

The Andersen Monthly Economic Report

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ASIA'S GROWTH PROSPECTS

Serious recessions have a way of accelerating existing trends. The rising importance of Asia for the world economy has been a fact of life for some time now. However, Asia's role has now increased exponentially. The economic recovery leaders will be Asia, not the United States.

Asian fiscal stimulus efforts outweigh the G-7 industrialized countries by a wide margin. As a per cent of GDP, the stimulus being injected in Asia is several percentage points higher than in the U.S., Canada and Europe. There is also a heavier Asian weighting on infrastructure spending, giving a stronger boost to materials and commodity demand.

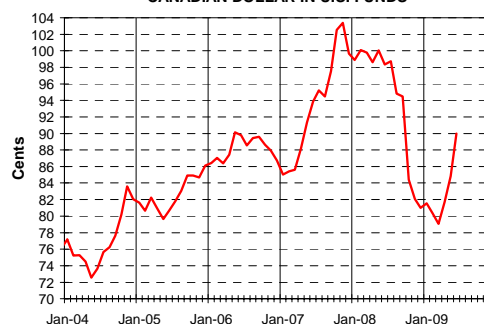
China has already shown a rebound in industrial production over the past two months. Dry-bulk shipping rates are increasing again. The Baltic Dry Index has increased significantly, reflecting increased Chinese demand for industrial materials. China's iron ore imports have been running at high levels for the past three months.

Industrial production in China could accelerate to 8.0% yr/yr growth rate in the current quarter, up from 5.1% in the 1st Quarter. China's industrial production growth rate picked-up to 7.3% in April. This is having a positive impact on trade with other Asian countries. Singapore showed an unexpected month-to-month industrial production increase in April. Taiwan is beginning to show signs an improvement in export orders from China.

If the global economy is in fact beginning to stabilize, albeit at a low level, then the USD is vulnerable to a sizeable decline. The USD has been artificially boosted by a safe-haven appeal brought on by the global economic crisis. A reduction in safe-haven USD demand, combined with increased concern about skyrocketing U.S. public debt, could emerge soon.

Britain's credit outlook was reduced by S&P to "negative" from "stable" in May, raising the possibility that the U.S. may eventually also lose its credit rating. In currency markets, perceptions are important. A USD downturn could feed upon itself. It could prompt China and a number of sovereign-wealth funds to activate plans to diversify foreign exchange holdings. In response, the CAD would likely be pushed higher.

CANADIAN DOLLAR IN U.S. FUNDS



Global

- World oil price at a 7-month high
- 1st time above 200-day moving avg. since Sep.
- \$75/bbl forecast by Saudi oil minister
- Asian oil demand has begun to recover
- CAD up sharply against USD
- Some are forecasting CAD at par with USD

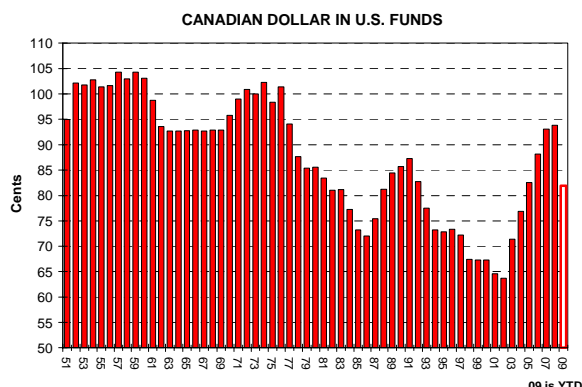
United States

- May job loss (-345k) much less than expected
- Positive 3rd Quarter growth possible
- But underlying problems not cleared up
- Troubled loans continue to accumulate
- Plan to remove toxic assets not yet operational
- 20% of FDIC insured banks not making a profit
- Shadow banking system is still shut-down
- Bank credit growth not enough to fill the gap
- Average Americans saving more, spending less
- Job losses threaten to overwhelm stimulus
- Downward pressure on wages and salaries
- New era of Americans living within their means
- Inventory of unsold homes continues to grow
- Foreclosures climbing rapidly
- House prices unlikely to bottom until 2010
- Sharp increase in Treasury bond issuance
- 10-yr Treasury yield up 100 b.p. since March
- 30-yr mortgage rate back up to 5.29%
- U.S. credit rating a long-term concern

Canada

- Housing demand reviving
- 1-yr mortgage rate 3.40%; 5-yr 3.95%
- 41,800 May job loss larger than expected
- Ontario jobless rate 9.4% - 15 year high
- GM bankruptcy means more layoffs
- 1st Quarter real GDP declined at a 5.4% rate
- Big export and business investment declines
- Oil and gas drilling activity down 41% in 2009
- Corporate operating profits down sharply

COVER PAGE CHART STORY



The chart on the left goes back to 1951.

