



## Highlights

**September 3, 2008**

Michael Gregory, CFA  
Senior Economist

Benjamin Reitzes  
Economist

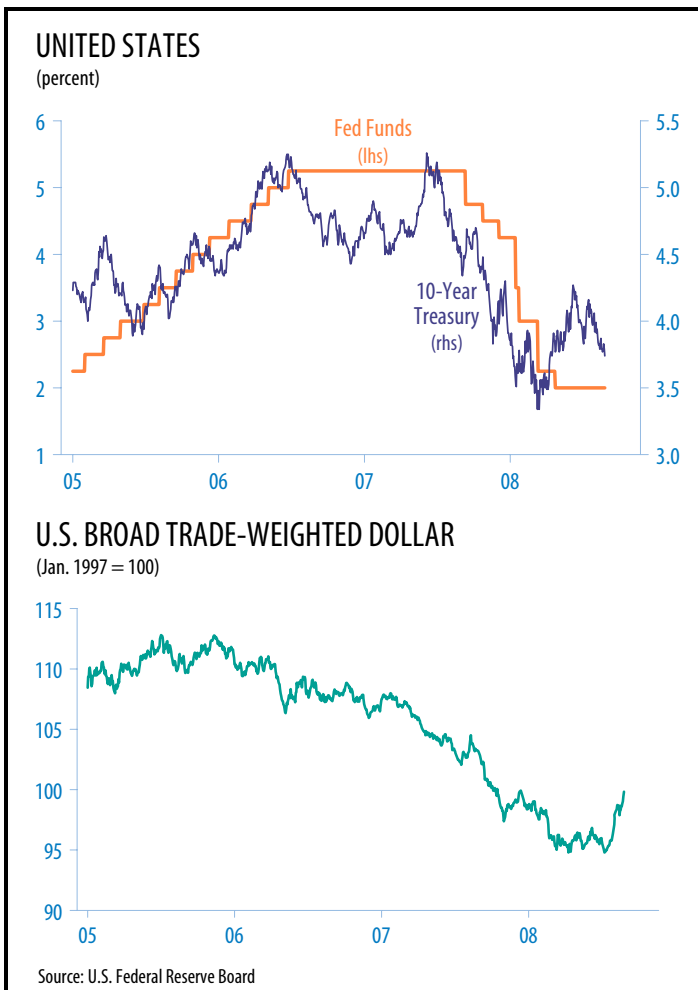
- The Bank of Canada kept its policy rate at 3% on September 3. Despite sluggish GDP growth, the Bank looks poised to remain on hold through year end barring a significant economic downturn.
- The Canadian dollar hit a one-year low in early September, pounded by easing speculation, a rallying US\$ and plunging commodity prices. A less-dovish BoC should help the loonie somewhat, but the depreciating trend will likely persist.
- The Fed remains in neutral with no clear near-term policy bias. Look for the Fed to stay on hold into 2009, as inflation worries subside and low rates nurse the economy back to health.
- The U.S. dollar continued to rally in August as the outlook in Europe, the U.K., Japan and most major economies dimmed. The six-year greenback bear run appears to be over.
- Easing inflation pressures and a flow of still-weak U.S. data should give Treasuries a lift towards year end. Canadas should follow suit but underperform with lessened BoC easing speculation.
- With Euro area inflation now cooling and the economy still weakening, the ECB tone has become a bit more dovish. A reversal of July's rate hike is likely by year end.
- With the U.K. economy on the precipice of recession, Bank of England rate cuts likely await only signs of inflation's rollover. Two cuts could be squeezed in before year end.
- The Bank of Japan appears on hold indefinitely with rates already very low, as the Japanese economy succumbs to the global slowing pressures.

