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Monthly Indicators

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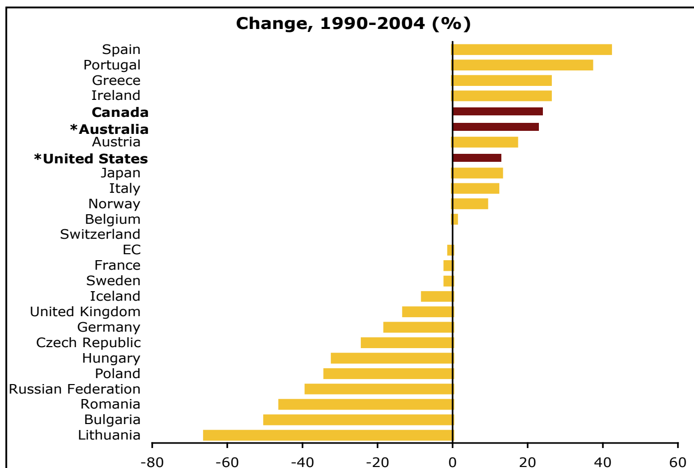
Beyond Kyoto

Past Canadian governments have been good at talking the talk on global warming, but far less adept at following up with concrete measures to limit greenhouse gas (GHG) emissions growth. Few signatories to the Kyoto protocol have strayed farther from their commitments than Canada. Even the US and Australia, two countries criticized for not ratifying the accord, have posted slower emissions growth than Canada (Chart). And both countries are now contemplating measures that would create a cap and trade system to manage and ultimately reduce their future emissions.

While required by Kyoto to reduce emissions to 6% below the 1990 level by 2012, Canadian emissions have soared. Environment Canada estimated that emissions had already climbed 27% above the 1990 level in 2004 and conservatively forecast that emissions will come in 35% above that level by decade end. Relative to the mandated 6% reduction, Canada will likely finish the decade over 40 percentage points shy of its Kyoto target. Honest miss or spurious commitment?

GHG Emissions Growth by Country



*Have not ratified the Kyoto Protocol. Source: UNFCCC (2005).

Canada's requirement under the Kyoto Accord is simply unachievable. The required cut in emissions not only implies a massively contracting energy sector, but a similarly contracting economy. But at the same time, slowing the explosive growth in Canadian emissions is something that not only is achievable but has become increasingly vital for this minority government's political survival, if not its longer-term ambitions for a parliamentary majority.

In the meantime, legislative developments south of the border may end up having more clout than domestic policy responses. The inclusion of full-cycle carbon costs in California's newly passed GHG legislation may threaten Canadian synthetic oil's access to the giant state energy market. And once legislators in Washington move to put a price on carbon emissions in their own economy, trade politics may require that Canada do the same. Linking environmental practice to trade and market access may ultimately turn out to be the weapon that compels the compliance of much more egregious carbon emitters, like China, down the road.

Investors who have been rightly cynical of Canada's Kyoto commitments will soon have to recognize carbon liabilities as part of a firm's balance sheet. And it won't just be coal-generated power utilities and oil sands producers that will bear scrutiny (see pages 4-7). With 40% of the market capitalization of the TSX likely to fall under meaningful measures for carbon abatement in the very near future, the vast majority adversely impacted, carbon exposure is broader than many investors yet suspect.

MARKET CALL

- Stronger near-term GDP growth stateside, and hefty employment gains in Canada, stand in the way of any consideration of central bank interest cuts by the Fed and the Bank of Canada in the first half of 2007. The Fed is unlikely to turn its hawkish talk into action given signs of a slowing pace to core CPI, and mortgage markets seeing new jitters over defaults. But we'll have to see a return to slower US GDP growth in Q2 (see pages 8-11), before lower inflation opens up room for an ease in the latter half of the year.

- Delayed prospects for Fed rate cuts have given the US$ a temporary reprieve, with the greenback able to shrug off the impacts of ongoing rate hikes in the eurozone and the UK, and a still-huge trade deficit. We've pushed off significant dollar depreciation until mid-year, when the Fed is likely to turn more dovish at least in talk. The C$ won't share much in any major currency rally against the US$, with the Bank of Canada likely to match any Fed rate cuts in order to prevent further pressure on manufacturing.

- A flat first half for central banks also makes the bond market, for now, a boring place to be. Further selling pressure should be muted, however, as rate cuts have essentially been priced out of the curve. But we'll have to get closer to conditions for central bank rate cuts before a rally can resume.

INTEREST & FOREIGN EXCHANGE RATES

				2007			2008	
END OF PERIOD:		**12-Feb**	**Mar.**	**June**	**Sep.**	**Dec.**	**June**	**Dec.**
CDA	Call loan (mid-point of range)	4.25	4.25	4.25	3.75	3.50	3.50	3.75
	98-Day Treasury Bills	4.18	4.10	3.95	3.50	3.35	3.35	3.70
	Chartered Bank Prime	6.00	6.00	6.00	5.50	5.25	5.25	5.50
	2-Year Gov't Bond (4.25% 12/08)	4.15	4.10	3.80	3.50	3.30	3.40	3.70
	10-Year Gov't Bond (4% 06/16)	4.20	4.20	3.95	3.65	3.45	3.70	3.95
	30-Year Gov't Bond (5.75% 06/33)	4.24	4.25	4.05	3.75	3.50	3.75	4.00
U.S.	Federal Funds Target	5.25	5.25	5.25	4.75	4.50	4.50	4.75
	91-Day Treasury Bills	5.03	5.05	4.90	4.40	4.20	4.25	4.55
	2-Year Gov't Note (4.875% 01/09)	4.93	5.05	4.70	4.25	4.20	4.40	4.70
	10-Year Gov't Note (4.625% 02/17)	4.80	4.90	4.75	4.50	4.25	4.55	4.85
	30-Year Gov't Bond (4.75% 02/37)	4.88	5.05	4.80	4.65	4.50	4.75	4.95
Canada - US T-Bill Spread		-0.84	-0.95	-0.95	-0.90	-0.85	-0.90	-0.85
Canada - US 10-Year Bond Spread		-0.60	-0.70	-0.80	-0.85	-0.80	-0.85	-0.90
Canada Yield Curve (30-Year — 2-Year)		0.09	0.15	0.25	0.25	0.20	0.35	0.30
US Yield Curve (30-Year — 2-Year)		-0.05	0.00	0.10	0.40	0.30	0.35	0.25
EXCHANGE RATES	— (US¢/C$)	85.0	84.4	85.8	86.2	87.0	87.7	87.7
	— (C$/US$)	1.176	1.185	1.165	1.160	1.150	1.14	1.14
	— (Yen/US$)	122	120	118	112	110	106	105
	— (US$/euro)	1.30	1.30	1.34	1.36	1.33	1.33	1.33
	— (US$/pound)	1.95	1.98	1.98	1.99	1.93	1.92	1.92
	— (US¢/A$)	77.3	77.0	76.0	76.0	75.0	77.0	76.5

STRATEGY AND EARNINGS OUTLOOK

- We remain fundamentally bullish on stocks at a recommended 66% portfolio weight at the expense of cash and bonds. With investor disappointment at fading prospects for near-term rate cuts offset by confidence over the economic and profit outlooks, the TSX should extend its rally to the 14,250 level by year-end.

