



## Highlights

**July 3, 2008**

Michael Gregory, CFA  
Senior Economist

Benjamin Reitzes  
Economist

- After surprising markets with no move in June, look for the Bank of Canada to remain sidelined for the rest of 2008, as upward inflation risk balances slowing growth.
- The Canadian dollar will likely continue to trade near parity through 2008. But, as global growth slows, softening commodity prices will likely weigh on the loonie.
- A renewed downturn in the economic data combined with increased upside risks to inflation should keep the Fed sidelined in August and into early 2009.
- The U.S. dollar took a beating as financial woes resurfaced in June and in early July. However, a softening economic outlook in Europe and the U.K. should put a floor under the greenback. The near term looks cloudy for the U.S. dollar, but as we move closer to 2009 a brighter picture should emerge.
- High inflation and weak data are likely to continue to whipsaw Treasuries. But, as long as the Fed looks solidly sidelined, yields should drift lower through the end of the year, but start rising with economic optimism in 2009. Canadas should follow suit, underperforming on rallies and outperforming on sell-offs.
- The ECB hiked rates today, as expected, and said it has "no bias", making an imminent second hike less probable. The euro could see some near-term weakness after a less-hawkish-than-expected press conference from Trichet.
- The Bank of England is data dependant and likely on hold. The economy is slowing sharply, but further cuts aren't likely until inflation worries ease.
- The Bank of Japan remains on pause, but is concerned about "heightened worldwide" inflation risk. The Bank's stance is unlikely to change as growth could weaken significantly in H2.

### Forecast Summary

	Actual 30-Jun	2008 Sep	Dec	2009 Mar	Jun	Sep	Dec
<b>Fixed Income</b>							
BoC overnight	3.00	3.00	3.00	3.00	3.25	3.75	4.00
10-yr Canadas	3.76	3.73	3.70	3.88	4.05	4.23	4.40
Fed funds	2.00	2.00	2.00	2.00	2.50	3.00	3.50
10-yr Treasuries	4.10	3.95	3.90	4.10	4.30	4.50	4.70
<b>Currencies</b>							
C\$/US\$	1.020	1.010	1.000	1.013	1.027	1.040	1.053
US\$/€	1.574	1.55	1.50	1.46	1.43	1.39	1.35
US\$/£	1.99	1.95	1.93	1.91	1.89	1.87	1.85
¥/US\$	106	108	110	113	115	113	110

## U.S. Rates

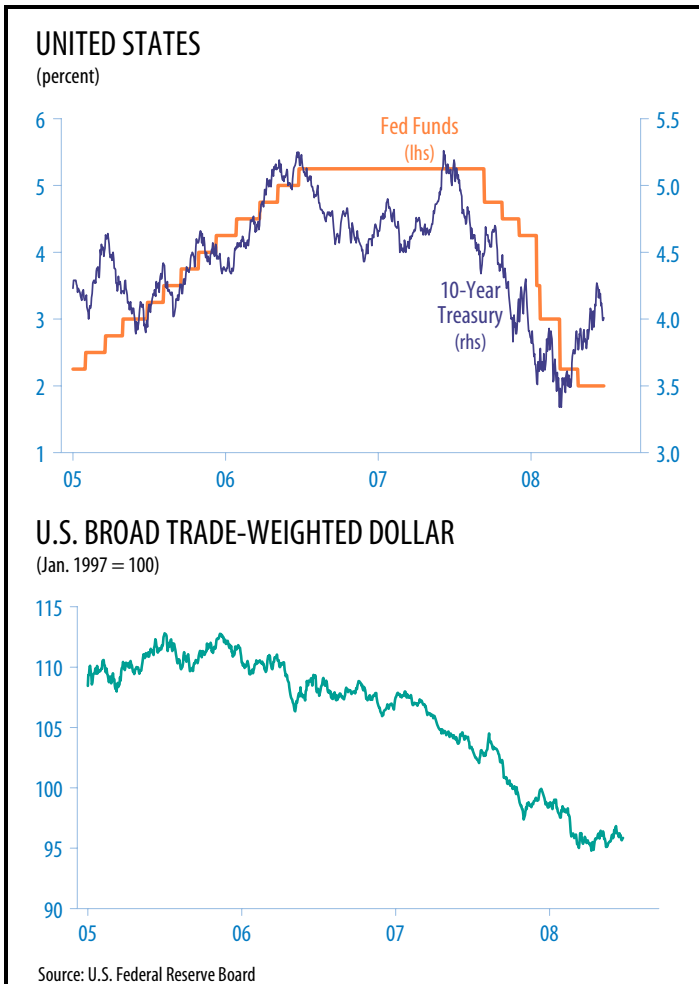
The Fed opted to keep its key policy rate unchanged at 2% on June 25, after cutting rates a cumulative (and continuous) 325 bps since last September. The risk assessment was purposely ambiguous: *“Although downside risks to growth remain, they appear to have diminished somewhat, and the upside risks to inflation and inflation expectations have increased.”* By not providing a net balance, the Fed was attempting to defuse expectations of an imminent policy move (in either direction). Nevertheless, with the one dissenting FOMC member voting for a rate hike, the policy sands at the Fed definitely appear to be shifting from easing to tightening.

