

Financial Monitor

by William Tharp

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March 9, 2012

LOOKING AHEAD



positive



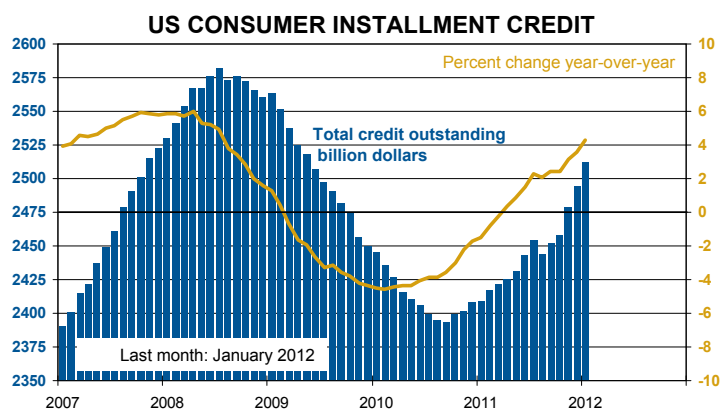
negative



caution/neutral

FOCUS	PERSPECTIVE	CURRENT OUTLOOK	FUTURE OUTLOOK	PAGE
Policy Interest Rates	The Fed has been expecting policy rates to remain near zero until at least late 2014 as it expects the rates of both economic growth and core inflation to taper off. While we still support this view, note the comments on rising compensation on page 3. The Bank of Canada, while eyeing near term economic improvement, remains on hold.	G	G	7
Bonds	Bond yields have been pulled up by an improving US economy (but the rate of growth is likely to fade). They have been pulled lower by European problems, somewhat abated for now. Net: yields are moving sideways, with some eventual downside risk.	G	G	8
Stocks	Stocks are supported by an improved US economy and hopes for further policy easing in Asia. Things look temporarily better in Europe but Iran is a looming problem.	Y	Y	10
Canadian Dollar	High oil (and metals) prices continue to help the Dollar but at a cost to global growth prospects. Odds of an interest rate hike have improved but are likely to fall back.	Y	R	11
European Currencies	Financial concerns, a recession, and credit contraction are apt to keep the Euro on a declining trend.	R	R	12
Renminbi	Slowing growth and a loosening of monetary policy have slowed the pace of currency appreciation to a virtual halt.	Y	G	13
Rupee	The Rupee may have risen a little too much but monetary policy continues to be loosened, attracting foreign investors. India's banking sector remains problematic.	Y	G	
Yen	A feeble economy and recent trade deficit have allowed the yen to weaken but it could become a refuge currency again.	Y	Y	

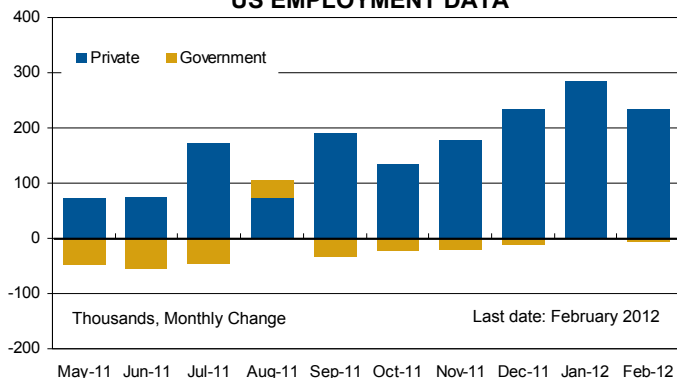
CHART OF THE WEEK



US Consumer Credit growth continues to recover, a plus for American banks. Car loans and student loans have been the fastest growing components, although the latter category largely represents direct lending by the government these days rather than by banks. Total credit (including mortgage lending and commercial/industrial loans) turned positive in the fourth quarter.

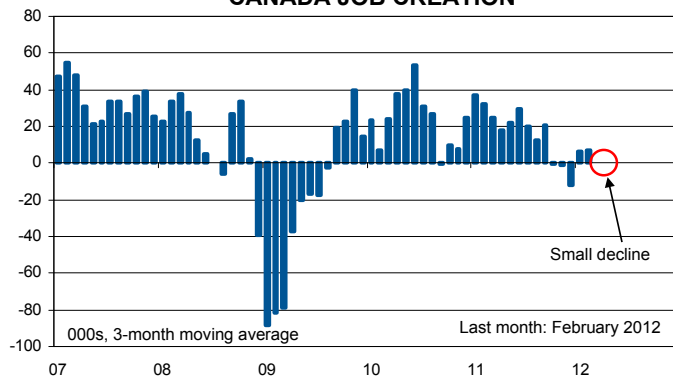
RECENT ECONOMIC DATA

US EMPLOYMENT DATA



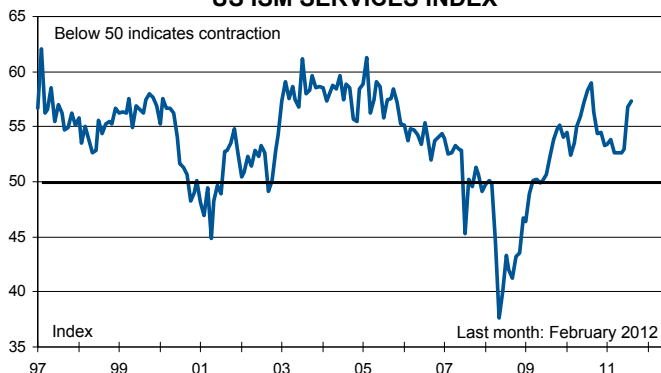
US Job Creation was strong again in February, with January revised up. The unemployment rate was unchanged at 8.3% as more workers joined the labour force. Government “dehiring” was minimal.

CANADA JOB CREATION



Canadian Job Creation disappointed yet again, the fourth month in the last seven where there was a net loss of jobs. The unemployment rate fell, however, to 7.4% as the labour force shrank.

US ISM SERVICES INDEX



US ISM-Services This index shows a further gain in February, building on January’s large advance.

FUTURE DATA RELEASES

CANADA:

- Vehicle Sales (Wednesday)
- Manufacturing Shipments (Friday)

US:

- Retail Sales (Tuesday)
- Current Account Balance (Wednesday)
- Producer Prices (Thursday)
- Consumer Prices/Industrial Production (Friday)

REGULAR FEATURES

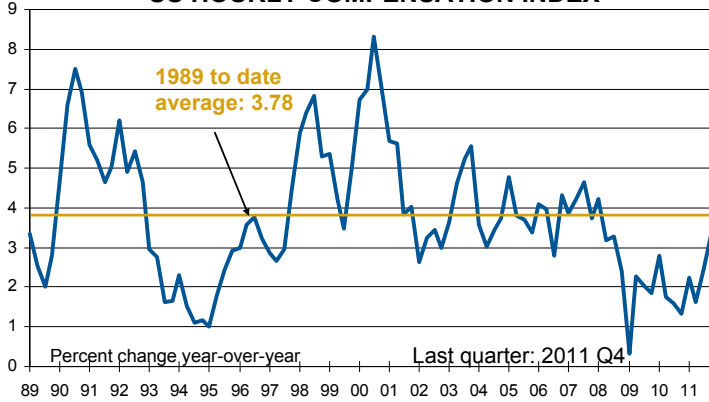
- The Current State of Affairs (P.6)
- European Bond Yield Spreads (P.9)

SPECIAL FEATURES

- US Labour Cost Indicators (P.3)
- European Developments (P.4)
- Bank of Canada Rate Decision (P.5)

