CIBC World Markets

STRATEGECON

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Economics & Strategy

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"Once the sleepy little resource backwater of the North American economy, Canada is turning the tables on its big brother in a hurry."

Reversal of Fortune

by Jeff Rubin

What a difference a decade can make. Turn the clock back a few years and most Canadians were looking wistfully across the border at the prosperity of their American neighbors. Seldom had America looked stronger and seldom had Canada been more in its shadow. The American economy, the cradle of the IT revolution, was nothing less than a technological dynamo that was single handedly driving nearly 30% of global GDP growth. Compared to American technology assets in Silicon Valley, Canada's resource based economy had that rust belt look of a place whose time had long past.

But that was when economic value-added resided in technological innovation. It didn't take long for today's global economy to commoditize technology and squeeze out the value-added through cost arbitrage, just as it has done so successfully in manufacturing. In the process, value-added migrated from the technology sector back to where it had for so long before resided—under the ground. Today, it lies not in integrated circuits or fibre optics, but in good old fashioned resource rents. Unlike technology, resource rents cannot be arbitraged by moving production to its lowest cost point. Instead resource rents must be extracted where the resource is found. And so much of those rents, particularly from energy, are found under Canadian soil.

As resource prices soar and technology prices plunge, the huge shift in the terms of trade has turned the US economy from the world's engine of growth to its Achilles heel. Contagion in world credit markets isn't emanating from a Russian or Mexican default, but from a default by homeowners deep inside the American heartland.

Nowhere is the stunning reversal of fortune between Canada and the US more apparent than in the exchange rate. Already at a three decade high, the loonie is a heartbeat away from parity against the once almighty US dollar. The 60% appreciation since the 61.8 cent low five and a half years ago represents its most rapid climb on record. Is a premium against the greenback just around the corner?

If the strength of the Canadian dollar is testament to the country's new found wealth, so is the performance of the TSX, where a 45% weighting in energy and materials gives resource rents lots of traction. Over the last four years those two sectors more than any others have driven TSX returns past those from the S&P 500. Look for that gap to diverge even further over the next 12 months.

Whether it's the exchange rate, the stock market, or housing prices, asset markets are all painting the same picture. Canada is getting richer relative to the US. Ultimately that's about the economy. With the developing world, not the US, driving global resource demand, the umbilical cord that has always connected the Canadian economy to the much larger American market is about to be severed (see pages 10-11).

Once the sleepy little resource backwater of the North American economy, Canada is turning the tables on its big brother in a hurry.

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MARKET CALL

- A downward revision to the US employment picture, coupled with the still-present credit squeeze, added significant risks that America's housing recession would stall the broader economy. The Fed's first 50 bps of easing improved financial market sentiment, but tepid GDP growth over the balance of the year will open the door to as much as two further quarter point cuts, in what would still be only a typical mid-cycle easing.

- The Bank of Canada can rest on its laurels, counting on the US slowdown, C$ appreciation, and higher credit spreads to ease growth in an economy that was too hot for its liking through the first half. Unless the C$ shoots dramatically through parity, which is a growing risk to our forecast, it won't be inclined to follow the Fed's lead towards lower rates.

- Treasury yields have already priced in further easing, and the long end could lose as much from the end of the flight to safety bid as it gains from lower rates at the short end. The Canadian bond market looks to be generally range-bound, given an on-hold central bank, though the front end of the government curve will see some upward pressure from an easing in credit concerns on competing private sector issues.

INTEREST & FOREIGN EXCHANGE RATES

		2007		2008			
END OF PERIOD:		**19-Sep**	**Dec**	**Mar**	**Jun**	**Sep**	**Dec**
CDA	Call loan (mid-point of range)	4.50	4.50	4.50	4.50	4.50	4.50
	98-Day Treasury Bills	4.07	4.25	4.30	4.40	4.40	4.45
	Chartered Bank Prime	6.25	6.25	6.25	6.25	6.25	6.25
	2-Year Gov't Bond (3.75% 06/09)	4.25	4.35	4.40	4.40	4.45	4.50
	10-Year Gov't Bond (4% 06/17)	4.41	4.45	4.50	4.55	4.50	4.65
	30-Year Gov't Bond (5.75% 06/33)	4.48	4.50	4.55	4.55	4.50	4.60
U.S.	Federal Funds Target	4.75	4.25	4.25	4.25	4.25	4.50
	91-Day Treasury Bills	3.91	3.95	4.00	4.05	4.20	4.40
	2-Year Gov't Note (4% 08/09)	4.00	3.95	4.15	4.50	4.55	4.60
	10-Year Gov't Note (4.75% 08/17)	4.55	4.40	4.55	4.65	4.70	4.75
	30-Year Gov't Bond (5% 05/37)	4.84	4.80	4.85	4.90	4.95	4.95
Canada - US T-Bill Spread		0.17	0.30	0.30	0.35	0.20	0.05
Canada - US 10-Year Bond Spread		-0.14	0.05	-0.05	-0.10	-0.20	-0.10
Canada Yield Curve (30-Year — 2-Year)		0.23	0.15	0.15	0.15	0.05	0.10
US Yield Curve (30-Year — 2-Year)		0.84	0.85	0.70	0.40	0.40	0.35
EXCHANGE RATES	— (US¢/C$)	98.5	100.0	100.0	96.2	95.2	94.3
	— (C$/US$)	1.015	1.000	1.000	1.040	1.050	1.060
	— (Yen/US$)	116	120	118	115	114	113
	— (US$/euro)	1.40	1.40	1.37	1.33	1.33	1.33
	— (US$/pound)	2.00	2.00	1.97	1.92	1.92	1.92
	— (US¢/A$)	85.7	86.0	85.0	82.0	82.0	80.5

STRATEGY AND EARNINGS OUTLOOK

- Further Fed rate cuts and the effect of robust global growth on the TSX's all important resource groups mean US subprime contagion is unlikely to derail the bull market in Canadian stocks. Credit woes are likely to continue but asset prices have now built in a more than adequate cushion against further bad news (pages 4–7). While attaining our 15,000 year-end target could be a challenge, we expect the TSX to test that level within the next six months. A 13% rise in operating earnings should see the rally extend into 2008, with the TSX ending the year at the 16,200 mark.

