Inside…

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FINANCIAL MARKETS MONTHLY

December 5, 2008

Financial market crisis shows limited signs of abating

The financial market crisis showed limited signs of abating in November, with Canada's stock market dropping about 5% and the U.S. benchmark S&P off 7.5%. Commodity prices swooned and credit spreads remained wide. Investors continued to run for cover, buying safer government bonds — the U.S. Treasury market posted a huge 5.4% total return and Government of Canada bonds rallied. Yields on government securities fell to the lowest level on record. LIBOR rates continued to move cautiously lower but are still elevated compared to official policy rates as the sting from the Lehman Brothers' bankruptcy keeps financial institutions worried that one of their counterparties could suffer a similar fate. It is the relatively high level of interbank funding rates that is preventing borrowing rates from falling. For the economy, the spinoff continues to be that businesses and households face both a high cost for capital and limited access to funds, which is hampering spending activity and resulting in recessions in both Canada and the United States.

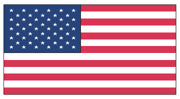
U.S. recession deepens

Recent economic reports highlight that the U.S. economy is falling more deeply into recession. Real GDP is expected to contract at much faster pace in the fourth quarter and the likelihood is growing that these recessionary conditions will persist through the first half of 2009. A sharply eroding labour market, persistent financial market volatility, with stocks slumping and credit spreads reaching higher, and tightening lending standards set up for both consumers and businesses to continue to retrench in the quarters ahead. We now project the U.S. recession to run from the third quarter of 2008 to the middle of 2009, resulting in real GDP falling by 1% on average next year following this year's tepid 1.3% growth rate.

Central bank near-term bias

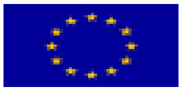
Bias three-months out

Mounting downside risks to the economy and softening inflation pressures set up for the Bank of Canada to cut the overnight rate by 50 basis points later this month.



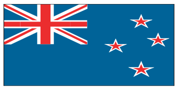
The Fed is likely to lean against the impact of the intensifying financial market crisis and deepening recession by lowering the Funds rate to just 0.5% — the lowest since the late 1950s.

The Bank of England cut the policy rate aggressively in the past month by a hefty 2-1/2 percentage points. We expect the policy rate to fall to 1% by mid-2009 as economic conditions warrant extremely accommodative policy.



Clear evidence of the slowing inflation on the back of falling commodity prices and an economy in recession saw the ECB pick up the pace of rate cuts in early December, with more likely early next year.

With the economy grinding to a halt in Q3 and Q4 data showing weakness, the RBA is likely to maintain their proactive approach, with the cash rate likely to fall to a new low in the months ahead.



Rising unemployment, faltering consumer confidence, weak equity markets, and still elevated mortgage rates set up for another negative quarter of growth and supports the case for further cuts from the RBNZ.

Highlights

▲ The financial market crisis has not abated, with investors selling all assets classes except government bonds.

▲ Economic activity is being constrained by credit crunch.

▲ The U.S. recession is deepening and Canada looks like another casualty of the financial market maelstrom.

▲ Inflation is falling on the back commodity price declines and growing economic slack...

▲ ...which is removing the impediment for central banks to cut policy rates to historical lows.

Inflation pressures ease igniting deflation concerns

As the economic news worsened and commodity prices slid, worries about a steady rise in the headline inflation rate quickly switched to concerns about a generalized decline in prices. We expect the U.S. headline inflation rate to continue to fall in 2009 partly due to the rapid drop in energy prices, but also reflecting a steady slide in core prices. Our revised forecast calls for the U.S. headline inflation rate to average 1.2% next year, a significant decline from 2008's estimated 4.1% average pace. Core inflation, which excludes movements in energy and food prices, is forecast to slow to 1.7% on average in 2009 from this year's 2.3% as growing slack in the economy dampens pricing power. Around mid-year, the U.S. headline inflation rate is likely to briefly fall into negative territory, but this is largely a base effect because the surge in energy prices that boosted the headline index by an average 0.8% in the months of May through July 2008 will not be repeated. Our baseline assessment assumes that oil prices will rebound modestly in 2009 from current levels but remain lower than 2008's average price.