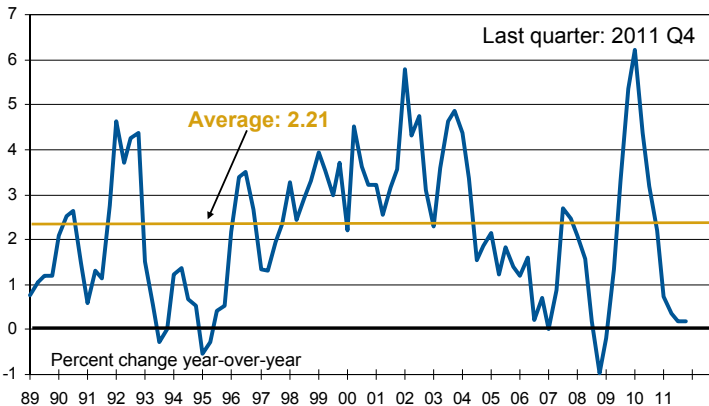
US LABOUR COST INDICATORS

US HOURLY COMPENSATION INDEX



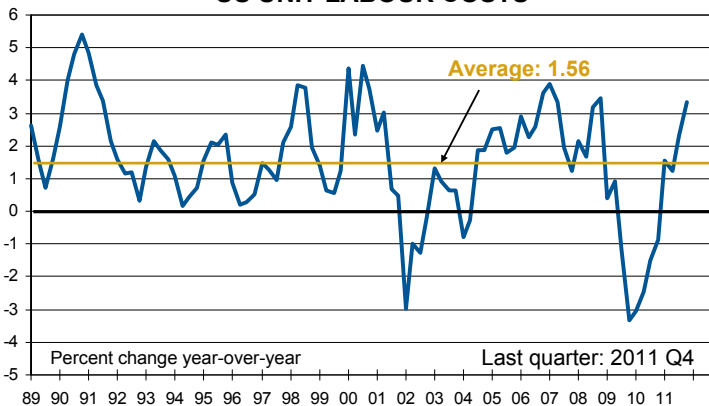
Upwardly revised third quarter compensation data and a further increase in the fourth quarter suggest that worker remuneration is rising much faster than previously believed. This is positive for retail sales and near-term economic growth. **ALERT!** Rising oil prices and fiscal restraint in 2013 are expected to trim future economic growth. Nevertheless, the rapid gain in labour costs, should they persist, could bring interest rate hikes sooner than the Fed has been expecting.

US PRODUCTIVITY



Productivity gains have vanished, largely (one suspects) because of the increased job creation.

US UNIT LABOUR COSTS



With compensation up and productivity down, unit labour costs have been rising sharply.

EUROPEAN DEVELOPMENTS

by Chantelle Schieven

- Greece reached another milestone Friday March 9 with a successful execution of the PSI (Private-Sector Involvement) bond swap. Greece has now both met the criteria for the €130bn bailout package, and staved off a messy default on March 20 when €14.5bn in bonds were set to come due. (The bonds were part of the restructuring and will not exist after the exchange.)
- Under the PSI agreement Greece will exchange 95.7% of its bonds held by the private sector for new bonds worth 31.5 cents on the euro (the new bonds also have extended maturities and lower interest rates than many of the original bonds). Greece had to force some investors to participate in the PSI by using a collective-action clause that the Greek parliament voted last month to add to all bonds issued under Greek law.
- The new bonds will have step-up interest rate coupons that will pay 2% through 2015, then 3% through 2020, and then 4.3% until maturity in 2042.
- Greek bond holders will also receive EFSF bonds worth 15 cents on the euro (the coupon rate has yet to be determined) and GDP-linked warrants. The GDP-linked warrants, will pay 1% if GDP growth targets for Greece are met starting in 2015 (the targets also have yet to be determined).
- Greece has given the remaining 4.3% (€9bn) of its original bond holders two additional weeks to exchange their bonds. If the holdouts choose not to exchange their bonds Greece can do one of three things:
 1. negotiate different terms
 2. pay the bonds at face value
 3. not pay the bonds at all

The most probable outcome is that Greece does not pay the bonds at all, the bond holders can then try to collect through the legal system, which could drag on for years and there is still no guarantee that Greece would pay.

Greek Bonds subject to the PSI Agreement

Billions of euros

206 total amount held by the private-sector
177 issued under Greek law (85.9% of the total)
152 voluntarily tendered
25 forced to participate by the collective-action clauses
29 issued under foreign law (14.1% of the total)
20 voluntarily tendered
9 given two extra weeks to participate (deadline March 23)

- The use of the Greek government's retroactive collective-action was determined to be a "credit event" by the ISDA (International Swaps and Derivatives Association, Inc.) which has triggered the payment of credit default swap (CDS) contracts. CDSs are like insurance policies on bonds, they pay out if the bond issuer is unable to pay. There is an auction scheduled for March 19 to determine the value of the exchanged bonds and once determined the CDSs will pay the difference. For example if the exchanged bonds are deemed to be worth 20% of the original bond value then the CDS would pay the remaining 80%.
- The net amount of outstanding CDS contracts for Greece is estimated to be \$3.2bn. But the gross amount is a staggering \$60-\$70bn, which raises the question of whether the counter parties will be able to pay. The CDS market is somewhat more transparent than some of the new types of debt instruments involved in the 2008 meltdown after Lehman Brothers failed, but there is still some risk of counter parties not being able to pay.
- Our main concern is that even after the debt restructuring Greece still won't be able to pay its debt. Furthermore, Greece will owe almost 75% of its debt to the "official sector" (other Eurozone countries, the IMF and ECB).
- The next restructuring (default) of Greek debt, which we think could come as early as this year, will likely be to the official sector. This would not sit well with the countries that have lent Greece money.

Greek Debt Before Restructuring*

Billions of Euros

206 bonds held by the private-sector
55 bonds held by the ECB
and National Central Banks
73 loans from first bailout package
21 other

355 Total Debt

Greek Debt After Restructuring*

Billions of Euros

70 bonds held by the private-sector
55 bonds held by the ECB
and National Central Banks
73 loans from first bailout package
130 loans from second bailout package
21 other

349 Total Debt

*estimates

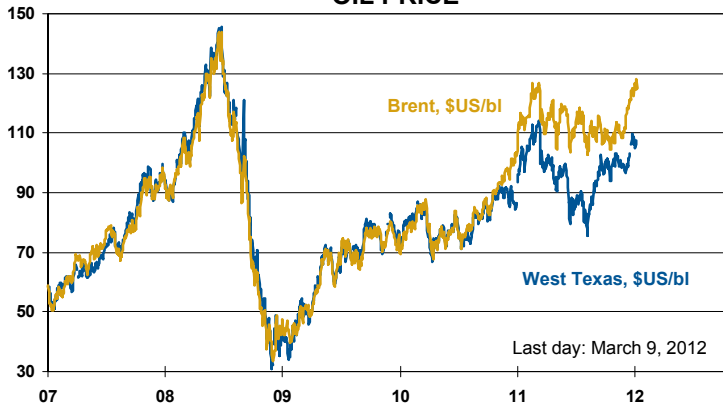
The €130bn from the second bailout will be paid out in quarterly tranches over 3-years to help Greece with its financing, but we do not think that it is enough or that Greece will be able to repay the loans.

