

## Interest Rate Forecast- February 2009

### Stressful times

The U.S. is stepping up its efforts to accelerate the flow of credit to consumers and businesses through more capital and liquidity injections to financial institutions. Federal bank regulators will stress test the loan portfolios of major banks. Those that fail the test and fail to attract enough private capital, the federal government would provide capital through loans that could convert into common stock in the future.

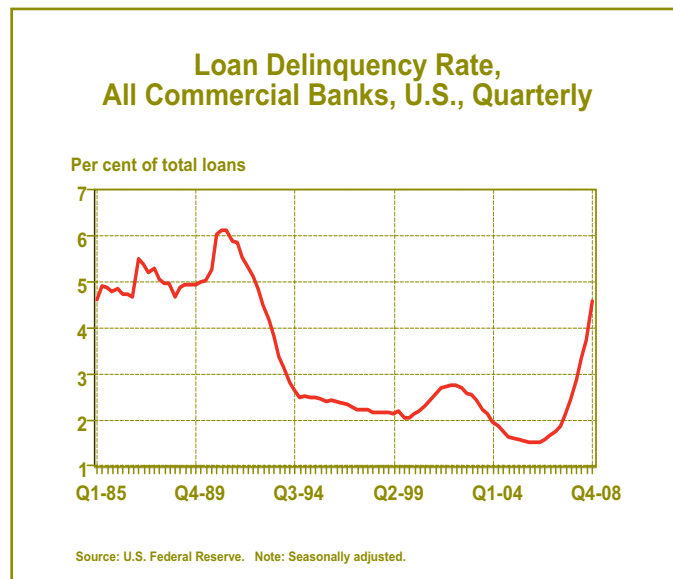
The Federal Reserve's Term Asset-Backed Securities Lending Facility will enable it to purchase a wide range of securities backed by credit cards, auto loans, small business loans, residential mortgages, and commercial mortgages. These moves are an effort to prevent the collapse of major banks considered too big to fail and to improve financial market conditions and break the negative feedback between credit markets and the economic recession.

Fiscal stimulus and home foreclosure policies help stabilize the highly stressed housing market and eventually the economy. Infrastructure stimulus spending will ramp up slowly but the various income support measures kick in during the second quarter. Nonetheless, forecast risk is on the downside.

Economies are shrinking at a faster pace entering the first quarter 2009 with the recession bottom not in sight and only a forecast. The real economy always follows the forward-looking financial markets and they offer little short-term hope after breaking through previous recent lows. At this point in the recession, the negative feedback loop is playing a larger role and contributing to the stress felt by all economic agents.

#### Economy

The U.S. economy is expected to contract through the third quarter of this year and job losses extend into 2010. Accurately predicting turning points is difficult with risk tilted toward a deeper, more prolonged recession. Factors supporting recovery later this year are low interest rates, low energy prices, fiscal stimulus, declining costs, and the emergence of buying and investment opportunities.



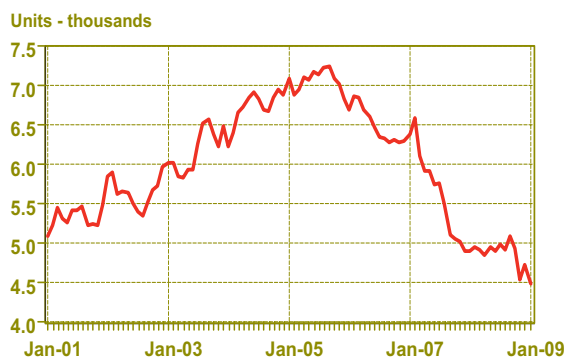
The labour market situation deteriorated in January with the largest job loss since December 1974 at 598,000. Losses for the prior two months were revised upwards to 577,000 and 597,000. In total, payroll employment dropped 1.8 million persons during the last three months.

