

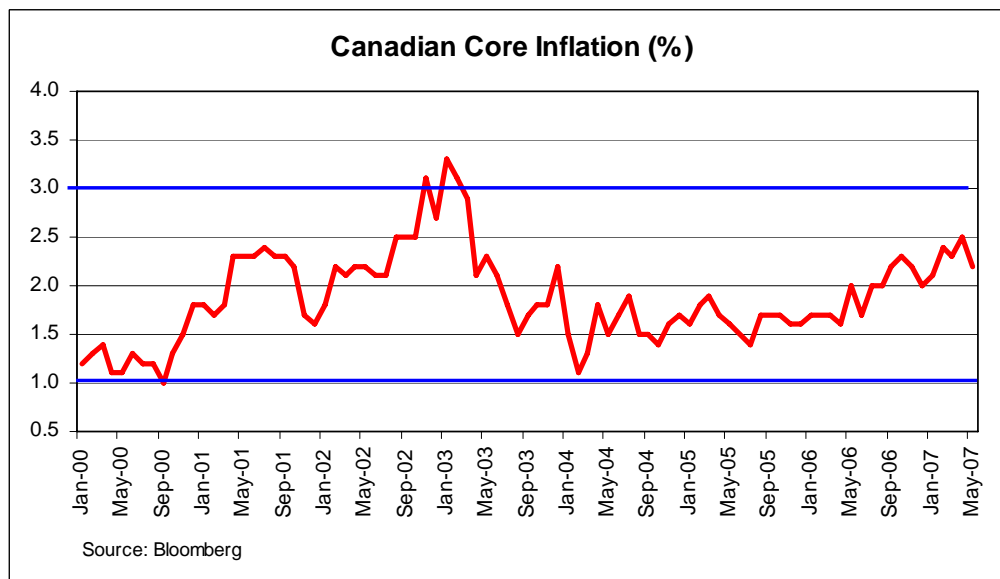
Some General Food for Thought

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Below we provide a casual discussion of the outlook for both Canadian and U.S. economic growth, implications for monetary policy and the outlook for the Canadian dollar.

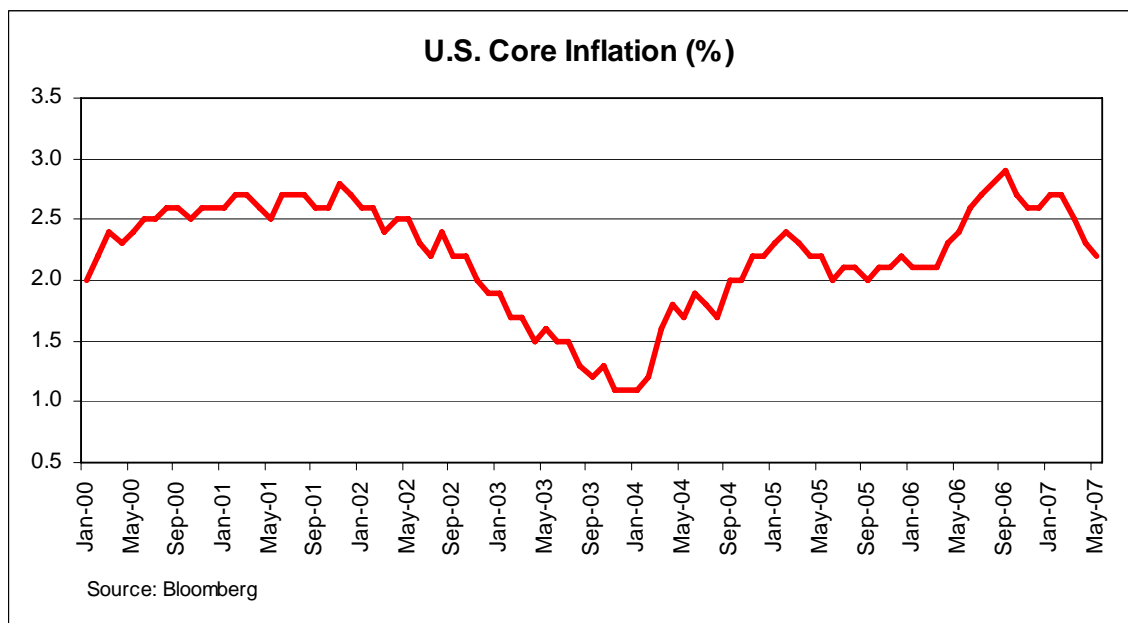
Let's start off with the **economic outlook for Canada**. I would argue that we've seen a 180 degree flip in expectations from only 6 months ago. At the beginning of the year a common theme we heard from a number of economists was that the Canadian economy was going to slow and that we should expect rate cuts some time this year. This is one of the main reasons we were suggesting that investors keep exposure to defensive and interest sensitive names in addition to remaining exposed to resources. It sounded unusual to recommend both defensive (non-economically sensitive) and cyclical (economically sensitive) stocks at the same time, but we thought that global growth would support resources while a domestic slowdown could support defensive and interest sensitive equities.

