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

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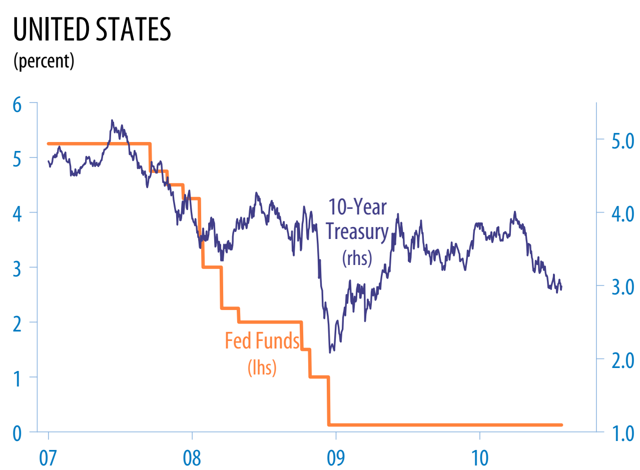
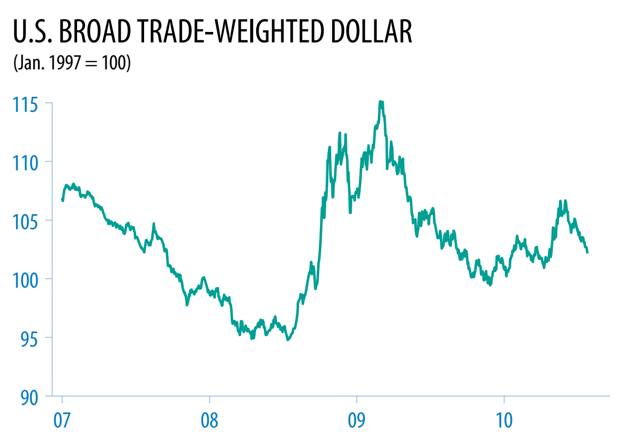
Forecast Summary (averages)

	Actual	2010					2011				2012
	Jul	Aug	Sep	Oct	Q3	Q4	Q1	Q2	Q3	Q4	Q1
BoC overnight	0.75	0.75	1.00	1.00	0.83	1.00	1.35	1.50	1.85	2.35	2.85
10-yr Canadas	3.19	3.15	3.10	3.05	3.15	3.05	3.15	3.40	3.60	3.85	4.05
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	3.01	2.95	2.95	2.90	2.95	2.85	3.00	3.30	3.60	3.90	4.15
C$ per US$	1.042	1.040	1.040	1.045	1.041	1.055	1.038	1.012	0.997	0.992	0.983
US$/€	1.28	1.30	1.29	1.28	1.29	1.26	1.27	1.29	1.28	1.26	1.26
US$/£	1.53	1.58	1.57	1.55	1.56	1.54	1.55	1.59	1.58	1.56	1.56
¥/US$	88	87	88	89	87	89	93	96	100	104	106

U.S. Rates

U.S. economic momentum is slowing, raising the risk that the Fed might have to take another stab at non-conventional easing. The options Chairman Bernanke cites include employing a more precise definition of "*extended period*" (the length of time the policy rate is expected to remain at "*exceptionally low*" levels), reinvesting maturing MBS and other agencies (currently they are being allowed to run off), and resuming net purchases of these securities and Treasuries (quantitative easing). However, in July's congressional testimony related to the semi-annual monetary policy report, **Bernanke indicated that the Fed would ease further only begrudgingly**, which, in our judgement, is at the juncture when the Fed sees the whites of deflation's eyes.





Source: U.S. Federal Reserve Board

We look for economic growth to slow to the low-2% range during the second half of this year, down from the 3.2% pace registered since positive growth resumed in 2009Q3, as the extra lift from inventory rebuilding and tax incentives fade. While such a pace is not a problem per se (it's not that far below potential growth, if at all), it's coming with significant disinflationary slack still lurking in the economy. The slack will likely cause core inflation to fall further; we look for it to bottom a couple tenths below 1% through the turn of the year. Early next year, as businesses begin deploying their record cash positions by picking up their hiring pace, growth should strengthen and disinflation trends should stabilize.

