Rates Scenario for February 5, 2024

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

Forecast Summary

(avg.)	Actual	Forecasts									
	2024	2024			2024			2025			
	Jan	Feb	Mar	Apr	Q2	Q3	Q4	Q1	Q2	Q3	Q4
BoC overnight[1]	5.00	5.00	5.00	5.00	4.75	4.50	4.00	3.75	3.50	3.25	3.00
10-yr Canadas	3.35	3.35	3.35	3.30	3.25	3.10	3.00	3.00	3.00	3.00	3.00
Fed funds[1]	5.38	5.38	5.38	5.38	5.38	4.88	4.38	4.13	3.88	3.63	3.38
10-yr Treasuries	4.06	4.00	4.00	3.95	3.90	3.80	3.75	3.75	3.70	3.70	3.65
C$ per US$	1.34	1.35	1.35	1.34	1.34	1.33	1.32	1.31	1.30	1.29	1.28
US$/€	1.09	1.08	1.08	1.09	1.09	1.10	1.12	1.12	1.13	1.13	1.14
US$/£	1.27	1.25	1.25	1.26	1.26	1.27	1.28	1.28	1.29	1.29	1.30
¥/US$	146	148	147	146	146	143	141	139	138	137	135

[1] end of period

Sources: BMO Economics, Haver Analytics

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Canada-U.S. Rates Outlook

Michael Gregory, CFA, Deputy Chief Economist

- We haven't changed our forecasts for Federal Reserve and Bank of Canada policy rates since the previous issue of Rates Scenario on December 15. Both central banks shifted into pause mode after their last rate hikes in July, as the **topic of policymakers' discussions** has since switched from whether rates are restrictive enough to **how long rates should remain restrictive**. The answer, for both the Fed and BoC, is until the evidence is unequivocal that inflation is on a sustainable path to 2%. The evidential scale is expected to be tipped as such by around mid-year, at which point rate cuts should start.
- We still expect the Bank to act first (on June 5), reflecting Canada's weaker economic performance (despite the year-end lift to real GDP growth), and greater sensitivity to interest rates. And we look for both central banks to cut quickly at the outset (100 bps' worth by year-end) as real policy rates are reduced rapidly to minimize the risk of overshooting the inflation target (and triggering a major economic downturn), and to sow the seeds of stronger growth down the road. They are both expected to adopt a more gradual easing pace as 2025 unfolds, as the final few tenths down to 2% inflation prove to be stubborn. The rate cutting should continue into 2026, until neutral policy rates are reached (2.75% for the BoC and 2.75%-to-3.00% for the Fed).
- ***Federal Reserve:*** The FOMC kept the fed funds target range at 5.25%-to-5.50% on January 31, for the fourth consecutive meeting. The policy statement was altered momentously; the previous tightening bias was dropped (recall the *"any additional policy firming"* phrase). It was replaced by (the underlining is ours): *"In considering any adjustments to the target range for the federal funds rate, the Committee will carefully assess incoming data, the evolving outlook, and the balance of risks. The Committee does not expect it will be appropriate to reduce the target range until it has gained greater confidence that inflation is moving sustainably toward 2 percent."*
- While the strong signal here is that the next Fed action will be a rate cut, the *"any adjustment"* mention means a possible rate hike is still not being ruled out, but we reckon it would take an extreme data development to trigger it, such as a major reacceleration of core inflation. More importantly, although rate cuts are coming, they won't be

happening anytime soon given the *"gained greater confidence"* criterion. In the press conference, Chair Powell said a March 20 move was *"unlikely"*. Subsequently, January's robust employment report made it even less likely.

