

# Vestcap Monthly Economic Report

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## ABOVE-POTENTIAL GROWTH

The U.S. has shifted into an above-potential growth phase. It began in the 4<sup>th</sup> Quarter of 2010 and is expected to continue through the next three years. We are now forecasting average annual real GDP growth in the U.S. of 4.0% in 2011, 3.4% in 2012 and 4.2% in 2013.

The U.S. Tax Relief Act provides a wide range of tax cuts and benefit extensions going far beyond a mere extension of the tax regime already in place. In combination with the second round of quantitative easing, it will provide another major injection of economic stimulus.

We expect Canada to at least match and perhaps show a growth premium over the United States in 2011 as a new global commodity cycle takes hold. There was no shortage of domestic demand in Canada in 2010. The domestic economy advanced at a 3.6% annualized real rate in the 2<sup>nd</sup> Half of 2010 but net export weakness kept the overall growth rate down. In 2011 an accelerating U.S. economy will revive Canadian export growth across a broad range of products.

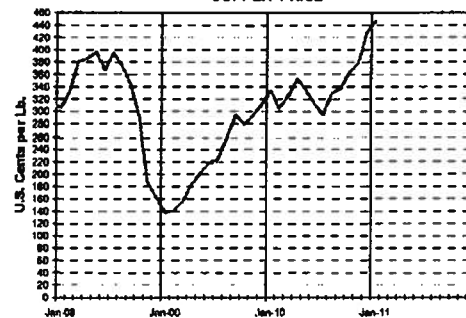
The financial causes of the Great Recession of 2008-09 are being addressed and replacement demand (both household and business) is now a key economic driver. U.S. corporate balance sheet repair is finally completed and household balance sheet repair is well underway.

The average age of U.S. passenger vehicles is over 10 years – an unprecedented level. Motor vehicle sales are already surprising on the upside. U.S. corporate profits are less than 1% from their previous cyclical peak. Business fixed investment is running at a 15% annualized real rate of increase. The recovery in equipment spending in the U.S. is faster than in previous cycles. This reflects a positive boardroom psychology that is being shared in Canada.

The European debt crisis is not a global recovery game changer. The European Central Bank will provide the market liquidity to allow Portugal, Spain and Ireland to roll-over large amounts of maturing sovereign debt in 2011. The ECB will also maintain the solvency of the European banking system.

A downtrend in the U.S. unemployment rate will be in place by mid-2011. By this time a year from now the U.S. unemployment rate is expected to be well below 9.0%. This will be the key to stabilizing the U.S. housing market.

COPPER PRICE



## Global

- A new commodity cycle has begun
- World growth forecasts will be revised higher
- World oil price at 2-year high; soon above \$100
- ECB will facilitate sovereign debt rollovers
- Europe's sovereign debt crisis can be contained
- Ireland/Portugal/Spain show fiscal discipline
- Ireland's 2009 govt. gross debt/GDP ratio 64.5%
- Compares with a 82.5% ratio for Canada in 2009
- European bank solvency is the main problem
- Euro is poised to decline further

## United States

- 2010 Tax Relief Act pushes forecasts higher
- Much more than an extension of Bush tax cuts
- Reinforces a Q4/2010 growth acceleration
- A wide range of positive monthly indicators
- GDP growth in excess of potential in 2011
- Job creation already accelerating
- Unemployment rate will begin to decline sharply
- Improving job market will stabilize housing
- Housing turnaround will assist the credit cycle
- Housing starts: 800,000 2011; 1.15 million 2012
- Capacity pressure on lumber/bldg materials
- U.S. growth recovery will boost the USD
- No Fed tightening in 2011
- But bond yields up sharply/prices down sharply
- "Crowding-out" will return as an issue by 2012

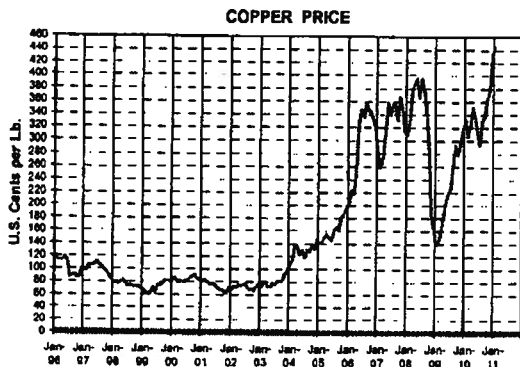
## Canada

- Canada will have growth premium over U.S.
- A healthier banking system; credit availability
- Households can afford to carry their debt
- Debt service ratio is close to a historic low
- Impressive full-time job growth
- 60% of job gains over past 12 months full-time
- Toronto Region shows strongest recovery
- Housing starts continue to exceed expectations
- Canada's export performance will improve
- CAD is overvalued at US\$1.01/CAD
- Purchasing power parity for CAD below US\$0.90
- Long-term natural gas export weakness

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## COVER PAGE CHART STORY



Inflation is a controversial subject.

