



# NORTH AMERICAN Outlook



## HIGHLIGHTS

North American economic recovery gains traction

U.S. growth outlook revised modestly higher

Canadian economy to strengthen amid robust domestic demand

Central banks still on hold until second half of year

Rising household debt raises medium-term concern for Canada

## Happier New Year

### RECOVERY TAKES ROOT

- What a difference a year makes. This time last year, the Great Recession was barreling down on the U.S., and threatening to steamroll over Canada. Stock markets were in freefall, with U.S. equities headed for their worst decade in two centuries. **However, the aggressive policy actions to steady the financial system and stimulate private demand are bearing fruit.** The green shoots of last spring, though yet to blossom, have sprouted into more durable stems.
- **The U.S. housing market, the epicentre of the crisis, is steadily improving on the back of the home buyer tax credit and attractive affordability.** Existing home sales rose at their second fastest rate in four decades in the three months to November. Home prices have stabilized, with inventories returning to normal levels in relation to sales. Homebuilding has emerged from the ashes and is contributing to GDP growth, a refreshing change from the past three years. Aggressive cost cutting and rapid productivity gains (in the U.S.) have boosted profits, positioning firms to expand output and hiring. Most importantly, U.S. job losses have slowed sharply, and an upturn in temporary work flags a near-term end to the longest employment slump since at least 1939. Improved equity markets have dragged consumer spirits out of the abyss. Auto sales have pushed ahead of pre-cash-for-clunker levels; and excluding autos, consumer spending has picked up modestly. **This, coupled with strengthening exports, suggests U.S. GDP grew 3.7% in Q4 following a modest 2.2% rate in Q3.**
- **Canada's economy crawled out of recession in the fall, with strong domestic demand met largely by foreign producers.** Real GDP grew 0.4% annualized in Q3, tempered by a 36% surge in imports. Domestic demand was solid, with personal consumption up 3% and machinery investment advancing for the first time in six quarters. As well, despite the strong currency, exports rose the most in five years in response to an upswing in global demand. Employment has turned modestly higher, suggesting the unemployment rate will peak around 8½%, a full three percentage points below the previous recession high and virtually in line with the three-decade mean. Hiring intentions are firming, according to the Business Outlook Survey. **The first back-to-back gains in monthly GDP since late 2007 point to 3½% growth in Q4, the best performance in 2½ years.**
- **Nowhere is demand stronger than in the interest-sensitive housing market.** Lured by record-low mortgage rates, Canadians dove back into the market, even as the recession was in full swing. As a result, home sales and prices have fully retraced last year's swoon—making Canada one of the few nations to pull off this feat. Demand has remained strong in the fall despite waning use of the

Sal Guatieri,  
Senior Economist  
[sal.guatieri@bmo.com](mailto:sal.guatieri@bmo.com)  
416-359-5295



# NORTH AMERICAN Outlook



government's Insured-Mortgage Purchase Program (which ends in late March). Housing starts have bounced from recent lows, supporting the recovery.

