JULY-AUGUST 2010

Canada

> Employment makes up lost ground
> Slowdown in housing starts
> Real GDP remains unchanged
> Trade balance back to a surplus
> Retail sales down

United States

> Fewer jobs, but unemployment rate down
> Manufacturing sector continues to expand but at a slower pace
> FOMC leaves key interest rate unchanged
> Housing starts plunge to their lowest level ever
> Retail sales declined

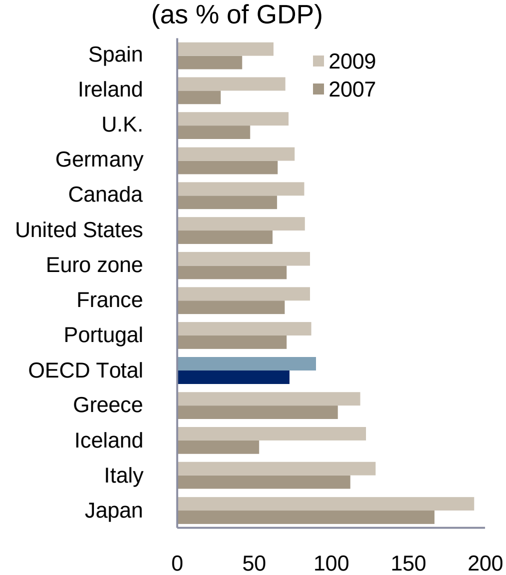
A quick look at the sovereign debt crisis

The sovereign debt crisis began in the last quarter of 2009, when the Greek government revised its public deficit projection for the year upward to nearly 13% of GDP, double the original estimate. Rating agencies reacted by downgrading the credit rating of Greek sovereign debt, which amounted to 110% of GDP. The lower rating inevitably drove up the cost of financing the debt.

Concerns surrounding Greece's ability to repay its sovereign debt spread to other highly indebted eurozone countries, including Italy and Portugal. This not only depressed the value of the euro, it also called into question the very viability of the common currency.

To save Greece from bankruptcy and stabilize the euro, the leaders of the eurozone countries developed a plan to help Greece finance its debt at a reasonable cost. They also gave the Greek government two more years to reduce its deficit to below 3% of GDP. In return, Greece undertook to implement a harsh austerity budget to rectify the situation.

Gross debt of select OECD countries
(as % of GDP)



Source: OECD

The aid plan, which was adopted by Greece in April, did not really succeed in calming the financial markets and stabilizing the euro. In May, Europe's Finance Ministers put together a mechanism to rescue countries in actual or potential difficulty. They created a stabilization fund, which will be able to make loans guaranteed by the Member States. These loans could be used to purchase the debt issued by countries in difficulty. The IMF hailed the creation of this fund and said it would contribute to it.

What happened in Greece raised concerns about the sovereign debt of many other countries. Public debt had risen dramatically in most industrialized countries in the previous year, as they responded to the financial crisis and ensuing recession. Many introduced plans to support the financial system and kick-start the economy, and their budget deficits ballooned.

As a result, the total deficits of the OECD countries reached 8.2% of total GDP in 2009 compared to 1.3% in 2007, while their gross debts rose from 73.1% to 90.0% of GDP over the same period. The gross debts of Canada and the United States grew from 65% and 62% of GDP respectively in 2007 to approximately 84% of GDP in 2009.

This deterioration in public finances is definitely a concern, but Canada and the United States are still able to finance their sovereign debt. As a last resort, these two countries could also print money to finance their debt. That is not an option for eurozone countries, since they do not have control over the issuing of the currency they use.

Leaders are still concerned about the widespread deterioration in public finances in industrialized countries. By the end of the G20 Summit, the countries involved had agreed to cut deficits by at least half by 2013, and stabilize or reduce public debt-to-GDP ratios by 2016. However, we must hope that the budget compression measures will be relatively gradual to avoid jeopardizing the global economic recovery.

Canada

According to the latest data, the growth in the Canadian economy – which was very strong in the first quarter – will be more moderate in the second. Real GDP took a breather in April, while retail sales declined. That being said, the recovery is well established in Canada, as borne out by the employment figures, which returned to almost pre-recession levels in June.

