

NORTH AMERICAN Outlook



BMO Capital Markets

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Shakin' Off That Ol' Ball and Chain

U.S. AND CANADA FACE DIFFERENT CHALLENGES

- **The housing slump remains the key brake on the U.S. expansion, while the lofty loonie is the anchor on Canada's growth.** However, U.S. activity remains robust outside of housing, while Canada's economy is seeing offsetting support from high commodity prices and still-low interest rates.
- U.S. GDP grew 0.7% in Q1, the slowest pace in four years, as homebuilding continued to slide. Despite the ongoing slump in housing, growth likely rebounded to 2.9% in Q2. Recent strength in capital goods shipments and orders flags an upturn in business investment. Exports are on the rise amid strong global demand and a weak greenback. The manufacturing Purchasing Managers' Index hit a 14-month high in June, as factories re-stocked inventories, while the broader services measure also sits at a 14-month peak. However, consumer spending has hit a speed bump after posting back-to-back quarterly gains of 4%-plus. Sales of new motor vehicles downshifted for the sixth straight month in June. That said, continued decent job growth likely means the pullback in spending will be short lived.
- Canadian GDP grew 3.7% in Q1, the fastest pace in more than a year, led by robust consumer spending. Low interest rates and high commodity prices are the cornerstones of the current economic expansion, now in its 16th year. Growth likely moderated to a still decent pace of 2½% in Q2 owing to the loonie's recent meteoric rise. But personal consumption remains strong. Sales of new motor vehicles accelerated 7.6% in June from a year ago, while existing home sales bounced 10.3% in May to record highs.

HIGHLIGHTS

U.S. economy weighed down by housing, Canada restrained by loonie

However, both economies display underlying strength

Canadian inflation bubbling to the surface

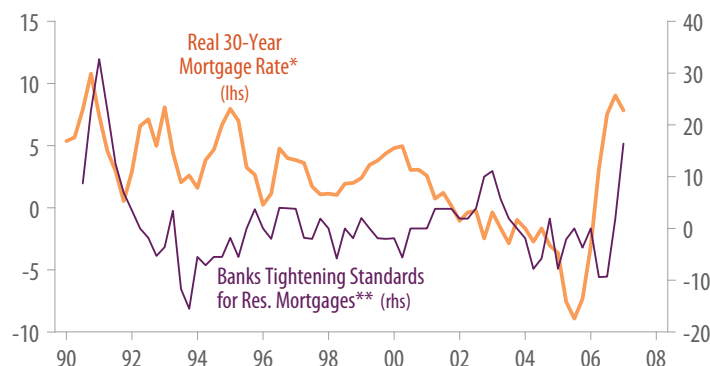
BoC tightens, Fed could follow suit in 2008

Bond bear market to grow louder

Loonie shooting for par, will likely settle for bogey

MORTGAGES ARE COSTLIER AND HARDER TO GET

United States (percent)



* Deflated by y/y % change in median existing home prices
 ** Source: FRB's Senior Loan Officer Survey

