

Markets reacted positively to the EU deal on the debt crisis but soon realized many important details needed finalization and the agreement was only another step to a solution. Recession concerns mounted. While a European recession is a foregone conclusion, a U.S. recession is much less certain. The likely outcome is a continuation of below-trend growth interrupted by various policy-driven and natural events.

Under these conditions, the low interest rate environment should exist for many more months. The Bank of Canada acknowledged the deteriorating economic outlook but gave no hint of any rate change. There is some room to add monetary stimulus in Canada, unlike other advanced nations, should conditions and the outlook warrant.

Economy

The Euro Summit reached agreement on the bailout fund, bank recapitalization and a haircut on Greek government bonds sparking a market rally in equities and commodities. Bond yields moved higher. While much uncertainty was removed, many details need to be hammered out and some obstacles are bound to emerge causing markets to retrench at times. Overall, it was a positive development and markets can now turn more attention to a possible U.S. recession and the forthcoming U.S. super-committee report.

The EFSF or rescue fund will be boosted about €1 trillion by a first loss insurance model (first 25% of losses covered) and a special purpose vehicle model (SPV). Foreign sovereign wealth funds can invest in the SPV. The new EFSF creates tranches of debt with the old sovereign debt made junior to the new debt with built in first-loss guarantees. China, the world's largest holder of foreign exchange reserves, was approached by the EU to participate in the SPV. The IMF will likely become involved in the SPV as well.

Bank capital ratios will have to be increased to 9% by the end of June 2012, after accounting for market valuation of sovereign debt. The European Banking Authority estimates this would cost €106.5 billion

raised from private investors, governments or the EFSF.

A voluntary agreement on a 50% haircut or about €100 billion on Greek government bonds was reached with private creditors. The EFSF will facilitate the debt swap, which is to take place at the beginning of 2012, with €30 billion. The goal is to reduce Greek government debt to more sustainable levels.

It is not clear whether the 50% haircut qualifies as a credit event triggering CDS contracts. The ISDA will reach a determination at some future date but for now it states "... that the bond restructuring is voluntary and not binding on all bondholders. As such, it does not appear to be likely that the restructuring will trigger payments under existing CDS contracts. ... the restructuring proposal is not yet at the stage at which the ISDA Determinations Committee would be likely to accept a request to determine whether a credit event has occurred."

While Greece's debt crisis may be contained for now, Italy's debt problem would be much more daunting for policymakers. Italy has a debt-to-GDP ratio around 120% with nominal debt approaching €2 trillion and needs to raise more than €400 billion next year in the context of a weak growth outlook and internal political uncertainty. The market sent Italian government bond yields to record highs at the latest auction and absorbed fewer bonds than offered by the government – a negative sign.

The latest plan is more comprehensive than the previous one and a positive step in the right direction. However, many details have to be finalized, further meetings are scheduled and many questions remain. Are the bail-out fund and Greek's haircut large enough? Will the Italian and Greek governments deliver on austerity targets? How will foreign and private investors react?

The European economy is in or about to enter a recession phase. Industrial production is expected to weaken on the heels of a sharply fallen manufacturing purchasing managers' index. The gauge fell to 48.5 from 49 in August, the lowest since August 2009, with new orders also declining. A reading below 50 indicates contraction.

Fiscal drag, tighter financial conditions, poor confidence among consumers and businesses, and a weaker global outlook drive Europe into a recession. The intensity and duration of the recession is not certain since much depends on policymakers but the next two quarters and 2012 look the bleakest. Beyond this recession, trend growth is likely to remain below 2% per annum for a number of years due to structural constraints.

