

# Financial Monitor

by William Tharp

wtharp@dundeewealththeconomics.com

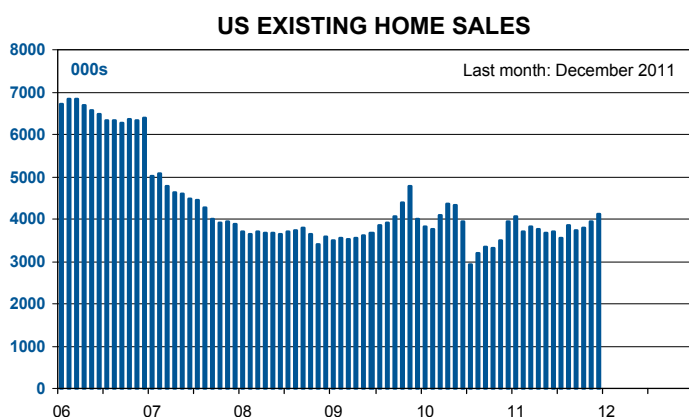
January 20, 2012

## LOOKING AHEAD

**G** positive    **R** negative    **Y** caution/neutral

FOCUS	PERSPECTIVE	CURRENT OUTLOOK	FUTURE OUTLOOK	PAGE
<b>Policy Interest Rates</b>	US policy rates are expected to remain near zero until at least mid-2013. The Bank of Canada may cut interest rates towards summer.	<b>G</b>	<b>G</b>	5
<b>Bonds</b>	Bond yields are being pulled up by an improving US economy – but this trend may not last long. They are being pulled lower by European problems, though disaster seems to have been avoided for now. Net: yields move sideways.	<b>G</b>	<b>G</b>	6
<b>Stocks</b>	Stocks are supported by the improved US economy, RRSP season, and hopes for policy easing in Asia. Things look a little better in Europe but significant problems remain.	<b>Y</b>	<b>Y</b>	8
<b>Canadian Dollar</b>	High oil prices are helping the Dollar but restraining global growth. The economic risk is to the downside but political events in the mid-East could push up both the Loonie and oil. We shall see!	<b>Y</b>	<b>R</b>	9
<b>European Currencies</b>	Financial concerns, a recession, and a credit contraction are apt to keep the Euro on a declining trend. The currency may be whipsawed at times by a continued pattern of belated and inadequate responses to the financial crisis.	<b>R</b>	<b>R</b>	10
<b>Renminbi</b>	China is still allowing the renminbi to rise but slowing growth, an outflow of capital and a loosening of monetary policy may either slow the pace of appreciation or bring it to a halt.	<b>Y</b>	<b>G</b>	11
<b>Rupee</b>	<b>Current Outlook Changed from Red to Yellow.</b> The Rupee would (perversely) benefit if interest rates are reduced, as capital flows would shift back into Indian stocks.	<b>Y</b>	<b>G</b>	
<b>Yen</b>	A weakening economy, perhaps back in contraction mode, is restraining any further rise in the yen.	<b>Y</b>	<b>Y</b>	

## CHART OF THE WEEK



**US Existing Home Sales** are again pushing higher. We saw a similar pattern from 2009 through 2010 but it failed to hold. At present the economy is improving along with the pace of job creation. However the rate of economic growth will likely slow somewhat as 2012 unfolds and the public sector is not in good shape, with job cuts likely extending into the federal level after the election in November. Consequently, although the housing market may be increasingly governed by exceptionally good affordability, slowing demographics and a so-so economy will likely keep houses from becoming runaway best sellers.

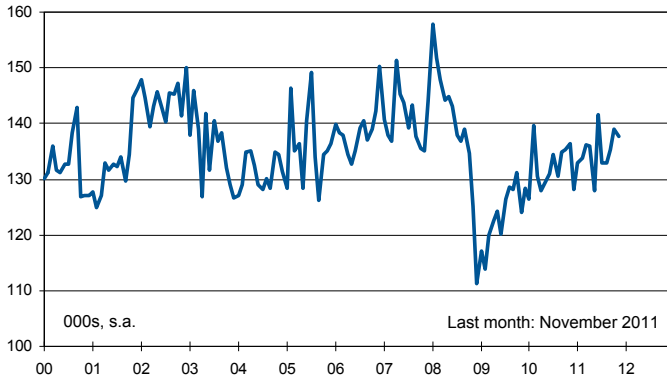
## RECENT ECONOMIC DATA

**CANADA MANUFACTURING SHIPMENTS**



**Canada's Manufacturing Shipments** (and also new orders) continued to look very strong in November, with a stronger US economy helping. But we expect this strength to wane in 2012 because of softer global demand and, in all likelihood, weakening domestic consumption as well. The slowdown won't be dramatic but if combined with some softening of commodity prices it could result in an eventual rate cut by the Bank of Canada.

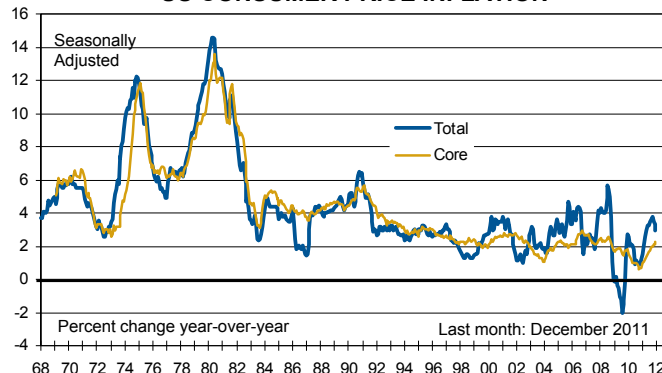
**CANADA NEW MOTOR VEHICLE SALES**



**Canada's New Vehicle Sales** fell by 1% from October through November but were still at relatively elevated levels for the period since 2008.

**US Consumer Prices** failed to rise once again in the latest month at the headline level. While the year-over-year CPI rate fell to 3.0%, the inflation rate remains higher than expected as energy prices have fallen only modestly. Core CPI decelerated back to a 0.1% monthly pace but held at 2.2% year-over-year.

**US CONSUMER PRICE INFLATION**



**US Housing Starts** slipped in November though the bigger picture reveals a very modest rising trend. The latest permits were higher than the starts, suggesting that the rising trend continues.