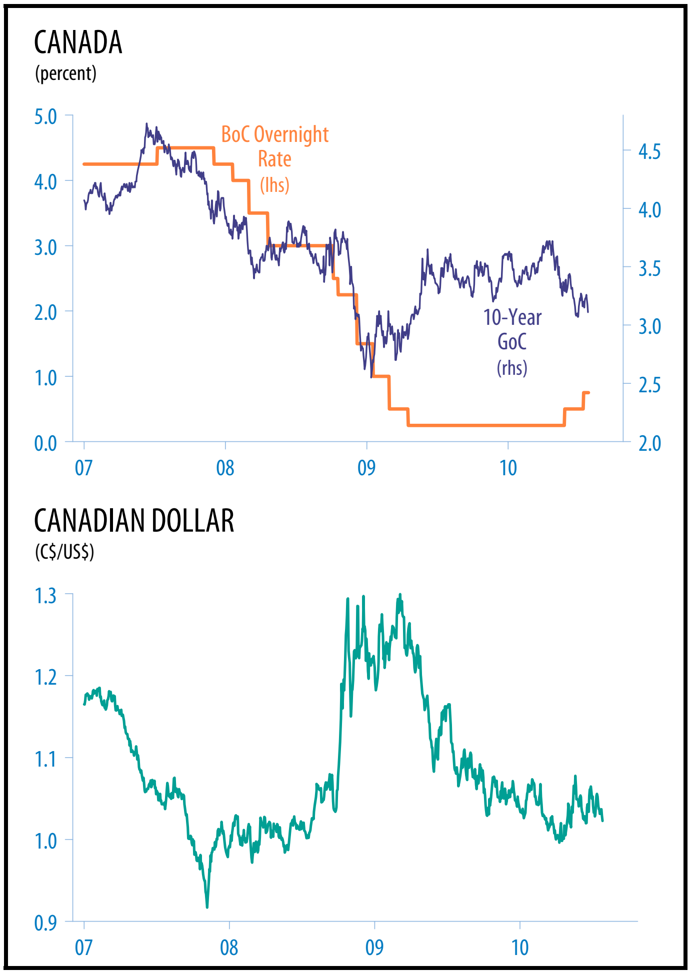
However, there is a growing risk that near-term downward momentum could be more powerful than expected and the job growth catalyst too feeble, causing real GDP growth to sport 1% handles or worse, and inflation to recede closer to, or through, the zero line. This risk could ignite yet another bout of global risk aversion, as investors juxtapose this potential U.S. scenario against the backdrop of policy-induced slower growth scenarios in Europe and Asia. This should lead to lower Treasury yields along the curve. 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).

With our base case forecast that core inflation will bottom closer to 1% than zero, and that slowing economic momentum will not morph into a "double dip", the stage is set for a turnaround in Treasury yields early next year. We look for the Fed to mark the second anniversary of the economic expansion (2011 Q3) by beginning to remove its emergency accommodation. 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 budget deficit out there) than by rising inflation expectations and expected Fed policy moves. Four percent 10-year Treasury yields should be a tough hurdle to cross next year.

The trade-weighted U.S. dollar is expected to drift mostly sideways for the remainder of this year. Support provided by risk-aversion flows should offset the impact of modest 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

The Bank of Canada raised its key policy rate 25 bps to 0.75% on July 20th, as expected, repeating that "*given the considerable uncertainty surrounding the outlook, any further reduction of monetary stimulus would have to be weighed carefully against domestic and global economic developments*." As well, the Bank downgraded its GDP projection sufficiently to push the return to full capacity out to 2011Q4 instead of Q2. This was a meaningful change, because it gave the BoC (in their mind) an additional six months to return policy rates to some semblance of short-run neutrality (which in our view is at least 2% and could be as high as the 3% range). In the Monetary Policy Report published two days later, the Bank added that "*this projection includes a gradual reduction in monetary stimulus consistent with achieving the inflation target*." So while the Bank is being purposely ambiguous about near-term policy prospects, the longer-term prospects are unambiguous: **the BoC has a tightening bias**.



