



NORTH AMERICAN Outlook

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New Year, New Hopes, Old Challenges

UNITED STATES: TWO STEPS FORWARD, ONE BACK

HIGHLIGHTS

- Recession risks have receded amid firmer U.S. data and some progress in containing the Euro Area debt crisis
 - The U.S. economy will do a little better in 2012 than last year, Canada a little worse, but both will grow modestly
 - Interest rates will remain low until 2013 as inflation ebbs and U.S. joblessness stays high
 - Potential missteps by U.S. and European officials pose the greatest threat to the economic outlook
- **After a lacklustre year, the U.S. economy is picking up. It likely grew 3% annualized in Q4, three times faster than the year-to-date mean.** Moreover, growth has broadened to most sectors, including the labour market. Business investment led the expansion in 2011, rising nearly 9%. Spurred by the full-expensing allowance, companies spent heavily on new gear, and, despite still-high office and industrial vacancy rates, commercial construction rebounded. Exports, though slowing in response to weaker global demand and a firmer greenback, likely rose a solid 7% in 2011. Even residential construction turned up late in the year after half a decade of either contraction or stagnation. Demand for rental units (due to the foreclosure crisis) has spurred multi-unit construction. Although existing home sales remain below the 5 million warranted by household formations, they are trending higher. Moreover, after sliding 18% in the past year, resale inventories are now below the 3 million warranted by household formations. This suggests a meaningful decline in the massive overhang of unsold properties that has dogged the market for four years. Still, high foreclosure and delinquency rates, though easing, could damp prices for some time. Despite high unemployment and volatile equity markets, consumer sentiment and spending have picked up modestly, the latter likely to a 2½% rate in Q4. Less restrictive loan standards have facilitated an upturn in consumer credit growth, while great bargains put some spirit back into the holiday shopping season. Though stuck in a slow lane, auto sales have sped up to two-year highs.
 - **While the economy ended last year with some momentum, it should begin the new year on the defensive.** Business capital spending, which was partially pulled forward by the recently expired full-expensing allowance, looks to moderate, as signalled by recent declines in core capital goods orders. Municipal government cutbacks should continue in 2012, albeit with less gusto owing to improved tax revenues. Consumers spent more in late 2011 by saving less of their income. However, another year of deleveraging is probably needed to return debt ratios to pre-credit-boom trends. Thus, household spending should remain moderate in the near term, driven by income rather than credit growth. **All in, GDP growth is expected to slow to 2.0% in Q1 from an estimated 3.0% in Q4.**
 - **Assuming Congress extends the payroll tax holiday and long-term U.I. benefits past February 29, U.S. growth should improve in 2012, supported by low interest rates, pent-up demand and healthy corporate finances.** The Fed is unlikely to raise interest rates until late 2013, especially if unemployment stays high and inflation ebbs. Meantime, demand for homes and cars has plenty of running room, if only to meet new household formations and to replace aging

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vehicles. Owning a home has never been cheaper in the past four decades. Meantime, nonfinancial firms have record amounts of cash to deploy and relatively low debts. **All in, U.S. growth should improve to 2.3% in 2012 from about 1.7% in 2011, with the second half of the year stronger than the first.** All sectors, except government, should contribute to the recovery, with business investment continuing to lead the way. With growth running no faster than potential, the jobless rate will likely remain near the current level of 8.5% this year.

