CAPITAL MARKETS RESEARCH

Derek Holt (416) 863-7707
derek_holt@scotiacapital.com

Karen Cordes Woods (416) 862-3080
karen_woods@scotiacapital.com

Daily Points

— Tracking the Numbers

On Deck for Tuesday, August 9

Country	Date	Time	Event	Period	BNS	Consensus	Latest
CA	08/09	08:15	Housing Starts (000s)	JUL	202.0	194.5	200.8
US	08/09	08:30	Unit Labor Costs (QoQ SAAR)	2Q P	- -	2.4	0.7
US	08/09	08:30	Nonfarm Productivity (QoQ SAAR)	2Q P	- -	-0.9	1.8
US	08/09	14:15	**FOMC Rate Decision**	9-Aug	**0.25**	0.3	0.3

KEY POINTS:

- The FOMC's options
- Today's Treasury auction will test post-downgrade appetite
- Chinese inflation ticks higher than expected
- German trade surplus narrows on soft exports
- UK factories and trade disappointed
- CDN housing starts a yawner
- Bank Indonesia extends pause

UNITED STATES

US equity futures are rising on a bet that the Fed will rescue the world today. I'm skeptical it has such powers at this juncture, but the market has set itself up for a one way disappointment if the Fed doesn't deliver.

Today's four week bills (11:30amET) and 3 year note (1:00pmET) auctions will be the second test of investor appetite for newly issued Treasuries this week. Yesterday's test failed. The auctions of three and six month bills were mostly taken down by those who have to when nobody else will – primary dealers. They bought over three quarters of both auctions. Indirect bidders are the ones to watch today. Yesterday they dove for cover, purchasing only 7% of three month and 18.5% of six month bills.

The Fed will be watching the auction results closely in advance of today's decision at 2:15pmET. There is no press conference following this decision (the next full-on press conference will come at the November meeting), so look solely to the statement for guidance unless a major policy effort is announced in which the usual post-statement details on execution could be posted afterward. The Fed does indeed have options, but none of them are likely to be successful. Here they are as we see it:

- It could strengthen the "exceptionally low" and for an "extended period" guidance, but with investors already quite happy demanding only 0.44% to lend to the just downgraded US government for three years, the effects of such guidance would be immaterial.

- The Fed could hint at keeping its balance sheet at elevated levels for an extended period along with the rate guidance, but that too is largely baked

BoC Events

BoC Overnight Lending Rate
Current Rate: 1.0%
Next Move: Sept. 7 @ 1.0%
Bias: Neutral

Fed Events

Fed Funds Target Rate
Current Rate: 0-0.25%
Next Move: August 9 @ 0-0.25%
Bias: Dovish

Key International Events

BoJ
Current Rate: 0.10%
Next Move: September 7 @ 0.10%
Bias: Dovish

BoE
Current Rate: 0.50%
Next Move: September 8 @ 0.50%
Bias: Dovish

ECB
Current Rate: 1.50%
Next Move: September 8 @ 1.50%
Bias: hawkish

... 2

Scotia Economics
Scotia Plaza 40 King Street West, 63rd Floor
Toronto, Ontario Canada M5H 1H1
Tel: (416) 866-6253 Fax: (416) 866-2829
Email: scotia_economics@scotiacapital.com

This Report is prepared by Scotia Economics as a resource for the clients of Scotiabank and Scotia Capital. While the information is from sources believed reliable, neither the information nor the forecast shall be taken as a representation for which The Bank of Nova Scotia or Scotia Capital Inc. or any of their employees incur any responsibility.

into markets.

- Maybe the Fed will extend the average maturity structure of its balance sheet either by rolling off short securities into longer lived ones, or through deliberate asset reallocations. That too wouldn't carry much effect when, say, US 10s are trading at about 2.35%.

