



NORTH AMERICAN Outlook

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Recovery?

Our outlook for North America's economy is now weaker than anticipated in the spring and the downside risks to growth are more serious than we earlier thought. As a result, our call for Fed tightening is pushed out well into next year, and the Bank of Canada is expected to raise rates more slowly than previously thought. While highly-expansionary monetary and fiscal policies should keep the recovery on track, the recent deterioration in financial conditions is a source of concern.

HIGHLIGHTS

Though moderating, Canada's recovery remains healthy. But slower growth in the still-fragile U.S. economy and Europe's credit crisis pose downside risks

A cautious Bank of Canada will tighten only gradually, while the Fed is likely on hold for another year

Wider rate spreads should support the C\$

Europe's credit crisis has abated somewhat but remains a key risk to the global outlook

CANADIAN ECONOMY: A FEW DENTS IN THE ARMOUR

- **Canada's economic recovery remains strong, though tentative signs of slowing have emerged.** Domestic demand, which was growing at a stunning 5% clip earlier in the year, has throttled back, with auto sales hitting a speed bump. Previously red-hot home sales have cooled, as demand was pulled forward in anticipation of higher interest rates, tougher mortgage rules (that took effect April 19) and the HST in Ontario and B.C. (which took effect July 1). Exports have slowed in response to the sturdy loonie and softer U.S. and European demand. Thankfully, businesses have taken the baton from flagging consumers. Higher oil prices are spurring renewed investment in Alberta's oil sands, which are poised to become the top source of U.S. imported crude. Still, after the fastest growth in more than a decade in Q1, real GDP probably slowed to 2.7% in Q2.
- Despite slowing, Canada is in far better shape than most other advanced economies, recovering almost all of the output and jobs that were lost in the recession, which officially ended last summer. The downturn was one of the shortest in the postwar era and less severe than the previous two, and a pale imitation of the Great Recession that ravaged other advanced nations.
- **Real GDP is expected to moderate to 2½% in the second half of 2010.** The HST no doubt pulled some spending forward, and home sales will likely weaken further as interest rates edge higher. In 2011, tighter fiscal and monetary policies will slow growth to 3.0% from an estimated 3.3% in 2010. **Still, firmer resource prices should help Canada out run the other G7 nations this year and next.** Western Canada should lead the nation amid firmer global demand for commodities, while rising auto production will help drive Ontario's recovery.

U.S. ECONOMY SHOWS SOFT UNDERBELLY

- **The U.S. recovery has lost some of its earlier pep.** More than two-thirds of GDP growth in Q1 stemmed from inventory rebuilding, with final sales slowing to 0.8%. Although not unusual at this stage of the recovery, the slowing in final sales suggests little positive momentum. Consumer spending, which picked up to a

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respectable 3.0% pace in Q1, looks to have moderated in Q2, with auto sales still cruising on the shoulder of the highway. Home sales and starts ratcheted back more sharply than expected following the expiry of the tax credit in late April. In fact, sales intentions and buyer traffic at builder lots have risen only slightly since the tax credit was initiated early last year, suggesting weak underlying demand. Despite middling success, the government's loan modification program was unable to stem the record number of delinquencies and foreclosures. Renewed private-sector job growth hasn't made a serious dent in the unemployment rate, which remains above 9%. High joblessness and weak equities are keeping consumers in a sour mood. Commercial and office construction continue to sag amid lofty vacancy rates. While banks have stopped tightening lending standards, the bar remains high and credit continues to shrink. State governments continue to slash public services and workforces, while overhauling pensions.

- Thankfully, business spending on new equipment remains sturdy, supported by rising profits. This, together with inventory rebuilding and healthy exports, has helped manufacturers recover nearly half of their 18% downturn. Recent increases in CEO confidence and machinery orders suggest Europe's woes and market turbulence haven't affected business confidence. **The boost from business investment likely lifted GDP growth slightly to 3.0% in Q2.**
- **However, U.S. growth is expected to slow to 2¼% in the second half of 2010.** Although inventories remain low, the impact on growth of further restocking will wane. While business capital spending will likely remain sturdy, it accounts for just 7% of GDP compared with the consumer's hefty 71% share. The triple-whammy of high debts, high foreclosures and high joblessness will restrain consumer spending and housing. Unless Congress reconsiders, roughly 2 million jobless workers could lose their extended UI benefits between late June and mid-July, damping consumer spending this summer. Growth is expected to remain moderate at 2.9% in 2011, as fiscal belt tightening at the federal level, including increases in income and capital-gains taxes on high-income earners, will restrain domestic demand.

