

North American Economic Outlook

The Canadian Plastics 13th Annual Resin Outlook Conference

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Financial Market Turmoil—What are the Implications?



Near-term macroeconomic impacts for the U.S. and Canada:

- Higher cost of capital will weigh on economic growth

Longer-term effects on the financial services sector:

- An upward adjustment to the pricing of risk that will permanently raise the cost of funds
- Increased regulation though more so in the U.S. than in Canada
- Impaired balance sheets that will result from re-capitalization and deleveraging
- Future of securitization?
- Demise of U.S. investment banks?



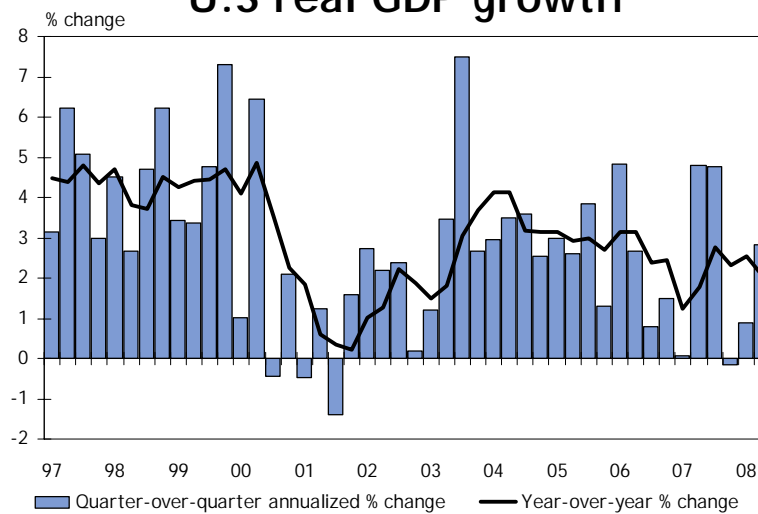
U.S. Economic Outlook: Weak Growth though Avoiding Sustained Declines

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The financial market turmoil has weighed on growth with fiscal stimulus providing a brief respite



U.S real GDP growth

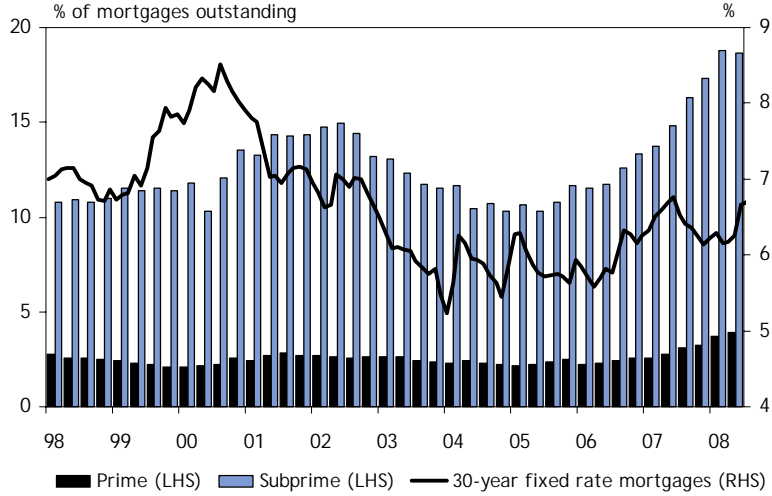


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The rise in defaults on subprime mortgages was the catalyst for the turmoil in financial markets



U.S. mortgage delinquencies

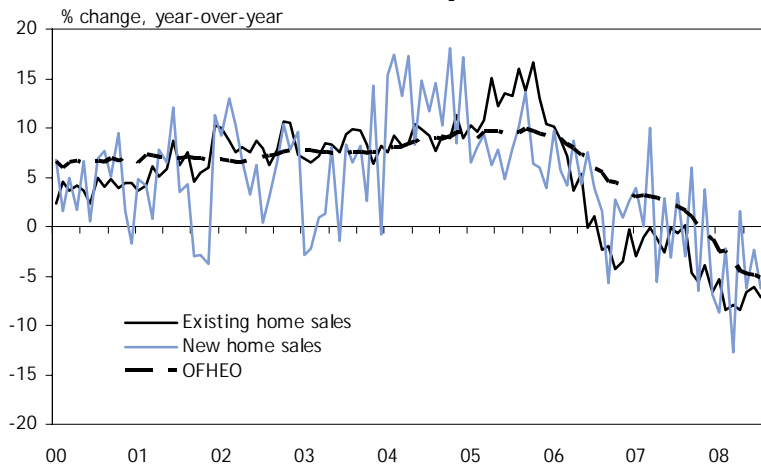


Source: MBA, RBC Economics Research

The situation has been aggravated by falling house prices.