- In keeping with the breadth of the Canadian market's recent gains, we have moved to a more balanced alignment on the equity side this month, paring our overweight in energy stocks from 4.5%-pts to 3%-pts. From mandating greater ethanol use to stricter auto fuel standards, governments are waging war on carbon, with potential adverse effects for industries like the oil sands (see pages 4-7). The intensifying global war on greenhouse gasses has also led us to drop the utilities sector as an overweight.

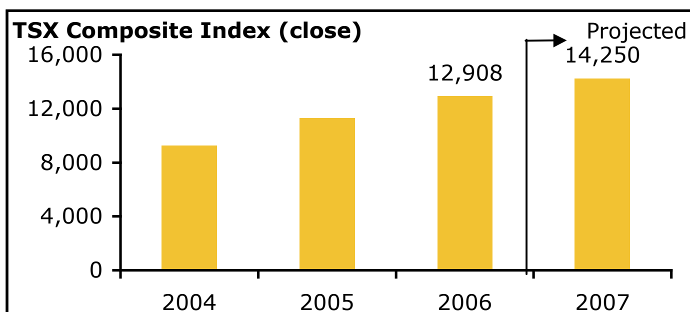
- Even with this month's reduction, the financial sector remains our biggest overweight, led by the banks. Canadian banks are less exposed to sub-prime mortgage strains and have not experienced the same fierce deposit pressures as their US peers, adding to potential gains for the sector on second-half rate cuts. The lack of household contagion from weakness in Canadian manufacturing has conversely prompted us to scale back our hitherto aggressive underweights on consumer discretionary and staples stocks. With global GDP likely to see a further healthy 4.8% increase this year and the greenback looking seriously overbought, we remain overweight the base metals and gold sectors.

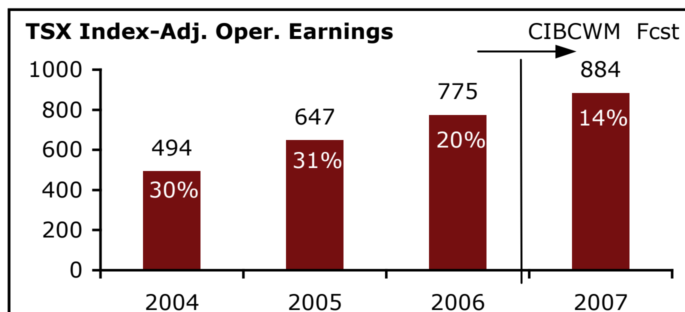
ASSET MIX (%)	Benchmark	Strategy Recommendation
Stocks	**56**	**66**
Bonds	38	34
Cash	6	0
GICS SECTOR EQUITIES (%)		
Consumer Discretionary	5.4	2.4
Consumer Staples	2.7	0.7
Energy	**27.2**	**30.2**
Financials	**31.9**	**35.9**
-Banks	**15.9**	**18.9**
Healthcare	0.8	0.8
Industrials	5.5	3.5
Info Tech	3.5	1.5
Materials	**16.5**	**18.5**
-Gold	**6.5**	**7.5**
-Other Metals	**5.4**	**6.4**
Telecom	5.0	5.0
Utilities	1.4	1.4

Note: Bold indicates recommended overweight.

TSX - Earnings Outlook & Forward PE

	Operating Earnings (% chg)			4-qtr Fwd PE	
	2005	2006	2007	Latest	Last 10 yrs.
Energy	54.5	12.1	24.2	13.4	13.0
Materials	23.3	99.3	11.9	15.5	27.5
Industrials	19.7	13.9	11.9	15.3	15.6
Consumer Discretionary	6.5	14.7	-8.0	21.4	18.6
Consumer Staples	2.4	3.1	-4.9	17.3	17.0
Health Care	-6.1	3.3	-6.4	18.4	49.7
Financials	12.8	15.5	12.9	12.8	10.9
Info Tech	260.9	-50.2	25.2	35.8	32.3
Telecom Svcs	2.4	32.8	9.2	15.5	27.5
Utilities	10.4	20.1	8.1	16.0	34.7
TSX Composite	**31.2**	**19.7**	**14.1**	**15.1**	**17.9**





Evaluating Carbon Risk in the Canadian Economy

Jeff Rubin and Benjamin Tal

Momentum for Carbon Abatement Growing in the US

More and more, investors are preparing themselves for the likelihood that North America will soon have a functioning market-based cap and trade system to reduce greenhouse gas (GHG) emissions. Already, the giant energy consuming state of California has taken the lead, with a statewide cap and trade system for emission credits playing prominently in an ambitious plan to cut state GHG emission levels back to their 1990 level by 2020. Meanwhile Connecticut, Delaware, Maine, New Hampshire, New Jersey, New York and Vermont have formed the Regional Greenhouse Gas Initiative that will cap emissions from major electric generating units beginning in 2009, with a 10% cut planned longer term. And a current bipartisan bill before Congress sponsored by Senators McCain, Obama and Lieberman would establish a nationwide cap and trade system for GHG emissions at the federal level.

Cap and trade systems for SO_2 and NO_x, two gases commonly associated with acid rain, have been functioning for well over a decade in the US. Over time, the number of emission permits has been reduced until the desired level of emissions has been achieved. Since established in 1994, SO_2 emissions have fallen 40% below their 1980 levels while the cost of allowances has soared from US$100 per ton to over $800 per ton (Chart 1). A trading system has the advantage of enabling firms to decide for themselves who will emit through a competitive bidding process, one that not only rewards carbon efficiency but over time, provides huge economic incentives for emissions-reducing technological change.

Canada Likely to Follow Suit

Canada has generally followed US environmental initiatives at both the provincial and federal level. It seems reasonable to assume that a system similar to those about to be implemented in California and the Regional Greenhouse Gas Initiative states will soon be adopted by Canadian provinces as well.

