

Global Views

Weekly commentary on economic and financial market developments

July 29, 2011

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Karen Cordes Woods (416) 862-3080
karen_woods@scotiacapital.com

Derek Holt (416) 863-7707
derek_holt@scotiacapital.com

Central Banks To Be Cautious In the Midst Of The US Debt Ceiling Impasse

- Please see our full indicator, central bank, auction and event calendars on pp. A3-A8.

Students of history would be hard pressed to think of a comparable period of time in which the forces of global deleveraging have been combined with creative destruction through the advent and application of new category-killing technologies that are rewriting business models. In the near-term such forces create enormous uncertainty, making the jobs of CEOs, portfolio managers and forecasters vastly more complex. In the longer run, the forces in play can re-invent economies and roll over a whole new set of winners and losers. Next week will be just a micro chapter along this path, but how policymakers address such uncertainty will be a key focal point in a week that will be chock full of global data, event and auction risk.

The ECB is expected to pause in its rate announcement on Thursday. A jerky hike-pause-hike path reflects policymaker experimentation in the current environment. There probably isn't going to be a single central bank that withdraws accommodative policy along a linearly prescribed path, versus a view that posits that the exit paths of monetary policy will be as erratic and uncertain as the entry paths toward accommodation earlier in the crisis. How different central banks are reading the risks will be further evidenced by the Bank of England's rate statement that same morning, but with a dovish bias that probably holds off on expanding QE efforts while nonetheless signaling no move toward tightening for a long time yet. Economies that are more hitched to Asia's and Latin America's fortunes — toward which relative purchasing power is being shifted through broad balance of payments influences — face concomitantly differing inflation risks, including the likelihood that the RBA won't raise rates on Tuesday but will probably express concern about recent inflation figures that point to a possible further withdrawal of policy accommodation later in the year. An exception is the Bank of Japan that will be encouraged by signs of recovery following the devastating March disasters but that will nonetheless retain a dovish bias throughout our forecast horizon.

Throughout it all, Washington's disarray in the debt ceiling and broader U.S. fiscal austerity debates will come closer to either a solution or a boiling point. Right now a solution is anything but obvious as the Democrats and Republicans sound less than conciliatory toward one another's proposals, and neither of their own proposals stand much of a chance at getting requisite bi-partisan support. Data risk will be off the charts on top of it due to several marquee releases. Encouragingly, ISM manufacturing may well have bottomed in May before getting a lift in June that consensus is expecting to be retained in July. That would be modest evidence of the US emerging from a soft spot made worse by Japan's supply shocks. Consumer income and spending figures as well as vehicle sales will be released Tuesday. But the even bigger market risk comes at the end of the week through nonfarm payrolls. The low-high range of estimates covers 30-130k in job gains and is centred on a median estimate of 95k. That would be an improvement from the 18k print in June, but it may be wishful thinking as initial jobless claims remain above the critical 400k level.

Canadian markets will be shut for the Civic Holiday on Monday, and will spend most of the week observing global markets from the sidelines. The only domestic influence on markets could come Friday with the next jobs report for the month of July. As in prior years, there is the risk of a sharp loss in the education component that could be big enough to swing the headline. The effect owes itself to contract changes affecting teaching and support staff over recent years that Statistics Canada cannot effectively control against through standard seasonal adjustment factors. Building permits will probably retreat sharply given the prior month's large 20.9% m/m rise that was focused upon select projects in the nonresidential segment.

Beside central banks, **Europe** will contend with auction risk as each of Belgium, Portugal and Spain tap markets following the re-emergence of German-led dissension within the Eurozone. Data risk will be skewed toward PMI readings on Monday (manufacturing) and Wednesday (services). EC retail sales (Wednesday) and German factory orders (Thursday) round out the key sources of data risk.

China's public- and private-sector manufacturing PMIs will both be released Sunday night and could set the **Asia-Pacific** market tone through an expected softening that brings the country's manufacturing sector closer to no growth, or even into outright contraction as the advance 'flash' readings suggest.

Karen Cordes Woods (416) 862-3080
karen_woods@scotiacapital.com

Derek Holt (416) 863-7707
derek_holt@scotiacapital.com

A Primer On What Divides the GOP And The Democrats

- **Uncertainty carries into the weekend and a deal is always possible, but the divisions within the GOP and between the GOP and Democrats are stark.**

With all of the political turmoil of the past week, we thought it would be useful to briefly summarize the key factors causing disagreement within the Republicans, and between the GOP and the Democrats in the debt ceiling debate. Given the speed of developments, there is the risk that by the time you read this it may well be outdated but it reflects our assessment as of early Friday afternoon. We judge the divisions to be stark and the parties so divided and entrenched that there is legitimate concern surrounding the credit rating and still small default risk facing the US. That said, 10th inning politics may well pull a surprise yet.

Republicans Don't Agree With Each Other

There are two key sticking points within the GOP itself: a balanced budget constitutional amendment; and a larger desired austerity package than the Boehner plan that itself is seeking \$917 billion in deficit reduction over ten years. It had appeared that the GOP had dropped its demand for a balanced budget amendment earlier in the week but the Tea Party resurrected it in their opposition to the austerity proposals that House Speaker John Boehner is trying to advance.

In my view, a constitutional amendment to balance the budget would be bad policy. It would tie the hand of government to always engage in pro-cyclical fiscal policy by hiking taxes and cutting spending when the economy weakens and threatens deficits, or cutting taxes and raising spending when a booming economy is feeding surpluses. That may sometimes be the way it is anyway, but I'd at least prefer the flexibility against such a straight jacketed approach. Indeed the outcome would be to engineer even greater average volatility in future cycles through more amplified under-shooting and over-shooting and that won't help businesses and households plan through cycles any better than the current way of doing things.

The GOP and Democrats Remain Far Apart

Even should the GOP reach internal agreement on these issues, they add to conflict with the Democrats. President Obama has stated he will veto Boehner's proposal even if it did pass through both chambers which itself looks unlikely. One difference of opinion is the size of the austerity measures being advanced. The Tea Party element within the GOP doesn't believe the Democrat's \$2.2 trillion in cumulative deficit reduction over the next decade is sufficient.

Further, there is the GOP insistence that any higher debt ceiling be achieved in two stages versus the Democrats desire to hike it once and not revisit it again until after the November 2012 elections. From the standpoint of confidence in the economy and markets at a frail point for both, it may be wise to raise the ceiling once and revisit after the election. Politics may well determine otherwise and see an election year as a necessary time within which to try to achieve such broad policy goals. Further, political pundits have pointed out that it may not even be in the interests of the Republicans to have to revisit a higher debt ceiling again early next year given that the GOP will be along the path of choosing one leader and running mate to run against the President. This could showcase the GOP's internal dissension.

The composition of desired spending cuts also differs between the GOP and Democrats. Democrats dropped their insistence upon raising revenues, but the Democrats wish to end the wars in Afghanistan and Iraq and slash military spending. The GOP counters this is likely in the numbers already, and the traditional support base of the Republicans is opposed and seeks cuts elsewhere.

One point remains firmly intact. Both parties' proposals would fail to meet S&P's requirement for a bi-partisan agreement toward about \$4 trillion in budgetary savings over the next ten years. A bi-partisan 'grand bargain' therefore looks increasingly unattainable. Neither the GOP's \$3 trillion two-step dance — \$917 billion now, vague details later after the creation of yet another committee — nor the Democrats \$2.2 trillion outline would come close to meeting the bar.

Karen Cordes Woods (416) 862-3080
karen_woods@scotiacapital.com

Derek Holt (416) 863-7707
derek_holt@scotiacapital.com

What To Watch In The Markets During The U.S. Debt Crisis

- **Hint: don't necessarily be assuaged by a muted Treasury market reaction.**

On the surface of it all, markets wouldn't appear to care that much about the US debt ceiling and fiscal austerity debate. Nominal US Treasury yields remain well behaved and if anything have captured a safe haven bid, equity option volatility as captured by the VIX metric has risen somewhat of late but is well behaved in a longer run context, so are interbank spreads, and the USD on a trade-weighted DXY basis has remained within the approximately 74-76 cent range since Spring. This has prompted some reaction that the concern is over stated. But dig a little deeper and the impact is more evident, and the relatively benign view in some markets could expose them to a swifter reaction even under a scenario marked by passage of a higher debt ceiling and hence avoidance of a technical default. So far the effect is not large, but we point to the variables you should watch more closely—and why Treasuries are a misleading gauge of the risks.

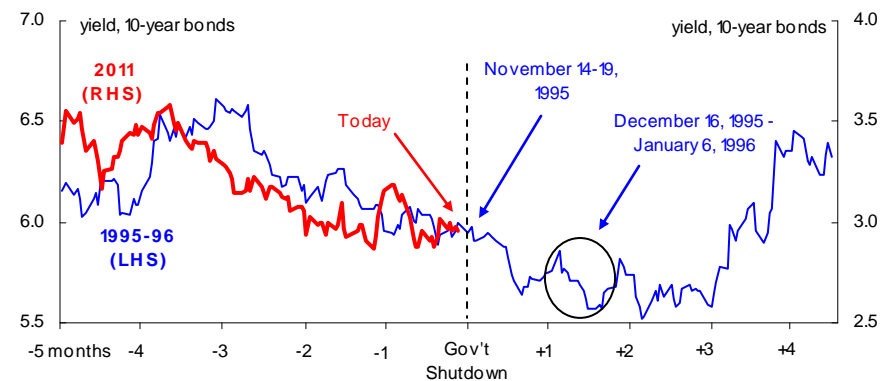
For starters, nominal Treasury yields are probably the worst barometer of market concern. They are thus far behaving exactly like they did in the 1995-96 debt ceiling show down despite the many differences and some similarities between then and now (chart 1). A major reason as to why they have been well behaved stems from reduced growth and inflation expectations and that has clouded the ability to assess the impact of the debt ceiling talks. Witness the fact that the one-year forward inflation break-even has been reduced from

nearly 3% as recently as late April to about one-third of that today (chart 2) as the market reverses earlier inflation concerns; this is a part of why Treasury yields are fairly well behaved, and such a sharp reduction in inflation expectations is not necessarily reflective of a positive outlook. A year ago, around the time the Fed embarked on its QE2 line of thinking, one-year break evens floated around 0% so we're not quite there yet but trending in that direction. Lower commodity prices were among the first harbingers of trouble ahead and that momentum through reduced inflation expectations was partly driven by and then built upon by US and

European debt troubles. The multiple influences upon Treasuries may therefore be making them a misleading barometer since they serve a safe haven role, sizeable alternatives that offer anything like the depth and liquidity of the US Treasury market are thin to none, concerns about future incremental supply shortages should the debt ceiling not be raised in time or by enough are putting a bid to today's outstandings, and the uncertainty factor is being priced in via possibly reduced growth and inflation expectations. In one sense, lower inflation break-evens should comfort the Fed in that it provides room for an extended period of accommodative

Chart #1

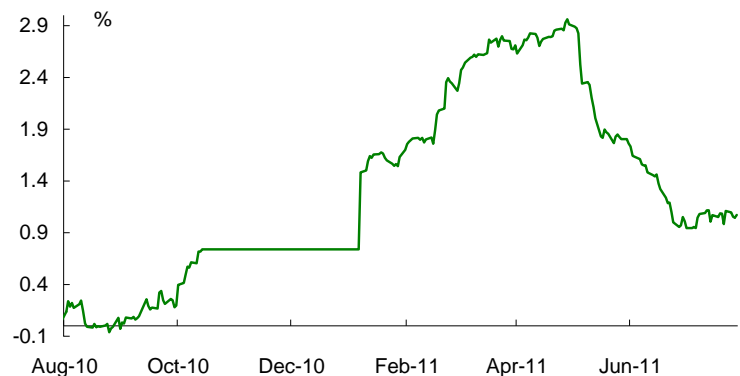
US Bond Market Reactions To Two Debt Ceiling Show Downs



Source: Bloomberg, Scotia Capital Economics

Chart #2

US 1-year TIPS break-evens



Source: Bloomberg, Scotia Capital Economics

Karen Cordes Woods (416) 862-3080
karen_woods@scotiacapital.com

Derek Holt (416) 863-7707
derek_holt@scotiacapital.com

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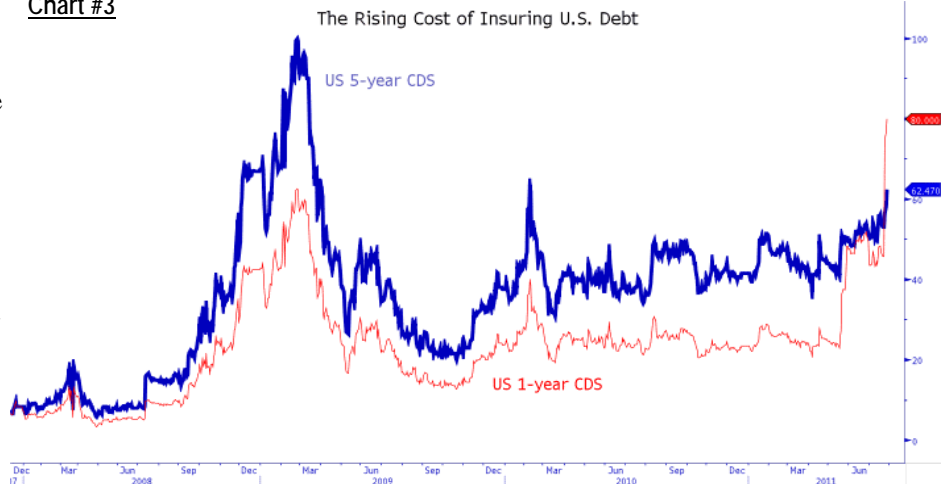
monetary policy. But what other markets are telling us could be more important. The evidence of reduced risk appetite is apparent elsewhere.

As for equities, despite a very strong earnings season they have not been able to sustainably rally due to forward looking concerns in part related to the uncertainty posed by the debt ceiling and fiscal austerity debate. A sharp sustained correction in the face of a strong earnings season was unlikely, but the fact that they couldn't build on gains reflects the limiting effects of the debt ceiling debate.

The cost of insuring US debt against default is sharply rising (chart 3) with the one-year premium eclipsing the prior record set in 1998 and crossing over the 5 year premium that itself is rising but less so than in 2008. This is a small market, but it is most aligned with the concerns.

