgage loan payment arrears since the end of 2008. In fact the rise in personal bankruptcies (which is already larger and beginning earlier than it did during previous recession cycles) should pick up speed during coming quarters and per capita personal bankruptcies will likely peak at their highest level ever.



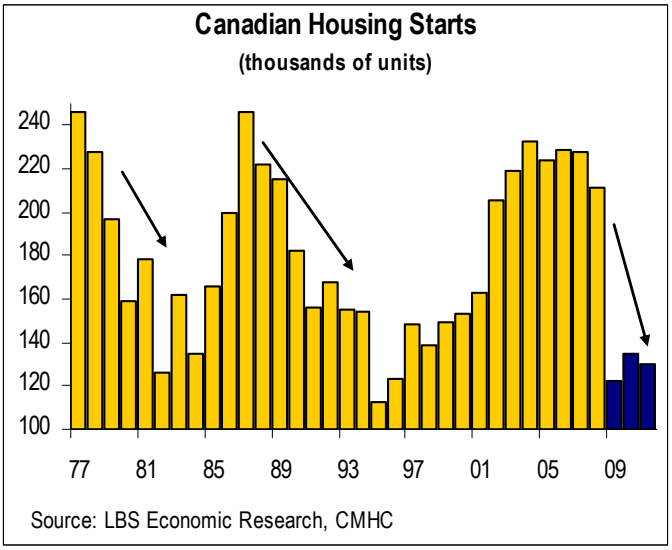
All in all, retailers will continue to have a difficult time, until recession-related uncertainty – which is holding back consumer spending – has completely abated. Households will also need to begin the long and arduous process of bringing down their debt levels (the debt-to-income ratio is at an elevated 140%). Only after improving their finances will consumers be able to think about buying bigger ticket-items and take advantage of low current interest rates (the effective weekly interest rate of households, a rate calculated by the Bank of Canada, is currently close to 4.25%). All told, a modest recovery in consumer spending will only really become evident next year.

