

## Fixed Income and Foreign Exchange Strategy

### February 6, 2012 Forecast Summary (averages)

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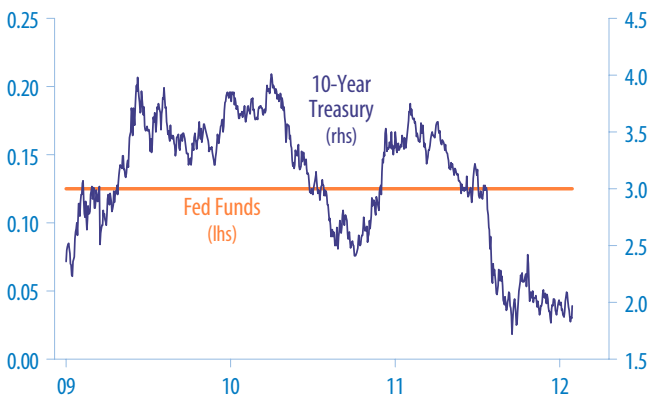
	Actual Jan	2012 Feb	Mar	Apr	2012 Q2	Q3	Q4	2013 Q1	Q2	Q3	Q4
BoC overnight	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.25
10-yr Canadas	1.98	1.96	1.94	1.92	1.90	2.05	2.25	2.45	2.60	2.80	3.00
Fed funds	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.15	0.15
10-yr Treasuries	1.97	1.95	1.90	1.85	1.80	1.95	2.15	2.40	2.60	2.80	3.05
C\$ per US\$	1.013	1.015	1.033	1.050	1.050	1.033	1.008	0.996	0.990	0.983	0.977
US\$/€	1.29	1.29	1.27	1.25	1.25	1.28	1.33	1.36	1.37	1.38	1.40
US\$/£	1.55	1.55	1.54	1.53	1.53	1.55	1.59	1.61	1.62	1.63	1.65
¥/US\$	77	77	77	77	77	78	80	81	83	85	89

### U.S. Rates

**Fed Policy:** The FOMC extended its conditional commitment to “exceptionally low levels” of the fed funds rate “at least through late 2014”, on January 25, 1½ years longer than the “mid-2013” language used since last August. The inaugural release of FOMC members’ fed funds forecasts

#### UNITED STATES

(percent)



#### U.S. BROAD TRADE-WEIGHTED DOLLAR

(Jan. 1997 = 100)



Source: U.S. Federal Reserve Board

required that the forward-looking language be modified. Among the 17 individual forecasts, there was a wide distribution of the expected timing of the first rate hike, with an equal number of “hawks” (3 in 2012, 3 in 2013) and “doves” (4 in 2015, 2 in 2016). The mode was 2014 (5 calls), with a slight skew to 2015, hence the “late 2014” reference. The mean year-end projections were 0.35% in 2012, 0.56% in 2013 and 1.12% in 2014. According to Chairman Bernanke, policy rates of 1% or less are “exceptionally low”.

It was not lost on the Fed that, even if this distribution hadn’t changed recently, the communication of this more precise projection would itself have policy easing properties. With our forecasts for real GDP growth, headline and core PCE inflation, along with the unemployment rate, well within the range of participants’ projections, we changed our Fed call and now look for rate hikes starting in 2014 Q4 (pushed back by a year), and ending 2014 at 0.75%.

Bernanke said “additional [asset] purchases remain a topic that we are still debating”. We judge that outright MBS purchases would be the choice if the Fed opts to flex its balance sheet again. The meeting Minutes, released on February 15, will provide “some

*additional qualitative information... about participants' views of the balance sheet going forward".* The odds of additional asset purchases could mount to the extent the U.S. economy loses some of its current momentum.