The CAD has not been above 90 cents (U.S.) very often since 1978.

2007 and 2008 were exceptions.

The CAD averaged 93.16 in 2007 and 93.81 in 2008.

It then took a dive last Fall and Winter.

It averaged only 79.16 in March.

It actually bottomed at 76.98 cents (U.S.) on March 9th.

This coincided almost to the day with the low on the S&P/TSX.

This was reached on March 10th, when the TSX index closed at 7,567.

By the end of May oil had increased by 43%, the TSX by 37%, and the CAD by 19%.

Investor perceptions of a future Asian-based global upturn, rather than current economic realities, are behind all three of these moves.

The CAD has actually been playing catch-up.

About half of its 19% increase from its March low has occurred since the end of April.

Another commodity currency, the Australian dollar, is up by 27% since March.

Some expect that the CAD will continue to climb. We are not so sure.

The outlook for the CAD is very uncertain at the present time.

USD weakness, by default, could add to the upward push on the CAD.

U.S. public debt could soon reach a new post-WW2 high as a share of GDP.

It will have to be paid for either through taxation or inflation.

If there is not the political will to raise taxes, it will be paid for by shrinking the value of the U.S. dollar.

This means a combination of both domestic inflation and USD depreciation against other currencies.

If oil tests the US\$75/bbl target in June and the USD depreciates, the CAD could reach par with the USD by mid-year. These are big "ifs".

This would be a set-back for Canada's economic recovery hopes.

We had been counting the depreciation of the CAD in the last half of 2008 to make an important lagged contribution to Canada's economic prospects in 2010.

Some will benefit though.

It will be the retailers, wholesalers, distributors and manufacturers that import equipment, materials and supplies from the United States.

NO RECOVERY YET

Peter R. Andersen, Ph.D.

OVERVIEW: Commodities, currencies and stocks are acting as if an economic recovery is just around the corner. Oil is closing-in on US\$70/bbl and some think it is just a matter of time until it reaches US\$75/bbl. The USD is quickly losing its safe-haven appeal. It now takes US\$1.40 to buy a Euro. By default, commodity based currencies such as the Australian and Canadian dollars are soaring. The CAD is fluctuating in the 89 to 92 cent (U.S.) range. It has been closely correlated to the stock market and oil prices. It increased by more than 9.0% in May. Major stock market indexes are up sharply from their March 10th cyclical low. The S&P/TSX bottomed at 7,560 that day and has now added-on almost 3,000 points. A recent survey of economists shows that over 70% think that U.S. real GDP will show a quarter-to-quarter increase in the 3rd Quarter.

NO LET-UP IN THE CREDIT SQUEEZE: Our advice is to be careful. A true recovery still seems a long way off. The U.S. housing sector has not bottomed yet. The foreclosure crisis is getting worse. Foreclosures are climbing quickly, now that foreclosure moratoriums have expired. The corporate bond market is performing better but total credit is still not flowing freely. The shadow banking system, which supplied more than half of the credit growth before the onset of the crisis, is still closed-down. At best, it will only return to 50% of its former size. It is leaving a large hole in the credit system that the traditional banking system cannot be expected to fill. In fact, The April Federal Reserve Loan Officer survey shows that banks are still tightening credit. Bank lending in the U.S., as of May 20th, is actually still declining. It is therefore not a Keynesian lack of demand that is pushing the economy down – it is an overall lack of credit. Companies unable to make loan repayments are trying to convince lenders to extend loan repayment dates. The terms for doing this are costly and companies are cutting back on expenses to stay alive. However, the resulting layoffs and job losses threaten to overwhelm the economic stimulus efforts.

