



## Highlights

**June 1, 2009**

Michael Gregory, CFA  
Senior Economist

Benjamin Reitzes  
Economist

- Look for no change in Bank of Canada policy this month, as only a major shock will push the Bank into the quantitative easing (QE) arena. However, the Canadian dollar's recent surge might get a mention and could eventually be that major shock. We expect the loonie to continue its advance, with a mid-summer hiccup as auto-related weakness hits the data.
- The Fed's committed to "exceptionally low levels of the federal funds rate for an extended period", and has executed about one-third of planned asset purchases, leaving rates with nowhere to go and little need to increase its QE commitments at this time.
- Improving global economic data have ended the safe-haven bid and weakened the U.S. dollar. While we expect the greenback to trend lower, look for a short reprieve after mid-year as markets lose patience with a slow-developing recovery.
- Treasuries weakened sharply in May amid rapidly rising supply, better data and sovereign credit worries. While the sell-off likely won't continue at this pace, these themes will continue to weigh on Treasuries through next year. Canadas will likely follow suit, but underperform on rallies and outperform on sell-offs.
- The ECB will lay out the details of its €60 bln covered bond purchases announced in May. No other action is expected, but rapidly slowing inflation could spark some deflation concern among ECB council members.
- The Bank of England boosted its Asset Purchase Facility to £125 bln in May, so don't expect anything significant from the June meeting.
- Tentative signs of stabilization and sizeable fiscal stimulus should keep an already extremely active Bank of Japan on the sidelines.

### Forecast Summary

	Actual 29-May	2009 Jun	Sep	Dec	2010 Mar	Jun	Sep	Dec
<b>Fixed Income</b>								
BoC overnight	0.25	0.25	0.25	0.25	0.25	0.25	0.75	1.25
10-yr Canadas	3.39	3.40	3.35	3.60	3.80	4.00	4.25	4.45
Fed funds	0.13	0.13	0.13	0.13	0.13	0.50	1.00	1.50
10-yr Treasuries	3.47	3.55	3.50	3.75	4.00	4.25	4.50	4.75
<b>Currencies</b>								
C\$ per US\$	1.092	1.100	1.138	1.100	1.075	1.050	1.025	1.000
US\$/€	1.41	1.41	1.36	1.40	1.44	1.48	1.51	1.55
US\$/£	1.62	1.63	1.58	1.65	1.71	1.78	1.84	1.90
¥/US\$	95	98	97	100	101	103	104	105

