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CIBC

Economics

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"... CEOs and investors may have already been building in more of a cushion."

Fear Itself

by Avery Shenfeld

Investors have plenty of reasons to be fearful. Is fear itself one of them? Although markets reacted to the recent downticks in North American confidence indexes, confidence never really recovered much in the first place. The various surveys climbed from the abyss set at the heights of the financial crisis, but thereafter, remained mired in normal recession territory in the US, and little better in Canada.

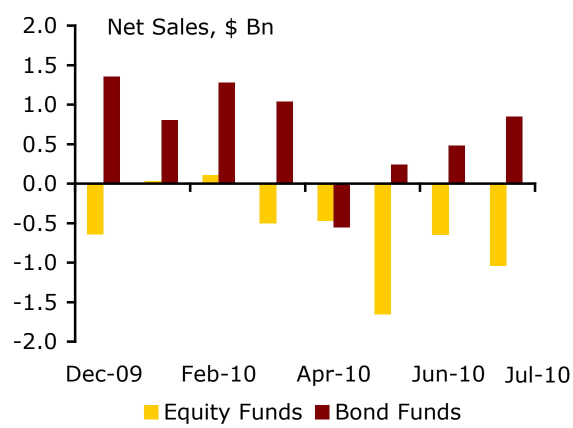
US household behaviour has been consistent with these barometers of fear. Americans have saved rather than spent, with fresh activity generated only in response to temporary tax relief that lifted after tax incomes, or short-lived incentives on home or vehicle purchases. With caution already built in, spending from here on might therefore be more affected by job creation and decisions on tax cut extensions than by primal fears of what lies ahead and a sharp further climb in the savings rate.

North of the border, fear itself is only now becoming an issue. Until this spring, with housing wealth rising and willing lenders, Canadians jumped at cheap interest rates to buy goods and houses, taking the savings rate back to near-historic lows. Tighter rules on mortgage insurance, signs that house prices have topped out and a less rosy assessment about future job prospects seem to have lifted the savings rate in the second quarter, with room for more of the same. Credit growth to the household sector is slowing. All the more reason why the Bank of Canada might be leery of adding to that worry list by continuing with rate hikes after September.

Fearing fear itself may not be as rational for investors at this point, however. Analysts do not yet appear to have been fearful enough to have taken down 2011 TSX earnings calls sufficiently, given the lacklustre revenue growth already in evidence (see pages 6-8). But CEOs and investors may have already been building in more of a cushion. The former are retaining extra cash and delaying dividend increases as they brace for continuing lean times. Individuals have already pulled out of stocks and flooded into safer bonds at a breakneck pace (Chart).

Bond yields are so low that in the US they assume the Fed will miss its inflation targets for 10 years to come (see pages 3-5). Stocks will be challenged to soar from here, but the downside also looks limited by the fear already priced in as investors pulled out. With so much fear built into their rally to date, government bonds could prove to be an unsafe haven for new buyers at these levels.

Canadians Already Braced for a Slowdown



Source: IFIC

MARKET CALL

- Early this month, we trimmed our outlook for Bank of Canada rate hikes by a quarter-point, with a half-year pause beginning in October rather than December. That reflected the somewhat earlier timing for the start of slower growth in the US, making it likely that the Bank's October policy report forecast would be downgraded enough to justify a wait-and-see stance. But it won't take a huge acceleration in growth in 2011 for the Bank to resume tightening by mid-year, given how low real rates sit, and Canada's smaller output gap relative to the US.
- Bond yields on both sides of the border appear to price in more gloom than equities, which have softened but not crashed. Who's right? If a double-dip recession and deflation are avoided, in part by delaying most of the fiscal tightening in the US, Treasuries will come under some pressure from a flight away from safe havens. But we trimmed our targets for yields on both sides of the border earlier this month, in light of a softer growth and inflation outlook.
- An earlier move to the sidelines by the Bank of Canada means a less rosy forecast for the Canadian dollar. It should still get a lift from a September tightening, which is not at this point fully priced in. But dampened global growth expectations have taken some of the shine off commodities currencies, and we could see the Canadian dollar weaker through early 2011 until a resumption of rate hikes gives the loonie a lift through capital flows.

INTEREST & FOREIGN EXCHANGE RATES

					2011			
END OF PERIOD:		**26-Aug**	**Sep**	**Dec**	**Mar**	**Jun**	**Sep**	**Dec**
CDA	Overnight target rate	0.75	1.00	1.00	1.00	1.25	1.75	2.00
	98-Day Treasury Bills	0.66	0.95	0.85	0.85	1.20	1.60	1.85
	2-Year Gov't Bond	1.24	1.60	1.50	1.65	2.00	2.55	2.75
	10-Year Gov't Bond	2.80	3.15	3.10	3.20	3.50	3.75	3.85
	30-Year Gov't Bond	3.43	3.70	3.70	3.80	3.95	4.05	4.15
U.S.	Federal Funds Rate	0.23	0.20	0.20	0.20	0.20	0.20	0.25
	91-Day Treasury Bills	0.16	0.15	0.15	0.15	0.15	0.15	0.20
	2-Year Gov't Note	0.52	0.60	0.60	0.80	1.00	1.25	1.50
	10-Year Gov't Note	2.48	2.75	2.70	2.75	3.00	3.50	3.65
	30-Year Gov't Bond	3.52	3.85	3.80	3.95	4.20	4.40	4.50
Canada - US T-Bill Spread		0.50	0.80	0.70	0.70	1.05	1.45	1.65
Canada - US 10-Year Bond Spread		0.32	0.40	0.40	0.45	0.50	0.25	0.20
Canada Yield Curve (30-Year — 2-Year)		2.19	2.10	2.20	2.15	1.95	1.50	1.40
US Yield Curve (30-Year — 2-Year)		3.00	3.25	3.20	3.15	3.20	3.15	3.00
EXCHANGE RATES	CADUSD	0.94	0.96	0.93	0.92	0.95	0.98	1.00
	USDCAD	1.06	1.04	1.07	1.09	1.05	1.02	1.00
	USDJPY	84	84	87	89	92	90	89
	EURUSD	1.27	1.25	1.24	1.19	1.23	1.27	1.30
	GBPUSD	1.55	1.52	1.53	1.50	1.56	1.62	1.67
	AUDUSD	0.890	0.880	0.870	0.850	0.870	0.890	0.920
	USDCHF	1.03	1.02	1.02	1.06	1.06	1.06	1.04
	USDBRL	1.76	1.79	1.81	1.82	1.78	1.75	1.70
	USDMXN	13.05	13.10	13.30	13.50	12.80	12.50	12.35

US Deflation: How Likely, How Troubling?

Avery Shenfeld and Meny Grauman

Deflation is no longer unthinkable for the US economy. It's not the consensus or our own outlook, and not priced into bond market yields at this point. But we're in the camp of the two-thirds majority of forecasters in a recent poll that judged deflation as a greater risk to America's fortunes than excessive inflation.

