



The Bottom Line

THE LATEST VIEW ON THE ECONOMY



The Clouds Really Are Parting

December 8, 2009

Dr. Sherry Cooper
Executive Vice
President,
Chief Economist

1-800-613-0205

The much-better-than-expected November employment numbers for Canada and the United States confirmed that the recession has ended and the recovery is underway. It will not be the booming recovery of past, following deep and protracted downturns, but dire predictions of a double dip are unfounded. Our economic forecasting model suggests that, barring another financial calamity, a slide back into recession next year is highly unlikely. In fact, never in recorded history has GDP contracted when the yield curve was as steep as it is today. Our model suggests that we could see 3% growth in the U.S. next year but,

given the extraordinary household deleveraging and the huge fiscal debt burden, we are holding our 2010 forecast at roughly 2.5% for both Canada and the U.S.

A return to potential growth in 2011 and beyond could well keep the economies of Canada and the U.S. growing at less than 3%, assuming that the recent surge in U.S. productivity is unsustainable. With the aging population, labour force growth will continue to slow for the next 15 years as boomer retirement does not crest until about 2025 (Chart 1). The potential growth rate of the economy in the next decade will likely be no more than 2.5%, compared to what some in the U.S. estimated to be in excess of 3% in the 1990s. It was this presumption of rapidly rising productivity growth emanating from the IT and Internet boom in the '90s that caused the Fed to keep interest rates far too low in the second half of the '90s, triggering the dot-com bubble. And with the dot-com bust and ensuing recession in 2001, the Fed once again felt justified in rapidly easing monetary policy, allowing mortgage rates to plummet and subprime lending to rise explosively, thereby fuelling the housing bubble.

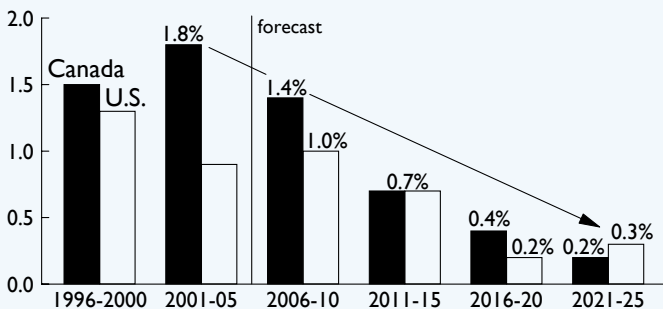
The fallout from that period of excess was nothing short of catastrophic, requiring central banks and federal governments everywhere to ease monetary and fiscal policy at an unprecedented pace. While the

Chart 1

Labour Supply Slows

(avg. ann. compound growth : %)

Total Labour Force Growth



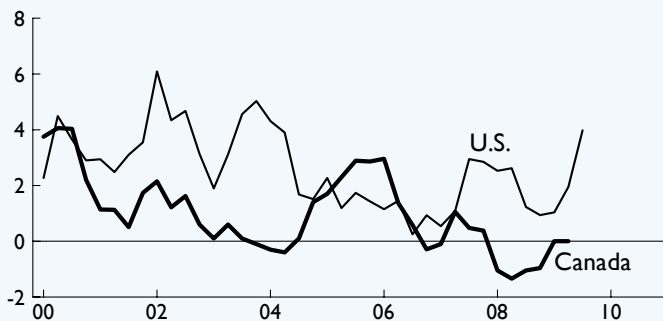
Sources: Haver Analytics, The Conference Board of Canada, Statistics Canada, U.S. Bureau of Labor Statistics

Chart 2

Potential Problems

(y/y % chng)

Labour Productivity



Sources: Haver Analytics, Statistics Canada, U.S. Bureau of Labor Statistics

credit crisis has ended and financial institutions are now able to raise capital from the private sector, unemployment and underemployment remain a critical problem.

The rise in U.S. productivity growth this cycle has been unprecedented as businesses use a pared down workforce more intensively (*Chart 2*). This surge, however, is unsustainable and, as hiring starts ratcheting up next year, productivity growth will likely slow to a more normal pace.

