Scotiabank Group

Global Views

Weekly commentary on economic and financial market developments

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Spanish and German Elections Pose Key Risks To Start The Week

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

The key risk to start the week off will be Sunday's local and regional elections in **Spain**. Prime Minister Zapatero's Socialist party is widely expected to be handed a resounding and destabilizing defeat that would lessen his party's ability to impose additional fiscal austerity and regulatory reforms. The bigger related risk is that of further disclosure of greater local government debts, and all of this will occur as Spain strives to auction bills on Tuesday. Further widening of peripheral spreads is a clear risk.

Another **German state election** lands this Sunday, and occurs in the smallest state of Bremen. It is the fifth of seven German state elections this year, with Berlin and Mecklenburg-Vorpommern to follow this fall. Next year's state elections include Hamburg, Bavaria, Lower Saxony and Hesse. All of them lead up to the Federal election in 2013, and the pattern to date has been unkind to German Chancellor Angela Merkel to say the least. Bremen is currently run by a Social Democrat Party (SDP) and Green Party coalition. The Green Party is on the upswing in the state, as elsewhere in Germany. Polls are showing Chancellor Merkel's Christian Democrats standing at about 20% of support in Bremen. Little if any market effect is likely since expectations are already set rather low, and more of the policy risk flows from Spain's elections. But the tone of state elections is more aggressively beginning to affect federal policy as witnessed, for instance, by Merkel's goal of introducing legislation to shut down Germany's seventeen nuclear power plants starting within a decade from now in a direct attempt at stemming the flow of support going to the Green Party, even if the longer-run effect is to increase German dependence on Russian natural gas and thus punt the political risk outward.

European markets will face elevated data risk throughout the week. We'll be looking for a soft German CPI print for the month of May next Friday given the reversal in commodity prices this month. The ECB has the strictest headline CPI focus of any central bank, so the consequences should be dovish to markets. Manufacturing and service sector purchasing manager indices always carry market risk and they start the week off, followed by market-sensitive German investor confidence on Tuesday that is likely to weaken. EU new industrial orders during the month of March arrive on Tuesday and could well show a negative Japan effect. No revisions are expected to German GDP on Tuesday, nor for the second estimate of Q1 UK GDP on Wednesday. Eurozone consumer and business confidence readings could well slip a touch to close the week off. An EU foreign ministers meeting is scheduled for Tuesday, and several ECB speeches during the week.

Key on the **US** docket could be downside risks to durable goods orders on Wednesday since the numbers cover the month of April and capture both what we already know about plane orders but perhaps also weakened orders from Japan. Upward revisions to Q1 GDP are expected, but the week ends with consumer spending and income prints for April that we expect to show nominal gains but inflation-adjusted weakness as higher gasoline and food prices during April probably crowded out discretionary spending on non-essentials.

Asian markets will be mostly focused upon further evidence of sharp downsides to Japan's economy stemming from the disasters that struck in March. Japan's trade surplus from March is expected to viciously swing toward a large trade deficit in April as the full effects of disrupted supply channels begin to show through the data. After plunging 7.6% m/m in March, consensus is expecting retail sales to post a gain of 2.6% in April but the risks are skewed lower and much of any spending is likely to be narrowly based upon post-disaster essentials. Japanese CPI for April (May for the city of Tokyo) will likely continue to flirt with deflation. Trade reports are also expected for other Asian economies and should further the evidence of Japan's disruptions on regional trade.

This will be a big week for **Mexico**. Retail sales should post solid but sub-peak growth, the trade surplus is expected to narrow, and Q1 GDP growth is expected to soften to a sub-9% y/y nominal print. That has consensus unanimously expecting no rate change by the Banco de Mexico next Friday.

Bank earnings will dominate **Canada** risk, with more focused implications for the broader credit and equity environments than CAD and the curve. Canadian markets are closed Monday for Victoria Day.

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Downside Risks to Growth, For Now

- **The list of growth-restraining factors continues to mount, increasing the risk that the pace of activity, globally as well as in Canada, could be weaker-than-expected. Nevertheless, longer-term structural changes suggest that the recovery will be sustained by the rebalancing of growth to the less-indebted and faster-paced emerging market economies.**

Early-year optimism about the global outlook is giving way to renewed pessimism. The increasing uncertainty over future prospects is reminiscent of last year's shifting economic sentiment and increased volatility in financial, commodity, and currency markets.

The resiliency of the global recovery is being challenged again. Japan's disasters have disrupted just-in-time production chains around the world. Heightened geopolitical tensions have aggravated the established upward trend in oil and food prices, and reduced discretionary spending power. China and the other emerging market powerhouses are beginning to tighten policy more aggressively to rein in credit, diffuse real estate bubbles, and contain mounting inflationary pressures. Persistent weakness in U.S. housing activity and repeated belt-tightening by state & local governments is dragging on the renewed momentum in hiring, car sales, and exports. Intensifying sovereign debt problems in the peripheral European nations will trigger even greater fiscal restraint and economic retrenchment, while further aggravating banking sector problems.

> ***"Emerging market economies now account for almost three-quarters of global growth — up from just one-third at the turn of the millennium."***
>
> ***Bank of Canada Governor Mark Carney***

Our longstanding view has been for global growth to moderate once the forces of recovery from recession play out, and an unprecedented period of deleveraging, primarily among the advanced economies, takes hold. Over the past few months, we have edged our forecasts even lower to account for increased drag from sharply higher commodity prices and shockwaves emanating form Japan, and some further fine-tuning may be needed.

However, quantifying the extent of any further forecast adjustments is not clear cut. Expectations of slower U.S. growth and a tamer outlook for inflation, as reflected in lower bond yields and a higher US$, are not in synch with America's stepped-up private sector hiring, improving car sales, strengthening exports, or its escalating government net debt-to-GDP ratio fast approaching 70%. Expectations that the economic and financial dislocations associated with Europe's smaller and southern peripheral nations will migrate to the larger and northern core countries are not in synch with the recent spate of stronger-than-expected growth reports. Expectations that tighter monetary policy will meaningfully slow, or even derail, many of the faster-growing emerging markets, and particularly China, are not in synch with the comparatively robust results being posted, the result of highly competitive production in many sectors, massive public and private sector investments, an increased focus on domestic-led growth, and a deep pool of savings to finance activity.

To navigate through these uncertain times, it is worth looking at the longer-term, structural changes that are reshaping the global economy — themes that have underscored our longer-term views, and reinforced in a speech by Bank of Canada Governor Mark Carney on May 16th in Ottawa entitled '*Canada in a Multi-Polar World*'.

The global economy is being transformed by the emerging market powerhouses, whose critical mass and high rates of growth are expected to persist. Extremely competitive production has helped fuel this performance, and it is being sustained by the rapid pace of urbanization, favourable demographic trends, large domestic savings, and significant capital inflows.

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At the same time, from an overall performance perspective, the advanced economies can only be expected to produce low rates of growth, notwithstanding their leadership roles in education and innovation, value-added output, and wealth. A multi-year period will be needed to reduce the massive accumulated debt of households, governments, and in most but not all countries, banks.

Risks are ever present. Eventually, emerging market economies must focus on limiting inflationary excesses caused by overly accommodative fiscal policies, persistently negative real interest rates, and insufficient currency appreciation. The debt-induced struggles of the advanced economies provide the emerging market economies with a blueprint for longer-term reforms needed to secure their globe-leading economic performances.

"Emerging Asia is rapidly urbanizing. Since 1990, the number of people living in cities in China and India has risen by nearly half a billion, the equivalent of housing the entire population of Canada every 18 months. This process can be expected to continue for decades."

Bank of Canada Governor Mark Carney

For Canada, these divergent growth trends present opportunities and challenges. The demand for commodities should remain fundamentally strong, and keep prices high, as the consumption intensity of emerging markets for infrastructure, housing, and consumer goods moves towards advanced nation levels. Canada's output and earnings is benefitting from this exponential growth in demand, with expanded developments continuing to favour prospects in the resource-rich regions across the country. But to achieve even greater returns requires expanding trade with the fast-growing emerging markets, the current destination for only 10% of Canadian exports. To meet this challenge, domestic competitiveness must increase though even larger capital expenditures, increased innovation, and expanded foreign investment.

Canada is, and will continue to be challenged, by capital flows that are inextricably linked to the growth in emerging markets, and the resultant demand for commodities. The large and continuing growth differential between emerging market economies and advanced nations will remain a magnet for capital flows, though policy responses to-date have resulted in these faster-growing regions becoming net exporters, instead of net importers of capital. Countries, like Canada, that have become 'commodity' proxies for investment dollars, will have deal with strong, and probably stronger currencies that will complicate the management of growth and inflation priorities for businesses and governments alike.

Effectively managing the rebalancing of global growth and capital flows, and reducing the inevitable periods of economic and financial market volatility, will take much more policy co-ordination than currently exists. For emerging market economies, it is incumbent upon them to allow greater investment inflows, pro-actively check inflation, and allow greater currency flexibility. For advanced economies, particularly the highly-indebted nations in the Euro zone, Japan, and the United States, there is an urgency to eliminate massive fiscal imbalances in order to reduce the potential for longer-term instability and economic underperformance. Monetary officials must do their part by keeping inflation low and interest rates at pro-growth levels.

In this environment, Canada should continue to benefit from its comparatively lower debt burden and resource-rich economy that gives us the potential to be a relative outperformer over the longer-term. But even so, the nation's prospects are limited by its very large trade ties to a slower U.S. economy, and the continuing likelihood of a strong currency that will dampen exports and earnings.

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Key Reasons Behind Our BoC Forecast

- **We're later and lower than consensus, and judge the fatter tail risk to be skewed toward later and less policy tightening than what we are currently forecasting.**

The purpose of this article is to provide an informal re-cap of the key reasons for our longstanding call for the BoC to remain on hold until at least October of this year. This follows several weeks of marketing to domestic and global clients on the global and Canadian outlook. Our BoC call remains later than consensus, although consensus and market pricing are both shifting in our direction. We also remain lower on the end point for rate tightening into next year with a forecast overnight rate peak of 2.25%. We judge the tail risks to our call to be skewed toward moving later and perhaps entirely pushing the BoC out of 2011, and capping at a lower peak. Clients on our Bloomberg distribution list will also receive a full slide deck to accompany this column; clients on our other distribution lists may request a PDF copy of the slide deck by contacting us directly.

- Medium-term inflation risk is over-stated. We were of the view that the March CPI report was a one-off distortion perhaps fed by the dropping out of a refunded HST tax credit effect and/or a temporary attempt by businesses to test their pricing power. The April CPI report vindicated this view since it showed a sharply lower print for both headline and core inflation. When juxtaposed with the fact that the inflation-adjusted volume of retail sales has fallen in three of the four months so far this year, the message is that attempts by businesses to pass through price increases will be countered by weakened demand.

- One possible reason for this last point is that nominal wage growth remains weak in Canada, and therefore Canadians are unable to absorb the impact of rising prices. Indeed, real wage growth is non-existent. That means that higher prices for gasoline and food result in the crowding out of demand for discretionary items as households balance their books to make ends meet. This is broadly disinflationary, and this effect came through in the April CPI report. While faster wage growth is a future risk, it is unlikely to occur in a material sense this year in our view.

- One other possible reason for why businesses cannot sustainably pass through price increases to consumers is related to the fact that the Canadian housing and consumer cycles are very advanced. Record highs for the home ownership rate, house prices, real consumer spending, real home renovation spending, household debt-to-income and debt-to-asset ratios, and debt service payments as a share of incomes all point to an exhausted consumer that is bound to be more price conscious than during the freer spending years that propelled the country to such record highs. The existence of such cycle tops on the household sector owes to the fact that the pent-up demand from the 1990s was unleashed with a fury over the past decade, thus enabling Canada to out perform other countries on growth in no small part due to differential timing of its shock compared to elsewhere. This process is largely over.

- Tightened labour markets feed concerns about accelerating wage pressures, but not always. Wage expectations generally remain soft on average across the economy, and labour market slack still exists. But an interesting observation is that two-thirds of all job growth over the past couple of years has been across those aged 55+. That's significant, because the life cycle hypothesis would point to more rapid wage growth at earlier stages of one's career and this therefore concentrated job gains on older cohorts are less of a concern in feeding wage inflation at this point. This may be a structural phenomenon owing to the aging of the baby boomer population that could remain as a source of wage disinflation for years to come.

- Market inflation expectations remain well behaved.

- Business inflation expectations have increased, but are largely adaptive in nature and thus extrapolate most of the input price increases to date assuming they can be sustained going forward. This is not a view rooted in forward-looking fundamental factors. We therefore discount the inflation component of the Bank of Canada's Business Outlook Survey.

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- BoC Governor Carney is guiding markets toward seeing through near-term inflation risk toward a cooler inflation profile next year and the Scotia Economics inflation forecast is consistent with this view. This is comparable to guidance provided by the Federal Reserve and BoE.

- CAD hasn't been given enough time to work through inflation readings, and there is enormous modeling uncertainty surrounding the effects of currency appreciation on core CPI that counsels caution on the BoC's part as evidenced by a very wide 95% confidence interval surrounding the effects of CAD appreciation on core inflation. See our article "To What Degree Will A Strong CAD Keep Canadian Inflation At Bay?", Global Views, April 29th 2011, pp. 4-5.

- Extraordinary output gap guidance has been provided by the BoC. Had the BoC just brought forward the closing off of spare capacity to the middle of next year and left it at that, it would have been a simple and clear hawkish signal without fussing further. The BoC could have easily chosen this route. But the BoC went to extraordinary lengths to provide guidance over what it expected beyond that via a forecast for actual growth and potential growth to match one another into 2013. That translates into a flat output gap after the point at which it is closed by the middle of 2012. Given that there is roughly a one year lag between closing off spare capacity and pressuring inflation higher, and a one year lag between monetary policy changes and their effects on growth and inflation, we work backward from such lags to expect rate hikes by the end of this year at the earliest. Today's output gap cycle is unique in contrast to prior cycles partly due to the BoC guidance into 2013, but also due to the coincident nature of an elevated currency—let alone rolling global sovereign shocks stemming in part from absorbing private balance sheet excesses.

