June 1, 2011

The Gradualist

by Avery Shenfeld

A central bank's task is to get the most out of an economy while avoiding the scourge of inflation. In the quarter-century after 1983, an era that became known as "The Great Moderation", the job seemed easy enough, as generally mild recessions and tame inflation allowed for a gentle steering in interest rates.

The Great Recession that followed has been blamed, in some quarters, on the glacial pace at which the Fed raised interest rates in the last expansion. But it was much more about too moderate a hand in regulatory, not interest rate, policy, which left US and European mortgage and credit markets steering towards an inevitable abyss. The economic shock meant that the moderate steering in interest rates went out the window as central banks cut rates in dramatic fashion.

In the current expansion, those in the monetary policy hot seat are once again back on a gradualist path. In most corners of the global economy, rate hikes are coming in dribbles, if at all.

That approach could prove problematic. Emerging-market policy makers look to be behind the curve in battling inflation through exchange rate adjustments (ideally) and/or interest rate hikes. The risks that raises for the global economy are twofold: an overheating in commodity prices that acts as a current headwind on the developed world, and second, the risks of miscalculating and excessively tightening later on if rates have to move up in a hurry in response to inflation.

In Canada, Governor Mark Carney could also be dubbed a gradualist, having thus far left real overnight rates significantly negative, despite judging the economy to be en route to its non-inflationary capacity within a year. The drags from an upcoming fiscal tightening, a tepid US economy and a strong Canadian dollar are good reasons for the Bank's hesitance thus far, particularly with commodity prices not offering as much of a boost as they would have historically (see pages 3-5).

In eschewing on a rate hike in May, the Bank's statement was dovish enough to have us drop our projection for another round of hikes beginning in July. We can understand the logic of that strategy, but it exposes Canada to the risk of having to take a less gradualist approach to rate hikes later on if inflation heats up. Holding rates low for longer could fuel what may already be a housing price overshoot. A sharper run-up in rates down the road will make a smooth price adjustment less attainable.

The alternative would be to deliver a couple of preemptive quarter-point hikes earlier, allowing room to keep on that gradualist path if the economy performs as expected and core inflation approaches the 2% target, but also leaving the door open to cutting rates again if it does not.

So while we're not forecasting a rate hike in July anymore, we've simply shifted that call to September. There are risks in waiting any longer should Canadian growth surprise to the upside.

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"There are risks in waiting any longer should Canadian growth surprise to the upside."

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MARKET CALL

- We see a rate hike by July as justified, but have doubts that the Bank of Canada sees it the same way. We therefore dropped it from our forecast, leaving three quarter point moves to the end of the year, with the first hike in September. The current lull in growth looks to be a one-time hit from gasoline prices and temporary supply chain disruptions, and if it gives way to a re-acceleration, monetary stimulus will have to be withdrawn.

- The bond market is at this point pricing in even fewer rate hikes, so look for pressure on two-year Canada's in a flattening bear market ahead. We trimmed our outlook for longer US yields in the wake of the market's rally, but if Europe's credit problems are simply pushed down the road, the flight to safety bid for Treasuries will fade.

- The Canadian dollar will be in a tug of war between two opposing forces: the advantages of wider short-term interest rate spreads vs. the US, but the disadvantages of a fading commodities rally and a generally more positive tone to the greenback. Call it a draw, and look for the C$ to be generally range-bound over the forecast horizon.

INTEREST & FOREIGN EXCHANGE RATES

		2011			**2012**			
END OF PERIOD:		**30-May**	**Sep**	**Dec**	**Mar**	**Jun**	**Sep**	**Dec**
CDA	Overnight target rate	1.00	1.25	1.75	1.75	1.75	1.75	2.00
	98-Day Treasury Bills	0.99	1.20	1.65	1.65	1.60	1.60	1.90
	2-Year Gov't Bond	1.50	1.80	2.20	2.10	2.20	2.40	2.75
	10-Year Gov't Bond	3.07	3.30	3.50	3.50	3.60	3.65	3.75
	30-Year Gov't Bond	3.50	3.60	3.65	3.70	3.80	3.85	3.95
U.S.	Federal Funds Rate	0.10	0.20	0.20	0.20	0.20	0.20	0.20
	91-Day Treasury Bills	0.04	0.10	0.15	0.15	0.15	0.15	0.20
	2-Year Gov't Note	0.48	0.50	0.60	0.75	0.80	0.85	1.00
	10-Year Gov't Note	3.07	3.20	3.35	3.40	3.70	3.75	3.85
	30-Year Gov't Bond	4.24	4.30	4.45	4.55	4.60	4.70	4.75
Canada - US T-Bill Spread		0.95	1.10	1.50	1.50	1.45	1.45	1.70
Canada - US 10-Year Bond Spread		-0.01	0.10	0.15	0.10	-0.10	-0.10	-0.10
Canada Yield Curve (30-Year — 2-Year)		2.00	1.80	1.45	1.60	1.60	1.45	1.20
US Yield Curve (30-Year — 2-Year)		3.77	3.80	3.85	3.80	3.80	3.85	3.75
EXCHANGE RATES	CADUSD	1.02	1.02	1.03	1.01	1.02	1.02	1.03
	USDCAD	0.98	0.98	0.97	0.99	0.98	0.98	0.97
	USDJPY	81	87	89	88	90	92	94
	EURUSD	1.43	1.36	1.34	1.30	1.35	1.34	1.32
	GBPUSD	1.65	1.60	1.62	1.62	1.67	1.65	1.65
	AUDUSD	1.07	0.98	0.97	0.98	1.03	1.01	1.00
	USDCHF	0.85	0.95	0.96	0.97	0.95	0.97	1.01
	USDBRL	1.59	1.62	1.65	1.62	1.60	1.58	1.56
	USDMXN	11.62	11.80	12.00	12.00	11.85	11.75	11.50

Commodity Prices: The More the Merrier for Canada?

Avery Shenfeld and Emanuella Enenajor

Canada's natural resource bounty is, no doubt, a blessing in an era in which commodities are getting expensive, while manufactured goods from clothing to high tech, seem to get ever cheaper. That shift in relative prices represents a winner in terms of living standards for Canadians, as a net exporter of commodities and a net importer of most consumer goods and business equipment. Comparing two points at which we were at full employment, Canada is better off in an equilibrium in which resource prices are high relative to what we buy abroad.

But an upward run in commodity prices is less likely to boost growth and get Canada to full employment as it might have been in the past. That largely reflects the new tendency for commodities demand growth to be overwhelmingly found in emerging markets (Chart 1) to which Canada has less direct ties.