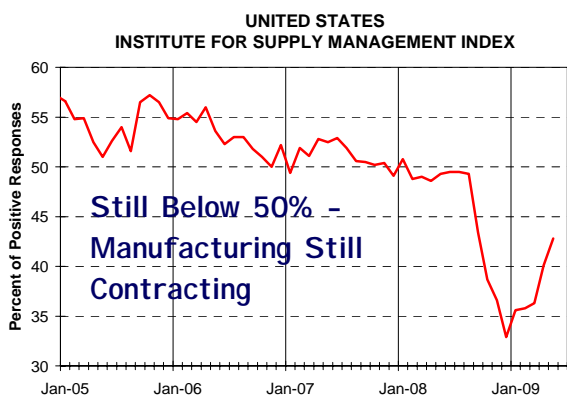
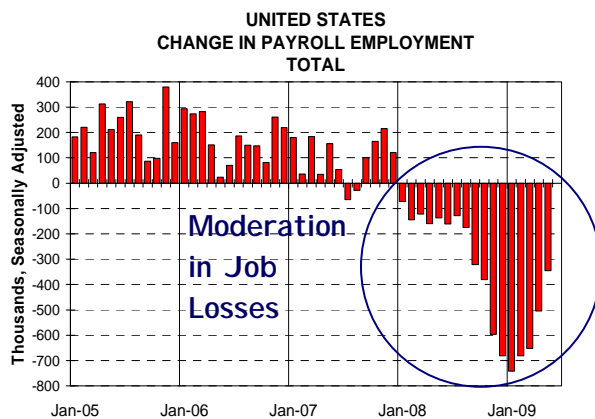
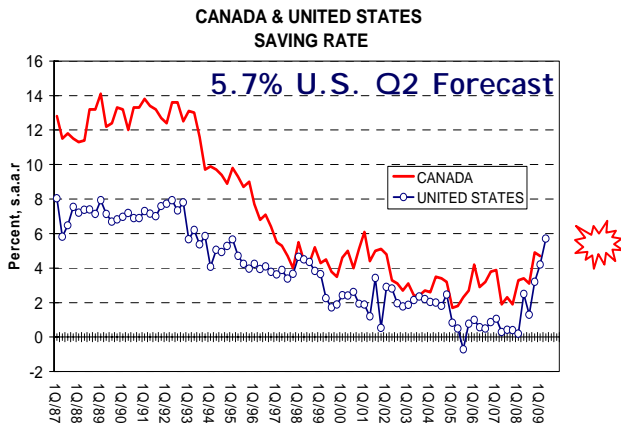
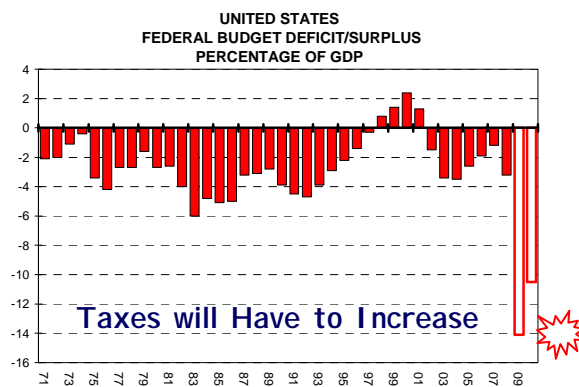
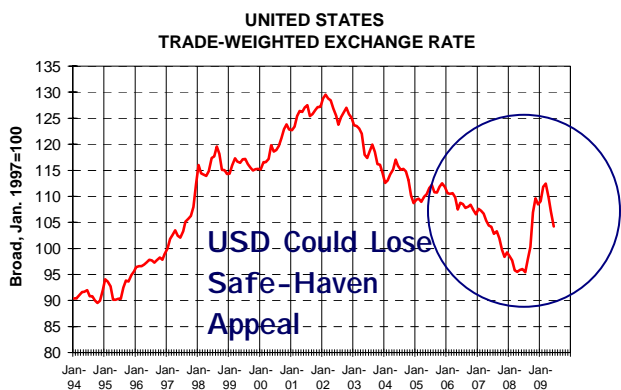
AUTO SECTOR PROBLEMS: American consumer confidence has moved higher but is still at levels that are consistent with a deep consumer recession. In addition, credit flows are not strong enough to sustain a significant improvement in vehicle sales in the United States. GM's bankruptcy filing means that 21,000 assembly jobs will be lost and 1,100 dealerships will be closed, resulting in an additional 58,000 in job losses. Parts producers are already suffering serious collateral damage. Thousands of additional suppliers' jobs will be lost as GM downsizes in bankruptcy. Furthermore, the direct job losses will cascade through the general economy. The auto sector has a high employment multiplier (estimated to be 9 to 1). Total vehicle sales could linger at an annual rate of 10 million units, or less, for an extended period of time. This would mean a continuing drain of cash for all auto producers. Chapter 11 for GM therefore may not work. If vehicle sales in the U.S. stay anywhere close to current levels, outright liquidation is a real threat. This would extend the recession through 2010.

