

The Hockey-Stick Recovery

HIGHLIGHTS

The Great Recession is over and a fragile recovery has begun

U.S. deleveraging will hold back the expansion

Aggressive fiscal and monetary policies will stay in place for some time

Inflation and interest rates to stay low well into 2010

Firmer commodity prices should lift the Canadian dollar above parity against a softer greenback

EARLY IN FIRST PERIOD OF RECOVERY GAME

- **Although the data remain choppy, a modest recovery is unfolding on both sides of the border.** U.S. home sales have risen since the spring, putting a floor under prices, while Canada's housing market has made a complete recovery in both sales and (remarkably) prices. The lengthy slide in residential construction has ended. Consumer spending has turned up in the U.S., even beyond the cash-for-clunkers boost to autos, while spending has trended modestly higher in Canada since the spring. Job losses have slowed in the U.S. and all but stopped in Canada. Led by automakers, manufacturers have raised production to replenish depleted inventories, with an upturn in exports providing extra support for U.S. factories. An increase in capital goods orders suggests business spending is steadying in both countries.
- **Record-low interest rates, massive fiscal stimulus and much-improved financial conditions (to above pre-credit crisis levels in Canada) have ended the recession.** Canada's economy has been supported further by higher commodity prices, which reflect the V-shaped recoveries in China and other East Asian economies. The marked improvement in private capital markets has even allowed the U.S. government to wind down its backstop programs for money market funds and bank debt.
- **In Q3, U.S. real GDP likely grew more than 3% annualized after declining 0.7% in Q2, while Canada's economy probably expanded more than 1% after shrinking 3.4%.** The growth discrepancy in the two countries largely reflects a larger swing in U.S. inventory investment and the one-off boost from the cash-for-clunkers program.

RECOVERY WILL BE SUBDUED BY A FEW BODYCHECKS

- Although American households have reduced their debts in the past year (for the first time in 56 years of record-keeping), the current ratio of 114% of personal income remains near record highs, and is up one-third in the past decade. A recent survey suggests that the Great Recession has permanently changed the spending patterns of a majority of Americans towards increased thriftiness. **We still believe households need to double their rate of savings from the current 3% of disposable income to restore finances to pre-credit boom conditions.** But it won't be easy trying to rebuild savings given the current high jobless rate (at an effective rate of 17% when you consider the discouraged and underemployed)

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and the record length of unemployment. And, with the length of the workweek at a record low, work hours will likely be expanded before new workers can be hired. In coming months, over one million Americans will exhaust their unemployment insurance benefits, leading to even more foreclosures. The government's mortgage modification program has had only limited success, with just one-in-eight distressed households benefitting. About \$900 billion in interest-only mortgages will reset higher in coming years, and a record one-in-eight mortgaged households are already in foreclosure or behind on payments. No wonder consumer confidence is so fragile.

- **Unlike housing, U.S. commercial real estate markets continue to weaken amid rising vacancy rates (at 16% for office buildings versus just over 9% in Canada) and rapidly rising delinquency rates.** Business spending in both countries will be constrained in the near term by record amounts of spare industrial capacity. Meantime, state governments are dealing with record declines in revenue by slashing jobs and services, mitigating some of the push from the federal stimulus plan. Private credit is still contracting, as U.S. banks continue to tighten credit standards, and a recent Fed survey suggested they will remain tight-fisted well into 2010. About 5% of the nation's banks are on the FDIC's "problem list", and the IMF estimates that, while American banks are further ahead than their European peers in writing off bad loans, there's still more pain to come.
- **Consumer deleveraging will not only restrain the U.S. recovery but Canada's as well.** However, Canadian households, with a lower debt ratio of 102% of personal income (though up more than one-third in the past decade), have a little more scope to continue spending compared with Americans. As well, proportionately half as many unemployed Canadians have been jobless for over four months.
- **Still, with the aggressive monetary and fiscal stimulus likely to remain in place for a while, both economies should manage to pick themselves off the ice and sustain a recovery in 2010.** The WSJ estimates that only one-fifth of the \$787 billion fiscal stimulus package was allocated as of early September. The bottoming in U.S. house prices should stop the rise in negative homeowner equity, removing a key downside risk to the outlook. Outside of financial firms, American businesses are fiscally fit after years of cutbacks. Cash flow remains strong and debts low, suggesting good potential to spend and hire, once demand picks up. Canada will enjoy the extra benefit of firmer commodity prices, with oil expected to top \$75/bbl next year. **All in, the U.S. economy should grow a moderate 2.5% in 2010, while Canada will likely expand a little faster, led by domestic demand.**



