

Interest Rate Forecast- Jan. 2010

Mixed economic news during the month kept rates down as did concerns over the future path of the economy. A strong U.S. GDP growth number ironically did not impress and the central banks stuck to their monetary policy stances. There are considerable differences on Canada's economic outlook with each view implying a different course for interest rates.

Economy

A 5.7% annualized rise in U.S. real GDP during the fourth quarter looks impressive but it overstates the strength of the economy when final sales to domestic purchasers grew only 1.7% annualized from 2.3% in the third quarter are considered. The large difference was mostly inventories with some assistance from the trade sector. Inventory destocking continued in the fourth quarter though at a lesser pace than previously, which lifted overall GDP.

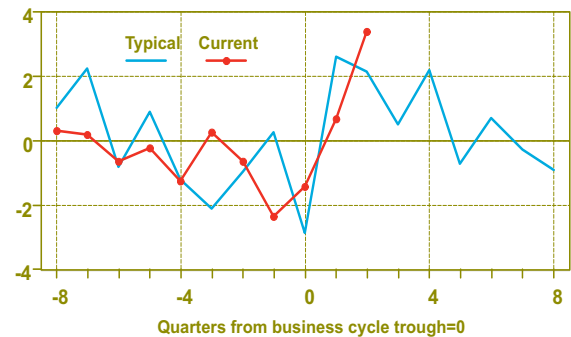
The inventory drawdown during the recession has been substantial but that is about to change, likely in the first quarter of 2010, into re-stocking and contribute to bottom-line GDP even with final sales growing at only 2%. Obviously, inventories are a temporary growth source and should weaken considerably in the second half of the year.

Other temporary sources of growth are also at play, notably the homebuying tax credits ending April 30 and the waning boost to auto production boost from last year's cash-for-clunkers program. More federal infrastructure spending this year helps as does some additional income transfers to the unemployed but fiscal policy stimulus will fade later this year and into 2011.

However, in the State of the Union address, measures were announced to provide tax credits to small businesses who hire employees and incentives to boost small business lending by community banks. These efforts are in the early planning stages and will probably not affect the economy for a few months, as might the proposed spending freeze. A temporary jobs impact will come from the hiring of about

Inventory Cycle during Current and Typical U.S. Economic Recovery

Percentage points annualized, contribution to real GDP



Source: US Bureau of Economic Analysis, C1CU.

one-half million or so persons to conduct the 2010 Census in April.

A self-sustaining recovery is expected to materialize slowly with the key requirement being jobs. Consumer spending is expanding, albeit moderately, and exports are posting decent numbers. Various technical indicators point to job growth in the near future and if this recovery is not 'jobless' in the full sense, it will be a 'jobs light' recovery. The growth outlook for 2010 ranges between 2 to 4.5% amongst U.S. forecasters with the central tendency around 3%. High unemployment, strained consumer balance sheets, credit issues, and mortgage problems in residential and commercial real estate top the worry list.

Forecasts for 2011 are in an even wider range reflecting higher uncertainty about the pace and durability of the U.S. recovery. For example, the consensus forecast is 3.1% while the IMF is 2.4% and the Bank of Canada is using 3.9%. The 2011 forecast is even more critical than the 2010 forecast since central banks must be forward-looking by nine to eighteen months. While the Bank has committed to no rate change in the first-half of 2010, its 2011 forecasts have huge bearing on when the first rate increase occurs.



