Rates Scenario

ECONOMIC RESEARCH

BMO Capital Markets

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Highlights

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- The strong loonie and below-target inflation should enable the Bank of Canada to reaffirm its commitment to keeping policy rates unchanged until June 2010 at the December meeting. Canadian dollar strength will likely persist as the global economic recovery continues.
- The Federal Reserve continued its commitment to "*exceptionally low levels of the federal funds rate for an extended period*" in November. With quantitative easing only ending in March 2010, Fed tightening isn't likely until 2010H2 at the earliest.
- An improving global economic outlook points to increasing risk appetite and a continuation of the greenback's weakening trend against the major currencies.
- We look for Treasury yields to remain range-bound through the turn of the year, before breaking out on the high side. Canadas will likely follow suit, but underperform on rallies and outperform on sell-offs.
- The ECB is unlikely to announce anything new this month, as it evaluates the strength of the still-nascent recovery and as inflation is evolving largely as it predicted.
- The Bank of England is expected to increase its Asset Purchase Facility in November, as further stimulus is needed to lift the economy out of recession.
- After already announcing a paring of its credit easing programs, look for the Bank of Japan to remain on the sidelines amid record deflation.
- The Reserve Bank of Australia is expected to tighten for a third straight month in December as the growth and inflation outlook is revised up.

Forecast Summary (averages)

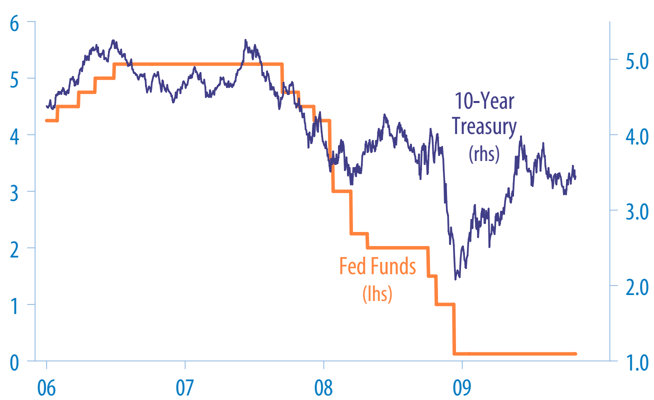
	Actual	2009		2010				2011	
	Oct	Nov	Dec	Q1	Q2	Q3	Q4	Q1	Q2
BoC overnight	0.25	0.25	0.25	0.25	0.25	0.58	1.08	1.58	2.08
10-yr Canadas	3.43	3.45	3.45	3.50	3.60	3.70	3.80	4.00	4.20
Fed funds	0.13	0.13	0.13	0.13	0.13	0.25	0.75	1.33	1.83
10-yr Treasuries	3.39	3.50	3.50	3.60	3.70	3.85	3.95	4.15	4.40
C$ per US$	1.055	1.040	1.030	1.021	1.008	0.994	0.997	0.996	0.990
US$/€	1.48	1.48	1.50	1.51	1.52	1.53	1.55	1.53	1.51
US$/£	1.62	1.62	1.60	1.62	1.66	1.70	1.74	1.76	1.77
¥/US$	90	91	92	93	95	97	99	102	104

U.S. Rates

The Fed made made no changes to its policy stance on November 4, still committing to *"exceptionally low levels of the federal funds rate for an extended period."* The asset purchase program was tweaked a bit, as the total purchases of agency coupons were pared to $175 billion due to their "*limited availability*", though the intent to purchase $1.25 trillion of agency mortgage-backed securities by next March was repeated. As of October 28, the Fed held $774 billion of agency MBS (62% of the target) and $142 billion of agency coupons (81% of the lowered target). The $300 billion program of Treasury coupon purchases was tapered to conclusion last month, which might have contributed to the net increase in mid- and long-term yields (5-10 bps for the former, 10-20 bps for the latter). There is perhaps a lesson to be learned here.

