

# WEEKLY ECONOMIC BULLETIN

**ATB Financial**<sup>®</sup>

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October 16, 2009

- **Consumer prices still falling**
- **US industrial production surprises**
- **Manufacturing reverses downward trend**
- **Fertilizer prices falling in Alberta**

## Alberta Still in Deflation

Overall, Alberta consumers had to shell out fewer dollars in September of 2009 than they did in the same month last year.

As measured by the Consumer Price Index, average prices in the province were lower by 1.1%. For Canada, prices fell by 0.9%.

The deflation story continues to be driven by falling energy prices. In Alberta, the energy sub-index fell by 24.2%, led by big drops in the price of natural gas (-34.8%), electricity (-13.1%), and gasoline (-26.0%).

If you exclude energy prices, Alberta's year-over-year inflation in September was 1.5%, which is actually very close to the Bank of Canada's inflation target of 2%.

Other items in Alberta's consumer basket of goods showed price *increases*. Homeowners' insurance (+6.3%), home maintenance and repair costs (+10.4%), and vehicle insurance (+11.4%) saw some of the highest price jumps.

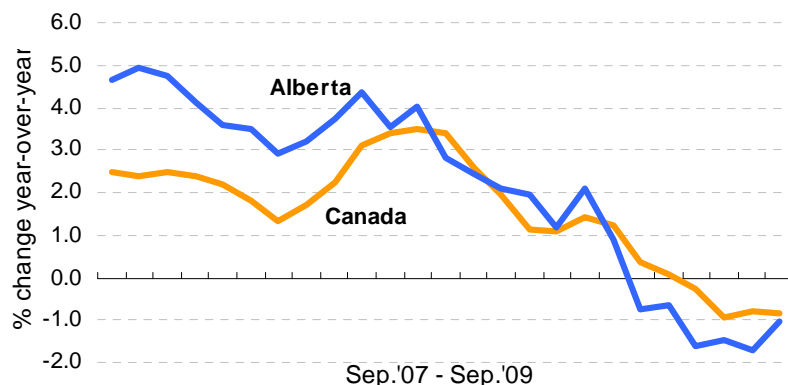
Food prices in Alberta, which had been leading inflation in the province a few months ago, have moderated. The overall food index

was up only 2.1%. Price deflation for fresh fruit (-3.7%) and fresh vegetables (-8.3%) helped keep a lid on overall food prices. The strengthening Canadian dollar is credited for the deflation in fruits and vegetables.

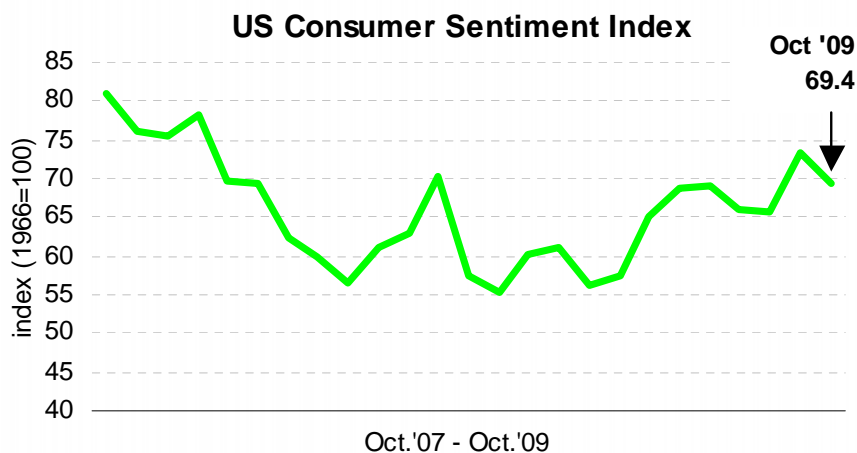
Overall, this morning's CPI report is not likely to prompt any action by the Bank of Canada at its Fixed Announcement Date next week on Tuesday. The bank's "core" inflation index posted a gain of only 1.5% – down from 1.6% in August and the smallest gain since July of 2008. (The core index sets aside items that tend to display volatile price movements, to get a better read of underlying inflation pressures).

If anything, the weak inflation numbers will *encourage* the Bank of Canada to stay on its course of stimulus monetary policy. That suggests the Bank will stick with its conditional commitment to keep the overnight interest rate at its record low of 0.25% until the middle of next year.