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CENTRAL BANKS CALLING A LOOSE GAME

- Because of the vast improvement in private credit markets, the Fed and the Bank of Canada have ended some emergency lending programs. But this shouldn't be confused with a shift towards tighter policy. Both banks have affirmed that, despite tentative signs of improvement, the economy still requires hefty doses of monetary (and fiscal) medicine, and likely will for some time. In fact, the Fed, which is currently providing up to 80% of mortgage financing, recently extended its mortgage purchase program by three months to March to sustain the housing market recovery. At the same time, owing to the massive slack in the economy, core inflation should continue to ease, suggesting a bias towards retaining the current stimulus. Accordingly, the Fed has pledged to keep rates exceptionally low for an "extended period," while the BoC has conditionally promised to keep rates steady until mid-2010, citing the drag from the strong loonie and weak U.S. consumer. **In our view, neither central bank will begin raising overnight rates until the second half of next year, though the BoC will likely move first.**

BONDS ON SAFE ICE FOR NOW

- Treasuries have rallied sharply since June (with 10-year yields dropping 80 basis points), benefitting from the choppy data and subdued inflation. Inflation expectations haven't budged in six months despite a weakening U.S. dollar. Meantime, corporate bonds continue to strengthen (returning 16% y-t-d for U.S. 10-year issues and 8% for Canadian long issues), with recovering risk appetites compressing spreads. **Corporate bonds should continue to perform well for a while under a backdrop of economic recovery, low inflation and steady monetary policy.** However, bonds in general, and Treasuries in particular, are likely to weaken early next year as the recovery gains traction.
- Since bottoming in March, equity markets have recovered about half of their recession losses. Stocks appear reasonably priced relative to trend earnings in both countries, and more companies are beating earnings estimates. **Given the sanguine (though not great) outlook—sustained growth, tame inflation and low interest rates—the upward trend in equities could remain intact, especially given the vast amount of liquidity parked in cash and money market funds.** Rising resource prices suggest the TSX will continue to outperform the S&P 500 this year.

LOONIE HAS CLEAR SHOT AT PARITY GOAL

- **Nothing appears to stand in the way of the Canadian dollar exceeding parity with the greenback next year**, except perhaps the currency itself—since at above 90 cents U.S., Canada's current account deficit will almost certainly stay in the red. But all the other pucks are lined up nicely on the blueline: commodity prices will likely strengthen further as global demand revives, Canada's fiscal house is the sturdiest among the G7 nations, and the greenback will likely play defense in the face of twin U.S. budget and current account deficits.

RISKS: RECOVERY COULD GET SENT BACK TO THE PENALTY BOX

- **The U.S. economy (and by extension Canada's) is not completely out of the woods until foreclosures (now led by prime borrowers losing their jobs) peak and job losses end.** There is some concern that the housing market will soften when (if) the \$8,000 first-time homebuyer tax credit expires at the end of November. As well, American households could take their new-found thriftiness to extremes, lifting savings above the 6% rate that we anticipate. Beyond 2010, governments will need to take the deleveraging baton from households, restraining activity especially in the U.S. The uncertain impact of the H1N1 virus also remains a risk.
- In Canada, the high (and rising) loonie will keep manufacturers on the ropes, risking another wave of layoffs in a sector that has already accounted for more than half of total job losses since October. As well, **rising house prices are starting to sap affordability again**, despite record-low mortgage rates. Should house prices continue to outpace family incomes, first-time buyers could get priced out of the market, causing it to buckle as in early 2008.

