

# Global Views

Weekly commentary on economic and financial market developments

September 9, 2011

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### **European Headline Risk & Key US Data Are The Swing Factors Next Week**

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

**European** politics and debt crisis headlines are likely to play a dominant role in shaping global market tone again next week. One such headline risk will be ongoing concerns regarding a potential Greek default owing to uncertain expressions of interest in a planned bond swap next month; those expressions are unlikely to be published, but a high take-up rate is required and markets are concerned it might not be high enough to avert default and possible domino consequences elsewhere. Hence absurdly high and rising Greek government debt yields with two year yields at 57% at the time of writing. Another key event will be an EU annual report on the state of public finances across the region on Monday morning (ET). This would follow comments made in July by the EU executive that Greece was falling short on reinforcing its fiscal austerity measures. That was among the first glimpses of concern that talk was cheaper than action in Greece, and something that Germany latched on to in stating that implementation progress had to be more material or else Greece couldn't count upon receiving near-term aid. Thus, the report could further fan such sentiments. The very next day, German Finance Minister Wolfgang Schäuble speaks on "ways out of the crisis." His voice has been among the more activist within the German government insofar as demanding accelerated fiscal reforms across Europe, so the headline risk could therefore compound upon itself early next week. If that's not enough, then the EC issues new interim growth forecasts on Thursday, and this will be followed by a press conference by EU Monetary Affairs Olli Rehn. There are no prizes to be awarded for guessing the direction of forecast revisions here, but the feedback loop upon making it more difficult to achieve fiscal reforms could concern markets. The week is capped off by speeches by ECB President Jean-Claude Trichet and ECB EU Financial Services Commissioner Michel Barnier both at a financial forum attended by EU Finance Ministers and central bankers. All of this segues into the Berlin state and local elections on Sunday September 18th. It is the last German state election in a string of seven this year, and Chancellor Merkel's CDU party is expected to lose yet again. It is expected that this election could seal the fate of her foreign minister who leads the FDP coalition partner. This is a key election because it could call into serious question Merkel's ability to govern a fractious CDU party into her own re-election bid in 2013 — and at an inopportune moment in the European crisis. Interwoven throughout the politics will be the return of auction risk in Italy, Spain and Belgium. European data risk will be focused upon the UK with updates for trade, CPI, jobs, and retail sales that will intensify implications for potentially further quantitative easing by the Bank of England. Finally, the Swiss National Bank is expected to keep its 3 month Libor target at 0% after having just announced a CHF pegged currency target of 1.20 against the euro and backed by the promise to engage in unlimited buying of euros in non-sterilized fashion.

So far, markets have been reliant upon a limited mixture of fresh and generally bearish **US** data that has pushed into the August-September period that coincides with the renewed global confidence shock. We'll get more next week in the form of August updates including retail sales and industrial production, while September data lands for the important Philly Fed and Empire gauges of regional manufacturing sentiments. Downsides to inflation risk will also land in Thursday's CPI report. Fed speak will remain prominent, but tilted more toward the hawks as Dallas Fed President Richard Fisher (voting 2011, non-voting non-alternate 2012) speaks on monetary policy and St. Louis Fed President James Bullard (alternate 2011, voting 2012) delivers short opening remarks at a conference. The US also auctions 3s, 10s and 30s into a market thoroughly enamoured of prospects of balance sheet maturity extension at the Fed.

**Canadian** markets will generally follow the global tone, with the possible exception of an expected rebound in manufacturing sales during the month of July. This could reflect the dissipation of temporary shocks like Alberta fires that disrupted oil production and the Japanese supply shocks on the auto sector, but the key will be whether this leaves a high base effect off of which further growth will be difficult to attain thereafter into the climate of sharply depressed late summer global confidence. A Canada 2 year auction occurs after a less dovish rate statement than the markets may have expected. This has largely been priced in already, so the global tone may determine the success of the auction.

**Asia-Pacific** markets will play a back seat observer role to most of the week's global developments. Regional markets within the zone will be impacted by a rate announcement by the RBI on Friday, as well as by Chinese new yuan loan growth and trade figures. The RBNZ is expected to remain on hold, where it has been since Spring due to the Christchurch earthquakes and shocks to foreign markets.

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### The President's Proposed American Jobs Act — Re-igniting Debate

- **The potential result — a mix of Administration and Congressional measures — will steepen the bipartisan Congressional Committee's challenge this Fall of developing an enlarged deficit-reduction package.**

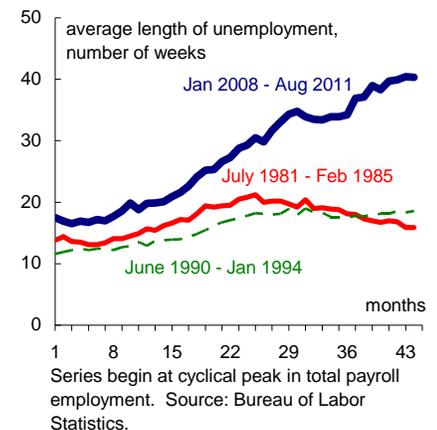
The President last night revealed further details of his sweeping *American Jobs Act*, with recent indications of softening U.S. economic growth supporting his strategy of introducing further near-term stimulus within a longer-term deficit reduction plan. While several measures have the advantage of some bipartisan support, inevitably contentious is the *Act's* steep price tag — US\$447 billion<sup>1</sup>, 2.9% of U.S. GDP in 2012 (see *Fiscal Pulse report for details of the proposed measures*). Moreover, the Administration has still to unveil its housing market and mortgage initiatives this Fall. The White House acknowledges that all of its proposed measures may not be incorporated, and the eventual compromise will likely reflect Republican input. In response to the Republicans' strong advocacy of scaling back the corporate regulatory burden, the President already has requested that the Environmental Protection Agency withdraw the contentious tightening of the standard governing future ground-level ozone emissions given industries' cost objections.

Concerns over the fragile U.S. recovery, such as the elevated share of long-term unemployed (see chart), are warranted, underlining the difficulties in sustaining the U.S. economy's momentum with global growth moderating and fiscal repair proceeding. Yet it is not clear that all of the Administration's suggested stimulus will pay off in terms of bolstering near-term growth and laying a stronger economic foundation to support the retiring baby boom generation and the necessary longer-term fiscal repair. The deeper payroll tax cut extended through 2012 for employees represents almost 40% of the package's total cost, but recent experience indicates that temporary tax relief may be largely saved by consumers, a positive development for households' balance sheet repair but disappointing as an immediate boost to consumption. For businesses, given current economic uncertainty, a one-time tax credit may be insufficient to spur sizeable, permanent workforce expansions. With the objective of more jobs, the focus on small business may be less effective in raising U.S. exports. The financing injection for State and local governments to limit and perhaps reverse layoffs of teachers and emergency personnel, such as police and firefighters, likely will not fully offset over the next year or so Washington's decreased funding for the State Fiscal Stabilization Fund and other federal programs that impact State finances. Conversely, a number of the President's targeted proposals, notably the Unemployment Insurance program enhancements such as expanded work-sharing, should be positive for the economy in the short-term. As well, extending current machinery & equipment investment incentives will bolster productivity, as will high-priority infrastructure projects. Implementation delays in the infrastructure proposals will possibly be shortened, not eliminated, this time around, but the eventual boost to flagging growth over the next few years will be important.

It is true that the current outlook for extended low interest rates will at least partially mitigate the consequences of the additional near-term borrowing required by a substantive new stimulus package. Nevertheless, the Administration has upped the ante for the bipartisan Congressional Committee this Fall, raising the target for the late November deficit-reduction package from \$1.5 trillion to at least \$1.8 trillion. A week Monday, the Administration will present its longer-term deficit-reduction plan, broader than the recently passed *Budget Control Act*, that will include selected tax increases and entitlement reforms, escalating the deficit reduction debate and private-sector uncertainty on future policy directions. An alternative to the President's proposals is a downsized stimulus package, accompanied by actions focused on rebuilding business and household confidence, such as a substantive start on comprehensive tax reform. Such an option would be less risky — the optics of a possible failure of Congress to pass an enlarged deficit reduction package of at least \$1½ trillion by mid-January 2012 could well add to markets' and rating agencies' concerns.

<sup>1</sup> Dollar amounts in U.S. dollars.

U.S. Long-Term Unemployment



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### **Canadian Business Investment Will Probably Fall In Q3 — Adding To Growth Risks**

- **Further reason why 2011H2 optimism may be misplaced at the BoC and within consensus.**

Business investment in machinery and equipment has thus far been a point of strength in the Canadian economy, and something the BoC and the consensus of economists are relying upon to continue to propel the economy forward in Q3 and perhaps beyond. After all, equipment spending accounts for 10% of the economy, and it single-handedly contributed 1.5 percentage points to Q2 GDP growth such that the absence of this effect would have led to a much harsher Q2 GDP print than the small 0.4% q/q contraction.

Using the latest trade figures, however, it's looking like investment in machinery and equipment might instead turn out to be a drag on Q3 GDP growth which would be a total story shift. It would also add to the list of volatile but on net downside risks to Q3 GDP on the heels of the small Q2 contraction in the economy.

#### **What The Trade Figures Showed Us About Business Investment**

Canada imports around two-thirds of its capital goods principally from the United States, thus explaining a good correlation between imports of capital goods and total investment in capital goods. Import figures in the trade account matter immensely when nailing the direction of investment spending in machinery and equipment (m&e). That's why the fact that July's import figures showed a large 5.0% m/m drop in the volume of m&e imports matters so much to the investment picture. It was the largest monthly drop since January 2009, and it would usually portend a steep drop in total business investment in m&e.

#### **An Optimistic Slant...**

The optimistic slant is that we have to fairly acknowledge that July's drop followed a large gain of identical magnitude (+5.2% m/m) in m&e imports the prior month. This angle would argue that one shouldn't read too much into one month's volatility in that perhaps a positive trend may well be restored over the rest of the quarter. Further, corporate balance sheets are in excellent shape which could support investment. Lastly, an upside risk could come through the oil patch which is expected to remain a bright spot for investment spending. This has been a record year for land sales in Alberta's oil sector and that typically drives strength in complementary equipment spending. Thus, it may be that this effect supports total investment spending going forward, but masks underlying weakness. An argument against this angle, however, is that the drop in July's equipment imports was broadly based across equipment categories: industrial and agricultural machinery fell at a 17% m/m pace; other machinery and equipment fell 2.3%; and imports of office machines and equipment were up 0.4% m/m annualized; only imports of aircraft and other transportation equipment grew (+6.6%) but that category of lumpy spending is notoriously among the most volatile.

#### **...Is Probably Unrealistic**

But here's where the math potentially turns against that argument. Because of the magnitude of the monthly decline in m&e imports during July over June, and because of the high base effect in Q2 which posted a large investment spending gain over the quarter as a whole, it would take large monthly gains in each of the next two months in order to just have flat m&e imports on the quarter. Indeed, it would take just over a 2% m/m rise in m&e import volumes in each of August and September over the prior month in order to have the full quarter's imports of machinery and equipment net out to being flat and thus neither a drag nor addition to GDP growth.

How likely is that kind of back-to-back monthly gain over the rest of this quarter? It happened in March-April of this year, and prior to that for a string of readings in the Spring of 2010. But note two things. First, those experiences occurred very rarely throughout the longer-run history. Second, I may be proven totally wrong, but such sustained gains in the current environment would run counter to what I think is likely to be a bias across businesses to be more cautious in their capital spending plans going forward. Faced with a large inventory overhang after two quarters of large undesired inventory additions that made heavy upside contributions to Q1 and Q2 GDP growth, why add to productive capacity through further equipment spending

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instead of curtailing existing capacity utilization rates in order to sell down this inventory overhang out of future sales, particularly in the context of elevated uncertainty over the business climate going forward?

We therefore offer one other scenario. If imports of capital goods are instead flat in August and September after the large July drop (rather than the strong Aug-Sept gains in the first scenario), then q/q investment spending could contract by over 2% at a non-annualized rate and that would single-handedly knock a full percentage point off GDP growth compared to the first scenario. One can play with infinite scenarios, but the more likely it becomes that investment momentum is being lost and perhaps turning toward sustained contraction, clearly the bigger the drag effect on GDP growth.

### **Many Q3 GDP Growth Drivers Are At Risk**

If Canada loses investment strength in Q3, then a sizeable pillar of support to the economy would be lost, and that leaves me very concerned about what's left to drive Q3 GDP growth. Let's walk through the GDP components.

1. **Trade** will probably contribute positively to Q3 GDP growth, but by how much is uncertain and its effects could be overwhelmed by other downsides in the GDP add-up. Following the release of July trade figures, we argued that the monthly improvement in the trade account was likely a one-off gain owing to the lifting of temporary shocks that hit sectors like autos and energy production. We doubt that such a magnitude of improvement in the trade deficit will be repeated over the rest of the quarter. As one scenario, however, if the trade deficit is flat-lined in August and September such that it retains the July gain but does not build further upon it, then the trade account would improve by a whopping 9.4% q/q in non-annualized terms using the price-adjusted figures that translate most readily into GDP. Put another way, assuming that total real exports rise by 10% q/q annualized and real imports are flat for Q3 as a whole would be in line with what the July figures and risks over the rest of the quarter may suggest, and that would have trade add over three percentage points to annualized GDP growth in Q3.
2. But the **inventories** side of the picture is likely to turn toward being a drag effect on GDP growth going forward as per our column "It Wouldn't Take Much To Get A Negative Q3 For Canadian GDP" on p.6 of last week's Global Views. History suggests that two back-to-back large quarterly gains in inventories such as those in the first half of this year, are followed by inventory depletion in the next quarter. We'll assume a small inventory contraction of \$5 billion in price-adjusted terms, which would mean that inventories would knock out of GDP growth two times the upside lift from the trade account and thus far more than negating its beneficial role.
3. This current column casts doubt upon strength in **machinery and equipment spending** in Q3. Assuming a 2.5% non-annualized drop in investment in machinery and equipment would detract about one percentage point from GDP growth. Some of this is double counting the import effect which we've roughly controlled against.
4. Besides inventories and equipment spending, that only leaves behind **non-residential** structures in the full private business investment add-up and that category made only a small 0.1% contribution to GDP growth in Q2 but with permits holding up well. We assume a largely flat contribution from this type of spending in Q3.
5. Additionally, Canada has turned from providing **fiscal stimulus** toward being among the first to apply fiscal drag to the economy such that government spending has dropped out of being a GDP growth driver. We'll assume a flat contribution to Q3 GDP growth.
6. The Scotia Economics forecast is assuming a fairly flat contribution to Q3 GDP growth from **housing investment**, given the difficulty in posting further gains off of already elevated housing starts.

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7. In the full GDP add-up, that potentially only leaves the **consumer** behind as something that could keep GDP in the black in Q3. Scotia Economics is forecasting q/q annualized consumption growth of about 2.4% in Q3. While solid, that pace would not be enough to avert a contraction in GDP in Q3 given what we have walked through thus far and that yields a GDP contraction of 2.5% in Q3. This is not Scotia Economics' base case forecast which was 1.4% released earlier this month and which was already at the lower bound of consensus. I am talking risks to this forecast given the scenarios outlined above whereby it does not take much reasonable imagination at all in order to get another negative GDP print. Consumers could surprise and rescue the day by sheer function of the nearly two-thirds weight on consumer spending in GDP, but the story change communicated throughout our work is that the other growth pillars are potentially being toppled one at a time going forward in such a manner as to negate the upsides from trade and consumption. Of course, the other option is that we're just plain wrong on my assumed sensitivities to the other GDP components given that we're at a very early stage of receiving incoming data on the third quarter. But insofar as the consumer is concerned, it's all about confidence as per our column "Confidence Matters — And It's Not Looking Good For The U.S. Economy," on pp.9-11 in last week's Global Views.

In all, the reader can discern the risks without the need for labels to be affixed to the outcome. It's important to recognize the sequence of events here in that lost momentum in the economy followed by diminished US and European political and policy confidence presaged a sharp decline in market confidence that was then met by a sharp plunge in consumer confidence. At this point, the consensus of economists has a much better job to do in properly interpreting the risks to Q3, as well as thereafter by way of the impact of a possible ensuing confidence shock against Q4 growth.

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### Canada's Resilient Housing Market

- **Early sales reports for August suggest that the general rise in consumer unease emerging from recent surveys has yet to curb Canadians' enthusiasm for real estate.**

MLS national home sales data for August will be released next week. Based on early regional figures, we anticipate an upbeat report. Aggregating the monthly sales figures from 14 regional real estate boards representing about 55% of national activity finds that sales increased 18% y/y in August. This suggests an acceleration from July, when sales transactions across major markets were up 14% y/y.

Base level effects should account for some of the pickup in the y/y sales figures. Last summer was a low point in sales, before activity started to pick up through the fall and winter. Nonetheless, taking into account that sales typically moderate heading into the fall, we are anticipating a healthy m/m increase in seasonally adjusted sales in August.

