

## Fixed Income and Foreign Exchange Strategy

### March 3, 2010 Forecast Summary (averages)

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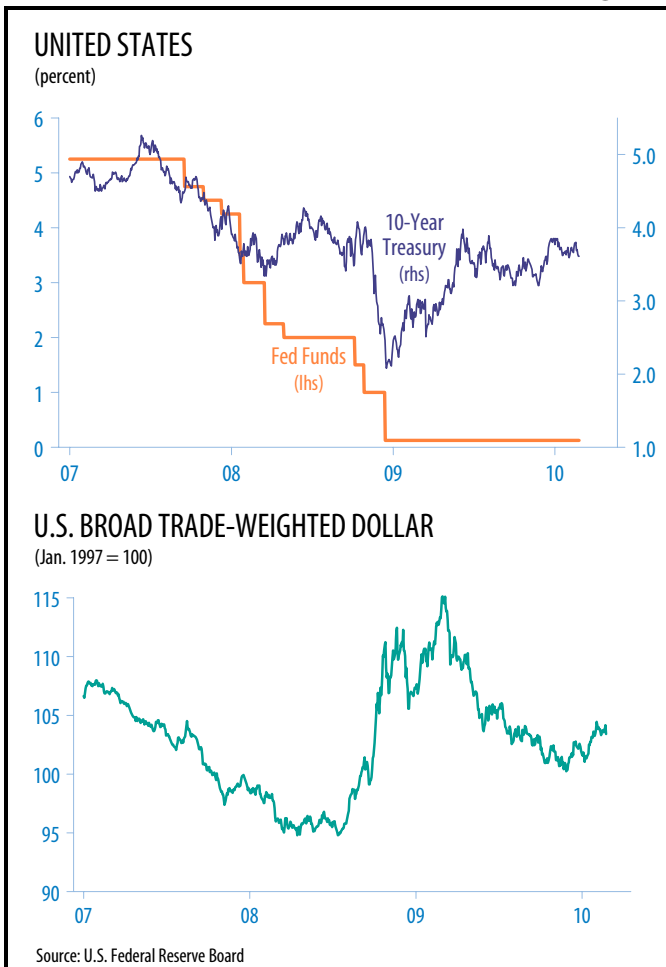
	Actual Feb	2010 Mar	Apr	May	Q2	Q3	Q4	2011 Q1	Q2	Q3	Q4
BoC overnight	0.25	0.25	0.25	0.25	0.25	0.60	1.10	1.60	2.10	2.60	3.10
10-yr Canadas	3.42	3.40	3.40	3.40	3.45	3.50	3.65	3.85	4.05	4.25	4.45
Fed funds	0.13	0.13	0.13	0.13	0.13	0.25	0.75	1.35	1.85	2.25	2.75
10-yr Treasuries	3.69	3.70	3.60	3.65	3.65	3.75	3.95	4.15	4.40	4.65	4.90
C\$ per US\$	1.057	1.048	1.038	1.028	1.028	1.000	0.997	0.996	0.990	0.983	0.977
US\$/€	1.37	1.36	1.38	1.39	1.39	1.41	1.44	1.44	1.43	1.42	1.40
US\$/£	1.56	1.52	1.54	1.55	1.55	1.58	1.60	1.62	1.64	1.67	1.69
¥/US\$	90	90	91	92	92	96	99	102	104	107	109

### U.S. Rates

The Fed raised the discount rate 25 bps to 0.75% on February 18 and tightened other terms of the discount window's primary credit program. This was another signpost that the Fed's credit and quantitative easing exercise was winding down. Interestingly, it was an easing of primary

credit terms that marked the start of this exercise back in August 2007, followed three months later by the Term Auction Facility. The last TAF tender will be held next week, as the alphabet soup of other liquidity and credit facilities that followed the TAF was allowed to expire last month, save for the Term Asset-Backed Securities Loan Facility. But TALF begins to be reined in this month, alongside the final transactions in the Fed's \$1.75 trillion asset purchase program. Although TALF will be completely phased out by June, and it's uncertain whether we'll get any additional solo discount rate hikes to restore the normal 100-bp spread over interbank rates, **March essentially marks the end of the Fed's credit and quantitative easing efforts.**

