Rates Scenario

ECONOMIC RESEARCH

BMO Capital Markets

Fixed Income and Foreign Exchange Strategy

July 6, 2010

Forecast Summary (averages)

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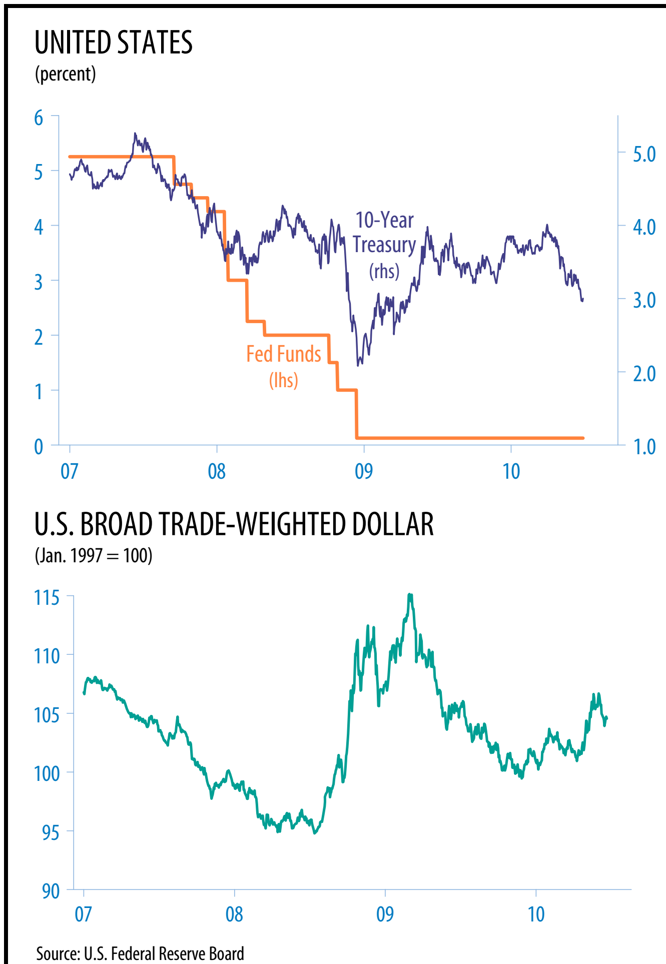
	Actual	2010					2011				2012
	Jun	July	Aug	Sep	Q3	Q4	Q1	Q2	Q3	Q4	Q1
BoC overnight	0.50	0.75	0.75	0.75	0.75	0.85	1.25	1.35	1.85	2.35	2.85
10-yr Canadas	3.30	3.25	3.15	3.10	3.15	2.95	3.10	3.35	3.55	3.80	4.00
Fed funds	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.45	1.00	1.60
10-yr Treasuries	3.20	3.10	3.05	2.95	3.05	2.85	3.00	3.30	3.60	3.90	4.15
C$ per US$	1.038	1.055	1.060	1.065	1.060	1.070	1.043	1.011	0.997	0.992	0.983
US$/€	1.22	1.25	1.24	1.23	1.24	1.21	1.22	1.24	1.23	1.21	1.21
US$/£	1.48	1.50	1.49	1.48	1.49	1.46	1.47	1.49	1.48	1.46	1.47
¥/US$	91	90	91	92	91	94	97	99	102	104	106

U.S. Rates

There are two tenets to our Fed call. The first is that core disinflation is the Fed's primary concern. Core disinflation and the associated risk of deflation encapsulate all of America's key economic ills: low rates of resource utilization, dysfunctional credit creation, and a fundamentally weak housing sector. The second is that, once inflation stabilizes and the risk of deflation lessens, the Fed is likely to begin tightening well before the economy has fully recovered from its ills, shifting from emergency ease to a "non-emergency-but-still-historically-accommodative" stance, given the eventual risks posed by rates being too low for too long.



