



## Highlights

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- Following the Bank of Canada's 50 bp cut to 0.5% in March, we look for a final 25 bps of easing and for a narrowing of its target band to +/-12.5 bps. April's MPR will likely also show a sharply downgraded forecast. Look for the Canadian dollar to remain weak through mid-year as global conditions stay soft, but strengthen in H2 as sentiment improves.
- Credit and quantitative easing are the prime tools for the Fed, with fed funds likely to stay essentially at zero into 2010. The Fed is focused on the recently initiated Term Asset-Backed Securities Lending Facility (TALF) and purchases of agency securities to unfreeze credit markets.
- The safe-haven bid should benefit the U.S. dollar until markets smell a recovery. Still-increasing monetary and coming fiscal stimulus should boost the economy starting in H2.
- Supply concerns continue to weigh on Treasuries, but poor economic data, deflation fears and potential Fed purchases should boost bonds through mid-year. Once recovery is on the horizon, yields should rise due to increasing supply. Canadas will likely follow suit, but underperform on rallies and outperform on sell-offs.
- Further ECB easing is likely in March, with a 50 bp cut expected. The ECB appears to finally understand the gravity of the downturn and may begin to openly consider quantitative/credit easing, which doesn't bode well for the euro.
- The Bank of England will likely cut a final 50 bps to 0.5% in March. Look for quantitative easing to potentially start this month as well. Low rates, a bleak outlook, sovereign credit worries and banking woes will weigh on the pound.
- The Bank of Japan continues to expand efforts to stabilize financial markets. Look for more of the same to ensure banks continue to lend.

### Forecast Summary

	Actual 27-Feb	2009 Mar	Jun	Sep	Dec	2010 Mar	Jun
<b>Fixed Income</b>							
BoC overnight	1.00	0.50	0.25	0.25	0.25	0.25	0.75
10-yr Canadas	3.12	3.05	2.85	2.85	2.95	3.05	3.15
Fed funds	0.13	0.13	0.13	0.13	0.13	0.13	0.50
10-yr Treasuries	3.02	2.90	2.50	2.50	2.75	2.95	3.15
<b>Currencies</b>							
C\$/US\$	1.272	1.255	1.275	1.245	1.200	1.188	1.175
US\$/€	1.268	1.28	1.25	1.30	1.35	1.38	1.40
US\$/£	1.43	1.40	1.35	1.39	1.42	1.45	1.49
¥/US\$	98	95	95	98	100	103	105

