Global Views

Weekly commentary on economic and financial market developments

December 16, 2011

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

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U.S. & Canadian Markets Will Be Next Week's Main Focus

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

A light schedule for Europe and Asia should focus most of next week's attention on developments in the US and Canada, while forecasting the imminent arrival of Christmas seems to be a safe bet. Next week will be a key week for **Canada** as we'll get the first solid reading on how the economy entered Q4 through October GDP to be released on Friday. We already know that trade and manufacturing performed dismally during the month such that what supported the economy in the Q3 rebound following the shocks to trade in Q2 that stemmed from Japan's earthquake and tsunami aftermath coupled with domestic supply disruptions in the oil patch has since dropped out as a growth driver. Further, we know that housing will likely be a mild detractor from GDP growth since housing starts were at an elevated but largely unchanged reading of about 209k but fell in the higher value-added singles category. Next week will round out the estimates as wholesale trade lands on Monday and retail sales arrive Wednesday. The current flat consensus estimate for October GDP is therefore playing it neutral on guessing how the retail and wholesale sectors performed, and also with respect to how the largely unobserveable natural resource, service and government sectors performed. Canada will also be influenced by Tuesday's CPI figures for the month of November following two consecutive upside surprises that are thus far fighting the BoC's forecast for inflation to trough at 1% y/y by the middle of next year. Monday will kick it all off with a meeting between Federal Finance Minister Jim Flaherty and his provincial counterparts on budget priorities, pensions, and the state of the Canadian economy. Finally, Canada auctions 2s right in the thick of it all on Wednesday.

US markets will chew on several significant data points throughout the week as markets essentially shut down into banks' year-end. Housing will be a theme throughout the week with November releases for each of housing starts (Tuesday), existing home sales (Wednesday), and new home sales (Friday) expected to remain around depressed levels. Following the downward revisions to the second print on Q3 GDP that took it from the initially reported 2.5% q/q annualized growth rate down to 2%, we'll get the final GDP release on Thursday. The consensus median is calling for no change, but the +/- one standard deviation range straddles outcomes from about 1.8% to 2.3%. This should tee up Q4 quite nicely in support of Scotia Economics' 3% annualized forecast, but the consumer remains key following weak retail sales figures for November that grew only 0.2% m/m in real terms. To this latter point, next Friday's personal spending figures for November will be important. Recall that the consumer entered Q4 through a weak 0.1% m/m gain in inflation-adjusted total consumer spending during October such that if November disappoints like the retail figures did then we'll be back to talking potential downside risks to critically important Q4 consumption and broader GDP. At present with what we know about the Q3 hand-off and October monthly consumer spending, we're tracking about a mild 1.8% annualized growth rate for consumer spending. Durable goods will also be released on Friday with the expectation that a pick-up in aircraft orders will lift the headline while core durables ex-transportation remain relatively soft. Richmond Fed President Jeffrey Lacker's appearance on a panel discussing the economic outlook on Monday will be worth watching since he goes from alternate voting status in 2011 to a full voting FOMC member in January. Finally, the US auctions 2s, 5s and 7s next week.

What? A light **European** schedule next week for a change? Data flow, scheduled event and auction risks are all relatively low. Downgrade risk, however, remains omni-present. A slim majority expects Sweden's Riksbank to cut rates on Tuesday. If it does so, it would be the first reversal following a tightening campaign that stretched from July 2010 to one year later that was followed by a pause. Russia's central bank makes a rate decision on Friday. German consumer confidence and the IFO German business confidence survey are both due out on Tuesday. BoE meeting minutes on Wednesday will add colour to the stimulus discussion at the December 8th meeting. The final prints for Q3 GDP may get some further attention for some countries.

The Hong Kong Monetary Authority and the Bank of Japan make rate announcements during the front half of the week. Other **Asian** market developments could entail another cut in China's reserve ratio requirement and will RBA meeting minutes for clues about the next rate decision following the cut at the December 6th meeting. New Zealand releases Q3 GDP on Wednesday. Finally, Japan releases export figures on Tuesday and the figures are expected to deteriorate.

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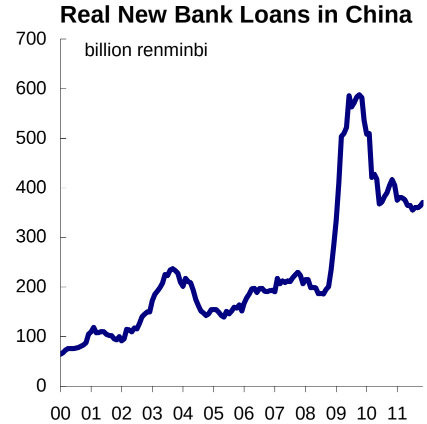
China's Domestic Demand-Led Growth Still Forging Ahead

- **Chinese GDP growth momentum is currently characterized mainly by additions to the country's capital stock, be it infrastructure or machinery and equipment, making the economic advance sustainable; medium-term viability, however, is an issue of concern.**

Evidence of well supported domestic demand conditions found in rising investment and credit flows adjusted for inflation points to a steady growth path for the Chinese economy.

Bank lending activity in real terms has stabilized in China during the past 12 months. The flow of loans to the system bottomed in July after falling over the previous 10 months (chart). This credit tightening move resulted from the policy reaction to gathering inflationary pressures at the turn of last year. Now that inflation — currently at 4.2% y/y — seems under control, the flow of credit in real terms is evidently changing course. Although when viewed from this short-term perspective bank lending in China has been in contraction mode, when analyzed with a medium-term lens it seems evident that the economy is currently receiving about double the amount of loans as prior to the 2008-09 global recession. This is hardly a picture of deleveraging.



PPI inflation adjusted monthly loan flow.
Source: National Bureau of Statistics China

China's economic model can best be characterized as one of investment-led growth. This contrasts with the view that the country's economic advance hinges mainly on exports, as the share of investment in overall spending is currently 46% (including private and public outlays), well above the 20% accounted for by net exports and the 34% participation of household and government consumption. Domestic capital formation became even more prominent as a result of the 2008-09 global recession, given a policy response to accelerate investment spending as the contribution of net exports to GDP growth turned negative. We foresee a similar response going forward. Importantly, however, while over the past ten years a 9.5% yearly economic advance was achieved with a below 40% investment rate, our expectation of GDP gains of just under 9% y/y for 2012-13 implies that new capital stock additions are becoming less productive. Thus, while in the medium-term something will need to give-in in order for the high-growth model in China to be sustainable, capital formation will remain very relevant at least over the next few years.

Still-abundant credit is consistent with no secular contraction in investment spending. Total real monthly investment outlays have returned to a pre-crisis expansion of between 13-15% y/y (table). Looking at spending on construction or machinery & equipment specifically, outlays have expanded at rates of 19% and 11% y/y, respectively, so far in 2011; above their respective rates of 13% and 10% in 2010.

Persistent double-digit yearly nominal retail sales growth in the midst of an inflationary downtrend implies that overall real domestic spending remains firm, notwithstanding short-term monetary tightening. Thus, the downturn in annual GDP growth currently underway in China seems dominated by base effects. Looking ahead, due to the relevance of euro area exports a slowdown is expected, but the steadiness and composition of local spending reaffirms the view that the sequential fall will not be too severe.

REAL FIXED ASSET INVESTMENT IN CHINA*

		Total	**Const.**	**Equip.**	**Other**
2007	Mar-May	629	383	135	111
	Jun-Aug	820	512	176	132
	Sep-Dec	888	532	199	157
	2007-Average	**779**	**476**	**170**	**133**
2008	Mar-May	711	437	152	122
	Jun-Aug	923	566	212	145
	Sep-Dec	1044	626	245	173
	2008-Average	**893**	**543**	**203**	**147**
2009	Mar-May	1059	661	223	175
	Jun-Aug	1388	863	303	222
	Sep-Dec	1397	848	318	231
	2009-Average	**1281**	**791**	**282**	**209**
2010	Mar-May	1189	728	243	217
	Jun-Aug	1575	977	331	267
	Sep-Dec	1592	971	358	262
	2010-Average	**1452**	**892**	**311**	**249**
2011	Mar-May	1443	921	295	228
	Jun-Aug	1745	1133	358	254
	Sep-Nov	1767	1124	385	259
	2011-Average	**1652**	**1059**	**346**	**247**

*Average monthly flows. Cumulative flows available only from February on.
Deflated by PPI using 1999 as base year.
Source: National Bureau of Statistics, China.

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A Snapshot Of Venezuela's Economic Outlook

- **Adverse oil price shifts and policy uncertainties are the main risks to the economy.**

A fixed exchange-rate regime with tight capital controls has been place since 2003. In 2010, the authorities devalued the Venezuelan Bolívar (VEF) from 2.15 to 4.30 per USD and introduced a parallel exchange rate to be used exclusively for essential imports. Additionally, legislation was approved that allows all foreign exchange transactions to be supervised and/or controlled by the central bank. An informal exchange rate system has emerged as a result of these regulatory changes. External financial shocks, adverse oil price shifts, and policy uncertainties related to next year's presidential election could prompt further currency adjustments in the near term.

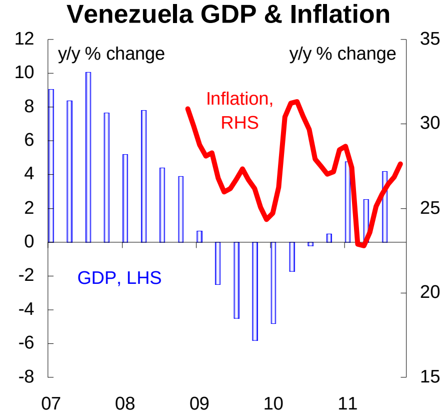
Sovereign credit ratings for Venezuela remain below investment grade. The country's credit default swaps, at around 1,000 basis points (bps), remain among the highest in the region, together with those from Argentina. The state-owned oil company, PDVSA (Petróleos de Venezuela S.A.) announced a new bond issuance of US$2.4 billion maturing in 2021 that will be used to pay outstanding notes due in 2013. With this, the total debt issued by the government and the company rose to nearly US$17.6 billion in 2011.

We expect Venezuela to grow by 3.8% in 2011 and by an average of 3.9% in 2012/13. After a poor economic performance in 2010 (GDP contracted 1.5%), the economic recovery in the first three quarters of 2011 significantly improved. Economic growth has been led by the strong performance of the local financial sector, government spending (especially in the construction sector) and a recovery — though moderate — in local demand. Additionally, a base effect from 2010 has boosted this year's numbers. We anticipate that government spending will continue to increase as the 2012 elections approach, which will help consumption. However, the high inflationary environment, less friendly private investment policies, elevated debt burden, and high exposure to a drop in oil prices will weigh on the country's 2012/13 economic outlook.

Venezuela's inflation rate is one of the highest in the region and we expect it to remain elevated. Recently, the government announced that for the holiday season, the official prices of some food items would be reduced. We expect more of this type of announcement ahead of the presidential election in October 2012. However, we anticipate that price distortions will remain high, with the annual inflation rate soaring between 25% and 30% in the 2012/13 period.

With oil profits accounting for half of the country's total revenue and about 95% of total exports, the country remains vulnerable to any shifts in oil prices. We expect the current account surplus to narrow in the coming years as oil prices stabilize and production remains steady. Joint-venture projects between Venezuela's oil company and China's National Petroleum Corporation — with loans from China being repaid with oil — will keep oil production high in the coming years.

Venezuela GDP & Inflation



Source: Bloomberg.

We do not foresee any changes in the nation's sovereign credit rating in the coming months; however, next year's presidential election and/or any unexpected sharp fall in crude oil prices could prompt rating agencies to adjust the country's risk profile. The current president, Hugo Chávez, has announced that he will seek his third consecutive term in office. The president announced in June that he was fighting cancer (with no detail provided on the type or severity), creating high uncertainty over the nation's future political course. Recent polls confirm that Chávez's popularity has increased due to his illness and subsequent recovery, prompting political analysts to question whether this could be a vote-seeking strategy. The opposition party will nominate a candidate in early 2012.

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U.S. Consumers To Spend More Cautiously In The New Year

- **Household spending is likely to moderate, as modest improvement in the labour market and confidence is offset by weaker wealth and income.**

The US economic data continues on its positive run, signaling that the final months of 2011 may make for the strongest quarter since mid-2010. The start to next year may be less rosy, as domestic consumers — who contribute 70% of GDP — are expected to become more cautious. No surprise there, as Americans continue to face a daunting set of challenges, including high unemployment, stagnant wage growth, a fragile housing market, ongoing deleveraging and political gridlock in both Washington and Brussels.

Our leading indicator of private consumption (LIC) — which examines developments in employment, income, wealth and consumer sentiment — provides a look-ahead of up to two quarters (chart 1). The LIC is a reliable early-warning system for turning points, foreshadowing a slowdown in household spending in the first half of the next year.

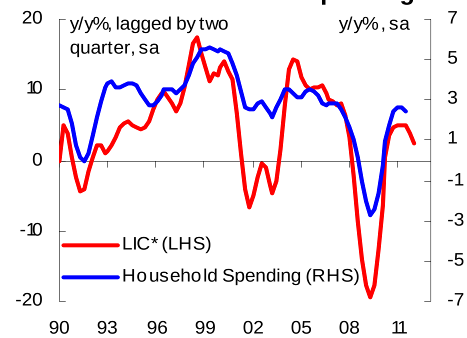
The performance across the individual components making up the LIC has been mixed. Employment, excluding the deleveraging sectors, continues to post gradual improvement. Since bottoming in February 2010, businesses — excluding construction, finance, real estate and government — rehired over 3 million Americans (chart 2), averaging a stepped-up monthly gain of 150,000 since September. In contrast, the deleveraging sectors, which make up just under 30% of overall employment, jointly shed more than 600,000 jobs over the same period, with the government accounting for 80% of the losses. While employment and consumer confidence have turned slightly more optimistic — although they are still well below their pre-recession levels — wages and household wealth remain under pressure.

It is of growing concern that wages — which represent 50% of overall household income — have been declining on a real, per-hour basis for twelve straight months, averaging a monthly decline of 5.5% since June. This does not bode well for the consumer, as, alongside employment, real and expected wage growth are the strongest drivers of household spending. Thankfully, inflation is showing signs of respite, alleviating at least some pressure on purchasing power. Mortgage rates also continue to trend lower, allowing for refinancing of the single-biggest monthly expense at a lower cost.

