



NORTH AMERICAN Outlook

Dr. Sherry Cooper, Chief Economist • www.bmonesbittburns.com/economics

HIGHLIGHTS

The recession is waning though a recovery may be several months away and will be mild

Improved affordability has recharged Canada's housing market and stabilized U.S. home sales

Central banks likely to hold steady well into 2010

The C\$ could test parity next year, greased by \$75 oil

Turning The Corner, Slowly

RECESSION WINDS LETTING UP

- Our views on the economy and interest rates haven't changed much in recent months. The economy is expected to contract 3% in the U.S. this year and 2½% in Canada, with modest growth resuming in the fall. The recovery should be mild by past standards, largely because of U.S. consumer deleveraging. This will keep unemployment rates high and central banks on hold well into next year.
- Recent data suggest the recession is easing. Auto sales have stabilized at quarter-century lows in the U.S. and decade-lows in Canada. Though still weak, consumer confidence has improved on both sides of the border, helping to stabilize spending. Home sales have stopped falling in the U.S., and are rising in several hard-hit states like California, Arizona and Nevada. In California, despite 11.5% unemployment, the supply of existing homes has fallen sharply, lifting prices for three straight months (after a 30% drop the past year). In Canada, home sales have risen 43% since January (seasonally adjusted), and prices have hooked up. After declining at a 5%-to-6% annual rate in Q1, real GDP in both countries likely contracted 3% in Q2.
- By many measures, financial conditions have improved to pre-Lehman levels. Recovering risk appetites have reduced corporate bond yields to historic norms, with spreads against Treasuries returning to their September 2008 levels. Inter-bank lending spreads have virtually normalized, reducing bank funding costs. Several large U.S. banks have repaid TARP funds, a vote of confidence that the worst of the financial crisis is over. Equity prices in both countries have bounced about 36% from their March lows, led by financials.
- That's not to say all is hunky-dory. Job losses, though slowing, remain large in both countries. One broad measure of U.S. unemployment that includes discouraged workers and part-timers looking for full-time work has never been higher in the postwar period. Consequently, consumer spending remains weak, despite a massive temporary boost to U.S. disposable income from tax cuts and increased social security payments. U.S. house prices continue to decline sharply due to weak demand and record foreclosures, while commercial real estate remains in distress amid rising office and mall vacancies. The rate of U.S. early mortgage delinquencies rose to a record high in May, flagging more foreclosures as the government's mortgage-modification program is having only limited success. Manufacturing continues to contract, albeit at a slower rate than before. Canadian exports are unlikely to stop falling until Americans start spending again.

Sal Guatieri,
Senior Economist
sal.guatieri@bmo.com
416-359-5295



NORTH AMERICAN Outlook



RECOVERY COMING BUT WON'T FEEL LIKE ONE

- Autumn should mark the resumption of growth in both countries, the pay-off of two years of unprecedented monetary and fiscal stimulus. Auto production will get a boost from the reopening of Chrysler's plants in late June and the planned reopening of GM's 13 American plants later this month. The U.S. government's "cash-for-clunkers" program will support auto sales beginning in late July, with the \$1 billion program possibly lifting sales an annualized one million units before it ends in November. Current lean manufacturing inventories in the U.S. will support production in H2. Rising oil and resource prices (thanks in part to China's massive fiscal stimulus plan) could revive investment plans in Western Canada.
- But the recovery will be subdued. Prolonged deleveraging by American consumers and (eventually by government) will restrain the expansion. U.S. savings, at nearly 7% of disposable income in May compared with nil about a year ago, will likely remain high in 2010 to restore household balance sheets to pre-credit-boom levels. Rising gasoline prices risk draining more than one per cent from discretionary spending this year, offsetting most of the benefit of the U.S. income tax cuts. Besides soft American demand, Canadian exporters must deal with a higher currency. Due to the anemic recovery, the U.S. jobless rate could remain near a 26-year high of 10% through 2010 (just below the 1982 postwar high of 10.8%), while Canada's rate could hover at a 12-year peak of 9%.

