Focus

Feature Article

Guns N' Bonds

Our Thoughts

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The Great Wall of Worry

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The boiling over of **tensions in the Middle East**, with Israel striking Iran, has abruptly injected yet a new source of risk into an already fraught global economic outlook. The one silver lining for the growth backdrop amid the intense trade uncertainty of the past five months had been the retreat in oil prices. With crude having tumbled from as high as $80/barrel early this year to below $60 at one point, the threat of a serious bout of inflation arising from the trade war seemed unserious. But that good news has proven to be quicksilver, as the overnight strike on Iran has sent oil surging, after it had already risen by 12% in the past two weeks. As a result, WTI now stands at $72, up from barely $60 a mere two Fridays ago. For perspective, that's still below last year's average crude price of $76, and a long way from the triple digits in 2022, but **energy is no longer the safety valve for inflation**.

Our energy analyst in equity research, Randy Ollenberger, concludes: *"This could disrupt Iranian oil exports of roughly 1.5 million b/d. If the conflict escalates, Iran could attempt to disrupt oil tanker flows through the Strait of Hormuz, which transits roughly 20% of global oil supplies. In the near term, we expect crude oil prices to remain volatile with a bias to the upside."*

The late-week spike in oil prices overshadowed the latest chapter in the trade war saga. What initially looked to be the big event of the week for markets—**China and the U.S. talking trade** in London—turned into a bit of a damp squib. Essentially, the two parties simply **agreed to get back to where we were a month ago**, with China loosening export restrictions on rare earths and critical minerals (for 6 months), and the U.S. backing off of some recent restrictions of their own. And the net new tariffs in 2025 remain at 30% on China, 10% on America. Markets appropriately offered a collective shrug. At the same time, China's May trade data showed a 34.5% y/y plunge in exports to the U.S., and yet overall exports still managed to rise almost 5% y/y, a notable show of resilience. Between that and the chokehold on rare earths, China appears better armed for the trade war than perhaps the U.S. Administration had anticipated.

Chart 1
Perception vs. Reality

Inflation Rate — United States

[1] University of Michigan (%); [2] (y/y % chng)
Sources: BMO Economics, Haver Analytics, U. of Michigan, BLS

While trade news offered little help, the one legitimate piece of good news for markets this week was an ultra-benign U.S. CPI for May, with PPI echoing the result. We have been asking for weeks now: **Tariffs, where is thy sting?** And it certainly wasn't to be found in the inflation data. Prices for goods ex food & energy, the very broad group that would be most directly affected by tariffs, *dipped* in May and are *down* at a 0.3% a.r. over the past three months. The absence of real price pressures at the consumer level so far may be permeating into the sentiment data. The University of Michigan reported a big bounce in June, with a related big drop in inflation expectations (the one-year outlook plunged 1.5 ppts to 5.1%, the largest move in nearly 25 years).

A variety of U.S. confidence surveys have been turning higher recently, albeit after diving to extraordinarily low levels at the height of the trade uncertainty. But **calm**

inflation on the ground and the **fast rebound in stocks** have revived the so-called soft data. Thus, the previously wide gap between weak surveys and the hard economic data (which had been mostly resilient) has narrowed. Of course, the flip side of that narrowing is that the **economic data are showing some cracks**. In a relatively light week, the back-up in continuing jobless claims was arguably the most important development on the growth front. Such claims rose to 1.96 million, the highest since early 2018 (aside from the pandemic burst). It's far from an alarming level, but the upward trend is clear.

Perhaps the most notable aspect of this week's market action was the **lack of a flight-to-safety move amid the flareup in the Middle East**. It's true that 10-year Treasury yields stepped down nearly 10 bps in the week to 4.4%, but that was primarily driven by the benign CPI & PPI reports. Meantime, the U.S. dollar continued to sag, with the euro pushing above $1.15, its highest level since late 2021 and up more than 12% just since the start of the year. The Canadian dollar hasn't quite managed to keep pace, but even the loonie has risen almost 7% from its early-year nadir, and is the strongest since just prior to the U.S. election at $1.357 (or 73.7 cents). In a similar vein, the TSX continued to outperform, hitting a series of record highs before stumbling along with others on Friday's news—yet, it still managed another small weekly win.

The Canadian equity market has been blissfully unaffected, on net, by the trade trauma. In part, that's due to the very narrow focus of the U.S. tariffs on Canada—primarily hitting autos, steel and aluminum. It's also in part due to the very specific and mostly narrow focus of the TSX, which has benefitted from the ongoing rally in gold, and firmness in financials. The sturdy recent performance, and the rebound in the loonie, may also reflect rumbling rumours that the U.S. and Canada are on the verge of an agreement, perhaps with some contours of the U.K. deal. The focus now turns to next week's **G7 meetings in Kananaskis**, **Alberta**, and the accepted invitation of Mexico's President has only heightened anticipation that there **may be some real news arising** from the confab.

Even a framework for a North American deal would be a big step, and just in time. **While Canada's economy has mostly held up, there are definitely cracks emerging.** The steady back-up in the unemployment rate to 7.0% and the 55,000 drop in factory jobs in just four months are the clearest signs of stress. But heavy declines in both manufacturing and wholesale trade in April suggest that the initial estimate of 0.1% GDP growth in that month will be revised away. A stand-down on North American tariffs would prompt an upward revision in our Canadian growth outlook, likely fewer Bank of Canada rate cuts, and a nice tonic in the face of a world of uncertainty.

Paraskevidekatriaphobia—the fear of Friday the 13th. This space has long asserted that it's a ridiculous, irrational fear. After all, isn't Friday the best day of the week? And what are the 3% of us who happened to be born on the 13th of any month supposed to think about that being an unlucky number? Unfortunately, the events overnight have lent some serious credence to the old saw, especially in combination with all the other deep uncertainties markets are grappling with at this point. But much as equities have managed to look well past the short-term trade clouds, the same may well go for this latest threat to stability. In such times, **we often lean on the olde-time wisdom of great song writers for guidance**. It may have seemed natural to give a nod to the two legends who both passed away this week at age 82, Brian Wilson ("God Only Knows") or Sly Stone ("I Want to Take You Higher"). Instead, we'll lean on Cousin Cole Porter (ok, second cousin, twice removed): He wrote "Anything Goes" 91 years ago, and the lyrics required only a tiny edit or two:

The world has gone mad today
And good's bad today
And gold's hot today
And dollar's not today
And that bond today
You sold across the pond today
Once had much mightier flows
When folks who decide what the U.S. owes
Find out that for Musk and Bezos
Tax relief grows
Anything goes

FOMC Preview: Sniffing for Stagflation Risks

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We look for the **FOMC to keep policy rates unchanged** on June 18, keeping the fed funds target range at 4.25%-to-4.50% for the fourth consecutive confab over the past six months. We reckon the key reason proffered for the hold will be comparable to May's motive. Back then, amid the Administration's *"substantial"* policy changes that were still *"evolving"* with their economic effects remaining *"highly uncertain"*, policymakers judged that *"the risks of higher unemployment and higher inflation have risen"*. The **stagflation risk alarm was rung**.