## A FEW WEEDS REMAIN

- **Although underlying demand is firming, the U.S. economic revival largely rests on temporary fiscal support and inventory rebuilding.** Further, the level of activity, though picking up, remains weak, with auto sales one-third below long-run norms and new home sales just one-half. While steadying in Canada, U.S. commercial real estate remains in disarray. Non-residential construction continues to retrench in the face of high vacancy rates and falling prices and rents. Office property prices slid further in Q3, and have retraced three-quarters of the 88% run-up since 2004. The default rate for commercial mortgages hit a 16-year high in Q3, prompting banks to keep a tight rein on credit. TALF-related financing for commercial real estate has so far been minimal (though financing for consumer debt has picked up). Bank credit is still tight, and the private debt-securitization market remains in limbo. Foreclosures, though plateauing in response to the government's mortgage modification program, probably will not peak for several more months, as a sizeable number of option-payment mortgages will reset higher in 2010 and unemployment will stay high. One in seven mortgages is either in foreclosure or overdue, and one in four mortgaged homes is in a negative-equity position. Although households have cut debts for the first time in over half a century, a further increase in savings is likely needed to restore finances to manageable levels. The record number of Americans who are either unemployed or under-worked continues to depress consumer spirits. As well, although job growth is likely to resume soon, U.S. companies show little tendency to ramp up hiring.
- **Despite lingering headwinds, the chance of the North American economy slipping back into recession is low.** Financial conditions in both countries have made V-shaped recoveries since late 2008. U.S. junk bond spreads have plunged 13 percentage points to almost normal levels, driving a 50%-plus return. Stock markets have unwound half their losses, allowing U.S. households to reclaim one-third of the wealth lost in the crisis, while Canadian households, assistive by the rebound in house prices, have regained one half. More fiscal stimulus is on tap, albeit with diminishing effects on growth. Most importantly, never in recorded history has the economy contracted when the yield curve was so steep, with the current U.S. 10/2-year spread the widest on record! In addition, rebuilding of still-low inventories will continue to support production. The temporary hiring of about one-half million Americans for Census 2010 in the first half of the year will provide a timely (albeit fleeting) boost to personal income. The extension of the first-time home buyer tax credit to April, and its expansion to include many current owners, will spur housing demand in coming months.



# NORTH AMERICAN Outlook



- **The improved momentum in U.S. indicators has warranted a slight upward revision to our near-term growth outlook. However, we still expect a relatively subdued rate of 2.6% in 2010.** Consumer spending will continue to be restrained by deleveraging, tight bank credit, still-high foreclosures and stubbornly high unemployment. The “shadow inventory” of unlisted foreclosed homes will restrain homebuilding, while commercial property construction should remain stalled for some time.
- Subdued U.S. demand and a strong loonie—which we see testing parity on the back of firmer commodity prices—will restrain Canadian growth in 2010. However, low interest rates should continue to support consumer spending, and firmer resource prices will spur business investment. Housing markets will likely remain strong in the first half of the year, ahead of expected interest rate hikes and the July introduction of the HST in Ontario and British Columbia (which will affect new homes priced above \$400,000 as well as a broad range of real estate services including realtor commissions and closing costs). The possible extension of the February 1 expiration date for the home renovation tax credit could also support spending. **All in, Canadian quarterly GDP growth should stay above 3% through 2010.**
- In **2011**, even as monetary policy becomes less accommodative and fiscal policy restrictive, growth should strengthen to above 3% in the U.S., as consumer deleveraging abates and banks relax lending standards. **Canada’s economy could post growth closer to 4%**, the best year in a decade, even as bloated deficits put the federal and Ontario governments on a fiscal diet.

## NO RUSH TO TIGHTEN

- Improved credit markets have allowed central banks to wind down some of their emergency lending programs. However, this does not imply a shift toward a tighter policy stance. Both the Fed and Bank of Canada foresee a subdued recovery in need of constant nurturing in order to grow at a rate that will curb disinflation pressures. Accordingly, the Fed pledges to keep rates very low for an “extended period”, likely until the unemployment rate trends down. Wary of the rising loonie, the Bank of Canada plans to remain on hold at least until mid-2010. **We continue to believe that rates will stay fixed until July in Canada and September in the U.S.** As rates climb, they should do so gradually given the tame inflation outlook and prospective fiscal deleveraging, and for fear of destabilizing the economic and financial sector recoveries.
- After trading in a narrow range since the summer, U.S. Treasuries have weakened on the improving economic data and rising equity market. **In 2010, Treasuries are likely to weaken further ahead of monetary tightening and in response to waning risk aversion and massive issuance.** We look for the 10-year yield to



# NORTH AMERICAN Outlook



climb about one-half percentage point this year and a further one-percentage point in 2011. Canadian bonds should continue to outperform Treasuries, reflecting a stronger fiscal position than in the U.S. and a strengthening currency, with long yields rising a lesser one-percentage point over the next two years. Canada continues to have the lowest public debt-to-GDP ratio among G7 nations.

