Rates Scenario
ECONOMIC RESEARCH
BMO Capital Markets
Fixed Income and Foreign Exchange Strategy

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Forecast Summary (averages)

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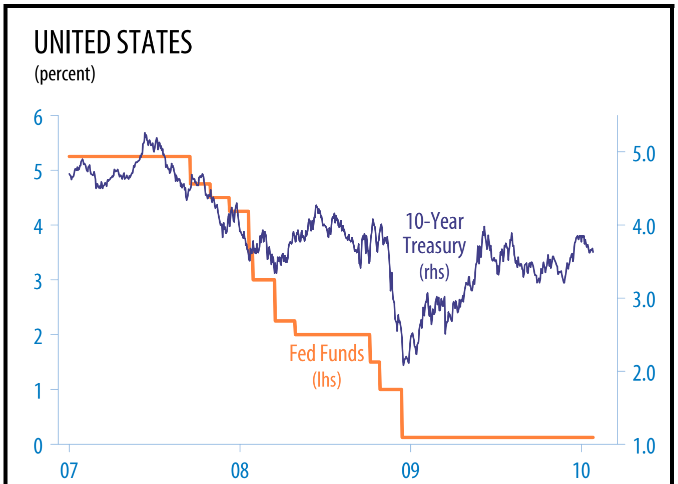
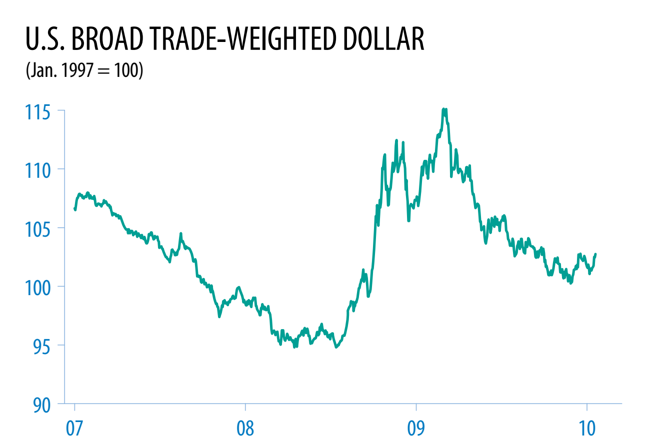
	Actual	2010						2011			
	Jan	Feb	Mar	Apr	Q2	Q3	Q4	Q1	Q2	Q3	Q4
BoC overnight	0.25	0.25	0.25	0.25	0.25	0.60	1.10	1.60	2.10	2.60	3.10
10-yr Canadas	3.49	3.35	3.40	3.45	3.45	3.60	3.70	3.90	4.10	4.30	4.55
Fed funds	0.13	0.13	0.13	0.13	0.13	0.25	0.75	1.35	1.85	2.25	2.75
10-yr Treasuries	3.73	3.65	3.70	3.70	3.75	3.90	4.05	4.25	4.50	4.75	5.00
C$ per US$	1.044	1.050	1.041	1.033	1.024	0.999	0.997	0.996	0.990	0.983	0.977
US$/€	1.43	1.40	1.41	1.42	1.43	1.46	1.49	1.49	1.48	1.47	1.45
US$/£	1.62	1.62	1.63	1.65	1.66	1.70	1.74	1.77	1.79	1.82	1.84
¥/US$	91	91	90	91	92	96	99	102	104	107	109

U.S. Rates

The Fed continues to keep the federal funds rate at "*exceptionally low levels… for an extended period*". However, Kansas City Fed President Hoenig, the lone dissenter at January's meeting, "*believed that economic and financial conditions had changed sufficiently that* [this policy] … *was no longer warranted*." This opinion will probably spread as the year unfolds, but not because the data on the ground will be signalling the need to tighten. We expect that Bernanke's "formidable headwinds" caused by **weak labour markets and credit creation will still justify very low policy rates well into 2011. However, the risks to financial stability from keeping rates too low for too long will also likely rise, eliciting a tightening shift before yearend (we're pencilling in September)**, but still keeping policy on the historically accommodative side for the foreseeable future.