DISINFLATION NATION

- Canadian core CPI inflation has stabilized at just under the 2% target, where it is likely to remain this year given the strong Canadian dollar and moderately-high unemployment rate. Meantime, **U.S. core inflation has trended down to a 44-year low of just 0.9%, and falling labour costs point to further disinflation ahead.** However, steadier inflation expectations and possible further quantitative easing should preclude outright deflation.



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NO URGENCY TO UNWIND EMERGENCY RATES

- Mindful of the downside risks to the economy, central banks on both sides of the border remain cautious about removing the stimulus too soon (in the U.S.) or too rapidly (in Canada). Due to massive unemployment and disinflation, the Fed maintains that rates can stay exceptionally low for an “*extended period*”. **Given our outlook for subdued growth and still lower inflation, we now expect the Fed to stay on hold until 2011H2.** Should the recovery falter or core inflation turn negative, policymakers could renew purchasing mortgage backed securities and Treasury notes to further reduce long-term interest rates and spur demand.
- Although the Bank of Canada has tightened in June and July, the timing of further moves isn’t “*preordained*”, according to Governor Carney. **While we anticipate another quarter-point rate increase in September, as the Bank still aims to unwind the emergency stimulus, we wouldn’t be surprised if it paused at the subsequent two meetings to assess the still-uncertain situation in Europe and the U.S. economy’s recent soft patch.** Given our view that Europe’s credit crisis will abate (as governments impose strict austerity measures) and the U.S. economy will continue to grow at least moderately, the Bank will likely resume raising rates in the new year. We expect overnight rates to climb slowly from 0.75% currently to 1.0% at year’s end, 2.5% by end-2011 and 3.5% in mid-2012.
- **Government bond markets have rallied on safe-haven demand and deflation fears.** Ten-year Treasury yields recently broke through 14-month lows of 3%, while 2-year rates tested the December 2008 all-time low of 0.60% when depression fears raged. The risk of renewed Fed credit easing should allow bond yields to grind lower in the second half of the year, before resuming a gradual upward trend in 2011, as European contagion risks fade and investor confidence in the recovery improves. We expect the 10-year Canada rate to slip below 3% by late 2010, before climbing gradually to 4¼% by mid-2012.

NOTHING LOONIE ABOUT THE LOONIE

- **The Canadian dollar remains firm, supported by solid economic growth, rising interest rates and relatively superior fiscal finances.** Although concerns about Europe’s debt and a global slowdown will likely impede its gains this year, the loonie should achieve parity with the greenback in 2011, as the spread between Canadian and U.S. short-term rates will likely widen by more than one percentage point before the Fed starts tightening.
- **China’s decision to unpeg its currency is positive for the Canadian dollar.** The yuan is expected to appreciate about 5% per annum against the greenback. This will provide modest long-run support to North American exports and commodity prices, and encourage further Chinese investment in Canada’s resource patch. By lifting domestic demand in Asia, the more flexible yuan should



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help rebalance global demand and lessen the risk of a trade war. And, by restraining China's inflation, the stronger yuan should reduce the risk of aggressive policy tightening and an Asian recession.

