

Highlights

- *Europe's cyclical momentum means that the chances of its dragging down global growth have lessened in recent months. However, a slowdown of the advanced economies next year is likely to bring a soft landing in 2011.*
- *The U.S. badly needs more private-sector job growth to reduce its unemployment rate and keep the Fed from moving to additional quantitative easing. BEA revisions of past GDP numbers have reduced our expectation of 2010 growth, but we have revised up our outlook for 2011 in response to a higher savings rate and a less aggressive reversal of fiscal policy.*
- *Since rock-bottom interest rates have encouraged Canadians to borrow from the future for spending on housing and consumption, the recent performance of the economy is no guarantee of its future as household dissaving comes to an end. We expect that strong 3.3% growth in 2010 will be followed by a deceleration of consumer spending and GDP in 2011.*

	2009	2010	2011	Change from Previous Forecast	
				2010	2011
United States					
GDP	-2.6%	2.7%	2.3%	-0.9%	-0.1%
CPI inflation	-0.3%	1.6%	1.9%	-0.1%	-0.4%
Overnight rate*	0.11%	0.25%	1.00%	unch	-100bp
Ten-year bond yield*	3.84%	2.68%	3.57%	-118bp	-76bp
Canada					
GDP	-2.5%	3.3%	2.1%	-0.3	unch
CPI inflation	0.3%	1.8%	2.4%	unch	unch
Overnight rate*	0.25%	1.00%	1.50%	-50bp	-125bp
Ten-year bond yield*	3.61%	2.95%	3.70%	-90bp	-40bp
USD/CAD	0.92	0.96	1.00	-0.01	+0.01

* end of period

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World: A soft landing in 2011

The chances that Europe will drag down global growth have lessened in recent months. However, a slowdown of the advanced economies next year is likely to bring a soft landing in 2011.

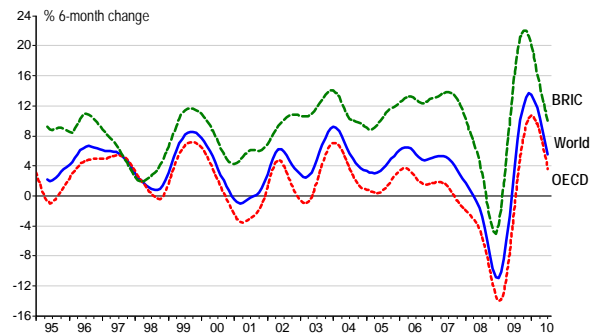
The six-month rise of the OECD composite leading indicator has slowed considerably from its 2009 peak, signalling a coming deceleration of global growth. That said, deceleration is not contraction. True, there is a risk that Chinese growth will be abruptly cramped by a slowdown of homebuilding accompanied by real estate price deflation. On the other hand, Asia's monetary policies are highly accommodative by historical standards and can be expected to remain expansionary. In China, only a slowdown is anticipated because its high level of homeowner equity implies a negative wealth effect for Chinese households, whose rate of saving is already considerable, rather than a banking crisis and credit freeze.

The recovery of world trade continues apace. Volume trade is now back to the previous peak, with 12-month growth running at an impressive 20%-plus. In parallel with the rebound of trade, industrial output has risen spectacularly in emerging countries and is now 11.9% above the pre-recession peak. This vigour more than offsets the drag from industrial output in the advanced economies, such that the aggregate industrial output of the world's major economies is now past the pre-recession peak. The hectic pace of the emerging economies is unlikely to continue for long – since the advanced economies are likely to slow as fiscal stimulus winds down – but they can be expected to continue growing briskly next year.

The International Energy Agency forecasts an all-time high in oil consumption next year. The rise will be due entirely to non-OECD demand. OECD demand is forecast to be flat.

