FINANCIAL MARKETS MONTHLY

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Inside…

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Recovery watch

Upbeat economic data dominated in August especially in the United States where the improvement in housing statistics and auto sales stole the headlines. Globally, talk of the end of the recessions in Germany, France and Canada and more positive news from Australia bolstered expectations that the world economy is tracking a course for positive growth in the second half of 2009. Investors piled into riskier assets for most of August, although a healthy dose of caution was evident into month-end as investors debate the relative strength of the recovery trend.

Near-term growth prospects rosy…

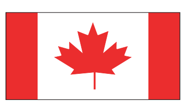
We have made upward revisions to our near-term forecasts for Canada, the United States and the Eurozone, taking into account the rise in auto sales and production as government programs boosted activity. In the United States, the pace of auto sales jumped by 16% in July and 26% in August as the Car Allowance Rebate System known as "cash-for-clunkers" motivated American consumers to purchase automobiles. With the level of auto inventories in both Canada and the United States having fallen to low levels, this pick-up in demand spurred a sharp increase in production, leading us to boost our third-quarter GDP forecast for both countries. In the Eurozone, Germany's rendition of the cash-for-clunkers program pushed economic growth up and supported a solid rise in French exports of motor vehicles, which limited the decline in the Eurozone's second-quarter GDP to 0.1% and sets up for a more vigorous third-quarter growth rate.

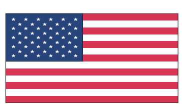
….but will this cannibalize growth in later quarters?

As the consensus ratcheted up third-quarter forecasts, the focus turned to the trajectory for these economies once the boost from the auto sector fades. While growth rates may ease up in late 2009

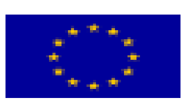
Central bank near-term bias

Bias three-months out

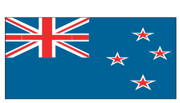

↔ The Bank of Canada will follow through on its conditional commitment by keeping rates unchanged at a low level through mid-2010. Although its measure of overall financial conditions continues to improve, the Bank remains concerned about the strengthening currency.


↔ In its August statement, the Fed described the economy as 'leveling out.' Because the recovery is still fragile, we expect the Fed to leave policy unchanged for most of 2010.


↘ The Bank of England increased its asset purchase program. While we don't expect further easing, the minutes showed three MPC members voting to increase asset purchases by an even greater amount, suggesting that the risks are on the side of further easing.


↔ Better-than-expected second-quarter growth and upgraded ECB forecasts suggest that further non-standard easing measures are unlikely.


↗ The RBA left the Cash Rate unchanged at 3% in September. Its upbeat statement on growth prospects combined with stronger-than-expected second quarter GDP support the case for rate hikes later this year.


↘ The RBNZ kept rates unchanged but retained an easing bias, repeating its commitment to hold policy rates steady until the latter part of 2010.

Highlights

▲ The global economy is emerging from recession.

▲ The U.S. economy is poised to post the first positive quarterly growth quarter in five quarters...

▲ ...with the cash-for-clunkers program supporting car sales and boosting production.

▲ Even as the economy returns to health, the output gap will be large and the unemployment rate won't peak until late this year.

▲ The Fed may take its foot cautiously off the accelerator by reducing its non-traditional stimulus, but the Fed funds rate will remain extraordinarily low until the recovery is well entrenched.

and early 2010 causing markets to reassess the durability of the upturn, we believe that there is enough stimulus in place to support a full-fledged recovery in 2010.

U.S. economy emerging from worst recession in decades

We expect the current quarter to be the first in the past five to show positive real GDP growth. The rise in auto sales, the auxiliary pick-up in industrial production and receding drag from residential construction have led us to revise up our forecast for third-quarter growth to 2% from 1.3%. We look for growth to slow mildly in the fourth quarter to 1.8% as consumer spending on durable goods eases. But, as long as financial markets remain stable, the U.S. economy will remain on a course for recovery. Looking forward, we look for the momentum to build in 2010 as most of the fiscal stimulus hits, although the dismal state of household balance sheets will likely restrain the pace of growth compared to past recovery periods. This pick-up in demand, will require inventory rebuilding after the drawdown that took place during the recession. Furthermore, improved access to capital markets and narrowing corporate bond spreads are expected to spur a pick-up in fixed investment as the profit outlook turns around. Our forecast is that real GDP will expand by an average 2.2% in 2010 following an expected 2.7% drop in 2009.

