



Economic and financial market outlook

Global growth powers ahead

▲ Growth has accelerated in most of the world's major economies despite the rise in oil prices and, as a result, an interest rate normalization cycle is under way.

▲ The world's three main economic engines—the United States, China and Japan—have each been showing signs of vibrant and durable growth. Other key economies such as Britain, France, Russia, India, Canada and Australia are all, to varying degrees, healthy and robust, while growth prospects in Germany and Italy appear to be improving.

▲ East Asian economies are growing rapidly, emerging European economies are enjoying the boost that comes from joining the European Union and Latin America is currently crisis-free.

Canada capitalizing on the global upturn

▲ Economic data for the first half of the year showed that Canadian growth is on the upswing, domestic and external demand are healthy and that the worst fears about the higher exchange rate have failed to materialize. Our call is for real growth of 3.2% this year and 3.6% in 2005.

▲ Canadian commodity producers have benefited from strong world demand and tight supplies, adding a positive element to projections for profits, employment growth and investment spending.

▲ Renewed job growth will underpin vibrant consumer spending, although the maturing of Canada's housing market cycle suggests that a more balanced market lies ahead and that residential investment will make less of a contribution to growth than in the past few years.

▲ Although Canadian growth is expected to start outpacing U.S. growth, Canada's interest rate tightening cycle will be milder because of Canada's lower inflation risks.

U.S. economy firing on all cylinders

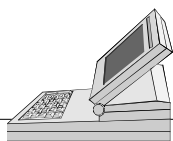
▲ With the labour market undergoing a strong recovery, the sustainability of the current expansion is on a sounder footing, with real growth expected to average 4.8% this year and 3.5% next.

▲ Growth in business investment, inventory rebuilding and gains from net trade will provide positive momentum going forward.

▲ A stronger job market will help consumers shore up their balance sheets, while rising mortgage rates will cool the hot housing market.

▲ High oil prices pose more of a risk to inflation than the growth outlook, and a returning downward trend for the U.S. dollar threatens price pressures and, hence, interest rates to rise higher.

▲ With inflation expectations threatening to move higher, we anticipate that the Fed will lift rates aggressively this year and next with the Fed funds rate expected to hit 4.50% by mid-2005.



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Global growth powers ahead

The negative reaction this spring after Chinese officials revealed they were going to slow China's growth to a more sustainable rate showed that investors were missing a key feature of the story, which is that world growth is on the upswing and that many countries stand to benefit tremendously. The world's three main economic engines—the United States, China and Japan—have each been showing signs of vibrant and durable growth. Other key economies such as Britain, France, Russia, India, Canada and Australia are all, to varying degrees, healthy and robust, while growth prospects in Germany and Italy appear to be improving. East Asian economies are growing rapidly, emerging European economies are enjoying the boost that comes from joining the European Union and Latin America is currently crisis-free. According to the IMF, world growth is expected to be 4.6% in 2004 and 4.4% in 2005.

Many countries face rising interest rates

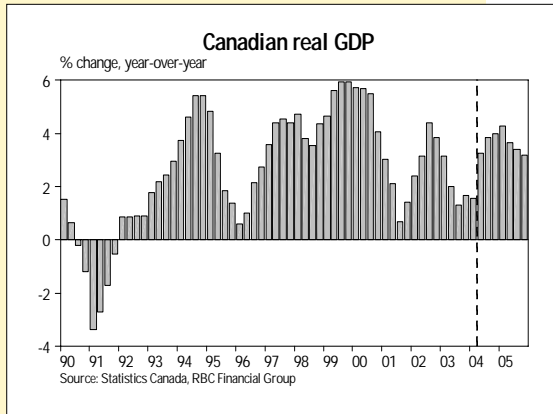
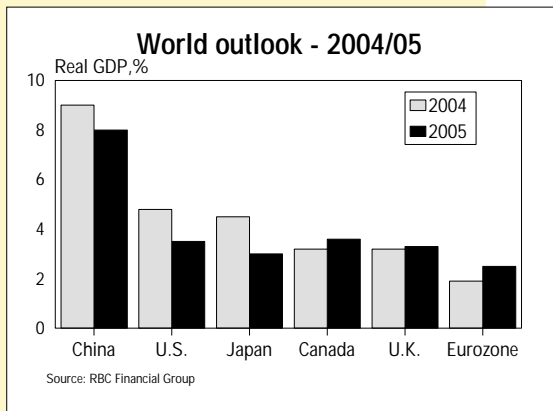
While the pattern of growth is similar in many countries, the timing is different with some countries well into recovery and some just at the beginning. The advanced state of the U.S. recovery means that interest rates have already begun to rise in anticipation of many more Fed rate hikes this year and next. In Britain, the Bank of England has already begun to raise interest rates, while the Bank of Canada is expected to lift rates by the year-end. Market interest rates have moved up in Japan and the Eurozone in anticipation of tighter monetary policy, although actual central bank moves in those regions are not expected before 2005. The early stages of a renormalization of monetary policies consistent with an improved global growth outlook have already begun.

