

BMO Blue Book

February 2012



Canada's Persistent Productivity Imperative

As the Canadian economy looks set for another year of modest growth in 2012, we are faced with an unyielding fact: There are only two ways to increase living standards—a rise in the price of what we produce and sell abroad versus what we buy and import, or produce more for every hour we work. The first channel is also known as rising terms of trade, and Canada has relied on this factor very heavily in the past decade. Buoyant commodity markets, a soaring loonie, and declining prices for many manufactured goods (such as clothing and cars) have boosted our terms of trade by almost 25% in the past ten years (*Chart 1*).

Given persistently robust demand for energy, food, and other resource products arising from the strong demand in emerging markets, we believe that Canada's terms of trade may continue to improve in the years ahead, providing a further lift to our living standards. However, this is no sure thing, and we have seen prolonged periods of declining terms of trade in the not-so-distant past—they fell by more than 15% over the 25 years from 1974 to 1999.

So, if the first channel is uncertain, what are the prospects for the second channel of boosting Canadian living standards? As strong as our terms of trade have been over the past decade, productivity has been almost the mirror image, disappointing at nearly every turn. Output per hour worked has nudged up at just a 0.8% annual rate in the past ten years, roughly half the 1.5% pace in the prior two decades. The recent Canadian productivity performance pales not just in comparison with prior patterns, but also against the U.S., where output per hour has advanced at better than a 2% annual rate in the past decade (*Chart 2*).

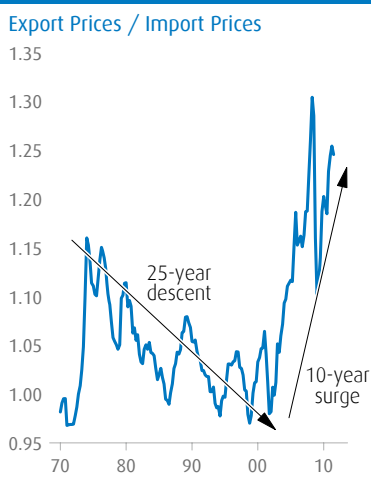
This seemingly esoteric difference has real-world consequences. The combination of a sustained and pronounced rise in the Canadian dollar, on top of the productivity gap, has boosted relative unit labour costs (compensation per unit of output) by a massive 80% in the past ten years versus our U.S. counterparts, and 50% above the average level of the prior two decades (*Chart 3*).

Quite simply, this has left Canadian labour with a severe competitive challenge vis-à-vis the U.S. in industries such as manufacturing, tourism, and even some resource sectors. Against this backdrop, factory payrolls could remain under downward pressure, even as U.S. spending and demand recover more forcefully in the next few years (*Chart 4*).

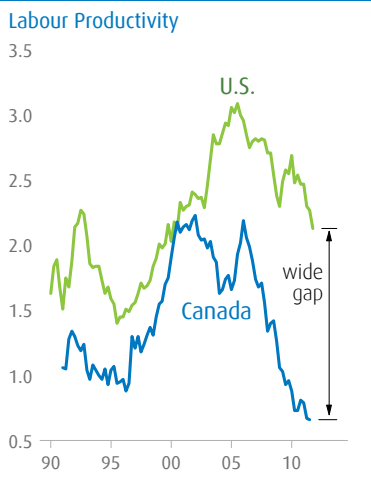
The regional implications of these trends are quite straightforward: The benefits of rising terms of trade tend to primarily favour the commodity-heavy regions of the country, while the competitive strains of weak productivity and a strong Canadian dollar weigh most heavily on the industrial centres. This has been the dominant regional economic theme for the past ten years, and appears destined to be a dominant theme for the next ten years.

One way manufacturing and other sectors facing external competition can ease the pressure is through stronger productivity growth. Of course, the weakness of Canada's relative productivity performance has been studied and assessed for

1. CANADA: TERMS OF TRADE (2002 = 100)



2. PRODUCTIVITY GAP (10-year % change : ann.)

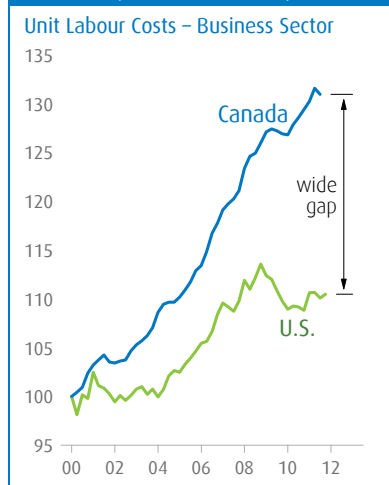


years, and years, and there is no simple recipe to help correct the Canada/U.S. gap. In fact, we have made the case in the past that the strong commodity price/strong Canadian dollar combination actually harms productivity, by undercutting activity in manufacturing (a high value-added sector).