Mind the gap — Modest recovery to keep unemployment rate high

The long and deep recession generated significant slack in the economy with the capacity utilization rate falling to a record low in June and the unemployment rate rising 4.8 percentage points since the recession began. Even with the economy forecast to grow by 2.2% next year, the output gap will remain wide, exerting only minimal downward pressure on the unemployment rate. The high level of unemployment will keep wages on a downward path and consumer price inflation muted. It is only in 2011, when we expect a return to an above-potential growth rate for the economy and a declining unemployment rate, that inflation concerns will re-emerge.

Giving Fed little incentive to raise interest rates

Against the backdrop of below-potential growth, high unemployment and easing prices, the Fed is likely to hold the Fed funds rate at the current extraordinary low 0% to 0.25%. A rate increase is likely to come but only when the economy is on the cusp of a sustained period of above-potential growth and the unemployment rate is falling. Initial steps by the Fed to reduce monetary policy stimulus are expected to come through an end to the quantitative and credit easing programs. The Fed slowed the pace of Treasury bond purchases in August, with some policymakers hinting that there may be less need for the Fed to implement the full amount of stimulus that is engendered in the mortgage-backed securities purchase program if the economy and financial markets continue to improve.

Interest rates to remain low

Our forecast for a modest recovery and unchanged Fed funds rate will likely result in short-term rates staying low until late 2010. Confidence that the recovery is durable and will be sustained will likely see two-year rates rise to 3% by the end of next year. Longer-term rates will be more influenced by concerns that the third-quarter pop in economic activity will prove to be a false start for the recovery and we forecast a move back to 3% in the final quarter of the year. Similar to our forecast for short-term interest rates, we expect 10-year yields to rise in 2010, gravitating toward the 4% by the end of next year.

Canada's recession — Running its course

The hefty 3.4% decline in Canada's second-quarter GDP marked the third consecutive quarter of contracting economic activity; but the slump was more modest than the first quarter's record 6.1% drop and output in June rose for the first time since July 2008.

Canadian consumer re-emerges

There were pockets of strength in Canada's economy from April to June with consumers buying autos and houses. Residential construction activity, which includes sales commissions and renovation spending, posted a surprising gain. Spending on durable goods was also firmer-than-expected mainly due to higher new and used vehicle purchases, which rose at close to a 20% annualized rate. Better functioning financial markets and low interest rates likely boosted activity in these rate-sensitive sectors of the economy. Government spending on goods, services and investment projects also boosted the quarterly growth rate as the stimulus dollars filtered into the economy.

Weighing against these gains were weakness in business investment with spending on machinery and equipment and structures falling. Even with the pick-up in residential spending, the investment component subtracted 1.8 percentage points from second-quarter growth. Inventories, which lopped off 5.2 percentage points off the growth rate in the previous two quarters, reduced output again in the second quarter, but by a more modest amount. Exports plunged again in the second quarter and imports recorded a smaller decline, meaning that net trade trimmed back the quarterly gain.

Green shoots ready to bud

The sizeable decline in quarterly GDP in the past nine months has generated significant slack in the economy, although the increase in June real GDP suggests that Canada's recession is nearing an end. The marked drawdown in inventories in recent quarters means that budding demand will have to be met by new production. Rising homes sales during the third quarter and a pick-up in the auto sector in line with the jump in U.S. car sales point to a return to positive growth. We forecast real GDP growth of 2% at an annualized pace in the third quarter with a 2.4% gain expected in the fourth quarter and 2.6% in 2010.

Yawning output gap to keep unemployment rate high

Given that the anticipated gains in the economy in the second half of the year will be modest, only a slight drop in the unemployment rate is expected in 2010. The persistent slack in the system is expected to exert continued, albeit easing, downward pressure on the inflation rate and upward pressure on the unemployment rate into 2010. The Bank of Canada has been worrying aloud about the implications of the Canadian dollar's rise on the export outlook having highlighted this as a key risk in their July outlook and in speeches by various Bank officials. To our mind, the upswing in the currency since early May has been largely supported by two factors — rising commodity prices, especially crude oil, and rising risk appetite. Both of these factors reflect growing optimism about the global economic outlook, which we expect will mitigate the downside risks to Canada's recovery as long as the global economy continues to pick up pace. Near-term, a fresh bout of risk aversion will likely be accompanied by another bout of U.S. dollar buying resulting in the Canadian dollar giving back some of its recent gains.