Oil price risks overstated

Higher oil prices pose a risk to the outlook, but one that tends to be overstated. Inflation-adjusted oil prices pose much less of a worry because they are still well off late-1970s peaks despite recent price spikes above the US\$40 a barrel mark in nominal terms. Energy intensity in production has also nearly halved since the 1970's oil price peaks. In addition, with oil supplies now expanding, prices have already fallen off their highs and are expected to trend into the mid-\$30s a barrel range during the remainder of this year. Finally, high oil prices are a transfer of resources from oil-importing countries to oil exporters, presenting a great help to some emerging economies because they pad current account surpluses and central bank reserves, thus averting potentially destabilizing financial crises.

Capitalizing on the global upturn

One of the key developments in the Canadian economic landscape during the first half of this year has been the clearing away of so many of the question marks that lingered over the outlook. The first-quarter National Accounts showed that the economy is looking good, growth is on the upswing, the consumer is shopping again and the worst fears about the higher exchange rate have failed to materialize. Even the Bank of Canada is expected to shift its tone and bring forward the timing of rate hikes. What has gone right this year and, more importantly, how long will it last?



Commodity prices

Although Canada's economy is highly diversified, the production of raw materials is still an important component of the Canadian economy. The boom in China is by now old news, as is the success of low interest rates in bringing about a recovery in U.S. demand. By early 2004, Japan and, to a lesser extent, Europe were both also posting stronger growth. As a result, commodity demand has outstripped supply. Canadian producers have been the beneficiaries of healthy sales and soaring prices. In the first half of 2004, the average level of RBC's commodity price index was almost 60% higher than two years ago. Indirectly, sharp gains posted by natural resource firms on Canadian equity markets had a secondary effect on consumer confidence and business investment activity. Despite an expected slowdown in growth in both China and the United States, non-energy commodity prices are expected to remain high.

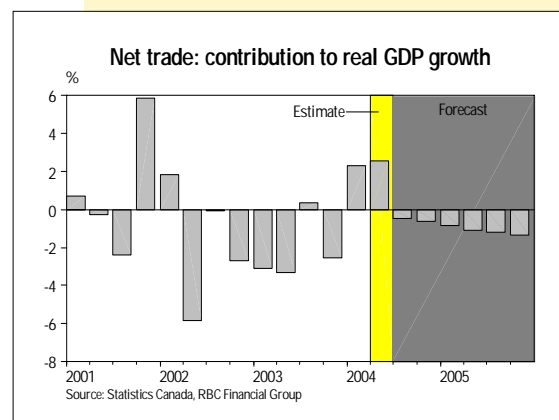
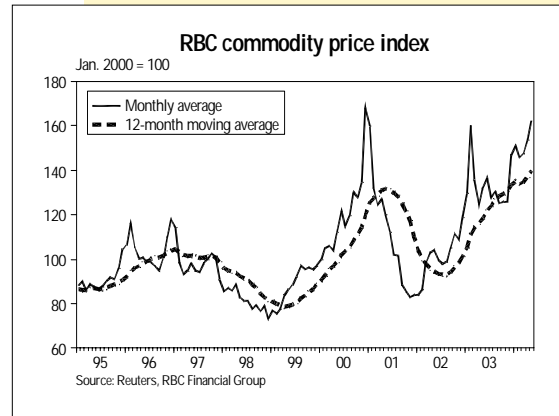
Net trade finally finds the back of the net

After the Canadian dollar appreciated about 20% in the 12 months from January 2003 to January 2004, predictions abounded that Canadian exporters were in for rough times. Certainly, some faced difficulty and even more saw profit margins shrink. For three out of four quarters in 2003, net trade was a drag on growth as exporters faced a period of adjustment to the sheer speed of the currency appreciation. Although we had highlighted how the positives from stronger U.S. demand would eventually dominate the negative exchange rate related price effects, we were still holding our collective breath in January as monthly merchandise trade flows took a beating.

