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Economic Update

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NEW YEAR, SAME OLD STORY

Highlights

- The Bank of Canada stated that since October, the global economic outlook has deteriorated and uncertainty has increased.
- After a solid end to 2011, growth is expected to remain healthy in 2012, but is dependent on global economic conditions.
- 2011 growth is forecast at 2.4%. Quarter four is expected to come in at 2.0%, compared to the 3.5% from quarter three.
- The Bank of Canada cut the U.S. growth outlook from 3.3% in October to 2.2% for 2012.
- The European Central Bank held interest rates unchanged in January after two consecutive cuts.
- The Canadian dollar remains just below par, trading around US\$0.98. Many forecasts expect it will soften slightly before exceeding parity in early 2013.
- The TSX remains above the 12,000 mark, but has not managed to climb back above the Dow.

Bank of Canada

- Overnight rate 1.00%
- Last: Jan. 17, hold
- Next: Mar. 8, hold *Forecast*

U.S. Federal Reserve

- Federal funds rate 0%-0.25%
- Last: Dec. 13, hold
- Next: Jan. 26, hold *Forecast*

It has been a mixed bag of data toying with the markets proverbial emotions over the past few months. The drama of 2011 is likely to carry well into 2012.

Still, it was no surprise that the Bank of Canada held the key interest rate unchanged at 1 per cent on January 17. A shaky global environment has left Governor Carney and the rest of the policy makers on hold since September 2010.

The next policy meeting is scheduled for March 8, when the overnight rate is expected to remain untouched once again.

The Central Bank estimates that the Canadian economy grew by 2.4 per cent in 2011 and projects that it will grow by 2.0 per cent in 2012 and 2.8 per cent in 2013, compared to 1.9 per cent and 2.9 per cent from the October forecast. The Central Bank stated there is less slack in the economy and projects it will be operating at full capacity in the third quarter of 2013, a quarter earlier than previously forecasted.

The Canadian economy will be influenced by both domestic and global data

during the coming year.

Inflation, employment and housing will remain on the radar. The Bank of Canada is forecasting core inflation to fall to 1.7 per cent by the end of 2012, before increasing back to 2.0 per cent by the end of 2013, which is below most major bank forecasts.

The housing market is also expected to cool. Debt to income levels are at record highs (153%) and speculative building in the condo market, particularly in Toronto, could lead to an overhang of inventory when interest rates increase and affordability decreases.

The global economy poses a large threat due to the implications on market volatility, commodity prices, confidence levels and financial conditions.

The European debt crisis has eased a bit, thanks to European Central Bank lending, but there are signs the economy entered into a recession in the final quarter of 2011. Spain has missed their deficit target and Greece has been unable to solidify their second bailout agreement.

The European Central Bank held interest rates unchanged in early January, but stated that a thorough analysis of incoming data will be conducted. This suggests that any sign of weakness is likely to be handled with further stimulus.

The U.S. economy also performed well during the final chapter of 2011. There is some expectation that their economy will slow, despite longer unemployment benefits and lower payroll taxes. Although confidence levels are improving, consumers remain cautious when it comes to spending. After a strong November, spending cooled in December. Future activity will depend on employment data. One report claims that a monthly average of 300,000 jobs must be created in order to see a continued decrease in the unemployment rate, which is well above recent levels.

For the past few months the story has been much the same, but the year has just begun and there are many up and downside risks hovering in

CANADIAN ECONOMIC RELEASES

Trends

<i>Employment; Unemployment rate</i>	Dec. +17.5k; 7.5%	Nov. -19.0k; 7.4%	Oct. -54.0k; 7.3%
<i>Headline; Core CPI (annualized)</i>	Dec. 2.3%; 1.9%	Nov. 2.9%; 2.1%	Oct. 2.9%; 2.1%
<i>Housing starts (annual units; monthly change)</i>	Dec. 200.2k; 7.9%	Nov. 185.6k; -12.3%	Oct. 211.7k; 1.2%
<i>Real GDP (quarter to quarter change)</i>	Q3-2011 +3.5%	Q2-2011 -0.4%	Q1-2011 +3.6%