While the combustion of fossil fuels generates GHG emissions throughout the economy, emissions are heavily skewed to certain industries (Chart 2). The oil and natural gas sector, as well as the utility sector are two of the biggest sources, together accounting for almost 40% of total Canadian emissions. Add in industrial processes, which include emission-intensive metal refining, and the smelting sector and you are talking almost half of total emissions in the country. Those emissions would be prime targets of any Canadian cap and trade system.

Emission Cap Vulnerability

Which industries will be the most affected by pricing carbon emissions? An industry's vulnerability to GHG

Chart 1
SO_2 Emissions & Price of Emission Allowances

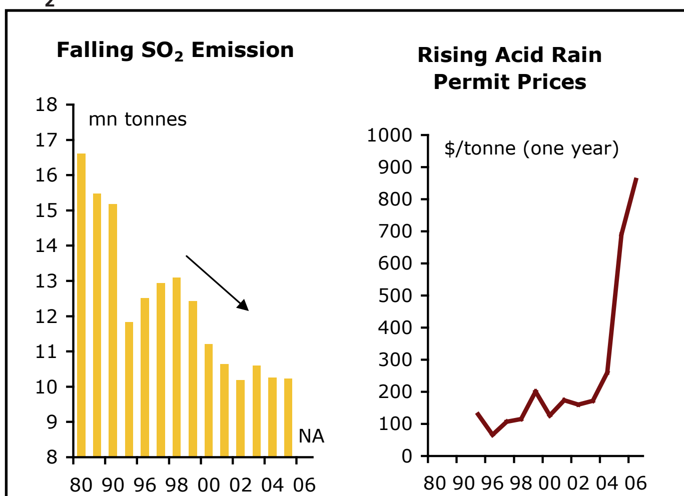


Chart 2
Greenhouse Gas Emissions by Sector, 2004

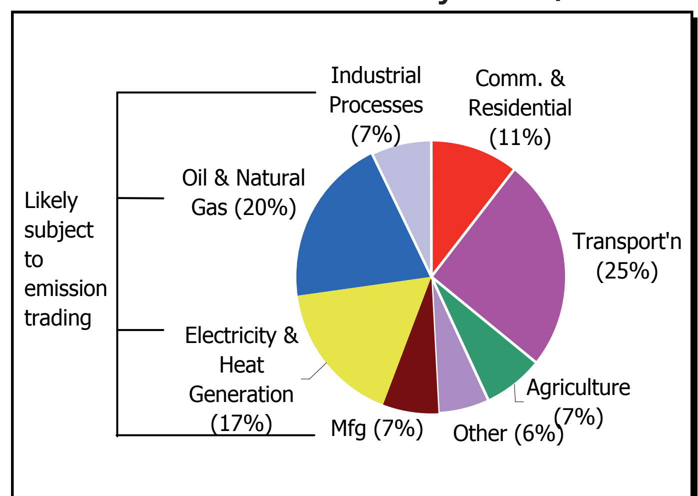


Chart 3
Emission Intensity vs Ability to Pass Costs

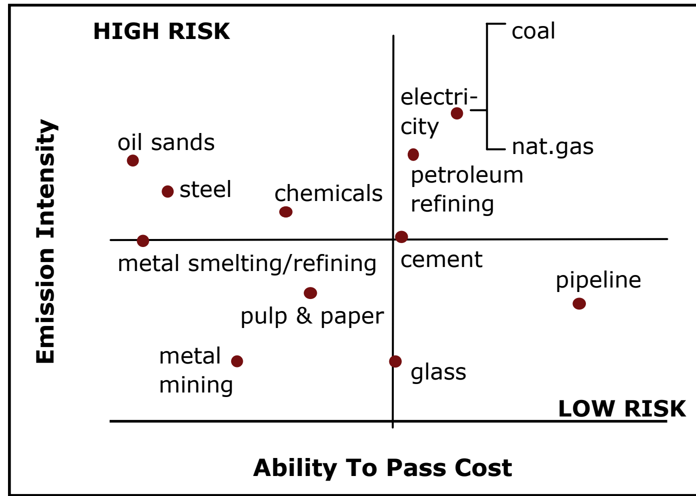
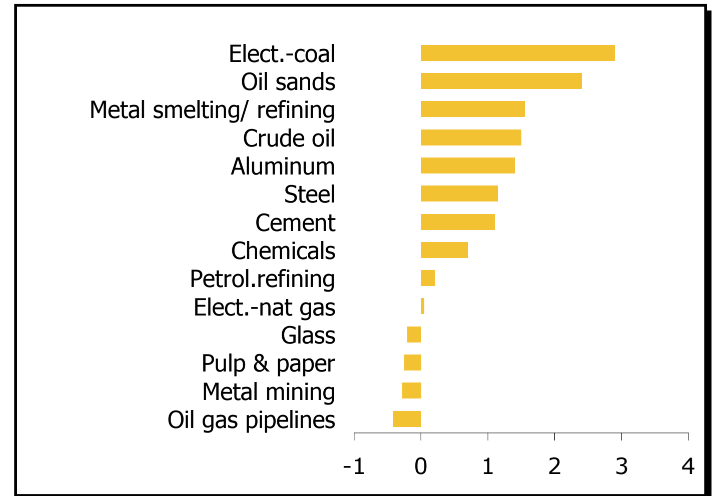


Chart 4
Carbon Risk — CIBC WM Carbon Cap Vulnerability Index



emission caps is not simply a sole function of its absolute emissions or emission intensity. There are other significant variables that can exacerbate or mitigate carbon risk. One is the ability to pass along the cost of emission credits to customers as opposed to absorbing that cost in profit margins. For example, the emission-intensive coal-fired utilities may be in a better position to pass along certain carbon costs than other sectors with less pricing power such as metal refining or oil sands production (Chart 3).

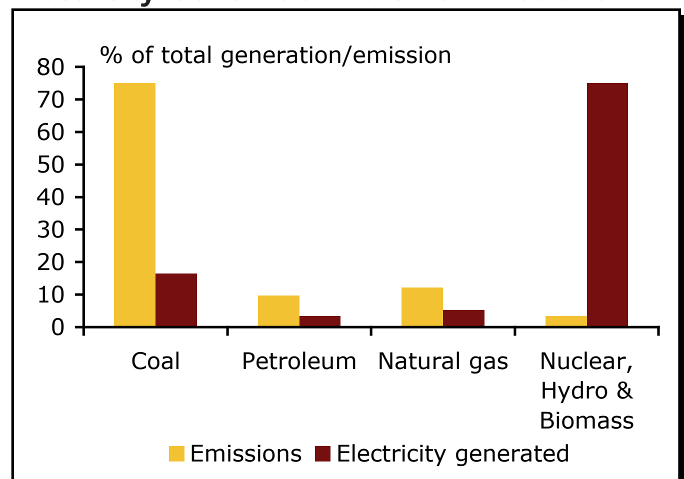
Another determinant of carbon vulnerability is the industry's energy intensity. To the extent that carbon emission allowances will raise the price of energy, it will penalize more energy-intensive industries even if they themselves are not major purchasers of emission credits. The chemical industry is a case in point. Lastly, the ability of firms to abate their emissions through better carbon practices will become increasingly important as the cost of emission allowances rises over time. Abatement can reduce required allowances that might otherwise have to be bought in the open market or create surplus credits that can be sold in the open market.

