PRESS RELEASE

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Canadian exports lagging behind U.S. recovery: CIBC World Markets

TORONTO, Ontario, December 08, 2010 — The link between Canadian exports and U.S. economic growth is weakening under the weight of a strong loonie and production that is geared more to strained American households than emerging markets, notes a new report from CIBC World Markets.

While "quarterly U.S. exports have regained virtually all of the ground lost during the recession," Canada's real exports are still 15 per cent below their pre-recession peak, notes Avery Shenfeld, CIBC's Chief Economist in the latest *Global Position Strategies* report.

Canada's "underperformance dates right back to the start of this recovery," says Mr. Shenfeld, citing the Bank of Canada's U.S. Activity Index, a composite measure of American economic performance that traditionally moves in close step with Canadian exports. But of late, the two have diverged, showing that Canadian exports are"lagging behind their historical linkage" to U.S. growth.

The contrasting recoveries reflect different export focuses north and south of the border, the report notes. Countries like China, Brazil and India "are lapping up U.S.-made machinery, aircraft, vehicles and other goods. As a result, [U.S.] exports to emerging markets have been consistently outpacing American shipments to industrialized trading partners like Canada, Europe and Japan. The capital spending by corporate America to meet those needs has also been ramping up sharply."

While prices for Canadian resources are getting a lift from overseas demand, the country's "role in emerging markets remains trivial relative to its U.S.-bound exports," says Mr. Shenfeld. With continued weakness in American housing starts and auto sales, traditional drivers for Canadian exports to the U.S., Mr. Shenfeld believes Canadian "exporters will have to do a better job of integrating themselves into American supply chains for goods destined for the faster growing demand in emerging markets."

To this point, Canada's recovery has been driven by debt-financed housing, consumption and government spending. Given that deficit reduction is scheduled to commence in 2011, turning government spending into a net drag, an improved performance for Canada's exports and business investment spending would be a welcome addition to Canada's growth mix, notes Mr. Shenfeld. However, "shaping policy to see the economy on that path will be a delicate exercise."

Higher interest rates might be used to steer households away from excessive debt accumulation, but taking rates well above those in the U.S. could send the Canadian dollar to new heights. Since the exchange rate is already "weighing against export's role as a growth driver," the Bank of Canada has to tread carefully, lest it put an even greater hurdle in front of companies trying to compete in the U.S. market, says Mr. Shenfeld.

"Look for the Bank of Canada, therefore, to take a very gradualist approach to rate hikes, one timed to hold back a further trade-denting surge in the loonie. That could see rates on hold through mid-2011, and no higher than two per cent before the [U.S. Federal Reserve] launches its own hikes.

In the report, Mr. Shenfeld raised his 2011 U.S. forecast by 0.5 per cent to 2.4 per cent in light of the expected American government tax-cut deal, but also projected somewhat higher bond yields. He also raised his Canadian 2011 GDP forecast to 2.2 per cent from 1.9 per cent to capture the updraft from reduced U.S. fiscal drag.

The complete CIBC World Markets report is available at:
http://research.cibcwm.com/economic_public/download/gps_dec10.pdf