

Global Forecast Update

Inflation Rising

- **Price pressures are building around the world. While the largest gains in consumer price inflation are more evident in the faster-growing emerging economies, the sharp rise in commodity prices is contributing to a renewed, albeit gradual, upswing in the slower-paced developed world. Policy is in the process of shifting from more to less accommodation, especially in the faster-growing regions of the world.**

The recession and financial crisis put inflation down and out. Now, two years into recovery, inflation is up and in. Around the world, price pressures are regaining momentum, though inflation is higher, and the pace of acceleration is faster in the emerging economies than the lower and slower performances in the developed nations. This month's forecast lifts consumer price inflation in a number of countries, both emerging and developed.

For the most part, emerging economies weathered the global downturn better than most of their debt-heavy developed counterparts, and have recovered at a much faster rate after being injected with significant doses of monetary and fiscal stimulus. They are now more susceptible to inflationary pressures because domestic credit conditions are still quite accommodative, economic growth is stronger, capacity utilization is tighter, and buoyant labour markets are triggering increased wage pressures. The steady rise in commodity prices, partly a function of the increasing demand by emerging markets for oil and food, has been compounded by increased geopolitical tensions and adverse agricultural growing conditions that have aggravated supplies. Emerging market officials have begun to tighten policies to rein in inflation, though the incremental adjustments, and modest currency appreciation, have not yet had a measurable impact.

Developed economies outside of Japan are also witnessing increased price pressures, though inflation is rebounding from much lower levels and at a slower pace. Policymakers have been slow, or in the case of the United States, reluctant, to reduce monetary and fiscal stimulus. This is a reflection of the pervasive concern over the underlying strength of economies whose growth potential is being constrained by a combination of excessive levels of household debt, lingering housing market weakness, soft employment gains, and the rehabilitation of the financial sector. Despite historically large output gaps, price pressures have re-emerged as the sharply higher prices for many key commodities — oil, food, and cotton, for example — pass through the production chain. Wage pressures are still relatively modest in the developed world, though labour shortages — principally in the commodity-producing regions, but also in higher-growth export-sensitive sectors — are beginning to resurface. Developed nations with both weaker growth and currencies, such as the United States, are witnessing slightly higher inflation, while countries like Canada and Germany with comparatively stronger economies and currencies are also being impacted.

Global inflationary pressures are likely to persist. In large part this reflects the underlying resilience of the global economy in the face of the drag on household and business spending caused by rising oil prices, the intensifying fiscal consolidation triggered by repeated sovereign debt strains, particularly in the peripheral euro countries, and more recently, the supply chain disruptions in manufacturing caused by the earthquake-related problems in Japan. Around the world, purchasing managers continue to report a high level of activity that

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largely reflects the ongoing strength in demand for products and services emanating from the faster-growing emerging markets, a development that will likely keep commodity prices at elevated levels.

In this environment, officials in emerging economies will continue to tighten policy, and favour stronger domestic currencies, though the adjustments will likely remain gradual in support of growth. Because the developed nations are on slower growth and inflation trajectories, the adjustment process will be more challenging and comparatively less aggressive.

Spotlight on Canada

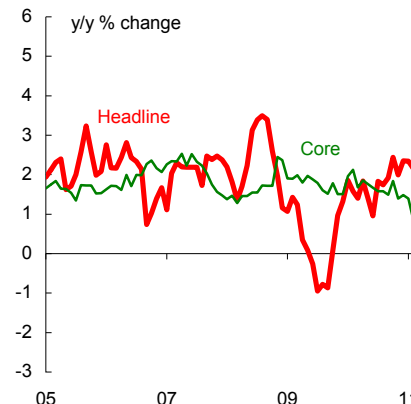
Canada's latest consumer inflation report has raised some alarm bells. Headline inflation jumped to a 2½-year high of 3.3% y/y in March, up a full percentage point from the prior month and breaching the upper limit of the Bank of Canada's 1-3% target range. Not surprisingly, the biggest contributors to the acceleration were rising costs for energy and, more recently, food. Excluding energy and food, inflation is tracking more than a percentage point lower.