**US HOUSING STARTS**



## FUTURE DATA RELEASES

### CANADA:

- Leading Indicators (Monday)
- Retail Sales (Tuesday)
- Average Weekly Earnings (Friday)

### US:

- New Home Sales (Thursday)
- Q4 2011 GDP (Friday)

## REGULAR FEATURES

- The Current State of Affairs (P.4)
- European Bond Yield Spreads (P.7)

## SPECIAL FEATURES

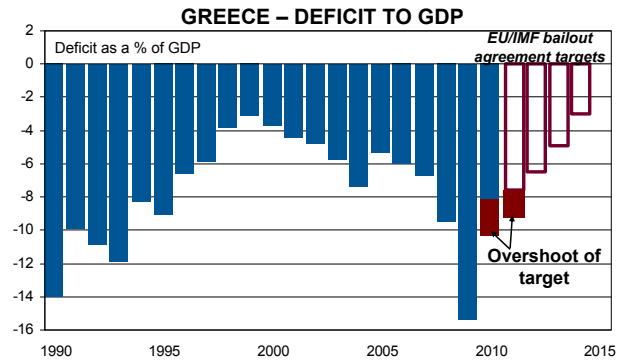
- European Developments (P.3)

# EUROPEAN DEVELOPMENTS

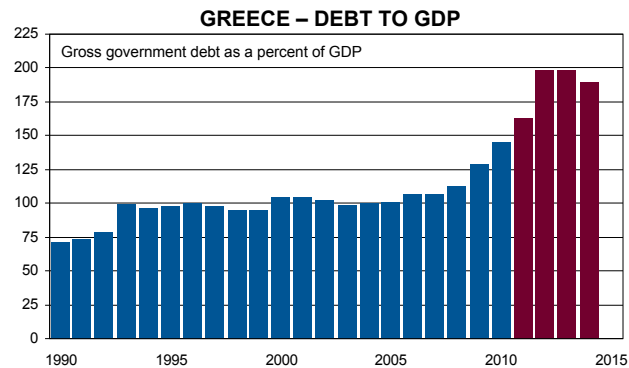
by Chantelle Schieven

cschieven@dundeewealththeconomics.com

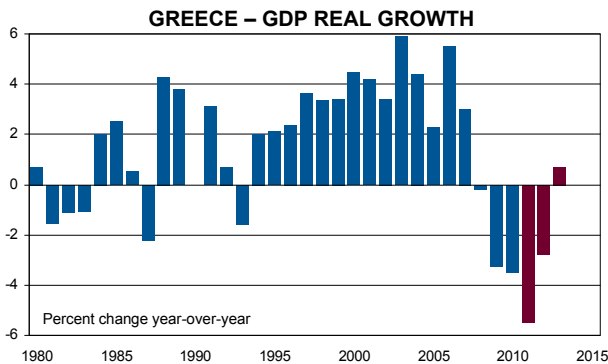
- The focus is on Greece for the next few weeks, as Greece negotiates the terms of a second bailout before its bond payment of €14.5bn comes due on March 20.
- In order to secure the second bailout the Greek government is negotiating with bond holders on a bond swap deal. The goal is to cut about €100bn of Greek debt, which totals about €339bn. According to news reports Greece was close to striking a deal on Friday, which would involve bondholders exchanging current bonds for 30-year bonds with a graduated interest rate. In this arrangement bondholder losses would be about 65 to 70%.
- The second bailout package will also require further structural reforms from Greece, including liberalization of its labor markets and less government bureaucracy. The package will also require Greece to make further budget cuts to make up for the missed targets of the last two years. This includes cutting 150,000 public sector jobs by 2015. The Greek government only cut about 1,000 jobs last year, after pledging to cut more than 30,000.
- Greece is entering its fifth year of economic recession and unemployment is expected to reach almost 20% this year (with 50% youth unemployment) making structural reforms and further austerity even more difficult to push through. And the requirement of the second bailout package for further austerity will only worsen the economic situation.



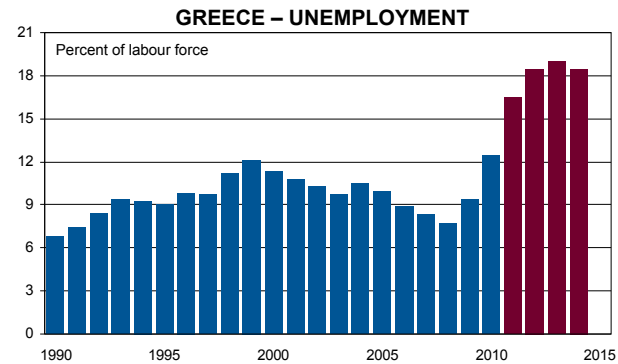
*Greece has missed its deficit to GDP target set in the first bailout package in May 2010 for the last two years; the result of a deeper recession and domestic backlash to reforms.*



*Debt to GDP is expected to reach 162% in 2011; even with a 50% write down for Greek private bond holders, debt to GDP is only forecast to decline to 120% of GDP by 2020.*



