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FINANCIAL MARKET UPDATE

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Risky business

Investors thought they heard the death knell for global recession in May and increased their appetite for risk, shying away from government bonds and buying equities, commodities and currencies except the U.S. dollar. As a result, the global stock market index we watch increased by 12.2%, oil prices rose 34%, while non-energy commodity prices hit their highest level since November according to the Bank of Canada's index. In the currency world, the U.S. dollar tumbled, with the trade-weighted index losing 4.4% in May alone.

Is the end in sight?

▲ We agree with the consensus that the global recession began to lose momentum in the second quarter but still expect another round of negative growth rates to be reported. The global manufacturing ISM index recorded its fourth consecutive monthly increase in May and the services index averaged 45.3 in April/May, well above the first quarter's 40.4.

▲ The levels remain unimpressive but signal a turnaround in sentiment, suggesting that the pace of contraction will be slower in the second quarter and that, if this trend persists, the global economy will likely be expanding in the second half of this year.

U.S. economy's first-quarter drop sets stage for better news ahead

▲ The revised GDP report showed a slower pace of decline in the first quarter with real GDP contracting at a 5.7% annualized pace, down from the preliminary estimate of 6.1% and the fourth quarter's 6.3% drop. The headline number still indicated that the economy remained in deep recession, but some of the underlying details suggest that the pace of decline will ease going forward.

▲ The sizeable drawdown in inventories in the quarter means that any pick-up in demand will need to be satisfied by new production, while an unexpected decline in government spending is likely to be reversed once transfers to state and local governments contained in the fiscal stimulus package get under way.

▲ Other good news in the report came from the corporate sector where after-tax profits rose unexpectedly, which augurs well for the sharp contraction in business investment to slow.

▲ We project that the U.S. economy contracted at an annualized 2.8% in the second quarter but anticipate a return to positive growth by the second half of the year. Despite the gyrations in the quarterly numbers, we are maintaining our 2009 forecast of a 2.9% contraction in U.S. real GDP and a 2.1% increase in 2010.

Canada's economy took a dive in Q1 but suffered less than thought

▲ Canada's real GDP contracted by a sizeable 5.4% annualized rate in the first quarter, but the decline was smaller than expected with the consensus (and RBC) looking for 6.5% drop, while the Bank of Canada projected an even steeper 7.3% plunge.

▲ Monthly GDP reports showed sizeable decreases in output in late 2008 and early 2009 supporting the call for a sharper drop in the quarter. It was the marked slowing in the pace of decline in February and March that saved the economy from a more pronouced downturn.

▲ Going forward, with the level of inventories having been drawn down in the first quarter, any revival in demand will be met by new production. To that end, the report gave encouragement to those looking for Canada's economy to work its way out of recession later this year.

▲ RBC's forecast is for the economy to regain its footing in the third quarter with the second quarter's projected decline of 3.2% being softer than the first quarter's 5.4% drop. For 2009 overall, we expect the recession to reduce real GDP output by 2.5%, with a forecast of a 2.5% increase in GDP in 2010.

C$ strength presents clear and present danger to economic outlook

For the economy, the Canadian dollar's rally means that the cost of imported machinery and equipment receded once again, giving Canadian companies relief as they invest in productivity-enhancing capital goods. On the downside, Canadian exporters, who are already struggling, face another obstacle to increasing demand for their products. On balance, the risks have grown that the trade account, which was one of the few supportive factors for the economy in the first quarter, will return to acting as a drag on output.

The positive effects of the rally in commodity prices on incomes will mitigate some of the downward pressure on the economy. Oil prices are more than double their December lows and non-energy commodity prices have gained 4.2% from their early March lows. The rebound in commodity prices juiced the Canadian dollar's rally, propelling the currency to levels that were slightly above those predicted by the Bank of Canada's currency model. Still, the prospect that some of the froth in the currency will recede in the months ahead stayed the hand of the Bank of Canada on June 4 when they held the policy rate at 0.25% and kept the option of quantitative easing on the backburner.