Economic Research - Financial Market Forecast
The Monthly Monitor
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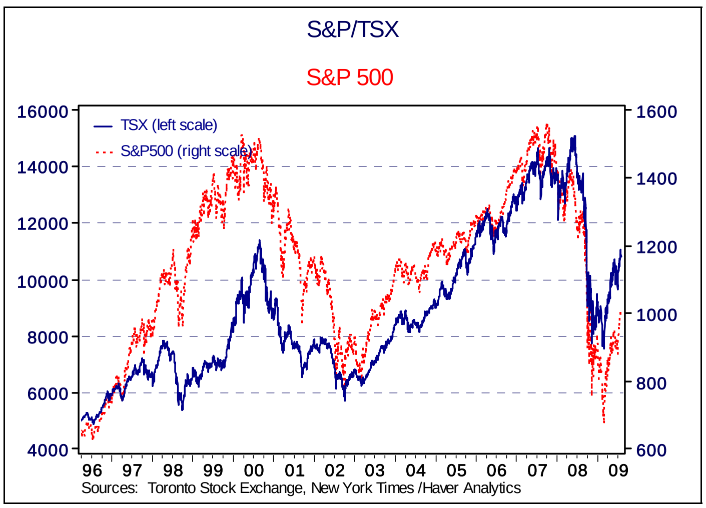
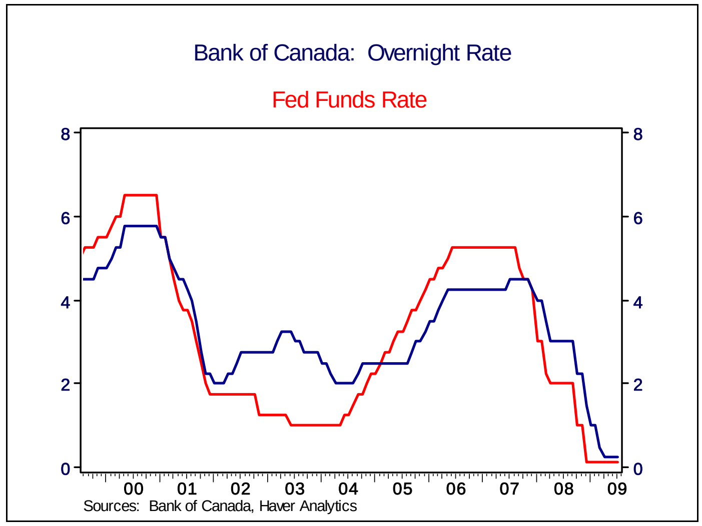
The Economic Outlook Is Still Little Changed From Two Months Ago And Yet Financial Markets Have Turned 180 Degrees

Two months ago we stated that the U.S. recession would eventually come to an end but that the subsequent recovery would be slow and uneven. Financial markets, for their part, generally reflected this cautious outlook with risk-appetite in check, bond yields drifting lower and a relatively firm US dollar. Well, what a difference a couple of months make! Even though the economic outlook is still basically the same, equity prices, bond yields, commodity prices and commodity currencies are all up on renewed risk-appetite. The catalysts for such an abrupt u-turn were generally positive second quarter financial results for the some of the largest U.S. publicly-traded firms and slightly more positive comments from both the Federal Reserve and the Bank of Canada regarding the state of the economy.



However, financial markets are overly optimistic in our view, although we do agree that real GDP growth should turn positive in Q3 in both Canada and the United States. That much was emphasized by the central banks although financial markets appear to have misinterpreted their intentions. Moreover, the financial system is still vulnerable to recession-related disruptions which could short-circuit the re-establishment of normal credit flows and thus derail the recovery.



The bottom line is that markets are once again too far ahead of themselves, anticipating a self-sustaining economic recovery is taking hold. Many things could still go badly wrong and this recovery will be slow and hesitant at best. Moreover, continued effective policy accommodation is required to make sure the recovery takes roots. Now (and by that we mean at least the next six months) is not the time to start removing monetary (or fiscal) stimulus. And this is where, in our opinion, financial markets are clearly off-base. With their recent forecasts, the North American central banks were not telegraphing an earlier tightening in monetary policy. Removing that stimulus before unemployment peaks could derail the recovery.

