

# North American Economic Outlook

## Approaching a turning point in the U.S. economy

The U.S. economy remains in the grip of the longest recession since WWII. Layoffs continue, consumer spending is stagnant, business capital spending is retrenching, and the housing sector shows few real signs of life. And yet, the change in mood over the past quarter is palpable: financial markets have taken off, the banking system appears to be finding its footing, consumer confidence is rebounding, and a consensus is building that the recession will be over soon.

We, too, expect a recovery in the second half of this year. Of course there are risks: commercial real estate looks shaky, state and local governments are on the verge of major cutbacks, and credit markets are not back to normal. But – as the overworked metaphor of “green shoots” suggests – there are increasing signs that the pace of decline is slowing fast enough to transition to positive growth this summer.

The key drivers of the turnaround will be inventories (especially in the auto industry), confidence, renewed health in the banking system, and government policy – both fiscal and monetary stimulus. In addition, the two-year-long decline in home-building may be over, removing a large drag on growth.

The pessimistic alternative to this outlook now focuses less on the length of the recession, and more on the chance of an anemic recovery. We argue that once growth resumes it can ramp up quite fast, as pent-up demand is released for cars, houses, capital goods and all kinds of durables. But it is undeniably possible that Americans' spending behavior has undergone a seismic shift towards more saving, which could persist and choke off the rebound that would be normal after such a deep trough.

In addition, it is also possible that the losses in the banking industry will combine with the demise of key parts of the Asset-Backed Security (ABS) market to constrain the overall growth of credit below what the economy needs to sustain a strong economic recovery. The Fed is working overtime to get the ABS market back on its feet; and we believe that capital will be available as needed to finance business and consumer spending. But after a year of turmoil, it's clear that dislocations in the normal flow of credit are possible.

### Key opinions shaping our outlook:

- Monetary & fiscal stimulus, inventories and confidence will be enough to end the recession this year.
- Once growth begins, pent-up demand from consumers and businesses will add to fiscal stimulus to drive a strong pace of demand growth in 2010, albeit less quickly than in previous cycles.
- The financial system will accommodate the credit needs of a growing economy, even if particular institutions are constrained or failing.
- Consumer saving rates will remain higher than pre-recession, but are unlikely to go much higher than they have already been driven by job insecurity and a credit crunch.
- Home prices may have further to fall, but home-building and home sales have bottomed out and will no longer be a drag on economic growth.