**Still hot: Toronto.** Home sales soared 24% above a year-earlier in August. While coming off a relatively low base, sales are running well above historical averages for the month. Meanwhile, listings have not kept pace with demand, keeping the overall market firmly in sellers' territory. Average prices last month were up 10% y/y.

In most other parts of central Canada, sales are probably best described as healthy but fairly typical. Sales volumes in Montreal, Ottawa, Kitchener, Hamilton and London, for example, were all up y/y in August, but were also essentially in line with their historical averages for the month. For the most part, market conditions are relatively balanced, with y/y price gains in the low- to mid-single digits.

There are also several hot pockets of activity in Manitoba and Saskatchewan. In Winnipeg, last month's home sales were close to a record for the month of August. In Regina, sales were the second highest ever for the month. Both markets continue to favour sellers.

**Warming up: Calgary.** Sales volumes jumped 23% y/y in August, though they remain well below the peak levels of 2004-2007. Demand for both higher-end 'move-up' properties as well as more affordable 'first-time buyer' condominiums are benefiting from improved affordability. The pickup in sales combined with a more modest rise in listings is shifting conditions from a buyer's market to one of relative balance. This in turn has pulled prices back above year-ago levels (+3% y/y in August).

**Cooling down: Vancouver.** Home sales transactions in August were up 8% y/y, but below their 10-year average for the month for the third month in a row. A lack of affordability is dampening demand. Meanwhile, high prices have prompted a strong response from sellers — new listings are running above their 10-year average — and restoring balance to the market. Average prices were up 8% y/y in August, the slowest pace in two years.

Historically low interest rates remain a powerful draw in the interest-sensitive housing sector, and should maintain a decent level of sales in the months ahead. Yet, increasing concern over the economic outlook will likely keep some potential first-time and move-up buyers on the sidelines for the time being. Recent signs of a loss of momentum in Canada's jobs market could also dampen demand. On a regional basis, favourable economic and demographic conditions (i.e. a resurgent energy sector and rising provincial in-migration) suggest Calgary could outperform. Affordability considerations are likely to weigh more heavily on Vancouver and Toronto.

MLS Housing Activity - August 2011				
	Sales		Average Price	
	units	y/y %	\$	y/y %
Montreal	2502	4.4	309050	4.0
Quebec City	514	-0.4	235839	-0.6
Ottawa	1329	20.9	337372	6.2
Toronto	7542	24.0	451663	10.3
Hamilton*	NA	12.5	NA	4.0
London	763	21.7	NA	NA
Kitchener	507	7.2	293149	4.3
Winnipeg	1290	27.0	229457	6.0
Saskatoon	415	33.4	315774	3.0
Regina	388	11.2	280972	10.8
Edmonton	1507	18.2	324217	-0.4
Calgary	1995	23.1	408637	3.1
Vancouver	2378	8.0	625578	8.5
Victoria	542	27.5	526738	11.8
<b>TOTAL</b>	<b>21672</b>	<b>17.8</b>	<b>NA</b>	<b>NA</b>
Source: Local real estate associations, Scotia Economics				
* Excludes condominiums				

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**Is The U.S. Employment Report Giving Mixed Signals?**

- **Definitional and procedural differences explain nonfarm-household survey divergences.**

Each month the Bureau of Labor Statistics (BLS) releases its much-anticipated employment report, which consists of two studies: 1) the Current Employment Statistics Survey, referred to as the Establishment or Payroll Survey, and 2) the Current Population Survey, also known as the Household Survey. While both studies exhibit similar long-term trends, they can produce differing monthly results. The August report serves as an example — the payroll survey posted a flat print, while its household counterpart showed a gain of 331,000 jobs.

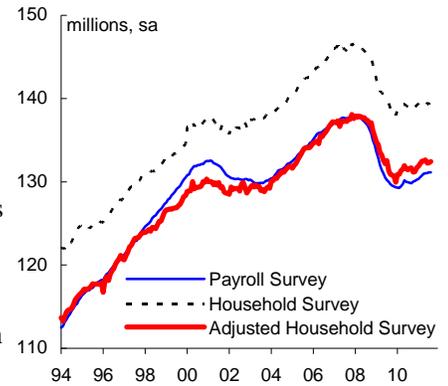
Total employment, as captured by the household survey, exceeds its business survey counterpart by roughly 6% (see chart 1). The discrepancies arise due to definitional and procedural differences. Unlike its payroll counterpart, the household survey captures self-employed, agricultural, private-household and unpaid workers as well as some ‘off-the-books’ employment. Population controls — weights assigned to adjust sample results to total population — are another contributing factor. For the household survey, they are computed using the intercensal estimates, while benchmark adjustments for the payroll survey are derived from unemployment insurance tax records.

Differences in survey and estimation procedures have spurred debate over which estimates are more reliable. Some prefer the payroll survey due to its larger sample size (390,000 establishments vs. 60,000 households) and a smaller margin of error ( $\pm 107,000$  vs.  $\pm 426,000$ ). However, the household survey is better equipped to catch turning points — leading the payroll survey by on average a quarter — largely due to its ability to capture changes in the number of self-employed, whose number tends to vary closely with economic conditions. Firms of up to four employees account for just under two-thirds of all business establishments, contributing considerably to job creation.

Those in favour of the household survey also argue that the margin of error in the payroll survey is underestimated by the prevailing presence of larger firms, which account for only 0.3% (18,500) of all business establishments, providing limited variability. They also point to the survey’s inability to account for the creation and dissolution of small businesses in a timely manner. The BLS began addressing this issue in 2003 with the introduction of the birth/death model (BDM), which estimates a monthly adjustment factor. However, the time-series nature and the backward-looking methodology of the model — “which assumes a predictable continuation of historical [five-year] patterns” — fail, as the BLS acknowledges, to capture cyclical turning points. For example, despite a loss of over 8 million jobs during the latest downturn, the BDM continued to provide positive support (see chart 2). What’s more, it has been contributing 30-50% of the monthly employment gains since the beginning of the year, and 89% of all the construction jobs added since December. Sizeable annual benchmark revisions reaffirm this view (see chart 3). In 2008, revisions amounted to a cumulative loss of over a million more jobs than originally reported (see chart 3). Earlier this year, the BLS announced that it would update its BDM estimates more frequently — quarterly rather than annually — to help minimize errors associated with using trailing data.

Chart #1

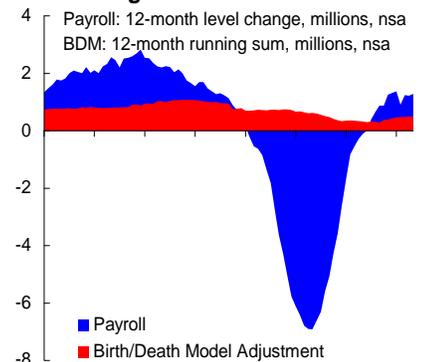
**Employment According to Household & Payroll Surveys**



Source: BLS, Scotia Economics.

Chart #2

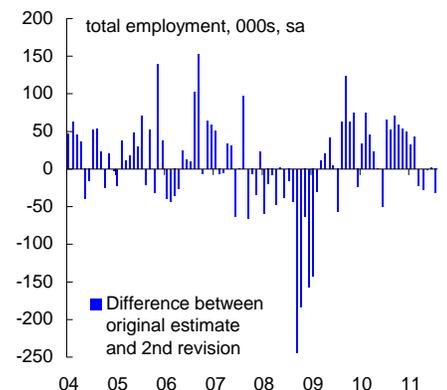
**The Birth/Death Adjustment Adding 30-50% of Jobs in 2011**



Source: BLS, Scotia Economics.

Chart #3

**Downward Revisions Exceeded One Million Jobs in 2008**



Source: BLS, Scotia Economics.

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### ***The Outlook For Monetary Policy In Emerging Markets, Don't Expect Big Swings***

- **Central banks in emerging countries will switch to wait and see mode.**
- **Search for yield implies exchange rates will do a lot of the monetary heavy lifting.**

Easing pressures in global commodity markets will lead to a cresting of inflationary trends in developing countries. This development is finally providing local monetary authorities with some elbow room in the anti-inflationary fight, but is unlikely to lead to a swift fall in benchmark interest rates. The reason behind this assertion lies in the fact that domestic demand in developing countries remains firm and locally generated cost increases have yet to ease.

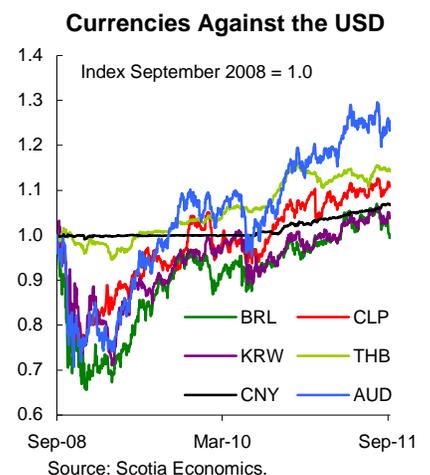
Local demand conditions in Asia and Latin America remain robust. Unemployment rates at record lows in some cases and industries operating close to full-capacity imply that domestically sourced inflationary pressures are still a concern. This is the case not only of India, China, South Korea, Australia or Thailand on the Asian bloc, but also in Chile and Brazil where core inflation (a measure that excludes volatile food and fuel costs) has yet to show a respite. This factor will take time to dissipate even in the worst case scenario where economic activity is significantly affected by slowing demand conditions in high-income countries.

Globally determined food and fuel costs will help reduce inflationary pressures in developing nations during the coming quarters, however, uncertainty about the outlook for the cost of agricultural commodities remains a threat. Indeed, a 15% downward adjustment in the benchmark WTI oil price is already proving relevant for locally determined fuel costs in oil importing countries. In several Asian countries, for instance, rising fuel costs have become a leading factor in transport levies, while government efforts to improve the profile for public finances have resulted in a withdrawal of public subsidies. Looking ahead, as economic activity in rich countries remains hostage to adverse confidence shocks and fiscal amendment concerns an upward rebound in the WTI is unlikely.

Bubbly food cost gains have already been deflating in recent months on the back of stabilization in the yearly advance of global corn, wheat and rice benchmarks. This is bound to combine favourably with base effects (consumer price gains in emerging markets re-accelerated in the second half of last year) to bring down yearly inflation rates. However, recent downward revisions to crop yields in the US (largest corn exporter) point to relative scarcity in the months ahead, conditioning the expectation of further stability in grain prices. This could entail a resurgence in the cost of food (weighted heavily in developing country CPIs).

It is hard to envisage central banks in emerging markets switching nimbly towards loose monetary conditions when output is expanding close or above potential and local labour markets remain tight. As upcoming wage negotiations are likely to become hostage to recent inflationary trends, local central banks will face the difficult task of managing expectations within the context of elevated uncertainty about future demand conditions.

A transition towards a stage where currency appreciation is the norm seems inescapable, as conditions vis-à-vis high income countries imply favourable interest and growth spreads. Unexpected moves, like the one by the Banco Central do Brasil last week, might allow for short-term deviations from trend (note that the Brazilian real had been moving almost in unison with the Korean won over the past 12 to 18 months, to deviate significantly only this past week, see chart) but economic fundamentals are likely to continue to drive the revaluation of emerging market currencies against the US dollar.



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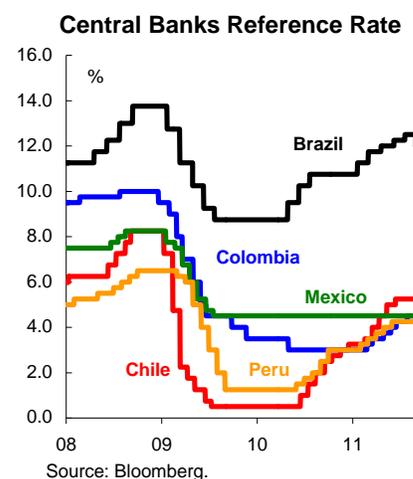
**Adjusting Monetary Policy Expectations In The Developing Americas**

- **Expectations are pointing towards looser monetary conditions.**

Amid persistent volatility and sell-off dynamics in financial markets in recent weeks, monetary policy expectations in Latin America have been shifting from a hawkish stance to a more neutral one, and in some cases, to even dovish.

The central banks of the major economies in the region (Brazil, Chile, Colombia, Mexico and Peru) recognized that economic activity has slowed in recent months and that the initial post-recession momentum of 2010 and early 2011 — backed by both the global recovery and strong local demand — has somewhat decelerated. Accordingly, real GDP growth forecasts have been revised downwards in some of these economies.

The inflation context has been stabilizing too, but some pressures remain vibrant. Apart from Brazil, the pace of consumer price inflation in each of the major economies has converged to around 3.0% y/y, the mid-point of the official target range for Mexico, Colombia and Chile and the upper limit for Peru. Brazilian inflation is well above the 4.5-6.5% official target range and currently stands at 7.2% y/y. Commodity as well as some food prices remain high, which could further threaten price stability. In addition, inflation expectations have failed to ease substantially in recent months.



Early in August — even before Brazil announced its first SELIC rate cut — expectations for lower interest rates were building up in the region. Recent surveys show a reversal in reference rate expectations and, after several months of anticipated increases, the consensus points now to rate cuts (please see table). The biggest change in monetary policy expectations has materialized in Brazil, especially after the rate cut, whereas in the rest of the region expectations have moved towards this direction at a slower pace. In its official August statement, the Mexican central bank acknowledged the risk of a major adverse impact stemming from the slowdown in the US and signaled that they are ready to act if necessary (it is important to highlight that Mexican monetary conditions are more closely related to those in the US than to Latin America). In Chile and Peru, the central banks have stressed that the current monetary policy stance is now neutral and any changes will reflect variations in economic performance.

We expect the reference rate in Colombia, Chile, Mexico and Peru to remain unchanged for at least the remainder of the year. Meanwhile in Brazil, we anticipate the loosening in monetary policy to continue, which could influence other South American central banks to move towards that direction too. However, in order to see more central banks joining Brazil’s new stance, inflation expectations, economic activity and commodity price inflation would need to ease significantly.

	Current reference rate (%)	Change on the reference rate expectations 6 months from now (latest monthly survey vs. previous)	Change on the 12 month inflation expectations (latest monthly survey vs. previous)
<b>Brazil</b>	12.00	-116 bps	+21 bps
<b>Chile</b>	5.25	-25 bps	-3 bps
<b>Colombia</b>	4.5	NA	-6 bps
<b>Mexico</b>	4.5	-20 bps	+5 bps
<b>Peru</b>	4.25	NA	-10 bps *

Source: Central bank's surveys. \* Change on the 2012 year-end expectations

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### ***Sputtering Or Stalling?***

- **The advanced economies remain under significant economic and financial stress.**

Weakening employment trends in the United States, Canada, and Europe can't help but lower economic expectations among the advanced nations, reinforce the sharp erosion in consumer and investor confidence, and contribute to further and destabilizing financial market volatility. The latest and most visible reminders of the loss of economic momentum are the unchanged level of U.S. payroll employment in August, and the 5,500 jobs lost in Canada. European data are lagged, but 'the increasing downside risks to growth' noted yesterday by the ECB President suggests a similar performance.

Coming so soon after last year's mid-year slowdown and the 2008-09 recession, the renewed soft patch highlights the pervasive 'debt-weight' drag preventing the G7 countries from maintaining a higher cruising altitude. The continuing loss of confidence is of concern and bears watching, particularly since growth among the advanced nations was already too low to provide a much-needed cushion, and for all intents and purposes, monetary and fiscal policy levers have already been pushed to full throttle.

Scotia Economics had expected a renewed slowing in growth in 2011 and 2012 as the initial stimulus and inventory-led rebound gave way to increasing fiscal retrenchment. But in recent months we have been incrementally lowering our below consensus growth forecasts for most of the advanced nations. Although the threat of stalling out has increased against the backdrop of deteriorating employment conditions, the economic reports for July and August are mixed, with the results generally more up than down.

U.S. and Canadian consumers regained some spending buoyancy in July, with motor vehicle purchases posting further gains in August. A number of factors, reduced gasoline and food prices in addition to increased price discounts, helped to support purchases despite the confidence dampening repercussions associated with the intensifying fiscal problems and financial fallout engulfing both the euro zone and the United States. Merchandise trade data for July also witnessed solid increases in export volumes in both Canada and the United States as shipments of transportation and other machinery & equipment continued to recover from the massive manufacturing supply chain disruptions emanating from Japan. Big order backlogs for airplanes and other infrastructure-related building equipment, and the resumption of oil shipments from western Canada, should reinforce these trends and contribute to growth. Even in the face of the sharper slowdown in U.S. and Canadian activity in Q2, industrial activity in Mexico continued to move ahead.

It is too early to sound the all clear siren, since the potential for lingering and sizeable aftershocks around the world is real. For example, renewed credit market concerns have been revived on the continent alongside the heightened sovereign debt risk. More fundamentally, consumer caution and deleveraging will remain a constant, while the pace of fiscal consolidation will inevitably increase next year and beyond.