By spring, however, the story shifted an abrupt 180 degrees. Months of strong U.S. growth finally hit Canada's trade numbers with a surge in export volumes making net trade a positive contributor to growth. Going forward, net trade will once again be a drag on growth as the U.S. economy slows to a more sustainable pace, Canadian growth drives up imports, and the Canadian dollar trends higher, but not nearly to the extent it was during the past three years because overall world demand is stronger and the exchange rate appreciation will not be as sharp as it was in 2003. The Canadian dollar is expected to end the year at \$0.77 US, and end 2005 at \$0.80 US.

Inventory story all in the details

The slowdown in Canada's headline first-quarter GDP growth to 2.4% from 3.3% in the fourth masks some decisive strength in the details. Not only did Canada's worst fears on the net trade side melt away with the spring thaw, but strong U.S. and world demand also allowed businesses to adjust inventories to more desirable levels. After adding \$12 billion in inventories in the fourth quarter of 2003, businesses added only \$1 billion in the first quarter of 2004. This slower pace of accumulation subtracted four percentage point from GDP growth. In the coming quarters, we will see stocks increase in line with sales. There is also a chance that, given tight supplies of raw materials, we will see some hoarding activity in the quarters ahead, further enhancing the positive impact on growth.



Domestic demand

The first quarter also saw impressive growth in Canadian domestic demand — that is, consumer spending and business investment. After a paltry gain of only 0.7% in last year's fourth quarter, real consumer expenditures rose 5.5% in this year's first quarter. We anticipate that the strength in durables spending will taper off to more sustainable rates of growth as the housing market cools off. However,

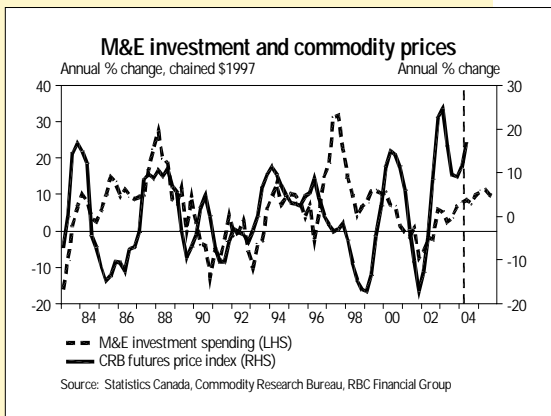
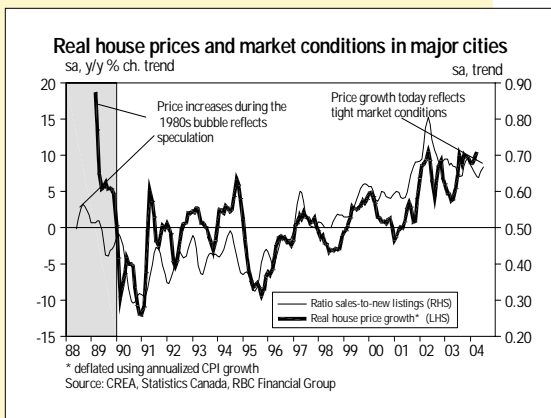
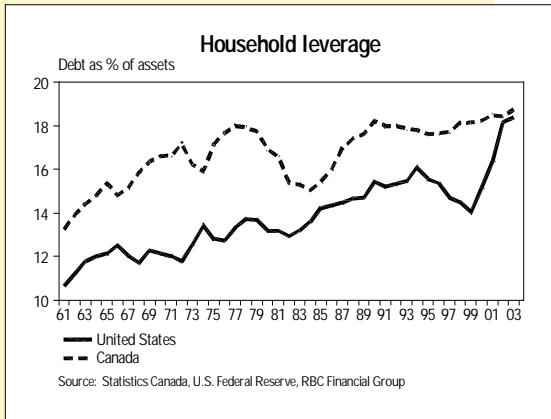
employment growth is now a supporting factor for consumers. More than 300,000 new full-time jobs have been created in the past 10 months, with 93,000 coming in April and May alone. Interest rates remain low and consumer confidence is high. A low savings rate is an area to monitor, but one that should not be overstated given solid household balance sheets.

