



Economic Monitor

October 27, 2009

Prepared by:
Dr. Martin Murenbeeld, Chief Economist
William Tharp, Senior Economist

FINANCIAL MARKETS OVERVIEW

- 1.▶ The **BANK OF CANADA** is expected to leave interest rates at an historic low level until mid-2010 when a gradual rise in rates will likely commence. However, if the Fed does not show any signs of raising rates by then and inflation remains subdued, the Bank may well leave rates alone to avoid fueling a further rise in the Canadian dollar. The issue is complicated further by a rise in house prices in Canada.
- 2.▶ The **FED** Funds target rate, currently a range of 0% to 0.25%, is likely to remain in this range until the beginning of 2010 when the Fed may announce that 0.25%, the upper end of the range, is the new Fed Funds Target. Regular rate hikes could commence as soon as mid-2010; however, if unemployment remains unduly high and inflation remains low, then the Fed may delay increases until year-end or into 2011. The Fed continues to maintain monetary ease by providing liquidity through the purchase of mortgage-backed securities, but other programs are being phased out or scaled back as the economy recovers and financial markets begin to function more normally.
- 3.▶ **BOND YIELDS** are expected to remain near 3.5% until the end of 2009, then gradually rise, topping 4% next year for the 10-year maturity. The economic recovery is not expected to be strong enough in the US to cause a near term rise in inflation. Indeed, core inflation is apt to slip somewhat over the next six months or so in both the United States and Canada.
- 4.▶ The **CANADIAN DOLLAR** has been driven up, in part by investor interest in commodities. While commodity prices will probably trend higher over the next 15 months, the Bank of Canada appears uncomfortable with the loonie approaching parity too quickly and may well intervene (near 98 cents?). The Bank's task of suppressing the loonie is complicated by the US dollar's global weakness, as well as by the early recovery in Canada's housing market. Options the Bank has for arresting a further rise in the Canadian dollar include direct foreign exchange market intervention – not employed since 1998. It is beginning to look more probable that the Bank will however employ this option in the event the dollar gets close to parity.
- 5.▶ The **US DOLLAR** is expected to weaken further now that it has become a favourite funding currency for the carry trade. There is growing political pressure on Asian countries (China in particular) to let their currencies appreciate. The renminbi may be allowed to float higher at some point over the next 15 months, assuming global economic growth is strong enough to see a further recovery in exports.

October 2009 Forecast - Base Scenario

	Actual					Projected						
	09-I	09-II	09-III	26-Oct		Nov	Dec	Jan	10-I	10-II	10-III	10-IV
Scenario B: Global Recession Has Ended; US Dollar Weakens												
US Dollar Index*	85.61	82.01	78.19	74.32	72.26	71.44	70.16	69.54	69.30	69.67	69.65	69.65
Can. Dollar CDN/US	1.253	1.166	1.097	1.065	1.045	1.045	1.035	1.020	1.010	1.000	0.985	0.985
Can. Dollar US/CND	79.81	85.76	91.16	93.94	95.69	95.69	96.62	98.04	99.01	100.0	101.5	101.5
Japanese Yen	93.70	97.30	93.90	91.80	89.00	87.50	86.00	86.00	86.00	88.00	89.50	89.50
British Pound	143.1	154.9	143.1	163.7	163.8	165.2	167.4	167.4	165.3	164.0	162.7	162.7
Euro	1.302	1.361	1.431	1.480	1.510	1.530	1.550	1.550	1.545	1.540	1.535	1.535
Australian Dollar	66.40	75.90	83.36	91.64	90.91	90.91	91.79	93.14	94.06	94.50	95.43	95.43
Chinese Yuan Rmb	6.837	6.830	6.831	6.830	6.822	6.817	6.810	6.800	6.750	6.650	6.500	6.500
Indian Rupee	49.77	48.79	48.38	46.83	45.00	44.00	43.50	43.00	42.00	42.00	41.50	41.50

* Index based on CDN\$, Euro, Pound, Yen

Scenario B: Recession Ends; Flattish ("L"-Shaped) Economic Recovery

Canada	0.72	0.23	0.23	0.22	0.22	0.22	0.22	0.22	0.22	0.55	1.03	1.25
Treasury Bill (91-day)	2.96	3.37	3.41	3.48	3.60	3.65	3.65	3.75	4.00	4.15	4.20	4.20
Government Bond (10-yr)	2.83	2.25	2.25	2.25	2.25	2.25	2.25	2.25	2.25	2.58	3.08	3.33
Target Overnight Rate	1.00	1.00	1.00	0.25	0.25	0.25	0.25	0.25	0.25	0.58	1.08	1.33
United States	0.21	0.17	0.14	0.06	0.10	0.15	0.20	0.20	0.30	0.63	0.95	0.95
Treasury Bill (90-day)	2.87	3.37	3.41	3.41	3.50	3.55	3.60	3.75	4.10	4.25	4.35	4.35
Treasury Bond (10-yr)	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.50	3.58	3.92	4.25	4.25
Fed Funds Target	0.18	0.18	0.18	0.17	0.13	0.13	0.25	0.25	0.33	0.67	1.00	1.00

Interest Rate Differential (Canada-US)

Treasury Bill	0.51	0.06	0.09	0.16	0.12	0.07	0.02	0.02	0.25	0.40	0.30	0.30
Bonds-10yr	0.09	0.00	0.00	0.07	0.10	0.10	0.05	0.00	-0.10	-0.10	-0.15	-0.15

This is our “baseline” scenario for the next four quarters. It is updated monthly. For alternative scenarios the reader may consult the Financial Monitor.

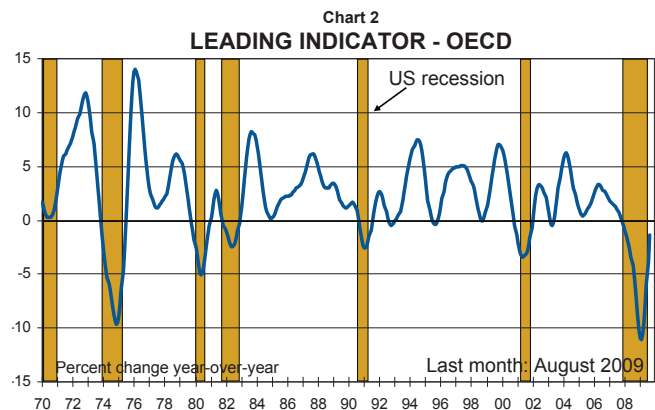
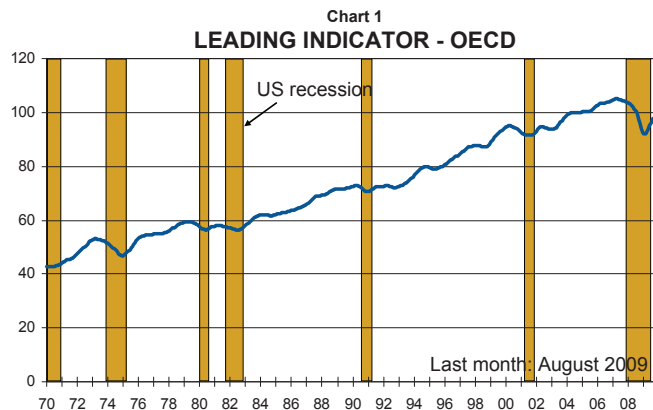
Comments by Martin Murenbeeld

The Recession Is History

The OECD composite leading indicator (Charts 1 and 2) suggests that the global recession ended in 2009-Q3. That's not just our observation (given that we predicted the recession would end in 2009-Q3 we have a professional interest in the "correctness" of this claim). There is a report from Ned Davis Research, Inc. in my inbox today (October 15) with the headline: "Leading indicators confirm global recession-end".

Let's hope we are both right; I'd hate to wake up one morning and find that those who have argued this is

the biggest suckers rally of all time were right after all. Nothing is certain when looking into the future of course, but we are anticipating economic recovery – albeit a subdued recovery on average – though quarterly numbers could be more volatile on account of government spending, inventory rebuilding, etc. The reasons were last outlined in the April Economic Monitor. Household consumption will be weak in many economies, and notably so in the US!

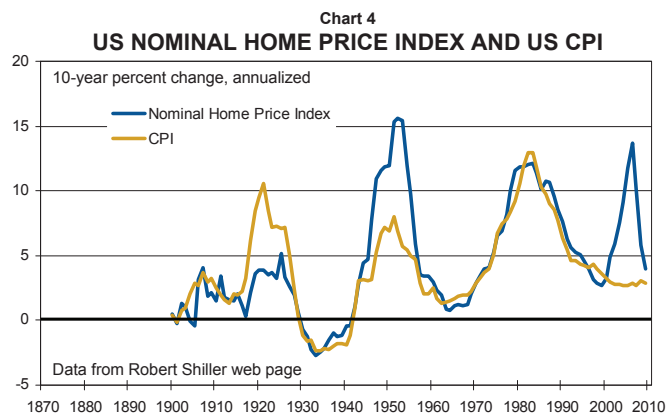
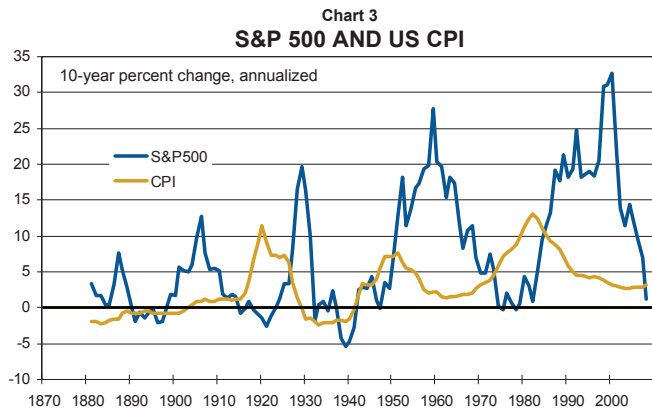


Inflation and what to do about it

Federal Reserve Vice Chairman Kohn said on October 13 that interest rates could stay low for a long time because the "subdued US economic recovery would keep inflation at bay". In contrast, the President of the Fed of St. Louis said that the slack in the US economy currently might actually be exaggerated, meaning that if there is less slack than estimated, "potential inflation problems" might be just around the corner. There is no unanimity of views on inflation for the near- or medium-term, in other words. Surveys of professional forecasters also show that there is growing disagreement about the inflation outlook (see for example FRBSF Economic Letter 2009-31, dated October 5, 2009). Such disagreement is of interest to us, not only because I have an academic interest in gold which is affected by inflation (by the debasement of money, really), but also because we'd like to be able to advise the reader on how to help "protect" a portfolio in the event inflation reemerges.

[DundeeWealth Economics](#)

Chart 3 compares the 10-year annualized gains in the S&P500 index with the 10-year annualized rises in the US consumer price index. The chart shows, for example, that the inflation rate for the 10-year period ending in 1920 was in excess of 10% per annum (very high in other words). The S&P500 index, on the other hand, declined by an average of 1.5% per annum for the same 10-year period. This pattern of high inflation together with low equity index returns repeats furthermore. Indeed, Chart 3 shows that the 10-year inflation cycles do not match up very well with 10-year equity cycles; when inflation has been high over a 10-year period, the gain in the S&P500 has been low over the same 10-year period, and when the inflation rate has been low over a 10-year period the gain in the index has been high.



The conclusion one is encouraged to draw, as many have in fact done, is that the basket of equities making up the S&P500 index does not protect the investor from inflation when inflation is running rampant. To inflation-proof a portfolio, in other words, investments in assets other than equity indices are required – if not also investments in specific sectors of the equity markets that might correlate better with inflation.

Chart 4 compares the 10-year inflation cycle with a 10-year house price cycle. It shows that, with the exception of the recent 10-year period, when the inflation cycle is high the house price cycle is also in full swing. This might suggest that residential real estate, as opposed to an equity index, might be the asset of choice when consumer price inflation is high. (Since the latest cycle indicates that real estate price inflation can occur without a commensurate bubble in consumer price inflation, the latter is not, strictly speaking, a necessary condition for residential real estate inflation.)

At this point it is probably useful to distinguish between inflation as measured by the CPI (which is the “normal”, headline inflation government statisticians calculate based on a basket of consumer goods and services) and inflation in asset prices.

Since, however, government statisticians haven’t actually calculated a price index for a basket of assets it is difficult to describe asset price inflation exactly. Most everyone simply observes a rise in asset prices and for want of a better description calls it asset price inflation. Anna Schwartz, who co-authored “*A Monetary History of the United States 1867-1960*” with Milton Friedman described asset price inflation as follows: “*Asset price inflation can take many forms, raising prices of art objects, land, housing purchases, equities*” (see: *Asset Price Inflation and Monetary Policy*, NBER, working paper 9321, Nov 2002). This is not a very satisfactory “definition” obviously, but there it is! Wikipedia has a somewhat more elaborate discussion of asset price inflation, but it essentially goes no further than what Anna Schwartz noted above.

