Global Views

Weekly commentary on economic and financial market developments

September 16, 2011

Global Views is available on: www.scotiabank.com, Bloomberg at SCOE and Reuters at SM1C

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Will A Constructive Bias Keep Building Upon Itself Next Week?

- **Please see our full indicator, central bank, auction and event calendars on pp. A2-A7.**

Is the past week's equity rally just a short covering move against the end-of-Europe trade that was getting carried away with unreasonable talk of the departure of countries from the euro and that zeroes the clock before addressing a calendar chock-full of global risks, or was it the start of a new constructive phase reflecting hopes that European Parliaments will all pass the Greek/EFSF aid package votes while central bank USD funding of European banks quells funding and liquidity concerns? Good arguments can be made in both directions, but our bias is toward the first argument due to what lies ahead on the calendar and what is facing the medium-term fundamentals. Next week is all about operation twist and housing data in **US markets**. If Treasuries have already priced in Fed balance sheet extension, then the curve and broader market risk is clearly should the Fed unexpectedly disappoint either by doing nothing or not enough. We think the Fed is likely, however, to deliver some form of the twist which differs from QE through being sterilized.

European markets could again be at the vanguard of global market volatility. Markets are bracing for a possible Moody's downgrade of Italy into the weekend given that it has reached the outer limit of the 90 day window for reviewing the credit. This could land like a cat among pidgeons at the conclusion of a meeting of EU finance ministers and central bankers. That could be followed by another defeat for Merkel's CDU at the Berlin elections on Sunday that could have her coalition partner and foreign minister being out of a job — potentially feeding further concerns about instability in German politics, and giving way to a week's worth of debate in the German Parliament on debt assistance to Greece before the September 29th vote. There are no Parliamentary votes across Europe next week; the key risks are votes by month's end in Finland, Austria, Germany, and the Netherlands. The world's fate then hangs on votes in little old Slovenia and Slovakia as they say they won't turn to the issue until December. In accordance with paragraph 17.8 of the EFSF's articles of incorporation, changes like that being contemplated require unanimous consent of the shareholders and hence each of the member states must approve what is being asked of them. Spanish and Portuguese auctions also return next week. Key data risk lies in European manufacturing PMIs that Alan Clarke believes could carry nasty surprises (see pages 13-14). BoE minutes from the September 8th meeting will shed further colour upon the QE debate on Wednesday, and Norges Bank is expected to maintain a hold. Other data risk includes EC new industrial orders, euro zone consumer confidence, and Germany's ZEW investor confidence survey.

Canadian markets will have four gems with which to contend. The broad tone of the week may be dovish toward relative Canada trades at the front end, but fiscal debate could be a risk further out along the curve. First, the House of Commons resumes sitting on Monday. The week could therefore bring debate on the economy and what to expect in the fall mid-year review. So far, Finance Minister Flaherty has argued in favour of staying the course, but the Prime Minister has flagged concerns about the economy and jobs. We may also receive further insight over coming days and weeks into key debates like amendments to the Investment Canada Act, foreign ownership in the telecommunications sector, and audited results for FY11 are due anytime over coming weeks. Second, BoC Governor Carney speaks Tuesday on the economic outlook after the BoC's more dovish turn in the September 7th statement. Third, August CPI (Wednesday) is expected to be a fairly dovish print owing to soft headline pressures through commodity markets, while the annual core rate has shaken out the Ontario-BC HST distortions that were introduced on July 1st last year such that the BoC is tracking well under its 2% target. Lagged effects of CAD strength, and a softening economy could well add to difficulties in achieving the BoC's inflation target. Finally, retail sales for July (Thursday) are expected to track vehicle sales lower, and a drop in confidence combined with reports from the National Retail Council that speak to a soft pattern for summer sales could keep core ex-auto sales soft.

Asian markets could also carry a surprise or two, although the only one with potentially global market ramifications could be China's flash manufacturing PMI. It has slipped into contraction mode for the past two months, along with other Asian PMIs for countries like Taiwan (global electronics), and South Korea (industrials and consumer diversifieds). Regional market influences could also arise through what will likely be dovish RBA minutes on Monday, fresher Japanese trade figures that push into August, and Q2 New Zealand GDP growth that likely cooled.

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Greece's Exit From The EMU: Potential Economic Consequences

- **Withdrawal from the euro zone would be a very costly policy path for Greece, potentially resulting in currency and banking crises together with a deep economic recession and a distressed sovereign default.**

The possibility of Greece exiting from the euro zone has been at the center of investor focus again this week. A country's withdrawal from the European Economic and Monetary Union (EMU) would be very costly in both economic and political terms. It would severely damage the country's international relations following decades of continued progress in European integration, which allows for free movement of capital and labour, and culminates in a fully integrated European financial system.

If Greece exited the euro in current circumstances, a new currency, the "new drachma", would initially lack investor confidence, resulting in capital flowing out of the country, with the currency depreciating dramatically. An uncontrolled currency crisis is unlikely a resolution to the country's economic and structural challenges. Worth noting is that Greece devalued its drachma several times in the 1980's and 1990's, with little evidence that it improved the country's economic fundamentals. Greece's problems result from structural issues of governance that cannot sustainably be solved by currency devaluation, but rather only by far-reaching reforms that require strong political will for an extended period of time.

Following the likely overshooting depreciation of the new currency, the risk of hyperinflation would emerge (Argentina provides a similar precedent). Private spending would fall dramatically since wage adjustments would lag inflationary developments. The central bank would be required to tighten monetary policy drastically to limit hyper-inflationary pressures at a time of recessionary economic conditions. Indeed, a deeper economic recession would be unavoidable. Since the liabilities of the government would remain denominated in the euro while its revenues would be valued in the new depreciated currency, servicing its debt would be virtually impossible. The same challenge would apply to the private sector, both companies and households. The government would go through distressed debt restructurings, while many companies and households would also have to declare bankruptcy, resulting in major write-offs for the banking sector. Unemployment would skyrocket as both the public and private sectors would announce wide lay-offs, further deepening the recession.

An introduction of the "new drachma" would likely result in massive bank-runs as people and companies would convert their savings into the euro on the back of lack of confidence in the new currency. As a result of the banking crisis following bank-runs and the devastation of the banks' balance sheets, the financial sector would require vast state intervention that is something that the Greek government would not able to provide in its current state, leading to a series of banking failures. While Greece is a small economy in the euro zone (accounting for 2.5% of the EMU's total GDP) the impacts of a banking crisis of this extent would be felt widely throughout the region, although at different levels. The Greek government would be cut out of international bond issuance markets for an extended period of time, forcing it to seek assistance from the International Monetary Fund (IMF) and other multilateral bodies. An IMF-supervised economic program including strict austerity requirements would follow within the context of even more challenging economic fundamentals than the country is currently facing. The sovereign default together with investor expectations of further devaluations would be reflected in the country risk premium, as well as currency and interest rate risks until domestic and international confidence is restored.

Any country's policymakers' primary objective is to maximize the wellbeing of its citizens. Therefore, it is highly unlikely that in current circumstances Greece would choose a policy route that would end up minimizing the society's welfare.

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Asia Moves Forward As The Global Economy Stands At A Crossroads

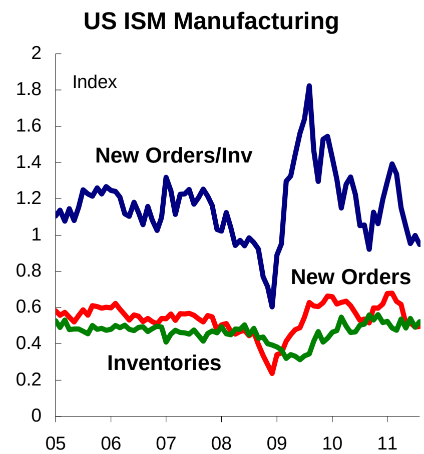
- **An index of Asian industrial output highlights a rebound from the March slump.**

Industrial output in Asia will continue to converge towards its long term average notwithstanding the slowdown in North Atlantic countries. As the radius of influence around Asian growth enlarges, with local spending indicators displaying still healthy expansionary signs, recent data point to the region's capacity to sidestep economic sluggishness in rich countries.

Observations through June show a weighted index of Asia's industrial output growth rebounding above 2.4% y/y, the long term average. The index includes the region's largest economies (China, Japan, India, S. Korea, Indonesia, Taiwan, Thailand, Malaysia and the Philippines) and is constructed as the sum of the nine countries' growth rates in industrial output weighted by their respective PPP-based shares in world GDP. While this is about the best that can be done to capture regional industrial trends, the exercise clearly underestimates the strength of the rebound from the March slump, as a high base effect conditions the results. Indeed, around this time last year Asia's industrial sector was expanding at a 4% annual clip, which dwarfs the sub-3% current gain. We delve into this matter given lack of access to seasonally adjusted data, which would obviate the issue. Overall, we place little doubt in the fact that the region has rebounded from the March Japanese supply disruption, and view lower growth rates in both industrial output and overall GDP as a natural development, whereby a smaller yearly gain multiplied by a wider base can imply an equal or even larger economic expansion.

Data for India from 2006 on; Malaysia and Philippines from 2008 on. The rest from 2005 on. Source: Scotia Economics.

Looking ahead, questions remain regarding the outlook for Asian industrial output given evidence of sluggishness in the US and Europe. The ratio of new orders to inventories from the US ISM manufacturing index is a widely used leading indicator of industrial sector activity. Working under the assumption that Asian industrial output is closely linked to this metric, one may conclude that a slowdown is just around the corner. According to the adjacent chart, the ratio of new orders to inventories dipped again recently pointing to an imminent slump in global manufacturing. However, with the benefit of hindsight, this is not what happened towards the end of 2010 —when this metric stood eerily at just about the same spot as it is today— as orders rebounded through the turn of the year. This resulted either from a policy change or a seasonal factor.



Source: Scotia Economics.

Our interpretation is that the pickup in manufacturing orders was induced as an end-of-the-summer lull in Asia combined with the devaluation of the dollar as a result of the announcement of QE2 by the US Federal Reserve. Could it happen again? It is hard to forecast policy decisions at the current juncture, but one thing that can be said is that the index of Asian industrial output outlined above — which encompasses about 32% of PPP-weighted global GDP — is already a reasonable lever. If enough of such inertia comes from within the Asian region, and provided that persistent US dollar weakness keeps commodity prices elevated, pulling South America (a net commodity supplier) within Asia's sphere of influence, a wider compass of about 42% of PPP-weighted world GDP results, compounding an even more significant expansionary force.

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Sharply Cooling Household Debt Growth Should Appease The BoC ...

