

Politicians hold the most influence over the economic and interest rate outlook and are the main cause of the huge uncertainty plaguing the markets. The European debt crisis will continue to intensify until adequate measures are in place to prevent a credit crunch. With Europe in the early stages of a recession, the U.S. economy could also fall into recession if its politicians do not offset the coming fiscal drag.

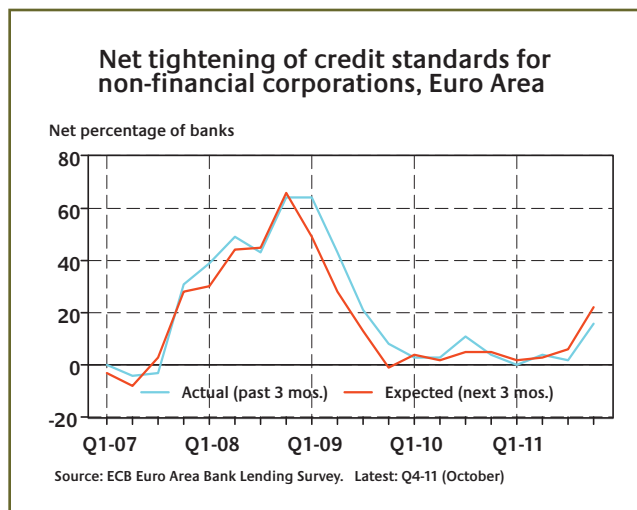
Canada's economy and financial markets are along for the ride. The current low interest rate environment will extend into 2013 and could turn lower if a banking crisis in Europe or a U.S. recession develops.

## Economy

Developments in the Euro debt crisis are fluid and can change suddenly but the overall pace is too slow for markets and agreed-upon measures considered inadequate. Euro zone politicians have a nearly impossible task arriving at an agreement allowing the ECB to be the lender of last resort and achieving some fiscal integration among 17 countries so Euro bonds can be issued. This process is necessarily involved, complex, and time-consuming leaving interim and partial measures as the only workable solution.

Most recently, Euro zone finance ministers agreed to enlarge the European Financial Stability Facility but yet not large enough to meet the debt financing needs of Italy and Spain. The IMF was approached adding another level of complexity to the problem. An attempt to increase budget discipline in the euro area was launched but no details or concrete steps were announced. However, the meeting did approve further assistance to Greece and Ireland.

The EMU summit next week will reveal the details of the new measures to expand the EFSF and the next steps towards fiscal integration. Some IMF involvement could also be announced. Markets will likely be disappointed and keep pressure on politicians by demanding a higher return on sovereign debt not only in the periphery countries but also in the core countries.



Yields on French and German government bonds are creeping up and German government bonds were under-subscribed in an auction last week—the first time since World War II that has happened.

Euro zone credit conditions are tightening and contributing to the region's fall back into recession. The net percentage of banks reporting tighter conditions for enterprises jumped to 16% in the third quarter from just 2% in the previous quarter rising to an expected 22% in the fourth quarter. The sovereign debt crisis risks igniting a new banking crisis and credit crunch since European banks are hold large amounts of that debt. Germany and France are the most exposed to Greek debt.

The euro zone's debt crisis is a headwind for the global economy not only because the euro area in back in recession but also because Euro banks provide considerable credit into emerging markets and accounts for a significant portion of trade financing. A euro zone credit crunch would quickly spread to other parts of the global economy and slow growth.

The global nature of the crisis prompted six central banks to ease interbank lending. The European Central Bank, Federal Reserve, Bank of Canada, Swiss National Bank, Bank of England, and the Bank of Japan announced a coordinated decision to cut the rate on the existing temporary US dollar liquidity swap agreements by 50 bps on all operations conducted from December 5 and the swap agreements will be extended to February 1, 2013. The central banks also

established temporary bilateral liquidity swap agreements in each jurisdiction's currencies.

Further afield, some central banks in the Asia-Pacific region have started lowering interest rates and others are likely to ease as Europe's recession is affecting export growth and the debt crisis is affecting consumer and business confidence. Credit and liquidity conditions are also on the radar of central banks. In general, Asian central banks have considerable scope to cut rates and boost liquidity.

