CIBC World Markets

StrategEcon

March 2, 2009

Wrong Turn

by Jeff Rubin

Detroit's biggest problem isn't that it's producing the wrong type of vehicles but rather, that it's producing too many vehicles—far too many. It looks like industry capacity took a lethal wrong turn just as vehicle sales were about to collapse.

Just as two million housing starts proved to be a bubble, so was the average 16 million unit auto sales of the last five years. That was a product of a world of cheap oil and cheap credit, neither of which are likely to figure in Detroit's future (see pages 4-7).

Easy credit is already gone. The credit bubble wasn't just about sub-prime mortgages. It was just as much about car sales. Some two-thirds of vehicle sales in America over the last decade were debt financed.

The leasing market has all but dried up and the securitization market for car loans isn't far behind. If you buy a car these days, try paying cash, which of course isn't super-abundant, particularly for the over 3½ million Americans who have already lost their jobs. Auto sales have already plunged to 30-year lows and consumer deleveraging will take them even lower.

But Detroit's problems are ultimately a lot bigger than the recession. Recessions, no matter how deep, are finite affairs that rarely last more than four to six quarters. It's the recovery that poses even bigger problems. The only reason gasoline is cheap, is because no one can afford to drive. Americans drove over 100 billion fewer miles last year, leading to steep declines in vehicle sales including hybrids, which are down 30% so far this year.

When the recession is finally over, and Americans start filling up their SUVs, pump prices will go right back up to the $4 per gallon price they were last Memorial Day. Unfortunately our energy appetite will come back a lot sooner than the supply that is being cancelled everywhere, from Canadian oil sands to Brazilian deepwater fields. US gasoline consumption has already recovered to above year-ago levels.

Between consumer deleveraging, further job losses and ultimately soaring gasoline prices, tomorrow's auto vehicle market in the US is likely to shrink to something half its former size. Annual vehicle sales are likely to stabilize somewhere in the 8-9 million range over the next half-decade as vehicle ownership rates retreat back to late 1980s levels. Stripping out imports, including North American cars made in Mexico and Canada, US domestic production will likely shrink to between six and seven million units a year. At that rate, almost half of the capacity now shut in will be lost for good.

Our sales projections also mean that with as many as 14 million vehicles scrapped every year, there will be a net reduction of some 5 million vehicles on American roadways every year. Run that model for a half decade and suddenly you will discover that the rush hour drive home has become a lot quicker—providing, of course, you are not one of the 25 million Americans who will be taking the bus.

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Economics & Strategy

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MARKET CALL

- A final 50-bp cut, most likely in a single step, will mark the end of conventional easing from the Bank of Canada. Unlike the Fed, the BoC will leave direct lending and buying of spread product to other agencies —EDC, CMHC, etc.—restricting itself to making loans against a broader list of collateral to support market liquidity. Rates will stay on hold through 2009, but could rise in early 2010 as spreads narrow, making a near-zero overnight rate less essential.

- Bond yields reversed some of the earlier sell-off as investors sought a safe haven from renewed trouble in equities. While the front end of both the Canadian and US government yield curves could remain anchored by overnight rates, longer yields could return to their rising trend if, as we expect, the economy starts to show at least some signs of life this summer.

- The US dollar's strength rests on debt repayment and the lack of any clear alternative other than gold. The euro and yen are weakening in the face of even more dire economic risks, and the C$ looks to soften through June, given commodity weakness. But rapid money printing by the Fed will see dollar devaluation begin to take hold in the second half, with C$ gains extended by a resource price recovery in 2010.

INTEREST & FOREIGN EXCHANGE RATES

		2009				2010
END OF PERIOD:		**27-Feb**	**Jun**	**Sep**	**Dec**	**Mar**
CDA	Overnight target rate	1.00	0.50	0.50	0.50	0.75
	98-Day Treasury Bills	0.61	0.35	0.40	0.40	0.60
	2-Year Gov't Bond (2.75% 12/10)	1.16	1.25	1.75	2.00	2.20
	10-Year Gov't Bond (3.75% 06/19)	3.13	3.20	3.30	3.45	3.55
	30-Year Gov't Bond (5% 06/37)	3.70	3.75	3.85	3.95	4.00
U.S.	Federal Funds Rate	0.25	0.10	0.10	0.10	0.75
	91-Day Treasury Bills	0.26	0.20	0.30	0.30	0.60
	2-Year Gov't Note (0.88% 02/11)	0.99	0.95	1.05	1.45	1.95
	10-Year Gov't Note (2.75% 02/19)	3.02	2.90	3.15	3.25	3.45
	30-Year Gov't Bond (3.5% 02/39)	3.71	3.65	3.80	3.90	4.00
Canada - US T-Bill Spread		0.35	0.15	0.10	0.10	0.00
Canada - US 10-Year Bond Spread		0.11	0.30	0.15	0.20	0.10
Canada Yield Curve (30-Year — 2-Year)		2.54	2.50	2.10	1.95	1.80
US Yield Curve (30-Year — 2-Year)		2.71	2.70	2.75	2.45	2.05
EXCHANGE RATES	— (US¢/C$)	78.8	76.9	80.0	84.7	86.2
	— (C$/US$)	1.269	1.300	1.250	1.180	1.160
	— (Yen/US$)	98	105	100	97	95
	— (US$/euro)	1.27	1.25	1.26	1.30	1.35
	— (US$/pound)	1.43	1.40	1.44	1.50	1.57
	— (US¢/A$)	64.1	63.0	68.0	72.0	75.0

STRATEGY AND EARNINGS OUTLOOK

- The downgrading of our near-term outlook for both the US and Canadian economies makes an expected partial recovery in the hard hit TSX over the course of 2009 look more and more like a second-half event. In the next 4-6 months, a further deterioration in the earnings environment and weakness in commodity markets will contribute to a continued level-to-negative bias for Canadian stocks.

- Deficits half the current size in relation to the US economy were ultimately monetized by the Federal Reserve in the past. With as much as 50% of Uncle Sam's debt owned by foreigners, expect the printing presses to be working overtime at the Federal Reserve Board. Given the doubt that casts on still ultra-low embedded inflation expectations, we moved a percentage point of weighting from bonds to cash.