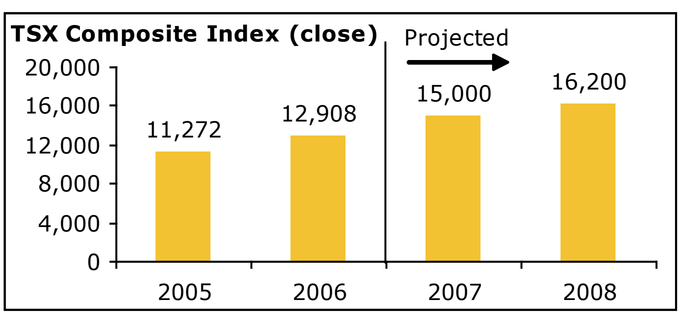
- While all of that warrants maintaining our 12%-pt equity overweight at the expense of bonds and cash, we fine tuned our recommendations for a number of individual equity sectors. The recent global collapse in private equity financings will hit the TSX telecom and media sectors the hardest, given the concentration of past deals in those sectors. Base metals stocks, thrashed as much as 25% in the selloff, now look oversold. We also added a half point of weighting to non-bank financials. Canadian insurance companies, with their large overseas operations, are well-positioned to benefit from growing opportunities in underinsured emerging markets. REITs should draw support from a strong Canadian commercial property market.

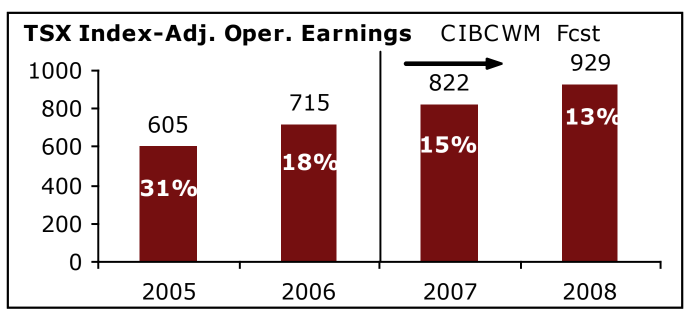
ASSET MIX (%)	Benchmark	Strategy Recommendation
Stocks	**56**	**68**
Bonds	38	27
Cash	6	5
GICS SECTOR EQUITIES (%)		
Consumer Discretionary	5.2	3.7
Consumer Staples	2.6	1.6
Energy	**27.0**	**31.0**
Financials	**30.8**	**31.3**
-Banks	17.2	17.2
-Insur., REITs, oth.	**13.6**	**14.1**
Healthcare	0.6	0.6
Industrials	5.6	4.6
Info Tech	4.3	2.3
Materials	**16.6**	**18.6**
-Gold	**5.4**	**5.9**
-Other Metals	**7.6**	**9.1**
Telecom	5.8	4.8
Utilities	1.5	1.5

Note: Bold indicates recommended overweight.

TSX - Earnings Outlook & Forward PE

	Operating Earnings (% chg)			4-qtr Fwd PE	
	2005	2006	2007	Latest	Last 10 yrs.
Energy	54.5	3.7	20.7	14.1	13.0
Materials	21.3	93.3	19.4	17.3	27.5
Industrials	23.6	6.6	13.4	15.6	15.6
Consumer Discretionary	4.5	8.2	7.0	19.4	18.6
Consumer Staples	1.3	-1.9	1.5	16.9	17.0
Health Care	-0.7	12.6	-31.3	19.5	49.7
Financials	12.8	18.3	13.4	12.7	10.9
Info Tech	260.9	-52.1	25.2	35.3	32.3
Telecom Svcs	2.1	34.7	12.7	15.8	34.7
Utilities	10.4	15.2	-10.0	16.6	13.9
TSX Composite	**31.2**	**18.1**	**15.0**	**15.0**	**17.9**





US Subprime—Has the Correction Gone Too Far?

Benjamin Tal

It's far from over. The news from the US subprime space will get much worse in the coming year, with default rates surging to unprecedented levels. But what really counts for the market is how much of this bad news is already reflected in current prices. It turns out that not only did the barrage of negative headlines of recent months raise the level of market immunity to adverse subprime news, but in fact, even after its recent improvement, the mortgage-backed market is currently pricing in a darker picture than the one likely to emerge when the smoke clears.

Subprime Defaults—You Ain't Seen Nothing Yet

While the credit squeeze extended well beyond subprime, the reality is that, at its core, this is a subprime crisis. And the news coming from that space will continue to dominate markets.

So let's see what's in the pipeline. The process of mortgage rate resets—the catalyst of the subprime meltdown—is far from over. Interest rates on roughly $700 billion worth of mortgages are due to be adjusted upward by the end of 2008. The number of reset mortgages will reach its peak late this year and will start easing slowly during the course of 2008. More than three-quarters of those mortgages are securitized, and more than 70% of them are subprime (Chart 1).

That picture is well understood. But what matters is not just the direction of the default rate, but its ultimate magnitude. There is enough information in the pipeline to allow us to form an educated guess regarding the likely trajectory of subprime defaults in the coming years.

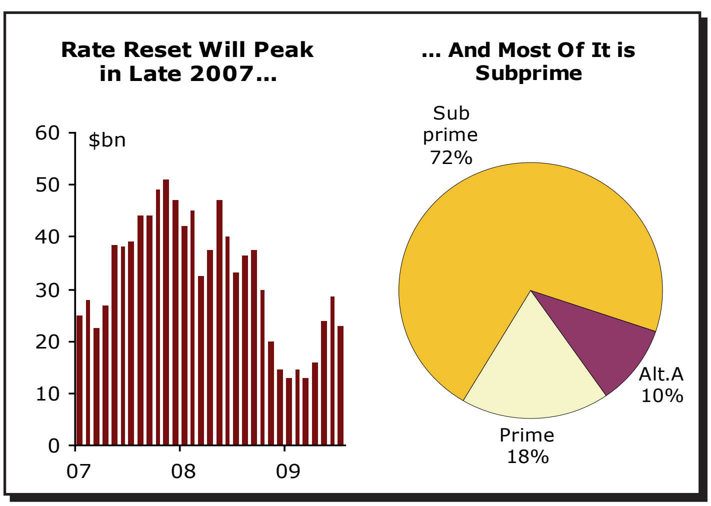
Bad Loans Getting Worse

Since the vast majority of the subprime mortgages taken since 2004 were originated with a teaser rate that is fixed for two years, the mortgages now being reset and those that will be reset in 2008 are the ones that were originated in 2005 and 2006. And as illustrated in Chart 2, the quality of those mortgages has deteriorated with every passing vintage year. The risk distribution of adjustable rate mortgages taken in 2006 (to be reset in 2008) is much less favorable than the 2005 vintage which, in turn, is worse than the 2004 vintage.

