

Fixed Income and Foreign Exchange Strategy

January 5, 2012 Forecast Summary (averages)

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	Actual Dec	2012 Jan	Feb	Mar	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	1.25	1.50	1.85
10-yr Canadas	1.99	2.00	2.00	2.00	2.00	2.20	2.45	2.70	2.90	3.15	3.40
Fed funds	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.20	0.60
10-yr Treasuries	1.98	1.95	1.95	1.90	1.90	2.10	2.40	2.65	2.90	3.15	3.40
C\$ per US\$	1.024	1.025	1.034	1.043	1.060	1.040	1.010	0.993	0.983	0.987	0.997
US\$/€	1.32	1.30	1.28	1.27	1.25	1.28	1.33	1.37	1.39	1.38	1.36
US\$/£	1.56	1.55	1.54	1.53	1.53	1.55	1.59	1.61	1.62	1.63	1.65
¥/US\$	78	77	77	76	76	77	79	81	83	85	89

U.S. Rates

Fed Policy: The December 13 policy announcement continued the commitment to "exceptionally low levels for the federal funds rate at least through mid-2013" along with the Maturity Extension Program and the reinvestment strategy. There was no mention, at the time, of

changes to communications strategy. However, the Minutes (released Jan. 3) announced that beginning January 25 the FOMC's quarterly Summary of Economic Projections will include the range of members' forecasts for the fed funds target rate (consistent with their already-published projections for real GDP growth, PCE and core PCE inflation, and the unemployment rate), along with their expectations on the timing of the first rate hike and "qualitative information" regarding their expectations on the Fed's balance sheet. With this new information, markets will be able to better assess what "at least through mid-2013" means along with the conditions that impinge on this policy commitment, and what it might take to trigger QE3. The market is already betting that this new info will point to rate hikes commencing later in the 2013 H2-and-beyond period than first assessed. (We've pushed back our 2013 Q3 rate hike start call to Q4.)

We look for real GDP growth to slow to just under 2% annualized in 2012 H1, from a 2011 Q4 reading close to 3%, owing to a deepening European recession, slowing emerging markets and ebbing domestic momentum. The latter reflects calmer consumer spending (the drawdown in savings and aggressive



price discounting were probably temporary) and cooler business capital spending (after tax incentives pulled outlays into 2011), amid continuing fiscal consolidation. This will keep the unemployment rate “elevated”, headline inflation falling and core inflation contained in its price stability range—a ripe environment for further Fed easing, particularly with this year’s rotation of voting regional Fed presidents more dovish than last year. Apart from employing the communications strategy to ease, we also look for more net purchases of MBS (with housing finally stabilizing, additional policy support would promote outright recovery). We don’t think the Fed will start buying Treasuries outright unless deflation risks rise or this credit easing requires reinforcement.

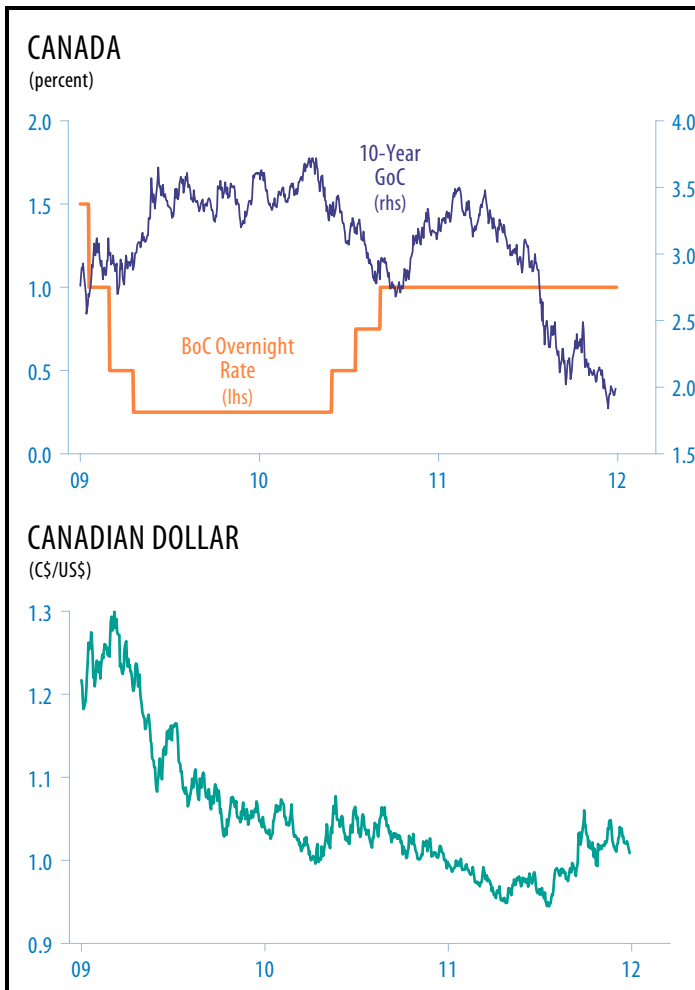
Treasuries: For the past two months, bellwether 10-year yields have been trading in the 1.80% to 2.10% range. With U.S. economic momentum expected to ebb during 2012 H1 (and the Fed expected to be on hold for longer), the trend should still drift down a bit, as the deepening European recession and inevitable sovereign debt crisis flare-up stoke the safe-haven bid for Treasuries. We’re forecasting a 1.9% monthly average low through this spring, likely hitting a record-low, sub-1.70% in trading. Beyond mid-2012, with self-sustaining, moderate U.S. economic growth becoming evident, the global situation stabilizing and the end of the Fed’s Maturity Extension Program, longer-term yields should head higher.

