



The Bottom Line

THE LATEST VIEW ON THE ECONOMY



Worst Is Behind Us

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Signs of improvement in the U.S. housing market, rising consumer confidence and a rally in financial stocks in the U.S. and Canada suggest that the economies are bottoming and the worst of the financial crisis is behind us. Indeed, the U.S. cut a net 345,000 jobs in May, the smallest loss in eight months. And, stock markets have risen sharply since March 9 as the biggest U.S. banks announced they were profitable in the first quarter. The TSX is among the strongest stock markets in the industrialized world, especially on a currency-adjusted basis (*Chart 1*). The rally in the S&P 500 above its 200-day average is sending a bullish signal after the index traded below that level for the longest period since the 1930s.

Chart 1

Global Bear Market

(% chng since December 31, 2007 : as of June 4, 2009)

Equity Markets

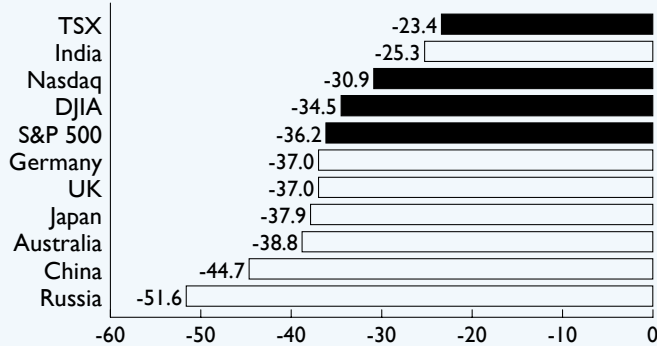
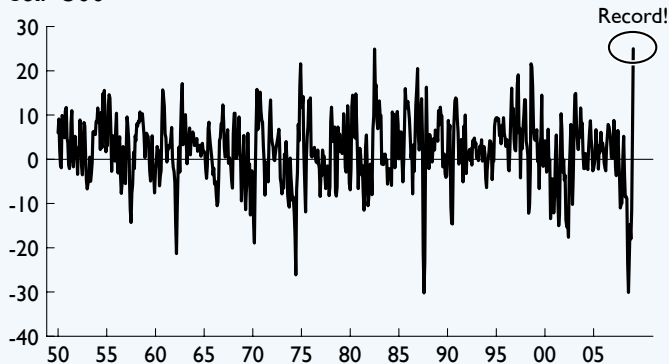


Chart 2

More than a Bear Market Rally?

(3-mnth % chng)

S&P 500



The three-month rise in the S&P 500 has been the biggest in the postwar period (*Chart 2*).

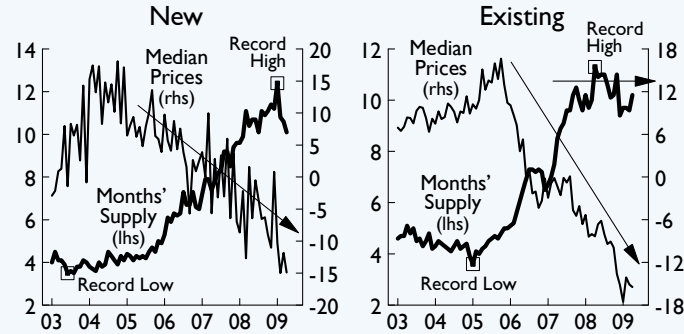
The Fed has set out the requirements for refunding TARP money to the Treasury, triggering a massive issuance of common equity by many of the TARP recipients, setting the stage for winding down government involvement in some of the stronger institutions. While the Term Asset-Backed Securities Loan Facility (TALF) has barely begun and the success of the Public-Private Investment Program for Legacy Assets (P-PIP) is uncertain, it appears that interest in these government programs is waning as market confidence improves. Banks would prefer to solve their problems without government assistance if they can.

The Fed and the Treasury have stabilized the situation sufficiently to concentrate now on the GM bankruptcy, coming health care revisions and other Obama campaign promises. If the Chrysler situation is any indication, GM could well emerge from bankruptcy in reasonably short order—60 to 90 days. Auto sales by the Detroit Three fared better than analysts expected in May, indicative of aggressive discounting and an increased willingness of consumers to visit the showrooms. Many dealers report that their biggest problem now is the inability of borrowers with

Chart 3

Overhang of Unsold Homes in US Down...

Home Sales – United States



...A Bit

Months' Supply = (ratio) Median Prices = (y/y % chng)