HOUSEHOLD BALANCE SHEETS: The continuing collapse in house prices has put American households under great pressure to service and pay down debt. An overwhelming amount of homeowner equity (estimates put it at around US\$6 trillion) has been lost since U.S. house prices peaked in 2006. Prime mortgage borrowers are now defaulting. Mortgage modification efforts by the Administration are too complex and have been ineffective so far. After living beyond their means for many years in the expectation of continuing asset inflation, American households are now being forced to rebuild balance sheets. This is a slow process. It could continue into the 1st half of the next decade. There is no hope for a return to the "old normal" of leveraged lifestyles. Much of the fiscal stimulus flowing to consumers is being put into saving rather than spending. The gap between monthly personal income and consumer spending is increasing. It totaled a record \$620 billion in April, pushing the ratio of saving to disposable income up to 5.7%. This is the highest since 1995. The problem is compounded by the fact that for many Americans, nominal wages and salaries per person are shrinking at the same time that the share of income saved is increasing.

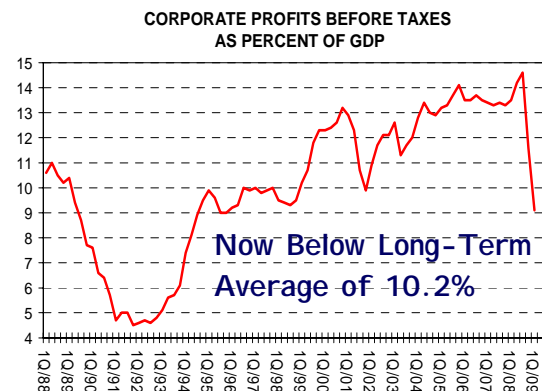
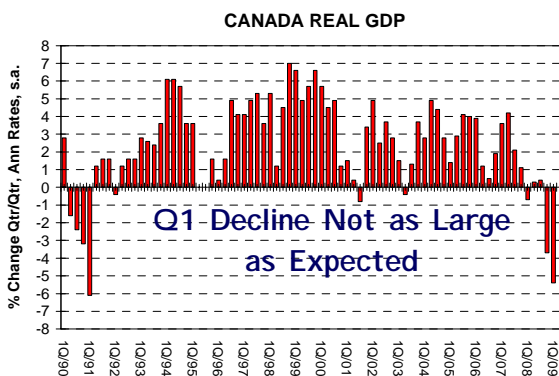
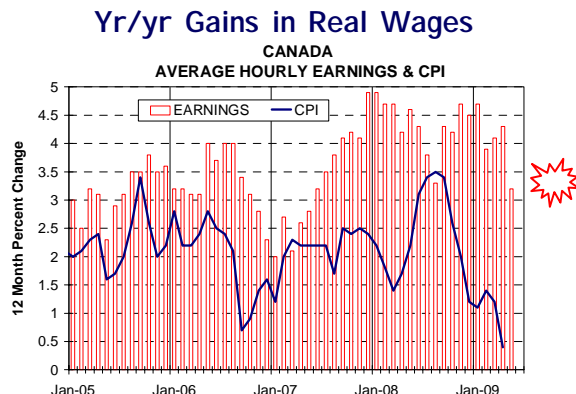
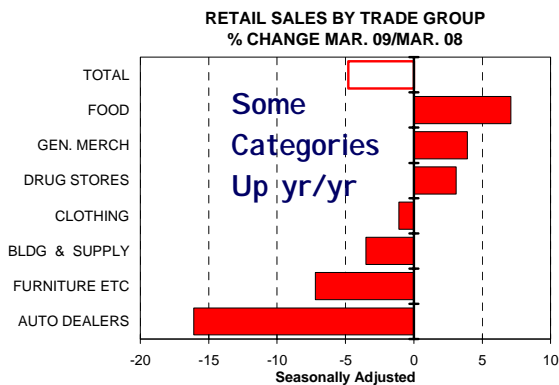
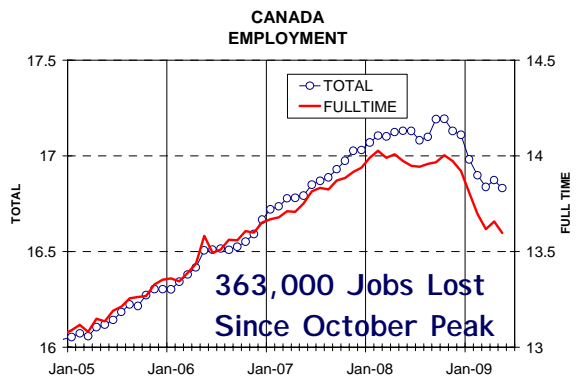
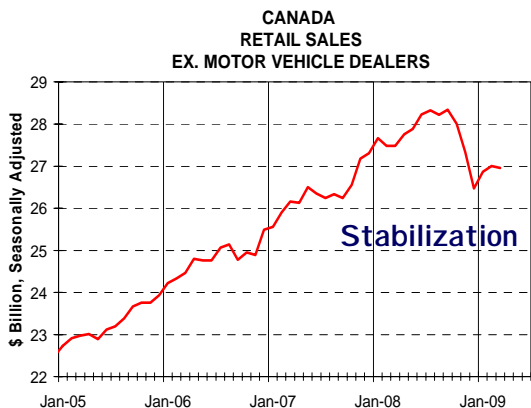