Greenback: The swinging pendulum between safety and risk assets remains the U.S. dollar’s primary driver. With the former likely to be felt more often than the latter during 2012 H1, we look for the greenback to rise on a trade-weighted basis. When the pendulum finally swings back the other way during 2012 H2, the dollar should resume depreciating.

Canadian Rates

BoC policy: The Bank of Canada kept policy rates unchanged on December 6. The Bank said *“uncertainty around the global economic outlook has increased”* and *“the recession in Europe is now expected to be more pronounced.”* Offsetting this, U.S. growth *“has been slightly more robust than anticipated”* while Canadian second-half growth is tracking *“slightly stronger”* than projected with inflation running *“slightly higher.”* The BoC judges these North American misses will prove temporary, and that growth and inflation will cool as projected, partly owing to the worsening global situation. Resulting sub-2% Canadian GDP growth and CPI inflation should keep BoC easing odds building through the spring. However, with household debt and housing market dynamics still arguing for higher, not lower rates, and the fact that the BoC notes that there is still *“considerable monetary policy stimulus”* in place, the external headwinds are going to have to blow much harder to elicit rate cuts. We’re holding to our view for unchanged policy all next year, and a before-the-Fed resumption of rate hikes in 2013.

Canadas: Canadian longer-term bonds continue their pattern of outperforming Treasuries amid rising yields but lagging as U.S. yields fall, and the latter should be the predominant theme during 2012 H1 (occasionally, factors such as the domestic demand for duration can

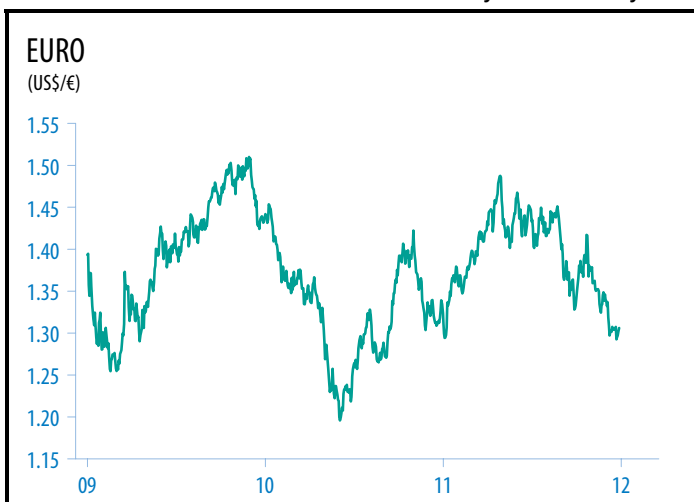


even cause mild Canadian outperformance at the longer end in a falling yield environment, which was the case last month). But, with the chance of BoC easing and the Fed selling the under-3-year Treasury segment, Canada's should outperform at the shorter end. Once the Treasury market takes a bearish turn 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: For the past two months, the loonie traded between 95 U.S. cents and just under parity, averaging around the mid-97s and reflecting swings between "risk on" and "risk off" (with the "risk off" impact muted a bit by high oil prices). With "risk off" the prevailing wind during 2012 H1 (along with slight BoC easing prospects), we look for the loonie to weaken further—a monthly average low near 94 U.S. cents. As risk appetites swing the other way during 2012 H2, and prospects for BoC rate hikes build, the loonie should reverse course, hitting parity by year end.

