

Fixed Income and Foreign Exchange Strategy

April 6, 2010 **Forecast Summary (averages)**

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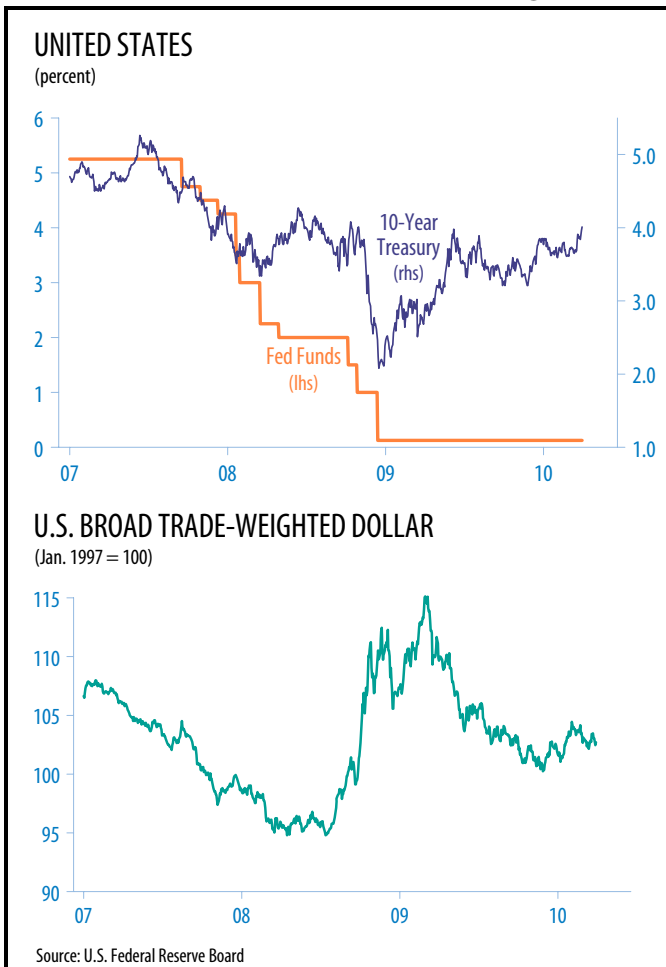
	Actual	2010						2011			
	Mar	Apr	May	June	Q2	Q3	Q4	Q1	Q2	Q3	Q4
BoC overnight	0.25	0.25	0.25	0.25	0.25	0.60	1.10	1.60	2.10	2.60	3.10
10-yr Canadas	3.49	3.65	3.65	3.70	3.65	3.75	3.85	4.00	4.15	4.30	4.45
Fed funds	0.13	0.13	0.13	0.13	0.13	0.25	0.75	1.35	1.85	2.25	2.75
10-yr Treasuries	3.73	4.00	4.05	4.05	4.05	4.15	4.20	4.40	4.55	4.75	4.95
C\$ per US\$	1.023	1.005	0.997	0.989	0.997	0.976	0.992	0.992	0.979	0.967	0.954
US\$/€	1.36	1.35	1.36	1.37	1.36	1.38	1.39	1.40	1.39	1.38	1.38
US\$/£	1.51	1.52	1.54	1.55	1.55	1.58	1.60	1.62	1.64	1.67	1.69
¥/US\$	91	93	94	95	94	97	99	102	104	107	109

U.S. Rates

The FOMC stuck to its policy of “exceptionally low levels of the federal funds rate for an extended period” on March 16th, after cutting rates to near zero 15 months earlier. Kansas City President Hoenig dissented for the second consecutive meeting, arguing that this “was no

longer warranted because it could lead to the buildup of financial imbalances and increase risks to longer-run macroeconomic and financial stability”. Meanwhile, last month essentially marked the end of the Fed’s credit and quantitative easing efforts, the legacy of which is \$1.4 trillion of excess bank reserves. As the Fed’s attention turns to its new tools to immobilize these reserves, the market’s attention turns to the potential timing of policy rate hikes. With other FOMC members concerned about rates being near zero for too long, and the broad economic backdrop improving, the preconditions to begin lifting rates are probably not as prohibitive as in past cycles (at least for the first stage of tightening from zero nominal to zero real rates). **We still look for rate hikes to begin in September, with the interest rate paid on excess reserves rising 75 bps to 100 bps by year end, and the fed funds rate following roughly in tow.** Nevertheless, the net risk remains that Bernanke’s “formidable headwinds”—weak labour markets and stifled credit creation—could still cause policy rates to remain unchanged even longer.