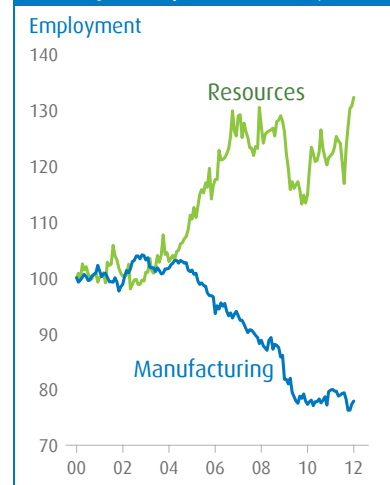
Given that we likely face a lengthy period of relatively high commodity prices and a currency close to par, export-competing industries must prepare by redoubling efforts to lift productivity. Upgrading equipment is a step in the right direction, but it's also critical how efficiently we use the equipment and our labour supply.

At the same time, policymakers must do whatever they can to support innovation and competitiveness, including restraining public sector costs. While concerns over lacklustre Canadian productivity growth have been trumpeted time after time in the past two decades, that doesn't make those concerns any less relevant today.

3. UNIT LABOUR COSTS DIVERGE (2000:Q1 = 100)



4. CANADIAN EMPLOYMENT: DIVERGING FORTUNES (January 2000 = 100)





COMMERCIAL BANKING

Gail Cocker,
Senior Vice-President,
Commercial & Treasury
Management, BMO
Financial Group

A \$10 Billion Vote of Confidence in Canada's Entrepreneurs

When we canvassed our commercial customers across the country about how they were feeling about the business environment, the phrase we heard most was “*cautiously optimistic*”. And the more we looked, the more positives we found to support that optimism.

In Nova Scotia, for instance, there is palpable excitement about the \$25 billion contract won by Halifax Shipyard to build combat vessels for the Canadian Navy. The impact on companies both directly and indirectly involved with this contract will support business expansion and growth for two decades. In Newfoundland & Labrador, major projects are further along in development and demand for skilled labour is high.

In the West, natural resource companies continue to invest and grow, creating jobs and leading consumers to spend at record levels in provinces like Alberta and Saskatchewan. Manitoba has shown resiliency and stability, and the B.C. construction industry is picking up after a post-Olympics' lull.

In Ontario and Quebec, manufacturers that survived the recession have emerged with potential for growth and strength; many firms are upgrading on elements of their businesses that will improve their productivity and give them a competitive advantage.

Such positives do not fully obscure the difficulties that the current economic environment has created. In today's interconnected world economy, our businesses can be impacted by events halfway around the world; one of our bankers noted that the slightest bit of momentum can be stymied by a new, worrying announcement about the European crisis. Meanwhile, the U.S. market, while picking up, is still sluggish; Canadian exporters, already coping with a high dollar, must still deal with this challenge.

But all in all, Canadian businesses are in good shape. That said, we strongly believe in the need for companies to continue innovating to remain competitive. We have an attractive marketplace, and it's important to keep that momentum going.

With tumultuous times come opportunities. With the strong dollar and low interest rates, we strongly support those customers who want to take this opportunity to make investments in their operations that will boost productivity. BMO recently announced that it is making \$10 billion available to businesses across Canada over the next three years; we firmly believe this money will provide small and medium-sized businesses with more certainty of available credit. It's a clear example of our ongoing confidence in them, and in the Canadian economy.



British Columbia



ECONOMICS

Robert Kavcic,
Economist

British Columbia's economy has cooled, and likely posted 2.4% real GDP growth in 2011. Activity is expected to moderate further to 2.3% this year, as residential construction and government spending ease, while U.S. economic growth continues at a sluggish pace. Still, barring a deeper global downturn, growth should be supported by strong, though slowing, Asian export demand and resource-sector investment.

The lofty housing market has shown signs of cooling in recent months, particularly in formerly white-hot Vancouver. Sales in Vancouver were 13% below year-ago levels in January and, after peaking above \$800k in June, seasonally-adjusted prices have drifted closer to \$700k (partly due to fewer high-end sales). Additionally, uncertainty over the timing of the transition from the HST back to the PST/GST appears to be having a negative impact on the new home market. As a result, housing starts should moderate to slightly above 23,000 units in 2012, from 26,400 in 2011.

The U.S. housing market has shown signs of levelling off in recent months, with homebuilder confidence improving and mortgage lending standards at least holding steady. While housing starts should see growth in the year ahead, the level of building activity remains depressed, providing little lift for forestry exports. At the same time, a cooling Chinese property market has sapped some momentum from recently robust forestry exports to that region. The B.C. labour market had little momentum at year-end, with employment falling in 3 of the last 4 months through January.



COMMERCIAL BANKING

Derral Moriyama,
Senior Vice-President,
Commercial, Greater
Vancouver District

Unlike six months ago, we are receiving mixed signals from B.C.'s commercial sector. While some concerns about the economic environment were certainly present before, now we are seeing a clear atmosphere of caution and a holding pattern in business activity.