Nevertheless, some of the constraining factors that contributed to the recent slide in activity are loosening their grip, allowing for output growth to gradually rebuild momentum through the remainder of the year and into 2012. In the advanced economies, business activity should benefit from significantly reduced supply chain disruptions, comparatively lower gasoline costs, stronger balance sheets and cash positions, and still vibrant export markets in the emerging economies. China's industrial production remains comparatively strong, increasing 13½ y/y in August, while retail sales and business investment posted much larger gains. Households should benefit from ultra-low borrowing costs that should assist refinancing and reduce debt-service burdens.

In this uncertain environment, policy settings will remain pro-growth. Monetary tightening around the globe has been put on hold, even in the faster-growing emerging economies. Both the Fed and the ECB have acknowledged the increasing economic and financial stress, and have the capabilities to provide additional accommodation if needed. The U.S. President has offered a US\$450 billion fiscal package to provide further assistance to households and businesses, though the eventual composition and extent of the program is unknown. Policy co-ordination will take on added importance at this weekend's meeting of G7 Finance Ministers in France. There is a renewed urgency for savings-rich economies to spend more to facilitate a quicker and stronger rebound at a time when many savings-poor nations are undergoing severe debt decompression.

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## Foreign Investors In Latam Local Bond Markets

*While the ability to issue debt to foreign investors in local currency carries enormous benefits to emerging market governments, that issuance may come at the cost of surrendering control of domestic monetary conditions to global markets. Meanwhile, the increasing role of foreign investors in some bond markets threatens to diminish the diversification benefits that those initial foreign investors were seeking. In this article, we review the recent experiences of Peru and Mexico in order to draw some conclusions about the role of foreign investors in local markets and to discuss the investment implications of the trends we are seeing.*

### Introduction

Foreign participation in local-currency fixed income markets has resumed its upwards trend over the past couple of years in a number of the Latin American countries we follow. To take a few of the more obvious examples, foreign ownership of Mbonos in Mexico continues to gradually increase, with the most recent government figures showing foreigners holding 40% of the total outstanding. In Peru, the increase was more sudden, as the share of Soberanos owned by foreigners doubled in the second half of 2010. Moreover, there is reason to believe that local inflows will continue, as problems in developed countries force investors to search for ways to diversify their holdings, including diversifying the currency denomination of those holdings. For example, EPFR data shows cumulative inflows YTD to local currency emerging markets funds at 20%, to hard currency emerging markets funds at 4%, and to US high yield funds at -2%.

The effects of this foreign participation on yields, whether on the level, the volatility, or the correlation with international markets, is important both for policymakers and for investors. While policymakers must surely appreciate their new ability to finance their fiscal shortfalls abroad in their own currency, they also likely worry about losing control over monetary conditions in their countries. For example, a recent study of a dozen developed countries found that capital market integration increased the correlation between long-term interest rates across those countries, possibly hindering the ability of the authorities to influence that critical variable by setting short-term rates.<sup>1</sup> Institutional investors, who may have thought that local EM bond markets would give them new sources of diversification, may soon find that they are indirectly trading mostly with other institutional investors from their home country. Consider the findings of a recent academic working paper on equities: the authors concluded that while the diversification benefit of EM still exists, it has been decreasing over time.<sup>2</sup>

While foreign portfolio flows to local equity markets have received significant attention from economists, often because of the volatile nature of those flows, flows into local bond markets have received less attention. An exception is a quantitative study across ten emerging market countries by the IMF which found that a one percentage point increase in the share of foreign investors lowers yields by 6bp without increasing the volatility of those yields.<sup>3</sup> The problem with such quantitative studies, however, is that we do not know whether foreign investors caused the fall in yields or if foreign investors correctly anticipated a fall in yields that would have occurred anyways. Further statistical problems come from the fact that there has really only been one cycle in the increase in foreign participation—occurring now—and that coincides with a fall in yields across many countries. Thus, there are not that many datapoints on which to base conclusions.

In this article, we take more of a case study approach, explaining the experience of a couple of Latin American countries that we follow with regards to the recent entrance of foreign investors.

### Peru's Soberanos

Foreign investors have had a substantial role in Peru soberanos at least since 2005, when the Ministry of Finance first started breaking out non-resident holdings in its data (Figure 1) and also embarked on a new program of local issuance. What we see is a surprisingly stable share of foreign holdings from late 2005 to late 2007. During that time, however, the total amount of soberanos outstanding increased from 4bn PEN in early 2005 to 9bn in late 2005 and then rose to 19bn by the end of 2007; thus, foreign investors were absorbing a steady share of new issuance. A massive appreciation of the currency during late 2007 and early 2008 likely led to, and was probably reinforced by, the uptick in foreign ownership that we saw in the first

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half of 2008. From September 2007 to March 2008, the currency appreciated 16%, while foreign bond ownership increased from 27% to 36% between December and March of that year. With yields on Soberanos not particularly high by emerging market standards, expectations on the currency naturally play a large role in foreign interest. For example, at the end of 2007, Soberano 10Y yields were at 6.4%, higher than the 4.1% offered by US Treasuries, but far lower than the 7.9% in Mexico and 13.2% in Brazil.

During the subsequent global financial crisis, foreign holdings dropped to a low of 17% before recovering in the second half of 2010. The re-emergence of foreign interest was rapid, with foreign positions rising from 20% to 46% in just four months. Foreign purchases were expedited by the government’s PEN-denominated issuance in November, an issuance implemented in GDN form to target that renewed foreign interest. We think expectations on currency appreciation again played a role in that huge increase in foreign ownership, especially as various restrictions in short-term capital flows imposed by the Peruvian Central Bank limited the routes by which investors could speculate on currency appreciation. With only \$9bn USD-equivalent of Soberanos outstanding (in contrast to 130bn USD-equivalent of Mbonos), it is easy to see how foreign investors can quickly overwhelm the Peruvian market. Consider for example that inflows to local currency funds in the second half of 2010 were \$10bn, and that is inflows for only those funds tracked by EPFR, which is a small subset of the universe of emerging markets investors.

We find noteworthy the stability of foreign holdings during Peru’s presidential elections this year. Despite the election of a leftist candidate, who in the past had espoused some fairly radical views but seems to have moderated since then, few foreign investors reduced their positions. If anything, it seems to us that local investors and businesspeople were more concerned than foreign investors about the direction their country would take under new leadership.

Figure 1.

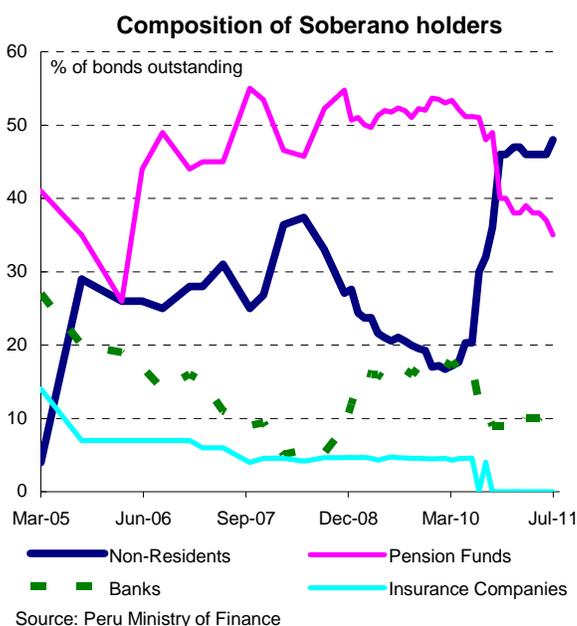
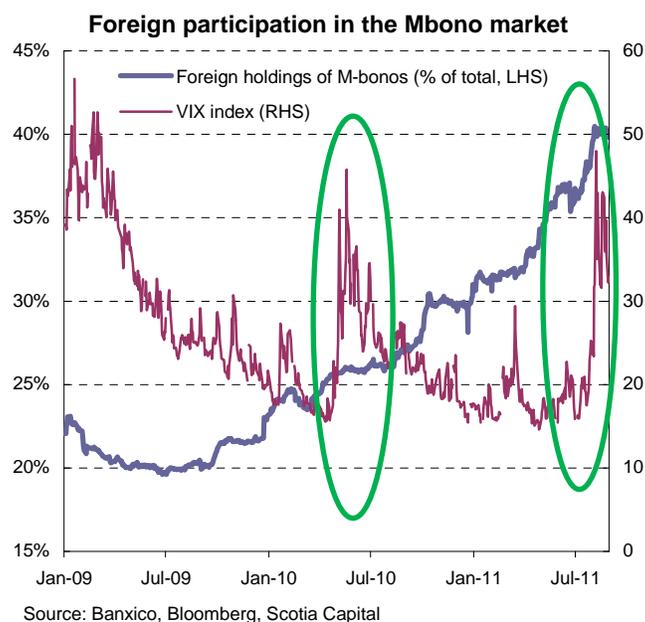


Figure 2.



**Mexico’s Mbonos**

In Mexico, recent data shows there has been no widespread Mbono selling by foreigners, despite heightened volatility in both global financial markets and MXN (Figure 2). Anecdotal evidence suggests that Mbonos held by foreigners are mostly in the hands of real money, who view these holdings as strategic. In addition, the high correlation of Mbonos with USTs could actually work in favour of holding them during “risk-off” environments.

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We believe a number of factors account for the stability of Mbono holdings including abundant global liquidity driving investors to a “hunt-for-yield”, but there is more to increasing Mbono exposure than just that. In our opinion, rising Mbono holdings by foreigners also respond to a combination of higher confidence in financial policy in Mexico (hands-off authorities and predictable rules), improved liquidity in local bond markets and the inclusion of Mbonos in global benchmark indices widely tracked by institutional investors, which has increased the dedicated investor base (Figure 3).

The government has taken a number of measures to improve liquidity in domestic bond markets, including the introduction of market makers to provide liquidity. In 2005, the possibility of “stripping bonds” was introduced so that investors could replicate long term zero coupon bonds. Since 2010, the government has relied on syndication for the initial issuance of benchmarks, and has proceeded to re-tap them through scheduled auctions. The objectives of syndication were: introducing more liquid bonds, broadening the potential investor base, allowing the bonds to be included in global indices upon issuance, and improving secondary market liquidity.<sup>4</sup> Another measure which could add liquidity to Mbonos and develop a deeper domestic investor base is the new CetesDirecto program, which will allow domestic retail investors to buy government securities at the auction price; the program has a very low minimum investment of roughly US\$10.

One of the strategies followed by the government to develop new investor bases abroad has been to first issue bonds in the target pool’s own currency to familiarize investors with Mexico and then to later market MXN denominated bonds to them (this strategy was followed in Japan ahead of the inclusion of Mbonos into the WGBI). Anecdotal evidence suggests there has been an important increase in the demand for Mbonos from Japan following the government’s marketing efforts and the WGBI inclusion.

Figure 3.

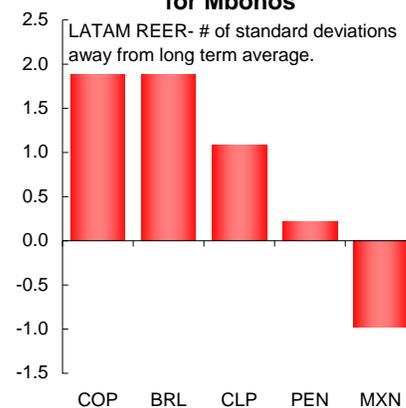
Inclusion of Mexico in Global Indices	
Year	Benchmark Mexico was added to
2003	JPM GBI - Broad
2003	Barcap - Universal Gov. Inflation Linked Bond Index
2005	JPM GBI - EM
2005	Global Aggregate Index (Lehman / Barcap)
2006	ML - Global Government Bond Index
2007	Barcap - EM Government Inflation Linked Bond Index
2007	ML - Global Government Inflation-Linked Index
2008	CEMX - Global Emerging Markets
2010	Citi - World Government Bond Index (WGBI)

Source: Mexico Ministry of Finance.

### Lessons from Latin America

The traditional view around foreign investors in emerging markets is that flows can be volatile, and as much as they provide new sources of funding in good times, they can be destabilizing in bad times. The pullback by foreign investors from both Mbonos and Soberanos during the recent global financial crisis validates that view in part. Nevertheless, we note that this withdrawal was only partial—about half of soberanos holders and only one-quarter of Mbonos holders sold their positions. Perhaps, more importantly, the effect on local monetary conditions was not significantly exacerbated by the presence of foreign investors. True, in Peru that pullback by foreigners was accompanied by a 3% increase in yields in the 10Y maturity in the months following the Lehman Brothers collapse, while Mexico saw yields increase by 1-2%. Nevertheless, the causation here is not obvious. For example, Colombia and Brazil, which have a relatively smaller presence of foreign bondholders showed 3% and 5% yield increases.<sup>5</sup>

Figure 4. MXN Valuations Supportive for Mbonos



Source: ScotiaFX, Bloomberg, IIF.

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We see similar results when we analyze rolling betas of the response of Latam weekly yield changes to changes in US 10Y Treasury rates. Mexico has a higher beta, which approaches one during some months, but it had that higher beta even when foreign presence was smaller. Meanwhile Peru's beta remain half that of Mexico's despite having a larger foreign presence in the bond market. Thus, it may be that integration of economies rather than integration of financial markets drives the correlations in fixed income markets.

Another contrast to the traditional view is that foreign investors are not as skittish as some emerging market policymakers may fear. In Peru, few foreign investors withdrew in the face of country political risk. Meanwhile, the more recent increases in global uncertainty have not deterred those investors, and foreign holdings in both Peru and Mexico continue to increase despite the current turmoil. The foreign response to global uncertainty may be non-linear and resilient to smaller crises and moderate economic slowdowns; or it may simply be changing and evolving.

Finally, our two case studies show the complexity of foreign investor motivations and behaviour. Differences in bond market size, in policies on currency intervention, and in marketing efforts are among the many factors that may drive the type of investors attracted to local markets and their willingness to hold long-term positions.

### **Recommendations**

Most data suggest that new money will continue flowing into emerging markets. For example, according to a survey conducted by Pensions and Investments Research, the 128 panel members who responded plan to increase EM allocations from 5.1%, to 8.7% of their portfolios on average by the end of 2016. That statistic, when extrapolated to the pension fund universe, means that the EM dedicated investor pool is likely to grow substantially over the coming years. Meanwhile, the weekly EPFR data continues to suggest that funds will flow increasingly into local currency rather than hard currency debt, suggesting that soberanos and especially Mbonos would be beneficiaries.

We believe the outlook remains supportive for Latam local currency bonds in the long run. Some investors may be motivated by the potential upside on the currency. Most metrics (REER, PPP, Big-Mac index, etc) show that MXN remains undervalued, giving foreign bond investors a potential upside from currency appreciation (Figure 4). Inflationary pressures in Mexico appear well contained, while the economy is widely expected to grow at rates greater than 3% in both 2011 and 2012. Furthermore, the government's fiscal situation is sound and well managed. Rate hikes seem a distant threat, and many market participants now expect rate cuts (about 50bps are priced into the TIEE curve). MXN's high correlation with US economic performance, however, means investors may have to wait some time before realizing those benefits. In contrast, Peru may provide some more immediate gratification with performance less correlated with that of the US. Significant FDI inflows, along with high export prices that motivate much of that FDI, create medium-term conditions for continued appreciation of the currency, an appreciation that should continue as long as President Humala does not implement any radical reforms. We continue to recommend this currency in the near-term.

Endnotes:

<sup>1</sup> Pieter W. Jansen, "Did capital market convergence lower the effectiveness of monetary policy," *Applied Financial Economics* 19: 975-984, 2009. See also, Gregory D. Sutton, "Is there excess comovement of bond yields between countries," BIS, July 1997.

<sup>2</sup> Peter Christoffersen et al, "Is the Potential for International Diversification Disappearing?" Working Paper, November 18, 2020.

<sup>3</sup> Shanaka J. Peiris, "Foreign Participation in Emerging Markets' Local Currency Bond Markets," IMF Working Paper, April 2010.

<sup>4</sup> "Plan Anual de Financiamiento 2011"; Mexican Ministry of Finance.

<sup>5</sup> One could argue that since the yields before the crisis were larger in Brazil and Colombia, the response to the crisis should also be larger.