- **...even though the debt-to-income ratio keeps climbing.**

Statistics Canada reported this week that Canada's household debt-to-income ratio crossed 150% (150.8% to be exact) in the second quarter of this year. That continues to put its debt ratio on an upward trend that is surpassing other countries like the US. In turn, it prompted concerns about household leverage and the impact of an extended period of low interest rates.

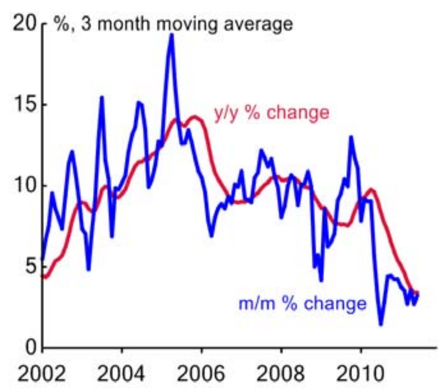
Residential mortgage growth

Source: Bank of Canada, Scotia Capital Economics

We offer a totally different interpretation by using higher frequency monthly debt figures and emphasizing yearly and quicker-turning monthly growth patterns. The facts in the accompanying charts point toward a disconcerting pace by which debt growth is slowing markedly. Take chart 1 for example. After growth in mortgage balances (on- and off-book, system wide) accelerated this past Spring in the rush to secure rate commitments with 90 day guarantees ahead of a tightening of mortgage rules in April, the pre-approvals pipeline has now moved through in such a manner as to drag mortgage debt growth sharply lower. Activity, in other words, was simply brought forward. The same is true of broad housing indicators such as the recent softening in home resales with August's sales tally falling a touch, and in a manner that is consistent with the Scotia Economics view toward a cooling housing market over 2011H2 onward.

Chart 2 completes the picture by portraying growth in consumer loans ex mortgages (again, on- and off-book, system wide). This includes fixed and variable rate loans plus drawn balances on lines and cards. Growth remains very weak and soft monthly rates continue to drag the yearly rate lower.

Consumer loan growth



Source: Bank of Canada, Scotia Capital Economics

In fact, after accounting for inflation and population growth, there is no growth in consumer loans outstanding and relatively soft growth in mortgage balances outstanding. Individual institutions will of course vary in their experiences based upon market share and goals, but the macro picture points to a very different set of risks than what is available through the crude debt-to-income ratio. Our take on it points toward the need for caution on behalf of policy makers to neither prematurely raise rates nor further tighten mortgage rules given evidence of a rapid loss of momentum in debt growth which may reflect diminished confidence but also reflects operating at all-time peaks for measures like the home ownership rate, inflation-adjusted renovation spending, inflation-adjusted consumer spending, inflation adjusted house prices, and debt payments as a share of incomes. Indeed, slowing debt growth is a positive sign that households are increasing their emphasis upon improving the health of household balance sheets — a necessary pre-condition to mitigating further risks.

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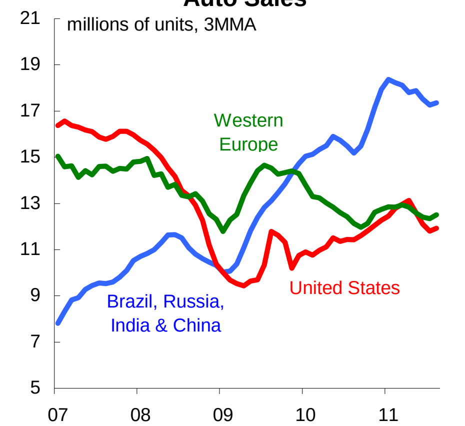
Global Car Sales & Production Strengthen In August

- **Improvement suggests that global economic activity is picking up, not moderating.**

Contrary to expectations, global car sales accelerated in August, pointing to a stronger-than-expected performance in consumer purchases during the third quarter. Global car sales advanced 5% y/y last month — the strongest gain since February — indicating that consumers are not tapped out as many commentators have suggested. It is particularly encouraging that the improvement occurred at a time of heightened financial market turmoil, given the ongoing sovereign debt crisis in several European nations. Of note, even with the difficulties in Western Europe, the region was a key contributor to the improvement in global sales last month, with volumes increasing 8% y/y — the strongest gain since March 2010.

Chart 1: Auto Sales



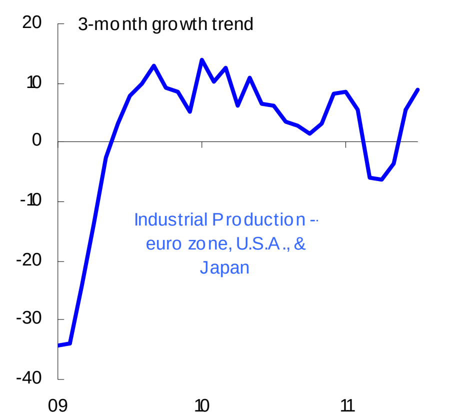
Source: Scotia Economics.

The sales gains in Western Europe were led by an 18% jump in Germany — the region's largest auto market and strongest economy. In addition, all of the region's largest ten markets posted gains last month — a development that bodes well for vehicle production in coming months. In contrast, volumes in the troubled nations of the periphery which have requested financial assistance, posted their tenth consecutive double-digit decline.

Also encouraging for global economic prospects is that sales accelerated to a double-digit year-over-year increase in every region outside of the mature markets of North America, Western Europe and Japan. In particular, Eastern Europe led the increase in August, with volumes jumping 24% above a year earlier, driven by a 33% surge in Russia — the world's sixth largest car market. Purchases in Russia are expected to total 2.48 million units this year, 70% above the 2009 low of only 1.47 million units. Volumes are also very strong in Turkey — Eastern Europe's second largest auto market — with volumes advancing 40% so far this year.

Car sales also continue to post gains in the other traditional emerging nations, with purchases in the BRIC nations posting a double-digit increase for the twenty-seventh consecutive month. Given the ongoing strength in emerging nations, automakers plan to boost global vehicle production 16% year-over-year in the final months of 2011, up from a 6% increase in the third quarter and a decline in the April to June quarter due to supply chain problems in the aftermath of the Japanese earthquake and tsunami in mid-March.

Chart 2: Industrial Production Improves



Source: Scotia Economics.

The benefits of rising global vehicle production on economic activity are beginning to show up in recent economic statistics. For example, euro-zone industrial production rebounded in July, led by a surge in German vehicle production. Automotive factories in Germany are working at 'full tilt', with output surging roughly 20% above a year earlier in July — a sharp acceleration from a flat performance in the second quarter. Assemblies are also strengthening in other regions, boosting industrial activity across the globe. In particular, the 3-month annualized trend in industrial production in the euro zone, the United States and Japan has been improving since May, and is currently at the strongest pace since the spring of 2010 (see chart 2).

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EUR Is Poised To Retrace Some Of Its Recent Losses Into Year-end, But Risks Are Elevated

- **Near-term pressure leaves EUR downside a real risk; but into the new year EMU uncertainty should fade, European authorities increase support and no country leaves the EMU.**

We have long held the view that the risks to EUR are significant and elevated, however our base case has been that the combination of ongoing (and increasing) support from European authorities and a generally weak USD should support EUR into year-end. In light of a recent escalation in concern, we recognize that the risks to our base case have increased, however with the evidence we have to date, we have not made any major shift in our EUR call. Accordingly, EUR is vulnerable to further near-term weakness, but should retrace most of these losses into year-end.

Speculation over what the European Monetary Union (EMU) will look like in the future has increased as the problems (low growth, austerity, banking sector risk, etc) have intensified and put downward pressure on EUR. However, the frameworks of the EMU limit the potential options and should reduce some of the uncertainty as to the future. Specifically, a country can voluntarily negotiate to exit the EMU, but cannot be expelled. In addition, any country that chooses to leave the EMU would also be forced to leave the EU. Accordingly, as long as politicians succeed in delivering the message, we think this implies ongoing support for the current EMU and potentially closer fiscal ties in the years to come. This is likely to support EUR.

Would Germany leave the EMU? Highly unlikely. The impact on its export sector would make this option excruciatingly painful for Germans. Leaving the EMU would establish a new currency (the new German mark), which would likely rally as Germany would have 'rid' itself of the weaker periphery. However, far more important is the impact of having to exit both the EMU and EU in tandem, thereby losing all intra Europe trade advantages. The combination of a strong currency and the loss of EU trade would be crushing to the German export sector. The end result would be far more painful economic consequences than providing further support to the weaker periphery.

Will Greece be expelled from the EMU? No. This option is essentially legally impossible[1].

Will Greece voluntarily negotiate its exit from the EMU? Unlikely. As Tuuli McCulli lays out (earlier in this edition of Global Views) in "Greece's Exit from the EMU" this is an unlikely scenario with dire consequences.

These fundamental assumptions, if able to be communicated, should reduce the possibility of the EMU's worst case scenario and increase the desire and likelihood of further support for the periphery, the banking sector and the long term viability of the EMU, even if this ultimately includes some form of closer fiscal ties. In turn this should be relatively supportive of EUR. However, in the near-term uncertainty is likely to remain high, markets do not like uncertainty and accordingly the EUR is at risk of more temporary downside.

In FX, valuations are relative. In the case of EURUSD, the EUR side is far from rosy and holds significant risk; however the USD side of the equation is also weak for three broad reasons:
1) US monetary policy is loose, expected to remain loose and there is speculation that alternative monetary policy tools might be increased this fall. Combined, this is a significant weight against the USD.
2) The US fiscal position is only complicated by a lower than expected growth trajectory; this combined with the lack of political will to introduce fiscal discipline should prove a weight against the USD.
3) The US economy benefits from a weak USD (the EMU's problems are not fixed by a weak EUR), accordingly we think there is incentive to have a weaker USD.

Accordingly, we recognize that further EUR downside is a material risk; however for those looking out to year-end or early next year, we continue to look for EUR to retrace its summer and early fall losses.

1. Athanassiou, Phoebus "Withdrawal and Expulsion from the EU and EMU", ECB Legal Working Paper, December 2009.

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Volatility & The Outlook For EM Bond Flows

As one of the newer asset classes, emerging markets have always had the highest average rate of inflows at the cost of the highest volatility of those flows. Recently, local currency EM funds have exhibited a similar behaviour to that which we saw for hard currency EM funds in previous years. In the event that developed country economic problems worsen, we think three factors will moderate somewhat the outflows from EM local funds: lower US Treasury yields, more preemptive central banks, and new motivations for currency diversification.

