

BMO Capital Markets

Eurozone's Real Problem

- Competitive is the fundamental problem
 - For Canadians, lagging productivity growth has been a structural problem for years, making it tougher to compete with the U.S.
 - Canadian business has been far too slow in shifting trade to emerging economies, posing both a structural and economic problem
- Eurozone Productivity differences among the members are an even bigger problem
 - Germany is the most productive economy and the gap has widened with the restructuring of its labor markets over the past decade
 - By abandoning the deutsche mark, Germany benefited from a significantly undervalued currency, sustaining a competitive advantage vis-à-vis the rest of the world.
- Different paths
 - The most likely path to redress the imbalanced is deflating these economies through a protracted period of recession and hardship
 - Alternatively, Greece or others could leave the Eurozone, which would involve massive devaluation (estimated at around 60% for Greece)
- Canada must work hard to become more competitive
 - Using corporate cash balanced to innovate, invest in technology, hire talented people from the global pool

Review of 2011

- US economy is in fact gaining strength, even as Europe absolutely dominates sentiment
- The latest plunge in weekly jobless claims hints that the US job market is taking a turn for the better
- Most pressing question for 2012 is whether US economy can decouple from Europe's woes: DOW is clinging to a small gain this year, while European stocks are down an average of over 20%
- TSX was closer to European performance this year, currently down 14%. First time in 8 years that Toronto will lag behind the S&P 500.
 - First cause is RIM
 - Second cause is hefty declines in the resources sectors
 - Commodity prices are reeling, with CRB now down more than 11%
- Commodity sag took another bite out of the loonie, down almost 4% for the year

U.S. Job Growth

- Initial jobless claims dropped to 3 year lows (366,000), while forward-looking NFIB small business and Manpower hiring indexes both rose to 3-year highs
- Retail spending and steadier housing markets will anchor a 3.0% gain in the real GDP in Q4, the fastest in 1 ½ years.

Canadian Provinces - downbeat

- Manitoba's flood-related costs will result in a deficit of \$989 million, or \$554 million worse than the budget
- Nova Scotia revised up its FY11/12 deficit forecast by \$46 million to \$365 million amid weaker near-term economic outlook
- British Columbia is considering delaying their plan to return to balanced by FY13/14
- Moody's lowering Ontario's credit rating outlook to negative sets a stage for potential downgrade. Ontario is currently expecting real GDP growth to rebound to 2.5% in 2013 and 2.6% in 2014, but now it's a lot closer to 2%

Where the Fed may delve in 2012

- Two potential changes in next month's FOMC meeting:
 - They can extract more impact from existing policy measures
 - They can provide more policy accommodations or make balance sheet/interest rate-related policy actions more effective
- Looking for real GDP growth to slow to 1.9% annualized in 2012 H1, from an estimated 2.5% in 2011 H2.
- Headline PCE inflation should continue to drift down, furthering Fed's moderated observation, while core will be contained within FOMC's longer-run projection
- On interest rate front, a discount rate cut is likely
 - A cut in interest rate paid on reserves (the "IOR" rate is currently 25 bps) is unlikely
- Fed has signaled a policy to stop reinvestment strategies, thus possible increase in net holdings of MBS
 - Housing remains the weakest link in the chain of self-sustaining economic recovery, additional Fed assistance could strengthen this link
- Additional QE is unlikely, most FOMC treat QE3 as last resort policy to deal with renewed risks of deflation
- 2012 is the year in which the past 4 ½ years of policy maneuvers finally start garnering cumulative traction

focus

A Weekly Financial Digest

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- Carney Warns on Household Debts... Again
- Moody's Warns Ontario on Debt
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Euro Slumps to 11-Month Low
- Gold Loses Lustre



SHERRY COOPER

The Eurozone's Real Problem

The eurozone has far more than a debt problem. If this were the only problem, the move toward a tighter fiscal union and deficit reduction, along with ECB support for banks and sovereign debt markets, could be a lasting solution. But competitiveness is the fundamental problem. It gets far too little attention and is far tougher to deal with.

For Canadians, lagging productivity growth has been a structural problem for years, making it tougher to compete with our number-one trading partner, the U.S., where productivity growth has surged and unit labour costs have fallen sharply over the past cycle. Normally, this divergence would be expected to weaken the Canadian-U.S. dollar exchange rate, and undoubtedly it has had that effect to some degree. But the impact of weaker productivity on the loonie has been more than offset by high commodity prices, the negative effects of the U.S. financial excesses, Washington's political problems and by the American trade and budget deficits. Canada's trade balance with the U.S. has deteriorated sharply, which has been the major dampening effect of the U.S. financial crisis and ensuing recession on the Canadian economy.

Canadian business has been far too slow in shifting trade to the rapidly growing emerging economies, posing both a structural and economic problem. Until we build an East-West pipeline from Ft. McMurray to the deep-sea ports of B.C., Canada cannot export oil to China and elsewhere in Asia. Exports of other products such as lumber and coal have picked up significantly, but far too little to offset the diminished net sales to the U.S.

For the eurozone, the productivity differences among the 17-member countries are an even bigger problem and, as Ottawa has learned, you cannot legislate productivity. Germany is by far the most productive economy in Europe and the gap has widened with the restructuring of its labour markets over the past decade. Since 2000, unit labour costs in Germany have risen about 20%-40% less than in the other euro countries. That gap has left Germany with a large intra-European trade surplus while most other countries run deficits. Germany is an export juggernaut, not just with the eurozone, but with China and the rest of the world, which has spurred its economic growth and mitigated the rise in its debt and deficit ratios. German employment hit another post-unification high in October, highlighting the massive disconnect between its current prosperity and the suffering in many other eurozone members.

This was no accident on Germany's part. Berlin was well aware that, by adopting the euro, it was almost certain to benefit from a significantly undervalued currency. By abandoning the deutsche mark, Germany locked into fixed exchange rates with the likes of Greece, Portugal, Italy and others. This virtually guaranteed it would have a sustained competitive advantage vis-à-vis the rest of the world, without being accused of manipulating its currency (like China). And, while Germans complain loudly that the cost of supporting the rest of the eurozone is an unreasonable burden, you better believe that burden has been well worth it, or the Germans would have never supported the creation of the eurozone in the first place.

