

# Special Report

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## 2012-13 Economic and Market Outlook

### *Not So Fast Forward*

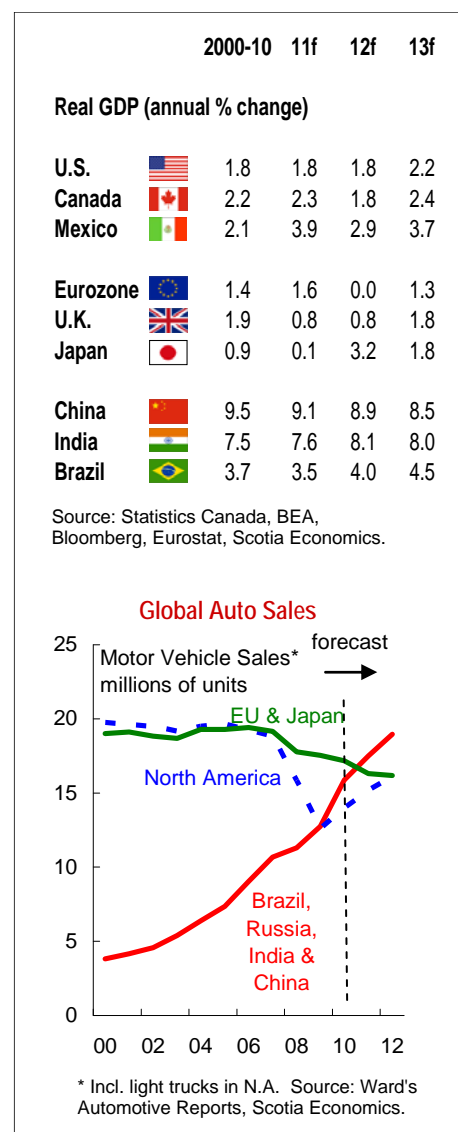
**Warren Jestin, Senior Vice-President & Chief Economist**

Financial markets have been buffeted in recent months by heightened investor anxiety over prospects for global growth, the sovereign debt crisis in Europe and the limited progress in bringing Washington's massive fiscal deficit under control. For debt- and deficit-heavy nations, the magnitude of the structural adjustments required for meaningful fiscal repair will dampen growth through mid-decade. The very high social costs and political risks associated with these very difficult fiscal decisions point to ongoing volatility in currency, equity and bond markets.

Output growth in 2012 will struggle to reach 2% in the U.S., even if interest rates remain near historic lows and fiscal retrenchment is postponed, which seems very likely given the high levels of unemployment, fragility of the housing sector and financial difficulties confronting state and local governments. While some European nations will eke out gains, overall growth will be non-existent in the eurozone as public sector retrenchment and private deleveraging push a number of distressed economies into — or deeper into — recession.

Economic momentum also has moderated in many emerging nations, though growth in 2012 should be close to 9% in China, 8% in India and 4% in Brazil. With the traditional developed nations stuck in the slow lane, emerging markets are accounting for over two-thirds of global growth and will likely continue to do so through the balance of the decade. *The Economist* magazine suggests that, by the end of the decade, China may surpass the U.S. as the world's largest economy.

Overall Canadian growth is likely to be similar to the U.S. in 2012, falling short of 2%. Domestic demand will be supported by resource sector mega-projects and public infrastructural



