

Highlights

- Unfavourable structural forces in Europe have put a question mark over the global expansion, but we doubt the headwinds will be strong enough to derail growth in other regions of the world. We are revising down our outlook for Europe in 2010 but maintaining our forecast of global growth in excess of 4%.
- The real economies of the U.S. and Europe are not tightly linked, and the adjustment mechanisms of the U.S. economy are more robust than Europe's because its labour market is more flexible. If Europe poses a risk to the U.S., it will be through financial and credit markets. At this writing, however, U.S. financial conditions have on the whole suffered very little.
- The Canadian private sector added a record 108,000 jobs in April. As with the U.S., we are maintaining our growth forecast in 2010, with worries about Europe countered by the vigour of the labour market, but are keeping close tabs on the risk of financial contagion.

	Change from Previous Forecast				
	2009	2010	2011	2010	2011
United States					
GDP	-2.4%	3.6%	2.3%	unch	unch
CPI inflation	-0.3%	1.8%	2.4%	-0.7%	-0.1%
Overnight rate*	0.11%	0.75%	2.50%	-50bp	unch
Ten-year bond yield*	3.84%	3.98%	4.16%	-26bp	-23bp
Canada					
GDP	-2.6%	3.5%	2.1%	unch	unch
CPI inflation	0.3%	1.8%	2.4%	unch	+0.2
Overnight rate*	0.25%	1.50%	2.75%	-25bp	unch
Ten-year bond yield*	3.61%	3.95%	4.20%	-19bp	unch
USD/CAD	0.92	0.96	0.99	unch	unch

* end of period

ECONOMIC AND STRATEGY GROUP – 514.879.2529
Stéphane Marion, Chief Economist and Strategist

General: National Bank Financial (NBF) is an indirect wholly owned subsidiary of National Bank of Canada. National Bank of Canada is a public company listed on Canadian stock exchanges. ♦ The particulars contained herein were obtained from sources which we believe to be reliable but are not guaranteed by us and may be incomplete. The opinions expressed are based upon our analysis and interpretation of these particulars and are not to be construed as a solicitation or offer to buy or sell the securities mentioned herein. ♦ **Canadian Residents:** In respect of the distribution of this report in Canada, NBF accepts responsibility for its contents. To make further inquiry related to this report or effect any transaction, Canadian residents should contact their NBF Investment advisor. ♦ **U.S. Residents:** NBF Securities (USA) Corp., an affiliate of NBF, accepts responsibility for the contents of this report, subject to any terms set out above. Any U.S. person wishing to effect transactions in any security discussed herein should do so only through NBF Securities (USA) Corp. ♦ **UK Residents:** In respect of the distribution of this report to UK residents, NBF has approved this financial promotion for the purposes of Section 21(1) of the Financial Services and Markets Act 2000. NBF and/or its parent and/or any companies within or affiliates of the National Bank of Canada group and/or any of their directors, officers and employees may have or may have had interests or long or short positions in, and may at any time make purchases and/or sales as principal or agent, or may act or may have acted as market maker in the relevant securities or related financial instruments discussed in this report, or may act or have acted as investment and/or commercial banker with respect thereto. The value of investments can go down as well as up. Past performance will not necessarily be repeated in the future. The investments contained in this report are not available to private customers. This report does not constitute or form part of any offer for sale or subscription or solicitation of any offer to buy or subscribe for the securities described herein nor shall it or any part of it form the basis of or be relied on in connection with any contract or commitment whatsoever. This information is only for distribution to non-private customers in the United Kingdom within the meaning of the rules of the Regulated by the Financial Services Authority. ♦ **Copyright:** This report may not be reproduced in whole or in part, or further distributed or published or referred to in any manner whatsoever, nor may the information, opinions or conclusions contained in it be referred to without in each case the prior express written consent of National Bank Financial.