CANADA'S PROSPECTS: The Bank of Canada continues to have what we consider to be an overly optimistic view of Canada's economic prospects. It is forecasting an accelerating recovery with real GDP growth picking-up from 2.5% in 2010 to 4.7% in 2011. They are using outdated forecasting models that work on the presumption that if you keep interest rates low enough for long enough there will be a strong economic response. They appear to be unaware that credit markets are unlikely to return to health anytime soon. They are also counting on the past devaluation of the CAD to boost Canada's trade prospects. This assumption looks doubtful given the sharp rise in the CAD to over 90 cents (U.S.) at present. Our base case forecast is for a much more subdued Canadian economy over the next two years. We are forecasting real GDP growth of only 1.2% in 2010 and 1.7% in 2011.

THE BOTTOM LINE: The U.S. Administration still faces a big challenge in getting the economy back onto a sustainable recovery track. A shortage of credit is still pushing the economy down. Rising longer-term U.S. Treasury yields are threatening to push U.S. mortgage rates higher. Housing has not bottomed yet. The shadow banking system is shut down. The traditional banking system cannot fill the hole left by the shadow system. Wholesale funding and asset securitization is dead. Traditional bank loan losses will continue to climb and banks will remain conservative lenders. Foreclosure mitigation is not working. The plan to remove "toxic assets" from lenders' balance sheets appears to be a failure. The Fed will have to expand quantitative easing. The U.S. fiscal stimulus was not large enough. We will need more in 2010. The question is whether there will be the political will to provide it.

