

*Happy Holidays
and
Best Wishes
for
a Prosperous
New Year*

Chantelle

Jane

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Financial Monitor

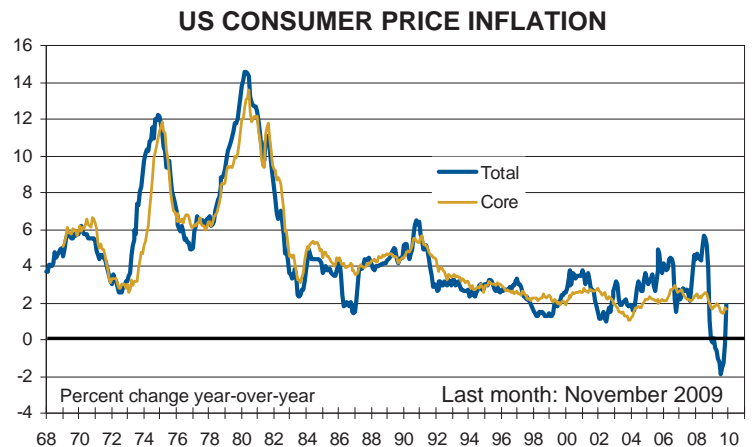
by William Tharp

December 18, 2009

THE WEEK IN REVIEW

BE OF GOOD CHEER!

- **Inflation** (the sort generated by rising energy costs) has returned. US headline CPI turned positive in November, up 1.8% over the latest twelve months: US core inflation was up 1.7% (little changed). Canada's headline CPI rose from 0.1% in October to 1.0% in November, but core inflation fell back from 1.8% to 1.5%. Other than energy costs, there has been little significant inflation except for used vehicles and (in Canada) house prices. US producer prices also bounced higher (raw materials including energy) and were up 2.4% in the twelve months through November. Gasoline prices have fallen in recent weeks so headline inflation should slip back in the next little while.
- **Growth data** were positive, with the leading indicators for both the US and Canada showing large increases in November. US industrial production also bounced up 0.8% in November after being unchanged in October. US housing starts rebounded in November, following the renewal of tax credits, but the number fell short of the September figures. Canada's manufacturing shipments rose in October to the best level since December 2008 but were still well below the peak set in July 2008.



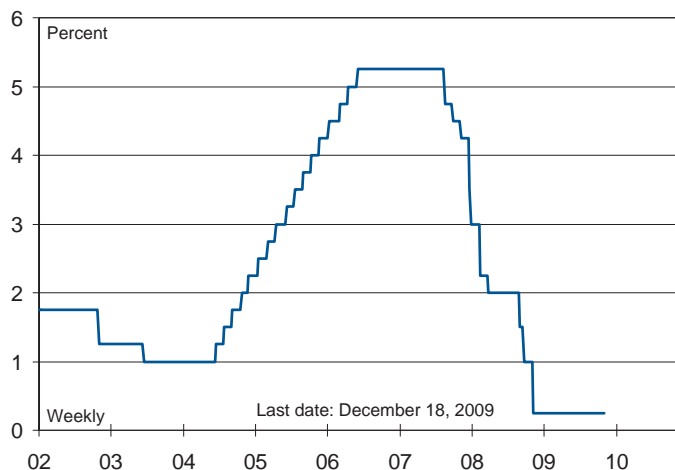
LOOKING FORWARD

- The **Bank of Canada** did not alter policy when it met on December 8 but it continues to issue warnings about rising consumer debt and the peril faced by home buyers from an upturn in mortgage rates (no hint on when that might be but it did reaffirm that it would hold off on any policy rate hikes before mid-2010, subject to inflation expectations staying low). It next meets on January 19. No policy changes are expected at that time. The next two weeks bring data for retail sales (Dec 21), wage data (Dec 22) and GDP for October (Dec 23).
- **The Fed** made no changes to policy rates on December 16. It next meets on January 27 when it is again expected to hold rates steady. The next two weeks will see new data for existing home sales (Dec 22), new home sales (Dec 23), and durable goods orders (Dec 24).
- **Government bond yields** were little changed this week. Ten year yields are likely to exceed 4% sometime next year but showed little response to this week's rise in headline inflation on both sides of the border.
- The **Canadian Dollar** ended at 93.82, down half a cent. We expect a gradual uptrend to resume in 2010.
- The **US Dollar has risen lately on the back of improving employment and retail sales data as well as fiscal and financial problems in Europe**. We expect dollar weakness to resume before long, though at a comparatively subdued pace. The dollar is unlikely to trend higher until the Fed is closer to raising interest rates, which appears unlikely before mid-2010 at the earliest. (See the discussion under Policy Rates for more details).
- **The next Financial Monitor will be January 8, 2010.**