**Treasuries:** The Fed's communications "ease" complemented the \$600 billion Maturity Extension Program, in not only applying downward pressure on the part of the Treasury yield curve the Fed is buying (6 years and longer), but also the part it is selling (3 years and less). In the wake of the announcement, 3-, 5- and 7-year Treasury yields flirted with or hit record lows. Among the longer-term maturities, we would have expected the 30-year sector to benefit the least from the announcement, but the FOMC's release of longer-run funds forecasts was an unsavoury reminder of where the root of the yield curve could trend in the distant future (the mean was a surprisingly high 4.21%). Through mid-year, we look for news of record low yields to be repeated, cascading to 10-year maturities, as the MEP continues and Treasuries find additional support from lingering Euro-crisis-related flows and some (temporarily) lost U.S. economic momentum. Beyond mid-2012, with U.S. growth likely revving again, the global situation stabilizing and the end of the MEP, longer-term Treasury yields should start heading higher on a more persistent basis.

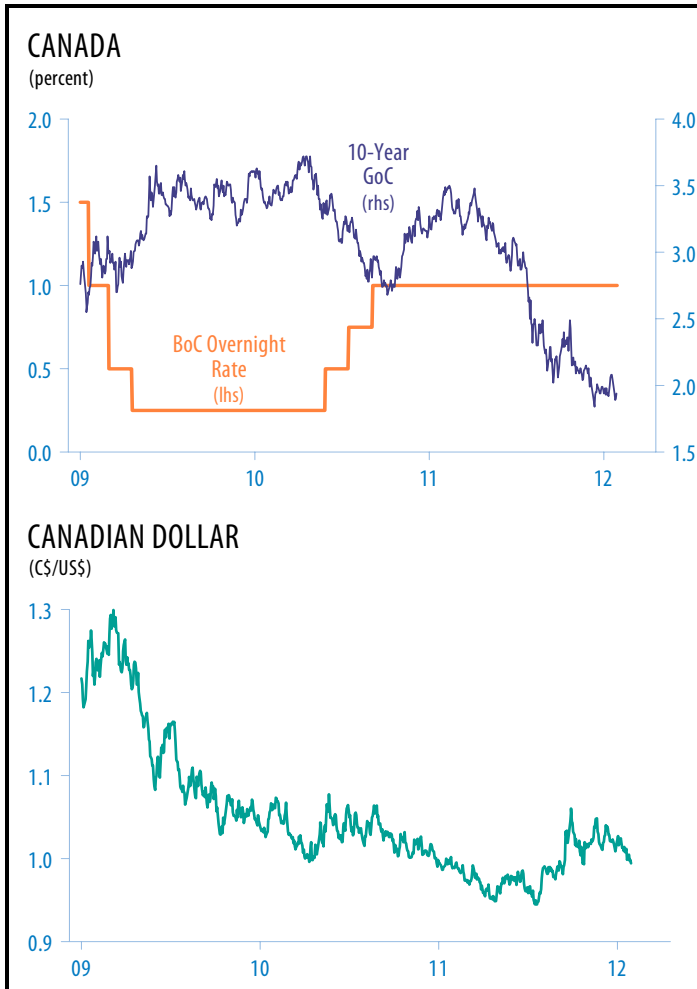
**Greenback:** Investor sentiment shifts between "risk off" (good for the greenback) and "risk on" (bad) remain the dollar's primary driver, with the latter side recently in play amid a more-positive-than-expected tone to global economic indicators. The Fed's latest "ease" added a dollop of weakening pressure as well. With the tone to turn more negative and European fears to flare again as 2012 H1 unfolds, we look for the greenback to rise on a trade-weighted basis. When the risk appetite pendulum finally swings back the other way during H2, the dollar should resume depreciating.

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## Canadian Rates

**BoC policy:** The Bank of Canada kept rates unchanged on January 17, and the distinction of being the only G-10 central bank not having eased policy since last March. While the incipient Euro Area recession and China's slowing economic momentum were sufficient to get all remaining G-10ers to ease recently, the BoC obviously believes these external risks are currently mitigated by the still *"considerable monetary policy stimulus"* in place. Meantime, the Bank's persistent concerns over household debt dynamics appear to be escalating, as *"very favourable financing conditions are expected to buttress consumer spending and housing activity. Household expenditures are expected to remain high relative to GDP and the ratio of household debt to income is projected to rise further."*