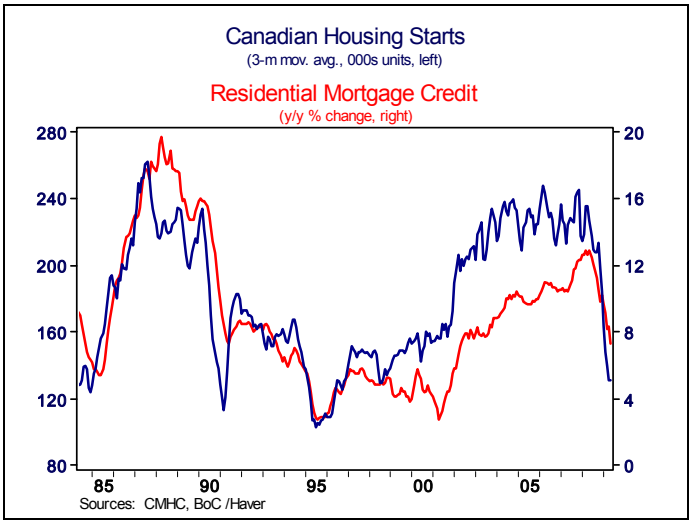




Housing Market: Soft Pace in Construction and Resale Activity to Continue

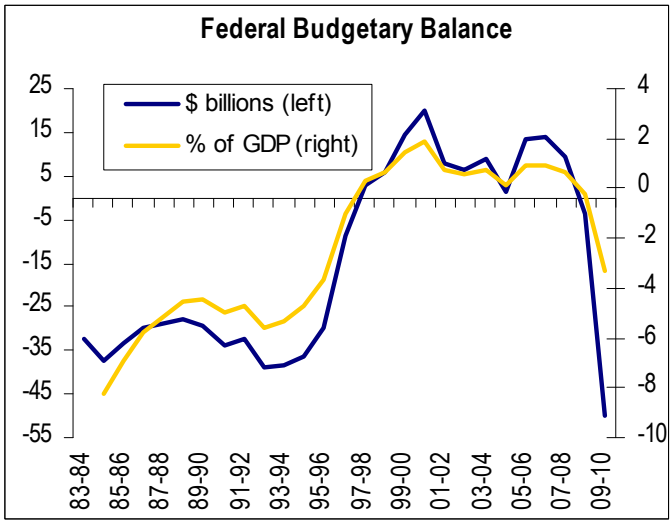
Despite the fact that mortgage rates are extremely low, residential construction is unlikely to emerge as a major pillar of economic growth during coming years. The lion's share of Canadians that had strived to become property owners (like the echo-boomers) already did so several years ago, when housing was much more affordable than it is today. The market for newly built homes has pulled back since the end of 2008, in tandem with the deteriorating job market. As a result, residential construction could go through a period similar to that of the 1990s. Between 1993 and 2000, annual housing starts fluctuated in the 120,000 to 150,000 range, a lower level than the country's demographic requirements. This scenario would also translate in continued softening in mortgage credit growth. As for the resale home market; this spring's spike in the number of transactions was typically seasonal in our view. We believe that the resale home market in most Canadian cities will continue to favor buyers during coming years. The price depreciation of existing homes will continue to vary greatly depending among regions. Western Canada and Ontario should be particularly hit, while Quebec, Manitoba and Atlantic Canada are set to perform relatively better.





Governments: Fiscal Stimulus has its Limits

During the budget season, Ottawa and the provinces introduced significant infrastructure plans for the two coming years. However, an expansionist fiscal policy cannot go on forever because of the rising debt. Tax revenues are down, and most provinces and the federal government will record larger-than-expected deficits. Some jurisdictions will have a hard time getting their budgets back in balance during the coming three to four years.

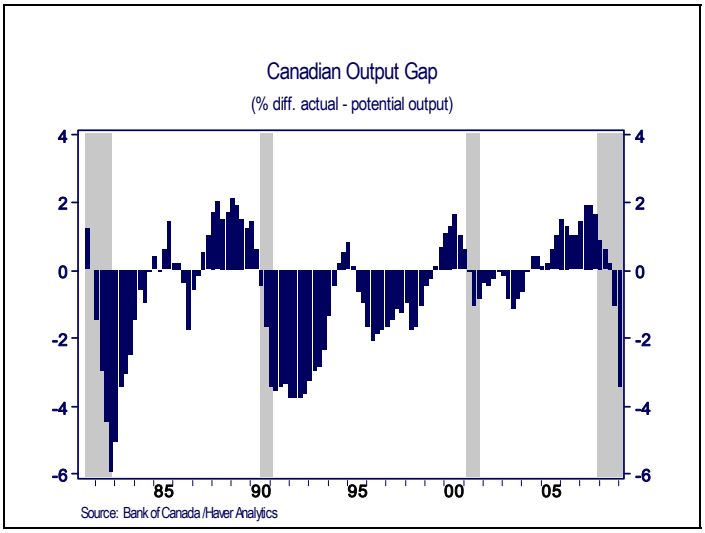


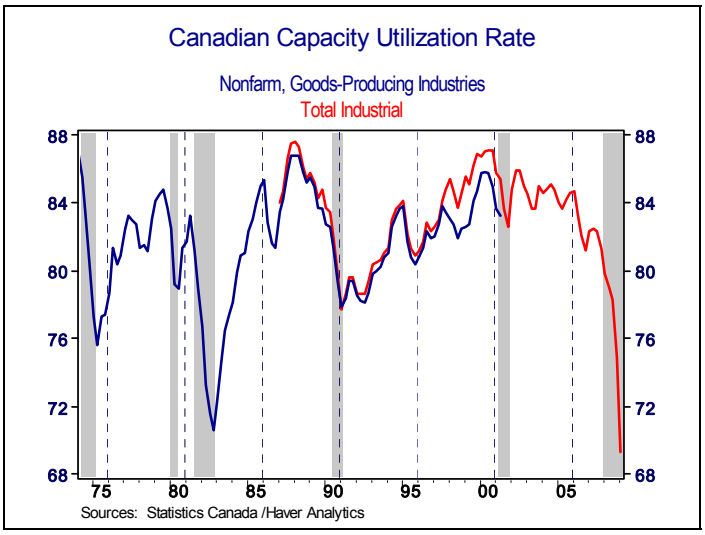
Fiscal deficits are not necessarily cyclical in nature. In some cases they show signs of becoming structural under a status-quo basis. Since governments are not raising enough money to pay for existing levels of public services are the moment, tax increases or spending cuts appear inevitable down the road. As such, look for a more restrictive fiscal policy after 2010, which will temper overall real GDP growth.

