

The Vestcap Monthly Economic Report

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ANOTHER EUROPEAN BAILOUT

The Greek financial crisis has eased somewhat as another bail-out appears to be coming. The European Central Bank is sending signals that it will facilitate rollovers of Greek government debt. The euro is rising versus the USD again. Gold is down by 2% from its May 2nd high.

Sovereign debt is still a huge problem. European banks (excluding Greek banks) have a Greek exposure of €102 billion, concentrated in German, French and British banks. In addition, Greek banks hold about €60 billion of Greek government debt. Depositors should be nervous.

The ECB probably knows that Europe's banks do not have enough capital to withstand a sovereign debt default. Greece is a small country but from a financial perspective it is too big to fail. Looking ahead, we can expect to see continuing bailouts. European taxpayers will face a heavy burden and will not be happy.

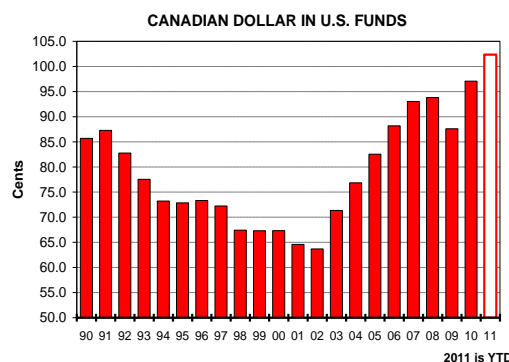
In contrast to Greece, there has been little if any financial market anxiety over the U.S. debt ceiling. The markets expect to see a deal in Washington and we think that one is coming.

The fight over raising the U.S. federal government's debt ceiling has started slowly. Moody's has warned that a credit rating downgrade is possible if there are no signs of progress in negotiations by mid-July. The slow pace is not surprising though. Neither side wants to appear to have compromised too easily.

In the end, it a "clean" debt limit increase, i.e., one that is not linked to spending cuts, is highly unlikely. There will in fact be benefits to the economy from such a linkage. It is the only way to assure financial markets that America can regain a sustainable fiscal condition.

Without such a link, the U.S. will run out of international financing room within 10 to 15 years. The awareness of this will surface much earlier, probably before mid-decade. We expect to see a deal before the August 2nd deadline.

President Obama's proposal would reduce spending growth by about \$2 trillion over the next 10 years. Republicans want a \$6 trillion reduction. A \$2.4 trillion increase in the debt limit seems to be the target and the two sides are close enough to agree by August 2nd on spending cuts that exceed this amount. The keys to the deal will be that these cuts will be from spending growth and will be over the next 10 years.



Global

- Commodity cycle is still in place
- Emerging economy demand remains strong
- Global recovery is still gaining strength
- German factory orders rebound
- Drought will push wheat and corn prices higher
- Saudi Arabia will increase oil output
- Libyan conflict in final stages
- Natural gas will be the substitute for nuclear
- Germany's nuclear shut-down will be costly
- New aid package being prepared for Greece

United States

- A temporary Japan supply shortage shock
- Recent economic weakness will be temporary
- 2nd Quarter real GDP growth around 2.0%
- Almost the same as 1.8% in 1st Quarter
- A rebound will become visible in August data
- Not all recent indicators are negative
- Weekly rail traffic steady (week ended May 28th)
- Intermodal volume is up 4.2% from year ago
- Railway car orders are at a 13-year high
- Heavy truck demand is up sharply
- Prices rising for non-distressed homes

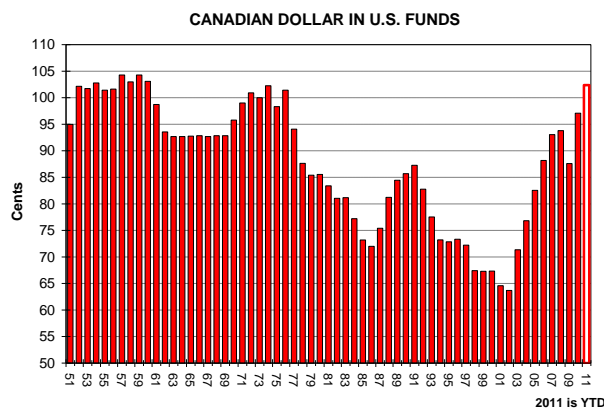
Canada

- Accelerated federal deficit cuts; 2014 surplus
- 30-yr bond yield 68 b.p. lower in Canada
- No personal tax increases, corporate tax cuts
- Stronger growth in Canada than the U.S.
- 3.9% real GDP growth rate in 1st Quarter
- Will be stronger than expected in 2nd Quarter
- Rebound in auto output is coming in 3rd Quarter
- The CAD is trading near a 2-month low
- Purchasing managers are upbeat
- Bank of Canada will tighten in 2nd Half of 2011
- Accelerated oil sands expansion plans
- Keystone XL project important for Alberta, CAD
- Western Canadian drilling activity up strongly
- Lumber shipments to China/Japan exceed U.S.
- B.C. lumber mills reopening
- Wheat prices up sharply yr/yr (over 70%)