Not only was the quality of the newest mortgages inferior, but refinancing them ahead of the reset deadline is becoming increasingly difficult. For the 2004 and 2005 vintages, no less than 60% of subprime borrowers were able to refinance out of the pool around the reset period (Chart 3). That's no longer the case. Subprime borrowers of the 2006 vintage increasingly find themselves locked out of refinancing, with mortgages issued in the first half of 2006 and now approaching 22-24 months not yet

Chart 1

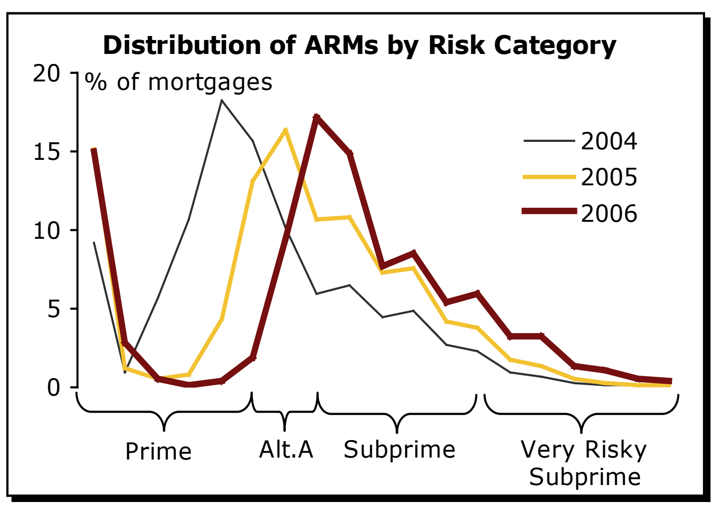
Mortgage Outstanding To Be Reset



Source: Loan Performance, CIBCWM

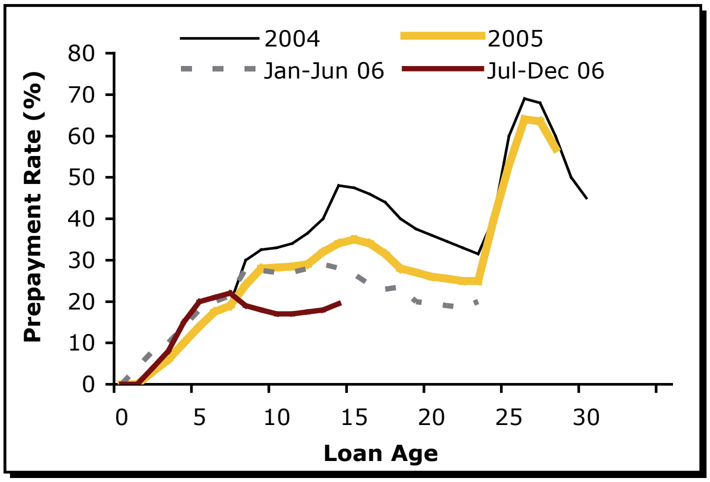
Chart 2

Risk Profile Rising with Vintage Year



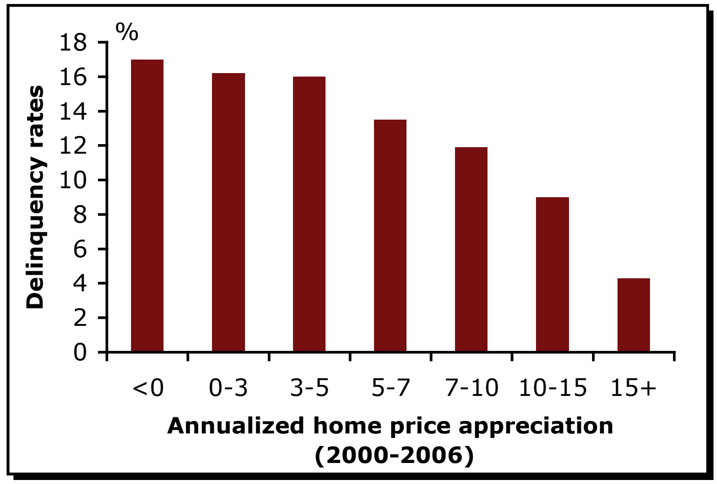
Source: First American Corelogic, CIBCWM

Chart 3
Prepayments—Less of An Option for Most Recent Vintages



Source: Loan Performance, Intex, Barclays Capital, CIBCWM

Chart 5
Delinquencies Rise Where Home Values Don't



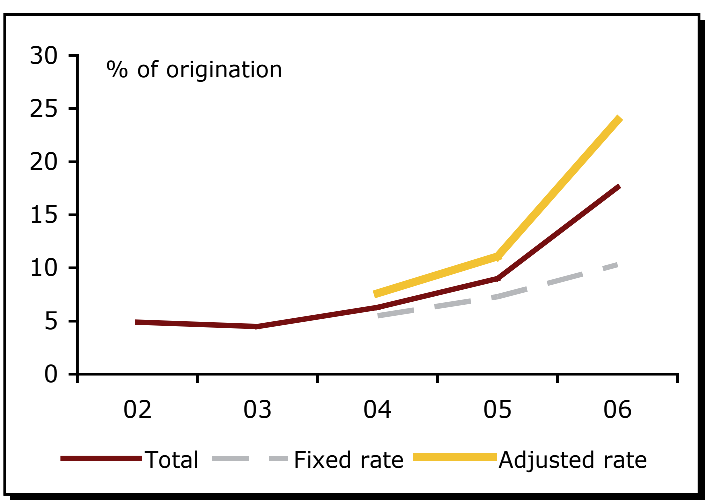
Source: Loan Performance, MBA

showing any notable pick-up in prepayment activity. And for every additional borrower staying in the pool and facing a huge rate jump, the probability of default rises.

Negative Equity

What's more, while previous vintages were able to enjoy some appreciation in home values, the 2006 vintage has experienced mostly flat to declining house prices. Given that most of those mortgages were taken with little to no money down, it is hardly a surprise that no less than one-quarter of adjustable rate mortgages originated in 2006 are now in a negative equity position (Chart 4). And

Chart 4
Negative Equity—By Year of Origination



Source: First American Corelogic, Loan Performance, CIBCWM

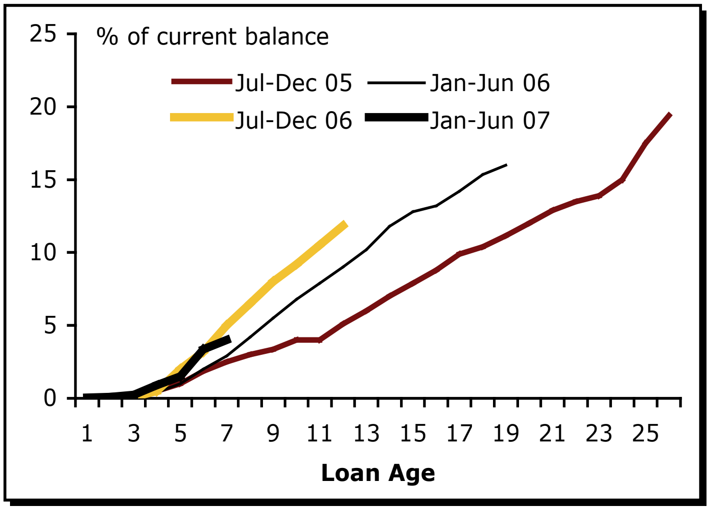
that's with house prices falling by only 3% on a year-over-year basis. An additional 10% drop in prices will take the negative equity rate to a dazzling 40% of originations. Falling prices and rising negative equity positions is a sure recipe for increased defaults. Indeed, default rates are notably higher among properties that experienced falling prices or limited price appreciation (Chart 5).

