CIBC

Economics

Avery Shenfeld
(416) 594-7356
avery.shenfeld@cibc.ca

Benjamin Tal
(416) 956-3698
benjamin.tal@cibc.ca

Peter Buchanan
(416) 594-7354
peter.buchanan@cibc.ca

Warren Lovely
(416) 594-8041
warren.lovely@cibc.ca

Meny Grauman
(416) 956-6527
meny.grauman@cibc.ca

Krishen Rangasamy
(416) 956-3219
krishen.rangasamy@cibc.ca

"... what looks at first glance like a "V" might be better pronounced like a "U", with a longer wait for sustained brisk growth to return. "

ECONOMIC INSIGHTS

August 25, 2009

RECOVERY BVILDING

by Avery Shenfeld

You see it on formal Roman-style structures, with the name of the building seemingly misspelled. It reflects the absence in the classical alphabet of the letter "U", which began its life as a "V". And it might well be appropriate for where we will soon be headed.

While a North American recovery is indeed beginning to build, it will be a while before we have a clear picture of its strength and durability. The first leg of growth could prove a bit hotter than suspected, at least stateside. With government stimulus in the US kicking in just as manufacturers restart production to rebuild inventories, American third quarter growth could top 3%.

To some, that could look a lot like a "V" shaped rebound we're all hoping for. But the true measure of success will be just how quickly private sector final demand is coming back, after stripping out the one-time boosts coming from inventory rebuilding, cash for clunkers, first time homebuyer grants, and tax cuts. If, as we expect, the fragility of the US household sector and a still-strained financial system keeps private sector demand on a lackluster track, what looks at first glance like a "V" might be better pronounced like a "U", with a longer wait for sustained brisk growth to return.

Perhaps it's fortunate then that one letter not in the classical Latin alphabet was the "W". A "W" shaped recovery, or double-dip recession, was most notably seen in the early 1980s. Back then, amidst signs of an unwelcome jump in inflation, central banks declared "mission accomplished" too soon, and the subsequent retightening in rates was more than the economy could handle. But this time, there are few risks to a tame inflation outlook in Canada (see pages 3-5), and the US Fed would likely live with some inflation pressures rather than slam what it knows is a household sector still struggling to stay afloat on excessive debt. While the bond market has been pricing in rate hikes for the first half of 2010, that could be a full year premature.

Tightening fiscal policy too abruptly is a more material risk, but one that we won't face until 2011. Much of the US stimulus spending still lies ahead, although Buy America provisions and other features will have a notable impact in dampening its initial benefits for Canada (see pages 6-8).

The equity market, having rallied as fears of a depression faded, has seen some jitters over whether consumers in the US and Canada can sustain a true expansion. But earnings are at this point giving ample support (see pages 9-11) by beating pessimistic expectations. And contrary to the prevailing wisdom, this hasn't only been about cost cutting. Looking ahead, even a "U" shaped recovery leaves room for upside surprises in earnings that could take equities higher.

MARKET CALL

- Despite some modest upward revisions to our near term growth outlook, we've made no material change to our interest rate projections through 2010. Inflation will be tame enough, and growth sufficiently sluggish, for central banks in both the US and Canada to stay on hold until 2011. Short rates are betting otherwise, but the need for the economy to absorb fiscal belt tightening beyond 2010, and lingering impediments to a "V" shaped rebound, give both Carney and Bernanke reason to be patient.

- Long rates are not as readily controlled by central bankers, particularly in the face of growing deficit financing needs and a shift into equities from bonds. We like Canadas to outperform Treasuries, only partly due to lighter supply relative to the size of the economy. The absence of quantitative easing will make it easier for the Bank of Canada to manage policy towards its 2% CPI target beyond 2010, and the absence of as large a household and government debt burden makes it less tempting to ignore those inflation objectives than will be the case stateside.

- We're sticking with our view that the correlation of nearly one between global equity market gains and the C$ will have to break down soon, lest the currency be pushed too strong, too soon, to allow the Canadian export sector to rebound. But admittedly, the market is trying our patience, by sending the loonie to much firmer levels than current commodity or trade balances prices warrant.

INTEREST & FOREIGN EXCHANGE RATES

		2009		2010			
END OF PERIOD:		**24-Aug**	**Dec**	**Mar**	**Jun**	**Sep**	**Dec**
CDA	Overnight target rate	0.25	0.25	0.25	0.25	0.25	0.25
	98-Day Treasury Bills	0.20	0.23	0.25	0.30	0.30	0.30
	2-Year Gov't Bond	1.32	1.15	1.25	1.30	1.40	1.60
	10-Year Gov't Bond	3.43	3.30	3.50	3.70	3.85	3.95
	30-Year Gov't Bond	3.91	3.90	4.10	4.25	4.30	4.35
U.S.	Federal Funds Rate	0.25	0.25	0.25	0.25	0.25	0.25
	91-Day Treasury Bills	0.16	0.15	0.15	0.20	0.25	0.25
	2-Year Gov't Note	1.02	0.95	1.20	1.30	1.45	1.65
	10-Year Gov't Note	3.48	3.50	3.85	4.05	4.20	4.35
	30-Year Gov't Bond	4.27	4.50	4.70	4.95	5.00	5.00
Canada - US T-Bill Spread		0.04	0.08	0.10	0.10	0.05	0.05
Canada - US 10-Year Bond Spread		-0.05	-0.20	-0.35	-0.35	-0.35	-0.40
Canada Yield Curve (30-Year — 2-Year)		2.60	2.75	2.85	2.95	2.90	2.75
US Yield Curve (30-Year — 2-Year)		3.24	3.55	3.50	3.65	3.55	3.35
EXCHANGE RATES	CADUSD	0.929	0.855	0.877	0.909	0.926	0.943
	USDCAD	1.077	1.170	1.140	1.100	1.080	1.060
	USDJPY	95	97	95	90	89	87
	EURUSD	1.43	1.35	1.35	1.37	1.39	1.40
	GBPUSD	1.64	1.58	1.59	1.62	1.64	1.67
	AUDUSD	0.838	0.795	0.825	0.855	0.875	0.895
	USDCHF	1.06	1.11	1.11	1.09	1.08	1.08
	USDBRL	1.84	2.01	1.95	1.87	1.83	1.79
	USDMXN	12.9	14.0	13.0	12.7	12.5	12.5

Canadian Inflation: Why It Still Matters, Where It's Going

Avery Shenfeld and Krishen Rangasamy

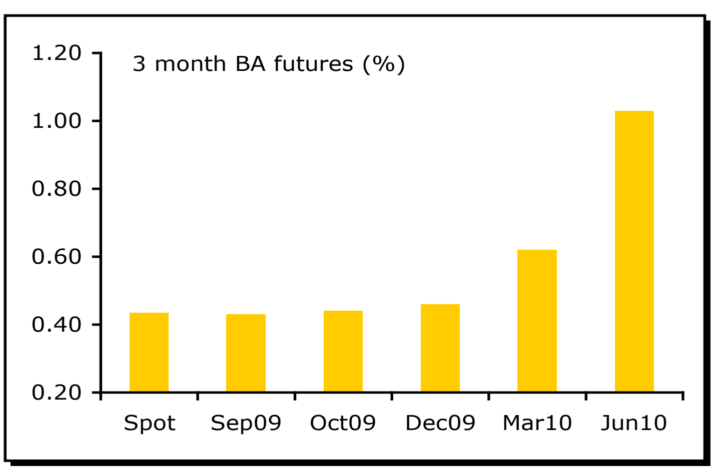
Raise the issue of inflation in Canada these days and you'll get some quizzical looks. Not because of any particular view on it, but because neither inflation nor deflation seems to be a serious threat. Prices are actually down from a year ago, but true deflation seems a limited risk, given that the CPI drop since July 2008 is nearly all about energy prices, which will be higher on a year-on-year basis by year end. The flip side is that excessive inflation seems an equally unlikely problem in an economy with so much slack.