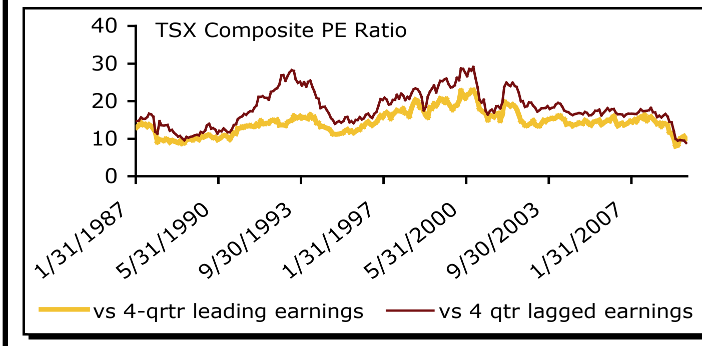
- We added another percentage point to gold stocks, a beneficiary both of ongoing turmoil and also the most obvious "currency" that the US dollar will depreciate against as monetization takes its toll. We also recommend a growing exposure to infrastructure stocks which have yet to rise as rapidly on the TSX as they have in some other equity markets.

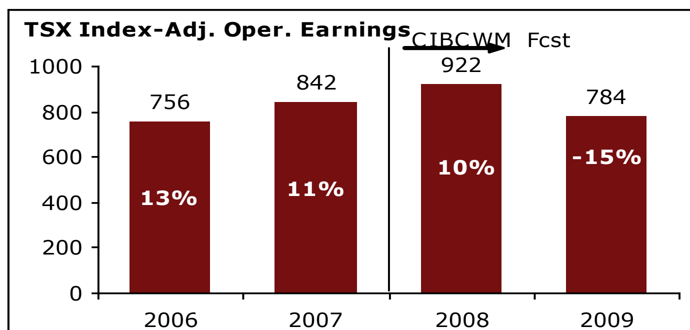
ASSET MIX (%)	Benchmark	Strategy Recommendation
Stocks	50	50
Bonds	39	34
Cash	**11**	**16**
GICS SECTOR EQUITIES (%)		
Consumer Discretionary	4.5	1.5
Consumer Staples	**3.5**	**5.5**
Energy	**27.1**	**31.1**
Financials	28.1	28.1
-Banks	16.3	16.3
-Insur., REITs, other	11.8	11.8
Healthcare	0.5	0.5
Industrials	5.8	2.3
Info Tech	4.4	3.4
Materials	**18.2**	**20.2**
-Gold	**11.7**	**13.7**
-Other Metals	2.0	2.0
-Chemicals	3.9	3.9
Telecom	6.1	4.6
Utilities	**1.9**	**2.9**

Note: Bold indicates recommended overweight.

TSX - Earnings Outlook & Forward PE

	Operating Earnings (% ch)				4-qtr Fwd PE	
	2006	2007	2008	2009	Latest	Last 10 yrs.
Energy	11.1	14.7	42.6	-24.6	8.3	12.0
Industrials	21.9	38.2	-3.1	-18.0	9.9	14.9
Materials	80.2	30.2	39.1	-9.4	13.4	28.9
Financials	19.2	13.5	-12.7	-11.1	9.1	12.0
Utilities	0.4	49.6	-61.2	122.6	28.2	17.4
Consumer Staples	-3.0	0.0	5.2	-7.9	14.7	17.8
Consumer Discretionary	6.1	8.5	19.6	-12.0	10.4	15.7
Info Tech	121.1	133.5	37.6	12.1	15.5	44.5
Health Care	29.8	-38.8	-20.5	6.0	15.4	22.0
Telecom Services	26.3	33.0	-4.3	-13.7	11.7	29.8
TSX Composite	**13.2**	**11.4**	**9.6**	**-15.0**	**10.1**	**16.1**





Source: Thomson First Call, CIBC WM

How Big Will the Post-Recession US Vehicle Market Be?

Jeff Rubin and Meny Grauman

For more than a decade now, easy access to consumer credit and cheap gasoline have fuelled an unprecedented boom in vehicle ownership in the United States that in many respects parallels the boom seen in home ownership. Yet, sales of new vehicles in the 16-17 million a year range are proving to be just as unsustainable as new home housing starts over the two million mark. The residential construction industry is now going through its most dramatic correction since the Great Depression, and the hard reality is that America's auto industry cannot escape a similar fate. The pace of housing sales and starts are half of what they were at their peak, and auto sales and production levels are destined to drop by similar proportions (Chart 1).

After two-and-a-half decades of uninterrupted growth, US automobile ownership metrics are likely to deteriorate markedly over the next five years, with both vehicles per household and vehicles per driver falling back to levels not seen since the late 1980s (Chart 2). As they do, millions of American drivers will have to come off the road, not just because of the weight of the current recession, but the longer-run challenges of tighter consumer credit and renewed strength in energy prices.

25 Million Too Many Cars on the Road Today

Both vehicles per licensed driver and vehicles per household have seen steady, almost uninterrupted growth since the last OPEC oil shock nearly thirty years ago. But both are likely to deteriorate markedly over the next five years, reversing the trend growth in vehicle ownership seen over much of the post-OPEC shock period. This fundamental change in the number of vehicles on American roads will be accomplished not only in the short-run by the broad deleveraging of consumer credit, but also by the prospect of consumers paying last Memorial Day weekend gasoline prices ($4/gal) once economic growth gets back on track.

Chart 1

The Shopping Spree Has Ended

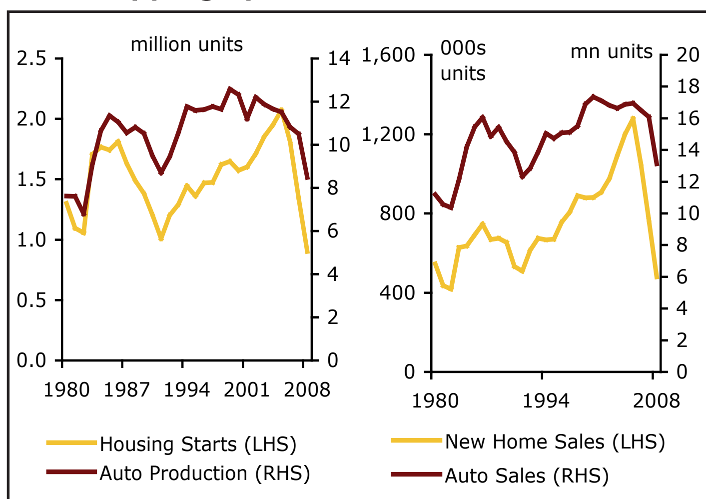
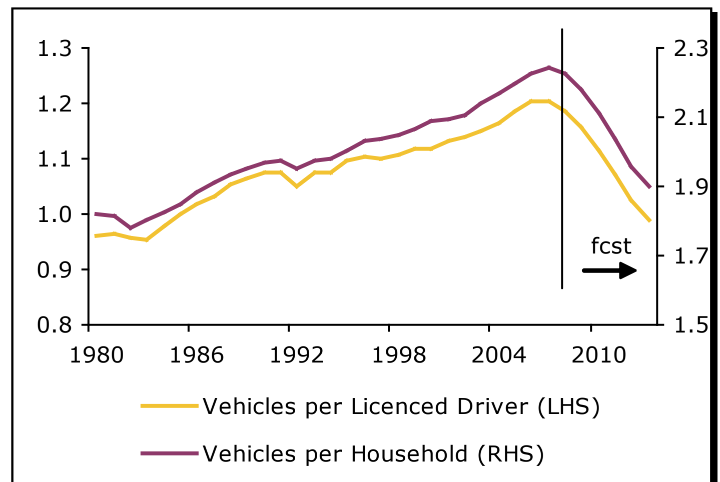