In order to gain an overall assessment of carbon risk, we have devised a Carbon Cap Composite Vulnerability Index, based on a weighted average of the four measures of carbon vulnerability. Emission intensity is measured as kilotonnes of emissions of CO_2 equivalent per dollar of output. Energy intensity is measured as terajoule of energy per dollar of output. Ability to pass along carbon costs as well as scope for carbon abatement is based on data obtained from independent consulting sources[1]. We assigned a 30% weighting to emission intensity and ability to pass costs, while assigning a 25% weighting to scope for abatement and 15% index weighting for energy intensity (Chart 4).

Coal-Fired Utilities Are Most At Risk

The coal-fired utilities sector tops our vulnerability index as potentially the most exposed sector of the economy to carbon risk, reflecting extremely high emission intensity per megawatt of power produced. While accounting for only 16% of the electricity produced in Canada, coal-fired plants account for over 70% of the emissions from all power utilities in the country (Chart 5). Conversely, nearly 70% of the electric power generated in Canada is done so carbon free, coming from either nuclear or hydroelectric sources. Carbon pricing will adversely impact the price of coal-fired power compared to other

Chart 5
Electricity Generation vs GHG Emissions



power sources. In the short-run, that could lead to lost power sales to non-regulated commercial and industrial power customers and in the long-run lead to a loss of market share to carbon-free nuclear power generation. Within the industry, carbon pricing should promote more rapid implementation coal gasification technologies that result in the burning of a much cleaner synthetic gas fuel and which greatly facilitates carbon capture and ultimate sequestration. Ontario's 4,000-megawatt Nanticoke plant on Lake Erie and 2,000-megawatt Sundance generator outside of Edmonton are the two largest coal-fired power plants in the country.

Oil Sands

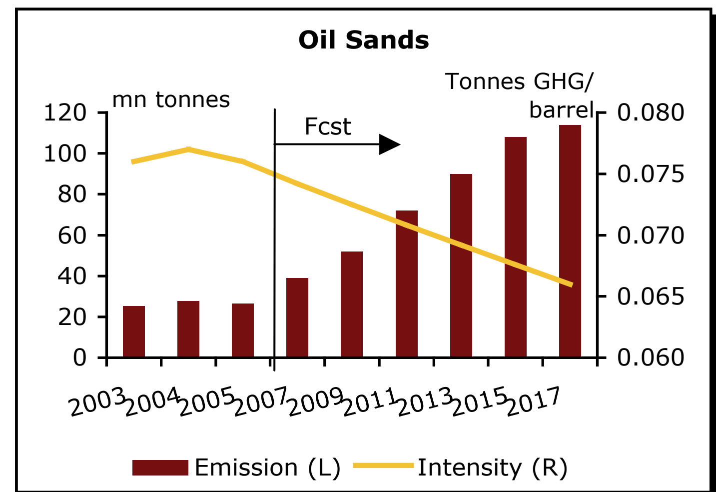
Next to coal-fired utilities, oil sands producers rank the highest on our vulnerability index. While the oil sands accounted for only 3.5% of Canada's GHG emissions in 2004, some estimates suggest that a virtual doubling in production to 2 million barrels per day will account for over 40% of the growth in national GHG emissions over the balance of the decade. Producing a barrel of synthetic oil from the oil sands releases up to 120 kilograms of CO_2 into the atmosphere, three times the equivalent emissions associated with producing a barrel of conventional oil. The difference owes mainly to the heating requirement that is necessary to separate bitumen from the surrounding tar sands and in particular, from in situ producers with their extensive use of steam.

While oil sands operators have made credible progress at reducing emissions by the equivalent of 2.6% per year over the past decade, improvements in emission intensity have been overwhelmed by increases in daily production. Hence total emissions have risen sharply and are projected to continue to do so as new mining and in situ operations come onstream over the next decade. By 2017, planned production increases would push carbon emissions from roughly 30 million tons per year to over 100 million tons per year (Chart 6).

Over time, oil sands operators may be able to improve their carbon risk on two important fronts. As oil sands production becomes more and more important on the margin to world oil supply, producers may be better able to pass on carbon costs to refineries or end users. By 2010, we estimate that oil sands production will replace deepwater wells as the single largest source of new global supply, making oil sands producers effectively the marginal supplier, with resulting pricing power.

Chart 6

Oil Sands Emissions is Projected to More Than Double in the Next Five Years



Secondly, over time, there is significant scope to reduce both the energy and emission intensity of the oil sands operations with the use of gasification and carbon sequestration technologies as well as the potential use of nuclear power as a heat source.

Metal Smelting and Refining

The metal smelting and refining sector ranks third on our vulnerability index and would likely be adversely affected by any cap and trade system for GHG emissions. Not only does the sector rank high in terms of emission intensity, but it is also extremely energy intensive. Energy represents about 30% of the total cost of production, leaving the sector highly vulnerable to the pass-through of carbon costs imposed on energy suppliers. At the same time, most smelters and refiners have little ability to pass along carbon costs to their customers in the form of higher metal prices. And in the short-run at least, the sector will be further disadvantaged by the fact that competing suppliers in the developing world would be outside the initial scope of GHG cap and trade systems. Lastly, opportunities for abatement appear limited.

Chemicals—More At Risk From Higher Energy Prices Than From Emission Costs

The chemical industry is likely to be impacted by carbon trading, more through its energy intensity and use of hydrocarbon feedstocks than from its emission intensity. Companies involved in the production of basic chemicals such as ammonia, nitric acid, and urea account for most

of the industry's emissions, but on the whole, however, the industry is not a major source of emissions. This is at least in part due to the industry's own voluntary efforts to reduce emissions over the last decade and a half. Emissions per unit of output in the chemical sector have fallen by 1½% per year for the last 15 years. While the industry's self-initiative has been laudable, it at the same time has left very limited opportunities for further carbon abatement. The sector's vulnerability emanates more from its energy intensity and use of hydrocarbon feedstocks, which together can account for as much as 85% of production costs for certain chemicals. Hence carbon-induced increases in energy prices will have a disproportionately large impact on total production costs in the chemical industry.