Prices: Inflation Will Remain Under Control

The fact that the Bank of Canada did not implement a quantitative easing program like the Fed or the Bank of England reduces the probability of an inflation spike at home. After running at a relatively high 2.4% during 2008, inflation measured by the total CPI should average a low 0.6% during 2009, due in part to an annual drop in gasoline and shelter. For 2010 and 2011, several macroeconomic factors point to continued low inflation:

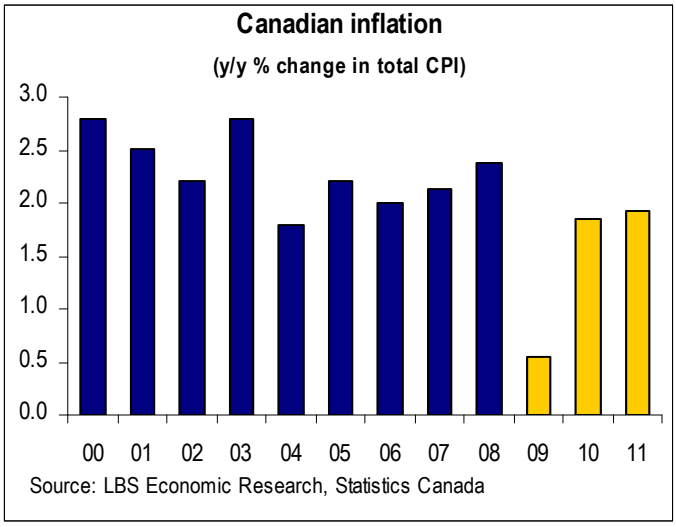
- The output gap in Canada (the difference between actual and potential production) will be larger this year than it was during the recessions of the 1980s and the 1990s. This large amount of excess supply is unlikely to be fully absorbed until at least 2012.
- Canadian industries functioned at only 69% of their production capacity during the first quarter of 2009. This considerably reduces upward pressure on prices.
- The growth in unit labor costs lost some steam lately (0.8% from quarter-to-quarter in 2009Q1), as well as average hourly earnings. This throws water on the cost-push inflation theory.
- With consumers more in savings as opposed to spending mode, retailers have very little pricing-power.





The anticipated acceleration in total CPI inflation in 2010 (1.9%) and 2011 (1.9%) will be driven mostly by tax hikes announced by provincial governments during the last budget season. For example Ontario's harmonization of its sales tax, effective in July 2010, will add close to 0.5 percentage points to total CPI. The 1% increase in Quebec's sales tax and other fees will also have an impact (though smaller) starting in January 2011. Although current inflation risks lie predominantly on the down side, one upside risk to watch out for is the possibility that cash-strapped governments could raise consumption taxes further to eliminate fiscal shortfalls.

The Bank of Canada does not take into account the effects stemming from these indirect tax increases on the CPI when it sets monetary policy since their impact only last for a year. The BoC's operational guide, core inflation, stick close to the 2% level despite the recession. But with the factors stated above, *LBS Economic Research* thinks core inflation will slow modestly into the 1.5% to 2.0% range during the next few months. Broken down by year, core inflation is forecast to average 1.1% in 2009, 1.5% in 2010, and 1.9% in 2011.



Tightening in the Accommodative Monetary Policy? Wait Until the Second Half of 2010

The Bank of Canada kept its policy rate at 0.25% in early June and reiterated its commitment to keep it at that low level until the end of the second quarter of 2010. For the moment there is no question of going any farther. True, the volatility of the Canadian dollar, which stems from a mix of swings in commodity prices (a type-one appreciation) and currency portfolio shifts (a type-two appreciation) underlies the BoC's strategy to leave the doors open for non-traditional tools. We estimate the probability that the Bank of Canada will engage in a quantitative easing program during the coming 12 months at a small 25%. After mid-2010, once credit growth start to recover, our central bank will progressively begin to tighten monetary policy. We expect the overnight rate to hit 1.25% by the end of 2010, and then climb closer to a neutral footing in 2011 (in the 3.50% to 4.00% range).

