

Recalibrating the Forecast

Economic Research Department

Judging from recent indicators, we are prepared now to say that the U.S. economy is in recession. The marked and widespread deterioration of business, consumer and investor sentiment since the start of 2008 has prompted us to revisit and revise our forecast. Even prior to the recent steep slide in global equity markets, it appeared that the U.S. economy was teetering on the edge of recession, and was vulnerable to any serious shock. The continued deterioration in the already-devastated housing market, weak Christmas sales and a significant drop in stocks have compounded the souring of sentiment from the subprime debacle, the tightening in credit conditions, and lofty energy prices. We are hoping that the prompt and decisive actions shown by policymakers, notably the Fed's aggressive 75 basis point cut this week, will limit the

U.S. recession to the mild variety. Washington appears ready to soon issue tax rebate cheques, but a consumer-led recession, coupled with the massive writedowns and earnings losses in finance-related businesses globally, leaves open the prospect of a longer and deeper recession. Clearly, the Fed, the White House and the Congress are well aware of this and will take further aggressive action to ameliorate the situation. One thing is certain, the rest of the world has not decoupled from the slowdown in the U.S. economy.

Here is a synopsis of our forecast revisions:

U.S. economy: U.S. economic conditions have deteriorated rapidly in recent weeks. Housing shows no sign of bottoming, with home prices falling steadily and foreclosures likely to climb further amid rising mortgage rate resets. Household wealth is under attack from declining house and equity prices, while purchasing power is squeezed by high energy costs. Credit conditions continue to tighten due to the massive (\$100 billion and counting) debt write-downs at financial institutions. Employment—the last pillar of consumer support—is now giving out, with private sector payrolls falling for the first time in four years last month, lifting the unemployment rate to a two-year high of 5%. Not surprisingly, the holiday shopping season ended with a thud. Investment is poised to slow, with confidence among business leaders hitting recession lows and machinery orders pulling back recently. Commercial construction is also set to downshift as credit

CHART 1
U.S. RECESSION RISKS

(q/q % chng : a.r.)

Real GDP

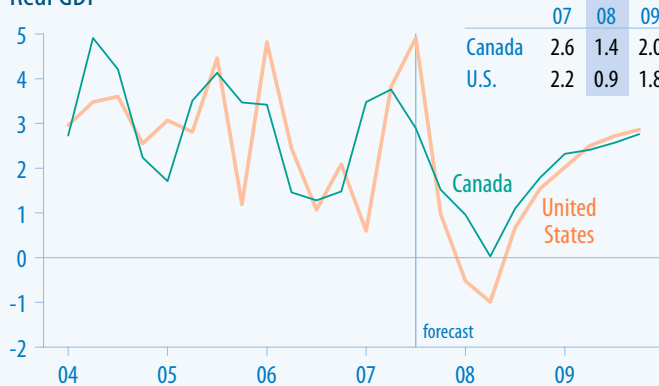
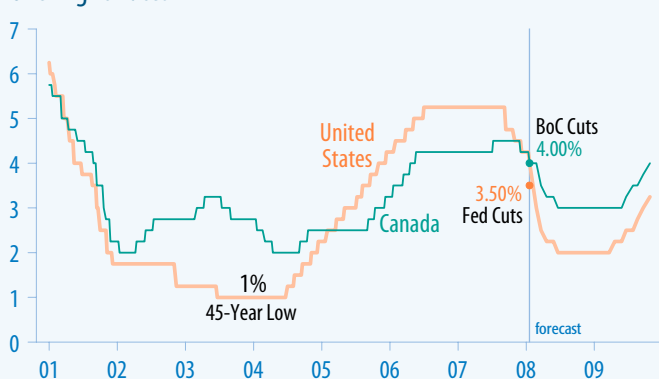


CHART 2
BoC AND FED WILL CUT FURTHER

(% : as of January 22, 2008)

Overnight Rates



tightens and vacancy rates climb. All in, the U.S. economy likely slipped into a modest recession around the turn of the year. We look for GDP to contract about 1% annualized in the first half of 2008, before recovering slowly in the second half and improving gradually next year on easier monetary policy and steadier housing markets. The jobless rate is expected to peak at 6½% early next year, while core CPI inflation should ease to 1½%.

Canadian economy: A downturn in the U.S. economy will spill over into Canada, both through the direct channel of reduced demand for Canadian exports and lower commodity prices, as well as the indirect financial channel of declining equity markets and the hit to sentiment. However, there are three solid reasons to believe that the Canadian economy can narrowly avoid an outright recession: a) the housing market is much healthier than in the U.S., b) government finances are in strong shape allowing for the recent GST cut and upcoming fiscal measures, and c) the commodity boom of recent years will support capital spending. Nevertheless, a weaker U.S. growth outlook has prompted us to shave our 2008 Canadian GDP growth outlook by 0.8 percentage points to 1.4%, and 2009 by 0.5 ppts to 2.0%. Much of the hit will be to net exports, and we now look for a current account deficit for this year, which should weaken the Canadian dollar. Meantime, our unemployment rate is now expected to rise to 7% by late this year from 5.9% at the end of 2007.