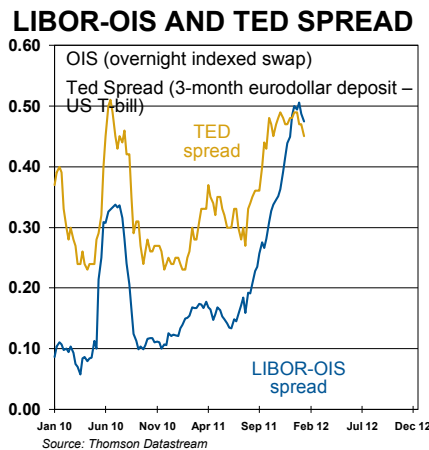
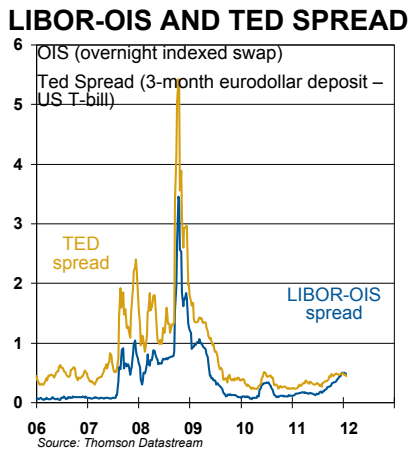
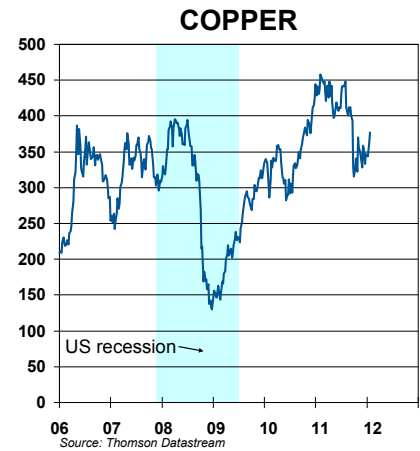
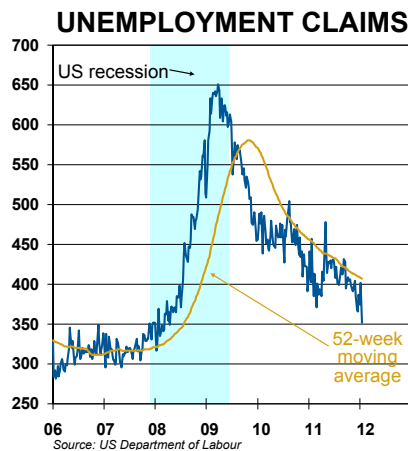
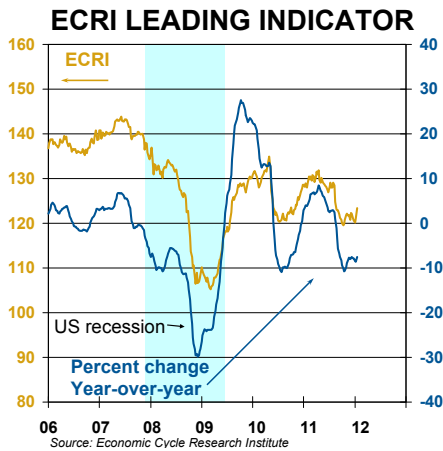
*Greece is in a deep recession with GDP expected to decline 5.5% in 2011; on top of a 3.5% decline in 2010.*



*Greece's unemployment rate is expected to climb to almost 20% this year; youth unemployment is estimated close to 50%.*

# CURRENT STATE OF AFFAIRS

by Martin Murenbeeld

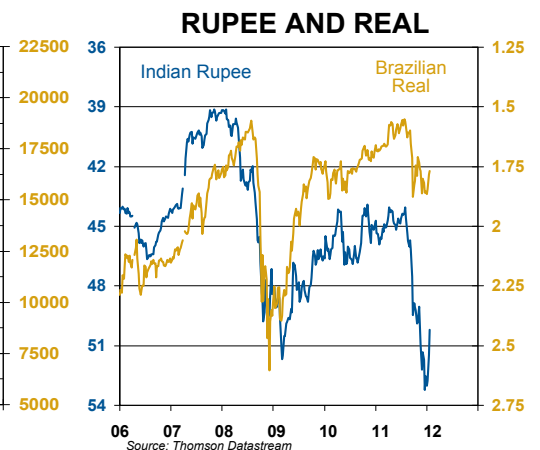
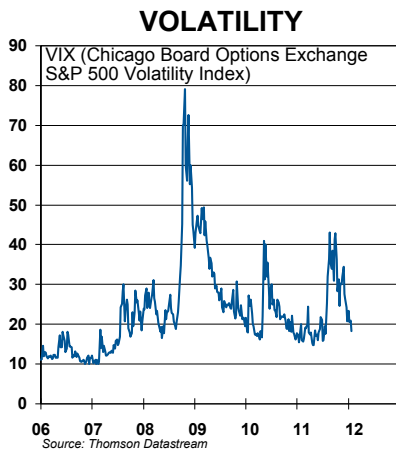


**BETTER:** Unemployment claims, copper, Short-term rate spreads, Volatility, Emerging markets, Rupee, Real.

**NEUTRAL:** ECRI leading indicator

**WORSE:** Nothing!

*We haven't had so many things better in some time.*



## POLICY INTEREST RATES

by Stephen Gaskin

[stephen.gaskin@dundeewealththeconomics.com](mailto:stephen.gaskin@dundeewealththeconomics.com)

### The Bank of Canada

Target overnight rate: 1.00%

Next meeting: March 8, 2012

The Bank of Canada maintained its target for the overnight interest rate at 1% at its latest meeting on January 17. Despite the expectation of modest growth in coming quarters, the Bank is reluctant to lower rates and stoke further rises in house prices and household debt levels.

Household expenditure currently accounts for about 64% of GDP (the long-term average is about 62%), but has been trending down from 66% for much of this year. If the recent uptick in unemployment continues or household borrowing slows, household consumption is likely to weaken and hurt overall growth. The bank must balance this risk against the risk of even greater leverage in the economy and potentially larger issues later.

Canadian exports are also likely to be weak in coming quarters on the back of a continued strong dollar and waning external demand, as well as a further deterioration in Europe's sovereign debt crisis. In light of planned fiscal retrenchment, business investment would have to increase to maintain growth, but with a souring outlook, businesses may be reluctant to invest until conditions improve.

In our view, risks to growth are biased to the downside. Consequently, we feel the bank may reduce rates at some point this year, but that it will wait for clearer evidence of slowing in the housing market and a reduction in household borrowing.

### The Federal Reserve

Fed funds rate: 0.00%-0.25%

Next meeting: January 24 and 25, 2012

### The Bank of England

Current policy rate: 0.50%

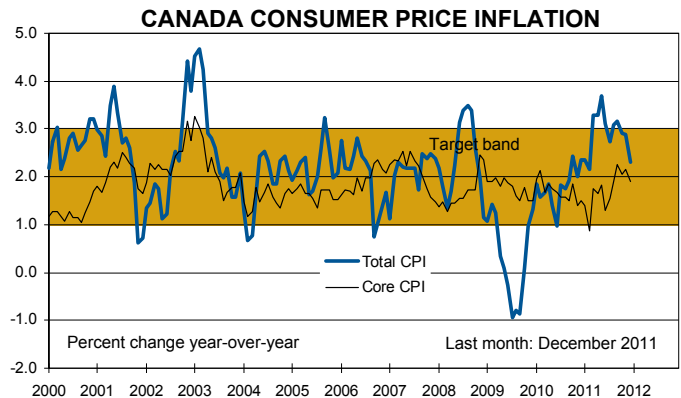
Next meeting: February 8 and 9, 2012

### The European Central Bank

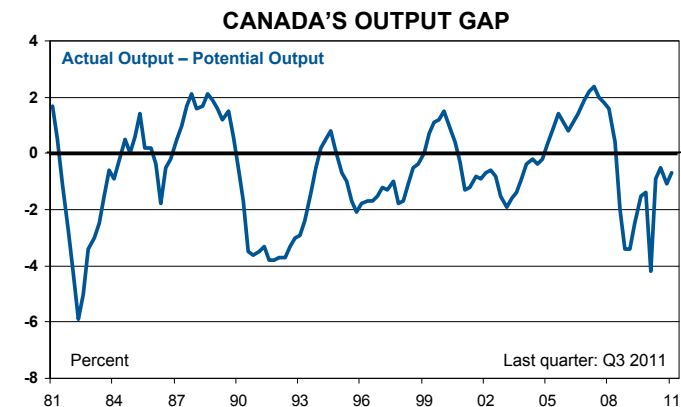
Current policy rate: 1.00%

Next meeting: February 9, 2012

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*Both headline and core inflation have been moving lower.... the Bank of Canada expects further declines in coming quarters.*



