



The Bottom Line

THE LATEST VIEW ON THE ECONOMY



BMO  Capital Markets

Recovery Still a Year Away

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With continued financial instability and the deceleration in global growth, Canada's economy has slowed and the TSX has fallen sharply on the heels of commodity price declines. While domestic economic activity, on balance, is stronger in Canada than in the U.S., headline growth has underperformed as the U.S. economy has been boosted by an improving trade balance (*Chart 1*). Certainly, labour markets as well as consumer and business confidence are much weaker in the U.S., largely the result of the housing crisis and credit crunch; but while these underlying factors point towards a U.S. recession,

negative GDP figures have yet to be posted. The Q2 growth rate of 3.3% in the U.S. is likely, however, to be the strongest reading we will see for a considerable time.

American consumers have pulled back sharply, as necessities have dominated their spending (*Chart 2*). High food and gasoline prices reduced discretionary income, yet consumers refrained from spending much of their rebate cheques. American savings rates in Q2 jumped from 0.2% to 2.6%, the largest rise in six years. This is a traditional recession signal. Savings rates rise as consumers tighten their belts and refrain from buying the extras. Earlier this year, American consumer spending hit a record high relative to GDP as consumers, until recently, cut their savings rate to nearly zero (*Chart 3*). Consumers are tapped out.

Even though food and oil prices have fallen considerably in the past couple of months, the average consumer has felt only modest relief. Packaged food and most grocery prices remain high and while oil prices have fallen a whopping 30% from its recent peak, gasoline prices are down only 12%.

The CRB index has posted its sharpest decline on record in the past two-to-three months. Virtually all food and industrial materials prices are off their highs posted since early 2007, retracing virtually all of the gains posted this

Chart 1

Domestic Demand: Stronger in Canada

(q/q % chng : a.r.)

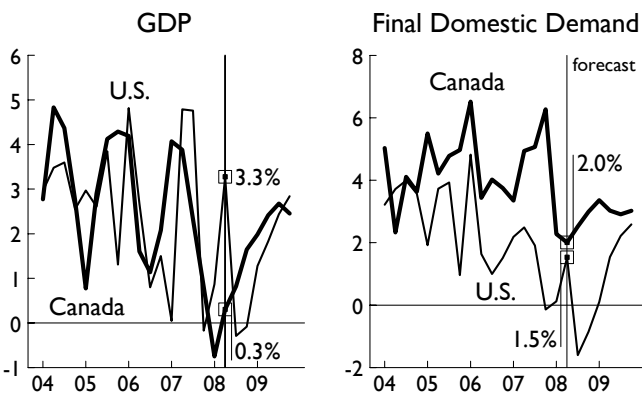
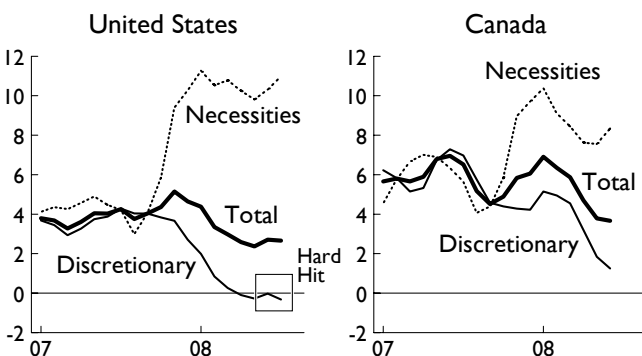


Chart 2

Retail Sales: Composition of Spending

Retail sales (3-mnth ma : y/y % chng)



Necessities = food, health care, gas

Chart 3

U.S. Consumers Tapped Out

United States (% of nominal GDP)

