

# economic outlook

> With a number of economies including China, India and the Eurozone outperforming expectations in the first half of the year, the pace of overall global growth was solid in 2007. But the global economy faces a host of challenges that will pose significant downside risks to the outlook. A major risk is whether the U.S. economy can successfully navigate through its current housing recession. In fact, even though global export diversification and the growth of China and India have left the U.S. economy no longer as central to world growth, exposure of the world economy to U.S. consumer demand remains significant.

## GLOBAL ECONOMIC FORECAST - (ANNUAL % CHANGE REAL GDP)

	(%)*	FORECAST				
		2005	2006	2007E	2008	2009
United States	20.1	3.1	2.9	2.1	1.8	2.6
Canada	1.8	3.1	2.8	2.6	2.2	2.5
Eurozone	14.8	1.6	2.9	2.5	1.7	1.8
EU accession members	1.8	3.2	3.8	4.6	4.5	3.5
Japan	6.4	1.9	2.2	2.0	1.0	2.0
Asian NIC's	3.2	4.7	5.3	4.7	4.3	4.0
China	15.4	10.4	11.1	11.5	10.8	10.5
India	6.0	9.2	9.4	9.0	8.2	8.3
Latin America	5.7	4.9	5.4	5.0	4.5	5.2
World		4.9	5.3	4.5	3.3	4.0

\* share of global economy

Source: Economap Inc.

### U.S. HOUSING MARKET CORRECTION CONTINUES

The magnitude of the U.S. housing correction is substantial. Rising debt burdens and home foreclosures, especially in the subprime market, have pushed single-family housing inventories in the U.S. to 18-year highs, while construction of new homes has fallen to the lowest level in more than a decade. As the erosion in mortgage credit quality and further declines in housing construction and house prices weigh on employment and consumer spending, overall U.S. growth will come under serious downward pressure in the next few quarters.

Complicating these matters, the subprime financial shock has critically strained global liquidity conditions and undermined business confidence. Lending institutions have become increasingly troubled about hidden exposure to the U.S. subprime market and interbank lending rates are likely to remain elevated in coming months as banks continue to demand increased risk premia. This will undoubtedly continue to affect borrowing conditions, particularly in the U.S. and Canada but also in the Eurozone. Tighter financial conditions are expected to result in a reduction in U.S. business investment – which until now has held up quite well thanks to strong corporate profit growth. As such, the risk of a U.S. recession and its adverse impact on global growth cannot be ignored.

However, the Fed's decisive moves to cut interest rates and inject liquidity back into the financial system should help to keep U.S. businesses confident enough to hold on to their payrolls. As a result, consumer spending should not capitulate even though the slowdown in the growth of household net worth due to the housing downturn combined with high energy costs will act as large headwinds. Furthermore, a silver lining of the materially weaker U.S. dollar is its positive effect on U.S. net export activity. Together, these supportive factors should help the U.S. economy avert a recession, but overall growth, averaging just 1.8% in 2008, will remain at a subpotential level.

### EMERGING ASIA ROCKETS AHEAD

As the U.S. economy manages to hold its head above water, growth in emerging Asia is expected to continue rocketing ahead. Economic growth in China continues to be mainly export-led thanks in part to a still undervalued currency vis-à-vis the greenback. The other key engine of Chinese growth – capital investment – also remains an important contributor. However, Chinese officials are increasingly worried about the prospects of over-investment and by extension surging asset values that may reflect overly aggressive expectations. If the scenario of continued super-strong growth does not eventuate then some investors will be left holding assets that are not as

valuable or as useful as previously thought. Under such a situation, China could face a fresh bout of bad loans as firms struggle to repay debts. Apart from shifting financial reform back to square one, this would lead to a protracted period of adjustment where growth would slow as the asset overhang was worked off.

To this end, Chinese authorities will continue with their attempts to manage expectations and cool growth through fiscal means, credit directives and by continuing to raise interest rates. With economic growth exceeding 11% in China and inflation at a decade high of almost 7%, the lending rate of just above 7% is low and well off the level where it will act as any sort of drag on lending.

On balance, the sheer momentum of growth in developing Asia, together with the rapid response of central banks around the world to maintain liquidity, should limit the chance that a significant global slowdown materializes in 2008. Expect global GDP to slow to 3.3%, from an estimated growth rate of 4.5% in 2007 with the balance of risks tilted to the downside. By 2009 global growth should improve to 4.0%.