The unemployment rate increased to 7.6% from 7.2% in December pushing it to the highest rate since 1992. Initial claims for jobless benefits increased to 667,000 for the week ending February 21, while continuing claims increased 114,000 to 5.112 million for the week ending February 14, a new high. February non-farm payrolls are forecast to drop another 600,000 and the unemployment rate to approach 8.0%.

Total industrial production fell 1.8% in January, and manufacturing output fell 2.5%, with significant downward revisions to prior months. Production is declining to realign inventories with slower sales. Export demand is also falling in tandem with the global recession. Regional manufacturing data released in February points to another substantial decline. The reading of -34.7 for the New York region is the lowest since the survey began in 2001; the Philly Fed survey to 41.3 is the lowest since 1990; and the Richmond Fed index stayed mired at its lowest readings on record.

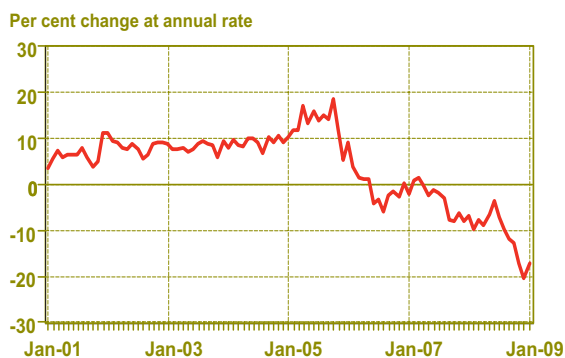


## U.S. Existing Housing Sales



Source: National Association of Realtors. Note: Seasonally adjusted at annual rate.

## U.S. Existing Housing Median Sales Price



Source: NAR, C1CU. Note: Based on seasonally adjusted prices.

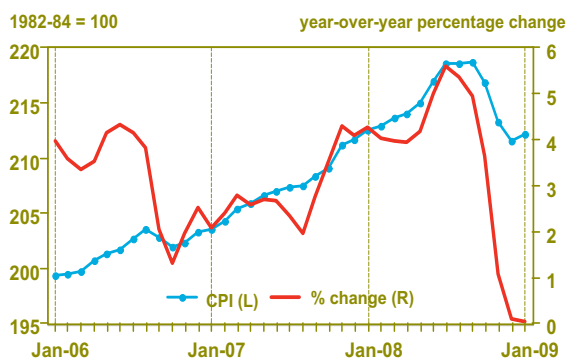
The housing market showed no signs or recovery in January. Existing-home sales fell 5.3% in January and reversed December's gain. The median sales price dropped 3.1% in January and fell at a 17% annualized rate. From its high in October 2005, the median sales price is down 23% and heading to 30% or more. This is the worst housing recession on the modern record. Housing starts dropping to a new postwar low to 466,000 annualized units, a 17% decline from December.

The National Association of Realtors (NAR) estimated that 45% of January sales were foreclosure-linked or otherwise distressed. A number of states and lenders imposed moratoriums on foreclosures, which slowed the number of foreclosed units coming on the market. A large backlog of foreclosed units remains and it is taking longer to complete foreclosure sales. Not all foreclosed units are sold through a realtor and the sales data provided by NAR likely understates sales as well as house price depreciation.

Near-term sales prospects appear bleak with the moving average of the weekly MBAA purchase index lower than at any point since 1999. An upswing in this index is a necessary precursor of a housing recovery. Households are more cautious about making large purchases during recessions but at some future date, the combination of attractive values and low financing costs overcomes uncertainty and leads to more purchases.

Consumer spending via weekly chain store sales shows modest improvement but remains weak. January's retail sales jump is encouraging but it is too early to put much stock in the improvement. Consumers are coping with job uncertainty, slower income growth, rapidly falling wealth, high debt burdens, and more restrictive consumer lending. Lower energy prices free up money but this is not big enough

## U.S. Consumer Price Index



Source: U.S. BLS.

to offset the other negatives. Pending tax cuts as part of the fiscal stimulus package helps later on.