ANDERSEN ECONOMIC RESEARCH INC

Tel: 512-243-7823 E-mail: pandersen39@gmail.com

COVER PAGE CHART STORY



The CAD is overvalued against the USD.

Ask any American visiting Canada.

Comparable consumer prices are much higher in Canada than in the U.S.

Purchasing power parity comparisons are imprecise but would suggest a CAD of less than 90 cents (U.S.)

Since the beginning of this year, the CAD has averaged \$1.0238 (U.S.)

We have to go back 35 years to 1976 to find anything comparable.

Canadians currently have a historically high purchasing power in the United States.

It is a good time for Canadians to buy American consumer goods, equities, real estate and even to take holidays in the United States.

It is also a good time for Canadian companies to buy U.S. machinery and industrial supplies. Their problem is the conversion of USD priced revenues back to CAD.

The Canadian dollar has been pushed lower partly by default.

Quantitative easing in the U.S. has pushed the USD lower against all currencies.

The USD has declined by 9.2% on a trade weighted basis over the past 12 months.

The CAD has also been pushed higher by a growing energy trade surplus.

Energy exports are up by 12% over the past 12 months in volume terms surpassing the 7% increase in energy imports.

The Bank of Canada has also pushed the CAD higher by tightening ahead of the Fed.

Currencies can be overvalued for a long time but we think the CAD will ease below parity with the USD again in 2012 when Libya and the Middle East stabilize and when the Fed begins to raise interest rates.

The CAD is not up against all currencies though. Its average so far this year has not changed much compared to its 2010 average against either the Euro (basically flat) or the British pound (an increase of less than 1%).

It is running about 7% below its 2010 average against the Swiss franc.

THE SLOWING IN THE U.S. IS TEMPORARY

Peter R. Andersen, Ph.D.

THE RECOVERY STILL NEEDS STIMULUS: Softer than expected U.S. economic indicators for May make it clear that the recovery still needs stimulus. An immediate big cut in U.S. Government spending would be bad news. Fiscal belt-tightening has to be spread out over time. Japan's supply chain interruptions and the spike in gasoline prices were partly, but not completely, responsible for the negative economic surprises last month. The domestic U.S. economy is still vulnerable and needs help. Fortunately U.S. export growth is solid and is broadly-based. We think that the federal Government will avoid a shut-down on August 2nd and that a credible fiscal restraint package will emerge. The challenge is to boost financial market confidence without counter-productive immediate spending cuts. As discussed on our cover page, we think that it can be done.

GASOLINE PRICES: The negative impact from soaring gasoline prices is already unwinding. Pump prices are declining again and we think the downtrend will continue. The U.S. national average for regular grade gasoline is currently down to \$3.78 per gallon from a peak of \$3.97 in May. However, this is still 71 cents higher than at the beginning of 2011. We are counting on oil prices to go lower as the political uncertainty in the Mideast winds down.

AMERICAN HOUSEHOLD WEALTH: At current levels, gasoline prices are still draining consumer finances. Nonetheless, household budgets have still improved. Household incomes are being boosted by job growth, the reduction in payroll taxes that Congress passed in December as well as increases in household wealth. The wealth gains reflect higher equity values since last summer. Even with the market sell-off since the peak at the end of April, the Dow Jones Industrial Average is currently up by 17% from June 11th, 2010.

There is even a positive contribution to household wealth coming from U.S. housing. Average house prices are still declining in the U.S. because of the large number of distressed sales. This is where the downward pressure on house prices is coming from. This kind of sale occurs when lender sells a property that it acquired through a foreclosure. These sales typically involve deep discounts and they account for about half of pre-owned home sales. However the lenders are the ones taking the financial hit, not households. Some households are actually in better financial shape after walking away from "underwater" mortgages. Strategic defaults are something that financial planners now actually recommend. The point, however, is that if we look at non-distressed home sales, we get a different picture. House prices are actually rising again for this category of housing.