No rate changes on the horizon

The moderate pace of growth and rising unemployment rate make it likely that policymakers will honour the conditional commitment to keep policy extremely accommodative until the second half of next year. The risk to this view is that the economic rebound proves to be much more vigorous than RBC or the Bank of Canada proposes as this would boost the upside risk to the inflation outlook and likely lead to a normalization of rates earlier than in our baseline forecast. Short-term yields are forecast to hold around current levels until mid-2010 when a rate increase looks imminent, with 10-year rates forecast to take their lead from U.S. 10-year bonds given that moderate recoveries are expected in both economies.

Highlights

▲ Canada's economy contracted in the second quarter, but at a slower pace than in the prior six months.

▲ Real GDP increased by 0.1% in June, marking the first month in 10 that the economy grew.

▲ Increased U.S. demand for autos and inventory rebuilding will support a pop in real GDP growth in the third quarter.

▲ Core inflation pressures will continue to ease into year-end as the economy grows at a below-potential pace.

Highlights

▲ Asset purchases by the Bank of England were increased by £50 billion, although three members voted for a larger increase.

▲ The Bank of England's *Inflation Report* showed that the CPI is well below the Bank's 2.00% target.

▲ Weakness in second-quarter economic growth points to a wider output gap.

▲ Economic growth in France and Germany returns to positive territory in the second-quarter.

▲ The European Central Bank upgrades its growth forecasts.

▲ The RBA is poised to hike rates before the end of this year.

Bank of England's summertime surprises

The Bank of England's decision to expand quantitative easing took markets by surprise as the Monetary Policy Committee (MPC) increased its total asset purchases by £50 billion to £175 billion. With July PMI survey data for both manufacturing and services in expansionary territory, many had assumed that the MPC would stand pat. The initial shock sent the yield on 10-year gilts down 31 basis points to 3.54%, although they settled at 3.72% by the end of the day.

The Bank of England's quarterly *Inflation Report* forecasted that the inflation rate will be 1.4% two years hence — well below the Bank's 2% target. Governor King explained that inflation would likely undershoot the target as weaker-than-expected second-quarter growth meant that the output gap would be larger than initially thought.

In August, the services PMI rose to 54.1, but the manufacturing PMI retreated below the 50-mark to 49.7. We expect third-quarter growth to be 'less bad' with a decline of 0.1% quarter-over-quarter before rising 0.4% quarter-over-quarter in the final quarter of the year as Britons bring forward purchases ahead of January's VAT hike. In 2010, as consumers retrench and the savings rate rises, the United Kingdom will experience an uneven quarterly growth profile, with annual growth averaging just 0.3%. For monetary policy, this spells a prolonged period of easy conditions with the Bank of England likely to hold the policy rate steady until late 2010.

Eurozone growth surprises on the upside

The preliminary estimate for second-quarter Eurozone GDP showed a 0.1% quarterly decline, significantly less than the 0.5% decrease expected by forecasters. Net trade made a positive contribution as exports fell by less than imports. Geographically, the region's two largest economies, France and Germany, led the upside surprise each growing 0.3%. Germany's cash for clunkers program was largely responsible pushing household spending up 0.2%, marking the first positive print since the first quarter of last year. In light of this stronger-than-expected number and improving survey data, the ECB upgraded its staff forecast for GDP to a 4.1% decline in 2009 and 0.2% rise in 2010 (from -4.6% and -0.3%, respectively). Its inflation forecast was nudged up to a mid-point of 0.4% in 2009 and 1.2% in 2010 (from 0.3% and 1%, respectively). The ECB left the refi rate unchanged at 1% and announced that the fixed rate for the second 12-months tender would be held at 1% as well.

Australia's economy continues to outperform

The RBA left rates unchanged at 3% where they have been since early April. The accompanying statement was optimistic and pointed to strength in Chinese growth and upside surprises in domestic consumption, confidence, investment and labour markets. In terms of inflation, the statement observed, "the likelihood of inflation being persistently below target now looks low."