It was no secret to anyone that the currency union would run into these problems sooner or later. It's amazing it took so long to rupture. The solution for the rest of the eurozone is very difficult. Germany could stimulate its economy and thereby increase domestic consumption, wages and prices, which is simply not going to happen. The other countries can engineer a productivity miracle by restructuring their labour markets and reducing the size of government, incentivizing private investment, encouraging foreign direct investment, building new business sectors, retraining workers, improving education and reducing impediments to wage reduction. While all of these actions are needed, many of them are simply unaffordable and would take years to bear fruit.

The most likely, but painful path, to redress the imbalances is deflating these economies through a protracted period of recession and hardship. When Canada engaged in such an effort in the 90s, the global economy was booming, which shortened the process and mitigated the pain; and, the situation in Canada was never as dire, and our currency's fall cushioned the blow.

Alternatively, Greece or others could leave the eurozone, the ramifications of which are uncertain, but would certainly involve massive devaluation (estimated at about 60% for Greece), which would destroy that proportion of incomes and wealth while the cost of living would surge. In fear of just this, substantial capital flight from Greece has already occurred. Any move away from the euro would require the freezing of bank accounts and other asset sales and default on government debt, which could trigger panic and potential collapse. Greece would be unable to borrow in open markets, requiring assistance from the IMF and triggering huge losses at the ECB, European banks and other investors. Some even expect this would topple the government and cause civil unrest requiring military action. The return to the drachma would create huge bargains for foreign consumers, tourists and businesses, eventually helping to return the economy to normalcy, but the interim price would be steep and could be frightening. Just how much of it would spill over outside Greece is uncertain.

Bottom Line: Over the continued period of turbulence, households and investors must become more prudent, reducing their exposure to debt and repairing their balance sheets as net worth has been damaged by the recent decline in asset values, particularly stocks. Shifting from debt-financed consumption to cash-financed business investment will bear fruit in the medium term, but look for sub-par growth and financial uncertainty for much of 2012. This is a good time for consumers to increase savings and reduce risk.

Canada must still work hard to become more competitive, using corporate cash balances to innovate, invest in technology, hire the best talent from the global pool, thereby increasing productivity. In the U.S., corporate productivity was, in large measure, the result of the willful and unprecedented slashing of payrolls, which has a prolonged negative effect on the economy and society. Canadian business doesn't usually respond that way, although some companies might be forced to adopt such measures if they don't create innovative products and services at a faster pace.





DOUGLAS PORTER

With more than half of December under our belt, it's fair to wonder just when the Santa Claus rally is going to show up, with the TSX down a nasty 700 points this month (or 5.7%). Well, those of you familiar with Austrian folklore may be aware that, according to legend, Saint Nicholas would dole out gifts and treats to the good children, always accompanied by a fellow named Krampus, who would deal with the bad children. (The grotesque creature would typically cart off with the bad kids in his sack, presumably to devour them for Christmas dinner... your typical, uplifting, light German fairy tale. And, after Googling Krampus, you will fully appreciate why people from the Alpine regions tend to stick to the rules.) In a broadly similar fashion, we seem to be having a Krampus rally this year, where misbehaving and wayward economies are having their stocks carted off for special punishment.

The irony to the particularly sour ending to a sour year is that evidence continues to mount that the U.S. economy is in fact gaining strength, even as Europe absolutely dominates sentiment. The latest plunge in weekly jobless claims, to their lowest level in three years, is a tantalizing hint that the U.S. job market is taking a turn for the better even in the face of relentless Eurogloom. While industrial production stumbled in November, a snapback in the Philly and Empire Surveys for this month suggests the setback was in part due to disruptions from flooding in Thailand. Retail sales were also a bit light last month, but they remain almost 7% above year-ago levels, hardly a sign that U.S. consumers are still sitting on their wallets. We continue to expect Q4 GDP growth to accelerate to a 3% pace, even as Europe sags into an outright downturn. The most pressing question for 2012 is whether the U.S. economy can decouple from Europe's woes. Equities seem to be giving a qualified yes, with the Dow clinging to a small gain this year, while European stocks are down an average of just over 20%.

The TSX was closer to the European performance this year, currently down 14% in 2011. This will mark the first time in 8 years that Toronto will lag behind the S&P 500. There's little mystery behind what's ailing the TSX, as three of the weakest sectors have been tech, materials and energy. The first is clearly a one-company story. (As an aside, the persistent advice among all pundits is for Canadian companies to aggressively seek out growth in emerging markets. RIM has done that, and look at the thanks it has received for the effort.) The hefty declines in the resource sectors have been driven by the darkening outlook for global growth in 2012. Commodity prices are reeling as the year draws to a close, with the CRB now down more than 11% in 2011. Even previously impervious gold was walloped with nearly a 10% correction in barely a week (although it remains the star commodity of 2011).

The commodity sag took another bite out of the loonie, with the currency shedding almost 2 cents this week to 96.5 cents, and down almost 4% for the year. The flip side of a weaker loonie and the commodity slide is a rejuvenated U.S. dollar. The greenback is now up on a trade-weighted basis for the year, despite the debt limit drama and the credit rating downgrade. Some of the US\$ firming reflects the fact that the U.S. now arguably has the best growth prospects over the medium term, at least among the major industrialized economies. Or as Dallas Fed President Fisher so astutely noted recently, *"we're the best looking horse in the glue factory."*





SAL GUATIERI

After tapping the brakes this summer, American businesses are pressing on the hiring pedal again. Three reports this week confirm that job growth is on the mend. Initial jobless claims dropped to 3-year lows (366,000), while the forward-looking NFIB small business and Manpower hiring indexes both rose to 3-year highs. Although neither measure currently flags even normal job growth, let alone strong growth, the improving trend is unmistakable. This adds some credibility to the stellar (and frankly unbelievable) four-month gain of 1.3 million jobs shown in the volatile household employment survey, more than twice the number found in the more credible business survey. Amid ongoing concerns about Europe's debt saga and the global economic outlook, the improved job growth affirms that, so long as companies expect firmer demand growth and enjoy low unit labour costs and solid earnings growth, they will hire.

