



Highlights

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- Bank of Canada easing to continue in April, likely a 25 bp cut, with rates bottoming at 2.75% by the summer.
- Fears of U.S. weakness spreading north and a pullback in commodity prices have backed the loonie away from par. Look for the Canadian dollar to meander around current levels with a weaker bias through 2008.
- With the U.S. economy in recession, the Fed will continue to slice rates, but at a more tepid pace as inflation worries linger. Look for a pair of 25 bp cuts in Q2, with rates flooring at 1.75%.
- The U.S. dollar will have trouble gaining traction as long as the Fed continues to ease. However, hopes that financial headwinds may soon be over could give the greenback a boost.
- Treasuries should rally modestly from current levels, as the U.S. trudges through recession. Canadas should follow suit, but underperform. As economic prospects improve in H2, bond yields on both sides of the border should rise.
- Sixteen-year high inflation should continue to keep the ECB on hold. A change of tone will only come after inflation has clearly peaked, or growth slows markedly. Until then, the euro could hit new highs.
- While inflation is a concern, financial market dislocations, a weakening housing market and signs of a general slowdown will likely prompt the Bank of England to cut 25 bps in April. Look for further gradual cuts into H2.
- With no governor in place, the Bank of Japan will likely stay on hold. However, signs of weakness are multiplying, and BoJ members are talking of being "flexible", which could mean a rate cut if conditions weaken sufficiently.

Forecast Summary

	Actual 31-Mar	2008 Jun	Sep	Dec	2009 Mar	Jun	Sep	Dec
Fixed Income								
BoC overnight	3.50	3.00	2.75	2.75	2.75	3.00	3.50	3.75
10-yr Canadas	3.45	3.35	3.35	3.55	3.68	3.80	3.93	4.05
Fed funds	2.25	1.75	1.75	1.75	1.75	2.25	2.75	3.25
10-yr Treasuries	3.45	3.25	3.25	3.50	3.69	3.88	4.06	4.25
Currencies								
C\$ per US\$	1.027	1.000	1.016	1.031	1.037	1.042	1.048	1.053
US\$/€	1.58	1.60	1.55	1.50	1.46	1.43	1.39	1.35
US\$/£	1.98	1.97	1.95	1.93	1.91	1.89	1.87	1.85
¥/US\$	100	95	98	100	103	105	108	110

U.S. Rates

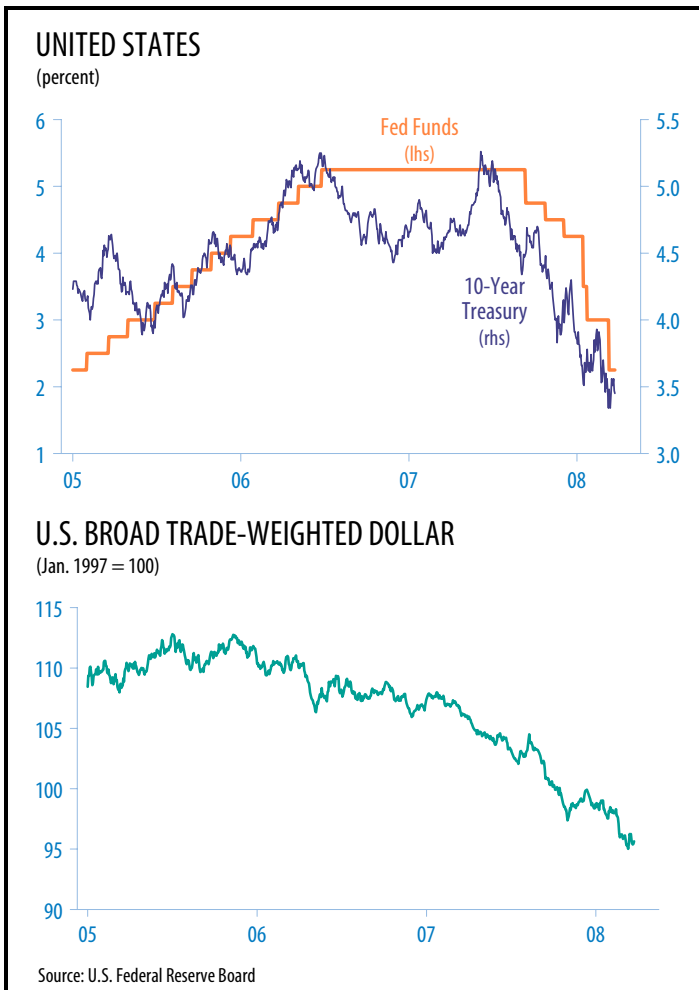
The Federal Reserve reduced its policy rates 75 bps to 2.25% for fed funds and 2.50% for the discount rate on March 18. The move capped an unprecedented display of monetary policy manoeuvrings during the preceding 11 days including a beefed-up Term Auction Facility (by \$40 billion to \$100 billion), a new \$200 billion Term Securities Lending Facility, a second round of (increased) coordinated global central bank intervention in money markets, a new Primary Dealer Credit Facility, an inter-meeting 25-bp cut in the discount rate, and a \$29 billion loan guarantee for the JPMorgan Chase-Bear Stearns deal.

