The Big Easy

by Jeff Rubin

All of a sudden there appears to be an exit door from the credit crunch.

The billions of illiquid, underwater mortgage-backed securities that have already bankrupted some of the world's largest investment banks and choked up the world financial system are about to go away. The US Treasury, in an act of unprecedented charity, will effectively nationalize Wall Street's most troubled assets and transfer them to the balance sheet of American taxpayers.

What the ultimate cost would be of not intervening will of course never be known. Both the slowing rate of recent housing price declines and vastly improved housing affordability ratios suggest that a trough in US real estate prices is probable within the next six months. But could Washington have waited that long before world financial markets would have totally seized up causing a global meltdown?

While the cost of taking another path will never be known, the cost of the one chosen is clear enough. Higher deficits can only bring higher taxes and higher inflation can only bring higher interest rates. Both are on their way in the American economy.

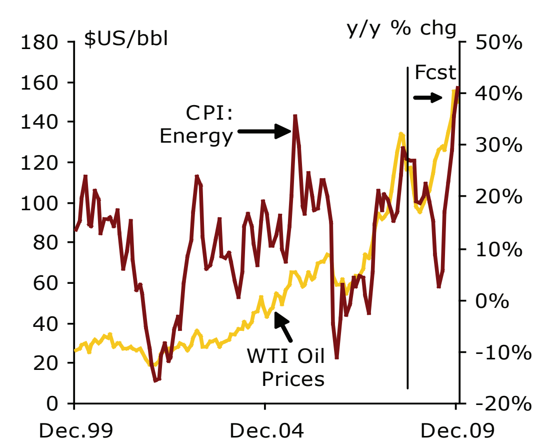
The big easy in today's Fed/Treasury policy sets the stage for mean reversion in tomorrow's policies. The world's largest financial bailout is sending oil short-sellers to the sidelines. The earlier plunge in energy prices now only sets the stage for even higher inflation rates next year as oil prices rebound to set new highs.

With fears of a financial system meltdown and growth collapse averted, prices for a range of commodities have already seen their lows. The weak OECD backdrop will slow the extent and pace of recovery. Still, the combination of strong emerging market demand and limited new supply should see oil prices average a record-high $150/barrel over the second half of next year.

The resulting near-$5/gallon gasoline prices will see CPI energy inflation make a triumphant return, posting no less than a 40% increase from yesterday's deleveraged prices (Chart 1). That, in turn, should see headline US CPI inflation punch through 6% towards the latter half of next year.

Chart 1

Rebounding Oil Prices Will Push US Energy Inflation Through the Roof



Economics & Strategy

Jeffrey Rubin
(416) 594-7357
jeff.rubin@cibc.ca

Avery Shenfeld
(416) 594-7356
avery.shenfeld@cibc.ca

Benjamin Tal
(416) 956-3698
benjamin.tal@cibc.ca

Peter Buchanan
(416) 594-7354
peter.buchanan@cibc.ca

Meny Grauman
(416) 956-6527
meny.grauman@cibc.ca

Krishen Rangasamy
(416) 956-3219
krishen.rangasamy@cibc.ca

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Table 1

FORECAST SUMMARY

(% Change Except Where Noted)

CANADA	2005A	2006A	2007A	2008F	2009F
GDP at Market Prices	6.3	5.7	5.9	**3.9**	**4.3**
GDP in $2002	2.9	3.1	2.7	**0.6**	**1.3**
Consumer Price Index	2.2	2.0	2.2	**2.5**	**3.3**
Unemployment Rate	6.8	6.3	6.0	**6.1**	**6.4**
Employment	1.4	1.9	2.3	**1.4**	**1.3**
Merchandise Trade Balance (C$ Bn)	62.3	49.5	48.0	**47.1**	**47.2**
Current Account Balance (C$ Bn)	26.5	20.2	13.6	**18.9**	**19.8**
Housing Starts (K)	225	227	228	**216**	**190**
Personal Saving Rate (% of disposable income)	2.0	3.1	2.7	**2.5**	**1.5**
UNITED STATES					
GDP at Market Prices	6.3	6.1	4.8	**3.9**	**4.6**
GDP in $2000	2.9	2.8	2.0	**1.6**	**1.9**
Consumer Price Index	3.4	3.2	2.9	**4.8**	**5.1**
Unemployment Rate	5.1	4.6	4.6	**5.6**	**6.2**
Current Account Balance (US$ Bn)	-755	-788	-731	**-715**	**-750**
Pre-tax Profits (with IVA/CCA)	17.6	15.2	-1.6	**-6.5**	**4.0**
Housing Starts (Mn)	2.07	1.81	1.34	**0.92**	**1.01**

