Rates Scenario for August 8, 2019

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

Forecast Summary

	Actual	Forecasts									
	2019	2019					2020	2020			
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Q1	Q2	Q3	Q4
BoC overnight	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
10-yr Canadas	1.52	1.25	1.30	1.30	1.35	1.45	1.45	1.45	1.55	1.60	1.70
Fed funds	2.38	2.13[1]	1.88	1.63	1.63	1.63	1.63	1.63	1.63	1.63	1.63
10-yr Treasuries	2.06	1.75	1.75	1.75	1.80	1.90	1.90	1.90	2.00	2.05	2.10
C$ per US$	1.311	1.320	1.300	1.307	1.313	1.320	1.318	1.317	1.312	1.307	1.302
US$/€	1.12	1.11	1.11	1.11	1.10	1.10	1.10	1.10	1.11	1.11	1.12
US$/£	1.25	1.21	1.20	1.17	1.16	1.15	1.15	1.15	1.17	1.19	1.22
MXN/US$	19.05	19.50	19.55	19.55	19.60	19.60	19.50	19.40	19.15	18.85	18.60
¥/US$	108	106	106	106	105	105	105	104	103	104	105

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

Sources: BMO Economics, Haver Analytics

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Since the previous issue of Rates Scenario (on July 17, 2019):

- In the wake of the Trump Administration officially labelling China a "*currency manipulator*", we now judge that the threatened (tweeted) 10% tariff on all remaining Chinese imports will happen next month. China retaliated by cancelling all agricultural orders from the U.S., with more moves likely to occur (such as restricting rare earth mineral exports). This **major escalation of the U.S./China trade war has caused us to change our Fed forecast. We now look for follow-up rate cuts in both September and October** (as opposed to just October, previously), with the same net downside risks surrounding the outlook as before.
- In last month's post-FOMC presser, Chair Powell said the motivation for cutting rates (at the time) was: first, to mitigate the downside risks to the U.S. economic outlook posed by weak global growth and trade tensions; and, second, to counter the negative effects these two developments were already having on the economy. These **motives are now even more compelling**. We also downgraded our near-term U.S. GDP forecast, with Q3 now at 1.6% annualized vs. 1.8% before, owing to the anticipated clip to business confidence, and thus capex, along with manufacturing activity.
- Note that the extra rate cut (so now 75 bps in total), along with the recently announced boost to federal government spending, should keep **2020 economic performance on track;** i.e., back to 2.0% growth by mid-year. This expected rebound (but, again, with net downside risks) should ensure that current easing becomes *"a mid-cycle adjustment to policy"* and not *"the beginning of a lengthy cutting cycle"* (Powell's words). The historic median mid-cycle adjustment is 75 bps of cumulative easing over four months, which should fit the current episode perfectly.
- **Lower-for-longer Fed policy rates will ripple along the Treasury yield curve**. We now judge 10-year yields are unlikely to climb back to the 2% mark by year-end. It's now a 2020 story. We still expect that unrealized market

expectations for Fed easing, along with the reasons for it (elevated risks to the outlook eventually backing off), will apply modest upward pressure on bond yields, albeit from a lower base than before.