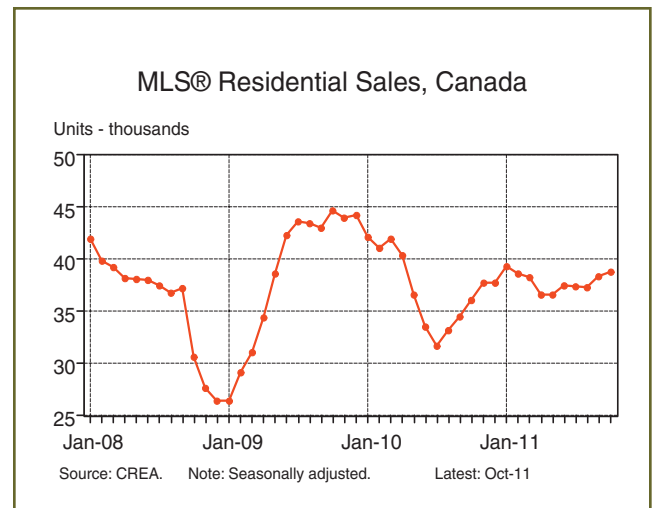
The European recession comes at an inopportune time for the U.S. economy, which is facing considerable headwinds of its own. Exports have made a significant contribution to the recovery and the European recession puts about 25% of its exports at risk. Recent U.S. economic indicators are positive and growth in Q4-2011 is estimated to come in between 2.5 to 3.0% annualized, up from 2.0% in Q3-2011. However, Europe's recession and looming fiscal drag point to a much slower first half in 2012.

This forecast does not incorporate a U.S. recession but rather a growth slowdown with a possible negative quarter. The growth outlook for 2011 is 1.8% and for 2012 1.6% rising to 2.7% in 2013. The consensus forecast is 1.5%, 2.2%, and 2.6% respectively.

Canada's economy rebounded in Q3-2011 since the temporary events depressing growth in Q2-2011 ended and output was partially back-filled. Real GDP grew by 0.9%, or 3.5% annualized compared to -0.5% in the previous quarter. Exports provided the largest boost as autos and oil and gas rebounded followed by a slower pace of inventory build-up. Residential investment was another notable source of growth. Machinery and equipment investment spending fell as did imports.

The housing market is holding up with October sales at the second highest seasonally adjusted level this year. Prices are holding as well. Concerns of an imminent collapse in high-priced markets are based on poor affordability metrics, investor speculations, and dependence on foreign buyers. While having some merit, the cause of a housing recession or collapse is usually an economic recession with the severity of the price decline partly dependent on those listed concerns. Those who conclude a housing collapse is inevitable because of high prices only fail to appreciate broader market dynamics.

The leading indicator rose 0.2% in October suggesting growth in the near term. A recession could play



out in the next three to six months if a shock event, such as a credit crunch or banking crisis in Europe, occurred. The leading index is not capable of foretelling a shock event.

Real GDP is forecast to slow to 1.5% annualized in Q4-2011 and to 1.0% in Q1-2012. For 2011, growth is forecast at 2.3% slowing to 1.8% in 2012 with exports and government spending pulling down growth. Less business investment is also likely to contribute to slower growth. The economy is expected to strengthen with 2.8% growth in 2013.

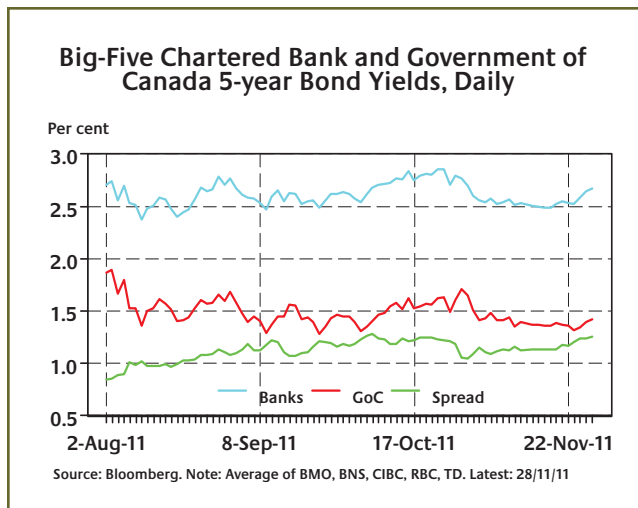
This base scenario could be derailed by a banking crisis in Europe, which results in a severe recession in Europe dragging down other parts of the global economy in the process. A U.S. recession would likely ensue with Canada close behind.

## Inflation

The inflation rate slipped to 2.9% in October, from 3.2% in September on higher gasoline and food prices. The Bank of Canada's core inflation measure edged down to 2.1% in October from 2.2% in September. Further declines in headline and core inflation are expected in 2012. Inflation is the least concern of the central bank at this time.

## Interest rates

Bond yields trended lower for most of November reaching decadal lows in most maturities. However, in the last few days bond yields for 5-year corporate bonds of the major chartered banks rose about 15 bps. The Government of Canada yield curve flattened another 10 bps to its lowest point in this cycle and since the recession.



Administered deposit and mortgage rates were unchanged in November other than minor tinkering in some products.