Treasury yields moved higher along the curve during March (nearly 25 bps in the 10-year sector), despite lingering European sovereign



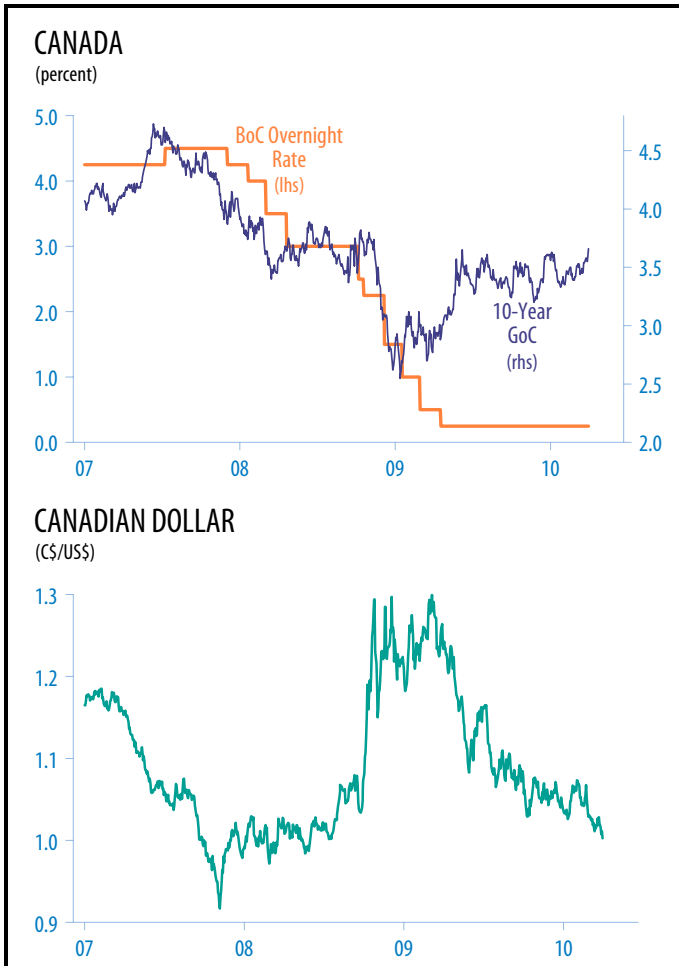
credit concerns and corresponding investor risk aversion. The month's record net issuance of notes and bonds caused a case of supply indigestion. Ten-year yields subsequently traded to 4%, as early-April-released economic data sported a stronger-than-expected tone. With a record \$1.5 trillion Treasury deficit to be financed this year, economic data improving (in the wake of recent employment data we upped our projection for real GDP growth by a tenth to 3.1% and 3.2%, respectively, for this year and next), and Fed rate hikes getting closer, the uptrend in Treasury yields should continue. **We raised our 2010-end target for 10-year yields to 4.25% from 4%, but still judge that they will find increasing resistance as yields chip way at the next big figure** reflecting healthy demand for Treasuries from domestic banks (instead of making loans) and households (a demographically-motivated shift in portfolio preference).

The U.S. dollar drifted stronger against the basket of major currencies last month, as gains against the yen, euro and pound slightly offset losses against the Canadian and Australian dollars. While some stability on the European policy and political fronts could cause the greenback to give back some of its recent gains, three longer-lasting themes should exert **downward pressure on the USD** (with more meaningful weakening on a broad trade-weighted basis): (1) The likely mid-year resumption of Chinese yuan appreciation which should lift other smaller Asian currencies; (2) more gains among the commodity currencies as commodity prices continue to climb in the wake of global economic recovery; and (3) the external financing pressure of Treasury deficits.