### Latam Equity Strategy

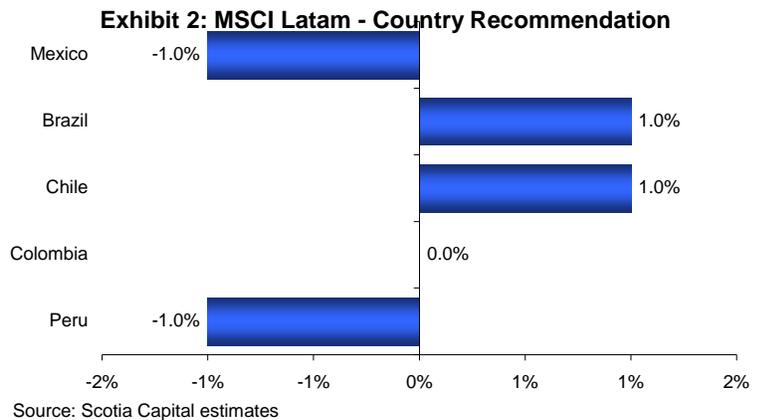
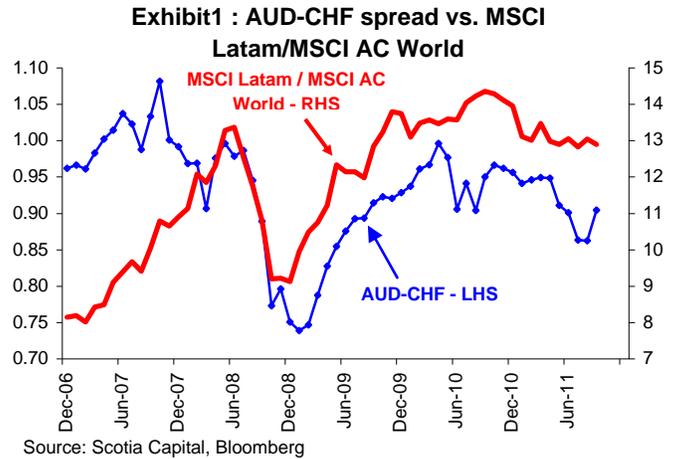
**Following performance figures are in USD unless otherwise stated. Year-to-date returns are price only as at September 1, 2011, close.**

- **Global equities slide on depressed risk-appetite, Europe collapses.** Global equity markets have suffered heavy losses in the last two months and most indices have gone from posting YTD gains in the first half to suffering heavy losses by the end of August. Europe has been especially hit hard with Germany's DAX index collapsing almost 30% in six weeks. Latam performance was already negative before the recent market rout and the MSCI Latam index is now down 11% so far this year. In comparison, the MSCI World AC index is down 7% YTD versus declines of 4% for the S&P 500 and the TSX (Canada) indices. Asia (and China) has performed somewhat better through the ongoing summer sell-off in equities.
- **Colombia, Chile, Mexico outperforming, Brazil & Peru lag.** Colombia (+2%) and Mexico (-5%) performances have been superior to the rest of the Latam group so far this year. At the other end of the spectrum, Peru (-17%) and Brazil (-13%) have lagged the most and Chile's return (-10%) in-line with the MSCI-Latam (-11%). Depressed risk-appetite, strengthening domestic currencies, and tightening monetary policies explain the MSCI-Latam's underperformance in the last 12-18 months. In local currency terms, global and Latam YTD returns have fared even worse.
- **Valuations and earnings momentum.** Latam valuations have been trending lower in recent months alongside widespread global P/E contraction. The MSCI Latam's forward P/E (9.3x) is down 2x from last June and compares to 10x for the MSCI World AC and 10.8x for the S&P 500. Brazil's valuations (forward P/E of 7.9x) are at the lowest level amongst the Latam Five and the MSCI World AC index. The Bovespa has suffered from a perfect storm over the course of its 16-month tightening cycle. Based on bottom-up consensus forecasts, Latam earnings growth should top 11% in the next 12-months, below the projected growth rate for the MSCI AC World (+14%). Earnings revisions are tilted to the downside in coming months for every region as GDP growth expectations are lowered. Still, Latam has been lagging in terms of earnings revisions throughout the year as well.
- **Mounting risks, challenged risk-appetite.** Although the 12-18 month risk-reward outlook for equities/cyclicals is currently very attractive, mounting risks should continue to challenge sentiment in the near term. In our opinion, investors must especially take notice of a potentially weakening U.S. employment outlook which would translate higher risk to earnings. Following a very disappointing U.S. employment report for the month of August (zero jobs added), we believe the risks that July/August equity weakness extends into September/October have increased. In addition, conditions for a rebound in risk-appetite remain challenging as long as China maintains its hawkish tone. Our bias is to take advantage of the ongoing panic selling and raise our cyclical/EM/Latam exposure in coming months. With mounting risks currently overweighting potential rewards, however, we would wait for tangible improvements in the Eurozone, clarity on jobless claims/ISM (new orders improving), and a peak in China's CPI as catalysts to move to an aggressive cyclical overweight.
- **Monitoring risk-appetite.** Although our tactical asset mix indicators continue to highlight an attractive equity risk-reward outlook, the trigger for increased risk appetite remains unclear in the near term. The global monetary policy outlook has materially shifted in the last few weeks with some "tighteners" reverting to easing. Brazil cut its benchmark rate by 50 bp last week and it is now widely expected that the ECB's stance (2 rate hikes in Q2!) may also change. China's policy holds the key to a rebound in risk-appetite. Further softness in commodity prices and a sub-50 PMI could eventually trigger a change of tone in Beijing as inflation pressures abate. As illustrated in Exhibit 1 on the following page, the AUD/CHF spread needs to rebound. EM and Latam leadership imperatively need enhanced risk-appetite a shift in monetary policy. By the end of 2011, most central banks who had been tightening in 1H11 should

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switch to a more dovish tone, if not outright easing. Monetary divergence has been the root cause for Latam underperformance since 2010 and we view a shift towards greater monetary policy convergence as friendly to Latam relative performance.

- Latam Five Strategy:** Brazil over Mexico; Chile over Colombia. In our opinion, Mexico's 22-month edge over Brazil will reverse as Brazil's monetary disadvantage unwinds. Mexico (Bolsa -6.8% YTD; +10.2% YOY) has outperformed Brazil (Bovespa -16.1% YTD; -13.4% YOY) on the back of more modest currency gains, U.S. proximity, and a yield advantage (Brazil raising rates, Mexico on hold). With Brazil easing policy at the end of August, we are now switching to a Brazil (up to OW) over Mexico (down to UW) stance. Easing and lower currencies should help lift valuations in domestic cyclical areas such as Financials and Discretionary, two areas that have suffered P/E contraction throughout the tightening cycle. Financials and Discretionary sectors weigh in at 31% in Brazil and 22% in Chile versus 20% in Mexico (6% Financials/14% Discretionary). In addition, our materials over oil preference is prompting us to lift Chile to OW and reduce Colombia to MW. Peru remains UW rated. See Exhibit 2 for our Latam Five strategy recommendation.



## **Operation Twist Revisited: Implications Of A New Fed Term-Extension Program**

*(originally published as a separate report on Sep 6, 2011)*

### **Overview**

Some kind of intervention from the Fed seems more likely after the very weak payrolls report, which follows a long series of weak data. Market speculation is high that it will be an extension of the average term of the Fed's security holdings, something that Bernanke and other Fed officials have frequently suggested as a possibility. The bull-flattening after the payrolls report is also consistent with anticipation of this kind of program: longer yields declined as much as 20 bps on Friday, while short-term yields actually rose, albeit marginally.

In this report we examine past studies of Fed asset purchases to assess the likely direct impact of this kind of program on the Treasury curve. We find that a program on the order of \$500 bn could reduce 10-year yields by between 11 and 29 basis points, and flatten the 2s/10s curve by between 18 and 48 basis points, holding everything else constant. However, we also think that this kind of program has been well anticipated, and its direct impact is largely priced in, with the possible exception of the front end. If the Fed were to sell a substantial part of its short term holdings to actively move out the curve, this should still push 2-year yields higher.

### **Background: Operation Twist circa 1961**

The potential term extension by the Fed is being dubbed a new Operation Twist, a reference to the program in the early 1960s in which the Fed and treasury department collaborated to try to reduce longer term rates without reducing short rates. The US was in recession at the time, but also on a modified gold standard, and so wanted to avoid cutting short term rates, in the belief that lower short term rates would exacerbate flows of gold and dollars out of the US into Europe. But the US administration and central bank still wanted to lower longer term rates in order to help stimulate the domestic economy. The program involved the Treasury issuing only short-term bonds, and the Fed buying long term bonds. There is no way there would be this kind of explicit collusion today; it would be engineered only by the Fed. Swanson of the San Francisco Fed, from whom much of the preceding discussion of the 1961 experience is drawn, estimates the program pushed long yields lower by a modest but still significant 15 bps, holding everything else constant.

### **What a new Operation Twist might look like**

There are two ways the Fed could implement a term extension program, and it may do a combination of both. It could extend the term of the securities it currently buys when it reinvests mortgage and Treasury principal repayments, and it could actively sell shorter-term bond holdings to buy longer term. The reinvestment approach would be something like \$200 bn per year, though that number could turn out to be larger given the incentive to refinance created by record low yield levels, and by any further mortgage market stimulus programs that Obama announces. The active approach, assuming the Fed isn't going to create new money, is limited by how many shorter-term securities the Fed holds that it could sell. Currently, the Fed has about \$515 bn of Treasury securities 3 years and shorter (and \$60 bn of agency securities, plus a lot of MBS, but we assume it won't sell any of those). In the analysis that follows, we assume the Fed sells a sizeable part of these holdings, \$300 bn. This, combined with \$200 bn of reinvested principal payments, would constitute a program of significant size, a bit smaller than QE2.

### **What term?**

We have seen before that "long term bond" for the Fed does not necessarily mean 30-year bonds, or at least not exclusively (before QE1, "long term" for the Fed might have just meant 3 years). The Fed would doubtless increase its purchases of 30-years, but much of its term extension would likely be focused closer to the 10-year area. This would also target a sector more relevant to the mortgage market than the 30 year Treasury.

### **How would a New Operation Twist affect Treasury yields?**

This is not easy to answer, because there is the direct supply and demand effect of the Fed's actions, in which buying pushes yields lower and vice versa, and there is the indirect way that the Fed's policy influences expectations of future growth and inflation. In this note we first consider the direct impact of Fed purchases and sales on yields. To do so, we borrow from analysis we did a year ago leading up to QE2, when we examined

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several studies of how Fed purchases affect Treasury yields. The results from three studies we examined last year are summarized in the table, standardized for a \$500 billion purchase program. We also show the results from a recent study by Swanson of the original Operation Twist.<sup>1</sup>

Based on these estimates, \$500 bn of longer-term purchases (\$200 bn of reinvestment, \$300 bn of active term extension) could reduce 10-year yields by between 11 and 29 basis points. Additionally, if we assume a similar, opposite effect from Fed sales of securities, then selling \$300 bn of shorter-term Treasuries could push their yields up by between 7 and 18 basis points. These estimates imply that a new Operation Twist of this magnitude could flatten the 2s/10s yield curve by between 18 and 48 basis points.

**Decline in 10-Yr Treasury Term Premium for \$500 billion of Purchases**

Gagnon et al #1	15 - 29 bps
Gagnon et al #2	11 - 15 bps
Hamilton & Wu	17.5 bps
Swanson	12.5 bps

***Is it already priced in?***

We know from theory and from past experience of QE1 and QE2 that it is the announcement of the total size of the Fed's intervention that has the main impact on market yields, not the gradual implementation of the program week to week. The biggest impact should therefore happen in advance. We also know that the market is pretty good at anticipating more Fed stimulus. This seems to be the case today: the 10 year yield has declined some 100 bps in a month, and the 2s/10s curve has flattened about 70 bps. Not all of this is anticipation of Fed intervention, but it is likely that the market has anticipated the Fed would be forced closer to acting as the economy deteriorates. And Fed speakers have suggested this kind of term extension program is possible.

***Indirect impact on market expectations?***

The other way Fed programs influence yields is indirectly, through expectations for growth, inflation and other variables. QE 1 and QE2 both had a large influence on market expectations for future inflation, growth, and the prices of risky assets. Leading up to QE2, for example, we recommended selling Treasuries and betting on higher yields in the next three to six months, because we thought that the indirect impact on risk appetite, growth, and inflation expectations would overwhelm the direct influence of the Fed's purchases on the Treasury curve (Sep 27, 2010 RV Weekly).

A term extension program today is likely to be far more modest than either QE1 or 2 in terms of how it influences broader expectations. First, the program itself is relatively modest, since it does not involve creating new money and adding to the Fed's total bond holdings. Second, market conditions in the US are not as dire. QE1 occurred under much more extreme conditions in the US economy and market, and was accompanied by a series of coordinated efforts on both the fiscal and monetary sides, in the US and elsewhere. During the lead-up to QE2, the threat of deflation seemed to be more significant than it seems to be today (at least so far — further details below).

***Is it worth doing?***

We've argued before that we think another round of QE or other more extreme unconventional Fed tool that involves creating new money is unlikely right now (in addition to asset purchases, other tools include a yield ceiling, a negative deposit rate, purchasing foreign assets, and, if things get very bad, possibly even radical steps like a tax cut funded by the Fed printing money, a close approximation to Milton Friedman's helicopter drop of money). First, these tools are best suited to fighting disinflation or deflation. So far, inflation remains much higher than it was leading up to QE2 (1.8% core, 3.6% headline y/y), though the Fed has indicated it sees the risks now of future inflation undershooting its desired target. It is possible that deflation risks rise in the months ahead — after all, the output gap, already large, is likely a couple of percentage points larger than previously thought now, after the recent downward revision to the US growth data.

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Second, there are costs to using the more extreme tools. There is political opposition to QE. There are also unintended or poorly understood consequences (e.g. QE requires creating bubble-like conditions in a range of markets, a fairly extreme and not necessarily stable situation). Finally, despite the Wizard of Oz kind of flash that the Fed's programs might get, many of the economy's real problems — long term unemployment, education, entitlements — are not best solved by the Fed, as Bernanke pointed out in his Jackson Hole speech, and the Fed's intervention could distract from addressing the problems in the most effective way.

Compared to many of the Fed's remaining tools, which likely will not be used unless the risk of deflation increases substantially further, a new operation twist, extending the term of the Fed's security holdings without printing new money, is pretty innocuous. Its impact on the economy is likely to be quite modest, though it should still have some impact. For example, the US has seen a big increase in refinancing during the summer as mortgage rates declined back to record levels (more recently, refinancing applications have declined in the past few weeks, but according to at least one anecdotal report, this may be due more to a shortage of staff to process the applications. See the Bloomberg story "Banks Overwhelmed by Mortgage Refinancing after Slashing Jobs," Sep 2). This suggests that homeowners are still responding to declines in rates, at least those homeowners who have positive equity... and jobs. (It does nothing to address the big underlying problem in the US economy, too many homeowners with negative equity, meaning a lot of loans that the banks probably need to write down. But I don't think the Fed can do much on this point. It is either up to the government, or to the private sector itself realizing that it could make more economic sense on both sides to restructure debts and keep people in their homes and paying their (reduced) loans rather than hoping to get 100% back and then going through foreclosure.)

### Conclusion

Given that the Fed's dual mandate includes employment as well as inflation, the recent worsening of the employment picture makes it more likely that the Fed will intervene further in the market, beyond its recent commitment to leave short rates low for the next two years. The fact that inflation readings remain relatively high suggest that the Fed would still be reluctant to implement another round of quantitative easing or another more extreme unconventional easing measure that involves creating new money. In contrast, a program like extending the term of its holdings is relatively simple to implement, and can be done up to quite large size before requiring the creation of new money, which also makes the program relatively palatable politically.

This sort of program could have a modest impact on the economy and on equity market sentiment through keeping rates relatively low, but I would think the impact would be much more subdued than QE2, let alone QE1, when market disruptions were extreme. The direct impact on the Treasury curve of a \$500 billion program should be significant, a bull flattening of 18 to 48 bps of 2s/10s, holding everything else constant. But based on all the market talk about a new Operation Twist, and the massive flattening rally in the Treasury market over the past month, it seems that the program is well anticipated and its impact has been largely priced in, with the possible exception of the front end of the curve, where yields could rise moderately if the Fed actively sells its holdings.

### Endnotes

1. We have scaled the results of the different studies to correspond to a \$500 billion asset-purchase program. In the original Gagnon et al Study #1, they estimate that \$1.7 trillion of purchases led to a 50 to 100 bp decline in the 10-year term premium. Hamilton and Wu estimated that a 0.4 trillion purchase program would lead to a 14 bp decline in the term premium. Swanson estimates that the original Operation Twist reduced the 10-year yield by 15 basis points, and argued that last year's \$600 bn QE2 program was similar in size, after adjusting for the growth in the Treasury market and economy since the early 1960s.

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J. Hamilton, J. Wu, "Effectiveness of Alternative Monetary Policy Tools in a Zero Lower Bound Environment, Sep 2010.  
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**The View From Europe: MPC — QE2 Looking More Likely**

- The BoE meeting for September passed without major surprise. Nonetheless, we believe that there was considerable discussion of the merits of further quantitative easing. Indeed, we see a significant risk that at least one more MPC member dissented in favour of QE2 at this meeting. If that was the case, we believe that speculation will build of QE restarting sooner (i.e. before end-year) and in bigger size than the consensus currently expects.