The changing face of housing

The housing market provides one of the biggest question marks for the outlook because it has defied gravity for so long. We are already witnessing a shift in aggregate market dynamics pointing to a maturing market. Rising rental vacancy rates in a number of major markets along with declining population growth rates in the 25-39 age cohort point to a diminishing influence from first-time buyers. Protracted increases in new resale listings during the past few months suggest that home-buying activity is now being driven by move-up buyers, especially in large markets such as Toronto and Calgary. This group is looking to take advantage of the recent run-up in house prices to buy bigger homes or recreational properties. At the same time, multi-unit construction activity, while still going strong, largely reflects projects that were started one to two years ago. New condo activity is expected to taper off in most markets as builders have a tougher time making the economics work given a large supply of product on or soon to hit the market, a weakening rental market, dwindling investor interest and an exhaustion of the prime condo-buyer of recent years, the first time buyer.

Our residential construction outlook, which shows the combined impact of construction, renovation and resale activity, reflects our view that rising interest rates combined with maturing demand will hold down growth rates in the coming quarters, with some quarters in the outlook even seeing a decline in overall activity. Note, however, that the downside is limited given that builders, especially on the single family home side, have been prudent this time around and supply conditions remain tight. Slower demand will lead to less construction, but without the excess supply glut seen in the late 1980s — a relatively balanced market is expected during the next few years. As such, the modest 2.6% decline in residential investment expected in 2005 will pale in comparison to the double-digit declines seen in the post-bubble years of the early 1990s.

Outside of residential construction, business investment should continue to build up steam. As we have pointed out in the past, the cost of imported machinery and equipment has declined in U.S. dollar terms. More importantly, the near-term outlook for business profits remains healthy and profit expectations have improved, as recent hiring activity attests.



Inflation outlook — Monetary policy differs from U.S. path in 2004

Despite firm domestic demand and inspiring growth prospects, Canada faces a different monetary policy outlook than in the United States. Certainly, the next interest rate move by the Bank of Canada will be up, but the start date is expected to be later this fall and the full cycle of rate hikes will occur over a longer time horizon than is expected from the Fed. Inflation fundamentals provide the reason why the Bank of Canada can be patient. While excess capacity is quickly being absorbed in both the United States and Canada, household and business surveys show that inflation expectations remain muted in Canada compared to the United States. One reason is last year's currency appreciation and another is the low degree of pipeline inflation further down the supply chain compared to the United States. The recent uptick in Canada's core CPI has already faded, and all signs point to core inflation reaching the mid-point of the Bank of Canada's 1-3% target band only by late 2005. The prudent move in such a scenario will be a slow, measured pace of interest rate hikes.

U.S. economy firing on all cylinders

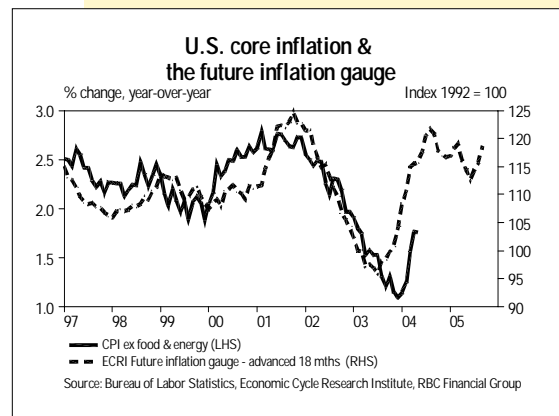
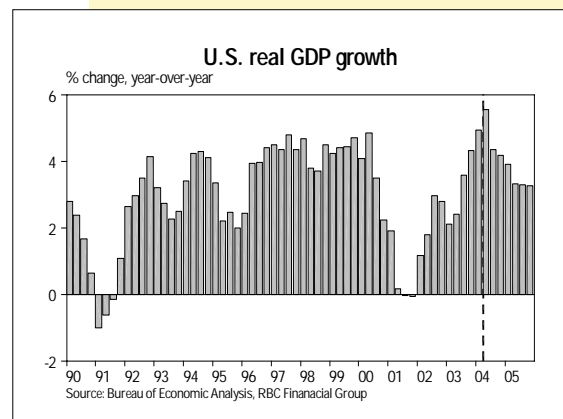
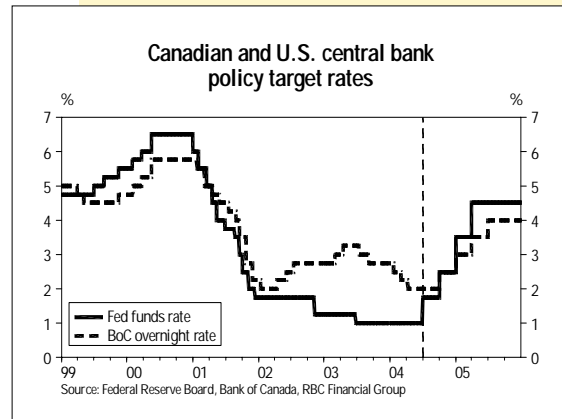
While growth is expected to moderate later this year as the pace of consumer spending tapers off, output and demand in the world's largest economic engine will remain vigorous. Meanwhile, the previously dormant labour market is now in a solid recovery, thereby helping to solidify the sustainability of the current economic expansion. Swelling cash positions have been partly responsible for prompting businesses to hire more forcefully. Indeed, cash holdings as a share of total non-financial corporate assets have jumped to recent highs thanks to surging corporate profits, which are, in turn, being supported by stronger sales, firmer pricing and stronger after-tax profit margins. But, businesses are also deploying their cash by stepping up investment spending, ramping up acquisitions and, most recently, growing inventories, which have been sitting at rock-bottom levels relative to sales during the past year. Growth is expected to average 4.8% this year, the fastest pace of growth in 20 years, before slowing to 3.5% next year.