- Indeed, labour market and broader economic resiliency are likely reasons why the Fed wants to gain greater confidence in the PCE price index's already impressive performance. Core PCEPI inflation was 2.9% in December (the first dip below 3% since March 2021), with further disinflation emphasized by a 1.9% (annualized) six-month change and a 1.5% three-month move. The FOMC wants to see *"a continuation of the good data that we've been seeing"*, which is not yet guaranteed given the resilient economic background along with CPI inflation readings that are running much faster than the PCEPI's. Again, less robust economic data and slower CPI readings should be evident by around mid-year, in time for an inaugural July rate cut, with the net risk it could occur earlier.
- ***Bank of Canada:*** The Bank kept its policy rate at 5% on January 24, also for the fourth consecutive meeting, and dropped the tightening bias. The previous statement's mention that the Council *"remains prepared to raise the policy rate further if needed"* was removed. In the press conference, Governor Macklem said this *"doesn't mean we have ruled out further policy rate increases. If new developments push inflation higher, we may still need to raise rates"*. But, should the economic situation unfold broadly as projected, *"I expect future discussions will be about how long we maintain the policy rate at 5%"*. On this pause, now entering its seventh month (and perhaps to temper any early easing market expectations stoked by the bias drop), Macklem said: *"We need to give these higher rates time to do their work"*. He later added that *"it is premature to discuss reducing our policy rate"*.
- Another notable change in the policy statement was the acknowledgement that *"the economy now looks to be operating in modest excess supply"*. This compares to the previous assessment that it was *"no longer in excess demand"*. The re-assessment means the Bank is now expecting that the disinflationary influence of economic slack will be aiding current (restrictive-enough) policy rates in steering inflation, and particularly core inflation, lower. (This probably made the Bank feel more comfortable about dropping the bias.) Macklem said: *"We need to see further and sustained easing of core inflation".* The latest 3-, 6- and 12-month runs of annualized changes for the CPI trim and CPI median were all in the 3.5%-to-3.8% range… sticky indeed.
- As weak demand continues (we expect only 0.4% net growth in the economy over the year ended 2024Q2), the underlying inflation readings should be much better behaved by around mid-year. This should elicit two pairs of back-to-back easing actions (June-July and October-December).
- ***Bond yields:*** Ten-year Treasury yields averaged 4.06% last month, the sixth consecutive month above 4%. Before this latest interval, you had to go back at least 15 years to find yields averaging above this level. Although, not surprisingly, some daily closes slipped below this mark, 3.75% has held as the bottom of the range since June-end (for example, the recent Christmas rally pushed yields down to 3.79%, and they are currently close to 4.15%). We're expecting a 3.75% bottom to hold (as a monthly average) for the remainder of the year, despite Fed rate cuts starting, and for 3.6% to hold through 2025 and beyond. This reflects the combination of higher neutral policy rates (a.k.a. the root of the yield curve or the 2.75%-to-3.00% range as mentioned above) and more normal-looking term premiums.
- Since the FOMC began targeting the fed funds rate in the 1980s, the spread between 10-year yields and the effective fed funds rates has generated a median around 150 bps. Our working assumption has an eventual spread in the range of 75-to-100 bps, resulting in a 3.50%-to-4.00% longer-run range for 10-year Treasury yields. Meanwhile, although there's a lot of market buzz about the Fed beginning to taper the pace of quantitative tightening (QT), we expect it will continue QT past the start of rate cuts, well into 2025. Other things equal, this should apply upward pressure on yields with the government sporting large deficits as far as the eye can see. At the same time, there's more credit risk inherent in Treasuries, according to the three major rating agencies.

- Ten-year Government of Canada yields averaged 3.35% last month, 71 bps below comparable Treasuries, and they are currently trading around 3.50% (67 bps through). During October, as U.S. 10-year tenors were testing 5% (and averaging 4.80% in the month), Canadas sold off as well but not as severely. This caused average spreads (in bps) to jump into the -70s range, from the -40s and -50s that prevailed during the prior six months. The outperformance reflected Canada's relatively stronger fiscal situation and relatively weaker economic performance, and these themes should continue for the foreseeable future. Although longer-term Canada yields should broadly follow Treasuries' lead, we expect relatively large negative spreads (in the -60s and -70s) to linger for a while.
- ***U.S. dollar:*** The Fed's trade-weighted dollar index appreciated slightly in January (by 0.3% on average). This followed back-to-back monthly declines worth -2.9%, as policy expectations continued to be a major currency driver. Using the March 2023 FOMC meeting as a barometer, market sentiment shifted from better-than-even odds of a rate hike during mid-October, to no change by November-end, to a full rate cut being priced in just after Christmas. Since then, the rate cut odds have been pared back to about 10%. Despite ongoing geopolitical and global economic concerns, we look for predicted and realized Fed rate cuts to again weigh on the currency. We see the greenback more than 2% weaker by the end of this year (compared to January's average) and an additional near-3% depreciation next year.
- ***Canadian dollar:*** As the market's Fed policy expectations shifted from its recently most hawkish (during October) to its most dovish (during December), the loonie strengthened alongside a weakening greenback. The Canadian dollar averaged just under US$0.745 (above C$1.342) in both December and January, after averaging US$0.729 (C$1.372) in October (the latter was the weakest level since the onset of the pandemic and, before that, a few months during the 2015 collapse in oil prices). As those most dovish expectations faded, so too did the loonie's lift, currently trading under US$0.74 (above C$1.35). Although the Bank of Canada will likely start easing before the Fed (but perhaps only barely), the theme of a broadly weaker greenback should still push the loonie stronger by nearly 2% by year-end (compared to January's average) and about 3% next year.