### Forecast Summary

	Actual 29-Aug	2008 Sep	Dec	2009 Mar	Jun	Sep	Dec
<b>Fixed Income</b>							
BoC overnight	3.00	3.00	3.00	3.00	3.00	3.50	4.00
10-yr Canadas	3.53	3.49	3.45	3.49	3.73	3.96	4.20
Fed funds	2.00	2.00	2.00	2.00	2.25	2.75	3.25
10-yr Treasuries	3.83	3.74	3.65	3.74	3.99	4.25	4.50
<b>Currencies</b>							
C\$/US\$	1.062	1.060	1.070	1.078	1.085	1.093	1.100
US\$/€	1.467	1.45	1.43	1.41	1.39	1.37	1.35
US\$/£	1.82	1.80	1.75	1.74	1.73	1.71	1.70
¥/US\$	109	108	110	113	115	113	110

## U.S. Rates

The U.S. dollar rallied throughout August and into September, as there's been a sea-change in sentiment. Since testing its March/April bottom in mid-July, the trade-weighted US\$ has appreciated 4.5%. Economic weakness in Europe, Japan, Canada, and the global economy has underpinned the comeback in the greenback. The Fed kept its policy rate steady at 2% for the second consecutive meeting in August, and the statement had no definitive bias: "although downside risks to growth remain, the upside risks to inflation are also of significant concern." The Fed appears to be on hold well into 2009, and that is giving the US\$ a helping hand.



U.S. economic data have been mixed of late. Optimists point to the tepid signs of improvement in the housing data. Home prices, while still falling on aggregate (9 of 20 cities were higher in June according to the Case-Shiller metric), could bottom in the next few months. Existing home sales have levelled out and new home inventories continue to fall. Net exports were solid in Q2, adding 3 ppts to growth, the benefit of a weak U.S. dollar. However, downside risks remain significant. Consumer spending has buckled and is poised to decline in Q3 for the first time in 17 years. Credit markets remain strained as spreads are holding at stubbornly wide levels. Fears of a Fannie/Freddie bailout by the government, rising bank failures and a potential shortfall at the FDIC are keeping markets on their toes. Overall, despite some upbeat reports, it looks as though recession is in store for the second half of the year.

The coming economic weakness will likely shift market sentiment away from Fed hikes and towards potential easing in the second half of the year, prompting bonds to rally. But with the Fed probably stuck on the sidelines, the rally will fizzle as we move through year end. As faint signs of a recovery start to appear early in 2009, the odds of Fed rate hikes will climb and yields should follow suit.

The yield curve shifted lower in August, as bonds rallied across the maturity spectrum with lower oil prices and generally weak U.S. economic data. Markets mostly ignored the 5.5% y/y print for CPI inflation. Two-year yields rallied to 2.25% at their best, and finished the month at 2.36%, down 16 bps. Ten-years closed the month at 3.83%, also 16 bps lower and only 6 bps above the August low.

Fading economic fundamentals in other major economies will continue to give the greenback a boost. Potential rate cuts in the U.K. and Eurozone, along with already reduced rates in Australia and New Zealand, should continue to benefit the U.S. dollar well into 2009. Temporary rate cut speculation in H2 could be a damper on the dollar, but will be short-lived. It appears that the six-year bear run for the big dollar is over for now.