Fed to keep policy accommodative throughout 2009

The prospect that the economy will remain in a recession in the first half of next year is likely to see the Federal Reserve keep priming the pump through an additional interest rate reduction. We anticipate that the Fed will cut the policy rate by another 50 basis points to 0.50% in December and to hold the policy rate at this level throughout next year. The case for the Fed to stand aside and hold the rate at the current 1% eroded in recent weeks as the pressures on the economy and financial markets intensified. There is some encouragement to be taken from the persistent decline in LIBOR rates. However, spreads remain elevated compared to the forecasted funds target and Treasury bill yields, meaning that financial institutions continue to have concerns about their counterparties. These elevated funding rates are preventing financial institutions from narrowing borrowing costs, which has blunted the effect of rate cuts by the Federal Reserve for users of credit. Additionally, with financial institutions still rebuilding their balance sheets, the amount of credit available is constrained, limiting access to funds for households and businesses.

Market priced for a lot of bad news

Interest rate markets have already priced in another 50 basis points of easing, a sustained recession and lower inflation rates. The flight to quality is likely to continue and will keep government bond yields low in 2009 although, as the worst for the economy passes and the risk of deflation fades, supply concerns will likely lead rates up in the latter part of next year. We look for the 10-year U.S. Treasury yield to remain below 3% and then gradually increase back up to 3.4% by year-end 2009. Two-year rates are forecast to linger around 1% and rise to 1.65% by year-end as the economy recovers and markets anticipate that the next move by the Fed will be a rate increase in 2010. We have modestly revised our year-end 2008 forecasts compared to our recent update.

Canada on course for recession

Canada, while somewhat insulated by a solid financial system, now faces a number of negative factors. With commodity prices slumping, the positive growth momentum in Canada's domestic economy will be challenged by an erosion in the terms of trade that will dampen income growth next year. Also, even though Canada's credit markets have not suffered to the same degree as many of its major trading partners, the recent widening in spreads and tightening in lending standards argue for slower household spending and a cut in business investment. As a result, we now expect Canada's economy to contract in both the fourth quarter of 2008 and first quarter of 2009. On average, Canada's economy is still expected to eke out mild growth next year of 0.3%, half the pace of this year's estimated 0.6% increase and much slower than the 2.7% pace of 2007.

Increasing slack and lower commodity prices spell lower inflation

Inflation pressures started to moderate in October, with the index posting its largest monthly decline since June 1959 and the annual inflation rate falling to 2.6% — back within the Bank of Canada's target band. We expect price pressures to continue to ease; the headline inflation rate is forecast to average 1.2% in 2009, one-half the estimated 2008 rate. The Bank of Canada's core inflation rate, which did not climb alongside the headline measure in 2008, is expected to hold steady at 1.6%. We look for the labour market to come under downward pressure as investment projects are scaled back and consumer demand weakens. Commodity prices are off sharply from recent highs, but do remain, according to the Bank of Canada's commodity indices, around the average level of the past five years, suggesting more moderate, but still positive, support to income growth in 2009.

Bank of Canada to cut policy rate further

Against the backdrop of ebbing price pressures at the headline level and an economy that is heading into recession, we expect the Bank of Canada to make another cut to the overnight rate when they meet later this month. Our assessment is that Canada's economy will likely disappoint the Bank's current subdued base-case forecast that the economy will grow by 0.6% next year. Additionally we see growing risks that the inflation rate will fall, at least temporarily, below zero in the middle of next year. These risks make it likely that the Bank will prefer to make a 50 basis-point cut to the policy rate later this year and hold steady at 1.75% for most of 2009. There is a risk that the Bank may lower rates further; however the combination of the stimulative effect from the weakening in the Canadian dollar and a potential fiscal stimulus package early next year argues against more substantive easing at this time.