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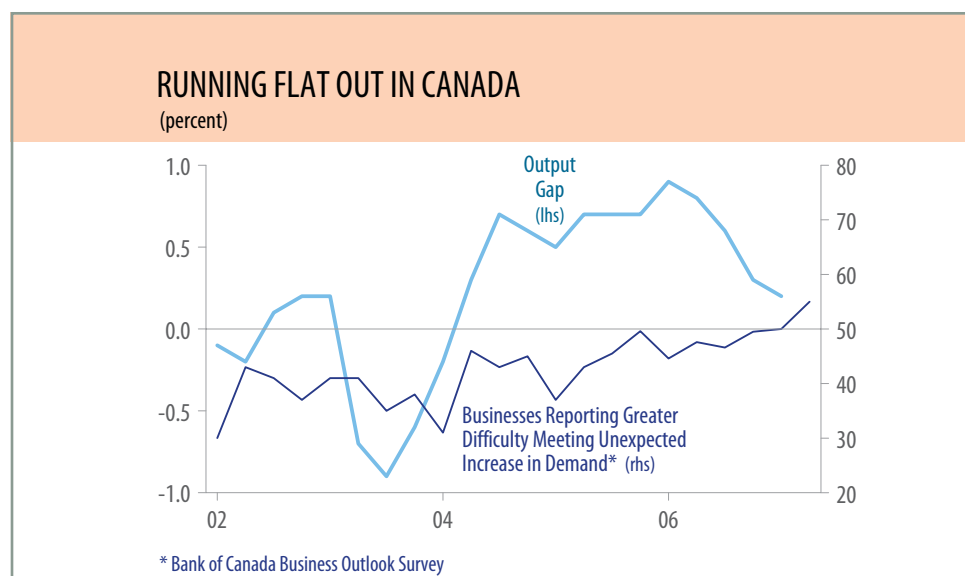
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- **The U.S. housing correction shows no sign of stabilizing.** As a consequence of rising mortgage rates and tightening credit standards, existing home sales have fallen to four-year lows in May. At the going sales pace, it will take almost nine months to clear the backlog of unsold homes, the longest since 1992. Foreclosure rates are at all-time highs, with many subprime borrowers throwing in the towel. Continued moderate home price deflation, though helping affordability, is also discouraging buyers from taking the plunge. **Until housing stabilizes, the U.S. economy will grow a modest 2.0% in 2007, before improving to 2.7% in 2008.**
- **Unlike the U.S., Canada's housing boom should wind down gradually rather than bust.** Activity in Alberta and now Saskatchewan has been driven by rising prices of oil and grains, and attendant strong income growth. With the housing market likely to moderate as interest rates climb, and net exports under intense pressure from the strong currency, **Canada's GDP growth will likely stay moderate at 2.4% in 2007 and 2.8% in 2008.** Alberta will be the locomotive of the nation's expansion for the fourth consecutive year, while Ontario, the manufacturing heartland of the country, will be the caboose.

INFLATION PRESSURES HOTTER IN CANADA THAN IN U.S.

- **Canada's economy has hit capacity limits, thanks to dismal productivity growth.** The jobless rate has stayed at a 33-year low for five straight months. The central bank's *Business Outlook Survey* reported that an increasing number of firms (and the most in seven years) were having difficulty meeting strong demand. No wonder unit labour costs ran at a 4% yearly clip in Q1, the fastest in 15 years. With growth in labour compensation outpacing prices, margins are



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getting squeezed. Capacity pressures, along with soaring home prices and rising food costs, are keeping the central bank's core measure of inflation above its 2.0% target. We expect the core rate to hover just above the target, with a strong Canadian dollar and cooling house prices partially offsetting excess demand pressures.

- Unlike Canada, the U.S. economy may not (yet) be operating above capacity limits. Unit labour costs have risen moderately, up 2.2% y/y in Q1. Core CPI inflation has eased to 2.2% in May from 2.9% last September. Although rising apartment vacancy rates will continue to subdue rents, rising import prices stemming from the weak dollar will likely keep core inflation in a holding pattern for the rest of the year. That said, the risks to inflation are on the upside. The jobless rate continues to hover near six-year lows of 4.5%, while energy and food costs remain elevated. Moreover, disinflation pressures from abroad could be on the wane, as growing worker shortages are fuelling wage increases in China.

