Economic Insights

January 26, 2012

Punch Drunk

by Avery Shenfeld

A US Fed Chairman once famously opined that a central banker's job is "to take away the punchbowl just as the party gets going", metaphorically noting the need to reduce stimulus when economic overheating becomes a risk. But in Canada's case, many of those at the party may already be recognizing that they are drunk on punch, so much so that they could begin to spurn its temptations on their own.

To this point, low interest rates have hit their mark, encouraging Canadians to eschew savings and run up debt, using the funds to finance a nice recovery in home building and consumer spending. In the process, although interest costs remain reasonable, debt burdens have climbed, to the point where both policy makers and bankers have raised concerns about where things will stand when, as they must at some point, interest rates begin to climb.

The media focus has been on record levels of average debt relative to income. But averages can lie. (What pair of brothers had the highest average career points in the NHL? The Gretzkys, Wayne and Brent, with the latter playing 6 games.) Some countries have withstood much higher average household debt burdens with no credit troubles.

What really counts is the distribution of the debt, and the incomes of those who hold it. Our new analysis of the micro data shows a troubling pattern in that regard. The growth in debt-to-income ratios has come from a piling on of debt by those with high debt burdens, rather than from less indebted households getting drawn to the punchbowl by the promise of low rates (see pages 3-5).

A rising share of the highly indebted are over 45 years old, an age where accumulating net assets ahead of retirement should be paramount. There is room for further borrowing across Canada, but we will have to be careful that the distribution of new debt shifts to those with greater financial room to add to their debt burden, and more time to earn the income to pay it off.

None of this is to say that we are on the precipice of a wave of defaults. We have time to avoid that outcome, and lending standards to date have been prudent enough to avoid a US-style blow-up. The danger instead is that low interest rates lose their power to propel growth. Housing starts already appear to have levelled off, and home prices and their wealth effect are showing tentative signs of doing the same. If the latter proves temporary, Ottawa could add further restrictions in the mortgage market to constrain lenders. Although it might have bounced back in the last quarter, consumer credit decelerated sharply on a year-on-year basis through most of 2011, hitting retailing in the process.

If, as we expect, households shy away from an aggressive tapping of low rates for further home building and consumption, the Bank of Canada will be able to leave the punchbowl in place for the business sector. Low rates not only support debt-financed capital projects that can boost capacity and productivity, but they also help keep the Canadian dollar from a sharp appreciation that would dent exports. With lots of slack in the labour market still to be absorbed and government restraint coming, we still need the business sector to party on.

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"The danger ... is that low interest rates lose their power to propel growth."

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MARKET CALL

- Hopes for better times, spurred by upside US data surprises, leaned in favour of the Canadian dollar in recent weeks. We still expect recession news out of Europe, and a slowing in emerging markets, to put downward pressure on commodities in the first half, but earlier this month, we softened our projections for the extent of temporary C$ weakness as we nudged our oil target higher. In any event, we expect demand for Canada's now rarer AAA paper will push the loonie back near parity if the eurozone skates through 2012 with only Greece in default.

- The Bank of Canada likely expects to be raising rates come 2013, but we have greater concerns about growth prospects that year, given a steep US fiscal tightening now scheduled to hit at that time. Moreover, with the Fed on hold until 2014 (which had been our forecast even prior to the FOMC statement) the Bank will be reluctant to add fuel to the C$ by widening spreads.

- We have left intact our end of year targets for a gradual drift towards higher North American government bond yields. Still, rates will remain very low by historical standards, anchored at the front end by central banks, and restrained further out by both global uncertainties and modest core inflation.

INTEREST & FOREIGN EXCHANGE RATES

		2012					2013	
END OF PERIOD:		**25-Jan**	**Mar**	**Jun**	**Sep**	**Dec**	**Mar**	**Jun**
CDA	Overnight target rate	1.00	1.00	1.00	1.00	1.00	1.00	1.00
	98-Day Treasury Bills	0.86	0.90	0.90	0.95	0.95	0.95	0.95
	2-Year Gov't Bond	1.01	1.10	1.20	1.40	1.50	1.40	1.35
	10-Year Gov't Bond	2.04	2.20	2.40	2.70	2.75	2.65	2.45
	30-Year Gov't Bond	2.65	2.80	3.05	3.10	3.15	3.00	2.90
U.S.	Federal Funds Rate	0.09	0.10	0.10	0.10	0.10	0.10	0.10
	91-Day Treasury Bills	0.04	0.05	0.10	0.10	0.10	0.10	0.15
	2-Year Gov't Note	0.22	0.30	0.35	0.40	0.40	0.35	0.30
	10-Year Gov't Note	2.00	2.10	2.25	2.45	2.60	2.60	2.55
	30-Year Gov't Bond	3.15	3.20	3.30	3.35	3.40	3.40	3.35
Canada - US T-Bill Spread		0.82	0.85	0.80	0.85	0.85	0.85	0.80
Canada - US 10-Year Bond Spread		0.04	0.10	0.15	0.25	0.15	0.05	-0.10
Canada Yield Curve (30-Year — 2-Year)		1.64	1.70	1.85	1.70	1.65	1.60	1.55
US Yield Curve (30-Year — 2-Year)		2.93	2.90	2.95	2.95	3.00	3.05	3.05
EXCHANGE RATES	CADUSD	1.00	0.96	0.94	0.99	1.00	0.99	0.98
	USDCAD	1.00	1.04	1.06	1.01	1.00	1.01	1.02
	USDJPY	78	77	77	75	74	74	73
	EURUSD	1.31	1.24	1.23	1.29	1.33	1.35	1.38
	GBPUSD	1.57	1.51	1.50	1.56	1.60	1.63	1.66
	AUDUSD	1.06	0.98	0.95	0.97	0.98	0.99	0.99
	USDCHF	0.92	0.98	1.00	0.96	0.94	0.94	0.93
	USDBRL	1.76	1.81	1.82	1.84	1.83	1.85	1.89
	USDMXN	13.02	12.95	12.55	12.45	12.10	12.40	12.71

