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U.S. DOLLAR: CYCLICAL AND STRUCTURAL FORCES IN TUG OF WAR

- Standard & Poor's downgrading of its credit rating outlook on the United Kingdom from stable to negative rattled the exchange markets and caused the fiscal sustainability of the principal advanced economies to be reassessed.
- Normally, the desynchronization of U.S. and European monetary policies will push the greenback to gain at least 10% on the euro over a period of one year. In the next 12 to 18 months, the positive cyclical forces of the greenback should dominate the negative structural forces related to the worsening of the U.S. budget deficit.
- For the first time in history, commodity prices are literally miles ahead of the actual state of the real economy. This, in turn, is driving up the cyclical currencies, including the Canadian dollar.
- At present, the loonie exceeds its long-term equilibrium value by nearly 10%. However, unlike in October, the price of oil today is less than \$70 a barrel and Canadian export levels are depressed. As the Bank of Canada cannot modify its position on quantitative easing, the loonie will depreciate only if the greenback appreciates across the board. In the end, if our forecast regarding the euro proves right, the loonie should come down a few cents from its current level.

		NBF Currency Outlook*							
		Current 05-Jun	2009 Q2	2009 Q3	2009 Q4	2010Q1	2010 Q2	2009	2010
USD/CAD	1.111	1.14	1.16	1.18	1.16	1.15	1.18	1.11	
US cents per CAD	0.900	0.880	0.862	0.847	0.862	0.87	0.850	0.90	
EUR/USD	1.400	1.37	1.30	1.25	1.20	1.17	1.30	1.20	
USD/JPY	95.7	97	100	105	110	115	100	115	
AUD/USD	0.800	0.78	0.76	0.74	0.76	0.80	0.74	0.84	
GBP/USD	1.600	1.58	1.60	1.62	1.64	1.66	1.54	1.66	
AUD/CAD	0.889	0.89	0.88	0.87	0.88	0.92	0.87	0.93	

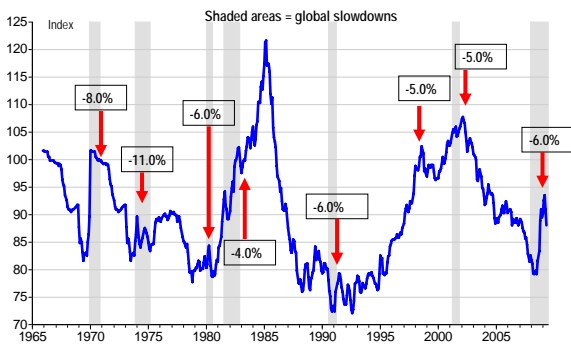
* forecasts for end of quarter and year average
Source: NBF Economic Research

Safe haven effect reversing

After benefitting from a safe-haven effect and an improvement in the U.S. current account deficit, the greenback has just registered a non-negligible pullback in trade-weighted terms. In the past month, the both British pound and the euro appreciated, as did the cyclical currencies (Australian, Canadian and New Zealand dollars) with a certain degree of emphasis.

1) Greenback under pressure

USD in nominal trade-weighted terms



NBF Economy and Strategy, Global Insight

With a recovery of the global economy more and more in the wind, carried among other things by a partial resolution of the financial crisis, the greenback has just suffered a reversal of the self-haven effect that recently sent it soaring. The magnitude of the present reversal is entirely in line with similar episodes on a historical basis at about 5% to 6% on average.

Cause for concern?

While reaffirming the United Kingdom's AAA credit rating, Standard & Poor's downgraded its outlook on the country from stable to negative last month. The decision rattled the exchange markets and caused the fiscal sustainability of the principal advanced economies to be reassessed.

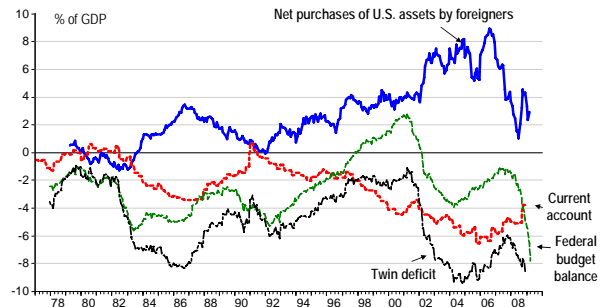
In this light, the recent upward pressure on government long rates did not merely reflect the ruling out of a deflation scenario in favour of an imminent recovery, but also an increase in the risk premiums on real U.S. Treasury rates.