Chart 2

US Vehicle Ownership Rates Will Reverse Course



Over the last decade two-thirds of new vehicle sales were debt financed, with as much as 30% financed from leasing alone. Not only do record household debt levels limit the demand for future financing as Americans struggle to service their outstanding obligations (Chart 3), but leasing and other forms of auto credit are also being rapidly withdrawn from the market. These forces alone will take 15 million Americans off the road over the coming years, as the US consumer shopping spree ends.

That change is already taking place. Over the first three quarters of 2008 transit ridership in the US rose by 5% while Americans drove around 100 billion fewer miles last year. But high energy prices will also do their share as driving habits continue to adjust to rising energy prices. A deep global recession has led to an over-50% drop in this summer's peak pump prices, but that should reverse as global economic fortunes improve. And when it does,

Chart 3

US Consumers Face High Debt Service Burdens

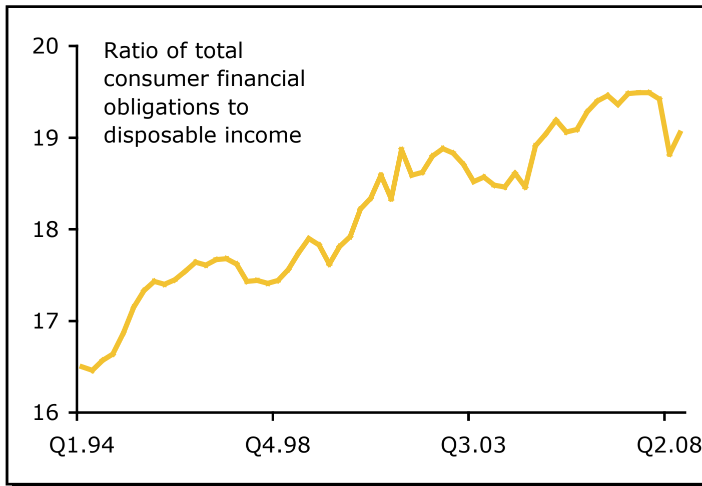
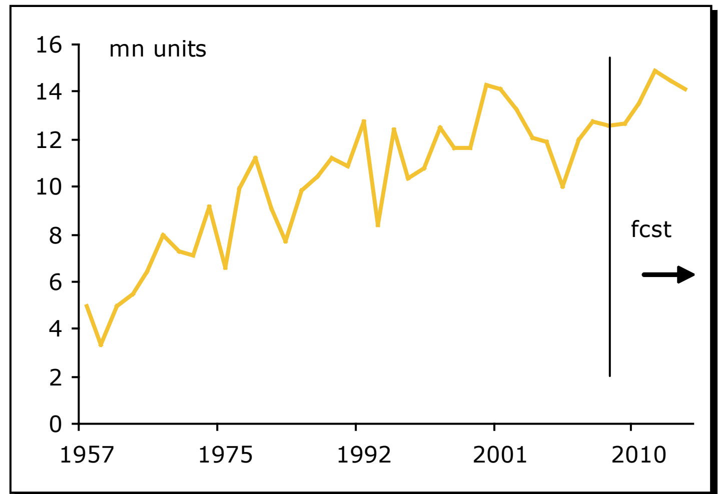


Chart 5

Number of Scrapped US Vehicles



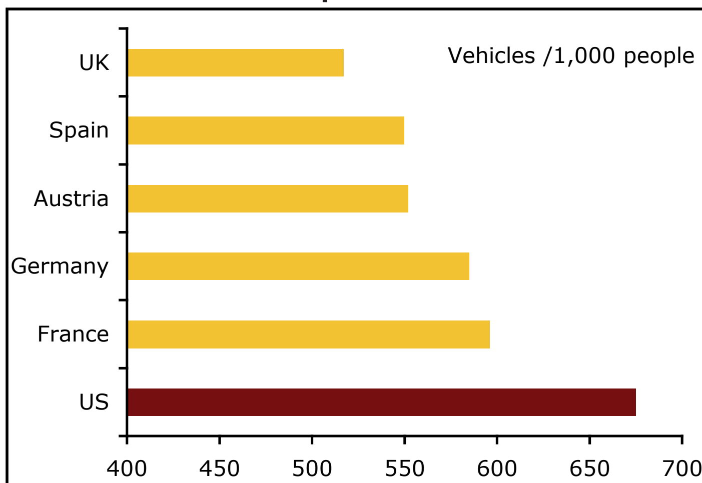
Source: R.L. Polk Co.

rising prices will force many more Americans to adopt European driving habits (Chart 4), which have been conditioned by years of paying much higher (tax-boosted) gasoline prices. The United States is not Europe, and not all Americans will give up their gas-guzzling ways. But applying European ownership rates to the 57 million US households that currently own a vehicle and that have reasonable access to public transit will get an additional 10 million Americans off the road over our forecast horizon. This is on top of the 15 million abandoning their cars for credit reasons, and is a trend that will continue to transform the US public's relationship with the automobile for some time to come.

Reductions in vehicle ownership rates can be achieved either by changes in the scrappage rate or changes in annual auto sales. Scrappage rates have historically responded to higher gasoline prices and we have allowed for a modest increase over the next five years, in line with our expectation of much higher gasoline prices during the next recovery period. But even if the scrappage rate, which has oscillated between 4-7% over the past eight years, rises modestly (Chart 5), most of the reduction in vehicle ownership should fall squarely on the shoulders of annual vehicle sales. That implies staggering reductions in volumes, almost mimicking the scale of contraction seen in the housing market.