BANK OF CANADA RATE DECISION

by Stephen Gaskin

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OIL PRICE

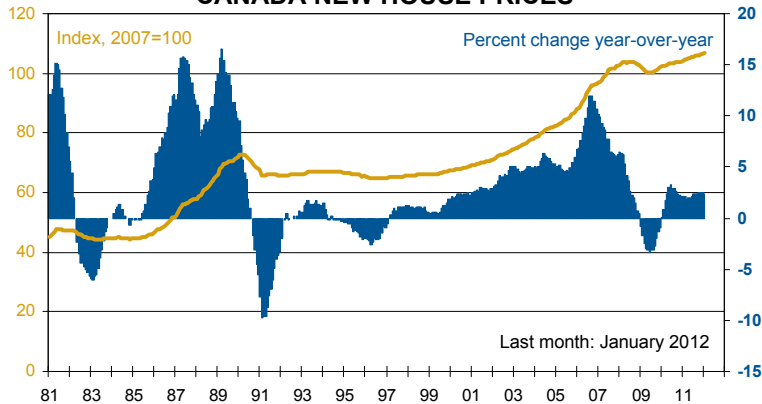


The Bank of Canada maintained its target for the overnight interest rate at 1% at its latest meeting on March 8. The Bank struck a more optimistic tone in its latest comments which suggested to some that it may raise interest rates late this year, or early next.

In our view, the Bank would need to see further confirmation of a strengthening economic recovery before it will start seriously considering a rate increase. While the global recovery has proceeded faster than the Bank forecasted in its January Monetary Policy Report, high and rising oil prices, and a renewed flare up in Europe could see the recovery fall back toward the Bank's expectation, or even somewhat below it.

Additional factors influencing the Bank's interest rate decision include the following:

CANADA NEW HOUSE PRICES



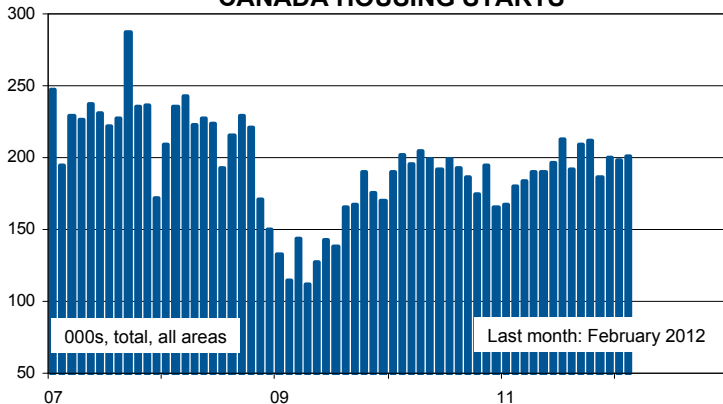
FOR A RATE INCREASE:

- If inflation were to rise beyond a temporary increase in energy prices – core and headline inflation appear to be higher than the Bank's low forecast issued in January.
- Continued rapid increases in Canadian household debt levels. The Bank views household debt levels as the key domestic economic risk.
- Further rises in house prices. The Bank wants to limit further price increases to prevent a housing bubble, but low rates continue to support housing.

AGAINST A RATE INCREASE:

- The Canadian dollar is already strong and hurting competitiveness.
- Economic growth has been modest, the labour market is soft.
- Government consolidation will subtract from economic growth later this year.
- Rising oil prices will put pressure on household budgets and weaken growth – exports would also be hurt from demand destruction abroad.

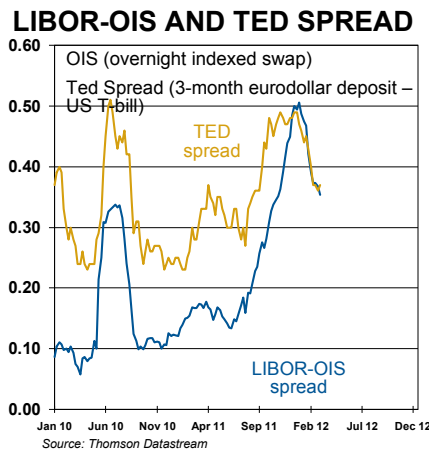
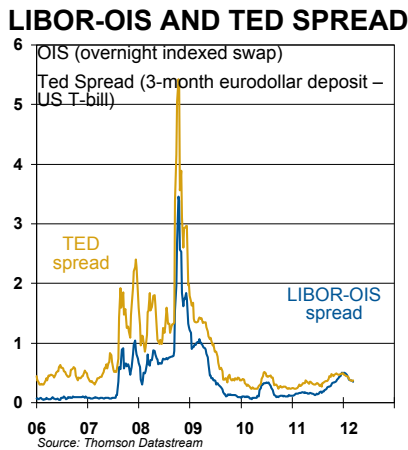
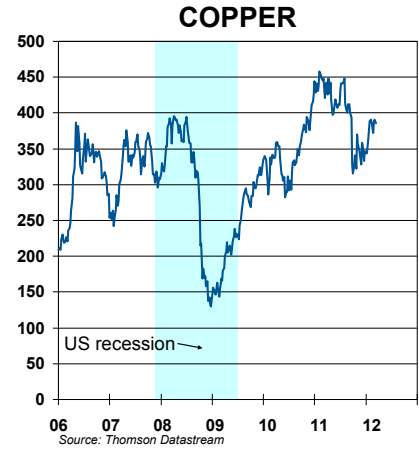
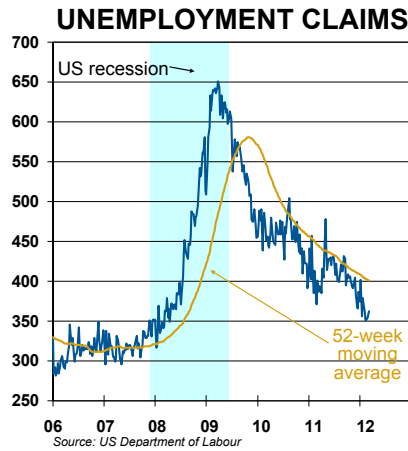
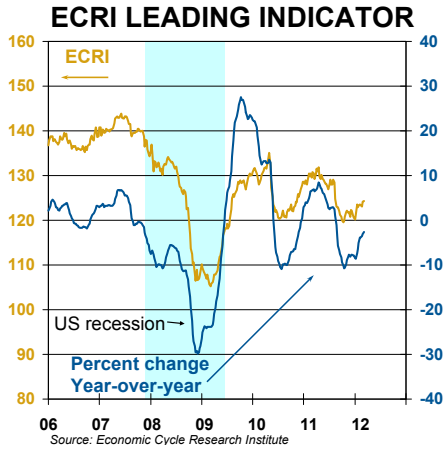
CANADA HOUSING STARTS



In short, we feel a near-term rate increase remains unlikely. We would need to see a further and sustained recovery before anticipating a rate increase late this year, or early next. Growth may yet deteriorate to the point of a rate cut later this year.