- Beware 2012-2013. Global monetary policy may well be confronted by severe fiscal austerity effects particularly stemming from US and European markets. Once short-term European stabilization mechanisms expire and peripheral economies are thus faced with the difficult necessity of raising capital on the open market, restructurings in a de facto or de jure sense are likely. This will coincide with rising pressures upon the US government to address Moody's demand for a credible fiscal exit path to be in place by 2013 at which point—following a Presidential election—a new electoral mandate is expected to impose sharp fiscal austerity upon the US economy. Canada looks relatively better positioned, but markets judge fiscal pressure points in absolute terms more so than relative terms, and Canada's gross debt to GDP ratio may well not escape unnoticed as the country's fixed cost of borrowing escalates perhaps at a slower pace than elsewhere.

- In addition to such longer-run fiscal policy risks, Canada will be imposing heavier fiscal austerity this year and into next in an effort to return to allow temporary forms of stimulus to drop off the books and in order to achieve balanced budgets within four fiscal years. We figure this will knock at least a percentage point off of real GDP growth in the near-term compared to what would have otherwise occurred. Such fiscal policy contraction may well require accommodative monetary policy.

- The terms of trade lift to Canadian GDP growth is over-stated by more bullish forecasters for two reasons. For one, rising export prices relative to import prices are being hoarded in company profit margins and cash balances without promoting wage growth that would feed the trickle down benefits of higher commodity prices through resource based portions of the economy over time. Indeed, as we've noted, inflation adjusted wages are flat. Second, a terms of trade boon to Canada is a terms of trade bane to the US that causes demand destruction in our key export market. It is this second round effect on US demand for Canadian exports that many analysts under-estimated in 2008 when they argued that Canada would escape the global crisis unscathed. For a further elaboration, see our article "Will An Improved Terms of Trade Lift Canadian Growth?", Global Views, April 29th 2011, p.3.

- Canada sits at or near cycle tops across many household sector variables so premature rate hikes would risk rolling over the economy. Going forward, because Canada has no pent-up demand from the crisis period, its consumer and housing cycles are likely to underperform many other countries going forward. The country

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cannot have its cake and eat it too by way of outperforming during the crisis period and expecting to do so afterward as well. Because of this cycle-top argument, this cycle likely requires a lower neutral rate than prior cycles.

- Rate hikes would do nothing to cool concerns in housing markets like Vancouver's. Much of the recent activity is being driven by purchases made by Asian investors and typically with cash. Higher rates will not cool this effect, but if they promote further CAD appreciation then that would attract more flows into Canadian dollar denominated assets like Vancouver housing. Should policymakers deem it necessary to cool the pace of foreign inflows into Vancouver housing, other macroprudential measures would be required perhaps such as Australia's tax on foreign purchases. Then again, this has not prevented Sydney's house prices from further speculation being driven by foreign capital. Unless very large, taxes on foreign flows would be dismissed as a modest transaction cost on highly priced homes. We're also not sure that imposing such a tax wouldn't come at the expense of Canada's reputation for being open to capital investment. In the long run, if Vancouver wishes to be a key hub in the Asia-Pacific economy, then mobile capital and labour flows with those economies will only develop much further yet and fighting this may be futile in general and an inappropriate goal of monetary policy.

- There is little too-low-for-too-long evidence in Canada. Household debt growth has sharply cooled, key credit spreads are generally still wider than pre-crisis, and M&A volumes have increased but remain far lower than their pre-crisis peak. Evidence of too-low-for-too-long is mixed elsewhere, but there is nothing a mid-sized central bank in an open economy like Canada's can do to address that.

- Many other forms of tightening are being done without tightening needed by the BoC, including: fiscal policy, CAD appreciation, tightened mortgage rules, commodity pressures in a weak wage growth environment, and our rising bond yield views into next year. Adding monetary policy tightening to this long list would risk being the straw that broke the proverbial camel's back.

- Canada is not really leveraging off of the US recovery through its trade account as yet. Indeed, it is unusual for Canada to be running record trade deficits after the US has been in recovery for two years now. This is in keeping with the BoC's view—and ours—that Canada has lost export competitiveness through an elevated CAD and moribund productivity growth while import leakage effects are being fed by a strong currency.

- Shaky Q2 dynamics would make it too soon thereafter to expect the BoC to hike this summer. While marketing to clients over recent weeks, we advocated a risk-off environment through much of Q2. This is due to concerns that demand destruction stemming from high commodity prices would erode fundamental indicators across many global economies, tightening policy across key emerging markets, and the impact of Japan's shocks on the world economy. In light of Governor Mark Carney's comments regarding how Q2 Canadian GDP growth is likely to come in much softer than Q1, it is difficult to accept that during such a period the BoC would abruptly shift its policy bias in order to tee up a July hike scenario as forecast by an albeit weakening consensus.

- Our base case is that the Federal Reserve begins raising its fed funds target rate by 2012Q1, but we judge the tail risk to be skewed later rather than sooner. This limits the extent to which the BoC can run further ahead of the Fed on overnight hot-money spreads. It is questionable whether spread widening in Canada's favour would be a wise policy option from a CADUS perspective given that US fiscal policy concerns will be a major contributing factor to a softened USD going forward.

- Cooling money supply and credit growth. Analysts pointing to accelerating money multipliers are wrongly suggesting accelerated credit growth. A proper decomposition of the money multiplier shows that the only reason it is soaring is that narrow money growth in the denominator of the money multiplier is being curtailed at a faster pace than broader money growth is cooling. Indeed, credit growth has sharply decelerated.

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The Debt Ceiling Impasse — Signaling America's Deeper Challenges

- **The challenges of the debt ceiling impasse extend well beyond the U.S. Treasury's "extraordinary measures".**

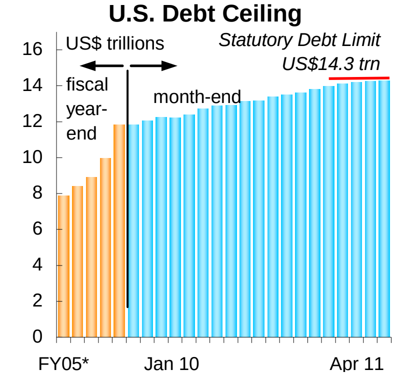
With Washington already bumping up against its legal borrowing limit *(top chart)*, the U.S. Treasury has embarked upon a series of extraordinary measures to allow Treasury auctions to the beginning of August. Washington presently requires new funding from the public of more than US$100 billion a month, thus an array of measures are needed to reduce intergovernmental and other federal obligations that fall under the debt ceiling definition. On May 6, the issuance of special securities to help state and local governments manage their finances was halted. As has been done before in prior debt ceiling stand-offs, a debt issuance suspension period from May 16 to August 2 will allow the U.S. Treasury to defer investment of new funds and redeem federal debt held in the Civil Service Retirement and Disability Fund. As well, full investment of the G Fund of the Federal Employees' Retirement System in interest-bearing government securities will be temporarily halted as of May 16. Final closure of the *Supplementary Finance Program*, already completed, would also gain new room under the debt ceiling. Other options, albeit with diminishing returns, include ceasing the reinvestment of Treasuries held in the Exchange Stabilization Fund.

Rejected by the U.S. Treasury are proposals for stepped-up sales of federal assets. Quickly disposing of the remaining financial investments acquired in 2008 and 2009 under the *Emergency Economic Stabilization Act* programs is deemed not in taxpayers' or markets' best interests, nor is rapidly accelerating the wind down of its mortgage-backed securities (MBS) portfolio, begun in March with sales of up to $10 billion MBS (principal) per month currently planned.

Ideally, the next rise in the debt ceiling would carry Washington past the November 2012 elections. However, the probable size of such an increase, likely exceeding the record posed by the most recent US$1.9 billion jump, would be contentious *(bottom chart)*. A comprehensive agreement on fiscal reform is unlikely any time soon, given the deep divisions on issues such as health care provision, retirement security, promoting growth and restructuring the tax code. An alternative, in part outlined by the Obama administration, is a multi-year framework of deficit reduction targets and spending caps to force policy development and compromise, alongside a blueprint for additional fiscal restraint through 2012.

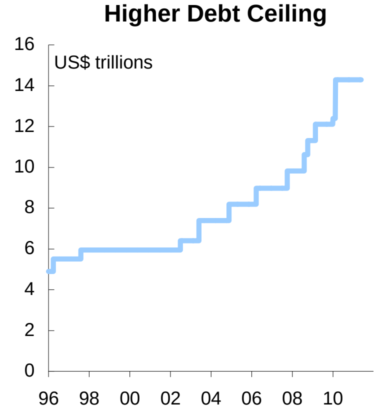
With ten-year Treasury rates dropping below 3.2% this week, the market seems to be trusting in an 11th hour compromise, and it is likely correct. Yet recent debate underlines the modest extent of the fiscal repair initiatives to date compared with the eventual reforms required. The Trustees' report on Medicare's Hospital Insurance (HI) and Supplementary Medical Insurance Trust Funds highlights current weaknesses. Many of Medicare's most contentious issues existed well before the economic downturn, such as the failure of the HI Trust Fund to meet the Trustees' formal test of short-range financial adequacy since 2003. The recent health care legislation has helped to trim Medicare's expected cost trajectory, but the assumption of trimming payment rate updates for most Medicare providers by the growth in economy-wide multifactor productivity is not expected to be sustainable over the longer term, and the fiction of implementing a correction approaching 30% in payment rates for physicians' services persists. The Supplementary Medical Insurance Fund appears to be on a more solid footing only because its draw from federal general revenues can be increased annually. For Washington, therefore, the risks extend beyond the debt ceiling impasse, and include maturities of Treasury bonds and notes well over US$1 trillion in both fiscal 2012 and 2013.

Bumping Against The U.S. Debt Ceiling



* Fiscal year-end: September 30.
Source: U.S. Treasury.

Washington's Progressively Higher Debt Ceiling



Source: U.S. Treasury, Scotia Economics.

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Long But Not So Hot Summer For Canadian Retailers

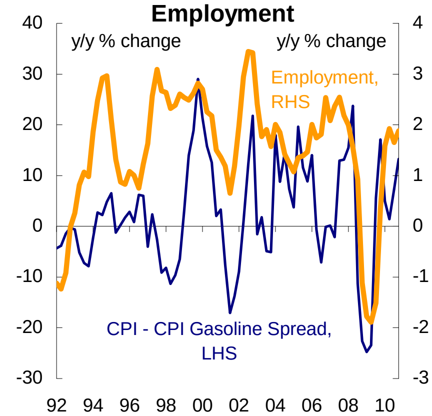
- **Rising fuel costs will not be matched with red-hot economic performance, as has been the case in the past two decades.**

Canadian retailers have gone to great lengths over the past two years to adapt to a changing consumer climate, offering countless promotions, sales and special offers all while maintaining strict inventory management. Consumers, having put cash aside and foregone purchases throughout the recession, responded favorably.

Retailers experienced healthy sales growth throughout the latter half of 2010, as pent-up consumer demand drove purchases. However, at the turn of the year consumers pulled back somewhat, as personal debt reached uncomfortable levels and employment growth slowed somewhat. Retailers found that they still lacked any pricing power in the market, and concluded that promotions would still be needed to tempt marginal customers. What they could not account for was the rapid appreciation of gasoline prices (up nearly 25% since the start of the year) and the effect they would play in dampening consumer confidence, pressuring household budgets and curtailing travel. Taken together, retailers now find themselves heading into a summer season where consumers are reticent to spend.

Historically, fuel prices have actually played a very limited role in 'core' retail (ex gas & autos) sales performance. Statistical analysis dating back to 1991 shows a very limited relationship over the past two decades. However, during this time period economic performance in Europe and North America dictated a large share of global fuel demand, and as a consequence prices. Strong performance in the Canadian economy accompanied rising fuel prices as Western economies outperformed in the late 1990s and mid-2000s.

Relative Fuel Prices and Employment



Source: Scotia Economics.

This relationship is demonstrated when the relative price of fuel to other consumer goods—the spread between growth in CPI-ex fuel and the CPI gasoline component—is mapped against employment growth (see chart). Gasoline prices increased by over 30% from 1999 to 2001, but this increase was accompanied by a 4.0% increase in employment. More recently, fuel prices increased by 28% from 2006 to 2008, but this was accompanied by a 4.2% increase in employment. In each instance, core retail sales were relatively unaffected by rising fuel prices, as strong economic performance and job growth helped to offset increased transportation costs.

However, the market has evolved considerably over the past two years. Emerging markets in Asia and Latin America now account for a much larger portion of worldwide gasoline demand, as tremendous economic growth has seen auto sales and ownership in these areas skyrocket over the past three years. With these regions continuing to grow an advanced pace, demand for fuel is being pushed at a much greater rate than in the past. In addition, unrest in the Middle East and weather-related disruptions at some U.S. refineries have also placed a premium on gasoline prices.

The situation for Canadians is much different now than it was over the past two decades, gasoline prices have risen 38% since 2009, while employment has increased only 2.1% over the same period. In this instance the recent rise in fuel costs is not being offset by red-hot economic performance as it has been in the past, while consumers are also concentrating on reducing record high debt burdens. As a result, growth in discretionary expenditures will likely follow a slower growth path in the coming months, with consumers' spending power being squeezed. However, retailers can take solace in the fact that consumer spending is still expected to continue to show decent gains through 2012. Consumption is expected to contribute an average of 1.5 ppt to Canadian GDP growth through 2012, a much better outlook than many other regions, including the United States.

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Mexican Peso Breaks Support Against Canadian Dollar

- **After trading within a tight range for the past 18 months the CADMXN is falling on the back of still favourable yield differentials and a solidified recovery in Mexico.**

The Mexican peso (MXN) is breaking over the 12 pesos per Canadian dollar mark for the first time since December 2009. The wind guiding the MXN is the result of a combination of factors, with Mexico's now more balanced growth picture figuring prominently. Interestingly, while yield spreads certainly are in favour of the peso with 2 year bond rates remaining above 5% (against 1.6% in Canada), they are not the main driver as inflationary pressures within Mexico remain subdued.