Chart 4

US Vehicle Ownership Out of Line



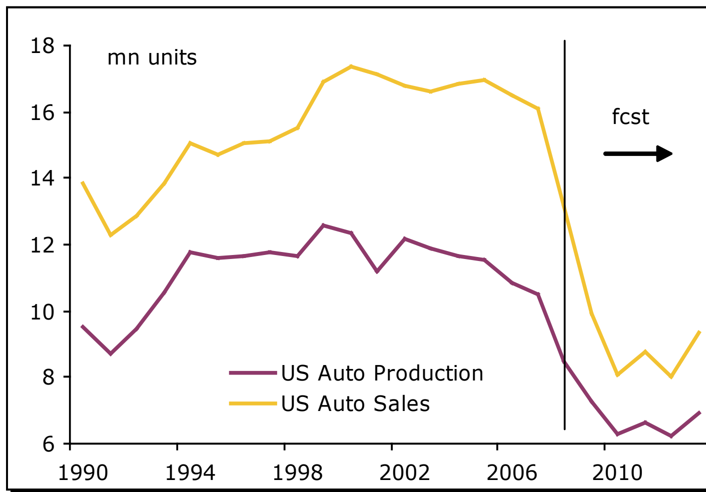
Source: IRF World Road Statistics, 2008

Although sales have already plunged to 34-year lows, our analysis suggests that they have considerably more room to contract. In 2008 sales of US vehicles were 24% below their 2000 peak of over 17 million units, and will likely fall by roughly 50% from their peak before sales begin to stabilize. Reducing vehicle ownership rates back to the late 1980s, a level suggested by both consumer deleveraging as well as higher fuel prices, implies future annual vehicle sales of somewhere in the eight to nine million unit range, or a further 30-40% reduction from 2008's already depressed level (Chart 6).

Those sales levels imply that there will be a growing exodus of vehicles from American roadways that will continue well after the current recession is over. While some 2.7 million vehicles are likely to head for the exit lane this year, we expect to see even larger reductions over the next four to five years.

Projected vehicle sales in the eight to nine million range, juxtaposed against a scrappage rate trending to 6%,

Chart 6
Production and Sales



means that roughly 5 million vehicles are likely to come off the road every year over the next five years. Overall, by 2013 we predict that there will be 25 million fewer passenger vehicles travelling on America's streets and highways compared with 2008 (Chart 7).

Making the Connection from the Showroom Floor to the Factory Floor

A market of eight to nine million in annual vehicle sales is a much smaller market than Detroit is presently built for, particularly when imports continue to account for a growing share of new auto sales every year. Most measures of US auto sales peg imports as making up no more than a quarter of the market, but that does not include the millions of vehicles sold in the US but produced in Canada and Mexico. Including these units, imports account for roughly 50% of vehicle sales, twice the level of overseas imports alone. Even assuming that this ratio does not continue to rise, but rather stays constant over the coming few years as US-based auto makers begin to hold their own versus foreign rivals, the implications for domestic production levels are significant.

Helping out US production to some extent is the fact that Detroit exports over 2 million cars and light trucks overseas every year. Nevertheless, netted out against total imports, the domestic US auto industry has been running a sustained trade deficit of over 5 million vehicles per year, and any improvement in that gap is likely to have a negligible impact on total US production.

Short-Term Production Cuts Likely To Become Permanent

The prospect of an eight to nine million US vehicle market is a sobering constraint on the size of American auto production, and the number of car plants that will remain economically viable even after economic growth returns to the United States. Netting out the reduction from imports and allowing for exports, US vehicle production is likely to be no more than 6-7 million units a year (Table 1). Compared to the production peak of nearly 13 million units back in 1999, it implies as dramatic a drop in production as the industry experienced around the second OPEC oil shock (Chart 8).

Chart 7
Annual Projected Decline in US Vehicle Stock

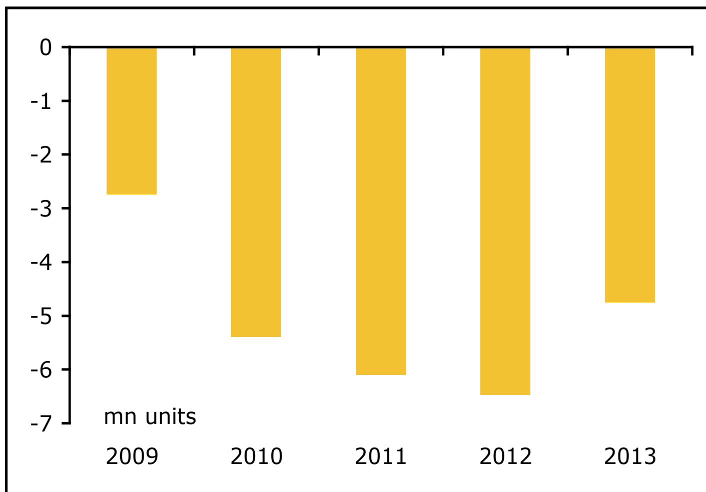
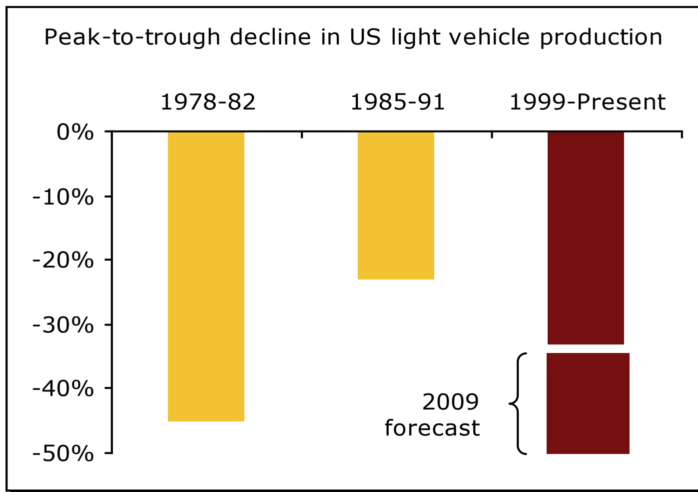


Table 1
Detroit's Shrinking World

US Sales and Production Statistics		
	2008	**2009-13 (Annualized)**
Vehicle Sales (mn)	13.1	8.0 - 9.0
Scrapped Vehicles (mn)	12.6	12.0 - 15.0
Decline in Total Vehicle Stock (mn)	0.50	3.0 - 6.0
Production (mn)	8.5	*6.0 - 7.0*

Chart 8

Historical Production Drops



Considering that average annual plant capacity in the US is roughly 250,000 units per year, our production estimate implies that roughly half of the US's 51 light vehicle plants should be permanently shuttered over the coming years as the industry shrinks to fit the contours of a vastly smaller market. And these reductions will, of course, also flow through to the employment picture, where overall job losses in auto manufacturing could add up to another 200K positions. This is on top of the 560K lost jobs in this sector since employment hit a high of 1.3 million in 2000 (Chart 10). All told, just like US housing sales and starts have fallen to levels with no modern precedent, the drop in US vehicle sales and production should be just as dramatic. Except in this case, long-term changes in the way Americans drive will mean that the good times for the auto industry are never coming back.

