

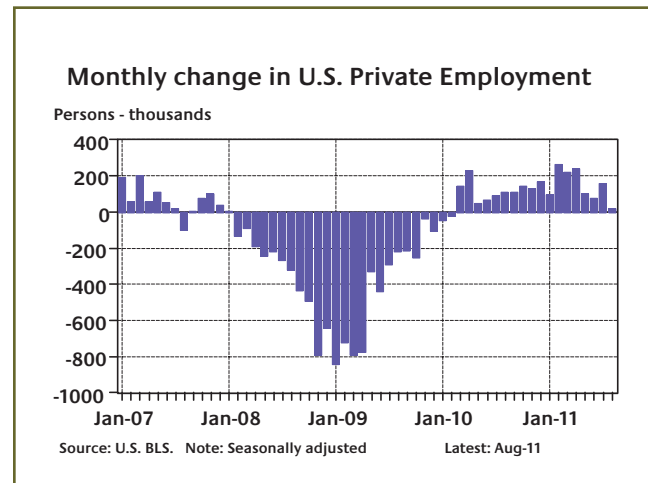
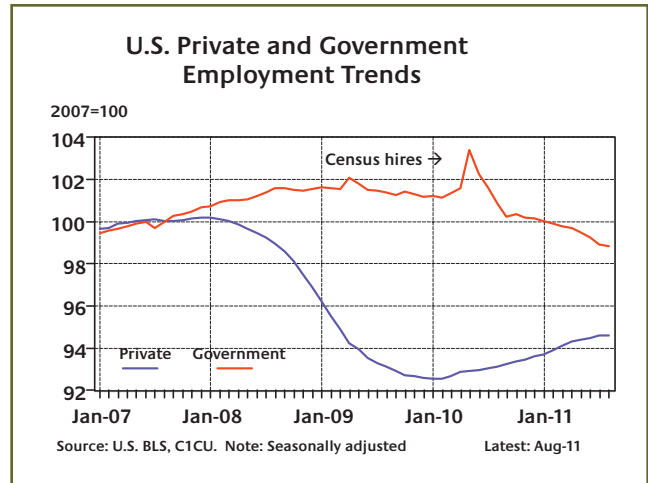
The end to a summer of debt downgrades, disappointing GDP, and political wrangling would normally be a welcome relief but with the U.S. economy stalling, emerging economies slowing, and European debt problems escalating, it looks like an autumn of despair for financial markets. Markets will have to watch divided U.S. policy-makers go at it again with likely dubious results and European politicians deal with seemingly intractable problems. Markets will pass their judgment by sending equities and safe-haven bond yields lower in a volatile setting.

These events also caused a large drop in the expectations of economic forecasters who cut their 2011 and 2012 economic growth and interest rate forecasts. The risk of another U.S. recession is the highest since the Great Recession. With monetary policy at maximum stimulus and fiscal policy in some disarray, private sector growth will proceed at a sub-par pace until the housing situation improves. Canada's economy will also face its growth challenges in this environment and the Bank of Canada will do its part by keeping rates low for a longer period.

## Economy

The flow of weak economic data during August and growing doubts about the second half recovery prompted a substantial downward revision to many forecasts. The negative financial and political events of August have done significant injury to confidence. Equity and bond markets were volatile but recovered some of their earlier losses by month-end. The European debt crisis is far from over and causes more damage to financial markets.

The strongest piece of evidence pointing to a bleak second half was the U.S. jobs report for August. There was no net gain in employment in August and May and June gains were revised down by almost 60,000. Leading indicators of employment remained weak; employment at temporary help services rose only 5,000 and the average workweek fell between July and August.



Private sector job creation is occurring, though August saw the smallest gain since February 2010. Persistent government layoffs have been a drag on the U.S. job market. Public sector employment fell by 17,000 in August, the 10th consecutive decline, but the smallest since December 2010. Government employment has fallen by 595,000, or 2.6%, since the recovery began in June 2009. Had government payrolls had remained unchanged, total U.S. employment would be higher. All three levels of government have shed employees, but local government payrolls are at their lowest level since 2005.

