



Highlights

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- The Bank of Canada is expected to reaffirm its commitment to keeping policy rates unchanged until June 2010 at the October meeting, as the recovery unfolds unevenly. Recent soft data could limit previously anticipated forecast upgrades in the MPR. Look for the loonie to hit parity late in 2010, as we anticipate the Bank of Canada will be more aggressive than the Fed.
- The Federal Reserve extended its MBS/Agency purchases to 2010Q1 and continued committing to "exceptionally low levels of the federal funds rate for an extended period." The extended quantitative easing period pushes back our Fed tightening expectations to September 2010.
- Despite the recent pull-back in risk appetite, an improving global economic outlook points to a resumption of the greenback's weakening trend against the major currencies (as it has since March).
- We look for Treasury yields to remain range-bound through the turn of the year, before breaking out on the high side. Canadas will likely follow suit, but underperform on rallies and outperform on sell-offs.
- The ECB is unlikely to announce anything new this month, as it evaluates the strength of the still-nascent recovery and as inflation is evolving largely as it predicted.
- Little is expected from the Bank of England in October, as it waits for the November Inflation Report before deciding on further policy actions (though there has been speculation of a cut in the deposit rate).
- Look for the Bank of Japan to remain on the sidelines amid record deflation. However, the BoJ will likely start to pare its credit easing programs.
- The Reserve Bank of Australia is expected to stay on hold in October, but is slowly leaning toward tightening (perhaps by year end).

Forecast Summary (averages)

	Actual Sep	2009 Oct	Nov	Dec	Q4	2010 Q1	Q2	Q3	Q4
BoC overnight	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.58	1.08
10-yr Canadas	3.37	3.25	3.30	3.35	3.30	3.45	3.55	3.65	3.75
Fed funds	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.25	0.75
10-yr Treasuries	3.40	3.20	3.30	3.40	3.30	3.50	3.65	3.80	3.95
C\$ per US\$	1.082	1.071	1.061	1.050	1.061	1.042	1.029	1.017	1.004
US\$/€	1.46	1.46	1.47	1.48	1.47	1.49	1.51	1.53	1.54
US\$/£	1.63	1.65	1.66	1.68	1.66	1.70	1.75	1.79	1.84
¥/US\$	91	93	94	95	94	96	97	98	100

U.S. Rates

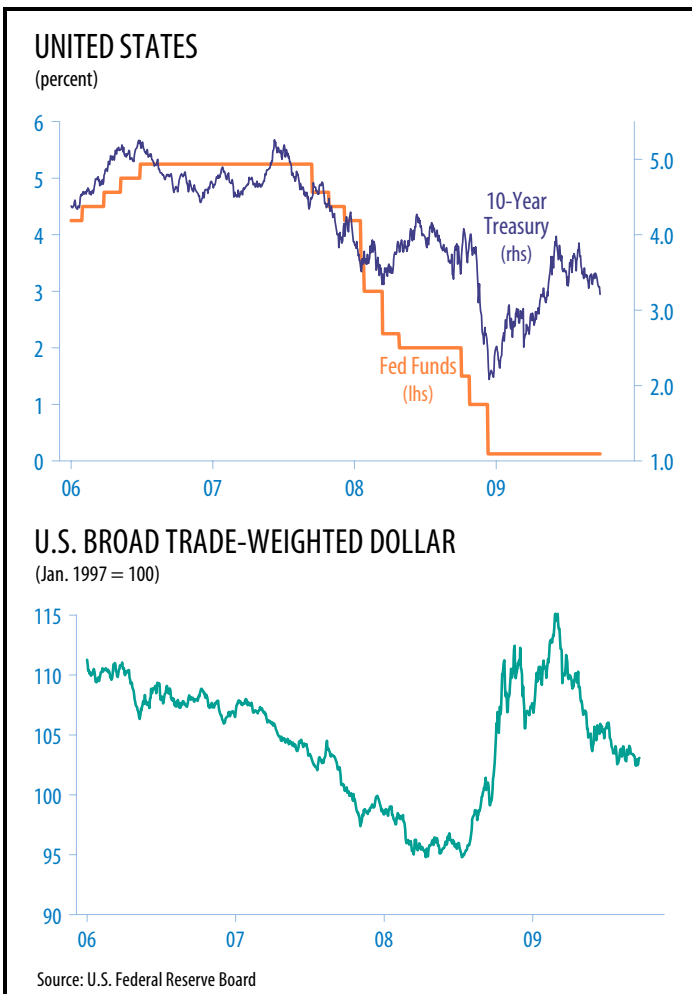
The Fed's September 23rd policy statement removed two minor words that had major implications. In the past, the FOMC referred to its purchases of agency mortgage-backed securities as "up to \$1.25 trillion" by December. The purchases were extended to March and the "up to" distinction was dropped. This means the Fed intends to purchase the full amount. Studies suggest that mortgage rates are already some 100 bps lower than what they otherwise would be owing to the Fed's actions, which is a critical reason why, as the Fed acknowledged, "activity in the housing sector has increased." The commitment to the full amount reflects the Fed's effort to ensure that the nascent housing recovery, a critical ingredient to economy-wide recovery, becomes entrenched.