The flurry of activity emphasized the extent to which the Fed was prepared to use non-interest rate measures to complement its easing efforts, and was probably a precursor of a more cautious approach to rate cuts. The FOMC Statement noted that the latest rate cut *“combined with those taken earlier, including measures to foster market liquidity, should help to promote moderate growth over time and to mitigate the risks to economic activity.”* Also signalling more nimbleness was the Statement’s assertion that *“uncertainty about the inflation outlook has increased”* and the Fed would *“act in a timely manner as needed to promote sustainable economic growth and price stability.”* At the January FOMC meeting, the timeliness of the Fed’s prospective actions was to be driven solely by the downside risks to growth. We look for the Fed

to continue cutting rates at a 25-bp-per-meeting pace, pulling the funds target down to 1.75% by mid-year, but with risks clearly skewed to larger, more prolonged parings.

Ten-year Treasury yields dropped from around 3.70% to below 3.35% during the first two-thirds of March but bounced off their lows to close the month around 3.45%. We judge that yields will continue to trend down in the months ahead, below March lows. A further 50 bps in Fed rate cuts by June is no longer fully priced in, and the data are going to worsen as the U.S. economy slips deeper into recession during the months ahead, probably prodding some bond buying by equity market refugees. Once there appears a light at the end of the U.S. recession tunnel, yields should start drifting up, with gains restrained by bank buying (in lieu of making loans in order to shore up capital) and ebbing core inflation.

The trade-weighted U.S. dollar hit record lows against the major currencies in March, as the Fed’s multi-pronged aggressive easing stood in stark contrast to other central banks. As the Fed continues to cut rates during H1, the greenback should continue to weaken, a trend exacerbated by heightened risk aversion—supporting the carry-trade currencies (Japanese yen and Swiss franc)—and the Chinese



authorities' willingness to permit faster yuan appreciation to counter local inflation pressures (lifting most other Asian currencies along with it). However, once the Fed stops easing and slower global growth during H2 digs into commodity prices (and the commodity-linked currencies), the U.S. dollar should finally stabilize.

Canadian Rates

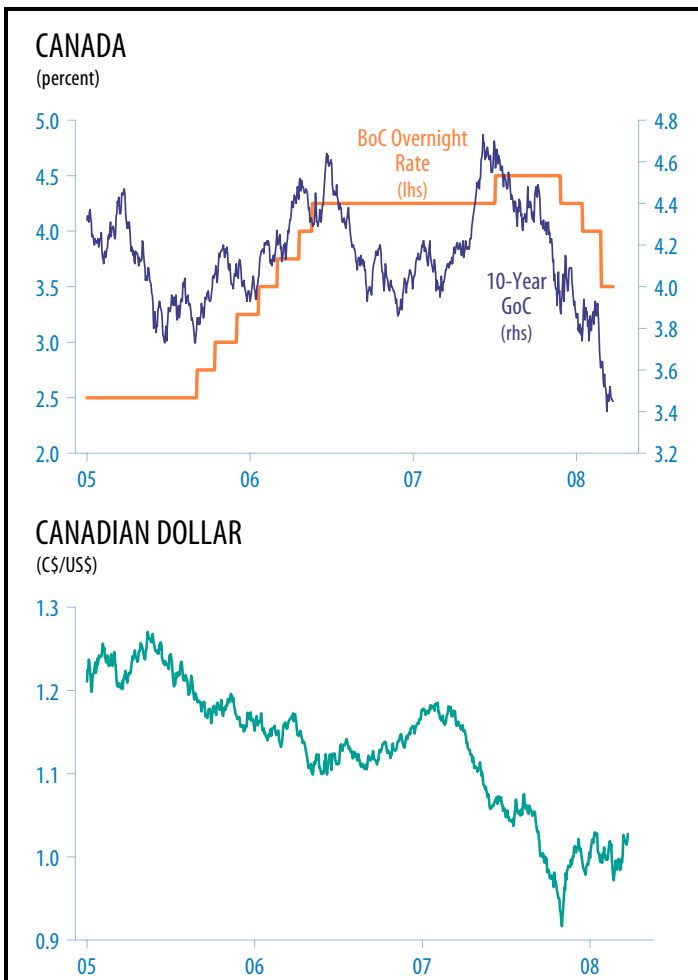
The Bank of Canada cut its policy rate 50 bps to 3.50% on March 4, stating that *"the deterioration in economic and financial conditions in the United States can be expected to have significant spillover effects on the global economy."* In turn, these spillover effects were *"intensifying"* the net downside risks to Canadian economic growth and inflation (risks that had been perceived as *"roughly balanced"* as recently as January). Since then, U.S. economic indicators have continued to deteriorate. However, the stability of U.S. financial conditions got a shot in the arm from the Fed's unprecedented myriad of policy manoeuvres.