U.S. house prices



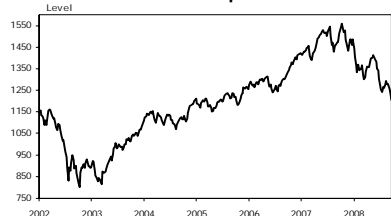
Source: National Association of Realtors, Bureau of Census, OFHEO, RBC Economics Research

The uncertainty as to who holds U.S. subprime assets has weighed on financial markets



Weekly observation

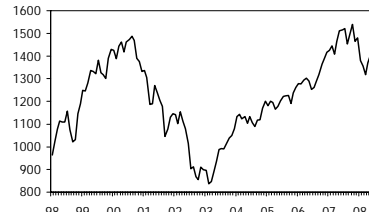
S&P 500 composite index



*September 23, 2008
Source: Bloomberg, RBC Economics Research

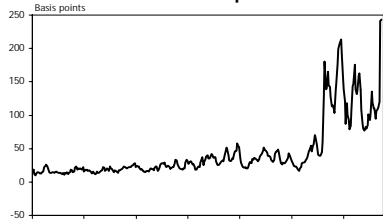
Monthly observation

S&P 500 composite index



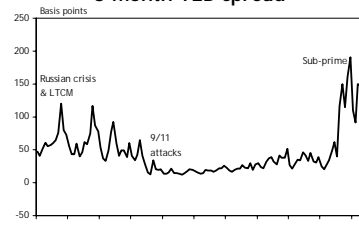
Source: Bloomberg, RBC Economics Research

3-month TED spread*



*3-month LIBOR rate - 3-month T-bill
*September 23, 2008
Source: Federal Reserve Board, RBC Economics Research

3-month TED spread*



*3-month LIBOR rate - 3-month T-bill
Source: Federal Reserve Board, RBC Economics Research

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What will turn around the deterioration in financial markets?



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Aggressive policy actions by the Administration and Congress:



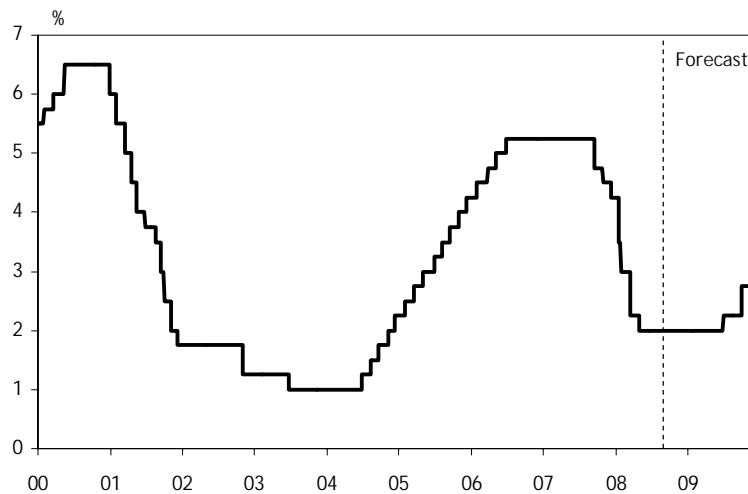
- have committed around \$1 trillion, shoring up financial markets
- have crafted a stimulative fiscal package and are contemplating passing a second one
- are undertaking initiatives to stem mortgage delinquencies

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The Fed has been forcefully cutting interest rates



U.S. Fed funds rate



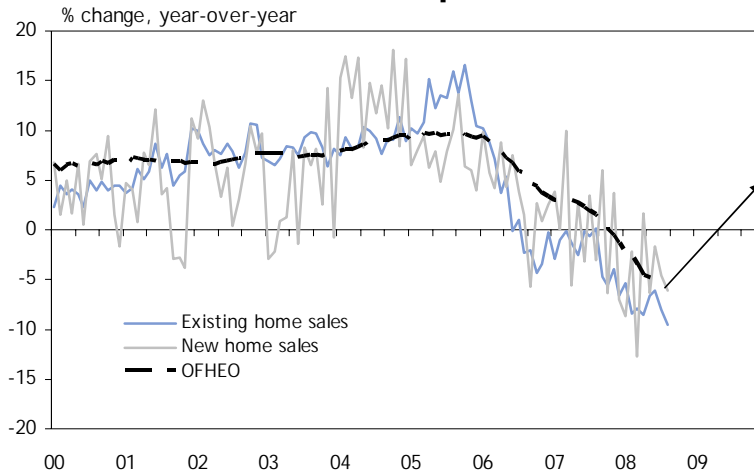
Source: Federal Reserve Board, RBC Economics Research

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Rising housing prices would also facilitate a recovery in financial markets



U.S. house prices



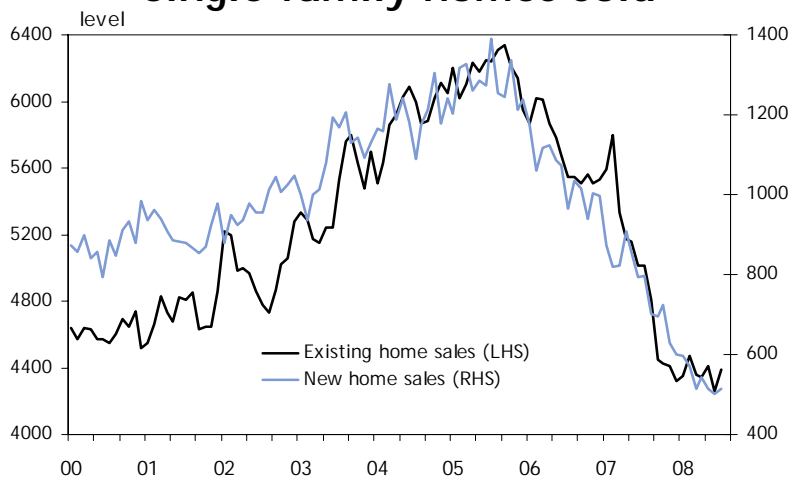
Source: National Association of Realtors, Bureau of Census, OFHEO, RBC Economics Research