With the majority of US auto plants either idled or running well below capacity in January, current vehicle production is essentially running at a record low 4 million annualized units a year (Chart 9). While that figure is sure to climb over the next few months, our analysis suggests essentially half of the production that is currently sidelined should be shut down for good. Total US light vehicle production fell to 8.5 million in 2008, but our current sales forecast suggests another decline of roughly 1.6 million units for all of 2009 before production hits a more sustainable level.

Chart 10

Employment Continues to Fall in Auto Sector

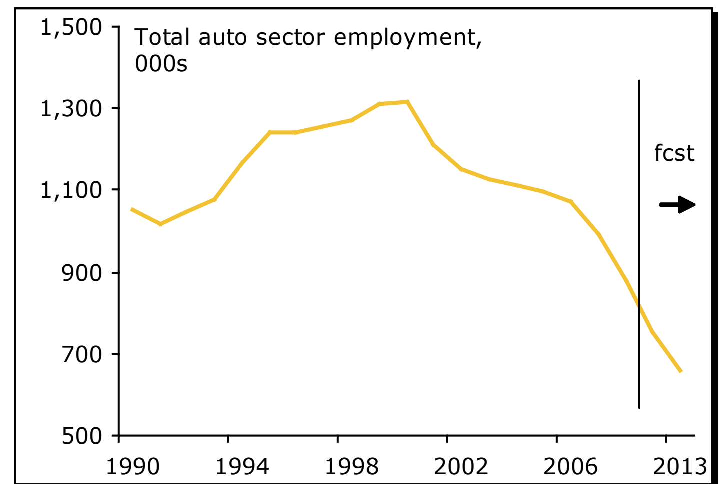
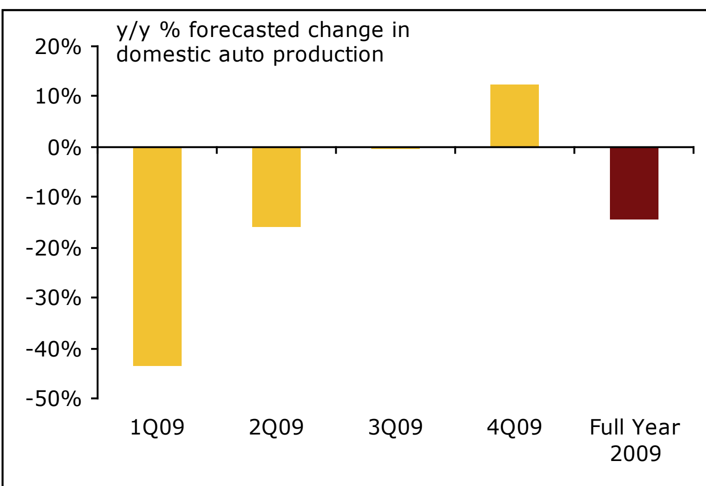


Chart 9

2009 Production Change



Source: Ward's Auto Group

Unmasked: Canada's Narrowing Economic Base

Avery Shenfeld and Krishen Rangasamy

Looked at through the lens of the past expansion, Canada appeared to be a world beater, paying down debt despite cutting taxes, pushing the employment rate to record highs, and running an impressive trade and current account surplus. But the headlines hid a dramatic narrowing of the country's economic base, particularly when it comes to trade with the rest of the world. That trend will likely continue in the next expansion, with implications for Canada's currency and economic volatility, and for regional disparities.

Why So Sensitive?

December saw Canada record its first goods trade deficit in decades, a stunning crash from surpluses in the $5 bn range that prevailed only months earlier (Chart 1). It's easy to blame that on a global recession and its impact on foreign demand, or to point a finger at the deep dive in commodity prices.

While both points are valid, they don't provide all the pieces of the trade puzzle. For one, we've had other global recessions in the past, without seeing as large a swing in Canada's trade position, in part because depressed domestic demand also stems import levels. And while resource prices have taken a drubbing, the Bank of Canada's commodity price index, when measured in Canadian dollars (to line up with the C$ trade data), is still at lofty levels relative to the 1998 Asian crisis or the 2001 US recession, periods in which Canada maintained a trade surplus.

What amplified the deterioration in the trade balance was a gradual structural shift in Canadian trade over the past decade. This recession and the associated commodities slump proved so damaging because over the past ten years, Canada has moved all of its trade eggs into a single basket, resources. A decade ago, Canada's trade surplus rested on several legs, including black ink in such sectors as autos, rail cars, ships, and furniture (Chart 2). By 2008, these were all sporting deficits, and trade gaps in other products like clothing had widened materially. So while the annual trade surplus was still very impressive last year, it rested solely on the ability of huge revenues from energy and other commodities to cover the costs of importing just about everything else.