Leading indicators point to global cooling

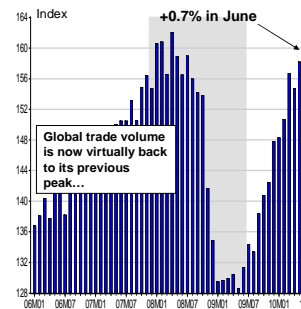
Leading economic indicators – world, OECD, BRIC



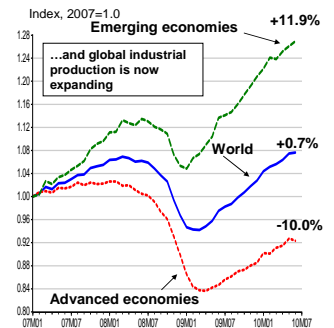
NBF Economy & Strategy (data via Datastream)

Global trade volume finally back to its previous peak

Global trade volume



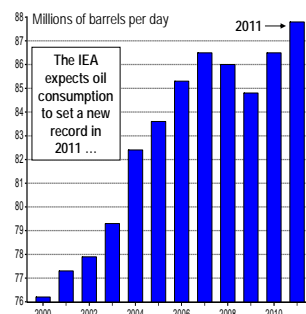
Global industrial production (volume output)



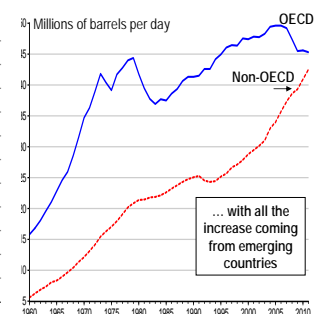
NBF Economy & Strategy (Data via CPB Bureau for Economic Policy Analysis)

World: Record oil demand forecast for 2011

Global oil consumption



Oil consumption: OECD vs. non-OECD countries



NBF Economy & Strategy (data via Datastream)

World Economic Outlook

Current Forecast

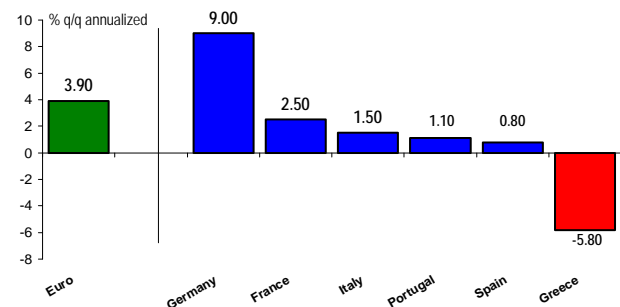
	2009	2010	2011
Industrialized Countries	-3.4	2.3	1.9
<i>(share of world GDP = 50%)</i>			
United States	-2.6	2.7	2.3
Euroland	-4.0	1.4	1.5
Japan	-5.1	2.8	1.5
UK	-5.0	1.5	2.0
Canada	-2.6	3.3	2.1
Australia	1.3	3.5	2.1
New Zealand	-1.4	3.0	2.9
Asia (excluding Japan)	5.9	8.4	7.1
<i>(share of world GDP = 25%)</i>			
China	8.7	10.0	8.5
Hong Kong	-2.7	5.0	4.0
India	7.0	8.0	7.5
Indonesia	4.5	5.5	4.7
Korea	0.2	5.5	4.0
Malaysia	-1.7	7.0	5.0
Philippines	0.9	5.0	4.2
Thailand	-2.3	5.0	4.2
Taiwan	-1.9	6.5	3.9
Singapore	-2.0	9.5	4.5
Latin America	-2.6	5.2	3.3
<i>(share of world GDP = 6%)</i>			
Mexico	-6.5	4.5	3.1
Brazil	-0.2	7.0	3.5
Argentina	-2.9	6.0	3.3
Venezuela	-3.3	-4.0	1.5
Chile	-1.7	4.5	4.7
Peru	0.9	6.0	4.5
Eastern Europe	-5.6	4.4	3.7
<i>(share of world GDP = 5%)</i>			
Russia	-7.9	4.8	3.9
Czech Rep.	-4.1	1.5	2.0
Hungary	-6.5	0.5	2.2
Poland	1.7	3.0	3.5
Turkey	-5.8	6.0	4.0
World	-0.8	4.4	3.7