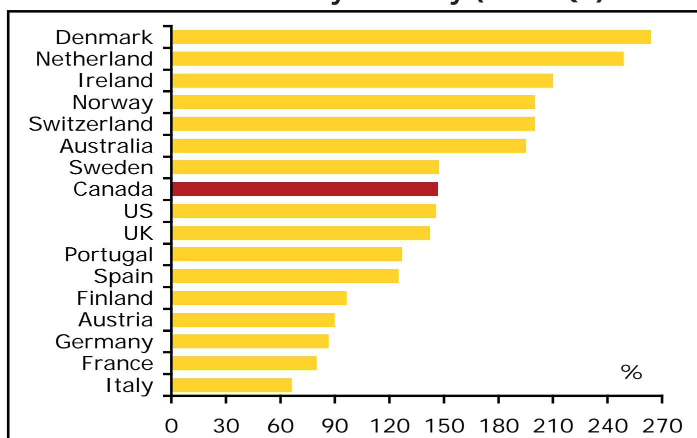
Beyond Debt-to-Income: New Light on How Canadians are *Really* Doing

Avery Shenfeld and Benjamin Tal

As a temperature reading on Canadians' financial health, one measure—the ratio of debt to after tax incomes—grabs all the headlines. As it sets record highs (Chart 1), it demands our attention as we consider both future spending power in the household sector, and the risks to credit quality. But when we look across other developed economies, there are seven that have run up much larger debt burdens (Chart 2), some of which have not experienced any grief. Even adjusted for high tax rates (and presumably greater government-paid goods and services), Denmark's burden is still light years above Canada's. There's simply no magic number for the average debt-to-income ratio that automatically spells trouble.

Chart 2

Debt-to-Income Ratio by Country (2011 Q1)



Source: ECB, IMF, Bank of Canada, CIBC

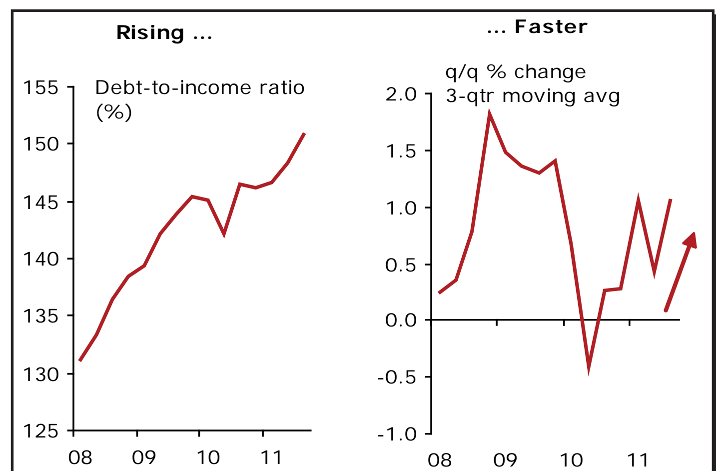
To assess how Canadians are really doing financially, we have to go beyond simply tallying up all the debt, and dividing it by all the income. Looking beyond the headlines at new micro data on the distribution of Canada's household debt, we find that while a crisis does not appear imminent, there are cracks emerging in the financial foundation of Canadians that are likely to impair spending growth ahead.

Weak Income Gains and Low Rates: A Cocktail for Debt Growth

At the root of recent debt growth has been the combination of ultra-low interest rates and weak growth in household real incomes. Borrowing is what fills the gap between what we want to buy and our incomes, particularly for lumpy expenditures like houses, vehicles and other durable goods. Strong growth in real incomes can therefore reduce the reliance on debt by the household sector.

Chart 1

Canadian Household Debt-to-Income Ratio



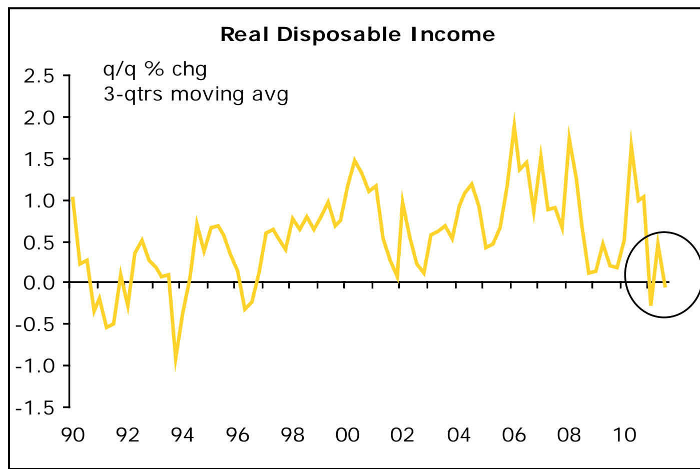
Source: Statistics Canada, CIBC

Recent years have been notably weak on the income front. Not only was there a sag in nominal incomes during the recession, but in the recovery, consumers faced a much quicker snapback in inflation than in average wages, driven by a jump in global energy and food commodity prices. The result is that real disposable income fell by 0.1% during the first three quarters of the 2011 (Chart 3). On that score, 2012 looks to be better for the average worker, as a leveling off in energy prices and a likely cooling in food inflation brings the consumption deflator closer in line with sluggish wage gains. But employment growth is likely to remain sluggish.

Low interest rates facilitated higher debt loads, as the Bank of Canada has been pushed into a reliance on debt-financed consumption and housing to drive growth. With no hikes in store for the next two years, and current arrears rates still quite low, there's no reason to fear a huge credit shock in the household sector. But high debt loads could constrain the ability of low rates to push housing and consumption forward, if Canadians' financial position begins to squeeze their willingness and ability to pile on more debt.

Chart 3

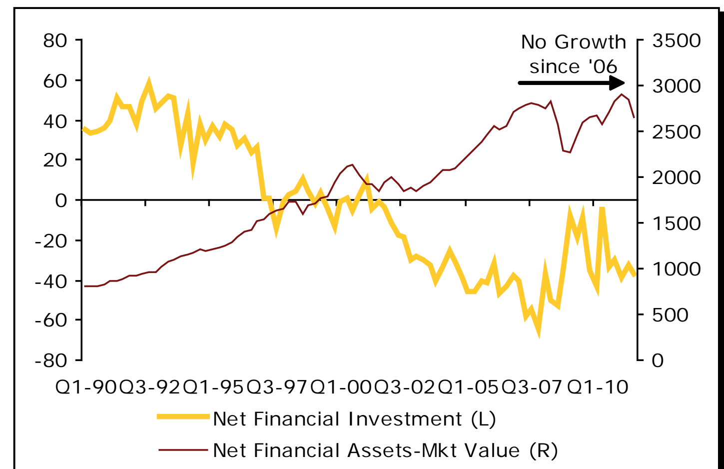
Growth in Real Disposable Income is at a 15-Year Low



Source: Statistics Canada, CIBC

Chart 4

Weak Savings, Low Returns Stall Growth in Household Assets



Source: Statistics Canada, CIBC

The Asset Side of the Ledger: Not that Comforting

True, debt is only one side of the household's balance sheet; the asset side also counts, and both total assets and household net worth have been climbing until the last couple of quarters. But much of the gain in total assets has been associated with rising market values for housing and land. If both mortgage debt and house price climbs are part of an unsustainable market overvaluation of housing fueled by unsustainably low mortgage rates, then the asset values could stall or even deteriorate, without a compensating change in debt outstanding.