Quarterly growth in Australia surprised on the upside for the second quarter in a row, rising 0.6% quarter-over-quarter against the expected 0.2% rise. The strength was broad-based, with household consumption posting the strongest gain since the final quarter of 2007. Business investment also posted a healthy rise. Thus far, Australia has suffered only one quarter of negative growth, giving it bragging rights to escaping a technical recession. We now expect the RBA to begin hiking rates by 25 basis points in November and again in December of this year (rather than in the first quarter of 2010), although we still expect to see the Cash Rate at 4.50% by the end of next year.

Interest rate outlook

%, end of period

		09Q1	09Q2	09Q3	09Q4	10Q1	10Q2	10Q3	10Q4
Canada									
	Overnight	0.50	0.25	0.25	0.25	0.25	0.25	0.75	1.25
	Three-month	0.40	0.24	0.30	0.35	0.50	0.75	1.25	1.85
	Two-year	1.11	1.21	1.20	1.20	1.30	1.50	2.10	2.60
	Five-year	1.79	2.46	2.65	2.75	2.80	2.85	3.10	3.40
	10-year	2.80	3.36	3.40	3.15	3.35	3.50	3.70	3.85
	30-year	3.55	3.86	3.95	4.00	4.00	4.25	4.45	4.75
United States									
	Fed funds	0 to 0.25	0 to 0.25	0 to 0.25	0 to 0.25	0 to 0.25	0 to 0.25	0 to 0.25	0.50
	Three-month	0.13	0.20	0.18	0.20	0.25	0.30	0.40	1.00
	Two-year	1.02	1.12	0.95	1.00	1.00	1.20	1.50	1.85
	Five-year	0.91	2.56	2.50	2.25	2.25	2.50	2.60	3.00
	10-year	2.01	3.54	3.30	3.00	3.25	3.50	3.75	3.95
	30-year	3.12	4.33	4.25	4.40	4.25	4.50	4.75	5.00
United Kingdom									
	Repo	0.50	0.50	0.50	0.50	0.50	0.50	0.50	1.00
	Two-year	1.20	1.33	0.90	1.00	1.10	1.30	1.40	1.60
	10-year	3.17	3.69	3.80	4.10	4.60	5.00	5.40	5.60
Eurozone									
	Minimum bid	1.50	1.00	1.00	1.00	1.00	1.00	1.25	1.75
	Two-year	1.20	1.37	1.20	1.30	1.40	1.70	1.90	2.30
	10-year	3.00	3.38	3.40	3.65	3.80	4.10	4.30	4.40
Australia									
	Cash target rate	3.25	3.00	3.00	3.50	4.00	4.50	4.50	4.50
	Two-year	2.60	4.03	4.50	4.75	5.00	5.15	5.20	5.25
	10-year	4.25	5.52	5.40	5.25	5.60	5.85	6.15	6.35
New Zealand									
	Cash target rate	3.00	2.50	2.50	2.50	2.50	3.00	3.50	4.00
	Three-year	3.20	3.82	3.90	4.10	4.25	4.50	4.75	5.00
	10-year	4.50	5.96	5.75	5.85	6.00	6.25	6.50	6.50
Yield curve									
	Canada	101	165	169	215	220	195	205	200
	United States	184	150	99	242	235	200	225	230
	United Kingdom	0	122	197	236	290	310	350	370
	Eurozone	10	119	180	201	220	235	240	240
	Australia	60	135	165	149	90	50	60	70
	New Zealand	-39	45	130	214	185	175	175	175

*New Zealand's yield curve: 10-year vs. three-year

Source: Reuters, RBC Economics Research

Central bank policy rates

%, end of period

		Current	Last	
United States	Fed funds	0.0-0.25	1.00	Dec. 16, 2008
Canada	Overnight rate	0.25	0.50	Apr. 21 2009
United Kingdom	Repo rate	0.50	1.00	Mar. 5, 2009

		Current	Last	
Eurozone	Min. bid rate	1.00	1.25	May 13, 2009
Australia	Cash rate	3.00	3.25	Apr 8, 2009
New Zealand	Cash rate	2.50	3.00	Apr. 30, 2009