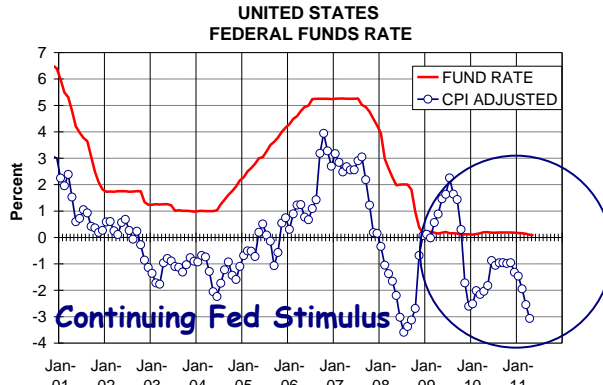
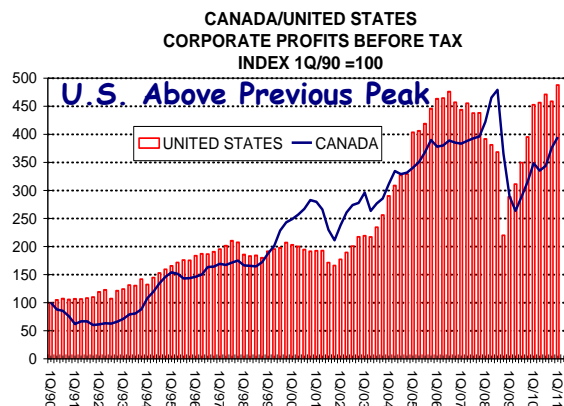
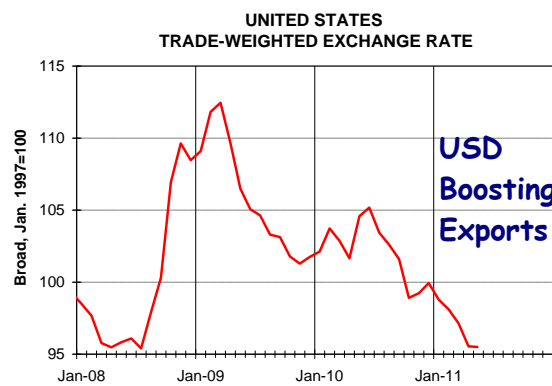
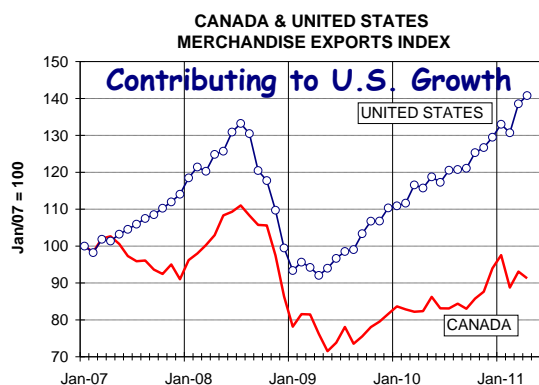
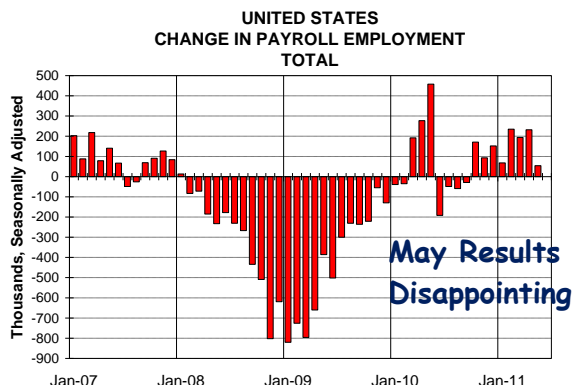
U.S. HOUSING STARTS WILL START TO MOVE HIGHER: The reappearance of job growth will feed into U.S. household formation. It fell to a 60-year low in 2010. The U.S. population is continuing to grow and there will be enough job creation in some regions to encourage individuals to establish independent residences. The first effect has been in the rental market, which has tightened significantly. The initial housing start recovery phase in the U.S. will therefore be in rental unit construction. We are already seeing indications in rental development. The demand is there and developers of such properties are not as restrained as new homebuyers by tight credit conditions.

