

2009 Outlook: A World of Challenges

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With most major economies staggering into a downturn, and global leading indicators still pointing deeply lower, it seems almost a foregone conclusion that recessionary forces will dominate the landscape in 2009. It will take a massive effort from the world's economic policymakers to pull the global economy out of this ditch. But, with the additional stimulus we are likely to see in coming months on top of the wave of earlier measures, the economy should bottom around the middle of 2009, followed by a sluggish recovery in the second half and moderate growth in 2010. Below we summarize our key forecasts for next year, along with some critical risk areas.

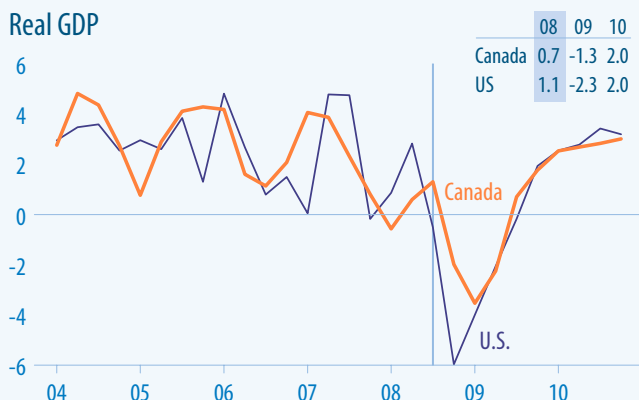
U.S. Economy: The recession is a year old and deepening. Job losses are accelerating, causing consumers to cut spending at the fastest clip in three decades. Homebuilding has plunged to record lows, but house prices are still falling as rising foreclosures add to the overhang of unsold homes. Consumers are paying down debt for the first time in half a century and rebuilding savings amid an unprecedented loss of wealth (about \$10 trillion) in the past year. Commercial construction is contracting amid tighter credit and rising vacancy rates. Once-strong exports are sagging as global growth suffers. The decline in both domestic and external demand has American businesses cutting back production and investment. The current recession should be the longest in the post-war era, at almost two years, and among the deepest, with nearly four million job losses. Real GDP is expected to contract 2.3% in 2009, lifting the jobless rate to 9% by year-end, the highest since 1983 and nearly five percentage points above the 2007 low. Economic slack and collapsing commodity prices will drive CPI inflation negative through most of next year. Core inflation should slip below 1% from 2% now. To stem deflation, the Fed and Administration will need to prime the policy pumps. Government spending could be the only expenditure area to expand next year. We are assuming that the Obama stimulus plan will contain upwards of \$700 billion (5% of GDP), split between spending on infrastructure, aid to

the states and unemployed, employee tax credits, foreclosure prevention programs and industry support. With assists from rising purchasing power and improving housing affordability, the U.S. economy should start to recover, albeit slowly, late in the year.

Canadian Economy: Canada has been hit by the one-two combination of a deep drop in U.S. spending and the collapse of commodity prices from their record highs in mid-2008. In addition, previously robust domestic demand has been undercut by sagging consumer and business confidence in the face of the vicious bear market in equities, tighter credit conditions, and a weaker housing market. Capital spending plans in the resource sector have been reeled in by the sudden drop in commodity prices. The deep drop in the Canadian dollar has slightly cushioned the

CHART 1
U.S. IN RECESSION: CANADA FOLLOWS

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



blow, as have aggressive Bank of Canada rate cuts, and fiscal policy is poised to provide some additional support next year. Even so, we now look for GDP to drop 1.3% in 2009 (with three negative quarters, and a peak-to-trough drop of just over 2%). This will drive the unemployment rate up to nearly 8% by year-end (from 6.3% now), and is likely to see inflation average just 0.5% for the year (with a temporary dip into negative terrain in view). This ugly backdrop is likely to push both the current account and Ottawa's budget balance into double-digit deficits next year, ending Canada's long string of twin surpluses.

Monetary Policy and Interest Rates: The Federal Reserve ended 2008 by reducing its policy rate to a record low 0%-to-0.25% range, capping more than 500 bps of rate cuts since the credit crisis began in 2007. Now, the focus will shift to quantitative easing. The Fed plans to step up its purchases of mortgage/asset-backed securities in 2009, along with Agencies and possibly even longer-term Treasuries, to place downward pressure on borrowing costs. While lower rates will help heal the credit-creation process, three major hurdles remain: (1) stabilization of home prices, (2) stabilization of employment and (3) restoration of bank balance sheet health.