However, this second tenet is fast becoming a distant blip on our policy radar screen. Despite a firmer May reading, we look for core PCE inflation to continue cooling through the end of the year, before stabilizing at a record (since 1960) low of 0.7% y/y to start 2011. **Given that the Fed will want to ensure that disinflation has definitely ended before beginning tightening, this puts the earliest Fed rate hike in 2011Q3.** Furthermore, there is a small (albeit rising) risk that additional quantitative easing (QE) and unsterilized credit easing (CE) might be required to ensure that America steers clear of deflation, which would necessarily push any rate hike into 2012. Through the summer and autumn, as U.S. (and global) economic indicators point to slower growth than occurred earlier in the year, we judge that QE/CE/deflation risks will mount in the

market's mind. This should provide support for Treasury and mortgage-backed securities.

For example, **we look for 10-year Treasury yields to take a run at the 2.50% range** (reminiscent of the Fed's first QE action). In terms of monthly averages, however, the benchmark note should average 2.80% by December. This will mark the lowest monthly average since the early 1950s (consistent with the multi-decade lows in core inflation and Fed policy rates), apart from a couple of months at the height of the recent global financial crisis (Dec-08/Jan-09). Another support for Treasury yields should come from the quest for liquidity as the above-mentioned run of weaker economic indicators stokes risk aversion among global investors.

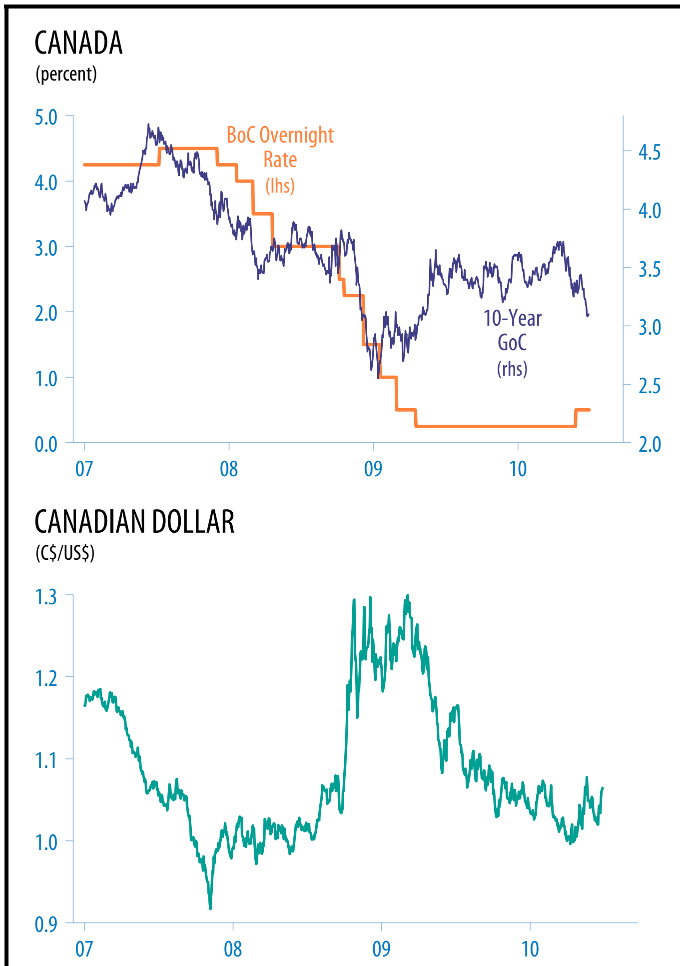
With our forecast that core inflation will bottom closer to 1% than zero, and the coming economic slowdown will not morph into a "double dip", the stage is set for a turnaround in yields by the turn of the year. This prognosis should whet risk appetites and temper perceived QE/CE/deflation risks. However, **next year's uptrend in yields should be more restrained than the historical norm**, held back by modest economic growth, and driven more by rising real yields (there's still a huge deficit out there) than by rising inflation expectations and expected Fed policy moves. Four percent Treasury yields should be a tough hurdle to cross next year.

The U.S. dollar, trade weighted against a basket of global currencies, is expected to drift mostly sideways for the remainder of this year. Support provided by risk-aversion flows should offset the impact of Chinese yuan appreciation and the related rise in other Asian currencies. As these supportive flows reverse next year, **the greenback is destined to drift lower**, with some resistance provided by eventual Fed tightening.

