ECONOMIC MONITOR

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HIGHLIGHTS

Financial Markets Overview (Page 2)

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2015 Economic Outlook (Page 4)

This article outlines three key geopolitical and three key economic risks for 2015, as well as the outlook for interest rates, currencies, commodities and equity markets.

Canadian Economic Charts (Page 12)

GDP growth is likely to average 2.5% in 2014, but we expect a somewhat lower growth rate next year. Concerns over the oil price decline, a weak global economic environment and low inflation will keep the Bank of Canada on hold in 2015. The Canadian dollar is forecast to decline further.

US Economic Charts (Page 21)

GDP growth in 2014 and 2015 will likely be a modest 2.4%. The lower oil price is a net benefit for the US economy (unlike a net cost for the Canadian economy), but cap-ex in the energy sector will be cut back. Consumers may also save some of the oil price “tax cut”. The US dollar is forecast to continue rising against most currencies, which will further lower the contribution of the foreign sector to US GDP.

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Canadian GDP growth is likely to average 2.5% in 2014, but somewhat less in 2015. Concerns over the oil price decline, the impact of a weak global economic environment on commodity prices and low inflation will keep the Bank of Canada on hold in 2015. The Canadian dollar is forecast to decline further.

To summarize, our baseline outlook includes the following:

1. ► The **FED FUNDS RATE** is expected to remain in the range of 0% to 0.25% in 2015 (baseline scenario) while the Fed monitors inflation (currently weakening), wage growth (currently improving but for how long?) and economic growth (strong now but likely to weaken). We recognize that the Fed is under pressure to "normalize" interest rates, and in our probability-weighted outlook there is indeed a rise in interest rates before 2015 year-end (see the *Interest Rate and Currency Forecast*).
2. ► The **BANK OF CANADA** is likely to leave interest rates unchanged for the foreseeable future. While growth has improved of late, this trend is likely to be reversed soon as problems mount for the energy sector. Disinflationary pressures may be severe by spring, furthermore, meaning we could eventually see talk of a rate cut in Canada.
3. ► **BOND YIELDS** will be pulled in two directions: up on account of stronger domestic growth and expectations of a Fed rate hike; down on account of lower inflation and economic troubles (i.e. Russian troubles) abroad. Overall the forecast is fairly flat.
4. ► Our outlook for the **CANADIAN DOLLAR** remains negative, with weaker energy prices a key depressing factor. The arrival of ultra-low inflation rates by spring will likely spark more dovish talk by the Bank of Canada, which will be another potential depressant.
5. ► The **US DOLLAR** is expected to continue rising against most currencies. Europe and Japan will be heavily into monetary stimulus in 2015 and investment flows into the US will likely pick up. China may also decide to weaken its currency. The Fed and US Treasury will not welcome a firmer dollar however, but short of exacerbating the currency war there is little they can do about it.

Updated Forecast - Base Scenario

	Actual				Projected						
	14-I	14-II	14-III	17-Dec	Jan	Feb	Mar	15-II	15-III	15-IV	16-I
CURRENCIES	***Scenario B: Very Weak Eurozone and Slowing Chinese Growth; Modest US Improvement***										
US Dollar Index*	80.52	79.70	81.08	88.91	89.61	91.02	92.31	93.49	93.94	93.72	93.08
Can. Dollar: CDN/US	***1.103***	***1.091***	***1.094***	***1.161***	***1.165***	***1.180***	***1.200***	***1.215***	***1.205***	***1.200***	***1.190***
Can. Dollar: US/CDN	90.66	91.66	91.41	86.17	85.84	84.75	83.33	82.30	82.99	83.33	84.03
Japanese Yen	***103.00***	***102.4***	**104.3**	**117.6**	**119.0**	**120.0**	**121.0**	**123.0**	**125.0**	**125.0**	**125.0**
British Pound	165.5	168.3	166.9	156.5	155.4	152.3	150.9	150.5	149.1	149.7	151.6
Euro	***1.370***	***1.371***	***1.325***	***1.241***	***1.233***	***1.205***	***1.190***	***1.180***	***1.165***	***1.165***	***1.175***
Australian Dollar	89.66	93.30	92.48	81.80	81.72	80.93	79.58	78.60	79.25	80.00	81.93
Chinese Yuan/Rmb	***6.118***	***6.158***	***6.160***	***6.197***	***6.185***	***6.185***	***6.185***	***6.180***	***6.180***	***6.150***	***6.120***
Indian Rupee	61.78	59.80	60.61	63.42	63.30	62.70	62.25	61.40	60.50	60.00	59.75

** Index based on CDN$, Euro, Pound, Yen*

INTEREST RATES	***Scenario B: US Growth Improves - Inflation Slips Under 1%***										
Canada											
Treasury Bill (91-day)	0.88	0.94	0.94	0.90	0.90	0.90	0.90	0.90	0.88	0.86	0.84
Government Bond (10-yr)	2.42	2.29	2.12	1.78	1.81	1.85	1.80	1.75	1.90	2.00	2.15
Prime	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00
Target Overnight Rate	***1.00***	***1.00***	***1.00***	***1.00***	***1.00***	***1.00***	***1.00***	***1.00***	***1.00***	***1.00***	***1.00***
Spread: 10-yr - T Bills	1.54	1.35	1.18	0.88	0.91	0.95	0.90	0.85	1.02	1.14	1.31
United States											
Treasury Bill (90-day)	0.05	0.03	0.03	0.03	0.03	0.03	0.04	0.05	0.07	0.08	0.14
Treasury Bond (10-yr)	2.70	2.57	2.49	2.10	2.15	2.20	2.15	2.10	2.25	2.35	2.50
Prime	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25
Fed Funds Target	***0.07***	***0.09***	***0.09***	***0.11***	***0.13***	***0.13***	***0.13***	***0.13***	***0.13***	***0.14***	***0.20***
Spread: 10-yr - T Bills	2.65	2.54	2.46	2.07	2.12	2.17	2.11	2.05	2.18	2.27	2.36
Interest Rate Differential (Canada-US)											
Treasury Bill	0.83	0.91	0.91	0.87	0.87	0.87	0.86	0.85	0.81	0.78	0.70
Bonds-10yr	-0.28	-0.28	-0.37	-0.32	-0.34	-0.35	-0.35	-0.35	-0.35	-0.35	-0.35

Source: Wall Street Journal, Federal Reserve, DCM Economics

This is our "baseline" scenario for the next four quarters. It is updated monthly. For alternative scenarios the reader should consult the *Currency and Interest Rate Forecast*.

2015 Economic Outlook

Overview

Risks for 2015

This issue of the *Economic Monitor* presents our 2015 outlook for some key areas of our collective concentration, including economic growth, interest rates, currencies, commodity prices, and equity markets. The discussion starts on page 7. In preparation for this issue however we started with a simple exercise: identify the three biggest geopolitical and three biggest economic risks for 2015. The results of this exercise are discussed herewith.

Before listing the specific risks (we independently identified) for 2015 however, it might be useful to quote Donald Rumsfeld (US Secretary of Defense from 2001 to 2006): "*There are known knowns. These are things we know that we know. There are known unknowns. That is to say, there are things that we know we don't know. But there are also unknown unknowns. There are things we don't know we don't know*". (*Source: http://www.brainyquote.com/quotes/authors/d/donald_rumsfeld*).

Identifying risks relates to Rumsfeld's *known unknowns*. For example, events of 2014 suggest that there is a non-zero probability Russia will invade Ukraine in 2015. (The reasons may include Russia's financial stress from greatly reduced oil prices, Putin's proclivity for geopolitical adventurism, and Russia's yearning for the "good old days" of the USSR – see more on this below.) We do not know the probability of this event, but it is a *known unknown*.

"*Uknown unknowns*" are almost certainly "*black swan*" events, events that lie "*outside the realm of regular expectations, because nothing in the past can convincingly point to its possibility*" (see Wikipedia from which this quote was taken, or Nassim Nicholas Taleb's original book: "*Fooled By Randomness*"). "*Black swan*" events are risks precisely because the probability of their occurrence is so infinitesimal they are excluded from anyone's set of expectations.

Will 2015 see a "*black swan*" event? We are guessing there could be one; the outlook for 2015 is problematic in many ways, both geopolitically and economically.

But enough of the preamble! There are many risks on the 2015 horizon, and the recent plunge in oil prices has magnified these risks.

Geopolitical Risks

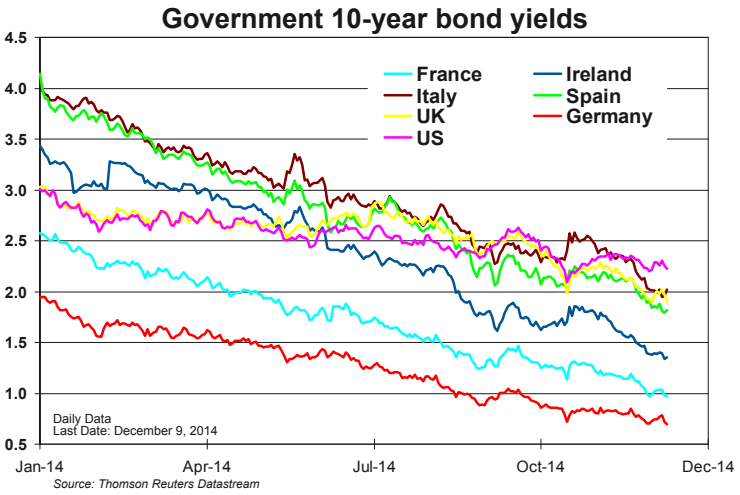
- **Russia:** We all concluded that one of the key geopolitical risks for 2015 starts with Russia. The sequence of events may go something as follows: Russia's financial collapse on the back of lower oil prices will initially encourages mini-military provocations in Ukraine, but outright invasion soon follows. Relations with NATO accordingly deteriorate sharply, and in retaliation Russia lifts Iranian sanctions and commences supporting Iranian nuclear empowerment. US-Iranian talks break down, Israel initiates military strikes against Iran, and Iran responds with more aggressive terrorist activity via its proxies (Hezbollah, etc.). The West becomes fragmented (some condemn Israel while others are willing to sacrifice Ukraine). China takes the opportunity to seize disputed lands in the South China Sea. US-Chinese relationships deteriorate dramatically and Japan chooses to rearm more aggressively. If this reads like 1914, well, that's the idea.

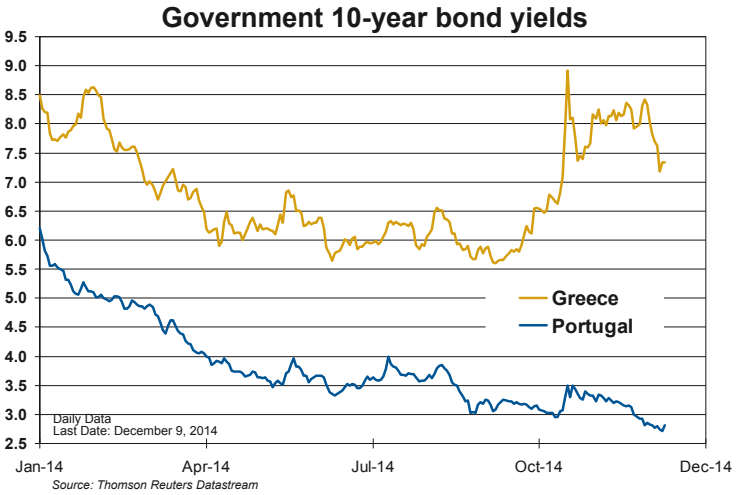
- **The Eurozone:** It's hard to say whether the Eurozone represents a geopolitical risk or an economic risk (but all geopolitical risks carry grave economic risks). In our view the Eurozone crisis is not over, just in remission.

There is a political party in each country that demands some alternative arrangement with the Eurozone, if not outright separation and the readoption of a national currency (and a sovereign central bank). Greece is currently in the headlines again, and as the first Eurozone member to plunge into financial crisis in late 2009 Greece bears close monitoring. But it is likely in Italy, France, and/or Germany where the matter of the Eurozone's continued existence will be settled.

In France the National Front (NF) polled 26% recently, more than any other party. The leader of the NF, Marina Le Pen, has threatened to take France out of the currency union. In Germany, the Alternative for Germany (AfD), wants the same thing; it is polling a modest 5%, but German patience with the Eurozone is ebbing. In Italy the Five Star Movement (M5S) is polling about 20% and its charismatic leader, Beppe Grillo, wants a nation-wide vote on Eurozone membership. There are other "Eurosceptic" parties in the Eurozone, including the UK Independent Party (UKIP - Nigel Farage), the Dutch Freedom Party (PVV – Geert Wilders), and Spain's Podemos (Pablo Eglesias), to complicate matters, and add to any momentum which might break up the Eurozone.

We use the charts of Eurozone 10-year yields herewith as a guide to the probability of crisis (economic and geopolitical). We do not expect a Eurozone breakdown in 2015, and the charts suggest the risk is low, but it is possible that Greece leaves in 2015. Equally important, the fractured nature of Eurozone politics makes a unified response to Russian adventurism problematic, and the ongoing financial problems in the Eurozone argue against a hike in defense expenditures as demanded by NATO.





- **International:** There was less overlap on the third geopolitical risk, so we have made it "international" to cover (1) the risk of smaller oil-producing countries (think Venezuela and Nigeria) slipping into political and financial chaos and joining the world's list of "failed states", and (2) the risk of an oil-price driven collapse in social order in Mid-East states. The former will test the resources of the IMF and World Bank whereas the latter will play directly into the hands of ISIS and other terrorist organizations domiciled in the region. Could one envision under the second point an attack on Saudi Arabia's political order? Would such a Saudi collapse be the "*black swan*" event?

