

## Highlights

- The latest indicators show the world economy off to a robust start in 2010 and point to continuing vigour. Beijing has begun to rein in Chinese credit expansion in response to surprisingly strong growth and soaring imports and exports.
- Despite a disappointing December employment report, the U.S. economy is headed in the right direction. Consumers have entered a virtuous circle of deleveraging, in which a savings rate in the neighbourhood of 5% allows growth in consumer spending in tandem with reduction of household debt. We continue to expect U.S. growth of 3.4% in 2010.
- Canada is well ahead of the U.S. in the recovery of its labour market. Jobs in services rose to an all-time high in December and the aggregate wage bill showed strong growth in Q4, confirming that domestic demand will have legs. We are raising our forecast of Canadian growth to 3.1% in 2010.

	2009	2010	2011	Change from Previous Forecast	
				2010	2011
<b>United States</b>					
GDP	-2,5%	3,4%	2,2%	unch	unch
CPI inflation	-0,3%	2,7%	2,2%	+0.4pp	-0.3pp
Overnight rate*	0,11%	1,25%	2,25%	-25bp	unch
Ten-year bond yield*	3,84%	4,34%	4,33%	+11bp	-29bp
<b>Canada</b>					
GDP	-2,5%	3,1%	2,2%	+0.2pp	unch
CPI inflation	0,3%	1,6%	2,3%	unch	+0.2pp
Overnight rate*	0,25%	1,75%	2,25%	+25bp	-25bp
Ten-year bond yield*	3,61%	4,14%	4,08%	+4bp	-50bp
USD/CAD	0,92	0,94	0,95	+0.01	-0.03

\* end of period

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## World: Surprising resurgence of trade

The latest indicators show the world economy off to a robust start in 2010 and point to continuing vigour. Beijing has begun to rein in Chinese credit expansion in response to surprisingly strong growth and soaring imports and exports.

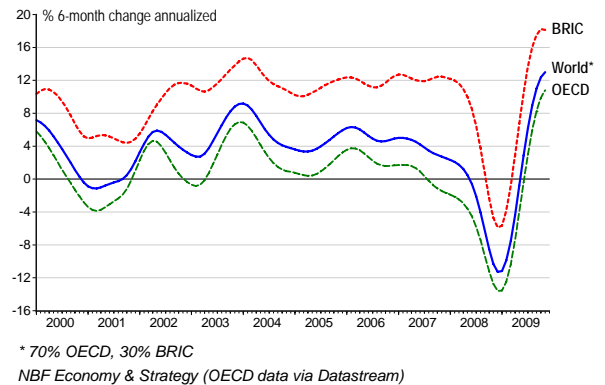
The news from the world economy is upbeat. Leading indicators for the OECD and BRIC countries show spectacular momentum, eclipsing all readings of the previous cycle. The world purchasing managers index, a gauge of global manufacturing strength, rose in December to a 44-month high. Such vigour will no doubt oblige the IMF to revise up its global growth forecast.

The oomph of the world trade rebound has surprised even Beijing. Chinese imports rose a blistering 21% in December. On a seasonally adjusted basis they are now 8% above the previous peak and 93% above the January low. Exports are also up strongly and are close to the 2008 peak. The combination has driven Chinese growth at a faster-than-expected pace.

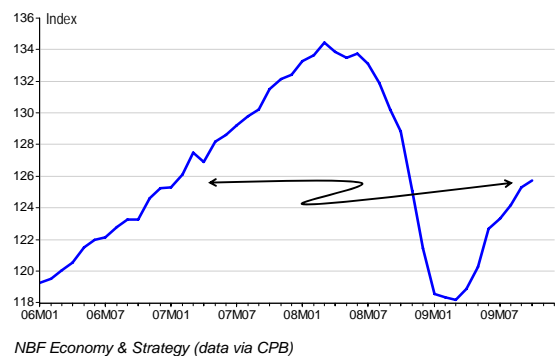
Beijing has responded by starting to normalize credit expansion. In the first 11 months of last year, China lent a cumulative 9.21 trillion yuan compared to 4.15 trillion in 2008. In mid-December 2009, the government guidance to banks for 2010 was on the order of 7.5 trillion yuan. In addition, Beijing raised the bank reserve requirement half a point last month, to 15%. Stiffer measures are possible but will probably wait until the second half of the year.