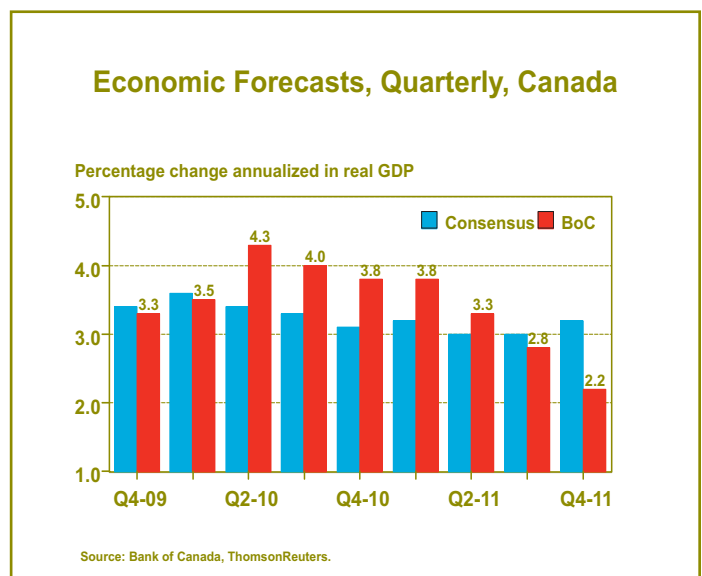
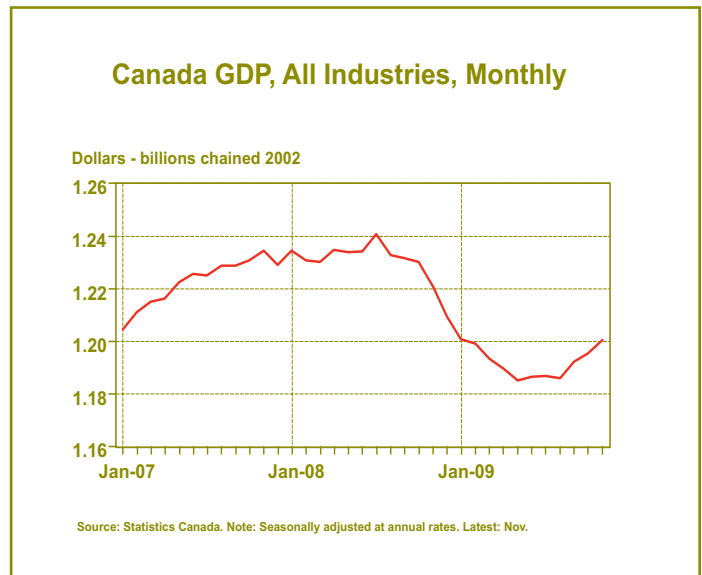
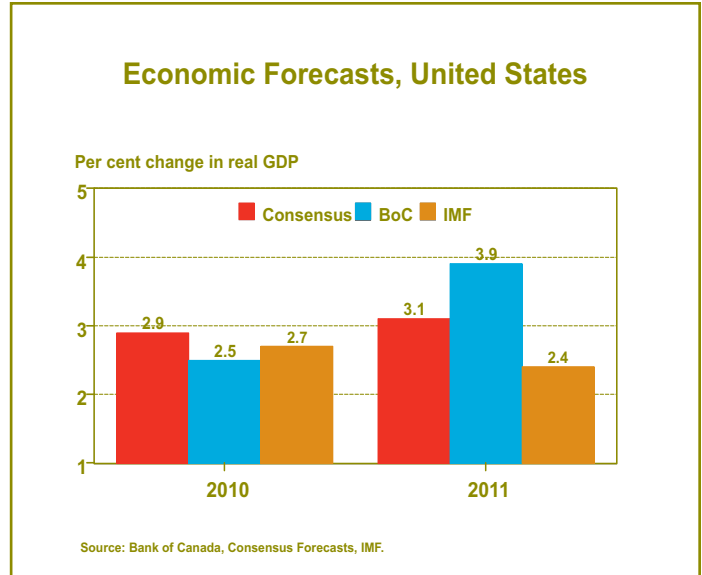
How realistic is the Bank's 2011 U.S. forecast? We will not know except in hindsight, but that it is among the optimistic outliers perhaps says something about its desire to commence the rate normalization phase sooner rather than later.