Mention deflation and what comes to mind are the Great Depression, and the more recent Japanese experience. As it turns out, the historical record is more mixed in terms of the economic consequences of deflation, while still suggesting that a bout of tumbling prices in the US context would be a significant negative. Despite Japan's story, deflations can always be ended by sufficiently aggressive policy responses, a reason why we see extremely low US 10-year rates, which are clearly counting on a lengthy period of very low price pressures, as vulnerable. And recent history shows that it's not that easy to fall into deflation in the first place.

Not All Deflations are Created Equal

The market's association of falling prices with severe economic outcomes is coloured by the most famous, or rather, infamous, bout of deflation in modern history—the Great Depression. But not all previous periods of deflation ended quite so badly.

The Depression and Japan figure so prominently in views on this topic because contemporary episodes of deflation are such a small sample set. A sustained drop in broad consumer prices has been a rare phenomenon in the post-WWII period, not just in the US but globally (Chart 1). Granted, US CPI did turn negative in 2009, but true deflation is not defined as a couple of quarters of falling consumer prices, but broader and persistent declines.

Besides the Japanese experience, which was also concurrent with tough economic times, the only other recent examples of true deflation are China and Hong Kong. In both of those cases falling prices did not coincide with a protracted recession (Chart 2). China's mild deflation corresponded with sustained real GDP growth of 7-8% per year, only a bit less than trend. Hong Kong's deflation came in the wake of a sharp recession that led to a 60% crash in property prices. Hong Kong also was running a peg to the dollar during that period, so some of the economic adjustment that would typically have come through a depreciating exchange rate instead was shifted to price declines that did the work to make the territory more competitive. But consumer price declines did not prevent an economic recovery, although one a bit choppy in annual growth rates.

Chart 1

Deflation Rarer in Modern Era

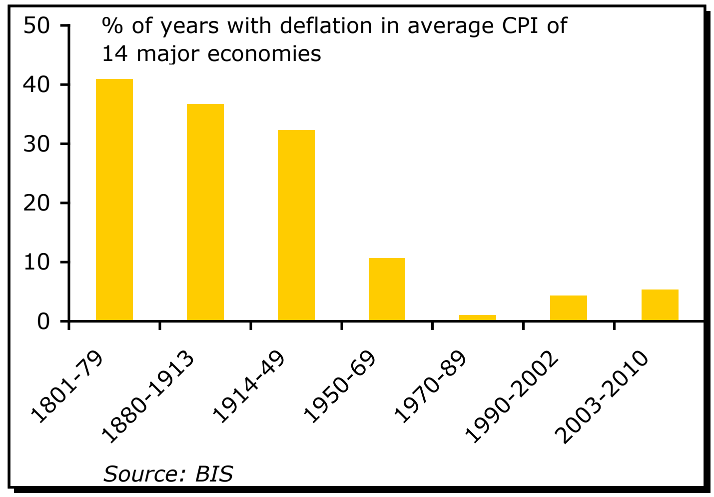
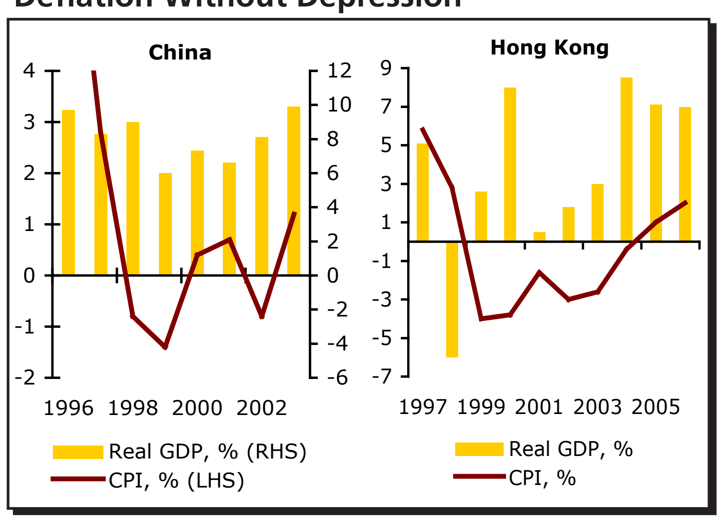


Chart 2

Deflation Without Depression



Deflation Through the Decades

Farther back in the record books, there were many examples of benign deflations between 1800 and World War II. That earlier period may have been amenable to benign deflations for the very same reason that falling prices did not seem to slow economic growth much in China during the late 1990s. As in modern-day China, the turn of the last century coincided with a dramatic surge in productivity across large parts of the western world. In those cases, as with China more recently, deflation emanated from the adoption of technologies that resulted in falling costs and a surge in supply, rather than a negative shock to demand. That could be considered "good deflation". Indeed, it is simply a more extreme version of the disinflation that prevailed in the global economy through the 1990s, as new lower costs sources of supply in Asia, and technology improvements that lowered prices for tech goods, telecom services and other items, provided downward pressure on inflation even in periods of healthy growth.

While falling prices don't therefore always come with economic calamity, the two-way relationship between growth and deflation fits the conventional wisdom. The economy does tend to climb at a slower average pace than during periods of moderate inflation—even when one excludes the impact of the Great Depression (Chart 3).

Clearly, the deflation now feared in the US would not be of the benign, positive supply shock variety. A better analogy would be to the bout of deflation faced by Japan during its "lost decade." As in Japan, the initial source of the economic crisis, a crash in asset values, is itself both deflationary (in its impact on housing costs) and a negative for economic growth through the wealth effect on consumption.

Crossing the Deflation Rubicon

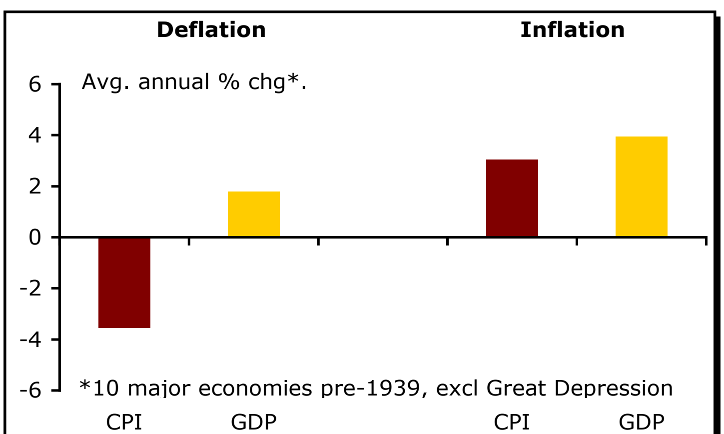
Standard macro models generally predict falling rates of inflation in the presence of an output gap – the divergence between the current level of GDP and the economy's non-inflationary potential. With America's CPI trend already so low, and no prospect for returning to full employment anytime soon, a linear relationship between the output gap and the change in the inflation rate would soon tip the economy into a negative CPI trend.