So why even *talk* about Canada's CPI? Because with an inflation targeting central bank, it's really all that matters for a fixed income market now trying to pin down when we can expect a turn to higher interest rates. Over the past few months, the market has, on an on-again, off-again basis, priced in some odds of a rate hike in the first half of the 2010 (Chart 1). If that doesn't happen, buying short term bonds on dips will be a profitable strategy.

As it turns out, it's the inflation outlook, not economic growth, that's really the only risk to that trade. The Bank of Canada has pledged to keep rates on hold until at least mid-2010, but you admittedly have to attach an asterisk to that promise; it's "conditional" on the economy performing along the lines of the Bank's projection. Given that the Bank's consensus-topping forecast has the economy advancing at an optimistic 4% quarterly clip in the first half of 2010, it will be hard for Canadian real GDP to surprise enough on the high side to compel the breaking of that pledge.

Chart 1

Markets Expecting Rate Hike in First Half 2010



Hitting the Bank's inflation projections, particularly for core CPI, is less obvious, however. Note that core CPI has already been misbehaving a bit, relative to Carney's dovish outlook back in April (Chart 2). Having failed to see the predicted deceleration to a 1.6% core rate in Q2, the Bank simply shifted that target into Q3. While it has lifted its forecast further out, it still has core inflation tracking at tame levels through 2010. Having raised its forecast once, will it have to do so again? Not likely.

Why the Delay?

A look at the underlying components of headline and core inflation helps identify what has, in our view temporarily, prevented core inflation from easing much thus far. And part of the answer lies in what economists call, the "income effect."

Ironically, it's the very steep plunge in some of the items stripped out of CPI to calculate the core measure that has delayed the easing in the latter. That headline CPI is negative owes mostly to the dive in gasoline prices from a year ago. But lower gas prices have also pulled down costs for intercity transportation fares, which the Bank of Canada excludes from core inflation. Other non-core items covering natural gas, fuel oil and mortgage interest costs, have also eased off (Chart 3).

Chart 2

Bank of Canada Core CPI Forecasts Revised Higher

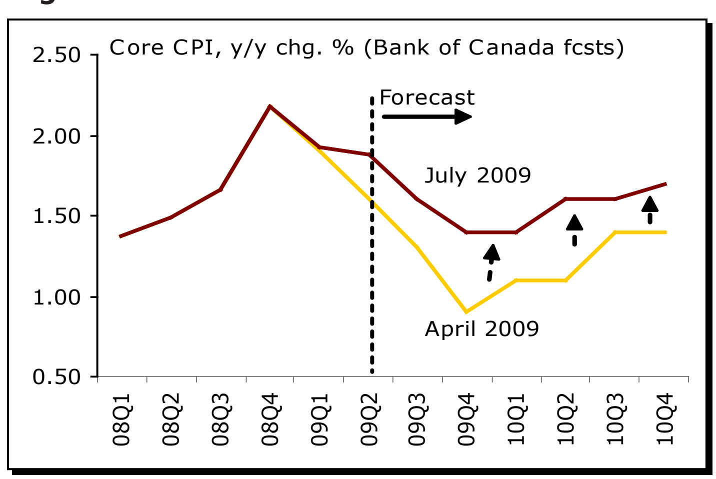


Chart 3

Non-Core Components of CPI Have Plunged

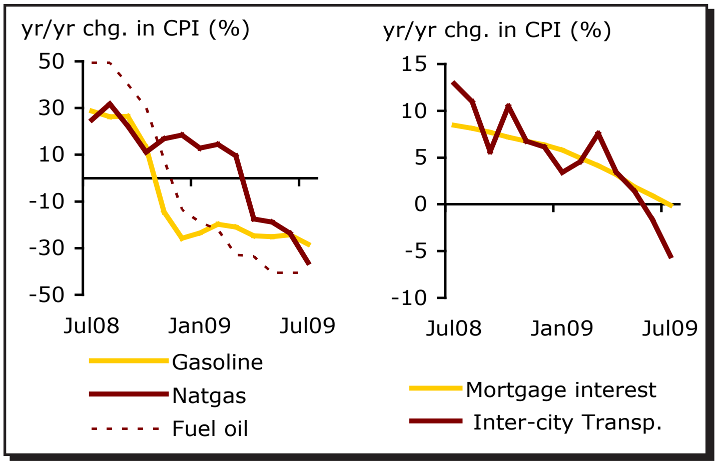
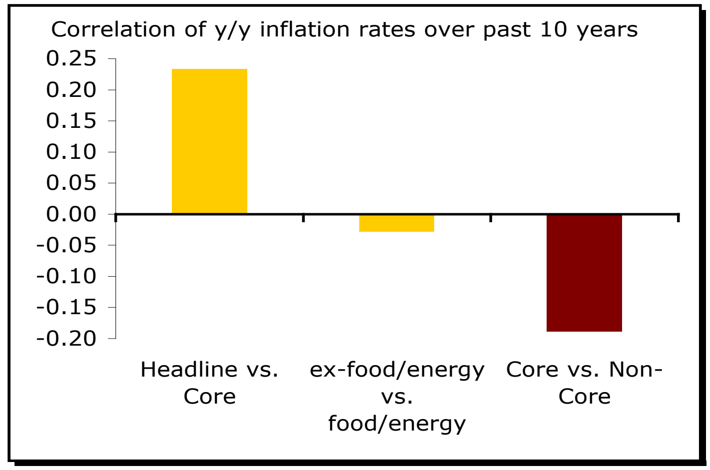


Chart 5

Core and Non-Core Inflation Negatively Correlated



Hence, in stripping out volatile items from the CPI, the Bank of Canada's core measure excludes most of what's been deflating, much more so than in the "old" core measure that simply left out all food and energy prices. That earlier measure of core inflation, still in use stateside, is now running 0.8%-pts below the new core.

The deep dive in non-core items, which pushed CPI into negative territory, has left those Canadians still working with some spending power. While nominal wages have begun to decelerate in a slack labour market, a negative year-on-year inflation rate has meant that in real terms, the buying power of the average wage has escalated (Chart 4). So after filling their gas tank and paying their new, lower, mortgage bills, Canadians simply have more money in their pockets when they go shopping for other items, keeping those prices aloft. Indeed, over the past decade, the items in core CPI have had a negative correlation with the volatile items excluded from the core (Chart 5). Last year high gasoline prices depleted demand and pricing power for other goods and services, particularly since the item most directly impacted by energy costs—airline and other transportation fees—is also excluded from core.