The Fed's agency purchases are having a significant impact on the cost of mortgage credit (lowered by more than 100 bps according to some estimates) and its availability. For example, mortgage originations for both purchases and refinancings amounted to $626 billion in Q2 (the latest data); Fed purchases of agency securities totalled $277 billion in the period, effectively underwriting nearly 45% of all new and renewed mortgages in the nation. There is a risk that, as this asset purchase program is also tapered to conclusion next March, the negative impact on the cost and availably of credit could nip the nascent recovery in the housing sector, with the latter a critical component to economy-wide recovery. As such, we don't expect any tightening signals by the Fed until next spring at the earliest (presuming banks and investors backfill the Fed's mortgage funding void), and look for any tightening actions to follow even later (we've penciled in a September start to rate hikes, with the odds favouring postponement).

UNITED STATES
(percent)



U.S. BROAD TRADE-WEIGHTED DOLLAR
(Jan. 1997 = 100)

Source: U.S. Federal Reserve Board

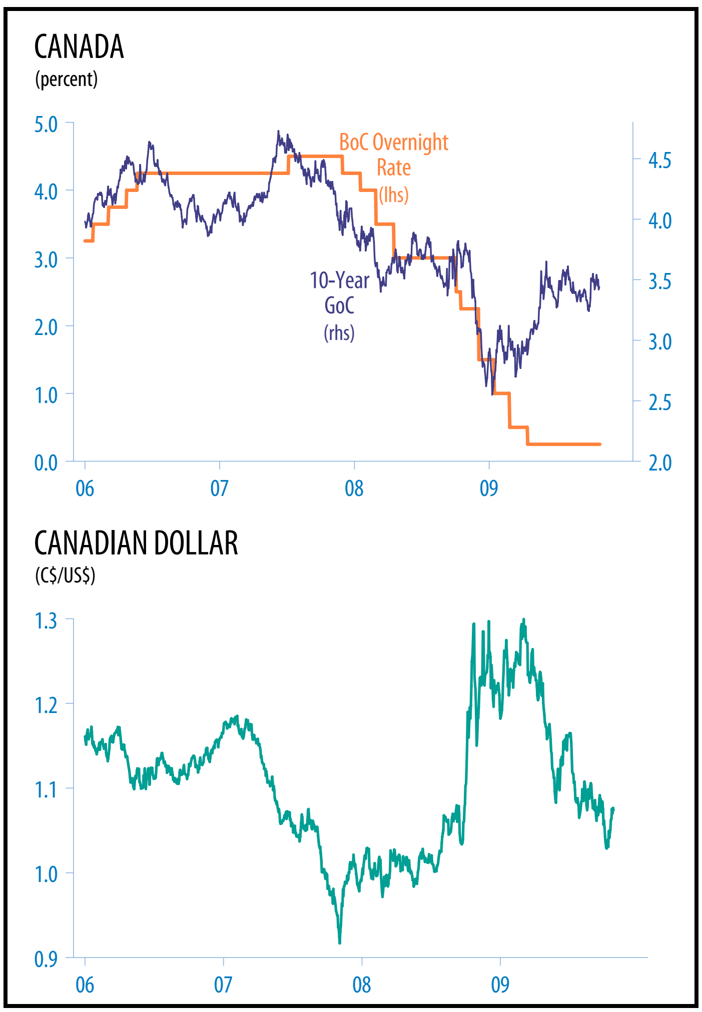
Congealing economic data added upward pressure on Treasury yields last month, intensifying the push from investors' net whetted risk appetites and super-sized auctions. However, some of the net supply pressure is being offset via buying for balance sheet restructuring, predominately by domestic banks but also from households, and buying by foreign authorities in an effort to resist their currency's appreciation against the greenback. It's going to be a steady, but slow, grind back to 4% 10-year yields.

