

Global Views

Weekly commentary on economic and financial market developments

July 22, 2011

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Deal Or No Deal? The U.S. Will Shape The Week's Global Market Tone

- **Please see our full indicator, central bank, auction and event calendars on pp. A3-A9.**

Howie Mandel should run for Congress. Why not, as every other solution seems to have been tried in overcoming debt deal gridlock in the U.S., other than a true game show format. Such theatrics, however, won't be required in order to make next week a potentially pivotal moment for global markets. Treasury Secretary Tim Geithner has long stated that August 2nd is the deadline after which the lights go out in Washington and its ability to meet its debt payment obligations expires. Working backward from that deadline, next Tuesday may be about as far as a potential deal could be pushed and still give time for legislation to be drawn up, voted upon and in place by August 2nd. There may be ways of extending the deadline should a deal appear imminent, but many of these tactics have already been utilized to date. Unfortunately this raises intensified risks surrounding planned auctions for 2, 5 and 7 year Treasuries.

Global markets will get another chance to digest the details surrounding **Europe's** latest €109 billion aid package. Key in this regard may be the start of European bank earnings season. Several key European banks hold sizeable portfolios of Greek debt and, should they participate in the voluntary debt reprofiling, then they may be forced to incur large write-downs against their net income. Also key will be a spate of European debt auctions that will test market sentiment toward the latest bail-out package proposal. Bill and bond auctions by Belgium, Spain and Italy will be in the market's crosshairs. European data risk will be especially focused upon Germany. German retail sales are expected to bounce back in the June print following the large decline of the prior month, but a gain would buck the very weak trend that has been in place since February as consumers have retrenched and offset export-led growth. German CPI will be released starting Wednesday morning and could well exhibit further softening following the prior month's reflection of diminished commodity price pressures. What toll recent developments have taken on euro zone confidence readings will be the focus on Thursday. UK GDP is expected to be soft and thus reinforce the BoE's consistently dovish bias.

U.S. data risk will be concentrated in a few short bursts of activity. The marquee release will be Q2 GDP on Friday. Estimates within consensus range all the way from a low of 0.9% annualized q/q growth to a high of 2.9% and with a median estimate of 1.8%. One of the greatest areas of uncertainty concerns how price-adjusted inventory effects will be captured during the quarter, as inventory disinvestment likely followed in the wake of Japan's shocks to global supply chains. This would serve as a sharp downward drag upon U.S. GDP growth that leaves high tail risk surrounding the report. We expect a slip in consumer confidence in the July reading on tap for Tuesday. Durable goods orders could post soft gains Wednesday on the heels of the high base effect posed by the prior month's sizeable rise. Also on Wednesday, the Fed's Beige Book will provide regional colour and anecdotes to the pattern of growth in the overall U.S. economy. Pending home sales (Thursday) will be interesting to watch given the high cancellation rate on prior pending home sales as buyers became leery of committing to large scale purchases during a soft spot in the U.S. economy, posing further downsides to U.S. housing markets. Finally, earnings season continues and there could be speech risk as the Fed's Lacker, Williams, Bullard and Lockhart all speak on the economy and monetary policy.

Canada will take a back seat to global market developments, until perhaps Friday. That's when May GDP is slated for release and we think only a tenth or two of a percentage point expansion in the economy lies in the cards compared to the prior month. On the heels of the downward surprise to May's CPI report, this could add to a post-BoC statement period of dovishness. Weakness in Q2 GDP is probably largely priced in, however, and instead we're left with Canada largely following the global market tone next week. Canada also conducts a 10-year auction on Wednesday.

Asian markets will have an eye on another round of key Japanese releases that push further into the post-shock environment, including retail sales, household spending, CPI, industrial production, housing starts, and vehicle production. We expect these figures to reinforce the notion of a quick post-shock rebound. The Reserve Bank of India is expected to hike 25bps, while the RBNZ remains on hold.

In **Lat-am** markets, only an expected 25bps rate hike in Colombia will garner much following.

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No Free Lunch In the U.S. Debt Ceiling Debate

- As the U.S. debt ceiling impasse continues, Scotia Capital Economics has prepared a paper titled, **No Free Lunch in the US Debt Ceiling Crisis**. Excerpts from this paper are included below, and readers can access the full report at: www.scotiabank.com.

Excerpts from our *Special Update*:

Whether or not a debt default solution arises in the next few days or weeks, there is no free lunch to be had in addressing America's fiscal problems. The fact that the immediate problem stems not from an actual inability to pay but rather from the use of the debt ceiling as a political bargaining tool has only served to underline the divisions within Washington on the tough trade-offs required. We worry that either default will be avoided through the pursuit of modest fiscal retrenchment that further agitates rating agencies and financial markets, or that the cuts necessary to satisfy rating agencies will come at the cost of a sharp long-run fiscal drag on growth. Should the champagne cork pop following the achievement of a deal to raise the debt ceiling, the reward is likely to take the form of weak growth prospects for the U.S. economy for a long time to come.

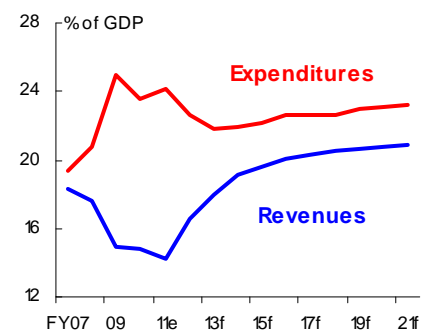
It is possible, however, that the impact of a short-term technical default might not be apocalyptic. There are three main reasons why the U.S. may be different from emerging market experiences. For one, an important contrast with emerging markets — and even with other developed sovereign markets — is that investors in those markets are used to thinking about forward-looking credit risk, and market prices respond continually to new information on the government's ability and willingness to pay in the future. Investors in U.S. Treasuries are much less experienced in having to consider evolving credit risk.

For another, despite Treasury Secretary Tim Geithner's understandable attempts to inject a sense of urgency into the debate, we are not sure that August 2 is a hard deadline.

Third, in sharp contrast to other sovereign debt markets is the current market situation for U.S. Treasuries. A combination of mutually reinforcing factors, including credit quality, high liquidity, stable monetary policy and the sheer size of outstanding issues has made Treasuries relatively immune to recent U.S. fiscal developments. Institutional investors do not have many choices when it comes to issuers of sovereign debt.

Once we recognize that the role of the U.S. in the global financial system does not just stem from some magical forces associated with the country's name and recent payment record, but rather depends on a forward-looking assessment of the same types of economic variables that are regularly used in the sovereign analysis of any other country, the situation becomes more difficult. Note, for example, that S&P foresees a one-in-two chance of lowering the U.S. credit rating, based not just on the threat of imminent default, but rather on its concern of a growing and unsustainable debt burden. For these reasons, we think considering the policy options available to lawmakers becomes critical.

**The February 2011 Budget:
Revenues and Expenditures**



Source: Office of Management and Budget (FY11 estimates updated with monthly data), Scotia Economics.

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The Bank of Canada Risks Coming in Below Its 2% Target

- **Why the Canadian dollar may prevent the BoC from sustainably hitting its 2% inflation target over its forecast horizon.**

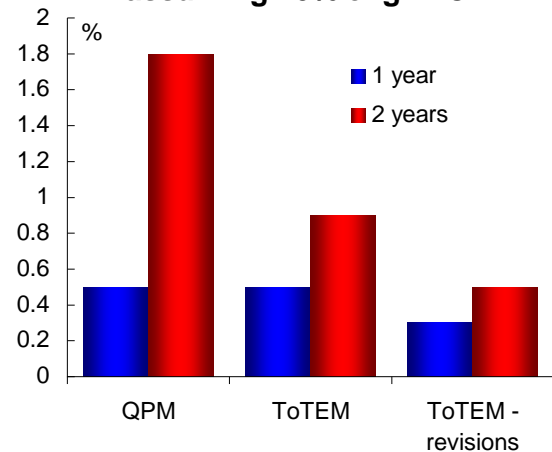
The Canadian dollar (CAD) has appreciated by over a dime against the USD since just last August and is closing in on levels not seen since late 2007 when newspaper ads were chock-full of advertisements for CAD-motivated price discounts. The Bank of Canada may not be allowing for enough time by which to evaluate CAD effects on inflation under the BoC's own modelling efforts (let alone on growth and the output gap). Evidence to this effect may have arisen in the latest inflation reading for May that posted a sharp downward surprise. Should the BoC commence a tightening cycle near-term which could well add even further momentum to CAD as illustrated by the post-statement rally, then it risks either abruptly halting in its tracks or perhaps even reversing course down the road when inflation may well be undershooting the BoC's target by a fair margin.

The BoC's workhorse ToTEM model (Terms of Trade Economic Model) assumes that the full impact of a 1% trade-weighted currency rise occurs in the second year following such appreciation, and its appreciation against the USD is clearly the biggest cross rate of exchange to consider by far. The spot estimate in the model is a drop of 0.03% in core inflation one year following a 1% trade weighted currency rise and 0.05% two years following. The estimate of the amount of pass-through from currency strength into inflation readings has diminished over time as reflected in the accompanying chart. The bars on the left plot the effects using the BoC's Quarterly Projection Model (QPM) that it used to use as its principal modeling tool. The middle bars show old estimates using the currently used ToTEM model, while the right-hand side bars show the freshest sensitivities used within the ToTEM model as published in last Fall's *Bank of Canada Review*. It takes time for agents in the economy to adjust their pricing models in response to perceptions of the temporary or permanent nature of currency appreciation. Since CADUSD has appreciated by over 10% since last summer, the drop in core inflation in the second year following such a currency rise could be on the order of about a half percentage point though the impact is perhaps not fully linear (i.e., a 10% currency appreciation may not have ten times the effect of a 1% currency rise).

The 95% confidence interval surrounding the impact of a 10% trade-weighted currency rise pushes toward a drop of as much as two percentage points in core inflation two years hence. Thus, the impact could be much larger than 0.5% or next to nothing at all with equal statistical faith 95 times out of 100, but with a mid-point estimate that points to lower prices.

There are two tail risks to this view. For one, perhaps the fact that measures of household activity and leverage are at all-time highs might suggest that tapped-out consumers will need to be enticed by deals more so than during the free-spending march toward cycle peaks, suggesting greater pass-through effects of a strong currency into lower prices. They also may play less of a role in driving economic growth than the BoC is anticipating. Alternatively, perhaps powerful import conglomerates hiding behind various border frictions, and global average cost pricing models that don't necessarily tailor pricing to the modestly sized Canadian economy will combine to have importers continuing to hoard the benefits of a strong currency in their operating margins and cash balances instead of passing through lower prices. It may thus be prudent to allow more time to evaluate such effects into 2012 before tightening monetary policy.

Chart 1 BoC's ERPT Estimates assuming 10% chg in CAD



Source: Bank of Canada, Statistics Canada, Scotia Capital Economics.

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Scotia's BoC Forecast Is Unchanged

- **While the risk of a near-term hike increased this week, executing that risk depends on many things simultaneously going right and we are not yet at that point.**

The BoC chose an awkward juncture at which to abruptly go hawkish in its latest rate statement. The BoC could have easily bought more time until further clarity results from Europe's debt situation, the US debt ceiling debate and the tone of domestic indicators like the sharp downside surprise to the latest inflation report. Instead, two key factors made for a more hawkish bias in the BoC's rate statement. One is that the BoC now expects core inflation to be at 2% throughout the forecast horizon. Two is that the statement dropped "eventually" from its rate guidance. Therefore, the risk is to pull forward our BoC call back to this Fall where it long stood previously over the past year and to also raise the CAD forecast showing further appreciation against the USD as it marches toward punching through 5 cents above the USD post-statement. Pull the trigger on actual hikes, and an over-valued currency risks marching in the direction toward a dime north of parity and further overshooting.

But we are resisting that risk and are not, as yet, changing our forecast that the BoC is on hold until 2012Q2 since a near term hike is contingent upon many things simultaneously going right. Further, the domestic economy remains weak and what momentum it has after temporary supply shocks have lifted and propelled Q3 growth remains highly uncertain. Q1 growth of 3.9% was largely driven by an undesired inventory build as the economy displayed weakness before the Japanese shocks arrived in such a manner as to broadside Q2 GDP growth. Lastly, the sharp downside to May's inflation report is a sign in the direction of how we think the risk facing the BoC is that it may not hit its 2% inflation target going forward (see page 4). Until we have been convinced otherwise, changing a forecast in the current environment seems pointless.

To this effect, there were four key supporting takeaways from the Bank of Canada's latest Monetary Policy Report. One is that the fuller tone to the report hardly provides much justification for removing "eventually" from its rate guidance and signalling a near-term rate hike. The BoC is hedging its bets. That plays to our concerns that that BoC has made a number of optimistic assumptions on the path toward such a hike that is littered by uncertain domestic growth, uncertainty in the US fiscal landscape, and whether or not Europe pulls a rabbit out of its hat in the next day or the days and weeks ahead. In short, I find there to be a significant inconsistency between the tone of the report and the possible signal of an imminent hike.