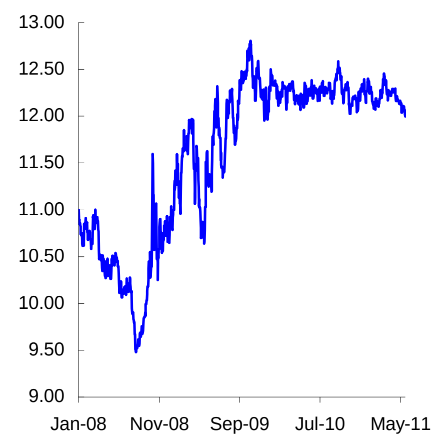
The MXN experienced little drawback from the recent downward correction in commodity prices. Since the beginning of May it has weakened only 1.6% against the greenback; this compares favourably with a 3% drop in the Canadian dollar, Brazilian real and Colombian peso as well as a 2% fall in the Chilean peso. The Mexican currency thus remains the biggest winner year-to-date amongst Latin America's major currencies, having gained 6%.

The economic recovery in Mexico gained additional momentum during the first quarter, with GDP advancing at an 0.5% q/q rate. Although this was below the 1% q/q gain of the final quarter of 2010, the slowdown is explained by an over 2% q/q contraction in agriculture, as the favourable industrial sector outlook remains solidly complemented by a surge evident in domestically oriented activities. Enhanced labour market conditions followed by improvements in liquidity on the back of recovering credit growth underpin an over 4.5% y/y expansion in the demand for services. While we expect Mexico's output to grow at a 4.3% yearly rate in 2011, following the 5.4% 2010 gain, the risk to the outlook is clearly on the upside.

Mexico's auto assembly lines appear to be less affected by the Japanese shock. The Mexican rebound can be adequately characterized by the evolution of exports of durable goods, with shipments of automobiles playing a prominent role. The country rode favourably the global inventory replenishment cycle, as foreign vehicle sales recovered after U.S. based car companies exited bankruptcy proceedings in the fall of 2009. Latest figures on global factory output point to an adverse effect from the March earthquake/tsunami in Japan, with the auto sector leading the deterioration as the country is the world's second largest auto parts supplier after Germany. However, Japanese automakers account for less than a quarter of Mexico's output, compared with over 30% and 35% in the U.S. and Canada, respectively. Thus, Mexican manufacturing production and automobile assembly, the leaders of the country's recovery since the outset, might be less affected by the current downshift.

The Canadian domestic landscape has been strong recently with Q410 growth topping 3.2% y/y while Q1 GDP is expected to increase by 2.8% y/y. However, much of the strength in Q1 will be given back in Q2 as distortions from unseasonable weather and auto plant shutdowns in Q410 provided a temporary lift to Q1. Softening global fundamentals and supply chain constraints from Japan's earthquake and tsunami will also provide downward pressure on Q2 growth. Inflation remains subdued, as illustrated by April's CPI report, restoring prices pressures to a fairly muted path. These developments support our longstanding view that the Bank of Canada will remain on hold until October of this year.

Mexican Peso vs. CAD



Source: Bloomberg.

Within the described context, the Mexican peso has been trading in a surprisingly tight 12.00 to 12.63 range since December 2009 (please refer to chart). Typically the breach of a long-held range is

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violent and accompanied by a fundamental change. Today’s drop to a low of 11.95 (at time of writing) suggests that downward momentum in CADMXN is increasing. A close below 12 today would suggest further downside ahead.

Technical studies are supportive of further MXN appreciation. The ADX, which attempts to quantify whether a currency is trending or ranging, is well into trending territory, which increases the importance of other technical studies. The CADMXN MACD generated a sell signal in mid-April and shows no warning of developing positive divergence. Both short-term and long-term moving averages are suggestive of further downside, with the 9-day having crossed below the 21-day in mid-April and the 50-day having broken below both the 100 and 200-day in early May. Finally, the RSI at just 32 is still above oversold levels. Accordingly, on a technical basis CADMXN looks to be at risk for further downside.

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Size Matters: A Top-Down Look at Small Cap Strategy

The following article was published on May 17, 2011.

We are pleased to launch a new strategy report focused on global small caps. This semi-annual report aims to provide a top-down view on small caps strategy and highlight how the global macro landscape should influence Canadian and global small cap absolute and relative performance. Our strategy views are put to test via our Strategic Edge Mid-cap portfolio (SEMCP), launched in January 2011. This semi-annual report on global small caps will be accompanied by shorter monthly updates.

A decade of domination for global small caps

Global small caps have performed strongly in the past decade, posting solid absolute and relative performance. The MSCI World Small Cap Index generated a 10-year compound annual growth rate (CAGR/ price only) of 7.6% from 2000 to 2010 vs. a paltry 0.5% gain for the MSCI World (large cap) Index. U.S. small caps also easily outperformed their large cap counterparts and the Russell 2000 posted a 4.9% 10-year CAGR vs. 0.0% for the Russell 1000.

In Canada, however, the small cap lead has been narrower from 2000 to 2010. The TSX SmallCap Index generated a 9.7% 10-year CAGR (US$) compared with 8.2% for the TSX 60 Index. Canadian small caps outperformed global small caps by 210 bp (10-year CAGR), while the TSX 60 edged global large caps by roughly 800 bp!

Longest U.S. capitalization cycle on record. Outperformance cycles based on capitalization, whether dominated by large or small caps, have historically been long, very long. For U.S. small caps, the average outperformance cycle is 88 months (7.3 years) compared with 76 months (6.3 years) for large caps leadership. U.S. small caps have dominated for over a decade, and the current stretch of outperformance can be traced to March 1999. This 145-month outperformance cycle by U.S. small caps is the longest on record and stands at 57 months above the average.

In Canada, capitalization cycles have also been persistent with an average duration of 70 months (5.8 years) for small cap. The current TSX SmallCap outperformance cycle started in December 2008 (29 months) towards the end of the last bear market.

Although U.S. small caps have been outperforming large caps for over a decade, the size or magnitude of the outperformance gap is below average. The Russell 2000 is up 118% since March 1999 vs. a 9% gain for the Russell 1000. This 109% outperformance is well below the historical average of 469%.

Monetary tightening: near-term threat to small cap domination

In the near term, monetary tightening (higher real rates) points to a challenging risk-reward outlook for global small caps in 2011 (see Exhibit 1). Year-to-date (YTD), most global small cap indices are lagging their large cap counterparts and small cap underperformance is more visible within countries having started to tighten monetary policy. For instance, EM small caps are underperforming DM small caps this year.

As the global transition in monetary policy hits more countries in 2011 and 2012, we expect equity leadership to migrate from small caps to large caps. Moreover, within the small cap universe, we would prefer small cap benchmarks in countries where monetary policy remains neutral to accommodative.

Canadian small caps have usually underperformed large caps in the six- and 12-month period after the first BoC rate hike. The TSX SmallCap underperformance has been even steeper in recent cycles. In the U.S, small caps have proven more resilient in the early days of Fed tightening cycles, outperforming large caps in the following six and 12 months. However, U.S. small caps underperformed large caps in most of the last five Fed tightening cycles.

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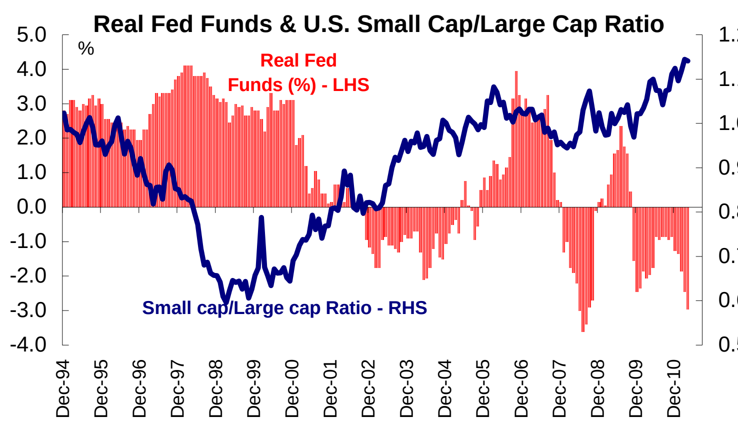
Exhibit 1



Source: Scotia Capital

Macro factors influencing small cap outperformance

Since the duration of capitalization cycles is longer than economic cycles, it is hard to identify one set of macro data that fully explains U.S. capitalization cycles. In Canada, however, the outlook for commodities (prices and sentiment) is key, since Energy and Materials represent 55% of the TSX SmallCap Index. Hence, China's inflation and monetary policy outlook will dictate the small vs. large cap trade in Canada as much as the BoC outlook. As long as the People's Bank of China maintains its hawkish stance and raises rates to choke inflation, small caps' outperformance could be more challenging in Canada.

In the U.S., the direction in real Fed funds, our ISM model, and the U.S. dollar are important drivers of small versus large leadership. With real Fed funds expected to move higher, along with the end of QE2 set for June, the high beta trade is already facing severe headwinds. Our ISM risk-reward model is also pointing to a challenging small cap risk-reward outlook when the ISM Index surpasses the 55-60 level (Q1/11) (see Exhibit 2). Although elevated ISMs suggest stronger economic growth, from an equity strategy perspective, the ISM is a contrarian risk-reward indicator. Finally, the dollar index (DXY) has posted a strong negative correlation with the small to large cap ratio. Longer term, any sustained large cap leadership cycle is likely to occur alongside a firmer U.S. dollar, which is at best a 2013 story (post November 2012 elections), in our opinion.

Exhibit 2

ISM Index and Investment Phases (1950-2011)*: One-year Forward Equity and Interest Rate Behaviour

		1-Yr Forward					
Phases	ISM Ranges	S&P 500	Prob. of Positive Return	Fed Funds (bp)	10-Yr Yield (bp)	U.S. Small-cap outperformance**	Prob. of Outperformance
Apocalypse	< 40	27%	100%	-106	-32	20%	90%
Worse-to-Bad	40-50	11%	75%	-102	-23	2%	60%
Show-me-the-Money	50-55	8%	72%	-47	-1	0%	45%
Optimism	55-60	6%	68%	+73	+13	-1%	51%
Goldilocks	60+	2%	62%	+113	+32	-4%	29%

*Based on Blended ISM (25% Manufacturing / 75% Services) since Jul-97.

**We used the Russell 1000 and 2000 since 1979.

Source: Scotia Capital, Bloomberg

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Small cap premium hard to sustain

The phenomenal 140%+ rebound in global small caps since March 2009 has pushed valuations toward the high end of their historical range. Small cap valuations are elevated on an absolute basis, and the premium over large caps is very high. From 1995 to 2001, U.S. small caps were trading at an average 6% discount to large caps on a forward P/E basis. U.S. small caps are currently trading at a 40% premium. Although the recent equity pullback has compressed the premium over large caps, most metrics remain at or close to one standard deviation above the historical average. Looking forward, however, this lofty small cap premium will be hard to sustain entering a more challenging period of rising interest rates.

Small cap premium valuations remain well supported by a solid earnings outlook. Looking out to 2011 and 2012, small caps offer a superior earnings profile than large caps. Most small cap benchmarks are expected to grow earnings two to three times faster than large caps over the next two years. In Canada, TSX SmallCap EPS should grow 77% in 2011 and a further 40% in 2012, according to bottom-up estimates, much faster than the TSX 60 expected earnings growth at +35% and +14% for 2011 and 2012, respectively. In the U.S., S&P 600 earnings are expected to grow 34% in 2011 and 24% in 2012, roughly double the S&P 500 expected rate. This superior earnings profile, however, is coming at a price.

Small Cap Strategy & Model portfolio

From a top-down perspective, the macro environment is challenging small cap supremacy. As we enter a more defensive/low beta environment, which should favour large cap stocks over small cap stocks, we recently made the following changes in our small/mid-cap model portfolio: (1) we started 2011 with an overweight cash position of 5%; (2) we raised the average market cap; (3) we added more yield; (4) we lowered the overall portfolio beta; and (5) we added more defensive sectors.

Our 2011 game plan of removing some risk off the table remains unchanged. However, it is still too early to adopt an outright defensive sector stance. Our sector focus is on Industrials, Energy, and Consumer Staples, and we are carrying a 6.3% underweight position in Materials-Gold. Our current sector strategy stance is a mix of late cyclicals and early defensive sectors.

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Strategic View on the Chinese Renminbi

- **CNY REER and NEER valuations are by no means stretched, particularly considering that the medium term structural trend is still well supported by currency fundamentals. We demonstrate the primary reason why Chinese policymakers will be strongly incented to pursue sustained CNY appreciation in the medium term; to do so eases the rapid pace of monetary expansion that is contributing to excessive domestic liquidity conditions. Finally, we review the current state of affairs in the Hong Kong offshore renminbi (CNH) market.**

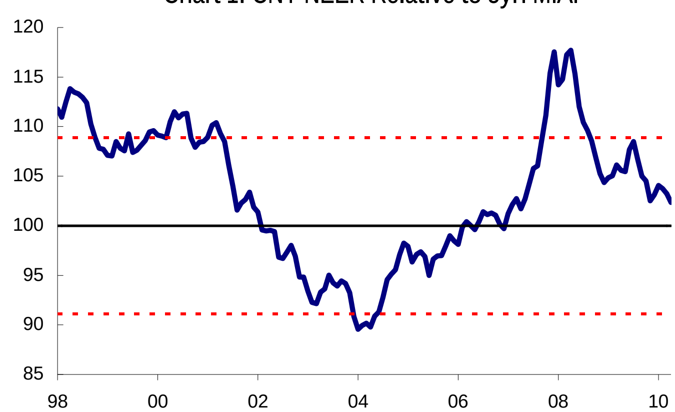
The fundamental factors underscoring the renminbi (RMB) continue to provide an obvious justification for structural CNY appreciation. China's macro dynamics as well as the country's fiscal and monetary policy stance all speak to the fundamental upside pressure on CNY vs. the USD. In addition, the well known aim of China's leaders to shift the longer term pattern of growth towards a greater emphasis on consumption and away from an emphasis on investment and net exports is consistent with further CNY appreciation. Though in the near term there may be some concern over an apparent slowing in Chinese growth momentum, we nevertheless believe that China will find it in its own domestic interests to necessarily pursue a steady and sustained pace of CNY appreciation. Too little or too slow a pace of appreciation risks exacerbating the adverse domestic liquidity expansion that sustained large-scale USDCNY buying creates. In addition, the fact that such intervention is tantamount to monetary easing, the practice runs counter to the stated medium term pursuit of a "prudent" monetary policy stance by Chinese policymakers.