Canada

	Historical data			Forecasts						
	2008	2008Q4	2009Q1	2009Q2	2009Q3	2009Q4	2010Q1	2009	2010	2011
Real GDP (%)	**0.4**	**-3.7**	**-5.4**	**-3.2**	**0.2**	**1.7**	**2.6**	**-2.5**	**1.9**	**2.5**
Consumption	3.0	-3.1	-1.6	-2.5	-0.7	1.0	1.5	-1.3	1.0	2.3
Private investment	-0.6	-20.4	-26.2	-9.8	-5.2	-3.6	-1.1	-13.9	-2.1	2.3
Machinery and equipment	0.5	-28.5	-35.7	-8.0	-5.5	-4.0	0.0	-18.7	-1.5	3.0
Residential construction	-2.7	-23.0	-21.0	-15.0	-5.8	-4.6	-4.0	-14.4	-4.5	0.0
Government spending	4.8	3.6	1.1	5.7	7.4	7.9	8.3	3.9	7.6	2.3
Exports	-4.7	-17.7	-30.4	-25.0	-7.0	-2.0	1.0	-18.0	-1.4	6.3
Imports	0.8	-23.4	-37.8	-23.0	-4.4	-2.0	2.0	-20.3	-0.2	6.2
Current account balance in % of GDP	0.6	-2.4	-2.8	-1.7	-2.3	-2.3	-1.9	-2.3	-1.5	0.7
Inflation (%)										
Total CPI	2.4	1.9	1.2	-0.2	-0.5	1.7	1.8	0.6	1.9	1.9
Core CPI	1.7	2.2	1.9	1.1	0.8	0.7	1.4	1.1	1.5	1.8
Unemployment rate (%)	**6.2**	**6.4**	**7.6**	**8.3**	**9.0**	**9.4**	**9.5**	**8.6**	**9.4**	**9.1**
Employment	**1.5**	**0.5**	**-5.5**	**-1.5**	**-1.9**	**-0.5**	**0.0**	**-1.8**	**-0.3**	**1.0**
Housing starts (000s)	**211**	**185**	**140**	**120**	**120**	**120**	**140**	**125**	**135**	**130**
Before-tax profits (annual % change)	**5.7**	**-11.7**	**-34.9**	**-41.8**	**-45.6**	**-29.3**	**-4.9**	**-38.5**	**2.9**	**12.5**

Real GDP (and its components) and before-tax profits: for quarters, quarter-to-quarter change annualized; for whole years, change from the previous year. Inflation: change in price index from a year earlier. Unemployment rate: average rate for the quarter or the year.

*** forecasts as of July 2, 2009**

Main Economic Indicators - Canada

	2003	2004	2005	2006	2007	2008	2009	2010	2011
							Forecasts		
Real GDP -- % change	1.9	3.1	3.0	2.9	2.5	0.4	**-2.5**	**1.9**	**2.5**
Real Personal Disposable Income -- % change	3.9	5.5	4.4	7.3	5.3	5.9	**0.5**	**1.4**	**3.1**
Employment -- % change	2.4	1.8	1.4	1.9	2.3	1.5	**-1.8**	**-0.3**	**1.0**
Unemployment Rate (%)	7.6	7.2	6.8	6.3	6.0	6.2	**8.6**	**9.4**	**9.1**
Housing Starts (000s units)	219.5	232.7	224.0	229.1	227.9	211.4	**124.9**	**135.0**	**130.0**
Before Tax Profits -- % change	6.9	16.4	10.9	5.1	4.1	5.7	**-38.5**	**2.9**	**12.5**
Total CPI Inflation (%)	2.8	1.9	2.2	2.0	2.1	2.4	**0.6**	**1.9**	**1.9**
Current Account Balance ($M)	14650	29837	25903	20333	15607	8116	**-29556**	**-20000**	**8750**
Growth of real GDP components (%)									
Consumption Expenditures	3.0	3.3	3.7	4.1	4.6	3.0	**-1.3**	**1.0**	**2.3**
Residential Construction	5.4	7.5	3.2	2.0	2.9	-2.7	**-14.4**	**-4.5**	**0.0**
Business Investment	6.9	8.3	12.7	10.1	3.9	0.3	**-13.7**	**-1.2**	**3.2**
Government Spending	3.4	2.5	2.6	3.3	3.7	4.8	**3.9**	**7.6**	**2.3**
Final Domestic Demand	3.7	4.0	4.5	4.6	4.2	2.7	**-2.7**	**2.0**	**2.3**
Exports	-2.3	5.0	1.9	0.8	1.1	-4.7	**-18.0**	**-1.4**	**6.3**
Imports	4.1	8.0	7.1	4.7	5.8	0.8	**-20.3**	**-0.2**	**6.2**
Change in Inventories ($M)	5770	7701	14223	12122	14990	12241	**-7329**	**-5000**	**500**