### Monetary policy

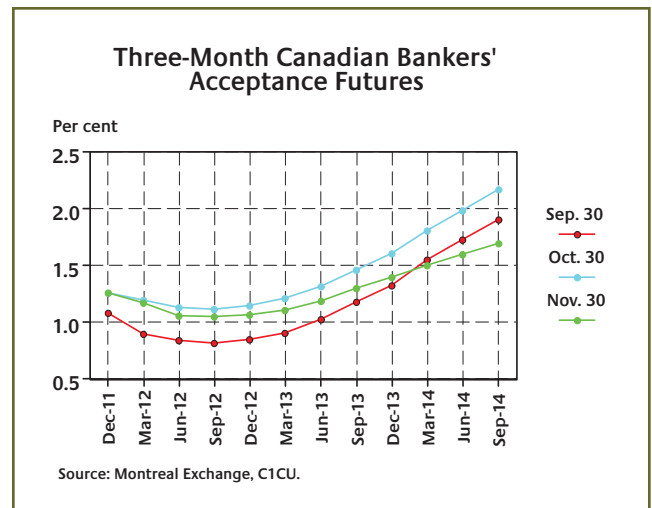
The Bank of Canada’s participation in the co-ordinated effort with other central banks to provide liquidity support to the global financial system is its latest move to support the economy. At its upcoming rate announcement on Dec. 6, the Bank will very likely keep its policy rate unchanged.

In the U.S., the Fed met in early November and announced no changes to monetary policy. It will continue to sell Treasuries of maturities of three years or less and purchase an equal amount of securities of maturities of six years or more. This is in an attempt to keep long-term interest rates low and support a recovery in the housing market.

### Interest rate forecast

The main change to this month’s forecast is pushing the next Bank of Canada rate increase into the spring of 2013 from the winter due to ongoing uncertainty over Europe and a sluggish economy in the first half of 2012. The economy needs to grow at an above trend pace for at least two consecutive quarters combined with a positive outlook before the Bank removes monetary stimulus. Under current output gap estimates and the base case scenario, the Bank will move to raise rate in the second quarter of 2013, about nine months before the gap closes.

Risks are skewed to the downside. The futures market for three-month Banker Acceptances is assigning an 80% probability of a 25 bps rate cut by June



2012. Market expectations can shift rapidly and in large jumps depending on the news flow. In October, markets were more positive but turned negative in November.

The main alternative scenario involves a banking crisis in Europe accompanied by a more severe recession than in the base case scenario, which is a ‘muddle through’ outcome whereby politicians do enough to ward off a collapse but not enough to resolve the crisis. The crisis drags out in varying degrees for months if not years.

The banking crisis scenario would mean even lower interest rates in Canada with the central bank taking its policy rate down to 0.25% in rapid fashion. The yield curve would steepen from the large drop at the short end and a lesser decline at longer maturities as in the last financial crisis.

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Target Overnight Rate Forecast	
Meeting Date	Rate (%)
Oct. 25 (a)	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	1.00
Oct. 23	1.00
Dec. 4	1.00
Jan. 2013	1.00
Mar.	1.00
Apr.	1.25
June	1.50
July	1.75
Sept.	1.75

(a) actual

Interest Rate Forecast									
Item	2011 Q3a	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2	2013 Q3
Target Overnight Rate	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.25	1.70
Prime Rate	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.25	3.80
1-mo. T-Bill	0.85	0.80	0.80	0.85	0.85	0.85	0.90	1.15	1.65
3-mo. T-Bill	0.89	0.85	0.85	0.90	0.95	0.95	1.00	1.25	1.70
6-mo. T-Bill	0.94	0.90	0.90	0.95	1.05	1.10	1.20	1.50	1.90
1-year T-Bill	1.00	0.90	0.90	1.00	1.10	1.15	1.25	1.55	2.00
2-year GoC Bond	1.12	1.00	0.95	1.05	1.15	1.25	1.40	1.75	2.20
3-year GoC Bond	1.32	1.15	1.05	1.15	1.20	1.40	1.55	1.95	2.40
5-year GoC Bond	1.73	1.50	1.40	1.50	1.60	1.80	2.00	2.45	2.95
10-year GoC Bond	2.52	2.25	2.10	2.20	2.35	2.55	2.75	3.25	3.75

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

Deposit Rate Forecast									
Item	2011 Q3a	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2	2013 Q3
1-year GIC	0.80	0.95	0.90	0.85	0.85	0.95	1.00	1.20	1.40
3-year GIC	1.22	1.35	1.30	1.30	1.30	1.30	1.30	1.40	1.55
5-year GIC	1.75	1.80	1.80	1.80	1.80	1.80	1.85	1.85	2.00

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

Mortgage Rate Forecast									
Item	2011 Q3a	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2	2013 Q3
1-year Mortgage	3.51	3.50	3.40	3.40	3.45	3.45	3.60	3.70	3.95
3-year Mortgage	4.35	4.10	4.05	4.05	4.05	4.10	4.30	4.50	4.75
5-year Mortgage	5.38	5.30	5.30	5.25	5.25	5.35	5.50	5.70	5.90

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