BOC TO LEAVE FED STANDING IN THE DUST

- **While the Fed talks a tough game on inflation, it is the Bank of Canada that is going on the offence.** Although the strong currency will damp inflation, higher interest rates are needed to cool domestic spending, especially on homes and autos. The Bank recently raised rates for the first time in over a year, and warned that a further modest increase may be needed to keep inflation on target. Accordingly, we expect one more quarter-point increase in September. With higher rates slowing domestic demand, and the stronger currency restraining net exports, the economy will grow at a moderate pace this year, thereby alleviating some pressure on inflation. Modest belt tightening now should preclude the need for more aggressive action later.
- **While still worried that low joblessness could spark inflation, the Fed is also aware that higher rates could wreak havoc on a wobbly housing market.** So, despite their leanings, policymakers have little desire to tighten policy yet. Core PCE inflation (1.9% in May) has already fallen within the Fed's presumed 1%-to-2% comfort range. Expected moderate economic growth and stable inflation should keep the Fed on the sidelines this year. **However, the next move by the Fed will likely be a rate hike, though not until they are confident that the economy is on a solid footing—probably in 2008.**
- North American bond yields have climbed sharply in the past two months as investors have priced out Fed easing and priced in BoC tightening. Near term, the U.S. housing/subprime woes could support long Treasuries. However, the medium-term trend remains bearish given the upside risks to U.S. inflation and monetary policy, the likelihood of further global monetary tightening, and the

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prospect of central bank reserve diversification. We look for the 10-year rate to climb from just over 5% currently to 6% by late 2008. Long Canada rates should increase slightly faster than U.S. rates due to BoC tightening.

LOONIE SOARS TO 30-YEAR HIGHS

- The Canadian dollar has soared 11% against the greenback this year, even outpacing rate-fuelled currencies like the euro and the pound and commodity currencies like the Aussie dollar. Higher oil prices, expected BoC tightening, greenback weakness, foreign takeover activity, and bullish sentiment (e.g., record net long positions in the futures market) have propelled the loonie's flight. At 95 cents U.S., the currency is now within striking distance of parity, last seen in November 1976, but we do not think it could be sustained at that level given current fundamentals.
- Near term, improving rate spreads and high resource prices should keep a solid bid to the currency. But barring a hefty increase in commodity prices or interest rates, the currency could have trouble reaching parity. Indeed, we see it slipping to 91 cents by late 2008 as the U.S. economy recovers and commodity prices moderate. A comparison of Canadian and U.S. prices suggests that the currency's "fair value" is likely below 90 cents. Nonetheless, Canada continues to post big trade surpluses owing to strong demand for, and high prices of, its resource exports. By the turn of the decade, Canada's holdings of foreign assets could exceed its liabilities, making it a net creditor for the first time in modern history. The payoff should be a currency that is less susceptible to sentiment shifts and more attractive to global investors.

RISKS

- A deeper correction in U.S. housing, stemming from a blow-up in subprime mortgages and a consequent credit squeeze, remains a key risk to the U.S. expansion. The longer the housing slump continues, the further home values will fall, eroding consumer wealth and confidence and ultimately causing demand to retrench. However, the longer-term risk is on the side of rising inflation and interest rates.
- The possibility of greater upward pressure on inflation stemming from tight labour markets and rising energy/food costs is the main risk to Canada's expansion. Rising inflation would cause interest rates and the Canadian dollar to shoot higher, stalling domestic demand and exports.

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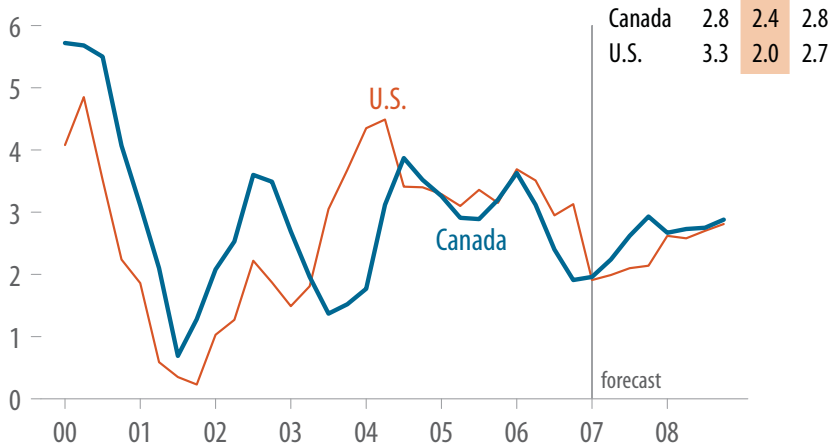


CHARTS

ECONOMIC GROWTH TO STAY MODERATE

(y/y % chng)