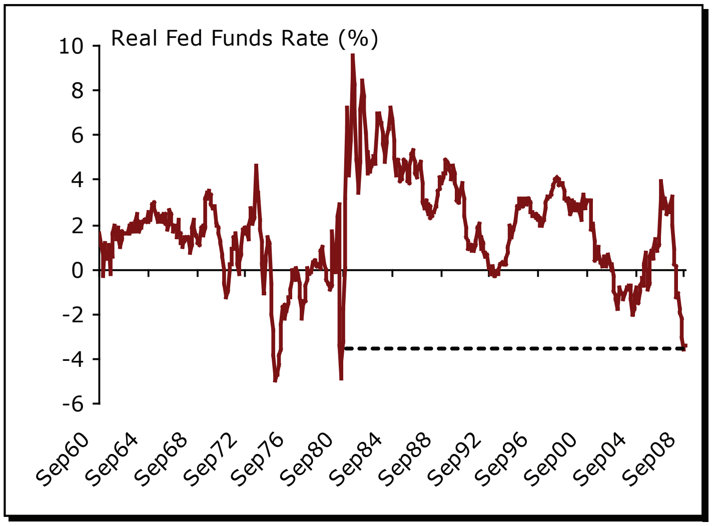
Table 2

INTEREST AND EXCHANGE RATE FORECAST

		2008		2009			
END OF PERIOD:		**22-Sep**	**Dec**	**Mar**	**Jun**	**Sep**	**Dec**
CDA	Overnight target rate	3.00	3.00	3.00	3.00	3.50	4.00
	98-Day Treasury Bills	2.14	2.45	2.75	2.80	3.30	3.70
	Chartered Bank Prime	4.75	4.75	4.75	4.75	5.25	5.75
	2-Year Gov't Bond (2.75% 10/10)	2.84	3.05	3.35	3.50	4.10	4.35
	10-Year Gov't Bond (4.25% 06/18)	3.65	3.80	4.00	4.10	4.30	4.35
	30-Year Gov't Bond (5% 06/37)	4.11	4.20	4.30	4.25	4.50	4.65
U.S.	Federal Funds Target	2.00	2.00	2.00	2.25	3.25	4.00
	91-Day Treasury Bills	0.84	1.50	1.70	2.20	3.00	3.60
	2-Year Gov't Note (2.375% 8/10)	2.12	2.35	2.55	3.20	3.85	4.00
	10-Year Gov't Note (4% 08/18)	3.84	4.00	4.35	4.40	4.60	4.65
	30-Year Gov't Bond (4.5% 05/38)	4.41	4.55	4.65	4.75	4.80	4.90
Canada - US T-Bill Spread		1.30	0.95	1.05	0.60	0.30	0.10
Canada - US 10-Year Bond Spread		-0.19	-0.20	-0.35	-0.30	-0.30	-0.30
Canada Yield Curve (30-Year — 2-Year)		1.27	1.15	0.95	0.75	0.40	0.30
US Yield Curve (30-Year — 2-Year)		2.29	2.20	2.10	1.55	0.95	0.90
EXCHANGE RATES	— (US¢/C$)	96.7	97.6	100.0	99.0	102.0	103.1
	— (C$/US$)	1.034	1.025	1.000	1.010	0.980	0.970
	— (Yen/US$)	105	108	102	97	96	94
	— (US$/euro)	1.48	1.48	1.48	1.42	1.40	1.39
	— (US$/pound)	1.86	1.84	1.80	1.75	1.75	1.75
	— (US¢/A$)	84.5	88.0	90.0	91.0	92.0	93.0

Chart 2

Real Fed Funds Rate



The last time CPI inflation was 6% was 1990 when the federal funds rate was 7½%, or almost four times today's setting. US real interest rates haven't been so negative since the second OPEC oil shock, nearly thirty years ago (Chart 2). Never have they remained so. And neither will they this time.

While the present job shedding in the US economy, and possibly a negative fourth quarter will keep the Fed tolerant of today's inflation, any stabilization in employment will bring the onset of Fed tightening. The Fed should begin raising the funds rate by early in the second quarter of next year. Once started however, they have a long way to go. By year-end they will have hiked the funds rate by 200 basis points, in what is likely to be a protracted and painful adjustment in real interest rates.

Main Street was never as much at risk as Wall Street, but the US economy has bled jobs for the last eight months and will probably continue to do so for the balance of the year. And certainly growth and employment prospects are no better in Europe or Japan. But the OECD economies don't pack nearly the same weight in global economic growth as they once did, and global growth is unlikely to fall much below 4%.

For the commodity- and particularly energy-leveraged Canadian economy, the Treasury bailout is unambiguously good news. After all, it won't be Canadian taxpayers that are on the hook, while it will be Canadian resource and energy companies that will benefit from the stability brought to financial markets and the more bullish outlook that shines on world growth.

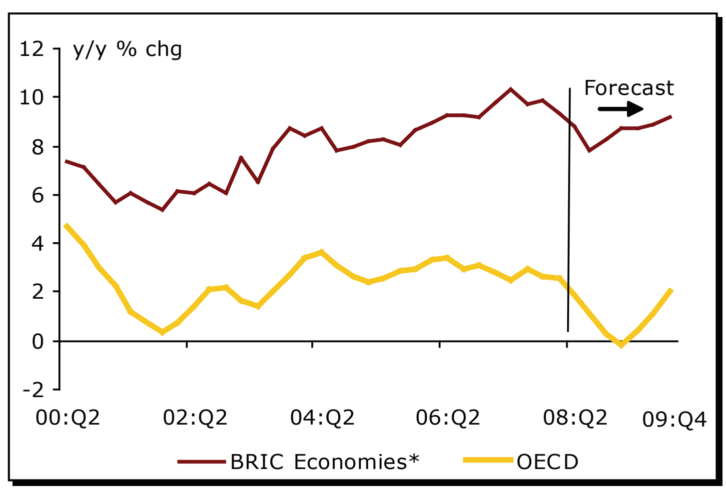
While growth in the OECD economies is likely to grind to a halt by year-end (Chart 3), global growth should regain a four-handle by next year. That will fall short of the near-record pace of growth of the last several years, but it will be more than sufficient to boost the energy and commodity-laden TSX.

The TSX is likely to take a run up to 14,000 before feeling the bite of interest rate hikes later next year. Not having cut rates as much as the Federal Reserve Board, the Bank of Canada will find itself in the enviable position of not having to raise them as much on the way up. The Bank is likely to do no more than half the Fed's 200-point rise while the loonie breaks through parity again on the back of climbing crude prices.

While Canadian growth should also stumble during the second half of this year, rising energy prices next year will once again add momentum to both corporate profit growth and income gains throughout the resource-dominated Canadian economy. GDP growth rates back in the 3% area by the second half of the year should halt the rise in the national jobless rate which is likely to peak at just over 6½%. But inflation, stoked by the same energy price pressures felt south of the border, will re-ignite, suggesting the Bank of Canada's work, like that of the Federal Reserve Board, may not yet be done.

Chart 3

An OECD-Led Recession



Brazil, Russia, India & China

The Next US Recession is Now

Meny Grauman

The collapse of the US housing market has not only triggered the most serious global financial crisis since the Great Depression, but is also the root cause of the first American recession since 2001. The good news is that we are closer to the end of this economic downswing than the beginning, thanks to early and aggressive rate cuts by the Fed, coupled with well over $1 trillion in actual and proposed bailout measures (Chart 4). These actions continue to prop up faltering consumers and a teetering financial system, and are coming together to make this current slowdown both shorter and milder than it otherwise would have been. Residential real estate values keep on dropping and foreclosure rates keep on climbing, but there are signs that home values will stabilize by early next year. This should lead to a modest economic recovery by the second quarter of 2009 and kick off a series of aggressive rate hikes.