Canadian Rates

In a March 24 speech (more than three weeks after the last policy announcement), Bank of Canada Governor Carney acknowledged that *"economic activity in Canada has surprised slightly on the upside in recent weeks relative to the projection in our January Monetary Policy Report."* He also stated that *"core inflation has been slightly firmer than projected, the result of both transitory factors and the higher level of economic activity,"* but asserted that the "underlying trend" of inflation was still less than 2% (compared to a published 14-month high of 2.1% y/y for the core in February). Importantly, Carney reiterated that *"the target overnight rate can be expected to remain at its current level until the end of the second quarter of 2010 in order to achieve the inflation target."* And, as has always been the case, but perhaps with a bit more emphasis this time, he said that *"this commitment is expressly conditional on the outlook for inflation."*

While the BoC's projections for Q1 core CPI inflation (1.6% y/y) and real GDP growth (3.5%) will almost certainly both be revised up in the next Monetary Policy Report on April 22, it's uncertain whether the upgrades themselves would be signals of impending policy rate hikes, particularly if the Bank offsets them with downgrades to other quarters. Instead, armed with the March and April CPI reports, look for the BoC to alert on the potential for rate hikes at the June 1 announcement, perhaps employing language last used in July 2004: *"monetary stimulus will have to be removed to avoid a buildup of inflation pressures. The pace of the withdrawal will depend on*



the evolving prospects for inflation and for capacity pressures.”

We still look for a first rate hike on July 20th, pending any further inflation and growth surprises. The Bank probably has a predilection to raise policy rates expeditiously, to zero real (1.75% to 2%), but the ultimate path will likely be dictated by the extent of subsequent Canadian dollar appreciation.

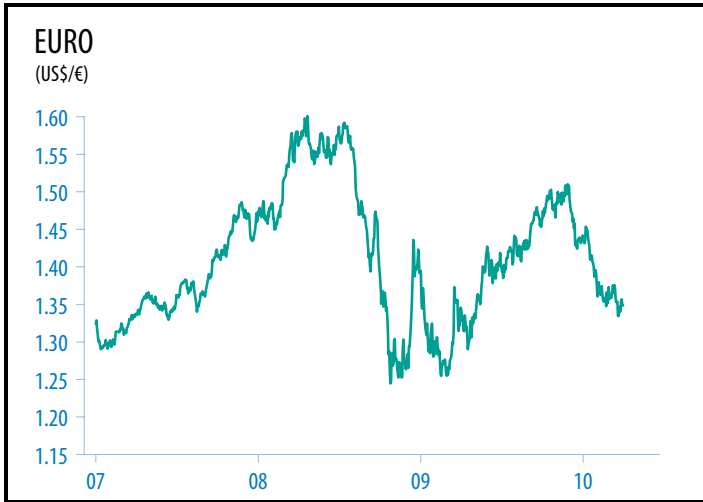
We look for the C\$ to trade, on average, a bit stronger than parity over the forecast horizon, reflecting firmer commodity prices and wider Canada-U.S. overnight spreads. This is probably not enough to derail rate hikes (at least through the first stage to zero real). The prospect of persistent parity is simply not igniting the same degree of angst among business and government leaders as it did back in 2007. That could all change, however, if the loonie nears its modern-day extreme of US\$1.1030 or C\$0.9066. But, there are reasons to believe this might not happen this time: commodity prices are currently not escalating as sharply, Canada has since moved into a current account deficit, and the loonie is likely already pricing in some solo BoC moves and might not get as much of a kicker when they do occur (the relatively restrained response of the Australian dollar to RBA rate hikes could be a guide).

Government of Canada bonds underperformed Treasuries at the short end of the curve last month (yield spreads widened nearly 25 bps) amid mounting speculation of BoC rate hikes, but they still outperformed at the long end (spreads narrowed more than 10 bps). As the uptrend in Treasury yields continues, **Canadas should continue to modestly outperform at the belly of the curve and beyond**, reflecting the nation’s superior fiscal fundamentals and a bit of currency appreciation to boot.

Euro

The Euro area and IMF finally came together on an “aid” package for Greece in March, but it wasn’t enough to fully soothe market concerns. Details of the package were lacking, providing essentially no actual aid, only offering a final option to avoid potential default. The lack of assistance to Greece means sovereign worries are likely to persist at least until May’s funding is completed without event.