The second reason for the delay in getting core inflation down is simply that economic slack usually takes time in exerting its disinflationary force. Wages get adjusted only as contracts come up, some prices are fixed ahead of time (as is the case for catalogues), and inflationary expectations are sticky. Note that in the prior two recessions, the 12-month core rate only responded with a lag to the ballooning negative output gap (Chart 6), although in this case we have to use the former core measure (CPI excluding food and energy) since longer term historical data are unavailable for the new definition.

Chart 4

Real Wages Have Increased

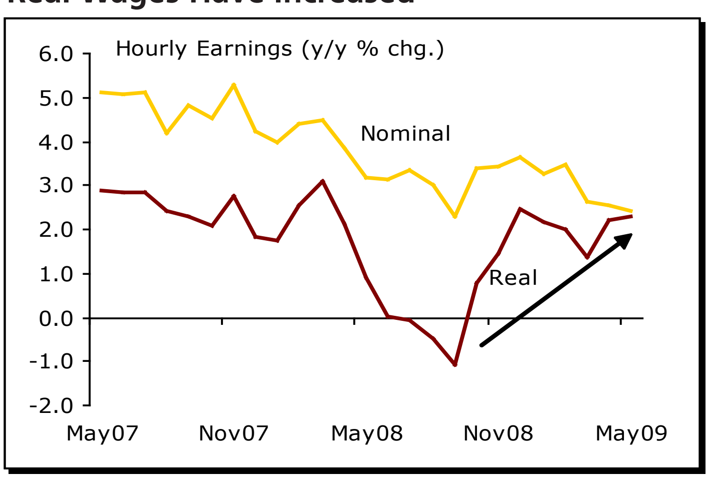


Chart 6

Falling Core Inflation Tends to Lag Large Drops in Output Gap

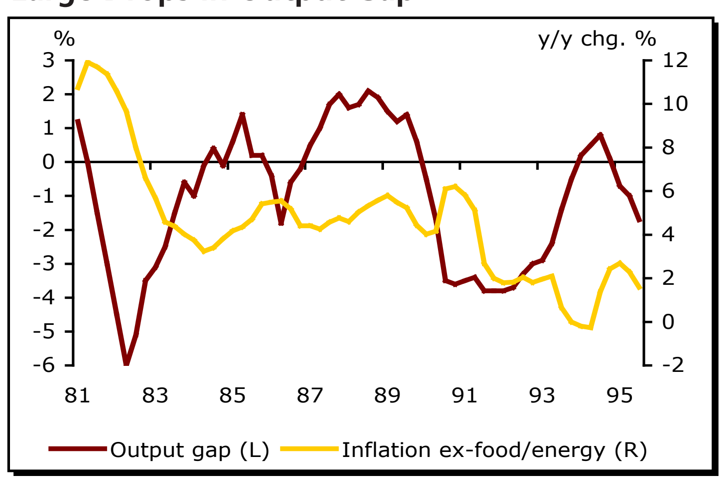
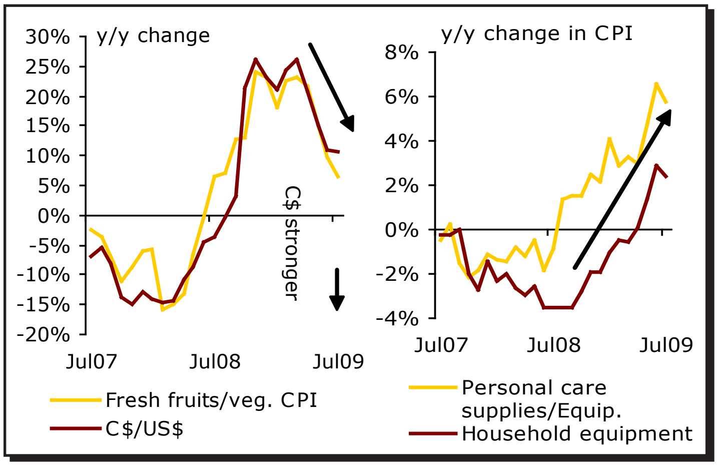


Chart 7

Some Imported CPI Components Track the C$ (L), Others Don't Immediately Do So (R)



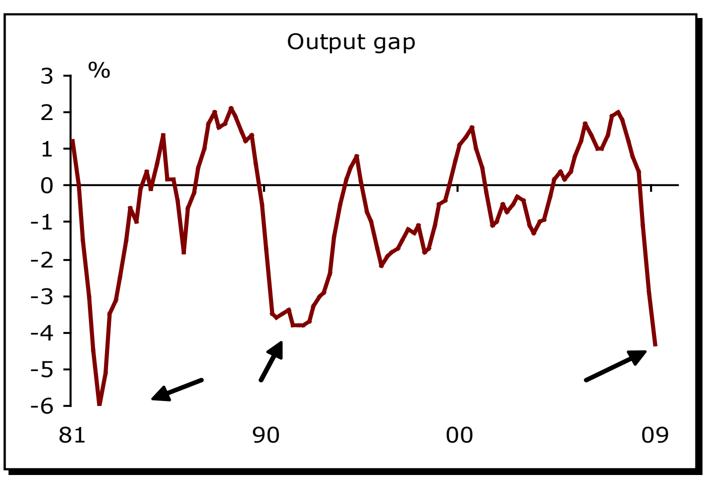
Another possible explanation for the stickiness in core inflation is the asymmetric impacts of the strengthening C$ on consumer products. While currency movements almost immediately impact some items in the headline, notably those with high import content such as fresh fruits and vegetables (Chart 7, left), several factors conspire to diminish and delay currency pass-through to other imported consumer products (Chart 7, right) many of which are part of core inflation. For instance, transportation costs as well as wholesale and retail margins are purely Canadian costs and they are set irrespective of the currency. Import contracts and FX hedges by importers also delay the pass-through from a stronger C$ into lower retail prices.

What Lies Ahead

While the 2009 recession may already be over, the slack it created is both large and likely to persist. Unlike the Bank of Canada, we don't expect growth to average above the non-inflationary potential until 2011. But even under Governor Carney's more optimistic trajectory, inflation will still be feeling the downward pressure of a sizeable output gap next year, one as large as we saw in the early 1980s and 1990s downturns (Chart 8).

Chart 8

Economic Slack as Large as in Prior Downturns

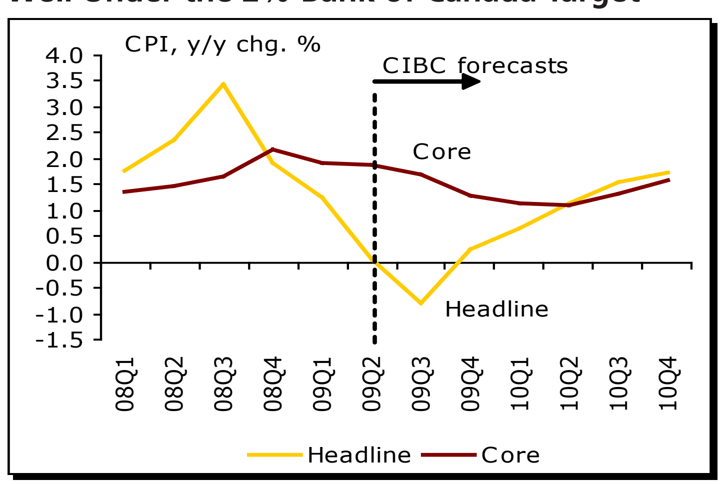


Headline inflation rates won't be as benign as they have been. If crude oil hugs the $60-70 range, energy will revert from a huge negative contributor to CPI to a modest positive in early 2010, with spillovers into related products like airline fares. But by reversing the "income effects" noted above, that implies diminished buying power for other goods, contributing to a cooling in core CPI. Finally, as we've seen, if growth accelerates as much as the Bank of Canada assumes, the market will be inclined to bid up the Canadian dollar (along with other commodities currencies). With a lag, that will provide a dampening impact on retail prices for imported goods and services.