Despite the lack of a measurable definition of asset price inflation central banks these days are debating more vociferously just how they might incorporate “asset price inflation” into their policy deliberations. Paul Jenkins, Senior Deputy Governor of the Bank of Canada, said at the Vancouver Board of Trade on October 8, 2009: “*There remains ... the issue of how central banks should react to developments in asset prices because of their consequences for both inflation and financial stability. Experience shows that increases and collapses in house prices affect aggregate demand, and have played a particularly important role as a driving force behind bouts of financial instability. In Canada, house prices enter directly into the calculation of the CPI. The Bank of Canada follows developments in house prices closely and factors them into our decision-making process regarding the level for the target overnight rate, consistent with achieving our inflation target*”. (I checked, by the way, just what Statistics Canada puts into its CPI calculation and as best as I can make out there is something under “*Owned Accommodation*” called “*Replacement Cost*”; it is only 3.27% of the consumer price index, meaning that there is actually very little house price inflation in the CPI!)

No matter! Central banks feel they need to get a handle on asset price inflation because the crisis now subsiding was to some degree a direct function of asset price inflation, not consumer price inflation. Indeed, it had already been suggested in some quarters that when monetary policy is focused too narrowly on consumer price inflation it might actually exacerbate asset price inflation, insofar as monetary policy might well be too loose when consumer price

inflation is absent. Anna Schwartz observed in the same paper that equity price inflation (one facet of asset price inflation) seems to actually come together with very modest consumer price inflation (as per Chart 3, which suggests there may be some linkage between the two such as low borrowing costs in a low inflation environment that the economics profession could usefully explore).

Asset price inflation is not incorporated in any standard economic model or GDP identity either, presumably because asset price inflation is typically the result of some “herd-like” behaviour which doesn’t fit the efficiency hypotheses of the standard economic models of investment behaviour. The President of the ECB observed in a speech back in June 2005 that, “consumer price inflation has been successfully contained for quite some time now, at least in the major OECD economies. But at the same time we are observing large cycles in a variety of asset prices accompanied by ample global liquidity”. (Yes, in 2005!) He was obviously aware of asset price inflation, but without a proper definition and measurement, there wasn’t much he was prepared to do about it policy-wise.

This article is not a policy piece; we do not question whether asset bubbles exist, how to identify one, how a boom turns into a bubble, what risks are inherent to the financial system at that juncture, and just when the opportune moment arrives for a central bank to prick the bubble (assuming one has been identified). Once central banks have defined asset price inflation properly and incorporated it into monetary policy it will be fodder for a future article. The topic here is simply to note that inflation has two facets and that the investor has different options depending upon whether he/she faces consumer price inflation or asset price inflation, or both.

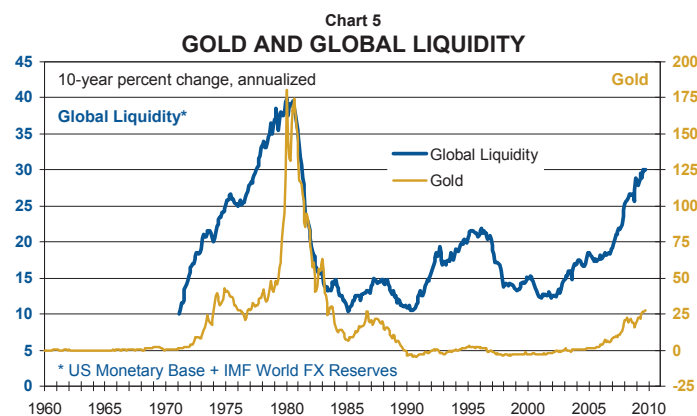
At this point, let me declare myself: I think the near-

and medium-term future will not be coloured by much consumer price inflation, despite all the money creation to date. From the equation $MV=PY$ (which states that money supply times velocity equals the “normal” price index times output), one may conclude that when M rises sharply, P must inevitably rise sharply as well. But since V is at depressed levels these days and Y can expand hugely on account of excess capacity, it is unlikely that P will rise. Once V picks up and excess capacity diminishes (hence the question as to how much excess capacity there currently is) P will commence rising. But since the monetary authorities are also aware of this linkage they will commence reigning in all the M that was created (i.e., they will commence their “exit strategies”). Depending upon how timely they are, a rising P may not become an issue for a while yet.

But we may very well see the reemergence of asset price inflation! Central banks have learned this much from the Japanese experience: had the Bank of Japan been successful in pumping up asset prices – real estate and equity prices in the main – it might have shortened Japan’s “lost decade”. Such “pumping up” would have bolstered the asset side of the typical Japanese bank’s balance sheet; ergo, “pumping up” the typical bank’s balance sheet is a key policy objective today! Mortgage agencies have been given money to help arrest house price deflation, for example, and near-zero interest rates have helped improve investor confidence and turn equity markets around. (Indeed, all the policies that helped the world economy eventually climb out of the Great Depression have been employed: there are now record fiscal deficits, there has been record money creation, and in so far as the Chinese RMB is undervalued by an estimated 40% against the US dollar, currency devaluation has also been employed.)

But the reader must note that arresting deflation in asset prices, as important and necessary as this is to exiting the crisis, is also the first step back on the road to asset price inflation.

The chart (Chart 5) of global liquidity, which is the sum of the US monetary base plus global foreign exchange reserves (less US reserves), shows that liquidity has been rising again since 2002, and particularly sharply since 2006. This liquidity has to go somewhere. For example, China invests its foreign exchange reserves in US government debt, commodity-producing entities (Teck in Canada comes to mind), and ... yes, even in hedge funds. Such centrally-directed investments may



not raise the price of goods and services in the US and OECD countries – maybe not even the price of goods and services in the emerging economies – but such investments are definitely raising the price of the assets that are targeted, be they in OECD countries, Africa, or the emerging economies more generally.

Which brings me to the point of this article! The investor who is worried about good old fashioned consumer price inflation has the choice of several investment vehicles, of which first and foremost are the Real Return Bonds (RRBs) in Canada and Treasury Inflation-Protected Securities (TIPS) in the US. These securities compensate the investor against consumer price inflation directly, but only against consumer price inflation! These securities do little for the investor when there is very modest consumer price inflation but significant asset price inflation. (I was reminded of this when someone argued on CNBC one night that TIPS were just the thing to inflation-proof one's portfolio; good point, I thought, but what if there was no consumer price inflation, but asset price inflation instead?) And the investor has the choice of residential real estate. Chart 4 made this clear: real estate is a good hedge against consumer price inflation!

The obvious strategy when asset price inflation looms is to buy the asset class that is most likely to inflate! Which actually is another plus for residential real estate! Since residential real estate is also an asset that central banks actually want to inflate (because a little inflation here helps the banking sector) I am now inclined to think that the real estate cycle is forming a bottom. (Residential real estate appears to have already bottomed in Canada – which has caught us by surprise, frankly!)

Gold is also an asset that often moves higher on the back of consumer price inflation and/or asset price inflation, though not always; gold prices declined from 1980 to 2000 despite consumer price inflation being positive though declining. But gold benefits from excesses in global liquidity and the types of depression-like problems in existence today that can only be effectively countered with global liquidity creation. Chart 5 shows that gold is directly affected by surges in global liquidity.

But gold may be too exotic an asset class for the average investor (although there are more investor-friendly gold funds in the marketplace on which I'd be happy to expound). Let's assume the typical investor

invests in equities, real estate and debt. Equities bubbled in 2000 and real estate bubbled in 2007, so maybe the next great bubble will be government debt. Asset price inflation could come in the form of sharply rising government bond prices, for example, even from current levels. I keep an open mind – it happened in Japan. Aging investors in North America typically want more fixed income in their portfolios, and the demographic cycle indicates that the ratio of aging investors will increase. And in the event there is no consumer price inflation in the next few years, nominal bond prices could do much better than real-return bond prices.

We like commodities, however. The commodity space is turning into an asset class and attracting investors around the globe. If I had to bet on the next "bubble", driven by ample liquidity and a global economic recovery, it would be commodities. It is still early days for commodities, despite the fact that they turned up in 2001 and dropped sharply during the crisis. Long-term commodity cycles typically last much longer than eight years, and the needs of the BRIC economies suggest this cycle will be longer than most. China needs more resources if it is to develop further, and no matter how often this is said it remains true. Also for India! China has targeted mining firms as potential investments, so it can extract long-term supply contracts from management. And if supply cannot keep up with growing demand, as remains most likely in our opinion, then prices of commodities must rise so that demand is choked off in the developed economies to make room for the increased demand in the emerging economies.

Not to be overlooked, commodities, like gold, also benefit from the rise in global liquidity. And some commodities, like oil, are important in the consumer price basket – making them also natural assets to hold when consumer price inflation is gearing up. Commodity prices are subject to the appetites of the BRIC economies however, which will boomerang on the commodity investor when China has its inevitable economic hiccup. (The reader has to remember at this point that economists are not investment advisors; economists can only advise investment advisors!) And since many commodities can be invested in directly through the energy and materials sub-sectors of the equity indices, we are inclined to think these sectors will give the investor "inflation protection", in whatever form it appears.

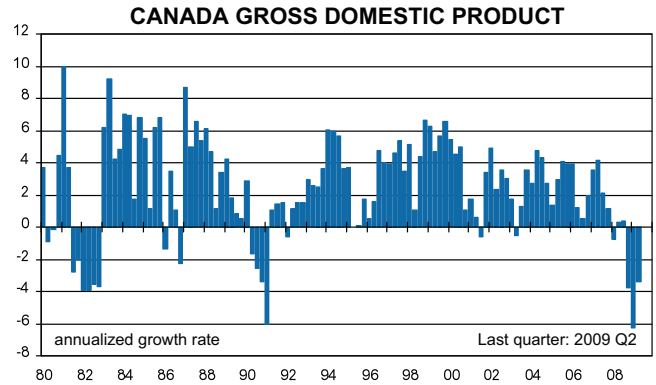
Notes from the BCA Conference – NY, October 19-20, 2009

Always interesting, this year's conference was entitled "*After the Storm: Making Sense of the Investment Outlook*". It was an intensive two-day conference but the following points stood out:

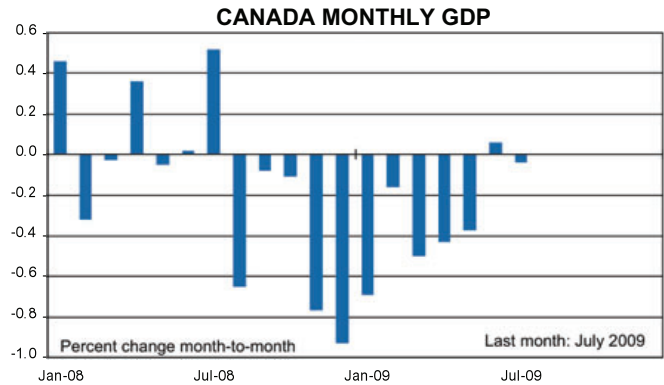
- US monetary policy has/will become more politicized. (This was noted by a number of speakers including Henry Kaufman.)
- Fiscal policy is politicized, which makes winding down the many crisis-induced programs very difficult. (Rudolph Penner argued that current fiscal policies will be extended and – or because – the Democrats will become nervous about the 2010 elections.)
- A "W" economic pattern, with a recession again in late 2010, was very possible. (Martin Feldstein thought the probability might be as high as 60% and that therefore the Fed would be quite reluctant to implement its "exit strategy". A US housing market turn-around was key to Martin Feldstein's view of the economy, and he was not convinced it had turned the corner.)
- Oil consumption has peaked and production will peak in 2013. Because of geopolitical risks, oil from Canada's tar sands will be in demand. (In a private conversation, Philip Verleger agreed that hiking US oil prices to \$150 with import tariffs/taxes would be good for a whole lot of reasons – but such a policy was unlikely to be adopted by this administration.) Oil price forecasts for the next 5-10 years ranged from \$25 to \$200.
- TIPS and Energy were the best ways to hedge consumer price inflation (at least according to the fixed-income discussants).
- Tony Boeckh, founder of the BCA organization, thought the world may have entered a "new age of asset price inflation". (His panel concluded that the dollar was suspect, gold was a good asset to invest in, and the next danger point might well be when the BRIC have to revalue their currencies – as this will change the dynamics of growth in the BRIC. BCA editor Chen Zhao was unequivocal: "*Buy gold – everyone wants a cheaper currency!*")
- Departing from the view that the Chinese RMB should be revalued, Geng Xiao argued (unconvincingly) that China was better served with a fixed exchange rate and more domestic inflation. The best way to play China was through commodities, it was agreed.
- Dollar devaluation was the "best way out" for the US economy: it should be devalued by at least 25% against the RMB. Europe and Japan have problems that hamper the euro and the yen. (There were counter-views; Marc Chandler saw the dollar doing much better because currency markets are sensitive to capital flows as well as the flows of international goods and services, while Havinder Kalirai from the BCA thought the yen was still grossly undervalued on a PPP basis.) Favourite investments by this panel were the C\$, the A\$ and gold.
- Gold seemed almost everyone's long-term best bet. (I don't know whether this is bullish for gold however!) US government debt, not mentioned directly, was probably one of the worst long-term bets. (I don't know whether this is bearish for debt, although I tend to agree!)
- Last, a comment that resonated with me (a committed "free-market" economist) was made by Henry Kaufman, "*even in soccer there is a referee*". Rules and regulations are necessary, he argued, but they have to be "good" rules and regulations. His panel member, Arthur Levitt, was pessimistic about "good" rules coming out of Congress, however.

