

Interest Rate Forecast- March 2010

Market expectations were lifted by positive economic news, particularly from the U.S. Interest rates turned higher in the month setting the stage for a Bank of Canada move in July. Canada's near term economic outlook points to a fairly robust first half performance but thereafter the outlook dims and the Bank's rate normalization phase pauses in early 2011.

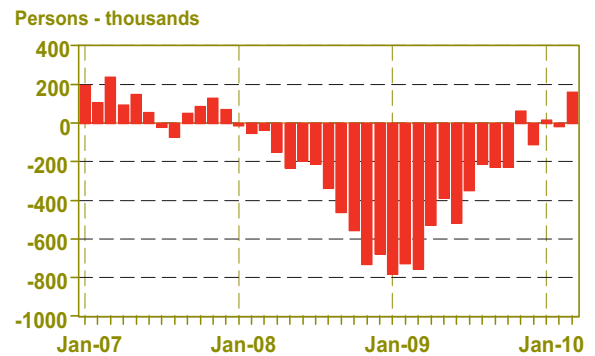
Economy

The most notable economic event in March was the increase in U.S. payroll employment, which contained more positive elements than expected. An increase in government positions due to the upcoming Census was not a surprise rather the increase in private employment was above expectations and February was revised up despite bad weather. In addition, the breadth of employment gains in March was significant with every major industry except information and financial activities adding to payrolls. Temporary employment hiring increased by 40,000 in March and was a positive for future growth.

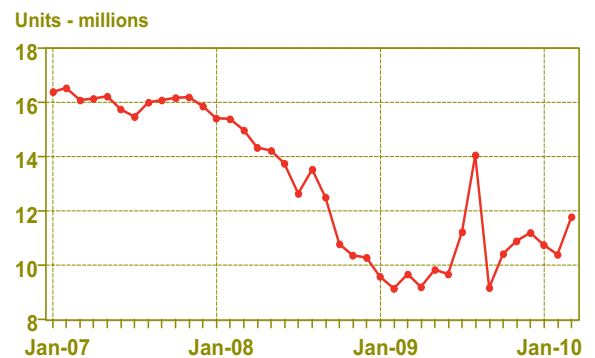
Industrial production stalled in February since manufacturing output was hit by a series of major snowstorms. However, information from the Institute for Supply Management's manufacturing March index was positive and showed that manufacturing has momentum heading into the second quarter beyond the weather-related snapback in March industrial production. The inventory cycle will still contribute to growth though it is now in the accumulation phase

New vehicle sales bounced back in March partially because of the severe winter weather in February and the sales incentives offered by manufacturers, particularly Toyota. This boosted vehicle sales to 11.8 million units on a seasonally adjusted annualized basis. Spending on consumer durables is one of the main contributors to growth in the early phase of a recovery but is generally lacking in this recovery except for the cash-for-clunkers spike. March's

Monthly Change in U.S. Payroll Employment



U.S. Autos and Light Truck Sales



jump is positive though driven by incentives and a weather event.

Low interest rates are normally a powerful force behind the resurgence in consumer durables spending but in this time some credit restrictions remain and high debt level is a problem for many households. In addition, household net



worth is down considerably, unemployment is high, and income growth is slow. As a result, the near-term consumer spending outlook is still problematic.

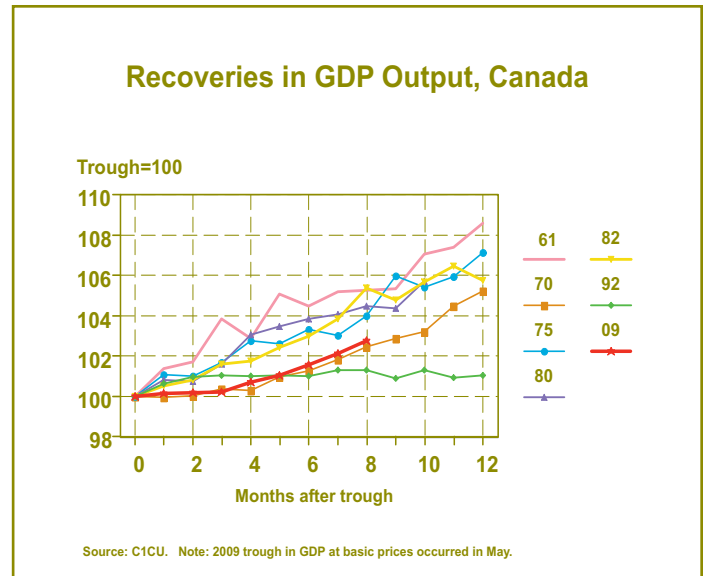
Housing is another key sector to kickstart the economic recovery and a bellwether for consumer spending. Existing home sales are running at about 5 million units seasonally adjusted annualized about 10% above the recession low. The approaching April 30 deadline to qualify for the extended tax credit implies another sales spike though probably not as high as last November's 6.5 million units.