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Hints of a stabilization in sales does provide a hopeful sign that housing has troughed



Single family homes sold



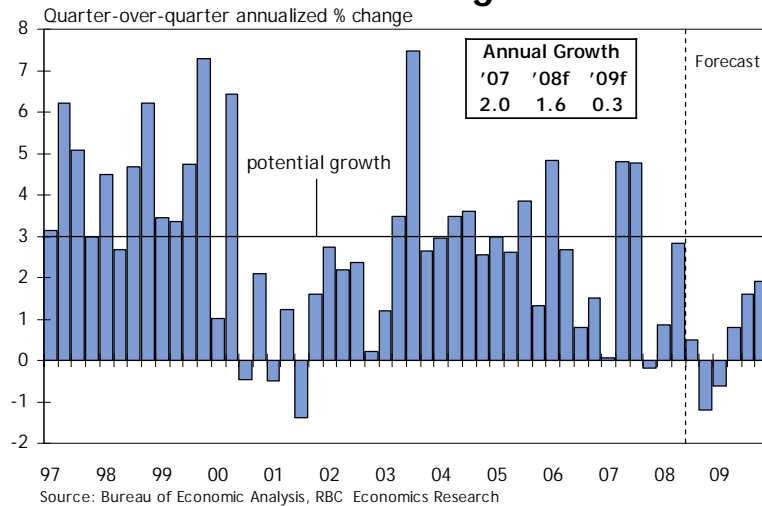
Source: National Association of Realtors, Bureau of Census, RBC Economics Research

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Credit tightening to needs to ease to allow growth to rebound



U.S. real GDP growth



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Canadian Economic Outlook: Expected to Weather U.S. Slowdown

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Three key assumptions affecting Canada's economic outlook:



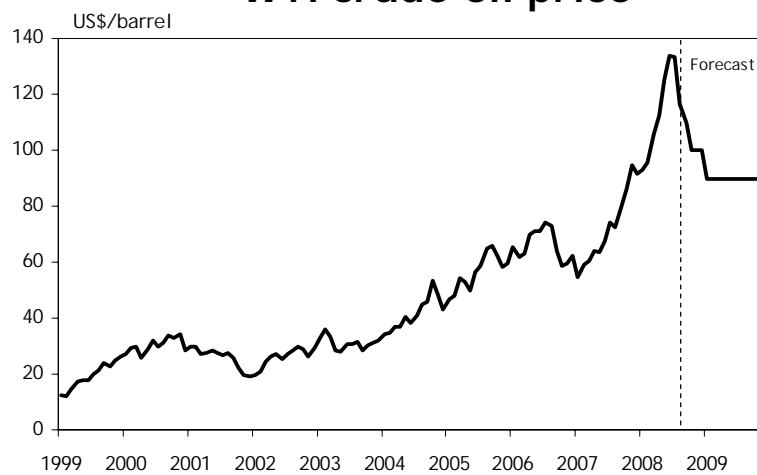
- **commodity prices, though trading lower, remain at historically high levels**
- **the Canadian housing market avoids the free-fall in activity evident in the U.S.**
- **financial market volatility eases and the U.S. avoids a major recession**

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Energy prices will remain high historically as concerns about oil supply ease only slightly...



WTI crude oil price



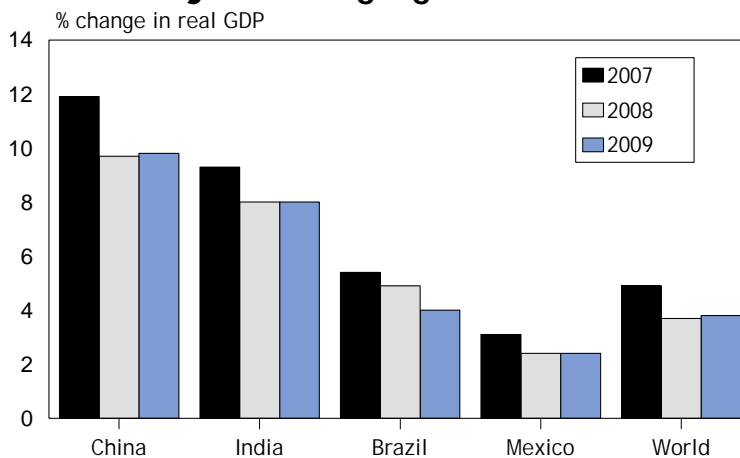
Source: Wall Street Journal, RBC Economics Research

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...while demand from emerging markets, though slowing, remains strong...