2009 — The year of low interest rates!

Interest rate forecasts have been adjusted lower across the yield curve, with the 10-year Canada bond yield forecast to remain low in early 2009 and then gradually increase to 3.75% by year-end as the economy gets back on firmer footing and risks to the downside for inflation abate. Short-term government yields are forecast stay below 2%, with the two-year rate gradually rising to 2.4% by the end of next year.

ECB picks up the pace

The ECB cut the policy rate by a record-setting 75 basis points in early December for a total of 175 basis points in less than two months. Waning inflation concerns and growing downside risks to economic growth instigated the strong policy response by the ECB. The recession in the Eurozone economies appears to be intensifying with both the services and manufacturing PMI's posting new record lows in November, thus underscoring the likelihood of a firmly negative growth print in the fourth quarter. Recent inflation data showed a marked deceleration in the harmonized inflation rate, which fell to 2.1% from 3.2% in October, according to the early flash estimate.

Bank of England cuts policy rate to record low — More easing likely

The Bank of England lowered the policy rate aggressively in the past month, pointing to substantial risk of undershooting the inflation target in the medium-term given the weak state of the economy and sharp declines in commodity prices. With credit conditions remaining tight and the central bank concerned about lending activity, we expect the it will use a "two-pronged" approach to shore up the economy by using specific liquidity measures alongside further policy easing. Even with the current policy rate at a record low, we look for U.K. rates to fall further and are forecasting a bottom of 1.00% by end of the first quarter of 2009.

Highlights

▲ The U.S. economy is in a deep recession and is unlikely to turn around until mid-2009 at the earliest.

▲ Interbank borrowing rates have eased up but remain well above official policy rates, meaning that financial institutions are still leery about counterparty risk…

▲ …and this is keeping credit spreads wide for households and businesses.

▲ Canada's economy is suffering from weak consumer and business confidence, falling export demand and rising credit costs.

▲ The chances of avoiding recession are being whittled away, with Canada's economy likely to contract in late 2008 and early 2009.

Interest rate outlook

%, end of period

	Actual			Forecast				
	08Q1	08Q2	08Q3	08Q4	09Q1	09Q2	09Q3	09Q4
Canada								
Overnight	3.50	3.00	3.00	1.75	1.75	1.75	1.75	2.00
Three-month	1.88	2.50	1.90	1.75	1.75	1.90	2.15	2.50
Two-year	2.55	3.22	2.65	1.65	1.75	2.00	2.10	2.40
Five-year	2.89	3.43	3.05	2.25	2.45	2.55	2.65	2.8
10-year	3.42	3.71	3.66	3.15	3.25	3.40	3.50	3.75
30-year	3.94	4.06	4.15	3.75	3.75	3.90	4.00	4.25
United States								
Fed funds	2.25	2.00	2.00	0.50	0.50	0.50	0.50	0.50
Three-month	1.30	1.68	0.72	0.25	0.50	0.50	0.75	1.00
Two-year	1.62	2.64	1.87	1.00	1.05	1.10	1.35	1.65
Five-year	2.46	3.33	2.85	1.70	1.90	2.05	2.25	2.5
10-year	3.42	3.96	3.71	2.75	2.95	2.90	3.05	3.4
30-year	4.30	4.51	4.22	3.20	3.40	3.40	3.55	3.90
United Kingdom								
Repo	5.25	5.00	5.00	2.00	1.00	1.00	1.00	1.00
Two-year	3.90	5.25	4.50	2.60	2.30	1.90	1.80	2.20
10-year	4.35	5.15	4.50	3.15	2.95	2.80	2.70	3.4
Eurozone								
Minimum bid	4.00	4.00	4.25	2.50	2.25	2.00	2.00	2.00
Two-year	3.46	4.55	4.10	1.90	1.70	1.60	2.00	2.30
10-year	3.90	4.60	4.20	2.90	2.80	2.80	3.10	3.30
Australia								
Cash target rate	7.25	7.25	7.00	4.25	3.50	3.50	3.50	3.50
Two-year	6.20	6.81	5.10	3.25	3.50	3.50	4.00	4.50
10-year	6.00	6.46	5.70	4.40	4.20	4.40	4.80	5.40
New Zealand								
Cash target rate	8.25	8.25	7.50	5.00	4.00	3.50	3.50	3.50
Three-year	6.75	6.35	5.90	4.30	4.00	3.50	3.60	4.00
10-year	6.45	6.34	5.51	4.80	4.70	4.65	4.90	5.40
Yield curve								
Canada	87	49	101	150	150	140	140	135
United States	180	132	184	175	190	180	170	175
United Kingdom	45	-10	0	55	65	90	90	120
Eurozone	44	5	10	100	110	120	110	100
Australia	-20	-36	60	115	70	90	80	90
New Zealand	-30	-1	-39	50	70	115	130	140