Economic Risks

- **The Eurozone:** We all agreed independently that one key economic risk for 2015 was continued recession in the Eurozone. Continued recession also risks lower world growth (the Eurozone is just over 20% of the global economy), and continued recession adds directly the geopolitical risk of Eurozone disintegration.

  Continued recession will stress policy to the point where Mario Draghi could resign as President of the ECB - on account of the ECB's inability to convince the President of the Bundesbank, Weidmann, that more (i.e. QE) needs to be done. Not that QE is needed to reduce interest rates in the Eurozone – they are already at historic lows - but the prospect of no further ECB support (which would follow from Draghi's resignation) could send 10-year Eurozone yields sharply higher.

  Weidmann's counter to QE is straightforward; he wants more structural reform in the "uncompetitive" southern half of the Eurozone (including in France). Everyone does! But the problem, as we have seen from the reunification of East Germany with West Germany, is that "restructuring" take at least a generation before there are major competitive payoffs; "old" work habits take time to evolve into "new" work habits, and this often only happens through attrition. (It's been 25 years since unification and the East German worker is still only 75% as productive as the West German. Of course, if the East German worker's wage is equal to 75% or less of the West German worker's wage, then there is no competitiveness issue. But that is not the case in the southern half of the Eurozone; we have quoted elsewhere from studies that indicate the southern half is not competitive with the northern half. But our main point is that it has been only five years – not 25 - since the Greek financial crisis commenced.)

- **China:** China is a *known unknown*; there was no debate in our office that a Chinese recession (defined as growth below some threshold, say 4-6% - assuming China is able and willing to give the world an accurate estimate of domestic GDP) is a major risk for the world economy in 2015. China represents about 13% of the world economy, but when it comes to world consumption of commodities the percentage is much higher. Ergo, China also represents an ongoing risk for commodity prices.

  The epicenter of the recession would likely be the real estate sector; sharp declines in real estate prices (houses, but also commercial real estate) will generate significant losses in the financial sector – and together will affect business sentiment negatively. On top of that, China needs to encourage more of a shift towards consumption-led growth, away from investment and export-led growth. In this shift economic resources will need to be redeployed, which always risks an interruption in growth.

- **Currency Wars:** There is increased pressure in the global economy to "devalue". One source of pressure is weak global growth, which leads policymakers to naturally to consider boosting exports and reducing imports. The other source is deflation, the fear of which leads policymakers to think of devaluation – along with QE – to boost prices. It follows that the risk of "*currency wars*", i.e. the willful devaluation of currencies against the US dollar in order to increase competitiveness in the US market (and third markets), will continue in 2015.

  The big risk is that currency wars will get out of hand. China is an export powerhouse, yet its currency has declined against the dollar recently. One reason is that the yen has plummeted, which negatively affects China's competitive position in the US and other markets. The yen itself, near 120 per US dollar,

is so grossly undervalued that we expect a major increase in Japan's trade surplus with the US. And in Europe, where the "depression" in the south continues, there are widespread calls for further euro devaluation – against the dollar of course.

Desperately needed is a (IMF-sponsored) global currency realignment, such as we used to see when global imbalances got out of hand during fixed exchange rate periods (i.e. Bretton Woods). Asian currencies need to rise against the dollar and euro, for a start.

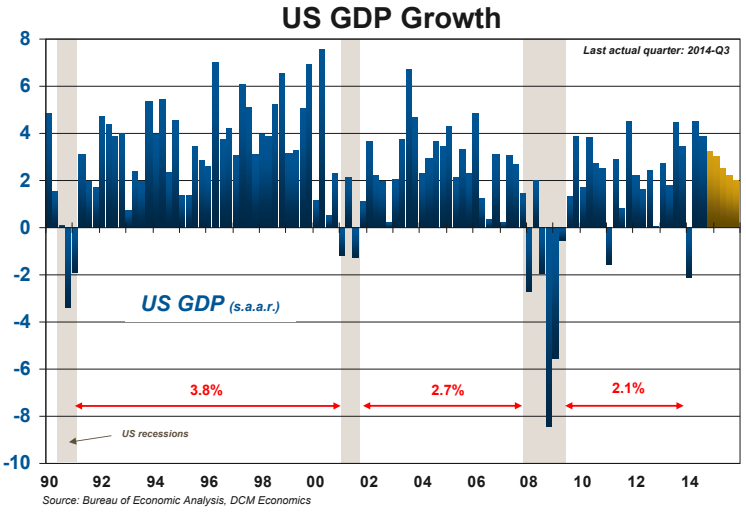
The end-risk here is "*protectionism*", tariffs and other forms of legal impediments to foreign goods and services. Yes, policymakers are too smart to implement such policies, but they were smart in the 1930's too. International trade, has a visceral element; foreign producers "steal" ideas and do not honor patent agreements, governments block foreign goods and services only to protect some local interest or to "protect the national interest" – whatever that is. Every country plays these games, just some more intensely than others. If currency wars do not stop in 2015 the risk of a global trade war, with tariffs and other legal impediments, rises exponentially. The US will not condone the dumping of structural problems in China, Japan and Europe onto the backs of US consumers indefinitely.

- **Other:** OK, we were to present only three economic risks, but there are others:
  - *An oil price collapse* – the oil price briefly traded in the $40-50 range during the Great Recession
  - *A commodity price collapse* – another 30% would take the Bank of Canada's commodity price index down to its lows during the Great Recession
  - *A Canadian house-price collapse* – often feared but now that oil prices are sharply lower the probability has risen
  - *US consumers save, not consume* – the often noted "*you should never bet against the US consumers' willingness to consume*" turns out to be wrong in 2015. US consumers are getting older and may want to save more!

Outlook

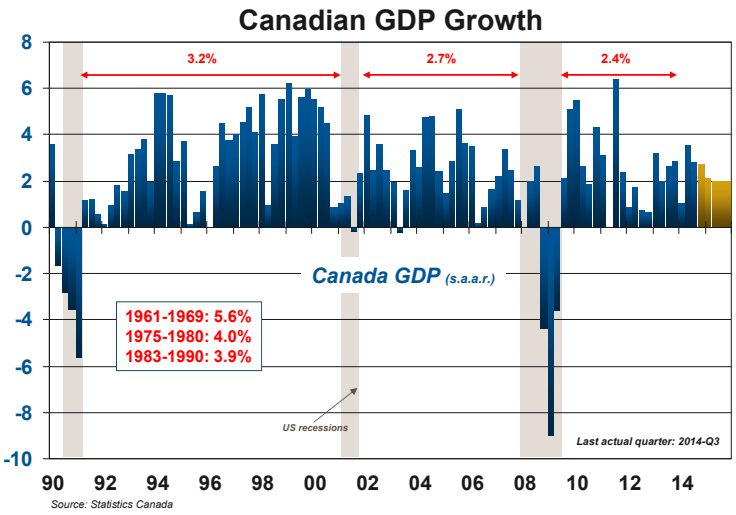
US Economy

The US economy ended 2014 with growth above trend, led by auto sales (cheap financing) and rising oil and gas production. While lower energy prices will curb energy sector investment, consumer spending will gain on lower energy costs. Even though an ageing population will probably save more of the windfall than in earlier decades, the net result is likely to be a plus for overall economic growth. Falling inflation and increased foreign demand for North American bonds will likely suppress bond yields and less stringent credit requirements will probably give housing a lift. Lower inflation is expected to trim wage growth, eventually offsetting the positive effect of lower energy prices on consumer spending. A rising US dollar is apt to see growth become more subdued as 2015 progresses and the trade deficit worsens. All considered, average growth may be only marginally higher than in 2014.



Canadian Economy

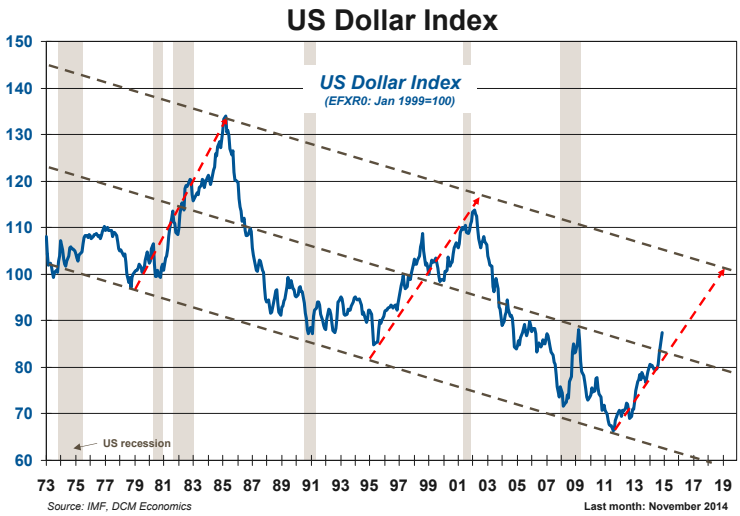
The Canadian economy followed the US lead in 2014, exhibiting increased strength toward mid-year, helped by the beneficial effects of a lower dollar on manufacturing and retail sales. Stronger auto demand and continued gains in energy production were major contributors but even housing gained strength. Plummeting oil prices in late 2014 are a net negative for growth in 2015 however. Declining inflation could lead to resumed speculation of a Bank of Canada rate cut towards mid-2015, although a weaker currency will help growth and consumers will benefit from cheaper fuel costs. On balance, we expect Canadian growth to slip slightly in 2015.



Currencies

As 2014 was drawing to a close, the economies of Europe, Japan and China were struggling whilst the US economy was recovering from a very poor first quarter. Accordingly, European and Japanese economic policies were geared to weakening their exchange rates through quantitative easing whilst the US was considering a further tightening of monetary policy.

Bottom Line: the US Dollar looks set to continue surging higher in 2015. The British pound is likely to follow the euro down because of close trading ties. China is likely to curb its recent currency strength in light of the weaker yen and Korean won. Commodity producing countries are likely to see their currencies weaken until such time as lower oil prices began to resuscitate global demand. The Canadian dollar is forecast hit the low 80s.



Policy Rates

Opinion is mixed over whether the Fed will begin to raise US rates in the second half of 2015. While firming growth suggested they will begin to nudge rates up, the restraint placed on wage growth by falling oil prices makes the result uncertain. Since a rising US dollar will also cause net exports to deteriorate in 2015 the outlook for policy rates is further muddied. The Bank of Canada, facing weakening energy investment, is unlikely to raise rates before the Fed, and could delay into 2016 even if the Fed raises rates in the second half of 2015.

Equity Markets

Our outlook for equity markets in 2015 is constructive, but we expect markets to be more volatile next year.

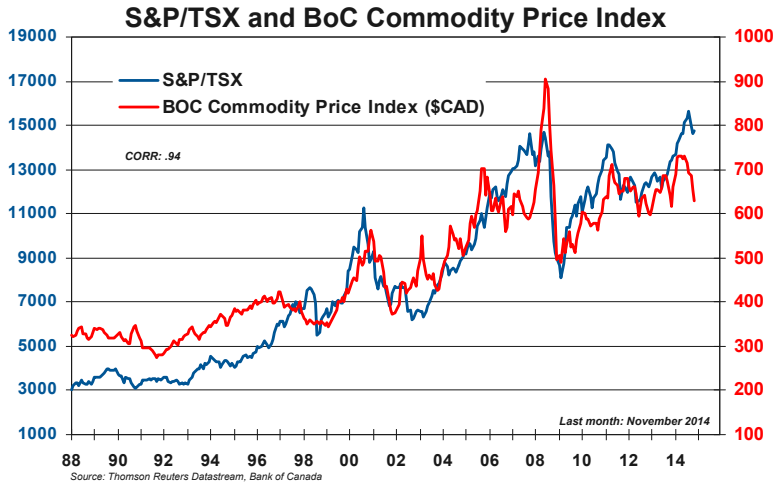
The S&P500 valuations will continue to be supported by a steady rise in US corporate earnings, share buybacks and mergers and acquisitions. But a strong US dollar and the

potential for rising interest rates will weigh on earnings growth in 2015.

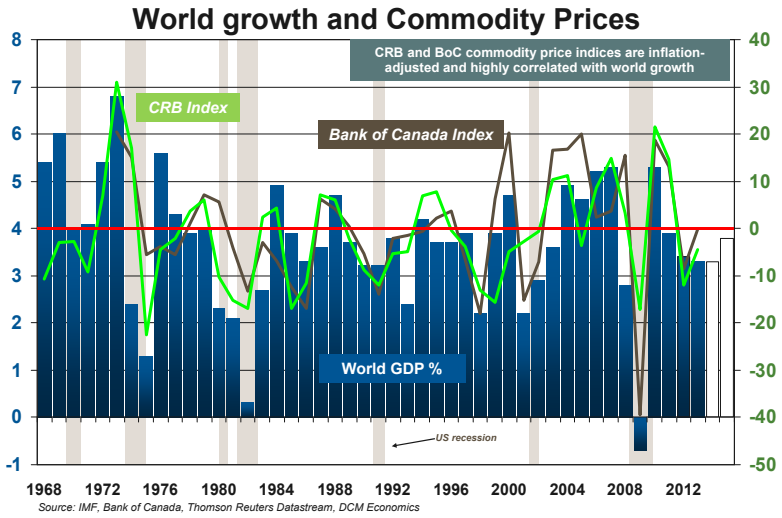
US equity markets will remain attractive for international investors, as the US economy will continue to outperform the European and Japanese economies. As economic growth in many emerging economies will continue to decelerate, the S&P500 will also benefit from capital outflows from emerging markets (especially out-flows from resource-exporting economies).

Market pullbacks will be more frequent than in 2014. Rising interest rate concerns, worries over economic growth prospects in China and Europe (a financial crisis or recession in Russia could damage European banks exposed to Russian debt and subsequently impair growth prospects in the Eurozone), and perhaps another bout of sovereign debt fears in Europe itself will weigh on North American markets from time to time. But any sizeable correction in US equity markets should present a good buying opportunity.