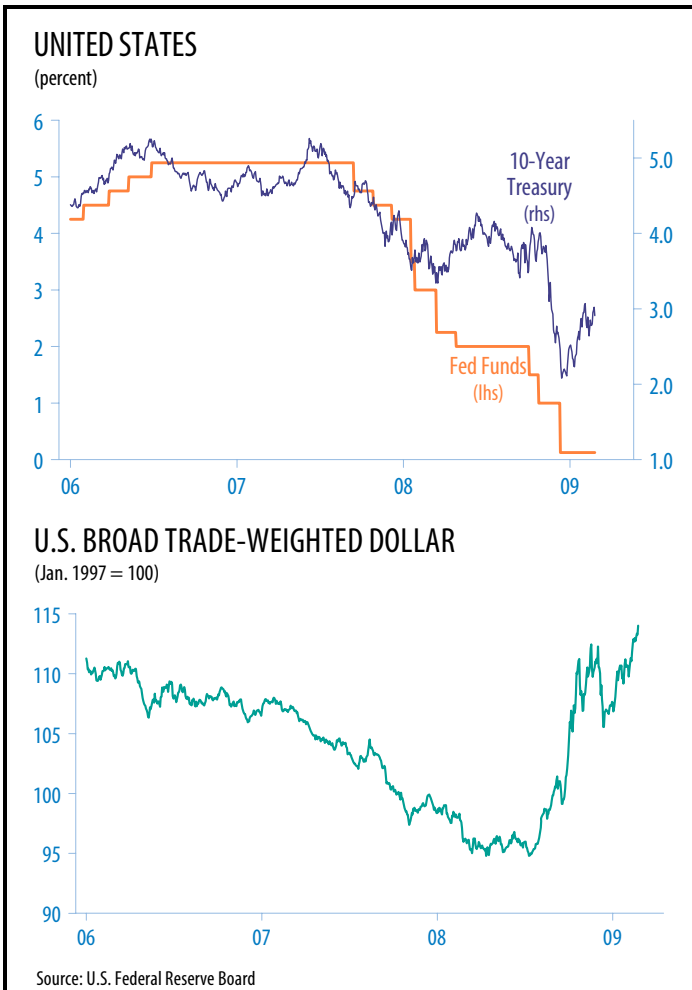
## U.S. Rates

With its policy rate at the lower bound (0% to 0.25%), the Federal Reserve expanded its quantitative easing efforts last month. The previously announced Term Asset-Backed Securities Loan Facility (TALF) was expanded from (up to) \$200 billion to \$1 trillion, with eligible assets broadened to eventually include non-Agency mortgage-backed securities and commercial MBS along with the originally planned ABS backed by vehicle, credit card, student and small business loans. And, the intention to purchase up to \$600 billion in Agency debt/MBS was reiterated. The TALF is just starting up, while the Fed has already purchased \$107 billion in Agency securities. This means the Fed is prepared to grow its current \$1.9 trillion balance sheet by up to 78% during the period ahead (a balance sheet that is already 118% larger than the level prevailing before the mid-September bankruptcy of Lehman Brothers). Meanwhile, the Fed continues to commit to keeping its policy rate low “for some time”, and we don’t look for any rate changes until at least a year from now.

It appears the Fed will focus on the TALF and Agency products to help pull down private sector borrowing costs, for the time being, instead of purchasing Treasuries (the Fed is not convinced about the efficacy of the latter in achieving lower private sector borrowing costs). Dimming market hopes for Treasury purchases combined with record-sized

Treasury auctions to push yields up modestly last month, ranging from more than 5 bps for 2 years (to around 1.00%) to around 15 bps for 10 years (slightly above 3%). During the months ahead, we look for a break from this theme of rising yields along a steepening curve, as the global credit crisis once again intensifies (probably stoked by bank balance sheet revelations on both sides of the Atlantic), and as U.S. and global economic indicators stubbornly refuse to broadly display positive second derivatives (the first sign of eventual turnaround). Long Treasury yields should drift down, but not test their recent lows owing to supply concerns. During the second half of this year, when U.S. and global economic inflection points become evident, the rising-yields-along-a-steepening-curve trend should resume (at least until the market starts smelling policy rate changes). Importantly, rising domestic demand for Treasuries (from banks and individuals) should alleviate some of the concerns over net foreign purchases, keeping the inevitable sell-off restrained for now.

The trade-weighted U.S. dollar appreciated around 3% last month, as global risk concerns continued to mount,



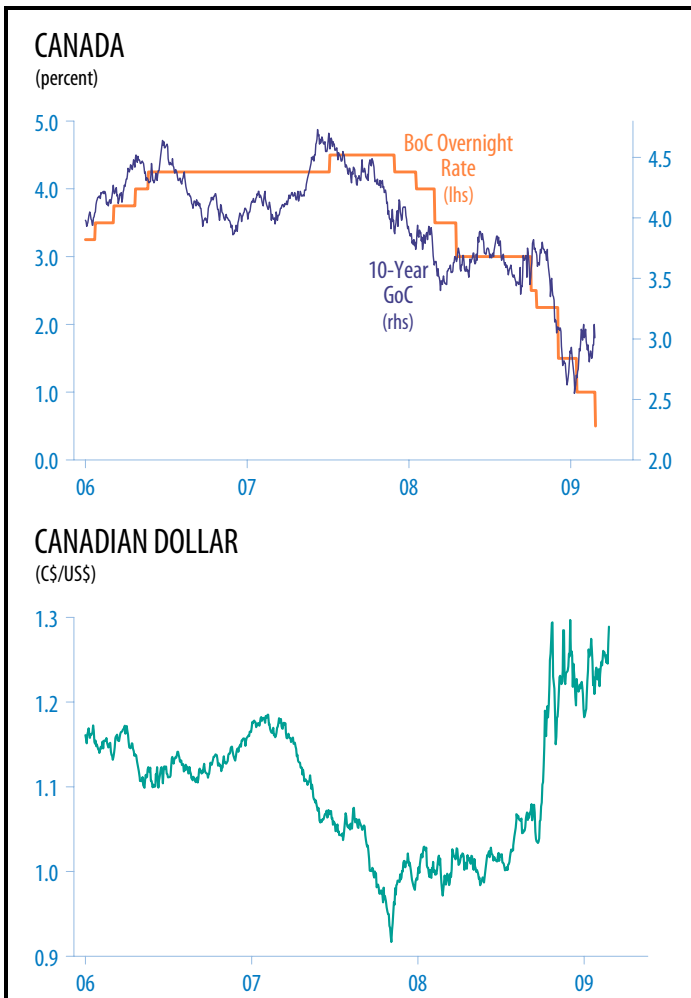
particularly surrounding emerging Europe's economic and financial situation, along with Japan's deepening recession. We look for greenback strength to continue, particularly given the forecast for another flare-up of global fear. Eventually, ebbing global risk aversion will start denting the dollar (during 2009:H2), with downside risks reflecting the external financing of the fiscal deficit (which the Obama Administration is projecting will top a combined \$2.9 trillion this year and next).