Alongside stagnant wages, household net worth has also been deteriorating at a quicker pace over the last two quarters (chart 3), walloped by a double whammy: ongoing declines in home equity and weaker financial markets due to jitters emanating from the European debt crisis. The rebound in household wealth from mid-2009 to early 2011 was a key factor behind the recovery in consumer spending and the rebuilding of the personal savings accounts, making its recent reversal an added concern.

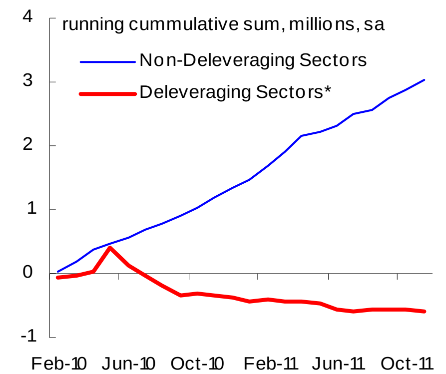
As the economy rebalances away from an over-reliance on the consumer, business investment and exports, especially to emerging markets, are expected to continue to contribute the most to growth.

Leading Indicator Forsees More Moderate Consumer Spending



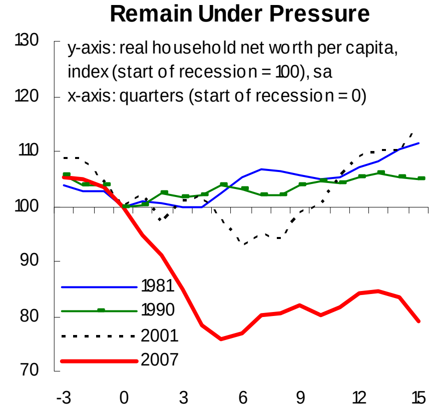
* Leading Indicator of Consumption - includes employment, real hourly wage, real net worth, and confidence. Source: BEA, BLS, Federal Reserve, Scotia Economics.

While Non-Deleveraging Sectors Added 3 Million Jobs Since 2010...



* Include construction, real estate, finance, and government. Source: BLS, Scotia Economics.

...Household Wealth And Wages Remain Under Pressure



Source: BLS, Federal Reserve, Scotia Economics.

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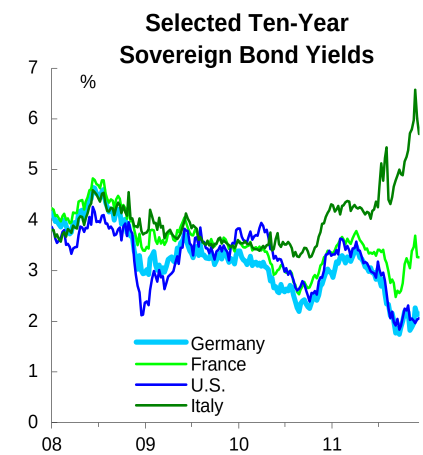
Elevated OECD Sovereign Issuance Continues

- **As government deficits contract, refinancing will keep near-term gross borrowing high.**

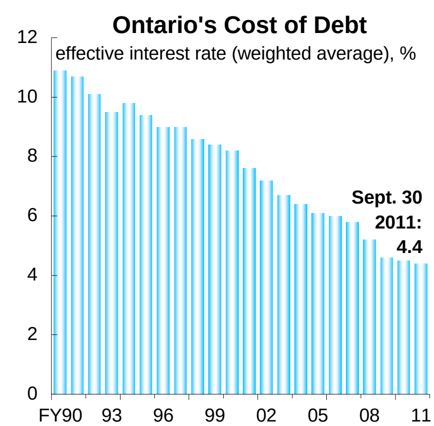
The OECD's latest survey of its members' sovereign borrowing plans indicates higher-than-anticipated gross government financing in 2011 of US$10.4 trillion, with a further US$10.5 trillion required in 2012. The 2012 estimate marks the fourth year of OECD gross government financing surpassing US$10 trillion, roughly US$3 trillion higher than 2007. Against a backdrop of escalating sovereign debt and economic uncertainty, with the OECD's real GDP growth now projected to slow from 1.9% in 2011 to 1.6% in 2012, accomplishing required government funding in 2012 with acceptable roll-over risk is expected to be expensive for some OECD nations *(top graph)*. Interestingly, in the euro zone, central government marketable gross borrowing relative to GDP is shifting lower, from 18.7% in 2009 to less than 15% in 2012.

After peaking at close to US$3.5 trillion in 2009, OECD general government deficits have only slowly contracted in absolute terms, with an aggregate shortfall of US$2.9 trillion estimated for 2011 and US$2.7 trillion projected for 2012. Thus only a small decline in central government marketable net borrowing requirements is anticipated, from an estimated US$2.3 trillion in 2011 to US$2.1 trillion in 2012. Long-term debt refinancing will continue to propel borrowing activity, particularly among emerging OECD nations, with the OECD expecting its members to refinance almost 30% of their outstanding long-term debt over the next three years. To enhance their fiscal resilience, many OECD nations are lengthening term, with the share of short-term issuance across the OECD peaking at close to 56% in 2008 and subsequently falling below 45%. The long-term share of OECD central government marketable debt is now forecast to edge up to 87% in 2012.

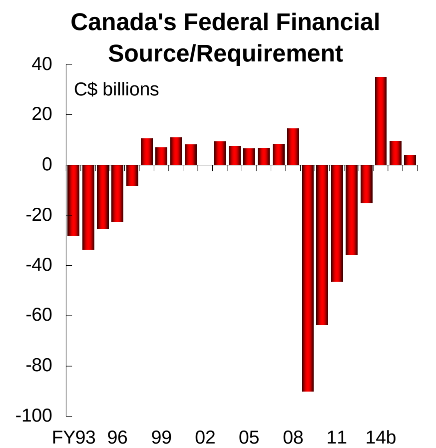
Canadian governments have benefitted from significant investor demand for their debt, as illustrated by the steady decline in the average effective interest rate on Ontario's debt *(middle graph)*. U.S. dollar global issuance by the Provinces, for example, averaged over C$16 billion in fiscal 2009-10 (FY10) and FY11 and is already close to C$12 billion in FY12. While the Provinces' final aggregate deficits for FY10 and FY11 were much narrower than the governments' forecasts, scaling back the red ink over the next few years will require tough decisions given moderate, not robust, economic growth prospects and Ottawa's simultaneous fiscal repair. The decision by Moody's this week to shift from a stable to a negative outlook for Ontario's Aa1 rating reflects this challenge. In FY13 and FY14, though the Provinces' net financing needs should contract, refinancing will preclude a substantial decline from their recent annual issuance of well over C$70 billion. Fortuitous, therefore, is Ottawa's expected shift from a C$46 billion financial requirement in FY11 to a substantial federal financial source of C$35 billion in FY14 as the principal on assets maturing under the Insured Mortgage Purchase Program is repaid. Moreover, Ottawa's planned focus on two-, three- and five-year maturities leaves more room for the share of provincial issues of ten years and longer to remain over 50%.



Source: Bloomberg, Scotia Economics.



Source: *Ontario Public Accounts* (1991-2011) and Ontario Financing Authority.



Source: Finance Canada, June 2011.

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Why The Fixation On Canadian Household Debt-To-Income?

- **The bigger concern should be an overly rapid deceleration of household debt growth.**

We learned this past week that Canada's household debt to income ratio hit yet another record high of 153%. This prompted further public discussion of the need for cooling off household debt growth. Our concern is that the debt-to-income ratio is one of the worst metrics of household finances, whereas the evidence of a sudden deceleration in household debt growth is clear and provides a cautionary note against further policy tightening that could risk tipping the ship right over from a soft landing to a potentially harder one. It may well be that weak cyclical supports such as falling real wages, combined with all-time structural highs on most measures of housing markets and consumer spending are working to slow momentum in a way that is magnified by pro-cyclical macroprudential policy. What follows are several key observations after properly adjusting the data.[1]

Chart 1 provides the common measure of the household debt to income ratio using credit market forms of debt and depicts Canada having crossed the US in 2011Q1. Chart 2 takes all forms of household sector debt in Canada and the US and shows the US ratio still higher than Canada's but with Canada likely to cross within the next two years. That said, Canadians are more heavily leveraged than they have ever been, but remain considerably less leveraged than Americans.

Charts 3 and 4 depict the sudden slowing in household debt growth. The industry-wide consumer loan book which includes all fixed and variable rate installment loans, credit card balances and drawn lines of credit has slowed to a crawl, and stopped growing after accounting for inflation (chart 3). The industry-wide mortgage loan book has slowed to among the weakest growth paces in decades (chart 4). After subtracting inflation, residential mortgage balances have slowed to a growth pace of just over 2% at annualized monthly trend rates.

Canadians have more assets relative to income now than Americans do even following the deleveraging experiences and house price correction south of the border. This ratio remains near the pre-crisis all-time high in Canada although it has slipped over the past two quarters (chart 5). This ratio is just as flawed as the debt-to-income measure that compares stocks to flows or the total amount of debt financed over a lifetime to a single year's worth of income, but at a minimum speaking to one measure requires speaking to the other to be balanced.

Total debt relative to assets also positions Canada to be lower than the US (chart 6). This is because Canadians use less debt to finance real estate purchases (chart 7) and less debt to purchase other non-real estate assets (chart 8). That said, real estate related debt is a slightly higher share of total household debt in Canada.

Total Canadian home equity as a share of the outstanding value of residential real estate assets is much higher than in the US (chart 9), and this is not solely because of the US house price correction. The gap between the two countries began to emerge when Americans aggressively pursued cash-out refinancing and mortgage equity withdrawals. Canada has done less of this through secured lines of credit in recent years. Nonetheless, the gap is starting to close, in a large part due to improvement on the US front. As a partial consequence, Canadian household net worth is higher relative to income than it is in the US (chart 10).

We remain of the belief that Canadian house prices are exceptionally rich, that massive house price gains have been booked across the whole country over the past decade, and that as a consequence Canada has a near-record high ratio of debt payments to income (chart 11). As a side note, principal payments as a share of income likely fell somewhat through amortization extension post-2007, but the elimination of 40 and 35 year insured mortgages is likely to result in higher principal payments upon renewal of previously longer amortization mortgages. Thus, an unintended consequence to shortened amortization periods could well be to put further upward pressure upon debt serviceability at an awkward juncture. That said, lower household leverage and — more importantly — the near absence of a shadow banking sector that has meant little by way of heavily leveraged CDO and SIV markets are among the many micro foundations to the mortgage market that insulate Canadian household finances to a greater extent than stateside. On net, the Canadian household sector is operating at structural and cyclical peaks, but we remain cautiously optimistic toward a soft landing.

1. In order to compare Canadian and US household leverage, adjustments are needed to account for some key differences such as:
- Unincorporated businesses are split out from households in the US but not in Canada. Therefore to compare to Canada, households and unincorporated businesses have to be carefully combined by avoiding double-counting of equity in unincorporated businesses. Combining the sectors makes sense due to unlimited liability and the household's claim on the residual assets of unincorporated businesses, and to neutralize the effect tax policy has on where to park debt and assets.
- We include ALL liabilities not just credit market debt, since households are ultimately on the hook for various other debts like trade and tax payables.
- Canadian secured lines of credit are counted as consumer loans, but in the US, HELOCs are counted as mortgage credit. Thus, you need to add secured lines of credit to Canadian real estate debt.
- In both Canada and the US, real estate assets and liabilities must reflect both residential and nonresidential structures given the combination of households with unincorporated businesses.

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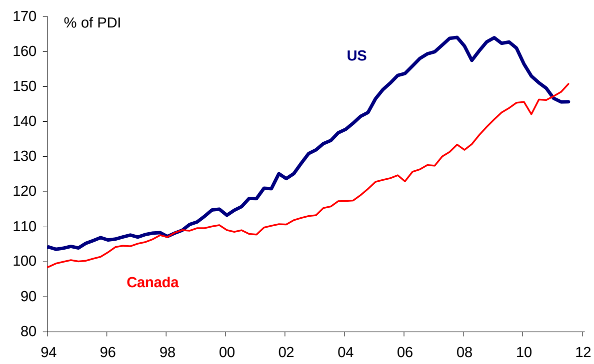
Chart 1