Source: NBF Economic Research, Consensus Economics

The euro zone has maintained its cyclical momentum and fears of a downturn have abated slightly. Real GDP expanded at 3.9% annualized in the second quarter, a pace well ahead of U.S. growth. In contrast to the U.S., however, Europe is supported by global demand while domestic demand remains weak. German GDP was up a startling 9% annualized in Q2, prompting the Bundesbank to raise its outlook for 2010 growth to 3% from 1.9%.

Euro zone: Who's strong, who's not

Q2 GDP growth



NBF Economy & Strategy (data via Datastream)

On the whole, manufacturing output has been rising strongly in the euro zone, with gains even in Spain and Portugal. New orders were up more than 30% in the second quarter, suggesting that this vigour will have some legs. Thus the chances that Europe will brake global growth have much abated in recent months. Even Chinese exports to Europe have continued to expand. That said, fiscal austerity has yet to bite fully into the euro-zone economy and the rebound is likely to be transient. This is the signal sent by the foreign exchange market in bidding the euro down from its recent peak.

Midway through the year, with Q2 results in for the main advanced and emerging countries, the global economy was on track for 2010 growth in excess of 4%. A slowing of the advanced economies is likely to cool the pace to about 3.7% next year – a soft landing, despite deleveraging by U.S. consumers.

U.S.: Employment wanted!

The U.S. badly needs more private-sector job growth to reduce its unemployment rate and keep the Fed from moving to additional quantitative easing. BEA revisions of past GDP numbers have reduced our expectation of 2010 growth, but we have revised up our outlook for 2011 in response to a higher savings rate and a less aggressive reversal of fiscal policy.

U.S. consumer spending, previously reported as having passed the pre-recession peak, is now reported still in recovery. On July 30 the Bureau of Economic Analysis (BEA) released its revised measures of U.S. real GDP since 2007. With a wave of its wand, \$100 billion was cut from GDP and \$134 billion from consumer spending, leaving the latter 1% below the previous peak. The revisions had the effect of reducing 2010 growth to 3.0% from 3.5%.

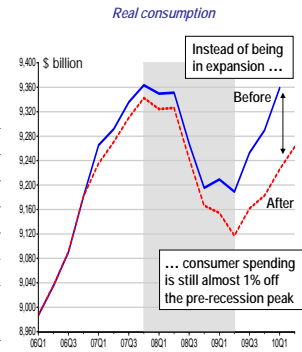
At this writing, U.S. real GDP is reported to have expanded 1.6% annualized in the second quarter. The Q2 report does show a better mix of growth. Domestic demand grew at 4.3%, the most in four years.

The revisions put the U.S. household savings rate at 6.4%, 2.4 percentage points higher than before, meaning that U.S. households are deleveraging faster than previously thought. A 4.4% rise of disposable personal income in Q2 allowed consumer spending to grow in tandem with the savings rate, limiting the risk of a downturn in consumption. This eventuality looks even less likely in the light of the mortgage refinancing index, whose current surge of more than 100% will give many households more leeway by reducing their ratio of financial obligations to personal disposable income.

U.S.: Less recovery than previously thought

Revisions from the Bureau of Economic Analysis
(difference in components as of 2010Q1)*

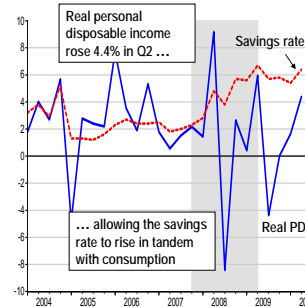
GDP components	Revisions in billions of US\$
Consumption	-134
Residential investment	-23
Nonresidential structures	-27
Equipment and software	46
Government	-25
Net exports	38
Inventories	-31
real GDP	-100



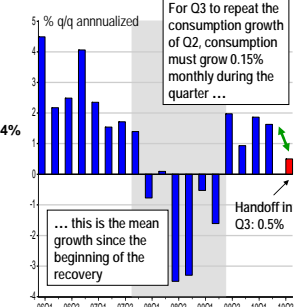
* Component differences do not add up to GDP difference because data are chain-weighted
NBF Economy & Strategy (BEA data via Global Insight)

U.S.: Can consumer spending keep growing?

