

Top 10 Questions for 2010

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1 Will the recovery become self-sustaining? Viewed from the depths of despair earlier this year, even the mild turnaround in the global economy in recent months is nothing short of remarkable. But while the economies of the U.S. and Canada may have stopped falling around the middle of 2009, the recovery has been tepid so far, and that's even with a heavy assist from government spending. Conditions are gradually falling into place for a firmer and self-sustaining recovery next year, especially with employment finally stabilizing and business confidence perking up. Even so, the conventional wisdom that the upturn will remain subdued by past standards looks quite compelling. The main reason: the U.S. consumer simply is not going to ride to the rescue for global growth as it has so often in the past. Accordingly, we look for GDP growth of around 2½% in both countries next year (*Chart 1*); that's not bad under normal circumstances, but it's disappointing in the wake of the worst single year for U.S. growth since the 1940s.

2 Has the jobless rate peaked? The unemployment rates in both Canada and the U.S. ticked down last month, and recent hiring intention surveys have picked up, sending a tantalizing hint that the worst may be over on the job market front. However, it may be a tad premature to sound the all-clear note just yet, especially in the U.S., where the recovery will still be too modest to generate solid job gains for some time yet (*Chart 2*). The employment outlook is generally more positive in Canada, due to the relative strength in job-rich domestic spending areas such as housing and consumer spending. However, in both countries, we look for the unemployment rate to be lower a year from now.

3 Will China's growth remain strong enough to drive commodities higher? To paraphrase our Global Commodity Strategist, Bart Melek, "Commodity markets have performed much better than anyone would have dared to predict at the beginning of 2009, when global depression chatter was rife and massive deleveraging and panic selling were the order of the day. Depression was averted thanks to massive government spending in China, the U.S., Europe and elsewhere totalling some \$2.2 trillion, zero interest rates and various central bank liquidity measures. This turned aggregate demand around and propelled China back on a high growth trajectory, helping improve the demand outlook for everything from copper,

CHART 1
GROWTH REVIVES, NOT THRIVES

(q/q % chng : a.r.)

Real GDP

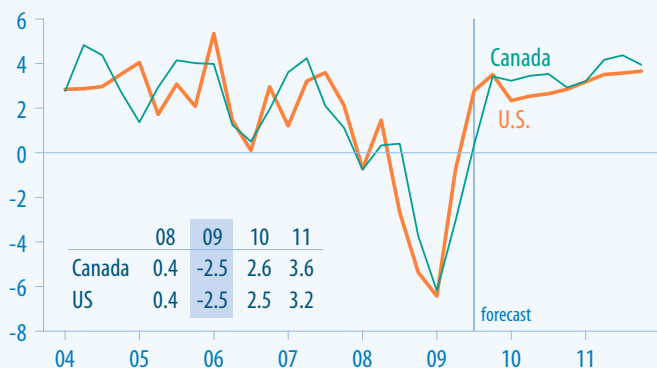
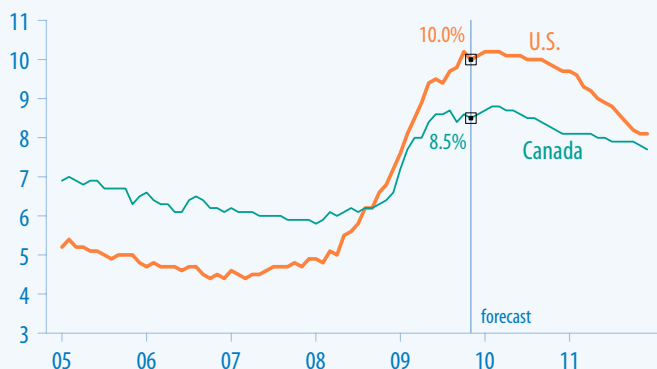


CHART 2
UNEMPLOYMENT TO REMAIN HIGH

(percent)

Unemployment Rate



to platinum, to energy (Chart 3). A weak U.S. dollar, supply concerns and growing interest in commodities as an inflation hedge were additional important drivers." While the period of maximum fiscal stimulus may have passed, we look for the global recovery to strengthen next year, led by GDP growth of just over 10% in China. Some of the other positive factors listed above may fade somewhat, but firmer global growth and a softer US\$ will be the key drivers in pushing commodities higher again in 2010.

4 After a powerful rebound, are stocks due for a correction? We have long maintained that the real distortion in equity markets this year was not the massive 65% bounce from the March lows, but the depth of those March lows. Much of the rebound in stocks occurred in the first two months after the lows were hit, driven by the realization that the global economy and credit markets were stabilizing, with a helping hand from extremely accommodative monetary policies globally. While the annual gains in many major equity markets in 2009 are certainly impressive—the

TSX is currently just shy of a 28% rise this year, vying for the best performance in 30 years—they are by no means highly unusual, especially in a recovery phase. Moreover, in most major markets, the rebounds did not recoup the heavy-duty losses of 2008. From a valuation perspective, we do not find the market to be particularly over-extended at this point. However, it is no longer decidedly cheap. Given our expectation of a muted economic recovery, and the likelihood that interest rates will begin to rise later next year, further sizable gains for the major equity averages will be much harder to come by in 2010—stocks are going to have to earn their keep in the coming year through solid earnings growth. We look for a 10% rise in U.S. before-tax profits over the next four quarters and 6% in Canada.