- Communication tools could be the most powerful weapon in the Fed's arsenal. It has to recognize that growth is being vapourized before its eyes. The US economy went nowhere throughout the first half of the year, the Fed won't hit its 2011 forecast, and recession risk is real and over 50% in my opinion. That clearly won't be acknowledged by the Fed and many others but it could talk through the weakness and reinforce its expectation for a solid rebound in future accompanied by the tag line that it remains prepared to do whatever it takes to engineer such an outcome. This tactic, however, is likely just about buying time. The Fed will likely have to revise its growth projections lower. The FOMC could hint at it today, could perhaps employ the exceptional step of reissuing a fresh forecast, or just hold off and issue a fully detailed fresh forecast as planned for the next FOMC meeting to be accompanied by a full press conference in November. Expect more forecast downgrades from the Fed going forward such that managing the negative signals to the market will be a trying task, but in keeping with the pattern to date of late year forecast capitulations (see "The Fed May Still Be Too High On 2012 Growth Prospects," Global Views, July 22nd, p.12).

- Lastly, there is the elephant in the room: QE3. Yes it's a risk that the Fed pulls out all of the stops and floods the market again as per Rogoff's advice in today's FT and his willingness to make future generations pay for much higher inflation risk. That may fool equities at least for a while (it's not that hard to do so…), but it would just be a futile attempt at denying the inevitable weakness coming across a broad swath of economic indicators. QE2 was an outright failure in my opinion. I'm comfortable debating that it either had no effect compared to all else, or had perverse effects that on net were damaging to the US economy. I'm not comfortable with the panoply of studies produced by Fed economists "proving" the efficacy of QE. It worked in QE1 when that was about leaning the Fed's balance sheet into a private market failure and outright liquidity disruption. But last year wasn't a liquidity problem or an outright market failure; growth downsides were being subjected to price discovery and since when should a central bank interfere with that quest? Either stock markets would have recovered on their own through higher earnings, and inflation would have risen off of weak base effects from last summer. Or, far more damning, QE2 may have lifted equities and inflation expectations but the tendency of Fed economists to leave it at that is a concern. If QE2 indeed had such influences, then one cannot cherry pick the risk trades in proving a point. It likely also boosted commodities, and hence the reason why real wage growth disappeared and the US consumer is going nowhere. It perhaps also raised the thirty year fixed mortgage rate by pushing inflation expectations higher, and thus the US entered the housing double dip of 2011 before the more recent retrenchment in borrowing rates. If QE2 lifted the risk trade, then one also has to counter that its effects on equities were barely felt in corporate bond spreads with key benchmarks only tightening in by a quarter of a percentage point or so. Lastly, of course, if QE2 was such a stellar success, then how come the economy fell flat on its face months later as per our guidance throughout last year and into this that the US economy would indeed stumble below the overly optimistic post-Obama stimulus upward forecast revisions? There is also the question of what the Fed would buy if it engages in QE3. Treasuries at record low yields? Mortgage bonds to compress spreads when they're already modest and not enticing borrowers? Japan has played this game for the better part of two decades to no avail.

Besides, all of this ignores the fact that this is not a rate problem; money demand is price inelastic in the US economy such that no level of rates will attract borrowers. Borrowers lack confidence in policy. They know taxes are going up eventually, so don't spend the extensions in a Ricardian equivalence twist. It is not clear that the Fed can do much in the current environment other than manage the market's move toward a new equilibrium. I don't think that's over yet. One first heard "buy the dip" talk when equities weren't reacting to a bullish backward looking earnings season and early in the correction phase. Now, analysts will have to revise earnings projections lower in accordance with downside risks to the economy. Those downside risks include corporate confidence that is likely to be more than just a one quarter hit. Why stick one's neck before a board with approvals on a big cap project or hiring plans at this point? Corporate titans are more likely to pull in the horns and cut as revenue growth suffers in the face of attempt to please high analyst earning expectations. For example, one-year forward earnings expectations on the S&P's tech subindex are at an all-time high extrapolating off the past. Are they doing it again? Ditto for consumer spending and big ticket durables and housing plans. The inventory cycle is a potential short-term offset in a GDP sense as it will likely build faster than efforts to contain stockpiling as usually happens especially with a lag, but when inventory cutting efforts catch up then sharper production downsides could materialize. Also, if S&P's decision rattles Washington, then stimulus extension odds just went lower yet as the US is set up for a potentially more divisive and confidence rattling debate potentially en route to another downgrade. Advocate more fiscal stimulus or delayed exits? I'm not so sure; I get the classic Keynesian prescription that was all pummeled into our heads in school and then refuted in course