Meantime, the latest Canadian CPI reading suggested that core inflation might no longer be on a path to a sub-1% print. Not only did the annual change drift up a notch, to 1.5% y/y in

February (the first rise in seven months), but the three-month change surged to 2.2% annualized from outright deflation at the end of last year. Elsewhere, Canadian domestic spending remains solid, and might even be picking up, if the recent reports on January retail sales along with February housing starts and employment are any guides. Even the Canadian dollar now appears to be cooperating with the Bank's US\$0.98 working assumption, a level *"not inconsistent with fundamental factors"*.

Amid less-worrisome U.S. financial conditions, these domestic developments point to incrementally improved net downside risks that might no longer be perceived by the Bank as *"intensifying"* and, thus, cause their sense of easing urgency to wane. We look for the Bank to shift back to quarter-point rate cuts, and continue them until the Fed stops cutting (which would be a signal that U.S.-related risks had been adequately addressed).

In March, Government of Canada bond yields followed U.S. Treasuries, falling from around 3.65% to 3.40% through the first two-thirds of the month, to establish record lows. This modestly underperformed Treasuries, pushing Canada-U.S. yield spreads above +10 bps from a slight negative start. The latter-month rebound in Canada yields lagged



Treasuries, paring spreads back to zero. We expect this pattern of underperforming U.S. Treasuries to continue as the latter rally. However, once yields resume rising on both sides of the border, Canada's superior inflation and fiscal fundamentals should prod narrower yield spreads.

Although Canada-U.S. overnight spreads widened during the month, from 100 bps to 125 bps, the Canadian dollar drifted down more than three cents. Softer commodity prices late in the month might have contributed to this, although the currency didn't garner much support from the prior upswing. Nevertheless, elevated commodity prices and wide overnight spreads should help offset the impact of deteriorating trade performance and GDP growth to keep the loonie close to parity in the months ahead. During the latter part of the year, as U.S. recession and tighter global credit conditions become a catalyst for slower global economic growth and even lower commodity prices, the loonie should end the year at 97 U.S. cents.

Euro

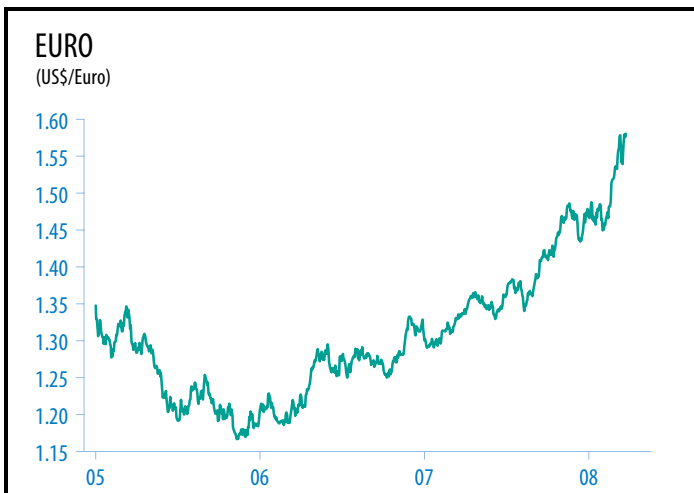
The euro continued its ascent in March to almost \$1.60. Fed rate cuts, U.S. financial turmoil and still-soft U.S. data pushed the common currency into record territory. Also fuelling the rise, Eurozone data have held up well for the most part, with retail sales even perking up after a

dismal Q4. Importantly, Germany's Ifo business confidence rose for a third straight month in March, pointing to solid Q1 growth (the Ifo correlates well with Eurozone & German GDP growth). The one blemish was the March manufacturing and services PMI figures, re-establishing the downtrend in place before February's surprise rise, perhaps signalling trouble on the horizon. However, that probably won't be enough to soften the ECB's anti-inflation stance.