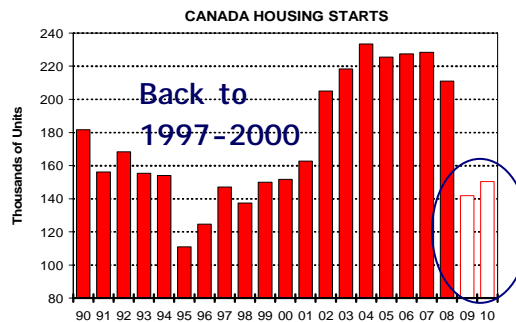
The economic news has been positive for the stock market. The S&P 500 Index has reached a 7-month high. The financial market rally since early March reflects the stress test results for the largest U.S. banks. The message is that the banks' capital needs are relatively modest, even under an adverse economic scenario, and that the U.S. banking system seems to be on the mend. Recent reports on payroll employment, personal income, manufacturing and construction also beat economists' forecasts. However, this improvement in the economic numbers only really says that economic activity is not declining at as fast a rate. There is a widespread consensus that growth will resume in the 3rd Quarter of this year. However, the strength and sustainability of this growth are likely to be disappointing. We remain highly skeptical. Government support to personal income will fade this summer. The non-manufacturing ISM index offsets the good news from the manufacturing survey. It is still well below the expansion/contraction threshold. Cumulative job losses now total 6 million since the recession began. They could accelerate again in June and July as auto industry suppliers feel the impact of the GM and Chrysler bankruptcies. The May vehicle sales rate, 9.9 million units, reflects liquidation sales by Chrysler and is below levels necessary for auto industry profitability.



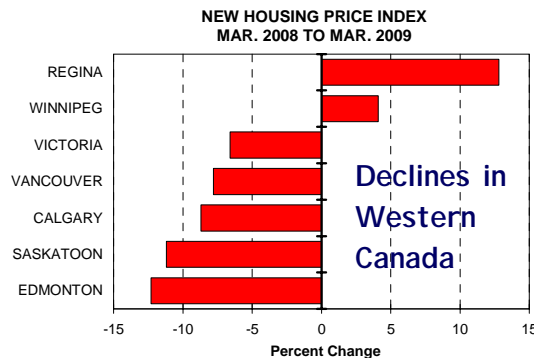
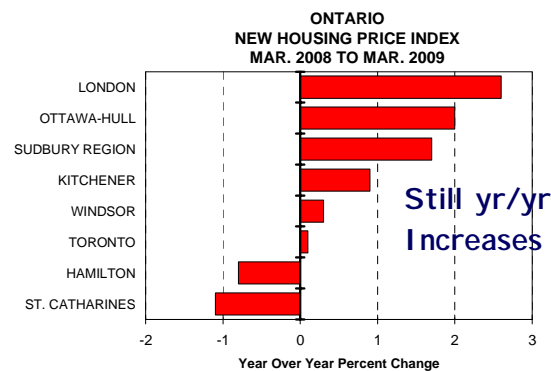
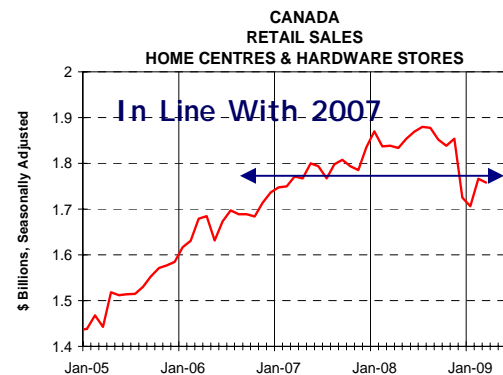
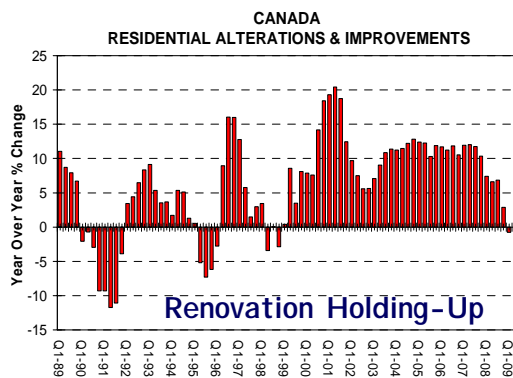
Canadians are now facing a \$50 billion-plus budget deficit in the current fiscal year. This means years of tax increases and government spending cuts in the coming decade. For the economy, the fiscal impact is slow in coming. Government spending showed a remarkably weak 1st Quarter increase. There was no offset to the weakness in private sector demand. StatsCan reported on June 1st that real GDP contracted at an annual rate of 5.4% between the 4th and 1st Quarters. This is basically in line with the 5.7% 1st Quarter rate of decline in the U.S. economy. This decline in Canada while huge, was still less than the 7%-8% rate of decline that had expected. It was not the largest quarterly decline in the post-WW2 period. That record was set in 1982. Goods-producing industries showed real output declining at a 17% annual rate in the 1st Quarter. The service-producing sector declined at a 2% annual rate. In the consumer sector, the weakness was concentrated in spending on durable goods. This category showed a 7.4% real decline at annual rates. Consumer spending on services showed a second consecutive quarterly decline. Exports of goods and services showed a shocking 40% 1st Quarter real rate of decline. Imports declined even faster though. Automotive exports showed an eight consecutive quarterly decline. Business investment in machinery and equipment declined at a 52% annual rate in real terms. Inventories were drawn down but not as aggressively as in the United States.