**Alberta and Canada CPI Inflation**



Source: Statistics Canada, The Daily, Oct. 16, 2009



Source: Reuters, Oct. 16, 2009

### US Confidence Still Tepid

Confidence among American consumers slipped in October, a stark reminder that while the economy does appear to be rebounding, shoppers are still feeling a bit queasy. That, in turn, suggests that the recovery period could be longer than in previous post-recession periods.

The drop in confidence, as tracked by the Reuters/University of Michigan preliminary index of consumer sentiment, was more than that expected by a consensus of economists. The index decreased to 69.4 from 73.5 in September, which was the highest in more than a year.

### Alberta New Houses Still Lower in Price

While housing prices appear to have stabilized in Alberta, compared to a year ago, prices for new homes are still down.

The New Housing Price Index shows that in October, prices for new homes are still lower than they were in the autumn of 2008.

New home prices in Calgary were lower by 6.3%, and in Edmonton they were lower by 11.4%. That continues a trend in lower prices that has marked all of 2009 for both cities.

Statistics Canada reports: *“Over the past few months, some builders in Alberta and British Columbia have offered lower prices, bonuses and incentives to motivate sales in the face of weaker market conditions.”*

### Industrial Production Rises in US

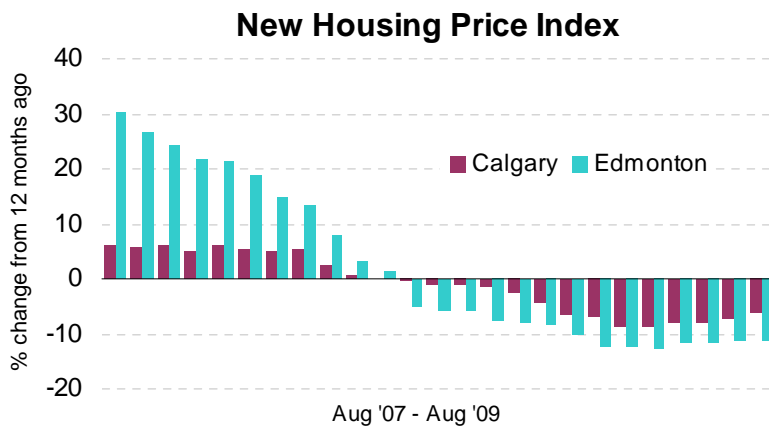
American industrial production in the US surprised economists this morning by showing an increase of 0.7%, September over August. That was more than three times as much as anticipated, placing manufacturing at the forefront of the emerging economic recovery.

The increase in production at factories, mines and utilities exceeded every forecast of economists surveyed by Bloomberg News, and followed gains of 1.2% in August and 0.9% in July.

The figures are collected and reported by the US Federal Reserve.

The rebound in industrial activity was partially spurred by a surge at automakers, but this will likely give way to more moderate and sustainable gains in coming months as companies rebuild inventories and exports grow.

However, as Bloomberg News reports, the improvement has yet



Source: Statistics Canada, The Daily, Oct. 13, 2009

to generate jobs in manufacturing, which is a reason why consumers remain anxious.

## Manufacturing in Canada and Alberta

Manufacturing sales across Canada declined 2.1% to \$40.9 billion in August following a 5.2% gain in July. The aerospace product and parts sector, along with the motor vehicle industries, were the major contributors to the decline in sales.

Sales have been relatively level since February, after declining 20.4% between October 2008 and January 2009.

The situation was somewhat better in Alberta. Here, the total value of manufacturing shipments rose to \$4.521 billion in August. That represents a 4.9% jump from July, and the first month-over-month increase since September of last year.