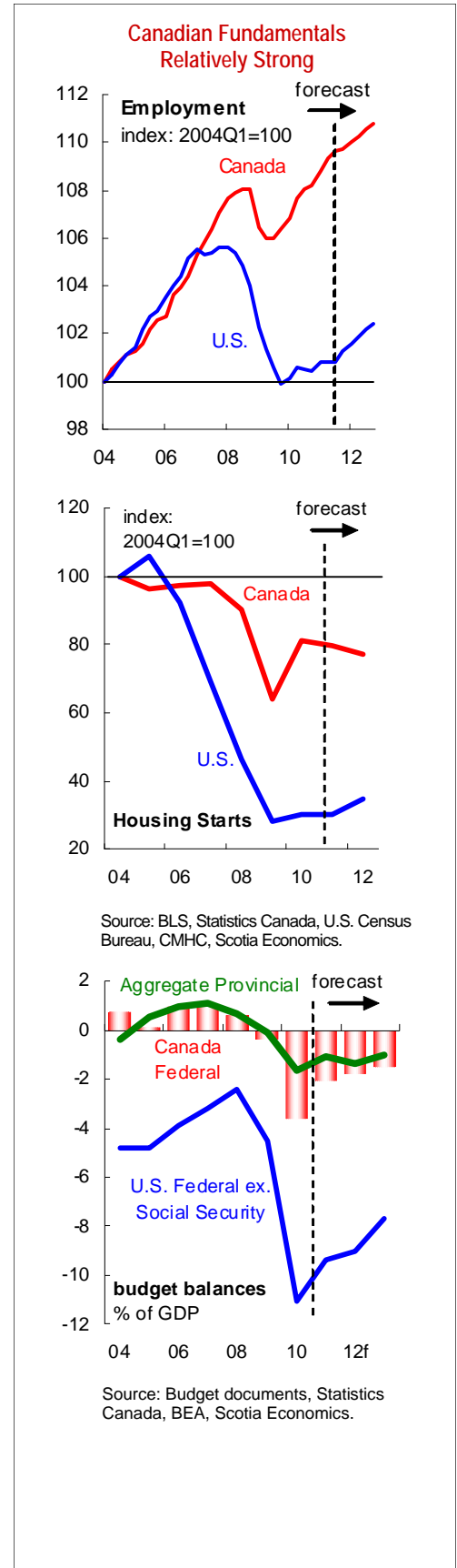
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investment. However, household spending gains will be dampened by a moderation in job creation and greater caution in taking on additional consumer debt, now at record levels relative to disposable income. With home ownership at an all-time high, housing activity will subside. While the Bank of Canada is likely to hold its benchmark interest rates at current levels into 2013, keeping interest rates near generational lows, Canadian fiscal policy will be less stimulative as Ottawa and many provincial governments move to bring their budgets back towards balance.

Reduced global economic momentum will temper Canadian export gains, although resource producers will continue to enjoy relatively buoyant demand from China and other emerging markets. Manufacturers will continue to be challenged by the strong loonie and soft markets in Europe, and in the U.S. — still the destination of over 70% of Canadian exports. Growth in the manufacturing sector will increasingly come from small- and medium-size enterprises that are focussed on higher value-added domestic markets and new global markets. Trends in the auto industry underline the shift that is occurring in the manufacturing sector. Canada now produces nearly one million fewer vehicles than a decade ago and is getting a much smaller share of the auto sector's North American investment than over the past decade.

In today's challenging global environment, Canada remains one of the best places to work and do business. Unlike the U.S. and Europe, Canada has fully regained the jobs lost during the financial crisis and recession of 2008-9. The buoyancy in our housing and commercial real estate markets contrasts sharply with the depressed conditions evident in the U.S. and much of Europe. Ottawa plans to balance its budget deficit, now equivalent to 2% of GDP, by 2017, if not before. Despite a shortfall running around 8% of GDP, Washington has no plans to move decisively towards a more balanced fiscal setting. Canada's fiscal advantage is strategically important for longer-term growth and prosperity because it underpins an internationally competitive tax system. Our financial system, the strongest in the world, supports national growth at a time when banking problems in many developed countries have become an impediment to the revitalization of economic activity.



## Outlook for Europe

Alan Clarke, Director, Fixed Income Strategy

### Eurozone — The Good, the Bad or the Ugly

Output is already shrinking — the only question is how severe the contraction is and how long it lasts. Perversely, the good news is that things have got so bad, there is a strong chance that something good comes of it. We are reaching a crescendo. The rating agencies have pointed a gun to the heads of the authorities.