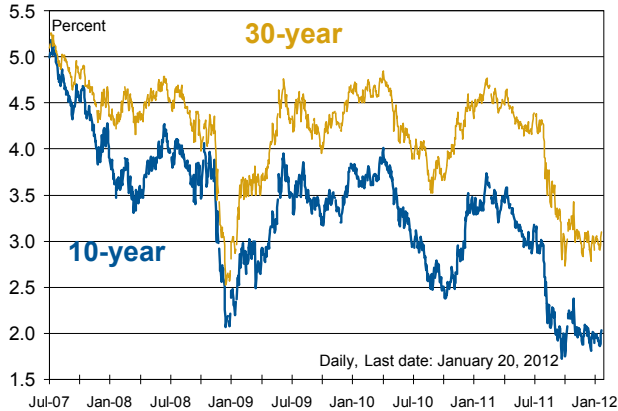
*The output gap suggests that Canada's economy continues to operate below trend.*



*Canada's unemployment rate has risen over the last three months suggesting growing excess capacity in the economy.*

# LONGER-TERM BOND YIELDS

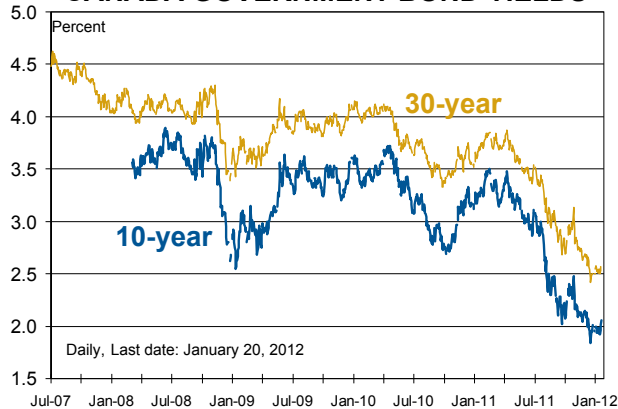
## US TREASURY YIELDS



The yield on low rated US corporate debt broke below the 8% barrier, aided by the improved tone of the American economy. This yield will likely drop further as a receding recession risk is particularly good for lower quality debt.

Our expected trading range for the benchmark US 10-year Treasury yield remains at 1.70% to 2.20% (central tendency of 1.95%). The yield pushed higher this week as European risk receded while US economic growth improved. But don't count on these improvements continuing indefinitely, especially together.

## CANADA GOVERNMENT BOND YIELDS



## US HIGH-YIELD BONDS



### 2-Year Government Bond Yield (%)

	19-Jan	2-Dec	Change
France	0.83	0.91	-0.08
Germany	0.21	0.22	-0.01
Greece	197.71	162.22	35.49
Ireland	5.57	8.16	-2.59
Italy	4.05	5.53	-1.48
Portugal	14.18	15.69	-1.51
Spain	3.17	3.83	-0.67

### Weekly Yield Change (%)

	Current	Last	Change
Cdn 10YR	2.06	1.93	0.13
US 10YR	2.03	1.87	0.16
US 30YR	3.10	2.91	0.19
US BBB	4.24	4.27	-0.03
US HI-YLD	7.85	7.99	-0.15