The S&P/TSX will continue to underperform the S&P500, especially in the first half of 2015, on account of weaker commodity prices and housing sector concerns in Canada. But we expect Canadian equity markets to partially close the performance gap when commodity markets stabilize in 2015-H2.



There are bullish and bearish factors in the outlook for commodity prices. The bullish factors include:



- Many base metal prices are currently near their structural (break-even) support levels; the current weakness in prices could eventually trigger sizeable production cuts. Global mine production has already begun slowing in recent months, and that should reduce the market surplus next year.
- The continuing weakness in crude oil prices should also trigger productions cuts in 2015, especially in high-production-cost regions (US shale, Canadian tar sands, Arctic and other deep water regions). This will improve the supply/demand balance in the market.
- A recovery in demand for commodities in the US, and later in Europe, is expected to partially fill in for the consumption slack in China.

Bearish factors should dominate next year however, especially in the first half of the year:

- Global economic growth is expected to rise by only 3.8% next year (according to the IMF). Our previous studies suggest that commodity markets tend to underperform (in 70% cases) when the global economy grows by less than 4% in any particular year.

Commodity Markets

- The US dollar is expected to remain strong throughout next year on account of monetary policy divergence between the US and other advanced economies. This should continue to weigh on commodity prices.
- Global production is inelastic to price conditions in the short run, and that means that the current market surplus will take time to decline.
- China's demand for commodities will continue to moderate in 2015 on the back of economic growth deceleration and transition to a consumption-led model of economic growth – which entails lower "intensity" of commodity consumption. That said, China's and other emerging economies' consumption will most likely continue to rise in "absolute" terms, which should be a stabilizing factor for commodity markets in the years ahead.

We expect commodity prices to remain under downward pressure in the first half of next year, but a subsequent supply adjustment, combined with better global growth thanks to lower oil prices, should revive commodity markets towards the end of next year. Overall, we expect most commodity prices to end 2015 slightly below current levels. But energy prices, including oil prices, are expected to recover by at least 5-10% towards the end of 2015.

Gold

The four charts herewith summarize our views of the gold market and our arguments as to what will continue to drive gold in 2015. The arguments have not changed very significantly over the course of 2014.

The December 19, 2013 Economic Monitor forecast gold to average $1245 in 2014 (the probability-weighted average); the average gold price to date is $1268. (We mention this because we are often regarded as gold "bulls", but our forecast was not very bullish last year!)

The Gold Price: 2007-2014

Source: London Bullion Market Association

Gold daily p.m. fix
Data through December 11, 2014

We hope to be wrong on the low side again this year too. The probability-weighted forecast is a modest $1230 for 2015, but we think the risks are shifting to the upside despite the obvious headwinds of a strong dollar, Fed policy tightening, and continued investor interest in the S&P500 (at the expense, to some degree, of gold).

Factors that are lined up more positively for gold include strong India/Chinese demand (which may be helped further in 2015 by the rise in disposable income resulting from the lower oil price), Central bank demand (who knows but China might yet tell the world that it has indeed

Bullish Factors for 2014-15

1. *Asian physical demand will continue to expand*
   - *Lower oil prices increase disposable income*
   - *The savings to India/China are over $100 billion*
2. *Central banks will continue to buy gold*
3. *The global debt crisis will worsen*
   - *Debt will expand faster than nominal GDP*
   - *Monetary policy will remain "loose" - despite Fed*
4. *The US dollar is overvalued*
   - *It must come down or global imbalances will worsen*
5. *Geopolitical crises will multiply (oil to be a factor)*
6. *ETF "supply" to turn into ETF "demand" in 2015*
7. *The commodity cycle will run many more years*
   - *India, China, etc., need "stuff" for years to come*

been adding gold to its reserves), and central bank policies to limit deflation, weak growth, and a rise in debt/GDP ratios (the Fed is the only major central bank seriously contemplating policy tightening in 2015).

A big concern for 2015 is geopolitical risk, hence the discussion thereof on page 4. Geopolitical risks are generally quite positive for gold (note the $100 impact of the Ukraine crisis during 2014-Q1 for example), though most often not long-lasting.

In our big picture view, the gold market has yet to recover from a severe supply surge in 2013 (880 tonnes of ETF sales). But it will recover because ETF sales have moderated and the world economy is not in a place where significant monetary policy tightening is likely or warranted. Indeed, the current environment is not a 1980 "Volcker environment", with 14%+ rates of inflation (an environment that necessitated massive hikes in interest rates which ended the bull markets in gold). Today most central bankers would dearly love to see higher, not lower, inflation, and this fact biases us to look for higher gold prices going forward.

Forecast Update: December 17, 2014

Gold Price Scenarios

		2015-avg	2015-end	2016-avg
Scenario A:	p = 30-20%	$1080	$1055	$1045
Scenario B:	p = 50-55%	$1240	$1270	$1315
Scenario C:	p = 20-25%	$1355	$1440	$1525
Weighted		**$1230**	**$1270**	**$1315**

The probabilities have shifted ever so slightly towards "C"!!

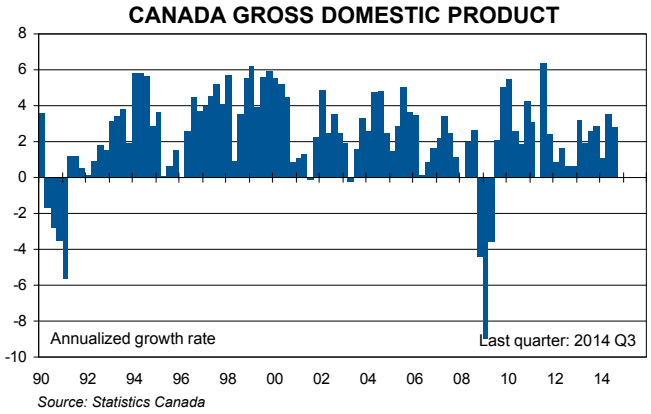
Bearish Factors for 2015-16

1. ***The Fed will tighten monetary policy***
   - ***The Fed has ended QE …***
   - ***… and will raise rates in 2015-16***
2. ***US dollar will remain firm in 2015-16***
   - ***The US is losing the currency war …***
3. ***The world economy will remain sluggish***
   - ***The oil price will be depressed …***
   - ***Meaning inflation will remain subdued …***
   - ***And Russia may need a "liquidity of last resort"***
4. ***The S&P500 will continue to compete with gold***
5. ***Gold ETF tonnages remain substantial – and could be dumped***

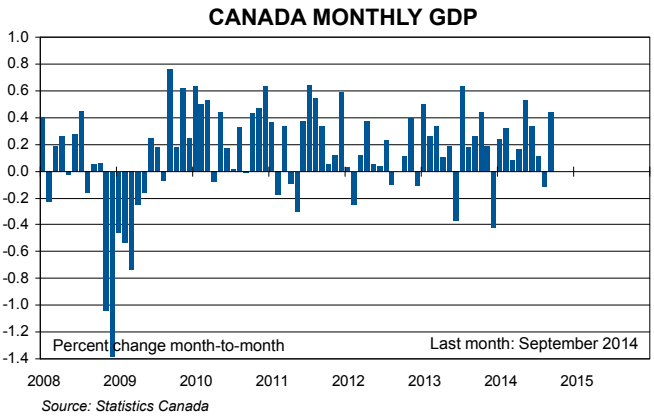
MONTHLY REVIEW ►
CANADA – ECONOMIC GROWTH

Growth for the full year should be near 2.5%. But the outlook for 2015 is more modest.

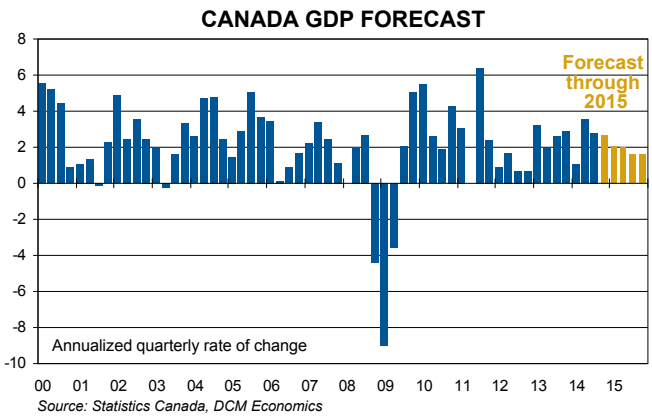
The economy grew 2.8% in the third quarter, down from 3.6% in the second quarter.



For the twelve months through September the economy grew 2.3%.

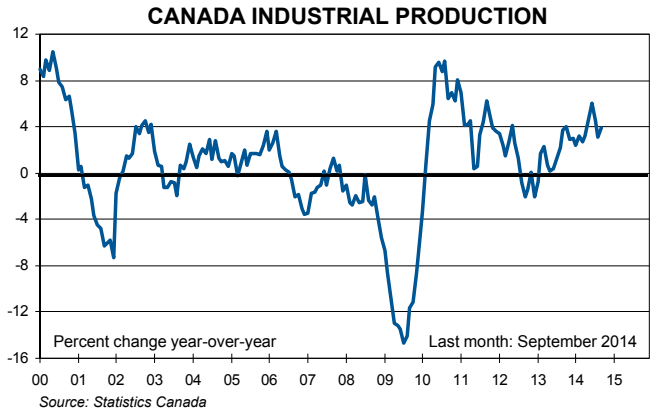


Stronger US growth and strong auto production should keep growth relatively firm in 2014 but then weaker energy investment kicks in.

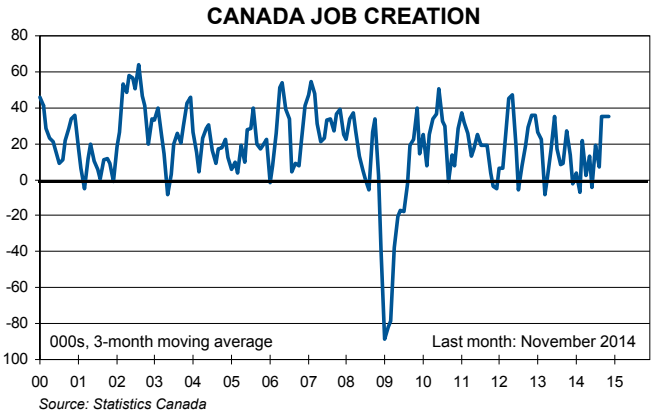


MONTHLY REVIEW ►
CANADA – ECONOMIC GROWTH

Over the latest twelve months industrial production was up 3.9%.



Job creation averaged a strong 35,500 per month over the latest three months, but will likely slow in future.



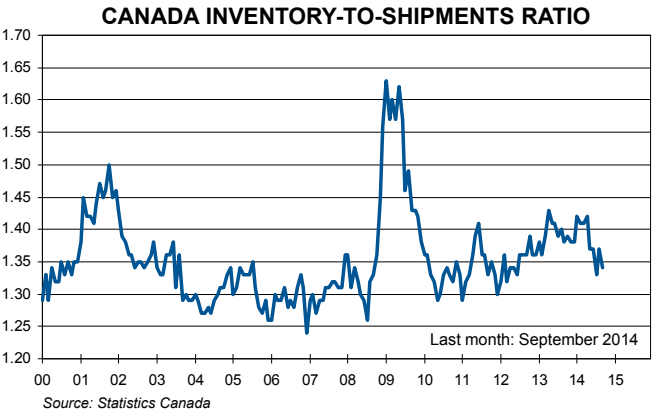
While the unemployment rate rose slightly to 6.6% in November, it was still close to a low since the recession.

MONTHLY REVIEW ►
CANADA – ECONOMIC GROWTH

Canadian manufacturing shipments have been strong, aided by a cheaper loonie.

New orders have also been strong.

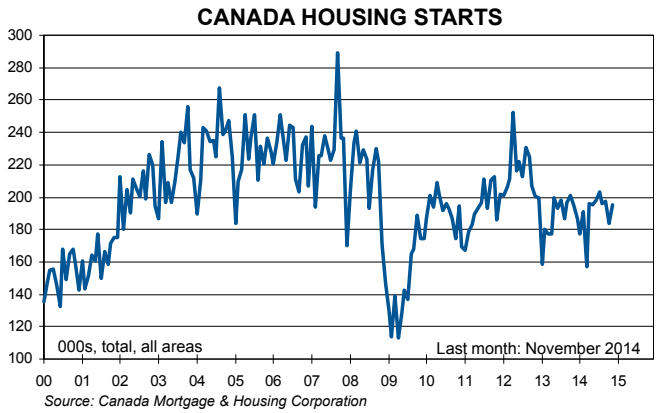
The inventory ratio has been falling back but may still be slightly high.



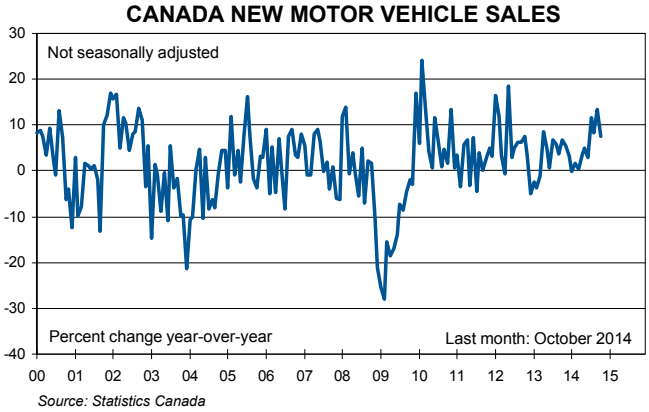
MONTHLY REVIEW ►
CANADA – ECONOMIC GROWTH

Retail sales haves been somewhat slow in recent months but strong car sales and lower gasoline prices will help.

Housing starts, despite a dip in October, are still fairly strong with multiple units (condos) leading the way.