World: The euro zone struggles with its fault lines

Unfavourable structural forces in Europe have put a question mark over the global expansion, but we doubt the headwinds will be strong enough to derail growth in other regions of the world. We are revising down our outlook for Europe in 2010 but maintaining our forecast of global growth in excess of 4%.

The latest data from the Netherlands CPB Bureau for Economic Policy Analysis continue to show surging global trade flows. The latest 12-month gain of more than 15%, the strongest since 2000, leaves world trade volume up 16% from its bottom of last May and only 7% off the peak of April 2008. The surge is driven by Asia, whose imports are now 8% above their previous peak. Imports of the advanced economies are still about 14% below peak.

Asian imports are commodity-intensive. Other things being equal, Asian demand would keep commodity prices fairly firm. But other things have not been equal recently. Prices have been depressed by the rise of the U.S. dollar in response to the troubles of the euro zone.

The countries in difficulty account for about a third of euro-zone GDP, with Italy and Spain ranking third and fourth among Euroland economies. Though Europe is struggling at present, a positive outcome is possible if the political will to dissipate uncertainty emerges soon. The US\$1-trillion joint assistance plan recent adopted by euro governments and the IMF is a first step. The next step is to make the profound changes that can no longer be put off. Concrete measures for better harmonization of social and fiscal policies are needed to ensure the viability of the zone.

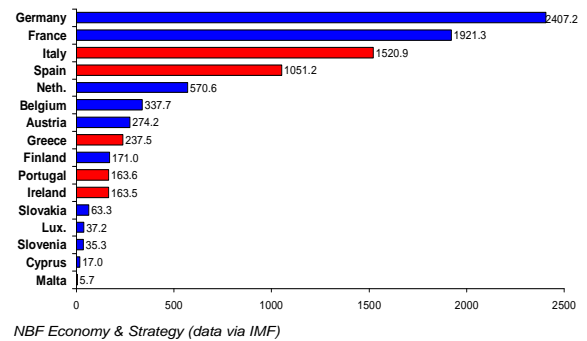
Greece remains in a parlous state to be sure, and some large European economies are sputtering. But other countries in the zone are on a recovery path. Portugal reported annualized growth of 4.1% in Q1, Italy 2.1%. For the zone as a whole, Q1 growth was 0.8% annualized.

