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## Forecast Summary (averages)

	Actual	Forecasts						2019			
	2018 Aug	2018 Sep	Oct	Nov	Dec	2019 Jan	Feb	2019 Q1	Q2	Q3	Q4
BoC overnight	1.50	1.50 <sup>1</sup>	1.75	1.75	1.75	1.75	1.75	1.75	2.00	2.25	2.25
10-yr Canadas	2.30	2.35	2.45	2.50	2.55	2.60	2.60	2.60	2.70	2.75	2.80
Fed funds	1.88	2.13	2.13	2.13	2.38	2.38	2.38	2.63	2.88	2.88	2.88
10-yr Treasuries	2.89	2.95	3.00	3.05	3.10	3.10	3.15	3.15	3.20	3.20	3.25
C\$ per US\$	1.304	1.297	1.290	1.282	1.275	1.273	1.271	1.271	1.265	1.258	1.252
US\$/€	1.15	1.16	1.17	1.17	1.18	1.18	1.18	1.18	1.20	1.22	1.24
US\$/£	1.29	1.29	1.28	1.28	1.28	1.27	1.25	1.26	1.30	1.34	1.39
MXN/US\$	18.86	19.35	19.35	19.30	19.30	19.25	19.15	19.15	18.95	18.75	18.55
¥/US\$	111	111	111	110	110	110	110	110	109	109	108

<sup>1</sup> actual value for September 2018

## Since the previous issue of Rates Scenario (on August 7<sup>th</sup>):

- We look for the **Bank of Canada** to continue, gradually, raising rates. The core inflation metrics are now averaging bang-on the 2% target, the economy is at capacity (with the output gap in the -0.5% to +0.5% range according to the Bank's reckoning), and a zero real policy rate (at least 2% nominal) is finally in sight. In the September 5<sup>th</sup> policy statement, the Bank said *"recent data reinforce Governing Council's assessment that higher interest rates will be warranted to achieve the inflation target. We will continue to take a gradual approach, guided by incoming data."*
- Top on the Bank's gradual agenda is uncertainty surrounding trade; it is *"monitoring closely the course of NAFTA negotiations and other trade policy developments, and their impact on the inflation outlook"*. Other agenda uncertainties include the economy's reaction to higher rates, whether sluggish (only *"moderate"*) wage growth indicates labour market slack persists, and whether *"digitalization of the economy is boosting aggregate supply and holding inflation pressures at bay"* (from Governor Poloz's Jackson Hole speech). Previous concerns about housing (*"beginning to stabilize"*) and household debt (*"credit growth has moderated and the household debt-to-income ratio is beginning to edge down"*) appear to be abating. After having raised rates in July, we look for the Bank to move again in October, presuming the items on the above agenda don't deteriorate (the text of the U.S.-Mexico trade deal must be delivered to Congress by the end of the month which constructs a hard deadline for Canada to be included). We still expect two rate hikes next year and for the Bank to only hit the bottom of its estimated neutral range (2.5%-to-3.5%) in 2020.
- On September 26<sup>th</sup>, we expect the **FOMC** to raise the fed funds target range by 25 bps to 2.00%-to-2.25%. This will lift the midpoint (2.13%) unequivocally above core PCE inflation (2.0% y/y) for the first time since March 2008, marking a critical juncture for Fed policy. Up until this point, the objective had been to shift policy rates from zero nominal to zero real; now, it is to shift them from zero real to neutral real—an objective fraught with much more uncertainty. First, while there's little doubt about the current level of the short-run, neutral real policy rate being non-negative, there's much more ambiguity about its exact positive value, let alone its longer-run level. And second, beginning in October, balance sheet reduction will have reached its maximum

permissible pace of \$50 billion per month, likely casting the inherent risk of an adverse reaction in financial markets to its highest level.