From the beginning, the Administration's trade policy was expected to complicate monetary policy. On the risks of faster inflation, U.S. tariffs lift import prices and, potentially, the prices of import-competing goods. On the risks of slower growth, these higher prices erode purchasing power and weaken real domestic spending. U.S. real exports also weaken to the extent other countries counter with retaliatory measures. And now, **further complicating monetary policy are the data themselves**. The impact of tariffs on the indicators, particularly the 'hard' data (prices, sales, and production), are either too preliminary, muddled, or delayed. Owing to the erratic implementation of tariffs, businesses are probably being extra cautious with their pricing, hiring and capex decisions. And 'front-running' buying also affected the immediate impact of tariffs but at the expense of whipsawing spending.

Since the last Fed meeting, on the **trade policy** front, the eye-watering 125%-to-145% U.S.-China bilateral tariffs were chopped to 10%-to-30%, but steel and aluminum duties were doubled to 50% with the return (or further postponement) of 'reciprocal' tariffs looming next month. The appeals court is not expected to give its ruling on the legality of International Emergency Economic Powers Act (IEEPA)-based tariffs until August. On the **fiscal policy** front, the House passed a budget chock-full of deficit-financed tax cuts (a potential boost to growth and inflation for a few years) with a controversial component that could negatively impact net foreign investment—which the U.S. still requires to cover its ballooning budget deficit and inadequate domestic savings. The One Big Beautiful Bill is now in the Senate's hands with significant changes anticipated.

True, the stagflation alarm may not be ringing as loudly as it did last month before America's average tariff rate was nearly halved. But there's still a sound, and policy uncertainty is still extremely elevated. Hence, the Fed's willingness to wait.

Meanwhile, there will be a new **Summary of Economic Projections (SEP)** and its famous 'dot plot' to focus on. We expect the two quarter-point rate cut profile to remain for this year and next; even though, for this year, it would take only two participants switching to the 'one-or-none' camp to turn the median dial to one. Last SEP (March) four folks joined this camp, doubling its size. However, this reflected a hefty stagflation-skewed forecast adjustment, hence a need for more policy caution. The median call for real GDP growth this year was lowered by 0.4 ppts to 1.7% y/y (in Q4) with core PCE inflation lifted by 0.3 ppts (to 2.8% y/y). This time, we expect a similar skew but by only a tenth or maybe two, not enough to flip the median.

Bottom Line: On the stagflation scale, we reckon the economic indicators must convincingly weigh heavier on the slower growth side, or lighter on the faster inflation side, before the Fed will resume rate cuts. We're thinking by September.

What Was Behind the Benign U.S. Inflation in May?

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There are more signs of weakening consumer demand and a softening labour market, shown through the U.S. economic data releases this week. **Initial and continuing claims** are rising at a quickening pace, pointing to a notable change in the labour market over the last few weeks. The weekly claims data are one of our most timely and reliable indicators that something is starting to go wrong in the labour market. Initial claims over the last two weeks have been at their highest level since October 2024, and the four-week average hasn't been this elevated since last August, right before the Fed pulled the trigger on an outsized 50 basis point rate cut. Continuing claims haven't been this high since November 2021, jumping to 1,956k in the last week of May. Rising continuing claims are a telltale sign of declining labour demand.

Equity investors have largely shrugged off any real concern, with U.S. stock prices holding up well again this week despite a direct military conflict between Israel and Iran erupting late Thursday. **Consumer price inflation** was surprisingly benign in May despite higher tariffs on China and other countries. We suspect this may have been a response to weak consumer demand in May and businesses' reluctance to fully pass price increases to consumers, especially since tariff rates are not set in stone and can vary substantially week-to-week. We will have a better feel of how aggressively the consumer is pulling back, and in what categories, next week, following the release of the May retail sales report. For the record, we are forecasting a sizeable 0.7% drop.

We saw big declines in prices for energy, new and used cars, and apparel last month. In fact, goods prices less food and energy were unchanged in May. **Auto sales** plunged 9.4% last month, according to Wards Automotive Group, and both new and used auto prices fell 0.3% and 0.5%, respectively. This is a pretty clear sign of at least a temporary pull-back in consumer demand for goods.

But, the real surprise was the sharp moderation in services and housing inflation, suggesting the consumer pull-back could be running even deeper. Services inflation, comprising around 64% of the overall CPI basket, slipped to 0.2% in May from 0.4% in April. Airline fares plunged 2.7%, and housing inflation moderated to 0.3% from 0.5%

in April. Zooming out, we can see that a big driver of the benign inflation over the last three months has been the drop in **supercore inflation**, or core services excluding housing. Over the last three months, on an annualized basis, it has been nearly non-existent at 0.1%, while overall CPI and core CPI inflation has also moderated, though not as dramatically. Supercore spiked to a 9.5% annualized pace in January but has largely been dormant since the trade wars started in February/March.

In short, **Q2 inflation is likely to come in somewhat below our previous forecasts**. We lowered our annualized CPI inflation estimate for the second quarter to just 1.7% with the core CPI now expected at 2.2%. But don't get too comfortable; we still anticipate a sizeable tariff-driven increase in consumer inflation in the second half of 2025, as more businesses are forced to bite the bullet and hike prices to remain viable. CPI inflation Q4/Q4 should hit 3.4% in 2025 with the core at an elevated 3.5%. Unfortunately, the Fed remains boxed in on monetary policy and won't be able to respond to the weakening labour market as quickly as some would like, as the stagflationary economic outlook remains intact. Equity investors should take note.

TSX: Is the Glitter Economic Gold?

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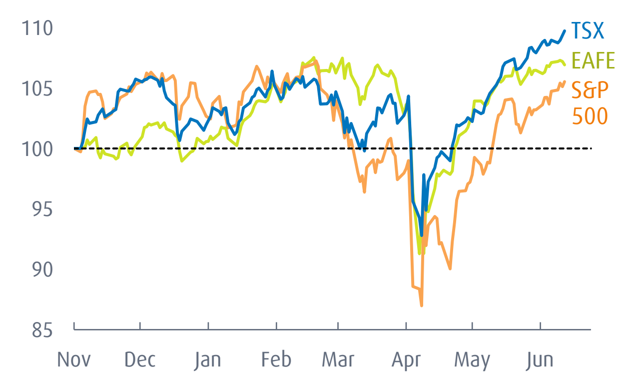
The TSX was churning out record highs this week despite ongoing uncertainty over the economic fallout from the trade war and the reality that Canada's economy is highly exposed to U.S. trade. Since the start of November (just before the U.S. election), the TSX has outperformed both the S&P 500 and EAFE. Let's consider a few reasons why, and whether this is a positive sign for the Canadian economic outlook.