*New Zealand's yield curve: 10-year vs. three-year

Source: Reuters, RBC Economics Research

Central bank policy rates

%, end of period

		Current	Last	
United States	Fed funds	1.00	1.50	Oct. 29, 2008
Canada	Overnight rate	2.25	2.50	Oct. 21, 2008
United Kingdom	Repo rate	2.00	3.00	Dec. 4, 2008

		Current	Last	
Eurozone	Min. bid rate	2.50	3.25	Dec. 4, 2008
Australia	Cash rate	4.25	5.25	Dec. 3, 2008
New Zealand	Cash rate	5.00	6.50	Dec. 4, 2008

Source: Bloomberg, Reuters, RBC Economics Research

Economic outlook

Growth outlook
% change, year-over-year in real GDP

	Actual		Forecast						Annual		
	08Q1	08Q2	08Q3	08Q4	09Q1	09Q2	09Q3	09Q4	2007A	2008F	2009F
Canada	1.6	0.8	0.5	-0.3	-0.2	-0.1	0.1	1.3	2.7	0.6	0.3
United States	2.5	2.1	0.7	-0.1	-0.8	-1.8	-1.4	-0.2	2.0	1.3	-1.0
United Kingdom	2.3	1.5	0.3	-0.9	-1.7	-1.8	-1.4	-0.6	3.0	0.8	-1.4
Eurozone	2.1	1.3	0.7	-0.9	-0.8	-0.6	-0.4	0.3	2.6	0.8	-0.4
Australia	3.3	2.7	1.8	1.4	1.0	1.2	1.8	2.0	4.3	2.3	1.5
New Zealand	2.2	1.0	-0.1	-0.8	-0.2	0.4	1.4	1.8	3.1	0.6	0.6

Inflation outlook
% change, year-over-year

	Actual			Forecast					Annual		
	08Q1	08Q2	08Q3	08Q4	09Q1	09Q2	09Q3	09Q4	2007A	2008F	2009F
Canada	1.8	2.4	3.4	2.0	2.2	1.2	-0.1	1.6	2.1	2.4	1.2
United States	4.1	4.4	5.4	2.5	2.1	0.6	-0.3	2.3	2.9	4.1	1.2
United Kingdom	3.5	3.8	4.8	3.8	2.3	1.0	0.1	0.6	2.3	4.0	1.3
Eurozone	3.5	4.0	3.6	2.4	1.9	1.5	1.4	1.9	2.3	3.4	1.7
Australia	4.2	4.5	5.0	4.3	3.6	2.7	2.1	2.4	2.4	4.5	2.7
New Zealand	3.4	4.0	4.8	4.2	4.1	2.9	2.2	2.0	2.4	4.0	2.6

Source: Statistics Canada, Bureau of Labor Statistics, Bank of England, European Central Bank, Reserve Bank of Australia, Reserve Bank of New Zealand, RBC Economics Research