The brighter job picture (outside the financial sector, as underscored by Morgan Stanley's 2.6% cut to its workforce) can't come soon enough. Despite the presumed need for further deleveraging, households have cut their savings rate to finance higher spending—likely a testament to five years of growing pent-up demand. After strong gains the prior two months, retail sales rose just 0.2% in November, providing a stark reminder that American consumers, though back from the dead, aren't back to full health. Many shoppers won't open their wallets unless offered good deals. Still, real consumer spending looks to pick up at least modestly to a 2.5% annualized rate in Q4, the best performance in a year. And, together with continued healthy business investment and steadier housing markets, should anchor a 3.0% gain in real GDP this quarter, the fastest in 1½ years. While growth will likely soften in Q1—and considerably so if Congress doesn't extend the payroll tax cuts (though recent comments are encouraging)—an improving labour market suggests the U.S. economic recovery has entered a more durable phase. The economy may not run a lot faster in 2012, but it should run a lot smoother.




ROBERT KAVCIC

A number of Canada's provinces were in the fiscal spotlight this week, and the news was unanimously downbeat. Updates from two Provinces continued to point to weakening budget positions since the summer. Manitoba said that this year's flood-related costs are now running at \$815 mln, which should cost the Province about \$343 mln after Federal assistance, pegging the deficit at \$989 mln (1.7% of GDP), or \$554 mln worse than the budget. Meantime, Nova Scotia revised up its FY11/12 deficit forecast by \$46 mln to \$365 mln, or 1% of GDP, amid a weaker near-term economic outlook. That now brings the combined upward provincial deficit revision to more than \$2 bln since the first round of updates was issued in the summer, with all updating Provinces either flat or worse. Granted, the overall revision has been relatively modest—the combined deficit is now tracking at 1.5% of GDP, versus 1.4% after the Q1 updates—but the key takeaway is that the positive momentum seen at the end of FY10/11 and the early part of FY11/12 appears to have reversed. To top it off, British Columbia is reportedly now considering delaying their plan to return to balance by FY13/14.

But the eye-catching headline was Moody's lowering Ontario's credit rating outlook to negative, setting the stage for a potential downgrade if *"a credible plan to address the fiscal imbalance and stabilize the debt burden is not implemented in the next provincial budget"*. Before running for Saskatoon, though, note that Moody's is still playing catch-up to the other big ratings agencies—for example, their rating is currently 2 notches above that of S&P. Still, they rightly highlight the fact that *"further downward revisions to growth would also place pressure on the province's ability to achieve medium term fiscal targets"*. The Province is currently expecting real GDP growth to rebound to 2.5% in 2013 and 2.6% by 2014, but trend growth in Ontario is likely now a lot closer to 2%. Additionally, the forecast horizon through 2018 essentially assumes 7 years of uninterrupted growth, and one economic hiccup over that extended period could force revenue-raising measures into the budget balancing equation that already involves very challenging spending restraint objectives.

Rob K.

Jennifer Lee, Senior Economist

CANADA

- BoC Governor Carney continues to warn about Canadians' high household debt levels

UNITED STATES

- FOMC stays on hold, sounds a bit more upbeat about the domestic economy... not so much about global growth
- 3, 10 and 30-year auctions very well received
- Congress reaches a deal, averts a government shutdown

EUROPE

- Peripheral bond yields tumble at week's end
- Italian and Spanish bond auctions decent
- EUR falls below \$1.30 briefly
- Italian PM Monti survives confidence vote

JAPAN

- Large manufacturers downbeat on economic prospects

AUSTRALIA

- Weak data justify latest RBA easing

CHINA

- Trade wars: Slaps tariffs on U.S. auto imports

GOOD NEWS

Leading Indicator +0.8% (Nov.)
Manpower Survey +2 ppts to +15% (Q1)
New Motor Vehicle Sales +3.3% (Oct.)
Existing Home Sales +5.0% y/y (Nov.)
Capacity Utilization +1.4 ppts to 81.3% (Q3)

Initial Claims -19,000 to 366,000 (Dec. 10 wk)
NFIB Small Business Optimism Index +1.8 pts to 92.0 (Nov.)
Business Roundtable CEO Economic Outlook Index +0.3 pts to 77.9 (Q4)
Manpower Survey +2 ppts to +9% (Q1)
Empire State Manufacturing Survey +8.9 pts to 9.5;
Philly Fed Index +6.7 pts to 10.3 (Dec.)
Business Inventories +0.8% (Oct.)
Consumer Prices unch (Nov.)
Budget Deficit narrowed to \$137.3 bln (Nov.)
Current Account Deficit narrowed to \$110.3 bln (Q3)

Eurozone—Manufacturing PMI +0.5 pts to 46.9;
Services PMI +0.8 pts to 48.3 (Dec. A)
Eurozone—Labour Costs slowed to +2.7% y/y (Q3)
Germany—ZEW Survey +1.4 pts to -53.8 (Dec.)
U.K.—Consumer Prices slowed to +4.8% y/y (Nov.)
U.K.—RICS House Price Balance +7 pts to -17% (Nov.)

Tertiary Index +0.6% (Oct.)
Corporate Goods Prices +0.1% (Nov.)

NAB Business Confidence unch at 2 (Nov.)

Imports +22.1% y/y (Nov.)—still decent
New Yuan Loans 562 bln (Nov.)
HSBC Manufacturing PMI +1.3 pts to 49.0 (Dec. P)

BAD NEWS

Real Manufacturing Sales -0.9% (Oct.)
Manufacturing New Orders -4.7% (Oct.)
Foreigners slow net purchases of Canadian securities to \$2.0 bln (Oct.)

Retail Sales +0.2% (Nov.)—below expectations
Industrial Production -0.2% (Nov.)
Capacity Utilization -0.2 ppts to 77.8% (Nov.)
Foreigners buy a net \$2.6 bln of U.S. securities (Oct.)—smallest inflow in 18 years
Redbook -2.8% (Dec. 10 wk)
Producer Prices +0.3% (Nov.)—driven by food
Import Prices +0.7% (Nov.)—long-term trend slowed

Eurozone—Industrial Production -0.1% (Oct.)
Eurozone—Consumer Prices confirmed at +3.0% y/y (Nov.)
Eurozone—Trade Surplus narrowed to €0.3 bln (Oct.)
U.K.—Jobless Claims +3,000 (Nov.)—and unemployment at 17-year high
U.K.—Retail Sales -0.4% (Nov.)