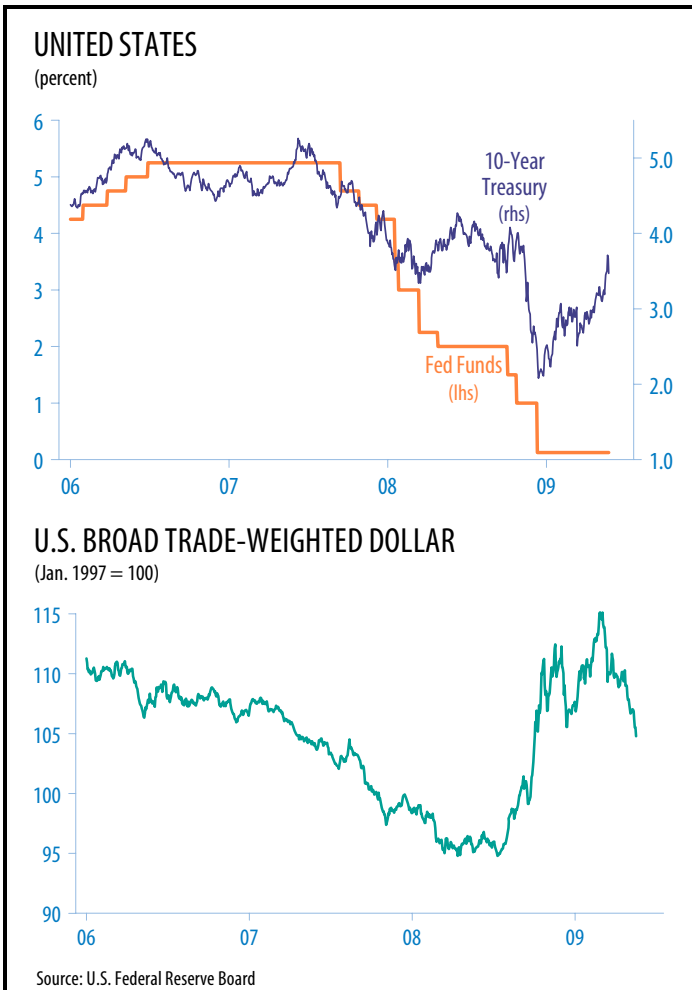
## U.S. Rates

The Fed's quantitative easing (QE) efforts continue. As of May 27, the Fed had bought \$632 billion (or 36%) of its planned purchases of up to \$1.75 trillion of Agency mortgage-backed securities (MBS) and bonds along with Treasuries. In April, the Fed said it would "evaluate the timing and overall amounts of its purchases of securities in light of the evolving economic outlook and conditions in financial markets". There are market rumblings that the Fed might expedite its purchases, because of the backup in long Treasury yields (which has started to impact the record-low mortgage rates engineered by the Fed) and as some of its older measures wind down (the Fed wants to keep its balance sheet growing). We'll see at the June 23/24 policy meeting. Meantime, the other QE workhorse, the Term Asset-Backed Securities Loan facility (TALF), continues to inch forward (\$15 billion on the books for a facility as large as \$1 trillion). Recent changes to permit both new and old commercial MBS, and its use in the Public-Private Investment Program (which kicks off in early July), should lift TALF's figures. Elsewhere, the Fed's continued commitment to "exceptionally low levels of the federal funds rate for an extended period" anchors the short end of the Treasury yield curve.

However, this anchor and Fed purchases were unable to calm increasing investor nervousness at the longer-end of the Treasury curve (yields were up about 35 bps last

month). As record amounts of Treasuries are being issued to finance a \$1.8 trillion budget deficit, demand is being damped by ebbing risk aversion, credit concerns (the latter sparked by last month's downgrade of the UK's credit outlook), inflation fears (owing to the Fed's monetization) and worries about waning official foreign appetite for Treasuries. Looking ahead, these pressures should be offset by escalating economic slack, Treasury buying by domestic banks (to strengthen their balance sheets) and persons (owing to a rising savings rate), and even official foreign buying as some authorities attempt to mitigate a weakening US dollar (see below). But, they'll only partially offset, as 4%-handles for 10-year Treasury yields move into sight. Any renewed economic uncertainty or another flare-up of the global credit crisis could give rising yields a reprieve, but it'll be temporary.

The trade-weighted US dollar depreciated 7.0% against the major currencies last month, with a cumulative loss of 12.1% from March's recent peak. The factors pushing up longer-term Treasury yields are also the factors forcing down the dollar... shifts into riskier non-US\$ assets along with worries



about US credit worthiness, Fed monetization (risk of currency debasement) and all the talk about the greenback's longevity as the predominant reserve currency. The latter three factors were not in the market's mind when the US\$ hit record lows last summer, before risk aversion soared in the wake of global economic and financial market collapse. Thus, as risk aversion continues to ebb, a retest of those record lows is likely.

