



# Capital Points

— A weekly look ahead at Canadian and U.S. financial markets

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## Canadian mortgage innovation doesn't mean it's the U.S.

A spurt of mortgage innovation coupled with recent resale housing weakness has sparked renewed fear that Canada's housing markets may not cool as gradually as once thought. We think that Canadian housing investment will become a disinflationary drag on economic growth in the second half of this year, giving the BoC policy wiggle room. But, while risks are being reshaped, that does not mean Canada is headed down the U.S. path with a massive loss of value.

To be sure, this is no longer your grandfather's boring mortgage market. The Federal Government began liberalizing the mortgage insurance market in early 2006 by unshackling its lucrative Crown corporation (the CMHC), allowing more foreign players into the market, and allowing new products. The result has been the arrival of longer amortization mortgages that we think now dominate three quarters of all monthly insured purchase applications, with the 40-year product rising out of nowhere since its introduction in November 2006 to account for half of that. Risks are misunderstood, however, as these new products actually extend near-term credit quality and the housing cycle by offering flexibility in a shock environment and bringing in new buyers. Future shock risk is being intensified, but we're not there yet.

Also, insured investor mortgages were introduced just last year. Investor mortgages, however, are only about 2-3% of all mortgages in contrast to 10-11% in the U.S., U.K., and Australia. However, a risk is that they are mostly focused upon condos in Canada. We estimate that one-in-four condo mortgages is not for occupancy such that adding insurance is fanning the flames.

But Canada does not have ultra-low teaser rates, and variable rate products only represent about one-quarter of all mortgages. They get repriced gradually and at market, such that delayed ARMs reset bombs aren't a factor like they were stateside. Canada never saw U.S.-style products like Ninja mortgages, liar loans, or negative amortization products. Subprime mortgages only accounted for about 6-7% of originations, unlike the U.S. peak of almost one-in-four in 2006. Lastly, mortgage equity withdrawals to finance spending are much harder to make in Canada, given penalty structures and high costs.

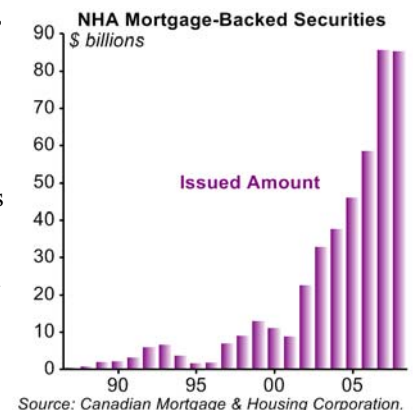
The funding model is also fundamentally different. The U.S. 1927 McFadden Act created a highly fragmented U.S. retail banking system reliant upon revolving door market funding at prevailing market conditions. Canada's nationwide banking system has seen its mortgage securitization marketplace grow, but it is overwhelmingly sovereign-backed and a much smaller share of the market that is more reliant upon classic retail and wholesale deposit funding supplemented recently by covered bonds. Most importantly, the nation's Mortgage Backed Securities market has not been used in CDOs and SIVs as a way of compounding massive amounts of leveraged bets, and the MBS market remains on a solid growth path into 2008 unlike elsewhere.

Canada generally has stronger underwriting standards with the requirement to qualify at the three-year posted rate before choosing the type of product. Unlike the U.S., there isn't a no-docs lending style; you still have to produce evidence of what you bought and at what price, that you actually have a job, and earn income. Canadian banks also generally didn't fully out-source their sales function to mortgage brokers that lacked any skin in the game.

What is a risk, however, are proposals to create a two-tier mortgage insurance market at a point when prices reflect sovereign backing to all potential insurers, and in today's environment. Having made the wise decision to liberalize the mortgage insurance market in the first place, the federal government needs to be fully aware of the risks to changing the rules—at least at this juncture in the markets.