Secondly, and more important, if there is one key takeaway from the MPR it is that while the risk of a near-term hike has risen, the path of future rate hikes will be slow and possibly erratic (hike, pause, ...) as the BoC takes its time to get back up to a neutral rate. This comes from Technical Box 2 in the full report from which we quote the following:

"the policy rate can deviate from its long-run level even if inflation is at target and output is at potential. In the context of a projection for inflation, this implies that the policy rate can return to its long-run level after inflation is projected to reach the 2 per cent target and output is projected to reach its potential. This contrasts with the assumption that the policy rate should always be at its long-run level when inflation is at target and the output gap is closed."

What did the BoC mean by this? In some respects it is a simple truism. If they haven't raised the overnight rate back to its neutral rate by now when core inflation is threatening the 2% y/y target and is expected to remain there throughout the forecast horizon, then by definition the policy rate will lag behind the output gap and inflation readings. But in another sense, it's a spirited defence against those who argue that the BoC is behind the curve which I don't believe it to be. Regardless, the key issue here is not what the BoC signals about near-term rate risks but what it is saying about the longer term path toward a higher overnight rate. That would support our view that the end point on 2012 rate hikes sits at 2.25% from the current 1% overnight rate.

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Third, we would argue that the BoC may be overestimating US economic growth for 2012 with our own forecast at 2.7% versus the BoC's current expectations of 3.2%. The BoC's view on US growth is more in tandem with the Fed's central tendency forecast of 3.3-3.7% which we know has perpetually come in too high throughout the crisis period (see page 12).

Fourth, the BoC estimates the size of the output gap to be currently equal to slightly less than 1% of the economy and reinforced that it expects the gap to close by 2012Q2. They get to this path through small upward revisions to Q3 and Q4 and by not going as low as they might have for Q2 growth that the BoC has pegged at 1.5% q/q annualized versus our 1% figure with downside risks. They also appear to count Q1 growth of 3.9% as playing a role in closing spare capacity, despite the fact it was heavily inventory driven (inventories added 3.1 percentage points to growth in Q1). What remains the case, however, is that the BoC's guidance is for the output gap to ride flat after closing by the middle of next year, since the BoC forecasts actual growth in the economy to match its potential growth and therefore the economy is not expected by the BoC to slip into material excess demand. That lends considerable flexibility to the BoC in carving out its longer run rate guidance.

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Growth, Inflation, And Eventually Interest Rates

- **The Bank of Canada's overnight rate was left unchanged at this week's policy announcement. Nevertheless, change is afoot. The central bank downgraded the economic growth forecasts for the advanced nations in its revised outlook, and kept Canada's relatively unchanged, though it rebalanced the performance to show more domestically driven activity in line with Scotia Economics' view. But with the forecasts also showing the country to be more inflation prone, the Bank of Canada has pulled forward expectations of an eventual rise in short-term interest rate, and at the same time, provided guidance that has pushed back expectations for the speed of any rate adjustments.**

Since last September when the Bank of Canada last raised its overnight rate 25bp to 1.00%, there have been seven policy-setting meetings, all of which ended with the central bank leaving the benchmark rate unchanged. For the first five meetings, the normalization of short-term interest rates was interrupted because global headwinds affecting the Canadian economy were deemed to be greater than the tailwinds, and 'core inflation' was either decelerating, or showing minimal signs of accelerating from a low base while remaining safely below the 2% target. The policy directives indicated that "any further reduction in monetary policy stimulus would need to be carefully considered".

The global headwinds affecting the Canadian economy were again deemed to be greater than the tailwinds at the Bank of Canada's May 2011 meeting, *but* 'core inflation' was posting faster-than-expected increases, and exhibiting signs of challenging the 2% target. Accordingly, the policy statement transitioned to 'some of the considerable monetary policy stimulus currently in place *will be eventually* withdrawn'. (Note that italics are used for effect). And while headwinds exceeded tailwinds once again in July, policymakers became increasingly focussed on 'core inflation' that was now expected to surpass the 2% target as the year progressed, albeit not by much and maybe not for long. The July directive dispensed with '*eventually*', indicating that 'some of the considerable monetary policy stimulus currently in place *will be* withdrawn'.

Clearly, headwinds are continuing to outpace tailwinds, with growth in the advanced economies having lost momentum, risk aversion having intensified, and the Canadian dollar continuing to strengthen. And inflation risks in Canada are on the upside since domestic demand, and not net exports, is driving growth. Recent developments — another, more comprehensive European bailout package was being hammered out on Thursday, while Canada's June CPI reversed the prior month's hefty gain — are constructive, but do not change the underlying dynamics.

The upward trend in inflation is being generated on a number of fronts. Robust emerging market growth will likely sustain high commodity prices, the run-up in local wages, and the broader trend in global inflation. In the absence of a meaningful pick-up in productivity in Canada, the combination of more buoyant domestic activity, strong job creation, and continuing credit demands increases the risk that the economy's excess capacity will be reduced at a faster rate, thereby putting further upward pressure on general price and wage trends.

The rising trend in the price of 'core' goods has been a key factor pushing inflation higher in Canada, albeit from a low base. The substantial run up in agricultural and energy prices, reflecting both sharply higher international demand and increased geopolitical tensions, have lifted the cost for most foodstuffs and fuel oils, even after accounting for the latest back-tracking. The prices of 'core' goods are headed towards a 1½% annualized rate, a trend that would be much higher if not for the highly competitive environment in which we operate, one where a much stronger currency helps to expose domestic producers and consumers to more and generally cheaper imports and increased cross-border shopping.

Price increases related to a number of 'core' services could prove more durable, since the upward trend in some key areas has been reinforced by the sharply higher energy prices experienced over the past year. 'Core' services appear more sensitive to the broader trends in the economy. The strong rebound in domestic-led growth from the recession, coupled with the spillover effect from rising energy prices, has lifted the trend in prices of 'core' services towards a 3% annualized rate, even after backing out the impact of the HST

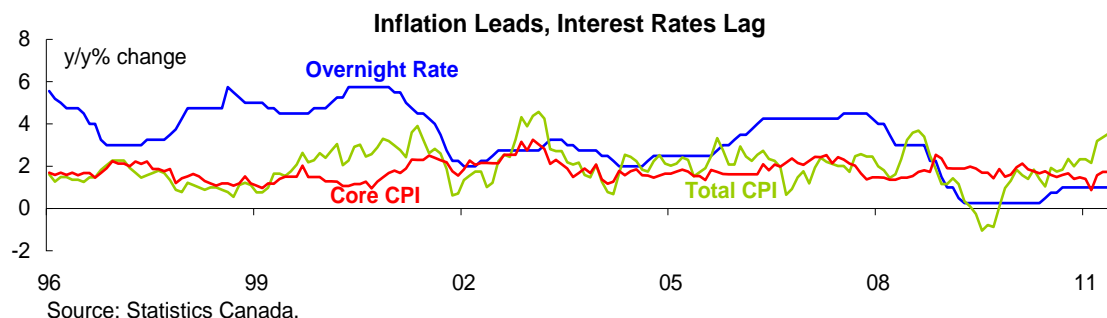
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introduction a year ago. There have been solid year-over-year gains in a variety of core service categories, ranging from homeowner's home and mortgage insurance, to internet access services and subscriptions to online content providers, services related to household furnishings and equipment, air, rail, highway bus and other inter-city transportation, cablevision and satellite services, use of recreational facilities and services, tuition fees, and newspapers, magazines and periodicals.

For now, a broader inflationary cycle has yet to generate more significant momentum because wage pressures are still moderate. Aggregate wage trends are around 2% even as the recovery gained traction. Sectors that are exposed to persistent competitive forces internationally will be hard pressed to register some, if any increases, while the public sector is facing a multi-year period of fiscal consolidation. However, wage pressures in the stronger-growth regions that are aligned to resource development, residential construction, as well as sectors that support professional and business services in the large urbanized centres, are moving higher, underpinned by labour and skills shortages in selected areas. Continuing solid job gains are eating into the pool of available labour, pulling the headline unemployment rate to a cycle-low of 7.4% in June. Currency appreciation has helped but not fully prevented the pass through of imported price increases. Nor has the sharp increase in business equipment investment provided the productivity boost needed to buffer inflation.

Because the growth and inflation divergences in Canada are likely to persist in the absence of an external shock that undercuts global growth and drags down trade-related activity, borrowing costs must eventually rise, and along with it, other price signals in the marketplace, to help ration credit. Domestic financial conditions remain quite supportive of growth in Canada, notwithstanding the severe economic and financial strains internationally, and the periodic bouts of increased global risk aversion. And Canadian interest rates are still very low by historical standards, while lending conditions have eased further. The overnight rate remains below the running rate of core inflation — as it has since the onset of the recession and even after the initial round of Bank of Canada tightening — in contrast to the positive real rate that was the norm in the prior decade, and even during periods when growth was less than robust.



Nevertheless, the timing of prospective rate increases, and the magnitude of the eventual rate adjustment, is still open for debate. First, although expectations are building that the central bank could resume its tightening phase later this year or into 2012, the outlook is clouded by the structural adjustments that are restraining growth throughout most of the advanced nations — the deleveraging of household balance sheets, the fiscal consolidation underway throughout much of Europe, the United States, and increasingly in Canada as well, the recapitalization of the banking sectors in many of the countries hardest hit by the financial/mortgage crisis, and the competitive restructuring of many businesses. Second, even in the faster-paced developing countries with large savings surpluses, increasing efforts are being made to slow, as well as rebalance economically, the stronger-growth and inflation-prone emerging countries. Third, the Canadian dollar has already jumped into a higher range of US\$1.05-1.10 on the prospect of an earlier and wider interest rate differential developing vis-à-vis the United States, a development that could add to the competitive challenges of non-commodity exporters. And fourth, the Bank of Canada has indicated that in periods of severe headwinds — like the current environment — it would tolerate 'lower for longer' borrowing costs and a less aggressive rise even if inflation has already achieved its 2% target and output has reached its potential.

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Markets Embrace Greek Solution, For Now

- **Comprehensive euro zone package for Greece and the rest of the periphery allays most pressing of investors' concerns, though significant longer-term challenges linger.**

The heads of state of the euro area and various European Union (EU) institutions came to an agreement on July 21 on a second bailout package for Greece, worth some €159 billion, amidst a major deterioration in confidence and risk appetite in financial markets. The framework contains three important features: an EU-sponsored Greek buyback of its own debt on the secondary market, a debt swap involving private sector creditors on a voluntary basis, and a substantial expansion in the size and role of the European Financial Stability Fund (EFSF) in order to effectively contain the risk of contagion. Absent from the deal is the controversial bank tax, which had been floated as one option for raising funds to help the struggling nation.

The agreement includes €109 billion for Greece in additional financing from the EU and IMF; a maturity extension of EFSF loans from the current 7.5 years to at least 15 years, and a lowering of lending rates to around 3.5% (conditions which will also be applied to Ireland and Portugal); a net contribution from the private sector of approximately €37 billion over the 2011-2014 period, rising to €50 billion with the inclusion of debt buybacks; and increased flexibility for the EFSF. The EFSF will now be permitted to lend to distressed states — including non-program states — on a precautionary basis, to recapitalize banks through government loans, and to intervene in secondary bond markets as deemed necessary to prevent contagion. Policymakers stressed that private sector involvement in the Greek deal was voluntary, and constituted an exceptional solution which would not be replicated elsewhere in the euro area.

The outcome of the emergency summit shows a greater sense of unity and cohesiveness among European political leaders in managing the sovereign credit crisis. Until now, European policymakers have responded to developments in the turmoil at the eleventh hour, or even after the fact, partly due to the slow political processes of the monetary union. This time may prove different; the expansion of the EFSF's muscle will allow European authorities to act preemptively, enhancing the potential for calming the markets and building firewalls to prevent wider contagion to the larger economies in the euro zone, such as Spain and Italy.

Investors seem to accept the summit agreement as a genuine step in the right direction, and are rewarding the plan as such, with the euro (EUR) appreciating steeply and CDS spreads for the euro zone periphery declining significantly. The EUR surged 2.1% in intraday trading yesterday to a peak of 1.4439 against the US dollar, before settling back to 1.4387 by the time of writing. Global stocks, oil and euro area bonds also rallied, with risk premiums on the debt of non-core issuers falling as the talks progressed. Despite the positive reception in global financial markets, the outlook for credit ratings by the major agencies is less clear. Fitch moved on Friday to declare Greece in "restrictive default" and S&P and Moody's will likely follow suit, though temporarily, given the deterioration in original loan terms implied by the private sector debt exchange. The Institute of International Finance estimates that the bond exchanges and roll-overs will result in a 21% net present value loss for holders of Greek debt. Given the ECB's oft-stated refusal to accept defaulted bonds as collateral for loans, euro zone leaders have preemptively pledged to provide guarantees for Greek bonds in order to maintain the nation's access to the ECB liquidity window for the period of time — expected to be short — when the debt is in selective default.