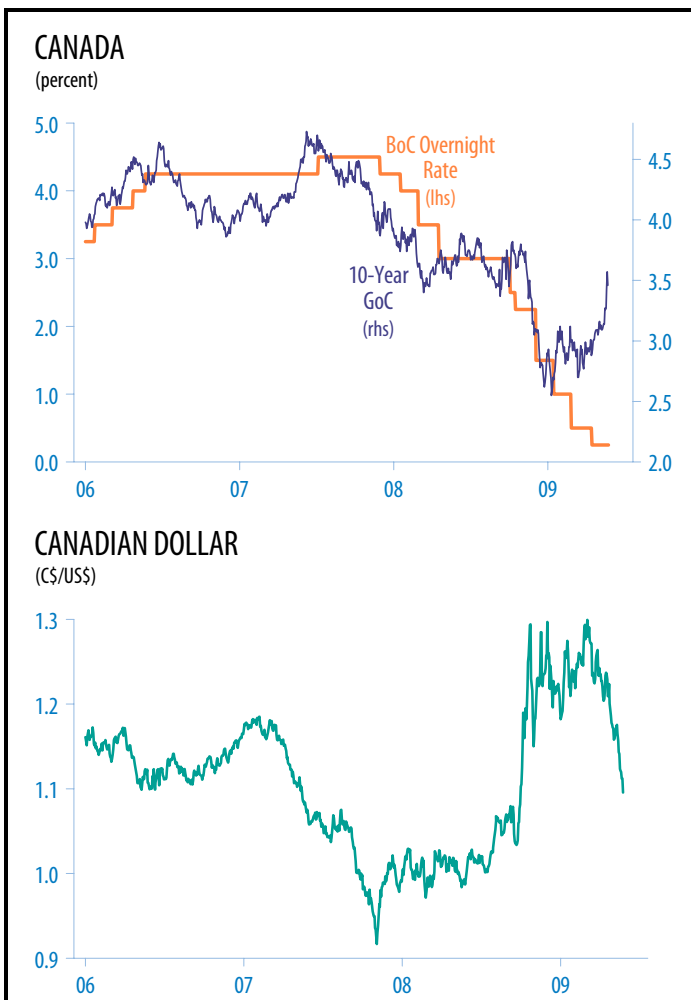
## Canadian Rates

The Bank of Canada continues its conditional commitment to keep the policy rate at the effective lower bound (0.25%) until June 2010. Unless economic and inflation performance deviates sharply from the Bank's projections, a venture into QE is unlikely, although the soaring loonie might lift QE risk. Persistent and significant appreciation driven by factors not related to rising commodity prices or improving trade flows (what the BoC would call a Type II move) causes an unwarranted net tightening of financial conditions which could require offsetting easier monetary policy, which at this stage would be QE. We look for the Bank to signal that it has its eye on the loonie at the June 4 policy announcement.

Government of Canada bonds sold off alongside US Treasuries last month, outperforming at

the longer end as investors found relative comfort in Canada's better fiscal position (Canada-US long spreads moved more negative by 5 to 15 bps). However, Canada underperformed at the shorter end of the curve (by as much as 25 to 35 bps). Recent "green shoots", particularly the positive employment reading for April and three-peat of growing existing home sales, cast some doubt about the Bank's commitment to keep policy rates stable for the next year, which compounded supply congestion in the mid-maturities. (Interestingly, buying shorter-term Canadas to reinforce the conditional commitment was a specific example discussed by the Bank in its QE framework). Meantime, while Canada's fiscal position remains relatively strong compared to the US, it nevertheless is deteriorating. Finance Minister Flaherty acknowledged last month that the federal deficit could top a record \$50 billion in 2009-10, suggesting that relative outperformance at the long-end could lessen. With C\$ strength making the conditional commitment a bit less conditional and raising QE risk, underperformance at the shorter-end of the curve should end.

News of a record fiscal shortfall coincided last month with news of a record current account deficit of \$36 billion annualized in Q1. Normally, deepening twin deficits would be



bad news for a currency, but don't tell that to the loonie. The Canadian dollar appreciated 9.0% against the US dollar in May, the most in any month in the modern era (since the 1950s), and is up 18.6% from the early March lows. A weakening US dollar, strengthening commodity prices, marquee economic "green shoots" and the BoC not crossing the QE line combined to lift the loonie. Furthermore, any concerns about record fiscal and current account deficits ran off the loonie's back. First, these twin deficits are re-emerging with Canada as a net creditor nation (a positive net international investment position) for the first time since the 1920s. Second, the deficits don't appear as onerous viewed against GDP and past recessions. Third, commodity prices are rising strongly, with the prospect that they could turn the current account balance back into the black. Looking ahead, with the trade-weighted greenback likely to retest record lows, parity likely lies ahead. But, at this stage, this could easily elicit a C\$-unfriendly BoC response.