Employment makes up lost ground

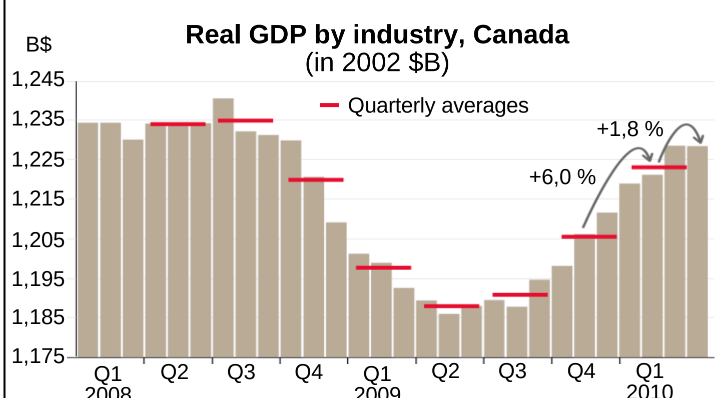
The number of workers jumped by 93,000 in June, which was a lot more than expected. In the past year employment has grown 2.4% and has recovered almost all of the ground lost since the labour market started to contract in the fall of 2008. What's more, most of the increase (88%) was in full-time employment. The unemployment rate dipped slightly in June to 7.9%, which is still a lot higher than the 6.2% it had fallen to before the recession. This is because the active population increased substantially over the same period, which in itself is good news (many people re-enter the labour market when it regains strength). Job creation was concentrated in the services sector in June. The goods sector lost some workers, especially in manufacturing, where employment remains well below pre-recession levels. The June figures show that the labour market is maintaining its momentum, which augurs well for economic growth in the second half of the year.

Slowdown in housing starts expected

The number of housing starts went down 3.1 % month-over-month, from 195,300 in May to 189,300 in June. The decline is essentially the result of a slowdown in activity in the urban multiple starts segment, particularly in Ontario. The number of housing starts in the single segment has remained relatively stable. The strength in housing starts over the last quarter of 2009 and the first of 2010 is explained by the catching up of a pent up demand caused by the recession, as well as by the low level of mortgage rates. Demographic forecasts combined to the expected increase in interest rates should moderate the housing sector activity in the coming months. The Canada Mortgage and Housing Corporation is still expecting housing starts to slow down to 182,000 units before the end of the year.

More moderate growth in real GDP likely in the second quarter

In April, GDP by industry did not change from the previous month. A significant fall-off in retail sales (-1.7%) and lower figures for manufacturing (-0.3%, the first decline since August 2009) and the production of public services (-0.7%) were offset by increases in the mining, oil and gas (0.5%) and wholesale trade (0.6%) sectors and, to a lesser extent, in the public and construction sectors. The finance and insurance sector did not change. The drop in GDP in April followed seven consecutive monthly increases. April results were weaker than generally expected (0.2%). However, even without any increase in May and June, GDP growth in the second quarter would still reach nearly 2.0%. We can therefore expect growth to continue in the second quarter of the year, though at a more moderate pace than in the first quarter.



Source: Statistics Canada and Desjardins Economic Studies

Trade balance goes from a deficit to a surplus

The trade balance went from a deficit of $236 million in March to a $175 million surplus in April. The value of exports declined by 1.0%, while the value of imports was down 2.2% from the previous month. These declines are due to lower prices for both exports and imports. In terms of volume, exports and imports actually increased for the third month in a row, but quite slowly (0.4% and 0.2% respectively). There was a large drop (23.4%) in exports to countries in the European Union, which was severely shaken by the sovereign debt crisis. Lastly, after two months of growth, machinery and equipment imports contracted. However, since the decline was due entirely to lower prices, we can remain optimistic about the willingness of businesses to improve productivity by investing in machinery and equipment.

Retail sales should continue to trend upwards

Retail sales declined by 2.0% in value and 1.9% in volume in April compared to March. The decline was widespread, with 10 of the 11 main sub-sectors posting negative numbers, but was more pronounced in the clothing (-5.2%) and auto parts and motor vehicles (-4.8%) sectors. The only sector that recorded a gain was the electronics and household appliances sector (0.6%). Retail sales can vary considerably from month to month, so the decline we saw in April is not necessarily indicative of a new trend. Over a twelve-month period we are seeing strong growth at 6.6% and, given the strength of the labour market, the upward trend should continue in 2010.

United States

The latest figures indicate that the recovery is still fragile in the United States. In May, retail sales declined and housing starts plunged to the lowest level ever recorded. However, despite job losses in June, the labour market has been rallying gradually since the start of the year. The manufacturing sector is also starting to expand again. The Federal Reserve's decision to leave the key interest rate unchanged in June and keep it at its current low level for even longer should help the recovery in the months to come.