The trade-weighted U.S. dollar drifted down fractionally (-0.3%) against the major currencies during October, but was down more than 2% at one point, as the oscillations between "risk on" and "risk off" continue to drive the big dollar. With the former still likely to dominate the latter, owing to continued global economic recovery, the downtrend in the US$ should persist, compounded by depreciation pressures exerted by external financing of Treasury deficits and official asset diversification flows.

Canadian Rates

On October 20, the Bank of Canada reiterated its commitment to keep the policy rate at 0.25% until the end of June 2010, conditional, as always, on inflation. This was widely expected. However, the Bank's heightened concern about the currency surprised the market. The policy announcement said: *"The current strength in the dollar is expected, over time, to more than fully offset the favourable developments since July."* The "*more than fully offset*" phrase was the strongest statement of concern the Bank has made since currency appreciation was identified as a key risk in the June policy announcement. A heftier C$ headwind also contributed to a downgrade of the Bank's economic projection for 2010 and 2011, which pushed back by one quarter the return of core inflation to the 2% target (to 2011 Q3). After trading as high as 97½ U.S. cents before the Bank's policy pronouncements, the loonie traded as low as 92¼ cents subsequently, and ended October about 1% weaker.

The Bank's heightened concern reflects the fact that the current bout of appreciation is occurring amid very sluggish U.S. domestic demand conditions (a double-whammy for Canadian exporters). Meantime, a larger proportion of the current run-up is owing to a weakening U.S. dollar, as opposed to rising commodity prices and expanding export receipts (thus, less offsetting gain for all the pain). In his post-MPR press conference, Governor Carney hinted that the strong loonie could be taken into account in setting future monetary policy by emphasizing that rates wouldn't necessarily rise immediately after the end of the commitment period. However, with asset prices now a faint blip on the Bank's radar screen (a new upside risk to their inflation projection), we still judge that the Bank will not wait too long before moving policy rates from their current emergency lows to levels that could be deemed merely accommodative. As such, we judge that the Bank of Canada will tighten before the Fed, which should strengthen the Canadian dollar; we look for the loonie to trade through parity by 2010 Q3. While this would likely lead the Bank to hike rates more cautiously (we look for quarter-point moves), it's unlikely to stop the first few rate hikes (unless, of course, the currency appears on a fast track beyond its modern-day high of US$1.10). Meanwhile, through June 2010, we look for the loonie to drift up gradually, reflecting Canada's G7-leading GDP



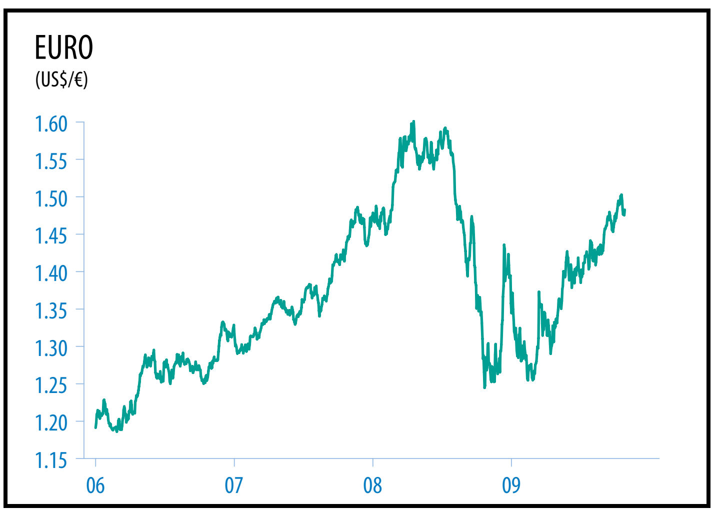
performance and strengthening commodity prices.

Government of Canada bond yields drifted up about 10 bps along the curve last month, underperforming Treasuries at the short-end but outperforming at the long-end. Given Canada's still-superior fiscal fundamentals (superior by default that is… they haven't deteriorated as much as the other G7 countries) and expected currency appreciation, outperformance at the long-end should persist. Ten-year Canada-U.S. yield spreads should move back and increasingly into negative territory during the forecast horizon, thus muting the rise in Canadian yields in the wake of expected BoC policy rate renormalization and some modest supply indigestion.