Having said that, movements in national house prices are of limited use when it comes to evaluating default in the subprime space, since the geographical distribution of subprime loans is hardly uniform. In fact, close to 40% of recent subprime exposure is concentrated across only six metropolitan areas, with Los Angeles ahead of the pack, followed by San Francisco, New York, Chicago, Washington and Miami. Accordingly, any house price projections regarding subprime defaults should account for this bias by applying appropriate weights based on subprime exposure by city/state.

Subprime Defaults on the 2006 Vintage Will Reach Record High

So the picture that emerges is that 2006 is, by far, the worst vintage due to poor underwriting, reduced prepayment activity and weaker home price appreciation. And as illustrated in Chart 6, this reality is already reflected in the trajectory of delinquency rates of that vintage compared to 2005. Note also that mortgages originated in the first six months of 2007 are now performing as badly as those that were originated in the second half of 2006, as

Chart 6
Subprime Mortgage in Severe Delinquencies



Source: Loan Performance, Intex, CIBCWM

mortgage providers were slow to react to the changing subprime environment. Look for the performance of mortgages issued in the second half of 2007 to improve dramatically.

Many of the losses on the vintages covering the 18 months to June 2007 are front-loaded. Early payment default rates on these vintages have reached record-highs and are more than twice as high compared to the 2005 vintage. Important factors behind this trend are the surge in second lien mortgages, which usually experience high early payment default rates, and a significant jump in mortgage fraud. In fact, based on recent estimates[1], as much as 70% of early payment defaults may be linked to misrepresentation of the original loan application. This is a clear reflection of the deterioration in underwriting standards and passing on the risks seen in 2006 and early 2007.

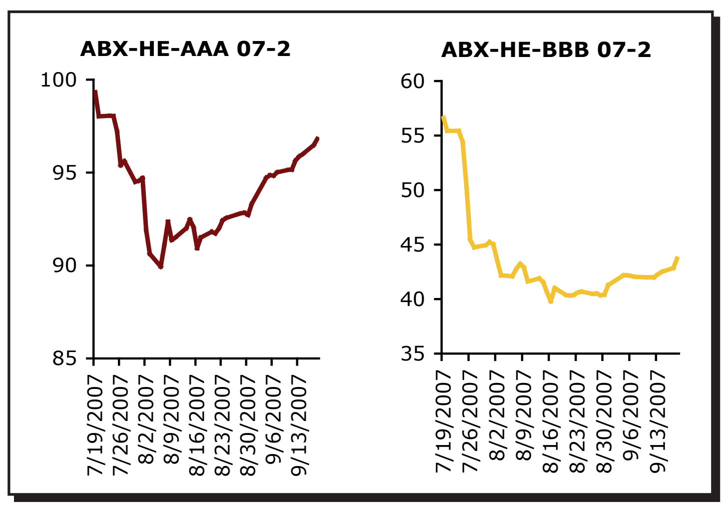
Based on this information and our main case macro scenario[2], we predict that the cumulative default rate on subprime mortgages for the 2006 and early 2007 vintages will reach 25% with the loss rate averaging just over 12%. To put things in perspective, this outcome is 35% worse than the losses seen in the 2000 vintage loans from Michigan, Indiana and Ohio—the worst performing vintage and geographic locations to date, and roughly in line with the performance of the 99th percentile of regional default rates in the recessionary vintage of 2000-2001.

What's Priced In?

That's what we believe to be the most likely scenario. But what does the market think? The closely watched ABX subprime-linked default swap indices can be used to derive the implied probability of default on the underlying pool of debt in the MBS market. The indices are constructed as equally weighted baskets of credit default swaps for tranches with different credit ratings of 20 underlining subprime MBS. Indices linked to "on-the-run" AAA and AA rated subprime tranches are down by 4.2% and 11.5% respectively since mid-July, while the BBB and BBB- indices now pay less than 45 cents to the dollar (Chart 7).

But those prices also tell us something about the implied probability of default for subprime transactions. Market spreads for bond classes within the same transaction can be used to calculate the likelihood of default on the underlying collateral. And since there are typically multiple bonds within each transaction, there are multiple data points on which to extract a distribution and therefore the likelihood of defaults[3].

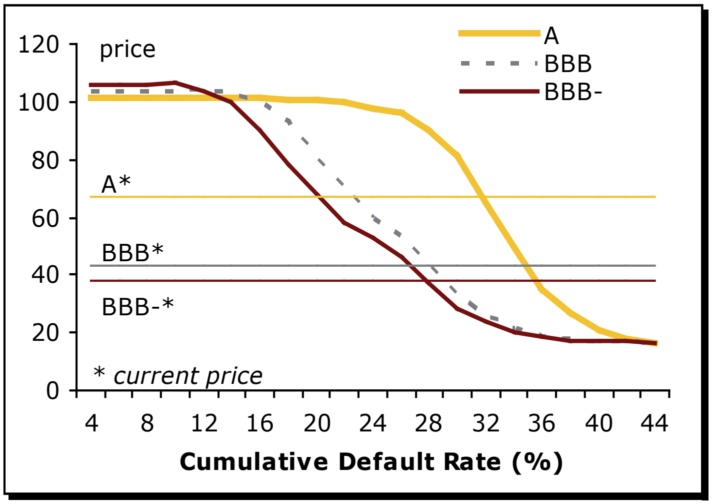
Chart 7
Subprime Credit Default Swap— Enough of a Correction?