## Canadian Rates

The Bank of Canada cut its policy rate 50 bps to 0.50% on March 3, stating that the U.S. (and global) recession is proving *"particularly challenging for Canada"*. Although the Bank remains confident that *"once the global financial system stabilizes and global growth recovers, the underlying strength of the Canadian economy and financial sector should ensure a more rapid recovery in Canada than in most other industrialized economies"*, they acknowledge that this is fast becoming a 2010 story (not 2009:H2 as portrayed in January's Monetary Policy Report Update), with core inflation possibly falling below 1% y/y during the interim. In response, the Bank said its policy rate *"can be expected to remain at this level or lower at least until there are clear signs that excess supply in the economy is being taken up"*, which we judge is at least a year from now. With hardly any rate cut room left (we look for one final

25-bp slice next month), the Bank said it is *"refining the approach it would take to provide additional monetary stimulus, if required, through credit and quantitative easing"*, which will be outlined in April's MPR. We suspect the initial phases of QE in Canada will involve significantly lengthening the maturities of existing liquidity measures (years instead of months) and providing direct support for asset-backed securities markets.

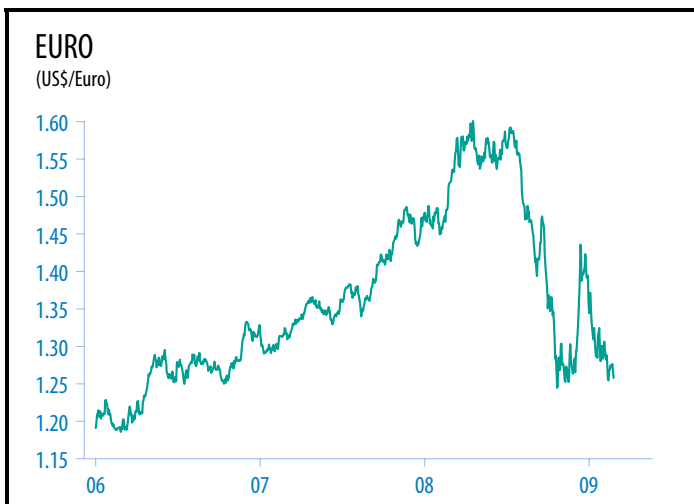
The Government of Canada bond yield curve steepened last month as short-term yields fell in anticipation of Bank of Canada easing, and the long end was mixed. Supply pressures are weighing on the Canadian bond market as well (bigger and more frequent auctions along with smaller buybacks), but Canada-U.S. yield spreads still narrowed during the month (e.g., from near 20 bps to around 10 bps in the 10-year area). This pattern of outperformance will probably be repeated during H2 and in 2010. However, during the next few months, as Treasuries again find support from more global economic and financial market malaise, falling Canadian yields will likely lag their U.S. counterparts (10-year spreads could move back to 40 bps, absorbing half the rally stateside).