Real personal disposable income and savings rate



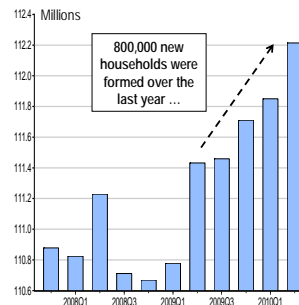
Real consumption



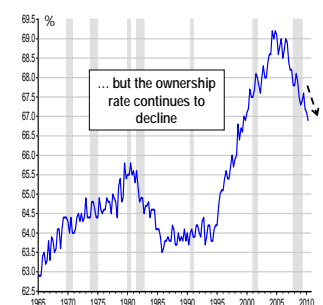
NBF Economy & Strategy (BEA data via Global Insight)

U.S.: More households, but homeownership still declining

Number of households

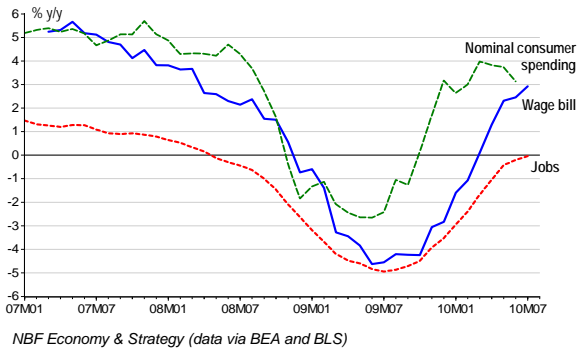


Homeownership rate
(% of housing units occupied by owners)



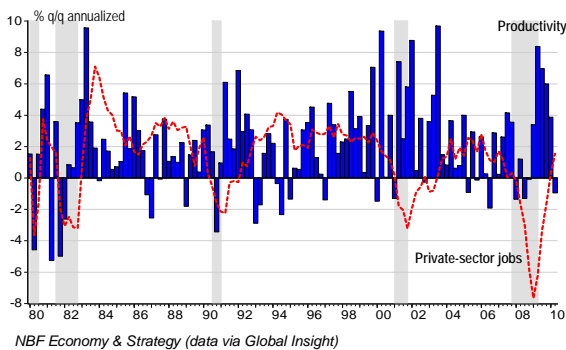
NBF Economy & Strategy (data via Census Bureau)

U.S.: Wage bill suggests further consumption growth
12-month change in nominal consumer spending, jobs and wage bill



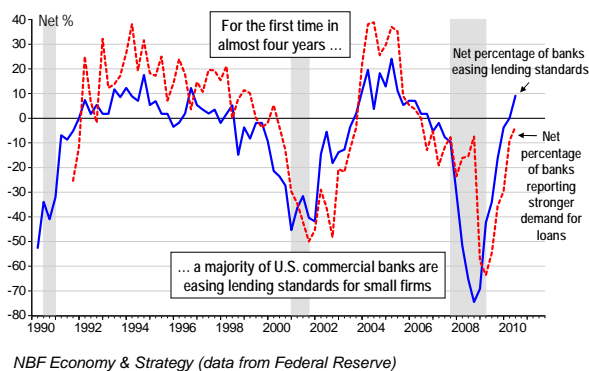
Meanwhile, investment in machinery and equipment is likely to continue growing – July showed a 1.8% jump – and business inventory rebuilding seems to have farther to run. Inventories have increased \$120 billion, only a fifth of the \$603-billion drawdown during the recession. On the other hand, residential construction is likely to languish for some time yet. A 2007 law gives owners an incentive to walk away from homes whose market value has fallen below their outstanding mortgage balance. Under these conditions the rate of homeownership continues to fall, offsetting the formation of 800,000 new households in the last year and delaying a revival of homebuilding. Building permits fell 3.1% in July to a very low 565,000. Residential investment is the GDP component with the largest multiplier effect on the rest of the economy. Its pre-recession share of GDP was only 6% but it accounts for almost 25% of all jobs lost to date. The weakness in housing means that the U.S. badly needs to create jobs in the rest of the private sector, which is not an easy task.