This weak job performance is symptomatic of the structural headwinds facing this recovery. A key missing component in this recovery is the consumer and housing. The depressed housing market cannot gain any traction, and at best, is forming a bottom. One of the most helpful policies for this recovery would be to

reduce foreclosures by facilitating more re-financings, changing loan limits, and possibly loan modifications. Without the housing market contributing more to the economic recovery (new construction, higher prices and wealth), domestic demand growth will continue to underperform by a wide margin.

The August employment data follow other reports showing the recovery accelerating. Real consumer spending, durable goods orders, and industrial production all posted strong gains in July. However, these data for August and September will be weaker. The U.S. ISM manufacturing index fell in August, its fifth decline in the past six months.

The primary movers in the U.S. economy are business investment and exports. The accelerated depreciation on business investment is scheduled to end this year and will leave a hole in 2012. Exports face a slowdown from the emerging markets, notably China. Government spending is a drag on growth and its ability to stimulate growth is doubtful with the political impasse in Washington. Another round of fiscal stimulus is useful, particularly if it helps housing. The U.S. President will announce a jobs strategy in early September, which may alter the growth outlook, though any policy package must pass through both Houses, which will be contentious.

The ECRI Weekly Leading Index decreased to 122.5 for the week ending August 26 and has fallen four straight weeks. Its turning points lead changes in the business cycle and recent moves are raising a yellow flag about the recovery.

Third quarter 2011 U.S. GDP growth is predicted at 1.5 to 2.0% annualized, downgraded from last month. The growth outlook for 2011 is cut to 1.8%. For 2012, a fair amount hinges on policymakers, particularly on the fiscal front, since monetary policy is at its effective limits. The ending of the payroll tax holiday and extended unemployment benefits along with lower (50% rather than 100%) accelerated depreciation on business investment are gaps in 2012 that need to be filled by private sector growth or new public initiatives.

The 2012 forecast is downgraded to 2.3% with forecast risk more evenly balanced than last month's forecast. Growth is forecast to modestly gain momentum rising to 2.7% in 2013. The consumer sector is expected to contribute more to growth along with residential construction. Exports will remain a source of growth. Business investment growth slows in 2012

and again in 2013 with the end of the depreciation benefits. The drag from government looks to continue unless another stimulus program is implemented.

Financial market conditions will also be key. If equity prices fall faster, confidence will fall again and consumers will retrench. Businesses in turn will not hire until they see sales improve and uncertainty diminish. Since financial markets reflect the current state of the economy and its prospects, U.S. policymakers can do much to restore confidence by dealing with the pressing issues promptly and wisely. The sovereign debt problems in Europe are another factor causing financial market uncertainty and they are a more intractable problem.

That debt crisis casts a dark cloud on market sentiment. Two-year Greek government bonds spiked to 46.8% following news that Greece was temporarily suspending bailout negotiations with the IMF, EU and European Central Bank. This comes after Greece admitted it would miss budget deficit targets for 2011. Markets are worried about a possible bankruptcy and insolvency.

The European economy slowed in the second quarter and was losing momentum into the third quarter. Inflation held at 2.5% in August and unemployment ticked higher to 10.0%; manufacturing contracted and the services sector slowed. The ECB may cut its policy rate at the next meeting.

The debt crisis will linger and cast a pall on the European economy and global financial markets for many more months if not years. Its problems are exceedingly difficult to solve politically and will take more time than the markets have patience. Market concerns are spreading to Spain, Italy, and even France are on their watch list and until there is real containment of the debt crisis, bond markets will continue to be volatile and in a negative tone.