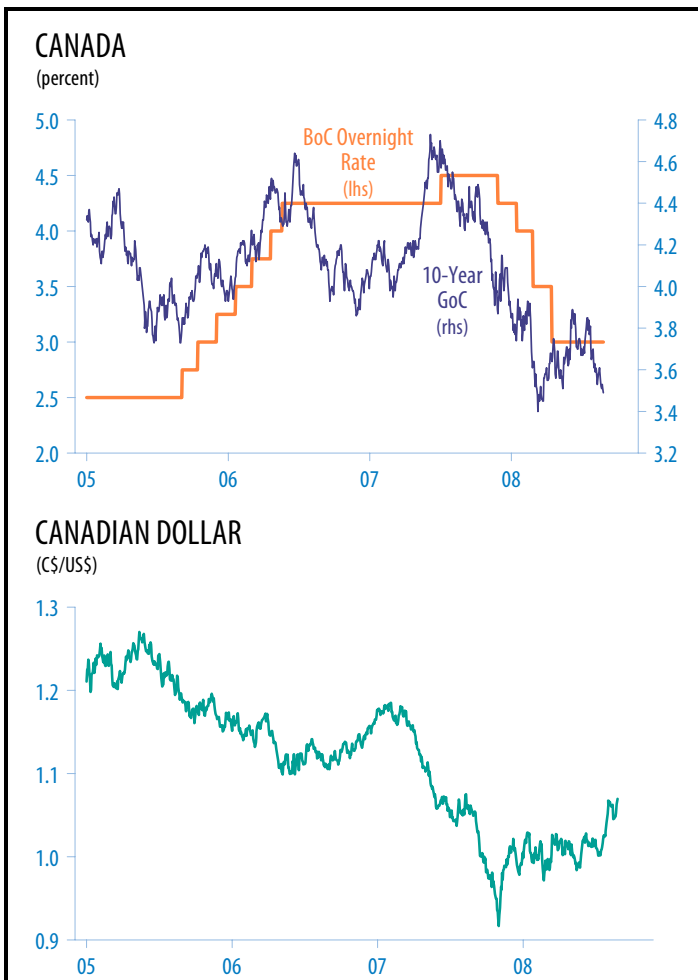
## Canadian Rates

The Bank of Canada maintained its policy rate at 3% on September 3<sup>rd</sup>, for the third straight meeting, citing that interest rates remain *"appropriately accommodative."* With markets pricing in more than one 25 bp cut by year-end going into the decision, the lack of easing hints was disappointing. The Bank pointed to increased downside risk to the U.S. economic outlook and noted that *"the level of economic activity (in Canada) is slightly lower than expected."* However, that latter dovish statement was couched in caution, as the level of activity is *"still close to the economy's production capacity."* In addition, the Bank is concerned that *"global inflation pressures remain elevated"* even as commodity prices have fallen sharply. Perhaps Carney & Co. did not want to appear complacent with

inflation well above target at 3.4% y/y.

While Canadian GDP has essentially stagnated over the past three quarters, and should remain sluggish in the second half of the year, real income growth continued to register solid gains, supporting domestic spending. The income boost from higher commodity prices is likely to fade somewhat as prices have come down, but levels remain relatively high, which should help prop up domestic demand. Overall, September's statement does not point to a cut in October and we look for the Bank to stay on hold into next year. However, with the growth outlook hinging largely on U.S. fortunes, which are expected to weaken further, lower rates cannot be fully ruled out.

Growing expectations of BoC rate cuts before year end gave GoCs a boost in August, rallying across the curve with a steepening bias. That led Canadas to outperform Treasuries in both the short- and mid-term as the Fed is expected to remain on hold through year end. Canada-U.S. yield spreads narrowed by less than 10 bps at the short end and were steady at the long end. However, the Bank's less-dovish-than-expected statement should temper rate cut expectations and weigh on bonds. With the BoC in a holding



pattern, GoC underperformance will likely reassert itself as Treasuries get buoyed by the expected shifting to net Fed easing expectations. Canadian bond market outperformance should resume next year as markets start sensing renormalization of policy rates and Canadian yield increases are restrained by more favourable fundamentals (e.g., low inflation, twin surpluses).

The broad-based U.S. dollar rally, the sell-off in commodities, and expectations for easier BoC policy all weakened the loonie in August and into the September meeting. In the minutes before the Bank's decision the Canadian dollar hit its weakest level in just over a year, but bounced back on the statement. As the U.S. dollar continues to rally, look for the loonie to continue to fade (but outperform on the crosses as Canada remains in relatively better economic health than other developed economies). The loonie could get a mild lift from expectations of Fed easing, but the overall trend will likely remain one of mild depreciation.

