

# Investment Review

## Global Growth Is Accelerating, But Jobs Remain Scarce

### Some Pleasant Surprises In The Fourth Quarter

On the whole, global growth was surprisingly strong in the fourth quarter of 2009. In the U.S., real GDP soared at an annual rate of 5.7%. Heavy inventory accumulation and a massive surge in business investment accounted for more than 60% of the quarterly expansion.

Canada was quick to capitalize on the expansion in the world's largest economy, posting November GDP growth of 0.4% (nearly 5% at an annual rate). This solid expansion in the penultimate month of the year puts Canada's economy on track for 4% annual growth in the final quarter of 2009.

Fourth-quarter growth was also surprisingly strong in China, where real economic growth accelerated 10.7% above year earlier levels. Industrial production in China also soared in December by 18.5% on a year-over-year basis. The World Bank expects China's economy to grow by 9% in both 2010 and 2011. The Bank Of Canada's recent projections for China are equally robust, and fairly close to the World Bank's.

Unfortunately, the economic news from Europe and Japan was much less upbeat. While Germany emerged from recession in Q2, well before the U.S., forecasters expect German economic growth to fall back to close to zero in the fourth quarter. Japan's recovery also seems to be fading and there are renewed concerns about deflation in that country.

Aside from stubbornly high unemployment, ballooning deficits have clouded the prospects for recovery in Europe. Deficits have soared in Greece, Portugal, Ireland, Italy and Spain in the wake of national stimulus programs and after years of poor fiscal management.

The U.S. budget outlook is also rather dreadful due to the severity of the recession and the bailout costs associated with jumpstarting the economy. The Obama Administration recently forecast a US\$1.6 trillion budget deficit for 2010, which represents 10.6% of GDP. The shortfall is projected to shrink to 3.9% of GDP by 2015. At US\$752 billion, this projected deficit is roughly double the highest budget deficits posted by the previous administration. Now that the Democrats have lost their super majority in the Senate, the medium-term budget outlook is very uncertain.

### A Weak Recovery For The Advanced Countries

The global economic outlook as highlighted in the following table suggests the advanced economies will experience weak and fragile growth in 2010 and 2011. Also of note, for the first time since WWII, the U.S. will not be leading the global economic recovery. That job has shifted to China.

While the global economic recovery is spreading, it remains too timid to halt the continuing rise in unemployment. In the U.S., for example, the jobless rate could again climb above 10% in the first half of this year, and it may not be until 2011 that unemployment begins to fall in the *Euro* area.

It is the ongoing fallout from the financial crisis that continues to slow the recovery in many of the world's advanced economies as households and businesses virtually everywhere continue to repair their finances and reduce their debts.

As the second half of this year unfolds, some central banks will begin to raise interest rates, while others will discuss the inevitable need to tighten monetary policy. At the same time, governments are already experiencing financial market and political pressures to lower their alarming budget deficits. In the case of China, the government has already ordered its banks to reduce lending in order to keep its economy from overheating and fueling inflation.

### The Global Economy At A Glance: 2009-10 (Annual % Change In Real GDP)

	Latest *	2009e	2010f	2011f
U.S.	5.7 Q4	-2.4	3.1	3.3
Japan	1.3 Q3	-5.4	1.5	1.1
Canada	0.4 Q3	-2.5	2.7	3.0
Germany	2.9 Q3	-4.9	1.0	1.2
France	1.0 Q3	-2.1	1.3	1.3
Italy	2.4 Q3	-5.0	0.5	0.7
U.K.	-1.2 Q3	-4.5	1.2	1.1
Euro Area	1.5 Q3	-3.8	1.3	1.1
China**	10.4 Q4	8.2	9.0	9.0
Russia	Q3	-8.7	4.9	4.2
India**	Q3	6.4	6.5	6.8
World	n.a.	-1.0	3.5	3.9

\*Annual growth in specific quarter.

