



The Monthly Monitor

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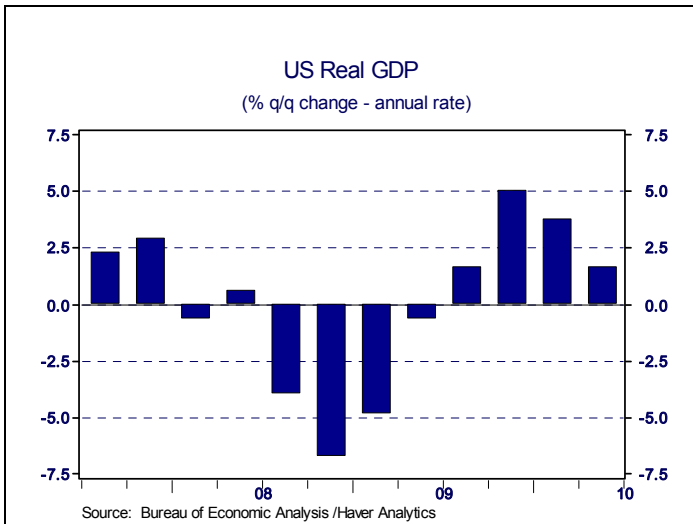
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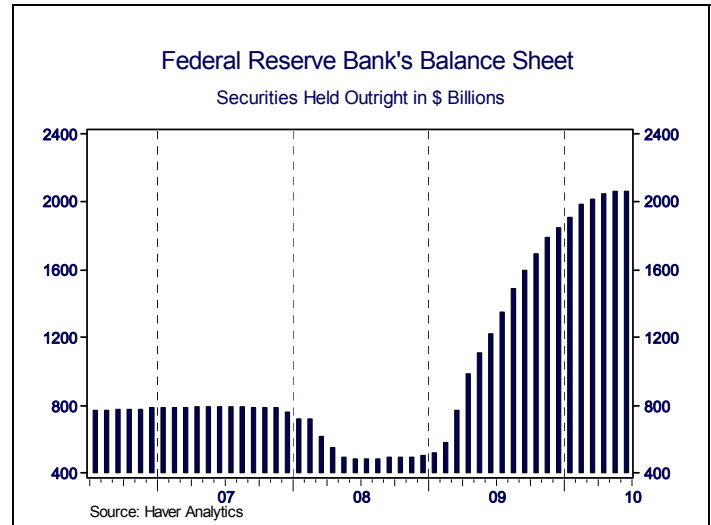
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Helicopter Ben is Ready to Take Off

Economic indicators released since the beginning of the second half of 2010 paint a much darker economic sky hovering over the United States: the expansion in manufacturing activity loses momentum, while new and existing home sales tumbles abruptly. In a nutshell, US real GDP growth during the third and fourth quarters is unlikely to outpace the 1.6% (q/q saar) lacklustre performance of the second quarter by much.



In light of a darkening economic sky and "unusual uncertainty" as Fed Chairman Ben Bernanke phrased it so perfectly, investors take shelter by buying less risky securities such as government and high quality corporate bonds. The US 10-year bond yield notably settles around 2.50% for the moment, while the 2-year bond yield remarkably stayed under 0.60% for 22 consecutive daily sessions. Of course, Federal Open Market Committee (FOMC) members realized the economic sky is less bright than before. They decided during their last meeting on August 10th to keep the size of the Fed's portfolio intact at \$2.3 trillion by reinvesting the proceeds of mortgage-backed securities (MBS) in treasury securities in the 2- to 10-year sector. Less than three weeks later at the Jackson Hole symposium, Bernanke clarified their decision, stating FOMC members wanted to avoid "a passive policy tightening", or, in other words, a natural shrinkage of the balance sheet. The Fed probably wanted to avoid the European situation, where the 3-month Euribor interbank lending rate inched up since the ECB cut back some of his financial facilities and saw its balance sheet contracting slightly.