But a recent IMF analysis by André Meier suggests that persistent bouts of economic slack work somewhat differently in terms of their CPI impact. Long periods with a wide output gap reduce the inflation rate by a constant proportion of the pre-crisis inflation rate (Chart 4), a relationship that implies that there is a wall that is difficult to breach between a low inflation rate and outright deflation. That could reflect monetary authorities getting more aggressive in fending off deflation compared to their response to below target but positive inflation. Or more likely, it captures in the aggregate what is well known in the micro level—the stickiness of prices, and particularly wages, against outright cuts.

It therefore takes a maelstrom to breach the apparent wall that divides inflation from deflation if the starting point was a positive inflation rate. Japan actually had dipped into deflation prior to the massive widening of its output gap. The same was true in the case of the Great Depression. America's CPI rate was already negative in

Chart 3

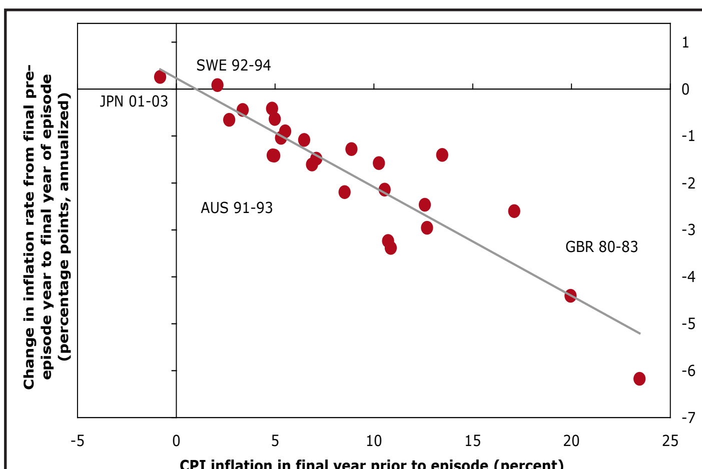
Deflation Typically Comes with Slower Growth



Source: Centre for Economic Policy Research

Chart 4

Change in Inflation During Long Output Gaps



Source: A. Mieir, IMF Discussion Paper, 2010

Chart 5

Deflation Pre-dated Great Depression

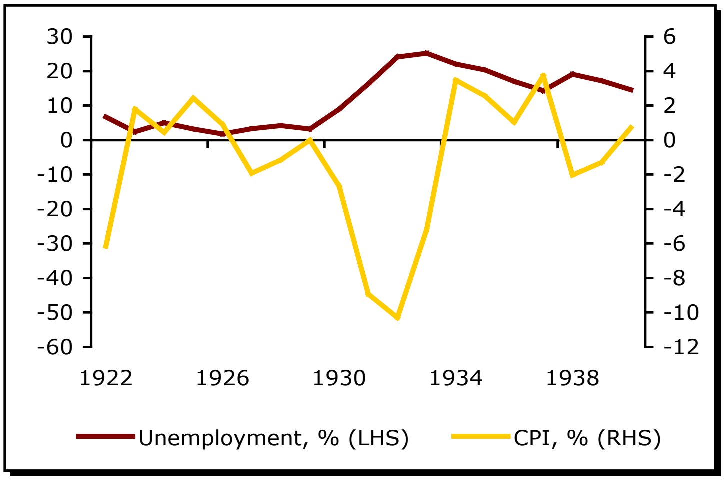
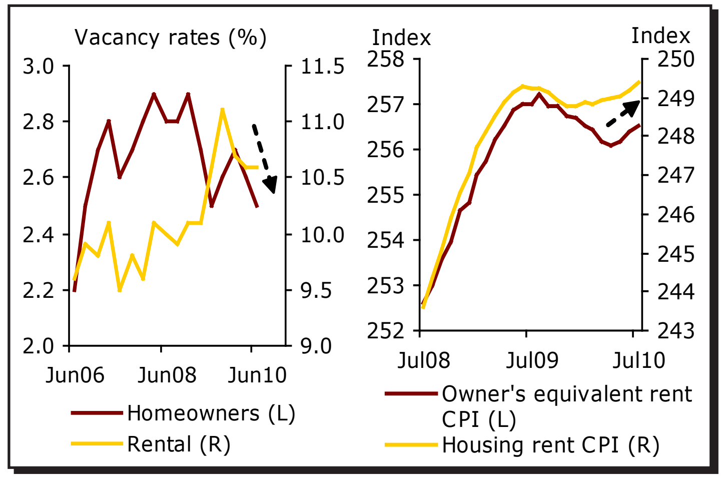


Chart 6

Lower US Vacancies; Rents No Longer Falling



1927, well ahead of the sharp upturn in joblessness (Chart 5).

In the US case, there are other reasons to expect inflation to remain positive barring an outright dive into renewed recession. Some of the now long-idled workers may have become structurally unemployed—unfit to fill new job opportunities and therefore not a reason for wages to be competed down to lower levels. Moreover, much of the earlier drop in core inflation was rooted in the heavily weighted rent component. Rents have ceased declining and have turned higher (Chart 6), perhaps supported by the throngs of Americans that have either been foreclosed on, or who can't get mortgages to buy a home.

The Quicksand Myth

If the US economy were to sufficiently darken to push core inflation into negative territory, the escape route would take policymakers down an unconventional path. Once short-term nominal rates hit their zero lower-bound, conventional policy runs out of room, and can be insufficient if low or negative inflation rates keep implied real rates too high.

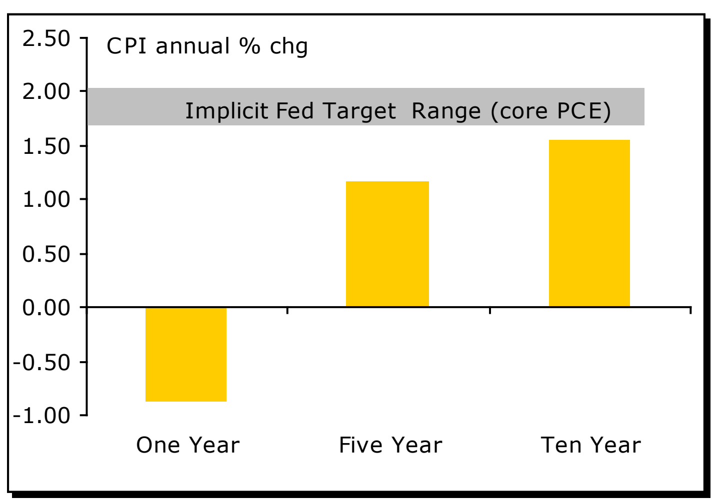
But Japan's story has led to a prevailing myth that sees deflation as quicksand, a trap that can't be escaped. As an economist well schooled in depression economics, Ben Bernanke understands more than anyone why that is inherently a falsehood.