Major emerging economies

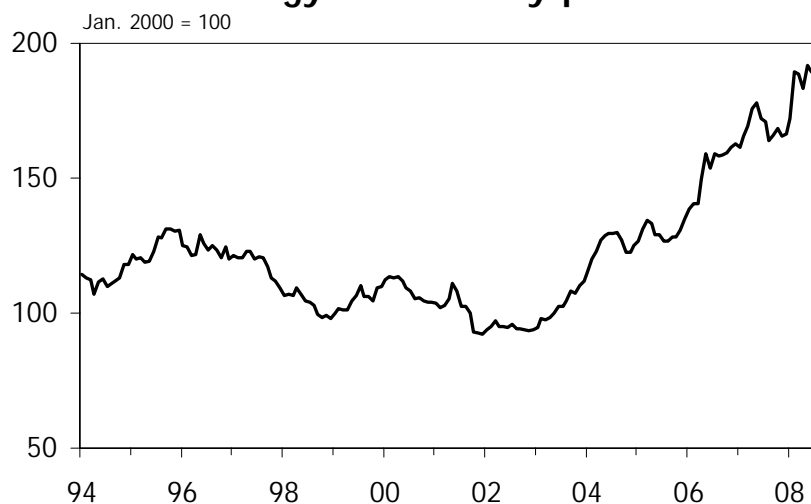


Source: International Monetary Fund, RBC Economics Research

... which will help keep non-energy commodity prices historically high as well



Non-energy commodity price index

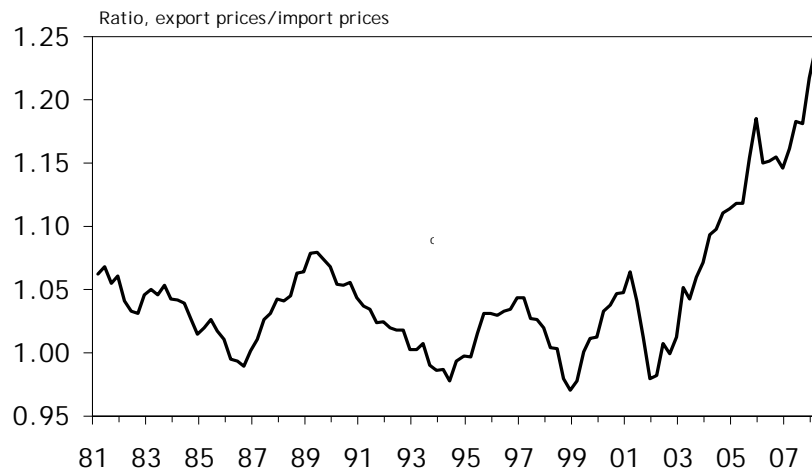


Source: Bank of Canada, RBC Economics Research

Favourable “terms of trade” will be maintained through the forecast period



Canadian terms of trade



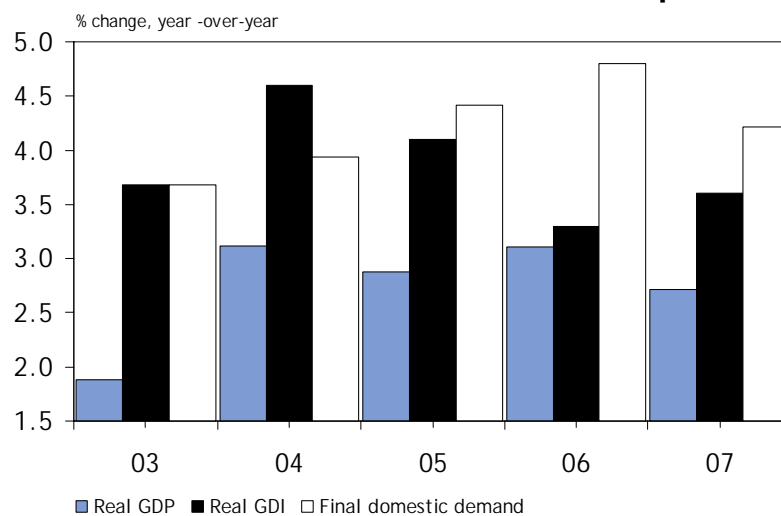
Source: Statistics Canada, RBC Economics Research

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Positive terms of trade has boosted income, and thus domestic spending, in recent years...



Canadian domestic demand and spending



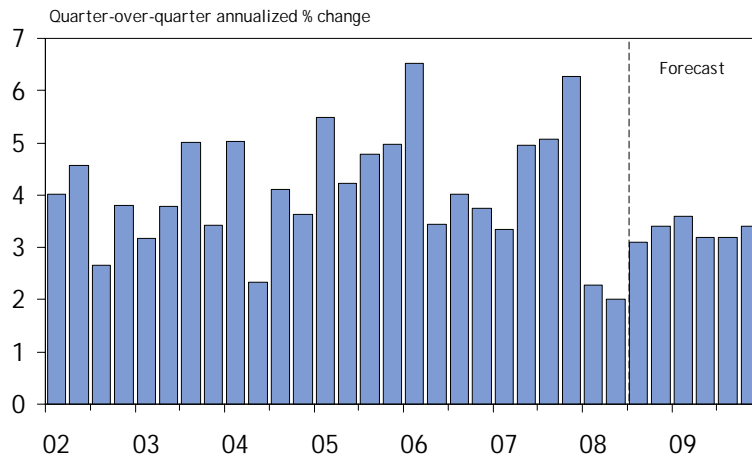
■ Real GDP ■ Real GDI □ Final domestic demand
Source: Statistics Canada, RBC Economics Research

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... and is expected to continue to do so through the forecast