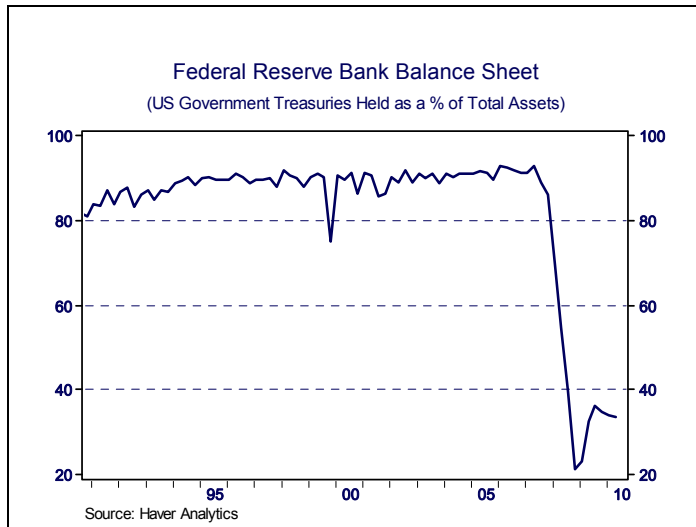
BB&BB: Ben Bernanke & Buying Bonds

Some passages of the Jackson Hole's speech are apparent to a love letter for bonds. Bernanke notably highlighted their appeal for effectiveness and operational purposes: "We decided to reinvest in Treasury securities rather than agency securities because the Fed already owns a very large share of available agency securities, suggesting that reinvestment in Treasury securities might be more effective in reducing longer-term interest rates... reinvestment in Treasury securities is more consistent with the Committee's longer-term objective of a portfolio made up principally of Treasury securities." Indeed, there is plenty of room to load up government bonds. They represented close to 90% of total assets held by the Fed until the 2008 financial crisis, compared to approximately 33% today.

Buying US government debt appears to be on top of the list. "Conducting additional purchases of longer-term securities" is officially what Bernanke referred to, but investors must read between the lines here. "The evidence suggests that the Fed's earlier program of purchases was effective in bringing down term premiums and lowering the costs of borrowing in a number of private credit markets". In other words, the FOMC does not need to directly purchase private debt to make it attractive to investors. Buying government bonds should indirectly do the job well. Purchasing public debt also appears to be the favourite among the Fed's arsenal amid a better cost-to-benefit ratio than other options outlined. Bernanke is notably more open minded on this idea than to stop paying interest on banks' excess reserves or to hyperextend the extend period with ultra-low rates for a even longer than the investors currently anticipate.

That said, we have trouble seeing how the Fed would purchase "only" \$300 billion worth of US bonds. It probably would not constitute a large enough liquidity injection to revive the economy. FOMC members, like us and everyone else on the street, "do not have very precise knowledge of the quantitative effect of changes in holdings on financial

conditions". Still, we argue that, if necessary, the balance sheet would need to surpass \$3 trillion – as a reminder, the impact of QE1 on bond yields lasted only one month and provided a weaker-than-expected boost on economic activity as excess reserves ballooned.

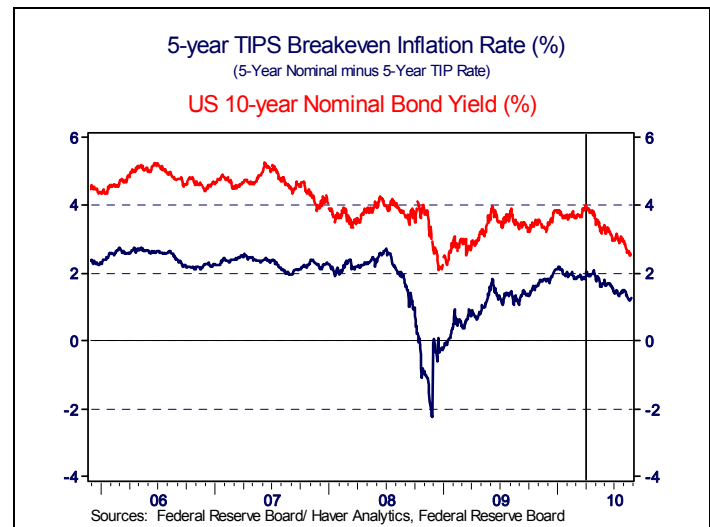


No Signs of Bond Bubble in Sight

Even though bonds are more expensive than before, *LBS Economic Research* does not see how we could be witnessing the creation of a bond bubble.