We do see a number of sectors exhibiting strength. For instance, there's been a particularly surprising run-up in the number of projects among our construction and engineering clients. There appears to have been an uptick in activity after a post-Olympics' lull; now these businesses report that they're extremely busy. This has resulted in renewed opportunities for jobs and capital machinery purchases. There has also been a solid increase in manufacturing activity. While this business growth isn't blowing the doors off, it represents good, solid steady business.

Real estate has pulled back, but we still have a lot of mainland Chinese developing parcels of land and building larger homes. There remains evidence that there are very wealthy individuals from mainland China doing business here. It's surprising to see a few individuals affect the economy like they have.

However, we do have customers who are concerned with the halting nature of the economic recovery. With any momentum seemingly stalled by single announcements in Europe, they feel as if they are taking two steps forward and one step back. We're noting particular volatility in commodities markets, which has led to several mining companies holding off on their IPOs. With the investment community staying cautious and keeping an eye on world events, these firms have clearly decided that this is not the time to raise funds this way. This caution exists in other sectors as well; lumber is not quite as buoyant as it was a few months ago, and mid-market clients have been trying to hold off on making their next major purchase.



Alberta



ECONOMICS

Robert Kavcic,
Economist

Alberta's economy significantly outperformed the national average in 2011, with real GDP on track to grow 3.7%. High oil prices are fuelling the energy sector; which, in turn, is driving strong labour market performance. Alberta should remain near the top of the growth leader board in the coming years.

Alberta oil production was up a solid 9.3% y/y through October, with even more robust 12.2% y/y growth in crude bitumen production. Longer term, the Province is expecting raw bitumen production to grow at a strong pace by 2015. Recent political wrangling over the Keystone Pipeline has introduced some long-term risk to the province's oil production. While the project will likely still be completed, the timing could become an issue—production in Western Canada could be negatively impacted by about 2015/16 if there is not enough new pipeline capacity.

Strength in the energy sector has rekindled in-migration and helped firm up the labour market. Net interprovincial in-migration was the highest since early-2008 in the first three quarters of 2011. Meantime, employment growth was a robust 3.9% y/y in January, well above the 0.8% y/y national pace, and the jobless rate has fallen to a cycle low of 4.9%. With the recent growth spurt, measures of cost pressure and capacity constraints are picking up, but remain far from the extremes of the last boom.



COMMERCIAL BANKING

Bill Hogg,
District Vice-President,
Commercial, Alberta

Across the province, our commercial clients continue to show rising levels of optimism and confidence.

In the key oil and gas sector, we see more investment and hiring. Our customers tell us that while 2012 will be a strong year, 2013 will be even better. Of particular note, companies that have contracts for rented equipment are keeping that equipment, even if they're aren't using it; in short, they anticipate more work very soon.

The retail sector has shown particular strength—with Albertans spending at record levels and showing the confidence to buy big-ticket items. Lance Kadatz at Rifco National Auto Finance noted to us that his firm expects additional auto sales growth in the year ahead: *"Replacement demand, strong trade in valuations, and attractive finance options for consumers will translate into robust sales growth."*

We also hear great things from the agricultural sector. In November, I attended the Agri-Trade event in Red Deer, the second-largest agricultural trade show in Western Canada. There was a great turnout and I spoke to a lot of farmers who were kicking the tires on new equipment. Peter Adams at Adams Ranch Ltd. recently told me that the outlook for the cattle and grain industries is quite optimistic and positive: *"Both industries are profitable for the first time in my memory. The outlook for the cow-calf operators is good—demand and prices are at all-time highs."*

One unknown that farmers must contemplate is the end of the Canadian Wheat Board monopoly. No one yet knows what it will mean for individual farmers. But, starting next season, they will have to choose between two options: marketing their own grain products, or remaining in a shrunken wheat board that will essentially act as a co-op. Their products will be true commodities—they will be worth what they are worth. Participants in the sector are keenly interested in how it all turns out.



Saskatchewan

ECONOMICS



Robert Kavcic,
Economist

Saskatchewan's economy has sidestepped some challenges, and again looks to be growing at among the fastest pace in Canada. Real GDP likely expanded 3.1% in 2011, helped by a rebound in agriculture output, before cooling slightly to a still-strong 2.9% pace this year.

Flooding again threatened crop production early in 2011, but much better growing conditions during the summer helped the sector, and agriculture exports were up more than 20% y/y through November. Crop production should be up nearly 9% in 2011, according to Statistics Canada estimates, with good-to-excellent quality.

Meantime, broader resource-sector activity remains robust. Potash production was up 25% y/y through September, and the sector will continue to support growth in Saskatchewan. However, note that Potash Corp. temporarily shut down some of its Canadian mines, representing about 10% of its operating capacity, as it attempts to offset soft industry pricing. Elsewhere, exploration activity in the oil & gas sector is strong in the Bakken, and oil output will continue to support growth.

Commodity-sector investment is supporting the labour market and driving wage growth. The province's unemployment rate averaged 5.0% in 2011, while average weekly earnings were up a firm 5.1% y/y in November, even as the national average cooled significantly. Solid job prospects and relatively low living costs should continue to drive population growth; and, combined with a modestly lower tax burden, will support consumer spending and the housing market.