Chart 1
Eh-Okay

Equity Indices — 2024-25 (Nov. 1, 2024 = 100 : as of June 12, 2025)



Sources: BMO Economics, Haver Analytics, MSCI

It's all relative (to expectations): The worst-case outcome on the tariff front was arguably priced in back in early April. Through a combination of carve-outs for U.S. tariffs on Canada, and a presumed eventual trade deal (with chatter ahead of the G7), the ultimate reality could bite much less hard. Equity markets are always operating at least three-to-six months in the future.

The tariff bite is narrow: There *are* some areas that are under heavy tariff pressure—steel & aluminum and, less so, autos. Most of the remaining tariffs are carved out by USMCA compliance. From an equity market perspective though, steel, aluminum and auto parts (the latter mostly exempt under USMCA as well) barely push 1% of the index. True, the impact of a trade war ripples across other industries, but the direct hit is narrow.

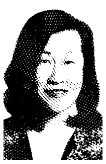
Canadian stocks were cheap: Before the trade war broke out, we were setting up for a solid contrarian year for the economy and relative TSX performance—the latter view shared by our strategy team. The forward earnings multiple was sitting around 15× versus above 22× for the S&P 500, a wide gap from a historical perspective.

Bank of Canada's head start: An earlier break in inflation and some proactive easing in the early days of the trade war have set Bank of Canada policy rates at a much more neutral level than those in the U.S. The 225 bps of easing in the past year could be taking the brakes off the economy (with a six-to-twelve month lag) just when it needs some help, and the TSX could be reflecting that.

Not the best bellwether: The TSX is notoriously not a perfect reflection of the underlying Canadian economy given its composition. The index is heavily weighted at more than 30% in each of financials and energy/materials. The former will pick up on broader economic conditions, but the latter don't swing real economic activity as much as they used to. Indeed, gold names make up five of the top ten contributors to the TSX increase this year, and account for almost a third of the year-to-date point gain. On the flip side, exposure to industrials (12%), consumer spending (7%) and real estate (2%) is disproportionately low. Over the past 25 years, the correlation between TSX performance and subsequent economic growth has been positive, but not as strong as in the U.S. where the S&P 500 is arguably a better reflection.

It's hard not to be impressed with the resilience of the Canadian equity market in the face of a trade war that can potentially do serious harm to the Canadian economy. We'd be somewhat cautious on fully passing this strength through to the economic outlook, but if the market is indeed discounting a manageable outcome—we'll take it.

BoE and BoJ: To Cut (or Hike), or Not to Cut (or Hike)



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To cut (or hike), or not to cut (or hike), that is the question. The BoE and the BoJ are not expected to adjust policy rates at their June meetings, but they will eventually. The question is when.

The **BoE** last cut rates 25 bps to 4.25% on May 8 and, once again, was able to shock and awe market-watchers with its vote. The cut itself was no surprise, but the vote of 5-2-2 was hardly dovish. Of the nine members of the MPC, a thin majority (of 5) voted in favour of the 25 bp cut and the 'majority of that majority' found the decision to be "*finely balanced*". Two other members voted to keep rates unchanged, while the remaining two opted for a 50 bp cut. Now, the views from the top—the Governor and the Chief Economist—are merging after being on divergent paths for awhile. Both sound more cautious on further cuts. In fact, Governor Bailey feels that the speed is "*shrouded in a lot more uncertainty*" and the pace of easing should be "*gradual and careful*". It doesn't help that the official data do not inspire confidence. The April CPI was overstated, while the jobs data are still problematic. Despite that uncertainty, the economy's rough start to Q2 (April's GDP drop of 0.3% was the largest since October 2023) may prompt the BoE to get off the sidelines earlier. **BMO looks for one more 25 bp rate cut, which could come as early as August.**

The **BoJ** is in a tough spot. At the start of 2025, it stood out in the crowd as being the only central bank to be very cautiously tightening. But like everywhere else, the trade war is taking a toll, and with above-target inflation, households' real cash earnings are declining; hence, some hesitancy to raise rates. Our base case is for no changes to monetary policy this year, but it is important to stress that the possibility of a move cannot be dismissed. The Bank wants to be clear: it intends to bring inflation back to target. On June 10, Governor Ueda said that if the Bank has "*more conviction that underlying inflation will approach 2% or hover around that level, we will continue to raise rates*". At the same time, given the recent hefty sell-off of long-term JGBs, there will be intense interest in its **bond purchases**.

Recap

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Indications of stronger growth and a move toward price stability are ***good news*** *for the economy.*

	Good News	Bad News
Canada ▪ Carney government plans to raise defence spending to 2% of GDP this fiscal year ▪ Household net worth rises for sixth consecutive quarter	**New Motor Vehicle Sales** +11.3% y/y (Apr.) **Capacity Utilization** +0.4 ppts to 80.1% (Q1)	**Manufacturing Sales Volumes** -1.8% (Apr.) **Wholesale Trade Volumes** -2.2% (Apr.) **Household Debt to Income Ratio** ticks up to 173.9% (Q1) **Building Permits** -6.6% (Apr.)
United States ▪ Inflation shows no sign of shocks from tariffs; higher odds of a Fed rate cut later this year ▪ Relief! 10- and 30-year Treasury auctions well received	**Consumer Prices** +2.4% y/y (May) and **core** +2.8% y/y—both slower than expected **Producer Prices** +2.6% y/y (May) and **core** +3.2% y/y—also mild **NFIB Small Business Economic Trends** +3.0 pts to 98.8 (May)—highest in three months **U of M Consumer Sentiment** +8.3 pts to 60.5 (June P) **Wholesale Inventories** revised higher to +0.2% (Apr. F) **Budget Deficit** narrowed y/y to $316 bln (May)	**Continuing Claims** +54k to 1,956k (May)
China ▪ Will issue more licences for rare-earth materials and technology to the U.S. but only for 6 months	**Aggregate Yuan Financing** Y18.63 trln (Jan.to-May)—of which **New Yuan Loans** Y10.68 trln **Foreign Reserves** steady at $3.3 trln (May)	**Exports** +4.8% y/y (May)—slowing, and plunged 34.5% y/y to the U.S. **Imports** -3.4% y/y (May) **Consumer Prices** -0.1% y/y (May)—but steadying **Producer Prices** -3.3% y/y (May)
Japan ▪ Waiting for next week's BoJ policy decision	**Real GDP** revised up to -0.2% a.r. (Q1 F)—thanks to an uptick in consumer spending **Bank Lending Ex. Trusts** +2.6% y/y (May)	**Machine Tool Orders** slowed to +3.4% y/y (May P)
Europe ▪ Weak U.K. data raise BoE rate cut expectations... but not next week	**Italy—Industrial Production** +1.0% (Apr.)	**Euro Area—Trade Surplus** cut to €14.0 bln (Apr.) **Euro Area—Industrial Production** -2.4% (Apr.) **U.K.—Real GDP** -0.3% (Apr.)—and **services** -0.4% **U.K.—Jobless Rate** +0.1 ppts to 4.6% (Apr.) **U.K.—Employment** +89,000 (3 mths to Apr.) —slowing markedly **U.K.—Avg. Reg. Weekly Earnings Ex. Bonus** slowed to +5.2% y/y (3 mths to Apr.) **U.K.—Industrial Production** -0.6% (Apr.) **U.K.—Trade Deficit** widened to £23.2 bln (Apr.)
Other ▪ WTI jumps on Middle East conflict	**Australia—NAB Business Confidence** +3 pts to 2 (May); **Westpac Consumer Confidence** +0.5% (June)	