The result is that a general rise in the Bank of Canada's commodity price index appears to have more modest benefits for Canadian GDP growth than was historically the case. Indeed, a vector autoregression analysis[1] of the relationship between the Bank of Canada's commodity price index, Canadian GDP and US GDP shows that an upward shock in that basket of resource prices tends to slightly lower the level of Canadian GDP (relative to the base case) over the period since 1995, excluding the recent recession. Further back, the linkage was measurably positive, raising the level of real output by more than 1% four quarters out (Chart 2).

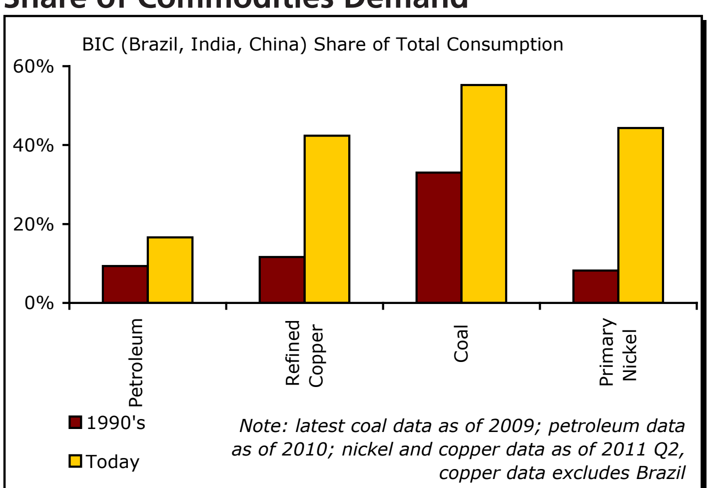
The New World Order

What lies behind that shift? Historically, when resource prices were on a demand-driven upswing (as opposed to a supply shock as we saw in oil in 1973), a booming US economy was part of that story, which meant good times for other Canadian exports. Not so today. Prices for copper, cotton, oil, gold, and other globally traded resources all reached multi-year highs despite America's economy sporting a roughly 5% output gap.

Looked at from 30,000 feet, the improvement in the terms of trade has been a stunning win for Canada, but real trade volumes have not, in fact, been that impressive in the past decade's run for resources. Net trade from 2000 to 2007, a period of huge gains in commodity prices, was actually a drag on growth in real terms, having been slightly positive in earlier decades (Chart 3). We earned more income from what we sold abroad, but we didn't sell more of it relative to the volume of imports, and that was during an expansion in which the US was doing much better than it is today.

Chart 1

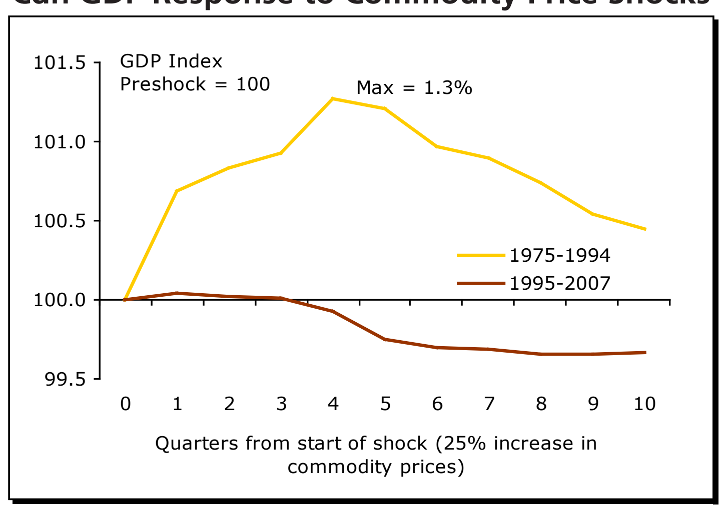
Key Emerging Markets Increase Their Share of Commodities Demand



Source: EIA, CRU, WBMS

Chart 2

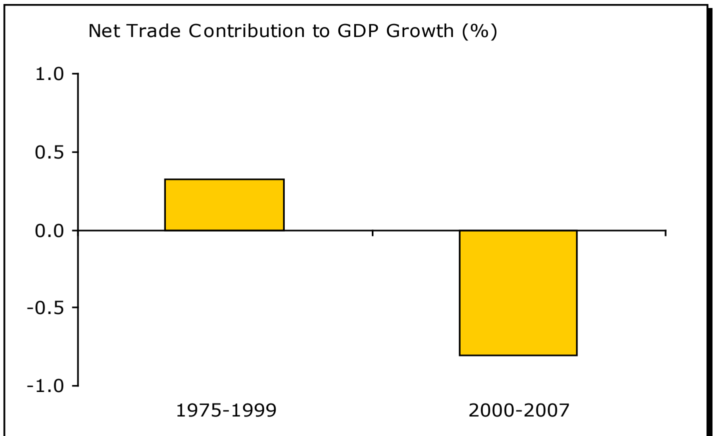
Cdn GDP Response to Commodity Price Shocks



[1] We regress the following variables: Bank of Canada Commodity Price Index, Canadian and US real GDP growth, CAD and 10-year government of Canada yield) on lagged values of each other. Our model is thus able to capture how a rise in commodity prices impacts Canadian GDP directly and via induced changes in the US economic growth, the exchange and interest rates.

Chart 3

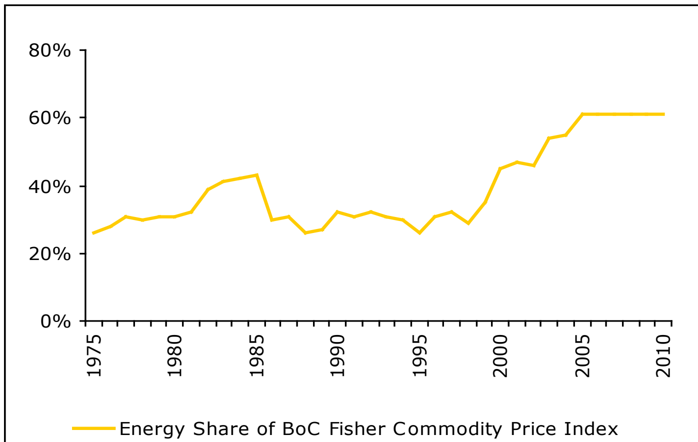
Trade Weighed on Cdn Growth in Last Expansion



Source: Statistics Canada

Chart 4

Canadian Commodity Output Tilting to Energy Sector



Source: Bank of Canada

Rather than booming, the US is being held back by the mess in its housing market, and to some extent, by high oil prices that have acted as a tax on American consumers. We estimate that the run-up in oil from $80 to $100/bbl chopped as much as a half-percent on US growth, as wages failed to keep pace with a gasoline-boosted CPI.

