

Interest Rate Forecast- Feb. 2010

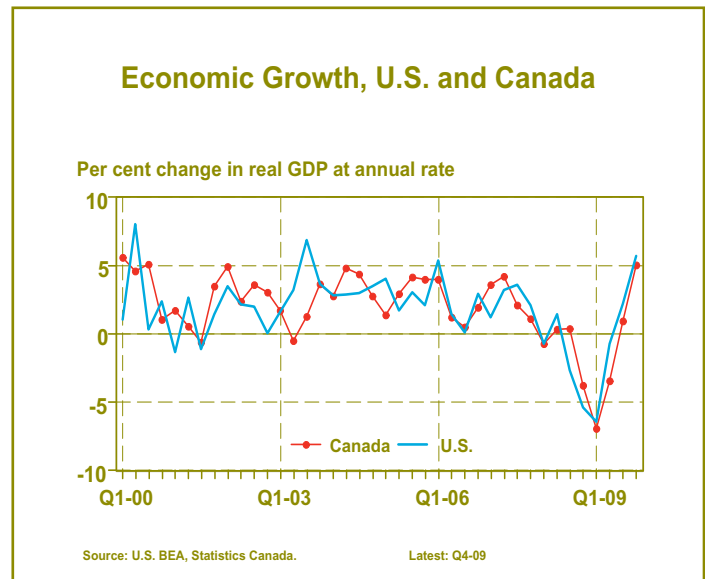
Canada's economic recovery is well underway with the strong year end GDP result, which lifts its future prospects. Since Canada's trade outlook depends critically on the U.S. economy and the exchange rate, overall growth will likely be more moderate than the initial burst out of a deep recession. Domestic sources of growth are limited to interest rate sensitive sectors, government spending, and the inventory cycle. The latter two sources will be winding down leaving the consumer and business investment to do the heavy lifting. Without sustainable growth in exports, moderate overall growth and a longer rate normalization phase is in the cards.

Economy

The U.S. economy is in the early stages of an economic recovery and its strength and durability remains the key consideration for monetary policy actions. Canada's economic recovery is closely aligned with the U.S. despite some significant national differences such as less stressed financial and consumer sectors as well as a more robust housing market. Nonetheless, the shape of the U.S. recovery will play a large role in Canada's monetary policy actions.

In last month's report, an examination of the Bank of Canada's U.S. forecast revealed an optimistic view for 2011, which leads to stronger Canadian exports in 2011. As an aside, its bottom-line forecast is aided by an unlikely import forecast, which has imports growing at a slower rate even though private domestic demand is growing at a faster rate in 2011. The Bank's forecast of 3.9% U.S. growth in 2011 is matched or exceeded by very few private forecasters. The consensus U.S. forecast is 3.1% in 2010 and 3.0% in 2011.

The U.S. recovery, in its second quarter, is tracking below the typical pace set in the post-war era and based on the prevailing view, will continue to underperform in 2010. A larger concern is the possibility of a substantial slowdown in the second half of 2010 since the temporary growth drivers wind down or expire. The key to a sustained economic recovery depends ultimately on the private sector and not



on publicly driven or stimulated demand for goods and services.

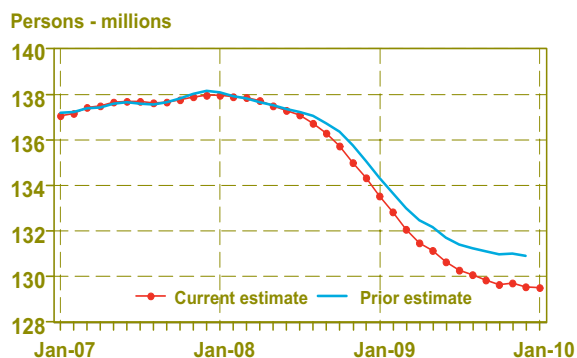
Private sector economic growth occurs under conditions that stimulate demand leading to a reinforcing process of consumption, production, and investment. Population growth, technical innovation, policy settings, and the profit motive are the main, but not the only, elements behind this process. The catalyst at this stage of the cycle is private consumption supported by job and income growth under favourable financing conditions.