BoC : First hike in 2010H2 at the earliest

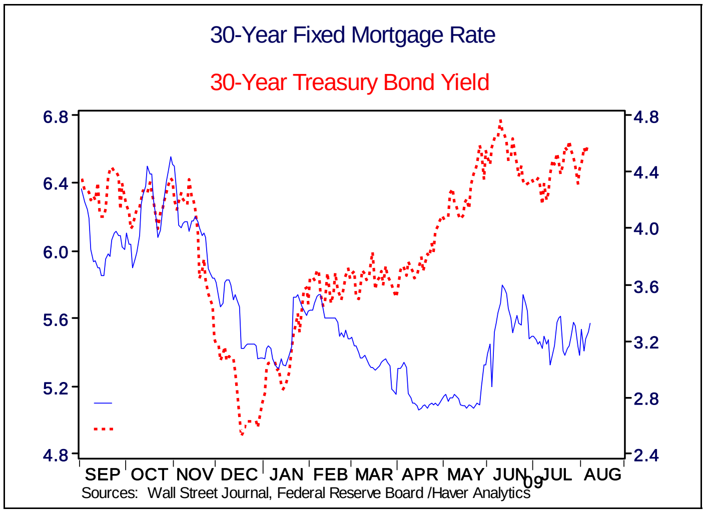
The Bank of Canada re-affirmed in July its conditional commitment to maintaining the overnight rate at 0.25% until mid-2010. And the reason is quite straightforward: the strategy is working! The Bank of Canada acknowledged the recent improvements on the economic front but maintained that the emerging recovery is *"nascent"* and depends upon "*effective and resolute policy implementation*". In other words, the admittedly optimistic outlook for inflation and the economy necessitates the firmly expansionary monetary policy to remain in place. The BoC will not begin to hike policy rates without a visible peak in unemployment and signs of a durable recovery.

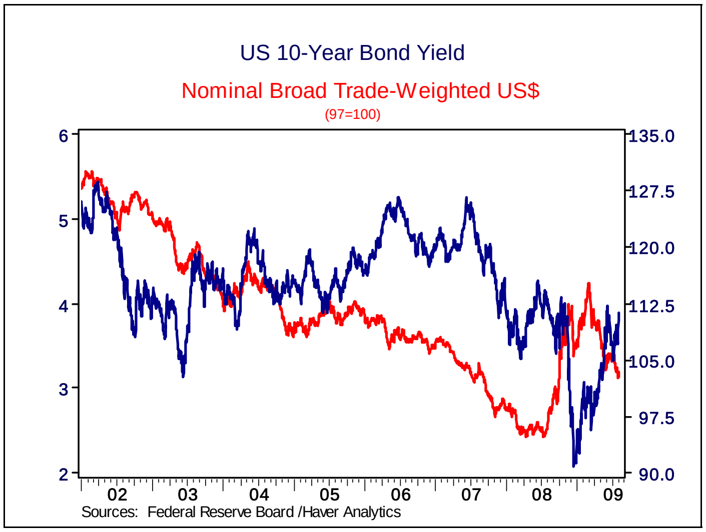
In terms of the outlook, the Bank of Canada now sees total and core inflation returning to target in Q2-2011, just one quarter earlier than in April's projection. Robust growth is expected to occur earlier than previously expected, based largely on signs of greater strength in household expenditures. And herein lies the main downside risk, in our view: The Bank of Canada is placing a great deal of weight on a consumer-led recovery, at least until the global economy recovers convincingly and pulls Canadian exports along. The Bank itself contends that some of the strength in domestic demand represents a *"bringing forward of household expenditures"* which, in our view, is not necessarily sustainable in the absence of a global recovery.

Fed's MPR And Statement: Staying On Course

In the US, Federal Reserve Chairman Bernanke remains focused on the path of economic recovery. Particularly significant was Bernanke's statement right up front in July about the *"possibility that the recent stabilization in household spending will prove transient"* (which means temporary, short-lived, brief, in a word, not V-shaped!). This statement was interpreted by some market participants as "dovish" on inflation but the bigger point is that inflation is not the problem at this stage, or anytime soon for that matter. But, in order to satisfy some of our more impatient financial market brethren, Bernanke did delve into the now famous *"exit strategies"* saying essentially that the Fed is fully confident it has the necessary tools and will use them when the time comes. The most important tool, but by no means the only one, is the fact the Fed can now pay interest on excess bank reserves.

Our forecast for the United States calls for real GDP growth to rebound in Q3-09 to +2.3% (Q/Q) but to still average -2.7% for the year as a whole. Growth in 2010 is still expected to average an uncharacteristically moderate +2.4% with unemployment peaking at 10.5% in mid-year. Core inflation should trend towards a very low 1% by mid-2010. In light of this economic backdrop, August 12th FOMC statement highlighted the Fed's intention to stay on course with most of the actual quantitative easing measures in place. There is no rush to exit strategies. The only notable exception was the "stretching" of the $300 billion US treasury purchase program from September to October, which has proved to be largely ineffective at holding yields lower. Other emergency-lending efforts – that is the effective purchase up to $1.25trn of agency mortgage-backed securities and $200bn of agency debt by the end of the year – stay intact.

