Global Economic Research

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Economic Directions

As The World Turns

Warren Jestin, Senior Vice-President & Chief Economist

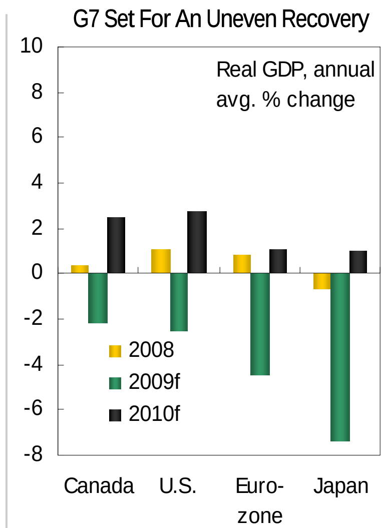
The global economy is turning the corner, with economic news moving increasingly from the *bad* towards the *good* side of the ledger. Enormous fiscal stimulus has put China at the vanguard of nations starting down the road to recovery, with the U.S. appearing to be in the pole position among major developed countries.

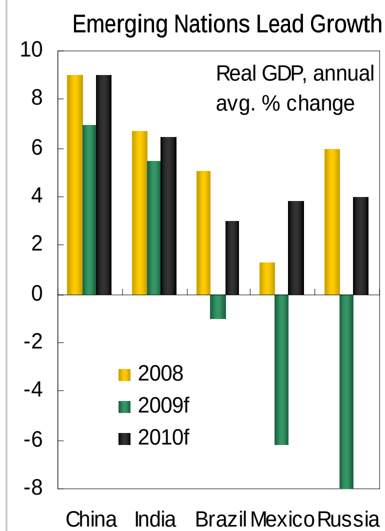
In the U.S., massive monetary and fiscal stimulus is beginning to gain traction and will account for the majority of growth during the next year. Government initiatives are bolstering disposable income and spending at a time when households are focussing on reducing debt and rebuilding savings. Monthly job losses appear to have crested and confidence surveys suggest that consumers and businesses are becoming less negative about current conditions and cautiously more optimistic about prospects for the balance of the year.

Inventory restocking will give an added boost to recovery. Automakers are restarting some idled plants now that inventories are within their comfort zone and sales have started to recover. U.S. housing activity also has bottomed after three years of unrelenting decline, although prices will continue to be depressed by a large volume of distressed sales and the huge overhang of unsold properties on the market or waiting in the wings.

While the convergence of government stimulus and inventory rebuilding will boost economic performance in the months ahead, U.S. growth through 2010 will do little more than backfill the hole created by the recent steep decline in activity. It will take longer to reverse the 22% drop in U.S. household net worth since mid-2007, to revitalize housing and to restructure the financial services and motor vehicle industries. Excess capacity and refinancing challenges point to a lengthy recuperation for non-residential construction. Regulatory reform and tighter lending practices will restrict leverage and raise funding costs for higher-risk activities. By this time next year, the Federal Reserve will also be nudging up interest rates from unprecedented lows and Washington will be under increasing pressure to rein in pedal-to-the-metal government stimulus to significantly reduce its US$1.6 trillion fiscal deficit (equivalent to 11% of U.S. GDP).

The European and Japanese economies also are showing tentative signs of turning the corner, and with the exception of the U.K., have not suffered the seismic shocks that have reverberated through the U.S. financial system. Nevertheless, the economic retrenchment in these overseas nations has been larger than on this side of the Atlantic and their recent GDP losses won't be recouped until well beyond 2010. Demographic challenges associated with aging and, in some cases, declining populations, are larger in Europe and Japan than in Canada or the U.S.





Scotia Economics

Scotia Plaza 40 King Street West, 63rd Floor
Toronto, Ontario Canada M5H 1H1
Tel: (416) 866-6253 Fax: (416) 866-2829
Email: scotia_economics@scotiacapital.com

In this environment, emerging markets will provide a large share of global locomotion. Even in a year when global output is shrinking by nearly 3%, China and India are expected to expand by 6-8% in 2009. Their growth is being — and will continue to be — driven by infrastructural investment and consumer spending. Vehicle sales in China are poised to surpass U.S. levels in 2009 and have recently set new records in India and Brazil. Intra-regional trade also is becoming more important — for example, trade flows among Asian nations are already double NAFTA levels.