Inflation tracking

	Measure	Current period	Month ago	Year ago	Three-month trend	Six-month trend
Canada	Bank of Canada core CPI[1]	Oct	0.0	1.7	2.2	2.3
United States	Core PCE[2]	Oct	0.0	2.1	2.2	2.3
United Kingdom	All-items CPI	Oct	-0.3	4.5	4.6	5.9
Eurozone	All-items CPI	Oct	0.0	3.2	0.1	3.8
Australia	Trimmed mean	2008Q3	1.2	4.6	NA	NA
New Zealand	CPI	2008Q3	1.5	5.1	NA	NA

[1] Seasonally adjusted measurement
[2] Personal consumption expenditures less food and energy price indices

Source: Statistics Canada, Bureau of Labor Statistics, Bank of England, European Central Bank, Reserve Bank of Australia, Reserve Bank of New Zealand, RBC Economics Research

Currency outlook

Level, end of period

	Actual			Forecast				
	08Q1	08Q2	08Q3	08Q4	09Q1	09Q2	09Q3	09Q4
Canadian dollar	1.03	1.02	1.06	1.27	1.29	1.31	1.27	1.25
Euro	1.58	1.58	1.41	1.23	1.20	1.18	1.15	1.15
U.K. pound sterling	1.98	1.99	1.78	1.58	1.56	1.55	1.53	1.53
New Zealand dollar	0.79	0.76	0.67	0.56	0.55	0.53	0.53	0.54
Japanese yen	99.7	106.2	106.1	96.0	97.0	98.0	98.0	98.0
Chinese renminbi	7.01	6.85	6.85	6.80	6.70	6.65	6.60	6.55
Australian dollar	0.91	0.96	0.79	0.63	0.62	0.60	0.61	0.62
Mexican peso	10.64	10.31	10.94	12.25	12.40	12.55	12.80	13.00

Canadian dollar cross-rates

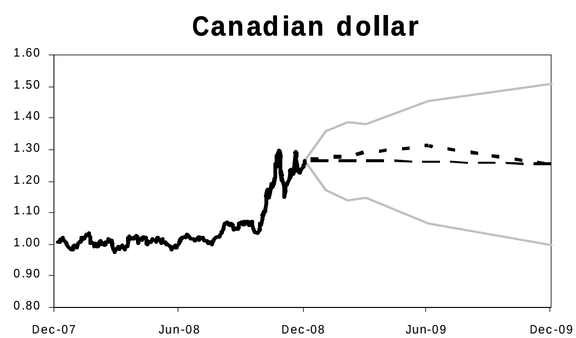
	08Q1	08Q2	08Q3	08Q4	09Q1	09Q2	09Q3	09Q4
EUR/CAD	1.62	1.61	1.50	1.56	1.55	1.55	1.46	1.44
GBP/CAD	2.03	2.04	1.90	2.00	2.01	2.03	1.95	1.92
NZD/CAD	0.81	0.78	0.71	0.71	0.71	0.69	0.67	0.68
CAD/JPY	97.2	104.0	99.7	75.6	75.2	74.8	77.2	78.4
AUD/CAD	0.94	0.98	0.84	0.80	0.80	0.79	0.77	0.78

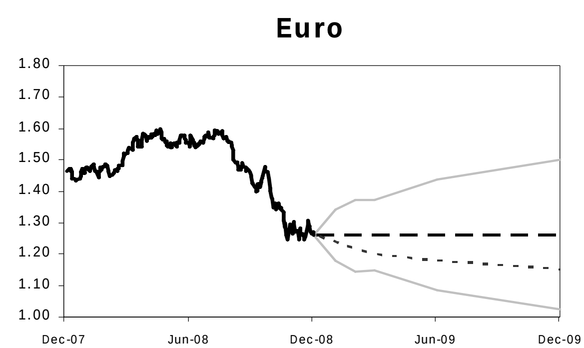
Rates are expressed in currency units per US$ and currency units per C$, except the euro, U.K. pound , Australian dollar and New Zealand dollar, which are expressed in US$ per currency unit and C$ per currency unit.