- Sustained moderate growth and relatively low interest rates (at least this year) should support equities, while waning risk aversion and narrowing spreads should help corporate bonds consolidate their impressive gains.

## BOC WARNS ON CANADIAN DEBT

- While in no hurry to tighten, the **Bank of Canada has become increasingly conscious of the side effect of super-cheap money—rising debt.** If current trends persist, Canadian household debt burdens could reach U.S.-peak levels by 2012. Rising debts and higher interest rates could make it difficult for a record number of households to service debts. In all likelihood, debt ratios will stabilize when rates normalize, reducing the risk of a sharp pullback in spending. If not, consumers could become increasingly vulnerable to adverse shocks.
- **A related concern is that Canadian house prices could reach levels that are unsustainable in a higher rate environment.** In relation to income and rent, housing appears overpriced. As with credit, prices should moderate when rates climb. If not, the possibility of a sharp correction could jeopardize the economic expansion. Since monetary policy is likely to remain loose for some time, the government may need to tighten mortgage regulations in the event that the housing market overheats. This may include reducing the maximum 35-year amortization period and/or increasing the minimum 5% down payment, as recently noted by the Finance Minister.
- Sovereign debt concerns have risen following Greece's credit-rating downgrade and Dubai's financial woes. These concerns could spread to major developed countries, driving bond yields sharply higher, if governments forgo a credible plan to reduce deficits once a self-sustaining recovery begins.
- **Upside growth risks cannot be ignored either.** The unprecedented amount of monetary and fiscal stimulus, coupled with the need to rebuild low inventories, could spur a synchronized global recovery that is stronger than expected. As well, though surveys suggest otherwise, there is some chance that American consumers will return to their pre-recession spendthrift ways.

# 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.)	-6.2	-3.1	0.4	3.4	3.2	3.4	3.5	2.9	0.4	-2.5	2.6
Consumer Spending	-1.4	1.8	3.1	2.6	2.5	3.1	3.1	2.9	3.0	0.1	2.7
Business Investment (non-residential)	-31.4	-16.6	4.2	-4.3	-5.0	1.0	1.8	2.5	0.2	-14.6	-2.2
Consumer Price Index (y/y % chng)	1.2	0.1	-0.9	0.9	1.2	1.5	2.1	1.5	2.4	0.3	1.6
Unemployment Rate (%)	7.6	8.4	8.6	8.6	8.8	8.7	8.5	8.2	6.1	8.3	8.5
Housing Starts (000s : a.r.)	140	128	148	158	163	174	168	175	211	143	170
Current Account Balance (\$blns : a.r.)	-31.1	-47.7	-52.5	-44.8	-46.7	-46.8	-47.2	-47.1	8.1	-44.0	-47.0
<b>Interest Rates</b> (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	0.21	0.19	0.28	0.78	1.25	2.33	0.33	0.63
10-year Bond	2.89	3.20	3.42	3.41	3.54	3.63	3.72	3.82	3.61	3.23	3.68
<b>Canada/U.S. Interest Rate Spreads</b> (average for the quarter : bps)											
90-day	43	8	6	15	14	22	60	57	94	18	38
10-year	15	-11	-10	-5	-22	-23	-25	-28	-6	-3	-25
<b>UNITED STATES</b>											
Real GDP (q/q % chng : a.r.)	-6.4	-0.7	2.2	3.7	3.0	2.7	2.4	2.8	0.4	-2.5	2.6
Consumer Spending	0.6	-0.9	2.8	2.0	1.9	2.0	2.3	2.4	-0.2	-0.6	2.0
Business Investment (non-residential)	-39.2	-9.6	-5.9	-0.8	-0.8	1.5	3.4	4.7	1.6	-18.1	-0.8
Consumer Price Index (y/y % chng)	-0.2	-0.9	-1.6	1.4	2.3	2.5	2.1	1.8	3.8	-0.3	2.2
Unemployment Rate (%)	8.1	9.2	9.6	10.1	10.2	10.1	10.0	9.8	5.8	9.3	10.0
Housing Starts (mlns : a.r.)	0.53	0.54	0.59	0.56	0.63	0.72	0.78	0.82	0.90	0.55	0.74
Current Account Balance (\$blns : a.r.)	-418	-392	-432	-418	-423	-418	-410	-409	-706	-415	-415
<b>Interest Rates</b> (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	0.06	0.06	0.06	0.18	0.68	1.39	0.15	0.25
10-year Note	2.74	3.31	3.52	3.46	3.76	3.86	3.97	4.10	3.67	3.26	3.92
<b>EXCHANGE RATES</b> (average for the quarter)											
US\$/C\$	80.3	85.6	91.1	94.7	96.2	98.2	100.3	100.3	94.3	88.0	98.8
C\$/US\$	1.245	1.168	1.097	1.056	1.040	1.018	0.997	0.997	1.067	1.141	1.013
¥/US\$	94	97	94	90	91	92	96	99	103	94	94
US\$/Euro	1.30	1.36	1.43	1.48	1.45	1.47	1.50	1.53	1.47	1.39	1.49
US\$/£	1.44	1.55	1.64	1.63	1.65	1.68	1.71	1.74	1.85	1.57	1.69