GREEN SHOOTS NEED WATERING

- The Fed is likely on hold for an "extended period". An expected soft recovery and the greatest amount of inflation-absorbing slack in at least six decades would seem to rule out the need for an early "exit strategy". The double-dip U.S. recession in 1937 and Japan's woeful experience in the 1990s suggest that Chairman Bernanke (a scholar of the Depression) won't jump the gun in removing the stimulus. We continue to see the Fed on hold until next summer, later than the consensus view. Meantime, an ebbing recession and lessening deflation risks likely preclude the need for further unconventional easing, such as a meaningful expansion of the Agency MBS/debt and Treasury purchase programs.
- Taking transparency to a new level, the Bank of Canada has been even clearer than the Fed on how long it plans to hold rates steady – until mid-2010. If anything, the risk is probably towards an even longer holding period given that the recovery will be subdued and core inflation (currently at the Bank's 2% target) will likely drift lower in response to spare capacity and a rising currency.
- The 1¼-ppt increase in 10-year Treasury rates this year reflects the pricing-out of depression risks, an unwinding of risk aversion, and massive new issuance. However, a subdued recovery and restrained core inflation, coupled with the Fed's ongoing Treasury purchases to September, should keep a lid on long rates



NORTH AMERICAN Outlook



for the balance of the year. Further out, 10-year rates are expected to climb one percentage point in 2010 in response to tighter monetary policy. Although the Bank of Canada hasn't walked in the Fed's QE footsteps, Canadian rates have risen a milder 70 bps this year, benefitting from less-bad fiscal trends. Ottawa's budget shortfall is estimated at just over 3% of GDP this year versus 13% stateside. Canadian yields should climb somewhat less than Treasury rates next year.

OIL'S WELL WITH CANADIAN DOLLAR

- Riding the commodity price wave, the Canadian dollar has risen 6% this year against a generally soft greenback. It will likely consolidate in the high-80 cent U.S. range near term, as the road to economic recovery could remain bumpy. However, the loonie should take aim at parity next year on the back of higher resource prices, including \$75 oil in 2010. As well, China's demands for a "super-sovereign" currency, even if largely talk, will continue to dog the greenback.

A FEW WEEDS REMAIN

- Falling U.S. home prices remain the biggest threat to the outlook. Until prices stabilize, mortgage-backed securities will continue to lose value, lending standards will remain tight, and foreclosures will climb (with an estimated one-in-five homeowners already underwater on their mortgage).
- Although the U.S. banking sector has stabilized, lending continues to contract and the securitization market remains shut down (amid a slow-starting TALF). Souring commercial real estate loans and rising credit-card defaults could continue to undermine lending at many midsize banks.
- The ballooning U.S. budget deficit could dent the government's triple-A credit rating, leading to higher borrowing costs for Americans. In Canada, Ontario's soaring budget deficit (owing partly to the GM/Chrysler bailouts) puts it at risk of a credit downgrade.
- Until motor vehicle sales rev higher, restructuring plans for GM and Chrysler could hit a major pothole, resulting in even more layoffs (and taxpayer support). One research group thinks Canada's auto-parts sector could shrink by one-third this year, resulting in about 37,000 job losses.
- The Bank of Canada has warned that Canadian household finances, though still reasonably healthy, continue to deteriorate amid rapid debt accumulation. This means households (especially low-income ones) are susceptible to sharp increases in unemployment or interest rates.