Chart 4

A Massive Bailout: Fed/Treasury Funding

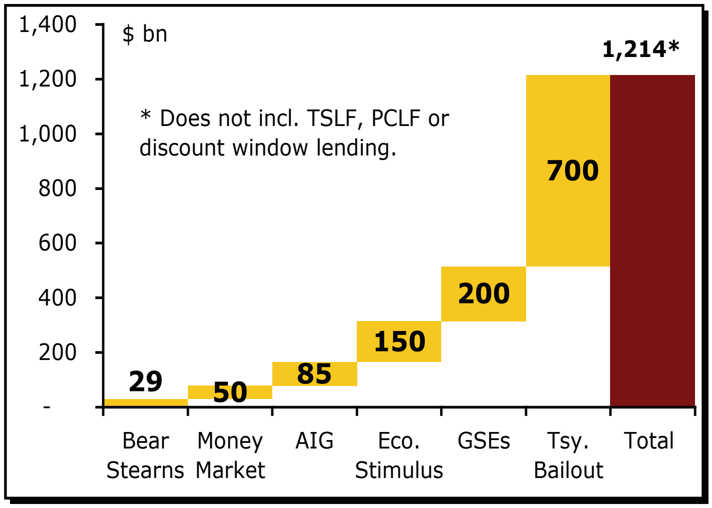


Table 3

US FORECAST DETAIL

(real % change, s.a.a.r., unless otherwise noted)

	08:2A	08:3F	08:4F	09:1F	09:2F	2007A	2008F	2009F
GDP At Market Prices ($Bn)	14,313	14,438	14,458	14,639	14,835	13,808	14,340	14,993
% change	4.6	3.5	0.6	5.1	5.5	4.8	3.9	4.6
Real GDP ($2000 Bn)	11,740	11,749	11,695	11,748	11,828	11,524	11,708	11,927
% change	3.3	0.3	-1.8	1.8	2.8	2.0	1.6	1.9
Final Sales	4.8	-1.1	-2.0	1.3	2.4	2.4	1.8	1.5
Personal Consumption	1.7	-1.5	-2.1	1.7	2.2	2.8	0.8	1.3
Total Govt. Expenditures	3.9	3.9	1.8	1.8	2.0	2.1	2.7	2.7
Residential Construction	-20.0	-23.0	-13.4	-1.0	5.0	-17.9	-21.5	-4.3
Business Fixed Investment	2.2	-1.9	-3.7	0.7	2.6	4.9	2.8	1.1
Inventory Change ($2000 Bn)	-49.4	-9.6	-4.8	8.7	20.3	-2.5	-18.5	26.8
Exports	13.2	4.0	2.9	3.0	4.4	8.4	8.5	4.2
Imports	-7.5	1.0	2.2	3.7	3.7	2.2	-1.7	2.7
GDP Deflator	1.3	3.2	2.4	3.2	2.6	2.7	2.2	2.6
CPI (yr/yr % chg)	4.4	5.4	5.1	5.2	4.5	2.9	4.8	5.1
Unemployment Rate (%)	5.3	5.9	6.2	6.4	6.2	4.6	5.6	6.2
Housing Starts (AR, Mn)	0.90	0.91	0.93	0.95	0.98	1.34	0.92	1.01

Chart 5
US Has Leaned Heavily on Net Exports

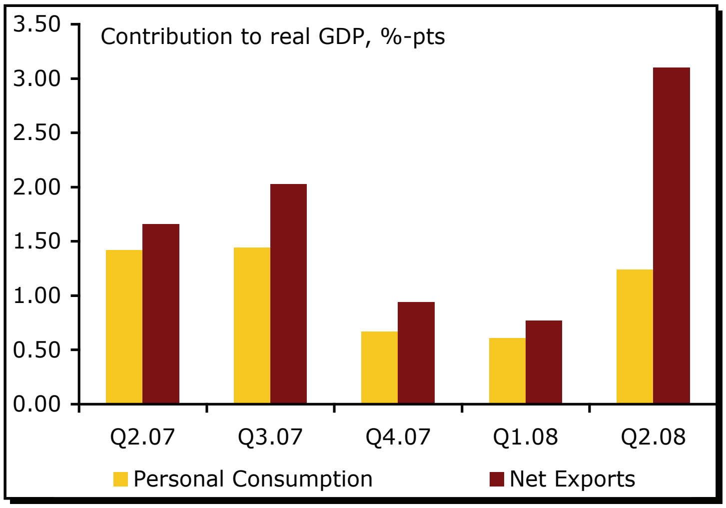
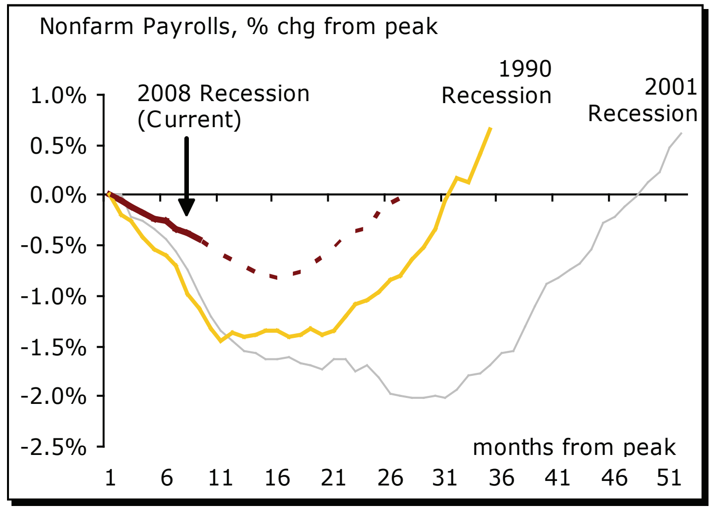


Chart 6
Job Losses Have and Will Be Milder This Time



GDP Doesn't Tell the Whole Story

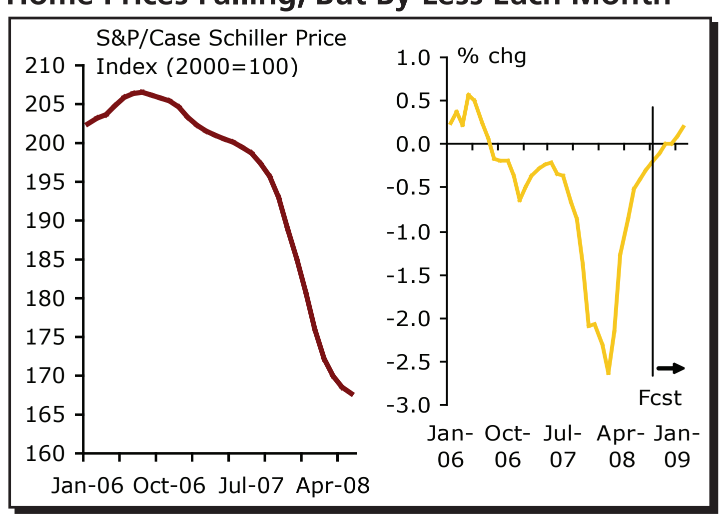
As of the first half of 2008, the US had the fastest growing economy in the G7, but that belies significant economic weakness lying just below the surface. American real GDP rose by an annualized 3.3% in the second quarter, but net exports accounted for over 90% of this gain (Chart 5). Meanwhile, private domestic demand actually fell despite close to $100 billion in direct tax rebates. Underlying domestic weakness will start to have a more significant impact on headline economic growth in the second half of 2008, but it is clear that the current economic slowdown will not be defined by GDP weakness alone.