There is ample global excess capacity.

More than 210 million people across the globe are unemployed.

This is up by more than 30% since 2007.

Commodity prices are warning of higher inflation though. Copper has soared.

Inflation is a serious problem in China and is expected to worsen. Consumer price inflation there is running at 5.1% and appears likely to move to 6% in 2011.

Inflation is even higher in India with consumer prices up yr/yr by 9.8%. However U.S. CPI inflation at 1.1% yr/yr is close enough to zero to keep deflationary fears alive.

We have always looked on commodity prices as a leading indicator for inflation.

Crude oil seems headed over US\$100 per barrel in 2011 and this is bound to create higher transportation costs.

With the U.S. economy picking up speed in 2011 and maintaining above-potential growth in 2012 and 2013, we believe that capacity pressure will return in many sectors.

In some industries such as housing, supplier capacity in the U.S. has been cut in response to the long and deep recession.

A recovery to 1.15 million U.S. housing starts by 2012 is likely to exert cost and price pressure on lumber, building supplies and base metals.

The same applies to the automotive sector and the industrial sector overall. We are forecasting 14.5 million U.S. vehicle sales by 2012.

Agricultural prices are already up sharply from a year ago, for example: wheat +36%, corn +44%, cattle +18%, milk +17%, cane sugar +20% and coffee +69%.

The 2010 U.S. Tax Relief Act provides \$858 billion of tax cuts and benefits. It guarantees sustainable growth but adds to the massive U.S. government debt.

Medicare funding and the new "Obamacare" costs will also add to the debt burden.

Hard budget choices may never be addressed. Inflation may be the only politically acceptable final solution. The Fed has a dual mandate and by mid-decade could be inclined to lean less towards inflation control and more towards supporting employment.

## GET READY FOR A REPLACEMENT DEMAND CYCLE

Peter R. Andersen, Ph.D

**A STRONGER OUTLOOK:** Check the date stamp on the label for any economic forecast for next year. Forecasts prepared in early December are already out of date. They are too pessimistic. President Obama used the Bush tax cut exemption to push through a large fiscal stimulus package. The U.S. economy has already accelerated, well before the new fiscal stimulus will kick-in. The U.S. economy advanced at an above-potential rate in the final quarter of 2010. The December U.S. fiscal stimulus package will keep the U.S. growing at an above-potential rate in 2011.

The compromise 2010 Tax Relief Act does more than extend Bush era tax cuts. It provides a wide range of tax reductions and benefit extensions going far beyond a mere extension of the tax regime already in place. It will combine with the second round of quantitative easing. The Fed's purchase of \$600 billion of longer dated U.S. Treasury securities by June 2011 is intended to maintain low risk-adjusted discount rates (i.e. market capitalization rates and the cost of capital). No wonder stock markets are setting fresh 2-year highs. This all amounts to a large amount of additional economic stimulus. The U.S. now seems capable of real GDP growth of 4.0% in 2011.

**REPLACEMENT DEMAND:** The great economic thinkers 65 years ago expected a return of the Great Depression at the end of WW2. They could not have been more wrong. Their mistake was to neglect the role of replacement demand. American consumers had held back from making discretionary durable goods purchases for many years. By 1945 they were tired of driving their Model A Fords, their 1936 Ford Woody Station Wagons and their 1939 Ford Coupes. A massive backlog of replacement demand had built up. Given the opportunity to pay off depression debts during the 4 years of wartime defense production, Americans were ready and able to spend.

Looking ahead to 2011 and 2012, we expect replacement demand to be an increasingly important economic recovery driver. The average age of the U.S. automobile fleet is over 10 years. This is an unprecedented high. Motor vehicle sales in the U.S. have shown a stronger than expected recovery in the final months of 2010, indicating a replacement demand effect. There has already been progress in repairing household balance sheets in the United States. More improvement is expected in 2011 and 2012. An important threshold will be the coming recovery in U.S. house prices. We expect to see this before the end of 2011. It will be triggered by declines in the U.S. unemployment rate in the 2<sup>nd</sup> Half of 2011.