U.S.: Productivity declined in Q2
Growth in labour productivity and private-sector employment



Private-sector employment disappointed in July with a gain of only 71,000. The good news was that hours worked and hourly earnings were up, boosting the aggregate wage bill. As the top chart shows, a downturn in consumer spending is unlikely under these conditions. Yet to bring down the unemployment rate and keep the Federal Reserve from moving to additional quantitative easing, private-sector payroll growth must accelerate. The three-month moving average fell from 150,000 to only 50,000 in July.

Some good news for small firms
Lending standards for commercial and industrial loans to small firms



There may be hope in the second-quarter decline of productivity. If businesses can no longer ramp up production without adding to headcounts, there is light at the end of the tunnel. An NFIB survey of small businesses reports that the net percentage of firms hiring is now positive for the first time. A clear idea of the strength of the labour market will have to wait for a few more monthly reports. Hiring could accelerate if money starts circulating faster, as is suggested by the latest Senior Loan Officer Survey showing an easing of conditions for lending to small business.

In sum, the BEA revisions and the recent softness of some indicators have lowered growth for 2010, but the higher rate of saving will mean higher growth in 2011. A less aggressive reversal of fiscal policy is also seen for 2011 because of a wider output gap and the need to put the homebuilding labour force to work elsewhere in the economy.

Canada: Dissaving on the way out

Since rock-bottom interest rates have encouraged Canadians to borrow from the future for spending on housing and consumption, the recent performance of the economy is no guarantee of its future. We expect that strong 3.3% growth in 2010 will be followed by a deceleration of consumer spending and GDP in 2011.

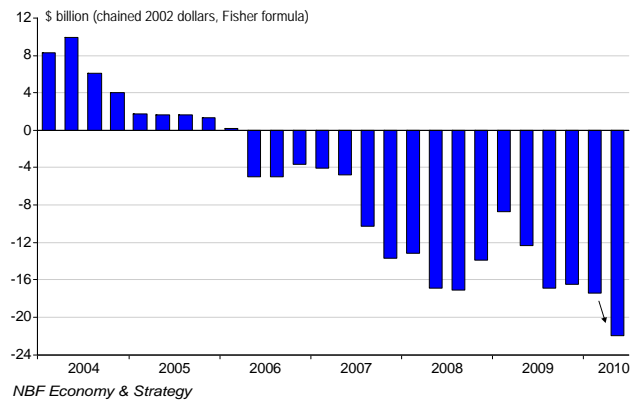
Domestic demand has remained strong in Canada, but at some expense in GDP growth. Imports have been rising so strongly that international trade will subtract more than 6 percentage points from Q2 growth. As the top chart shows, the real merchandise trade deficit widened considerably during the quarter.

In contrast to the U.S., however, Canadian real GDP has passed the pre-recession peak. Business investment in machinery and equipment will show a strong increase in Q2 and inventory building is also likely to have contributed to growth. Though quarterly GDP growth will likely come in lower, domestic demand growth will remain very robust, on the order of 5%. In Q1, domestic demand was 0.4% above the pre-recession peak in Canada while still falling 2.6% short in the United States.