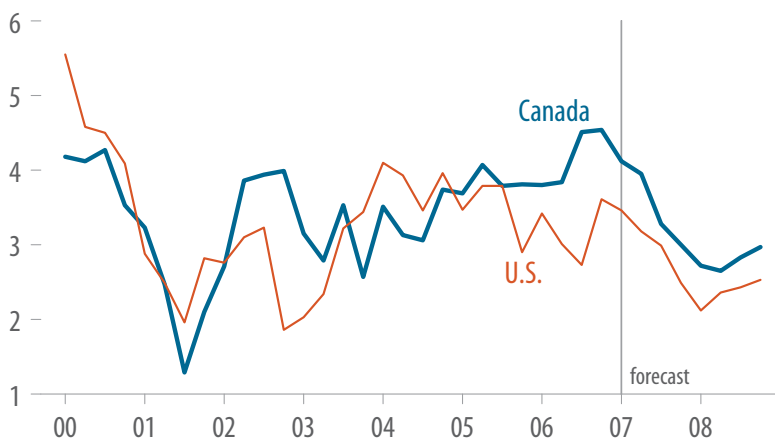
Real GDP



HIGHER RATES WILL COOL CONSUMPTION

(y/y % chng)

Real Personal Consumption Expenditures



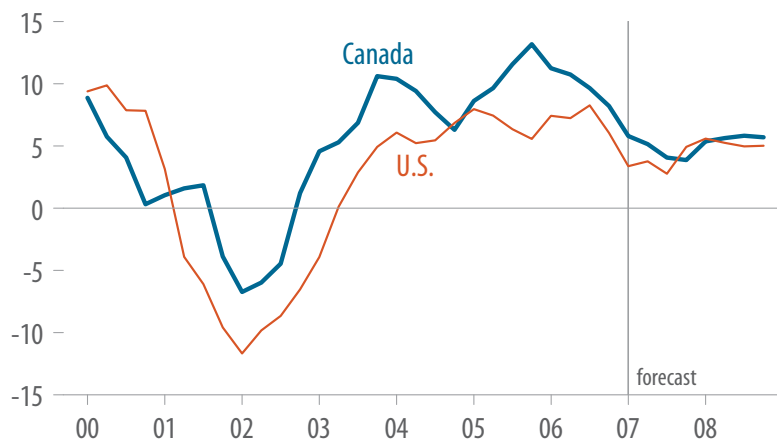
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BUSINESS INVESTMENT STRONGER IN CANADA

(y/y % chng)

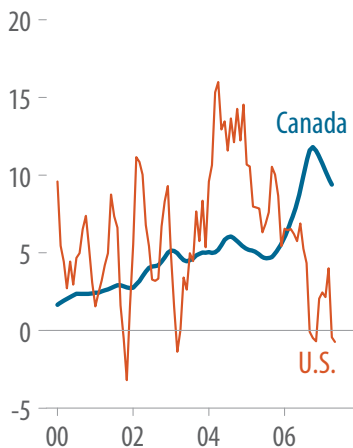
Real Non-Residential Business Investment



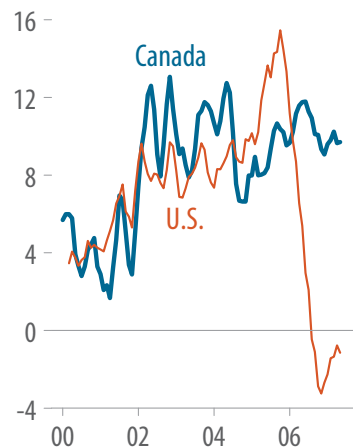
U.S. HOUSING SLIDES... CANADA STAYS STRONG

(y/y % chng : 3-mnth m.a.)