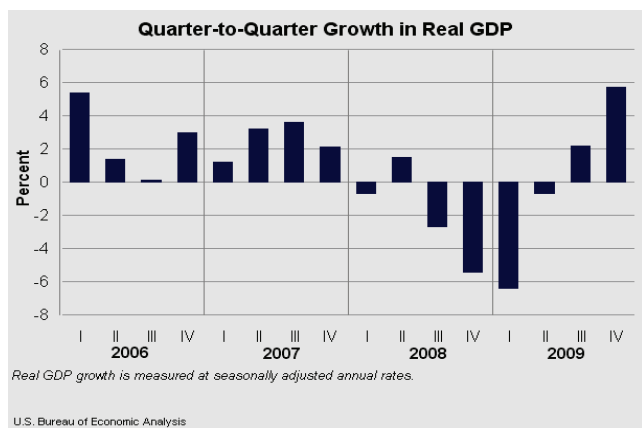
\*\*12-month growth.

### U.S. Growth Bounced Sharply Higher In Q4

U.S. real GDP appeared to take off in the fourth quarter, increasing at a seasonally adjusted annual rate of 5.7%. Real GDP rose by just 2.2% in the July-to-September quarter. (A cautionary note is required, since the fourth-quarter advance GDP estimate is based on incomplete data. It is certain to be revised in the coming months.)

Nonetheless, the U.S. economy has now grown in real terms for two consecutive quarters following a full year of contraction. In all of 2009, U.S. GDP fell 2.4% -- the steepest one-year drop since 1946. GDP rose 0.4% in 2008 and 2.1% in 2007.

Almost two-thirds of the 5.7% fourth quarter advance in real GDP was due to inventory rebuilding. Private fixed investment also soared at a 13.3% real annual rate in Q4, contributing significantly to total GDP growth. The surge in business investment was the fastest in years. The fact that more than 60% of the growth in Q4 was due to non-repeatable or extraordinary factors, however, suggests a major slowdown is imminent.



### Canada's Federal Government Aims To Balance The Budget Without Raising Taxes

“The time is not yet, but it will come. Taxes will have to be raised. It is not too early to think hard about how. There are, of course, illusionists who deny this need, who claim that public expenditures can be slashed enough to balance the books. They are not living in the contemporary world.” (Tom Kent, *Globe and Mail*, January 8, 2010)

Federal Finance Minister Jim Flaherty has projected that Canada will record a \$55.9 billion deficit this fiscal year, a figure that is very plausible given the slowdown in tax revenues, escalating employment insurance payouts and the auto industry bailout. He also projects the budget deficit will fall to \$27.4 billion in 2011–’12 before virtually disappearing by 2015.

He claims that the balanced budget can be achieved without any tax increases or major program cuts. To accomplish this seemingly miraculous feat, he simply plans to slow the growth of program expenditures below that of the economy.

Flaherty’s calculations are based on the assumption that economic growth can tame the budget deficit. They also ignore the fact that the government recently gave up more than \$12 billion in annual receipts by cutting the GST.

Fiscal projections from the Parliamentary Budget Office (PBO) appear to be more realistic. In its latest review of federal finances, the PBO projects that Ottawa will face structural budget deficits well into the future, even after the Canadian economy returns to normal growth. (A structural deficit is a shortfall that remains even when the economy is running at full capacity.)

The PBO is forecasting structural deficits ranging between \$12.5 billion and \$18.9 billion for each of the next five fiscal years.

Should the PBO’s forecast prove to be accurate, Canada’s structural deficit would represent roughly 1% of potential GDP. This is still rather low by many global standards.

Despite all of the austerity talk in Ottawa, the Finance Minister insists some program spending areas will be protected from cuts. For example, he says Ottawa won’t reduce transfers to the provinces or spending commitments made to pensioners and the disabled.

As Tom Kent correctly concludes, however, taxes will have to be raised at some point.

