

ADVISORNEWS

No Rose-Coloured Glasses

Nation's economic forecast hits a slump, despite commodity prices

BY BRYAN BORZYKOWSKI AND MARK NOBLE

As America's economy tanks, Canada's financial fortunes have remained relatively positive – that is until now.

In fact, the U.S. slowdown has sunk its hooks into the Canadian economy, new economic data suggest. The question now is whether the high-flying commodities sector can keep the Canadian market afloat.

The weakening U.S. economy contributed to Canada's economic growth taking an unexpected drop in the first quarter of 2008. The national growth rate is forecast to slow to 1.4% for 2008, according to the latest economic report from RBC.

"Going forward, Canada's economy will continue to be hampered by flagging U.S. demand for exports, but domestic demand will more than offset the drag this year," says Craig Wright, senior vice-president and chief economist at RBC.

"The surprise economic contraction will be short-lived as growth prospects for the remainder of the year should brighten, with financial market pressures starting to ease, the U.S. economy getting a boost from the issuance of tax rebate cheques, and commodity prices remaining historically high."

Yet, the slowdown prompted leading CIBC economist Jeff Rubin to lower his target for the TSX Composite Index, as stagflation becomes an increasingly greater threat.

Rubin expects the TSX Composite Index to hit 14,300 this year, and 15,250 by the end of 2009, down from 14,500 and 16,200 respectively.

He says the combination of 1% real GDP growth, over 4% inflation and a Federal Reserve tightening of 200 basis points "will be challenging to the large swaths of the stock market, par-

ticularly anything connected to the energy-exposed transport sector."

Up until now commodities were a rallying point for the Canadian economy since there is still pent-up demand in markets (other than the U.S.) such as China and India. Over the past five years, Canada's gross domestic income has outpaced gross domestic product by an average of 1.2 percentage points, also providing steady support for government revenues, corporate profits and the labour market.

And there's no question that the energy sector will continue to perform well, at least in Rubin's mind. He's adding another half percentage weighting to his energy stocks, and continues to predict that oil will hit \$200 a barrel by 2010. The economist expects "significant" merger and acquisition activity in the energy sector as Canadian oil sands make up nearly

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70% of the world oil reserves that are open to private investment.

However, high commodity prices are a dual-edged sword. Real GDP growth has been flat, largely as a result of high energy prices. Real GDP did rebound slightly in April, but a report from BMO Economics does not forecast sustained growth.

"We continue to look for GDP growth of just under a 1% annual rate in Q2 following the small dip in Q1, and not much better in Q3. If anything, the risks for second-half growth in North America remain squarely tilted to the downside amid ramping oil and gas prices," writes Douglas Porter, deputy chief economist of BMO Capital Markets.

Regionally, the situation remains dire for central provinces heavily reliant on the U.S. market for exports. Sal Guatieri, a senior economist at BMO Capital Markets, also expects the Canadian economy to suffer in the long run, due to reliance on the U.S. economy.

"The weak U.S. outlook means Canada's economy will struggle to expand even modestly this year,"

he writes in his regular economic report.

The economist explains that the housing market and credit issues "will need time to unwind," while banks will keep de-leveraging as they continue to deal with loan loss provisions. He adds that Americans will need time to "rebuild savings, pay down debts and emerge from a deep funk."

Canadians can expect an uneven economic performance in the coming months, as growth will continue in the west, but stall in the east. Guatieri points to Ontario specifically as a province that will likely suffer in 2008.

Guatieri also predicts Canada's housing market will cool, especially condos and cottages.

Over the past couple of years, TD Economics repeatedly forecasted a cooling of the Canadian housing market. "Housing remained stronger for longer than we had anticipated, largely due to increased affordability through new financing options, such as no money down or extended amortizations." As such, analysts with TD Economics predict a modest national average price growth of 2% this year and 3.5% in 2009, down substantially from the 10% annual pace of the last six years.

Consumer discretionary stocks and industrials are two other sectors that aren't looking so hot.