Source: Markit

Based on information obtained from various sources[4] we calculated the market implied default rate for a given ABX price. Since the lower-rated tranches absorb the first losses from defaults, leaving the higher rated tranches unscathed, their price is the first to react to any increase in defaults on the underlying collateral. This is illustrated in Chart 8 which maps the price profile of the bonds

Chart 8
Performance Profile (Average ABX 062-071)

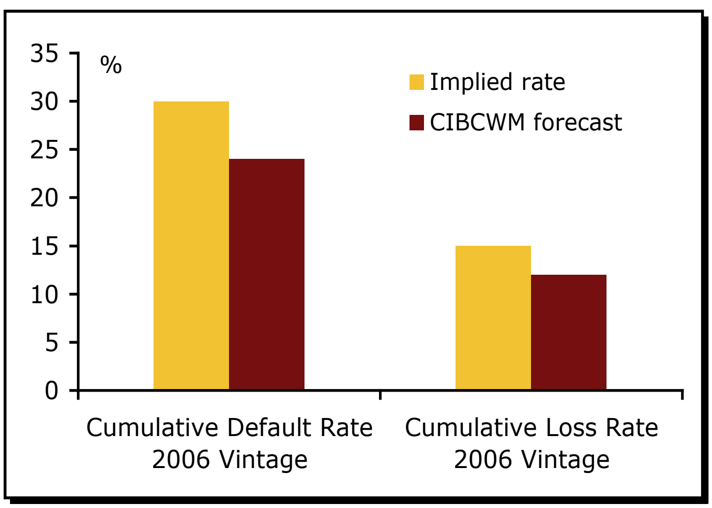


CIBCWM calculations based on Markit, Barclays Capital, Credit Suisse and Andrew Davidson & Co, Inc

making up the A, BBB and BBB- indices for the 2006 vintage. Note that higher rated bonds can withstand a higher level of collateral loss before experiencing write-downs.

Current ABX prices suggest cumulative default rates ranging between 28% for the BBB- rated tranche and 32% for the A rated tranche—for a weighted average of close to 30%. Those implied default rates are roughly 20% higher than our projection (Chart 9)—suggesting that the market is currently pricing in a much more draconian outcome than our main case scenario suggests.

Chart 9
Markets Could Be Pricing In Too Much Bad News



There is no such thing as a bad loan, only bad pricing. And our assessment is that US subprime debt is mispriced by roughly 20%—with higher rated tranches being mispriced the most. This means opportunities not only in the ABX space but also for the MBS and equity markets as a whole, as the subprime default rate will not jump high enough to clear the bar set by the market.

Note:

1. *Source: BasePoint Analytics.*
2. *See our forecast section on page 12. We assume an average prepayment rate of 20% and a cumulative 10% decline in subprime-weighted house prices over the next 4 years.*
3. *For more information, see for example "A Framework for Market — Implied Defaults". Andrew Davidson & Co., Inc. March 2006.*
4. *Data sources: Andrew Davidson & Co, Inc. First American CoreLogic, Markit, Barclays Capital, Credit Suisse and JP Morgan. Results for the 2006-02 vintage were calculated based on Andrew Davidson and results for the 2007-01 vintage were derived based on input from the other sources. We assumed a 50% loan severity rate in estimating recoveries.*

Canadian Banks: Short Term Pain, Long Term Gain

Avery Shenfeld

Canadian banking stocks didn't fully escape financial market fears over credit quality. Much of that impact was already captured in Q3 earnings reports, but near term pressures have us currently recommending only a neutral weighting on bank equities. Further out, improved margins after a re-pricing of risk, a greater share of credit activity running through the banks, and reinvigorated growth following Fed rate cuts, suggest a longer term buying opportunity.

Near-Term Squeeze

Since August, a sharp rise in risk aversion globally has spread to Canada. Although bank analysts' earnings expectations have been marked down, they may be hesitant to fully adjust given their earlier misses on the low side of actual earnings

Funding costs through 3-month BA's have risen sharply, despite treasury bill rates falling on a flight to safety bid (Chart 1). There is roughly $60 bn of BA's outstanding, so even a 50 bp rise would add only $300 mn to funding costs across all banks if sustained for a full year, and nearly all of that will be passed through to borrowers. But there are other, broader implications.

US data, available on a more timely basis than for Canada, show commercial paper outstandings dropping like a stone in recent weeks. Yields on asset backed CP, have risen sharply, reducing the economics of that funding vehicle. As more financing worldwide is done through the banks directly, banks are rushing to issue term debt to raise the required capital. The troubles in Canada's ABCP market are centered on non-bank conduits. Banks are continuing to fund their conduits, but as in the US, yields on bank ABCP have risen sharply. As a result of the anticipated shift to direct bank financing, and also in response to providing their conduits with "global style liquidity" to support their status in the market, Canadian banks are joining others in becoming more active in term debt issuance.

Coupled with a general widening of corporate spreads in the bond market, that has put pressure on bank term debt. A typical 5-year bank bond now swaps back to a floating rate at more than 40 bps above 3-month BA's (Chart 2), up roughly 30 bps from where it stood ahead of the credit crunch, and representing an additional funding cost on top of the spike in BA rates. Higher term debt funding costs could in turn push banks into being more aggressive in competing for wholesale and retail deposits by offering higher yields.

In the corporate world, that funding pressure is passed on to borrowers who have floating rate debt linked to CDOR. Debt originators who sold assets into bank sponsored conduits also bear a burden as their take from the waterfall of payments on the assets is reduced as funding costs rise. While margins are ultimately protected, business volumes will be hurt by the economic impacts

Chart 1

Canadian BA–T-Bill Spread Widens

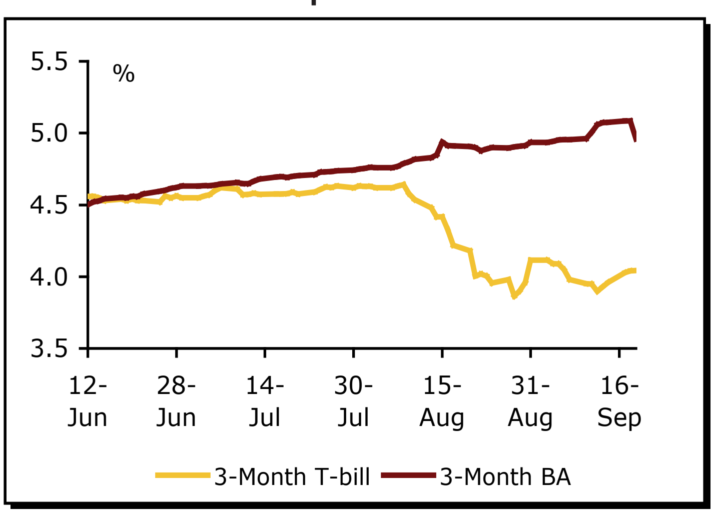
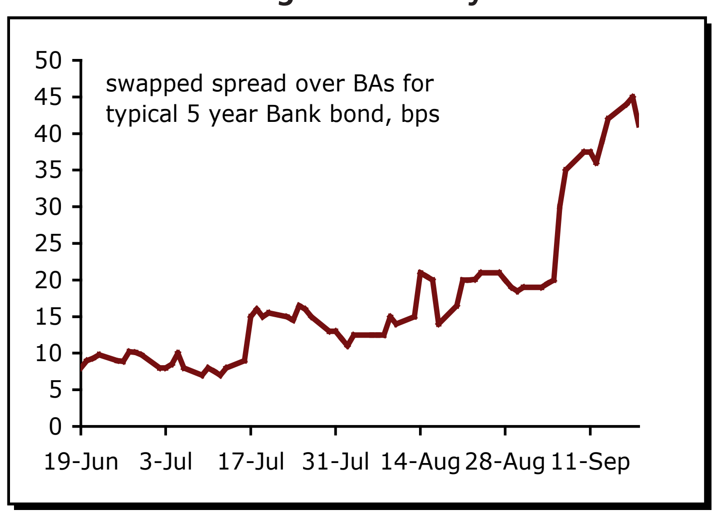