Employment managed to pick up 17,500 positions in December after two months of significant declines, but the devil is in the details. Full time positions fell a disappointing 25,500 and the unemployment rate increased for a third consecutive month, to 7.5% from 7.4%. Total hours worked dropped 0.3% and average hourly wages increased 2.2% year-over-year, down from 2.4% in November. Total job gains for 2011 were 199,000, with nearly all of the positions created in the first six months. The unemployment rate was down only one tick from the 7.6% realized in December 2010. *(January release—February 3)*

Consumer prices fell 0.6% in December, cutting the headline rate to 2.3% from 2.9%, as the holiday shopping season saw intense discounting. Core prices also fell a hefty 0.5%, taking the annual rate to 1.9% from 2.1%. The report came in below expectations, as clothing, audio equipment and vehicles were all down during the month. Food prices were also flat, a welcome change after consecutive monthly increases. A 3.0% decrease in gasoline prices helped lower the headline rate. Pump prices are up 7.6% compared to a year ago, compared to average price increases of 20% last year. For all of 2011, inflation averaged 2.9%, which is the highest annual reading since 1991. *(January release—February 17)*

Housing starts increased more than expected, climbing 7.9% to 200,200 positions in December. Ontario reported the largest monthly increase, gaining 32% following a similar decrease in the prior month. For all of 2011, starts totaled 193,200 units, up 0.9% compared to 2010. There was a shift towards multiple units throughout the year, at 106,700 compared to singles of 66,600. The supply of detached homes is getting tighter compared to the condo market. In 2011, Ontario, Saskatchewan and Atlantic Canada were all up, while B.C. and Alberta were down slightly. *(January release-February 8)*

Manufacturing shipments increased 0.2% in November to \$49.6 billion as 14 out of 21 industries reported an increase. This is the fourth increase in the past five months. Higher sales were reflected in machinery, petroleum and coal, and motor vehicles. Inventory levels increased for the fourteenth consecutive month, while the inventory-to-sales ratio dipped to 1.31 from 1.33. The level of untitled orders also increased, primarily in aerospace products and parts and primary metals. *(December release—February 16)*

Retail sales increased for the third consecutive month, gaining 1.0% in October and matching the activity in September. The rise was led by auto sales, along with clothing, personal care and sporting goods. Sales are up 4.4% year-over-year or 1.9% excluding autos. The provincial hot spots remain Alberta (10.4% y/y) and Saskatchewan (10.6% y/y), while Ontario (2.6% y/y) and Quebec (1.9% y/y) are a bit cooler. Despite a lack of confidence, consumer spending continues to show a great deal of life. *(November release-January 24)*

Real GDP was unchanged in October, following four consecutive monthly increases. Services increased 0.2%, led retail trade, finance and insurance and professional services. Meanwhile, goods producing industries dropped 0.2% thanks to utilities, construction, mining and oil and gas. Manufacturing managed to increase during the month. *(November release—January 31)*

U.S. ECONOMIC RELEASES

Trends

<i>Employment; Unemployment Rate</i>	Dec. 200k; 8.5%	Nov. 120k; 8.7%	Oct. 210k; 8.9%
<i>Headline; Core CPI (annualized)</i>	Dec. 3.0%; 2.2%	Nov. 3.4%; 2.2%	Oct. 3.5%; 2.1%
<i>Housing starts (annual units; monthly change)</i>	Dec. 657k; -4.1%	Nov. 685k; 9.3%	Oct. 627k; -0.3%
<i>Real GDP (quarter to quarter change)</i>	Q3-2011 1.8%	Q2-2011 1.3%	Q1-2011 0.4%

Non-farm payrolls rose by a hefty 200,000 in December, thumping expectations of a 155,000 increase. Manufacturing and construction activity were both positive, along with transportation, retail trade, mining and health care. The unemployment rate continues to trend down, falling to 8.5%. It has retreated 0.6% from August. For all of 2011, the economy created 1.6 million jobs, well above the 872,000 created in 2010, and the best annual report since 2006. *(January release—February 3)*