**Getting inside the MPC meeting room**

The tried and tested way of gauging the likely next move by the BoE is to take the latest assessment from the minutes and judge what the incremental news has been since then. More often than not this has helped to alert to a change in the voting pattern and even surprise rate moves. Table 1 shows a dissection of the latest MPC minutes, along with how we judge the Bank’s assessment has changed since then — and whether each area has become more hawk or dove friendly.

Table 1: MPC Minutes Digest

	August-2011 (Actual)			Sep-2011 (Scotia Capital Judgement)		
	Comments	Hawkish / Dovish / Neutral	Overall	Comments	Hawkish / Dovish / Neutral	Overall
Financial Markets	Markets had been unsettled during the month, particularly reflecting european fiscal jitters	-	-	Further worsening	-	-
	Eurozone sovereign bonds spreads had widened to Germany, concerns about the banking sector had risen	-		More of the same	-	
	Timing of first rate hike pushed back here and overseas	0/+		Rate hikes pushed back even further	0/+	
	GBP 2.3% stronger on the month	-		GBP 0.75% weaker on the month	0/+	
	Equities down 7% on the month	-		Equities down 5% on the month	-	
International Economy	Forward and backward looking indicators pointed to slowing activity.	-	-	Further sharp weakening particularly in forward looking surveys	-	-
	Weak US Q2 GDP and downward revisions to the back-data.	-		Weak payrolls and soft surveys (except non-man ISM)	-	
	Some slowing in the eurozone indicators for Q2 and suggestions that Q3 would also continue to slow	-		More extreme signs of slowdown in Q3	-	
	Tighter policy in asia likely to slow growth in those regions	-		More of the same	0	
Money, credit, demand and output	Prel Q2 GDP was 0.2 - though underlying growth was probably more robust	0	0	No big revisions as yet, though 5 October may still see big upward revisions to growth	0	-
	Business surveys pointed to similar pattern of growth in Q3 though with slower underlying growth	0		Sharp fall in surveys...	-	
	Services sector CIPS was more robust than expected	+		...especially CIPS services	-	
	Signs of subdued consumption in the near term	-		More signs of weakening in consumer spending	-	
	After near term slowing, a gradual recovery in activity is expected over the medium term	0/+		Medium prospects looked more shaky	0/-	
Supply, Costs and Prices	Lower than expected CPI inflation, down to 4.2% due to AV discounts	-	0	Inflation reaccelerated to 4.4% - broadly as expected	0	0
	Still expected inflation to peak around 5%	0/+		Still likely to peak around 5%	0/+	
	Inflation expectations fell in July - reversing the sharp June increase	-		Inflation expectations stable in August	0	
	Little evidence to suggest that elevated inflation had begun to feed into wages, earnings growth remained subdued	0		Underlying wage inflation broadly stable. Signs of deferred bonus payments in the headline measure	0	
	Commodity prices important for the inflation outlook. Less hawk friendly outlook given weakening global demand	0/-		Oil down on the month, though signs of renewed agricultural commodity price pressures	0	
Immediate Policy Decision	Key upside risk is that elevated inflation provokes inflation expectations to contribute to inflation staying higher for longer	+	0	Upside risks to inflation remained from likelihood of 5% print	0/+	0/-
	Key downside risk to inflation was that demand growth would not be sufficiently strong to absorb the pool of spare capacity	-		Downside risks intensified	-	
	Q2 growth was probably stronger than suggested by headline GDP, but forward looking indicators had softened.	0		Q3 outlook worsened materially	-	
	Assumptions that the first hike would arrive later contributes loosening and boosts medium term inflation assumption	+		Same again - though a case for arguing that there is a reason rate hike expectations have been pushed back - the outlook is suffering	0/+	
	If financial stresses continued, it would hurt the banking sector and hence credit availability	-		same again	-	
	Euro area stresses posed a threat to UK growth - though little merit in reacting to possible risks in advance	0/-		same again	0/-	
	News on inflation outlook had been largely on the downside	-		mixed	0	

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Most importantly, the August MPC minutes noted that some members considered whether more asset purchases were warranted, but the case was not yet strong enough. However, further purchases could be warranted if some of the downside risks to the Bank's forecasts materialised. One thing that had tempered the move in the dovish direction was the fact that market expectations for the first rate hike had been pushed back, which represented loosening in conditions.

We judge that the key developments since the August meeting were:

- a deterioration in the outlook for growth in both the domestic and external economies;
- Financial market turmoil has continued / intensified; and
- The market and consensus has pushed back expectations of the timing of the first rate hike.

Essentially, the downside risks to the Bank's forecasts have begun to materialise. Clearly given that the Bank left monetary policy unchanged showed that the downside risks had not materialised sufficiently to provoke a majority of MPC members to vote for QE at this stage. Once again there was a pushing back of expectations of the timing of the first rate hike. This probably tempered some of the shift in the dovish direction.

Nonetheless, we expect the minutes of this meeting (21 September) to show greater discussion of the possibility of more QE. We also see a significant chance that another MPC member joins Adam Posen in voting for another round of quantitative easing.

### **Why wait?**

If monetary policy is supposed to be pre-emptive and the downside risks to the Bank's projections are materialising — why wait? There are a number of issues that may be holding the MPC back at this stage:

- On October 5<sup>th</sup> there will be significant revisions to the GDP data (the Bank expects substantial upward revisions). The MPC is likely to want to await and digest this news before taking the extreme step of restarting QE — that is likely to delay a move until November;
- Survey indicators suggest a risk of weak Q3 GDP. However, surveys have not always been reliable. The MPC is likely to want to await the initial estimate of Q3 GDP on 1 November;
- To take such an extreme step as to restart QE would normally be left for an *Inflation Report* month;
- The Bank's 2-year-ahead inflation forecast is sub-target, but not as low as it was during QE1. Similarly, growth is disappointing, but not as downbeat as during QE1; and
- The Bank has limited ammunition. Although the outlook is concerning, it is not yet an emergency. There may be a case in holding back what ammunition the Bank has left until it is really needed.

Clearly there are counter arguments to the above and indeed the case for whether QE is a good idea in the first place. In particular, we believe that the biggest drag on growth at the moment is inflation since this is eroding household real purchasing power and hence holding back consumption. If QE were to weaken the exchange rate or add to inflation, there is a case for arguing that it actually holds back GDP growth. Ultimately though, forecasting the BoE on the basis of what one thinks the MPC *should* do is likely to be wrong 90% of the time.

### **When and how much?**

The latest consensus showed a minority of forecasters expect QE to restart (7 out of 60 forecasters). Moreover, of those, only the minority expected QE to restart this side of Christmas (3). Given the potential for an extra dissenter at this meeting, that could provoke speculation that QE will start sooner than most expect.

Furthermore, of those forecasters who expect QE, the average of those forecasters is for only a GBP50bn expansion. Our view is that if QE2 does begin, then the scale of asset purchases is likely to be much bigger — more like GBP100bn. The Bank has already explicitly signalled that asset purchases are likely to be less effective during a second phase of QE. Moreover, throughout QE1 the consensus persistently underestimated the scale of asset purchases.

### **Conclusion**

The MPC minutes have told us that if downside risks to its outlook materialise then it is likely to restart QE. These risks have begun to materialise. We expect more of the same so it is looking increasingly like it is a case of when rather than if QE2 begins. We see a significant chance that another MPC member dissented in favour of QE at this meeting. If that is confirmed then we suspect speculation will begin to build that QE2 will begin before year end and in bigger size than the current consensus forecasts.

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### **ECB Meeting Sept. 2011 — ECB Confirms Status Quo On Rates & Shifts To The Dovish Side**

- Mr. Trichet confirmed that there will be no further rate hikes by neglecting to use the “strong vigilance” code word. The indication that the decision to leave rates unchanged this week was unanimous and the tone of the statement hint that the ECB will maintain the status quo for the time being.
- In the meantime, the central bank’s growth projections were cut significantly, with the risks seen on the downside. Inflation projections remained unchanged, but the risks to price stability are now judged as “balanced”. These two changes in the balance of risks are mentioned by Mr. Trichet as major changes, suggesting that the ECB is shifting into a dovish mode, and they could create more room to manoeuvre to cut rates to adjust to the economic slowdown if needed.
- Our expectation for a reacceleration of EMU inflation as of September due to higher energy prices and some upward payback after artificially low inflation numbers, as well as the turnover in the ECB presidency with Mr. Draghi taking the position in November, points nonetheless for a status quo over the coming months. However, if activity remains depressed the risk of rate cuts early in 2012 when inflation is expected to cool down could increase significantly.

#### ***The ECB shifts to a dovish stance***

At the ECB press conference, there were numerous indications in our view that the central bank is now in status quo mode. First, Mr. Trichet emphasised that the decision to leave rates unchanged was unanimous. Second, while he failed to answer questions regarding whether there were any talks of a rate change, he did mention the multiple dimensions of the meeting this week. Finally, he also indicated that the central bank will conduct thorough analysis ahead remains warranted.

We have previously mentioned (“*ECB Meeting Preview*”, 06/09/11) that growth projections were likely to be cut, while there would be little change in inflation projections. That is exactly what the ECB announced. Indeed, GDP growth is now expected to be in the range of 1.4% to 1.8% for this year and 0.4% and 2.2% for next, meaning mid-points of 1.6% and 1.3%. Compared to the last June projection, these are downward revisions of 0.3% and 0.4%, respectively. Just for this year, given the carry at the end of H1, a 1.6% GDP growth rate would suggest almost flat quarterly growth in H2.

The range of the inflation projections were tightened as is usually the case when the time horizon is shortened, but the mid-points remained unchanged vs. June. For this year, inflation is expected to hover between 2.5% and 2.7%, so unchanged at 2.6% while the range for next year is between 1.2% and 2.2%, with a mid-point of 1.7%, in line with three month ago.

Beyond these forecast changes, the most interesting fact — and pinpointed by Mr. Trichet — is that the balance of risks on both the growth and inflation fronts have changed significantly compared to the beginning of August. Risks to growth are seen on the downside vs. balanced previously while risks to inflation are now balanced vs. tilted to the upside previously. These changes are key indications in our view that the central bank has shifted to a dovish stance.

#### ***Where do we stand now? The angle from a policy reaction index***

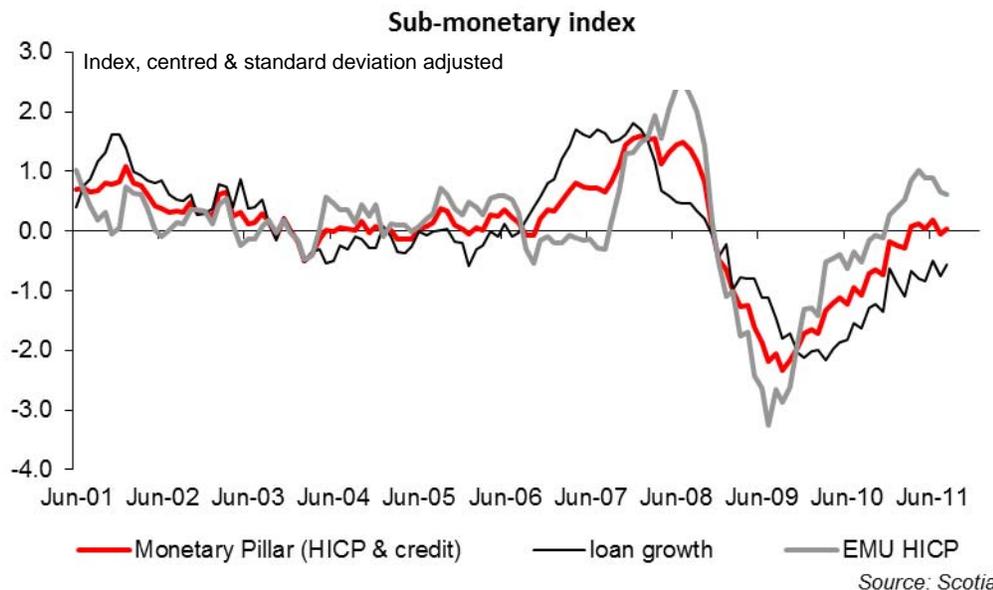
We try to assess the direction of ECB monetary policy by building a policy reaction index. This index is based on two sub-indices, both having the same weight in the policy making decision process: a monetary index and an activity index. While the ECB president constantly reiterates in press conferences that the ECB has only one anchor, which is price stability, he also emphasises that the assessment of risks to price stability is done through the evaluation of many indicators.

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ECB Macroeconomic Projections											
Sept 2011 (latest)							Consensus (end-August)		Scotia		
	2010	2011		2012		2011 mid	2012 mid	2011	2012	2011	2012
HICP	1.6	2.5	to 2.7	1.2 to 2.2		2.6	1.7	2.7	1.6	2.7	1.6
GDP	1.7	1.4	to 1.8	0.4 to 2.2		1.6	1.3	1.7	1.4	1.7	1.4
Jun 2011 (previous)							2011 mid	2012 mid			
	2010	2011		2012		2011 mid	2012 mid				
HICP	1.6	2.5	to 2.7	1.1 to 2.3		2.6	1.7				
GDP	1.7	1.5	to 2.3	0.6 to 2.8		1.9	1.7				
Revisions Sept-Jun							2011 mid	2012 mid			
	2010	2011		2012		2011 mid	2012 mid				
HICP	0.0	0.0	to 0.0	0.1 to -0.1		0.0	0.0				
GDP	0.0	-0.1	to -0.5	-0.2 to -0.6		-0.3	-0.4				

It is true that monetary indicators have been at the forefront of the ECB’s assessment of the risks to price stability. Numerous comments from the ECB and working papers have emphasised the need to watch carefully figures like M3 growth to assess possible medium-term risks to price stability and, to some extent, the risk of an asset price bubble which is a key difference with the Fed. However, the ECB has also turned more pragmatic with the release of studies indicating that M3 growth could be distorted by strong portfolio shifts, especially when monetary policy experiences strong swings. Working papers also indicated that there exists a high risk of medium-term inflation when both M3 and credit growth are strong, while the risk is more limited when there is only M3 growth. These changes could be seen by 1/ the fact that the comments on M3 growth at each press conference came after the comments on the assessment on the activity while previously (from 1999 to April 2003), these comments were always first and mentioned as the first pillar; 2/ the fact that this comment on M3 growth is always associated with a comment on credit growth.

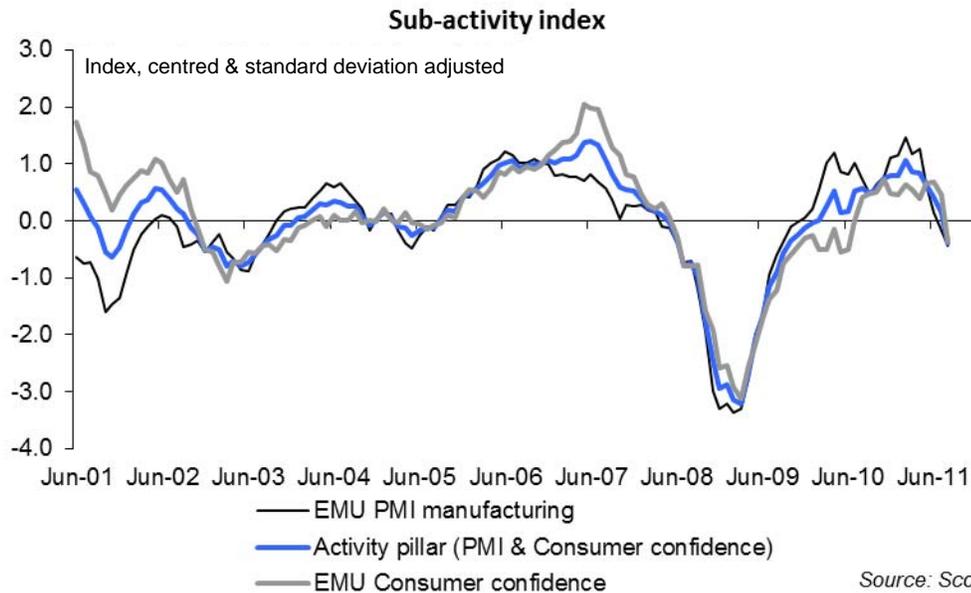
So, half of our sub-monetary index is therefore based on the trend of harmonized inflation vs. 2% (the ECB inflation target), while the other 50% is based on the rate of loan growth vs. its long term average (5.6% y/y from 2001/2010).