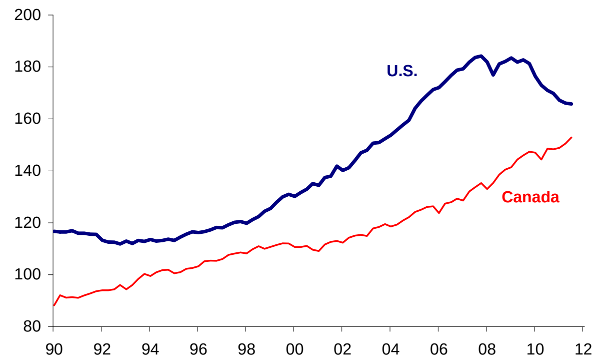
Credit Market Debt as % PDI



Source: Federal Reserve, Statistics Canada, Scotia Capital Economics

Chart 2

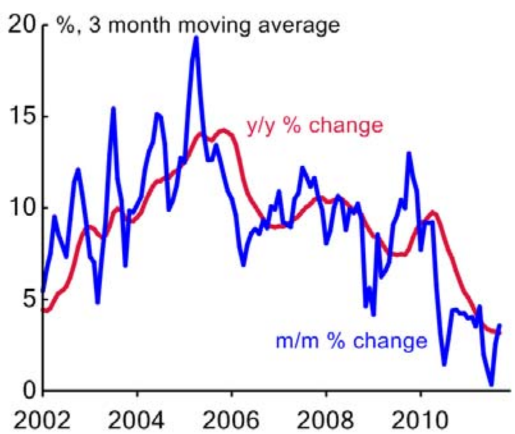
Total Debt as % PDI



Source: Federal Reserve, Statistics Canada, Scotia Economics

Chart 3

Consumer loan growth



Source: Bank of Canada, Scotia Capital Economics

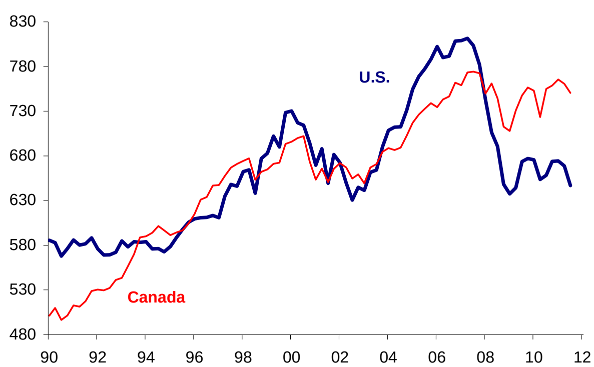
Chart 4

Residential mortgage growth

Source: Bank of Canada, Scotia Capital Economics

Chart 5

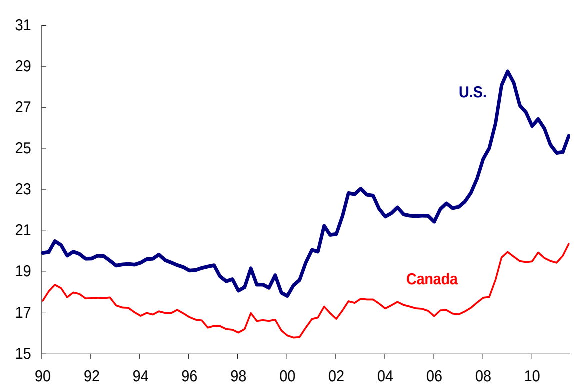
Total Assets as % PDI



Source: Federal Reserve, Statistics Canada, Scotia Economics

Chart 6

Total HH Liabilities as % Total Assets



Source: Federal Reserve, Statistics Canada, Scotia Capital Economics

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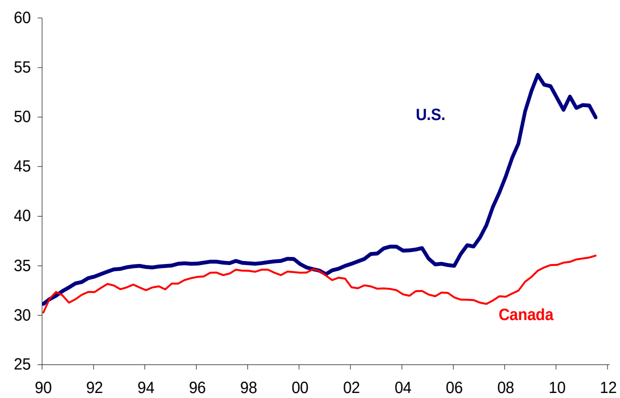
Chart 7

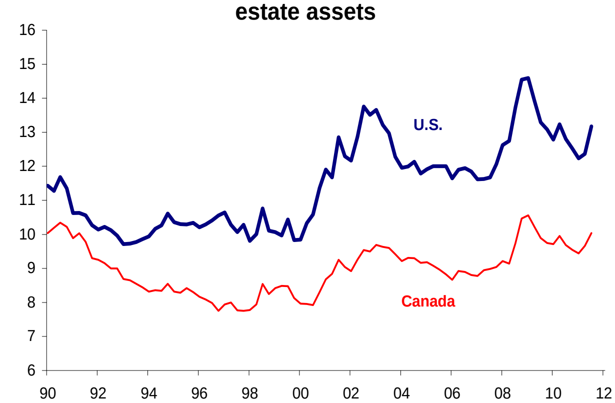
Real Estate Debt as % Total Real Estate Assets



Source: Federal Reserve, Statistics Canada, Scotia Capital Economics

Chart 8

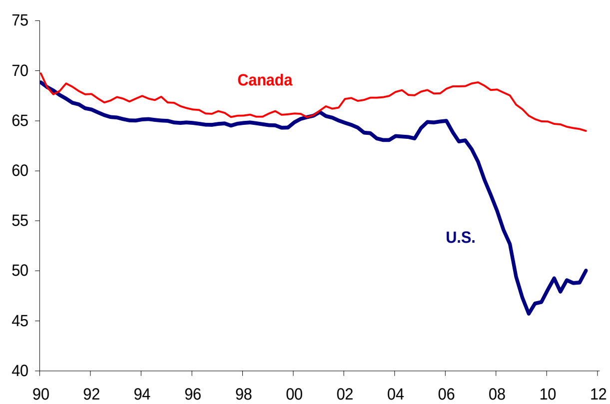
Total non-real estate liabilities as % total non-real estate assets



Source: Federal Reserve, Statistics Canada, Scotia Capital Economics

Chart 9

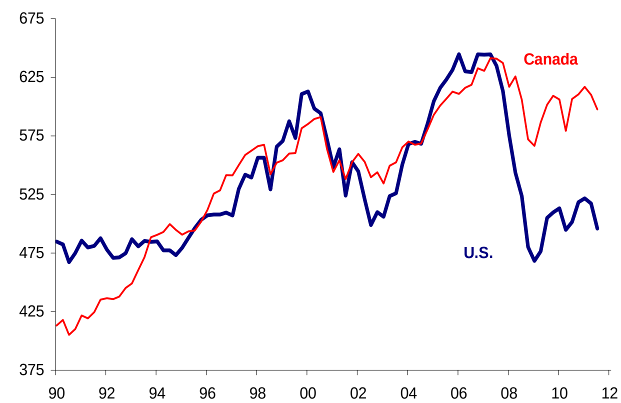
Owners' Equity as % Real Estate Assets



Source: Federal Reserve, Statistics Canada, Scotia Capital Economics

Chart 10

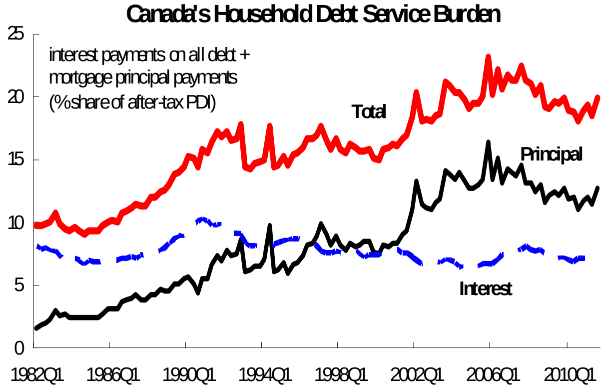
Net Worth as % PDI



Source: Federal Reserve, Statistics Canada, Scotia Capital Economics

Chart 11

Canada's Household Debt Service Burden



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

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2012 Outlook

- **We have appreciating trends built into the non-EUR, triple A rated sovereigns, which include CAD, AUD, GBP, SEK, NOK and SGD.**

USDCAD FORECAST Q411: 1.04 AND Q412: 0.98

The near-term outlook hinders on risk aversion (a notoriously difficult component to forecast). Our expectation is that the European crisis continues to accelerate into year-end, keeping risk aversion elevated. In addition year-end flows are likely to be USD positive as investors position for the holidays.

Looking out to 2012 - At some point risk aversion will subside, allowing a more normal market to emerge. We envision this as a CAD positive environment for several reasons. Canada's triple A status and developed bond market should keep global flows into Canada and CAD positive. In addition, we expect an engineered soft landing in China, which suggests that commodity prices can be supported at current levels (Scotia Economics forecasts WTI oil prices to average $95 in 2012). The Canadian economic fundamentals are not as strong as they have been historically, but on a relative basis they shine. Recent US data suggest that the economic outlook is stabilizing, which would also be positive for CAD. Finally, interest rate spreads have been relatively stable since the summer, but as we move closer to 2013, we would expect that spreads begin to move against USDCAD as the BoC proves more likely to tighten policy ahead of the Fed.

USDCAD EXPECTED TO REVERSE GAINS

EURUSD FORECAST Q411: 1.30 AND Q412: 1.25

The near and medium-term outlook for EUR has deteriorated rapidly. The market has grown impatient with tentative proposals from the EU, a lack of political agreement and a central bank that under the existing framework is unwilling to enter a large scale bond buying program. Sentiment has shifted materially and rapidly and EUR has collapsed lower. Looking out to 2012 the combination of a weak economic backdrop, strict austerity, loose ECB policy, social unrest and uncertainty are likely to weigh heavily on EUR. However, authorities are slowly moving towards closer fiscal ties, which should halt the collapse in EUR.

EURUSD DOWNTREND TO CONTINUE

The average level of EUR since inception is 1.2044, having hit a low of 0.8352 in July 2001 and a high of 1.6038 in July 2008. On this basis EUR remains in the top half of its historic valuation. During the 2008 financial crisis, EUR fell to a low of 1.2334 and in 2010, the initial phases of the European crisis, it fell to a low of 1.1877. Until confidence is rebuilt and there is an understanding of the path for the EMU, the risk is that EUR trends towards 1.2334 first and then 1.1877, but these levels are unlikely to prove sustainable.

GBPUSD FORECAST Q411: 1.55 AND Q412: 1.63

The near-term outlook - Since its April 29th closing high of 1.6747, GBP has lost 7.4%; however on its crosses it has performed very well, gaining 2% against CAD, CHF and AUD and 5% against EUR. We expect this pattern of weakness against USD but outperformance on the crosses to remain in place in the early months of 2012.

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Looking out further in 2012 the outlook for GBP brightens. The fundamental backdrop is not strong. The BoE is widely expected to announce another round of QE in the first quarter, the growth outlook is dismal and strict austerity remains in place. However, market participants are well aware of the path ahead for the UK (unlike the highly uncertain path for much of Europe). This, combined with the UK's Triple A rating, should support positive flows into the UK and in turn support GBP. Accordingly, we have a relatively bullish GBP forecast, expecting the fundamentals to be overlooked in favour of its clearer path and strong rating.

GBPUSD TO PERFORM INTO Q4 2012

USDJPY FORECAST Q411: 0.78 AND Q412: 0.82

The near-term outlook - After repeated rounds of intervention USDJPY sits 3.5% above its all time low of 75.35 and on a relative basis has been notably stable. We do not expect a major shift from current levels into year-end, though note that should risk aversion rise, downward pressure on USDJPY is also likely to rise.

Looking out to 2012 - Japanese fundamentals are a mixed lot. The benefits of a large current account surplus (2.3% of GDP), a low unemployment rate (4.5%) and an expected 2012 growth rate of 3.2% are offset by the country's struggle with deflation, an aging population and shocking debt levels of 230% of GDP this year, not to mention a 9.2% budget deficit. The Bank of Japan is likely to keep ZIRP in place for years to come. Longer-term valuation metrics like PPP suggest the currency is well overvalued. Accordingly, the fundamental backdrop is not particularly supportive of ongoing yen strength. We expect positive flows to offset some of these weaknesses, for yen to remain close to historic highs but slowly begin to trend lower.

USDJPY TO RISE ON FUNDAMENTALS

AUDUSD FORECAST Q411: 1.00 AND Q412: 1.08

The near-term outlook - AUD is particularly vulnerable to spikes in risk aversion and the outlook for Chinese growth. As we move into year-end neither are moving in the currency's favour. Accordingly, we expect AUD weakness into the early part of 2012.

Looking out to 2012 - Near-term weakness is likely to be replaced by strength in 2012 as AUD benefits from several differentiating attributes. Australia's strong sovereign position, that includes a Triple-A rating, gross debt of just 21% of GDP, and a budget deficit of -2.6% of GDP, sets the country apart and brings in AUD positive flows. China's growth outlook has a material impact on the Australian economy. Scotia Economics' base case is for an engineered soft landing, which should help support Asian growth and commodity prices. We recognize that the RBA has entered an easing cycle, however the relative yield advantage that Australia is expected to maintain should leave AUD one of the favoured longs in carry trades and makes it very expensive to short. Accordingly we hold a favourable AUD 2012 forecast of 1.08.

AUDUSD TO RISE ON SOVEREIGN POSITION

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LATAM FX Outlook For 2012

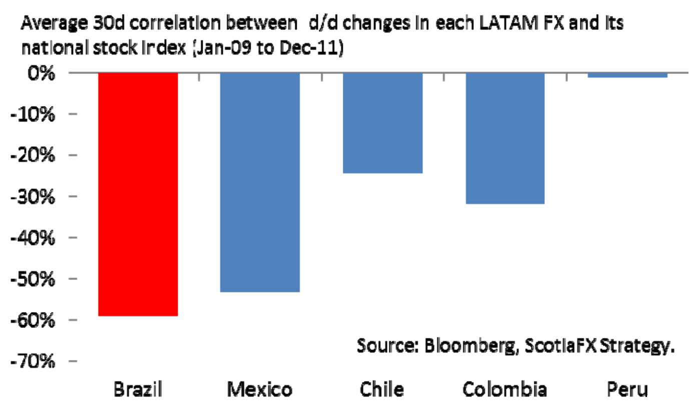
- **We published our "LATAM FX's 2011 Report Card & Outlook for 2012", where we evaluate the performance of currencies in 2011, simulate currency portfolios containing different FX baskets to determine which of them offer the best risk-return tradeoffs, and describe or LATAM currency views for 2012. In this space we summarize our views for the LATAM FX outlook for 2012.**

- **BRL**: Although recent Brazilian economic data has been underwhelming, there is significant stimulus in the pipeline (BCB rate cuts + Gov. stimulus), which should help growth pick up in 2012. Stronger growth + the elimination of the 2% IOF on equities and a pipeline of ~40 IPOs in the BM&F could be a driver for portfolio inflows into Brazil in 2012 (BRL has the strongest correlation to the national equity index of any major LATAMFX — see **Graph 1**), which should serve as a complement for strong FDI. **We think that after the recent weakness we've witnessed in the real, it could be a strong performer in 2012Q1** (or whenever the EZ induced turbulence settles).

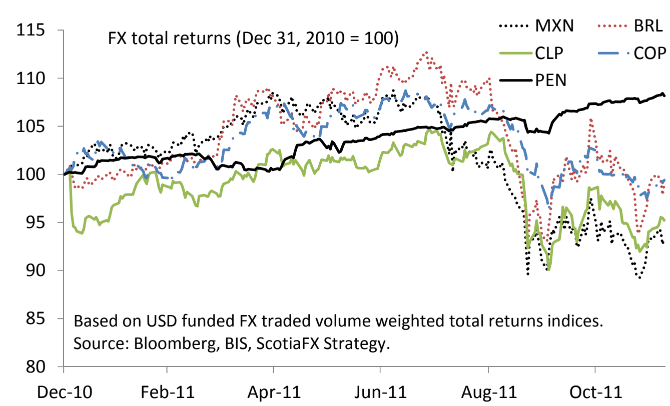
- **CLP**: the peso underperformed its LATAM peers in 2011 due to a combination of factors: copper prices underperformed the broader commodity complex in 2011 (CRB index –11.5%, vs copper –17.0%), the BCCh's intervention announcement led to a sharp sell-off in January, and CLP was unable to recover from it (see **Graph 2**), as one of the world's most open economies (imports + exports = 60% of GDP) the global slowdown had a negative impact on the peso. Our global forecasting committee sees USD/CLP on a gradual appreciating trend from 514 to 510 in 2012. Based on REER valuations (**Graph 3**), and 2011 underperformance, we believe the skew of risks is tilted towards an even stronger CLP in 2012, consistent with our view of a Chinese soft landing (+8.9% growth in 2012).