As of September 30, the Fed held \$692 billion of agency MBS. Average weekly purchases were \$17 billion during the latest four-week period, which will lift the total to \$1.1 trillion by the end of March. As such, the Fed must lift its MBS purchase pace to attain its target (while tapering the pace towards the end), with incremental positive impacts for mortgage rates. Furthermore, committing to the full MBS amount means that asset purchases could soon start growing the Fed's balance sheet again. Despite more than \$1 trillion in asset purchases to date, the Fed's balance sheet and thus reserves in the banking system have hardly budged, as

use of the Fed's credit and liquidity programs has fallen sharply from their crisis peaks.

The Fed's credit-easing program will continue until March 2010 for agency securities and June 2010 for the Term Asset-Backed Securities Loan Facility (the TALF extension was announced August 17). Should the Fed continue not to sterilize these transactions (allowing them to create net bank reserves), this pushes back the inevitable policy shift to tightening. The elapsed time between the last easing move and first tightening action has been more than a year for recent policy cycles. Given that we are starting from an "emergency" situation, the elapsed time between easing and tightening should be shorter, but the Fed will likely wait until it can discern the ultimate impact of the end of its credit-easing efforts, at a minimum. For the record, we've penciled in a September rate hike start (the odds of postponing to 2011 are low, but building). We judge that the risk of a double-dip recession will keep the Fed on a cautious tightening path, particularly as the impact of the stimulus measures and temporary factors such as inventory rebuilding fade, and credit creation remains constrained.

Treasury yields drifted down along the curve in September, despite super-sized auctions, higher equity prices and a weaker