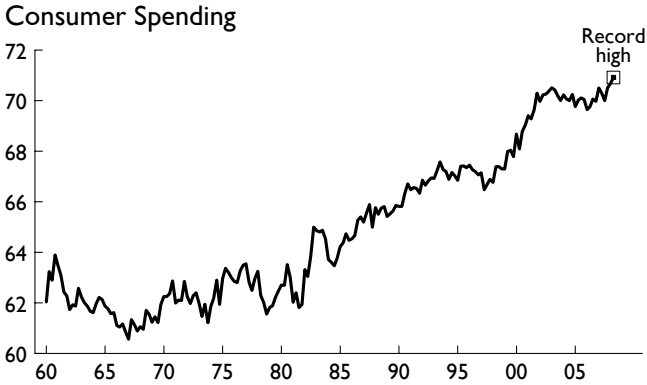


Chart 4

Commodity Price Pullback

Commodity Price Range (since Jan '07 : as of Sep 10, '08)

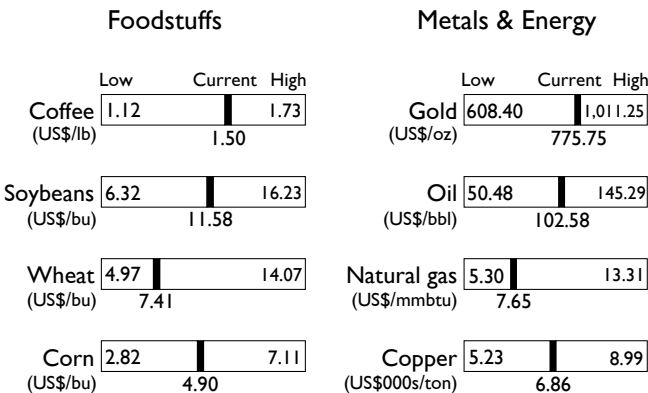
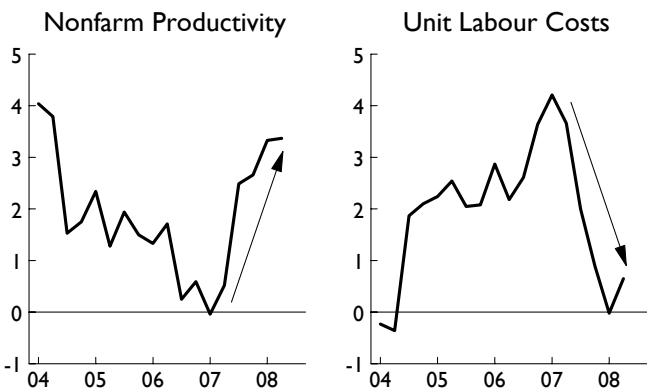


Chart 5

Unit Labour Costs Dropping in U.S.

United States (y/y % chng)



year (*Chart 4*). Much of the decline in commodity prices reflects a slowdown in global demand and reduced gasoline usage. To a lesser degree, it is also reflective of the strength in the U.S. dollar, which in itself was caused by the more recent economic deterioration outside the U.S.

The U.S. jobless rate has climbed very rapidly to 5-year high of 6.1%. The continued strength in headline GDP growth has generated a very steep rise in productivity growth (*Chart 5*). There has been a commensurate decline in U.S. unit labour costs as wage increases are small and in a declining trend.

Job prospects are far better in Canada as the employment rate has hovered above the U.S. rate for the past 18 months (*Chart 6*). The jobless rate in the U.S. has risen to the level in Canada for the first time in 26 years. Both large and small U.S. businesses are cutting payrolls. The U.S. Manpower Employment survey of hiring intentions is at a five-year low, suggesting further nonfarm payroll declines ahead. Considerable weakness is evident in the financial, insurance and real estate sectors where hiring intentions are at a 16-year low. In direct contrast, the Canadian Manpower survey showed steady hiring plans in Q4. Canadian employment growth has slowed somewhat reflecting the recent decline in the terms of trade and housing markets in most parts of the country. Though off its peak, the still-high employment rate suggests solid underlying support for domestic demand. We are looking for the U.S. jobless rate to rise above Canada's soon.