We judge the Fed is still far away from raising rates. They are still injecting billions of dollars of liquidity into the money market, and until they start scaling this back, rate hikes would create a glaring policy inconsistency. Meantime, the fiscal stimulus continues to work its way through the economy. Fed rate hikes this year will require a shocking inflation surprise or signs of post-rebate momentum in consumer spending. But we expect a post-rebate retrenchment in consumer spending that will drag GDP growth to a halt (and potentially tip the economy into a full-blown recession), pushing market expectations for Fed rate hikes well into 2009 (likely to occur during

H2 by our reckoning) and pumping some limited market speculation about resumed rate cuts.

As the market’s Fed tightening speculation escalated through mid-June, the yield curve flattened as 2-year yields soared nearly 40 bps to 3.05% and 10-years rose more the 20 bps to top 4.25%. As this speculation receded, yields reversed course. By month-end, yields were a few basis points lower along the curve (4 to 7 bps). This volatile monthly performance will likely set the pattern for the next few months, as market participants continue to mull over Fed policy prospects amid a probable parade of conflicting economic reports (strengthening inflation pressure vs. weakening economic growth). We judge the latter will continue to carry marginally more weight, allowing yields to drift down modestly (by about 10 to 20 bps, with a slight steepening). The key risk remains the emergence of economic recession, which would not only result in even lower yields, but a more pronounced steepening bias as Fed rate cuts get priced in again.

The trade-weighted U.S. dollar flirted with four-month highs against the major currencies through mid-June, finding support from the Fed tightening speculation. However, as the prospect for imminent action faded, so too did the greenback’s fortunes. By month-end, the



currency erased most of its gains, and it weakened further during the first days of July leading up to the ECB rate hike. With U.S. economic performance to deteriorate during the months ahead, this would ordinarily spell trouble for the greenback. But we judge that with European growth also softening, the dollar should follow a flat profile through year-end. However, the currency risks remain on the downside, should the Fed break from what we believe is a G7 monetary policy holding pattern with a rate cut, or the ECB surprises with another rate hike.