Euro

European leaders made some progress at the December summit, but it clearly isn't sufficient to contain the crisis. The bright side is that Europe appears to be tentatively on the right path, headed toward a fiscal union, though the path is long and arduous. Expect more summits in the year ahead, with each taking baby steps forward. Meantime, the ECB will do all it can to support the economy. The three-year refinancing operation in December was very successful and should



help banks avoid a liquidity crunch, which will in turn help the economy. The tender also appears to have lowered short-term bond yields for Italy and Spain, as banks take advantage of cheap funding. However, long-term yields remain elevated (Italy is near 7%), keeping pressure on those governments to shrink deficits and restructure their economies.

Further action from the ECB in January is probably asking too much. While the Euro Area is likely already in recession, the December rate cut was not a unanimous decision and the data since then have not materially altered the outlook. However, data

releases through January are expected to make the worsening economic picture clear and prompt rate cuts in February and March. If growth continues to falter into Q2 and inflation slows sufficiently to give rise to deflation fears, quantitative easing would be a possibility.

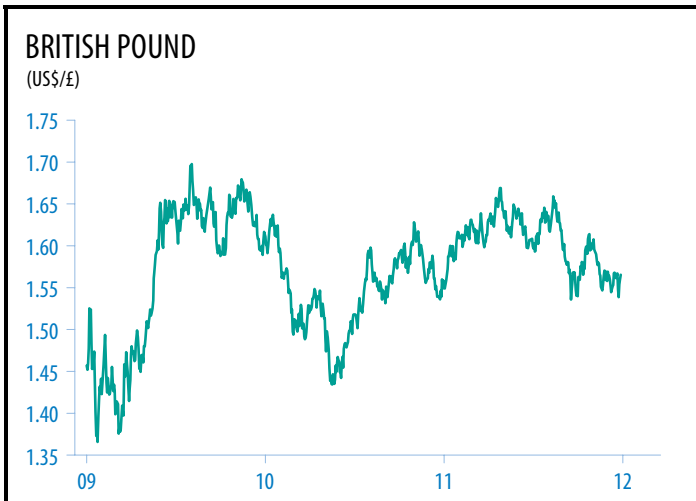
While we anticipate the euro will remain intact, it will take time for the appropriate decisions to be made, meaning the crisis atmosphere will persist in the near term. As such, the euro will remain under pressure amid further ECB easing. Once it becomes clear that the Euro Area will survive as is—and that may not be until around mid-2012—the euro should appreciate.

U.K. Pound

The U.K. economy is facing two major headwinds: fiscal cutbacks and the Euro Area crisis. That prompted the Bank of England to expand its Asset Purchase Facility in October. Since then, the European economic data point to renewed recession and the government announced that weaker growth will mean austerity measures will have to last an extra two years (until 2017) and

public sector employment will shrink much more than previously announced. Given those factors, we anticipate the BoE will increase its Asset Purchase Facility further in either January or February, by which time inflation should start to trend downward (the VAT increase will fall out of the calculation in January).

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.

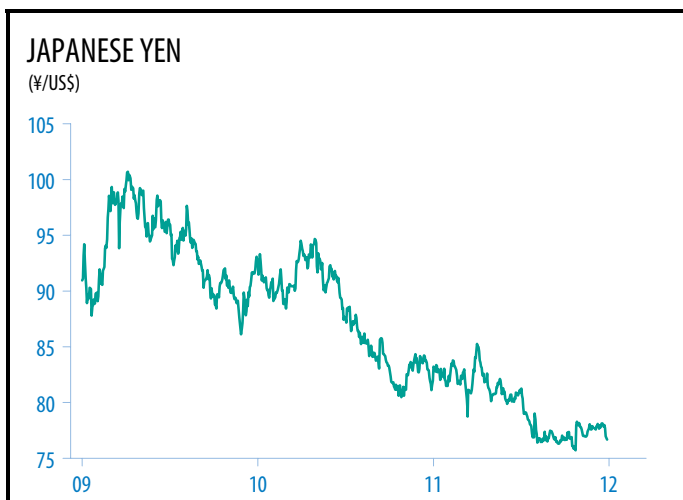


Japanese Yen

The Japanese yen was among the top performing currencies in 2011, much to the chagrin of exporters and policymakers. However, the currency remains off the record level hit in late