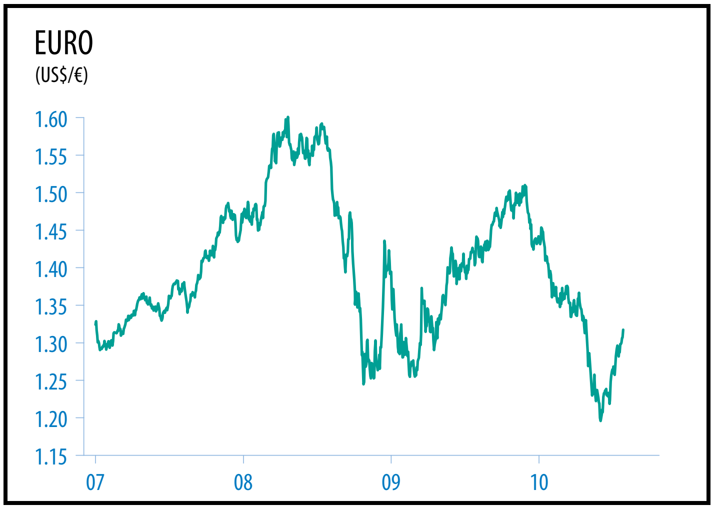
We look for the rate hike pattern to be one of fits and starts, consistent with the Bank's intent to weigh each individual move carefully yet still ensuring rates rise gradually over time. **After another 25-bp rate hike on September 8th, we look for the Bank to pause through the turn of the year** as U.S. economic and deflation risks mount. 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 more consistent.

Market expectations for Bank of Canada policy pauses, concerns about global economic and commodity price prospects, and the support the greenback garners from risk-aversion flows should continue to act as Canadian dollar headwinds through the end of the year. Early next 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, re-whetting investor risk appetites).

Government of Canada bonds have been underperforming their U.S. counterparts as a trend, 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

Europe made it through a second straight month with no explosion in sovereign debt worries. The European bank stress tests were highly anticipated but landed with a bit of a thud, as the scenarios faced scathing criticism. However, bank credit spreads narrowed in the aftermath, which argues to the success of the tests. Meantime, in a surprise twist, recent economic data point to accelerating growth, led by Germany. It appears the weaker euro (though well off recent lows) is having a positive economic impact. Higher PMIs and confidence point to a potentially stronger H2 than expected.

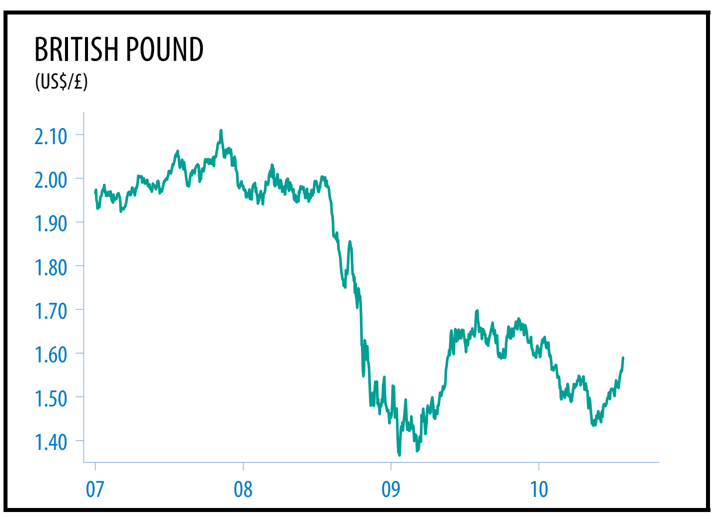


On the inflation front, conditions remained benign at 1.7% y/y in July, somewhat elevated from prior months due to largely higher energy prices. The relatively positive stress test results, upbeat data and potentially better-than-expected Q3 growth are unlikely to change the outlook for the ECB, as 2011 growth faces a number of headwinds. Fiscal tightening really gets into gear next year, which will limit growth, and the financial system still needs to heal further. Soft 2011 growth will ensure inflation remains contained, which underpins our expectation that the **ECB will hold its policy rate steady through next year.**