Single-family construction will follow next year. Vacant pre-existing homes are far from being perfect substitutes for new homes. Their numbers are huge but they are concentrated in the markets in Arizona, Nevada, Florida and central California, which have the poorest economic prospects. The demand will come elsewhere in markets such as Texas where the economy is now accelerating. In addition, the condition of distressed properties typically deteriorates over the course of foreclosure proceedings. Given the choice, a homebuyer would often prefer a new home to a damaged pre-owned one. This is where the vacancy situation becomes important. The media gives all of the attention to the nearly 2 million pre-owned homes that are estimated to be vacant in the United States. However, there are hardly any vacant new homes. The latest figures show that there are only 175,000 new homes available for sale. This is the lowest number since the data began to be compiled in 1963. Only a small increase in new single-family home sales will have an immediate effect on construction.

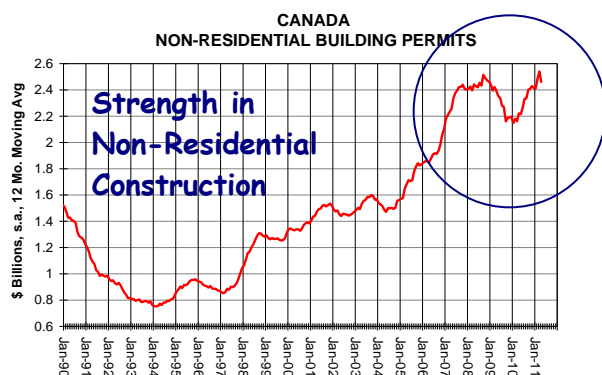
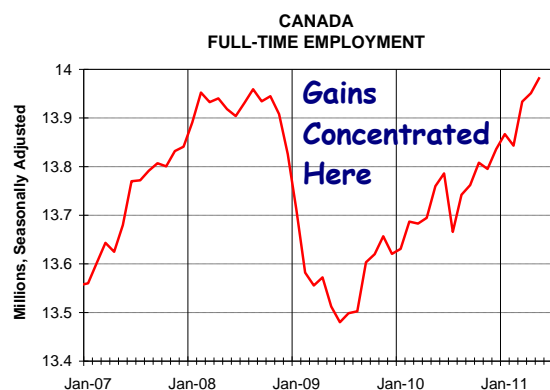
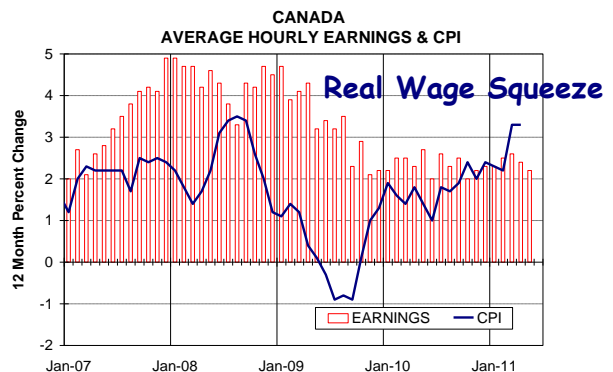
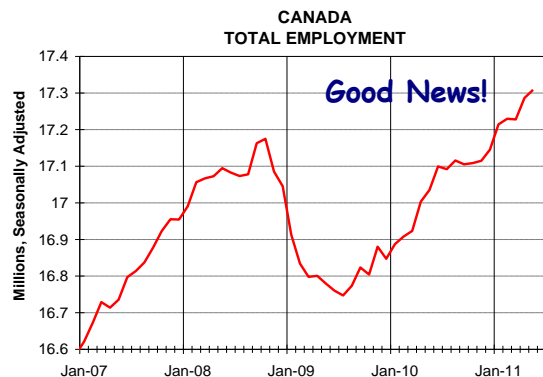
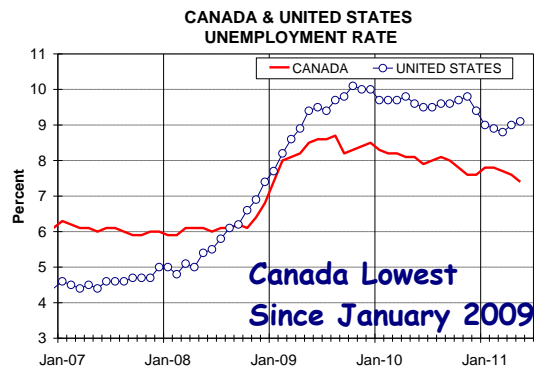
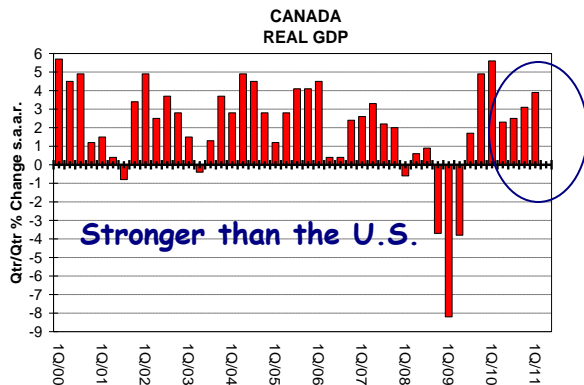
SUPPLY DISRUPTIONS: Japan's industrial activity should be rebounding before the end of the summer. Honda expects that its vehicle production will return to normal in August. The May U.S. payroll employment news was a disappointment but has probably been exaggerated. Looking across a span of several months, there has been a definite improvement in employment conditions since earlier this year. While the 83,000 May increase in private sector jobs fell well short of expectations, it followed gains averaging 244,000 over the three month period February to April. The question going ahead through the fall, after supply shortages end, will be how much the U.S. job market has actually improved compared to last year. We still expect that job growth will be running at about double its pace in 2010. Full employment will not be achieved until the end of 2014 but such job growth will be enough to allow the economy to maintain its forward momentum.