MONTHLY REVIEW ►
CANADA - ECONOMIC GROWTH

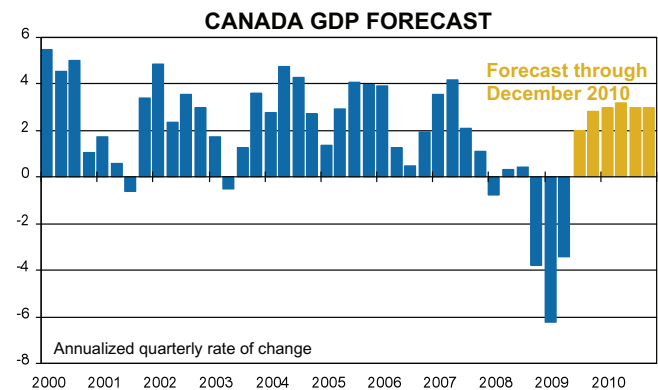
Following a steep (though short) recession, Canada's economy appears to be growing again.



Although many indicators suggest a recovery began in June, there was a small decline in GDP in July. (The depressing factors in July were mostly temporary however.)

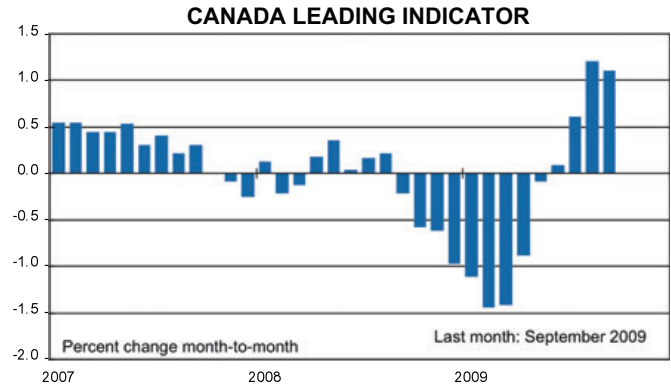


Growth near 3% is expected in 2010 and 2011, but thereafter the pace may begin to cool.

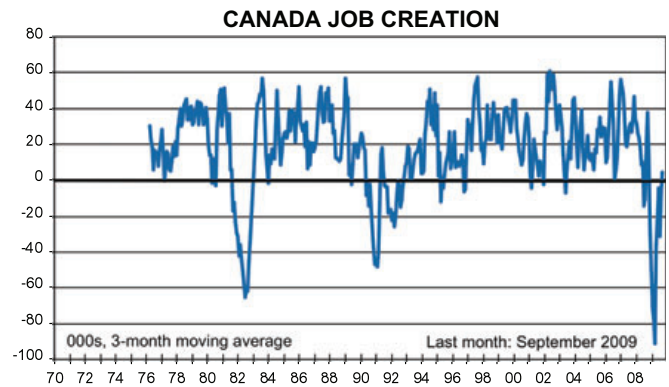


MONTHLY REVIEW ► CANADA - ECONOMIC GROWTH

The leading indicator has rebounded strongly.



The three-month moving average of job creation has also (surprisingly) moved back into positive territory.

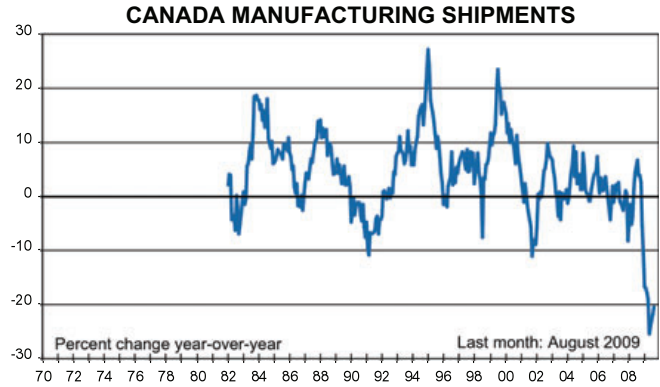


The Canadian unemployment rate appears to have peaked.

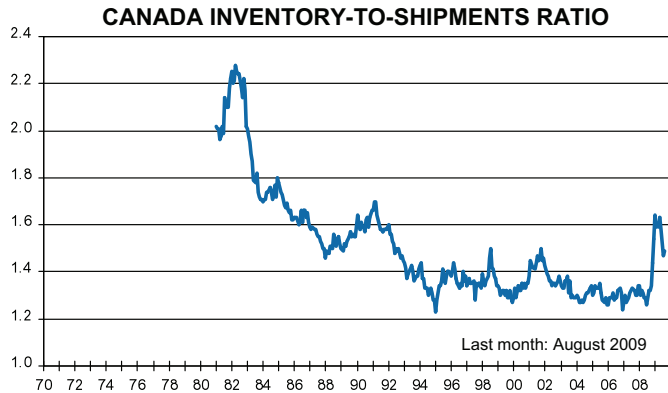


MONTHLY REVIEW ►
CANADA - ECONOMIC GROWTH

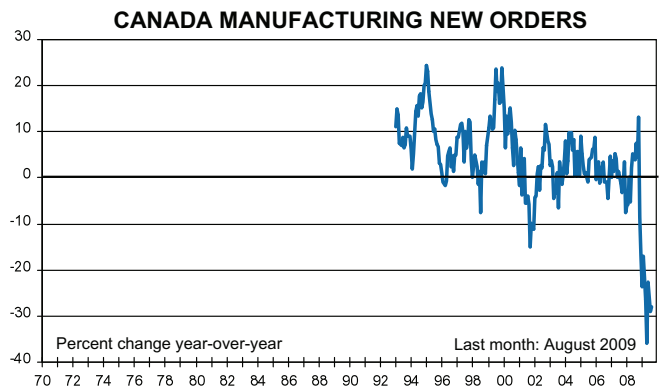
Manufacturing remains in recession – weak US demand, compounded by a high and rising Canadian dollar, are the reasons.



Inventories have begun to correct downwards, but have further to decline.



New orders are off their earlier lows but remain depressed.

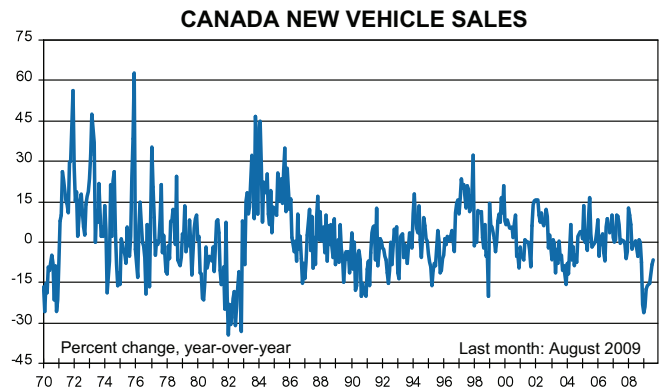


MONTHLY REVIEW ► CANADA – ECONOMIC GROWTH

Retail sales have improved somewhat in recent months, but not dramatically.



Vehicle sales have bounced off their lows without a Canadian “cash for clunkers” program. There has been some discounting however.

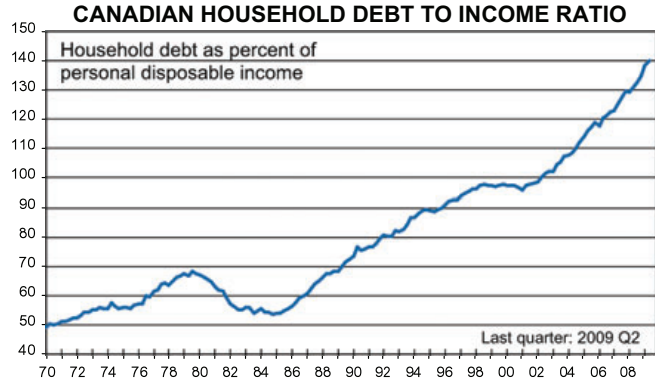


Although housing starts slipped back a little in September, anecdotal evidence suggests strong sales activity.

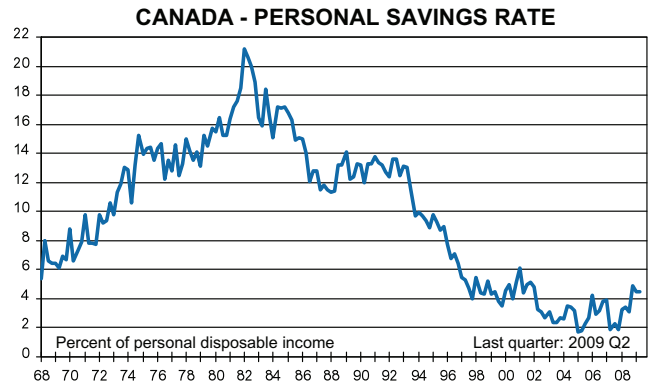


MONTHLY REVIEW ►
CANADA – DEBT AND CREDIT

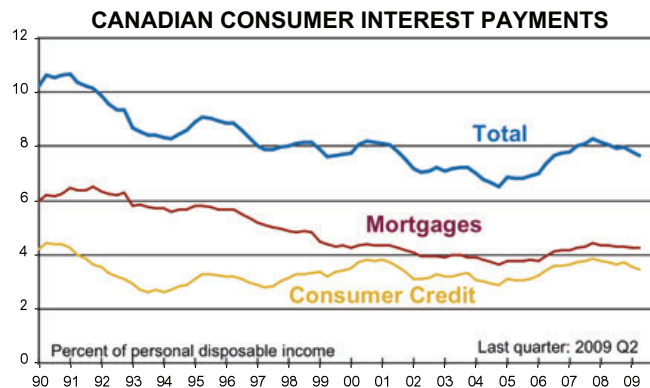
Debt-to-income continues to rise almost uninterruptedly. This could become a problem in the next few years.



The savings rate appears to have bounced off the bottom and may be starting to rise. Demographics say a rise in the rate is due to begin.

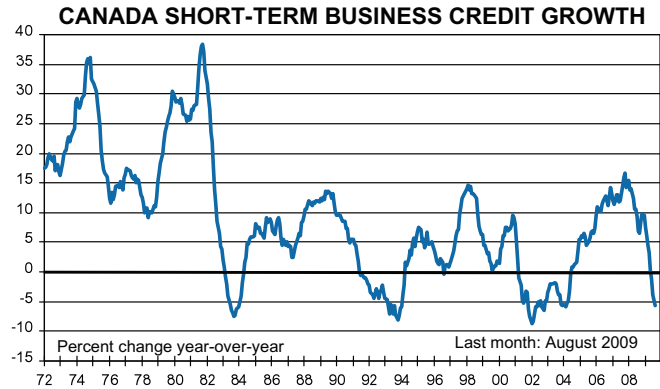


The interest portion of Canadian consumer debt payments is well off its peak.

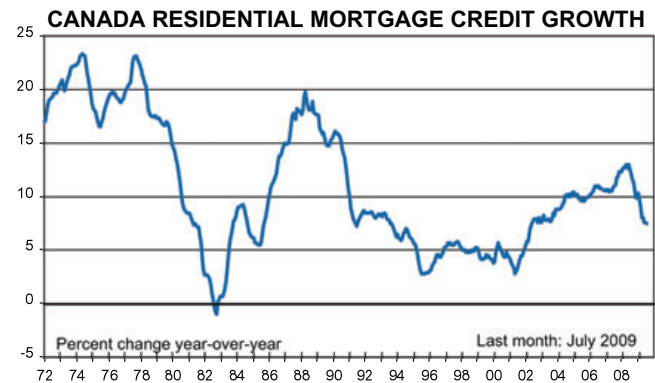


MONTHLY REVIEW ► CANADA – DEBT AND CREDIT

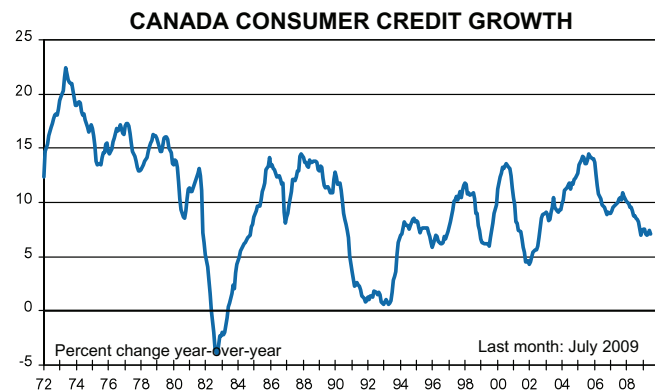
Business credit growth is contracting, but this is normal in the early stages of an economic recovery.