Euro

The Euro area likely returned to growth in Q3, with Germany and France leading the way after already recording positive growth the previous quarter. However, the growth is likely to slow as we move into 2010 and fiscal stimulus fades. Overall, the data are improving but are still generally sluggish for a recovery. The region's jobless rate is still rising and headed for 10%. We could still see a sharp rise in German unemployment as fiscal incentives to retain workers expire. Spain remains a weak link with unemployment nearing 20%, as the country struggles to recover from its construction collapse. There was some good news on the credit front. The ECB's Bank Lending Survey pointed to easing credit conditions in Q4, following less net tightening in Q3 which *"further confirms the indications of a turning-point in the tightening trend observed at the time of the April 2009 survey."*

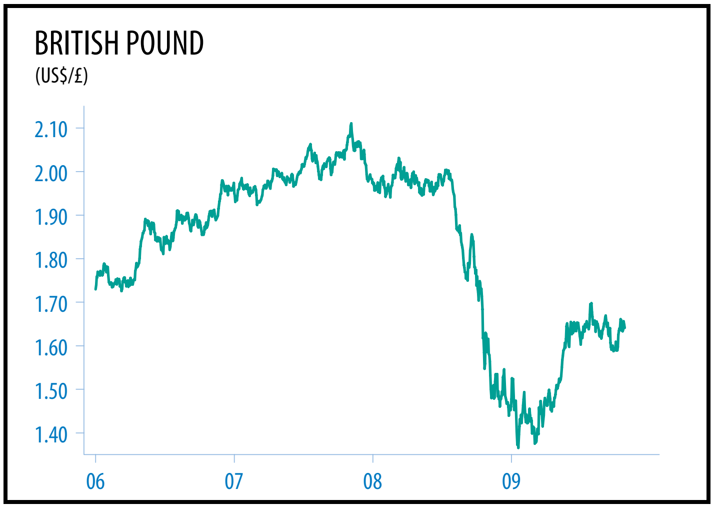
CPI inflation accelerated to -0.1% y/y in October. Inflation will likely rise somewhat further over the next couple of months as year-ago declines in energy prices fall out of the calculation. However, large labour and output gaps will keep downward pressure on prices, likely keeping inflation below 2% through 2010. Meantime, M3 money supply growth continues to slow, confirming little inflation pressure on the horizon. With the recovery still fragile and inflation on the backburner, policy rates are likely to stay steady well into 2010.



The euro's rally through most of October was halted by a drop in equities and the accompanying US$ rally late in the month. The currency has been appreciating relentlessly since mid-April and occasional pull backs should not be a surprise. Look for the euro rally to continue, moving into the mid-$1.50s by the end of 2010 as the global economic recovery unfolds, before pulling back once the US-euro policy rate spread starts to narrow as we move into 2011.

British Pound

The U.K. is likely the only country among the G20 to remain mired in recession. Real GDP fell 0.4% in Q3, lengthening the duration of recession to 6 quarters, with the total decline now at 5.9%. Financial sector uncertainty continues to weigh on the economy, with recent reports that the government will break up Lloyds, RBS and Northern Rock into new banks and create more competition in the banking sector. RBS and Lloyds also just received their second injection of government funds to the tune of £31.3 bln. On the data front, unemployment is still rising, and retail sales were weak in September, but there are ongoing signs of progress in the housing market.