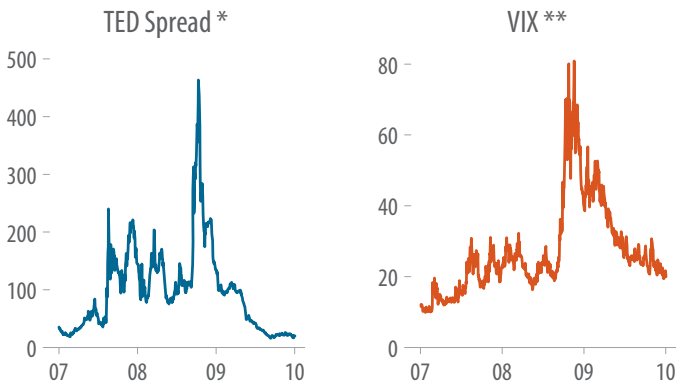
Note: Blocked areas represent BMO Capital Markets forecasts

# NORTH AMERICAN Outlook



## RISK APPETITE RETURNS

United States (as of January 5, 2010)

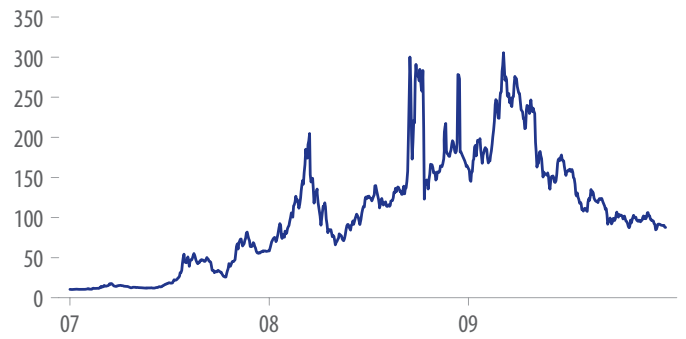


\* 3-mnth Eurodollar minus 3-mnth T-bills : bps \*\* CBOE market volatility index

## CREDIT DEFAULT CONCERNS DIMINISHING

5-Year Spreads – United States (bps)

Average Market Spreads, Credit Default Swaps



Source: Credit Derivatives Research

## LOONIE PARITY BOUND

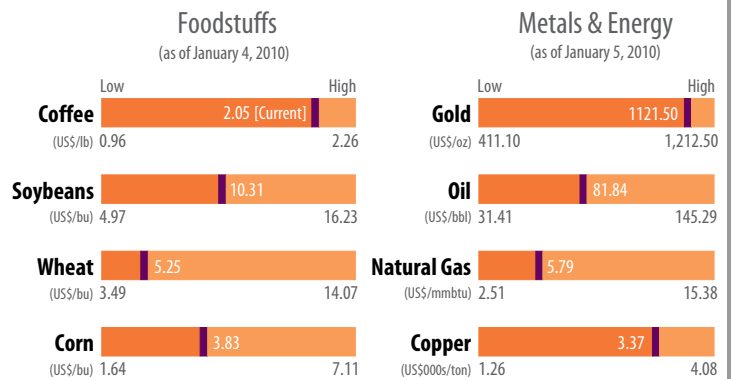
(US¢ : as of January 5, 2010)