The Fed has the unlimited capacity to print US dollars to battle deflation. Using that power to buy bonds might only see the cash return in idle deposits at the Fed. But as Bernanke outlined in a 2001 speech, that's not the only option. In the extreme, the Fed could buy newly minted government bonds with the Treasury using the proceeds to finance a tax cut. That "helicopter drop" of money, if large enough, *has* to produce positive inflation. If not, who would care? Every household could then be given millions in purchasing power with printed money and no debt issued to the public. But the reality is that such a flood would make each dollar worth less, the very definition of inflation.

The bond market isn't yet priced for deflation, but it's moving that way (Chart 7). TIPS spreads imply a negative CPI pace over the next year, and only 1.5% over a 10-year horizon. Betting that the Fed will stand aside and let inflation stay permanently below its 1.75-2% implicit target (for core PCE prices) is likely to be unrewarding.

Chart 7

TIPS Breakeven US Inflation Rates Are All Below Fed Target



TSX Earnings: Not a Bad Quarter, Stripping Out the Insurers

Peter Buchanan

Equity investors stateside have been accused of fiddling while Rome burns, as recession worries re-emerge. But the S&P 500's limited reaction to some decidedly unpleasant economic news isn't altogether surprising given Q2's feisty 38% year-on-year rise in earnings. The TSX earnings recovery has been tamer, never having fallen as steeply in the recession. But a closer examination of Q2's flat year-on-year headline still shows hidden strength. Lower yields and stock prices sliced over $4 billion from insurers' bottom lines. Net of that hit, that could be reversed if volatile markets change course, earnings are on track for a 26% rise in the year, not much different from Q1's decent pace (Chart 1).

View from Boardrooms Turning More Cautious

Economic disappointments clearly haven't, so far, stood in the way of good earnings news. But the gap between boardroom and Main Street sentiment may be starting to narrow. Negative-to-positive earnings guidance for the S&P 500 for Q3 has been running at an above average 2.3-to-1 so far. That's a departure from the earlier overtly positive pattern, and may signal an end to the string of better-than-expected earnings reporting seasons that fueled the market's ascent from its March 2009 lows. Forward earnings expectations for the TSX are still fairly healthy, with the bottom-up analysts' consensus looking for increases of around 15% this year and over 20% next. But the decline in the number of firms raising dividends so far in Q3 compared with pattern of recent quarters is a potential sign that corporations, like their US counterparts, are becoming more cautious. Q2's dip in revenue growth also suggests a need for prudence on the outlook.

Past is prologue and the latest harvest of TSX reports show the mining and fertilizer/chemicals-dominated materials group continuing to drive the earnings recovery. Although prices for a number of resource products softened on growth jitters and the housing credit's expiry hammered lumber, earnings still managed to record an impressive 89% gain on the year in Q2, only modestly softer than the preceding quarter's triple-digit tempo (Table 1). De-hedging has amplified the gold group's sensitivity to underlying price movements, a key plus given debt-related haven demand. Gains in the group, combined with the positive impact of firmer volumes and prices on the potash/chemical group, accounted for about two-thirds of the year on year dollar rise in the material sector's profitability. While a measurable downshift in global growth could present risks for some industrial commodities next year, hopes for an "inflection point" in the potash market has drawn investment to that sector.

Chart 1

TSX Earnings, Total and Ex Insurance

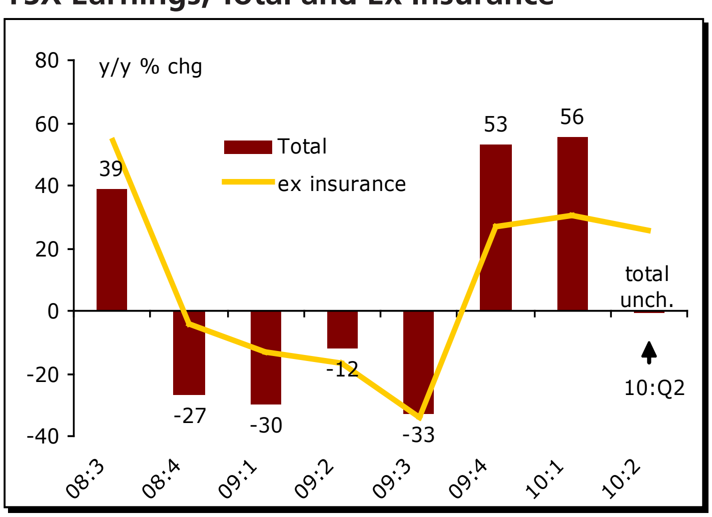


Table 1

Operating Earnings, TSX Composite vs S&P 500

yr/yr % change	TSX Composite 2010:Q1	TSX Composite 2010:Q2	*S&P 500 2010:Q2*
Energy	24.0	**24.7**	*93*
Materials	139.3	**88.6**	*97*
Industrials	10.0	**16.2**	*27*
Consumer Discretionary	70.1	**53.2**	*66*
Consumer Staples	17.5	**15.5**	*7*
Health Care	-8.0	**27.6**	*14*
Financials	83.2	**-42.7**	*37*
Info Tech	35.0	**33.6**	*66*
Telecom Svcs	11.2	**21.7**	*2*
Utilities	149.0	**30.7**	*4*
All Sectors	55.6	**-0.4**	*28*
-less insurance	*30.5*	*25.6*	

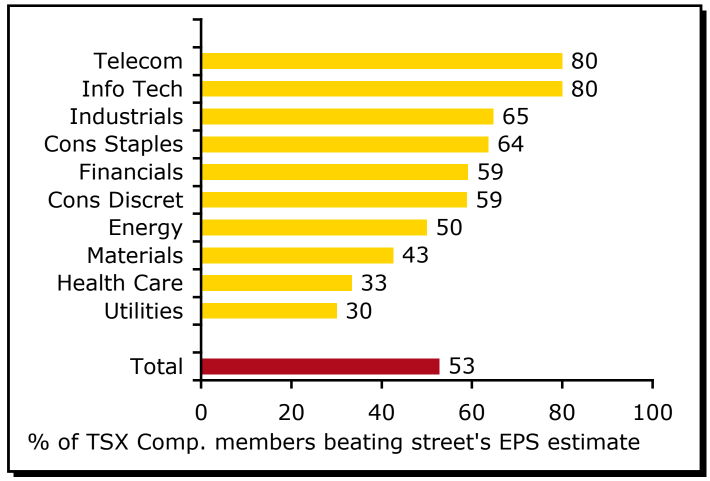
Note: May, Jun or Jul quarter end

Source: CIBC , Thomson Reuters

Canada's job recovery has shown some light and fire recently, in contrast to the US. Stronger outlays at domestic retailers and gains in both the media and auto parts sectors, reflecting supportive developments at home and abroad, bolstered earnings in the consumer discretionary group. Helped by an easy comparison to a weak prior year, earnings in that sector advanced by 53%, the second best performance of any market group. While the higher C$ is a negative for a range of industries, it aids others, including many retailers, who benefit from lower input costs. That may also be reinforcing the sector's performance.

