

Rates Scenario for July 17, 2019

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

Forecast Summary

	Actual	Forecasts									
	2019	2019					2019	2020			
	Jun	Jul	Aug	Sep	Oct	Nov	Q4	Q1	Q2	Q3	Q4
BoC overnight	1.75	1.75 ¹	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
10-yr Canadas	1.46	1.55	1.55	1.55	1.55	1.55	1.55	1.60	1.65	1.70	1.75
Fed funds	2.38	2.13	2.13	2.13	1.88	1.88	1.88	1.88	1.88	1.88	1.88
10-yr Treasuries	2.07	2.10	2.05	2.05	2.05	2.00	2.00	2.05	2.10	2.15	2.25
C\$ per US\$	1.329	1.305	1.280	1.300	1.307	1.313	1.313	1.317	1.312	1.307	1.302
US\$/€	1.13	1.12	1.12	1.11	1.11	1.10	1.10	1.10	1.11	1.11	1.12
US\$/£	1.27	1.25	1.23	1.24	1.24	1.25	1.25	1.26	1.27	1.28	1.30
MXN/US\$	19.27	19.35	19.40	19.45	19.50	19.55	19.55	19.40	19.15	18.85	18.60
¥/US\$	108	108	107	107	106	106	106	104	103	104	106

(policy rates are end of period; averages otherwise); ¹ actual value for July 2019

Sources: BMO Economics, Haver Analytics

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Since the previous issue of Rates Scenario (on June 11th):

- **We continue to look for a couple of Fed rate cuts in 2019H2 (July and October), and no change in Bank of Canada policy this year and next, with the net risks skewed to the downside.** The latest policy pronouncements on both sides of the border support our forecast.
- After the FOMC foreshadowed a rate cut in the **June 19 statement** (“... uncertainties about this outlook have increased. In light of these uncertainties and muted inflation pressures, the Committee will closely monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion...”), in subsequent **congressional testimony** (July 10-11), Fed Chair Powell said: “Since then, based on incoming data and other developments, it appears that uncertainties around trade tensions and concerns about the strength of the global economy continue to weigh on the U.S. economic outlook. Inflation pressures remain muted.” The rate-cut herald holds fast.
- In the latest **Summary of Economic Projections**, although only 8 of 17 participants pencilled in at least one rate cut this year (including St. Louis President Bullard who dissented in favour of an immediate 25 bp move), we suspect policymakers’ views were already in a state of flux when submitted for the June meeting and that they continued to morph in the interim. Indeed, the Minutes revealed that, in addition to “many” policymakers favouring a “near term” rate cut, “several others” were on the cusp of conversion to rate cuts.
- In an expected July 31 rate reduction, there will probably be at least one dissenter in the no-cut camp, echoing what a “few” participants argued in June... that “an easing of policy in an attempt to increase inflation a few tenths of a percentage point risked overheating the labor markets and fueling financial imbalances.” The market is currently fully pricing in a 25 bp move, along with modest odds of a 50-pointer. We judge that the reasons compelling a few participants not to support rate cuts at this time also likely compel most in the rate-cut camp

to act cautiously when it comes to the magnitude of individual cuts and the frequency of follow-ups. We doubt the FOMC is thinking that it will have to drop rates 225 bps to the zero lower bound again (if it did, getting there sooner rather than later via 50-bp-or-greater increments could be the better risk-mitigating strategy). Instead, we suspect the Fed is envisioning a cumulative action akin to November 1987-February 1988, July 1995-January 1996 and September 1998-November 1998... all 75 bps or less.