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CANADA	2009				2010				ANNUAL		
	I	II	III	IV	I	II	III	IV	2008	2009	2010
Real GDP (q/q % chng : a.r.)	-6.1	-3.4	1.3	3.4	2.9	3.3	3.5	2.9	0.4	-2.4	2.6
Consumer Spending	-1.2	1.8	1.6	2.6	2.5	3.1	3.1	2.9	3.0	-0.1	2.6
Business Investment (non-residential)	-31.3	-17.0	-14.5	-11.5	-6.0	1.0	1.7	2.5	0.2	-17.1	-6.3
Consumer Price Index (y/y % chng)	1.2	0.1	-0.9	0.7	1.2	1.4	1.9	1.7	2.4	0.3	1.5
Unemployment Rate (%)	7.6	8.4	8.7	9.2	9.3	9.2	8.9	8.7	6.1	8.5	9.0
Housing Starts (000s : a.r.)	140	128	143	149	142	143	142	153	211	140	145
Current Account Balance (\$blns : a.r.)	-30.9	-44.8	-41.5	-42.8	-43.1	-44.6	-46.0	-46.3	8.1	-40.0	-45.0
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	0.22	0.22	0.22	0.30	0.78	1.25	2.33	0.33	0.64
10-year Bond	2.89	3.20	3.42	3.30	3.43	3.54	3.65	3.76	3.61	3.20	3.60
Canada/U.S. Interest Rate Spreads (average for the quarter : bps)											
90-day	43	8	6	12	12	20	55	53	94	17	35
10-year	15	-11	-10	0	-7	-11	-15	-19	-6	-2	-13
UNITED STATES											
Real GDP (q/q % chng : a.r.)	-6.4	-0.7	3.8	2.7	2.3	2.5	2.7	2.9	0.4	-2.4	2.5
Consumer Spending	0.6	-0.9	3.0	-2.4	0.9	1.6	2.3	2.4	-0.2	-0.8	0.8
Business Investment (non-residential)	-39.2	-9.6	-8.8	-5.1	-1.7	1.5	3.4	4.7	1.6	-18.6	-2.2
Consumer Price Index (y/y % chng)	-0.2	-0.9	-1.6	1.0	2.0	2.3	2.0	2.0	3.8	-0.4	2.1
Unemployment Rate (%)	8.1	9.2	9.6	10.0	10.2	10.0	9.9	9.8	5.8	9.2	10.0
Housing Starts (mlns : a.r.)	0.53	0.54	0.60	0.62	0.68	0.74	0.78	0.82	0.90	0.57	0.75
Current Account Balance (\$blns : a.r.)	-418	-395	-409	-379	-375	-373	-369	-361	-706	-400	-370
Interest Rates (average for the quarter : %)											
Fed Funds Target Rate	0.13	0.13	0.13	0.13	0.13	0.13	0.25	0.75	1.86	0.13	0.31
3-month Treasury Bill	0.21	0.17	0.16	0.10	0.10	0.10	0.23	0.73	1.39	0.16	0.29
10-year Note	2.74	3.31	3.52	3.31	3.50	3.65	3.80	3.95	3.67	3.22	3.73
EXCHANGE RATES (average for the quarter)											
US\$/C\$	80.3	85.6	91.1	94.3	96.5	98.4	100.3	100.3	94.3	87.8	98.9
C\$/US\$	1.245	1.168	1.097	1.061	1.037	1.017	0.997	0.997	1.067	1.143	1.012
¥/US\$	94	97	94	94	96	97	98	100	103	95	98
US\$/Euro	1.30	1.36	1.43	1.47	1.49	1.51	1.53	1.54	1.47	1.39	1.52
US\$/£	1.44	1.55	1.64	1.66	1.70	1.75	1.79	1.84	1.85	1.57	1.77