RISKS

- While concerns about sovereign default have abated somewhat following the establishment of the nearly \$1 trillion European Financial Stability Facility on May 10, North America's recovery could falter if **Europe's credit crisis** flares again and causes further weakness in equity and credit markets. Europe's problems have already led to a meaningful increase in financial stress indicators, though nowhere near the levels that prevailed during the subprime credit crisis.
- A further sharp pull-back in **U.S. home sales** that causes prices to sag would increase foreclosures and reinforce weakness in bank lending. Nearly 1-in-5 mortgage defaults are "strategic", and falling prices would push even more owners under water and out the door.
- The historic **U.S. financial regulatory overhaul** is not expected to have a sizeable adverse impact on the economy. The reduction in uncertainty about capital rules may even provide a near-term lift to depressed bank lending. However, measures to curb risk taking and raise capital levels could have a longer-term restraining effect on lending and growth. Similarly, the Basel III proposals to increase the quantity and quality of bank capital will likely lead to some reduction in bank lending and higher funding costs. However, the proposals are not expected to take effect until late 2012.
- In **Canada**, the housing market could weaken more rapidly than expected if too much demand was pulled forward or if interest rates climb too fast. However, the recent softening in sales and prices has eased fears that the market was heading for a bubble.

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CANADA	2010				2011				ANNUAL		
	I	II	III	IV	I	II	III	IV	2009	2010	2011
Real GDP (q/q % chng : a.r.)	6.1	2.7	2.0	2.7	3.0	3.4	3.7	3.5	-2.5	3.3	3.0
Consumer Spending	4.4	3.3	2.3	2.9	3.7	4.2	4.1	3.9	0.4	3.5	3.5
Business Investment (non-residential)	0.9	16.0	4.9	5.1	5.6	4.5	6.1	7.1	-19.9	0.6	6.0
Consumer Price Index (y/y % chng)	1.6	1.6	2.5	2.1	2.1	2.4	1.7	1.6	0.3	2.0	1.9
Unemployment Rate (%)	8.2	8.0	7.9	7.8	7.6	7.5	7.4	7.3	8.3	8.0	7.5
Housing Starts (000s : a.r.)	198	197	170	162	169	179	182	185	149	182	179
Current Account Balance (\$blns : a.r.)	-31.3	-44.0	-42.4	-42.4	-41.8	-42.9	-43.3	-44.0	-43.5	-40.0	-43.0
Interest Rates (average for the quarter : %)											
Overnight Rate	0.25	0.33	0.83	1.00	1.25	1.33	1.83	2.33	0.40	0.60	1.69
3-month Treasury Bill	0.19	0.41	0.86	1.03	1.29	1.38	1.89	2.40	0.33	0.62	1.74
10-year Bond	3.47	3.47	3.15	2.97	3.10	3.33	3.55	3.78	3.23	3.27	3.44
Canada/U.S. Interest Rate Spreads (average for the quarter : bps)											
90-day	8	26	74	91	117	126	144	140	18	50	132
10-year	-25	-2	11	14	10	2	-5	-13	-3	0	-1
UNITED STATES											
Real GDP (q/q % chng : a.r.)	2.7	3.0	2.0	2.5	3.0	3.2	3.3	3.4	-2.4	2.9	2.9
Consumer Spending	3.0	2.8	2.1	2.4	2.9	3.3	3.8	3.6	-0.6	2.3	2.9
Business Investment (non-residential)	2.2	3.4	2.6	5.2	6.5	4.5	4.8	4.8	-17.8	1.4	4.9
Consumer Price Index (y/y % chng)	2.4	1.8	0.9	0.7	0.6	1.1	1.4	1.4	-0.3	1.4	1.2
Unemployment Rate (%)	9.7	9.7	9.5	9.2	9.0	8.7	8.5	8.4	9.3	9.5	8.6
Housing Starts (mlns : a.r.)	0.62	0.61	0.56	0.60	0.65	0.68	0.71	0.74	0.55	0.60	0.70
Current Account Balance (\$blns : a.r.)	-436	-456	-460	-470	-470	-468	-471	-472	-378	-455	-470
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	0.13	0.13	0.43
3-month Treasury Bill	0.11	0.15	0.12	0.12	0.12	0.12	0.46	1.00	0.15	0.13	0.43
10-year Note	3.72	3.49	3.04	2.83	3.00	3.30	3.60	3.90	3.26	3.27	3.45
EXCHANGE RATES (average for the quarter)											
US\$/C\$	96.0	97.3	96.0	94.8	95.9	98.9	100.3	100.8	88.0	96.0	99.0
C\$/US\$	1.041	1.028	1.042	1.055	1.043	1.011	0.997	0.992	1.141	1.041	1.011
¥/US\$	91	92	91	94	97	99	102	104	94	92	100
US\$/Euro	1.38	1.27	1.24	1.21	1.22	1.24	1.23	1.21	1.39	1.28	1.23
US\$/£	1.56	1.49	1.49	1.46	1.47	1.49	1.48	1.46	1.57	1.50	1.48

