



August 5, 2009

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*This month's Rates Scenario focuses on the long-range forecast, highlighting the themes that should influence interest rates and foreign exchange rates through 2014.*

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## U.S. Rates

The recent U.S. recession was the longest and deepest since the Great Depression, earning its "Great Recession" moniker. The peak-to-trough decline in real GDP was 3.9%, rivaling the deepest recession in terms of employment losses (5.2% in 1948-49). The policy responses have been equally extreme, with Treasury's budget deficit soaring to its highest level (as a share of GDP) since the U.S. was financing its WWII effort, and with the Fed's policy rate falling to a record low level. Unfortunately, the next expansion phase looks to join this extreme camp, in terms of sluggishness.

U.S. consumer spending should remain restrained for years by balance sheet restructuring (deleveraging and rising savings rates) and encumbered credit creation. This drag (recall that consumer spending is 70% of U.S. GDP) should be augmented later by fiscal consolidation—higher taxes and lower discretionary spending—keeping the unemployment rate higher for longer and placing another damper on consumer spending. Nevertheless, even after the current fiscal stimulus fades, the slow removal of Fed monetary accommodation (see below) and unwinding pent-up demand should fuel accelerating annual economic growth through 2012, peaking just below 3.5%. Afterwards, the absence of monetary accommodation and heftier fiscal contraction following the 2012 election should pull growth back below 3%. Importantly, the projected growth rate peak this cycle will be the lowest among all expansion phases since the Great Depression.

Starting with a post-WWII extreme degree of economic slack, we judge that the Fed will start removing its monetary accommodation only once the slack stabilizes and starts ebbing around mid-2010. With an eye on the slowly shrinking but still-large output and employment gaps, we further judge the Fed will move very gradually, returning policy rates to neutral by 2012 (fed funds in the low-4% range), but not move immediately to a net tightening stance. However, there is an asymmetric risk that economic slack might not be as large as estimated, reflecting the fact that some capacity could be permanently lost owing to economic restructuring (e.g., some closed automotive plants aren't going to produce anything else). This means that policy could remain too accommodative for too long. The Fed appears prepared to take this risk—out of fear of a Japanese-style multiple-dip recession—but it's a risk that will likely be realized, at least to some extent. Thus, with

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less inflation-absorbing slack in play along with strengthening commodity prices and a weakening U.S. dollar (see below), this should push core PCE inflation slightly above the Fed's 1.7%-to-2.0% long-term target by 2013 (but still under 3%) and push the Fed into a slight tightening stance. This will also weigh on the expected economic slowdown through the middle of the decade.

Investor risk appetite, already whetted by the prospects for U.S. and global economic growth, should get increasingly roused by confirmation of this scenario, thus further reducing safe-haven demand for U.S. dollars and Treasuries.

With policy rates renormalizing, large budget deficits persisting and inflation expectations drifting up modestly, Treasury yields should trend higher through 2013. However, the long-range question for Treasuries is not whether they will rise, but rather how serious the uptrend might be? Despite lessened safe-haven demand and concerns about continued purchases by FX reserve managers and sovereign wealth funds, increased domestic demand for Treasuries by households (reflecting rising savings rates and more conservative investment practices) and banks (part of the multiyear healing process from the credit crisis) should provide some offsets. Besides, with the greenback likely to weaken steadily against the basket of emerging market currencies (as China allows a gradual yuan appreciation to resume), some FX reserve managers might actually increase their Treasury purchases to resist local appreciation. Eventually, slowing U.S. economic growth through the middle of the decade should turn the tide in Treasuries.

The resumption in global economic growth will provide added impetus to commodity prices and, of course, the commodity-linked currencies. Meanwhile, concerns about the external financing of the U.S. budget deficit and sovereign credit risk will also weigh on the U.S. dollar. Indeed, with domestic demand providing some offsetting support for Treasury prices, the greenback might have to play a larger role in cheapening prices in the eyes of foreign investors. And, as the U.S. dollar continues to depreciate gradually against a broad basket of currencies, market rumblings about the greenback's reserve currency status will no doubt persist.