Canadian final domestic demand

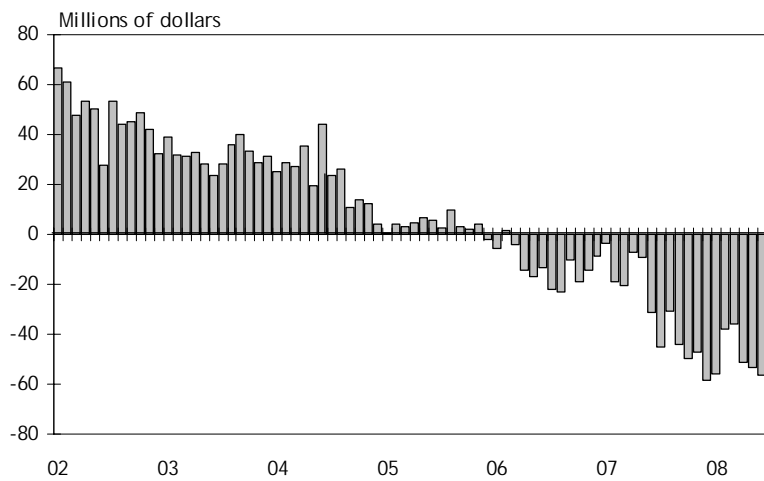


Source: Statistics Canada, RBC Economics Research

In contrast, the strong C\$ and high export prices have been weighing on net exports...



Canadian real trade balance

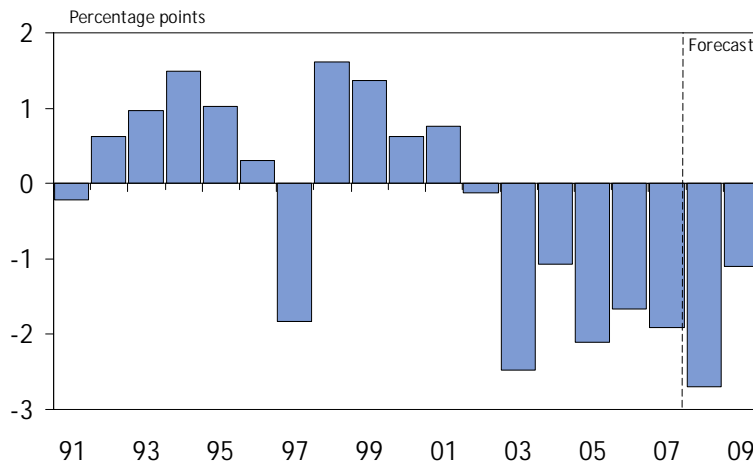


Source: Statistics Canada, RBC Economics Research

... with the restraint from net exports further aggravated by weak US growth near term



Canadian net trade contribution to growth

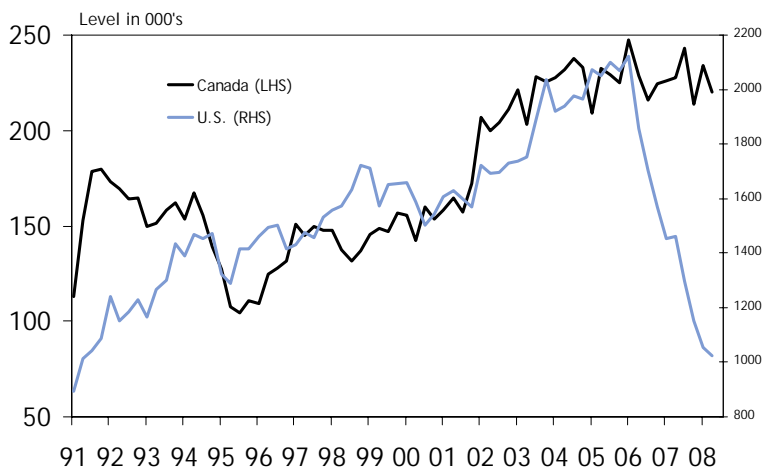


Source: Statistics Canada, RBC Economics Research

In contrast to the U.S., Canadian housing construction is holding up well...



Housing starts

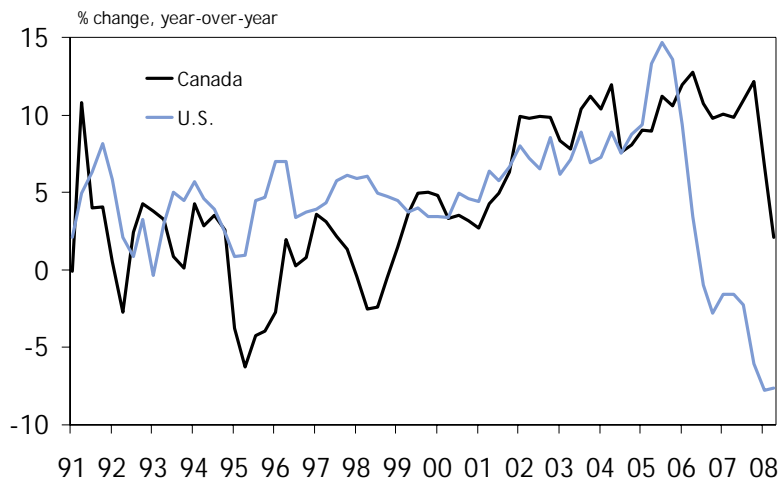


Source: Statistics Canada U.S. Census Bureau, RBC Economics Research

... though housing prices in Canada are starting to move lower mirroring the U.S.



