

Economic Comment

Third Quarter 2011

“Unfulfilled Expectations”

In the first half of 2011, the U.S economic growth rate has slowed to approximately 2.0% from its 3.1% growth rate in the fourth quarter of 2010. The American economy has been hit with a number of factors which have restricted economic activity. Just to name a few: high gasoline prices, bad weather, Japan’s tsunami effect on manufacturing and reduced employment at state and municipal governments. The net result is an unemployment rate of 9.2% in June. A jobless recovery and falling house prices (albeit not as fast as last year) are holding down consumer confidence which in turn holds down consumer spending (approximately 70% of the economy). To compound this negative environment, the U.S Congress and the President are fighting over the need to increase their overall debt ceiling. We have seen this type of political theatre before but the parties appear to be diametrically opposed to each other at this time. Clearly, there needs to be spending cuts and tax increases if the U.S. wants to get its financial house in order.

So the question remains: will the U.S. economy slip back into recession? The answer as we look at the data is NO! Many of the factors which have depressed U.S. economic growth in the first half of the year will reverse in the second half and produce a growth rate of near 3%. Gasoline prices are down \$.40 per gallon from the peak reached in May. Production of Japanese autos made in North America declined sharply in the first half of the year (Honda -21.8%, Toyota -15.4%) and are expected to return to normal levels shortly. The weather is better (less tornados). In many ways the natural economic forces which have been held back recently, such as housing and business investment, are expected to snap back to levels more in tune with the current economic growth rate. Our 2011 U.S. GDP forecast of 2.5 – 3.0% is now closer to the lower end of this range.

The Canadian economy expanded at a 3.9% rate in the first quarter of 2011. However, we have had similar negative impacts to our growth rate in the second quarter. Our GDP growth rate is expected to be 2.0% or less in the second quarter. Commodity prices, particularly oil, continue to support business activity in Western Canada. Manufacturing remains soft in Eastern Canada. However, our economy has produced 191,800 new jobs in the first half of 2011. Our current unemployment rate for the month of June is 7.4%. Our forecast for Canadian GDP in 2011 remains 2.9%.

Given the health of the Canadian government financial position, a solid housing market, high commodity prices and growing jobs, the outlook for the Canadian dollar is higher than the current level of \$1.037 (U.S.). With core inflation moving up to the Bank of Canada’s policy level of 2.0%, there is a case to be made for higher policy interest rates. However, given the strength we are seeing in the Canadian dollar and

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the current weakness in the U.S. economy, we believe the Bank of Canada will hold off increasing the Bank Rate until year end.

The bond market has been pushed around in the first half by changing economic expectations. In the first quarter, interest rates rose as economic growth expectations were high. The DEX Universe Bond Index had a return of -.3%. In the second quarter, as economic expectations fell, interest rates declined which resulted in a return of 2.5%. For the first half of the year bonds returned 2.2%. With the expectation for economic growth to increase in the second half, we expect bond returns to be low during that period.

The stock market has had the same influences pushing it around. The S&P/TSX Composite Index generated a 5.6% return (including dividends) in the first quarter and -5.2% in the second quarter. For the first half of 2011 the stock market returned .2% (including dividends). We anticipate higher returns for stocks in the second half. Improving economics, solid corporate earnings and relatively low interest rates provide strong support.

Risks to the forecast have increased over the second quarter. The largest risk is a default in Greek debt. The global banking system (particularly Europe) would be placed under renewed financial stress in dealing with the fallout of this event. China is slowing economic growth to curb inflation. The concern here is a “hard landing” where GDP growth slows too much. Furthermore, the U.S. debt ceiling political game must be resolved. If not, the U.S. could be in default of its debt obligations and diminish its status as a safe haven for international investors. All these issues can be resolved in a positive way if the political will is there.

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July 17, 2011

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