Although the year-over-year numbers show deceleration, month-to-month changes in mortgage credit were already showing mild acceleration back in April.

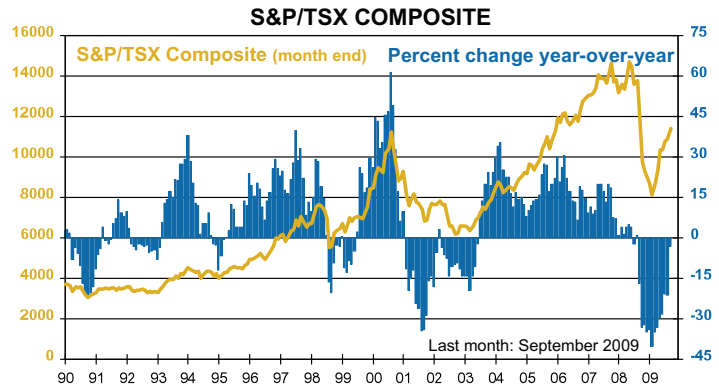


Consumer credit growth remains positive, though the rate of growth has flattened out at a more modest pace of late.

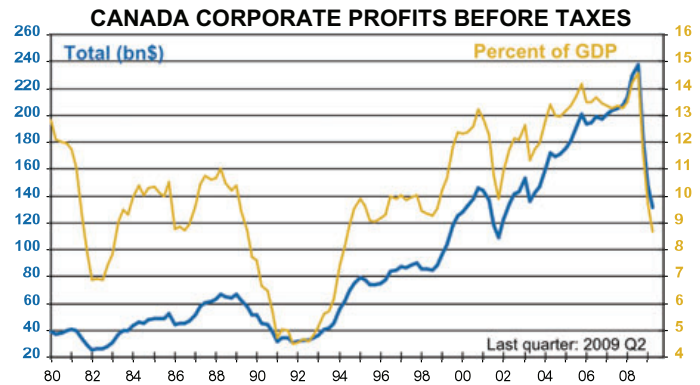


MONTHLY REVIEW ►
CANADA – WEALTH CREATION

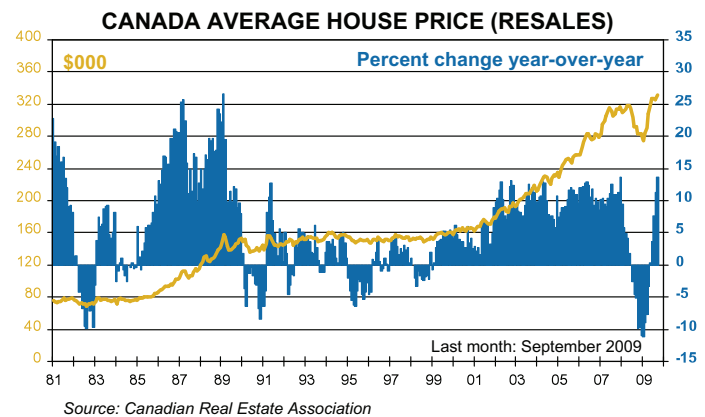
The TSX had recouped about half of its loss at the end of September, and had risen further in the first half of October.



Profits were still down sharply as of mid-year however.

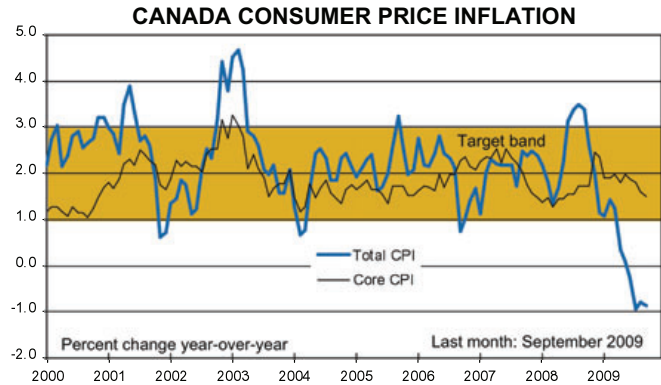


House prices fell less than expected and have staged a remarkable turnaround in the last few months.

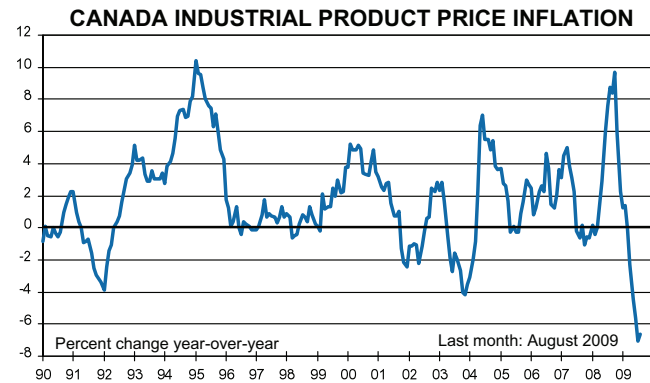


MONTHLY REVIEW ► CANADA – INFLATION

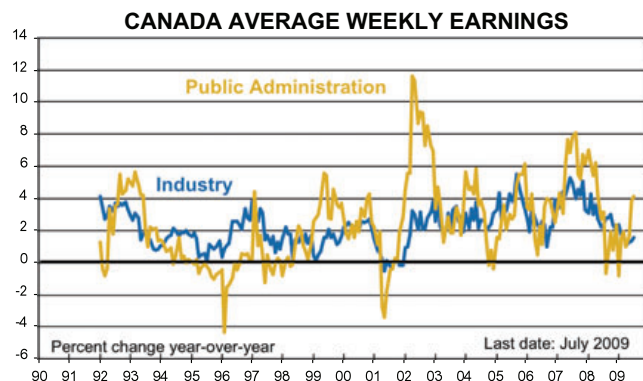
Headline inflation is expected to move back into positive territory in November. The headline number reflects large swings in energy prices. However, the core inflation rate, currently 1.5%, stands a good chance of falling under 1.0% in the months ahead.



Industrial product prices are starting to rise, along with commodity prices.

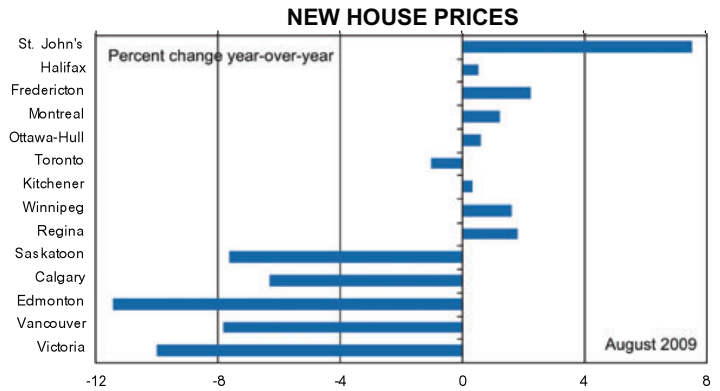


Average weekly earnings have moved above their lows for manufacturing. They are up even more in the public sector, but this series is much more volatile.

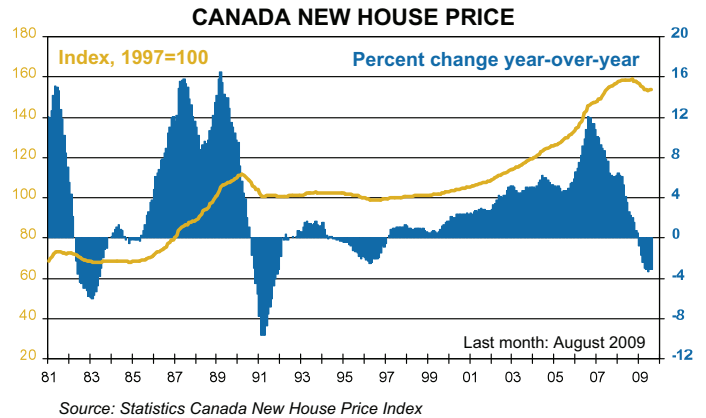


MONTHLY REVIEW ►
CANADA – INFLATION

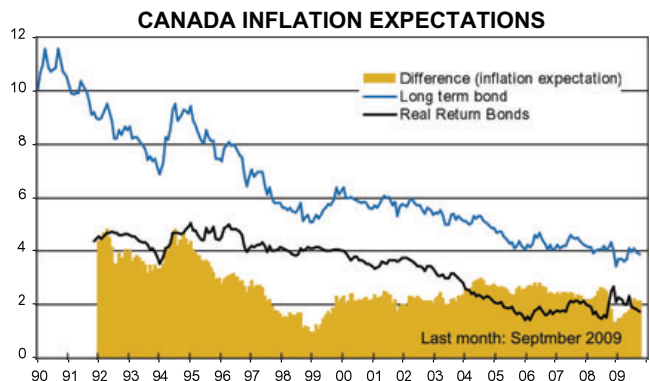
While new house prices have fallen considerably out west, they have moved higher in the last two months.



The national new house price index bottomed in June and has since inched up.

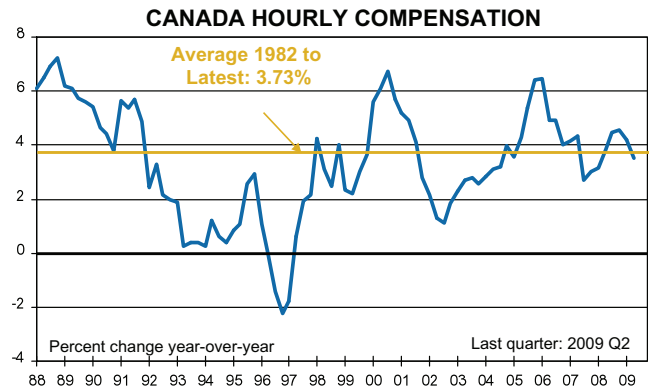


Inflation expectations have moved back to 2%, according to this measure.



MONTHLY REVIEW ► CANADA – INFLATION

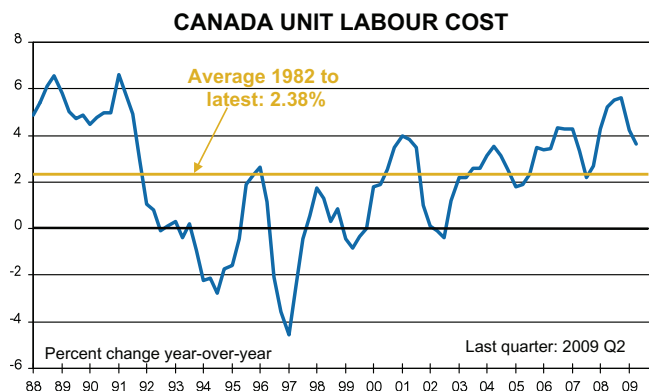
Hourly compensation has moved somewhat lower.



Productivity “improved” to zero in the second quarter. Canada’s performance here has been disappointing.



Unit labour costs (which are derived from the above two statistics) have been rising too rapidly, despite some recent deceleration.

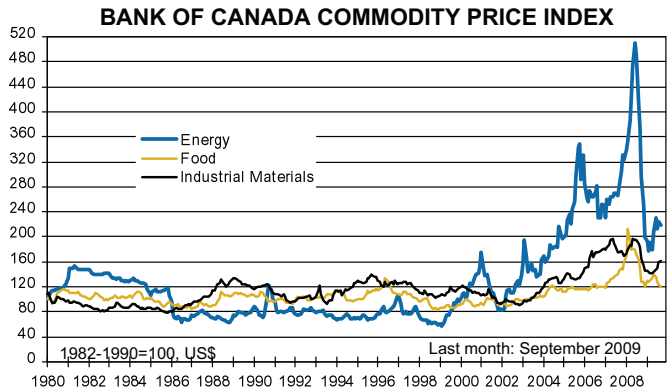


MONTHLY REVIEW ►
CANADA – FINANCIAL MARKETS

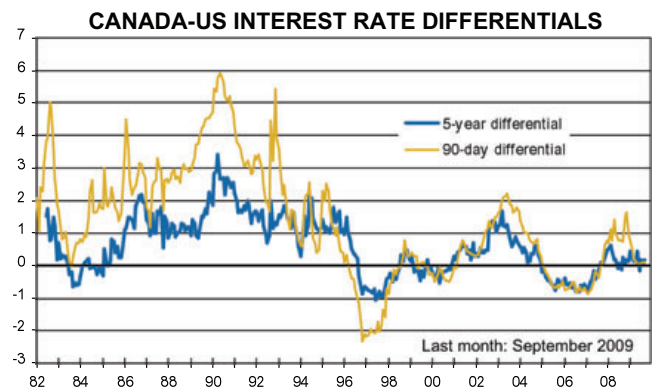
The Canadian dollar has risen dramatically this year, much to the displeasure of the Bank of Canada (and the manufacturing and tourism sectors).



Energy and industrial material prices have been moving up, though weak natural gas prices have restrained the energy index.