- As before, we look for a follow-up move in October, but this could easily be pulled forward to September or pushed back to December or later, depending on how the economy and financial conditions unfold.
- Unless Fed easing coincides with a more severe deterioration in the U.S. economy, or is associated with much weaker oil prices or a much stronger Canadian dollar, **we doubt the Bank will match the Fed**. Three factors are dictating caution: (1) Core inflation is already close to the 2% target (trimmed mean 2.1%, weighted median 2.2% and common component 1.8%, for an average of 2.0%); (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 extra carefully when it comes to rate cuts to avoid boosting both again. The 2015 rate cuts and subsequent surge in the housing markets outside the oil patch, particularly in Vancouver and Toronto, linger fresh in one's memory. Nevertheless, the Bank sounded more dovish on July 10. The statement warned that an *“escalation of trade conflicts remains the biggest downside risk to the global and Canadian outlooks”*. In May, it only cited an increase in trade policy risks. By expressing more concern, the market rightfully believes the Bank will spring into action should the risk unfold.
- As the Fed cuts twice, we look for Treasury yields to remain at a low ebb this year. However, unrealized market expectations for Fed easing (in the OIS market, 67 bps worth of rate cuts this year and a cumulative 96 bps by the 2020 election), and the reasons for it (elevated risks to the outlook eventually backing off), are bound to exert some upward pressure. We reckon 10-year yields will average around 2% by 2019-end before drifting up as 2020 unfolds (2¼% by year-end). While the yield curve (3 month vs 10 years) should steepen over the period, shedding inversion in the wake of Fed easing, we look for the 2s10s segment to stay close to current readings.
- 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 to deteriorate to only the -40 bp range) 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 poorer economic competitiveness (that should result in market expectations of a perennially more-cautious-than-the-Fed monetary policy stance), in addition to expectations that the Fed will eventually reverse its 2019 rate cuts.
- We look for only a mild downturn in the big dollar (on a trade-weighted basis), as Fed rate cuts are occurring amid a worsening global trade war and dimming global economic prospects.
- With the Bank of Canada resisting the Fed's rate-cutting lead, we anticipate the **Canadian dollar** has some modest near-term upside. There's currently nothing on the Bank of Canada's calendar until the September 4 policy meeting. Unless the domestic data deteriorate, the loonie should benefit from falling U.S. interest rates while Canadian rates hold steady. However, too much loonie strength will likely prompt unease among policymakers and trigger more dovish talk, limiting gains. Beyond the brief 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 broad, global shift to the dovish side of monetary policy continues; but, while the reasons are obvious (slower global growth and trade, protectionist threats), the resulting hit to the respective currencies will likely cause the U.S. to raise its complaints of currency manipulation.

- The **BoJ** continues to be dovish, and its unconventional measures of easing, such as targeting longer-term yields, are attracting the interest of other central banks. But, the BoJ hasn't been silent, either. Deputy Governors Masazumi Wakatabe (*"if the economy comes under severe downward pressure... the BoJ must ease... immediately without hesitation"*) and Masayoshi Amamiya (*"...if such risks hurt the economy's momentum ... we won't hesitate to consider easing more"*) are signalling more easing if necessary.
- The volume on the **ECB's** dovishness has been cranked up to an 8 out of 10 over the past month. President Draghi is now expected to change the forward guidance on rates at the July 25 meeting (dropping the reference to *"through the first half of 2020"*), cut the deposit rate, and possibly introduce a tiered deposit rate. The stage may soon be set to resume asset purchases in the fall, perhaps at President Draghi's last meeting (October 24). That will be the parting gift to Christine Lagarde, assuming she passes muster.
- Even a couple of **BoE** officials are changing their tune. Governor Carney started that ball rolling in late June, when he testified to Parliament that, in the event of a no-deal, interest rates would be lower than they otherwise would be. But perhaps the most pointed admission came from Gertjan Vlieghe, who clearly stated that, in the event of a no-deal Brexit, he would *"move to cut Bank Rate towards the effective lower bound of close to 0%"*.