Consumer confidence tumbled to another record low in February and is consistent with a severe recession. It bodes poorly for February retail and housing sales. The Conference Board's index plunged 12.4 points to 25 in February. The expectations component of the index led the decline in February, dropping 15 points to 27.5. Since the late 1970s, this component had not been below 50.

Headline CPI increased at a 0.3% in January, the first in six months. Core CPI increased 0.2% in January from December. The year-over-year change in CPI is 0.2% for headline inflation and 1.7% for core inflation. Overall CPI is heading for negative territory on a year-over-year comparisons and is down about 3% since the summer peak.

Most of this drop is due to energy prices but also to lower prices for durable goods, notably new vehicles.

Core CPI is the more relevant inflation measure and is not expected to turn negative or in deflation territory. This of course depends on consumer spending and other economic activity improving later in the year and avoiding larger excess capacity.

The Leading Economic Indicator (LEI) is up in the past two months but it is too soon to say the contraction is ending. The main source of strength in the LEI in recent months is from the money supply and the interest rate spread. The weekly LEI is still declining but at a slower pace since the beginning of the year. Turning points in these measures predict turning points in the economy but none are signaling a recovery in the next three to six months.

Fourth quarter GDP growth was revised down to -6.4% annualized from -3.8% mainly due to lower inventories but also to weaker exports, construction, and consumption. This is the worst quarterly performance since 1982. GDP increased 1.1% in 2008 compared with an increase of 2.0% in 2007. The current quarter is tracking -4 to -6% annualized and 2009 is forecast at -2.5%.

What kind of recovery should be expected, a V, L, or W? The V recovery suggests a sharp turnaround next year, the L path suggests a longer and weaker recovery, and the W recovery is a volatile, hesitant recovery. Obviously, the financial system needs to stabilize and recover as a precondition for economic recovery and those policy efforts are still making their way through the system or those benefits have yet to materialize. Similarly, with fiscal policies, those benefits are still weeks and months away.

The compromise forecast is something between a V and L recovery with growth around 2% in 2010. However, the likelihood is for a small w outcome driven by inventory swings, more government spending, modest personal consumption, and little private investment spending. The outlook for 2011 and 2012 is more promising with some additional growth from exports and the release of pent-up demand.

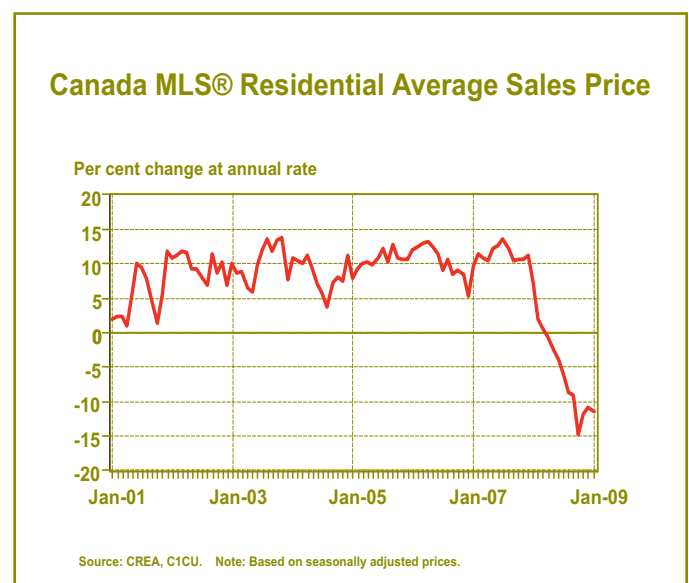
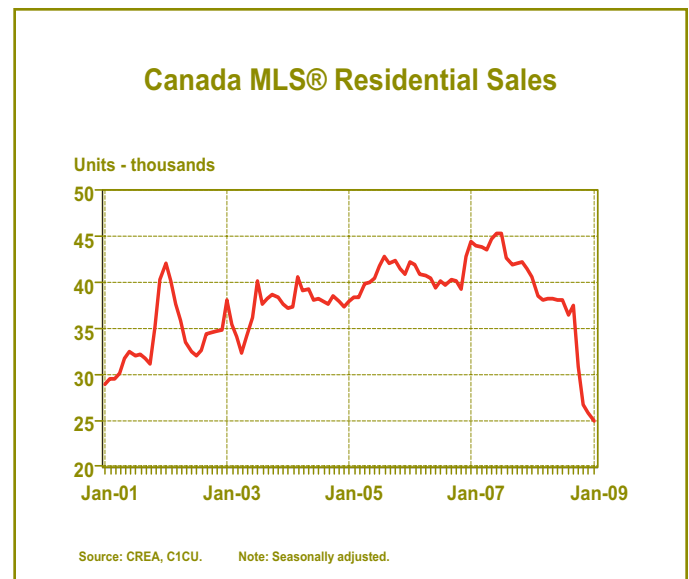
Canada's employment declined by 129,000 jobs in January, exceeding any monthly decline during the two previous recessions and brings total job losses for the last three months to 213,000, the most on record. The unemployment rate jumped to 7.2% from 6.6% in December. February's job report repeats the same trends but with fewer job losses. Company layoff notices are not subsiding.