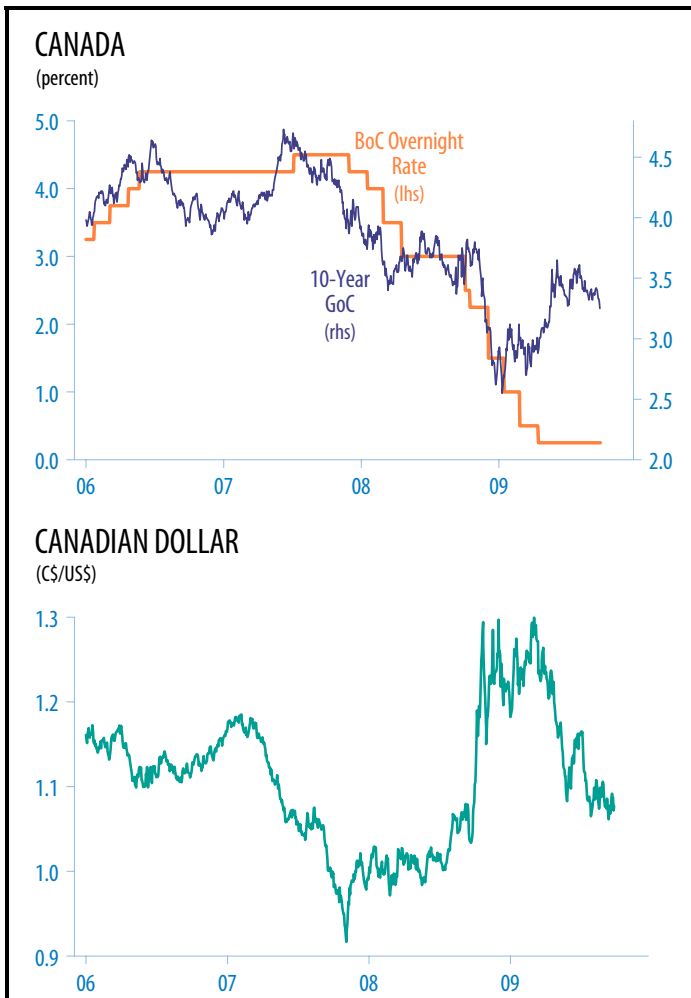


US\$ (the latter two being indicative of increased risk appetite). Buying for balance sheet restructuring, predominately by domestic banks but also from households, and buying by foreign authorities, in an effort to resist their currency's appreciation against the greenback, more than offset the pressure coming from growing supply and risk appetite. We judge that the latter two forces will eventually get the upper hand and look for long-term yields to grind steadily higher (albeit moderately). The short-end should get whipsawed by Fed tightening prospects.

The trade-weighted US dollar drifted down almost 1% against the major currencies during September, reflecting rising risk appetites. Indeed, the USD is being double hit by this phenomenon: the shift out of safe-haven Treasuries and the greenback's emergence as a carry-trade currency (borrowing in USDs to fund higher-yielding investments in other currencies). This trend should persist, compounded by depreciation pressures exerted by external financing of Treasury deficits and official asset diversification flows.

Canadian Rates

The Bank of Canada reiterated its commitment to keep the policy rate at 0.25% until the end of 2010 Q2 on September 10th, conditional, as always, on inflation. The Bank's projection for the



total CPI didn't change (troughing in the past quarter and hitting the 2% target by 2011 Q2), but they didn't comment on the core rate (which had been projected to trough through the turn of the year at 1.4%). We judge that mounting economic slack and a firming loonie, along with recently-reported grocery price wars, will push the core rate below the Bank's forecast for next year. Carney & Co. will likely stick to their commitment, and an inflation case could be made to extending it. However, we look for the Bank to begin the policy rate renormalization process in July 2010, with an eye on asset prices. Apart from new homes, asset prices are not included in the CPI, and the Bank of Canada has, in the past, waited for wealth and income effects to feed through to spending pressures before any policy response. However, given the extreme low level of policy rates, and with asset prices ranging from existing homes to commodities and equities likely to continue escalating, a preemptive removal of emergency ease would appear appropriate.

This means that the Bank of Canada would act before the Fed, which should push the Canadian dollar stronger; we look for the loonie to trade through parity by 2010 Q3. While this would likely lead the Bank to hike rates more cautiously (we look for quarter-point moves), it's unlikely to stop the first few rate hikes