Chart 2

Telecoms, Info Tech Had Highest Beat Rate



Earnings Growth Stronger in TSX Telecoms, Health, Utilities Segments

On a north-south basis, TSX showed greater earnings momentum than the S&P in four market groups (Table 1). Canadian telecoms did particularly well in comparative terms. Decent subscriber growth numbers allayed, for now, fears of heightened competition from new market entrants. The over-20% rise in earnings in that sector contrasted with a flat quarter for the major carriers stateside. Cell and other services are increasingly a "must have", making the sector a potential defensive play. A higher dollar also cuts imported equipment costs. The TSX health and utilities sectors, meanwhile, outpointed earnings growth stateside, the latter benefiting from improved power margins. The oil and gas sector, in contrast, lagged momentum stateside. Soft natural gas prices partly offset a solid 87% rise in profitability in the integrated sector, including the major oil sands producers.

Profit Margins Hold Up, Revenue Growth Decelerates

Benchmarked to analysts' consensus, the latest crop of TSX results beat the street's expectations in 53% of all cases. On a comparative basis, the telecom and info tech sectors once again did well, with four-fifths of firms in those sectors surpassing the consensus. Two-thirds of industrial and consumer staples firms also surprised to the upside (Chart 2). While the beat rate was lower than the 75% recorded for the S&P 500, that did not stop the TSX index from registering modestly stronger performance during the reporting period. One reason is that beats or misses on the earnings and revenue side are not punished or rewarded as decisively in Canada as in the US (Chart 3). With less material consequences, firms arguably have less incentive for guiding expectations precisely.

Looking at the two key drivers of earnings performance, profit margins for TSX companies continued to hold up well in Q2. The evidence suggests, in fact, that TSX stocks have done a bit better than S&P members in that regard in recent years, despite widespread concerns over Canada's uninspiring productivity track record (Chart 4). Revenue growth, however, slowed sharply to a 3% pace on the year (Chart 5). The higher C$ and flatter recent trend in resource prices likely contributed to the deceleration. Alongside more difficult year-on-year comparisons as the recovery matures, that's a reason to look for softer earnings growth in coming quarters.

Chart 3

Consequences of Missing or Beating Street Larger Stateside

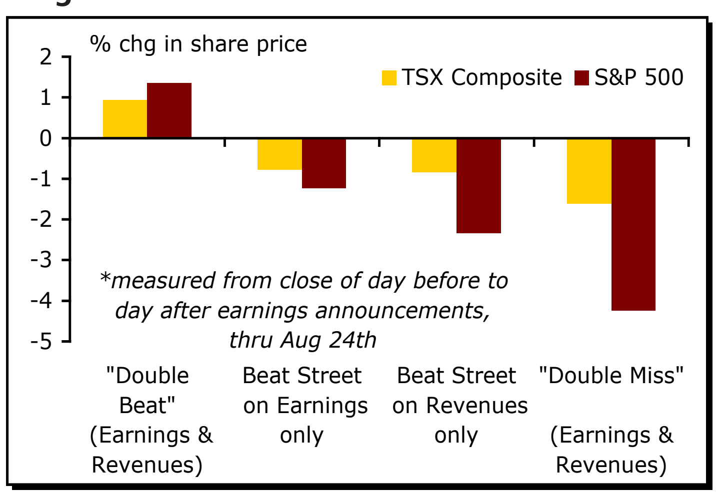


Chart 4

Profit Margins Hold Up

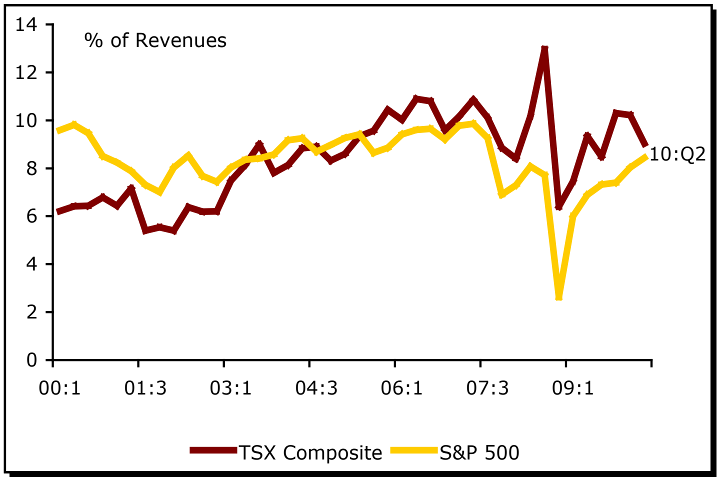
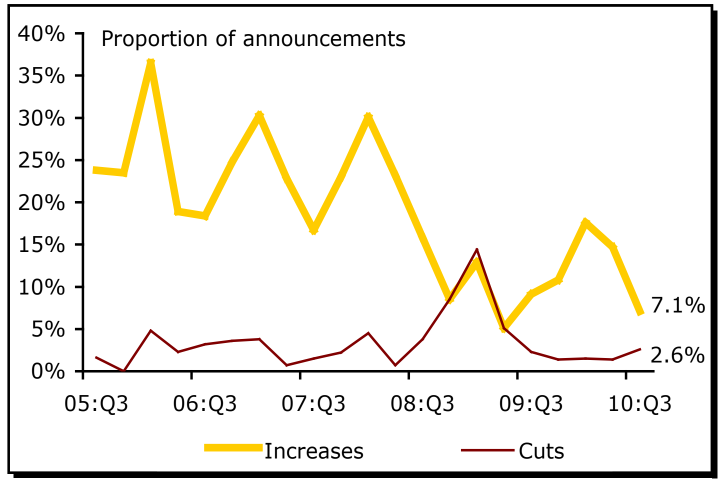


Chart 6

Caution on the TSX Dividend Front



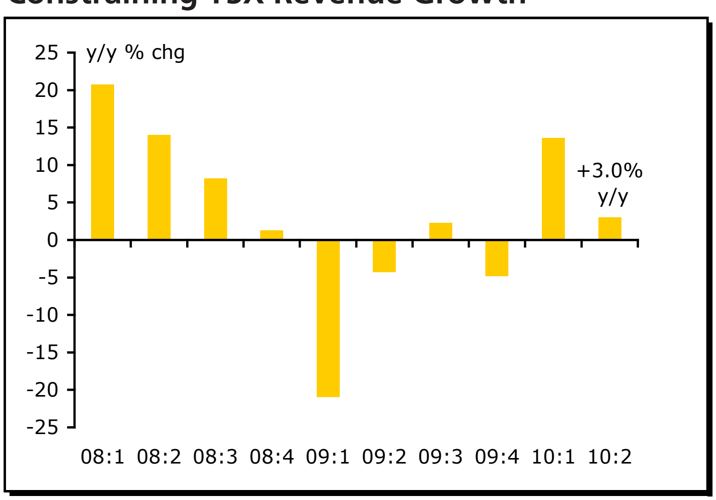
Source: CIBC, Bloomberg

Corporations Somewhat Cautious About Distributing Excess Cash

As in the US, rising cash from operations and still-constrained capital spending levels have combined to put upward pressure on corporate cash holdings. Earlier in the year, we estimated that corporate cash holdings were about 20% heavier than normal relative to sales, a difference equal to $45 billion. Not surprisingly in view of current uncertainties, corporations appear to be showing some caution these days on how much of that money to give shareholders immediately. The proportion of dividend announcements setting higher rates climbed from the recession's end to a high of 18% late last year (Chart 6), but has eased modestly since. That pattern suggests firms for now are inclined to hold onto some of their excess cash as a hedge against uncertainty. Buybacks are sometimes favoured as a method of funnelling excess cash to shareholders, especially in cloudy economic times, since they do not involve the same commitment to maintaining a steady payout. Activity on that front has also eased in recent quarters (Chart 7).

