ECONOMIC AND FINANCIAL MARKET UPDATE

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Risky business

† Investors thought they heard the death knell for global recession in May and increased their appetite for risk, shying away from government bonds and buying equities, commodities and currencies except the U.S. dollar. As a result, the global stock market index we watch increased by 12.2%, oil prices rose 34%, while non-energy commodity prices hit their highest level since November.

† We agree with the consensus that the global recession began to lose momentum in the second quarter but still expect another round of negative growth rates to be reported before the global economy starts expanding in the second half of this year.

U.S. economy's first-quarter drop sets stage for better news ahead

† The revised GDP report showed a slower pace of decline in the first quarter with real GDP contracting at a 5.7% annualized pace, down from the preliminary estimate of 6.1% and the fourth quarter's 6.3% drop.

† The sizeable drawdown in inventories in the quarter means that any pick-up in demand will need to be satisfied by new production. Other good news in the report came from the corporate sector where after-tax profits rose unexpectedly, which augurs well for the sharp contraction in business investment to slow.

† We project that the U.S. economy contracted at an annualized 2.8% in the second quarter but anticipate a return to positive growth by the second half of the year. Despite the gyrations in the quarterly numbers, we are maintaining our 2009 forecast of a 2.9% contraction in U.S. real GDP and a 2.1% increase in 2010.

Canada's economy took a dive in Q1 but suffered less than thought

† Canada's real GDP contracted by a sizeable 5.4% annualized rate in the first quarter, but the decline was smaller than expected with the consensus (and RBC) looking for a 6.5% drop. It was the marked slowing in the pace of decline in February and March that saved the economy from a more pronouced downturn.

† Going forward, with the level of inventories having been drawn down in the first quarter, any revival in demand will be met by new production. To that end, the report gave encouragement to those looking for Canada's economy to work its way out of recession later this year.

† RBC's forecast is for the economy to regain its footing in the third quarter with the second quarter's projected decline of 3.2% being softer than the first quarter's 5.4% drop. For 2009 overall, we expect a 2.4% contraction in real GDP, with a forecast of a 2.5% increase in 2010.

C$ strength presents a risk to economic outlook

For the economy, the Canadian dollar's rally means that the cost of imported machinery and equipment receded once again, giving Canadian companies relief as they invest in productivity-enhancing capital goods. On the downside, Canadian exporters, who are already struggling, face another obstacle to increasing demand for their products. On balance, the risks have grown that the trade account, which was one of the few supportive factors for the economy in the first quarter, will return to acting as a drag on output.