Another example of the yawning gap between Canadian and U.S. consumer spending is the divergent performance of auto sales—near record highs in Canada and 15-year lows in the U.S. (*Chart 6*). Owing to intense competitive pressure and the legacy of the loonie crossing parity, Canadian auto prices are declining at the fastest rate ever recorded. And, the back-to-school shopping season in the U.S. appears to be disappointing, which is often a strong leading indicator of the all-important holiday season.

Chart 6

Separate Ways

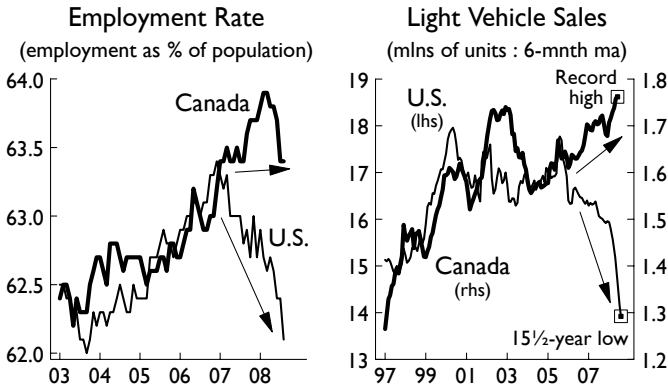
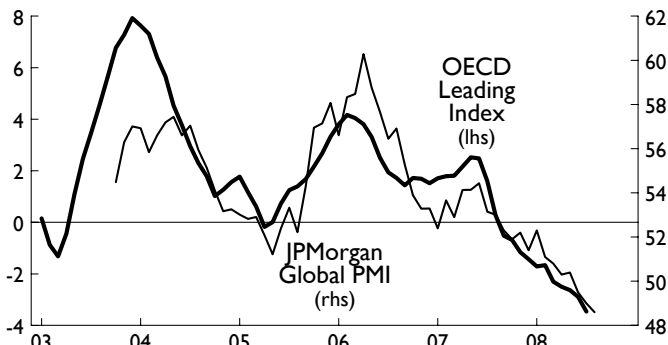


Chart 7

Global Slowdown More Pronounced



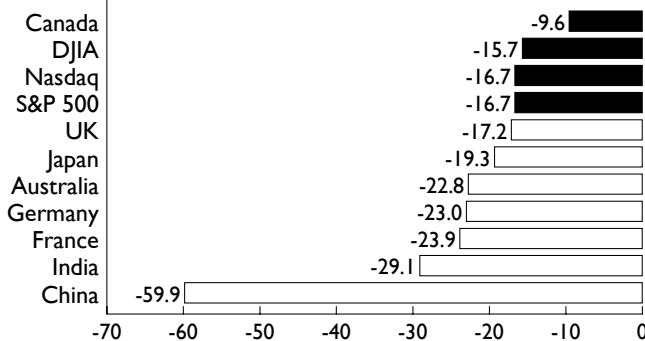
OECD Leading Index = (6-mnth % chng : a.r.)

Chart 8

TSX Outperforms

(y-t-d % chng : as of September 11, 2008)

Equity Markets



In recent months, the slowdown in other countries has become more pronounced as the OECD's leading indicator fell sharply in July, pointing to a global slowdown that will lead to higher unemployment in most countries. A measure of global manufacturing fell to 48.6 in August (Chart 7). The Baltic Dry Index plunged over 1000 points in the first week after Labour Day, accompanying the sharp decline in base metals, oil and gold prices. As well, Spain and the U.K. are suffering from a U.S.-style housing bust which is weakening their banks' earnings and lending activity.

Not just the industrial world has been impacted. According to the MSCI, emerging market stock markets declined 6.2% that week, and are down 31.5% from their peak. On a relative basis year-to-date, the TSX index performance doesn't look too bad, but we are catching up fast (Chart 8).