CURRENT STATE OF AFFAIRS

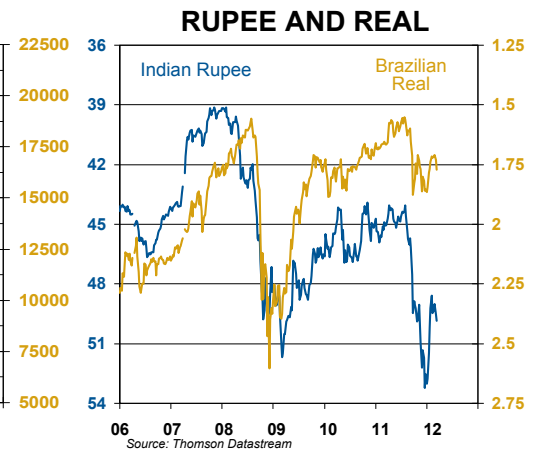
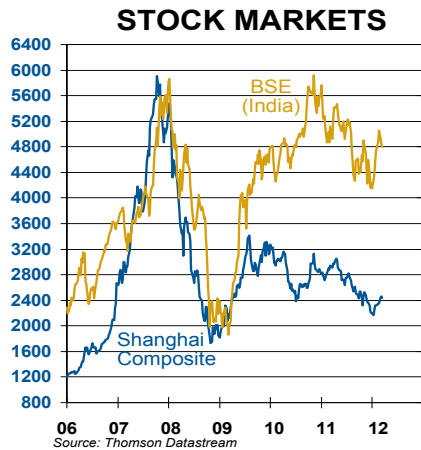
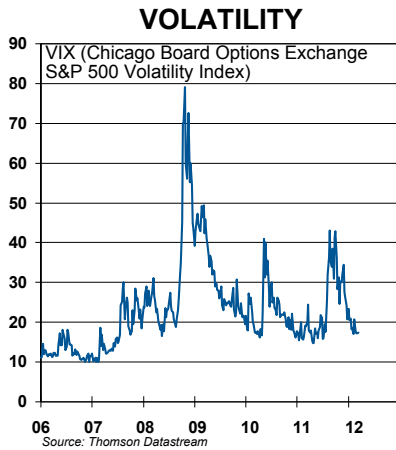
by Martin Murenbeeld



BETTER: ECRI leading indicator, short-term rate spreads.

NEUTRAL: Unemployment claims, copper, volatility, emerging markets.

WORSE: Rupee, real.



POLICY INTEREST RATES

by Chantelle Schieven

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The Bank of Canada

Target overnight rate: 1.00%

Next meeting: April 17, 2012

The Bank of Canada held its policy rate at 1.00% at its March 8 meeting. We are not expecting any policy changes at its April 17 meeting. (see *Bank of Canada Rate Decision* on page 5 for more information).

The Federal Reserve

Fed funds rate: 0.00%-0.25%

Next meeting: March 13, 2012

We are not expecting any policy changes at the Fed's meeting next week. If deemed necessary, there are several ways the Fed could carry out further stimulus measures later this year. The Fed could:

- buy US longer term Treasuries or mortgage-backed securities outright. If the goal of the Fed is to put downward pressure on long-term rates, which might encourage investors to buy other assets besides US Treasuries, the Fed would buy longer term securities. If the goal is direct support for the housing market then the Fed could purchase mortgage-backed securities.
- extend "operation twist". This involves the Fed selling US treasuries with shorter maturities and buying US Treasuries with longer maturities. One advantage to this option compared to outright purchases is that the purchases do not add to the size of the Fed's balance sheet or the monetary base. One disadvantage, however, is that the Fed will only have about \$200bn in shorter term Treasuries left that it could sell after the current operation twist is complete in June.
- buy longer term US treasuries and then offer reverse repos to banks in the same amount. The advantage to this option is that the Fed would put downward pressure on longer term yields and not increase the monetary base, which some fear could cause inflation down the road. (This option does increase the size of the Fed's balance sheet but not the monetary base, since it takes the liquidity back out of the market via sterilization).

The Bank of England

Current policy rate: 0.50%

Next meeting: April 4 and 5, 2012

The Bank of England held its policy rate at 0.50% and its QE program at £325bn. The BoE's statement, like the ECB's and Bank of Canada's, had a more hawkish tone as inflation, mostly due to higher oil prices, has once again become a worry. We are not expecting any changes to policy at the BoE's April meeting.

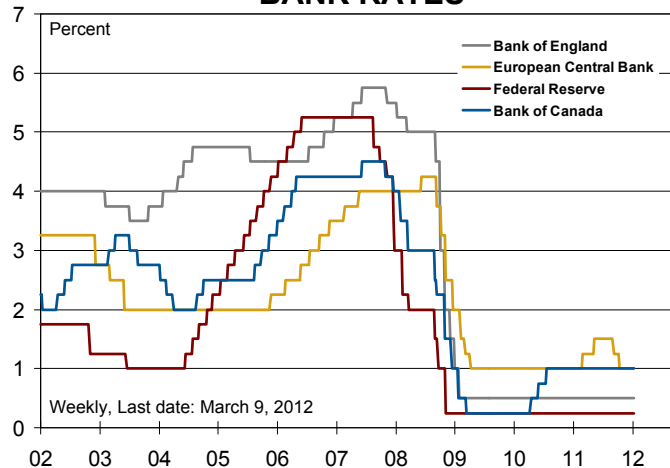
The European Central Bank

Current policy rate: 1.00%

Next meeting: April 4, 2012

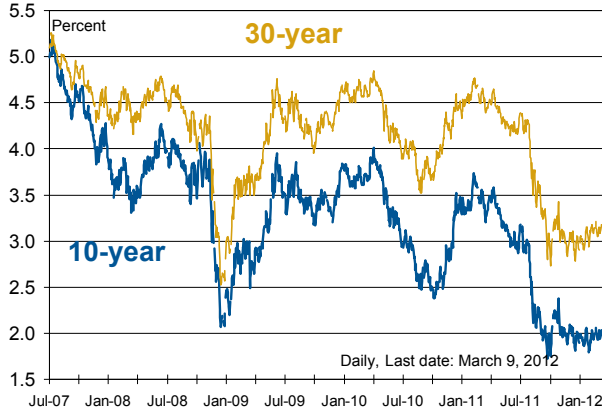
The ECB held its policy rate at 1.00% at its March 8 meeting. In a press conference after the release of the statement, ECB President Draghi, said that there are signs of stabilizing economic activity in the Eurozone, but he acknowledged that there are significant downside risks. Two downside risks that he noted are an "intensification of tensions" in the sovereign debt markets (that could feed into the broader economy) and further increases in commodity prices (which could potentially increase inflation and slow economic growth). We are not expecting any changes to the ECB's policy at its April 4 meeting, but we could see further support later this year if financial conditions deteriorate.

BANK RATES



LONGER-TERM BOND YIELDS

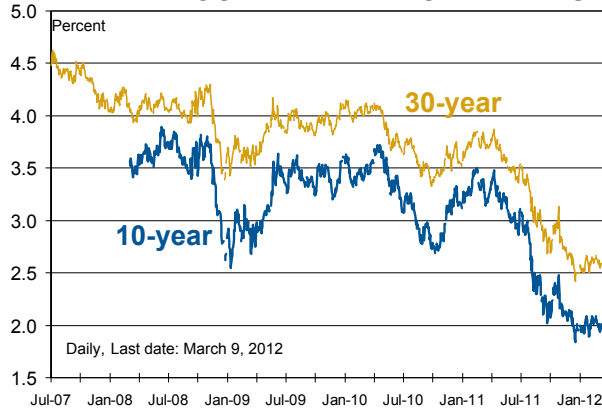
US TREASURY YIELDS



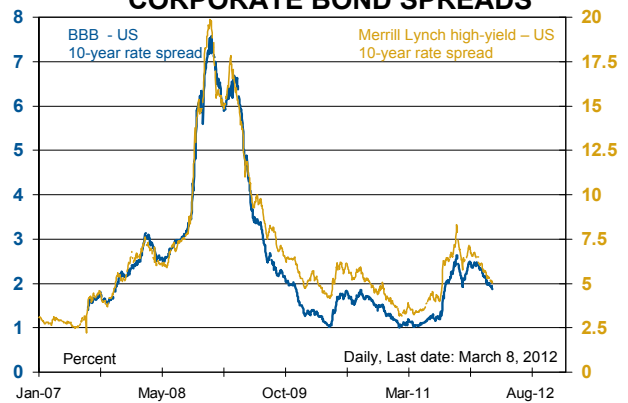
North American 10-year government bond yields moved up a bit this week, with German and Japanese yields unchanged. Despite an improving domestic economy, American yields remain near the mid-point of our unchanged target range of 1.70% to 2.20%. While yields could move a little higher in the immediate future (subject to international developments), future economic/financial news will likely tilt yields down later this year.