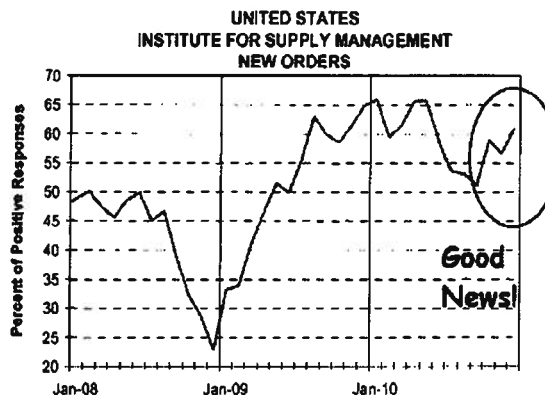
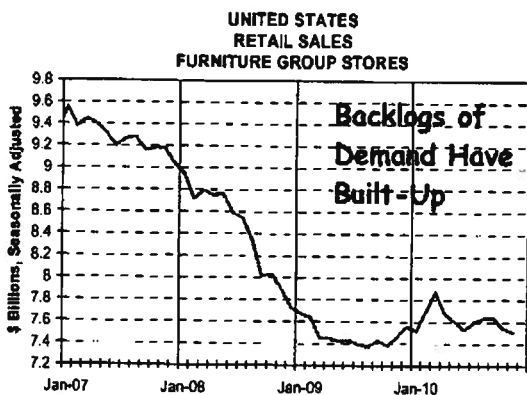
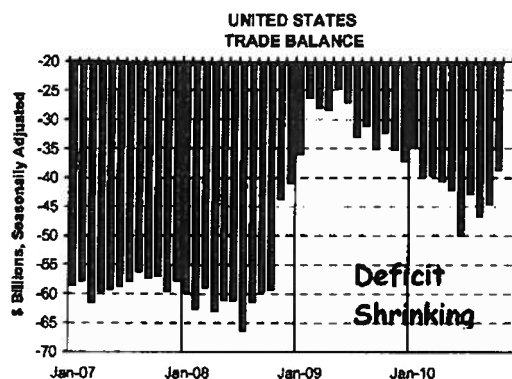
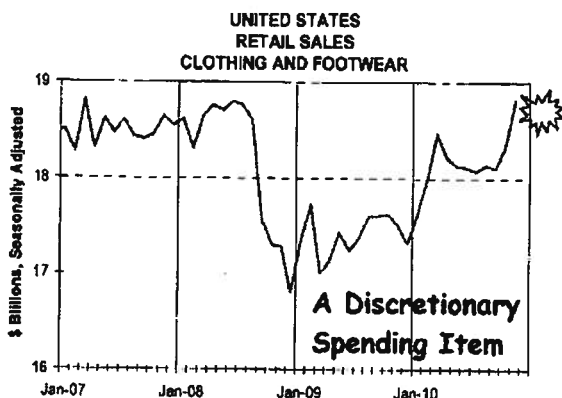
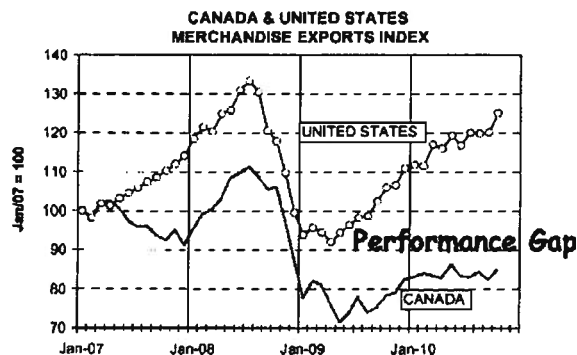
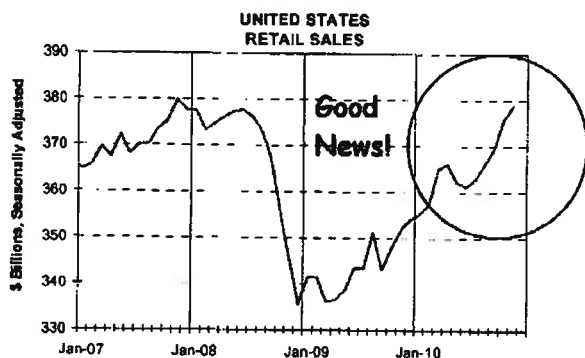
**CANADA'S ECONOMY IN 2011:** With Canada's best customer shifting into an above-potential growth path, Canada's export performance will improve. This has been the weak link in Canada's economy. There has been plenty of domestic demand in Canada – real consumption has been growing at almost a 4% rate and plant & equipment has been showing double digit growth. However, there was a big import drain in 2010 and exports slumped. Looking ahead, Canadian exports will be helped by accelerating economic activity in the United States. We expect Canada to at least match and perhaps show a growth premium over the United States in 2011 as a new global commodity cycle takes hold. Canada did not suffer as much financial damage as the U.S. during the crisis. The CAD is overvalued by about 14% but this will not prevent a turnaround in net export volumes. The currency effect will be on profit margins rather than on export and import volumes. Cross-border trade is mainly priced in USD.