- Firstly, Ben Bernanke acknowledges at the Jackson Hole symposium that the low rates can reflect a soft economy rather than being a sign of loose monetary policy.
- Since a run-up in inflation – the main driver at the long end – is not in the cards either, it is difficult to see how the yield curve could suddenly become a lot steeper.
- Also, the Fed's chairman ruled out the possibility of opting for a higher implicit inflation target (from 1.5-2.0% to 4% for example), reducing future inflation volatility, the inflation risk premium, and the odds of a bear steepener. *"I see no support for this option on the FOMC... Such a strategy is inappropriate for the United States... Inflation expectations appear reasonably well-anchored, and both inflation expectations and actual inflation remain within a range consistent with price stability... raising the inflation objective would likely entail much greater costs than benefits. Inflation would be higher and probably more volatile..."* Clearly, there are too many costs related to this option at this stage.
- Fourthly, we do not see any trigger in the short-run that could change bond investors' mind about the quality of US government securities. Bond vigilantes are currently not worried about the size of the fiscal deficit in Washington, or distort bond prices compared to their real fundamental value.
- Lastly, the decline in treasury yields and TIPS breakevens observed so far in 2010 is not steep like the plunge in late 2008, suggesting an orderly rather than an irrational behaviour by investors.

In short, we think rates will remain lower for longer. At the short end of the curve, look for the Fed to stand pat until 2012 at the earliest. At the long end, the absence of inflation and below-potential growth should keep the US 10-year bond yield closer to 3% than 4% in the next 18 months and possibly below 3% for the remaining of 2010.



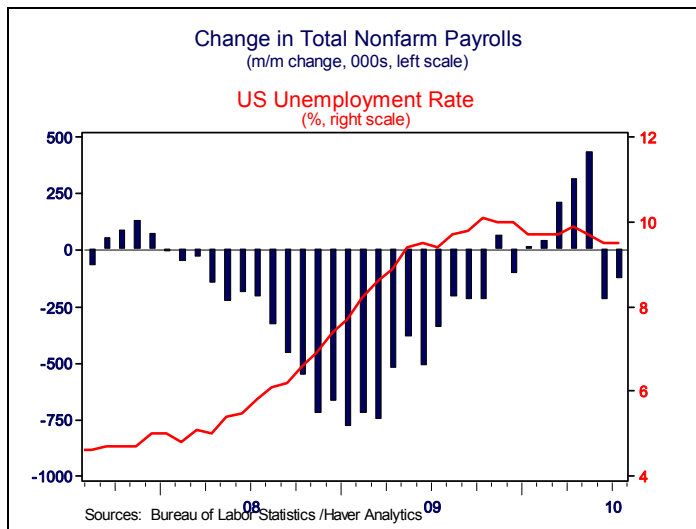
A Lacklustre Job Market, More than Deflation, Would Liff off the Helicopter

All in all, Ben Bernanke is readier than ever to expand the balance sheet, which is to print a lot of money and to drop it out of his helicopter. It is quite reassuring to find out Bernanke shows some willingness to use QE2, if necessary. Unfortunately, many market participants believed otherwise at the moment his comments were made public, as they were hoping more concrete actions right away. In contrast to some market participants that cannot see beyond very short term considerations, Bernanke can. He is well aware of the fine double-edged sword tied to QE2. This explains why he plans to intervene only *"if the outlook were to deteriorate significantly"*.

The Fed probably cannot wait another 18 months before resuming QE. Otherwise, chances of bolstering effectively the economy will diminish seriously – just look at Japanese authorities who waited too long, once deflation was well established. At the same time, it is difficult to conceive how Bernanke could fly the helicopter before the mid-term legislative elections held in November and Basel III. US President Obama is likely to steal the show in the first place by potentially announcing the partial ending of the 2001 Bush tax cuts for high-income earners. Then, should it be necessary to proceed, Bernanke could flex his muscles at the December 14 meeting at the earliest, and set the tone for a better year 2011.

At the end of the day, Bernanke's decision is tied to his dual mandate: price stability and maximum employment. He will *"strongly resist deviations from price stability in the downward direction"* (aka deflation) and promote *"growth in employment"*. *LBS Economic Research* thinks it all comes down to the job market, where troubles are likely to come first. In fact, we agree with Bernanke's statement that *"falling into deflation is not a significant risk for the United States at this time"*.