Also, Treasuries are used as collateral in repurchase agreements that are used for borrowing and lending in the short-term by agents not wishing to sell their securities for cash but rather to lend them through over-collateralized amounts in exchange for short-term cash requirements. Treasury market volatility, default and/or downgrade concerns would prompt more collateral to have to be offered in such transactions (ie: more Treasuries for the same cash in exchange).

Chart #3



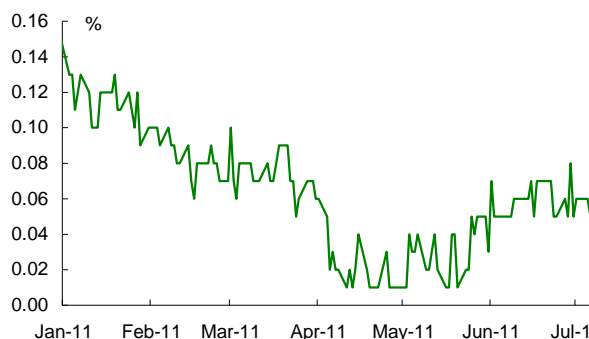
Source: Bloomberg, Scotia Capital Economics

Such wider hair-cuts in repo markets are moderately evident in a small rise in borrowing costs already in the overnight market and the one-month forward market (chart 4). This is also reflected in the small inversion at the very front of the US curve that has one month T-bills trading at higher yields than 3 months.

Returning to the Treasury curve itself, the 10s-30s slope (chart 5) is a classic bellwether gauge of market concerns, and it has widened by about 20bps since April.

Chart #4

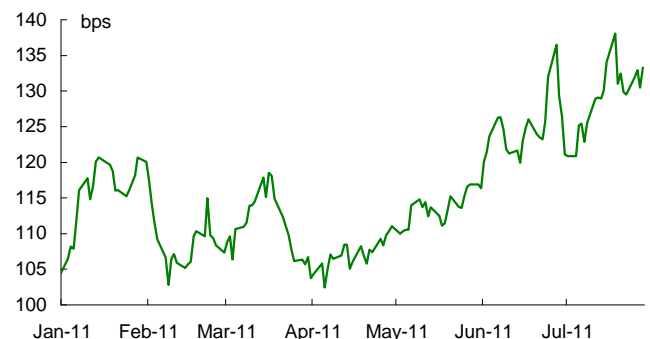
U.S. 1-month Repo



Source: Bloomberg, Scotia Capital Economics

Chart #5

U.S. 10/30-year Treasury Yield Spread



Source: Bloomberg, Scotia Capital Economics

Karen Cordes Woods (416) 862-3080
karen_woods@scotiacapital.com

Derek Holt (416) 863-7707
derek_holt@scotiacapital.com

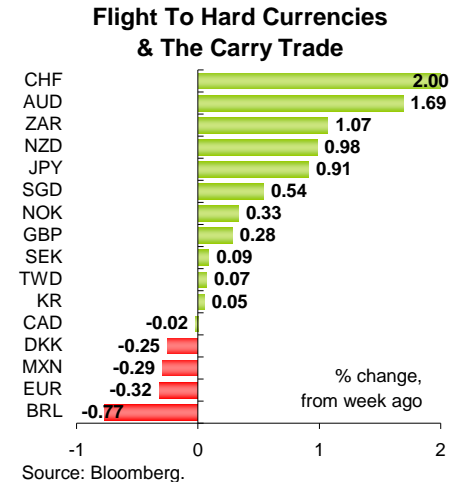
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Throughout it all, what we have little time for is comparisons to other AA countries in order to gauge the effect of a drop from the present AAA status of the US market. Those other countries' bond markets do not serve anywhere near the same role as Treasuries in global financial markets through the base security in system wide leverage, so a downgrade to US debt could well carry more implications for markets than elsewhere by creating a domino effect of reduced leverage and liquidity.

Currency markets offer an additional view. Money is being diverted partly into currencies like the yen, NZ\$, A\$, CAD, and the Swiss Franc (chart 6); all hard currencies that are playing substitute roles as safe havens and/or that offer lucrative carry prospects. The trade-weighted USD doesn't capture this because of the weight attached to other challenged currencies like the euro, but currency markets are indeed punting money into the peripheral currencies.

Again, these are all relatively modest movements thus far. They are not supportive as yet of the Lehman factor that some speak toward. They are, however, measures that are worthy of much closer attention as the debt crisis evolves than looking simply at nominal Treasury yields. As such, large movements in these variables could well impact the risk trade and borrowing costs even in the absence of a large move in Treasury yields.

Chart #6



Pablo Bréard (416) 862-3876
pablo_breard@scotiacapital.com

Latin America Continues to Benefit from Excess Global Liquidity & the Ongoing Quest for Yield

- **Adequate preparedness to weather US-induced financial market volatility.**

Foreign portfolio investors continue to deploy capital into Latin American securities and currencies despite the distressed fiscal situation affecting the US economy and the prospect of a sovereign credit rating downgrade revision. The process of global economic and capital market rebalancing remains uninterrupted, directing capital flows to rapidly-growing low-leveraged economies in Asia and Latin America with developing credit markets and robust financial sectors. The (de)valuation potential of the US dollar (USD), the prolonged accommodating monetary stance of the US Federal Reserve (Fed) and the degree of Fed intervention in the US treasury yield curve (through its large-scale asset-purchase programme) remain key factors instilling a fundamentally-justified positive investor sentiment into core Latin American countries. Nevertheless, the region's financial markets will not be immune to (most likely temporary) disruptive contagion waves caused by increased volatility in short-term funding, foreign exchange and securities markets should a US credit rating downgrade materialize.

Preference for high yielding local financial assets remains the norm, exerting appreciating pressures (versus the USD) on the region's floating currencies. Local central banks continue to amass vast amounts of foreign exchange reserves to be deployed as a liquidity shield against an adverse external shock (such as a US rating downgrade or a distressed sovereign debt restructuring in Greece). Brazil alone will soon count on US\$400 billion in international reserves. Moreover, Brazilian authorities have adopted a more aggressive intervention to counteract a speculative desire for real-denominated assets. Beyond the uncertainties posed by the US political impasse on addressing the debt-ceiling issue, Latin American investors remain sensitive (and vulnerable) to profit-taking momentum in developing Asian equity securities as well as a potential policy shift in China's vast holdings of US Treasury debt securities. A rebalancing of foreign equity portfolios in favour of US markets may cause a sell-off corrective phase in some jurisdictions, as it has been recently observed in Brazil and Chile.

The process of credit differentiation within the emerging-market credit universe remains active. Market participants and international rating agencies reflect clear distinctions between the sovereign credit quality of Latin American and European periphery borrowers. Colombia, Uruguay and Brazil have been rewarded with sovereign credit rating upgrades this year. Looking ahead, rating agencies may further upgrade the sovereign ratings of Chile, Peru and Brazil in the near term. This is in contrast with the constant wave of rating downgrades suffered by Greece, Ireland, Portugal and Spain so far this year.

Credit market metrics also offer another gauge of credit differentiation amongst developing economies. Credit default swaps (CDS), financial instruments used as risk insurance against sovereign debt default, imply a sharp difference between the implied creditworthiness of the largest Latin American countries: Brazil, Mexico and Colombia CDS value ranging between 100 and 120 bps while the fiscally distressed European credits: Greece = 1,645 bps; Portugal = 950 bps; Ireland = 900 bps; Spain = 335 bps. Even so, the persistent quest for yield is also providing a window of opportunity to low credit quality countries to tap global bond markets: this week, Venezuela launched a 20-year US\$4.2 billion international bond despite the country displaying the worst credit profile in Latin America.

Karen Cordes Woods (416) 862-3080
karen_woods@scotiacapital.com

Derek Holt (416) 863-7707
derek_holt@scotiacapital.com

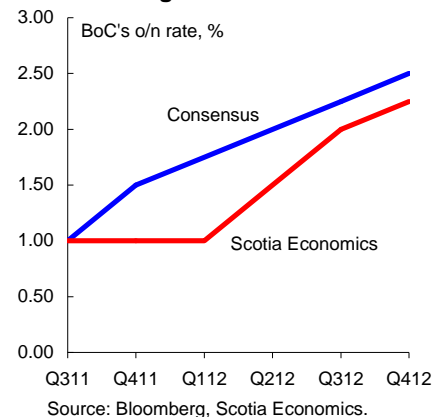
Consensus Swings Toward Scotia's BoC View

- It is difficult to imagine a Fall rate hike given dovish growth and inflation figures, and global debt worries.

Bloomberg's monthly poll of the consensus of Canadian economists has resulted in a lowering of its BoC rate forecast into 2012. Consensus now expects the BoC's overnight rate to end 2012 at 2.5%. Scotia has not changed its forecast as we were always there with the view of a lower neutral rate in this cycle — a view supported by the BoC's recent MPR. Our forecast remains for a 2.25% overnight rate by the end of 2012, and we are not changing our view that the first rate hike will not arrive until next year in contrast to consensus that still expects a Fall hike. In fact we still think that first hike arrives in 2012Q2 (see chart).

Recent growth and inflation prints support this. I just don't see the BoC swinging toward a Fall rate hike with numbers like we're getting of late on the inflation and growth fronts, not to mention the state of the global debt picture. The June CPI report had core inflation tracking well below the BoC's 2% target for headline inflation that uses core as the operational guide. In fact, at 1.3% y/y, core inflation is very muted and we continue to think that a key risk is that the BoC may not hit its 2% target into next year due to CAD strength as we argued in "The Bank of Canada Risks Coming In Below Its 2% Target" in last week's Global Views.

Consensus Approaches Scotia, But Still Too High In The Near-Term



Going into the Fall, the risk could well be that the BoC pushes out its output gap assumption in the October MPR and thereby delays the point at which it believes the Canadian economy returns to balance from its current assumption of the middle of 2012. The BoC is shaping up to be well off its downwardly revised forecast for mild 1.5% annualized q/q growth in Q2. Following on May's disappointing contraction of 0.3% m/m, if we assume a flat June in order to focus upon what we know about Q2 so far and what we know about the Q1 hand-off, then annualized q/q growth is shaping up to be -0.2% in Q2. That's also well below our own 1% forecast that now faces downsides. Now, granted, monthly GDP figures don't always translate well into quarterly figures but the difference is usually within a half a percentage point.

Weakness was broadly based. StatsCan stated that the mining, oil and gas extraction sectors were "the main source of the decline in May." We're not sure that's entirely accurate. Those sectors collectively account for only about 4.3% of GDP. Thus, the 5.3% m/m decline in that sector subtracted about 0.2 percentage points from headline GDP. Removing this would have resulted in a monthly GDP decline of about -0.1% instead of -0.3% and still would have left behind a weaker than expected print.

Why remove those sectors? Because the wild fires and poor weather that disrupted activity in this category were temporary and production will therefore reverse upward next month and perhaps also into the month after that. That won't be enough to save the BoC's forecast, however, since should the full 5.3% decline in mining, oil and gas reverse entirely in the June report (as opposed to being spread out) then it will only add about 0.2% to headline GDP in the next report a month from now.

Why not remove all of the effects of this one sector? Because we're skeptical that all of it was due to one-off natural disasters. Volumes in these sectors were probably hit on soft demand out of the #1 export market south of the border on the heels of very disappointing U.S. GDP growth of only 0.4% q/q in Q1 and 1.3% in Q2 — both at annualized rates.

Regardless, the softness in the economy in May was about much more than just this one sector. Five sectors retreated including construction and manufacturing. Two were flat at zero m/m, and six posted gains of only 0.1 or 0.2% m/m. That leaves 13 out of eighteen total sectors of the economy in a weak state including many of the service categories that were more immune to the impact of the Japanese supply shocks. Indeed, only wholesale trade and public admin were bright spots on the service side of the economy in May and the only real bright spot on the goods side of the economy was the 0.5% m/m rise in agriculture, forestry and fishing.

Oscar Sánchez (416) 862-3174
oscar_sanchez@scotiacapital.com

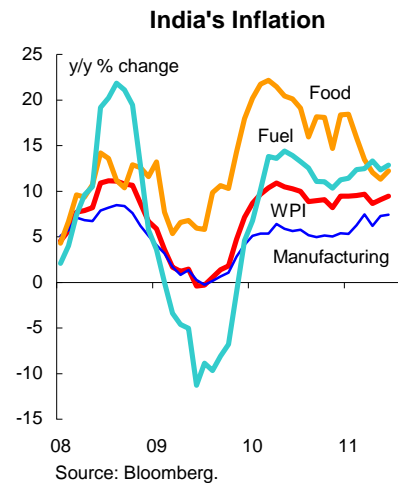
The Outlook for India: Strong Growth Amid Elevated but Down Trending Inflation

- **One-off adjustments in publicly administered prices means still elevated inflation ahead.**
- **Monetary tightening is paying off supporting an eventual price pressure capitulation.**

The Reserve Bank of India (RBI) will retain a hawkish stance until inflationary trends give in. The RBI accelerated the pace of monetary tightening in July with an unexpected 50 basis points (bps) rise in the benchmark repo rate after its first quarter monetary policy review for the fiscal year 2011-12. Notwithstanding the strength of economic activity indicators in India, we expect price pressures to subside in coming months and anticipate one additional 25 bps interest rate lift for the rest of 2011.

Inflation remains the main concern of the RBI. Since October 2009, the repo rate has been raised ten times for a cumulative 325 basis points to 8%, and the reserve ratio for banks has been increased by 100 bps. While a lag is to be anticipated, still, aggressive monetary tightening has done little to dent the price pressure surge as inflation in India continues to fluctuate within a narrow range. The yearly advance in the wholesale price index (WPI, benchmark inflationary gauge) currently lies at 9.44% y/y. It is off the 9.74% April peak, and has had a maximum variation of +/-0.26% in the past seven months (chart).

Two forces are at play in Indian inflationary dynamics. A secular downtrend in food prices, established since the second quarter of last year after food cost inflation peaked at 22.2% y/y in March 2010. The trend has persisted more or less uninterrupted, and is being compensated by rising domestic fuel costs as of last November. Elevated global oil prices combined unfavourably with local adjustments in the public subsidy scheme as the government aims to streamline the fiscal imbalance.