Overseas

Jennifer Lee, Senior Economist

- Central banks have shifted their positions, from hikes to pauses and now to focussing on the timing of coming rate cuts. Some are more accepting of this than others.
- Take the **ECB**. Although it is now a generally accepted view that rate cuts are coming, one or two of the Governing Council members are not even entertaining the idea. But they are a minority—although the word "*patience*" has been used generously by many. As of now, it seems that June is the most likely month for the first cut, even though President Lagarde, during the most recent press conference, did not downplay the possibility of an April move. In fact, France's Villeroy de Galhau even went so far as to say that every meeting was live. However, **June would make sense** as policymakers will have a new set of staff forecasts on hand and all the wage negotiations will be completed by then, and their impact on spending will have been observed. Look for the discussion for rate cuts to kick off during the March meeting, along with signals on the month that the easing will begin. It certainly helps that Euro Area GDP is sluggish, and that core CPI hit a 22-month low in January. Unfortunately, services CPI is still sticky.
- The **BoE** has officially removed its tightening bias. Governor Bailey said so. In his words during the February press conference, "*We've taken away the upside bias*" and now, "*the key question has moved from how restrictive do we need to be to how long do we need to maintain this position for?*" But, like the ECB, not all members of the MPC are on board. Indeed, how the vote went down (6-to-2-to-1) was also quite telling: the hawks lost one of their own, Megan Greene, to the "hold" camp; while the "hold" camp lost its uber-dove, Swati Dhingra, to the "cut" camp. This central bank can never be accused of group-think. We see the BoE cutting the Bank Rate in May, when

it is armed with a new set of economic forecasts. By then, the majority should be "*more confident*" that inflation is falling.

- The **BoJ** has teased often, dropping hints of a change in the lead-up to the last few meetings, only to disappoint by leaving policy unchanged. But Minutes from the December meeting showed a push to *"deepen discussions"* on rate hikes. And, the Summary of Opinions from the most recent January meeting gave strong indications that they were coming. According to one Board member, "*conditions for policy revision… are being met*" and another one called it a "*golden opportunity*" to take action soon, and warned of the side effects if they do not act. Although this Bank has cried wolf often, given these hints, we look for a policy change in June. No use crying over spilt milk, but nationwide inflation has already peaked and Toyko's core CPI hit a 2-year low in January.
- The **RBA** is not expected to change its path at the first meeting of 2024. However, expectations for its first rate cut have been hastened after the faster-than-expected decline in inflation to its lowest level in over two years. CPI peaked one year ago at 8.4% (December 2022) and has headed south since, with a couple of twists along the way. The last Media Release stated that the "*data and the evolving assessment of risks*" will determine whether further tightening is needed. Since then, the December data have been weak: 65,100 jobs were lost, the jobless rate was steady at a 19-month high, household spending fell sharply, and retail sales slumped. And, there is pressure from the general public, according to *"internal RBA documents"*, that showed inflation was weighing on consumers and businesses. The central bank could start cutting by mid-2024.