The authorities are running out of second chances. European governments and the ECB had the power to end this situation long ago, but neither wanted to flinch first. A sequence of half-measures resulted in a saw-tooth pattern for bond yields in the distressed nations. Leading up to key summits or decisions, panic pushed bond yields sharply higher. New measures were announced which tended to induce 24-48 hours of relief before panic resumed and the process repeated itself.

### Make or Break Time

There are now two choices; the authorities pull out all the stops and help to turn the page on a deeply unpleasant episode, or hold back and watch the eurozone tear itself apart. There are three scenarios;

**Best case scenario:** Governments agree on steps towards greater fiscal union, supervision, automatic sanctions and perhaps eventually E-bonds. This is sufficient to placate the ECB that it is not giving anyone a free ride. The central bank commits to buying government bonds of distressed nations in big size. If it commits to the same scale of QE as the Bank of England, purchases could easily exceed EUR1trn — sufficient to absorb the issuance from Italy and Spain over the coming year — pushing bond yields down to much more sustainable levels.

The Italian bond market has demonstrated at the start of December that restoring confidence can have a massive effect on yields — down by around 150bp in less than a week. If decisive action by the ECB and European governments can restore market confidence, it could become self-reinforcing — boosting business and consumer sentiment and restarting the recovery. It is too late to avoid a mild recession in the eurozone. Nonetheless, action now could prevent a deeper and longer contraction and put the eurozone economy back on the path to recovery.

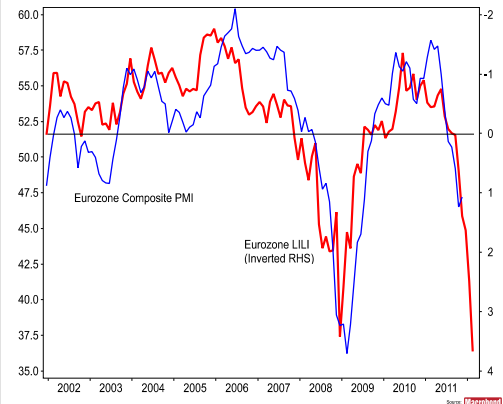
**Best worst-case scenario:** Significant contagion from the periphery to the core as European leaders fail to restore confidence. This would involve a sharp tightening in monetary conditions in bigger nations as equity markets plunge, a significant bear flattening in the yield curve occurs and BOR-OIS spreads explode.

Our models suggest that this would look like the aftermath of the Lehman brothers collapse. That would mean PMI surveys in the mid-30s and GDP shrinking by 2% q/q for at least 6 months (Chart 1).

A key difference with that episode is that it ended relatively swiftly, helped by fiscal and interest rate easing — neither of which are available now.

**Worst Case scenario:** When we run scenarios for the EUR exchange rate, equities and bond yields according to a messy eurozone breakup, it points to PMI readings in the 20s and GDP contracting by around 4% q/q. This should be avoided at all costs, the authorities know this and we think they will do everything possible to do so.

Chart 1: Composite PMI vs LILI Model Simulation



## Not All Currencies Can Weaken Together

**Camilla Sutton, Managing Director, Chief Currency Strategist**

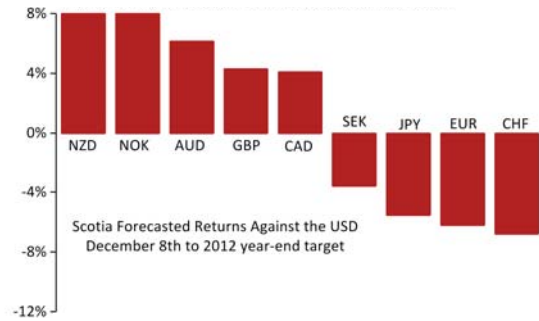
The current environment of high uncertainty, low growth and major global imbalances lays a difficult backdrop for foreign exchange markets. Most valuation tools suggest that currencies are overvalued for the fundamental landscape; however it is impossible for all currencies to weaken together. On a relative basis, we expect the non-EUR, triple-A rated sovereigns to outperform and accordingly hold bullish forecasts on CAD, AUD, GBP, NOK and SGD — see chart 1. The outlook for EUR has materially softened over the last quarter of 2011 and we expect the currency to trend lower in 2012, closing the year at 1.25. Accordingly, in what is an atypical pattern, we expect EUR to trend lower against the USD, but for the USD to be weak against most of the non-EUR currencies.