Despite positive growth during the first half of the year, the current US recession began in late 2007, and its most reliable indicator has been the beleaguered labour market which has been on a downward trend since January (Chart 6). Since the beginning of the year the unemployment rate has climbed by over one full percentage point, but total job losses are tracking a milder course than in the prior two recessions.

Economic relief is still inexorably tied to a stabilization in home values. Current monthly price declines are already only a quarter of what they were earlier in the year (Chart 7), hinting at an approaching bottom. We can therefore expect to see the economy strengthen very modestly by the second quarter of 2009. It will still take many years for the housing market to recover from its massive slide, but even a flat housing market will ease mortgage defaults and provide the basis for a broader economic recovery.

In the meantime, lower gasoline prices should provide some support for beleaguered consumers in the coming months, but the impact will be limited by the fact that this relief will both be temporary and modest. Every $1/gallon decline in gas prices translates into about $100 billion in additional discretionary spending power, but that will still not be enough to keep consumer spending from contracting in both the third and fourth quarters. In fact, even with current price declines Americans will still pay between 15-50% more to heat their homes this winter compared to last year (depending upon the type of fuel), not to mention the fact that pump prices should move towards $5/gallon next summer as energy prices head higher with global growth back on track.

Chart 7
Home Prices Falling, But By Less Each Month



Outside of these gas price effects, other important factors still seem quite negative for the consumer. The government's tax stimulus package is all gone, and even the checks that were cut could not push personal consumption growth above 2% in the second quarter. Furthermore, income growth is moderating in conjunction with a deteriorating labour market, while the wealth effect from both housing and equities has moved from a significant positive just a few years ago to an overwhelming negative.

These are not new developments, but unlike previous quarters, with global growth down, and virtually the entire OECD already in recession or teetering on the brink of one, the US economy will find it increasingly hard to lean on its exports to make up for softness at home. A further slowing in US import growth will certainly do its part to help the trade balance, but that decline should not be enough to make up for weaker demand from abroad.

Inflation Still a Longer-Term Threat

Slower global growth is also putting downward pressure on global commodity prices, but the impact on inflation will be minimal. Lower energy prices will dampen US headline CPI in the short-run, but the impact will be relatively small as prices bounce back early next year. Meanwhile, core inflation should still head higher as companies struggle to play catch-up with an earlier explosion in their input costs. As the Fed's September policy statement made abundantly clear, recent commodity price declines do not mean that longer-run inflation risks have materially subsided.

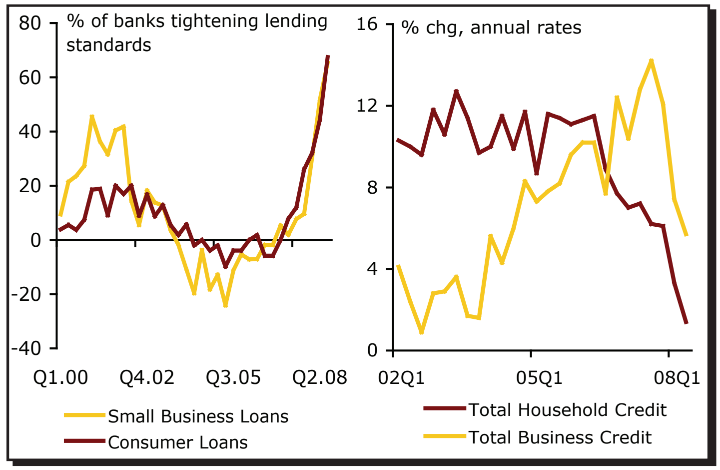
Rate cuts are therefore clearly not on policymakers' radar screens, and even the worst US financial crisis since the Great Depression is not changing the FOMC's view that the current overnight target rate is appropriate. With the real fed funds rate already at -3.6%, the Fed is convinced that monetary policy is too blunt an instrument. Instead, a fiscal package will likely be needed for consumers, and Washington has turned to a whole host of alternative measures to solve Wall Street's woes.

Where Wall Street Meets Main Street

These moves have become more aggressive as the year-long credit crunch has taken on a new dimension. The bursting of the largest asset bubble in American history has effectively reshaped Wall Street, and forced the federal treasury to commit to buying hundreds of billions of dollars worth of distressed financial assets. It is hoped

Chart 8

US Credit Conditions

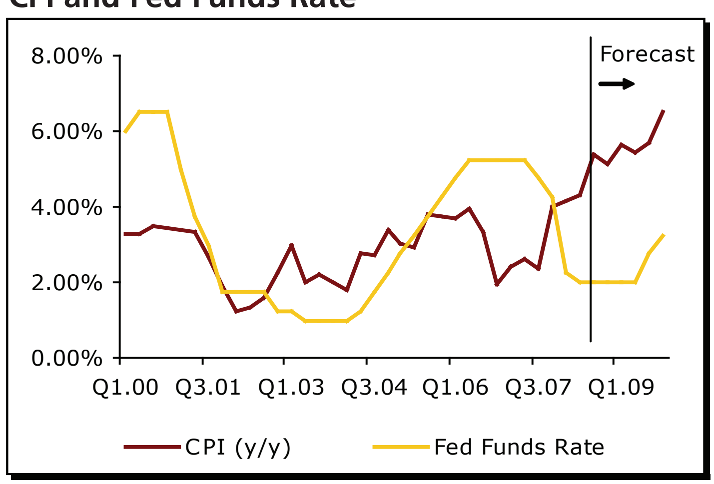


that this concerted action will be more effective than earlier ad hoc measures intended to stabilize a shaky US banking system that saw a number of the country's premier financial institutions either go out of business or taken over by the government.

In theory this extreme financial instability threatens to hurt both businesses and consumers by constraining their access to credit, but so far there is no concrete evidence that there is severe credit rationing going on in the United States. We do know that lending standards have tightened significantly since last year and household borrowing is plunging (Chart 8), but it is unclear whether this is more a function of lower demand rather than lower supply. What is clear is that the government's bailout plan should help alleviate systematic risk in the banking system which is a net positive for the real economy, even if the extra required borrowing to put this plan into place means that rates are heading higher next year (Chart 9).