## U.S. Economic Research Forecast Summary

Summer 2009	Forecast										Year-over-Year % Change or Annual Average				
	2008.3	2008.4	2009.1	2009.2	2009.3	2009.4	2010.1	2010.2	2010.3	2010.4	2007	2008	2009	2010	2011
% Change at annual rate															
<b>Gross Domestic Product</b>	<b>-0.5</b>	<b>-6.3</b>	<b>-5.7</b>	<b>-1.2</b>	<b>1.0</b>	<b>2.0</b>	<b>2.4</b>	<b>5.0</b>	<b>4.0</b>	<b>4.0</b>	<b>2.0</b>	<b>1.1</b>	<b>-2.5</b>	<b>2.7</b>	<b>4.4</b>
Personal Consumption Expenditures	-3.8	-4.3	1.5	0.4	0.9	1.2	1.5	4.0	3.2	3.4	2.8	0.2	-0.6	2.1	3.4
Business Fixed Investment	-1.7	-21.7	-36.9	-8.6	-13.5	-9.0	-0.7	6.4	8.9	11.0	4.9	1.6	-18.3	-1.4	8.2
Residential Investment	-16.1	-22.7	-38.7	-23.4	-7.9	8.2	16.7	20.2	25.7	21.3	-17.9	-20.8	-22.7	10.8	21.7
Government Purchases	5.8	1.3	-3.5	5.3	3.3	2.9	1.3	2.3	0.1	0.1	2.1	2.9	1.9	2.0	1.4
Change in Inventories	-30	-26	-91	-111	-69	-24	4	18	31	40	-2.5	-29.1	-73.8	23.2	4.9
Exports	3.0	-23.6	-28.7	-3.8	0.9	3.0	5.8	8.8	8.6	9.9	8.4	6.2	-12.1	5.2	9.5
Imports	-3.5	-17.5	-34.1	-0.8	3.1	5.1	6.5	6.3	7.9	8.7	2.2	-3.5	-13.4	5.6	7.4
Real Disposable Income	-8.5	2.9	6.5	3.2	0.0	1.2	2.0	2.4	2.2	2.5	2.8	1.3	2.3	1.8	3.5
Personal Saving Rate (%)	1.3	3.2	4.4	5.3	5.2	5.1	5.1	5.2	5.2	5.2	0.6	1.8	5.0	5.2	4.4
Corporate Profits with IVA & CCAdj	-4.7	-51.4	14.2	6.5	-30.0	12.2	28.6	15.3	-7.4	10.2	-1.6	-10.1	-13.7	6.9	4.6
Unemployment rate %	6.0	6.9	8.1	9.1	9.5	9.8	9.9	9.7	9.5	9.0	4.6	5.8	9.1	9.5	8.0
Private Housing Starts (thous. units)	868	658	529	450	563	646	657	746	820	854	1341	901	547	769	1138
<b>Prices</b>															
GDP Price Index	3.9	0.5	2.8	0.8	1.3	1.4	1.5	1.4	1.6	1.7	2.7	2.2	1.7	1.4	2.2
<b>Consumer Price Index: CPI-U</b>	<b>6.2</b>	<b>-8.3</b>	<b>-2.4</b>	<b>1.0</b>	<b>2.0</b>	<b>1.5</b>	<b>1.8</b>	<b>1.9</b>	<b>2.0</b>	<b>1.8</b>	<b>2.9</b>	<b>3.8</b>	<b>-0.6</b>	<b>1.8</b>	<b>2.3</b>
CPI-U Excl Food & Energy	2.8	0.6	1.5	2.0	-0.6	1.4	1.6	1.8	1.9	1.7	2.3	2.3	1.3	1.4	2.1
Foreign Exchange Rate	97.9	108.3	111.1	106.5	105.0	103.5	103.1	102.1	101.7	101.6	103.4	99.8	106.5	102.1	101.1
(Broad Trade-Weighted Value of US\$)															
Refiners' Cost of Imported Oil (\$/b)	111.8	51.8	41.0	52.8	57.8	58.8	60.0	60.8	61.6	62.5	67.1	92.3	52.6	61.2	67.0
<b>U.S. Interest Rates (avg. %)</b>															
Federal Funds Rate	2.0	0.5	0.2	0.2	0.2	0.2	0.2	0.2	0.5	1.2	5.0	1.9	0.2	0.7	2.7
Ninety-day Treasury Bill Rate	1.5	0.3	0.2	0.2	0.2	0.3	0.4	0.7	1.0	1.4	4.4	1.4	0.2	0.9	2.9
3-month LIBOR	3.3	3.6	1.7	1.3	0.9	1.0	1.1	1.4	1.7	2.1	5.3	3.3	1.2	1.6	3.5
<b>10-year Treasury Note Yield</b>	<b>3.9</b>	<b>3.3</b>	<b>2.7</b>	<b>3.3</b>	<b>3.7</b>	<b>3.8</b>	<b>3.9</b>	<b>4.2</b>	<b>4.3</b>	<b>4.4</b>	<b>4.6</b>	<b>3.7</b>	<b>3.4</b>	<b>4.2</b>	<b>4.7</b>
<b>Treasury Yield Spreads (avg. basis points)</b>															
5yr - 2yr	75	96	86	122	111	110	109	101	99	88	7	80	107	99	49
10yr - 2yr	150	204	183	231	243	244	236	229	213	186	27	166	225	216	102
30yr - 10yr	59	43	72	86	66	57	62	52	50	50	20	61	70	53	50
<b>Credit Spreads (avg. basis points over Treasuries)</b>															
10yr AAA	260	357	326	255	195	188	181	175	168	161	87	252	241	171	145
10yr A	291	469	417	347	264	255	246	237	228	219	114	305	321	233	197
10yr BAA	322	592	587	472	366	354	341	329	316	304	149	368	445	323	273