The picture outlined above has been framed by an economy that gathered momentum through the turn of the year, adding another element to the price pressure mélange as Indian manufacturing firms working closer to full capacity have been able to pass cost increases to consumers. Thus, non-food manufacturing price inflation (core inflation) has been trending up in the last eight months. This is disconcerting for the RBI, as only latest evidence from April-May suggests that domestic demand is undergoing some moderation implying an impact from progressive monetary tightening.

Looking ahead, as long as weather conditions remain close to normal capping the rise in agricultural prices, Indian inflation should be coming down in the second half of 2011. Demand forces have not been the main price pressure driver. A plethora of one-off effects have plagued recent monthly cost gains as the government continues to move away from energy price controls, with the increase in administered petroleum product prices (petrol, diesel kerosene and LPG) in May-June being the latest example. This recent adjustment could still prevent a premature fall in fuel costs in the coming months. While we believe that growth will remain well supported by record gains in net exports and solid discretionary consumer spending, credit growth has slowed to below 20% y/y backing evidence of softer domestic demand conditions. We expect a slight slowdown in GDP growth to 8.4% in FY2011, after the 8.6% yearly advance FY2010. The downtrend is predicated on falling government outlays compensated by rising discretionary consumer spending and continued gains in net exports, with the latter supported by a relatively weak Indian rupee whose appreciation since the 2008 overshooting has lagged most other Asian currencies.

Adrienne Warren (416) 866-4315
adrienne_warren@scotiacapital.com

Entrepreneurs, Small Businesses Provide Employment Stability

- **Self-employment opportunities and small businesses helped to cushion the Canadian labour market during the recession, and remain an important source of new job creation.**

The ranks of the self-employed in Canada — employed individuals not on a payroll, with or without paid employees — rose sharply during the 2008-2009 recession (chart 1). Along with increased hiring in the public sector (including health care and education), this helped offset sizeable job losses in the private 'paid' sector. This trend has reversed somewhat over the past two years alongside the rebound in private paid employment, but there are still more entrepreneurs today than prior to the downturn. Almost 2.7 million Canadians are self-employed, representing over 15% of the total workforce.

Self-employment typically rises during economic downturns, as more limited private sector paid employment opportunities prompt job-seekers to consider more enterprising alternatives. However, the composition of the gains suggest they were not primarily a stop-gap option for the newly-unemployed, but rather a deliberate preference for many eying growth opportunities in expanding service industries.

The vast majority of payroll job losses during the recession were in manufacturing, construction and transportation (table). However, the rise in self-employment during this period was primarily in finance, insurance & real estate, professional, scientific & technical services (e.g. lawyers, accountants, architects, engineers, consultants) and 'other' services. The specialized skills required for many of these positions are likely not easily transferable from the job-shedding sectors. Moreover, while men accounted for almost three-quarters of the job losses in the paid sector, almost three-quarters of the rise in self-employment was among women. The trend toward self-employment has moderated as private sector hiring has picked up, but the earlier gains have been retained.

Small firms — those with fewer than 100 employees — have been another stabilizing factor. Employment at small firms, which account for 47% of private sector payroll jobs, fell less sharply during the recession than for medium (100-499 employees) or large firms (500+ employees) (chart 2). While hiring among small firms has been slower to recover, employment levels are closer to their pre-recession peaks.

Small firms dominate service industries such as professional services which held up well during the downturn, but are also prevalent in construction which suffered large recession job losses. Meanwhile, larger firms dominate the manufacturing sector which led both job losses and the subsequent recovery. Across industries, however, small firms have been more reluctant to cut or add to payrolls, likely due in part to their relatively higher employee recruitment and training costs.

Given a greater-than-usual level of global economic uncertainty, we expect hiring nationally to be more moderate in the coming months, with small businesses continuing to lag larger firms.

Chart 1 - Total Employment By Class of Worker

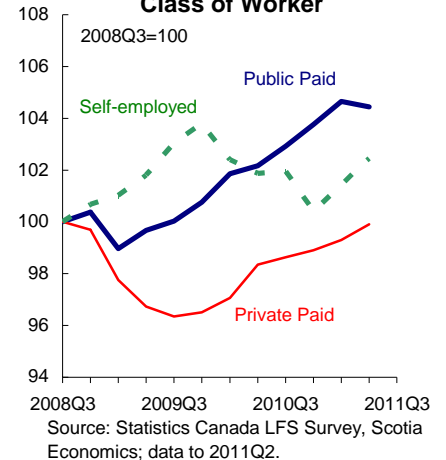
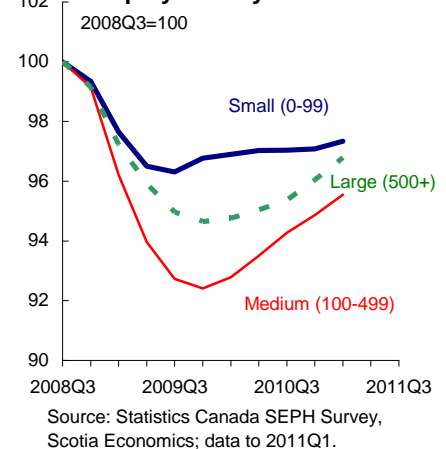


Chart 2 - Private Sector Employment by Firm Size



Employment Change				
	08Q3-09Q3		09Q2-11Q2	
	000s	%	000s	%
Paid Employment	-426	-2.9	497	3.5
Construction	-217	-11.3	-14	-0.8
Manufacturing	-85	-9.0	124	16.1
Transportation	-53	-7.3	7	1.1
Men	-312	-4.2	340	4.8
Women	-114	-1.6	157	2.2
Self-Employment	97	3.6	4	0.2
FIRE	37	20.8	17	8.9
'Other' Services	34	15.0	-16	-6.6
Prof. Services	26	6.6	65	15.8
Men	26	1.5	3	0.2
Women	71	7.9	1	0.1

Source: Statistics Canada LFS Survey, Scotia Economics

Gorica Djerić (416) 866-4214
gorica_djeric@scotiacapital.com

Small Business Credit Conditions Gradually Thaw

- **Small business lending conditions are improving, but greater sensitivity to economic conditions is keeping the pace more subdued than for larger firms.**

Last week, we highlighted the importance of small & medium enterprises (SMEs) for the broader US economy, particularly the labour market. This week, we take a look at the credit conditions for SMEs. While small business lending has yet to return to its pre-recession levels, credit conditions are showing signs of gradual improvement.

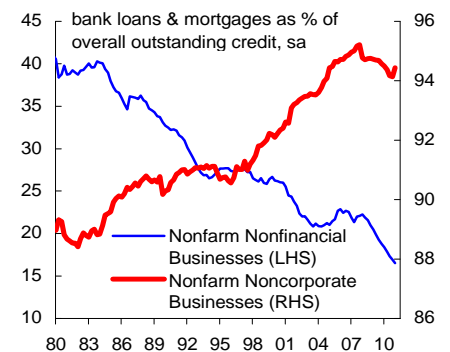
SMEs are more sensitive to bank lending conditions than larger firms, due to a heavier reliance on traditional bank loans and mortgages (see chart 1), especially products that were heavily securitized prior to the downturn, such as credit cards, auto loans and commercial real estate mortgages. Despite stimulus programs that targeted small business lending — to the like of Term Asset-Backed Securities Loan Facility and the Small Business Loan Fund — the overall debt outstanding for smaller businesses remains well below its pre-recession peak, a stark contrast to their larger counterparts (see chart 2).

Greater sensitivity to economic conditions explains why banks remain more hesitant to lend to smaller businesses. Aside from having no credit rating, tighter profit margins and less ability to predict cash flows, for many SMEs their business balance sheets are linked to owners' personal finances, especially since 61.0% (or 3.6 million) of US business establishments have fewer than five employees. With their frequent use of residential and commercial real estate as collateral — and the fact that SMEs account for 99.8% of all construction and real estate-related firms — the ongoing real estate struggles have disproportionately affected this segment. What's more, these companies tend to obtain financing through community and regional banks, hurt the most by commercial real estate woes. These factors have made borrowing more difficult, turning owners to alternative sources of financing (e.g., factoring, self-financing). Aside from the supply side challenges, demand side factors are also at play, including, leaner operations and a still-cautious sentiment.

That said, credit market indicators point to both a gradual strengthening and broadening of credit conditions for SMEs. The July issue of the National Federation of Independent Business (NFIB) Small Business Survey — the most comprehensive SME report — reveals that the “overwhelming majority” of the respondents indicated that credit was no longer a major hurdle. The latest Senior Loan Officer Survey further reaffirms this view, showing that credit standards continue to ease, and loan demand is slowly warming up (see chart 3), albeit at a slower pace than for larger firms. A recent survey conducted by the Atlanta Federal Reserve Board showed that nearly half of the respondents did not need any additional financing because they had sufficient cash on hand (26.4%) or existing finances met their needs (20.3%), a sign that smaller businesses, like their larger counterparts, are keeping cash reserves. Unfavourable lending terms were cited by only 5.4% of the participants, an improvement over the prior quarter's results. As the economic recovery inches along — helped by solid export demand — credit conditions should continue to improve, contributing to increased hiring and generating multiplier effects through the broader economy.

Chart #1

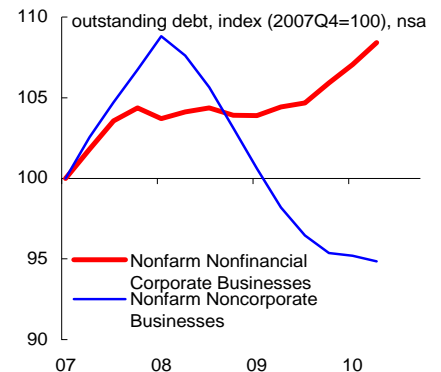
Bank Loans and Mortgages Account For Nearly All SME Debt



Source: Fed's Flow of Funds, Scotia Economics.

Chart #2

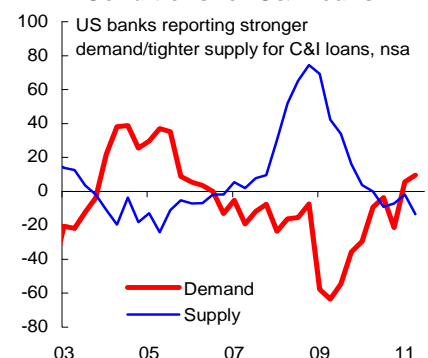
Small Business Lending Has Yet to Return To Pre-Recession Levels



Source: Flow of Funds, Scotia Economics.

Chart #3

Improving Demand and Supply Conditions for C&I Loans



Source: Fed's Senior Loan Officer Survey, Scotia Economics.

Carlos Gomes (416) 866-4735
carlos_gomes@scotiacapital.com

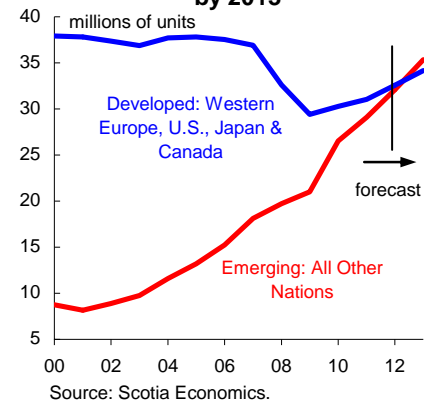
Emerging Nations Driving Global Car Sales To Record High In 2011

- Gains to accelerate in the second half of the year.

Global car sales advanced 5% in the first half of 2011, despite rising headwinds associated with sovereign debt problems in Western Europe, vehicle shortages from Japanese automakers, and increased consumer caution due to near triple-digit oil prices and higher financial market volatility since April. The emerging nations have led the way with sales advancing 13% so far this year — triple the gain in the mature auto markets of North America and Western Europe. Emerging automotive markets now account for 47% of global car sales, up from only 18% a decade ago.

We expect a further acceleration in global sales during the second half of 2011, as product shortages wane for Japanese automakers and the pace of job creation in emerging markets remains solid. Job growth in developing nations exceeds 3% year-over-year — nearly five times the tepid growth in the mature auto markets of Western Europe and North America. In fact, robust vehicle demand in emerging nations will likely drive purchases above volumes in developed nations by 2013 (see chart).

Emerging Nations' Car Sales Set to Surpass Developed Countries by 2013



A dramatic increase in car sales in China has been the main driver of rapid growth in emerging market automotive volumes in recent years. China surpassed the United States in 2009, to become the world's largest auto market and sales will likely approach 10.5 million this year, up from 9.4 million in 2010, and only 4.6 million five years ago. Rapid per capita income growth in China — hovering around 9% per annum — is the key driver of rapid sales gains.

Purchases in China will also be supported through the end of this year by a vehicle replacement scheme for rural vehicle buyers introduced in early June. Under the plan, rural buyers will get up to US\$2,800 to replace their older vehicle with a new model by December 31, 2011. Given a low vehicle penetration rate of only 47 vehicles per 1,000 people — compared with an average of nearly 700 vehicles in the G7 — and strong income growth, car sales in China will likely exceed 25 million units per annum by 2020.

While China is the world's largest auto market, Russia is posting the strongest sales gains this year, with first-half volumes surging a stronger-than-expected 56% yr/yr. The improvement reflects a government scrappage program which was in effect through May, as well as robust economic growth bolstered by high energy prices. Russia is the world's largest oil producer, with annual output of 10 million barrels — roughly 1.4 million barrels above production in Saudi Arabia.

Despite sharp increases in short-term interest rates in both India and Brazil, car sales continue to post solid gains. In India, car sales jumped 15% in the first half of 2011, a growth rate expected to be maintained in coming months, alongside robust economic growth of roughly 8%. Industrial activity remains strong in India, and a good monsoon season suggests an improving outlook for the agricultural sector, which will support rural discretionary spending. For its part, Brazil continues to benefit from strengthening commodity prices — resource products account for 60% of its overall exports — enabling it to become the fourth-largest auto market in 2011, surpassing Japan. We expect Brazil to become the world's third-largest car market by mid-decade, overtaking Germany. The Brazilian population under 35 years of age is four times greater than its German counterpart.

Patricia Mohr (416) 866-4210
patricia_mohr@scotiacapital.com

Gold Maintains Its Allure As A 'Safe-Haven'

Spot gold prices touched a new record high of US\$1,632 per ounce on July 29 on the U.S. debt ceiling impasse and a general loss of investor faith in paper currencies, undermined by high government deficits and debt. This has prompted demand for non-fiat money or assets with intrinsic value such as gold and silver.