Attention now turns to the Fed's exit strategy, which was laid out in Chairman Bernanke's February 10<sup>th</sup> testimony. The legacy of this easing exercise is \$1.3 trillion of excess bank reserves. Instead of permanently sopping up these reserves by selling its accumulated assets (and potentially causing term borrowing costs to spike), the Fed intends to temporarily—but repeatedly—tie up these reserves in reverse repos, term deposits and special auctions of Treasury securities. These transactions will be tested and calibrated during the period ahead until they are able to exert upward pressure on



overnight interbank rates comparable to any announced changes in the Fed's new key policy rate (the rate it pays on bank reserves). Slowly but surely the stage will be set for Fed policy rate hikes. However, we judge that Bernanke's "formidable headwinds" caused by weak labour markets and stifled credit creation could cause policy rates to remain at "exceptionally low levels" well into 2011. Nevertheless, **the risks to financial stability from keeping rates too low for too long will still likely elicit a tightening shift before yearend** (we're pencilling in September).

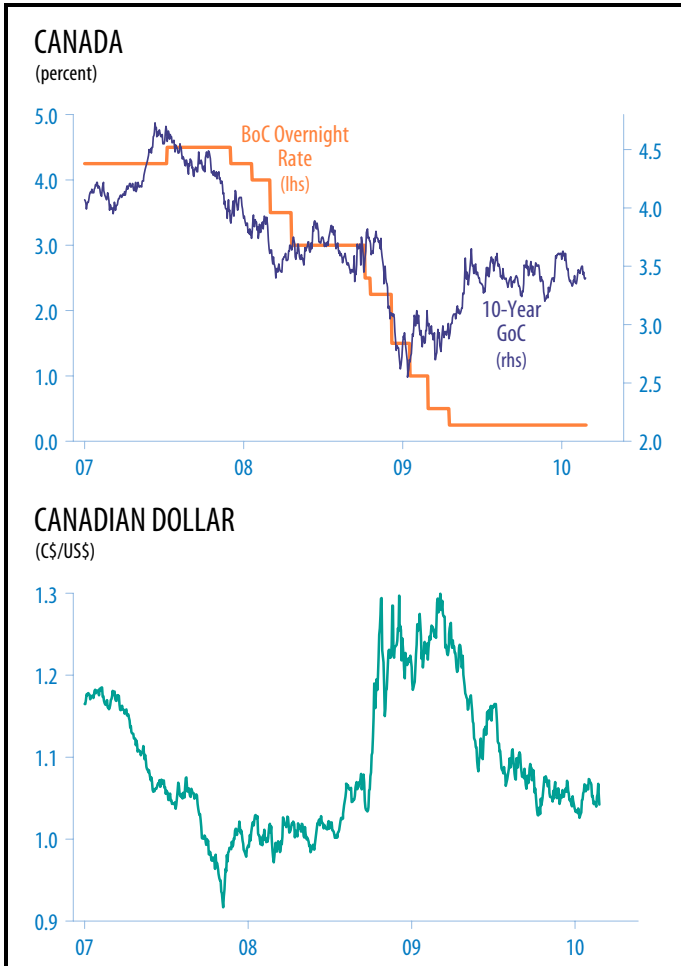
Treasury yields began to rise last month, but reversed course to close down a few bps, owing to the softer tone to U.S. economic data during the latter half of the month and as risk aversion was stoked by European sovereign credit concerns. Once the impact of harsh winter weather washes out, the data should improve and **yields should resume their uptrend** (assuming sovereign credit risks subside). Importantly, the uptrend should remain a grinding one (e.g., 10-year yields remaining below 4% for most of this year), despite record-sized Treasury budget deficits, 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 (resisting local FX appreciation against the USD).

The U.S. dollar drifted down slightly last month on a broad trade-weighted basis (-0.2%), despite firming a bit against the basket of major currencies (+0.2%). The latter reflected rising risk aversion as sovereign credit concerns increased. The former, however, is more reflective of the expected trend. China's efforts to cool its red-hot economy should eventually lead local authorities to allow moderate yuan appreciation against the USD again (around midyear), which will lift other smaller Asian currencies. Meantime, as the global economic recovery continues, risk appetites should be re-whetted (again, as sovereign credit risks subside), the commodity currencies should find further support from rising commodity prices, and external financing of Treasury deficits should prove to be a bit more problematic. As such, despite scoring some gains against select currencies, **the greenback appears destined to depreciate on a broad basis.**

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## Canadian Rates

On March 2, the Bank of Canada reiterated the conditional commitment to hold its policy rate at 0.25% until the end of the second quarter of 2010. However, the Bank noted that stronger-than-projected real GDP growth, partly owing to "*vigorous domestic spending*", along with faster-than-projected core CPI inflation, partly due to "*the higher level of economic activity*" were unfolding. The Bank also removed the boilerplate reference to its policy flexibility to ease further if they wanted to, despite rates being at their lower bound, which necessarily also removed the "tilted slightly to the downside" reference to inflation risk. Bottom line, **the Bank of Canada took a hawkish turn this month, one that should lead to a 25-bp rate hike on July 20<sup>th</sup>, with rising risks that this and/or subsequent moves could be in larger increments.** There is



also a low, but still discernable, risk that the growth-inflation dynamic currently unfolding could trigger the “conditional” criterion of the Bank’s policy commitment.