NORTH AMERICAN Outlook



CANADA	2009				2010				ANNUAL		
	I	II	III	IV	I	II	III	IV	2008	2009	2010
Real GDP (q/q % chng : a.r.)	-5.4	-3.0	0.0	1.5	2.6	2.8	2.9	2.9	0.4	-2.5	1.8
Consumer Spending	-1.6	0.0	0.1	1.8	1.9	2.2	2.6	2.9	3.0	-0.7	1.7
Business Investment (non-residential)	-25.8	-17.5	-12.0	-5.0	-0.5	1.0	1.7	2.5	0.2	-14.9	-3.3
Consumer Price Index (y/y % chng)	1.2	0.2	-0.1	1.3	1.8	2.0	1.6	1.5	2.4	0.6	1.8
Unemployment Rate (%)	7.6	8.3	9.0	9.3	9.3	9.2	8.9	8.7	6.1	8.6	9.0
Housing Starts (000s : a.r.)	140	125	135	140	142	143	142	153	211	135	145
Current Account Balance (\$blns : a.r.)	-36.2	-35.6	-31.5	-32.7	-34.7	-36.4	-38.3	-38.6	8.1	-34.0	-37.0
Interest Rates (average for the quarter : %)											
Overnight Rate	0.83	0.25	0.25	0.25	0.25	0.25	0.58	1.08	2.96	0.40	0.54
3-month Treasury Bill	0.64	0.25	0.23	0.23	0.23	0.31	0.81	1.29	2.33	0.34	0.66
10-year Bond	2.89	3.20	3.33	3.43	3.66	3.90	4.15	4.39	3.61	3.21	4.03
Canada/U.S. Interest Rate Spreads (average for the quarter : bps)											
90-day	43	8	6	6	6	14	31	25	94	15	19
10-year	15	-11	-16	-22	-27	-31	-35	-39	-6	-8	-33
UNITED STATES											
Real GDP (q/q % chng : a.r.)	-5.5	-2.9	0.0	1.5	2.3	2.5	2.7	2.8	1.1	-3.0	1.7
Consumer Spending	1.4	-1.0	-1.7	-1.2	0.9	1.6	2.2	2.4	0.2	-1.4	0.4
Business Investment (non-residential)	-37.3	-27.3	-16.6	-7.3	-1.2	1.7	3.5	4.7	1.6	-22.1	-5.0
Consumer Price Index (y/y % chng)	-0.2	-1.1	-2.2	0.2	1.2	1.6	1.7	1.8	3.8	-0.8	1.6
Unemployment Rate (%)	8.1	9.2	9.8	10.1	10.2	10.2	10.0	9.9	5.8	9.3	10.1
Housing Starts (mlns : a.r.)	0.53	0.50	0.49	0.57	0.68	0.74	0.78	0.82	0.90	0.52	0.75
Current Account Balance (\$blns : a.r.)	-406	-366	-370	-358	-347	-342	-338	-330	-706	-375	-340
Interest Rates (average for the quarter : %)											
Fed Funds Target Rate	0.13	0.13	0.13	0.13	0.13	0.13	0.46	1.00	1.86	0.13	0.43
3-month Treasury Bill	0.21	0.17	0.17	0.17	0.17	0.17	0.50	1.04	1.39	0.18	0.47
10-year Note	2.74	3.31	3.49	3.65	3.94	4.22	4.50	4.78	3.67	3.30	4.36
EXCHANGE RATES (average for the quarter)											
US¢/C\$	80.3	85.6	87.6	89.9	92.3	94.5	96.8	99.2	94.3	85.9	95.7
C\$/US\$	1.245	1.168	1.142	1.113	1.083	1.058	1.033	1.008	1.067	1.167	1.046
¥/US\$	94	97	96	99	101	102	103	105	103	97	103
US\$/Euro	1.30	1.36	1.38	1.39	1.43	1.46	1.50	1.54	1.47	1.36	1.48
US\$/£	1.44	1.55	1.61	1.64	1.69	1.75	1.82	1.88	1.85	1.56	1.79

Note: Blocked areas represent BMO Capital Markets forecasts

NORTH AMERICAN Outlook



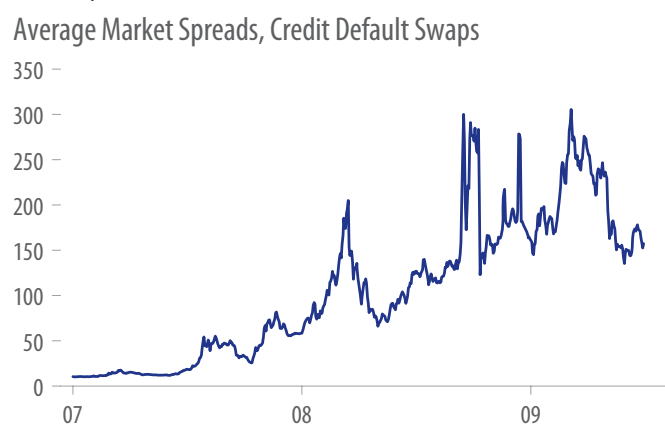
RISK AVERSION ABATES...

