

The European sovereign debt crisis intensified and the European economy faces a recession. Downside risks are considerable and in the hands of slow-moving policymakers. Financial markets are volatile and have no patience for policy paralysis. While the situation may be dire in Europe, a possible U.S. recession has even more negative consequences for Canada.

The current forecast incorporates a slowdown and not a recession in Canada's economy, which is enough to keep the Bank of Canada on hold well into next year. A U.S. recession would likely prompt a rate cut in Canada, as would co-ordinated G-20 policy actions to stimulate the global economy.

## Economy

European events dominate market sentiment causing volatility and instability in the bond and equity markets. Worries about the global economy pushed equities to their worst quarter since the 2008 credit crisis. Falling commodity prices reflect recession concerns. Consumer and business confidence are also major casualties. Recession calls are louder and more frequent with a prominent source issuing a U.S. recession alert.

The latest developments in the Euro sovereign debt crisis are the Greek government admitting that it will not meet its deficit targets for this year and next, casting doubt on whether it will receive its next tranche and not run out of money. The country's recession is worsening and boosting the deficit/GDP and debt/GDP ratios. Despite failing to meet targets, the next tranche will be advanced since the consequences of the Greek government becoming illiquid and insolvent are too disastrous. This payment is now reported to be forthcoming in November.

European finance ministers will meet to discuss steps beyond those agreed to in July to bolster the regional financial stabilization fund. Indications are that a plan will be unveiled at the next G-20 meeting in November. These possible measures include increasing the size of the European Financial Stability Facility,

recapitalizing weak banks, and restructuring Greece's debts. A larger haircut than the 21% proposed to earlier is under discussion.

The EU has begun to implement agreements reached in July to increase the stability funds to €440 billion and allow it to buy government bonds and recapitalize banks. All 17 members must pass these changes, which Germany did last week. Slovakia will be the last and is expected to vote by mid-October. Once the fund gains these expanded powers in mid-October, a debt restructuring will become increasingly likely.

The European Central Bank (ECB) is the primary institutional actor in the crisis; at least until the European bailout fund is completely authorized to take over. The ECB is providing banks under stress with additional liquidity and buying bonds from countries under stress. There is speculation that the bank will reintroduce longer-term refinancing operations, resume its covered-bond purchases, and provide liquidity to banks. Over the past seven weeks, the ECB has bought almost €85 billion of sovereign bonds of fiscally troubled countries.

With the cumbersome and time-consuming policy-making process, for example it has not even started to implement the July agreements, delays will contribute to Europe's slipping into recession in the fourth quarter and to contagion fears. Purchasers of Italian bonds demanded a yield of 5.86%, up from 5.22% at last month's auction. Adding to concerns were reports that the French and Belgian governments had moved to guarantee all loans of Dexia, a Belgian bank, highlighting the risk of a new banking crisis.

Financial institutions are becoming more nervous about sovereign debt. The 3-month Euribor-OIS spread, which measures banks' willingness to lend to each other, climbed in July and remains elevated at over 80 basis points, jumping to 89 bps on Sept. 23, compared to around 20 bps at the beginning of the year and normally close to zero.

Recent data show the Euro area on the verge of recession. The Purchasing Managers Index (PMI) for manufacturing declined in September with declines