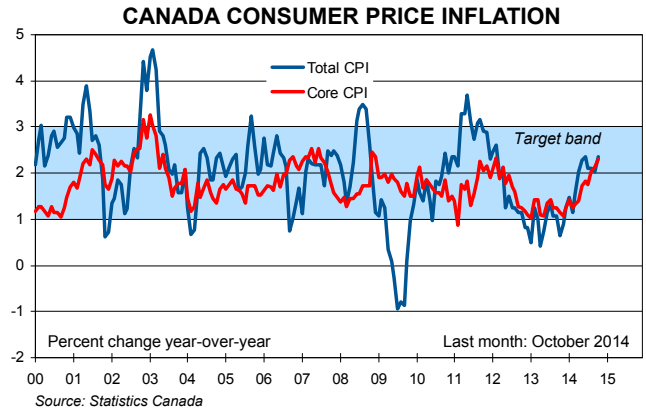
Vehicle sales are up 10%+ year-on-year.



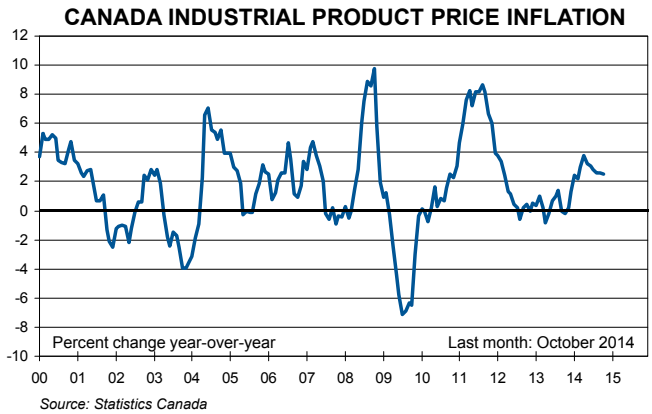
MONTHLY REVIEW ►
CANADA – INFLATION

With oil prices falling faster than expected, inflation is apt to be lower in 2015.

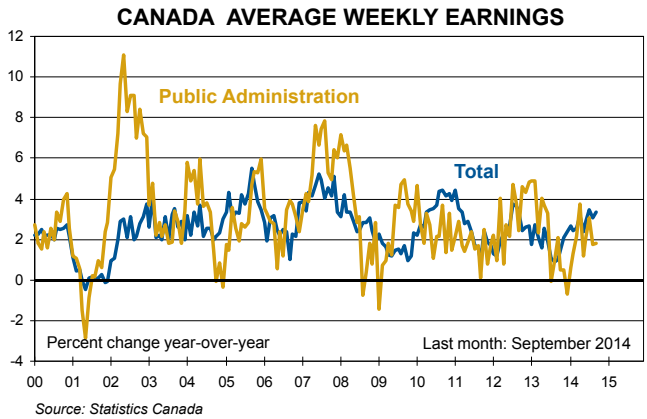
Inflation was 2.4% in October, matching June's high point for the year. The core rate rose to 2.3%, the highest it has been since February 2012.



Industrial product price inflation fell slightly to 2.5% in October.

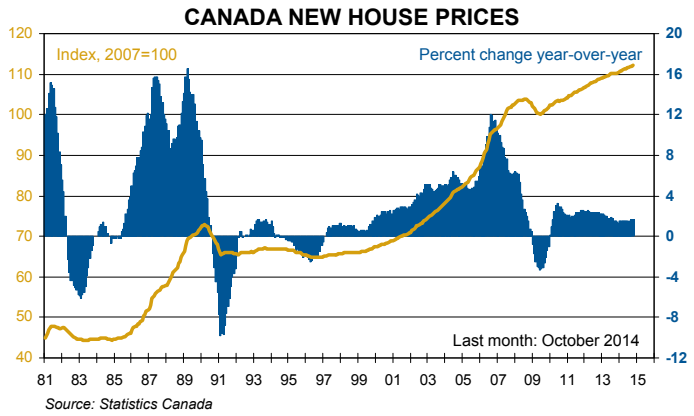


Earnings have been rising somewhat over 3% in recent months but the slowing energy sector likely means future deceleration.

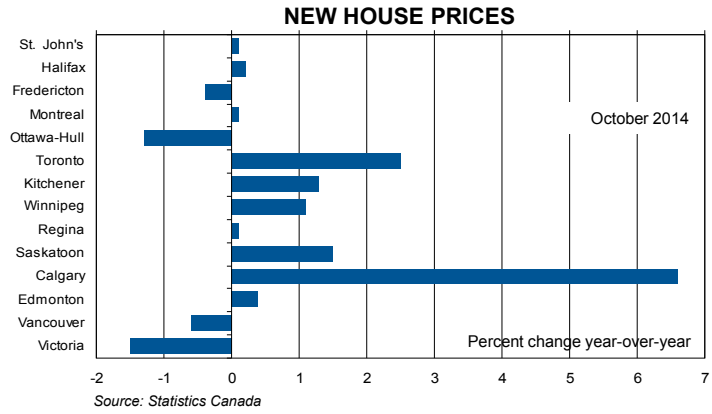


MONTHLY REVIEW ► CANADA – INFLATION

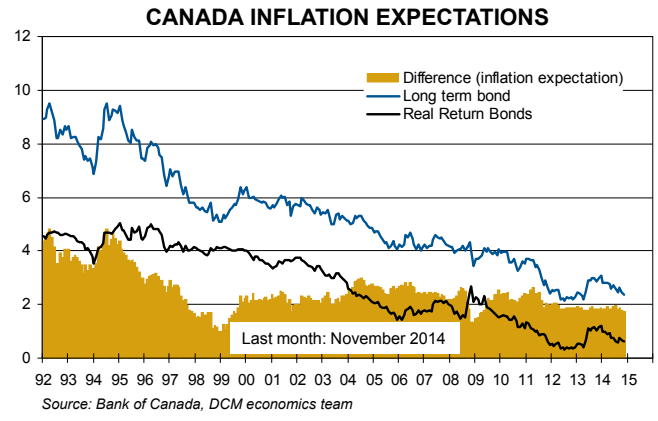
New house price increases were up 1.6% in October from a year earlier but the building of smaller units is keeping price increases down.



Calgary has led price increases across major cities but a major slowdown is expected soon thanks to reduced energy-sector activity.



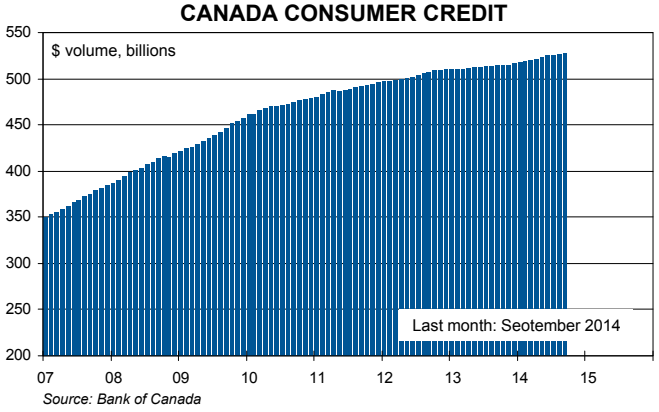
Inflation expectations are ebbing.



MONTHLY REVIEW ►
CANADA – DEBT AND CREDIT

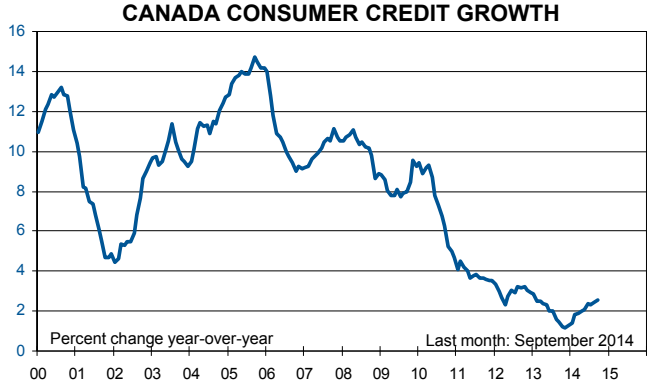
Consumer credit growth is slow but accelerating somewhat; mortgage credit growth remains modest while business credit growth has been strong.

CANADA CONSUMER CREDIT



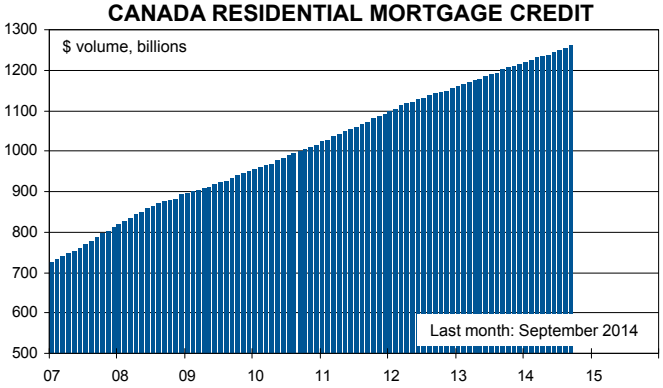
Source: Bank of Canada

CANADA CONSUMER CREDIT GROWTH



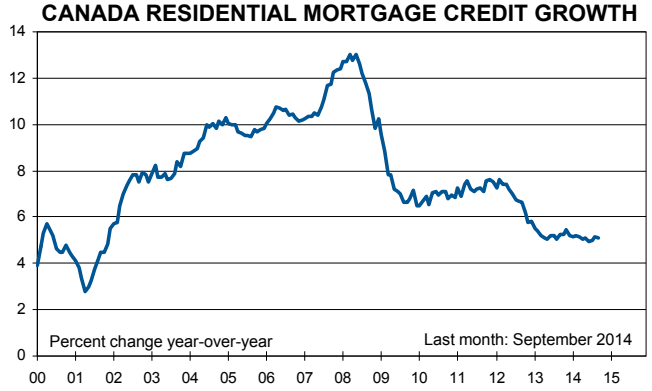
Source: Bank of Canada

CANADA RESIDENTIAL MORTGAGE CREDIT



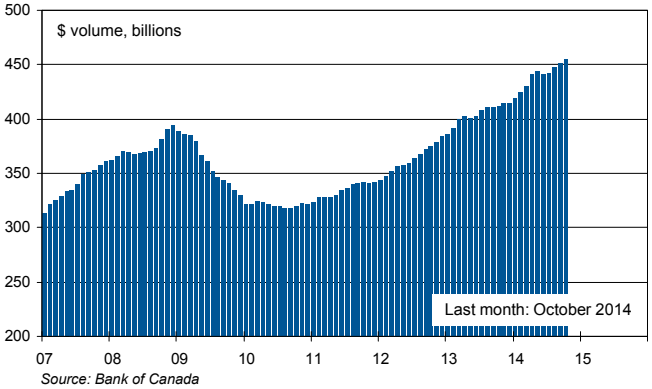
Source: Bank of Canada

CANADA RESIDENTIAL MORTGAGE CREDIT GROWTH



Source: Bank of Canada

CANADA SHORT-TERM BUSINESS CREDIT



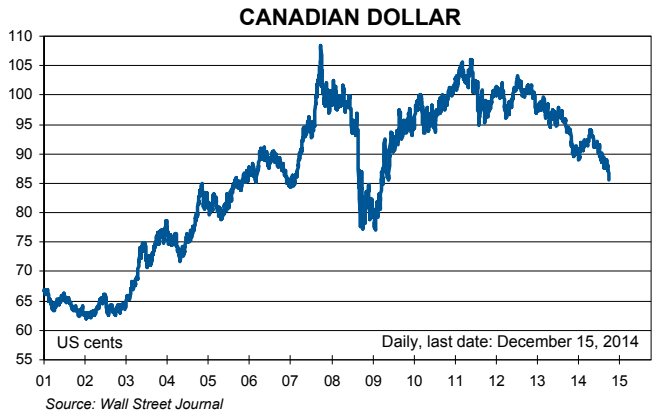
Source: Bank of Canada

CANADA SHORT-TERM BUSINESS CREDIT GROWTH

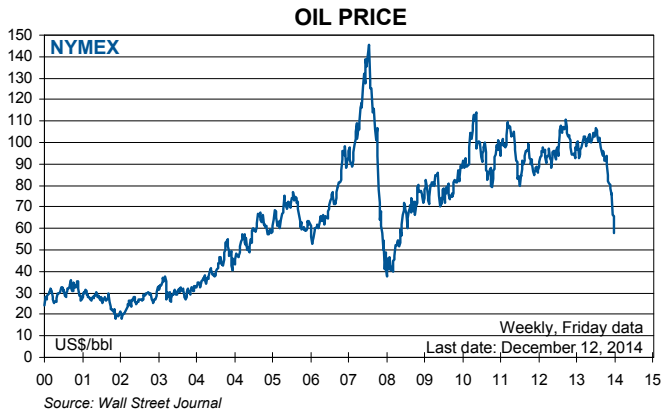
Source: Bank of Canada

MONTHLY REVIEW ►
CANADA – FINANCIAL MARKETS

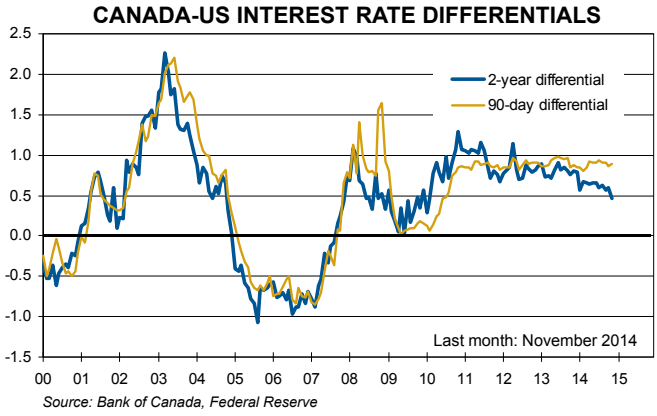
The Canadian dollar has not fallen as much as oil prices over the last month - probably on speculation about possible interest rate increases next year. We doubt Canadian rates will rise, potentially leaving the dollar exposed to a bigger decline.