However, there is also evidence that rising energy and non-energy commodity prices may be beginning to infiltrate broader price trends. Core inflation also jumped in March, to 1.7% y/y. While there are some temporary factors obscuring year-over-year comparisons, including price level effects from the 2010 Winter Olympics and the impact of HST-related tax refunds, price increases in March were widespread.

For the time being, continued excess capacity, Canadian dollar strength (and its lagged effects on growth and inflation), limited retail pricing power and well anchored inflation expectations will keep underlying price pressures in check. Nonetheless, the trend is biased higher as excess capacity is gradually absorbed, and rising manufacturing costs continue to pressure wholesale and retail margins. Headline inflation may well edge higher before stabilizing in the second half of the year. While the transmission of rising oil prices to consumer inflation is fairly immediate, rising agriculture prices take much more time to feed through to retail food prices. This implies the roughly 40% jump in agricultural prices (measured by Scotiabank's Commodity Price Index) since last May is just now beginning to appear on grocery store shelves. Assuming commodity prices settle around current levels, headline inflation should converge back in line with core price trends in 2012.

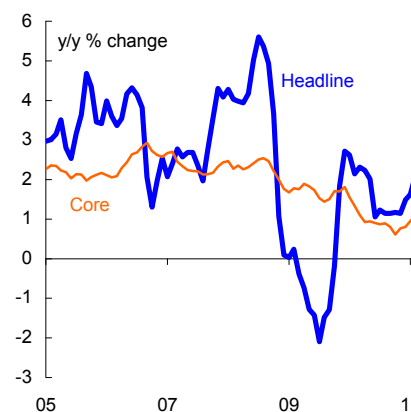
(For a more complete perspective on foreign exchange trends, please refer to our May 2011 *Foreign Exchange Outlook* at http://www.scotiacapital.com/English/bns_econ/fxout.pdf.) ■

Canadian CPI



Source: Statistics Canada.

U.S. CPI



Source: BLS.

Global Forecast Update

North America	2000-09	2010	2011f	2012f
	(annual % change)			
Canada				
Real GDP	2.1	3.1	2.9	2.6
Consumer Spending	3.2	3.4	2.8	2.5
Residential Investment	3.7	10.4	-1.0	1.2
Business Investment	2.1	5.2	11.2	8.4
Government	3.5	5.0	1.3	-1.0
Exports	-0.7	6.4	6.9	6.5
Imports	2.0	13.4	6.2	5.2
Nominal GDP	4.5	6.2	5.5	4.7
GDP Deflator	2.4	3.0	2.5	2.0
Consumer Price Index	2.1	1.8	2.8	2.3
Core CPI	1.9	1.7	1.6	1.9
Pre-Tax Corporate Profits	2.9	18.4	12.5	11.0
Employment	1.6	1.4	1.4	1.1
thousands of jobs	241	231	244	195
thousands of jobs (Q4/Q4)	229	279	230	208
Unemployment Rate (%)	7.0	8.0	7.6	7.4
Current Account Balance (C\$ bn.)	14.1	-50.0	-42.6	-35.6
per cent of GDP	1.2	-3.1	-2.5	-2.0
Merchandise Trade Balance (C\$ bn.)	51.8	-8.6	3.0	9.0
Federal Budget Balance (C\$ bn.)	2.0	-39.5	-30.5	-20.5
per cent of GDP	0.3	-2.4	-1.8	-1.1
Housing Starts (thousands)	201	190	175	175
Motor Vehicle Sales (thousands)	1,591	1,557	1,590	1,605
Motor Vehicle Production (thousands)	2,481	2,100	2,150	2,400
Industrial Production	-0.6	4.7	4.8	4.5
United States				
Real GDP	1.8	2.9	2.6	2.8
Consumer Spending	2.4	1.7	2.9	2.8
Residential Investment	-5.0	-3.0	-1.4	7.2
Business Investment	0.7	5.7	7.7	6.0
Government	2.1	1.0	-0.9	-0.6
Exports	3.1	11.7	6.9	7.0
Imports	2.5	12.6	4.3	5.5
Nominal GDP	4.2	3.8	4.1	4.5
GDP Deflator	2.4	1.0	1.5	1.6
Consumer Price Index	2.6	1.6	2.8	2.0
Core CPI	2.2	1.0	1.2	1.4
Pre-Tax Corporate Profits	3.9	29.2	7.5	8.0
Employment	0.1	-0.7	1.3	1.8
millions of jobs	0.18	-0.97	1.63	2.35
millions of jobs (Q4/Q4)	-0.09	0.70	2.29	2.12
Unemployment Rate (%)	5.5	9.6	8.7	8.2
Current Account Balance (US\$ bn.)	-574	-470	-541	-570
per cent of GDP	-4.7	-3.2	-3.5	-3.6
Merchandise Trade Balance (US\$ bn.)	-634	-647	-729	-787
Federal Budget Balance (US\$ bn.)	-318	-1,294	-1,395	-1,195
per cent of GDP	-2.3	-8.8	-9.1	-7.5
Housing Starts (millions)	1.54	0.59	0.60	0.85
Motor Vehicle Sales (millions)	15.8	11.6	12.7	13.5
Motor Vehicle Production (millions)	10.9	7.7	8.2	8.8
Industrial Production	-0.1	5.7	4.3	3.8
Mexico				
Real GDP	1.9	5.5	4.3	3.8
Industrial Production	0.8	6.1	4.7	3.9
Consumer Price Index (year-end)	4.9	4.4	4.1	4.1
Current Account Balance (US\$ bn.)	-10.7	-5.7	-11.7	-17.8
per cent of GDP	-1.5	-0.6	-1.0	-1.4