Canadian business has been adjusting to the stronger Canadian dollar since 2003. Improved technology and processes, enhanced product quality and innovation, and much faster productivity growth are essential for Canadian exporters to regain their competitive advantage. Our forecast suggests that the Canadian dollar will remain near current levels or higher over the forecast horizon (*Chart 3*). Canada's previous record trade surplus has been

driven down to a record trade deficit as the recession swept through the U.S. and commodity prices fell worldwide. Even so, Canada's rate of structural unemployment is far lower than in the U.S. (*Chart 4*).

Signs of Improvement

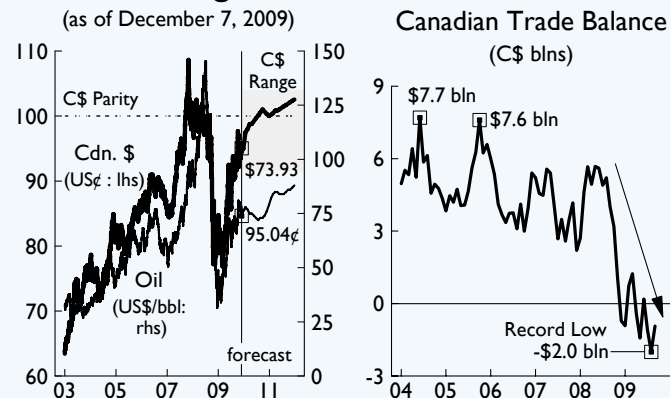
Leading indicators now suggest that U.S. employment will finally turn positive early in 2010. Temporary employment has increased for the past four months and net payrolls were revised up a cumulative 159,000 jobs in the latest report for November. Hours worked in the private sector finally rose a bit from record lows and the manufacturing workweek edged higher as well. The jobless rate ticked downward to 10% from 10.2% and the combined unemployment/underemployment rate eased back from record highs, though it still remains at a troubling level (*Chart 4*).

Of great concern is the continued rise in the average duration of U.S. unemployment to a record-high 7 months (*Chart 5*). And discouraged workers are dropping out of the labour force in unprecedented numbers, cushioning the fall in the jobless rate when hiring improves and these workers return to search for openings.

Because of these headwinds, the Fed will be reticent to reverse its extraordinary stimulus too rapidly. Even if overnight rates are held steady until next fall and

Chart 3

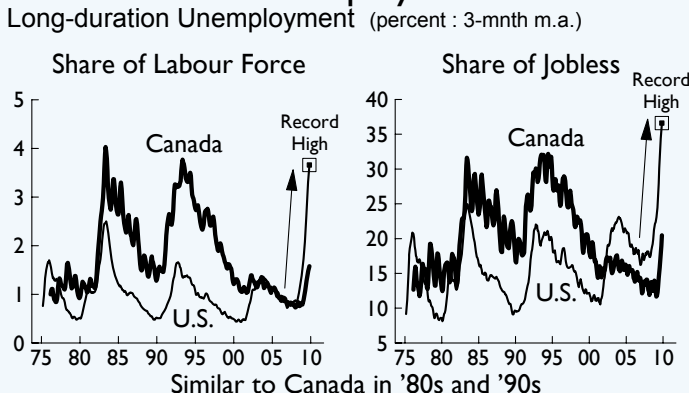
Loonie Strength to Persist



Sources: Haver Analytics, U.S. Federal Reserve, Wall Street Journal, Statistics Canada, BMO Capital Markets

Chart 4

U.S. Structural Unemployment Problem



Long-duration Unemployment = Unemployed 27 weeks or more
Sources: Haver Analytics, Statistics Canada, U.S. Bureau of Labor Statistics

climb only slowly thereafter, as we anticipate, growth could moderate in late 2010, leaving plenty of disinflationary slack. This is a risk the Fed—whose mandate is to achieve sustainable maximum employment growth and stable low inflation—will need to consider before raising rates and removing all quantitative easing.