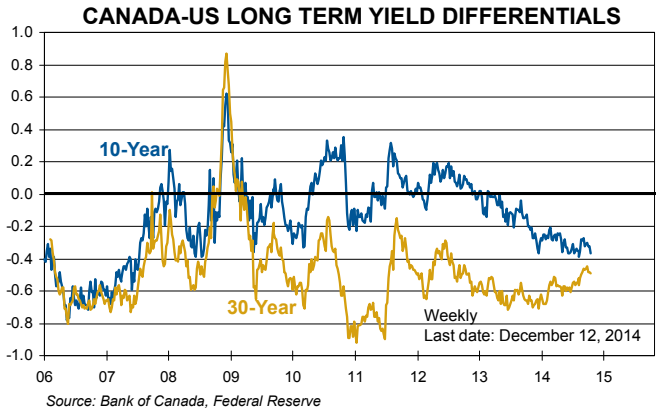
Saudi concerns over loss of market share have led to a price war. There may well be further price declines ahead which could spread to natural gas.



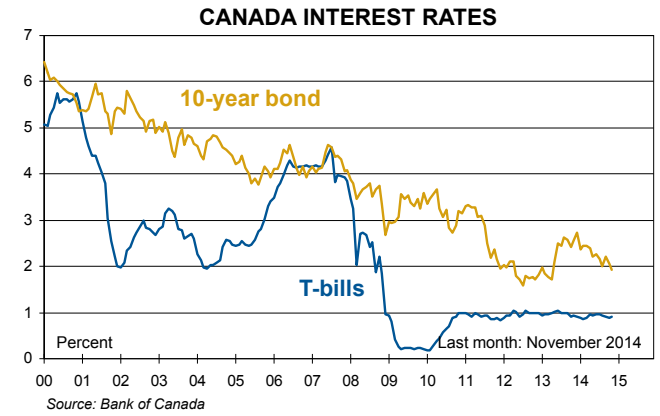
Short-term interest rates remain higher in Canada than in the US, creating uncertainty about whether the Bank of Canada would follow a possible US rate rise in 2015.



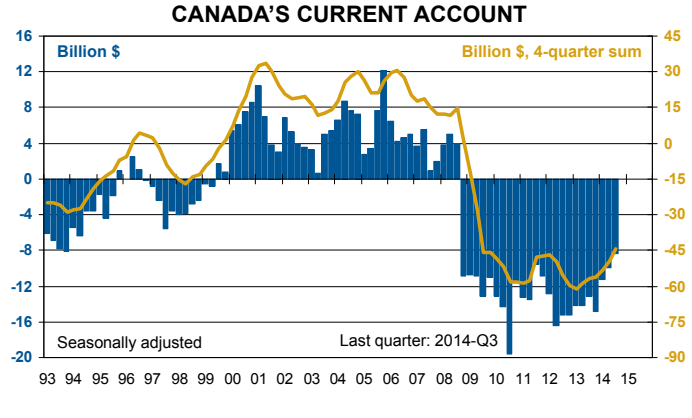
Longer-term yields are noticeably lower in Canada than in the US.



At this point we don't expect the Bank of Canada to raise rates next year.



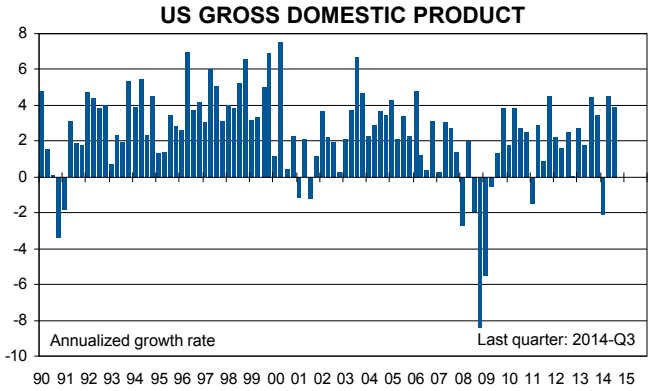
The Canadian current account deficit has been declining but may increase again to the extent that oil prices stay down.



MONTHLY REVIEW ►
UNITED STATES – ECONOMIC GROWTH

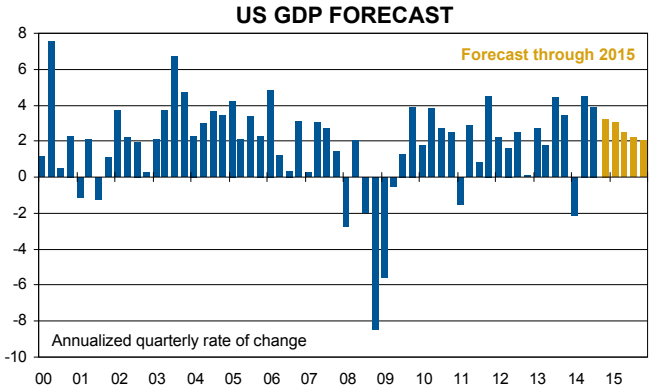
Growth for 2014 will likely be about 2.4%, with a similar pace in 2015.

Third quarter growth was revised up to 3.9%. Strong growth over the last two quarters follows on a first quarter contraction.



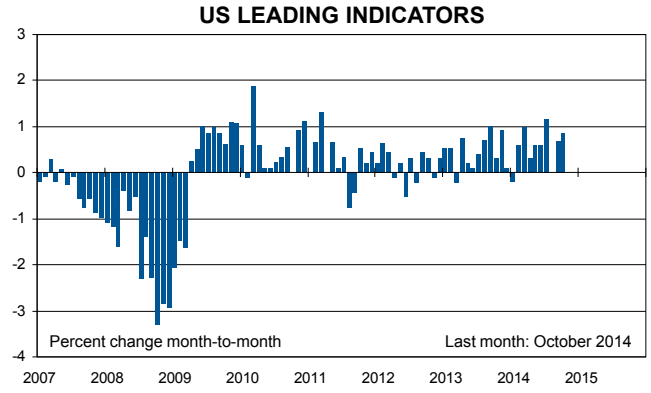
Source: US Bureau of Economic Analysis

Growth could be near 3% for several more quarters but is then expected to slow (slower energy investment, weaker net trade). Consumption should benefit from lower oil prices however – depending upon how much of the windfall will be saved!



Source: US Bureau of Economic Analysis, DCM Economics

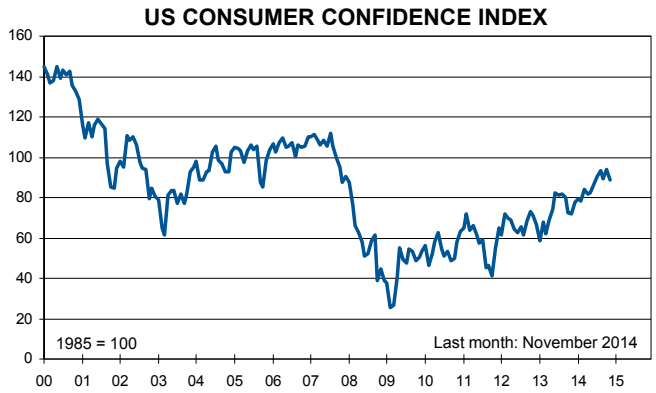
The leading indicators have been fairly strong.



Source: The Conference Board

MONTHLY REVIEW ►
UNITED STATES – ECONOMIC GROWTH

Consumer confidence has lost a little momentum in recent months ...



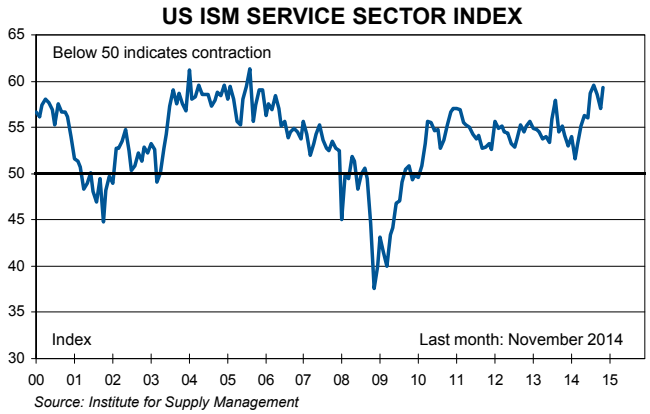
... but job creation has been strong ...

... and the unemployment rate is at the lowest point since the recession.

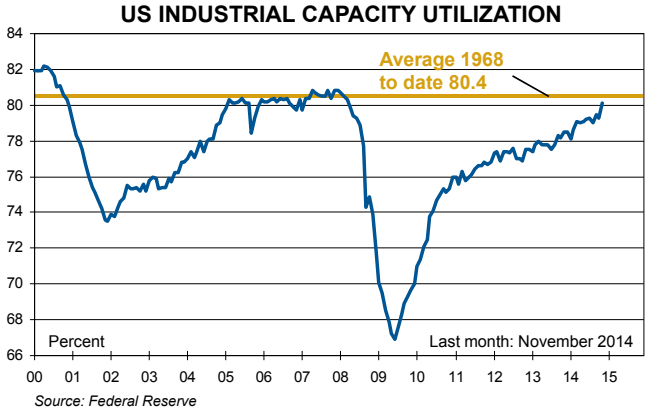
MONTHLY REVIEW ►
UNITED STATES – ECONOMIC GROWTH

The ISM manufacturing index remains at a very high level ...

... the service sector ISM rebounded unexpectedly in November and is also at a very high level ...

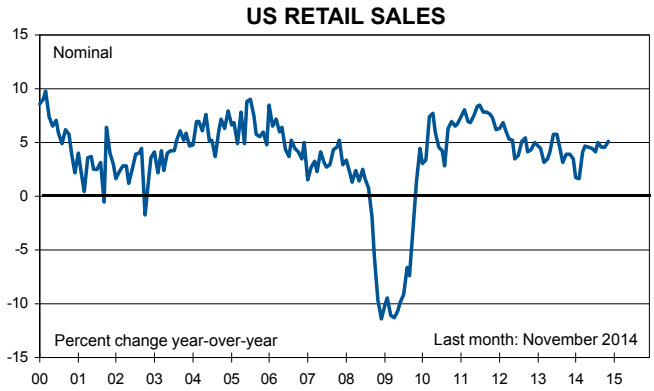


... and capacity utilization recently rose above 80%!



MONTHLY REVIEW ►
UNITED STATES – ECONOMIC GROWTH

Overall retail sales remain reasonably strong. Lower gasoline prices are the equivalent of a tax cut - but an ageing society may save more than expected (after Christmas).

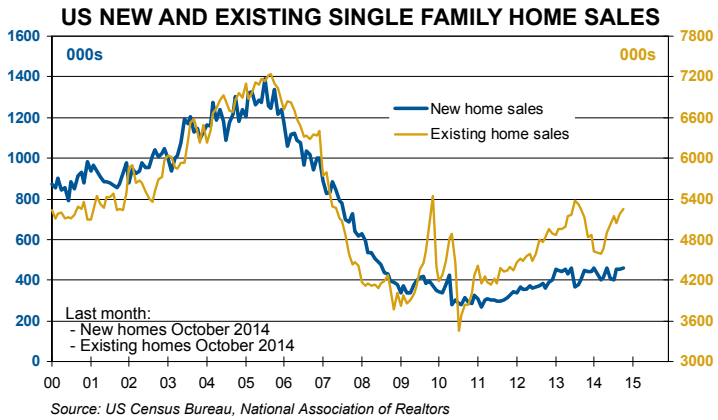


Source: US Census Bureau

Upward momentum for housing starts remains disappointing, although less onerous lending terms may help in 2015.

Source: US Census Bureau

Existing home sales continue to rebound from last year's rise in mortgage rates, but new home sales are lackluster and mostly at the high-priced end of the spectrum.

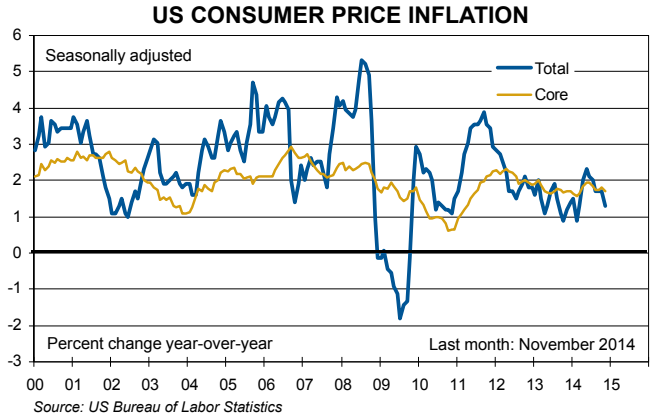


Source: US Census Bureau, National Association of Realtors

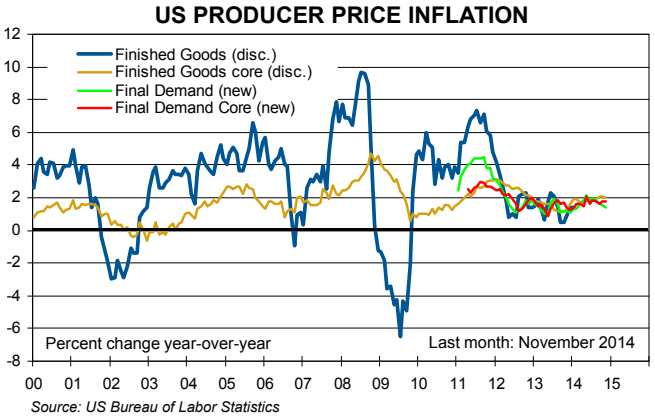
MONTHLY REVIEW ►
UNITED STATES – INFLATION

After moving briefly above 2% earlier this year, CPI has fallen back below 2%; headline inflation will likely fall considerably, reflecting lower energy prices.