Housing prices

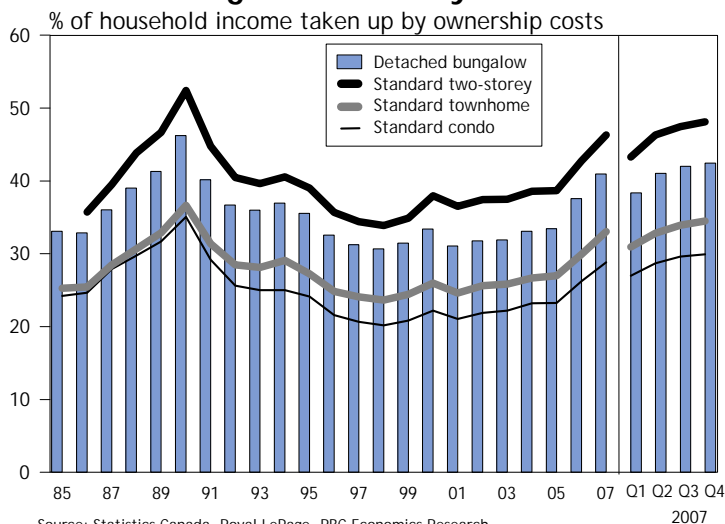


Source: National Association of Realtors, CREA, RBC Economics Research

Though with housing affordability deteriorating...



Housing affordability in Canada

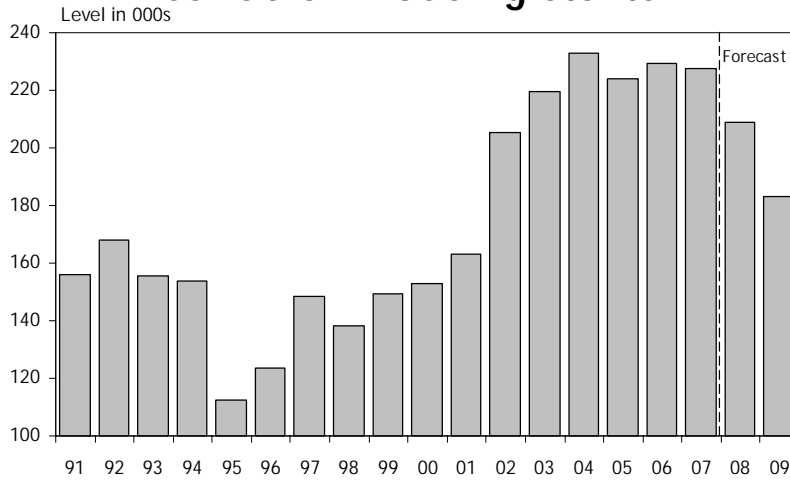


Source: Statistics Canada, Royal LePage, RBC Economics Research

... Canadian housing starts will slow significantly in both 2008 and 2009...



Canadian housing starts

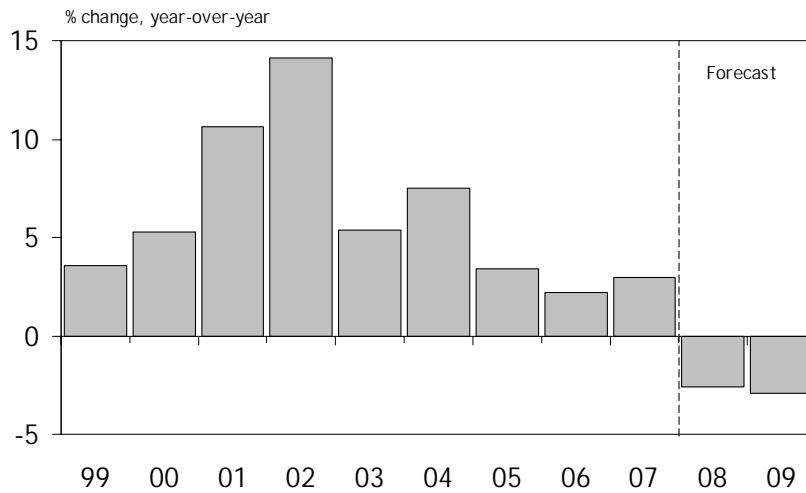


Source: Statistics Canada, RBC Economics Research

... and residential investment growth will turn negative through the forecast period.



Canadian residential investment



Source: Statistics Canada, RBC Economics Research

Positive terms of trade is expected to support M&E spending offsetting tightening credit



Investment in machinery & equipment

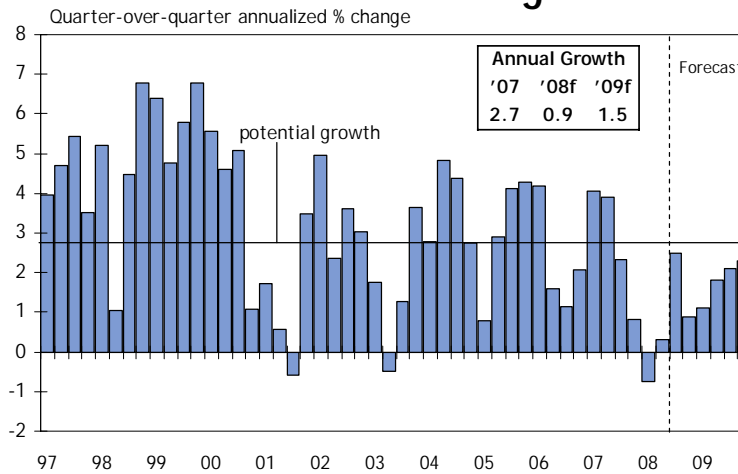


Source: Statistics Canada, RBC Economics Research

Weakness in net exports along with credit tightening will weigh on near-term growth