Chart 9

CPI and Fed Funds Rate



Canada: Climbing Out of a Hole

Avery Shenfeld

By the most widely watched measure, the Canadian economy through the first quarter of 2009 won't be any worse than the first half of 08, but it will still feel that way for a while. Measured by real GDP, the quantity of what Canada produces, output has already been stagnant. But with crude oil and grains setting records, and other commodities still firm, the value of first-half production soared. Now, with the growth stall moving from the US to overseas and temporarily depressing the commodities basket, Canada has lost its immunity for now.

As a result, a similarly sluggish real GDP performance will translate into a larger drag on employment and profits (Chart 10 and Table 4). That pinch will be felt from coast to coast, and not only in Central Canada where the pain has been greater thus far. But given that the growth slump should end as early as Q2 2009, as of September, we are already closer to its end than its beginning. The secular benefits of energy resource abundance will once again be in evidence as global growth picks up further into next year, but so too will be the risks to inflation.

Chart 10

Similar Real GDP Growth, But Worse Impact

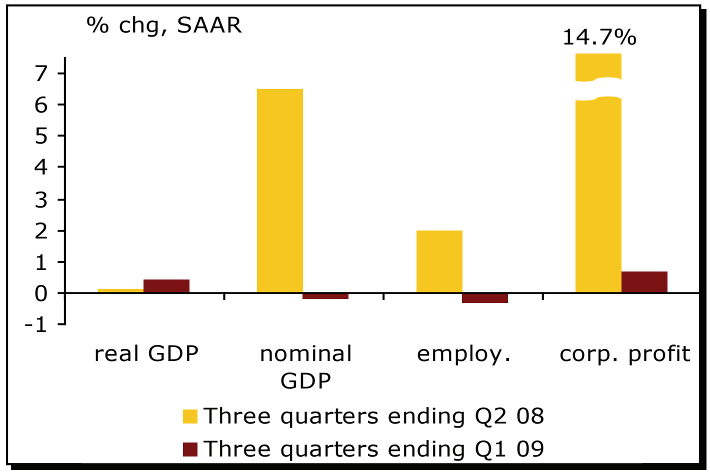


Table 4

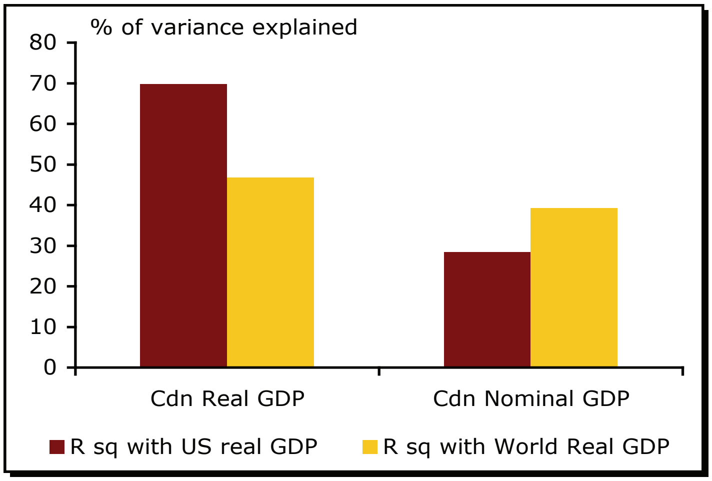
CANADA: GDP FORECAST DETAIL

(real % change, s.a.a.r., unless otherwise noted)

	08:2A	08:3F	08:4F	09:1F	09:2F	2007A	2008F	2009F
GDP At Market Prices ($Bn)	1,616	1,603	1,589	1,614	1,646	1,536	1,596	1,665
% change	10.8	-3.3	-3.5	6.4	8.2	5.9	3.9	4.3
Real GDP ($2002 Bn)	1,327	1,330	1,328	1,331	1,340	1,320	1,328	1,346
% change	0.3	0.8	-0.5	1.0	2.6	2.7	0.6	1.3
Final Domestic Demand	2.0	2.6	1.7	2.1	2.5	4.2	3.5	2.3
Personal Consumption	2.4	2.0	0.9	1.8	2.4	4.5	3.8	2.0
Total Govt. Expenditures	4.5	3.1	4.3	2.7	3.6	4.2	4.5	3.3
Residential Construction	-3.9	-1.7	-1.1	-0.4	-3.0	3.0	-1.6	-2.1
Business Fixed Investment*	-1.4	6.0	1.9	3.0	3.0	3.5	3.0	3.5
Inventory Change ($2002 Bn)	8.4	7.7	5.5	3.8	6.5	13.2	6.1	6.2
Exports	-5.9	0.4	1.0	2.6	2.5	1.0	-3.4	1.7
Imports	2.3	4.3	4.5	3.7	4.0	5.5	3.1	3.9
GDP Deflator	10.5	-4.0	-3.0	5.3	5.5	3.1	3.3	2.9
CPI (yr/yr % chg)	2.4	3.4	2.6	2.5	2.1	2.2	2.5	3.3
Unemployment Rate (%)	6.1	6.1	6.4	6.5	6.6	6.0	6.1	6.4
Employment (m/m avg, K)	8	-16	-3	12	27	30	6	28
Goods Trade Balance (AR, $bn)	64.9	42.5	29.8	33.4	45.6	48.0	47.1	47.2
Housing Starts (AR, K)	220	205	203	198	188	228	216	190

Chart 11

Nominal GDP More Linked to Global Growth



How the World Comes to Canada

Canada has always been judged as the 51st state economically, joined at the hip to its giant neighbour to the south. That's still true in terms of real GDP, with US growth explaining about 68% of the variance in annual Canadian growth. But for nominal GDP, the correlation is somewhat stronger with world than with US output (Chart 11), as the former is critical in setting prices for resources, which are increasingly dominant in our trade performance.

Healthy resource prices had earlier masked a lot of what ailed the Canadian economy. On the trade front, the nominal surplus surged due to price effects, even as in real terms, net exports were the economy's greatest drag. That drag in real net trade continued into the third quarter, but with prices for resources off their highs, the nominal trade surplus will also be crushed (Chart 12). As a result, the Canadian dollar is likely to stay below parity through the next two quarters, before again breaking stronger as commodity price recoveries lift the trade surplus.

Bay Street has also seen a significant hit from the troubles on Wall Street, both in equity valuations and bank funding costs (Chart 13). But Canada's better capitalized banking system has meant that, unlike the US situation, there have been no major players teetering on the brink of, or falling into, default. Nor has the ripple impact of wider spreads and the collapse of securitized substitutes for bank loans stood in the way of borrowing activity by the household sector, a reason why the Bank of Canada didn't follow the Fed towards more negative real overnight rates. Instead, consumer and business spending will be impacted the old-fashioned way, not by credit rationing but by the usual cyclical forces affecting spending.