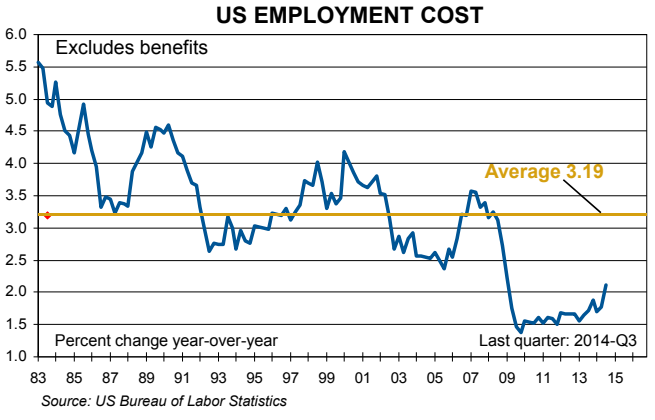
CPI remained at 1.7% in October, although the core rate nudged up to 1.8%.



Producer price inflation fell to 1.5% in October.

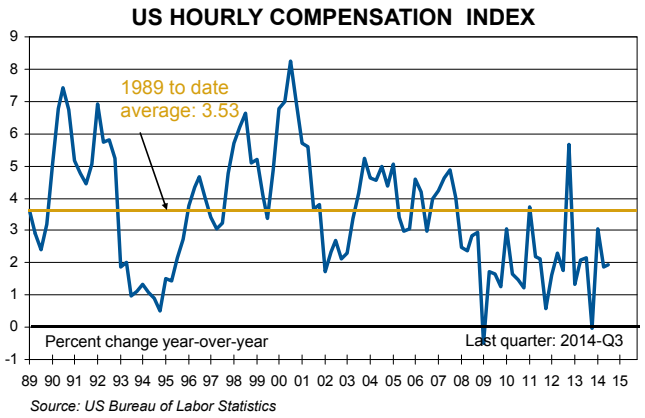


But employment costs picked up in recent quarters.

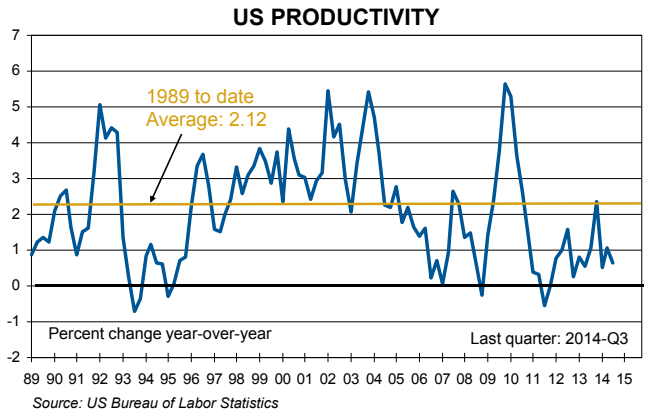


MONTHLY REVIEW ►
UNITED STATES – INFLATION

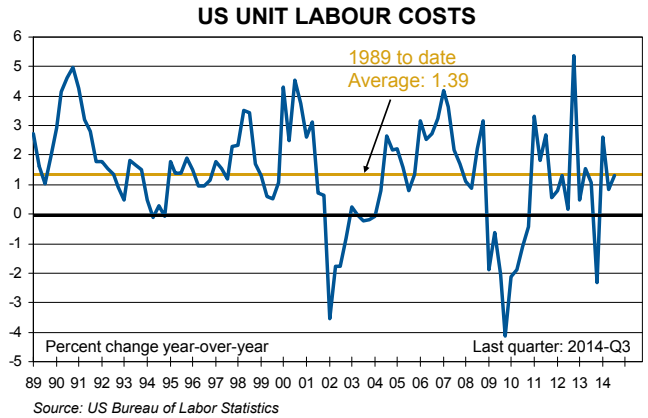
Hourly compensation has risen 1.7% over the past year.



Productivity increases have averaged 1.2% over the same period ...

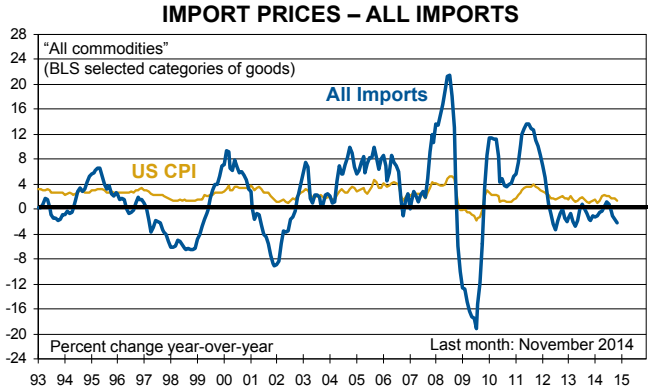


... leaving unit labour costs up just 0.6%.

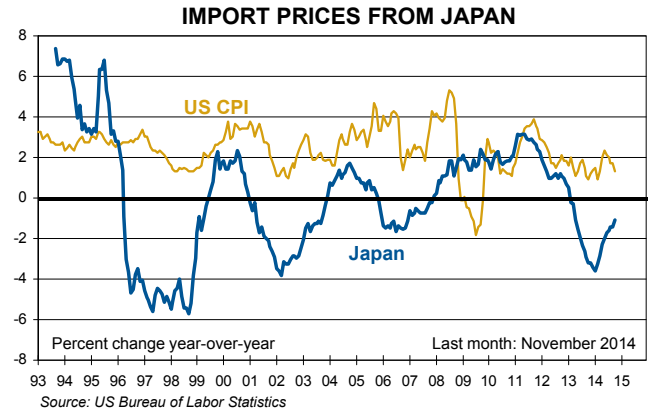


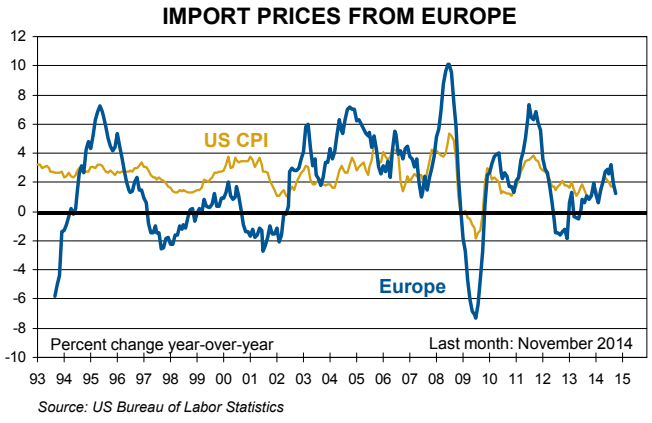
MONTHLY REVIEW ►
UNITED STATES – INFLATION

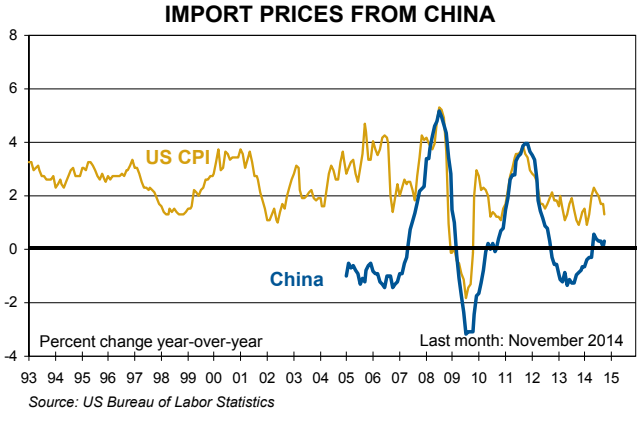
Import price deflation accelerated in October, largely because of falling oil prices.



Although Asian import prices have increased slightly in recent months, European import prices show deceleration, with the euro falling.

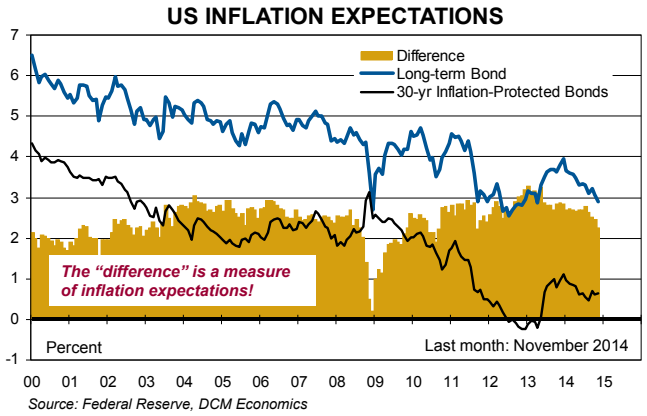




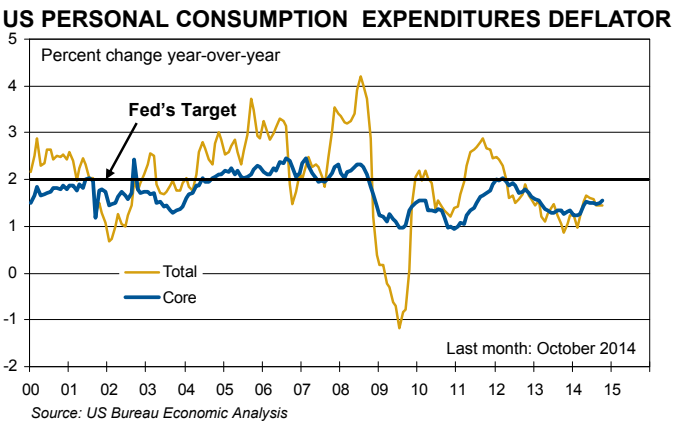


MONTHLY REVIEW ►
UNITED STATES – INFLATION

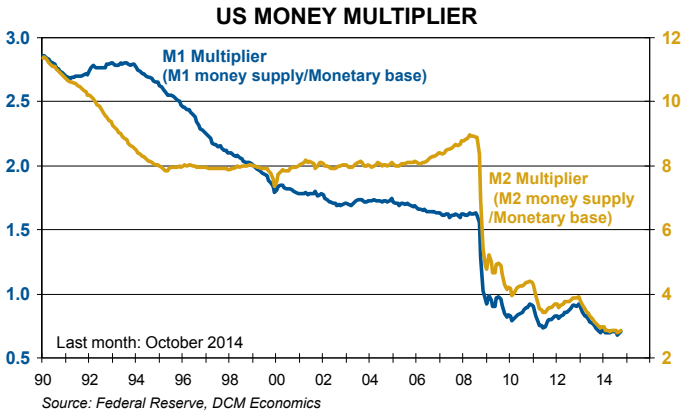
Inflation expectations are falling.



The personal consumption measure of inflation remains near 1.5%.

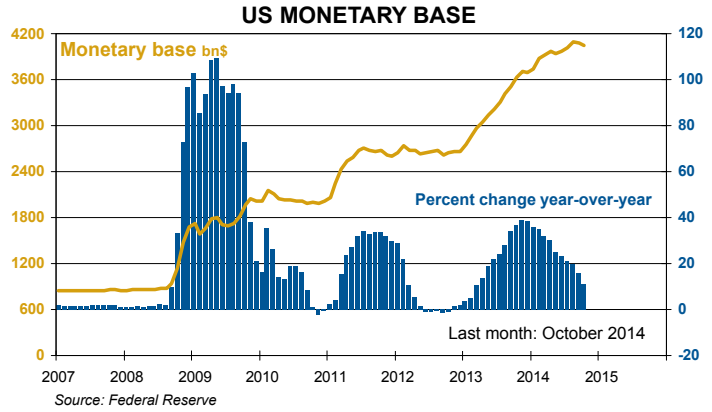


The money multipliers show no sign of significant increase ... but will hopefully soon!

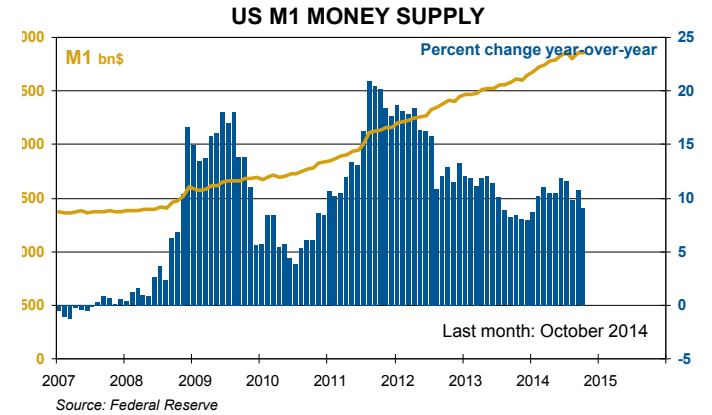


MONTHLY REVIEW ►
UNITED STATES – MONEY SUPPLY GROWTH

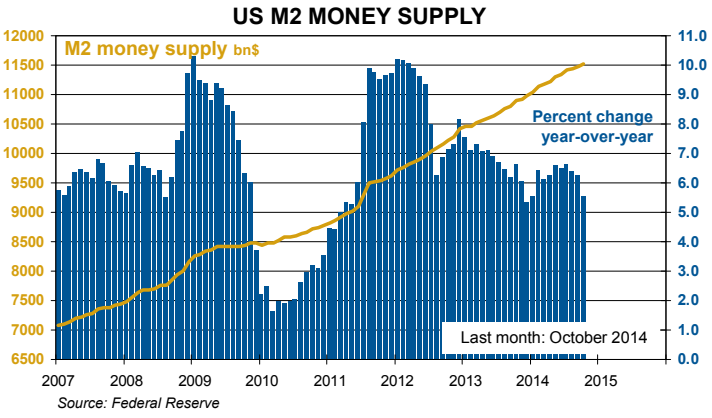
The monetary base is expanding less rapidly of late ...



