Economic Comment

First Quarter 2011

“Guaranteed Growth”

This is a bold statement, however with the impact of the continuation of the Bush tax cuts announced in December along with zero interest rates and quantitative easing by the Fed, it is hard to see a double dip recession in the U.S. in 2011 or 2012. The American GDP growth rate is expected to be fairly constant throughout the year with stimulus driving growth in the first half of 2011 and the business sector and exports kicking in to support economic growth later in the year. Corporate USA is in good shape with solid balance sheets and plentiful cash reserves; non-financial corporations held 7.4% of their assets in cash as of September. It is anticipated that business confidence is high enough to allow this cash to be deployed into the economy. The U.S. dollar has been under downward pressure over the past two years and is providing a boost to exports. Manufacturing activity as measured by the ISM Manufacturing Index has improved in the second half of 2010 and is expected to continue in 2011. The all important consumer will have a neutral impact on GDP ie, not weak but not strong. Softness is expected to continue in the housing market during the year due to the high level of foreclosures. Notwithstanding this, we have increased our 2011 GDP forecast from 2.7% to 3.1 %.

Canadian GDP growth is expected to increase 2.8% in 2011 which is slightly better than earlier forecast due to the better American growth rate. The pattern of economic growth is not expected to change much from last year when commodity rich provinces outpaced the growth in central Canada’s manufacturing basin. While all this looks like business as usual, there are a number of factors which will be a drag on our economic performance; 1) The dollar at parity will hold back exports and encourage consumers to shop in the U.S.. 2) Provincial and Federal budget deficits will cause a policy shift away from stimulus to restraint. (Look forward to higher taxes and less services.) 3) The Bank of Canada and the Minister of Finance are concerned about the level and growth in consumer debt and have announced new tighter mortgage underwriting standards. While the economy will have these headwinds, there are some areas of strength found in business spending on equipment and non-residential construction. Also, exports of commodities will remain strong.

Commodity prices such as oil, base metals, gold and grain products have risen during 2010 and are expected to maintain their prices or even go slightly higher in 2011. This demand for commodities is coming from the developing world, China in particular. Economic growth rates in the developing world are outpacing the developed economies (Europe and North America) by a factor of 2 or 3 times. While it’s great to see a new locomotive of global growth replacing the America economy, there is a growing inflationary problem developing.

Inflation concerns are different around the world. In North America, with substantive slack in the economy (high unemployment), inflation pressures are confined to food

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and energy. Inflation rates for this year and next in Canada and the U.S. are expected to be around 1.5 – 2.0%. The same situation is seen in Europe; just too much slack in the economy. The case is quite different in China, India and Brazil. With faster growing economies, the demand for goods and services increases and so do prices. Food prices have increased sharply over the past year as crop failures and floods have reduced supplies. Inflation rates in developing countries are over two times the rates in developed countries. The developing countries are adopting policies to reduce their GDP growth rates. In China, there are higher capital requirements for banks (reduces bank lending) and in India and Brazil, central banks have raised interest rates. It is unknown at this time if these policy shifts will be successful and as a result represent a risk to our forecast.

By far the greatest risk to the forecast is the Euro debt crisis and the possibility of a Euro currency problem. If this situation deteriorates, global growth would decline and the value of the U.S. dollar would increase as money would be looking for a **relatively** safe haven.

So, how do all these factors play out in the Canadian capital markets in 2011? We believe the Canadian dollar will remain at parity with the U.S. dollar in 2011. The Bank of Canada will not increase the Bank Rate in the first quarter, however, depending on the strength of the economy, they could start increasing the Bank Rate in the second quarter. We would not be surprised or concerned if the Bank Rate hit 1.75– 2.0 % by year end. The outlook for bond yields in 2011 is not clear at this time due to the number of cross currents in the economic environment. Inflation expectations are the key driver of long term interest rates. While our inflation expectations remain low over the next 1 or 2 years, could the higher prices in global commodities back into our economy and cause prices to rise over the longer term? We view the risk to inflation is to the upside which would result in small upward pressure on long bond yields. Currently, 10 year Government of Canada bonds yield 3.3%. We would not be surprised to see 3.7 – 4.0% by year end. While higher short term and long term interest rates will reduce the valuation of stocks, corporate profits are expected to increase 10-15% over last year therefore providing the stimulus for rising stock prices. We are forecasting S&P/TSX Composite Index will increase to 14,200 by year end.

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