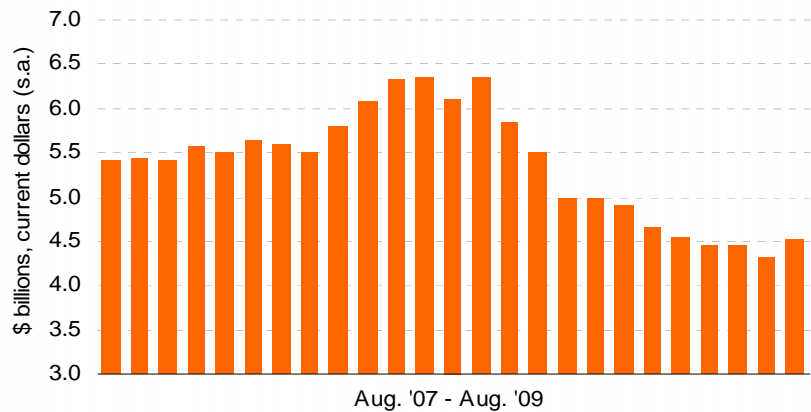
Comparing the year-to-date totals, manufacturing is still down 22% during the January to August period compared to the same period of 2008.

## Loonie Loses a Bit of Steam

After trading as high as \$US 0.975 on Thursday afternoon, the Canadian dollar has pulled back by more than a cent Friday morning.

On news this morning that the Canadian economy remains in a state of price deflation (see page 1), the loonie fell half a cent to 96.30 cents (U.S.). Spurred on by rising oil and gold prices, a depreciating US dollar, and

## Alberta Manufacturing Shipments



Source: Statistics Canada, The Daily, October 15, 2009

speculation that the Bank of Canada could follow Australia's lead in raising interest rates, traders had lifted the loonie to a 15-month high on Thursday. But the inflation report has tempered any anticipation of rate increases in Canada in the immediate future.

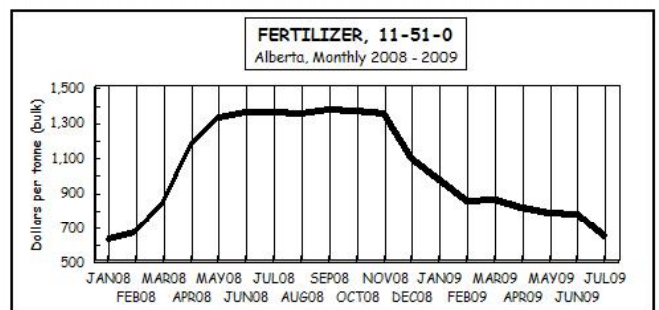
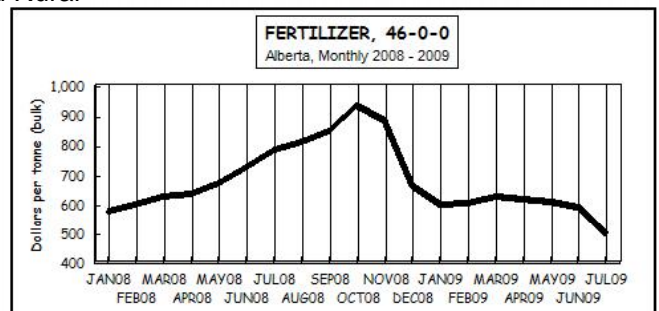
## AG UPDATE:

The average fertilizer price is less than half what it was in the fall of 2008, a pleasant surprise for crop producers. Dr. Ross McKenzie, agronomy research scientist with Alberta Agriculture and Rural Development, indicates the positive change means fall fertilizer application is definitely an option to consider. Last fall, many producers held off purchase and application due to high costs and dropping commodity prices.

Input costs have come down because the world demand for fertilizer has dropped off, and there is ample supply available. Falling

energy costs pave the way for fertilizer prices. We've all seen the white stuff on the ground this week – that doesn't mean it's too late for farmers to fertilize. Depending on the blend, application should take place late in the fall and as close to freeze-up as possible.

The graphs show the decline in price to July 2009. 46-0-0 urea is currently in the range of \$430/metric tone; while phosphate (11-51-0) is in the range of \$480/metric tonne.



# TECHNICALLY SPEAKING

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by Will Van't Veld

## Trade Flows and Currency Woes

It was great while it lasted, but it's been evident for some time now that America's trade deficit party is coming to an end. By importing and consuming far more than they export, America has been binging at the table of global trade.

Starting at the end of the '90s, the American trade balance went drastically negative. At its peak, in the third quarter of 2006, the US was consuming \$805 billion dollars more than it was actually producing. It has fallen back recently, to a trade deficit of \$339 billion, but that figure is still larger than Alberta's entire economy.

The reason for America's huge trade deficit is hotly debated.