Hence, despite the Federal Reserve's plan to purchase federal government bonds on a massive scale, long-term interest rates are rising in the

United States. The markets are concerned in particular that the enormous budget deficit nurtured by the recession and the financial crisis will persist despite the economy's eventual improvement.

2) Do foreigners still want U.S. assets?

Net purchases of U.S. assets by foreigners, current account, budget balance and twin deficit

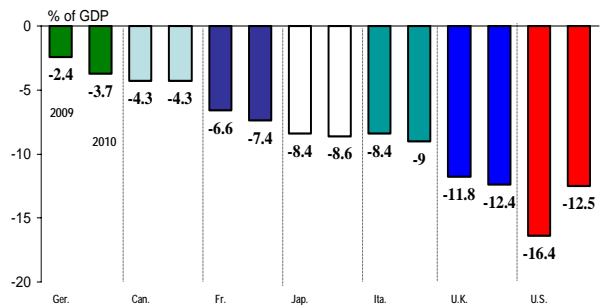


NBF Economy and Strategy, U.S. Treasury, BEA

It need be pointed out that, despite the improvement in the U.S. current account relative to GDP, the federal budget deficit has deteriorated at breakneck speed and the U.S. economy's twin deficit (sum of current account and budget deficits) will be the worst amid the G7 members in 2009 and 2010 according to the IMF.

3) G7 twin deficits projected by IMF

Sum of budget and current account deficits relative to GDP as projected by IMF for 2009 and 2010



NBF Economy and Strategy, International Monetary Fund

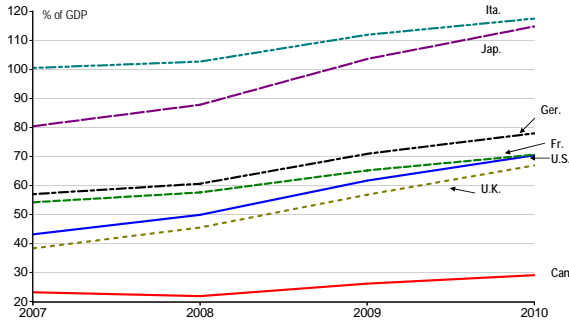
All this, combined with the drop in the ratio of net foreign purchases of U.S. assets, is prompting market players to question the greenback's fundamentals.

In this connection, the Federal Reserve Chairman warned last week that the government could not go on borrowing indefinitely and that "unless we demonstrate a strong commitment to fiscal sustainability in the longer run, we will have neither

financial stability nor healthy economic growth". By so doing, the Chairman wished to underscore that the markets could propel real rates to even higher levels if a credible game plan was not implemented. Needless to say, the one thing the fragile U.S. economy does not need at this point is a sustained rise in mortgage rates.

4) U.S. debt third lowest among G7

Net debt of advanced economies



NBF Economy and Strategy, IMF

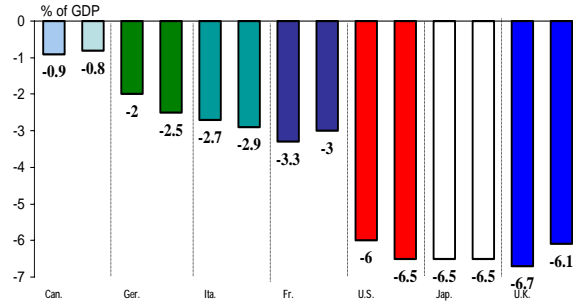
That said, the mounting concern over the U.S. credit rating seems, to our eyes, somewhat overblown. There is no denying that the twin deficit is in a sorry state south of the border. However, even after this trying period for activity, the fact remains that the U.S. debt at the end of 2010 should still, according to the IMF, rank third lowest among the G7. Europe and Japan will certainly not be in better shape than the United States in terms of debt-to-GDP ratio. Why then all the fuss about the situation south of the border if the debt is denominated in a single currency?

Structural deterioration...

Probably, the markets are worried about the structural or secular U.S. budget deficit and not so much about the cyclical input from the recession. However, here too the United States does not stand alone. Japan and the United Kingdom are exactly in the same boat with a structural budget deficit of about 6% to 7% of GDP. Consequently, strictly on the basis of structural deficit and debt load, we fail to see why the situation in the United States should be any more alarming than that in certain other countries.