The Bank expects the economy to be at full capacity in 2013 Q3, but we could see that being pushed back a quarter given recent weak employment and output readings (we judge the output gap will close in 2014). As such, rate hikes should resume by 2013 Q4, a full year ahead of the Fed's profile. With an eye on the potential for economically painful currency appreciation, we look



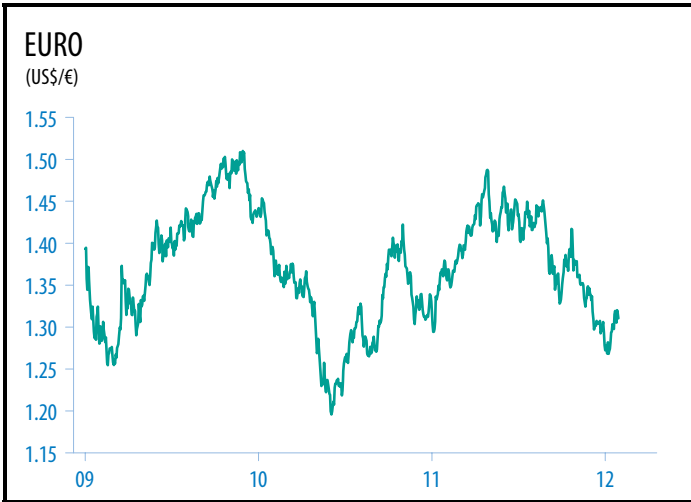
for the BoC to move on a quarter-per-quarter pace (beginning in 2013 Q4) until the Fed enters the tightening game (Canada-U.S. overnight spreads reach a maximum in the 175-200-bp-range by 2014 Q4). Note, the Monetary Policy Report still warns that *“this projection includes a gradual reduction in monetary stimulus over the projection horizon, consistent with achieving the inflation target.”*

**Canadas:** Canadian longer-term bonds should continue their pattern of outperforming Treasuries amid rising yields but lagging as U.S. yields fall. Fed actions should assist the latter scenario during 2012 H1 amid ebbing North American economic momentum and re-flared Euro Area fears. That same ebbing momentum (which is already worse for Canada) could stoke expectations of BoC easing, which, when combined with the Fed selling the under-3-year Treasury segment, could still permit Canadas to outperform at the shorter end. Once the Treasury market takes a bearish turn during 2012 H2, look for a reversal in these trends. Canadian longer-term maturities should garner additional support from wider and/or less-negative Canada-U.S. yield differentials (the result of prior lagging performance), not to mention Canada’s stronger fiscal fundamentals and an appreciating currency.

**Loonie:** The Canadian dollar began February stronger than parity, for the first time since late October. The renewed vigour reflected a combination of the BoC’s escalated concern over household debt (probably raising the bar for possible rate cuts), the Fed’s “communications” easing action, and the recent “risk on” background painted by the more-positive-than-expected tone to global economic indicators. However, that tone was not evident in recent key Canadian economic indicators, which should weaken the currency, particularly once U.S. economic momentum ebbs a bit and the European sovereign debt crisis flares again. We look for the loonie to average C\$1.05 on a monthly basis by mid-year, and rebound back to parity by year-end, with U.S. growth likely revving again along with the European and remaining global situation likely stabilizing. The appreciation should continue into 2013 and beyond, as the countdown to resumed BoC rate hikes provides some lift.

## Euro

Entering the third year of the sovereign debt crisis, January brought some welcome stability. A number of successful debt auctions lowered yields throughout the region, with Italian and Spanish bonds outperforming. Ten-year Italian bond yields dropped to 6% by month end, after starting the



year north of 7%, while Spanish 10-year yields opened February at 14-month lows. Markets appear to be finally rewarding the progress made by European leaders—though the near-€500 bln three-year ECB refinancing operation no doubt provided some assistance.

There was also advancement in the Greek situation, but a deal isn't a foregone conclusion, with the debt restructuring and a new aid package still being negotiated. Meantime, the focus has shifted back to Portugal and whether it too will need a debt restructuring, with the pressure ramping up after the last of the credit rating agencies downgraded it to junk status. The resulting

surge in yields suggests that Portugal will be unable to demonstrate one year in advance that it will be able to return to the market in September 2013. Even so, European leaders have suggested that countries adhering to the stipulations in their first bailout would continue to be supported. If Portugal is allowed to default, talk of Greece being exceptional would no longer be credible.

