

# NORTH AMERICAN Outlook

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## After the Bailout: the New, New Reality

### HIGHLIGHTS

*Greater risk of deep, long downturn amid heightened credit market turmoil*

*U.S. likely in recession, slow recovery at best*

*Canada's economy faces more stress, will barely avoid recession*

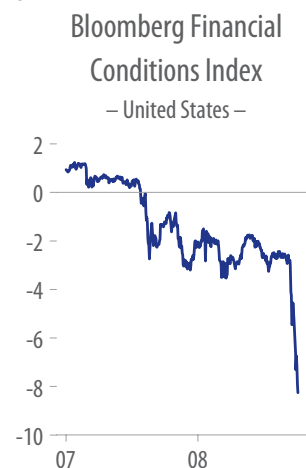
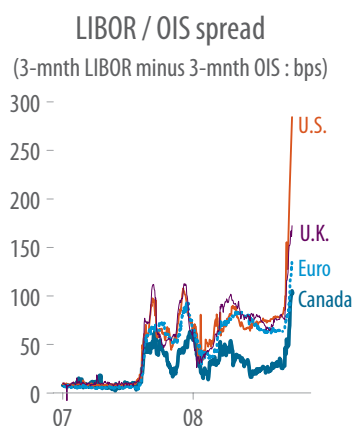
*Rate cuts to resume*

*C\$ hit by commodity rout*

- **We have lowered our outlook for the North American economy** in response to the watershed events that have reshaped Wall Street and roiled global credit markets. Even with the massive U.S. bailout package, the near-term growth outlook has worsened, as confidence has undoubtedly taken a major hit. A primary concern is that U.S. credit spreads have blown out, causing financial conditions to tighten significantly (*Chart 1*). We now see a deeper contraction of the U.S. economy in the second half of the year and minimal recovery (0.8% growth) in 2009. For Canada, we expect little growth in the second half of the year and just a modest 1.0% gain next year.
- **The growing risks to the economy are expected to spur the Fed and Bank of Canada to cut rates further, with an inter-meeting move in the U.S. possible if financial conditions do not improve soon.** The Fed has been reluctant to lower rates again, preferring to first flood the system with liquidity. However, the economic impact of the latest credit market distress is mounting, and recent U.S. data on employment, manufacturing and auto sales suggest the underlying economic situation alone warrants further rate relief.
- **The financial turmoil has led to higher U.S. borrowing costs, tighter lending standards, and a further equity sell-off.** Banks are paying more to raise capital to absorb losses on mortgage-related securities. Higher borrowing costs and tighter credit are prolonging the slump in consumer and business spending, both of which likely contracted in the third quarter. Despite improved affordability, home sales remain depressed because of tighter credit standards. Consequently, inventories remain high despite sharply lower

CHART 1

### FINANCIAL CRISIS HITS EXTREMES



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housing starts, and prices continue to fall. And it may get worse. Many households with option-ARMs will see their payments reset higher in coming years, keeping foreclosures high. While the government's takeover of Fannie/Freddie has helped trim mortgage rates, sales will remain soft until lending standards ease. With banks deleveraging, it will take time for the credit taps to open and the housing market to bottom, likely next year at the earliest.

- The government's \$700 billion plan to purchase troubled assets could help banks recapitalize so they can renew lending to businesses that are facing a credit squeeze. Still, the credit crisis could linger until house prices stop falling, likely sometime next year. Banks are unlikely to increase lending until consumers get a better grip on their finances. All in, the plan may ease the symptoms of the credit crisis but it is unlikely to spur a fast economic recovery, and banks will need further capital injections for a lasting cure.
- **For Canada, weaker American spending will put even more strain on exporters and manufacturers, while the pullback in commodity prices will slow the Western provinces.** Companies have turned cautious, trimming jobs in recent months and likely reining in capital spending. Consumer spending has slowed notably, with retail volumes sagging the past three months. Still, there remains a clear separation between Canada and the U.S. on the consumer front—even amid the intense financial turbulence in September, Canadian auto sales managed to climb slightly from year-ago levels compared with a 24% plunge in U.S. sales. The housing market continues to cool in response to reduced affordability, with resales down 19% in August from a year ago. House prices are falling in a number of major cities, and some further moderate declines may be needed to return affordability to historic norms. However, the risk of a full-fledged housing bust is minimal because of Canada's more conservative lending standards. As well, credit remains readily available, though at a somewhat higher cost than a month ago.
- **The risks to the North American economy remain to the downside.** There are many inter-related stress points, and sectors beyond housing are getting pinched. U.S. commercial real estate is starting to buckle in the face of lower values and tighter credit. State and local finances have been eroded by falling property values. The Boeing strike is an added strain on factory activity.
- After wobbling last month on concerns about a deeper recession and growing public debt, the **U.S. dollar has climbed** further as the credit crisis expands its global reach and sinking commodity prices hammer resource-based currencies like the loonie. The U.S. debt is currently at 67% of GDP and could rise to 72% if the government uses the proposed \$700 billion to purchase troubled assets. However, this ratio is still well below that of several other countries (Japan, Italy and Belgium). An improving trade balance should provide ongoing support to