Consumers vs. Capital Spending

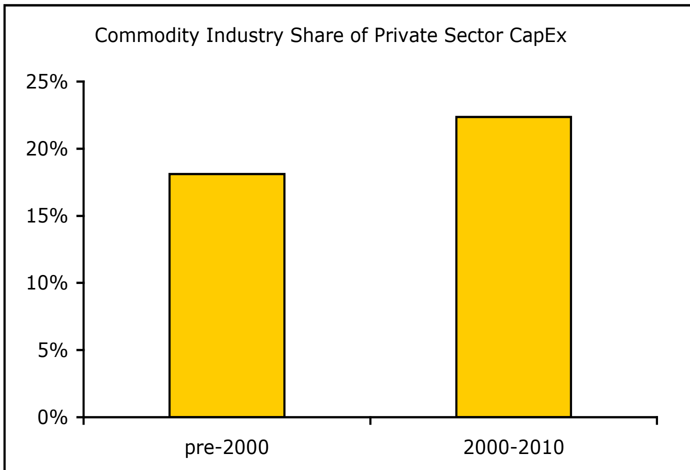
In Canada, our own consumers also face similar costs, although as shareholders in energy companies they are reaping the income effects of higher oil prices. Historically, Canada's commodity basket was well diversified, and included heavy weights for items that don't feature prominently in the CPI basket (e.g. forest products). In recent decades, the energy, and particularly oil's share of the basket has grown (Chart 4), meaning that a rising Bank of Canada commodity price index has weighed more heavily on real consumer spending power than it might have in the past when industrial commodities had a greater weight. Although wages and employment in the resource sector benefit from higher energy prices, that lift has not been sufficient to prevent gasoline purchases from eating up a higher share of incomes and retail sales.

While consumers might be constrained, capital spending in Canada's resource sector clearly benefits from higher resource prices. Such projects have accounted for roughly 22% of all private capital spending in the economy in recent years, up about 4%-points from the pre-2000 share (Chart 5). But it's not necessarily the case that extreme peaks in resource prices are needed to get the lion's share of that boost.

Take the oil sector, for example. Annual oil sands capital budgets were pared back during the recession's dive to less than $40/bbl prices, but those projects were ramped up again once crude recovered towards $80/bbl (Chart 6). Projects with hurdle rates above, say, $100/bbl are unlikely to be green-lighted unless crude spends a convincingly long period of time above that level, as capital budgets tend to use conservative assumptions. So at peak prices, we feel the hit to US growth and Canada's exports to that market without much of an offsetting lift to capital spending here.

Chart 5

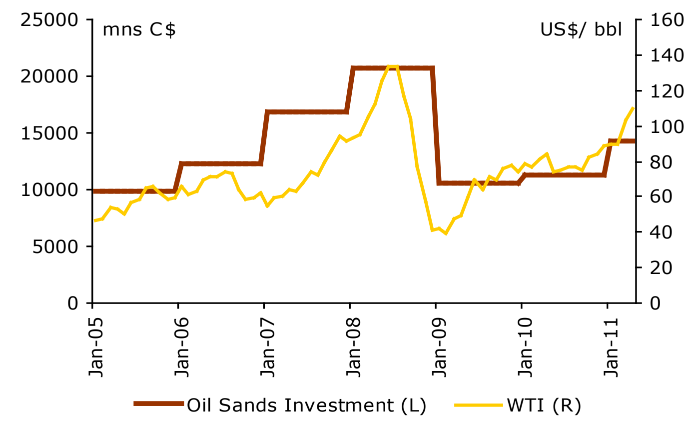
Increasing Importance of Commodity Sector Investment



Source: Statistics Canada

Chart 6

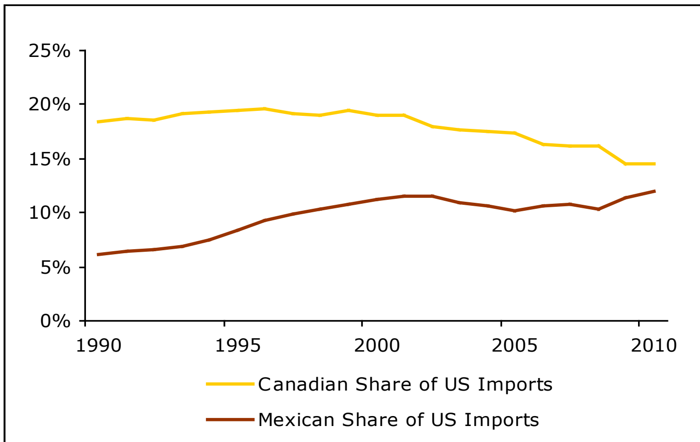
Oil Sands Investment Up on $80+ WTI



Source: CAPP, Statistics Canada, Haver Analytics

Chart 7

Canada's Eroding Share of US Imports



Source: BEA, US Census Bureau

Dollars and Dutch Disease

A further twist in the commodities-growth nexus is that the Canadian dollar has become more responsive to commodity prices. Indeed, the quarterly correlation has been nearly 100% of late, having been negative prior to 1995. While that does mean that those working have the benefit of greater global purchasing power, it also makes the economic drag on non-resource exporters more troubling, leaving a "Dutch disease" effect that makes it more difficult to attain full employment.

The tighter C$-commodity linkage is, in part, a side effect of a period in which some of the legs of support for resource prices are themselves a potential spur to Canadian dollar appreciation. First, new sources of investor demand for commodities, operating through vehicles such as ETFs, have been, in part, a response to fears of US$ devaluation, the latter a trend that also creates investor flows into the C$ as another big-dollar alternative.

Second, huge growth in some emerging markets, alongside efforts to control their exchange rates, led to a massive build-up in their foreign exchange reserves. Diversification of those reserves helped further boost the loonie in 2010.

Finally, the impact of the Dutch disease on Canada's factory sector has meant that what were once trade surpluses in auto parts, rail equipment and other manufactured goods are now deficits, leaving commodities as the sole source of Canada's trade surplus by the end of the last expansion, and making the currency even more tied to commodities.

That has meant that the economic boost to growth from rising resource sector capital spending is partially dulled by the drag on other exports from its consequences for the C$ and manufacturing competitiveness. Note that despite the higher prices for our resource exports, Canada has given up about a quarter of its former share of nominal US imports (Chart 7), with Mexico, a competitor in such areas as auto parts, picking up share over the same period.

The result of all of these forces is that commodity booms in prior decades were associated with less C$ appreciation, more US growth, a healthier Canadian factory sector and even more response in our resource export volumes than the two booms since 2000 (Table 1). That's despite the fact that these recent booms were more powerful in terms of the pace of resource price gains.