THE U.S. ECONOMY IS STILL EXPANDING: Real GDP growth is expected to be around 2.0% in the 2nd Quarter in the U.S., about the same as the 1.8% 1st Quarter rate of advance. The Fed's June 8th Beige Book report shows that the economy is still expanding. Information technology and business/professional services are growth leaders. Commercial and wholesale lending is picking-up. We still expect to see accelerating growth in the 3rd and 4th Quarters to almost double the growth rate in the 1st Half. Lost output will be regained when supply disruptions end.

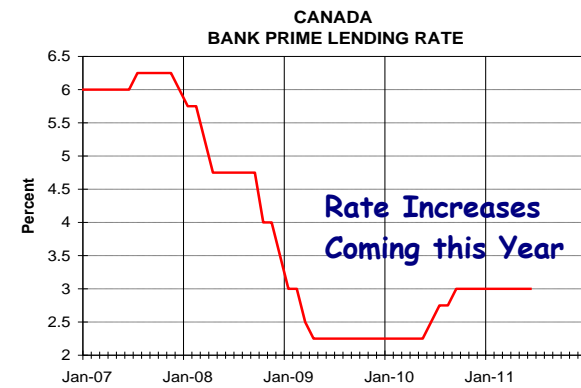
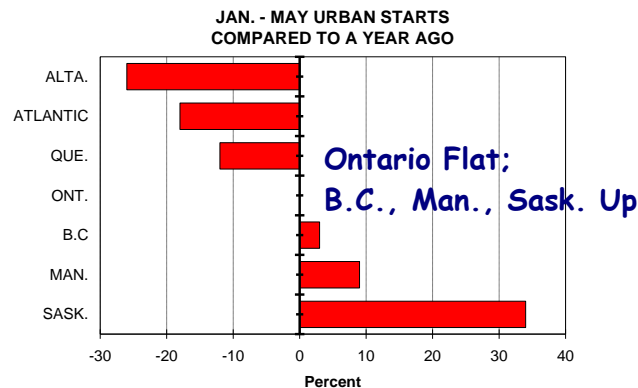
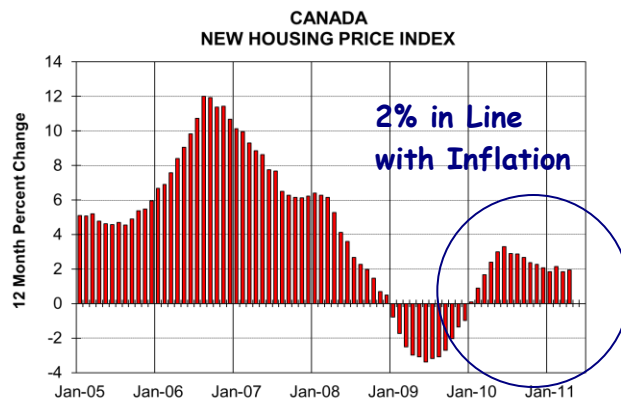
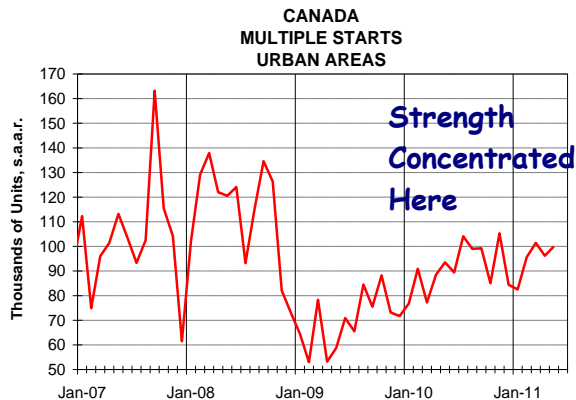
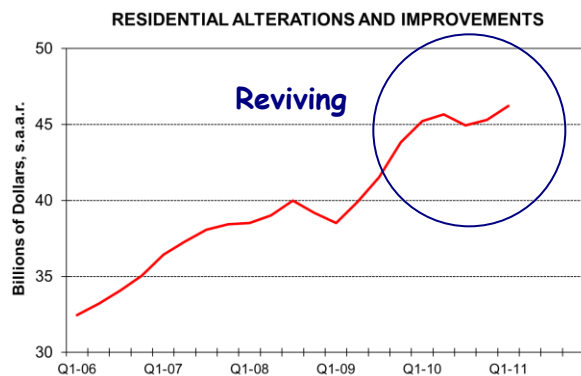
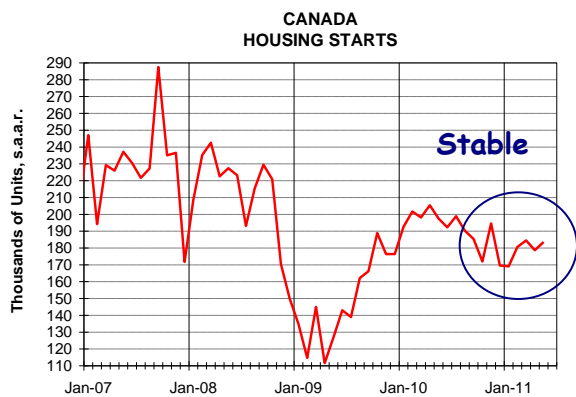
Exports are making an important contribution to growth. Widespread export strength indicates that the global recovery is still in place. The latest reports describe consumer spending as being either steady or increasing modestly despite high gasoline prices. The flow of new automobiles into dealers' inventories has been disrupted by the disaster in Japan and vehicle sales declined in May. Demand for used cars has been strong, however. Non-auto retail sales are described as expanding steadily in a number of regions and mixed in others. Despite temporary supply shortages in a number of industries, manufacturing activity has continued to expand, albeit more slowly. Service-related industries still show steady growth. The outlook for tourism, a discretionary spending item, has improved. Market conditions have strengthened in rental housing and multi-family construction is beginning to pick-up. Commercial leasing is stable but non-residential construction is still at a low level. Lenders report that commercial and industrial loan demand is gaining strength. Smaller businesses still face difficulties in obtaining credit but surveys of both banks and borrowers indicate that conditions are slowly improving for such borrowers. Oil drilling and extraction show robust expansion. There are some reports of shortages of workers with specialized technical skills. Capital budgets for equipment and software spending are still expanding. This reflects an improving sales outlook and the need to replace aging capital. Replacement demand for both capital goods and durable consumer goods will continue to be an economic driver.