Consumer prices were flat in December, compared to market expectations of a 0.1% increase. The headline rate was 3.0%, pulling back from 3.4% in November. The energy index decreased once again, as gasoline prices retreated for the third straight month. Energy prices are up 6.6% compared to a year ago, verses 19.3% in September. Core inflation came in as expected, rising 0.1% during the month. The annual pace was unchanged at 2.2%. For all of 2011, headline inflation was the highest since 2007 at 3.0%, which compares to 1.5% in 2010. *(January release—February 17)*

Housing starts dropped 4.1% in December, reaching 657,000 annualized units. The report was worse than the 0.7% decrease expected. Single family units increased 4.4%, while the volatile multi-family units shed 20.4%. Building permits were also slightly lower. Despite the weak headline reading, the three month average for housing starts is the highest since 2008 and building permits remain at a post-recession high. Single family units have also increased for the past three months. Unfortunately the housing market continues to face considerable headwinds, such as elevated stock from foreclosures and high unemployment. *(January release—February 16)*

The ISM (Institute of Supply Management) Index increased 1.2% in December to 53.9%, suggesting that the manufacturing sector has been expanding for twenty-nine consecutive months. New orders increased 0.9% to 57.6%. Manufacturing ended the year on a positive note, with new orders, production and employment all rising at a faster pace than in November. Respondents have an optimistic view about the start of 2012. *(January release—February 1)*

Retail sales increased only 0.1% in December, the weakest monthly showing in the past seven months. Sales are up 6.5% compared to a year ago. Total sales excluding autos were down 0.2% during the month, but remain 6.0% above year-ago comparisons. Aside from autos, the other two areas of strength included building materials and home furnishings. Electronics were down during the month after a robust November, suggesting that Black Friday shopping took away from some of the December activity. *(January release—February 14)*

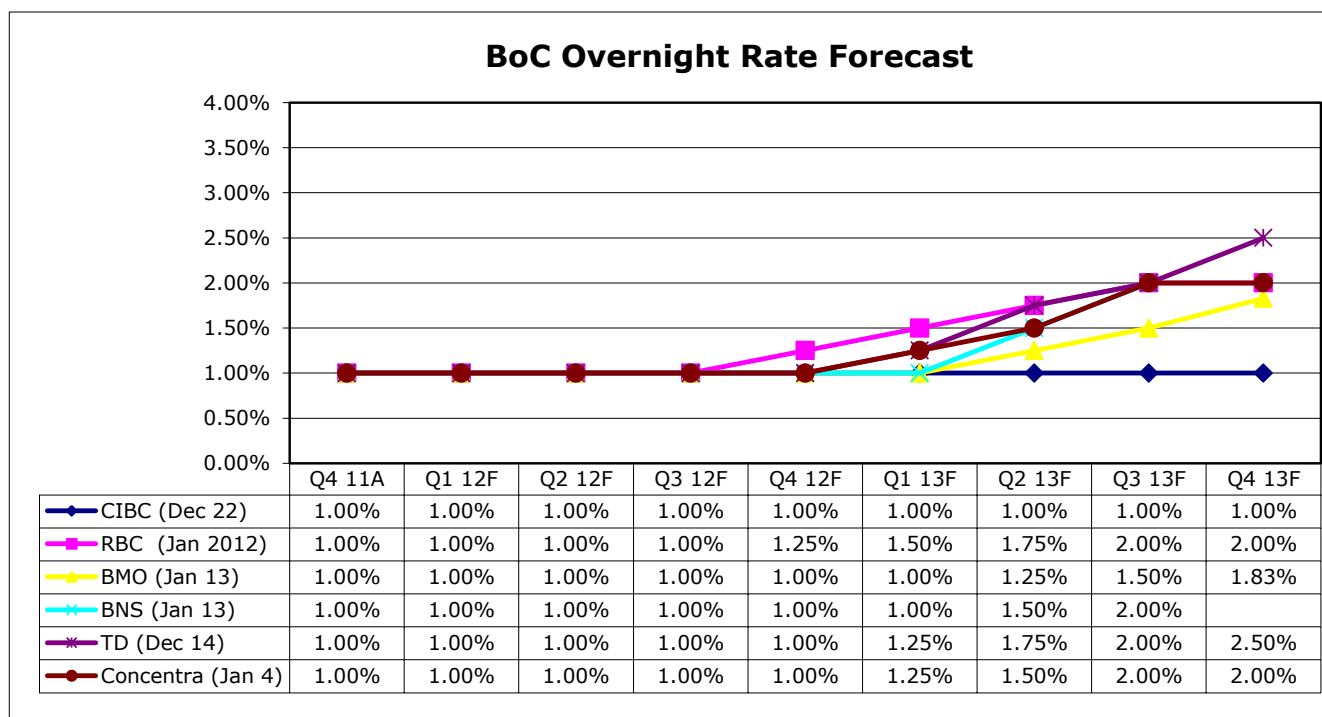
Real GDP rose 1.8% in quarter three following a 1.3% advance in quarter two. There were positive contributions from personal consumption expenditures, nonresidential fixed investment, exports and federal government spending. State and local government spending, imports and private inventory investment had a negative impact on the report. *(Quarter 4-2011 advance estimate—January 27)*