- **COP**: the vast majority of net private (non-commercial bank lending) inflows into Colombia are foreign direct investment flows (**Graph 4**), of which most is destined to the resource sector.

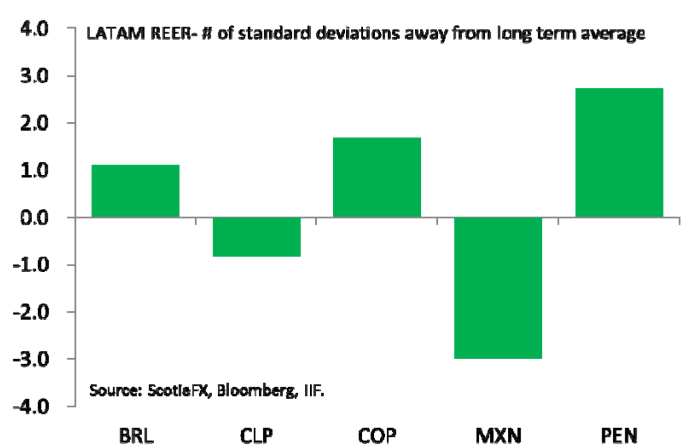
Graph 1: IPO pipeline + equity IOF unwind = BRL support



Graph 2: CLP failed to gain traction in 2011



Graph 3: CLP looks cheap from a REER perspective



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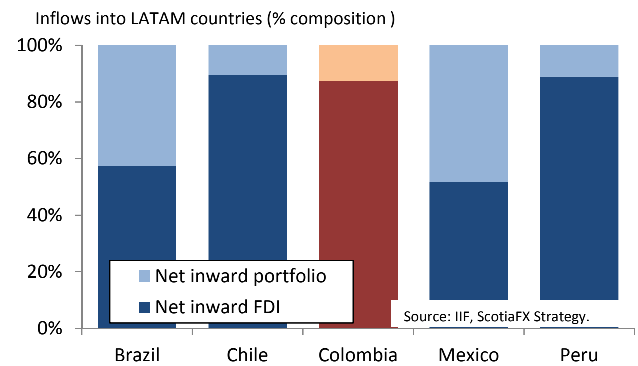
Given the vast untapped resources available in the country, the government's plans to start selling exploratory mining blocks, and the ongoing development of the oil industry, we expect these inflows to remain strong. One of the drawbacks of COP, over some of its LATAM peers, is its relatively low carry, which makes choosing the entry point especially important. **Our bias on USD/COP is trade ranges, betting on a move towards 1870 by year end 2012.**

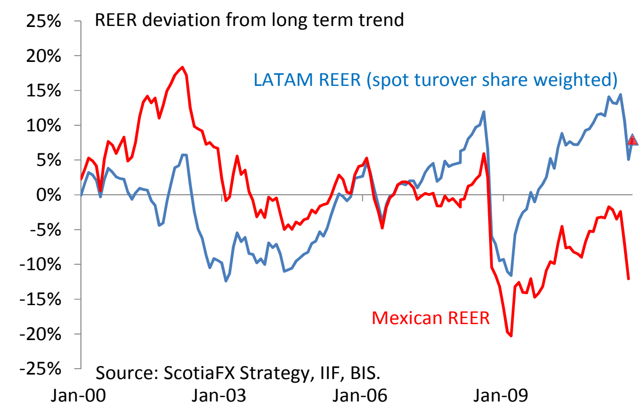
- **MXN**: Although MXN looks cheap from a valuations perspective (**Graph 5**), this has been the case for a number of years. We believe this is partly explained by the fact that while most of LATAM has benefited from Chinese growth via higher commodity prices, as a manufacturing country, the impact from the rise of the "Asian Giant" may have been negative for Mexico as Chinese exports have put downward pressure on manufacturing good's prices. Still we believe 2012 will be a good, although volatile year for MXN (presidential elections + MXN's high beta). Given relatively low carry, and likely high volatility, **our bias is to either play MXN as a carry trade through local fixed income instruments** (cetes offer a ~100bps pick up over FX implied yields), **"swapitos", or tactically pairing MXN with other high beta EMFX to reduce the currency pair's beta.**

- **PEN**: BCRP intervention behavior suggests that rather than trying to defend certain levels in USD/PEN (see **Graph 6),** the central bank wants to curb rapid appreciation, while reducing volatility due to still high financial sector dollarization. As a result of this behavior, USD/PEN has one of the lowest vols of any major FX, accompanied by a high carry. **Our bias is to trade short USD/PEN as a carry trade, targeting annualized total returns of 4%- 8%.**

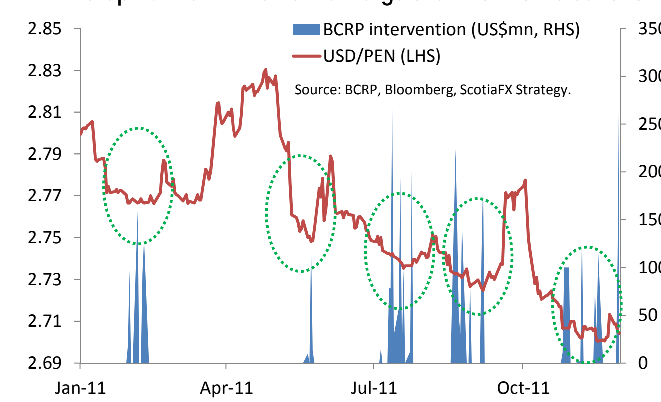
Graph 4: COP performance primarily driven by FDI



Graph 5: MXN's valuations look compelling



Graph 6: BCRP intervention targets low vol. not valuations



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Stabilizing Reserves At Pemex

The long-run outlook for oil production at Pemex has improved considerably, with reserves stabilizing thanks to increasing investment. While delays in the execution of production sharing contracts continue, the interest that multinational firms showed in the first stage was a pleasant surprise. Despite improving fundamentals, the spread over sovereign of Pemex has increased by about 10-20bp due to recent Europe-related volatility. We continue to believe that the spread pickup on Pemex over Mexico exceeds the risk of a selective default on Pemex bonds.

The fate of long-run oil production

When we wrote our comprehensive outlook on Pemex almost two years ago,[1] our biggest concern, and that of many investors as well, was the worrisome trend in oil production. Oil production had fallen by 5% every year since peak oil production was reached in 2004. Meanwhile domestic politics was a significant impediment to reversing that trend in oil production, as the importance of current spending seemed to outweigh long-term investment needs and the ability to attract foreign technology for deep water exploration was hampered by Constitutional restrictions on foreign participation. We don't mean to exaggerate the concerns even then; it would have been many years before bondholders felt the effects even under the worst scenario. Nevertheless, there were many investors concerned that Mexico was slowly running out of oil.

Over the past two years, we have received mostly good news regarding these developments. Most importantly, oil production has stabilized at around 2,500 to 2,600mbd, a range in which it has remained since 2009. Yet, short-term production statistics can be deceptive. For example, some geologists have criticized Pemex for its use of nitrogen injection at Cantarell, arguing that this technology allowed Pemex to temporarily boost production there ten years ago at the expense of long-term production, as this rapid method of retrieving oil can damage the fields. While the many years it takes for such effects to become visible seems an eternity in the eyes of capital markets, Pemex does attract many long term investors who should rightly be concerned about such effects when purchasing 30-year bonds.

Other indicators of long-term production potential are also supportive. The total investment budget for Pemex continues to grow, rising from $14bn in 2006 to $24bn in 2011 and projected by the company to rise further to $30bn by 2014. A portion of that investment budget, among other things, is related to the development of existing fields, and another portion represents new exploration, with the budget for the latter rising from $1.3bn to $2.4bn in the same period. Both the development budget and existing exploration budget contribute to the replacement rate of proved reserves, which rose from 26% to 86% in those five years.[2] Of course some of that increase in replacement rate was due to a decrease in the denominator from falling oil production, but even after accounting for that effect, we see that the rate at which Pemex adds new proved reserves, whether due to revisions or to new discoveries, has increased by 160%. In fact, that number seems so good that it raises some questions: if investment has increased by only 70%, why did the rate at which Pemex adds new reserves increase by 160%? We are not sure but it is hard to dispute the fact that the steady increase in annual replacement rates demonstrates a positive trend and suggests that Pemex could attain a replacement rate of proved reserved of over 100% soon. The replacement rate of possible reserves (in contrast to proven reserves) has remained slightly above 100% for the last three years.

None of that means that all production problems have been resolved. Half of current crude oil production continues to come from the Northeast region, which is composed of Cantarell, a field whose production started to rapidly decline in 2006 but has stabilized more recently at one-third of previous output levels, and Ku-Maloob-Zapp (KMZ), three fields which should start their decline this decade. KMZ is the set of fields that has experienced the biggest increase in recent years, with production rising from 250 mbd ten years ago to 840mbd in 2010; this increase has been critical to the government's stabilization of overall production levels. Pemex tells us that the development of KMZ has been staggered, such that the decline should first start at one field and provide an early warning for declines in other fields.

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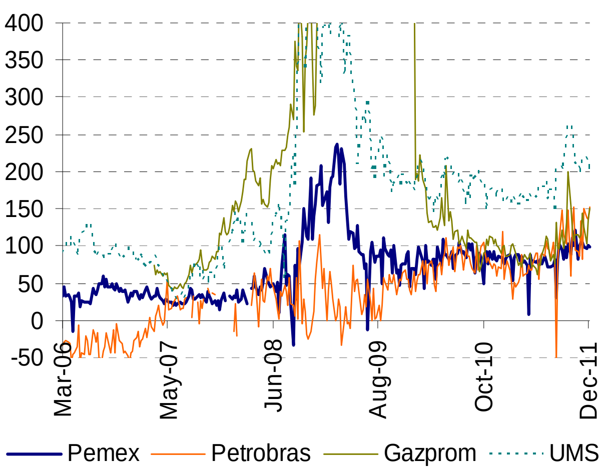
Another uncertainty in recent years critical to production in the very long term is the fate of the incentive contracts that Pemex has been developing for many years. These are supposed to mimic some of the incentive aspects of equity participation without giving foreign companies actual ownership in violation of Mexico's Constitution. The contracts will be auctioned in three stages, starting with mature fields whose reserves have been mostly depleted, then with Chicontepec whose geology makes extraction difficult, and then finally for deep waters, where Pemex is most in need of foreign technology. Even though delays continue in this program with stage two postponed till 2012 and stage three not likely till 2013, the first incentive contracts for mature fields were successfully auctioned this year. It had been widely assumed that multinational firms would have no interest in developing small mature fields. Moreover, many observers thought that multinationals would have little interest in participating at all, not even in the deep water fields, since they could drill for oil instead in other countries which allow equity participation. Thus, it comes as a pleasant surprise that multinationals participated in stage 1 and that one contract was won by Schlumberger Ltd., the world´s largest oilfield-services provider.

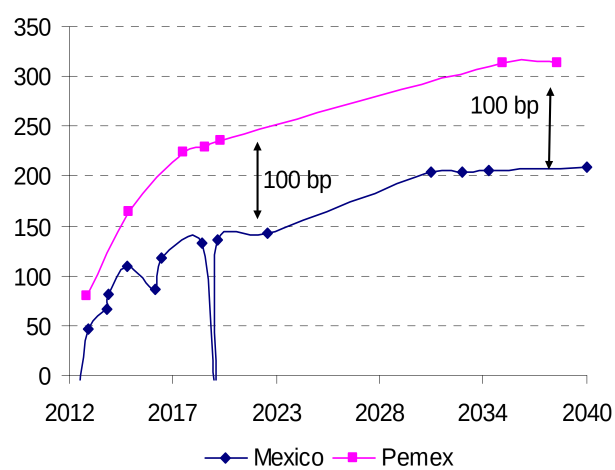
We would not put much faith in recent discussions in the press about a possible privatization of Pemex, including remarks from the PRI's presidential candidate. While some in the party may be supportive of private-public partnerships in certain downstream activities and perhaps a privatization of certain activities related to distribution, we don't think there is serious support in the party for a privatization of exploration, which is what many foreign bondholders might like to see at this time as a way to boost Pemex reserves.

Figure 1. Evolution of spread over sovereign



Source: Bloomberg, Scotia Capital

Figure 2. Pemex vs. UMS curve



Source: Bloomberg, Scotia Capital

Market pricing versus the sovereign

Most other factors about the company remain the same. Taxes and royalties which exceed 50% of Pemex revenues continue to absorb all of Pemex's profits, leaving the firm with marginally negative equity on its balance sheet. Yet, we insist that the fact that Pemex is owned by the government and provides about 30% of government revenue makes these traditional measures of corporate debt sustainability inappropriate. To the extent that the government and Congress frequently review the structure of Pemex taxes and royalties and make adjustments, we would think that under most scenarios taxes would be reduced as necessary to ensure timely debt service. Surely, the government would prefer to receive slightly less in taxes than risk having its key revenue generator plunged into bankruptcy. A bankruptcy would put all oil revenue at risk, embarrass an employer of 147,000 unionized workers, and destroy a symbol of national pride. In fact, the greater than 50% tax rate means to us that the company could absorb at least a 50% drop in world oil prices, which speaks to Pemex's low costs of oil extraction.

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Markets have not paid much attention to the positive fundamental news, however. Instead, spreads over sovereign remained stable at around 80-90bp in the two-year period ending this summer (Figure 1). More recently, they have risen to about 100bp as global volatility has negatively affected spread products (Figure 2). In this case, both Pemex and Mexico sovereign bonds actually did quite well on a price basis, thanks to the drop in US Treasury yields, but nevertheless the episode confirms what we think is the tradeoff in investing in Pemex bonds as opposed to buying sovereign bonds: On a fundamental basis, we think the 50% to 75% spread premium on Pemex bonds over the spread on the sovereign bonds exceeds the risk of a selective default (Pemex pays an additional 100bp over the 130bp to 210bp spread to US Treasuries on the sovereign bonds.) Nevertheless, history suggests that on a short-term mark-to-market basis, the bonds can also be more volatile and will underperform the sovereign bonds in times of extreme global uncertainty.