Chart 2

Bank Term Funding More Costly



of higher rates in terms of the demand for loans, leases and other forms of credit. That said, much of the same hit would otherwise have been felt by an additional Bank of Canada rate hike that, had it not been for the credit crunch, would have been delivered in August.

In retail banking, some of the floating rate debt (e.g. adjustable mortgages) is tied to the prime rate. The BA-prime spread is now at less than 130 bps, its tightest since 1999 (Chart 3). Prior to 1996, the prime rate, which is at the discretion of the banks, might have increased as banks passed on the higher effective funding costs. Since then, prime has moved only in lock step with the Bank of Canada's target rate, so it would take a break out from that holding pattern or a change in spreads vs. prime to restore interest margins on retail lending.

The credit squeeze is also likely to show up in reduced capital markets activity, as projects that can't survive the higher funding costs get pushed aside. Globally, stalled deals to fund leveraged buyouts have put a temporary kibosh on new private equity M&A deal announcements, which dropped by some 80% in August from the year-to-date average. Equity underwriters are also likely to be less active, though government issues are in high demand.

The other source of near-term earnings risk is on mark-to-market adjustments to the bank's own portfolios. The recovery in credit default swap markets in the last few weeks, and our findings that US mortgage defaults may be more than fully priced-in (see pages 4-7) would suggest that August (fully captured in US Q3 results but part of the Q4 picture for Canadian banks) could mark the nadir on that front.

Longer Term Wins

From a broader perspective, Canadian banks stand to benefit at the expense of other institutions. As equities with healthy dividend yields, bank stocks tend to be among the most sensitive to changes in interest rates, and the Bank of Canada's decision to eschew a further rate hike in August is therefore a plus.

US rate cuts are already helping markets unwind some of the undue risk aversion hitting Canadian bank funding spreads. By year end, an improved outlook for global growth in the wake of US rate cuts should see equity markets fully recover from their losses, aiding capital market activity in 2008.

A return to the extremes of risk tolerance seen prior to July is unlikely. But a more realistic price for risk will be a longer term positive for Canadian banks. Wider lending spreads and tighter covenants will mean greater profitability on future corporate lending deals.

Moreover, even if the current illiquidity problems are resolved, the formerly-fast-growing non-bank ABCP market will likely be gone as a significant competitor to bank financing. Corporates' own single-name CP programs were already losing market share (Chart 4), and may face a permanently reduced appetite for their issues. Both of these developments should see a greater share of the short term financing market occupied by Canadian banks. Knocked down prices for global bank equities may also allow Canadian banks to expand abroad through acquisitions at a more reasonable cost.

Chart 3
Prime–BA Spread

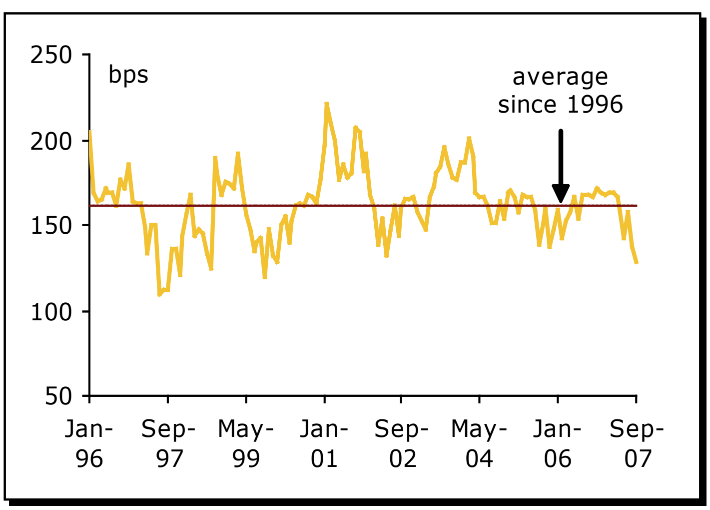
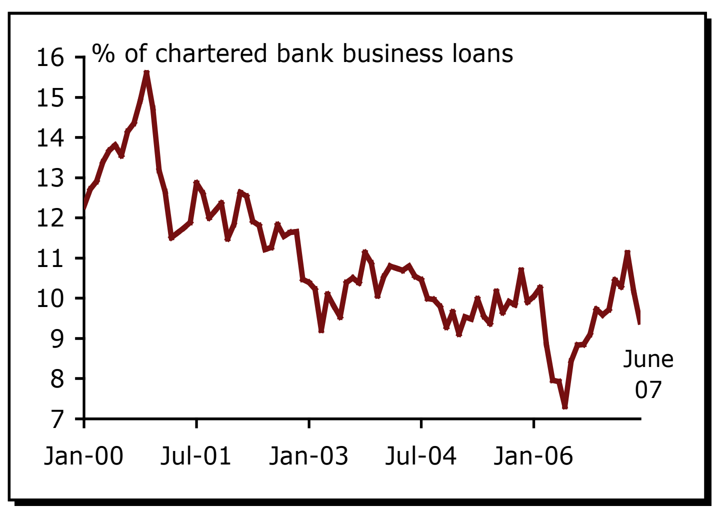


Chart 4
Non-Financial CP Outstanding (incl. Foreign)