OVERSEAS

Eurozone finance ministers are once again in discussion. The debt crisis continues to prompt negotiations as Germany and France press for a deal between Greece and its private creditors. Greece currently has a debt load of 160 per cent of GDP, with a desired level of 120 percent of GDP by 2020. The second tranche of financial support needs to be implemented by March or Greece faces a disastrous default. The Euro reached its highest level against the U.S. dollar in nearly three weeks on hopes the discussions will be successful. The currency is currently trading at €0.77/US\$ or €0.76/C\$. The European Union has formally adopted an oil embargo against Iran with sanctions to immediately ban all new oil contracts. The European Union, who buys 20 per cent of Iran's oil exports, disagrees with Iran's nuclear program. The United States plans to keep the trade route open, which could increase tensions. The price of oil increased with the news and is trading just below \$100/barrel. China, the world's largest energy consuming country, refuses to back the oil embargo against Iran.

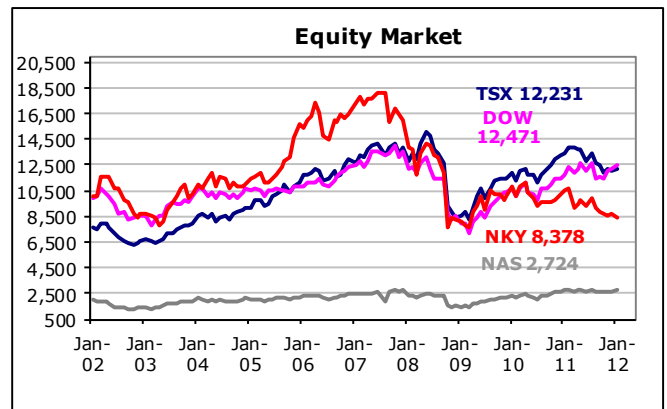
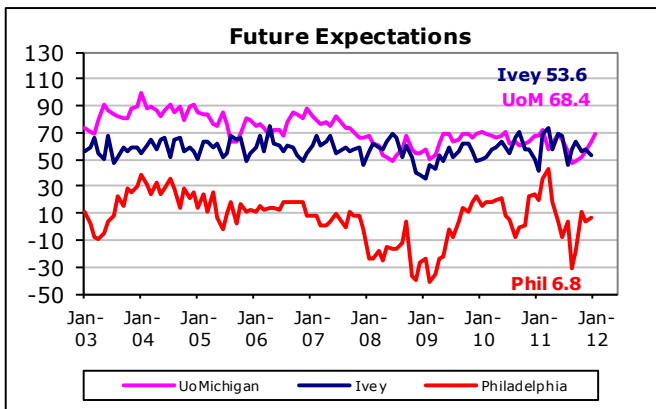
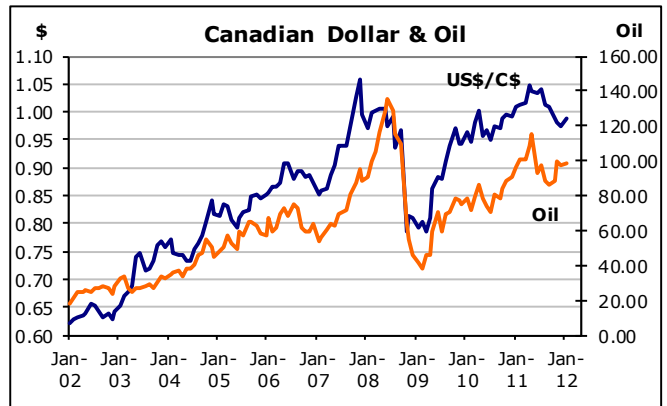
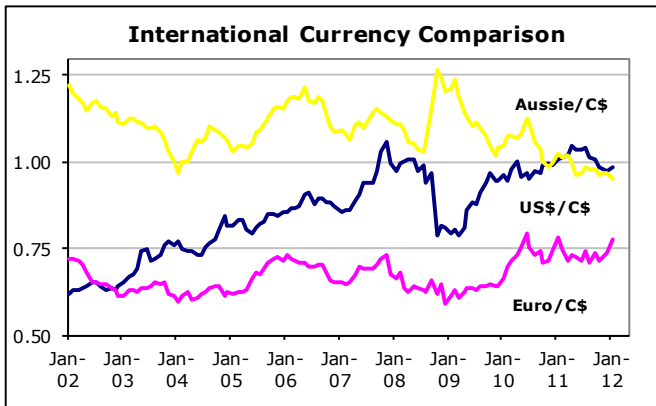
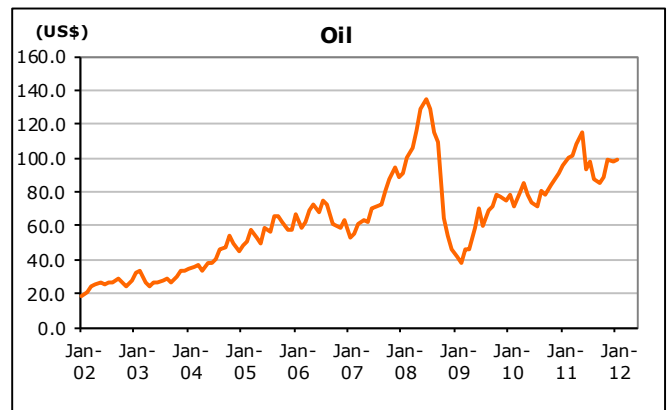
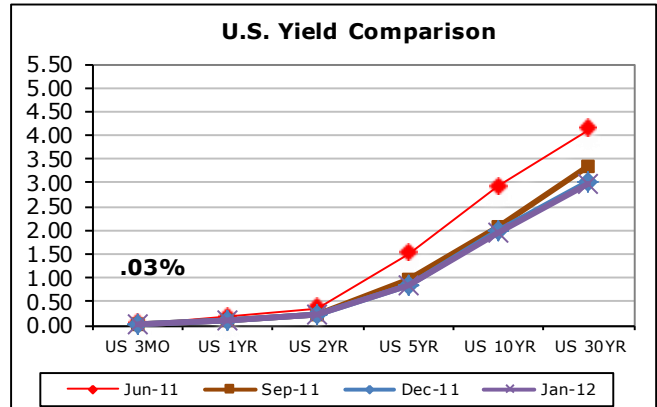
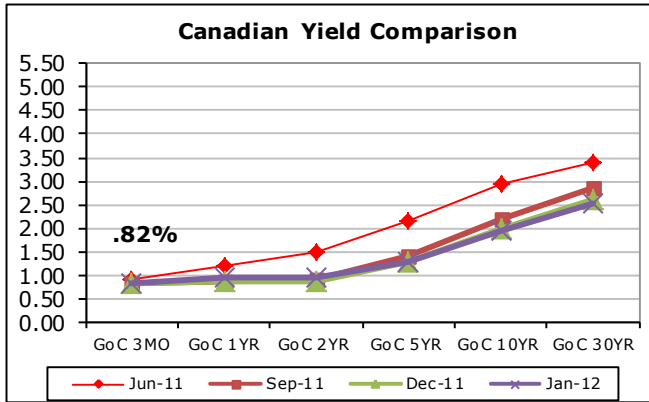
Japan's finance minister, Azumi, stated that Japan is not immune to a European style financial crisis. He said the government is prepared to double the consumption tax to improve the nation's finances. Japanese officials have also expressed concern over the 10 per cent appreciation of the yen versus the euro since the start of November. The recent moves in the euro are yet another headache for Japanese exporters, who are already struggling due to the U.S. dollar (¥99.6/€, ¥76.9/US\$). Azumi stated they will watch the currency markets carefully before intervening.