World: Global trade is firing on all cylinders

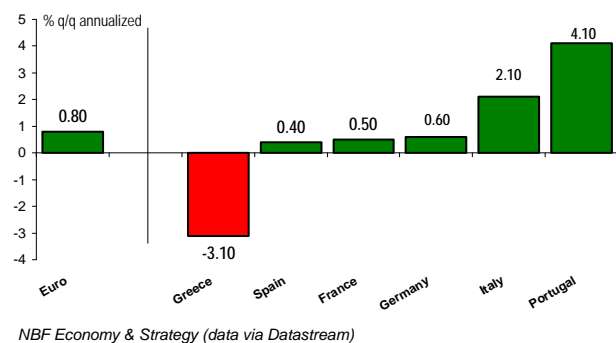


Countries in difficulty represent 35% of euro-zone GDP

GDP of euro-zone countries in 2009



Euro zone: Q1 real growth



World Economic Outlook

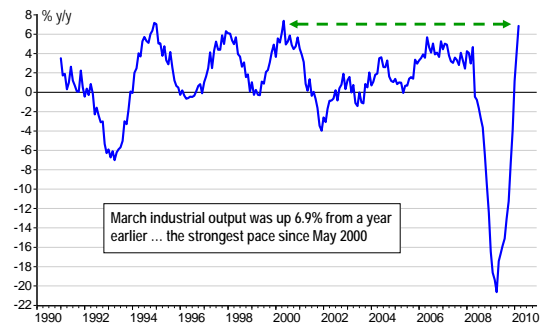
	<u>Current Forecast</u>		
	2009	2010	2011
Industrialized Countries	-3.3	2.4	2.0
<i>(share of world GDP = 50%)</i>			
United States	-2.4	3.6	2.3
Euroland	-4.0	1.0	1.6
Japan	-5.1	1.9	1.5
UK	-5.0	1.5	2.0
Canada	-2.6	3.5	2.1
Australia	1.3	3.5	2.8
New Zealand	-1.4	2.8	2.5
Asia (excluding Japan)	5.9	8.2	7.0
<i>(share of world GDP = 25%)</i>			
China	8.7	10.0	8.5
Hong Kong	-2.7	5.0	3.3
India	7.0	8.0	7.2
Indonesia	4.5	5.4	4.2
Korea	0.2	4.9	4.0
Malaysia	-1.7	5.2	3.8
Philippines	0.9	4.0	3.5
Thailand	-2.3	4.0	3.8
Taiwan	-1.9	5.1	4.2
Singapore	-2.0	6.1	4.3
Latin America	-2.6	4.4	2.9
<i>(share of world GDP = 6%)</i>			
Mexico	-6.5	4.5	2.5
Brazil	-0.2	5.5	3.5
Argentina	-2.9	4.5	2.0
Venezuela	-3.3	-3.0	1.5
Chile	-1.7	4.5	3.5
Peru	0.9	5.0	3.8
Eastern Europe	-5.6	3.8	3.2
<i>(share of world GDP = 5%)</i>			
Russia	-7.9	4.5	3.3
Czech Rep.	-4.1	1.5	2.0
Hungary	-6.5	0.0	2.2
Poland	1.7	2.5	2.8
Turkey	-5.8	4.5	3.8
World	-0.8	4.3	3.6

Source: NBF Economic Research, Consensus Economics

Euro-zone industrial production has also bottomed and in volume terms is now up more than 6% from a year ago. True, that leaves it still very low. Also, the €762-billion exposure of European banks to Spain, Greece and Portugal could squeeze available credit to the euro-zone private sector. In sum, Europe is likely to recover much more slowly than the rest of the world. Its economic torpor will amplify the structural problems of its public finances.

Euro zone: Cyclical forces are not dead

12-month change in industrial production – volume terms



NBF Economy & Strategy (data via Datastream)

Despite the unfavourable structural forces in Europe opposing the cyclical momentum of the global economy, we do not think the euro zone will disappear anytime soon. Euro-denominated private-sector debt is highly ramified throughout the zone and a dismantling of the common currency would wreak havoc on balance sheets, not to mention financial distress and many bankruptcies. The much less costly solution is a migration to greater harmonization of social and fiscal policies.

That said, we are keeping very close tabs on Europe and the risk of contagion, which is non-negligible. At this writing, the structural headwinds from the euro zone are not strong enough to derail expansion in other regions of the world. We are therefore revising down our outlook for Europe in 2010 but maintaining our forecast of global growth in excess of 4%.

U.S.: A more resilient economy

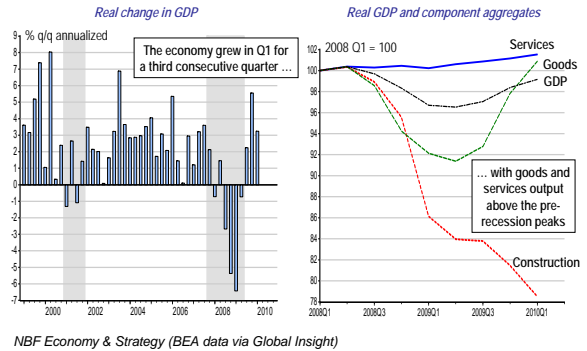
The real economies of the U.S. and Europe are not tightly linked, and the adjustment mechanisms of the U.S. economy are more robust than Europe's because its labour market is more flexible.

U.S. real GDP grew at 3.2% annualized in Q1. It was a third straight quarter of expansion and it brought GDP within 1.2% of the pre-recession peak. Two of the three main components of U.S. demand – goods and services – have now topped their previous peak. The lagging component is construction, which accounts for only 7% of GDP. In other words, more than 90% of U.S. demand has now moved from a recovery to an expansion phase.

