Economic Outlook and Forecast: US and Canada

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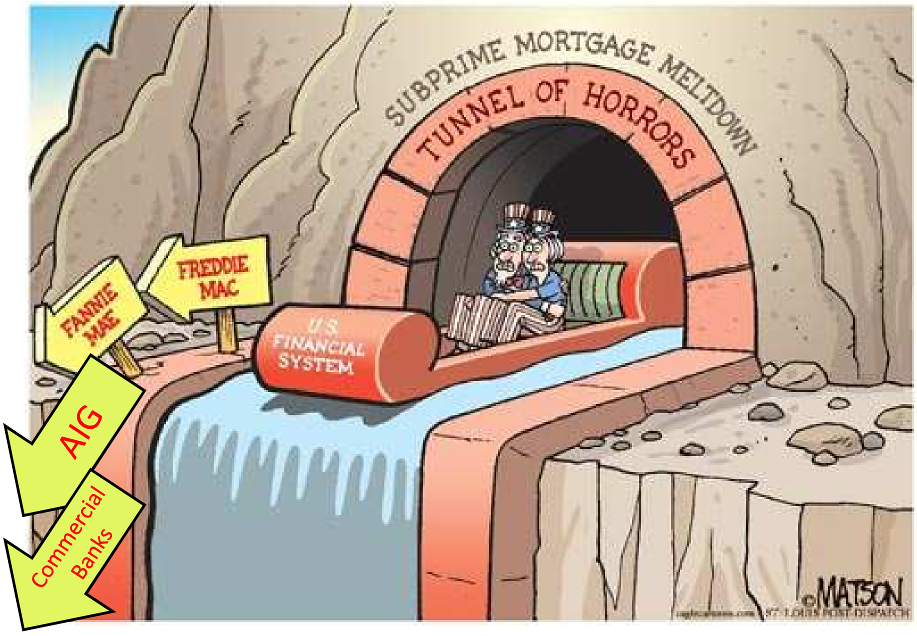
U.S. Economic Outlook and Forecast

A look back one year ago…

"I THOUGHT WE WERE JUST BUYING A HOUSE!"

Today…



How did we get here?

- Lead up to "The Perfect Storm"
  - 2001 to 2006: Low yields on safe financial assets
  - Investors seeking higher yields created new and innovative mortgage schemes
  - Huge growth in subprime mortgage lending
    - 2001: $160 billion in subprime mortgage originations
    - 2006: $600 billion in subprime mortgage originations
      - 20 % of all mortgage originations
    - Many subprime mortgages viable only if housing prices continue to rise
      - 80 % of subprime loans were refinances

How did we get here?

- The spread of subprime mortgages throughout the financial sector
  - "Originate and Distribute" mortgage lending not new to this era
  - Mortgage backed securities (MBSs):
    - Fannie Mae introduced in 1981
    - Private sector MBSs
  - Collateralized Debt Obligations (CDOs)
    - CDO "Tranches" comprised of MBSs
      - Grouped into various risk grades
    - Evaluated and graded by Moody's, Standard and Poor's, and Fitch Ratings …

Markets, Information, and Risk

vs.

Why such a deep and widespread crisis?

- Countless financial entities bought CDOs
  - Assumed the risk rating was accurate: naïve?
- Private underwriters began offering insurance contracts on CDOs
  - Credit Default Swaps (CDSs)
  - Huge scale:

    $5 trillion in outstanding bonds worldwide

    $60 trillion in CDSs

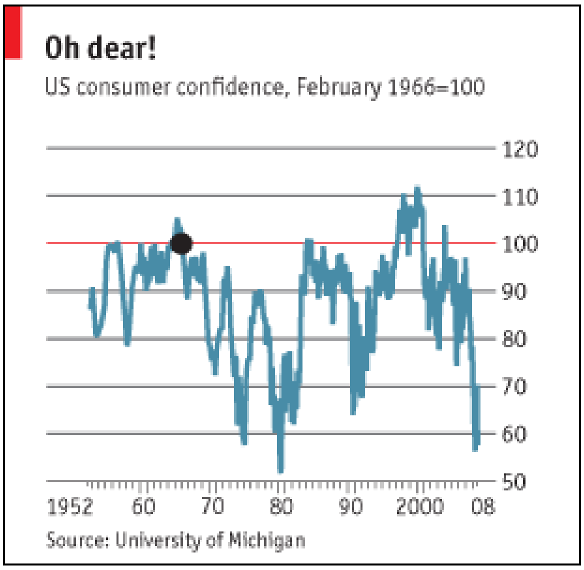
Why such a deep and widespread crisis?