Improving economic data also lifted spirits in January. Nascent signs of stability on the economic and crisis front look like they will be enough to keep the ECB sidelined for a second straight month. However, we anticipate the crisis will flare again, and the economic data will see renewed weakness, prompting further rate cuts in the first half of the year.

With that backdrop, the euro is expected to weaken into mid-year, before rebounding as Europe's economic data stabilize and the debt crisis is convincingly contained.

## U.K. Pound

Fiscal cuts and the Euro Area crisis are weighing on U.K. growth, illustrated by the 0.8% annualized contraction in Q4 real GDP. With the U.K. likely already in recession, we anticipate the Bank of England will expand its Asset Purchase Facility by £50-to-£75 bln in February, with purchases lasting three months. The Monetary Policy Committee will be armed with a new

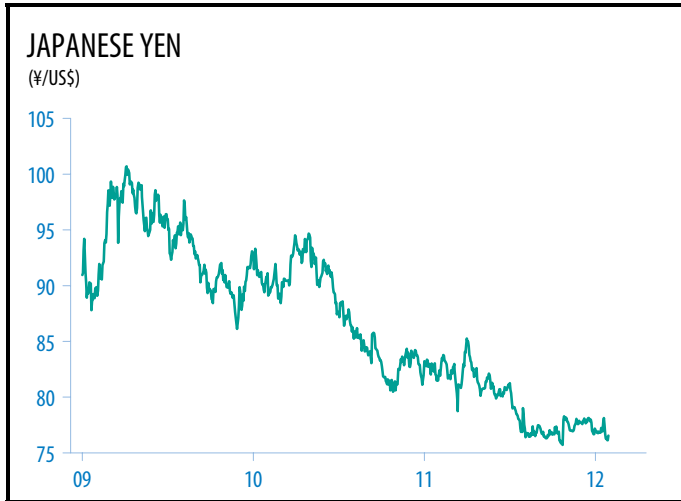


Inflation Report, which will underpin the anticipated easing manoeuvre. Indeed, the Report will likely show inflation falling below target by the end of the two-year projection period as the growth outlook should be downgraded as well.

Bank of England easing and a generally risk averse mood in markets as the euro crisis lingers are expected to weaken the pound to the middle of 2012. As the global outlook then starts to improve, sterling should strengthen on improved risk appetite and as the BoE shifts away from an easing bias.

## Japanese Yen

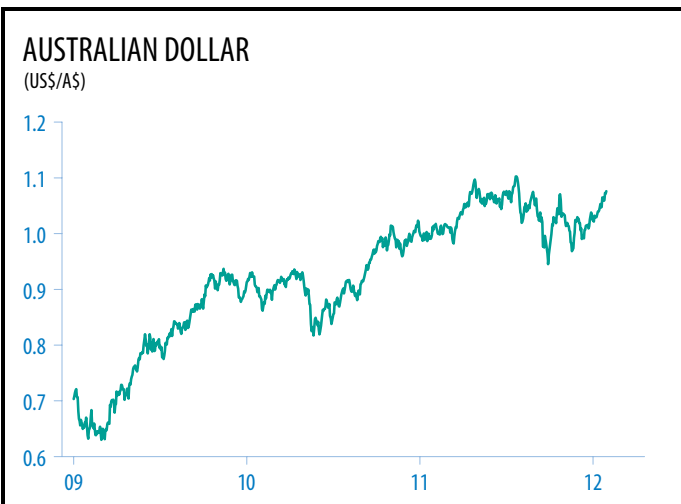
The Japanese yen has been range bound (between about ¥76 and ¥78) since August, trading to both extremes in January. By month-end the yen was testing the bottom of the range, prompting renewed speculation of government intervention to weaken the currency. The exceptionally strong yen and Tohoku quake/tsunami left Japan with its first annual trade deficit since 1980. While 2012 should see some improvement, there's a clear deteriorating trend and a slowing global economy will make matters more challenging.