New Home Prices



Existing Home Prices



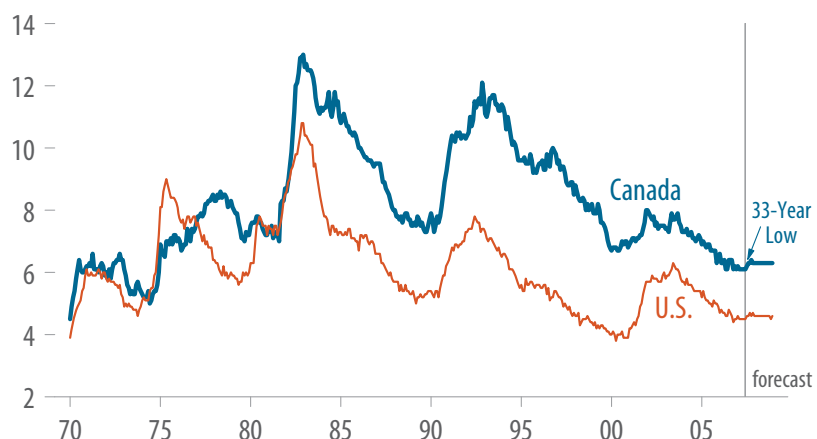
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JOBLESS RATES TO REMAIN LOW

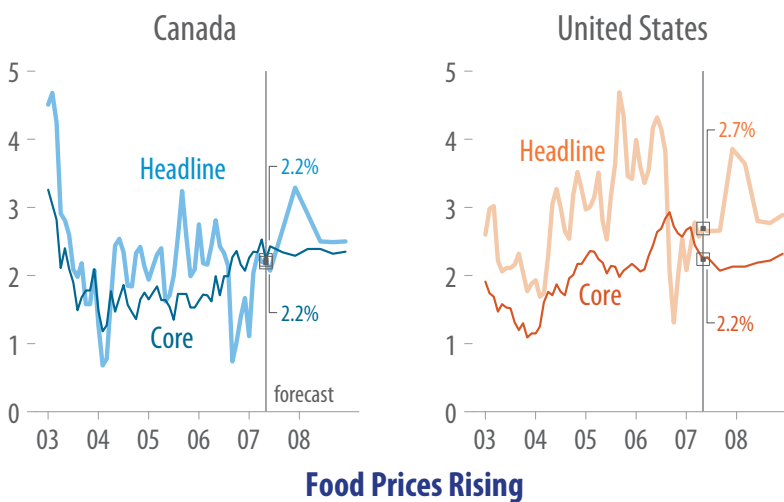
(percent)

Jobless Rates



INFLATION TO STAY ELEVATED

Consumer Price Index (y/y % chng)



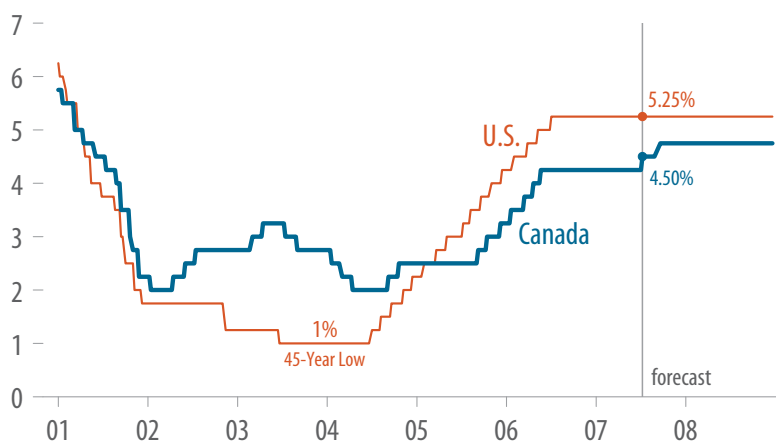
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BoC TIGHTENS, FED MIGHT FOLLOW

(% : as of July 10, 2007)