Chart 5

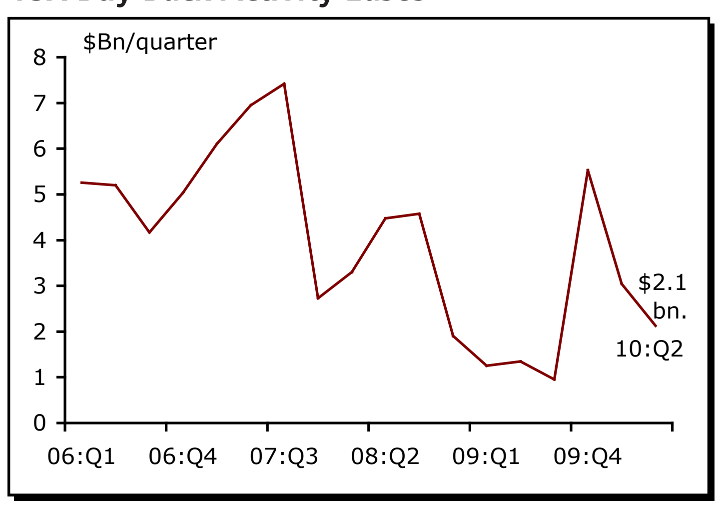
Higher Loonie, Softer Resource Prices Constraining TSX Revenue Growth



Source: CIBC, Bloomberg

Chart 7

TSX Buy Back Activity Eases



Source: CIBC, Bloomberg

US States & Canadian Provinces: Apples & Oranges

Warren Lovely

It's tempting to draw comparisons between Canadian provinces and US states—Ontario vs. California is a favoured pairing—but this is akin to comparing apples to oranges. Canadian provinces look debt laden relative to US states, but provincial interest burdens remain manageable, support from the federal government is more meaningful, and access to capital markets is exceptional. And fundamentally, fiscal prospects are brighter in Canada, putting ratings less at risk. Collateral damage from a weaker US is surely a concern, but there is greater flexibility in provincial capitals than in US states, and credit spreads will continue to reflect this reality.

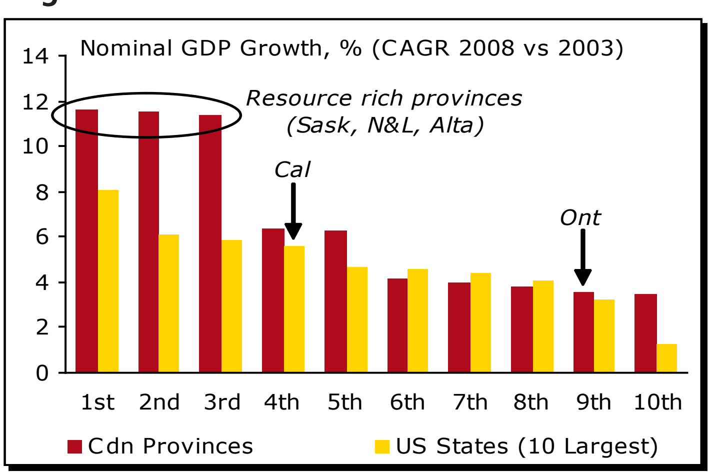
Deviation in Economic Fundamentals

Economic disparities have not been as pronounced in the US as they have been in Canada, where leverage to vast natural resource wealth has meant stronger but more volatile provincial growth (Chart 1).

We see a brighter economic outlook north of the border, particularly for nominal GDP, which serves as a proxy for government revenue growth. Outperformance in the labour market remains striking—a big reason why government taxes suffered less damage and are recovering more quickly (Chart 2). While a number of states will be forced to acknowledge a more sober economic reality, a number of provinces, including Ontario, could upgrade their current-year economic outlook in fall updates.

Chart 1

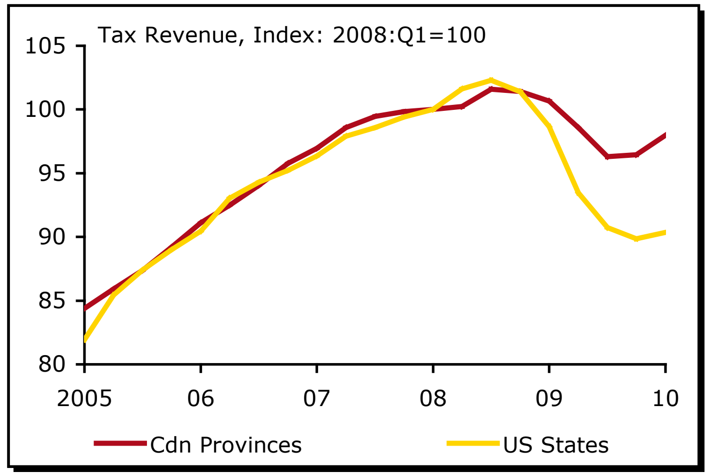
Regional Economies See Varied Growth



Source: CIBC, StatCan, US BEA

Chart 2

Provincial Revenue: Smaller Hit, Quicker Recovery



Source: CIBC, StatCan, US Census Bureau

Budget Requirements Differ Materially

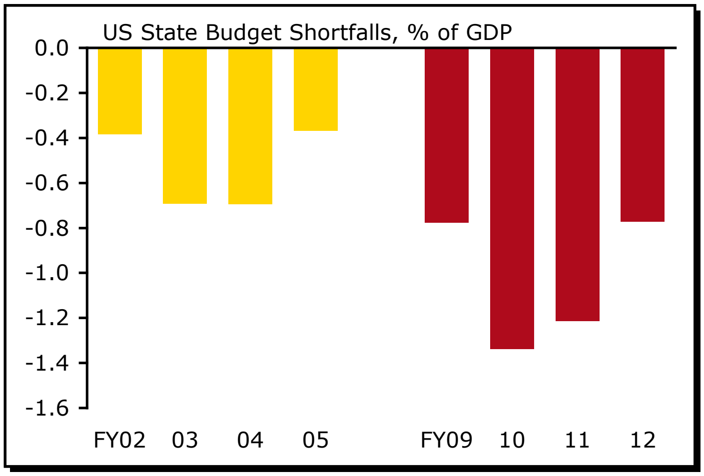
But economic performance goes only so far in explaining fiscal differences between provinces and states. Material differences in fiscal make-up are an important reason why the two are not considered peers by credit rating agencies.