In the coming months, Italy, Spain, and other Euro countries will need to issue bonds for their financing needs and markets will likely demand higher compensation for taking on higher perceived risk. It is highly likely that the ECB will need buy more sovereign debt. Out of the €750 billion available to the bailout fund, the EU and IMF have already spent €380 billion, leaving €370 billion, which is insufficient to meet funding needs. The European Financial Stability Facility will have to increase significantly to well above €1 trillion. The political negotiations will not go smoothly and will cause market volatility.

Canada's economic situation is also looking bleaker with real GDP declining 0.4% annualized in the second quarter, following a 3.6% (revised downward from 3.9%) increase in the first quarter. The weaker U.S. economy was responsible for a large drop in exports, which offset growth in business investment and modest growth in household spending. The wildfires in Northern Alberta disrupted energy production and exports and the supply chain disruptions hit manufacturing. On a positive note, industry GDP for June following May's event-driven drop. The main drag on the economy, offsetting 3% growth in domestic demand, was the widening trade deficit.

July data are mixed pointing to slow growth in the third quarter. Housing sales stalled in July though consumer and residential mortgage credit rose modestly in July as did business credit. Manufacturing shipments fell and inventories rose in July, which may slow future production, but new orders surged in July after a dip in June. Employment grew at a slower pace.

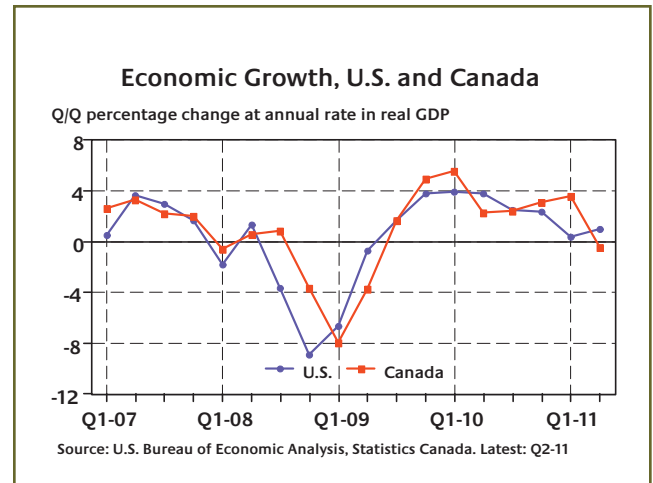
The turmoil in the stock market is likely to weigh further on consumer confidence and demand through the third and possibly fourth quarters. The decline in stock prices along with the drop in some key commodity may have negative implications for business investment, which has been an important source of growth in recent quarters.

The composite leading indicator rose 0.2% in July, slightly above June but slower than the pace recorded over the first five months of the year indicating the growth slowdown extends into the third quarter. A recession is not likely. The trade sector is main weakness and forecast risk.

Third quarter growth will remain weak and now estimated at 1.5% annualized versus 2.3% last month. Real GDP growth in 2011 is put at 2.2% with a slight pickup to 2.5% in 2012. Growth is expected to strengthen to 2.9% in 2013 as global growth resumes, boosting demand for Canada's exports. A stronger U.S. economy will be crucial to realizing the forecast.

## Inflation

Consumer price inflation dropped a full percentage point in the past two months, from 3.7% in May to 2.7% in July due to lower energy costs and sales tax changes. July was the first month in which year-ago comparisons were comparable under the July 2010