The euro performed well in July, bouncing back nicely from a weak June. While conditions in Europe aren't as dire as they were a couple of months ago, the currency might have a tough time appreciating further as much of the rally was likely due to an unwinding of massive short euro positions. We anticipate **the euro will weaken into next year**, as the global economy works through a soft patch in 2010H2, which will benefit the safe-haven US$. As the global outlook clarifies early next year, the euro should benefit, but a divergence in monetary policy (Fed vs. ECB) is expected to hurt the euro's prospects around mid-2011.

U.K. Pound

Increasing confidence that continental Europe isn't going to crumble and that the U.K. fiscal mess will be corralled propelled pound sterling to a 5-month high in July. Britain faces similar headwinds to Europe though, with austerity measures likely to weigh heavily on 2011 growth. While, Q2 GDP growth was surprisingly strong, it is expected to fade. Meantime, households continue to rebuild their balance sheets, also limiting growth prospects. Strictly from a growth perspective, the Bank of England would surely hold rates steady and perhaps even engage in more quantitative easing (QE). However, inflation continues to be a problem, sitting at 3.2% y/y in June, above the BoE's 2% target and 3% upper limit. Moreover, inflation isn't expected to recede until 2012, due partially to the higher VAT and the weaker pound.

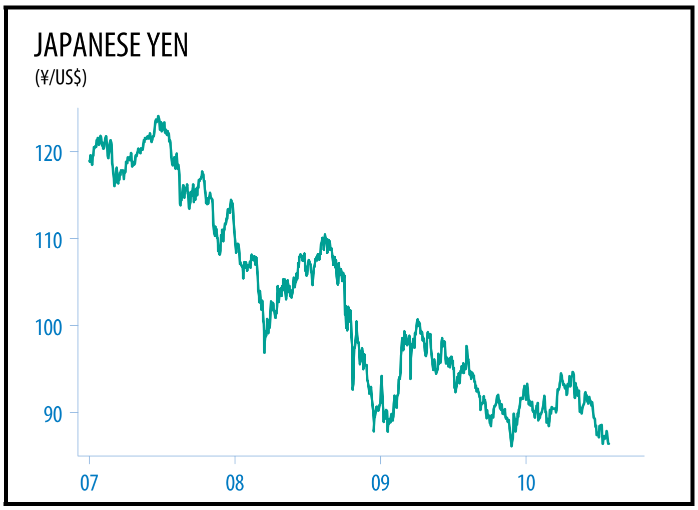


Soft growth, coupled with elevated inflation, puts the Bank in a tough spot. For now, Governor King and Co. are willing to let elevated inflation persist as long as inflation expectations aren't dislodged. Indeed, King recently noted that interest rates aren't expected to return to normal levels for a "*considerable*" period. Another policy committee member David Miles said that he wasn't ruling out further QE. There is one official, Andrew Sentance, who has twice called for a rate hike, but he is clearly in the minority.

Consistent with the BoE's dovish tilt and our view that inflation expectations will remain steady, **we look for rates to stay on hold through next year**, with the first hike likely in 2012. Similar to the euro, Sterling's solid run of late may be nearing an end as significant short positions have unwound. We anticipate that the global soft patch will likely **weaken the pound into next year**. As the global outlook clarifies early next year, the pound should benefit, but a divergence in monetary policy (Fed vs. BoE) is expected to hurt Sterling's prospects around mid-year.

Japanese Yen

The Bank of Japan continues its fight against deflation, keeping policy rates at rock-bottom levels and implementing unconventional measures. Deflation has eased over the course of the year, thanks in part to solid growth in the early part of the 2010. However, slowing growth in emerging Asia means ebbing momentum in Japan's export-dependant economy. The recent strength in the yen hasn't helped export prospects either. Decelerating growth and the ongoing battle against deflation suggests the Bank of Japan will keep rates steady through next year and perhaps even longer.