Guns N' Bonds


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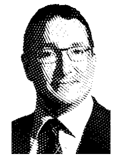
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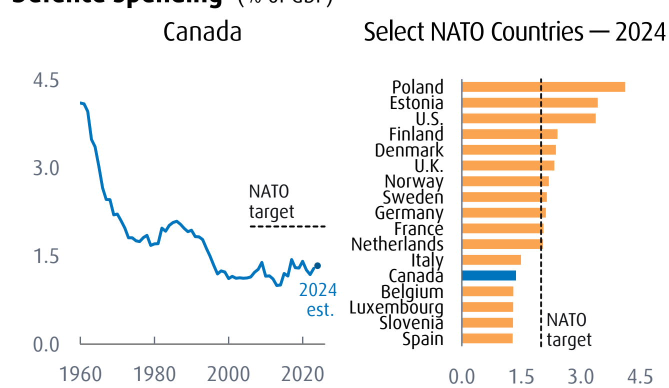
Ottawa's sudden shift to higher defence spending will also have implications for the budget deficit and, potentially, long-term interest rates.

The near-universal initial reaction to Ottawa's announcement that it plans to **ramp up defence spending** to hit NATO's 2% of GDP target this fiscal year was: *"That's good, but how are we going to pay for it?"*. Building on the Liberal election platform, which already included a substantial increase in defence spending over the next five years, this latest announcement will add $9 billion in the current year, which presumably grows with nominal GDP in coming years. Meantime, the Prime Minister suggested that the increased commitments will not be funded through higher taxes. Re-allocated spending could potentially step in, but there's little doubt that Ottawa's budget deficit will absorb at least some of the new outlays. Coming at a time of heightened global sensitivity on all matters fiscal, **what impact will this new, large spending commitment have on Canada and its borrowing costs?**

Defence Deficit

Canada has persistently lagged behind the NATO commitment to spend 2% of GDP on defence, and by a wide margin. With defence spending also likely factoring into Canada-U.S. trade negotiations, the urgency on this front is easy to see. As of 2024, Canadian defence spending sat at $41 billion, or 1.3% of GDP by NATO's calculation. Since fiscal restraint gripped the 1990s, defence spending has trended in the 1%-to-1.5% of GDP range (*Chart 1*), well down from 2% last hit in 1987, and north of 4% entering the 1960s. At the same time, Canada continues to lag the vast majority of NATO countries on this front, sitting ahead of only four of 30 other nations and well below the 2.1% median spending share. With that context, **Canada indeed has catching up to do**—and policymakers are planning to do so quickly.

Chart 1
Canada's Defence Spending in Context



Sources: BMO Economics, NATO

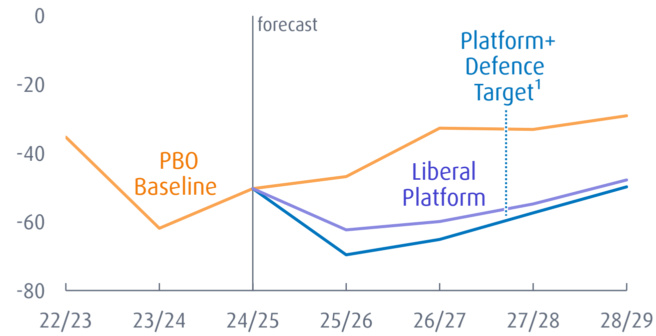
The sharp ramping of defence spending is going to apply further pressure to the budget deficit. New promises in the Liberal election platform (our best reference since a budget has yet to be tabled) already planned to widen the FY25/26 deficit to $62.3 billion versus $46.8 billion in the Parliamentary Budget Officer's pre-election baseline. Arguably, there was already downside risk to that platform given the baseline was built on pre-trade war economic assumptions, and the platform banked on retaliatory tariff revenues that might now be overestimated.

Within the platform was $18 billion of new defence spending over four years; and a commitment to reach the 2%-of-GDP target before 2030—the urgency to reach that target clearly pulled spending forward. Indeed, the June 9th announcement increases FY25/26 defence outlays by $9 billion ($8.3 billion on an accrual basis), which will apply further immediate downward pressure to the deficit (*Chart 2*). All else equal, the federal deficit could easily push through $70 billion this fiscal year and remain structurally wider through the forecast horizon.

Of course, all is not always equal, and there could be some offsets. The economy is showing signs of holding up better than expected, which could temper the downside versus the pre-election baseline. As such, various support programs related to the trade war could be scaled back for FY25/26. Some reclassification could also take place to shift existing spending under the defence umbrella. And, discretionary spending elsewhere could be scaled back, although it will be tough to squeeze out enough to cover the increase in defence. Of the $560 billion in annual federal spending, interest costs ($54 billion), dedicated transfers ($116 billion), key personal transfers ($144 billion) and defence ($60 billion assumed) account for more than two-thirds of the bill, which would require a hefty chop to remaining discretionary outlays. And, the Liberal platform already assumed significant savings ($13 billion annually by FY28/29) through government productivity in the fiscal plan.

Chart 2
Budget Impact: More Red Ahead

Federal Budget Balance — Canada (C$ blns)



[1] assumes June 9th announced funding (for FY25/26 on an accrual basis) grows in-line with nominal GDP Sources: BMO Economics, federal government, LPC

Paying the Tab: Guns versus Butter and Bonds

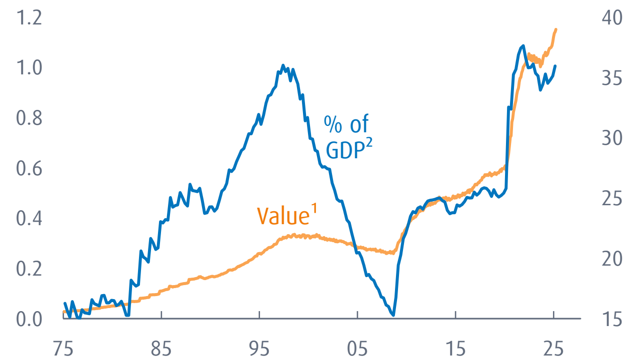
The announced increase in military spending begs the question: **How will the government pay for this commitment?** While we don't have a Budget/Debt Management Strategy to fully outline Government of Canada bond issuance for the year, the government provided guidance to primary dealers on supply expectations. For FY25/26, gross issuance is already poised to ramp up to $310 bln from $241 bln in the last fiscal year, with increases focused in the 2-, 5- and 10-year sectors. The new spending commitment suggests we'll see debt issuance rise further in the coming quarters. There's been no indication where on the curve any uptick in issuance would come, but the message from officials has been that it is unlikely to be concentrated in one sector. Note that the deficit accounts for only a small part of those funding needs, with the largest portion needed for refinancing and the rest for non-budgetary transactions (e.g., buying of CMBs). The **risks have been skewed to higher issuance**, which is only reinforced by the announced rise in military spending.