Forecast

Changes

Canada & United States

- We have trimmed our forecast for Canadian and U.S. output growth in 2011 to 2.9% and 2.6%, respectively. Global supply shortages caused by recent events in Japan have led to some temporary production disruptions, primarily in the large motor vehicle and parts sector, though these losses are partially expected to be recouped in the second half of the year. Adding to the slightly softer tone of the current quarter are recent signs that high gas prices are beginning to dampen consumer spending on more discretionary purchases.
- Given persistently high commodity prices, and a modest upward revision to our forecast for crude oil in 2011-2012, we anticipate slightly higher headline consumer inflation in both countries relative to our early April *Update*. Core inflation pressures remain generally well contained.
- In the shadow of Canada's federal election, data for the first 11 months of fiscal 2010-11 (FY11) point to a deficit that potentially betters the government's \$40.5 billion estimate. Mid-way through fiscal 2011, U.S. federal revenues are up almost 7% from a year ago, but program spending and net interest are both more than 10% higher, though negotiated restraint should narrow this gap in the second half of the year.

Mexico

- Retail sales, strong exports, the Global Economic Activity Indicator (a proxy of monthly GDP) and financial data reflect that Mexico's economy remains strong. Also, excess liquidity and the continued demand for high yield assets have favoured the Mexican currency, which has reached a multi-year record level of around 11.50 per USD. With elevated oil prices, local inflation on a downward trend combined with a positive economic outlook, we have revised our MXN end-of-year forecast to 12.00 per USD.