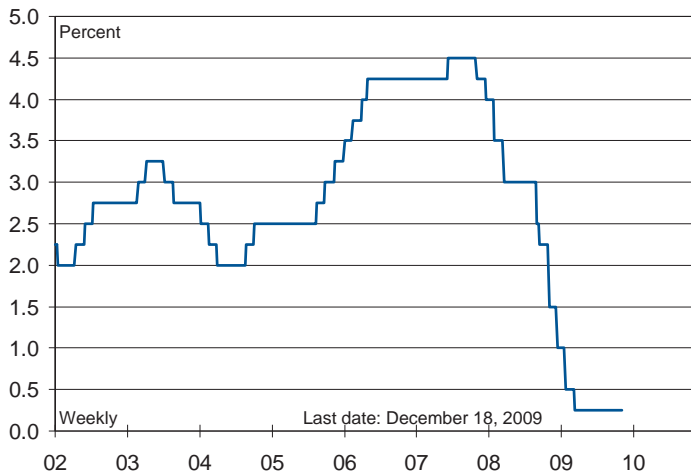


POLICY INTEREST RATES

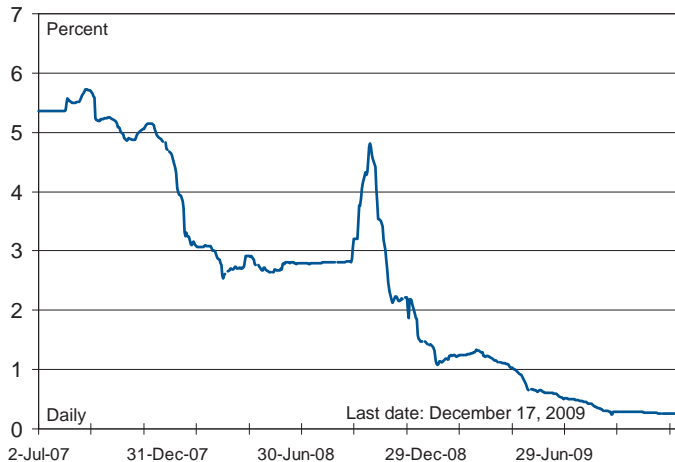
US FED TARGET RATE



BANK OF CANADA TARGET RATE



3-MONTH LIBOR



No significant change in policy interest rates is expected in the US or Canada in the immediate future. While a better case can be made for Canada to raise rates towards mid-year (if not sooner) in order to deal with recovering domestic demand and worrisome signs of a renewed house price bubble, the Bank of Canada doesn't want a premature hike to set the Canadian dollar on fire again, thereby depressing inflation further below its 2% target.

The Fed faces a more difficult challenge on a number of fronts:

1. Unemployment remains high (as in Canada), and job creation has not yet turned positive. Job creation might resume as soon as next month but could be slow.
2. Capacity utilization remains very low, implying little inflation pressure in the immediate pipeline (this is also true of Canada).
3. Wage pressures remain downward and are already approaching 1% (in Canada wage gains are higher and no longer appear to be decelerating). Positive US productivity is also trimming unit labour costs, putting further downward pressure on inflation. (No such luck (?) in Canada where productivity has been negative).
4. Bank lending is still shrinking in the US at both the consumer and company levels. (In Canada consumers continue to borrow, and not just for mortgages).
5. In the US the housing market is still encountering problems, though there are some early signs of stabilization or even recovery. But foreclosures remain high and US banks continue to experience high levels of souring loans for home lending, commercial real estate and credit cards.

At this point our forecasts show modest interest rate increases by the Fed starting in August 2010. But it is not hard to imagine a later starting date, particularly if the various problems cited above lead to further declines in core inflation.

WINDING DOWN

by Chantelle Schieven

- The US Government announced programs to guarantee or spend almost \$15 trillion from December 2007 to March 2009. Many of these programs are winding down and/or have never been utilized to their full extent (currently about 24% is being used). The table herewith shows the total amount guaranteed or committed and the amount currently utilized.

- The **Federal Reserve's** liquidity facilities are winding down, except to support the housing market. In addition to the liquidity program that expired at the end of October, the FOMC anticipates five others will expire on February 1, 2010 (shown in blue on the table). The Fed is continuing its support of the housing market, by purchasing mortgage-backed securities and agency debt until end of Q1-2010.

- The **US Treasury** has extended the **Troubled Asset Relief program (TARP)** until October 2010, with the intent of directly helping small businesses and homeowners. Banks that received TARP investments earlier continue to announce plans to repay the government (about \$175 billion in repayments is anticipated by the end of 2010).

- The **American Recovery and Reinvestment Act (ARRA)** has distributed a total of \$242 billion to date: \$92.8 billion in tax benefits, \$62.6 billion in spending, and \$86.5 billion in entitlements. The majority of the remaining \$458 billion is scheduled to be dispersed in 2010.