Meantime, the European recovery is expected to be sluggish and growth has been lacklustre thus far, though recent data have shown some reason for optimism (strong March PMIs). Even so, fiscal belt-tightening is going to be a drag on growth for the next few years as governments move back towards the Maastricht Treaty mandated maximum fiscal deficit of 3% of GDP.



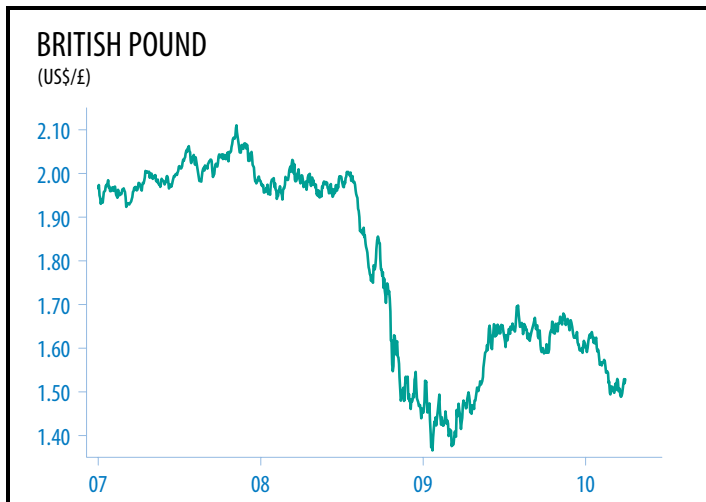
Despite soft growth, inflation perked up in March as a weaker euro and strength in emerging markets have driven up commodity prices. Even so, inflation at 1.5% is still below the ECB's target of just below 2%, and won't set off any alarm bells as excess capacity in the region remains significant. **The growth and inflation backdrop will likely keep the ECB sidelined well into the second half of 2010, with some risk of tightening being delayed into 2011.**

The euro had a rough ride in March, hitting a 10-month low on Greece debt worries. While we don't expect sovereign debt concerns to end in the near future, they should move out of the

spotlight assuming Greece can raise sufficient funds in May, which should take some pressure off the euro. Add in an improving economic climate and that will likely allow the euro to appreciate into year end.

U.K. Pound

U.K. economic data have been improving and Q4 real GDP was revised up again. The economic picture is expected to continue brightening slowly, while inflation should decelerate from the recent run above 3%. That background will likely keep the Bank of England on hold well into the

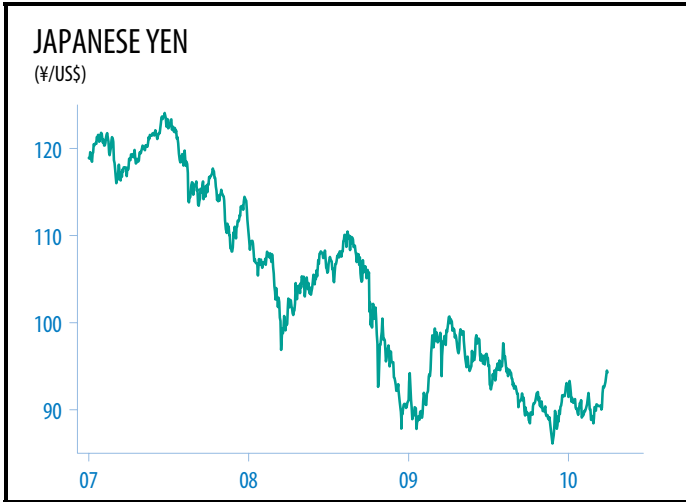


second half of 2010. In addition, the U.K. general election, slated for May 6, likely means the BoE will take a more subdued tone in order to remain apolitical. As such, **we expect the BoE to stay on hold in April, but keep the option for more quantitative easing (QE) open until around mid-year.**

The pound hit a 10-month low in March, but bounced back at month's end. Election uncertainty, along with QE remaining an option for the BoE, will weigh on the pound over the next few months. However, once those factors dissipate, look for the pound to strengthen through year end.

Japanese Yen

Exports continue to drive Japan's recovery, but solid February retail sales (up 4.2% y/y, the fastest pace in 13 years) provide some potential hope for domestic strength. The jobless rate has fallen sharply since peaking last summer, which should support domestic spending. Also, the Tankan survey of business sentiment showed significant improvement in both the manufacturing and non-manufacturing sectors. The only potential negative in the survey was that business capital expenditure plans remain down from a year ago.