Following every recession and weak recovery phase, a period of above-average growth typically emerges but timelines vary and depend on a number of demand factors. Research conducted into recessions and financial crises reveals a weak recovery process lasting between two to four years. The unprecedented amount of policy stimulus thrown at this crisis could shorten the recuperative process and allow for a self-sustaining recovery sooner.

Canada's fourth quarter real GDP growth looks to come in between 3.5 to 4.5% annualized based on the 0.3% and 0.4% increases in monthly GDP for all industries in October and November, respectively. December's employment number was down insignificantly from November's large jump while retail sales dipped in November likely due to abnormal weather.

Housing sales are still rising though at a lesser pace in recent months and housing prices set another monthly high in December. Housing's main economic boost comes from new construction rather than housing sales and housing starts are on an established upturn. One bump in the road is the Harmonized Sales Tax effective July 1, 2010 in B.C. and Ontario pulling forward activity at the expense of the second half. Beyond this, housing starts are likely to increase by 10 to 15% in 2011 despite higher mortgage rates and affordability concerns.

The Bank's forecast for Q4-09 real GDP forecast of 3.3% is likely low but of more interest are its quarterly forecasts to the end of 2011. The Bank's forecasts are well above consensus reflecting either a clearer understanding of the economy's workings or more optimistic assumptions or a desire to achieve its 2% inflation target at the end of the two-year projection period or all of the above and more. The Bank's forecast has the core inflation rate at 2% in the second half of 2011 and the output gap eliminated from its Q3-09 reading of -4.0%. However, using the consensus forecast instead of the Bank's, the output gap at the end of 2011 is -0.5% rather than 0.0%.



The U.S. is Canada's most important external economic influence and its growth outcome is likely to come in below the Bank's expectations resulting in a disappointed Canada forecast as well. Looking into the details of the Bank's forecasts for Canada, its 2011 forecast of 3.5% growth incorporates a significant improvement in net exports partially helped by more exports but mainly by fewer imports. Its drop in imports is at odds with a business investment pickup in 2011 since a fair portion of machinery and equipment is imported and is similarly at odds with the increase in consumer spending. The Bank has the domestic economy cooling in 2011 on less government spending and less housing investment with inventories providing a substantial boost. If the Bank's forecast goes awry, it will most likely be in its trade sector forecasts.

Inflation

Consumer price inflation in Canada remains modest at 1.5% and below the Bank's target rate of 2% suggesting the Bank will keep to mid-2010 commitment of no rate increase. Headline inflation is up for the third straight month of year-to-year price acceleration because of energy prices, primarily gasoline. Overall, there is excess capacity in the economy and little pricing power by businesses. In addition, the strength of the Canadian dollar holds down or lowers some prices.

In the U.S., a similar situation exists with the core inflation rate below 2% but considerably more excess capacity in the economy. Occasional concerns over deflation still crop up. CPI forecasts for 2010 and 2011 range from 0.4 to 4.0% with most forecasters around 2%. Those at the extreme ends have either weak or strong economic growth forecasts.

Monetary policy

The Senate's confirmation of Ben Bernanke for a second term as Federal Reserve Chairman removes some of the uncertainty about the path of monetary policy. That policy will keep its target fed funds rate low "for an extended period" but the Fed is starting to withdraw some of the support it has provided to the financial system in the way of liquidity, loans to banks, and swap lines with other central banks. As an aside, the currency swap line with the Bank of Canada, which was not used ends on February 1, 2010.

For the first time during since this crisis emerged, a committee member cast a contrary vote and argued that

the federal funds rate be increased sooner rather than later. However, with the lack of inflationary pressures and a 10% unemployment rate, the Fed is unlikely to raise rates for many months. When the Fed raises rates, it will likely be aggressive in 50 or 75 basis point increments to move off zero and to avoid a potential inflation overshoot or the impression that it is not concerned about asset bubbles.