And housing price gains do not really add to national well-being to the same extent as gains in other asset prices. As Bank of England Governor Mervyn King once pointed out, leaving aside foreign purchasers, a rise in house prices is mostly a transfer of wealth to those who own a house (i.e. the older generation) from those who will be buying one ahead. The former could sell their house and live off the proceeds, implying less need to save, but the latter have to save more to make their first house purchase.

Net financial assets are therefore a better measure of household wealth, and on that score, results have been disappointing, with no growth since 2006 (Chart 4). That owes to the combination of a low savings rate and rapid borrowing, which has meant that Canadians stopped pouring funds into new asset accumulation, and the incomplete recovery from the recession's hit to equity markets.

Moreover, if anything, we need to see an acceleration in net financial assets given that the baby boom bulge is getting closer to retirement age. If low real interest rates and less robust equity appreciation continues, it's going to take a larger pool of financial assets to generate the returns needed for an adequate retirement.

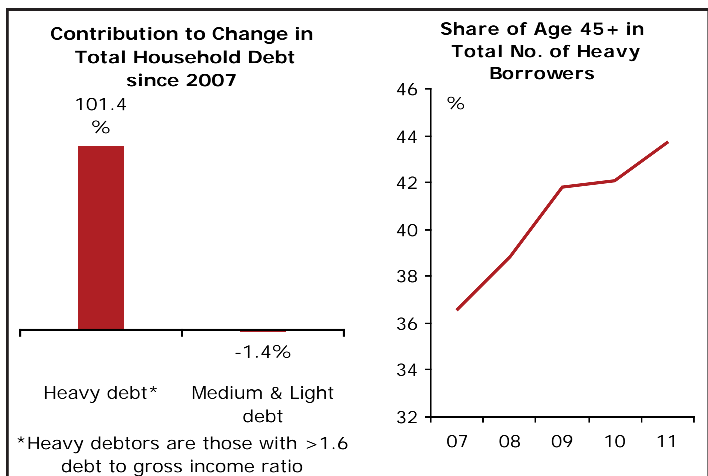
Beyond the Averages: The Micro Story

Average wealth and income levels tell only part of the story. Wealth levels can be highly skewed, particularly since equity holdings are very concentrated in the hands of higher net worth households. Debt could be held by those with lots of income to support it, or less favourably, by those pressing against their debt service limits. The micro story is therefore as important as the macro picture, not only in looking at credit risks, but also at the degree to which existing debt levels will impede the room for future consumption growth.

Here the news is not encouraging. Looking at a unique data set that allows us to zoom in only on those households carrying debt, we found that all of the rise in debt since 2007 has been driven by borrowing from those with a high debt-to-gross income ratio (Chart 5-left), using that measure rather than disposable income due to data limitations. The indebted have piled on still more debt. Some 34% of households that have debt are now in the high-debt-burden category (defined as a ratio of 1.6 or above for debt to gross income) and they account for nearly three-quarters of household debt outstanding. Not surprisingly, among those in debt, the share of those with high debt-to-income ratios is greater in provinces

Chart 5

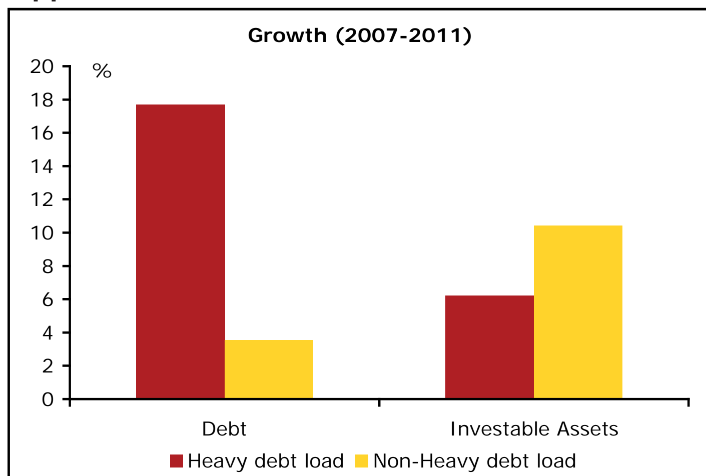
Heavy Debtors Piled on More (L), Older Canadians Part of the Problem (R)



Source: Canadian Financial Monitor, CIBC

Chart 6

Heavy Borrowers: More Debt, Less Capital Appreciation



Source: Canadian Financial Monitor, CIBC

where housing is expensive (BC, Alberta and Ontario) as families have chased the home ownership dream in markets where price gains have outstripped incomes.

Of note, the share of those over 45 among the high-debt-burden group has been rising much faster than their share of the overall population (Chart 5, right). Canadians nearing retirement who should be in their prime savings years are, instead, getting themselves deeper into debt. We are already seeing an uptrend in bankruptcies for those 50 and over, but the more material impact will be that this group's ability to spend could be severely squeezed upon retirement.

Controlling for family composition and age, households with lower debt-to-income ratios appear to devote the lower costs they face on debt service to savings, rather than consumption. The result is that high-debt-load Canadians are also being hurt relative to other families in terms of their accumulation of assets on that side of their balance sheet. While their debts advanced by 18%, high debt-to-income Canadians have seen a less-than-4% accumulation in assets since 2007, as compared to a roughly 10% advance for those with more moderate debt-to-income burdens (Chart 6).