Source: Bloomberg, Reuters, RBC Economics Research

Economic outlook

Growth outlook

% change, year-over-year in real GDP

	09Q1	09Q2	09Q3	09Q4	10Q1	10Q2	10Q3	10Q4	Annual 2007A	2008A	2009F	2010F
Canada	-2.3	-3.2	-2.8	-1.3	1.0	2.8	3.1	3.5	2.5	0.4	-2.4	2.6
United States	-3.3	-3.9	-2.8	-1.0	1.3	2.3	2.5	2.8	2.1	0.4	-2.7	2.2
United Kingdom	-4.9	-5.5	-5.0	-2.9	-0.6	0.5	0.7	0.5	3.0	0.7	-4.6	0.3
Eurozone	-4.9	-4.7	-4.0	-2.1	0.4	0.6	0.6	0.8	2.6	0.6	-3.9	0.6
Australia	0.3	0.6	0.7	1.1	1.3	1.4	2.1	3.5	4.3	2.4	0.7	2.2
New Zealand	-2.7	-2.9	-2.2	-0.9	0.6	1.5	1.9	2.2	3.1	0.3	-2.2	1.5

Inflation outlook

% change, year-over-year

	09Q1	09Q2	09Q3	09Q4	10Q1	10Q2	10Q3	10Q4	Annual 2007A	2008A	2009F	2010F
Canada	1.2	0.1	-0.8	1.2	1.9	1.7	1.7	1.7	2.1	2.4	0.4	1.8
United States	0.0	-1.2	-1.7	1.2	2.1	1.7	1.2	1.2	2.9	3.8	-0.5	1.5
United Kingdom	3.0	1.6	0.2	0.4	1.4	0.9	1.0	1.4	2.3	3.6	1.3	1.2
Eurozone	1.0	0.0	-0.5	0.8	1.2	1.5	1.5	1.4	2.3	3.3	0.4	1.4
Australia	2.5	1.5	0.8	1.6	2.0	2.1	2.2	2.3	2.4	4.4	1.6	2.2
New Zealand	3.0	1.8	0.8	1.7	1.8	1.7	1.6	1.6	2.4	4.0	1.8	1.7

Source: Statistics Canada, Bureau of Labor Statistics, Bank of England, European Central Bank, Reserve Bank of Australia, Reserve Bank of New Zealand, RBC Economics Research

Inflation tracking

Inflation Watch

	Measure	Current period	Month ago	Year ago	Three-month trend	Six-month trend
Canada	Bank of Canada core CPI[1]	July	0.0	1.8	2.0	1.7
United States	Core PCE[2]	July	0.1	1.4	1.8	1.4
United Kingdom	All-items CPI	July	0.0	1.8	3.8	1.2
Eurozone	All-items CPI	July	-0.7	-0.7	1.3	-0.1
Australia	Trimmed mean	Q209	0.8	3.6	N/A	N/A
New Zealand	CPI	Q209	0.6	1.9	N/A	N/A

[1] Seasonally adjusted measurement

[2] Personal consumption expenditures less food and energy price indices

Source: Statistics Canada, U.S. Bureau of Labor Statistics, Bank of England, European Central Bank, Reserve Bank of Australia, Reserve Bank of New Zealand, RBC Economics Research

Currency outlook

Level, end of period

	09Q1	09Q2	09Q3	09Q4	10Q1	10Q2	10Q3	10Q4
			Forecast					
Canadian dollar	1.26	1.16	1.14	1.09	1.08	1.07	1.05	1.05
Euro	1.33	1.40	1.38	1.42	1.44	1.45	1.51	1.52
U.K. pound sterling	1.43	1.65	1.68	1.75	1.80	1.84	1.91	1.92
New Zealand dollar	0.56	0.65	0.67	0.70	0.71	0.72	0.72	0.72
Japanese yen	99.0	96.4	92.0	90.0	88.0	87.0	85.0	85.0
Chinese renminbi	6.83	6.83	6.83	6.83	6.80	6.67	6.60	6.50
Australian dollar	0.69	0.81	0.80	0.86	0.88	0.89	0.90	0.90
Mexican peso	14.17	13.19	13.10	12.75	12.50	12.25	12.00	11.75