Forecast beginning in 2009.2

## Canada Economic Research Forecast Summary

Summer 2009	Forecast										Year-over-Year % Change or Annual Average				
	2008.3	2008.4	2009.1	2009.2	2009.3	2009.4	2010.1	2010.2	2010.3	2010.4	2007	2008	2009	2010	2011
% Change at annual rate															
<b>Gross Domestic Product</b>	<b>0.4</b>	<b>-3.7</b>	<b>-5.4</b>	<b>-2.4</b>	<b>1.3</b>	<b>2.1</b>	<b>3.4</b>	<b>3.7</b>	<b>3.5</b>	<b>3.1</b>	<b>2.7</b>	<b>0.4</b>	<b>-2.2</b>	<b>2.6</b>	<b>3.6</b>
Personal Consumption Expenditures	0.6	-3.1	-1.6	-1.1	1.0	1.8	2.4	3.2	3.3	2.9	4.5	3.0	-0.8	2.2	4.2
Business Fixed Investment	2.1	-16.2	-25.8	-15.5	-12.0	-5.0	-0.5	1.0	1.7	2.5	3.5	0.2	-14.6	-3.2	3.8
Residential Investment	0.0	-23.0	-21.0	-22.0	-2.2	0.8	1.0	6.2	7.2	7.1	3.0	0.0	0.0	0.0	0.0
Government Purchases	0.9	3.6	1.1	4.1	3.9	6.3	6.8	4.2	4.0	3.2	4.2	4.8	3.0	5.1	4.3
Change in Inventories (\$ bill CAD)	15.0	10.3	-5.8	-2.3	-1.3	-0.6	1.2	3.0	5.1	6.6	13.2	15.9	0.2	4.0	12.3
Exports	-4.1	-17.7	-30.4	-11.2	5.4	3.0	3.7	4.1	4.6	5.5	1.0	-4.7	-13.9	3.1	2.9
Imports	-3.4	-23.4	-37.8	-9.3	1.3	3.0	4.2	4.6	6.1	6.4	5.5	0.8	-17.0	3.2	6.5
Unemployment rate %	6.1	6.4	7.6	8.3	8.9	9.1	9.3	9.1	8.9	8.7	6.0	6.1	8.5	9.0	7.1
Private housing starts (thous. units)	208	185	140	125	135	140	142	143	142	153	227.8	211.5	135.0	145.0	227.8
<b>Prices</b>															
<b>Consumer Price Index: CPI-U</b>	<b>4.6</b>	<b>-3.1</b>	<b>-0.9</b>	<b>-0.1</b>	<b>2.6</b>	<b>2.1</b>	<b>1.4</b>	<b>1.8</b>	<b>1.7</b>	<b>1.9</b>	<b>2.1</b>	<b>2.3</b>	<b>0.4</b>	<b>1.7</b>	<b>2.5</b>
CPI-U excl food & energy	1.5	1.1	0.8	1.2	1.9	1.7	1.1	1.3	1.4	1.4	2.0	1.2	1.3	1.4	1.9
Foreign Exchange Rate USD/CAD	0.96	0.83	0.80	0.80	0.80	0.83	0.84	0.85	0.86	0.87	0.94	0.94	0.81	0.85	0.93
<b>CAN Interest Rates (avg. %)</b>															
BoC Overnight Rate	3.00	2.0	0.8	0.3	0.3	0.3	0.3	0.3	1.0	1.5	4.4	3.0	0.4	0.8	2.7
Ninety-day Treasury Bill Rate	2.33	1.5	0.7	0.3	0.4	0.6	0.8	1.1	1.4	1.8	4.1	2.4	0.5	1.3	2.9
<b>10-year Treasury Note Yield</b>	<b>3.65</b>	<b>3.4</b>	<b>2.9</b>	<b>3.2</b>	<b>3.6</b>	<b>3.7</b>	<b>3.9</b>	<b>4.1</b>	<b>4.2</b>	<b>4.4</b>	<b>4.3</b>	<b>3.7</b>	<b>3.4</b>	<b>4.1</b>	<b>4.7</b>

Forecast beginning in 2009.2

### Changes since the Spring 2009 U.S. Outlook

While the recession continues and serious downside risks remain, our central forecast has actually improved slightly since March. We now expect a slightly less rapid contraction of U.S. GDP in the second quarter, and slightly more growth in the second half of 2009:

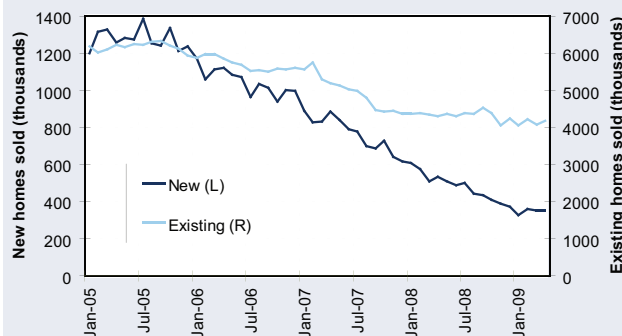
- Our year-over-year GDP forecast is now 0.2% stronger both in 2009 and 2010.
- Despite the better GDP outlook, the rapid pace of job losses to date leads us to expect a higher peak unemployment rate of 9.9%, vs. 9.2% last quarter. This implies that on a monthly basis the rate will almost certainly touch 10% before it starts to decline during 2010.
- The U.S. dollar has weakened in recent months, and U.S. bond yields have risen. Both of these are assumed to persist through the near-term forecast, despite no material change in Federal Reserve monetary policy.
- The housing market has probably bottomed out, but at a somewhat lower level of home-building than was previously forecast.