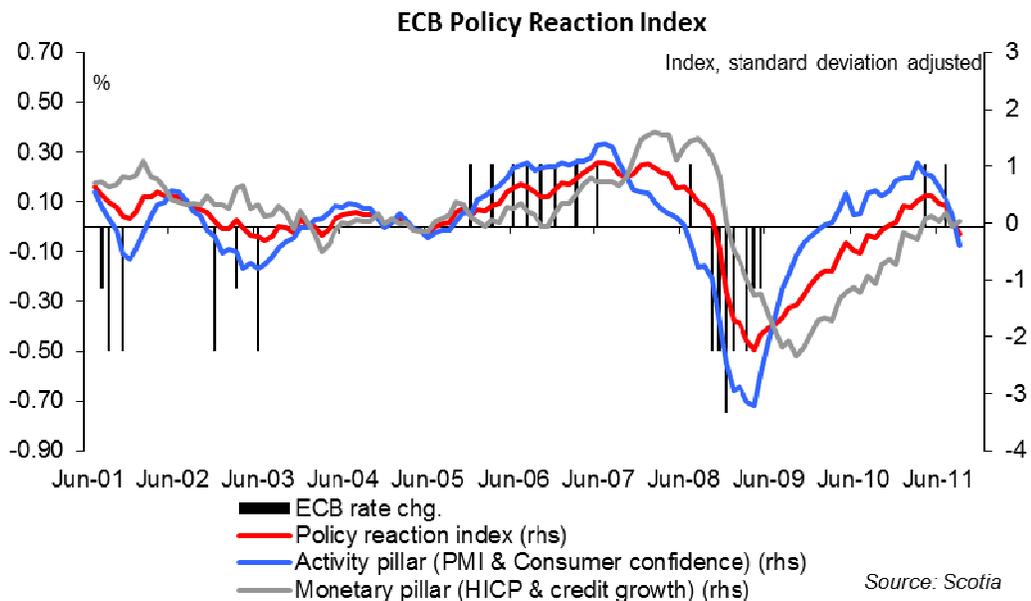
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The fact that the comments on activity have since May 2003 taken precedence at the press conference is an indication that the ECB, like any central bank, is watching closely all signals on this point. In building up our sub-activity index, we decided to take into account the EMU PMI manufacturing index vs. its long term average (51.3 for 2001/2010), as well as the EMU consumer confidence index vs. its long term average (-14 for 2001/2010). In this way we cover both the signals sent by the supply and the demand sides of the economy.



Finally, we aggregate our simple ECB monetary policy reaction index by combining the sub-monetary index and the sub-activity index, both with equal weights. The index is then centered & standard deviation-adjusted which means that when it moves into positive territory, the probability to see a more hawkish stance and rate hikes is increased. It is of course the reverse when the index shifts into negative territory.



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In this regard, we can see that the decision to start normalizing monetary policy away from the low of 2.0% back in December 2005 followed signals sent by the sub-monetary and the sub-activity indices, both of which were slightly positive. This trend was confirmed all the way up until the summer of 2007 and was accompanied by regular rate hikes. The uncertainty on the impact of the financial turmoil back in 2007 forced the ECB to freeze its monetary policy for all H1 2008 despite our index still largely sitting in positive territory, but we can see that the surprising rate hike in July 2008 has to be viewed from the angle of an ongoing upside risk to price stability while the activity data were about to turn negative. More recently, it is mainly the acceleration of the activity in 2010 and a normalization of inflation away from deflation which helped our policy reaction index to turn positive at the beginning of this year, opening the door again for more hawkish stance and rate hikes in April.

### **Confirming ECB status quo.**

Over the past three months, the sub-activity index has turned down quickly and moved into negative territory with both the PMI manufacturing and EMU consumer confidence (respectively at 49 and -16.5 in August) moving below their respective long-term average. The sub-monetary index has remained roughly stable, around the zero line as weak loan growth (0.9% y/y in July) is compensated by EMU inflation above the 2% line (2.5% y/y in August). As a whole, the policy reaction index is now back to zero or even slightly negative, justifying the current freezing of monetary policy with a dovish bias.

### **Could we see the ECB cutting rates?**

Our ECB rate scenario is for a status quo up to the end of next year, which seems to be confirmed by Thursday's ECB statement. However, it is true that the shift in the balance of risks to neutral for price stability clearly increases the capacity of the ECB to adjust its rate policy with the downside risk to growth. Our expectation that EMU inflation will reaccelerate closer to 2.9%/3.0% in September/October on the back of rebounding energy prices and some upward payback after artificially low inflation numbers during the sales period this summer could nonetheless limit the willingness of the ECB to cut rates in the very short term. Also, with Mr. Draghi taking charge of the ECB in November, there could also be few months of a "wait and see" attitude. However, if the activity data continues to remain depressed, the risk of a rate cut early in 2012 when inflation is expected to cool down could increase significantly.

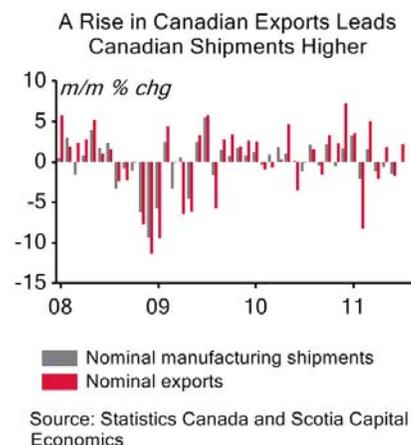
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## Key Data Preview

### CANADA

We should witness a strong rebound in **manufacturing sales** (Thursday) in July for several reasons. First, given the tight correlation between nominal exports and nominal manufacturing sales, the 2.2% increase in exports in this past week's trade report suggests at least a 1%+ m/m gain in manufacturing sales during the month. Second, given that manufacturing sales declined by 1.5% m/m in June, there is an added base effect in play in July. Third, after several months of weak auto production following the Japanese disasters in mid-March, July witnessed a rebound in production in North America after supply chain constraints diminished sharply as Japan focused on rebuilding after the devastating events. Given that autos account for about 11.4% of overall shipments, this could provide a decent lift to the July headline print, especially since auto exports jumped 7.6% m/m in July and auto shipments tend to follow behind exports. Crude oil shipments should also help to prop up overall numbers in July — also accounting for roughly 11% of overall shipments — after exports of the same product rose in July. In addition, price-adjusted shipments should rebound in July after three months of weakness with autos accounting for much of the gain. This will provide even further support to monthly real GDP which is already being bolstered by a strong gain in home construction and aggregate hours worked. This raises questions regarding the sustainability of monthly GDP gains going forward, and how well they translate into q/q GDP growth (see “Canadian Business Investment Will Probably Fall in Q3 — Adding to Growth Risks” on pages 4-6 for a more detailed quarterly picture).



### UNITED STATES

Consensus is looking for a gain in both headline and core **US retail sales** (Wednesday) in August but we don't see how that could come to pass with our own estimates looking for a slight negative on both measures. Not only did incomes decline in August, with both wages and hours worked down for the first time in over a year, but consumer confidence also took a huge hit at the end of July and into August on the back of a substantial global market sell-off that likely pushed many consumers to the sidelines. Add to this the fact that autos dipped slightly during the month after a 7% m/m gain in July, gasoline prices fell a further 1% m/m and weekly ISCS chain store sales declined by 1.8% m/m on the month — all pointing to a decline in headline retail sales as well. What will matter more, however, is the price-adjusted results. Perhaps the saving grace will be on discounting if retailers are able to increase volumes which could provide some support to real sales in August. However, if consumers are staying away from the malls, then the foot traffic may not be sufficient. Nonetheless, there is a risk to our forecast which is the impact of Hurricane Irene. Given how late in the month it hit the US coast, making landfall on the outer banks of North Carolina on August 27th and moving to New York the following day, there is an uncertainty as to how the pre-spending and post-weakness will play into these numbers given that this advanced report is based on responses within the first two weeks of the month. The final report, however, may be more telling as all of the answers are tallied up, including responses from the latter half of the month.

**US industrial production** (Thursday) is set to increase once again in August although the magnitude of growth will be more modest than in July. Nonetheless, autos will likely be behind some of the gains once again — autos were a main support to overall production in July — as auto production continues to ramp up after supply chain constraints halted production through the Spring. Strong exports in July will also provide a lift to industrial production in August. There is a risk to this forecast, however, as manufacturing production shrank in August, according to the ISM manufacturing index, on the back of a contraction in new manufacturing orders and an expansion in inventories, putting downward pressure on overall industrial production during the month and suggesting that growth will come ex-manufacturing sectors.

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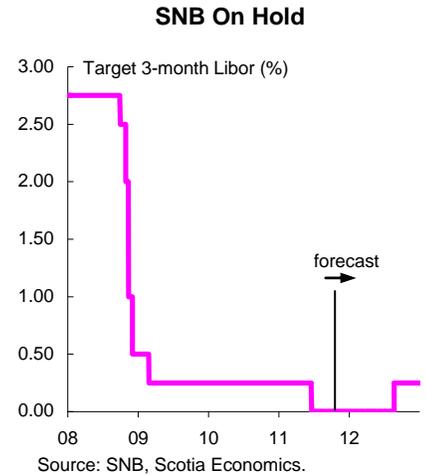
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**EUROPE**

Swiss monetary authorities will likely leave the target range for the 3-month Libor rate unchanged next week at “as close to zero as possible”. In its latest bid to contain what it believes to be extreme Swiss franc overvaluation (the franc reached a high of 1.03 against the euro in early August), on September 6 the Swiss National Bank (SNB) announced an exchange rate floor of CHF 1.20 per euro, which it stands prepared to defend with ‘unlimited’ foreign currency buying. Although exports have recently begun to suffer under the strong CHF — contracting 3.0% m/m in July — the Swiss economy has performed relatively well through the global and Eurocentric turbulence of the last several months. Second quarter real GDP expanded by a healthy 0.4% q/q (non-annualized), and the unemployment rate is among the lowest in Europe, at 3.0%. We expect output to advance at a rate near 2% through 2012. Deflationary concerns persist however, fueled by the latest CPI reading which showed a 0.3% y/y contraction in the harmonized measure in August. We do not foresee the inflation rate much in excess of 1.0% in the medium term, as the SNB will maintain a highly accommodative monetary stance until 2012Q3, when a 25 basis point hike will mark a gradual return to more normal conditions.



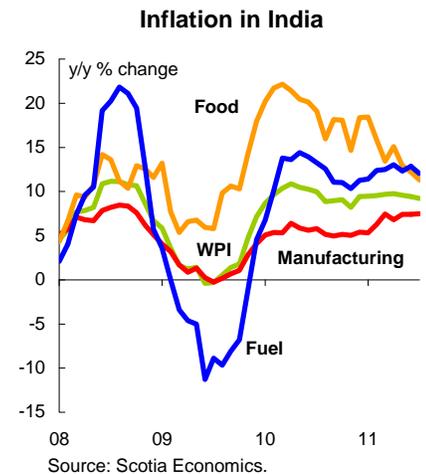
**LATIN AMERICA**

Mexican industrial production (IP) for July will be released on September 12<sup>th</sup> and we expect the report to show continued positive performance, though at a slower pace. Amid concerns regarding the impact of the US economic slowdown, industrial production has regained local markets’ attention. In June, IP expanded by 3.7% y/y, its 19<sup>th</sup> consecutive y/y advance; however, on a monthly basis output decreased by 0.57%. The construction sector surprised with an increase of 4.6% y/y, which could help IP to maintain positive momentum in the coming months; nevertheless, the manufacturing sector is losing strength. We expect IP to advance 3.6% y/y in July and 3.9% in 2011 as a whole.



**ASIA**

India’s yearly wholesale price inflation (WPI) likely remained elevated in August, with fuel costs continuing to advance at a double-digit annual pace, contrasting with food price gains which advanced at a more moderate (single-digit) yearly pace. The increase in fuel, and therefore transport costs, is linked not only to relatively elevated global oil prices but also to the withdrawal of public subsidies in an attempt to streamline Indian government finances. We estimate that WPI inflation remained elevated (over 9% y/y) in August, with some chance of it coming down slightly. The observation that will attract the most attention from monetary policymakers in India will be the transmission to manufacturing product prices, which continue on an upward trend. Evidence of this is likely to prompt the Reserve Bank of India to raise the benchmark repo rate an additional 25 basis points at the upcoming monetary board meeting.



## Key Indicators for the week of September 12 - 16

North America								
Country	Date	Time	Event	Period	BNS	Consensus	Latest	
MX	09/12	09:00	Industrial Production (YoY)	JUL	3.64	3.35	3.67	
MX	09/12	09:00	Industrial Production (MoM)	JUL	--	--	-0.6	
MX	09/12	09:00	Gross Fixed Investment (YoY)	JUN	--	--	9.1	
MX	SEP 12-16		Vehicle Exports (AMIA) (units)	AUG	--	--	177843	
MX	SEP 12-16		Vehicle Domestic Sales (AMDA) (units)	AUG	--	--	68533	
MX	SEP 12-16		Vehicle Production (AMIA) (units)	AUG	--	232000	209534	
US	09/13	08:30	Import Price Index (MoM)	AUG	--	-0.8	0.3	
MX	09/13	10:00	Central Bank Announces International Reserves for Prev. Week					
US	09/13	14:00	Monthly Budget Statement (USD billions)	AUG	--	-130	-129	
US	09/14	07:00	MBA Mortgage Applications (WoW)	9-Sep	--	--	-4.9	
CA	09/14	08:30	Capacity Utilization Rate (%)	2Q	--	78	79.0	
US	09/14	08:30	Producer Price Index (MoM)	AUG	--	-0.1	0.2	
US	09/14	08:30	PPI Ex Food & Energy (MoM)	AUG	--	2.5	2.5	
US	09/14	08:30	Advance Retail Sales (MoM)	AUG	-0.1	0.2	0.5	
US	09/14	08:30	Retail Sales Less Autos (MoM)	AUG	-0.1	0.2	0.5	
US	09/14	08:30	Retail Sales Ex Auto & Gas (MoM)	AUG	--	0.3	0.3	
US	09/14	10:00	Business Inventories (MoM)	JUL	--	0.5	0.3	
CA	09/15	08:30	Manufacturing Sales (MoM)	JUL	1.6	1.5	-1.5	
US	09/15	08:30	Consumer Price Index (MoM)	AUG	0.1	0.2	0.5	
US	09/15	08:30	CPI Ex Food & Energy (MoM)	AUG	0.1	0.2	0.2	
US	09/15	08:30	Consumer Price Index (YoY)	AUG	3.6	3.6	3.6	
US	09/15	08:30	CPI Ex Food & Energy (YoY)	AUG	1.7	1.9	1.8	
US	09/15	08:30	Current Account Balance (USD billions)	2Q	--	-123	-119	
US	09/15	08:30	Empire Manufacturing Index	SEP	-4.0	-3.5	-7.7	
US	09/15	08:30	Initial Jobless Claims (000s)	9-Sep	415	410	414	
US	09/15	08:30	Continuing Claims (000s)	3-Sep	3720	3710	3717	
US	09/15	09:15	Industrial Production (MoM)	AUG	0.2	0.1	0.9	
US	09/15	09:15	Capacity Utilization (%)	AUG	77.6	77.5	77.5	
US	09/15	10:00	Philadelphia Fed. Index	SEP	-20.0	-15.0	-30.7	
CA	09/16	08:30	Int'l Securities Transactions (CAD billions)	JUL	--	--	-3.5	
US	09/16	09:00	Net Long-term TIC Flows (USD billions)	JUL	--	--	3.7	
US	09/16	09:00	Total Net TIC Flows (USD billions)	JUL	--	--	-29.5	
US	09/16	09:55	U. of Michigan Confidence Index	SEP P	--	56.5	55.7	
US	09/16	12:00	Flow of Funds					

Forecasts at time of publication.

Source: Bloomberg, Scotia Economics.