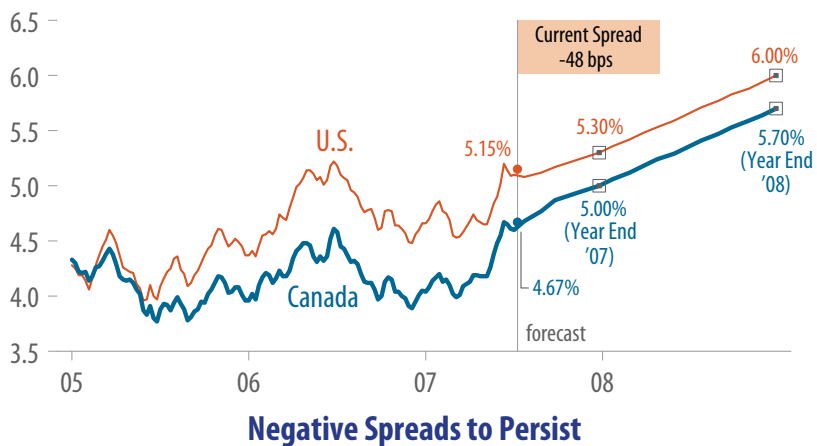
Overnight Rates



BOND YIELDS ON THE RISE

(% : as of July 9, 2007)

10-Year Bonds



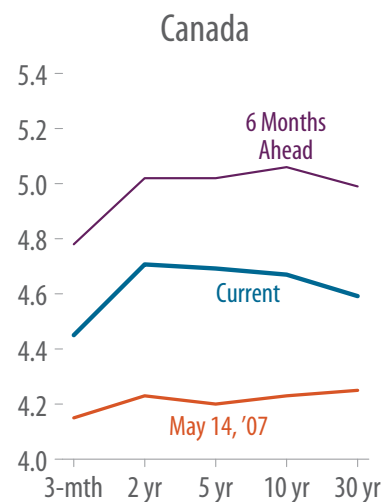
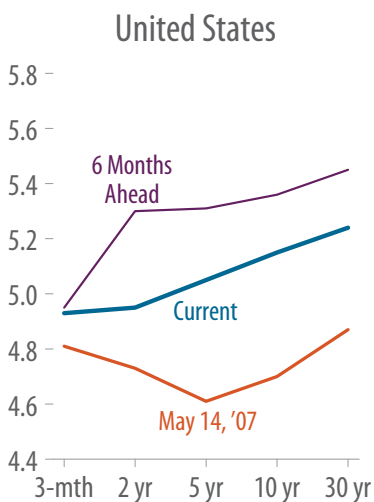
Negative Spreads to Persist

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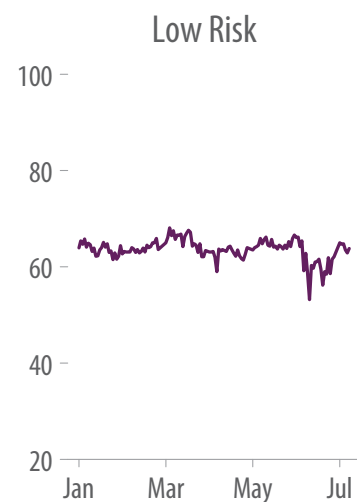
CURVE STEEPENING AHEAD

Yield Curves (percent)



HIGH-RISK CREDIT SPREADS HAVE BACKED UP

10-Year Credit Spreads—United States—2007 (basis points)



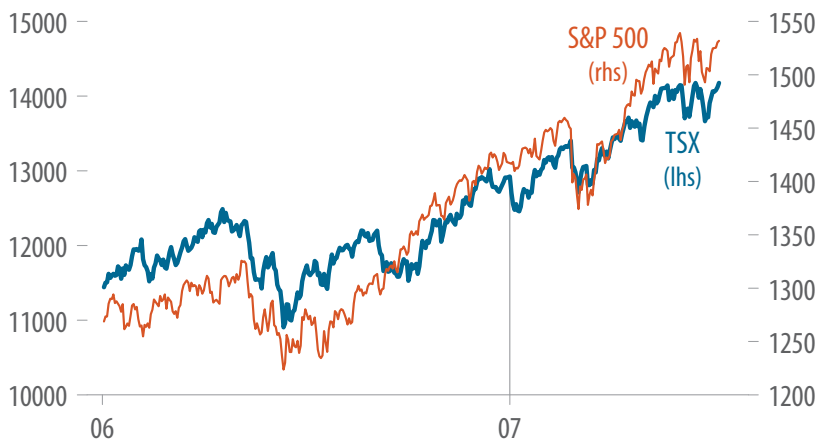
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STOCK MARKETS IN RECORD TERRITORY