COMMERCIAL BANKING



Mike Darling,
District Vice-President,
Saskatchewan

Positive news continues to flow in Saskatchewan for our commercial clients. On the political front, the recent landslide victory for Brad Wall's Saskatchewan Party has ensured a stable political climate. When combined with the continued government fiscal surplus, this creates a positive environment for businesses to operate and grow.

One of our customers, Airline Hotels Group president Betty Anne Latrace-Henderson, spoke to me about her pride of being a Saskatchewan business person during both today's period of strong growth and the difficulties of the past: *"This diverse province has provided the foundation to build a solid business in which we have learned how to survive during the good and the bad economic times. It is these lessons learned that have enabled many businesses, ours included, to prosper."*

New opportunities abound in natural resources. Mining is driving investment. For instance, November saw the announcement by Europe's largest potash producer, K&S Aktiengesellschaft, that it would be investing \$3.25 billion in the development of a new potash mine 50 km north of Moose Jaw. This means the creation of 1,000 construction jobs and 300 high-quality permanent jobs, providing an already-vibrant Moose Jaw with even more opportunities for growth.

Oil continues to provide increasing support for the economy. Activity has moved beyond just the southeast; more exploration is taking place in the Swift Current and Maple Creek area. Investment dollars continue to flow into Saskatchewan as a result.

In agriculture, the harvest numbers are in and they are not as bad as anticipated. While there have been some difficulties near the U.S. border, yields have been solid in the rest of the province. Combined with robust prices, 2011 was a solid year.



Manitoba



ECONOMICS

Robert Kavcic,
Economist

Manitoba's diverse economy continues to grow at a modest pace, with real GDP likely expanding 2.0% in 2011, held back by another poor crop year. Growth should pick up to 2.3% this year, outpacing the national average.

Wet weather contributed to a 14% drop in real crop & animal production in 2010, which shaved almost a full percentage point from real GDP growth. Last year's Assiniboine River flooding again had a negative impact, with crop production expected to be well below year-ago levels.

Manufacturing, however, continues to perform well, with shipments up nearly 7% y/y through November, led by firm growth in machinery and transportation equipment. Meantime, energy and mining activity should maintain their momentum given that commodity prices, especially oil, have held up relatively well. Note that energy exports were running at more than twice year-ago levels through November.

Job growth, however, has been sluggish overall, with employment up just 0.3% y/y in January. This largely reflects a decline in public-sector employment as the Province restrains spending. Private-sector job growth, however, is still firm thanks to growth in services. The 5.4% jobless rate was the third lowest in Canada in January.

A diverse economy and healthy labour market, combined with the Provincial Nominee Program, continue to attract international migrants. Net international migration was a near-record 13,500 people in the latest four quarters, which has helped hold population growth steady at 1.2% y/y, near the fastest pace since the early-1980s. As a result, retail sales and housing should continue to see support.



COMMERCIAL BANKING

Lynda Taylor,
Vice-President,
Manitoba & Northwest
Ontario

No matter what's in the news on the economic front, Manitoba typically shows a steady-as-she-goes outlook. Even through the past few years with the financial crisis and generally down market, we haven't seen wild swings one way or the other.

But today, we see an impressive amount of optimism. From the return of the Winnipeg Jets to a solid economic forecast, Manitoba is looking forward.

We are particularly encouraged to see several of our corporate customers investing in their businesses. For instance, air distribution supplier PRICE's CEO, Gerry Price, tells us his company is making a concerted effort to invest in its operations to ensure they will grow and prosper in a much-reduced North American market, and be well ahead of their competition when activity picks up. BMO's recent announcement that it is making \$10 billion in credit available to businesses across Canada over the next three years will help to support other Manitoba companies to do the same.

Manitoba businesses have also benefited from the tendency to sell products to the rest of Canada, not the United States. This has insulated a good portion of the provincial economy from the impact of the sluggish American recovery.

On the agriculture side, the recent flooding and last summer's subsequent drought have clearly had a negative impact on our customers in the sector. Nonetheless, we've been struck by their lack of complaint. They look prepared to figure out what to do next and go on. Provided the weather cooperates, Manitoba's farmers can look forward to a solid rebound.



Ontario



ECONOMICS

Robert Kavcic,
Economist

The Ontario economy continues to gear down, with temporary auto sector disruptions having a negative impact in 2011Q2. Growth rebounded in Q3, however, but real GDP was on pace for a modest 1.9% rise for all of 2011. The longer-term headwinds of sluggish U.S. demand and fiscal restraint will continue to blow this year, and growth should remain relatively sluggish in 2012.

Canadian auto production fell sharply last spring due to supply-chain issues stemming from the Japanese earthquake/tsunami, and was impacted by flooding in Thailand in the fall—Honda's Alliston plant was running as much as 50% below full capacity before returning to normal production by late November. Indeed, Canadian auto production rose sharply at year-end, and had recovered the entire decline seen during the recession by January. More broadly, a prolonged period of soft U.S. growth, along with a near-parity loonie, should weigh on manufacturing and exports, but strong momentum in U.S. auto sales is a positive recent development.