- **Growth should improve further to 2.7% in 2013, as household deleveraging ends and a meaningful housing recovery begins.** However, federal government belt-tightening will begin in earnest after five years of deficit financing totalling more than \$5 trillion. The combined impact of (1) the end of the payroll tax holiday, long-term U.I. claims, and Bush tax cuts for high-income earners, and (2) the start of the already-approved automatic spending cuts to defense and program spending could carve 2 ppts from 2013 GDP growth. Consequently, the jobless rate will likely average 8.0% in 2013.
- **One risk to the 2012 outlook is if Congress fails to extend the payroll tax cut beyond February 29.** In this case, the typical household could face a reduction in annual take-home pay of about \$1,000, chopping GDP growth by just under 0.7 ppts. In addition, millions of recipients could lose their extended U.I. benefits starting March 1. The associated loss of about \$30 billion in personal income could clip 0.2 ppts from growth in 2012. These two “shocks” could slow growth to around 1½% in 2012, pushing unemployment higher.
- **Another risk to our outlook stems from Europe’s ongoing debt saga, with the latest development involving S&P downgrading the credit rating of nine Euro area countries, including previously triple-A rated France and Austria.** While a quick resolution to the crisis is unlikely, it is hoped that European leaders will take further steps to contain the risk of global financial contagion. The ECB's extended loan facility has alleviated the credit crunch for Europe’s banks, and the EU’s pledge to enshrine fiscal discipline in national constitutions may eventually help restore investor confidence. But more needs to be done to establish fiscal integration and to reform labour markets and pension systems in the peripheral nations. With 17 countries striving to ratify a new treaty in 2012, implementation risks will run high.
- One other significant risk is that rising geopolitical tensions in Iraq, Iran and elsewhere in the Middle East could drive oil prices sharply higher in 2012. This would undercut U.S. consumer spending and prolong the Euro Area recession.
- **The U.S. Midwest economy is slightly outperforming the rest of the nation, a trend that should continue in 2012.** The region is benefiting from a pickup in auto production and manufacturing, strong export growth, and favourable agricultural production.



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CANADA: STUCK IN THE MIDDLE WITH YOU

- **Canada's expansion continues in fits and starts.** Despite faster U.S. growth, Canadian GDP likely slowed to a sub-2% rate in Q4 after rebounding 3.5% in Q3 and contracting slightly in Q2. Opposing forces continue to pull the economy in opposite directions. Debt-laden consumers are retrenching, while cash-rich firms are investing heavily. High household debts and tighter fiscal policies are blunting the effect of easy monetary policy. The pull from a still-strong loonie and slow-growing developed economies are offsetting the push from still-high commodity prices and healthy (albeit slowing) emerging-market economies. Consumer loan growth has slowed sharply, while business credit has picked up. In 2011, Canadian consumers likely spent at a slower rate (1.9%) than Americans for the first time since 2004. Following a hiring spree in the first half of the year, companies (outside of Alberta) have all but frozen payrolls in recent months, uncertain about the direction of the economy and Europe's debt crisis.
- **Housing demand remains resilient but valuations are a concern.** If you listen closely you can hear the sound of air seeping out of Canada's housing balloon. (Unlike a bubble, a balloon can deflate slowly). Home sales have moderated since new mortgage rules were introduced in March (for the third time in four years). Markets are balanced in over half the country, though sellers still rule in Toronto where detached properties are in short supply. Prices have pulled back moderately from spring highs, led by once white-hot Vancouver. In 2012, we expect modest gains in home sales and a small dip in starts, with mortgage growth moderating from the current 8% pace. Nationwide, house prices should remain steady, allowing incomes to catch up with elevated valuations before interest rates return to normal.
- **In 2012, Canada's economy is expected to grow 2.0%, slowing from about 2.3% in 2011.** Elevated debts and a lack of pent-up demand will restrain consumer spending, and government spending should be flat. The **Canadian dollar is expected to weaken moderately** toward 94 cents U.S. by mid-year due to Euro Area jitters. A softer currency and firmer U.S. spending should prevent net exports from restraining GDP growth for only the second year in the past decade. With the unemployment rate likely to remain above 7%, the **Bank of Canada is expected to keep interest rates low until spring 2013**, and it could cut rates if the Euro crisis materially worsens.