We're blessed by our resource base, but when it comes to commodity price rallies, it's not clear that the more the merrier holds true for Canada these days.

Table 1

Recent Booms Less Impressive for Canada

	Annualized Quarterly Growth Rate	
	Commodity Booms (pre-2000)[1]	**Commodity Booms (post-2000)[2]**
Bank of Canada Commodity Price Index	17%	22%
Commodity Export Volumes	5%	2%
Mfg Export Volumes	8%	1%
C$ Appreciation	4%	8%
US GDP Growth	4%	2%

[1] Geometric ave. Q3 1986-Q1 1989 and Q4 1998-Q4 2000;

[2] Geometric ave. for Q4 2001-Q2 2008 and Q1 2009-Q1 2011.

Source: Bank of Canada, Statistics Canada, Haver Analytics

Estimating the Odds of an Equity Bear Market

Peter Buchanan

A Cooler Spring for Stocks After a Hot Winter

Proving that sustained performance wins, the hare didn't prevail in Aesop's tale. After a surge to 2½ year highs earlier in 2011, North American equity markets have settled back into a more modest groove lately. While it's too early to write the epitaph for one of the past half century's strongest rallies, several forces could help to keep the market express rolling down a slower track for a while longer.

One restraint—though perhaps not such a bad thing seen in a broader context—is the reawakening of investors' appreciation for risk. Rekindled eurozone debt woes have contributed to the more cautious mindset in markets, as evidenced by the strong recent performance not only of government bonds, but other havens, like quality dividend stocks (Chart 1).

Also inspiring caution are perceptions that the global expansion may have already seen its best days, as efforts to cut deficits in the developed world compound the drag from higher energy prices and emerging market central bankers' efforts to tame hot inflation. After padding their growth estimates for 2011 only months ago, many forecasters have consequently been trimming them recently. The good news is that for the great majority of countries, a double dip recession doesn't look like a clear and present danger. The bad is that it looks more and more as if global growth this year will come in closer to our earlier scaled back 4% forecast than 2010's hot 5% pace. The US data revisions point to stiffer energy headwinds for the consumer even as capital spending is downshifting from its earlier vigourous clip. Nor have some of the global economy's strongest players been spared. The recent 10-month low in China's flash PMI, stalled auto sales and further central bank tightening all point to less toasty growth there.

Earnings News: Not Bad But the Bar Has Risen

While commodity prices remain at one of the highest levels on record, the recent modest correction has served to remind investors that those prices can move up and down, notwithstanding the obvious bullish implications in the longer run of rising demand from China and India. Resource stocks have trailed the TSX lately after pacing gains late last year. The curse of high expectations has also helped cool the rally's earlier momentum. Q1's 18% year-on-year rise in TSX earnings was good compared to the 7% longer term annual average. But it trailed pre-reporting season expectations for a rise of over 20%, as misses by energy and materials producers offset street-beating numbers from the telecoms, utilities and non-bank financials (Chart 2).

Chart 1

Quality Dividend Stocks Have Done Well Recently

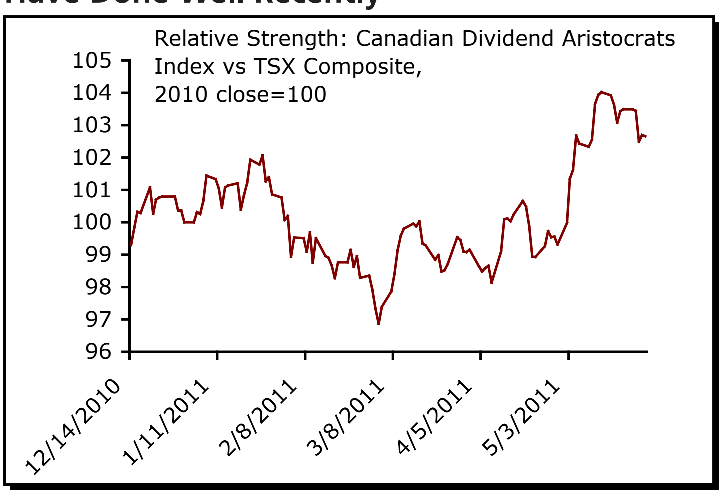
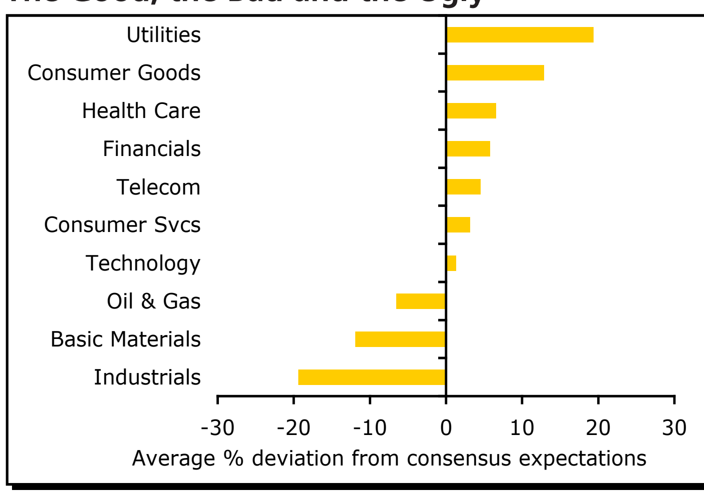


Chart 2

TSX Composite Q1 Earnings: The Good, the Bad and the Ugly



Source: Bloomberg

Some Pluses as Well as Challenges

Not all of the news has been bad, one reason why softer market performance does not in our view portend a sharp retreat. It appears all the more likely that central banks in both Canada and the US will hold their fire for a while longer (see page 1), given the recent growth and inflation data. That could help the TSX more than the S&P 500, given the Canadian market's appreciably higher 35% weighting in interest sensitive sectors (financials, utilities, telecoms) (Chart 3). The past month's 5% drop in US gasoline pump prices may also portend reduced headwinds from that quarter.

How TSX Fared After Earlier Oil/Resource Rallies

In terms of potential risk scenarios, an obvious one given the economic backdrop and a potentially firmer US dollar is that commodity prices could lose a bit more ground.

Our analysis (see pages 3-5) suggests that wouldn't be an unalloyed negative for Canada's economy, given the country's close ties with a heavily energy using US economy and damage to consumer pocket books. What might the effect be on equity valuations? While modest oil prices swings are a plus for Canadian stocks, the historical evidence would appear to suggest that large, recession inducing ones, which rob consumers of purchasing power and squeeze margins elsewhere in the economy, aren't.