China's one-year lending rate is currently 5.31%, lower than during the Asian crisis. The current rate of growth will oblige the central bank to raise its policy rate this year to mop up liquidity. That said, China is far from adoption of a restrictive monetary stance. Any rate rise would be aimed more at forestalling bubbles than at slowing the economy.

### World: Leading indicators signal above-trend growth

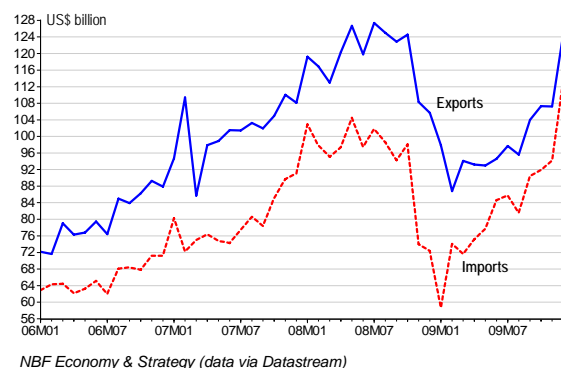


### World: Real industrial output back to 2007 level



### Surging Chinese trade ...

Value of monthly exports and imports (seasonally adjusted)



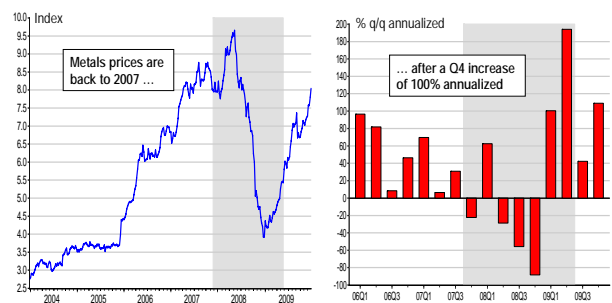
**World Economic Outlook**

	<u>Current Forecast</u>		
	2009	2010	2011
<b>Industrialized Countries</b>	<b>-3,1</b>	<b>2,5</b>	<b>1,9</b>
<i>(share of world GDP = 50%)</i>			
United States	-2,5	3,4	2,2
Euroland	-3,2	1,9	1,6
Japan	-5,3	1,5	1,5
UK	-4,5	1,5	1,8
Canada	-2,4	3,1	2,1
Australia	1,1	2,8	2,8
New Zealand	-1,2	2,5	2,2
<b>Asia (excluding Japan)</b>	<b>5,5</b>	<b>7,9</b>	<b>6,9</b>
<i>(share of world GDP = 25%)</i>			
China	8,5	10,0	8,5
Hong Kong	-2,9	4,0	3,3
India	6,6	7,8	7,2
Indonesia	4,5	5,0	4,2
Korea	0,2	4,7	4,0
Malaysia	-2,2	4,5	3,8
Philippines	1,2	3,7	3,5
Thailand	-3,0	4,2	3,8
Taiwan	-3,4	4,5	4,2
Singapore	-2,1	5,0	4,3
<b>Latin America</b>	<b>-2,7</b>	<b>3,8</b>	<b>2,9</b>
<i>(share of world GDP = 6%)</i>			
Mexico	-6,9	3,9	2,5
Brazil	-0,1	4,5	3,5
Argentina	-2,5	3,0	2,0
Venezuela	-2,2	0,3	1,5
Chile	-1,8	4,5	3,5
Peru	0,9	4,2	3,8
<b>Eastern Europe</b>	<b>-5,7</b>	<b>3,2</b>	<b>3,1</b>
<i>(share of world GDP = 5%)</i>			
Russia	-7,9	4,0	3,3
Czech Rep.	-4,1	1,5	1,8
Hungary	-6,5	0,0	2,0
Poland	1,5	2,0	2,5
Turkey	-5,8	3,5	3,8
<b>World</b>	<b>-1,0</b>	<b>4,1</b>	<b>3,4</b>

Source: NBF Economic Research, Consensus Economics

Meanwhile, metals prices are back where they were in 2007 and early 2008, driven by turnarounds in world industrial output and trade. The Netherlands CPB Bureau of Economic Policy reports industrial production up at an annual rate of 4.4% in October, a seventh straight monthly rise that takes this indicator back to its 2007 level. Thus it is hard to argue that commodity prices are out of line with economic fundamentals. BRIC and OECD leading indicators suggest that the uptrend will continue in 2010.