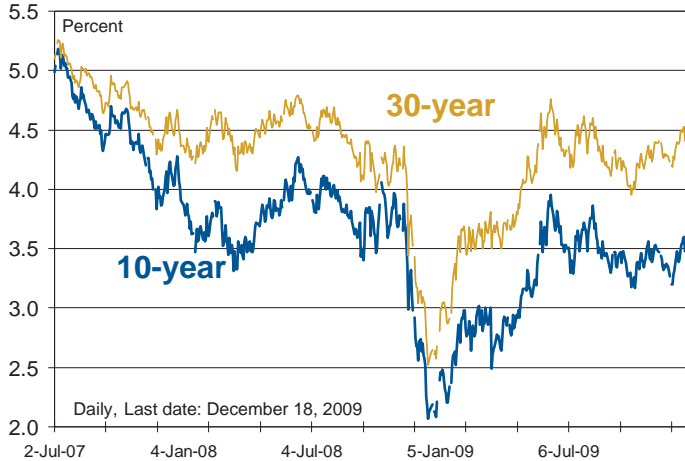
- The **Federal Deposit Insurance Company (FDIC)** has two parts to its **Temporary Liquidity Guarantee Program (TLGP)**: the debt guarantee program and the transaction guarantee program. Under the debt guarantee program, October 31, 2009 was the last date for banks to issue new debt (the guarantee expires December 31, 2012). The transaction guarantee part of the TLGP is scheduled to expire June 30, 2010.

- In 2010 additional US government support will likely center around the real estate market (both residential and commercial) and funding for small businesses.

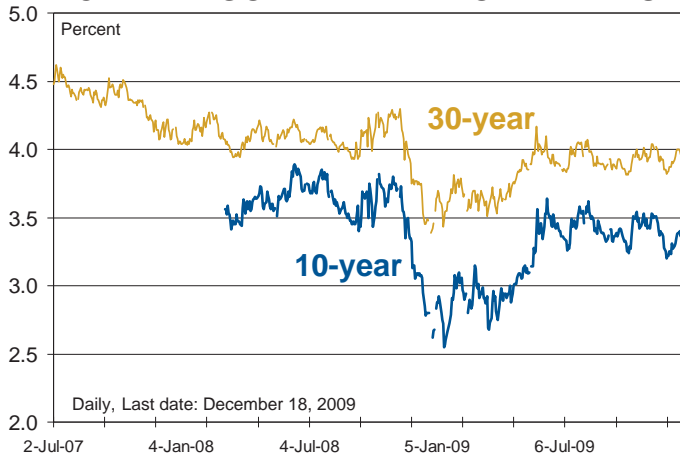
US MONETARY AND FISCAL PROGRAMS		
	Total committed or guaranteed (billions)	Current amount outstanding (billions)
Federal Reserve		
Term Auction Facility (TAF)	900	86
Temporary Reciprocal Currency Arrangements	583	14
Term Securities Lending Facility (TSLF)	75	0
Primary Dealer Credit Facility (PDCF)	148	0
Bear Stearns bailout	29	26
AIG Bailout	60	35
Asset-Backed CP MM Fund Liquidity Facility (AMLF)	152	0
Commercial Paper Funding Facility (CPFF)	1800	14
Money Market Investor Funding Facility (MMIFF)	540	Expired
Federal Reserve purchase of mortgage-backed securities	1250	874
Agency debt purchases	200	157
Term Asset-Backed Securities Loan Facility (TALF)	1000	47
Purchase of longer-term Treasury securities	300	300
Federal Reserve Total	7037	1553
US Treasury		
Economic Stimulus Package	218	218
Fannie Mae/ Freddie Mac Bailout	400	111
Temporary Guarantee Program for Money Market Funds	3000	Expired
Troubled Assets Relief Program (TARP)	700	291
Public- Private Investor Fund (PPIP)	1000	7
American Recovery and Reinvestment Act (ARRA)	787	242
US Treasury Total	6105	869
Federal Deposit Insurance Corporation		
Temporary Liquidity Guarantee Program (TLGP)	1400	1068
FDIC Total	1400	1068
Federal Housing Administration (FHA)		
Hope for Homeowners Program	300	7
FHA Total	300	7
US Government Total	14842	3497