The 1973-74 OPEC oil shock provides a case in point. The S&P 500 rebounded strongly from late 1974 on in that episode, as slowing growth eased pressure on energy markets, improving the general economic outlook. The TSX bottomed at precisely the same time as the US index in that episode, despite its greater energy weighting. The stimulus from falling energy costs also certainly contributed to the strength of the rebound in both stock markets in the aftermath of the recent recession. Although the energy sector lagged the market as a whole, the TSX nevertheless rose by 60% in the first year after the bottom, one of the strongest rallies on record (Chart 4).

Chart 3

TSX Has More Weight in Yield-Sensitive Areas

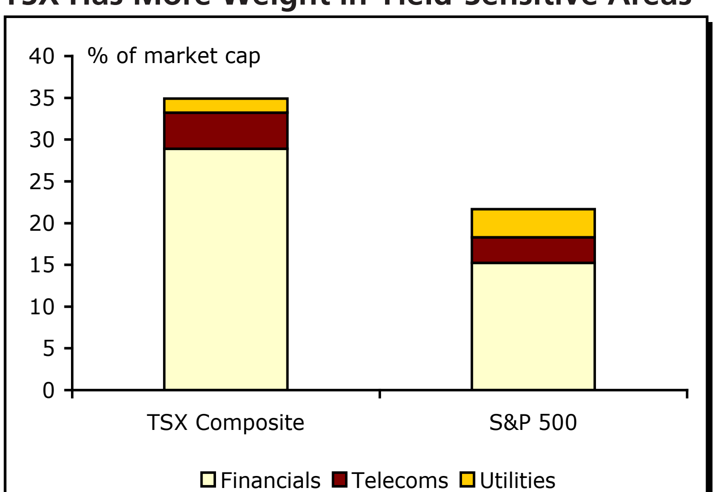
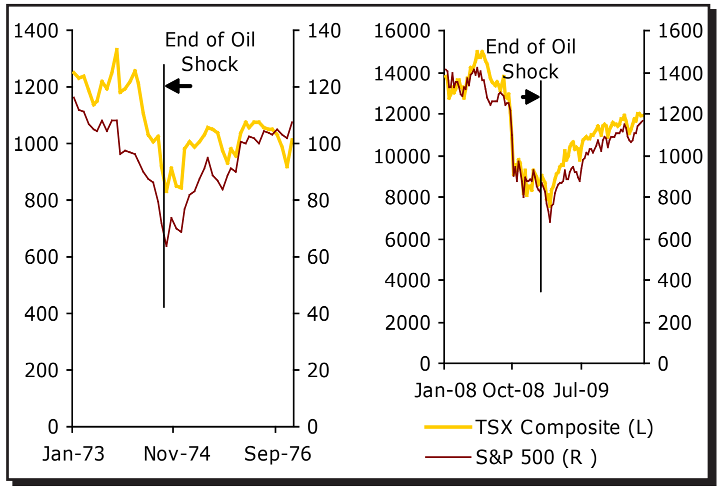


Chart 4

TSX & S&P 500 Rallied Together on Improving Growth Outlook After Past Oil Shocks



Handicapping the Odds on Future Bull and Bear Markets

If energy alone isn't such a decisive driver, what are the odds that other factors either tip the recent sell-off into a full-fledged bear market or send the TSX to new heights? In modelling those probabilities, we have chosen to focus on a three-month horizon, because that period is a relevant one for many investors and the predictive power of many indicators declines over longer time periods. The TSX has had ten rallies—defined loosely as a 20% rise in prices—since 1956, the earliest year for which consistent data is readily available. (Comparable data on the level and changes in forward earnings are, unfortunately, available only back to the mid-1980s.) The TSX has been in a bullish phase about 80% of the time in the past half-century, making that by far the most prevalent trading regime (Table 1, Chart 5).

The biblical reference to seven good harvests followed by seven meagre ones is one of the oldest references to "persistence" in asset markets. A Markov Chain, one

Chart 5

TSX's Time in Different Regimes Since 1956 (%)

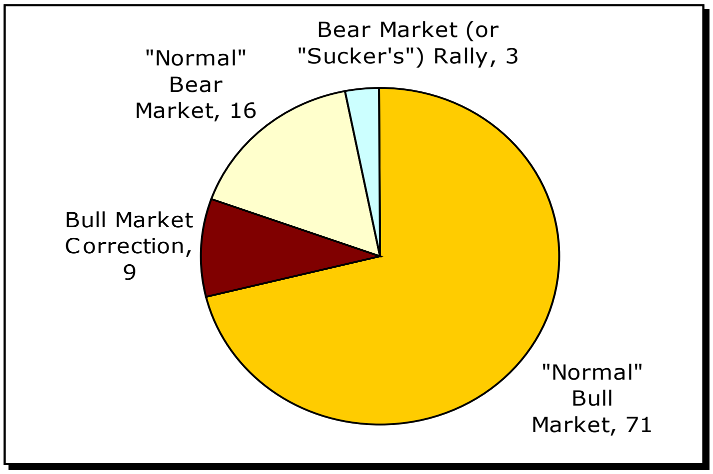
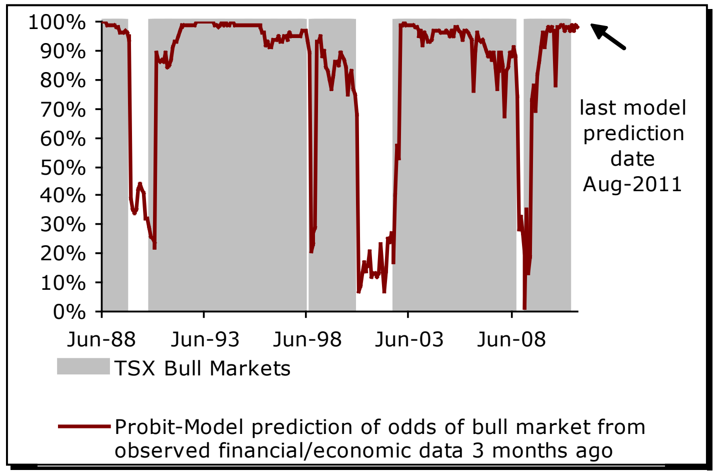


Chart 6

Actual and Predicted Bull and Bear Markets



*Probit Model — (market state 3 mo. ahead: bull=1, bear=0) = Φ [1.09 + .14 x (mo/mo US GDP chg.) + .0018 x (10 yr – 3 mo. GOC yield)** -.28 x (equity market liquidity) - .12 x (12 mo. fwd PE ratio)** +0.26 x (ratio of 12 mo. fwd to 12 mo. trailing earnings)** – .012 (3 mo. % chg. in CRB index) + 1.94 x (current market state: bull=1, bear=0)**]*

*Where 'market liquidity' is the TSX 60 bid ask spread and index earnings refer to survey and lagged historical numbers from Thomson Reuters. ** denotes statistical significance at the 10% level. Φ is the normal cumulative distribution function, as per the usual practice. US monthly GDP changes are interpolated from the quarterly data. The model was estimated over the May 1987 – May 2011 period.*

model of time-correlated performance used increasingly in modern financial analysis, holds that tomorrow's trading regime (e.g. bull or bear market), depends on today's state—but not on any earlier history. The transition probabilities in a Markov Chain (the odds, say, that a bull market this month will be followed by "a bull market correction" next) are fixed in the simplest case. However, a more complex but realistic and useful approach from an investment perspective, is where the odds of progressing from one market regime to another depend on the state of the economy, earnings and other financial variables.

