Review and Forecast

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A CONTINUING RECOVERY

Despite the twin economic shocks of higher oil prices and widespread earthquake damage to Japan's economy, the North American economic recovery appears to be capable of continuing. It is now more broadly based and a self-reinforcing process has been established. We expect that 2011 will be the first true recovery year for Canada and the United States.

GLOBAL ECONOMIC PERFORMANCE

The world economy has been performing better than expected. The OECD has reported that the economic recovery in the G-7 countries is gaining strength, with the private sector taking over from the public sector as the growth provider. It expects that six of the seven major G-7 countries will grow at a 3% annual rate in the first half of 2011.

This is a substantial improvement from earlier expectations. The OECD is unwilling to make a prediction at this time for Japan - the seventh member of the group - given the difficulties in estimating the damage from the earthquake, tsunami and nuclear disaster.

FORECAST RISKS

The wild cards for the global outlook are therefore the outcome of Japan's crisis and the reliability of the major OPEC oil producers. At this point, the economic recoveries in the U.S. and Canada are not expected to be affected much by Japan. We are assuming that China and the emerging Asian economies will help prevent economic distress in Japan from stopping the global recovery.

Another key assumption is that both Iran and Saudi Arabia will remain politically stable. Libya is not a major oil producer and OPEC can replace its production loss. However if the turmoil spreads, oil could easily jump to the $150 per barrel range.

This would undoubtedly be a large enough energy shock to bring on another U.S. recession. However, the likelihood of a pro-democracy uprising sweeping the Arab world seems to be a low probability event. It is in OPEC's best interest to prevent a destabilizing oil price spike.

For now the best assumption is that the oil price stabilizes around current levels. Crude oil prices are currently the highest since September 2008. They could even be brought down somewhat by a drop in crude oil consumption in Japan. It is the world's third largest importer and faces an economic decline over the short-term.

THE ENERGY MIX

Japan's imports of liquefied natural gas and low-sulfur crude oil will increase because of the nuclear shut-downs. North American natural gas markets will not be directly affected as the U.S. does not rely on LNG for domestic consumption. Nonetheless, natural gas will be viewed more positively as a result of an increased global dislike of nuclear power. This will be good news for western Canada.

Longer-term, natural gas may be the green alternative to nuclear in electric power generation. New power plants are more likely to use natural gas. Nonetheless, nuclear power is an important part of President Obama's overall energy plan. There are 104 nuclear power stations currently operating in the U.S. and they supply 20% of U.S. electric power.

JAPAN'S IMPACT

On its own, Japan's crisis will not have a significant direct on the overall U.S. economy. There will be impacts on certain companies and industries but the negatives will be approximately offset by the positives. Also Japan is no longer a big trading partner for the Unites States.

Foreign trade will show a positive effect on U.S. exports of food and agricultural products but a negative effect on exports of chemicals and machinery. Imports of autos, electronics and industrial equipment from Japan will be affected but there will be substitutes in the United States.

Japanese rebuilding will put upward pressure on a number of construction-related materials such as lumber, plywood and OSB. North American lumber prices were already moving higher before the earthquake.

JAPAN'S RECONSTRUCTION

Estimates on the cost of the reconstruction in Japan have now increased into the US$300 billion range. This is a huge number. Approximately 70% of this will be borne by the government and the rest, by private insurers. It means that funds will have to be repatriated back to Japan. Japan is a big holder and buyer of U.S. government bonds.

Japan accounts for about 20% of all U.S. government debt held abroad. The repatriation of some of these holdings and a decreased Japanese appetite for new offerings of U.S. government bonds appear likely to push long-term interest rates higher. The question is when and how much?

Central bank purchases of Japanese government bonds are likely to keep the lid on long-term interest rates. If they threaten to move too high in the U.S., the U.S. Federal Reserve itself could resort to yet another round of quantitative easing. However we do not expect this to happen and do not think it will be necessary.

MONETARY POLICY

The combination of such possible economic shocks changes the outlook for monetary policy in both Canada and the United States. No central bank will want to raise rates at a time like this. Some had thought that the Bank of Canada would begin to raise its overnight target rate in July. Now it looks like it will wait until sometime in 2012.

In the U.S., the Q2 quantitative easing operations will now definitely continue until the end of June. In addition, the Fed will now wait longer until it begins to move its policy rate back to a more normal level. The Fed will probably not start tightening until the spring of 2012.

A REVIVING U.S. ECONOMY

Renewed job growth is the critical factor that will enable a sustainable U.S. recovery. After a year and a half of a very deep recession, and another year and a half of a disappointingly slow recovery, the U.S. economy now appears to be moving into a new phase of improved growth. Purchasing managers' surveys are giving strong readings. Fed Chairman Bernanke has stated that the recovery is on "firmer footing".

PRIVATE SECTOR U.S. JOB GROWTH

Employment growth is necessary for a sustained recovery. It will create the income and confidence that will boost consumer spending and in turn, lead to even more employment gains. Fortunately, the job market recovery is gaining momentum. A new phase of stronger job creation appears to have begun.

The preconditions for a pick-up in hiring have been in place for some time and payroll employment reports are now finally showing solid monthly job gains. Credit conditions are beginning to ease for small businesses and this is helping to lift hiring plans.

Private sector payrolls increased by 230,000 in March from the month before. This followed an increase of 240,000 in February. In comparison, private sector employment increases averaged only 146,000 per month in the final quarter of 2010. Layoffs at the state and local government level appear to be winding-down as tax revenues gradually improve. There was a loss of only 14,000 public sector jobs in March.

THE U.S. CONSUMER

American households have made major progress in rebuilding their balance sheets. Reduced debt payments are making a big difference to consumers' cash flow. Replacement demand for vehicles and other consumer durables is becoming an increasingly important factor for the consumer sector. Renewed employment growth is supporting consumer spending despite the adverse effects on consumer confidence from higher gasoline prices.

U.S. RESIDENTIAL CONSTRUCTION

Despite currently weak U.S. housing starts numbers, U.S. housing starts could begin to move higher again before the end of 2011. In 2012 a further increase in U.S. housing construction is possible. The inventory of new homes available for sale in the U.S. is extremely low and even a small improvement in sales will immediately boost U.S. construction. Many home buyers are not interested in vacant foreclosed homes, many of which badly need repair and are in undesirable locations.

CANADA'S ECONOMY

A significant acceleration in economic activity is possible in Canada in 2011. Leading indicators are giving positive signals. The composite leading indicator index showed a strong increase in February. It increased by 0.8% from the month before. This was the strongest advance since May 2010. Nine of the ten components of the index increased in February, compared with only four the month before.

Canada's manufacturing sector appears to be turning around. New orders and shipments have increased. Companies appear optimistic that they are experiencing a sustained improvement in demand. This reflects improving economic conditions in the United States and stronger Canadian exports. The manufacturing purchasing managers' index in the U.S. is giving the strongest readings since 2004.

The length of the manufacturing workweek has been extended in Canada and there has been a substantial increase in manufacturing employment over the past three months. Manufacturing has important linkages with the services sector and the recent signs of a revival indicate that the recovery is broadening and gaining momentum.