CNY Valuation Dynamics

While CNY is currently near "modern" record highs versus the USD, there has been a divergence between spot USDCNY and the broad nominal and real trends in the renminbi. Charts 1 and 2 place CNY's nominal and real effective exchange rates (NEER and REER respectively) in the context of an ad hoc measure of medium term over/under-valuation. As a gauge of the severity of over/under-valuation, we use the five year moving average of the CNY's NEER and REER, though we do add the caveat that that it is but an empirical metric devoid of any theoretical underpinning. However, a five year moving average can constitute a useful "naïve equilibrium" measure as a five year span does provide ample opportunity for a currency to at least show partial adjustment (or display a refusal to adjust) to underlying trends in fundamentals like a country's net foreign asset position, relative productivity, terms of trade, real return trends, fiscal stance and trade related considerations like openness. In addition, if currency fundamentals are concurrently very strong and broadly unidirectional, they will help to confirm or contradict trends evident in the REER and/or NEER.

On a nominal basis, the official management of spot CNY vs. the USD combined with broad USD weakness over the past year has resulted in a depreciation in CNY's NEER. The NEER has fallen towards the (upwards sloping) medium term trend, and resides only about 0.5 standard deviations (+/- 2stdev. lines marked in red on charts 1 and 2) or 2.3% above the current trend level. This reflects the broad depreciation in CNY vs. currencies like EUR, JPY (and all non-USD "majors"), and a more mixed performance vs. EM Asia. The superficial face value implication of this nominal metric is that the trade-weighted renminbi can by no means be accused of being at an extremely rich medium

Chart 1: CNY NEER Relative to 5yr. M.A.



Source: Scotia FX Strategy, BIS

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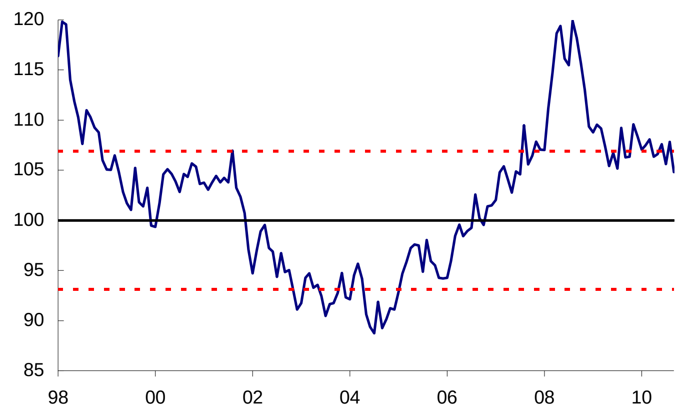
term valuation. Interestingly, the desire of China to maintain USDCNY stability during the financial crisis and global recession, thus providing a modicum of stability for the Asian region, actually constituted a tightening in monetary conditions considering the degree to which CNY appreciated (via its USD peg) on a trade weighted basis. China instead chose to enact economic stimulus via a large fiscal pulse. Since then, the depreciation in the NEER represents an unwind of this implicit tightening. However, in the context of still stimulatory fiscal policy and high growth, there have been costs in resisting broader renminbi appreciation that we will examine further below.

On the basis of the CNY REER, a measure arguably more important for the Chinese real economy, CNY appears to be more dearly valued than on an NEER basis, reflecting the degree to which Chinese inflation has outstripped that of its trading partners. CNY's REER currently sits 1.4 standard deviations (or 4.8%) above the medium term trend, having shown a degree of stability around the +2 standard deviation level following the global economic rebound. This suggests that the current real level of the (broadly measured) renminbi is more burdensome than the NEER perhaps suggests, and speaks to the measured and steady pace of appreciation that policymakers have repeatedly reiterated as being the preferred path for CNY. While we have pointed out that both the NEER and REER are trading above their medium term trends, we also note that the actual trend is still well appreciatory. Indeed, the NEER and REER trend rates of appreciation currently sit around 2.3% y/y and 3.2% y/y respectively. Though CNY on an REER basis may appear to be somewhat on the expensive side, a selection of currency fundamentals important for CNY supports the valuation.

Chart 2: CNY NEER Relative to 5yr. M.A.

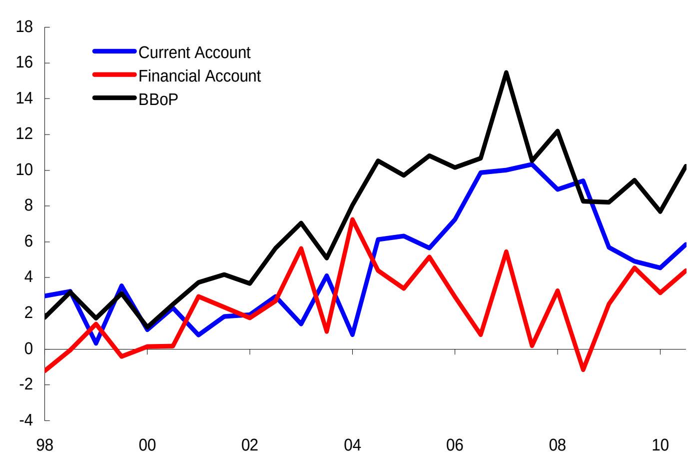


Source: Scotia FX Strategy, BIS

Renminbi Fundamentals

China's external accounts remain very well supportive of the exchange rate trend (see Chart 3), with the current account surplus persisting at levels between 4.5% to 6% of GDP (semi-annual basis) over the pas two years. The CA surplus has been driven by the trade component which has experienced a stabilization over the past 12 months and currently sits near 2006 levels on a 1yr monthly moving average trend basis. While the trade surplus trend is below pre-global recession peak, it is still very robust and implies a CA surplus in the 4%-5% range. Add to positive current account dynamics a sustained rebound in financial account inflows, and China maintains a very

Chart 3: China's External Balances (% of GDP)



Source: Scotia FX Strategy, EMED

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substantial broad balance of payments surplus of around 10% of GDP. This, combined with China's currency policy, has obviously implied a massive build in FX reserves, a factor directly related to our key justification for continued appreciation.

The government's fiscal stance also appears to be still quite expansionary, with the structural fiscal deficit only likely to close by 2014 according to the IMF. This implies that China is operating with a (cyclically adjusted) stimulatory fiscal policy stance, currently with a deficit of about 1.8% of GDP. The fiscal stance, combined with a positive output gap, tightening monetary policy, and the aforementioned external account dynamics is suggestive that there are few sources of structural CNY weakness in play. Indeed, given these structural factors, the current valuation and uptrend in the CNY REER (and NEER) is justified.

Key Justification for Structural CNY Appreciation

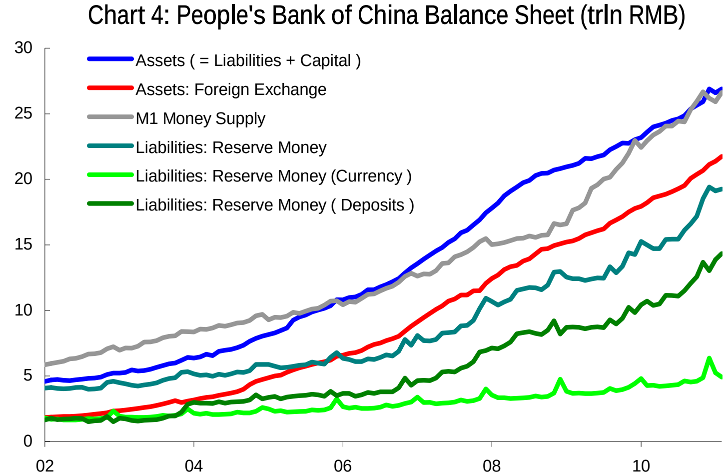
The above is justification enough for a bullish stance on CNY, and all the more relevant if the renminbi had a greater degree of market flexibility. However, there is a more prominent reason for a unidirectional view on CNY's medium term path, and one that necessitates continued appreciation, even in the case of any moderation (albeit mild) in growth momentum. The fact of the matter is that for all of the People Bank of China's (PBoC) efforts to the contrary, the managed float constitutes counter-productive monetary loosening that is flooding the Chinese financial system with liquidity and contributing to domestic macro-financial risks.

Persistently providing more renminbi per unit of foreign currency purchase (to exporters converting USD earnings for example) than the market would naturally gravitate towards constitutes an easing in monetary conditions and creates more renminbi in the financial system per unit of USD export earnings than would otherwise be the case. This presents an upwards force on the money supply, and inevitably inflation. Over time it slows, or in the worst case prevents, an adjustment in external accounts to a level that would ease the BoP surplus and prevent the over-expansion in domestic liquidity that is currently the case.

The PBoC has obviously made liquidity control the centerpiece of its current monetary tightening strategy, favouring rather sizable increases in reserve ratio requirements over interest rate increases or even CNY appreciation (see our earlier observations regarding the CNY NEER). Thus far in the current cycle, the RRR has been raised 550bps versus an increase in the 1yr deposit rate of 100bps to 3.25%, while CNY has appreciated by 4.7% against the USD over the past 11 months since flexibility was increased.

The focus on liquidity is evident and comments from policymakers have made this abundantly clear. PBoC governor Zhou Xiaochuan has characterized reserves as exceeding the country's rational demand and that "too much accumulation has caused excessive liquidity in our markets." Chart 4 exhibits the pace of expansion in the PBoC's balance sheet, and how the rapid increase has been predominantly driven by FX reserve accumulation (see the mutual trend and spread between total PBoC assets and FX assets). The liability side of the balance sheet shows the increase in reserve money (domestic renminbi liquidity) that has in great part been driven by the foreign exchange accumulation,

Chart 4: People's Bank of China Balance Sheet (trln RMB)



Source: Scotia FX Strategy, EMED

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which itself is obviously well correlated with the pace of M1 money supply growth. It also bears noting that the pace of increase in FX reserve accumulation began to pick up again in September of 2009 (after slowing at the end of 2008) and has continued to increase at an elevated trajectory, mirroring the November 2006 to August 2008 (pre-global recession) period.

CNY appreciation will help to tame the pace of reserves accumulation, and thus dampen the resulting liquidity injection into the economy. Supporting a weak currency while attempting to restrain the subsequent liquidity expansion places stress on the financial system as there are limits to the effectiveness of liquidity management tools which impose certain costs on the domestic economy. For instance, RRR hikes constitute something of a tax on the financial system as they lock in the banking sector's pool of assets into very low yielding deposits (1.62% currently vs. 12 month SHIBOR of 4.86%) that certainly do not even cover the rate of inflation. In addition, bill issuance and repo operations used to soak up liquidity created by intervention constitute a cost to the PBoC as Chinese rates remain well above those on liquid short term USD assets (Chinese 3mth bills yield 2.6% to 2.9% vs. 0.03% to 0.04% in the US), implying steep negative carrying costs for the PBoC between the bills it issues to soak up liquidity vs. what its USD reserves earn.

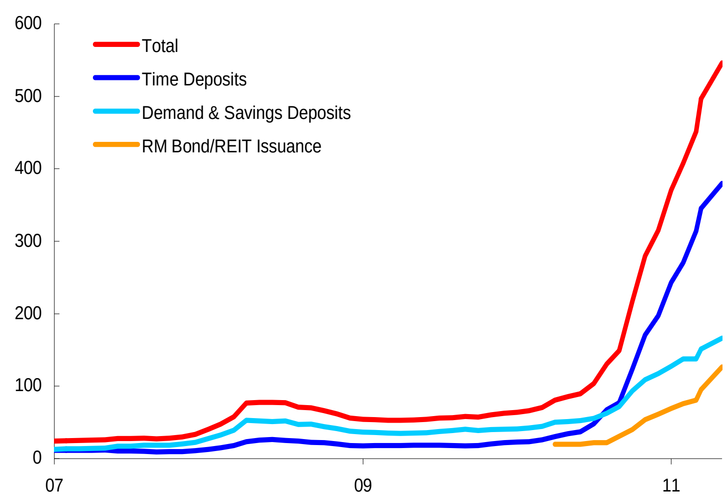
The implicit costs of quantitative liquidity constraining measures, which have been favoured over outright interest rate increases due to the risk of engendering hot money inflows, imply that ultimately the most effective long term solution to countering domestic liquidity is continued exchange rate appreciation. This would continue to be the case even if Chinese growth were to moderate as shorter term indicators are hinting at, as a still very rapid pace of growth is expected to persist over our forecast horizon. Scotia sees growth averaging over 9% annually in 2011 and 2012, with inflation averaging over 4.5% annually. We see CNY appreciating against the USD by at least 4.5% from current levels through the end of the year, and at least 6% in 2012.

CNH Market Developments

The pace of expansion in the offshore renminbi (RMB) market (offshore renminbi for general non-trade related purposes is called CNH) in Hong Kong has been impressive. As of the end of the first quarter of 2011, the total RMB deposits in Hong Kong amounted to 451.4bn RMB (see chart 5), just under 70bn USD. This represents a nearly 540% increase over the same period in 2010.