Adopting the latter of these two approaches, we have used a probit regression on six financial and economic series and a variable representing the market's current state (i.e. bull market=1, or bear market=0) to calculate odds for a particular type of market performance three months ahead. A bull market-bear market indicator constructed this way has had considerable success tracking the timing of regime shifts since the mid-1980s (Chart 6). Using the latest data, it is currently placing under 5% odds on the start of a new bear market in the next two-three months, suggesting that the TSX's recent decline is a bull market correction. Our analysis suggests that the variables that convey the most information about future market performance are: 1) the slope of the yield curve, 2) the ratio of 12-month forward to trailing earnings, and 3) the 12-month forward PE ratio. That suggests investors might be well advised to pay close attention to these metrics, as part of their tracking of general economic and financial trends.

Table 1

Historical TSX Bull & Bear Markets

Bottom	Top	Rise (%)	Subsequent Decline (%)
Dec-57	Dec-61	62.2	-18.4
Sep-62	May-69	97.8	-28.3
Jun-70	Feb-74	54.8	-32.7
Dec-74	Nov-80	184.5	-44.0
Jul-82	Aug-87	205.5	-30.9
Nov-87	Aug-89	41.3	-25.1
Oct-90	May-98	158.1	-28.8
Aug-98	Sep-00	105.9	-50.0
Oct-02	Jun-08	164.7	-49.8
Mar-09	?		

A downshifting global recovery and assorted other developments have contributed to a cooler ride in equity markets recently. Within each economic cycle, there are typically many market ups and downs, jogs and short-term corrections. Although the situation bears watching, our analysis does not suggest a materially worse equity market outcome than that typical bump in the road.

Unleashing India's Potential

Benjamin Tal and Krishen Rangasamy

India has often been referred to as a sleeping giant as it has remained in China's economic shadow, despite its GDP growth averaging a healthy 6.5% a year over the last two decades. With its demographic advantages and more room to realign resources towards more productive areas of the economy, India could potentially outperform China in the coming decades and accordingly provide further tremendous opportunities for investors. But that potential is at risk of remaining unfulfilled, if some pressing challenges are not addressed.

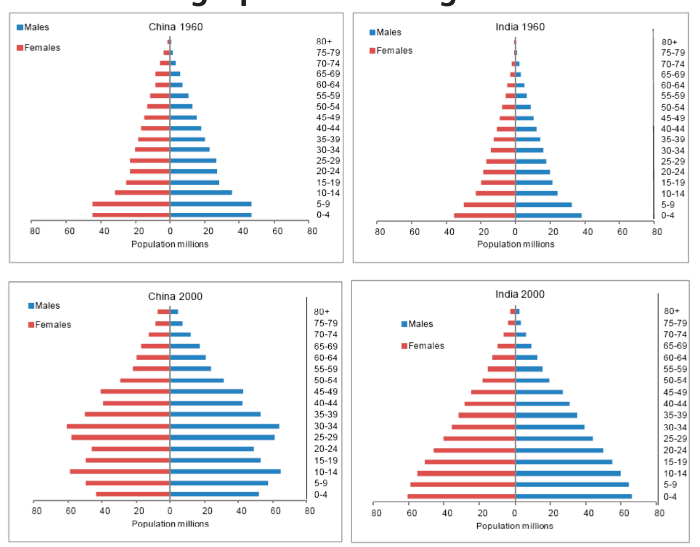
Demographics: Advantage India

On demographics alone, India is in many ways a quite attractive proposition for investors. The country already has the highest working-age population growth rates in the world and that advantage is likely to be preserved, with roughly a quarter of the increase in the global population in the 15–64 age bracket over the next three decades projected to be in India[1]. The increase in the proportion of the working-age group and the corresponding drop in the dependency ratio (i.e. the ratio of elderly and children to working age population), should help alleviate fiscal pressures and leave more room for savings to flow into investment spending rather than deficit finance.

The benefits to per capita GDP of a higher share of its population available to work give India an edge over China, where demographics aren't quite as favourable due to historic efforts to limit family size (Chart 1). India also has more scope for productivity gains from transferring resources to the manufacturing sector from the low-productivity agricultural sector. The latter currently accounts for 17.5% of GDP in India compared to an already trimmed-down 11% in China. Moreover, India's faster growing middle class (expected to reach 41% of the population by 2025 from 5% in 2005) is set to fuel domestic demand for decades to come[2].

Chart 1

India's Demographic Advantage Over China



Source: IMF

Need to Deal With Inflation Challenge

While India seems ready for take off, it faces some economic hurdles that could delay its launch. For one, inflation remains a major threat to growth. The spike in food and energy prices, which together account for over half of the weight in India's CPI, has pushed inflation to double digits until recently, prompting the Reserve Bank of India to raise its repo rate by 200 basis points in the last twelve months alone. Further tightening is needed to bring real interest rates into positive territory, and we expect the RBI to hike another 50 basis points in the third quarter en route to taking the repo rate to pre-recession levels of 9% by the end of next year (Table 1).