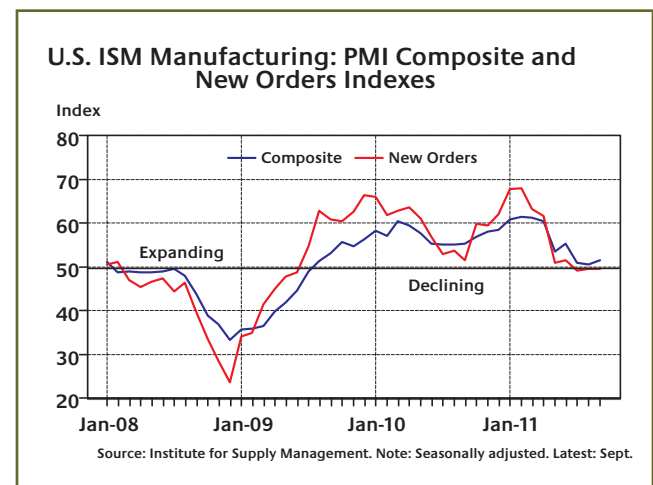
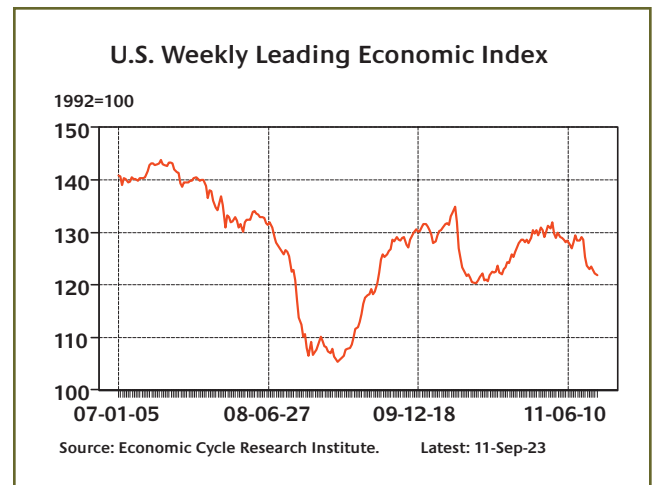
in almost all countries with the steepest in Greece and Spain. Manufacturers are reporting the worst business conditions for over two years, facing a combination of lacklustre domestic demand and falling export sales. Output fell only modestly in September, but a faster rate of decline in new orders suggests manufacturers will be cutting production in the fourth quarter.

Economic growth in the euro zone slowed to 0.2% in the second quarter of 2011 on a quarter-over-quarter basis, down from 0.8% in the first quarter. Third quarter GDP is likely did not expand at a faster pace than in the second quarter. The slowdown is broadly based across most sectors and countries. Fourth quarter GDP will contract and the odds of a technical recession are above 50%. A rate cut by the ECB before the end of 2011 is a high probability.

The global economy is slowing, pulled down by the advanced economies of the U.S., Europe, and others. Exports and industrial production in the emerging economies are easing though overall GDP growth rates remain high due to domestic demand in many cases. Nonetheless, slower growth should be expected in the near term and heading into 2012. For China, short-term indicators point to a gradual slowdown of high economic growth with the manufacturing PMI remaining subdued.

The U.S. economy is heading for a recession according to a prominent source. The Economic Cycle Research Institute (ECRI) issued a recession call for the U.S. economy based on its analysis of dozens of specialized leading indexes collectively behaving as they did leading to full-blown recessions. The Weekly Leading Economic Index continues to decline though it is not as negative as in early 2010 when double-dip recession fears last emerged. The ECRI's call could be a false signal, only time will tell. The consequences of a recession are substantial and negative for financial markets.

A recession is not yet upon the U.S. economy at least in the available data. September's jobs report will be a key indicator and it may not show a decline – the consensus forecast is +60,000. The ISM manufacturing index rose in September for only the second time in the past seven months and remained in expansion territory. Its employment index added 2 points to 53.8. Trade was positive suggesting exports would contribute to third quarter GDP growth. However, new orders remained weak or below the expansion threshold of 50.



Vehicle sales were stronger in September with sales at 13.1 million units, seasonally adjusted annualized rate, and the highest since April. Pent-up demand and incentives lifted sales facilitated by a larger supply of new vehicles after the Japanese disasters disrupted the auto supply chain. Should a recession ensue, vehicle sales would plunge.

Consumer confidence rose in September following a steep plunge in August. This does not represent a turning point and is probably a natural rebound from the highly negative events in August. Economic drivers of confidence remain very mixed, consistent with the still-low level of confidence. A volatile stock market does not lift confidence. Lower gasoline prices will help but substantial gains in the job market are needed to lift confidence.

Third quarter GDP growth is estimated at 2 to 2.5%, up from 1.3% in the second quarter. No recession at this juncture, but fourth quarter growth is more problematic. The main recession risks are a banking crisis in Europe followed by a substantial slowdown in China and other emerging economies. The first

would hit U.S. banks creating a credit squeeze and the second means U.S. exports would no longer be a growth driver. Policymakers would react to a recession but it is not clear how swift or efficacious those efforts would be on the fiscal front given the gridlock in Washington. However, the Fed would be able to act swiftly and help backstop banks but could not do much to help stimulate the real economy.