Higher defence spending, if it doesn't replace other outlays, will provide meaningful economic stimulus. The timeline for the increase in spending remains unknown, which makes pinning down when the economy will benefit challenging. The market took the announcement in stride, with Bank of Canada rate cuts odds falling modestly. That reaction looks appropriate, as more spending may lower the odds of further BoC rate cuts, but it does not preclude them. Unfortunately, Canada's relatively limited military-industrial base means that a potentially sizeable portion of equipment purchases will come from abroad (albeit perhaps with less focus on the U.S., and more on Europe), mitigating the stimulative impact. The details of the spending package are an important input for policymakers and markets.

Beyond the immediate impact on monetary policy, a higher profile for defence spending **implies increased borrowing needs throughout the forecast horizon**. This comes amid elevated refinancing needs over the coming years due to the surge in pandemic era issuance. Canada has already increased auction sizes across the curve, with some maturities more than doubling in size in recent years. However, auction performance has been strong in the 2- and 5-year sectors, suggesting there's room for further increases if necessary. It's further out the curve that could be problematic, with 10-year and 30-year auctions seeing uneven results amid the global surge in issuance. And this adds to the large stock of outstanding bonds, which is near the levels of the mid-1990s as a share of the economy (*Chart 3*). Earlier this year, the spread between U.S. and Canadian 10-year yields hit a record wide around 150 bps. With Canada's borrowing set to ramp higher, that spread looks to narrow in coming years (*Chart 4*).

Chart 3
Bonds Away

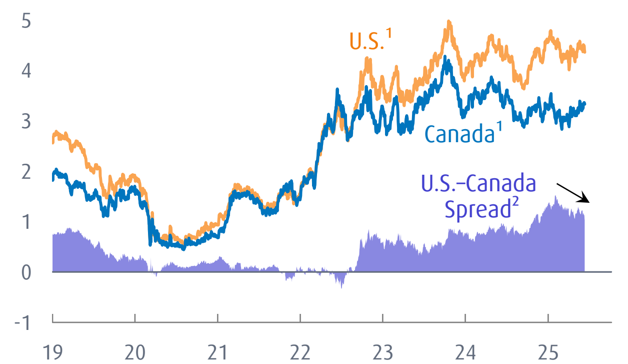
Government of Canada Bonds Outstanding



Sources: BMO Economics, Haver Analytics, StatCan [1] (C$ trlns : lhs); [2] (% : rhs)

Chart 4
U.S.–Canada Spreads: Past the Peak

10-year Government Bond Yields (as of June 12, 2025)



Sources: BMO Economics, Haver Analytics, LSEG, U.S. Treasury [1] (%); [2] (ppts)

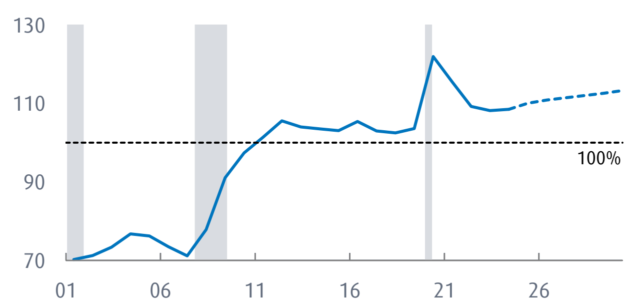
Global Arms Race Pressures Yields

The upward lift in Canada's budget deficit profile, and implicitly on borrowing costs, comes at a time when **bond markets globally are already on edge around fiscal concerns**. Headlining those concerns is the **U.S.** and its deficit of about 6.5% of GDP, its recent credit rating downgrade, the looming debt ceiling deadline, and the One Big Beautiful Bill currently before the Senate. Meantime, concerns over **Japan's** massive government debt/GDP ratio (of more than 230%) have been awakened by the grinding upswing in JGB yields, with 10s testing 1.5% for the first time in 15 years and 30 years touching 3% for the first time this century.

It's not just two of the world's largest borrowers that are causing some angst on the fiscal outlook. Government finances in many mature economies were rocked by the pandemic, after already suffering a heavy blow a decade earlier from the Great Recession (*Chart 5*). And on the defence front, **Canada is far from alone in the sudden shift on military outlays**, with Germany, France, the U.K. and others ratcheting up spending plans. And the pressure looks to rise further, with NATO seeming primed to lift the spending target from 2% to 3.5% (and 5% including related infrastructure spending).

Chart 5
Government Debt: Further Above 100%

Advanced Economies (% of GDP)
General Government Gross Debt



Shading marks U.S. recessions
Sources: BMO Economics, Haver Analytics, International Monetary Fund

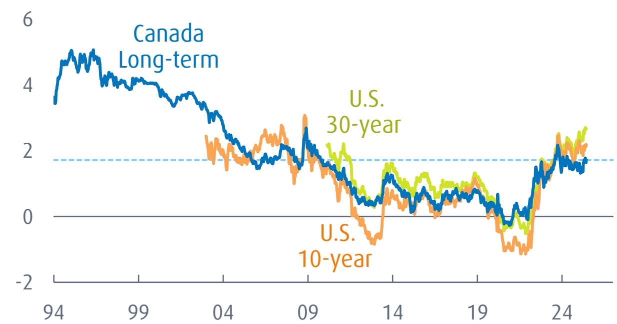
This widespread rise in spending, and likely budget deficits, is a factor behind the **persistent upswing in real long-term interest rates**. After holding at around 1% or lower in the decade after the Global Financial Crisis, and then turning negative in the pandemic, real bond yields have forged higher in the past three years. Looking at the most extreme example, the real 30-year U.S. Treasury yield has pushed above 2.6% from negative readings barely three years ago (*Chart 6*). Canada's real long bond yields have been a bit less whippy, but are now near 1.7%, a level they haven't seen on a sustained basis since 2009, and miles above the 0.5% average real yield in the five years before the pandemic. While we don't see these real rates returning to the bad old days of the 1990s, when 4% was the norm, the higher underlying rate makes it much more costly to run deficits. For example, there has been much hand-wringing over Washington now spending more on interest costs than on the military budget, but Ottawa is already deep in that boat—interest costs have totalled $53 billion over the past 12 months (1.7% of GDP), or double pre-pandemic levels.