The explosive growth in offshore RMB deposits has reflected a few different factors, including the expansion of a Chinese trade settlement pilot program in June of 2010, and the signing of a supplementary memorandum of cooperation to expand the scope of RMB business and increase the flexibility of RMB financial services in Hong Kong. These were watershed events for the offshore RMB market as they acted to both increase the supply and demand of RMB in Hong Kong. While there was already supply and demand of RMB in Hong Kong before the supplementary memorandum, without sufficient opportunities to put offshore RMB to some productive financial/economic use,

Chart 5: RMB Deposits In Hong Kong (bln RMB)



Source: Scotia FX Strategy, EMED

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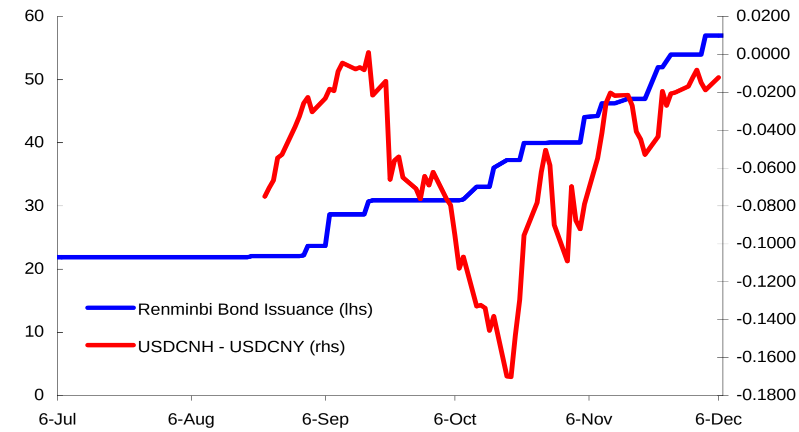
there would be little interest amongst participants in seeing the market develop. The allowance of the general purpose usage of RMB in Hong Kong permits a deepening in CNH financial products. Future developments, particularly those that increase the use of offshore RMB for investment back onshore are expected to further enhance the attractiveness, size and liquidity of the market. The fact that deposit rates for CNH are so far below the onshore deposit rates (1yr CNH rate at around 0.5% vs. onshore CNY at 3.05%) lays bare the necessity for continued financial market deepening in CNH products.

As it stands currently, there are three primary conduits through which RMB flows into Hong Kong: Chinese importers setting trade through Hong Kong, tourism from the mainland, and domestic resident conversion of currency into RMB (limited currently to 20K RMB daily). There are also plans in the works to develop Hong Kong as a hub for outwards direct investment from the mainland, which would serve to increase the potential flow of RMB to the offshore market.

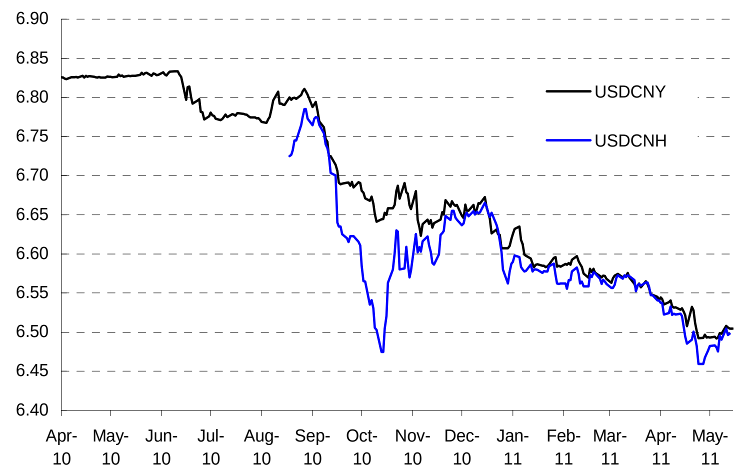
The quantity of issuance of RMB denominated bonds by both mainland Chinese entities, and the mainland subsidiaries of multinational corporations, has been increasing at a steady pace since the "big bang" legislative expansion from the PBoC and HKMA regarding the aforementioned usage of general purpose RMB. Attractively low yields for issuers and the degree to which the offshore market is starved for RMB investment products has helped this dynamic. In addition, the first RMB denominated IPO (a REIT) began trading in April, a hint of future product development to come.

Chart 6: Hong Kong RMB Bond Issuance



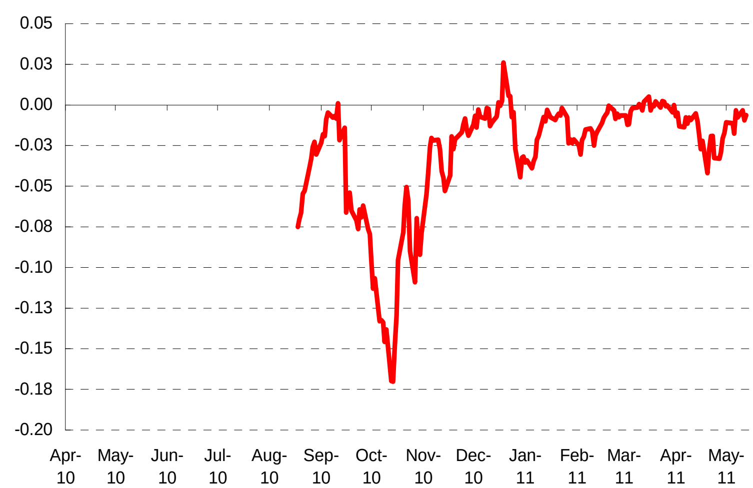
Source: Scotia FX Strategy, EMED

Chart 7: CNY Onshore vs. CNH Offshore



Source: Scotia FX Strategy, EMED

Chart 8: USDCNH - USDCNY



Source: Scotia FX Strategy, EMED

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CNH Valuation

The supply/demand balance for RMB in Hong Kong relative to the mainland is the key feature that drives price divergence between the CNH and CNY market, as CNH has tended to trade with a (sometimes very wide) premium to CNY. Indeed as chart 8 shows, the gap had been as large as 1700 points at one point in October of last year. This coincided with the exhaustion of Hong Kong's annual quota for yuan-conversion trade settlement, resulting in the activation of the Hong Kong Monetary Authority's RMB swap line with the PBoC which may have eased needs to access the CNH market for RMB liquidity. During that period, the pace of issuance of RMB bonds began to increase, coinciding with a strong supply response in RMB deposits in Hong Kong, though supply did not keep up with demand as the CNH premium over CNY surged. The HKMA and PBoC introduced limits on the degree to which authorized institutions in Hong Kong could hold open long (or short) positions or access RMB, to ensure a more balanced supply-demand dynamic in the offshore market and prevent a large deviation between CNH and CNY. Essentially, Hong Kong banks would be discouraged from hoarding CNH liquidity and then accessing CNY at the onshore rate from the clearing bank (Bank of China HK) to meet client trade related demands.

These measures, along with the still rapid pace of increase in RMB deposits in Hong Kong should help keep supply and demand more balanced and limit the spread between USDCNH and USDCNY. The average spread thus far in 2011 has been a 130 point premium for CNH, compared with an average of 470 points in 2010 (since CNH inception). There remain solid opportunities to benefit from divergences in the CNH and CNY markets for those entities that have the ability buy and sell CNH and CNY. The availability of spot CNH and a CNH forward curve, combined with a liquid CNY NDF market (priced off of the onshore CNY) also provides opportunities to take a CNY view vis-à-vis CNH via a number of instruments.

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Putting an Interesting Month into Perspective

- **The recent EUR trading pattern hints at further near-term weakness, but our year-end valuation is unchanged at 1.50.**

EUR has had a volatile three weeks. After reaching a 16-month high of 1.4940 on May 4th, the currency collapsed 6% down to 1.4048 on May 16th. Since then it has been attempting to retrace some of these loses, but Friday's trading pattern pushes even this into question. The degree of near-term weakness that EUR is likely to experience is unlikely to prove comparable with what we saw in the first half of 2010 and again in the fall of 2010. We have made no change to our year-end EUR target of 1.50.

The selling pressure that emerged on May 4th was the result of several triggers that occurred in unison. A collapse in extended commodity prices, which began in the silver market quickly rippled across other commodities. This downward pressure was aggravated when several Asian countries tightened monetary policy even as early signs emerged that they were on softer growth trajectories. As fears escalated, risk aversion increased and the USD strengthened broadly. EUR selling was aggravated by the ECB's signal that it would delay further interest rate hikes until the summer. Then raising concerns over the outlook for the European periphery and waning political and constituent support for the European aid packages only intensified the selling. Accordingly extended long EUR traders were quick to take profits, pushing the currency through technical levels and adding further downward pressure.

The short-term EUR outlook is vulnerable to further downside. Selling pressure on Friday intensified, suggesting that the failure to break above the 50-day moving average at 1.4342 brought the bears back into control of the market. Friday's price action hints that next week could see further downside as:

1) Position squaring out of long EUR positions continues and sentiment has temporarily shifted to favour short-EUR positions.
2) Fears are rising over the uncertainty ahead for Greek debt, including a possible restructuring and/or request for more aid and what this means for the ECB and European banking system. Markets do not like uncertainty and this is an important near-term weight.
3) The potential contagion impact into the other peripherals is also a worry for markets.
4) There is a widening dispersion of growth between the strong core and weak periphery, which is only serving to complicate the role of the ECB and the path of fiscal austerity.
5) Concerns over the trajectory of global growth and whether recent softening has been fully priced in or is simply the warning sign of a more important shift.
6) A softening in oil prices, which has reduced some of the inflationary fears that had built up expectations for ECB interest rate hikes.
7) Upheaval at the IMF, including an unknown new head and uncertainty over their negotiating ability and leanings.
8) Technicals, which for short term traders have turned bearish. Support lies at the May low of 1.4048, followed by the psychologically important 1.40, a close below here would open up a test down to the 50% Fibonacci retracement of the January to May rally at 1.3963.

Next week could prove an important and volatile one for EUR traders, which is likely to see further downside.

In the medium-term, we have made no change to our forecast and believe that what is transpiring now is different than what happened in the first half of 2010. Today we have aid packages in place, the commitment of European authorities to support the union and a far better understanding of where the European periphery exposure lies. Below is a brief summary of the key points that leave us relatively comfortable (but watching closely) our year-end EUR target of 1.50.

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Problems in Greece are a known entity, a request for further aid or a restructuring of current debt should not break the EUR. The fear is the stress it might cause on the European banking system, however to date authorities appear to be protecting this at almost any cost. The ECB is the most vulnerable to Greek debt, with an estimated €140bn in exposure. While German banks are reported to hold approximately €70bn in exposure, this is not new and should have been factored into valuations already. Peripheral Europe is a great concern, but to date it remains a significant risk and not a game changer. The response of authorities is important, as is the reaction of markets. We will be watching both closely.

After the most recent meeting, it has become apparent that the ECB is unlikely to hike interest rates in June, but will likely do so in the summer or early fall. For the US, the end of QE2 is nearing, however the stance at the Fed remains highly accommodative. Nine percent unemployment and contained core inflation should keep the US overnight target on hold into 2012. Accordingly, there is likely a further widening in the US-EU interest rate spread, which in turn should support EUR.

These are two of the important factors at play, but there are others as well. A strong outlook for the German economy, combined with still accommodative monetary policy, should allow the Eurozone-wide economic outlook to remain favourable. On the USD side of the equation the US has made little headway in providing a credible fiscal plan, with the debt ceiling being just a symptom of a far bigger problem. In addition, USD bearish positioning has been pared back, but sentiment continues to dislike USD exposure and the longer-term downward trend remains intact. On the global basis, the outlook for Asian growth has been recalibrated lower, but even at these new levels it is still strong and supportive of global economic expansion, which should support the European recovery.

Accordingly, we are watching closely what is transpiring in global FX markets and particularly for EUR. Price action suggests that EUR is vulnerable to near-term downside; but fundamentals remain supportive of EUR retracing current losses to close the year at 1.50.

EUR struggles but is unlikely to break

Source: TraderMade & Scotia FX Strategy

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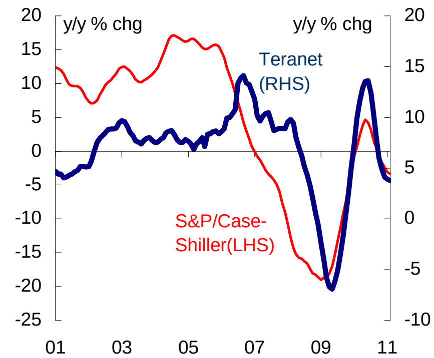
Key Data Preview

CANADA

The Teranet-National Bank House Price Index (Wednesday) is expected to post another decent gain in March, the third monthly increase in as many months. While this is the preferred gauge for Canadian home prices given its repeat sales focus, the index still tends to follow a pattern similar to the MLS data released earlier in the month, albeit with a lag. Nonetheless, for comparison purposes across countries, this measure provides an equivalent to the S&P/Case-Shiller index which is closely watched in the US.

Teranet Remains the Preferred Gauge of Cdn Home Prices



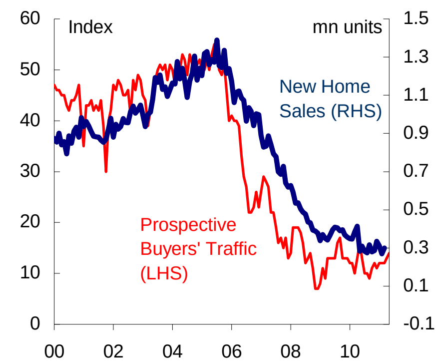
Source: Teranet/National Bank House Prices Index, S&P/Case-Shiller Index, Scotia Capital Economics

UNITED STATES

While there are several economic releases out in the U.S. next week, durable goods orders and personal income and consumption carry the highest risk to markets. The revisions to Q1 GDP could also spark a market reaction but only if the print is largely off consensus estimates.