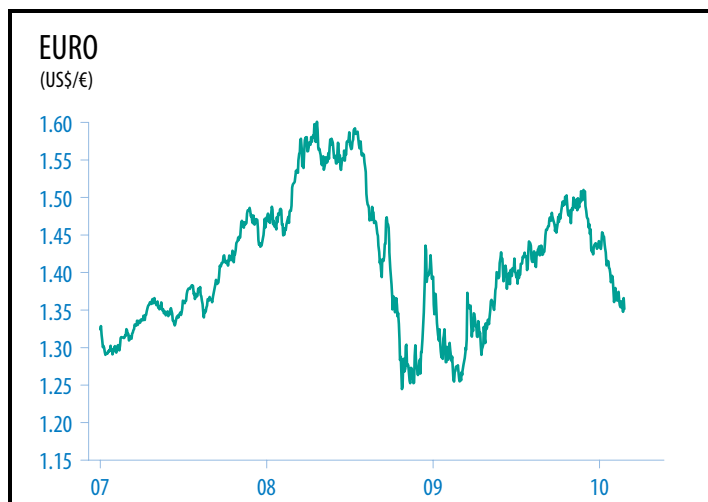
This makes it more likely that the BoC will be tightening ahead of, and more aggressively than, the Fed. This should push the Canadian dollar higher, augmenting the strength garnered from firming commodity prices (the C\$ gained 1.6% last month). **We look for the loonie to trade through parity by Q3, leading the Bank to hike rates more cautiously** (which is why we expect a series of 25-bp moves). However, with “*persistent strength of the Canadian dollar*” still a downside growth/inflation risk, should the C\$ appreciate too quickly or too much (say, testing the modern-day high above US\$1.10), the Bank would probably space the rate hikes out even more.

Amid the mild net improvement in the Treasury market last month, Canada-U.S. yield spreads widened 5-to-10 bps among medium- and long-term maturities, continuing the directional pattern of late. As the uptrend in Treasury yields resumes, and although increased supply and prospective central bank rate hikes will contribute to higher government yields north of the border as well, **Canadas should continue the pattern of**

**outperformance at the belly of the yield curve and beyond reflecting the nation’s superior fiscal fundamentals and expected currency appreciation.**

## Euro

Beware the ideoes of March with Greece’s deadline to report progress on its fiscal tightening the following day. Greece worries continue to weigh on the euro, which hit a 9-month low in February.



**A bailout plan to the tune of €25 or €30 bln has been rumored**, where fellow Euro members would buy Greek debt if they were unable to sell it publicly. Greece needs to rollover €22 bln in debt by the end of May in addition to new borrowing. Assuming Greece is willing to pay current market rates plus a sweetener, we don’t anticipate European intervention will be necessary. Even so, a plan may just be announced in order to avoid speculative attacks on Greek debt. Don’t expect this saga to end until confidence is restored in Greece, meaning this could drag on throughout 2010.

Meantime, the economic data show a **meek exit to recession** for the region, which essentially stalled in Q4. The first quarter isn't looking any better with both German business confidence and Euro area economic confidence falling in February. Adding to the bad news, winter storms pummelled continental Europe to start March, which could hamper early month activity.

As long as the growth picture remains soft and sovereign debt troubles persist, the euro is going to struggle. If the monetary union comes forward with a package and Greece satisfies the EU's budget demand by the March 16 deadline, the euro should recover through the rest of this year. However, if the Greek issues aren't soon brought under control, there is significant downside risk to our euro forecast.