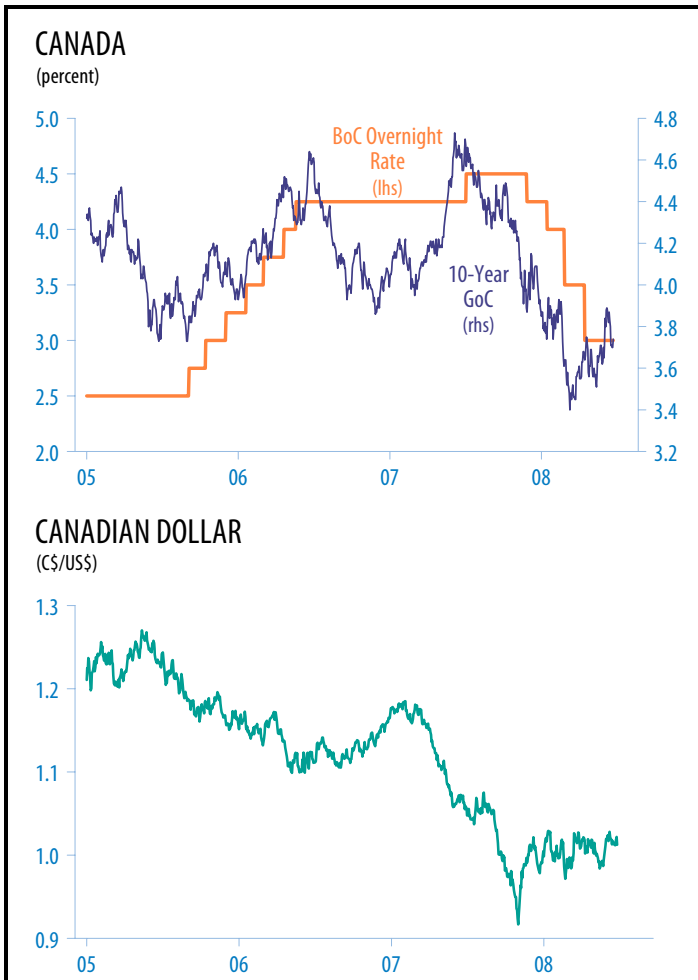
## Canadian Rates

The Bank of Canada kept its policy rate unchanged at 3% on June 10, after cutting rates a cumulative (and also continuous) 150 bps since last December. At the prior (April 22) announcement, the Bank indicated that *“some further monetary stimulus will likely be required”* but noted that it *“will depend on the evolution of the global economy and domestic demand, and their impact on inflation in Canada.”* This dependency clause ended up being triggered by the continuing surge in commodity prices, particularly since the move was unaccompanied by Canadian dollar appreciation and occurred alongside rapid wage inflation. Meantime, local credit conditions have improved more than in the other affected markets. Not only have Canadian money market credit spreads moved closer to normal levels, but the Bank

of Canada appears to have ended its provision of “special” liquidity.

At this point, the Bank judges that *“the current accommodative stance of monetary policy is appropriate”* and that the downside and upside risks to inflation are *“evenly balanced”*. Furthermore, with core inflation still running well under target at 1.5% y/y, the Bank likely has a long tightening fuse, despite headline inflation taking a run at 3%-plus. This fuse is being lengthened by the fact that the previously hot housing market has cooled considerably (which the Bank referred to as a *“welcome”* event).

Canada bonds continued their recent pattern of outperforming U.S. Treasuries in rising yield environments (most Canada-U.S. yield spreads narrowed or moved more negative through mid-June) but lagging when yields decline. The latter underperformance was compounded as the BoC failed to cut rates, causing Canada-U.S. yield spreads to close June some 5 to 15 bps wider or less negative. With both the Fed and BoC now likely on hold, we look for Canada-U.S. spreads to continue grinding wider or less negative amid the mild downtrend in yields through year-end. Canadian bond market outperformance should resume

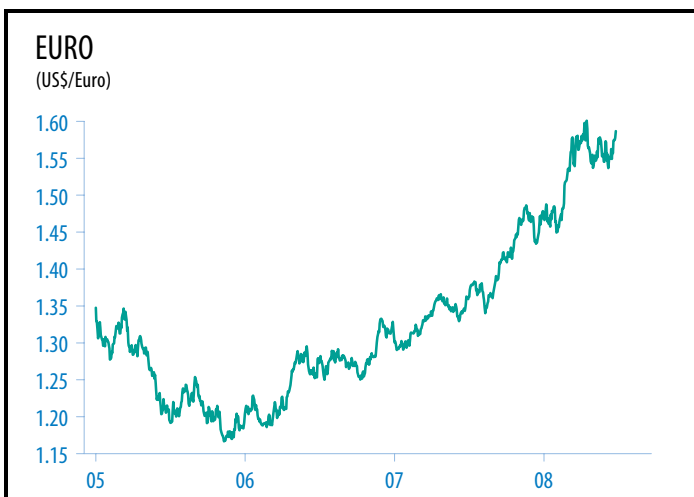


next year as markets start smelling renormalization of policy rates and Canadian yield increases are restrained by more favourable fundamentals (e.g., low inflation, twin surpluses).