However, the opposite appears to be occurring as first quarter Canadian GDP growth was better than expected at 3.7% and the Bank of Canada (BOC) is certainly indicating that rate cuts are unlikely in the near future. In fact, BOC Governor David Dodge has said the Canadian economy is growing faster than the BOC had anticipated and that inflation could creep towards 3.0%. If you look at a chart of Core CPI (inflation excluding the effects of food and energy prices), you'll notice that core inflation has been creeping higher since last May (coincidentally around the time when the BOC stopped hiking rates). When I hear the head of the Bank of Canada tell me that growth is better than expected and that core inflation could reach the upper level of the Bank of Canada's preferred 1% to 3% band, I can't help but think that rates are likely to move higher over the coming months. Also, David Dodge recently made comments that implied the value of the Canadian dollar is too high. Quite frankly this was not that surprising. Here's a fellow that wants to raise rates but at the same time doesn't want to see the currency move higher and hurt an already struggling manufacturing sector in Canada. So what do you do when you don't want something to go up? You talk it down and you try and scare speculators out of the market. One could argue from these comments that Mr. Dodge doesn't want to raise rates, but may be forced to move in that direction.



Scotia Economics recently changed their forecasts to include a rate hike in July, **so the ongoing debate is not whether we'll get a rate hike in Canada, but how many rates hikes will we see in the coming months.** Scotia Economics believes we will only see one rate hike this year as they think the Canadian dollar could be pushed to a level where the Bank of Canada will try and withhold raising rates at all costs. However, many economists can probably argue that the Canadian dollar has not been the main driver for monetary policy over the past decade. Instead it has been core inflation. **So the question remains, even after a rate hike in July, what will the Bank of Canada do if inflation continues to climb?** This is where a divergence of opinion takes place. If we base the answer to that question on historical precedence of the Bank of Canada favouring its core inflation target over the Canadian dollar, then one can conclude that more than one rate hike is on the way. The key here is core inflation. Now that we could be at a turning point for interest rates, it will likely be watched even more closely than it was before.

What about the **U.S. economic growth** though? According to Scotia Economics we should see a rate cut in the fourth quarter of this year. This prediction does not seem completely unrealistic considering that the U.S. recently reported its worst quarterly GDP growth rate in 4 years at 0.6%. However, we are also hearing that growth in the second quarter has accelerated and the U.S. is producing a decent stream of positive economic data such as recent retail sales numbers, the ISM Manufacturing Index, and monthly employment reports. **Was the first quarter a bottom for economic growth? Does the U.S. need monetary stimulus or has that economy already started to pick up steam? Could the U.S. follow Canada's lead and be a country where rate cuts are expected, only to see rate hikes in the future?** This is the ongoing debate and if recent market volatility is an indicator, it would appear that investors are becoming more convinced that rate cuts are less likely. Ben Bernanke has been telling us that inflation remains a concern even though it has been declining since last May; however, it is still at a 2.3% level which is above the average core inflation rate we've seen since the beginning of the decade. **If core inflation starts to creep higher in the near future then that will only add fuel to fire of this interest rate debate.**



Everyone knows that the Canadian dollar has appreciated since 2002. A number of factors have contributed to this strength including a strong growth outlook for Canada, an improving fiscal position for our governments, and higher commodity prices. However, we have seen a recent jump from US\$0.86 to US\$0.945 over the past two months alone which is a large move for our currency in a short period of time leading many investors to ask why the recent surge in value?