Note: US BBB and US High Yield data is Thursday data

### 10-Year Government Bond Yield (%)

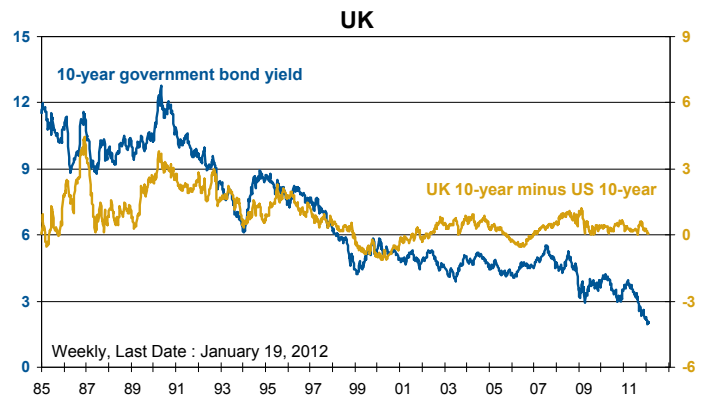
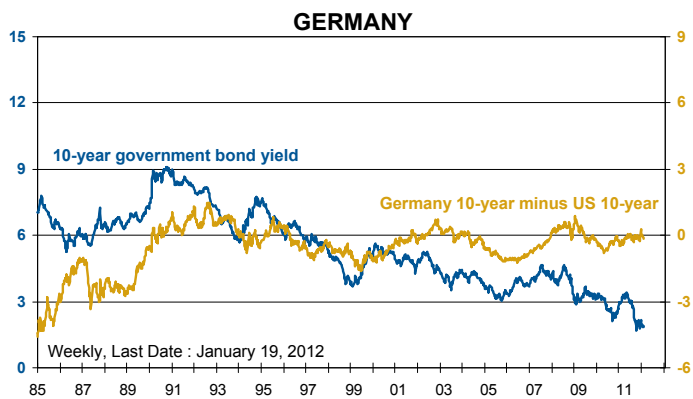
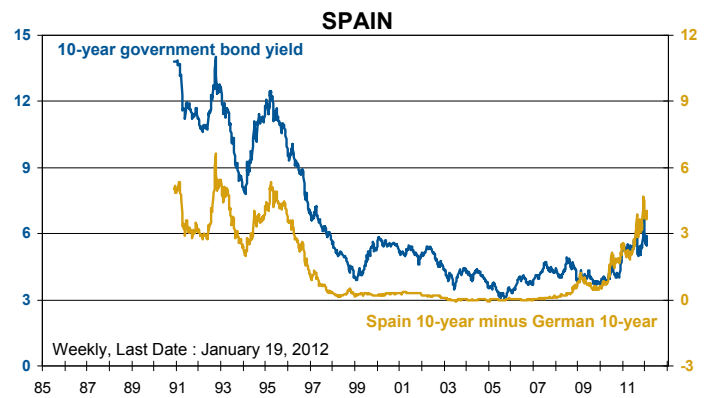
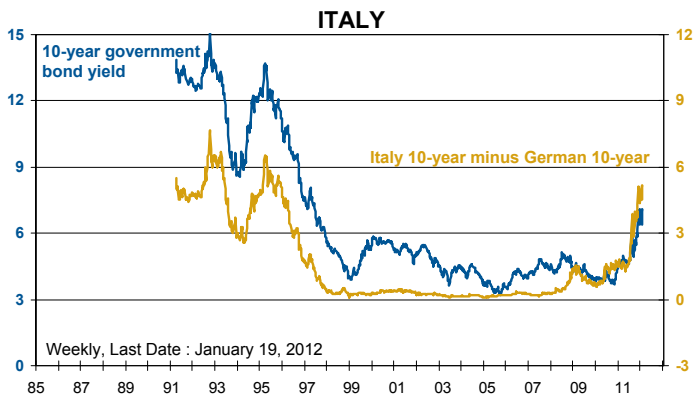
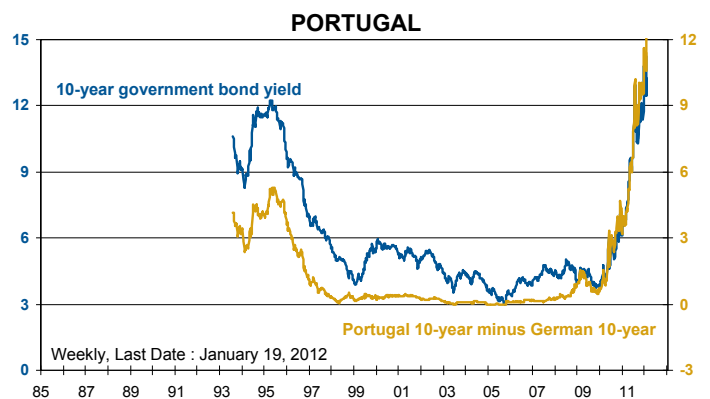
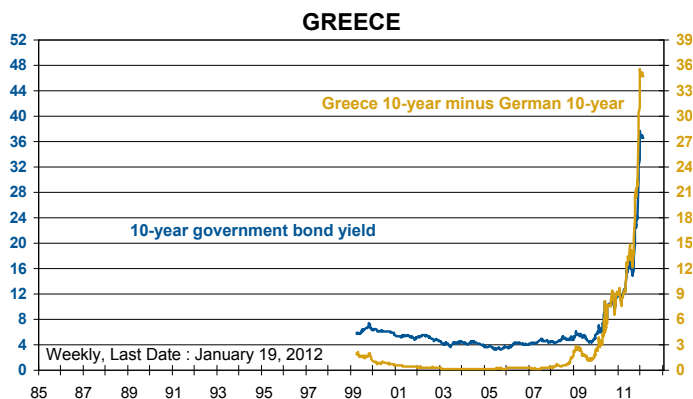
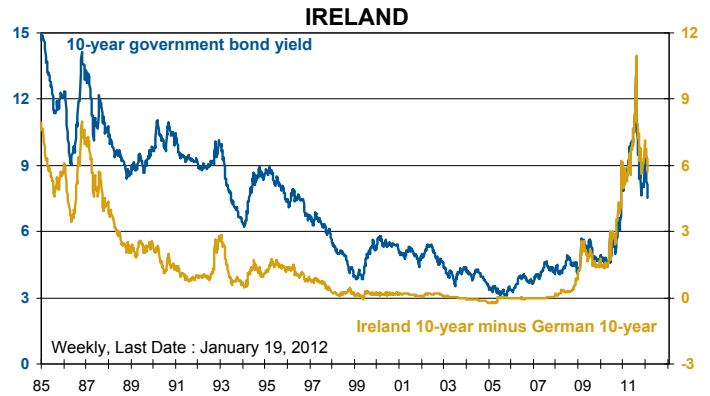
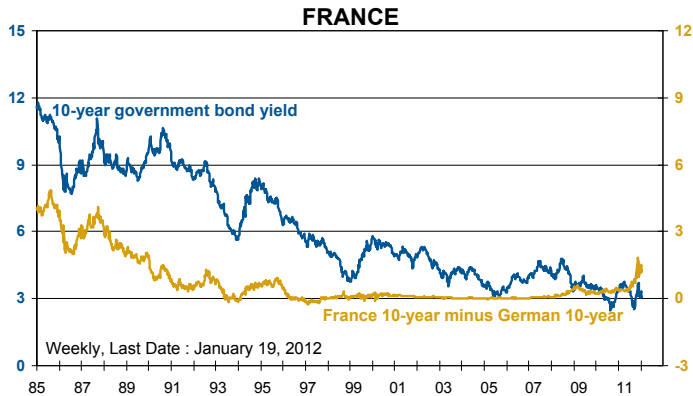
	19-Jan	2-Dec	Change
France	3.12	3.13	-0.01
Germany	1.83	1.93	-0.10
Greece	36.60	36.69	-0.09
Ireland	7.55	8.70	-1.15
Italy	6.38	6.64	-0.26
Portugal	14.22	12.87	1.35
Spain	5.51	5.88	-0.37

### Monthly Changes in 10-year Government Bond Yields (%)

	Jan 20	Dec 16	Change
US	2.03	1.85	0.18
UK	2.11	2.04	0.07
Canada	2.06	1.87	0.19
Germany	1.93	1.86	0.07
Japan	0.99	0.99	0.00

# 10-YEAR BOND YIELDS AND SPREADS

The spread for Germany and the UK is against the 10-year US Treasury, all the others are against the 10-year German Bund