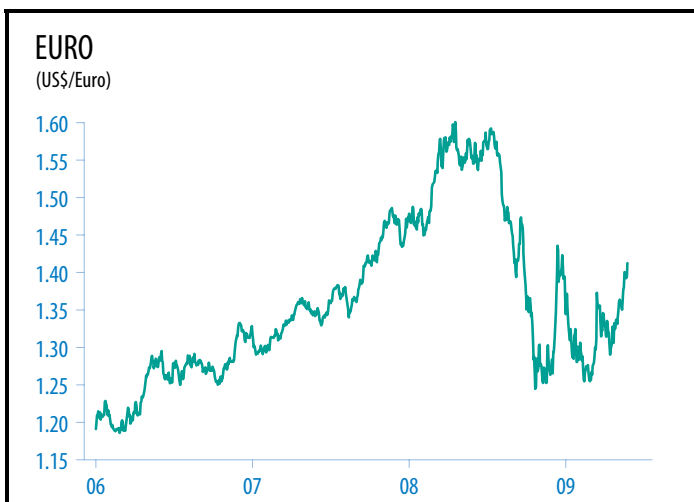
## Euro

The Euro area economy had its worst quarter on record in Q1, with weakness prevalent in export-dependent Germany. The current quarter has started off on a better note though, with confidence perking up, perhaps pointing to Q1 as a bottom and a lesser rate of decline going forward. Even if Europe has bottomed, don't expect meaningful growth until 2010. Consumers are unlikely to drive a recovery, as unemployment will continue to rise through next year and export markets probably won't see strong growth either.

Euro area inflation has slowed drastically and is now flat from a year ago. Germany experienced mild deflation in May, joining Spain, Ireland and Portugal. Regional deflation is likely over the next couple of months, but positive inflation should return by year-end, dampening any deflationary spiral worries. Until then, pressure will build on the ECB to expand its asset purchases. The ECB announced €60 bln in covered bond purchases and a 12-month lending facility in May. Both actions should improve conditions for financial institutions which play a critical role in Europe (more so than in the U.S.). The ECB should

explain the details of the covered bond purchase in June, but don't expect any new announcements. ECB President Trichet will also be watched closely for any hints of other asset purchases or any other potential actions.

The euro performed well in May, hitting its best levels of the year, thanks largely to broad US\$ weakness. While the focus is on US fiscal worries, Euro area economies face fiscal deterioration as well (though not to the same extent), especially the smaller countries. We could see some further near-term strength before the economic data stumble (in part thanks to auto shutdowns) which will weigh on the

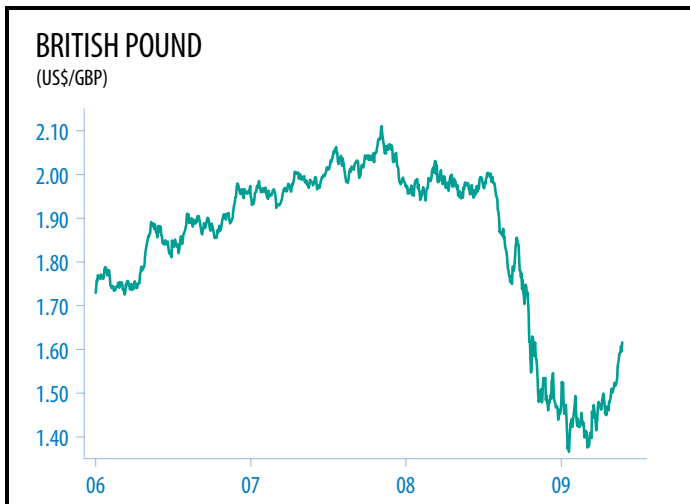


currency around mid-summer. However, this weakness will be short-lived with the appreciating trend re-emerging through 2010.