United States – 2008-09 (as of July 2, 2009)



...THOUGH CREDIT DEFAULT STILL A CONCERN

5-Year Spreads – United States (bps)



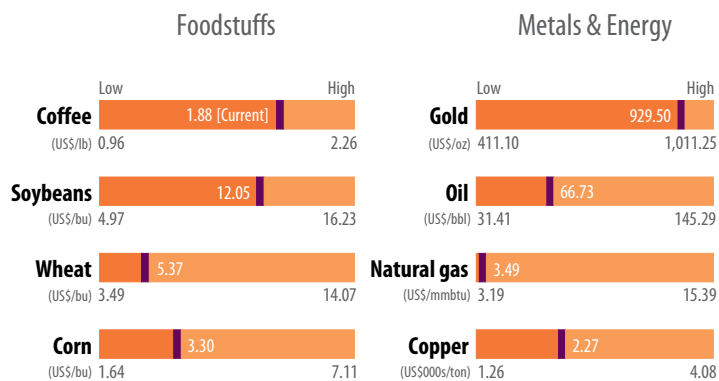
LOONIE: FROM HERE TO PARITY

(US¢ : as of July 2, 2009)



COMMODITY PRICES FIRMING

Commodity price range (since January 2005 : as of July 2, 2009)



NORTH AMERICAN Outlook

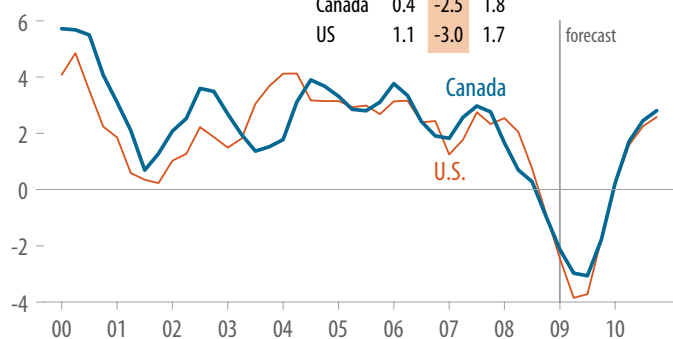


RECESSION TO END LATE 2009

(y/y % chng)

Real GDP

	08	09	10
Canada	0.4	-2.5	1.8
US	1.1	-3.0	1.7

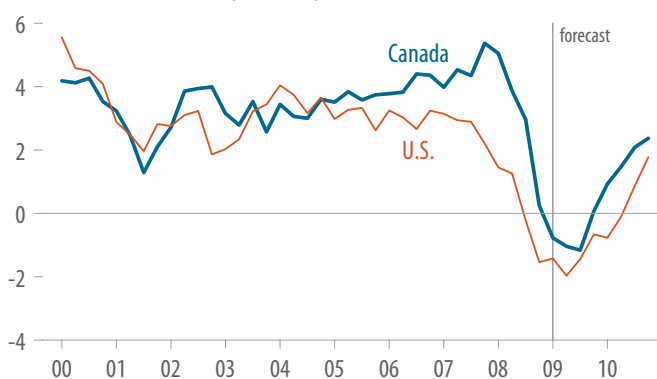


But Recovery Will Be Mild

CONSUMERS UNDER PRESSURE

(y/y % chng)

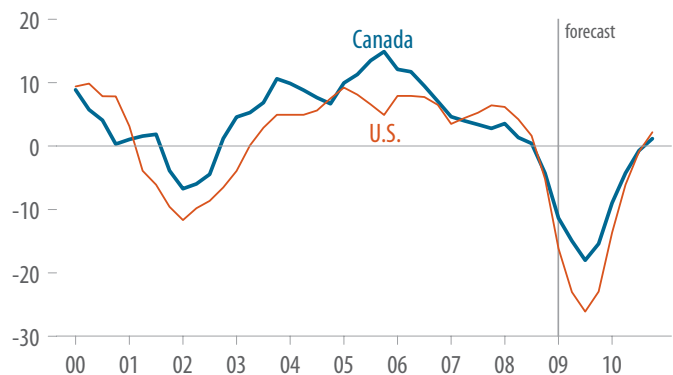
Real Personal Consumption Expenditures



BUSINESS INVESTMENT IN FULL RETREAT

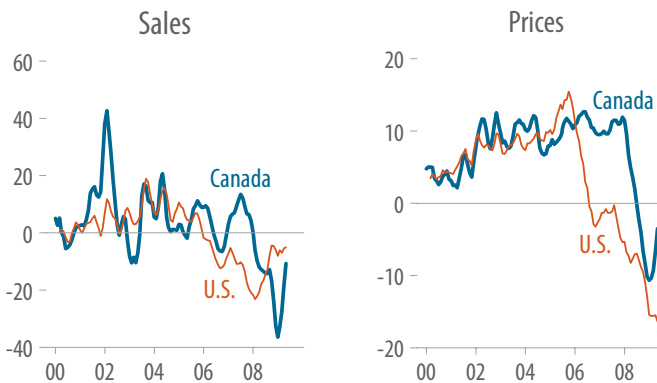
(y/y % chng)

Real Non-Residential Business Investment



HOUSE PRICES STILL FALLING IN U.S.