## U.K. Pound

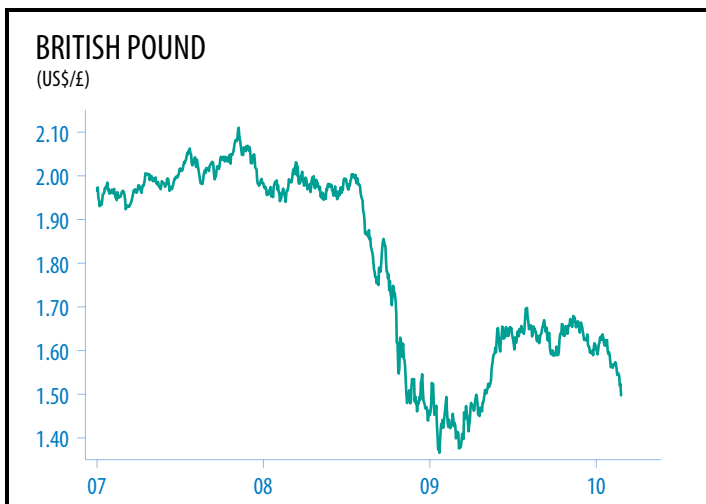
U.K. Q4 real GDP was revised up, but that didn't help the pound, which hit a 10-month low vs. the US\$ in February, as fiscal concerns continue to weigh ahead of the yet-to-be-called spring election. The latest polls point to a minority government, increasing market doubts that a fix to the fiscal problems is forthcoming. The concern is that a minority government will not be able to push through the necessary difficult budget measures to put the fiscal outlook on a more sustainable path. Near-term prospects for the pound weren't aided by news that the U.K.'s Prudential will buy AIG's Asia unit for \$35.5 billion.

On the policy front, February's Inflation Report lowered both the growth and inflation forecast, but that wasn't enough to prompt BoE easing and the recent data likely haven't altered the outlook significantly. **We are expecting no changes in interest rates or the Asset Purchase**

**Facility from the Bank of England in March.** Consumer price inflation running at 3%+ is no doubt lessening the Bank's desire to loosen policy further for fear of destabilizing inflation expectations. In addition, the proximity of the coming election and the Bank's desire to remain apolitical, point to little change in policy until the summer.

With the BoE open to more quantitative easing, and that stance unlikely to change in the near term, the pound is likely to remain under pressure. **Fiscal and monetary policy uncertainties are a troubling combination for any currency and represent downside risk.** However, once

the BoE firmly rules out further QE, and fiscal worries are laid to rest (though a minority government would make that difficult), the pound should start to recover.



## Japanese Yen

Japan is benefitting from the rebound in Asian growth, with exports bouncing smartly. January industrial production had its best gain in eight months, pointing to another potentially strong

increase in Q1 real GDP after Q4's 4.6% pop. Despite the strong data, worries about the sustainability of growth persist amid **still-anemic domestic demand**, which is the key driver of the ongoing **deflation** that plagues the country. The Government, which has yet to make



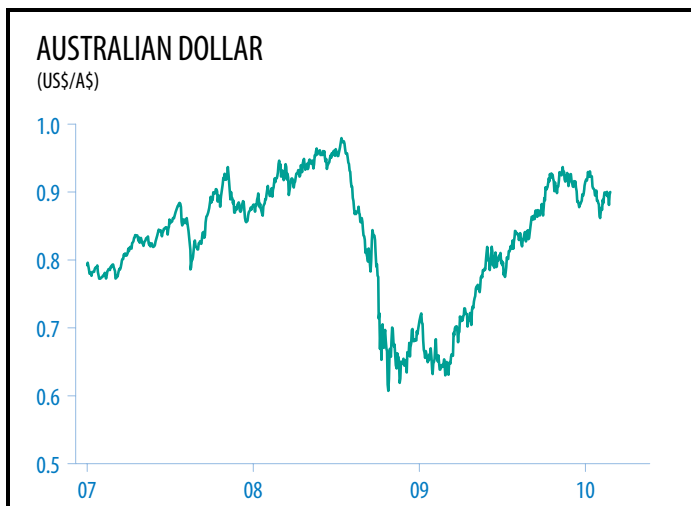
any real impact, has ratcheted up the pressure on the Bank of Japan to fight deflation. Thus far, the BoJ has resisted the demands, not wanting to be seen as monetizing the debt. Any further easing is more likely to come in the form of lending facilities until the government decides to tackle the deficit and halt the increase in the massive debt.

We expect the Bank of Japan to hold rates steady in March, with further easing possible in the coming months if the economic data again turn sour. Even if the recovery continues, moderate growth should keep the BoJ from raising rates until 2012 at the earliest. Following some fiscal year end strength in the yen, we

anticipate that **widening interest rate spreads vs. other countries will weaken the currency**, especially through H2/2010 and 2011.

