ECONOMIC RESEARCH

The Bottom Line

THE LATEST VIEW ON THE ECONOMY

BMO Capital Markets

The Clouds Have Parted

February 15, 2011

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While we were *cautiously* optimistic about the economic outlook at the turn of the year, we are now more certain of a sustained expansion in North America through this year and next. Consumers are more confident, opening their wallets for the best Christmas season in four years. American consumers, having increased their savings rate during the recession, will likely now maintain it at about 6% of disposable income. Canadians, having experienced a much milder recession, did not tighten their belts as aggressively. With the recent tightening in mortgage standards, Ottawa is discouraging Canadians from becoming over-leveraged. The savings rate in Canada is likely to average about 4% this year, rising to about 4.4% next year.

Industrial production has strengthened. Business confidence has also risen for both small and large companies, and cost cutting during the recession has paid off in strong corporate profits. The growth in profitability accelerated as revenues picked up and many businesses stepped up their investment in software, machinery and equipment last year. This contributes to productivity growth and ultimately results in more hiring.

Credit availability has also improved as U.S. banks are reporting a moderate easing in credit conditions. While loan demand is still relatively weak, it is expected to pick up over the course of this year. Larger companies have successfully tapped the capital markets with stepped up issuance of corporate bonds and commercial paper, especially in the U.S.

Canadian employment picked up recently, remaining well above that in the U.S. American jobs are still lagging, but leading indicators suggest a sharp rise in civilian employment is coming. Budgetary problems at the state and local levels, however, are offsetting some of this private sector momentum. In Canada, the fiscal issues are more easily managed, representing a far lower percentage of GDP. Nevertheless, the jobless rate will likely remain above 7% in Canada this year, and gradually decline to around 8.6% in the U.S. by year-end.

The trade outlook has improved sharply in both countries. Canada's export position benefits from the better-than-expected growth in the U.S. as well as the improvement in our terms of trade—export prices have risen faster than import prices. Our recession-induced trade deficit returned to surplus in the fourth quarter, boosting Canada's growth prospects for 2011. Canada will benefit from a rise in U.S. auto demand this year. Not only is Canada's trade with the U.S. improving, but Canadian businesses are increasingly tapping other markets, especially in Asia and Latin America. Businesses are adjusting to the strength in the Canadian dollar, which we forecast to continue through next year.

Recent data suggest the U.S. is also enjoying an improvement in trade in lagged response to the weakness in the U.S. dollar. American demand for imports has slowed sharply with rising import prices. The recent surge in food and energy prices might well cause people to economize and to spend less on other goods and services, having little sustainable effect on inflation.

Inflation in both countries remains mild, albeit a bit stronger in Canada. We continue to forecast the Bank of Canada will begin once again to re-normalize interest rates in the second half, taking the overnight interest rate up gradually from its current low-level of 1%. The Federal Reserve, on the other hand, will keep overnight rates unchanged until some time early next year. We do, however, think the Fed will let its current program of buying Treasury securities run out in June as planned with no need to introduce further quantitative easing.

The brighter economic outlook has already led to a sell-off in bonds and a sharp rise in stocks since late last year. Mortgage rates are moving higher as well, especially in the U.S. despite the continued weakness in housing. The residential real estate market remains a dark cloud over American renewal, although anecdotal evidence suggests that the housing market is improving in some of the hardest hit regions of the country. In Canada, residential construction weakened sharply last spring and will likely pick up in the second half of this year. While house prices are off their peak, activity remains fairly robust.

Bottom Line: Bond yields will be heading higher this year and next in both countries, but the rise will be moderate given our benign forecast for inflation. The Canadian government bond market will outperform the U.S. We are forecasting Canadian ten-year GoC bond yields to finish 2012 at about 4¼% (compared to roughly 3.5% now), about 50 basis points below U.S. rates. Stock markets will continue to benefit from the strength in corporate earnings, foreign capital inflows and rising boomer savings flows. Dividends will play an important role in total returns.