The real economic punch from housing comes from new construction not housing sales, though higher sales and prices are necessary before new construction picks up. Housing starts are at historic lows and projected to increase about 10 to 15% in 2010, which is positive for growth but its contribution to growth will be small since it is operating at such a low level. Thus far, the recovery in housing starts is the weakest on record.

Another policy-induced spike affected the economy in Q4-09. This time spending on equipment and software surged in Q4-09 due to the investment tax credit. Spending jumped at a 19% annual rate in the quarter and contributed 20% of the 5.6% total growth. Almost certainly, this spending line will decline in Q1-10 and subtract from total growth.

One source of growth is exports buoyed by the lower U.S. dollar and high growth rates in the emerging economies, notably China. The trade balance after netting out imports is improving but will remain negative for several more years. Historically, the U.S. economy was not very dependent on trade for its growth but in this recovery trade is a more important factor due to globalization, fewer trade restrictions, and larger U.S. intra-company trade. The lower dollar helps as well.

U.S. Q1-10 real GDP growth is forecast to ease back from the 5.6% pace in the prior quarter to 3 to 3.5% annualized. A small majority of U.S. forecasters expect growth at less than 3%. The outlook for the rest of the year is more uncertain. Two views dominate the medium term outlook – one sees a second half slowdown and the other does not. A good case can be made for both scenarios but since various one-time effects occur in the first half, the likelihood is the pace of growth will slow in the second half.



The 2011 growth outlook is in the 3% range plus or minus 0.5%. Normally in the second year of a U.S. recovery, growth rates are in the 4 to 5% range. The key to growth is the U.S. consumer and the previously mentioned headwinds largely remain though at the margin improvements will play out as the recovery progresses. Consumers will become a greater force in 2011 and beyond contrary to the normal cycle when they are usually a lesser growth driver as the recovery ages. Employment and income growth will be important as well as looser credit conditions.

There is much buzz over Canada's Q4-09 real GDP growth figure of 5% annualized and January's GDP output growth of 0.6% in the month. Talk of a V-shaped recovery surfaced. To place this in context, whenever a market or an economy falls into a deep hole, the bounceback is often quite vigorous and naturally generates some high percentage comparisons off the low. Recall that in Q1-09, at the worst of the recession, real GDP dropped at a 7% annual rate, the largest quarterly drop on record, which begins in 1961.

The GDP measure of value-added output reported for January was a positive sign and the best monthly growth performance in more than three years. On a growth rate basis, this recovery is impressive in the last three months but that is not enough to qualify as a V-shaped recovery and it needs to continue at that pace for a few more months.

A historical examination of this measure reveals that the current recovery, which began in June 2009, is actually among the weaker recoveries. This comparison is not with growth rates but rather levels of total value-added of goods

and services produced. The current recovery began by this measurement in June 2009 with the trough or low in May 2009. In the eight months from the trough, GDP output is up 2.8% in this recovery but this compares to 3.8% at the same point for all recoveries since 1961. The most robust recovery after eight months was in 1982 when GDP was up 5.4% followed by 5.3% in the 1961 recovery. Two other recoveries, 1975 and 1980, were also stronger than the current one.

Canada's employment report for February was positive with a gain of 21,000 jobs. It was a second consecutive monthly gain and the sixth in the nine months since the economy's trough. The unemployment rate remains above 8% though past its peak of 8.7% set last August.

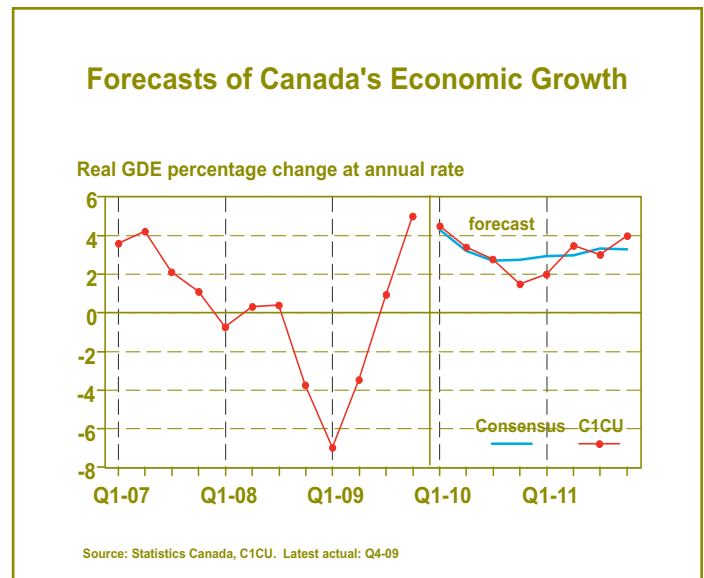
The Canadian Home Renovation Tax Credit drove a 0.7% gain in January retail sales, led by sales at building and outdoor home supplies stores. In volume or inflation-adjusted terms, retail sales were up only 0.1%.