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the greenback. Still, the path to recovery will be bumpy, especially if the U.S. economy leads the global race to the bottom.

| CANADA  | 2008  |       |       |       | 2009  |       |       |       | ANNUAL |       |       |
|---|-------|-------|-------|-------|-------|-------|-------|-------|--------|-------|-------|
|   | I     | II    | III   | IV    | I     | II    | III   | IV    | 2007   | 2008  | 2009  |
| Real GDP (q/q % chng : a.r.)  | -0.8  | 0.3   | 1.7   | -0.4  | 0.6   | 1.4   | 2.0   | 2.4   | 2.7    | 0.7   | 1.0   |
| Consumer Spending   | 3.1   | 2.4   | 2.0   | 2.0   | 2.0   | 2.2   | 2.7   | 2.9   | 4.5    | 3.9   | 2.2   |
| Business Investment (non-residential)                                       | 2.1   | -1.4  | 3.2   | 1.5   | 0.5   | 1.5   | 3.0   | 4.0   | 3.5    | 2.6   | 1.6   |
| Consumer Price Index (y/y % chng)   | 1.8   | 2.3   | 3.5   | 3.4   | 3.4   | 2.5   | 1.9   | 2.1   | 2.1    | 2.7   | 2.5   |
| Unemployment Rate (%)   | 5.9   | 6.1   | 6.1   | 6.4   | 6.6   | 6.7   | 6.6   | 6.6   | 6.0    | 6.1   | 6.6   |
| Housing Starts (000s : a.r.)  | 234   | 220   | 197   | 190   | 188   | 185   | 184   | 183   | 228    | 210   | 185   |
| Current Account Balance (\$blns : a.r.)                                     | 17.8  | 27.0  | 10.1  | 5.2   | 0.4   | -2.5  | -4.4  | -5.5  | 13.6   | 15.0  | -3.0  |
| <b>Interest Rates</b><br>(average for the quarter : %)                      |       |       |       |       |       |       |       |       |        |       |       |
| Overnight Rate  | 3.83  | 3.00  | 3.00  | 2.67  | 2.50  | 2.50  | 2.58  | 3.17  | 4.35   | 3.13  | 2.69  |
| 3-month Treasury Bill   | 2.99  | 2.54  | 2.31  | 2.04  | 2.00  | 2.34  | 2.85  | 3.36  | 4.14   | 2.47  | 2.64  |
| 10-year Bond  | 3.73  | 3.67  | 3.63  | 3.38  | 3.40  | 3.57  | 3.76  | 3.94  | 4.27   | 3.60  | 3.67  |
| <b>Canada/U.S. Interest Rate Spreads</b><br>(average for the quarter : bps) |       |       |       |       |       |       |       |       |        |       |       |
| 90-day  | 90    | 89    | 79    | 78    | 57    | 60    | 74    | 88    | -34    | 84    | 70    |
| 10-year   | 7     | -22   | -23   | -12   | -13   | -17   | -21   | -24   | -36    | -12   | -19   |