Investors should plan for a lengthy period of steady modest economic growth and low interest rates—a desirable climate for both corporate bonds and equities.

Risks Remain

Economic conditions and market behaviour have been uncertain for some time. Even though we have seen a marked improvement since earlier this year, economic headwinds remain and virtually no one is unequivocally bullish. Longer term, the global imbalances

that triggered the financial crisis need to be addressed. Deleveraging of the U.S. household (and business sectors) is underway, and financial services regulation will no doubt be tightened worldwide. But the key imbalance remains: the extraordinary trade and budget deficits in the U.S. (and now in much of the G7) that accompany the huge and mounting current account surplus in China and other countries where currencies are undervalued (*Chart 6*).

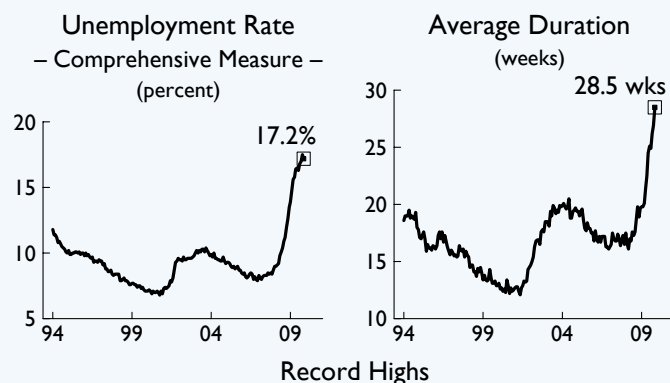
To be sure, the explosion in budgetary red ink at all levels of government in the U.S., Canada and elsewhere is the necessary result of actions taken to end the credit crisis and mitigate its impact on the economy. Without these support measures, the global economy could well have plunged into depression.

The odds favour only a moderate and orderly further decline in the U.S. dollar, which will continue to boost American net exports and contribute to moderate growth. Corporate profits have risen sharply as businesses cut costs and massively retrenched in terms of employment, inventories and capital spending. Finally, we are seeing some top-line growth as revenues rise gradually from their collapse just over a year ago. This should lead to stepped up business investment in machinery, equipment and software, as well as a gradual improvement in labour markets.

Chart 5

U.S. Job Losses a Long-term Problem

Unemployment – United States (as of November, 2009)

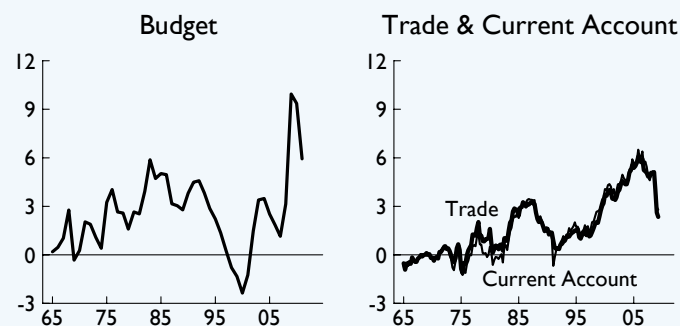


Sources: Haver Analytics, U.S. Bureau of Labor Statistics

Chart 6

Triple Deficits

Deficits – United States (% of GDP)



Budget Deficit [2009-11] = BMO Capital Markets' forecast
Sources: Haver Analytics, U.S. Office of Management and Budget, U.S. Bureau of Economic Analysis, U.S. Census Bureau

Things may be getting better, but it would be naïve to think that the depth and brutality of the crisis-driven recession would leave no lasting damage. While housing markets in Canada have bounced back with a vengeance, bank foreclosures in the U.S. will rise sharply this year as an estimated 23% of homeowners have mortgages that are larger than the value of their homes and refinancings and restructurings have been limited. Although most homeowners who can make their payments would prefer to stay in their homes, some will likely walk away if the mortgage gap is too wide. This is particularly the case for those whose income has fallen sharply.

It doesn't take long before the jobless fall behind on their mortgage and credit card payments. Even for those that have jobs, the decline in household wealth has generated a necessary rise in savings and frugality. Retail sales in November were disappointing. Although it is likely that Christmas sales will beat last year's crisis-depressed levels, people are still looking for bargains.