But amid all the solid data of late, Q4 real GDP growth was revised down, and remains 6.3% below the 2008Q1 peak. The significant output gap is keeping downward pressure on prices. Consumer prices have been falling for over a year now, and deflation is expected to continue through at least next year. The Bank of Japan will update its forecast at month's end, with the semi-annual outlook report due at the April 30 meeting. The growth forecast will likely be revised up slightly from the October report, while deflation looks to persist (though perhaps at a slower pace), which should keep the policy rate at current levels through next year, if not longer. Indeed, considering there isn't any further room for fiscal

stimulus, the Bank of Japan could opt to increase quantitative easing further in the near term.

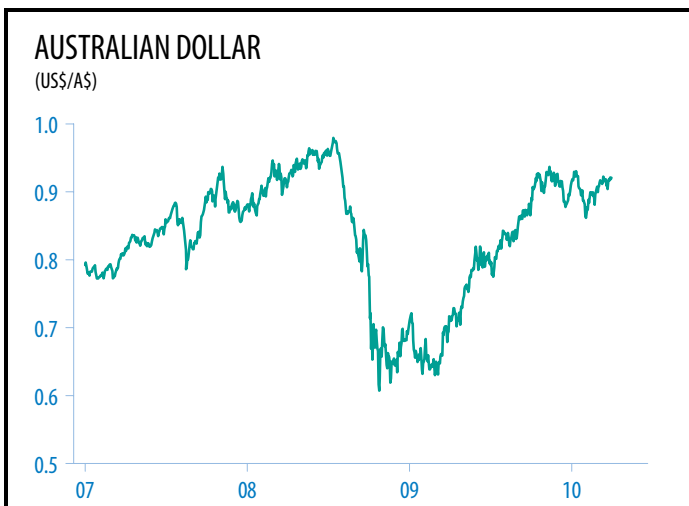
With the BoJ on an extended hold while other major central banks are expected to raise rates in the second half of 2010, widening rate spreads are going to put increasing pressure on the yen. Look for the yen to weaken consistently through the rest of the year.

Australian Dollar

The **Reserve Bank of Australia hiked rates 25 bps to 4.25% at its April 6 meeting.** The statement was somewhat more hawkish than expected, pointing to further tightening in the near term. The RBA is clearly concerned about a potential housing market bubble, noting that the market is *"still characterised by considerable buoyancy"* as prices continue to rise despite recent increases in the policy rate. Indeed, the central bank essentially ignored recent softness in the economic data which was likely partly driven by prior rate hikes. Even so, the RBA judges that

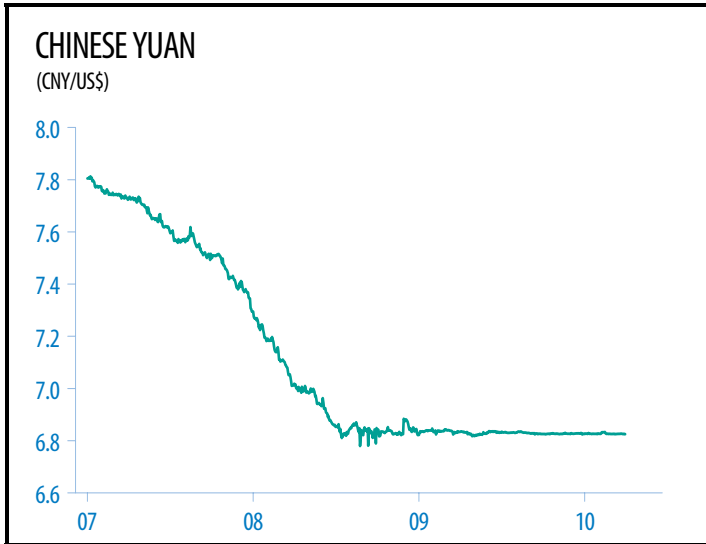
growth will likely *"be around trend and inflation close to target over the coming year"*, meaning interest rates *"closer to average"* are more *"appropriate."* Average rates have been characterized as around 4.50%-to-4.75% by Governor Stevens. It looks as though the RBA is going to be a little more aggressive than previously thought, as the Bank pushes back against a hot housing market. As such, look for another rate hike in May.