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



...But Stabilizing in Canada

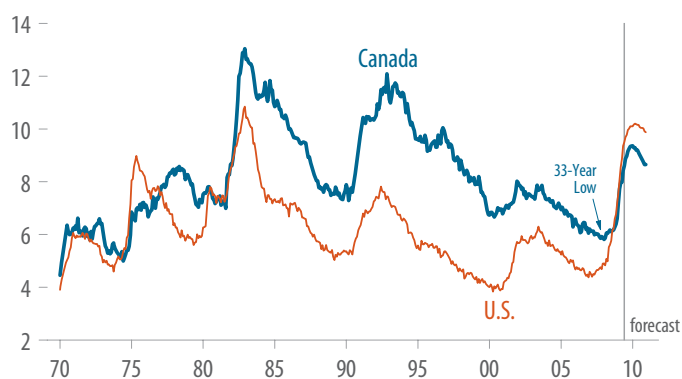
NORTH AMERICAN Outlook



JOBLESS RATE ON THE RISE

(percent)

Jobless Rates

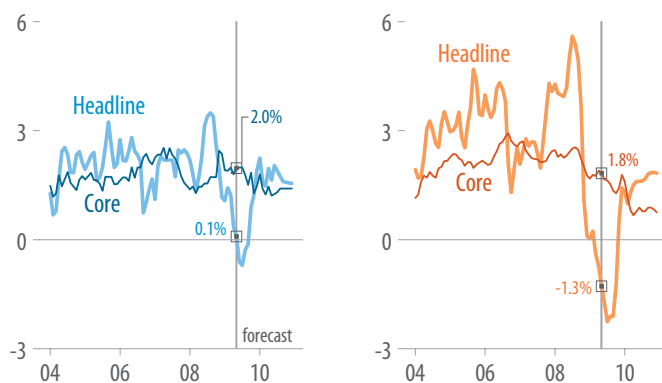


CORE INFLATION HEADED LOWER

Consumer Price Index (y/y % chng)

Canada

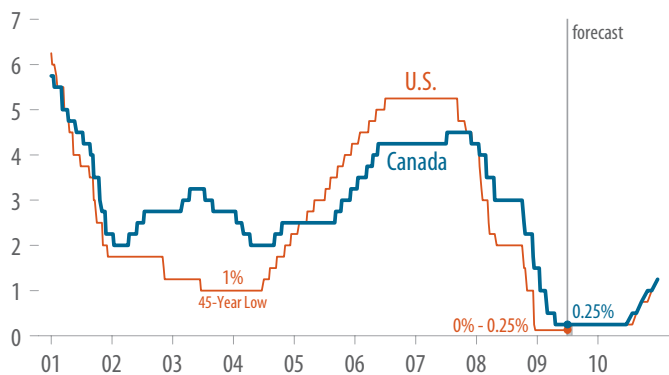
United States



ZERO RATES TO PERSIST A WHILE

(% : as of July 2, 2009)

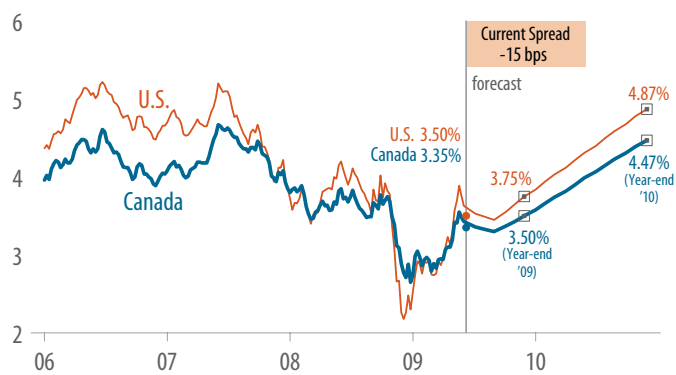
Overnight Rates



BONDS FACE A BLEAKER FUTURE

(% : as of July 3, 2009)

10-Year Bonds





NORTH AMERICAN Outlook



ECONOMIC
RESEARCH

BMO  Capital Markets

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.