## Key Indicators for the week of September 12 - 16

Europe								
Country	Date	Time	Event	Period	BNS	Consensus	Latest	
SP	09/12	03:00	House transactions (YoY)	JUL	--	--	-22.9	
IT	09/12	04:00	Industrial Production sa (MoM)	JUL	--	0.0	-0.6	
PO	09/12	05:00	Consumer Price Index (MoM)	AUG	--	--	-0.1	
PO	09/12	05:00	CPI - EU Harmonised (MoM)	AUG	--	--	0.1	
UK	09/12	19:01	RICS House Price Balance	AUG	-20.0	-23.0	-22.0	
FR	09/13	01:30	CPI - EU Harmonised (MoM)	AUG	0.5	0.3	-0.5	
FR	09/13	01:30	CPI - EU Harmonised (YoY)	AUG	2.3	2.2	2.1	
FR	09/13	02:45	Current Account (EUR billions)	JUL	--	--	-3.4	
SP	09/13	03:00	CPI (EU Harmonised) (MoM)	AUG	-0.1	-0.1	-1.2	
SP	09/13	03:00	CPI (EU Harmonised) (YoY)	AUG F	2.7	2.7	2.7	
SP	09/13	03:00	CPI (Core Index) (MoM)	AUG	--	0.2	-0.9	
SP	09/13	03:00	CPI (Core Index) (YoY)	AUG	--	1.5	1.6	
SW	09/13	03:30	CPI - Headline Rate (MoM)	AUG	--	0.0	0.0	
SW	09/13	03:30	CPI - Headline Rate (YoY)	AUG	--	3.3	3.3	
UK	09/13	04:30	DCLG UK House Prices (YoY)	JUL	--	-1.2	-2.0	
UK	09/13	04:30	Visible Trade Balance (GBP millions)	JUL	-9100	-8500	-8873	
UK	09/13	04:30	Total Trade Balance (GBP millions)	JUL	-4600	-4200	-4496	
UK	09/13	04:30	CPI (MoM)	AUG	0.5	0.6	0.0	
UK	09/13	04:30	CPI (YoY)	AUG	4.5	4.5	4.4	
UK	09/13	04:30	Core CPI (YOY)	AUG	3.0	3.0	3.1	
UK	09/13	04:30	RPI (MoM)	AUG	0.5	0.6	-0.2	
UK	09/13	04:30	RPI (YoY)	AUG	5.0	5.1	5.0	
UK	09/13	04:30	RPI Ex Mort Int.Payments (YoY)	AUG	5.2	5.2	5.0	
UK	09/14	04:30	Claimant Count Rate (%)	AUG	5.0	5.0	4.9	
UK	09/14	04:30	Jobless Claims Change (000s)	AUG	30.0	35.0	37.1	
UK	09/14	04:30	Average Weekly Earnings (3M/YoY)	JUL	2.7	2.7	2.6	
UK	09/14	04:30	Weekly Earnings exBonus (3M/YoY)	JUL	2.1	2.1	2.2	
UK	09/14	04:30	ILO Unemployment Rate (% 3mths)	JUL	7.9	7.9	7.9	
EC	09/14	05:00	Euro-Zone Ind. Prod. sa (MoM)	JUL	1.6	1.5	-0.8	
SW	09/15	03:30	Unemployment Rate (%)	AUG	--	6.8	6.9	
SZ	09/15	03:30	<b>SNB 3-Month Libor Target Rate</b>		0.0	0.0	0.0	
IT	09/15	04:00	CPI - EU Harmonized (MoM)	AUG F	0.3	0.3	0.3	
IT	09/15	04:00	CPI - EU Harmonized (YoY)	AUG F	2.2	2.2	2.2	
UK	09/15	04:30	Retail Sales Ex Auto Fuel(MoM)	AUG	-0.1	-0.2	0.2	
UK	09/15	04:30	Retail Sales w/Auto Fuel (MoM)	AUG	-0.1	-0.3	0.2	
EC	09/15	05:00	Euro-Zone CPI - Core (YoY)	AUG	--	1.2	1.2	
EC	09/15	05:00	Euro-Zone CPI (MoM)	AUG	0.2	0.2	-0.6	
EC	09/15	05:00	Euro-Zone CPI (YoY)	AUG	2.5	2.5	2.5	
EC	09/15	05:00	Eurozone Employment (QoQ)	2Q	--	--	0.1	
IT	09/15	05:00	Current Account (EUR millions)	JUL	--	--	-4252.0	
SP	09/16	03:00	Labour Costs (YoY)	2Q	--	--	0.8	
EC	09/16	04:00	ECB Euro-Zone Current Account (EUR billions) SA	JUL	--	--	-7.4	
IT	09/16	04:00	Trade Balance (Total) (EUR millions)	JUL	--	--	-1829.5	
EC	09/16	05:00	Euro-Zone Labour Costs (YoY)	2Q	--	--	2.6	
EC	09/16	05:00	Euro-Zone Trade Balance (EUR millions) SA	JUL	--	--	-1600.0	
UK	SEP 16-23		Nationwide Consumer Confidence Index	AUG	--	48.0	49.0	

Forecasts at time of publication.

Source: Bloomberg, Scotia Economics.

## Key Indicators for the week of September 12 - 16

## Asia Pacific

Country	Date	Time	Event	Period	BNS	Consensus	Latest
CH	SEP 09-15		Actual FDI (YoY)	AUG	--	--	19.8
CH	SEP 09-10		Trade Balance (USD)	AUG	22.4	24.6	31.5
CH	SEP 09-10		Exports (YoY)	AUG	21.5	21.9	20.4
CH	SEP 09-10		Imports (YoY)	AUG	23.1	21.0	22.9
CH	SEP 10-15		New Yuan Loans (CNY billions)	AUG	495.0	500.0	492.6
NZ	09/11	18:45	Manufacturing Activity (QoQ)	2Q	--	--	2.9
NZ	09/11	18:45	Manufacturing Activity Volume SA (QoQ)	2Q	--	1.0	1.9
JN	09/11	19:50	Tertiary Industry Index (MoM)	JUL	--	0.2	1.9
JN	09/11	19:50	Domestic CGPI (MoM)	AUG	--	-0.2	0.2
JN	09/11	19:50	Domestic CGPI (YoY)	AUG	--	2.7	2.9
AU	09/11	21:30	Trade Balance (AUD millions)	JUL	--	1900.0	2052.0
JN	SEP 11-16		Nationwide Dept. Sales (YoY)	AUG	--	--	0
JN	SEP 11-16		Tokyo Dept. Store Sales (YoY)	AUG	--	--	-1.3
JN	SEP 11-16		Machine Tool Orders (YoY)	AUG P	--	--	15.3
IN	09/12	01:30	Industrial Production (YoY)	JUL	--	6.2	8.8
PH	09/12	21:00	Total Exports (YoY)	JUL	--	-6.8	-9.4
PH	09/12	21:00	Total Monthly Exports (USD millions)	JUL	--	--	4128.0
JN	09/14	00:00	Tokyo Condominium Sales (YoY)	AUG	--	--	-1.3
JN	09/14	00:30	Industrial Production (MoM)	JUL F	--	--	0.6
JN	09/14	00:30	Capacity Utilization (MoM)	JUL	--	--	5.2
IN	09/14	02:30	Monthly Wholesale Prices (YoY)	AUG	9.5	9.6	9.2
NZ	09/14	17:00	<b>RBNZ Official Cash Rate</b>	15-Sep	2.50	2.50	2.50
NZ	09/14	18:30	Business NZ PMI	AUG	--	--	53.2
PH	09/14	21:00	Unemployment Rate (%)	JUL	--	--	7.2
AU	09/14	21:30	New Motor Vehicle Sales (MoM)	AUG	--	--	8.6
AU	09/14	21:30	RBA Foreign Exchange Transactn (AUD millions)	AUG	--	--	605
HK	09/15	04:30	Industrial Production (YoY)	2Q	--	--	3.5
HK	09/15	04:30	Producer Price (YoY)	2Q	--	--	8.2
SK	09/15	17:00	Export Price Index (MoM)	AUG	--	--	-1.3
SK	09/15	17:00	Import Price Index (MoM)	AUG	--	--	-1.1
IN	09/16	02:30	India REPO Cutoff Yld (%)	16-Sep	8.25	8.25	8.00
IN	09/16	02:30	Cash Reserve Ratio (%)	16-Sep	--	6.0	6.0
IN	09/16	02:30	Reverse Repo Rate (%)	16-Sep	--	7.3	7.0

## Latin America

Country	Date	Time	Event	Period	BNS	Consensus	Latest
BZ	09/12	07:30	Central Bank Weekly Economists Survey				
CL	09/12	08:30	Central Bank Economist Survey				
BZ	09/13	08:00	Retail Sales (MoM)	JUL	--	0.7	0.2
BZ	09/13	08:00	Retail Sales (YoY)	JUL	--	5.9	7.1
BZ	09/13	08:00	Broad Retail Sales (YoY)	JUL	--	--	9.5
CO	09/13	17:00	Trade Balance (USD millions)	JUL	--	--	378.3
BZ	SEP 14-21		Economic Activity Indx (MoM) SA	JUL	--	--	-0.3
BZ	SEP 14-21		Economic Activity Indx (YoY) NSA	JUL	--	--	2.9
CL	09/15	17:00	<b>Nominal Overnight Rate Target</b>	15-Sep	5.25	5.25	5.25
PE	09/15		GDP (YoY) NSA	JUL	--	5.3	5.3
PE	09/15		Unemployment Rate (%)	AUG	--	--	7.00
PE	09/16		Central Bank Quarterly Inflation Report				

Forecasts at time of publication.

Source: Bloomberg, Scotia Economics.

## Global Auctions for the week of September 12 - 16

## North America

<u>Country</u>	<u>Date</u>	<u>Time</u>	<u>Event</u>
US	09/12	11:30	U.S. to Sell 3-Month Bills
US	09/12	11:30	U.S. to Sell 6-Month Bills
US	09/12	13:00	U.S. to Sell 3-Year Notes
CA	09/13	10:30	Canada to Sell CAD8.90 Bln 98-Day Bills
CA	09/13	10:30	Canada to Sell CAD3.30 Bln 168-Day Bills
CA	09/13	10:30	Canada to Sell CAD3.30 Bln 350-Day Bills
US	09/13	11:30	U.S. to Sell 4-Week Bills
US	09/13	13:00	U.S. to Sell 10-Year Notes Reopening
CA	09/14	12:00	Canada to Sell 2-Year Notes
US	09/14	13:00	U.S. to Sell 30-Year Bonds Reopening

## Europe

<u>Country</u>	<u>Date</u>	<u>Time</u>	<u>Event</u>
IT	09/12	05:00	Italy to Sell Bills
GE	09/12	05:15	Germany to Sell EU4 Bln 6-Mth Bills
FR	09/12	09:00	France to Sell Bills
EC	09/12	09:30	ECB Calls for Bids in 7-Day Main Refinancing Tender
EC	09/12	09:30	ECB Calls for Bids in 1-Month Tender
EC	09/12	09:30	ECB Announces Bond Purchases
NE	09/13	04:00	Netherlands to Sell Up to EUR 2.5Bln 3.25% 2021 Bond
IT	09/13	05:00	Italy to Sell 4.75% 2016 Bonds
IT	09/13	05:00	Italy to Sell 4.5% 2018 Bonds
IT	09/13	05:00	Italy to Sell 4.5% 2020 Bonds
IT	09/13	05:00	Italy to Sell 4% 2020 Bonds
SZ	09/13	05:30	Switzerland to Sell 3-Month Bills
BE	09/13	05:30	Belgium to Sell Bills
IC	09/13	07:45	Iceland to Sell Bills
EC	09/13	05:15	ECB Announces Allotment in 7-Day Main Refinancing Tender
EC	09/13	05:15	ECB Announces Allotment in 1-Month Tender
EC	09/13	07:00	ECB Announces Allotment in 7-Day Term Deposits
EC	09/13		ECB's Reserve Maintenance Period Ends
SW	09/14	05:10	Sweden to Sell Bills
GE	09/14	05:15	Germany to Sell Add'l EU5 Bln 2-Year Notes
SZ	09/14	05:30	Switzerland to Sell Bonds
EC	09/14	03:15	ECB Calls for Bids in 7-Day Dollar Tender
EC	09/14	05:00	ECB Announces Allotment in 7-Day Dollar Tender
SP	09/15	04:30	Spain to Sell 4.6% 2019 Bonds
SP	09/15	04:30	Spain to Sell 5.5% 2021 Bonds
FR	09/15	05:00	France to Sell Bonds/Notes
SW	09/15	05:10	Sweden to Sell I/L Bonds
UK	09/15	05:30	U.K. to Sell GBP900 Mln 0.75% I/L 2047 Bonds
SW	09/16	05:10	Sweden to Exchange I/L Bonds
UK	09/16	06:10	U.K. to Sell Bills

## Asia Pacific

<u>Country</u>	<u>Date</u>	<u>Time</u>	<u>Event</u>
JN	09/12	23:35	Japan to Sell 1-Year Bills
JN	09/12	23:45	Japan to Sell 20-Year Bond
CH	09/13	23:00	China to Sell 1 Year Bond
JN	09/13	23:35	Japan to Sell 3-Month Bills
JN	09/15	04:00	Japan Auction for Enhanced-Liquidity
CH	09/15	23:00	China to Sell 182D Bills
JN	09/15	23:35	Japan to Sell 2-Month Bills

Source: Bloomberg, Scotia Economics.

## Events for the week of September 12 - 16

## North America

<u>Country</u>	<u>Date</u>	<u>Time</u>	<u>Event</u>
US	09/12	16:00	Fed's Fisher Speaks on Monetary Policy in Dallas
US	09/12	20:00	Fed's Bullard Gives Brief Opening Remarks at Fed Event
US	SEP 13-22		United Nations General Assembly's 66th Session
US	09/14	08:30	Secretary Geithner Speaks at Delivering Alpha Conference In NY
CA	09/14	12:00	OSFI's Mark White Speaks on Contingent Capital

## Europe

<u>Country</u>	<u>Date</u>	<u>Time</u>	<u>Event</u>
UK	SEP 09-10		Chinese Vice Premier Wang Qishan Visits U.K.
GE	09/11	04:00	Merkel, Wulff Attend Berlin Service to Mark Sept. 11 Attacks
UK	09/12	02:00	Independent Commission on Banking Issues Final Report
EC	09/12	05:00	EU Issues Annual Report on Public Finances
GE	09/12	08:00	Merkel Addresses 'International Peace Gathering' in Munich
EC	09/12		EU Foreign Ministers Meet in Brussels
IT	09/13	05:00	Istat President Giovanni Presents Italy's 2011 Census
GE	09/13	05:30	German Finance Minister Schaeuble Speaks in Munich on Global Crisis
GE	09/13	07:15	German Economy Minister Roesler Gives Speech on Promoting Infrastructure Projects
IT	09/14	05:00	Bank of Italy Releases July Public Finance Supplement
EC	SEP 15-16		EU Finance Ministers, Central Bankers Meet in Wroclaw, Poland for Eurofi Financial Forum
EC	09/15	02:30	EU's Almunia Speaks at Eurofi Forum in Wroclaw, Poland
EC	09/15	03:30	ECB's Praet Moderates Panel at Eurofi in Wroclaw, Poland
SZ	09/15	03:30	SNB 3-Month Libor Target Rate
EC	09/15	05:15	European Commission Releases Economic Forecasts
EC	09/15	12:00	EU's Barnier Speaks at Eurofi Forum in Wroclaw, Poland
AS	09/15	12:30	ECB's Stark Speaks in Vienna
EC	09/15	14:00	ECB President Trichet Speaks at Eurofi Forum in Wroclaw, Poland
UK	09/15		Last Day of Parliamentary Session Before Party Conferences
GE	09/16	10:00	Merkel Attends Berlin State Election Campaign Event
IT	09/16		Uil Union May Announce General Strike of Public Employees

## Asia Pacific

<u>Country</u>	<u>Date</u>	<u>Time</u>	<u>Event</u>
JN	09/11	19:50	BOJ to Publish Minutes of Aug. 4-5 Board Meeting
NZ	09/14	17:00	Reserve Bank of New Zealand Monetary Policy Statement

## Latin America

<u>Country</u>	<u>Date</u>	<u>Time</u>	<u>Event</u>
CL	09/15	17:00	Nominal Overnight Rate Target

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	October 25, 2011	1.00	--
Federal Reserve – Federal Funds Target Rate	0.25	September 21, 2011	0.25	--
Banco de México – Overnight Rate	4.50	October 14, 2011	4.50	--

For the most part, the Bank of Canada's rate statement stuck to the script laid out in Governor Carney's dovish House of Commons testimony on August 19th. They provided no signal of rate cuts but sent a strong signal that their bias was to preserve a longer hold than previously planned. As such, Scotia Economics continues to forecast that the BoC will remain on hold until the end of the third quarter of 2012 after which the overnight rate is expected to rise gently toward 2% into 2013. In the U.S., Fed Chairman Bernanke's speech and President Obama's jobs plan released this week offer no reason to alter our current call for the Fed to remain on hold until Q3 2013.

## 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	October 6, 2011	1.50	--
Bank of England – Bank Rate	0.50	October 6, 2011	0.50	0.50
Swiss National Bank – Libor Target Rate	0.00	September 15, 2011	0.00	0.00
Central Bank of Russia – Refinancing Rate	8.25	September 14, 2011	8.25	8.25
Hungarian National Bank – Base Rate	6.00	September 20, 2011	6.00	6.00
Central Bank of the Republic of Turkey – 1 Week Repo Rate	5.75	September 20, 2011	5.75	--

European Central Bank President Trichet's comments in the policy announcement of September 8 confirmed our view of a more dovish ECB stance going forward. We do not expect another rate hike before the first quarter of 2013. The Swiss National Bank will likely maintain the 3-month Libor target rate at "as close to zero as possible" at next week's meeting. For a more detailed analysis, see the Key Data Preview on page A2.