Canada: Living With a US Slowdown, Stronger C$

Warren Lovely

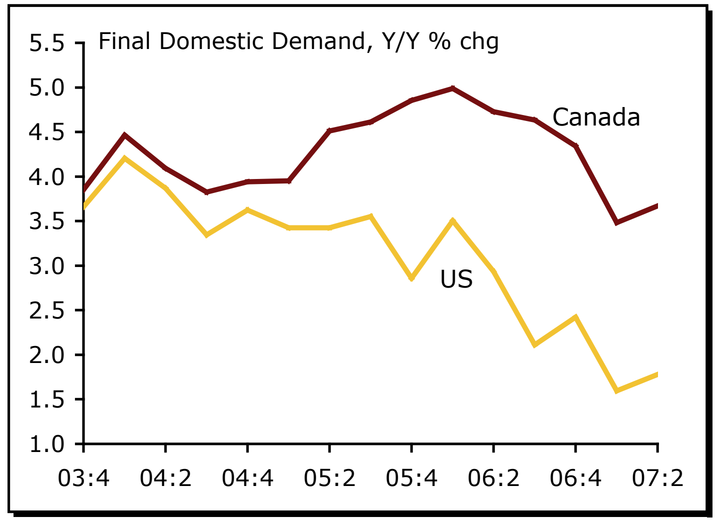
Economic linkages between Canada and the US are legion, having been fostered over decades by trade agreements, financial market integration and a growing number of firms operating on both sides of the border. Little surprise then, that for much of the past half century, Canadian and US growth rates have been joined at the hip. That is, until the most recent US business cycle.

Since 2002, the once tight relationship between the two economies has been tested, with little correlation between year-over-year real GDP growth rates (Chart 1). There are specialized factors aplenty: differences in industrial composition; deviations in fiscal policy; and isolated events like SARS, a major power disruption and the discovery of mad cow disease, all of which imparted a heavier drag on Canada. And then of course, there's the C$. A five-year appreciation totaling nearly 60% has constrained Canada's factory output (and GDP growth) below where it otherwise would have been. An initial wave of C$ adjustment contributed to Canada's relative economic underperformance during 2003-04.

More recently, we've witnessed a material divergence in Canadian and US final domestic demand (Chart 2). Eschewing currency headwinds, Canada's robust domestic economy, unimpeded by US-style housing weakness, helped deliver 3½%-plus real GDP growth in the first half of 2007. Stateside, spillovers from subprime mortgage losses limited first half US real GDP growth to little more than 2%. This performance gap will not be closed in coming quarters, as housing remains a key differentiating factor.

Chart 2

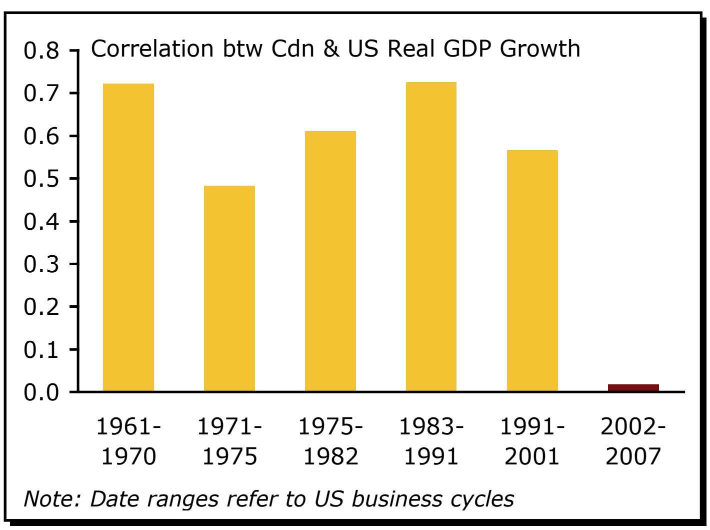
Canada Has a Stronger Domestic Economy



The share of Canadian exports flowing to the US may have fallen from its past peak, but America is still the destination for fully three-quarters of Canadian exports. Clearly, then, the American economy's growing recession risk is a concern for Canada. Flagging US demand will, after all, add to already severe challenges in the form of a near-parity exchange rate and unbridled global

Chart 1

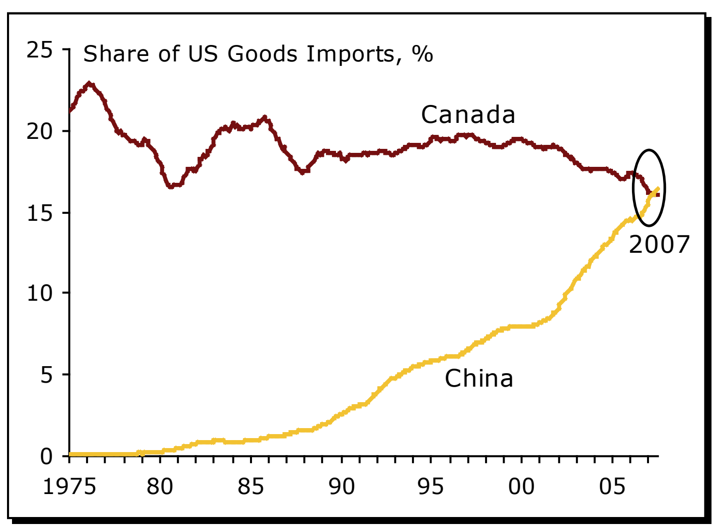
Canada's Looser Ties to US Growth



Note: Date ranges refer to US business cycles

Chart 3

Canada's Eroding US Market Share



competition. Canadian exporters are being displaced by low-cost overseas producers in a growing number of sectors, with China snatching away the title of world's largest US supplier (Chart 3).

Still, Canada's trade balance has hardly been blown up by the C$ or by the growing dominance of Chinese manufacturing. Yes, the auto balance—once the source of one half of Canada's total trade surplus—now prints in red ink (Chart 4). But energy and other commodities have filled the void, and today, the composition of Canadian exports is less levered to fluctuations in underlying US demand, and more critically tied to global growth.

The country's energy production will balloon in coming years, and America will take every extra barrel of crude Canada can extract from its vast oil sands deposits. Elsewhere, immense supplies of other coveted commodities, covering everything from wheat to potash to uranium and other minerals, buoy the trade surplus, even as once dominant sectors like autos and forestry products wane. With a still-healthy trade balance, and resource support for profits, wages and government tax receipts, the blow from a US slowing would be easier to absorb today than ever before.

The resource-driven loonie's ascent serves to increase the affordability of imported goods. This impact is tougher to isolate and operates with a lag in consumer price inflation, but the translational impact of the currency on machinery and equipment prices is plain as day. There, the deflator has plunged nearly 30% since the start of 2002 (Chart 5). At the same time, Canadian investment in machinery and equipment has managed to outpace that of the US. But that business capital spending is being pursued most aggressively in the resource sector, and critically, manufacturers—still the source of 15% of Canadian GDP—have had little success generating productivity gains.