**HOUSEHOLD FINANCES:** Canada's household debt levels are making headlines and undoubtedly will put its economy and Canada's housing sector in a vulnerable position when the next recession inevitably arrives. However this is not in our short-term planning horizon over the coming three years. For now it is the cost of servicing debt that matters, not the actual level of debt. The reality is that Canadian households can afford to carry their debt. The share of disposable income taken up by debt payments is close to a historic low and is on a downtrend. In addition, asset values have been increasing as fast as debt. The ratio of debt to household net worth has been moving sideways. The debt story will not be a problem until the debt service ratio is much higher than it is today.

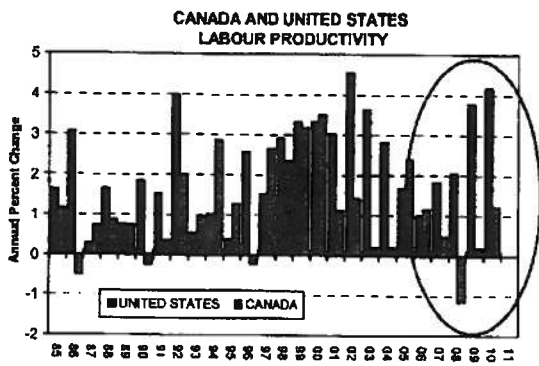
**COSTS AND PRICES:** Above potential growth in the U.S. will reinforce our forecast that the global economy has already begun a new commodity cycle. Energy, base metals and lumber prices will continue to rise. The exception will be natural gas where prices are expected to remain depressed and the market over-supplied through mid-decade. Shale gas production in the U.S. is pushing Canadian gas out of the U.S. market. The U.S. Energy Information Administration (EIA) is forecasting that imports of natural gas into the U.S. will not return to 2008 levels until 2015, despite significant gains in U.S. natural gas consumption.

An upturn in residential construction in the U.S. is expected to add to capacity pressures in building materials markets. We are forecasting U.S. housing starts to recover to 800,000 units in 2011, up from an estimated 609,000 in 2010. We expect them to reach 1.15 million units by 2012. This would be the first time in four years that U.S. starts have exceeded 1.0 million units. Our recovery outlook for U.S. housing starts is based on our expectation that the U.S. unemployment rate will begin to move down sharply starting this summer. Canadian new home builders can therefore expect continuing increases in lumber prices as well as a range of other building materials prices. Lumber price futures have jumped to their highest level in more than four years. Lumber futures for May 2011 delivery are up to US\$340 per 1,000 board feet. Elevated levels of non-residential construction will also put some categories of construction workers in short supply.