Canadian Dollar



## COMMODITY PRICES CONTINUE TO FIRM

Commodity price range (since January 2005)



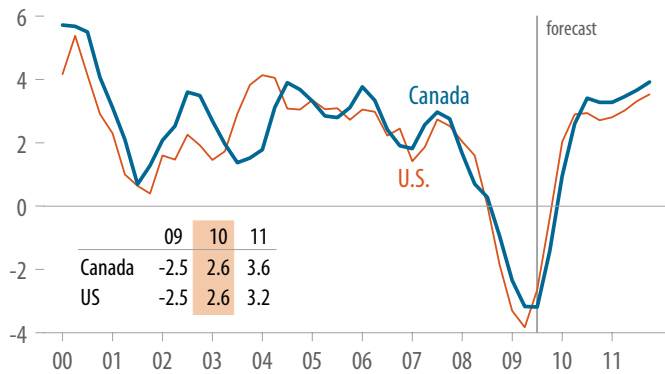
# NORTH AMERICAN Outlook



## RECOVERY TAKES ROOT

(y/y % chng)

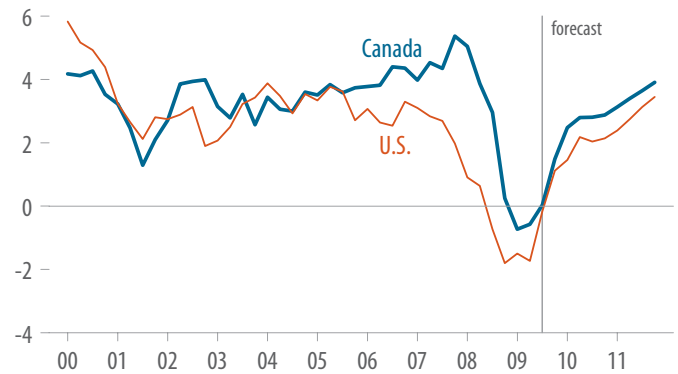
Real GDP



## CONSUMER SPENDING PICKS UP

(y/y % chng)

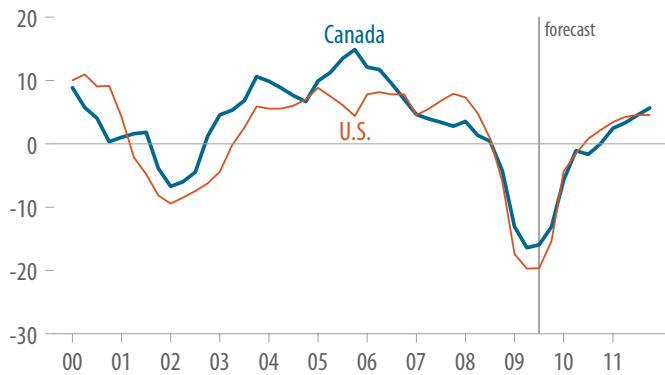
Real Personal Consumption Expenditures



## BUSINESS INVESTMENT STEADYING

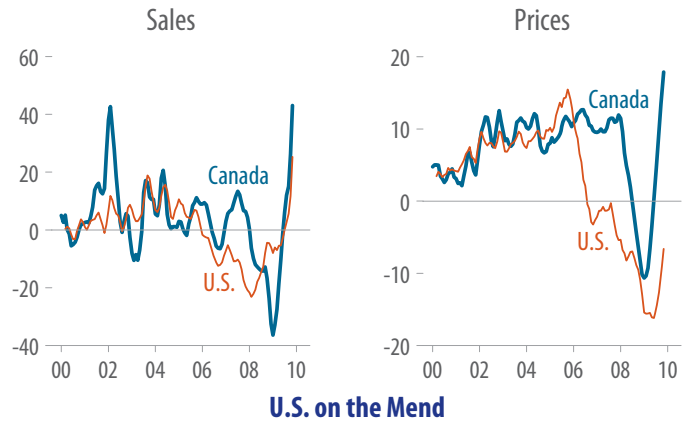
(y/y % chng)