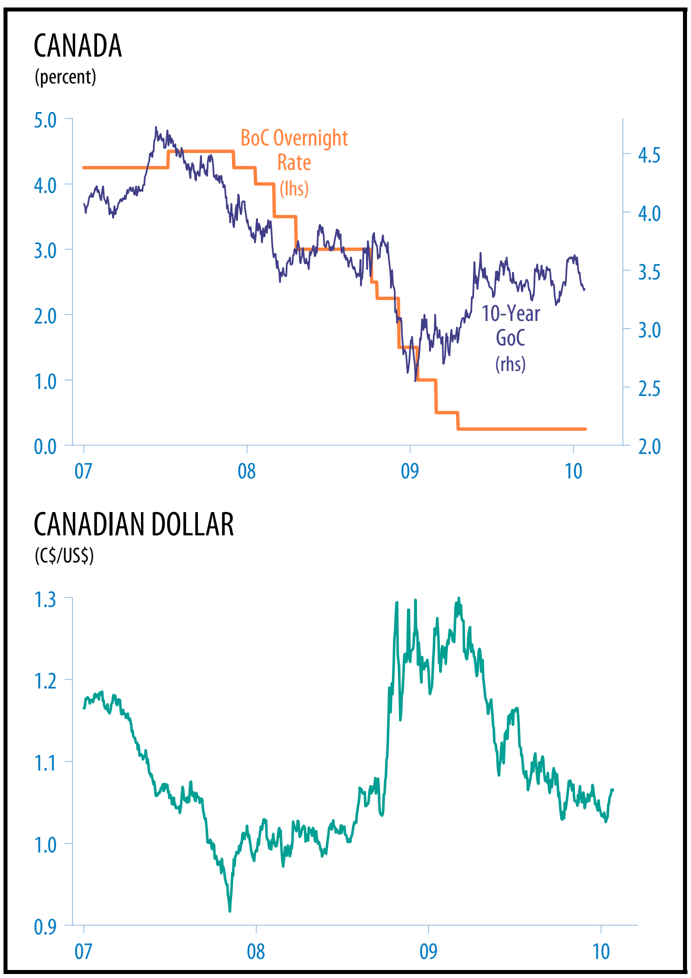
Source: U.S. Federal Reserve Board

Although Treasury yields drifted lower last month, they remain above their late-November lows and we expect them to resume their uptrend once risk appetites are re-whetted by improved global economic data and as the financing of this year's record-sized Treasury budget deficit causes some supply indigestion. Importantly, the uptrend should remain a grinding one (e.g., 10-year yields should remain below 4% for most of 2010), as the demand for Treasuries still finds support from balance sheet restructuring (predominantly by domestic banks but also from households via pensions and investment funds), and buying by foreign authorities (parking their FX reserves to resist local appreciation against the USD).

The U.S. dollar continues to gain against the major currencies, since bottoming at the end of November. Global economic and financial concerns are being stoked by European sovereign credit risks and China's efforts to cool its red-hot economy. Eventually, the latter should push China to permit moderate yuan appreciation against the USD again, which will lift other smaller Asian currencies (taking some of the secular appreciation pressure off the majors). Meantime, as global economic recovery continues, this should further fan risk appetites, alleviate some sovereign credit concerns (pushing Greece et al to the backburners), and provide additional support to the commodity currencies. Thus, **we look for the greenback to eventually head south again**, augmented by pressures exerted by external financing of Treasury deficits and official asset diversification flows. However, we judge the USD will likely fall short of establishing a new record low against the majors, particularly as the Fed removes its excessive easing and U.S. economic growth begins to noticeably surpass the Euro area.

Canadian Rates

The Bank of Canada reiterated its commitment on January 19th to keep the policy rate *"at its current level until the end of the second quarter of 2010"*, conditional on inflation (which should be cooperative). **We look for rates to rise in Q3 (pencilling in July 20th), early after the commitment period ends.** With a fully-functioning credit creation process (check the hot housing market if you have any doubts), the clock is ticking on the policy imperative to lift policy rates and the general cost of credit from current extreme lows, for fear of fuelling financial instability (asset price bubbles, excessive risk taking). Furthermore, with the output gap now closing (average GDP growth in the three months ending November was 3.3% compared to a potential pace under 2%), and the Bank itself expecting the gap to be gone by 2011 H2, the long and variable lags required by monetary policy to work its way through the economy necessitates an early rate hike start (as does a simple Taylor Rule approach).