The sovereign credit crisis consists of two distinct elements that need to be addressed simultaneously. First, weak public finances and the resulting need for strict fiscal austerity have created a very challenging economic environment in the euro zone periphery. Second, rapidly changing investor sentiment is powerful enough to spread the crisis to countries whose also shaky economic fundamentals are in comparatively better shape. The emergency summit created a solution that should be effective particularly in addressing the second aspect. Nevertheless, while the periphery's debt servicing burden will ease, its economic and structural challenges remain in place. Indeed, Greece's problems result from structural issues of governance that cannot sustainably be solved by any debt restructuring schemes, only by far-reaching reforms that require strong political will for an extended period of time. The need for decisive actions on the fiscal consolidation and economic reform fronts has not disappeared despite the favourable summit outcome.

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The Outlook for China, Higher Growth with Stabilizing Inflation

- **We expect the economy to continue to gain momentum through 2011-12.**
- **Tamer cost-push effects should help stabilize inflation in the second half of 2011.**

A steady growth trajectory for China's economic output will continue to play out through the second half of 2011. Latest indicators point to persistent GDP growth underpinned by monetary conditions which have yet to become overtly restrictive. Moreover, a pick-up in economic activity is expected through the turn of the year led mainly by the political cycle which implies a supportive fiscal and public credit boost.

According to official figures, China's GDP accelerated to a 2.2% quarterly (non annualized) seasonally adjusted growth rate during the second quarter, from the 2.1% q/q gain of the first three months of 2011. Momentum gains are expected in the coming quarters on the back of a pick-up in domestic demand as a solid rhythm of investment spending combines favourably with rebounding household outlays, while export growth remains range-bound. Such sequential GDP performance will be consistent with falling year-over-year growth through the third quarter and a rebound on the fourth, squaring well with our overall forecast of a 9.3% y/y gain for 2011 as a whole.

Looking ahead to 2012, we expect the Chinese economy to expand at a quicker 9.5% y/y pace on the back of political developments. A generational change in China's top leadership is in the cards for next year, as the country's politburo has agreed on the replacement of President Hu Jintao and Premier Wen Jiabao with Xi Jinping and Li Keqiang, respectively. The incoming leaders' general economic mandate has been spelled out in the published economic plan for 2012-17. While the document emphasizes the maintenance of overall social stability and thus looks to turn household spending into the economy's main growth engine going forward, sustained rapid economic expansion clearly remains a priority.

Examining the historical record, we observe that over the last 30 years China's GDP growth has accelerated every five years during the passing of the leadership baton, with the sole exception of 1997, the year of the Asian currency crisis (see table). This is consistent with the view that within a centralized system, continuity is guaranteed by assuring that incoming governments are perceived as building over and above the previous administration's achievements. But more importantly, it squares well with current economic indicators which point to sustained growth in investment spending, underpinned by a centrally designed policy of affordable housing development which aims to build 36 million dwelling units in 2011-15. Latest information from China's State Council indicates that by end-June more than half of the 10 million units planned for this year had already started construction, up from 34% as of end-May.

The propositions outlined above explain in part why the Chinese economy has failed to lose momentum in the midst of monetary tightening, as real investment spending (a key link in the monetary policy transmission mechanism) has failed to slow down. Moreover, they also support the view that economic momentum will pick up in coming months. A key issue that remains to be tackled, however, is how can this forecast be consistent with inflationary pressures easing within China?

	GDP Growth	Change in Growth
1980	7.9	
1981	5.2	-2.7
1982	9.1	3.9
1983	10.9	1.8
1984	15.2	4.3
1985	13.5	-1.7
1986	8.8	-4.7
1987	11.6	2.8
1988	11.3	-0.3
1989	4.1	-7.2
1990	3.8	-0.3
1991	9.2	5.4
1992	14.2	5.0
1993	14.0	-0.2
1994	13.1	-0.9
1995	10.9	-2.2
1996	10.0	-0.9
1997	9.3	-0.7
1998	7.8	-1.5
1999	7.6	-0.2
2000	8.4	0.8
2001	8.3	-0.1
2002	9.1	0.8
2003	10.0	0.9
2004	10.1	0.1
2005	11.3	1.2
2006	12.7	1.4
2007	14.2	1.5
2008	9.6	-4.6
2009	9.2	-0.4
2010	10.3	1.1
2011F*	9.3	-1.0
2012E*	9.5	0.2

*Forecast Scotia Economics.

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We expect the annual CPI inflation rate in China to end 2011 at 5%, down from the current 6.4% y/y record for June. Thus, while according to our forecast domestic demand will continue to accelerate, this will guarantee that inflation remains elevated by historical standards (China's CPI inflation has averaged 2.4% y/y in the past ten years). However, current trends imply that inflation should come down from recent peaks.

China's recent price pressure spurt has been mainly characterized by "cost-push" inflation, with food and fuel items playing a primary role. The stabilization of food costs within China was interrupted in June by a double-digit pick-up in the price of pork meat, resulting in 14.4% y/y food inflation in June. Going forward, however, cost attenuating forces should take over as global raw material costs stabilize.

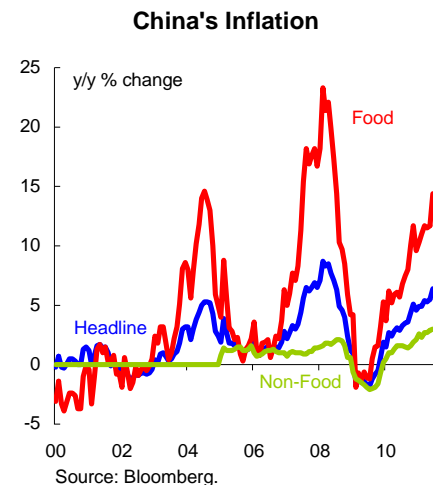
Indeed, the advance in the prices of agricultural commodities has finally started to give in, as peaks in the acceleration in world prices for wheat and corn have been reached in June. This has yet to be the case for rice, however.

Transport costs represent a sizable share of the total cost of food distribution, with the recent decline in crude oil prices (about 15% from their recent high of US\$114/bbl for WTI to US\$95) also boding well for diminished food price pressures. This will imply that non-food inflation in China should start to stabilize in coming months as well.

As agricultural commodities and fuel have a relevant import content in China, the persistent appreciation of the Chinese renminbi (CNY) will also act in favour of stabilizing domestic price gains. A recent acceleration in the strengthening trend of the CNY is consistent with our expectation for a 5.4% appreciation vis-à-vis the US dollar during 2011. We expect the CNY to hover at 6.25 at the end of the year.

Base effects will play a key role in bringing the yearly inflation rate down in China during the second half of 2011, as the country experienced food deflation for six months up until July of 2009. Thus, base effects started to kick in lifting the yearly inflation rate over and above 3% as of August 2010. The opposite effect will play out in 2011, with base effects now working as a stabilizer of the annual inflation rate as of August of 2011.

Finally, according to estimates by the Institute of International Finance, the monthly rate of inflation in China in seasonally adjusted terms through May of the current year has averaged 0.4% m/m. This is an extraordinary figure, as it is a clear break with the recent past, and is also consistent with our forecast for a 5% y/y gain in consumer prices by end-2011. Moreover, as outlined above, such a monthly pace of price gains has been happening while the economy has been acquiring more speed, which again does not contradict our expectation of higher growth with inflation stabilizing although at a high level.



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The Fed May Still Be Too High On 2012 Growth Prospects

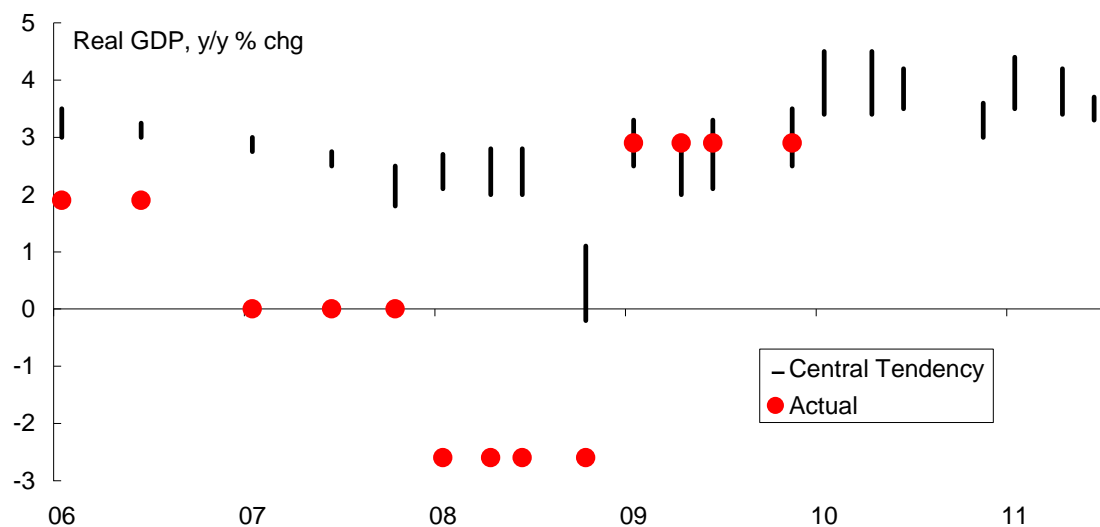
- **Fed's central tendency growth forecast tends to overestimate growth one year forward and may be doing so again, potentially having an impact on Canadian monetary and fiscal policy.**

The Fed released its updated economic projections in mid-June with much fanfare over their downward revisions to growth estimates for not only 2011 but 2012 as well. However, in comparison to the Scotia Economics forecast, we think the Fed is still being overly optimistic especially insofar as 2012 is concerned.

In fairness, these are remarkably uncertain times that make the job of any forecaster enormously difficult. But, having said that, as the chart below illustrates, the Fed's track record for projecting growth one year out lends little confidence to its bullish views going forward, even as the Fed has stepped up transparency and increased the number of times it publishes its economic projections. The vertical lines represent the Fed's central tendency quarterly forecast hi-low ranges for real GDP growth one year out with multiple lines within a year representing each forecast released to the public. The red dots symbolize the actual growth rate that materialized in the year being forecast. While the Fed projections come closer to the actual rate as the forecasts near the end of the year and more information arrives, the Fed has been overly optimistic every year back to 2006 except for one year. In 2009, the Fed was able to predict real GDP growth in 2010 relatively well one year prior. Nonetheless, from what we already know for 2011, the Fed seems to have been too bullish on growth for this year back in 2010 and we think there is the risk they will be too optimistic next year.

This has implications for both the Bank of Canada and Canadian government budgets. As the Bank of Canada's Monetary Policy Report noted this week, the BoC revised down its 2011 forecast for U.S. growth but kept its 2012 forecast at 3.2%, roughly in line with the Fed's central tendency forecast of 3.3-3.7%, as published in the June projections. The Federal government is also assuming a U.S. growth rate of 3.1%, as published in its March 2011 budget, based on private sector forecasts. However, with our own forecast for 2012 US growth at 2.7%, we would argue that the BoC and Federal budget assumptions may be overestimating U.S. economic growth and thus potentially Canadian economic activity.

The Fed's Forecast Accuracy



Source: The Federal Reserve, Bureau of Economic Analysis, Scotia Capital Economics

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Small Businesses Key For US Recovery

- **With small businesses employing half of all working Americans and accounting for the majority of jobs gains, their success is imperative for the sustainability of the US recovery.**

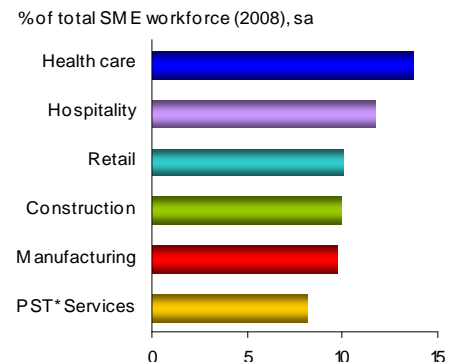
A number of recent speeches by government officials mention the importance of Small & Medium Enterprises (SMEs) to the national economy, especially in non-metropolitan areas. Why is this segment so relevant?

Small firms — defined by the Office of Advocacy as businesses having fewer than 500 employees — made up 99.7% of all business establishments in 2008, according to Census Bureau's figures, with companies of fewer than 20 employees representing 90%. SMEs employed half of all working Americans, providing 44% of the national annual payroll. The International Trade Administration finds that SMEs also accounted for roughly 98% of all exporters in 2008, a key factor in the economic recovery. Only six industries, mostly in the services sector, make up roughly two-thirds of the SME workforce — health care, hospitality, retail, construction, manufacturing and professional & scientific services (see chart 1).