| <b>UNITED STATES</b>  |       |       |       |       |       |       |       |       |        |       |       |
| Real GDP (q/q % chng : a.r.)  | 0.9   | 2.8   | -0.6  | -0.6  | 0.5   | 1.4   | 2.2   | 2.5   | 2.0    | 1.5   | 0.8   |
| Consumer Spending   | 0.9   | 1.2   | -1.5  | -1.2  | -0.3  | 0.9   | 1.6   | 2.0   | 2.8    | 0.7   | 0.1   |
| Business Investment (non-residential)                                       | 2.4   | 2.5   | -3.3  | -4.0  | -3.9  | -1.5  | 0.5   | 1.1   | 4.9    | 2.7   | -2.2  |
| Consumer Price Index (y/y % chng)   | 4.2   | 4.3   | 5.3   | 4.3   | 3.6   | 2.7   | 1.5   | 1.6   | 2.9    | 4.5   | 2.3   |
| Unemployment Rate (%)   | 4.9   | 5.3   | 6.0   | 6.4   | 6.6   | 6.8   | 6.8   | 7.0   | 4.6    | 5.6   | 6.8   |
| Housing Starts (mlns : a.r.)  | 1.05  | 1.03  | 0.91  | 0.83  | 0.80  | 0.83  | 0.89  | 0.95  | 1.34   | 0.96  | 0.87  |
| Current Account Balance (\$blns : a.r.)                                     | -703  | -733  | -702  | -643  | -609  | -577  | -553  | -539  | -731   | -695  | -570  |
| <b>Interest Rates</b><br>(average for the quarter : %)                      |       |       |       |       |       |       |       |       |        |       |       |
| Fed Funds Target Rate   | 2.75  | 2.00  | 2.00  | 1.50  | 1.50  | 1.50  | 1.58  | 2.08  | 5.00   | 2.06  | 1.67  |
| 3-month Treasury Bill   | 2.09  | 1.66  | 1.52  | 1.26  | 1.43  | 1.74  | 2.11  | 2.48  | 4.47   | 1.63  | 1.94  |
| 10-year Note  | 3.66  | 3.88  | 3.86  | 3.49  | 3.53  | 3.74  | 3.96  | 4.18  | 4.63   | 3.73  | 3.85  |
| <b>EXCHANGE RATES</b><br>(average for the quarter)                          |       |       |       |       |       |       |       |       |        |       |       |
| US\$/C\$  | 99.6  | 99.0  | 96.0  | 93.0  | 92.0  | 91.2  | 90.4  | 89.6  | 93.5   | 96.9  | 90.8  |
| C\$/US\$  | 1.004 | 1.010 | 1.042 | 1.075 | 1.087 | 1.097 | 1.107 | 1.117 | 1.074  | 1.033 | 1.102 |
| ¥/US\$  | 105   | 105   | 108   | 108   | 110   | 114   | 113   | 111   | 118    | 106   | 112   |
| US\$/Euro   | 1.50  | 1.56  | 1.50  | 1.39  | 1.38  | 1.35  | 1.33  | 1.31  | 1.37   | 1.49  | 1.34  |
| US\$/£  | 1.98  | 1.97  | 1.89  | 1.77  | 1.74  | 1.73  | 1.72  | 1.70  | 2.00   | 1.90  | 1.72  |