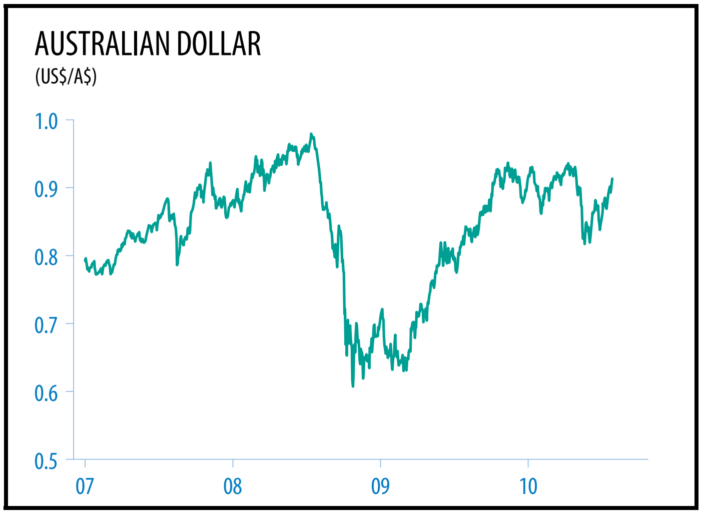


July saw increasing talk of a double dip in the U.S. and worries about a sharp slowdown in China, prompting safe-haven flows which strengthened the yen to its best level in eight months. Look for the yen to remain relatively strong through the second half of the year, as global slowdown fears boost safe-havens. However, as the global outlook brightens around the turn of the year, look for persistent weakness in the yen. Indeed, as monetary policy diverges in 2011 and beyond, broad-based selling pressure should weigh on the currency.

Australian Dollar

The Reserve Bank of Australia held policy rates steady for a third straight month at 4.5% in August. The policy statement from Governor Stevens was a mixed bag, citing expectations of slowing second half growth in Europe and the U.S., while highlighting that "*the caution evident in financial markets in the past few months has abated of late.*" The Bank continues to anticipate that global and Australian growth will be about "*trend over the coming year*", though the outlook is "*somewhat more uncertain than a few months ago.*"

The RBA is watching inflation intently. Consumer prices rose less than expected in the second quarter, with underlying inflation slowing to about 2¾% y/y. The softer reading takes pressure off the Bank to tighten policy in the near term. However, "*through to mid 2011, underlying*

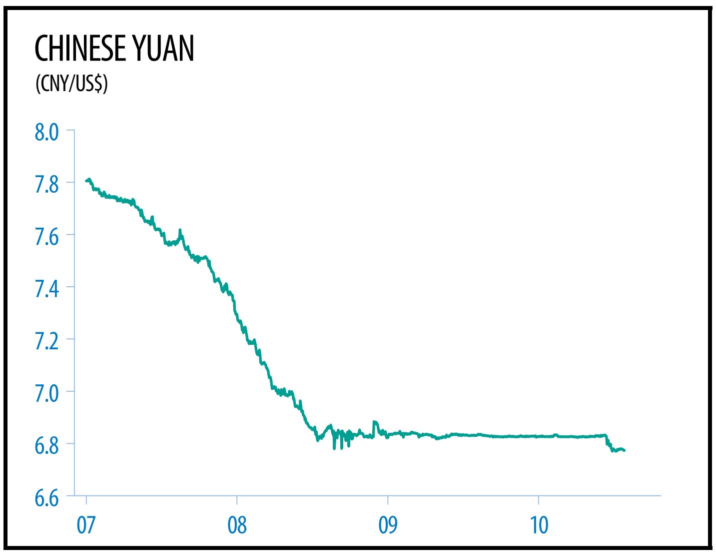


inflation is likely to be in the top half of the target zone," which points to the potential for further tightening later this year. Given the inflation and growth outlook, **we expect the RBA to pause through year end until the outlook becomes less clouded**.