While SMEs were hit hard by the past two downturns, these firms managed to post stronger recoveries than their larger counterparts (see chart 2). In 2001, when the technology bubble burst, SMEs shed 3.6 million jobs, 67% of the national payroll reduction. However, they started to add jobs once the economic conditions improved, expanding their workforce in excess of 7 million by December 2007. Conversely, larger firms shed an additional 14,000 posts over that period. During the most recent downturn, SMEs let go of 6.1 million employees, or 78.3% of all laid-off workers. However, they have recovered 30% of those positions, mostly in the services sector, while larger corporations have re-hired only about 2%. Deeper cutbacks and a slower recovery than in the early 2000s is likely due to the struggling housing market, as SMEs dominate the construction industry, accounting for 99.8% of all firms in the sector, and 84% of employment.

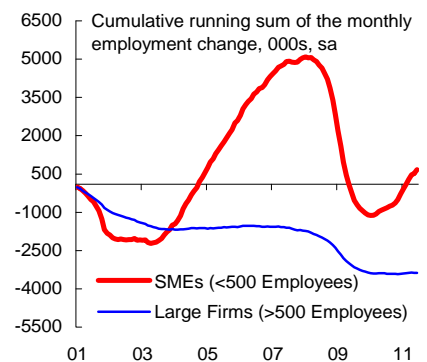
Small business sentiment tends to lead the economy by up to two quarters (see chart 3), since SMEs are more sensitive to economic conditions due to tighter profit margins, less ability to predict cash flows and a heavier reliance on bank loans and mortgages for financing. As a result, the NFIB small business survey provides some insight on the broader economic developments. It appears that weaker activity in the second quarter weighed on SME sentiment. The headline optimism index has been trending lower for four straight months, and the component indices suggest increased concern over future business conditions, sales included, and more cautious hiring activity and capital outlays. Uncertainty about the economic outlook, taxes and government regulations are being cited as principal impediments. Although exporters are taking advantage of solid growth abroad, a pick-up in domestic demand — alongside better access to early-stage and capital market financing — would improve prospects for SMEs, and for the broader US economy, particularly the labour market.

Chart 1
Six Industries Account For Nearly 2/3rds of SME Employment



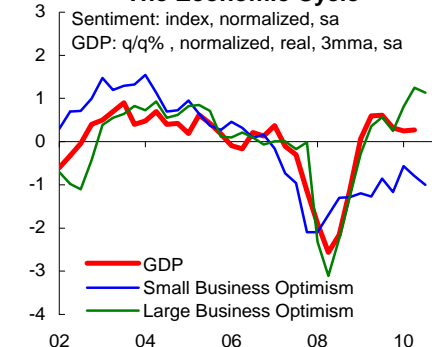
* Professional, Scientific & Technical Services
 Source: Census Bureau, Scotia Economics.

Chart 2
SMEs Contribute The Most To US Employment, Especially Services



Source: ADP Employment Report, Scotia Economics.

Chart 3
Small Business Sentiment Leads The Economic Cycle



Source: BEA, Business Roundtable CEO Outlook Survey, NFIB Small Business Outlook Survey, Scotia Economics.

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Student Jobs — No Longer a Summer Pastime

- Student job market lags overall recovery by a significant margin.

June's Labour Force Survey kicked-off the summer job market, as high school students completed exams and joined post-secondary students in their hunt for summer employment. Thus far, roughly 300,000 seasonal jobs have been created for full-time students between the ages of 15 and 24, slightly outpacing last year's jump of 290,000. However, unemployment in the segment current lies at 15.9%, well above the pre-recessionary level of just over 11% in 2008. This compares to a differential of just under 1.5% for the labour market as a whole and highlights the difficulties faced by one of the most vulnerable components of the labour force.

Aside from the fact that students have limited options in terms of employers (given their education and temporary status), the sectors in which they are most likely to find a job are typically those that are the most exposed to economic shocks: retail, tourism and business support services. These segments are typically hit hardest, as consumers and businesses quickly pull back on discretionary expenditures. This trend is displayed in chart 1, where one can observe that not only has student unemployment been structurally higher than headline unemployment, but that the spread widens during periods of economic duress.

An important consideration is that post-secondary students are now more dependent on their employment income to fund their studies. Tuitions have increased at a average annualized rate of nearly 7% since 1990, compared to an average of 2% for the total CPI basket (Chart 2). Over the course of the 1990s the value of student loans in Canada more than tripled, pushing an increasing amount of students to work concurrently with their studies. Chart 3 shows that the share of summer job creation relative to total student employment has been on a steady decline since the 1980s, with a greater portion of students working the entire school year in order to cover the rising cost of education.

An aspect that is not factored into the unemployment rate however, is unpaid internships being staffed by students. These positions do not factor into the Labour Force Survey and while they offer no monetary rewards, the experience gained proves to be of significant benefit. The effect that these staffed positions have on labour force numbers is difficult to ascertain, though a slight upward bias in unemployment is possible.

Nevertheless, it remains clear that the student labour market lags the general economy recovery by a significant margin at a time when students are highly dependent on part-time or full-time work to fund their studies and living expenses.

Chart 1

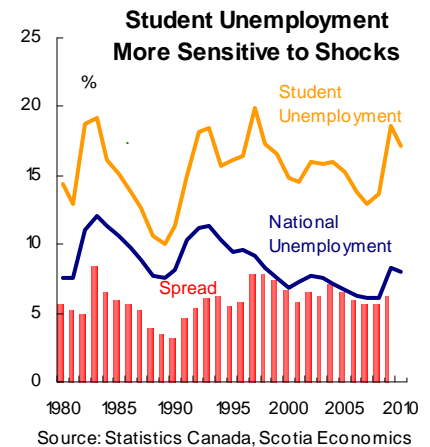


Chart 2

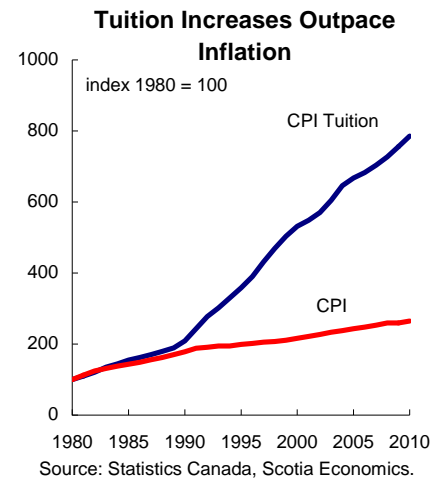
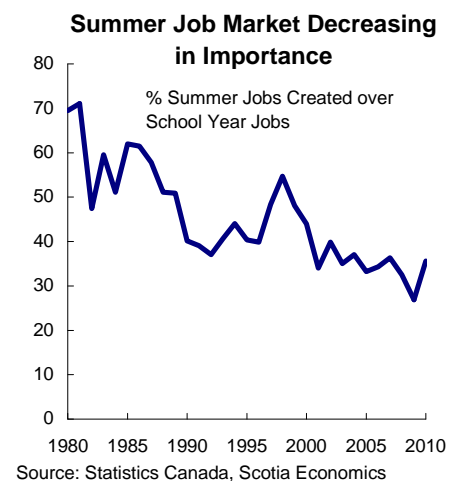


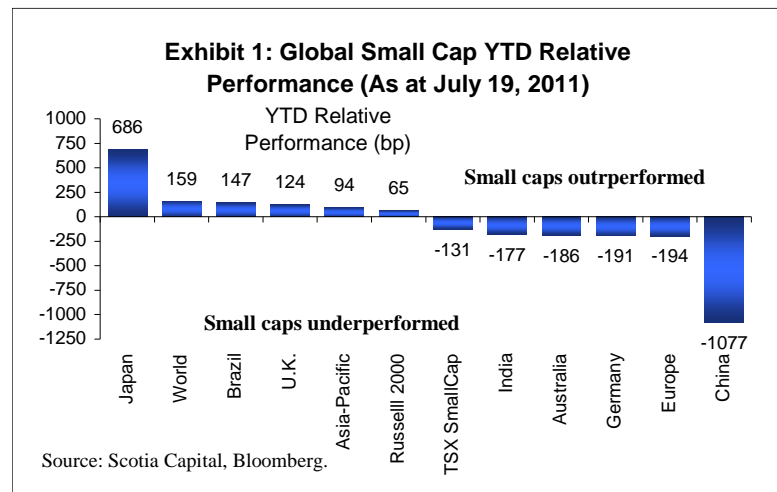
Chart 3



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Monetary Tightening Slowing Small Caps Leadership In 2011

- July market performance edging out negative sentiment so far.** Improving news on the debt front (U.S. and Europe) and a very strong start to the Q2 earnings season have provided much needed support to global equities in recent days. Although media headlines have been dreadful since the start of July, the S&P 500 has managed to gain 1.9% with leadership coming from Technology, Energy, and Materials. In Canada, the TSX is up a 0.3% so far this month (+2.1% in USD) with the gold sector (+8.7% in July) crowding out other sectors.
- Lingering uncertainty is obviously taking a toll on equity/cyclical sentiment, but global small caps have been surprisingly resilient so far this month. To be sure, most global small cap benchmarks are posting negative performances in July, but eight of twelve small cap benchmarks we track are outperforming large caps month-to-date. In Canada, the TSX SmallCap is outperforming the TSX 60 by as much as 362 bp in July, propelled by the sharp rebound in Materials-gold stocks. In the U.S., small caps are outperforming by a slight margin (43 bp). European small caps are trailing by 24 bp. Broadly speaking, it appears that recent market behaviour is edging out depressed sentiment. Since the start of the year, however, small cap leadership has waned as monetary and fiscal normalization impact risk appetite.
- Canadian small caps underperforming YTD.** The TSX 60 index is outpacing the TSX SmallCap by 131 bp since the start of 2011. It is worth noting that the lead Canadian large caps had built in the first half of 2011 (+476 bp) has eroded recently. As pointed out in Exhibit 1, small caps in countries burdened by tightening monetary policy are underperforming so far this year. Small caps in China, Europe, Australia, and India are lagging their large cap counterparts, while small caps in the U.S., U.K., and Japan are outperforming. Brazil is the outlier.



- Monetary tightening coming to Canada.** At its last meeting, the BoC left its benchmark rate unchanged at 1.00% while indicating that "some of the considerable monetary policy stimulus currently in place will be withdrawn", suggesting a rate hike as soon as this fall. We believe a tighter monetary stance in Canada should continue to hurt small caps' relative performance over the coming months, as it is the case in most countries where monetary policy is restrictive. In the last nine BoC tightening cycles dating back to the early 70's, Canadian small caps underperformed in seven tightening cycles with an average underperformance of 5.4% twelve months following the first rate hike. U.S. small caps have proved more resilient, outperforming in four of the last eight Fed tightening cycles. In the five most recent cycles, however, U.S. small caps underperformed three times, lagging by an average of 1.8% in the 12 months following the first Fed shot.

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- **Negative flows.** Although equities staged a nice rebound since their March 2009 lows, equity sentiment remains fragile. Mutual fund flows in Canada have been mostly directed toward balanced funds in 2011. Inflows in to balanced funds totalled \$20.8B vs. an outflow of \$6M for equity funds. Small cap equity funds are also registering small outflows (-\$5M) this year, but the pace of redemptions has accelerated in the last two months with outflows of \$89M in May and \$150M in June. With investors continuing to pour money into more defensive investment vehicles (balanced funds/large cap equities), small caps could lack the fire power to outperform.
- **Huge valuation premium.** From a valuation perspective, small caps are far from cheap relative to large caps. Global small caps are expected to grow earnings twice faster than large caps in 2012, but they command a lofty valuation premium. Small caps have benefited from a strong re-rating relative to large caps during the last decade. From trading at discount between '95-'00, they are now trading at a 30%+ premium. The size of the premium has been declining in the last few months, but it is still at the upped end of the historical range. In a context monetary normalization (higher rates), the magnitude of the current premium could be hard to sustain. Rising earnings will continue to push small caps higher, but a shrinking premium relative to large caps could impact their relative performance.
- **Weaker beat ratio.** With the U.S. Q2 earnings season well underway, it is interesting to note that U.S. small caps' beat ratio (the % of companies beating consensus) is weaker than large caps. The S&P 600 Small Cap beat ratio stands at 73% currently vs. 79% for the broader S&P 500. The small cap beat ratio was also weaker in Q1. Moreover, earnings revisions are favouring large caps. In the last two months, 2011 EPS forecasts for the S&P 600 Small Cap index have been reduced by 0.7% compared to a 0.6% increase for the S&P 500. Earnings growth is higher for small caps, but the momentum is playing in favour of large caps.
- **Bottom-line:** Equities should continue to march higher over the coming months, lifted mainly by rising earnings and relatively modest valuations. However, we believe the capitalization cycle has shifted in favour of larger capitalization after a decade of small cap domination.

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Why Is Inflation So Much Higher In The UK Than The Eurozone?

- For at least the last two years, UK inflation has been a significant margin above Eurozone inflation. We look at why UK inflation has been so much higher and whether it is likely to persist.

Mind the gap!