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CANADA	2011				2012				ANNUAL		
	I	II	III	IV	I	II	III	IV	2010	2011	2012
Real GDP (q/q % chng : a.r.)	3.5	-0.5	3.5	1.8	1.7	2.2	2.4	2.7	3.2	2.3	2.0
Consumer Spending	-0.1	2.1	1.2	1.8	1.3	1.7	2.1	2.4	3.3	1.9	1.7
Business Investment (non-residential)	12.3	14.6	-3.6	8.0	6.5	7.0	6.2	5.5	7.3	12.1	5.9
Consumer Price Index (y/y % chng)	2.6	3.4	3.0	2.8	2.6	2.4	2.6	2.2	1.8	2.9	2.4
Unemployment Rate (%)	7.7	7.5	7.2	7.4	7.5	7.5	7.4	7.3	8.0	7.5	7.4
Housing Starts (000s : a.r.)	177	192	205	199	186	181	181	182	191	193	182
Current Account Balance (\$blns : a.r.)	-41.3	-64.5	-48.5	-49.8	-52.1	-50.5	-50.5	-48.8	-50.9	-51.0	-50.5
Interest Rates (average for the quarter : %)											
Overnight Rate	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	0.60	1.00	1.00
3-month Treasury Bill	0.95	0.95	0.88	0.86	0.82	0.82	0.82	0.82	0.56	0.91	0.82
10-year Bond	3.31	3.16	2.53	2.13	2.00	2.00	2.18	2.46	3.24	2.78	2.16
Canada/U.S. Interest Rate Spreads (average for the quarter : bps)											
90-day	82	90	86	84	80	80	80	80	42	86	80
10-year	-15	-5	10	9	5	10	8	6	2	0	7
UNITED STATES											
Real GDP (q/q % chng : a.r.)	0.4	1.3	1.8	3.0	2.0	2.4	2.8	2.9	3.0	1.7	2.3
Consumer Spending	2.1	0.7	1.7	2.5	2.1	2.3	2.7	2.8	2.0	2.2	2.2
Business Investment (non-residential)	2.1	10.3	15.7	4.6	2.7	5.3	6.1	6.3	4.4	8.8	6.2
Consumer Price Index (y/y % chng)	2.2	3.3	3.8	3.4	2.7	2.4	2.2	2.3	1.6	3.2	2.4
Unemployment Rate (%)	9.0	9.1	9.1	8.7	8.6	8.5	8.4	8.3	9.6	8.9	8.5
Housing Starts (mlns : a.r.)	0.58	0.57	0.62	0.66	0.68	0.70	0.71	0.71	0.58	0.61	0.70
Current Account Balance (\$blns : a.r.)	-478	-499	-441	-442	-442	-440	-440	-439	-471	-465	-440
Interest Rates (average for the quarter : %)											
Fed Funds Target Rate	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13
3-month Treasury Bill	0.13	0.05	0.03	0.01	0.02	0.02	0.02	0.02	0.14	0.05	0.02
10-year Note	3.46	3.21	2.43	2.05	1.95	1.90	2.10	2.40	3.21	2.79	2.09
EXCHANGE RATES (average for the quarter)											
US\$/C\$	101.4	103.4	102.1	97.8	96.7	94.3	96.2	99.0	97.1	101.2	96.6
C\$/US\$	0.986	0.967	0.979	1.023	1.034	1.060	1.040	1.010	1.030	0.989	1.036
¥/US\$	82	82	78	77	77	76	77	79	88	80	77
US\$/Euro	1.37	1.44	1.41	1.35	1.28	1.25	1.28	1.33	1.33	1.39	1.29
US\$/£	1.60	1.63	1.61	1.57	1.54	1.53	1.55	1.59	1.55	1.60	1.55

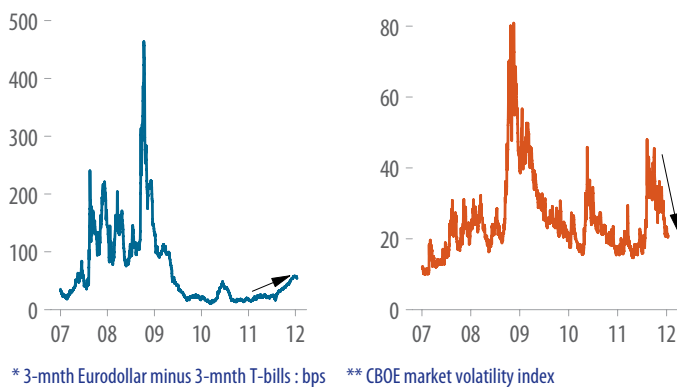
Note: Blocked areas represent BMO Capital Markets forecasts

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FINANCIAL STRESS RISES (THOUGH NOT FOR EQUITIES)...