As the Fed moves along its renormalization path, Treasury yields rise relative to most other government bonds, rising risk appetites stoke carry trades, and U.S. GDP growth accelerates (shining against dull Euro area and Japanese economic performance and helping pacify some external financing and sovereign credit concerns), the U.S. dollar should start gaining modestly against the major currencies during 2011. However, the modest rebound will not be sufficient to offset additional depreciation against the emerging currencies. We look for the Chinese authorities to resume a moderate appreciation pace for the yuan against the U.S. dollar, which should lift other emerging currencies in tow. On balance, we judge that the U.S. dollar will continue to depreciate on

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a broad trade-weighted basis over the long run. This is one of the means through which the U.S. economy will restructure, relying more on net exports and investment and less on consumer spending.

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## Canadian Rates

**Faster rate of expansion than in the U.S. for the next few years**

Although Canada's recession is turning out to be less severe than previous ones, this is little consolation for the still significant losses in output and jobs—driven by the worst contraction in real exports on record, an unprecedented plummet in commodity prices, a housing correction and the global credit crisis. However, the latter factor did not impact Canada as much as the U.S. and other economies, partly owing to the soundness of the Canadian banking system. Indeed, with household and corporate balance sheets still in relatively good shape, and Bank of Canada policy rates at record lows, the credit creation process has continued to work to Canada's advantage (proof point: existing home sales have grown strongly for the past five months in a row). This is helping pull Canada out of recession along with rebounding commodity prices, and both are poised to fuel a faster rate of expansion than in the U.S. for the next few years. However, Canadian economic performance will still be weaker than what it otherwise might have been owing to sluggish U.S. growth.

**The Bank of Canada is likely to start tightening before (or more aggressively than) the Fed**

The Bank of Canada continues with its conditional commitment to keep its policy rate at 0.25% until June 2010, with the risk greater that the interval will be shortened rather than lengthened. Indeed, given Canada's relatively stronger economic recovery, slack is going to start ebbing sooner than in the U.S. And, with low interest rates more effective because of the well-functioning banking system, the Bank of Canada is likely to start tightening before (or more aggressively than) the Fed. However, such a scenario would surely add more strength to the Canadian dollar, which would lessen the urgency to hike rates from a monetary conditions perspective. In the end, the Bank's tightening path might not deviate too much from the Fed's, owing to a steady strengthening Canadian dollar (see below). Given the Bank's reluctance to engage in quantitative easing along with the natural check on growth from a sluggish U.S. economy and the loonie's check on inflation, the Bank is not expected to push policy rates much above neutral (low-4% range).

The renormalization of policy rates will prod Canadian bond yields higher, along with the additional supply to cover the ballooning budget deficit. However, Canada's fiscal situation remains manageable; the budget deficit can easily be put on a path of significant reduction with relatively modest restraint, in stark contrast to the draconian budget measures that will be required south of the border. Indeed, better fiscal and external financing fundamentals suggest that Canada should steadily outperform Treasuries amid the rising yields on both sides of the border. Continued commodity price increases and recovery in U.S. trade volumes should eventually lead the current account balance back to surplus, ensuring Canada's net international investment position stays on the "net creditor" side of the ledger.

**The Canadian dollar should muster more strength, hitting parity once again**

As commodity prices continue gaining, Canada's expansion edges out U.S. economic performance, and the Bank of Canada is seen to be leading the Fed along the policy renormalization path, the Canadian dollar should muster more strength, hitting parity once again. Some of this strength might eventually be sapped by increasing negative bond yield spreads (there will likely be little carry trade support for the C\$), the greenback's rebound against the euro and yen, and eventual slightly higher Fed policy rates, but the loonie should still hold its own. While a mid-decade economic slowdown could cause a break from trend (commodity price appreciation would cool for a while as well), the loonie looks to have a steady-to-elevating flight plan for the next few years.