New home sales (Tuesday) will likely continue to bounce along the bottom in April as housing demand remains sluggish amid still-high food and fuel costs as well as moderate wage and employment growth. Indeed, any increase in demand continues to disproportionately benefit resales given the glut of foreclosures which keep resale prices depressed. Nonetheless, new home sales should witness a modest increase in April — despite the double-digit gain in March — as prospective homebuyers' traffic continues to improve. This should provide some support to housing construction which has been sidelined for several years now. **Pending home sales** (Friday), on the other hand, will likely witness a decline in April given the large increase in March but should bounce back in May.

US New Home Sales Likely to Increase in April



Source: U.S. Census Bureau, NAR, Scotia Capital Economics

Headline durable goods orders (Wednesday) have been extremely volatile over the past year, and April's report will likely continue that trend with an expected decline after a strong print in March. A large drop in Boeing aircraft orders should account for some of the decline but weaker vehicles and parts orders should also impact the headline number. Excluding transportation, orders are expected to come in flat from March as businesses react to the Japanese triple threat: earthquake, tsunami and nuclear power issues. There is a risk, however, that we could witness a negative print in April as business investment moderates.

We are looking for an upward revision to **Q1 real GDP** (Thursday) within the second estimate on the back of better-than-expected export growth and an upward revision to personal consumption (March retail sales were revised up). While this may provide some lift to markets, even with an expected 2.3% q/q annualized gain, this is still much below most analysts' initial estimates and remains the weakest print since Q2 2010. Add to this the fear that Japanese-induced supply constraints will weigh heavily on US GDP in Q2 and even with a rebound in Q3, the pace of economic growth still remains quite morose.

US retail sales released last week provided an initial glimpse of consumer demand in April. As expected, continued price gains weighed on consumers during the month as nominal sales outpaced price-adjusted sales once again. High cash balances in the aggregate household sector and the 2% payroll tax cut that was extended in January should continue to provide some support to consumption but tepid wage growth and modest employment gains, together with high commodity prices will likely keep most consumers on the sidelines. This will likely be reflected in the **personal income and consumption report** (Friday) as nominal consumption outpaces gains on the real side and shows another increase in April, in line with retail sales. Income should also post another modest increase despite sluggish wage growth, supported by government benefits and continued tax relief.

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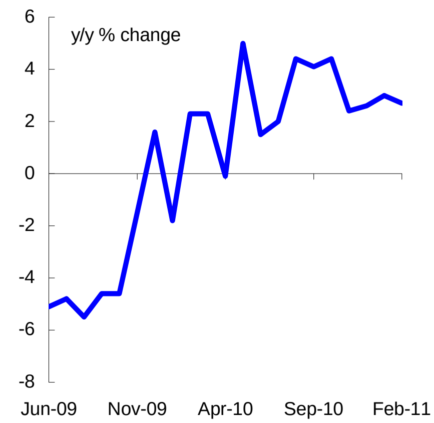
MEXICO

Over the coming week, data regarding retail sales, bi-weekly consumer price inflation, trade and current account balances, the unemployment rate and the central bank's monetary announcement will be released in Mexico. Recent GDP growth numbers confirm that the Mexican economy has grown at a solid rate during the first months of 2011, expanding by 0.52% from the final quarter of 2010 and by 4.6% y/y. Therefore, we expect retail sales to continue to reflect a strong local demand, despite the slowdown a month ago. Meanwhile, inflation remains subdued. The next monetary policy announcement will take place on Friday 27th. We do not expect any significant changes in policy stance, with authorities once again emphasizing positive economic dynamics while showing some concerns regarding international food and oil prices.

Mexico Retail Sales

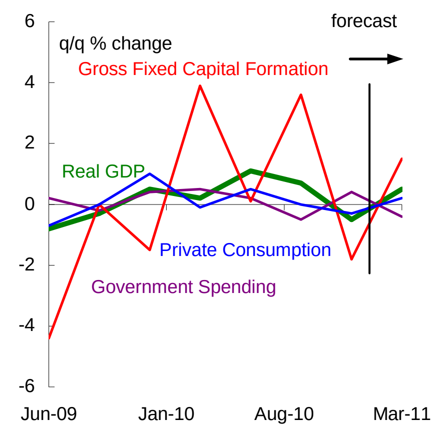


Source: Bloomberg.

EUROPE

The UK will release estimates for first-quarter 2011 real GDP growth by expenditure components on May 25th. According to a preliminary estimate, output increased by 0.5% q/q (up 1.8% y/y) in the January-March period, thereby erasing the contraction recorded in the final quarter of 2010. We assess that private consumption, which accounts for two-thirds of GDP, continues to reflect consumer caution, increasing by 0.2% q/q in the first quarter of the year, following a 0.3% q/q contraction in the previous quarter. Meanwhile, government spending continues to be dampened by ongoing fiscal restraint, decreasing by 0.4% q/q in Q1 2011 (up 0.4% q/q in Q4 2010). Investment likely recovered in the first months of the year, supported by an accommodative monetary policy stance. Aggressive fiscal restraint and slower export sector momentum are expected to limit the UK's real GDP growth to 1.4% in 2011. Expansion should pick up to 1.7% in 2012, as both the global and domestic recoveries becomes more broad-based.

UK Real GDP Components

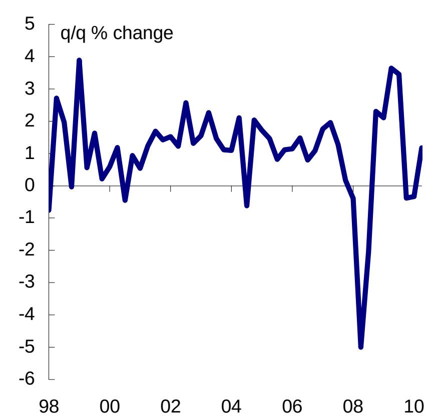


Source: Bloomberg. Scotia Economics.

ASIA

We expect Thailand's Q1 GDP report to depict a solid advance during the first quarter of 2011 at a 1% q/q rate; a slight deceleration from the 1.2% gain of the final three months of 2010. Although an effect from the Japanese earthquake/tsunami of March has already become evident in Thailand's manufacturing output figures, the economy remains on an uptrend as domestically generated activity compensates for some of the losses on the factory output side, particularly auto assembly.

Thailand's Quarterly GDP Growth



s.a not annualized. Source: Bloomberg.

Key Indicators for the week of May 23 - 27

North America

Country	Date	Time	Event	Period	BNS	Consensus	Latest
US	05/23	08:30	Chicago Fed Nat Activity Index	APR	- -	0.2	0.3
MX	05/23	09:00	Retail Sales (INEGI) - (YoY)	MAR	2.57	2.50	2.70
MX	05/24	10:00	Bi-Weekly CPI (% change)	15-May	-0.39	-0.44	0.11
MX	05/24	10:00	Bi-Weekly Core CPI (% change)	15-May	- -	0.1	0.1
US	05/24	10:00	New Home Sales (000s)	APR	310	305	300
US	05/24	10:00	Richmond Fed Manufact. Index	MAY	- -	10.0	10.0
US	05/25	07:00	MBA Mortgage Applications (WoW)	20-May	- -	--	7.8
US	05/25	08:30	Durable Goods Orders (MoM)	APR	-2.6	-2.4	4.1
US	05/25	08:30	Durables Ex Transportation (MoM)	APR	0.0	0.5	2.3
US	05/25	08:30	Cap Goods Orders Nondef Ex Air (MoM)	APR	- -	-2.0	4.3
MX	05/25	09:00	Trade Balance (US$ mns)	APR P	- -	988.0	1445.1
CA	05/25	09:00	Teranet/National Bank HPI (MoM)	MAR	0.3	--	0.1
MX	05/25	10:00	Current Account Balance (US$ mns)	1Q	- -	1595	-3626
US	05/25	10:00	House Price Index (MoM)	MAR	- -	-0.5	-1.6
US	05/25	10:00	House Price Purchase Index (QoQ)	1Q	- -	--	-0.8
US	05/26	08:30	GDP (QoQ, SAAR)	1Q S	2.3	2.2	1.8
US	05/26	08:30	Personal Consumption (QoQ, SAAR)	1Q S	- -	2.9	2.7
US	05/26	08:30	GDP Price Index (QoQ, SAAR)	1Q S	- -	1.9	1.9
US	05/26	08:30	Core PCE (QoQ, SAAR)	1Q S	- -	1.5	1.5
US	05/26	08:30	Initial Jobless Claims (000s)	21-May	405	400	409
US	05/26	08:30	Continuing Claims (000s)	14-May	3700	3700	3711
MX	05/26	09:00	GDP Current Prices (YoY)	1Q	- -	8.8	9.5
MX	05/26	09:00	Unemployment Rate	APR	4.48	4.70	4.61
US	05/26	16:00	RPX Composite 28dy (YoY)	MAR	- -	--	-4.3
US	05/27	08:30	Personal Income (MoM)	APR	0.4	0.4	0.5
US	05/27	08:30	Personal Spending (MoM)	APR	0.4	0.5	0.6
US	05/27	08:30	PCE Deflator (YoY)	APR	- -	2.2	1.8
US	05/27	08:30	PCE Core (MoM)	APR	- -	0.2	0.1
US	05/27	09:55	U. of Michigan Confidence	MAY F	- -	72.4	72.4
MX	05/27	10:00	**Overnight Rate**	27-May	**4.50**	**4.50**	**4.50**
US	05/27	10:00	Pending Home Sales (MoM)	APR	-0.5	-1.0	5.1

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

Key Indicators for the week of May 23 - 27

Europe

Country	Date	Time	Event	Period	BNS	Consensus	Latest
FR	05/23	03:00	PMI Manufacturing	MAY P	- -	57.0	57.5
FR	05/23	03:00	PMI Services	MAY P	- -	62.1	62.9
GE	05/23	03:30	PMI Manufacturing	MAY A	- -	61.0	62.0
GE	05/23	03:30	PMI Services	MAY A	- -	57.0	56.8
EC	05/23	04:00	PMI Composite	MAY A	57.5	57.3	57.8
EC	05/23	04:00	PMI Manufacturing	MAY A	57.5	57.5	58.0
EC	05/23	04:00	PMI Services	MAY A	57.0	56.5	56.7
GE	05/24	02:00	GDP s.a. (QOQ)	1Q F	1.5	1.5	1.5
FR	05/24	02:45	Production Outlook Indicator	MAY	- -	--	20.0
FR	05/24	02:45	Business Confidence Indicator	MAY	- -	109.0	110.0
GE	05/24	04:00	IFO - Business Climate	MAY	- -	113.7	114.2
GE	05/24	04:00	IFO - Current Assessment	MAY	- -	120.7	121.0
GE	05/24	04:00	IFO - Expectations	MAY	- -	107.0	107.7
EC	05/24	05:00	Industrial New Orders SA (MoM)	MAR	- -	-1.1	0.7
GE	05/25	02:00	GfK Consumer Confidence Survey	JUN	- -	5.6	5.7
IT	05/25	04:00	Retail Sales s.a. (MoM)	MAR	- -	-0.2	0.1
UK	05/25	04:30	Total Business Investment (QoQ)	1Q P	- -	--	0.0
UK	05/25	04:30	GDP (QoQ)	1Q P	0.5	0.5	0.5
UK	05/25	04:30	Index of Services (MoM)	MAR	- -	0.5	0.6
FR	05/26	02:45	Consumer Confidence Indicator	MAY	- -	84.0	83.0
IT	05/26	04:00	Business Confidence	MAY	- -	102.7	103.0
UK	05/26	19:01	GfK Consumer Confidence Survey	MAY	- -	-31.0	-31.0
EC	05/27	05:00	Euro-Zone Consumer Confidence	MAY F	- -	-12.0	-9.7
EC	05/27	05:00	Euro-Zone Economic Confidence	MAY	- -	105.7	106.2
EC	05/27	05:00	Euro-Zone Indust. Confidence	MAY	- -	5.3	5.8
EC	05/27	05:00	Euro-zone Services Confidence	MAY	- -	10.0	10.4
GE	05/27		Consumer Price Index (MoM)	MAY P	- -	0.0	0.2
GE	05/27		Consumer Price Index (YoY)	MAY P	- -	2.3	2.4
GE	05/27		CPI - Brandenburg (MoM)	MAY	- -	--	0.2
GE	05/27		CPI - Bavaria (MoM)	MAY	- -	--	0.3
GE	05/27		CPI - Baden Wuerttemberg (MoM)	MAY	- -	--	0.3
GE	05/27		CPI - Hesse (MoM)	MAY	- -	--	0.3
GE	05/27		CPI - EU Harmonised (MoM)	MAY P	0.2	0.1	0.3
GE	05/27		CPI - EU Harmonised (YoY)	MAY P	2.8	2.7	2.7
GE	05/27		CPI - North Rhine-West. (MoM)	MAY	- -	--	0.3
GE	05/27		CPI - Saxony (MoM)	MAY	- -	--	0.4

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

Key Indicators for the week of May 23 - 27

Asia Pacific

Country	Date	Time	Event	Period	BNS	Consensus	Latest
PK	05/21		**Benchmark Interest Rate**	21-May	**- -**	**14.00**	**14.00**
TH	05/22	22:30	Gross Domestic Product SA (QoQ)	1Q	1.0	2.2	1.2
CH	05/22	22:30	HSBC Flash China Manufacturing PMI	MAY	- -	--	51.8
JN	05/23	01:00	Coincident Index CI	MAR F	- -	--	103.6
JN	05/23	01:00	Leading Index CI	MAR F	- -	--	99.5
SI	05/23	01:00	CPI (MOM) - NSA	APR	- -	0.4	0.1
JN	05/24	19:50	Merchnds Trade Balance Total (¥ bns)	APR	- -	-703.7	189.4
JN	05/24	19:50	Merchnds Trade Exports (YoY)	APR	- -	-12.7	-2.3
JN	05/24	19:50	Merchnds Trade Imports (YoY)	APR	- -	12.8	11.9
AU	05/24	20:00	Conference Board Leading Index (%)	MAR	- -	--	0.6
PH	05/24	21:00	Trade Balance (US$ mns)	MAR	- -	--	-823.0
HK	05/26	04:30	Trade Balance (HK$ bns)	APR	- -	-35.3	-40.1
SK	05/26	19:00	Current Account (US$ mns)	APR	- -	--	1434.5
JN	05/26	19:30	Tokyo CPI (YoY)	MAY	- -	0.1	-0.1
JN	05/26	19:30	Tokyo CPI Ex-Fresh Food (YoY)	MAY	- -	0.2	0.2
JN	05/26	19:30	Tokyo CPI Ex Food, Energy (YoY)	MAY	- -	0.1	0.0
JN	05/26	19:30	Natl CPI (YoY)	APR	- -	0.3	0.0
JN	05/26	19:30	Natl CPI Ex-Fresh Food (YoY)	APR	- -	0.6	-0.1
JN	05/26	19:30	Natl CPI Ex Food, Energy (YoY)	APR	- -	-0.1	-0.7
JN	05/26	19:50	Retail Trade (MoM) SA	APR	- -	2.6	-7.6
JN	05/26	19:50	Large Retailers' Sales (YoY)	APR	- -	-1.3	-7.7
TH	05/27	03:00	Mfg. Production Index ISIC (SA)	APR	- -	--	188.5

