

The European sovereign debt crisis and banking problem continues to dominate the news flow and presents the greatest risk to the economic outlook. While Europe is in a recession, the U.S. economy is expanding and growth in the emerging market economies is slowing. This growth de-synchronization may only be temporary once the full effect of the European recession works through the global economy. Fiscal austerity in Europe and in other advanced economies will contribute to slower global economic growth in 2012 as well. The 2013 growth outlook is more positive and dependent on no banking or sovereign default crisis erupting in Europe.

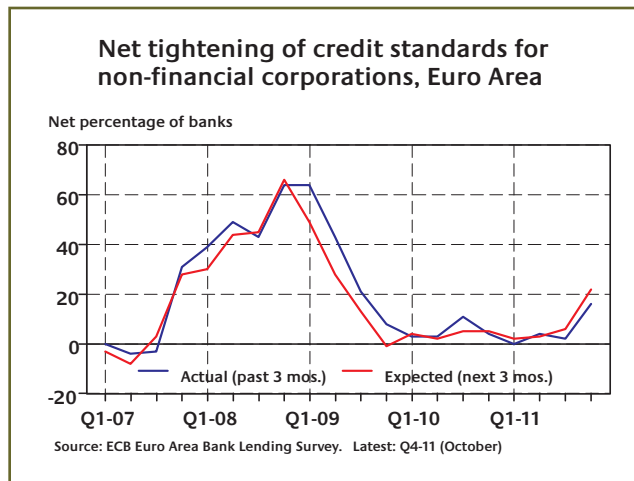
Financial markets will remain volatile as the news stream ebbs and flows from negative and positive political and economic developments. Government bond yields in Canada and the U.S. will remain very low and those central banks will remain on hold into 2013. Corporate bond yields will continue to reflect a higher risk premium.

### Economy

A credit squeeze is underway in Europe and should it intensify, the region will experience a credit crisis pushing its economy into a deeper recession. More sovereign and bank downgrades are expected in 2012 in another volatile year for financial markets. European banks are increasing their liquidity, selling assets, and slowing new lending. The most recent survey of credit conditions in the euro area shows sharp tightening in September and more tightening ahead.

The European Banking Authority determined the EU banking system requires an additional €115 billion to conform to new capital requirements in June 2012. However, some observers believe the EBA's capital estimate falls short and the capital need is closer to €250 billion since the stress test does not consider an adverse economic scenario and uses bond values as of September 30.

European banks will need to roll over debt to almost €700 billion in 2012 at the same time Italy and Spain need to refinance about €480 billion.



Italy has a heavy debt repayment schedule in the first quarter of 2012. However, there is room for some optimism since Italy's latest bond auction was successful with the yield on 10-year bonds falling to 6.98% compared to 7.56% previously. The Italian Treasury also sold 6-month bills at 3.251% versus 6.504% at the previous auction.

The European Central Bank cut its key policy rate to 1% and in a less publicized move announced significant liquidity measures to the commercial banking sector by lowering the reserve ratio, expanding the eligible collateral (to A from AAA) for loans, extending its loan term to three years, and allowing full allotment for all. Basically, banks can borrow as much as they want from the ECB at the policy rate (1%), limited by only their collateral.

At the long-term refinancing operation (LTRO) on December 21, the ECB provided banks with €489 billion in three-year loans. This could help with refinancing around €230 billion of bank bonds due to mature in the first quarter. The next LTRO is scheduled for February 2012.

Deposits by euro zone banks at the ECB surged to a record high as they used the latest liquidity injection to build up reserves rather than take on new risks. The amount placed in the ECB's 0.25% deposit facility hit €452 billion, well above the previous high. Banks are building up precautionary liquidity reserves to prepare their balance sheets for year-end reporting and to deal any new stresses.

At the last EU summit, leaders agreed to create the European Stability Mechanism in 2012 instead of 2013 and on whether to give the International Monetary Fund an additional €200 billion to aid some euro zone countries. These long-term solutions are a step in the right direction but do not directly address the current crisis. Another summit is planned for January 30.