Canadian Rates

We look for the Bank of Canada to raise its policy rate 25 bps to 0.75% on July 20, despite having ample excuses to pause such as the *"significant excess supply in Canada"*, the *"uneven global recovery"*, the risks posed by the European sovereign credit crisis and, moving up the charts, by a potential double-dipping, deflation-prodding U.S. downturn. We judge that the Bank's policy scale will tip slightly to the tightening side, owing to the *"strength of domestic spending"*. Although Canadian economic indicators have also cooled lately, and the Bank will likely pare the front-end of its growth projection this month, the actual and forecasted combination of above-potential economic growth with core inflation running close to target justifies higher policy rates over time. Moreover, the risks posed by rates being too low for too long are already becoming apparent amid the rapid run up in household debt.

However, as Canadian and other global economic indicators continue to cool, and U.S. risks mount (see above), the "excuses" side of the scale should start weighing heavier. **We look for the Bank of Canada to pause for at least a couple of announcement dates through**



the autumn. By December, with U.S. deflation risk presumably ebbing, we could see the Bank resuming its rate hike campaign, with a cadence still dictated by developments outside Canada's border. Even if the Bank opts to wait until the start of 2011 to resume, we look for this oscillating pattern of rate hikes and pauses to be repeated next year as the Bank steers policy on a cautious tact. Once the Fed starts tightening, which would be a signal to the Bank that U.S. risks have receded sufficiently, Canadian rate hikes should become steadier.

Market expectations for less aggressive Bank of Canada tightening, concerns about global economic prospects (a.k.a. commodity prices) along with the support the greenback garners from risk-aversion flows should continue to act as **Canadian dollar headwinds through the autumn**. By the end of this year, the latter two factors should turn to the loonie's advantage, leading to some modest appreciation. And, **we are likely to see parity again**, as tandem rate hikes take place during the second half of next year across the Canada-U.S. border (a sign that the global economy is back on the mend).

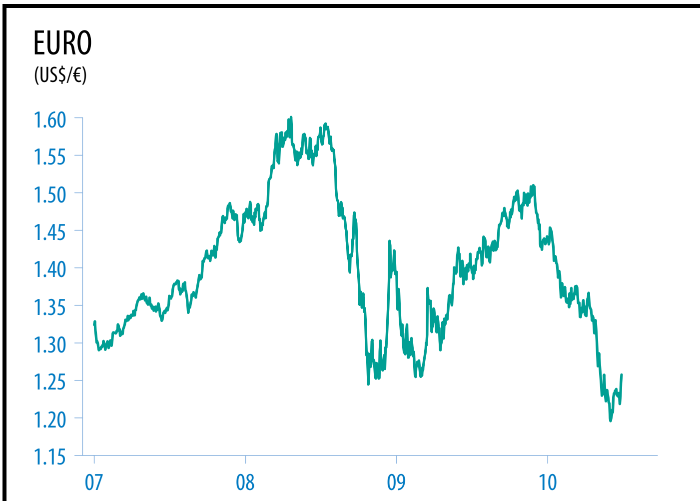
Government of Canada bonds have been underperforming their U.S. counterparts, with the global flight to liquidity favouring Treasuries and Canada's short- and mid-term sectors hurt by BoC tightening prospects. Canada-U.S. yield spreads are now positive along the curve (except in the 30-year sector), and we look for all spreads to widen further as global risk aversion worsens through the autumn. Once the latter reverses, and the market gets wind of next year's Fed tightening and Canada's credible fiscal restraint moves into full stride, **Canadas are destined to outperform Treasuries along the curve, with 10-year spreads rejoining their 30-year counterparts in negative territory**.

Euro

While June was free from any major European blowups, sovereign debt worries remained front and centre in the minds of financial markets and policymakers. Austerity measures, now present throughout Europe, have sparked concerns the region could derail global growth. Recent European economic data have been mediocre, growing at a very tepid pace. Even so, Q2 real GDP growth should be better than a weather-depressed Q1, led by Germany. Indeed, German business confidence has remained buoyant despite the fiscal and financial fears. We anticipate that Europe will see modest growth of around 1% for this year and next year,

keeping the output gap wide and putting downward pressure on inflation, which currently sits at 1.4%.