5) Three G7 economies in same boat

Structural budget balance according to IMF



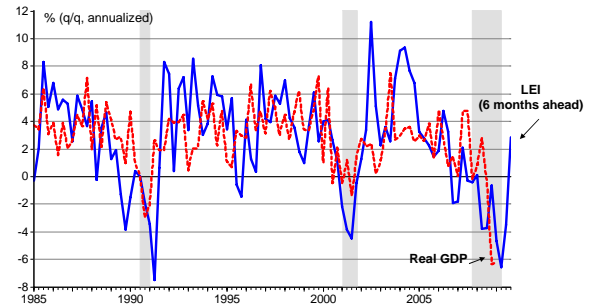
NBF Economy and Strategy, IMF

...but recovery in sight

We believe that, despite the appearance of a structural force to potentially drag the U.S. dollar downward, improved cyclical factors will pull in the opposite direction and probably have a net positive effect on the greenback. In sum, our scenario is predicated on structural and cyclical forces going head to head, but with the latter having the better of the former.

6) U.S. economy: better days ahead?

Real GDP and leading economic indicator

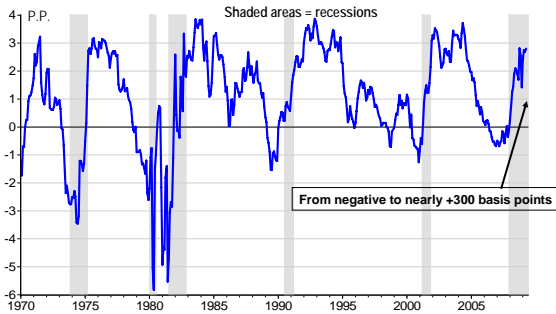


NBF Economy and Strategy, BEA, Conference Board

Inflation expectations derived from the bond markets jumped from 150 basis points at the end of April to almost 200 recently, after being practically nil early in the year. Consequently, the increase in long rates cannot be explained solely by the government's deteriorating budget position but also by recovery expectations. In this connection, the leading economic indicator is heralding better days ahead.

7) Bond yield curve signals recovery

Yield curve, 10-year rate minus Fed funds rate



NBF Economy and Strategy, Global Insight

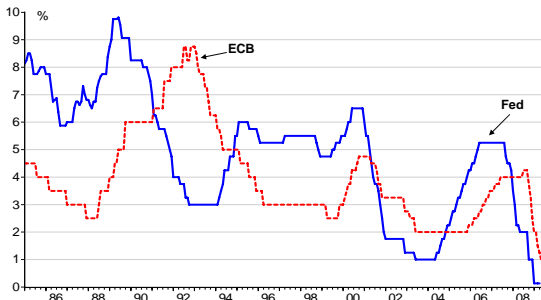
Same tune where the slope of the yield curve is concerned. Though this indicator has on occasion sent wrong signals in periods of economic expansion, it has never done so when it came to predicting a recovery period following a recession.

Odd expectations

It is our conviction that positive cyclical factors are about to come to the support of the U.S. dollar.

8) Despite being out of synchrony...

Federal Reserve and European Central Bank key rates

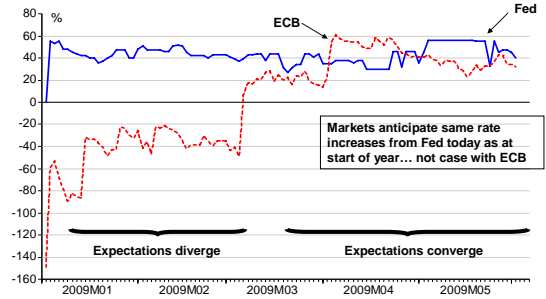


NBF Economy and Strategy, Federal Reserve, ECB

ECB staff has just revised down considerably their growth prospects for the euro zone. In 2009, the zone should contract -4.1% to -5.1% and probably register negative growth in 2010 as well (forecast range of -1% to 0.4% next year).