October which prompted official intervention. Still, the yen remains exceptionally strong, weighing heavily on exporters. Making matters more challenging, the global economy has clearly slowed. Japan's exports fell a hefty 6.5% in the two months to November and industrial production slumped that month. Growth will continue to get a boost from post-quake rebuilding, but that won't be sufficient to offset global headwinds.

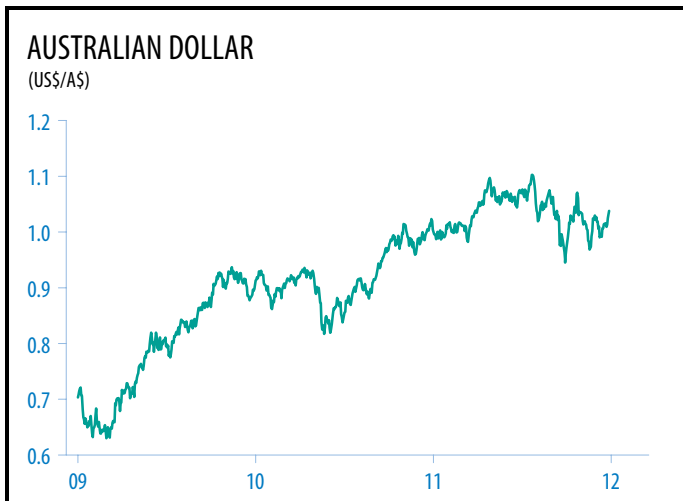
Slowing growth, ongoing turmoil in Europe, and a stubbornly strong yen will likely prompt further easing from the Bank of Japan. That should keep the yen from strengthening beyond



the range that has prevailed since August. One potential risk to the yen outlook is Japan's credit rating. Rumours of a potential downgrade hit the yen in late November; and, if proven true, could weigh heavily on the currency.

Australian Dollar

The Reserve Bank of Australia cut rates 25 bps for a second straight month in December, bringing the policy rate to 4.25%. The Bank highlighted concerns about Europe, increasing the "likelihood of a further material slowing in global growth". Domestic growth was characterized as at trend, with inflation expected to be consistent with the 2%-to-3% target.



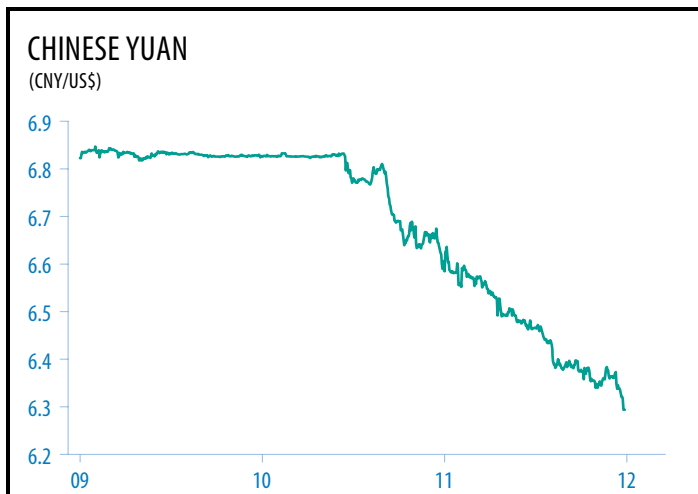
Importantly, the statement noted that bank funding conditions have worsened and credit growth remains subdued. Further easing by the RBA will likely be contingent on how the situation in Europe and domestic data evolve.

Since we expect the European crisis to persist, though not necessarily worsen, and China's economic growth to slow, there's potential for more rate cuts early in 2012. The slowing global economy and possible easing will weigh on the Australian dollar through early 2012, with the currency expected to fall below parity. Once global growth starts to reaccelerate around mid-year, the A\$ should turn higher.