So far this year, gold has been a strong 'asset class' — with spot prices up 14.9% since late 2010 — compared with a -4.0% decline for the S&P/TSX Composite Index and a modest 2.7% gain for the S&P 500, though the Swiss franc (up 18.6% vis-à-vis the U.S. dollar) has been even stronger and rose to a new record high against both the U.S. dollar and the euro today.

A disconnect appears to have emerged for valuations of gold mining companies, with the S&P/TSX Gold Equities Index declining -9.8% through July 29. Though in some cases reflecting weaker-than-anticipated mine production gains and escalating mine development costs, some catch up in equity values is likely warranted. (Selected industrial commodity prices such as potash — up 29.3% — and coking coal — up 50.7% — have performed even better than gold on strong world demand — especially in 'emerging markets' — and tight supplies, though related equity valuations have recently lost ground, in some cases temporarily.)

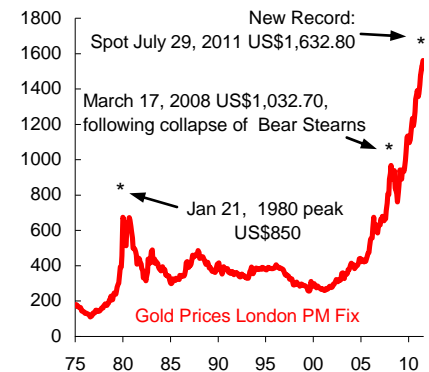
With inflation-adjusted interest rates in significant negative territory, the opportunity cost of holding gold has been limited. Three-month Libor adjusted for the core U.S. CPI is currently -1.34% and the two-year Treasury bond -1.22%.

Gold prices could well move higher yet. At issue is not only the timing of the U.S. debt ceiling increase from the current US\$14.29 trillion to avoid default, but also the credibility and size of the proposed deficit reduction package to place the United States on a sounder fiscal footing. While a second EU/IMF bailout package was agreed for Greece the week of July 21, there appears to be concern over the long-term sustainability of the measures, though new powers for the European Financial Stability Facility, to prevent contagion in other countries, were a welcome development. Lingering debt-related problems in the southern Euro-zone economies persist. Moody's again downgraded the sovereign debt of Greece on July 25. Standard & Poor's also cut Greece's rating to CC from CCC on July 27.

In this environment, gold remains an attractive investment and a hedge against uncertainty.

Chart #1

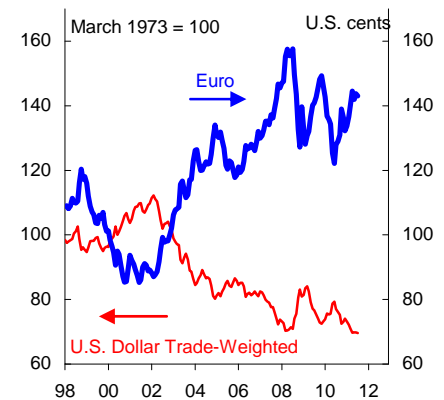
U.S. Debt Crisis Re-Monetizes Gold



July 29, 2011/Dec. 31, 2010 % change:
 Gold (spot): 14.9%, Swiss Franc: 18.6%,
 S&P/TSX Gold Equities: -9.8%.
 Source: Scotiabank Commodity Price Index.

Chart #2

Currency Trends



Source: Scotia Economics.

Chart #3

Swiss Franc



Source: Scotia Economics.

Taylor Glassco (416) 945-4792
taylor_glassco@scotiacapital.com

Mary Webb (416) 866-4202
mary_webb@scotiacapital.com

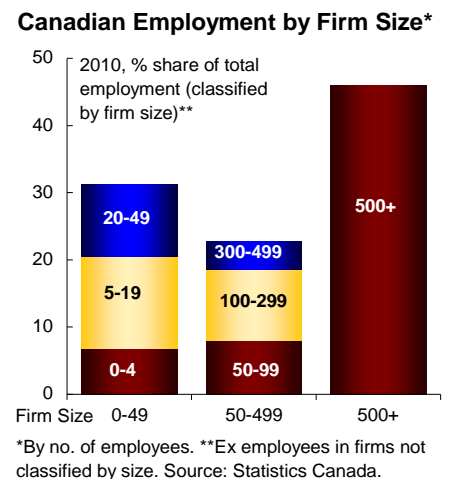
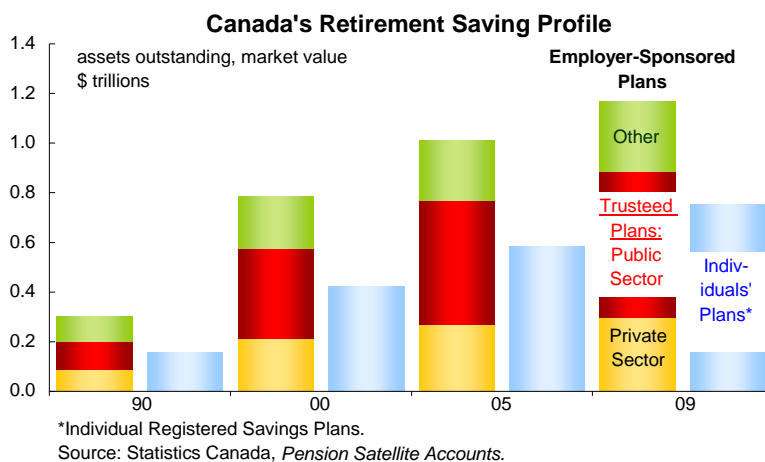
Critical Design Details for Canada's Pooled Registered Pension Plans

- PRPP details key for employer and worker participation.

Last December, federal, provincial and territorial Finance Ministers reached broad agreement for Canada's newest retirement savings vehicle, Pooled Registered Pension Plans (PRPPs) — low-cost defined contribution pension plans open to all workers, with or without a participating employer, including the self-employed¹. Finance Canada is currently seeking feedback on multiple issues to amend the tax code to integrate PRPPs into Canada's retirement savings system. These details are key to PRPPs' eventual success as a retirement savings solution offering professional administration and investment management at more affordable rates to supplement whatever pension coverage is available from employers. While public-sector workers are largely covered by defined benefit Registered Pension Plans (RPPs), less than a third of Canada's workers outside of government have RPP coverage. The market value of assets in employer-sponsored plans continues to outstrip individuals' registered savings plans (*left chart*), primarily because of asset growth in public-sector plans. Private-sector employers providing RPPs increasingly favour defined contribution alternatives and employer RPPs are typically less available to the large universe of workers employed by small- and mid-size firms.

A sampling of PRPP design issues illustrate their importance. With many Canadians currently not taking full advantage of available, voluntary retirement saving opportunities such as RRSPs, an essential PRPP feature is automatic enrolment of employees with regular payroll deductions for employers offering PRPPs. If an employee chooses to opt out, a possible feature is automatic re-enrolment every three to five years, providing re-occurring decision points. To limit administration fees and encourage employers to offer PRPPs, the regulatory framework should be pan-Canadian and straightforward, with PRPP administrators assuming responsibility for compliance, records and reporting. Therefore, should qualifications/restrictions be outlined for administrators? For example, can existing pension plans, public- or private-sector, be a PRPP administrator? If an employer makes regular PRPP contributions for employees, will PRPP contributions with respect to the tax code be governed by defined contribution RPP limits with Pension Adjustments issued to employees identifying their allowed RRSP contribution room? For the self-employed and employees whose employers do not contribute, will tax-deductible PRPP contributions be governed by RRSP limits? In either case, should these contribution limits be increased further over time to create a more level playing field with RPPs? For employers making PRPP contributions, will vesting periods be permitted? Will PRPPs be subject to investment guidelines? RPPs are prohibited from investing in sponsoring employers and related employers, but this would be more difficult for PRPPs with their potential coverage across multiple employers. Thus, a key opportunity and challenge of PRPPs is creating a lower-cost, effective retirement savings vehicle flexible enough to meet the needs of workers across Canada over their entire careers.

¹ See [Fiscal Pulse: December 20, 2010](#) for a fuller PRPP description.



Joe Kogan (212) 225-6541
joe.kogan@scotiacapital.com

Mexican Homebuilder Bonds: 2Q11 Wrap-up

While quarterly results for the homebuilding sector were generally good, significant uncertainty remains about the long-term outlook. We review recent results, and then discuss key news items we will be watching for later this summer.

Mexican homebuilders with global bonds reported quarterly financial results this week. As shown in the table, sales grew in all four firms mostly due to increases in price rather than increases in units sold, although the latter also had some modest improvements. Profit margins remain high and mostly stable. Javier was an exception to some of these trends, perhaps because it operates in a specific geographic market. Consistent with a profile of historically more volatile revenue, its unit sales rose 27%, but an increased concentration of sales in the lower income segment led to price declines, and what to us seems an unusually large decline in margins; Javier went from having the most attractive margins in the industry to the least attractive.

Figure 1. Comparative Homebuilder Results

	2Q11 Million Ps				2Q10 Million Ps			
	Urbi	Homex	Geo	Javer	Urbi	Homex	Geo	Javer
Units	8,932	12,576	14,742	3,886	8,517	12,312	14,919	3,062
Growth vs. 2Q10	5%	2%	-1%	27%				
Sales	3,869	5,490	5,412	1,093	3,350	4,826	5,208	973
Growth vs. 2Q10	16%	14%	4%	12%				
Gross Margin	28.1%	30.9%	31.4%	30.9%	28.1%	30.8%	30.7%	36.4%
Operating Margin	19.4%	17.0%	16.1%	15.6%	18.8%	16.4%	15.5%	22.6%
Ebitda Margin	26.7%	22.5%	21.6%	17.1%	27.0%	22.0%	21.8%	23.9%
Net Debt / Ebitda (x)	1.45	2.17	1.80	2.58	1.04	2.33	2.00	2.50
Cash Flow from Operations	(120)	651	124	(156)	198	(223)	1,635	(316)
Inventories	22,229	29,423	22,948	3,328	22,433	24,760	19,962	3,359
Sales L12M	15,885	20,821	20,099	5,187	14,181	18,525	18,821	4,069
Inventories / Sales L12M	1.40	1.41	1.14	0.64	1.58	1.34	1.06	0.83

Source. BMV, Firm reports

While the industry remains profitable, investor concerns usually center instead on the lack of cash flow. Three of four homebuilders reported positive free cash flow this quarter, though operating cash flow remains significantly short of profits. We would not put too much emphasis on any quarter's particular cash flow results, as the investment decisions of these firms can be bulky and some cash flows are non-recurring, leading to large variability in cash flow numbers from quarter to quarter and between firms. For example, Homex was helped by an advance payment on Federal Government construction contracts, while Geo improved free cash flow through its Geo Maquinaria transaction. Our table shows operating cash flow based on stock exchange data to ensure that the items are comparable, and these numbers are lower than the cash flow numbers reported in firm press releases in some cases.

We found it interesting that Homex, during its investor call, said it would reduce land reserves from 5 years to 3.5 years. Management said this was motivated by a reassessment of land needs in consideration of the government's focus on vertical housing. That explanation seems reasonable, but we wonder if there were any other factors at work here, perhaps demands from investors to see positive cash flow or a reassessment of future demand. In any event, Homex inventories actually increased in the second quarter. In today's call with analysts, Geo management also indicated that they might reduce the size of the land bank.

The strong sales figures this quarter, and probably for the rest of the year, tend to obscure the significant doubts about volumes in the long-run. As is well understood in the industry, the number of affiliates of housing agency Infonavit who want to buy a house will decrease substantially in several years, and the

Joe Kogan (212) 225-6541
joe_kogan@scotiacapital.com

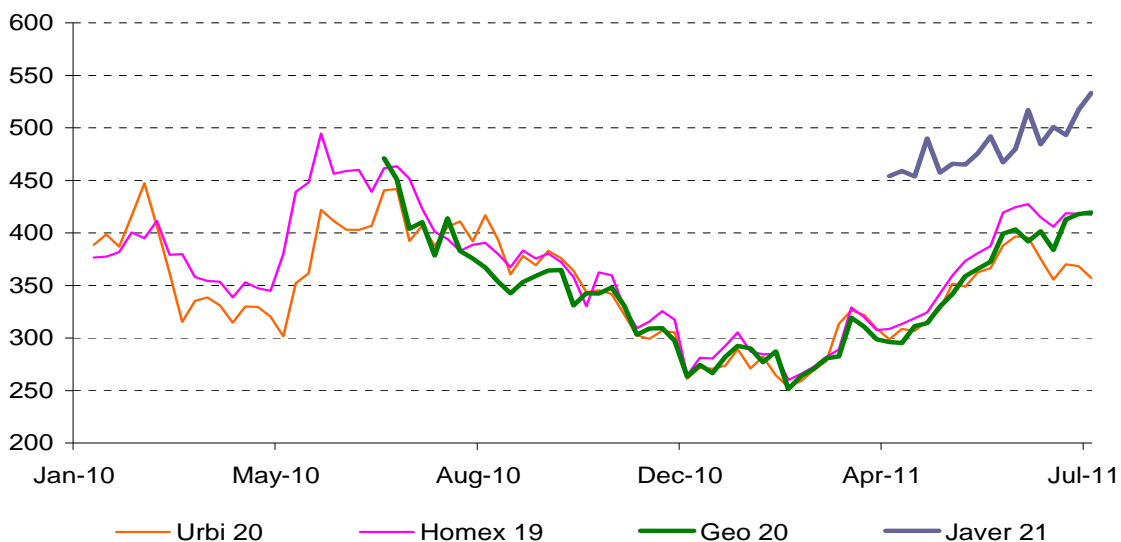
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industry is hoping that these buyers will be replaced by a new clientele, whether independent professionals or workers in the informal economy, who have previously not had access to financing.

There are two sources of uncertainty here. First, will the government pass the necessary reforms and legislation to provide such financing? Even though the Infonavit reform bill we were expecting to pass in April will not be taken up till the Mexican Congress resumes its session in September, we still think the government is highly committed to tackling the housing shortages in the country. In addition, SHF, the Mexican agency charged with promoting the housing sector by providing funds to Mexican financial institutions and builders, is currently preparing its housing plan for non-affiliates which it intends to present sometime in August. The second uncertainty is whether enough non-affiliated members will be able to pay their housing loans. We may have to wait longer to get the answer to that question. Some early signs will likely come from Urbi, which has taken a lead in providing housing to members of the informal economy using financing from private equity/multinational sources. Also worth watching is progress in Geo Fácil, which targets this market as well.