ECB President Trichet maintained a hawkish tone in the March press conference. The staff projections for 2008-2009 inflation were upgraded, while growth was downgraded. Trichet also highlighted the ECB's different

policy approach from the Fed, stating that *"maintaining price stability in the medium term is our primary objective in accordance with our mandate."* Therefore, with inflation (+3.5% y/y in March, a 16-year high) expected to be sticky, the ECB is unlikely to adopt a more dovish posture unless the economic data weaken markedly.

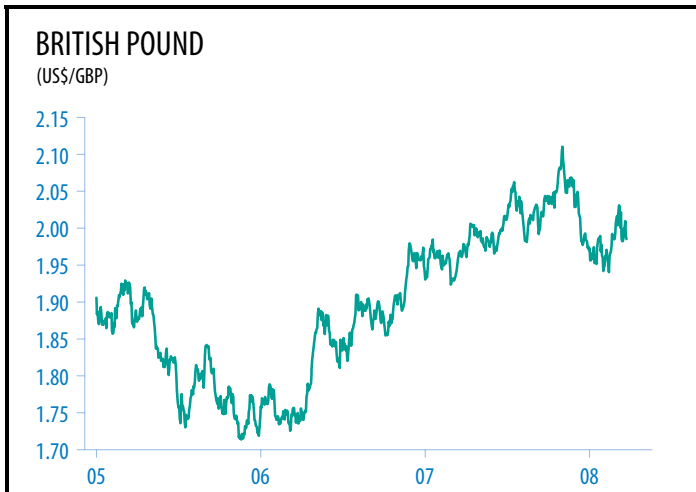
We look for weakness to start showing up in Q2. So, while we don't expect any change in ECB tone or policy this month, Trichet & Co. could sound more dovish by the summer. In the meantime, with the U.S. economy likely weakening further, there's little to restrain the euro from testing its high and potentially rising above \$1.60, at least temporarily.



Bunds were mixed in March, with 2 years selling off sharply and 10 years unchanged, flattening the curve. The short-end underperformed Treasuries and Gilts, while the longer-end performed on par with Gilts and underperformed Treasuries. As expectations of a rate cut solidify closer to mid-year, expect the curve to steepen.

British Pound

The pound continued to hang around \$2 in March, trading in a 3-to-4 cent band around the big figure, and closing the month near \$1.985. On the euro cross, the pound fell to a record low, as the Bank of England and ECB appear to be moving in opposing directions. U.K. economic data have weakened, especially on the housing front. Home prices have fallen for six consecutive months according to some indicators. This will likely put a dent in consumer spending, yet retail sales remained very firm in the first two months of 2008. Despite resilient domestic spending, growth likely slowed somewhat in Q1, and will continue to soften through at least mid-year. Look for the pound to slowly back away from the \$2 mark, and continuing to hit new lows on the euro cross.



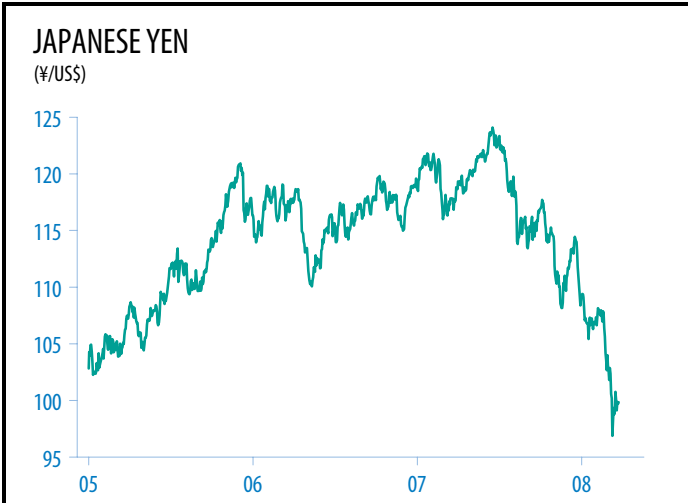
While the data alone aren't likely enough to induce a rate cut, tight credit markets and widening credit spreads should tip the balance towards easing at the April meeting. GBP LIBOR has risen consistently since late January despite February's 25-bp rate cut. Three-month LIBOR is about 75 bps above the repo rate, the widest spread since mid-December. The BoE is keenly aware of this issue, and John Gieve, responsible for the Bank's Financial Stability work and one of the two MPC members who called for a March cut, could be a little more persuasive this time around.