## British Pound

Recent U.K. data have shown some improvement, hinting that the worst is over. The manufacturing PMI rose for the second straight month in May, and the services PMI rose for the fifth straight month, both hitting their best levels since August. Confidence measures are rising as well. But, industrial production is still falling (though at slower pace), unemployment continues to march higher, and home price depreciation persists (though also at a lesser pace).

The Bank of England increased its QE in May to £125 bln, which will last until August at the current pace of purchases (£25 bln per month). The May Inflation Report projected inflation will remain below the 2% target through the forecast horizon, pointing to perhaps another



increase in QE. The Bank is currently authorized by Treasury for up to £150 bln, but meeting minutes have shown the Monetary Policy Committee is willing to apply for more. If conditions don't improve markedly by August (the next inflation report), or perhaps even July, the BoE will likely opt to increase its QE further. For June, however, don't look for much action on the policy front.

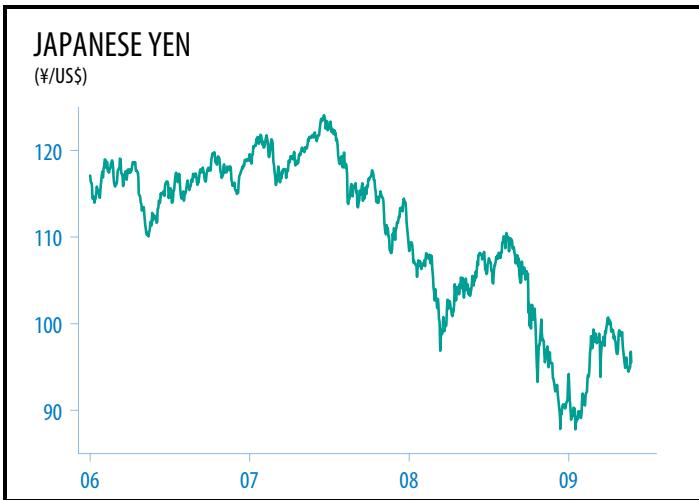
S&P downgraded the U.K.'s credit outlook to negative in May, as the budget forecast by the Treasury was thought to be overly optimistic. The pound had little initial reaction. In fact, sterling had a stellar run in May, but the deteriorating

fiscal situation should serve to limit its gains going forward. Indeed, the currency might have trouble continuing the move in June with softening summer economic data prompting some temporary weakness.

## Japanese Yen

Japan's economic data have shown signs of stability following record declines in real GDP in Q4 and Q1. Fiscal stimulus measures are bearing some fruit, with retail sales rising for the first time in eight months in April. Exports have risen two months in a row as has industrial production pointing to growth in Q2 after four straight quarterly contractions. Though growth is expected in the current quarter, it should remain muted as Japan remains reliant on foreign demand. That's likely to be the theme for Japan going forward as it's very unlikely the U.S. or Europe are going to provide the demand growth Japan needs.

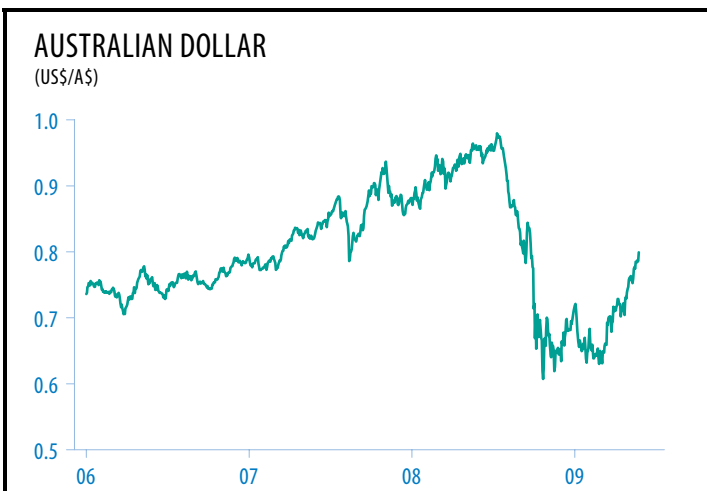
The Bank of Japan upgraded its assessment of the economy in May, saying *"Economic conditions have been deteriorating, but exports and production are beginning to level out against the backdrop of progress in inventory adjustments both at home and abroad."* That doesn't sound too promising but is an improvement on the previous, *"economic conditions have deteriorated significantly"*. The BoJ has acted aggressively with a substantial amount of QE and liquidity support, but at the end of the day, Japan is still dependent on exports, which cannot be cured through domestic monetary policy.