The homebuilders have performed particularly badly in the Mexican equity market, with drops since December of 45%, 28%, and 13%, for Geo, Homex, and Urbi respectively. We imagine that these drops result from concerns about future housing demand but we are unaware of any specific fundamental news significant enough to motivate drops of this magnitude. As shown in Figure 2, yields on the bonds suffered as well during this period. Meanwhile, Urbi bonds have outperformed in relative terms, thanks to significantly lower leverage.

Figure 2. Homebuilders' Spread over Mexican Sovereign bonds



Source: Bloomberg, Scotia Capital. Calculated as the yield to maturity of each homebuilder minus the yield on the Mex 20 global bonds.

Thus, the yield premium on the bonds over the sovereign is reaching past highs and may tempt some investors, especially given the increase in sales we saw in the last quarter. We like the bonds as well at these levels, but we are anxious about future demand.

This article was written jointly with Leonor Lopez.

For more information see:

"Javer's discount vs. other Mexican homebuilders," Scotia Capital, July 8, 2011.

"A new market for Mexican homebuilders," Scotia Capital, March 18, 2011.

"Making houses like tortillas: Mex. homebuilders," Scotia Capital, October 28, 2010.

Alan Clarke (44 207) 826-5986
alan_clarke@scotiacapital.com

The View From Europe — Q2 GDP is Old News ...

- This week saw confirmation that the UK economy grew by a pedestrian 0.2% q/q during Q2 — depressed by one-off factors such as the royal wedding. We expect a robust bounce of around ¾% q/q during Q3 as these influences reverse. We discuss the risk to the upside and downside.

Q2 GDP is old news — what is going to happen in Q3?

For some time we warned that Q2 GDP growth would be held back by one-off factors such as the extended Easter break associated with the royal wedding. Indeed, the ONS suggested that these factors probably held the headline GDP growth rate back by around ½% point. When we run some scenarios for the main components of GDP on a monthly basis during Q2, this looks reasonable.

We believe that the focus of attention for the market should be on the prospects for GDP growth during Q3. As we have also highlighted for some time, once the temporary factors that held back growth during Q2 reverse, there should be a decent bounce in GDP during Q3. We have run a number of scenarios for the main components of GDP on a monthly basis to gauge the extent of the likely bounce. Based on some reasonable m/m gains in output between July and September, it is not hard to envisage GDP growth in the region of 0.75% q/q.

Survey indicators will be key

Unfortunately, the first of the monthly data are not going to be released until early September. Furthermore, the first data for the all-important services sector will not be released until early October. Hence the best clues to gauge the extent of the Q3 bounce will come from survey indicators, starting with next week's CIPS surveys.

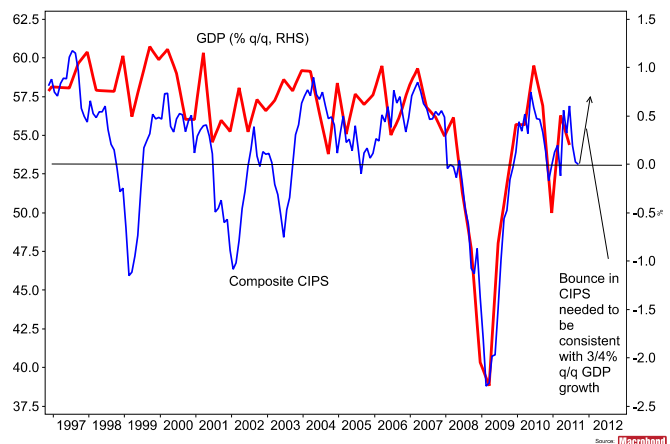
These surveys have had a mixed track record with regards to helping to predict the initial GDP print in recent quarters. Nonetheless, they do tend to provide the best early warning indicator of the likely trajectory for growth.

Chart 1 plots the relationship between the composite of the two CIPS surveys against the q/q pace of GDP growth. It shows that in order to be consistent with the ¾% q/q pace of GDP growth discussed above, the composite of the two CIPS surveys will need to rebound pretty much imminently towards the upper-50 territory from 53.1 currently.

Essentially what this suggests is the CIPS surveys need to begin to rise by an average of 1¼ points per month — starting next week. At face value, the early indications from last week's Eurozone flash PMI surveys are not good — having fallen by 2½ points to 50.8. However, while there is an 80% correlation coefficient between the UK CIPS surveys and its Eurozone cousins, the UK typically leads by 1-2 months. Hence it is not a given that the UK surveys will follow the Eurozone lower.

Consumer confidence may also provide clues to the evolution of the biggest component of GDP by expenditure — consumption. Given the dive in the GfK measure of consumer confidence earlier in the year, it should have come as no surprise that consumption contracted by 0.6% q/q during Q1. Sentiment has

Chart 1



Alan Clarke (44 207) 826-5986
alan_clarke@scotiacapital.com

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recovered a little since then, but remains at a level consistent with falling consumer spending. In turn, the gyrations in consumer sentiment have tended to coincide with swings in inflation. The rationale is that higher inflation erodes household real disposable income growth, which depresses sentiment and vice versa.

Going forward, there is a risk that consumer sentiment begins to fall again, particularly as inflation is likely to rise to above 5% y/y. In particular, utility bill increases of 10-20% beginning in August will increase the burden on household disposable income by around £200 per year.

The Glass Half Full Scenario

Is it possible for GDP growth to bounce back by 1% q/q or more? The impressive bounce in business services output during May — if maintained — gets the arithmetic for Q3 off to a good start. If we assume that:

- Industrial production growth accelerates to post rises of around 0.3% m/m each month during Q3 (perhaps helped by the waning of the drag from the Japanese Tsunami);
- Construction output rises by 2% m/m each month during Q3 (which would push the y/y rate of increase back into positive territory — where it was prior to the royal wedding); and
- Services output posts a steady 0.1% m/m gain each month during Q3...

... the net result is headline GDP growth could be 1% q/q. The last time the economy grew this fast was Q2 2010 at which point the composite CIPS reading was 57.8. Hence it is perfectly plausible that output bounces by as much as 1% q/q. However, the fact remains that the survey indicators would need to start heading higher pretty soon.

Conclusion

Our working assumption is that GDP growth will rebound by around ¾% q/q during Q3 as the temporary factors that held back growth during Q2 reverse. This should then give way to a more pedestrian pace of output during Q4 (around 0.3% q/q) resulting in full year GDP growth of 1¼% y/y for 2011.

There are risks in both directions to this view. If the CIPS surveys fail to rebound soon then GDP growth may not stray far from Q2's artificially subdued pace. At this stage, while we concede that a more robust reading of 1% q/q is possible, it seems rather unlikely. The clues from the upcoming CIPS surveys will be crucial.

Malaysian Ringgit Strategic View

- **Bank Negara Malaysia's need to tighten monetary conditions, and MYR's key role in overall financial conditions, implies the potential for MYR to be in the upper echelon of Asian FX performers over the next few months.**

The Malaysian Ringgit has been one of the better performing currencies since late June when the Asian currency complex began to make its next leg higher against the US dollar. Regional central banks have taken a varied approach in the degree of strength they've allowed in their currencies, with Bank Negara Malaysia generally electing to step away from the market to some degree and allow the MYR to reach its strongest level against the USD in well over a decade. Is this move due to short term factors (US debt ceiling indecision) and general Asian currency outperformance, or is there an underlying dynamic at play that suggests MYR outperformance over the coming months?

MYR Evolution vs. Output and Inflation Trends

The basis of the currency's short term performance vs. the greenback is deeply linked to Bank Negara Malaysia's policy stance and the evolution of global and domestic economic conditions. Malaysia's monetary tightening has been much more focused on currency dynamics rather than rate hikes, with a few reserve ratio requirement increases added for good measure. Indeed, the actual overnight policy rate has played a relatively minor role in comparison, and a quick study of Asian central bank policy rate variation going back to 2005 shows that the Malaysian overnight policy rate has been the least frequently adjusted in relation to the operational rate targets of other Asian central banks. Overall currency developments have tracked inflation and output dynamics to a reasonable degree, hinting at an explanation for MYR strength in July. The actual level of annual inflation in Malaysia is currently at its highest since March of 2009, when price pressures were rapidly falling despite the deep global financial crisis-induced depreciation in the MYR.

Heading into July, the pace of MYR appreciation on a quarterly basis had reached a 1.5 year low, despite the still very evident trend in prices. The relative stability in USDMYR in the months of February through June that contributed to a moderation in the Y/Y pace of MYR appreciation was perhaps due to concerns over the impact of the Japanese earthquake/tsunami and a broader slowing in the pace of global demand. However, inflation has failed to move off of its upwards path. Bank Negara Malaysia has pointed to food and fuel prices (supply factors) as the key dynamics pushing domestic inflation, though there are signs that domestic demand could begin to place unwanted pressure on prices as we move through the second half of the year. Stability in MYR no longer appears as justified as perhaps it did in the past few months.

MYR as a Key Influence on Malaysian Monetary Conditions

With Malaysia's output gap back in positive territory and climbing (currently at 0.8% by our estimation at the end of Q1), and CPI inflation 1.25 percentage points above its longer term trend of 2.25% (and building) there are certainly upside risks for inflation. The central bank pursues a multifaceted approach to policy, with exchange rate valuation playing a key role in the management of financial conditions for the purpose of monetary policy in the six years that the ringgit has been in its current "managed float" regime.

Given this multi-faceted approach that Malaysia takes in managing monetary policy, adjusting the overnight rate, the cash reserve ratio requirement and the exchange rate, it is somewhat more difficult to grasp the monetary stance of the central bank relative to developments in prices and growth. To come to grips with the direction of currency policy, and how growth-supportive or growth-restrictive the current monetary stance is, we construct a financial conditions index and estimate the importance of MYR in BNM's management of financial conditions as it relates to growth.

Our methodology involves estimating a long run relationship (using a co-integration modeling approach) between industrial production and financial conditions, with the latter described by a combination of the three

Sacha Tihanyi (852) 6117-6070
sacha_tihanyi@scotiacapital.com

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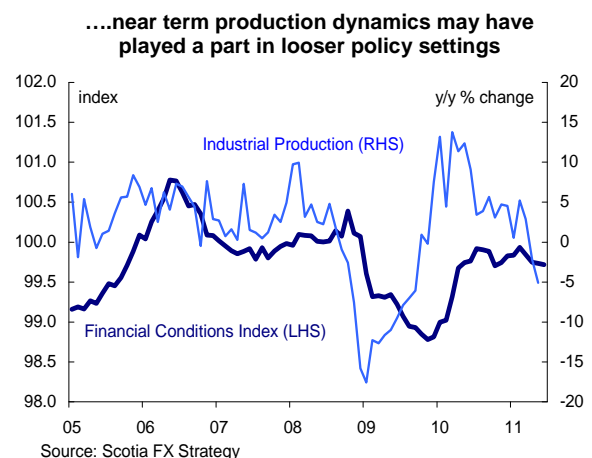
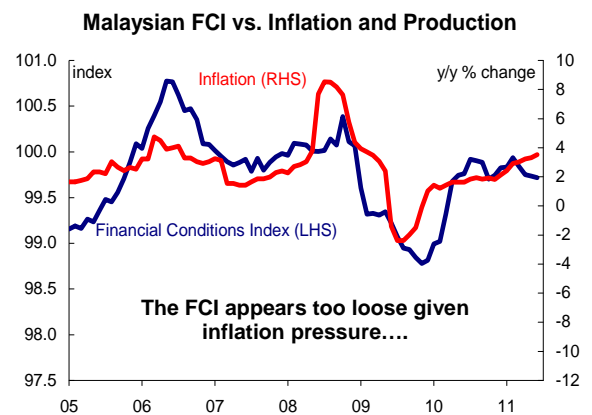
month Treasury bill rate, the MYR nominal effective exchange rate, money supply growth and equity prices in Malaysia. We then derive weights from the long run estimated relationship in order to construct the financial conditions index (FCI) using the aforementioned monetary-financial variables. The variables have been expressed relative to their long run trends so that our FCI is standardized, and will tend to vary about the 100 index level, with the FCI moving higher indicating a growth-restricting tightening in monetary conditions, and a move lower in the FCI indicating a growth-supportive loosening in monetary conditions. Due to the way that we have constructed the FCI (and expressed variables relative to their long term trends), we note that it is the direction of change in the FCI that matters as much as the overall level of the index, and that index levels across larger time gaps may not be exactly comparable.

Essentially, we've found that the Malaysian ringgit, on a nominal trade weighted basis, is THE key policy variable as far as shifts in monetary conditions are concerned. This is in line with our previous tally of the frequency with which Malaysia has adjusted its policy rate relative to other Asian central banks. As such, we have produced an index where the MYR NEER carries more than a third of the weight, with the overnight policy rate accounting for about a quarter, while money supply and equity prices receive an equal share of the balance.

Financial Conditions Remain Growth Supportive → MYR Should Appreciate

What we observe in our FCI is that conditions have remained fairly stable on a medium term trend basis in being rather supportive of growth, in contradiction to some degree with what the trend in inflation suggests is required. However, this stable evolution has been in line with the recent softening in production (mining has been a near term drag). However, we feel that the growth/inflation trade-off of relatively loose financial conditions is becoming less attractive to Bank Negara Malaysia, and suspect that the recognition of this by BNM has led to the increased pace of MYR appreciation through July. Consensus real GDP forecasts from Bloomberg remain at over 5% on an annual basis for 2011 through 2013, indicating an increasingly positive output gap. In addition, the normalization in the regional supply chain and Japan's rebound bode well for the country's external balances, which will complement domestic consumption and investment strength. The concern voiced by BNM that there are signs that domestic demand forces in the second half of 2011 could exert upward pressure on prices also lends credence to the view that monetary conditions require tightening.

These monetary dynamics should argue for the ability of USDMYR to rally towards 2.90 on a sustained basis through the end of the year, with obvious risks skewed to the downside for USDMYR (MYR-bullish) should inflation continue to build and domestic demand pressure remain robust. USDMYR has been subject to violent swings over the past few months, but anything less than a trade above the 3.05 level in the pair should not shake a structurally bullish MYR view in the near term.