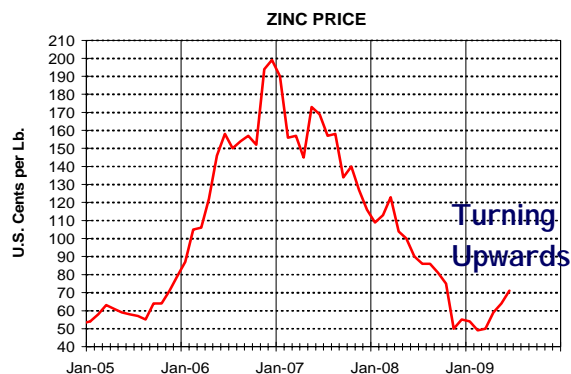
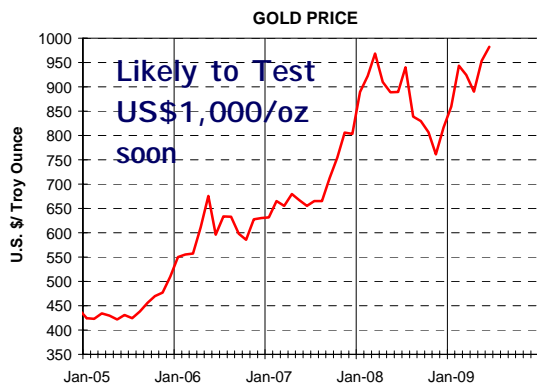
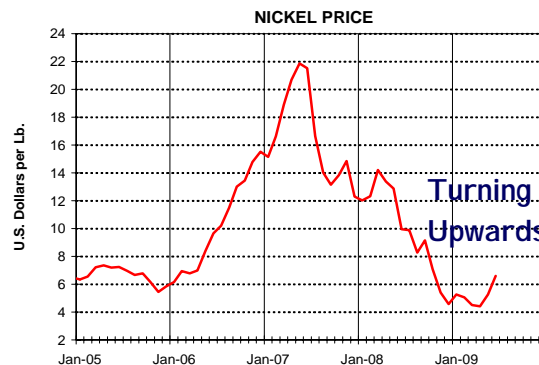
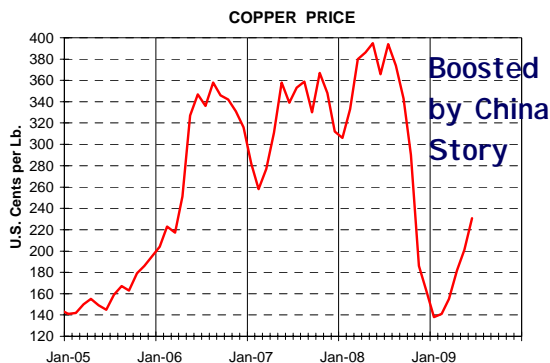
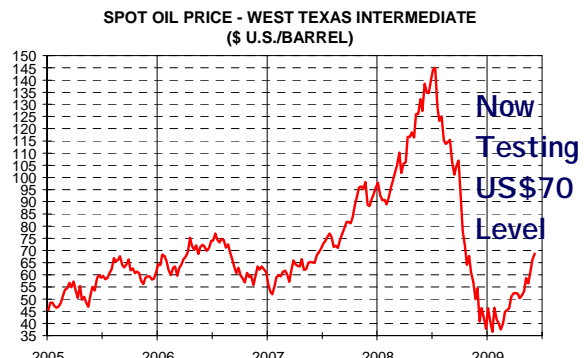
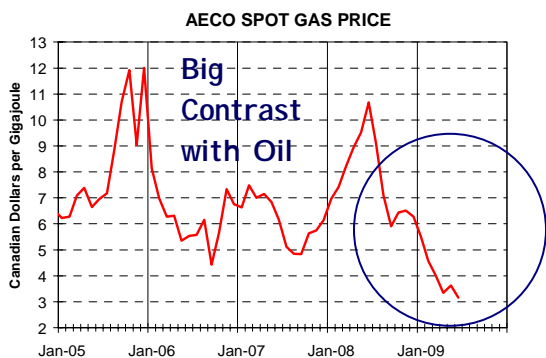
Residential construction activity in Canada will decline by about 34% this year. Housing starts are now forecast at 140,000 units, compared to 211,100 in 2008. This follows seven consecutive years of annual starts in excess of 200,000 units. Using the ratio of 10 to 1 in comparing Canada and the U.S., starts have been much stronger on a relative basis in Canada this decade. The 140,000 to 150,000 range expected for Canada's housing starts in 2009 and 2010 puts them roughly in line with the experience of the years 1997 through to 2000. The decline from peak levels of housing start activity has been far greater in the United States – a decline of almost 80% from the 2001 peak of 2.1 million starts, to the April 2009 annualized start rate of 458,000 units. In percentage terms, from the peak year in Canada, which was 2004, the decline is expected to be only half that experienced in the United States. It will be even less in Central and Atlantic Canada, which is expected to show a 25% starts decline this year. Existing home sales have actually picked-up across Canada for four consecutive months now. They showed a large increase between March and April and preliminary information points to another month to month increase in May. Renovation spending is holding up well. It is running lower than a year ago but the expected 2009 decline is less than 5%.