## Australian Dollar

The **Reserve Bank of Australia hiked rates 25 bps to 4% at its March 2 meeting**. The statement signalled more tightening ahead, but the timing remains uncertain. The RBA is clearly more confident in the economic outlook, as *"labour market data and a range of business surveys suggest growth in the economy may have already been at or close to trend for a few months."* With rates characterized as *"lower than average"*, and *"with growth likely to be close to trend and inflation close to target over the coming year, it is appropriate for interest rates to be closer to average."* In his testimony before parliament, Governor Stevens noted that the *"average"* level of interest rates is about 4.25% to 4.75%. With the *"average"* level not far off, look for further rate increases to come every second or third month, as we anticipate the RBA will likely move towards



the upper end of the above range. The statement was more dovish than anticipated which could keep a lid on the A\$ in the near term. Expect the RBA to stay on hold in April and provide a signal for the May meeting.

The Australian dollar ended February mildly stronger. The solid outlook for the Australian economy, along with expected RBA tightening, should provide a boost to the Australian dollar through 2010. We've moved our parity call into 2011, which coincides with a stronger global economic background, as the US\$ has shown more resilience than expected.

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

	Actual Feb	2010 Mar	Apr	May	Q2	Q3	Q4	2011 Q1	Q2	Q3	Q4
<b>Canadian Dollar</b>											
C\$ per US\$	1.057	1.048	1.038	1.028	1.028	1.000	0.997	0.996	0.990	0.983	0.977
US\$ per C\$	0.946	0.954	0.963	0.973	0.973	1.000	1.003	1.004	1.010	1.017	1.024
Trade-Weighted	113.9	114.3	115.1	116.0	117.0	119.8	119.9	120.0	121.0	121.9	122.9
<b>U.S. Dollar</b>											
Trade-Weighted*	103.4	102.5	102.0	101.6	101.2	99.9	99.1	98.7	98.6	98.5	98.4
<b>European Currencies</b>											
Euro**	1.37	1.36	1.38	1.39	1.39	1.41	1.44	1.44	1.43	1.42	1.40
Danish Krone	5.44	5.50	5.40	5.35	5.35	5.30	5.20	5.15	5.20	5.25	5.30
Norwegian Krone	5.92	5.85	5.78	5.72	5.72	5.50	5.30	5.30	5.35	5.45	5.50
Swedish Krona	7.27	7.20	7.05	6.95	6.95	6.65	6.35	6.30	6.40	6.50	6.60
Swiss Franc	1.07	1.10	1.08	1.07	1.07	1.06	1.04	1.05	1.06	1.07	1.08
U.K. Pound**	1.56	1.52	1.54	1.55	1.55	1.58	1.60	1.62	1.64	1.67	1.69
<b>Asian Currencies</b>											
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	90	90	91	92	92	96	99	102	104	107	109
Korean Won	1156	1140	1130	1115	1115	1075	1040	1010	975	945	915
Indian Rupee	46.3	45.5	45.3	45.2	45.2	44.7	44.2	43.7	43.7	43.9	44.2
Singapore Dollar	1.41	1.41	1.41	1.40	1.40	1.39	1.39	1.37	1.35	1.34	1.32
Malaysian Ringgit	3.41	3.40	3.39	3.38	3.38	3.32	3.25	3.21	3.18	3.16	3.13
Thai Baht	33.1	33.0	32.9	32.8	32.8	32.2	31.6	31.0	30.5	30.0	29.4
Philippine Peso	46.3	46.2	46.0	45.9	45.9	45.4	45.0	44.5	43.9	43.4	42.8
Taiwan Dollar	32.1	31.9	31.8	31.6	31.6	31.1	30.7	30.2	29.8	29.4	28.9
Indonesian Rupiah	9336	9300	9260	9220	9220	9100	8980	8900	8850	8800	8750
<b>Other Currencies</b>											
Australian Dollar**	0.886	0.892	0.899	0.905	0.905	0.924	0.944	0.960	0.975	0.990	1.005
N.Z. Dollar**	0.697	0.705	0.713	0.721	0.721	0.744	0.767	0.783	0.796	0.808	0.821
Mexican Peso	12.94	12.70	12.70	12.70	12.70	12.60	12.55	12.45	12.50	12.60	12.70
Brazilian Real	1.84	1.80	1.79	1.79	1.79	1.77	1.75	1.73	1.73	1.74	1.75
Russian Ruble	30.1	29.8	29.8	29.7	29.7	29.5	29.3	29.2	29.1	29.0	29.0
South African Rand	7.7	7.6	7.6	7.7	7.7	7.7	7.8	7.8	7.9	8.0	8.1

