

The Canadian Housing Industry Economic Update



Monthly Report

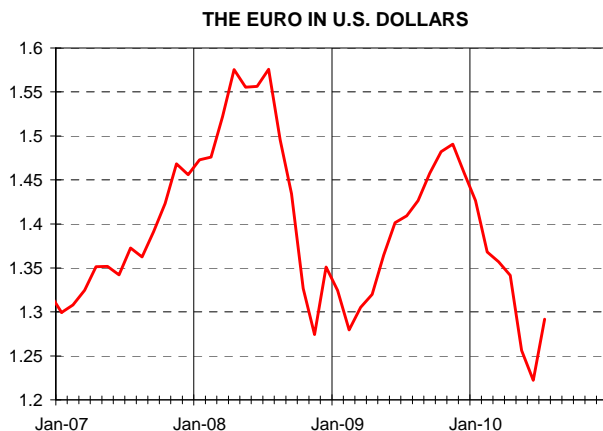
August 2010

Exaggerated Downside Risks

Recently there has been a lot of negative press and media coverage about an economic slowdown and downside risks to the economic recovery. It's like turning on the weather channel. Bad news always gets the attention. There are also economists who have made a career out of saying that the glass is half empty. There are of course risks to the economic outlook but our forecast of a sustained economic recovery remains intact. We always knew that the U.S. economy would slow from its early recovery pace as the policy stimulus faded and inventory cycle matured. The important question is how much slowing will there be.

Europe's Debt Crisis

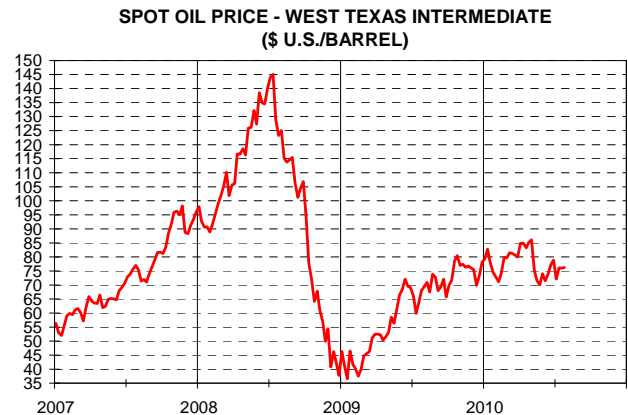
The rebound in the Euro over the past month suggests that the intensity of Europe's debt crisis may be past its peak. The Euro had plunged to a low US\$1.1959 on June 7th on fears of debt default by southern European countries. However, it has since recovered to around US\$1.2800.



A key development will be the results of the stress tests for the 91 European banks. It was the stress test results of the U.S. banks in 2009 that brought confidence back to the North American financial markets. Hopefully the same result will be seen in Europe.

Global Economic Developments

Developing countries now account for a much larger share of the world economy than the more mature industrial countries in the G-7. China's economy did slow to a 10.3% yr/yr growth rate in the 2nd Quarter from 11.9% in the 1st Quarter, but this was the expected result of government restraint measures. This growth rate has to be put into perspective. At an ongoing 10% rate, China's economy would double in seven years. China is not expected to implement further policy tightening as the risk of over-heating has eased.



Commodity prices are signaling a positive outlook for the world economy. The world oil price is approaching US\$80 per barrel again. The spot price for WTI crude is currently US\$76.26 per barrel. The futures price for light sweet crude for September delivery is US\$78.45 per barrel. Base metals prices are also climbing again. For example, the price of copper has moved back above US\$3.05 per pound. A pick-up in global air travel is also evident. Airliner sales at the Farnborough air show are up sharply from last year's Paris air show sales.

The U.S. Economy

We are forecasting that the U.S. economy does not face a dangerous stall-out speed. The growth rate will not be much lower than the 2.7% 1st Quarter advance. Real GDP growth in the 3rd Quarter will probably slow to around 2.0% at annual rates but that will be the low point. After that our base case forecast calls for a reacceleration. Average annual real growth in the U.S. is estimated at 2.9% in 2010 and is forecast at almost 4.0% in 2011 and around 5.0% in 2012. This will provide Canada with a solid platform for sustained economic expansion.

The Positive Indicators

There are a lot of positive indicators that point to continuing growth in the United States. The composite leading indicator index suggests that the U.S. economy is still growing but at a slower pace, in line with our expectations. The manufacturing purchasing managers' index still points to ongoing output growth. America's manufacturing expansion is still intact. The non-manufacturing purchasing managers' index also points to continuing but slower U.S. growth in the middle quarters of 2010. On a more micro level, the Association of American Railroads reports that monthly rail carloads for June are up by 10.6% compared with June 2009. Railroads are bringing freight cars back out of storage.