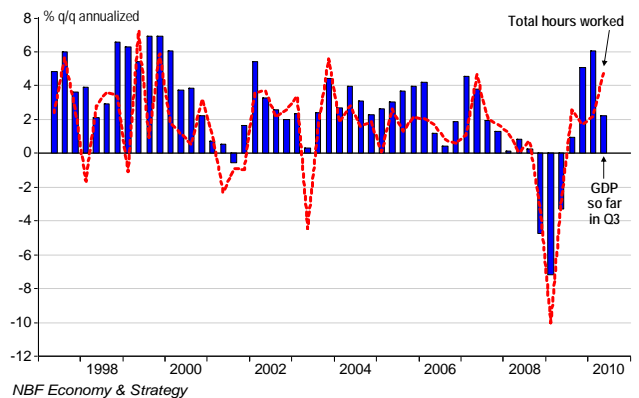
Employment growth took July off. A loss of 9,000 jobs followed an unsustainably large gain of more than 225,000 in the previous three months. On the other hand, hours worked were up strongly on a quarterly basis, ensuring continuity of growth in Q3. The growth of the aggregate wage bill remains appreciable. In other words, the July employment report was not an inflection point.

The key feature of the current outlook is that sharply reduced interest rates led Canadian to front-load their consumption, the largest component of GDP. Consumer spending cannot maintain its recent growth – an annual rate of about 4% in each of the last three quarters.

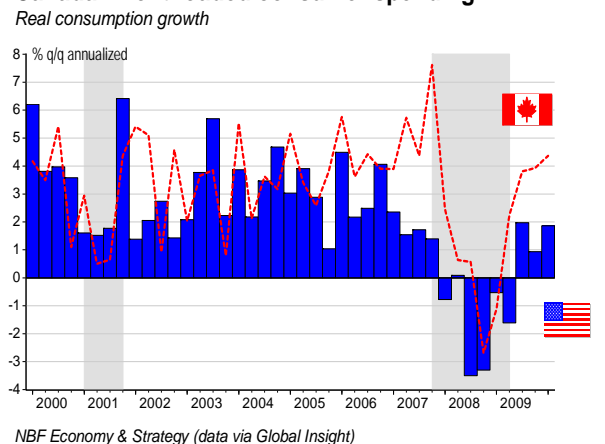
Canada: Q2 growth braked by international trade
Merchandise trade balance in constant dollars



A cheering trend in hours worked
Change in real GDP at basic prices and total hours worked (q/q annualized)

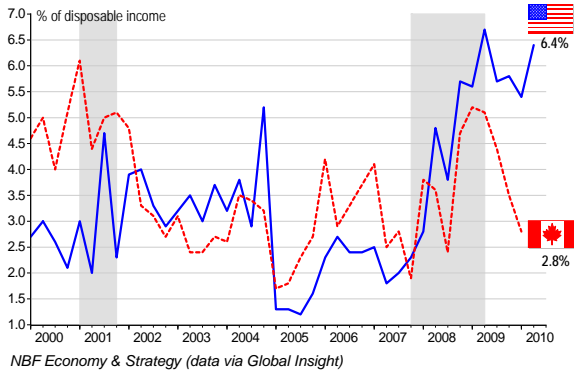


Canada: Front-loaded consumer spending



Canada: Consumption must slow

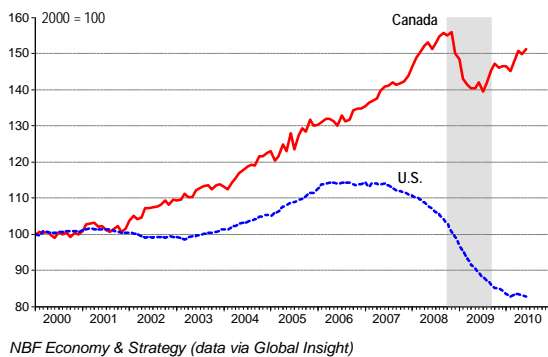
Households savings rate, Canada vs. U.S.