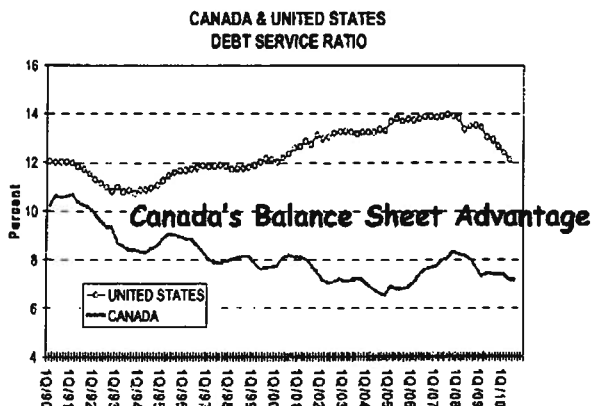
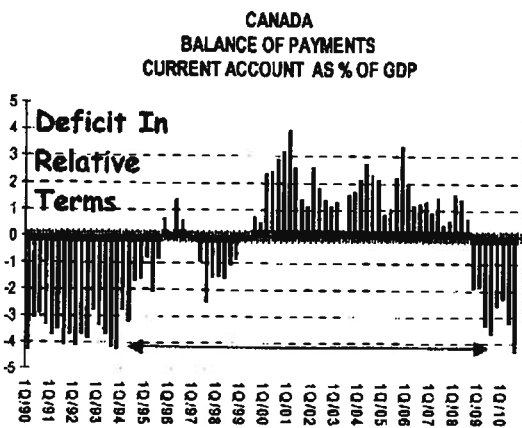
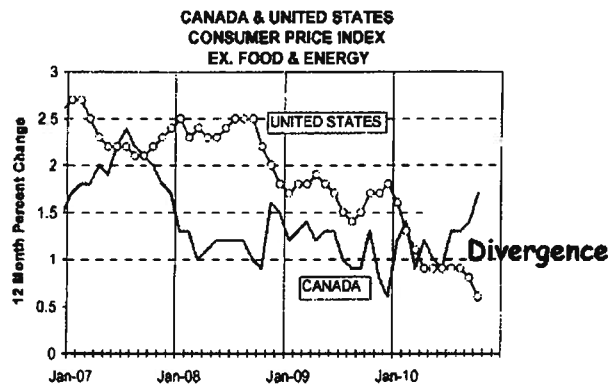
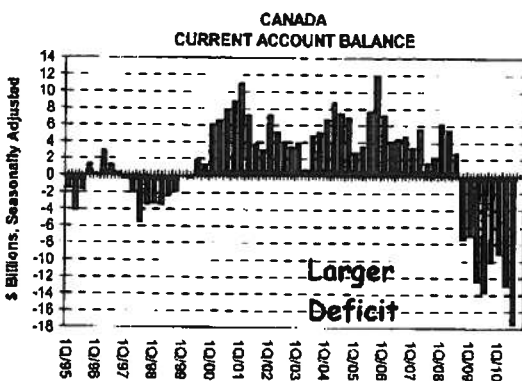
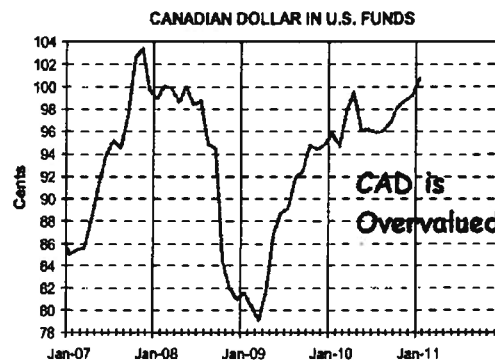
Financial, foreign exchange and commodity markets are all giving economic recovery signals. The yield on the benchmark U.S. 10-yr Treasury note is up from 2.93% at the end of June to 3.46% now. The Dow Jones Industrial Average is up to 11,735 from 9,774 at the end of June. From year-end to year-end, the Dow had a total return (including dividends) of 14%. Commodity linked currencies such as the Canadian (CAD) and Australian (AUD) dollars are also up sharply since June. The CAD has increased by 6.8% against the USD over the past six months. The AUD is up by 20%. WTI crude oil is up from \$75.63 per barrel to over \$90 now. Oil is trading at near a 27-month high. The employment situation in the U.S. is steadily improving and this is the key to a self-sustaining recovery. The latest U.S. fiscal package will make a big difference for the economy. Stronger job markets and declining unemployment in 2011 will fuel discretionary consumer spending and replacement demand. It will also be what is needed to stabilize the U.S. housing market. Private sector job growth picked up substantially in December. Jobless claims are down sharply. Holiday season retail sales were strong. Purchasing managers report accelerating economic activity. They are increasingly optimistic for production and new orders. Watch for a fight in Congress early in 2011 over the U.S. federal debt ceiling. U.S. gross federal debt is fast approaching the statutory debt limit of \$14.3 trillion and we can expect incoming House speaker John Boehner to push hard for spending cuts. In the end the debt ceiling will be raised but in exchange for significant federal government spending cuts. Republicans want to roll back federal spending to 2008 levels.