**... surging commodity prices**  
CRB Metals index



NBF Economy & Strategy (Commodity Research Bureau, data via Global Insight)

At this writing we see neither much upside nor much downside in commodity prices. The experience of a decade ago suggests that at a time of brisk global and Chinese expansion (the latter at 8%-plus this year), a rise of Chinese interest rates will not be enough to trigger a correction of commodity prices as long as rates remain accommodative.

In short, conditions seem to be in place for above-trend global growth in 2010.

## U.S.: Headed in the right direction

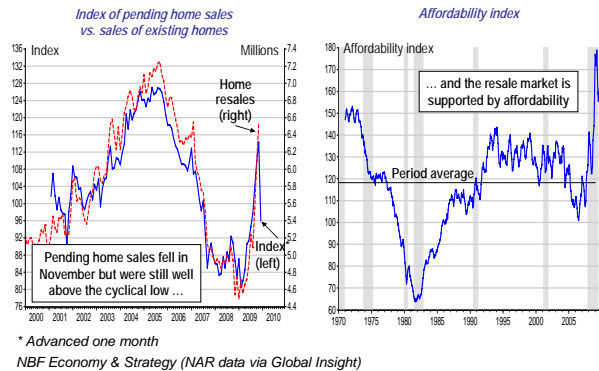
The U.S. economy has entered a virtuous circle of consumer deleveraging. A savings rate in the neighbourhood of 5% is reducing household debt while allowing growth in consumer spending.

The U.S. index of pending home sales – a leading indicator of home resale volume – fell a record 16% in November. The slide was probably due to the scheduled expiry of the first-time homebuyer tax credit, which was later extended to April 30, 2010. But even after that decline, the pending sales index is 20% above its cyclical low. If the Federal Reserve manages to keep mortgage rates fairly low and the labour market firms as we expect, we do not fear an extended housing slump. The affordability index is very high even without support programs.

Some forecasters will no doubt take the opportunity to declare the U.S. economy still too weak to recover without massive government assistance. The same fear was expressed when the cash-for-clunkers program ran out, but new-vehicle sales are already back up 25% from their post-buyback low. We are confident the housing market will come back too.

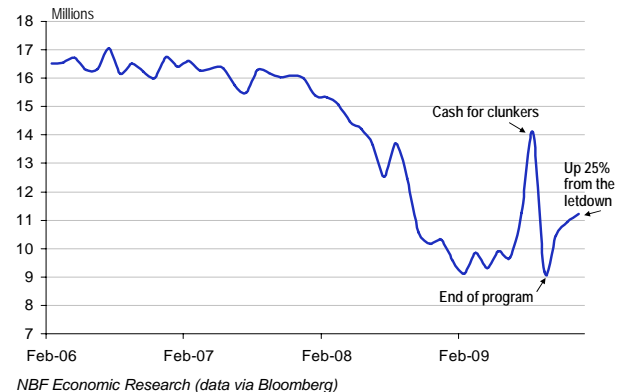
The ISM manufacturing index rose in December to a 44-month high. Its production and new-orders components are both above 60, well over the growth threshold of 50. The improvement of diffusion indexes in recent months is increasingly reflected in the official data. Two months into Q4, manufacturing shipments of nonmilitary capital goods excluding aircraft were up more than 6%. When machinery and equipment imports are added in, the data clearly point to a second quarter of growth in national-accounts business investment – a strong recovery signal.

### U.S.: Index of pending home sales plummets in November



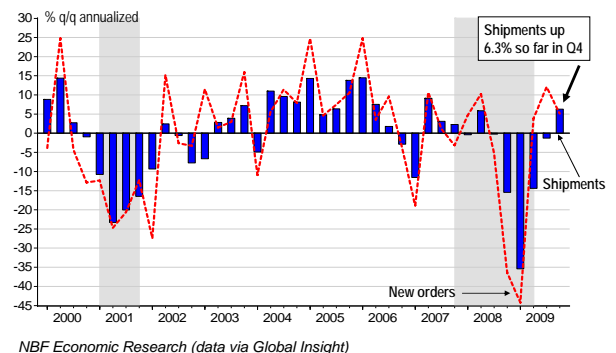
### Auto sales up from post-cash-for-clunkers blues