- Despite a third Fed action, we still judge the **Bank of Canada** will remain on hold, but it has become a much closer call. Indeed, **we assess even odds of a rate cut by Q4**. We're staying on the hold side because of the penchant for Trump Administration trade remedies to be postponed, watered-down in implementation or reversed, along with previous hold arguments. Recall: (1) core inflation is already at the 2% target; (2) policy rates are already negative in real terms (175 bps nominal); and, (3) having achieved a semblance of stability in the housing sector and in household debt ratios, we suspect the Bank will tread carefully to avoid destabilizing them. Note that, although 2015's "*insurance*" rate cuts contributed to surging housing markets outside the oil patch (particularly in Vancouver and Toronto), more restrictive macroprudential policies have since been adopted at the federal and local levels.
- As long as the coming two Fed rate cuts are painted more as measures to mitigate risk (insurance) as opposed to measures designed to stave off a potential recession, and the risks surrounding the U.S. outlook don't noticeably escalate from current readings, we suspect the Bank of Canada will fidget, but still sit on its hands. However, **should U.S. growth suffer** more than just a couple of tenths, **oil prices weaken too much,** the **Canadian dollar strengthens too much,** an **inter-meeting or 50 bp Fed cut** signals greater urgency, then **we judge the Bank of Canada will cut rates,** too.
- Although shorter-term Canada-U.S. yield spreads are likely to become much less negative as the Fed cuts rates, **longer-term spreads should remain more resilient** (e.g., 10-year tenors close to current levels) before moving more negative next year. As before, the larger negative spread at the long end reflects America's much worse fiscal dynamics as well as Canada's weaker economic competitiveness (that should result in market expectations of a perennially more-cautious-than-the-Fed monetary policy stance).
- We now look for the **U.S. dollar (on a trade-weighted basis) to drift more sideways than down**, despite additional Fed rate cuts, as more global central banks are jumping on the easing bandwagon. Meanwhile, the greenback should garner some support from a worsening global trade war and dimming global economic prospects.
- With the Bank of Canada resisting the Fed's rate-cutting lead (for now), we anticipate the **Canadian dollar has some modest near-term upside**. The net risk is that it's more than just modest, which would flash bright on the BoC's radar. Beyond the near-term strength, we look for the loonie to hover in the low-1.30s through 2019Q4 and 2020. We still judge that competitiveness issues are a longer-term drag for the currency, and the October 2019 election could also inject some temporary volatility.
- The Federal Reserve is not alone in easing monetary policy; it has plenty of company. Since its July 31 rate cut, it has been followed by the **Reserve Bank of New Zealand** (more aggressive with its 50 bp slice), **India** (a larger-than-expected 35 bps), **Brazil** (50 bps), **Thailand** (25 bps), and the **Philippines** (25 bps). And the Fed wasn't even the first out of the gate. It was preceeded by **Australia** (had eased twice this year and is poised to go lower), **South Korea**, **Indonesia** and **South Africa**, all by 25 bps. And note that New Zealand was the first central bank in the developed world to ease this cycle, trimming rates 25 bps back in May. In addition, after the **People's Bank of China** allowed the yuan to weaken beyond the psychologically important 7.0 mark, signalling that Beijing is willing to tolerate a weaker currency, Asian currencies came under pressure.
- The **BoJ** hasn't strayed from its already massive QE program but it is clear that it "*won't hesitate*" to do more if "*the momentum to achieve its price target is under threat*".
- The **ECB** all but eased in July with its dovish statement and press conference. It adopted an easing bias by adding the word "*lower*" to the rates guidance…"*The Governing Council expects the key ECB interest rates to remain*

at their present or lower levels at least through the first half of 2020", and revealed that the ECB staff had been instructed to look at different options, including reinforcing its forward rates guidance, introducing a tiered-deposit rate, and resuming asset purchases. President Draghi also emphasized its determination to act if inflation continues to disappoint. So ECB easing is expected in September, and the size of the package will likely weigh on the currency. (Also weighing are the Italian elections.)

- Only the **BoE** stands alone, fiercely defending its base-case assumption that, in the event of a smooth Brexit, "*increases in interest rates, at a gradual pace and to a limited extent, would be appropriate*..." but that bias is wavering. The prospect of a no-deal Brexit is, in the market's mind, quickly becoming the base-case scenario. That (an assessment we cannot disagree with), along with likely elections in November, will put further downward pressure on the GBP.