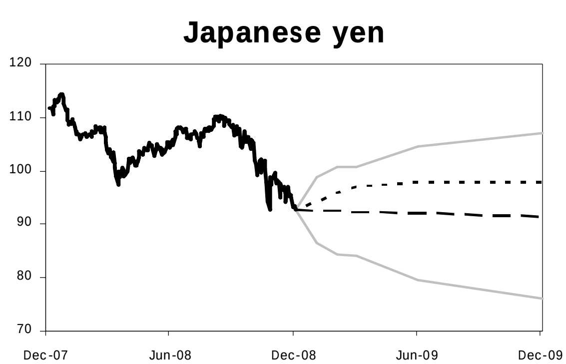
Source: Bloomberg, RBC Economics Research

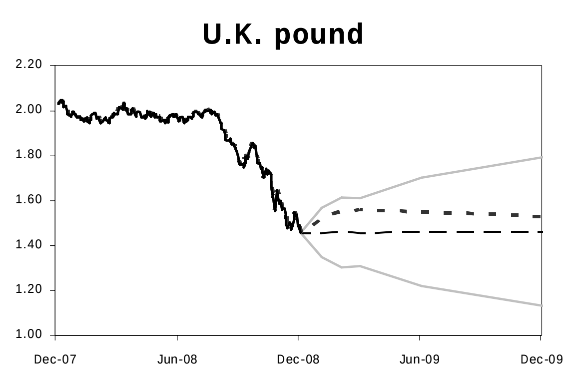
RBC Economics outlook compared to the market

The following charts track historical exchange rates plus the forward rate (dashed line) compared to the RBC Economics forecast (dotted line) out one year. The cone for the forecast period frames the forward rate with confidence bounds using implied option volatilities as of the date of publication.







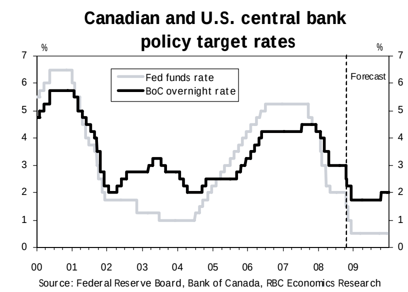


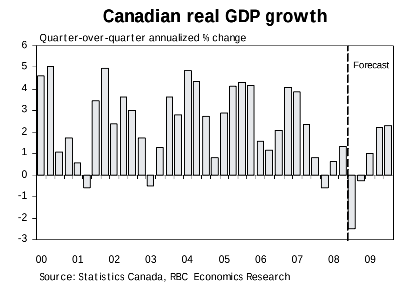
Source: Reuters, RBC Economics Research

Bank of Canada

• The Bank of Canada sees the need for more monetary policy stimulus and has hinted that a rate cut later this month is a f*ait accompli.*

• Our base case is that the Bank will hold the policy rate at 1.75% but, with the downside risks to growth becoming more firmly entrenched, additional easing can't be ruled out.

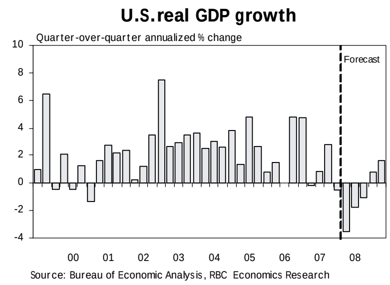


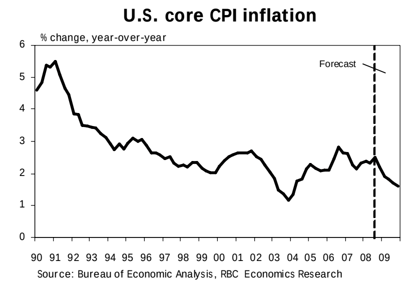


Federal Reserve

• The Fed is likely to cut the policy rate again this month due to deteriorating economic fundamentals and intense financial market pressures.