More To Come

Clearly, the US recession that began in 2008 has been tough news for non-resource Canadian trade, but the trouble predates the US downturn. And it's likely to continue in its wake even if export volumes recover, as

Chart 1

Canadian Trade Balance: Disproportionate Hit to the Drop in Commodity Prices

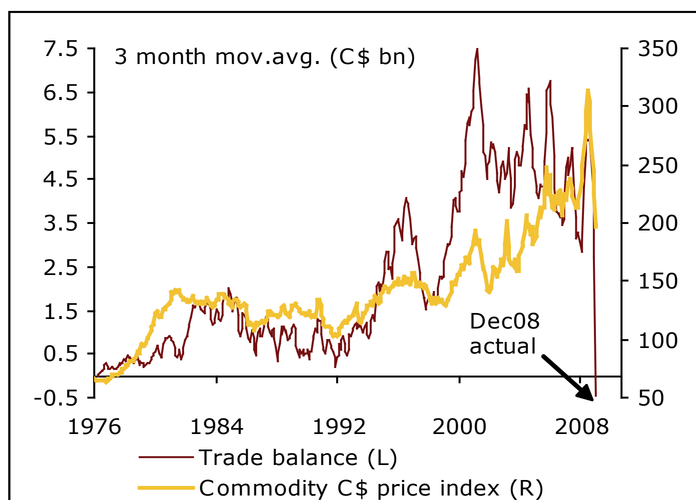


Chart 2

A Structural Shift in Canadian Trade

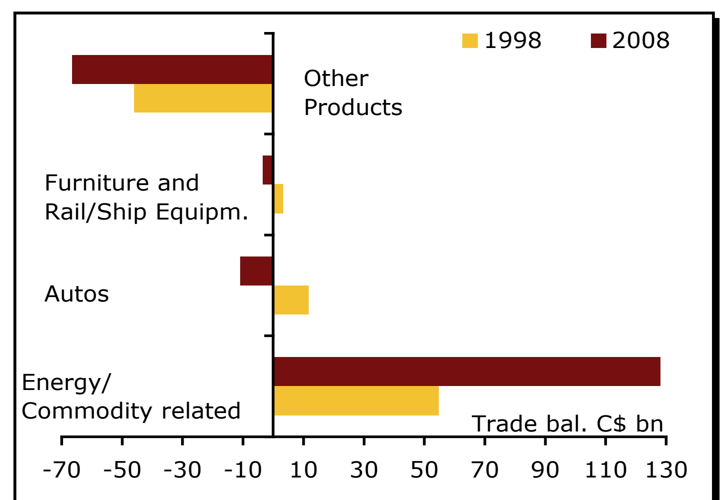
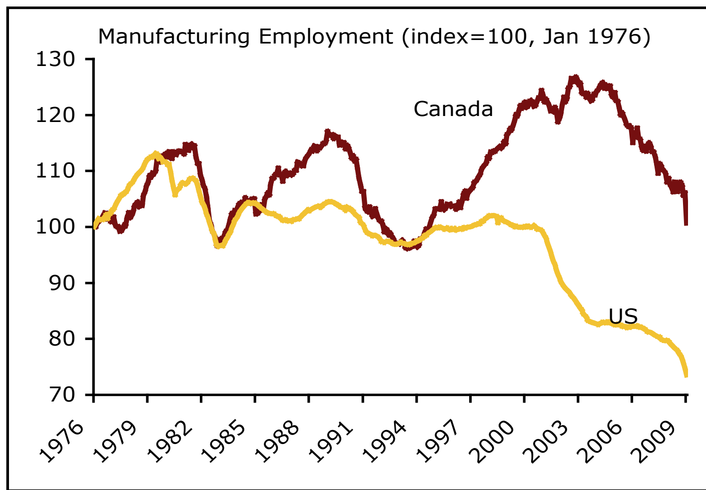


Chart 3

Canadian Factory Jobs Again Tracking US Trend



manufactured imports will also be drawn in by a revival in Canada's domestic demand.

A look just across the border provides a sense of what lies ahead. With two exceptions, Canada's factory employment has closely tracked American developments (Chart 3). Those exceptions came in the wake of deep depreciations in the Canadian dollar in the mid-1980s and again in the late 1990s, currency moves that put a huge "for sale" sign on Canada's manufacturing workers relative to those stateside. The latter depreciation, for a while, prevented Canada from seeing the same rush to Asia that plagued US factories at the time.

But the currency appreciation over the 2002-2007 period drove the final nail into the coffin for many Canadian non-resource manufacturers, and led to plant shutdowns in autos and parts, furniture, clothing and other sectors, putting Canada on the same sliding track visible in America's manufacturing heartland. As a result, expect the purge in output and jobs to continue, even at those factories still standing after the recession ends.

Don't Count on a Cheap Loonie

Of course, the loonie has recently lost some 20% of its value against the greenback. But don't count on that to open up a lasting window for Canada to recoup what it has shed in terms of its earlier, more diverse industrial base, simply because the weak currency is unlikely to outlive the current recession. By the time the recovery is far enough along for industries to be looking to add to capacity, the Canadian dollar will surely be much closer to parity against the greenback.

That will parallel the response in both global growth and commodity prices to huge stimulus efforts worldwide. Commodity prices are, of course, highly cyclical. The recession didn't create any new supply for oil, metal, and the like, it simply depressed global demand. Indeed, reduced exploration and development spending during the slowdown will deplete supply projections for the first few years of the economic recovery.

And because the Canadian trade balance now leans so heavily on resources, the currency has become much more sensitive to a cyclical upturn in commodity prices (Chart 4) than was the case in prior decades. Moreover, for all exporters, the link to volatile resource markets has made foreign exchange planning a much greater headache, as it had made the currency more volatile and subjected it to much wider peaks and troughs.

The currency can sustain these stronger levels, even given what it dishes out to the manufacturing base, owing to the huge potential surpluses in resources. Moreover, the current account has been buttressed by the earlier run of large surpluses in the trade and current account. That left Canada running a net outflow position in the financial account, allowing the country to make considerable progress in paying off its net foreign debt. The result is that the now smaller net interest and dividend outflows no longer provide as powerful a check against C$ strength (Chart 5).