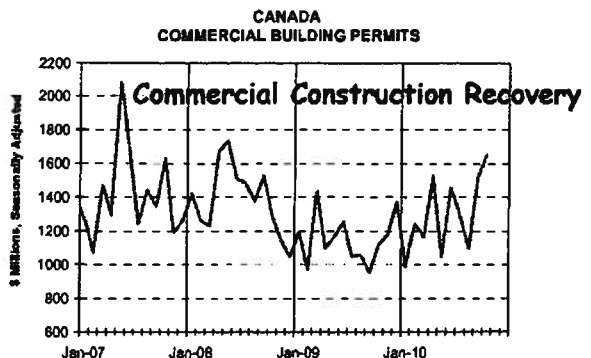
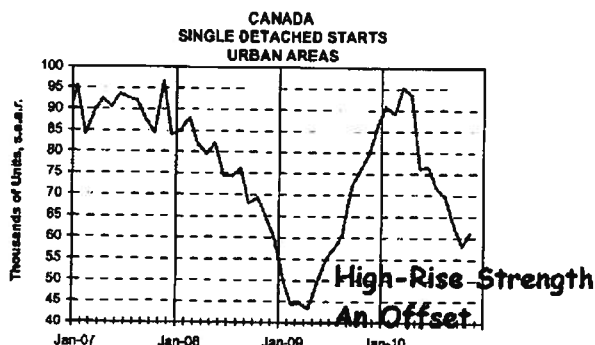
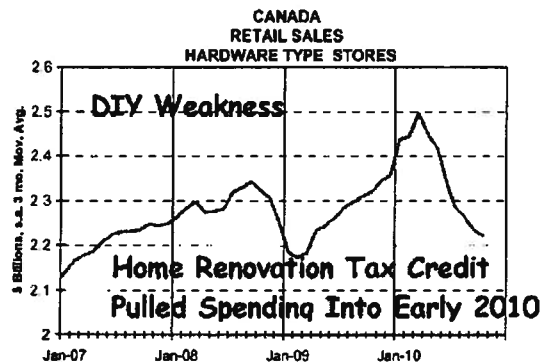
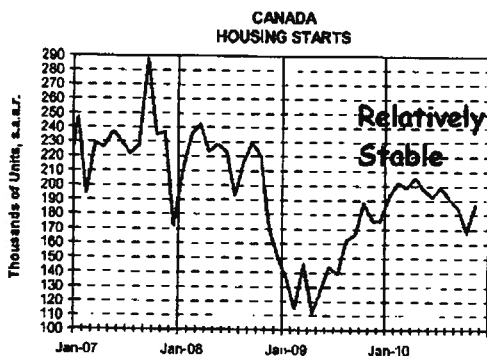
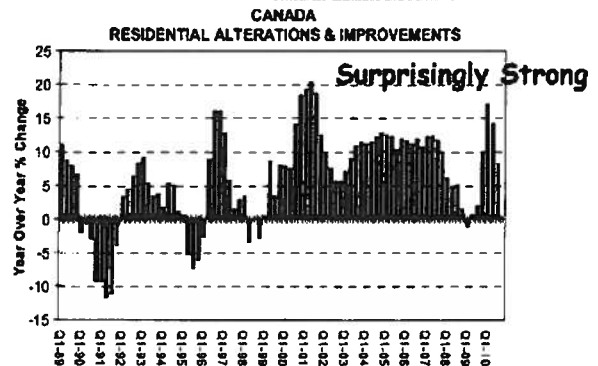
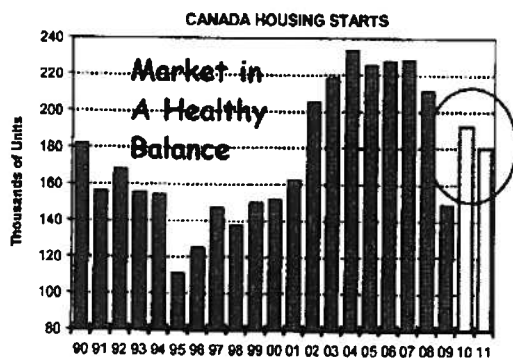
Purchasing power calculations show that the CAD is overvalued by about 14% compared to the USD. With the CAD now slightly above parity with the USD, Canada is not competitive internationally. It has not been for some time. This is apparent in its poor productivity performance and in the recent deterioration in its foreign trade and current account balances. The foreign exchange market never likes current account deficit countries and the recent boost to the CAD could therefore be short-lived. The onset of a new global commodity and energy cycle is giving a psychological boost to currencies of resource producing countries such as Canada. Forecasts for oil at above \$100 per barrel enhance the CAD's image as a "petro-currency". However this positive sentiment directed towards the CAD is not supported by the reality of Canada's energy situation. Natural gas is an important component of Canada's energy exports. Canada faces continuing declines in natural gas exports for a number of years. Canada's natural gas is being squeezed out of the U.S. market by new technologies that are generating large increases in U.S. shale gas production. Canada's public finances also tend to be over-rated. This is often one of the factors cited by the media to explain foreign investor confidence in Canada and in the CAD. The latest annual figures do not support this. They show a general government debt to GDP ratio almost as high in Canada as in the United States (82.5% in Canada and 83.2% in the United States).