Since mid-2008, UK inflation has outpaced Eurozone inflation by an average of 1.6 percentage points. When we look at the contributions of the 12 key sub-components of the UK and Eurozone HICP basket on average over the period since mid-2008 eleven of the twelve components have shown a bigger contribution to inflation in the UK than in the Eurozone. This shows that the overshoot relative to the Eurozone has been broad based. Please contact Alan Clarke directly for

The components that stand out as contributing most to the overshoot in the UK relative to the Eurozone are: food, transport, housing and utilities, restaurants and hotels and recreation and culture. In the majority of cases, the bigger contributions reflect a faster pace of inflation in the respective components. However, in some cases, differences in weights between the two economies may also have accounted for some of the overshoot.

Housing

Within housing, the biggest driver of faster inflation has been utility bill increases. UK housing energy price increases have sharply outpaced those in the Eurozone over the last 5 years. Chart 1 shows that since 2006, UK housing energy prices have risen by 65% (even before the latest price hike announcements have entered the index). This is more than double the 27% increase observed in the Eurozone over the same period.

Chart 2 shows the % y/y inflation rates for these two series. Of the increase since 2006, two special factors help to explain why the UK outpaced the Eurozone. In early 2006, the Rough gas storage facility (the biggest facility in the UK) closed down following a major fire. This came amid supply disruptions from continental Europe at the same time as unseasonably cool winter temperatures. These contributed to a near 30% price hike that year – more than double that seen in continental Europe.

Similarly, in 2008-2009, price hikes of around 40% were recorded in the UK, compared to less than 20% in the Eurozone. In both cases, it was the sharp increase in oil and wholesale gas that was principally responsible. However, the sharp weakening in the GBP exchange rate around that time (of close to 20%) that is likely to have exacerbated the divergence at that time.

As the far right portion of Chart 2 shows, over the last 18 months, UK housing energy inflation has been a little slower than the pace recorded in the Eurozone. Given the typical lags and what we already know from announcements by the main UK utility providers, it is very likely that the situation will reverse very soon.

Chart 1: HICP Electricity, Gas and Other Fuels Index

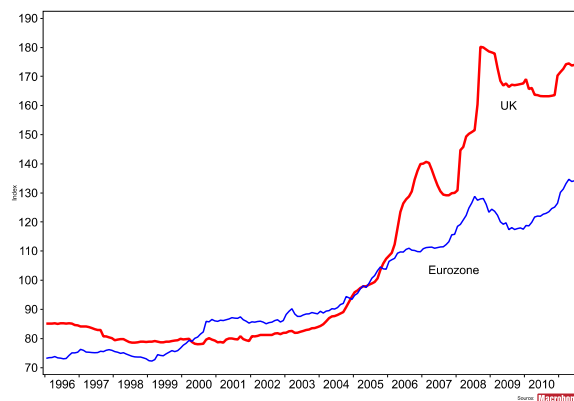
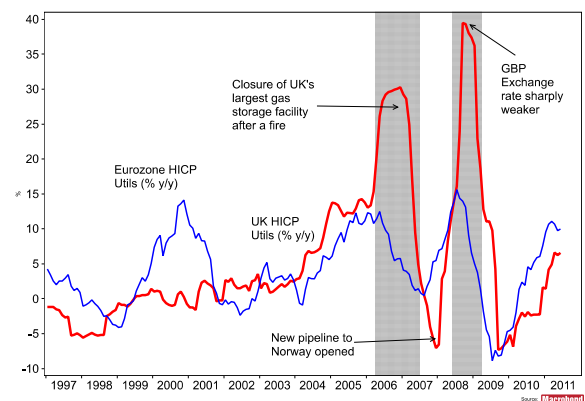


Chart 2: HICP Electricity, Gas and Other Fuels % y/y



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The main utility providers are in the process of passing on price increases of 10-20% in response to the surge in the wholesale cost of gas. These are scheduled to enter the CPI index from August onwards. We expect this to push UK housing energy inflation up to around 20% y/y, whereas Eurozone housing energy inflation has probably peaked at 10% y/y.

To summarise, since 2008, housing energy price inflation in the UK has outpaced the equivalent in the Eurozone by 3½ percentage points. With a weight of close to 5% in the HICP basket, this accounts for around 0.2 percentage points of the gap between headline UK and Eurozone inflation. With UK housing energy bill increases in the process of rising by between 10 and 20% imminently, this contributor to the wedge between the UK and Eurozone is unlikely to go away in the immediate few quarters.

Further ahead, we assume that energy price inflation will converge towards zero in both the UK and Eurozone. This should help the gap between UK and Eurozone headline inflation narrow by late-2012.

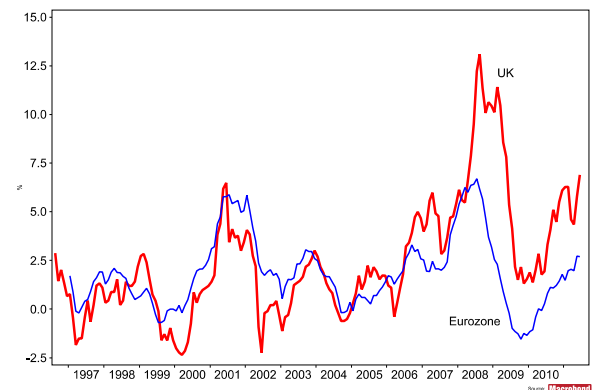
Food Prices

A significant wedge between UK and Eurozone food price inflation emerged around mid-2008 and has persisted ever since (Chart 3). Over that period, UK food price inflation has been an average of 4% y/y faster than the equivalent in the Eurozone and has accounted for 0.4 percentage points of the gap between headline UK and Eurozone inflation.

Much of the gap between UK and Eurozone food price inflation appears to be explained by the plunge in the GBP exchange rate during 2008. Since food has a higher import content in the UK than the Eurozone, food price inflation here is more vulnerable to swings in the exchange rate. However, while the surge in food price inflation during 2008 coincided with the fall in the GBP, it doesn't explain why the wedge has persisted over the latest 12 months or so.

Going forward, we are confident that food price inflation both in the UK and Eurozone will fall pretty sharply. Given the likely plunge in the % y/y rate of change in agricultural commodity prices, food price inflation in both the UK and Eurozone should fall to close to zero. Even if UK food price inflation continues to outpace the Eurozone (which is what we suspect) we doubt the gap between the two will be as wide as it is currently.

Chart 3: UK vs Eurozone HICP Food % y/y



Transport

UK transport price inflation has outpaced the Eurozone equivalent by three percentage points over the last three years. With a weight of around 15% in the HICP basket – that accounts for 0.5 points of the gap between UK and Eurozone inflation.

A quarter of that gap reflects faster increases in the price of petrol and diesel. This is likely to reflect the combination of the weakening in the GBP in 2008-09 coupled with Budget-related increases in taxes on petrol in the UK. The other major source of difference has been car prices. The car scrappage scheme in the UK caused a collapse in the supply of second hand cars – since a high proportion were crushed. As a result, second hand car price inflation surged to almost 20% y/y. The net result was near double digit car price inflation in the UK, versus zero car price inflation in the Eurozone accounted for 0.5 percentage points of the gap between UK and Eurozone headline inflation.

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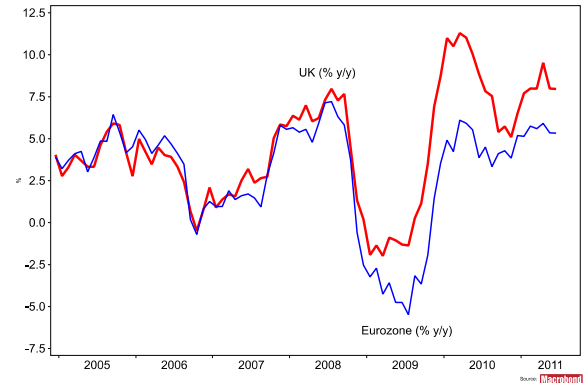
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Clearly the car scrappage scheme was a one-off and the effects have since dissipated. Going forward, with UK household real disposable income growth under severe pressure, there is a risk that UK car price inflation falls further relative to the Eurozone.

VAT

The rise in the UK's headline VAT rate has accounted for much of the wedge between UK and Eurozone inflation over the last 18 months. While some economies in the Eurozone have also raised their VAT rates, this has typically only affected smaller economies. Combined, the countries that have raised VAT in the last 12 months account for 20% of the weight of all countries in the Eurozone. Together this suggests a contribution to headline Eurozone inflation of only around 0.2 percentage points. In the UK, the VAT hike accounts for close to 1 percentage point. This is likely to begin to drop out of the headline UK inflation rate from December onwards and should contribute to narrowing the gap between the UK and Eurozone by close to a percentage point by early 2012.

Chart 4: UK-Eurozone HICP Transport % y/y



Pressure of Demand

It was striking that during the deepest recession since the war, UK core inflation managed to accelerate, while Eurozone core inflation decelerated. UK real household disposable income growth accelerated during the recession – while real disposable income growth slumped in the Eurozone. We suspect the two were related.

By far the biggest contributor to the buoyancy of UK RPDI was the collapse in the household interest burden. Mortgage interest payments slumped from close to 10% of disposable income, down to only around 1% - thanks to the aggressive BoE interest rate cuts. The point is that ironically, households in the UK saw their disposable incomes increase, they had more spare cash to spend and retailers didn't have to discount by as much as might otherwise have been the case. When we calculate the gap between UK and German real household disposable income growth and plot this against the gap between UK and German core inflation the two appear to coincide. When UK RPDI growth outpaces that in Germany, core inflation in the UK has also tended to outpace the German equivalent and vice-versa.

UK real disposable income growth has slumped (into negative territory) so far this year. This has reflected the combination of sharply higher inflation and the fading boost from the falling mortgage interest burden (since interest rates are no longer falling). Clearly it is very early days, but the surprisingly low reading for core inflation in the UK in the latest months is probably no coincidence given that the squeeze on household disposable incomes has intensified as this year has progressed. With the UK consumer's disposable income under increasing pressure, while the German and Eurozone equivalent less stressed, there is some grounds to expect the gap between UK and Eurozone core inflation to narrow in the period ahead.

Conclusion

The gap between UK and Eurozone inflation in recent years has reflected the combination of the VAT hike in the UK, divergence in food energy and transport price inflation and divergences in household disposable income growth. Over the course of the next year we expect the gap to narrow sharply as the UK VAT hike drops out of the % y/y calculation, the effects of sharply lower UK real disposable income bear down on core inflation and as food and energy price inflation falls back towards zero. Nonetheless, UK inflation is likely to continue to outpace the Eurozone – not least given the ECB's more hawkish stance. Indeed, the upcoming UK university tuition fee hikes are also likely to ensure that UK inflation does not fall back below the Eurozone. The bottom line is the gap between UK and Eurozone headline inflation is likely to narrow, but not disappear entirely.

(For a copy of the full 12-page report in pdf format, please contact Alan Clarke directly at (44 207) 826-5986 and/or alan_clarke@scotiacapital.com.)

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Key Data Preview

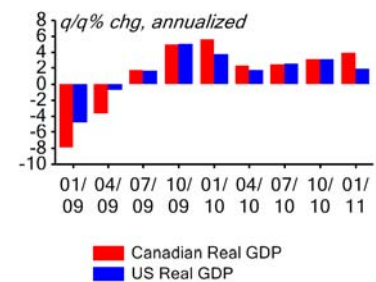
CANADA

After this week's economic update by the Bank of Canada via its rate announcement and Monetary Policy Report, next week should be relatively quiet in terms of data releases with only May real GDP (Friday) of importance to the markets. Indeed, our expectations for a modest gain in real GDP in May will not likely shift the growth picture given that part of the expected weakness stems from the supply chain disruptions from the Japanese disasters with a rebound set to take place in Q3. From what we know from the observable factors — which are only a portion of this report since there are several unobservable factors as well such as many services, natural resource sectors, government, and utilities — home construction, aggregate hours worked and price-adjusted wholesale sales increased in May, offsetting further deterioration in real manufacturing shipments and unchanged retail sales in inflation adjusted terms. However, there are two risks to our forecast, one to the downside and one to the upside. On the downside, the magnitude of support from residential activity will likely be smaller than the headline number would suggest given that 98% of the increase in housing starts was in the multi-family segment which involves less value added than singles. On the upside, however, while real manufacturing shipments deteriorated further in May, net exports improved, resulting in the first narrowing in the real trade deficit since December 2012. In addition, given that real GDP was unchanged in April, we should also witness a base effect. Putting this all together we are looking for a rebound of 0.2% m/m in May. Should this come to fruition, even a flat print in June would lead to a roughly 1.5% q/q annualized increase in Q2 GDP, less than half that registered in Q1 but slightly better than we are currently expecting.