### Employment growth in the recovery

The critical ongoing weakness is in employment, which continues to drag down wages and incomes. The pace of job losses (or reductions in hours worked) has kept pace with falling output during this recession, leaving a healthy trend in productivity. This suggests that as soon as demand revives, businesses will have to start hiring again, since they have not allowed slack to build up in the form of underutilized workers. This pattern would be consistent with the majority of U.S. recoveries.

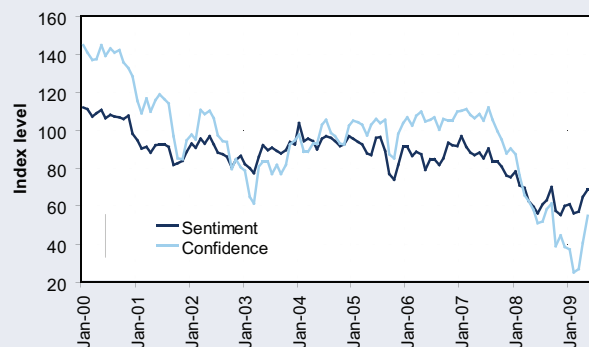
Unfortunately, both for the job prospects of the unemployed and for the reputation of forecasters, both of the last two recessions (1990-91 and 2001) were exceptions. When demand turned up, businesses raised output mainly through productivity growth, and job gains did not show up for another year. Depending on which pattern asserts itself in this cycle, we may have anything from a rapid drop in unemployment

### Single-Family Home Sales: finally bottoming out



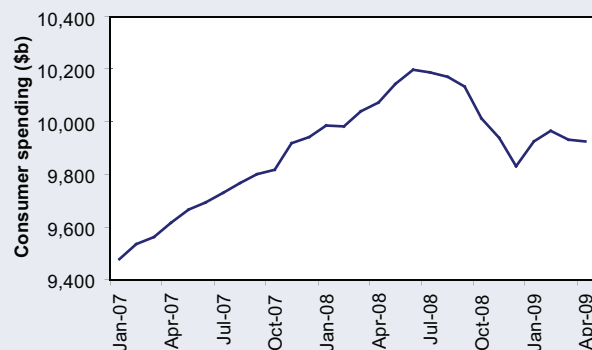
Source: Census (New); National Association of Realtors (Existing)

### Consumers: feeling a bit less awful



Source: U. Michigan; Conference Board

### Consumer Spending: depressed but holding level



Source: U.S. Bureau of Economic Analysis

to continued job losses through 2010, with major implications for consumer and business spending. Our judgment is that this cycle has been so deep that the rebound will be fast enough to generate job growth relatively soon, but the speed remains in doubt. With unemployment at historically high levels through 2010, employers may be able to keep squeezing more out of their existing workforce for some time.

## Inflation

The flood of money created by the Federal Reserve has already inflated the Fed's balance sheet to over \$2 trillion, and existing policies could come close to doubling it again. Not surprisingly, there is talk of inflation in our future.

Such a massive monetary expansion would – with other things being equal – lead naturally to a burst of inflation. But with other things so far from equal, the conventional logic is irrelevant. The trillions pumped into the financial system have merely served to preserve some degree of liquidity and shore up the capital reserves of banks, but the vast bulk of the money has not been lent, let alone spent. The increase in bank reserves has helped to avert a monetary contraction, but it cannot feed through to inflation until a bank lends it, and then somebody, somewhere spends it.

Even when an increased money supply does feed into spending, it should mainly stimulate more output rather than higher prices and wages as long as there is still substantial slack in the economy (unemployment and underutilized capital). Only after a period of recovery long enough to bring down unemployment will the threat of inflation become serious, giving the Fed plenty of time to make sure the recession is really over and pull back the trillions that it has pumped out.