	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Budgetary balance	9.6	-5.8	-54.2	-43.1	-27.9	-23.2	-19.0
Structural balance	-0.3	-3.2	-12.5	-13.5	-13.1	-16.8	-18.9
Cyclical balance	9.9	-2.5	-41.8	-29.6	-14.8	-6.5	-0.1

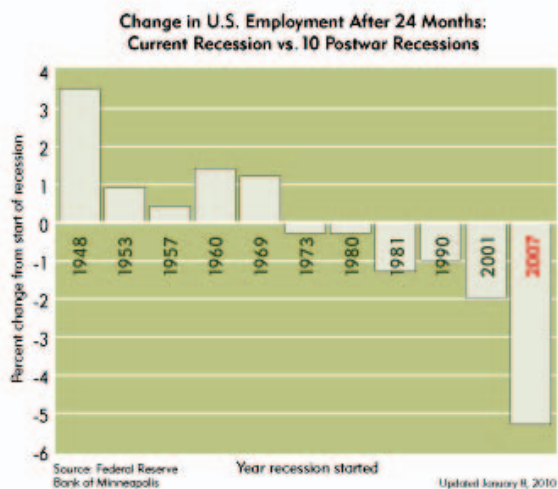
Source: Office of the Parliamentary Budget Officer

### Canada's Job Market Is Strong, Relative To That Of The U.S.

For the first time in a long while, Canada’s labour market is much stronger than the American, even though job markets in both countries are weak. In January, for example, Canada’s unemployment rate was 8.3% compared with a 9.7% rate in the U.S..

The U.S. recession, which began in December of 2007, has been devastating on its economy and its job market. Thus far, 8.4 million Americans have lost their jobs and 1.1 million discouraged workers have left the labour force.

At the same time, the so-called “underemployment” rate in the U.S. -- which includes everyone in the official rate plus those who say they want a job and have looked for work recently -- fell to 16.5% in January from 17.3% a month earlier. Clearly, these figures are a stark reminder of the difficult employment conditions that remain in the U.S..



In Canada, employers do not appear to be in a hurry to re-hire the 280,000 workers who have lost jobs since October of 2008.

Since the beginning of the fourth quarter of 2009 (an assumed recovery period for the economy) Canada’s monthly job creation figures have been on a roller coaster ride. The economy created 43,000 jobs in January, 7,000 jobs in December and 80,000 jobs in November after losing 44,000 jobs in October. In other words, Canada’s economy has created roughly 21,500 jobs per month over the last four months.

If the economy maintains this pace of job creation throughout 2010, all of the jobs lost since the jobs recession began in 2008 would be restored. It would not, however, provide employment for those workers who have entered the labour force since the slowdown began – the labour force has expanded 1% per year since the slowdown began.

Consequently, it is difficult to be enthusiastic about the end of the Canadian and American recessions when continued weakness in the job market may well dampen the recovery.

### The Fed Has Begun Winding Down Emergency Programs

“In light of improved functioning of financial markets, the Federal Reserve will be closing the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, the Commercial Paper Funding Facility, the Primary Dealer Credit Facility, and the Term Securities Lending Facility on February 1, as previously announced. (U.S. Federal Reserve Media Release, January 27, 2010)

At their first meeting of the year, U.S. Federal Reserve policy makers provided a slightly more optimistic assessment of economic activity than in previous statements.

More importantly, the Fed also reaffirmed its intent to wind down one of its most extraordinary interventions in recent years — its purchases of US\$1.25 trillion in mortgage-backed securities — by the end of March. The committee also reiterated its plan to immediately end a number of other emergency lending programs, including one that lends directly to securities firms — and not only banks — by giving them access to the Fed’s discount window.

The emergency programs were sharp departures from the history of monetary policy, and Fed officials are treading cautiously in ending them.

Meanwhile, minutes from the Fed’s December meeting also expressed concern that the tentative comeback in the U.S. housing market could fall apart as a tax credit for home buyers expires and the Fed’s program to hold down mortgage rates comes to a close.

Finally, Fed policy makers also left the federal funds rate — the rate at which banks lend to one another overnight — at zero to 0.25%. The rate has remained at this generational low since the depths of the recession in December of 2008. The Fed also indicated that it has little concern about rising prices, since inflation was “likely to be subdued for some time.”