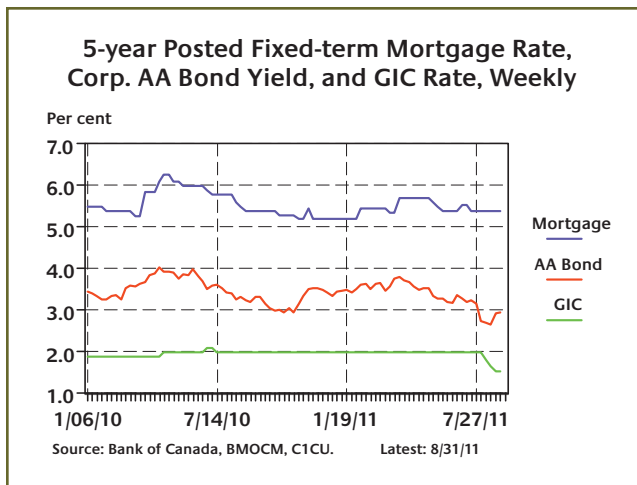
introduction of the harmonized sales tax in Ontario, British Columbia and Nova Scotia. July inflation dropped as a result. The Bank of Canada's core measure of inflation rose slightly to 1.6% but still well below the bank's 2% central target. Inflation concerns are a non-issue for the foreseeable future.

## Interest rates

Bond yields and short-term rates plunged in early August on the negative developments out of Washington and Europe fed by some negative economic news. The yield curve downshifted and flattened with the 2-year government bond yield touching the 3-month T-bill rate very briefly. Some sanity returned to the market by mid-month and yields turned higher from their yearly lows.

Administered deposit rates declined but not lending rates. GIC rates fell about 30 to 40 bps in the first half of the month bringing the 3-year and 5-year rates to recent historic lows. Despite the decline in deposit rates and a general decline in the cost of funds, fixed term mortgage rates did not decline. However, there was a change in lending rates for variable mortgages, which increased about 20 bps. According to industry sources, high demand for variable rate mortgages and very thin margins forced the increase.

That posted fixed-term mortgage rates have not declined is puzzling, at least on the surface. The cost of funds is clearly lower by any measure, whether by deposit rates or market funding costs. Demand for mortgage credit is growing but not at a fast pace according to Bank of Canada data or housing sales data via the MLS®. Weak market competition could be a factor since most of the mortgage credit issued in Canada is by the few chartered banks.



Another factor is with the posted rates themselves, which are not contract rates. No public data source for contract rates is available. However, an in-house survey of broker rates reveals a decline of between 20 to 50 bps, depending on term and broker, since early August.

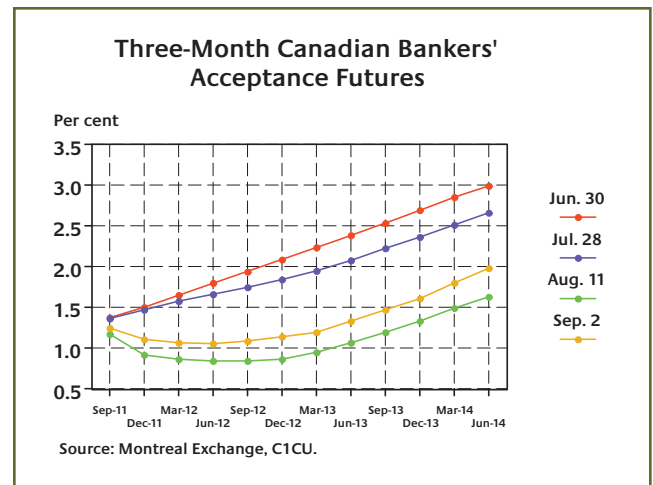
### Monetary policy

The next rate-setting meeting by the Bank of Canada is Sept. 6 with the announcement on Sept. 7. The Bank will acknowledge the recent economic weakness and that growth is slower than anticipated. It will highlight the risks to the outlook from the U.S. and European situations. The Bank will change its wording to impart the message that any rate change is further in the future than at the last statement.

In the U.S., the Federal Open Market Committee's August 9 meeting minutes noted that growth so far in 2011 was weaker than expected, with temporary factors explaining only part of the softness. Risks were on the downside and had increased. The Fed is at its practical operational limits with very few options left to stimulate the economy. As the Fed Chairman indicated, fiscal policy will have to do the heavy lifting. The Fed's limited options include expanding the duration maturity of its holdings, reducing the interest rate it pays on excess bank reserves, and clearly communicating its intentions. QE3 is a possibility but only as a last resort and under more dire circumstances than currently exist.