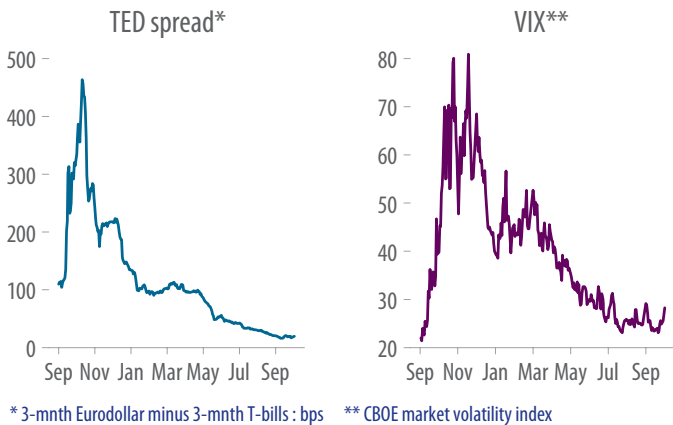
Note: Blocked areas represent BMO Capital Markets forecasts

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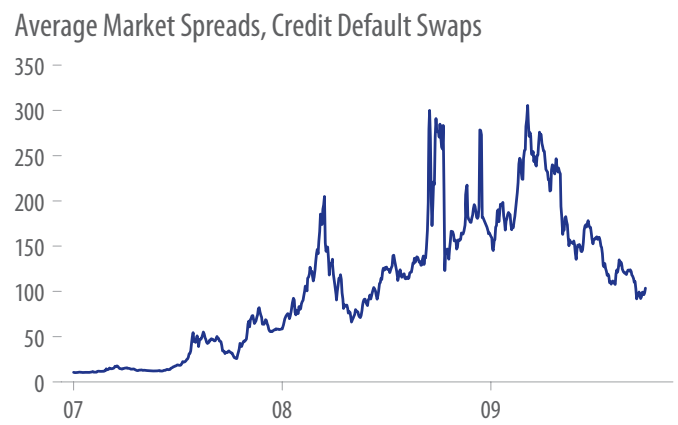
RISK APPETITE MUCH IMPROVED

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



...THOUGH CREDIT DEFAULT STILL A CONCERN

5-Year Spreads – United States (bps)



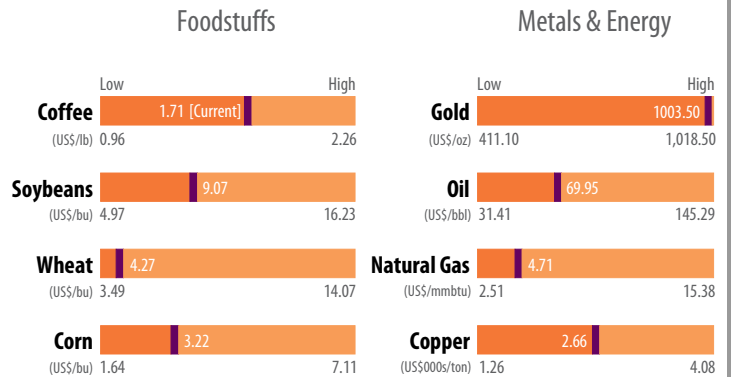
LOONIE: FROM HERE TO PARITY

(US¢ : as of October 6, 2009)