The Canadian dollar depreciated more than 3½% against the greenback last month, reflecting increased global risk aversion (which benefitted the U.S. dollar), lower commodity prices (Canada’s trade-weighted basket hit its lowest level in more than four years), and Bank of Canada easing speculation. As the global economy takes one more turn for the worse (again... bad for commodities and good for USD), we look for the loonie to hover within the \$1.25 to \$1.30 range. But, as the dark global clouds start dissipating in 2009:H2, the Canadian dollar should strengthen closer to \$1.20 by year end.

## Euro

The outlook for the Euro area deteriorated further in February, laying the groundwork for another aggressive rate cut by the ECB. Confidence has been shattered by the string of bad news and falling equity markets; both Euro economic confidence and Germany’s Ifo survey of business confidence hit record lows. Unemployment is rising across the region, with the jobless rate up almost a full percentage point from the lows hit in late 2007/early 2008.

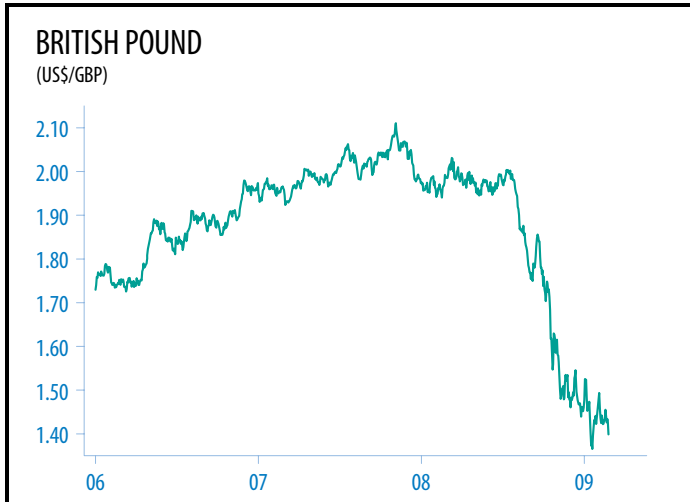


After February’s pause, we are likely to see another 50 bp easing in March. The ECB might also signal that they finally understand the gravity of the downturn and that rates may have to move to 1% or even lower, and that quantitative or credit easing might be necessary. Inflation remains tame at 1.2% y/y in February and shouldn’t keep the ECB from easing. Indeed, inflation is likely to continue slowing and could turn negative for a few months around mid-year. A widening output gap will keep a lid on price pressures, and what we expect to be a slow recovery means the gap could remain wide for an extended period.

The euro weakened a couple of cents in February amid the weak data and ongoing worries about the stability of the currency union. Sovereign credit spreads widened on the month, with German, Italian, and French (among others) spreads moving out to a record high. Markets are worried about the fiscal health of Europe, while the lack of a coordinated fiscal policy could hamstring any recovery. These worries along with the potential for more aggressive action from the ECB should keep the euro under pressure.

## British Pound

The U.K. economy is in shambles: home prices are falling at a double-digit pace, large swathes of the banking sector have been nationalized and job losses are multiplying (the list could continue). Real GDP contracted at a 6% annualized rate in Q4 (the most in 29 years), and Q1 will likely see a similar decline, marking the worst recession since the early



1980s. One of the only pieces of positive news is retail sales which have risen three straight months to January (odd considering the weakness in employment and elsewhere).

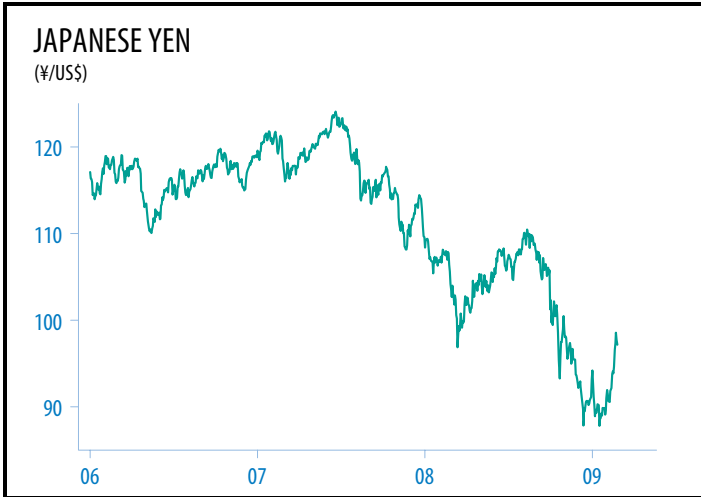
Banking sector weakness has prompted bold action by the U.K. Treasury. Following the U.S. Treasury's example with Bank of America and Citigroup, the U.K. created an "Asset Protection Scheme" which will insure pools of bank assets against catastrophic losses. The program should ease concerns about the U.K. banking system, but it could increase funding pressures on the government if asset values fall sharply and it needs to absorb some losses.