In this context there are two main risks. First, the Fed could misjudge the moment to tighten, either waiting too long and giving inflation a foothold, or moving too soon and snuffing out the recovery before it gets going. Second, the markets could overdo the fear of inflation, driving up real interest rates and thus throttling back the economy's ability to grow. Either way, the risks are still at least one year out, and inflation is a non-issue for now.

A larger and more relevant inflation risk is the prospect of oil prices crowding out domestic spending. As market participants – China, investors – drive up the price of oil, gas prices follow. This is one added pressure that consumer spending simply does not need. We expect oil prices to recede a little with inflation expectations – though probably not enough to get gasoline back to two bucks a gallon.

## The role of credit

Bank balance sheets have taken a beating throughout the financial crisis, and some lending channels – the shadow banking system (mainly Asset-Backed Securities markets) – are no longer available to facilitate credit flow. The Treasury's PPIP program seems to be on hold, but stronger banks are using private capital to extricate themselves from their problems. We believe that once economic growth re-emerges, bank lending will also improve. To be sure, lending capacity may be meager at first compared to what it was going into the crisis, but so will the demand for credit given the gradual emergence of growth. As growth picks up, we expect new institutions and new capital raised in commercial banking to fill the current credit void left by the shadow banking system. Lending in a growing economy is a very profitable business, and there is almost no chance that the opportunities to make money will be ignored.

## U.S. Financial Markets

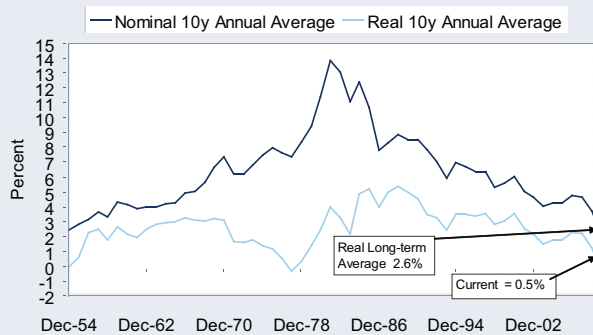
### The return of the bond vigilante and the Fed

#### *Bracing for even higher rates*

Ben Bernanke fired a shot across the bows of Congress, warning that long-term public budget deficits can lead to a future debt trap, unless we begin planning now for a restoration of fiscal balance. This, of course, is not a new insight, but the markets reacted as if it had been, driving bond rates up sharply. More troublesome, if this is the beginning of a new trend, then higher rates could derail the emerging economic recovery. We're not expecting this to happen, but the fixed income market has the potential to change the balance of economic risks to the downside.

Financial markets are starting to price in the hope that this is a normal economic cycle and that trend GDP growth, or better, is imminent. However, it is possible that much potential improvement has been factored in asset prices already, so much so that the market has all but dismissed the anemic 2009 outlook in favor of the 2010 recovery. In this environment, if actual data in the coming months disappoints, then 2010 expectations will come down sharply, dragging equity values lower and bond prices higher.

### The sharp fall in real and nominal long-term rates increase the likelihood of a turnaround



Source: Federal Reserve Bank, Economic Research

As global governments add fiscal stimulus, debt will expand, and – other things being equal – interest rates will eventually rise. In theory, the accumulation of debt could continue indefinitely as long as the economy grows faster than the rate of debt accumulation, and/or foreigners continue to lend their excess savings. In reality, growth may not be as strong as needed, foreigners may choose to keep their savings in other currencies, and the political pressure of budgetary goals could all conspire to push rates up, dampening private spending. At best, government spending would be crowding out a small portion of private capital only when the economy reaches full potential; at worst, it could crowd out all kinds of private investment by making debt unaffordable for companies and households, delaying the recovery.

The deficit is not a problem yet. Preventive measures – cutting spending and/or increasing tax rates – are inappropriate given that we are still in a recession. In the short term, fiscal stimulus can offset sagging private spending. Longer-term, if budgetary remedies are timed properly, they could increase tax revenue enough to repay and even reduce total outstanding debt – something close to what we experienced briefly during the Clinton Administration.

For now, nominal interest rates remain low by historical standards. However, the recent spike shows that investors are on edge. A sharper rise in rates would come at a critical stage, threatening to hold back private spending. As we go to print the 10-year Treasury rate stands at near 3.6% – a sharp drop from just above 4% on June 11th. Our forecast calls for the 10-year treasury rate to climb steadily. By the middle of next year, when the Fed begins to scoop off liquidity, we see a rate climbing steadily above 4%.

