



# The Bottom Line

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## The Pall of Uncertainty

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Economic activity in Canada is clearly ebbing, in line with the slowdown in the rest of the world. Consequently, business and consumer confidence is shaky, edging downward as great uncertainty continues to weigh on sentiment. Canadian and U.S. businesses are holding record volumes of cash, and while investment in machinery, equipment and software is very strong in the U.S., and rising in Canada, job growth in the U.S. remains a sore spot. The U.S. long-term unemployment rate is extremely high, plaguing a recovery in confidence and consumer spending.

Businesses, especially in the U.S., are mired in the negative feedback loop of tepid consumer spending leading to disappointing orders, which discourages job creation and rehiring. As long as 14.6 million workers are unemployed in the U.S., everything from housing to auto sales to spending on clothing and even necessities is muted.

Inevitably, this weakens Canadian economic activity both directly—through weaker exports—and indirectly, through reduced confidence. The news has been dominated of late by mounting concerns of a double dip. Canadians can't help but be impacted by this, even though employment has been very strong here.

Fear of a double dip can be self-fulfilling. First among the causes for concern is the effect of falling business and household confidence, the glue holding the global recovery together. The initial sign came in May when the global purchasing managers' index for both manufacturing and services fell from the April peak as activity and new orders dropped. The declines continued in June, fuelling fears that the rapid phase of the recovery could be short-lived. But July's results for Europe—the main cause for concern in the spring—were much more encouraging.

Households have also shown signs of a slide back into a fear of spending. In most recession-hit countries, consumers have been saving much more than before the crisis and they are reducing debt. In the U.S., housing activity has slumped after the homeowner's tax credit expired and the overhang of unsold homes, boosted by continuing foreclosures, remains a longer-term shroud on the market. Even in Canada, housing has slowed since earlier this year.

As the newly released Q2 GDP results show, the U.S. economic recovery remains patchy and heavily reliant on government support and inventory rebuilding. We are expecting even softer growth in the second half—at roughly a 2% pace, which means that the jobless rate will barely budge. Optimism would improve if companies shifted spending and

retained earnings toward hiring, helping consumers overcome their rut. But, something needs to spur business confidence for that to happen.

The murky outlook is also reflective of European bank exposure to sovereign risk and economic slowdown. The recent stress tests helped to mitigate this concern, but the unwinding of temporary boosts to growth and the massive fiscal restraint in Europe are raising the prospects of a further slowdown.

In the U.S., the debate is raging between Democratic (Keynesian) calls for fiscal stimulus and Republican (Supply-Side) calls for government spending cuts. Ironically, the Dems are also supporting the expiry of the Bush tax cuts for households earning \$250,000 or more, an act of fiscal restraint, while the Republicans want to see the continuation of the tax cuts (due to expire January 1, 2011), an act of fiscal stimulus.

**Bottom Line:** As Bernanke says, these are “*unusually uncertain*” times, and that does not bode well for business or consumer confidence. We will continue to spiral through this negative loop, raising the prospects of a double dip, until something penetrates the gloom and spurs confidence in a brighter outlook. What this something might be is once again uncertain. My view is that some additional fiscal stimulus is necessary—hopefully in the form of corporate tax cuts and additional federal assistance to state and local government, an enormous source of new layoffs. I believe a double dip is unlikely, but we are clearly in store for sub-par growth and only a very slow rise in hiring.

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