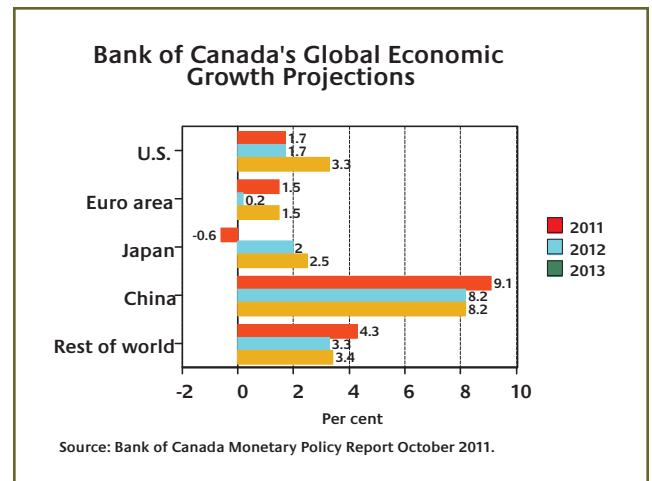
Turning to the U.S., its economy grew at a 2.5% annualized rate in Q3-2011 up from 1.3% in Q2-2011. For the first time, real GDP is above its pre-recession peak of the fourth quarter of 2007 and by one definition marks the beginning of the economic recovery. By a wide margin, this is the longest time in the post-war era for the U.S. economy to recover to its previous cycle peak. However, real GDP per capita remains well below its pre-recession peak.

Final sales of domestic product—GDP minus the change in inventories—grew 3.6% annualized following a 1.6% gain in the second. Personal consumption expenditures rose 2.4% and fixed nonresidential investment expanded 14%. Investment in residential structures added less than 0.1 percentage point to growth but it was the second straight increase. Inventories subtracted from growth while exports grew more than imports. Government spending was unchanged in the third quarter - an increase in federal spending offset the drag from state and local governments.

With September data showing improvement and financial markets rebounding, there is some upside momentum to near-term growth. The handoff to Q4-2011 is quite good. The Federal Reserve Bank of Chicago's national activity index (comprised of 85 economic indicators) rose to -0.22 in September from -0.59 in August. The index has edged off the -0.7 threshold that has been consistent with recession.

The ECRI leading index increased for the second consecutive week but this is not sufficient evidence to overturn its recession call. Although the ECRI index has a good track record of predicting recessions, a downturn is not necessarily baked in. In the latest survey of U.S. economic forecasters, a recession was expected by only one though economist profession's track record is tarnished with the large majority not predicting the Great Recession of 2008-09 either.

Exports will become a source of weakness with Europe's recession since it takes more than 20% of total



exports. Fiscal drag from the expiration of this year's reduced payroll tax rate, emergency unemployment insurance benefits, and state and local transfers from the federal government but could be mitigated by new stimulus measures. However, political gridlock in Washington suggests little resolution on this front nor with Congress' super committee charged with finding \$1.2 trillion in a 10-year deficit reduction by the end of November.

A recession, should it occur, would likely be brief and mild since few excesses exist and recessions are often about rectifying excesses such as high inflation, asset price and investment booms, or real economy imbalances. The main recession risks are from external sources from Europe and a hard landing in emerging market economies. A European banking and credit crisis is the greatest risk and could throw the U.S. economy into a severe recession.

The most likely quarter for a recession to begin would be Q1-2012 when the effects of more fiscal drag and weaker exports combine against a potentially weaker consumer spending backdrop. Historically, a mild recession sees U.S. real GDP contract 1 to 1.5% from the peak and ends after two or three down quarters. To place this in context, the 2008-09 recession caused U.S. GDP to contract 5.1% in a six quarter span; the worst since the Depression.

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.

The Bank of Canada's latest forecast in its *Monetary Policy Report October 2011* concluded that a brief recession would play out in the Euro area in 2012.

The Bank slashed its U.S. outlook for 2011 to 1.7% from 2.4% and in 2012 to 1.7% from 3.2% while holding 2013 at 3.3%. Since the U.S. is Canada's largest export market, any slowdown will have a direct impact on its economic performance.

Canada's large employment gain (+60.9k) in September is suspicious since an unlikely 44k gain occurred in Metro Vancouver, which was the largest one-month increase on record. The September report is positive but private employment declined led by manufacturing. Large monthly swings in employment, particularly those narrowly based, are likely the result of sample variability.

Housing sales bounced back in September after two consecutive monthly declines but have been stuck in a +/-4% range for many months. Housing prices are sliding lower with modest declines in five of the last six months ending September. An outright housing recession is unlikely unless an economic shock or recession ensues. The likely path for the housing market is a gradual adjustment phase until the economy strengthens.

