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WHAT'S INSIDE:

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- Commodity Bust Prolongs C\$ Slide
- Premature Surge for European Currencies
- Yen Feeds Off Enhanced Risk-Aversion
- Aussie Finds a Floor, For Now
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CURRENCY STRATEGY HIGHLIGHTS

- **Still Trading Equities:** Currency traders are still trading equities, in effect, as the US dollar and the Japanese Yen gain on days when stocks tumble, and reverse course when stocks rebound. That makes it hard to pick a turning point for the C\$, since the global equity market has been plagued by forced selling by funds seeing redemptions or reductions in their available leverage.
- **Scope of C\$ Rebound:** While we see the C\$ rebounding in 2009, we've reduced the pace of appreciation we expect to see. A dampened global growth forecast means it will take longer for resource prices to recover lost ground.

EVENTS TO WATCH IN COMING MONTH

- **Stimulus Package and Bailouts:** With an all-star "Team Obama" already in place, markets have huge expectations for a fiscal plan due for unveiling by January. Even before then, Congress will again be looking at a request from automakers. Anything that reassures markets that the recession will be effectively addressed will be a plus for the growth-sensitive C\$.
- **Monetary Stimulus and Spreads:** Inflation is now a non-issue and central banks can be aggressive with interest rate cuts to complement side initiatives to assist the banking industry in thawing the frozen credit market. But keep an eye on corporate bond and CDS spreads for signs that rate cuts will flow through to corporate borrowers. Positive news on that front would be a plus for the C\$.
- **Québec Election:** Polls currently show the Liberals with a solid lead.

CURRENCY OUTLOOK

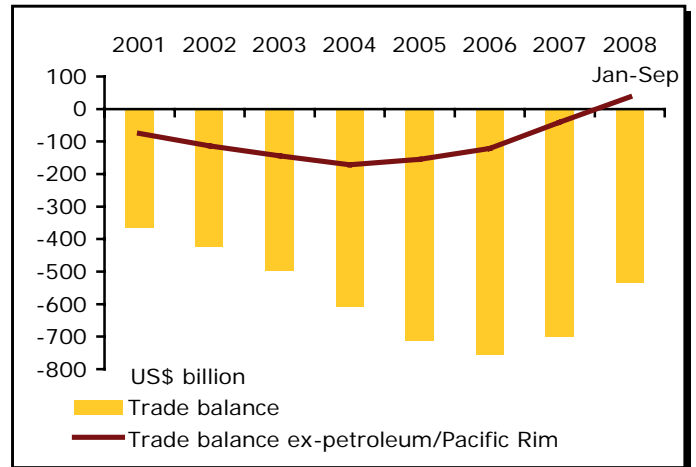
End of period:	2009 I	2009 II	2009 III	2009 IV
US\$ Rates:				
C\$/US\$	1.220	1.190	1.150	1.090
US\$/Euro	1.27	1.29	1.30	1.35
Yen/US\$	99	97	96	94
US\$/Sterling	1.55	1.59	1.63	1.70
SFr/US\$	1.20	1.19	1.19	1.19
US cents/A\$	68.0	70.0	73.0	75.0
Mex Peso/US\$	13.1	13.5	13.8	14.0
Euro crosses:				
Yen/Euro	126	125	125	127
Sterling/Euro	0.820	0.810	0.800	0.795
SFr/Euro	1.530	1.540	1.550	1.600

Deleveraging and Forced Dollar Buying: When Does it End?

After a traumatic month for major currencies against the US\$, the bleeding continued for most in November, albeit at a slower pace, with the unrelenting disintegration of global equity markets as the main driver. Deleveraging and losses on stocks around the world are forcing institutional investors into buying dollars and yen to cover short positions or to repay debts raised in those currencies, resulting in unprecedented volatility in foreign exchange markets. Moreover, demand for greenbacks and yen are being pumped further by the repatriation of those investments back home following divestment from crumbling overseas stock markets. As a result, major currencies are moving in lockstep with the stock market (Chart 1). Hence, forecasting an end to the currency rout is no easier than picking a stock market bottom.