A U.S. recession would likely be a mild, technical one lasting about six to nine months followed by sluggish trend growth. Fiscal stimulus could result in above-trend growth in one or more quarters. While the ECRI is expecting a recession, this forecast does not though a negative quarter is possible.

The growth outlook for 2011 is 1.6% and for 2012 2.1% with growth modestly gaining momentum, rising to 2.7% in 2013. These are relatively lacklustre growth outcomes and indicative of weak consumer and housing sectors. Fiscal consolidation is ill-timed in current circumstances and contributes to the sub-par growth profile.

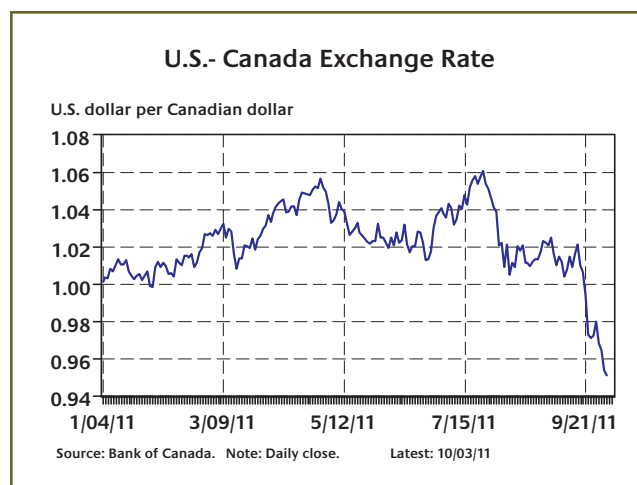
In Canada, third quarter growth will also come in higher than in the second quarter. This forecast puts it at 1.5% annualized while other forecasts range to 2.9%. July's industry GDP expanded 0.3% boosted by manufacturing and wholesale trade. August GDP is expected to increase 0.2% assuring a better growth result in the third quarter.

The composite leading indicator rose 0.2% in July, slightly above June but slower than the pace recorded over the first five months of the year indicating a slow growth environment. Should the U.S. economy fall into a recession, Canada would follow.

Fourth quarter GDP will likely expand at a slower pace, currently estimated at 1.5% annualized. Weakness in the trade sector will be the primary source of the slowdown. Government spending is another area of subtracting from growth.

Real GDP growth in 2011 is forecast at 2.2% slowing to 2.0% in 2012 with exports and government pulling down growth. Less business investment is also likely to contribute to slower growth. The economy is expected to strengthen mildly to 2.4% in 2013. The recent swift decline in the exchange rate would be welcome news for exporters but it comes with lower commodity prices.

Oil prices have fallen to below \$80 US and copper is close to \$3 US. In late July, these prices were \$100 US



and \$4.50 US, respectively. The Canadian dollar was \$1.05 US in late July and now stands below \$0.95 US. Any benefit to exporters from a lower dollar is more than offset by these commodity price declines.

## Inflation

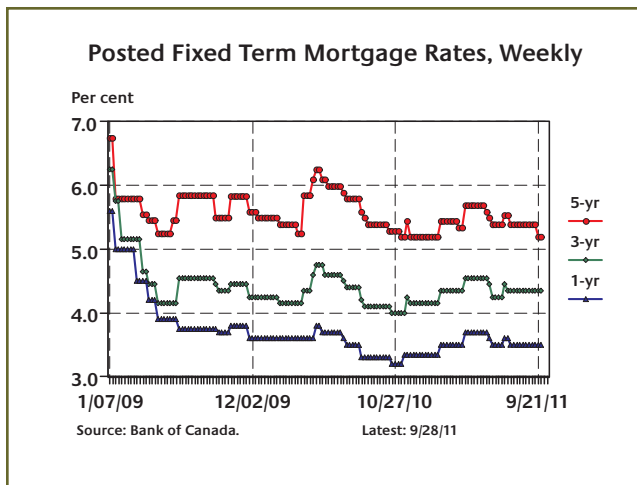
Consumer price inflation rose to 3.1% in August after dropping to 2.7% in July, reflecting higher transportation costs and motor vehicles prices. The Bank of Canada's measure of core inflation came in at 1.9% for the 12 months through August, up from 1.6% in July. August's higher rate of inflation also reflected higher prices for electricity and homeowner insurance.