Tankan Survey -6 pts to -4 (Q4)
Consumer Confidence -0.5 pts to 38.1 (Nov.)
Machine Tool Orders +15.8% y/y (Nov. F)—slowing

Trade Surplus narrowed to A\$1.6 bln (Oct.)
Westpac Consumer Confidence -8.3% (Dec.)
New Motor Vehicle Sales -0.7% (Nov.)

Trade Surplus narrowed to \$14.5 bln (Nov.)
M2 eased to +12.7% y/y (Nov.)
Foreign Direct Investment -9.8% y/y (Nov.)—but still up YTD

CANADA

U.S.

EUROPE

JAPAN

AUSTRALIA

CHINA

Indications of stronger growth and a move toward price stability are good news for the economy.

Where the Fed May Delve in 2012

Michael Gregory, CFA, Senior Economist

The FOMC's last meeting of 2011 gave no clues as to where Fed policy may go next year. Most of the announcement was identical to November's, continuing the commitment to "exceptionally low levels for the federal funds rate at least through mid-2013" along with the Maturity Extension Program (on track for \$400 billion by June) and reinvestment strategy (agency coupons/MBS into MBS). Even Chicago Fed President Evans dissented again in favour of more accommodation. The economic assessment was awash with offsetting observations, such as GDP "expanding moderately" but global growth "slowing", or "improvement" in labour markets but an "elevated" unemployment rate.

The pre-meeting market buzz on changes to the Fed's public communications proved wrong, but was probably only premature. Next month's FOMC meeting is a two-day affair, affording a fuller discussion of any changes, and includes Chairman Bernanke's press conference, providing a convenient public venue to explain them. **Two things are prodding potential communications changes.** First, **they can extract more impact from existing policy measures.** For example, the phrase "at least through mid-2013" is not only vague on timing but also on the factors that impinge on this conditional commitment. This is behind the market buzz about setting numerical thresholds for unemployment and inflation that would warrant "exceptionally low levels" for the funds rate, or including FOMC members' fed funds forecasts along with their economic projections. Second, **they can themselves provide more policy accommodation (see below) or make balance sheet/interest rate-related policy actions more effective.** The November Minutes revealed that members who leaned toward further easing felt "any such accommodation would likely be more effective if it were provided in the context of a future communications initiative."

Whatever the Fed does on the communications front next month or next year, we judge that it will inevitably be tied with providing more policy accommodation, given the near-term economic outlook. We look for real GDP growth to slow to 1.9% annualized in 2012 H1, from an estimated 2.5% in 2011 H2, partly owing to the already acknowledged global "slowing", paced by a deepening European recession and ebbing emerging markets momentum. Domestically, the recent sparkle in consumer spending should lose some lustre, since it was

partly shined by a probable temporary decrease in savings rates. Business capital spending should cool after tax incentives pulled some forward this year. Meantime, the absent housing recovery, along with state and local government austerity, continue to take their tolls.

In this scenario, headline PCE inflation should continue to drift down (furthering the Fed's "moderated" observation), while its core component stays contained within the FOMC's longer-run projection (Chart 1). Unfortunately this should also cause the unemployment to drift up a few tenths, keeping it stubbornly "elevated" in the Fed's eyes (tucked just under 9%). **Given the Fed's dual mandate, this is a prescription for further easing next year.** Meanwhile, **the incoming rotation of voting regional Fed presidents will take on a more dovish tone.**

CHART 1
DUAL MANDATE
United States

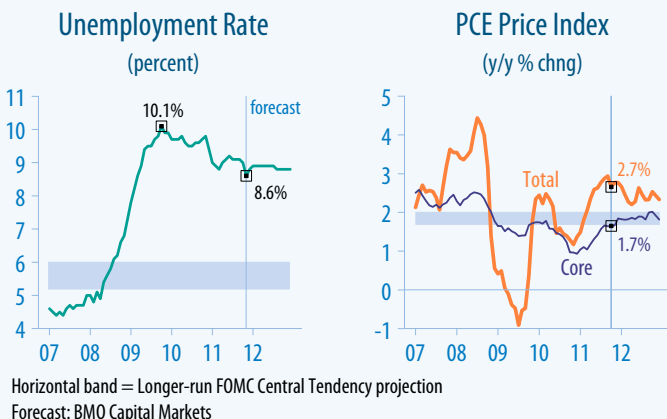


TABLE 1
CHANGING OF THE GUARD

Federal Open Market Committee – Regional Voting Members

In	Out
Cleveland Pres. Pianalto	Chicago Pres. Evans
Richmond Pres. Lacker	Philadelphia Pres. Plosser
Atlanta Pres. Lockhart	Dallas Pres. Fisher
San Francisco Pres. Williams	Minneapolis Pres. Kocherlakota

For the Fed’s two easing actions in August (fed funds guidance) and September (“Operation Twist” and revised reinvesting), Fed presidents Fisher from Dallas, Kocherlakota from Minneapolis, and Plosser from Philadelphia, dissented in favour of no further accommodation. In the stand-pat November and December meetings, Chicago President Evans dissented in favour of more accommodation. Thus, three hawks and one dove will leave the FOMC voting roll to be replaced by Fed presidents Pianalto from Cleveland, Lacker from Richmond, Lockhart from Atlanta and Williams from San Francisco (*Table 1*).

Cleveland President Pianalto is a middle-of-the-roader with dovish tendencies. She last voted in 2010 (the other three districts last voted in 2009) and, during 2010, she voted in favour of quantitative easing (QE) in November

and the stand-pat policies at all other meetings, as everybody else did, except for Kansas City’s Hoenig. She has called current policy “*appropriate*”, supporting this year’s easing actions. Judging that most current unemployment is “*cyclical*”, she would likely support any easing actions in the face of rising unemployment rates.

Richmond President Lacker is a hawk. He did not support QE in November 2010, or this year’s two easing actions. In fact, he goes on record as dissenting even before his voting tenure began. In the November 28 FOMC videoconference call in which it was agreed to expand the Fed’s central bank liquidity swaps and to lower their cost, Philadelphia President Plosser could not attend so he was replaced by his alternate, Mr. Lacker. The vote was 9 to 1 in favour of the policy change (Lacker likely had a problem with the swaps potentially expanding the Fed’s balance sheet).

