PRESS RELEASE

For immediate release

Laurentian Bank of Canada economic and financial outlook for 2007

Montréal, December 27, 2006 - Carlos Leitao, chief economist and strategist and Sébastien Lavoie, economist of Laurentian Bank Securities have disclosed this morning their 2007 economic and financial outlook.

Economic and financial outlook for 2007
By *Carlos Leitao, Chief Economist*
The U.S. economy has proven to be remarkably resilient, despite the relentless focus on downside risks. The economic slowdown remains well contained, with housing and automobile assembly the only main areas of weakness.

The Canadian economy is also in the midst of a significant slowdown that we still think should be relatively short-lived. Nevertheless, the downside risks are important and far outweigh upside risks.

As such, the Bank of Canada is still expected to lower interest rates this spring. Nevertheless, this should be seen more as an insurance policy against a deeper slowdown rather than the start of a new easing cycle.

The U.S. economy has proven remarkably resilient
Despite the relentless focus on the downside risks, the U.S. economy has proven to be quite resilient, posting a rate of growth of about 3.3% in 2006. For 2007, we now forecast an annual average rate of growth of 2.5%. Nevertheless, this slowdown is more arithmetic than reflective of an underlying economic event. In fact, we expect economic growth to gradually accelerate throughout the year, with the economy returning to potential by Q4-2007.

Evidence continues to mount to the effect that housing and automobile assembly remain the only major sources of weakness and that so far, this has not "spilled-over" into the rest of the economy. In fact, overall job growth continues to chug along, sustained by healthy gains in the service sector. In November, non-farm payrolls increased by 132,000 jobs and the rate of unemployment hit a near record low of 4.5%; the year-to-date monthly average of job gains is now a respectable 149,300. Nominal annual wage growth reached 4.1% in November, which further narrowed the Fed's "discomfort" index to 40 basis points (that is to say 4.5%-4.1%), from 50 basis points in October and a much wider 200 basis points one year earlier. This clearly implies that the Federal Reserve is not about to significantly change its tune any time soon, <u>even if it wanted to</u>. No change in the monetary policy stance is therefore likely before the second quarter of 2007 at the earliest. The Fed will then reduce interest rates by about 50 basis points. However, this should not be interpreted as the start of a new easing cycle but rather as an "insurance" against a longer slowdown.

The "soft landing" scenario is still very much on track

In fact, for some time now, the Federal Reserve has been trying to engineer a "soft landing" of the U.S. economy in order to reduce inflationary pressures. These pressures result from rising wages in an environment of virtually full employment of domestic labour and capital resources. To slow the economy down, the Fed pushed short-term interest rates up by 425 basis points from June 2004 to June 2006. A slowdown in U.S. consumer spending is now clearly underway which is both "inevitable" and "desirable", as Fed Vice Chairman Donald Kohn declared in October. Sub-potential economic growth into the first semester of 2007 should allow for core inflation to gradually ease and finish the year under 2.5%. The rate of unemployment could well rise towards 5%, but that would still be relatively low by historical standards.

Significant risks remain but they are manageable

One of the key assumptions behind our (and the Fed's) "soft landing" scenario is that the U.S. housing market will undergo only a mild correction, slowing overall consumer spending enough to ease inflationary pressures but not hard enough to tip the economy over into recession. Although severely tested in the second semester of 2006, this assumption still holds. In fact, we expect demand for housing to hit bottom in the fourth quarter of 2006, and then to remain relatively flat throughout 2007.

Canada's moderate growth outlook for 2007 should be short-lived…
By Sebastien Lavoie, Economist

The Canadian economy is right in the middle of a «soft landing» period. Real GDP growth moderated in the third quarter to 1.7% (on a Q/Q annualized basis) from 2.0% in the second quarter. Even though on surface this suggests that the Canadian economy expanded at its weakest pace in three years, the details were not worrisome. Consumer spending and business investment continued to be pillars of strength, amid a strong performance of the labour market and a solid profitability of Canadian firms. The slight deceleration in output growth was related to three factors: a sizeable drop in investment of inventories, a temporary softening in government spending (due to the end of the Census), and, to a lesser extent, the beginning of the gentle landing in residential construction. Surprisingly, inflation-adjusted net exports (exports minus imports) were not a drag on growth in the third quarter despite a slowing U.S. economy, as exports growth momentarily bounced back in positive territory.