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**Euro**

**Europe is likely to lag the global recovery throughout the next cycle**

Euro area real GDP has contracted 4.9% from its 2008Q1 peak, worse than the U.S. or Canada, and it is likely to lag in recovery as well owing to the region's low potential growth (reflecting stricter labour laws and slower population growth). The Euro area jobless rate is expected to rise above 10% before year end and remain there through 2010 (and maybe beyond). Europe's more stringent labour laws will make employers reluctant to hire until they are fully convinced a recovery is in train. The significant slack in the economy should ensure that inflation will remain tame for the next few years. Even so, an ultra-cautious ECB will likely raise rates aggressively (at least initially) once conditions improve, as it remains ever fearful of inflation. These structural concerns and a more-inflation averse central bank mean Europe is likely to lag the global recovery throughout the next cycle.

Also, Europe's greater reliance on the banking sector for corporate funding could spell trouble as the region's banks face further writedowns. The European approach to solving the banking issues has been fragmented (as regulations differ by country) and less impactful than U.S. initiatives which could lead to stiffer financial headwinds on growth in the medium term. Exposure to Eastern European economies remains a potential skeleton in the closet as well. However, Germany is putting together a troubled asset relief plan, which would be a step in the right direction for the banking sector.

**Increase in risk appetite favours the euro**

Sovereign debt concerns plague Europe as well. Germany is thrifty but others could face downgrades (or further downgrades in some cases). Ongoing sovereign credit worries could prompt further talk of a euro breakup and would weigh on the currency. Despite the soft economic outlook, the euro should benefit from an accelerating global economy. The resulting increase in risk appetite favours the euro, a trend which should continue past 2010. However, once it becomes clear that Euro area growth will lag on an ongoing basis, look for momentum to slow and for the currency to start pulling back toward long-term equilibrium levels. The ongoing (and slow) shift away from the U.S. dollar as the global reserve currency should aid the common currency, but will only serve to mitigate weakness as the growth story takes centre stage.

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## British Pound

**The U.K. is facing similar issues as the U.S.: significant household debt, an overly large financial sector, and a massive budget deficit and growing debt legacy**

The U.K. is facing similar issues as the U.S.: significant household debt, an overly large financial sector, and a massive budget deficit and growing debt legacy. The financial sector had been an important source of growth (economy and tax revenues) over the past decade, but that well has dried up. Increased regulatory scrutiny is very likely and that should keep the sector restrained. The government remains a major shareholder in two big banks (Lloyds and RBS) and it owns/operates mortgage lender Northern Rock. The ownership increases scrutiny on financials, and might also ensure that stricter regulations are instituted before those holdings are liquidated. This shift in the structure of the economy will likely slow the recovery, but provide more balance longer term.

On the labour front, the U.K. job market is more flexible than in continental Europe, so reluctance to hire might not be as much of a drag on growth. Even so, balance sheet restructuring among highly indebted households, unable to rely on home price appreciation and big bonuses from the City (or their trickle down), means domestic spending growth will remain tepid through at least 2010. And, since the European Union accounts for half of U.K. exports (don't expect much growth there), growth will rely heavily on home-grown sources, which points to a sluggish recovery.

The Bank of England has aggressively countered deflation worries by purchasing a significant quantity of government debt. While their actions have alleviated deflation concerns, they could spark inflation expectations if the Bank's exit strategy lacks credibility. With the Asset Purchase Facility at the current £125 bln target, the BoE has purchased about 20% of conventional gilts outstanding, far surpassing the Fed's less than 10% share of Treasury long-term securities.

An explosion in U.K. government debt might also hamper sterling's medium-term performance. Debt could rise to about 80% of GDP in 2010, almost doubling from 44% in 2008/9 (though the bank rescues are in the 2010 total and a good portion of those funds should be recovered). Rating agencies have even mused about debt-to-GDP reaching 100% if spending is not curtailed, which could prompt a downgrade of the U.K.'s credit rating. A rating downgrade would no doubt sideswipe the pound, though we don't believe such a move is likely in our forecast horizon. Indeed, Fitch recently reaffirmed the U.K.'s AAA rating.

After falling sharply vs. the US\$ from August 2008, the pound has rebounded since the start of the year and will likely gain further in the near term. Increasing risk appetite should benefit the pound (similar to the euro) and a healing financial sector should allow the currency to outperform the euro following two-years of underperformance. A short period of economic underperformance amid much needed fiscal tightening could halt sterling's

upward trend. However, as the U.K. economy shows increasing signs of life in 2012 (similar to the U.S.), the pound should continue to gain ground vs. the euro and US\$.