Bottom Line: Geopolitical realities have prompted the rapid shift in Ottawa's defence spending commitments. Unless there is a significant reallocation of spending, this means even larger budget deficits and more upward pressure on the long-term interest rate outlook. And this comes at a time when real interest rates have long since turned positive, meaning that the net new borrowing is no longer a near-costless exercise.

Chart 6
Real Rates Really Rising

(percent : as of June 10, 2025)

Real Return Government Bond Yields



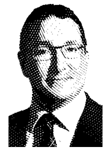
Sources: BMO Economics, Haver Analytics, Federal Reserve Board, Bank of Canada

Economic Forecast Summary for June 13, 2025

	2024				2025				Annual		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2024	2025	2026
CANADA											
Real GDP (q/q % chng : a.r.)	2.1	2.5	2.4	2.1	2.2	-0.5	-0.5	1.0	1.6	1.3	1.3
Consumer Price Index (y/y % chng)	2.8	2.7	2.0	1.9	2.3	1.9	1.9	1.8	2.4	2.0	2.0
Unemployment Rate (percent)	5.9	6.3	6.5	6.7	6.6	7.0	7.6	7.7	6.4	7.3	7.5
Housing Starts (000s : a.r.)	244	250	238	248	223	240	228	228	245	230	225
Current Account Balance ($blns : a.r.)	-9.2	-21.3	-11.5	-14.2	-8.5	-46.0	-46.9	-50.6	-14.1	-38.0	-50.0
Interest Rates (average for the quarter : %)											
Overnight Rate	5.00	4.92	4.42	3.58	2.92	2.75	2.50	2.25	4.48	2.60	2.00
3-month Treasury Bill	4.94	4.81	4.27	3.46	2.85	2.65	2.50	2.25	4.37	2.55	1.95
10-year Bond	3.43	3.58	3.14	3.21	3.12	3.20	3.30 ↑	3.25 ↑	3.34	3.20 ↑	3.15 ↑
Canada-U.S. Interest Rate Spreads (average for the quarter : bps)											
90-day	-52	-66	-95	-112	-149	-174 ↓	-191 ↓	-186 ↓	-53	-175 ↓	-149 ↓
10-year	-73	-87	-80	-107	-133	-116 ↑	-107 ↑	-103 ↑	-87	-115 ↑	-93 ↑
UNITED STATES											
Real GDP (q/q % chng : a.r.)	1.6	3.0	3.1	2.4	-0.2	1.7	1.4	1.2	2.8	1.5	1.5
Consumer Price Index (y/y % chng)	3.2	3.2	2.7	2.7	2.7	2.5 ↓	3.1 ↓	3.4 ↓	3.0	2.9 ↓	3.0
Unemployment Rate (percent)	3.8	4.0	4.2	4.2	4.1	4.2	4.5	4.7	4.0	4.4	4.8
Housing Starts (mlns : a.r.)	1.42	1.34	1.34	1.39	1.40	1.38	1.40	1.40	1.37	1.40	1.42
Current Account Balance ($trlns : a.r.)	-0.97	-1.11	-1.24	-1.22	-1.47	-1.08	-1.08	-1.09	-1.13	-1.18	-1.11
Interest Rates (average for the quarter : %)											
Fed Funds Target Rate	5.38	5.38	5.21	4.63	4.38	4.38	4.29	4.04	5.15	4.27	3.42
3-month Treasury Bill	5.45	5.47	5.22	4.58	4.34	4.40 ↑	4.40 ↑	4.10 ↑	5.18	4.30 ↑	3.45 ↑
10-year Note	4.16	4.44	3.95	4.28	4.45	4.40 ↑	4.35 ↑	4.30 ↑	4.21	4.35	4.10 ↑
EXCHANGE RATES (average for the quarter)											
US¢/C$	74.2	73.1	73.3	71.5	69.7	72.3 ↑	73.5 ↑	73.9 ↑	73.0	72.4 ↑	74.7 ↓
C$/US$	1.35	1.37	1.36	1.40	1.43	1.38 ↓	1.36 ↓	1.35	1.37	1.38 ↓	1.34
¥/US$	149	156	149	152	152	144	144	142	151	146	141
US$/Euro	1.09	1.08	1.10	1.07	1.05	1.13	1.16 ↑	1.17 ↑	1.08	1.13 ↑	1.19 ↑
US$/£	1.27	1.26	1.30	1.28	1.26	1.33	1.36 ↑	1.37 ↑	1.28	1.33 ↑	1.38 ↑

Blocked areas mark BMO Capital Markets forecasts; up and down arrows (↑↓) indicate forecast changes; spreads may differ due to rounding

Canada



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Existing Home Sales

Monday, 9:00 am

	Existing Home Sales	Average Prices
May (e)	**-5.0% y/y**	**-2.5% y/y**
June	-9.8% y/y	-3.9% y/y

9:00 am	**MLS Home Price Index**
May (e)	**-4.5% y/y**
June	-3.6% y/y

Canada's **housing** market continues to tip-toe through a tepid spring. We expect home sales to fall 5% from year-ago levels in May, which could translate to a small monthly increase in seasonally-adjusted terms. Average prices look to be down 2.5% y/y, while the quality-adjusted MLS HPI could drop 4.5% y/y. With affordability still posing a challenge in many segments, demand is likely to stay on the sidelines until interest rates fall further and/or economic uncertainty dissipates. — S.K.

BoC Summary of Deliberations for the June 4 decision

Tuesday, 1:30 pm

The **Summary of Deliberations** from the Bank of Canada's June 4 policy meeting will be scoured for hints on what it will take on inflation to prompt further cuts. The BoC held policy rates steady for a second consecutive meeting after cutting at the seven prior meetings. While elevated uncertainty continues to cloud the outlook, Governor Macklem made it clear that elevated underlying inflation was the sole reason the Bank wasn't easing further in June. The macro backdrop clearly points to inflation slowing through the back half of the year—output gap, slowing housing, slowing wage growth, firming C$—but the Bank of Canada cannot afford to allow inflation to accelerate further, keeping it on the sidelines until underlying inflation actually prints lower. — B.R.

Retail Sales

Friday, 8:30 am

		Ex. Autos
Apr. (e)	**+0.4%**	**unch**
Consensus	+0.5%	unch
Mar.	+0.8%	-0.7%

Canadian consumers have so far weathered the trade storm better than expected, though **retail sales** growth likely cooled in April as auto tariffs led to temporary plant closures and job cuts in Ontario. We look for a 0.4% increase in spending, a bit softer than the 0.5% preliminary estimate but still in line with historic norms. Lower gas prices (and goods prices more broadly) acted as headwinds, suggesting volumes could come in a touch firmer than the headline. — S.K.

