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FINANCIAL MARKET UPDATE

November 4, 2008

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Global initiatives piling up

▲ Global central banks and governments have been active in putting policies into place to combat the weakening in economic growth, supplementing aggressive cuts to policy rates by central banks as global players worked to weigh against the burgeoning global recession.

▲ While these measures have been aggressive, the reaction in financial markets has been positive, but muted. Still, there are some encouraging signs that the policy actions are getting some traction with global LIBOR rates coming off recent highs. Corporate bond spreads, however, remain sticky and there has not been a discernible increase in loan supply or demand.

▲ Equity markets are nervous and, although there are tentative signs of stability, it is too early yet to tell if the bottom has been reached.

U.S. economy slips in the third quarter; bigger declines ahead

▲ The Fed has pushed the funds rate back to 1% and, even though policymakers left the door open to additional cuts, early signs that funding costs are easing may give the Fed the leeway to hold rates steady and concentrate on other easing initiatives.

▲ The U.S. recession likely started in the third quarter. We now expect the economy to contract at a 2% annualized rate in the fourth quarter, with another substantial decline likely in the first quarter of next year of slightly more than 1% at an annual rate. The peak-to-trough decline in U.S. GDP will be greater than in any other three-quarter period during the 1970s, 1980s and 1990s.

▲ We still hold the view that the eventual narrowing in credit spreads, combined with accommodative monetary policy, will result in a modest recovery in late 2009.

Canada’s economy gearing down

▲ Canada’s economy is slipping, too, and is barely skirting recession. We think that Canada’s economy will avoid following the United States into recession because the favourable terms of trade effect, while weakening, will still provide support to domestic demand and Canada’s financial stress has been more limited than in the United States, meaning that the toll on household and business will be less.

▲ We see slower growth in Canada later this year and into 2009 with the economy now expected to contract mildly in the fourth quarter and grow by less than one-half a percent in the first quarter of 2009 before picking up pace in the second half of next year.

▲ For this year overall, we are calling for a 0.7% increase in real GDP growth Canada’s economy and a modest acceleration to a 1% pace in 2009. The weak pace of growth and lower commodity prices have lessened concerns about inflation and we now forecast the inflation rate will average 2% next year.

▲ With the economy running at a sub-potential pace and inflation risks falling, the Bank of Canada will likely ease the policy rate again in December of this year to 2%.

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