

Investing Opportunities in Canada

October 2011

- **Short-term interest rates will probably rise in 2012**
- **Bond yields are unsustainably low and will rise with global yields**
- **CAD is high in trade weighted terms and will fall if the USD rises**

Economic activity contracted in the 2008-2009 recession before rebounding solidly during the past two years. Very accommodative macro policy has supported an increase in private sector spending with corporate spending rebounding particularly rapidly. This has fuelled a rise in employment and a reduction in the quantity of spare resources. The private sector remains well placed to increase expenditure even if the policy stimulus is removed. Inflation has risen due largely to higher commodity prices, but competitive forces should keep it contained over the coming years (see table of key forecasts).

The Bank of Canada began reducing its monetary policy stimulus in the middle of 2010 but with short-term interest rates still only 1%, the policy stance remains extraordinarily accommodative. The global financial market turmoil of recent months has led expectations of future interest rates to move lower (see top chart). Current futures market prices imply that official interest rates are expected stay near 1% throughout the coming year. Such an outcome is possible but it seems unlikely unless current financial market problems prove long lasting and result in a marked worsening of the general economic environment. The risks are heavily skewed towards a rise in official interest rates in the coming years as the central bank moves its policy stance gradually back towards a more "neutral" position.

Bond yields have declined sharply during recent months mirroring the sharp falls in many other countries. This decline has taken yields down to a multi-decade low (see middle chart). The current level of yields appears unsustainably low with Canadian bond yields low in real terms, low relative to short-term interest rates and low relative to global bond yields. Bond yields are highly likely to rise particularly if global bond yields rise.

The Canadian dollar reached a multi-decade high in 2007. Since then, it has been volatile with a sharp decline in 2008 followed by an equally sharp rebound. CAD was back at the 2007 highs in the middle months of this year before declining again recently (see bottom chart). High energy prices are almost certainly helping to underpin the currency but much of the "weakness" and "strength" of the dollar in the past few years has actually been due to rises and falls in the US dollar (which dominates the Canadian trade-weighted index). If the USD rebounds from its current low levels, the Canadian dollar would probably decline in trade-weighted terms.

Canadian equities have fallen sharply in recent months in line with global equities. The total loss during the past twelve months has exceeded -5%. In the coming couple of years, the corporate sector should be a relatively comfortable position if the economic environment unfolds in line with our expectations. This could be assisted by currency movements restoring competitiveness to Canadian firms. In such an environment, positive equity returns would be expected.

Key Forecasts			
	Dec-12	Dec-13	Dec-14
GDP	1	3	2
CPI	2	2	2
Overnight	2.00	4.50	5.00
10 year	4.75	5.25	5.25
CAD/USD	1.15	1.25	1.25