Slowing growth, ongoing turmoil in Europe, and a stubbornly strong yen will likely prompt further easing from the Bank of Japan, though probably not for another month or two. That should keep the yen from strengthening beyond the recent range. One potential risk to the yen outlook is Japan's credit rating. A downgrade would likely hit the yen hard, as global investors are hyper-sensitive to sovereign debt issues. Once the global outlook begins to improve in the second half of 2012, risk appetite should firm and weaken the yen consistently.

## Australian Dollar

The Reserve Bank of Australia has had two months to evaluate the economic landscape since cutting rates 25 bps at the last two meetings of 2011. Europe likely remains a key concern for the Bank despite recent stability. Over the past two months, the domestic economic data have been relatively weak, with a sharp decline in December employment leaving full-year job growth negative for the first time since 1992. Moreover, China, a key driver for Australia's



resource-driven economy, is clearly slowing as well. Also, the recent strength in the Australian dollar is likely concerning for the RBA. Those factors should set the stage for a third consecutive 25 bp rate cut in February.

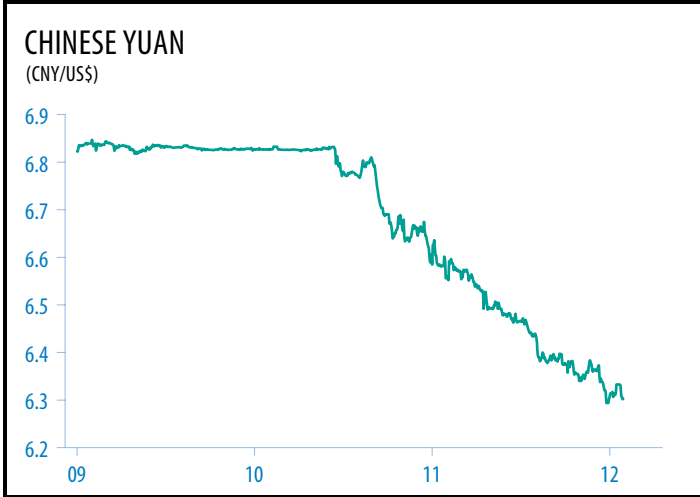
The anticipated rate cut will likely weigh on the A\$ in the near-term and retrace a portion of the latest rally. Since we expect the European crisis to persist, and China's economic growth to continue slowing, the Australian dollar is forecast to weaken consistently through mid-2012. Once global growth starts to reaccelerate around mid-year, the A\$ should turn higher.

**Chinese Yuan**

Chinese economic momentum has slowed with real GDP growth decelerating to 8.9% y/y in Q4, a ten-quarter low. Chinese officials cut banks' reserve requirements by 50 bps to 21% in December and have adopted a more-stimulative posture. Look for more easing in the form of reserve requirement and, possibly, interest rate cuts in the first quarter. However, officials may

be reluctant to reduce interest rates until inflation comes down further from December's 4.1% y/y rate.

After appreciating strongly in December following four months of stability, the yuan retreated modestly in January. With the global economy slowing and uncertainty persisting in Europe, China will likely remain reluctant to allow the yuan to appreciate significantly. Look for the yuan to stay flat to modestly stronger over the next few months until there is greater clarity on the outlook. We're forecasting 5%-to-8% annual appreciation to resume in mid-2012.