Despite August's bump, underlying inflation pressures remain muted and not a concern for the Bank of Canada. Unemployment above 7% and with industrial capacity utilization below 80%, cost-push inflation is nonexistent nor is demand-pull inflation a force in the weakening economy.

## Interest rates

Bond yields continued declining through September interrupted only by the occasional respite from the negative news flow. The yield curve compressed to levels not seen since the 2008 crisis. Three-month government T-bills are hovering close to 0.80% while the 10-year government bond yield around 2.15% - a record low. Bond markets are pricing for a recession and reflect safe-haven flows as well.

The five-year posted mortgage rate was cut 25 bps in mid-September in a belated catch up to lower discounted rates. No other administered rate changes occurred.



### Monetary policy

The Bank of Canada is in a wait-and-see mode due to the high uncertainty in the global economy and financial markets. In its September 7 announcement it said, “the need to withdraw monetary policy stimulus has diminished.” Events since then reinforce this view and if anything raise the odds of a rate cut, i.e., adding monetary stimulus.

Worsening economic conditions or a banking crisis in Europe would prompt co-ordinated G-20 policy actions to stimulate the global economy. Some countries, like Canada, could cut interest rates while others such as the U.S. would rely on fiscal policy and non-traditional monetary tools (QE3).

### Interest rate forecast

A rate cut is not in this forecast despite the market pricing in a 100% chance of a 25 bps cut by March 2012. Rather, a holding stance by the Bank of Canada through most of 2012 is foreseen since no recession is expected in Canada. The growth slowdown will prompt a wait-and-see approach in the absence of a co-ordinated international policy move.

The main alternative forecast scenario is a rate cut before the end of the year or in early 2012 in response to deteriorating economic conditions and prospects. Under these circumstances, the market would price in a second 25 bps rate cut and the three-month T-bill rate would approach 0.50% and the 10-year government bond yield falling to 1.80%. Administered deposit and lending rates would decline accordingly.

In either scenario, administered rates are expected to decline in October. A drop of 20 to 25 bps in deposit and mortgage rates is forecast since the cost of funds is lower and yields on alternative savings vehicles such as government bonds have fallen.

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### Target Overnight Rate

Meeting Date	Rate (%)
Sept. 7 (a)	1.00
Oct. 25	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	1.25
Oct. 23	1.50
Dec. 4	1.50
Jan. 2013	1.50
Mar.	1.50
Apr.	1.50
June	1.75
July	2.00
Sept.	2.00

(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	1.05	1.40	1.50	1.55	1.80
Prime Rate	3.00	3.00	3.00	3.00	3.05	3.40	3.50	3.55	3.80
1-mo. T-Bill	0.85	0.80	0.85	0.85	0.90	1.30	1.40	1.45	1.75
3-mo. T-Bill	0.89	0.85	0.90	0.95	1.05	1.40	1.50	1.55	1.80
6-mo. T-Bill	0.94	0.90	0.95	1.05	1.15	1.50	1.65	1.70	1.90
1-year T-Bill	1.00	0.95	1.00	1.10	1.20	1.60	1.70	1.80	2.00
2-year GoC Bond	1.12	1.00	1.05	1.15	1.35	1.80	1.85	2.10	2.25
3-year GoC Bond	1.32	1.05	1.15	1.25	1.40	1.80	1.90	2.10	2.30
5-year GoC Bond	1.73	1.35	1.60	1.70	1.80	2.20	2.25	2.40	2.60
10-year GoC Bond	2.52	2.15	2.35	2.45	2.55	2.95	3.00	3.15	3.35

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	0.55	0.55	0.60	0.65	0.95	1.00	1.05	1.15
3-year GIC	1.22	0.85	0.85	0.90	0.95	1.10	1.15	1.20	1.35
5-year GIC	1.75	1.35	1.35	1.40	1.50	1.70	1.70	1.75	1.90

Note: Quarterly average based on weekly data. a = actual, all others forecast. 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	3.30	3.40	3.40	3.45	3.60	3.65	3.70	3.80
3-year Mortgage	4.35	4.15	4.20	4.20	4.25	4.40	4.50	4.55	4.70
5-year Mortgage	5.38	5.05	5.10	5.15	5.25	5.55	5.60	5.70	5.85

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