

New Year blues

The stream of economic news is entirely negative and not over. The next six months look particularly bleak for the global and North American economies even with very low policy rates, central bank liquidity provisions, and stepped up government fiscal stimulus. The financial crisis is severe and pervasive having a substantial negative impact on the real economy lasting through most of 2009.

The conventional view has consistently underestimated the crisis and its impact on the real economy. Forecast risk is on the downside in 2009 and 2010 and the downside scenario includes record low policy rates, abnormally large central bank balance sheets, recession-like economic performance, and a longer bout of deflation.

More policy measures are forthcoming, particularly in the U.S., with a type of 'bad bank' likely. Once the market sees material progress on cleaning up the balance sheets of financial institutions, the outlook improves markedly and economic recovery is more certain.

Economy

The U.S. recession intensified with real GDP contracting at a 3.8% annualized rate in the fourth quarter of 2008, the largest drop since the first quarter of 1982. Consumer spending, business investment, and investment in housing all declined in the fourth quarter. Additions to inventories contributed to growth in the fourth quarter but that is negative for the near term.

January data suggest continued economic weakness. Regional manufacturing indices from the Federal Reserve banks remained well into negative territory indicating contraction at a rapid pace. Weekly chain store retail sales and weekly mortgage applications data also confirmed a slow start to the first quarter.

Plunging energy prices will bring a temporary bout of deflation as measured by headline price indices. Discounting by retailers and auto dealers contributes to the retreat in headline CPI. Rising excess capacity, higher unemployment, and tight credit conditions suggest weak demand will continue to put downward pressure on prices.

A more significant development is deflation in core CPI or CPI less food and energy. A temporary decline in headline CPI due to energy prices is not broadly based deflation and little concern to markets and policymakers. However, several monthly declines in core CPI during a recession would heighten the deflation-depression scenario. Financial markets will react badly

to such a scenario and send government bond yields lower, corporate bond yields higher, and equity markets down.

The question is whether deflation will spread from energy to core CPI and whether it is temporary. Recently, core CPI is no longer rising and unfavourable demand trends are likely to continue through the first half. Some upside inflation may come from the just-passed fiscal stimulus package, which included \$275 billion in tax relief in 2009 and 2010, and lower energy and mortgage refinancing costs boosting discretionary income and consumer spending in the coming months. The deflation risk is rising.

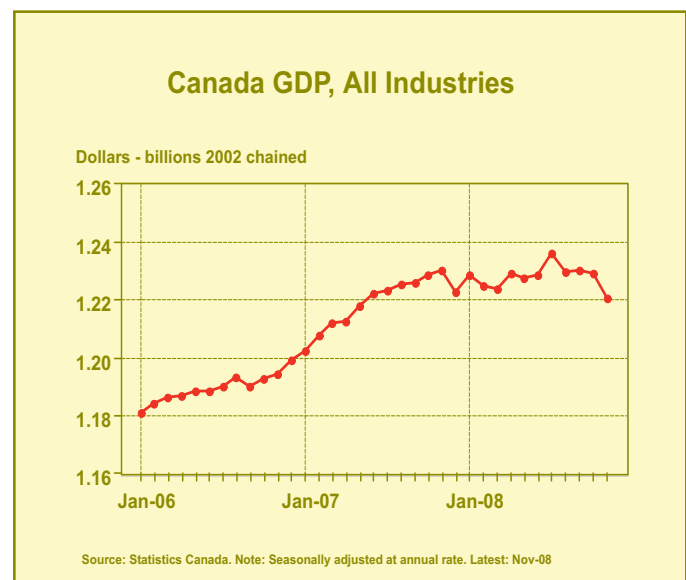
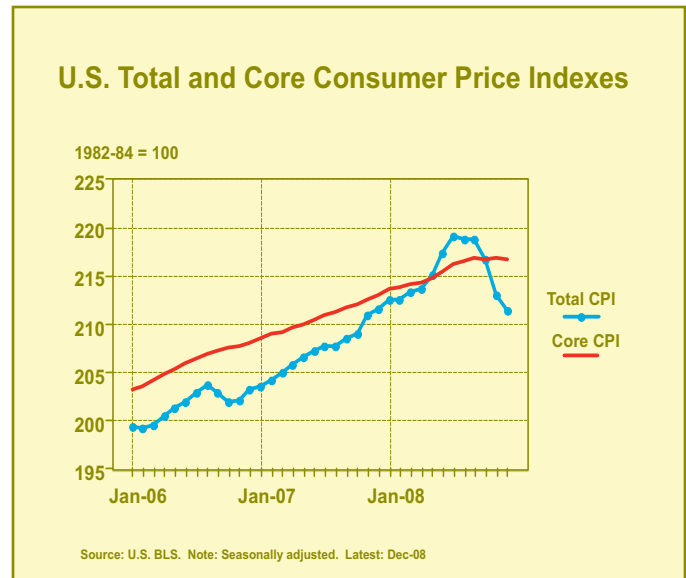
The U.S. government's \$819 billion tax-and-spending bill puts about \$526 billion into the economy in 2009 and 2010. The tax relief in the stimulus package focuses more on lower-income families whose propensity to consume is the highest. It also includes business incentives to spur job creation and a \$500 payroll tax holiday for workers.