The historical evidence on flows

Investor demand for EM assets has always been one of the more volatile across asset classes. For example, among the 33 asset classes tracked by ICI, foreign bond funds rank in the highest 6% since 1991, as far as the standard deviation of monthly fund flows is concerned. The redeeming feature of EM, despite such volatility in investor sentiment, is that it is also the fastest growing asset class when viewed as a percentage of assets under management. Since 1991 inflows grew faster than any asset class except emerging market equities, and, looking at just the last ten years, inflows grew even faster on average than those of emerging market equities.

While ICI does not track emerging market bond funds in particular, the EPFR data on those funds demonstrates a similar story. As shown in Figure 1, flows to emerging market bond funds were weak in much of the 1990s, but turned positive once the US started to recover from the 2001 recession. Average flows since then were 1.2% monthly, though the suddenness of the 2009 financial crisis led to record-setting outflows. Also noticeable during the last decade is the close correlation between returns and flows, though we have found in the past that outperformance is not the only factor that drives the reallocation to EM—a structural shift is also at work. (See “Making the big leagues: a shift to EM investment,” January 22, 2010). The recent data clearly supports this idea as well. Figure 1 shows that recent inflows had remained strong long after returns had moderated.

With hard currency emerging market bonds no longer such a new asset class to investors, attention has shifted to local currency funds, which account for much of recent inflows, as well as much of the volatility in those inflows (Figure 2). We calculate that the volatility of local currency flows is twice as high as that of hard currency flows despite the fact that the level of returns and the volatility of those returns has been fairly similar between the two asset classes. In this sense, local currency funds are taking the place of “newest” asset class that hard currency EM funds have held in the past. Our regression analysis finds that while local currency inflows depend in part on very recent past returns, there is also an additional shift towards local currency funds independent of those returns.

Factors driving flows today

Despite the depreciation that occurred in some EM currencies recently amid fears of a crisis in Europe and the possibility of another recession in the US, emerging market local market flows have remained resilient. While we cannot rule out outflows if the global environment deteriorates, we think there are several factors that make large outflows less likely than in 2008.

First, thanks to the Federal Reserve’s quantitative easing program, US yields are extremely low. The correlation of some local currency yields with those of the US has meant that some local yields have actually fallen in response to global shocks. That correlation was not present in the past week as some local yields rose, but nevertheless, has helped local markets in general over the past few months. At the same time, low yields on USD-denominated assets may have prompted a search for other currencies. We are not aware of any evidence on whether the relevant statistic that investors look at is the difference between local and foreign yields or the ratio of those yields; obviously, if it is the latter, then emerging market instruments stand to benefit tremendously.

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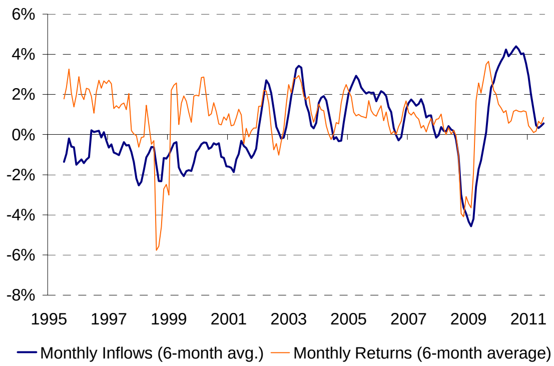
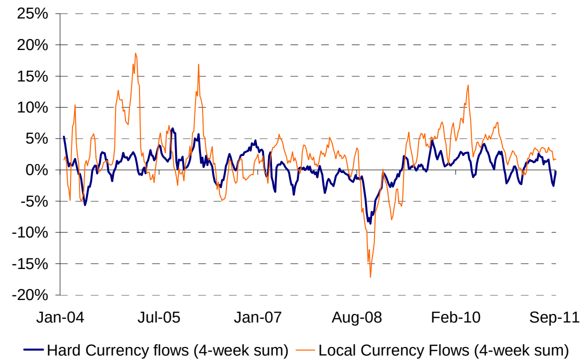
Figure 1. EM Flows and Returns Since 1995



Source: EPFR.

Figure 2. Hard vs. Local Currency Flows Since 2004



Source: EPFR.

Second, with recent fears of Lehman Brothers-type incidents in the back of the minds of not just the ECB but also some developing country policymakers, countries are more likely to take preemptive actions to avoid tail risk. Brazil surprise's rate cut at the end of August is perhaps the most obvious example, though many analysts believe that the fears of a global downturn that justified the committee decision was merely a pretext. Recent statements from Central Banks in Mexico and Peru have suggested that rate cuts could come more quickly than they did back in 2008, a time when many central banks were actually hiking rates even as the global crisis was worsening. That stance is also helpful for yields, but at the expense of EM currencies. Brazil's recent depreciation, for example, started when the rate cut was announced. Overall, the situation marks a reversal from 2008 when currency appreciation offset increasing yields.

Third, the reasons for a move into local currency have changed somewhat. In 2005 to 2007, a key reason was that hard currency spreads had compressed so much that investors, accustomed to double digit total returns, needed to look elsewhere. Even though the financial crisis stemmed from the US rather than developing countries, that factor was only sufficient to postpone rather than prevent a response from emerging market asset prices. Today, troubles in Europe give investors reason for concern and EM is again on the periphery, but that alone is not enough to prevent an impact on EM if global problems grow. Nevertheless, we can append additional reasons for the move to local currency bonds that were not present in 2007. Many economists now believe that the growth problems in the US are longer-term than initially expected. Meanwhile, S&P's downgrade of the US give at least some investors reason to diversify the currency denomination of their holdings in the long-term.

Data for the week ending Wednesday showed inflows into local currency funds of nearly 0.5% despite a negative weekly return of 3.2%. That loss represents the largest weekly loss since 2004 with the exception of three datapoints all occurring in October and November of 2008. It will be interesting to see whether short-term EM sentiment can withstand such a large loss, especially since both past and recent history suggest that investor flows into local emerging market assets may remain volatile in times of global turmoil. Academic research has shown that retail investor response to fund returns can be non-linear, with investors mostly ignoring small gains or losses but responding more forcefully to larger movements. Despite these short-term factors, we continue to believe there is a positive structural component in investor flows that should eventually reassert itself.

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Small Cap Outperformance Cycle At Crossroads

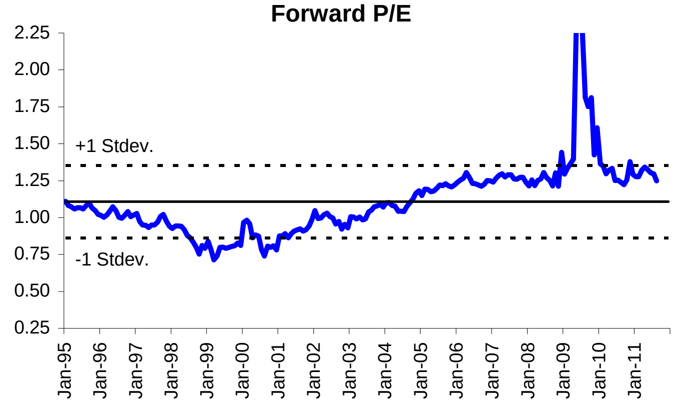
The following text was published on September 12, 2011.

- **Favour large caps over small caps.** With the global macro-economic backdrop deteriorating, small caps absolute and relative performances should continue to be challenged in the coming weeks. In fact, the Canadian and U.S. small cap outperformance cycle is likely over, in our view. In a relief rally, small caps would track the broader equity market higher, but we doubt small caps could outperform large caps on a sustained basis going forward. Amongst the factors underpinning our preference for large caps, we note that: (1) small caps are still trading at lofty premiums over large caps; (2) negative earnings revisions are likely to hit small caps harder; (3) fund flows are less detrimental to large caps than small caps, and (4) the ISM model is not yet pointing toward an attractive risk-reward for small caps.

- **Small caps' relative P/Es still elevated.** Negative headline news over the summer has affected investor sentiment, which in turn has pushed P/E ratios lower. The TSX SmallCap and S&P 600 forward P/Es have contracted just over two points in the last four months**. Currently, the TSX SmallCap is trading at 14.8x forward earnings and the S&P 600 is trading at 15.0x.** Absolute valuation looks more attractive than a few months ago, but large cap forward P/Es have also declined, leaving **small caps' relative valuation at the high end of the historical range,** as illustrated in Exhibits 1 and 2. In a context of high volatility, modest global economic growth, and weak investor sentiment for equities, small caps' current valuation premium to large caps could be difficult to sustain over the coming months.

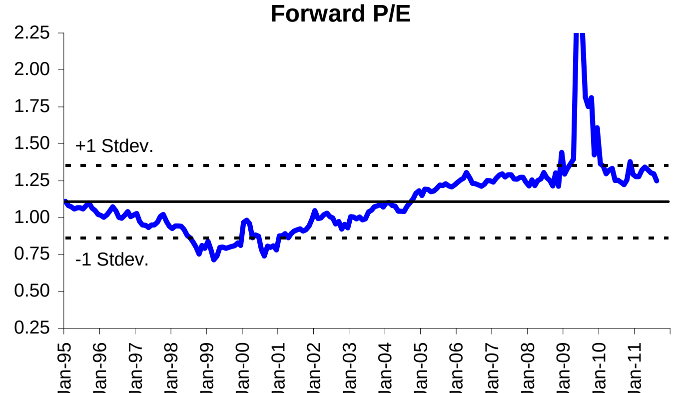
- **Negative EPS revisions hit small caps harder.** Thus far, the earnings growth outlook for small caps has remained quite strong despite the deteriorating macro landscape. Canadian and U.S. small caps are still expected to grow earnings about two times faster than large caps in 2011 and 2012. With rapidly decelerating global growth, expectations are more likely to come down faster for small caps, hurting sentiment further. In fact, negative earnings revisions have already started and they should continue to gain traction over the coming weeks. **Although negative revisions have been widespread, small caps have been hit harder than large caps. S&P 600 2011 EPS forecasts were cut by 3.2% in August compared to a mild 0.4% negative revisions for the S&P 500. In Canada, TSX SmallCap 2011 consensus EPS was reduced 0.3% in August versus -0.2% for the TSX index.**

Exhibit 1 : Canadian Small Cap Relative Forward P/E



Source: Scotia Capital, Thomson Financial

Exhibit 2 : U.S. Small Cap Relative Forward P/E



Source: Scotia Capital, Thomson Financial

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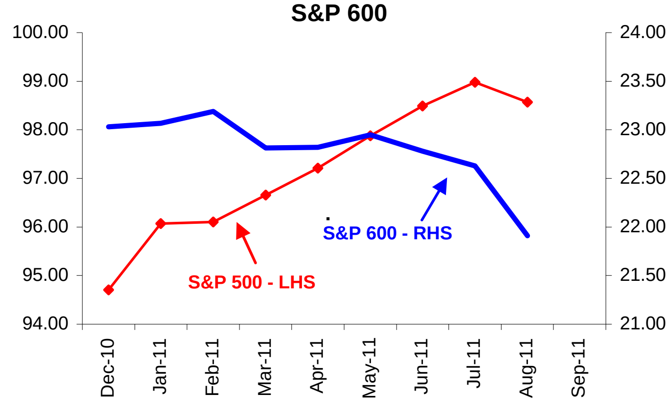
- From a sector perspective, S&P 600 Materials, Energy, and Telecom are accounting for the highest percentage of stocks, having suffered negative earnings revisions. About 70% of S&P 600 Materials stocks have had their 2011 EPS forecasts reduced in the last four weeks. This percentage stands at 60% for Energy and 50% for Telecom. The TSX SmallCap scorecard is somewhat different with 73% of Discretionary stocks being hit by negative revisions, followed by Materials (44%), Utilities (43%), and Industrials (41%).