After robust growth during the recession, real government spending contracted in 2011Q3—the restraint required to balance the budget will further restrict public-sector growth. The Province is targeting program spending growth of 1.4% per year through FY17/18, with an even more aggressive target likely—regardless, it will be a stark change from the near 8% annual growth over the past decade.

Before weakening in recent months, the labour market had recovered all of the jobs lost during the recession. But employment growth has stalled since mid-year with 16,100 jobs lost since June—public-sector employment has begun to contract. The housing market, however, remains firm thanks to extremely low interest rates, and condo construction continues at a robust pace.



COMMERCIAL BANKING

Susan Brown,
Senior Vice-President,
Ontario Regional
Division

Across Ontario, the worst of the recession is behind us. However, cautious and tempered attitudes persist, and optimism differs across various industry segments in the province.

Customers who survived the recession—those who had strong balance sheets—are looking to consolidate the gains they have made over the past few years by reducing their operating expenses and using up surplus productive capacity before investing in new equipment. Those who are upgrading their operations, however, are investing only in those things that will give them significant competitive advantages and/or improvements in productivity. This renewed focus on productivity will only benefit these firms in the long run.

Our clients do believe that the economy will slowly improve over the coming year, and this retrenchment will help ensure they are ready to take advantage when the time comes. But, for now, caution is the order of the day.

Exporting manufacturers continue to feel the impact of the relatively high Canadian dollar. For many of these companies, the strong dollar is a double-edged sword: it reduces their costs to purchase imported equipment and technology but increases the price of their exports, especially to the U.S. Exporters have therefore responded by hedging currency and sourcing raw materials from those same markets to which they export, thereby minimizing the impact of our stronger currency. Also, during

the recession, many Canadian exporters focused on American high-value niche markets, which allowed them to protect their margins and sheltered them somewhat from lower price competitors in the U.S.

The agriculture sector experienced a fairly strong year, with cash croppers benefiting from both strong prices and high yields and dairy producers enjoying income stability. However, heavy commodity consumers, such as hog producers, have felt the pain of increasing input costs, as they compete with ethanol producers for the corn required for feed.

The construction sector is in a wait-and-see mode, as the heavy infrastructure spending, from which they have benefitted in recent years, begins to wind down. Retail continues to be affected by the strength of the dollar and increasing cross-border shopping, although the service businesses, in general, are showing positive signs.

Greater Toronto Area



COMMERCIAL BANKING

Mike Bonner,
Vice-President,
Commercial, Greater
Toronto District

We are starting to see signs of confidence in the GTA, as clients are beginning to invest in their businesses. The tough economic conditions persistent since 2008 have made our customers more focused on seeking new market opportunities domestically and internationally. This has positively positioned businesses in the Greater Toronto Area to take advantage of the many opportunities that are presenting themselves.

Recently at a networking event, many customers told us they were feeling optimism about this marketplace. Mario Pestrin of York Tile indicated that for his business: *“The outlook for 2012 is very good. I have numerous projects on the go and many that we are quoting on. There appears to be money in the market and an appetite for construction.”*

In the year ahead, several customers are planning to control expenses, increase capabilities and position themselves to take advantage of low borrowing costs for the acquisition of key capital assets and expansion of facilities. Innovation and investment in human capital are atop of their business agenda as measures to boost their competitive advantage.

Companies involved in specialized manufacturing, who have identifiable niches, are continuing to experience growth. These manufacturing companies have successfully differentiated themselves from traditional mass production manufacturers. As a result, they have created higher gross profit margins than their competitors. However, traditional manufacturers, retailers, transportation and businesses related to the import/export of goods have indicated that market conditions continue to weigh on their bottom line.

Several of our clients involved in food manufacturing, service-based companies focused on IT and consulting have all reported continued growth in their respected sectors. These companies have reiterated that their focus has been on expanding target markets, increasing product offerings and differentiating themselves from their competitors as key mitigating factors against the economic conditions.

But overall, it's great to see our customers feeling more positive. While not “out of the woods” as of yet, they appreciate that we are ready to help them eliminate the uncertainties they are facing in 2012 by helping them make sense of the economy and move their businesses to the next level.



Quebec



ECONOMICS

Robert Kavcic,
Economist

Economic growth has slowed in Quebec, as real GDP likely expanded a sluggish 1.7% in 2011, and should ebb further to 1.6% this year. Fiscal restraint and a rising tax burden will weigh domestically, while a modest pace of U.S. economic growth will keep the manufacturing sector in check.

Fiscal restraint has taken root in Quebec, as the Province remains fully in budget-balancing mode. This is being felt on multiple fronts, with program spending growth projected to run below combined growth in inflation and the population, while the tax burden will continue to rise in 2012. This rising tax burden will cut into disposable income and consumer spending. Retail sales in the province were up a modest 1.8% y/y in November, and could be under further pressure early in 2012. Offsetting this somewhat will be a still-solid level of capital spending. Ongoing Hydro Quebec investments continue to support growth, while the Plan Nord will see the Province inject \$2.1 bln into infrastructure.