Financial markets will remain volatile during what is likely to be an uneven and protracted global convalescence. The U.S. dollar and bond yields are vulnerable to Washington's sky-high fiscal deficits and to a renewed widening of the U.S. trade deficit as commodity prices rise. These risks will intensify as investors become more confident that an economic revival is underway and start rebalancing portfolios across asset classes and currencies to improve overall performance. Mood swings along the road to recovery are bound to trigger big gyrations in currency and high-yield markets.

What The Global Recovery Means For Canada

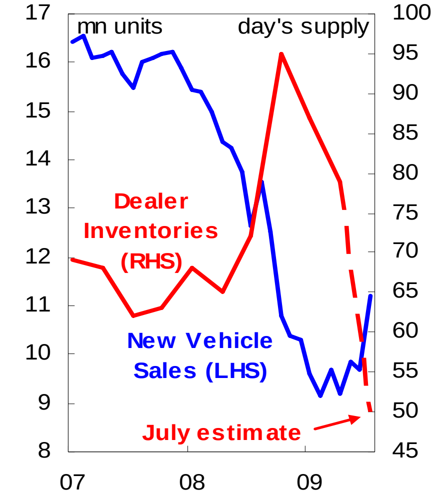
While Canada's performance was lacklustre through the first half of 2008, it was partially insulated from the deepening retrenchment in the U.S. and other developed nations by the resilience of its banking system, the relative financial strength of the government and household sectors, and by a huge revenue infusion from booming commodity markets. Our nation was dragged fully into the global recession only when faltering emerging economies triggered a collapse in resource prices and export earnings. Even then, the erosion in employment, housing activity and car sales has been less severe than south of the border. Canada's headline jobless rate remains roughly a percentage point below U.S. levels — a rare occurrence — and the $50 billion deficit Ottawa projects for FY2009-10, is less than one-third the comparable U.S. level when measured as a share of GDP.

As in the U.S., Canadian domestic activity will revive in the months ahead as consumers begin to return to the malls in greater numbers and a myriad of government-funded *shovel ready* projects actually get into the ground. The Bank of Canada will likely nudge up interest rates as the economy recovers in 2010, but borrowing costs will not be an impediment to the revival of domestic demand. However, with foreign sales one-third of Canadian GDP, the strength of the rebound will be tied to commodity markets and reversing the recent slide in U.S. sales.

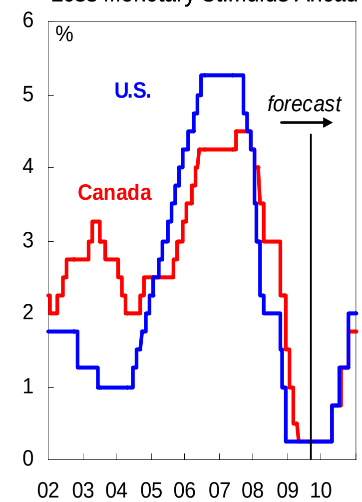
Canada is already benefitting from higher commodity prices in response to demand from China and other nations, but global growth through 2010 will be too tepid to reverse last year's unprecedented slide. The U.S. rebound will help bolster south-bound exports, but gains will be tempered if, as we expect, the loonie moves towards parity vis-à-vis the U.S. dollar as commodity markets strengthen further and the greenback comes under pressure on global currency markets. Prices for oil and most minerals are expected to move higher as global growth gets into gear, although sales of natural gas and forest products to the U.S. will be constrained both by that country's slow pace of expansion and competition from alternative sources. Auto exports also will be disrupted as the industry enters a prolonged restructuring.

The bottom line — we will soon begin moving away from one of the most difficult economic setbacks experienced in our lives, but patience will be required because the road to recovery will be a long and winding one.

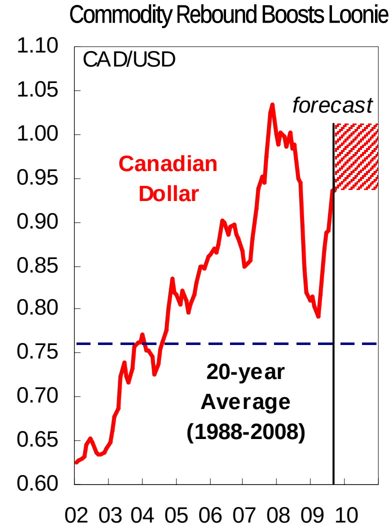
U.S. Auto Sales Turn The Corner



Less Monetary Stimulus Ahead



Commodity Rebound Boosts Loonie



Beyond Economic Recovery — New World Realities

The road to recovery won't take us back to the world that existed before the sub-prime crisis began. The global financial system is being revamped and, in some areas, reconstructed. Big government deficits are back and will be politically difficult to unwind. We soon will begin to experience the profound impact of an aging global population and the crusade to improve energy efficiency and environmental outcomes.