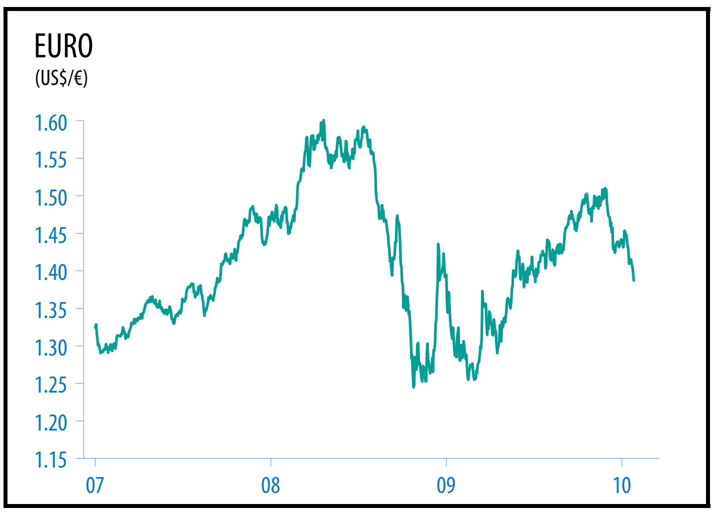


This means the BoC will likely move ahead of the Fed, prodding a stronger Canadian dollar and augmenting the expected strength garnered from firming commodity prices and a weakening U.S. dollar. **We look for the loonie to trade through parity by Q3,** leading the Bank to hike rates more cautiously. Given that *"persistent strength of the Canadian dollar that could act as a significant further drag on growth and put additional downward pressure on inflation"* remains a key downside risk, BoC policy is not insensitive to the loonie. Should the C$ appreciate too quickly or too much (say, testing the modern-day high above US$1.10), the Bank is more likely to stay on hold for longer and keep to only very gradual rate hikes.

The recent uptrend in Treasury yields during the past couple months did not completely cross the border, causing Canada-U.S. bond yield spreads to narrow (or move more negative beyond a 5-year tenor). This is a taste of things to come. Although increased supply and prospective central bank rate hikes will contribute to higher Government of Canada yields as well, they should continue to outperform Treasuries owing to their relatively superior fiscal fundamentals and expected currency appreciation. The global spotlight cast on sovereign credit risk has shone favourably on Canada.

Euro

Greek fiscal concerns continue to overshadow all else in Europe, with its sovereign credit spreads widening to a record high. Other potentially worrisome countries like Spain, Portugal and Italy have seen some deterioration in their spreads as well. Considering the size of the Greek deficit (>12% of GDP), this issue is likely to remain a cloud over the region through at least the first half of the year.

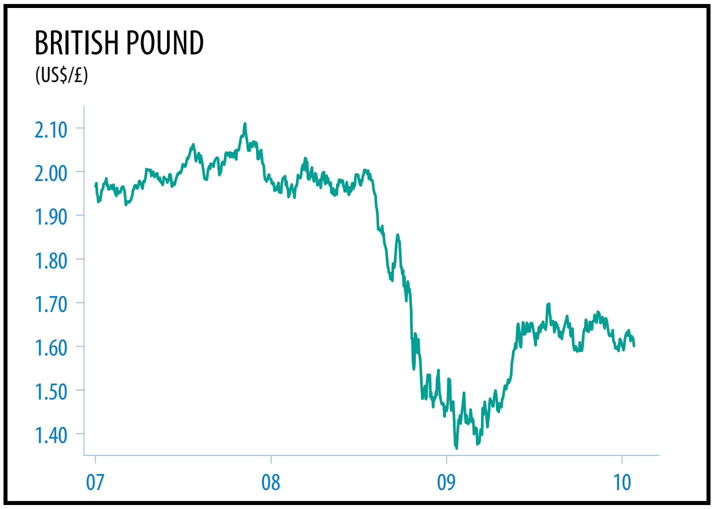


The continued uncertainty is weighing on the euro, which fell below $1.40 for the first time since July. Europe's less-than-stellar recovery hasn't helped much either. Indeed, growth is expected to remain subdued in the region. However, ebbing risk aversion should allow the currency to gain ground through 2010, as the global recovery continues to pick up steam led by emerging markets.