Foreign Exchange Forecasts

(local currency per US$: avg.)	Actual 2024 Jan	Forecasts 2024 Feb	Mar	Apr	2024 Q2	Q3	Q4	2025 Q1	Q2	Q3	Q4
Canadian Dollar											
C$ per US$	1.34	1.35	1.35	1.34	1.34	1.33	1.32	1.31	1.30	1.29	1.28
US$ per C$[1]	0.745	0.741	0.742	0.744	0.746	0.751	0.756	0.761	0.767	0.773	0.779
Trade-weighted	117.8	117.6	117.6	117.7	117.8	118.0	118.2	118.6	119.1	119.6	120.1
U.S. Dollar											
Trade-weighted[2]	120.5	121.5	121.1	120.7	120.4	119.3	118.2	117.4	116.6	115.9	115.1
European Currencies											
Euro[1]	1.09	1.08	1.08	1.09	1.09	1.10	1.12	1.12	1.13	1.13	1.14
Danish Krone	6.84	6.95	6.90	6.90	6.85	6.75	6.70	6.65	6.60	6.55	6.55
Norwegian Krone	10.41	10.65	10.60	10.55	10.55	10.40	10.30	10.25	10.20	10.15	10.10
Swedish Krone	10.35	10.60	10.55	10.50	10.45	10.35	10.20	10.15	10.10	10.05	10.00
Swiss Franc	0.86	0.87	0.87	0.87	0.86	0.86	0.85	0.85	0.84	0.84	0.83
U.K. Pound[1]	1.27	1.25	1.25	1.26	1.26	1.27	1.28	1.28	1.29	1.29	1.30
Asian Currencies											
Chinese Yuan	7.17	7.19	7.17	7.14	7.12	7.05	6.97	6.91	6.85	6.78	6.72
Japanese Yen	146	148	147	146	146	143	141	139	138	137	135
Korean Won	1,325	1,335	1,330	1,325	1,320	1,305	1,290	1,280	1,265	1,255	1,245
Indian Rupee	83.1	83.0	82.7	82.4	82.2	81.3	80.5	79.7	79.0	78.3	77.5
Singapore Dollar	1.34	1.33	1.33	1.33	1.32	1.32	1.31	1.30	1.28	1.27	1.26
Malaysian Ringgit	4.68	4.75	4.75	4.70	4.70	4.65	4.60	4.55	4.50	4.45	4.40
Thai Baht	35.2	35.8	35.7	35.6	35.4	35.1	34.7	34.4	34.1	33.7	33.4
Philippine Peso	56.0	56.3	56.1	55.9	55.7	55.1	54.6	54.0	53.6	53.1	52.6
Taiwan Dollar	31.2	31.4	31.3	31.2	31.1	30.7	30.4	30.1	29.8	29.6	29.3
Indonesian Rupiah	15,620	15,700	15,645	15,590	15,535	15,375	15,210	15,065	14,930	14,795	14,660
Other Currencies											
Australian Dollar[1]	0.664	0.650	0.652	0.654	0.656	0.662	0.668	0.673	0.676	0.680	0.684
New Zealand Dollar[1]	0.617	0.600	0.602	0.604	0.606	0.612	0.618	0.623	0.626	0.630	0.634
Mexican Peso	17.08	17.20	17.20	17.15	17.15	17.10	17.00	16.95	16.90	16.85	16.75
Brazilian Real	4.91	4.95	4.95	4.95	4.90	4.90	4.85	4.85	4.80	4.80	4.75
South African Rand	18.8	19.0	18.9	18.9	18.8	18.6	18.3	18.2	18.1	18.1	18.0
Cross Rates											
Versus Canadian Dollar											
Euro (C$/€)	1.46	1.46	1.46	1.46	1.46	1.47	1.48	1.48	1.47	1.47	1.46
U.K. Pound (C$/£)	1.71	1.69	1.69	1.69	1.69	1.69	1.69	1.69	1.68	1.67	1.67
Japanese Yen (¥/C$)	109	110	109	109	109	108	106	106	106	106	106
Australian Dollar (C$/A$)	0.89	0.88	0.88	0.88	0.88	0.88	0.88	0.88	0.88	0.88	0.88
Versus Euro											
U.K. Pound (£/€)	0.86	0.86	0.87	0.87	0.87	0.87	0.87	0.88	0.88	0.88	0.88
Japanese Yen (¥/€)	159	160	160	159	159	158	157	156	156	155	154