United States (as of January 13, 2012)



...AS DOES CREDIT RISK AMID GLOBAL ECONOMIC CONCERNS

United States (bps)



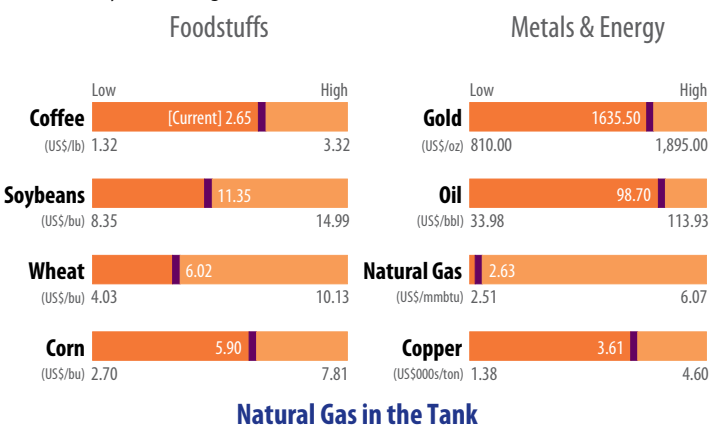
C\$ TO HOVER BELOW PARITY UNTIL EUROPE'S DEBT CRISIS ABATES

(US¢ : as of January 13, 2012)



COMMODITY PRICES MIXED

Commodity Price Range (since January 2009 : as of January 13, 2012)



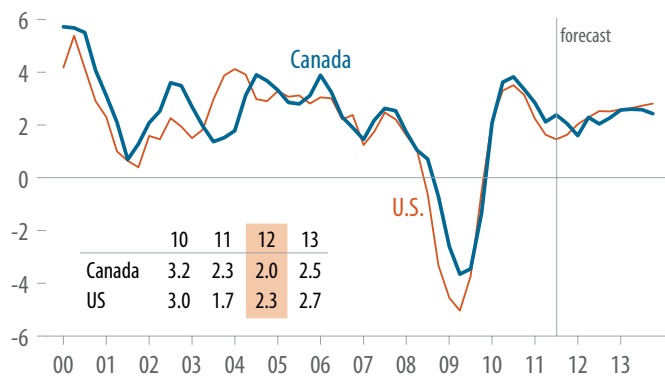
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MODEST GROWTH AHEAD

(y/y % chng)

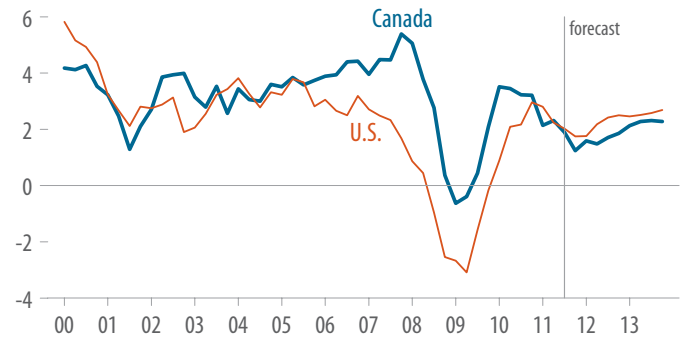
Real GDP



CONSUMER SPENDING WILL MODERATE IN CANADA...

(y/y % chng)

Real Personal Consumption Expenditures

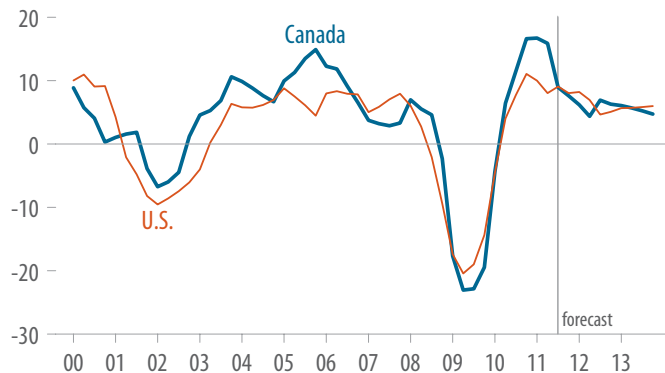


...And Remain Subdued in the U.S.