Oil and Gas Pipelines—A Likely Winner

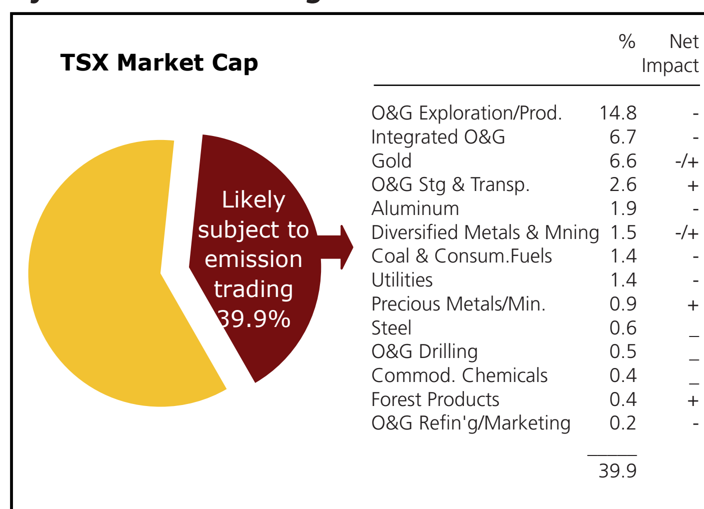
While oil and gas producers will be adversely affected, not everyone in the energy patch would necessarily be a loser from a cap and trade carbon emission system. Pipeline companies would likely benefit, quickly becoming a source of surplus emissions credits that could be sold to other sectors including oil sands producers. While pipelines transport massive amounts of energy, the sector itself is not a significant source of carbon emissions. Moreover, energy intensity of the sector has fallen by about 15% since 1990 due to technological change. And while the sector is unlikely to be a net purchaser of credits, it is one industry where carbon abatement costs could be easily passed on to its customers. More likely, however, the industry will be a net seller of credits. Further improvements in pumping efficiencies will reduce energy intensity while infrared imaging will cut down fugitive emissions through early detection of pipeline leaks.

Gold

The impact of emission caps on the gold industry is mixed. Companies that are exposed mainly through their gold mining operations will, in all likelihood, be net sellers of emission credits due to low-emission intensity in mining activities as well as above-average room to abate due to both little voluntary emission-reduction activity in the past, and some ability to convert mining equipment to electrical power. At the same time, companies that are exposed through their smelting and refining operations are more vulnerable due to their high-energy intensity, low ability to pass along cost, and below average ability to abate (see earlier discussion on Metal Smelting and Refining).

Chart 7

40% of TSX Will be Directly Impacted by Emissions Trading



40% of TSX to be Impacted

Some 90 companies account for nearly 50% of the country's total emissions. Not all carbon emitters are in the investment domain. Some, like the giant Nanticoke plant in Ontario, reside in the public sector. Nevertheless most of the major sources of industrial GHG emissions come from the private sector. The majority of these are publicly traded. We estimate that some 40% of the TSX market capitalization will be directly affected by emissions trading, of which the vast majority will be adversely affected (Chart 7). The disproportionately large contribution of the energy sector to total national emissions is mirrored in its similarly large weighting in the TSX. In addition, there is significant carbon exposure in the non-energy resource sector, and in particular, metal refining and smelting.

The full extent to which corporate valuations will be impacted by carbon risk will depend on the distribution of permits, the initial severity of the emissions caps and the rate at which they are lowered over time. At the end of the day, legislators will determine those parameters. But investors beware: carbon emissions are very soon going to carry a price in the Canadian economy.

1. Abatement options are based on data obtained from ICF consulting, M.K. Jaccard and CIBC Environmental Risk Management. Data sources used to derive the index: Statistics Canada, ICF Consulting, M.K. Jaccard, Pembina Institute, AMG, CIBC Environmental Risk Management, and CIBC WM.

North American Growth: Not Out of the Woods

Avery Shenfeld and Warren Lovely

Where to from here? That's what the North American bond market has to be asking, now that it has all but priced out any hope of central bank rate cuts in 2007 (Chart 1). Economic reports have leaned that way, with labour markets staying far too tight to justify an ease and, at least in the US, high frequency data pointing to improved growth momentum. Whether to buy bonds now or stay short, therefore, depends on whether that growth pick-up is a sign of things to come, or as seems more likely, a temporary reprieve.

America's Bouncing Ball

Results from the final quarter of 2006 set the stage for firmer near-term US real GDP growth and we've added a full percentage point to our earlier projection, taking Q1 growth to 3% (Table 1). But a fortuitous mix of weather, timing shifts in capital spending, and energy price swings lies behind that resurgence, none of which will carry through into the spring.

Fourth-quarter investment spending was decidedly lackluster. That may in part have reflected postponed computer and software purchases ahead of a new operating system release, but there was also broad-based softness in other equipment categories. Equipment orders picked up late in the quarter, pointing to a rebound in cap-ex for Q1. But we continue to see a cautious pattern relative to the boom in corporate cash flows, in part because manufacturers are expanding capacity overseas, where costs are lower and trend growth is faster.

The energy price drop helped buttress consumer spending in Q4. Extending a pattern we've seen over the past few years, price-related jumps and declines in spending at gas stations have seen offsetting movements in other retail sales (Chart 2). Higher pump prices early in 2007 look to reverse the prior quarter's lift by Q2, and upward pressure on food prices (due to weather damage to fruit/vegetable crops, and ethanol's impact on corn) will also take a bite out of quarterly real income gains.

That suggests that a bounce in production in the first quarter, tied to replenishing depleted inventories, will be short lived. As well, some of that restocking is likely to come from imports, rather than domestic production, as imports were atypically light in the fourth quarter.

Don't be fooled by the distortions generated in the housing data by a later-than-normal start to winter weather. A 25% seasonally adjusted monthly jump in starts in the northeast merely borrowed from activity in the spring, with a still-elevated stock of unsold new homes, and a record share of houses now standing vacant, pointing to no underlying pick-up in building (Chart 3, right).