LONGER TERM BOND YIELDS

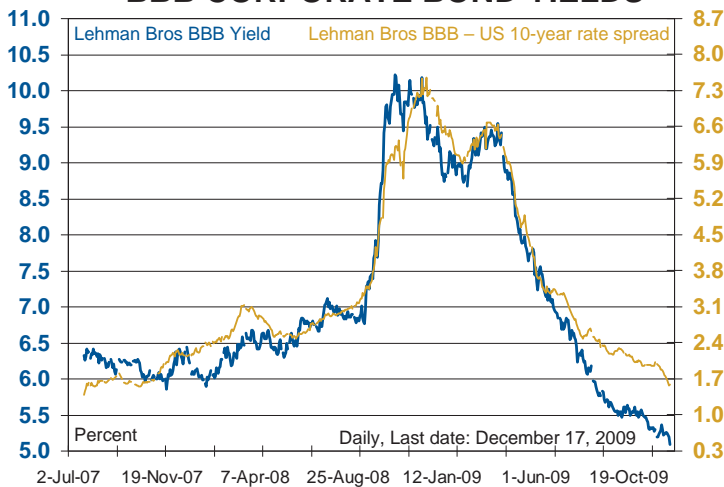
US TREASURY YIELDS



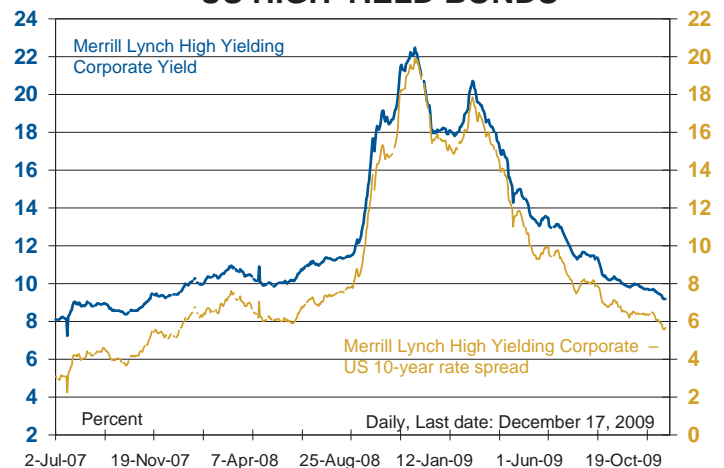
CANADA GOVERNMENT BOND YIELDS



BBB CORPORATE BOND YIELDS



US HIGH-YIELD BONDS



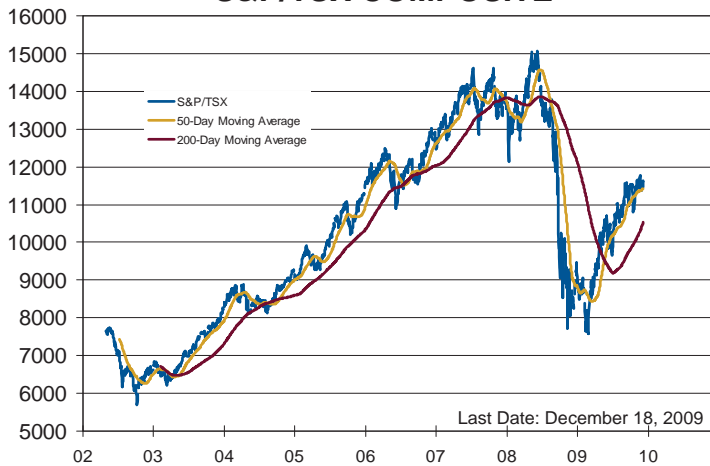
Longer term government bond yields will probably rise towards 4% or a little higher in 2010 on both sides of the border. We don't have a more aggressive forecast for a number of reasons. First, the trend and level of rates will likely continue to be dominated by what transpires in the US economy. The list of hurdles to be overcome before the Fed feels confident about raising rates significantly is an impressive one (see Policy Rates page) and suggest that we are not yet out of a potential deflationary stage, regardless of what headline inflation (energy prices) might be doing. Second, there is a widespread consensus that either inflation will trend significantly higher in two years or so or, in any event, significant fiscal deficits will clash with a resumption of corporate investment borrowing and this will drive rates higher. These views are sufficiently widespread that longer term bond yields already incorporate these expectations to some extent and yields are already noticeably higher than they would otherwise be. Consequently when (if) yields do rise, the size of the increase is likely to disappoint many who are waiting for significantly higher yields. Third, concerns about fiscal deficits look overblown (I dare say I'm in the minority on this), though not as badly overblown as they were over the summer. As emergency policies designed to cope with the financial and economic crisis continue to wind down, the fear premium contained in longer term bond yields is apt to abate as well, and this will offset rising cyclical pressures to some extent.



STOCK MARKETS

by William Tharp and Chantelle Schieven

S&P/TSX COMPOSITE



Percent changes

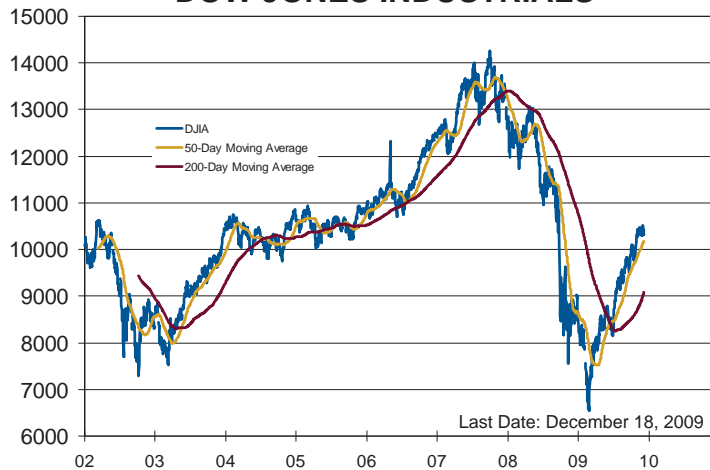
	1-week	4-week	52-week
TSX	0.3	-1.0	32.7
DJI	-1.4	0.1	21.3
S&P500	-0.4	1.0	26.3
NASDAQ	1.0	3.1	44.5

Equity markets were mixed again this week. The DJI declined 142.61 points for the week to close at 10328.89. The NASDAQ gained 21.38 points this week to close at 2211.69 and the S&P 500 closed the week at 1102.47 a 3.94 point decline for the week. The TSX gained 39.47 points to close the week at 11463.40.