5 Is the Canadian housing market set to pop? It seems many are falling over themselves to pronounce that the Canadian housing market is in a bubble, partly because it has been able to fully recoup all of its (fleeting) recession losses in a matter of months (Chart 4). If anything, we believe the risk is that the market will get even hotter in the first half of 2010, ahead of impending interest rate hikes and the Harmonized Sales Tax in B.C. and Ontario at mid-year. There is bound to be at least some modest correction in the second half of next year, almost certainly in sales, and possibly in prices. However, with borrowing costs likely to remain quite low by almost any standard, and employment beginning to recover more broadly, we would suggest that the bigger story next year will be that the housing market remains quite buoyant overall.

CHART 3
COMMODITIES: SLOW TURN
Canada (as of December 17, 2009)

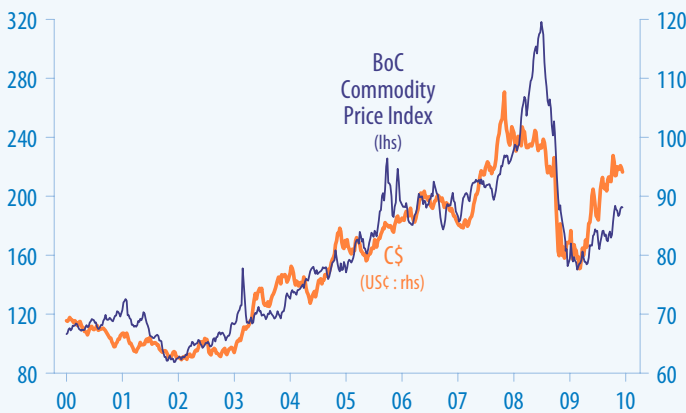
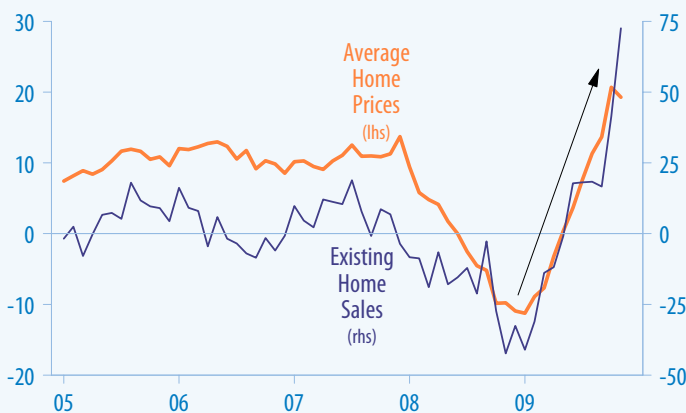


CHART 4
CANADIAN HOUSING: RECOVERY
Canada (y/y % chng)



6 When will the Fed raise rates? The Fed’s commitment to “exceptionally low levels of the federal funds rate” should continue through most of next year, as the economic conditions eliciting this stance—“low rates of resource utilization, subdued inflation trends, and stable inflation expectations”—remain in place. However, we’ve pencilled in a September rate hike start, reflecting the Fed’s concern that low policy rates for too long “could lead to excessive risk-taking in financial markets or an unanchoring of inflation expectations.” Rate hikes will likely be gradual, with the risk that continued high unemployment and dysfunctional credit creation could delay them to 2011. Further emphasizing this risk is the typical transition interval between last easing and first tightening actions, which has recently been well over a year. The Fed’s non-traditional easing via MBS purchases is expected to only end in March 2010.

7 Will the Bank of Canada hike before the Fed? Ultimately, central banks raise policy rates to slow credit creation and ease spending pressures. In Canada, the credit creation process is functioning much more effectively than in the U.S., with housing the most glaring example—residential mortgage credit is up 7% y/y. South of the border, home sales, prices and mortgage credit are still down from a year ago. As such, the BoC is much closer than the Fed to a tightening shift. Meantime, with core CPI inflation running a bit faster than the Bank’s projections (*Chart 5*), and given their increasing concern over rising household debt burdens (pumped, in turn, by low borrowing costs), we judge the Bank will start renormalizing policy rates in July, once their commitment to keep the policy rate “at its current level until the end of the second quarter of 2010” ends. Note that by July 2010, we will have had another half-year for firms to adjust to a potentially stronger Canadian dollar and for the domestic economy to muster even more forward momentum from ultra-low borrowing costs.