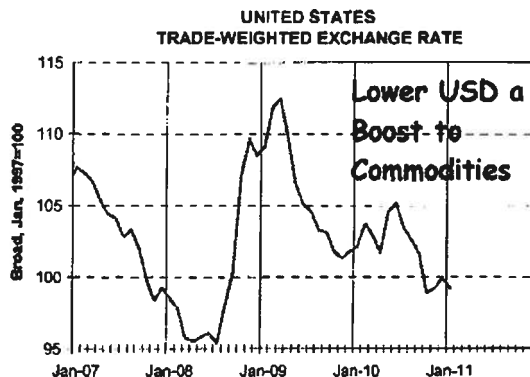
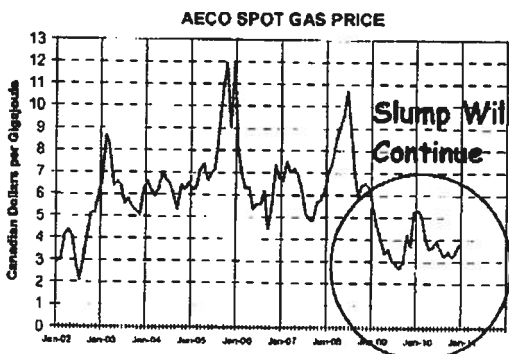
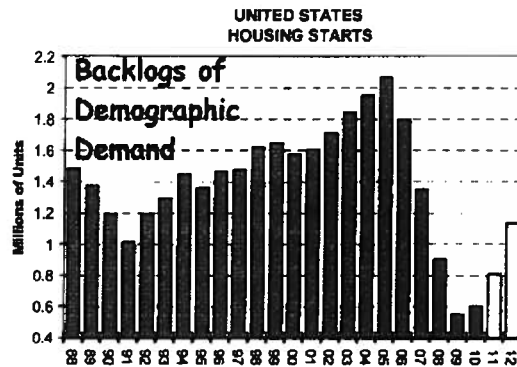
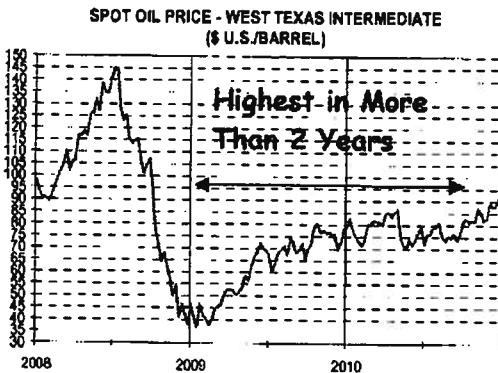
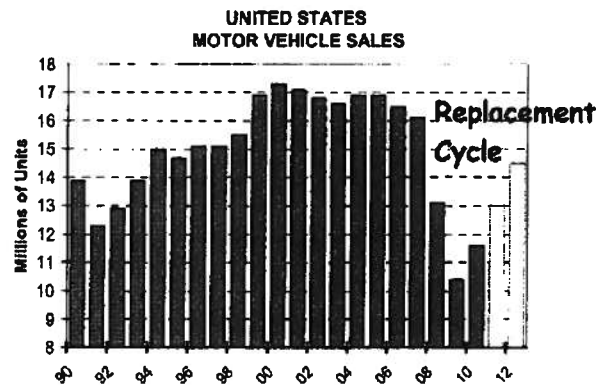
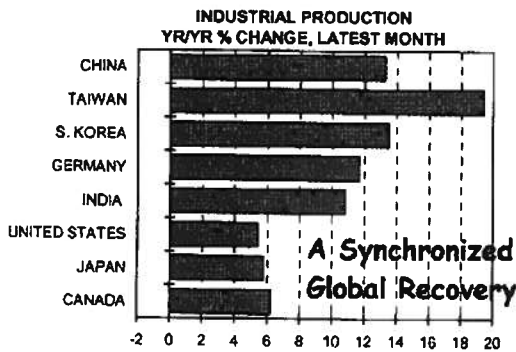
Poor Productivity Performance