The Australian dollar strengthened following the rate hike and more hawkish statement. The solid Australian economic outlook and further RBA tightening will likely prompt the Australian dollar to appreciate further through 2010.



Chinese Yuan

The U.S. Treasury decided to delay the release of the Semiannual Report on International Economic and Exchange Rate Policies for three months (it was due April 15), in order to give



China more time to revalue its currency. China's economy continues to strengthen (Q2 GDP growth is slated for 11%+ y/y), so the economic argument against appreciation is difficult. The coming G20 central banker and finance minister meeting on April 22-23, U.S.-China Strategic and Economic Dialog set for May, and the G20 meeting in late June should set the stage for some flexibility on the currency front. China can resist pressure from the U.S., but when the whole G20 speaks, the call for appreciation will be much more difficult to ignore.

Look for the yuan to start appreciating by mid-July at a 3%-to-5% annual rate, ahead of the release of the delayed Treasury report.

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

	Actual Mar	2010 Apr	May	June	Q2	Q3	Q4	2011 Q1	Q2	Q3	Q4
Canadian Dollar											
C\$ per US\$	1.023	1.005	0.997	0.989	0.997	0.976	0.992	0.992	0.979	0.967	0.954
US\$ per C\$	0.978	0.995	1.003	1.011	1.003	1.025	1.008	1.008	1.021	1.034	1.048
Trade-Weighted	117.8	119.9	120.6	121.3	120.6	122.7	121.3	121.3	122.9	124.6	126.4
U.S. Dollar											
Trade-Weighted*	103.5	102.6	102.3	102.0	102.3	101.3	100.8	100.4	99.9	99.6	99.3
European Currencies											
Euro**	1.36	1.35	1.36	1.37	1.36	1.38	1.39	1.40	1.39	1.38	1.38
Danish Krone	5.48	5.55	5.50	5.45	5.50	5.40	5.35	5.35	5.35	5.40	5.40
Norwegian Krone	5.92	5.85	5.80	5.75	5.80	5.60	5.40	5.40	5.45	5.55	5.60
Swedish Krona	7.16	7.10	7.05	6.95	7.05	6.80	6.60	6.55	6.60	6.65	6.70
Swiss Franc	1.07	1.07	1.07	1.06	1.07	1.06	1.06	1.06	1.06	1.08	1.09
U.K. Pound**	1.51	1.52	1.54	1.55	1.55	1.58	1.60	1.62	1.64	1.67	1.69
Asian Currencies											
Chinese Yuan	6.83	6.83	6.83	6.83	6.83	6.77	6.69	6.61	6.53	6.45	6.35
Japanese Yen	91	93	94	95	94	97	99	102	104	107	109
Korean Won	1136	1125	1110	1100	1110	1070	1035	1000	975	945	915
Indian Rupee	45.5	45.1	44.8	44.5	44.8	44.2	43.7	43.2	43.3	43.5	43.7
Singapore Dollar	1.40	1.40	1.40	1.40	1.40	1.39	1.39	1.38	1.36	1.34	1.33
Malaysian Ringgit	3.32	3.27	3.26	3.24	3.26	3.20	3.14	3.11	3.10	3.08	3.07
Thai Baht	32.5	33.0	32.9	32.8	32.8	32.2	31.6	31.0	30.5	30.0	29.4
Philippine Peso	45.7	45.1	45.0	45.0	45.0	44.9	44.7	44.3	43.6	43.0	42.4
Taiwan Dollar	31.8	31.7	31.7	31.6	31.7	31.2	30.6	30.1	29.7	29.3	28.9
Indonesian Rupiah	9166	9130	9090	9050	9090	8970	8850	8790	8750	8710	8670
Other Currencies											
Australian Dollar**	0.912	0.917	0.921	0.925	0.921	0.933	0.946	0.960	0.975	0.990	1.005
N.Z. Dollar**	0.704	0.712	0.720	0.727	0.720	0.743	0.767	0.783	0.796	0.808	0.821
Mexican Peso	12.57	12.50	12.45	12.40	12.45	12.35	12.25	12.15	12.10	12.20	12.30
Brazilian Real	1.79	1.78	1.77	1.76	1.77	1.75	1.73	1.72	1.73	1.74	1.75
Russian Ruble	29.6	29.5	29.5	29.4	29.5	29.3	29.2	29.1	29.0	29.1	29.2
South African Rand	7.4	7.4	7.4	7.4	7.4	7.5	7.6	7.7	7.8	7.9	8.0