Similar to the ECB, however, the BoE faces stiff inflation pressures. Governor King recently stated that he expected inflation to accelerate to around 3% y/y in the next few months, but also noted that the increase was temporary, due to higher utility, energy and food costs. The Bank doesn't appear concerned about the coming higher inflation, but rather about the impact on inflation expectations. Look for further rate cuts through at least mid-year and likely at a similar pace (every other month). However, if the economy weakens or inflation turns down faster than expected, the tempo of cuts may accelerate.

The Gilts curve steepened slightly in March, with 2 years rallying and 10 years flat, outperforming Treasuries and Bunds on the short-end and underperforming at the longer-maturities. With the BoE likely cutting further, Gilts should strengthen over the next few months.

Japanese Yen

Falling global equity markets and risk aversion gave the yen a further boost in March, strengthening to its best level in a dozen years and nearly touching 95. Japan's sagging economic fundamentals could limit further gains. Industrial production fell for a second straight month in February and consumption has remained flat, squeezed by high food and energy prices, pointing to lacklustre first quarter growth. The outlook for Q2 isn't any rosier according to the latest Tankan survey, which fell to a four-year low, as Japanese businesses cope with a surging yen, rising input costs and a U.S. recession.



Meantime, the Bank of Japan is rudderless as the government is unable to agree on a suitable candidate. For now, Deputy Governor Shirakawa has filled the void, and he along with two other board members said the Bank is ready to take "flexible" policy steps if necessary. This likely means the BoJ is not entirely opposed to cutting rates if the economy were to weaken sufficiently. Despite the weaker outlook, the Bank of Japan will probably keep rates steady through the rest of the year.

Look for the yen to continue to be influenced by financial market events rather than economic data. If equity markets

swoon and test recent lows, don't be surprised if the yen strengthens further, to the dismay of Japanese exporters. JGB 10 years had a decent month, rallying down to 2½-year lows as fears of a Japanese recession grew.

Global Roundup

- The Reserve Bank of Australia kept rates steady at 7.25% after hiking in back-to-back meetings to start the year. Look for the RBA to stay on hold for a few months as it evaluates the impact of its previous tightening.
- In its battle against surging inflation (mostly due to food prices), China allowed yuan appreciation to accelerate, ending March 9.3% stronger than year-ago levels. Bank reserve requirements were hiked 50 bps to slow money supply growth.
- Balancing rising inflation pressures and downside economic risks, both the Swiss National Bank and Norges Bank left rates steady in March. The Norges Bank was, however, more hawkish, hinting at another rate hike by mid-year.