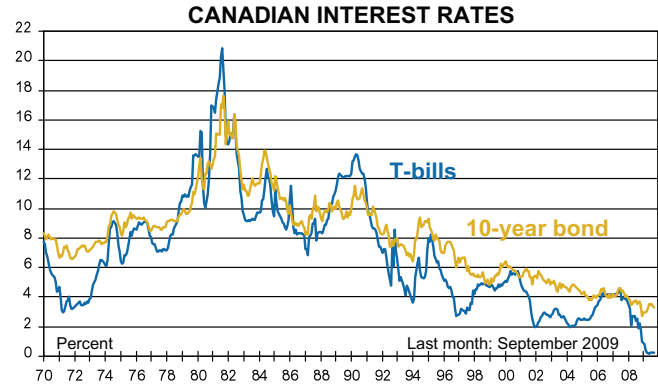


Short-term interest rate differentials remain very narrow against the US.

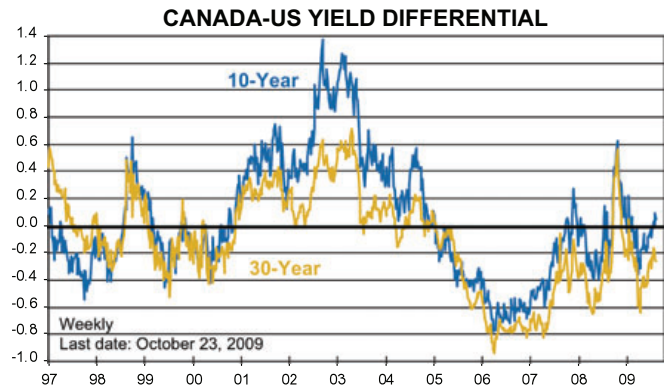


MONTHLY REVIEW ► CANADA – FINANCIAL MARKETS

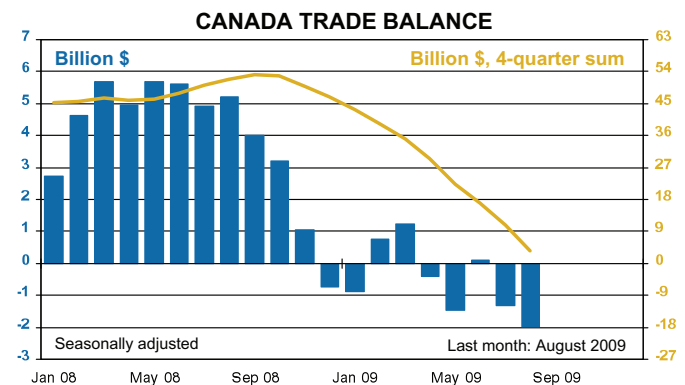
The 10-year yield could slip a bit further in the next few months, but a cyclical rise is expected in either 2010 or 2011 when the Bank of Canada (and the Fed) begin to raise policy rates.



Canada enjoys a small yield advantage at the 10-year maturity but a disadvantage at the 30-year maturity.

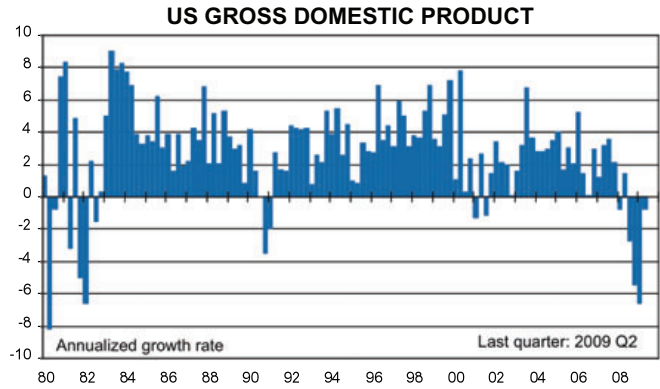


Canada's trade balance is in deficit, the result of a weak US economy and a strong Canadian dollar on the back of capital inflows.

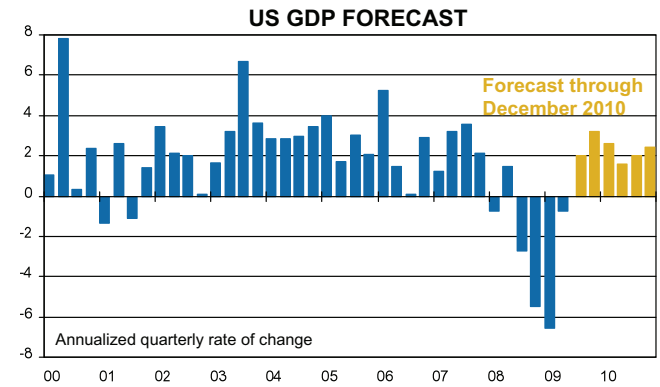


MONTHLY REVIEW ►
 UNITED STATES – ECONOMIC GROWTH

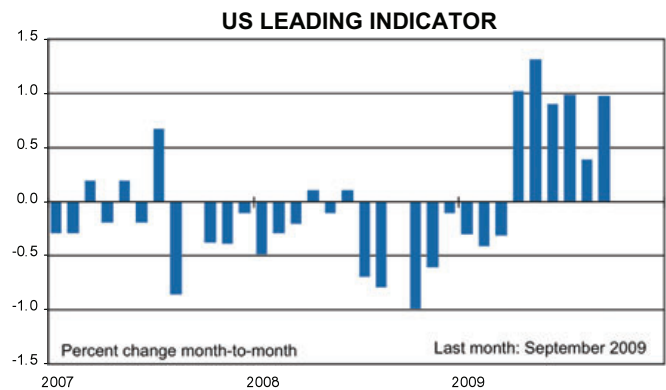
US GDP looks set to turn positive in the third quarter...



...but the recovery is expected to be relatively weak, absent strong consumer spending.

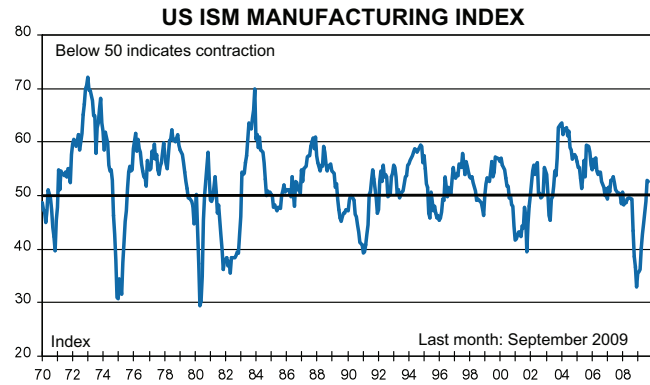


The US leading indicator continues to rise strongly.

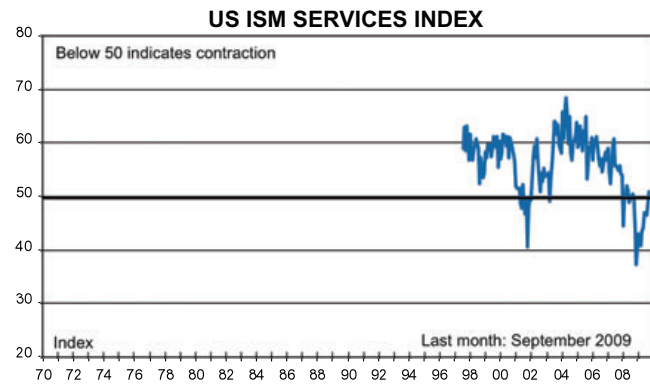


MONTHLY REVIEW ► UNITED STATES – ECONOMIC GROWTH

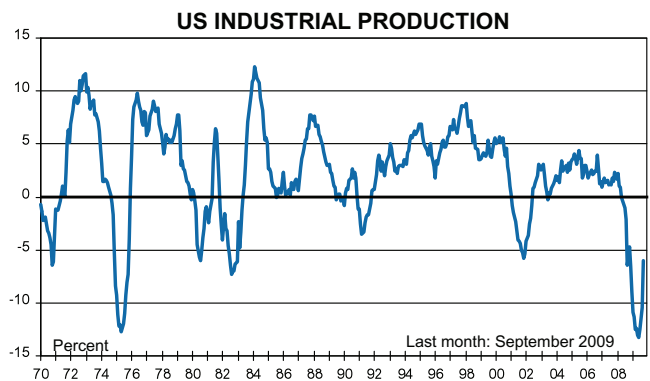
US manufacturing is expanding again, aided by the weak US dollar.



The service sector is also back in expansion territory - though barely.

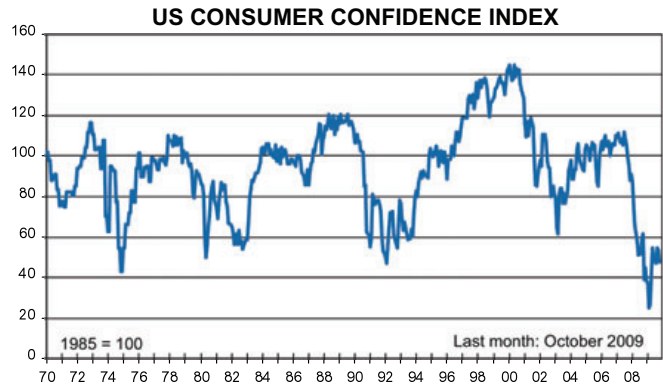


Industrial production has risen for the last three months.

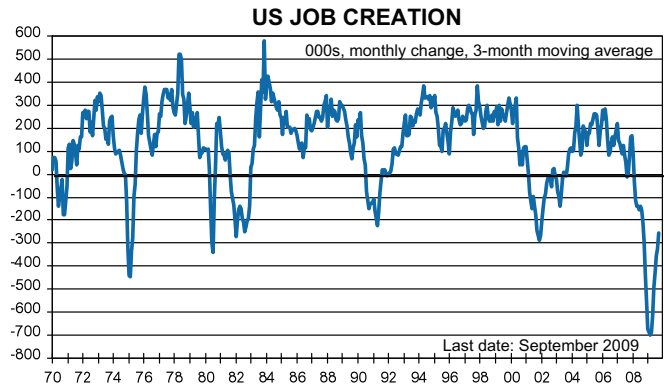


MONTHLY REVIEW ► UNITED STATES – ECONOMIC GROWTH

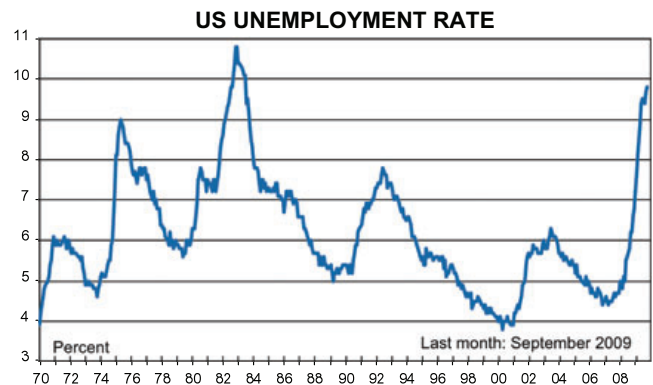
Consumer confidence is off its low, but has been held back by rising unemployment.



Jobs continue to be lost at a rapid pace, though the pace is slowing.



The unemployment rate is likely to move higher in the next few months; it might peak near 10.5%.



MONTHLY REVIEW ► UNITED STATES – ECONOMIC GROWTH

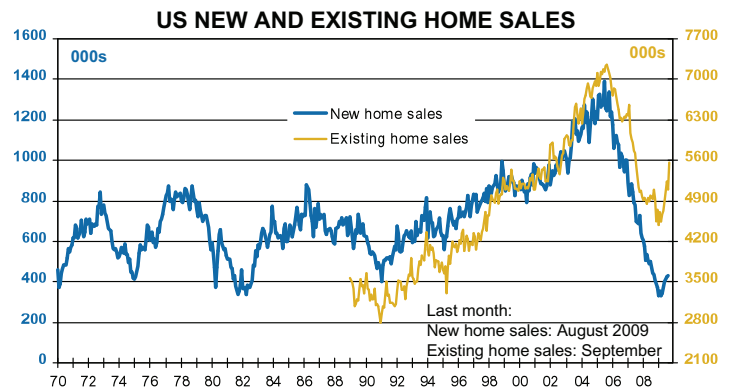
Retail sales have improved somewhat in recent months, but not dramatically.



Housing starts are off their lows but have been flat around 590,000 for the last four months.

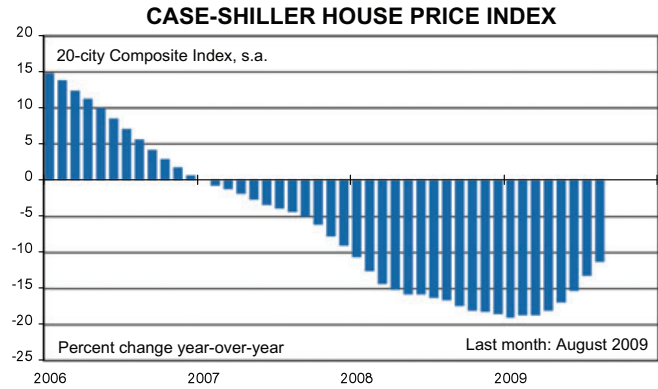


Home sales have been helped by the \$8,000 rebate for first-time buyers but, unless renewed, this program will expire in November.