Personal consumption growth improved in the second half of last year with the help of the CARS program and the homebuyers tax credit, which was extended to April 2010. Federal government income transfers are no longer a factor. A look at recent job and income trends suggests a modest growth profile for personal consumption.

The annual benchmark revisions revealed the economy shed 8.4 million jobs, equivalent to 6.4% of employment, since the start of the recession, up from the previous estimate of 7.2 million, or a 5.2% decline. The rate of job decline appears set to end and will, at least temporarily,



Total Nonfarm Payroll Employment, U.S.



Source: U.S. Dept. of Labor. Note: Seasonally adjusted

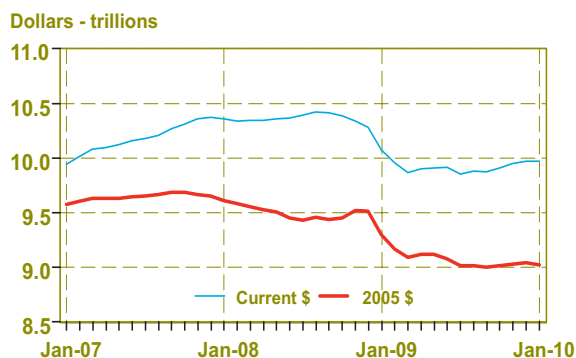
with the hiring of up to one million workers to conduct the 2010 Census. This will boost employment in February with a particularly large jump in May, but these workers will be gone by September.

Personal income after government transfers is edging higher after falling 5.4% in current dollars and 6.3% in 2005 dollars during the recession. Real personal income is up in three of the last four months. Excluding government income transfers gives a better picture of the true income generation capability by individuals and the environment for sustainable consumer spending. Weak job and income growth in 2010 means the outlook for consumer spending is not robust. Larger improvement in the labour market is expected in 2011 bringing the unemployment rate below 9%, setting the stage for a more active consumer sector.

Volatility in monthly economic data will increase in the near term adding more uncertainty on the state of the economy and its outlook. The hiring and layoff of Census workers, the expiry of the homebuyers tax credit by May, and heavy snowstorms on the east coast in February all combine to make for skewed survey results in the labor market, housing, retail and wholesale trade, and manufacturing sectors. Weather is accounted by seasonal adjustment factors based on historical patterns but they do not handle abnormal weather events well. Markets struggle when uncertainty rises.

Canada's economy surged ahead at 5.0% annual pace in the last quarter of 2009, exceeding the most optimistic forecast. Does this mean a more positive economic outlook?

Personal Incomes Less Transfer Payments, U.S.



Source: U.S. BEA, C1CU Note: Seasonally adjusted at annual rate.

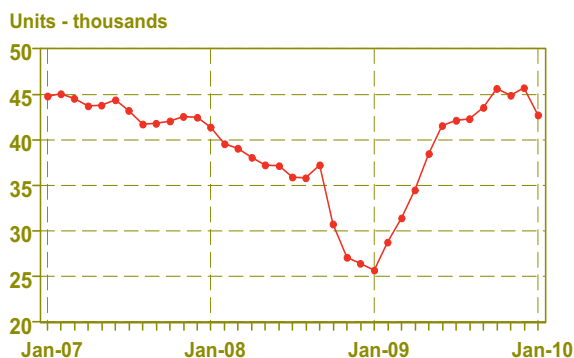
Possibly, but the latest quarterly release includes downward revisions to prior quarters leaving a deeper recession than previously estimated. The third quarter 2009 growth rate is now at 0.9% up from 0.4% previously but that is off a lower base but still left the economy at lower level than the initial estimate.

To place the latest performance in context, the typical recovery growth pace is 3.5% and 5.3% in the first two quarters after the cycle trough and even with a robust fourth quarter, the current recovery remains below average to this point. In the typical recovery, growth in the first two quarters is 3.5% and 5.3%, followed by 3.4% to 5.9% per quarter in the next year.

The fourth quarter growth surge originated from sharply higher residential investment, more goods exports, and slower growth in goods imports. Negative contributions came from faster inventory decumulation and a substantial drop in business investment. The consumer and government sectors grew at a slightly slower pace than in the third quarter. Final domestic demand growth slowed to 4.6% from 5.6% in the prior quarter.