Despite job losses, mood remains optimistic

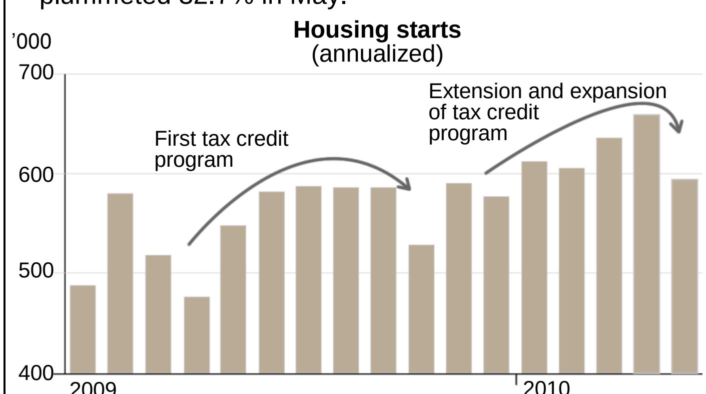
Non-farm sectors lost 125,000 jobs in June as the remaining 225,000 temporary positions created for the 2010 census disappeared. The government had hired 411,000 temporary workers in May for the census, which had inflated the job numbers. The unemployment rate actually went down in June to 9.5%, due to a decline in the labour force participation rate. To get a more accurate picture of recent changes in the employment situation in the United States we have to ignore public sector figures, which are skewed by the variations in census-related jobs. The private sector, which lost 8.5 million jobs between December 2007 and December 2009, has regained 593,000 since the start of 2010, including 83,000 in June. This is a modest gain, but it is also the sixth in a row, which is reason to believe that the upward trend will continue in the coming months as business confidence strengthens.

Manufacturing sector returns to more sustainable growth

The manufacturing sector continued to expand in June, according to the ISM index, which again rose above the 42-point bar to 56.2%. Thirteen of the eighteen manufacturing industries reported advances in June. However, the index was down 3.5 percentage points from May, which indicates slower growth in June. After the remarkable strength shown in the first six months, a slowdown in the growth of the manufacturing sector in the second half of the year was to be expected, and the June results only confirm this expectation, according to the ISM.

End of tax credits reveals a housing market still in dire straits

Housing starts in May stood at 593,000 units, down 10.0% from April. Starts of single-family homes plunged 17.2% while multiple dwelling starts jumped 38.3%. The number of building permits dropped by 5.9%, reflecting the 9.9% decline in the single-family sector and the 9.7% increase in the multiple dwelling sector. A decline in housing starts and building permits was expected due to the expiry of the U.S. government home buyers' tax credit program (at the end of April), but the decline was greater than anticipated. The end of this program also had a major impact on the sales of new homes, which plummeted 32.7% in May.



Source: U.S. Census Bureau and Desjardins Economic Studies

Growth in consumption showing signs of weakening

Retail sales were down 1.4% in May from the previous month, after a 0.6% rise in April. Sales of auto parts and motor vehicles contracted 1.7% and gas sales were down 3.3%. Even without these two components, the figures show a 1.0% decline. The biggest reason for the decline in May was the drop in retail sales of building materials and gardening equipment (-9.4%). This is a reversal, since the same component had risen 8.4% in April. However, it should be noted that growth in this component varies substantially from month to month. That being said, retail sales results for April and May suggest that the growth in consumption will not be as strong in the second quarter of 2010 as it was in the first.

Interest Rates

Interest rate gaps between Canada and the United States expected to widen

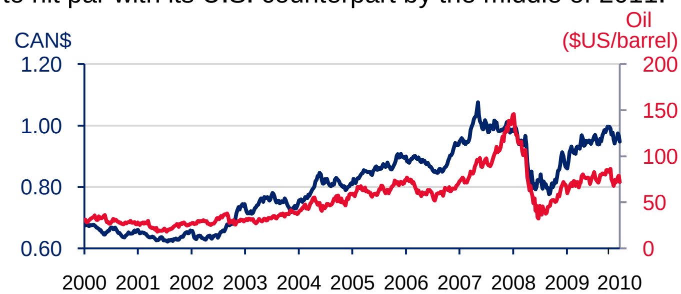
After reducing the key interest rate to 0.25% in April 2009, the Bank of Canada had left it alone until deciding to raise it to 0.50% this June. The next monetary policy decision will be announced on July 20. Most forecasters expect the central bank to continue raising the rate. However, given its current low level, it could go up substantially before monetary policy would be considered “restrictive,” i.e. as putting a brake on consumption and investment. Since the economic recovery seems well established in Canada, the Bank needs to raise the key interest rate to prevent rising inflation. The increase should be gradual, however: it is forecast to reach around 2.0% in March 2011.