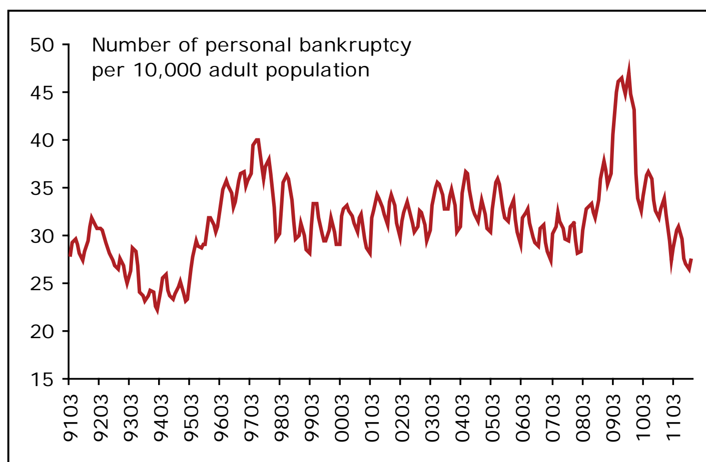
Squeeze Ahead

None of this is to say that Canada is on the precipice of a sharp run-up in household bankruptcies, which have thus far eased dramatically from the recession's highs (Chart 7). Many Canadians still have room to borrow and take advantage of low rates, as they have eschewed that temptation in recent years. The trigger for a sharp jump in bankruptcies would have to be sharply rising interest rates and a steep climb in unemployment, neither of which seems likely, particularly in combination, given that the Bank of Canada has inflation under wraps.

But it does raise the spectre of a further deceleration in Canadians' appetite and room for additional debt, as more reach the constraints of their ability to service debt. We have already seen a deceleration in consumer debt, which has sapped some of the stimulative impacts of the Bank of Canada's low rate policy. Housing might be next to feel the same pinch, with new construction and prices leveling off in the year ahead. That will leave Canada more at the mercy of the global environment, which remains clouded by the impacts of fiscal tightening across much of the developed world.

Chart 7

Personal Bankruptcy Rate—The Lowest Since 1995



Source: Office of the Superintendent of Bankruptcy Canada

Jumping the Gun on a US Jobs Recovery

Emanuella Enenajor and Andrew Grantham

It's been nearly three years since the end of the US recession, and hiring remains one of the slowest aspects of the recovery. Some signs of life have been popping up, with a falling jobless rate and hiring perking up in recent months. But we've been here before—markets initially cheer a few months of decent hiring in hopes of a turnaround, only to be disappointed as bleaker jobs numbers roll in. This time around, the story's not much different. With the latest bounce in hiring lacking indicators of staying power, the US jobs market could underperform expectations as the year wears on (Chart 1), meaning it's still too early to bet on an employment turnaround.

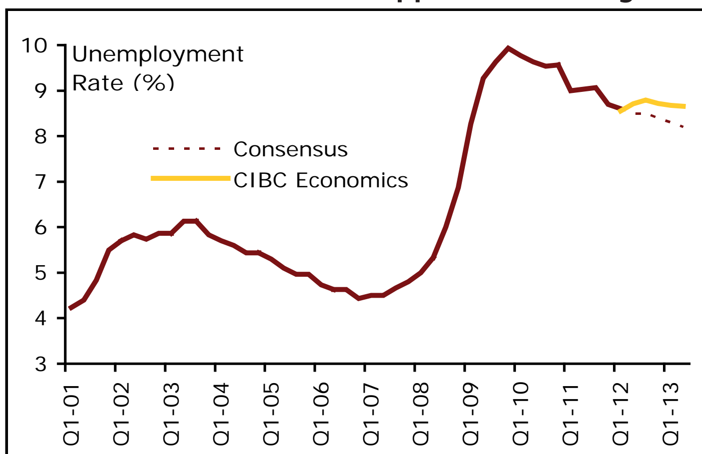
The Falling Jobless Rate: A Numbers' Game

One puzzle of the past year has been a notable decline in the US unemployment rate, from 9.1% in January 2011 to 8.5% in December, which has sparked talk of a more sustainable and stronger US recovery. But a sub-2% GDP growth would typically be consistent with (at best) a stable rate of unemployment, as it fails to require the pace of hiring needed to offset population growth.

The primary cause of this discrepancy was a further reduction in the US civilian workforce, rather than particularly strong increases in employment. Due to a combination of slower population growth and further declines in labour force participation, the workforce posted a third successive annual decline during 2011 (Chart 2, left). While demographic changes could result

Chart 1

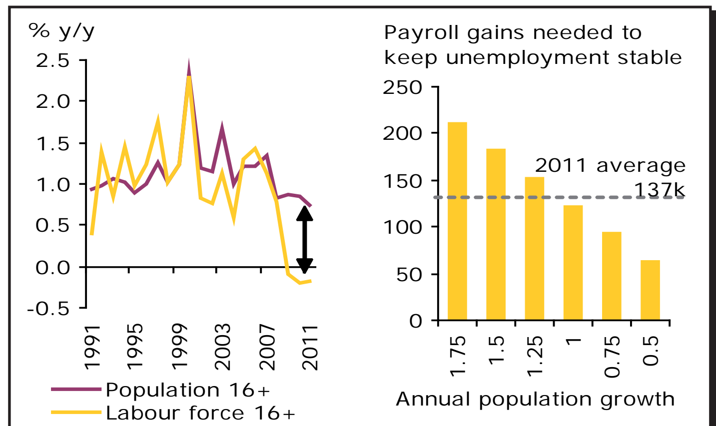
US Jobs Market Should Disappoint in Coming Year



Source: BLS, Bloomberg, CIBC

Chart 2

Lower Unemployment Rate a Reflection of Declining Labour Force (L) Rather Than Improved Hiring



Source: US Bureau of Labor Statistics, CIBC

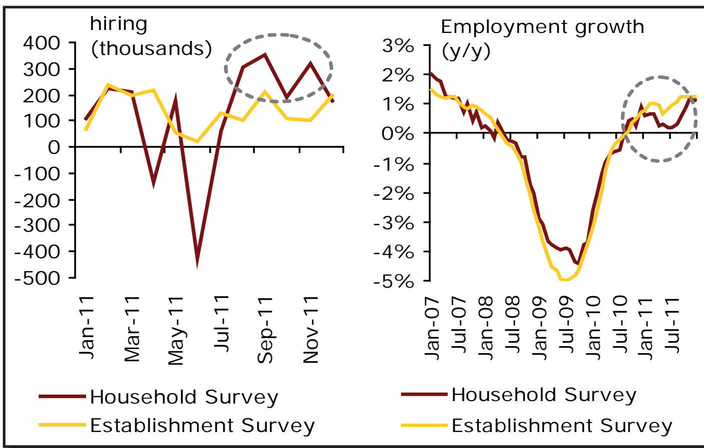
in further modest reductions in labour force participation in the near term, the potential return of previously discouraged workers, including those exiting the work force to pursue further studies, would mean that job gains in the future will have to be stronger for the unemployment rate to continue falling. Given expected workforce growth of around 1-1¼%, the average increase in payrolls last year (137K) would be consistent with a broadly stable rate of unemployment (Chart 2, right).