8 Is parity in the loonie’s flight plan? Through the first half of next year, we look for the Canadian dollar to grind higher, supported by up-trending commodity prices in the wake of continued global economic recovery (see #3), and a down-

trending greenback (see #9). However, once the market gets a whiff that the Bank will start tightening before the Fed, the currency will likely strengthen to parity and beyond. However, “persistent strength in the Canadian dollar that could act as a significant further drag on growth and put additional downward pressure on inflation” remains the BoC’s key downside risk, so policy is by no means insensitive to the loonie. Should the C\$ appreciate too quickly or by too much (say, testing the modern-day high above US\$1.10), the Bank is more likely to stay on hold for longer and keep to only very gradual rate hikes.

9 Will we sing another refrain of the greenback blues? The trade-weighted U.S. dollar should continue to depreciate on a broad basis, under the weight of whetted risk appetites, the external financing of

CHART 5
HEADLINE INFLATION: POSITIVE AGAIN
Consumer Price Index (y/y % chng)

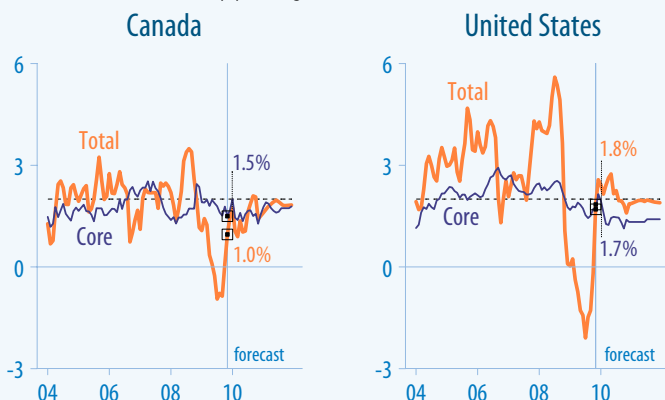
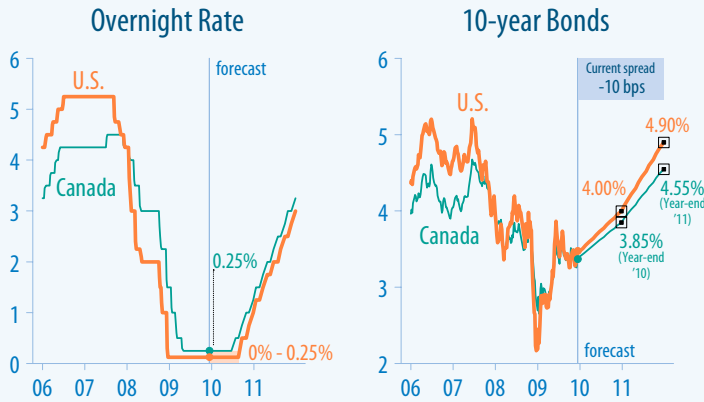


CHART 6
U-TURN FOR INTEREST RATES
(percent)



Treasury deficits, and official asset diversification flows. However, the major currencies should shoulder less of the adjustment burden, once Chinese authorities resume yuan appreciation (probably early in 2010), which should lift other currencies in the emerging Asian space. Indeed, the greenback is unlikely to break its prior record low (July 2008) against the majors. When it becomes apparent that U.K., Euro area and Japanese economic growth are all lagging the U.S. (by late 2010), the greenback should stabilize. Meantime, with the Bank of Japan destined to be the last major central bank to raise rates, the yen carry-trade should make a comeback (a move not unwelcome by Japanese authorities as they grapple with deflation).

10 Have we seen the bottom in bond yields?

Year-end risk aversion and balance sheet window dressing buoyed the demand for Treasuries in late 2009. As these demands reverse course, yields should drift up, augmented by supply pressures. The U.S. federal deficit is expected to top US\$1 trillion again in FY09/10, after coming in at \$1.4 trillion in FY08/09, while investors' risk appetites are whetted by ongoing global economic recovery—not a constructive combination for bonds. Expected Fed tightening will add to the upward pressure on yields (*Chart 6*). However, these pressures will be partly offset by domestic buying for balance sheet restructuring, predominately by banks but also from households, and buying by foreign authorities to restrain their local currencies. Meantime, double-digit unemployment and slowing core prices should keep inflation expectations in check. Nevertheless, the upward pressure on yields should ripple across the border, particular with the BoC poised to raise rates. Government of Canada bonds should outperform Treasuries owing to their relatively superior fiscal fundamentals and expected currency appreciation. Although federal and provincial government finances have been ravaged by recession and economic stimulus efforts, the deterioration has been less severe than in other G7 countries and Canada continues to sport the lowest debt-to-GDP ratio. With sovereign credit becoming an increasing issue, Canada seems destined to be over-weighted in global government bond portfolios, sitting among the best in a bad situation.

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