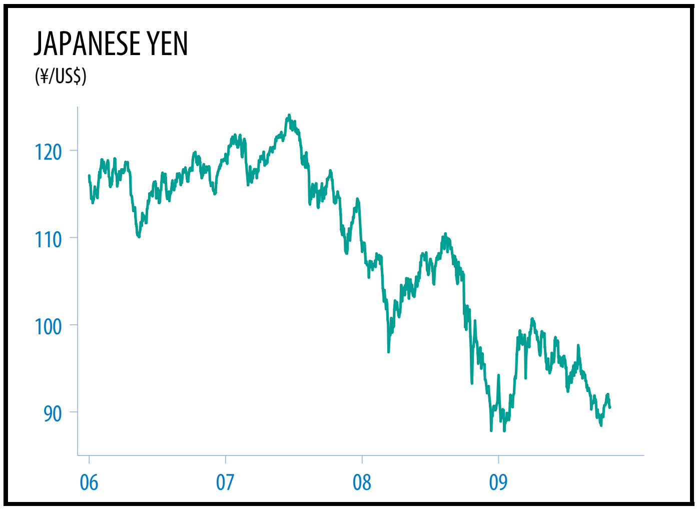
The unexpected decline in Q3 real GDP opened up an even larger output gap than the Bank of England was likely anticipating, putting even more downward pressure on inflation. With that in mind, the Monetary Policy Committee is poised to increase the Asset Purchase Facility (APF) by at least another £25 bln to £200 bln. Signs of improvement since the previous increase (which was £50 bln) argue for a smaller increase, but the wider output gap might tilt the Bank towards another £50 bln. Either way, this pushes out the eventual date for rate hikes, which aren't at all likely until late 2010, with the risks moving towards waiting until 2011. The BoE's Quarterly Inflation Report (released to the public the week after the November policy decision) will heavily influence policymakers and will probably show inflation accelerating over the next few months, (as last year's energy price increases fall out) but remaining subdued and below target through 2010.

The pound rebounded sharply in October amid premature speculation that the BoE wasn't going to increase its APF. But the rally was cut short by the GDP numbers and the realization more quantitative easing is coming. Expect sterling to remain weak as long as the spectre of more QE remains. Once the Bank declares it's done with QE, look for the pound to rally and trade more in line with other major currencies, benefitting from the improving economic climate.

Japanese Yen

Japan's economy is coming out of recession thanks to stimulus-boosted domestic spending and firming exports as emerging Asia has rebounded sharply. The data continue to improve with industrial production rising for a seventh straight month in September, and indications are that growth will persist. The jobless rate has also unexpectedly dipped in recent months, perhaps a sign of rising corporate confidence.

Despite the improving economic outlook, real GDP remains 7.9% below the 2008Q1 peak. The gaping output gap is keeping downward pressure on consumer prices, which were 2.3% below a year ago in September. Even prices excluding food and energy are down 1% y/y. The BoJ's semi-annual Outlook Report forecast growth to remain below potential until the second half of FY2010, then accelerating above potential in FY2011. Deflation is projected to



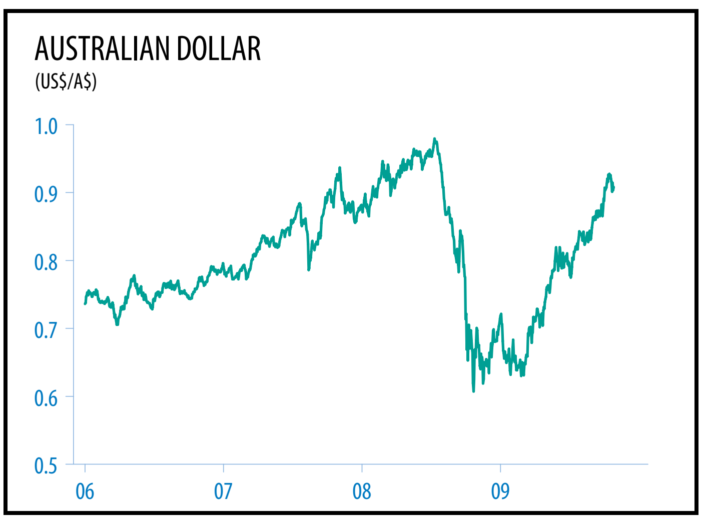
persist with the wide output gap, but will slow to -0.8% in FY2010, and -0.4% in FY2011 according to the BoJ.