UNITED STATES

While there are several data releases next week, Q2 advanced GDP (Friday) will likely be the only release of importance as the markets remain focused on the looming US debt ceiling deadline and further developments in Europe. While we are expecting an increase of roughly 1.5% q/q annualized in Q2, which would mark the slowest pace of growth since Q2 2010, uncertainty surrounding this report remains quite large with analyst estimates ranging from a low of 1.3% to a high of 2.5%. Business investment will likely be the main support behind growth during the quarter, according to recent durable goods orders reports which have shown a strong improvement in the non-defense capital goods ex-aircraft orders component. Trade should also provide a decent boost to growth as net exports improve further on the back of a weak US dollar. However, aside from investment and trade, weakness abounds in other areas of the economy. Perhaps the largest deterioration will come from personal consumption which witnessed a contraction in both April and May according to the US personal income report. Even with an expected rebound in June after price-adjusted retail sales figures rose 0.4% m/m (using the St. Louis Fed's measure), personal consumption will likely come in at roughly 1% q/q annualized during the quarter which would still be the slowest pace of growth since Q4 2009. The US housing sector also remains subdued although home construction has come in slightly stronger than previously expected. Nonetheless, on balance, residential investment will likely ride flat in terms of contributions to Q2 GDP growth. Lastly, given the supply chain disruptions stemming from Japan's triple threat — tsunami, earthquake, nuclear meltdown — inventories will likely be way down during the quarter as auto assembly plants were forced to shut down, creating a drag on real GDP.

Growth Comparison Between Canada and the U.S.



Source: Statistics Canada, Bureau of Economic Analysis, Scotia Capital Economics

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MEXICO

Economic activity in Mexico, measured by the Global Economic Activity Indicator (IGAE) as proxy for monthly GDP, showed some signs of a slowdown at the beginning of the second quarter; however seasonally adjusted data suggest that economic performance remains on track. The IGAE grew 2.4% y/y in April, with the service sector increasing by 3.1% y/y and industry by 1.4%. We expect the IGAE (to be published on July 27th), to advance 3.6% y/y in May.

EUROPE

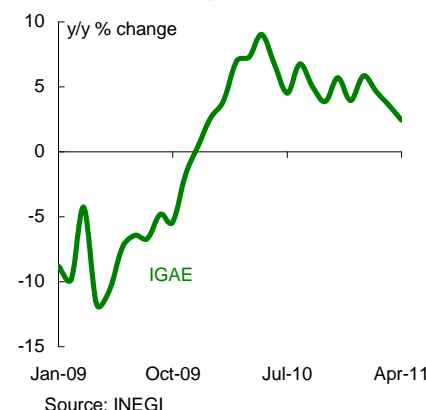
Consumer price inflation in the euro zone continues to exceed the European Central Bank's (ECB) target of "below, but close to, 2%" by a wide margin. The flash estimate for euro zone headline inflation will be released on July 29th; we estimate that consumer prices decreased by 0.4% m/m in July; nevertheless, due to a low base, the annual inflation rate would climb to 2.8% from 2.7% the month before. We expect the ECB to continue the gradual monetary normalization process, increasing the main refinancing rate by 25 basis points to 1.75% in October.

We forecast that UK GDP (to be released on July 26th) will fall moderately during Q2 — down by 0.2% compared with Q1. While this is more pessimistic than most expect, we stress that much of the weakness is associated with the temporary effect of the extended Easter break (on the back of the Royal wedding). In very simple terms, since the majority of the population enjoyed an extra day off work, don't be surprised if the level of output in the economy goes down (albeit temporarily). We already know that industrial, construction and services sector output fell sharply in April as a result of this. Moreover, the bounce back in activity during May has so far been lacklustre. More generally, consumer spending (which accounts for the biggest share of overall GDP) is likely to have been weak again. Surveys of consumer confidence show that households are extremely pessimistic. That should come as little surprise when the pace of increase in the prices of goods and services is around double the pace of increase in household incomes. Essentially what this means is households have less spare cash, so they are spending less. In turn, this should depress GDP growth.

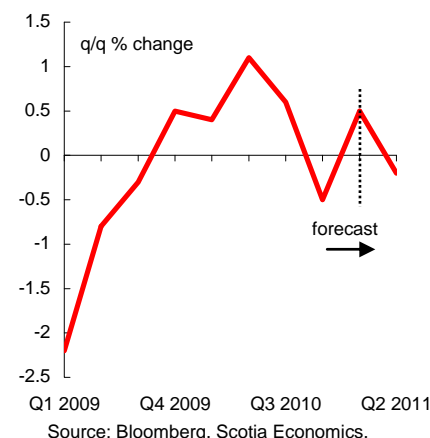
ASIA

Thailand's exports for June are expected to continue to bounce back towards their normal trend as the effects of the supply-chain disruptions emanating from Japan dissolve. Indeed, evidence of improving trade conditions in the Japanese economy are disseminating to the rest of the region, with Thailand being a main beneficiary given its relatively open economy stance and its heavy concentration in vehicle exports. We expect the US dollar value of exports to reach US\$21,400 million, which implies a 20% y/y rate of expansion, in line with pre-Japanese earthquake-tsunami trends. Imports are expected to reach US\$19,800 million in June, with the trade surplus expanding to US\$1,600.

Mexican Global Economic Activity Indicator



UK Real GDP Growth



Thailand's Export Growth



Key Indicators for the week of July 25 - 29

North America								
Country	Date	Time	Event	Period	BNS	Consensus	Latest	
US	07/25	08:30	Chicago Fed Nat Activity Index	JUN	--	-0.4	-0.4	
US	07/25	10:30	Dallas Fed Manf. Activity	JUL	--	-8.6	-17.5	
MX	07/26	09:00	Trade Balance (US\$ mns)	JUN P	95.0	--	555.1	
US	07/26	09:00	S&P/CS 20 City SA (MoM)	MAY	--	0.0	-0.1	
US	07/26	09:00	S&P/CS Composite-20 (YoY)	MAY	-4.6	-4.6	-4.0	
US	07/26	10:00	Consumer Confidence	JUL	--	56.0	58.5	
US	07/26	10:00	Richmond Fed Manufact. Index	JUL	--	4.0	3.0	
US	07/26	10:00	New Home Sales	JUN	318	322.0	319.0	
US	07/26	10:00	New Home Sales (MoM)	JUN	-0.3	0.9	-2.1	
US	07/27	07:00	MBA Mortgage Applications (WoW)	22-Jul	--	--	15.5	
US	07/27	08:30	Durable Goods Orders (MoM)	JUN	0.5	0.3	2.1	
US	07/27	08:30	Durables Ex Transportation (MoM)	JUN	0.4	0.5	0.7	
US	07/27	08:30	Cap Goods Orders Nondef Ex Air (MoM)	JUN	--	0.6	1.6	
MX	07/27	09:00	Global Economic Indicator IGAE (YoY)	MAY	3.62	5.1	2.4	
CA	07/27	09:00	Teranet/National Bank HPI (MoM)	MAY	-0.5	--	1.1	
US	07/27	14:00	Fed's Beige Book					
US	07/28	08:30	Initial Jobless Claims (000s)	22-Jul	410	415	418	
US	07/28	08:30	Continuing Claims (000s)	16-Jul	3700	3700	3698	
US	07/28	10:00	Pending Home Sales (MoM)	JUN	-2.0	-2.0	8.2	
CA	07/29	08:30	Gross Domestic Product (MoM)	MAY	0.2	0.2	0.0	
CA	07/29	08:30	Industrial Product Price (MoM)	JUN	0.2	-0.1	-0.2	
CA	07/29	08:30	Raw Materials Price Index (MoM)	JUN	-2.0	-2.0	-5.2	
US	07/29	08:30	Employment Cost Index (QoQ SAAR)	2Q	--	0.5	0.6	
US	07/29	08:30	GDP (QoQ SAAR)	2Q A	1.5	1.8	1.9	
US	07/29	08:30	Personal Consumption (QoQ SAAR)	2Q A	0.8	0.9	2.2	
US	07/29	08:30	GDP Price Index (QoQ SAAR)	2Q A	--	2.0	2.0	
US	07/29	08:30	Core PCE (QoQ SAAR)	2Q A	--	2.2	1.6	
US	07/29	09:45	Chicago Purchasing Manager Index	JUL	--	60.2	61.1	
US	07/29	09:55	U. of Michigan Confidence	JUL F	--	64.0	63.8	
US	07/29	10:00	NAPM-Milwaukee	JUL	--	--	59.3	
MX	07/29		Budget Balance YTD (MXN bns)	JUN	--	--	-17.8	

Forecasts at time of publication.

Source: Bloomberg, Scotia Economics.

Key Indicators for the week of July 25 - 29

Europe								
Country	Date	Time	Event	Period	BNS	Consensus	Latest	
IT	07/25	04:00	Consumer Confidence Index SA	JUL	--	104.8	105.8	
UK	07/25	04:30	BBA Loans for House Purchase	JUN	--	31000.0	30509	
UK	JUL 25-29	JUL	Nationwide House Prices SA (MoM)	JUL	--	-0.2	0.0	
GE	07/26	02:00	GfK Consumer Confidence Survey	AUG	--	5.6	5.7	
FR	07/26	02:45	Consumer Confidence Indicator	JUL	--	82.0	83.0	
UK	07/26	04:30	GDP (QoQ)	2Q A	-0.2	0.2	0.5	
UK	07/26	04:30	GDP (YoY)	2Q A	0.4	0.8	1.6	
UK	07/26	04:30	Index of Services (MoM)	MAY	1.2	0.8	-1.2	
SP	07/26		Spain Budget Balance YTD (€ bns)	JUN	--	--	-13767.0	
GE	07/27	03:00	CPI - Saxony (MoM)	JUL	--	--	0.1	
EC	07/27	04:00	Euro-Zone M3 s.a. (YoY)	JUN	--	2.3	2.4	
GE	07/27	04:00	CPI - Brandenburg (MoM)	JUL	--	--	0.1	
GE	07/27	04:00	CPI - Hesse (MoM)	JUL	--	--	0.1	
IT	07/27	04:00	Business Confidence	JUL	--	99.5	100.5	
GE	07/27	06:00	CPI - Bavaria (MoM)	JUL	--	--	0.1	
UK	07/27	06:00	CBI Business Optimism	JUL	--	10.0	9.0	
UK	07/27	06:00	CBI Trends Total Orders	JUL	--	-3.0	1.0	
UK	07/27	06:00	CBI Trends Selling Prices	JUL	--	26.5	27.0	
FR	07/29	12:00	Jobseekers- Net Change (000s)	JUN	--	--	17.7	
FR	07/27	12:00	Total Jobseekers (000s)	JUN	--	--	2686.8	
GE	07/27		Consumer Price Index (MoM)	JUL P	0.3	0.3	0.1	
GE	07/27		CPI - Baden Wuerttemberg (MoM)	JUL	--	--	0.2	
GE	07/27		CPI - EU Harmonised (MoM)	JUL P	0.4	0.3	0.0	
GE	07/27		CPI - North Rhine-West. (MoM)	JUL	--	--	0.2	
GE	07/27	00:00	Import Price Index (MoM)	JUN	--	-0.2	-0.6	
SP	07/28	03:00	Retail Sales (Real) (YoY)	JUN	--	--	-5.8	
GE	07/28	03:55	Unemployment Change (000's)	JUL	--	-15.0	-8.0	
GE	07/28	03:55	Unemployment Rate SA	JUL	--	7.0	7.0	
IT	07/28	04:00	Hourly Wages (MoM)	JUN	--	--	0.0	
EC	07/28	05:00	Business Climate Indicator	JUL	--	0.8	0.9	
EC	07/28	05:00	Euro-Zone Consumer Confidence	JUL F	-10.5	-11.4	-11.4	
EC	07/28	05:00	Euro-Zone Economic Confidence	JUL	104.8	104.0	105.1	
EC	07/28	05:00	Euro-Zone Indust. Confidence	JUL	2.5	1.8	3.2	
EC	07/28	05:00	Euro-zone Services Confidence	JUL	9.7	9.0	9.9	
PO	07/28	05:00	Consumer Confidence	JUL	--	--	-50.7	
PO	07/28	05:00	Economic Climate Indicator	JUL	--	--	-2.2	
IR	07/28	06:00	Retail Sales (Volume) (MoM)	JUN	--	--	1.3	
UK	07/28	06:00	CBI Reported Sales	JUL	--	2.0	-2.0	
UK	07/28	19:01	GfK Consumer Confidence Survey	JUL	-20.0	-26.0	-25.0	
SP	07/28		Total Housing Permits (MoM)	MAY	--	--	-15.0	
GE	07/29	02:00	Retail Sales (MoM)	JUN	--	1.7	-2.5	
FR	07/29	02:45	Producer Prices (MoM)	JUN	--	-0.1	-0.5	
FR	07/29	02:45	Consumer Spending (MoM)	JUN	--	0.8	-1.5	
SP	07/29	03:00	CPI (EU Harmonised) (YoY)	JUL P	--	2.9	3.0	
SW	07/29	03:30	GDP s.a. (QoQ)	2Q P	--	0.6	0.8	
IT	07/29	04:00	PPI (MoM)	JUN	--	-0.1	-0.2	
UK	07/29	04:30	Net Consumer Credit (£ bns)	JUN	0.2	0.3	0.2	
UK	07/29	04:30	Mortgage Approvals (000s)	JUN	46.0	46.0	45.9	
EC	07/29	05:00	Euro-Zone CPI Estimate (YoY)	JUL	2.8	2.7	2.7	
IT	07/29	05:00	CPI (NIC incl. tobacco) (MoM)	JUL P	--	0.2	0.1	
IT	07/29	05:00	CPI (NIC incl. tobacco) (YoY)	JUL P	--	2.6	2.7	
IT	07/29	05:00	CPI - EU Harmonized (MoM)	JUL P	-0.7	-1.1	0.1	
IT	07/29	05:00	CPI - EU Harmonized (YoY)	JUL P	3.2	2.9	3.0	

Forecasts at time of publication.