Source: Scotia FX Strategy

Karen Cordes Woods (416) 862-3080
karen_woods@scotiacapital.com

Derek Holt (416) 863-7707
derek_holt@scotiacapital.com

Key Data Preview

CANADA

Jobs will be the main focus next week as employment reports in both Canada and the US will be released next Friday. As we wrote about both leading up to and following the June employment report (Global Views, “Be Skeptical of Canada’s Summertime Job Reports, July 8, 2011) last month, Canadian educational employment is continuing to go through a structural shift whereby education workers are routinely being let go in the early summer months only to be re-hired in the late summer to early fall. While some of this shift has been taken into account by Statistics Canada when seasonally adjusting the raw data, the distortions are unstable and are thus very difficult to control during the summer months. For instance, the temporary-permanent ratio continues to rise in favour of temporary workers, suggesting that the number of teachers with short-term contracts is rising. In addition, primary, secondary and post-secondary schools differ in terms of length of school year which requires different contracts. It also suggests that depending on what month these workers are laid off and then rehired, given the nature of the Labour Force Survey, these workers could be counted as unemployed with no contract in hand at the time of the phone call regardless of their prospects for renewal. While we witnessed a decline in education employment in May — earlier than normal given recent trends — followed by a slight increase in June, this suggests that post-secondary education may be accounting for most of that loss with primary and secondary school cuts to potentially come later in the summer. As a result, there is an increased risk that we could witness another large decline in this sector in July when next Friday’s report is released although given improved seasonal adjustments, the magnitude of the decline would likely be smaller than in past years. Other areas to watch for in next week’s report are the breakdown between self-employed, public and private sector employment, and manufacturing employment. Over the past few reports, self-employment and public-paid jobs have been large swing factors from one report to the next in terms of the headline print, increasing the chances that markets will misread the headline print before delving into the details. There is also an increased risk that we could witness a relatively large gain in manufacturing employment in July after almost 33,000 workers were shed from March to May (23,000 of them in May alone) in part due to the supply chain disruptions from the Japanese disasters in mid-March, and in part due to the temporary shutdown of the Windsor van plants in early April. While June witnessed a modest gain in manufacturing jobs, many auto assembly plants are now back up and running at higher capacity levels, suggesting a further restoration of manufacturing jobs.

UNITED STATES

Nonfarm payrolls (Friday) will take centre stage next week although personal income and spending (Tuesday) and the ISM manufacturing (Monday) and non-manufacturing (Wednesday) reports may also garner some market attention. Over the past two months, US employment has come in substantially weaker than analyst expectations, with gains of 25,000 and 18,000 workers, respectively, versus expectations for a +100,000 increase each month. The unemployment rate has also edged higher, hitting 9.2% in June, the highest level since December 2010 at a time when US employment is supposed to be recovering, not deteriorating. Indeed, of the over 8.7 million jobs lost from December 2007-February 2010, only 1.8 million have been restored. While we won’t likely witness a full revival given increased productivity, the pace of employment growth has been extremely disappointing. Add to this the fact that wage growth is now at 1.9% y/y, the slowest pace of growth since March 2004 — with real wage growth still below zero — and the US consumer is in trouble. Given that the US consumer accounts for roughly 70% of real GDP, this suggests that US economic growth will likely witness further weakness in the months and quarters ahead. This also suggests that inflation growth will remain quite modest as firms are unable to pass on recent gains in energy and food costs as consumers do not have ample funds to spend on discretionary goods with much of their earnings still being put towards staple goods. And indeed, this month’s Fed Beige Book does not provide much optimism for the future as labour market conditions remained soft along with wage pressures as the pace of economic growth slowed in many Districts. This should keep the Fed on hold until at least Q3 of next year.



Daniela Blancas (416) 862-3908
daniela_blancas@scotiacapital

Alan Clarke (44 207) 826-5986
alan_clarke@scotiacapital.com

Oscar Sánchez (416) 862-3174
oscar_sanchez@scotiacapital.com

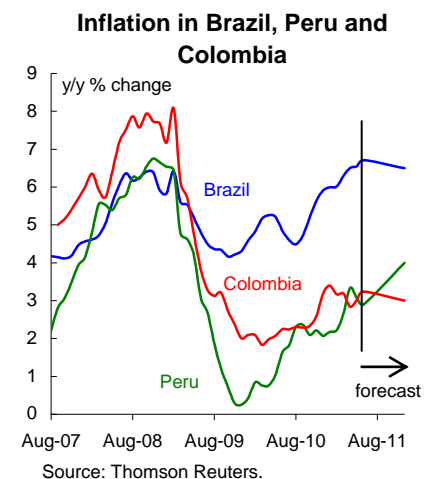
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EUROPE

The UK's CIPS surveys will provide the best clues to the likely recovery in GDP during Q3 — having been artificially depressed during Q2 by the royal wedding. The CIPS services survey has fallen by 3 points in the last 3 months. Meanwhile, the CIPS manufacturing is down by almost 10 points in the last 4 months. How much of this is down to temporary factors is not clear. The after effects of the Japanese Tsunami may be imposing a temporary drag on the manufacturing survey. Given the squeeze on profit margins, the trend in the CIPS services should be downwards over the coming months, which would be bad news for GDP growth in Q3. The euro zone flash estimate showed a sharp fall — down by 2½ points. At face value, these point to downside risks to the UK counterparts. The correlation between the UK and euro zone PMI surveys is high at around 80%. However, the UK tends to lead the euro zone by 1-2 months. Hence it may be misleading to assume that the UK surveys will continue to fall, just because the euro zone series fell. If anything, the manufacturing PMIs appear to be more closely related and reflect common factors such as overseas demand and the fallout from the Japanese Tsunami. Hence we forecast a small fall in the manufacturing CIPS. Meanwhile, the services sector survey tends to reflect domestic economic conditions and there is better reason to expect the UK index to diverge from the euro zone. We expect a broadly stable reading for services in July.

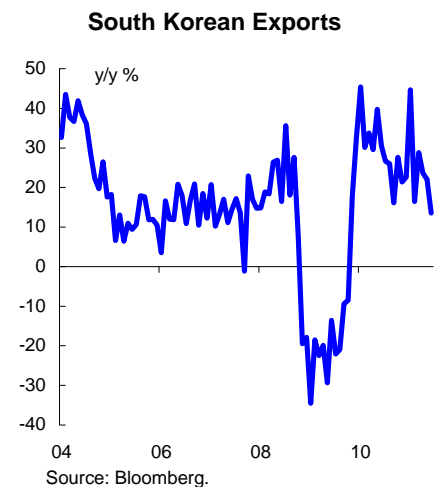
LATIN AMERICA

For the coming week (August 1st - 5th), July inflation numbers in Colombia, Peru and Brazil will attract investors' attention. Consumer prices in Colombia remain close to the mid-point of the central bank's target range, increasing by 3.23% y/y in June. Similarly, recent inflationary developments in Peru have remained within acceptable limits, with consumer prices increasing less than 3.0% y/y in June, prompting monetary authorities to leave the reference rate unchanged in the last two meetings. In contrast, Brazilian CPI has not shown signs of stabilization yet, accelerating from 6.55% y/y in May to 6.7% in June, continuing to exceed the central bank's tolerance range. We expect inflationary pressures to re-emerge in Peru by year-end, while they will likely ease somewhat in Colombia and Brazil.



ASIA

South Korean exports are due to a continued bounce back from the recent soft patch. We expect foreign sale values to rise to an 18.5% yearly rate in July, up from the 13.5% y/y gain of June. The replenishment of supply coming out of Japan, and the persistent rise in demand from China, Korea's main export destination, will continue to support the demand for Korean manufacturing products. We expect the value of imports to rise at a stronger pace of 27% y/y in July on the back of a persistently stronger Korean won.



Key Indicators for the week of August 1 - 5

North America								
Country	Date	Time	Event	Period	BNS	Consensus	Latest	
MX	08/01	10:00	Central Bank Economists Survey					
US	08/01	10:00	Construction Spending (MoM)	JUN	--	-0.1	-0.6	
MX	08/01	10:00	Remittances (USD millions)	JUN	--	--	2166.5	
US	08/01	10:00	ISM Manufacturing	JUL	54.5	55.0	55.3	
US	08/02	08:30	Personal Income (MoM)	JUN	0.2	0.2	0.3	
US	08/02	08:30	Personal Spending (MoM)	JUN	-0.1	0.2	0.0	
US	08/02	08:30	PCE Deflator (YoY)	JUN	--	--	2.5	
US	08/02	08:30	PCE Core (MoM)	JUN	--	0.2	0.3	
US	08/02	17:00	Total Vehicle Sales (millions of units)	JUL	--	11.9	11.4	
US	08/02	17:00	Domestic Vehicle Sales (millions of units)	JUL	--	9.3	9.0	
US	08/03	07:00	MBA Mortgage Applications (WoW)	29-Jul	--	--	-5.0	
US	08/03	07:30	Challenger Job Cuts (YoY)	JUL	--	--	5.3	
US	08/03	08:15	ADP Employment Change (000s)	JUL	90	100	157	
US	08/03	10:00	ISM Non-Manf. Composite	JUL	54	53.8	53.3	
US	08/03	10:00	Factory Orders (MoM)	JUN	0.6	-0.5	0.8	
US	08/04	08:30	Initial Jobless Claims (000s)	29-Jul	390	406	398	
US	08/04	08:30	Continuing Claims(000s)	23-Jul	3690	--	3703	
MX	08/04	10:00	Consumer Confidence	JUL	--	--	93.0	
US	08/04		ICSC Chain Store Sales (YoY)	JUL	--	--	6.9	
CA	08/05	07:00	Unemployment Rate (%)	JUL	7.5	7.4	7.4	
CA	08/05	07:00	Net Change in Employment (000s)	JUL	5.0	20.0	28.4	
CA	08/05	08:30	Building Permits (MoM)	JUN	-5.0	-5.0	20.9	
US	08/05	08:30	Change in Nonfarm Payrolls (000s)	JUL	90.0	90.0	18.0	
US	08/05	08:30	Change in Private Payrolls (000s)	JUL	--	126.0	57.0	
US	08/05	08:30	Change in Manufact. Payrolls (000s)	JUL	--	13.0	6.0	
US	08/05	08:30	Unemployment Rate (%)	JUL	9.2	9.2	9.2	
US	08/05	08:30	Avg Hourly Earning (MoM) All Emp	JUL	--	0.2	0.0	
US	08/05	08:30	Avg Hourly Earning (YoY) All Emp	JUL	--	1.9	1.9	
US	08/05	08:30	Chg in Household Survey Empl	JUL	--	--	-445.0	
US	08/05	15:00	Consumer Credit (USD billions)	JUN	--	5.0	5.1	

Forecasts at time of publication.

Source: Bloomberg, Scotia Economics.

Key Indicators for the week of August 1 - 5

Europe								
Country	Date	Time	Event	Period	BNS	Consensus	Latest	
SW	08/01	02:30	Swedbank PMI Survey	JUL	--	--	52.9	
NO	08/01	03:00	Norway PMI (SA)	JUL	--	--	56.1	
IT	08/01	03:45	PMI Manufacturing	JUL	--	49.0	49.9	
FR	08/01	03:50	PMI Manufacturing	JUL F	50.1	50.1	50.1	
GE	08/01	03:55	PMI Manufacturing	JUL F	52.1	52.1	52.1	
IT	08/01	04:00	Unemployment Rate (%) (SA)	JUN P	--	--	8.1	
EC	08/01	04:00	PMI Manufacturing	JUL F	50.4	50.4	50.4	
UK	08/01	04:30	PMI Manufacturing	JUL	51.0	51.0	51.3	
EC	08/01	05:00	Euro-Zone Unemployment Rate (%)	JUN	9.9	9.9	9.9	
IT	08/01	13:00	Budget Balance (Euro billions)	JUL	--	--	1.3	
IT	08/01	13:00	Budget Balance (Year to date)	JUL	--	--	-43.5	
SP	08/02	03:00	Unemployment MoM Net ('000s)	JUL	--	--	-67.9	
SP	08/02	04:00	Spain Consumer Confidence	JUL	--	--	74.9	
UK	08/02	04:30	PMI Construction	JUL	--	53.1	53.6	
EC	08/02	05:00	Euro-Zone PPI (MoM)	JUN	-0.1	0.1	-0.2	
EC	08/02	05:00	Euro-Zone PPI (YoY)	JUN	5.8	5.9	6.2	
FR	08/03	03:15	PMI Services	JUL F	54.2	54.2	54.2	
IT	08/03	03:45	PMI Services	JUL	--	--	47.4	
GE	08/03	03:55	PMI Services	JUL F	52.9	52.9	52.9	
EC	08/03	04:00	PMI Composite	JUL F	50.8	50.8	50.8	
EC	08/03	04:00	PMI Services	JUL F	51.4	51.4	51.4	
UK	08/03	04:30	PMI Services	JUL	54.0	53.2	53.9	
EC	08/03	05:00	Euro-Zone Retail Sales (MoM)	JUN	--	0.5	-1.0	
EC	08/03	05:00	Euro-Zone Retail Sales (YoY)	JUN	--	-1.0	-1.8	
GE	08/04	06:00	Factory Orders (MoM) (SA)	JUN	-1.2	-0.2	1.8	
UK	08/04	07:00	BOE Asset Purchase Target	AUG	200	200	200	
UK	08/04	07:00	BOE Announces Rates		0.50	0.50	0.50	
EC	08/04	07:45	ECB Announces Interest Rates		1.50	1.50	1.50	
FR	08/05	02:45	Trade Balance (Euro millions)	JUN	--	-6500.0	-7422.0	
IT	08/05	04:00	Industrial Production sa (MoM)	JUN	--	--	-0.6	
IT	08/05	04:00	Industrial Production wda (YoY)	JUN	--	--	1.8	
IT	08/05	04:00	Industrial Production nsa (YoY)	JUN	--	--	4.9	
UK	08/05	04:30	PPI Input NSA (MoM)	JUL	1.0	0.7	0.4	
UK	08/05	04:30	PPI Output n.s.a. (MoM)	JUL	0.0	0.2	0.1	
UK	08/05	04:30	PPI Output Core NSA (MoM)	JUL	0.2	0.2	0.2	
IT	08/05	05:00	GDP sa and wda (QoQ)	2Q P	--	--	0.1	
GE	08/05	06:00	Industrial Prod. (YoY) (nsa wda)	JUN	9.1	8.1	7.6	
GE	08/05	06:00	Industrial Production (MoM) (sa)	JUN	0.7	0.1	1.2	

Forecasts at time of publication.