Expect the Australian dollar 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

After an initial burst of strength following the breaking of the US$ peg in June, the yuan has held basically steady. China's economy downshifted in Q2, with growth slowing to 10.3% y/y, from a white-hot 11.9%. At first, ebbing growth sparked worries about the global outlook. However, investors quickly changed tack, as the data eased concerns that Chinese authorities would tighten policy further. Indeed, it even sparked speculation that some stimulus could be in store in the second half of the year. Despite decelerating growth, **we anticipate the yuan will strengthen 3%-to-4% this year, and at a 5% annual rate thereafter**, as a stronger currency will help rebalance the economy towards domestic demand.



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

	Actual Jul	2010 Aug	Sep	Oct	Q3	Q4	2011 Q1	Q2	Q3	Q4	2012 Q1
Canadian Dollar											
C$ per US$	1.042	1.040	1.040	1.045	1.041	1.055	1.038	1.012	0.997	0.992	0.983
US$ per C$	0.960	0.962	0.962	0.957	0.961	0.948	0.963	0.988	1.003	1.008	1.017
Trade-Weighted	115.9	115.8	115.9	115.5	115.9	114.6	116.5	119.4	121.4	122.5	123.7
U.S. Dollar											
Trade-Weighted*	103.4	102.5	102.6	103.1	102.8	103.5	102.9	101.5	101.1	101.4	101.0
European Currencies											
Euro**	1.28	1.30	1.29	1.28	1.29	1.26	1.27	1.29	1.28	1.26	1.26
Danish Krone	5.82	5.75	5.80	5.85	5.80	5.90	5.90	5.75	5.80	5.95	5.95
Norwegian Krone	6.26	6.05	6.10	6.20	6.15	6.25	6.20	6.05	6.05	6.15	6.15
Swedish Krona	7.41	7.20	7.30	7.35	7.30	7.45	7.40	7.30	7.30	7.40	7.35
Swiss Franc	1.05	1.03	1.04	1.05	1.04	1.07	1.08	1.08	1.11	1.15	1.18
U.K. Pound**	1.53	1.58	1.57	1.55	1.56	1.54	1.55	1.59	1.58	1.56	1.56
Asian Currencies											
Chinese Yuan	6.78	6.74	6.71	6.69	6.74	6.65	6.56	6.48	6.40	6.32	6.25
Japanese Yen	88	87	88	89	87	89	93	96	100	104	106
Korean Won	1204	1175	1180	1200	1185	1205	1165	1110	1060	1010	955
Indian Rupee	46.8	46.6	46.0	45.8	46.5	45.7	45.2	44.7	44.3	44.1	44.0
Singapore Dollar	1.38	1.36	1.36	1.37	1.37	1.37	1.37	1.35	1.33	1.32	1.30
Malaysian Ringgit	3.20	3.16	3.16	3.17	3.17	3.19	3.18	3.16	3.13	3.11	3.08
Thai Baht	32.3	32.2	32.3	32.4	32.3	32.4	32.2	31.7	31.2	30.7	30.2
Philippine Peso	46.2	45.3	45.5	45.7	45.7	45.8	45.4	44.4	43.5	42.5	41.8
Taiwan Dollar	32.1	31.9	31.6	31.6	31.9	31.6	31.4	30.8	30.2	29.6	29.0
Indonesian Rupiah	9040	8950	8990	9025	8993	9065	9050	8975	8900	8825	8750
Other Currencies											
Australian Dollar**	0.879	0.900	0.888	0.875	0.889	0.863	0.867	0.892	0.917	0.942	0.958
N.Z. Dollar**	0.715	0.730	0.728	0.725	0.724	0.723	0.738	0.764	0.790	0.816	0.833
Mexican Peso	12.80	12.75	12.60	12.55	12.70	12.55	12.35	12.10	11.95	11.95	12.10
Brazilian Real	1.77	1.76	1.77	1.77	1.77	1.76	1.75	1.73	1.73	1.74	1.75
Russian Ruble	30.6	30.3	30.4	30.5	30.4	30.5	30.4	30.1	30.1	30.3	30.5
South African Rand	7.5	7.5	7.6	7.7	7.6	7.8	7.8	7.7	7.7	7.9	7.9

