Rates Scenario for September 20, 2019

A Publication of BMO Capital Markets Economic Research • Douglas Porter, CFA, Chief Economist, BMO Financial Group

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Forecast Summary

	Actual	Forecasts								
	2019	2019			2020		2020			
	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Q1	Q2	Q3	Q4
BoC overnight	1.75	1.75[1]	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
10-yr Canadas	1.21	1.35	1.30	1.35	1.40	1.45	1.45	1.45	1.55	1.65	1.75
Fed funds	2.13	1.88[1]	1.63	1.63	1.63	1.63	1.63	1.63	1.63	1.63	1.63
10-yr Treasuries	1.63	1.70	1.65	1.70	1.75	1.80	1.80	1.80	1.90	2.00	2.10
C$ per US$	1.327	1.325	1.320	1.325	1.330	1.328	1.325	1.325	1.318	1.310	1.303
US$/€	1.11	1.11	1.10	1.10	1.09	1.09	1.09	1.09	1.10	1.10	1.11
US$/£	1.22	1.23	1.24	1.23	1.22	1.21	1.20	1.20	1.21	1.22	1.23
MXN/US$	19.68	19.60	19.60	19.60	19.60	19.50	19.40	19.40	19.15	18.85	18.60
¥/US$	106	107	106	106	105	105	104	104	103	104	105

(policy rates are end of period; averages otherwise); [1] actual value
Sources: BMO Economics, Haver Analytics

Since the previous issue of Rates Scenario (on August 8):

- August's escalation of the U.S./China trade war via the announcements that all remaining U.S. imports from China would face tariffs and that all U.S. tariff rates would rise by 5% (to either 30% or 15%) was the catalyst that caused us to change our Bank of Canada call last month. From a previous projection of no moves through the forecast period, we then had a solo rate cut on October 30 to match the same-day move by the Fed. Our Fed call did not change, expecting a rate cut on September 18 in addition to October.
- However, **recent policy pronouncements by both the Bank of Canada and the Fed**, along with the news of high-level U.S./China trade talks resuming next month and of token actions taken to lessen tensions, point to **pared October odds of rate cuts** on both sides of the border. While it's tempting to officially change our calls, we remind ourselves that a lot can happen in the next 40 days and that we're just one tweet away from re-escalation of the global trade war.
- On September 4, the **Bank of Canada** kept its policy rate at 1.75%; but, it gave no major signals that a change may be in the offing. The rate has been pegged at this level since last October, but the tone of the Statement left the Bank with the option to trim this October. In its first public comments since the early-July rate decision, the Bank highlighted the steep escalation in global trade risks. While this was partially offset by the strong Q2 GDP results (seen as temporary) and a firming housing market, the BoC left little doubt where the focus will be—squarely on trade developments.
- On September 18, the **FOMC** cut the target range for the fed funds rate by 25 bps to 1.75%-to-2.00%, but there was more ambiguity about a subsequent action than was the case amid the first cut on July 31. The Statement emphasized the glaring dichotomy in the economy; that, *"although household spending has been rising at a strong pace, business fixed investment and exports have weakened."* The voting pattern suggested that the risks to the outlook were now more fluid than before. KC President George and Boston's Rosengren again dissented in

favour of no rate cut; and, this time, St. Louis President Bullard dissented in favour of a 50 bp rate reduction. In the presser, Chair Powell even downplayed his prior reference to a *"mid-cycle adjustment"*, which had conjured memories of 1998's episode (three rate cuts over four months) and conveniently aligned in the market's mind with a cumulative 75 bp move over the July-October interval. Mentioned instead was the well-worn phrase that policy wasn't on a *"preset course"* (actually mentioned three times), and was *"highly data dependent"*.