Exhibit 3 : 2011 EPS Forecasts: S&P 500 vs. S&P 600



Source: Scotia Capital, S&P

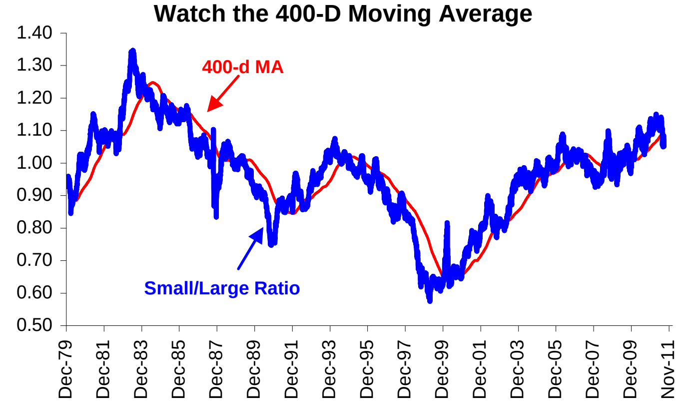
- **Flows not supportive of small caps.** With investors running for shelter, equity funds in Canada suffered outflows in July. Equity funds redemptions amounted to $964 million in July, of which small and mid-cap funds outflows accounted for 22% (outflows of $213 million). This percentage is quite elevated given that small caps represent only 9% of all equity fund assets under management in Canada. With negative sentiment toward equities (and higher-beta small caps) likely to persist over the coming months, fund flows/redemptions should continue to be less detrimental for large caps than small caps, on a relative basis. In the United States, small cap mutual funds registered outflows of US$3.2 billion in August.

- **ISM model.** From a macro standpoint, ISM indices reflect the general mood of the broader economy. Although high ISM suggests stronger economic growth, in our view from an equity perspective, we believe it makes sense to buy low ISMs and sell high ISMs. In our initiation report in May, we pointed out that an ISM above 60 was translating into a weak risk-reward outlook for small caps. Although the ISM has declined since then, we believe the small caps' risk-reward is not quite yet appealing. **An ISM in the mid-40s would suggest a more attractive risk-reward profile for small caps, in our view.**

- Small caps' or large caps' historical outperformance cycles are usually very long, and we like to look at the 400-day moving average (MA) of the small cap to large cap ratio for confirmation that the capitalization cycle is reversing course. Although it takes some time to get confirmation that a cycle is over, this delay is rather short compared with the duration of the average capitalization cycle. The 400-day MAs of the small cap to large cap ratio in both Canada and the United States are now barely rising, and could start declining over the coming weeks, suggesting small caps' outperformance cycle is likely over.

- From a geographic perspective, we prefer Canadian small caps to U.S. small caps in the short term. If the difficult trading environment persists in the coming weeks, the large gold and precious metal exposure in the TSX SmallCap should help its relative performance compared with U.S./global small cap benchmarks. The TSX SmallCap should, however, lag if equities stage a comeback.

Exhibit 4 : Russell 2000/Russell 1000 Ratio: Watch the 400-D Moving Average



Source: Scotia Capital, Bloomberg

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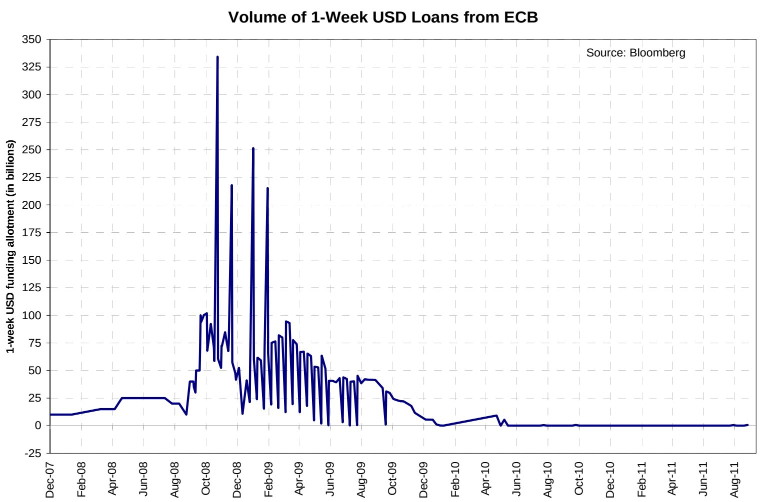
Central Banks' USD Term Funding Announcement

The ECB, BoE, SNB, and BoJ announced Thursday that they will provide 3-month US dollar loans in coordination with the Fed and other central banks. The ECB has scheduled three loans, one October 13, one in November, and one in December. The BoJ has already been providing 3-month dollar funding, though affirmed as part of this announcement that it would continue to do so. As we wrote in Thursday's note after the announcement, it is an important step and a positive development, but a relatively modest one.

It is important because, if there are worries that dollar funding for European or other banks could get worse, then this helps alleviate those worries. It will help reduce concerns about European banks being unable to get dollar funds through year end. It also has symbolic value. It shows that the ECB and other global central banks are prepared to act in a coordinated way, so in that sense it also can boost market confidence.

It is however fairly modest. It is basically a modification to an already existing dollar-funding arrangement that has been little used since 2009. What is new is that the loans will now be longer term, three months. The central banks have long been able to provide USD funding via swap lines with the Fed, but up to now few have wanted it. The ECB, for example, has been offering one-week US dollar funding for a long time. The BoJ has been offering both 1-week and 3-month funding (in yesterday's announcement, the BoJ was just confirming that it would continue to do so). But thus far these lending facilities have been little used.



Attached is a chart showing the ECB's weekly US dollar lending allotment. It used to be big. There were four auctions during 2008-09 that were well over 200 bn, and 25 to 75 billion used to be common. The program was largely dormant since then. However, there has been a comparatively small increase in one week USD loans from the ECB very recently: 500 million back in mid August, and 580 million as of yesterday. The SNB also recently provided 200 mn of 1-week USD loans in August (not shown).

The BoJ has been offering 3 month USD funding for some time. This funding has so far not been used, at least not in the past year anyway. The BoJ's one week USD loans have not been used since May of 2010, according to statistics from the Fed.

Cost: the minimum rate on a central bank's dollar swap with the Fed is the USD OIS for the appropriate term, plus 100 bps. For example, the recent $580 million one-week loan made by the ECB was done at a rate of 1.1%, which corresponds to an OIS rate that was close to 10 bps earlier this week, plus 100 bps. If the cost of obtaining USD funds in the interbank market increases substantially further, presumably the central bank facilities would be used a lot more.

Note that the Bank of Canada did not join in the 3-month USD loan announcement. This is just a reflection of the lack of demand for these funds in Canada. The BoC does have USD swap lines in place with the Fed, the same as the other central banks, so it could participate if the need arose. To the best of my recollection, the BoC did not make any USD emergency loans during 2008-2009 (or if they did the amounts were negligible).

The initial Treeasury market reaction to the announcement at 9am Sep 15 was fairly modest. Treasury securities did weaken a lot on the day, but most of this happened before 9am. Risk appetite had already increased on hopes for Greece following earlier comments from Merkel and Sarkozy. The US CPI report also likely contributed to some Treasury weakness, on the view that it may give the Fed less reason to announce aggressive bond purchases next week. The yield on 10-year Treasuries rose another 2 to 3 bps immediately after the 9am central bank announcement, but by an hour or so later had reversed most of this move.

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The View From Europe: Eurozone PMI Preview

- **Among the highlights of next week's Eurozone economic calendar will be the flash estimate of the Eurozone PMI surveys for September. Given the on-going financial market turbulence and the typical relationship with these indicators, we believe that there is a significant chance of a sharp deterioration in the PMIs next week. In turn this is likely to fuel speculation of negative GDP growth during H2 and the prospect of ECB rate cuts.**

Look Out Below

Survey indicators in the Eurozone posted some dramatic declines last month, aggravated by the intensification in financial market tensions. The ZEW index saw much bigger than expected falls in both sub-indices — down by 22.5 points for the expectations index and 37.1 points for current conditions — the biggest fall on record. The Ifo index fell sharply — not quite a record, but not far off. The biggest surprise is that the PMI surveys didn't fall by more. However, we believe that was a delayed reaction and a big fall is likely in the coming week's data for September.

Early Warning Indicators

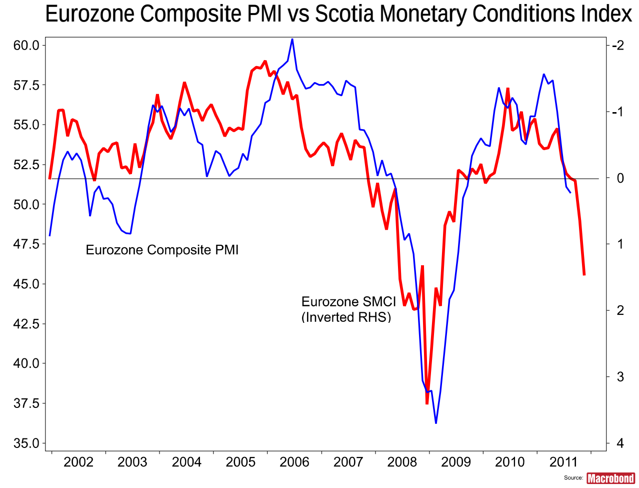
A reliable way of predicting future trends and turning points in the PMI surveys has been via the use of a monetary conditions index (MCI). Traditional MCIs were used by the BoC and RBNZ, but were relatively simple, taking account of just short term interest rates and the exchange rate. Our Scotia Monetary Conditions Index (SMCI) takes account of a much broader range of influences. More specifically, our model captures:

- The exchange rate;
- the slope of the yield curve;
- equity prices;
- real corporate bond yields;
- money supply growth;
- the real policy rate;
- the spread between Eurozone bond yields and the bund; and
- the ted spread.