December retail sales declined 5.4%, the worst monthly drop in 15 years. Automobiles led the decline with new car dealers registering a 15.1% decrease, in line with December's reported 15% drop in new vehicle sales. Gasoline stations (-11.7%) also contributed strongly to December's poor

performance, because of falling prices. Excluding autos, sales diminished 3.2% in broad-based declines.

January housing sales seasonally adjusted dropped 3% from December and since last September plunged 34%. This is third largest four-month drop on record (since 1980) and illustrates the rapid deterioration unfolding in the housing market. Housing sales prices declined in January and further declines are certain in the coming months.

The sales-supply imbalance in the market is large and growing. A below-normal spring sales rebound is in the offing notwithstanding steadily improving purchasing affordability for low-equity buyers. Declining prices and mortgage rates are competing against job uncertainty brought about by the economic recession. Housing is usually a leading sector coming out of a recession and a housing sales recovery is still a few months away.



Housing starts dropped 11% in January to 153.5 thousand units seasonally adjusted at annual rate. Starts are down 29% since last summer and since sales performance leads housing starts, a further 20% drop to 120 thousand units before June is highly likely. The negative impact on GDP from less new housing construction is considerable.

The trade balance posted a \$458 million deficit in December, the first trade deficit in more than three decades and mainly the result of a 10% drop in exports. However, in real or inflation-adjusted terms, Canada has been running a goods trade deficit since 2007. The negative feedback loop from the U.S. and global recession is taking at toll on Canada.

Falling gas prices drove inflation down in Canada, bringing headline CPI below the Bank of Canada's 2% target. The Bank of Canada's core index advanced 1.9% in the 12 months to January. A temporary bout of deflation is underway with the CPI down 1.3% since September.

The composite leading index fell for a fifth month in a row in January, dropping by 0.5%. The stock market and housing components decelerated sharply and the only component registering a gain was the money supply. No turning point is in sight for the Canadian economy and further recession-like declines in GDP and other main indicators is expected at least through to June.

The federal government budget recently announced a stimulus package, spread over two years, to boost the economy through infrastructure spending, fiscal incentives to homeowners for renovation projects, and tax cuts to boost consumer spending. Their impact on the real economy will not be felt quickly. Overall, fiscal stimulus is modest amounting to about \$20b in two years, with the remaining \$20b deficit due to the cyclical hit on revenue and expenses, which is not new stimulus.

Real GDP in the fourth quarter fell -3.4% annualized on a rapidly deteriorating monthly pattern. The handoff to the first quarter 2009 is on a very weak note. First quarter 2009 real GDP is forecast to decline -4.5% annualized followed by -2.0% in the second quarter. Declines are broadly based across sector with large inventory and investment declines dominating the early quarters of a recession. Exports drop and personal consumption tails off. The only growth sector is government spending.