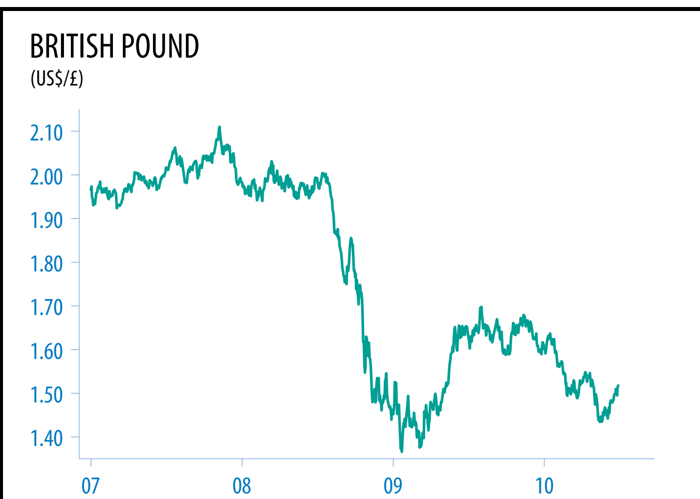
We've pushed our call for the first ECB hike to the start of 2012, due to expectations of soft growth and low inflation. In fact, considering the weak outlook, a strong case could be made for immediate further easing. However, it doesn't appear that the ECB has any appetite for looser policy despite their sterilized purchases of sovereign bonds (which were solely for the purpose of improving market liquidity to ensure a functional transmission mechanism for monetary policy).



With interest rates expected to remain unchanged through 2011, the **euro will likely continue to move with risk appetite**. Slowing momentum in the global economy points to a weaker euro in 2010H2, before a slight rebound in early 2011 as growth fears subside. However, with the Fed likely to tighten ahead of the ECB, widening interest rate spreads will weigh on the euro in 2011H2. Also, ongoing sovereign debt worries are likely to act as a headwind for the currency throughout the forecast horizon.

U.K. Pound

The June 22 emergency budget presented by the newly elected coalition government was a key event for sterling, with the currency ending the month 3.6% above recent lows. The budget appears to be a credible first step toward narrowing the fiscal deficit, though the spending cuts have yet to be sorted out (details are due in October). Meantime, on the economic data front, the recovery continues but, similar to Europe, remains lacklustre. Weak growth is expected to persist at least through 2010, and softness in Europe, along with significant government spending cuts, doesn't bode well for the outlook over the next couple of years.



The Bank of England has held rates steady for 15 months, and they're expected to remain on the sidelines until 2012. Indeed, Governor King has maintained a largely dovish tone and has yet to rule out further quantitative easing. However, Andrew Sentance dissented at the June meeting, calling for a 25 bp rate hike due to the improving outlook. In fact, there is a possibility that the BoE could be forced into action earlier than anticipated if inflation expectations start to rise. Inflation has been at or above 3% (above the 1%-to-3% target band) for the past 5 months and, with the 2.5 ppt hike in the VAT coming in January 2011,

inflation will likely remain elevated through much of next year as well (prior forecasts had inflation receding).

Some clarity on the fiscal front has boosted the pound over the past couple of weeks, but the outlook for **weak growth and low policy rates will keep sterling under pressure**. Fiscal clarity should cap the downside risk for sterling, and outperformance vs. the euro could continue. On a broader basis, look for the pound to weaken in the second half of the year amid ongoing risk aversion.