Payroll employment was reported up 290,000 in April on top of upward adjustments totalling 121,000 for the previous two months. Of the jobs added in April, 231,000 were in the private sector. According to the household survey, the U.S. has gained almost 2 million jobs in the last four months. According to the payroll survey, the gain is 573,000. The household-survey advance, the strongest since 1994, puts the U.S. recovery on a self-sustaining path. Though the unemployment rate rose 0.2 percentage points in April, the employment-to-population ratio rose to an eight-month high of 58.8%. If the U.S. credit market does not deteriorate too much in reaction to European developments, we expect the payroll survey will catch up to the household survey in the months ahead, with further upward revisions of previously reported numbers.

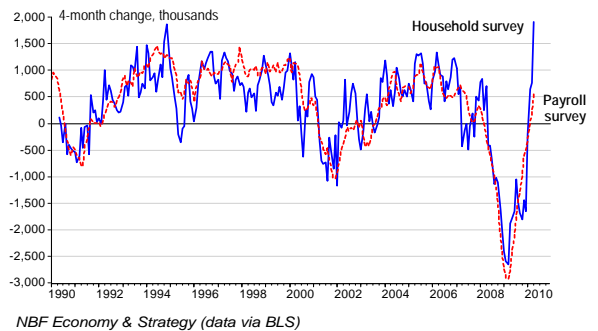
U.S. consumer spending continues to expand. Retail sales were up 0.4% in April, both including and excluding motor vehicles. Though volume retail sales are published with a one-month lag, the report confirms solid real growth early in the second quarter: The second quarter is already up 5.1% annualized from the first quarter average. So the U.S. economy is likely to show very respectable growth again in Q2, especially since the return of job creation will keep the aggregate wage bill expanding.

U.S.: Over 90% of the economy past the pre-recession peak



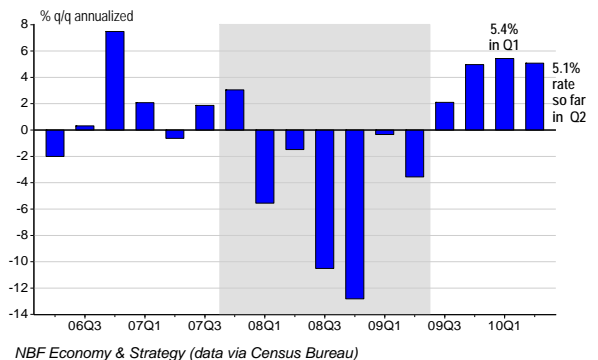
U.S.: Employment growth is back

Jobs added according to household survey and payroll survey



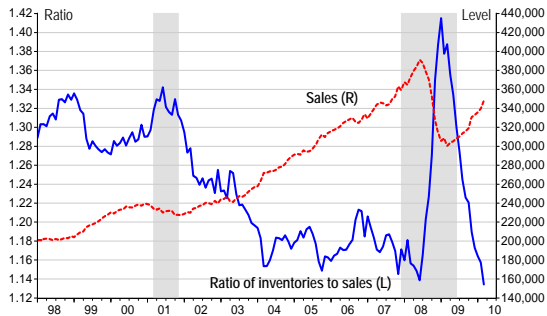
U.S. retail sales off to a strong start in Q2

Volume sales



Wholesaling: Inventories in need of rebuilding

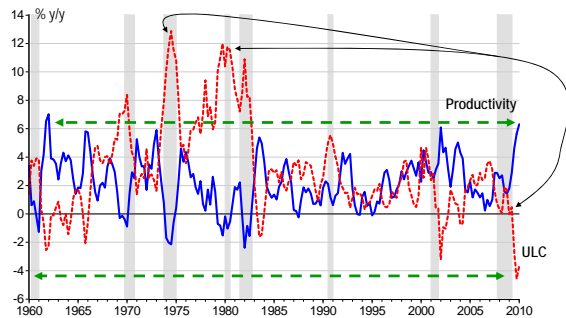
Sales and inventory-to-sales ratio of U.S. wholesalers