What's clear, however, is that this US\$ rally will not be sustained by current account fundamentals, and we expect major currencies to make a comeback when markets revert to calm. But we expect that to benefit some more than others. Prior to the surge in the greenback, the bulk of the US trade deficit was with the Pacific Rim and petroleum exporting nations (Chart 2). While some of that deficit will be wiped out by cheaper oil, a now stronger US\$ will limit any further improvement in the trade balance and current account. To prevent the export sector from choking and to bring the current account deficit to a more sustainable level in 2009, the dollar will therefore have to depreciate significantly against China and other Pacific Rim exporters, and also against the currencies of oil exporting nations, including Canada.

Chart 2 - US Trade Balance



Commodity Bust Prolongs C\$ Slide

The loonie is trading at roughly the same level as when this publication went to press last month. But underneath this apparent stability has been unprecedented daily volatility, with the loonie falling as weak as 1.30 C\$/US\$ and trading as strong as 1.15 during that period. That range, more typical of a few years than a single month, has sent option volatilities soaring to record highs (Chart 3), making hedging anything other than a large move very expensive.

While much of the loonie's volatility and weakness can be traced back to the stock market, at least some of the currency's depreciation was due to a sharp deterioration in fundamentals. Canada is weathering recessionary conditions with a flagging export sector and sluggish consumption. The Bank of Canada not only revised its outlook in October, but by November was already citing downside risks to that fresh forecast, pointing to 75 bps

Chart 1 - World Currencies Driven by Stocks

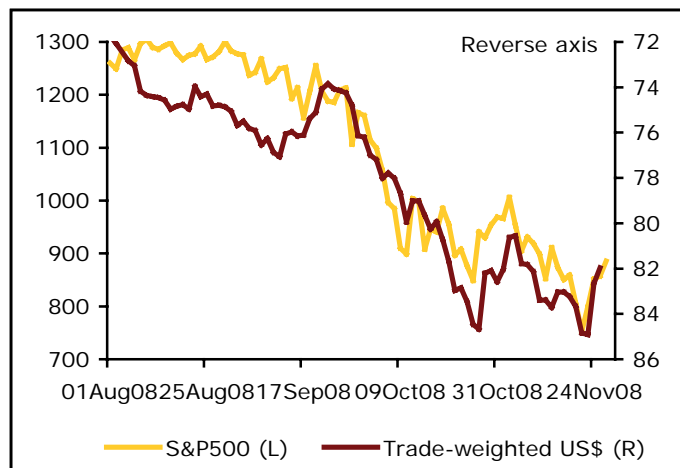


Chart 3 - Costly Hedging



of interest rate reductions still to come, more than the Fed has room for. Add to that a global recession that has taken oil, gas and metals prices sharply lower, and it's not difficult to see why the loonie is flying so low these days.

Until global growth and commodities pick up next year, it is difficult to see a quick comeback for the loonie, especially given that the commodity price crash is threatening to end Canada's run of nine consecutive years of current account surpluses (Chart 4), if only temporarily. Improved resource markets should have the current account in the black again by 2010.

Premature Surge for European Currencies

The euro made a comeback in November, shrugging off a worsening current account deficit and a recession. The eurozone economy contracted for the second successive quarter in Q3, and the souring economic mood was reflected in a plummeting IFO index to within a hair of an all-time low. The eurozone purchasing managers index hit a historic low in November, also a reflection of waning business confidence, while industrial production remains very weak. Consumer confidence isn't improving either, and real retail spending is in a tailspin. Europe's banking system was by some measures even more shell-shocked than that of the US, and new worries centre around their large exposures to a faltering Latin American market. The massive plunge in the Brazilian Real and Mexican peso enhanced default risks on dollar-denominated loans in those regions, and Eastern Europe has a similar problem

with foreign currency debt. Add it all up, and there will be plenty of bad news that could, in the near term, send the euro weaker again, as the weak economy makes it inevitable that the euro will lose much of its current yield advantage vs the dollar.

Unlike the euro, cable lost some more ground after October's rout, with the UK recession now in full flight. Industrial production is on the decline, house prices continue to fall and unemployment is on the rise. The re-capitalization of British banks will take some time to resume free-flow of credit and to restore confidence in financial markets. Credit growth is still being limited as suggested by low mortgage approval rates and weak consumer demand. The latter is, however, holding better than the eurozone (Chart 5). Sterling will continue to face headwinds in the near term, but should recover next year thanks to the expansionary effects of aggressive BOE rate cuts coupled with fiscal stimulus from Gordon Brown's government.