Japanese Yen

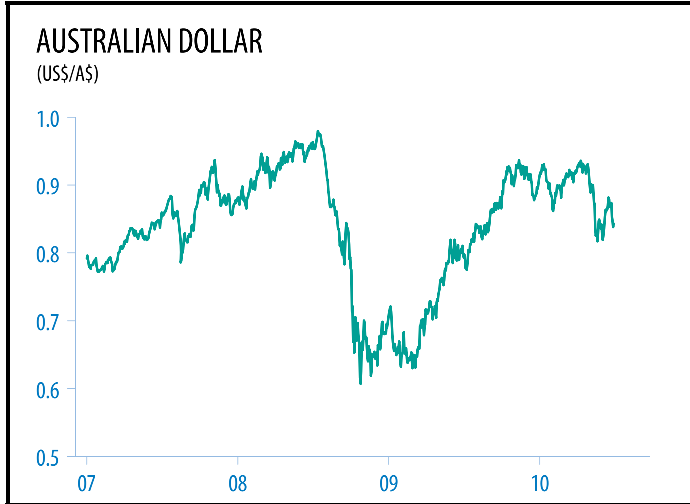
After charging out of the recovery gate in Q4 and Q1, with the best two-quarter growth pace in seven years, Japan's economy is expected to see more modest expansion going forward. Reliance on exports remains a problem and slowing overseas economies would likely derail the recovery. While narrowing, the output gap is still wide in Japan, and deflation persists. Under increasing pressure to combat deflation, the Bank of Japan unveiled a larger-than-expected ¥3 trillion credit facility for businesses. We expect deflation to slow over the next year, but the **Bank of Japan will keep its foot on the policy accelerator and rates shouldn't move any higher through this year and next**.

On the back of continued risk aversion, the yen strengthened in June, closing at its best level in 3 months. The new focus on fiscal issues also provided a boost to the yen following the ascension of Finance Minister Kan to the Prime Minister's office, following PM Hatoyama's resignation and ahead of Fall parliamentary elections. The new PM introduced a fiscal plan to help contain a massive and still-growing debt. Our core view remains that the global economy is recovering despite the current soft patch. While the outlook for the yen will be fraught with periods of strength, largely due to risk aversion, we anticipate the currency will weaken as major global central banks tighten while the Bank of Japan stays on the sidelines.

Australian Dollar

The Reserve Bank of Australia held policy rates steady for a second straight month at 4.5% in July. Similar to the June statement, the Bank devoted a relatively large section to developments in Europe, and also noted worries about global growth. The RBA is keeping a close eye on the potential economic and financial ramifications of international developments (e.g. the apparent slowdown in China).

With growth expected to be around trend in 2010 and 2011, and amid heightened global uncertainty, **we expect the RBA to pause for at least a few more months until the**

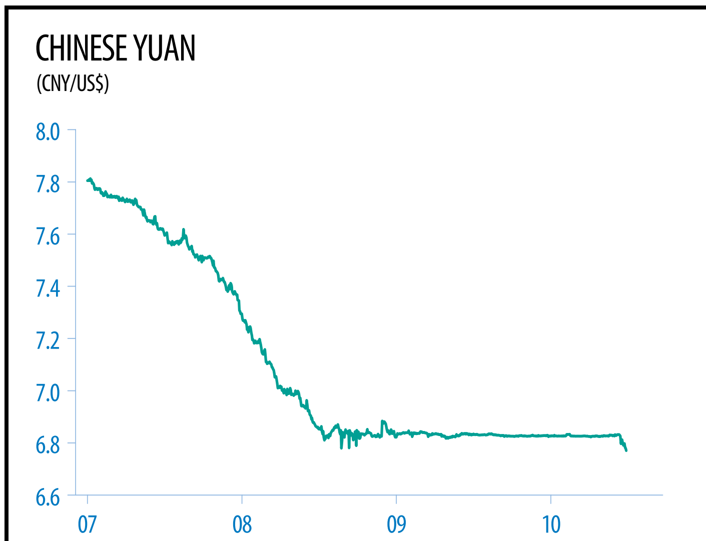


outlook has some clarity. However, the Bank expects inflation to remain in the upper half of its 2%-to-3% target band, which means that above-expected growth would likely put upward pressure on inflation and could prompt renewed tightening.

Expect the A$ to move with the ebb and flow of the global economic outlook, as Australia is highly exposed to natural resource exports. A continued, though bumpy, recovery should benefit the A$. However, until the RBA shifts back into tightening mode, which we expect early in 2011, upside for the Aussie dollar is likely capped.

Chinese Yuan

In a move timed to avoid criticism at the G20 meetings in Toronto, China announced on June 19 that it would break the yuan peg to the U.S. dollar. The policy shift had its intended effect, as China was not singled out at the G20. However, the statement accompanying the decision highlighted that while "*it is desirable to proceed with reform of the RBM (yuan) exchange rate regime and increase the RMB exchange rate flexibility*", "*the basis for large-scale appreciation of the RMB exchange rate does not exist.*" Since the decision, the currency has appreciated 0.8%.