## Foreign Exchange Forecasts Local Currency per U.S. Dollar (averages)

	Actual Jan	2012 Feb	Mar	Apr	2012 Q2	Q3	Q4	2013 Q1	Q2	Q3	Q4
<b>Canadian Dollar</b>											
C\$ per US\$	1.013	1.015	1.033	1.050	1.050	1.033	1.008	0.996	0.990	0.983	0.977
US\$ per C\$	0.987	0.985	0.968	0.952	0.952	0.968	0.992	1.004	1.010	1.017	1.024
Trade-Weighted	118.3	118.0	116.3	114.5	114.6	116.1	118.5	119.7	120.3	121.0	121.9
<b>U.S. Dollar</b>											
Trade-Weighted*	100.0	99.7	100.7	101.6	101.8	100.5	98.5	97.3	96.5	95.8	95.2
<b>European Currencies</b>											
Euro**	1.29	1.29	1.27	1.25	1.25	1.28	1.33	1.36	1.37	1.38	1.40
Danish Krone	5.76	5.80	5.85	5.95	5.95	5.80	5.60	5.50	5.45	5.40	5.35
Norwegian Krone	5.94	6.00	6.10	6.15	6.25	6.10	5.90	5.80	5.70	5.75	5.85
Swedish Krona	6.85	6.90	7.00	7.15	7.20	7.05	6.80	6.65	6.60	6.50	6.45
Swiss Franc	0.94	0.94	0.97	1.00	1.00	0.99	0.97	0.97	0.97	0.97	0.97
U.K. Pound**	1.55	1.55	1.54	1.53	1.53	1.55	1.59	1.61	1.62	1.63	1.65
<b>Asian Currencies</b>											
Chinese Yuan	6.32	6.30	6.29	6.28	6.27	6.20	6.13	6.05	5.98	5.90	5.83
Japanese Yen	77	77	77	77	77	78	80	81	83	85	89
Korean Won	1140	1130	1135	1140	1145	1135	1110	1090	1070	1055	1040
Indian Rupee	51.0	49.5	50.0	50.3	50.7	50.3	49.3	48.6	48.0	47.3	46.7
Singapore Dollar	1.28	1.27	1.28	1.30	1.31	1.30	1.26	1.23	1.20	1.17	1.15
Malaysian Ringgit	3.11	3.08	3.10	3.12	3.13	3.12	3.07	3.00	2.93	2.86	2.79
Thai Baht	31.5	31.0	31.1	31.3	31.4	31.0	30.2	29.6	29.1	28.7	28.2
Philippine Peso	43.6	43.0	43.3	43.5	43.8	43.3	42.2	41.4	40.8	40.3	39.7
Taiwan Dollar	30.0	29.7	29.9	30.1	30.3	30.1	29.5	29.0	28.5	28.0	27.5
Indonesian Rupiah	9062	9000	9040	9075	9115	9015	8815	8710	8650	8580	8520
<b>Other Currencies</b>											
Australian Dollar**	1.042	1.030	1.005	0.980	0.980	0.987	0.997	1.008	1.021	1.033	1.046
N.Z. Dollar**	0.802	0.800	0.780	0.760	0.760	0.767	0.777	0.792	0.809	0.827	0.844
Mexican Peso	13.38	13.85	13.90	14.00	14.00	13.70	13.30	13.10	12.80	12.60	12.50
Brazilian Real	1.79	1.75	1.77	1.78	1.79	1.79	1.77	1.75	1.73	1.71	1.70
Russian Ruble	31.3	30.8	31.0	31.3	31.3	31.2	30.8	30.6	30.2	30.0	30.3
South African Rand	8.0	7.9	8.0	8.1	8.2	8.1	7.8	7.6	7.5	7.4	7.2

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

## Cross Rates

### Versus Canadian Dollar

Euro (C\$/€)	1.31	1.31	1.31	1.31	1.31	1.33	1.34	1.35	1.36	1.36	1.36
U.K. Pound (C\$/£)	1.57	1.57	1.59	1.61	1.61	1.60	1.60	1.60	1.60	1.61	1.61
Japanese Yen (¥/C\$)	76	76	75	73	73	76	79	81	84	86	91
Australian Dollar (C\$/A\$)	1.055	1.045	1.038	1.029	1.029	1.020	1.005	1.004	1.011	1.015	1.022

### Versus Euro

U.K. Pound (£/€)	0.83	0.83	0.82	0.82	0.82	0.83	0.84	0.84	0.85	0.85	0.85
Japanese Yen (¥/€)	99	99	98	96	96	100	107	110	114	118	124