NBF Economy & Strategy (data via Global Insight)

U.S.: Striking productivity gains

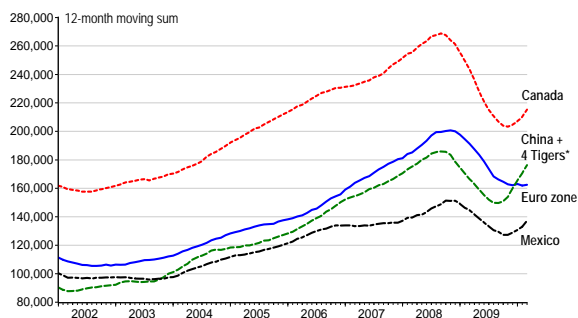
12-month changes in labour productivity and unit labour cost



NBF Economy & Strategy (data via BLS)

Asia passes Europe as second-biggest U.S. customer

U.S. goods exports to selected countries and regions



* Hong Kong, Korea, Singapore, Taiwan

NBF Economy & Strategy (data via BEA)

On the production side, momentum in manufacturing continues to surprise. New orders for nonmilitary capital goods – a key advance indicator of investment in machinery and equipment – were up 4.5% in March. The second quarter began strongly, with shipments excluding aircraft up 8.6% and new orders up 16.5% annualized, the strongest gain since the first quarter of 2006.

Strength in manufacturing is pulling up other sectors of the economy. Wholesale sales are up, for example, and inventories fell so steeply during the recession that the inventory-to-sales ratio is now at an all-time low of 1.13. The need to restock is likely to lift economic output further.

The U.S. and European stories are different in two important ways. First, U.S. growth is distinctly more robust. Second, the quality of that growth continues to impress. Labour productivity jumped 3.6% in Q1 for a year-over-year gain of 6.3%, the second-best since data have been compiled. As a result, unit labour costs were down an unprecedented 4%-plus from a year earlier. The strength of productivity and the recent easing of gasoline prices prompt us to revise down our U.S. inflation scenario.

The adjustment mechanisms of the U.S. economy are on the whole much stronger than Europe's because of the greater flexibility of its markets for products and labour. As a result the U.S. cyclical rebound is stronger and the U.S. economy is more resilient in the face of shocks.

The U.S. real economy is at little risk from European developments. U.S. exports to Europe have been outpaced by those to Asia, now the U.S.'s second-biggest customer. If Europe poses a risk to the U.S., it will be through financial and credit markets and a possible effect on confidence that would hurt the private sector. At this writing, however, U.S. financial conditions have on the whole suffered very little and confidence is still rising.

Canada: Employment surprises again

The Canadian private sector added a record 108,000 jobs in April. As with the U.S., we are maintaining our growth forecast in 2010, with worries about Europe countered by the vigour of the labour market, but are keeping very close tabs on the risk of financial contagion.

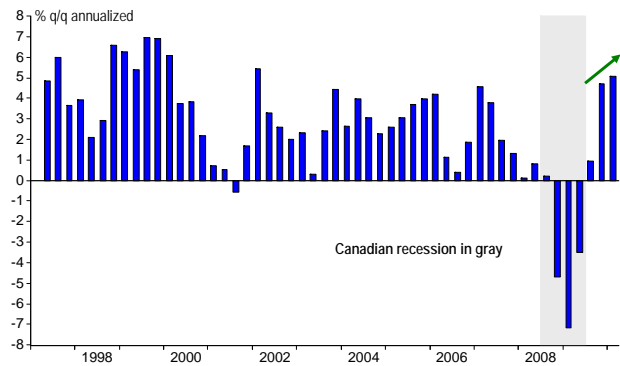
The monthly growth of Canadian real GDP remains on track to meet expectations for the first quarter. The economy seems to have accelerated further from the strong pace of Q4. The country's output gap is closing fast.