9) ...financial markets anticipate same scenario

Increase in key rate expected over 12 months



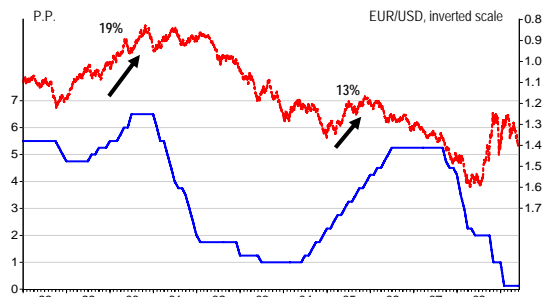
NBF Economy and Strategy, Bloomberg, Crédit Suisse

The ECB President expects growth in the euro zone to resume only in the second half of 2010. The Fed, instead, is talking about seeing U.S. activity back in positive territory in the second half of 2009. Our growth scenario goes in the same direction.

Growth in European money aggregates continues to decelerate and bank bond purchases by the ECB will run through to July 2010. Once again, European monetary policy will lag behind Fed action. Despite this lack of synchronization between monetary policies--something that has been around now for more than 20 years now--the financial markets persist in expecting the same monetary tightening over the next 12 months from the Fed as from the ECB. We believe that these expectations will again diverge in future.

10) Does monetary policy still carry weight?

Federal funds rate and EUR/USD exchange rate



NBF Economy and Strategy, Global Insight, Federal Reserve

Productivity is making good progress in the United States, hardly registering cyclical decline as U.S. companies continue to exercise very tight cost control. A sooner recovery in the United States means that the Fed will have the jump on the ECB. Past episodes of monetary tightening clearly

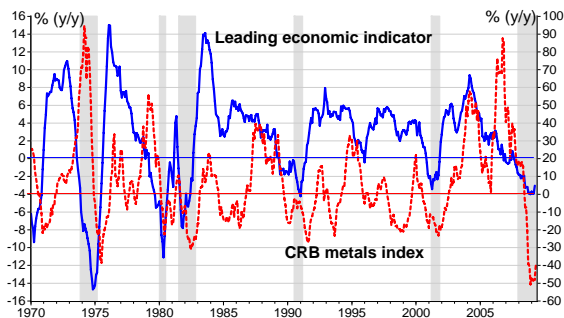
demonstrate that when monetary policies are out of synch, the greenback tends to gain at least 10% on the euro over a period of one year. The positive cyclical forces of the greenback should, therefore, dominate the negative structural forces over the next 12 months.

First time in history

Predicting what the cyclical currencies (Australian, New Zealand and Canadian dollars) will do is a particularly difficult task these days. Commodity prices have always lagged behind the global economic cycle since record-keeping began. Today, the situation is completely inverted, with world commodity prices behaving like the U.S. leading economic indicator for the first time in history.

11) A first in modern history...

Trend growth in leading economic indicator and CRB metals index



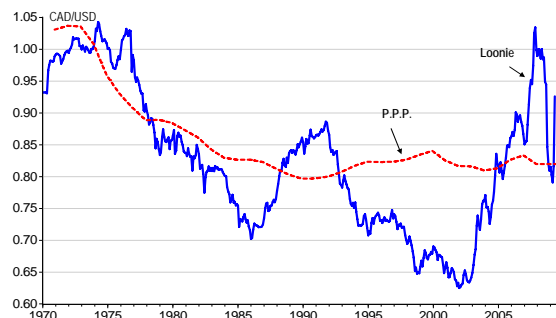
NBF Economy and Strategy, Global Insight, Conference Board, CRB

It should come as no surprise, then, that the Canadian dollar, a currency hitched to commodity prices, rebounded more sharply than most forecasters were predicting no more than six months ago. After bottoming out at less than US\$0.77 this past March 9, which coincided with the low point in the stock market, the loonie has just struck a high of more than US\$0.92, a leap of more than 20% in less than three months. Such a gain in so little time was unprecedented for the loonie, as illustrated in Chart 12.

In its latest Monetary Policy Report, the Bank of Canada assumed the loonie would be trading on average at US\$0.80. In its latest press release last week, the Bank indicated that the Canadian dollar was reacting to a surge in commodity prices and a turnaround in the greenback.