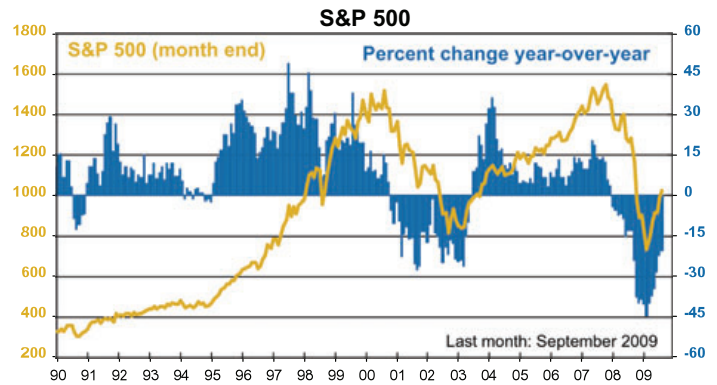


MONTHLY REVIEW ► UNITED STATES – WEALTH CREATION

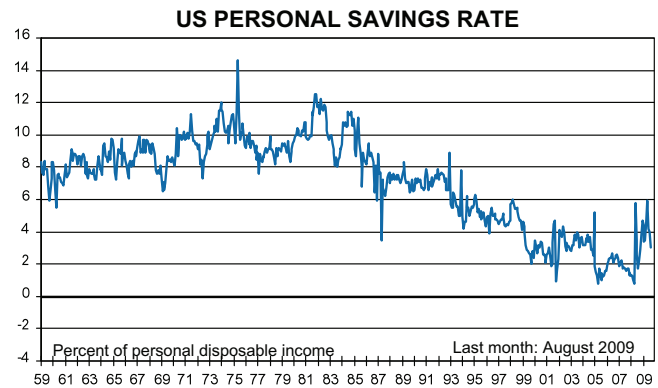
The Case-Shiller house price index has risen for the last three months.



Stocks have been on a rising trend since March.

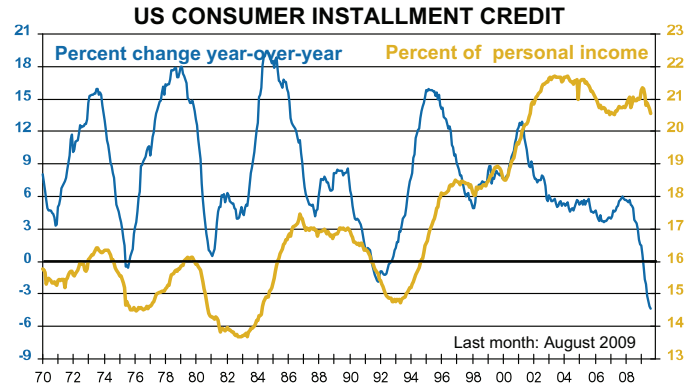


The savings rate is trending higher, helping suppress consumer spending.

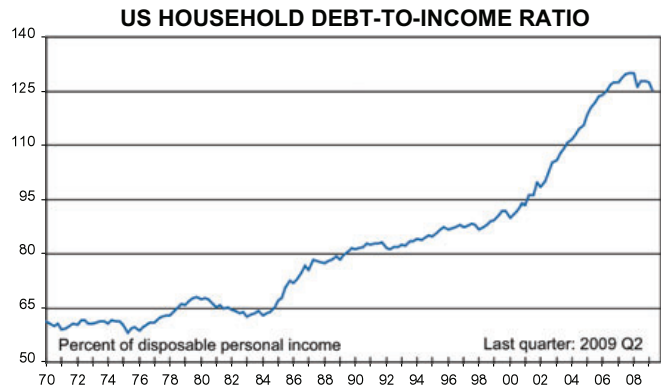


MONTHLY REVIEW ►
UNITED STATES – DEBT AND CREDIT

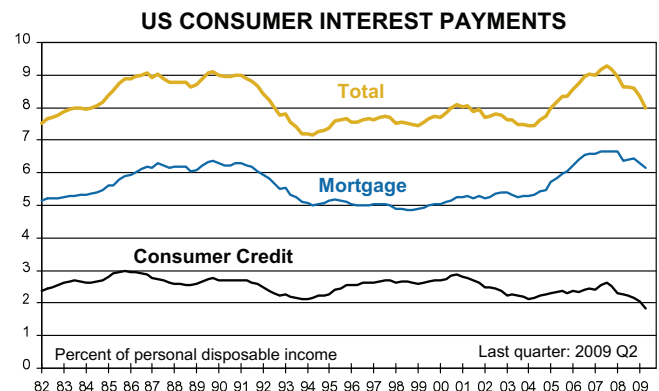
Consumer credit continues to decline at a record pace.



The debt-to-income ratio has fallen slightly.

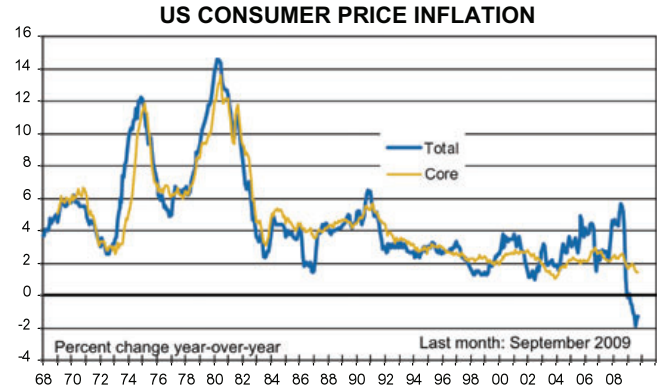


While the interest portion of consumer debt payments is down, mortgage interest is still quite high.

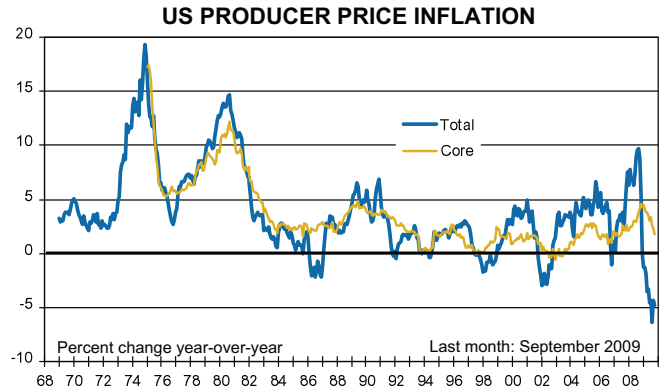


MONTHLY REVIEW ►
UNITED STATES – INFLATION

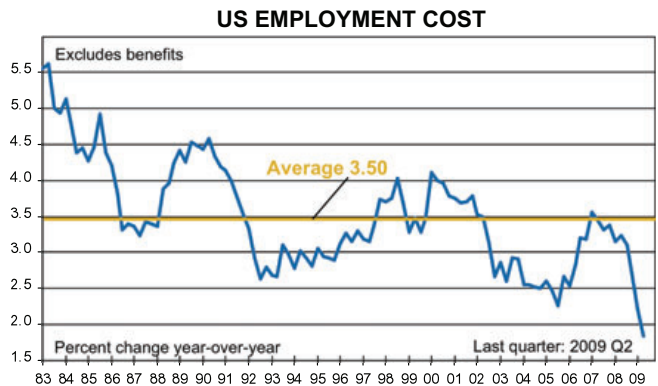
Headline inflation is expected to turn positive again in November but the core rate (1.4%) is apt to head lower in the months ahead.



Producer prices fell unexpectedly in September.

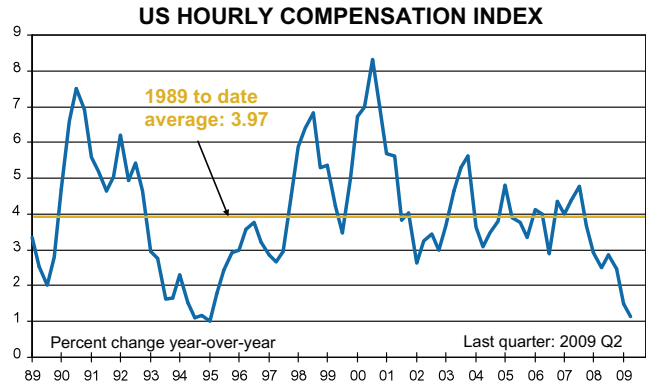


Employment costs have sunk to a record low.

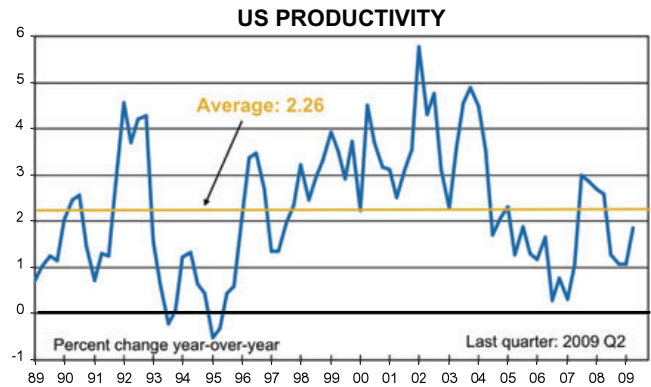


MONTHLY REVIEW ► UNITED STATES – INFLATION

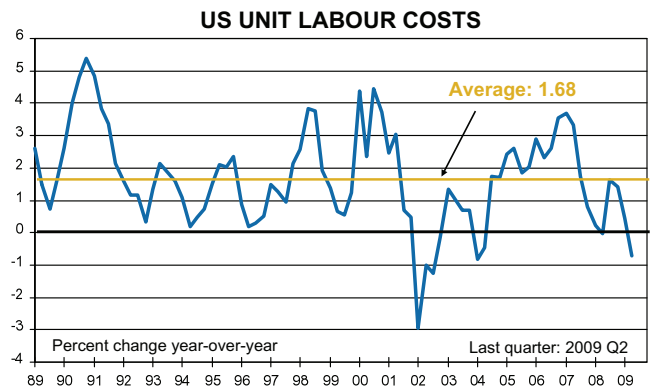
Hourly compensation gains may fall below one percent.



Productivity has held up surprisingly well, thanks to cost cutting. Good for profits!



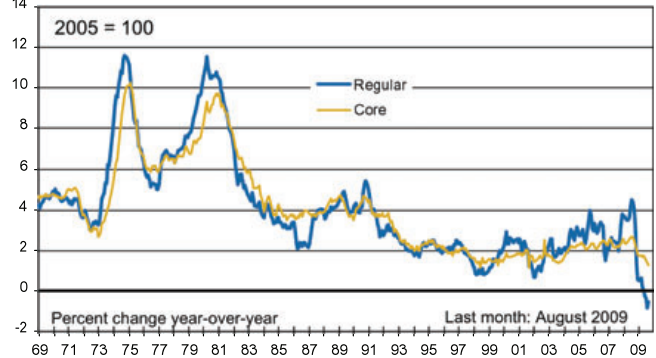
Unit labour cost increases are back under zero.



MONTHLY REVIEW ►
UNITED STATES – INFLATION

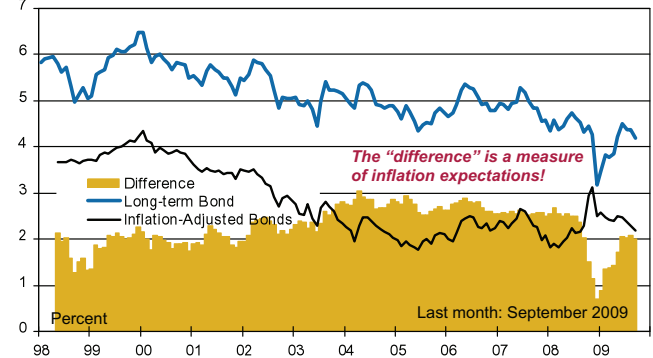
The consumption deflator has swung up and down because of big changes in energy prices. It is set to rise again in November, though probably not dramatically.

US PERSONAL CONSUMPTION EXPENDITURES DEFLATOR



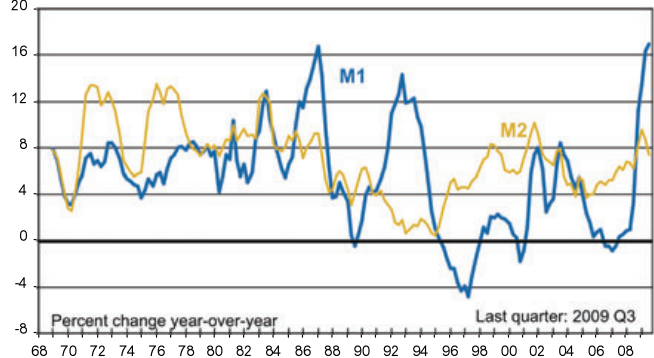
Inflation expectations are back at 2% according to this measure.