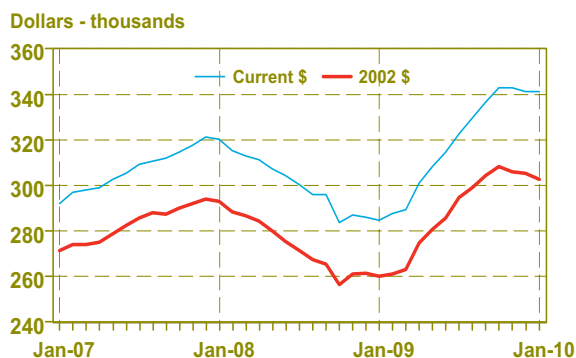
Last quarter's goods exports were boosted by automotive products and assisted by more energy and forest products. Auto sales in the U.S. came in at 10.8 million units in January, about equal to the fourth quarter average. The forecast is for fewer sales in February in part due to the severe winter and to Toyota's problems. Sales for 2010 should post a modest gain to about 11.7 million units followed by more than 13 million in 2011.

MLS® Residential Sales, Canada



Source: CREA, C1CU. Note: Seasonally adjusted

MLS® Residential Average Sales Prices, Canada



Source: CREA, C1CU. Note: Seasonally adjusted

The strong resurgence in housing sales has cooled off. MLS® residential sales are no longer rising since last October and underwent a sizable decline in January. Whether MLS® market share has changed (MLS® represents an unknown share of total transactions, 80%?) or the bargain hunting phase petered out as sales prices climbed is not certain. Demand factors other than price are likely not the cause for January's decline though poor weather would influence sales. Mortgage rates remain very favourable and the economy is growing which should lift sales.

Housing prices are beginning to lose steam. The seasonally adjusted average sales price is lower in the latest two to three months and should sales continue to decline, housing prices will follow. More supply is coming onto the market and should soften prices as well.

Home renovation spending, adjusted for inflation, expanded at a plus 17% annual rate in the fourth quarter and some of momentum will spill over to the first quarter of 2010. However, the end of the federal government tax credit on January 31, 2010 means a decline in second quarter spending since the incentive pulled forward some activity. Residential investment spending will keep expanding though, since housing starts will increase in the first half.

Did the federal government act prematurely to cool the housing market? Only time will tell but the market is in the early stages of a cooling adjustment off the initial rebound and with higher mortgage rates looming in 2011 market forces would have led to another demand adjustment as

well. The main regulatory change affecting sales is to have borrowers needing mortgage insurance qualify at the posted five-year term rate instead of the three-year rate previously in effect. This squeezes some low-equity buyers out of the market since it raises qualifying income by 10 to 15%.

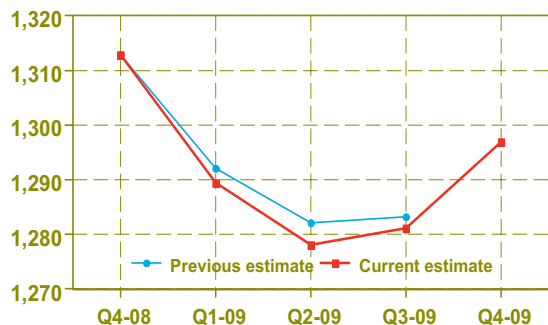
Mortgage rates and other rates will not rise unless the economy is growing and the growth outlook is positive. Housing sales will be supported and lifted by these improved economic conditions and offset the negative effect of those higher rates to some extent. The government's move to cool the market could be appropriate under this scenario but its timing requires the economic recovery to gain a strong footing in 2010. The upcoming federal budget will reveal the government's economic forecasts.

Looking at some recent economic numbers, Canada's job count increased in January though mostly a result of higher part-time employment. However, Statistics Canada's annual revisions included a substantial cut to December employment by 28,200, all in full-time positions. Retail sales rose 0.4% in December, reversing the 0.3% decline of the previous month. In volume terms, sales were up by 0.6%.

December's industry GDP increased 0.6%, up from 0.4% in November and 0.3% in October in a strong hand-off to the first quarter. Manufacturing and wholesale trade were among the main contributors and reflect the reversal in the auto sector from its mid-2009 depths. Construction, led by residential, is another notable growth driver.