BANK OF CANADA EXPECTATIONS



The Bank of Canada's Monetary Policy report, released on January 18, included an upward revision to the growth forecast for 2012, resulting from the upward momentum in the second half of 2011. The Central Bank does expect the European crisis to be deeper and longer than originally anticipated and the U.S. growth forecast has been cut back notably. Domestic demand and sound financial conditions are expected to promote growth, helping maintain consumer spending, residential investment and business investment. The Bank of Canada is expected to hold the overnight rate at 1.0% until early 2013, with RBC calling for a rate hike at the end of 2012. The latest inflation report gives the Central Bank some breathing room, coming in at 2.0% in quarter four, below the 2.2% forecast.

MARKET TRENDS



PROVINCIAL HIGHLIGHTS

	Employment <i>December</i>			Unemployment <i>December</i>			CPI (2002=100) <i>December</i>		
	Value (Thousands)	% Change (Period)	% Change (Year)	Value	% Change (Period)	% Change (Year)	Value	% Change (Period)	% Change (Year)
Canada	17,300.0	0.1	1.2	7.5	0.1	-0.1	120.2	-0.6	2.3
British Columbia	2,239.0	0.5	1.4	7.0	0.0	-0.6	116.5	-0.9	1.7
Alberta	2,131.0	0.0	4.9	4.9	-0.1	-0.6	126.5	-0.1	2.9
Saskatchewan	527.8	0.6	0.7	5.2	0.1	-0.3	122.4	-0.8	2.5
Manitoba	626.3	0.3	0.9	5.4	-0.1	0.2	118.6	-0.8	2.6
Ontario	6,750.9	0.2	1.4	7.7	-0.2	-0.4	120.3	-0.6	2.0
Quebec	3,902.7	-0.7	-1.3	8.7	0.7	1.2	118.7	-0.5	2.5
New Brunswick	354.1	0.8	0.0	9.4	-0.4	0.0	120.4	-0.7	3.3
Nova Scotia	458.1	0.9	2.3	7.8	-0.8	-2.6	122.7	-1.0	2.8
Newfoundland	227.2	1.4	1.9	12.8	-0.4	-1.2	121.9	-0.8	3.2
P.E.I.	73.4	1.1	5.0	11.4	0.3	-0.4	123.4	-0.5	2.9

	Retail Trade <i>October</i>			Manufacturing Shipments <i>November</i>			Housing Starts <i>December</i>		
	(SA, \$ millions)			(SA, \$ millions)			(SAAR, thousands of units)		
	Value	% Change (Period)	% Change (Year)	Value	% Change (Period)	% Change (Year)	Value	% Change (Period)	% Change (Year)
Canada	38,598.4	1.0	4.4	49,643.0	2.0	10.2	200.2	7.9	20.8
British Columbia	5,065.3	1.7	3.6	3,206.0	0.9	5.9	23.0	-18.1	-23.1
Alberta	5,584.1	3.0	10.4	6,421.0	5.9	23.0	28.3	-5.4	37.4
Saskatchewan	1,409.5	1.9	10.6	1,168.0	2.2	21.5	5.9	-18.1	-20.3
Manitoba	1,413.6	1.9	7.6	1,287.0	4.2	1.9	4.9	-34.7	-25.8
Ontario	13,524.7	-0.1	2.6	22,467.0	2.0	9.7	71.5	32.4	58.5
Quebec	8,566.3	0.8	1.9	11,744.0	0.0	4.8	50.6	7.2	10.0
New Brunswick	951.5	1.3	6.8	1,693.0	-4.0	23.3	3.7	5.7	23.3
Nova Scotia	1,109.0	0.0	4.3	903.0	0.7	2.5	8.5	203.6	203.6
Newfoundland	667.2	0.2	7.4	640.0	20.8	17.7	3.0	-23.1	-6.3
P.E.I.	162.0	1.2	8.7	110.0	18.4	9.9	0.8	-46.7	-27.3

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