Europe is in crisis and there is no quick fix. Even an upbeat scenario, where authorities are able to detail a plan that is sufficiently constructive to calm markets and ease contagion, is unlikely to lay the groundwork for a period of medium-term EUR appreciation. If such a ‘solution’ for Europe were to materialize, EUR would likely temporarily rally, however the medium-term outlook for EUR would still be to trend lower. The combination of loose ECB policy, a looming recession, fiscal austerity, social unrest and political uncertainty is not the backdrop of a strong currency.

The environment for Canada is challenging and the risks are significant. CAD is typically a pro-cyclical currency, outperforming in periods of strong global growth and underperforming when the global economy is weak; however the current environment is not typical. As chart 2 suggests, the current risk environment is following the path it took in 2010, not the path it followed in 2008. This is encouraging for the near-term CAD outlook, as the currency is highly correlated with risk aversion. The 2010 experience suggests that CAD could weaken further, but is unlikely to enter the volatile period it entered in late 2008 — see chart 2. With near-term risks high, the bias is for CAD to weaken into year-end. However once in 2012, the combination of a soft landing in China, oil prices averaging \$95 (Scotia Economics’ forecast) and Canada’s triple-A status should help support the currency pushing it back through parity. We hold a 2012 year-end CAD forecast of 1.02 (or USDCAD of 0.98).

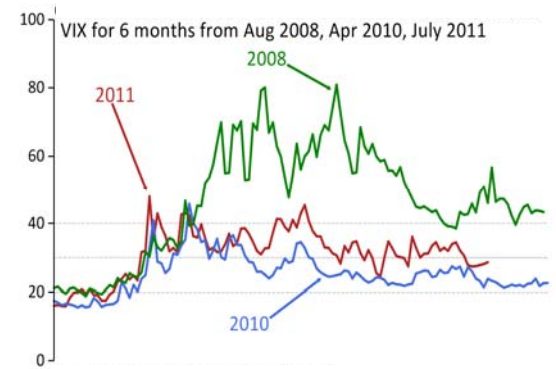
It is an understatement that these are challenging times. The risks to our outlook are significant. A hard landing in China, a significant deterioration in the outlook for Europe or disappointing U.S. growth would cause us to re-evaluate our forecasts. As we look out to 2012, we expect CAD, GBP, AUD, and NOK to outperform, as EUR and JPY trend lower.

Chart 1: FX Forecast - Returns Against USD



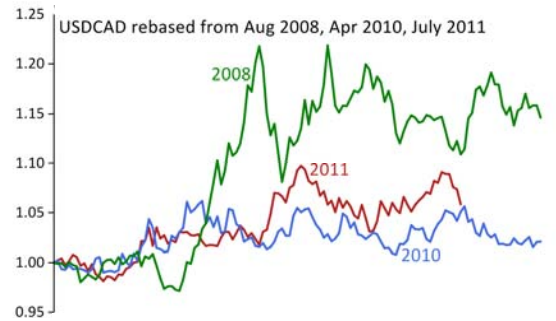
Source: Scotia FX Strategy, Data Insight