Foreign Exchange Forecasts

	Actual	Forecasts					2019	2020	Q2	Q3	Q4
	2019	2019	Aug	Sep	Oct	Nov					
	Jun	Jul	Aug	Sep	Oct	Nov	Q4	Q1	Q2	Q3	Q4
Canadian Dollar											
C\$ per US\$	1.329	1.305	1.280	1.300	1.307	1.313	1.313	1.317	1.312	1.307	1.302
US\$ per C\$	0.753	0.766	0.781	0.769	0.765	0.761	0.761	0.759	0.762	0.765	0.768
Trade-weighted	94.8	96.7	98.6	97.2	96.7	96.2	96.2	95.8	96.0	96.3	96.6
U.S. Dollar											
Trade-weighted ¹	128.3	128.0	128.2	128.9	129.3	129.7	129.7	129.7	129.0	128.5	128.0
European Currencies											
Euro ²	1.13	1.12	1.12	1.11	1.11	1.10	1.10	1.10	1.11	1.11	1.12
Danish Krone	6.61	6.65	6.65	6.70	6.70	6.75	6.75	6.75	6.70	6.70	6.65
Norwegian Krone	8.63	8.60	8.65	8.70	8.80	8.85	8.85	8.90	8.80	8.75	8.70
Swedish Krone	9.41	9.40	9.50	9.60	9.70	9.75	9.75	9.80	9.70	9.65	9.55
Swiss Franc	0.988	0.988	0.989	0.989	0.989	0.990	0.990	0.992	0.994	0.997	0.999
U.K. Pound ²	1.27	1.25	1.23	1.24	1.24	1.25	1.25	1.26	1.27	1.28	1.30
Asian Currencies											
Chinese Yuan	6.90	6.90	6.92	6.93	6.95	6.96	6.96	6.97	6.95	6.93	6.91
Japanese Yen	108	108	107	107	106	106	106	104	103	104	106
Korean Won	1,174	1,175	1,180	1,185	1,185	1,190	1,190	1,190	1,185	1,180	1,175
Indian Rupee	69.4	68.6	69.4	70.2	71.0	71.8	71.8	72.3	71.8	71.3	70.9
Singapore Dollar	1.36	1.37	1.37	1.38	1.38	1.39	1.39	1.40	1.40	1.39	1.39
Malaysian Ringgit	4.16	4.15	4.15	4.15	4.20	4.20	4.20	4.20	4.10	4.05	3.95
Thai Baht	31.1	30.8	31.0	31.3	31.6	31.8	31.8	32.2	32.2	32.3	32.4
Philippine Peso	51.7	51.2	51.6	52.1	52.5	53.0	53.0	53.1	52.7	52.3	51.9
Taiwan Dollar	31.3	31.1	31.2	31.4	31.5	31.6	31.6	31.8	31.8	31.7	31.7
Indonesian Rupiah	14,234	14,075	14,185	14,295	14,405	14,515	14,515	14,580	14,510	14,440	14,375
Other Currencies											
Australian Dollar ²	0.695	0.700	0.696	0.692	0.688	0.684	0.684	0.683	0.688	0.693	0.698
New Zealand Dollar ²	0.660	0.667	0.664	0.660	0.657	0.653	0.653	0.652	0.654	0.657	0.659
Mexican Peso	19.27	19.35	19.40	19.45	19.50	19.55	19.55	19.40	19.15	18.85	18.60
Brazilian Real	3.86	3.80	3.85	3.90	3.95	4.00	4.00	4.05	4.05	4.00	4.00
Russian Ruble	64.1	63.2	64.2	65.2	66.2	67.2	67.2	68.0	67.7	67.4	67.1
South African Rand	14.6	14.1	14.0	14.0	14.0	14.0	14.0	14.0	14.0	14.0	14.0
Cross Rates											
Versus Canadian Dollar											
Euro (C\$/€)	1.50	1.47	1.43	1.44	1.45	1.45	1.45	1.45	1.45	1.45	1.46
U.K. Pound (C\$/£)	1.68	1.63	1.57	1.61	1.62	1.64	1.64	1.66	1.67	1.68	1.69
Japanese Yen (¥/C\$)	81	82	84	82	81	80	80	79	79	80	81
Australian Dollar (C\$/A\$)	0.92	0.91	0.89	0.90	0.90	0.90	0.90	0.90	0.90	0.91	0.91
Versus Euro											
U.K. Pound (£/€)	0.89	0.90	0.91	0.90	0.89	0.89	0.89	0.88	0.87	0.87	0.86
Japanese Yen (¥/€)	122	121	120	118	117	116	116	115	115	116	118