Finally, a sluggish pace of U.S. growth will be an ongoing headwind for manufacturing, though the sector is still seeing solid growth—recent aerospace orders should provide a boost to exports in 2012. Still, manufacturing employment continues to fall, down 3.7% y/y to near the lowest level on record. Note that the stunning late-year drop in employment reported in the Labour Force Survey doesn't appear entirely consistent with broader economic trends, and could be a correction for stronger-than-warranted reported job growth earlier in the year.



COMMERCIAL BANKING

Victor Pellegrino,
Vice-President,
Commercial, Montreal
District

While Quebec companies enter 2012 with a sense of caution, there remains a solid foundation. With the economy slowing and less stimulus money available for projects, we are seeing more retrenchment and less expansion among our customers.

The positives are still clear. For instance, Montreal still has everything a company needs to succeed—a large, well-educated workforce, excellent real estate, plus strong domestic and international markets. Indeed, certain companies stand out with their successes. One excellent example is Speedware, a Montreal-based IT modernization company. Despite the slowdown in the economy, Speedware has continued to perform well. In fact, after it was acquired by a U.S.-based firm in 2005, local company management initiated a leveraged buyout of Speedware, re-establishing the company as independent and private. In short, they took back what was theirs.

Speedware is also one example of a firm that is taking the opportunity to invest in its operations. President and CEO Andy Kulakowski told us: *“We continue to invest in Research & Development and in our Sales & Marketing organizations, to support the expansion that we see and believe in, and to support the rise in activity in some of the markets we serve.”*

But, by and large, our customers are holding back. We have seen several examples of companies deciding to defer implementation of major projects. This is particularly the case for those who rely on exports and stable economies in the U.S. and Europe. With the U.S. recovery sluggish and Europe's struggles well-known, investment and expansion have ground to a halt. These business owners want to see genuine growth in outside markets before they show a willingness to take on more debt, despite the advantages of a high dollar and historically low borrowing costs.



New Brunswick



ECONOMICS

Robert Kavcic,
Economist

Economic growth in New Brunswick has slowed after a firm post-recession rebound. A shift from fiscal stimulus to restraint, along with modest U.S. economic growth, should likely hold growth to 1.4% in 2011, with little momentum to be gained this year.

Some major private-sector capital projects are set to wind down this year, including Potash Corp's \$1.7 bln Sussex mine development and the \$1 bln Point Lepreau nuclear plant refurbishment. By 2013, however, growth will get a boost as potash production comes on stream. Government capital investment is also poised to slow sharply, with total capital spending by the Province pegged at \$593 mln in FY11/12, down from \$940 mln in FY10/11. Meantime, as U.S. growth remains soft, exports and manufacturing activity should downshift after a strong performance in 2011. New Brunswick has the distinction of being Canada's most export-dependent economy, with about 85% heading south of the border to the U.S.

Consumer spending has held firm, up 4.7% y/y in November, despite some headwinds including a higher tax burden. Personal income tax reductions put in place by the previous government have been suspended, which will leave marginal rates unchanged in 2012 from lowered 2011 levels. Additionally, the top marginal rate previously in place for 2011 (12.7%) was put back to the 2010 level of 14.3% as of July 1st, a move that boosted payroll deductions. Going forward, spending should also be held back by a soft labour market, which saw the jobless rate hover near 10% for much of the year, and employment rise just 0.5% y/y in January.



COMMERCIAL BANKING

John Duff,
Area Manager,
Commercial Banking,
New Brunswick /
Prince Edward Island

Perhaps the best news for a number of our New Brunswick customers was the announcement of the new Canadian Navy shipbuilding contract for the Halifax Shipyard, next door in Nova Scotia. Despite the distance between the project site and these businesses, the spinoff opportunities are clear.

Saint John, as an example, remains home to several companies that were involved in the frigate program 20 years ago. These firms still possess key expertise that can support the project in the years ahead.

Another benefit comes from direct administration jobs related to the project. No doubt, many Nova Scotia firms will be called upon to tackle this responsibility; as a result, there will be a reduction in the number of outside firms willing to bid aggressively for business in New Brunswick. We can expect this to help the profit margins of a number of our commercial customers.

There is also strength to be found with smaller IT firms, with the number of companies in this space starting to grow.

Meanwhile, with below-average growth and a lack of strength in export markets, a number of New Brunswick businesses are wary. We're hearing from customers who think the provincial government's \$10 billion debt will lead to tax increases to make up the shortfall; this has led to some uncertainty about the business environment.

With the withdrawal of stimulus, combined with the government's austerity, there are few major projects in prospect, although the new four-lane highway between Saint John and Saint Stephen continues to generate some activity. As a result, firms, such as those in manufacturing in the southwest of the province, remain cautious.