(as of July 9, 2007)

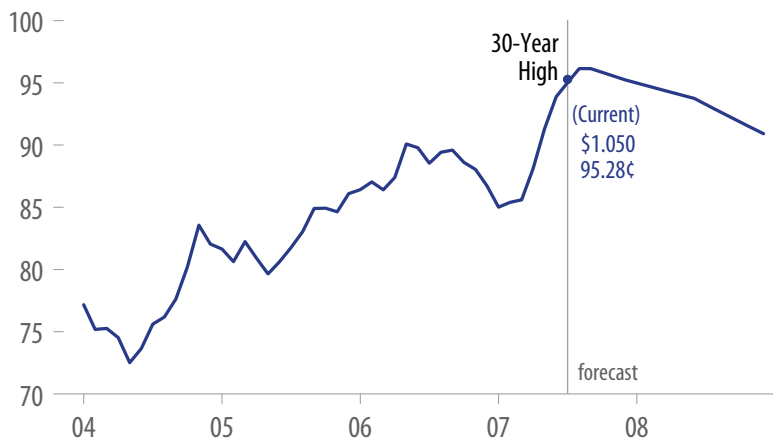
Stock Market Indexes



LOONIE AT 30-YEAR HIGH

(USC : as of July 9, 2007)

Canadian Dollar versus U.S. Dollar

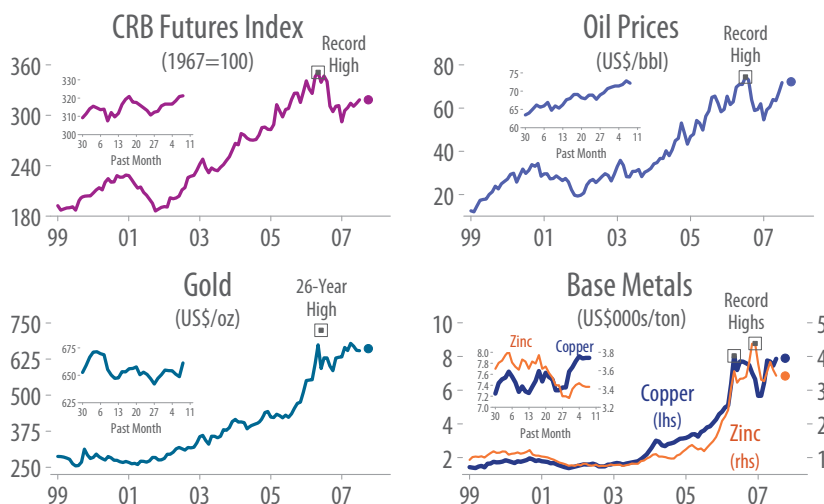


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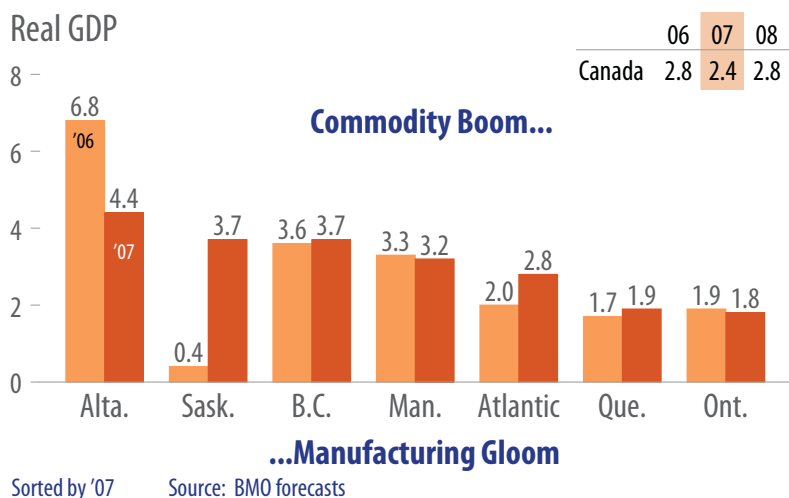
COMMODITIES REMAIN ELEVATED