Chart 4

C$ Now More Responsive to Commodities

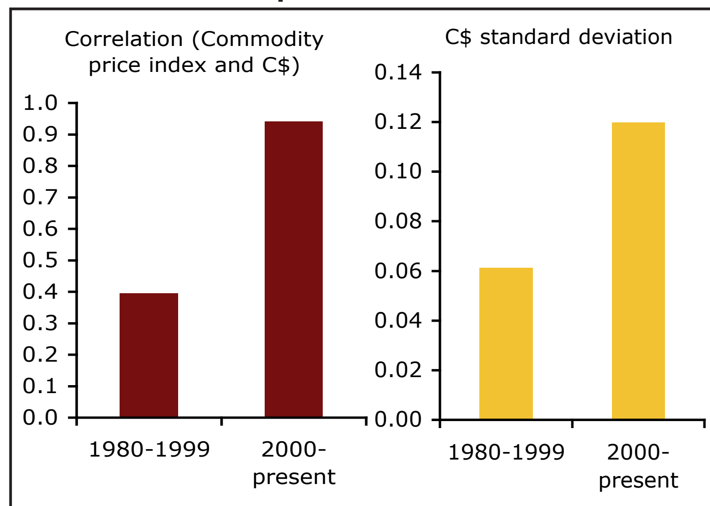
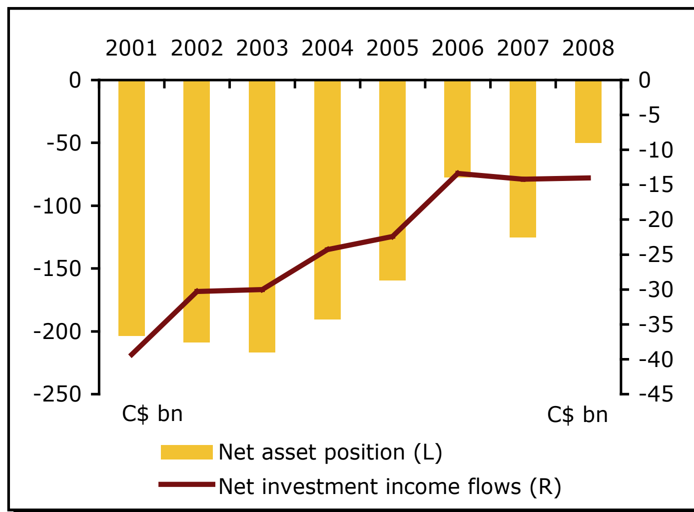


Chart 5

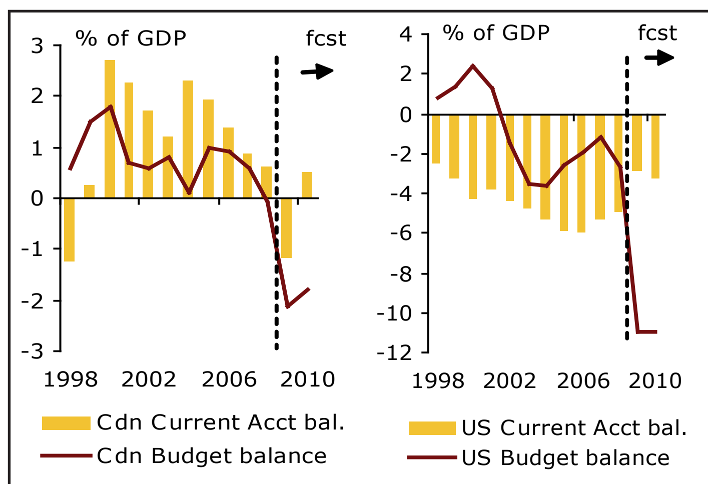
Canadian International Investment Position and Income Flows



And the greenback has problems of its own. America's economy looked reasonably healthy in the past expansion, but with hindsight, it's clear that growth was funded off an unsustainable mix of easy credit from abroad that funded aggressive tax cuts, and an asset bubble that encouraged households to join in the borrow-and-spend trend. That enabled the US economy to shrug off an ever-growing trade deficit as production shifted elsewhere, but helped set up today's credit crunch recession. In the next expansion, the US will need a cheaper currency to stem its import appetite and improve its export performance in order to allow the economy to be less dependent on debt-financed government and household spending.

Chart 6

Twin Deficits Not Permanent in Canada



Not in America's Path

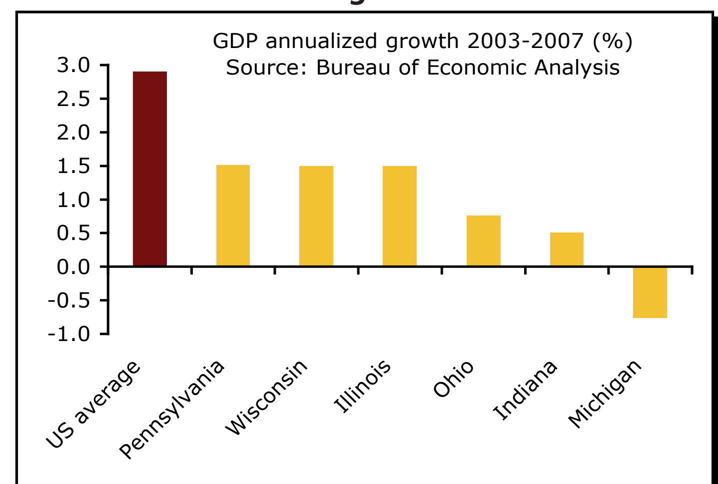
Fortunately, while Canada is now following the US lead in terms of its manufacturing base, that won't have all of the same adverse consequences for our economic fortunes. It is true that Canada now shares one key hallmark of the Bush era, twin deficits for both government and the current account (Chart 6). But at least the latter looks to be temporary, given prospects for a return to more favourable terms of trade beyond 2009. Indeed, even in the absence of much of a rebound in real exports, a price rebound for commodities should see a small current account surplus in 2010. So unlike the US, Canada will not be dependent on net borrowing abroad to finance its import purchases in the coming expansion.

Still, for some regions, particularly manufacturing-centered Ontario, US developments point to some serious challenges ahead to avoid the fate of states in America's midwest manufacturing heartland, which bore the brunt of the adjustment towards shifting production overseas (Chart 7). With the C$ now firmly in the grasp of resource price developments, a global economic recovery is only a mixed blessing for Ontario, since that will lift the C$, making the province even less competitive on a labour cost basis. All the more so given the sobering prospects for the North American auto industry (see pages 4-7).

For now, all regions of Canada are struggling as both manufacturing and resource industries are hit by the global recession. But look for Canada's East-West growth divide to return as commodities recover in the next global expansion.

Chart 7

Manufacturing-Intensive US States Trailed National Average Even Pre-Recession



What is the True Price of Oil?

Peter Buchanan

WTI Cushing Makes Oil Look Cheaper Than It Is

WTI priced at Cushing, an obscure Oklahoma town, is so often used to represent the general price of oil, that the two are viewed as synonymous, but there's a difference—a growing one, in fact. Roughly 160 crudes are traded in volume around the world, a few serving as "benchmarks"—reference points for pricing other crudes, or futures contracts. Ideally, a benchmark should have a stable, predictable relationship to other crude prices. That's scarcely been true of WTI, which has traded at a record discount of $11/bbl, or more, to the world's other leading crude benchmark, Brent recently, vs a historical average $1-2 quality-related premium (Chart 1).