- As before, we're not expecting any further moves by either the Fed or the Bank of Canada past October, on the assumption that global trade policy risks along with U.S. and Canadian economic performance all stabilize beyond the turn of the year. The latter should contribute to mildly rising bond yields on both sides of the border. However, the profile for longer-term Treasury yields are a little lower than before, and for Canada/US spreads, a little less negative than before, reflecting the legacy of August's massive rally.
- With Bank of Canada and Fed policies now more in sync, we look for the **Canadian dollar** to trade around current levels, in the $1.32-to-$1.33 range. We still judge that competitiveness issues are a longer-term drag for the currency, and the October 21 election could also inject some temporary volatility.
- Since August, the broader **FX market** has come under increased scrutiny. Recall how the **CNY** weakened early in the month, from around 6.84 to above 7 for the first time since 2008. This prompted the U.S. Treasury to label China as a "*currency manipulator*" although the IMF didn't agree with its finding. The CNY has depreciated to 7.09, indicating that the PBoC is comfortable with the weaker trend. But, it wasn't just the CNY that fell. Many other currencies did too, as a number of central banks piled on the 'easing' bandwagon, including New Zealand, India, Thailand, the Philippines, Brazil, Mexico, South Korea, Indonesia, and South Africa.
- The **ECB** gets the trophy for the most significant changes. President Draghi pulled an equivalent of a mic drop on September 12th, his 2nd last meeting at the helm. He announced a series of measures to boost the region's economic growth and to help persistently weak underlying inflation "*robustly converge*" at or near 2%. This included changing the **forward guidance** on rates so it would become state-, rather than calendar-, dependent (RIP to the phrase "*at least through the first half of 2020*"); cutting the **deposit facility rate** 10 bps to -0.50%, while introducing a new **two-tier system for reserve remuneration** to take some of the pain off the banks from the lower deposit rate; and, changing the modalities of the **new TLTRO III terms** (if bank lending exceeds a benchmark, banks can get a rate as low as the average deposit facility rate).
- However, the return of **QE** was the most controversial measure within the Governing Council. The asset purchase program, which began in March 2015 (€60 bln/month) and ended in December 2018, added €2.6 trln to the ECB's balance sheet (from €2 trln to €4.6 trln). Now, it will return from its brief retirement and restart on November 1st at €20 bln/month. This will keep the EUR from strengthening too much, although additional measures will be limited. In fact, President Draghi called on those governments with "*fiscal space*" to act. It was "high time" as monetary policy alone cannot do the job.
- The **Bank of England** is facing what is arguably one of the most challenging environments, in which rates can truly go in either direction. Economic growth has slowed, inflation is not far from target, but it could be juiced by a weaker currency in the event of a no-deal Brexit. If that were the case, the Bank would likely ease monetary policy as the economy slows. But, if the U.K. is able to secure a deal with the EU, then there could be a case for tighter monetary policy, though it would be done at a gradual pace, and to a limited extent. Indeed, Brexit-related developments are certainly making domestic data volatile. Meantime, at the September meeting, the Committee unanimously voted to leave Bank Rate at 0.75%, and the APF at £435 bln. We judge that at some point early next year, the BoE will cut rates as the economy slows further.
- The **Bank of Japan** maintained its current monetary policy at the September meeting but there were some notable changes in the Statement. Some members of the **Policy Board have been dropping more hints** than usual

about their willingness to go deeper below zero if needed. And those hints became **more 'official'** as the latest Statement included the following line: "*The Bank judges that it is becoming necessary to pay closer attention to the possibility that the momentum towards achieving its price stability target will be lost ....the Bank will re-examine economic and price developments at its next policy meeting, when it updates the outlook for economic activity and prices*." That's similar to the ECB's July message. If it follows the same pattern, **the BoJ could ease in October**. Still, one wonders how beneficial even lower rates would be at this stage. The onus should be on PM Abe and his arrows.