US INFLATION EXPECTATIONS



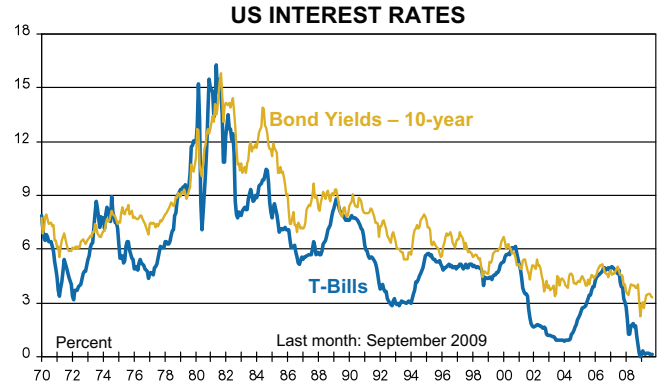
Money supply growth has been elevated, but (so far) on a par with the mid-1980s. (By 1990 inflation peaked briefly at just over 6%, then headed back below 3%.)

US MONEY SUPPLY GROWTH

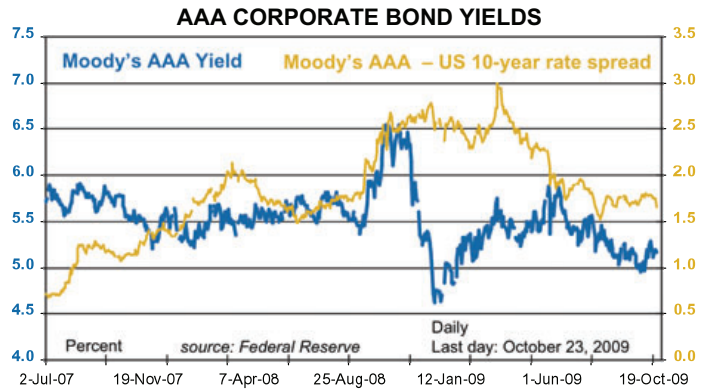


MONTHLY REVIEW ► UNITED STATES - FINANCIAL MARKETS

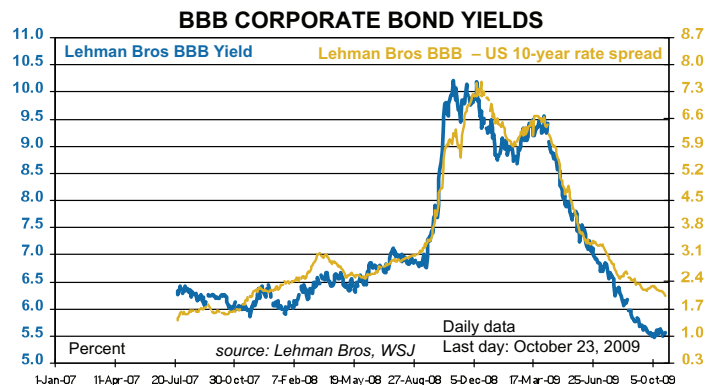
Short-term rates may flatline for some quarters yet, possibly into 2011. Longer-term rates could begin to trend higher as soon as early 2010.



AAA spreads have fallen considerably but may have a little further to go.

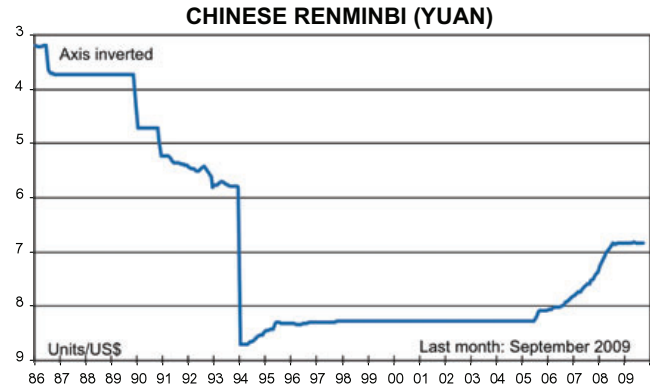


BBB yields are about half what they were at the peak, and may approach 5%.

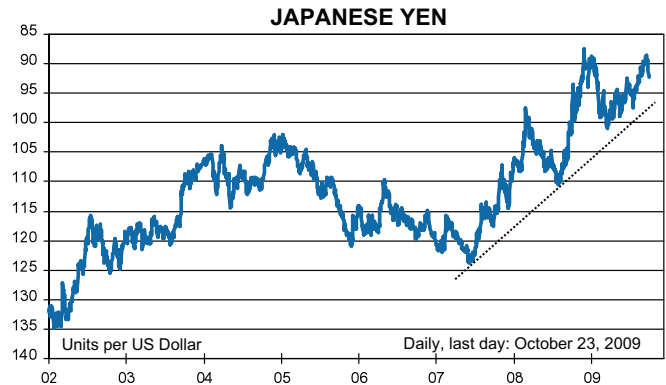


MONTHLY REVIEW ►
FOREIGN EXCHANGE RATES

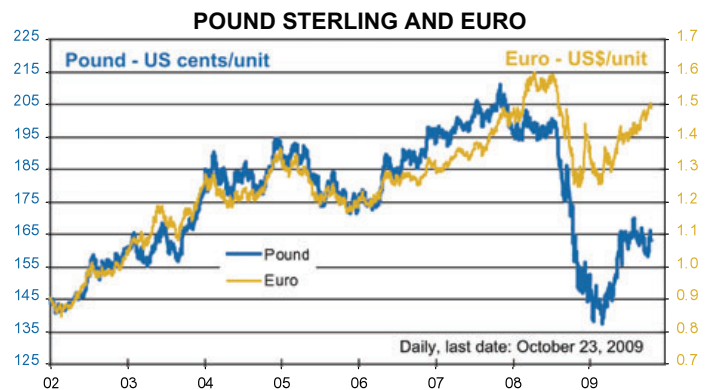
The renminbi continues to flatline though there is growing speculation that it will resume rising in 2010 if the economy continues to grow rapidly.



The yen has been rising strongly in recent weeks but has slipped back in recent days.

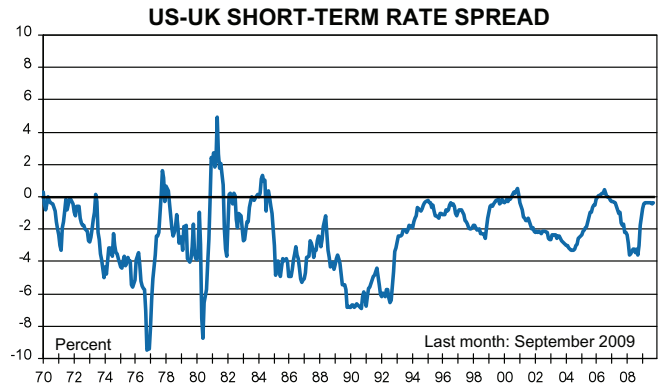


The euro broke 1.50 briefly, but has since fallen back. The pound has also recovered in recent days, and remains suspect as a cheap carry-trade currency.



MONTHLY REVIEW ► INTERNATIONAL SHORT-TERM SPREADS

UK short-term (policy) rates are slightly higher than in the US.

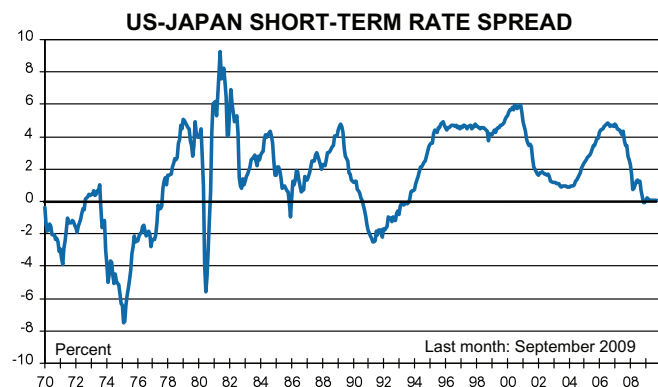


German short term rates are roughly equal to US rates.



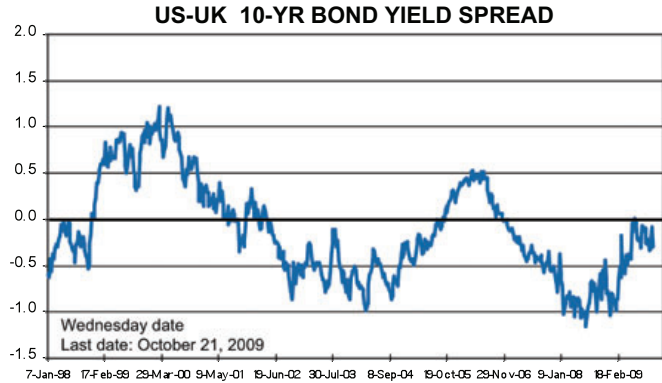
Japanese short-term rates are also about equal to US rates.

Low US rates make the US dollar a “carry-trade” currency these days.

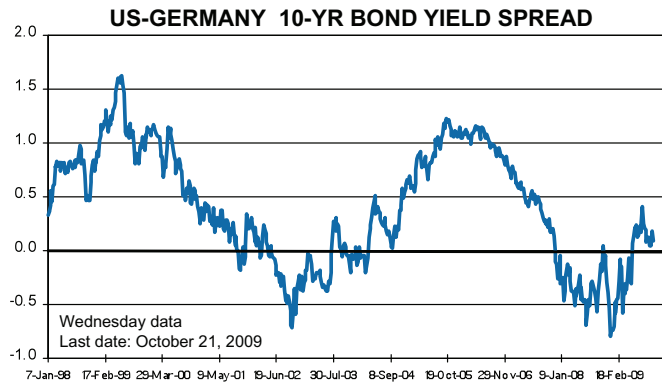


MONTHLY REVIEW ►
INTERNATIONAL LONG-TERM SPREADS

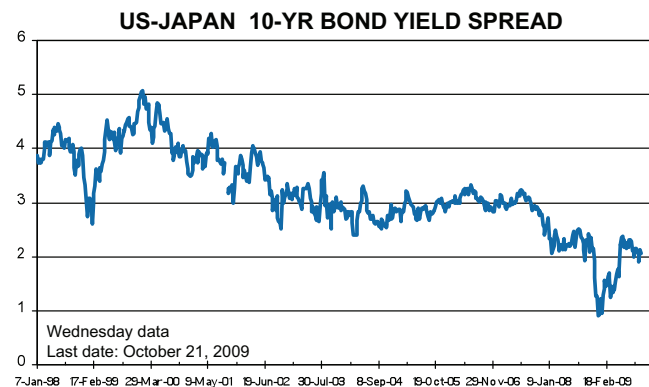
Britain's yield advantage at the 10-year maturity has risen to about 30 points (as of October 22).



Germany, however, was at a 10 point disadvantage.

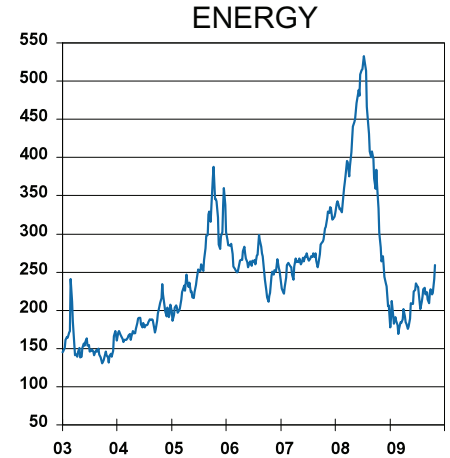
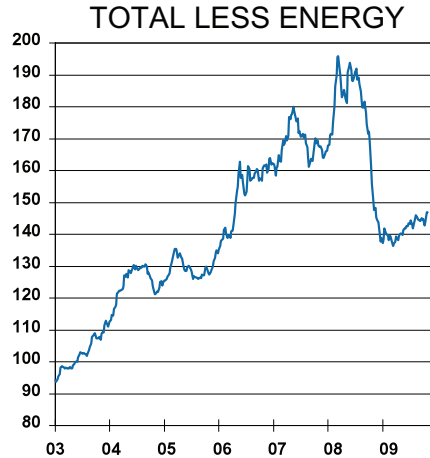
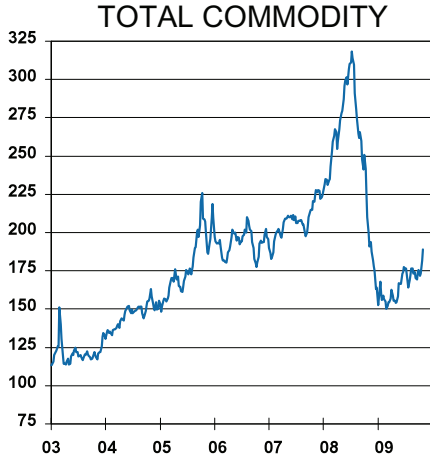


Japanese yields are much lower (despite a much higher national debt).