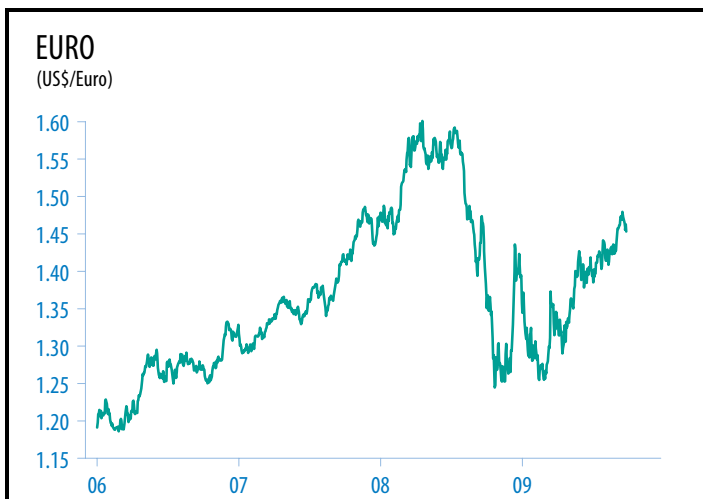
(unless, of course, the currency appears on a fast track beyond its modern-day high of US\$1.10). It's not that the loonie doesn't matter... it does. Governor Carney's September 26th speech warned that *"a persistently strong Canadian dollar would reduce real growth and delay the return of inflation to target."* However, with the Financial Conditions Index currently at its highest (loosest) level in its 10-year history, the impact of low short- and long-term interest rates, narrowing credit spreads and rising equity prices are providing some relief to a lofty loonie. Once the Fed joins in the rate hike parade, the C\$ will probably pare some of its gains. In the meantime, through June 2010, we look for the loonie to drift up gradually, reflecting Canada's G7-leading GDP performance and higher commodity prices in the wake of the global economic recovery (it appreciated more than 2% last month).

Ten-year Canada yields dropped just over 5 bps during September, pushing Canada-U.S. spreads back into positive territory. Given this directional tendency, along with Canada's still-superior fiscal fundamentals and expected currency appreciation, 10-year Canada-U.S. spreads should move back and increasingly into negative territory during the forecast horizon, muting the rise in Canadian bond yields.

Euro

The Euro area likely emerged from recession, led by Germany and France which should see growth for a second straight quarter. However, not all countries have entered recovery with Italy and Spain to remain laggards. Germany's growth has been fuelled partly by government stimuli. German employment has held up well thanks to fiscal incentives to retain workers. That's kept the jobless rate from rising sharply (it's up only 0.6 ppts from the 16-year low hit late last year). But whether employers will refrain from layoffs once the support expires remains in question. While the regional outlook is improving, the depth of the recession in Spain and ongoing sluggishness in Italy should result in a tepid and choppy recovery.

Deflation persisted for a fourth straight month in September and could continue for another month. While inflation will almost certainly turn positive in Q4 as year ago declines fall out of



the calculation, slowing money supply growth highlights a lack of inflation pressure. With that backdrop, the ECB is expected to stay on hold and likely to remain there well into 2010. One event that should make the ECB happy was the smaller-than-expected uptake on the 12-month auction—€75 bln vs. €442 bln at the first 12-month auction in June—a clear indication financial market strains are easing and banks are more willing to lend to one another.

The euro appreciated in September, touching a 1-year high before retreating towards month-end as risk appetite waned amid concern from European officials about the currency's

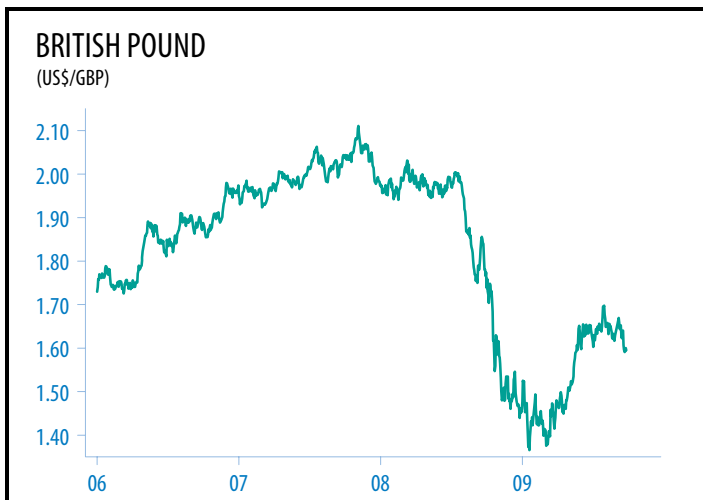
gains. With no indication that the ECB will tighten policy before the Fed, risk appetite and favourable interest rate spreads are driving the euro, with broad-based US\$ weakness providing a boost as well. An improving global economy (even if in fits and starts) will likely keep this trend intact, pushing the euro above the \$1.50 level in the first half of next year. Only once the US-euro policy rate spread starts to narrow and eventually reverses will the euro begin to trend weaker.