While the fiscal issues are keeping the ECB busy, they aren't likely impacting policy just yet. Looking ahead, fiscal austerity will act as a headwind on growth, limiting the scope for rate hikes, but that's likely more of a 2011 story. ECB policy looks to remain unchanged this week for the 9th straight month, with inflation to remain subdued. Money supply actually fell in the Euro area from a year ago in November for the first time on record, indicating there's little inflation pressure in the pipeline. **The benign inflation outlook points to the ECB staying on hold through at least the first half of the year.**

U.K. Pound

The U.K. was the last G7 economy to emerge from recession with Q4 real GDP growing for the first time in nearly two years. While growth was a meagre 0.1%, and well below expectations, economic conditions are improving, with unemployment falling in the final two months of 2009. Meantime, inflation has jumped thanks largely to the year-ago VAT cut falling out of the calculation and will rise sharply again in January as the VAT increased 2.5 ppts back to 17.5%. Even though the price pressure is transitory, it will still force Governor King to write a letter to the Finance Minister as inflation will breach 3%.

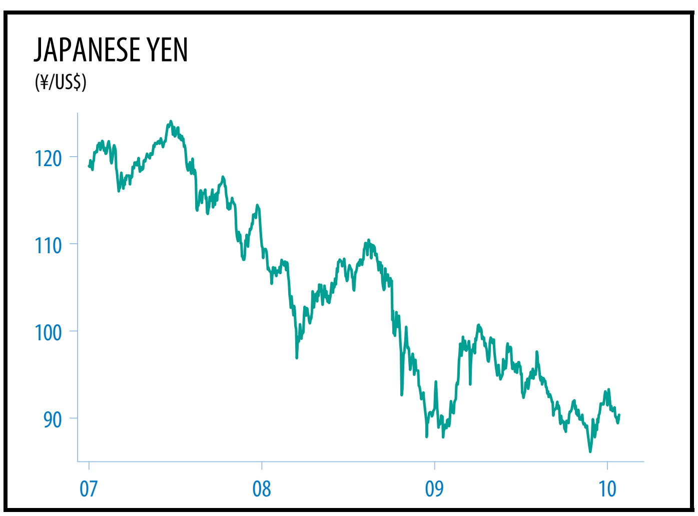


February is a decisive month for the BoE as it will be armed with a new Inflation Report. We anticipate that **elevated inflation and an improving outlook will be highlighted in the report and likely be enough for the BoE to stand pat**. However, look for the door to further easing to stay open as the recovery has yet to establish a solid foundation.

The pound should benefit somewhat from a steady BoE. However, ongoing fiscal uncertainty along with the looming November election will weigh on the currency throughout the year. S&P also downgraded the U.K banking system, undercutting the pound at month end. Despite the headwinds, **rising risk appetite should be sufficient to push the pound on an upward trend through 2010.**

Japanese Yen

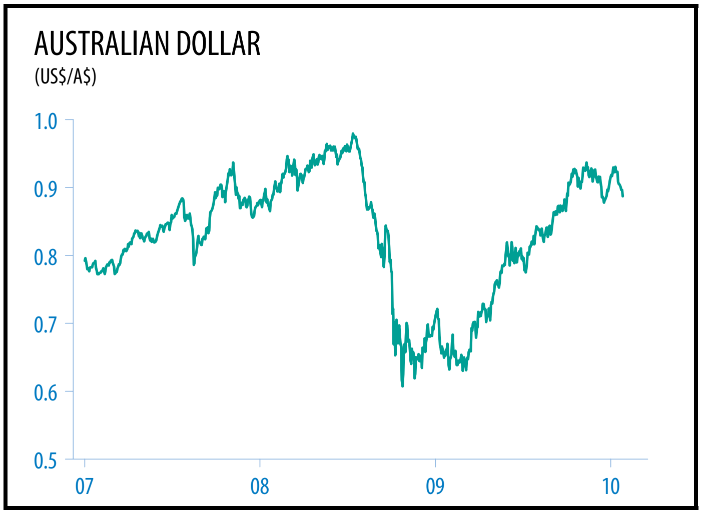
The Bank of Japan held steady in January despite some expectations of further easing. The Bank's growth forecast was largely unchanged, though inflation was revised up. Even so, Japan remains mired in deflation which is still projected to persist through 2011. More aggressive policy action will be needed in order to effectively combat deflation. As such, **we expect the BoJ will increase its quantitative easing efforts in the first half of 2010.** The Bank may wait to ease further until April's semi-annual outlook report, in order to have a more comprehensive evaluation of the economy.