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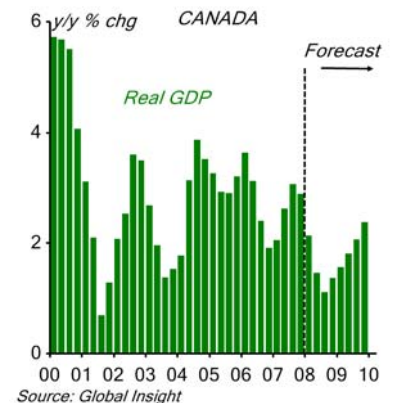




## Canada — What's Out Next Week

### GDP (February) Wednesday, April 30 Weaker growth ahead

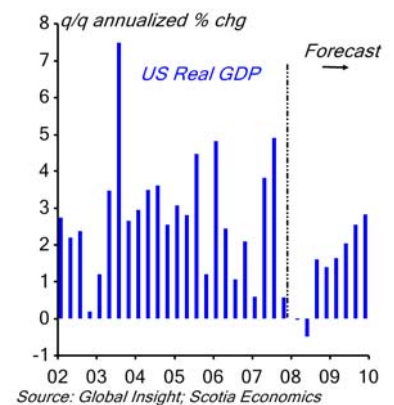
Economic activity surged in January, suggesting Canada's economic outlook may not be as weak as everyone was expecting. However, January's report was very misleading as a surge in auto production—a recovery from plant shutdowns in the prior two months—accounted for almost one-third of the gain. In addition, housing starts bounced back after an unusually weak December and 'one-time' gift-card redemptions led consumer spending. Turning to February then, we are not expecting as strong a print for real GDP. While auto production continued to rebound, supporting Canada's export market, retailers and wholesalers saw sales vanish after a strong January. Single-unit housing activity was also muted during the month suggesting we will likely see a more modest gain in real GDP in February.



## United States — What's Out Next Week

### Conference Board's Consumer Confidence (April) Tuesday, April 29 Not much reason for optimism

Consumer confidence likely fell yet again in April, to an overall index reading of 61. That would haul the index all the way down to its lowest reading since October 1993. More telling of what consumers are thinking is that the forward looking expectations component sits at its lowest level since December 1973—recall the first oil shock—and likely fell even further in April. Ugly by any historical comparison and bound to get worse as the full effects of falling house prices, job losses, and soaring gas prices hit home. Normally, we'd say that confidence measures make poor predictors of actual consumer spending, and would point to the post-9/11 period as an example of how actions speak louder than words. In this newly charted territory, however, the bearish consumer psyche must be front and centre.

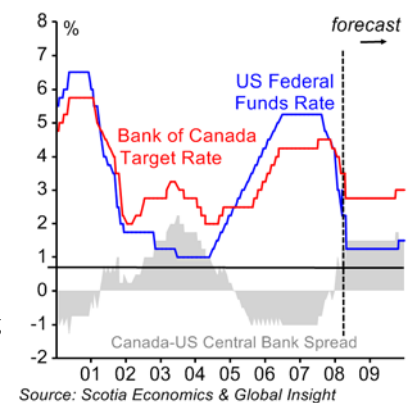


### GDP (Q1 advance) Wednesday, April 30 Moving over to the dark side

The U.S. economy continued to cool in Q1 likely leading to a print of 0.0% q/q annualized, the weakest reading since Q3 2001. The main drag on the economy continues to be the U.S. housing market which deteriorated further in Q1. Consumer spending also contracted as home prices continued to plummet along with equity prices and the labour market shed over 100,000 jobs. In addition, gasoline prices surged ahead to record levels eating into disposable income. International trade remains one of the few bright spots as the U.S. dollar weakened over 6% in Q1 2008.

### FOMC Interest Rate Meeting, Wednesday, April 30 The risks of a 25 bp cut continue to mount

While we would still argue that the Fed will reduce the overnight rate by 50 bps next Wednesday—as the U.S. housing market weakens further, inflation begins to moderate and uncertainty remains high in global financial markets—the risks that the Fed will be less aggressive going forward are mounting. In fact, Wall St. is now pricing in a less aggressive move by the Federal Reserve, with the probability of a 25 bp cut next Wednesday (April 30th) at almost 80% according to Fed funds futures. What is even more interesting is that the market has now completely taken out the possibility of a 50 bps cut as the remaining 20% is now attached to no change in the Fed funds rate next Wednesday! This is drastically different from just last week when the probability of a 50 bp cut was still showing at around 20%. So, what has changed?



First, with 300 bps already shaved off of the target rate, along with the creation of three new lending facilities—TAF, TSLF and PDCF—a substantial liquidity injection by the Fed, and the U.S. government's tax rebate plan, some have argued that the full effect of all of these measures has yet to be felt. As a result, further easing may not be needed as higher inflation may end up being the by-product. This is the argument Dallas Fed President Fisher posed in defense of his dissent to the FOMC's 75 bp cut in March.