### Are We On The Verge Of A Trade War?

Global trade and financial imbalances have narrowed considerably since the financial and economic crisis began, largely because the volume of international trade contracted by 20 % from its peak before the crisis. However, it is also likely that trade imbalances will widen again as economic growth revives.

China was the major beneficiary from the recent trade boom, and its trade surpluses and foreign currency reserves are massive. Pressure is mounting, however, for China to begin shifting demand towards domestic consumption and relatively away from exports.

While this is a lengthy and difficult transition to make, it is also politically unacceptable for the advanced trade-deficit countries to continue to export jobs to China. Many of these countries are coming off the worst recession since the 1930s and they are still suffering from unusually high unemployment.

Most of the world's major currencies "float" against one another, though government policies clearly affect the purity of the float. China is a great exception to the hands off approach.

Despite the rapid growth of the Chinese economy over the past 10 years, and the massive increase in trade surpluses, China has held its currency, the *yuan*, more or less fixed to the U.S. dollar. Thus, the *yuan* has been persistently weak, and it weakened further as the U.S. dollar dropped against the *yen*, the *euro*, the pound and the Canadian dollar.

In effect, China has been following a beggar-thy-neighbour devaluation policy, which has provided Chinese exporters with a growing competitive advantage over their rivals.

In the long run, a stronger *yuan* would benefit China's economy—and the world's—by helping shift growth from investment and exports towards consumption. It would also boost consumers' purchasing power and squeeze corporate profits, which have accounted for most of the increase in China's excessive domestic saving in recent years.

### Slow Productivity Growth Is Hurting Canada's Competitiveness

A recent Statistics Canada study confirmed that Canada's labour productivity growth is slow, and is lagging behind the U.S.. (*Canadian Economic Observer*, January 2010). In the report, labour productivity was conventionally defined as business output divided by the employed work force. Three issues concerning recent developments in productivity growth are interesting and have important competitive and economic public policy implications for Canada.

- Firstly, productivity growth has recently slowed to an annual pace of about 1% per year. In the past, productivity growth of 2% was the norm. A secular slowdown in productivity growth is associated with a similar slowdown in the growth of the real standard of living of Canadians.
- Secondly, unlike its neighbour to the south, Canadian labour productivity growth actually declined in the latest recession. In the U.S., labour productivity expanded 4.9% between the fourth quarter of 2007 and the third quarter

of 2009. In Canada, labour productivity fell 1.2% over the same period.

- Finally, a pricey US95 cent Canadian dollar is also a competitive problem for Canadian firms. This suggests that Canadian business is losing its competitive edge against American firms despite substantial layoffs and efficiency drives.

### Closing Comments On The Housing Markets In Canada And The U.S.

- Despite evidence of soaring housing prices in some parts of the country, recent reports by the Bank of Canada have strongly asserted that it is premature to talk about a bubble in Canada's housing market. Indeed, the Bank argues that recent house price increases do not appear to be out of line with the underlying supply/demand fundamentals. Moreover, with housing starts below long-term demographic requirements, inventories are still declining.
- Canadian housing starts expanded 5.8% in January, to an annualized level of 186,300 units. The January surge in starts represented the fourth increase in five months, and was 51,000 units higher than a year earlier. The influx of additional housing supply coming on to the market, compared to a relative tightness that existed in the latter half of last year, and the likelihood of higher mortgage rates later in the year could, however, cool Canada's housing market.
- Housing sales in the U.S. increased 5% last year and the backlog of unsold homes on the market fell significantly. Many observers, including the Fed, worry that the U.S. housing market could stumble later this year when government measures to boost sales -- including ultra-low interest rates and a tax credit for home buyers -- expire.