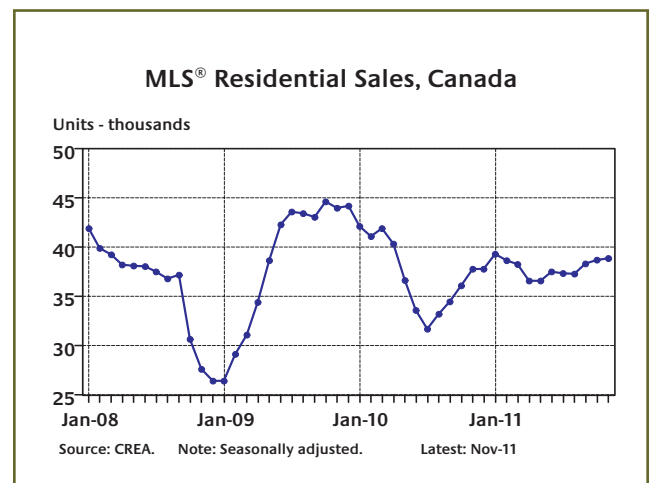
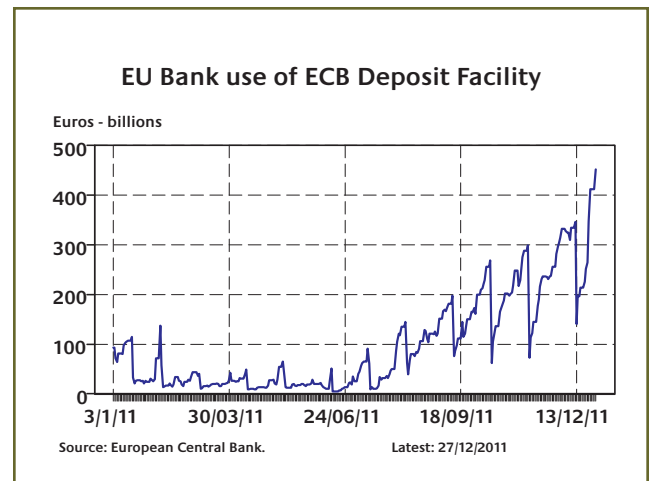
Turning to the economy, Euro zone industrial production contracted for the second consecutive month in October. The purchasing managers' index for euro zone manufacturing signaled contraction falling to a 28-month low in November and the flash estimate for December indicated another contraction. Industrial production will remain weak heading into 2012.

Europe is in the early phase of a recession, which will intensify in 2012 due to the credit squeeze and sharp fiscal austerity. Should the sovereign debt crisis lead to a default or should a banking crisis erupt, the recession would become deeper and longer with a weaker recovery. The prevailing view is for a mild recession in the euro zone in 2012 with modest growth in 2013.

The U.S. economy appears to be ending 2011 on a solid note with growth accelerating and unemployment edging lower. However, there are cracks in this optimism. Industrial production fell 0.2% in November after a 0.7% increase in October. The latest inventory reports point to a shift to inventory rebuilding which should assist industrial production and GDP but the downside could be at the expense of production in the spring 2012.

The key will be domestic demand. Consumer spending growth moderated in November following out-sized gains in the third quarter. Business investment spending remains a source of strength in the fourth quarter in contrast to government spending. However, business investment could be easing since core capital goods orders fell in November, the second straight monthly decline.

The housing market is generating some positive signs. Existing-home sales increased in November compared with October, rising to an annualized 4.42 million units and the second highest level this year. Sales of existing homes are up 10% from the July 2011 low. However, home prices are still sliding lower and more foreclosures coming onto



the market in 2012 will delay the end of the price correction.

Residential construction climbed in November with housing starts at a 685,000 annual pace, up almost 25% from last year and the highest since April 2010. Since housing sales and prices will not rise much in 2012, housing construction will remain depressed. In the not too distant future though, pent-up housing demand will materialize and send domestic demand and overall GDP growth considerably higher.

That future date will have to wait until strong job growth resumes. The labour market is not robust. The pace of job growth is restrained by cutbacks in the public sector while private sector employment has expanded every month since March 2010. The unemployment rate is high with many potential workers on the sidelines waiting for openings. Initial jobless claims in December were a bit weaker but generally encouraging and below the significant 400,000 mark.

Exports through to October have held up. In volume terms, exports rose 1.2% and put the fourth quarter off to a good start. The recession in Europe will put a dent into exports by the end of this quarter and in the first half of 2012.

Leading indexes point to growth in the near term. The Conference Board index of leading indicators rose 0.5% in November, exceeding expectations, after rising 0.9% in October. The financial components—stock prices, money supply and the yield curve—were positive contributors along with consumer confidence. Weakness in the manufacturing components held back November's advance. The ECRI's weekly leading index paints a slightly weaker picture with a decline for the third week in a row in December and suggests a decline in the Conference Board's December index.