Japan is likely to be the only country easing monetary policy further in 2010. The policy rate is expected to remain steady at 0.1% through 2010 and 2011. **We look for the yen to weaken throughout that period, as interest rates will be rising elsewhere, and the yen carry trade re-emerges**. However, bouts of strength should be expected as doubts about the global recovery pop up.

Australian Dollar

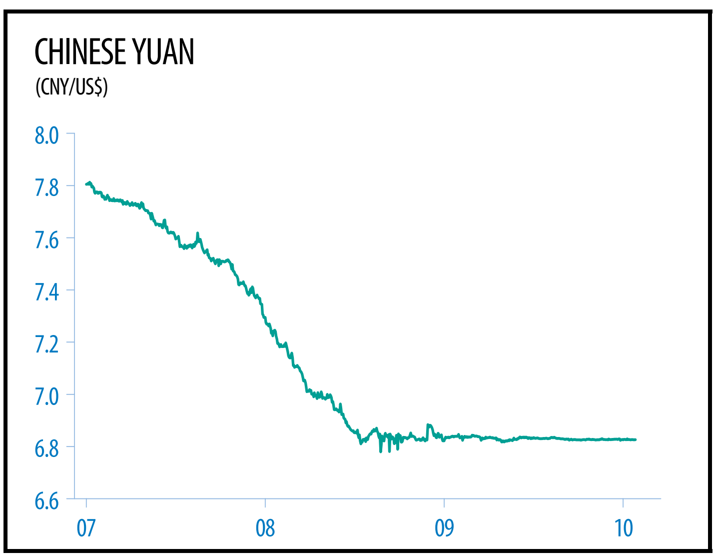
The Reserve Bank of Australia has been among the most aggressive central banks, raising rates 75 bps to 3.75% in 2009Q4. **Look for that trend to continue in February with another 25 bp rate hike.** Recent economic data have been stellar, with employment, auto sales, building approvals, and retail sales recording very strong gains. Consumer confidence also rebounded in January following two down months, pointing to continued strength ahead. On the inflation front, Q4 CPI came in slightly above expected. Underlying inflation was also a tad above the RBA's November forecast (which will be revised this month). Australia's exposure to China and strong commodity prices should keep the economy rolling and points to rising interest rates throughout 2010.



The Australian dollar was about flat in January, with late-month weakness offsetting earlier gains. Despite recent struggles, Australia's solid growth outlook and more aggressive RBA tightening will likely **push the Australian dollar to parity in the second half of 2010 for the first time in 18 years**.

Chinese Yuan

The People's Bank of China sent a shudder through financial markets in January by raising bank reserve requirements and putting further restrictions on lending. **While these actions are indeed tightening, they don't indicate China is slamming on the brakes**. Lending was reportedly surging early in January (over 1 trillion yuan) and it's likely that officials wanted to ensure annual lending quotas aren't filled too early in the year. With a reported 7.5 trillion yuan annual quota for 2010, lending should average about 625 billion per month, well below January's pace. Indeed, China's extraordinary effort to jumpstart its economy in late 2008 with a US$586 bln stimulus package isn't about to be squandered. Chinese officials are likely trying to ensure that growth doesn't accelerate much beyond Q4's 10.7% y/y pace, in order to avoid inflationary pressure. We believe the market's reaction to China's tightening has been overdone, considering we have yet to see any signs of a slowdown. On the currency front, little has changed with the yuan holding its peg to the US$. However, **pressure continues to build to allow the yuan to appreciate and we expect China to accede at some point this year**.