Nova Scotia



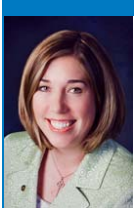
ECONOMICS

Robert Kavcic,
Economist

Economic growth in Nova Scotia is currently running at a sluggish pace, with real GDP likely expanding 1.6% in 2011, but upside looms on the horizon. Growth should firm slightly this year, before accelerating to a 2.5% clip by 2013, when the positive impact of the recently-announced federal shipbuilding contract begins to take root.

The contract landed by Irving Shipbuilding to build combat ships for the Royal Canadian Navy is worth an estimated \$25 bln through 2030. The Conference Board of Canada estimates that about 8,000 new jobs (or more than 1% of total employment in the province) will be sustained over that period, and that real GDP will see a boost of about \$800 mln per year on average. While the exact timing of building is still not certain, we've assumed that some activity will be underway by 2013, boosting real GDP growth roughly 0.5 ppts (about \$200 mln) above our previous forecast, to 2.5%. Meantime, the announcement had an immediate positive impact on consumer confidence, which posted the biggest increase in Atlantic Canada in more than two years in November, before falling back in December.

Construction activity at Encana's \$800 mln Deep Panuke natural gas project continues, and production is expected to boost total exports in 2012, though offset by declining output at Sable. Public-sector investment is slowing as stimulus spending retreats. Indeed, overall capital spending in the province is poised to fall modestly this year after growth of 5% per year in the prior two years. The job market was sluggish through most of 2011 before a late-year jump in jobs lifted employment 1% above year-ago levels by January—both the private and public sectors have contributed to growth in the past year.



COMMERCIAL BANKING

Laura Charlton,
District Vice President,
Nova Scotia

In Nova Scotia, our business customers are very excited about the announcement that Halifax Shipyard had won a \$25 billion contract to build new combat ships for the Canadian Navy over the next 20 years. While no immediate impact is expected, a massive boom is on the way that will benefit the provincial economy for years to come.

From trades to professionals, in Halifax and elsewhere in the province, whole industries are set to benefit from this contract with ripple effects throughout the economy. Most importantly, hundreds of people who would otherwise have needed to leave the province to work in their chosen fields will get the opportunity to stay in Nova Scotia for their entire careers—a further boon to the provincial economy.

For the next two years, we're going to see businesses ramping up for the start of the project; by 2015, there will be tangible benefits to the province.

In the meantime, the economy remains a bit soft, but the province has typically benefited from its growth, moving on a longer trajectory without sudden peaks and valleys. Some difficulties are present, such as the recent layoffs and \$50 million provincial bailout at the Bowater Mersey Paper Co. in Brooklyn. But, in the main, we are waiting for the party to begin.



Prince Edward Island



ECONOMICS

Robert Kavcic,
Economist

The P.E.I. economy continues to plod along at a modest pace, with real GDP set to rise 1.7% in 2011 before cooling slightly to 1.4% this year—a downshift in public-sector capital spending will work against recently improving population trends.

Public-sector capital spending levelled off in 2011, and is expected to fade more significantly in 2012. P.E.I.'s latest five-year capital plan calls for a net \$124 mln in FY11/12, about in-line with the prior year's total. However, capital spending will be sliced to \$87 mln in FY12/13, which will weigh on economic growth next year.

After strong 3.1% growth in 2010, employment rose 1.8% on average in 2011. Public-sector growth led, but the private sector also rose 3.7%. Employment in the accommodation & food services sector was also up a solid 4.8%. However, while U.S. consumer attitudes are improving, still-depressed levels of confidence and an elevated loonie could continue to weigh on tourism activity. At 12.2%, the province's jobless rate is about 1 ppt above the average of the past decade.

Population growth has been one recent area of strength in the province, topping 2% y/y in August for the first time since 1980—the Provincial Nominee Program has been particularly successful in attracting international migrants.



COMMERCIAL BANKING

John Duff,
Area Manager,
Commercial Banking,
New Brunswick /
Prince Edward Island

Through the recovery after the economic downturn, our Prince Edward Island-based commercial clients and other businesses have remained steady performers.

With the provincial government solidly into its new mandate, we're hearing about a lot of positive feelings on the fiscal situation and commercial prospects. Residential and commercial development is still taking place, and a large commercial project is typically on the go at all times. We certainly expect this to continue into 2012, and we expect BMO's announcement of a \$10 billion boost in commercial lending to contribute to more such activity.

Economic diversification continues to provide strength for the provincial economy, with the biotech industry leading the way.

One area that remains a concern is agriculture. The sector continues to be affected by price fluctuations along with the price of fuel and overall input costs. That said, Prince Edward Island potato farmers, overall, are satisfied with crop quality and yield of 2011. They remain optimistic for price improvements for the 2011 crop currently in storage given that supply in Eastern Canada in 2011 was down 20% year-over-year and down 10%-to-15% across North America.

The fishery also continues to have difficulties, particularly in crab and lobster. The high dollar and still-sluggish U.S. economy, combined with lower demand and consumption in Japan, are keeping prices low.