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

Cross Rates

Versus Canadian Dollar

Euro (C\$/€)	1.39	1.36	1.36	1.35	1.35	1.35	1.38	1.38	1.36	1.34	1.31
U.K. Pound (C\$/£)	1.54	1.53	1.54	1.53	1.54	1.54	1.58	1.60	1.61	1.61	1.61
Japanese Yen (¥/C\$)	89	93	94	96	94	99	100	103	106	111	114
Australian Dollar (C\$/A\$)	0.933	0.922	0.918	0.915	0.918	0.910	0.938	0.952	0.955	0.957	0.959

Versus Euro

U.K. Pound (£/€)	0.90	0.89	0.88	0.88	0.88	0.88	0.87	0.86	0.85	0.83	0.81
Japanese Yen (¥/€)	123	126	128	130	128	134	138	142	145	148	150

Barney Bonekamp contributed to the above forecasts

Interest Rate Forecasts Percent (averages)

	Actual Mar	2010 Apr	May	June	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	0.22	0.30	0.30	0.50	0.35	0.80	1.25	1.75	2.20	2.70	3.15
6 month	0.35	0.50	0.50	0.70	0.55	1.00	1.45	1.90	2.35	2.80	3.25
1 year	0.77	1.00	1.05	1.20	1.05	1.35	1.80	2.20	2.60	3.00	3.40
2 year	1.57	1.80	1.90	2.00	1.90	2.15	2.45	2.80	3.10	3.45	3.75
3 year	1.88	2.10	2.20	2.30	2.20	2.45	2.70	3.00	3.30	3.60	3.90
5 year	2.77	3.00	3.05	3.10	3.05	3.15	3.35	3.55	3.75	3.95	4.10
7 year	3.00	3.20	3.25	3.30	3.25	3.35	3.55	3.75	3.95	4.10	4.30
10 year	3.49	3.65	3.65	3.70	3.65	3.75	3.85	4.00	4.15	4.30	4.45
30 year	4.06	4.10	4.15	4.15	4.15	4.20	4.30	4.45	4.55	4.70	4.85
3m BA	0.39	0.50	0.50	0.70	0.55	1.00	1.45	1.95	2.40	2.90	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	0.15	0.20	0.20	0.20	0.20	0.35	0.85	1.45	1.95	2.35	2.85
6 month	0.23	0.25	0.30	0.30	0.30	0.45	0.95	1.50	2.00	2.45	2.95
1 year	0.40	0.50	0.55	0.65	0.55	0.90	1.45	1.95	2.35	2.70	3.15
2 year	0.96	1.15	1.35	1.55	1.35	1.90	2.45	2.85	3.20	3.50	3.85
3 year	1.51	1.75	1.90	2.10	1.90	2.40	2.90	3.25	3.55	3.80	4.10
5 year	2.43	2.75	2.90	3.00	2.90	3.30	3.70	3.95	4.20	4.35	4.55
7 year	3.16	3.45	3.55	3.65	3.55	3.90	4.25	4.45	4.55	4.65	4.80
10 year	3.73	4.00	4.05	4.05	4.05	4.15	4.20	4.40	4.55	4.75	4.95
30 year	4.64	4.85	4.85	4.90	4.85	4.95	5.05	5.20	5.35	5.55	5.70
3m LIBOR	0.27	0.30	0.30	0.30	0.30	0.45	0.95	1.55	2.05	2.45	2.95
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.35	3.75	4.35	4.85	5.25	5.75
Other G7 Yields											
ECB Refi	1.00	1.00	1.00	1.00	1.00	1.00	1.25	1.65	1.90	2.35	2.65
10yr Bund	3.10	3.20	3.25	3.30	3.20	3.35	3.55	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	4.08	4.20	4.25	4.35	4.20	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	1.35	1.40	1.40	1.40	1.40	1.40	1.45	1.55	1.60	1.65	1.75

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