The recession extends through 2009 with the growth re-emerging in the first quarter of 2010. The consensus view has the recession ending in the second quarter of 2009, however, this is a moving target for forecasters and no one really knows when the recession will end. Fiscal and monetary stimulus and most importantly a stabilization of the U.S. financial system are necessary ingredients to ending the recession.

## Interest rates

Administered rates changed little in February though government bond yields mostly held onto their increases from late January. Government T-bill rates held or inched lower during the month. Overall, the government yield curve steepened about 20 basis points, probably due to perceptions of higher government debt from fiscal stimulus measures.

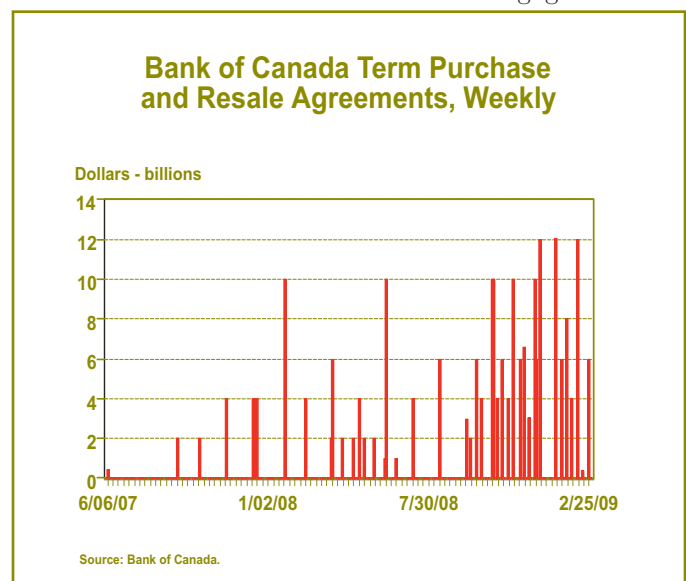
Corporate borrowing rates generally mirrored government fixed income performance. Long bond yields rose and short-term paper rates held or inched down during the month. Spreads off government rates and yields remain elevated, though lower than the peaks during the intense moments of the financial crisis of last year.

Bankers' acceptance rates continue to edge lower and credit outstanding is rising faster in December and January. However, non-financial commercial paper credit is exhibiting a hesitant recovery from the November 2008 low. It is difficult to separate supply and demand factors from these data but the economic recession is likely playing a greater role in restraining credit demand than before.

## Monetary policy

No rate announcements by the Federal Reserve of the Bank of Canada were scheduled during the month. The latest Federal Open Market Committee minutes reveal it is considering setting explicit targets for monetary aggregates or inflation. The Fed is using its balance sheet as the primary tool to stimulate growth and improve financial market conditions because traditional monetary policy tools are constrained by the zero-interest rate policy.

The Bank of Canada continues to engage in term



purchase and resale agreements and 30 Day Term Loan Facility auctions to provide additional liquidity to financial markets. The Bank remained as active in February as in the prior two months, suggesting little improvement in that market.

To speed up the process of returning markets to normal, the Bank of Canada announced a new Term Purchase and Resale Agreement Facility for Private Sector Instruments, which includes eligible corporate bonds and possibly those with a minimum rating of BBB and term Asset-Backed Securities.

### Interest rate forecast

A 50bps cut in the target rate to 0.50% by the Bank of Canada on March 3 is widely expected. Thereafter, the forecast is more uncertain but with economic risk on the downside for the next six months, another rate cut to 0.25% is possible.

This forecast has the Bank in a holding pattern at 0.50% into early 2010. Once economic growth prospects improve, the Bank will embark on a rate-normalization phase and likely in 50bps increments initially. The first such increase comes in March 2010 and the target rate rises to 1.50% by the end of 2010.