British Pound

The U.K. economy likely emerged from recession in Q3, following peak-to-trough real GDP decline of 5.6%. Even so, the recovery is far from solid. Unemployment has risen for 18-straight months, though the pace of increase has slowed. On the plus side, industrial production is up two months in a row and retail sales have improved. Credit conditions remain relatively tight but the Bank of England's Q3 Credit Conditions Survey indicated that credit was increasingly available for consumer mortgages and corporations, and is expected to improve again over the next quarter.

The Bank of England is expected to stay on hold in October, waiting for the November Inflation Report before deciding if further quantitative easing is necessary. There has been some speculation that the BoE might opt to cut the deposit rate in an effort to spark bank lending. Considering the choppy improvement in the data, the Bank is likely to either slow asset purchases again or halt them altogether in November. If the Monetary Policy Committee chooses to slow purchases, they might opt to buy £25 bln over 3 months, down from £50 bln

from August to October and £75 bln from May to July.



With policy likely to remain unchanged in October, Governor King has turned his attention to the pound, which he apparently wants to remain weak to support the recovery. King's loose lips sideswiped the currency in September, pushing it to a four-month low. Ongoing potential for further quantitative easing will weigh on the currency until the BoE explicitly states that no further assets will be purchased. Once that happens, which could be as soon as November, look for the pound to bounce back sharply towards \$1.65, then trend higher at a more gradual pace.

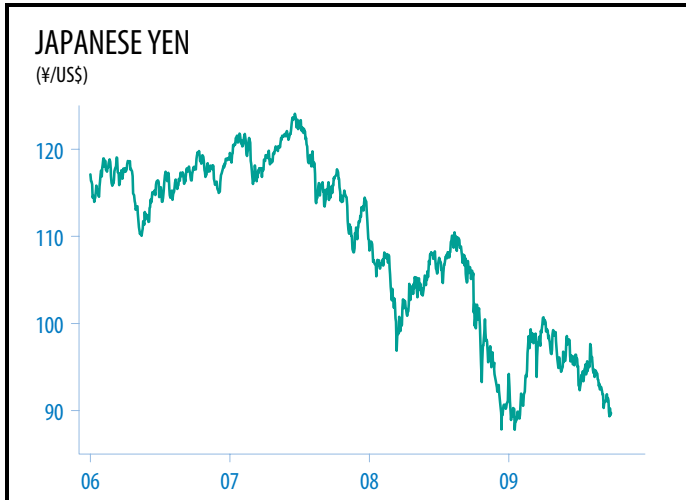
Japanese Yen

The yen strengthened in September, boosted by comments from new Finance Minister Fujii that he isn't opposed to a stronger currency and a recent stall in the global equity rally. Japan's economy is poised to grow for a second straight quarter in Q3, with industrial production now up 6 consecutive months (the best streak in 13 years). Even so, output is down 23.6% from its early 2008 peak. Exports remain weak as well, recovering very slowly from the steep drop that began in October 2008.

Weak domestic activity has contributed to the deepest deflation on record, with CPI falling -2.2% y/y in August. Deflation should keep the Bank of Japan on the sidelines until at least 2011. But we still expect the BoJ to pare some of its emergency credit facilities around year end as financial markets heal.

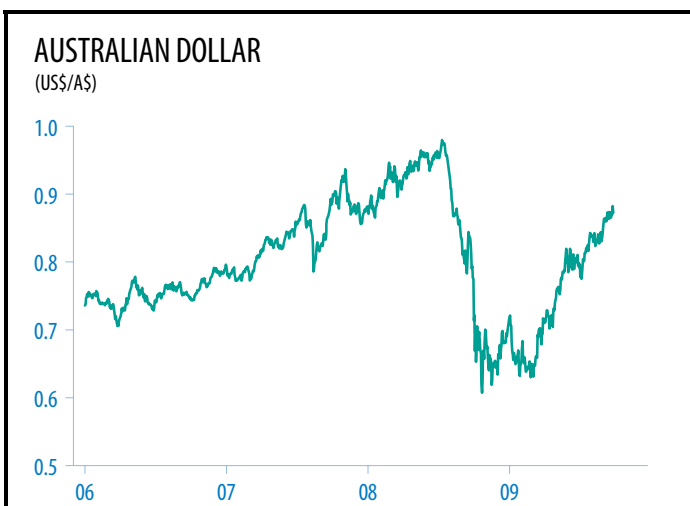
Japan's new government came into power with a lot of ink spilled, but there's been little