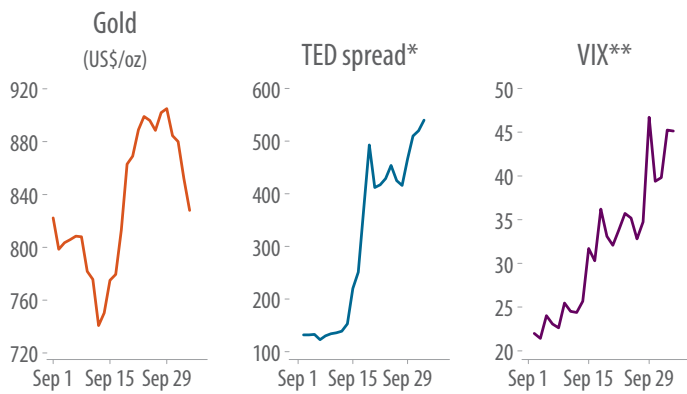
Note: Blocked areas represent BMO Capital Markets forecasts

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## RISK AVERSION PARAMOUNT

United States – 2008 (as of October 6, 2008)

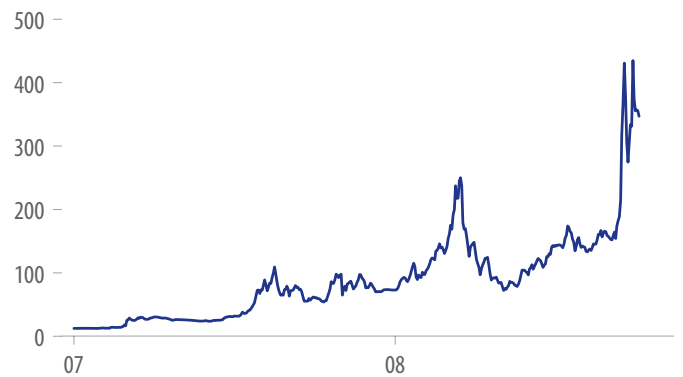


\* 3-mnth Eurodollar minus 3-mnth T-bills : bps \*\* CBOE market volatility index

## U.S. CREDIT DEFAULT SWAP SPREADS SURGE

5-Year Spreads – United States (bps)

Average Market Spreads, Credit Default Swaps



## LOONIE WEAKENS WITH ECONOMY

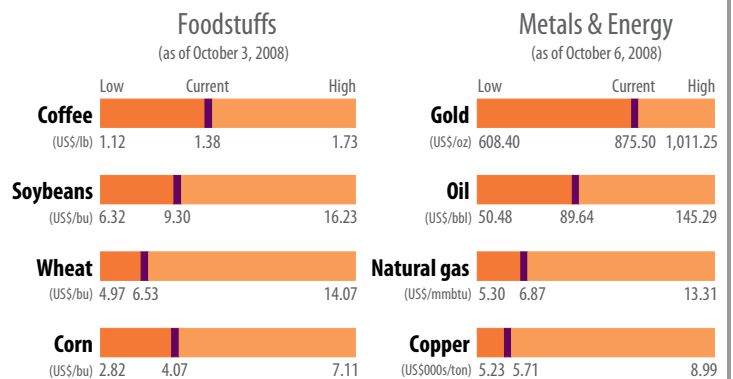
(US¢ : as of October 6, 2008)

Canadian Dollar



## COMMODITY PRICE PULLBACK

Commodity price range (since January 2007)



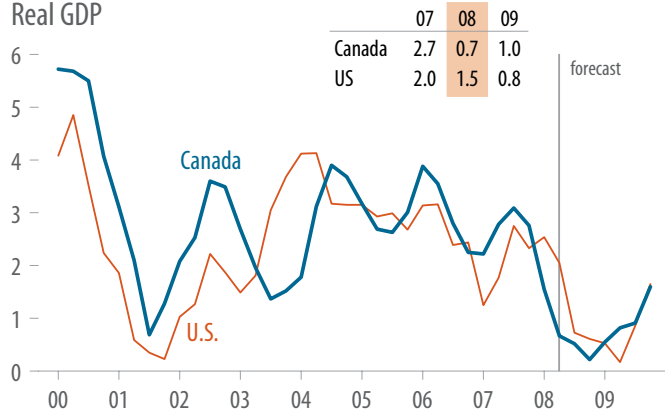
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## GROWTH VANISHES

(y/y % chng)

Real GDP



## AMERICAN CONSUMERS PULL BACK

(y/y % chng)

Real Personal Consumption Expenditures

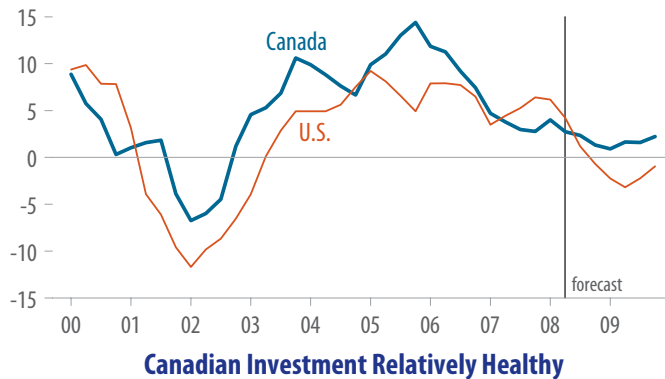


**Canadian Shoppers Stepping Back Too**

## U.S. BUSINESS INVESTMENT WILL RETRENCH

(y/y % chng)