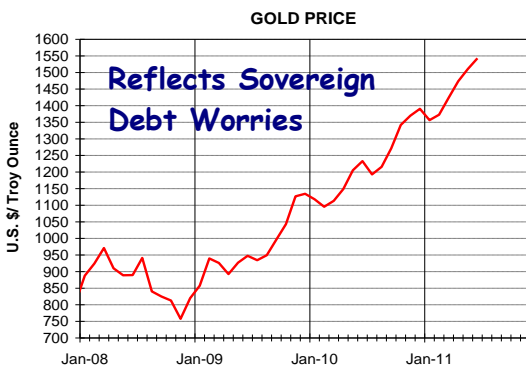
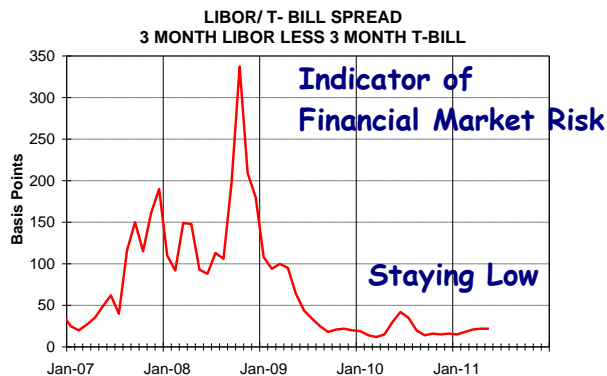
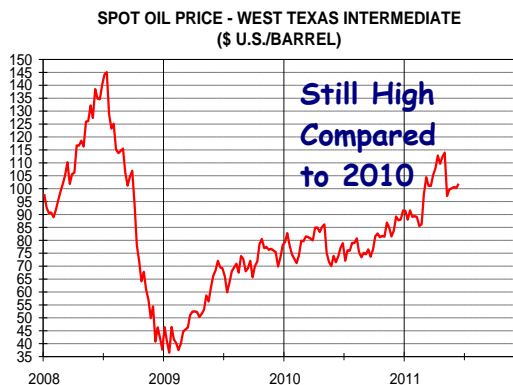
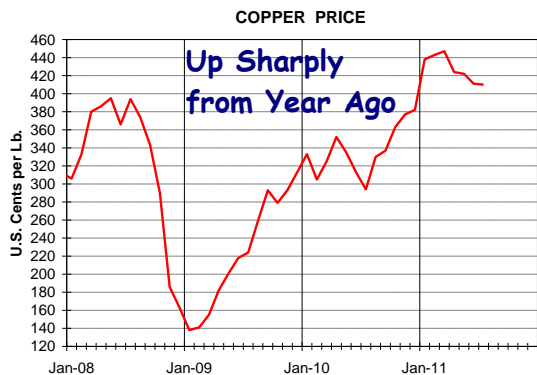
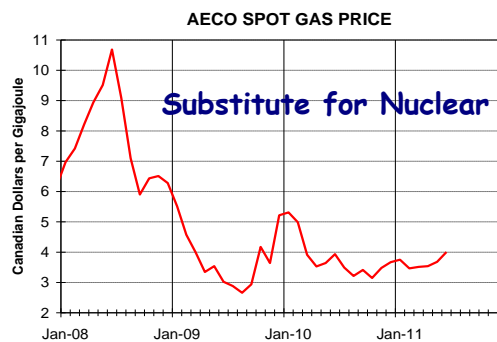
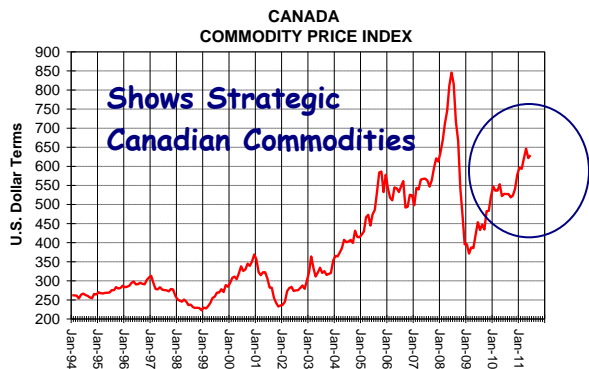
Canada is outpacing the United States. Real GDP advanced at an annual rate of 3.9% in the 1st Quarter following a 3.1% growth rate in the 4th Quarter of 2010. This compares with a 1st Quarter real growth rate of 1.8% in the United States. Canada's economy appears to have continued to expand at an above-average rate in the 2nd Quarter. There was a solid month to month real GDP gain in March, giving a good start-off level to the 2nd Quarter. In addition, employment moved to significantly higher levels in April and May. Purchasing managers' reports are positive. The composite leading indicator index shows sustained advances. It increased by 0.8% in the latest month, with 8 of its 10 components moving up. Rebounding auto production in the 3rd Quarter and will keep GDP growth at a high level. The seasonally adjusted unemployment rate is down to 7.4% - its lowest level since January 2009. The momentum in the job market is concentrated in full-time, private sector work. Adult male employment is the strongest category. This is good news for the consumer sector as income growth and consumer confidence are being supported. Business spending on plant and equipment is the growth leader. Outlays on non-residential structures are also making an important contribution to growth. Investment in engineering structures is particularly strong. Companies are adding to inventories in order to keep pace with sales. In the residential sector, household spending on renovation has turned upwards again after declining through the final nine months of last year. While the strength in the overall economy has been concentrated in the domestic markets, export performance has begun to improve. Canada's energy exports show a pronounced improvement since the beginning of the year. Drilling activity in western Canada shows strong gains.