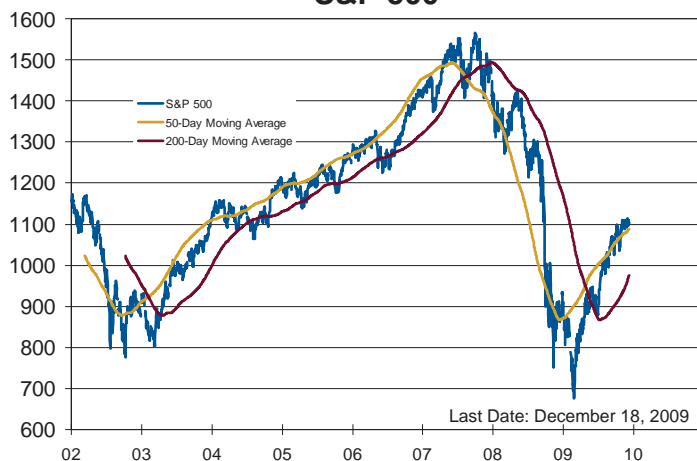
The NASDAQ led a gain in US equity indices on Friday led by technology stocks, after better than expected earning reports by Oracle and Research in Motion. Continuing concerns about global economic growth and new worry over sovereign debt levels have some investors shying away from equity markets.

We don't expect the current "mini-correction" to last long or go much deeper. For one thing, oil prices appear to have found a bottom only slightly below \$70.