## 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	October 7, 2011	0.10	--
Reserve Bank of Australia – Cash Target Rate	4.75	October 3, 2011	4.75	--
Reserve Bank of New Zealand – Cash Rate	2.50	September 14, 2011	2.50	2.50
People's Bank of China – Lending Rate	6.56	TBA	--	--
Reserve Bank of India – Repo Rate	8.00	September 16, 2011	8.25	8.25
Hong Kong Monetary Authority – Base Rate	0.50	TBA	0.50	--
Central Bank of China Taiwan – Discount Rate	1.88	September 29, 2011	--	--
Bank Negara Malaysia – Overnight Policy Rate	3.00	November 11, 2011	3.00	--
Bank of Korea – Bank Rate	3.25	October 12, 2011	3.25	--
Bank of Thailand – Repo Rate	3.50	October 19, 2011	3.25	--
Bank Indonesia – Reference Interest Rate	6.75	October 11, 2011	6.75	--
Central Bank of the Philippines – Overnight Policy Rate	4.50	October 20, 2011	4.50	--

The Reserve Bank of India (RBI) will likely decide in favour of an additional increase in the benchmark repo rate given that yearly gains in fuel costs remain in the double-digits and continue to permeate into the rest of the economy, with key manufacturing price inflation (core) still on the rise, single-digit gains in food costs notwithstanding. As the RBI focuses on core inflationary pressures there is scant evidence of slowing local demand. The Reserve Bank of New Zealand (RBNZ) will likely take a pass this time around. We expect the RBNZ to withdraw some of the monetary stimulus injected in the first half of 2011 sometime before year-end.

## 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	12.00	October 19, 2011	11.50	--
Banco Central de Chile – Overnight Rate	5.25	September 15, 2011	5.25	5.25
Banco de la República de Colombia – Lending Rate	4.50	September 30, 2011	4.50	--
Banco Central de Reserva del Perú – Reference Rate	4.25	October 6, 2011	4.25	--

We anticipate that the central bank of Chile will likely maintain its monetary policy rate unchanged at 5.25%, despite increasing expectations that monetary conditions could be loosened after Brazil's surprise rate cut. Market participants will pay special attention to the statement's tone in anticipation of a change in stance from neutral to more dovish.

## 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
<b>Output and Inflation (annual % change)</b>								
		<b>Real GDP</b>			<b>Consumer Prices<sup>2</sup></b>			
World <sup>1</sup>	3.6	5.1	3.9	4.2				
Canada	2.1	3.2	2.2	2.1	2.1	1.8	2.7	1.9
United States	1.7	3.0	1.7	2.1	2.6	1.6	2.8	1.9
Mexico	1.7	5.4	3.7	3.5	4.9	4.4	3.6	3.8
United Kingdom	1.7	1.4	1.2	1.5	1.9	3.7	4.4	2.1
Euro zone	1.1	1.7	1.7	1.4	2.0	2.2	2.5	2.0
Japan	0.6	4.0	0.3	3.5	-0.3	-0.4	1.1	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	4.9	5.3	3.1	3.5	3.7	3.3
Brazil	3.3	7.5	4.0	4.5	6.7	5.9	6.5	5.5
Chile	3.7	5.2	6.5	5.5	3.5	1.4	4.0	3.5
Peru	5.2	8.8	6.2	5.6	2.5	2.1	3.8	2.7
<b>Central Bank Rates (% end of period)</b>	<b>11Q1</b>	<b>11Q2</b>	<b>11Q3f</b>	<b>11Q4f</b>	<b>12Q1f</b>	<b>12Q2f</b>	<b>12Q3f</b>	<b>12Q4f</b>
Bank of Canada	1.00	1.00	1.00	1.00	1.00	1.00	1.25	1.75
Federal Reserve	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
European Central Bank	1.00	1.25	1.50	1.50	1.50	1.50	1.50	1.50
Bank of England	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Swiss National Bank	0.25	0.25	0.00	0.00	0.00	0.00	0.25	0.25
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	4.75	5.00	5.00	5.00	5.25	5.25
<b>Exchange Rates (end of period)</b>								
Canadian Dollar (USDCAD)	0.97	0.96	0.96	0.96	0.95	0.95	0.94	0.94
Canadian Dollar (CADUSD)	1.03	1.04	1.04	1.04	1.05	1.05	1.06	1.06
Euro (EURUSD)	1.42	1.45	1.45	1.50	1.48	1.46	1.43	1.40
Sterling (GBPUSD)	1.60	1.61	1.63	1.65	1.66	1.67	1.69	1.70
Yen (USDJPY)	83	81	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	6.3	6.3	6.2	6.1	6.0	5.9
Mexican Peso (USDMXN)	11.9	11.7	12.3	12.3	12.3	12.2	12.3	12.5
Brazilian Real (USDBRL)	1.63	1.56	1.59	1.60	1.61	1.62	1.64	1.65
<b>Commodities (annual average)</b>	<b>2000-09</b>	<b>2010</b>	<b>2011f</b>	<b>2012f</b>				
WTI Oil (US\$/bbl)	51	79	94	97				
Brent Oil (US\$/bbl)	50	80	113	118				
Nymex Natural Gas (US\$/mmbtu)	5.95	4.40	4.40	4.75				
Copper (US\$/lb)	1.78	3.42	4.30	4.30				
Zinc (US\$/lb)	0.73	0.98	1.05	1.06				
Nickel (US\$/lb)	7.11	9.89	11.00	9.35				
Gold, London PM Fix (US\$/oz)	522	1,225	1,635	1,800				
Pulp (US\$/tonne)	668	960	990	1,040				
Newsprint (US\$/tonne)	572	607	648	715				
Lumber (US\$/mfbm)	275	254	255	260				

<sup>1</sup> World GDP for 2000-09 are IMF estimates; 2010e-12f are Scotia Economics' estimates based on a 2010 PPP-weighted sample of 38 countries.

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

<b>Canada</b>	<b>2010</b>	<b>11Q1</b>	<b>11Q2</b>	<b>Latest</b>	<b>United States</b>	<b>2010</b>	<b>11Q1</b>	<b>11Q2</b>	<b>Latest</b>
Real GDP (annual rates)	3.2	3.6	-0.4		Real GDP (annual rates)	3.0	0.4	1.0	
Current Acc. Bal. (C\$B, ar)	-50.9	-40.3	-61.3		Current Acc. Bal. (US\$B, ar)	-471	-477		
Merch. Trade Bal. (C\$B, ar)	-9.0	6.9	-14.4	-9.0 (Jul)	Merch. Trade Bal. (US\$B, ar)	-646	-729	-762	-728 (Jul)
Industrial Production	4.6	5.3	1.5	0.0 (Jun)	Industrial Production	5.3	5.3	3.9	3.9 (Jul)
Housing Starts (000s)	192	178	193	185 (Aug)	Housing Starts (millions)	0.58	0.58	0.57	0.60 (Jul)
Employment	1.4	1.9	1.6	1.4 (Aug)	Employment	-0.8	0.9	0.9	1.0 (Aug)
Unemployment Rate (%)	8.0	7.8	7.5	7.3 (Aug)	Unemployment Rate (%)	9.6	8.9	9.1	9.1 (Aug)
Retail Sales	5.5	2.5	4.1	4.6 (Jun)	Retail Sales	6.8	8.6	8.1	8.9 (Jul)
Auto Sales (000s)	1561	1573	1574	1626 (Jun)	Auto Sales (millions)	11.6	13.0	12.1	12.1 (Aug)
CPI	1.8	2.6	3.4	2.7 (Jul)	CPI	1.6	2.1	3.4	3.6 (Jul)
IPPI	1.0	4.1	5.0	-5.1 (Jul)	PPI	4.2	4.9	7.0	7.2 (Jul)
Pre-tax Corp. Profits	21.2	12.9	14.8		Pre-tax Corp. Profits	25.0	2.8	1.1	
<b>Mexico</b>					<b>Brazil</b>				
Real GDP	5.4	4.6	3.3		Real GDP	6.7	3.8	2.7	
Current Acc. Bal. (US\$B, ar)	-5.7	-4.2	-10.4		Current Acc. Bal. (US\$B, ar)	-47.4	-58.3	-43.5	
Merch. Trade Bal. (US\$B, ar)	-3.0	7.6	5.7	-14.1 (Jul)	Merch. Trade Bal. (US\$B, ar)	20.2	12.6	39.2	46.5 (Aug)
Industrial Production	6.0	5.2	3.4	3.7 (Jun)	Industrial Production	10.5	2.6	0.7	1.4 (Jul)
CPI	4.2	3.5	3.3	3.4 (Aug)	CPI	5.1	6.8	6.5	7.2 (Aug)
<b>Chile</b>					<b>Italy</b>				
Real GDP	5.2	10.0	6.8		Real GDP	1.2	1.0	0.8	
Current Acc. Bal. (US\$B, ar)	3.1	0.7	0.1		Current Acc. Bal. (US\$B, ar)	-0.07	-0.12	-0.09	-0.07 (Jun)
Merch. Trade Bal. (US\$B, ar)	11.6	16.5	15.5	14.6 (Jul)	Merch. Trade Bal. (US\$B, ar)	-39.1	-77.2	-46.1	-31.6 (Jun)
Industrial Production	0.5	11.7	7.8	0.7 (Jul)	Industrial Production	6.5	2.3	2.0	0.3 (Jun)
CPI	1.4	2.9	3.3	3.2 (Aug)	CPI	1.6	2.3	2.7	2.7 (Jul)
<b>Germany</b>					<b>France</b>				
Real GDP	3.6	4.6	2.8		Real GDP	1.4	2.1	1.6	
Current Acc. Bal. (US\$B, ar)	187.6	194.8	158.7	128.4 (Jul)	Current Acc. Bal. (US\$B, ar)	-44.5	-59.7	-106.5	-97.3 (Jun)
Merch. Trade Bal. (US\$B, ar)	201.5	209.3	208.4	173.2 (Jul)	Merch. Trade Bal. (US\$B, ar)	-39.1	-54.3	-52.5	-54.3 (Jul)
Industrial Production	10.1	12.8	7.7	10.3 (Jul)	Industrial Production	5.1	4.8	2.2	3.7 (Jul)
Unemployment Rate (%)	7.7	7.3	7.1	7.0 (Aug)	Unemployment Rate (%)	9.8	9.7	9.7	9.9 (Jul)
CPI	1.1	2.1	2.3	2.4 (Aug)	CPI	1.5	1.8	2.1	1.9 (Jul)
<b>Euro Zone</b>					<b>United Kingdom</b>				
Real GDP	1.7	2.4	1.6		Real GDP	1.4	1.6	0.7	
Current Acc. Bal. (US\$B, ar)	-77	-169	-164	-57 (Jun)	Current Acc. Bal. (US\$B, ar)	-71.6	-74.0		
Merch. Trade Bal. (US\$B, ar)	32.0	-68.5	-9.0	16.0 (Jun)	Merch. Trade Bal. (US\$B, ar)	-153.0	-142.4	-160.3	-172.6 (Jun)
Industrial Production	7.4	6.5	4.0	2.8 (Jun)	Industrial Production	2.1	2.0	-0.8	-0.7 (Jul)
Unemployment Rate (%)	10.1	9.9	9.9	9.9 (Jul)	Unemployment Rate (%)	7.9	7.7		7.9 (May)
CPI	1.6	2.5	2.8	2.5 (Jul)	CPI	3.3	4.1	4.4	4.5 (Jul)
<b>Japan</b>					<b>Australia</b>				
Real GDP	4.0	-0.7	-1.1		Real GDP	2.7	1.0	1.4	
Current Acc. Bal. (US\$B, ar)	195.9	193.9	74.7	149.5 (Jul)	Current Acc. Bal. (US\$B, ar)	-31.8	-41.7	-22.4	
Merch. Trade Bal. (US\$B, ar)	74.8	32.0	-52.8	-19.7 (Jul)	Merch. Trade Bal. (US\$B, ar)	19.3	21.9	45.2	39.6 (Jun)
Industrial Production	16.6	-2.5	-7.0	-1.5 (Jul)	Industrial Production	4.5	-4.7	-3.3	
Unemployment Rate (%)	5.1	4.7	4.6	4.7 (Jul)	Unemployment Rate (%)	5.2	5.0	4.9	5.3 (Aug)
CPI	-0.7	-0.5	-0.4	0.2 (Jul)	CPI	2.8	3.3	3.6	
<b>China</b>					<b>South Korea</b>				
Real GDP	10.3	9.7	9.5		Real GDP	6.2	4.2	3.4	
Current Acc. Bal. (US\$B, ar)	305.4				Current Acc. Bal. (US\$B, ar)	28.2	10.4	22.0	59.3 (Jul)
Merch. Trade Bal. (US\$B, ar)	181.5	-7.4	186.3	377.8 (Jul)	Merch. Trade Bal. (US\$B, ar)	41.2	29.3	33.5	9.9 (Aug)
Industrial Production	13.5	14.8	15.1	13.5 (Aug)	Industrial Production	16.6	11.2	6.7	5.4 (Jul)
CPI	4.6	5.4	6.4	6.2 (Aug)	CPI	3.0	4.5	4.2	5.3 (Aug)

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

Source: Bloomberg, Scotia Economics.

## Interest Rates (% , end of period)

Canada	11Q1	11Q2	Sep/02	Sep/09*	United States	11Q1	11Q2	Sep/02	Sep/09*
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	0.93	0.82	3-mo. T-bill	0.09	0.01	0.02	0.00
10-yr Gov't Bond	3.35	3.11	2.39	2.15	10-yr Gov't Bond	3.47	3.16	1.99	1.96
30-yr Gov't Bond	3.76	3.55	3.04	2.86	30-yr Gov't Bond	4.51	4.37	3.30	3.31
Prime	3.00	3.00	3.00	3.00	Prime	3.25	3.25	3.25	3.25
FX Reserves (US\$B)	60.4	62.3	63.1	(Jul)	FX Reserves (US\$B)	128.3	136.6	138.7	(Jul)
<b>Germany</b>					<b>France</b>				
3-mo. Interbank	1.26	1.51	1.51	1.48	3-mo. T-bill	0.80	1.18	0.62	0.56
10-yr Gov't Bond	3.35	3.03	2.01	1.78	10-yr Gov't Bond	3.71	3.41	2.76	2.49
FX Reserves (US\$B)	64.8	66.0	66.9	(Jul)	FX Reserves (US\$B)	61.0	60.3	59.5	(Jul)
<b>Euro-Zone</b>					<b>United Kingdom</b>				
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	0.88	0.86	3-mo. T-bill	4.85	4.85	4.85	4.85
FX Reserves (US\$B)	319.9	317.2	321.3	(Jul)	10-yr Gov't Bond	3.69	3.38	2.44	2.27
<b>Japan</b>					<b>Australia</b>				
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	4.41	4.27
10-yr Gov't Bond	1.26	1.14	1.03	1.01	FX Reserves (US\$B)	33.3	40.3	40.4	(Jul)
FX Reserves (US\$B)	1080.6	1100.8	1110.8	(Jul)					

## Exchange Rates (end of period)

USDCAD	0.97	0.96	0.99	1.00	¥/US\$	83.13	80.56	76.80	77.51
CADUSD	1.03	1.04	1.01	1.00	US¢/Australian\$	103.29	107.22	106.45	104.46
GBPUSD	1.603	1.605	1.622	1.588	Chinese Yuan/US\$	6.55	6.46	6.38	6.39
EURUSD	1.416	1.450	1.421	1.367	South Korean Won/US\$	1097	1068	1063	1077
JPYEUR	0.85	0.86	0.92	0.94	Mexican Peso/US\$	11.905	11.714	12.408	12.647
USDCHF	0.92	0.84	0.79	0.88	Brazilian Real/US\$	1.632	1.563	1.641	1.679

## Equity Markets (index, end of period)

United States (DJIA)	12320	12414	11494	11052	U.K. (FT100)	5909	5946	5292	5239
United States (S&P500)	1326	1321	1204	1162	Germany (Dax)	7041	7376	5538	5216
Canada (S&P/TSX)	14116	13301	12701	12538	France (CAC40)	3989	3982	3149	2984
Mexico (Bolsa)	37441	36558	35134	34341	Japan (Nikkei)	9755	9816	8951	8738
Brazil (Bovespa)	68587	62404	58118	56047	Hong Kong (Hang Seng)	23528	22398	20213	19867
Italy (BCI)	1120	1039	837	797	South Korea (Composite)	2107	2101	1868	1813

## Commodity Prices (end of period)

Pulp (US\$/tonne)	990	1035	1020	1020	Copper (US\$/lb)	4.26	4.22	4.11	4.04
Newsprint (US\$/tonne)	640	640	640	640	Zinc (US\$/lb)	1.05	1.05	0.99	0.99
Lumber (US\$/mfbm)	290	237	245	257	Gold (US\$/oz)	1439.00	1505.50	1875.25	1851.00
WTI Oil (US\$/bbl)	106.72	95.42	88.93	86.74	Silver (US\$/oz)	37.87	35.02	42.50	41.40
Natural Gas (US\$/mmbtu)	4.39	4.37	4.05	3.97	CRB (index)	359.43	338.05	338.06	334.96

\* Latest observation taken at time of writing.  
Source: Bloomberg, Scotia Economics.

### Emerging Markets Strategy

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