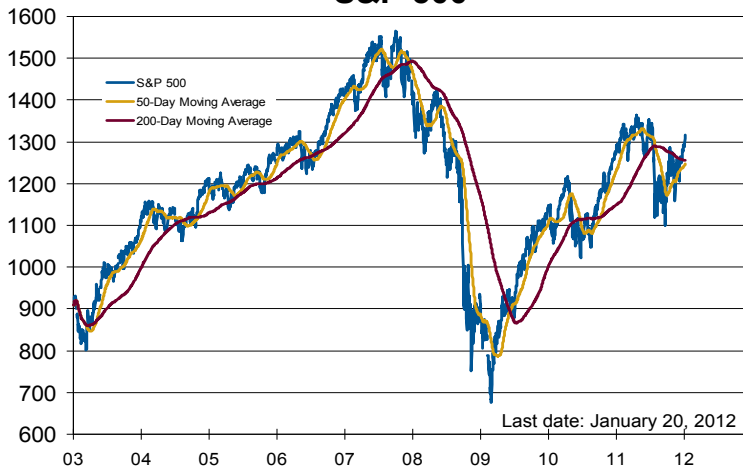


# STOCK MARKETS

by Stephen Gaskin

stephen.gaskin@dundeewealththeconomics.com

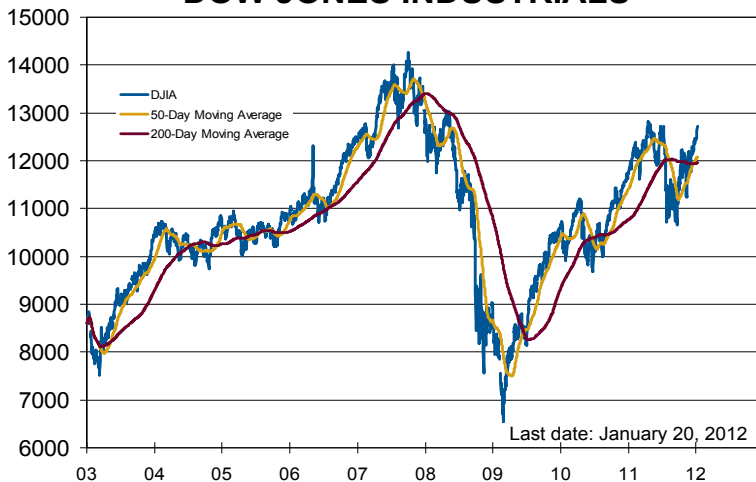
## S&P 500



North American equity markets performed well again this week. Continued improvement in the US economy, highlighted by a reduction in jobless claims to 352,000, is playing a key role. This week's jobless claims are the lowest since mid-April 2008.

A stronger US economy and the ECB's provision of massive liquidity to Europe's banks has had a calming effect on markets and facilitated sustained rises in equities which is reassuring for investors. Indeed, the Chicago Board Options Exchange volatility indicator (VIX, see page 4) closed today at 18.28; it has not closed below 20 since July 25, 2011. We have also witnessed declining yields on sovereign debt for many Eurozone members (see p.6). Consequently, the immediate risks for equities seem held at bay.

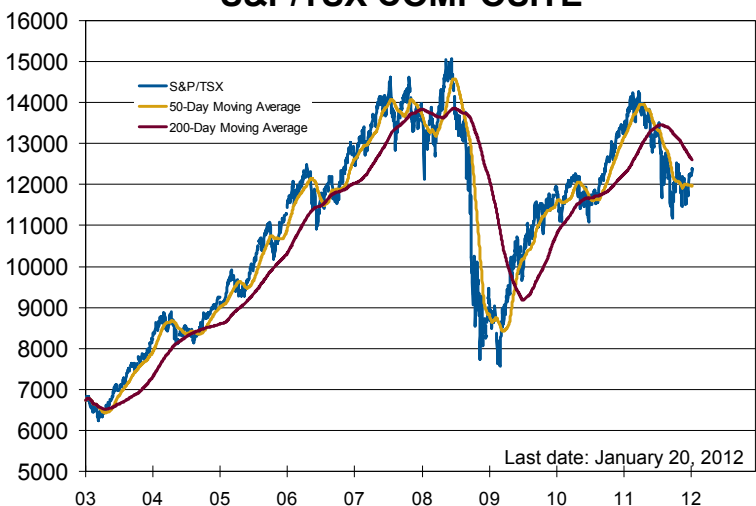
## DOW JONES INDUSTRIALS



The gradual improvement in these factors makes us cautiously optimistic that further gains can be achieved in the near-term. **In fact, we strongly considered raising our current outlook for equities to 'positive' this week. However, given the potential of events in Europe, China, and the Middle East to disappoint, we elected to maintain our cautious outlook.**

Looking further out, we expect China's economy to slow further next quarter, and we believe that Chinese authorities may wait longer than markets expect to enact significant stimulus. Greek bond negotiations and a European recession remain concerns as well. A recession in Europe also has knock-on effects in China through reduced exports. Lastly, the slow creep upward in oil prices to \$100/bl will act as a headwind for growth and stocks.

## S&P/TSX COMPOSITE



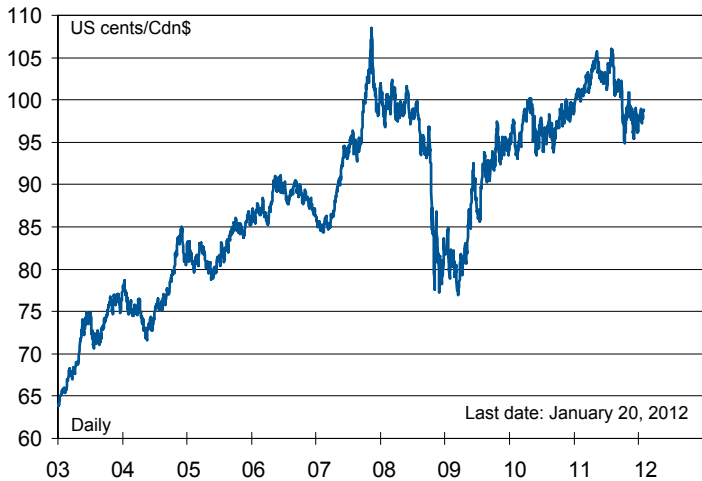
Finally, investors will note that US equities have outperformed the S&P/TSX again this week. We expect this trend to continue as commodity prices are likely to remain flat with further slowing in China and the Canadian economy forecast to slow somewhat in the first half of this year.