Chinese Yuan

Chinese economic momentum has slowed with most economic indicators decelerating. In response, 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 interest rate cuts early this year. However, officials may be reluctant to reduce

interest rates until inflation comes down further from November's 4.2% y/y rate.



After a few months of stability from August to November, the yuan strengthened in December, closing the year at its best level in 18 years and gaining 5% for all of 2011. 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's more 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 Dec	2012 Jan	Feb	Mar	2012 Q2	Q3	Q4	2013 Q1	Q2	Q3	Q4
Canadian Dollar											
C\$ per US\$	1.024	1.025	1.034	1.043	1.060	1.040	1.010	0.993	0.983	0.987	0.997
US\$ per C\$	0.977	0.976	0.967	0.959	0.943	0.962	0.990	1.007	1.017	1.013	1.003
Trade-Weighted	117.1	117.0	116.1	115.2	113.5	115.4	118.3	120.0	121.0	120.7	119.8
U.S. Dollar											
Trade-Weighted*	100.5	100.8	101.3	101.8	102.4	100.9	98.7	97.3	96.2	95.9	96.3
European Currencies											
Euro**	1.32	1.30	1.28	1.27	1.25	1.28	1.33	1.37	1.39	1.38	1.36
Danish Krone	5.65	5.75	5.80	5.90	5.95	5.80	5.60	5.45	5.35	5.40	5.50
Norwegian Krone	5.89	6.00	6.10	6.15	6.25	6.10	5.90	5.80	5.70	5.75	5.85
Swedish Krona	6.86	6.95	7.00	7.15	7.25	7.10	6.80	6.65	6.50	6.50	6.60
Swiss Franc	0.93	0.94	0.96	0.98	1.00	0.99	0.97	0.96	0.95	0.97	0.99
U.K. Pound**	1.56	1.55	1.54	1.53	1.53	1.55	1.59	1.61	1.62	1.63	1.65
Asian Currencies											
Chinese Yuan	6.35	6.34	6.32	6.31	6.28	6.22	6.14	6.07	6.00	5.92	5.85
Japanese Yen	78	77	77	76	76	77	79	81	83	85	89
Korean Won	1148	1155	1160	1165	1175	1150	1115	1090	1075	1060	1040
Indian Rupee	52.4	52.5	52.8	53.0	53.0	51.7	49.7	48.6	48.0	47.4	46.8
Singapore Dollar	1.30	1.29	1.30	1.30	1.31	1.30	1.26	1.23	1.20	1.18	1.15
Malaysian Ringgit	3.16	3.18	3.19	3.20	3.20	3.15	3.08	3.01	2.94	2.87	2.80
Thai Baht	31.2	31.5	31.6	31.7	31.9	31.3	30.3	29.7	29.2	28.8	28.3
Philippine Peso	43.6	43.9	44.0	44.1	44.2	43.5	42.3	41.5	41.0	40.4	39.8
Taiwan Dollar	30.3	30.3	30.3	30.4	30.5	30.1	29.6	29.0	28.5	28.0	27.6
Indonesian Rupiah	9076	9050	9070	9090	9130	9020	8820	8710	8650	8580	8520
Other Currencies											
Australian Dollar**	1.012	1.010	0.990	0.970	0.950	0.967	0.992	1.017	1.042	1.033	1.008
N.Z. Dollar**	0.770	0.780	0.760	0.740	0.720	0.738	0.767	0.800	0.838	0.842	0.829
Mexican Peso	13.77	13.85	13.90	14.00	14.00	13.70	13.30	13.10	12.80	12.60	12.50
Brazilian Real	1.84	1.84	1.84	1.85	1.85	1.83	1.81	1.79	1.77	1.75	1.75
Russian Ruble	31.6	32.0	31.1	32.1	32.2	31.9	31.3	30.7	30.2	30.0	30.3
South African Rand	8.2	8.2	8.3	8.4	8.5	8.3	8.1	7.9	7.6	7.5	7.4

* Federal Reserve Broad Index

** (US\$ per local currency)

Cross Rates

Versus Canadian Dollar

Euro (C\$/€)	1.35	1.33	1.33	1.32	1.33	1.33	1.35	1.36	1.37	1.37	1.35
U.K. Pound (C\$/£)	1.60	1.59	1.59	1.60	1.62	1.61	1.60	1.60	1.59	1.61	1.64
Japanese Yen (¥/C\$)	76	75	74	73	72	74	78	82	84	86	89
Australian Dollar (C\$/A\$)	1.036	1.035	1.024	1.012	1.007	1.006	1.002	1.010	1.024	1.020	1.005