Fed falls behind the curve

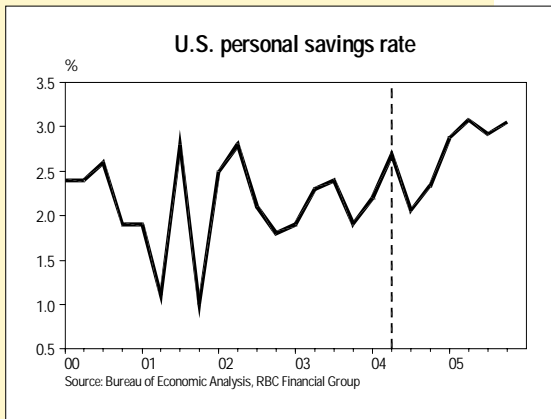
The growth spurt of the U.S. economy in the last 12-months has left the current stance of extremely loose monetary policy well behind the curve, especially amid mounting cost-push inflationary pressures. To be sure, with businesses regaining more pricing power, household inflation expectations have begun to creep higher, with core CPI inflation now poised to finish the year at 2.2%. With inflation expectations threatening to move higher, the Fed will need to be bold as it strives to move monetary policy to a neutral setting. As a result, we anticipate that the Fed will lift rates aggressively this year and next with the Fed funds rate expected to hit 4.50% by mid-2005.

Time to shore up consumer balance sheets

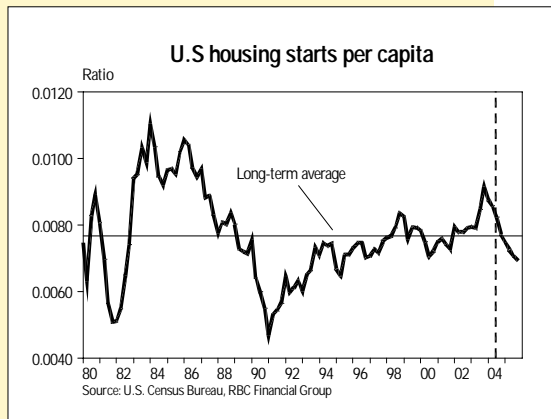
An improving job market will certainly give households the wherewithal to continue spending. Indeed, the increase in expected wage income should



sufficiently fill the void left by fading fiscal stimulus as real disposable income rises by nearly 4% this year and next. However, the main thrust for U.S. consumers will not be an acceleration of spending activity, especially following a period of strong expenditures during the past few years. Rather, consumers will concentrate on shoring up their household balance sheets during the second half of this year and into next. As such, the personal saving rate is expected to improve from 2.3% this year to 3.0% in 2005.