Global Forecast Update

International	2000-09	2010	2011f	2012f
Real GDP (annual % change)				
World	3.6	4.9	4.4	4.4
United Kingdom	2.7	1.3	1.4	1.7
Euro zone	1.2	1.7	1.4	1.6
Germany	0.7	3.5	2.7	2.6
France	1.8	1.5	1.3	1.5
Italy	0.5	1.3	0.9	1.0
Japan	0.7	3.9	1.0	2.9
Australia	3.0	2.8	3.8	3.5
China	10.2	10.3	9.5	9.7
India	7.2	8.7	8.5	8.8
Korea	4.5	6.3	5.5	5.3
Brazil	2.9	7.5	4.0	4.5
Chile	3.6	5.2	6.0	5.5
Peru	5.1	8.8	7.0	7.2
Consumer Prices (y/y % change, year-end)				
United Kingdom	2.2	3.7	3.7	2.9
Euro zone	2.1	2.2	2.5	2.3
Germany	1.7	1.9	2.5	2.0
France	1.9	2.0	2.2	2.1
Italy	2.3	2.0	2.5	2.3
Japan	-0.3	-0.5	0.5	1.2
Australia	3.2	2.7	2.8	2.5
China	2.0	3.3	5.0	4.5
India	5.7	9.4	7.5	6.0
Korea	3.2	3.5	3.3	3.0
Brazil	6.6	5.9	6.5	5.5
Chile	3.7	3.0	4.5	3.5
Peru	2.5	2.1	3.5	3.0
Current Account Balance (% of GDP)				
United Kingdom	-2.0	-2.5	-2.0	-1.6
Euro zone	0.1	-0.6	-0.4	-0.2
Germany	3.9	5.1	5.3	5.4
France	-0.1	-2.2	-2.3	-2.4
Italy	-1.7	-3.3	-3.4	-3.2
Japan	3.3	2.9	2.5	2.2
Australia	-4.7	-3.9	-4.5	-4.7
China	5.5	5.0	4.0	3.0
India	-0.5	-2.2	-2.1	-1.7
Korea	1.9	2.6	2.8	2.1
Brazil	-0.9	-2.5	-2.6	-2.8
Chile	0.8	2.0	1.2	-0.5
Peru	-0.6	-1.6	-2.5	-4.2
Commodities (annual average)				
WTI Oil (US\$/bbl)	51	79	105	110
Brent Oil (US\$/bbl)	50	80	118	122
Nymex Natural Gas (US\$/mmbtu)	5.95	4.40	4.40	4.75
Copper (US\$/lb)	1.78	3.42	4.40	4.15
Zinc (US\$/lb)	0.73	0.98	1.09	1.09
Nickel (US\$/lb)	7.11	9.89	11.25	8.90
Gold, London PM Fix (US\$/oz)	522	1,225	1,530	1,500
Pulp (US\$/tonne)	668	960	1,018	1,050
Newsprint (US\$/tonne)	572	607	660	705
Lumber (US\$/mfbm)	275	254	270	300

Forecast

Changes

International

- Reflecting elevated energy and food prices, inflationary pressures continue to intensify in Europe. We have adjusted our inflation forecasts for the core economies in the euro zone, and now expect that the regional inflation rate will close the year at 2.5% y/y.
- Widening interest rate differentials between the euro zone and the United States, together with increasing confidence in European policymakers' ability to stabilize the ongoing sovereign debt turmoil, are providing support to the euro. We have revised our EURUSD forecast, and expect the euro to close the year at US\$1.50.
- We have revised up our inflation forecasts for China and India for 2011 on the back of evidence that elevated fuel and food costs are feeding into the broader economy. While prior monetary tightening and base effects will lead to more subdued inflationary readings during the second half of the year, we now expect Chinese consumer prices to advance at a 5.0% y/y rate and Indian wholesale prices to gain 7.5% in 2011.

Commodities

- WTI oil prices surged over US\$114 per barrel on May 2 — the highest level since September 2008. World prices have been lifted by a widening 'geopolitical risk premium' linked to political upheaval in Libya as well as parts of North Africa and the Middle East. Price spreads between light, sweet crude oil and heavier, sourer blends have widened sharply. Most Libyan production is light, sweet crude oil. While Saudi Arabia, the UAE, Kuwait and Qatar hold 3.7 mb/d of 'spare capability' to offset lost supplies from other producers, the vast bulk is heavier, sourer blends.
- Gold prices have also surged to record highs (US\$1,569.32 per ounce in intraday trading on April 29). Investors have turned to precious metals, given weakness in the U.S. dollar and Standard & Poor's announcement that it has placed the U.S. sovereign credit rating on negative watch. Given prospects for ongoing U.S. dollar weakness, further gains are likely as 2011 unfolds.