COMMODITY PRICES FIRMING

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



...Even Natural Gas

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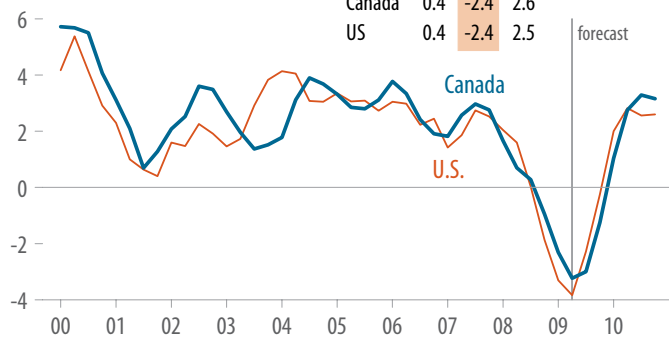


RECESSION IS OVER

(y/y % chng)

Real GDP

	08	09	10
Canada	0.4	-2.4	2.6
US	0.4	-2.4	2.5

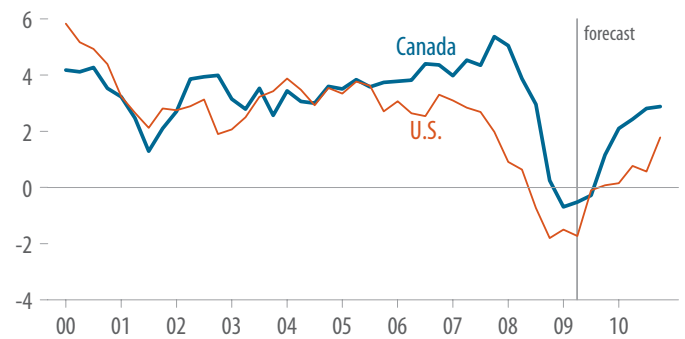


But Recovery Will Be Subdued

CONSUMER SPENDING STEADYING IN U.S.

(y/y % chng)

Real Personal Consumption Expenditures

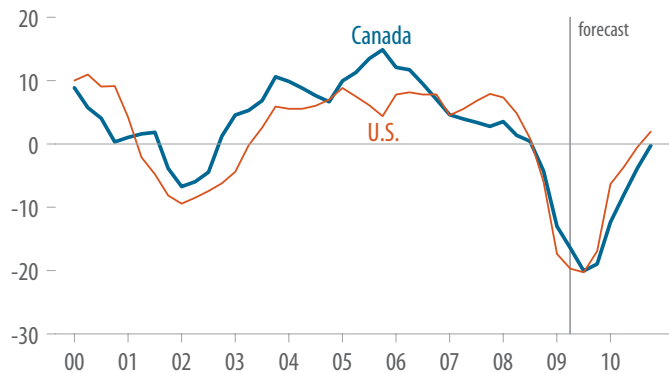


..And Turning Up Modestly in Canada

BUSINESS INVESTMENT BEGINNING TO STEADY

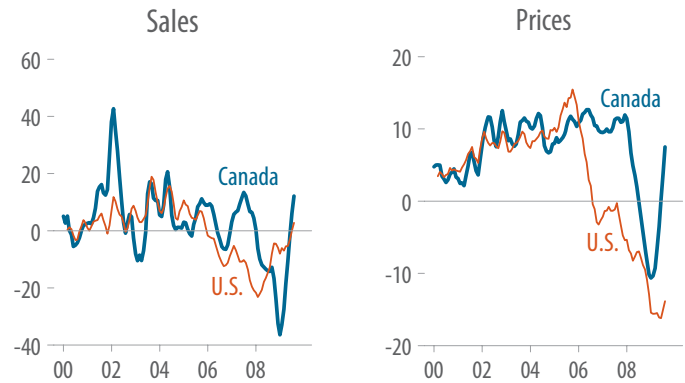
(y/y % chng)