Housing sales during February slipped from January though BC pulled down the national figure due to the Winter Olympics in Vancouver. A bounceback is expected in March sales and the looming April 19 changes to federal mortgage insurance regulations should advance some sales activity into March and April. The HST implementation on July 1 in BC and Ontario will have a lesser impact on affordability but will advance some sales nonetheless.

However, the HST has a large impact on new housing construction and builders are ramping up production to beat the HST as well as to rebuild inventory and meet higher sales levels. Both provincial governments have introduced rebates with price caps to lessen the tax bite but the rebates may not be tax neutral if builders do not pass on the estimated 2% embedded tax savings to purchasers. New housing priced above those caps will cost more with the HST after the rebates.

The construction surge in the first half brings a larger source of growth in the economy possibly peaking in Q3-10 or Q4-10 at the latest. Lower residential investment spending in the first half of 2011 follows and unless there is an offset from other sectors, overall economic growth slows.

The domestic economy is generating most of Canada's growth with the trade sector dragging down overall gains. Exports to the U.S. are the main swing factor and the higher



Canadian dollar is doubly concerning since imports usually rise with a higher currency. Trade is the main forecast risk for Canada not only due to the currency but also to a U.S. economic slowdown.

First quarter 2010 real GDP growth is pegged at 4.5% annualized slowing to 1.5% in Q4-10 before reviving to 4.0% in Q4-11. The consensus view is 4.3%, 2.8%, and 3.3%, respectively. There is considerable variation in the consensus view, though which illustrates amount of uncertainty that prevails. These are uncharted waters for policymakers, forecasters, and others in the midst of considerable data volatility due to various stimulus programs here and in the U.S.

Inflation

Canada's Consumer Price Index (CPI) inflation slowed to 1.6% in February from a year ago, following a 1.9% increase in January. Gasoline was still the main driver of changes in the inflation rate. The Bank of Canada's core index rose 2.1% over last February, following a 2.0% rise in January. February's increase raised some eyebrows since it was above the bank's 2% target, however, the increase was due primarily to price increases for vehicles and for traveler accommodation affected by the Olympics.

Monetary policy

The Bank of Canada kept its target rate at 0.25% and reiterated its commitment to maintain that rate through the second quarter of 2010, provided the inflation outlook does

not change. The Bank made a subtle change in its March statement to “the main macroeconomic risks to the inflation projection are roughly balanced” from “the overall risks to its inflation projection are tilted slightly to the downside” in its January statement.

As for its economic outlook, the Bank sees upside risks from stronger than projected global and domestic demand while the downside risks are a more protracted global recovery and the high Canadian dollar slowing growth and dampening inflation through cheaper imports.

The Bank’s next Monetary Policy Report released on April 22 will provide an important update to the Bank’s outlook and expectations. It will likely upgrade its economic outlook for 2010, but nudge down the 2011 forecast from the previous report.

Interest rates

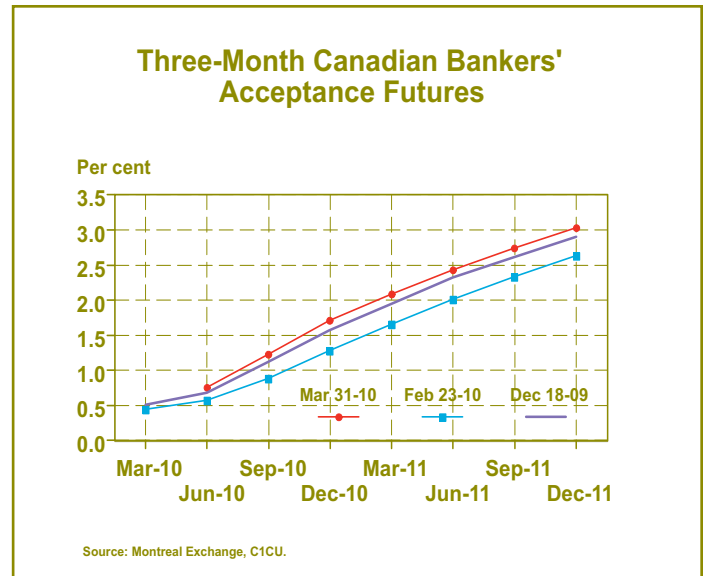
Canadian government bill rates and bond yields rose rather sharply in March mainly in the 6-month to 5-year maturities. Corporate bond yields moved less in the month. U.S. government yields also moved higher but by less than in Canada. The balance of economic news in Canada and the U.S. was positive and lifted market expectations of growth and inflation. Another factor was concern over government debt levels and the Greek debt crisis.