Domestic Contagion

Those cyclical forces will show up in the domestic side of the economy, having been triggered by the slump in real and now nominal exports. Until recently, fiscal stimulus, including huge public sector hiring, a GST cut and income tax cuts in some jurisdictions, kept consumer activity on fire. But with employment now dropping, particularly in export-oriented manufacturing, and household debt sitting at a record 135% of income, neither paychecks nor borrowing will be enough to sustain spending at last year's breakneck pace. Indeed, real retail sales have been flat to declining since March (Chart 14), and big-ticket buying, like autos, is showing particular weakness. Sales volumes could grow slowly again late this year once gasoline prices ease their pinch on spending power, and employment will see a one-month election-related pop in October. But the broader trend is towards weaker hiring. Look for real consumption to be held to only a 1½% pace

Chart 12

Real vs. Nominal Goods Trade

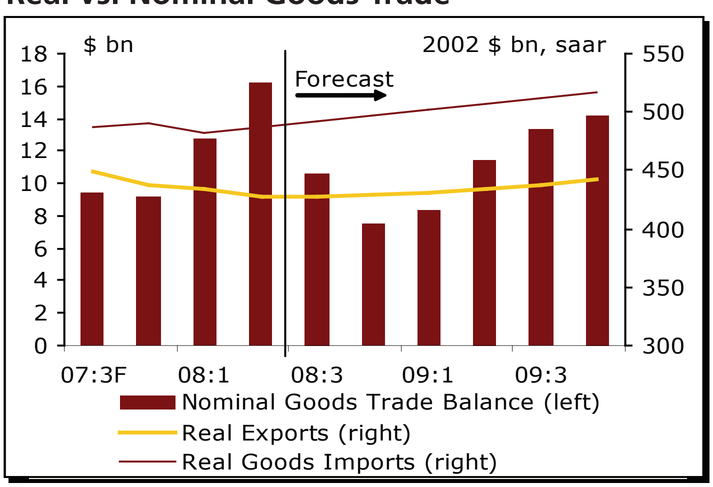


Chart 13

Wide Bank Spreads, But Brisk Borrowing

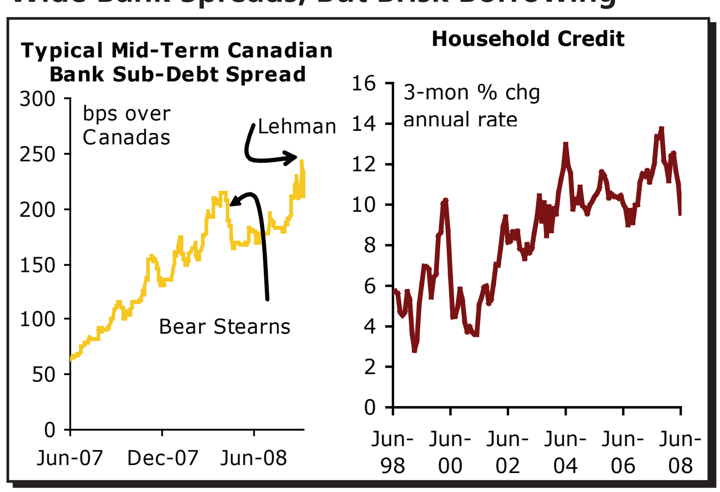
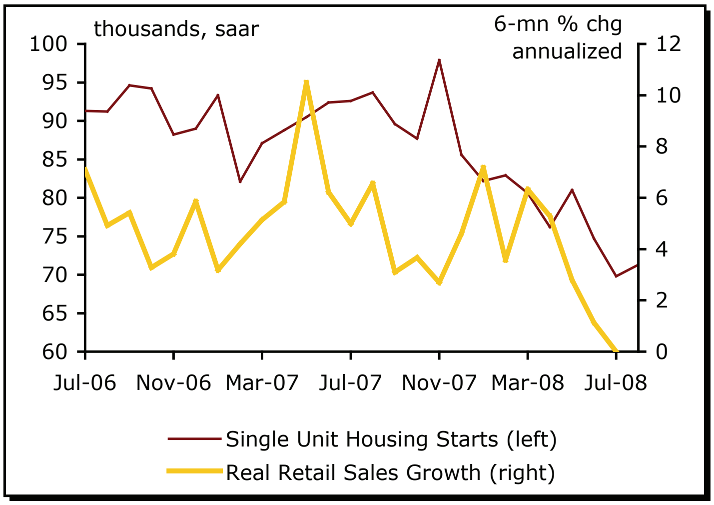


Chart 14

Softer Domestic Demand



in the three quarters ending Q1 2009, after 4.3% in the prior four quarters.

Housing, while not crashing, has come off the boil, and both starts and prices could ease in the months ahead. In many markets, house prices do not appear to be overly stretched relative to incomes, and mortgage defaults remain extremely low. But prices are seeing outright declines in several previously overheated Western Canadian cities, as builders managed to catch up to demand and restore more balance to the market. There's no huge wealth impact here, as prices were up in some cases by 50% last year, so only the relatively small number who bought late in the rally will see prices fall below their initial purchase price. Building permits for single-family homes show a clear downtrend, and we expect starts to fall below 200,000 next year.

Business capital spending presents a more mixed picture. Recent announcements pertaining to offshore Atlantic Canada suggest that energy prices remain high enough to spark new mega-project activity, although conventional natural gas drilling remains quiescent. Manufacturing profits and capacity use have both been hammered, a precursor to declining capital budgets.

With resource prices softer, Western Canada will, for now, share some of the pain previously focused elsewhere. Already, Alberta's economy has fallen off its pedestal as a combination of weaker natural gas prices (and drilling), the end of a housing boom and skilled labour shortages has seen its employment and retail sale growth slip back to or below the national norms. Ontario and Québec, as net oil importers, will get a short-lived lift for their consumer sectors. But by the latter half of 2009, renewed energy price strength should lift Western Canada, and the Atlantic region will also see a boost from offshore activity.

Inflation: I'll Be Back

On a monthly basis, Canadian inflation should begin to retreat by late this year, helped by somewhat cheaper gasoline, and discounts prevalent in a slower holiday shopping season. But the bond market is far too complacent in terms of its longer-term view. For one, most of the current differential between Canadian and US inflation in the past year pertained to the lagged disinflationary impact of earlier C$ gains. That showed up, most notably, in a steep drop in car prices. But our research suggests that these anti-inflation impacts are fully in place within two years after the C$ levels off, implying they will be much less helpful come 2009.