[1] (US$ per local currency); [2] Federal Reserve Broad Index

Sources: BMO Economics, Haver Analytics

Interest Rate Forecasts

(% : avg.)	Actual 2024 Jan	Forecasts 2024 Feb	Mar	Apr	2024 Q2	Q3	Q4	2025 Q1	Q2	Q3	Q4
Canada											
Overnight target (period end)	5.00	5.00	5.00	5.00	4.75	4.50	4.00	3.75	3.50	3.25	3.00
Overnight target	5.00	5.00	5.00	5.00	4.93	4.57	4.26	3.93	3.55	3.29	3.08
CORRA[2]	5.05	5.05	5.03	5.02	4.93	4.57	4.26	3.93	3.55	3.29	3.08
3-month bills	4.97	4.90	4.90	4.90	4.85	4.50	4.15	3.85	3.45	3.20	2.95
6-month	4.89	4.95	4.95	4.95	4.90	4.55	4.25	3.95	3.60	3.35	3.15
1-year	4.73	4.75	4.70	4.65	4.55	4.25	4.00	3.75	3.50	3.25	3.05
2-year bonds	4.00	4.05	3.90	3.80	3.70	3.55	3.40	3.25	3.15	3.00	2.90
3-year	3.78	3.85	3.75	3.65	3.55	3.40	3.30	3.20	3.10	3.00	2.90
5-year	3.42	3.45	3.45	3.45	3.45	3.30	3.20	3.15	3.05	3.00	2.95
7-year	3.33	3.35	3.35	3.35	3.35	3.20	3.10	3.05	3.05	3.00	2.95
10-year	3.35	3.35	3.35	3.30	3.25	3.10	3.00	3.00	3.00	3.00	3.00
30-year	3.28	3.30	3.30	3.25	3.25	3.25	3.20	3.20	3.15	3.15	3.10
1m BA	5.43	5.40	5.40	5.40	5.30	4.95	4.60	4.25	3.80	3.55	3.30
3m BA	5.45	5.40	5.40	5.40	5.30	4.95	4.60	4.25	3.85	3.55	3.30
Prime rate	7.20	7.20	7.20	7.20	7.13	6.77	6.46	6.13	5.75	5.49	5.28
United States											
Fed funds target (period end)	5.38	5.38	5.38	5.38	5.38	4.88	4.38	4.13	3.88	3.63	3.38
Fed funds target	5.38	5.38	5.38	5.38	5.38	5.18	4.69	4.34	4.07	3.84	3.59
EFFR[3]	5.33	5.33	5.33	5.33	5.33	5.14	4.66	4.32	4.05	3.82	3.58
SOFR[4]	5.32	5.32	5.32	5.32	5.32	5.13	4.65	4.31	4.04	3.81	3.57
3-month bills	5.45	5.45	5.45	5.45	5.45	5.20	4.70	4.35	4.05	3.85	3.55
6-month	5.21	5.20	5.20	5.20	5.20	5.05	4.60	4.25	4.00	3.80	3.55
1-year	4.79	4.80	4.75	4.75	4.70	4.55	4.25	4.00	3.80	3.65	3.45
2-year notes	4.32	4.35	4.30	4.20	4.15	4.00	3.85	3.75	3.60	3.50	3.35
3-year	4.11	4.15	4.10	4.05	4.05	3.95	3.85	3.75	3.65	3.55	3.45
5-year	3.98	4.00	4.00	4.00	4.00	3.90	3.80	3.75	3.65	3.60	3.50
7-year	4.03	4.00	4.00	3.95	3.95	3.85	3.80	3.75	3.70	3.65	3.60
10-year	4.06	4.00	4.00	3.95	3.90	3.80	3.75	3.75	3.70	3.70	3.65
30-year bonds	4.26	4.20	4.20	4.20	4.20	4.15	4.10	4.05	4.00	4.00	3.95
Prime rate	8.50	8.50	8.50	8.50	8.50	8.30	7.82	7.47	7.20	6.97	6.71
Other G7											
ECB Refi[1]	4.50	4.50	4.50	4.50	4.25	4.00	3.75	3.50	3.25	3.00	2.75
10yr Bund	2.21	2.20	2.25	2.25	2.25	2.30	2.30	2.30	2.20	2.10	2.05
BoE Repo[1]	5.25	5.25[6]	5.25	5.25	5.00	4.75	4.50	4.25	4.00	3.75	3.50
SONIA[5]	5.19	5.19	5.19	5.19	5.02	4.77	4.54	4.28	4.04	3.79	3.53
10yr Gilt	3.85	3.85	3.85	3.80	3.80	3.80	3.75	3.75	3.70	3.70	3.65
BoJ O/N[1]	-0.10	-0.10	-0.10	-0.10	0.00	0.00	0.00	0.00	0.00	0.00	0.00
10yr JGB	0.64	0.67	0.71	0.74	0.77	0.87	0.97	0.97	0.92	0.87	0.82

[1] end of period; [2] Canadian Overnight Repo Rate Average; [3] Effective Fed Funds Rate; [4] Secured Overnight Financing Rate;
[5] Sterling Overnight Index Average; [6] actual value

Sources: BMO Economics, Haver Analytics

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