



ECONOMIC AND FINANCIAL MARKET UPDATE

November 2009

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The turning point

The tide has turned for the global economy with U.S. real GDP posting a stronger-than-expected increase and China recording a breathtaking 8.9% jump in output, both in the third-quarter. Canada, the United Kingdom and the Eurozone have yet to produce clear indications that their economies are out of recession, but conditions are improving and we expect reports of positive growth soon.

United States bounds out of recession

- The U.S. economy grew at a 3.5% annualized pace in the third quarter backed by a rebound in consumer spending and surging residential investment, which ended 14 consecutive quarters of decline.
- Early reports on fourth-quarter activity point to another increase in output, with the ISM manufacturing index driving solidly into expansionary territory in October and housing indicators pointing to firming sales against a shrinking inventory overhang.
- However, consumer confidence reports showed that households became less optimistic early in the fourth quarter, thus raising alarm bells that they could retreat again.
- Emerging from the deepest recession since the Great Depression, the U.S. economy remains fraught with uncertainty about the health of the financial system and pockets of weakness outside of housing.
- Real U.S. GDP is forecast to expand by just 2.5% in 2010, a modest recovery by historical standards, and then to pick up pace, growing by 3.4% in 2011.
- Our forecast is that the first rate increase will come late next year with the funds target ending 2010 at 75 basis points and then rising to 2.75% by year-end 2011.

A mixed bag of Canadian data

- Unlike the United States where the data point to the end of recession, Canada's numbers are less clear-cut. The economy shrank by 0.1% in August after posting no growth in July. We think that the economy will skate back into positive territory in September, but the risks are that the rebound will fall short of the consensus forecast for a 2% annualized gain. Our reckoning is that on an expenditure basis, real GDP growth was 0.5% to 1% at an annual rate in the third quarter.
- We expect economic momentum to build, spurred by a strengthening U.S. economy, low interest rates and a steady influx of government spending. We forecast that the economy will grow by 2.6% in 2010 with the unemployment rate peaking early in the year and then drifting lower.
- Against a backdrop of firming global growth and rising commodity prices, Canada's economy will pick up pace with real GDP growth of 3.9% in 2011 even as both fiscal and monetary policy stimulus starts to dissipate as long as credit conditions continue to improve.
- For the Bank of Canada, the road to the normalization of interest rates will be long. Our forecast is that the Bank will boost the overnight rate to 1.25% by the end of 2010 with further increases in 2011, yielding a policy rate of 3.5% by year-end.

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