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Although the press may chalk up the gains to strength in commodity prices, I would probably argue that commodities have likely had little to do with the most recent run as most commodity prices are either unchanged or lower over the same two month period. Obviously talk of better than expected growth and higher inflation leading to interest rate hikes has had a positive impact and recent GDP growth differences between Canada and the U.S. could be pinpointed as a source of strength. However, one could also conclude that strength has been accentuated as of late by **speculators stepping into the market** with the expectation that the loonie will move higher. Speculators have a reason to be bullish and the source of that bullish sentiment can be found in the recent wave of **Merger & Acquisition transactions** in Canada. More importantly M&A activity that involves foreign companies buying Canadian companies for cash consideration. There are currently four large Canadian companies that have announced they have received takeout offers from foreign buyers:

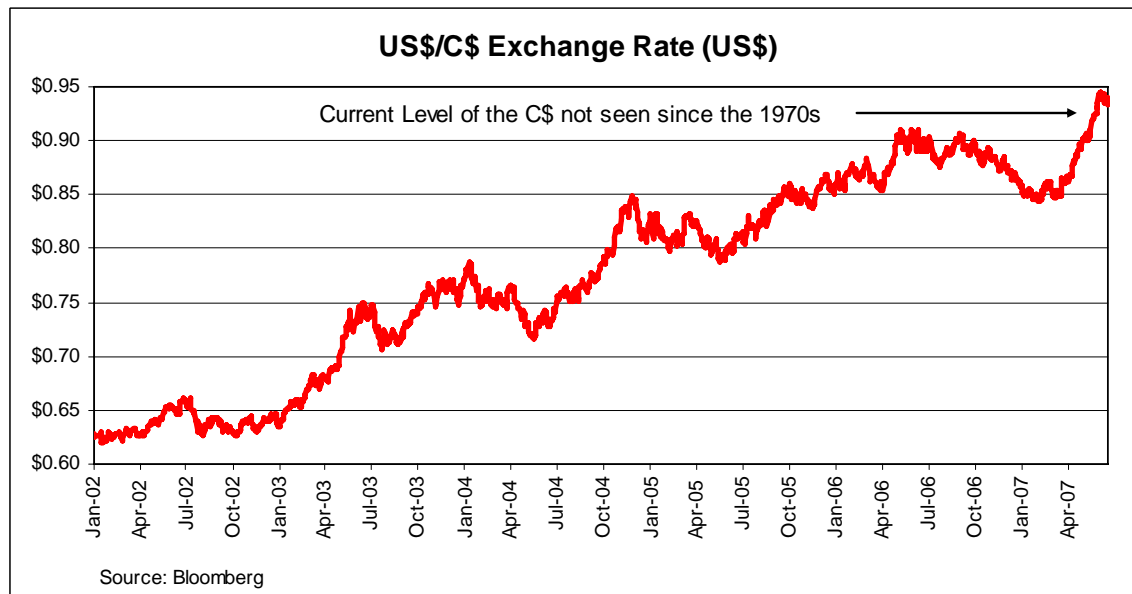
An Indian company is offering to buy Algoma Steel for \$1.6 billion cash

A Swedish company is offering to buy IPSCO for \$8.2 billion cash

A Russian company is offering to buy Lionore for \$5.5 billion cash

And Alcoa, a U.S. company, is offering to buy Alcan where the cash consideration of the deal is currently about \$21.6 billion

If all of these deals were to close under their current terms, and who knows, Alcan could go for a higher amount with more cash consideration, then you have about **\$37 billion worth of Canadian dollar purchases likely coming within the next 6 months**. Now \$37 billion over a longer period of time may not be a large amount, but most of these purchases will be made at one time, especially in the case of Alcan. And just like any supply/demand situation, when you have more buying than selling, pricing pressure is likely to move higher. If you're a speculator, you can foresee these purchases coming and your instinct is to buy the currency before some of these companies make their Canadian dollar purchases in the hope that foreign purchases will push the Canadian dollar higher and make speculators some short term profit. **So interest rate talk may not be the only reason why the Canadian dollar has spiked, speculators may have a lot to do with it as well.**



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Of course the big question is whether we're going to parity and my answer to that in all honesty is that I have no clue. However, what I would say is that if we do go to parity, I would expect that any stay above the US\$1.00 would be short lived simply because if M&A cash transactions tend to slow then speculators may elect to exit the Canadian dollar market which will remove some of the short term momentum that we've seen since April. **So in conclusion, can the Canadian dollar go higher in the short term? Absolutely. Are we going to par with the U.S. dollar? I really don't know. If we do go to parity will it stay there for a long period of time? Probably not.**

And so concludes today's food for thought.

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