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

## Cross Rates

### Versus Canadian Dollar

Euro (C\$/€)	1.45	1.43	1.43	1.43	1.43	1.41	1.43	1.44	1.41	1.39	1.37
U.K. Pound (C\$/£)	1.65	1.59	1.60	1.59	1.59	1.58	1.59	1.61	1.63	1.64	1.65
Japanese Yen (¥/C\$)	85	86	88	89	89	96	99	102	105	109	112
Australian Dollar (C\$/A\$)	0.936	0.935	0.933	0.930	0.930	0.924	0.941	0.956	0.965	0.973	0.982

### Versus Euro

U.K. Pound (£/€)	0.88	0.89	0.90	0.90	0.90	0.90	0.90	0.89	0.87	0.85	0.83
Japanese Yen (¥/€)	123	122	126	128	128	136	142	147	149	152	153

Barney Bonekamp contributed to the above forecasts

## Interest Rate Forecasts Percent (averages)

	Actual Feb	2010 Mar	Apr	May	Q2	Q3	Q4	2011 Q1	Q2	Q3	Q4
<b>Cdn. Yield Curve</b>											
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	1.70	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	0.58	0.60	0.70	0.80	0.85	1.30	1.75	2.15	2.55	3.00	3.40
2 year	1.32	1.30	1.45	1.65	1.65	2.05	2.35	2.70	3.05	3.40	3.75
3 year	1.63	1.60	1.80	1.95	1.95	2.40	2.65	3.00	3.30	3.60	3.90
5 year	2.50	2.50	2.55	2.60	2.60	2.80	3.00	3.25	3.55	3.80	4.10
7 year	2.86	2.85	2.95	3.00	3.00	3.25	3.40	3.60	3.85	4.05	4.30
10 year	3.42	3.40	3.40	3.45	3.45	3.50	3.65	3.85	4.05	4.25	4.45
30 year	4.03	4.00	4.05	4.05	4.05	4.15	4.25	4.45	4.60	4.80	5.00
3m BA	0.33	0.30	0.30	0.30	0.40	0.90	1.35	1.85	2.35	2.80	3.30
Prime Rate	2.25	2.25	2.25	2.25	2.25	2.60	3.10	3.60	4.10	4.60	5.10
<b>U.S. Yield Curve</b>											
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	0.11	0.15	0.15	0.15	0.15	0.25	0.75	1.35	1.85	2.25	2.75
6 month	0.18	0.20	0.20	0.20	0.20	0.30	0.80	1.40	1.90	2.30	2.80
1 year	0.35	0.30	0.45	0.55	0.55	0.95	1.40	1.90	2.35	2.70	3.15
2 year	0.86	0.80	1.05	1.25	1.25	1.95	2.35	2.75	3.15	3.45	3.85
3 year	1.40	1.35	1.55	1.75	1.75	2.30	2.70	3.05	3.40	3.70	4.05
5 year	2.36	2.30	2.45	2.60	2.60	3.10	3.40	3.70	4.00	4.25	4.55
7 year	3.12	3.05	3.15	3.25	3.25	3.50	3.70	4.00	4.25	4.50	4.75
10 year	3.69	3.60	3.65	3.65	3.65	3.75	3.95	4.15	4.40	4.65	4.90
30 year	4.62	4.55	4.60	4.60	4.60	4.70	4.85	5.05	5.30	5.55	5.80
3m LIBOR	0.25	0.25	0.25	0.25	0.25	0.40	0.90	1.45	1.95	2.40	2.90
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.35	3.75	4.35	4.85	5.25	5.75
<b>Other G7 Yields</b>											
ECB Refi	1.00	1.00	1.00	1.00	1.00	1.00	1.50	1.90	2.15	2.60	2.90
10yr Bund	3.20	3.25	3.25	3.30	3.30	3.45	3.60	3.85	3.95	4.10	4.20
BoE Repo	0.50	0.50	0.50	0.50	0.50	0.50	0.75	1.50	2.00	2.50	3.00
10yr Gilt	4.07	4.10	4.15	4.25	4.25	4.40	4.65	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	1.35	1.40	1.40	1.45	1.50	1.55	1.60	1.65	1.75

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