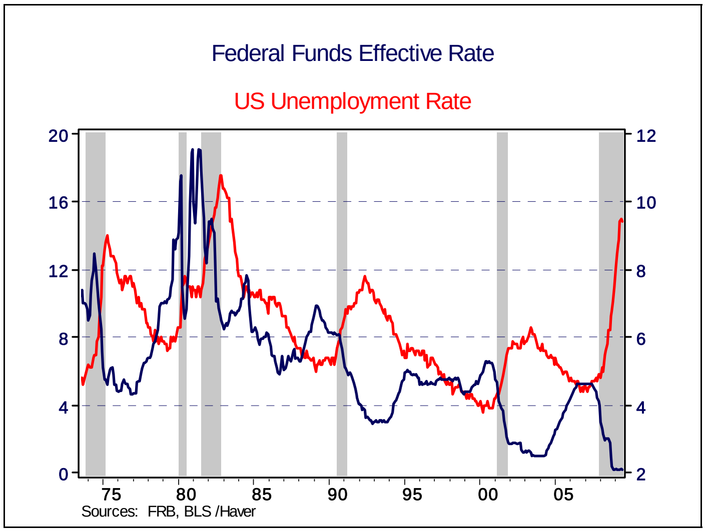




What Does This All Mean For Financial Markets?

When the dust settles and financial markets fully digest the importance of the Fed's smooth transition, we are likely to see a modest bond rally, a flattening of the yield curve, a stock market correction, lower commodity prices and commodity-driven currencies. We continue to believe markets are off-base on the inflation front. Heavy disinflation remains the more likely scenario for the next 12 months or so. This implies that the removal of policy accommodation could well happen later rather than earlier. Heavy disinflation and slow economic growth are also not exactly stock-market friendly.

Lastly, one of the major risks facing North American businesses and consumers in 2011 and beyond is the very real possibility of an interest rate shock, even in the absence of any public debt / inflation panics. The simple fact of life is that interest rates will ultimately "normalize" at the very least, meaning a sharp 300-or-so basis points increase from current levels. Businesses and consumers need to start planning for such an event while there is plenty of time. We are not there yet, but we are definitely on the way and no detour or early exit will prevent us from getting there.



Interest-Rate and Exchange-Rate Forecasts

	Historical Data						Forecasts*					
	2007	2008	2008 Q3	2008 Q4	2009 Q1	2009 Q2	2009 Q3	2009 Q4	2010 Q1	2010 Q2	2010 Q3	2010 Q4
Canada												
Overnight Rate	4.35	3.03	3.00	1.50	0.50	0.25	0.25	0.25	0.25	0.25	0.50	1.00
3-Month Treasury Bills	4.14	2.33	1.89	0.83	0.39	0.24	0.25	0.25	0.30	0.30	0.60	1.10
2-Year Bond	4.18	2.66	2.78	1.09	1.07	1.20	1.30	1.10	1.15	1.20	1.30	1.50
10-Year Bond	4.27	3.61	3.75	2.69	2.79	3.36	3.40	3.10	3.15	3.20	3.30	3.45
30-Year Bond	4.31	4.06	4.13	3.45	3.74	3.91	4.10	3.70	3.75	3.80	3.90	4.05
United States												
Federal Funds Rate	5.05	2.08	2.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	1.00
3-Month Treasury Bills	4.48	1.40	1.15	0.03	0.21	0.19	0.20	0.20	0.25	0.25	0.50	1.00
2-Year Bond	4.36	2.01	2.08	0.82	0.81	1.11	1.00	1.00	1.10	1.15	1.20	1.30
10-Year Bond	4.63	3.66	3.69	2.42	2.71	3.53	3.40	3.10	3.15	3.30	3.45	3.60
30-Year Bond	4.84	4.29	4.27	2.90	3.56	4.32	4.20	4.00	4.00	4.10	4.25	4.25
Canadian Dollar (US$/C$)	0.930	0.938	0.943	0.813	0.794	0.893	0.925	0.900	0.875	0.888	0.900	0.915
Canadian Dollar (Euro/C$)	0.679	0.637	0.669	0.602	0.599	0.652	0.649	0.643	0.621	0.621	0.634	0.654
Euro (US$/Euro)	1.371	1.473	1.410	1.350	1.326	1.370	1.425	1.400	1.410	1.430	1.420	1.400
Yen (Yen/US$)	118	103	106	91	99	95	96	95	93	91	93	95

Quarter-end data and annual averages

August 3rd 2009

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* Subject to approval by the regulatory authorities.