Source: Bloomberg, Scotia Economics.

Key Indicators for the week of July 25 - 29

Asia Pacific							
Country	Date	Time	Event	Period	BNS	Consensus	Latest
AU	07/24	21:30	Producer Price Index (QoQ)	2Q	--	0.5	1.2
CH	JUL 24-28		Leading Index	JUN	--	--	102.0
NZ	07/25	18:45	Trade Balance (NZ\$ mns)	JUN	--	400.0	605.0
NZ	07/25	18:45	Exports (NZ\$ mns)	JUN	--	4300.0	4625.9
NZ	07/25	18:45	Imports (NZ\$ mns)	JUN	--	3800.0	4021.1
AU	07/25	20:00	Conference Board Leading Index	MAY	--	--	0.1
PH	07/25	21:00	Trade Balance (US\$ mns)	MAY	--	--	-1195.0
PH	07/25	21:00	Total Monthly Imports (US\$ mns)	MAY	--	--	5497.2
JN	JUL 25-26		Small Business Confidence	JUL	--	--	43.1
IN	07/26	01:30	India Repo Cutoff Yield	26-Jul	7.75	7.75	7.50
IN	07/26	01:30	Cash Reserve Ratio	26-Jul	6.00	6.00	6.00
IN	07/26	01:30	Reverse Repo Rate	26-Jul	6.75	6.75	6.50
SK	07/26	19:00	GDP at Constant Price (QoQ)	2Q P	1.5	0.7	1.3
NZ	07/26	21:00	NBNZ Activity Outlook	JUL	--	--	38.7
NZ	07/26	21:00	NBNZ Business Confidence	JUL	--	--	46.5
AU	07/26	21:30	Consumer Prices (QoQ)	2Q	--	0.7	1.6
AU	07/26	21:30	Consumer Prices (YoY)	2Q	3.5	3.4	3.3
CH	07/26	22:00	Industrial Profits YTD (YoY)	JUN	--	--	27.9
NZ	07/27	17:00	RBNZ Official Cash Rate	28-Jul	2.50	2.50	2.50
JN	07/27	19:50	Retail Trade SA (MoM)	JUN	--	1.5	2.4
JN	07/27	19:50	Large Retailers' Sales (YoY)	JUN	--	-0.4	-2.5
PH	07/28	04:00	Overnight Borrowing Rate	28-Jul	4.50	4.50	4.50
HK	07/28	04:30	Exports (YoY)	JUN	--	4.9	10.1
HK	07/28	04:30	Imports (YoY)	JUN	--	5.9	13.0
HK	07/28	04:30	Trade Balance (HK\$ bns)	JUN	--	-39.1	-35.7
NZ	07/28	18:45	Building Permits (MoM)	JUN	--	3.0	2.2
JN	07/28	19:15	Markit/JMMA Manufacturing PMI	JUL	--	--	50.7
JN	07/28	19:30	Job-To-Applicant Ratio	JUN	--	0.6	0.6
JN	07/28	19:30	Overall Hhld Spending (YoY)	JUN	--	-2.3	-1.9
JN	07/28	19:30	Jobless Rate	JUN	--	4.6	4.5
JN	07/28	19:30	Tokyo CPI (YoY)	JUL	--	0.0	-0.2
JN	07/28	19:30	Tokyo CPI Ex-Fresh Food (YoY)	JUL	--	0.2	0.1
JN	07/28	19:30	Tokyo CPI Ex Food, Energy (YoY)	JUL	--	0.1	0.1
JN	07/28	19:30	Natl CPI (YoY)	JUN	--	0.2	0.3
JN	07/28	19:30	Natl CPI Ex-Fresh Food (YoY)	JUN	--	0.5	0.6
JN	07/28	19:30	Natl CPI Ex Food, Energy (YoY)	JUN	--	0.1	0.1
JN	07/28	19:50	Industrial Production (MoM)	JUN P	--	4.5	6.2
AU	07/28	21:30	Private Sector Credit (MoM)	JUN	--	0.4	0.3
JN	07/29	00:00	Vehicle Production (YoY)	JUN	--	--	-30.9
JN	07/29	01:00	Construction Orders (YoY)	JUN	--	--	25.5
JN	07/29	01:00	Annualized Housing Starts	JUN	--	0.8	0.8
TH	07/29	03:30	Total Exports (US\$ mns)	JUN	21400	--	19284
TH	07/29	03:30	Total Imports (US\$ mns)	JUN	19800	--	19010
TH	07/29	03:30	Total Trade Balance (US\$ mns)	JUN	1600	--	274
TA	07/29	04:00	GDP - Constant Prices (YoY)	2Q P	4.5	4.4	6.6

Forecasts at time of publication.

Source: Bloomberg, Scotia Economics.

Key Indicators for the week of July 25 - 29

Latin America							
Country	Date	Time	Event	Period	BNS	Consensus	Latest
BZ	07/25	07:00	FGV CPI IPC-S (WoW)	22-Jul	--	--	-0.1
BZ	07/25	07:30	Central Bank Weekly Economists Survey				
BZ	07/26	07:00	FGV Consumer Confidence	JUL	--	--	118.0
BZ	07/26	09:30	Current Account - Monthly (US\$ mns)	JUN	--	-4220.0	-4102.8
BZ	07/26	09:30	Foreign Investment (US\$ mns)	JUN	--	4550.0	3970.0
BZ	07/28	07:30	COPOM Monetary Policy Meeting Minutes				
CL	07/28	09:00	Industrial Production (YoY)	JUN	--	6.3	9.7
CL	07/28	09:00	Industrial Sales (YoY)	JUN	--	--	6.9
CL	07/28	09:00	Retail Sales (YoY)	JUN	--	10.0	8.5
BZ	07/28		Central Govt Budget (BRL bns)	JUN	--	--	4.1
CL	07/29	09:00	Unemployment Rate	JUN	--	7.3	7.2
CO	07/29	12:00	Urban Unemployment Rate	JUN	--	11.2	11.0
CO	07/29		Overnight Lending Rate	29-Jul	4.50	4.50	4.25

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

Global Auctions for the week of July 25 - 29

North America

<u>Country</u>	<u>Date</u>	<u>Time</u>	<u>Event</u>
US	07/25	11:30	U.S. to Sell 3-Month Bills
US	07/25	11:30	U.S. to Sell 6-Month Bills
US	07/26	11:00	U.S. Fed to Purchase USD2.75-3.50 Bln Notes/Bonds
US	07/26	11:30	U.S. to Sell 4-Week Bills
US	07/26	11:30	U.S. to Sell 52-Week Bills
US	07/26	13:00	U.S. to Sell 2-Year Notes
CA	07/27	12:00	Canada to Sell 10-Year Notes
US	07/27	13:00	U.S. to Sell 5-Year Notes
US	07/28	13:00	U.S. to Sell 7-Year Notes
US	07/29	11:00	U.S. Fed to Purchase USD2.50-3.00 Bln Notes/Bonds

Europe

<u>Country</u>	<u>Date</u>	<u>Time</u>	<u>Event</u>
GE	07/25	05:15	Germany to Sell EU3 Bln 12-Mth Bills
BE	07/25	05:30	Belgium to Sell 4.25% 2041 Bonds
HU	07/25	05:30	Hungary to Sell 6-Week Bills
BE	07/25	05:30	Belgium to Sell 4.25% 2021 Bonds
BE	07/25	05:30	Belgium to Sell 3.5% 2017 Bonds
FR	07/25	09:00	France to Sell Bills
EC	07/25	09:30	ECB Announces Bond Purchases
SP	07/26	04:30	Spain to Sell 3M and 6M Bills
IT	07/26	05:00	Italy to Sell Bills & Zero Coupon Notes
SZ	07/26	05:30	Switzerland to Sell 3-Month Bills
EC	07/26	09:30	ECB Calls for Bids in 3-Month Tender
IT	07/27	05:00	Italy to Sell I/L Bonds
IT	07/28	05:00	Italy to Sell Bonds/Floating Rate Notes
UK	07/29	06:10	U.K. to Sell Bills

Asia Pacific

<u>Country</u>	<u>Date</u>	<u>Time</u>	<u>Event</u>
JN	07/26	04:00	Japan Auction for Enhanced-Liquidity
CH	07/26	23:00	China to Sell 20 Year Bond
JN	07/26	23:35	Japan to Sell 3-Month Bills
JN	07/27	23:45	Japan to Sell 2-Year Bond

Source: Bloomberg, Scotia Economics.

Events for the week of July 25 - 29

North America

<u>Country</u>	<u>Date</u>	<u>Time</u>	<u>Event</u>
US	07/26	14:00	Fed's Hoenig to Testify on Monetary Policy
US	07/27	14:00	Fed Releases Beige Book Economic Survey
US	07/28	12:45	Fed's Lacker Speaks on economy in Chantilly, Virginia
US	07/28	14:30	Fed's Williams Speaks in Salt Lake City
US	07/29	15:15	Fed's Bullard and Lockhart Discuss Monetary Policy in Wyoming

Europe

<u>Country</u>	<u>Date</u>	<u>Time</u>	<u>Event</u>
GE	07/24	12:30	Economy Minister Roesler Gives Interview to ARD Television
PO	07/25	04:00	Bank of Portugal Governor, Finance Minister Gaspar Speak
EC	07/28	04:00	ECB Publishes its Bank Lending Survey
PO	07/28		Bank of Portugal Publishes Bank Survey on Credit Market

Asia Pacific

<u>Country</u>	<u>Date</u>	<u>Time</u>	<u>Event</u>
AU	07/25	00:30	RBA's Edey Speaks in Darwin to Property Council Congress
AU	07/25	23:05	RBA Governor Stevens Gives Speech in Sydney
IN	07/26	01:30	India Repo Cutoff Yield
NZ	07/27	17:00	Reserve Bank of New Zealand Reviews Official Interest Rate
PH	07/28	04:00	Overnight Borrowing Rate

Latin America

<u>Country</u>	<u>Date</u>	<u>Time</u>	<u>Event</u>
PE	07/28		UNASUR Presidential Summit
CO	07/29		Overnight Lending Rate

Source: Bloomberg, Scotia Economics.

Global Central Bank Watch

North America

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

Canadian CPI for the month of June (-0.7% m/m headline, -0.6% m/m core) was at least as big of a miss to the downside as the market took the prior month's miss to the upside. Pulling forward BoC rate forecasts to September or October at this point would be premature and we are not changing our forecast as yet. The May inflation report vindicates our bias and reinforces our view that the BoC may have acted prematurely in removing 'eventual' references from its rate guidance. Indeed, we think actual inflation risks coming in below the BoC's 2% forever forecast in no small part due to the lagged influences of CAD appreciation that may motivate more significant price pass through effects going forward.

Europe

<u>Rate</u>	<u>Current Rate</u>	<u>Next Meeting</u>	<u>Scotia's Forecasts</u>	<u>Consensus Forecasts</u>
European Central Bank – Refinancing Rate	1.50	August 4, 2011	1.50	--
Bank of England – Bank Rate	0.50	August 4, 2011	0.50	0.50
Swiss National Bank – Libor Target Rate	0.25	September 15, 2011	0.25	--
Central Bank of Russia – Refinancing Rate	8.25	August 1, 2011	8.25	--
Hungarian National Bank – Base Rate	6.00	July 26, 2011	6.00	6.00
Central Bank of the Republic of Turkey – 1 Week Repo Rate	6.25	August 23, 2011	6.25	--

The Hungarian National Bank will likely keep the benchmark interest rate unchanged at 6.0% in the coming months. Monetary authorities assess that weak domestic demand and loose labour market conditions should limit possible second-round effects arising from elevated commodity prices, with the inflation rate (3.5% y/y in June) expected to return towards the central bank's 3% target in the medium term.