The Fed is still contemplating further quantitative easing activity, should the economy falter in the months ahead, but is now discussing the possibility of a sterilized operation (no net increase in the money supply) to allay fears of a spurt in inflation.

CANADA GOVERNMENT BOND YIELDS



CORPORATE BOND SPREADS



2-Year Government Bond Yield (%)

	8-Mar	2-Feb	Change
France	0.50	0.69	-0.19
Germany	0.14	0.20	-0.06
Greece	307.55	224.37	83.18
Ireland	5.02	5.37	-0.35
Italy	1.87	3.07	-1.19
Portugal	12.46	17.30	-4.83
Spain	1.96	2.32	-0.36

Weekly Yield Change (%)

	Current	Last	Change
Cdn 10YR	2.01	1.96	0.05
US 10YR	2.03	1.98	0.05
US 30YR	3.18	3.11	0.07
US BBB	3.93	3.90	0.03
US HI-YLD	7.22	7.04	0.17

Note: US BBB and US High Yield data are Thursday data

10-Year Government Bond Yield (%)

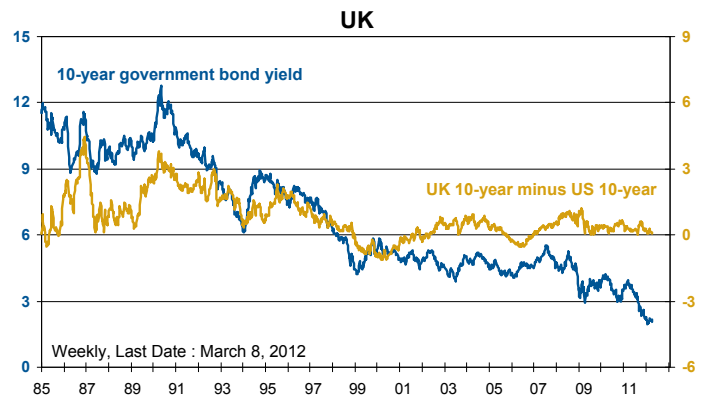
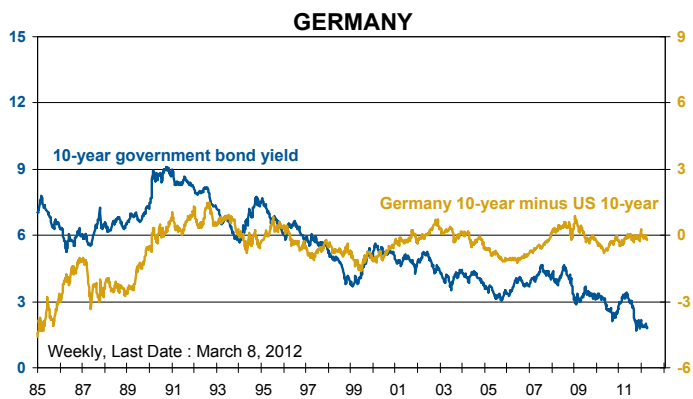
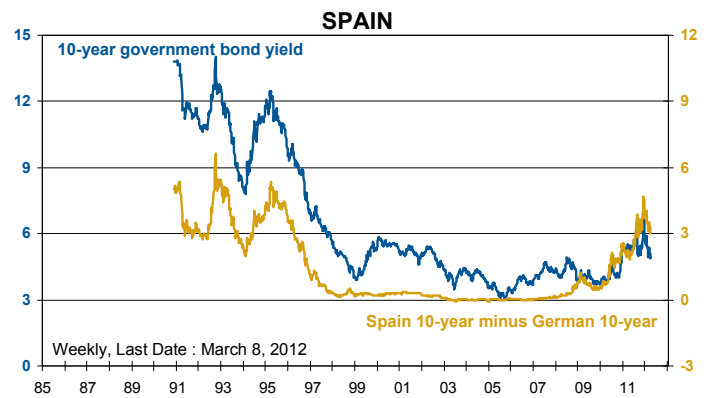
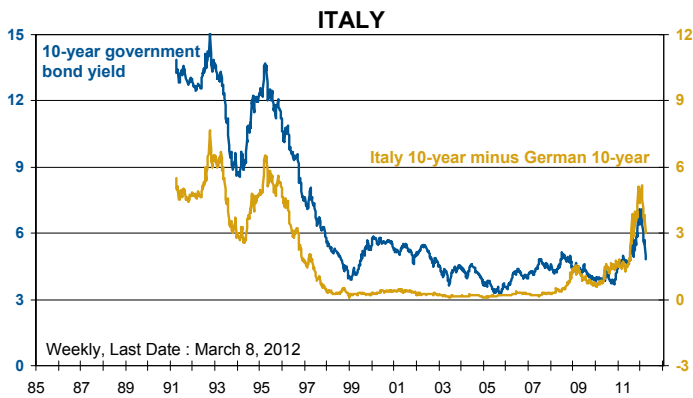
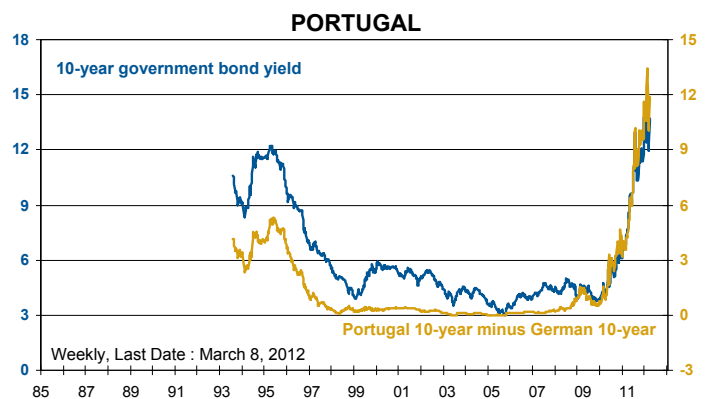
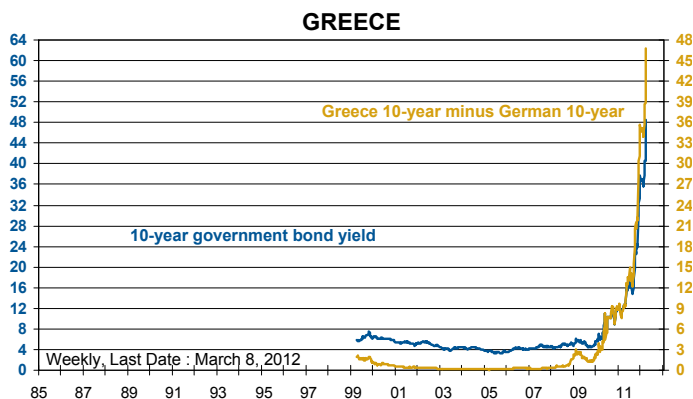
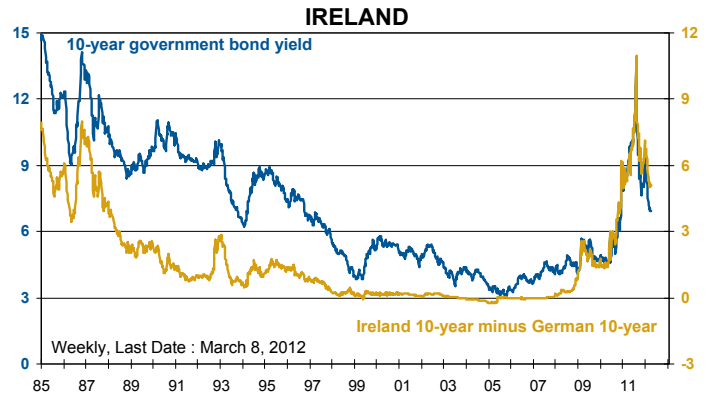
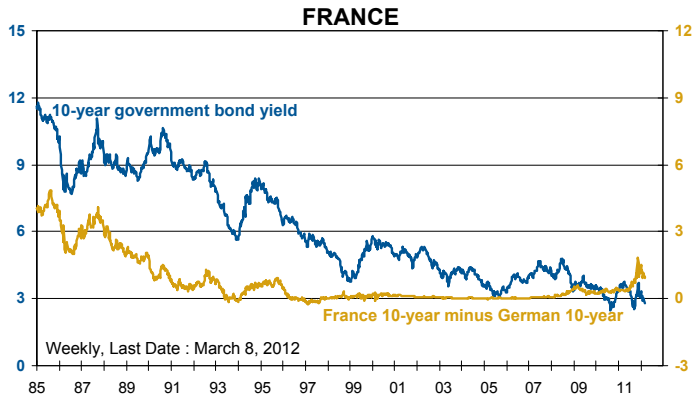
	8-Mar	2-Feb	Change
France	2.80	2.94	-0.14
Germany	1.80	1.83	-0.03
Greece	48.60	36.29	12.31
Ireland	6.92	7.22	-0.30
Italy	4.82	5.62	-0.81
Portugal	13.69	14.73	-1.04
Spain	5.07	4.93	0.14