And in terms of actual GDP contribution and employment, the earlier drop in starts will still be working its way into the number of homes under construction, which tend to lag behind (Chart 3, left). As a result, we have yet to see how construction job losses spill over into the overall economy. The steep drop in housing starts to date isn't the worst that the economy can deliver, with past

Chart 1

Rate Futures See Flat Outlook

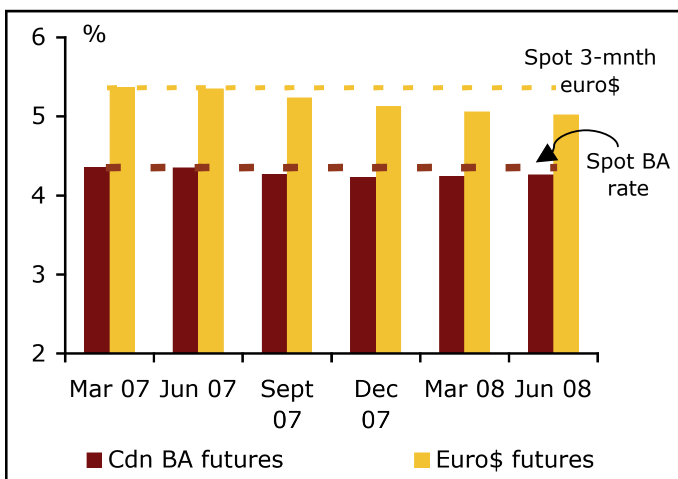


Chart 2

Real Consumption Rises as Gas Prices Fall

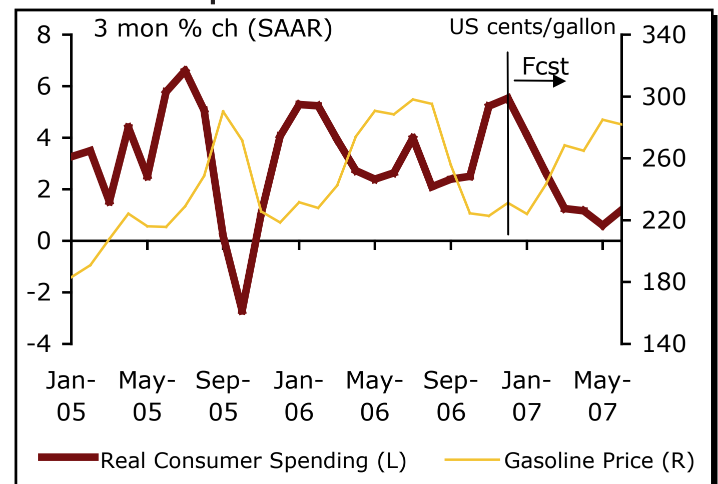
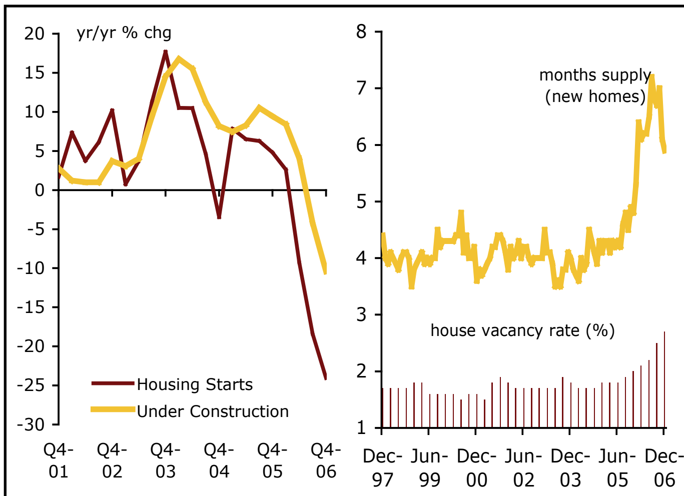


Chart 3
Housing Data Point to More Weakness



downturns leading to a halving in activity. In the absence of Fed rate cuts that hold mortgage rates down, there would be a lot of room for further damage.

Housing prices continue to slip according to the most consistent measure, the Case-Shiller index, posing a downside risk to both consumer confidence and borrowing capacity. Cutting into consumer spending power, home equity withdrawals have dropped off sharply, and rising mortgage arrears will see credit standards at mortgage lenders, and in the MBS market, tightening this year.

As consumer spending softens again, real GDP growth should return to the 2% range in the second and third quarters. Headline inflation will perk up on rising food and fuel prices, though conservation efforts have seen us lower our annual average crude forecast which, in turn, has chopped our 2006 CPI outlook. Core inflation seems to have seen its worst days, having run at only 1.4% annualized in the latest three-month stretch, and unit labour costs running at only 0.1% year-on-year in the non-financial corporate sector. Weaker housing demand and increased house vacancies will depress rent inflation, which accounted for much of the Fed's fears on prices last year.

Table 1
North American Macro Outlook

UNITED STATES	06:4A	07:1F	07:2F	07:3F	07:4F	2006A	2007F	2008F
Real GDP (% chg, AR)	3.5	3.0	1.6	1.8	2.4	3.4	2.5	3.0
Personal Consumption	4.4	3.0	2.2	1.9	2.7	3.2	2.9	2.7
Total Govt. Expenditures	3.7	2.5	2.0	0.9	1.1	2.1	2.1	1.0
Residential Construction	-19.2	-4.4	-13.0	0.0	0.6	-4.2	-10.5	2.7
Business Fixed Investment	-0.4	9.7	5.6	6.5	6.5	7.4	6.1	6.7
Inventory Change ($2000 Bn)	35.3	41.8	37.8	21.9	23.9	46.4	31.3	39.9
Exports	10.0	7.0	6.3	7.6	6.6	8.9	7.4	7.1
Imports	-3.2	8.9	5.4	4.6	7.9	5.8	4.4	5.8
CPI (Y/Y % chg)	1.9	2.2	1.4	1.6	3.1	3.2	2.1	2.6
Core CPI (Y/Y % chg)	2.6	2.5	2.0	1.8	1.7	2.5	2.0	2.0
Unemployment Rate (%)	4.5	4.5	4.6	5.0	5.1	4.5	4.8	4.9
Housing Starts (AR, Mn)	1.53	1.53	1.46	1.50	1.55	1.81	1.51	1.52
CANADA	**06:4F**	**07:1F**	**07:2F**	**07:3F**	**07:4F**	**2006F**	**2007F**	**2008F**
Real GDP (% chg, AR)	0.9	2.8	2.0	2.2	2.5	2.7	2.1	2.7
Personal Consumption	1.2	3.2	2.5	2.4	2.5	3.7	2.7	2.6
Total Govt. Expenditures	3.2	2.8	2.9	2.8	2.8	3.7	2.7	2.8
Residential Construction	-2.5	4.8	-4.0	1.8	3.0	2.3	-1.0	1.1
Business Fixed Investment	4.5	5.7	5.3	5.7	5.3	8.0	5.5	5.8
Inventory Change ($97 Bn)	8.5	9.2	9.2	9.5	9.3	13.5	9.3	8.9
Exports	0.1	3.9	3.2	3.0	4.1	1.2	2.5	4.0
Imports	-3.0	6.0	4.5	4.8	4.9	4.8	3.7	4.7
CPI (Y/Y % chg)	1.3	1.4	1.3	2.1	2.8	2.0	1.9	2.3
Core CPI (Y/Y % chg)	2.2	2.0	1.9	1.7	1.7	1.9	1.8	1.9
Unemployment Rate (%)	6.2	6.2	6.3	6.4	6.4	6.3	6.3	6.3
Housing Starts (AR, K)	222	235	208	205	202	228	213	200

That leaves the job market as the last tumbler to fall before the Fed can move from hawkish talk to dovish action. Jobs are already disappearing in the traditional cyclical leaders, and we look for weakness in construction and factory employment to spread to other sectors by spring.