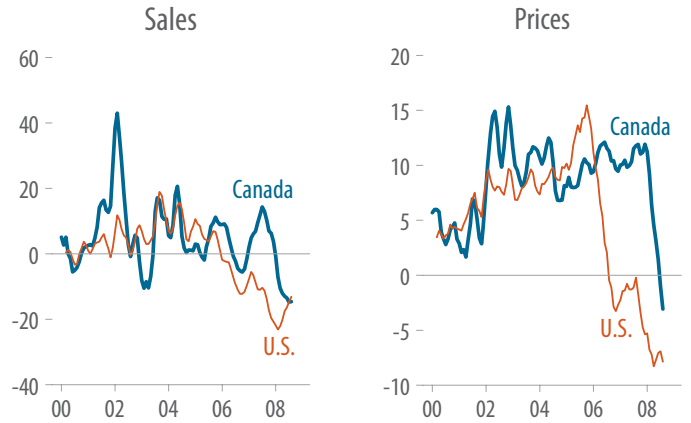
Real Non-Residential Business Investment



**Canadian Investment Relatively Healthy**

## CANADIAN HOUSING COOLING FAST

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



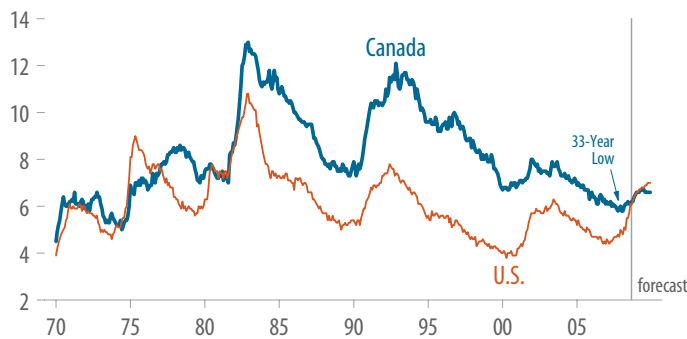
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## U.S. JOBLESS RATE RISING SHARPLY

(percent)

Jobless Rates

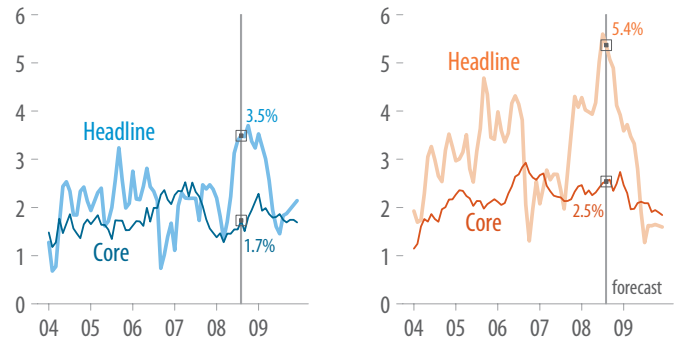


## INFLATION TO FALL SHARPLY

Consumer Price Index (y/y % chng)

Canada

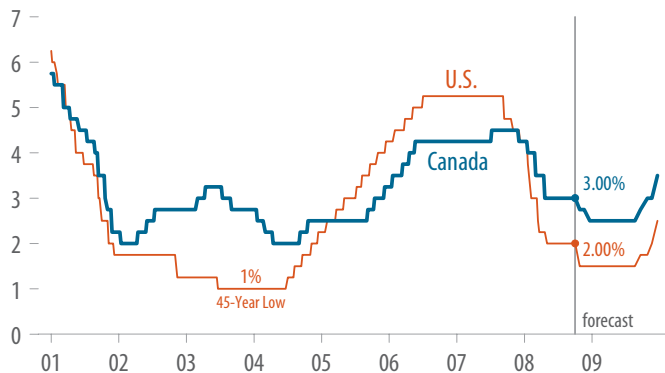
United States



## CENTRAL BANKS TO RESUME EASING

(% : as of October 3, 2008)

Overnight Rates



## TREASURY YIELDS REMAIN VERY LOW

(% : as of October 6, 2008)

10-Year Bonds





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