work showcasing a profession in search of a mythical all-encompassing school of thought that doesn't exist. But we have to acknowledge that the Keynesian prescription has utterly failed to date by only leaving behind a bigger burden on present and future generations. Yes, generations. To subscribe to a particular school of thought in economics during times like this is tantamount to adhering to impractical ideology perhaps best left for other facets of life. Lastly, there is the market. We're getting into official bear market territory or already in it, depending upon the index. Brazil was there long ago, with the Bovespa down 28% ytd and rapidly solving Brazil's longstanding complaints regarding capital inflows. The global MSCI index is down 19%, the Russell 2000 is about 25% lower, Wilshire 5000 -19%, blue chip Dow stocks are off 16%, the FTSE100 -18%, TSX -18%. You get the picture. The range for major global indices runs from -11% to -31% and most are closing in on 20% -- official or unofficial bear market territory. That negative wealth effect will sap confidence, lessening down payment options for the upper end of housing markets, and cause firms to manage their capital structures much more cautiously including via toeing the line on dividend policy and other forms of capital redeployment.

CANADA

Canadian housing starts (8:15am ET) will likely be a non-event this morning given the bigger picture worries right now. Nonetheless, consensus is expecting a decline in starts in July from 200.8k in June although the estimates range from 185k-202k, highlighting the increased uncertainty of how the recent tightening in mortgage rules will play out on home construction. We would argue that there is a risk of a slight uptick after building permit volumes rose the previous month as many prospective homebuyers tried to get into the market ahead of the rule changes. While the rules came into effect in mid-March and mid-April, several exceptions were made to agreements signed ahead of the legislation to allow the mortgage pre-approvals pipeline to work through. Nonetheless, as these exceptions diminish, we will likely witnessing a cooling in home construction with a deceleration in housing starts in the late summer or early Fall.

INTERNATIONAL

Chinese inflation came in one-tick higher than expected at 6.5% versus consensus at 6.4%. Whippee. A tiny tick above the guess is a rounding error in this business, but that didn't stop some from claiming that China has no policy flexibility. Hogwash. As commodities retreat, inflation is disappearing before your very eyes and that will connote significantly greater policy flexibility in future. At US$3.2 trillion and counting, China is the only significant economy in which the capacity to stimulate has risen over recent years in some respects. Its government operates within a system fully lacking in transparency, in which the cost of capital does not serve the same rationing role as elsewhere, and hence it can engage in stimulus when opportunity arises and do so expeditiously without the democratic policy encumbrances that lie elsewhere.

After a strong trade report in May in which exports jumped 4.4% m/m while imports rose 3.8% m/m, **Germany's trade surplus** narrowed more than expected in June on the back of a decline in exports (-1.2% m/m) and a modest uptick in imports (0.3%). While we do not have the price-adjusted results yet, assuming that the gains on the real side are equal to the nominal results, this suggests that trade detracted from GDP in June and most likely for the quarter as whole as import growth substantially outpaced gains in exports. This likely weighed on equities even further this morning, fueled by increased worries of even weaker growth in the Eurozone.