Foreign Exchange Forecasts

	Actual	Forecasts									
	2019	2019				2020		2020			
	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Q1	Q2	Q3	Q4
Canadian Dollar											
C$ per US$	1.327	1.325	1.320	1.325	1.330	1.328	1.325	1.325	1.318	1.310	1.303
US$ per C$	0.753	0.755	0.758	0.755	0.752	0.753	0.755	0.755	0.759	0.763	0.768
Trade-weighted	95.3	95.5	95.8	95.5	95.2	95.4	95.6	95.6	96.0	96.4	96.9
U.S. Dollar											
Trade-weighted[1]	130.4	130.7	131.1	131.7	132.3	132.3	132.2	132.2	131.8	131.3	130.7
European Currencies											
Euro[2]	1.11	1.11	1.10	1.10	1.09	1.09	1.09	1.09	1.10	1.10	1.11
Danish Krone	6.70	6.75	6.80	6.80	6.85	6.80	6.80	6.80	6.80	6.75	6.70
Norwegian Krone	8.97	9.00	9.00	9.00	9.05	9.00	9.00	9.00	8.95	8.85	8.80
Swedish Krone	9.65	9.70	9.80	9.90	9.95	9.90	9.90	9.90	9.80	9.70	9.60
Swiss Franc	0.979	0.990	0.977	0.963	0.950	0.950	0.950	0.950	0.950	0.950	0.950
U.K. Pound[2]	1.22	1.23	1.24	1.23	1.22	1.21	1.20	1.20	1.21	1.22	1.23
Asian Currencies											
Chinese Yuan	7.06	7.13	7.16	7.19	7.22	7.24	7.26	7.26	7.28	7.26	7.22
Japanese Yen	106	107	106	106	105	105	104	104	103	104	105
Korean Won	1,210	1,195	1,210	1,225	1,240	1,240	1,240	1,240	1,240	1,240	1,240
Indian Rupee	71.2	71.5	71.7	72.0	72.2	72.3	72.5	72.5	72.9	73.3	73.7
Singapore Dollar	1.38	1.38	1.40	1.42	1.44	1.44	1.45	1.45	1.45	1.45	1.45
Malaysian Ringgit	4.19	4.20	4.25	4.30	4.40	4.35	4.35	4.35	4.30	4.30	4.25
Thai Baht	30.7	30.6	30.9	31.1	31.4	31.6	31.8	31.8	32.4	33.0	33.6
Philippine Peso	52.2	52.5	52.9	53.4	53.8	53.8	53.8	53.8	53.9	53.9	54.0
Taiwan Dollar	31.4	31.2	31.7	32.3	32.9	32.9	32.9	32.9	33.0	33.0	33.1
Indonesian Rupiah	14,232	14,080	14,430	14,775	15,125	15,115	15,100	15,100	15,065	15,025	14,990
Other Currencies											
Australian Dollar[2]	0.677	0.680	0.673	0.667	0.660	0.662	0.663	0.663	0.668	0.673	0.678
New Zealand Dollar[2]	0.643	0.639	0.636	0.633	0.630	0.631	0.632	0.632	0.634	0.637	0.639
Mexican Peso	19.68	19.60	19.60	19.60	19.60	19.50	19.40	19.40	19.15	18.85	18.60
Brazilian Real	4.02	4.10	4.10	4.05	4.05	4.05	4.05	4.05	4.05	4.05	4.05
Russian Ruble	65.8	65.5	66.0	66.5	67.0	67.0	67.1	67.1	67.2	67.4	67.5
South African Rand	15.2	14.8	14.6	14.5	14.4	14.3	14.3	14.3	14.2	14.1	14.0
Cross Rates											
Versus Canadian Dollar											
Euro (C$/€)	1.48	1.47	1.46	1.45	1.45	1.45	1.45	1.45	1.45	1.45	1.44
U.K. Pound (C$/£)	1.61	1.63	1.64	1.63	1.62	1.61	1.59	1.59	1.59	1.59	1.60
Japanese Yen (¥/C$)	80	81	81	80	79	79	79	79	78	79	80
Australian Dollar (C$/A$)	0.90	0.90	0.89	0.88	0.88	0.88	0.88	0.88	0.88	0.88	0.88
Versus Euro											
U.K. Pound (£/€)	0.92	0.90	0.89	0.89	0.89	0.90	0.91	0.91	0.91	0.91	0.90
Japanese Yen (¥/€)	118	119	117	116	114	114	114	114	113	114	116

Local currency per U.S. Dollar (averages); [1] Federal Reserve Broad Index; [2] (US$ per local currency)