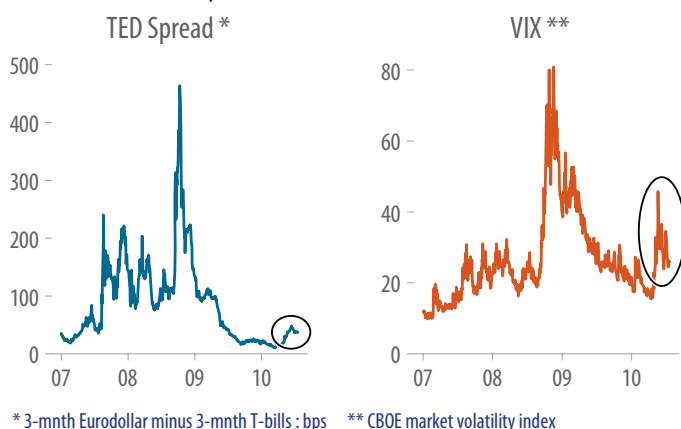
Note: Blocked areas represent BMO Capital Markets forecasts

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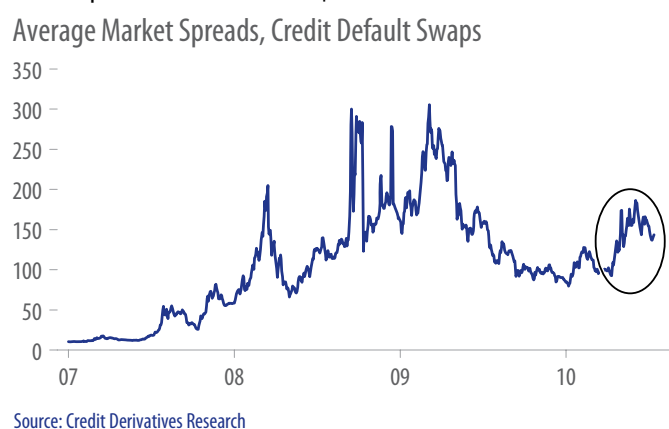
FINANCIAL STRESS TURNS UP...

United States (as of July 20, 2010)



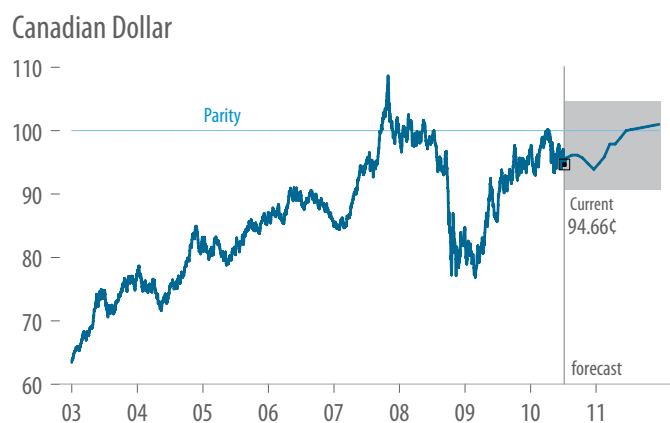
...AS CREDIT DEFAULT STILL A CONCERN

5-Year Spreads – United States (bps)



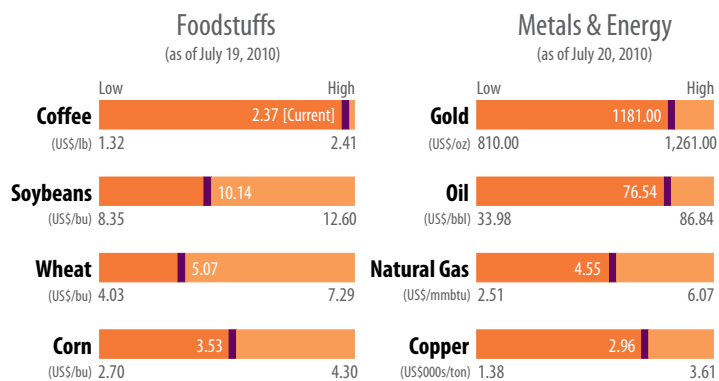
C\$ STILL PARITY BOUND NEXT YEAR

(US¢ : as of July 20, 2010)