Look for the Bank of England to cut its policy rate 50 bps to 0.5%, which will likely mark the bottom for U.K. rates. Pending approval from Treasury, the BoE has indicated it will start quantitative easing as soon as possible (likely this month). The Bank could buy all types of fixed income assets, with Gilt purchases probable. The statement should provide some guidance to the size of the quantitative easing as well. The BoE is obviously very concerned about deflation, and funding government spending is the most effective weapon—expect the money supply to surge.

The Asset Protection Scheme, Asset Purchase Facility, and soon to be implemented BoE quantitative easing are all negatives for the pound. The first two potentially boost government funding commitments, and printing money to fund government spending is never good for a currency. Don't be surprised if the pound revisits the 24-year lows hit in late January.

## Japanese Yen

Japan has been hardest hit among industrialized economies, with Q4 GDP contracting at the fastest pace since 1974 (-12.7% annualized). Making matters worse, Q1 likely won't be any better, with another double-digit decline in real GDP likely. Industrial production and exports have collapsed, leading to rising job losses and weakening already anemic domestic demand. After declining 12% in the fourth quarter, industrial production fell another 10% in January alone, setting up a decline of at least 15% for the quarter (likely much worse). The global drop in demand pushed Japanese exports down 45% y/y in January.



As the economy suffers through what will likely be its deepest post-WWII recession, the Bank of Japan is expanding its non-traditional monetary policy actions. With no more room to cut, the BoJ has taken to buying assets to ensure companies have access to funding, and to support financial markets. The Bank has announced it will purchase up to ¥1 trillion (about US\$10 billion) of equities from banks and short-term corporate bonds. Those moves come in addition to expanded collateral eligibility for repurchase agreements with the Bank and purchases of up to ¥3 trillion in commercial paper and ABCP.

Over the past six months, risk appetite has been the key driver for the yen, markedly strengthening the currency. However, this trend may have hit the wall at the end of February with the yen weakening sharply despite heightened risk aversion. The extreme weakness of the Japanese data finally caught up to the currency. The yen has likely seen its best levels already and the new trend should be flat to weaker. Also, once there's a whiff of global recovery, yen weakness should accelerate with rising risk appetite.

## Global Roundup

Global interest rates have fallen sharply as central banks react to the steep slowdown. Look for rate cuts to continue in March, but perhaps at a less aggressive pace with monetary policy already loosened significantly. (The Reserve Bank of Australia holding rates steady is a prime example.) Fiscal stimulus should start to have an impact by mid-2009 and help build the foundation for a recovery in 2010.