All told, Governor Carney will not fret about the stickiness of core inflation because, given time, core prices will come down. Look for headline and core prices to cross paths in the second quarter of 2010, at a level well under the Bank of Canada's 2% target (Chart 9). As a result, Canada's inflation rate will be no threat to the Bank easily fulfilling its pledge to keep interest rates at a slim quarter point through mid-2010. Indeed, if as we expect, sluggish final demand keeps the economy on a tamer trajectory than the Bank hopes, it will be able to defer the first hike until early 2011. Like low interest rates? Get used to them for a while longer.

Chart 9

Headline and Core Inflation to Cross Paths Well Under the 2% Bank of Canada Target



What the US Stimulus Package Means for the Canadian Recovery

Benjamin Tal and Meny Grauman

Although officials at the Bank of Canada remain cautious about growth prospects for the rest of 2009, they appear to be very upbeat about the economic outlook for next year. So much so that their 4% real GDP growth call for 2010 is twice our forecast (Chart 1). Such a strong bounce-back in economic activity is largely based on the hope that a favourable sectoral distribution of the US recovery will lift Canadian exports. That would not be unusual in the wake of a normal recession. But the nature of the budding recovery will be very different than what we have seen in the past, with US consumer spending taking a back seat to government stimulus. Add in the bite of US protectionism, and the benefit to Canadian exports is likely to be much more modest this time around.

Not Your Father's Economic Recovery

As usual, the Bank's GDP forecast is based on an array of assumptions including the value of the Canadian dollar and the level of interest rates. But because of the central role that US demand plays in the Canadian economy, its key forecasting tool is its "US activity index". That index is supposed to measure how economic growth in the US will translate into growth north of the border by weighting specific US demand and production variables according to the relative size of the related category in total Canadian exports. While that would normally be a very reasonable approach to estimating Canadian economic output, relying on the historical linkages between Canada and the US to predict next year's GDP is a risky proposition, given that the upcoming US recovery will be all but typical.

Every past US economic recovery in the post-war era has been led by the consumer sector, with an average contribution of more than 3 percentage points to GDP growth in the first year after a recession. By contrast, the average contribution of total government spending to the early stages of any post-war recovery has been negligible. Unfortunately for Canada, the 2010 recovery will turn this pattern on its head.

The new American consumer is a shadow of his former self. Deleveraging and rising saving rates, along with a still weak labour market, suggest that consumer spending will contribute a mere 0.4 percentage points to 2010 growth, while at the same time hundreds of billions in fiscal stimulus dollars should boost 2010 real GDP growth by double that amount (Chart 2). With the public sector acting as the main driver of the US economy next year, any assessment of Canadian GDP growth must focus on how Canada-friendly President Obama's stimulus plan really is.

In Stimulus We Trust

To do that we need to take a closer look at the plan itself. Officially titled the American Recovery and Reinvestment

Chart 1

Two Views of Canada's Growth Outlook

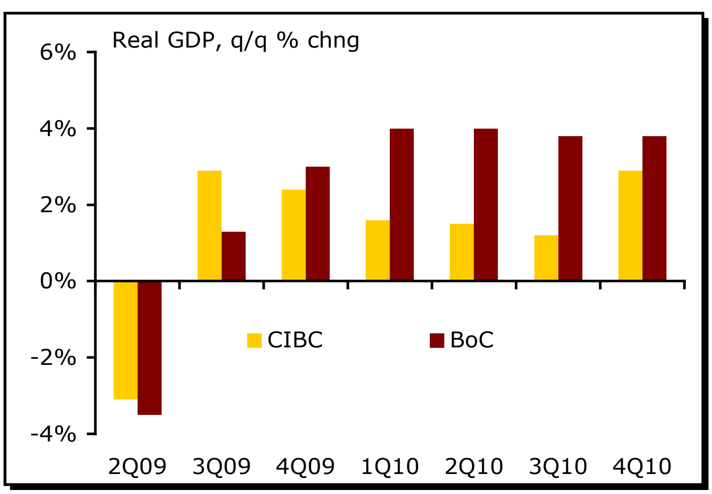


Chart 2

US Rebound Will Lean Heavily on Government

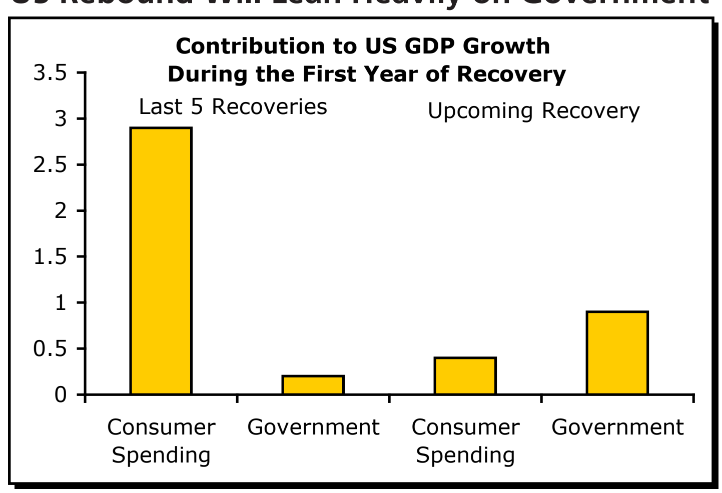
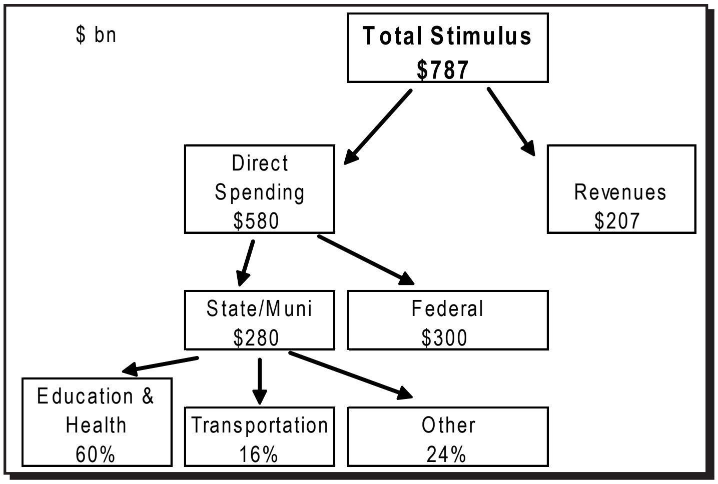