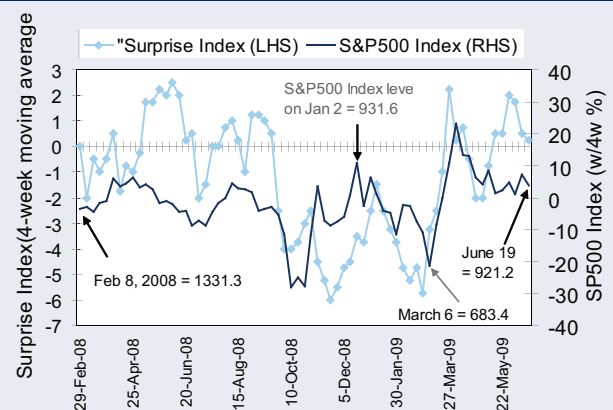
### Equities – Animal spirits on the rise

U.S. equity markets have recovered most of this year's losses from the March 2009 trough, and the price action since then has been impressive. Many see it as another sign that we are getting back to normal and that a quick economic recovery is in sight. We agree with this view, but the timing and the rate at which it will improve remain deeply unpredictable.

Research about the market's ability to anticipate economic inflection points suggests that the stock market is a key directional economic predictor, but that it is not very accurate at predicting the strength in growth. One reason is that the market's forecasting ability cannot be easily compartmentalized into what accounts for actual activity, expected activity, and/or any measure of surprise. Another reason is that a significant amount of market volatility is random.

At present, it seems that investors' severe pessimism back in March incorporated a meltdown scenario that pushed equity values down and widened credit spreads. But very low expectations have since been regularly beaten by actual data. Our economic surprise index supports this view. While this could indeed signal an end to the recession, it could also be interpreted as market participants merely re-thinking their own catastrophic views. The S&P 500 level is still about 40% below its peak in October 2007 and a recovery of a similar magnitude this year and next seems far from assured even given our above-consensus view of growth in 2010.

### After a short period of exuberance, a new string of below expectations data reports seem to be moderating investors' animal spirits



Source: Economic Research surprise index (non-weighted actuals less bloomberg-consensus), Bloomberg (weekly data through June 19th, 2009)

## The dollar

As the thirst for capital in the U.S. increases with economic growth, and as the flight to quality recedes and the rest of the world gets a better foothold on its path to recovery, the dollar is anticipated to get weaker. This ongoing trend will of course encounter numerous short-term reversals, based on the differing patterns of economic and financial news emanating from each of the world's major economies.

## In conclusion

Positive economic surprises in May and June seem linked to rising confidence in an economic recovery and the growing tolerance for risk. Investors are abandoning government bonds for riskier corporate credit and stocks. Of course, a bad patch of economic data could reverse the sentiment and reverse those gains temporarily. For now, we have to hope that the recovery gets on a better footing before the bond vigilantes force real rates high enough to choke off the still tentative signs of growth.

The Fed's job will be to lean against the wind and start preparing the markets for an eventual withdrawal of monetary easing. One of the Fed's challenges will be when and how to reverse policy to prevent a jump in inflation expectations. We assume that any significant liquidity pullback begins before policy rates begin to rise, about the middle of next year. A related challenge revolves around the Fed's program to purchase Treasury and Mortgage-backed securities. So far, the Fed has successfully supported prices, but now as those rates have been rising, the Fed needs to decide (halfway through its previously announced purchase program) whether to stay the course, lightly leaning against the wind, or to take a more aggressive position. Our forecast implies the Fed will steer successfully down a middle course, keeping rates lower than they would otherwise be, but letting them to rise in line with the economic recovery in advance of any inflation pressure.

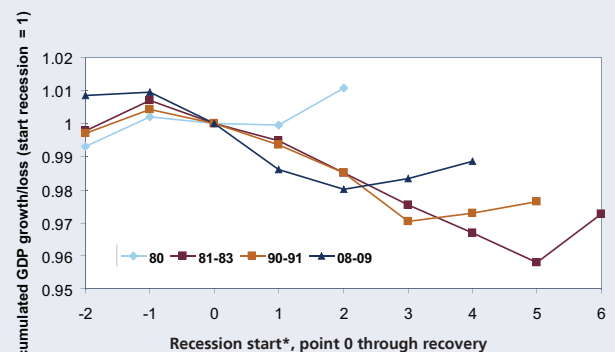
## Canada: biding time on the sidelines

Canada's getting a bounce, not on exports to the U.S., but on a puzzling gain in the volatile commodity markets. However, we expect that the surge in oil, like all other things volatile, will dissipate. Going forward, in spite of an expected drop in oil prices, massive fiscal and monetary interventions, and a bottom in key

markets are expected to drive Canadian growth higher starting in Q3 2009. In total, the recession is expected to steal an accumulated 2.5-3% of GDP, but could be more if exports to the U.S. don't bounce back.