A Closer Look at the Hiring Numbers

The Household Survey of employment also brought cheer to markets, with a falling unemployment rate and hiring that has averaged nearly 250,000 in recent months. But a cross-check against the Establishment Survey from which the non-farm payrolls number is derived, suggests the upturn in hiring may be exaggerated (Chart 3, left).

Over time, the pace of hiring in the two surveys tends to track each other, but it's common for the results to temporarily diverge due to sampling and methodology differences. While the Household Survey queries 60,000 households regarding their employment status, the Establishment Survey counts the payroll employment of 400,000 worksites who collectively employ a third of all non-farm employees. The latter survey excludes self-employed and agricultural workers, and counts payroll positions not employee headcount, which can

Chart 3
Household Survey Outperforms (L) But Only Plays Catch-up (R)

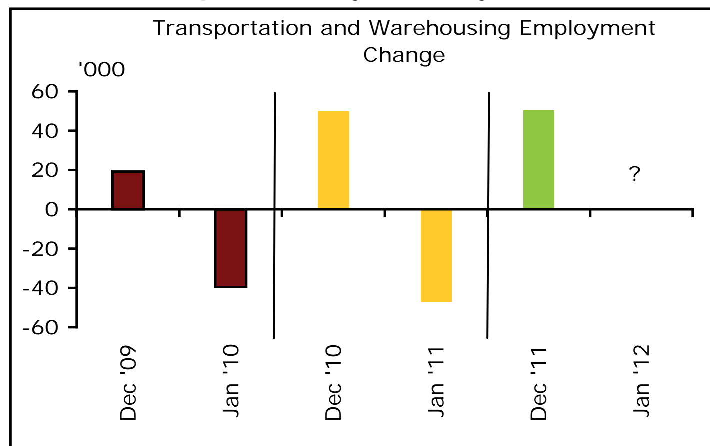


Source: US Bureau of Labor Statistics, US Census, CIBC

differ in the case of multiple jobholders. Given the larger sample size and institutional focus that limits the scope for individual errors/bias in responses, the Establishment Survey is considered a more reliable month-to-month indicator.

Taking a closer look at the acceleration in the Household Survey, it appears that recent outsized gains are only correcting for the underestimation of hiring earlier in the year (Chart 3, right). The discrepancy could be due to noise in the less-precise, smaller-sample series. Also, falling self-employment in early 2011 could have weakened the Household Survey results relative to the Establishment Survey, where self-employment is not counted. In either case, the acceleration in hiring in the Household Survey looks more like a case of catch-up than newfound strength.

Chart 4
December's Upturn in Payrolls May be Short-Lived



Source: US Bureau of Labor Statistics, CIBC

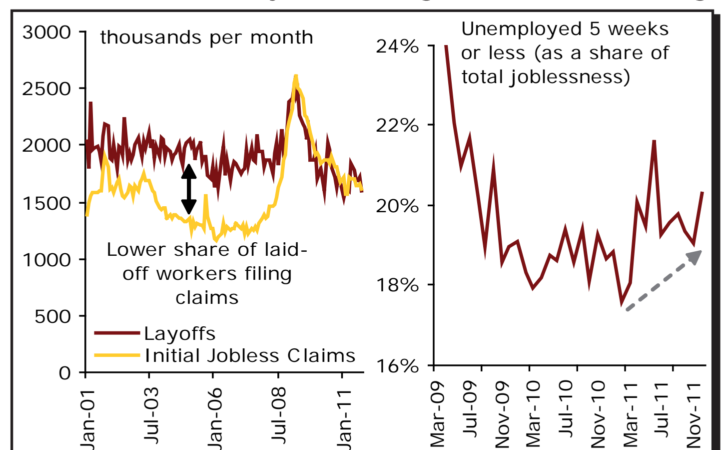
Moreover, the Establishment Survey may have also recently overstated the strength in US hiring. December's better than expected 200K rise in non-farm payrolls was partly driven by a 50K increase in the transport and warehousing sector. A similarly sharp increase was seen in December 2010, only to be largely reversed in the following month (Chart 4). Shifting seasonality within this sector may well have flattered December's payrolls data, and that impact could reverse in January.

Jobless Claims: An Imperfect Indicator

One of the most encouraging indicators of US employment lately has been the fall in the initial jobless claims, taken together with a drop in continuing claims in early January. However, there could be a transitory seasonal source for the good news, as warmer-than-normal temperatures since the start of the winter could have been supportive for hiring in January, temporarily reducing seasonal layoffs in industries like construction.

Drilling down further into the data, there may be another source of noise in the initial claims numbers that impedes confidence in interpreting recent dynamics. JOLTS data on firings suggest that the pace of layoffs has declined recently to pre-crisis levels; however, the initial claims data remain measurably elevated relative to pre-crisis (Chart 5, left). That likely reflects an elevated share of fired workers filing jobless claims since the onset of the recession. Indeed, with unemployment duration persistently elevated since then, the newly fired have had stronger incentives to apply for income support.