Banks are already passing such tightening signals to borrowers, and that's impacting investment demand. The growth rate in capital spending has come down quite steeply from 25% year-on-year in the second quarter to about 6% in the final quarter of 2010 (Chart 2). Clearly, higher rates are hurting corporate margins, and with the

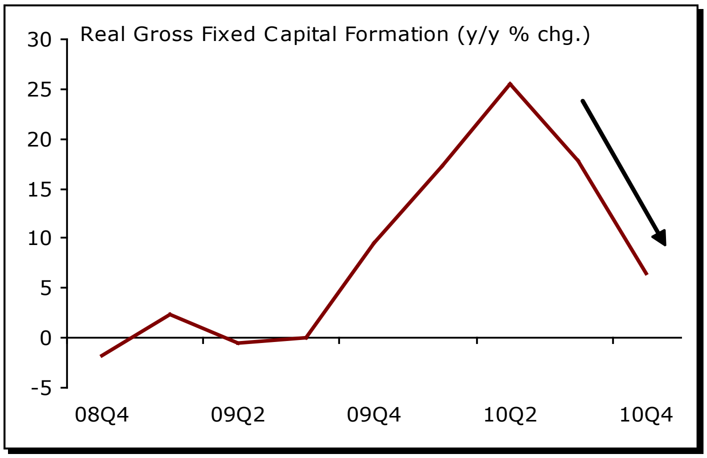
Table 1

Interest Rate and Exchange Rate Outlook

end of period	11Q1A	11Q2F	11Q3F	11Q4F	12Q1F	12Q2F	12Q3F	12Q4F	13Q1F	13Q2F	13Q3F	13Q4F
Repo rate	6.75	7.25	7.75	8.00	8.25	8.50	8.75	9.00	9.00	9.00	9.00	9.00
Rupee/US$	44.6	44.7	44.8	45.0	44.6	44.2	44.0	43.9	44.3	44.7	45.0	45.5

Chart 2

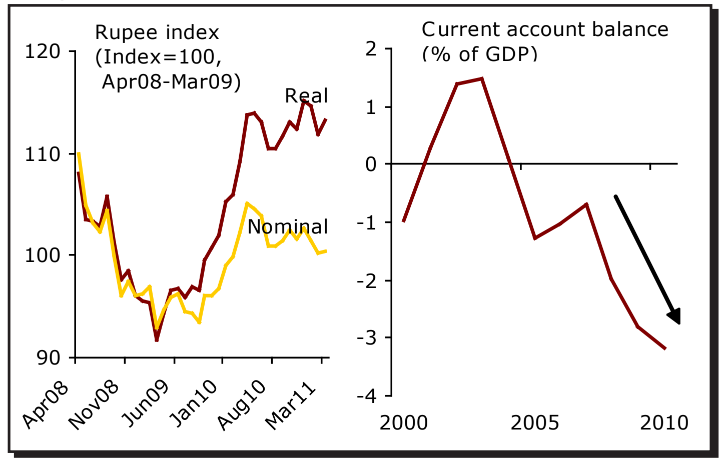
Investment Already Softening



Source: Haver Analytics, CIBC

Chart 3

Real Rupee Has Appreciated (L) Leaving a Larger Dent in India's External Balance (R)



Source: IMF, Reserve Bank of India, CIBC

RBI attempting to stay ahead of the curve, that will make the investment environment even weaker. Higher interest rates are also pushing up the savings rate. That trend will probably continue in the coming quarters, taking some steam out of consumption and holding GDP growth below 8% this year.

And high inflation is hurting not just the domestic economy. While India's currency, the rupee, remains weaker in nominal terms compared to before the global recession hit, the currency is now much stronger in real terms (Chart 3, left). High inflation in India relative to trade partners has caused the real rupee to appreciate, making Indian goods and services less competitive in global markets. That, coupled with rising domestic demand for imports, has caused the current account deficit to widen in recent years (Chart 3, right). More troubling is that the financing of the external deficit has come mostly via volatile portfolio flows. In fact, were it not for huge portfolio investment inflows into the IPO market in 2010, the rupee could have weakened significantly last year, in line with the steady decline in net FDI inflows.

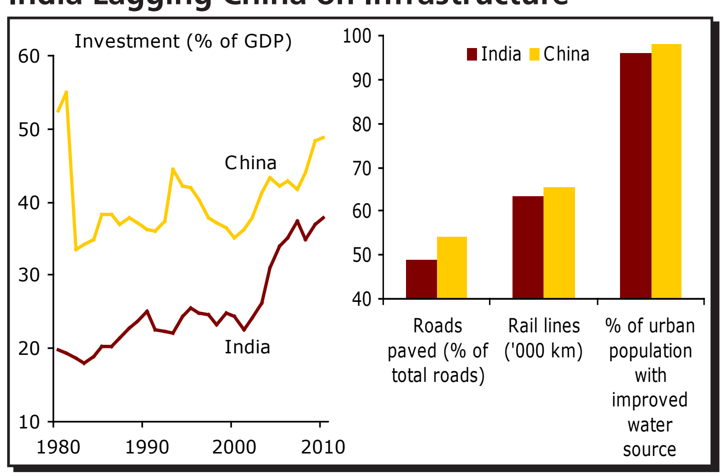
The large external imbalance remains the rupee's Achilles heel and that's why, despite India having favourable interest rate spreads and a buoyant economy, we expect any appreciation to be minimal through 2012. With the US Fed starting to hike rates in a couple of years and India's repo rate stabilizing near pre-recession levels then, expect the narrowing spread to take some steam out of the rupee/US$ exchange rate come 2013 (Table 1).

The Infrastructure Deficit and Supply Constraints

Another challenge to India's prosperity is its infrastructure deficit (Chart 4). The lack of a fully-modernized infrastructure system has been limiting productivity growth and clearly contributing to supply constraints, which are in turn feeding inflationary pressures. The still-deepening financial markets and bureaucratic red tape make it difficult for some infrastructure projects to be implemented. The government is attempting to address those issues by targeting wider private sector involvement. For instance, with regards to funding, the government is encouraging bank participation so as to tap retail investors. The authorities are also tackling the thorny issue of land compensation for displaced individuals. How quickly India capitalizes on its massive potential will depend, in large part, on how successful government

Chart 4

India Lagging China on Infrastructure



Source: IMF, World Bank, CIBC

reforms are in unleashing the wave of infrastructure projects that India so desperately needs.