Odds are that a corrective dose of interest rate relief can set a floor under housing and prevent that sector's tumble from tipping the US into outright recession. Labour markets will end the year with a bit of slack, but if 2008 is back on a 3% growth track, we could see the Fed fine-tuning rates upward again next year.

Canada: So Many Jobs, So Little to Show for It

In Canada, the question isn't whether a growth spurt will last—there hasn't been one—but whether a jobs boom is temporary. Job creation has been explosive, averaging nearly 40,000/month during the past half-year. The jobless rate has plumbed three-decade lows, and the employment rate has established a new record. But vigorous hiring hasn't translated into meaningful economic growth. Annualized GDP growth in the second half of 2006, at less than 1½%, will mark the weakest two-quarter performance since a shock-filled 2003.

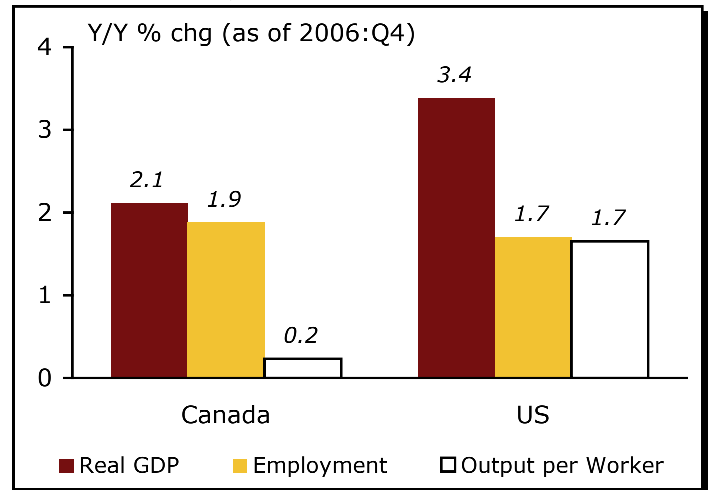
While it's natural to observe a moderation in productivity growth as an expansion matures—the most productive workers are snatched up first, after all—growth in output per worker is now non-existent, in stark contrast to the US (Chart 4). That abysmal productivity record looks to be at least partly the byproduct of faltering employment quality. There may be jobs aplenty, but recent hiring has been skewed heavily to self-employed positions and low-paying industries, helping to explain why, despite a seemingly 'tight' labour market, wage growth has moderated notably (Chart 5).

It's hard to overstate the significance of the jobs/growth disconnect. The timing and direction of the Bank of Canada's next move on rates comes down to which data are painting a more accurate picture. Ultimately, it's about how this gap ends up being closed (if at all).

Note that there was an altogether more striking deviation between jobs and growth as recently as 2002-03 (Chart 6). That divide was largely redressed via a reversion to more restrained hiring, and a similar path looks to be followed in 2007, as quarterly growth rates see only a modest improvement. Moreover, it will again pay to look past employment headlines, as the quality of employment continues to go wanting. With poor job quality impairing wage growth and resurgent energy prices offsetting incremental tax relief, more restrained growth in consumer spending should be anticipated.

Chart 4

No Productivity Growth in Canada



They're Called Cyclicals for a Reason

As in the US, clues to where the economy is headed are best found in the goods sector, home to key cyclical industries that have been the source of recent weakness (Chart 7). Paramount among them, the manufacturing sector has suffered declining real output for four straight quarters. Although it's tempting to blame a drawdown of inventories for production woes, prospects for improvement in 2007 are hampered by muted US demand and unending competition from low cost overseas producers, necessitating additional job cuts in this high-paying industry.

Chart 5

Wages Cool Despite 'Tight' Labour Market

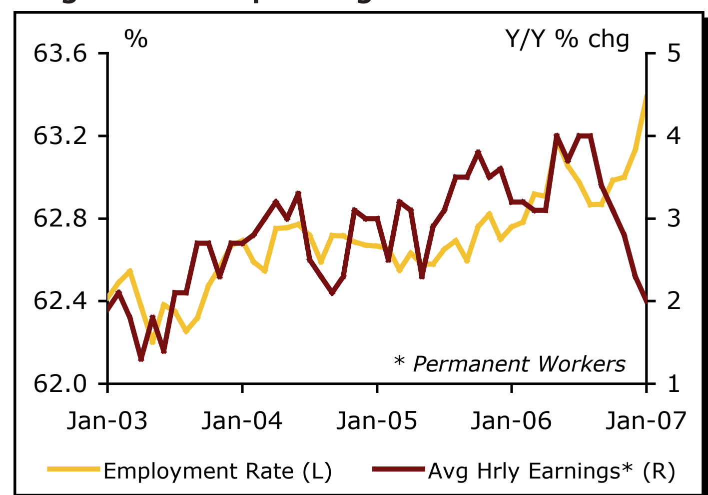
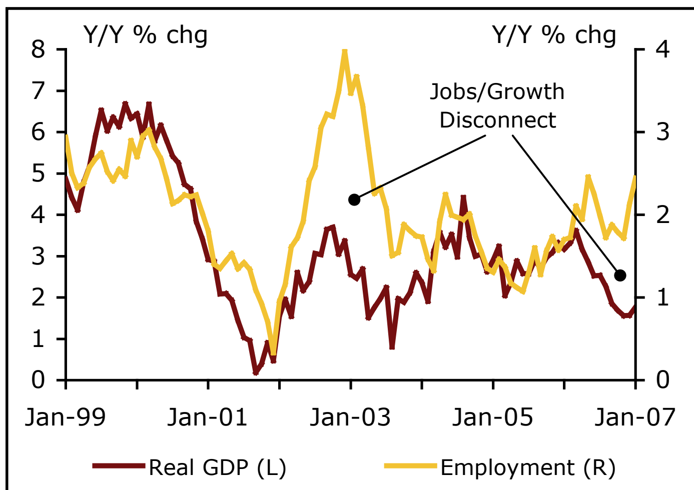