We anticipate the yuan will strengthen 3%-to-4% this year, and at a 5% annual rate thereafter. However, there is a risk of slower appreciation if the global economy continues to lose momentum.

China's Q2 economic data are due this month, and are expected to show some signs of slowing. That could fan fears of a global double-dip, which we deem unlikely. China was never going to maintain Q1's 11.9% growth rate, so some slowing shouldn't be shocking. Look for growth to taper off through the course of the year to between 9% and 10%, close to the average rate over the past decade.

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

	Actual	2010					2011				2012
	Jun	July	Aug	Sep	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Canadian Dollar											
C$ per US$	1.038	1.055	1.060	1.065	1.060	1.070	1.043	1.011	0.997	0.992	0.983
US$ per C$	0.964	0.948	0.943	0.939	0.943	0.935	0.959	0.989	1.003	1.008	1.017
Trade-Weighted	117.3	115.0	114.7	114.3	114.7	114.1	117.0	120.6	122.4	123.5	124.5
U.S. Dollar											
Trade-Weighted*	105.2	104.6	105.0	105.3	105.0	105.7	104.7	103.2	102.7	102.9	102.4
European Currencies											
Euro**	1.22	1.25	1.24	1.23	1.24	1.21	1.22	1.24	1.23	1.21	1.21
Danish Krone	6.09	5.95	6.05	6.05	6.00	6.15	6.15	6.00	6.05	6.20	6.20
Norwegian Krone	6.47	6.50	6.55	6.60	6.55	6.65	6.60	6.45	6.40	6.45	6.40
Swedish Krona	7.83	7.65	7.62	7.60	7.62	7.55	7.40	7.30	7.40	7.65	7.65
Swiss Franc	1.13	1.08	1.08	1.09	1.08	1.10	1.13	1.16	1.20	1.23	1.24
U.K. Pound**	1.48	1.50	1.49	1.48	1.49	1.46	1.47	1.49	1.48	1.46	1.47
Asian Currencies											
Chinese Yuan	6.82	6.79	6.75	6.72	6.75	6.65	6.57	6.49	6.41	6.33	6.25
Japanese Yen	91	90	91	92	91	94	97	99	102	104	106
Korean Won	1214	1200	1220	1230	1215	1215	1165	1115	1060	1010	960
Indian Rupee	46.5	46.3	46.2	46.0	46.2	45.7	45.2	44.7	44.3	44.1	44.0
Singapore Dollar	1.40	1.39	1.39	1.39	1.39	1.38	1.37	1.35	1.34	1.32	1.30
Malaysian Ringgit	3.26	3.25	3.23	3.21	3.23	3.17	3.13	3.12	3.10	3.08	3.06
Thai Baht	32.4	32.4	32.3	32.2	32.3	32.0	31.6	31.2	30.8	30.4	29.9
Philippine Peso	46.3	46.1	45.9	45.7	45.9	45.2	44.6	43.9	43.2	42.5	41.8
Taiwan Dollar	32.2	32.1	32.0	31.8	32.0	31.6	31.1	30.5	30.0	29.4	28.9
Indonesian Rupiah	9138	9100	9080	9060	9080	9020	8960	8900	8830	8770	8710
Other Currencies											
Australian Dollar**	0.854	0.840	0.837	0.834	0.837	0.828	0.846	0.877	0.908	0.940	0.958
N.Z. Dollar**	0.693	0.690	0.691	0.693	0.691	0.696	0.721	0.752	0.783	0.815	0.833
Mexican Peso	12.71	12.74	12.77	12.80	12.80	12.75	12.65	12.55	12.45	12.50	12.55
Brazilian Real	1.80	1.79	1.78	1.77	1.78	1.76	1.74	1.73	1.73	1.74	1.75
Russian Ruble	31.3	31.2	31.0	30.9	31.0	30.7	30.5	30.3	30.1	30.0	29.9
South African Rand	7.6	7.7	7.7	7.8	7.7	7.8	7.9	8.0	8.1	8.2	8.3