Newfoundland & Labrador



ECONOMICS

Robert Kavcic,
Economist

Newfoundland & Labrador likely led the country with 3.8% real GDP growth in 2011, helped by investment activity in both the public and private sectors. However, growth will cool this year as investment levels off and oil production dips.

Construction activity has been the biggest economic driver in the province since the recession. Government infrastructure spending is on pace to total more than \$1 bln in FY11/12 (more than 3% of GDP), helping boost overall capital spending an expected 27% in calendar 2011. The private sector is also providing a lift, with projects like the Vale nickel processing plant, Hibernia South and Hebron adding to the level of public-sector investment this year. However, this activity will begin to level off in 2012, and oil production should drift down—output at Terra Nova has peaked, and production was down 4.6% y/y through the third quarter of 2011.

Other underlying economic trends in the province have begun to cool. Employment was down 0.5% y/y in January, versus a pace of more than 7% y/y in the spring. Construction employment remains robust thanks to investment activity (December saw record employment in this sector), but employment in wholesale and retail trade has begun to decline. The jobless rate edged back up to 13.5% by January from a record low of 11.3% in April.



COMMERCIAL BANKING

Jim Fallon,
District Vice-President,
Newfoundland &
Labrador

The mood among our customers in Newfoundland & Labrador is definitely more optimistic than it was just six months ago, mainly because key projects are further along in their development. Real money is now being spent at Vale Inco's project at Voisey's Bay and on Iron Ore's upgrades. Meanwhile, the Muskrat Falls hydro and Hebron oil projects are now in the full planning stages, with the engineering and environmental assessments underway.

The rapid expansion has led to some difficulties; there's a shortage of housing, along with a shortage of skilled labour. Vale Inco, for example, needs 800 more workers. These concerns are especially pronounced in the project areas in the west of Labrador. In general, however, we are seeing lots of money spent on these projects, and job opportunities to go with them. The Province is doing its part by sponsoring immigrants through the nominee program; as a result, a significant number are heading to Labrador West to work in the service industries. It is also trying to get more people in skilled trades through expanding post-secondary enrolment. In the Avalon Peninsula, there's lots of work for skilled labourers. But companies face the problem of relocation. Many expatriate Newfoundlanders are considering moving back. But, when the projects have finite ends, it makes such a decision more difficult.

The province is also becoming a key centre for innovation. As the host for the Ocean Sciences Centre at Memorial University and a growing expertise on oil & gas, deep water drilling and deep water exploration, Newfoundland & Labrador now boasts some of the best ocean science expertise in the world.

In the fishery, most fishers and processors had a reasonably good year. Prices were high enough for everyone to make a dollar. But there's a rising concern about overcapacity in processing, which is not helped by the Chinese market preferring to receive the whole fish. This has led to a couple of closures.

Provincial Economic Summary

	BC	Alberta	Sask.	Manitoba	Ontario	Quebec	NB	NS	PEI	NL	Canada
Real GDP Growth (chain-weighted : year/year % change)											
2011 f	2.4	3.7	3.1	2.0	1.9	1.7	1.4	1.6	1.7	3.8	2.3
2012 f	2.3	3.0	2.9	2.3	1.9	1.6	1.5	1.8	1.4	1.6	2.0
2013 f	2.7	3.1	3.0	2.5	2.4	2.2	2.0	2.5	1.5	2.0	2.5
Employment Growth (y/y % chng)											
2011	0.8	3.8	0.3	0.7	1.8	1.0	-1.2	0.0	1.7	2.9	1.5
2012 f	1.1	2.7	1.0	0.8	0.5	-0.3	0.5	0.6	1.2	0.2	0.7
2013 f	1.4	1.8	1.4	1.0	1.1	1.0	0.6	1.6	0.2	0.6	1.2
Unemployment Rate (percent)											
2011	7.5	5.5	5.0	5.4	7.8	7.7	9.5	8.9	11.4	12.6	7.5
2012 f	7.0	5.0	4.9	5.3	7.9	8.2	9.5	8.4	11.5	12.7	7.5
2013 f	6.6	4.8	4.9	5.2	7.6	7.9	9.3	8.2	11.5	12.5	7.2
Housing Starts (thousands)											
2011	26.4	25.5	7.2	5.9	67.7	48.2	3.2	4.7	1.0	3.5	193.2
2012 f	25.0	26.0	7.0	5.4	67.4	44.5	3.2	4.6	0.7	3.3	187.0
2013 f	23.0	29.0	7.2	5.2	64.5	43.5	3.5	5.0	0.7	3.4	185.0
Consumer Prices (year/year % change)											
2011	2.4	2.4	2.8	3.0	3.1	3.0	3.5	3.8	2.9	3.4	2.9
2012 f	2.2	2.4	2.5	2.2	2.2	2.6	2.1	1.9	2.0	2.3	2.3
2013 f	1.4	2.4	2.3	2.0	2.2	1.9	1.7	2.0	1.5	2.0	2.1

f = forecast

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