Laurentian Bank Securities (LBS)

President

Michel Trudeau, MBA

Institutional Equity

Simon Lussier, MBA (514) 350-3060
Senior Vice President
lussiers@lb-securities.ca

Research

Frédéric Beausoleil, CFA (514) 350-2839
Head of Equity Research
Special Situations Analyst
beausoleilf@lb-securities.ca

David Buma, CFA (514) 350-2957
Deputy Head of Equity Research
Industrial Products Analyst
bumad@lb-securities.ca

Catherine Bouchard, MSc, MBA (514) 350-2938
Healthcare Analyst
bouchardca@lb-securities.ca

Alex Grassino, MSc (514) 350-2855
Information Technology Analyst
grassinoa@lb-securities.ca

Éric Lemieux, MSc, P. Geo (514) 350-2874
Mining Analyst (819) 472-8037
lemieuxe@lb-securities.ca

Vincent Perri, CA, CFA (514) 350-2876
Special Situations Analyst
perriv@lb-securities.ca

Ben Vendittelli, MBA, CFA (514) 350-2803
Transportation & Infrastructure Analyst
vendittellib@lb-securities.ca

Mathieu Chevrier (514) 350-2949
Research Associate
chevrierm@lb-securities.ca

Trading

Bob Magtanong (416) 865-5781
Trader
magtanongb@lb-securities.ca

Demitri Prassinos (514) 350-3055
Trader
prassinosd@lb-securities.ca

Ronald Monaldi (514) 350-2823
Trader
monaldir@lb-securities.ca

* Subject to approval by the regulatory authorities.

Sales

Suzy Champagne, MSc, CFA (514) 350-2992
champagnes@lb-securities.ca

Marcia Wisniewski, CFA (416) 865-5982
wisniewskim@lb-securities.ca

Eric Fredrickson (416) 865-5876
fredricksone@lb-securities.ca

Deborah Honig (416) 865-5889
honigd@lb-securities.ca

Corporate Finance

Patrick Langlois, CFA, MBA (416) 865-5798
langloisp@lb-securities.ca

David Hinchey, CFA, MBA (514) 350-3021
hincheyd@lb-securities.ca

Syndication

Pierre Godbout, CIM (514) 350-3050
Vice President
godboutp@lb-securities.ca

Retail Division

Riccardo Magini (514) 350-2960
Vice President*
maginir@lb-securities.ca

Fixed Income Division

Chris B. Ward (514) 350-2904
Vice President & Director,
Debt Capital Markets
wardc@lb-securities.ca

Patrick Sheils (416) 865-5811
Vice President, Fixed Income
ShielsP@lb-securities.ca

Jean Bordeleau (514) 350-2904
Vice President, Trader, Fixed Income
BordeleauJ@vmbl.ca

Robert Sforza (514) 350-2905
Trader, Money Markets
SforzaR@lb-securities.ca

Michel Richard (514) 350-2863
Vice President, Debt Capital Markets
RichardM@vmbl.ca

Thomas Berky (416) 865-5670
Vice President, Debt Capital Markets
BerkyT@lb-securities.ca

Jean-François Gauthier (514) 350-2904
Vice President, Government Finance
GauthierJF@vmbl.ca

Barry Calhoun (416) 865-5951
Vice President Director
Debt Capital Market
CalhounB@lb-securities.ca