Once weighted and normalised, the composite index provides a gauge of whether conditions in an economy are tighter or looser than average. In turn, conditions that are tighter than average have tended to be an early warning that survey and activity indicators are about to weaken and vice versa.

Over the last month, our model has suggested that conditions have become rather more restrictive in the Eurozone as a whole. In particular, the sharp fall in equity prices, the blowout in the ted spread and the resilience of the EUR exchange rate up until the end of August has contributed to the tightening in conditions.

Chart 1:
Eurozone Composite PMI vs Scotia Monetary Conditions Index



Source: Macrobond and Scotia Capital

Charts 1 to 3 put this indicator into the context of the upcoming PMI surveys in the Eurozone. More specifically, Chart 1 shows that given the tightening in financial and monetary conditions in the Eurozone as a whole, there is a significant risk that the composite of the two PMI surveys falls sharply this month. Given the relationship, it would not be surprising to see a reading as low as 45.

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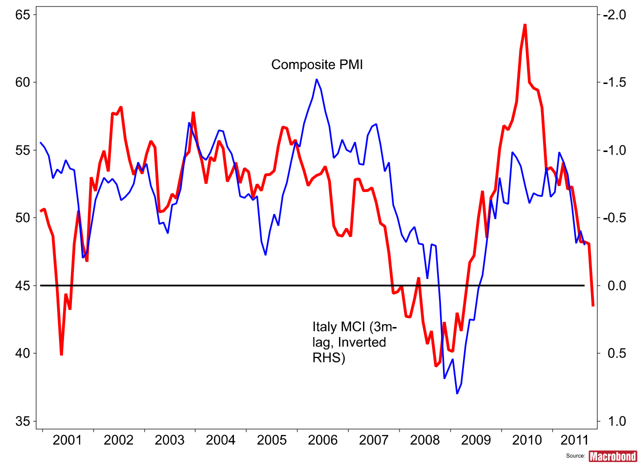
Chart 2 illustrates that the tightening in financial and monetary conditions has been particularly acute in Italy. In addition to the headwinds captured by the index for the Eurozone as a whole, the blowout in the 10-year BTP yield relative to bunds over the last two month has reinforced the tightening in conditions in Italy.

Chart 2:
Italian Composite PMI vs Scotia Monetary Conditions Index



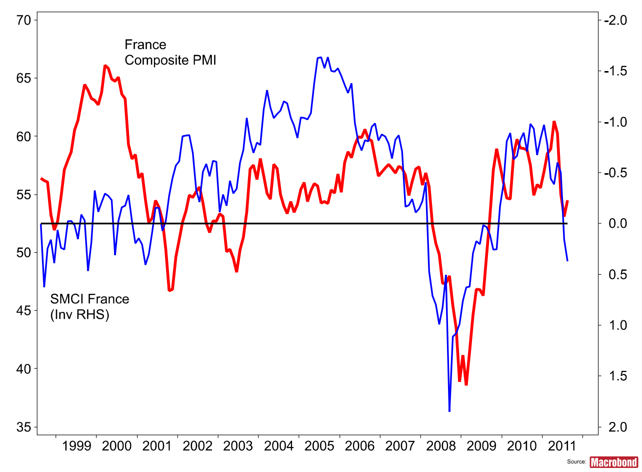
Source: Macrobond and Scotia Capital

Crucially, when the flash estimate for the Eurozone PMIs is published we only see the breakdown for the Eurozone as a whole as well as Germany and France. We will have to wait until the start of October to see the outcome for Italy in isolation.

Downside risks to France

France is also likely to experience a sharp deterioration in its PMI surveys based on monetary conditions as well as home grown issues. Amazingly, the French services sector PMI actually rose last month — up by 2.6 points to 56.8. Given the on-going fiscal jitters, especially in the French banking sector, three are good reasons to expect a correction in the September data. The same signal is confirmed by our SMCI for France (Chart 3).

Chart 3:
French Composite PMI vs Scotia Monetary Conditions Index



Source: Macrobond and Scotia Capital

The Good News

There are two positives. Firstly, our model for Germany suggests little if any downside for the composite PMI for the biggest country in the Eurozone. The other is that so far in September, the weakening in the EUR points to a softening in conditions (albeit in isolation).

Conclusion

Last month saw the first signs of financial market turmoil feeding back into the macroeconomic data. Given the combination of on-going equity market weakness and bond market stresses, there is more potential for downside this month. If our model is right and the PMIs fall, it will reinforce the likelihood of negative GDP growth during H2 and fuel speculation of ECB rate cuts.

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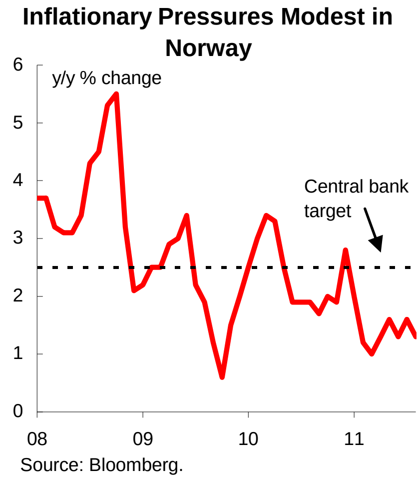
Key Data Preview

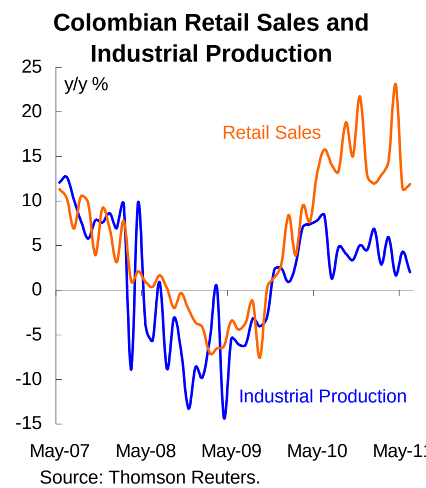
EUROPE

The central bank of Norway is expected to hold the deposit rate at 2.25% again next week, on the back of global growth concerns, still contained domestic inflation and ongoing financial market turmoil related to the euro zone debt crisis. Monetary authorities renewed the process of policy normalization in May of this year, expecting to increase the key interest rate by as much as 125 bps by October 2011. However, despite the relatively robust performance of the Norwegian economy (second quarter real GDP rebounded by 0.4% q/q non-annualized, supported by the non-crude oil and natural gas economy), inflationary pressures remain contained, and additional planned hikes have been shelved amid the turbulent global economic environment. The accompanying chart shows that the yearly pace of inflation has stayed well below the bank's 2.5% long-term target since mid-2010, with the exception of a spike in prices in December. While the central bank expects inflation to pick up toward 2% in the coming months with a resurgence in energy prices, the impetus for any tightening action by the central bank in the near term is nevertheless lacking.



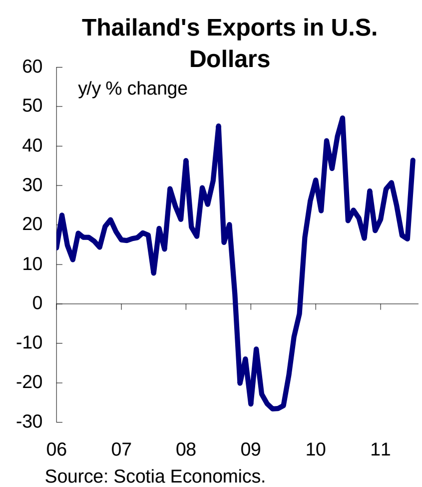
LATIN AMERICA

Colombian industrial production and retail sales for July will be released next week (September 19th). The industrial sector expanded by 2.2% y/y in June, reaching an annual growth of 3.7% for the first half of the year. Both readings were weaker in comparison to 2010 data, which was partly due to a high base effect rather than a clear slowdown in industrial activity. Taking into account the12-month period, the industrial sector output grew by 3.7% compared with a 2.2% advance in 2010, with the automotive sector leading the positive performance. Retail sales posted another solid expansion of 11.9% y/y in June, indicating that local demand is still supportive of economic activity. Durable goods have been the major contributor, which reflects the still high optimism in the Colombian economy. This will be tested in the coming months as the US economic slowdown and the recent financial market volatility could create more caution in consumption and the industrial sector.



ASIA

Thailand has been the poster child for industrial sector recovery in Asia, as its automotive industry regrouped swiftly from last March's Japanese supply-chain disruptions. We expect customs exports in US dollars to extend their recent recovery, placing the value well above the first quarter average, which implies a 29% y/y advance in August. The continued rebound is being driven by the replenishing of Japanese automobile company inventories which collapsed following the interruptions to assembly line operations as a result of scarcity of parts coming from Japan. Persistent improvement in global car sales, echoed in Asia, is expected to continue to generate gains for Thailand's manufacturing exporters, who enjoy a strategic geographical position within the region.



Key Indicators for the week of September 19 - 23

North America

Country	Date	Time	Event	Period	BNS	Consensus	Latest
US	09/19	10:00	NAHB Housing Market Index	SEP	- -	15.0	15.0
CA	09/20	08:30	Leading Indicators (MoM)	AUG	- -	0.1	0.2
CA	09/20	08:30	Wholesale Sales (MoM)	JUL	- -	0.3	0.2
US	09/20	08:30	Housing Starts (MoM)	AUG	-4.0	-2.3	-1.5
US	09/20	08:30	Building Permits (MoM)	AUG	- -	-1.8	-2.6
CA	09/21	07:00	Consumer Price Index (MoM)	AUG	0.1	0.1	0.2
CA	09/21	07:00	Consumer Price Index (YoY)	AUG	2.8	2.9	2.7
CA	09/21	07:00	Bank Canada CPI Core (MoM)	AUG	0.1	0.1	0.2
CA	09/21	07:00	Bank Canada CPI Core (YoY)	AUG	1.6	1.6	1.6
US	09/21	07:00	MBA Mortgage Applications (WoW)	16-Sep	- -	--	6.3
MX	09/21	09:00	Retail Sales (INEGI) (YoY)	JUL	- -	3.9	4.8
US	09/21	10:00	Existing Home Sales (mns)	AUG	4.60	4.75	4.67
US	09/21	10:00	Existing Home Sales (MoM)	AUG	-1.5	1.7	-3.5
US	09/21	14:15	**FOMC Rate Decision**	21-Sep	**0.25**	**0.25**	**0.25**
CA	09/22	08:30	Retail Sales (MoM)	JUL	-0.4	-0.4	0.7
CA	09/22	08:30	Retail Sales Less Autos (MoM)	JUL	0.0	0.1	-0.1
US	09/22	08:30	Initial Jobless Claims (000s)	16-Sep	425	420	428
US	09/22	08:30	Continuing Claims (000s)	10-Sep	- -	--	3726
MX	09/22	09:00	Bi-Weekly CPI (% change)	15-Sep	0.53	0.4	0.0
MX	09/22	09:00	Bi-Weekly Core CPI (% change)	15-Sep	- -	0.3	0.1
US	09/22	10:00	Leading Indicators (MoM)	AUG	- -	0.1	0.5
US	09/22	10:00	House Price Index (MoM)	JUL	- -	0.2	0.9
MX	09/23	09:00	Unemployment Rate	AUG	5.8	5.7	5.6