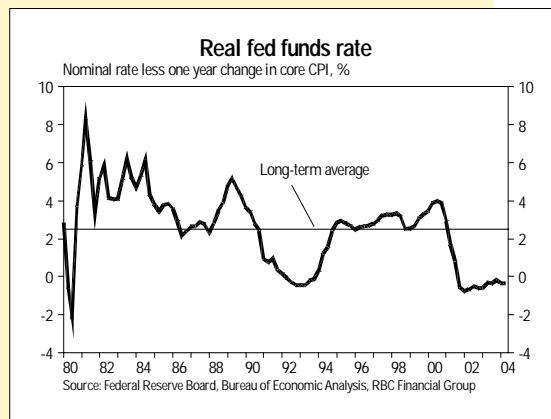


A slowing housing market will be the driver behind a more moderate pace of consumer spending. Overall housing activity has been running well ahead of its long-term trend predominately due to record-low mortgage rates and demographic influences. The long duration of this outsized pace of activity ultimately suggests that there will be more payback now that mortgage rates are heading higher. Thus, after posting an expected 1.856 million housing starts in 2004 thanks to strength in the early part of the year, housing starts are anticipated to tumble by 13% next year as housing's contribution to the economy begins to subtract from growth. Higher mortgage rates will also cool the rapid rise in house prices. Adjusted for inflation, house prices are increasing at their fastest pace since the 1970s. Excessive house price appreciation is a concern and some regional markets could be vulnerable to a more severe price correction. Nevertheless, given still relatively tight housing inventory levels, the correction will not pose a substantial threat to the overall economy.

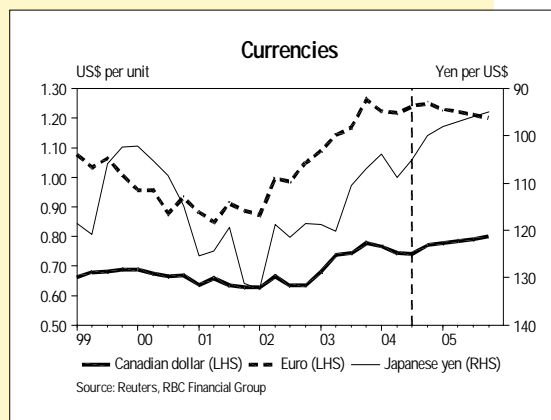


Risks to the outlook remain

Although the U.S. economy is off and running, there are still a number of risks hanging over the outlook. Certainly, the threat of renewed terrorist activity, should it re-emerge, could quickly stonewall confidence and derail economic momentum. History has also shown that substantial run-ups in oil prices have the potential to derail economic activity. But, it is worth noting that the risks associated with high oil prices today are tilted more heavily towards higher inflation with the economy operating at near full capacity, inflation expectations rising and monetary policy at still very accommodative levels



The inflation outlook is further complicated by the fact that the structural savings imbalances that led to the U.S. dollar's downfall in 2003 remain very much in place. While the private sector is saving enough to finance expenditures, state, local and federal governments are spending well beyond their means and running huge deficits. The dollar's fall since 2003 will promote net exports and savings going forward but will only put a slight dent in the current account deficit and the need to import foreign capital to finance the gap. Hence, the U.S. dollar remains poised to resume its downtrend, threatening inflation and interest rates to rise higher.





**Forecasts
Annual averages**

**FORECASTS OF THE ECONOMY
AND FINANCIAL MARKETS**

ECONOMIC FORECAST DETAIL



ANNUAL AVERAGES



ANNUAL AVERAGES

	2002 ACTUAL	2003 ACTUAL	2004 FORECAST	2005 FORECAST	2002 ACTUAL	2003 ACTUAL	2004 FORECAST	2005 FORECAST
Growth in the economy (% change after subtracting inflation)								
Consumer spending	3.4	3.1	3.7	3.9	3.4	3.1	3.8	3.1
Durables	8.3	2.0	4.3	5.0	6.5	7.4	4.4	2.0
Non-durables	2.3	2.1	2.5	3.2	3.0	3.8	4.4	3.0
Services	2.6	3.9	3.8	4.0	3.0	2.0	3.4	3.4
Business investment	1.4	4.6	6.6	5.5	-3.7	4.4	7.5	3.7
Residential construction	14.5	7.5	6.6	-2.6	4.9	7.5	4.8	-5.1
Non-residential structures	-8.3	1.0	2.8	7.9	-18.4	-4.6	-0.1	5.7
Machinery & equipment	-1.2	4.5	8.4	10.1	-2.8	5.5	11.8	8.8
Government spending	2.8	3.8	2.2	3.2	3.8	3.4	2.5	1.6
External trade								
Exports of goods & services	1.1	-2.4	6.2	4.4	-2.4	2.0	8.9	8.6
Imports of goods & services	1.4	3.8	5.9	6.5	3.3	4.0	7.4	4.8
Inventories (change in \$billions)	2.1	11.9	1.1	4.5	5.7	-0.8	66.0	92.0
Real gross domestic product	3.4	2.0	3.2	3.6	2.2	3.1	4.8	3.5
Balance of payments (\$ billions)								
Current account balance	22.7	23.8	37.8	33.3	-480.9	-541.8	-599.6	-604.9
% of GDP	2.0	2.0	2.9	2.5	-4.6	-4.9	-5.1	-4.9
Balance on goods	56.4	57.5	74.1	69.9	-492.6	-557.9	-614.2	-628.5
% of GDP	4.9	4.8	5.8	5.2	-4.7	-5.1	-5.2	-5.1
Inflation (% change)								
Consumer price index	2.2	2.8	1.7	1.9	1.6	2.3	2.5	2.6
Core consumer price index (CPIX for Canada)	2.4	2.2	1.5	1.8	2.3	1.5	1.8	2.4
Price deflator for GDP	1.0	3.2	2.5	1.3	1.5	1.7	1.9	2.1