Canadian dollar cross-rates

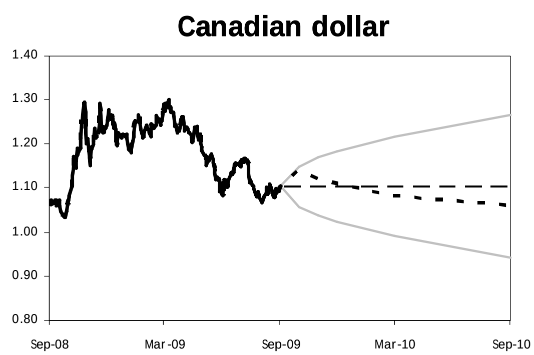
	09Q1	09Q2	09Q3	09Q4	10Q1	10Q2	10Q3	10Q4
EUR/CAD	1.67	1.63	1.57	1.55	1.56	1.55	1.59	1.60
GBP/CAD	1.80	1.91	1.92	1.91	1.94	1.96	2.01	2.02
NZD/CAD	0.70	0.75	0.76	0.76	0.77	0.77	0.76	0.76
CAD/JPY	78.5	82.9	80.7	82.6	81.5	81.3	81.0	81.0
AUD/CAD	0.87	0.94	0.91	0.94	0.95	0.95	0.95	0.95

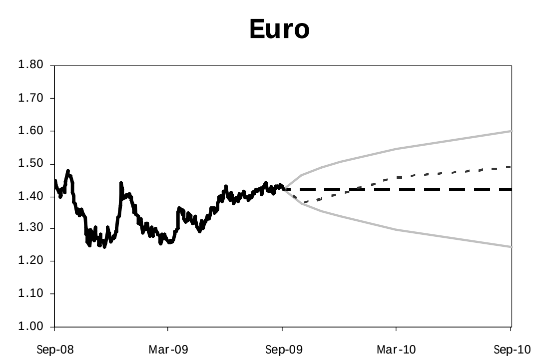
Rates are expressed in currency units per US$ and currency units per C$, except the euro, U.K. pound , Australian dollar and New Zealand dollar, which are expressed in US$ per currency unit and C$ per currency unit.

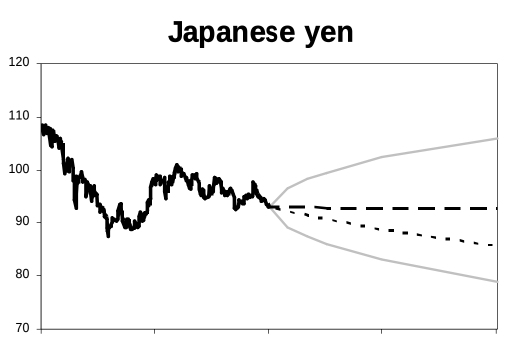
Source: Bloomberg, RBC Economics Research

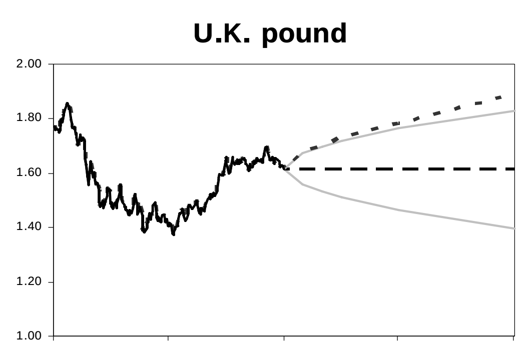
RBC Economics outlook compared to the market

The following charts track historical exchange rates plus the forward rate (dashed line) compared to the RBC Economics forecast (dotted line) out one year. The cone for the forecast period frames the forward rate with confidence bounds using implied option volatilities as of the date of publication.









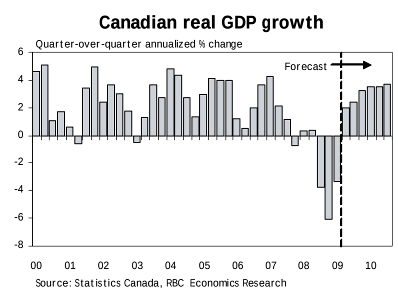
Source: Reuters, RBC Economics Research

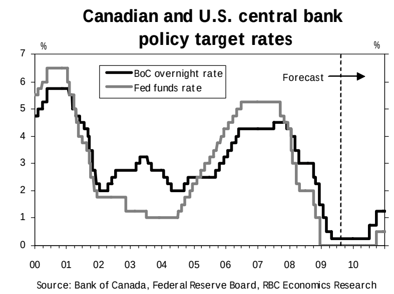
Central bank watch

Bank of Canada

• The return to positive growth in June suggests that the Bank of Canada is unlikely to implement non-traditional easing measures.

• The overnight rate will be held at 0.25% until mid-2010. This past month, the Bank reiterated its concern about the downside risk to growth posed by continued currency strength.