Atlanta President Lockhart is a middle-of-the-roader, also with dovish tendencies (albeit less than Pianalto). He supported this year’s easing actions, but is “*sceptical*” that additional asset purchases, at this stage, would be effective. Lockhart is an overt supporter of inflation targeting, and would support further easing (particularly via communications) amid a combination of down-drifting inflation and up-drifting unemployment.

San Francisco President Williams is a dove. Not only did he support this year’s two easing actions, but he argued last month that more accommodation “*may be needed*” to reduce “*persistently high unemployment*”. This is Williams’ first voting round (the last time San Fran had the vote, Janet Yellen was the Prez).

Clearly, next year’s FOMC voters are more amenable than those this year to ease policy again, and, given our economic outlook, they may well do more.

On the communications front, **we look for a lengthening of the “*mid-2013*” language, after first clarifying its “*at least through*” aspect. Perhaps this will be reinforced with temporal reference to the size of the Fed’s balance sheet.**

On the interest rate front, **a discount rate cut is likely.** The recent reduction in the cost of the Fed’s central bank liquidity swaps, to the overnight index swap (OIS) rate plus 50 bps instead of 100 bps, now provides short-term

CHART 2
CREDIT'S DUE

United States

Bank Loans and Leases*

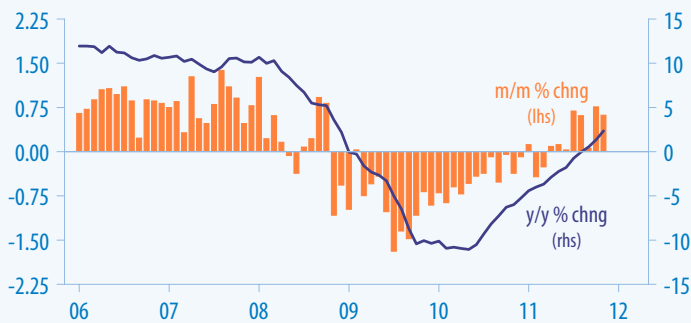
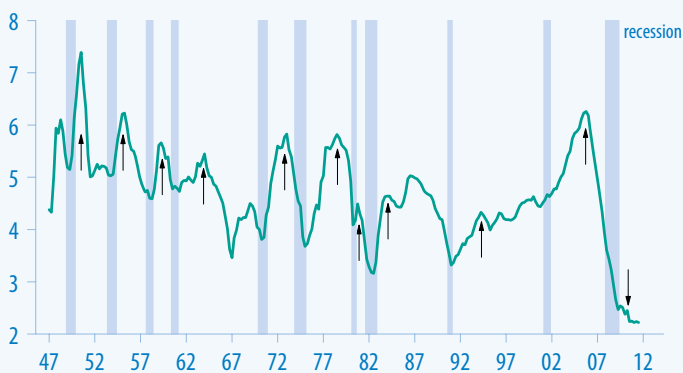

 * Adjusted for accounting changes
 Source: Haver Analytics

CHART 3
HOME IS WHERE THE RECOVERY IS

United States (% of GDP)

Residential Investment



U.S. dollar funding to foreign banks at about 60 bps which is below the 75 bps charged to domestic banks at the Fed's discount window. This rate cut would be more cosmetic than anything else, since this type of borrowing, which peaked above \$100 billion during the crisis, now hardly budges past \$100 million.

A cut in the interest rate paid on reserves (the "IOR" rate is currently 25 bps) is not likely. With the effective fed funds rate trading below 10 bps (pushed further below the IOR because of increased deposit insurance costs), an IOR cut could push fed funds too close to zero and interfere with the functioning of the money market. It has also been argued that cutting the IOR would get banks to seek higher-yielding assets for their excess reserves, perhaps to the point of making more loans. However, bank loan growth has already started to pick up, diffusing this argument (*Chart 2*).

On the balance sheet front, the Fed's revised reinvestment strategy (agency coupons/MBS into MBS instead of Treasuries) was designed to "help reduce the spread between yields on mortgage-backed securities and those on comparable-maturity Treasury securities... and so contribute to lower mortgage rates." The previous reinvestment strategy was, in effect, passive credit tightening. Having signalled a policy desire to stop this, the next step for the Fed would be outright credit easing via **increasing net holdings of MBS**. Housing remains the weakest link in the chain of self-sustaining economic recovery (*Chart 3*). And, with job growth firming, household deleveraging lessening and lending standards relaxing, additional Fed assistance could strengthen this link.

Net buying of MBS is, technically, credit easing. While the reserve-augmenting impact of initial purchases might be sterilized (offset by ramping up Treasury's Supplementary Financing Program), later purchases will likely remain unsterilized, causing the Fed's balance sheet to increase. From a reserves perspective, the latter resembles quantitative easing, but credit easing is not QE—they differ markedly in intent. The former is designed to narrow credit spreads and support the functioning of the credit creation process. QE is designed to increase reserves and/or lower interest rates (to stimulate the broad economy), by buying securities. **At this stage, additional QE is unlikely.** Most FOMC members treat QE3 as the last-resort policy option to deal with renewed risks of deflation.

How and whether the Fed ultimately opts to ease, the key point is that it has many policy tools available and the willingness to employ them; **2012 could be the year in which the past 4½ years of conventional and unconventional policy manoeuvres finally start garnering cumulative traction.**