Based on the economic indicators released of late, we estimate that the Canadian economy expanded at a similar moderate pace in the last quarter of the year (1.7%). While we expect business investment and consumer spending to remain healthy, the weakening in U.S. demand will bring down exports for the third time in the last four quarters and narrow Canada's merchandise trade surplus.

Given the weaker-than-expected real GDP growth observed in the third quarter and that a similar figure is in the cards for the fourth quarter, the performance of the Canadian economy in the second half of 2006 is somewhat weaker than we previously anticipated. With this weak handoff, look for economic growth to moderate at 2.3% in 2007, from 2.8% this year. This having been said, the real story resides in the quarterly profile. The last quarter of 2006 is likely to be the bottom in terms of economic growth. As we move forward into the new year, the pace of expansion of the economy is anticipated to regain gradually some steam in tandem with the anticipated U.S. economic rebound. Real GDP is forecast to grow close to its long-term trend (2.9%) by the last quarter of 2007. With the economy keeping this momentum thereafter, overall growth is forecast at 2.9% in 2008.

Sub-par economic growth will translate into fewer job creation in 2007 and a modest increase in the jobless rate to 6.9%, which is still low by historical standards. It also means that a bit of slack in the economy will build up, waning upward inflation pressures in the early stages of 2007 and eventually pushing the Bank of Canada to change its tune. The Bank is expected to stay on the sidelines in the first three months of 2007, as it has done since the summer of 2006, before lowering its policy rate by a small cumulative 50 basis points during the second quarter, just enough to ensure that the economic slowdown stays moderate and short-lived. This would leave the overnight rate at 3.75% by mid-year.

Downside risks could deepen and lengthen the slowdown

While our base-case scenario calls for modest real GDP growth of 2.3% in 2007, we have mentioned for quite some time that the five following risks could dampen the outlook:

The US real estate market

In October, the median price of homes on the resale market was a modest 3.5% lower than a year ago and listings of new unsold properties are at an 18-year high. On the positive side, mortgage rates have declined lately and housing starts rebounded from the lowest level in more than six years in November. The odds of a fallout of the U.S. housing market may have declined but remain present. The combination of further and sustain reduction in resale home prices could weigh on households' confidence and consumer spending and bring the U.S. economy over into recession.

Cost of energy

The slowing of the energy-hungry U.S. economy explained in part why crude oil prices pulled back this summer and traded around US$60/bbl since September. However, the supply/demand remains tight and any supply disruption or unexpected geopolitical events could drive up prices sharply and hit the world economy.

Disorderly depreciation of the US dollar

This year's U.S. trade deficit is well on track to be more sizeable than that of 2005 (US$724 billion). So far, foreign investors have financed «excesses» of Americans' habits. However, the softening in economic conditions could potentially have snow ball effects: the U.S. could become suddenly less attractive, thereby triggering a more rapid (and disorderly) depreciation of the US dollar which, in turn, could push long-term interest rates up sharply.

A manufacturing recession in Quebec and Ontario

The export-oriented manufacturing sector represents about one-fifth of overall real GDP in the two largest provincial economies of the country. And, unfortunately, both employment and output in that sector have been declining for quite a while. There is always the risk that this weakness could deteriorate households' confidence and spread to the rest of the economy, notably consumer spending and housing demand.

Political risks: 2007 will be an election year

Ontario has fixed election dates with the next one scheduled for October 2007. In Quebec, the provincial government is likely to call an election within the next 12 months. Lastly, the odds of another federal election this year are also high, which could potentially further fuel volatility in financial markets, notably the currency. But more importantly, the risk of a simultaneous deadlock is real and one should not underestimate the consequences of policy paralysis for an extended period.

-30-

Information:

Manon Stébenne
Senior advisor
Public Affairs and Communications
Office: 514 284-4500, extension 8232