### Interest rate forecast

The events of August along with the downward revisions to U.S. and Canada GDP data and Canada provoked a wholesale recasting of the rate forecast



-- downwards. A Bank of Canada rate increase is no longer expected later this year, rather the first move is later next year. A rate cut is a possibility if the economy heads towards a recession but that is not the base scenario.

The futures market for 3-month Bankers Acceptances also downshifted its rate expectations by a large amount. For example, during the most negative times in August, the market was pricing in a 25 bps rate cut by year-end and the small possibility of another cut by June 2012. Compared to late July, the difference to current rate expectations is a drop of 75 bps for the March 2013 contract. The first rate increase is now priced to occur in the third quarter of 2013.

This forecast makes a similar large scale downgrade of rate expectations and considers risks more evenly balanced with a lower likelihood for future downside revisions. The Bank of Canada remains on hold for another year until its Sept. 5, 2012 meeting and begins a gradual rate normalization process with three consecutive 25 bps increases before pausing to re-assess the situation. With improving growth prospects, the yield curve initially steepens rather than narrows which usually occurs during the typical post-war era recovery phase. However, this economy and recovery is anything but normal.

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### Target Overnight Rate Forecast

Meeting Date	Rate (%)
July 19 (a)	1.00
Sept. 7	1.00
Oct. 25	1.00
Dec. 6	1.00
Jan. 17, 2012	1.00
Mar. 8	1.00
Apr. 17	1.00
June 5	1.00
July 17	1.00
Sept. 5	1.25
Oct. 23	1.50
Dec. 4	1.75
Jan. 2013	1.75
Mar.	1.75
Apr.	1.75
June	2.00

(a) actual

### Interest Rate Forecast

Item	2011 Q2a	2011 Q3	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2
Target Overnight Rate	1.00	1.00	1.00	1.00	1.00	1.05	1.40	1.75	1.80
Prime Rate	3.00	3.00	3.00	3.00	3.00	3.05	3.40	3.75	3.80
1-mo. T-Bill	0.90	0.85	0.85	0.90	0.90	0.95	1.30	1.65	1.75
3-mo. T-Bill	0.95	0.90	0.90	0.95	0.95	1.05	1.45	1.75	1.80
6-mo. T-Bill	1.07	0.95	0.95	1.00	1.05	1.15	1.55	1.85	1.90
1-year T-Bill	1.31	1.00	1.00	1.15	1.20	1.40	1.75	2.00	2.05
2-year GoC Bond	1.63	1.15	1.10	1.30	1.40	1.65	2.00	2.35	2.35
3-year GoC Bond	1.95	1.40	1.35	1.50	1.65	1.90	2.30	2.65	2.65
5-year GoC Bond	2.46	1.75	1.65	1.80	2.00	2.40	2.85	3.15	3.15
10-year GoC Bond	3.15	2.55	2.40	2.60	2.80	3.30	3.75	4.10	4.10

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

### Deposit Rate Forecast

Item	2011 Q2a	2011 Q3	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2
1-year GIC	1.08	0.80	0.65	0.65	0.65	0.65	0.75	1.05	1.10
3-year GIC	1.43	1.20	1.00	1.00	1.00	1.05	1.25	1.40	1.45
5-year GIC	1.98	1.75	1.55	1.55	1.55	1.65	1.85	2.05	2.15

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

### Mortgage Rate Forecast

Item	2011 Q2a	2011 Q3	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2
1-year Mortgage	3.63	3.50	3.35	3.35	3.35	3.40	3.75	4.05	4.10
3-year Mortgage	4.45	4.35	4.20	4.15	4.15	4.25	4.55	4.90	4.95
5-year Mortgage	5.57	5.40	5.25	5.20	5.25	5.35	5.70	5.90	5.95

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