12) Loonie dives... then takes off again

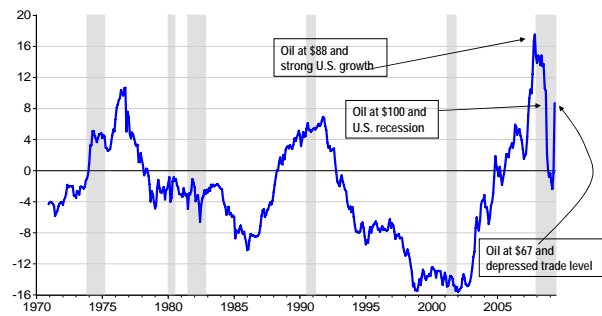
Loonie and purchasing power parity (loonie's equilibrium value) as calculated by OECD



NBF Economy and Strategy, Global Insight, OCDE

13) Is Canadian dollar over-valued?

Difference in value of loonie as % of PPP



NBF Economy and Strategy, Global Insight, OCDE

At present, the loonie exceeds its long-term equilibrium value by nearly 10%. However, unlike in October when the loonie traded for as much, the price of oil today is less than \$70 a barrel and Canadian export levels are depressed.

It is not surprising, then, that while the Bank of Canada noted an improvement in financial conditions in the past few months, it also pointed out that were the high-flying loonie to persist, it could offset any further progress in this regard. The question begging to be asked is the following: Could the loonie's appreciation be enough of a factor to spur the central bank into adopting quantitative easing?

In our opinion, the Bank of Canada could have limited the loonie's ascent by setting the bar for quantitative easing lower. In its latest Monetary Policy Report, the Bank placed it so high that the door was thrown open for the loonie to take off.

Manufacturing margins in Canada will be hurt

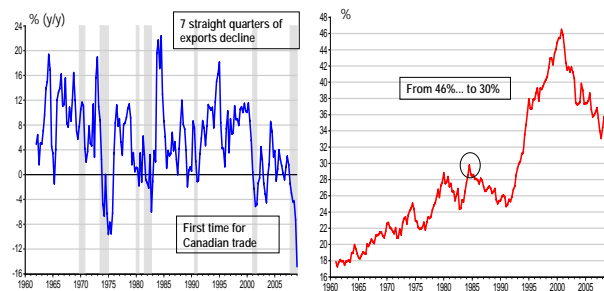
Exporters have faced seven straight quarters of sliding export volumes, with the decline reaching 30% at an annualized rate in Q1 2009. The shock is such that the export-to-GDP ratio has plunged to 30% in Canada, the same level it was at in 1985, thus wiping out all the positive effects of NAFTA.

14) Appreciation... not appreciated

Growth in Canadian exports in real terms and ratio of exports to GDP

Real growth in Canadian exports

Ratio of exports to GDP



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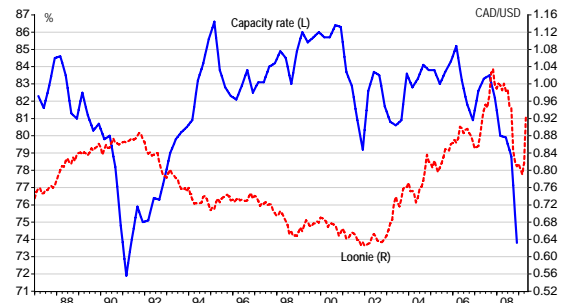
At this stage, though the situation is becoming strained for Canadian exporters, the BoC cannot modify its position on quantitative easing. Quantitative easing is not the answer to a partial portfolio shock to the loonie at a time when credit markets are operating relatively well in Canada.

The monetary authority has its hands tied in the short run as it must wait to see whether the shock caused by the loonie's appreciation will have a big enough impact on the real economy before resorting to quantitative monetary policy. The chances are slim, then, that such policy will see the day in Canada.

Given that the loonie's surge has occurred at a time when demand for Canadian exports south of the border is depressed and production capacity rates are very low, the buoyant loonie will squeeze the profit margins of manufacturers in the central provinces, the ones that draw no benefit from the hike in commodity prices.

15) Bad combination

Production capacity rate of Canadian manufacturing sector and loonie



NBF Economy and Strategy, Global Insight

Seeing how cutting interest rates is no longer an option to counter a probably all too sudden appreciation in the currency, the Canadian dollar can be expected to depreciate only if the greenback accrues dramatically in the coming months. If our forecast for the euro proves right, the loonie should get caught in the wake and come down a few cents from its current level.

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Annex



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