Asia Pacific

<u>Rate</u>	<u>Current Rate</u>	<u>Next Meeting</u>	<u>Scotia's Forecasts</u>	<u>Consensus Forecasts</u>
Bank of Japan – Target Rate	0.10	August 5, 2011	0.10	--
Reserve Bank of Australia – Cash Target Rate	4.75	August 2, 2011	4.75	4.75
Reserve Bank of New Zealand – Cash Rate	2.50	July 27, 2011	2.50	2.50
People's Bank of China – Lending Rate	6.56	TBA	--	--
Reserve Bank of India – Repo Rate	7.50	July 26, 2011	7.75	7.75
Hong Kong Monetary Authority – Base Rate	0.50	TBA	0.50	--
Central Bank of China Taiwan – Discount Rate	1.88	September 30, 2011	--	--
Bank Negara Malaysia – Overnight Policy Rate	3.00	September 8, 2011	3.00	--
Bank of Korea – Bank Rate	3.25	August 10, 2011	3.25	--
Bank of Thailand – Repo Rate	3.25	August 24, 2011	3.25	--
Bank Indonesia – Reference Interest Rate	6.75	August 9, 2011	6.75	--
Central Bank of the Philippines – Overnight Policy Rate	4.50	July 28, 2011	4.50	4.50

The Reserve Bank of India is expected to lift the benchmark repo rate 25 basis points on July 26th. The annual rise in the wholesale price index remains elevated, with the non-food manufacturing sector component (core inflation) continuing to rise. The RBI is likely to continue to tighten until it sees evidence of core inflation slowing. In our view, the respite in global oil prices will combine favourably with slower local demand growth to bring down inflation in the second half of 2011. The Reserve Bank of New Zealand will likely keep interest rates constant next week.

Latin America

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

We expect the central bank of Colombia to maintain its monetary tightening stance on July 29th and hike the reference rate by 25 basis points (bps) to 4.50%. June's meeting Minutes showed that the last increase was not unanimous, signaling that this could be the last hike of the cycle. Despite inflation having increased slightly from 3.02% y/y in May to 3.32% y/y in June, credit and local demand continue to improve, while inflation expectations for the end of 2011 remain within the central bank's expected target range.

Africa

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

Forecasts at time of publication.

Source: Bloomberg, Scotia Economics.

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

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

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

Canada	2010	10Q4	11Q1	Latest	United States	2010	10Q4	11Q1	Latest
Real GDP (annual rates)	3.2	3.1	3.9		Real GDP (annual rates)	2.9	3.1	1.9	
Current Acc. Bal. (C\$B, ar)	-50.9	-41.1	-35.7		Current Acc. Bal. (US\$B, ar)	-471	-449	-477	
Merch. Trade Bal. (C\$B, ar)	-9.0	1.5	6.4	-9.8 (May)	Merch. Trade Bal. (US\$B, ar)	-646	-637	-730	-779 (May)
Industrial Production	4.6	6.0	5.6	5.0 (Apr)	Industrial Production	5.3	6.2	5.3	3.4 (Jun)
Housing Starts (000s)	192	179	175	197 (Jun)	Housing Starts (millions)	0.58	0.54	0.58	0.63 (Jun)
Employment	1.4	1.7	1.9	1.3 (Jun)	Employment	-0.8	0.5	0.9	0.9 (Jun)
Unemployment Rate (%)	8.0	7.7	7.8	7.4 (Jun)	Unemployment Rate (%)	9.6	9.6	8.9	9.2 (Jun)
Retail Sales	5.5	5.3	2.5	8.2 (May)	Retail Sales	6.8	8.1	8.6	8.5 (Jun)
Auto Sales (000s)	1561	1554	1577	1656 (Apr)	Auto Sales (millions)	11.5	12.3	13.0	11.4 (Jun)
CPI	1.8	2.3	2.6	3.1 (Jun)	CPI	1.6	1.3	2.1	3.6 (Jun)
IPPI	1.0	2.6	4.0	-5.7 (May)	PPI	4.2	3.8	4.9	7.0 (Jun)
Pre-tax Corp. Profits	21.2	19.1	13.4		Pre-tax Corp. Profits	36.8	16.1	9.3	
Mexico					Brazil				
Real GDP	5.4	4.4	4.6		Real GDP	6.7	4.2	3.8	
Current Acc. Bal. (US\$B, ar)	-5.6	-14.0	-5.5		Current Acc. Bal. (US\$B, ar)	-47.4	-48.0	-58.3	
Merch. Trade Bal. (US\$B, ar)	-3.0	-4.2	7.6	6.7 (May)	Merch. Trade Bal. (US\$B, ar)	20.3	30.1	12.7	53.2 (Jun)
Industrial Production	6.0	4.8	5.3	12.9 (May)	Industrial Production	10.5	3.8	2.4	14.7 (May)
CPI	4.2	4.2	3.5	3.3 (Jun)	CPI	5.1	6.1	6.8	6.4 (Jun)
Chile					Italy				
Real GDP	5.2	5.8	9.8		Real GDP	1.2	1.5	1.0	
Current Acc. Bal. (US\$B, ar)	3.1	4.9	2.9		Current Acc. Bal. (US\$B, ar)	-0.07	-0.07	-0.11	-0.09 (May)
Merch. Trade Bal. (US\$B, ar)	11.6	17.7	17.4	7.1 (Jun)	Merch. Trade Bal. (US\$B, ar)	-39.1	-46.3	-77.2	-41.4 (May)
Industrial Production	0.6	2.7	11.5	12.6 (May)	Industrial Production	6.5	5.3	2.3	11.0 (May)
CPI	1.4	2.5	2.9	3.4 (Jun)	CPI	1.6	1.8	2.3	2.7 (Jun)
Germany					France				
Real GDP	3.5	3.8	4.8		Real GDP	1.4	1.4	2.2	
Current Acc. Bal. (US\$B, ar)	188.0	251.7	194.8	118.7 (May)	Current Acc. Bal. (US\$B, ar)	-44.5	-86.6	-59.7	-167.9 (May)
Merch. Trade Bal. (US\$B, ar)	201.5	219.8	209.3	220.5 (May)	Merch. Trade Bal. (US\$B, ar)	-39.0	-39.4	-55.0	-62.1 (May)
Industrial Production	10.1	11.8	13.0	19.4 (May)	Industrial Production	5.1	4.6	4.9	10.5 (May)
Unemployment Rate (%)	7.7	7.4	7.3	7.0 (Jun)	Unemployment Rate (%)	9.8	9.7	9.7	9.5 (May)
CPI	1.1	1.5	2.1	2.3 (Jun)	CPI	1.5	1.6	1.8	2.1 (Jun)
Euro Zone					United Kingdom				
Real GDP	1.7	1.9	2.4		Real GDP	1.4	1.5	1.6	
Current Acc. Bal. (US\$B, ar)	-77	-41	-169	-315 (May)	Current Acc. Bal. (US\$B, ar)	-71.6	-72.2	-74.0	
Merch. Trade Bal. (US\$B, ar)	32.0	53.2	-68.5	26.4 (May)	Merch. Trade Bal. (US\$B, ar)	-153.0	-171.9	-142.4	-166.0 (May)
Industrial Production	7.4	8.1	6.6	13.2 (May)	Industrial Production	2.1	3.3	2.0	1.0 (May)
Unemployment Rate (%)	10.1	10.0	9.9	9.8 (May)	Unemployment Rate (%)	7.9	7.9	7.7	7.7 (Apr)
CPI	1.6	2.0	2.5	2.7 (Jun)	CPI	3.3	3.4	4.1	4.2 (Jun)
Japan					Australia				
Real GDP	4.0	2.4	-0.7		Real GDP	2.7	2.7	1.0	
Current Acc. Bal. (US\$B, ar)	195.9	176.8	193.9	87.3 (May)	Current Acc. Bal. (US\$B, ar)	-31.8	-37.4	-37.9	
Merch. Trade Bal. (US\$B, ar)	74.7	60.5	31.8	-28.5 (Jun)	Merch. Trade Bal. (US\$B, ar)	19.3	26.1	21.7	49.0 (May)
Industrial Production	16.6	6.8	-2.5	10.1 (May)	Industrial Production	4.3	0.0	-5.4	
Unemployment Rate (%)	5.1	5.0	4.7	4.5 (May)	Unemployment Rate (%)	5.2	5.2	5.0	4.9 (Jun)
CPI	-0.7	0.1	0.0	-0.4 (May)	CPI	2.8	2.7	3.3	
China					South Korea				
Real GDP	10.3	9.8	9.7		Real GDP	6.2	4.7	4.2	
Current Acc. Bal. (US\$B, ar)	305.4				Current Acc. Bal. (US\$B, ar)	28.2	36.6	10.4	27.1 (May)
Merch. Trade Bal. (US\$B, ar)	181.6	247.0	-5.9	267.3 (Jun)	Merch. Trade Bal. (US\$B, ar)	41.2	52.1	29.5	33.9 (Jun)
Industrial Production	13.5	13.5	14.8	15.1 (Jun)	Industrial Production	16.6	9.9	11.2	22.8 (May)
CPI	4.6	4.6	5.4	6.4 (Jun)	CPI	3.0	3.6	4.5	4.4 (Jun)

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

Source: Bloomberg, Scotia Economics.

Interest Rates (% , end of period)

Canada	11Q1	11Q2	Jul/15	Jul/22*	United States	11Q1	11Q2	Jul/15	Jul/22*
BoC Overnight Rate	1.00	1.00	1.00	1.00	Fed Funds Target Rate	0.25	0.25	0.25	0.25
3-mo. T-bill	0.95	0.90	0.94	0.88	3-mo. T-bill	0.09	0.01	0.01	0.03
10-yr Gov't Bond	3.35	3.11	2.88	2.96	10-yr Gov't Bond	3.47	3.16	2.91	2.98
30-yr Gov't Bond	3.76	3.55	3.35	3.41	30-yr Gov't Bond	4.51	4.37	4.25	4.28
Prime	3.00	3.00	3.00	3.00	Prime	3.25	3.25	3.25	3.25
FX Reserves (US\$B)	60.4		63.8	(May)	FX Reserves (US\$B)	128.3		135.9	(May)
Germany					France				
3-mo. Interbank	1.26	1.51	1.58	1.58	3-mo. T-bill	0.80	1.18	1.06	1.05
10-yr Gov't Bond	3.35	3.03	2.70	2.83	10-yr Gov't Bond	3.71	3.41	3.37	3.42
FX Reserves (US\$B)	64.8		66.2	(May)	FX Reserves (US\$B)	61.0		61.7	(May)
Euro-Zone					United Kingdom				
Refinancing Rate	1.00	1.25	1.50	1.50	Repo Rate	0.50	0.50	0.50	0.50
Overnight Rate	0.90	1.72	1.46	1.08	3-mo. T-bill	4.85	4.85	4.85	4.85
FX Reserves (US\$B)	319.9		319.5	(May)	10-yr Gov't Bond	3.69	3.38	3.08	3.11
Japan					Australia				
Discount Rate	0.30	0.30	0.30	0.30	Cash Rate	4.75	4.75	4.75	4.75
3-mo. Libor	0.14	0.13	0.13	0.13	10-yr Gov't Bond	5.49	5.21	4.91	4.97
10-yr Gov't Bond	1.26	1.14	1.08	1.10	FX Reserves (US\$B)	33.3		39.3	(May)
FX Reserves (US\$B)	1080.6		1101.7	(May)					

Exchange Rates (end of period)

USDCAD	0.97	0.96	0.95	0.95	¥/US\$	83.13	80.56	79.13	78.43
CADUSD	1.03	1.04	1.05	1.05	US\$/Australian\$	103.29	107.22	106.53	108.49
GBPUSD	1.603	1.605	1.614	1.632	Chinese Yuan/US\$	6.55	6.46	6.46	6.45
EURUSD	1.416	1.450	1.416	1.437	South Korean Won/US\$	1097	1068	1058	1052
JPYEUR	0.85	0.86	0.89	0.89	Mexican Peso/US\$	11.905	11.714	11.742	11.626
USDCHF	0.92	0.84	0.82	0.82	Brazilian Real/US\$	1.632	1.563	1.575	1.552

Equity Markets (index, end of period)

United States (DJIA)	12320	12414	12480	12686	U.K. (FT100)	5909	5946	5844	5935
United States (S&P500)	1326	1321	1316	1343	Germany (Dax)	7041	7376	7220	7326
Canada (S&P/TSX)	14116	13301	13300	13511	France (CAC40)	3989	3982	3727	3843
Mexico (Bolsa)	37441	36558	36156	35532	Japan (Nikkei)	9755	9816	9936	10132
Brazil (Bovespa)	68587	62404	59478	60481	Hong Kong (Hang Seng)	23528	22398	21875	22445
Italy (BCI)	1120	1039	983	997	South Korea (Composite)	2107	2101	2145	2171

Commodity Prices (end of period)

Pulp (US\$/tonne)	990	1035	1035	1035	Copper (US\$/lb)	4.26	4.22	4.36	4.40
Newsprint (US\$/tonne)	640	640	640	640	Zinc (US\$/lb)	1.05	1.05	1.05	1.11
Lumber (US\$/mfbm)	290	237	253	258	Gold (US\$/oz)	1439.00	1505.50	1587.00	1602.00
WTI Oil (US\$/bbl)	106.72	95.42	97.24	99.57	Silver (US\$/oz)	37.87	35.02	38.17	39.67
Natural Gas (US\$/mmbtu)	4.39	4.37	4.55	4.40	CRB (index)	359.43	338.05	346.30	346.68

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

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