- Purchases of CDOs and CDSs by all types of financial entities, including some the same banks who made the original subprime mortgages
- Mark-to-market assets valuation
- Financial crisis poster child:
  - American International Group (AIG)

Current Situation

- Banks hesitant to lend to each other and other financial entities due to uncertainty about
  - Their own positions
  - The positions of potential borrowers
- Tight credit supplies negatively affect all businesses and households
  - Existing businesses need operating credit
  - New investments derailed
- Contracting consumer demand due to
  - Falling stock market
  - Growing unemployment
  - Stronger US dollar (foreign consumers of US goods)

Declining Consumer Confidence



Source: *The Economist* Nov. 6, 2008

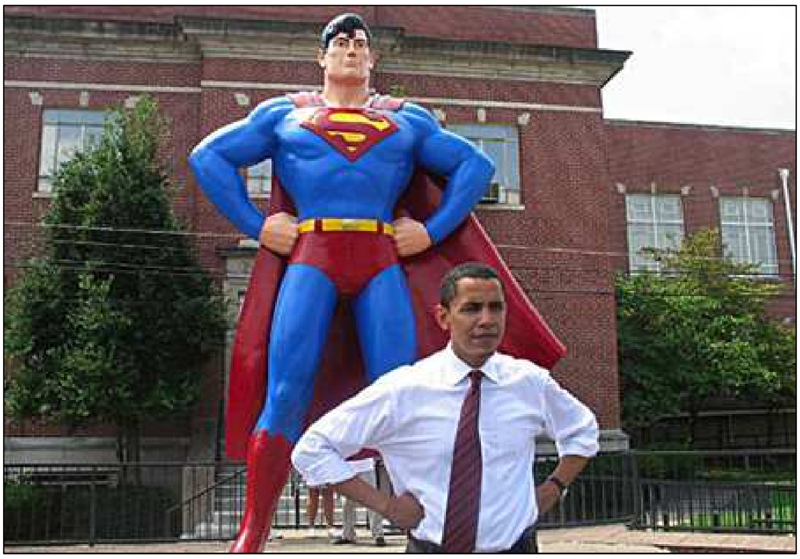
Current Macroeconomic Indicators

Variable	previous 12 months	latest (date)
Unemployment	5.3 %	6.5 % (Oct. 08)
Annual Inflation	4.9 %	2.7 % (July-Sept. 08)
Annual Real GDP Growth	2.1 %	-0.3 % (July-Sept. 08)

Outlook

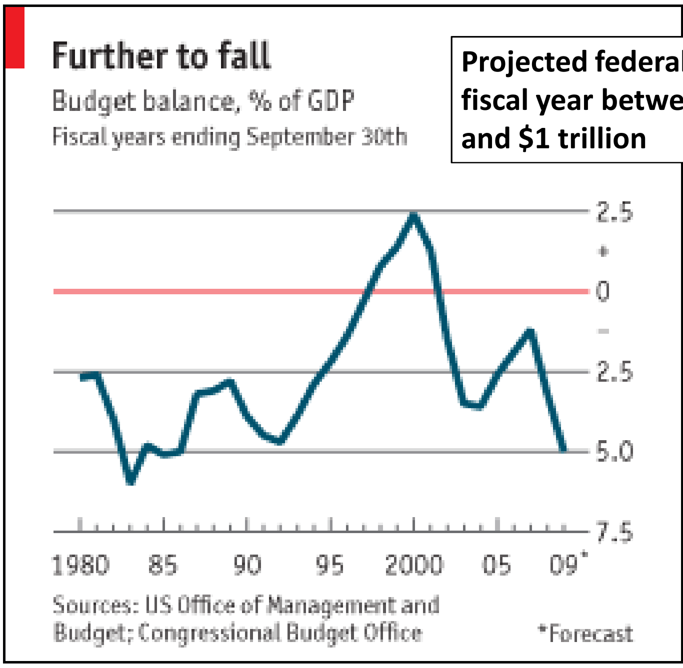
- Nouriel Roubini (a.k.a Dr. Doom), NYU, Sept. 15, 2008
  – "This is a severe economic and financial crisis. And the only light at the end of the tunnel so far is the one of the incoming train wreck…"
  – See *Foreign Policy* March/April 2008