BUSINESS INVESTMENT TO COOL SOMEWHAT

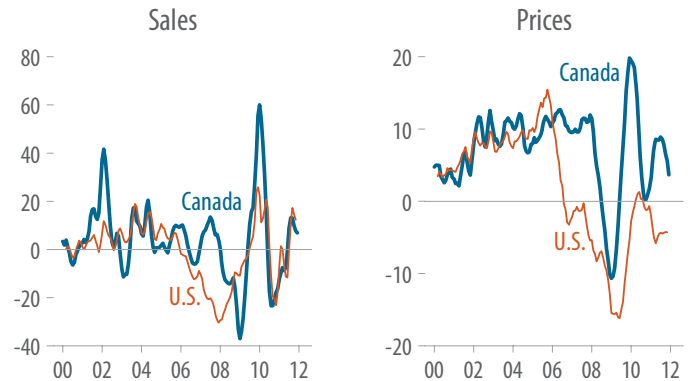
(y/y % chng)

Real Non-Residential Business Investment



CANADIAN HOUSE PRICES STILL HIGH

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



...U.S. Prices Still Soft

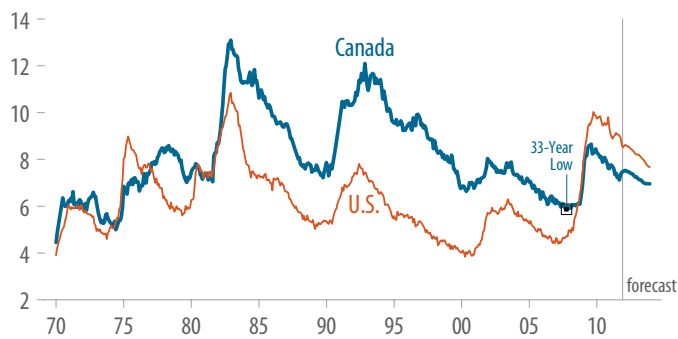
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JOBLESS RATES EASING SLOWLY

(percent)

Jobless Rate



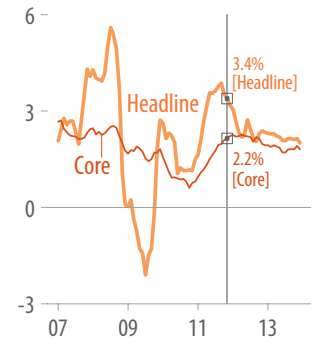
INFLATION SHOULD DECLINE IN 2012

Consumer Price Index (y/y % chng)

Canada



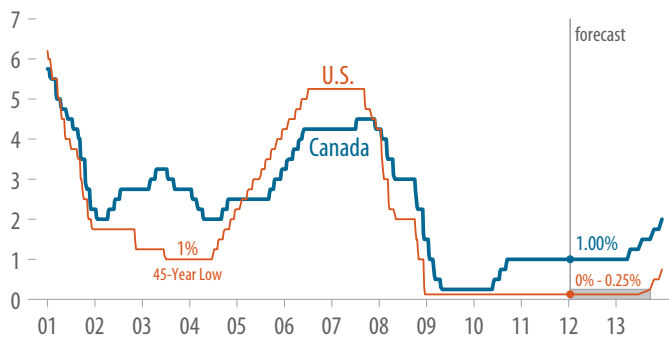
United States



BoC ON HOLD UNTIL SPRING 2013

(% : as of January 16, 2012)

Overnight Rate

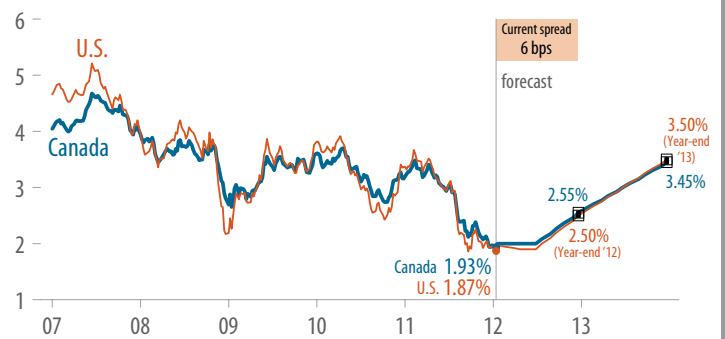


...Fed Funds Rate on Hold Until Late 2013

TREASURIES TO REMAIN STRONG NEAR-TERM

(% : as of January 16, 2012)

10-year Bonds



...But Weaken in 2013



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ECONOMIC
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