

# Review and Outlook

## KATRINA – A TRAGEDY

We are all saddened by the human loss left in Katrina's wake. The economic impact will be the greatest ever in U.S. history from a natural disaster; estimated at \$200 bln. Most hurricanes are viewed as largely neutral to the economy over the longer term as damage to productivity short term is made up with the stimulus of rebuilding in the aftermath. Private and government insurance programs underwrite much of the cost of rebuilding.

Katrina is different than most because of the scale of destruction, displacement of people and the damage to the infrastructure necessary to allow people to return to rebuild their lives. Some summary statistics highlight the magnitude of this disaster:

Federal disaster declarations now cover 90,000 square miles across seven states.

More than 75,000 response, rescue, recovery and law enforcement personnel are working around the clock to bring aid and support to the Gulf Coast region. Over 35,000 emergency evacuations have been made from New Orleans and 559 emergency shelters have been established, housing 182,000 people. New Orleans had a population of 500,000 most of which have been displaced for an indefinite period.

It is estimated that the disaster could slow economic growth in the U.S. by .5% in the third and fourth quarters this year but will likely result in a positive contribution of approximately 1% in 2006. The net impact on the federal level will be higher deficits, possibly resulting in renewed pressure on the USD unless monetary policy tightens. The

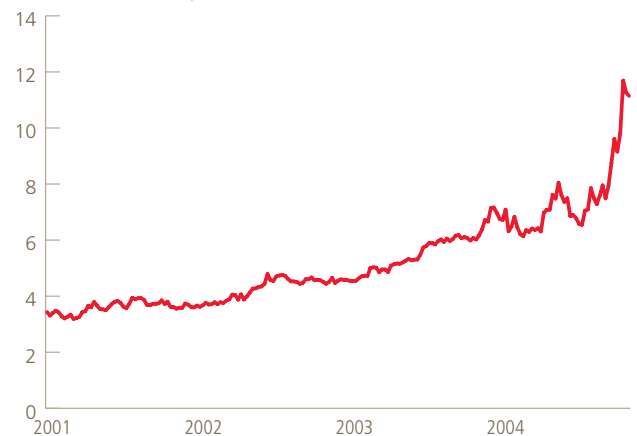
U.S. GDP is approximately \$12 trillion, so there is no doubt about the country's ability to rebuild. The combined effect of the war in Iraq and the rebuilding of the gulf states will, however, make it a challenge for the White House to also retain the tax cuts that were to be made permanent.

## Higher Oil and Gas Prices

The immediate impact of Katrina was to raise gasoline prices as many refineries were taken out of operation. Gas prices across North America jumped 20-30% and more where there were shortages. The U.S. made the decision to release supply from the Strategic Oil Reserve which served to calm the oil markets which approached \$70/barrel.

Natural gas prices were up 22% at the wholesale level as there were concerns that gas fields and the infrastructure to extract gas was materially damaged. The oil and gas markets retraced about half of their initial gains as refineries and pipelines come back into operation, but hurricane Rita is prompting a return to higher prices. It will, however, take weeks and in some cases months before the former capacity is restored.

Natural Gas Price – \$US



## Impact on the Federal Reserve

There was much anticipation in the aftermath, that the short term economic drag created by Katrina would prompt the Fed to pause on any further interest rate increases. This was confirmed by market action where the two year note yield declined to under 3.90 from over 4% prior. The Fed, however, has remained diligent, raising rates 0.25% on September 20th to 3.75% reflecting a consistent move towards a less stimulative monetary policy.

2-Year Treasury Bond Yield – %



## Outlook for the Fourth Quarter

There is little doubt that the economy will slow somewhat in the fourth quarter as a result of Katrina and the subsequent rise in oil and gas prices. Discretionary incomes are being eroded and it is showing up in the expectations for some retail stocks (especially at the low end). Recently, the U.S. personal savings rate has gone negative. This clearly is not sustainable.

The impact on financial markets will be to keep long term interest rates near term lower than they may have been otherwise. For equity markets the response has been highly sector specific. The oil and gas sector remains strong both on the producers as well as the service sector. Airlines have been hit the most with several bankruptcies in the offing and the prospects for a difficult operating environment for some time. The insurance sector will suffer unprecedented losses (approximately \$50 bln) but much of the damage was uninsured.

Canadian equities will likely continue to do better than the U.S. because of its larger energy weighting, although the U.S. could get a good year end rally if the Fed ends its rate increase cycle in time. The environment for bonds will be difficult as low yields are going to be difficult to maintain as inflationary pressures are building and real rates could climb because of a fairly strong economy, larger deficits and low savings rates. We therefore have modest expectations for financial markets going into the year end. At some point in 2006 the rebuilding of New Orleans will become stimulative, creating jobs, hopefully more good news and greater prosperity.

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