• There are tentative signs that the interbank market is thawing but the LIBOR rate needs to gravitate toward the policy rate if the effects of easier monetary policy are to be realized.

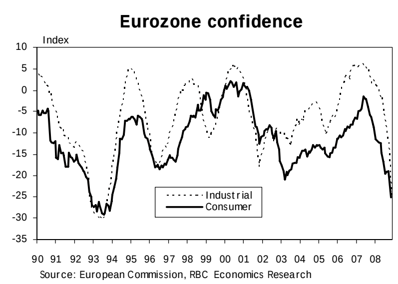


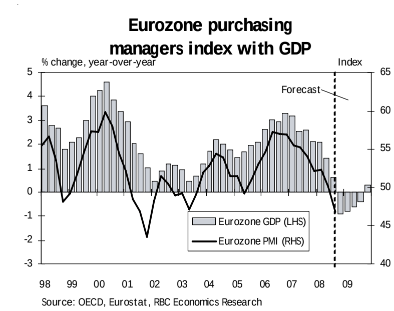


European Central Bank

• The ECB stepped up the pace of rate cuts and took 75 basis points off the policy rate as the aggressive. Broad-based slowing in economic activity and the falling inflation rate elicited this strong response.

• Even with the policy rate at its lowest in about 2-1/2 years, there is still scope for more easing in early 2009 .

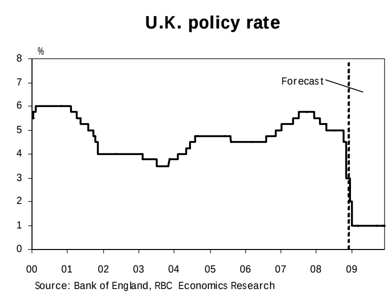


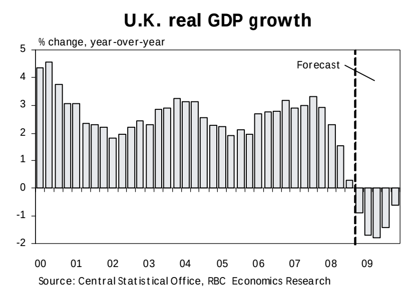


Bank of England

• The central bank aggressively cut the policy rate by 2.5% in the past month given the marked deterioration in the growth outlook, serious disruption in the global banking system, limited credit and quieting inflation pressures.

• The dismal state of the economy will likely see the Bank of Englandcontinue along its easing path and cut the policy rate to 1%.