Foreign Exchange Forecasts

	Actual 2019 Jul	Forecasts 2019 Aug	Sep	Oct	Nov	Dec	2020 Jan	2020 Q1	Q2	Q3	Q4
Canadian Dollar											
C$ per US$	1.311	1.320	1.300	1.307	1.313	1.320	1.318	1.317	1.312	1.307	1.302
US$ per C$	0.763	0.758	0.769	0.765	0.761	0.758	0.759	0.759	0.762	0.765	0.768
Trade-weighted	96.3	95.7	97.3	96.9	96.4	96.0	96.1	96.2	96.4	96.6	96.8
U.S. Dollar											
Trade-weighted[1]	127.8	129.7	129.9	130.5	131.0	131.5	131.5	131.4	130.8	130.0	129.1
European Currencies											
Euro[2]	1.12	1.11	1.11	1.11	1.10	1.10	1.10	1.10	1.11	1.11	1.12
Danish Krone	6.66	6.70	6.70	6.75	6.75	6.75	6.75	6.75	6.70	6.70	6.65
Norwegian Krone	8.62	8.90	8.90	8.90	8.90	8.90	8.90	8.90	8.80	8.75	8.70
Swedish Krone	9.42	9.60	9.65	9.75	9.80	9.85	9.85	9.80	9.70	9.65	9.55
Swiss Franc	0.988	0.980	0.973	0.965	0.958	0.950	0.950	0.950	0.950	0.950	0.950
U.K. Pound[2]	1.25	1.21	1.20	1.17	1.16	1.15	1.15	1.15	1.17	1.19	1.22
Asian Currencies											
Chinese Yuan	6.88	7.03	7.06	7.09	7.12	7.15	7.18	7.22	7.22	7.13	7.03
Japanese Yen	108	106	106	106	105	105	105	104	103	104	105
Korean Won	1,177	1,210	1,215	1,220	1,225	1,230	1,230	1,225	1,220	1,215	1,205
Indian Rupee	68.7	70.0	70.4	70.8	71.1	71.5	71.5	71.5	71.6	71.7	71.7
Singapore Dollar	1.36	1.38	1.39	1.40	1.42	1.43	1.43	1.43	1.42	1.42	1.42
Malaysian Ringgit	4.12	4.20	4.25	4.25	4.30	4.35	4.30	4.30	4.25	4.20	4.15
Thai Baht	30.8	30.8	30.9	31.0	31.0	31.1	31.3	31.4	31.9	32.3	32.8
Philippine Peso	51.1	51.9	52.2	52.6	52.9	53.3	53.2	53.1	52.9	52.8	52.6
Taiwan Dollar	31.1	31.5	31.8	32.0	32.3	32.5	32.5	32.5	32.4	32.3	32.2
Indonesian Rupiah	14,026	14,215	14,405	14,600	14,790	14,980	14,945	14,910	14,805	14,700	14,595
Other Currencies											
Australian Dollar[2]	0.698	0.675	0.671	0.668	0.664	0.660	0.662	0.663	0.668	0.673	0.678
New Zealand Dollar[2]	0.668	0.650	0.645	0.640	0.635	0.630	0.631	0.632	0.634	0.637	0.639
Mexican Peso	19.05	19.50	19.55	19.55	19.60	19.60	19.50	19.40	19.15	18.85	18.60
Brazilian Real	3.78	4.00	4.00	4.05	4.05	4.05	4.05	4.05	4.05	4.05	4.05
Russian Ruble	63.2	63.8	64.5	65.1	65.7	66.4	66.4	66.5	66.6	66.8	66.9
South African Rand	14.0	14.9	14.8	14.6	14.5	14.4	14.3	14.3	14.2	14.1	14.0
Cross Rates											
Versus Canadian Dollar											
Euro (C$/€)	1.47	1.47	1.44	1.45	1.45	1.45	1.45	1.45	1.45	1.45	1.46
U.K. Pound (C$/£)	1.63	1.60	1.56	1.53	1.52	1.52	1.52	1.51	1.53	1.56	1.59
Japanese Yen (¥/C$)	83	80	81	81	80	80	79	79	79	79	80
Australian Dollar (C$/A$)	0.91	0.89	0.87	0.87	0.87	0.87	0.87	0.87	0.88	0.88	0.88
Versus Euro											
U.K. Pound (£/€)	0.90	0.92	0.93	0.95	0.95	0.96	0.96	0.96	0.95	0.93	0.92
Japanese Yen (¥/€)	121	118	117	117	116	116	115	115	115	115	117