The Bank of Canada maintained its target for the overnight rate at 0.25% and restated its commitment to this rate until the end of the second quarter of 2010 with the caveat that its inflation outlook does not change -- a safe presumption.

Interest rates

No movement in administered rates during the month though there was a general down drift in government treasury-bill rates and government bond yields. Corporate bond yields also declined in the month and are at their lowest levels since 2005. Notwithstanding the high U.S. and China GDP growth figures released at the end of the month, economic news tended to be negative with concerns over China's removal of stimulus, sovereign debt, weak company earnings, potential new bank taxes and increased financial regulation, and a possible second-half 2010 economic slowdown.

Interest rate forecast

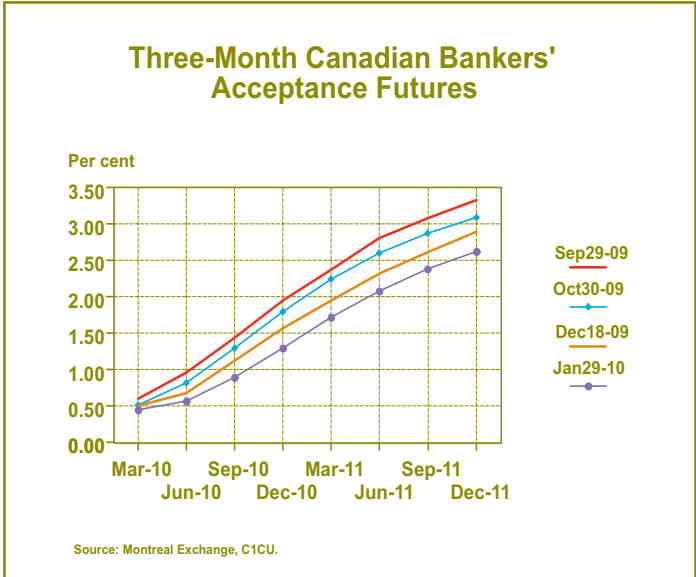
Minor changes to the forecast this month and the timing of the Bank's first rate increase brought forward to December 2010 -- an unwelcome Xmas gift. This is later than most forecasts since sub-par economic performances in the U.S. and Canada are assumed in 2010 and 2011. The consensus forecast uses a more robust growth scenario resulting in rate increases commencing in September.

The growth forecast is only one component determining the Bank's first move; the other is the initial condition. Substantial excess capacity exist as a result of the recession leaving the output gap at levels comparable to the 1990-92 recession but above the 1982 recession. This means the economy can grow at a high rate for two or three quarters or at a below-average pace for several more quarters without causing inflation to exceeding the Bank's 2% target. Following the early 1990s recession, the Bank did not begin its rate tightening phase until 1994.

The futures market for three-month Bankers Acceptances is pricing in a 50 bps rate increase for September 2010 and by June 2011, short rates are 125 bps higher and 200 bps higher at the end of 2011. Market expectations change with the economic news and since last September, expectations have been regularly downgraded. Since few have experienced a financial crisis of this magnitude, a re-calibration takes time since past economic performance in normal times carries much weight.

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.

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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	0.20	0.20	0.20	0.35	1.15	1.60	1.95	2.15
3-mo. T-Bill	0.21	0.25	0.25	0.25	0.45	1.25	1.75	2.00	2.30
6-mo. T-Bill	0.29	0.30	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	1.40	1.45	1.55	1.80	2.60	2.60	2.75	3.20
3-year GoC Bond	1.83	1.80	1.90	2.05	2.40	2.95	3.00	3.10	3.55
5-year GoC Bond	2.62	2.65	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	3.20	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	1.45	1.50	1.55	1.60	2.00	2.05	2.10	2.35
5-year GIC	1.94	1.95	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	3.65	3.65	3.65	3.75	4.30	4.55	4.75	4.95
3-year Mortgage	4.35	4.30	4.35	4.45	4.65	5.10	5.10	5.15	5.50
5-year Mortgage	5.67	5.50	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.