Second, while the Fed continues to reduce the target rate aggressively, the pass-through to consumers has been blunted by the rise in funding pressures. Thus, further monetary policy easing would not likely obtain the desired outcome and the FOMC would be pushing on a string.



Lastly, the risk that inflation will not moderate as expected has grown over the past few weeks as commodity prices have continued to move up. Crude oil hit an all-time high on Tuesday, closing at US\$119.37/bbl while rice futures prices hit record highs on Wednesday as some countries have begun to hoard soft commodities for their own citizens, restricting their exports abroad. While many businesses have thus far swallowed the higher energy prices, profit margins continue to be squeezed causing some to start passing these higher costs on, increasing the risk that inflation expectations may begin to move up drastically in the near future.

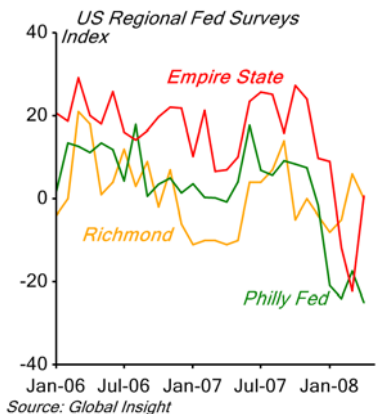
### **Total Vehicle Sales (April) Thursday, May 1 Downshifting**

An expected print of 15 million vehicle sales in April would continue the downward trend that has emerged in recent months, compared to a prior cruising speed of about 16.25 million sales. We fear the worst is yet to come and would look for further trend weakening on both sales and production over 2008-09. A spent-out consumer is likely to rein in big-ticket spending. More dangerous is that the days of bringing forward future demand via extraordinarily generous financing terms are likely coming to an end given the pressures of searching for a new normal in today's credit markets. Auto finance companies are going to find it increasingly difficult to maintain stratospheric loan-to-value ratios that essentially involve no-money-down, plus the lengthiest loan length.



### **ISM Manufacturing Index (April) Thursday, May 1 Manufacturing remains under pressure despite weak U.S. dollar**

While the Philly Fed regional survey plummeted to its lowest level on record, both the Empire State and Kansas City surveys showed some optimism as they returned to expansionary territory. Thus, we will likely see an improvement in the ISM manufacturing survey in April but likely not enough to push it back above the break-even 50 level. Strength should continue to come from the trade side while the domestic side remains a drag.

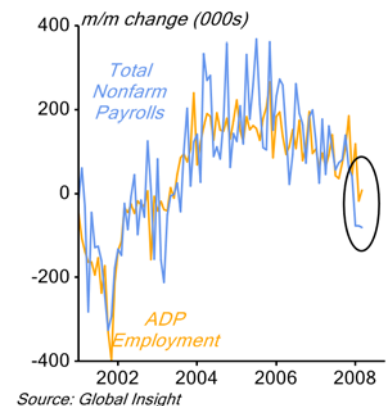


### **Personal Income/Consumption (March) Thursday, May 1 Consumer headwinds intensifying**

Personal income will likely soften in March as job losses continue to mount, housing prices continue to fall and the economy as a whole deteriorates further. With gasoline prices also soaring to all-time highs, personal consumption has begun to weaken with real consumption now growing on a year-over-year basis at just half the level registered in January 2007. Also included in this report is the core PCE deflator, the Fed's preferred inflation measure, which has actually been moderating since December 2007 and is expected to remain at 2.0% in March. This challenges the core CPI measure which is currently moving up and fanning inflation worries despite the fact that the core PCE deflator is now the Fed's preferred inflation measure.