With Pemex fundamentals continuing to evolve rather slowly, changes in the spread over sovereign may come from the demand for quasi-sovereign debt among an expanding global investor base. The Mexican government and some of Mexico's largest companies have made efforts in recent years to diversify their funding sources, seeking out long-term investors in Asia for example. Pemex itself recently completed a GDN-issue, placing local currency instruments in the hands of global investors in what was the first issuance of a GDN by any corporate in the world. We have yet to see how newer emerging market investors will weigh sovereign vs. quasi sovereign risk and whether they will respond to the Pemex's improving fundamentals.

Endnotes:

[1]"Rocks for jocks: A Wall St. guide to Pemex," Scotia Capital, April 20, 2010.
[2] A replacement rate of 100% would signify that Pemex is finding enough new oil to compensate for the oil it is extracting, making stable oil production likely.

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Outlook For Europe

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.

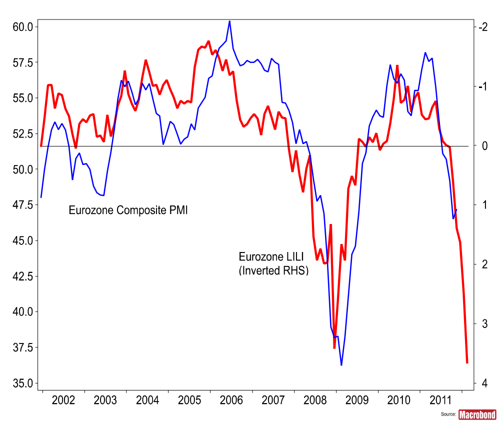
Best worst-case scenario: Significant contagion from the periphery to the core as European leaders fail to restore confidence. This would involve a sharp tightening in monetary conditions in bigger nations as equity markets plunge, a significant bear flattening in the yield curve occurs and BOR-OIS spreads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



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10 Themes For 2012

- Based on our forecasts, equity total returns (9%) are expected to exceed bonds and cash in 2012. However, the high level of Euro uncertainty and weaker Chinese data expected through 1H12 warrants a modest equity overweight stance to kick off 2012.
- We have been recommending a U.S. over EM preference in both 2010 and 2011 and are sticking with this stance for the early part of 2012. Canada's TSX could lag the S&P500 in 1H12 and outperform emerging markets.
- Materials and Energy are rated underweight in light of persistent global growth/China worries expected through the first half.
- Our 2012 objective will be to raise cyclical exposure as easing monetary policy is extended, China's PMI index bottoms, and the S&P500 settles above its 200-day average.

Global Portfolio Strategy Outlook — 2012

Exhibit 1 - Scotia Capital Asset Mix - Q1-2012

	Asset Mix Benchmark	Asset Mix Recommended	Overweight/ Underweight	Expected Total Return Next 12-M
Equities	**60%**	**62%**	**+12%**	**9%**
Canada (TSX)	*5%*	*6%*	+1%	**8%**
U.S. (S&P 500)	*20%*	*22%*	+2%	**10%**
Int'l (Europe, Japan)	*18%*	*19%*	+1%	**8%**
EM-Asia	*10%*	*9%*	-1%	**8%**
EM-LatAm	*7%*	*6%*	-1%	**6%**
Bonds	**40%**	**36%**	**-12%**	**0%**
Government	*30%*	*22%*	-8%	*0%*
Corporate	*10%*	*14%*	+4%	*1%*
Cash (91-D Tbills)	**0%**	**2%**	**0%**	**1%**

Source: Scotia Capital estimates

Exhibit 2 - TSX Sector Strategy - Q1-2012

Sectors	Recommendation
Energy (Integrated over Producers)	Underweight
Materials (Fertilizers, Golds, Mining)	Underweight
Industrials	Overweight
Discretionary	Underweight
Staples	Overweight
Healthcare	Marketweight
Financials (Banks over Insurance)	Overweight
Technology	Overweight
Telecoms (Telco over Cables)	Overweight
Utilities	Marketweight

Source: Scotia Capital

Exhibit 3: Scotia Capital Financial Forecasts

Forecasts	2009	2010	2011 E	2012 E	2013E
		Equity			
S&P/TSX	11,746	13,443	***12,100***	**13,250**	
EPS	600	700	**900**	**925**	**975**
S&P 500	1,115	1,258	***1,250***	**1,375**	
EPS	57	83	**98**	**100**	**105**
Bolsa	32,121	38,551	***37,000***	**40,000**	
Bovespa	68588	69,305	***58,500***	**65,000**	

Source: Scotia Capital estimates

10 themes for 2012

- **1-Synchronized easing should be the norm in 2012**. EM central banks should do most of the visible easing in 2012 as China, Brazil, and India unwind part of their 2010-2011 rate hikes. Since last September, our Global Central Bank Monitor has dipped below 0, signalling an easing shift. Monetary policy works with lags and investors should not expect tangible impacts from the recent easing shift until 2H12. Still, reverting back into "easing" territory should help the equity risk-reward outlook as the year unfolds.

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- **2-China growth risks could trump EU debt worries**. European risks have attracted most of the attention in the second half of 2011, but the extent of China's slowdown should be front-and-centre early in 2012. Commodity-sensitive markets could experience volatility until China's manufacturing data bottoms.
- **3-TSX, EM & LatAm indices could regain leadership in 2H12**. Risk appetite could recover once broader easing measures are implemented in China. EM and LatAm indices have trailed the S&P500 in the last 24 months as China/Brazil/India tightening policy intensified. China is likely to pursue selective easing in the near term with broader measures (lending rate cut) potentially coming in later. A shift in China monetary policy could thus trigger a leadership change in 2H12, a few months after rate cuts are implemented.
- **4-U.S. political cycle focus** could also take the spotlight away from Europe as the November 2012 Presidential elections draw closer. Since 1928, U.S. GDP growth has been the strongest during election years and the S&P500 has posted the 2nd best of year in election cycles. Pre-election years have exhibited the strongest returns for the S&P500 with an average gain of 13.5%. 2011 was a pre-election year and did not live up to expectations.
- **5-Modest post-crisis P/E expansion.** For equity investors, 2011 has been a frustrating year and eroding valuations tops the list of complaints. In the last 12 months, MSCI World AC EPS growth of 9% has been offset by forward P/E declining 2.0x (-16%). The ongoing uninterrupted stretch of P/E contraction (28 months; since September 2009) is the second longest in almost 25 years after the 2000-2003 episode. Historically, forward P/E expansion has occurred in post-crisis times and/or coming out of recessions.
- **6-Keep your eyes on earnings.** Confusing slower U.S. growth with recession scenarios has been the norm since 2009 and this trend should continue into next year. Debt fuelled recessions give way to slower recoveries as deleveraging lingers on, but sub-par U.S. economic growth forecasts for 2012/2013 could still generate earnings upside. The trend in the U.S. LEI doesn't foreshadow an outright decline in earnings and improving capacity utilization also points to elevated margins. Should forward earnings expectations bottom and revert higher, theme #5 (P/E expansion) could materialize quicker.
- **7-Monitoring U.S. weekly jobless claims** has made it into our "10 Themes" list since 2010 and we continue to believe it should be on investor's radar screens. As long as jobless claims improve, our S&P500 earnings bias will remain positive. Reversals in jobless claims have coincided with every U.S. recession since 1969. Jobless claims have averaged 399k in Q4-2011 versus 459k in 2010.
- **8-Euro crisis heading north**. Europe's Mediterranean members have been at the forefront of concerns since 2010, but the pressure has recently migrated North. German flexibility is at the core of successfully dealing with the European sovereign debt crisis in 2012 as plans for fiscal integration and a larger ECB role could alleviate market fears and bring funding costs down. Bickering between Germany, France, and the U.K. have been the latest blow to confidence and are indicative late-stage crisis development, in our view.
- **9-Still a beta market, focus on tacticals**. Elevated correlations between asset classes and sectors should be the norm as long as macro headwinds prevail. Negative real interest rates also support a beta-driven market. In this context, sporadic cyclicals/defensive leadership cycles should continue and tactical focus should edge buy-and-hold strategies. We expect equity signals to improve in coming months, but our tactical indicators are pointing to a neutral asset mix stance and cyclical bias to start 2012.
- **10-DXY strength in 1H12 and WTI weakness**. The USD posted modest gains in 2011 as EU growth fears and easing policy shift in emerging markets helped the DXY index to a 2.0% return in 2011. Since 2004, the DXY has been down in 4 of the last 8 years. EUR pressure could continue in coming months and LatAm/EM easing could support the USD. In the absence of USD weakness, commodities prices will be hard pressed to rally, especially with building China uncertainties. Copper has already declined 30% from its 2011 peak (4.63 in Feb-2011), but oil prices (WTI/Brent -17% from 2011 peak) appear more vulnerable entering 2012.

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Small Cap Outlook For 2012

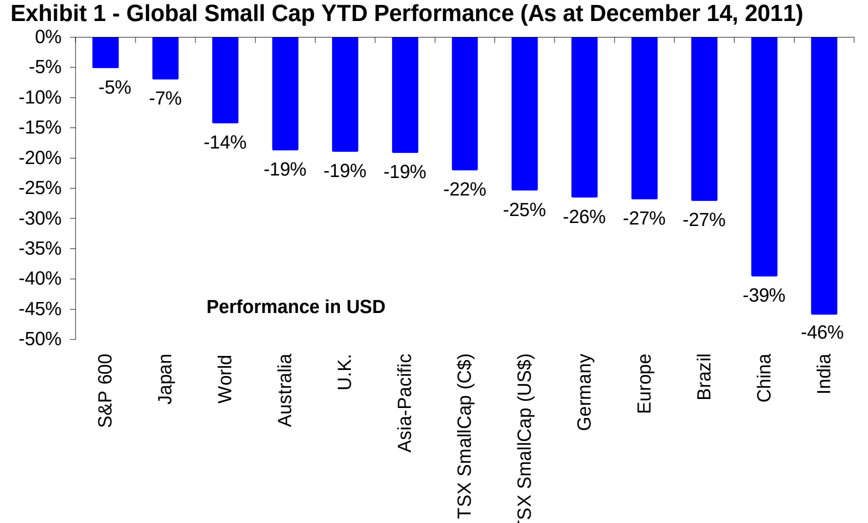
Uncertainties and Politics Sink Small Caps in 2011

- This year has been quite challenging for investors, who had to navigate through economic and politic uncertainties. The lack of political leadership in both the U.S. and Europe made an already difficult situation worse, leading to sustained equity outflows, sharp P/E erosion, and negative earnings revisions. With investors running for shelter, small caps had a tough year. The MSCI World Small Cap (SC) plunged 14% in 2011, its worst decline since 2008 (-47.9%). The S&P 600 is off 5% YTD, and the TSX SmallCap is down 22% (-25% in USD). Most global small cap benchmarks are currently standing in bear market territory, with declines in excess of 20% from their 2011 peak levels.

Economic Pulse: Challenging Macro Outlook

- 2012 is shaping up to be another challenging year. The deleveraging process in developed countries should continue alongside fiscal restraints, keeping the pace of economic expansion in 2012 well below historical averages. Emerging economies are cooling down as well, impacted by the European slowdown and two years of monetary tightening. Clearly, the world economy is entering 2012 on shaky ground. However, global monetary easing should accelerate and spread to a growing number of countries in 2012, and economic momentum should improve in the second half of the year.

Exhibit 1 - Global Small Cap YTD Performance (As at December 14, 2011)



Based on MSCI indices, except for Canada (TSX SmallCap) and the U.S. (S&P 600).
Source: Scotia Capital, Bloomberg

2012 Outlook for Small Caps

- Although 2012 offers relatively weak economic prospects, we believe small cap equities should nevertheless generate positive returns. As witnessed since 2008, economic and equity performances are far from being perfectly correlated. A mix of earnings growth and modest P/E expansion should underpin positive equity performance next year. Moreover, M&A activity should pick up steam, which should support equity prices. **We would expect Canadian and U.S. small caps to deliver low double-digit total returns in 2012 (based on current levels), with a slight advantage for Canada.**
- These positive factors should be somewhat offset by further negative earnings revisions, rising bond yields, and weak appetite for small caps. We believe the global macro environment will continue to drive equity markets in 2012, suggesting that asset/sector correlation is likely to stay high and volatility above average. Hence, elevated correlation should make alpha generation difficult and above-average volatility is suggesting that investors should take advantage of risk-on/risk-off windows to generate superior returns.
- We still prefer U.S. small caps over Canadian small caps entering 2012, but leadership should turn in Canada's favor when China adopts a full-scale monetary easing policy.
- **Large over small**. In terms of size, we continue to prefer large caps (larger small caps) over small caps. Elevated volatility, lack of appetite for smaller capitalization stocks, and a deflating valuation premium relative to large caps should translate into small cap underperformance next year.

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Key Data Preview

CANADA

There are three major data reports out of Canada this week that should garner some market attention. First up, Canadian inflation (November) should remain relatively stable in November although be careful when looking at the numbers that flash on your Bloomberg screens as these are not seasonally adjusted. As a result, seasonal factors such as higher auto prices, reflecting the introduction of new car models, and higher vegetable prices will have a larger impact on the reported numbers than the seasonally adjusted results. Nonetheless, we should also witness a further increase in replacement costs as house-only prices continue to increase while a decline in gasoline prices should offset this strength leading to only a modest gain on both the headline and core. This should keep headline inflation below 3% y/y while core should continue to hover around 2% y/y. Going forward, however, after elevated month-over-month gains in CPI in the first five months of 2011, the year-over-year rate in Canada should really start to fall off starting with the January CPI release, in line with the BoC's recent forecast for more modest inflation growth in 2012. Having said that, their forecast for headline CPI to fall to 1.0% y/y by Q2 contrasts with our own estimate of 1.6% y/y. Nonetheless, while Canadian inflation is currently below that of the US, the two rates will likely cross by mid-year after stronger monthly gains in US inflation last year result in larger year-over-year declines this year.