U.S. motor vehicle sales, seasonally adjusted annual rate

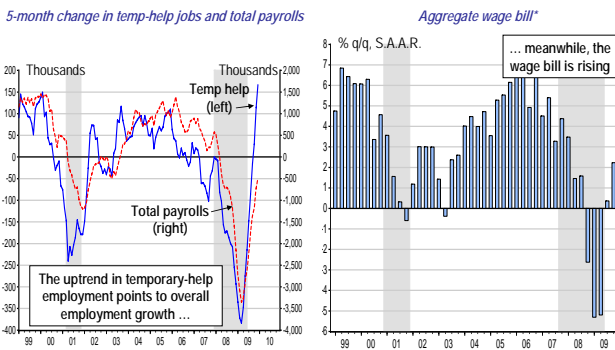


### New orders still firm

New orders and shipments of nonmilitary capital goods excluding aircraft



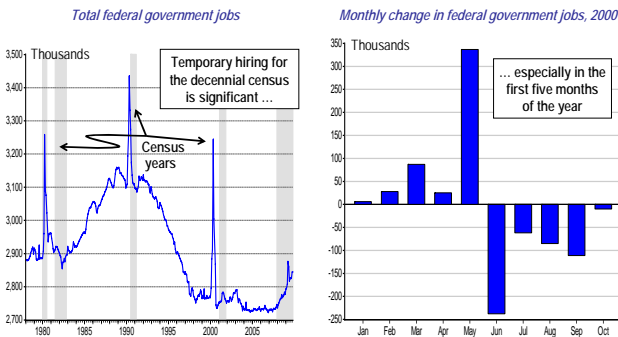
**U.S.: Room for optimism on employment**



\* Total hours worked times average hourly earnings  
NBF Economy & Strategy (BLS data via Global Insight)

The U.S. lost 85,000 jobs in December. This decline followed a revised November gain of 4,000, the first upturn in 23 months. The December disappointment does not herald a relapse. On the whole, the news from the labour market continues to improve. In mid-January, initial unemployment insurance claims were down to 444,000 weekly, the lowest since mid-2008 and a decline of 230,000 from the March 2009 peak of 674,000. This is the sharpest nine-month drop since the end of the 1982 recession. Moreover, employment in temporary-help agencies rose 46,500 in December, the fifth consecutive monthly gain. As the chart shows, the cumulative five-month increase suggests that the U.S. labour market is in on the verge of much better health. And although payrolls shrank in December, consumer spending was sustained by a 2.2% rise of the aggregate wage bill in Q4, the largest increase since the beginning of the recession.

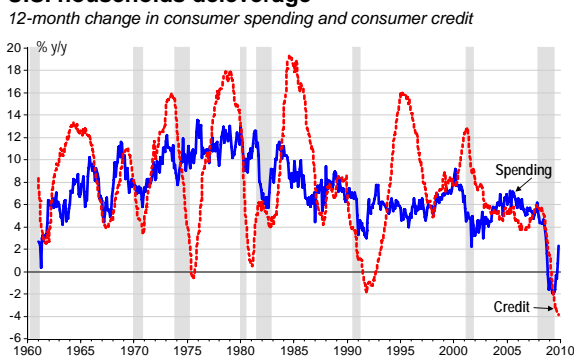
**U.S.: An employment boost from census-taking jobs**



NBF Economy and Strategy (data via BLS)

This spring the Census Bureau will start taking the next decennial census. The preparatory work requires many temporary workers. By chance, and for the first time in 40 years, the census will boost payrolls right at the beginning of recovery. As the middle chart shows, employment rose 500,000 in the first five months of 2000. A similar spike this year can be expected to buoy household confidence.

**U.S. households deleverage**



NBF Economy and Strategy (data via Global Insight)

The decline of consumer credit continues to spill ink but does not shake our confidence in the U.S. economy. Consumer spending is growing. With a savings rate close to 5%, U.S. households are putting aside a little more than \$40 billion a month, repaying \$17 billion in credit and still increasing their spending apace with disposable income. This is a virtuous circle of orderly household deleveraging. Consumption is up 2.3% from a year ago and consumer credit is down 3.9% (chart). The U.S. economy is headed in the right direction.

## Canada: Ahead of the U.S.

Canada is well ahead of the U.S. in the recovery of its labour market. Jobs in services rose to an all-time high in December and the aggregate wage bill showed strong growth in Q4, confirming that domestic demand will have legs. We are raising our forecast of 2010 GDP growth to 3.1%.