This time a year ago we were calling for a good year for Canada's new home builders in 2010. Housing starts were projected to increase by about 23% in 2010 to an annual total of 175,000 units. Such an outlook was described as respectable performance by past historical standards. We were too pessimistic a year ago in our 2010 housing outlook. As we begin 2011, we can say that the housing market is in a healthy balance. Existing home sales are running at sustainable levels. Starts have been stronger than anticipated. In 2010 they ran at an annualized rate either in excess of, or close to 190,000 units for 10 out of 11 months. December estimates are not available yet. Media reports were misleading as initial monthly starts reports were consistently revised upwards. The revisions never received much attention though. December 2010 starts figures will not be released until later in January but it is safe to say that housing starts in 2010 will end up totaling around 192,000 units - well above our beginning of the year forecast. It is an increase of 29% from the 2009 actual, which is now shown to be 149,081 units. We are forecasting 180,000 housing starts in 2011. Bubble worries are a thing of the past. We were warned a year ago that houses were over-priced by 15% to 35% relative to normal relationships with rents and incomes. These relationships were misleading. There has been no sign of excessive new house price increases anywhere. Mortgage rates at the beginning of 2011 are basically unchanged from January of last year. The "special offer" 1-year rate is currently 3.05% and the 5-year rate is 4.24%. Mortgage rates will continue to be very "housing friendly" through the homebuilders' 2011 spring selling season. A significantly higher mortgage rate environment is unlikely until 2012. Given recent gains in resale housing activity and stock market gains, we expect a near-double digit growth rate for the residential renovation market in 2011.



Commodity demand is being revived by a synchronized global economic recovery. Industrial production is an important indicator for commodity consumption and the latest numbers show widespread strength. Taiwan shows a 19.4% yr/yr increase over the most recent 12-month period. South Korea and China both show gains in the 13% range. The anticipated slowdown in production in China has not materialized. India shows a 10.8% yr/yr increase in industrial production. There is global output momentum underway and it is expected to continue into 2011. It will be reinforced by accelerating output in the U.S. and Canada. Industrial production in the U.S. is currently running 5.4% above its year-earlier level and the latest purchasing managers' survey points to a pick-up in the pace of output growth. A cyclical recovery in motor vehicle sales and automotive production is underway in the United States and this will provide further stimulus in 2011. The average age of the U.S. vehicle fleet is now over 10-years, which is unprecedented. A replacement demand cycle has now begun in the U.S. and is expected to continue through 2011 and 2012. Housing starts in the U.S. are also expected to begin a multi-year recovery in 2011. They have been running far below underlying demographic demand for the past three years. Recovery cycles in the U.S. for vehicles and housing will push demand higher for base metals such as copper and zinc. There will also be a major upturn in lumber prices which have slumped for several years. WTI crude oil closed the year 2010 at US\$91 per barrel and appears to be headed well over US\$100.



Contrary to general expectations, we expect Ontario's economic recovery to pick-up momentum in 2011. Real GDP growth in Ontario is capable of accelerating from an estimated 3.3% in 2010 to 4.0% or higher in 2011. Stronger growth in the U.S. will be the key factor behind this improvement. The U.S. recovery is being led by manufacturing and this will spill-over into Ontario. The U.S. motor vehicle replacement cycle will provide an important stimulus for Ontario. The upturn in U.S. vehicle demand in the final months of 2010 has been much stronger than expected. It is forecast to continue in both 2011 and 2012. Ontario's manufacturing industries will also benefit from persistently low natural gas prices. The economy of the Toronto Region is currently Canada's growth leader as indicated by its recent employment surge. Alberta will begin to catch-up with Ontario in 2011 as a result of rising oil prices and increased oil sands production and development. However at this point, Alberta's recovery has lagged behind Ontario's. Employment in Calgary has struggled to rise above recession lows. There is a noticeable performance gap between Ontario and Alberta in both retail sales and housing starts. The North American over-supply of natural gas will remain a headwind for Alberta's conventional energy sector and spin-off industries. British Columbia will benefit from an upturn in U.S. lumber demand. The impact on B.C. will be the most pronounced in 2012. A strong rebound in agricultural production and output of potash will make Saskatchewan Canada's economic growth leader in 2011. Saskatchewan and Newfoundland are the only two Canadian provinces on track for budget surpluses in FY2011.