Chart 5
Layoffs Already at Pre-crisis Low (L), Frictional Joblessness (R) May be Driving Fewer Claims Filings

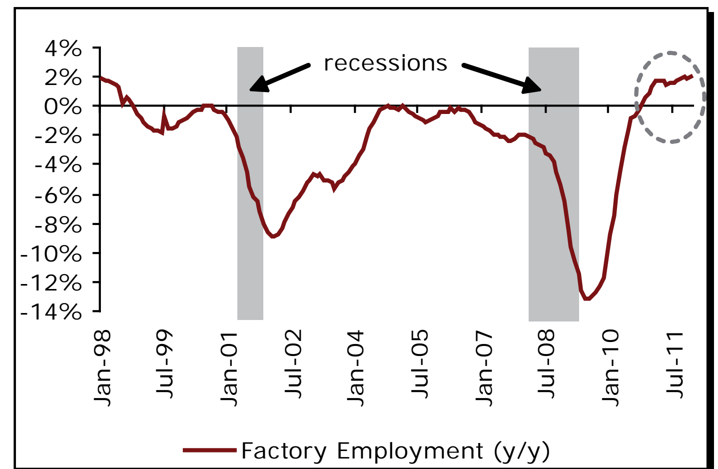


Source: US Bureau of Labor Statistics, US Census, CIBC

With JOLTS layoffs data unavailable for the months of December and January, we are unable to thoroughly analyze the cause of the recent drop in jobless claims. But it seems unlikely that it will have been due to a reduced pace of firing, given that layoffs are already running at levels that are tamer than what we see during buoyant economic times. More likely, we are simply seeing a smaller share of laid-off workers filing claims, which would jibe with recent increases in the proportion of temporary unemployment (Chart 5, right). But those delaying their benefits filings could find that their confidence in being rehired proves to be overdone if, as we expect, growth decelerates from its Q4 pace. Finally, we note that historicaly, jobless claims have been a better indicator of turning points than they have been in terms of measuring accelerations in a mid-recovery phase.

Chart 7

Current Recovery Supported by Quality Blue-Collar Jobs



Source: US Bureau of Labor Statistics, CIBC

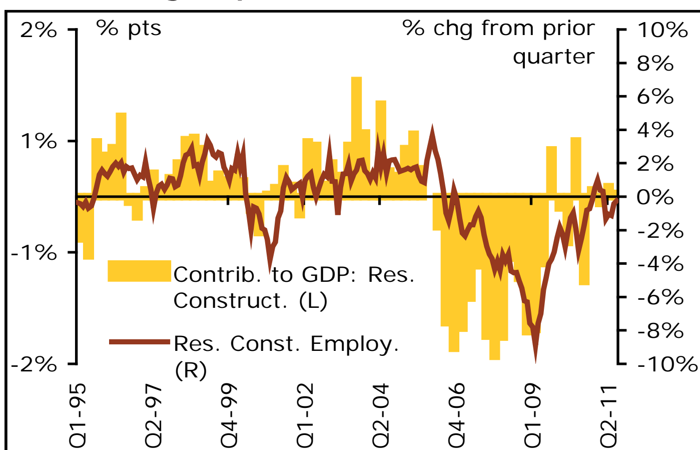
Why Hiring Will Crawl, Not Run

The US is in a hiring-growth catch-22. Firms won't speed up hiring until they see stronger economic growth. But with household consumption accounting for two-thirds of the economy, GDP will be hard-pressed to accelerate unless cash-rich firms put wages in the pockets of consumers.

It's not that there aren't sectors showing signs of improvement in terms of employment prospects. Thanks to rising multi-family activity, the residential construction industry, which experienced one of the most severe job reductions due to the housing market crash, is on track to make a small positive contribution to GDP in 2012, after exerting a drag on growth in recent years. With that indicator typically leading the pace of construction hiring by a few quarters (Chart 6), there could be a modest upturn in that sector's pace of job creation this year.

Chart 6

Residential Construction Employment: The Bleeding Stops



Source: US Bureau of Labor Statistics, Depart. of Commerce, CIBC

Factory employment has also rebounded, in a notable departure from the 2002-07 recovery when factory jobs continued to shrink (Chart 7). That could reflect the benefits of a US$ that has depreciated by 25% against trading currencies since 2002. So this time around, the recovery is being buttressed by well-paying factory jobs, supporting the staying power of consumer spending.

But manufacturing and residential construction combined only account for around 10% of total US employment. Slower hiring in other sectors should keep aggregate job growth at around 1.3% this year, barely topping population growth, as sluggish sales keep requirements for staffing lean.

For now, markets hoping for a quick hiring boom in the US must wait—the progress being made there is slow and structural in nature as industries recover and shift in importance. Firms are gradually warming up to the prospects of improved US growth, but they are waiting to see sustained momentum before adding aggressively to headcounts. While there will be monthly volatility, we won't likely see a sustained acceleration any time soon. And with the jobless rate remaining elevated, the Fed will, as it now projects, keep rates on hold through at least the next two years.

Resource Rally: Handle With Caution

Peter Buchanan

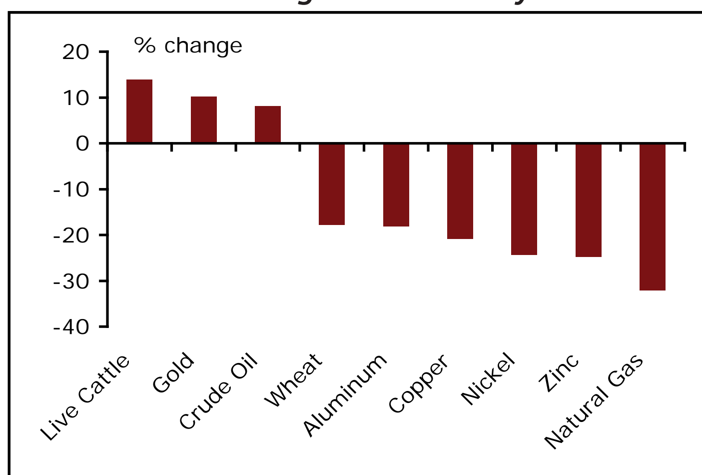
Notwithstanding the exuberance of gold, oil, and a handful of other sectors, 2011 was a generally lacklustre year for commodity markets—and a difficult one by extension for many resource investors, and related equities. Prices for only about a third of major, internationally traded commodities advanced in the year (Chart 1). Note however that 2011's lagging performance only compensates to a degree for earlier heady gains, and the cumulative rally thus far in aggregate resource prices from early 2009's cyclical low has not, consequently, been out of line with past recovery cycles.

Aided by diminished risk aversion, prices for commodities, as with other volatile assets, have shown better traction in the early going in 2012. But as the Aesop fable shows, it takes more than a strong start to win the race. And if there's a lesson from the two-way action of recent years (and reason for some caution), it's that commodity markets remain inherently cyclical, even with the prospect of further support in the long run from greater emerging-market consumption.