To the rescue?



Congressional and/or Presidential Reaction

- Any new initiatives (e.g., health care, alternative energy) will be severely constrained by a growing federal deficit
- Another fiscal stimulus (?)



Projected federal deficit in current fiscal year between $700 billion and $1 trillion

Source: *The Economist* Oct. 23 2008

Endgame

- Potential for a deep and prolonged recession is much higher than in recent history
- Conventional monetary and fiscal tools not available to policy makers
  - New activities and tools of the Federal Reserve untested
- Impending financial regulatory changes
  - Where to start?
  - Recent debate at economist.com

Canadian Economic Outlook and Forecast

Canada-US Comparison

- Causes of the current economic conditions are different in Canada then the US
- US situation is largely related to financial system problems and poor financial conditions
- Canada’s situation is largely a trade problem

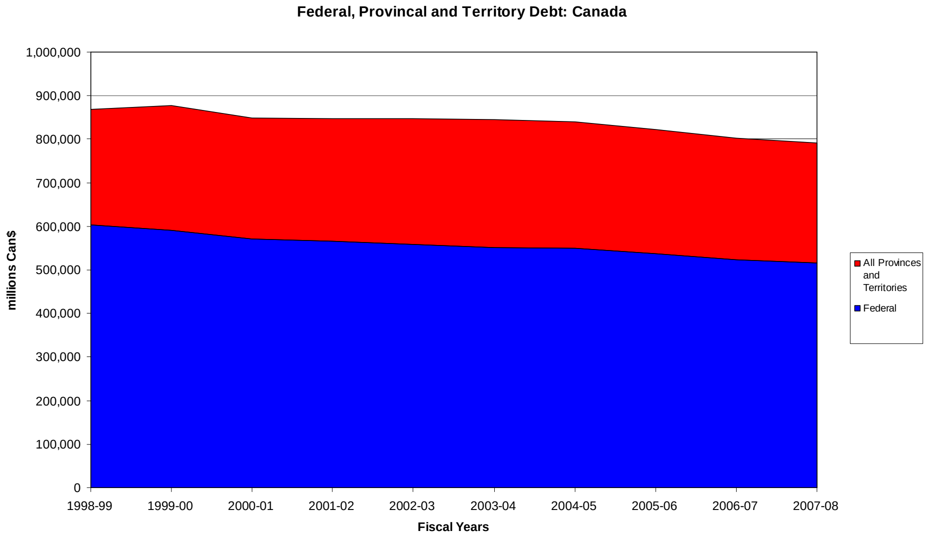
Canadian Financial Conditions

- Two areas of consideration
  - Public Sector (i.e.. Government deficits & debt levels)
  - Private Sector (i.e.. Bank Solvency and Personal debt levels)