The consensus outlook for the U.S. economy is recovery to begin in Q3-2009 and grow 1.5 to 2.0% in 2010. Headline CPI inflation turns year-over-year negative in January lasting until July 2009 and posting modest increases thereafter. The deflation-depression scare ends nicely.

One thing this financial crisis revealed is the frailty of economic forecasts. The consensus forecast is lowered with each passing month and there is considerable uncertainty when the credit markets will normalize and the flow of financing increases. Clearly, the economic impact of the financial crisis has been widely underestimated and it is not clear that forecasters have caught up, never mind getting ahead of it.

Canada's economy is in the early stages of a recession. The economy lost 34,000 jobs in December and 71,000 in November. Canadian retail sales declined 2.4% in November; the worst monthly decline in nearly 10 years, led by the automobile sector with new car dealer sales falling 3.4%. Excluding autos, sales fell 2.3% in broad-based declines.

Monthly industry GDP for November dropped a sharp 0.7% under widespread weakness. Declining production in manufacturing, wholesale trade, construction and real estate agents and brokers were the largest contributors to the drop. The previous recessions in forestry and auto manufacturing are now joined by downturns in most other industries.

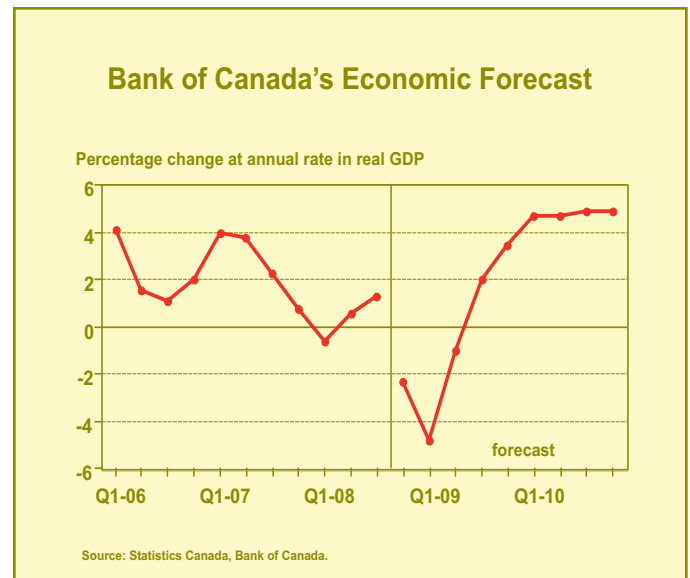


Housing sales fell in December to their lowest levels since 1998 and for the third consecutive month. The sales plunge from the July 2008 high is a stunning 32% based on seasonally adjusted data and rivals the 1982 housing recession. Not surprisingly, housing starts are dropping fast and residential construction is one of the main sources of weakness in the 2009 economy.

A housing turnaround in the next few months is highly unlikely even with substantially lower housing prices and mortgage rates boosting low-equity buyer affordability. The economic downturn and its uncertainty keep most potential buyers on the sidelines until later this year or early 2010. Housing is usually one of the first sectors out of recession and leading the economic recovery.

The Bank of Canada released its latest forecasts in its *Monetary Policy Report Update* and presented a rosy outlook for 2010. Real GDP growth advances 3.8% in 2010 led by personal consumption and government following a -1.2% outcome for 2009. Forecast annualized growth rates of 4.7% and 4.9% in the first and second half of 2010, respectively, are impressive and would be the highest since the growth surges of 2004 and 2005.