Much of the drive comes from manufacturing, which is buoyed by recovery of U.S. domestic demand and by inventory rebuilding. The latest data show factory-sector output growing faster than at any time since 1998.

This acceleration combined with growth in other sectors is juicing the labour market. Total employment jumped a record 108,700 in April, and the percentage gain was among the top five or six on record. The private sector stole the show with an addition of 108,500 jobs. As the chart shows, private-sector employment has accelerated strongly and is now up 1.2% from a year ago. It is no surprise, then, that domestic demand is on a roll. The Canadian wage bill is 1.7% above its pre-recession summit and is up a robust 4.3% so far in Q2.

There is a downside to the Canadian employment gains. In this country relative to the U.S., economic growth has translated disproportionately into employment, implying an ever-greater lag in labour productivity. In the short term this is not a problem. Over the medium term, however, real wages will suffer if the trend is not corrected. Though a 9.5% jump in machinery and equipment imports in Q1 shows that Canadian producers are moving in the right direction, more is needed.

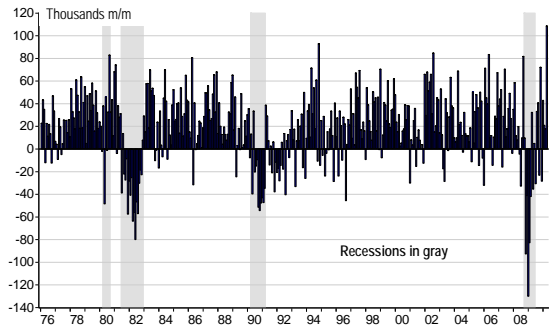
Canada: After a torrid pace in Q4, acceleration in Q1
Quarterly real change in GDP at basic prices



NBF Economy & Strategy (data via Statistics Canada)

April: A month for the record book

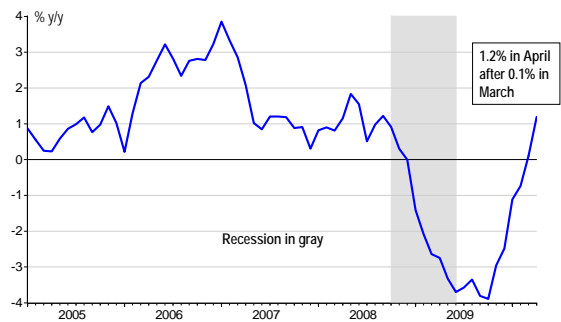
Monthly change in Canadian employment



NBF Economy & Strategy (data via Statistics Canada)

Private-sector hiring on a roll

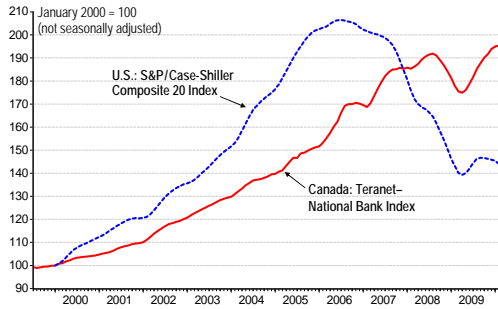
12-month change in private-sector employment



NBF Economy & Strategy (data via Statistics Canada)

Canada: Home prices back above pre-recession peak

Teranet–National Bank House Price Index (Canada),
S&P/Case-Shiller Composite 20 Index (U.S.)