Canada has inherited most of its problems from the U.S. – the quintessential drawback of export-driven growth. But in contrast to the U.S.' economic woes, Canada's downturn is a qualitatively "normal" recession. Of the four recessions since 1961 (defined as two consecutive quarters of negative growth), 1980, 1981-83, 1990-91 and 2008-09, the current downturn is expected to set merely a 20-year record, rather than the often cited 60-year records around the world. Fresh commodity revenues, near-zero monetary policy, a nicely cushioned banking system, and stable household balance sheets have made Canada relatively immune to the current global financial collapse.

### Canada's last four recessions: 08-09 not the deepest nor the longest!



\* Recession start is first quarter of two consecutive quarters of negative growth.  
 \*\* 08-09 includes forecast of recovery and growth in second half of 2009.  
 Source: Statistics Canada; Economic Research

Still, though, its pain is ongoing, and the Q2 data shows that the economy is not growing, just declining less quickly. Going forward, we expect GDP to post a slightly positive growth rate in Q3 2009, with a more robust recovery into 2010, held back slightly by an elongated U-shaped U.S. recovery.

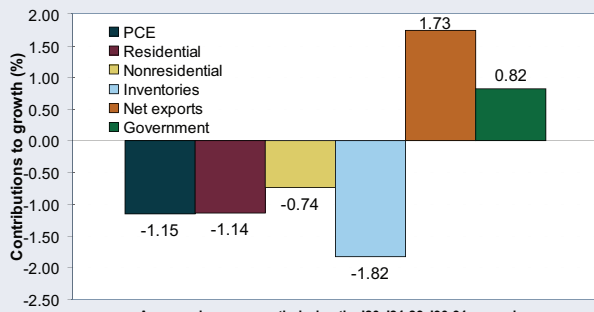
## A "normal" recession

During the average recession, inventory liquidation rips apart economic growth, as firms are caught holding the "hot potato" just as domestic demand takes a sharp turn. Residential investment and consumption spending likewise provide significant drags to growth. This time is no different. Our forecast is close to the "normal" average, with residential investment and consumption eventually taking around 1% from

overall growth, while the inventory liquidation is slightly less pronounced, at -1.3%.

During the average recovery, the same consumption growth, residential investment growth and inventory accumulation are dominant sparks to the early stages of the economic recovery. Although the contribution coming from residential investment and inventories is expected to be slightly lower than the average, consumption is slightly larger, with an expected contribution of close to 1.7% in the four quarters following the recession's end. Relaxed credit standards, easy money, and a lot of pent-up demand should drive consumer spending forward. Admittedly, though, as personal saving rises in reaction to lost wealth, the consumer remains a "wild card" for Canada's recovery.

**During the recession, inventories are the biggest drag on growth**



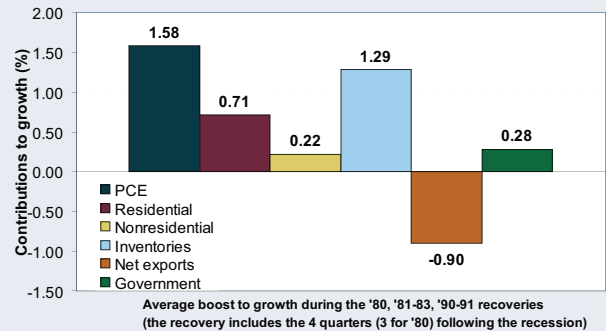
Source: Statistics Canada; Economic Research

**The economic biggies: trade, housing and labor**

World trade came crashing down in the second half of 2008, driven by a sharp decline in U.S. import demand. Canada with its 75% export share to the U.S. must bide its time until the U.S. economy steps up to the trading plate. The struggling manufacturing sector has been particularly heavy hit, dragged down by auto and parts production; and industrial output has dropped 14% since its peak in July 2007.

The drags on the industrial and exports sectors slashed almost 9% off of the goods sector workforce, accounting for most of the payroll decline (the service industry saw just 0.3% of its workforce lost). We expect another 15-20k auto-related layoffs to populate the unemployed over the next year. Into 2010, the unemployment rate is expected to rise to peak around 9.5%.