Fourth quarter real GDP is tracking 3 to 3.5% annualized growth, well above 1.8% in the third quarter and the highest since Q2-2010. The first estimate of Q4-2011 will be released in late January and it should lift market sentiment. The concern of course will be in what lies ahead.

Fiscal policy is a source of uncertainty and a potential drag on the economy. A two-month extension of the payroll-tax cut was brokered but another round of negotiations remains to extend for the balance of the year will be necessary. If no deal is struck and payroll taxes rise, it would reduce growth. Similarly, other measures such as the Bush tax cuts are set to expire at the end of 2012. Political gridlock in Washington adds risk to the outlook, however, one should assume that policymakers would ultimately do the right thing and not tip the economy back into recession.

Real U.S. GDP growth in 2012 is expected to expand about 2.4% from 1.8% in 2011 and accelerate to 2.8% in 2013. The global economic soft patch in the first half of 2012 will give way to firmer growth in the second half with the U.S. growth profile largely mirroring this. Underlying trends in U.S. consumer demand and the housing market will improve at a modest pace in 2012 with ongoing developments and market adjustments setting the stage for firmer growth in subsequent years.

In the emerging markets, slowing growth in China and India will play out into 2012. China's manufacturing activity continued to shrink in December

according to the HSBC PMI citing weaker external demand and the ongoing property market correction. China's official non-manufacturing PMI rebounded in December to 56.0 from 49.7, supported by a strong retail sector and domestic demand. Policymakers have begun to loosen some settings to avoid a hard landing brought about by a European recession.

Canada's economic outlook is closely tied to the U.S. and increasingly to emerging markets. The European recession has a negative impact mainly through the financial and confidence channels since Canada's exports to Europe are less than 10% of the total. Indirectly, Canada's trade with the U.S. and other trading partners will be jeopardized should those economies weaken or fall into recession due to Europe.

Most recent Canadian economic indicators are less positive than in the third quarter. Industry GDP was flat in October compared to substantial increases in the prior three months. Employment fell in October and November though from an outsized jump in September. On a trend basis, employment is growing about 1% while the cyclical component is declining. Exports were down in October following a third quarter resurgence.

The housing market is generally holding up. Housing sales edged up in November to their second highest level this year though housing starts dropped and prices slipped. Retail sales, another indicator of consumer activity, were up for the third month in a row to October.

Private non-residential investment spending tailed off in the third quarter and October building permits suggest no increase in the fourth quarter. However, public sector investment should register an increase based on permits issued. Government spending on current goods and services will grow but at a slower pace.

The short-term growth profile was influenced by the impact of Japan's supply chain disruption in the second quarter and the developments in Europe via the financial markets. The unwinding of the Japan effect combined with the negative financial market developments in the fourth quarter will result in Q4-2011 real GDP growth at 1.6% annualized in Q4-2011 compared to 3.5% in the prior quarter.

For 2011, growth is forecast at 2.3% slowing to 2.0% in 2012 with exports and government spending pulling down growth. Less business investment is also likely to contribute to slower growth. The economy is expected to strengthen in 2013 to 2.8% against the backdrop of more robust U.S. and emerging market economies. The European recession likely ends in 2012 with that economy growing at a modest pace in 2013 but with ongoing bouts of instability in financial markets as those policymakers grapple with fiscal integration and banking sector issues.

## Inflation

Consumer price inflation was 2.9% in November, the same as in October. Food price inflation is higher though gasoline prices are beginning to ease from a year earlier. The Bank of Canada's measure of core inflation held at 2.1% in November. Inflation is playing out generally according to the Bank of Canada's forecast and further easing in the headline and core inflation rates is expected.

## Interest rates

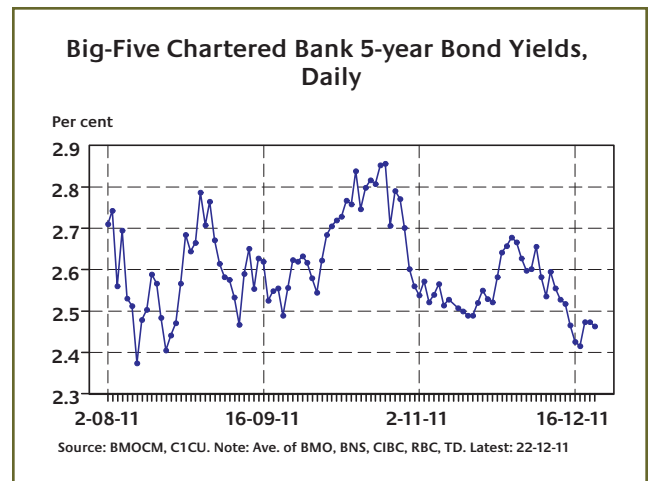
Government T-bill rates and bond yields declined in December with long-bond yields hitting record lows. The average yield on 5-year senior notes issued by the Big-Five chartered banks declined about 20 bps in the month, increasing the likelihood of a small mortgage rate cut next month. There was no change in the main administered deposit or mortgage rates.