## Euro

The euro depreciated about 6% against the U.S. dollar during August, from above \$1.56 to under \$1.47, as regional economic clouds continued to gather and even ECB President Trichet started to sound a shade more dovish. (The slide continued through early September, to under \$1.45, as the post-Gustav drop in oil prices sparked a greenback rally.) Euro area real GDP contracted at a 0.8% annual rate in Q2. Some weakness was anticipated in Q2, predominantly in Germany as payback for a Q1 surge, but the depth and dispersion of the downturns suggest that this was more than just "technical" (e.g., France and Italy also contracted, and regional retail sales volumes dropped during both June and July). Indeed, after bracing for technical weakness alone as recently as July's policy announcement, ECB President Trichet admitted in August that mid-year growth was also expected to be weaker because of "slower expansion at the global level and dampening effects from high and volatile oil and food prices". We would also add the "significant

tightening of credit" (according to the ECB's lending survey), the sharp housing corrections in Spain and Ireland, and the lagged impact of the euro's past strength.

Although inflation remains well above the medium-term target of "below but close to 2%", it has started to roll over. The flash estimate for August was 3.8% y/y, down from the June and July cyclical high of 4.0%. During the months ahead, lower energy prices should create subdued or even negative monthly CPI changes as favourable year-ago comparisons pull down sharply the reported inflation rate, back into the 2% range for the first time in more than



a year. Once the ECB is confident that the region's recession-like economic conditions can exert an effective check on any lingering wage-price spiral risks, we look for July's rate hike (which was engineered to check those risks in the first place) to be taken back by December. During the first half of next year, a couple more quarter-point rate cuts are likely. Even so, the pressure on the euro is unlikely to fade even after the ECB pauses again, as Fed rate hikes subsequently move to the fore. We look for the euro to slip below \$1.40 by early next year.

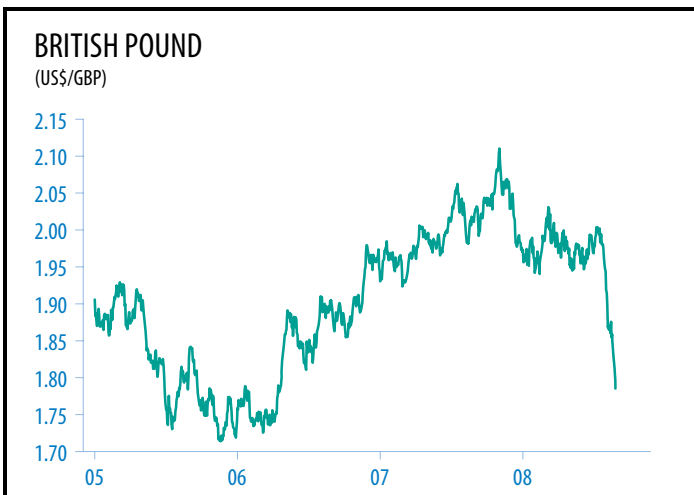
## British Pound

Sterling depreciated more than 8% against the U.S. dollar during August, from above \$1.98 to near \$1.82. The slippage continued in early September to under \$1.78, as the countdown to hefty recession-prodded Bank of England rate cuts continues. The pound also weakened to a record low against the euro. The U.K. economy stood still in Q2, the worst reading in the past 18 years. Like the ECB, the Bank of England is concerned about escalating inflation expectations. At 4.4% y/y, CPI inflation is well above the 2% target (and above the +/- 1% threshold that compels BoE Governor King to write a letter to Chancellor Darling). However, unlike the ECB, the BoE must also contend with more severe local symptoms of the global credit squeeze (the availability of credit continues to be curtailed at an increasing rate according to the BoE's latest survey) and a broader housing correction. In testament to these latter factors, U.K. house prices are falling at their fastest

pace since 1991 and retail sales plunged to their lowest level in 25 years.

Even the BoE downgraded its economic projection in last month's Inflation Report to "broadly flat" with downside risks over the next year. Although there doesn't appear yet to be growing support for rate cuts—the July and August MPC Minutes showed 7 members supporting the status quo with one member each supporting a rate hike and rate cut—sentiment should quickly shift towards easing once headline inflation starts drifting down. We judge that among the G7 central banks, the BoE will respond the most aggressively, both in timing and magnitude, to the

forthcoming mix of falling headline inflation and slowing GDP growth. We look for a couple of cuts before year end, and at least as much during the first half of next year. This should contribute to further weakness in the pound (below \$1.75 by early next year).