United States

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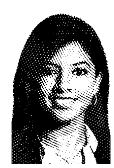

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Retail Sales

Tuesday, 8:30 am

		Ex. Autos/Gas
May (e)	**-0.7%**	**unch**
Consensus	*-0.7%*	*+0.4%*
Apr.	+0.1%	+0.2%

Consumers likely took a break from spending in May following a strong increase in March and a lacklustre April. **Headline retail sales** are projected to decline 0.7% in May following a 0.1% gain in April. We expect big declines in motor vehicle and gasoline station sales to set the trend. Unit vehicle sales were down 9.4% in May, according to Wards, while gasoline prices fell 2.6% in May. Nonfarm payroll growth moderated in May with two consecutive months of decline for retail payrolls, highlighting softening consumer demand. **Retail sales ex-autos** are projected to decline 0.2%, with retail sales ex-autos and gas remaining unchanged following a 0.2% increase in April. — S.A.

Industrial Production
Tuesday, 9:15 am

	Industrial Production	Capacity Utilization
May (e)	**-0.1%**	**77.7%**
Consensus	*unch*	*77.7%*
Apr.	unch	77.7%

Industrial production is expected to decline 0.1% in May, following an unchanged reading in April. Trade war uncertainty, rising input prices, and slowing U.S. and global demand are expected to weigh on manufacturing activity this year. We are forecasting a large pullback in business equipment spending in the second quarter following a first quarter surge. The ISM Manufacturing PMI slipped another 0.2 points in May to a still-contractionary 48.5. The production, new orders, and employment components improved a bit from April levels, though all remain firmly in contraction territory. Manufacturing payrolls declined by 8k in May following a 5k increase in April, pointing to a lacklustre production environment. The capacity utilization rate is forecast to remain unchanged at 77.7%. — S.A.

Housing Starts
Wednesday, 8:30 am

May (e)	**1.37 mln a.r. (+0.7%)**
Consensus	*1.36 mln a.r. (-0.1%)*
Apr.	1.36 mln a.r. (+1.6%)

Building Permits

May (e)	**1.43 mln a.r. (+0.6%)**
Consensus	*1.43 mln a.r. (+0.6%)*
Apr.	1.42 mln a.r. (-4.0%)

Housing starts likely climbed for a second straight month, up 0.7% to 1.37 mln annualized in May. Despite the expected increase, home building activity remains subdued amid high input prices, elevated borrowing costs, and downbeat sentiment. Meantime, **building permits**, a good proxy for future home construction, are expected to rebound slightly, though the gauge has remained muted for the past couple of years. Overall, the report will likely showcase a still-subdued housing market amid issues on both the demand and supply side. — P.T.

FOMC Announcement and Summary of Economic Projections
Wednesday, 2:00 pm
Press briefing at 2:30 pm

See Michael Gregory's Thought on page 4.

Central Banks

BoJ Monetary Policy Announcement
Tuesday

See Jennifer Lee's Thought on page 7.

BoE Monetary Policy Announcement
Thursday, 7:00 am ET
Press briefing to follow

Financial Markets Update for June 13, 2025

		Jun 13 [1]	Jun 6	Week Ago	4 Weeks Ago (basis point change)	Dec 31, 2024
Canadian Money Market	Call Money	2.75	2.75	0	0	-50
	Prime Rate	4.95	4.95	0	0	-50
U.S. Money Market	Fed Funds (effective)	4.50	4.50	0	0	0
	Prime Rate	7.50	7.50	0	0	0
3-Month Rates	Canada	2.67	2.66	1	9	-49
	United States	4.36	4.34	2	2	4
	Japan	0.43	0.46	-3	6	22
	Australia	3.70	3.71	0	-10	-70
2-Year Bonds	Canada	2.72	2.70	2	19	-21
	United States	3.96	4.04	-7	-4	-28
10-Year Bonds	Canada	3.38	3.34	4	21	15
	United States	4.43	4.51	-8	-5	-14
	Japan	1.40	1.45	-4	-5	32
	Germany	2.54	2.57	-4	-5	17
	United Kingdom	4.56	4.64	-9	-9	-1
	Australia	4.15	4.27	-11	-30	-21
Risk Indicators	VIX	19.4	16.8	2.6 pts	2.2 pts	2.1 pts
	Inv. Grade CDS Spread [2]	54	54	-1	-2	4
	High Yield CDS Spread [2]	338	341	-3	-11	26
					(percent change)	
Currencies	US¢/C$	73.64	73.01	0.9	2.9	5.9
	C$/US$	1.358	1.370	—	—	—
	¥/US$	143.99	144.85	-0.6	-1.2	-8.4
	US$/€	1.1565	1.1397	1.5	3.6	11.7
	US$/£	1.360	1.353	0.5	2.4	8.6
	US¢/A$	65.12	64.90	0.3	1.7	5.2
Commodities	CRB Futures Index	302.76	300.89	0.6	2.3	2.0
	Oil (generic contract)	72.12	64.58	11.7	15.4	0.6
	Natural Gas (generic contract)	3.57	3.78	-5.8	6.9	-1.9
	Gold (spot price)	3,424.18	3,310.42	3.4	6.9	30.5
Equities	S&P/TSX Composite	26,548	26,429	0.4	2.2	7.4
	S&P 500	6,009	6,000	0.1	0.9	2.2
	Nasdaq	19,532	19,530	0.0	1.7	1.1
	Dow Jones Industrial	42,497	42,763	-0.6	-0.4	-0.1
	Nikkei	37,834	37,742	0.2	0.2	-5.2
	Frankfurt DAX	23,502	24,304	-3.3	-1.1	18.0
	London FT100	8,842	8,838	0.0	1.8	8.2
	France CAC40	7,679	7,805	-1.6	-2.6	4.0
	S&P ASX 200	8,547	8,516	0.4	2.4	4.8