Monthly Changes in 10-year Government Bond Yields (%)

	Mar 9	Feb 3	Change
US	2.01	2.01	0.00
UK	2.15	2.18	-0.03
Canada	2.01	2.01	0.00
Germany	1.79	1.93	-0.14
Japan	0.99	0.95	0.04

10-YEAR BOND YIELDS AND SPREADS

The spread for Germany and the UK is against the 10-year US Treasury, all the others are against the 10-year German Bund

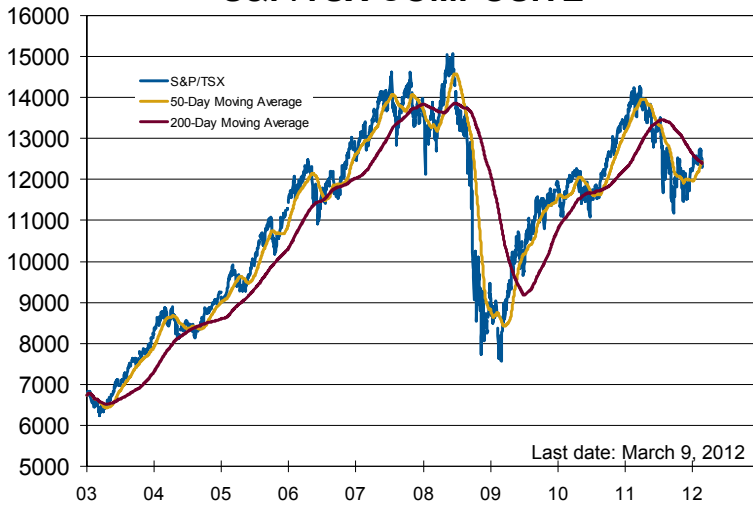


STOCK MARKETS

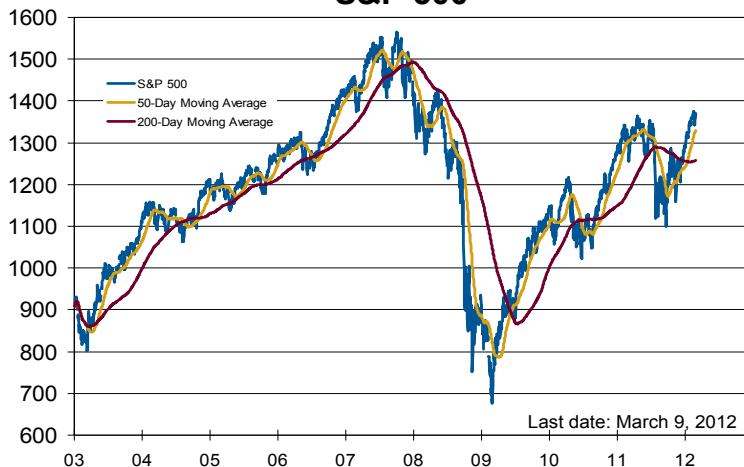
by Stephen Gaskin

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S&P/TSX COMPOSITE



S&P 500



DOW JONES INDUSTRIALS



US equity markets finished flat on the week after recovering from early-week losses. The S&P/TSX declined by 1.1% as its recovery was insufficient to overcome deep mid-week losses.

A number of developments impacted equity markets this week.

First, this past Monday, China announced that it was lowering its annual economic growth forecast for 2012 to 7.5% from 8.0%. While still a rapid pace of growth, this is another step in what appears to be a gradual deceleration. The following day, Brazil reported that its growth in 2011 had fallen to 2.7% from 7.5% in 2010. Slowing emerging markets are bad for equity markets in general, but hit the S&P/TSX disproportionately hard through commodity prices.

Second, beginning on Wednesday, equities began rising as Greece's bond swap deal appeared to be going forward as planned. The deal was completed on Thursday with about 86% of bondholders electing to participate voluntarily (95.7% with the inclusion of the Collective Action Clause (CAC), see page 4). The completion of this deal will likely be followed by a second Greek bailout which should lessen market concern of an imminent disorderly Greek default and immediate Eurozone exit.

However, the use of the CAC triggered the CDS market after US equity markets closed, which could unsettle equity markets if problems occur in making settlement payments.

Finally, late week US employment data continued to show an improving labour market which is supportive of equities. While weekly unemployment claims were up modestly, job creation was above market expectations.

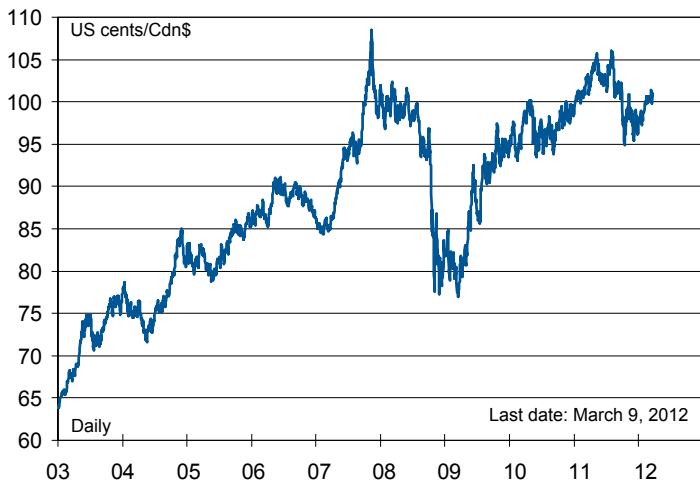
Oil rose again this week, which remains our key concern. **We maintain our cautious outlook.**