COMMODITY PRICES ►

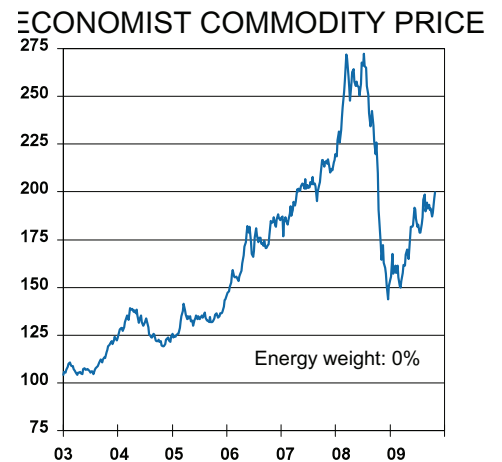
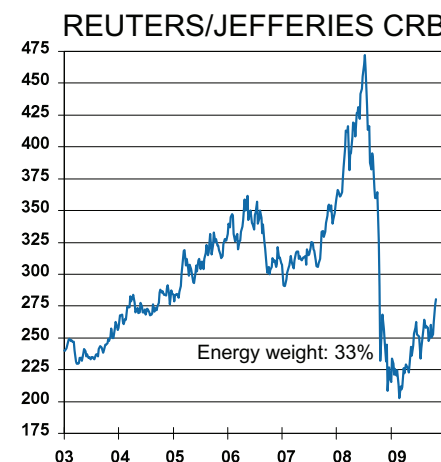
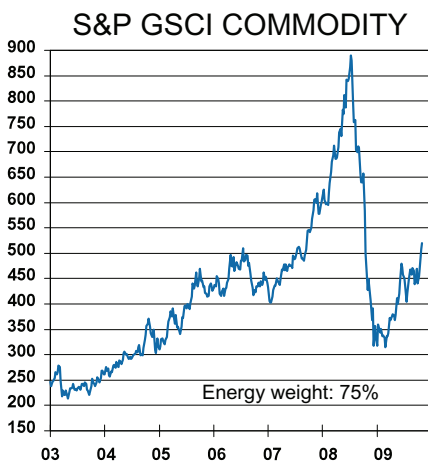
1. Bank of Canada commodity price indices (Weekly data to October 23, 2009)



Commodity prices indicate that the world economy is recovering.

Commodity prices should continue to advance as the global recovery advances, but we expect setbacks from time to time as the global recovery is likely to be sub-par.

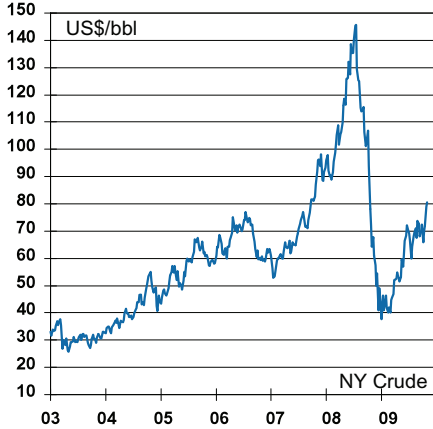
2. Other indices (Weekly data to October 23, 2009)



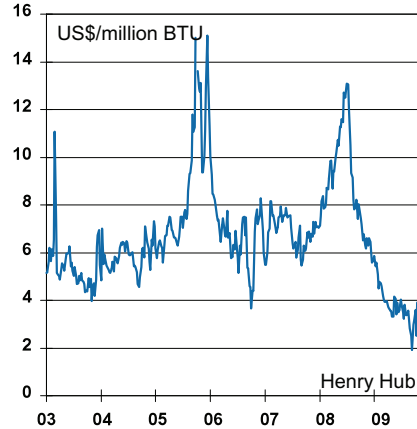
COMMODITY PRICES ►

4. Energy (Weekly data to October 23, 2009)

SPOT OIL



NATURAL GAS



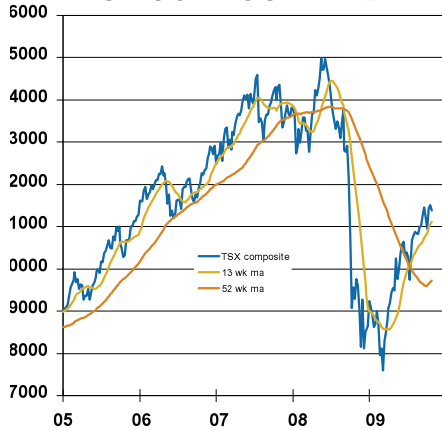
Oil prices appear to have hit a plateau for the time being. OPEC has indicated it doesn't want to see oil prices much above \$70.

Recently oil broke \$80 however...

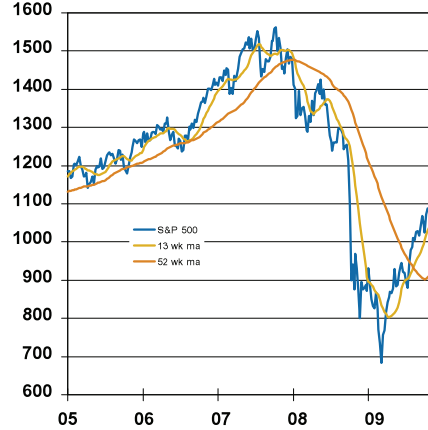
EQUITY MARKETS ►

1. North America (Weekly data to October 23, 2009)

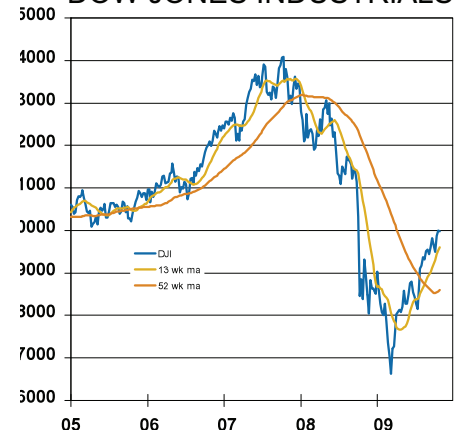
TSX COMPOSITE INDEX



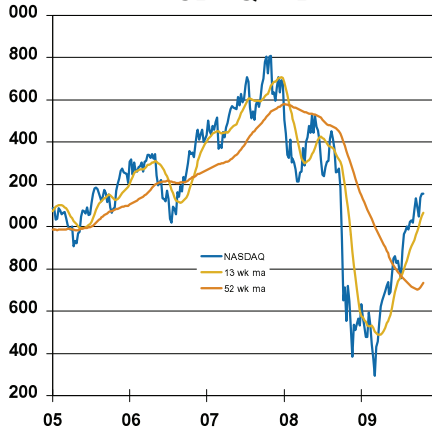
S&P 500 INDEX



DOW JONES INDUSTRIALS



NASDAQ INDEX

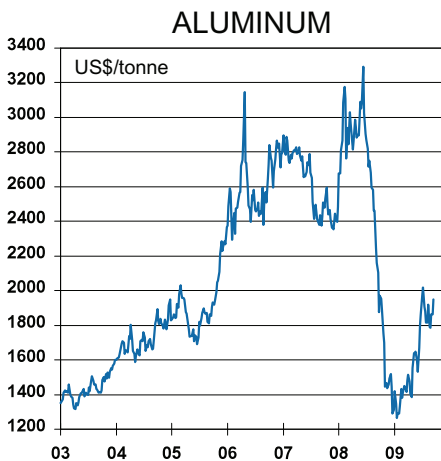
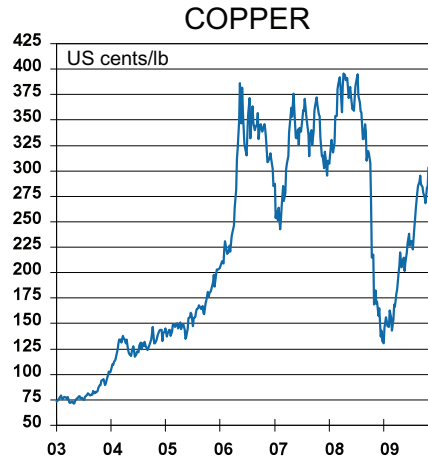


North American equity markets bottomed on March 9. The rise since then has been so explosive that North American markets have now scored a "golden cross": the 13-week moving average has moved ahead of the 52-week moving average. This is a very bullish technical development.

One would have to think a "correction" of sorts is just around the corner, but just when is difficult to project. Weaker US economic data – disappointing news from the US consumer sector (confidence, employment, retail sales, etc.) – could trigger a "correction".

COMMODITY PRICES ►

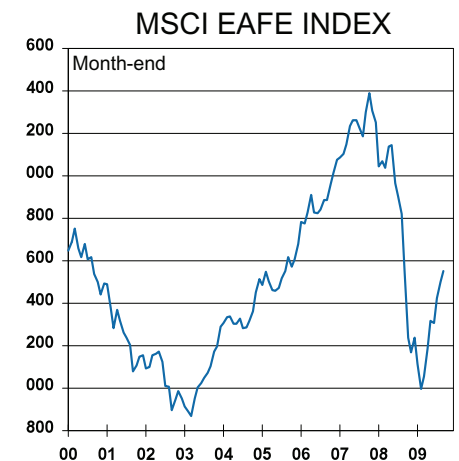
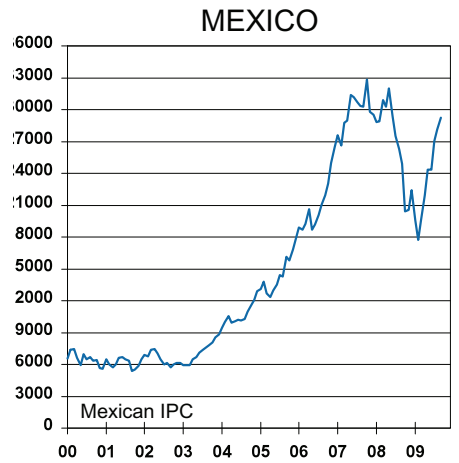
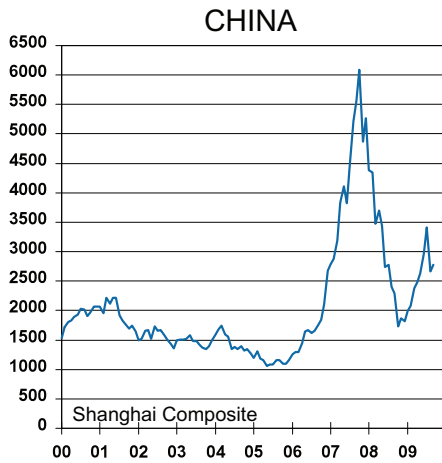
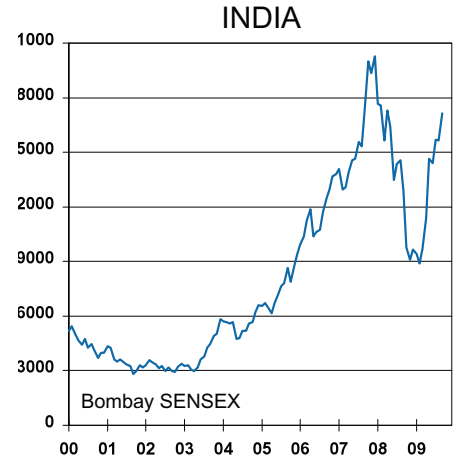
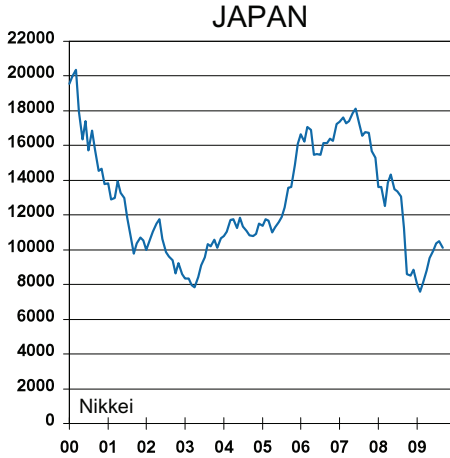
3. Metals (Weekly data to October 23, 2009)



Of the industrial metals, copper has led the pack, and we look to it as an indicator of world economic health.

EQUITY MARKETS ►

2. Around the world (Monthly data, last date September 2009)



Views contained in this report regarding a particular company, security, industry or market sector are the views of the writer and do not necessarily represent the views of DundeeWealth Inc., its affiliates and subsidiaries. Views expressed should not be considered a recommendation to buy or sell nor should they be relied upon as investment advice. Information contained in this report is current as of the date of publication and has been obtained from third party sources believed to be reliable. DundeeWealth Inc., its affiliates and subsidiaries does not warrant or make any representations regarding the use or the results of the information contained herein in terms of its correctness, accuracy, timeliness, reliability, or otherwise, and does nor not accept any responsibility for any loss or damage that results from its use.