The Bank of Canada also ended 2008 by cutting its key policy rate to a 50-year low of 1.50%, for a cumulative 300-bp reduction in little over a year. Canada's credit-creation process has been less impaired owing to the relatively better shape of consumer, business and bank balance sheets. But Canada has not been immune given the ongoing saga of non-bank-sponsored ABCP, the tightest business lending standards on record, and the upward pressure on borrowing rates from higher bank funding costs. These pressures, combined with economic risks, will keep the Bank of Canada in easing mode as we head into 2009. We look for the Bank to cut at least another 50 bps next month, with the potential for more (in January or afterwards). Rates should remain at very low levels until 2010 (like in the U.S.).

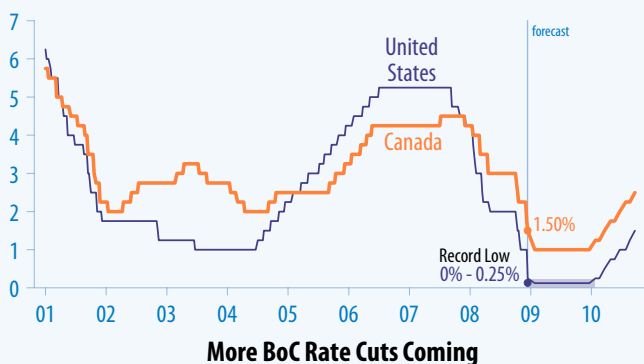
With the Fed pushing rates to record lows and signalling its willingness to buy government debt outright, the Treasury market is ending 2008 on a strong note. The quest for safety and

liquidity, along with fast-falling inflation, are also helping to pull yields down, despite a ballooning U.S. federal deficit. We look for 10-year Treasury yields to take a run at the 1½% range in the months ahead. However, supply pressures will eventually dominate, with yields rising in the latter half of 2009, possibly gripping a "3-handle" for long Treasuries. Government of Canada long bonds have not kept pace, as Canada/U.S. spreads have moved quickly from negative to positive, and could widen further. However, Canada's superior fiscal fundamentals—even allowing for stimulus in Ottawa's January 27 budget—should set the stage for Canada bond outperformance in the latter half of next year.

Exchange Rates: This summer's heightened global risk aversion was a turning point for the U.S. dollar. Against the major currencies, the greenback had been trending

CHART 2
INTEREST RATES FALL
(% : as of December 18, 2008)

Overnight Rates



weaker since 2002 (-39% peak to trough), but the global flight to safety saw it gain 23%. The rebound started to reverse as the Fed cut rates to nearly zero, but we expect the greenback will stabilize through 2009, as other central banks seem destined to catch-up with much of the Fed's aggressive easing. Meantime, continued risk aversion and a sharply improving U.S. trade deficit should counter the weight of a deteriorating budget deficit. While aggressive U.S. monetary and fiscal policy could pose longer-term problems for the greenback, it reinforces the view that the U.S. economy should be among the first to emerge from the global malaise. The day of reckoning for the greenback, when global risk appetite returns, is now probably a 2010 story. The Canadian dollar was caught in the vortex of a rebounding greenback and collapsing commodity prices, and these will be the key drivers of the currency in 2009. This points to a mildly weakening loonie through the first part of the year (back to under 80 cents U.S.), but ending 2009 around the mid-80s.

Global Outlook: The credit crisis originated in the U.S., but its tentacles span the globe. Economies in North America, Europe and Japan will all contract in 2009. The weakness has rippled to emerging markets. Global GDP is expected to slow to 1% next year, the slowest since 1982.

The early part of 2009 will see weakness on all fronts. European fiscal stimulus remains uncertain and interest rate cuts were enacted late and have been modest. Accordingly, the Eurozone will lag other developed countries when conditions improve in the second half of the year. Britain faces a similarly deep downturn as the U.S., with its high exposure to the global financial sector, and with credit conditions likely to remain tight. Significant monetary easing and some fiscal stimulus should help the economy emerge from recession late in 2009. In Japan, exports have fallen sharply and renewed weakness in domestic demand has pushed the economy into recession. China has also thrived on export growth over the past years. But, with demand contracting globally and exports sliding in recent months, China is moving aggressively. The US\$586 bln fiscal stimulus package should give growth a lift in 2009, but a return to the double-digit pace of earlier this decade is likely awhile away. Even 7% growth next year may be a struggle.