Home Sales are Recovering



Economic performance in the major industrial countries is not consistent with the sharp rise in oil and other commodity prices over the past three months. The economic news from Europe is particularly dismal. The commodity market is being driven by hopes on an economic recovery beginning in the U.S. in the 3rd Quarter of this year and signs that China's economic stimulus package is working. We think this optimism is premature. American consumers face a long period of weak income growth and are increasing their rate of saving. China is still locked into an export growth model that depends on the U.S. consumer. The European Union's statistics office reported on June 3rd that real GDP in the euro region declined at a 10.4% annual rate between the 4th Quarter of 2008 and the 1st Quarter of 2009. Both business investment and exports show extreme weakness. Exports declined at a 37% annual rate and investment at an 18% rate. The euro-area economy is down in real terms by 4.8% yr/yr. Other countries showing massive 1st Quarter real GDP declines are the U.K. (a decline of 8% at annual rates) and Japan (a decline of 16% at annual rates). The recent improvement in industrial activity in Asia therefore faces strong headwinds. The latest monthly industrial production gains in Japan, South Korea and Taiwan are still at an early stage.



The recession is having a strong impact on all provinces but the shock is particularly noticeable in B.C. and Alberta. They are the provinces showing the sharpest yr/yr declines in economic indicators such as retail sales and housing starts. Non-residential building permits are showing a particularly sharp decline in Alberta. Depressed natural gas prices and oil sands project cancellations are major negatives for Alberta. In comparison, non-residential building intentions are holding up relatively well in Ontario, and on a 12-month moving average basis, are still trending higher in Quebec. In a major reversal, Alberta is actually showing signs of consumer price deflation. In April, the CPI for Alberta showed an outright yr/yr decline of -0.7%. In comparison, consumer prices in Ontario were up by +0.6%. The longer-term outlook for Alberta is clouded by possible competition from shale gas development in the United States. Recent technical developments with hydraulic fracturing and horizontal drilling could open up vast reserves of this energy source and have a fundamental impact on the global demand/supply balance for energy. The possibility of a major conversion to compressed natural gas for automotive transport could have a material impact on future U.S. demand for oil produced by Alberta's oil sands. The possibility of sustained low prices for natural gas, and its use for baseload electric power production, could improve the longer-term prospects for both U.S. and Canadian manufacturing.