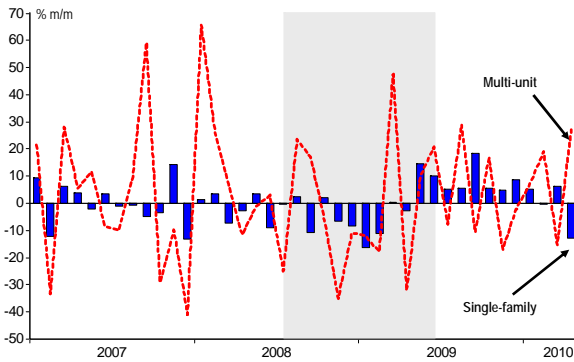
NBF Economy & Strategy

Home prices have been reflatting for some time now with the support of credit availability, labour market strength and low interest rates. As the chart shows, the Teranet–National Bank index is now above its pre-recession peak after 10 straight months on the rise. Its 12-month increase is now 9.9%.

The month-over-month rise of the Canadian index has recently slowed appreciably. The 12-month rise continues to accelerate, because prices were still deflating a year earlier. This base effect will continue for another month or two. That said, the ratio of Canadian home prices to disposable income is now high. The effect of this development on affordability is offset for now by low mortgage rates.

Have housing starts peaked?

% monthly change



NBF Economy & Strategy (data via Statistics Canada)

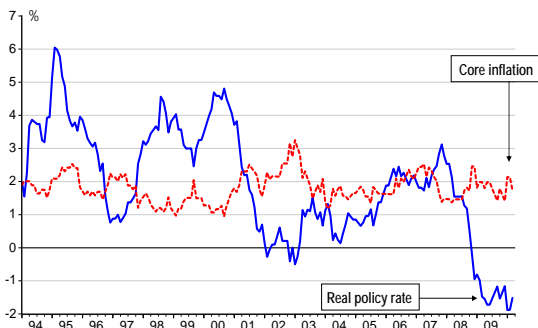
Housing starts edged up in April to an annual rate of 201,700 units. However, starts of single-family homes in urban areas fell 12.7%, the largest decline since the recession. This drop was offset by a rise in multi-unit starts. Is the April report a foretaste of the path of Canadian residential investment in coming quarters?

Since looming interest-rate rises have spurred many homebuyers to act sooner rather than later, we think homebuilding is likely to cool in the quarters ahead, perhaps enough to subtract from economic output.

As the last chart shows, monetary policy has never been lodged so deep in accommodative territory. This stance has revived a recession-hit housing market, but the Bank of Canada must soon take away the punch bowl.

Inflation still near 2%

Real Bank of Canada policy rate and core inflation rate (CPIX)



As with the U.S., we are maintaining our growth forecast in 2010, with worries about Europe countered by the vigour of the labour market, but are keeping very close tabs on the risk of financial contagion.

Yanick Desnoyers
Assistant Chief Economist

Canada Economic Forecast

<i>(Annual % change)*</i>	2007	2008	2009	2010	2011	Q4/Q4	
						2010	2011
Gross domestic product (2002 \$)	2.5	0.4	(2.6)	3.5	2.1	4.1	1.2
Consumption	4.6	3.0	0.2	2.9	2.6	2.6	2.7
Residential construction	2.9	(2.7)	(7.4)	8.5	1.2	2.4	1.0
Business investment	3.7	0.2	(17.4)	0.1	7.2	5.6	6.3
Government expenditures	3.7	4.8	4.5	4.2	2.6	2.4	2.5
Exports	1.1	(4.7)	(14.0)	6.1	2.3	5.0	1.0
Imports	5.8	0.8	(13.4)	7.5	5.1	3.7	5.7
Change in inventories (millions \$)	14,990	12,241	(4,900)	4,750	7,000	7,000.0	7,000.0
Domestic demand	4.1	2.6	(1.7)	3.3	3.0	2.9	3.0
Real disposable income	3.6	4.2	1.4	2.3	2.3	2.5	2.2
Employment	2.3	1.5	(1.6)	1.0	1.2	1.3	1.2
Unemployment rate	6.0	6.2	8.3	8.1	7.8	7.9	7.7
Inflation	2.2	2.4	0.3	1.8	2.4	2.3	2.5
Before-tax profits	4.1	5.7	(33.2)	18.0	8.6	15.0	5.0
Federal balance (Public Acc., bil. \$)	\$9.6	\$0.0	(\$45.0)	(\$30.0)	(\$20.0)
Current account (bil. \$)	\$15.6	\$8.1	(\$41.3)	(\$12.3)	\$1.5	(\$5.0)	\$2.0