Interest rates: We look for Bernanke & Co. to cut the fed funds target further from 3.5% today to 2% by the middle of this year, as past policy responses to recessions have typically been to reduce rates to at least “zero real” (and core PCE inflation is currently running at 2.2%). Last week, the Fed Chairman testified that policy will be “exceptionally alert and flexible, prepared to act in a decisive and timely manner”, indicating that further aggressive moves are possible. Treasury yields should continue to drift down during the months ahead, despite already pricing in the better part of this recession scenario. Ten-year yields, in particular, will likely test their all-time closing low of 3.13% (set June 2003), pushed by equity market refugees and increased bank holdings. Once the Fed stops easing, yields should begin drifting up, although meaningful increases will be reserved until the Fed starts signalling its intention to resume normalizing policy rates (not until the spring of 2009).

The Bank of Canada will likely continue to follow the Fed’s easing lead, lagging in magnitude. After cutting rates 25 bps this week, we look for quarter-point cuts to continue (and probably one 50 pointer) through mid-year, as the Bank attempts to mitigate the downside risks arising from a U.S. recession, along with the lingering legacies of a strong loonie and tighter credit conditions. Wider Canada-U.S. overnight rate spreads (from 50 bps to 100 bps) will reinforce the tendency for Canada bonds to lag their U.S. counterparts in a declining-yield environment. However, the Canadian bond market heads into U.S. recession with much more favourable fiscal and inflation trajectories, which should contribute to relative outperformance in the eventual reverse trade.

Foreign exchange rates: After getting pummelled for much of 2007, the U.S. dollar will likely see better days in 2008, even with aggressive Fed cuts. Growth concerns have gone global, making the greenback relatively more attractive. The loonie will continue its fall from grace as the economy slows and commodity prices cool. We see the currency dipping back towards the 90-cent level by year-end. Elsewhere, the Bank of England is cutting interest rates amid slowing growth, but could get more aggressive with U.K. housing facing a potentially sharp downturn, undercutting the pound. The ECB's inflation focus will likely end around mid-year as growth concerns come to the fore. The shift to an easing bias will end the euro's three-year winning streak. With the bears taking a bite out of equities, the yen is strengthening as carry trades continue to unwind en masse. As long as this story holds, the yen should maintain its strengthening trend.

Global growth: The spillover from the credit crunch and the slowdown in U.S. economic activity had already begun to hamper global growth, even prior to the equity market slide. But a U.S. recession will cause additional damage to its major trading partners, even if it is mild and short. Accordingly, we have revised our global growth forecasts lower. The biggest change to our outlook, outside of Canada and the U.S., was to Japan, where the economic recovery was already precarious, at best. Now, exporters will continue to be hurt by a still-strong yen, and consumer spending will remain tepid as deflation forces linger. We had already pencilled in slower growth for Europe, and we've taken those estimates a touch lower. The emerging market economies will certainly not escape the industrial world cooling, and we look for China's GDP growth to ebb to below 10% this year after an 11.5% burst in 2007. Overall, we see global GDP growth cooling to 3.5% this year from 4.5% in 2007, a significant slowdown.

Commodities: A U.S. recession this year would weigh on commodities, to varying degrees. With U.S. domestic demand expected to decline in the first half of 2008, followed by a tepid recovery, growth in China should also throttle back sufficiently to take some steam off energy and metals prices, although not cause them to collapse. We project oil prices (WTI) to average US\$81/barrel in 2008, down from the US\$90-to-\$100 range of November to mid-January, albeit 12% higher than in 2007. Base metals, already well down from their earlier speculative-driven peaks, are slated to drop on average by 20% this year. Nevertheless, they would still be running two to three times their average levels during 2000-2005, with the exception of aluminum which would be up a more modest 50%. Once current liquidity-driven sales wane, precious metals should hold up well as a safe haven given pronounced volatility in equity and currency markets. The hit on forest products—particularly lumber and newsprint—is unlikely to take the form of further price declines. Prices are already below average cost of production. The recession will instead hasten mill closures, a process already underway. Of all commodity groups, agriculture should perform best, given continued competition between food and biofuels for limited land and the rising demand for protein and higher-value grains in emerging markets.