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## Japanese Yen

Japan faces significant long-term economic issues: an aging & declining population, reliance on exports, and the resulting lack of domestic economic momentum. A shrinking population negatively impacts potential growth and shifts resources towards caring for a growing elderly demographic. Japan's growth in the past cycle came primarily from exports, as households were hesitant to spend. Japanese manufacturing prowess in automobiles and other high-tech or highly specialized products meshed well with ever-increasing demand from the U.S. and China. That strategy won't likely yield the same benefits during the coming economic cycle, as U.S. households repair their balance sheets. China is certainly a growth market, but the drop in U.S. demand cannot be replaced overnight.

From a domestic perspective, Japanese households aren't likely to go on a spending binge, especially as real wages have been at best stagnant over the past decade. Indeed, private domestic spending growth has averaged less than 1% over that period. Stronger spending growth is necessary to diversify away from exports. Don't look to the government to pick up the spending slack, as it already carries the largest debt burden among developed countries. Funding the ongoing fiscal gap hasn't been an issue yet as domestic savings have funded the deficit, but if the current account balance doesn't improve that might be a future issue, which wouldn't bode well for the yen.

**Expect a weak  
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Expect a weak recovery in Japan, which will keep inflation very subdued. That should mean less aggressive tightening by the Bank of Japan relative to other major central banks. Even once the BoJ starts hiking, it would be a little surprising if overnight interest rates even made it much beyond 1%. Widening overnight and term rate spreads versus nearly every country in the world will push investors back towards the yen carry trade. Initially, the trade might not be as popular as before the recent crisis, but as risk appetite grows amid a sturdy global economic expansion, the pressure on the yen is likely to increase. Look for the yen to weaken both in the near term as risk aversion fades and, longer term, as the carry trade returns to prominence.



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

	Actual 31-Jul	2009 Q3	Q4	2010 Q1	Q2	Q3	Q4	2011 H1	H2	2012 H1	H2	2013	2014
<b>Canadian Dollar</b>													
C\$ per US\$	1.078	1.092	1.058	1.042	1.029	1.017	1.004	0.990	0.974	0.957	0.979	1.027	1.050
US\$ per C\$	0.928	0.916	0.945	0.960	0.972	0.983	0.996	1.010	1.027	1.045	1.021	0.974	0.952
Trade-Weighted	111.2	110.1	113.6	115.1	116.3	117.4	118.7	120.5	123.0	125.5	122.8	116.7	114.0
<b>U.S. Dollar</b>													
Major Trade-Weighted	74.9	75.5	74.4	73.6	72.8	72.1	71.3	71.6	72.5	73.2	74.6	76.1	76.5
Broad Trade-Weighted	103.2	103.8	102.7	101.6	100.3	99.0	97.8	97.1	96.7	95.9	95.5	94.9	93.8
<b>Major Currencies</b>													
Euro*	1.43	1.42	1.44	1.47	1.49	1.52	1.54	1.52	1.47	1.44	1.41	1.39	1.38
U.K. Pound*	1.67	1.67	1.73	1.78	1.81	1.85	1.88	1.87	1.82	1.79	1.76	1.78	1.83
Japanese Yen	95	95	99	101	102	103	105	106	109	111	114	112	110
Swiss Franc	1.07	1.08	1.06	1.04	1.03	1.00	1.00	1.01	1.04	1.07	1.09	1.10	1.11
Swedish Krona	7.22	7.32	7.00	6.85	6.60	6.30	6.10	6.10	6.30	6.45	6.55	6.70	6.75
Australian Dollar*	0.836	0.818	0.843	0.863	0.881	0.900	0.919	0.947	0.986	1.024	1.005	0.937	0.900
Chinese Yuan	6.83	6.83	6.83	6.75	6.67	6.58	6.50	6.40	6.25	6.10	5.95	5.75	5.45

\* (US\$ per local currency)