### Percent changes

	1-week	4-week	52-week
<b>TSX</b>	1.4	3.9	-6.5
<b>DJI</b>	2.4	3.5	7.1
<b>S&amp;P 500</b>	2.0	4.0	2.5
<b>NASDAQ</b>	2.8	6.4	3.6

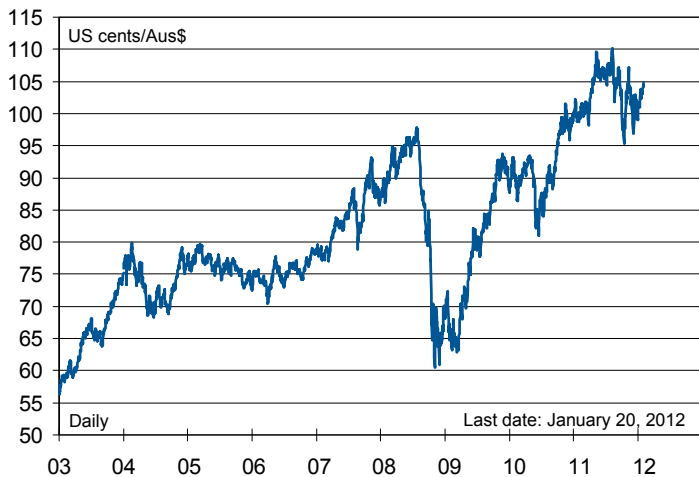
## DOLLAR CURRENCIES

### CANADIAN DOLLAR



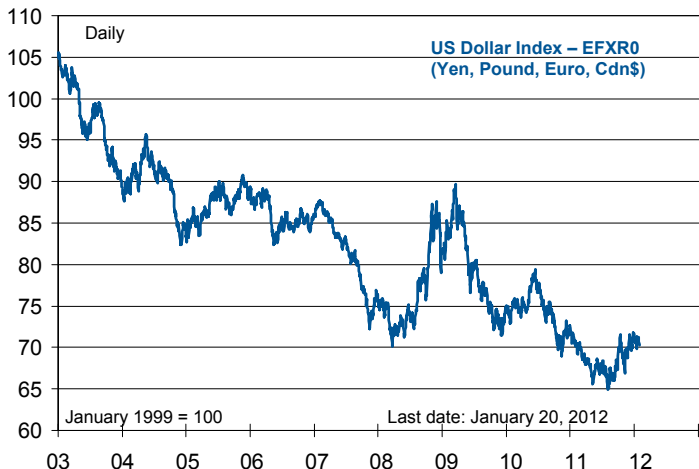
The **Canadian Dollar** gained nearly a cent this week, ending at **98.69** (97.74 last week). Commodity prices were again mixed with gold and copper again up, oil down a bit more and natural gas still slumping as the supply glut overwhelms the usually supportive seasonal factors.

### AUSTRALIAN DOLLAR

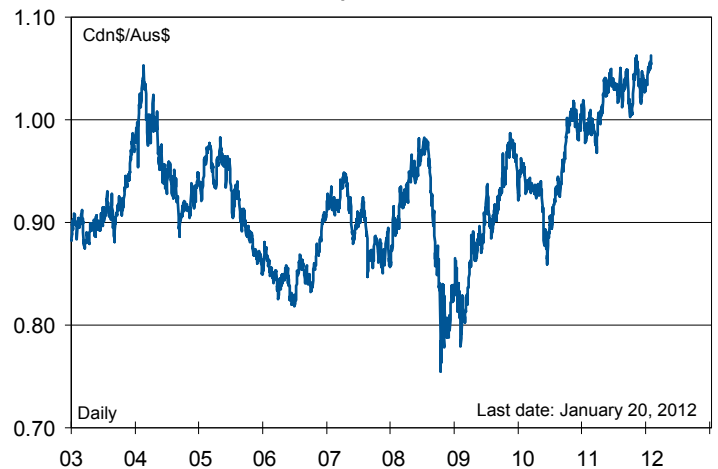


The **Australian Dollar** rose by about one and a half cents to close at **104.84** (103.22 last week). The spread between the two dollars is now so large as to invite speculators to narrow the difference. This appears somewhat more likely to come in the form of a lower Aussie currency (the local job situation has been deteriorating in recent months and the Australian housing market is weakening) although recent strength in Canadian economic data certainly does not rule out a catch up rise in the Canadian dollar instead.

### US DOLLAR INDEX



### CANADIAN per AUSTRALIAN



# EUROPEAN CURRENCIES

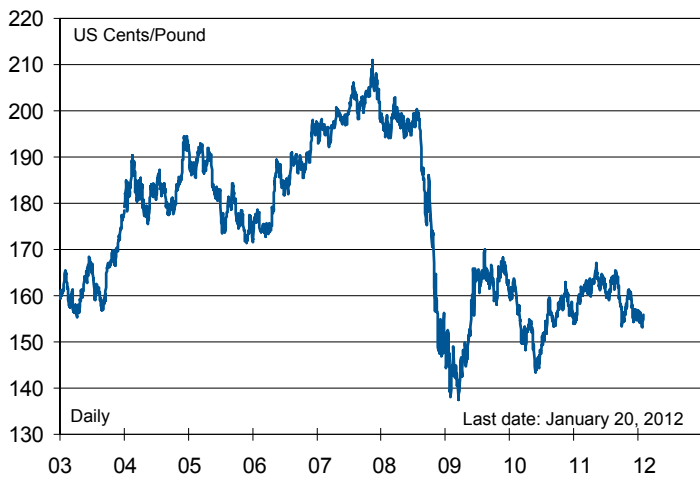
## EURO



The IMF is seeking a further \$500 billion more to lend out as it cuts its outlook for global growth and, no doubt, expects more trouble out of Europe. It also appears to be shifting its recent policy stance – away from fiscal austerity when global growth is already weak/weakening. Optimists will be pleased that more rescue money is to be made available in case of need, while pessimists will see it as evidence of worsening economic times. (On balance the optimists probably have a slight edge for now).