Real Non-Residential Business Investment



## CANADIAN HOUSING MARKET FULLY RECOVERS

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



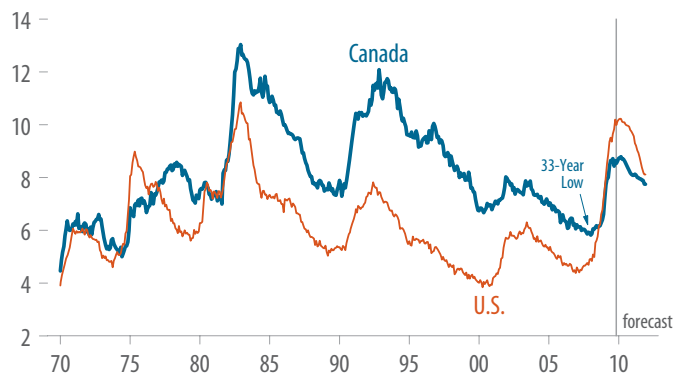
# NORTH AMERICAN Outlook



## JOBLESS RATE PEAKING

(percent)

Jobless Rate



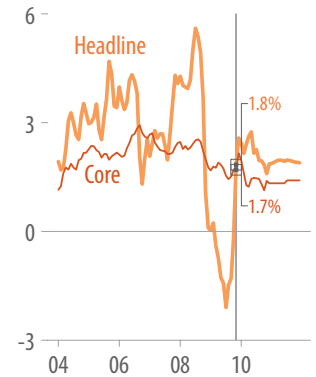
## CORE INFLATION EBBING

Consumer Price Index (y/y % chng)

Canada



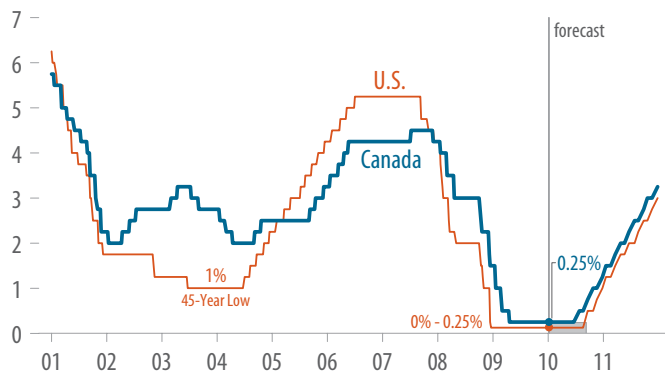
United States



## EMERGENCY-LOW RATES TO PERSIST A WHILE LONGER

(% : as of December 31, 2009)

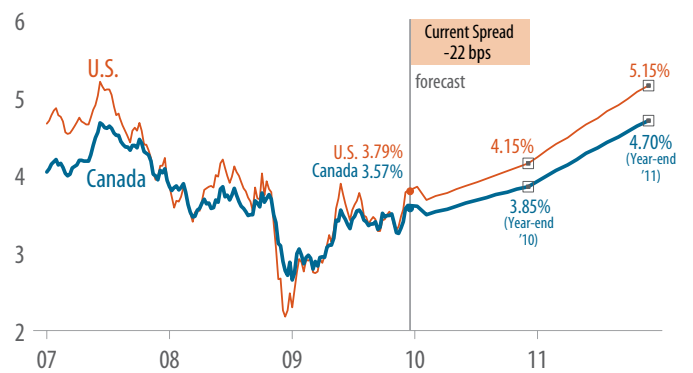
Overnight Rates



## TREASURIES WILL WEAKEN

(% : as of January 5, 2010)

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.