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

Cross Rates

	Actual	2010					2011				2012
	Jun	July	Aug	Sep	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Versus Canadian Dollar											
Euro (C$/€)	1.27	1.32	1.31	1.31	1.31	1.29	1.27	1.26	1.23	1.20	1.19
U.K. Pound (C$/£)	1.53	1.58	1.58	1.58	1.58	1.56	1.53	1.51	1.48	1.44	1.44
Japanese Yen (¥/C$)	88	85	86	86	86	88	93	98	102	105	108
Australian Dollar (C$/A$)	0.886	0.886	0.887	0.888	0.887	0.886	0.882	0.887	0.905	0.932	0.942
Versus Euro											
U.K. Pound (£/€)	0.83	0.83	0.83	0.83	0.83	0.83	0.83	0.83	0.83	0.83	0.82
Japanese Yen (¥/€)	111	113	112	113	113	114	118	123	126	126	128

Barney Bonekamp contributed to the above forecasts

Interest Rate Forecasts
Percent (averages)

	Actual	2010					2011				2012
	Jun	July	Aug	Sep	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Cdn. Yield Curve											
Overnight	0.50	0.75	0.75	0.75	0.75	0.85	1.25	1.35	1.85	2.35	2.85
3 month	0.53	0.80	0.80	0.80	0.80	0.85	1.30	1.40	1.90	2.40	2.90
6 month	0.77	1.00	1.00	1.00	1.00	1.10	1.55	1.65	2.15	2.70	3.20
1 year	1.16	1.30	1.25	1.25	1.25	1.40	1.85	2.00	2.40	2.85	3.30
2 year	1.67	1.65	1.65	1.60	1.65	1.85	2.30	2.45	2.80	3.15	3.45
3 year	2.05	2.05	2.00	1.95	2.00	2.10	2.50	2.60	2.95	3.30	3.60
5 year	2.60	2.55	2.50	2.45	2.50	2.50	2.75	2.85	3.15	3.45	3.75
7 year	2.82	2.75	2.70	2.65	2.70	2.65	2.85	3.00	3.30	3.65	3.90
10 year	3.30	3.25	3.15	3.10	3.15	2.95	3.10	3.35	3.55	3.80	4.00
30 year	3.74	3.65	3.60	3.55	3.60	3.40	3.55	3.75	4.00	4.20	4.40
3m BA	0.78	1.00	1.00	1.00	1.00	1.10	1.55	1.65	2.15	2.65	3.15
Prime Rate	2.50	2.75	2.75	2.75	2.75	2.85	3.25	3.35	3.85	4.35	4.85
U.S. Yield Curve											
Fed funds	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.45	1.00	1.60
3 month	0.12	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.45	1.00	1.60
6 month	0.19	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.55	1.10	1.70
1 year	0.32	0.30	0.30	0.30	0.30	0.30	0.50	0.75	1.20	1.70	2.20
2 year	0.72	0.70	0.70	0.70	0.70	0.70	1.05	1.60	2.10	2.65	3.05
3 year	1.17	1.15	1.15	1.10	1.15	1.10	1.40	1.90	2.45	2.95	3.30
5 year	2.00	1.95	1.90	1.85	1.90	1.80	2.05	2.50	2.95	3.40	3.75
7 year	2.66	2.60	2.55	2.45	2.55	2.35	2.60	3.00	3.35	3.75	4.05
10 year	3.20	3.10	3.05	2.95	3.05	2.85	3.00	3.30	3.60	3.90	4.15
30 year	4.13	4.05	3.95	3.90	3.95	3.75	3.90	4.20	4.50	4.80	5.10
3m LIBOR	0.54	0.55	0.55	0.55	0.55	0.55	0.55	0.55	0.85	1.40	2.00
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.50	4.00	4.60
Other G7 Yields											
ECB Refi	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.35
10yr Bund	2.60	2.55	2.60	2.65	2.55	2.70	2.90	3.05	3.25	3.45	3.60
BoE Repo	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.90
10yr Gilt	3.57	3.45	3.55	3.60	3.45	3.70	3.90	4.05	4.25	4.45	4.60
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	1.21	1.15	1.15	1.20	1.15	1.20	1.30	1.35	1.40	1.50	1.55

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