Percent changes

	1-week	4-week	52-week
TSX	-1.1	0.9	-8.6
DJI	-0.4	0.9	7.3
S&P 500	0.1	2.1	5.1
NASDAQ	0.4	2.9	10.0

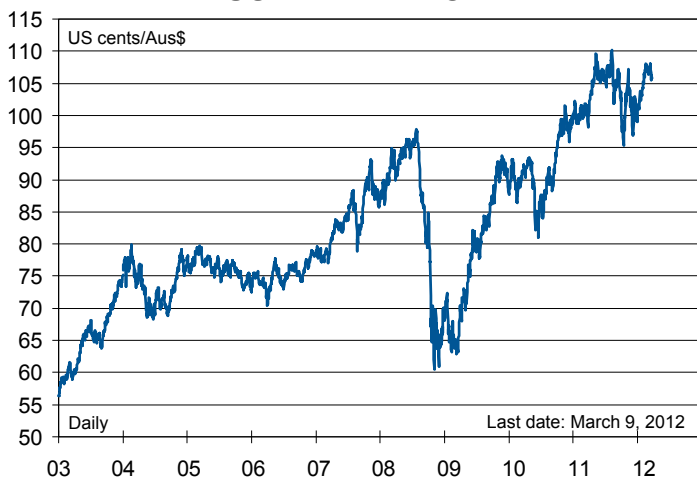
DOLLAR CURRENCIES

CANADIAN DOLLAR



The **Canadian Dollar**, while up at times during the week, closed marginally lower **at 100.94**. Commodity prices were also slightly lower for the most part, though oil was up a bit to \$107.69. While a slightly more hawkish tone from the Bank of Canada supported a higher dollar initially, another weak employment report contrasted unfavorably with upbeat US job creation data. **There are risks in both directions for the loonie – a net risk to the upside if oil prices rise further (timing uncertain as Iran will play a key role), a downside economic risk in the next few months if global and North American growth disappoints, and an eventual turn back up in the second half of 2012 assuming Asian growth is in recovery mode.**

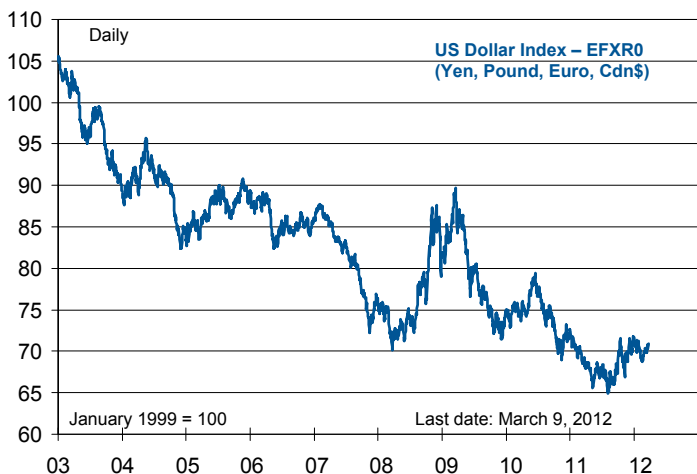
AUSTRALIAN DOLLAR



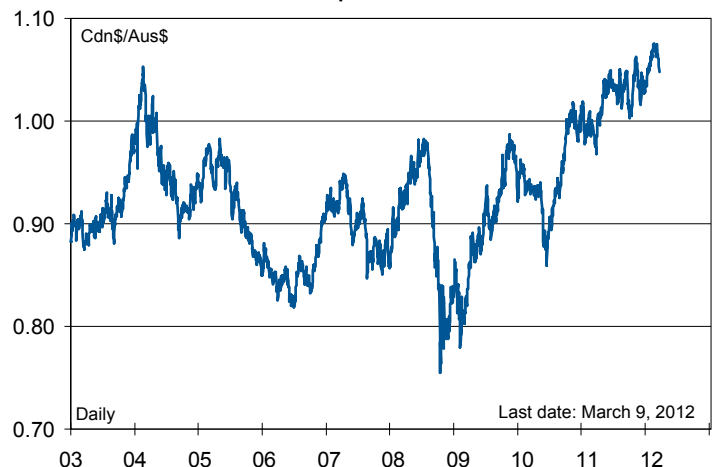
The **Australian Dollar** fell more than the loonie this week, ending **at 105.75** (107.33 last week). Australian economic data were sub par this week. The economy expanded by only 0.4% in the fourth quarter, less than the downwardly revised 0.8% of the third quarter (the numbers are not annualized). There were job losses in February, and January's trade balance fell into deficit thanks in part to weak Chinese demand during the lunar New Year holiday.

US Dollar Overview: The potential for renewed quantitative easing has fallen in recent weeks but growth remains subject to deceleration in coming months, raising the possibility of QE3 towards mid year. We retain a mildly positive outlook for the US currency for the time being. This week it gained against all major currencies.

US DOLLAR INDEX



CANADIAN per AUSTRALIAN



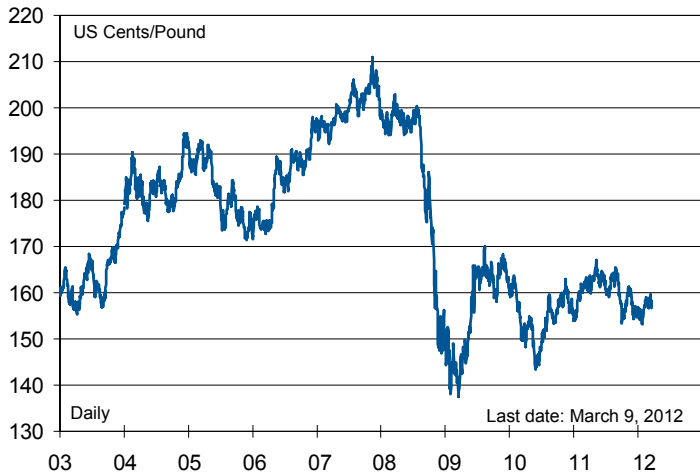
EUROPEAN CURRENCIES

EURO



The **Euro** faded a bit more this week, closing at **1.312** (1.320 last week). The Eurozone's debt crisis appears contained for now in the sense that the situation is worsening at a much slower and seemingly more predictable pace, allowing the shares of the banking sector to price in a reduced risk. The latest Greek developments are discussed elsewhere but Greece remains under serious economic and financial pressure, with an election coming up. France also has an election (in April). Future governments may decide to renegotiate various matters or, in the case of Greece, leave the Euro – setting off a new round in the financial crisis. As well Spain and Portugal remain under significant financial and economic pressure.

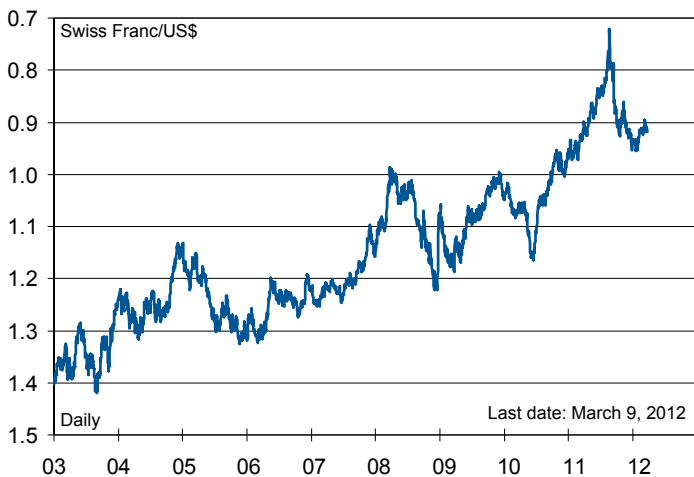
POUND STERLING



German industrial output climbed 1.6% from December to January but this did not fully offset the 2.6% decline from the prior month. German factory orders did not fare so well in January, falling 2.7% as foreign demand for capital goods dropped.