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	1.5	1.9	2.3	2.4	2.7	3.2	2.3	2.0
Consumer Price Index (y/y % chng)	2.6	3.4	3.0	2.9	2.6	2.4	2.6	2.2	1.8	3.0	2.5
Unemployment Rate (%)	7.7	7.5	7.2	7.4	7.5	7.4	7.4	7.2	8.0	7.5	7.4
Housing Starts (000s : a.r.)	178	192	204	191	184	181	181	182	192	191	182
Current Account Balance (\$blns : a.r.)	-41.3	-64.5	-48.5	-53.8	-52.1	-49.9	-49.6	-48.5	-50.9	-52.0	-50.0
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	0.87	0.88	0.88	0.88	0.88	0.56	0.91	0.88
10-year Bond	3.31	3.16	2.53	2.17	2.07	2.05	2.15	2.30	3.24	2.79	2.14
Canada/U.S. Interest Rate Spreads (average for the quarter : bps)											
90-day	82	90	86	86	87	87	87	87	42	86	87
10-year	-15	-5	10	12	14	15	13	11	2	1	13
UNITED STATES											
Real GDP (q/q % chng : a.r.)	0.4	1.3	2.0	3.0	1.7	2.0	2.4	2.7	3.0	1.8	2.2
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 (%)	8.9	9.1	9.1	8.8	8.9	8.9	8.8	8.8	9.6	9.0	8.8
Housing Starts (mlns : a.r.)	0.58	0.57	0.61	0.62	0.61	0.62	0.63	0.64	0.58	0.60	0.63
Current Account Balance (\$blns : a.r.)	-478	-499	-441	-442 ↓	-440 ↓	-438 ↓	-442 ↓	-441 ↓	-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	0.02	0.01	0.01	0.01	0.01	0.14	0.05	0.01
10-year Note	3.46	3.21	2.43	2.05	1.93	1.90	2.02	2.19	3.21	2.79	2.01
EXCHANGE RATES (average for the quarter)											
US\$/C\$	101.4	103.4	102.1	97.4	95.5	94.3	96.2	99.0	97.1	101.1	96.2
C\$/US\$	0.986	0.967	0.979	1.026	1.047	1.060	1.040	1.010	1.030	0.990	1.039
¥/US\$	82	82	78	77	76	76	77	79	88	80	77
US\$/Euro	1.37	1.44	1.41	1.35 ↓	1.29 ↓	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
Up and down arrows indicate changes to the forecast ↑↓

CANADA

Douglas Porter, CFA, Deputy Chief Economist

Consumer Price Index

Tuesday, 7:00 am

Nov. (e)	m/m (nsa) unch (+0.1% sa)	y/y +2.8%
<i>Consensus</i>	+0.1%	+2.9%
Oct.	+0.2%	+2.9%
Nov. (e)	Core CPI +2.2% y/y	
<i>Consensus</i>	+2.2% y/y	
Oct.	+2.1% y/y	

Canadian headline inflation is expected to ease a bit further in November, as lower gasoline prices and calmer food prices are expected to hold the CPI nearly steady in the month. This would trim the annual inflation rate a tick to 2.8%, down from as high as 3.7% earlier this year. While still higher than the Bank of Canada's targeted 2% pace, it's still one of the mildest inflation rates in the world. Recall that Europe's rate is 3.0%, the U.S. is at 3.4% and Britain's is above 4%. However, while overall inflation is expected to slip slightly, we look for a mild push higher in core CPI. Underlying prices are likely to rise 0.1%, which will be enough to lift core inflation to 2.2% y/y, matching the fastest pace of the past three years. The Bank's latest forecast called for core inflation to average 2.0% in Q4, before easing to 1.8% in Q1. But, even a high-side surprise here will make little impact, with the focus almost entirely on external risks (i.e. Europe).

Retail Sales

Wednesday, 8:30 am

Oct. (e)	+0.5%	Ex. Autos +0.2%
<i>Consensus</i>	+0.4%	+0.2%
Sep.	+1.0%	+0.5%

A solid gain in autos is expected to power a 0.5% rise in overall retail sales in October. After a soft patch earlier this year, sales have regained momentum in recent months, despite a deep sag in consumer confidence since mid-year. Still, our call would leave retail receipts up a moderate 4% from year-ago levels, compared with almost 7% y/y growth in U.S. sales. And, much of the recent rise in Canada is due to autos—sales excluding autos and gas are now up little more than 1% from year-ago levels. Sales volumes are expected to rise 0.2% in the month, setting the stage for a slightly better performance for real consumer spending in Q4 than the lacklustre 1.2% a.r. rise in Q3.

Real GDP at Basic Prices

Friday, 8:30 am

Oct. (e)	unch
<i>Consensus</i>	unch
Sep.	+0.2%

As is the tradition, the final major economic report of the year in Canada will be October GDP. Unfortunately, this will not provide much seasonal cheer, as it looks like growth paused in the month. After a hearty four-month rebound, which saw the economy power ahead at better than a 4% annualized clip (0.3%-to-0.4% per month), GDP likely flattened in October. Manufacturing volumes fell 0.9%, employment took a big step back, and hours worked fell 0.2%. The picture isn't quite as complete as normal this month, as wholesale and retail trade will only be available in the days leading up to the GDP release—the former likely dipped somewhat, while retail trade probably rose. The soft start to Q4 suggests that growth for the full quarter will ease to around 1.5%, less than half the 3.5% spurt in Q3.

UNITED STATES

Sal Guatieri, Senior Economist

Housing Starts

Tuesday, 8:30 am

Nov. (e)	640,000 a.r. (+1.9%)
<i>Consensus</i>	630,000 a.r. (+0.3%)
Oct.	628,000 a.r. (-0.3%)

Existing Home Sales

Wednesday, 10:00 am

Nov. (e)	5.15 mln a.r. (+3.6%)
<i>Consensus</i>	5.08 mln a.r. (+2.2%)
Oct.	4.97 mln a.r. (+1.4%)

New Home Sales

Friday, 10:00 am

Nov. (e)	315,000 a.r. (+2.6%)
<i>Consensus</i>	313,000 a.r. (+1.8%)
Oct.	307,000 a.r. (+1.3%)

A jump in building permits in October and a recent upturn in the homebuilder activity index suggest **housing starts** had their best month of the year in November, rising about 2% to 640,000 annualized. An upturn in new mortgage applications and a 10% bounce in pending sales in October indicate strengthening demand, pushing builders to replenish the record-low supply of new homes. **New home sales** likely rose 2.6% in November to 315,000 annualized, the second best rate this year, though still a fraction of long-run norms. **Existing home sales** should advance nearly 4% to 5.15 million annualized, also the second fastest rate this year. The gain should reduce the current 8-month supply of unsold homes, though not to a more normal six months, and the overhang will continue to weigh on median prices (-4.7% y/y). So long as job growth continues to improve and lending standards ease, housing demand should strengthen in 2012. Lower prices and record-low mortgage rates have led to the best affordability in at least four decades. For the typical household, mortgage payments now consume about half as much income as in frothy 2006.