... whereas M1 is expanding close to 10% ...



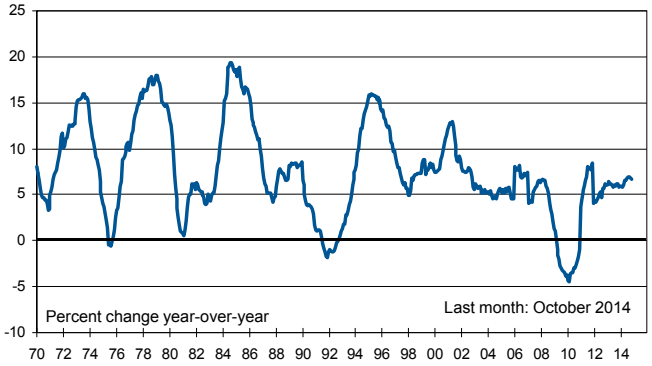
... and M2 is expanding at a 6% rate.



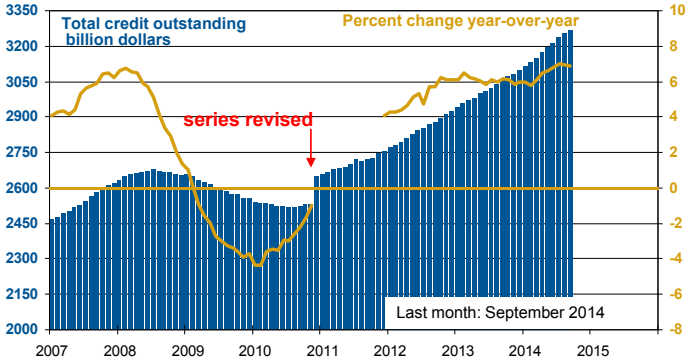
MONTHLY REVIEW ►
UNITED STATES - CREDIT GROWTH

Credit growth remains somewhat limp compared with past cycles, and mortgage credit is still contracting!

US CONSUMER INSTALLMENT CREDIT

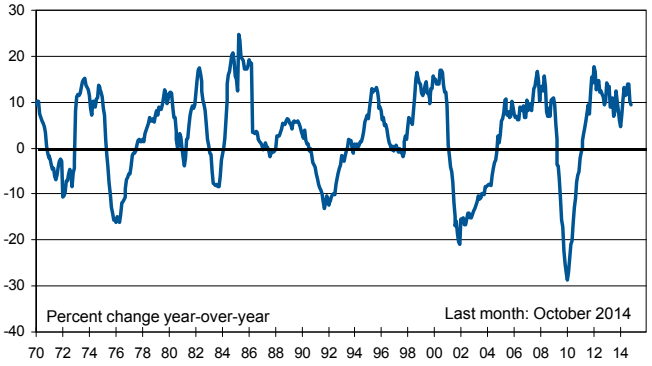


US CONSUMER INSTALLMENT CREDIT

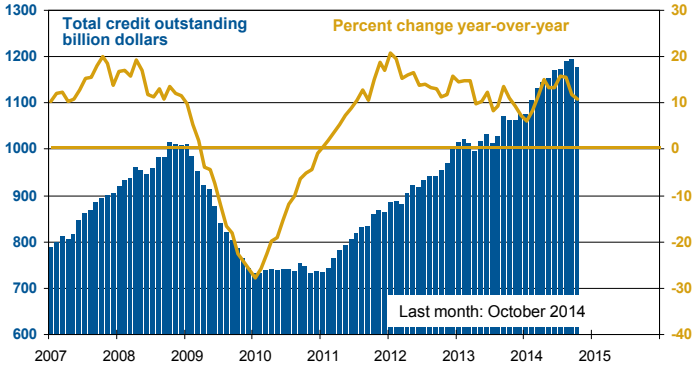


Source: Federal Reserve

US COMMERCIAL AND INDUSTRIAL LOANS



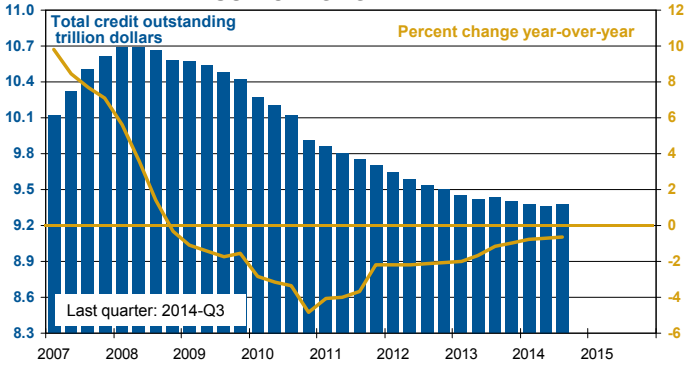
US COMMERCIAL AND INDUSTRIAL LOANS



Source: Federal Reserve

US MORTGAGE CREDIT

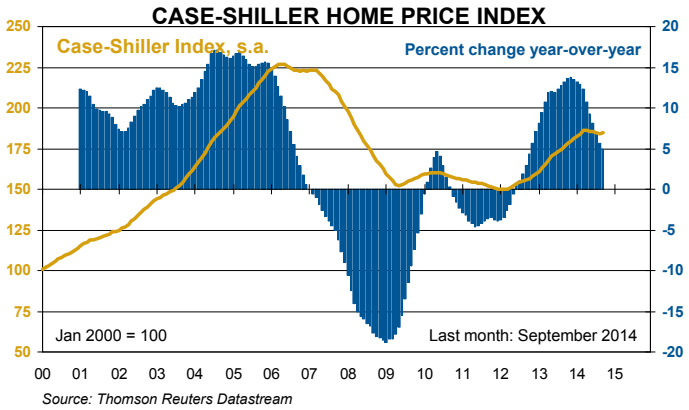
US MORTGAGE CREDIT



Source: Federal Reserve

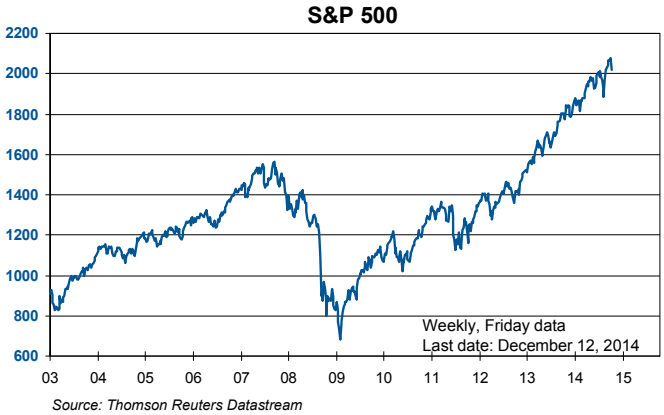
MONTHLY REVIEW ►
UNITED STATES - WEALTH CREATION

Month-to-month house prices resumed rising in September although the year-over-year rate of increase continued to decelerate.



Source: Thomson Reuters Datastream

US stocks continue to hit new highs.

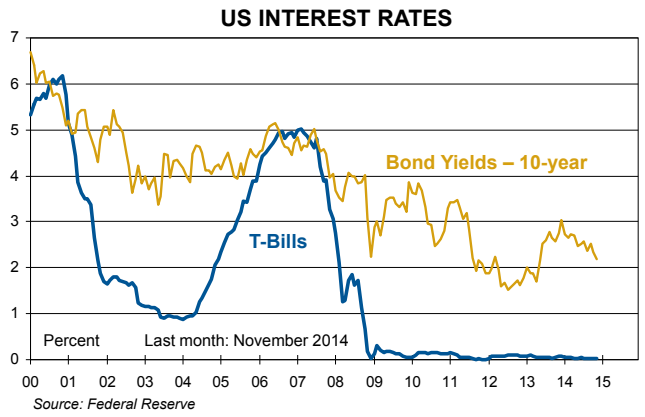


Source: Thomson Reuters Datastream

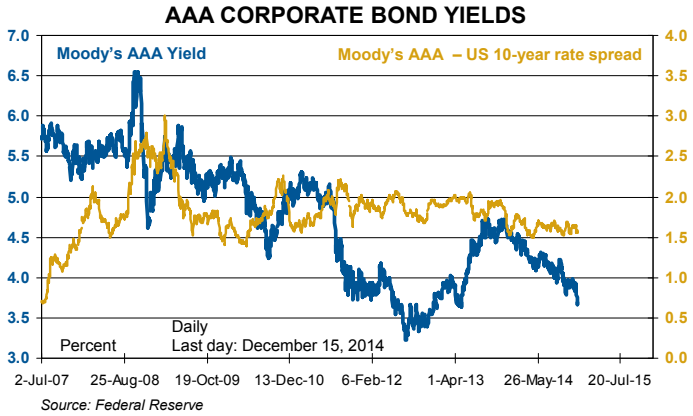
The personal savings rate was revised again - this time downward. Currently the rate is near 5%.

Source: US Bureau of Economic Analysis

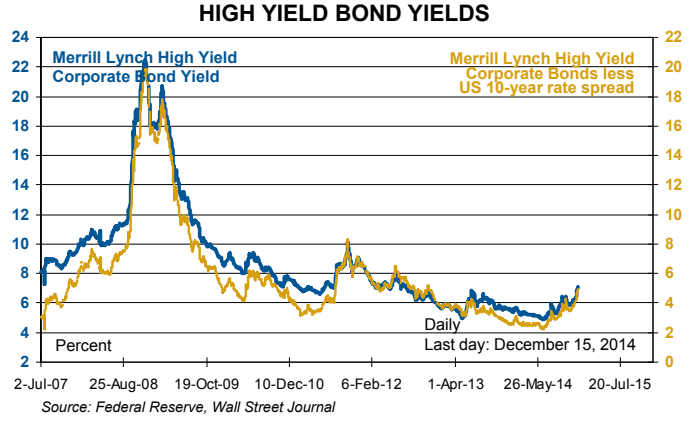
Fed officials would like to begin "normalizing" interest rates sometime next year, but most likely will continue to monitor core inflation and economic growth until at least mid-2015 before any decision is made.



Good quality bond yields have drifted lower ...

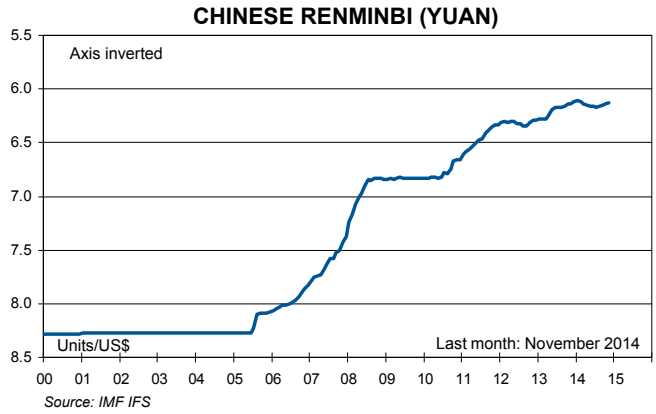


... but lower quality yields have risen sharply, led by energy company bonds.

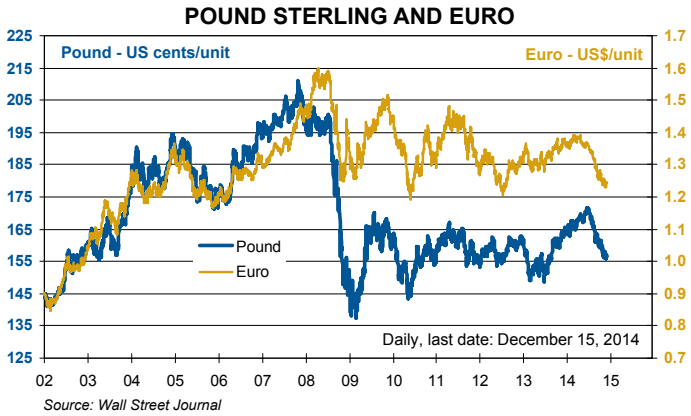


MONTHLY REVIEW ►
FOREIGN EXCHANGE RATES

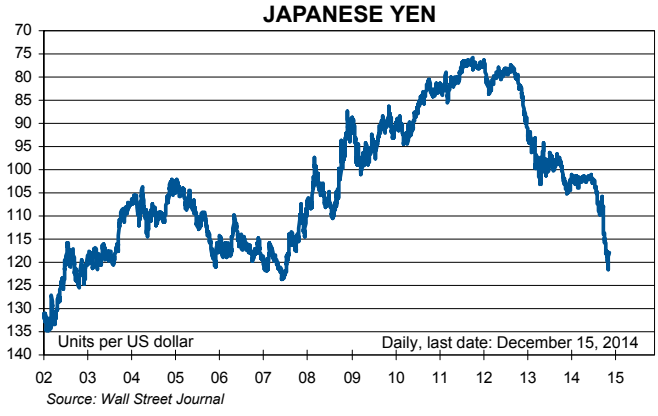
The renminbi has declined in recent days, and may remain weak given ongoing weakness in the yen and euro.



Policy will likely drive the euro lower yet in 2015, given the Eurozone's weak growth and threat of deflation. Some of that weakness has spread to Britain via the trade link and the pound has fallen too.

