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MAY 31, 2008. ISSUE 5

E.Q Trendwatch™

Canada contracts in Q1

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Last week we learned that Canadian GDP contracted by 0.3% in the first quarter of 2008. This came as a substantial downward surprise to many analysts and the Bank of Canada itself who had forecast 1.0% growth during the quarter. It was the first contraction in Canadian GDP since Q2 2003.

In addition to a negative Q1, there was a downward revision to the previously reported Q3 2007 GDP which was reduced from 3.0% to 2.3%. As a result the output gap (demand over our potential) in Canada is now likely closed and has done so a few months sooner than the Bank of Canada had expected.

The momentum heading into Q2 is also very weak, and likely to bring a second quarter of below potential and possibly negative growth. This makes it highly likely that the Bank of Canada will continue to cut rates into the next couple of meetings. It also means that an official recession is now in the cards in Canada and our unemployment numbers are likely to rise over the coming months.

We have been writing for several months that we believed the US entered into a recession in the last quarter of 2007. Typically the Canadian economy has lagged the US by about 8 months, so a decline in Q1 is the first part of a slowing story that will likely be confirmed in Q2 and continue in Canada for the next few quarters.

Meanwhile the US Q1 GDP number updated last week revised US reported growth to a slightly positive .9% versus the earlier guesstimate of .6%. The barely positive read comes courtesy of a substantial inventory build (stuff made but not sold) and an understated inflation deflator of 3.5%. Had a more accurate inflation estimate like 5% or even 4% been used, the extent of the US contraction would have been more accurately reflected in the official headline. As usual, it is almost certain that the official numbers will be revised again in the future with the benefit of more retrospection.

Already Canadians are feeling high levels of concern about the months ahead. While it is popular to bash US consumers for wanton spending and over-leveraged housing, Canadians too have some skeletons in our closets. We have over-spent and under-saved for the past several years as well. Our debt levels are at multi-decade highs and not surprisingly our consumer confidence is near historic lows. All of this makes us now collectively less immune to economic headwinds over the months ahead.

Canada is likely about to learn once again that we are in fact still heavily tied to the fate of our southern neighbour. And with commodities and energy now accounting

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for more than 50% of our stock market composite, the ongoing aggregate demand correction, coupled with recently announced regulatory crackdowns on speculative loop-holes in commodity markets now threatens to hit us harder than many have so far dreamed possible.

It is true we have hard assets and resources that the world wants to consume, but even strong secular demand cycles can and do correct as a normal part of the economic cycle. Just a casual glance at any Andex or market chart will attest that Canada and our stock markets have never been immune to a downturn in the US and the rest of the world.

Even where Canada has escaped following the US into outright recession as we did in 1953, 1960, 1974, and 2001, our market corrections in contraction cycles have been nothing short of stunning. We can hope that this time will be different. The odds do not however, favour such hopes.

The recent run in crude oil has been amazing, up 100% in the past year, and 60% since February, all with no rational demand case to support the moves. Although it is not possible to tell exactly where wild speculation will exhaust itself, parabolic moves always resolve in violent corrections. This is what makes prices particularly unstable and dangerous at this time.

The April/May bounce: a blip in the big picture

April and May 2008 were bounce months. But when we look at it in the context of the price action over the past 12 months, we can see that, in itself, this bounce accomplished nothing to reverse the overall bear trend.

Dow Industrial Index (past 12 months)

S&P 500 (past 12 months)

With most markets now back to over-bought, they seem more likely poised for the next leg down than the start of the next bull cycle.

In our January 2008 market letter we pointed out that all around the world, markets had entered into a cyclical bear or down trend. We then said:

> "The first thing to note is that even within an ongoing bear market we should expect big gaps down followed by dramatic rallies. So it is likely that we will see a few days or even weeks of up days as this bear grinds on. We must be aware that these "false rallies" are likely to be fleeting and not alter the primary bear-market trend that has now been established. Expect many optimistic market commentators to prematurely recommend that people "buy the dips" all the way down through this part of the cycle…Its worthy to note that the last bear (2000-2002)

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which took world markets down by some –45%, included three separate rally segments where markets roared back 20% before collapsing again to a final bottom. As exciting as these interim rallies can seem on the screen, they are notoriously dangerous and must not be allowed to suck disciplined investors back into the fray."

With US financials now back re-testing prior lows (its clear the Bear Stearns bail-out did not solve the larger problems) and with housing, retail, airlines, automobiles and general manufacturing all in outright contraction, there is ample reason to be defensive of our capital for a bit longer still.

Housing is rotting in America… (and the UK, and Spain, and New Zealand, and, and)

Over the past three years, there have been many optimistic calls that US housing would only have to contract a modest 5% maximum and then start back up from there... So much for high hopes.

The S&P/Case-Schiller National House-Price Index (U.S.) fell 14.1% in Q1/08, *already much bigger than the 10.5% drop in 1932 during the Great Depression.* Adjusting for inflation/deflation, nationally property prices have, on average fallen by an even worse 18% over the past year.

Chart source: economist.com

We cannot help but wonder how much this re-pricing will spill over to the Canadian real estate market over the next couple of years. We hope for the best. But we acknowledge that we have never been immune from the rest of the world in the past.

Remember you can visit our blog: www.jugglingdynamite.com for our weekly commentary and media interviews.

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