### **ADP Employment Report (April), April 30 Nonfarm Payrolls (April) Friday, May 2 More job losses will weigh on consumer spending**

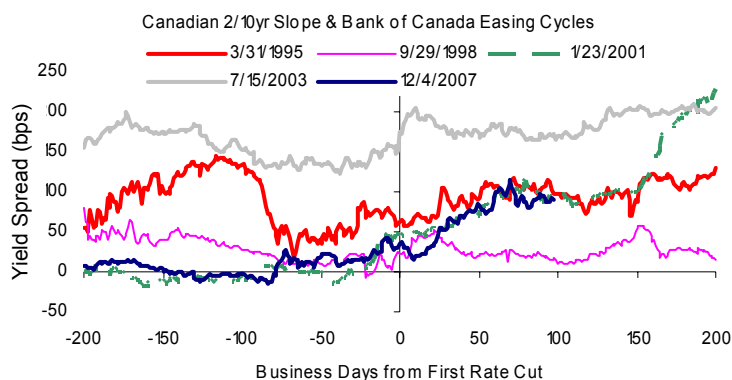
Discount the ADP report which has been out of line with nonfarm payrolls data this year. We're expecting nonfarm payrolls to post a loss of 90,000 jobs in April and an up-tick in the unemployment rate to 5.2%. This would bring the cumulative job losses to about 322,000 so far this year since the cuts began in January. By comparison, so far this is a mild job retrenchment in relation to the 2.7 million jobs lost after the dot-bomb and 9/11 induced shocks. One might therefore be tempted to think that with 95% of labour force participants holding their jobs and growing their wages by around 3.5% over a year ago, cash flow for consumer spending remains strong. We agree, but quantifying shocks to higher energy bills, ARMs resets, negative wealth effects through falling house prices, credit tightness and financial portfolios offset the income growth argument. The result is at best a very weak rate of growth in consumer spending going forward, after controlling for what we think is the one-off effect of tax rebates—assuming a significant portion gets spent. The key is that households are looking more and more likely to view falling house prices as a permanent wealth shock that will have them adjusting spending downward.



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## Fixed Income Markets

### Bank of Canada Easing & Yield Curve Slope



Government bond markets have been volatile, as Treasury investors have reassessed their expectations for Fed easing. Safe-haven concerns have also subsided, in the wake of central bank liquidity measures, financial companies successfully raising new capital, and increased corporate bond issuance. This reappraisal of risk overshadowed the dovish Bank of Canada statement and weak Canadian retail sales this past week.

The Bank of Canada was dovish, even if it also said that the timing of any further cuts would depend on the data. This is a central bank that targets inflation, and that believes inflation will remain below target until 2010. The Bank also recognizes the threat to the

real economy from the effective decline in the supply of credit caused by the global financial crisis. The risks are therefore that the BoC cuts further. Notwithstanding the events of the past week in US Treasuries, this suggests that Canada 2-year yields near 3% are reasonable value. It also argues for at least a modest re-steepening of the curve over the months ahead.

The chart shows the 2x10 spread in Canada during the current easing cycle, which began Dec 4, compared to the 2x10 slope during previous easing cycles. The current episode has so far been very consistent with the two major easing cycles in the past, 1995 and 2001, and with our forecast (e.g. Oct 2 and Dec 18 recommendations). The curve has flattened from its peak near 115 bps in March. Though it has re-steepened slightly in recent weeks, to about 88 bps this week, it remains near the flatter end of what appears “typical” for this point in the cycle. If the BoC does need to cut rates further, at least a modest further re-steepening of the curve seems likely.

For more in-depth fixed income analysis, please refer to the weekly *Fixed Income & Relative Value Strategy* publication.

## Foreign Exchange Markets

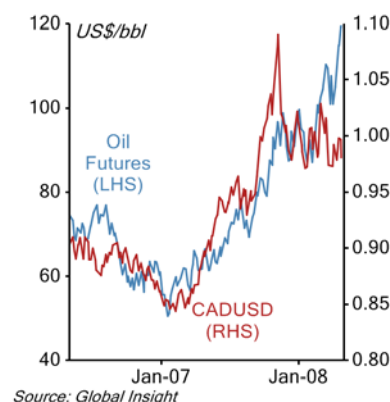
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### Impact of oil prices on CAD

It is hard to ignore the impact that record high oil prices is having on global financial markets and the economic outlook. The effect on FX markets is also noticeable as it has helped propel the EUR higher while leaving CAD stuck in a range. One of the most fascinating aspects of the move higher in oil prices is the circularity between Fed interest rate cuts, a weak USD, high oil prices and inflation, which is beginning to look like a very dangerous cycle for the U.S. and leaves the Fed in a difficult predicament. In a sense the Fed's very attempt to stimulate growth by cutting interest rates might actually be accelerating the move higher in oil prices and hence contributing to the U.S. economic contraction.