Arthur Donner, PhD  
February 17, 2010

## Interest Rates

		Current Level <u>1/31/2010</u>	Quarter End <u>12/31/2009</u>	Previous Quarter <u>9/30/2009</u>	Approximate Hi (1 yr)      Low (1 yr)	
<b><u>NORTH AMERICA:</u></b>						
PRIME:	U.S. Prime Rate	3.25	3.25	3.25	3.25	3.25
	Canadian Prime Rate	2.25	2.25	2.25	3.00	2.25
KEY RATES:	U.S. Discount Rate	0.50	0.50	0.50	0.50	0.50
	Canadian Bank Rate	0.50	0.50	0.50	1.25	0.50
U.S.:	U.S. Fed Funds Rate	0.13	0.13	0.04	0.25	0.04
	UST 3 month	0.08	0.06	0.12	0.26	0.05
	UST 6 month	0.15	0.19	0.18	0.44	0.15
	UST 1 year	0.31	0.51	0.44	0.68	0.31
	UST 2 year	0.86	1.16	0.98	1.16	0.82
	UST 5 year	2.36	2.69	2.33	2.69	1.68
	UST 10 year	3.61	3.84	3.31	3.84	2.69
	UST 30 year	4.51	4.63	4.04	4.63	3.55
CANADA:	Canadian Call Loan Rate	0.20	0.20	0.20	1.00	0.20
	CAN 3 month	0.16	0.18	0.22	0.80	0.16
	CAN 6 month	0.27	0.27	0.32	0.86	0.27
	CAN 1 year	0.53	0.66	0.58	0.93	0.43
	CAN 2 year	1.17	1.48	1.26	1.48	0.99
	CAN 5 year	2.45	2.77	2.57	2.77	1.75
	CAN 10 year	3.34	3.61	3.31	3.61	2.78
	CAN 30 year	3.94	4.08	3.84	4.08	3.56
SPREADS: (CAN-US)	3 Month	0.09	0.12	0.10	0.56	0.04
	6 Month	0.12	0.08	0.15	0.51	-0.02
	1 year	0.22	0.15	0.14	0.58	-0.02
	2 year	0.31	0.32	0.28	0.32	0.05
	5 year	0.09	0.09	0.24	0.35	-0.13
	10 year	-0.27	-0.23	0.00	0.20	-0.27
	30 year	-0.56	-0.55	-0.20	0.15	-0.56
	(ONT-CAN)	Ont 10 year	0.68	0.74	0.77	1.62
<b><u>INTERNATIONAL</u></b>						
JAPAN:	JGB 3 Month	0.12	0.06	0.15	0.25	0.06
	JGB 10 year	1.33	1.36	1.30	1.43	1.26
GERMANY:	DM 3 Month	0.28	0.31	0.28	0.87	0.28
	DM 10 year	3.16	3.16	3.24	3.38	3.04
<b><u>COMMODITIES</u></b>						
	CRB Futures Index	265.59	285.71	259.39	285.71	211.59
	Gold - US\$	1078.50	1087.50	995.75	1087.50	883.25
	West Texas Int. Oil US\$	72.84	79.93	70.43	79.93	41.70
	GSCI	486.15	524.62	462.75	524.62	336.21
<b><u>CURRENCIES</u></b>						
	CAD/USD	0.9352	0.9560	0.9345	0.9560	0.7860
	USD/YEN	90.2500	93.1000	89.7400	98.9700	89.7400
	EUR/USD	1.3861	1.4333	1.4630	1.4712	1.2670
	GPD/USD	1.5981	1.6154	1.5980	1.6700	1.4310
	AUD/USD	0.8841	0.8976	0.8820	0.8995	0.6350
<b><u>Headline</u></b>						
<b><u>INFLATION</u></b> (CPI yr/yr)	CANADA	1.3		(Dec)		
	UNITED STATES	2.7		(Dec)		
	JAPAN	-1.7		(Dec)		
	EURO-11	1.0		(Jan)		
	UNITED KINGDOM	2.9		(Dec)		
	AUSTRALIA	1.1		(Dec)		
					<b>CLOSE:</b> 1/31/2010	
					<b>TODAY:</b> 2/10/2010	