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

Key Indicators for the week of September 19 - 23

Europe

Country	Date	Time	Event	Period	BNS	Consensus	Latest
UK	09/18	19:01	Rightmove House Prices (MoM)	SEP	- -	--	-2.1
GE	09/20	02:00	Producer Prices (MoM)	AUG	- -	0.0	0.7
GE	09/20	02:00	Producer Prices (YoY)	AUG	- -	5.8	5.8
SW	09/20	03:30	**Riksbank Minutes**				
SW	09/20	03:30	GDP s.a. (QoQ)	2Q F	1.0	0.9	1.0
SW	09/20	03:30	GDP w.d.a. (YoY)	2Q F	5.3	5.1	5.3
IT	09/20	04:00	Industrial Orders s.a. (MoM)	JUL	- -	-1.5	4.1
IT	09/20	04:00	Industrial Sales s.a. (MoM)	JUL	- -	--	-1.7
EC	09/20	05:00	ZEW Survey (Econ. Sentiment)	SEP	-43.0	--	-40.0
GE	09/20	05:00	Zew Survey (Current Situation)	SEP	40.0	45.0	53.5
GE	09/20	05:00	ZEW Survey (Econ. Sentiment)	SEP	-40.0	-45.0	-37.6
UK	09/20	19:01	Nationwide Consumer Confidence	AUG	- -	47.0	49.0
NO	09/21	04:00	Unemployment Rate (AKU)	JUL	3.3	3.3	3.3
UK	09/21	04:30	**Bank of England Minutes**				
UK	09/21	04:30	Public Sector Net Borrowing (£ bns)	AUG	11.3	11.3	-2.0
NO	09/21	08:00	**Norwegian Deposit Rates**	21-Sep	**2.25**	**2.25**	**2.25**
FR	09/22	03:00	PMI Manufacturing	SEP P	48.0	48.5	49.1
FR	09/22	03:00	PMI Services	SEP P	50.0	54.2	56.8
GE	09/22	03:30	PMI Manufacturing	SEP A	50.2	50.5	50.9
GE	09/22	03:30	PMI Services	SEP A	50.5	50.5	51.1
EC	09/22	04:00	PMI Composite	SEP A	47.0	49.8	50.7
EC	09/22	04:00	PMI Manufacturing	SEP A	47.0	48.5	49.0
EC	09/22	04:00	PMI Services	SEP A	47.0	51.0	51.5
EC	09/22	05:00	Industrial New Orders NSA (YoY)	JUL	- -	10.5	11.1
EC	09/22	05:00	Industrial New Orders SA (MoM)	JUL	- -	-1.2	-0.9
EC	09/22	10:00	Euro-Zone Consumer Confidence	SEP A	-19.0	-18.0	-16.5
SP	09/22		Trade Balance (€ mns)	JUL	- -	--	-3924.9
FR	09/23	02:45	Consumer Confidence Indicator	SEP	82.0	83.0	86.0
FR	09/23	02:45	Business Confidence Indicator	SEP	- -	100.0	105.0
SP	09/23	03:00	Producer Prices (MoM)	AUG	- -	0.0	0.6
SP	09/23	03:00	Producer Prices (YoY)	AUG	- -	7.0	7.4
IT	09/23	04:00	Retail Sales s.a. (MoM)	JUL	- -	0.2	-0.2
IT	09/23	04:00	Retail Sales (YoY)	JUL	- -	-0.9	-1.2

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

Key Indicators for the week of September 19 - 23

Asia Pacific

Country	Date	Time	Event	Period	BNS	Consensus	Latest
HK	SEP 18-19		Composite Interest Rate	AUG	- -	--	0.31
AU	09/19	21:30	**Reserve Bank's Board September Minutes**				
TH	SEP 19-23		Customs Exports (YoY)	AUG	29	--	38.3
TH	SEP 19-23		Customs Imports (YoY)	AUG	19	--	13.5
TH	SEP 19-23		Customs Trade Balance (US$ mns)	AUG	2600	--	2797.7
JN	09/20	01:00	Leading Index CI	JUL F	- -	--	106.0
JN	09/20	01:30	Nationwide Dept. Sales (YoY)	AUG	- -	--	-0.1
JN	09/20	01:30	Tokyo Dept. Store Sales (YoY)	AUG	- -	--	-1.3
TA	09/20	04:00	Export Orders (YoY)	AUG	- -	7.6	11.1
HK	09/20	04:30	Unemployment Rate SA	AUG	- -	--	3.4
NZ	09/20	18:45	Current Account Balance (NZ$ bns)	2Q	- -	-0.7	-0.1
SK	09/20	19:00	Unemployment Rate (SA)	AUG	- -	--	3.3
JN	09/20	19:50	Merchnds Trade Balance Total (¥ bns)	AUG	-50	-300	70
JN	09/20	19:50	Adjusted Merchnds Trade Balance (¥ bns)	AUG	- -	-22.1	-130.5
JN	09/20	19:50	Merchnds Trade Exports (YoY)	AUG	11.3	8.0	-3.4
JN	09/20	19:50	Merchnds Trade Imports (YoY)	AUG	14.2	14.3	9.9
CH	09/20	22:00	Conference Board China July Leading Economic Index				
MA	09/21	05:00	CPI (YoY)	AUG	- -	3.3	3.4
NZ	09/21	18:45	GDP (QoQ)	2Q	- -	0.5	0.8
NZ	09/21	18:45	GDP (YoY)	2Q	- -	1.7	1.4
CH	SEP 21-25		HSBC Flash China Manufacturing PMI	SEP	- -	--	49.8
TA	09/22	04:00	Unemployment Rate - sa	AUG	- -	4.4	4.4
HK	09/22	04:30	CPI - Composite Index (YoY)	AUG	- -	5.8	7.9
CH	09/22	21:35	MNI September Flash Business Sentiment Survey				
TA	09/23	04:00	Industrial Production (YoY)	AUG	- -	4.0	3.9

Latin America

Country	Date	Time	Event	Period	BNS	Consensus	Latest
CO	09/19	17:00	Industrial Production (YoY)	JUL	- -	3.8	2.2
CO	09/19	17:00	Retail Sales (YoY)	JUL	- -	10.8	11.9
BZ	09/22	08:00	Unemployment Rate	AUG	- -	6.1	6.0
CO	09/22	12:00	GDP (YoY)	2Q	- -	5.2	5.1
BZ	09/23	09:30	Current Account - Monthly (US$ mns)	AUG	- -	-2865.0	-3496.8
BZ	09/23	09:30	Foreign Investment (US$ mns)	AUG	- -	4500.0	5971.0

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

Global Auctions for the week of September 19 - 23

North America

Country	Date	Time	Event
US	09/19	11:30	U.S. to Sell 3-Month Bills
US	09/19	11:30	U.S. to Sell 6-Month Bills
US	09/20	11:30	U.S. Sells USD 27 Bln 4-Week Bills
US	09/20	11:30	U.S. to Sell 52-Week Bills
US	09/22	13:00	U.S. to Sell 10-Year TIPS Reopening

Europe

Country	Date	Time	Event
NO	09/19	05:00	Norway to sell Bills
SW	09/19	05:10	Sweden to Exchange I/L Bonds
HU	09/19	05:30	Hungary to Sell 6-Week Bills
FR	09/19	09:00	France to Sell Bills
SP	09/20	04:30	Spain to Sell 12M and 18M Bills
SW	09/20	05:10	Sweden to Exchange I/L Bonds
SZ	09/20	05:30	Switzerland to Sell 3-Month Bills
HU	09/20	05:30	Hungary to Sell 3-Month Bills
HU	09/21	04:30	Hungary's Central Bank to Sell 2-Week Bills
GE	09/21	05:15	Germany to Sell Add'l EU5 Bln 10-Year Notes
PO	09/21	05:30	Portugal to Sell 3M and 6M Bills
HU	09/21	05:30	Hungary to Buy Back Bonds
CZ	09/21	06:00	Czech Rep. to Sell CZK8 Bln 2.75% 2014 Bonds
RU	09/21	06:00	Russia to Sell Up to RUB10 Bln OFZ Notes
UK	09/22	05:30	U.K. to Sell GBP4.75 Bln 1.75% 2017 Bonds
HU	09/22	05:30	Hungary to Sell Bonds
PD	09/22	06:00	Poland to Sell Floating Rate Bonds
UK	09/23	06:10	U.K. to Sell Bills

Asia Pacific

Country	Date	Time	Event
JN	09/19	23:35	Japan to Sell 3-Month Bills
CH	09/20	23:00	China to Sell 10 Year Bond
JN	09/21	04:00	Japan Auction for Enhanced-Liquidity

Source: Bloomberg, Scotia Economics.