In terms of FX, it is notable that the Canadian dollar has been unable to strengthen even in light of oil reaching a new high of \$119.90 per barrel (see chart). Though we think oil prices at these levels continue to be a net positive for the Canadian economy, the offset is that \$120 oil will only aggravate the economic contraction in the US (and globally), which will weigh on Canadian exports and CAD. Accordingly, the market's perception of the impact of elevated crude prices on CAD has gone from a net positive to a net neutral; leaving the Canadian dollar struggling even in the face of \$120 oil. Though in the medium term we think elevated oil prices will prove supportive of a strong CAD, in the near-term we expect market participants to be hesitant to go long CAD in the face of the deterioration in the US and global economic weakness. This leaves the currency trading in what has become an all too familiar range (CAD: 0.9650 and 1.0300).



Source: Global Insight

## Fiscal Policy

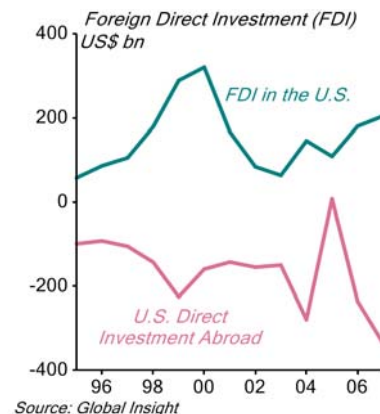
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### Sovereign Wealth Fund Sensitivities

The increasing impact of sovereign wealth funds (SWFs) on global M&A transactions and markets is causing industrialized nations to reassess their response and global organizations to weigh in on the issue. In the U.S., as legislation is implemented overhauling the review process of the Committee on Foreign Investment in the United States (CFIUS) and tightening the scrutiny of foreign investment proposals, the Treasury Department is suggesting additional rules. Specifically, CFIUS can proceed with a review of a proposed foreign purchase involving a stake less than 10% if the purchase offers a level of control to the foreign buyer. The issue revolves around SWFs potentially limiting their investments in U.S. firms to less than 10% to avoid a CFIUS probe. In fact, this action, similar to the U.S. Treasury Agreement late last month with Singapore and Abu Dhabi on “Principles for Sovereign Wealth Fund Investment” underlines the difficulties inherent in monitoring SWF intentions and activity. The policy principles for SWFs stipulated that their investment decisions

should be based solely on commercial grounds, on the basis of equitable competition, complying with all the host country’s regulatory and disclosure requests. In addition the SWFs should have in place strong governance structures, internal controls and operational and risk management systems. Conversely, host countries should ensure a predictable investment framework, a level playing field and national security restrictions proportional to the genuine security risks of the transaction. These guidelines could be viewed as cumbersome or potentially ineffective, yet intensifying economic strains have elevated the risk of protectionist barriers to portfolio or foreign direct investments as well as trade. For Canada, this debate is timely with the federal Competition Policy Review Panel’s report due in June. Canada currently does not have a national security test for foreign investment, an issue that the federal government has indicated it will address, looking at provisions among the other G8 countries and NATO and WTO obligations. Upcoming: Nova Scotia Budget, April 29.



## Monetary Policy

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**FOMC to cut again next week — 50 is our bet, with 25 the risk. Please see page 2.**

### Bank of Canada Still Has at Least Another Rate Cut up Its Sleeve

We generally sympathized with the Bank of Canada’s recent assessments of the pressures facing the global, U.S., and Canadian economies. It was in line with our forecasts, and marks ourselves as being at odds with a fringe view that is only paying attention to the upside risks to inflation while ignoring the big weights attached to downside risks. On balance, we’re of the view that markets are recently getting carried away with inflation concerns, and ignoring the very real prospects for long-term weakness in the U.S., Canadian and global economies beyond simply the next quarter’s expected rebate-fed U.S. growth pop. That may be off current market sentiments, but this whole story has been about markets being out of sync with evolving risks from the beginning. So, our present forecast has one more BoC quarter point cut in the cards for the next rate announcement on June 10<sup>th</sup>, followed by a prolonged holding pattern.

We’re generally in line with the BoC’s inflation forecast. Our call for core CPI to rise modestly to the 1.8% range in the second half of 2009 leads nicely into the BoC’s view that inflation is not expected to reach 2% on either headline or core until 2010 with changes in indirect taxes holding down the headline throughout 2008.