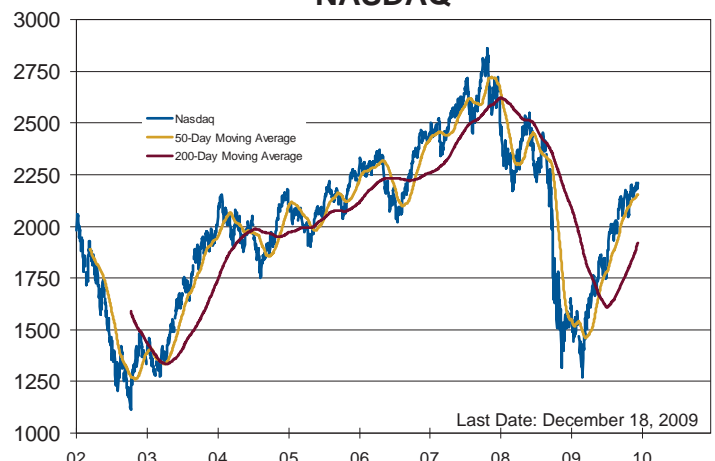
DOW JONES INDUSTRIALS



S&P 500

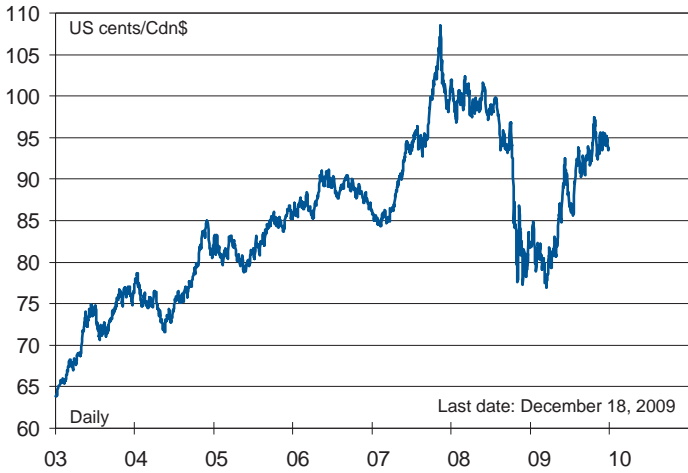


NASDAQ

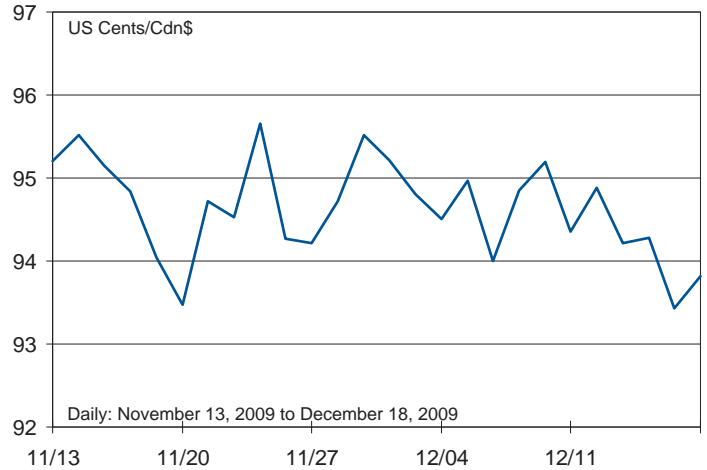


DOLLAR CURRENCIES

CANADIAN DOLLAR



CANADIAN DOLLAR

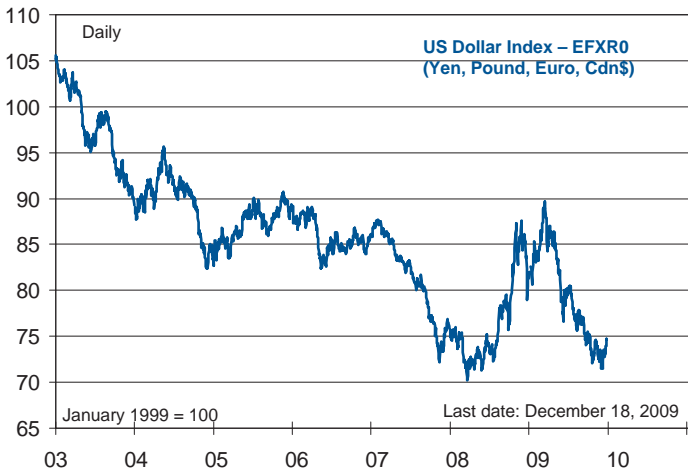


The **Canadian Dollar** slipped to 93.82 from 94.35 last week. Our models (based on commodity prices) suggest fair value for the loonie at about 95.40.

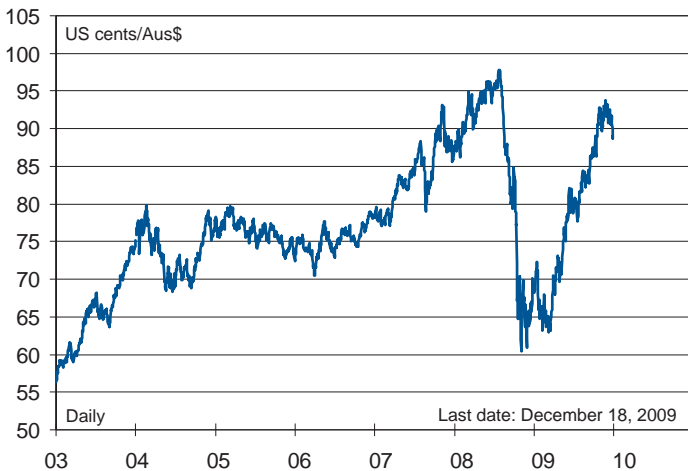
Should the dollar rebound to 96.0 in coming months we will probably hear further words of disapproval from the Bank of Canada. Above 98.0 the Bank could be feeling pressure to intervene to pre-empt a surge to parity. But we may again test parity towards the end of 2010 or in early 2011 provided that global growth continues and financial stability improves further.

The **Australian Dollar** ended the week at 89.07, down from 91.19 a week earlier. Third quarter Australian growth disappointed (just 0.2%) and the Reserve Bank of Australia noted that following three earlier rate hikes, domestic banks had tacked on a little extra (no doubt to justify those year end bonuses), thereby bringing commercial lending spreads back up to normal. Ergo the next rate hike might be postponed for a several months. Bad for the Aussie dollar, not so bad for bank margins!