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	Forecasts									
	2019	2019					2020	2020			
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Q1	Q2	Q3	Q4
Cdn. Yield Curve											
Overnight	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
3 month	1.65	1.65	1.65	1.65	1.65	1.65	1.65	1.65	1.65	1.65	1.65
6 month	1.70	1.65	1.65	1.65	1.65	1.65	1.65	1.65	1.65	1.65	1.65
1 year	1.69	1.60	1.60	1.55	1.60	1.70	1.70	1.70	1.70	1.70	1.70
2 year	1.52	1.35	1.30	1.25	1.40	1.50	1.50	1.55	1.60	1.65	1.70
3 year	1.49	1.30	1.25	1.20	1.35	1.50	1.50	1.50	1.60	1.65	1.70
5 year	1.46	1.25	1.20	1.15	1.30	1.45	1.50	1.50	1.55	1.60	1.70
7 year	1.47	1.25	1.20	1.15	1.30	1.45	1.45	1.50	1.55	1.60	1.70
10 year	1.52	1.25	1.30	1.30	1.35	1.45	1.45	1.45	1.55	1.60	1.70
30 year	1.73	1.45	1.50	1.50	1.60	1.65	1.70	1.70	1.80	1.90	1.95
1m BA	1.95	1.95	1.95	1.95	1.95	1.95	1.95	1.95	1.95	1.95	1.95
3m BA	1.97	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00
6m BA	2.01	2.05	2.05	2.05	2.05	2.05	2.05	2.05	2.05	2.05	2.05
12m BA	2.11	2.10	2.05	2.05	2.10	2.15	2.15	2.15	2.15	2.15	2.15
Prime Rate	3.95	3.95	3.95	3.95	3.95	3.95	3.95	3.95	3.95	3.95	3.95
U.S. Yield Curve											
Fed funds	2.38	2.13[1]	1.88	1.63	1.63	1.63	1.63	1.63	1.63	1.63	1.63
3 month	2.15	2.05	1.75	1.55	1.55	1.55	1.55	1.60	1.60	1.65	1.65
6 month	2.08	2.00	1.70	1.55	1.55	1.55	1.55	1.60	1.65	1.65	1.70
1 year	1.96	1.80	1.70	1.55	1.55	1.55	1.55	1.60	1.65	1.70	1.75
2 year	1.84	1.60	1.55	1.50	1.55	1.65	1.65	1.65	1.70	1.75	1.75
3 year	1.80	1.55	1.55	1.55	1.65	1.70	1.70	1.70	1.75	1.80	1.85
5 year	1.83	1.55	1.60	1.65	1.70	1.75	1.75	1.80	1.85	1.90	1.95
7 year	1.93	1.65	1.65	1.70	1.75	1.80	1.85	1.85	1.90	1.95	2.00
10 year	2.06	1.75	1.75	1.75	1.80	1.90	1.90	1.90	2.00	2.05	2.10
30 year	2.57	2.25	2.25	2.25	2.35	2.40	2.40	2.45	2.50	2.55	2.65
1m LIBOR	2.31	2.20	1.95	1.70	1.70	1.70	1.70	1.70	1.70	1.75	1.75
3m LIBOR	2.29	2.20	1.90	1.70	1.70	1.70	1.70	1.75	1.80	1.85	1.90
6m LIBOR	2.21	2.05	1.80	1.60	1.60	1.60	1.65	1.65	1.75	1.80	1.90
12m LIBOR	2.20	2.00	1.90	1.75	1.75	1.75	1.80	1.80	1.90	2.00	2.10
Prime Rate	5.50	5.25	5.00	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	0.00	0.00	0.00	0.00	0.00	-0.10	-0.10	-0.10	-0.10
10yr Bund	-0.35	-0.40	-0.45	-0.50	-0.55	-0.65	-0.60	-0.60	-0.55	-0.55	-0.50
BoE Repo	0.75	0.75[1]	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
10yr Gilt	0.73	0.70	0.70	0.65	0.65	0.65	0.65	0.65	0.70	0.75	0.80
BoJ O/N	-0.07	-0.05	-0.05	-0.05	-0.05	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
10yr JGB	-0.14	-0.13	-0.13	-0.12	-0.11	-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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