Some argue that the deficit was simply the result of Americans' low savings rates, with foreigners more than willing to pick up the slack. Others see it a result of exchange rate manipulation, with the US dollar being manipulated by foreign governments to artificially keeping their own currencies low and stimulate exports. These aren't mutually exclusive explanations, and it's probably more a case of which had a greater effect.

It's easy to see why the low savings rate might be responsible. Think of a world with no global trade: each dollar earned is either spent or invested (or, taxed and then spent by government). By definition, "savings" is money that is not spent and must equal what was invested. A zero savings rate equals zero investment. Once trade is introduced into the picture, however, domestic investment is no longer completely dependent on the domestic savings rate. The result is a *positive* capital balance (i.e., cash) that is offset by a *negative* trade balance (i.e., cars, oil and other stuff). This allows investment to still take place, while at the same time allowing Americans to not save a dime.

But clearly, exchange rates also play a role in determining trade flows. A currency's value is influenced by demand related to the flows of goods and services (called the "trade account") and demand for investment assets (called the "capital account"). If there is an insatiable demand for investment assets, the currency's value will remain high despite a negative trade balance. This has arguably been the recent case in the US – foreigners are

just willing to pick up the slack produced by the trade imbalance by purchasing US capital assets.

What is behind foreigners' insatiable demand for America's capital assets? Is it the dynamic American economy? Or the result of currency manipulation?

A central bank can keep its currency deliberately below market value (i.e. manipulation) by accumulating foreign assets, exchanging as much of its own currency as necessary for foreign currency to maintain the exchange rate (of course if the flow is the other way, the process reverses itself). The currency can then be converted to dollar-denominated assets. This insatiable demand for assets is then just a result of government policy geared towards a low-priced currency.

China, for example, used to "peg" its exchange rate well below the level at which a freely exchanged currency would trade. China has always contended that this was more about maintaining stability rather than subsidizing its exports. To avoid an all out trade war China, however, agreed to modify its peg to a "managed peg" in 2005. Under the managed peg, the Bank of China allows the value of its currency to change slightly based on the value of a basket of currencies. At the outset of the change in policy the exchange rate did not change much, but by September 2009 the value of the Chinese yuan relative to the US dollar had appreciated by about 16% since '05. Even at this, the yuan is still likely undervalued relative to what would be the case under normal market forces, but it is a move in the right direction.

It's no surprise where the trade imbalance is concentrated. According to US trade data for 2008, Asia represents 74% of the entire imbalance, and if you include the Middle East, the figure increases to just less than 85%. These regions have been amassing US dollar denominated assets defending their currencies. China alone, for example, has amassed approximately \$US 2 trillion in reserves.

But foreign currency manipulation aside, the US greenback is depreciating against currencies around the world, including the Canadian dollar. That weakness is fueled by a belief that America's abnormally high and persistent trade balance just isn't sustainable in the long term. Neither Washington nor the US Federal Reserve are likely to step in and prop up the dollar because a low US dollar stimulates foreign demand for American exports – just the tonic that the US economy could use at the moment.

So Canada, along with America's other trading partners, should probably just get used to a weaker US dollar in the months and years ahead.

# ECONOMICALLY SPEAKING...

**ATB Financial**<sup>®</sup>

Senior Economist Todd Hirsch

## Oil Prices Tethered to Fundamentals

October 16, 2009

Oil was on fire this week!

Prices rose to nearly \$US 78 per barrel for West Texas Intermediate crude on Thursday. But the big question on everyone's mind is: *what's driving the price increase?* And, is it *sustainable?*

One big factor this week has been the depreciating US dollar. The greenback has

slipped to the lowest level in more than a year, making dollar-denominated commodities like oil and gold more affordable for investors and consumers buying in other currencies (like euros or yen).

The talking heads on the news will surely bring up "*the fundamentals*" – a phrase that's thrown around like confetti any time there's a

question of commodity prices rising too high, or falling too low.

***Do the fundamentals support the price approaching \$US 80?***

Probably not. Or at least, not yet.

For one thing, the market fundamentals are determined by the cost of the *marginal barrel of oil* coming out of the ground. That is, how much does it cost producers to extract the last barrel that goes onto the market? Given the wide range of types of projects currently producing oil – from the mature, low-cost oil fields in the Middle East to the high-cost projects like off-shore oil and oil sands – experts estimate that the "marginal cost" is presently around \$US 65-70 a barrel. Oil at nearly \$US 80 is clearly getting out of that range.