ANNUAL AVERAGES

2002 ACTUAL 2003 ACTUAL 2004 FORECAST 2005 FORECAST



ANNUAL AVERAGES

2002 ACTUAL 2003 ACTUAL 2004 FORECAST 2005 FORECAST

Labour market (% change)

People available for employment	2.7	2.2	1.3	1.9	0.8	1.1	0.6	1.9
People employed	2.2	2.2	1.8	2.2	-1.1	-0.3	1.3	2.4
Unemployment rate (%)	7.7	7.6	7.2	7.0	5.8	6.0	5.5	5.3
Wages & salaries / employed person	1.7	1.4	2.1	3.8	2.4	3.3	4.3	5.0
Labour productivity	1.2	-0.1	1.3	1.4	3.4	3.4	3.4	1.0

The consumer

Real personal disposable income	1.7	1.4	2.3	3.5	3.8	2.7	3.8	3.8
Personal saving rate (%)	3.2	1.4	0.0	-0.3	2.3	2.1	2.3	3.0
Housing starts (millions)	0.21	0.22	0.21	0.20	1.71	1.85	1.86	1.62
Motor vehicle sales (millions)	1.73	1.63	1.60	1.63	17.1	17.0	16.7	16.7

Corporate profits (% change)

Domestic profits before tax	8.6	10.0	12.6	-4.1	7.0	15.1	14.0	13.2
Profits as a % of GDP	11.9	12.4	13.2	12.1	7.0	7.7	8.2	8.8

Fiscal indicators (% of GDP on a National Accounts basis)

Federal budget balance	0.8	0.4	0.5	0.9	-2.3	-3.8	-3.7	-3.3
Net foreign liabilities	17.6	17.9	15.1	11.8	24.9	28.3	31.1	34.1

Interest rates and exchange rates (year-end %)

90-day T-bills	2.66	2.57	2.50	4.00	1.20	0.93	2.50	4.50
Government bonds (5-year)	3.96	3.91	4.80	5.60	2.78	3.25	5.00	5.80
Government bonds (10-year)	4.79	4.66	5.50	6.00	3.83	4.27	5.60	6.00
Exchange rate (C\$ in US\$)	-	-	-	-	0.634	0.771	0.769	0.800



**Forecasts
Fourth-over-fourth
quarter**

**FORECASTS OF THE ECONOMY
AND FINANCIAL MARKETS**



FOURTH-OVER-FOURTH QUARTER

2002 2003 2004 2005
ACTUAL ACTUAL FORECAST FORECAST



FOURTH-OVER-FOURTH QUARTER

2002 2003 2004 2005
ACTUAL ACTUAL FORECAST FORECAST

Growth in the economy

(% change after subtracting inflation)