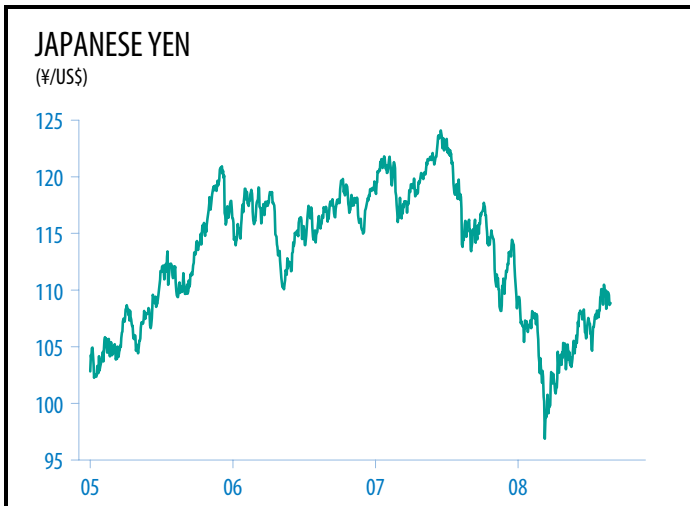


## Japanese Yen

The yen weakened slightly against the U.S. dollar during August, by about 0.8% to just under ¥109, as the Japanese economy continued to be dragged down by high oil prices and slowing G7 activity. Real GDP contracted at a 2.4% annual rate in Q2. As demand in its major North American and European trading partners falters, the Japanese economy will continue to feel the pain. However, there are some offsets. First, Japanese credit markets have been much less affected by the global squeeze. Second, with its terms of trade highly leveraged to oil prices, the economy will benefit proportionately more from any fall in prices. Third, China just replaced the U.S. as Japan's largest export market, providing an offsetting trade flow. Fourth, the government is compiling a fiscal stimulus package (although the political clouds

have surely darkened with the surprise resignation of Prime Minister Fukuda).

The Bank of Japan shifted to a more flexible policy approach in April, from its prior goal of rate renormalization. And, despite downgrading its own economic assessment during the past two policy meetings, we judge that the BoJ has the longest easing fuse among the G7 central banks. With a 0.50% policy rate there's simply not much room to cut rates. Nevertheless, in the wake of deteriorating domestic economic and political conditions, we look for the yen to continue drifting weaker, to ¥115 by early next year.



## Global Roundup

The **RBA** cut rates 25 bps to 7%, the first decrease in seven years, as economic momentum ebbs... Battling inflation, Mexico, Chile, South Korea, Indonesia, the Philippines, Thailand, and Israel hiked rates—a trend that will likely wane, and could reverse, as commodity prices have fallen sharply.