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	2020	Q2	Q3	Q4
	2019	2019	Aug	Sep	Oct	Nov					
	Jun	Jul									
Cdn. Yield Curve											
Overnight	1.75	1.75 ¹	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
3 month	1.67	1.65	1.65	1.65	1.65	1.65	1.65	1.65	1.65	1.65	1.65
6 month	1.68	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70
1 year	1.66	1.70	1.70	1.70	1.70	1.65	1.65	1.65	1.70	1.70	1.70
2 year	1.41	1.55	1.55	1.50	1.50	1.45	1.45	1.50	1.55	1.65	1.70
3 year	1.38	1.55	1.50	1.50	1.50	1.50	1.50	1.50	1.60	1.65	1.70
5 year	1.35	1.50	1.50	1.50	1.50	1.50	1.50	1.55	1.60	1.65	1.70
7 year	1.38	1.55	1.55	1.55	1.55	1.50	1.50	1.55	1.60	1.65	1.70
10 year	1.46	1.55	1.55	1.55	1.55	1.55	1.55	1.60	1.65	1.70	1.75
30 year	1.72	1.75	1.75	1.75	1.75	1.75	1.75	1.80	1.85	1.95	2.00
1m BA	1.96	1.95	1.95	1.95	1.95	1.95	1.95	1.95	1.95	1.95	1.95
3m BA	1.98	1.95	1.95	1.95	1.95	1.95	1.95	2.00	2.00	2.00	2.00
6m BA	2.02	2.00	2.00	2.00	2.00	2.00	2.00	2.05	2.05	2.10	2.10
12m BA	2.11	2.10	2.10	2.10	2.05	2.05	2.05	2.10	2.10	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	2.13	2.13	1.88	1.88	1.88	1.88	1.88	1.88	1.88
3 month	2.22	2.15	2.15	2.05	2.00	1.95	1.95	1.90	1.90	1.90	1.90
6 month	2.17	2.10	2.05	2.00	1.95	1.95	1.90	1.90	1.90	1.95	1.95
1 year	2.00	1.95	1.95	1.90	1.90	1.85	1.85	1.85	1.90	1.95	1.95
2 year	1.81	1.85	1.80	1.80	1.80	1.75	1.75	1.80	1.85	1.90	1.95
3 year	1.78	1.80	1.80	1.80	1.80	1.80	1.80	1.85	1.90	2.00	2.05
5 year	1.83	1.85	1.85	1.85	1.85	1.85	1.85	1.90	2.00	2.05	2.10
7 year	1.95	1.95	1.95	1.95	1.95	1.95	1.95	2.00	2.05	2.10	2.15
10 year	2.07	2.10	2.05	2.05	2.05	2.00	2.00	2.05	2.10	2.15	2.25
30 year	2.57	2.60	2.60	2.55	2.55	2.55	2.55	2.55	2.60	2.70	2.75
1m LIBOR	2.40	2.35	2.30	2.30	2.05	2.05	2.05	2.05	2.05	2.00	2.00
3m LIBOR	2.40	2.30	2.30	2.20	2.15	2.10	2.10	2.05	2.10	2.15	2.15
6m LIBOR	2.30	2.25	2.20	2.15	2.10	2.05	2.05	2.05	2.10	2.15	2.20
12m LIBOR	2.28	2.25	2.20	2.20	2.15	2.10	2.10	2.15	2.20	2.30	2.35
Prime Rate	5.50	5.25	5.25	5.25	5.00	5.00	5.00	5.00	5.00	5.00	5.00
Other G7 Yields											
ECB Refi	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
10yr Bund	-0.27	-0.30	-0.30	-0.30	-0.30	-0.35	-0.35	-0.30	-0.25	-0.20	-0.15
BoE Repo	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
10yr Gilt	0.84	0.85	0.80	0.80	0.80	0.75	0.75	0.80	0.85	0.90	0.95
BoJ O/N	-0.08	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05
10yr JGB	-0.13	-0.13	-0.12	-0.12	-0.11	-0.11	-0.11	-0.10	-0.10	-0.10	-0.10

Percent (policy rates are end of period; averages otherwise); ¹ actual value for July 2019

Sources: BMO Economics, Haver Analytics

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