The global economic landscape also is changing, with developed nations like Canada and the U.S. likely to experience relatively subdued growth in the decade ahead. World activity will be driven increasingly by China, India, Brazil and other emerging powerhouses, with their production and investment decisions having a major impact on world trade, commodity prices and financial markets. The unprecedented meeting of G20 government heads in Washington last December to deal with the financial crisis officially recognized the need to broaden global economic management beyond the traditional G7 developed nations. At the same time, the great divide in performance between G7 and emerging nations has the potential to heighten friction over international trade and investment, which have been powerful drivers of the global economy over the past two decades.

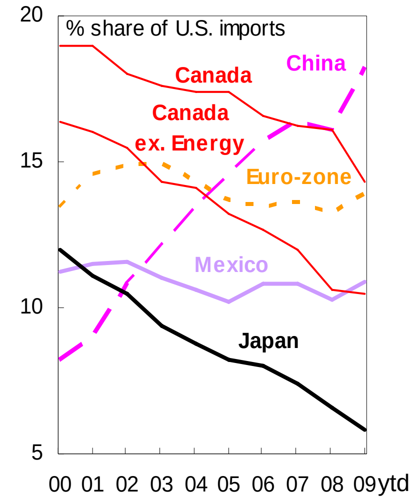
For many Canadian businesses, these new world realities point to tougher competition in traditional markets, but a world of opportunity in emerging ones. Our share of the U.S. market has dropped significantly over the past decade, with China gaining bragging rights as the largest U.S. supplier and, excluding energy products, the euro zone surpassing Canada in U.S.-bound sales. Canada's tourist industry has experienced a secular decline in U.S. visitors. Our bilateral trade balance in motor vehicles and parts has plummeted from a $20 billion surplus at the start of the decade to an $11 billion deficit over the past year. Additional bilateral trade risks include a thickening of the border via even longer crossing times and Buy America biases by U.S. governments.

Focussing our collective attention and scarce national resources on supporting the familiar while avoiding the unfamiliar is a losing strategy. Government subsidies and other temporary palliatives can't insulate domestic business from the powerful forces reshaping the global economic landscape. Currency depreciation won't be riding to the rescue — rising commodity prices may soon push the loonie to parity and beyond. Skilled labour shortages also will intensify as the economy revives, limiting the potential for businesses to cut costs in the quest for a better bottom line performance.

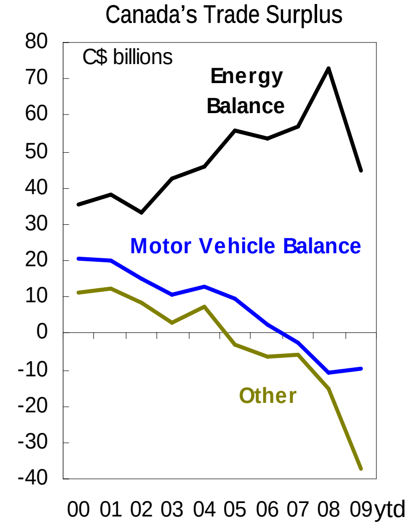
In this environment, successful business strategies will increasingly hinge on identifying high value-added, skill-based products and services which can plug into global supply chains or take advantage of unique local or international niche market opportunities. Highly entrepreneurial small- and medium-sized businesses will be a key source of job creation. At a time when the auto sector and other traditional manufacturing industries are shedding jobs, new enterprises associated with environmental remediation, global infrastructural development, and emerging market demands have the potential for sustained, rapid growth.

When it comes to helping business adjust to these new world realities, Canadian governments have limited resources and a long '*to do'* list that includes fully implementing the proposed plan for a more competitive corporate tax structure, returning to fiscal balance and investing in big-ticket transportation, power and communications projects. Among the many competing priorities, however, education and skills training should be right at the top of the list because work force quality is one area where we must be able to compete with the best.

Canada Loses U.S. Market Share



Commodities Drive Canada's Trade Surplus



A Big Decline In U.S. Visits To Canada