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Upward Revision in Q3 U.S. Growth

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We are revising upward our forecast for third quarter growth in the U.S. by a full percentage point, from an estimated 2.8% to 3.8%. This is a swing of four full percentage points from -1% in the second quarter. While this continues to be subpar growth in an economic recovery, it is far better than the consensus expectation not too long ago. A number of factors have contributed to the uptick.

Housing, of course, is an important factor as the longstanding contraction in residential construction is dissipating and may well turn positive later this year through 2010. We estimate that auto sales, thanks to the cash-for-clunkers program, will add one percentage point to third quarter growth as sales surged and the automakers announced production increases in the U.S. to restock exceptionally low inventories. This will add to personal income as overtime pay rises and some laid off workers are called back.

Other fiscal stimulus measures are also contributing to growth, such as the first-time homebuyer tax credit and infrastructure spending. The infrastructure spending boost kicks in more strongly next year and lower-than-expected costs of these projects are increasing the number of projects and the labour demanded, boosting the bang for the buck.

Inventory depletion had an enormous negative impact on Q2 growth. Inventory replenishment of material inputs and finished goods will boost Q3 GDP even with relatively modest buying by wholesalers and retailers for the back-to-school and Christmas seasons. Private sector spending incentives will boost consumer demand for items such as appliances and baby items. For example, Toys "R" Us launched its own cash-for-clunkers-type program, baby style. Toys "R" Us is offering customers the chance to trade-in used cribs, car seats, high chairs and strollers in exchange for a 20% discount on selected items. The three-week program begins today with no limit to the number of products turned in. Even day-care centres are welcome to 'trade-in' all of their baby items. Initially, the program is limited to the U.S., but the company says it may offer it in Canada depending on its success. Other customer incentive programs are also popping up for many products including travel, gasoline and luxury goods. Even many of the U.S. airlines are enhancing their frequent flier programs, and Neiman Marcus, the high-end department store that has suffered 25% year-over-year revenue declines, has introduced free shipping to Canada even on highly discounted items.

Tax credits for 'green' renovations are also a stimulant and as corporate earnings improve, we might even see businesses jump on the spending bandwagon. None of this erases the

still-dismal jobs picture or households' need to build their much-eroded wealth. It's just that the enormous liquidity poured into the economy, low interest rates and fiscal stimulants combine to push the growth outlook to stronger levels than once feared. It will still be a moderate long recovery period, but with no inflation worries for at least the next year, it could well be stronger than expected.

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