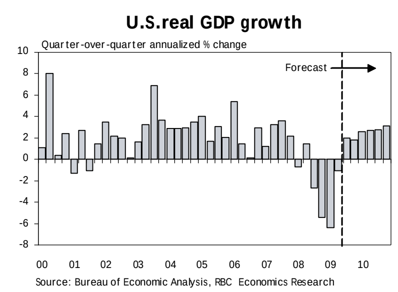


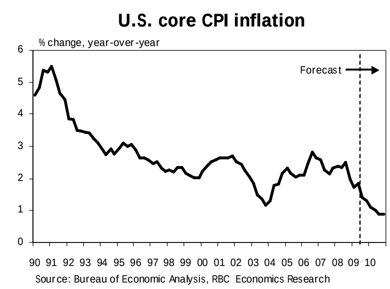


Federal Reserve

• The Fed opted not to increase the amount of Treasury purchases. In its statement, it described the economy as 'leveling out.'

• Bernanke subsequently stated that the near-tern prospects for the economy are "good." But, with the recovery still fragile, we expect the Fed to leave its overnight rate unchanged until the fourth quarter of next year.

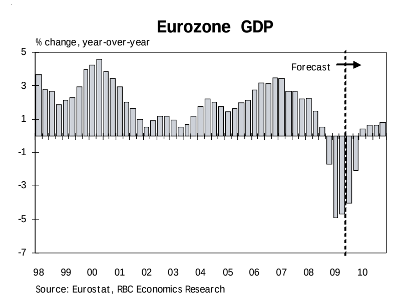


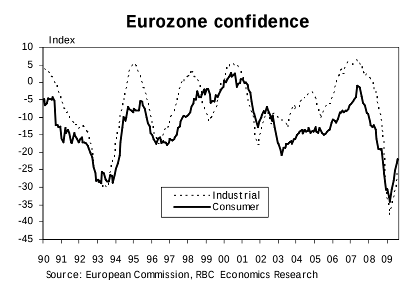


European Central Bank

• Eurozone growth for the second quarter exceeded expectations, falling only 0.1%. Germany and France saw positive quarterly growth.

• While leaving rates on hold, the ECB upped its staff economic forecast. Nonetheless, it remains tentative about the sustainability of the recovery. We expect it to leave rates on hold through the end of the second-quarter of 2010.

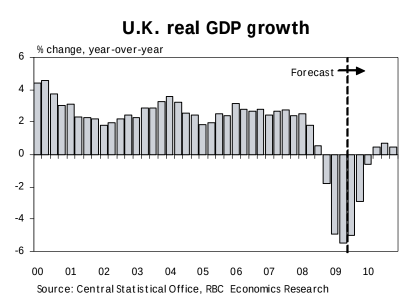


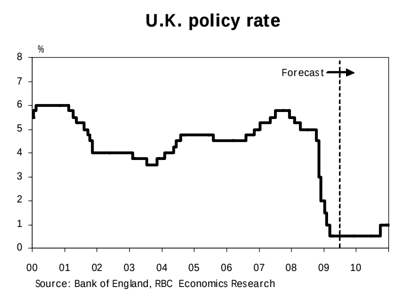


Bank of England

• The Bank of England surprised the market when it announced another £50 billion in asset purchases, bringing the total to £175 billion.

• The Bank of England's quarterly inflation report suggested that the wide output gap would restrain it from hiking rates as aggressively as markets were expecting.

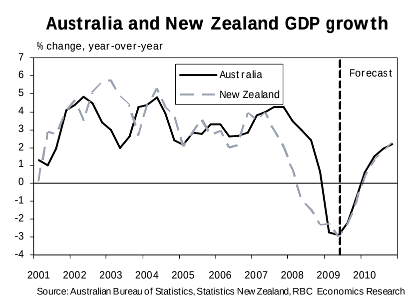


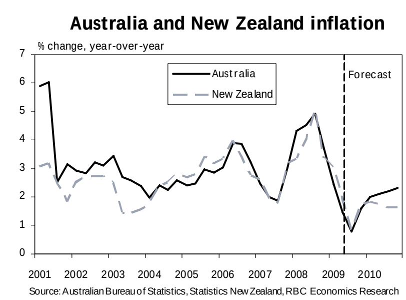


Australia and New Zealand Reserve Banks

• The RBA left rates unchanged at 3.00% in September. Its statement recognized strength in China and stronger-than-expected domestic activity. We expect 50 basis points of hikes in the final quarter of this year.