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

	Actual 29-Aug	2008 Sep	Dec	2009 Mar	Jun	Sep	Dec
<b>Canadian Dollar</b>							
C\$ per US\$	1.062	1.060	1.070	1.078	1.085	1.093	1.100
US\$ per C\$	0.942	0.943	0.935	0.928	0.922	0.915	0.909
Trade-Weighted	112.3	112.8	112.1	111.6	111.1	110.4	109.7
<b>U.S. Dollar</b>							
Trade-Weighted*	99.0	99.3	100.1	100.9	101.7	101.8	101.8
<b>European Currencies</b>							
Euro**	1.47	1.45	1.43	1.41	1.39	1.37	1.35
Danish Krone	5.08	5.15	5.20	5.30	5.35	5.40	5.55
Norwegian Krone	5.42	5.50	5.65	5.75	5.80	5.90	5.95
Swedish Krona	6.45	6.50	6.60	6.65	6.70	6.75	6.80
Swiss Franc	1.10	1.12	1.14	1.17	1.19	1.20	1.22
U.K. Pound**	1.82	1.80	1.75	1.74	1.73	1.71	1.70
<b>Asian Currencies</b>							
Chinese Yuan	6.85	6.82	6.75	6.67	6.60	6.53	6.45
Japanese Yen	109	108	110	113	115	113	110
Korean Won	1089	1100	1140	1160	1190	1175	1160
Indian Rupee	43.9	45.0	45.5	45.0	45.0	45.5	46.0
Singapore Dollar	1.42	1.42	1.42	1.43	1.44	1.42	1.41
Malaysian Ringgit	3.39	3.41	3.42	3.44	3.44	3.41	3.37
Thai Baht	34.2	34.4	34.7	34.9	35.0	34.6	34.1
Philippine Peso	46.0	43.4	42.5	42.1	41.6	41.2	40.7
Taiwan Dollar	31.6	31.7	31.8	32.0	32.1	31.7	31.2
Indonesian Rupiah	9149	9160	9220	9280	9340	9280	9220
<b>Other Currencies</b>							
Australian Dollar**	0.859	0.840	0.820	0.803	0.785	0.768	0.750
N.Z. Dollar**	0.700	0.690	0.670	0.653	0.635	0.618	0.600
Mexican Peso	10.28	10.40	10.45	10.50	10.60	10.70	10.80
Brazilian Real	1.63	1.65	1.68	1.70	1.73	1.75	1.78
Russian Ruble	24.6	25.2	25.3	25.4	25.4	25.5	25.5
South African Rand	7.7	7.8	7.9	8.0	8.1	8.2	8.3

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

## Cross Rates

### Versus Canadian Dollar

Euro (C\$/€)	1.56	1.54	1.53	1.52	1.51	1.50	1.49
U.K. Pound (C\$/£)	1.94	1.91	1.87	1.88	1.88	1.87	1.87
Japanese Yen (¥/C\$)	103	102	103	105	106	103	100
Australian Dollar (C\$/A\$)	0.912	0.890	0.877	0.865	0.852	0.839	0.825

### Versus Euro

U.K. Pound (£/€)	0.80	0.81	0.82	0.81	0.80	0.80	0.79
Japanese Yen (¥/€)	160	157	157	159	160	155	149

**Interest Rate  
Forecasts  
Percent  
(averages)**

	Actual 29-Aug	2008 Sep	Dec	2009 Mar	Jun	Sep	Dec
<b>Cdn. Yield Curve</b>							
Overnight	3.00	3.00	3.00	3.00	3.00	3.50	4.00
3 month	2.40	2.40	2.38	2.40	2.94	3.48	4.01
6 month	2.64	2.64	2.62	2.64	3.10	3.56	4.03
1 year	2.68	2.64	2.62	2.64	3.11	3.58	4.05
2 year	2.71	2.67	2.65	2.67	3.15	3.62	4.10
3 year	2.87	2.82	2.80	2.78	3.23	3.68	4.12
5 year	3.02	2.96	2.93	2.89	3.31	3.73	4.15
7 year	3.25	3.20	3.17	3.08	3.44	3.81	4.18
10 year	3.53	3.49	3.45	3.49	3.73	3.96	4.20
30 year	4.01	4.00	3.96	3.97	4.18	4.38	4.59
<b>U.S. Yield Curve</b>							
Fed funds	2.00	2.00	2.00	2.00	2.25	2.75	3.25
3 month	1.72	1.72	1.70	1.72	2.23	2.74	3.25
6 month	1.97	1.93	1.90	1.93	2.37	2.81	3.25
1 year	2.17	2.12	2.05	2.12	2.61	3.10	3.59
2 year	2.36	2.26	2.15	2.26	2.80	3.34	3.88
3 year	2.60	2.51	2.41	2.49	3.01	3.52	4.04
5 year	3.10	3.00	2.90	2.91	3.35	3.79	4.22
7 year	3.45	3.37	3.28	3.24	3.63	4.01	4.40
10 year	3.83	3.74	3.65	3.74	3.99	4.25	4.50
30 year	4.43	4.36	4.27	4.33	4.55	4.78	5.00

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.