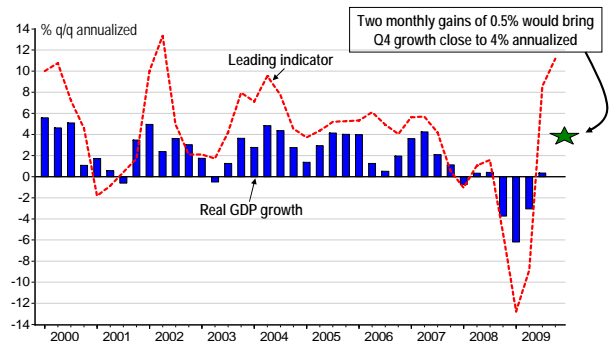
Canadian GDP at factor cost grew 0.2% in October. Its services component grew at the same rate, a seventh straight month of expansion. The weakest component of GDP was durable goods production, down 0.4%. We expect a rebound here because exports to the U.S. were up robustly in the fourth quarter and the vigour of the housing market is likely to boost the construction component. Taking account of one-off factors and the sharp rise of the leading indicator, we see the Canadian economy accelerating to fourth-quarter growth of about 4% annualized.

Paradoxically, the output gap calculated by the Bank of Canada shows a supply overhang comparable to that of the recession of 1990-91. But this measure masks another development, a shift of the Canadian economy from goods to services, which now account for 75% of all GDP. And the last recession was sector-specific – the bulk of the excess supply is in goods production (chart). Monetary policy responded to a shock affecting a declining share of GDP, and we fear that inflationary pressure could turn up sooner than expected in services, especially given the strength of the global recovery.

Especially, also, given that Canada is well ahead of the U.S. in the recovery of its labour market. True, 2,600 jobs were lost in December, but a marginal decrease is normal after the unusual November rise of 79,100. Most important, employment in services is now at an all-time high, in sharp contrast to the U.S. where it is still 3% down from the previous peak. In addition, the Canadian aggregate wage bill was up a strong 3.5% annualized in Q4, the second straight quarter of highly respectable growth. These two developments give strong support to domestic demand on this side of the border. Since Canada is a commodity exporter, real GDP is not the only important indicator. Gross domestic income is more in line with labour market statistics.

### Canada: Acceleration of GDP growth in Q4

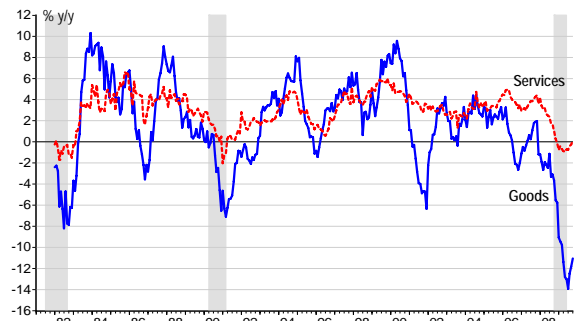
Real GDP and leading economic indicator



NBF Economy & Strategy (Statistics Canada data via Global Insight)

### Canada: A changing economic structure

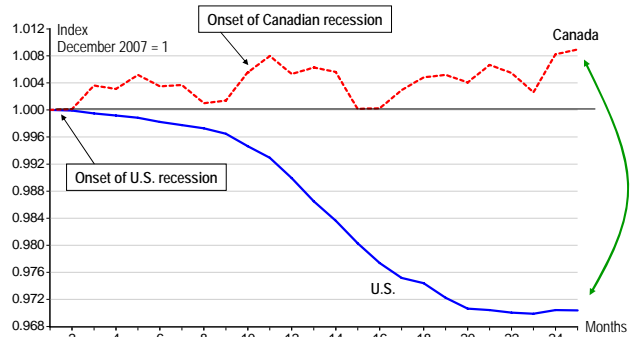
12-month change in goods output and services output



NBF Economy & Strategy (Statistics Canada data via Global Insight)