Latin America

Country	Date	Time	Event	Period	BNS	Consensus	Latest
BZ	05/23	07:30	Central Bank Weekly Economists Survey				
BZ	05/23	10:00	Trade Balance (FOB) - Weekly (US$ mns)	22-May	- -	--	1491
BZ	05/25	07:00	FGV Consumer Confidence	MAY	- -	--	118.2
BZ	05/25	09:30	Current Account - Monthly (US$ mns)	APR	- -	-4575.0	-5676.1
BZ	05/25	09:30	Foreign Investment (US$ mns)	APR	- -	4800	6791
BZ	05/26	07:00	FGV Construction Costs (MoM)	MAY	- -	--	0.8
BZ	05/26	08:00	Unemployment Rate	APR	- -	6.4	6.5
CL	05/27	08:30	Central Bank Meeting Minutes				
BZ	05/27		Central Govt Budget (BRL bns)	APR	- -	8.2	9.1

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

Global Auctions for the week of May 23 - 27

North America

Country	Date	Time	Event
US	05/23	11:00	U.S. Fed to Purchase USD6-8 Bln Notes/Bonds
US	05/23	11:30	U.S. to Sell 3-Month Bills
US	05/23	11:30	U.S. to Sell 6-Month Bills
CA	05/24	10:30	Canada to Sell CAD7.4 Bln 98-Day Bills
CA	05/24	10:30	Canada to Sell CAD2.8 Bln 168-Day Bills
CA	05/24	10:30	Canada to Sell CAD2.8 Bln 350-Day Bills
US	05/24	11:00	U.S. Fed to Purchase USD5-7 Bln Notes/Bonds
US	05/24	11:30	U.S. to Sell 4-Week Bills
US	05/24	13:00	U.S. to Sell 2-Year Notes
US	05/25	11:00	U.S. Fed to Purchase USD4-6 Bln Notes/Bonds
CA	05/25	12:00	Canada to Sell 3-Year Notes
US	05/25	13:00	U.S. to Sell 5-Year Notes
US	05/26	11:00	U.S. Fed to Purchase USD5-7 Bln Notes/Bonds
US	05/26	13:00	U.S. to Sell 7-Year Notes

Europe

Country	Date	Time	Event
NO	05/23	05:00	Norway to Sell NOK3 Bln 3.75% 2021 Bonds
FR	05/23	09:00	France to Sell Bills
SP	05/24	04:30	Spain to Sell 3M and 6M Bills
SW	05/25	05:10	Sweden to Sell Bills
GE	05/25	05:15	Germany to Sell Add'l EU5 Bln 10-Year Notes
IT	05/26	05:00	Italy to Sell Bills & Zero Coupon Notes
UK	05/27	06:10	U.K. to Sell Bills

Asia Pacific

Country	Date	Time	Event
SK	05/22	22:30	Korea to Sell KRW900 Bln 20-Year Bonds
SI	05/23	00:00	Singapore to sell 91-Day T-Bills
TA	05/23	00:30	Taiwan to Sell TWD30 Bln 20-Year Treasury Bonds
IN	05/23	06:30	5-9 year security for Rs.4,000-5,000 crore
IN	05/23	06:30	10-14 year security for Rs.5,000-6,000 crore
IN	05/23	06:30	20-year and above security for Rs.2,000-3,000 crore
AU	05/23	21:00	Australia to Sell Treasury Indexed Bonds
TH	05/23	23:00	Bank of Thailand to Sell THB25 Bln 28D Bills
TH	05/23	23:00	Bank of Thailand to Sell THB22 Bln 91D Bills
TH	05/23	23:00	Bank of Thailand to Sell THB15 Bln 182D Bills
HK	05/23	23:30	Hong Kong to Sell HKD25.15 Bln 91-Day Bills
HK	05/23	23:30	Hong Kong to Sell HKD9 Bln 182-Day Bills
HK	05/23	23:30	Hong Kong to Sell HKD3 Bln 364-Day Bills
PH	05/24	01:30	Philippines Plans to Sell PHP9.0 Bln 4-Yr Bonds Due 2015
JN	05/24	04:00	Japan Auction for Enhanced-Liquidity
ID	05/24	04:30	Indonesia to Sell 5-Yr to Maturity Government Bond
ID	05/24	04:30	Indonesia to Sell 10-Yr to Maturity Government Bond
ID	05/24	04:30	Indonesia to Sell 1-Yr to Maturity Treasury Bills
TH	05/24	23:00	Thailand to Sell THB8 Bln Bonds due 2014
JN	05/24	23:35	Japan to Sell 3-Month Bills
IN	05/25	07:30	India to Sell INR 80Bln 91-Day Bills
IN	05/25	07:30	India to Sell INR 30Bln 182-Day Bills
NZ	05/25	22:30	New Zealand Plans to Sell Government Bonds
HK	05/25	23:30	Hong Kong to Sell HKD300 Mln 24-Day Bills
HK	05/25	23:30	Hong Kong to Sell HKD300 Mln 33-Day Bills
JN	05/25	23:45	Japan to Sell 20-Year Bond
TH	05/26	23:00	Bank of Thailand to Sell THB10 Bln FRN due 2013
SI	05/27	00:00	Singapore to sell 10-Year Bonds

Source: Bloomberg, Scotia Economics.

Events for the week of May 23 - 27

North America

Country	Date	Time	Event
US	05/23	20:10	Fed's Bullard Speaks on Economy in Missouri
US	05/24	00:00	Fed's Rosengren Speaks at Conference in Russia
US	05/24	09:50	Fed's Hoenig Speaks in Philadelphia
US	05/24	13:20	Fed's Bullard Speaks in Cape Girardeau, Missouri
CA	05/25	01:00	Bank of Montreal Releases Second-Quarter Results
US	05/25	13:30	Fed's Kocherlakota Speaks in Rochester, Minnesota
CA	05/26	01:00	CIBC Releases Second-Quarter Results
CA	05/27	06:00	Royal Bank of Canada Releases Second-Quarter Results
MX	05/27	10:00	**Overnight Rate**

Europe

Country	Date	Time	Event
GE	05/21	07:00	Merkel, Seehofer Brief After CSU Meeting in Kloster Andechs
GE	05/22	13:00	German Finance Minister Schaeuble Attends Karlsruhe Event
GE	05/22		German State Election in Bremen
EC	05/23	03:00	ECB's Weidmann Speaks in Frankfurt
EC	05/23	04:50	ECB's Tumpel-Gugerell Speaks at Event in Frankfurt
SP	05/23	05:30	ECB's Ordonez Speaks in Madrid
EC	05/23	09:00	ECB's Bini Smaghi Speaks at Austrian National Bank, Vienna
EC	05/23	09:30	ECB Announces Bond Purchases
EC	05/23		ECB's Mersch Speak in Zurich
EC	05/23		EU Foreign Ministers Meet in Brussels
GE	05/25	02:00	GfK Consumer Confidence Survey
EC	05/25	08:15	ECB's Draghi, Liikanen Speak in Berlin
EC	05/25	10:30	ECB's Stark Speaks at Event in Berlin
EC	05/26	05:15	ECB's Ewald Nowotny Speaks in Vienna
EC	05/26	05:20	ECB's Trichet Speaks at Event in Berlin
EC	05/26	08:00	ECB's Bini Smaghi Speaks at Event in London
LX	05/26	09:00	Luxembourg's Juncker Speaks at Event in Luxembourg
EC	05/27	04:00	ECB's Kranjec Speaks at Conference in Portoroz, Slovenia

Asia Pacific

Country	Date	Time	Event
PK	05/21		**Benchmark Interest Rate**
NZ	05/23		Finance Minister English Attends Singapore Forum
JN	MAY 23-24		Cabinet Office Monthly Economic Report
NZ	05/24	17:00	Prime Minister Key Speaks at Tourism Conference
NZ	05/24	20:00	Finance Minister English Speaks in Singapore
JN	05/24	23:30	BOJ Governor Shirakawa to Speak at forum in Tokyo
AU	05/25	19:15	RBA's Battellino Speaks at Stockbrokers Conference in Sydney
NZ	05/26	01:15	Finance Minister Speaks in Hong Kong

Latin America

Country	Date	Time	Event
CL	05/21	08:30	President's Annual Address
BZ	05/27	06:30	Brazilian Environment Minister Speaks at Conference in Lisbon

Source: Bloomberg, Scotia Economics.

Global Central Bank Watch

North America

Rate	Current Rate	Next Meeting	Scotia's Forecasts	Consensus Forecasts
Bank of Canada – Overnight Target Rate	1.00	May 31, 2011	1.00	--
Federal Reserve – Federal Funds Target Rate	0.25	June 22, 2011	0.25	0.25
Banco de México – Overnight Rate	4.50	May 27, 2011	4.50	4.50

With inflation on a downward trend while solid economic performance continues, we expect Banco de Mexico to maintain its monetary policy intact, leaving the reference rate unchanged at 4.50%. We expect the first hike to come in line with the Federal Reserve at the first quarter of 2012. In the US, this week's FOMC minutes to the April 27 meeting provided a clear exit strategy as the Fed looks to normalize monetary policy. In Canada, April's better than expected CPI report, together with weaker than expected retail sales in March provided further support to our longstanding view that the Bank of Canada will remain on hold until October of this year with a risk that they hold off even longer.

Europe

Rate	Current Rate	Next Meeting	Scotia's Forecasts	Consensus Forecasts
European Central Bank – Refinancing Rate	1.25	June 9, 2011	1.25	--
Bank of England – Bank Rate	0.50	June 9, 2011	0.50	0.50
Swiss National Bank – Libor Target Rate	0.25	June 16, 2011	0.25	--
Central Bank of Russia – Refinancing Rate	8.25	May 27, 2011	8.25	--
Hungarian National Bank – Base Rate	6.00	June 20, 2011	6.00	--
Central Bank of the Republic of Turkey – 1 Week Repo Rate	6.25	May 25, 2011	6.25	6.25

We expect the Central Bank of Turkey to hold the benchmark interest rate at 6.25% following its monthly meeting next week. While inflation in Turkey will likely accelerate in the near term, economic activity is showing signs of moderation.

Asia Pacific

Rate	Current Rate	Next Meeting	Scotia's Forecasts	Consensus Forecasts
Bank of Japan – Target Rate	0.10	June 14, 2011	0.10	--
Reserve Bank of Australia – Cash Target Rate	4.75	June 7, 2011	4.75	4.75
Reserve Bank of New Zealand – Cash Rate	2.50	June 8, 2011	2.50	--
People's Bank of China – Lending Rate	6.31	TBA	--	--
Reserve Bank of India – Repo Rate	7.25	TBA	7.25	--
Hong Kong Monetary Authority – Base Rate	0.50	TBA	0.50	--
Central Bank of China Taiwan – Discount Rate	1.75	June 24, 2011	1.75	--
Bank Negara Malaysia – Overnight Policy Rate	3.00	July 7, 2011	3.00	--
Bank of Korea – Bank Rate	3.00	June 9, 2011	3.00	--
Bank of Thailand – Repo Rate	2.75	June 1, 2011	2.75	--
Bank Indonesia – Reference Interest Rate	6.75	June 9, 2011	6.75	--

Latin America

Rate	Current Rate	Next Meeting	Scotia's Forecasts	Consensus Forecasts
Banco Central do Brasil – Selic Rate	12.00	June 8, 2011	12.25	--
Banco Central de Chile – Overnight Rate	5.00	June 14, 2011	5.25	--
Banco de la República de Colombia – Lending Rate	3.75	May 30, 2011	3.75	4.00
Banco Central de Reserva del Perú – Reference Rate	4.25	June 9, 2011	4.25	--

Africa

Rate	Current Rate	Next Meeting	Scotia's Forecasts	Consensus Forecasts
South African Reserve Bank – Repo Rate	5.50	July 18, 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 Prices[2]		
World[1]	3.6	4.9	4.4	4.4				
Canada	2.1	3.1	2.9	2.6	2.1	1.8	2.8	2.3
United States	1.8	2.9	2.6	2.8	2.6	1.6	2.8	2.0
Mexico	1.9	5.5	4.3	3.8	4.9	4.4	4.1	4.1
United Kingdom	2.7	1.3	1.4	1.7	2.2	3.7	3.7	2.9
Euro zone	1.2	1.7	1.4	1.6	2.1	2.2	2.5	2.3
Japan	0.7	3.9	1.0	2.9	-0.3	-0.5	0.5	1.2
Australia	3.0	2.8	3.8	3.5	3.2	2.7	2.8	2.5
China	10.2	10.3	9.5	9.7	2.0	3.3	5.0	4.5
India	7.2	8.7	8.5	8.8	5.7	9.4	7.5	6.0
Korea	4.5	6.3	5.5	5.3	3.2	3.5	3.3	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	7.0	7.2	2.5	2.1	3.5	3.0