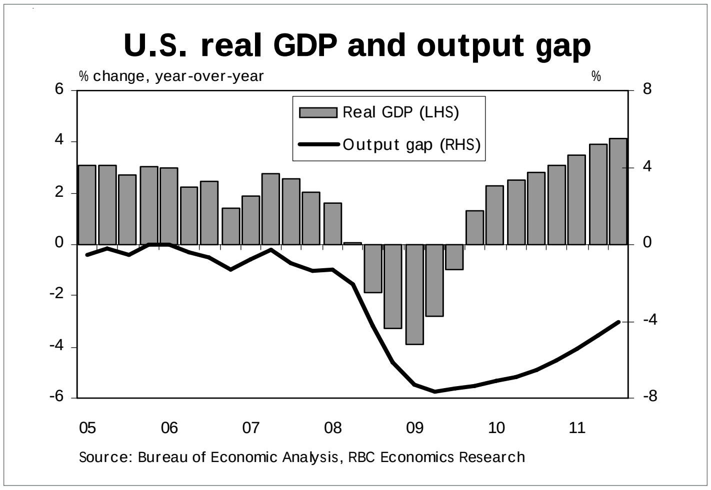
• The RBNZ left rates on hold at 2.50% in July but retained an easing bias via a commitment to hold rates steady until the latter part of 2010.



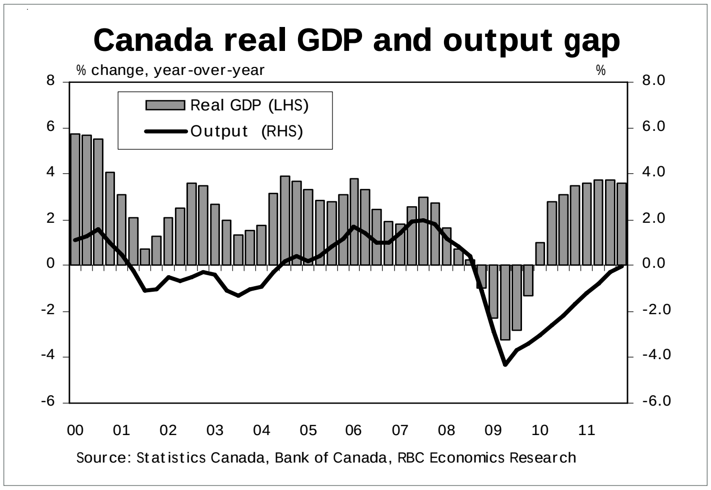


Big output gaps keep inflation concerns at bay

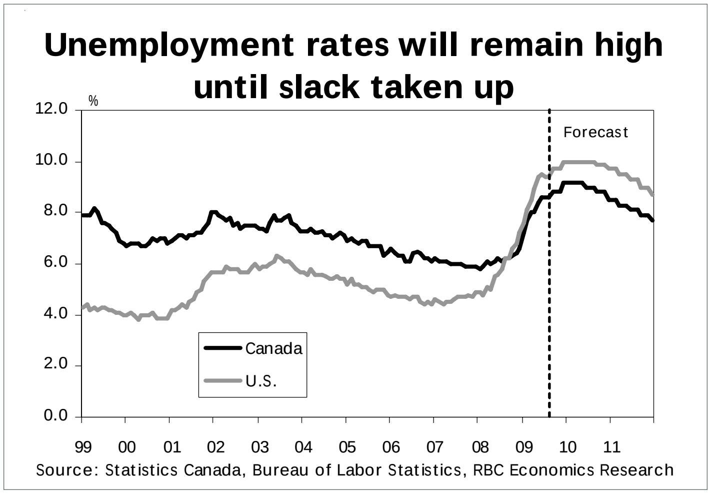
The deep recession of 2008/09 created a large output gap in the United States that will only start to be closed in the second half of 2010.



Canada's output gap is smaller than in the United States but, with the recovery expected to be muted, it will persist into 2012.



Unemployment rates are likely to creep higher until the slack starts to be taken up, thus keeping downward pressure on wages and, ultimately inflation, rates.



Ten-year rates in Canada have been tracking U.S. yields very closely, with a swing lower later this year expected on concerns about the longevity of the economic upturn.