It is true that household balance sheets are in much better shape in Canada than in the U.S., with home prices here now 4.2% above the pre-recession peak. On the other hand, this wealth effect, arising from a period of low interest rates, leads naturally to a drop in the savings rate. The surge of consumer spending has come at the expense of saving. At a time when U.S. households are saving 6.4% of their incomes, the Canadian rate has fallen almost a 2.5 percentage points to 2.8%. In short, the recent showing of the Canadian economy is partly borrowed from future performance. We expect consumer spending to slow on this side of the border while picking up in the United States.

Two different worlds

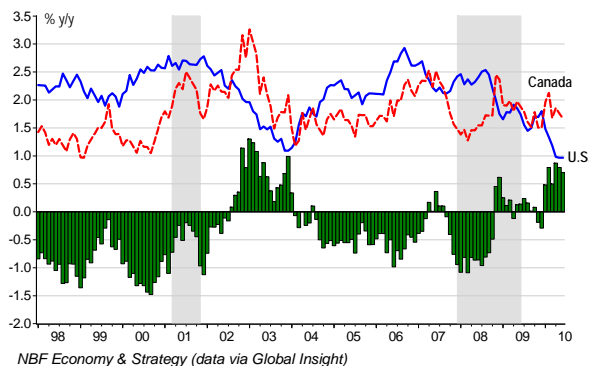
Construction employment, Canada vs. U.S.



Though Canada is now in an expansion phase, the current retreat in homebuilding bears watching. The reversal of its multiplier effect will brake the rest of the economy. Despite the recent decline of long-term rates, sales of existing homes have been declining for months now and housing starts have begun to weaken. With home prices now very high relative to incomes, mortgage payments now exceed the cost of renting by a good margin. It should also be kept in mind that construction has accounted for 23% of all Canadian job gains since the recession bottom. Residential investment currently accounts for 7% of GDP in Canada, a historically unsustainable share. (The current U.S. share is 2.5%.) At this writing, construction accounts for 7.1% of all Canadian employment, very close to the all-time high of 7.3%, and the decline of existing-home sales has made the resale market a buyer's market. So employment growth will decelerate in coming quarters.

A large gap

Core inflation, Canada vs. U.S.



Canadian inflation is likely to run well ahead of U.S. inflation and close to the Bank of Canada target rate. The Canadian CPI is under pressure from its shelter component, the largest in the index (26.6%), which has risen at an annual rate of 6% over the last three months. Though the central bank now sees an output gap persisting until the second half of next year, that kind of inflationary pressure calls for a different monetary policy in the medium term.

In summary, since the homebuilding and consumption components of GDP have used rock-bottom interest rates to borrow from the future, the recent showing of the economy is no guarantee of its future. We expect a deceleration of consumption and GDP in 2011.

Yanick Desnoyers
Assistant Chief Economist

Canada Economic Forecast

(Annual % change)*	2007	2008	2009	2010	2011	Q4/Q4	
						2010	2011
Gross domestic product (2002 \$)	2.2	0.5	(2.5)	3.3	2.1	3.6	1.4
Consumption	4.6	2.9	0.4	3.5	2.3	3.2	2.0
Residential construction	2.8	(3.7)	(8.2)	11.3	(3.9)	4.2	(5.0)
Business investment	3.3	3.4	(19.9)	3.0	8.2	10.9	6.3
Government expenditures	3.2	4.1	5.1	4.6	2.6	2.5	2.5
Exports	1.2	(4.6)	(14.2)	7.5	4.6	7.1	4.0
Imports	5.9	1.2	(13.9)	13.3	6.0	10.3	5.7
Change in inventories (millions \$)	12,239	9,011	(2,879)	12,796	16,000	15,000.0	16,000.0
Domestic demand	4.0	2.8	(1.8)	4.3	2.7	4.0	2.3
Real disposable income	4.0	3.7	1.2	1.5	2.3	2.2	2.2
Employment	2.3	1.5	(1.6)	1.6	1.4	2.1	1.2
Unemployment rate	6.0	6.2	8.3	8.0	7.8	7.9	7.7
Inflation	2.2	2.4	0.3	1.8	2.4	2.3	2.4
Before-tax profits	1.9	8.0	(32.3)	23.9	8.6	20.6	5.0
Federal balance (Public Acc., bil. \$)	\$9.6	\$0.0	(\$45.0)	(\$30.0)	(\$20.0)
Current account (bil. \$)	\$12.8	\$6.9	(\$43.5)	(\$14.1)	\$1.5	(\$5.0)	\$2.0