New housing construction remains stable at a respectable level. In addition, spending on residential renovation is expanding again after declining through the final nine months of last year. May housing starts stood at a seasonally adjusted annual rate of 183,600 units. This is the highest start rate so far this year and compares with an average of 181,300 starts over the previous three months. Through the first five months of 2011, starts in urban areas are running flat in Ontario with 2010 activity levels. They show a comparable increase of 3% in B.C. and are down from 2010 in most other provinces. Among the large provinces, the most noticeable decline so far this year is the 26% drop in Alberta. Looking at major cities, Toronto shows a 30% yr/yr starts increase through the first five months. Calgary shows a 29% decline. The strength in Toronto is concentrated in multiple unit starts which are up by 54%. This pattern of strength in multiple starts and weakness in single-detached starts is reflected across the country. National multiple starts are up by 10% in urban areas through the first five months, and single-detached starts are down by 27%. This reflects government land use policies which have limited the supply of land to builders and made low-rise housing more expensive than high-rise product. Despite the surge in multi-family housing starts, the rental market is getting tighter in Canada. The national rental market vacancy rate has declined to 2.5% - down from 2.9% a year ago. The 1.6% vacancy rate in Toronto is well below the national average. The tightest rental markets are in Regina and Winnipeg, which both show vacancy rates of only 0.7%. Alberta shows a rental vacancy rate of 4.7% - the highest of any province.



The global commodity cycle will last for years. Only a severe global recession will bring it to an end. The supply of commodities cannot keep up with demand. Growth in the emerging market economies is highly commodity-intensive. Global commodity demand will continue to increase even though commodity consumption in advanced countries has not only stabilized but is in fact declining. Oil consumption in the U.S. is down by 2-1/2% over the period 2000 to 2010, even though real GDP is up by almost 20% over this time. Oil consumption in the emerging economies has surged by about 40% over the past decade, by far offsetting the 4% decline among advanced economies. The world oil market has become much tighter as production has increased by less than 1% per year since 2004. The world oil price has recently come off from its 2011 highs but is still up by about 40% from a year ago. For industrial metals, there have been even larger double-digit consumption declines in the advanced countries over the past decade. Again this has been offset by even stronger increases in the emerging economies. The price of copper is up by more than 30% over the past 12 months. The growth of the middle class in emerging economies has changed lifestyles and this has increased agricultural commodity demand. The percentage increases in corn and wheat prices have been even larger than industrial metals. They have approximately doubled over the past 12 months. Volatile weather seems to have become more commonplace and is constraining global production of agricultural crops. Corn prices have surged to a record high approaching \$8 per bushel. Adding to the upward price pressure on agricultural commodities, U.S. ethanol production this year is estimated to represent 40% of last year's corn crop. Ethanol prices have recently hit a 3-year high. Germany's announced move away from nuclear power will increase the strategic role of natural gas.



Alberta and British Columbia are reviving and will show the strongest economic growth through the summer. Edmonton is booming but Calgary has still not regained pre-recession levels of employment. Labour shortages are already an issue in Alberta. The May unemployment rate was down to 5.4% in Alberta. This compares with 6.7% in May last year. Only Saskatchewan (5.0%) and Manitoba (5.3%) have lower unemployment rates. Employment is picking up again in British Columbia. Vancouver is experiencing sharp gains in industrial and commercial building permits. The "Japan effect" is having its strongest impact on manufacturing, especially auto production. This is having a dampening effect on Ontario's economy this summer. However, these output losses are temporary and will be reversed in the 3rd Quarter. Employment in Toronto has declined from the high levels reached earlier this year but continues to stand far above its pre-recession peak. Western Canada is more closely linked to the global commodity cycle and the continuing strength in the emerging economies in Asia. China is now a much more important customer for B.C. lumber. A number of lumber mills have recently re-opened. The lumber industry will receive a further boost later this year as a revival in U.S. multi-family home building becomes more evident. Sustained high oil prices are accelerating oil sands expansion plans in Alberta. The Keystone XL pipeline project is of vital importance to Alberta's heavy oil export prospects in the United States. The U.S. State Department has a year-end approval deadline by for the \$7 billion project. Approval of the project is not guaranteed. The decision will be important for both Alberta the CAD. Drilling activity in western Canada is up sharply. Drill rig utilization is running higher than expected and the CAODC has increased its forecast of well completions. There has been a shift towards oil well drilling and a de-emphasis on natural gas.