action thus far, except from the mouth of Finance Minister Fujii. The newly installed Minister has noted on several occasions his support for yen strength to support domestic spending. While he is correct in the long-run about a strong currency supporting domestic spending, the short-run negatives for exporters cannot be overlooked. Considering the significant export base in the economy, a strong currency hammers profits and that weighs on GDP and job growth which is certainly negative for the domestic economy, so his words could backfire. Despite the rhetoric, yen strength is unlikely to persist, as other major central banks will hike rates as we move through 2010 while the BoJ stays on hold.



Australian Dollar

While Australia's economy has shown signs of strength, its recovery appears to be on a bumpy road as well. Employment fell in August, though retail sales rose, muddling the performance of the domestic economy. The RBA is concerned about the sustainability of domestic spending as the fiscal stimulus peters out. The decent data also lowered "the likelihood of inflation being persistently below the target." Despite potential potholes, Australia will likely continue to be among the leaders of the economic recovery due to its leverage to China's economy.



The upward trend in many indicators underlies our expectation that the RBA will be among the first central banks to hike rates. However, the bank will need to see clear signs that the recovery is sustainable first. For now that's likely an early 2010 story, however, there is a chance we could see a Q4 hike.

An aggressive central bank, along with continued strength in commodities due to improving global growth, will provide strong support for the Australian dollar. The currency had another solid month in September, appreciating 4.6% to a one-year high of over 88 cents. Look for further strength in the Aussie as long as global growth continues to accelerate.

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

	Actual Sep	2009 Oct	Nov	Dec	Q4	2010 Q1	Q2	Q3	Q4
Canadian Dollar									
C\$ per US\$	1.082	1.071	1.061	1.050	1.061	1.042	1.029	1.017	1.004
US\$ per C\$	0.925	0.934	0.943	0.952	0.943	0.960	0.972	0.983	0.996
Trade-Weighted	110.7	111.8	112.9	114.0	112.9	115.4	117.5	119.6	119.4
U.S. Dollar									
Trade-Weighted*	103.1	102.9	102.6	102.4	102.6	101.6	100.3	99.1	98.2
European Currencies									
Euro**	1.46	1.46	1.47	1.48	1.47	1.49	1.51	1.53	1.54
Danish Krone	5.11	5.10	5.10	5.05	5.10	5.00	4.95	4.90	4.85
Norwegian Krone	5.91	5.85	5.80	5.75	5.80	5.65	5.45	5.25	5.05
Swedish Krona	7.00	6.95	6.85	6.80	6.87	6.70	6.50	6.30	6.10
Swiss Franc	1.04	1.04	1.04	1.04	1.04	1.03	1.02	1.00	1.00
U.K. Pound**	1.63	1.65	1.66	1.68	1.66	1.70	1.75	1.79	1.84
Asian Currencies									
Chinese Yuan	6.83	6.83	6.83	6.83	6.83	6.77	6.69	6.61	6.53
Japanese Yen	91	93	94	95	94	96	97	98	100
Korean Won	1214	1205	1195	1190	1195	1160	1120	1080	1045
Indian Rupee	48.3	48.0	47.8	47.5	47.8	47.2	46.7	46.3	46.1
Singapore Dollar	1.42	1.42	1.41	1.40	1.41	1.40	1.39	1.38	1.37
Malaysian Ringgit	3.49	3.48	3.47	3.46	3.47	3.41	3.35	3.28	3.22
Thai Baht	33.8	33.7	33.6	33.5	33.6	33.1	32.5	31.9	31.3
Philippine Peso	48.0	47.8	47.5	47.3	47.5	46.4	45.0	43.8	42.6
Taiwan Dollar	32.6	32.5	32.4	32.3	32.4	32.0	31.5	31.1	30.7
Indonesian Rupiah	9848	9790	9730	9670	9730	9550	9370	9190	9020
Other Currencies									
Australian Dollar**	0.861	0.875	0.887	0.900	0.887	0.908	0.921	0.933	0.946
N.Z. Dollar**	0.703	0.711	0.718	0.725	0.718	0.733	0.746	0.758	0.771
Mexican Peso	13.42	13.44	13.47	13.50	13.47	13.47	13.40	13.35	13.25
Brazilian Real	1.82	1.81	1.80	1.79	1.80	1.78	1.77	1.76	1.75
Russian Ruble	30.7	30.5	30.2	29.9	30.2	29.8	29.7	29.6	29.5
South African Rand	7.5	7.6	7.7	7.7	7.7	7.9	8.1	8.3	8.5