Real Gross Domestic Product, Canada

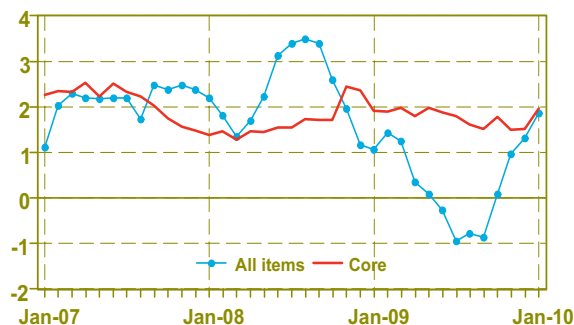
Dollars - billions chained 2002



Source: Statistics Canada. Note: Seasonally adjusted at annual rate.

Consumer Price Inflation Rates, Canada

Per cent change y-o-y



Source: Statistics Canada, C1CU.

Canada's composite leading indicator increased 0.9% in January, a similar pace to prior months. The U.S. leading indicator is slowing and with some moderation in the housing market, Canada's leading indicator is expected to be rising less robustly in the coming months. These leading indicators are signaling a potential slowdown in the second half of 2010, and while not infallible, there is some basis for concern.

The just-released fourth quarter economic accounts will prompt some forecast revisions. Currently, the consensus quarterly real GDP forecast is about 3.5% per quarter in the first half of 2010 and 3.0% in the second half. Growth rates in 2011 are more dispersed around the mean of 3.3% reflecting divergent views. The Bank of Canada is at the upper end in 2010 and the lower end in 2011.

The 5.0% growth rate, which surpassed all expectations, likely means upward revisions but the key point is will it continue on a stronger path or it is just a one-time shift? If it is the latter, then it does not change too much other than perhaps spurring the Bank to move a little sooner. However, if it is the beginning of a more vigorous growth profile then there are substantial implications. Since it is difficult to expect 4% plus growth rates in Canada when the U.S. economy is underperforming and facing considerable headwinds, the latest GDP reading is taken to be a one-time shift due to some temporary factors.

Private sector demand in the U.S. needs to grow at a sustainable pace in order for Canada's exports to expand and contribute to growth in a meaningful way as foreseen

in the Bank's forecast. Government stimulus in Canada will contribute to growth in 2010 but begin to diminish in 2011 since the upcoming federal budget likely reduces discretionary spending growth. The quarterly profile of private sector growth in the U.S. and Canada will determine the path of interest rates.

Inflation

Headline inflation in Canada is picking up and accelerated measurably in January. The month-to-month increase in the all-items CPI was also stronger compared with a month ago. The year-over-year gains in prices mainly emanated from energy and gasoline prices in particular. A base effect is at work and will disappear by June unless energy prices spike in the meantime. The year-over-year all-items CPI will settle around 2% for several months.

Core inflation remains slightly under the Bank of Canada's 2% target. With an elevated currency and considerable excess capacity, inflation pressures are not a major concern in 2010 or 2011.

In the U.S. core inflation measures are coming in around 1.5% y-o-y while headline inflation is 2.6% in January. On a more current basis, the 6-month rate on core CPI is below 1% and since there huge excess slack in labor markets, real estate, and industrial production, inflation will stay low for the next two years.

Monetary policy

The main story this month is the U.S. Fed's move to raise the discount rate and the Chairman's semi-annual testimony on Capital Hill. The move to raise the discount rate this week is part of the Fed's exit strategy and a technical move to restore the spread between the discount rate and the fed funds rate. The Fed's statement indicates the changes are "not expected to lead to tighter financial conditions for households and businesses and do not signal any change in the outlook for the economy or for monetary policy." The next step in this process will be the completion of the agency MBS purchase plan in March.

The Bank of Canada's March 2 rate announcement will likely reiterate its stance of keeping rates on hold until mid-year but its tone and word choice will be closely scrutinized for clues to the first rate hike. The Bank's last statement ended with "... the overall risks to its inflation projection are tilted slightly to the downside." Should this change to indicate more inflation pressure then the Bank is likely to pull the trigger soon after mid-year.