Events for the week of September 19 - 23

North America

Country	Date	Time	Event
US	SEP 13-22		United Nations General Assembly's 66th Session
CA	09/19	11:00	House of Commons Resumes Sitting
CA	09/19	14:00	Bank of Canada's Lane Speaks at Sibos Conference in Toronto
CA	09/20	11:30	Bank of Canada Gov. Carney Speaks in Saint John, New Brunswick
US	09/21	14:15	FOMC Rate Decision
US	09/23	10:00	International Monetary Fund-World Bank Hold Annual Meetings
US	09/23	13:30	Fed's Dudley to Speak on Panel in Washington
US	09/23	14:00	Fed's Williams on Uncoventional Monetary Policy in Zurich
EC	09/23	16:30	ECB's Trichet Speaking in Washington

Europe

Country	Date	Time	Event
EC	09/17	03:00	EU Finance Ministers, Central Bankers Meet in Wroclaw, Poland
UK	SEP 17-21		Liberal Democrat Party Conference
GE	09/18	12:00	German State Election in Berlin
UK	09/18	19:01	Bank of England Publishes Quarterly Bulletin
FI	09/19	04:00	ECB's Liikanen Speaks at Bank of Finland Quarterly Briefing
GE	09/19	05:30	Weidmann, Regling at Open Parliamentary Debt Hearing Debt:
PO	09/19	06:00	Portugal Reports Monthly Economic Survey
EC	09/19	09:00	ECB's Gonzalez-Paramo Speaks in Frankfurt
UK	09/19	07:20	Cable Speaks at Liberal Democrat Conference
UK	09/19	10:15	Clegg Q&A Session at Liberal Democrat Conference
GE	09/19	12:30	Merkel Gives Speech at CDU Party Event in Hesse State
UK	09/19	19:00	Bank of England Financial Policy Meeting
GE	09/19		Expert Hearing in German Budget Committee on Greece Aid, EFSF
SW	09/20	03:30	Riksbank Minutes
EC	09/20	07:15	Belgium's Leterme Speaks at Brussels Think Tank
UK	09/20	07:20	Huhne Speaks at Liberal Democrat Conference
GE	09/20	13:00	Merkel, Roettgen Take Part in Panel on Sustainable Growth
PO	09/20	14:00	Portugal Year-to-Date Budget Report
UK	09/21	04:30	Bank of England Releases Monetary Policy Committee Minutes
NO	09/21	08:00	Norwegian Deposit Rate
UK	09/21	09:30	Clegg Speaks at Liberal Democrat Conference
GE	09/21		Germany's Budget Committee Has Final Meeting on Greece, EFSF
EC	09/23	08:00	ECB's Weidmann, Germany's Schaeuble Speak in Washington
EC	09/23	16:30	ECB's Trichet Speaking in Washington

Asia Pacific

Country	Date	Time	Event
PH	SEP 18-25		Budget Deficit/Surplus
AU	09/19	21:30	Reserve Bank's Board September Minutes
NZ	09/21	09:00	RBNZ Governor Bollard Speech in New York
AU	09/21	09:20	RBA's Battellino Speaks at Conference in New York
AU	09/21	19:00	RBA's Lowe Speaks at Australia Economic Forum in Sydney

Latin America

Country	Date	Time	Event
PO	09/19	04:30	Brazil's Tombini, Bank of Portugal's Costa Speak at Conference

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

The US Federal Reserve is expected to bring back the twist, and reminiscent of the last time it did so in the 1960s. Roger Quick's article in last week's Global Views provided a good assessment of the policy move that entails reinvesting short-dated securities further out along the curve into longer dated Treasuries. The purpose is to engineer a flatter curve, but without adding to money in circulation since the move would be sterilized and hence unlike another round of quantitative easing. Other possible options at next week's FOMC may include cutting the interest rate paid on excess reserves, and providing further guidance on what metrics the Fed will use to evaluate the appropriateness of its loose commitment to keep the Fed funds target rate on hold until mid-2013. We are skeptical that any of these policies will do much of any good to the economy.

Europe

Rate	Current Rate	Next Meeting	Scotia's Forecasts	Consensus Forecasts
European Central Bank – Refinancing Rate	1.50	October 6, 2011	1.50	--
Bank of England – Bank Rate	0.50	October 6, 2011	0.50	0.50
Swiss National Bank – Libor Target Rate	0.00	December 15, 2011	0.00	--
Central Bank of Russia – Refinancing Rate	8.25	October 21, 2011	8.25	--
Hungarian National Bank – Base Rate	6.00	September 20, 2011	6.00	6.00
Central Bank of the Republic of Turkey – 1 Week Repo Rate	5.75	September 20, 2011	5.75	5.75

Despite an ongoing deceleration in inflation and a deteriorating growth outlook, it is unlikely that the Hungarian National Bank will move to loosen monetary conditions next week. A rate cut might act to further weaken the currency, which would offset recent government measures to assist households and businesses with their substantial foreign currency-denominated debt. The Turkish central bank is also expected to remain on hold next week, as the impact of a recent 50 basis point rate cut is being assessed.

Asia Pacific

Rate	Current Rate	Next Meeting	Scotia's Forecasts	Consensus Forecasts
Bank of Japan – Target Rate	0.10	October 7, 2011	0.10	--
Reserve Bank of Australia – Cash Target Rate	4.75	October 3, 2011	4.75	--
Reserve Bank of New Zealand – Cash Rate	2.50	October 26, 2011	2.50	2.50
People's Bank of China – Lending Rate	6.56	TBA	--	--
Reserve Bank of India – Repo Rate	8.00	October 25, 2011	8.25	8.25
Hong Kong Monetary Authority – Base Rate	0.50	TBA	0.50	--
Central Bank of China Taiwan – Discount Rate	1.88	September 29, 2011	--	--
Bank Negara Malaysia – Overnight Policy Rate	3.00	November 11, 2011	3.00	--
Bank of Korea – Bank Rate	3.25	October 12, 2011	3.25	--
Bank of Thailand – Repo Rate	3.50	October 19, 2011	3.25	--
Bank Indonesia – Reference Interest Rate	6.75	October 11, 2011	6.75	--
Central Bank of the Philippines – Overnight Policy Rate	4.50	October 20, 2011	4.50	--

Latin America

Rate	Current Rate	Next Meeting	Scotia's Forecasts	Consensus Forecasts
Banco Central do Brasil – Selic Rate	12.00	October 19, 2011	11.50	--
Banco Central de Chile – Overnight Rate	5.25	October 13, 2011	5.25	--
Banco de la República de Colombia – Lending Rate	4.50	September 30, 2011	4.50	--
Banco Central de Reserva del Perú – Reference Rate	4.25	October 6, 2011	4.25	--

The central bank of Chile left its reference interest rate unchanged at 5.25% in September, recognizing a moderation in the local economy, a slowdown in the advanced economies, and high commodity prices. In our view, the nation's monetary policy stance will maintain a neutral bias, and any rate changes will depend on both local and international economic developments that could impact inflation expectations.

Africa

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

The South African Reserve Bank is not expected to alter monetary conditions next week. Following an expansionary campaign in 2009-2010, the central bank has kept the benchmark repo rate unchanged at a 35-year low at its last four meetings. While inflation has accelerated since the start of 2011 - reaching 5.3% y/y in July - significant global economic uncertainty will nevertheless preclude any tightening at this point.

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	5.1	3.9	4.2				
Canada	2.1	3.2	2.2	2.1	2.1	1.8	2.7	1.9
United States	1.7	3.0	1.7	2.1	2.6	1.6	2.8	1.9
Mexico	1.7	5.4	3.7	3.5	4.9	4.4	3.6	3.8
United Kingdom	1.7	1.4	1.2	1.5	1.9	3.7	4.4	2.1
Euro zone	1.1	1.7	1.7	1.4	2.0	2.2	2.5	2.0
Japan	0.6	4.0	0.3	3.5	-0.3	-0.4	1.1	1.3
Australia	3.1	2.7	3.4	3.0	3.2	2.7	2.8	2.5
China	9.4	10.4	9.3	9.5	2.0	4.6	5.0	4.5
India	7.4	9.0	8.3	8.5	6.2	9.5	7.5	6.0
Korea	4.4	6.2	4.9	5.3	3.1	3.5	3.7	3.3
Brazil	3.3	7.5	4.0	4.5	6.7	5.9	6.5	5.5
Chile	3.7	5.2	6.5	5.5	3.5	1.4	4.0	3.5
Peru	5.2	8.8	6.2	5.6	2.5	2.1	3.8	2.7
Central Bank Rates (%, end of period)	**11Q1**	**11Q2**	**11Q3f**	**11Q4f**	**12Q1f**	**12Q2f**	**12Q3f**	**12Q4f**
Bank of Canada	1.00	1.00	1.00	1.00	1.00	1.00	1.25	1.75
Federal Reserve	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
European Central Bank	1.00	1.25	1.50	1.50	1.50	1.50	1.50	1.50
Bank of England	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Swiss National Bank	0.25	0.25	0.00	0.00	0.00	0.00	0.25	0.25
Bank of Japan	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Reserve Bank of Australia	4.75	4.75	4.75	5.00	5.00	5.00	5.25	5.25
Exchange Rates (end of period)								
Canadian Dollar (USDCAD)	0.97	0.96	0.96	0.96	0.95	0.95	0.94	0.94
Canadian Dollar (CADUSD)	1.03	1.04	1.04	1.04	1.05	1.05	1.06	1.06
Euro (EURUSD)	1.42	1.45	1.45	1.50	1.48	1.46	1.43	1.40
Sterling (GBPUSD)	1.60	1.61	1.63	1.65	1.66	1.67	1.69	1.70
Yen (USDJPY)	83	81	79	80	82	83	84	85
Australian Dollar (AUDUSD)	1.03	1.07	1.08	1.09	1.09	1.10	1.10	1.11
Chinese Yuan (USDCNY)	6.5	6.5	6.3	6.3	6.2	6.1	6.0	5.9
Mexican Peso (USDMXN)	11.9	11.7	12.3	12.3	12.3	12.2	12.3	12.5
Brazilian Real (USDBRL)	1.63	1.56	1.59	1.60	1.61	1.62	1.64	1.65
Commodities (annual average)	**2000-09**	**2010**	**2011f**	**2012f**				
WTI Oil (US$/bbl)	51	79	94	97				
Brent Oil (US$/bbl)	50	80	113	118				
Nymex Natural Gas (US$/mmbtu)	5.95	4.40	4.40	4.75				
Copper (US$/lb)	1.78	3.42	4.30	4.30				
Zinc (US$/lb)	0.73	0.98	1.05	1.06				
Nickel (US$/lb)	7.11	9.89	11.00	9.35				
Gold, London PM Fix (US$/oz)	522	1,225	1,635	1,800				
Pulp (US$/tonne)	668	960	990	1,040				
Newsprint (US$/tonne)	572	607	648	715				
Lumber (US$/mfbm)	275	254	255	260				

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

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

Canada	2010	11Q1	11Q2	Latest	
Real GDP (annual rates)	3.2	3.6	-0.4		
Current Acc. Bal. (C$B, ar)	-50.9	-40.3	-61.3		
Merch. Trade Bal. (C$B, ar)	-9.0	6.9	-14.4	-9.0	(Jul)
Industrial Production	4.6	5.3	1.5	0.0	(Jun)
Housing Starts (000s)	192	178	193	185	(Aug)
Employment	1.4	1.9	1.6	1.4	(Aug)
Unemployment Rate (%)	8.0	7.8	7.5	7.3	(Aug)
Retail Sales	5.5	2.5	4.1	4.6	(Jun)
Auto Sales (000s)	1561	1573	1574	1626	(Jun)
CPI	1.8	2.6	3.4	2.7	(Jul)
IPPI	1.0	4.1	5.0	-5.1	(Jul)
Pre-tax Corp. Profits	21.2	12.9	14.8		