The Canadian dollar traded within a 2 to 3 cent U.S. range below parity in June, down from May's above-parity close, despite the continuing climb in commodity prices and the perceived shift in Bank of Canada policy. Futures market flows in the latter half of the month confirm that C\$ sentiment has soured. Still, the pull of parity, a force that has acted on the currency all year, and elevated commodity prices should provide some support for the loonie. However, by year-end, remounting U.S. economic risks and less frothy commodity prices (amid a general G7/global slowdown) will likely clip the currency's wings, likely revisiting (and surpassing) this year's lows (in US\$) during 2009.

## Euro

The euro gained some ground in June, closing above \$1.57, only a few cents shy of April's record high. Hawkish ECB talk, a July rate hike, still-rising inflation and renewed U.S. financial sector worries near month-end gave the common currency a boost. The preliminary June CPI reading accelerated to 4.0% y/y, a 16-year high, and could accelerate further in the months ahead. But while the inflation picture is worsening, the growth outlook is deteriorating as well. European confidence measures have turned down. Notably, Germany's Ifo business confidence survey, which had held up well until recently, fell sharply for the second time in three months in June, totalling the largest 3-month decline in seven years and marking a more than 2-year low.



European growth is no doubt slowing, and Q2 will be much softer than the very strong Q1, but the ECB has said it will view Q1 & Q2 combined rather than as individual quarters. That means the ECB is likely waiting for Q3 data before it decides how quickly growth is decelerating.

After ECB President Trichet bellowed out his anti-inflation war cry, which evolved to "heightened alertness" (the last few hikes were signalled by "vigilance"), at the June post-meeting press conference, a July rate hike ensued. With inflation accelerating more than expected in June, the rate path for the rest of 2008 is much cloudier. Some ECB

officials painted a one-and-done scenario, but the ECB has inflation tunnel vision and sees signs that second round effects could be brewing in the form of rising services prices and wage demands, both of which point to potential further rate hikes. But for now, Trichet said that they have "no bias" for monetary policy, suggesting another move is not imminent. Slowing regional economies are another reason for the ECB to stay on the sidelines. Italy is stagnating, France continues to trudge along, and even Germany,

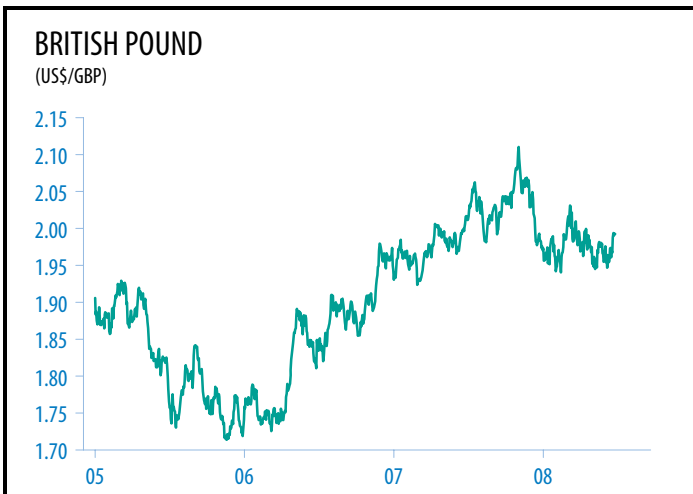
Europe's strong man, is starting to weaken. Also, the 20% fall in European equity markets year-to-date can't be viewed as positive.

Trichet's less-hawkish-than-expected press conference dragged the euro sharply weaker despite the 25-bp rate hike. The potential for further rate hikes puts some upside risk to our euro forecast, although it's unlikely to hold current lofty levels if the economic data continue to soften.