Chart 2: Risk Environment Is Following 2010 Not 2008



Source: Scotia FX Strategy, Data Insight, Bloomberg

Chart 3: USDCAD Is Following Its 2010 Path Not 2008



Source: Scotia FX Strategy, Data Insight



## Portfolio Strategy Outlook

Vincent Delisle, Director, Portfolio Strategy

### Macro headwinds spur bond/defensive leadership in 2H11

The TSX (-9.6% in 2011) is lagging the S&P500 (-0.4%) in 2011 and flight-to-safety has pushed bond yields lower in 2H11. YTD, Canadian bonds are outpacing the TSX by roughly 16%. Since 1980, bonds have outperformed equities 14 other times with prior bond outperformance occurring when markets were discounting recessions. World GDP growth is slated to hit 4.0% in 2011 and is at risk of slowing towards the 3.5-3.8% range next year. In our opinion, markets are currently pricing much weaker *year-ahead* growth. Negative revisions to 2012 profits could support further bond outperformance early in 2012 and China slowdown fears could sustain macro uncertainty. Ultimately, 2012 market leadership will be dictated by the extent of the pending slowdown, the degree of "landing" in China, and the 2013 recovery.

### Chinese policy and the TSX

Canadian equities have been hit by the perfect storm in recent months, as fears of a Chinese slowdown add to a challenging global debt outlook. Cyclical markets such as the TSX and the MSCI LatAm tend to hurt in periods of Chinese tightening. With the lagged effects of China's two-year tightening cycle likely visible for another three to six months, TSX headwinds could prevail heading into 2012. However, easing prospects could restore risk appetite and trigger a positive reversal for the TSX and the MSCI LatAm. U.S. and European policy risks should remain challenging in 2012 as election intangibles suppress market sentiment, but China's path to more accommodative measures may be the silver lining in these policy-driven markets.

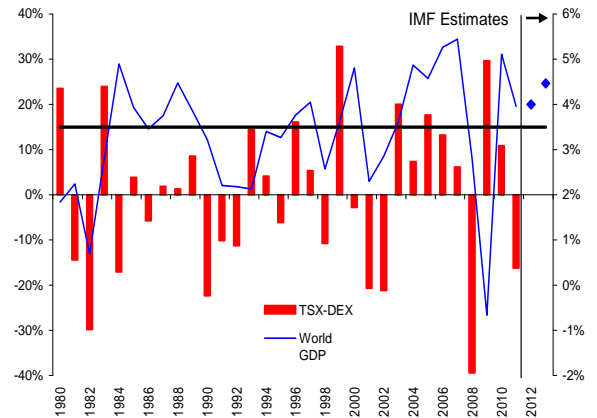
### Big picture outlook

Based on the latest manufacturing surveys (PMI and ISM indices), momentum heading into 2012 is negative in China (PMI at 49), Brazil (49), Japan (49), and Europe (46) and positive in the U.S. (53), Canada (57), and Mexico (53). World GDP growth should be weakest in the first half of 2012 with *year-ahead* expectations improving in the latter part of the year. Global monetary policy is shifting back into easing and more accommodative measures should help revive growth in the second half of 2012.

### Strategy: Modest cyclical bias heading into 2012

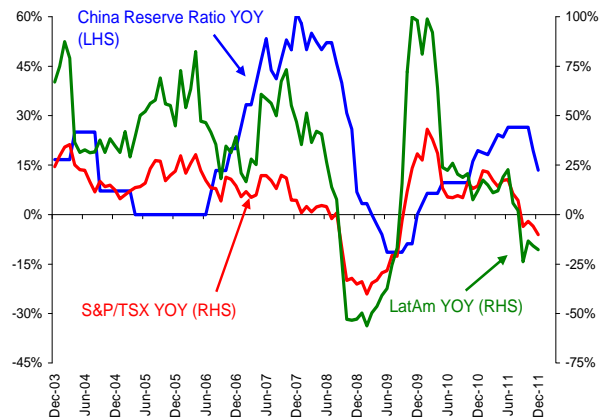
Synchronized easing and positive U.S. payroll momentum could prove equity supportive in the near term, but we are not getting the signal to go high beta/cyclical yet. Our tactical indicators are currently pointing to a neutral cyclical tilt, which is reflected in our recommended asset mix and sector strategy. Based on our 12-month forecasts, equity total returns (+8%) are expected to exceed bonds (0%) and cash (+1%) in 2012. However, the high level of Euro uncertainty and weaker Chinese data expected through Q1-12 warrants a cautious cyclical stance. Our 2012 objective will be to raise cyclical exposure (more LatAm/TSX) as easing monetary policy extends, China's PMI index bottoms, and when the S&P500 settles above its 200-day average. Managing our risk-exposure has been our main focus throughout 2011 and our goal has been to take advantage of tactical opportunities. We expect to remain proactive and are heading into 2012 with a cautious/modest cyclical bias.