Mexico					
Real GDP	5.4	4.6	3.3		
Current Acc. Bal. (US$B, ar)	-5.7	-4.2	-10.4		
Merch. Trade Bal. (US$B, ar)	-3.0	7.6	5.7	-14.1	(Jul)
Industrial Production	6.0	5.2	3.4	3.2	(Jul)
CPI	4.2	3.5	3.3	3.4	(Aug)

Chile					
Real GDP	5.2	10.0	6.8		
Current Acc. Bal. (US$B, ar)	3.1	0.7	0.1		
Merch. Trade Bal. (US$B, ar)	11.6	16.5	15.5	14.6	(Jul)
Industrial Production	0.5	11.7	7.8	0.7	(Jul)
CPI	1.4	2.9	3.3	3.2	(Aug)

Germany					
Real GDP	3.6	4.6	2.8		
Current Acc. Bal. (US$B, ar)	187.6	194.8	156.6	128.5	(Jul)
Merch. Trade Bal. (US$B, ar)	201.5	209.3	208.4	173.2	(Jul)
Industrial Production	10.1	12.8	7.7	10.3	(Jul)
Unemployment Rate (%)	7.7	7.3	7.1	7.0	(Aug)
CPI	1.1	2.1	2.3	2.4	(Aug)

Euro Zone					
Real GDP	1.7	2.4	1.6		
Current Acc. Bal. (US$B, ar)	-77	-169	-163	-54	(Jul)
Merch. Trade Bal. (US$B, ar)	32.0	-68.5	-9.1	56.8	(Jul)
Industrial Production	7.4	6.5	4.0	4.1	(Jul)
Unemployment Rate (%)	10.1	9.9	9.9	9.9	(Jul)
CPI	1.6	2.5	2.8	2.5	(Aug)

Japan					
Real GDP	4.0	-0.7	-1.1		
Current Acc. Bal. (US$B, ar)	195.9	193.9	74.7	149.5	(Jul)
Merch. Trade Bal. (US$B, ar)	74.8	32.0	-52.8	-19.7	(Jul)
Industrial Production	16.6	-2.5	-7.0	-1.7	(Jul)
Unemployment Rate (%)	5.1	4.7	4.6	4.7	(Jul)
CPI	-0.7	-0.5	-0.4	0.2	(Jul)

China					
Real GDP	10.3	9.7	9.5		
Current Acc. Bal. (US$B, ar)	305.4				
Merch. Trade Bal. (US$B, ar)	181.5	-7.4	186.3	213.1	(Aug)
Industrial Production	13.5	14.8	15.1	13.5	(Aug)
CPI	4.6	5.4	6.4	6.2	(Aug)

United States	2010	11Q1	11Q2	Latest	
Real GDP (annual rates)	3.0	0.4	1.0		
Current Acc. Bal. (US$B, ar)	-471	-478	-472		
Merch. Trade Bal. (US$B, ar)	-646	-729	-762	-728	(Jul)
Industrial Production	5.3	5.3	3.8	3.3	(Aug)
Housing Starts (millions)	0.58	0.58	0.57	0.60	(Jul)
Employment	-0.8	0.9	0.9	1.0	(Aug)
Unemployment Rate (%)	9.6	8.9	9.1	9.1	(Aug)
Retail Sales	6.8	8.6	8.1	7.5	(Aug)
Auto Sales (millions)	11.6	13.0	12.1	12.1	(Aug)
CPI	1.6	2.1	3.4	3.8	(Aug)
PPI	4.2	4.9	7.0	6.5	(Aug)
Pre-tax Corp. Profits	25.0	2.8	1.1		

Brazil					
Real GDP	6.7	3.8	2.7		
Current Acc. Bal. (US$B, ar)	-47.4	-58.3	-43.5		
Merch. Trade Bal. (US$B, ar)	20.2	12.6	39.2	46.5	(Aug)
Industrial Production	10.5	2.6	0.7	1.4	(Jul)
CPI	5.1	6.8	6.5	7.2	(Aug)

Italy					
Real GDP	1.2	1.0	0.8		
Current Acc. Bal. (US$B, ar)	-0.07	-0.12	-0.09	0.03	(Jul)
Merch. Trade Bal. (US$B, ar)	-39.1	-77.2	-45.6	24.6	(Jul)
Industrial Production	6.5	2.2	1.9	-1.3	(Jul)
CPI	1.6	2.3	2.7	2.9	(Aug)

France					
Real GDP	1.4	2.1	1.6		
Current Acc. Bal. (US$B, ar)	-44.5	-59.7	-106.5	-23.7	(Jul)
Merch. Trade Bal. (US$B, ar)	-39.1	-54.3	-52.5	-54.3	(Jul)
Industrial Production	5.1	4.8	2.2	3.7	(Jul)
Unemployment Rate (%)	9.8	9.7	9.7	9.9	(Jul)
CPI	1.5	1.8	2.1	2.2	(Aug)

United Kingdom					
Real GDP	1.4	1.6	0.7		
Current Acc. Bal. (US$B, ar)	-71.6	-74.0			
Merch. Trade Bal. (US$B, ar)	-153.0	-142.4	-160.3	-172.6	(Jul)
Industrial Production	2.1	2.0	-0.8	-0.7	(Jul)
Unemployment Rate (%)	7.9	7.7	7.8	7.9	(Jun)
CPI	3.3	4.1	4.4	4.5	(Aug)

Australia					
Real GDP	2.7	1.0	1.4		
Current Acc. Bal. (US$B, ar)	-32.9	-41.7	-22.4		
Merch. Trade Bal. (US$B, ar)	19.3	21.9	48.8	26.7	(Jul)
Industrial Production	4.5	-4.7	-3.3		
Unemployment Rate (%)	5.2	5.0	4.9	5.3	(Aug)
CPI	2.8	3.3	3.6		

South Korea					
Real GDP	6.2	4.2	3.4		
Current Acc. Bal. (US$B, ar)	28.2	10.4	22.0	59.3	(Jul)
Merch. Trade Bal. (US$B, ar)	41.2	29.3	33.5	9.9	(Aug)
Industrial Production	16.6	11.2	6.7	5.4	(Jul)
CPI	3.0	4.5	4.2	5.3	(Aug)

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

Source: Bloomberg, Scotia Economics.

Interest Rates (%, end of period)

Canada	11Q1	11Q2	Sep/09	Sep/16*	United States	11Q1	11Q2	Sep/09	Sep/16*
BoC Overnight Rate	1.00	1.00	1.00	1.00	Fed Funds Target Rate	0.25	0.25	0.25	0.25
3-mo. T-bill	0.95	0.90	0.89	0.80	3-mo. T-bill	0.09	0.01	0.01	-0.01
10-yr Gov't Bond	3.35	3.11	2.11	2.28	10-yr Gov't Bond	3.47	3.16	1.92	2.06
30-yr Gov't Bond	3.76	3.55	2.81	2.90	30-yr Gov't Bond	4.51	4.37	3.25	3.31
Prime	3.00	3.00	3.00	3.00	Prime	3.25	3.25	3.25	3.25
FX Reserves (US$B)	60.4	62.3	63.1	(Jul)	FX Reserves (US$B)	128.3	136.6	138.7	(Jul)
Germany					**France**				
3-mo. Interbank	1.26	1.51	1.50	1.48	3-mo. T-bill	0.80	1.18	0.56	0.49
10-yr Gov't Bond	3.35	3.03	1.77	1.86	10-yr Gov't Bond	3.71	3.41	2.48	2.60
FX Reserves (US$B)	64.8	66.0	66.9	(Jul)	FX Reserves (US$B)	61.0	60.3	59.5	(Jul)
Euro-Zone					**United Kingdom**				
Refinancing Rate	1.00	1.25	1.50	1.50	Repo Rate	0.50	0.50	0.50	0.50
Overnight Rate	0.90	1.72	0.86	0.95	3-mo. T-bill	4.85	4.85	4.85	4.85
FX Reserves (US$B)	319.9	317.2	321.3	(Jul)	10-yr Gov't Bond	3.69	3.38	2.26	2.49
					FX Reserves (US$B)	75.3	79.7	81.2	(Jul)
Japan					**Australia**				
Discount Rate	0.30	0.30	0.30	0.30	Cash Rate	4.75	4.75	4.75	4.75
3-mo. Libor	0.14	0.13	0.13	0.13	10-yr Gov't Bond	5.49	5.21	4.27	4.24
10-yr Gov't Bond	1.26	1.14	1.01	1.01	FX Reserves (US$B)	33.3	40.3	40.4	(Jul)
FX Reserves (US$B)	1080.6	1100.8	1110.8	(Jul)					

Exchange Rates (end of period)

USDCAD	0.97	0.96	1.00	0.99	¥/US$	83.13	80.56	77.61	76.94
CADUSD	1.03	1.04	1.00	1.02	US¢/Australian$	103.29	107.22	104.70	103.54
GBPUSD	1.603	1.605	1.588	1.578	Chinese Yuan/US$	6.55	6.46	6.39	6.38
EURUSD	1.416	1.450	1.366	1.377	South Korean Won/US$	1097	1068	1077	1112
JPYEUR	0.85	0.86	0.94	0.94	Mexican Peso/US$	11.905	11.714	12.692	12.983
USDCHF	0.92	0.84	0.88	0.88	Brazilian Real/US$	1.632	1.563	1.674	1.712

Equity Markets (index, end of period)

United States (DJIA)	12320	12414	10992	11412	U.K. (FT100)	5909	5946	5215	5375
United States (S&P500)	1326	1321	1154	1205	Germany (Dax)	7041	7376	5190	5593
Canada (S&P/TSX)	14116	13301	12388	12374	France (CAC40)	3989	3982	2975	3043
Mexico (Bolsa)	37441	36558	34712	35181	Japan (Nikkei)	9755	9816	8738	8864
Brazil (Bovespa)	68587	62404	55778	56259	Hong Kong (Hang Seng)	23528	22398	19913	19455
Italy (BCI)	1120	1039	797	789	South Korea (Composite)	2107	2101	1833	1840

Commodity Prices (end of period)

Pulp (US$/tonne)	990	1035	1020	1020	Copper (US$/lb)	4.26	4.22	4.04	3.98
Newsprint (US$/tonne)	640	640	640	640	Zinc (US$/lb)	1.05	1.05	0.99	0.99
Lumber (US$/mfbm)	290	237	257	257	Gold (US$/oz)	1439.00	1505.50	1851.00	1794.00
WTI Oil (US$/bbl)	106.72	95.42	87.24	87.89	Silver (US$/oz)	37.87	35.02	41.40	39.97
Natural Gas (US$/mmbtu)	4.39	4.37	3.92	3.84	CRB (index)	359.43	338.05	334.24	330.25

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

Emerging Markets Strategy

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