All US states, save Vermont, are prevented from planning for operating deficits, with fiscal handcuffs generally embedded in state constitutions or other legislation. Budget requirements focus on the state general fund, which captures discretionary spending of own-source revenue. Capital spending is not subject to the same stipulations. Shortfalls cannot typically be rolled into future years, requiring budget amendments to remedy gaps that arise. States have a solid track record in this regard.

Balanced budget requirements are generally much less rigorous in Canada. Fiscal restrictions haven't been around as long, really only coming to the fore during the country's bounty of surpluses in the past decade. Legislation proved much less stringent, and was promptly rewritten or repealed during times of fiscal duress. As in the US, there is no ban against borrowing for capital spending.

Chart 3

States Forced to Close Large Budget Shortfalls



Source: CIBC, CBPP

States Close Gaps, Provinces Support Economy

Unencumbered by binding legal restraints, Canadian provinces have used deficits as a fiscal shock absorber. Hamstrung by fiscal requirements, states were forced to close a budget shortfall of nearly $200 bn in fiscal 2010. That's equivalent to roughly 30% of state spending or 1.3% of GDP—much more severe than in the wake of the early 2000s downturn (Chart 3). A further $120 billion gap has so far been addressed for fiscal 2011, but could grow further as growth decelerates.

After two years of cutbacks, only modest spending growth is planned for fiscal 2011 (Chart 4). Following $25 bn of tax and fee increases in fiscal 2010, more modest revenue measures are planned for 2011. But here again, a softer economy could add more intense pressure. Year-end balances have also been depleted, which outside of Texas and Alaska, now average just 2% of annual expenditures—less than half of the buffer states generally strive to maintain.

While states have succeeded in closing large fiscal shortfalls—with an important assist from federal stimulus money—fiscal actions are exerting a drag on a fragile US economy. The Fed has argued that the overall fiscal impact should prove modest, but fiscal tightening risks growing more pronounced as the broader American economy decelerates.

Aiming to cement recovery, Canadian provinces won't put program spending on a slower track until fiscal 2011/12. Public sector wages will be less severely impacted and job cuts will be largely achieved via attrition as opposed to layoffs. Still, the resulting deficits are generally quite manageable at 0.5% to 1.5% of GDP, but are higher in Ontario and New Brunswick. Budget plans generally foresee a return to balance in three to five years, with Ontario moving slower.

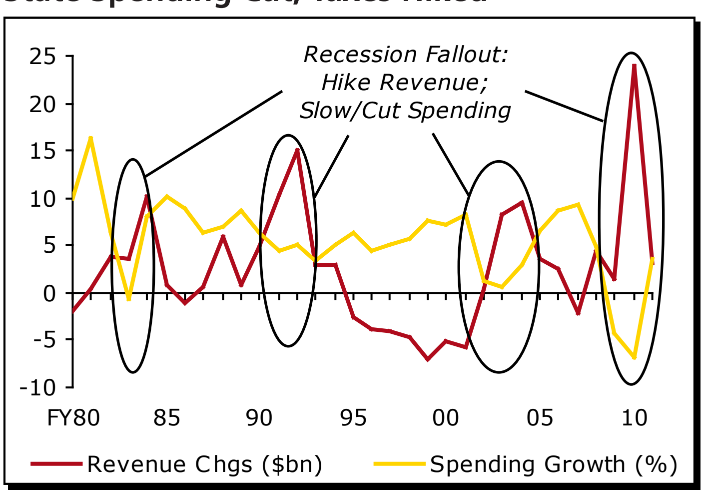
Debt & Rating Agency Comparisons

Decisive fiscal actions by state governments, while a negative for the economy, have prevented more damage to credit ratings. Despite some high profile downgrades, the weighted average credit rating for state general obligation (GO) debt is still solidly AA. Only Illinois and California are rated below AA-, with both seeing 5-year CDS levels of around 300 basis points.

State credit ratings draw support from a diverse and rich tax base and tight fiscal controls. Many states lack easy access to long-term funding, with the issuance of GO

Chart 4

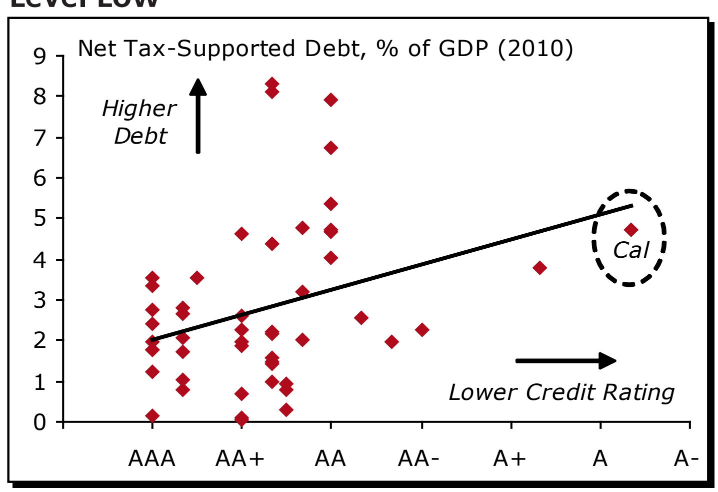
State Spending Cut, Taxes Hiked



Source: CIBC, NASBO

Chart 5

Some Exceptions, But State Ratings High, Debt Level Low



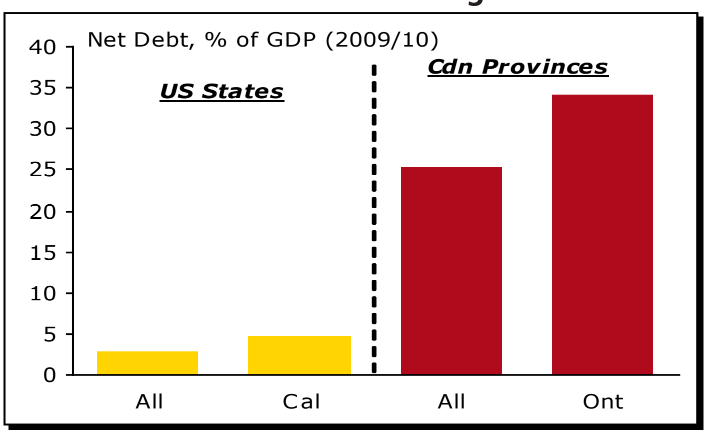
Source: CIBC, S&P, Moody's, Fitch

debt often requiring legislative or full voter approval. As such, state net tax-supported debt currently averages less than 3% of GDP. Even at the high end of the spectrum, debt-to-GDP ratios are south of 10% (Chart 5). These figures do not include unfunded pension liabilities, which are typically larger than the same burdens in Canada.