Chart 3

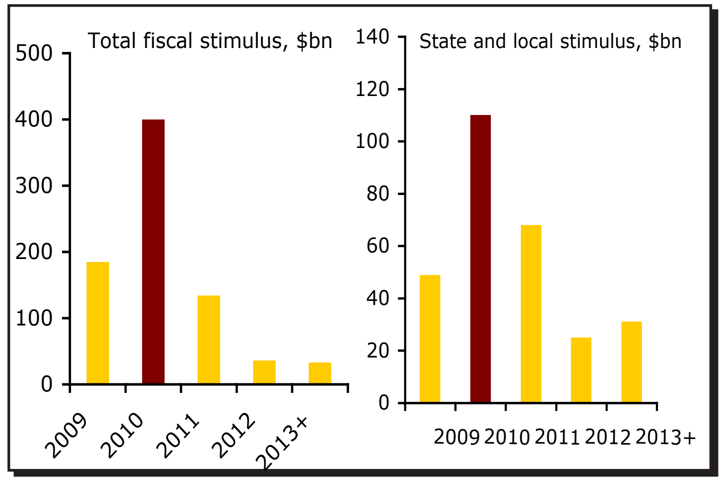
Where the US Stimulus Package is Going



Source: GAO

Chart 4

US Fiscal Boost Peaks in 2010

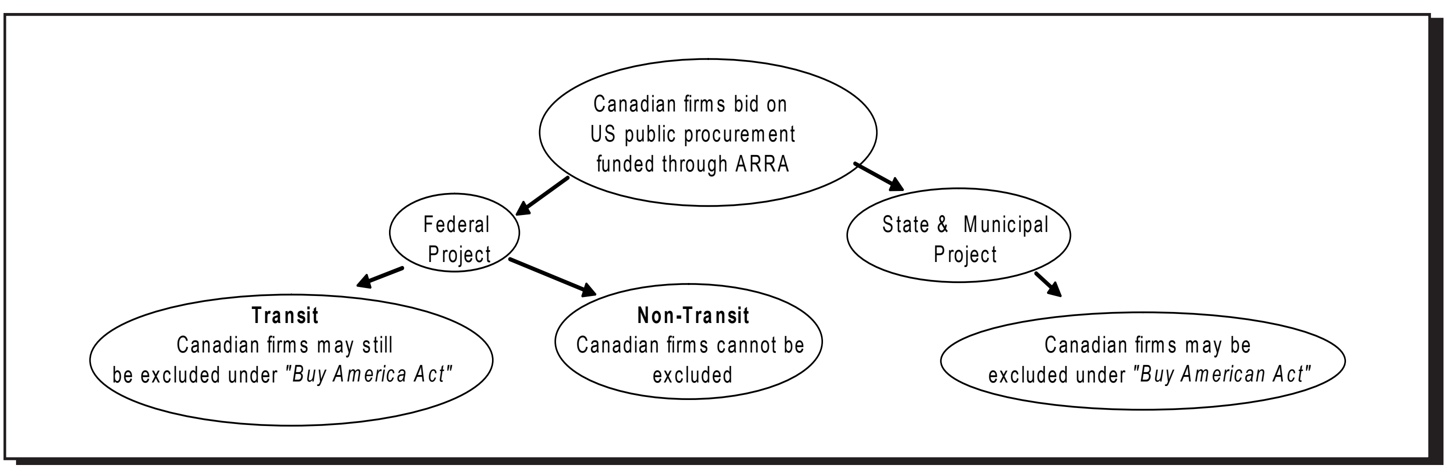


Act (ARRA), the $787 bn US stimulus package is made up two main components, $580 bn in spending measures and an additional $207 bn in tax cuts and subsidies (Chart 3). Projections from the Congressional Budget Office (CBO) suggest that just over half of all stimulus spending will take place in 2010 (Chart 4). However, only 45% of that amount will take the form of tax provisions instead of direct spending. Although a portion of these tax provisions will make their way into the general economy, we can already see that a growing percentage of government tax cuts and supplements has been going directly into savings, not spending.

Furthermore, even the 55% of the stimulus dollars devoted to direct spending should have a reduced impact on the Canadian economy because of protectionism. Although NAFTA and the WTO trade agreements largely prevent the federal government from restricting trade except in a few key areas like defense, approximately $280 bn of the $580 bn in total direct earmarked stimulus spending is being distributed at the state and municipal levels, which are much freer to restrict trade with Canada. Thirty-seven US states have committed to abiding by international trade commitments to one degree or another, but they can still close their procurement processes to Canadian firms because provincial governments have not made similar international commitments (Chart 5). That should be a particular problem in 2010 due to the fact that about one quarter of all ARRA spending next year will be administered by states and municipalities.

Chart 5

Where Protectionism Bites



Source: US Government

When it comes to protectionism the US economic stimulus package actually contains two separate protectionist provisions that will work to limit the impact that government spending can have on the Canadian economy. The first is the Buy American Act which stipulates that all goods for public use procured under the ARRA, including iron and steel, must be produced in the US with US materials.

The second restriction, known as the almost identically named Buy America Act, applies solely to grants issued by the Federal Transit Administration and Federal Highway Administration, and covers only transit-related procurements valued over US$100,000. Unlike the broader Buy American Act, this legislation is not bound by NAFTA or the WTO agreements even at the federal level. Since the ARRA includes $48 bn in pure transportation projects alone, Canadian firms could face significant trade barriers even at the national level.

Beyond Protectionism

That being said, protectionism is not the only roadblock that will work to dull the impact of massive US government spending on the Canadian economic recovery in 2010. Although the geographical distribution of the fiscal stimulus is roughly in line with each state's import intensity from Canada, the distribution across industries has a distinctly negative bias against Canada. In the absence of fully detailed data on the plan's industry distribution, we partially used the distribution of US employment gains, as identified by Obama advisor Christina Romer (Chart 6). In addition, we adjusted those figures for the boost to retail and wholesaling from our own analysis of the impact of tax cuts on spending.

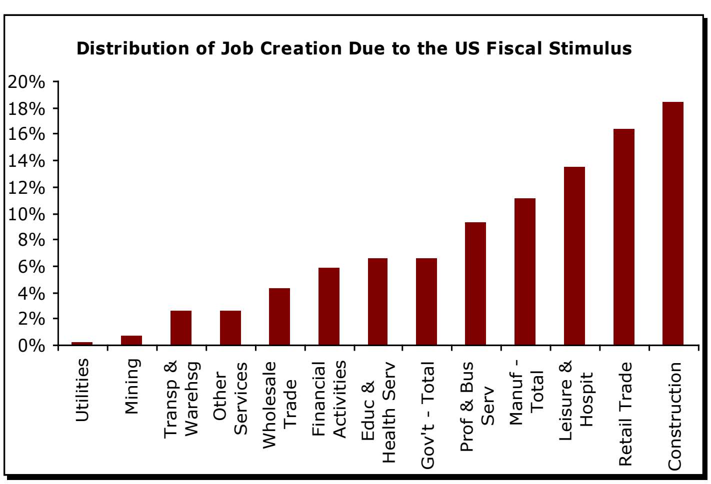
The spillover north of the border from the stimulus will then depend on the share of those US industries' inputs that have traditionally been sourced by imports from Canada. US Commerce Department data were used to track these shares, with the exception of two sectors (construction and utilities) where the absence of data required the use of inferences from Canadian export data.