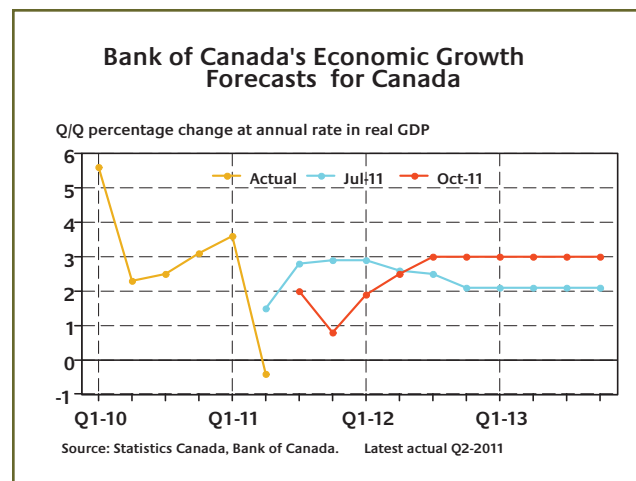
Retail sales rose in August offsetting the previous month's decline. Higher sales at gasoline stations and motor vehicle and parts dealers helped. Total retail sales rose 0.3% after adjusting for price changes.

Industry GDP in August expanded 0.3% compared to 0.4% in July and 0.2% in June. This sets up Q3-2011 GDP to come around 2.5% or higher. The one-time events that pulled down GDP in Q2-2011 have unwound and boosted third quarter activity above trend growth.

The composite leading indicator fell by 0.1% in September on weaker financial market indicators. This is the first monthly decline following a slowdown in the preceding four months, which portends slower growth at a minimum. It is too early to call a recession based on the available evidence but all eyes are on the U.S. and Europe.

Fourth quarter real GDP is forecast at 1.5% annualized, down from an estimated 2.5% in Q3-2011. Real GDP growth in 2011 is forecast at 2.2% slowing to 2.0% in 2012 with exports and government pulling down growth. Less business investment is also likely to contribute to slower growth. The economy is expected to strengthen mildly to 2.5% in 2013.

The Bank of Canada released its latest forecast, which incorporated a large downgrade to its outlook in



2011 and 2012 while upgrading its 2013 expectations. Its 2013 forecast, while in the right direction, is likely too high and should be viewed in the context of the Bank's long-standing practice of setting the growth rate relative to the economy's potential growth rate such that the output gap closes near the end of the projection period.

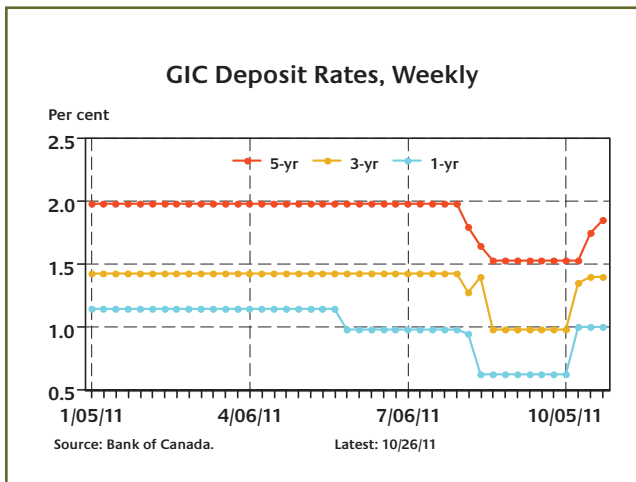
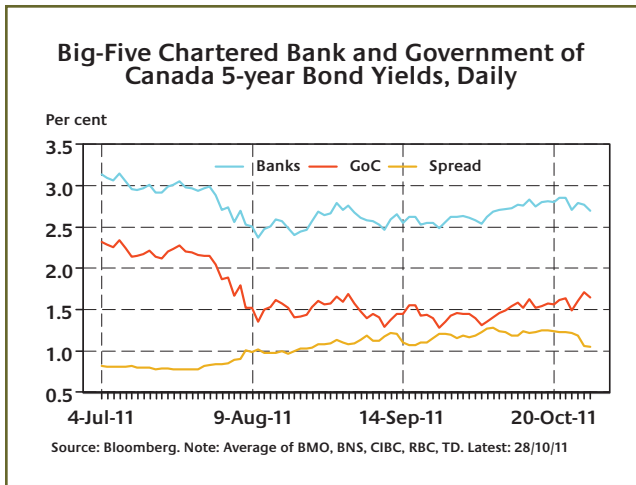
Inflation

Consumer price inflation edged up to 3.2% in September from 3.1% in August. Higher gasoline and food prices are behind this year's climb above 3%. The Bank of Canada's core inflation measure rose to 2.2% in September from 1.9% in August. Under normal conditions, this would raise a red flag but with considerable slack in the economy and weaker growth prospects, it will not affect monetary settings. The Bank sees headline CPI increasing by 1% year-over-year in Q2-2012 and gradually rising to 2% by the end of 2013.