[1] = as of 11:40 am *[2] = One day delay*

Global Calendar — June 16–June 20

	Monday June 16	Tuesday June 17	Wednesday June 18	Thursday June 19	Friday June 20
China	**Retail Sales (YTD)** **May (e) +4.8% y/y** Apr. +4.7% y/y **Industrial Production (YTD)** **May (e) +6.4% y/y** Apr. +6.4% y/y **Fixed Asset Investment (YTD)** **May (e) +4.0% y/y** Apr. +4.0% y/y				
Japan	**BoJ Monetary Policy Meeting (June 16-17)**		**Trade Deficit** **May '25 (e) ¥0.9 trln** May '24 ¥1.2 trln **Core Machine Orders** **Apr. (e) -9.5% +4.2% y/y** Mar. +13.0% +8.4% y/y		**CPI / Core CPI** **May (e) +3.5% y/y +3.6% y/y** Apr. +3.6% y/y +3.5% y/y **CPI ex. Food & Energy** **May (e) +3.2% y/y** Apr. +3.0% y/y **BoJ Minutes from Apr. 30-May 1 meeting**
Europe	**EURO AREA** **Labour Costs** **Q1** Q4 +3.7% y/y **ITALY** **Consumer Price Index** **May F (e) +0.1% +1.9% y/y** Apr. +0.4% +2.0% y/y	**GERMANY** **ZEW Survey—Expectations** **June (e) 35.0** May 25.2	**EURO AREA** **Consumer Price Index** **May F (e) unch +1.9% y/y** Apr. +0.6% +2.2% y/y **Core CPI / Services** **May F (e) +2.3% y/y +3.2% y/y** Apr. +2.7% y/y +4.0% y/y **UNITED KINGDOM** **Consumer Price Index** **May (e) +0.2% +3.3% y/y** Apr. +1.2% +3.5% y/y **Core CPI / Services** **May (e) +3.5% y/y +4.8% y/y** Apr. +3.8% y/y +5.4% y/y	**UNITED KINGDOM** **7:00 am BoE Monetary Policy Announcement**	**EURO AREA** **Adjusted Private Sector Credit** **May** Apr. +2.7% y/y **Consumer Confidence** **June P (e) -14.6** May -15.2 **ECB Economic Bulletin** **FRANCE** **Retail Sales** **May** Apr. +0.4% y/y **Business Confidence** **June (e) 97** May 96 **UNITED KINGDOM** **GfK Consumer Confidence** **June (e) -20** May -20 **Retail Sales (ex. Fuel)** **May (e) -0.7% +1.8% y/y** Apr. +1.3% +5.3% y/y
Other	**G7 Summit in Kananaskis, AB, Canada (June 15-17)**		**BRAZIL** **Central Bank of Brazil Monetary Policy Meeting**	**AUSTRALIA** **Employment** **May (e) +20,000** Apr. +89,000 **Jobless Rate** **May (e) 4.1%** Apr. 4.1% **NEW ZEALAND** **Real GDP** **Q1 (e) +0.7% -0.8% y/y** Q4 +0.7% -1.1% y/y	

[D] = date approximate

Upcoming Policy Meetings | Bank of England: Aug. 7, Sep. 18, Nov. 6 | European Central Bank: July 24, Sep. 11, Oct. 30

Canada

Monday June 16

8:15 am **Housing Starts**
May (e) **260,000 a.r. (-6.7%)**
Apr. 278,606 a.r. (+30.1%)

9:00 am **Existing Home Sales[D]** | **Average Prices**
May (e) **-5.0% y/y** | **-2.5% y/y**
Apr. -9.8% y/y | -3.9% y/y

9:00 am **MLS Home Price Index[D]**
May (e) **-4.5% y/y**
Apr. -3.6% y/y

Tuesday June 17

8:30 am **Int'l Securities Transactions** — **Inflows** | **Outflows**
Apr.
Mar. -$4.2 bln | $15.6 bln

8:30 am **New CPI Basket Weights**

1:30 pm **BoC Summary of Deliberations for the June 4 decision**

10:30 am 3-, 6- & 12-month bill auction $24.0 bln (new cash -$0.5 bln)

11:15 am Cash management bond buybacks $0.5 bln

Noon 1-month bill auction $2.5 bln

Wednesday June 18

8:30 am **Canada's Population Estimates (Q1)**

8:30 am **Household Credit** | **Mortgage Credit**
Apr.
Mar. +4.4% y/y | +4.5% y/y

11:15 am **BoC Governor Macklem speaks in St. John's, NL**

Thursday June 19

8:30 am **Construction Investment**
Apr.
Mar. -0.9% | +5.8% y/y

2-, 10-year bond auction announcements

Friday June 20

8:30 am **Retail Sales** | **Ex. Autos**
Apr. (e) **+0.4%** | **unch**
Consensus *+0.5%* | *unch*
Mar. +0.8% | -0.7%

8:30 am **Industrial Product Price Index** | **Raw Materials Price Index**
May (e) **unch** | **-1.5%**
Apr. -0.8% | -3.0%

8:30 am **New Housing Price Index**
May (e) **-0.5%** | **-1.0% y/y**
Apr. -0.4% | -0.6% y/y

United States

Monday June 16

8:30 am **Empire State Manufacturing Survey**
June (e) **-7.0**
Consensus *-6.0*
May -9.2

11:30 am 13- & 26-week bill auctions $144 bln

1:00 pm 20[R]-year bond auction $13 bln

G7 Summit in Kananaskis, AB, Canada (June 15-17)

Tuesday June 17

8:30 am **Retail Sales** | **Ex. Autos/Gas**
May (e) **-0.7%** | **unch**
Consensus *-0.7%* | *+0.4%*
Apr. +0.1% | +0.2%

8:30 am **Import Prices**
May (e) **-0.2%** | **unch y/y**
Apr. +0.1% | +0.1% y/y

9:15 am **Industrial Production** | **Capacity Utilization**
May (e) **-0.1%** | **77.7%**
Consensus *unch* | *77.7%*
Apr. unch | 77.7%

10:00 am **NAHB Housing Mkt. Index**
June (e) **36**
May 34

10:00 am **Business Inventories**
Apr. F (e) **unch**
Apr. P unch
Mar. +0.1%

11:30 am 6-week bill auction $55 bln

1:00 pm 5[R]-year TIPS auction $23 bln

FOMC Meeting begins

Wednesday June 18

7:00 am **MBA Mortgage Applications** | **30-year FRM**
June 13
June 6 +12.5% | 6.93%

8:30 am **Initial Claims**
June 14 (e) **250k (+2k)**
June 7 248k (unch)

8:30 am **Continuing Claims**
June 7
May 31 1,956k (+54k)

8:30 am **Housing Starts**
May (e) **1.37 mln a.r. (+0.7%)**
Consensus *1.36 mln a.r. (-0.1%)*
Apr. 1.36 mln a.r. (+1.6%)

8:30 am **Building Permits**
May (e) **1.43 mln a.r. (+0.6%)**
Consensus *1.43 mln a.r. (+0.6%)*
Apr. 1.42 mln a.r. (-4.0%)

2:00 pm **FOMC Announcement and Summary of Economic Projections**

2:30 pm **Fed Chair Powell's Press Briefing**

4:00 pm **Net TIC Flows** — **Total** | **Long Term**
Apr.
Mar. $254.3 bln | $161.8 bln

11:00 am 13- & 26-week bill, 2-, 5-, 7-year note, 2[R]-year FRN auction announcements

Thursday June 19

Juneteenth (markets closed)

Friday June 20

8:30 am **Philadelphia Fed Index**
June (e) **-1.0**
Consensus *-1.0*
May -4.0

10:00 am **Leading Indicator**
May (e) **-0.2%**
Consensus *-0.1%*
Apr. -1.0%

[C] = consensus; [D] = date approximate; [R] = reopening

Upcoming Policy Meetings | Bank of Canada: July 30, Sep. 17, Oct. 29 | FOMC: July 29-30, Sep. 16-17, Oct. 28-29

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