Retail sales (Wednesday) will be next in line with another decent print, especially on the headline, as auto sales surged ahead once again in October. Indeed, new auto sale volumes jumped 3.3% m/m during the month while auto prices increased further, according to the October CPI report. Core sales should also post a decent gain as prices for clothing and furniture continued to increase on the month. Should this come to fruition, this would mark the third solid retail sales report. What will matter even more, however, are the price-adjusted results which have also been quite strong but we wouldn't rule out another modest gain, especially given the decent jump in auto volumes on the month. This would support Q4 GDP growth and also suggests that only modest further gains would be needed to post a gain on the quarter.

Lastly, we will obtain the results for October GDP. While we are only able to normally observe about 2/3rds of the economy via leading indicators in any given month, our estimate at this juncture will also be made without two major inputs into our GDP model — price-adjusted wholesale sales and retail sales which will be released next Monday and Wednesday, respectively. Nonetheless, what we do know is that housing starts were flat in October as single-family starts plunged 8.2% m/m while multi-family starts rose 2.3%, suggesting a downward bias from this indicator as singles tend to have a larger impact on GDP. We also know that real manufacturing shipments fell by 0.9% after three months of gains, real exports plummeted by 1.4% m/m while aggregate hours worked slipped a further 0.2% m/m. While these results would suggest a negative print for real GDP in October, a modest gain in price-adjusted retail sales (as suggested in the preview above) and a flat print for price-adjusted wholesale sales could point to a 0.1% m/m increase in real GDP in October.

UNITED STATES

There are also several US data releases out next week with a focus on housing, income/spending and durable goods. On the housing front, we continue to expect modest improvements in homebuilder confidence (Monday) in December, along with housing starts/permits (Tuesday), existing home sales (Wednesday) and new home sales (Friday) in November. Indeed, prospective buyers traffic has started to pick up once again, a decent indicator for new home sales, while MBA purchase applications witnessed a strong upward trend through the month of November. Months' supply for new home sales has also continued to decline, currently sitting at the lowest level since April 2010, likely spurring on some home construction despite still elevated inventory levels for existing homes. Indeed, while foreclosure filings have leveled off somewhat, they still remain quite elevated.

Durable goods orders (November) are expected to rebound in November after a decline the previous two months as Boeing aircraft orders jumped substantially during the month. However, a strong increase in auto orders in October could temper gains in the transportation sector this month and limit headline durable orders for the month. Watch the non-defense capital goods orders ex-aircraft print, a decent measure for business investment, which went sharply negative in October.

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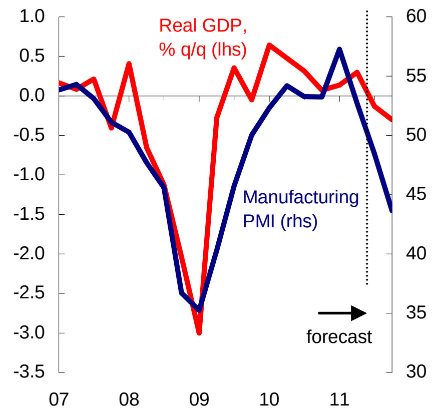
EUROPE

Italian third-quarter GDP data will be released next Wednesday, and we expect the report to show that output growth slowed to 0.4% y/y from 1.0% and 0.8% in the first and second quarters, respectively. This result will mark the first quarterly contraction (-0.1% q/q) since the second quarter of 2009. Unemployment increased in the third quarter, up from an average of 8.0% in April-June to 8.1% in July-September. Industrial production and retail sales also turned increasingly negative in the quarter, as consumer and business confidence was battered by the intensifying debt, financial and political crises in the euro zone. Quarterly GDP is well correlated with the Italian manufacturing PMI, which shrank from an average of 52.7 in the second quarter to 48.5 in the third quarter (see chart). Further deterioration in the PMI in October and November points to a deeper output contraction in the final quarter of this year. Moreover, with bond yields still elevated near the 6.5% mark, financial market pressure for accelerated fiscal austerity measures will extend the recession. We anticipate successive GDP declines through at least mid-2012, implying an overall loss of around 1% next year.

Italian GDP and PMI

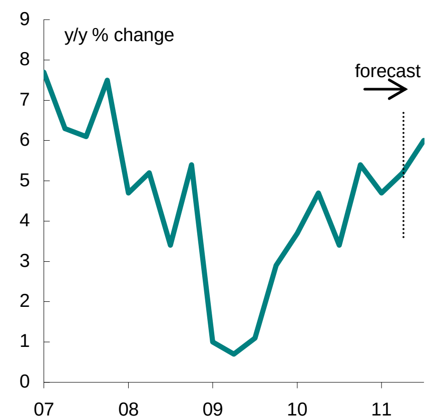


Source: Bloomberg, Scotia Economics.

LATIN AMERICA

Colombia has been one of the most dynamic economies in the region. The nation is expected to post growth of 6.0% y/y in the third quarter GDP report, to be released next week (December 22nd). Colombia has displayed a promising economic and financial outlook in recent months, fuelled by strong local consumption. Retail sales, goods imports, employment and consumer credit remain buoyant, helping the country's output to weather the global slowdown (the effect of which has yet to be observed). However, inflationary pressures have emerged caused by higher food prices, prompting the central bank to restart its monetary policy tightening cycle in late November. We expect Colombian GDP to increase by 5.5% y/y in 2011 and by 5.0% on average over 2012/2013.

Colombia GDP

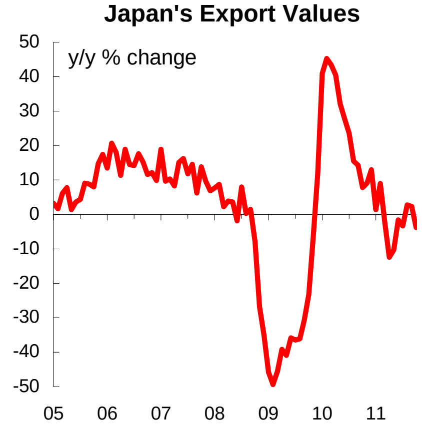


Source: Bloomberg, Scotia Economics.

ASIA

Japan's merchandise trade figures will be reported next week. The latest October reading on export values was disappointingly low, breaking the recovery path registered through the third quarter with a 3.8% y/y contraction in shipment values. The fallout is attributed at least partly to the effects of excessive flooding in Thailand, which backtracked manufacturing conditions for several Japanese automakers and electronic parts suppliers. Latest reports point to a normalization of assembly lines, leading to an expectation of improving output performance towards the end of the year. We could see part of the gains in the November figures. Yen strength has been the other element that has altered the prospects of Japanese manufacturers recently. The safe-haven status of the currency is damaging the profit outlook with some of the effects already visible in the latest quarterly tankan survey. While the competitiveness factor will continue to alter the conditions under which an industrial rebound in Japan will play out, we believe that the country will continue to benefit from the momentum of the Asian expansion. We therefore expect November export values to display a rebound back towards positive yearly gains, specifically, a 2% y/y advance.

Japan's Export Values



Source: Ministry of Trade and Industry, Japan.

Key Indicators for the week of December 19 - 23

North America

Country	Date	Time	Event	Period	BNS	Consensus	Latest
CA	12/19	08:30	Wholesale Sales (MoM)	OCT	0.2	0.1	0.3
US	12/19	10:00	NAHB Housing Market Index	DEC	21.0	20.0	20.0
CA	12/20	07:00	Consumer Price Index (MoM)	NOV	0.1	0.1	0.2
CA	12/20	07:00	Consumer Price Index (YoY)	NOV	2.9	2.9	2.9
CA	12/20	07:00	Bank Canada CPI Core (MoM)	NOV	0.1	0.1	0.3
CA	12/20	07:00	Bank Canada CPI Core (YoY)	NOV	2.2	2.2	2.1
US	12/20	08:30	Housing Starts (000s)	NOV	640	630	628
US	12/20	08:30	Housing Starts (MoM)	NOV	2.0	0.3	-0.3
US	12/20	08:30	Building Permits (000s)	NOV	650	635	644
US	12/20	08:30	Building Permits (MoM)	NOV	0.9	-1.4	9.3
MX	12/20	09:00	Retail Sales (YoY) (INEGI)	OCT	4.4	--	4.7
US	12/21	07:00	MBA Mortgage Applications (WoW)	16-Dec	--	--	4.1
CA	12/21	08:30	Retail Sales (MoM)	OCT	0.5	0.4	1.0
CA	12/21	08:30	Retail Sales Less Autos (MoM)	OCT	2.0	0.2	0.5
MX	12/21	09:00	Aggregate Supply & Demand (YoY)	3Q	6.2	--	4.2
US	12/21	10:00	Existing Home Sales (millions)	NOV	5.15	5.07	4.97
US	12/21	10:00	Existing Home Sales (MoM)	NOV	3.6	2.1	1.4
US	12/22	08:30	Chicago Fed Nat Activity Index	NOV	--	--	-0.1
US	12/22	08:30	GDP (QoQ) (Annualized)	3Q T	2.0	2.0	2.0
US	12/22	08:30	Personal Consumption (QoQ)	3Q T	--	2.3	2.3
US	12/22	08:30	GDP Price Index (QoQ)	3Q T	--	2.5	2.5
US	12/22	08:30	Core PCE (QoQ)	3Q T	--	2.0	2.0
US	12/22	08:30	Initial Jobless Claims (000s)	16-Dec	380	375	366
US	12/22	08:30	Continuing Claims (000s)	9-Dec	3600	--	3603
MX	12/22	09:00	Bi-Weekly CPI (MoM)	15-Dec	0.19	--	0.17
MX	12/22	09:00	Unemployment Rate	NOV	5.3	5.0	5.0
MX	12/22	09:00	Bi-Weekly Core CPI (MoM)	15-Dec	--	--	0.1
US	12/22	09:55	U. of Michigan Confidence	DEC F	--	68.0	67.7
US	12/22	10:00	Leading Indicators (MoM)	NOV	--	0.3	0.9
US	12/22	10:00	House Price Index (MoM)	OCT	--	0.2	0.9
CA	12/23	08:30	Gross Domestic Product (MoM)	OCT	0.1	0.0	0.2
US	12/23	08:30	Durable Goods Orders (MoM)	NOV	1.7	2.2	-0.5
US	12/23	08:30	Durables Ex Transportation (MoM)	NOV	0.5	0.4	1.1
US	12/23	08:30	Cap Goods Orders Nondef Ex Air (MoM)	NOV	--	0.9	-0.8
US	12/23	08:30	Personal Income (MoM)	NOV	0.1	0.3	0.4
US	12/23	08:30	Personal Spending (MoM)	NOV	0.2	0.3	0.1
US	12/23	08:30	PCE Deflator (YoY)	NOV	--	2.7	2.7
US	12/23	08:30	PCE Core (MoM)	NOV	--	0.1	0.1
US	12/23	08:30	PCE Core (YoY)	NOV	--	1.7	1.7
MX	12/23	09:00	Trade Balance (USD millions)	NOV P	--	--	-466.4
US	12/23	10:00	New Home Sales (000s)	NOV	315	313	307
US	12/23	10:00	New Home Sales (MoM)	NOV	2.6	2.0	1.3

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

Key Indicators for the week of December 19 - 23

Europe

Country	Date	Time	Event	Period	BNS	Consensus	Latest
UK	12/18	19:01	Rightmove House Prices (MoM)	DEC	--	--	-3.1
EC	12/19	04:00	ECB Euro-Zone Current Account SA (EUR billions)	OCT	--	--	0.5
IT	12/19	04:00	Trade Balance (Total) (EUR billions)	OCT	--	--	-1840.0
EC	12/19	05:00	Construction Output SA (MoM)	OCT	--	--	-1.3
UK	12/19	19:01	GfK Consumer Confidence Survey	DEC	-28.0	-32.0	-31.0
UK	12/19	19:01	Nationwide Consumer Confidence	NOV	--	36.0	36.0
GE	12/20	02:00	GfK Consumer Confidence Survey	JAN	5.7	5.5	5.6
GE	12/20	02:00	Producer Prices (MoM)	NOV	--	0.1	0.2
SW	12/20	03:30	**Riksbank Interest Rate**		**2.00**	**1.75**	**2.00**
GE	12/20	04:00	IFO - Business Climate	DEC	106.3	106.0	106.6
GE	12/20	04:00	IFO - Current Assessment	DEC	115.5	116.0	116.7
GE	12/20	04:00	IFO - Expectations	DEC	97.0	97.0	97.3
IT	12/20	04:00	Industrial Orders s.a. (MoM)	OCT	--	-1.3	-8.3
IT	12/20	04:00	Industrial Sales s.a. (MoM)	OCT	--	--	-5.4
UK	12/20	06:00	CBI Reported Sales	DEC	--	-11.5	-19.0
PO	12/20		Producer Prices (MoM)	NOV	--	--	-0.3
SP	12/20		Spain Budget Balance YtD (EUR billions)	NOV	--	--	-40.1
SW	12/21	03:00	Consumer Confidence	DEC	--	-8.0	-7.4
SW	12/21	03:00	Manufacturing Confidence s.a.	DEC	--	-14.0	-12.0
IT	12/21	04:00	GDP sa and wda (QoQ)	3Q F	-0.1	-0.1	0.3
IT	12/21	04:00	GDP sa and wda (YoY)	3Q F	0.4	0.4	0.8
UK	12/21	04:30	Bank of England Minutes				
UK	12/21	04:30	Public Finances (PSNCR) (GBP billions)	NOV	--	10.3	-0.6
UK	12/21	04:30	PSNB ex Interventions (GBP billions)	NOV	20.0	19.7	6.5
UK	12/21	04:30	Public Sector Net Borrowing (GBP billions)	NOV	--	16.6	3.4
EC	12/21	10:00	Euro-Zone Consumer Confidence	DEC A	-20.0	-21.0	-20.4
NO	12/22	03:00	Unemployment Rate	DEC	--	2.4	2.4
SP	12/22	03:00	Total Housing Permits (MoM)	OCT	--	--	71.9
SW	12/22	03:30	PPI (MoM)	NOV	--	0.5	-0.3
IT	12/22	04:00	Retail Sales s.a. (MoM)	OCT	--	-0.2	-0.4
UK	12/22	04:30	GDP (QoQ)	3Q F	0.5	0.5	0.5
UK	12/22	04:30	Total Business Investment(QoQ)	3Q F	--	-1.4	-1.4
UK	12/22	04:30	Current Account (GBP billions)	3Q	--	-6.1	-2.0
SP	12/22		Trade Balance (Mln Euros)	OCT	--	--	-4853.0
RU	12/23		**Refinancing Rate**		**8.25**	--	**8.25**
FR	12/23	01:30	Gross Domestic Product (QoQ)	3Q F	0.4	0.4	0.4
FR	12/23	02:45	Producer Prices (MoM)	NOV	--	0.0	0.5
SP	12/23	03:00	Producer Prices (MoM)	NOV	--	--	0.0
IT	12/23	04:00	Hourly Wages (MoM)	NOV	--	--	0.0
UK	12/23	04:30	Index of Services (MoM)	OCT	-0.2	-0.1	0.1
IT	12/23	05:00	Consumer Confidence Index sa	DEC	--	95.5	96.5