Put simply, the main risk is that economic growth could be insufficient to reduce the elevated 9.6% jobless rate – in the 1-1.5% area in the next 18 months and clearly below FOMC's upbeat expectations. Unfortunately, two negative dynamics are occurring at the same time: On the exit front, weekly initial jobless claims climbed during August, a sign that businesses are starting to lay off workers again in an effort to deliver bottom line growth. On the entry front, only 10% of small businesses surveyed plan to hire in the next three months according to the *National Federation of Independent Businesses Survey*. Consequently, there is only one job opening for every five unemployed workers compared to a 1:2 ratio during the pre-crisis period. All things considered, these two negative labour market dynamics suggest US payrolls is set to decline for a third consecutive month in August, clearly not going in the right direction. Unless a major turnaround occurs, we do not see how the unemployment rate could magically fall from 9.5% to 8.0-8.5% within the next year, adding pressures on Bernanke to fly the helicopter. Overall, we think the odds of such an intervention are slightly higher than 50%.



"One and Done" for Governor Carney

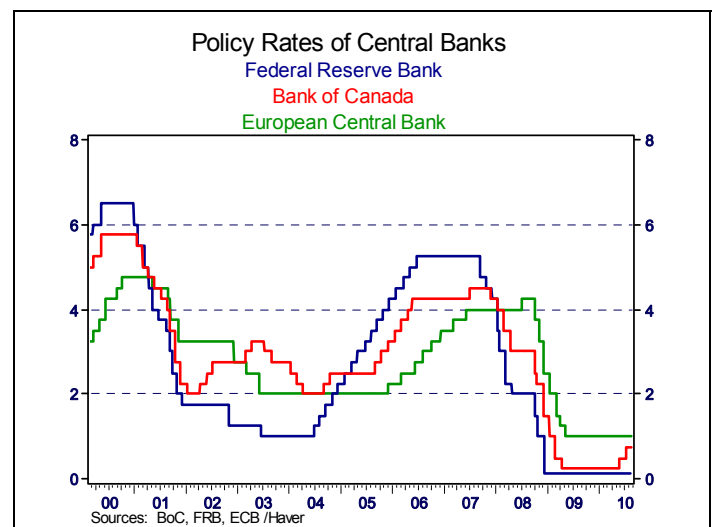
The pace at which the US recovery is losing steam undeniably has repercussions in Canada. Real GDP growth cooled off from 5.8% (q/q annualized) in 2010Q1 to 2.0% in 2010Q2, while core inflation slipped by a tenth of a point three straight months to reach 1.6% in July, comfortably below the 2% target.

Through out the summer, the Canadian bond market gradually reduced tightening expectations. The 2-year yield fell from 2.00% in May to approximately 1.25% today. We are now of the view that the overnight rate target will not rise beyond 1.00% by the end of 2010. The list of arguments supporting a 25bp hike on September 8th is admittedly shorter than before, while the list of factors supporting a pause is growing fast. Nevertheless, *LBS Economic Research* is still leaning towards one last 25 basis point hike, mainly for four reasons:

- There is more than meets the eye in the 2010Q2 GDP report. The 16% surge in imports proves businesses and households are confident, supporting growth. Labour income and corporate profits growth are respectable as well, suggesting a positive momentum going forward.

- Tom Hoenig's concerns in the US about overly low interest rates apply to Canada as well. By raising the overnight rate target from 0.75% to 1.00%, which after all is still a very low level, the BoC can just improve financial stability over the medium term. No one will blame the BoC hiking from 0.75% to 1.00%. It won't be seen as a policy mistake. Our central bank will probably never bring back the policy rate to 0.25-0.50% even if the North American economy turns south.
- Moreover, the rally in bond prices pushed down some of consumers and businesses' key borrowing rates. The BoC's own household and business effective interest rates calculations notably declined in August by approximately 10 basis points, an atypical situation given the early stage of the tightening policy. This mild easing in credit conditions may have caught the BoC by surprise, adding chances of a 25 basis points increment.
- Finally, the rest of the world economy is expanding, notably emerging markets. Also, uncertainties surrounding Europe's financial tensions have abated since the July 20th decision.