In time, governments will be forced to raise taxes and cut non-essential services. While it is highly unlikely that the U.S. will lose its reserve currency status, it will be coerced by foreign lenders, especially China, to tighten its belt. I am not suggesting that the U.S. will be confronted with failed auctions or an inability to finance its debt, but a much-needed revaluation of the Chinese currency will ultimately mean that China's financial spigots will finally be turned down a bit, leading to higher interest rates if the U.S. neglects to sufficiently tighten fiscal policy. Politically, these are very difficult issues and would be daunting for any president. But, it is especially worrisome today, as the degree of cooperation between the two political parties is at a modern-day low.

I am confident that the equilibrating mechanisms of price adjustment—be it through the change in exchange rates, wage rates or product prices—will gradually reduce the imbalances and return the global economy to a sustainable pace of expansion. This pace, however, will likely be well below the 5% level of the bubble era. The recovery is likely to be subpar, especially in the U.S. Downside risks remain, but the clouds are gradually parting. Those who suffered the worst consequences of this maelstrom remain bruised and weary, but new opportunities will emerge as the excesses of the past are painfully whittled away.

The information, opinions, estimates, projections and other materials contained herein are provided as of the date hereof and are subject to change without notice. Some of the information, opinions, estimates, projections and other materials contained herein have been obtained from numerous sources and Bank of Montreal ("BMO") and its affiliates make every effort to ensure that the contents thereof have been compiled or derived from sources believed to be reliable and to contain information and opinions which are accurate and complete. However, neither BMO nor its affiliates have independently verified or make any representation or warranty, express or implied, in respect thereof, take no responsibility for any errors and omissions which may be contained herein or accept any liability whatsoever for any loss arising from any use of or reliance on the information, opinions, estimates, projections and other materials contained herein whether relied upon by the recipient or user or any other third party (including, without limitation, any customer of the recipient or user). Information may be available to BMO and/or its affiliates that is not reflected herein. The information, opinions, estimates, projections and other materials contained herein are not to be construed as an offer to sell, a solicitation for or an offer to buy, any products or services referenced herein (including, without limitation, any commodities, securities or other financial instruments), nor shall such information, opinions, estimates, projections and other materials be considered as investment advice or as a recommendation to enter into any transaction. Additional information is available by contacting BMO or its relevant affiliate directly. BMO and/or its affiliates may make a market or deal as principal in the products (including, without limitation, any commodities, securities or other financial instruments) referenced herein. BMO, its affiliates, and/or their respective shareholders, directors, officers and/or employees may from time to time have long or short positions in any such products (including, without limitation, commodities, securities or other financial instruments). BMO Nesbitt Burns Inc. and/or BMO Capital Markets Corp., subsidiaries of BMO, may act as financial advisor and/or underwriter for certain of the corporations mentioned herein and may receive remuneration for same. "BMO Capital Markets" is a trade name used by the Bank of Montreal Investment Banking Group, which includes the wholesale/institutional arms of Bank of Montreal, BMO Nesbitt Burns Inc., BMO Nesbitt Burns Ltée/Ltd., BMO Capital Markets Corp. and Harris N. A., and BMO Capital Markets Limited. TO U. S. RESIDENTS: BMO Capital Markets Corp. and/or BMO Nesbitt Burns Securities Ltd., affiliates of BMO NB, furnish this report to U. S. residents and accept responsibility for the contents herein, except to the extent that it refers to securities of Bank of Montreal. Any U. S. person wishing to effect transactions in any security discussed herein should do so through BMO Capital Markets Corp. and/or BMO Nesbitt Burns Securities Ltd. TO U. K. RESIDENTS: The contents hereof are not directed at investors located in the U. K., other than persons described in Part VI of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001.

™ - "BMO (M-bar roundel symbol) Capital Markets" is a trade-mark of Bank of Montreal, used under licence. © Copyright Bank of Montreal.