Bunds led global bond markets lower in June, 2- and 10-years sold off and the curve flattened, maintaining a slight positive slope, after a mid-month inversion. The short & long end underperformed Treasuries as inflation accelerated and with the ECB's hawk talk. The curve will likely remain flat for now, but could steepen near year-end as the economic data weaken further.

## British Pound

The pound rose in June, closing the month above \$1.99, the best level in two months. Against the euro, the pound weakened marginally. Accelerating inflation and talk from Bank of England Governor King that they "will ensure that it (inflation) falls back to the 2% target" gave the pound a boost. While inflation is accelerating, U.K. economic data are weakening. First quarter real GDP growth was revised down, consumer confidence plunged to a near 18-year low, and home prices are falling. The surge in May retail sales was a bright point, but that was likely a one-off and waning confidence points to weaker spending.



While BoE rate hikes aren't the most likely scenario, it's a possibility that cannot be ignored. Even with growth slowing sharply, the Bank expects inflation to continue to accelerate to 4% or perhaps higher later this year if oil prices continue their upward march. Such a rise is of great concern as it could dislodge inflation expectations, potentially forcing the BoE to hike rates even in the face of a very weak economy.

Overall, the Bank of England is data dependent which means rates will probably stay steady for another month. But another surge in commodity prices or a sharper downturn in economic growth could tilt the policy scales in

either direction. Inflation is a definite concern, but a softening labour market should keep wages tame, in turn keeping a lid on second-round price effects. The potential for near-term hikes should keep the pound afloat. However, once economic concerns become dominant, look for the pound to drift lower.

The Gilts curve inverted further in June with 2s underperforming 10s. Two-year Gilts weakened sharply following the above-consensus May inflation figures, but retraced some of the losses

after more measured BoE talk, weak economic data, and the sell-off in equity markets. Gilts underperformed Treasuries at the short and long end. Until the Bank signals that rate hikes are no longer a near-term possibility, the curve is like to remain about flat or slightly inverted.

## Japanese Yen

The yen weakened only mildly in June, thanks to a late-month surge as risk aversion and financial worries re-emerged. Economic data over the past month have been mostly weaker. The Q2 Tankan dropped sharply to the lowest in at least five years, as business grows increasingly pessimistic. Profits are being squeezed by rising energy prices and waning U.S. and local demand. Indeed, Japanese consumers are tightening their belts, with household



spending contracting in four of the first five months this year and 3.2% below year-ago levels. The rise in May industrial production was one bit of good news, but the gain came after two monthly declines and unless June sees an increase, production could fall for the second straight quarter.

Very little has changed for the Bank of Japan, which remained on hold for the 16th straight month in June. While BoJ officials have voiced some concern about inflation, notably about "heightened worldwide" inflation risk, rate hikes are not on the agenda. The economy is weakening and though inflation is at a decade-high, it is entirely due to higher food and energy prices. Excluding both food and

energy, CPI remains in deflation. If the U.S. economy weakens further, recession risks will mount which could prompt speculation of a rate cut. While that is a possibility, the BoJ won't ease lightly as getting rates to current levels (even if only at 0.5%) was an onerous process. For now, the BoJ is likely to stay the course and hold interest rates steady.

Changing risk tolerance or financial stresses will likely steer the yen's near-term direction. However, with Japanese economic data probably weakening further over the next few months, the yen will have trouble gaining traction. Ten-year JGBs strengthened in June, falling 8 bps and outperforming major bond markets.