Real Non-Residential Business Investment



HOUSING MARKETS ON THE MEND

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



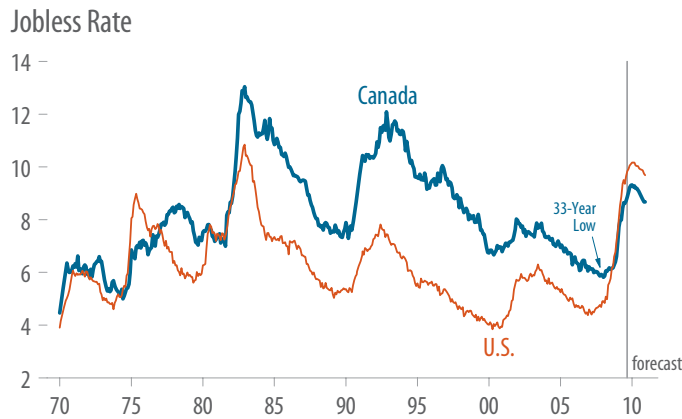
...Especially in Canada

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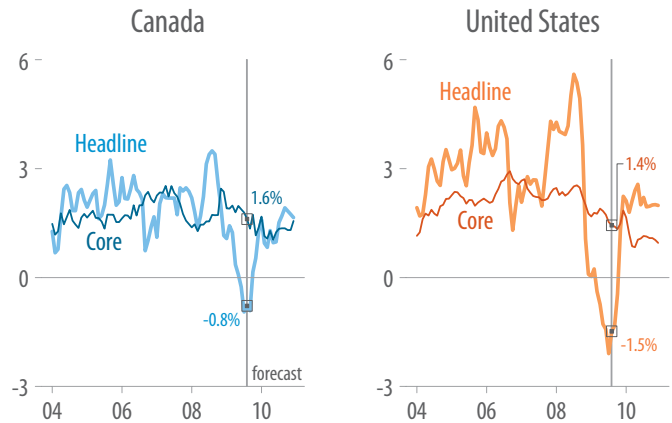
JOBLESS RATE PEAKING

(percent)



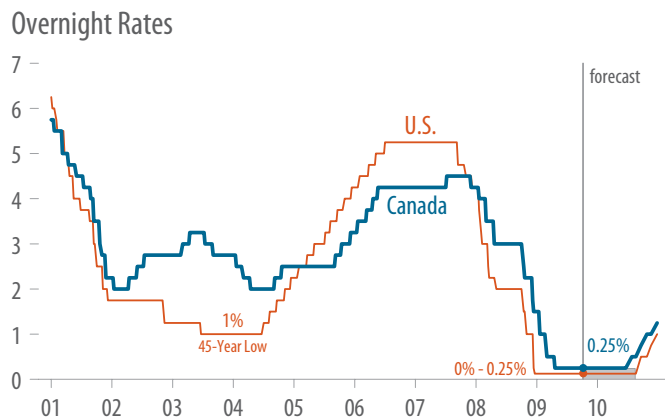
CORE INFLATION STILL EBBING

Consumer Price Index (y/y % chng)



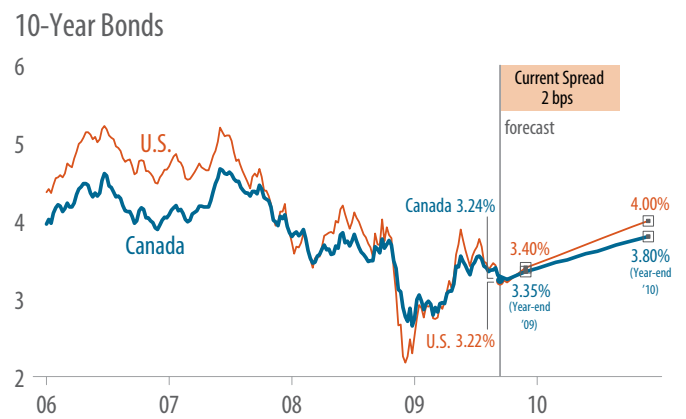
ZERO RATES TO PERSIST WELL INTO 2010

(% : as of October 2, 2009)



TREASURIES REMAIN STRONG, FOR NOW

(% : as of October 5, 2009)





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