In Canada's manufacturing sector, increases in output per worker have been hard to come by, and US$ unit labour costs have absolutely spiraled vis-à-vis a nearly flat profile in the US (Chart 6). Canada may be better positioned to weather a US slowdown, likely preventing the Bank of Canada from following the Fed's move to lower rates. But salvation will be hard to come by for non-resource manufacturers. We're but half way through a painful factory job shedding exercise, one that will continue to colour Canada's regional economic performance in the coming years.

Chart 4

Energy Surplants Autos in Canada's Trade

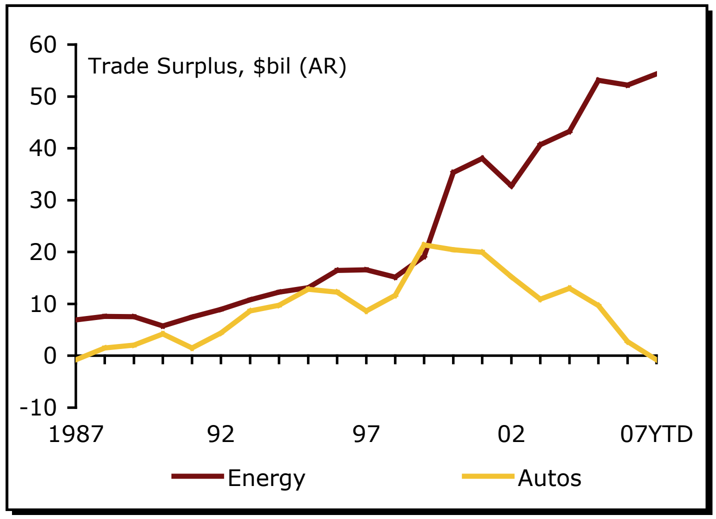


Chart 5

C$ Gains Cheapen Imported Machinery...

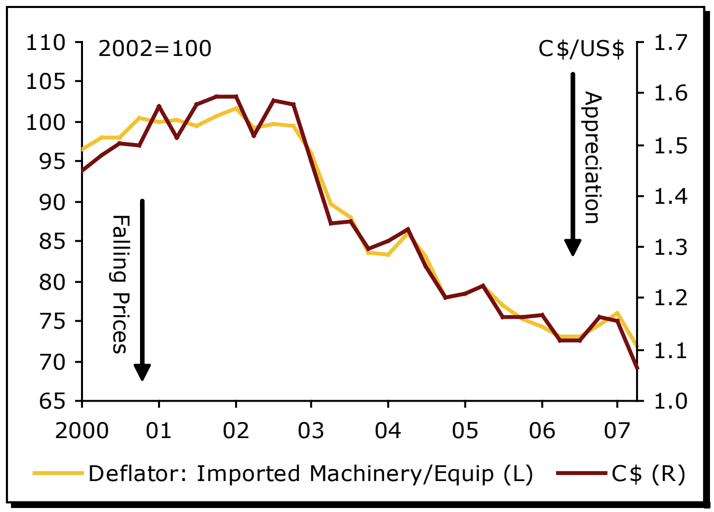
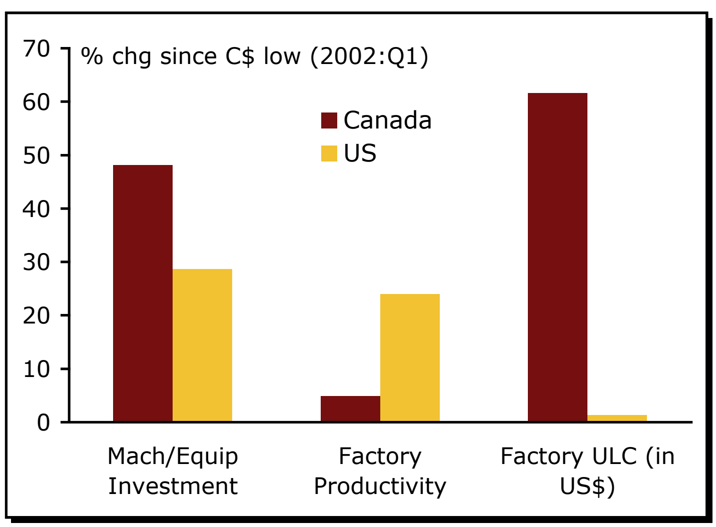


Chart 6

...But Factory Productivity Lags, Costs Soar



ECONOMIC UPDATE

CANADA	07Q2A	07Q3F	07Q4F	08Q1F	08Q2F	2006A	2007F	2008F
Real GDP Growth (AR)	3.4	2.3	2.0	2.5	2.6	2.8	2.5	2.5
Real Final Domestic Demand (AR)	4.3	2.7	2.8	3.2	3.2	4.7	3.4	3.1
All Items CPI Inflation (Y/Y)	2.2	2.0	2.4	2.0	1.8	2.0	2.1	2.3
Core CPI Ex Indirect Taxes (Y/Y)	2.4	2.2	2.1	2.1	2.0	1.9	2.3	2.1
Unemployment Rate (%)	6.1	6.0	6.0	6.1	6.1	6.3	6.1	6.1
Merchandise Trade Balance (C$ Bn)	63.3	52.6	57.0	57.6	59.4	51.3	57.7	58.8
U.S.								
Real GDP Growth (AR)	4.0	2.2	0.9	1.9	2.7	2.9	1.9	2.3
Real Final Sales (AR)	3.7	1.3	1.1	1.9	2.4	2.8	2.1	2.1
All Items CPI Inflation (Y/Y)	2.7	2.3	3.3	2.9	2.0	3.2	2.7	2.6
Core CPI Inflation (Y/Y)	2.3	2.1	1.9	1.9	1.9	2.5	2.2	1.9
Unemployment Rate (%)	4.5	4.6	4.7	4.7	4.8	4.6	4.6	4.8

CANADA

What's not to like about a first half growth performance that highlighted the country's strong domestic economic fundamentals? A US slowdown will challenge near-term prospects, and a slower second half pace to real GDP gains should be expected. But Canada looks better positioned to ride out American weakness than in past cycles (see pages 10-11). Energy prices will continue to buffet headline inflation, but core CPI has taken important steps towards the Bank of Canada's 2% target, and we could get back there a bit ahead of the central bank's current schedule. The trade surplus leans heavily on energy and other commodities these days, but that's hardly a bad thing with crude topping US$80/barrel and global growth still buoyant.

UNITED STATES

Third quarter growth still has a head of steam, but the downward revisions and fresh weakness in job creation has us cutting our Q4 growth outlook by a half point to roughly 1%, with risks to the downside. The Fed is on the job, however, and a becalming in risk aversion, coupled with further rate cuts, opens the door for a rebound in 2008. Core and headline inflation will part ways as the year-over-year CPI energy component turns ugly.