Versus Euro

U.K. Pound (£/€)	0.84	0.84	0.83	0.83	0.82	0.83	0.84	0.85	0.86	0.85	0.83
Japanese Yen (¥/€)	102	100	98	97	95	99	105	111	116	118	121

Interest Rate Forecasts Percent (averages)

	Actual	2012			2012			2013			
	Dec	Jan	Feb	Mar	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Cdn. Yield Curve											
Overnight	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.25	1.50	1.85
3 month	0.83	0.82	0.82	0.82	0.82	0.82	0.82	0.82	1.07	1.32	1.65
6 month	0.88	0.95	0.95	0.95	0.94	0.94	0.94	0.94	1.19	1.44	1.75
1 year	0.89	0.96	0.95	0.95	0.94	1.05	1.20	1.40	1.65	1.90	2.20
2 year	0.89	0.98	0.97	0.96	0.95	1.15	1.50	1.85	2.10	2.35	2.60
3 year	0.96	1.02	1.01	1.00	1.00	1.25	1.60	2.00	2.30	2.50	2.80
5 year	1.28	1.31	1.30	1.30	1.30	1.50	1.85	2.20	2.50	2.75	3.00
7 year	1.53	1.54	1.54	1.54	1.55	1.75	2.10	2.45	2.75	2.95	3.20
10 year	1.99	2.00	2.00	2.00	2.00	2.20	2.45	2.70	2.90	3.15	3.40
30 year	2.56	2.55	2.55	2.55	2.55	2.70	3.00	3.20	3.45	3.65	3.85
1m BA	1.16	1.16	1.16	1.16	1.16	1.16	1.16	1.16	1.40	1.65	2.00
3m BA	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.45	1.70	2.05
6m BA	1.29	1.35	1.35	1.35	1.35	1.35	1.35	1.35	1.60	1.85	2.20
12m BA	1.33	1.40	1.40	1.40	1.40	1.50	1.65	1.85	2.10	2.35	2.65
Prime Rate	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.25	3.50	3.85
U.S. Yield Curve											
Fed funds	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.20	0.60
3 month	0.01	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.10	0.44
6 month	0.05	0.06	0.06	0.06	0.06	0.06	0.06	0.06	0.06	0.10	0.48
1 year	0.12	0.12	0.13	0.13	0.14	0.23	0.38	0.52	0.65	0.85	1.20
2 year	0.26	0.27	0.28	0.29	0.30	0.49	0.80	1.07	1.35	1.65	2.00
3 year	0.39	0.40	0.41	0.41	0.42	0.65	1.00	1.30	1.65	2.00	2.35
5 year	0.89	0.89	0.89	0.88	0.88	1.11	1.45	1.80	2.15	2.50	2.85
7 year	1.43	1.41	1.40	1.38	1.35	1.60	1.90	2.25	2.55	2.90	3.20
10 year	1.98	1.95	1.95	1.90	1.90	2.10	2.40	2.65	2.90	3.15	3.40
30 year	2.98	3.00	2.95	2.90	2.85	3.05	3.35	3.60	3.85	4.10	4.35
1m LIBOR	0.28	0.30	0.30	0.30	0.30	0.30	0.25	0.25	0.20	0.25	0.65
3m LIBOR	0.56	0.55	0.55	0.60	0.60	0.55	0.45	0.40	0.30	0.35	0.75
6m LIBOR	0.78	0.80	0.80	0.80	0.85	0.80	0.70	0.60	0.50	0.60	0.95
12m LIBOR	1.10	1.10	1.10	1.15	1.15	1.20	1.25	1.30	1.40	1.55	1.90
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.60
Other G7 Yields											
ECB Refi	1.00	1.00	0.75	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75
10yr Bund	2.10	2.00	1.95	1.92	1.90	2.05	2.30	2.55	2.75	2.95	3.15
BoE Repo	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.65
10yr Gilt	2.17	2.10	2.10	2.05	2.05	2.25	2.60	2.90	3.15	3.40	3.65
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	1.01	1.00	1.00	1.00	1.00	1.05	1.15	1.20	1.30	1.40	1.45

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