Sources: BMO Economics, Haver Analytics

Interest Rate Forecasts

	Actual 2019 Aug	Forecasts 2019 Sep	Oct	Nov	Dec	2020 Jan	Feb	2020 Q1	Q2	Q3	Q4
Cdn. Yield Curve											
Overnight	1.75	1.75[1]	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
3 month	1.64	1.60	1.50	1.40	1.40	1.40	1.40	1.40	1.40	1.40	1.40
6 month	1.64	1.65	1.50	1.40	1.40	1.40	1.40	1.40	1.40	1.40	1.40
1 year	1.57	1.70	1.50	1.45	1.45	1.45	1.45	1.45	1.50	1.55	1.60
2 year	1.37	1.55	1.30	1.30	1.30	1.35	1.35	1.35	1.45	1.55	1.65
3 year	1.32	1.50	1.25	1.30	1.30	1.35	1.40	1.40	1.50	1.55	1.65
5 year	1.22	1.40	1.20	1.30	1.35	1.40	1.40	1.40	1.50	1.60	1.70
7 year	1.22	1.40	1.25	1.30	1.40	1.40	1.45	1.45	1.55	1.60	1.70
10 year	1.21	1.35	1.30	1.35	1.40	1.45	1.45	1.45	1.55	1.65	1.75
30 year	1.44	1.55	1.45	1.55	1.60	1.65	1.65	1.65	1.75	1.90	2.00
1m BA	1.95	1.95	1.85	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
3m BA	1.96	1.95	1.85	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
6m BA	1.97	2.00	1.85	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
12m BA	2.04	2.10	1.90	1.85	1.85	1.85	1.90	1.90	1.90	1.95	2.00
Prime Rate	3.95	3.95	3.70	3.70	3.70	3.70	3.70	3.70	3.70	3.70	3.70
U.S. Yield Curve											
Fed funds	2.13	1.88[1]	1.63	1.63	1.63	1.63	1.63	1.63	1.63	1.63	1.63
3 month	1.99	1.95	1.65	1.65	1.65	1.65	1.65	1.65	1.65	1.65	1.65
6 month	1.93	1.90	1.60	1.60	1.65	1.65	1.65	1.65	1.65	1.70	1.70
1 year	1.77	1.85	1.55	1.60	1.65	1.65	1.65	1.65	1.70	1.70	1.75
2 year	1.57	1.65	1.50	1.55	1.65	1.65	1.65	1.65	1.70	1.75	1.75
3 year	1.51	1.60	1.55	1.60	1.65	1.65	1.70	1.70	1.75	1.80	1.85
5 year	1.49	1.60	1.55	1.65	1.70	1.70	1.75	1.75	1.80	1.85	1.95
7 year	1.55	1.65	1.60	1.65	1.70	1.75	1.75	1.75	1.85	1.95	2.00
10 year	1.63	1.70	1.65	1.70	1.75	1.80	1.80	1.80	1.90	2.00	2.10
30 year	2.12	2.20	2.10	2.15	2.20	2.25	2.25	2.25	2.35	2.45	2.55
1m LIBOR	2.17	2.05	1.75	1.70	1.65	1.65	1.65	1.65	1.65	1.65	1.70
3m LIBOR	2.16	2.15	1.85	1.80	1.80	1.80	1.80	1.80	1.85	1.85	1.90
6m LIBOR	2.06	2.05	1.75	1.75	1.75	1.80	1.80	1.80	1.85	1.90	1.95
12m LIBOR	2.00	2.00	1.75	1.80	1.80	1.85	1.85	1.85	1.90	2.00	2.05
Prime Rate	5.25	5.00	4.75	4.75	4.75	4.75	4.75	4.75	4.75	4.75	4.75
Other G7 Yields											
ECB Refi	0.00	0.00[1]	0.00	0.00	0.00	0.00	0.00	-0.10	-0.10	-0.10	-0.10
10yr Bund	-0.63	-0.70	-0.80	-0.85	-0.75	-0.75	-0.70	-0.70	-0.65	-0.55	-0.50
BoE Repo	0.75	0.75[1]	0.75	0.75	0.75	0.50	0.50	0.50	0.50	0.50	0.50
10yr Gilt	0.49	0.45	0.40	0.35	0.50	0.50	0.25	0.35	0.40	0.50	0.60
BoJ O/N	-0.06	-0.05[1]	-0.05	-0.05	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
10yr JGB	-0.23	-0.22	-0.21	-0.20	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10

Percent (policy rates are end of period; averages otherwise); [1] actual value

Sources: BMO Economics, Haver Analytics

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