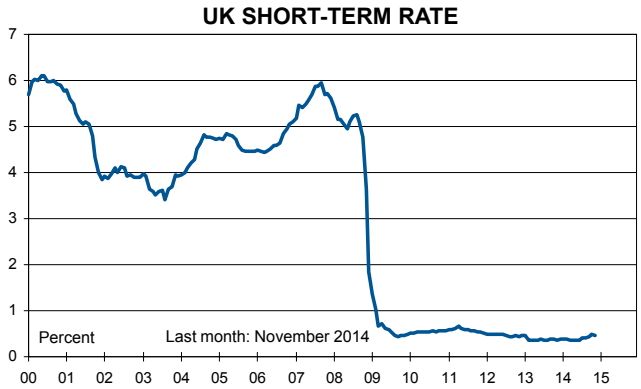


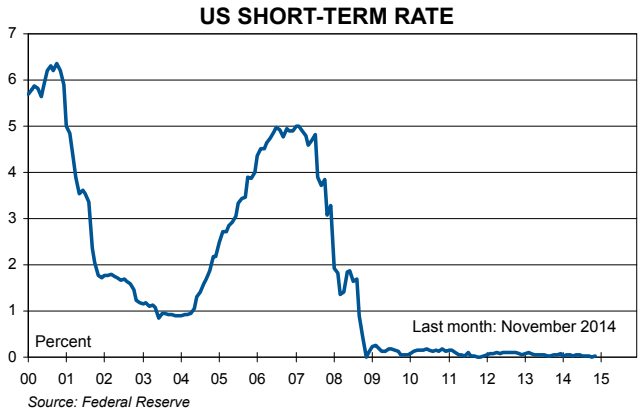
There is also the danger that policy will push the yen much lower over the next year.



MONTHLY REVIEW ►
INTERNATIONAL SHORT-TERM RATES

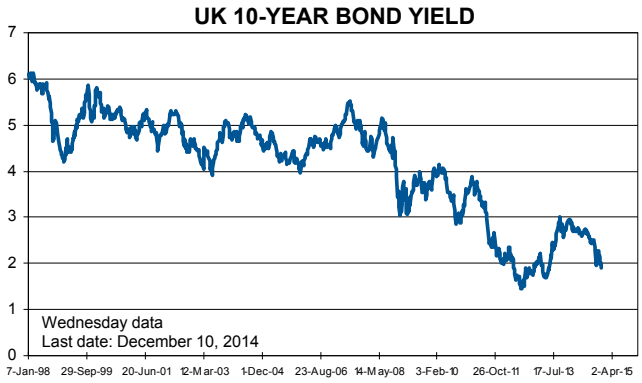
The US has replaced the UK as the country most likely to raise interest rates next year. (The UK is suffering from low wage growth and weak exports to the Eurozone.) The US economy may slow towards spring however and falling inflation may have a negative impact on wage growth, so we haven't raised the probability of a hike in the fed funds rate above 50% just yet.



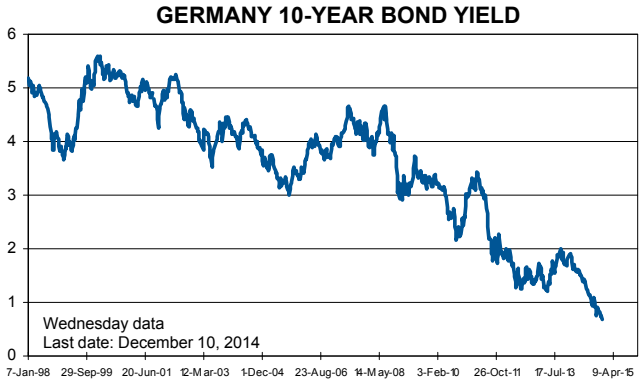


MONTHLY REVIEW ►
INTERNATIONAL 10-YEAR YIELDS

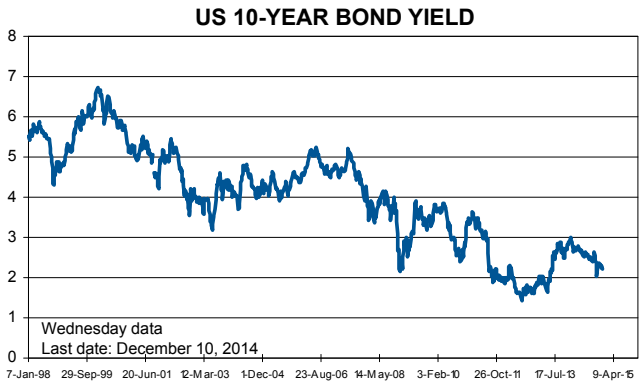
The low inflation of Europe and Japan, even Britain, will likely keep local bond yields down, attracting investors to North America. Currency suppression in Europe and Asia will also tend to keep North American yields low.



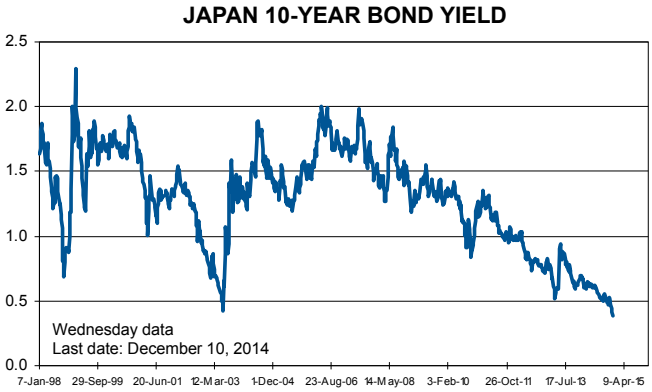
Source: Financial Times



Source: Financial Times



Source: Financial Times



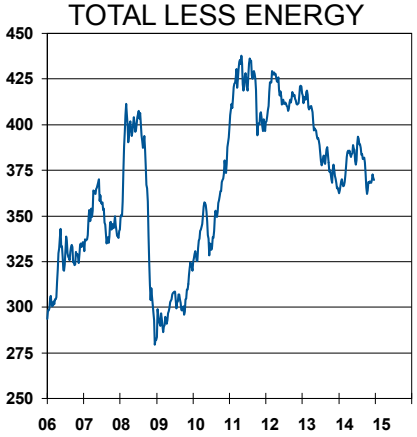
Source: Financial Times

COMMODITY PRICES

1. Bank of Canada Commodity Price Indices (Weekly data to December 12, 2014)

TOTAL COMMODITY

TOTAL LESS ENERGY



ENERGY

AGRICULTURE

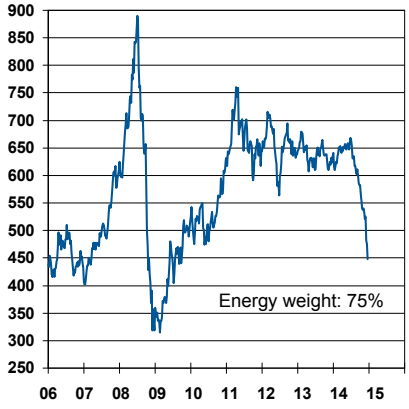
METALS & MINERALS

Were it not for the plunge in oil prices affecting the broader commodity price baskets, most commodity price indicators would signal a somewhat more stable price environment in recent days.

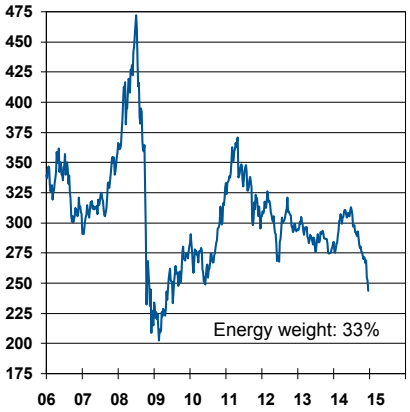
The plunge in oil prices has pluses and minuses for other commodities: plus – potentially somewhat higher economic growth on the back of a rise in disposable income (after energy expenses); minus – investment in the oil patch will decline and hence absorb less material resources.

2. Other Indices (Weekly data to December 12, 2014)

S&P GSCI COMMODITY



REUTERS/JEFFERIES CRB



ECONOMIST COMMODITY PRICE

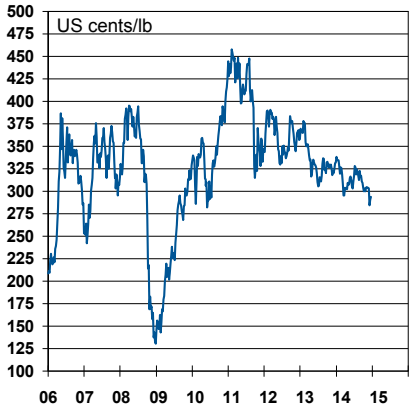
Sources: Bank of Canada, Thomson Reuters Datastream, The Economist

COMMODITY PRICES

3. Metals (Weekly data to December 12, 2014)

NICKEL

COPPER



ZINC

ALUMINUM

LEAD

GOLD

PLATINUM

SILVER

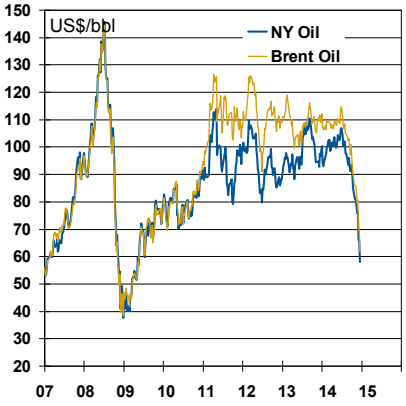
Metal prices have come down from their summer-time highs. The near-term outlook is clouded by oil price developments.

Sources: LME, LBMA, Wall Street Journal

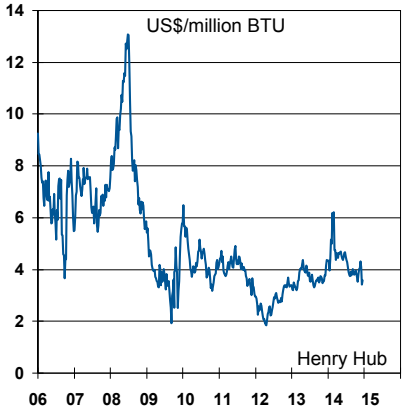
COMMODITY PRICES

4. Energy (Weekly data to December 12, 2014)

SPOT OIL PRICES



NATURAL GAS

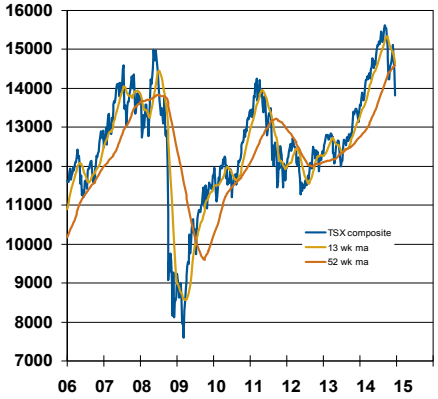


Oil prices have declined to (nearly) Great Recession lows and the outlook is precarious. Best to expect low oil prices right through the first half of 2015!

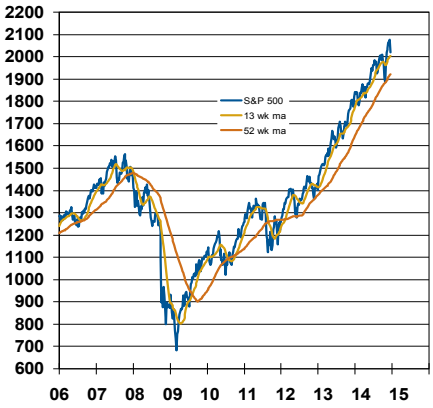
EQUITY MARKETS

5. North America (Weekly data to November 28, 2014)

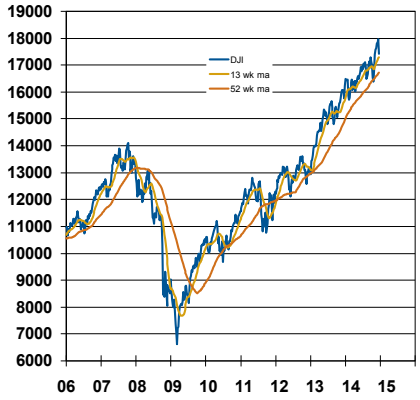
TSX COMPOSITE INDEX



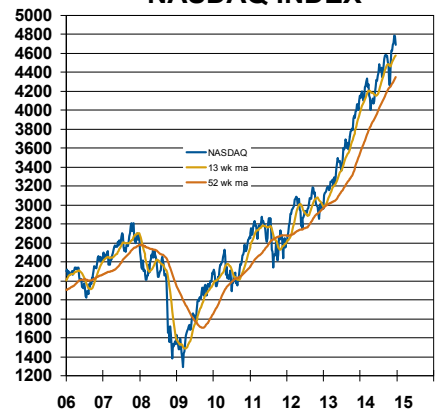
S&P 500 INDEX



DOW JONES INDUSTRIALS



NASDAQ INDEX



The outlook for US equity markets remains broadly constructive; policy interest rates will remain low and no US recession is on the horizon. That said, there will be volatility as the markets debate if/when the Fed will raise interest rates.

The decline in oil prices has been hard on the S&P/TSX, and we expect it to under-perform the S&P500 in 2015. Overseas, large oil-importing countries have seen gains in their equity markets!

Source: Thomson Reuters Datastream

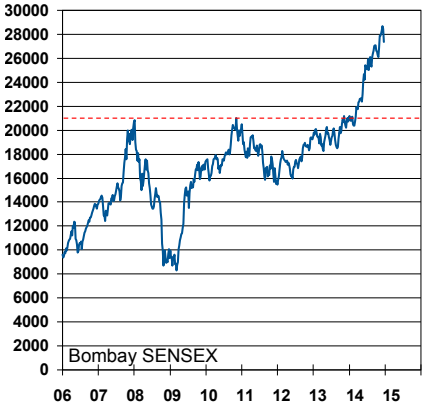
EQUITY MARKETS

6. Around the world (Weekly data through December 12, 2014)

JAPAN

GERMANY

INDIA



CHINA

RUSSIA

MEXICO

MSCI EAFE INDEX

BRAZIL

MSCI WORLD INDEX

Source: Thomson Reuters Datastream

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