The 2010 forecast is optimistic and probably reflects an institutional bias as well as an economic recovery. The Bank's tendency is to generate GDP forecasts that roughly meeting its 2% inflation target at the end of the two-year forecast period. However, this outlier forecast is useful since it reveals the strong recovery required to absorb excess capacity and return inflation to target.



As an aside, the Bank in the upcoming April report will probably lower its estimate of the economy's potential growth rate, allowing it to achieve its inflation target at the end of the forecast period with a more realistic 2010 growth forecast.

One forecast not in doubt is temporary deflation in headline CPI as in the U.S. The first emergence of a negative year-over-year CPI result is probably March 2009 lasting at least until September. If the global economic recovery does not take hold by the fourth quarter, deflation continues.

While monetary conditions are highly stimulative – record low policy rates and a low currency – the cost and availability of credit to the private sector is restrictive and restraining growth. Low government bond yields are a boon for government looking to borrow but do not help corporations or individuals.

Fiscal policy is stimulative with the federal and provincial governments stepping up spending and cutting some taxes. The federal government's Budget 2009 is moderately stimulative but it does not avert a 2009 recession. The time lags involved in some of the spending initiatives are considerable despite the 'shovel ready' aspect of some projects.

This forecast sees Canada's recession deepen and lasting into the fourth quarter 2009, assuming the U.S. economy emerges from recession in the third quarter. The 2010 outlook is more positive

but not the 'V' shaped recovery the Bank of Canada is predicting. Growth between 1.5% and 2% next year is all that is expected.

Interest rates

By month-end, government bond yields climbed from their multi-decade lows in mid-January and closed the month higher than at the end of December. The roller-coaster path suggests uncertainty rather than a firm conviction that the worst is over or yet to come. Higher government bond yields usually signal higher growth and inflation but could also be a reaction to higher future government deficits and debt. That the equity market did not display any optimism about company earnings implies further economic weakness.

The yield curve steepened during January with short rates held down by the Bank of Canada and long bond yields rising. The T-bill market was slightly disappointed that the Bank did not cut by 75bps on January 20.

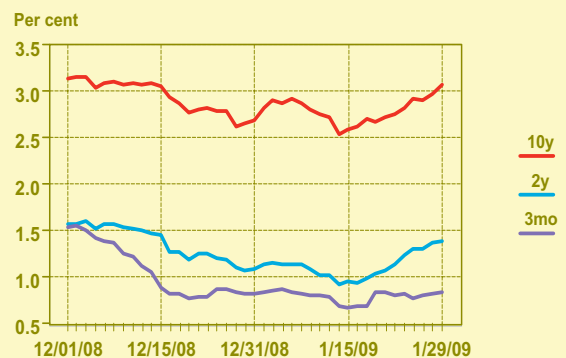
Administered rates dropped after the Bank of Canada's cut. The largest cuts were in posted mortgage rates with the 1-year rate falling 60bps to 5.00% and the 5-year rate down 96bps to 5.79%. The latter move is one of the largest on record. GIC rates fall 50bps for a 5-year term and 5bps for a 1-year term. The prime lending rate matched the Bank's 50bps reduction and sits at 3.00%.

Monetary policy

The Federal Reserve stated it would employ "all available tools" to promote the resumption of sustainable economic growth, interest rates will be "exceptionally" low for some time and its balance sheet will remain at a high level. Policymakers also said, "prices could fall below a rate that best promotes economic growth." This is new Fed speak for deflation.

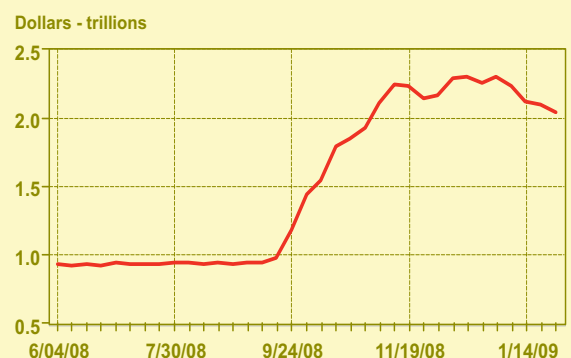
The Fed has referred to its many recently introduced policy tools as "credit easing," pointing out that it is a conceptually different approach than "quantitative easing," which the Bank of Japan used from 2001 to 2006. The difference is not subtle. Quantitative easing focuses policy on the quantity of banks' reserves, which are liabilities of a central bank. In contrast, credit easing focuses on the composition of assets on the central bank's balance sheet. One increases the money supply by increasing reserves and the other swaps assets from troubled institutions.