Government t-bill rates and bond yields come down in the next two quarters with short rates falling faster than long yields resulting in a steeper yield curve. The yield curve shifts up and narrows slightly later in the forecast period.

Deposit rates decline another 30 to 60 bps from current levels and then track government rates higher in 2010. Posted mortgage rates decline another 60 to 100bps reflecting a lower cost of funds, central bank rate moves, and federal government purchases of mortgage-backed securities. The prime lending rate falls to 2.50% before rising to 3.50% by the end of 2010.

Target Overnight Rate Forecast	
BoC Meeting Date	Rate
Jan. 20, 2009	1.00
Mar. 3 (f)	0.50
Apr. 21	0.50
June 4	0.50
July 21	0.50
Sept. 10	0.50
Oct. 20	0.50
Dec. 8	0.50
Jan. 2010	0.50
Mar.	0.50
Apr.	1.00
June	1.00
July	1.00
Sept.	1.50
Oct.	1.50
Dec.	1.50

## Interest Rate Forecast

Item	2008 Q4a	2009 Q1	2009 Q2	2009 Q3	2009 Q4	2010 Q1	2010 Q2	2010 Q3	2010 Q4
Target Overnight Rate	2.15	0.95	0.50	0.50	0.50	0.50	1.00	1.10	1.50
Prime Rate	3.98	2.95	2.50	2.50	2.50	2.50	3.00	3.10	3.50
1-mo. T-Bill	1.32	0.60	0.35	0.30	0.35	0.35	0.85	0.95	1.35
3-mo. T-Bill	1.46	0.75	0.45	0.40	0.45	0.50	0.95	1.05	1.55
6-mo. T-Bill	1.57	0.80	0.55	0.55	0.55	0.60	1.05	1.20	1.75
1-year T-Bill	1.64	0.85	0.65	0.60	0.65	0.70	1.20	1.35	1.95
2-year GoC Bond	1.82	1.15	0.90	0.85	0.85	0.85	1.40	1.50	2.05
3-year GoC Bond	2.10	1.45	1.15	1.15	1.10	1.15	1.60	1.75	2.30
5-year GoC Bond	2.51	1.95	1.55	1.55	1.50	1.55	2.10	2.25	2.65
10-year GoC Bond	3.39	2.85	2.45	2.40	2.55	2.60	3.15	3.35	3.55
Spread: 10y less 3m	1.93	2.10	2.00	2.00	2.10	2.10	2.20	2.30	2.00

Note: Quarterly average based on daily or weekly data. a = actual, all others forecast.

## Deposit Rate Forecast

Item	2008 Q4f	2009 Q1	2009 Q2	2009 Q3	2009 Q4	2010 Q1	2010 Q2	2010 Q3	2010 Q4
Prime Rate	4.00	2.95	2.50	2.50	2.50	2.50	3.00	3.10	3.50
1-year GIC	1.69	0.95	0.70	0.60	0.60	0.60	0.85	1.00	1.40
3-year GIC	2.56	1.90	1.15	1.00	1.00	1.00	1.30	1.35	1.70
5-year GIC	2.91	2.15	1.50	1.40	1.40	1.40	1.65	1.80	2.05

Note: Quarterly average based on weekly data. a = actual, all others forecast. Redeemable rates.

## Lending Rate Forecast

Item	2008 Q4f	2009 Q1	2009 Q2	2009 Q3	2009 Q4	2010 Q1	2010 Q2	2010 Q3	2010 Q4
Prime Rate	4.00	2.95	2.50	2.50	2.50	2.50	3.00	3.10	3.50
1-year Mortgage	6.08	4.90	4.60	4.60	4.45	4.40	4.20	4.15	4.25
3-year Mortgage	6.79	5.40	5.05	5.00	4.95	4.90	4.70	4.60	4.65
5-year Mortgage	7.07	5.85	5.60	5.40	5.20	5.05	4.95	4.95	5.10

Note: Quarterly average based on daily or weekly data. a = actual, all others forecast.

Fixed term posted mortgage rates.