Central Bank Rates (%, end of period)	11Q1	11Q2f	11Q3f	11Q4f	12Q1f	12Q2f	12Q3f	12Q4f
Bank of Canada	1.00	1.00	1.00	1.50	2.00	2.25	2.25	2.25
Federal Reserve	0.25	0.25	0.25	0.25	0.75	1.25	1.75	2.00
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	0.75	1.00	1.25	1.50	1.75	2.00
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	0.25	0.25	0.50
Reserve Bank of Australia	4.75	5.00	5.25	5.50	5.75	6.00	6.25	6.50
Exchange Rates (end of period)								
Canadian Dollar (USDCAD)	0.97	0.95	0.94	0.93	0.94	0.94	0.93	0.92
Canadian Dollar (CADUSD)	1.03	1.05	1.06	1.08	1.06	1.06	1.08	1.09
Euro (EURUSD)	1.42	1.47	1.49	1.50	1.48	1.48	1.50	1.50
Sterling (GBPUSD)	1.60	1.64	1.64	1.65	1.65	1.67	1.69	1.70
Yen (USDJPY)	83	79	82	84	86	87	89	90
Australian Dollar (AUDUSD)	1.03	1.07	1.08	1.09	1.09	1.10	1.10	1.11
Chinese Yuan (USDCNY)	6.5	6.4	6.2	6.1	6.0	5.9	5.8	5.8
Mexican Peso (USDMXN)	11.9	11.6	11.8	12.0	12.1	12.0	12.1	12.3
Brazilian Real (USDBRL)	1.63	1.59	1.59	1.60	1.62	1.65	1.67	1.70

Commodities (annual average)	2000-09	2010	2011f	2012f
WTI Oil (US$/bbl)	51	79	105	110
Brent Oil (US$/bbl)	50	80	118	122
Nymex Natural Gas (US$/mmbtu)	5.95	4.40	4.40	4.75
Copper (US$/lb)	1.78	3.42	4.40	4.15
Zinc (US$/lb)	0.73	0.98	1.09	1.09
Nickel (US$/lb)	7.11	9.89	11.25	8.90
Gold, London PM Fix (US$/oz)	522	1,225	1,530	1,500
Pulp (US$/tonne)	668	960	1,018	1,050
Newsprint (US$/tonne)	572	607	660	705
Lumber (US$/mfbm)	275	254	270	300

[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	10Q3	10Q4	Latest	
Real GDP (annual rates)	3.1	1.8	3.3		
Current Acc. Bal. (C$B, ar)	-50.0	-67.9	-44.2		
Merch. Trade Bal. (C$B, ar)	-9.1	-26.0	0.6	7.5	(Mar)
Industrial Production	4.8	7.9	6.1	5.0	(Feb)
Housing Starts (000s)	192	192	179	179	(Apr)
Employment	1.4	1.8	1.7	1.7	(Apr)
Unemployment Rate (%)	8.0	8.0	7.7	7.6	(Apr)
Retail Sales	5.5	4.0	5.3	0.9	(Mar)
Auto Sales (000s)	1560	1609	1554	1578	(Feb)
CPI	1.8	1.8	2.3	3.3	(Apr)
IPPI	1.1	1.1	2.7	-5.0	(Mar)
Pre-tax Corp. Profits	18.4	15.3	16.2		

United States	2010	10Q3	10Q4	Latest	
Real GDP (annual rates)	2.9	2.6	3.1	1.7	(Q1-A)
Current Acc. Bal. (US$B, ar)	-470	-502	-453		
Merch. Trade Bal. (US$B, ar)	-647	-683	-625	-745	(Mar)
Industrial Production	5.3	6.7	6.2	4.9	(Apr)
Housing Starts (millions)	0.58	0.58	0.54	0.52	(Apr)
Employment	-0.8	-0.1	0.5	1.1	(Apr)
Unemployment Rate (%)	9.6	9.6	9.6	9.0	(Apr)
Retail Sales	6.8	5.8	8.1	7.9	(Apr)
Auto Sales (millions)	11.5	11.6	12.3	13.1	(Apr)
CPI	1.6	1.2	1.3	3.2	(Apr)
PPI	4.2	3.8	3.8	6.8	(Apr)
Pre-tax Corp. Profits	36.8	34.8	16.1		

Mexico	2010	10Q3	10Q4	Latest	
Real GDP	5.4	5.1	4.4		
Current Acc. Bal. (US$B, ar)	-5.7	-7.7	-14.5		
Merch. Trade Bal. (US$B, ar)	-3.1	-9.2	-4.6	17.3	(Mar)
Industrial Production	6.0	6.2	4.8	4.2	(Mar)
CPI	4.2	3.7	4.2	3.4	(Apr)

Brazil	2010	10Q3	10Q4	Latest	
Real GDP	6.7	5.9	4.2		
Current Acc. Bal. (US$B, ar)	-47.4	-46.1	-48.0		
Merch. Trade Bal. (US$B, ar)	20.2	19.3	30.0	22.4	(Apr)
Industrial Production	10.5	8.2	3.7	0.5	(Mar)
CPI	5.1	5.0	6.1	6.5	(Apr)

Chile	2010	10Q3	10Q4	Latest	
Real GDP	5.2	6.9	5.8		
Current Acc. Bal. (US$B, ar)	3.6	-0.2	4.9		
Merch. Trade Bal. (US$B, ar)	11.6	14.7	17.7	19.0	(Apr)
Industrial Production	0.6	4.4	2.7	30.8	(Mar)
CPI	1.4	2.2	2.5	3.2	(Apr)

Italy	2010	10Q3	10Q4	Latest	
Real GDP	1.2	1.4	1.5		
Current Acc. Bal. (US$B, ar)	-0.07	-0.05	-0.06	-0.09	(Mar)
Merch. Trade Bal. (US$B, ar)	-39.1	-28.2	-46.3	-66.2	(Mar)
Industrial Production	6.5	7.5	5.1	3.2	(Mar)
CPI	1.6	1.6	1.8	2.6	(Apr)

Germany	2010	10Q3	10Q4	Latest	
Real GDP	3.5	3.9	3.8		
Current Acc. Bal. (US$B, ar)	187.9	165.7	250.8	328.0	(Mar)
Merch. Trade Bal. (US$B, ar)	201.5	207.6	219.8	256.0	(Mar)
Industrial Production	10.1	10.2	11.8	10.9	(Mar)
Unemployment Rate (%)	7.7	7.6	7.5	7.1	(Apr)
CPI	1.1	1.2	1.5	2.4	(Apr)

France	2010	10Q3	10Q4	Latest	
Real GDP	2.2	2.9	2.6		
Current Acc. Bal. (US$B, ar)	-54.3	-41.8	-94.9	-46.1	(Mar)
Merch. Trade Bal. (US$B, ar)	-38.6	-42.2	-38.6	-49.3	(Mar)
Industrial Production	5.1	4.3	4.8	3.3	(Mar)
Unemployment Rate (%)	9.8	9.8	9.6	9.5	(Mar)
CPI	1.5	1.5	1.6	2.1	(Apr)

Euro Zone	2010	10Q3	10Q4	Latest	
Real GDP	1.7	1.9	2.0		
Current Acc. Bal. (US$B, ar)	-77	-43	-41	-64	(Mar)
Merch. Trade Bal. (US$B, ar)	0.0	43.0	53.2	39.6	(Mar)
Industrial Production	7.4	7.2	8.0	5.4	(Mar)
Unemployment Rate (%)	10.0	10.0	10.0	9.8	(Mar)
CPI	1.6	1.7	2.0	2.8	(Apr)

United Kingdom	2010	10Q3	10Q4	Latest	
Real GDP	1.3	2.5	1.5		
Current Acc. Bal. (US$B, ar)	-56.1	-56.0	-62.2		
Merch. Trade Bal. (US$B, ar)	-151.4	-160.1	-169.4	-148.6	(Mar)
Industrial Production	2.0	3.0	3.3	0.7	(Mar)
Unemployment Rate (%)	7.9	7.8	7.9	7.7	(Feb)
CPI	3.3	3.1	3.4	4.5	(Apr)

Japan	2010	10Q3	10Q4	Latest	
Real GDP	4.0	4.8	2.4		
Current Acc. Bal. (US$B, ar)	195.9	227.5	176.8	246.3	(Mar)
Merch. Trade Bal. (US$B, ar)	74.4	72.7	61.2	14.1	(Mar)
Industrial Production	16.6	13.3	6.8	-13.1	(Mar)
Unemployment Rate (%)	5.1	5.0	5.0	4.6	(Mar)
CPI	-0.7	-0.8	0.1	0.0	(Mar)

Australia	2010	10Q3	10Q4	Latest	
Real GDP	2.7	2.7	2.7		
Current Acc. Bal. (US$B, ar)	-31.8	-29.2	-34.4		
Merch. Trade Bal. (US$B, ar)	19.2	27.8	25.8	31.7	(Mar)
Industrial Production	4.3	4.2	-0.3		
Unemployment Rate (%)	5.2	5.2	5.2	4.9	(Apr)
CPI	2.8	2.8	2.7		

China	2010	10Q3	10Q4	Latest	
Real GDP	10.3	9.6	9.8		
Current Acc. Bal. (US$B, ar)	30.5				
Merch. Trade Bal. (US$B, ar)	182.1	259.9	248.5	137.1	(Apr)
Industrial Production	13.5	13.3	13.5	13.4	(Apr)
CPI	4.6	3.6	4.6	5.3	(Apr)

South Korea	2010	10Q3	10Q4	Latest	
Real GDP	6.2	4.4	4.7		
Current Acc. Bal. (US$B, ar)	28.2	39.7	36.6	17.2	(Mar)
Merch. Trade Bal. (US$B, ar)	41.2	42.5	52.1	61.7	(Apr)
Industrial Production	16.6	12.9	9.9	8.9	(Mar)
CPI	3.0	2.9	3.6	4.2	(Apr)

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

Source: Bloomberg, Scotia Economics.

Interest Rates (%, end of period)

Canada	10Q4	11Q1	May/13	May/20*	United States	10Q4	11Q1	May/13	May/20*
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	1.05	0.96	0.98	0.88	3-mo. T-bill	0.12	0.09	0.02	0.04
10-yr Gov't Bond	3.12	3.35	3.20	3.14	10-yr Gov't Bond	3.29	3.47	3.17	3.16
30-yr Gov't Bond	3.53	3.76	3.59	3.56	30-yr Gov't Bond	4.33	4.51	4.31	4.32
Prime	3.00	3.00	3.00	3.00	Prime	3.25	3.25	3.25	3.25
FX Reserves (US$B)	59.4	57.0	60.4	(Mar)	FX Reserves (US$B)	122.1	121.4	128.3	(Mar)
Germany					**France**				
3-mo. Interbank	0.96	1.26	1.39	1.41	3-mo. T-bill	0.40	0.80	0.95	1.00
10-yr Gov't Bond	2.96	3.35	3.08	3.06	10-yr Gov't Bond	3.36	3.71	3.42	3.43
FX Reserves (US$B)	62.4	62.3	64.8	(Mar)	FX Reserves (US$B)	52.2	55.8	61.0	(Mar)
Euro-Zone					**United Kingdom**				
Refinancing Rate	1.00	1.00	1.25	1.25	Repo Rate	0.50	0.50	0.50	0.50
Overnight Rate	0.82	0.90	1.06	1.16	3-mo. T-bill	4.85	4.85	4.85	4.85
FX Reserves (US$B)	300.1	300.2	319.9	(Mar)	10-yr Gov't Bond	3.40	3.69	3.37	3.35
					FX Reserves (US$B)	67.2	68.3	75.3	(Mar)
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	0.13	0.14	0.13	0.13	10-yr Gov't Bond	5.55	5.49	5.37	5.32
10-yr Gov't Bond	1.13	1.26	1.13	1.13	FX Reserves (US$B)	38.1	38.7	33.3	(Mar)
FX Reserves (US$B)	1077.4	1061.5	1080.6	(Mar)					

Exchange Rates (end of period)

USDCAD	1.00	0.97	0.97	0.97	¥/US$	81.16	83.13	80.80	81.63
CADUSD	1.00	1.03	1.03	1.03	US¢/Australian$	102.33	103.29	105.74	106.49
GBPUSD	1.561	1.603	1.620	1.621	Chinese Yuan/US$	6.59	6.55	6.50	6.49
EURUSD	1.339	1.416	1.412	1.417	South Korean Won/US$	1125	1100	1089	1083
JPYEUR	0.92	0.85	0.88	0.86	Mexican Peso/US$	12.360	11.906	11.728	11.655
USDCHF	0.93	0.92	0.89	0.88	Brazilian Real/US$	1.660	1.632	1.637	1.617

Equity Markets (index, end of period)

United States (DJIA)	11578	12320	12596	12513	U.K. (FT100)	5900	5909	5926	5946
United States (S&P500)	1258	1326	1338	1334	Germany (Dax)	6914	7041	7403	7264
Canada (S&P/TSX)	13443	14116	13377	13617	France (CAC40)	3805	3989	4019	3993
Mexico (Bolsa)	38551	37441	35045	35173	Japan (Nikkei)	10229	9755	9649	9607
Brazil (Bovespa)	69305	68587	63235	62757	Hong Kong (Hang Seng)	23035	23528	23276	23199
Italy (BCI)	1048	1120	1124	1113	South Korea (Composite)	2051	2107	2120	2112

Commodity Prices (end of period)

Pulp (US$/tonne)	960	990	1020	1020	Copper (US$/lb)	4.42	4.26	4.02	4.07
Newsprint (US$/tonne)	640	640	640	640	Zinc (US$/lb)	1.10	1.05	0.99	0.97
Lumber (US$/mfbm)	308	290	228	218	Gold (US$/oz)	1405.50	1439.00	1505.75	1490.75
WTI Oil (US$/bbl)	91.38	106.72	99.65	97.75	Silver (US$/oz)	30.63	37.87	36.20	34.80
Natural Gas (US$/mmbtu)	4.41	4.39	4.25	4.19	CRB (index)	332.80	359.43	338.53	339.18

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

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