Global Forecast Update

Provincial	2000-09	2010e	2011f	2012f	2000-09	2010	2011f	2012f
	<u>Real GDP</u> (annual % change)				<u>Budget Balances*, FY March 31</u> (\$millions)			
Canada	2.1	3.1	2.9	2.6	9,024	-55,598	-39,500	-30,500
Newfoundland & Labrador	3.1	5.2	4.0	2.5	99	-33	485	59
Prince Edward Island	1.7	2.6	2.0	2.1	-26	-74	-54	-42
Nova Scotia	1.7	1.9	2.0	2.0	52	-330	447	-390
New Brunswick	1.8	2.0	1.9	2.2	52	-738	-740	-449
Quebec	1.8	2.9	2.4	2.6	-115	-3,174	-4,200	-3,800
Ontario	1.7	3.0	2.6	2.3	-722	-19,262	-16,686	-16,315
Manitoba	2.1	2.1	2.8	2.5	312 **	-201	-467	-438
Saskatchewan	1.6	2.0	4.6	2.8	425	425	20	383
Alberta	2.7	3.6	4.4	3.3	4,268	0	0	0
British Columbia	2.5	3.2	3.0	3.1	870	-1,779	-1,265	-925
	<u>Employment</u> (annual % change)				<u>Unemployment Rate</u> (annual average, %)			
Canada	1.6	1.4	1.4	1.1	7.0	8.0	7.6	7.4
Newfoundland and Labrador	0.5	3.3	2.0	1.2	15.3	14.4	13.3	12.8
Prince Edward Island	1.3	2.9	0.5	0.9	11.3	11.2	11.2	10.9
Nova Scotia	1.1	0.2	0.5	0.6	8.8	9.3	9.2	8.9
New Brunswick	1.0	-0.9	0.0	0.9	9.4	9.3	9.5	9.0
Quebec	1.5	1.7	1.3	1.1	8.3	8.0	7.7	7.5
Ontario	1.4	1.7	1.6	1.1	6.8	8.7	8.2	8.1
Manitoba	1.2	1.9	1.1	1.0	4.8	5.4	5.0	5.0
Saskatchewan	1.0	0.9	1.1	1.1	5.0	5.2	5.0	4.9
Alberta	2.8	-0.4	2.6	1.8	4.6	6.5	5.6	5.2
British Columbia	1.6	1.7	1.0	1.3	6.6	7.6	7.5	7.3
	<u>Housing Starts</u> (annual, thousands of units)				<u>Motor Vehicle Sales</u> (annual, thousands of units)			
Canada	201	190	175	175	1,591	1,557	1,590	1,605
Atlantic	12	13	11	11	113	122	123	124
Quebec	44	51	46	44	404	414	420	423
Ontario	74	60	57	56	607	576	586	592
Manitoba	4	6	5	5	44	44	46	46
Saskatchewan	4	6	6	5	40	46	48	49
Alberta	35	27	25	28	205	200	210	212
British Columbia	27	26	25	26	178	155	157	159

* FY11 and FY12: provincial gov't estimates. **FY04-FY09.

Forecast Changes

Provincial

- A shortage of auto parts sourced from Japan will reduce vehicle production across North America in the second and third quarters of 2011, dampening the pace of economic activity. Among the provinces, Ontario will be most impacted, as the auto sector accounts for more than 20% of its manufacturing activity.
- On the Prairies, Manitoba is once again grappling with extensive flooding. In Saskatchewan and Alberta, planting has been delayed by heavy rain, but farmers are still planning to seed a larger acreage this year in response to buoyant oilseed and grain prices. After diminished crop volumes last year due to excessive moisture, a good harvest this fall plus strong prices would represent a welcome turnaround.
- Quebec's manufacturing outlook has been reinforced by new aircraft orders and announced plans for further investment in aluminum smelter retrofits, in line with increased global demand.
- In Alberta, regulatory approvals for another oil sands project will contribute to the upbeat forecast for non-residential construction in this province over the next few years.
- The provincial spring Budgets estimate an aggregate \$22½ billion deficit for fiscal 2010-11 (FY11), \$2.7 billion narrower than the FY10 aggregate. For FY12, a \$21.9 billion (1.3% of GDP) combined shortfall is forecast. Bottom line improvements are anticipated for both FY11 and FY12, particularly in the resource-rich jurisdictions.