Indeed, the Bank of Canada has said nothing to justify market expectations for rate cuts ahead, and with good reason. The current 6.1% unemployment rate would have been considered a huge inflation threat in the 1980s and 1990s. The Bank's own estimates show the economy operating only barely below its non-inflationary capacity, and real interest rates are low relative to that gap. With world oil and food prices resuming their upward climb, headline CPI will top 3½% in the second half of 2009, well above the Bank's 2% target, and more than enough to trigger a return to higher interest rates.

The resulting sell-off in bonds should still see Canadas fare better than US Treasuries, in part because short rates didn't get as deeply discounted during this year's rally. Supply will also be a factor. Ottawa's days of huge surpluses and double digit-spending growth are over, and even with resource revenues likely to rebound later next year, it will take a much tighter budget come February to stay in balance. But the US is facing a mountain of supply, not only for cyclical budget deficit reasons, but to fund this year's massive "investments" in the financial system.

Global Slowdown Not as Severe as in 2001

Peter Buchanan

Though the gloom in financial markets has eased considerably, September's financial rescue package will not breathe new life into a virtually moribund G-7 economy overnight. Signs point to recessions in Europe and in all probability Japan, while the US is losing traction after a surprisingly solid Q2 as the tax rebate money ends (see pages 4-6). Lingering strains from the 21st century's first serious financial storm juxtaposed on a 1970s style energy shock have prompted us to cut our forecast for global GDP growth to 3.8% this year (Chart 15). As was the case earlier, the good news is that the world economy's pains are far from evenly spread. Growth in the resource-hungry BRIC countries has decelerated from last year's near-10% pace, but remains at levels that would draw envy almost anywhere else. Those countries did not follow the US and Europe into recession in 2000-01, and we see little reason to expect them to this time (Table 5).

Stealing a page from the US, governments in Japan and even China are apparently now considering stimulus packages. Outside of the US, central banks are already easing (China, Australia) or poised to trim borrowing costs in coming months (the ECB). Those efforts and a gradual easing of mortgage and credit pressures, aided by September's bold financial rescue plan and billions of newly injected liquidity, should lift global growth back to a 4.2% pace in 2009.

With fears of a financial system meltdown and growth collapse averted, prices for a range of commodities have already likely seen their lows. The weak OECD growth backdrop will slow the extent and pace of recovery. Still, the combination of strong emerging market demand and limited new supply should see crude prices retrace to an average $140/barrel in 2009, setting new records late in the year. Firmer prices for a range of other commodities should also aid the C$, as the rotation away from resources to safe havens reverses itself (Chart 16).

Eurozone Faces Bumpiest Ride

For the time being, Europe remains the global economy's weakest link. Real GDP shrank by 0.2% in the second quarter, as investment, exports and consumer spending lost ground. Signs point to a further decline in Q3, satisfying the popular definition of recession. Industrial

Chart 15

Real Global GDP Growth

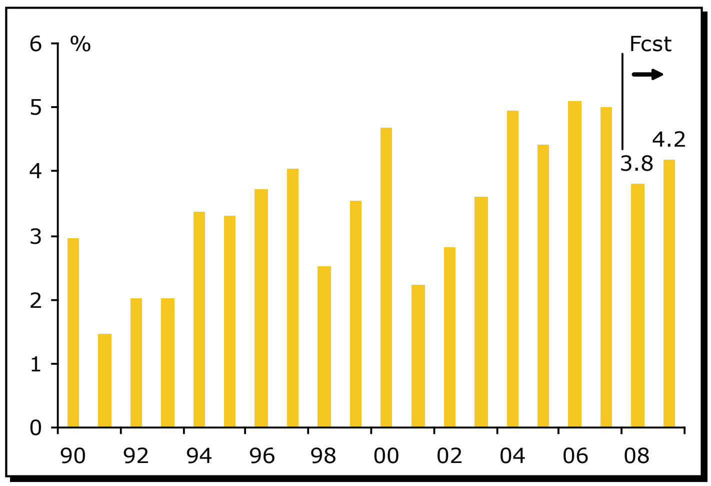


Table 5

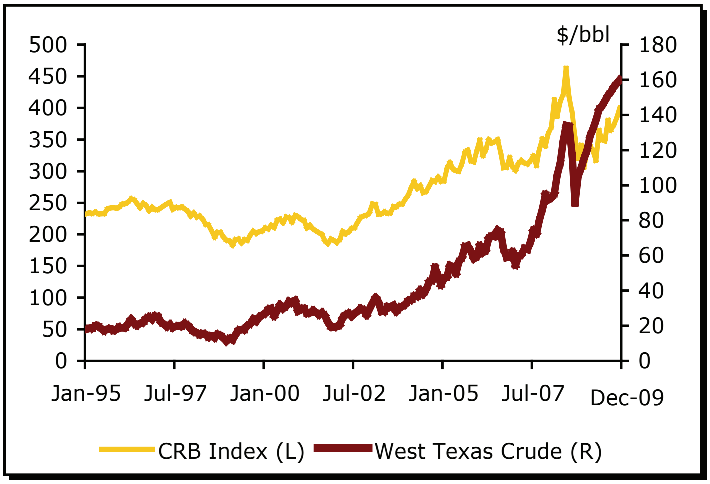
REAL GDP GROWTH RATES

	2005A	2006A	2007A	2008F	2009F
World*	4.4	5.1	5.0	3.8	4.2
North America	3.1	3.0	2.3	1.6	2.0
Euroland	1.8	3.0	2.6	0.9	1.2
UK	1.9	2.9	3.0	0.8	0.9
Japan	1.9	2.4	2.0	0.6	1.0
BRIC	8.5	9.2	9.7	8.7	9.0
-China	10.0	11.6	11.9	9.8	10.0
-India	9.1	9.7	9.2	7.5	7.7

**Country growth rates weighted using purchasing power parities*

Chart 16

Commodity and Oil Price Outlook



output in the 15-nation currency bloc posted a third consecutive 0.3% month/month decline in July, evidence that the factory sector continues to labour under the weight of past euro overvaluation. Adding to the drag from trade, capital spending plans are being marked down due to capital availability problems and weak external demand. Decelerating job creation, meanwhile, creates risks going forward for Eurozone retail sales, which fell by 1.5% on the year in the last three months, the largest pullback in over a decade (Chart 17).