U.S. Recovery Drivers

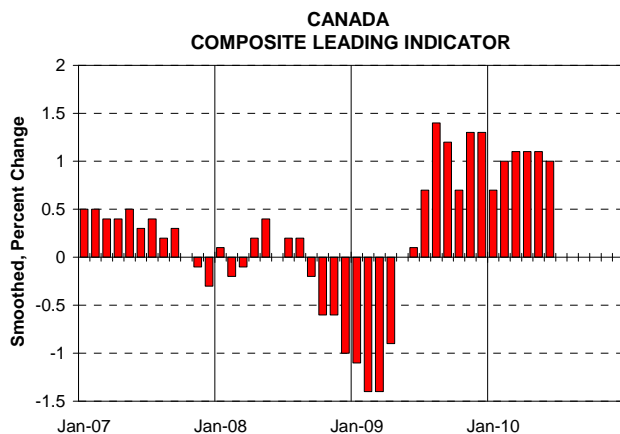
The recovery drivers for the U.S. economy at present are business capital spending and exports. Real outlays on business equipment are running at around a 10% annualized rate of increase. Both new orders and shipments of machinery are up sharply. This reflects healthy corporate profitability and improving balance sheets. Companies have lots of cash and debt levels have been reduced. With companies increasing their investment intentions, a new hiring cycle is expected to begin by the end of the year. Exports of goods have been rising sharply, in real terms. Strength in real non-petroleum imports (consumer goods and capital goods) is a sign of firmer domestic demand.

No Double-Dip Recession

We should remember that double-dip recessions are rare events. The only one was in 1981-82. It was the result of interest rate overkill by Fed Chairman Paul Volker who was fighting to deal with inflation, which peaked at 13.5% in 1981. Short-term interest rates were pushed up to 20% in June of that year. Economic policy is now much more growth friendly than in the early 1980's. With U.S. inflation still edging lower and deflation now a worry, the Fed is now willing to err on the side of providing too much stimulus rather than not enough.

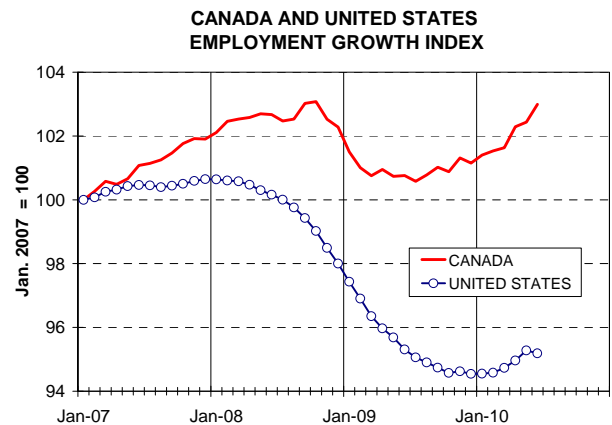
Canada's Economy

While economic growth has to slow from the 6.1% annualized rate of advance shown in the 1st Quarter, it will remain significantly higher than in the United States. In addition, it will be strong enough to continue to bring the unemployment rate down. Canada's composite leading indicator has continued to show strong monthly advances through to mid-year. New orders for durable goods, one of the 10 leading indicators in the composite index, have been showing strong gains.



This indicates an expansionary outlook by companies and is also good news for future hiring plans. Employment showed a large quarterly increase in the 2nd Quarter. This suggests that 2nd Quarter real GDP will also show an above-average increase, when the official figures are released at the end of August. Employment correlates closely with GDP.

Canada has now replaced almost all of the jobs lost during the recession. In comparison, the U.S. has replaced hardly any. Most of the employment gains in Canada since last summer have been in full-time work. Private sector job creation accounts for 87% of the job gains since July 2009 and most of the gains have occurred in recent months. The job gains in June were concentrated in Ontario and Quebec. The employment news is saying that Canada's economy is still growing at a solid recovery pace. It also implies continuing support for housing and renovation demand.



The Bank of Canada

We expect the continuation of an "interest rate friendly" environment for new home builders, despite continuing Bank of Canada rate increases. Special offer mortgage rates are still very attractive. The July 20th increase in the Bank of Canada's overnight target rate to ¾ per cent pushed the prime lending rate at the chartered banks up to 2.75%. However, the "special offer" rate on 1-year mortgages is still very low at 3.10% and the 5-year rate is 4.39%.

Longer-term rates have actually been coming down. The current rate on 10-year U.S. Treasury notes is 2.94% and on 10-year Canada bonds is 3.17%. With economic growth in the U.S. below its long-term average this summer, long term rates are expected to remain low on both sides of the border. We expect further Bank of Canada rate increases on September 8th, October 19th and December 7th in response to Canada's continuing economic recovery.

FORECAST SUMMARY

| | | 1Q09 | 2Q10 | 3Q10 | 2009 | 2010 |
|----------------|----------------------|-------|-------|-------|-------|-------|
| CPI | (% ch. from yr. ago) | 1.6 | 1.7 | 2.9 | 0.3 | 2.4 |
| PRIME RATE | (end of period) | 2.25 | 2.50 | 3.00 | 2.25 | 3.50 |
| HOUSING STARTS | (000's annualized) | 193.0 | 197.9 | 195.0 | 149.1 | 196.5 |