Foreign Exchange Forecasts
Local Currency per U.S. Dollar (averages)

	Actual Jan	2010 Feb	Mar	Apr	Q2	Q3	Q4	2011 Q1	Q2	Q3	Q4
Canadian Dollar											
C$ per US$	1.044	1.050	1.041	1.033	1.024	0.999	0.997	0.996	0.990	0.983	0.977
US$ per C$	0.958	0.952	0.961	0.968	0.977	1.001	1.003	1.004	1.010	1.017	1.024
Trade-Weighted	114.9	114.3	115.1	116.0	117.0	119.8	119.9	120.0	121.0	121.9	122.9
U.S. Dollar											
Trade-Weighted*	102.7	102.5	102.0	101.6	101.2	99.9	99.1	98.7	98.6	98.5	98.4
European Currencies											
Euro**	1.43	1.40	1.41	1.42	1.43	1.46	1.49	1.49	1.48	1.47	1.45
Danish Krone	5.22	5.35	5.30	5.25	5.20	5.10	5.00	5.00	5.05	5.10	5.15
Norwegian Krone	5.74	5.75	5.68	5.60	5.53	5.30	5.10	5.05	5.15	5.25	5.30
Swedish Krona	7.15	7.15	7.05	6.90	6.80	6.45	6.10	6.05	6.15	6.25	6.35
Swiss Franc	1.03	1.06	1.06	1.05	1.04	1.03	1.01	1.01	1.02	1.03	1.04
U.K. Pound**	1.62	1.62	1.63	1.65	1.66	1.70	1.74	1.77	1.79	1.82	1.84
Asian Currencies											
Chinese Yuan	6.83	6.83	6.83	6.83	6.82	6.75	6.67	6.58	6.50	6.42	6.35
Japanese Yen	91	91	90	91	92	96	99	102	104	107	109
Korean Won	1138	1125	1110	1100	1085	1050	1010	980	955	925	900
Indian Rupee	45.9	45.6	45.5	45.3	45.2	44.7	44.2	43.7	43.7	43.9	44.2
Singapore Dollar	1.40	1.40	1.40	1.40	1.40	1.39	1.39	1.37	1.35	1.34	1.32
Malaysian Ringgit	3.38	3.39	3.38	3.37	3.35	3.29	3.23	3.19	3.17	3.14	3.12
Thai Baht	33.0	32.9	32.8	32.7	32.6	32.0	31.4	30.9	30.3	29.8	29.3
Philippine Peso	46.0	46.2	46.1	45.9	45.8	45.4	44.9	44.5	43.9	43.4	42.8
Taiwan Dollar	31.9	31.8	31.7	31.5	31.4	31.0	30.6	30.2	29.8	29.4	28.9
Indonesian Rupiah	9267	9300	9260	9220	9180	9060	8940	8870	8820	8770	8720
Other Currencies											
Australian Dollar**	0.913	0.920	0.933	0.947	0.960	0.996	1.000	1.004	1.011	1.018	1.024
N.Z. Dollar**	0.726	0.720	0.728	0.736	0.744	0.768	0.792	0.808	0.821	0.833	0.846
Mexican Peso	12.81	12.80	12.80	12.75	12.75	12.65	12.55	12.45	12.45	12.55	12.65
Brazilian Real	1.78	1.80	1.80	1.79	1.77	1.75	1.74	1.74	1.75	1.76	1.77
Russian Ruble	29.9	29.8	29.8	29.7	29.7	29.5	29.4	29.3	29.2	29.1	29.0
South African Rand	7.5	7.5	7.5	7.5	7.6	7.6	7.7	7.8	7.9	8.0	8.1

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

Cross Rates

	Actual Jan	2010 Feb	Mar	Apr	Q2	Q3	Q4	2011 Q1	Q2	Q3	Q4
Versus Canadian Dollar											
Euro (C$/€)	1.49	1.47	1.46	1.47	1.46	1.46	1.49	1.49	1.46	1.44	1.42
U.K. Pound (C$/£)	1.69	1.70	1.69	1.70	1.70	1.70	1.73	1.76	1.77	1.79	1.80
Japanese Yen (¥/C$)	87	87	86	88	90	96	99	102	105	109	112
Australian Dollar (C$/A$)	0.953	0.966	0.972	0.978	0.983	0.995	0.997	1.000	1.001	1.000	1.000
Versus Euro											
U.K. Pound (£/€)	0.88	0.86	0.86	0.86	0.86	0.86	0.86	0.84	0.83	0.81	0.79
Japanese Yen (¥/€)	130	127	126	129	132	140	148	152	154	157	158

