



Strong Markets, Soft Economies

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Global Backdrop: Light in the Tunnel

Global financial markets started 2013 on a strong footing, driven by the perception that the darkest clouds have partially parted. Even the deadlocked elections in Italy and government spending cuts in Washington failed to seriously dent sentiment for long. Europe remains the ongoing risk, although policymakers have done a reasonable job limiting the potential downside. China's economy looks to have hit an inflection point late last year and is set to again grow 8% this year and next. Even Japan is finally taking bolder action to kick start its long moribund economy. In this environment, we look for a modest improvement in global growth this year to nearly 3½% and a bit better in 2014, following a sub-par performance in 2012.

This moderately better picture relies heavily on our call for a firming U.S. economy as 2013 unfolds. We remain relatively upbeat on the U.S. outlook, although it does face a series of challenges in the months ahead. Fiscal issues continue to loom largest and gasoline prices appear to be doing their now-annual early-year sprint, thus clipping consumer spending. Finally, markets are questioning how long the FOMC will continue with QE3, with guidance on this issue coming at the March 20 FOMC meeting.

U.S./Canada Role Reversal

The U.S. economy grew faster than Canada last year for the first time since 2004, and the gap looks set to widen this year. With some of the fiscal fog lifting, credit conditions thawing, and the housing recovery looking more impressive by the day, the U.S. economy appears poised to gather momentum. Although growth was restrained around the turn of the year, we see it accelerating by the second half. While we look for a similar contour for Canada, growth is expected to consistently lag the U.S. over the forecast period.

The factors driving the broad-based economic role reversal between both countries are not hard to find. Probably the single most important difference is the degree of pent-up demand for big-ticket items; while there is next to none in Canada, there is ample bottled-up demand stateside. The glaringly different fortunes of housing alone explain most of the expected growth gap between the two economies. In a similar vein, the household credit cycles are now moving in opposite directions, with Canada cooling notably, and the U.S. finally emerging from the deep freeze. Additionally, Canadian exporters are grappling with an overvalued currency and the double discount on oil prices, while the U.S. dollar is at competitive levels and the economy is also benefitting from the dramatic upturn in domestic energy production.

The comprehensive deterioration in Canada's relative growth performance and soft commodity prices have weighed heavily on Canada's relative equity market performance. The TSX managed to handily outpace much of the world for more than a decade from 2000 until the spring of 2011. But the sag in global growth, and thus commodities, since that point has tipped the scales back in favour of the S&P 500.

The Bottom Line: While we don't believe that this underperformance of the TSX will be a permanent feature on the landscape, many of the factors that weighed on the relative performance will hang on in 2013, with the growth outlook for the underlying Canadian economy high on that list. Of course, the much more positive perspective is the flip side of this role reversal story—the gradual rejuvenation of U.S. growth and the comeback in U.S. equity markets, a theme that should build through 2013.

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