For its part the FOMC opted for the status quo on June 23 by maintaining the key interest rate within a target range of 0–0.25%. The Committee continues to think that the economic outlook will probably require keeping the rate exceptionally low for a long time to come. The tone of the press release was slightly more negative than the tone in April: the Committee fears that the deterioration in financial conditions resulting from events overseas (a reference to the sovereign debt crisis in Europe, no doubt) is not supporting economic growth as much as expected. Most forecasters think the Federal Reserve will leave the key interest rate unchanged until 2011, so we should expect the gap between Canadian and U.S. interest rates to widen.

Oil, CAN$

Fears about the recovery weigh on the loonie and the price of oil

Fears about the global economic recovery, fueled by weakness in U.S. economic indicators and a slowdown in the growth of emerging economies, drove down the price of oil and, with it, the value of the loonie. However, the strength of the Canadian economy - confirmed by the results of the survey of the active population in June - and the expected widening of Canada-U.S. interest rate gaps, should push up the value of the loonie in the medium term. Most forecasters expect the Canadian dollar to hit par with its U.S. counterpart by the middle of 2011.



Source: Global Insight

SME optimism wavers slightly

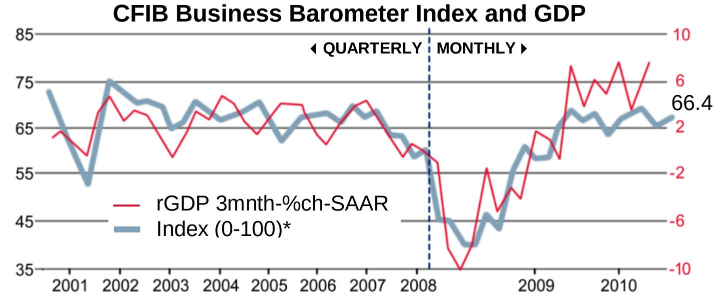
The CFIB Business Barometer Index dipped slightly in June to 66.4. However, it is still well above the low of 39.4 it hit during the recession.

Compared to three or four months ago, business performance continues to improve although the short-term outlook is less positive than it was in May.

Business leaders in the business services and the information, arts and recreation sectors are the most optimistic. The agriculture, accommodation and construction sectors continue to post weaker results.

SME owners in British Columbia and Newfoundland & Labrador are the most optimistic. Confidence dipped in Manitoba and Quebec in June, but strengthened in Ontario.

CFIB Business Barometer Index and GDP



Source: Canadian Federation of Independent Business

* Index of 50 = equal balance of stronger and weaker business expectations. Note that CFIB’s Business Barometer Index has been revised as of May 2009. The Index is based on the same survey, but is now a weighted average of response scores: 100 for stronger performance, 50 for same performance and 0 for weaker performance.

KEY INDICATORS - CANADA	Historical				2010				Latest		Forecast	
	2006	2007	2008	2009	Q1	Q2	Q3	Q4			2010	2011
Real GDP (% growth)	2.8	2.2	0.5	-2.5	6.1				Mar.	6.1	3.5	2.9
Machinery and Equipment Expenditures (% growth)	10.2	4.2	-0.9	-20.3	7.5						3.4	7.1
Pre-Tax Corporate Profits (% growth)	5.7	1.9	8.0	-32.3	16.8						23.2	10.8
Industrial Production (% growth)	0.3	0.1	-4.2	-10.0	11.7						5.8	5.2
Industrial Product Prices (% growth)	2.3	1.6	4.3	-3.4							1.3	2.8
Non-Residential Construction (% growth)	7.5	6.9	-2.7	-8.5	-5.4					-8.5		
Housing Starts (' 000 units)	227	228	211	149	199				May	201.7	184	177
Personal Expenditures (% growth)	4.2	4.6	2.9	0.5	4.4						3.5	2.8
Consumer Price (% growth)	2.0	2.1	2.4	0.3	2.3				May	1.4	1.9	2.2
Employment (% growth)	1.9	2.3	1.5	-1.6	1.6							
Unemployment Rate (%)	6.3	6.0	6.1	8.3	8.2	8.0			June	7.9	8.1	7.7
SMEs Confidence Index (CFIB)	67.3	67.2	56.1	57.7	68.4	66.7			June	66.4		
Manufacturers Confidence Index (CFIB)	66.4	64.5	52.7	56.0	69.7	69.1			June	68.5		
Credit Conditions (Bank of Canada)	-9.8	3.8	32.0	8.0	-1.0				Mar.	-1.0		

Sources: Statistics Canada, Consensus Economics and Canadian Federation of Independent Business, Bank of Canada