The yen gained ground through most of May as the US\$ was broadly weaker and the rally in global equity markets stalled. However, the yen gave up most of its gains in the closing days of the month as increased risk appetite prompted yen selling. As the coming data point to a bottom for the global economy over the next few weeks, risk appetite should pick up further and weaken the yen. However, an expected mid-summer pause in the improving economic picture could provide a short reprieve for the currency, which should resume a weakening trend thereafter.

## Australian Dollar

Australia's economy continues to weather the global downturn relatively well. For example, employment unexpectedly rose in April and pulled the jobless rate down. March retail sales were also positive and new motor vehicle sales hint at another decent reading in April. After cutting rates sharply (425 bps) since August 2008, the RBA decided to stay on hold in May, citing improvement in the Chinese economy and global signs of stabilization. Considering the



decent domestic data, the RBA is likely to again keep rates steady in June. However, if conditions worsen in the months ahead, more cuts remain a possibility (though they would be moderate and at a slow pace).

The Australian dollar has performed well over the past three months, benefitting from improving global sentiment (and the resulting higher commodity prices) and increased risk tolerance. Similar to the Canadian dollar, the Aussie dollar should continue to benefit meaningfully from a global recovery. While we do see a hiccup in the recovery talk this summer, the outlook for the A\$ remains solid through 2010.

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

	Actual 29-May	2009 Jun	Sep	Dec	2010 Mar	Jun	Sep	Dec
<b>Canadian Dollar</b>								
C\$ per US\$	1.092	1.100	1.138	1.100	1.075	1.050	1.025	1.000
US\$ per C\$	0.916	0.909	0.879	0.909	0.930	0.952	0.976	1.000
Trade-Weighted	109.8	109.6	106.3	109.6	111.7	114.0	116.3	118.9
<b>U.S. Dollar</b>								
Trade-Weighted*	104.8	104.4	106.2	104.3	102.4	100.5	98.6	96.9
<b>European Currencies</b>								
Euro**	1.41	1.41	1.36	1.40	1.44	1.48	1.51	1.55
Danish Krone	5.27	5.30	5.45	5.35	5.20	5.05	4.95	4.80
Norwegian Krone	6.30	6.40	6.60	6.25	6.00	5.75	5.50	5.25
Swedish Krona	7.56	7.60	7.80	7.25	6.95	6.65	6.30	6.00
Swiss Franc	1.07	1.08	1.12	1.09	1.06	1.04	1.01	1.00
U.K. Pound**	1.62	1.63	1.58	1.65	1.71	1.78	1.84	1.90
<b>Asian Currencies</b>								
Chinese Yuan	6.83	6.82	6.79	6.75	6.67	6.59	6.51	6.43
Japanese Yen	95	98	97	100	101	103	104	105
Korean Won	1258	1250	1275	1250	1200	1160	1125	1085
Indian Rupee	47.1	47.5	47.0	46.5	46.3	46.0	45.8	45.5
Singapore Dollar	1.44	1.44	1.45	1.43	1.41	1.38	1.36	1.33
Malaysian Ringgit	3.49	3.49	3.53	3.50	3.40	3.30	3.21	3.12
Thai Baht	34.3	34.3	34.6	34.3	33.7	33.1	32.5	31.9
Philippine Peso	47.2	47.0	48.3	47.6	46.2	44.9	43.6	42.4
Taiwan Dollar	32.6	32.5	32.6	32.2	31.4	30.7	29.9	29.2
Indonesian Rupiah	10288	10220	10300	10060	9820	9580	9340	9130
<b>Other Currencies</b>								
Australian Dollar**	0.801	0.800	0.763	0.800	0.831	0.863	0.894	0.925
N.Z. Dollar**	0.641	0.620	0.598	0.650	0.681	0.713	0.744	0.775
Mexican Peso	13.17	13.25	13.50	13.20	13.00	12.80	12.60	12.50
Brazilian Real	1.97	2.00	2.10	2.05	2.03	2.01	2.00	1.98
Russian Ruble	30.8	31.5	31.5	31.3	31.0	30.8	30.5	30.3
South African Rand	8.0	8.0	8.3	8.5	8.5	8.4	8.3	8.2