As it turns out, even ignoring trade barriers, Canada's traditional participation in the sectors gaining from US stimulus has been less than impressive. Weighted by their direct benefits from the stimulus package, these industries import an average of 1.7% of their inputs from Canada. That's about one third lower than Canada's overall share of US GDP inputs (Chart 7). For example, much of the benefits will go to America's health, education and government sectors, all of which have marginal tendencies to import from Canada. Additionally, Canada's fuel and mining services sectors will see little benefit as their US target markets (utilities and mining respectively) reap comparatively less stimulus funding.

Thus, the sectoral distribution of an economy led by US stimulus spending, and the barriers of a high protectionist wall, will tend to dampen the benefits of America's recovery for Canada. Uncle Sam is in a spending mood these days, but fewer of those dollars will find their way north of the border than the Bank of Canada's official forecast implicitly assumes.

Chart 6

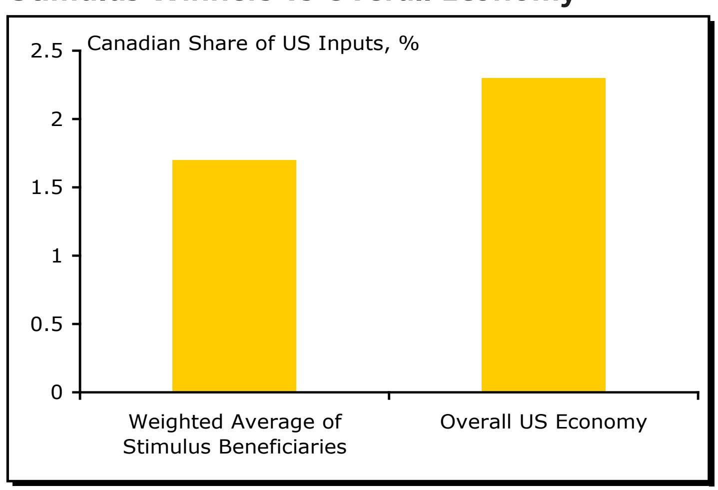
Which US Sectors Will See Stimulus Job Gains?



Source: Romer, CEA

Chart 7

Canada's Weighted Share of US Activity: Stimulus Winners vs Overall Economy



Latest TSX Earnings Season: The Best of Times and the Worst of Times

Peter Buchanan

The past earnings season has been the best and worst for investors—the best because earnings didn't fall nearly as much as expected, or as severely as in the last Canadian recession. And the worst, because they remain well off bountiful year ago highs. Second half consensus projections may not be as hard to jump over as some assume, athough 2010 hopes will be tougher to meet.

Nearly 80% of the cap weight of the TSX Composite has now posted results for the latest reporting period—almost all the key players, except for the banks who cross the plate in coming days. Using consensus expectations for the fewer than two dozen remaining entities, earnings for the quarter net of one offs are likely to come in 29% below year ago levels. That's pretty much the same as the retreat expected for the S&P 500, over 95% of whose members have now reported. While that's a sobering pullback, it is less severe than the 33-34% drop expected for the TSX a month and a half ago, when the results began to trickle in. It's also less severe than the first quarter's 42% decline, the probable low point for the current cycle given our forecast of renewed growth in both the Canadian and global economies in the second half of the year. Notwithstanding Q2's sharp year-on-year decline, we estimate that earnings were up by well over 10% on a sequential basis from Q1, after allowing for normal seasonal fluctuations (Chart 1).

Comparing performance across sectors, the insurer-dominated non-bank financials and materials groups have fared the best relative to expectations (Chart 2), topping pre-season expectations by an average of 21% and 14% respectively. The energy sector has brought up the rear, although the recent gains in commodity prices will benefit resource producers in coming quarters.

Another popular performance metric is the "beat rate"—the percentage of reporting firms that have surpassed consensus earnings. Based on the results so far, that ratio stands at 54% (Chart 3). That's well below the over 70% level for the S&P 500, but is about 3-4%-pts higher than

Chart 1

TSX Earnings, Actual and Seasonally Adjusted

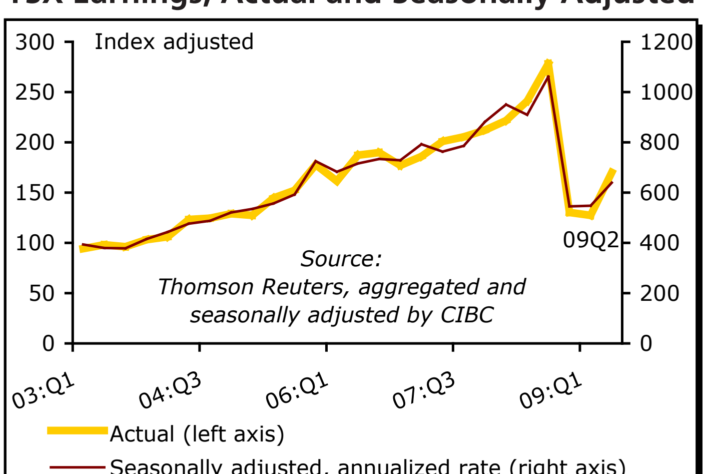


Chart 2

TSX Q2 Earnings by Sector, % Deviation from Consensus Expectations

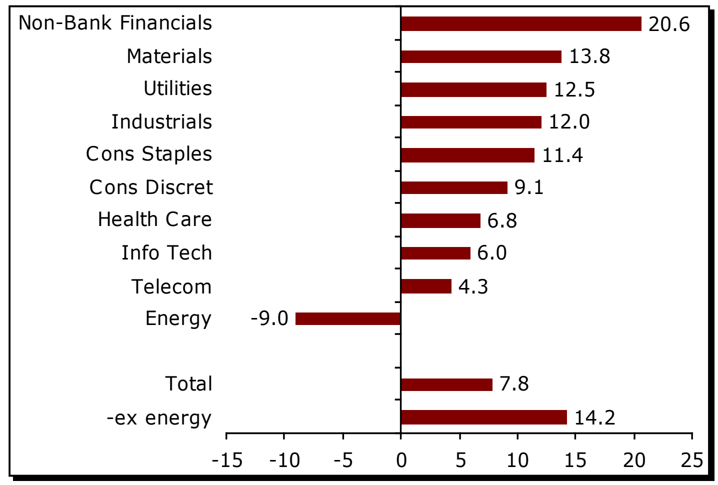


Chart 3

TSX Q2 Earnings by Sector (% of Reporting Firms Beating Consensus EPS)