So let’s tackle the headline focus on food and energy prices. Food prices have a 15% CPI weight in the U.S., and 17% in Canada. Energy has roughly 9% weights in both countries. Roughly three-quarters of the CPI baskets in both countries lie in other categories. But what’s good for primary sector producers is crimping wallets and processor margins further up the supply chain who lack pricing power. Even if successfully passed through, this may well crimp other forms of spending and raise competing downside risks to inflation. If you’re paying perhaps hundreds more for groceries and gas, there goes the new car, or backyard deck and 40” flat screen. And if Canadian housing tanks, how exactly do homebuilders pass through higher input costs versus taking back fairly lofty margins? Shelter costs have a one-quarter CPI weight (one-third in the U.S.), such that peaking housing markets and lower mortgage rates will be disinflationary as housing becomes a drag on the economy later this year. Also, as subprime style auto financing gets reined in, look for sales and production to take disinflationary hits. All that said, the reaction function of central banks matters at least in the short-run. The risk is that central banks freeze in their tracks and take a pause (not our base case). We remain of the view, however, that conventional and nonconventional policy adjustments are not over as the credit crisis dominoes have yet to all topple over.

## Estimates for the week of April 28 – May 2

 **Canada**

<u>Date</u>	<u>ET</u>	<u>Indicator</u>	<u>Period</u>	<u>BNS</u>	<u>Consensus</u>	<u>Latest</u>
04/30	(08:30)	Real GDP (m/m)	Feb	0.2	0.2	0.6
04/30	(08:30)	IPPI (m/m)	Mar	--	0.9	0.1
04/30	(08:30)	Raw Materials Price Index (m/m)	Mar	--	--	0.5

 **United States**

<u>Date</u>	<u>ET</u>	<u>Indicator</u>	<u>Period</u>	<u>BNS</u>	<u>Consensus</u>	<u>Latest</u>
04/29	(09:00)	S&P/Case-Shiller Home Price Index (y/y)	Feb	--	-11.9	-10.7
04/29	(10:00)	Consumer Confidence (index)	Apr	61.0	62.0	64.5
04/29	(17:00)	ABC Consumer Confidence (index)	Apr. 27	--	--	-40
04/30	(07:00)	MBA Mortgage Applications (w/w)	Apr. 25	--	--	-14.2
04/30	(08:15)	ADP Employment Report	Apr	-50	-62.5	8.0
04/30	(08:30)	GDP Deflator (q/q a.r.)	Q1-A	2.5	3.0	2.4
04/30	(08:30)	GDP (q/q a.r.)	Q1-A	0.0	0.3	0.6
04/30	(08:30)	Employment Cost Index (q/q)	Q1	--	0.8	0.8
04/30	(09:45)	Chicago PMI (index)	Apr	--	48.0	48.2
04/30	(14:15)	FOMC Interest Rate Meeting (%)		1.75	2.00	2.25
05/01	(00:00)	Total Vehicle Sales (mn a.r.)	Apr	15.0	15.1	15.1
05/01	(00:00)	Domestic Vehicle Sales (mn a.r.)	Apr	--	11.4	11.1
05/01	(08:30)	Initial Jobless Claims (000s)	Apr. 26	--	--	342
05/01	(08:30)	Personal Income (m/m)	Mar	0.4	0.4	0.5
05/01	(08:30)	Continuing Claims (mn)	Apr. 19	--	--	2.93
05/01	(08:30)	Personal Consumption (m/m)	Mar	0.1	0.2	0.1
05/01	(08:30)	PCE Deflator (y/y)	Mar	3.2	3.2	3.4
05/01	(08:30)	PCE ex. Food & Energy (y/y)	Mar	2.0	2.0	2.0
05/01	(10:00)	Construction Spending (m/m)	Mar	--	-0.6	-0.3
05/01	(10:00)	ISM Manufacturing Index	Apr	49.0	48.0	48.6
05/02	(08:30)	Employment Report (000s m/m)	Apr	-90	-75	-80
05/02	(08:30)	Unemployment Rate (%)	Apr	5.2	5.2	5.1
05/02	(08:30)	Average Hourly Earnings (m/m)	Apr	0.2	0.3	0.3
05/02	(08:30)	Average Weekly Hours	Apr	33.7	33.7	33.8
05/02	(10:00)	Factory Orders (m/m)	Mar	--	0.2	-1.3



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