Source: Bloomberg, Scotia Economics.

Key Indicators for the week of August 1 - 5

Asia Pacific

Country	Date	Time	Event	Period	BNS	Consensus	Latest
SK	07/31	19:00	Consumer Price Index (MoM)	JUL	--	0.3	0.2
SK	07/31	19:00	Consumer Price Index (YoY)	JUL	--	4.4	4.4
SK	07/31	20:00	HSBC Manufacturing PMI	JUL	--	--	51.1
CH	07/31	21:00	PMI Manufacturing	JUL	51.0	50.2	50.9
AU	07/31	21:00	HIA New Home Sales (MoM)	JUN	--	--	-0.2
SK	07/31	21:00	Ext Trade - Export (YoY)	JUL	18.5	17.1	13.6
SK	07/31	21:00	Ext Trade - Imports (YoY)	JUL	27.0	26.1	27.5
SK	07/31	21:00	Ext Trade - Balance in (USD millions)	JUL	3000	2550	2823
CH	07/31	22:30	HSBC Manufacturing PMI	JUL	--	--	50.1
ID	08/01		Total Trade Balance (USD millions)	JUN	--	2355	3509
JN	08/01	01:00	Vehicle Sales (YoY)	JUL	--	--	-23.3
IN	08/01	01:30	Exports (YoY)	JUN	--	--	56.9
IN	08/01	01:30	Imports (YoY)	JUN	--	--	54.1
TH	08/01	03:00	Consumer Price Index (YoY)	JUL	4.0	4.1	4.1
TH	08/01	03:00	Core CPI (YoY)	JUL	2.8	2.7	2.6
HK	08/01	04:30	Retail Sales - Value (YoY)	JUN	--	28.3	27.8
HK	08/01	04:30	Retail Sales - Volume (YoY)	JUN	--	21.6	21.6
AU	08/01	21:30	House Price Index (QoQ)	2Q	--	-1.0	-1.7
AU	08/01	21:30	House Price Index (YoY)	2Q	--	-3.0	-0.2
AU	08/01	21:30	Trade Balance (AUD millions)	JUN	--	2200	2333
AU	08/01	21:30	Building Approvals (MoM)	JUN	--	3.0	-7.9
AU	08/02	00:30	RBA CASH TARGET		4.75	4.75	4.75
CH	08/02	21:00	China Non-manufacturing PMI	JUL	--	--	57.0
AU	08/02	21:30	Retail Sales s.a. (MoM)	JUN	--	0.4	-0.6
CH	08/02	22:30	China HSBC Services PMI	JUL	--	--	54.1
NZ	08/03	18:45	Employment Change (QoQ)	2Q	--	0.0	1.4
NZ	08/03	18:45	Unemployment Rate (%)	2Q	--	6.5	6.6
MA	08/04	00:01	Exports (YoY)	JUN	--	6.0	5.4
MA	08/04	00:01	Imports (YoY)	JUN	--	2.7	5.6
MA	08/04	00:01	Trade Balance (MYR billions)	JUN	--	8.0	8.5
PH	08/04	21:00	Consumer Price Index (YoY)	JUL	--	4.9	5.2
PH	08/04	21:00	Core CPI (YoY)	JUL	--	--	4.0
JN	08/05		BOJ Target Rate		0.10	0.10	0.10
TA	08/05	04:00	CPI (YoY)	JUL	--	2.0	1.9

Latin America

Country	Date	Time	Event	Period	BNS	Consensus	Latest
BZ	8/1/2011	07:00	FGV CPI IPC-S	29-Jul	--	--	-0.1
BZ	8/1/2011	07:30	Central Bank Weekly Economists Survey				
BZ	8/1/2011	09:00	PMI Manufacturing	JUL	--	--	49.0
BZ	8/1/2011	10:00	Trade Balance (FOB) - Monthly	JUL	--	5200.0	4430.0
PE	8/1/2011		Consumer Price Index (MoM)	JUL	--	0.3	0.1
PE	8/1/2011		Consumer Price Index (YoY)	JUL	--	2.8	2.9
BZ	8/2/2011	08:00	Industrial Production sa (MoM)	JUN	--	-0.3	1.3
BZ	8/2/2011	08:00	Industrial Production (YoY)	JUN	--	2.6	2.7
BZ	8/5/2011	08:00	IBGE Inflation IPCA (MoM)	JUL	--	0.1	0.2
BZ	8/5/2011	08:00	IBGE Inflation IPCA (YoY)	JUL	--	6.8	6.7
CL	8/5/2011	08:30	Economic Activity (YoY)	JUN	--	--	7.3
CO	8/5/2011	20:00	Consumer Price Index (MoM)	JUL	--	0.2	0.3
CO	8/5/2011	20:00	Consumer Price Index (YoY)	JUL	--	3.4	3.2

Forecasts at time of publication.

Source: Bloomberg, Scotia Economics.

Global Auctions for the week of August 1 - 5

North America

<u>Country</u>	<u>Date</u>	<u>Time</u>	<u>Event</u>
US	08/01	11:30	U.S. to Sell 3-Month Bills
US	08/01	11:30	U.S. to Sell 6-Month Bills
CA	08/02	10:30	Canada to Sell CAD8 Bln 98-Day Bills
CA	08/02	10:30	Canada to Sell CAD3 Bln 168-Day Bills
CA	08/02	10:30	Canada to Sell CAD3 Bln 350-Day Bills
US	08/02	11:30	U.S. to Sell 4-Week Bills
US	08/04	11:00	U.S. Fed to Purchase USD2.75-3.50 Bln Notes/Bonds

Europe

<u>Country</u>	<u>Date</u>	<u>Time</u>	<u>Event</u>
FR	08/01	09:00	France to Sell Bills (BTF)
SZ	08/02	05:30	Switzerland to Sell 3-Month Bills
UK	08/02	05:30	U.K. to Sell GBP2 Bln 4.5% 2034 Bonds
BE	08/02	05:30	Belgium to Sell Bills (TC)
PO	08/03	05:30	Portugal to Sell 3M Bills
SP	08/04	04:30	Spain to Sell 3.4% 2014 Bonds
UK	08/05	06:10	U.K. to Sell Bills

Asia Pacific

<u>Country</u>	<u>Date</u>	<u>Time</u>	<u>Event</u>
CH	07/31	23:00	China Muni to Sell CNY22.66 Bln 3-Year Bonds
JN	08/01	23:45	Japan to Sell 10-Year Bond
CH	08/02	23:00	China to Sell 5 Year Bond
JN	08/02	23:35	Japan to Sell 3-Month Bills
JN	08/03	23:35	Japan to Sell 6-Month Bills
JN	08/04	04:00	Japan Auction for Enhanced-Liquidity
CH	08/04	23:00	China to Sell 273D Bills

Source: Bloomberg, Scotia Economics.

Events for the week of August 1 - 5

Europe

<u>Country</u>	<u>Date</u>	<u>Time</u>	<u>Event</u>
UK	8/4/2011	07:00	BOE Asset Purchase Target
UK	8/4/2011	07:00	BOE Announces Rates
EC	8/4/2011	07:45	ECB Announces Interest Rates
EC	8/4/2011	08:30	Trichet Speaks at ECB Monthly News Conference

Asia Pacific

<u>Country</u>	<u>Date</u>	<u>Time</u>	<u>Event</u>
AU	8/2/2011	00:30	RBA CASH TARGET
NZ	8/2/2011	22:30	RBNZ Assistant Governor McDermott Speech
JN	8/4/2011		BOJ Target Rate

Source: Bloomberg, Scotia Economics.

Global Central Bank Watch

North America

<u>Rate</u>	<u>Current Rate</u>	<u>Next Meeting</u>	<u>Scotia's Forecasts</u>	<u>Consensus Forecasts</u>
Bank of Canada – Overnight Target Rate	1.00	September 7, 2011	1.00	--
Federal Reserve – Federal Funds Target Rate	0.25	August 9, 2011	0.25	0.25
Banco de México – Overnight Rate	4.50	August 26, 2011	4.50	--

After a much weaker than expected Canadian real GDP print for May, Q2 economic growth is shaping up to be much weaker than the Bank of Canada's downwardly revised forecast of 1.5% q/q annualized. If we assume no growth in June in order to focus upon what we know about Q2 so far and what we know about the Q1 hand-off, then annualized q/q growth is shaping up to be -0.2%. That's also well below our own 1% forecast that now faces downsides. This, along with a weak inflation report released last week, should keep the BoC on the sidelines for longer than their recent statement suggests. Indeed, we continue to look for the BoC to remain on hold until Q2 of next year although there still remains a risk that they could hike prior to that. In the U.S., Q2 real GDP also came in much weaker than expected with weakness across the board, suggesting that the Japanese supply disruptions may not be the sole culprit for the weak report, supporting our current call that the Fed will remain on hold until at least Q3 of next year.

Europe

<u>Rate</u>	<u>Current Rate</u>	<u>Next Meeting</u>	<u>Scotia's Forecasts</u>	<u>Consensus Forecasts</u>
European Central Bank – Refinancing Rate	1.50	August 4, 2011	1.50	1.50
Bank of England – Bank Rate	0.50	August 4, 2011	0.50	0.50
Swiss National Bank – Libor Target Rate	0.25	September 15, 2011	0.25	--
Central Bank of Russia – Refinancing Rate	8.25	August 2, 2011	8.25	8.25
Hungarian National Bank – Base Rate	6.00	August 23, 2011	6.00	6.00
Central Bank of the Republic of Turkey – 1 Week Repo Rate	6.25	August 23, 2011	6.25	--

The European Central Bank and the Bank of England will likely keep their benchmark interest rates on hold next week. We expect the ECB to continue tightening monetary conditions in October, while the BoE will likely remain on hold until the second quarter of 2012.

Asia Pacific

<u>Rate</u>	<u>Current Rate</u>	<u>Next Meeting</u>	<u>Scotia's Forecasts</u>	<u>Consensus Forecasts</u>
Bank of Japan – Target Rate	0.10	August 5, 2011	0.10	--
Reserve Bank of Australia – Cash Target Rate	4.75	August 2, 2011	4.75	4.75
Reserve Bank of New Zealand – Cash Rate	2.50	September 14, 2011	2.50	--
People's Bank of China – Lending Rate	6.56	TBA	--	--
Reserve Bank of India – Repo Rate	8.00	TBA	7.75	--
Hong Kong Monetary Authority – Base Rate	0.50	TBA	0.50	--
Central Bank of China Taiwan – Discount Rate	1.88	September 30, 2011	--	--
Bank Negara Malaysia – Overnight Policy Rate	3.00	September 8, 2011	3.00	--
Bank of Korea – Bank Rate	3.25	August 10, 2011	3.25	--
Bank of Thailand – Repo Rate	3.25	August 24, 2011	3.25	--
Bank Indonesia – Reference Interest Rate	6.75	August 9, 2011	6.75	6.75
Central Bank of the Philippines – Overnight Policy Rate	4.50	September 8, 2011	4.50	--

We expect the Reserve Bank of Australia to retain the status quo following its monetary policy meeting on August 2nd. While inflationary pressures remain elevated, with the latest reading leading to an uptick in the yearly inflation rate, evidence of sound investment spending is being balanced by weakness on the household outlay front, with the strength of the Australian dollar helping contain imported price pressures. We also anticipate that the Bank of Japan will likely stay put at 0.1% next week.

Latin America

<u>Rate</u>	<u>Current Rate</u>	<u>Next Meeting</u>	<u>Scotia's Forecasts</u>	<u>Consensus Forecasts</u>
Banco Central do Brasil – Selic Rate	12.50	August 31, 2011	12.50	--
Banco Central de Chile – Overnight Rate	5.25	August 18, 2011	5.25	--
Banco de la República de Colombia – Lending Rate	4.25	July 29, 2011	4.50	4.50
Banco Central de Reserva del Perú – Reference Rate	4.25	August 11, 2011	4.25	--

Africa

<u>Rate</u>	<u>Current Rate</u>	<u>Next Meeting</u>	<u>Scotia's Forecasts</u>	<u>Consensus Forecasts</u>
South African Reserve Bank – Repo Rate	5.50	September 22, 2011	5.50	--

Forecasts at time of publication.
Source: Bloomberg, Scotia Economics.