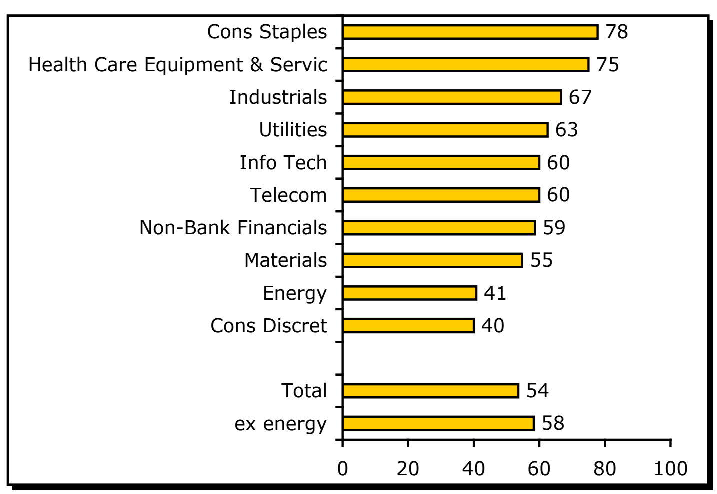
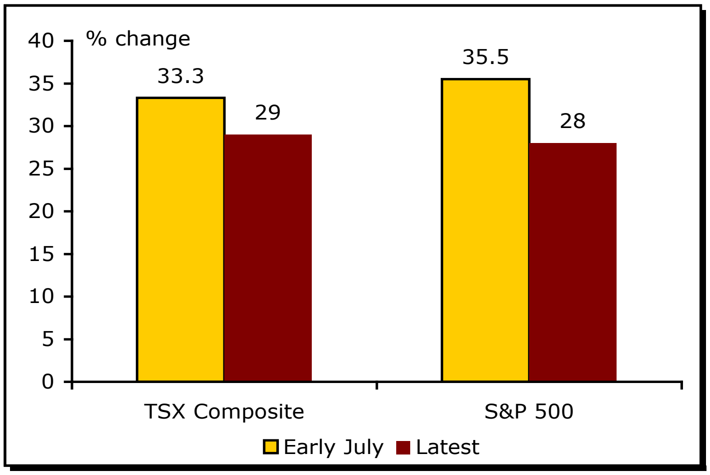


Chart 4

Expected Decline in Earnings vs a Year Ago



the first quarter's level. The north-south divide is also due to a lower bar. Earnings expectations for Canadian firms were simply not quite as beaten down as stateside, where preseason expectations were for a 36% decline (Chart 4). The best TSX sectors, with the highest proportion of reporters meeting the market's target, were consumer staples and health care. The worst were consumer discretionary stocks and energy.

Looking at absolute earnings changes, the best performers on a year-to year terms in Q2 were info tech and telecoms along with health stocks, recovering from an atypically weak year earlier quarter. Earnings growth surpassed the S&P 500 in eight major sectors trailing in two others (Table 1).

Table 1

TSX Earnings vs S&P 500 Earnings

	TSX Composite			S&P 500
yr/yr % change	2009:Q1	2009:Q2	2009	2009:Q2
	Actual	Estimate*	Consensus	Actual
Cons. Discr.	-30.0	-21.5	-16.5	-20.0
Cons. Staples	8.5	6.3	0.2	-3.9
Energy	-49.7	-73.3	-57.4	-68.8
-E&P Firms	-77.3	-95.5	61.2	-69.3
Financials	-47.3	1.5	-2.1	-8.4
-Banks	-4.0	-11.6	-3.7	-50.5
-Insurance	-114.3	22.3	-44.9	2.4
Health Care	22.8	55.1	47.2	2.1
Industrials	-30.4	6.3	-23.2	-35.8
Info Tech	21.9	11.7	22.5	-21.5
Materials	-63.9	-51.1	-29.1	-65.0
-Gold	-32.7	12.4	29.5	-9.0
-Diversified Mining	-77.5	-57.0	-36.0	-36.6
-Chemicals	-72.4	-64.3	161.0	-40.1
Telecom	1.7	6.7	4.6	-23.6
Utilities	-15.4	NM	463.3	-3.4
Total, All Sectors	-42.5	-29.4	-26.5	-27.9

*Estimate based on actual EPS for firms that have reported for quarter, latest estimate for others. NM = not meaningful.

Expectations for Second Half Look Easy to Beat

Looking ahead, current expectations for the year as a whole are for a decline of about 27% in TSX earnings. That's worse than expectations six months ago, but materially less severe than the 80% nosedive experienced in the 1991 recession, when corporations were socked by the one-two punch of a soaring currency and borrowing costs as the Bank of Canada's waged all out war on inflation. Breaking things down by quarter, analysts are looking for a decline of about 38% on the year in Q3 earnings, followed by a dramatic swing to a 35% gain in the fourth. That looks at first glance like a tough peak to scale, but first appearances can be deceiving. Given the easy comparison to very weak earnings in year earlier base period, our analysis suggests that all that would be needed to achieve that target would be a relatively modest sequential increase of about 5-7% in earnings in the next two quarters.

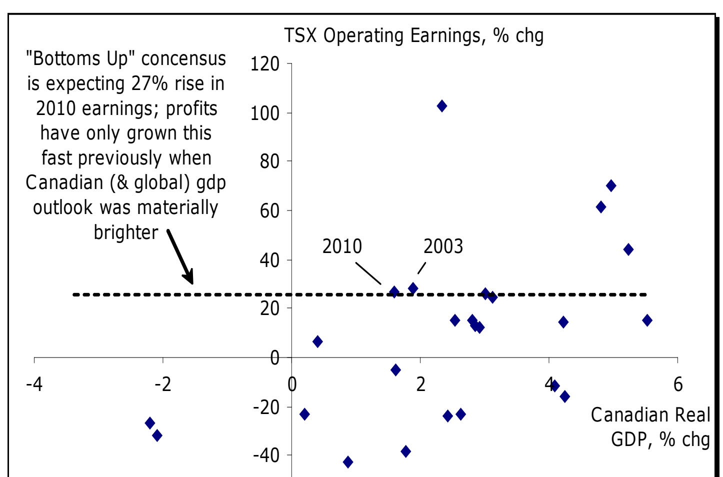
We believe that validating an expected 27% rise in earnings next year could prove to be more problematic, given a strong loonie and lacklustre macro growth. Earnings did rise as forcefully as that in 2003 coming out of the last US recession, in spite of fairly soft domestic growth (Chart 5). But the global economy performed much more strongly, expanding at a rate of just under 4%. That's nearly double our estimate for the year ahead.

TSX Revenues Generally Surpassed Expectations

Some observers have argued that consensus-beating earnings have been all about cost cutting and dismiss the

Chart 5

TSX Earnings vs Real Canadian GDP, 1986-2010



Source: Thomson One Analytics, Statistics Canada, CIBC WM implications for future quarters due to the lack of top line surprises.

While its true that revenues, unlike earnings, haven't surprised greatly to the upside, neither have they disappointed greatly on a market-wide basis. Revenues have matched expectations for S&P 500 members, and have been running about 2% above expectations for the TSX Composite, leaving out the energy sector (Chart 6). Production levels in energy were temporarily impacted in Q2 by a shutdown at a key oil sands facility. Our estimates also suggest that revenues for TSX firms that have reported were up by about 11% on a sequential basis in Q2 after seasonal adjustment.

Moreover, the view that cost cutting invariably provides only a one term lift to profits is also debatable. Some types of cost cutting—slashing R&D spending, or customer service and marketing—may provide at best a transitory boost. Others, like reorganizing a plant or outsourcing to a new and more efficient supplier, are likely to result in continuing cost savings over time. Such changes contribute to better-looking earnings numbers not only today, but in the future as well.