The growth and inflation environment should keep the BoJ from raising rates until 2011 at the earliest. In the meantime, improving financial market conditions have enabled the Bank to set a timetable for exiting some of its quantitative/credit easing.

The yen weakened slightly in October, after hitting a 9-month high early in the month. Rallying global equity markets amid rising risk appetite contributed to the softer yen. With the BoJ likely to be on hold even as most other global central banks start to tighten as we move through 2010, look for the yen to trend weaker.

Australian Dollar

Australia's economic outperformance has prompted the RBA to hike interest rates by 25 bps in each of the past two months to 3.5%. The RBA is the only major central bank to hike rates twice thus far. Key to the recovery is the rebound in Asian economies, Australia's main trading partners. Recent data have confirmed the strengthening trend, with September employment increasing the most in nearly two years, consumer confidence continuing to rise, and home prices jumping 6.2% from a year ago in Q3.



The statement from Governor Stevens accompanying the November hike disappointed markets, which were expecting a more hawkish tone. The statement was largely similar to the prior month's, with the RBA believing "*that it is prudent to lessen gradually the degree of monetary stimulus*." While market expectations of a December hike fell following the statement, barring a weak spate of data (like the weakness in September retail sales), we expect another 25 bp rate increase with the next meeting not until February 2010.

The recent move towards risk aversion, and the disappointment with the RBA's tone, pushed the Australian dollar down from its late-October 14-month high. While a further correction in equity markets could hurt the near-term prospects for the currency, continued RBA tightening, while most other major central banks remain on hold, will be a positive. Look for further strength in the Aussie dollar as long as global growth continues to accelerate.

FX Forecasts
Local Currency per U.S. Dollar (averages)

	Actual Oct	2009 Nov	Dec	2010 Q1	Q2	Q3	Q4	2011 Q1	Q2
Canadian Dollar									
C$ per US$	1.055	1.040	1.030	1.021	1.008	0.994	0.997	0.996	0.990
US$ per C$	0.948	0.962	0.971	0.979	0.992	1.006	1.003	1.004	1.010
Trade-Weighted	113.3	115.0	116.0	116.9	118.4	119.9	119.5	119.7	120.7
U.S. Dollar									
Trade-Weighted*	102.2	101.7	101.1	100.5	99.6	98.7	98.1	97.8	97.6
European Currencies									
Euro**	1.48	1.48	1.50	1.51	1.52	1.53	1.55	1.53	1.51
Danish Krone	5.03	5.05	5.00	4.95	4.90	4.85	4.85	4.85	4.95
Norwegian Krone	5.65	5.60	5.50	5.40	5.30	5.15	5.05	5.05	5.15
Swedish Krona	6.96	6.95	6.80	6.70	6.50	6.30	6.10	6.10	6.15
Swiss Franc	1.02	1.03	1.02	1.01	1.01	1.00	0.99	1.00	1.01
U.K. Pound**	1.62	1.62	1.60	1.62	1.66	1.70	1.74	1.76	1.77
Asian Currencies									
Chinese Yuan	6.83	6.83	6.83	6.77	6.69	6.61	6.53	6.45	6.37
Japanese Yen	90	91	92	93	95	97	99	102	104
Korean Won	1174	1170	1160	1130	1090	1055	1020	980	945
Indian Rupee	46.6	46.6	46.5	46.3	46.1	45.8	45.6	45.3	45.1
Singapore Dollar	1.40	1.39	1.39	1.38	1.38	1.37	1.37	1.36	1.34
Malaysian Ringgit	3.40	3.40	3.39	3.35	3.28	3.22	3.15	3.10	3.05
Thai Baht	33.4	33.4	33.3	32.9	32.3	31.7	31.1	30.5	30.0
Philippine Peso	46.9	47.3	47.0	46.8	46.4	46.0	45.6	44.9	44.0
Taiwan Dollar	32.3	32.5	32.4	32.1	31.6	31.1	30.7	30.2	29.7
Indonesian Rupiah	9478	9500	9440	9360	9240	9120	9000	8920	8860
Other Currencies									
Australian Dollar**	0.905	0.910	0.920	0.929	0.943	0.957	0.970	0.982	0.993
N.Z. Dollar**	0.738	0.730	0.740	0.746	0.755	0.763	0.772	0.788	0.806
Mexican Peso	13.23	13.25	13.00	13.00	12.90	12.85	12.75	12.65	12.55
Brazilian Real	1.74	1.75	1.75	1.74	1.73	1.72	1.71	1.70	1.70
Russian Ruble	29.5	29.3	29.0	28.8	28.5	28.3	28.0	28.3	28.5
South African Rand	7.5	7.9	7.8	7.7	7.8	7.9	8.0	8.2	8.3