COMMODITY PRICES HAVE SOFTENED

Commodity price range (since January 2009)



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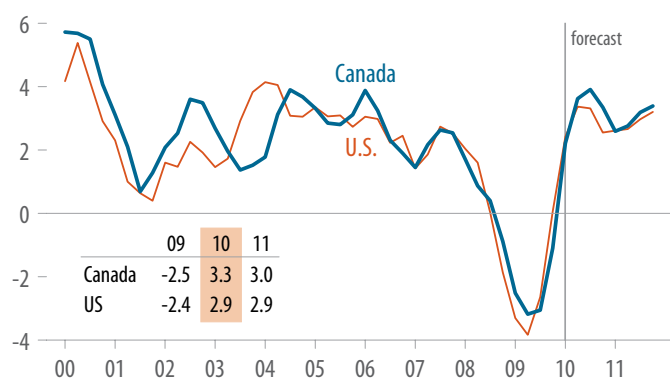


BMO Capital Markets

RECOVERY CONTINUES

(y/y % chng)

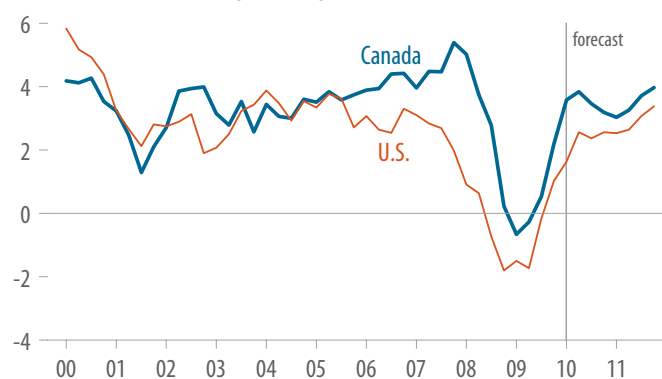
Real GDP



CONSUMER SPENDING STRONGER IN CANADA

(y/y % chng)

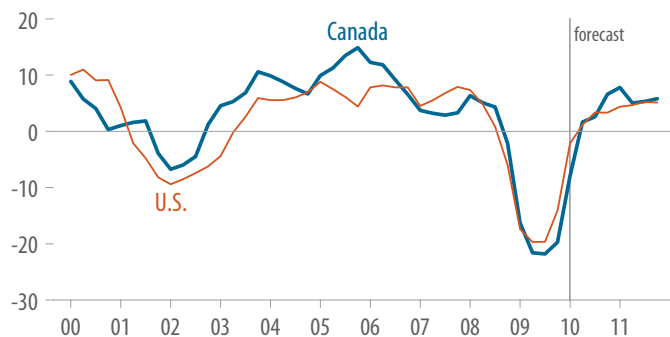
Real Personal Consumption Expenditures



BUSINESS INVESTMENT IMPROVING

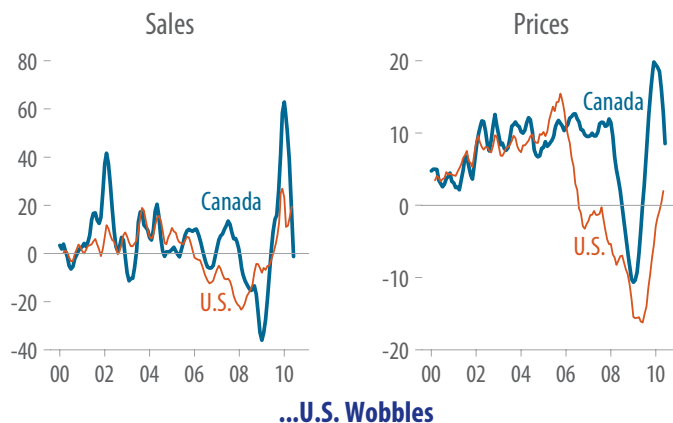
(y/y % chng)