Treasury Takeover Welcome

In this environment, foreign investors were becoming ever more leery of holding GSE debt and the flight to the safe haven of Treasuries had taken bond yields down to their lowest level in nearly five months. The value of marketable federal agency securities held by foreign central banks, dominated by Freddie Mac and Fannie Mae debt, has fallen sharply, explaining the U.S. Treasury's decision to take over Fannie and Freddie (Chart 9). In the six weeks of data since the initial bailout announcement in mid-July, foreign central banks and other international accounts sold more than \$15 billion in agency securities (with net sales in five of the six weeks). That compared with typical net purchases of around \$4-to-\$5 billion per week the year before. Over the same period, foreign central bank purchases of Treasuries soared to more than \$65 billion compared to an average of just over \$2 billion/week in the prior year. This flight to safety was driving up agency spreads and keeping long-term interest rates high.

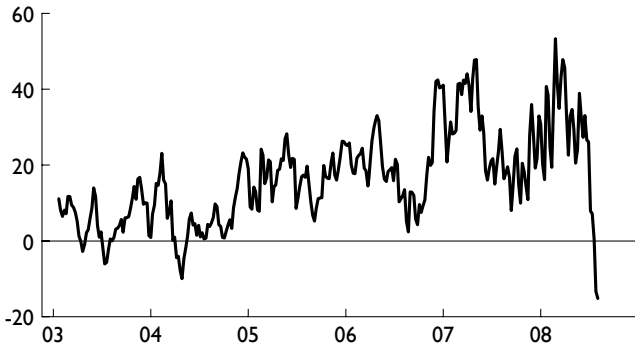
Despite the 2% fed funds rate, down from 5.25% in the past 12 months, 30-year fixed-rate mortgage rates

Chart 9

One Key Reason Treasury Moved When It Did

United States (US\$ blns : 6-wk chng)

Foreign Agency Holdings with the Fed



remained just under 6.5%, near the level posted when the Fed started easing a year ago. Mortgage rates have since fallen sharply with the Treasury takeover. This, along with meaningful house price declines, has improved affordability, which is a big issue for first-time homebuyers. For existing homeowners, however, the supply imbalance continues, making it difficult to sell, thus postponing most buying decisions. In contrast to earlier years, immigration isn't helping to reduce the excess inventory of unsold homes; immigration applications tumbled 17.4% in July from year-ago levels.

Refinancing activity might bounce a bit and consumer confidence has already edged upward with the recent decline in gasoline prices. But consumer incomes are

slowing and many creditworthy households and businesses will continue to have difficulty financing their operations and capital spending plans. Moreover, the risks are rising in the commercial real estate market as office vacancy rates are rising and leading indicators suggest a slowdown in nonresidential construction. Office buildings have excess capacity, too many hotel rooms are vacant and shopping centre space is in excess supply. Many banks, particularly regional and community banks in the U.S., are exposed to these commercial real estate sectors.

It is feasible that many other sectors will be looking for federal government assistance as well, among these would be the auto and airline industries and state unemployment insurance funds. California, New York, Ohio and Michigan are among the most populous states likely to deplete their unemployment insurance funds this year or next.

With the slowdown in the global economy, the improvement in the U.S. trade deficit is likely going to slow. Even if GDP growth remains positive, however, persistent declines in employment and weakness in real sales might be enough for the NBER to declare a recession. President emeritus of the NBER Business Cycle Dating Committee, Professor Martin Feldstein of Harvard, believes a recession began earlier this year. With falling commodity prices, headline inflation should fall quickly, opening up the possibility of central bank rate cuts in the near future, especially by the Bank of England and possibly the ECB. Easing by the Fed or the Bank of Canada is unlikely given that benchmark overnight rates are already so low.

The Bottom Line: The key to a turnaround remains a recovery in U.S. housing, which will boost economic growth, reduce credit risk and thaw the credit freeze. The Treasury's takeover action helps, but it still appears that a real turnaround is a 2009 story.

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