For consumers, the pinch at the pump prompted a nationwide reduction in driving in the U.S. As a result, Rubin expects vehicle sales to fall "to as low as 11 million units by 2012, the lowest level since the early 1980s." This means more bad news for an already suffering Ontario.

While two of Canada's economists think the country's economy is in dire straits, the Bank of Canada has different ideas.

"Clearly, the BoC doesn't believe the economy is on the cusp of recession," says Guatieri, pointing to the lack of recent rate cuts as proof.

Avery Shenfeld, senior economist with CIBC World Markets believes the Canadian markets can tread water long enough to avoid dropping into the bear market territory – defined as a 20% drop – that the Dow Jones Industrial Average and S&P 500 entered in early June.

Still, Guatieri cautions the Bank of Canada, saying the federal institution should "refrain from tightening until mid-2009" if commodities moderate and economic growth stays soft. **AER**

Fund Wrap

After a poor showing in the first three months of 2008, investment funds that focus on foreign equities suffered more losses in the second quarter, according to preliminary performance data released today by Morningstar Canada.

Rising commodity prices, inflation fears

and persisting concerns over the health of the economy in the U.S. drove many of the world's markets down, particularly in June.

Mutual fund sales, however, were "decent" in June, according to preliminary data compiled by the Investment Funds Institute of Canada, totalling between \$1.46 billion and \$1.96 billion. Net industry assets under management for the month of June will be

between \$698.5 billion and \$703.5 billion, down approximately 2.5% from last month's total of \$719.3 billion.

The funds that were hit hardest were those that target the financial sector, as the protracted credit crunch crimped the profits of companies well beyond Wall Street banks. The plight of this sector worsened in June, particularly in the U.S. **AER**

MORNINGSTAR FUND INDEX

As of June 30, 2008	1M	YTD	As of June 30, 2008	1M	YTD
Precious Metals Equity	4.5	3.1	2015 Target Date Portfolio	-2.8	-1.8
Canadian Inflation-Protected Fixed Income	2.7	8.8	Canadian Equity Balanced	-2.9	-0.7
Natural Resources Equity	1.7	16.1	2020+ Target Date Portfolio	-2.9	-1.5
Canadian Income Trust Equity	1.3	8.4	Global Neutral Balanced	-3.1	-3.2
Global Fixed Income	1.1	3.6	Global Equity Balanced	-3.8	-3.6
Canadian Long Term Fixed Income	0.2	0.1	Canadian Focused Equity	-3.8	-1.6
Canadian Money Market	0.2	1.6	Canadian Dividend & Income Equity	-4.0	-1.7
US Money Market	0.2	1.4	US Small/Mid Cap Equity	-5.0	-7.9
Canadian Fixed Income	-0.1	1.6	North American Equity	-5.3	-6.0
Canadian Short Term Fixed Income	-0.3	2.2	Japanese Equity	-5.5	-6.4
Canadian Small/Mid Cap Equity	-0.5	0.3	Global Small/Mid Cap Equity	-6.3	-10.5
High Yield Fixed Income	-1.2	-0.6	Asia Pacific Equity	-6.5	-12.6
2010 Target Date Portfolio	-1.3	0.2	US Equity	-6.8	-11.5
Canadian Fixed Income Balanced	-1.7	-0.3	Global Equity	-6.8	-10.5
Global Fixed Income Balanced	-1.7	-0.3	European Equity	-6.9	-9.9
Tactical Balanced	-1.8	-1.6	Asia Pacific ex-Japan Equity	-7.0	-14.3
Canadian Equity	-1.9	4.9	Science & Technology Equity	-7.3	-11.1
Canadian Neutral Balanced	-2.1	0.4	International Equity	-7.5	-11.8
Health Care Equity	-2.2	-7.0	Real Estate Equity	-7.9	-7.8
Canadian Focused Small/Mid Cap Equity	-2.5	-4.9	Emerging Markets Equity	-8.0	-10.8
2020 Target Date Portfolio	-2.8	-1.2	Financial Services Equity	-9.6	-16.2