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

Key Indicators for the week of December 19 - 23

Asia Pacific

Country	Date	Time	Event	Period	BNS	Consensus	Latest
HK	DEC 18-19		Composite Interest Rate	NOV	--	--	0.43
PH	DEC 18-19		Balance of Payments (USD millions)	NOV	--	--	208.0
PH	DEC 18-23		Budget Deficit/Surplus (PHP billions)	NOV	--	--	-21.3
JN	12/19	00:30	Nationwide Dept. Sales (YoY)	NOV	--	--	-0.5
JN	12/19	00:30	Tokyo Dept. Store Sales (YoY)	NOV	--	--	-1.9
HK	12/19	03:30	Unemployment Rate SA	NOV	--	--	3.3
AU	12/19	18:00	Conference Board Leading Index	OCT	--	--	0.1
AU	12/19	19:30	Reserve Bank's Board December Minutes				
TH	DEC 19-23		Customs Exports (YoY)	NOV	2.4	--	0.3
TH	DEC 19-23		Customs Imports (YoY)	NOV	17.2	--	21.5
TH	DEC 19-23		Customs Trade Balance (USD millions)	NOV	500.0	--	-1009.1
JN	12/20		Leading Index CI	OCT F	--	--	91.5
JN	12/20		Coincident Index CI	OCT F	--	--	90.3
TA	12/20	03:00	Export Orders (YoY)	NOV	--	2.4	4.4
HK	12/20	03:30	CPI - Composite Index (YoY)	NOV	--	--	5.8
NZ	12/20	16:45	Current Account Balance (NZD billions)	3Q	--	-3.8	-0.9
NZ	12/20	16:45	Net Migration SA	NOV	--	--	-650
JN	12/20	18:50	Adjusted Merchnds Trade Bal. (JPY billions)	NOV	-250.0	-305.7	-457.9
JN	12/20	18:50	Merchnds Trade Exports (YoY)	NOV	2.0	-4.3	-3.8
JN	12/20	18:50	Merchnds Trade Imports (YoY)	NOV	9.8	8.3	17.9
JN	DEC 20-21		**BOJ Target Rate**		**0.10**	**0.10**	**0.10**
MA	12/21	04:00	CPI (YoY)	NOV	--	3.3	3.4
NZ	12/21	16:45	GDP (QoQ)	3Q	--	0.6	0.1
TA	12/22	03:00	Unemployment Rate - sa	NOV	--	4.3	4.3
HK	12/22	03:30	Bal of Paymts - Current A/C (HKD billions)	3Q	--	--	4.6
HK	12/22	03:30	Bal of Paymts - Overall (HKD billions)	3Q	--	--	19.6
TA	12/23	03:00	Industrial Production (YoY)	NOV	--	-2.8	1.4

Latin America

Country	Date	Time	Event	Period	BNS	Consensus	Latest
BZ	12/19	05:30	Central Bank Weekly Economists Survey				
BZ	12/19	08:00	Trade Balance (FOB) - Weekly (USD millions)	18-Dec	--	--	-730.0
CO	12/19	16:00	Industrial Production (YoY)	OCT	--	4.2	5.2
CO	12/19	16:00	Retail Sales (YoY)	OCT	--	8.7	8.1
BZ	DEC 19-23		Economic Activity Indx (MoM) SA	OCT	--	--	-0.3
BZ	DEC 19-23		Economic Activity Indx (YoY) NSA	OCT	--	--	0.7
BZ	12/20	07:30	Current Account - Monthly (USD millions)	NOV	--	--	-3108.6
BZ	12/20	07:30	Foreign Investment (USD millions)	NOV	--	--	5550.0
BZ	12/21	06:00	IBGE CPI IPCA-15 (MoM)	DEC	--	0.5	0.5
BZ	12/21	09:30	Central Bank Posts Currency Flows' Data for Prev. Week				
BZ	12/22	06:00	Unemployment Rate	NOV	--	5.7	5.8
BZ	12/22	07:30	Outstanding Loans (MoM) %	NOV	--	--	0.8
BZ	12/22	07:30	Private Banks Lending (BRL billions)	NOV	--	--	1118.2
CO	12/22	11:00	GDP (YoY)	3Q	6.0	6.0	5.2

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

Global Auctions for the week of December 19 - 23

North America

Country	Date	Time	Event
US	12/19	11:00	U.S. Fed to Purchase USD4.25-5.00 Bln Notes
US	12/19	11:30	U.S. to Sell 3-Month Bills
US	12/19	11:30	U.S. to Sell 6-Month Bills
US	12/19	13:00	U.S. to Sell 2-Year Notes
CA	12/20	10:30	Canada to Sell CAD4.875 Bln 98-Day Bills
CA	12/20	10:30	Canada to Sell CAD1.875 Bln 182-Day Bills
CA	12/20	10:30	Canada to Sell CAD1.875 Bln 364-Day Bills
US	12/20	11:00	U.S. Fed to Purchase USD2.25-2.75 Bln Notes
US	12/20	11:30	U.S. to Sell 4-Week Bills
US	12/20	13:00	U.S. to Sell 5-Year Notes
US	12/21	11:00	U.S. Fed to Sell USD8.00-8.75 Bln Notes
CA	12/21	12:00	Canada to Sell 2-Year Notes
US	12/21	13:00	U.S. to Sell 7-Year Notes
US	12/21	14:00	U.S. Fed to Sell USD8.00-8.75 Bln Notes
US	12/22	11:00	U.S. Fed to Purchase USD4.25-5.00 Bln Notes

Europe

Country	Date	Time	Event
NO	12/19	05:00	Norway to sell Bills
FR	12/19	09:00	France to Sell Bills
UK	DEC 19-23		U.K. to Sell 4.25% 2027 Bonds on Week Commencing Dec. 19
SP	12/20	04:30	Spain to Sell 3M and 6M Bills
GR	12/20	05:00	Greece to Sell Bills
SZ	12/20	05:30	Switzerland to Sell 3-Month Bills
SW	12/21	05:10	Sweden to Sell Bills
EC	12/21	05:15	ECB Announces Allotment in 3-Month Tender
EC	12/21	05:15	ECB Announces Allotment in 3-Year Refinancing Tender
PO	12/21	05:30	Portugal to Sell 3-Month Bills
EC	12/23	09:30	ECB Calls for Bids in 7-Day Main Refinancing Tender

Asia Pacific

Country	Date	Time	Event
JN	12/18	22:35	Japan to Sell 3-Month Bills
JN	12/20	03:00	Japan Auction for Enhanced-Liquidity
JN	12/21	22:45	Japan to Sell 2-Year Bond

Source: Bloomberg, Scotia Economics.

Events for the week of December 19 - 23

North America

Country	Date	Time	Event
US	12/19	12:30	Fed's Lacker, Bank of America's Moynihan to Speak in Charlotte
CA	12/19		Canadian Finance Ministers meet in Victoria, British Columbia

Europe

Country	Date	Time	Event
FR	12/19	02:45	ECB's Noyer Opens Bank of France Debt Crisis Conference
EC	12/19	10:30	ECB's Draghi Speaks to European Parliament Committee
EC	12/19	12:00	ECB Releases Financial Stability Review
SW	12/20	03:30	**Riksbank Interest Rate**
UK	12/21	04:30	Bank of England Releases Monetary Policy Committee Minutes
EC	12/21	18:00	European Systemic Risk Board meets in Frankfurt
RU	12/23		**Refinancing Rate**

Asia Pacific

Country	Date	Time	Event
AU	12/19	19:30	Reserve Bank's Board December Minutes
JN	20-21 DEC		**BOJ Target Rate**

Latin America

Country	Date	Time	Event
AR	12/19	22:00	Argentina Releases Results of the 2010 Census

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	January 17, 2012	1.00	--
Federal Reserve – Federal Funds Target Rate	0.25	January 25, 2012	0.25	--
Banco de México – Overnight Rate	4.50	January 20, 2012	4.50	--

Bank of Canada Governor Mark Carney spoke in Toronto this week, raising concerns once again that household debt in Canada remains at unsustainable levels. What he didn't mention, however, is that the pace of growth has slowed considerably as we discuss in our article titled "Why the Fixation on Canadian Household Debt-to-income". This is key for inflation going forward and is one reason why the BoC will likely remain on the sidelines until at least mid-2013. In the US, the Fed will hold steady through the end of the year with no further rate announcements expected and with the current FOMC voting committee expected to shift at the first FOMC meeting of 2012. Indeed, next year's voting committee will likely have a more dovish composition, providing some room for additional monetary policy easing should Fed Chairman Bernanke feel it necessary.

Europe

Rate	Current Rate	Next Meeting	Scotia's Forecasts	Consensus Forecasts
European Central Bank – Refinancing Rate	1.00	January 12, 2012	1.00	--
Bank of England – Bank Rate	0.50	January 12, 2012	0.50	0.50
Swiss National Bank – Libor Target Rate	0.00	March 15, 2012	0.00	--
Central Bank of Russia – Refinancing Rate	8.25	December 23, 2011	8.25	--
Hungarian National Bank – Base Rate	6.50	December 20, 2011	7.00	7.00
Central Bank of the Republic of Turkey – 1 Week Repo Rate	5.75	December 22, 2011	5.75	5.75

The central bank of Turkey will likely leave the reference rate at 5.75% next week. At the last meeting, the monetary authorities assessed the economy had begun to rebalance (between domestic and external demand) and that credit growth was moderating, thanks to the weakened lira and alternative monetary measures already implemented. Indeed, the current account deficit narrowed in October to US $4.2 billion (from $6.8 billion in September), though the 12-month rolling shortfall remains at a record $78.7 billion. Inflation jumped again in November (to 9.5% y/y from 7.7%), but the surge, driven by food price base effects and administered prices, is expected to be temporary and the rate should fall considerably in 2012. We expect the Hungarian central bank to raise interest rates with a second 50 basis point (bps) hike in as many months, bringing the policy rate to 7.00%. Although the forint has leveled off somewhat since the first hike (influenced by the announcement that the government would enter financial assistance talks with the IMF), bond yields and credit default swap spreads have begun to creep up again as investors incorporate a higher default risk premium. Furthermore, the inflation rate breached the bank's 3±1% tolerance range in November, measuring 4.3% y/y.

Asia Pacific

Rate	Current Rate	Next Meeting	Scotia's Forecasts	Consensus Forecasts
Bank of Japan – Target Rate	0.10	December 21, 2011	0.10	0.10
Reserve Bank of Australia – Cash Target Rate	4.25	February 6, 2012	4.25	4.00
Reserve Bank of New Zealand – Cash Rate	2.50	January 25, 2012	2.50	--
People's Bank of China – Lending Rate	6.56	TBA	--	--
Reserve Bank of India – Repo Rate	8.50	January 24, 2012	8.50	--
Hong Kong Monetary Authority – Base Rate	0.50	TBA	0.50	--
Central Bank of China Taiwan – Discount Rate	1.88	December 29, 2011	1.88	1.88
Bank Negara Malaysia – Overnight Policy Rate	3.00	January 31, 2012	3.00	--
Bank of Korea – Bank Rate	3.25	January 12, 2012	3.25	--
Bank of Thailand – Repo Rate	3.25	January 25, 2012	3.25	--
Bank Indonesia – Reference Interest Rate	6.00	January 12, 2012	6.00	--
Central Bank of the Philippines – Overnight Policy Rate	4.50	January 19, 2012	4.50	--

The Bank of Japan will likely keep the target rate constant after its monetary policy meeting next week. Although there is some chance of an enlargement of the central bank's bond buying program, we believe that this is slim given a global environment of persistent uncertainty. The monetary authorities are likely to step up credit injections once the global situation normalizes somewhat, so long as the yen remains strong.