### Canada vs. U.S.: Different stories

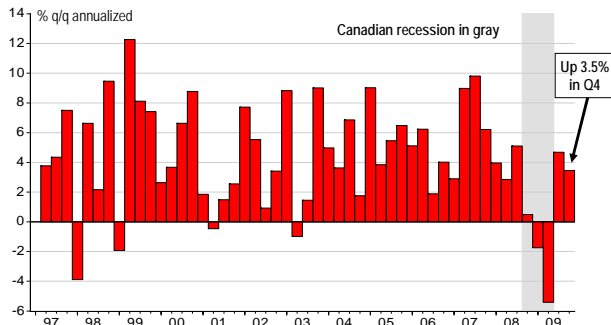
Employment in services



NBF Economy & Strategy, Global Insight

**Canada: Strong growth of aggregate wage bill in Q4**

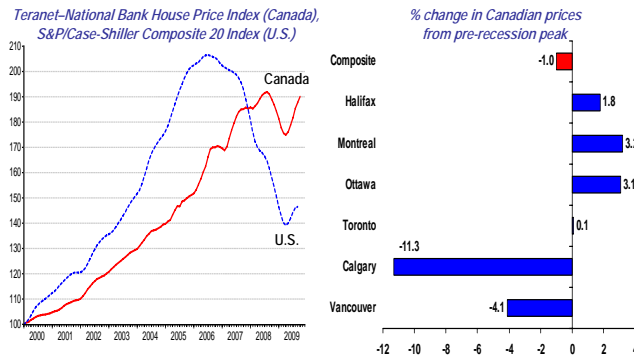
Change in total hours worked times average hourly earnings, seasonally adjusted



The selling prices of existing Canadian homes rose sharply in October. The Teranet–National Bank Composite House Price Index was up 1.3% from September, a sixth consecutive monthly rise. Prices rose in all six of the metropolitan markets surveyed. Toronto became the fourth market where prices reached new highs, leaving the composite index down only 1% from its pre-recession peak. In just six months the index has recovered almost all the ground lost in the recession. In marked contrast to the U.S. experience, prices have recovered so fast that regulators are thinking of tightening access to homeownership. With prices rising and inventories low, housing starts jumped almost 70% in Q4. The quarter will come in as another good one for residential investment.

**Canada: Home prices almost back to peak**

Index of home prices (repeat-sales method)



NBF Economy & Strategy (Teranet–National Bank, S&P/Case-Shiller)

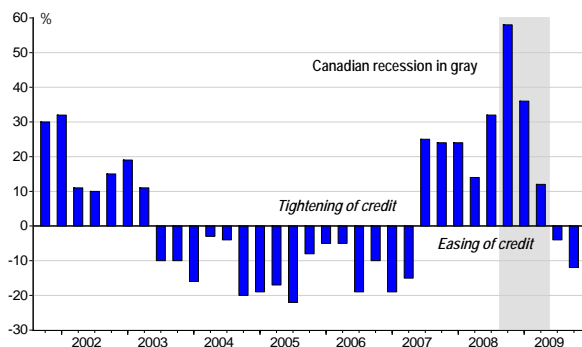
The Canadian recovery has gained additional lift from a relaxation of business credit conditions for the first time since the pre-recession days of 2007. This will help businesses as well as households contribute to the recovery now under way, further supporting our growth scenario.

With the labour market recovering a little faster than expected in Canada, we are raising our forecast of real GDP growth in 2010 to 3.1% from 2.9%.

**Yanick Desnoyers**  
Assistant Chief Economist

**Business credit eases**

Balance of opinion – Bank of Canada Business Outlook Survey



### Canada Economic Forecast

<i>(Annual % change)*</i>	2007	2008	2009	2010	2011	Q4/Q4	
						2010	2011
Gross domestic product (2002 \$)	2,5	0,4	(2,5)	3,1	2,2	3,8	1,4
Consumption	4,6	3,0	0,1	2,7	2,6	2,6	2,7
Residential construction	2,9	(2,7)	(8,4)	2,4	1,2	0,6	1,0
Business investment	3,7	0,2	(14,9)	1,5	7,1	7,3	6,3
Government expenditures	3,7	4,8	3,9	3,1	2,6	2,4	2,5
Exports	1,1	(4,7)	(13,9)	5,0	2,1	4,2	1,0
Imports	5,8	0,8	(13,9)	6,7	5,1	4,0	5,7
Change in inventories (millions \$)	14 990	12 241	(6 874 )	5 875	9 750	8 000,0	10 000,0
Domestic demand	4,1	2,6	(1,6)	2,7	3,1	3,0	3,0
Real disposable income	3,6	4,2	1,2	2,1	2,3	2,5	2,2
Employment	2,3	1,5	(1,6)	0,7	1,2	1,1	1,2
Unemployment rate	6,0	6,2	8,3	8,3	8,0	8,1	8,0
Inflation	2,2	2,4	0,3	1,6	2,3	1,8	2,5
Before-tax profits	4,1	5,7	(34,8)	13,3	8,6	15,0	5,0
Federal balance (Public Acc., bil. \$)	\$9,6	\$0,0	(\$45,0)	(\$30,0)	(\$20,0)	....	....
Current account (bil. \$)	\$15,6	\$8,1	(\$32,8)	\$4,5	\$8,0	\$5,0	\$8,0