| CANADA | 2007 | | | | 2008 | | | | ANNUAL | | |
|--|-------|-------|-------|-------|--------|--------|--------|--------|--------|-------|--------|
| | I | II | III | IV | I | II | III | IV | 2006 | 2007 | 2008 |
| Real GDP (q/q % chng : a.r.) | 3.5 | 3.8 | 2.9 | 1.5 | 1.0 ↓ | 0.0 ↓ | 1.1 ↓ | 1.8 ↓ | 2.8 | 2.6 | 1.4 ↓ |
| Consumer Price Index (y/y % chng) | 1.8 | 2.2 | 2.1 | 2.5 | 1.5 | 1.2 | 1.7 | 1.8 | 2.0 | 2.2 | 1.5 |
| Unemployment Rate (%) | 6.1 | 6.1 | 6.0 | 5.9 | 6.1 ↑ | 6.6 ↑ | 6.9 ↑ | 7.0 ↑ | 6.3 | 6.0 | 6.7 ↑ |
| Housing Starts (000s : a.r.) | 222 | 226 | 247 | 217 | 207 | 200 | 197 | 196 | 228 | 228 | 200 |
| Current Account Balance (\$blns : a.r.) | 25.5 | 25.4 | 4.2 | 5.0 | 4.1 ↓ | 0.1 ↓ | -4.3 ↓ | -6.4 ↓ | 23.6 | 15.0 | -1.6 ↓ |
| Interest Rates | | | | | | | | | | | |
| (average for the quarter : %) | | | | | | | | | | | |
| Overnight Rate | 4.25 | 4.25 | 4.48 | 4.42 | 3.83 ↓ | 3.17 ↓ | 3.00 ↓ | 3.00 ↓ | 4.01 | 4.35 | 3.25 ↓ |
| 3-month Treasury Bill | 4.17 | 4.35 | 4.00 | 3.84 | 3.34 ↓ | 3.01 ↓ | 3.03 ↓ | 3.04 ↓ | 4.01 | 4.09 | 3.11 ↓ |
| 10-year Bond | 4.05 | 4.61 | 4.36 | 4.02 | 3.63 ↓ | 3.40 ↓ | 3.45 ↓ | 3.50 ↓ | 4.21 | 4.26 | 3.50 ↓ |
| Canada/U.S. Interest Rate Spreads | | | | | | | | | | | |
| (average for the quarter : bps) | | | | | | | | | | | |
| 90-day | -95 | -64 | -19 | 43 | 85 ↑ | 130 ↑ | 146 ↑ | 148 ↑ | -84 | -34 | 127 ↑ |
| 10-year | -58 | -49 | -27 | -9 | 16 ↑ | 27 ↑ | 25 ↑ | 18 ↑ | -58 | -36 | 21 ↑ |
| UNITED STATES | | | | | | | | | | | |
| Real GDP (q/q % chng : a.r.) | 0.6 | 3.8 | 4.9 | 1.0 | -0.5 ↓ | -1.0 ↓ | 0.7 ↓ | 1.5 ↓ | 2.9 | 2.2 | 0.9 ↓ |
| Consumer Price Index (y/y % chng) | 2.4 | 2.7 | 2.4 | 4.0 | 3.9 | 3.0 | 3.0 | 2.4 ↓ | 3.2 | 2.9 | 3.0 |
| Unemployment Rate (%) | 4.5 | 4.5 | 4.7 | 4.8 | 5.2 | 5.6 ↑ | 6.0 ↑ | 6.4 ↑ | 4.6 | 4.6 | 5.8 ↑ |
| Housing Starts (mlns : a.r.) | 1.46 | 1.46 | 1.30 | 1.15 | 0.99 | 0.96 | 0.92 | 0.92 | 1.81 | 1.34 | 0.95 |
| Current Account Balance (\$blns : a.r.) | -788 | -756 | -714 | -701 | -693 ↑ | -679 ↑ | -674 ↑ | -673 ↑ | -811 | -740 | -680 ↑ |
| Interest Rates | | | | | | | | | | | |
| (average for the quarter : %) | | | | | | | | | | | |
| Fed Funds Target Rate | 5.25 | 5.25 | 5.18 | 4.52 | 3.57 ↓ | 2.33 ↓ | 2.00 ↓ | 2.00 ↓ | 4.96 | 5.05 | 2.48 ↓ |
| 3-month Treasury Bill | 5.12 | 4.87 | 4.42 | 3.47 | 2.60 ↓ | 1.82 ↓ | 1.56 ↓ | 1.56 ↓ | 4.85 | 4.47 | 1.89 ↓ |
| 10-year Note | 4.68 | 4.85 | 4.73 | 4.26 | 3.55 ↓ | 3.21 ↓ | 3.18 ↓ | 3.31 ↓ | 4.79 | 4.63 | 3.31 ↓ |
| EXCHANGE RATES | | | | | | | | | | | |
| (average for the quarter) | | | | | | | | | | | |
| US\$/C\$ | 85.3 | 91.0 | 95.7 | 101.9 | 97.3 ↓ | 94.5 ↓ | 91.8 ↓ | 89.3 ↓ | 88.2 | 93.5 | 93.2 ↓ |
| C\$/US\$ | 1.172 | 1.098 | 1.045 | 0.982 | 1.028 | 1.058 | 1.089 | 1.120 | 1.134 | 1.074 | 1.074 |
| ¥/US\$ | 119 | 121 | 118 | 113 | 105 ↓ | 103 ↓ | 101 ↓ | 101 ↓ | 116 | 118 | 103 ↓ |
| US\$/Euro | 1.31 | 1.35 | 1.38 | 1.45 | 1.47 | 1.46 | 1.43 | 1.39 | 1.26 | 1.37 | 1.44 |
| US\$/£ | 1.96 | 1.99 | 2.02 | 2.04 | 1.98 | 1.95 | 1.93 | 1.91 | 1.84 | 2.00 | 1.94 |

Note: Blocked areas represent BMO Capital Markets forecasts
Up and down arrows indicate changes to the forecast ↑↓

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