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

	Actual 27-Feb	2009 Mar	Jun	Sep	Dec	2010 Mar	Jun
<b>Canadian Dollar</b>							
C\$ per US\$	1.272	1.255	1.275	1.245	1.200	1.188	1.175
US\$ per C\$	0.786	0.797	0.784	0.803	0.833	0.842	0.851
Trade-Weighted	96.5	97.6	96.4	98.5	101.8	102.8	103.7
<b>U.S. Dollar</b>							
Trade-Weighted*	114.0	113.7	115.3	113.8	111.8	110.8	109.8
<b>European Currencies</b>							
Euro**	1.27	1.28	1.25	1.30	1.35	1.38	1.40
Danish Krone	5.88	5.85	5.95	5.75	5.55	5.45	5.35
Norwegian Krone	7.03	7.00	7.25	7.00	6.75	6.60	6.40
Swedish Krona	9.01	9.00	9.50	9.15	8.75	8.45	8.10
Swiss Franc	1.17	1.17	1.22	1.19	1.16	1.13	1.11
U.K. Pound**	1.43	1.40	1.35	1.39	1.42	1.45	1.49
<b>Asian Currencies</b>							
Chinese Yuan	6.84	6.85	6.85	6.80	6.78	6.75	6.70
Japanese Yen	98	95	95	98	100	103	105
Korean Won	1534	1550	1590	1555	1525	1500	1470
Indian Rupee	51.0	51.0	51.3	51.5	51.3	50.0	49.8
Singapore Dollar	1.55	1.55	1.56	1.54	1.52	1.50	1.48
Malaysian Ringgit	3.71	3.70	3.73	3.69	3.66	3.62	3.59
Thai Baht	36.2	36.0	36.1	35.7	35.2	34.8	34.3
Philippine Peso	48.7	48.5	50.0	49.1	48.2	47.3	46.4
Taiwan Dollar	35.0	35.0	35.3	34.9	34.4	34.0	33.5
Indonesian Rupiah	11976	12000	12220	11950	11650	11400	11100
<b>Other Currencies</b>							
Australian Dollar**	0.640	0.640	0.630	0.665	0.700	0.713	0.725
N.Z. Dollar**	0.501	0.510	0.500	0.530	0.560	0.583	0.605
Mexican Peso	15.23	15.50	15.65	15.80	15.70	15.60	15.50
Brazilian Real	2.39	2.42	2.45	2.50	2.50	2.48	2.45
Russian Ruble	35.9	37.5	39.0	39.5	40.0	40.5	41.0
South African Rand	10.1	10.3	10.4	10.5	10.6	10.7	10.7

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

## Cross Rates

### Versus Canadian Dollar

Euro (C\$/€)	1.61	1.61	1.59	1.62	1.62	1.63	1.65
U.K. Pound (C\$/£)	1.82	1.76	1.72	1.73	1.70	1.72	1.75
Japanese Yen (¥/C\$)	77	76	75	79	83	87	89
Australian Dollar (C\$/A\$)	0.814	0.803	0.803	0.828	0.840	0.846	0.852

### Versus Euro

U.K. Pound (£/€)	0.89	0.91	0.93	0.94	0.95	0.95	0.94
Japanese Yen (¥/€)	124	122	119	127	135	142	147

**Interest Rate  
Forecasts  
Percent  
(averages)**

	Actual 27-Feb	2009 Mar	Jun	Sep	Dec	2010 Mar	Jun
<b>Cdn. Yield Curve</b>							
Overnight	1.00	0.50	0.25	0.25	0.25	0.25	0.75
3 month	0.59	0.50	0.25	0.25	0.25	0.45	0.95
6 month	0.66	0.60	0.40	0.40	0.40	0.60	1.10
1 year	0.76	0.70	0.50	0.50	0.70	1.00	1.40
2 year	1.15	1.05	0.75	0.75	1.20	1.65	1.95
3 year	1.64	1.55	1.25	1.25	1.60	1.95	2.25
5 year	2.05	1.95	1.70	1.70	2.00	2.30	2.55
7 year	2.26	2.20	1.95	1.95	2.30	2.70	2.90
10 year	3.12	3.05	2.85	2.85	2.95	3.05	3.15
30 year	3.70	3.65	3.45	3.45	3.50	3.60	3.65
<b>U.S. Yield Curve</b>							
Fed funds	0.13	0.13	0.13	0.13	0.13	0.13	0.50
3 month	0.26	0.25	0.20	0.20	0.20	0.20	0.60
6 month	0.45	0.40	0.30	0.30	0.30	0.30	0.65
1 year	0.72	0.65	0.45	0.45	0.65	0.85	1.15
2 year	1.00	0.95	0.80	0.80	1.15	1.55	1.80
3 year	1.40	1.35	1.10	1.10	1.50	1.90	2.15
5 year	1.99	1.90	1.65	1.65	2.00	2.35	2.55
7 year	2.69	2.60	2.25	2.25	2.50	2.75	2.95
10 year	3.02	2.90	2.50	2.50	2.75	2.95	3.15
30 year	3.71	3.60	3.20	3.20	3.45	3.65	3.85