Although we're not in the synchronized recession camp, 2012's expected just over-3% rate of growth of the world economy is in the range normally associated with a flat-to-modestly negative bias for many cyclically sensitive industrial product prices. Eurozone leaders and the ECB have taken some useful steps, but in spite of that, the question is not whether the region is not in recession—just how long and deep a one. Q4 was clearly the best in an otherwise lacklustre year for the US. But that economy is not as resource intense as the EMs, and at any rate, the household sector's uneven fundamentals cast doubt on the sustainability of recent improvements. Nor have emerging markets been spared from the cooling process, as evidenced by China's 2½-year low growth rate in Q4.

Chart 1

2011 was a Mixed Bag for Commodity Prices



Source: Bloomberg

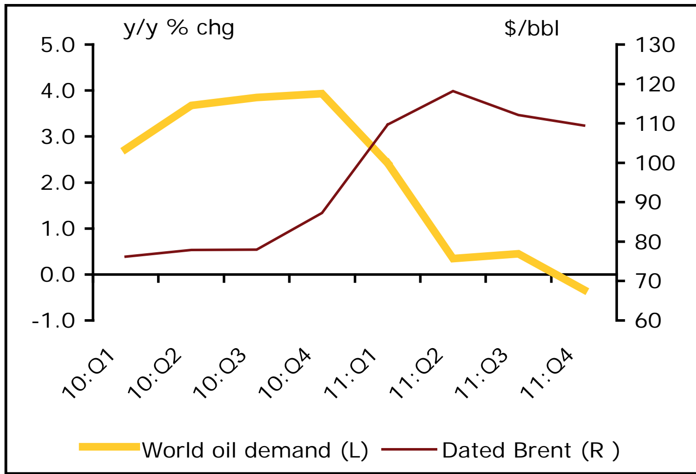
While all of that creates some nearer-term downside risk for a range of industrially sensitive material prices, the second half of the year could see a somewhat better market tone re-emerge as optimism grows that Europe is getting a handle on its problems. The ECB's injection of €500 billion into the banking system, while not perhaps a game changer on its own, is nevertheless a helpful step forward. Policy in China, moreover, has also begun to shift back to a pro-growth bias. While local government debt fears militate against a reprise of the country's earlier massive stimulus package, added social housing investment should provide some support for growth and resource demand, as potentially could an acceleration of resource-intense utilities and other projects in the current five-year plan.

Turning more specifically to expectations for a number of individual sectors:

Oil Prices

Rising geopolitical risk premiums, as a result of developments in the Persian Gulf and to a lesser extent Nigeria's recently suspended strike over fuel subsidy cuts, appear to be masking an appreciable deterioration in underlying fundamentals. After expanding at a comfortable near-1½% rate in the first half, global oil consumption fell on the year for the first time since the recession in the last quarter of 2011 (Chart 2), as torrid demand growth waned in the emerging markets and key industrial countries continued to conserve. Constraining the near-term outlook, China's apparent crude demand is expected to decelerate to the 4-5% range in 2012 after an increase of 14% and 7% in the past two years, with lower vehicle miles and price-related conservation continuing to take a toll on fuel use stateside. After tightening measurably in the fall, US crude oil inventories have rebounded in recent weeks, to stand measurably

*Chart 2—**High Prices, Softening EM Growth Helping to Cool Oil Demand***



Source: Bloomberg, IEA

above normal seasonal levels, with gasoline demand down a full 6% on the year in the latest four-week period. Industrial country inventories increased for the first time in three months in November, and record OPEC and rising non-OPEC production juxtaposed on muted demand growth are conducive to further restocking. Barring a major supply shock like a closure of the Straits of Hormuz, or the stronger demand growth anticipated by CIBCs commodity strategist, we see these forces underpinning an average WTI price of around $95/bbl both this year and next.

Natural Gas

North American hub prices have succumbed to a perfect bearish storm of unseasonably mild early winter weather and heavy inventories due to the continued fast paced expansion of non-conventional output, especially shale production. Non-conventional production makes up half of US gas production today versus just 10%-15% a decade ago. Far outstripping domestic demand growth in demand, US gas production rose by a record 7.4% in 2011. Official estimates point to a further increase of around 2% this year, even with the obvious disincentive for new development from low prices. Low prices have encouraged greater use by the electric power and other industries, but even with that production continues to outrun demand. Even with cold weather from here, inventories will start the 2012 injection season at very high levels. Although prices will ultimately have to rise to cover producer's full cycle costs, recent market and climatic developments have prompted us to cut our targets to an average $3.25 MM Btu in 2012 and $4.00/ MM Btu next year.

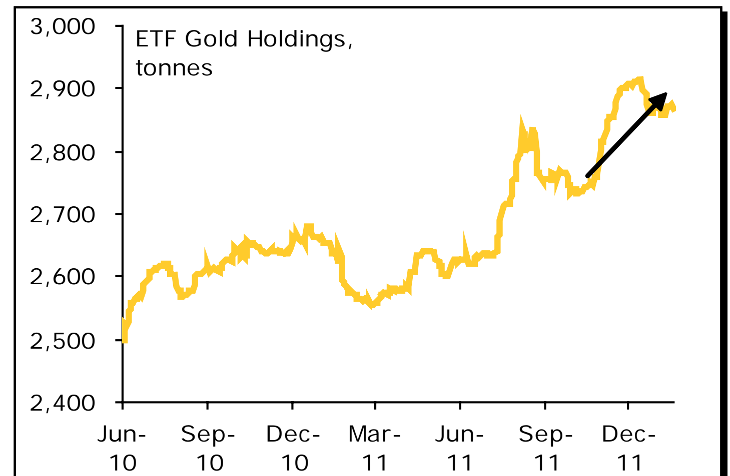
Gold

China easing chatter, gains in risk markets generally and positive seasonals tied to the Lunar New Year have breathed life back into the precious metal's fortunes of late. While inflation appears to be subsiding in the Middle Kingdom, pressures remain worrisome in some other emerging markets. Indian Finance Minister Mukherjee's recent statement that policymakers will start concentrating on buttressing growth, as opposed to curbing still-relatively high inflation, could support hedging demand in what has traditionally been the world's largest gold market. ETFs have resumed net buying, acquiring 250 tonnes since the late summer (Chart 3). Although we don't see particularly high odds for another round of QE by the Fed at this point, reduced equity market volatility has helped to ease the liquidation pressures that weighed during the summer and fall. Official net purchases and low or even lower rates in key industrial countries should also support a year-end target of $1750/oz, up modestly from current levels.