Administered rates changed, notably the posted five-year fixed mortgage rate, which jumped 60 basis points to 5.85% at the end of the month. It is not clear how much the cost of funds rose but there was no change in deposit rates. Lenders relying on markets to raise funds probably faced higher rates, however.

The large increase in the five-year mortgage rate will likely be partially unwound in May when demand lessens after the April 19 rush to beat federal mortgage insurance regulation changes.

Interest rate forecast

The futures market for three-month Bankers Acceptances is pricing in a 25 bps rate increase in June and another 50 bps in September 2010 and another by December. By June 2011, short rates are 200 bps higher and 250 bps higher at the end of 2011. These expectations move on economic



news along with other factors. A substantial change has occurred in the past month with a general upshift in the futures curve.

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. The rate forecast is changed from last month to reflect this growth profile and since it is necessary to forecast what the Bank will do rather than what it should do. This is always an important rule to bear in mind for a forecaster and from one easily strayed.

The shift to 25 bps increases commencing July 20 and at each meeting until the January 2011 date is significantly different from the futures market, which has priced in a steady round of increases until mid-2012. The forecast incorporates a six-month pause until September 2011 reflecting the anticipated economic slowdown in the U.S. and Canada before resuming the rate normalization phase when growth prospects have improved.

The consensus view has rates moving steadily higher and by a larger amount so by the end of 2011 the target rate sits above 3.00% from its current 0.25%. The consensus forecast presumes an uninterrupted economic recovery with quarterly growth rates consistently above 2.5%, which is possible, but runs counter to history.

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Target Overnight Rate Forecast

Meeting Date	Rate (%)
Mar. 2, 2010	0.25
Apr. 20	0.25
June 1	0.25
July 20	0.50
Sept. 8	0.75
Oct. 19	1.00
Dec. 7	1.25
Jan. 2011	1.50
Mar.	1.50
Apr.	1.50
June	1.50
July	1.50
Sept.	1.75
Oct.	2.00
Dec.	2.25

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	0.50	1.00	1.50	1.50	1.55	2.00
Prime Rate	2.25	2.25	2.25	2.50	3.00	3.50	3.50	3.55	4.00
1-mo. T-Bill	0.16	0.15	0.20	0.35	0.85	1.35	1.35	1.40	1.85
3-mo. T-Bill	0.21	0.20	0.25	0.55	1.05	1.50	1.50	1.60	2.05
6-mo. T-Bill	0.29	0.30	0.40	0.70	1.25	1.55	1.55	1.65	2.25
1-year T-Bill	0.56	0.65	0.80	1.15	1.70	2.00	1.90	1.85	2.55
2-year GoC Bond	1.35	1.40	1.65	1.95	2.30	2.45	2.30	2.35	3.00
3-year GoC Bond	1.83	1.75	2.10	2.30	2.65	2.85	2.70	2.75	3.20
5-year GoC Bond	2.62	2.60	2.90	3.20	3.60	3.90	3.65	3.80	4.10
10-year GoC Bond	3.41	3.45	3.55	3.65	4.00	4.25	4.15	4.30	4.50
Spread: 10y less 3m	3.20	3.25	3.30	3.10	2.95	2.75	2.65	2.70	2.45

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	2.50	3.00	3.50	3.50	3.55	4.00
1-year GIC	0.28	0.28	0.30	0.45	0.75	0.95	0.90	0.80	1.25
3-year GIC	1.41	1.33	1.45	1.55	1.65	1.75	1.70	1.70	2.00
5-year GIC	1.94	1.88	2.00	2.10	2.40	2.75	2.45	2.60	2.75

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	2.50	3.00	3.50	3.50	3.55	4.00
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	4.30	4.50	4.85	5.10	4.90	4.95	5.45
5-year Mortgage	5.67	5.43	5.70	5.75	5.95	6.25	5.95	6.05	6.40

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