* Federal Reserve Broad Index

** (US\$ per local currency)

Cross Rates

Versus Canadian Dollar

Euro (C\$/€)	1.58	1.57	1.56	1.55	1.56	1.55	1.55	1.55	1.55
U.K. Pound (C\$/£)	1.76	1.76	1.76	1.76	1.76	1.78	1.80	1.82	1.84
Japanese Yen (¥/C\$)	85	87	89	90	89	92	94	96	100
Australian Dollar (C\$/A\$)	0.932	0.937	0.941	0.945	0.941	0.946	0.948	0.949	0.950

Versus Euro

U.K. Pound (£/€)	0.89	0.89	0.88	0.88	0.88	0.87	0.86	0.85	0.84
Japanese Yen (¥/€)	133	136	138	140	138	143	146	149	154

Barney Bonekamp contributed to the above forecasts

**Interest Rate
Forecasts
Percent
(averages)**

	Actual Sep	2009 Oct	Nov	Dec	Q4	2010 Q1	Q2	Q3	Q4
Cdn. Yield Curve									
Overnight	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.58	1.08
3 month	0.22	0.20	0.20	0.20	0.20	0.20	0.30	0.80	1.25
6 month	0.30	0.30	0.30	0.30	0.30	0.30	0.40	0.95	1.40
1 year	0.52	0.55	0.60	0.65	0.60	0.75	0.95	1.35	1.75
2 year	1.26	1.20	1.30	1.40	1.30	1.60	1.85	2.10	2.40
3 year	1.91	1.85	1.90	1.95	1.90	2.10	2.30	2.50	2.75
5 year	2.60	2.50	2.55	2.60	2.55	2.65	2.75	2.90	3.10
7 year	2.86	2.75	2.80	2.90	2.80	3.00	3.20	3.35	3.50
10 year	3.37	3.25	3.30	3.35	3.30	3.45	3.55	3.65	3.75
30 year	3.89	3.80	3.85	3.90	3.85	4.00	4.10	4.20	4.30
U.S. Yield Curve									
Fed funds	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.25	0.75
3 month	0.12	0.10	0.10	0.10	0.10	0.10	0.10	0.25	0.75
6 month	0.21	0.15	0.15	0.15	0.15	0.15	0.15	0.30	0.80
1 year	0.40	0.35	0.45	0.50	0.45	0.60	0.80	1.05	1.40
2 year	0.96	0.85	1.00	1.10	1.00	1.35	1.70	2.05	2.35
3 year	1.48	1.35	1.45	1.60	1.45	1.80	2.15	2.45	2.75
5 year	2.37	2.20	2.30	2.40	2.30	2.60	2.85	3.15	3.40
7 year	3.02	2.80	2.90	3.00	2.90	3.15	3.40	3.60	3.80
10 year	3.40	3.20	3.30	3.40	3.30	3.50	3.65	3.80	3.95
30 year	4.19	3.95	4.05	4.15	4.05	4.25	4.40	4.55	4.65

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