Personal Income and Spending

Friday, 8:30 am

	Personal Income	Pers. Spending
Nov. (e)	+0.4%	+0.4%
<i>Consensus</i>	+0.3%	+0.3%
Oct.	+0.4%	+0.1%

	Core PCE Deflator	
Nov. (e)	+0.1%	+1.7% y/y
<i>Consensus</i>	+0.1%	+1.7% y/y
Oct.	+0.1%	+1.7% y/y

	Savings Rate
Nov. (e)	3.6%
Oct.	3.5%

A solid advance in auto sales and moderate increase in retail sales suggest personal spending rose 0.4% in November, a decent start to the holiday season. Real consumer spending likely rose 0.3% in the month and 2.5% annualized in the quarter, improving on Q3's 2.3% rate. But households are once again saving less of their income to finance spending, flagging a potential pullback if incomes don't improve. Thankfully, personal income likely rose a solid 0.4% for the second straight month amid firming job growth. The core deflator should increase 0.1%, holding the yearly rate at 1.7%—the low end of the Fed's price-stability range.

Durable Goods Orders

Friday, 8:30 am

		Ex. Transport
Nov. (e)	+2.0%	+0.4%
<i>Consensus</i>	+2.2%	+0.4%
Oct.	-0.5%	+1.1%

After swooning for two months, durable goods orders look to rebound 2.0% in November, with Boeing aircraft sales taking off. Capital goods orders (excluding defense and aircraft) should increase for the third time in four months, as companies advance spending in the event that Congress fails to extend the accelerated depreciation allowance next year. Business capex likely slowed, albeit to a still-healthy pace in Q4, after surging 16% annualized in Q3.

	DEC 16 *	DEC 9	CHANGE FROM: (BASIS POINTS)		
			WEEK AGO	4 WEEKS AGO	DEC. 31/10
Canadian Money Market					
Call Money	1.00	1.00	0	0	0
Prime Rate	3.00	3.00	0	0	0
U.S. Money Market					
Fed Funds (effective)	0.25	0.25	0	0	0
Prime Rate	3.25	3.25	0	0	0
3-Month Rates					
Canada	0.81	0.83	-2	-8	-16
United States	-0.01	0.00	-1	-1	-12
Japan	0.20	0.10	10	10	8
Eurozone	1.42	1.44	-2	-5	41
United Kingdom	1.06	1.05	1	5	31
Australia	4.59	4.58	1	-9	-31
Bond Markets					
2-year Bond					
Canada	0.85	0.90	-5	-5	-83
United States	0.24	0.23	1	-5	-36
10-year Bond					
Canada	1.90	2.06	-17	-23	-123
United States	1.88	2.06	-18	-13	-142
Japan	0.98	1.02	-4	4	-15
Germany	1.89	2.15	-26	-8	-107
United Kingdom	2.09	2.16	-7	-16	-131
Australia	3.79	3.79	-1	-21	-176
Risk Indicators					
VIX	23.5	26.4	-2.8 pts	-8.5 pts	5.8 pts
TED Spread	57	54	3	8	39
Inv. Grade CDS Spread **	130	122	8	-6	45
High Yield CDS Spread **	741	695	46	-18	311
Currencies					
				(% CHANGE)	
US\$/C\$	96.58	98.34	-1.8	-0.8	-3.6
C\$/US\$	1.035	1.017	—	—	—
¥/US\$	77.80	77.65	0.2	1.2	-4.1
US\$/Euro	1.3033	1.3386	-2.6	-3.6	-2.6
US\$/£	1.552	1.567	-1.0	-1.8	-0.6
US\$/A\$	99.93	102.16	-2.2	-0.1	-2.3
Commodities					
CRB Futures Index	295.92	306.43	-3.4	-5.2	-11.1
Oil (generic contract)	94.35	99.41	-5.1	-3.1	3.3
Natural Gas (generic contract)	3.14	3.32	-5.4	-5.3	-28.7
Gold (spot price)	1590.53	1711.60	-7.1	-7.7	11.9
Equities					
S&P/TSX Composite	11637	12035	-3.3	-2.1	-13.4
S&P 500	1230	1255	-2.0	1.2	-2.2
Nasdaq	2583	2647	-2.4	0.4	-2.6
Dow Jones Industrial	11954	12184	-1.9	1.3	3.3
Nikkei	8402	8536	-1.6	0.3	-17.9
Frankfurt DAX	5732	5987	-4.3	-1.2	-17.1
London FT100	5427	5529	-1.8	1.2	-8.0
France CAC40	2990	3172	-5.7	-0.2	-21.4
S&P ASX 200	4159	4203	-1.0	-0.4	-12.3

* as of 10:30 am ** One day delay

JAPAN

MONDAY DECEMBER 19

Nationwide Department Store Sales
Nov.
 Oct. -0.5% y/y

TUESDAY DECEMBER 20

All-Industry Activity Index
Oct. (e) +1.0%
 Sep. -0.9%
Leading Index
Oct. F (e) 91.5
 Sep. 91.5

WEDNESDAY DECEMBER 21

Merchandise Trade Balance
Nov. '11 (e) -¥485 bln
 Nov. '10 +¥159 bln

THURSDAY DECEMBER 22

BoJ Monthly Report

FRIDAY DECEMBER 23

**Emperor's Birthday
(Markets Closed)**

EUROZONE

GERMANY

IFO Survey
Dec. (e) 106.0
 Nov. 106.6
GfK Consumer Confidence
Jan. (e) 5.5
 Dec. 5.6
Producer Price Index
Nov. (e) +0.1% +5.2% y/y
 Oct. +0.2% +5.3% y/y

France T-bill Auction

ITALY

Industrial Orders
Oct. (e) -1.3% -0.7% y/y
 Sep. -8.3% -3.6% y/y

Spain T-bill Auction

EUROZONE

Consumer Confidence
Dec. A (e) -21.0
 Nov. -20.4
ITALY
Real GDP
Q3 F (e) -0.1% +0.4% y/y
 Q2 +0.3% +0.8% y/y

ECB 3-Year Refinancing Tender Result

ITALY

Retail Sales
Oct. (e) -0.2% -1.5% y/y
 Sep. -0.4% -1.6% y/y

FRANCE

Real GDP
Q3 F (e) +0.4% +1.6% y/y
 Q3 P +0.4% +1.6% y/y
 Q2 -0.1% +1.6% y/y
Producer Price Index
Nov. (e) unch +5.2% y/y
 Oct. +0.5% +5.8% y/y

U.K.