Chart 4

Manufacturing to Rebound

ISM Index – United States

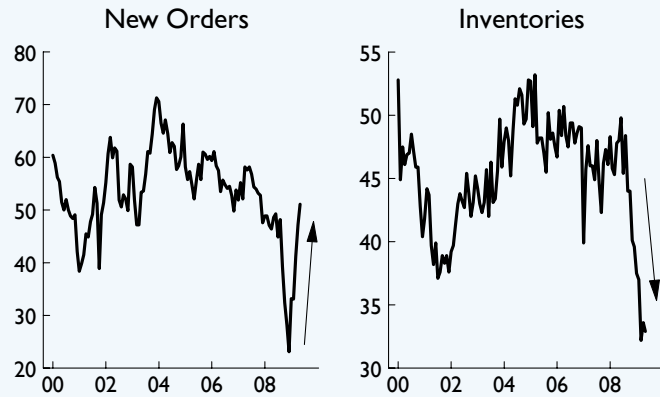
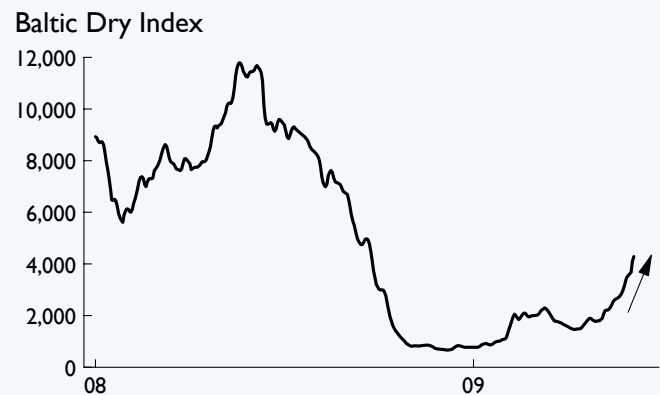


Chart 5

Shipping Costs Rise

(ratio)



relatively strong credit scores to get funding. If a 'cash for clunkers' program is introduced, as many expect, auto sales could jump in the next six months. In France, for example, tax incentives have lifted auto sales by 26% in the past six months. Pent-up demand for autos is no doubt mounting.

Indications of an improvement in the U.S. and Canadian economies are coming from many sources now. Real disposable income in the U.S. was much stronger than expected in April thanks to fiscal stimulus and May is likely to post another uptick. With the rise in consumer confidence, the unprecedented slump in consumer spending may be behind us.

Even the housing market is showing signs of improvement as new homebuilding remains at rock-bottom levels and pending and actual sales are picking up. The inventory of unsold homes is finally edging downward, thanks to continued rapid declines in house prices (*Chart 3*). Sellers—individuals, builders and banks—are now capitulating, anxious to unload vacant properties.

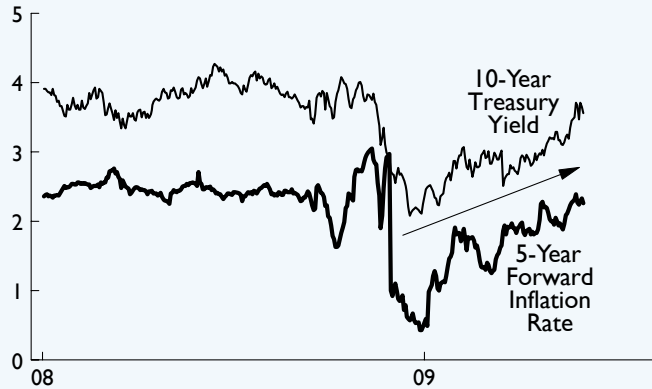
Manufacturing is likely on the cusp of a rebound as orders are finally increasing at the same time that inventories are plunging at a record pace (*Chart 4*). Inventory reductions have been a huge factor contributing to the economic contraction; that process may now be set to reverse. Indeed, there is anecdotal evidence that some stores are having difficulty replenishing their shelves because suppliers have cut production.

There are now signs that the global economy is improving. Copper is up over 80%, lumber is up about 20%, and oil prices have risen to just under \$70 a barrel, a level that would make oil sands investment projects once again profitable. The Baltic freight rate gain suggests that commodity demand is increasing (*Chart 5*).

Chart 6

Some Inflation Risk

United States (percent)



The decline in the U.S. dollar, accompanied by the improvement in the global economy, could boost U.S. exports, narrowing the trade deficit.

To be sure there are headwinds. Longer-term interest rates have risen sharply as the supply of government bonds has surged and inflation concerns are front-page news. And, judging from real return bonds or TIPs, inflation expectations have risen (*Chart 6*). But wage cuts and freezes continue to eliminate the prospect of wage-price spiralling for at least the next several years. Also, capacity utilization rates worldwide are very low, which mitigates any sustained excess-demand pressures that might push

prices upward, triggering an inflation spiral. Remember, rising commodity prices does not necessarily equal inflation. Over the first half of this decade, commodity prices surged yet inflation rates declined.

Also, the recent suggestion that the U.S. would lose its reserve currency status is way overblown. There is no alternative to the U.S. dollar and even the Chinese have said so. In addition, the net inflow of foreign capital to the U.S. Treasury market is likely to continue to rise. No other market is deep or liquid enough to accommodate the credit flow. Foreign countries need to buy U.S. dollar assets to prevent too large an appreciation in their currencies, and U.S. debt-to-GDP ratios remain well below levels posted in Italy, Japan, and in Canada in the mid-1990s.

Bottom Line: Canada benefits disproportionately in a global economic rebound. Commodity price increases boost those sectors and their stock prices. Canadian banks have proven to be far more solid than virtually anywhere in the world. Household balance sheets are in much better shape. The subprime mortgage market is very small in Canada and the ratio of equity-to-mortgage-value is much higher than in the U.S. Corporate and government balance sheets are also much stronger in Canada. We continue to predict that the Canadian economy will begin to grow in the second half of this year. Unemployment will remain high for some time, likely peaking in mid-2010. A sustained period of jobless recovery cannot be ruled out, but compared to the last three quarters, it will feel much better.

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