## Global Roundup

The **Swedish Riksbank** hiked rates 25 bps and signalled a couple more moves up its sleeve, owing to inflation risks... Signs of slowing growth kept the **RBA** on hold in July... The **RBNZ** is moving towards rate cuts as potential recession looms... **India** hiked rates and reserve requirements 75 bps as inflation neared 12% y/y... **China** hiked its reserve ratio 100 bps and accelerated yuan appreciation in a bid to rein in inflation... No fewer than **10 central banks tightened policy in June.**

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

	Actual 30-Jun	2008 Sep	Dec	2009 Mar	Jun	Sep	Dec
<b>Canadian Dollar</b>							
C\$ per US\$	1.020	1.010	1.000	1.013	1.027	1.040	1.053
US\$ per C\$	0.981	0.990	1.000	0.987	0.974	0.962	0.950
Trade-Weighted	116.0	118.5	118.9	117.8	116.7	115.4	114.1
<b>U.S. Dollar</b>							
Trade-Weighted*	95.8	96.5	96.4	97.2	98.0	98.4	98.8
<b>European Currencies</b>							
Euro**	1.57	1.55	1.50	1.46	1.43	1.39	1.35
Danish Krone	4.74	4.80	5.00	5.10	5.25	5.40	5.55
Norwegian Krone	5.09	5.15	5.30	5.45	5.60	5.75	5.90
Swedish Krona	6.02	6.10	6.20	6.40	6.55	6.75	6.90
Swiss Franc	1.02	1.06	1.09	1.13	1.16	1.19	1.22
U.K. Pound**	1.99	1.95	1.93	1.91	1.89	1.87	1.85
<b>Asian Currencies</b>							
Chinese Yuan	6.85	6.70	6.60	6.50	6.35	6.25	6.15
Japanese Yen	106	108	110	113	115	113	110
Korean Won	1046	1030	1025	1020	1015	1010	1005
Indian Rupee	42.9	44.0	44.5	45.0	45.5	46.0	46.5
Singapore Dollar	1.36	1.35	1.33	1.31	1.29	1.28	1.26
Malaysian Ringgit	3.27	3.20	3.15	3.10	3.07	3.03	3.00
Thai Baht	33.4	32.7	32.3	31.8	31.4	30.9	30.5
Philippine Peso	44.8	43.4	42.5	42.1	41.6	41.2	40.7
Taiwan Dollar	30.3	30.1	29.8	29.5	29.2	28.9	28.6
Indonesian Rupiah	9217	9230	9170	9110	9060	9030	9000
<b>Other Currencies</b>							
Australian Dollar**	0.959	0.921	0.890	0.868	0.845	0.823	0.800
N.Z. Dollar**	0.762	0.746	0.730	0.718	0.705	0.693	0.680
Mexican Peso	10.31	10.50	10.60	10.70	10.80	10.90	11.00
Brazilian Real	1.60	1.63	1.67	1.71	1.75	1.79	1.83
Russian Ruble	23.5	23.5	23.6	23.8	23.9	24.1	24.3
South African Rand	7.8	8.0	8.2	8.4	8.6	8.8	9.0

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

## Cross Rates

### Versus Canadian Dollar

Euro (C\$/€)	1.61	1.57	1.50	1.48	1.46	1.44	1.42
U.K. Pound (C\$/£)	2.03	1.97	1.93	1.93	1.94	1.94	1.95
Japanese Yen (¥/C\$)	104	107	110	112	112	109	104
Australian Dollar (C\$/A\$)	0.978	0.930	0.890	0.879	0.868	0.855	0.842

### Versus Euro

U.K. Pound (£/€)	0.79	0.79	0.78	0.77	0.75	0.74	0.73
Japanese Yen (¥/€)	167	167	165	165	164	157	149