## Interest Rate Forecasts Percent (averages)

	Actual Jan	2012 Feb	Mar	Apr	2012 Q2	Q3	Q4	2013 Q1	Q2	Q3	Q4
<b>Cdn. Yield Curve</b>											
Overnight	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.25
3 month	0.82	0.85	0.85	0.85	0.85	0.85	0.85	0.85	0.85	0.93	1.20
6 month	0.90	0.95	0.95	0.95	0.93	0.93	0.93	0.93	0.93	1.03	1.30
1 year	0.97	0.98	0.98	0.97	0.97	1.03	1.10	1.20	1.35	1.50	1.75
2 year	0.98	0.97	0.96	0.95	0.95	1.05	1.25	1.45	1.70	1.95	2.10
3 year	1.02	1.01	1.00	0.99	1.00	1.15	1.35	1.65	1.90	2.15	2.35
5 year	1.31	1.30	1.28	1.27	1.25	1.40	1.65	1.90	2.15	2.40	2.55
7 year	1.53	1.53	1.53	1.53	1.55	1.65	1.85	2.15	2.40	2.60	2.80
10 year	1.98	1.96	1.94	1.92	1.90	2.05	2.25	2.45	2.60	2.80	3.00
30 year	2.56	2.55	2.50	2.50	2.50	2.60	2.80	2.95	3.15	3.35	3.50
1m BA	1.15	1.15	1.15	1.15	1.15	1.15	1.15	1.15	1.15	1.15	1.40
3m BA	1.21	1.21	1.21	1.21	1.21	1.21	1.21	1.20	1.20	1.20	1.45
6m BA	1.32	1.30	1.30	1.30	1.30	1.30	1.30	1.30	1.30	1.35	1.60
12m BA	1.38	1.35	1.35	1.35	1.35	1.40	1.50	1.60	1.70	1.80	2.00
Prime Rate	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.25
<b>U.S. Yield Curve</b>											
Fed funds	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.15	0.15
3 month	0.03	0.03	0.03	0.03	0.03	0.03	0.03	0.03	0.03	0.03	0.03
6 month	0.07	0.06	0.06	0.06	0.06	0.06	0.06	0.06	0.06	0.06	0.06
1 year	0.12	0.11	0.11	0.11	0.11	0.11	0.11	0.12	0.12	0.20	0.25
2 year	0.24	0.22	0.22	0.22	0.22	0.22	0.22	0.23	0.25	0.50	0.85
3 year	0.36	0.28	0.28	0.28	0.28	0.34	0.45	0.55	0.65	1.00	1.35
5 year	0.84	0.74	0.73	0.71	0.71	0.82	1.00	1.15	1.35	1.75	2.10
7 year	1.38	1.37	1.34	1.31	1.30	1.40	1.55	1.75	1.95	2.35	2.65
10 year	1.97	1.95	1.90	1.85	1.80	1.95	2.15	2.40	2.60	2.80	3.05
30 year	3.03	3.00	2.95	2.90	2.85	3.00	3.20	3.40	3.60	3.80	4.00
1m LIBOR	0.28	0.30	0.30	0.30	0.30	0.30	0.25	0.20	0.20	0.20	0.20
3m LIBOR	0.57	0.60	0.60	0.60	0.60	0.55	0.50	0.40	0.30	0.30	0.30
6m LIBOR	0.80	0.80	0.80	0.85	0.85	0.80	0.70	0.60	0.55	0.50	0.50
12m LIBOR	1.11	1.15	1.15	1.15	1.15	1.10	1.05	0.95	0.85	0.90	1.00
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25
<b>Other G7 Yields</b>											
ECB Refi	1.00	1.00	0.75	0.75	0.60	0.50	0.50	0.50	0.50	0.50	0.50
10yr Bund	2.00	1.86	1.83	1.80	1.75	1.90	2.10	2.25	2.40	2.60	2.75
BoE Repo	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
10yr Gilt	2.10	2.00	1.95	1.90	1.85	2.00	2.25	2.45	2.65	2.90	3.15
BoJ 0/N	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
10yr JGB	0.98	1.00	1.00	1.00	1.00	1.05	1.10	1.15	1.15	1.20	1.25

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