Increasingly Sensitive to Local Rather Than Broad Market Conditions

WTI's increasingly tenuous link to other key crude prices is all the more a shortcoming, since its share of total US supply has fallen to a diminutive 2-3% (Chart 2, left). The bulk of supply these days is from heavy crudes, and less than half of the oil stored in Cushing is, reportedly, WTI. Attesting to the light Texas oil's suitability for gasoline production, differentials between WTI and other crude streams have a seasonal component, rising in step with summertime gasoline demand, and are also strongly influenced by available free capacity at the Cushing pricing point. Cushing oil is mostly used, these days, by local refiners. Storage capacity pressures (Chart 2, right), as these have cut their runs due to the recession's hit to demand, have made it impossible for traders to arbitrage away differentials of as much as $11/bbl between spot prices and the front or second NYMEX contract.

Cushing Becoming a Waystation for Alberta Crude

Changing oil supply patterns are also helping to divorce prices at Cushing from broader national and global trends. Oil used to move northward through the continental heartland, but today flows the other way. Nearly three years ago, Enbridge reversed a newly acquired pipeline, bringing Canadian crude to Cushing for the first time, and that flow will become a flood later this year when the half-million barrel-per-day Keystone Pipeline starts up, further intensifying capacity pressures at Cushing. High quality crudes like benchmark Light Louisiana Sweet now routinely trade at Gulf Coast ports at a $7-8/bbl premium to Cushing, but the lack of a south-flowing pipeline link keeps traders from arbitraging those differences away.

The prospect that Cushing oil will continue to march to its own drummer is forcing market players to look at other bellwethers, but some of these also have shortcomings. Brent is based on crudes from four North Sea fields, meaning quality can differ at times, resulting in the need for pricing adjustments. The US average refiners' acquisition cost may well be the best broad indicator of crude prices since it averages all streams in the world's largest market, but it's available only with a two-month lag.

Chart 1

WTI Failing to Track Brent, Other US Crudes

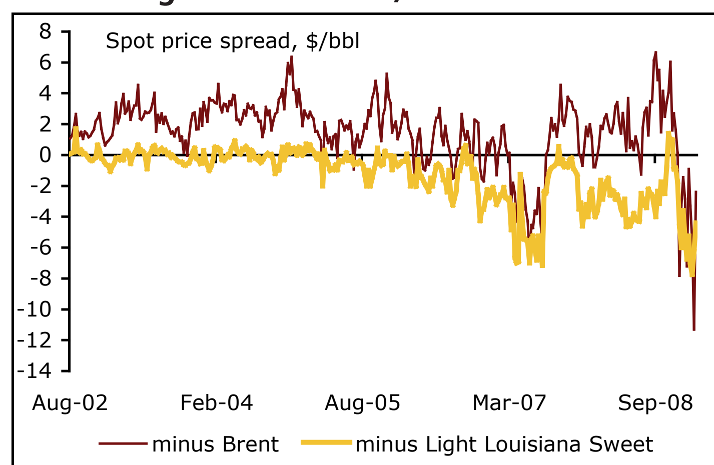
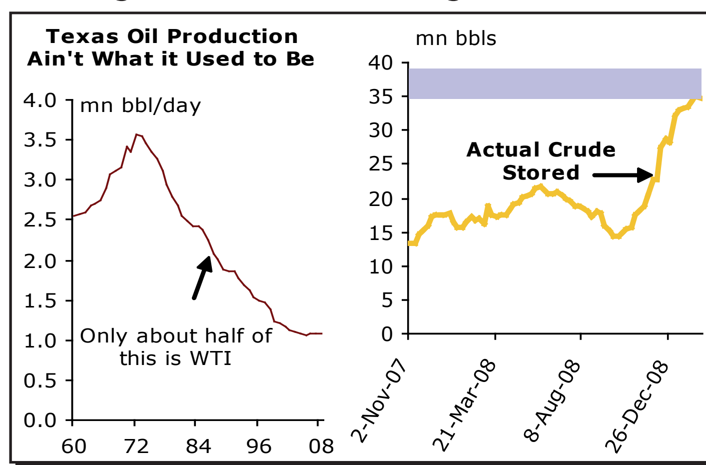


Chart 2

Texas Oil Production Falling (L), Cushing's Tanks Are Brimming (R)



Shading indicates est. max. operable storage capacity at Cushing, 37-39 mn bbls

ECONOMIC UPDATE

CANADA	08Q4F	09Q1F	09Q2F	09Q3F	2008F	2009F	2010F
Real GDP Growth (AR)	-3.8	-4.0	-1.6	2.7	0.6	-1.3	2.0
Real Final Domestic Demand (AR)	-2.7	0.6	-0.5	1.9	2.9	0.2	2.1
All Items CPI Inflation (Y/Y)	1.9	1.5	0.6	0.0	2.4	0.8	3.3
Core CPI Ex Indirect Taxes (Y/Y)	2.2	2.1	1.8	1.7	1.7	1.8	2.1
Unemployment Rate (%)	6.4	7.5	8.2	8.5	6.1	8.2	8.4
U.S.							
Real GDP Growth (AR)	-6.2	-4.2	-2.4	2.2	1.1	-2.1	2.2
Real Final Sales (AR)	-6.4	-3.3	-3.6	1.4	1.4	-2.3	2.5
All Items CPI Inflation (Y/Y)	1.6	-0.2	-1.7	-2.2	3.8	-0.7	4.2
Core CPI Inflation (Y/Y)	2.0	1.7	1.5	0.0	2.3	1.5	2.3
Unemployment Rate (%)	6.7	7.9	8.6	9.0	5.8	8.6	8.4

CANADA

Early this month, we revised our 2009 GDP projection from -0.5% to a more than 1% drop, as data pointed to steeper declines in both Q4 2008 and Q1 2009. We're sticking to our call for growth to resume in the latter half, and for a somewhat lackluster expansion in 2010. "Fixing" the global financial system, particularly outside Canada's borders, remains a piece of the puzzle that needs to be resolved if the recession is indeed to end later in 2009, and Canada will likely require extended deficit-financed fiscal stimulus as well.

UNITED STATES

Massive fiscal spending and unprecedented monetary action by the Fed continue to anchor our belief in a modest economic recovery over the second half of the year. Nevertheless, for the time being, the US remains mired in a deep economic recession that rivals the slowdowns of the early 1980s. Industrial production is crashing, consumer spending has dried up and job losses are expected to push the unemployment rate to a peak of 9.0% by Q3. Soft demand and plunging energy prices will keep weighing on inflation, sending year-over-year headline CPI into negative territory. However, this inflation trend should reverse in 2010 as the US government increasingly turns to the printing press to manage an exploding deficit.

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