Interest rates

Government treasury bill rates and bond yields generally increased during October as did corporate bond yields. From the end of September, short rates moved up 10 to 15 basis points while long bond yields climbed about 25 to 30 bps by month-end. Market sentiment improved from September's abyss with expectations of a substantial agreement to forestall a European banking crisis.

By the end of October, the average five-year bond yield of the major chartered banks declined about 15 bps following a 25 to 30 bps increase since mid-September. It became more difficult for banks to raise funds in the market during the worst moments of the European debt crisis.



GIC deposit rates shot up 35 to 40 bps in early October reflecting difficulties in the wholesale market and their need to access the retail market for deposits. Mortgage rates, though, moved somewhat contradictorily with the posted three-year fixed term cut 30 bps to 4.05% while the five-year term rate increased 10 bps and the one-year rate held steady. It was an unusual month for the markets and rate-setters.

Monetary policy

The Bank of Canada kept its target rate unchanged at 1%, to no one's surprise. There was no hint of a rate cut despite its sharply lower economic outlook. However, should circumstances and more downside risks arise, the Bank would respond with more stimulus.

Interest rate forecast

There is no major change to the low interest rate, flatter-than-normal yield curve outlook in 2012. The Bank of Canada's next rate move is pushed back to Jan. 2013 with a 25 bps increase in the target rate. The pace of monetary tightening in 2013 will

be gradual. The yield curve is expected to steepen during 2013.

The sudden increase in GIC rates will likely be partially unwound in November with a declining cost of wholesale bank financing emerging in late October and likely continuing into November.

The futures market for three-month bankers' acceptances is assigning about a 50% probability of a rate cut in the first half of 2012. Market sentiment improved over last month. By the end of Sept. 2013, the market is expecting slightly higher short rates.

Helmut Pastrick

Chief Economist, Central 1 Credit Union
 hpastrick@central1.com
 www.central1.com
 604.737.5026

Target Overnight Rate

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	1.25
Mar.	1.50
Apr.	1.50
June	1.75
July	2.00
Sept.	2.00

(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	1.25	1.55	1.80
Prime Rate	3.00	3.00	3.00	3.00	3.00	3.00	3.25	3.55	3.80
1-mo. T-Bill	0.85	0.85	0.85	0.85	0.85	0.90	1.20	1.45	1.75
3-mo. T-Bill	0.89	0.90	0.90	0.95	0.95	1.00	1.25	1.55	1.80
6-mo. T-Bill	0.94	0.95	0.95	1.00	1.05	1.10	1.35	1.70	1.90
1-year T-Bill	1.00	1.00	1.00	1.05	1.10	1.20	1.50	1.80	2.00
2-year GoC Bond	1.12	1.05	1.05	1.10	1.15	1.30	1.65	2.00	2.25
3-year GoC Bond	1.32	1.25	1.25	1.25	1.30	1.50	1.90	2.20	2.40
5-year GoC Bond	1.73	1.55	1.60	1.65	1.70	1.90	2.35	2.55	2.75
10-year GoC Bond	2.52	2.35	2.35	2.40	2.50	2.75	3.10	3.35	3.55

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	0.85	0.70	0.65	0.65	0.75	0.90	1.05	1.15
3-year GIC	1.22	1.25	1.00	0.95	0.95	1.10	1.25	1.40	1.55
5-year GIC	1.75	1.70	1.65	1.60	1.60	1.70	1.95	2.05	2.10

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	3.60	3.65	3.70	3.80
3-year Mortgage	4.35	4.15	4.20	4.20	4.25	4.40	4.50	4.55	4.70
5-year Mortgage	5.38	5.25	5.20	5.25	5.25	5.55	5.60	5.70	5.80

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