	2000-09	2010	2011f	2012f	2000-09	2010	2011f	2012f
Output and Inflation (annual % change)	Real GDP				Consumer Prices²			
World ¹	3.6	5.1	4.2	4.5				
Canada	2.1	3.2	2.7	2.5	2.1	1.8	2.9	2.1
United States	1.8	2.9	2.5	2.7	2.6	1.6	2.8	2.0
Mexico	1.9	5.5	4.4	3.8	4.9	4.4	3.6	3.8
United Kingdom	1.7	1.4	1.2	1.5	1.9	3.7	4.7	2.0
Euro zone	0.9	1.6	1.8	1.7	2.1	2.2	2.8	2.1
Japan	0.6	4.0	0.3	3.5	-0.3	0.0	0.8	1.3
Australia	3.1	2.7	3.4	3.0	3.2	2.7	2.8	2.5
China	9.4	10.4	9.3	9.5	2.0	4.6	5.0	4.5
India	7.4	9.0	8.3	8.5	6.2	9.5	7.5	6.0
Korea	4.4	6.2	5.4	5.3	3.1	3.5	3.5	3.0
Brazil	2.9	7.5	4.0	4.5	6.6	5.9	6.5	5.5
Chile	3.6	5.2	6.0	5.5	3.7	3.0	4.5	3.5
Peru	5.1	8.8	6.0	5.8	2.5	2.1	4.0	3.7
Central Bank Rates (% end of period)	11Q1	11Q2f	11Q3f	11Q4f	12Q1f	12Q2f	12Q3f	12Q4f
Bank of Canada	1.00	1.00	1.00	1.00	1.00	1.50	2.00	2.25
Federal Reserve	0.25	0.25	0.25	0.25	0.25	0.25	0.75	1.25
European Central Bank	1.00	1.25	1.50	1.75	2.00	2.25	2.50	2.50
Bank of England	0.50	0.50	0.50	0.50	0.50	0.75	1.00	1.25
Swiss National Bank	0.25	0.25	0.25	0.50	0.50	0.75	0.75	1.00
Bank of Japan	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Reserve Bank of Australia	4.75	4.75	5.00	5.25	5.50	5.75	6.00	6.25
Exchange Rates (end of period)								
Canadian Dollar (USDCAD)	0.97	0.95	0.96	0.96	0.95	0.95	0.94	0.94
Canadian Dollar (CADUSD)	1.03	1.06	1.04	1.04	1.05	1.05	1.06	1.06
Euro (EURUSD)	1.42	1.47	1.45	1.50	1.48	1.46	1.43	1.40
Sterling (GBPUSD)	1.60	1.64	1.61	1.63	1.65	1.67	1.69	1.70
Yen (USDJPY)	83	79	79	80	82	83	84	85
Australian Dollar (AUDUSD)	1.03	1.07	1.08	1.09	1.09	1.10	1.10	1.11
Chinese Yuan (USDCNY)	6.5	6.5	6.4	6.3	6.2	6.1	6.0	5.9
Mexican Peso (USDMXN)	11.9	11.6	11.9	12.0	12.1	12.1	12.2	12.3
Brazilian Real (USDBRL)	1.63	1.57	1.59	1.60	1.62	1.65	1.67	1.70
Commodities (annual average)	2000-09	2010	2011f	2012f				
WTI Oil (US\$/bbl)	51	79	97	100				
Brent Oil (US\$/bbl)	50	80	110	114				
Nymex Natural Gas (US\$/mmbtu)	5.95	4.40	4.40	4.75				
Copper (US\$/lb)	1.78	3.42	4.25	4.15				
Zinc (US\$/lb)	0.73	0.98	1.03	1.05				
Nickel (US\$/lb)	7.11	9.89	11.25	8.90				
Gold, London PM Fix (US\$/oz)	522	1,225	1,530	1,600				
Pulp (US\$/tonne)	668	960	1,000	1,055				
Newsprint (US\$/tonne)	572	607	655	715				
Lumber (US\$/mfbm)	275	254	265	270				

¹ World GDP for 2000-09 are IMF estimates; 2010-12f are Scotia Economics' estimates based on a 2009 PPP-weighted sample of 34 countries.

² CPI for Canada and the United States are annual averages. For other countries, CPI are year-end rates.

Canada	2010	10Q4	11Q1	Latest	United States	2010	10Q4	11Q1	Latest
Real GDP (annual rates)	3.2	3.1	3.9		Real GDP (annual rates)	3.0	2.3	0.4	1.3 (Q2-A)
Current Acc. Bal. (C\$B, ar)	-50.9	-41.1	-35.7		Current Acc. Bal. (US\$B, ar)	-471	-449	-477	
Merch. Trade Bal. (C\$B, ar)	-9.0	1.5	6.4	-9.8 (May)	Merch. Trade Bal. (US\$B, ar)	-646	-637	-730	-779 (May)
Industrial Production	4.6	6.0	5.3	8.0 (May)	Industrial Production	5.3	6.2	5.3	3.4 (Jun)
Housing Starts (000s)	192	179	178	201 (Jun)	Housing Starts (millions)	0.58	0.54	0.58	0.63 (Jun)
Employment	1.4	1.7	1.9	1.3 (Jun)	Employment	-0.8	0.5	0.9	0.9 (Jun)
Unemployment Rate (%)	8.0	7.7	7.8	7.4 (Jun)	Unemployment Rate (%)	9.6	9.6	8.9	9.2 (Jun)
Retail Sales	5.5	5.3	2.5	8.2 (May)	Retail Sales	6.8	8.1	8.6	8.5 (Jun)
Auto Sales (000s)	1561	1554	1572	1656 (Apr)	Auto Sales (millions)	11.5	12.3	13.0	11.4 (Jun)
CPI	1.8	2.3	2.6	3.1 (Jun)	CPI	1.6	1.3	2.1	3.6 (Jun)
IPPI	1.0	2.6	4.0	-5.2 (Jun)	PPI	4.2	3.8	4.9	7.0 (Jun)
Pre-tax Corp. Profits	21.2	19.1	13.4		Pre-tax Corp. Profits	25.0	1.1	2.8	
Mexico					Brazil				
Real GDP	5.4	4.4	4.6		Real GDP	6.7	4.2	3.8	
Current Acc. Bal. (US\$B, ar)	-5.6	-14.0	-5.5		Current Acc. Bal. (US\$B, ar)	-47.4	-48.0	-58.3	
Merch. Trade Bal. (US\$B, ar)	-3.0	-4.2	7.6	1.3 (Jun)	Merch. Trade Bal. (US\$B, ar)	20.3	30.1	12.7	53.2 (Jun)
Industrial Production	6.0	4.8	5.3	12.9 (May)	Industrial Production	10.5	3.8	2.4	14.7 (May)
CPI	4.2	4.2	3.5	3.3 (Jun)	CPI	5.1	6.1	6.8	6.4 (Jun)
Chile					Italy				
Real GDP	5.2	5.8	9.8		Real GDP	1.2	1.5	1.0	
Current Acc. Bal. (US\$B, ar)	3.1	4.9	2.9		Current Acc. Bal. (US\$B, ar)	-0.07	-0.07	-0.12	-0.09 (May)
Merch. Trade Bal. (US\$B, ar)	11.6	17.7	17.4	7.1 (Jun)	Merch. Trade Bal. (US\$B, ar)	-39.1	-46.3	-77.2	-41.4 (May)
Industrial Production	0.5	2.7	11.7	4.0 (Jun)	Industrial Production	6.5	5.3	2.3	11.0 (May)
CPI	1.4	2.5	2.9	3.4 (Jun)	CPI	1.6	1.8	2.3	2.7 (Jun)
Germany					France				
Real GDP	3.5	3.8	4.8		Real GDP	1.4	1.4	2.2	
Current Acc. Bal. (US\$B, ar)	188.0	251.7	194.8	118.7 (May)	Current Acc. Bal. (US\$B, ar)	-44.5	-86.6	-59.7	-167.9 (May)
Merch. Trade Bal. (US\$B, ar)	201.5	219.8	209.3	220.8 (May)	Merch. Trade Bal. (US\$B, ar)	-39.0	-39.4	-55.0	-62.1 (May)
Industrial Production	10.1	11.8	13.0	19.4 (May)	Industrial Production	5.1	4.6	4.9	10.5 (May)
Unemployment Rate (%)	7.7	7.4	7.3	7.0 (Jul)	Unemployment Rate (%)	9.8	9.7	9.7	9.5 (May)
CPI	1.1	1.5	2.1	2.4 (Jul)	CPI	1.5	1.6	1.8	2.1 (Jun)
Euro Zone					United Kingdom				
Real GDP	1.7	1.9	2.4		Real GDP	1.4	1.5	1.6	
Current Acc. Bal. (US\$B, ar)	-77	-41	-169	-315 (May)	Current Acc. Bal. (US\$B, ar)	-71.6	-72.2	-74.0	
Merch. Trade Bal. (US\$B, ar)	32.0	53.2	-68.5	26.4 (May)	Merch. Trade Bal. (US\$B, ar)	-153.0	-171.9	-142.4	-166.0 (May)
Industrial Production	7.4	8.1	6.6	13.5 (May)	Industrial Production	2.1	3.3	2.0	1.0 (May)
Unemployment Rate (%)	10.1	10.0	9.9	9.8 (May)	Unemployment Rate (%)	7.9	7.9	7.7	7.7 (Apr)
CPI	1.6	2.0	2.5	2.7 (Jun)	CPI	3.3	3.4	4.1	4.2 (Jun)
Japan					Australia				
Real GDP	4.0	2.4	-0.7		Real GDP	2.7	2.7	1.0	
Current Acc. Bal. (US\$B, ar)	195.9	176.8	193.9	87.3 (May)	Current Acc. Bal. (US\$B, ar)	-31.8	-37.4	-37.9	
Merch. Trade Bal. (US\$B, ar)	74.7	60.5	31.8	-28.5 (Jun)	Merch. Trade Bal. (US\$B, ar)	19.3	26.1	21.7	49.0 (May)
Industrial Production	16.6	6.8	-2.5	-1.7 (Jun)	Industrial Production	4.3	0.0	-5.4	
Unemployment Rate (%)	5.1	5.0	4.7	4.6 (Jun)	Unemployment Rate (%)	5.2	5.2	5.0	4.9 (Jun)
CPI	-0.7	0.1	0.0	0.2 (Jun)	CPI	2.8	2.7	3.3	
China					South Korea				
Real GDP	10.3	9.8	9.7		Real GDP	6.2	4.7	4.2	
Current Acc. Bal. (US\$B, ar)	305.4				Current Acc. Bal. (US\$B, ar)	28.2	36.6	10.4	35.9 (Jun)
Merch. Trade Bal. (US\$B, ar)	181.5	246.8	-6.8	267.3 (Jun)	Merch. Trade Bal. (US\$B, ar)	41.2	52.1	29.5	33.9 (Jun)
Industrial Production	13.5	13.5	14.8	15.1 (Jun)	Industrial Production	16.6	9.9	11.2	6.1 (Jun)
CPI	4.6	4.6	5.4	6.4 (Jun)	CPI	3.0	3.6	4.5	4.4 (Jun)

All data expressed as year-over-year % change unless otherwise noted.

Source: Bloomberg, Scotia Economics.

Canada	11Q1	11Q2	Jul/22	Jul/29*	United States	11Q1	11Q2	Jul/22	Jul/29*
BoC Overnight Rate	1.00	1.00	1.00	1.00	Fed Funds Target Rate	0.25	0.25	0.25	0.25
3-mo. T-bill	0.95	0.90	0.94	0.86	3-mo. T-bill	0.09	0.01	0.03	0.08
10-yr Gov't Bond	3.35	3.11	2.93	2.80	10-yr Gov't Bond	3.47	3.16	2.96	2.85
30-yr Gov't Bond	3.76	3.55	3.39	3.31	30-yr Gov't Bond	4.51	4.37	4.26	4.18
Prime	3.00	3.00	3.00	3.00	Prime	3.25	3.25	3.25	3.25
FX Reserves (US\$B)	60.4		63.8	(May)	FX Reserves (US\$B)	128.3		135.9	(May)
Germany					France				
3-mo. Interbank	1.26	1.51	1.58	1.55	3-mo. T-bill	0.80	1.18	1.05	0.95
10-yr Gov't Bond	3.35	3.03	2.83	2.55	10-yr Gov't Bond	3.71	3.41	3.41	3.24
FX Reserves (US\$B)	64.8		66.2	(May)	FX Reserves (US\$B)	61.0		61.7	(May)
Euro-Zone					United Kingdom				
Refinancing Rate	1.00	1.25	1.50	1.50	Repo Rate	0.50	0.50	0.50	0.50
Overnight Rate	0.90	1.72	1.08	0.90	3-mo. T-bill	4.85	4.85	4.85	4.85
FX Reserves (US\$B)	319.9		319.5	(May)	10-yr Gov't Bond	3.69	3.38	3.11	2.87
					FX Reserves (US\$B)	75.3		77.8	(May)
Japan					Australia				
Discount Rate	0.30	0.30	0.30	0.30	Cash Rate	4.75	4.75	4.75	4.75
3-mo. Libor	0.14	0.13	0.13	0.13	10-yr Gov't Bond	5.49	5.21	4.97	4.80
10-yr Gov't Bond	1.26	1.14	1.10	1.08	FX Reserves (US\$B)	33.3		39.3	(May)
FX Reserves (US\$B)	1080.6		1101.7	(May)					
Exchange Rates (end of period)									
USDCAD	0.97	0.96	0.95	0.95	¥/US\$	83.13	80.56	78.54	77.14
CADUSD	1.03	1.04	1.05	1.05	US\$/Australian\$	103.29	107.22	108.51	110.04
GBPUSD	1.603	1.605	1.630	1.646	Chinese Yuan/US\$	6.55	6.46	6.45	6.44
EURUSD	1.416	1.450	1.436	1.440	South Korean Won/US\$	1097	1068	1052	1054
JPYEUR	0.85	0.86	0.89	0.90	Mexican Peso/US\$	11.905	11.714	11.637	11.716
USDCHF	0.92	0.84	0.82	0.79	Brazilian Real/US\$	1.632	1.563	1.552	1.554
Equity Markets (index, end of period)									
United States (DJIA)	12320	12414	12681	12225	U.K. (FT100)	5909	5946	5935	5835
United States (S&P500)	1326	1321	1345	1302	Germany (Dax)	7041	7376	7326	7168
Canada (S&P/TSX)	14116	13301	13495	12951	France (CAC40)	3989	3982	3843	3641
Mexico (Bolsa)	37441	36558	35755	35905	Japan (Nikkei)	9755	9816	10132	9833
Brazil (Bovespa)	68587	62404	60270	58786	Hong Kong (Hang Seng)	23528	22398	22445	22440
Italy (BCI)	1120	1039	997	968	South Korea (Composite)	2107	2101	2171	2133
Commodity Prices (end of period)									
Pulp (US\$/tonne)	990	1035	1035	1035	Copper (US\$/lb)	4.26	4.22	4.40	4.41
Newsprint (US\$/tonne)	640	640	640	640	Zinc (US\$/lb)	1.05	1.05	1.11	1.12
Lumber (US\$/mfbm)	290	237	258	256	Gold (US\$/oz)	1439.00	1505.50	1602.00	1628.50
WTI Oil (US\$/bbl)	106.72	95.42	99.87	96.14	Silver (US\$/oz)	37.87	35.02	39.67	39.63
Natural Gas (US\$/mmbtu)	4.39	4.37	4.40	4.19	CRB (index)	359.43	338.05	347.93	342.64

* Latest observation taken at time of writing.

Source: Bloomberg, Scotia Economics.

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Scotia Economics

Scotia Plaza 40 King Street West, 63rd Floor
Toronto, Ontario Canada M5H 1H1
Tel: (416) 866-6253 Fax: (416) 866-2829
Email: scotia_economics@scotiacapital.com

For general and publication-related inquiries, contact us by telephone, email and/or fax.