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

Cross Rates

	Actual Jul	2010 Aug	Sep	Oct	Q3	Q4	2011 Q1	Q2	Q3	Q4	2012 Q1
Versus Canadian Dollar											
Euro (C$/€)	1.34	1.35	1.34	1.33	1.34	1.33	1.32	1.31	1.28	1.25	1.24
U.K. Pound (C$/£)	1.59	1.64	1.63	1.62	1.62	1.62	1.61	1.61	1.58	1.55	1.53
Japanese Yen (¥/C$)	84	84	85	85	84	84	90	95	100	105	108
Australian Dollar (C$/A$)	0.916	0.936	0.923	0.914	0.925	0.910	0.900	0.902	0.914	0.934	0.942
Versus Euro											
U.K. Pound (£/€)	0.84	0.82	0.82	0.82	0.83	0.82	0.82	0.81	0.81	0.81	0.81
Japanese Yen (¥/€)	112	113	113	113	112	112	118	124	128	131	133

Barney Bonekamp contributed to the above forecasts

Interest Rate Forecasts
Percent (averages)

	Actual	2010					2011				2012
	Jul	Aug	Sep	Oct	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Cdn. Yield Curve											
Overnight	0.75	0.75	1.00	1.00	0.83	1.00	1.35	1.50	1.85	2.35	2.85
3 month	0.56	0.70	0.85	0.90	0.70	0.95	1.30	1.45	1.80	2.30	2.85
6 month	0.84	0.95	1.10	1.15	1.00	1.20	1.55	1.75	2.10	2.65	3.15
1 year	1.11	1.25	1.35	1.40	1.25	1.40	1.75	2.00	2.35	2.80	3.25
2 year	1.57	1.70	1.80	1.80	1.70	1.85	2.10	2.45	2.80	3.15	3.50
3 year	1.82	1.90	2.00	2.00	1.90	2.00	2.25	2.60	2.95	3.30	3.65
5 year	2.43	2.45	2.50	2.50	2.45	2.45	2.65	2.95	3.20	3.50	3.75
7 year	2.66	2.65	2.70	2.65	2.65	2.65	2.80	3.10	3.40	3.70	3.90
10 year	3.19	3.15	3.10	3.05	3.15	3.05	3.15	3.40	3.60	3.85	4.05
30 year	3.74	3.70	3.65	3.60	3.70	3.60	3.70	3.95	4.15	4.40	4.60
3m BA	0.87	1.00	1.15	1.20	1.00	1.25	1.60	1.80	2.10	2.55	3.00
Prime Rate	2.75	2.75	3.00	3.00	2.85	3.00	3.35	3.50	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	0.16	0.15	0.15	0.15	0.15	0.15	0.15	0.20	0.55	1.05	1.60
6 month	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.30	0.75	1.20	1.80
1 year	0.29	0.30	0.30	0.30	0.30	0.30	0.45	0.80	1.30	1.80	2.30
2 year	0.62	0.60	0.60	0.60	0.60	0.60	0.95	1.50	2.05	2.60	3.05
3 year	0.98	0.95	0.95	0.95	0.95	0.95	1.30	1.85	2.40	2.90	3.30
5 year	1.76	1.75	1.70	1.70	1.75	1.70	1.95	2.45	2.90	3.40	3.75
7 year	2.43	2.40	2.35	2.35	2.40	2.30	2.55	2.95	3.35	3.75	4.05
10 year	3.01	2.95	2.95	2.90	2.95	2.85	3.00	3.30	3.60	3.90	4.15
30 year	3.99	3.95	3.90	3.85	3.95	3.80	4.00	4.30	4.60	4.90	5.15
3m LIBOR	0.51	0.45	0.45	0.45	0.45	0.45	0.45	0.50	0.85	1.30	1.90
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	2.70	2.60	2.55	2.55	2.60	2.55	2.65	2.90	3.15	3.40	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	3.48	3.40	3.40	3.35	3.45	3.35	3.45	3.70	3.95	4.20	4.45
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	1.11	1.10	1.10	1.10	1.10	1.10	1.15	1.25	1.35	1.45	1.55