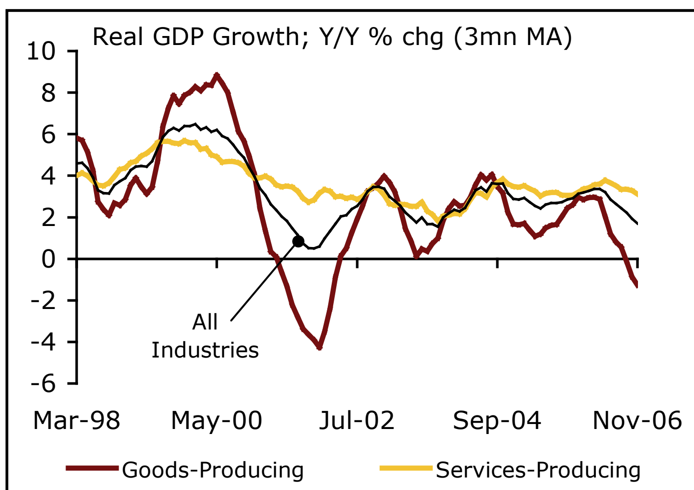
Chart 6
Jobs/Growth Disconnect Can't Last



Canada's housing market still looks better insulated than that of the US, with prices and activity holding up much better. Still, moving beyond an early year weather-related burst, housing starts are seen moving onto a lower plane.

With key cyclical sectors under pressure, GDP growth will hold below the economy's non-inflationary speed limit in 2007 (year-on-year growth of less than 2½% by the end of Q4). The same cyclicals that are today holding growth back will be the ones to drive an eventual improvement in North American growth. But that resurgence remains a story for 2008, and one that is predicated on the lift from anticipated central bank easing.

Chart 7
Cyclical, Goods Sector Leads Economy Lower



Regional Imbalances Less Pronounced

Vast divergences in provincial economic performance had threatened to render national growth rates useless; just who lives in an average province anymore?

While still enjoying brisk growth, Alberta's edge over the rest of country will be less pronounced in 2007. We've pared back our call for energy prices, and heightened political attention to climate change raises uncertainties for oil sands projects. British Columbia is leveraging its role as the gateway to rapidly growing Asia, with non-residential construction advancing briskly. Saskatchewan, meanwhile, as a major uranium and fertilizer producer is uniquely positioned to benefit from demand for nuclear power and ethanol.

Central Canada has been hardest hit by a stateside deceleration, with an industrial-mix heavy in manufacturing still taking its toll. For Ontario and Québec, full-year growth rates are likely to see little or no improvement in 2007, with gains in the neighbourhood of 1½% trailing well back of the West (Table 2).

Provincial inflation has been as uneven as real GDP growth. Alberta remains a bonafide hot spot, due to earlier explosive gains in home prices. But things are now cooling off, with the hottest market—Calgary—seeing almost no increase in new home prices during the past three months. As an ongoing supply response reins in housing prices, a key source of core inflation looks to be blunted, even as the C$'s once dampening influence on imported goods inflation fades from view. That, and weaker job growth, will create the elbow room for interest rate cuts in the second half of the year.

Table 2
Provincial Real GDP Growth Outlook

Y/Y % chg	05A	06E	07F	08F
British Columbia	3.7	4.3	3.4	3.3
Alberta	4.6	7.3	4.5	4.0
Saskatchewan	3.1	2.4	3.1	3.2
Manitoba	2.7	3.1	2.2	2.5
Ontario	2.8	1.3	1.4	2.6
Québec	2.2	1.7	1.5	2.4
New Brunswick	0.3	2.4	2.1	2.5
Nova Scotia	1.6	2.1	1.9	2.3
Prince Edward Island	2.1	2.0	1.7	2.0
Newfoundland & Lab.	0.4	3.0	4.4	2.1
Canada	**2.9**	**2.7**	**2.1**	**2.7**

ECONOMIC UPDATE

CANADA	06Q4A|F	07Q1F	07Q2F	07Q3F	07Q4F	2006A|F	2007F	2008F
Real GDP Growth (AR)	0.9	2.8	2.0	2.2	2.5	2.7	2.1	2.7
Real Final Domestic Demand (AR)	1.9	3.5	2.6	2.9	3.0	4.1	2.9	3.0
All Items CPI Inflation (Y/Y)	1.3	1.4	1.3	2.1	2.8	2.0	1.9	2.3
Core CPI Ex Indirect Taxes (Y/Y)	2.2	2.0	1.9	1.7	1.7	1.9	1.8	1.9
Unemployment Rate (%)	6.2	6.2	6.3	6.4	6.4	6.3	6.3	6.3
Merchandise Trade Balance (C$ Bn)	52.1	49.4	49.8	53.1	54.4	54.7	51.7	58.0
U.S.								
Real GDP Growth (AR)	3.5	3.0	1.6	1.8	2.4	3.4	2.5	3.0
Real Final Sales (AR)	4.2	2.8	1.7	2.4	2.4	3.1	2.6	2.9
All Items CPI Inflation (Y/Y)	1.9	2.2	1.4	1.6	3.1	3.2	2.1	2.6
Core CPI Inflation (Y/Y)	2.6	2.5	2.0	1.8	1.7	2.5	2.0	2.0
Unemployment Rate (%)	4.5	4.5	4.6	5.0	5.1	4.5	4.8	4.9

CANADA

A gulf remains between employment creation and real economic growth, leaving Canadian economists (ourselves included) shaking their heads. We're sticking to our guns, anticipating a rapid deceleration in employment growth over the balance of 2007. Despite the parade of new hires, wage gains remain relatively muted—reflecting a poorer mix of jobs—and one significant source of core inflation—housing—is cooling. When it comes to GDP growth, Q4:2006 looks to have set a low-water mark of 0.9%. Things will warm up in Q1, but annualized quarterly growth should average less than 2½% this year. Of course, one is left to wonder whether the abundance of new jobs means real output has been dramatically understated of late.

UNITED STATES

We raised our Q1 GDP forecast in light of near-term momentum from consumer spending, and a weather-affected lift to early-year housing starts, but some of the demand and inventory rebuilding will spill into imports, rather than domestic GDP. Beyond the first quarter, look for rebounding gasoline and rising food prices to take some of the steam out of consumer spending, particularly with higher mortgage defaults tightening credit standards ahead. Our downwardly revised oil price forecast for 2007 pushes some of the headline CPI impacts from energy into 2008, where the gap will widen relative to core CPI. See pages 8-11 for more detail.

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