**Interest Rate  
Forecasts  
Percent  
(averages)**

	<b>Actual 30-Jun</b>	<b>2008 Sep</b>	<b>Dec</b>	<b>2009 Mar</b>	<b>Jun</b>	<b>Sep</b>	<b>Dec</b>
<b>Cdn. Yield Curve</b>							
Overnight	3.00	3.00	3.00	3.00	3.25	3.75	4.00
3 month	2.61	2.43	2.42	2.82	3.22	3.62	4.03
6 month	2.88	2.92	2.91	3.20	3.48	3.77	4.05
1 year	3.09	3.14	3.13	3.37	3.62	3.86	4.10
2 year	3.18	3.21	3.20	3.45	3.70	3.95	4.20
3 year	3.30	3.36	3.34	3.57	3.79	4.02	4.25
5 year	3.43	3.44	3.42	3.64	3.86	4.08	4.30
7 year	3.58	3.57	3.54	3.75	3.95	4.16	4.36
10 year	3.76	3.73	3.70	3.88	4.05	4.23	4.40
30 year	4.13	4.05	4.02	4.17	4.31	4.46	4.60
<b>U.S. Yield Curve</b>							
Fed funds	2.00	2.00	2.00	2.00	2.50	3.00	3.50
3 month	1.89	1.74	1.62	2.09	2.56	3.03	3.50
6 month	2.19	2.02	1.90	2.31	2.73	3.14	3.55
1 year	2.42	2.27	2.15	2.56	2.96	3.37	3.78
2 year	2.77	2.52	2.40	2.80	3.20	3.60	4.00
3 year	3.08	2.80	2.70	3.07	3.44	3.82	4.19
5 year	3.49	3.25	3.17	3.47	3.78	4.09	4.39
7 year	3.73	3.55	3.48	3.76	4.04	4.32	4.59
10 year	4.10	3.95	3.90	4.10	4.30	4.50	4.70
30 year	4.69	4.47	4.42	4.59	4.76	4.93	5.10

The information, opinions, estimates, projections and other materials contained herein are provided as of the date hereof and are subject to change without notice. Some of the information, opinions, estimates, projections and other materials contained herein have been obtained from numerous sources and Bank of Montreal ("BMO") and its affiliates make every effort to ensure that the contents thereof have been compiled or derived from sources believed to be reliable and to contain information and opinions which are accurate and complete. However, neither BMO nor its affiliates have independently verified or make any representation or warranty, express or implied, in respect thereof, take no responsibility for any errors and omissions which may be contained herein or accept any liability whatsoever for any loss arising from any use of or reliance on the information, opinions, estimates, projections and other materials contained herein whether relied upon by the recipient or user or any other third party (including, without limitation, any customer of the recipient or user). Information may be available to BMO and/or its affiliates that is not reflected herein. The information, opinions, estimates, projections and other materials contained herein are not to be construed as an offer to sell, a solicitation for or an offer to buy, any products or services referenced herein (including, without limitation, any commodities, securities or other financial instruments), nor shall such information, opinions, estimates, projections and other materials be considered as investment advice or as a recommendation to enter into any transaction. Additional information is available by contacting BMO or its relevant affiliate directly. BMO and/or its affiliates may make a market or deal as principal in the products (including, without limitation, any commodities, securities or other financial instruments) referenced herein. BMO, its affiliates, and/or their respective shareholders, directors, officers and/or employees may from time to time have long or short positions in any such products (including, without limitation, commodities, securities or other financial instruments). BMO Nesbitt Burns Inc. and/or BMO Capital Markets Corp., subsidiaries of BMO, may act as financial advisor and/or underwriter for certain of the corporations mentioned herein and may receive remuneration for same. "BMO Capital Markets" is a trade name used by the Bank of Montreal Investment Banking Group, which includes the wholesale/institutional arms of Bank of Montreal, BMO Nesbitt Burns Inc., BMO Nesbitt Burns Ltée/Ltd., BMO Capital Markets Corp. and Harris N. A., and BMO Capital Markets Limited. TO U. S. RESIDENTS: BMO Capital Markets Corp. and/or BMO Nesbitt Burns Securities Ltd., affiliates of BMO NB, furnish this report to U. S. residents and accept responsibility for the contents herein, except to the extent that it refers to securities of Bank of Montreal. Any U. S. person wishing to effect transactions in any security discussed herein should do so through BMO Capital Markets Corp. and/or BMO Nesbitt Burns Securities Ltd. TO U. K. RESIDENTS: The contents hereof are not directed at investors located in the U. K., other than persons described in Part VI of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001.

™ - "BMO (M-bar roundel symbol) Capital Markets" is a trade-mark of Bank of Montreal, used under licence. © Copyright Bank of Montreal.