Canadian real GDP growth

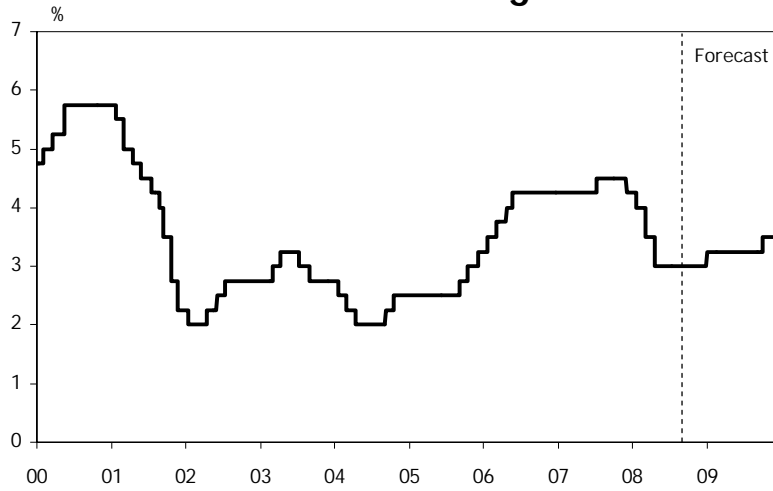


Source: Statistics Canada, RBC Economics Research

To assure that the weak growth is short-lived, Bank of Canada is expected to keep interest rates low



Canadian overnight rate



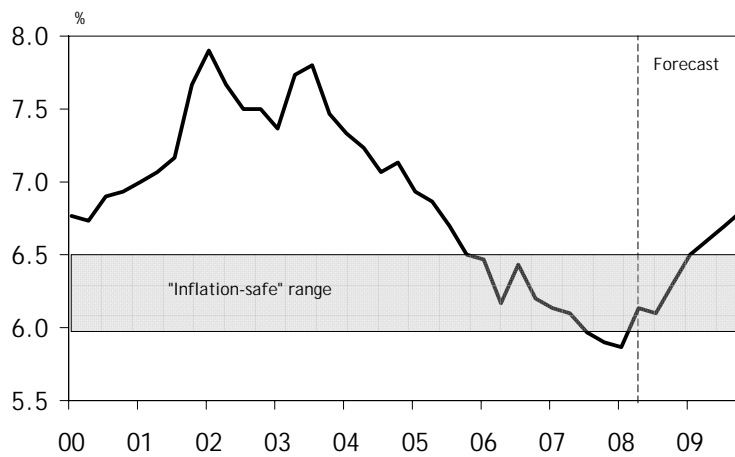
Source: Bank of Canada, RBC Economics Research

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This moderate pace of growth will keep the unemployment rate out of inflationary territory.



Canadian unemployment



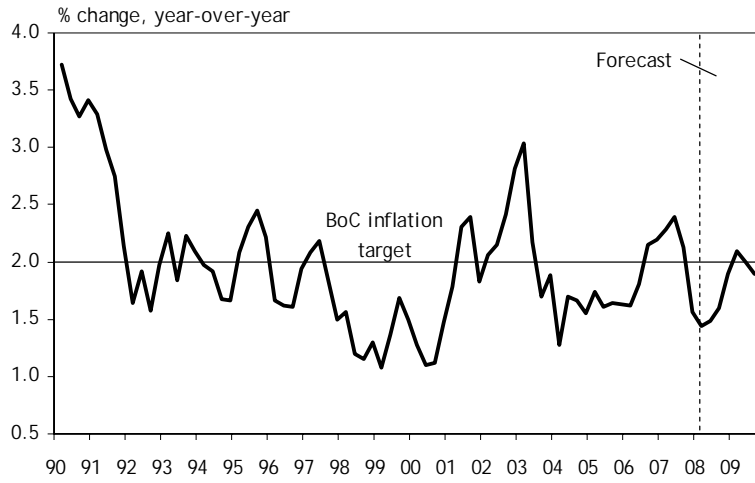
Source: Statistics Canada, RBC Economics Research

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Core inflation to remain close to the central bank's target as the impact of a strong C\$ wanes.



Canadian core inflation



Source: Statistics Canada, RBC Economics Research

Bond yields eventually rise as markets anticipate that the rate cuts will start to be reversed



Canadian 10-year bond yield

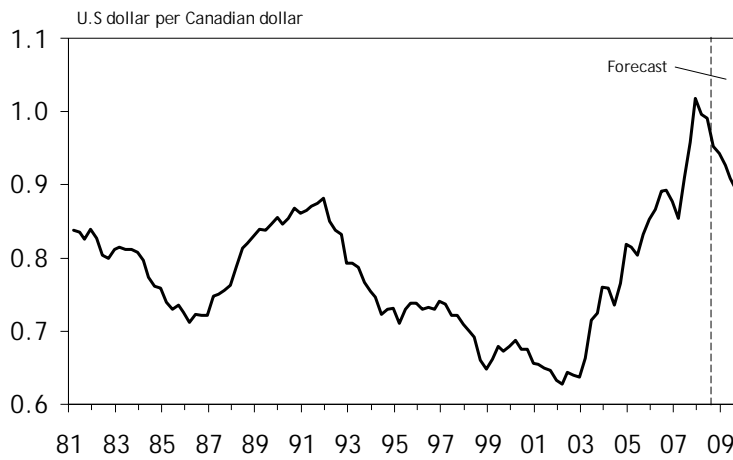


Source: Statistics Canada, RBC Economics Research

A rebound in U.S. growth and moderation in commodity prices will send C\$ lower.