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

	Actual 31-Mar	2008 Jun	Sep	Dec	2009 Mar	Jun	Sep	Dec
Canadian Dollar								
C\$ per US\$	1.027	1.000	1.016	1.031	1.037	1.042	1.048	1.053
US\$ per C\$	0.974	1.000	0.984	0.970	0.964	0.960	0.954	0.950
Trade-Weighted	114.8	117.9	116.5	115.2	114.6	114.0	113.4	112.8
U.S. Dollar								
Trade-Weighted*	95.6	93.9	94.7	95.8	96.5	97.2	97.9	98.6
European Currencies								
Euro**	1.58	1.60	1.55	1.50	1.46	1.43	1.39	1.35
Danish Krone	4.72	4.65	4.80	5.00	5.10	5.25	5.35	5.55
Norwegian Krone	5.09	4.95	5.10	5.20	5.40	5.55	5.75	5.90
Swedish Krona	5.94	5.95	6.10	6.25	6.35	6.45	6.55	6.65
Swiss Franc	0.99	0.97	1.03	1.08	1.13	1.16	1.19	1.22
U.K. Pound**	1.98	1.97	1.95	1.93	1.91	1.89	1.87	1.85
Asian Currencies								
Chinese Yuan	7.01	6.80	6.60	6.50	6.40	6.28	6.15	6.05
Japanese Yen	100	95	98	100	103	105	108	110
Korean Won	990	935	930	925	920	915	915	910
Indian Rupee	40.0	40.0	40.1	40.2	40.3	40.3	40.4	40.4
Singapore Dollar	1.38	1.36	1.34	1.32	1.30	1.29	1.27	1.26
Malaysian Ringgit	3.20	3.15	3.10	3.05	3.00	2.95	2.90	2.85
Thai Baht	31.5	31.0	30.5	30.1	29.6	29.2	28.7	28.3
Philippine Peso	41.6	40.3	39.4	38.5	38.1	37.6	37.2	36.7
Taiwan Dollar	30.4	30.3	30.0	29.7	29.4	29.1	28.8	28.5
Indonesian Rupiah	9208	9110	9060	9030	9000	8970	8940	8910
Other Currencies								
Australian Dollar**	0.914	0.930	0.903	0.875	0.856	0.838	0.819	0.800
N.Z. Dollar**	0.787	0.800	0.775	0.750	0.733	0.715	0.698	0.680
Mexican Peso	10.64	10.70	10.85	11.00	11.10	11.20	11.30	11.40
Brazilian Real	1.75	1.78	1.82	1.86	1.90	1.94	1.97	2.00
Russian Ruble	23.5	23.8	24.0	24.2	24.4	24.6	24.8	25.0
South African Rand	8.1	8.3	8.5	8.7	8.9	9.0	9.2	9.3

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

Cross Rates

Versus Canadian Dollar

Euro (C\$/€)	1.62	1.60	1.57	1.55	1.52	1.48	1.45	1.42
U.K. Pound (C\$/£)	2.04	1.97	1.98	1.99	1.98	1.97	1.96	1.95
Japanese Yen (¥/C\$)	97	95	96	97	99	101	103	104
Australian Dollar (C\$/A\$)	0.938	0.930	0.917	0.902	0.888	0.873	0.858	0.842

Versus Euro

U.K. Pound (£/€)	0.80	0.81	0.79	0.78	0.77	0.75	0.74	0.73
Japanese Yen (¥/€)	157	152	152	150	151	150	150	149

**Interest Rate
Forecasts
Percent
(averages)**

	Actual 31-Mar	2008			2009			
		Jun	Sep	Dec	Mar	Jun	Sep	Dec
Cdn. Yield Curve								
Overnight	3.50	3.00	2.75	2.75	2.75	3.00	3.50	3.75
3 month	1.87	2.52	2.73	2.77	2.80	3.05	3.52	3.77
6 month	2.24	2.60	2.72	2.78	2.85	3.10	3.54	3.79
1 year	2.52	2.65	2.69	2.82	2.94	3.20	3.57	3.83
2 year	2.58	2.61	2.63	2.88	3.14	3.39	3.65	3.90
3 year	2.64	2.64	2.65	2.91	3.16	3.42	3.68	3.93
5 year	2.91	2.88	2.88	3.10	3.32	3.54	3.76	3.98
7 year	3.10	3.03	3.04	3.23	3.43	3.63	3.82	4.02
10 year	3.45	3.35	3.35	3.55	3.68	3.80	3.93	4.05
30 year	3.95	3.85	3.85	4.02	4.12	4.21	4.31	4.40
U.S. Yield Curve								
Fed funds	2.25	1.75	1.75	1.75	1.75	2.25	2.75	3.25
3 month	1.38	1.31	1.31	1.31	1.33	1.86	2.39	2.92
6 month	1.51	1.39	1.39	1.41	1.44	1.97	2.50	3.03
1 year	1.55	1.49	1.49	1.72	1.94	2.42	2.90	3.38
2 year	1.62	1.63	1.63	2.05	2.48	2.90	3.33	3.75
3 year	1.79	1.74	1.74	2.17	2.60	3.03	3.45	3.88
5 year	2.46	2.36	2.36	2.70	3.03	3.37	3.70	4.03
7 year	2.88	2.73	2.73	3.02	3.31	3.60	3.88	4.17
10 year	3.45	3.25	3.25	3.50	3.69	3.88	4.06	4.25
30 year	4.30	4.10	4.10	4.32	4.48	4.64	4.79	4.95

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