\* or as noted

### Financial Forecast\*

	Current	Q1/10	Q2	Q3	Q4	2010	2011
	1-15-10						
Overnight rate	0,25	0,25	0,75	1,25	1,75	1,75	2,25
Prime rate	2,25	2,25	2,75	3,00	3,50	3,50	4,00
3 month T-Bills	0,29	0,53	0,96	1,44	2,02	2,02	2,22
Treasury yield curve							
2-Year	1,29	1,50	1,97	2,22	2,43	2,43	2,70
5-Year	2,65	2,95	3,24	3,48	3,52	3,52	3,60
10-Year	3,50	3,84	3,99	4,19	4,14	4,14	4,08
30-Year	4,06	4,30	4,35	4,51	4,45	4,45	4,37
Exchange rates*							
USD per CAD	0,97	0,97	0,95	0,93	0,92	0.94**	0.95**

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\* end of period

\*\* annual average

### United States Economic Forecast

(Annual % change)*						Q4/Q4	
	2007	2008	2009	2010	2011	2010	2011
Gross domestic product (2005 \$)	2,1	0,4	(2,5)	3,4	2,2	3,5	1,9
Consumption	2,6	(0,2)	(0,6)	2,1	1,7	2,2	1,5
Residential construction	(18,5)	(22,9)	(20,2)	8,6	6,3	9,5	5,0
Business investment	6,2	1,6	(17,8)	3,4	6,2	7,3	4,7
Government expenditures	1,7	3,1	2,1	2,5	2,0	2,0	2,0
Exports	8,7	5,4	(10,3)	6,9	3,9	5,2	3,0
Imports	2,0	(3,2)	(14,1)	8,7	5,7	7,7	4,5
Change in inventories (bil. \$)	19,5	(25,9)	(120,8)	42,5	77,5	70,0	85,0
Domestic demand	1,7	(0,4)	(2,6)	2,5	2,3	2,8	2,0
Real disposable income	2,2	0,5	1,3	2,9	2,3	3,1	1,8
Household employment	1,2	(0,5)	(3,8)	(0,0)	1,7	2,0	1,5
Unemployment rate	4,6	5,8	9,3	9,7	9,3	9,5	9,3
Inflation	2,9	3,8	(0,3)	2,7	2,2	2,2	2,4
Before-tax profits	(4,1)	(11,8)	(5,2)	13,2	5,5	8,0	4,0
Federal balance (unified budget, bil)	(\$161,0)	(\$459,0)	(\$1 800,0)	(\$1 200,0)	(\$900,0)	...	...
Current account (bil. \$)	(\$746,0)	(\$690,0)	(\$410,0)	(\$490,0)	(\$450,0)	(\$450,0)	(\$450,0)

\* or as noted

### Financial Forecast

	Current						
	1-15-10	Q1/10	Q2	Q3	Q4	2010	2011
Fed Fund Target Rate	0,11	0,16	0,23	0,75	1,25	1,25	2,25
3 month Treasury bills	0,06	0,07	0,42	0,93	1,33	1,33	2,18
Treasury yield curve							
2-Year	0,87	1,13	1,57	1,77	2,04	2,04	2,60
5-Year	2,42	2,74	3,09	3,30	3,41	3,41	3,66
10-Year	3,68	4,01	4,16	4,38	4,34	4,34	4,33
30-Year	4,58	4,82	4,88	5,03	4,99	4,99	4,99
Exchange rates*							
U.S.\$/Euro	1,44	1,40	1,35	1,30	1,25	1.33**	1.30**
YEN/U.S.\$	91	98	102	108	110	105**	104**

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\* end of period

\*\* annual average