Government of Canada Bond Yields and Treasury Bill Rate, Daily



Source: Bank of Canada.

Federal Reserve Total Assets



Source: US Federal Reserve. Latest: 1/28/09

The Bank of Canada did not state further monetary stimulus is needed but reading between the lines on its recession and inflation forecasts and commentary for 2009 strongly suggests a lower target rate in the future. The Bank continues to engage in term purchase and resale agreements and 30 Day Term Loan Facility auctions to provide additional liquidity to financial markets.

Interest rate forecast

Another 50bps cut by the Bank of Canada on March 3 puts the target rate at 0.50%. The Bank holds at that rate through 2009 before embarking on its rate-normalization phase. A below-average economic recovery means rates need not rise rapidly, however, the Bank will likely be aggressive with 50bps increments in the initial phase before using the more normal 25bps moves. This pattern prevailed in 2002 and 2004 when the target rate was very low.

The futures market for three-month bankers' acceptances is pricing in a small drop in that rate in Mar. 2009 and not the 50bps forecast drop in the target rate. Market expectations of the target rate influence the futures market but market specific factors come into play as well. Further, market expectations can change rapidly and negative economic news released before the next rate setting data will shift those down.

Government t-bill rates and long bond yields come down in the next three quarters. Short rates fall more than long yields causing a steeper yield curve. The curve shifts up and narrows modestly later in the forecast period.

Administered rates are heading lower. Deposit rates decline from current levels and then generally track government rates higher in 2010. Posted mortgage rates decline another 60 to 90bps partly reflecting a lower cost of funds, central bank rate moves, and federal government purchases of mortgage-backed securities. The prime lending rate is currently 3.00% and falls to 2.50%.

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	1.00
Mar.	1.50
Apr.	1.50
June	1.50
July	1.75
Sept.	2.00
Oct.	2.00
Dec.	2.25

Interest Rate Forecast									
Item	2008 Q4a	2009 Q1f	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	1.15	1.50	1.80	2.00
Prime Rate	3.98	2.95	2.50	2.50	2.50	3.15	3.50	3.50	4.00
1-mo. T-Bill	1.32	0.65	0.40	0.40	0.50	1.05	1.35	1.65	1.85
3-mo. T-Bill	1.46	0.80	0.50	0.50	0.60	1.10	1.45	1.80	1.95
6-mo. T-Bill	1.57	0.80	0.55	0.55	0.75	1.25	1.55	1.85	2.05
1-year T-Bill	1.64	0.95	0.55	0.60	0.75	1.30	1.60	1.90	2.10
2-year GoC Bond	1.82	1.20	0.90	0.95	1.10	1.70	1.95	2.25	2.50
3-year GoC Bond	2.10	1.40	1.15	1.20	1.40	1.90	2.15	2.40	2.70
5-year GoC Bond	2.51	1.80	1.65	1.65	1.90	2.35	2.60	2.70	3.00
10-year GoC Bond	3.39	2.80	2.60	2.65	2.85	3.10	3.25	3.35	3.70
Spread: 10y less 3m	1.93	2.00	2.10	2.15	2.25	2.00	1.80	1.55	1.85

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	3.15	3.50	3.50	4.00
1-year GIC	1.69	0.80	0.60	0.60	0.65	1.00	1.25	1.40	1.50
3-year GIC	2.56	1.60	1.15	1.00	1.00	1.30	1.40	1.55	1.75
5-year GIC	2.91	2.00	1.50	1.40	1.50	1.75	1.95	2.00	2.20

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	3.15	3.50	3.50	4.00
1-year Mortgage	6.08	4.85	4.30	4.20	4.25	4.40	4.50	4.55	4.65
3-year Mortgage	6.79	5.70	5.15	5.00	4.95	5.00	5.00	5.10	5.15
5-year Mortgage	7.07	5.80	5.20	5.10	5.00	5.05	5.05	5.15	5.30

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

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