US DOLLAR INDEX



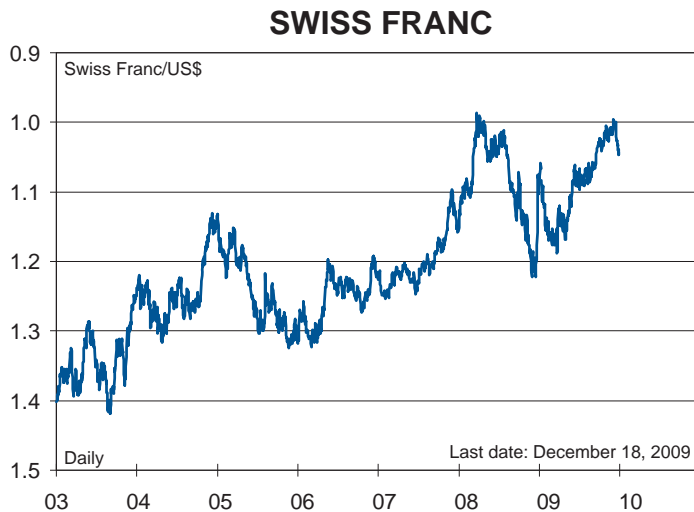
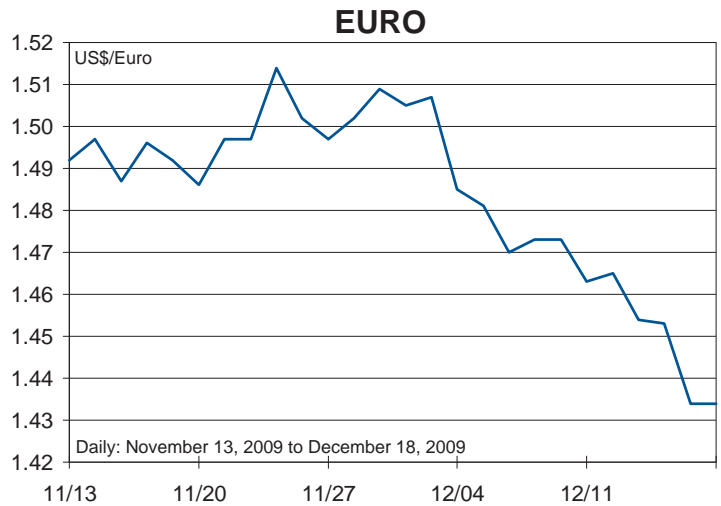
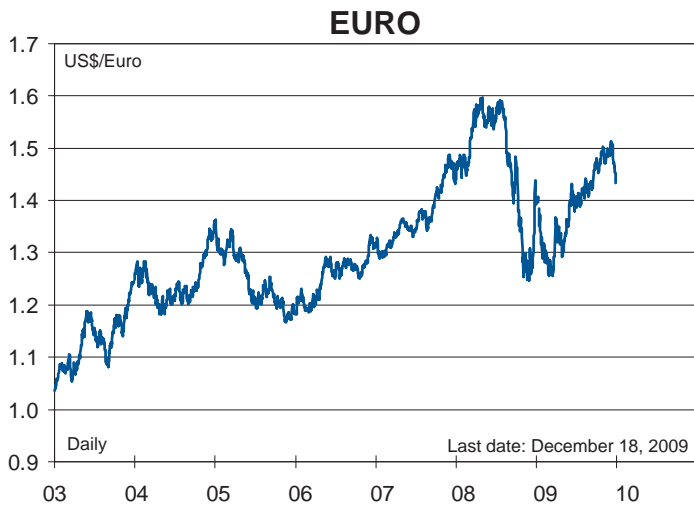
AUSTRALIAN DOLLAR



AUS/CDN



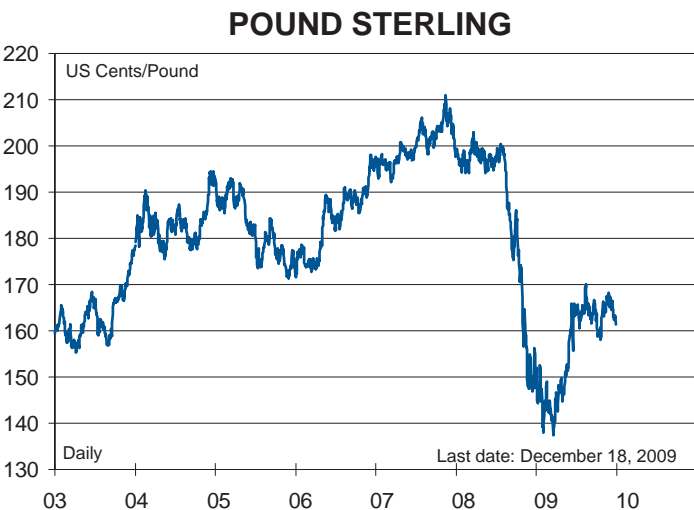
EUROPEAN CURRENCIES



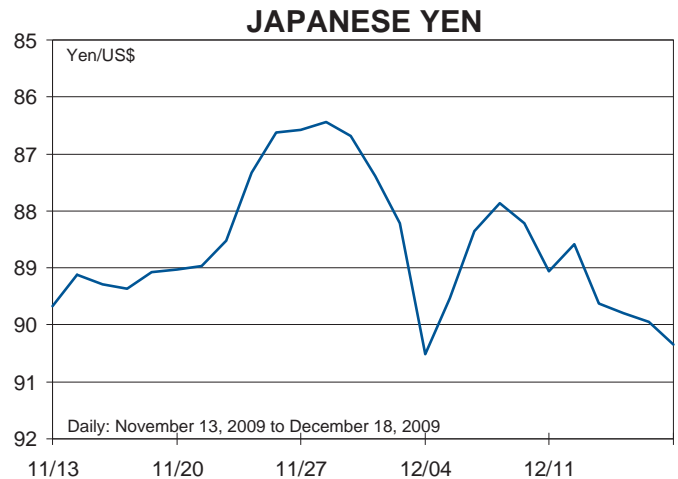
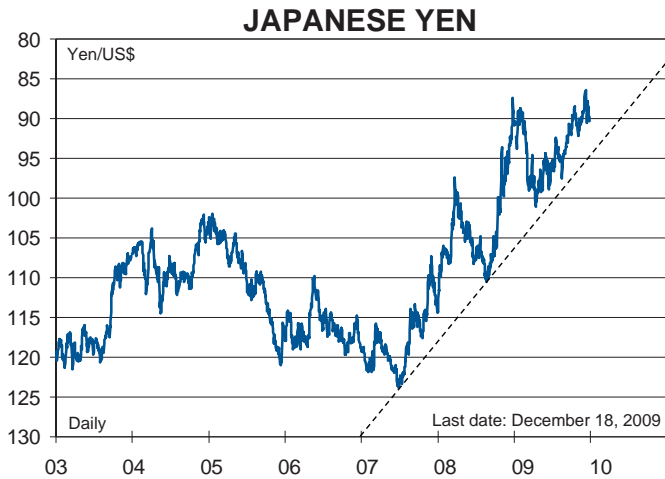
The **Euro** lost more ground this week, ending at 1.434, after sinking under 1.43 early Friday morning. All the negatives have hit the euro at once: downgrades to Greek sovereign debt (and speculation as to which country might be next), worries about Austrian banks, and a warning from the German finance minister “Germany is heading for a severe fiscal crackdown once the economic crisis is over” (bad for economic growth and the Euro, but good for bonds). And all of this on the heels of better than expected US employment data and retail sales in the last few weeks.