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

## Cross Rates

### Versus Canadian Dollar

Euro (C\$/€)	1.54	1.55	1.55	1.54	1.55	1.55	1.55	1.55
U.K. Pound (C\$/£)	1.77	1.79	1.79	1.82	1.84	1.87	1.89	1.90
Japanese Yen (¥/C\$)	87	89	85	91	94	98	101	105
Australian Dollar (C\$/A\$)	0.874	0.880	0.868	0.880	0.893	0.906	0.916	0.925

### Versus Euro

U.K. Pound (£/€)	0.87	0.87	0.87	0.85	0.84	0.83	0.82	0.82
Japanese Yen (¥/€)	135	138	132	140	145	152	157	163

**Interest Rate  
Forecasts  
Percent  
(averages)**

	<b>Actual 29-May</b>	<b>2009 Jun</b>	<b>Sep</b>	<b>Dec</b>	<b>2010 Mar</b>	<b>Jun</b>	<b>Sep</b>	<b>Dec</b>
<b>Cdn. Yield Curve</b>								
Overnight	0.25	0.25	0.25	0.25	0.25	0.25	0.75	1.25
3 month	0.20	0.20	0.20	0.20	0.20	0.45	0.95	1.45
6 month	0.32	0.30	0.30	0.30	0.35	0.65	1.20	1.65
1 year	0.50	0.50	0.55	0.75	0.90	1.20	1.60	2.05
2 year	1.23	1.25	1.15	1.50	1.85	2.20	2.50	2.85
3 year	1.79	1.80	1.70	2.00	2.30	2.60	2.90	3.20
5 year	2.45	2.45	2.40	2.60	2.85	3.10	3.35	3.65
7 year	2.70	2.70	2.65	3.00	3.40	3.65	3.90	4.15
10 year	3.39	3.40	3.35	3.60	3.80	4.00	4.25	4.45
30 year	3.99	4.05	4.00	4.25	4.45	4.65	4.85	5.05
<b>U.S. Yield Curve</b>								
Fed funds	0.13	0.13	0.13	0.13	0.13	0.50	1.00	1.50
3 month	0.14	0.15	0.15	0.15	0.15	0.55	1.05	1.55
6 month	0.30	0.30	0.30	0.30	0.35	0.70	1.25	1.75
1 year	0.47	0.45	0.45	0.75	1.05	1.40	1.85	2.25
2 year	0.92	0.95	0.90	1.50	2.05	2.35	2.75	3.15
3 year	1.42	1.45	1.40	2.00	2.55	2.85	3.20	3.55
5 year	2.34	2.35	2.35	2.80	3.20	3.50	3.80	4.10
7 year	3.06	3.05	3.00	3.40	3.80	4.05	4.30	4.60
10 year	3.47	3.55	3.50	3.75	4.00	4.25	4.50	4.75
30 year	4.34	4.40	4.35	4.60	4.85	5.10	5.30	5.55

Bond yields are constant maturity yields as calculated by BMO Capital Markets, U.S. Federal Reserve