* or as noted

Financial Forecast*

	Current 5/21/10	Q2	Q3	Q4	Q1/11	2010	2011
Overnight rate	0.25	0.50	1.00	1.50	2.00	1.50	2.75
Prime rate	2.25	2.50	3.00	3.25	3.75	3.25	4.50
3 month T-Bills	0.38	0.76	1.26	1.75	2.23	1.75	2.72
Treasury yield curve							
2-Year	1.69	1.98	2.29	2.59	2.61	2.59	3.26
5-Year	2.62	2.93	3.20	3.39	3.46	3.39	3.84
10-Year	3.35	3.65	3.84	3.95	4.05	3.95	4.20
30-Year	3.77	4.00	4.09	4.12	4.20	4.12	4.32
Exchange rates*							
USD per CAD	0.94	0.98	1.00	0.96	0.97	0.96**	0.99**

National Bank Financial

* end of period

** annual average

United States Economic Forecast

(Annual % change)*	2007	2008	2009	2010	2011	Q4/Q4	
						2010	2011
Gross domestic product (2005 \$)	2.1	0.4	(2.4)	3.6	2.3	3.7	1.7
Consumption	2.6	(0.2)	(0.6)	2.5	1.8	2.8	1.5
Residential construction	(18.5)	(22.9)	(20.5)	(0.8)	9.7	1.3	10.0
Business investment	6.2	1.6	(17.8)	3.3	7.5	7.3	6.2
Government expenditures	1.7	3.1	1.8	1.3	2.2	1.8	2.0
Exports	8.7	5.4	(9.6)	9.9	4.6	6.7	3.0
Imports	2.0	(3.2)	(13.9)	9.3	5.4	7.5	4.5
Change in inventories (bil. \$)	19.5	(25.9)	(108.3)	80.3	56.3	100.0	50.0
Domestic demand	1.7	(0.4)	(2.7)	2.2	2.7	3.0	2.3
Real disposable income	2.2	0.5	0.9	1.3	2.3	2.3	1.8
Household employment	1.2	(0.5)	(3.8)	0.1	1.9	2.4	1.5
Unemployment rate	4.6	5.8	9.3	9.4	9.0	9.0	8.9
Inflation	2.9	3.8	(0.3)	1.8	2.4	1.7	2.1
Before-tax profits	(4.1)	(11.8)	(3.8)	17.7	5.5	8.0	4.0
Federal balance (unified budget, bil. \$)	(\$161.0)	(\$459.0)	(\$1,800.0)	(\$1,200.0)	(\$1,100.0)
Current account (bil. \$)	(\$746.0)	(\$690.0)	(\$410.0)	(\$490.0)	(\$450.0)	(\$450.0)	(\$450.0)

* or as noted

Financial Forecast

	Current 5/21/10	Q2	Q3	Q4	Q1/11	2010	2011
Fed Fund Target Rate	0.20	0.23	0.23	0.75	1.25	0.75	2.50
3 month Treasury bills	0.16	0.17	0.58	1.08	1.58	1.08	2.43
Treasury yield curve							
2-Year	0.77	0.82	1.11	1.63	1.94	1.63	2.87
5-Year	2.03	2.19	2.52	2.89	3.11	2.89	3.58
10-Year	3.24	3.46	3.78	3.98	4.10	3.98	4.16
30-Year	4.10	4.30	4.55	4.68	4.74	4.68	4.67
Exchange rates*							
U.S.\$/Euro	1.25	1.20	1.18	1.20	1.22	1.28**	1.26**
YEN/U.S.\$	90	92	95	98	100	95**	102**

National Bank Financial

* end of period

** annual average