Government Finances Need Improvement

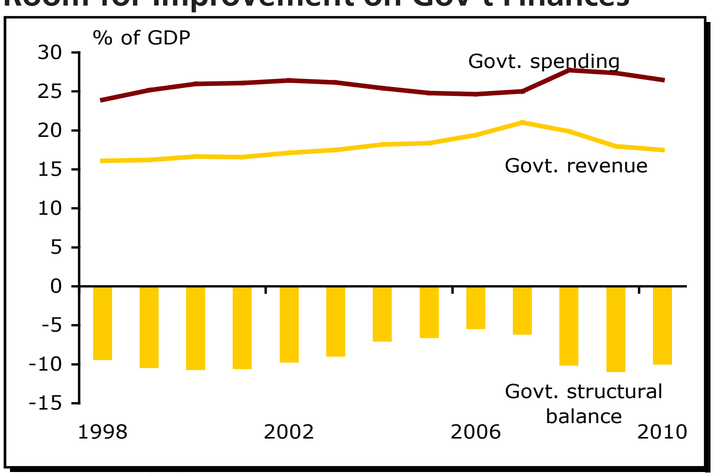
A third potential threat to India is its government finances. Last year, the budget deficit was over 10% of GDP and the public debt over 70% of GDP (Chart 5). The government is, accordingly, working towards a more sustainable path for the deficit. The thirteenth Finance Commission tabled in parliament last year called for the budget deficit to shrink by 4 percentage points of GDP, and for public debt-to-GDP to drop from 79% to 68% by 2014-15. Those targets seem ambitious given the hardships brought by the recent food price spike, which have increased the demands on the government to spend on food, fuel and fertilizer subsidies. So, for now, fiscal tightening towards the target is an unlikely scenario meaning that the RBI will have to continue shouldering the burden of reining in inflation. But letting monetary policy do all the heavy lifting for too long can be hazardous as India would have learnt from its own experience of the late 1990s when interest rates went up to 12% and growth slowed to 2%.

Opportunities for Canada

As India moves to overcome those challenges, opportunities will abound not just for the local population but also for countries with major trade links with India. Canada, for now, does not fall in that category, accounting for less than 1% of India's overall exports and imports last year. Distance between the two countries is an obvious impediment to trade, but controlling for that in a gravity model of trade (i.e. one using distance between trade partners and GDP of trade partners) to gauge India's trade potential with the rest of the world, we observe that trade with Canada has underperformed not just relative to potential (i.e. model estimates) but also relative to most of India's trade partners (Chart 6).

Chart 5

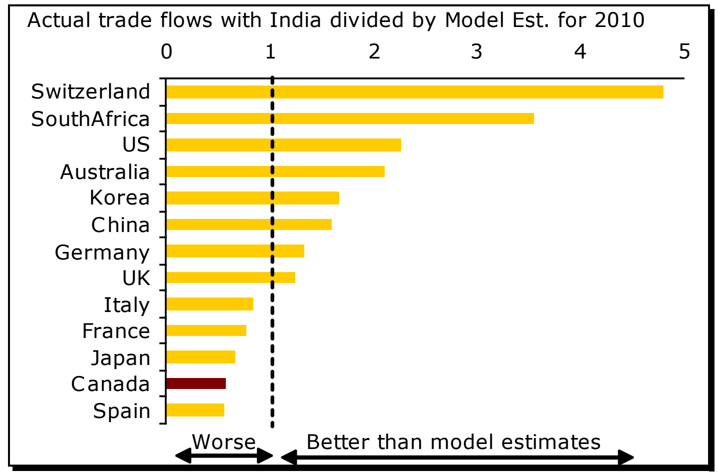
Room for Improvement on Gov't Finances



Source: IMF, CIBC

Chart 6

Canada-India Trade Has Underperformed Relative to Distance and GDP



Source: CIBC

And it's not as if India is consuming things that Canada doesn't produce. Machinery and transportation equipment which accounted for a good 10% of India's imports last year came predominantly from China, Germany and to a lesser extent the US. Gold and related jewellery, which represented another 10% of India's imports, were shipped primarily from Switzerland. Clearly, years of neglecting the Indian market, have put Canadian exporters at a disadvantage relative to competitors with deeper trade linkages with India.

That said, it's not too late for Canada to capitalize on India's economic ascent. There will be growing demand for a whole range of goods and services in which Canada has strength and holds a worldwide reputation, such as telecom and transportation equipment, heavy engineering, resources, education services, agriculture, nuclear power and more. Whether those opportunities translate into actual dollars, however, will depend on the willingness of Canadian corporations to look beyond near-term risks and broaden their search for markets abroad.

[1] *The Demographic Dividend, Evidence from the Indian States: Aiyar and Mody, 2011*

[2] *Seizing Opportunities for Canadians, India's Growth and Canada's Future Prosperity: The Standing Senate Committee on Foreign Affairs and International Trade, 2011*

ECONOMIC UPDATE

CANADA	11Q1A	11Q2F	11Q3F	11Q4F	12Q1F	12Q2F	12Q3F	2010A	2011F	2012F
Real GDP Growth (AR)	3.9	1.8	2.8	1.9	2.3	3.1	4.2	3.2	2.8	2.8
Real Final Domestic Demand (AR)	2.3	2.3	1.8	1.9	2.3	3.0	4.0	4.5	3.0	2.7
All Items CPI Inflation (Y/Y)	2.6	3.3	2.7	2.2	1.6	1.4	1.9	1.8	2.7	1.7
Core CPI Ex Indirect Taxes (Y/Y)	1.3	1.8	2.0	2.1	2.0	2.0	2.1	1.7	1.8	2.0
Unemployment Rate (%)	7.7	7.6	7.5	7.4	7.6	7.5	7.4	8.0	7.6	7.4

U.S.	11Q1A	11Q2F	11Q3F	11Q4F	12Q1F	12Q2F	12Q3F	2010A	2011F	2012F
Real GDP Growth (AR)	1.8	2.4	3.3	1.9	2.1	2.5	2.7	2.9	2.5	2.4
Real Final Sales (AR)	0.6	2.4	3.6	2.3	2.0	2.5	2.7	1.4	2.6	2.5
All Items CPI Inflation (Y/Y)	2.1	3.3	3.7	3.5	2.8	1.8	2.0	1.6	3.2	2.2
Core CPI Inflation (Y/Y)	1.1	1.3	1.4	1.6	1.8	1.7	1.9	1.0	1.3	1.9
Unemployment Rate (%)	8.9	9.0	9.1	9.2	9.2	9.0	8.8	9.6	9.0	8.9

CANADA

Q1 GDP came in near expectations at 3.9% as a surge in capital spending and inventory rebuilding more than offset soft consumption. Although the savings rate held steady, consumers were hit by eroded real incomes on higher gasoline prices and a drop in volatile government transfers. An end to such transitory factors should see personal consumption rebound, but a stall in the manufacturing sector and softer US activity could keep growth tame at a 1.8% pace in Q2. We still think that 2011 growth could track 2.8%, as temporary curtailments in activity get a boost in the latter half of the year.

UNITED STATES

A weak start to Q2, courtesy of adverse weather and supply-chain problems related to Japan's March earthquake, had us trim our call for the quarter's growth rate to 2.4%. Our forecast for 2011 as a whole remains unchanged, however, as we bumped up our Q3 forecast, expecting a rebound as normal production resumes. The slightly hotter-than-expected April CPI data had us raise our projections again for inflation, although we remain convinced, given the persistently high unemployment rate, that the Fed will not be raising interest rates this year and next.