We've made our case for one last 25 basis points hike on September 8th. However, it is worth looking at the other side of the spectrum. There is notably one key argument supporting a pause: The BoC has warned the markets on several occasions that *"nothing is pre-ordained"*, and perhaps we should listen. There is a chance the Canadian bond market may live an experience similar to June 10th 2008. Let us refresh our memories for a moment: crude oil prices were above \$US100 per barrel and total CPI inflation near 3%; economists were unanimously expecting one last 25 basis points rate cut in June 2008 before the BoC moved to on the sidelines; But Governor Carney did not keep his arms crossed for an instant. He kept the overnight rate target at 3.00%. Admittedly, the level of rates and the macroeconomic picture were very different then from what we are seeing now. Nevertheless, that episode from the summer of 2008 adds uncertainty to our September 8th call.



Interest-Rate and Exchange-Rate Forecasts

	Historical Data							Forecasts*					
	2008	2009	2009 Q2	2009 Q3	2009 Q4	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4
Canada													
Overnight Rate	3.03	0.43	0.25	0.25	0.25	0.25	0.50	1.00	1.00	1.00	1.50	1.50	1.50
3-Month Treasury Bills	2.33	0.33	0.24	0.22	0.19	0.28	0.50	0.95	1.10	1.25	1.50	1.50	1.65
2-Year Bond	2.66	1.23	1.20	1.26	1.47	1.73	1.39	1.35	1.50	1.75	1.95	2.00	2.15
10-Year Bond	3.61	3.23	3.36	3.31	3.61	3.56	3.08	2.90	3.10	3.20	3.45	3.60	3.75
30-Year Bond	4.06	3.85	3.86	3.84	4.08	4.07	3.65	3.50	3.70	3.75	3.85	4.00	4.15
United States													
Federal Funds Rate	1.93	0.16	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13
3-Month Treasury Bills	1.37	0.15	0.19	0.16	0.06	0.11	0.18	0.20	0.20	0.20	0.20	0.20	0.20
2-Year Bond	2.01	0.96	1.11	0.95	1.14	1.02	0.61	0.50	0.60	0.65	0.70	0.75	0.80
10-Year Bond	3.66	3.26	3.53	3.32	3.85	3.84	2.97	2.75	2.80	3.00	3.15	3.30	3.50
30-Year Bond	4.29	4.09	4.32	4.03	4.63	4.72	3.91	3.65	3.65	3.70	3.85	4.00	4.20
Canadian Dollar (US\$/C\$)	0.944	0.880	0.861	0.933	0.956	0.985	0.943	0.970	0.925	0.940	1.000	1.000	0.980
Canadian Dollar (Euro/C\$)	0.641	0.632	0.614	0.638	0.667	0.728	0.767	0.800	0.758	0.783	0.830	0.830	0.800
Euro (US\$/Euro)	1.473	1.394	1.402	1.463	1.433	1.352	1.229	1.250	1.220	1.200	1.200	1.180	1.150
Yen (Yen/US\$)	103.4	93.7	96.4	89.5	93.1	93.4	88.5	85.0	85.0	90.0	90.0	95.0	95.0