The **Pound** also fell, ending at 1.614 from 1.624 last week. British retail sales slipped a bit in November (no great surprise after several months of gains), unemployment fell (the first drop since the crisis hit), and (here’s the surprise) home prices fell 2.2% in the latest month after rising for several months.

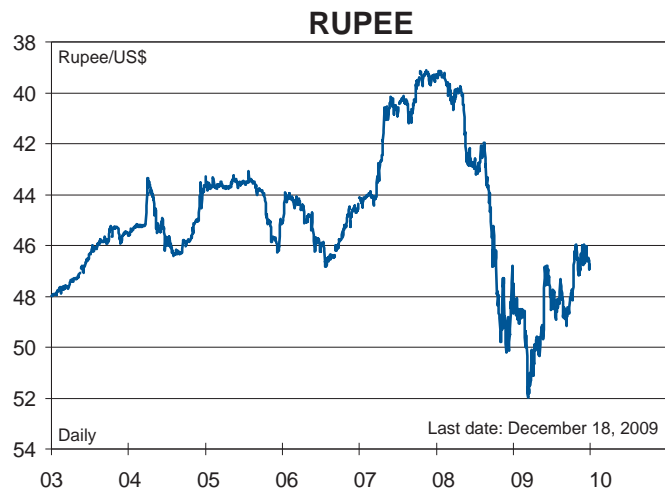
We expect the US dollar to give up most of its recent gains in the first half of 2010 but the decline may be less enthusiastic than during 2009 assuming the US economy continues to improve (helped by a now cheap dollar) and the European economic recovery looks a little tentative (hurt by the now cheap dollar).



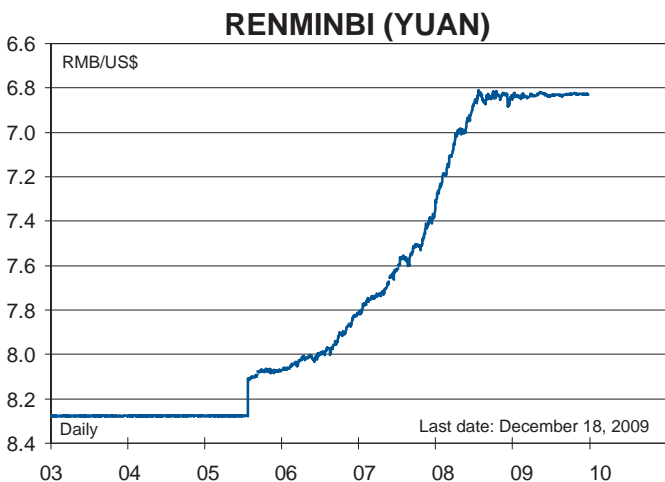
ASIAN CURRENCIES



The **Yen** weakened back beyond 90 this week, ending at 90.34. There were no specific made-in-Japan reasons but recent currency changes (as well as some global stock market wobbles) might be bringing the yen back into favor as a carry trade currency, while traders reassess the role of the US dollar. It is likely too soon for any major changes here however.



The **Chinese Renminbi** was little changed at 6.828. A Chinese official suggested that policy would be stable in 2010 because of “weak export demand”. The indication was that the renminbi would remain pegged to the dollar for the immediate future. (Perhaps he doesn’t have much faith in Chinese statistics but these show a significant improvement in exports in recent months, or so we are told). At any rate, the Chinese remain reluctant to let the renminbi resume a managed upward float.



The **Indian Rupee** lost a bit more ground, ending at 46.73 (46.49 a week earlier). Surging economic growth and industrial production imply a rate hike in the offing. Headline consumer prices rose to 4.8% in November, up from 1.3% in the twelve months through October; food prices are up thanks to a local drought.

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