Economic forecasts in both Germany and France have been pared in recent months. Weakness in the periphery will also help hold Eurozone growth to a disappointing 0.9% pace this year, pressuring the ECB to trim rates by at least 50 bps in the next 6-8 months. After a decade of decent performance, economies in the continent's south are floundering due to a reduction in bank lending and rising defaults. A property boom turned bust is taking a notable toll on Spain, which has accounted for a third of Europe's growth in recent years. Nor are things looking much better in Britain, hit by recent financial turmoil and a shaky housing market. The latest consensus forecast for just over 1% growth this year is a little more than half of what observers were expecting just five months ago.

Japan's economy, in common with much of Europe, evinced broad weakness in Q2. A 0.5% drop in consumption spending, coupled with declines in residential and business investment, pushed GDP down by 0.5% from the previous quarter. Japan's new PM, Taro Aso, is likely to enrich the $105 billion stimulus package proposed by the outgoing Fukuda Administration in August. Even with help on that front, the recession-bound economy is likely to grow by no more than 1% this year and next.

But Resource-Hungry BRICs Still Holding Their Own

Despite fears of export-related drag from a slowing global economy, China's economy still appears to be growing at a decent clip. Olympics-related shutdowns could hurt Q3 GDP, but the economy's main domestic pillars still look relatively solid. Domestic consumer spending has accounted for about two-thirds of GDP growth in recent years. Real retail sales strengthened further in August to a 17.4% yearly pace, a sign weaker stock valuations have little bearing on consumer behaviour. Fixed income investment has also firmed to a 27% pace on the year in recent months, aided by the effects of earthquake reconstruction (Chart 18). Inflation, an earlier problem, also seems to be receding (Chart 19).

Chart 17

Eurozone Consumers Hunker Down

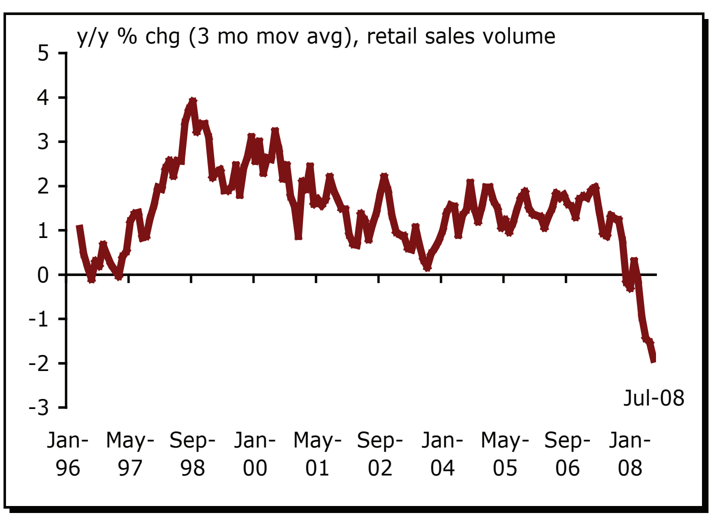


Chart 18

Domestic Demand in China Still Looks Solid

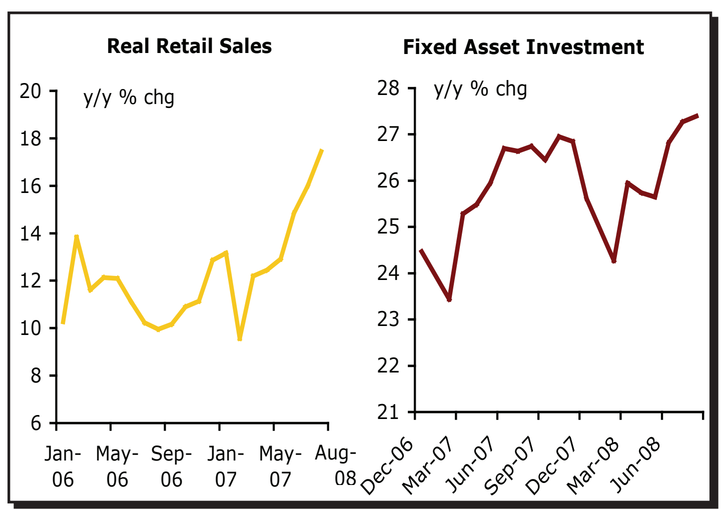
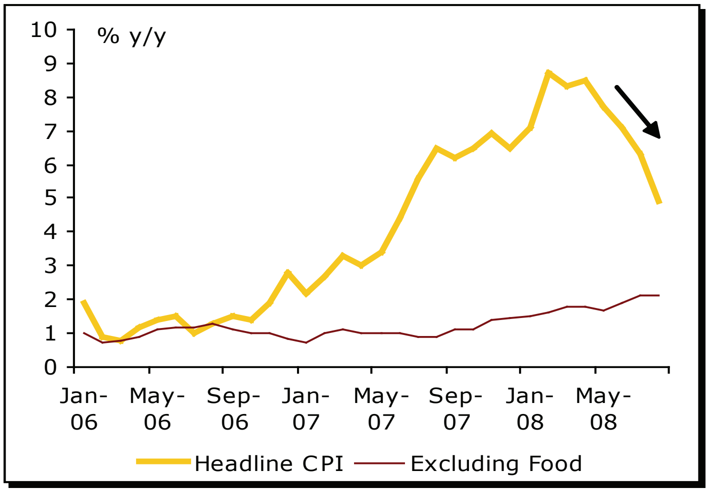


Chart 19

Falling Chinese Inflation Creates Room for More Rate Cuts



The effects of recent market volatility in Russia, the smallest of the BRICs, will take time to emerge. But recent 8% GDP growth and a huge $560 billion foreign exchange war chest suggest the country is in a better position to ride out some financial bumps these days than when turmoil last hit in 1998.

Despite recessionary conditions in most of the industrial world, oil prices at over $100/barrel remain at levels that would have been thought extraordinarily high a year ago. The key factors behind the past half decade's quadrupling in prices remain in place, with demand in countries like China and the Middle East still climbing at a 5-6% rate and production flat in recent years (Chart 20). That sets the stage for a further upleg in prices when the global economy turns the corner in the months ahead, rekindling demand growth.

Indian GDP growth, turning to the next largest BRIC, has downshifted to a 7.9% year-on-year pace recently. The deceleration is more a reflection of past Reserve Bank of India tightening than any drag from exports, which account for a relatively modest 15% share of GDP. The factory sector has been front and centre in the recent slowdown and July's strong rebound in production suggest the worst there may now be over. The economy should expand by 7-8% both this year and next.

Brazil, riding an energy-development wave, remains on firm economic ground, aided by double-digit gains in capital spending and strong personal income growth. GDP growth there should tip the scales at around 5% this year, close to 2007's pace.

Chart 20

Stagnant World Oil Production Means Higher Prices When Demand Returns