Quarter-end data and annual averages
August 25th, 2010

United States

Period-Over-Period Annualized Per Cent Change Unless Otherwise Indicated

							Annual Average			4th Qtr/4th Qtr	
	2010Q1	2010Q2	2010Q3	2010Q4	2011Q1	2011Q2	2009	2010	2011	2010	2011
Real GDP (%)	3.7	1.6	1.8	2.0	2.5	2.5	-2.6	2.7	2.4	2.3	2.7
Consumption	1.9	2.0	2.4	2.0	2.2	2.3	-1.2	1.6	2.2	2.1	2.3
Private investment	9.4	18.6	4.8	6.9	7.1	7.3	-16.8	6.2	7.9	9.8	8.4
Non-residential structures	-17.8	0.4	4.0	3.5	4.0	5.0	-20.4	-12.9	4.1	-2.9	4.7
Machinery and equipment	20.5	24.9	5.0	8.0	8.0	8.0	-15.3	13.9	9.1	14.3	9.5
Residential construction	-12.3	27.1	-8.0	4.0	3.5	2.5	-22.9	0.2	3.0	1.6	2.7
Government spending	-1.6	4.3	-1.0	-0.5	0.3	0.1	1.6	0.5	0.2	0.3	0.3
Exports	11.4	9.2	9.0	9.0	9.0	9.0	-9.5	12.1	8.8	9.6	8.5
Imports	11.2	32.4	3.5	4.0	4.0	4.5	-13.8	12.0	5.8	12.2	4.9
Inflation (%)											
Total (y/y)	2.4	1.8	1.1	1.0	1.0	1.2	-0.3	1.6	1.3	1.0	1.5
Core (y/y)	1.3	1.0	0.9	0.8	1.0	1.0	1.7	1.0	1.0	0.8	1.0
Unemployment rate (%)*	9.7	9.7	9.5	9.4	9.3	9.2	9.3	9.6	9.1	-	-
Employment	0.2	2.1	-0.5	1.0	-0.5	1.2	-4.3	-0.5	1.1	0.7	1.3
Housing Starts (000s)	617	601	560	600	675	700	554	595	715	-	-
Before-tax Corp. profits (% y/y)	37.6	39.2	9.3	7.2	5.0	7.5	-0.4	22.1	7.9	7.2	10.0

* Average rate for the quarter or the year.

Forecasts as of September 1st 2010

Canada

Period-Over-Period Annualized Per Cent Change Unless Otherwise Indicated

									Annual Average			4th Qtr/4th Qtr	
	2010Q1	2010Q2	2010Q3	2010Q4	2011Q1	2011Q2	2011Q3	2011Q4	2009	2010	2011	2010	2011
Real GDP (%)	5.8	2.0	2.1	2.2	2.6	2.3	2.9	3.2	-2.5	2.6	2.4	2.9	2.8
Consumption	4.3	2.6	2.8	2.4	2.2	2.4	2.5	2.7	0.4	3.4	2.4	3.0	2.4
Business investment	6.6	18.6	8.0	7.9	7.7	7.7	9.3	10.0	-20.0	3.6	8.7	10.2	8.6
Non-residential structures	-1.1	1.0	4.5	6.0	7.0	7.0	8.0	8.0	-19.5	-5.2	6.3	2.6	7.5
Machinery and equipment	11.3	29.7	10.0	9.0	8.0	8.0	10.0	11.0	-20.3	9.1	10.1	14.7	9.2
Residential construction	21.6	1.2	-11.0	-16.0	-10.0	-4.0	-3.0	-1.0	-8.2	8.7	-8.2	-2.0	-4.6
Government spending	2.1	2.0	2.2	2.2	1.8	-1.5	-1.0	-0.4	5.1	4.5	0.8	2.1	-0.3
Exports	10.7	6.0	6.5	5.5	6.0	7.0	8.0	8.0	-14.2	7.5	6.5	7.2	7.2
Imports	13.9	16.4	7.0	4.0	4.0	5.0	5.0	5.0	-13.9	13.0	5.5	10.2	4.7
Current account balance in % of GDP	-2.6	-3.4	-3.1	-2.9	-2.7	-2.6	-2.4	-2.2	-3.4	-3.0	-2.5	-	-
Inflation (%)													
Total CPI (y/y)	1.6	1.4	2.0	2.0	2.1	2.0	1.7	1.9	0.3	1.8	1.9	2.0	1.9
Core CPI (y/y)	1.9	1.8	1.6	1.6	1.7	1.7	1.8	1.9	1.8	1.7	1.8	1.6	1.9
Unemployment rate (%)*	8.2	8.0	7.9	7.7	7.8	7.7	7.5	7.3	8.3	8.0	7.6	-	-
Employment	1.6	4.2	1.0	0.9	1.3	1.5	1.8	2.0	-1.6	1.5	1.5	1.9	1.6
Housing starts (000s)	198	199	170	160	165	165	168	170	149	182	167	-	-
Before-tax Corp. Profits (y/y)	16.8	27.5	18.0	11.0	4.9	9.0	9.7	10.0	-32.3	17.9	8.4	11.0	10.0

*Average rate for the quarter or the year.

Forecasts as of August 31st, 2010