Rightmove House Prices
Dec.
 Nov. -3.1% +1.2% y/y

GfK Consumer Confidence
Dec. (e) -32
 Nov. -31
Nationwide Consumer Confidence
Nov. (e) 36
 Oct. 36

**Minutes from the BoE
Monetary Policy Meeting**

Real GDP
Q3 F (e) +0.5% +0.5% y/y
 Q3 P +0.5% +0.5% y/y
 Q2 +0.1% +0.6% y/y

OTHER

AUSTRALIA

**Minutes from the Reserve Bank of
Australia Monetary Policy Meeting**

MONDAY DECEMBER 19

8:30 am	Wholesale Trade
Oct. (e)	-0.1%
Sep.	+0.3%
<hr/>	
10:00 am	NAHB Housing Index
Dec. (e)	21
Consensus	20
Nov.	20

11:00 am	4-week bill auction announcement
11:00 am	Fed buying \$4.25-5.0 bln notes (Dec. 2017-Nov. 2019)
11:30 am	13- & 26-week bill auction \$56.0 bln
1:00 pm	2-year note auction \$35.0 bln

TUESDAY DECEMBER 20

7:00 am	Consumer Price Index	m/m (nsa)	y/y
Nov. (e)	unch	+2.8%	
	(+0.1% sa)		
Consensus	+0.1%	+2.9%	
Oct.	+0.2%	+2.9%	
<hr/>			
7:00 am	Core CPI		
Nov. (e)	+2.2% y/y		
Consensus	+2.2% y/y		
Oct.	+2.1% y/y		
<hr/>			
10:35 am	3, 6 & 12-month T-bill auction \$12.0 bln		
	(New cash \$-2.4 bln)		
<hr/>			
7:45 am	ICSC Same-Store Sales		
Dec. 17			
Dec. 10 (mtd)	-1.4% m/m	+3.4% y/y	
<hr/>			
8:30 am	Housing Starts		
Nov. (e)	640,000 a.r. (+1.9%)		
Consensus	630,000 a.r. (+0.3%)		
Oct.	628,000 a.r. (-0.3%)		
<hr/>			
8:30 am	Building Permits		
Nov. (e)	635,000 a.r. (-1.4%)*		
Oct.	644,000 a.r. (+9.3%)		
<hr/>			
8:55 am	Redbook Same-Store Sales		
Dec. 17			
Dec. 10 (mtd)	-2.8% m/m	+3.0% y/y	

11:00 am	Fed buying \$2.25-2.75 bln bonds (Feb. 2036-Nov. 2041)
11:30 am	4-week bill auction
1:00 pm	5-year note auction \$35.0 bln

WEDNESDAY DECEMBER 21

8:30 am	Retail Sales	Ex. Autos
Oct. (e)	+0.5%	+0.2%
Consensus	+0.4%	+0.2%
Sep.	+1.0%	+0.5%
<hr/>		
7:00 am	MBA Mortgage Apps	
Dec. 16		
Dec. 9	+4.1%	
<hr/>		
10:00 am	Existing Home Sales	
Nov. (e)	5.15 mln a.r. (+3.6%)	
Consensus	5.08 mln a.r. (+2.2%)	
Oct.	4.97 mln a.r. (+1.4%)	
<hr/>		
11:00 am	Fed selling \$8.0-8.75 bln notes (Nov. 2013-Mar. 2014)	
1:00 pm	7-year note auction \$29.0 bln	
2:00 pm	Fed selling \$8.0-8.75 bln notes (June 2013-Nov. 2013)	

THURSDAY DECEMBER 22

8:30 am	Survey of Employment, Payrolls, and Earnings (Oct.)	
<hr/>		
8:30 am	Initial Claims	
Dec. 17 (e)	370k (+4k)*	
Dec. 10	366k (-19k)	
8:30 am	Continuing Claims	
Dec. 10		
Dec. 3	3,603k (+4k)	
8:30 am	Real GDP	GDP Deflator
Q3 F (e)	+2.0% a.r.	+2.5% a.r.
Consensus	+2.0% a.r.	+2.5% a.r.
Q3 P	+2.0% a.r.	+2.5% a.r.
Q2	+1.3% a.r.	+2.5% a.r.
8:30 am	Pre-Tax Corporate Profits	
Q3 R (e)	+7.9% y/y	
Q3 P	+7.9% y/y	
Q2	+8.5% y/y	
8:30 am	Chicago Fed National Activity Index	
Nov.		
Oct.	-0.13	
9:45 am	Bloomberg Consumer Comfort Index	
Dec. 18		
Dec. 11	-49.9	
9:55 am	Univ. of Michigan Consumer Sentiment	
Dec. F (e)	68.0*	
Dec. P	67.7	
Nov.	64.1	
10:00 am	FHFA House Price Index	
Oct. (e)	unch	-1.8% y/y
Consensus	+0.2%	-1.6% y/y
Sep.	+0.9%	-2.1% y/y
10:00 am	Leading Indicator	
Nov. (e)	+0.3%	
Consensus	+0.3%	
Oct.	+0.9%	
<hr/>		
11:00 am	13- & 26-week bill auction announcements	
11:00 am	Fed buying \$4.25-5.0 bln notes (Feb. 2020-Nov. 2021)	

FRIDAY DECEMBER 23

8:30 am	Real GDP at Basic Prices	
Oct. (e)	unch	
Consensus	unch	
Sep.	+0.2%	
<hr/>		
8:30 am	Durable Goods Orders	Ex. Transport
Nov. (e)	+2.0%	+0.4%
Consensus	+2.2%	+0.4%
Oct.	-0.5%	+1.1%
<hr/>		
8:30 am	Personal Income	Personal Spending
Nov. (e)	+0.4%	+0.4%
Consensus	+0.3%	+0.3%
Oct.	+0.4%	+0.1%
<hr/>		
8:30 am	Core PCE Deflator	
Nov. (e)	+0.1%	+1.7% y/y
Consensus	+0.1%	+1.7% y/y
Oct.	+0.1%	+1.7% y/y
<hr/>		
8:30 am	Savings Rate	
Nov. (e)	3.6%	
Oct.	3.5%	
<hr/>		
10:00 am	New Home Sales	
Nov. (e)	315,000 a.r. (+2.6%)	
Consensus	313,000 a.r. (+1.8%)	
Oct.	307,000 a.r. (+1.3%)	

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