Yen Feeds Off Enhanced Risk-Aversion

Japan is in a recession but you wouldn't know it from its soaring currency. After reaching 13-year highs in the prior month, the yen has remained comfortable near those levels, buoyed by enhanced levels of risk aversion, and outperforming the greenback by over 15% so far this year. While the credit crunch has been bad for most currencies by raising perceived risks to global growth and decimating world equity markets, it has also curtailed carry trade activity, a big plus for the yen.

Chart 4 - Temporary End to Current Acct Surpluses

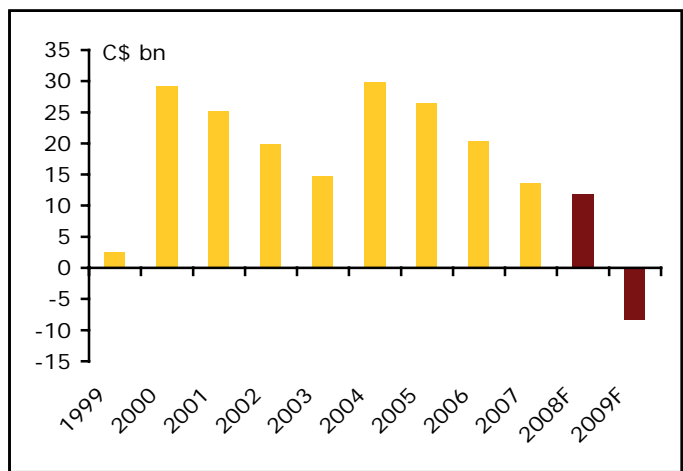
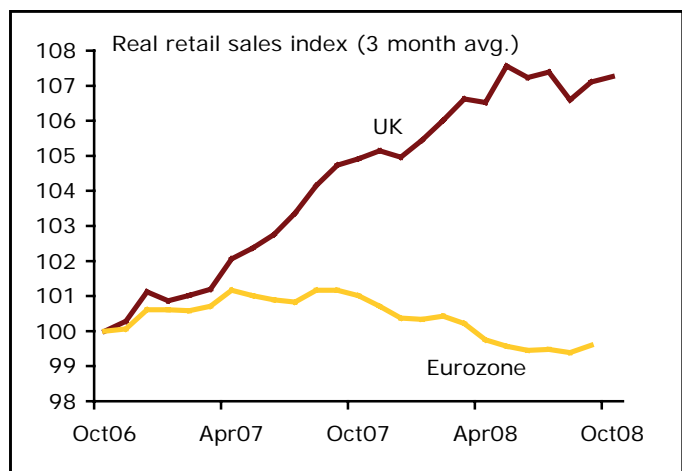


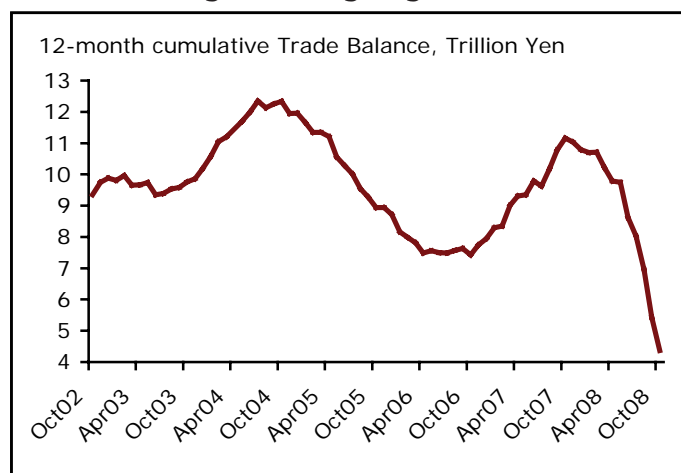
Chart 5 - Retailing Looks Worse on the Continent



Following two consecutive quarterly declines in GDP, the final quarter of the year is not looking good either, with the strong currency and a global recession devastating the export sector (Chart 6). Not surprisingly, industrial production is being curtailed to deal with those reduced shipments. Business confidence is also being eroded with the global recession, and this is discouraging investment in capital goods. Consumers are being stretched, with spending adversely affected by waning confidence and slow jobs growth.