* or as noted

Financial Forecast*

	Current	Q3	Q4	Q1/11	Q2	2010	2011
	8/20/10						
Overnight rate	0.75	0.75	1.00	1.50	1.50	1.00	1.50
Prime rate	2.75	2.75	2.75	3.25	3.25	2.75	3.25
3 month T-Bills	0.67	0.83	1.17	1.43	1.43	1.17	1.58
Treasury yield curve							
2-Year	1.31	1.26	1.47	1.89	2.05	1.47	2.40
5-Year	2.19	2.04	2.17	2.47	2.68	2.17	3.06
10-Year	2.92	2.89	2.95	3.13	3.35	2.95	3.70
30-Year	3.53	3.50	3.56	3.67	3.84	3.56	4.07
Exchange rates*							
USD per CAD	0.95	0.95	0.97	1.00	0.99	0.96**	1.00**

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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 \$)	1.9	(0.0)	(2.6)	2.7	2.3	2.6	2.4
Consumption	2.4	(0.3)	(1.2)	1.5	2.2	1.9	2.4
Residential construction	(18.7)	(24.0)	(22.9)	(2.0)	7.0	(2.1)	13.7
Business investment	6.7	0.3	(17.1)	5.4	7.8	10.4	6.4
Government expenditures	1.3	2.8	1.6	1.0	2.3	1.5	2.2
Exports	9.3	6.0	(9.5)	11.9	5.3	9.1	3.5
Imports	2.7	(2.6)	(13.8)	13.0	7.4	15.0	4.5
Change in inventories (bil. \$)	27.7	(37.6)	(113.1)	75.6	61.3	110.0	50.0
Domestic demand	1.5	(0.6)	(3.1)	1.7	2.9	2.5	3.1
Real disposable income	2.3	1.7	0.6	1.5	2.3	2.9	1.8
Household employment	1.2	(0.5)	(3.8)	(0.1)	1.8	2.1	1.5
Unemployment rate	4.6	5.8	9.3	9.4	8.4	8.6	8.3
Inflation	2.9	3.8	(0.3)	1.6	1.9	0.9	2.3
Before-tax profits	(6.1)	(16.4)	(0.4)	30.8	6.1	20.1	4.0
Federal balance (unified budget, bil. \$)	(\$161.0)	(\$459.0)	(\$1,800.0)	(\$1,200.0)	(\$1,100.0)
Current account (bil. \$)	(\$746.0)	(\$690.0)	(\$410.0)	(\$490.0)	(\$450.0)	(\$450.0)	(\$450.0)

* or as noted

Financial Forecast

	Current 8/20/10	Q3	Q4	Q1/11	Q2	2010	2011
Fed Fund Target Rate	0.19	0.25	0.25	0.25	0.25	0.25	1.00
3 month Treasury bills	0.16	0.16	0.17	0.18	0.33	0.17	0.93
Treasury yield curve							
2-Year	0.50	0.44	0.58	0.70	0.96	0.58	1.64
5-Year	1.46	1.39	1.54	1.69	2.02	1.54	2.59
10-Year	2.61	2.55	2.68	2.84	3.16	2.68	3.57
30-Year	3.66	3.61	3.70	3.83	4.08	3.70	4.38
Exchange rates*							
U.S.\$/Euro	1.27	1.28	1.30	1.28	1.26	1.27**	1.23**
YEN/U.S.\$	86	86	90	95	100	88**	102**

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* end of period

** annual average