One final point, while the fourth quarter growth rate of 5.0% topped the bank's forecast of 3.3%, the growth rate for the whole year came in at -2.6% versus the Bank's forecast of -2.5%. Even with the last quarter's outperformance, the economy is roughly in the same position, after revisions, than before leaving the Bank's growth outlook more important than what just transpired.

Interest rates

Administered rates were little changed in February other than a small decline in posted three and five-year fixed term mortgage rates. Government t-bill rates and bond yields moved lower in the first half of the month and climbed in the third week but overall, there was modest change.

Interest rate forecast

The economic growth forecast underpinning this interest rate forecast incorporates a second half 2010 slowdown in the U.S. and Canada before picking up in 2011 with a strong close to the year. This is an opposite growth path than taken by the Bank of Canada – steadily stronger into 2011 before slowing in the second half of next year. If the Bank's forecast was adopted, the first rate increase would

occur in July 2010 followed by a series of increases to about 3.50% at the end of 2011.

The futures market for three-month Bankers Acceptances is still pricing in a 50 bps rate increase for September 2010 even after the strong GDP release. By June 2011, short rates are 150 bps higher and 220 bps higher at the end of 2011.

The steep yield curve gives way to a more normal term structure during the rate normalization phase though with an upward shift in all terms. This rotational up-shift occurs in administered rates as well.

Helmut Pastrick, Chief Economist
hpastrick@central1.com
604 737 5026

Target Overnight Rate Forecast	
Meeting Date	Rate (%)
Jan. 19, 2010	0.25
Mar. 2 (f)	0.25
Apr. 20	0.25
June 1	0.25
July 20	0.25
Sept. 8	0.25
Oct. 19	0.25
Dec. 7	0.75
Jan. 2011	1.25
Mar.	1.50
Apr.	1.75
June	1.75
July	1.75
Sept.	2.00
Oct.	2.25
Dec.	2.50

Interest Rate Forecast									
Item	2009 Q4a	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4
Target Overnight Rate	0.25	0.25	0.25	0.25	0.40	1.20	1.70	2.00	2.25
Prime Rate	2.25	2.25	2.25	2.25	2.40	3.20	3.70	4.00	4.25
1-mo. T-Bill	0.16	0.15	0.20	0.20	0.35	1.15	1.60	1.95	2.15
3-mo. T-Bill	0.21	0.20	0.25	0.25	0.45	1.25	1.75	2.00	2.30
6-mo. T-Bill	0.29	0.25	0.30	0.35	0.55	1.35	1.85	2.15	2.45
1-year T-Bill	0.56	0.60	0.60	0.65	0.85	1.60	2.00	2.35	2.70
2-year GoC Bond	1.35	1.35	1.45	1.55	1.80	2.60	2.60	2.75	3.20
3-year GoC Bond	1.83	1.70	1.90	2.05	2.40	2.95	3.00	3.10	3.55
5-year GoC Bond	2.62	2.60	2.70	2.90	3.25	3.60	3.65	3.60	3.90
10-year GoC Bond	3.41	3.45	3.50	3.65	4.00	4.20	4.35	4.40	4.65
Spread: 10y less 3m	3.20	3.25	3.25	3.30	3.55	3.35	2.60	2.40	2.35

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

Deposit Rate Forecast									
Item	2009 Q4a	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4
Prime Rate	2.25	2.25	2.25	2.25	2.40	3.20	3.70	4.00	4.25
1-year GIC	0.28	0.30	0.30	0.30	0.40	0.85	1.05	1.25	1.45
3-year GIC	1.41	1.35	1.50	1.55	1.60	2.00	2.05	2.10	2.35
5-year GIC	1.94	1.90	2.00	2.10	2.25	2.50	2.55	2.55	2.85

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

Lending Rate Forecast									
Item	2009 Q4a	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4
Prime Rate	2.25	2.25	2.25	2.25	2.40	3.20	3.70	4.00	4.25
1-year Mortgage	3.70	3.60	3.65	3.65	3.75	4.30	4.55	4.75	4.95
3-year Mortgage	4.35	4.20	4.35	4.45	4.65	5.10	5.10	5.15	5.50
5-year Mortgage	5.67	5.45	5.55	5.75	6.00	6.25	6.30	6.35	6.70

Note: Quarterly average based on weekly data. a = actual, all others forecast. Fixed term posted mortgage rates.