UK industrial production disappointed markets in June, remaining unchanged versus expectations of a 0.4% m/m increase even after a slight downward revision in May. Having said that, the details suggest a slightly better picture as manufacturing was the only sector to witness an outright decline—also catching analysts off guard—as elec, gas & water supply, mining & quarrying, and oil & gas production all increased in June (albeit with the latter two sectors coming off a 6%+ decline in May). Nonetheless, given this weakness, Q2 real GDP could be revised down a touch. **UK trade data** was also disappointing as the trade deficit widened to GBP8.8bn from GBP8.5bn in May, contrary to expectations for a narrowing. Exports plunged 4.8% m/m (in part due to a decline in oil exports) while imports also dropped 2.4% on the month as demand remains weak in the UK as well as across many of its trading partners both within EU 27 as well as outside of the EU.

Bank Indonesia kept rates on hold at 6.75% as expected, the sixth month that the central bank has remained on the sidelines since unexpectedly tightening back in February.

Fixed Income	Government Yield Curves (%):											
	2-YEAR			5-YEAR			10-YEAR			30-YEAR		
	Last	1-day	1-wk	Last	1-day	1-wk	Last	1-day	1-wk	Last	1-day	1-wk
US	0.27	0.26	0.32	1.14	1.08	1.22	2.38	2.32	2.61	3.70	3.65	3.91
CANADA	0.85	0.81	1.25	1.54	1.52	1.86	2.49	2.48	2.63	3.13	3.13	3.17
GERMANY	0.75	0.72	1.07	1.47	1.39	1.58	2.36	2.26	2.42	3.12	3.04	3.18
JAPAN	0.14	0.14	0.16	0.35	0.33	0.36	1.05	1.01	1.05	1.99	1.93	1.98
UK	0.58	0.58	0.63	1.38	1.38	1.50	2.65	2.64	2.77	3.92	3.89	4.01
	Foreign - U.S. Spreads (bps):											
CANADA	58	54	94	40	44	64	11	16	2	-57	-53	-75
GERMANY	48	46	75	33	30	36	-2	-6	-20	-58	-61	-73
JAPAN	-12	-12	-16	-79	-75	-86	-132	-131	-156	-171	-172	-193
UK	32	32	31	24	30	28	27	32	15	22	24	10

Equities	Last	Change	% change: 1 Day	1-wk	1-mo	1-yr
S&P/TSX	11670.96	-491.21	-4.0	-9.8	-12.7	-1.6
Dow 30	10809.85	-634.76	-5.5	-10.9	-14.6	1.0
S&P 500	1119.46	-79.92	-6.7	-13.0	-16.7	-0.7
Nasdaq	2357.69	-174.72	-6.9	-14.1	-17.6	2.3
DAX	5071.49	2.54	0.1	-11.3	-15.3	-6.3
FTSE	5829.79	-93.48	-1.6	-14.2	-21.2	-8.2
Nikkei	8944.48	-153.08	-1.7	-9.1	-11.8	-6.6
Hang Seng	19330.70	-1159.87	-5.7	-13.8	-14.9	-11.3
CAC	3150.70	25.51	0.8	-10.6	-19.5	-16.6
Commodities			% change:			
WTI Crude	80.71	-0.60	-0.7	-13.9	-16.1	-0.9
Natural Gas	3.94	0.00	0.0	-5.3	-6.4	-8.7
Gold	1693.00	34.25	2.1	4.3	9.8	40.2
Silver	38.36	-1.50	-3.8	-3.4	5.7	107.6
CRB Index	317.74	-9.06	-2.8	-6.9	-7.5	15.7
Currencies			% change:			
USDCAD	0.9929	-0.0016	-0.2	3.3	2.5	-3.3
EURUSD	1.4265	0.0086	0.6	0.4	1.7	7.9
USDJPY	77.1600	-0.6100	-0.8	0.0	-3.9	-10.2
AUDUSD	1.0201	0.0014	0.1	-5.4	-4.3	11.3
GBPUSD	1.6343	0.0025	0.2	0.3	2.7	2.8
USDCHF	0.7443	-0.0107	-1.4	-2.3	-10.9	-29.1

Source: Bloomberg. All quotes reflect Bloomberg data as at the time of publishing.
While this source is believed to be reliable, Scotia Capital cannot guarantee its accuracy.