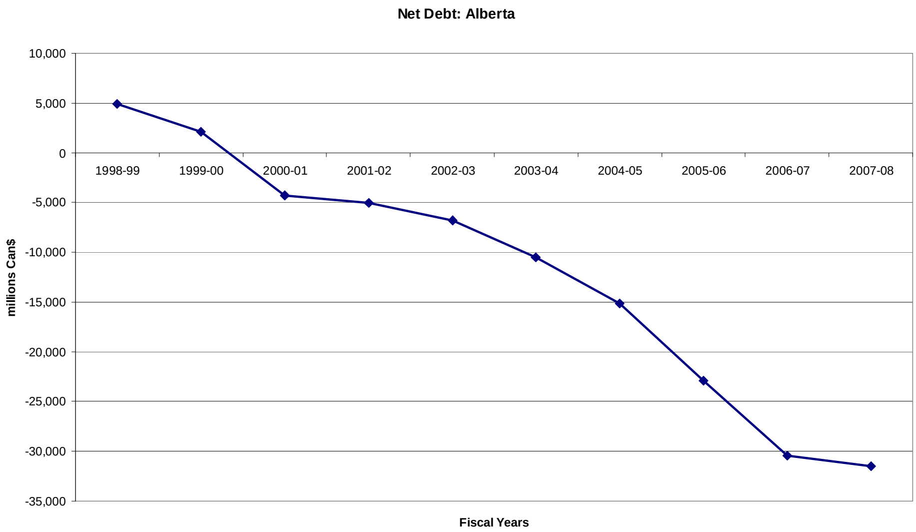
Public Sector

- Canadian governments have been mostly running surplus in recent years
  - Federally since 1999-2000 fiscal year
  - Provincially most since 2004-2005 fiscal year

Public Sector



Public Sector



Private Sector

- Canadian Banks most solvent in the World
  - More risk adverse
  - Tighter Regulations
    - Cash holding = 7% Tier 1 capital
    - Chartered Bank exist at the leisure of the Finance Minister (Nationalization does not require legislation)
  - Investment banks owned by commercial banks

Private Sector

- Exposure to international debt crisis minimal
  - $10 billion write down < 1% of world losses
- Result is Canadian government has not spent any money to bailout banks
- Loan Guarantees for Chartered Banks' international loans
  - There is no expectation of ever exercising them

Private Sector

- Personal and Corporate debt levels have followed similar pattern in Canada and US

Canadian Trade Conditions

- 50% of Canadian GDP is directly or indirectly linked to trade
- 80% of Canada's export trade is with the US
- Approximately $1 billion per day in bilateral trade
- Canada runs trade surpluses year after year
- Canada's economy is highly dependent on trade

Current Situation

- The drop in foreign domestic demand has resulted in declining Canadian exports
  - 2007 +1.0%
  - 2008 -3.4%
- Export dependent sectors effected first
  - Auto Sector
  - Lumber and Building Products
  - Manufacturing
  - Oil, Gas and Natural Resources (lower prices)

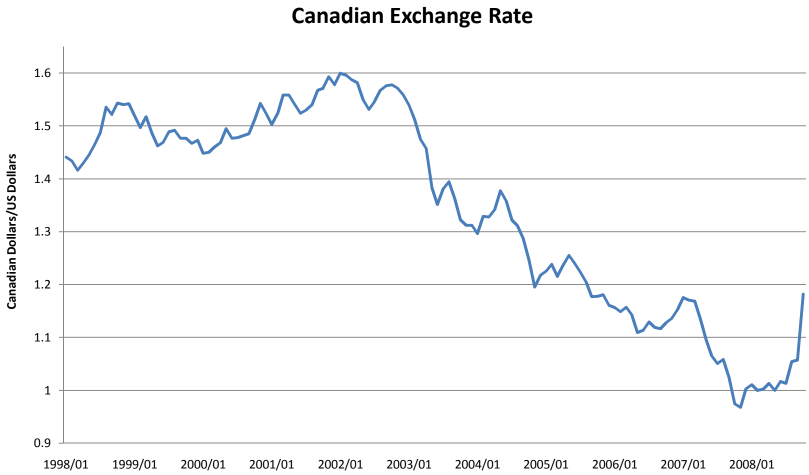
Current Situation

- Regional difference
  - Ontario, Quebec and British Columbia face more negative pressure
  - Prairies and Atlantic Canada face less negative pressure

Current Macroeconomic Indicators

Variable	2007	2008
Unemployment	6.0 %	6.1%
Annual Inflation	2.2%	2.5%
Annual Real GDP Growth	2.7 %	0.6 %

Current Macroeconomic Indicators



Endgame

- Canada's strong fiscal policies over the last decade gives Canadian Governments more options then US
- Continued weakness in the Canadian economy until US economy and consumer demand picks up

Questions

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Selected References and Places of Interest

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