Global Forecast Update

Financial Markets	10Q4	11Q1	11Q2f	11Q3f	11Q4f	12Q1f	12Q2f	12Q3f	12Q4f
(% , end of period)									
Canada									
BoC Overnight Target Rate	1.00	1.00	1.00	1.00	1.50	2.00	2.25	2.25	2.25
3-month T-bill	1.05	0.96	1.10	1.30	1.70	2.20	2.30	2.30	2.30
2-year Canada	1.68	1.83	1.75	1.80	2.00	2.30	2.50	2.50	2.50
5-year Canada	2.42	2.78	2.65	2.70	2.85	3.00	3.10	3.25	3.35
10-year Canada	3.12	3.35	3.25	3.40	3.50	3.70	3.75	3.90	4.05
30-year Canada	3.53	3.76	3.70	3.80	3.90	4.15	4.20	4.30	4.50
Real GDP (q/q, ann. % change)	3.3	4.0	2.0	3.0	3.0	2.5	2.6	2.6	2.6
Real GDP (y/y, % change)	3.2	2.8	2.8	3.1	3.0	2.6	2.8	2.6	2.6
Consumer Prices (y/y, % change)	2.3	2.6	2.9	2.9	2.9	2.5	2.1	2.2	2.2
Core CPI (y/y % change)	1.6	1.3	1.5	1.8	1.7	1.9	1.6	1.9	2.1
United States									
Fed Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.75	1.25	1.75	2.00
3-month T-bill	0.12	0.09	0.15	0.20	0.40	0.90	1.40	1.90	2.20
2-year Treasury	0.59	0.82	0.70	0.85	1.00	1.40	1.75	2.00	2.20
5-year Treasury	2.00	2.28	2.10	2.20	2.25	2.60	2.85	3.05	3.40
10-year Treasury	3.29	3.47	3.40	3.65	3.75	4.00	4.10	4.30	4.65
30-year Treasury	4.33	4.51	4.50	4.65	4.75	4.95	5.05	5.20	5.35
Real GDP (q/q, ann. % change)	3.1	1.7	2.9	3.5	3.0	2.7	2.7	2.5	2.5
Real GDP (y/y, % change)	2.8	2.3	2.6	2.8	2.8	3.0	3.0	2.7	2.6
Consumer Prices (y/y, % change)	1.3	2.2	3.1	3.2	3.0	2.1	2.0	1.9	1.9
Core CPI (y/y % change)	0.6	1.1	1.1	1.2	1.4	1.3	1.4	1.4	1.5
Spreads									
Target Rate	0.75	0.75	0.75	0.75	1.25	1.25	1.00	0.50	0.25
3-month T-bill	0.93	0.87	0.95	1.10	1.30	1.30	0.90	0.40	0.10
2-year	1.09	1.01	1.05	0.95	1.00	0.90	0.75	0.50	0.30
5-year	0.42	0.50	0.55	0.50	0.60	0.40	0.25	0.20	-0.05
10-year	-0.17	-0.12	-0.15	-0.25	-0.25	-0.30	-0.35	-0.40	-0.60
30-year	-0.80	-0.75	-0.80	-0.85	-0.85	-0.80	-0.85	-0.90	-0.85
Central Bank Rates									
European Central Bank	1.00	1.00	1.25	1.50	1.75	2.00	2.25	2.50	2.50
Bank of England	0.50	0.50	0.50	0.75	1.00	1.25	1.50	1.75	2.00
Swiss National Bank	0.25	0.25	0.25	0.25	0.50	0.50	0.75	0.75	1.00
Bank of Japan	0.10	0.10	0.10	0.10	0.10	0.10	0.25	0.25	0.50
Reserve Bank of Australia	4.75	4.75	5.00	5.25	5.50	5.75	6.00	6.25	6.50
Exchange Rates									
Canadian Dollar (USDCAD)	1.00	0.97	0.95	0.94	0.93	0.94	0.94	0.93	0.92
Canadian Dollar (CADUSD)	1.00	1.03	1.05	1.06	1.08	1.06	1.06	1.08	1.09
Euro (EURUSD)	1.34	1.42	1.47	1.49	1.50	1.48	1.48	1.50	1.50
Euro (EURGBP)	0.86	0.88	0.90	0.91	0.91	0.90	0.89	0.89	0.88
Sterling (GBPUSD)	1.56	1.60	1.64	1.64	1.65	1.65	1.67	1.69	1.70
Yen (USDJPY)	81	83	79	82	84	86	87	89	90
Australian Dollar (AUDUSD)	1.02	1.03	1.07	1.08	1.09	1.09	1.10	1.10	1.11
Chinese Yuan (USDCNY)	6.6	6.5	6.4	6.2	6.1	6.0	5.9	5.8	5.8
Mexican Peso (USDMXN)	12.3	11.9	11.6	11.8	12.0	12.1	12.0	12.1	12.3
Brazilian Real (USDBRL)	1.66	1.63	1.59	1.59	1.60	1.62	1.65	1.67	1.70

Scotia Economics

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