Canadian dollar



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Risks to the Canadian outlook



- **Financial market volatility continues unabated resulting in a prolonged U.S. recession**
- **Commodity prices go back to levels that prevailed in the 1990's**

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Regional Outlook

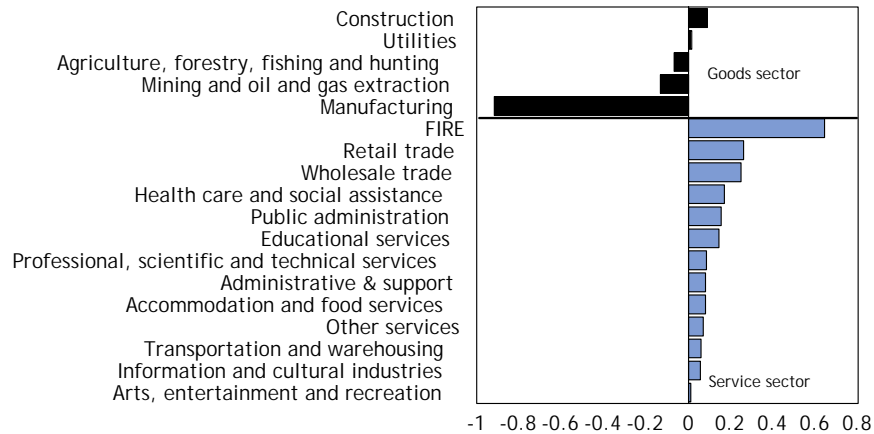
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Marked divergence in activity by industry in Canada ...



Canadian GDP by industry

Contributions to 2008H1 annual growth of 1.04%



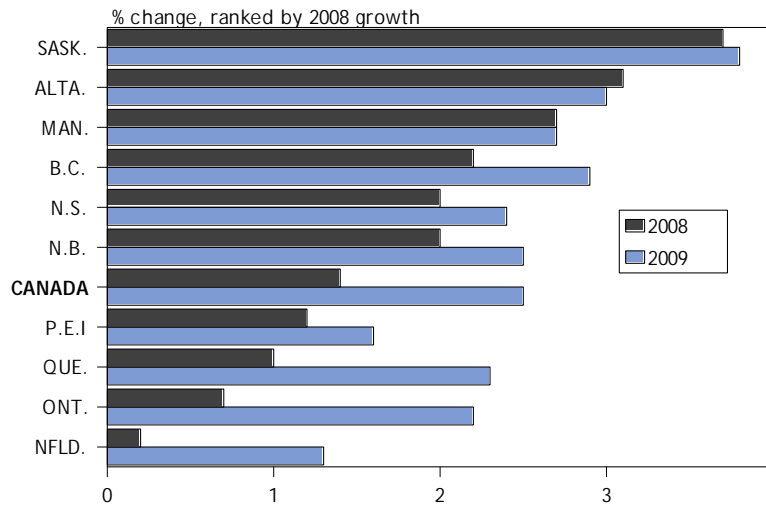
Source: Statistics Canada, RBC Economics Research

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... is mirrored in a marked divergence in regional performance.



Real GDP growth

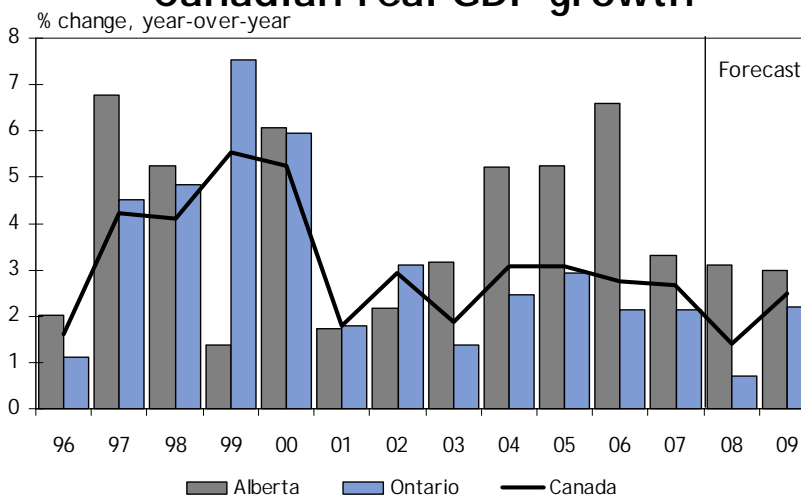


Source: Statistics Canada, RBC Economics Research

Provincial growth rates are expected to converge through the forecast period.



Canadian real GDP growth



Source: Statistics Canada, RBC Economics Research

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