The commodity outlook hinges on global prospects, and will therefore remain under pressure for much of 2009. With China and India's commodity appetite slowing, and industrial world demand contracting, prices should remain muted, and may fall further early in the new year. However, once the global outlook brightens, even slightly, commodities could start to creep higher, pointing to a better second half of the year and 2010.

Provincial Implications: At the regional level, no Canadian province will be fully sheltered from the downturn. Central Canada faces the deepest recession as manufacturing remains under siege—most obviously

TABLE 1
GLOBAL RECESSION
(% chng : avg.)

Economic Growth	2004-2007	2008e	2009f
WORLD	4.8	3.4	1.0
North America	3.0	1.1	-2.1
Euro Area	2.4	0.9	-1.3
Japan	2.3	0.0	-1.7
China	11.0	8.9	6.5
India	9.0	7.5	6.0
Latin America	6.1	5.4	1.3
Eastern Europe	7.2	5.9	3.5

e = estimate f = forecast

autos—amid weak U.S. demand. Real GDP in Ontario will likely contract for the first time since 1991, by more than 2% in 2009, the worst performance in Canada, largely the result of stalled auto production and ensuing job losses in the sector. The outlook for Western Canada has also deteriorated after five years of unbridled growth, and a small overall contraction is expected in 2009. With oil falling below \$40, cancellation and delays of marginal oil sands projects have mushroomed. Tighter lending standards and declining confidence will weigh further on Western housing markets. B.C. home prices have registered the sharpest annual decline since the early-80s as sales plunge, posing further downside risk to construction activity. Atlantic Canada's outlook is mixed. Capital investment projects have boosted domestic demand, but the region can't escape the force of a deep U.S. downturn, which should hold growth rates near-zero next year. All told, the regional disparity that has seen the West outperform appears to have crested, and should close when Central Canada rebounds in 2010.

In response to the downturn, provincial governments are eyeing an array of fiscal stimulus measures, ranging from tax cuts to infrastructure spending. These actions, combined with weak economies and sharply lower commodity prices, will weigh on budget balances—Ontario, New Brunswick and PEI have already projected red ink for FY2008/09, and many more will follow next year.

Risks: Forecasts of economic recovery in late 2009 rest on the back of monetary and fiscal stimulus. Signposts of a U.S. economic recovery include a stabilization in house prices and a decline in record-wide credit spreads. However, if monetary policy remains impotent (due to still-frozen credit markets) or fiscal stimulus is delayed, the U.S. and Canadian recessions would likely deepen, with a recovery pushed into 2010. The risks of a prolonged recession and potential deflation would increase if U.S. equity prices breached their November lows. Further, with 12 million U.S. homeowners already underwater on their mortgage, a substantial further decline in home prices could unleash another wave of foreclosures. A worsening recession would increase consumer defaults and hammer the

commercial real estate sector, putting further strain on the global financial system. In this event, commodity prices would fall further, driving resource-based regions and currencies sharply lower. Meantime, a ballooning U.S. bailout bill could cause investors to question the long-term safety of Treasuries, resulting in a U.S. dollar sell-off. The developing world, notably China, is showing greater vulnerability to the global downturn than widely expected, suggesting the potential for a worse outcome. For optimists, the unprecedented policy response to date on the monetary side, and to come on the fiscal side, implies some risk of a stronger-than-expected recovery. In this event, given the extreme pessimism already priced into markets, stocks and corporate bonds could rally meaningfully next year.

TABLE 2
PROVINCIAL OUTLOOK

(chn-wt : % chng)

Economic Growth

	2008e	2009f	2010f
CANADA	0.7	-1.3	2.0
British Columbia	1.4	0.0	2.0
Alberta	1.9	-0.7	2.1
Saskatchewan	3.0	1.0	1.6
Manitoba	1.7	-0.4	1.8
Ontario	-0.2	-2.3	2.2
Quebec	0.2	-1.0	1.9
New Brunswick	1.0	0.3	1.9
Nova Scotia	1.1	-0.1	1.6
P.E.I.	0.8	0.2	1.2
Newfoundland	1.3	0.7	2.0

e = estimate f = forecast

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