	2002 ACTUAL	2003 ACTUAL	2004 FORECAST	2005 FORECAST	2002 ACTUAL	2003 ACTUAL	2004 FORECAST	2005 FORECAST
Consumer spending	3.6	2.8	4.3	3.8	2.7	4.0	3.2	3.3
Durables	5.4	-1.6	9.3	3.2	1.8	11.1	0.8	2.5
Non-durables	3.6	1.4	3.0	3.7	2.8	4.9	3.4	3.3
Services	3.2	4.7	3.3	4.2	2.9	2.2	3.6	3.5
Business investment	3.5	6.8	5.2	6.3	0.2	8.1	5.6	2.9
Residential construction	12.2	8.3	-0.5	0.9	7.1	9.5	-0.9	-5.3
Non-residential structures	-9.9	4.9	4.2	8.7	-14.9	-0.9	2.1	5.9
Machinery & equipment	5.9	6.7	9.8	8.7	1.6	10.0	11.1	7.2
Government spending	3.2	3.5	2.2	3.4	4.5	2.1	2.8	1.1
External trade								
Exports of goods & services	2.0	-0.8	7.3	3.4	3.3	6.4	6.8	9.5
Imports of goods & services	7.1	5.0	5.3	6.6	9.4	4.5	5.7	4.5
Inventories (change in \$billions)	11.3	12.2	3.3	5.0	21.5	9.0	83.7	82.3
Real gross domestic product	3.8	1.7	4.0	3.2	2.8	4.3	4.2	3.3

Balance of payments (\$ billions)

	2002 ACTUAL	2003 ACTUAL	2004 FORECAST	2005 FORECAST	2002 ACTUAL	2003 ACTUAL	2004 FORECAST	2005 FORECAST
Current account balance	13.6	26.6	35.8	31.8	-514.3	-510.2	-612.5	-593.6
% of GDP	1.1	2.2	2.7	2.3	-4.8	-4.5	-5.1	-4.7
Balance on goods	53.1	55.5	72.6	67.1	-542.5	-566.7	-623.5	-634.0
% of GDP	4.5	4.6	5.6	4.9	-5.1	-5.0	-5.2	-5.0

Inflation (% change)

	2002 ACTUAL	2003 ACTUAL	2004 FORECAST	2005 FORECAST	2002 ACTUAL	2003 ACTUAL	2004 FORECAST	2005 FORECAST
Consumer price index	3.8	1.7	2.0	2.0	2.2	1.9	2.8	2.5
Core consumer price index (CPIX for Canada)	2.8	1.9	1.5	2.0	2.0	1.2	2.2	2.5
Price deflator for GDP	4.1	2.2	2.7	1.1	1.4	1.6	2.0	2.5



FOURTH-OVER-FOURTH QUARTER



FOURTH-OVER-FOURTH QUARTER

	2002 ACTUAL	2003 ACTUAL	2004 FORECAST	2005 FORECAST	2002 ACTUAL	2003 ACTUAL	2004 FORECAST	2005 FORECAST
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Labour market (% change)

People available for employment	3.3	1.7	1.3	2.0	0.7	1.2	0.9	2.0
People employed	3.4	1.7	1.8	2.2	-0.5	-0.2	2.2	2.3
Unemployment rate (%)	7.6	7.5	7.1	6.9	5.9	5.9	5.5	5.2
Wages & salaries / employed person	1.5	1.1	3.1	4.0	2.3	4.2	4.1	5.9
Labour productivity	0.5	-0.1	2.2	1.0	3.3	4.5	1.9	1.0

The consumer

Real personal disposable income	0.8	2.1	2.5	3.8	3.5	3.8	3.5	4.1
Personal saving rate (%)	2.0	1.3	-0.4	-0.4	1.8	1.9	2.3	3.1
Housing starts (millions)	0.211	0.226	0.195	0.195	1.73	2.03	1.73	1.57
Motor vehicle sales (millions)	1.76	1.53	1.64	1.62	16.9	17.2	16.4	16.7

Corporate profits (% change)

Domestic profits before tax	34.6	5.2	11.1	-6.8	23.3	20.6	4.1	10.5
Profits as a % of GDP	12.3	12.5	13.0	11.6	7.4	8.4	8.3	8.6

Fiscal indicators (% of GDP on a National Accounts basis)

Federal budget balance	1.2	0.8	0.9	0.8	-2.8	-3.7	-3.4	-3.2
Net foreign liabilities	15.5	16.7	13.8	10.8	26.2	29.4	32.2	35.1

Interest rates and exchange rates (year-end %)

90-day T-bills	2.66	2.57	2.50	4.00	1.20	0.93	2.50	4.50
Government bonds (5-year)	3.96	3.91	4.80	5.60	2.78	3.25	5.00	5.80
Government bonds (10-year)	4.79	4.66	5.50	6.00	3.83	4.27	5.60	6.00
Exchange rate (C\$ in US\$)	-	-	-	-	0.634	0.771	0.769	0.800