## Cross Rates

### Versus Canadian Dollar

Euro (C\$/€)	1.54	1.55	1.52	1.53	1.53	1.55	1.55	1.50	1.43	1.38	1.38	1.43	1.45
U.K. Pound (C\$/£)	1.80	1.82	1.83	1.85	1.86	1.88	1.89	1.85	1.77	1.71	1.72	1.83	1.92
Japanese Yen (¥/C\$)	88	87	94	97	99	101	105	107	112	116	116	109	105
Australian Dollar (C\$/A\$)	0.901	0.89	0.89	0.90	0.91	0.92	0.92	0.94	0.96	0.98	0.98	0.96	0.95

### Versus Euro

U.K. Pound (£/€)	0.85	0.85	0.83	0.83	0.82	0.82	0.82	0.81	0.81	0.80	0.80	0.78	0.75
Japanese Yen (¥/€)	135	135	143	148	152	157	162	161	160	160	161	156	152



## Interest Rate Forecasts Percent (averages)

	Actual 31-Jul	2009 Q3	Q4	2010 Q1	Q2	Q3	Q4	2011 H1	H2	2012 H1	H2	2013	2014
<b>Cdn. Yield Curve</b>													
Overnight	0.25	0.25	0.25	0.25	0.25	0.58	1.08	1.83	2.83	3.83	4.25	4.60	4.60
3 month	0.24	0.25	0.25	0.25	0.30	0.80	1.25	2.00	2.95	3.90	4.30	4.65	4.65
6 month	0.31	0.30	0.35	0.35	0.45	1.00	1.45	2.10	3.05	3.95	4.35	4.70	4.70
1 year	0.60	0.55	0.60	0.75	0.95	1.40	1.80	2.40	3.25	4.10	4.45	4.80	4.75
2 year	1.41	1.30	1.40	1.70	1.95	2.20	2.50	3.00	3.70	4.40	4.65	5.00	4.95
3 year	1.87	1.85	1.90	2.15	2.35	2.55	2.80	3.25	3.90	4.50	4.75	5.10	5.05
5 year	2.60	2.60	2.60	2.70	2.85	3.00	3.15	3.55	4.10	4.65	4.90	5.20	5.15
7 year	2.84	2.85	2.95	3.20	3.40	3.50	3.60	3.90	4.35	4.85	5.00	5.35	5.25
10 year	3.46	3.50	3.55	3.65	3.70	3.80	3.90	4.15	4.55	4.95	5.10	5.40	5.35
30 year	3.95	4.00	4.05	4.10	4.20	4.25	4.30	4.55	4.95	5.30	5.45	5.75	5.65
<b>U.S. Yield Curve</b>													
Fed funds	0.13	0.13	0.13	0.13	0.13	0.46	1.00	1.83	2.75	3.83	4.25	5.05	4.65
3 month	0.18	0.20	0.20	0.20	0.20	0.50	1.05	1.90	2.80	3.90	4.30	5.10	4.65
6 month	0.26	0.25	0.25	0.25	0.25	0.60	1.15	2.00	2.90	4.00	4.40	5.20	4.75
1 year	0.48	0.45	0.55	0.80	0.90	1.20	1.60	2.35	3.15	4.10	4.45	5.15	4.80
2 year	1.13	1.10	1.35	1.85	2.05	2.25	2.60	3.20	3.90	4.70	5.00	5.60	5.30
3 year	1.62	1.60	1.90	2.35	2.55	2.75	3.00	3.55	4.20	4.90	5.20	5.75	5.50
5 year	2.53	2.55	2.70	3.00	3.20	3.35	3.55	4.00	4.60	5.20	5.45	5.90	5.70
7 year	3.14	3.20	3.35	3.60	3.75	3.90	4.05	4.40	4.90	5.45	5.65	6.10	5.90
10 year	3.52	3.60	3.70	3.85	3.95	4.10	4.20	4.55	5.05	5.55	5.75	6.15	6.00
30 year	4.31	4.40	4.45	4.60	4.70	4.80	4.95	5.25	5.75	6.20	6.40	6.75	6.55

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