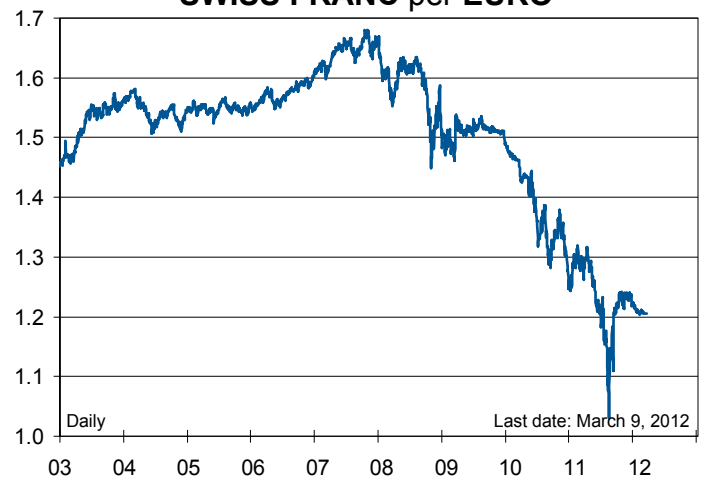
We still see plenty of problems ahead for the Eurozone and expect the euro to remain on a downward trend, but with occasional reversals in weeks where policy actions reduce near term risks.

SWISS FRANC



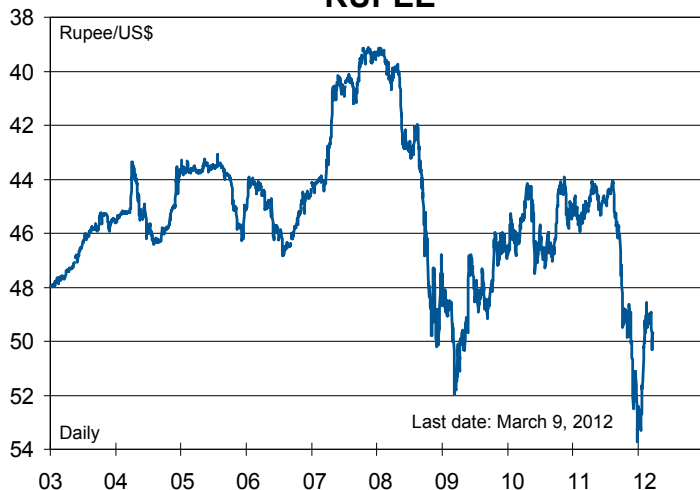
The **Pound** also lost ground, falling to **1.567** from 1.583. The purchasing manager's service sector index fell from a fairly strong 56 in January to 53.8 for February. Retail sales at established outlets slipped for a second consecutive month in February. And by one measure house prices were down in February (the third decline in the last four months).

SWISS FRANC per EURO



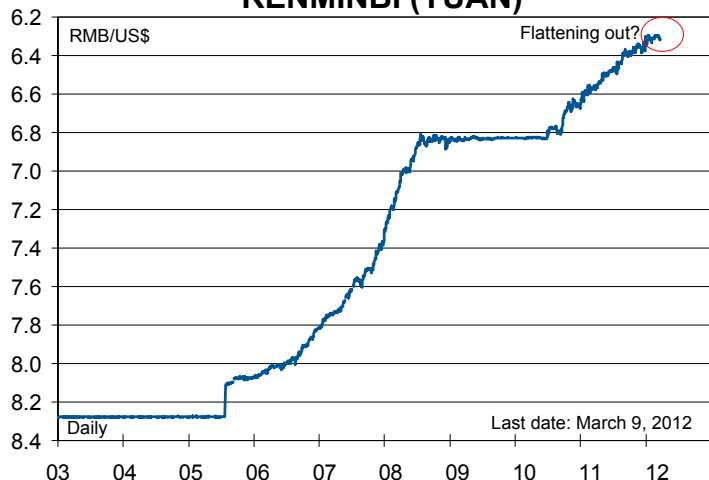
ASIAN CURRENCIES

RUPEE



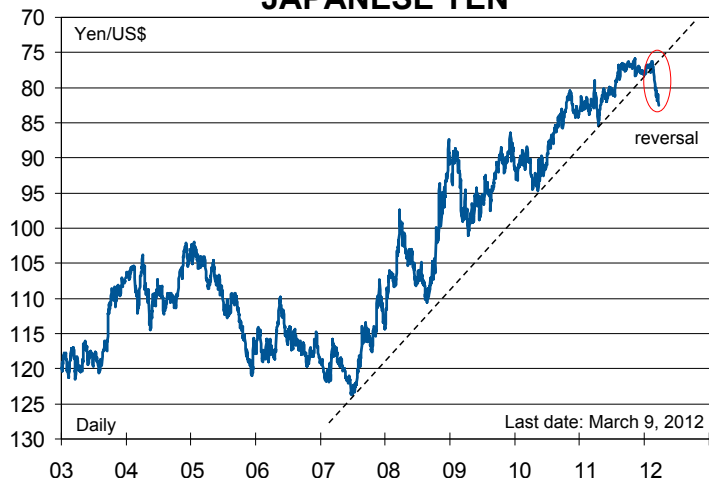
The **Indian Rupee** slipped a little this week to end at **49.67** (49.53 per USD last week). India's central bank took a further step to loosen monetary policy by slashing bank reserve ratios from 5.5% to 4.75% effective March 10. Not only was the cut larger than the 50 point initial reduction on January 24, it also came outside the normal central bank policy meeting framework. The move is designed to ease a liquidity squeeze which has been dampening economic growth, but as yet there has been no reduction in policy interest rates.

RENMINBI (YUAN)



China released a series of economic data this week. Consumer price inflation slowed to 3.2% in February (4.5% in January). Producer prices were said to be zero in the twelve months through February, down from 0.7% in January (oil prices were close to today's level in February 2011). Lower inflation may encourage officials to reduce interest rates before long, though there is still some concern about setting off another property price bubble if rates are cut too soon. China's M2 money supply was up by a subdued 13% in February (compared with a year ago), similar to growth rates since last August but well down from the last few years (15.7% in February 2011, 25.5% in February 2010 when authorities were anxious to goose growth). Other data showed economic activity weakening too: retail sales rose 14.7% in January/February (they were up 18.1% in December) and factory production rose by 11.4% in January/February (12.8% in December). For the first two months of the year car sales were down 4.4% compared with the same period in 2011. The **Renminbi** closed weaker this week, ending at **6.311** per USD (6.299 last week).

JAPANESE YEN



The **Yen** weakened again to close at **82.5** (81.8 a week earlier). Although the economy did not shrink as much during the fourth quarter as initially reported, it was still down by an annualized 0.7%. But markets were worried by Japan's shift into a current account deficit in January, caused by weakening global demand for Japan's exports (especially from China) but also a rise in oil imports (52 of 54 nuclear reactors were reported shut). Japan normally runs a current account surplus, but an extended deficit could mean that Japan would need foreign investors to buy a larger share of its bonds (implying a need for higher interest rates on those bonds since foreign owners don't enjoy the benefits of Japan's deflation).

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