Secondly, traders seem to be anticipating that global consumption and demand is about to pick up quite a lot. But will it? For sure, the



American economy has grown much more stable over the past several months, but it's still a long way from posting good, solid economic growth. Unemployment has not yet peaked in the US, and consumer confidence remains moribund. If demand for oil is about to take off, that demand isn't likely to come from the US.

China? India? Certainly these are better bets for growing oil demand. But even here, it seems a bit overblown to suggest that these emerging economies can, on their own, lift oil prices from \$33 to nearly \$80 in less than a year.

But the single most important reason why we shouldn't get too excited about rising oil prices this week is that this is simply the nature of commodity market movements. Prices regularly overshoot on the way up, and undershoot on the way down. Speculators do play a part, but they really just tend to exaggerate the trends the market is already displaying. If market forces of supply and demand are moving prices higher, speculators tend to push them *much* higher; and if market prices are moving lower, speculators will move them *much* lower.

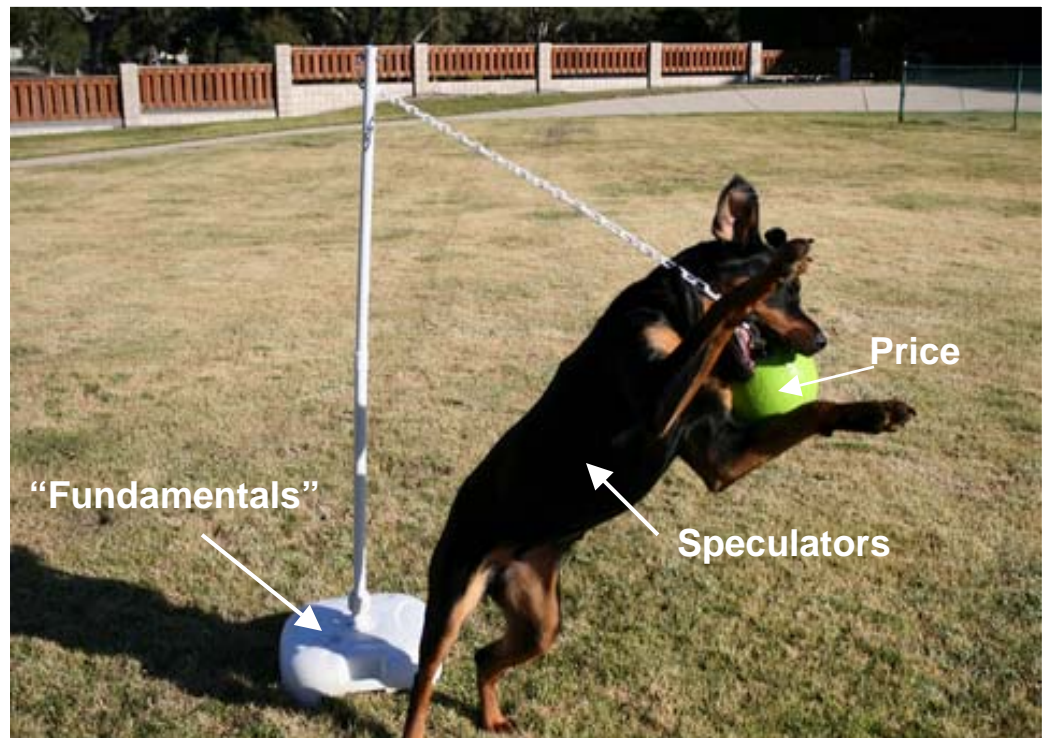
This is what we are seeing at the moment. Global supply and

demand fundamentals are, indeed, moving prices gradually higher. But commodity traders are sniffing the trend, and are moving the market price ahead of itself.

Think of global oil prices like a tether ball, where the position of the *ball* represents current price, and the position of the *post* represents the underlying global fundamentals. The ball will swing to-and-fro, and at times the size of those swings will be very dramatic (think of oil at \$147 in July 2008!). The ball may never actually be at rest with the post, but the position of the ball will always tend to move back towards the position of the post. The ball is tethered to the post, just like oil prices are tethered to global supply and demand.

It's very probable that the steep gains posted this week are being driven more by psychological factors (like market sentiment and speculation of economic recovery in the US). So some pull-back in oil prices could be expected in the days and weeks ahead.