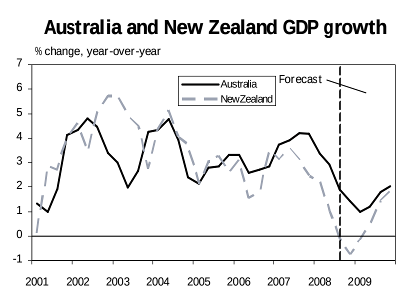


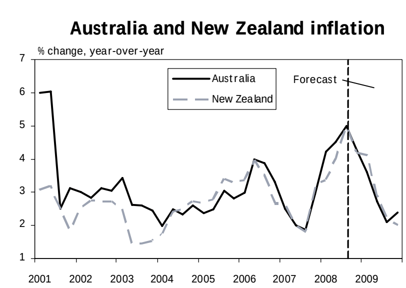


Australia and New Zealand Reserve Banks

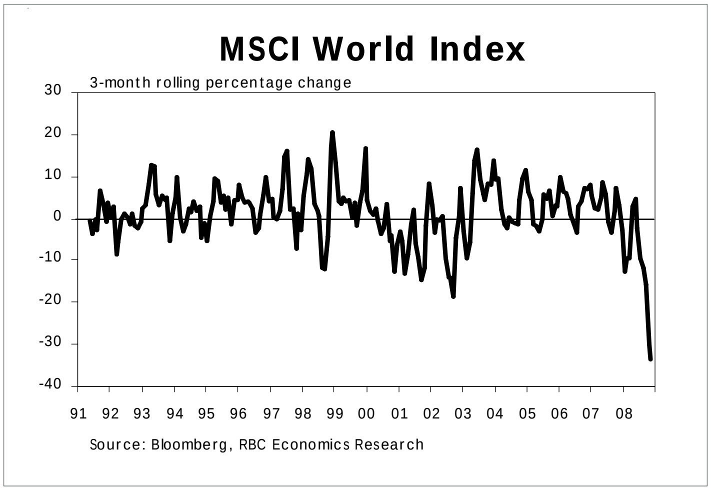
• Recent data point to a weak fourth quarter, with the economy skirting dangerously close to recession, justifying the RBA's aggressive action in recent months with more easing likely

• The RBNZ cut the policy rate by a mighty 150 basis points to combat the deteriorating global outlook. Even with the policy rate at this more stimulative level, additional easing is likely, given the persistent downside risks to growth.

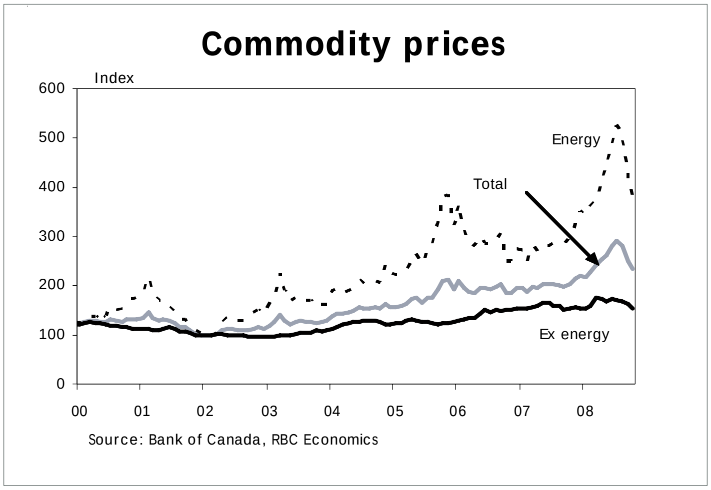




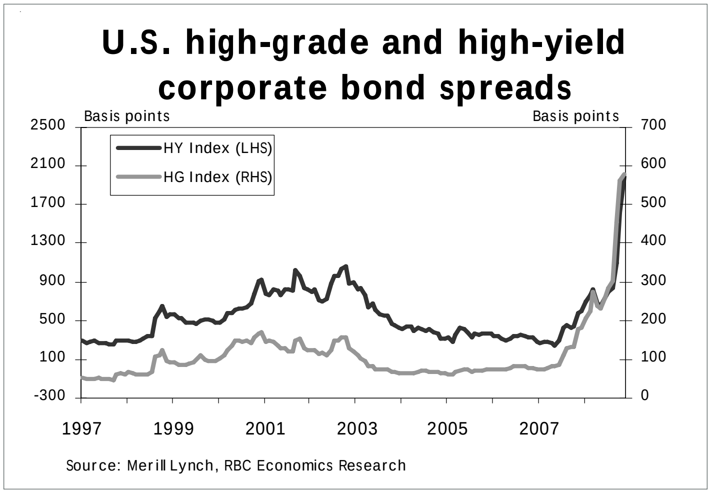
During the past three months, the world stock index lost 34%, a sharper decline than the 16% dip in the first eight months of the year



All asset classes are being hit, with the prospect of a global recession taking a toll on commodities



Credit spreads are not easing up yet.



The IMF forecasts a global recession with real GDP expected to increase by just 2.2% next year and the advanced economies expected to contract on average by one quarter of one percent.