With fewer budgetary restraints, provincial net debt now stands at some 25% of GDP (Chart 6), up 5%-pts in 2009/10 alone. Still, the long-term credit rating for Canada's provincial sector (a strong AA-) is not much lower than for US states. And in the case of Ontario vs. California, the former's credit rating is stronger despite a debt to GDP ratio that is some 30%-pts higher (Chart 7). This partially speaks to reduced flexibility that California possesses, where fiscal policy changes are more difficult to adopt. More importantly, Ottawa has safeguarded transfers to the provinces, which on average comprise nearly 25% of revenue. And there's little chance the federal government would allow a provincial default.

Chart 6

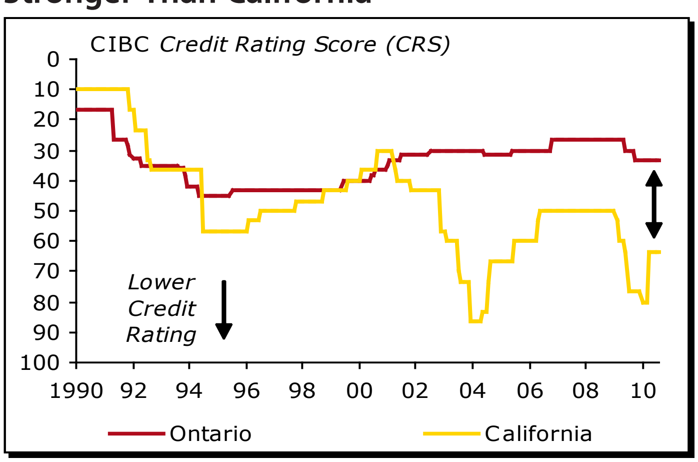
Provincial Debt Levels Much Higher



Source: CIBC, Provincial Public Accounts, Moody's

Chart 7

Despite Higher Debt, Ontario's Credit Rating Stronger Than California



Source: CIBC, S&P, Moody's, DBRS, Fitch

This implicit guarantee is embedded in Moody's provincial ratings, which hover in a narrow band from Aa2 to Aaa.

Future Pressures

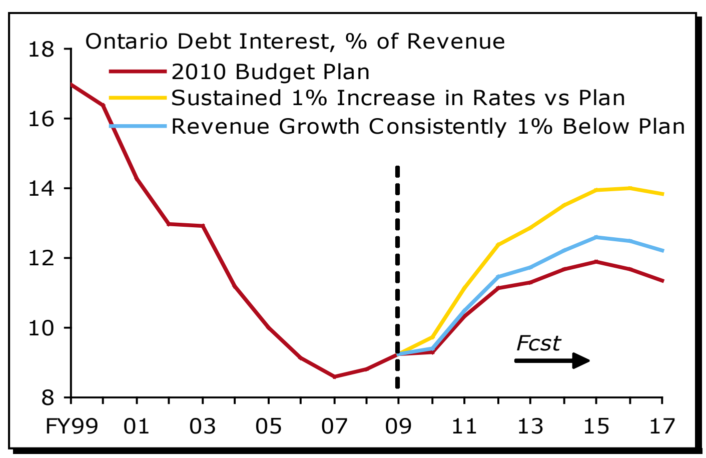
Looking ahead, economic weakness, structural deficits, unfunded pension liabilities, declining federal support, depleted reserves and limited liquidity weigh on the outlook for US states. Rating agencies also take issue with budget planning assumptions, whereas provinces tend to apply greater prudence to their outlooks. Meanwhile, divisive state politics can wreak havoc on the budget process, delaying budget adoption and leaving state governments in financial limbo. Witness California's reliance on IOUs and unpaid leave for state employees. All provinces are currently governed by majority, allowing for timely adoption of budget measures. And you won't find furloughed workers in Canada, with that tactic not used since Ontario's 'Rae Days' in the 1990s.

Taming provincial health care costs could be tricky, and additional fiscal measures could be needed to balance the books. But past debt reduction efforts created fiscal flexibility for most provinces. In Ontario, the debt service burden looks to remain manageable, even if rates are higher than forecast or growth disappoints (Chart 8).

While CDS levels imply very real concern over the ability of some states to manage their liabilities, spreads on provincial debt reflect the relative safety of the asset class. Provinces are taking advantage of international demand to relieve pressure on the domestic market, where investors continue to favour the sector for its liquidity and incremental spread over Canadas in a low yield world. So look past catchy media headlines; a province is not a state, and Ontario is not California.

Chart 8

Provincial Debt Burdens Remain Affordable



Source: CIBC, Ontario Budget

ECONOMIC UPDATE

CANADA	10Q1A	10Q2F	10Q3F	10Q4F	11Q1F	11Q2F	2009A	2010F	2011F
Real GDP Growth (AR)	6.1	2.6	2.5	1.4	1.7	2.9	-2.5	3.2	2.5
Real Final Domestic Demand (AR)	4.7	6.4	2.3	1.6	2.1	1.9	-1.8	4.3	2.4
All Items CPI Inflation (Y/Y)	1.6	1.4	1.8	1.5	1.6	2.0	0.3	1.6	1.9
Core CPI Ex Indirect Taxes (Y/Y)	1.9	1.8	1.6	1.6	1.5	1.8	1.8	1.7	1.8
Unemployment Rate (%)	8.2	8.0	8.0	8.1	8.2	8.2	8.3	8.1	8.1
U.S.									
Real GDP Growth (AR)	3.7	2.4	1.9	1.7	0.7	2.5	-2.6	2.6*	1.9
Real Final Sales (AR)	1.1	1.3	2.0	1.6	1.3	2.6	-2.1	1.3	2.1
All Items CPI Inflation (Y/Y)	2.4	1.8	1.2	1.1	0.9	1.3	-0.4	1.6	1.5
Core CPI Inflation (Y/Y)	1.3	0.9	0.9	0.7	1.0	1.1	1.7	1.0	1.1
Unemployment Rate (%)	9.7	9.7	9.8	10.1	9.8	9.8	9.3	9.8	9.6

* Assumes 10:Q2 GDP growth revised down to approx. 1-1/2% SAAR

CANADA

Second quarter GDP growth should come in just under the Bank of Canada's estimates but still above potential, which means that the negative output gap continues to narrow. But the US slowdown already in evidence and a cooling in home building here will adversely impact Canadian growth ahead. The corresponding deceleration in job creation should have the unemployment rate creep higher, which, together with the tame inflation outlook, will help keep the BoC on hold until mid-2011. We trimmed our forecasts for both headline and core inflation in response to the downside surprises in the July CPI report.

UNITED STATES

We materially scaled back our GDP forecast for both 2010 and 2011. Although we still don't see a double dip as the most likely outcome, a more job-challenged consumer, softer housing market and weaker near-term outlook for capital spending all suggest Q3 GDP will trail our earlier projections. States are clearly in a restraint mode. Our forecast assumes that Congress moves into the White House camp by softening the fiscal drag next year through an extension of tax cuts, if not exactly in the fashion proposed by Obama. Still, ample slack means that core inflation is unlikely to rise much from its record low.