Yet, global supply and demand fundamentals *do* point towards gradually rising oil prices in the future. A depreciating US dollar, limited supply of low-cost oil, and an inevitable recovery in the global economy will bring prices higher. The tether ball may swing back and forth around the pole, but if the pole itself is moving – the ball has no choice but to gradually move with it.



## Financial Data

Interest Rates	16-Oct-09	09-Oct-09	Equity Markets	16-Oct-09	09-Oct-09	
<i>Note: Data is as of 10 a.m. MST</i>			S&P TSX Composite	11,432.29	11,433.01	
Call Loan	0.20	0.20	Dow Jones Industrial Average	9,967.17	9,804.48	
CAD Prime Rate	2.25	2.25	NASDAQ	2,418.51	2,130.28	
Fed Funds (effective)	0.120	0.130	Commodity Prices	16-Oct-09	09-Oct-09	
USD Prime Rate (base rate)	3.75	3.75	NYMEX MMBTU(USD)	4.503	4.962	
1 month schedule I Bank B.A. (bid)	0.35	0.35	Crude Oil (WTI in USD)	77.40	71.00	
3 month schedule I Bank B.A. (bid)	0.36	0.37	Gold (London A.M. in USD)	1050.00	1048.20	
1 year CAD T-Bill (bid)	0.67	0.63	Prices \$/tonne*	15-Oct-09	09-Oct-09	1 year ago
2 year CAD Bond (bid)	1.644	1.648	<i>*Average elevator bids, Edmonton, unless otherwise noted</i>			
5 year CAD Bond (bid)	2.863	2.785	Canola (crusher FOB)	n/a	374.4	407.9
2 year CAD Swap	1.6080	1.0456	Feed Barley	n/a	115.18	138.8
5 year CAD Swap	2.9580	1.5406	Oats (Red Deer)	n/a	109.17	155.2
Implied 2 year CAD Swap in 1 Year	3.0169	1.6660	Feed Wheat	n/a	120.5	n/a
Implied 5 year CAD Swap in 1 Year	3.6830	85.3600	Alberta direct cattle sales \$/cwt			
Exchange Rates	16-Oct-09	09-Oct-09	Steers	77.0-78.00	79.5-81.2	76.75-79.00
Canada/U.S.	1.0393	1.0456	Heifers	n/a	79.5	78.25-79.75
Canada/Euro	1.5467	1.5406	Western Hog Exchange (WHE) base cash price			
Canada/GBP	1.7004	1.6660	Index 100 hogs (\$/kg)	0.939	0.997	1.013
Yen/Canada	87.60	85.36				

*Data as of Thursday, Oct. 15, 2009*

Compass Portfolio Fund Name	1 week % change	30 day % change	YTD % change	Incep (as of Sept. 30)	Compass Portfolio Fund Name	Current yield %
Compass Balanced Growth Portfolio	0.42	1.13	16.87	4.77 (12/02)	ATB Money Market Series A	0.14
Compass Balanced Portfolio	0.17	1.00	15.11	4.89 (12/02)	ATB Money Market Series I	0.24
Compass Conservative Balanced Portfolio	-0.16	0.68	14.63	5.08 (12/02)		
Compass Conservative Portfolio	-0.29	0.47	11.84	4.17 (12/02)		
Compass Growth Portfolio	0.69	1.24	17.44	4.25 (12/02)		
Compass Maximum Growth Portfolio	0.87	1.41	18.56	3.50 (12/02)		

## Economic Data

New Motor Vehicle Sales <i>seasonally adjusted</i>	Aug-08	Jul-09	Aug-09	Aug '08 to Aug '09	July to Aug 2009
	number of vehicles			% change	
<b>National Sales</b>	135,264	126,785	126,401	-6.6	-0.3
Passenger cars	72,504	63,076	62,425	-13.9	-1.0
North American	44,551	37,332	33,853	-24.0	-9.3
Overseas	27,953	25,744	28,572	2.2	11.0
Trucks, vans and buses	62,760	63,709	63,976	1.9	0.4
<b>Alberta Sales</b>	19,115	15,773	15,617	-18.3	-1.0

*More data is available in Statistics Canada, The Daily, Oct. 14, 2009*

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Where there's a way