Base Metals

Copper has outperformed a number of the other base metals in recent months, regaining about 40% of the early fall's losses to close at 4-month highs recently. While mine outages have lent some support, fundamentals in other respects remain broadly constructive, with an expected global supply deficit of close to 200K tonnes in 2012 in the face of continued demand growth and relatively limited gains in supply. China's recent record imports (Chart 4), moreover, point to underlying resilience in demand there even as growth cools with low inventories limiting the potential for additional destocking. Aluminum

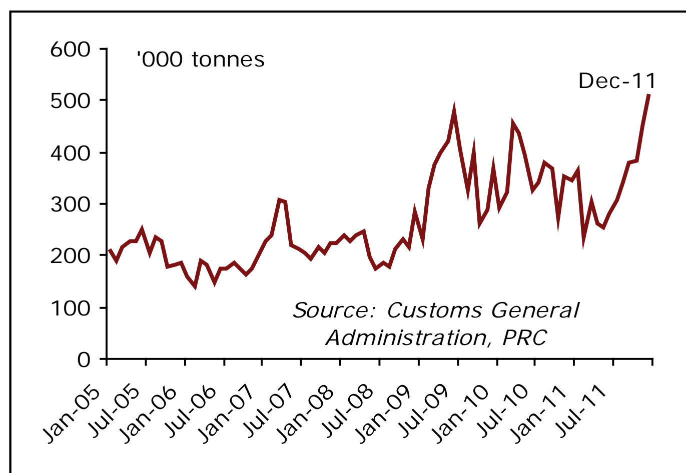
Chart 3
ETF Gold Holdings, tonnes



Source: Bloomberg

Chart 4

China's Unwrought Copper Imports—No Cooling Yet!



spot prices have fallen from a 3-year high of just under $1.30/lb last spring to a bit less than $1 recently. Recent and planned capacity cuts by North American and other producers should nonetheless help to cushion prices from the full effect of a slowing global economy. Spot nickel prices meanwhile have fallen by about a third from the recent highs. Inventory levels have come down but remain appreciably above pre-recession levels. About two-thirds of nickel is used in stainless steel production, and a deceleration in building in China and softening global activity suggest more downside risk.

Agricultural Prices

Upgraded world inventory and crop estimates have contributed to a further easing in prices for key grains in recent months. Wheat prices have hit 17-month lows and are now down by about 30% from the spring highs. Overall Canadian wheat production is estimated to have risen by about 9% this year, lagging gains by some other key producers. Heavy year-end inventories and reduced feedstock demand, due to the lapse of US ethanol subsidies, have likewise pressured corn and soybeans. Cattle futures, in contrast, have set seasonal records due to lucrative export sales and recent herd reductions owing to drought.

Lumber Prices

Imports by China grew by a hefty 46% in 2011 to reach a record 21.56 million m^3. Notwithstanding that fact, excess production capacity and a still-depressed housing market stateside have conspired to keep a lid on prices. With a decent recovery in the US single construction segment still two to three years away, we expect only a modest recovery in prices to an average $260/1000 bd ft this year and $285/1000 bd ft in 2013.

Table 1—**Spot Commodity Prices**

				Average				
		24-Jan	2008	2009	2010	2011	2012 (f)	2013 (f)
Oil (WTI)	$/bbl	99	100	62	80	95	95	95
Natural Gas (Henry)	$/Mn Btu	2.63	8.89	3.82	4.37	3.99	3.25	4.00
Gold	$/troy oz	1665	870*	1088*	1406*	1531*	1750*	1750*
Copper	$/lb	3.79	3.16	2.35	3.43	4.01	3.75	3.85
Aluminum	$/lb	1.00	1.17	0.76	0.99	1.09	0.90	0.85
Nickel	$/lb	9.35	9.57	6.69	9.91	10.38	8.50	8.25
Zinc	$/lb	0.96	0.85	0.76	0.98	1.00	0.85	0.90
Lumber**	$/'000 bd ft	235	252	221	245	255	260	285

** end of period* **1st Futures

ECONOMIC UPDATE

CANADA	11Q3F	11Q4F	12Q1F	12Q2F	12Q3F	12Q4F	2011F	2012F	2013F
Real GDP Growth (AR)	3.5	2.3	1.8	1.9	2.0	1.9	2.4	2.0	2.1
Real Final Domestic Demand (AR)	0.9	2.1	2.8	2.4	2.8	2.8	2.9	2.4	2.7
All Items CPI Inflation (Y/Y)	3.0	2.7	2.0	1.2	1.4	1.9	2.9	1.6	2.0
Core CPI Ex Indirect Taxes (Y/Y)	1.9	2.0	2.0	1.9	2.0	2.0	1.7	2.0	2.1
Unemployment Rate (%)	7.2	7.4	7.5	7.6	7.6	7.5	7.5	7.5	7.2

U.S.	11Q3A	11Q4F	12Q1F	12Q2F	12Q3F	12Q4F	2011F	2012F	2013F
Real GDP Growth (AR)	1.8	3.0	2.0	1.6	2.0	2.2	1.7	2.1	1.9
Real Final Sales (AR)	3.2	2.4	1.5	1.5	1.9	2.2	2.0	2.0	1.8
All Items CPI Inflation (Y/Y)	3.8	3.3	2.3	1.4	1.2	1.3	3.2	1.6	1.9
Core CPI Inflation (Y/Y)	1.9	2.2	2.1	2.1	1.9	1.8	1.7	2.0	2.0
Unemployment Rate (%)	9.1	8.7	8.6	8.7	8.8	8.7	9.0	8.7	8.6

CANADA

Despite weak hiring and trade figures to cap 2011, we've nudged up our Q4 GDP forecast by three ticks to 2.3%, given surprisingly robust consumer activity. Moving into 2012, GDP growth is still likely to track around 2% or so, as low interest rates provide less of an impetus to growth in the face of higher household debt levels, and governments continue to pull back from earlier stimulus.

UNITED STATES

The US economy picked up steam towards the end of 2011, and indications of improvement in the labour market from lower claims and stronger hiring have seen us slightly bump up our projection for 2012 GDP growth, to 2.1% from 1.9%. That still sluggish pace captures the risks to trade with Europe that we have already seen in recent data, and our expectation for somewhat weaker jobs growth ahead. Looking further ahead, the US faces its own fiscal squeeze in 2013, which will restrict the pace of recovery next year as well.

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