**Inventory accumulation and personal spending usually boost the economy**



Average boost to growth during the '80, '81-83, '90-91 recoveries (the recovery includes the 4 quarters (3 for '80) following the recession)

Housing has taken a hefty tumble. Although mild by U.S. standards, new residential construction is 46% off its peak, contributing 0.7% to the cumulative 2.3% loss in GDP to date. However, sales and starts are showing signs of stabilization amid record affordability. Homebuyers are slowly hitting the open houses, as price declines and low mortgage rates become too much to resist. Going forward, rising unemployment should keep a quick recovery in housing under wraps.

Critical to the outlook is household spending, which is still in its "falling less quickly" phase. Amid a sharp downturn in net worth and weak labor conditions, households are saving more. However, aggressive policy and improved consumer confidence are expected to halt the decline in consumer spending. At a quarter lag or so, consumer spending should be back, although at a more modest pace amid a rising unemployment rate.

**Policymakers: providing some actual stimulus**

The only time that record government spending is cause for joy is during an economic collapse. Claiming that 80% of the stimulus is already being implemented, Prime Minister Harper has pushed his package through quickly, including tax breaks, direct job creation, new infrastructure projects, and support for the financial system. Although the government is still projecting small surpluses throughout 2009, the rainy day fund that was created by past budget surpluses will likely be rebuilt through prudent spending cuts and/or higher tax rates after 2010.

On the other side of the policy fence, the Bank of Canada (BoC) lowered rates to near zero, vowed

to keep them there, and is holding quantitative strategies on the table. Inflation remains muted, further fortifying the BoC's decision to keep rates low. However, since the economy is already responding to the stimulus in place, we are not expecting the BoC to engage in any quantitative easing because it would risk inflation stability into the medium run. We expect that the underlying slack in the economy will keep the drag on prices very much a reality. There is no inflation-related reason to think that the BoC will raise rates before the middle of 2010, but we expect an incremental tightening trend thereafter.

### **Risks to the Canada Outlook**

Inflation, the dollar, and oil: risks and rewards to the outlook. To be sure, the recent surge in oil has sparked some serious market activity. As of June 12, the S&P/TSX total return index surged over 140% since March 2009; and in response, the Canadian dollar (CAD) is gaining momentum. If oil remains elevated, the outlook on investment and jobs improves significantly, driven by higher expected profits. However, a strengthening CAD puts further downward pressure on inflation and exports. Going forward, we expect a receding price of oil (below \$70/barrel throughout 2009), and weak economic fundamentals to drive down the CAD and stir up much-needed export revenue.

## Risks to the U.S. Outlook

The global recession seems to be abating, but there is little consensus on whether the recovery will be fast (V-shaped), sluggish or even “double-dip”. We are still forecasting stabilization in the second half of 2009, but there are many alternative trajectories.

*[These scenarios are not all mutually exclusive, so probabilities cannot be added]*

### 1. Policy mistakes lead to longer U.S. recession – probability 20%

Higher consumer saving and political blockages in the flow of fiscal stimulus could cause the U.S. recession to drag on for several more quarters. Home values and equities would set new cyclical lows, generating political support for restricting trade. Stimulus policies would become more aggressive, but not in time to avoid double-digit unemployment rates through 2010.

### 2. Global meltdown – probability 15%

A weaker U.S. economy could help send Europe and Asia into another downward spiral, leading to a sharper drop in asset prices with further spiking of corporate and financial defaults. If U.S. and European consumer demand dives in shock, it may take more than another year before the cumulative impact of pro-growth policies gains any traction.

### 3. Deflation – probability 10%

The recession results in sharp and persistent price declines. Premature withdrawal of fiscal and monetary stimulus could set in motion a deflationary spiral, pushing ever more borrowers into bankruptcy as the real burden of debt rises. Assuming that major countries do not then embark on a trade war, we would expect that global fiscal responses and massive injections of liquidity eventually pull us away from depression dynamics, but not without serious collateral damage to households and businesses.

### 4. The perfect outcome – probability 10%

Fiscal and monetary policies are on their way to kick in just in time to prevent further macroeconomic deterioration. Credit markets calm down, oil stays cheap, and price stability is maintained. After a short period of intense pain, the recovery gains just enough momentum that central banks can withdraw excess liquidity in time to avoid a surge in inflation. Some insolvent financial institutions are allowed to fail without much negative market reaction, while private capital returns to credit markets and bank lending recovers sufficiently to support healthy growth.

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