Exhibit 1 — TSX-DEX Relative Return vs. World GDP Growth (1980-2011)



Source: Scotia Capital, IMF.

Exhibit 2 — China Reserve Ratio, TSX and MSCI Latin America YOY (2003-2011)



Source: Scotia Capital, Bloomberg.

Exhibit 3

Scotia Capital Asset Mix - EMOC 2012	Asset Mix		Expected Total Return Next 12-M
	Benchmark	Recommended	
<b>Equities</b>	<b>60%</b>	<b>62%</b>	<b>9%</b>
Canada (TSX)	5%	6%	8%
U.S. (S&P 500)	20%	22%	10%
Int'l (Europe, Japan)	18%	19%	8%
EM-Asia	10%	9%	8%
EM-LatAm	7%	6%	6%
<b>Bonds</b>	<b>40%</b>	<b>36%</b>	<b>0%</b>
Government	30%	22%	0%
Corporate	10%	14%	1%
<b>Cash (91-D Tbills)</b>	<b>0%</b>	<b>2%</b>	<b>1%</b>

Source: Scotia Capital estimates

## Economic and Market Outlook 2012-2013

	2010	2011f	2012f	2013f
<b>Economic Performance</b>				
<b>Real GDP (annual % change)</b>				
Canada	3.2	2.3	1.8	2.4
United States	3.0	1.8	1.8	2.2
Euro zone	1.8	1.6	0.0	1.3
Japan	4.1	0.1	3.2	1.8
China	10.4	9.1	8.9	8.5
<b>Consumer Prices (y/y % change)</b>				
Canada	1.8	3.0	1.8	2.0
United States	1.6	3.2	1.8	2.1
Euro zone	2.2	2.6	1.5	1.8
Japan	-0.4	0.2	0.4	0.5
China	4.6	5.0	4.5	4.3
<b>Markets</b>				
			———— (end of period) ————	
<b>Yield Curve - Canada</b>				
Bank of Canada Overnight Target Rate	1.00	1.00	1.00	2.25
2-Year Canada Bond	1.68	1.00	1.80	2.40
10-Year Canada Bond	3.12	2.10	2.95	3.30
<b>Yield Curve - U.S.</b>				
Fed Funds Target Rate	0.25	0.25	0.25	1.25
2-Year Treasury	0.59	0.30	1.00	1.50
10-Year Treasury	3.29	1.90	3.00	3.50
<b>Foreign Exchange</b>				
Canadian Dollar (CADUSD)	1.00	0.96	1.02	1.04
Yen (USDJPY)	81	78	82	84
Euro (EURUSD)	1.34	1.30	1.25	1.29
Sterling (GBPUSD)	1.56	1.55	1.63	1.68
<b>Equities*</b>				
S&P/TSX*	13443	12100	13250	--
EPS*	700	900	925	975
S&P 500*	1258	1250	1375	--
EPS*	83	98	100	105
			———— (annual average) ————	
WTI Oil (US\$/bbl)	79.00	95.00	95.00	104.00
Nymex Natural Gas (US\$/mmbtu)	4.40	4.05	3.50	4.25
Copper (US\$/lb) <i>LME Base Metals</i>	3.42	4.00	4.00	3.50
Zinc (US\$/lb) <i>LME Base Metals</i>	0.98	0.99	0.99	1.10
Gold (US\$/oz) <i>London PM Fix</i>	1225	1565	1675	1600

f: Forecast (Scotia Economics, December 1, 2011)

Source: Scotia Economics, Statistics Canada, U.S. Department of Commerce, U.S. Bureau of Labor Statistics, Bloomberg

\* Source: Scotia Capital, CPMS, S&amp;P

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