The recent plunge in imported commodities will take inflation down and restore Japanese purchasing power. Together with the stimulus package, that will go some way towards reviving consumer demand. Japan should be back on the growth track next year as a stimulus-driven pick-up in global demand spurs Japanese exports again, while nominal imports will be contained by the fact that most imported commodities will see lower prices in yen terms. That should help restore the current account balance, and we therefore see the yen as able to hang on to its recent gains into 2009.

Chart 6 - Strong Yen Weighing on Trade



Aussie Finds a Floor, For Now

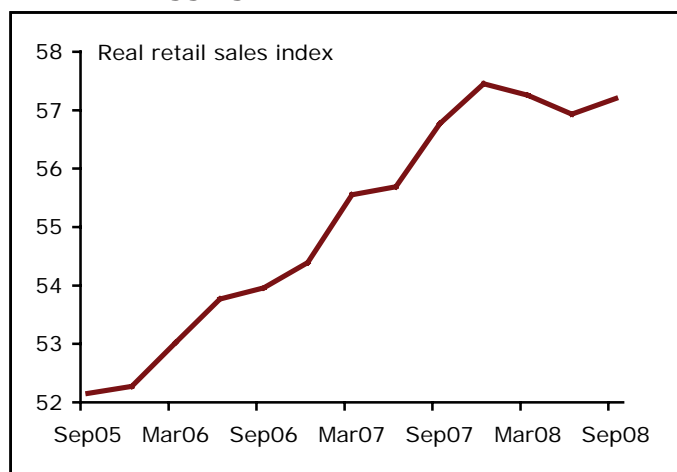
November was a good month for the Aussie, at least relatively speaking, with the 2% depreciation against the greenback feeling like a gentle breeze compared to October's typhoon. The main drivers of the Aussie's depreciation in the second half of this year, namely the erosion of its interest rate advantage and plummeting

commodities, now seem to have been well priced into the currency, as suggested by the latter's stabilization in recent weeks. While further stimulus is expected from the Reserve Bank of Australia, the pace of further cuts should be a bit more moderate, given the huge stimulus the RBA has already dispatched since October, and with government-led banking initiatives starting to bear fruit with a narrowing of credit spreads.

Supplementing the interest rate cuts is the recent fiscal stimulus package which will give Australia a better chance at steering clear of a recession that is knocking on the door down under. The credit crunch has constrained household credit, with a marked impact on domestic demand as suggested by weaker motor vehicle sales compared to last year and the flat retail volumes (Chart 7). The slowdown of the real estate markets and the loss of equity from the stock market collapse are also prime culprits for the stagnant state of consumption spending. And worse is to come with declining incomes resulting from the deterioration in the terms of trade and a softer jobs market, as employers adjust to new economic realities and start adjusting payroll to cope with weak demand and production.

We expect commodities to rally as global growth picks up late next year and help Australia in reducing its current account deficit. That should allow the Aussie to better deal with the loss of the country's yield advantage, and lay the groundwork for a more sustainable A\$ in the US\$0.70-0.75 range next year.

Chart 7 - Flagging Australian Consumers



Peso Lacks Support

High Mexican yields have failed to prevent capital outflows over the past couple of months, taking the peso to historic lows. While the currency recently made a brief comeback, that was mostly due to the Banco de Mexico intervention to defend the currency, which is clearly unsustainable. In fact, Mexico's economic fundamentals are deteriorating quickly thanks to the country's linkages to a US economy already in recession. The recent downgrade by Fitch on Mexico's debt was a belated recognition of the darkening economic picture.

The latest IGAE index, a measure of economic growth, was weaker than expected, reflecting soft retail and

weaker export performances as well as declining industrial production. Adding insult to the export injury is a plunge in oil revenue, driven by a lethal combination of lower prices and depleting reserves. All told, expect a widening of Mexico's current account deficit over the balance of the year, which would make for a more vulnerable peso should there be another sudden burst of capital outflows.

We expect yield spreads to narrow significantly over the coming months as the central bank dispatches aggressive rate cuts to address enhanced growth risks. While the peso is already near all-time lows, there is room for further depreciation as the US recession worsens and the Banco is seen to have fewer bullets left for intervention.

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