* Federal Reserve Broad Index ** (US$ per local currency)

Cross Rates

	Actual Oct	2009 Nov	Dec	2010 Q1	Q2	Q3	Q4	2011 Q1	Q2
Versus Canadian Dollar									
Euro (C$/€)	1.56	1.54	1.54	1.54	1.53	1.52	1.54	1.53	1.49
U.K. Pound (C$/£)	1.71	1.68	1.65	1.65	1.67	1.69	1.73	1.75	1.75
Japanese Yen (¥/C$)	86	88	89	91	94	98	99	102	105
Australian Dollar (C$/A$)	0.955	0.946	0.948	0.949	0.951	0.951	0.967	0.978	0.983
Versus Euro									
U.K. Pound (£/€)	0.91	0.91	0.93	0.93	0.92	0.90	0.89	0.87	0.85
Japanese Yen (¥/€)	134	135	138	140	144	149	153	156	157

Interest Rate Forecasts
Percent
(averages)

	Actual	2009		2010				2011	
	Oct	Nov	Dec	Q1	Q2	Q3	Q4	Q1	Q2
Cdn. Yield Curve									
Overnight	0.25	0.25	0.25	0.25	0.25	0.58	1.08	1.58	2.08
3 month	0.22	0.20	0.20	0.20	0.30	0.80	1.25	1.75	2.20
6 month	0.31	0.30	0.30	0.30	0.40	1.00	1.45	1.90	2.35
1 year	0.60	0.55	0.60	0.70	0.90	1.35	1.75	2.20	2.60
2 year	1.47	1.40	1.50	1.65	1.90	2.15	2.45	2.80	3.15
3 year	1.97	1.85	1.95	2.10	2.30	2.50	2.75	3.05	3.40
5 year	2.71	2.70	2.70	2.75	2.85	2.95	3.15	3.40	3.65
7 year	2.96	2.95	3.00	3.10	3.25	3.40	3.55	3.75	4.00
10 year	3.43	3.45	3.45	3.50	3.60	3.70	3.80	4.00	4.20
30 year	3.93	3.95	3.95	4.00	4.10	4.20	4.30	4.45	4.65
U.S. Yield Curve									
Fed funds	0.13	0.13	0.13	0.13	0.13	0.25	0.75	1.33	1.83
3 month	0.07	0.05	0.05	0.05	0.10	0.20	0.70	1.30	1.80
6 month	0.16	0.15	0.15	0.20	0.20	0.30	0.85	1.40	1.90
1 year	0.37	0.40	0.45	0.60	0.75	1.05	1.40	1.90	2.35
2 year	0.95	0.90	1.05	1.30	1.70	2.05	2.35	2.75	3.15
3 year	1.46	1.45	1.55	1.80	2.15	2.50	2.75	3.10	3.45
5 year	2.33	2.35	2.45	2.65	2.90	3.20	3.40	3.65	3.95
7 year	2.96	3.05	3.10	3.25	3.45	3.65	3.80	4.05	4.30
10 year	3.39	3.50	3.50	3.60	3.70	3.85	3.95	4.15	4.40
30 year	4.19	4.35	4.35	4.40	4.55	4.65	4.75	4.95	5.20