Latin America

Rate	Current Rate	Next Meeting	Scotia's Forecasts	Consensus Forecasts
Banco Central do Brasil – Selic Rate	11.00	January 18, 2012	11.00	--
Banco Central de Chile – Overnight Rate	5.25	January 12, 2012	5.25	--
Banco de la República de Colombia – Lending Rate	4.75	TBA	4.75	--
Banco Central de Reserva del Perú – Reference Rate	4.25	January 5, 2012	4.25	--

Africa

Rate	Current Rate	Next Meeting	Scotia's Forecasts	Consensus Forecasts
South African Reserve Bank – Repo Rate	5.50	TBA	5.50	--

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

Forecasts as at December 1, 2011*	2000-10	2011f	2012f	2013f	2000-10	2011f	2012f	2013f
Output and Inflation (annual % change)		Real GDP				Consumer Prices[2]		
World[1]	3.7	3.8	3.7	4.0				
Canada	2.2	2.3	1.8	2.4	2.1	3.0	1.8	2.0
United States	1.8	1.8	1.8	2.2	2.5	3.2	1.8	2.1
Mexico	2.1	3.9	2.9	3.7	4.9	3.6	4.0	4.1
United Kingdom	1.9	0.8	0.8	1.8	2.1	4.4	2.1	2.5
Euro zone	1.4	1.6	0.0	1.3	2.1	2.6	1.5	1.8
Japan	0.9	0.1	3.2	1.8	-0.3	0.2	0.4	0.5
Australia	3.1	2.1	4.2	3.3	3.1	3.0	2.8	2.5
China	9.5	9.1	8.9	8.5	2.3	5.0	4.5	4.3
India	7.5	7.6	8.1	8.0	6.4	8.1	6.5	6.0
Korea	4.6	3.8	4.3	4.5	3.1	3.7	3.3	3.0
Thailand	4.1	2.8	3.5	4.5	2.6	3.5	3.0	2.8
Brazil	3.7	3.5	4.0	4.5	6.6	6.5	5.7	5.0
Chile	3.8	6.5	4.7	5.8	3.3	3.5	2.8	3.8
Peru	5.5	6.9	5.5	5.6	2.4	4.8	3.5	2.5
Central Bank Rates (%, end of period)	11Q4f	12Q1f	12Q2f	12Q3f	12Q4f	13Q1f	13Q2f	13Q3f
Bank of Canada	1.00	1.00	1.00	1.00	1.00	1.00	1.50	2.00
Federal Reserve	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.75
European Central Bank	1.00	0.75	0.75	0.75	0.75	0.75	0.75	1.00
Bank of England	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75
Swiss National Bank	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.25
Bank of Japan	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.25
Reserve Bank of Australia	4.50	4.25	4.25	4.25	4.25	4.25	4.50	4.50
Exchange Rates (end of period)								
Canadian Dollar (USDCAD)	1.04	1.02	1.01	0.99	0.98	0.98	0.97	0.97
Canadian Dollar (CADUSD)	0.96	0.98	0.99	1.01	1.02	1.02	1.03	1.03
Euro (EURUSD)	1.30	1.29	1.28	1.27	1.25	1.25	1.26	1.28
Sterling (GBPUSD)	1.55	1.56	1.59	1.62	1.63	1.65	1.66	1.67
Yen (USDJPY)	78	78	80	80	82	83	83	84
Australian Dollar (AUDUSD)	1.00	1.02	1.04	1.06	1.08	1.09	1.09	1.10
Chinese Yuan (USDCNY)	6.3	6.3	6.2	6.1	6.1	6.0	6.0	5.9
Mexican Peso (USDMXN)	13.5	13.5	13.2	13.0	13.0	13.1	13.2	13.3
Brazilian Real (USDBRL)	1.80	1.79	1.77	1.76	1.75	1.77	1.80	1.82

Commodities (annual average)	2000-10	2011f	2012f	2013f
WTI Oil (US$/bbl)	54	95	95	104
Brent Oil (US$/bbl)	52	111	108	110
Nymex Natural Gas (US$/mmbtu)	5.81	4.05	3.50	4.25
Copper (US$/lb)	1.93	4.00	4.00	3.50
Zinc (US$/lb)	0.75	0.99	0.99	1.10
Nickel (US$/lb)	7.36	10.35	9.00	8.00
Gold, London PM Fix (US$/oz)	586	1,565	1,675	1,600
Pulp (US$/tonne)	694	977	912	950
Newsprint (US$/tonne)	575	640	680	725
Lumber (US$/mfbm)	273	255	260	300

[1] World GDP for 2000-10 are IMF PPP estimates; 2011-13f 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.

* See Scotia Economics 'Global Forecast Update' (www.scotiacapital.com/English/bns_econ/forecast.pdf) for additional forecasts & commentary.

Canada	2010	11Q2	11Q3	Latest	
Real GDP (annual rates)	3.2	-0.5	3.5		
Current Acc. Bal. (C$B, ar)	-50.9	-64.5	-48.5		
Merch. Trade Bal. (C$B, ar)	-9.0	-13.9	1.8	-10.6	(Oct)
Industrial Production	4.9	2.4	3.5	5.2	(Sep)
Housing Starts (000s)	192	192	204	181	(Nov)
Employment	1.4	1.6	1.5	3.1	(Nov)
Unemployment Rate (%)	8.0	7.5	7.2	7.4	(Nov)
Retail Sales	5.5	4.1	4.1	4.2	(Sep)
Auto Sales (000s)	1561	1574	1604	1634	(Oct)
CPI	1.8	3.4	3.0	2.9	(Oct)
IPPI	1.0	5.1	5.3	-4.7	(Oct)
Pre-tax Corp. Profits	21.2	15.1	17.0		

Mexico					
Real GDP	5.4	3.2	4.5		
Current Acc. Bal. (US$B, ar)	-5.7	-11.9	-15.0		
Merch. Trade Bal. (US$B, ar)	-3.0	5.7	-15.3	-5.6	(Oct)
Industrial Production	6.0	3.5	3.4	3.3	(Oct)
CPI	4.2	3.3	3.4	7.5	(Nov)

Chile					
Real GDP	5.2	6.6	4.8		
Current Acc. Bal. (US$B, ar)	3.0	1.0	-11.6		
Merch. Trade Bal. (US$B, ar)	11.6	14.8	3.6	7.9	(Nov)
Industrial Production	0.5	7.8	2.4	-0.8	(Oct)
CPI	1.4	3.3	3.1	3.9	(Nov)

Germany					
Real GDP	3.6	2.9	2.6		
Current Acc. Bal. (US$B, ar)	188.2	156.6	169.8	169.6	(Oct)
Merch. Trade Bal. (US$B, ar)	201.9	212.0	225.3	207.2	(Oct)
Industrial Production	10.1	8.1	8.1	4.0	(Oct)
Unemployment Rate (%)	7.7	7.1	7.0	6.9	(Nov)
CPI	1.1	2.3	2.5	3.1	(Nov)

Euro Zone					
Real GDP	1.8	1.6	1.4		
Current Acc. Bal. (US$B, ar)	-77	-120	-66	-42	(Sep)
Merch. Trade Bal. (US$B, ar)	32.0	-15.3	5.7	35.5	(Sep)
Industrial Production	7.4	4.2	4.0	1.6	(Oct)
Unemployment Rate (%)	10.0	9.9	10.1	10.2	(Oct)
CPI	1.6	2.8	2.7	4.7	(Nov)

Japan					
Real GDP	4.5	-1.7	-0.8		
Current Acc. Bal. (US$B, ar)	195.9	75.4	153.5	87.9	(Oct)
Merch. Trade Bal. (US$B, ar)	74.6	-54.0	-29.3	-71.6	(Oct)
Industrial Production	16.6	-7.0	-2.0	0.1	(Oct)
Unemployment Rate (%)	5.1	4.6	4.4	4.5	(Oct)
CPI	-0.7	-0.4	0.1	-0.2	(Oct)

China					
Real GDP	10.4	9.5	9.1		
Current Acc. Bal. (US$B, ar)	305.4				
Merch. Trade Bal. (US$B, ar)	181.5	185.9	250.5	174.3	(Nov)
Industrial Production	13.5	15.1	13.8	12.4	(Nov)
CPI	4.6	6.4	6.1	4.2	(Nov)

United States	2010	11Q2	11Q3	Latest	
Real GDP (annual rates)	3.0	1.3	2.0		
Current Acc. Bal. (US$B, ar)	-471	-499	-441		
Merch. Trade Bal. (US$B, ar)	-646	-762	-727	-705	(Oct)
Industrial Production	5.3	3.8	3.7	8.5	(Nov)
Housing Starts (millions)	0.58	0.57	0.61	0.63	(Oct)
Employment	-0.8	0.9	1.1	2.1	(Nov)
Unemployment Rate (%)	9.6	9.1	9.1	8.6	(Nov)
Retail Sales	6.8	8.1	8.3	14.6	(Nov)
Auto Sales (millions)	11.6	12.1	12.4	13.6	(Nov)
CPI	1.6	3.4	3.8	4.8	(Nov)
PPI	4.2	6.9	6.8	9.1	(Nov)
Pre-tax Corp. Profits	25.0	1.3	4.2		

Brazil					
Real GDP	6.9	2.9	2.0		
Current Acc. Bal. (US$B, ar)	-47.4	-43.4	-42.2		
Merch. Trade Bal. (US$B, ar)	20.2	39.3	40.3	7.0	(Nov)
Industrial Production	10.5	0.6	0.1	-2.7	(Oct)
CPI	5.1	6.5	7.1	12.5	(Nov)

Italy					
Real GDP	1.2	0.8			
Current Acc. Bal. (US$B, ar)	-0.07	-0.08	-0.04	-0.04	(Oct)
Merch. Trade Bal. (US$B, ar)	-39.1	-45.6	-18.6	-30.4	(Sep)
Industrial Production	6.5	1.6	-0.1	-3.2	(Oct)
CPI	1.6	2.7	2.9	5.0	(Nov)

France					
Real GDP	1.4	1.6	1.6		
Current Acc. Bal. (US$B, ar)	-44.5	-81.9	-48.6	-113.9	(Oct)
Merch. Trade Bal. (US$B, ar)	-39.0	-52.8	-50.1	-54.7	(Oct)
Industrial Production	4.6	1.9	2.8	1.8	(Oct)
Unemployment Rate (%)	9.8	9.7	9.8	9.8	(Oct)
CPI	1.5	2.1	2.1	3.9	(Nov)

United Kingdom					
Real GDP	1.8	0.6	0.5		
Current Acc. Bal. (US$B, ar)	-56.9	-12.2			
Merch. Trade Bal. (US$B, ar)	-152.5	-162.7	-177.3	-142.9	(Oct)
Industrial Production	1.9	-1.3	-1.3	-1.7	(Oct)
Unemployment Rate (%)	7.9	7.8	8.2	8.3	(Sep)
CPI	3.3	4.4	4.7	7.6	(Nov)

Australia					
Real GDP	2.6	1.9	2.5		
Current Acc. Bal. (US$B, ar)	-35.2	-18.3	-33.8		
Merch. Trade Bal. (US$B, ar)	19.3	50.3	43.5	31.9	(Oct)
Industrial Production	4.3	-1.6	0.8		
Unemployment Rate (%)	5.2	4.9	5.2	5.3	(Nov)
CPI	2.8	3.6	3.5		

South Korea					
Real GDP	6.2	3.4	3.5		
Current Acc. Bal. (US$B, ar)	29.4	22.0	27.6	50.8	(Oct)
Merch. Trade Bal. (US$B, ar)	41.2	33.4	25.2	46.9	(Nov)
Industrial Production	16.6	6.7	5.4	7.6	(Oct)
CPI	2.9	4.0	4.3	6.9	(Nov)

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

Source: Bloomberg, Scotia Economics.

Interest Rates (%, end of period)

Canada	11Q2	11Q3	Dec/09	Dec/16*
BoC Overnight Rate	1.00	1.00	1.00	1.00
3-mo. T-bill	0.83	0.82	0.86	0.82
10-yr Gov't Bond	3.11	2.16	2.06	1.87
30-yr Gov't Bond	3.55	2.77	2.66	2.46
Prime	3.00	3.00	3.00	3.00
FX Reserves (US$B)	62.3	63.5	65.2	(Oct)
Germany				
3-mo. Interbank	1.51	1.51	1.40	1.41
10-yr Gov't Bond	3.03	1.89	2.15	1.87
FX Reserves (US$B)	66.0	66.9	67.1	(Oct)
Euro-Zone				
Refinancing Rate	1.25	1.50	1.00	1.00
Overnight Rate	1.72	1.46	0.73	0.57
FX Reserves (US$B)	317.2	311.0	315.3	(Oct)
Japan				
Discount Rate	0.30	0.30	0.30	0.30
3-mo. Libor	0.13	0.13	0.13	0.13
10-yr Gov't Bond	1.14	1.03	1.02	0.99
FX Reserves (US$B)	1100.8	1160.7	1167.5	(Oct)

United States	11Q2	11Q3	Dec/09	Dec/16*
Fed Funds Target Rate	0.25	0.25	0.25	0.25
3-mo. T-bill	0.01	0.02	0.00	-0.01
10-yr Gov't Bond	3.16	1.92	2.06	1.86
30-yr Gov't Bond	4.37	2.91	3.11	2.87
Prime	3.25	3.25	3.25	3.25
FX Reserves (US$B)	136.6	137.4	137.4	(Sep)
France				
3-mo. T-bill	1.18	0.38	0.21	0.08
10-yr Gov't Bond	3.41	2.60	3.27	3.08
FX Reserves (US$B)	60.3	51.8	52.9	(Oct)
United Kingdom				
Repo Rate	0.50	0.50	0.50	0.50
3-mo. T-bill	4.85	4.85	4.85	4.85
10-yr Gov't Bond	3.38	2.43	2.16	2.06
FX Reserves (US$B)	79.7	78.9	80.5	(Oct)
Australia				
Cash Rate	4.75	4.75	4.50	4.25
10-yr Gov't Bond	5.21	4.22	3.79	3.79
FX Reserves (US$B)	40.3	39.7	42.8	(Oct)

Exchange Rates (end of period)

	11Q2	11Q3	Dec/09	Dec/16*
USDCAD	0.96	1.05	1.02	1.04
CADUSD	1.04	0.95	0.98	0.96
GBPUSD	1.605	1.558	1.567	1.552
EURUSD	1.450	1.339	1.339	1.304
JPYEUR	0.86	0.97	0.96	0.99
USDCHF	0.84	0.91	0.92	0.94
¥/US$	80.56	77.06	77.65	77.66
US¢/Australian$	107.22	96.62	102.16	99.91
Chinese Yuan/US$	6.46	6.38	6.36	6.35
South Korean Won/US$	1068	1178	1147	1159
Mexican Peso/US$	11.714	13.897	13.574	13.846
Brazilian Real/US$	1.563	1.879	1.798	1.848

Equity Markets (index, end of period)

	11Q2	11Q3	Dec/09	Dec/16*
United States (DJIA)	12414	10913	12184	11935
United States (S&P500)	1321	1131	1255	1227
Canada (S&P/TSX)	13301	11624	12035	11620
Mexico (Bolsa)	36558	33503	36641	36242
Brazil (Bovespa)	62404	52324	58236	56233
Italy (BCI)	1039	796	822	783
U.K. (FT100)	5946	5128	5529	5402
Germany (Dax)	7376	5502	5987	5699
France (CAC40)	3982	2982	3172	2971
Japan (Nikkei)	9816	8700	8536	8402
Hong Kong (Hang Seng)	22398	17592	18586	18285
South Korea (Composite)	2101	1770	1875	1840

Commodity Prices (end of period)

	11Q2	11Q3	Dec/09	Dec/16*
Pulp (US$/tonne)	1035	970	920	920
Newsprint (US$/tonne)	640	640	640	640
Lumber (US$/mfbm)	237	240	239	245
WTI Oil (US$/bbl)	95.42	79.20	99.41	93.79
Natural Gas (US$/mmbtu)	4.37	3.67	3.32	3.15
Copper (US$/lb)	4.22	3.23	3.54	3.33
Zinc (US$/lb)	1.05	0.86	0.90	0.85
Gold (US$/oz)	1505.50	1620.00	1709.00	1594.00
Silver (US$/oz)	35.02	30.45	32.00	29.78
CRB (index)	338.05	298.15	306.43	294.92

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

Emerging Markets Strategy

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Foreign Exchange Strategy

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