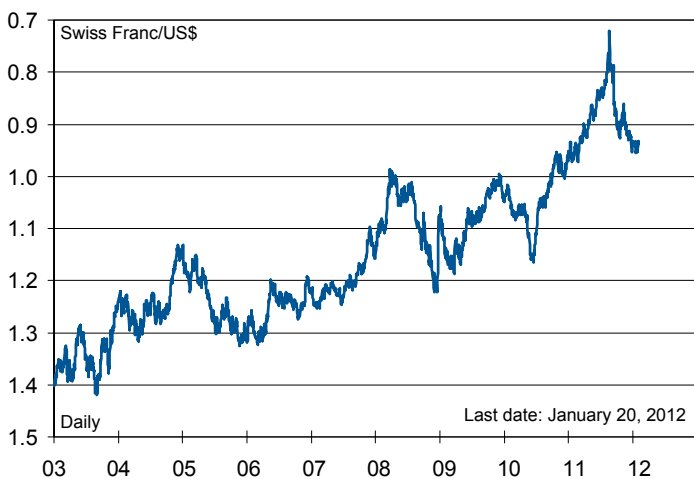
The **Euro** closed the week up at **1.2931**, following last week's close at 1.268. Lower European borrowing costs (it appears that European banks are using cheap ECB funding to buy short dated (ie. 3 years or less) sovereign paper, driving down yields). Negotiations between Greece and private debt holders appeared to be making progress as well on restructuring debt, thereby reducing pessimism. But no results were reported as of Friday. Even so, Europe's problems are far from being resolved with many countries facing high interest rates on longer term debt (Italy especially), a heavy rollover calendar this year, and ultimately the seemingly unresolvable issue of growing competitive imbalances within the Eurozone (and with the outside world). We expect the euro to continue trending lower despite the occasional countertrend rallies.

## POUND STERLING



The **Pound** rose to **1.558** from 1.532. British CPI fell to 4.2% in December, from 4.8% in November. The number remains disappointingly high but has been boosted by increases in the British VAT. The government is forecasting a sharp further decline in 2012.

## SWISS FRANC

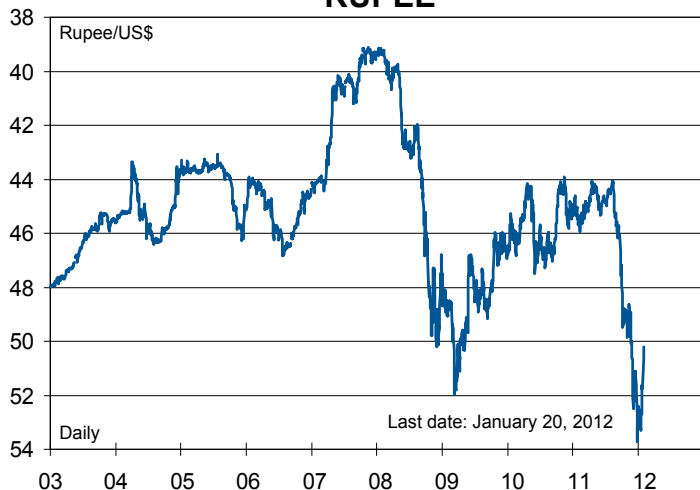


## SWISS FRANC per EURO



## ASIAN CURRENCIES

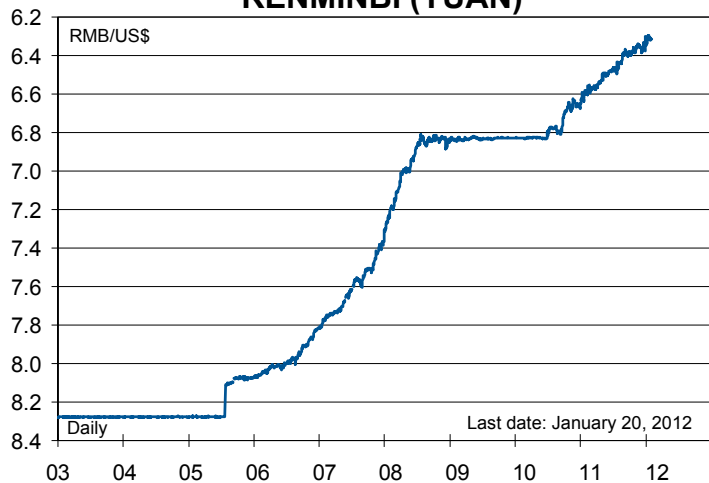
### RUPEE



**ALERT!** Both the IMF and the World Bank are busy chopping their growth forecasts for this year. The IMF numbers have not yet been released (although thinking is shifting away from the use of fiscal austerity measures during downturns) but the World Bank now expects global growth of only 2.5% this year as against roughly 2.7% in 2011 (and a forecast last June of 3.6% for this year). We are standoffish on commodity prices this year as a result.

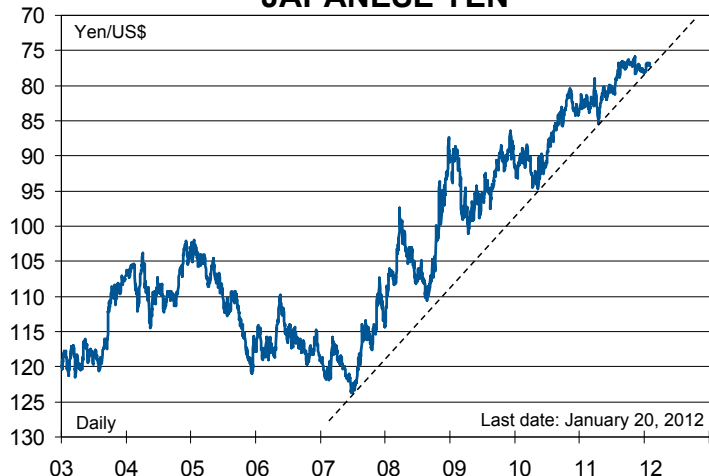
The **Indian Rupee** rose again this week to finish at **50.19** (51.48 a week earlier). Needless to say Indian equity prices also rose as inflation fell, raising hopes that Indian interest rates might start to fall sooner than previously expected. One adviser to the Bank of India expects inflation to fall to 6% by the end of March, thanks to falling food prices. Wholesale price inflation fell from 9.1% in November to 7.5% in December. Whether 6% is doable anytime soon, however, will require some co-operation from fuel prices (currently trending up) unless the government is prepared to grant new subsidies.

### RENMINBI (YUAN)



The **Renminbi** strengthened marginally to **6.315** this week, from 6.319 a week ago. The jury is still out on whether or not authorities are thinking of freezing the currency for a while, or at least slowing its ascent. This week there was fresh data on the weakness of the economy, though nothing drastic. The HSBC purchasing managers index improved slightly in January but at a preliminary 48.8 was below 50 for a third successive month, supposedly denoting contraction for the sector. And new home prices fell in 52 out of 70 Chinese cities surveyed in December, indicating a worsening trend. On the plus side, the deteriorating economy might be bringing policy easing closer but for the time being authorities are likely to show caution to avoid creating a new property bubble and/or wage inflation. (We note that labour shortages have begun to spur wage increases but so far productivity in the manufacturing sector appears to be offsetting rising labour costs).

### JAPANESE YEN



The **Yen** closed virtually unchanged at **77.02**.

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