Real Non-Residential Business Investment



CANADIAN HOUSING COOLS

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



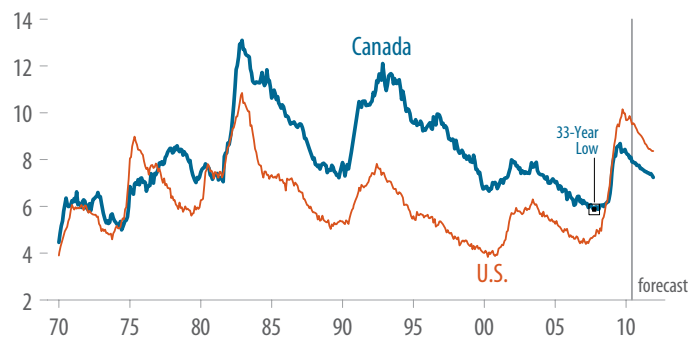
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JOBLESS RATE DRIFTING DOWN

(percent)

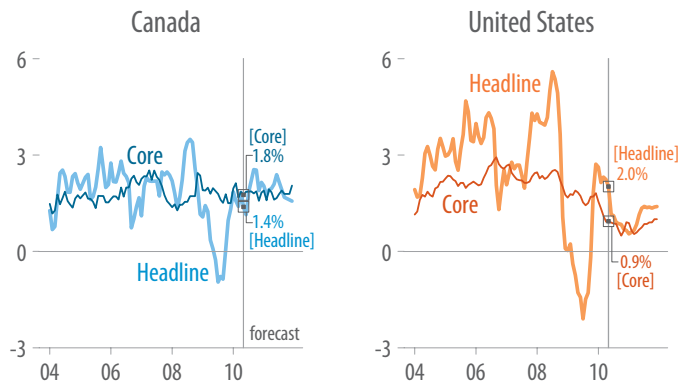
Jobless Rate



...But Still High in U.S.

CORE INFLATION EBBS IN U.S.

Consumer Price Index (y/y % chng)

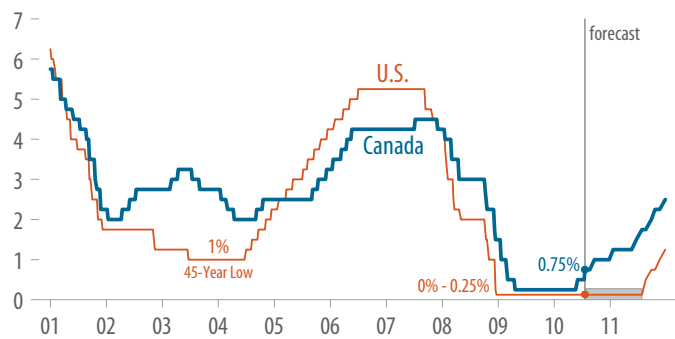


...Stickier in Canada

BoC TO TIGHTEN CAUTIOUSLY

(% : as of July 20, 2010)

Overnight Rates

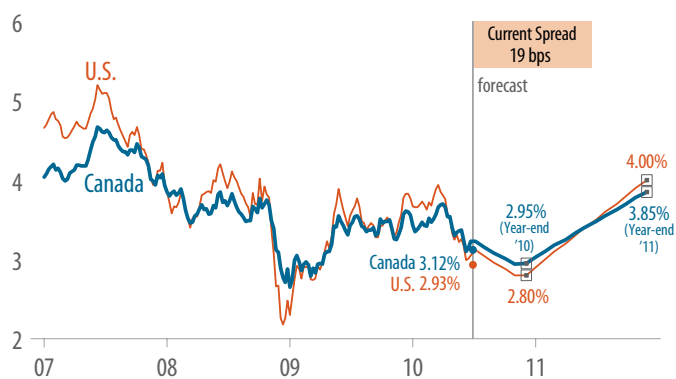


...Fed on Hold Another Year

TREASURIES WILL REMAIN STRONG THIS YEAR

(% : as of July 20, 2010)

10-Year Bonds





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