**CENTRAL BANKS SUPPORTING LIQUIDITY**

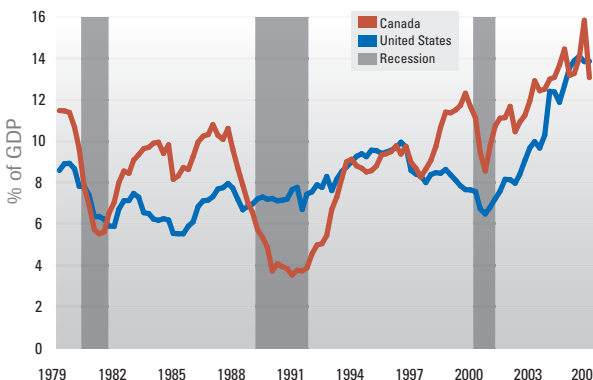
Solid global economic growth combined with rising prices for commodities and food has kept inflation rates above target for a number of major economies. As a result, official short-term interest rates globally were on a firm upward path for most of 2007 before the credit crunch forced central banks to take a more accommodative stance. The Fed, in particular, will continue to do what is necessary to shore up financial market confidence suggesting additional rate cuts are in store in 2008. Amidst receding inflationary pressure, the Bank of Canada has also taken on an accommodative role largely due to external risks to growth including U.S. economic weakness and global financial market difficulties stemming from the credit crunch.

**CANADA'S DOMESTIC FUNDAMENTALS HEALTHY**

The Canadian economy has been expanding at an above potential pace over the last few quarters, leaving it in a state of excess demand as of late 2007. Strong improvements in Canada's international purchasing power along with the lowest unemployment rate the country has seen in three decades has resulted in solid

wage gains and supported a sharp increase in disposable income and net worth. As a result, consumer spending has been extremely well supported and continues to grow well above its long term average pace while housing activity has also remained strong. This is in sharp contrast to the U.S. situation.

**CORPORATE PROFITS - CANADA & U.S.**



Source: Statistics Canada, BEA

In addition, Canadian businesses have seen remarkably strong growth in corporate profits over this cycle. Together with a strong dollar, this has resulted in significant investments in non-residential real estate and capital equipment.

However, Canada's trade sector has continued to bear the brunt of a surging Canadian dollar, which broke through parity in late 2007. The trade surplus fell to \$11.1 billion in the third quarter of 2007, the lowest level since the second quarter of 1999, while output and employment growth in some export-oriented industries such as manufacturing continue to be hobbled. In addition, domestic auto manufacturers have faced stiff competition from their foreign counterparts and have been frantically restructuring. Since many of these vulnerable industries tend to be concentrated in Central Canada, overall growth rates and therefore manufacturing-based space market performance in that part of the country has continued to lag the resource-intensive economies of Western Canada.

### CANADIAN GROWTH SET TO MODERATE

A materially weaker U.S. economy together with the recent tightness in credit markets will likely have a dampening effect on Canadian growth rates in early 2008. The main source of weakness will continue to be the manufacturing sector but industries such as forestry and tourism which strongly depend on U.S. demand, will continue to stumble too. The good news is that Canada's healthy domestic fundamentals have allowed the federal government to deliver significant tax cuts to both consumers and businesses. This should provide enough stimuli to help the service sector more than offset the expected deterioration in goods exports. Healthy domestic fundamentals should also prevent the Bank of Canada from cutting interest rates as forcefully as the Fed in 2008.

With global growth expected to soften over 2008, commodity prices are also likely to moderately ease from near record levels. This suggests that activity in Canada's red hot resource sector will see some cooling.

In particular, drilling in Western Canada's oil patch will likely remain well below its 2005 peak owing to increased uncertainty due to new royalty measures and softer natural gas pricing. Indeed, the region's boom period for conventional oil and gas activity increasingly appears to be over with activity continuing to return to more normalized levels, at least until oil sands production begins around 2009-2010. Fortunately, this normalization should help to relieve some of the capacity constraints that have plagued this region over the past two years.

As the speculative premium on oil prices partially unwinds and the U.S. economy regains some momentum late in 2008, the Canadian dollar should ultimately see some downward pressure. By 2009, the loonie is expected to fall to an average of about 90-95 U.S. cents. This should provide only modest relief to export-oriented manufacturers in Central Canada, but will be enough to reduce some of the regional disparities currently evident in the country.

### CANADIAN ECONOMIC INDICATORS

INDICATOR	2005	2006	FORECAST		
			2007E	2008	2009
Real GDP*	3.1	2.8	2.6	2.2	2.5
Employment*	1.4	2.0	2.1	1.0	1.3
Unemployment Rate**	6.8	6.3	6.0	6.3	6.1
CPI*	2.2	2.0	2.2	1.5	2.0
Real Disposable Income*	2.6	4.9	3.7	3.0	3.0
Housing Starts (000s)	224	228	228	200	195
Real Consumer Spending*	3.8	4.2	4.0	3.0	2.7
3 Month T-Bills**	2.73	4.03	4.11	3.75	4.10
10-Year GoC Bond Yields**	4.05	4.22	4.25	4.00	4.40
Canadian \$ (US cents)**	82.6	88.2	95.8	97.0	93.5

\* Rate of change %  
 \*\*Average rate for the year

Source: Economap Inc.