Conservative Expectations, Greater Resource Leverage Could Help TSX in Second Half

Economic stirrings in emerging Asia and the latest GDP figures from Europe and Japan call in to question the "first in-first out theory", that the US will lead the world into recovery as it did into the recession. Analysts have been revising up their expectation for some sectors most likely to benefit from an overseas-led recovery.

Chart 6

How TSX Revenues Have Fared This Quarter vs Analysts' Expectations (% Deviation)

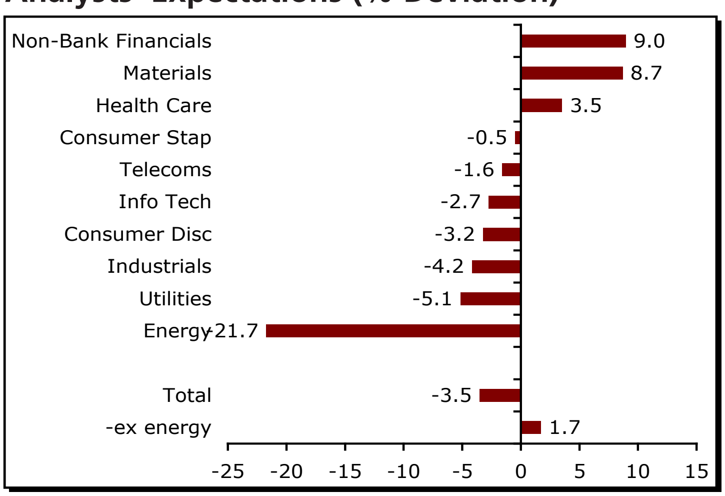
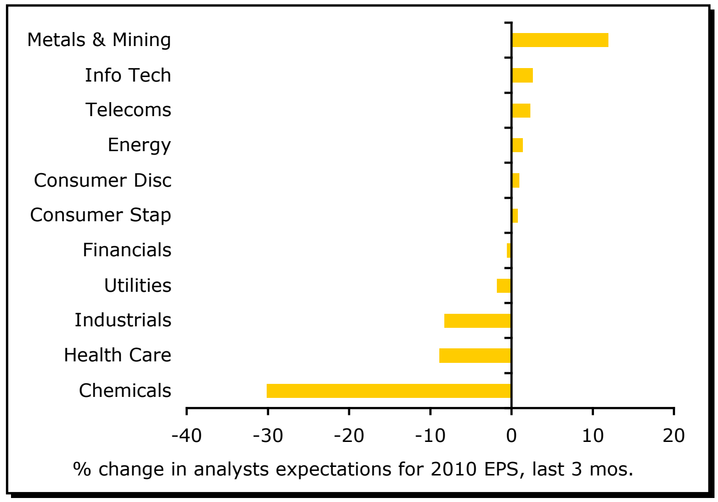


Chart 7

Analysts' TSX 2010 Earnings Revisions

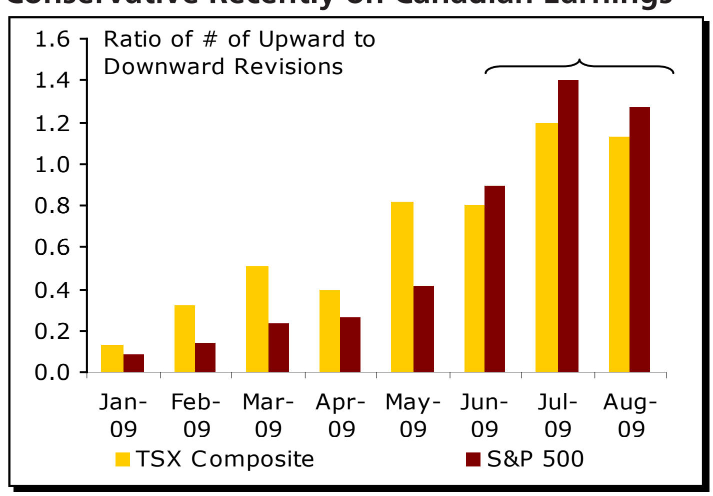


As noted, expectations for both the mining and energy sectors have been lifted appreciably, as have those for technology and the telecoms (Chart 7). Those two sectors are seen as better able to capitalize on demand shifts and perform well in an environment of continuing excess capacity than their US counterparts.

Positive earnings revisions for US stocks continue to surpass negative revisions by a larger margin than in Canada. That is somewhat surprising in our view, since the present pattern of global recovery is likely to be more constructive for the TSX, given the Canadian market's near-50% resource weighting. It suggests some potential for the TSX to outperform stocks stateside, as perceptions adjust to that reality (Chart 8).

Chart 8

Analysts Have Been Relatively More Conservative Recently on Canadian Earnings



ECONOMIC UPDATE

CANADA	09Q1A	09Q2F	09Q3F	09Q4F	10Q1F	10Q2F	2008A	2009F	2010F
Real GDP Growth (AR)	-5.4	-3.1	2.9	2.4	1.6	1.5	0.4	-2.1	1.6
Real Final Domestic Demand (AR)	-5.7	1.0	1.3	1.8	1.7	1.9	2.6	-1.8	1.7
All Items CPI Inflation (Y/Y)	1.2	0.1	-0.8	0.2	0.7	1.1	2.4	0.2	1.3
Core CPI Ex Indirect Taxes (Y/Y)	1.9	1.9	1.7	1.3	1.1	1.1	1.7	1.7	1.3
Unemployment Rate (%)	7.6	8.4	8.7	8.7	8.9	9.0	6.1	8.3	9.0
U.S.									
Real GDP Growth (AR)	-6.4	-1.0	3.2	1.4	1.9	1.8	0.4	-2.6	1.8
Real Final Sales (AR)	-4.1	-0.2	-1.7	1.5	1.7	0.5	0.8	-2.3	1.1
All Items CPI Inflation (Y/Y)	0.0	-1.2	-1.8	0.5	1.0	1.2	3.8	-0.6	1.8
Core CPI Inflation (Y/Y)	1.7	1.8	1.5	1.9	2.1	1.9	2.3	1.7	2.2
Unemployment Rate (%)	8.1	9.3	9.8	10.0	10.1	10.0	5.8	9.3	10.0

CANADA

Canada's recession may have ended in June, with a good hand-off from that month prompting an upward revision to our call for Q3 GDP growth. While inventory replenishment in the US will boost Canada's export sector in Q3, growth in subsequent quarters is likely to disappoint. The unemployment rate will continue to creep higher in the sub-par recovery period, and shallow US growth will have less than its typical benefits for Canada. The year-on-year headline inflation rate will move back into positive territory in the final quarter of the year, but core inflation should head down towards 1% and remain subdued next year, giving the Bank of Canada little reason to break its pledge of keeping interest rates unchanged through the first half of 2010.

UNITED STATES

We continue to look for an inventory related jump in real GDP growth during the second half of the year, but the overall pace of recovery should be held back by sluggish business and consumer spending. The labour market did show signs of improvement in July, but monthly job losses remain in the triple-digits and the unemployment rate should keep rising to 10% by year end. Year-over-year inflation has likely troughed, but pricing pressures are expected to remain very soft well into next year.