Barney Bonekamp contributed to the above forecasts

Interest Rate Forecasts
Percent (averages)

	Actual Jan	2010 Feb	Mar	Apr	Q2	Q3	Q4	2011 Q1	Q2	Q3	Q4
Cdn. Yield Curve											
Overnight	0.25	0.25	0.25	0.25	0.25	0.60	1.10	1.60	2.10	2.60	3.10
3 month	0.17	0.15	0.15	0.15	0.25	0.75	1.25	1.75	2.20	2.70	3.15
6 month	0.26	0.25	0.25	0.25	0.35	0.95	1.40	1.85	2.35	2.80	3.25
1 year	0.59	0.55	0.60	0.65	0.80	1.35	1.75	2.15	2.60	3.00	3.45
2 year	1.28	1.30	1.45	1.60	1.75	2.10	2.40	2.75	3.10	3.45	3.80
3 year	1.72	1.60	1.75	1.95	2.10	2.45	2.70	3.00	3.35	3.65	4.00
5 year	2.60	2.45	2.50	2.60	2.65	2.85	3.05	3.30	3.60	3.90	4.15
7 year	2.94	2.80	2.90	3.00	3.10	3.30	3.45	3.65	3.90	4.15	4.40
10 year	3.49	3.35	3.40	3.45	3.45	3.60	3.70	3.90	4.10	4.30	4.55
30 year	4.05	3.95	4.00	4.00	4.05	4.20	4.30	4.45	4.65	4.85	5.05
3m BA	0.32	0.30	0.30	0.30	0.40	0.95	1.40	1.90	2.35	2.85	3.35
Prime Rate	2.25	2.25	2.25	2.25	2.25	2.60	3.10	3.60	4.10	4.60	5.10
U.S. Yield Curve											
Fed funds	0.13	0.13	0.13	0.13	0.13	0.25	0.75	1.35	1.85	2.25	2.75
3 month	0.06	0.10	0.10	0.10	0.10	0.20	0.70	1.30	1.80	2.20	2.70
6 month	0.15	0.15	0.15	0.15	0.15	0.30	0.80	1.35	1.85	2.25	2.75
1 year	0.35	0.30	0.40	0.50	0.60	0.95	1.40	1.90	2.35	2.70	3.15
2 year	0.93	0.80	1.00	1.20	1.40	2.00	2.40	2.80	3.15	3.50	3.90
3 year	1.49	1.40	1.55	1.75	1.90	2.45	2.75	3.15	3.50	3.80	4.15
5 year	2.48	2.35	2.50	2.60	2.75	3.20	3.45	3.75	4.05	4.30	4.60
7 year	3.21	3.10	3.20	3.30	3.40	3.65	3.90	4.10	4.40	4.65	4.90
10 year	3.73	3.65	3.70	3.70	3.75	3.90	4.05	4.25	4.50	4.75	5.00
30 year	4.60	4.50	4.55	4.60	4.65	4.75	4.90	5.10	5.35	5.60	5.85
3m LIBOR	0.25	0.25	0.25	0.25	0.25	0.35	0.85	1.45	1.95	2.35	2.85
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.55	4.15	4.70	5.20	5.65	6.15
Other G7 Yields											
ECB Refi	1.00	1.00	1.00	1.00	1.00	1.10	1.75	2.15	2.40	2.85	3.15
10yr Bund	3.30	3.35	3.40	3.45	3.50	3.70	3.85	4.00	4.15	4.30	4.45
BoE Repo	0.50	0.50	0.50	0.50	0.50	0.60	1.25	2.00	2.50	3.00	3.50
10yr Gilt	3.97	4.05	4.15	4.20	4.25	4.50	4.70	4.90	5.05	5.25	5.45
BoJ O/N	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
10yr JGB	1.34	1.35	1.40	1.40	1.45	1.50	1.60	1.65	1.65	1.70	1.75