(as of July 9, 2007)



CANADIAN REGIONAL DISPARITIES TO NARROW SLIGHTLY

(y/y % chng)



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CANADA	2007				2008				ANNUAL		
	I	II	III	IV	I	II	III	IV	2006	2007	2008
Real GDP (q/q % chng : a.r.)	3.7	2.5	2.8	2.7	2.6	2.8	2.9	3.2	2.8	2.4	2.8
Consumer Price Index (y/y % chng)	1.9	2.1	2.7	3.3	2.8	2.5	2.5	2.5	2.0	2.5	2.6
Unemployment Rate (%)	6.1	6.1	6.2	6.3	6.3	6.3	6.3	6.3	6.3	6.2	6.3
Housing Starts (000s : a.r.)	222	219	202	197	197	188	188	188	228	210	190
Current Account Balance (\$blns : a.r.)	26.0	27.2	25.9	25.0	21.7	18.4	16.3	15.5	23.6	26.0	18.0
Interest Rates											
(average for the quarter : %)											
Overnight Rate	4.25	4.25	4.58	4.75	4.75	4.75	4.75	4.75	4.06	4.46	4.75
3-month Treasury Bill	4.17	4.23	4.73	4.78	4.79	4.79	4.80	4.81	4.01	4.48	4.80
10-year Bond	4.10	4.36	4.77	4.96	5.12	5.29	5.47	5.64	4.21	4.55	5.38
Canada/U.S. Interest Rate Spreads											
(average for the quarter : bps)											
90-day	-95	-64	-9	-4	-5	-8	-10	-12	-84	-43	-9
10-year	-59	-49	-35	-30	-30	-30	-30	-30	-58	-43	-30
UNITED STATES											
Real GDP (q/q % chng : a.r.)	0.7	2.9	2.4	2.6	2.6	2.7	2.8	3.1	3.3	2.0	2.7
Consumer Price Index (y/y % chng)	2.4	2.7	2.7	3.9	3.6	2.8	2.8	2.9	3.2	2.9	3.0
Unemployment Rate (%)	4.5	4.5	4.6	4.6	4.6	4.6	4.6	4.6	4.6	4.6	4.6
Housing Starts (mlns : a.r.)	1.46	1.48	1.45	1.42	1.42	1.44	1.49	1.57	1.81	1.45	1.48
Current Account Balance (\$blns : a.r.)	-770	-775	-767	-759	-747	-737	-736	-740	-811	-768	-740
Interest Rates											
(average for the quarter : %)											
Fed Funds Target Rate	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	4.96	5.25	5.25
3-month Treasury Bill	5.12	4.87	4.82	4.82	4.84	4.87	4.90	4.93	4.85	4.91	4.89
10-year Note	4.68	4.85	5.12	5.26	5.42	5.59	5.77	5.94	4.79	4.98	5.68
EXCHANGE RATES											
(average for the quarter)											
US¢/C\$	85.3	91.1	95.5	94.6	93.8	92.9	92.0	91.2	88.2	91.7	92.5
C\$/US\$	1.172	1.098	1.047	1.057	1.067	1.077	1.087	1.097	1.134	1.093	1.082
¥/US\$	119	121	123	119	116	114	111	109	116	121	113
US\$/Euro	1.31	1.35	1.36	1.39	1.38	1.35	1.33	1.31	1.26	1.35	1.34
US\$/£	1.96	1.99	1.99	1.97	1.96	1.94	1.92	1.91	1.84	1.98	1.93

Note: Blocked areas represent BMO Capital Markets forecasts



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