## Monetary Policy

The Bank of Canada kept its target rate at 1% at its December meeting. The Bank is concerned with the global economic outlook and the impact of worsening credit conditions in Europe spreading to global financial markets. While its policy stance will remain focused on domestic inflation, economic developments abroad as well as those in Canada will influence its next rate move.

## Interest rate forecast

No major change to this month's rate forecast occurred. The Bank of Canada will remain on the sideline through to Spring 2013 when it initiates the first 25 bps increase on the long road to rate normalization. The government yield curve remains below normal steepness for most of 2012 but begins



to steepen when markets sense better economic prospects and push up long bond yields.

Risks remain on the downside. The futures market for three-month Banker Acceptances is expecting a 25 bps rate cut by December. However, market expectations can shift rapidly depending on the news flow.

The main alternative scenario involves a banking crisis in Europe accompanied by a more severe recession than in the base case scenario, which is a 'muddle through' outcome with many potholes along the road to greater fiscal integration and a more secure banking system.

The banking crisis scenario would mean lower interest rates in Canada with the central bank taking its policy rate down to 0.25% in rapid fashion. The yield curve would steepen from the large drop at the short end and a lesser decline at longer maturities as in the last financial crisis.

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**Target Overnight Rate**

Meeting Date	Rate (%)
Oct. 25 (a)	1.00
Dec. 6	1.00
Jan. 17, 2012	1.00
Mar. 8	1.00
Apr. 17	1.00
June 5	1.00
July 17	1.00
Sept. 5	1.00
Oct. 23	1.00
Dec. 4	1.00
Jan. 2013	1.00
Mar.	1.00
Apr.	1.25
June	1.50
July	1.75
Sept.	1.75

(a) actual

**Interest Rate Forecast**

Item	2011 Q3a	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2	2013 Q3
Target Overnight Rate	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.25	1.70
Prime Rate	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.25	3.70
1-mo. T-Bill	0.85	0.80	0.75	0.80	0.85	0.90	0.95	1.15	1.65
3-mo. T-Bill	0.89	0.85	0.85	0.90	0.95	1.00	1.05	1.25	1.70
6-mo. T-Bill	0.94	0.90	0.90	0.95	1.05	1.10	1.20	1.50	1.90
1-year T-Bill	1.00	0.90	0.90	1.00	1.10	1.15	1.25	1.55	2.00
2-year GoC Bond	1.12	0.95	0.95	1.05	1.15	1.25	1.40	1.75	2.20
3-year GoC Bond	1.32	1.05	1.05	1.15	1.25	1.35	1.50	1.90	2.40
5-year GoC Bond	1.73	1.40	1.35	1.45	1.60	1.75	1.95	2.35	2.85
10-year GoC Bond	2.52	2.15	2.00	2.15	2.30	2.50	2.75	3.20	3.75

Note: Quarterly average based on daily data. a = actual, all others forecast.

**Deposit Rate Forecast**

Item	2011 Q3a	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2	2013 Q3
1-year GIC	0.80	0.95	1.00	1.00	1.00	1.00	1.00	1.20	1.40
3-year GIC	1.22	1.35	1.40	1.40	1.40	1.40	1.40	1.50	1.65
5-year GIC	1.75	1.80	1.85	1.85	1.85	1.85	1.85	1.85	2.00

Note: Quarterly average based on weekly data. a = actual, all others forecast. Non-redeemable rates.

**Mortgage Rate Forecast**

Item	2011 Q3a	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2	2013 Q3
1-year Mortgage	3.51	3.50	3.50	3.50	3.50	3.55	3.60	3.70	3.95
3-year Mortgage	4.35	4.10	4.05	4.05	4.05	4.10	4.30	4.50	4.75
5-year Mortgage	5.38	5.30	5.25	5.25	5.25	5.35	5.50	5.70	5.90

Note: Quarterly average based on weekly data. a = actual, all others forecast. Posted fixed term rates.