- Our **current base case** calls for a pause after June 2019, with the FOMC continuing its quarterly rate-hike cadence until the 2.88% midpoint is reached (reflecting a neutral real rate in the 0.50%-to-0.75% range). This reflects caution ahead of the first policy steps into net restrictive territory (in 2020). However, the pause could be earlier, and we're tracking four broad catalysts that could cause the Fed to skip at least one rate hike (along an otherwise quarterly cadence): (1) inflation failing to run at or slightly above 2%; (2) the yield curve inverting (particularly the 3-month to 10-year version); (3) financial conditions tightening too quickly; and, (4) risks to the economic outlook deteriorating materially.
- In the **Treasury market**, we judge that a slow, ratcheting uptrend in longer-term yields will continue to unfold. A mounting positive output gap, a super-low jobless rate that's primed to move lower, and inflation rates that are poised to push (further) above the FOMC's 2% target all argue for higher yields, along with surging supply to fund trillion-dollar deficits and Fed redemptions alleviating some of the compression pressure on term premiums. However, it's clear that flight-to-liquidity flows can be formidable, not to mention buying by yield-starved investors. Meanwhile, the market is also musing about a possible Fed pause. On balance, for 10-year yields, it's going to be a slow grind to the 3.10% range, which we expect by the turn of the year (revisiting the near 7-year high of 3.11% reached in May 2018), and 3.25% late next year. Longer-term Canadas should underperform as the Bank of Canada also tightens, with 10-year yields averaging around 2.55% by year-end, and topping 2.80% next year.
- **The Canadian dollar** has been trading above C\$1.29 but below C\$1.33 since late May, often pushed to either extreme by NAFTA uncertainty, amid the tug-of-war between firming oil prices and a firming greenback (an unfortunate double-drag for commodity-importing emerging markets). Presuming NAFTA uncertainty is alleviated this month, we look for the loonie to break out of this range—to the strong side—averaging C\$1.275 by the end of this year; and, in the wake of further BoC tightening, C\$1.25 by the end of 2019.
- Our view for the BoE and the ECB has not changed. The **BoE**, after raising rates 25 bps in August to an 8-year high of 0.75%, will likely be parked on the sidelines as Brexit talks heat up ahead of the October EU Summit. The data have been mixed but the economy looks to be softening in the second half of 2018, partly on Brexit uncertainty. There is a possibility that BoE Governor Carney may stay longer than anticipated, beyond June 2019. He is willing to do so in order to ensure a "*smooth Brexit and effective transition*" at the central bank. We look for the GBP to weaken to around \$1.25 ahead of Brexit day in March 2019. The **ECB** has already laid out its plans, and will chop its monthly bond purchases in half starting in October and, assuming the inflation outlook remains the same, will wrap up QE by the end of this year. We do not expect these plans to change, but keep an eye on Italy as the populist government prepares to introduce a budget for the coming year. If the deficit blows past the 3% of GDP target, the central bank may have to rejig its plans to end QE.
- The **BoJ** is expected to stay the course over the next year. In the words of Governor Kuroda, "*There is no thought about raising (rates) for quite some time.*" In fact, there were rumours of even more stimulus after the planned October 2019 sales tax hike, but it is unlikely. Meantime, the **Bank of Mexico** has sat on the sidelines since mid-year, after tightening seven times since 2017, leaving rates at a 9-year high of 7.75%. Although the trade deal with the U.S. has yet to pass Congress, having come to an agreement, particularly on autos, certainly comes as a relief. And, given that inflation has turned higher again for the last two months, the central bank is likely not finished tightening, which will give the MXN another lift.

## Foreign Exchange Forecasts

Local Currency per U.S. Dollar (averages)

	Actual 2018 Aug	Forecasts 2018					2019		2019			
		Sep	Oct	Nov	Dec	Jan	Feb	Q1	Q2	Q3	Q4	
<b>Canadian Dollar</b>												
C\$ per US\$	1.304	1.297	1.290	1.282	1.275	1.273	1.271	1.271	1.265	1.258	1.252	
US\$ per C\$	0.767	0.771	0.775	0.780	0.784	0.786	0.787	0.787	0.791	0.795	0.799	
Trade-weighted	96.5	97.0	97.5	98.0	98.5	98.7	98.9	98.8	99.0	99.2	99.4	
<b>U.S. Dollar</b>												
Trade-weighted <sup>1</sup>	125.3	126.2	126.2	126.1	126.0	125.9	125.8	125.7	124.8	123.8	122.7	
<b>European Currencies</b>												
Euro <sup>2</sup>	1.15	1.16	1.17	1.17	1.18	1.18	1.18	1.18	1.20	1.22	1.24	
Danish Krone	6.46	6.40	6.40	6.35	6.30	6.30	6.25	6.25	6.15	6.10	6.00	
Norwegian Krone	8.34	8.35	8.25	8.15	8.05	8.00	8.00	8.00	7.85	7.75	7.65	
Swedish Krone	9.07	9.05	9.10	9.15	9.25	9.15	9.10	9.10	8.85	8.65	8.40	
Swiss Franc	0.988	0.995	1.002	1.010	1.017	1.016	1.014	1.014	1.010	1.006	1.001	
U.K. Pound <sup>2</sup>	1.29	1.29	1.28	1.28	1.28	1.27	1.25	1.26	1.30	1.34	1.39	
<b>Asian Currencies</b>												
Chinese Yuan	6.85	6.86	6.87	6.89	6.90	6.89	6.88	6.88	6.86	6.83	6.81	
Japanese Yen	111	111	111	110	110	110	110	110	109	109	108	
Korean Won	1,120	1,125	1,130	1,135	1,140	1,140	1,135	1,135	1,135	1,130	1,130	
Indian Rupee	69.6	71.4	71.7	72.1	72.5	72.1	71.7	71.7	70.6	69.5	68.4	
Singapore Dollar	1.37	1.37	1.37	1.38	1.38	1.38	1.38	1.38	1.37	1.37	1.36	
Malaysian Ringgit	4.09	4.15	4.15	4.15	4.20	4.20	4.15	4.15	4.15	4.15	4.15	
Thai Baht	33.0	33.1	33.2	33.4	33.5	33.5	33.4	33.4	33.4	33.4	33.3	
Philippine Peso	53.3	53.6	53.8	54.0	54.2	54.0	53.9	53.9	53.6	53.2	52.8	
Taiwan Dollar	30.7	30.8	30.9	31.0	31.1	31.0	31.0	31.0	31.0	31.0	30.9	
Indonesian Rupiah	14,565	14,910	14,965	15,020	15,075	15,050	15,025	15,025	14,945	14,865	14,785	
<b>Other Currencies</b>												
Australian Dollar <sup>2</sup>	0.732	0.720	0.713	0.707	0.700	0.703	0.705	0.705	0.713	0.720	0.728	
New Zealand Dollar <sup>2</sup>	0.667	0.663	0.658	0.654	0.650	0.651	0.652	0.652	0.654	0.657	0.659	
Mexican Peso	18.86	19.35	19.35	19.30	19.30	19.25	19.15	19.15	18.95	18.75	18.55	
Brazilian Real	3.93	4.15	4.25	4.25	4.20	4.20	4.20	4.20	4.15	4.15	4.10	
Russian Ruble	66.5	68.4	67.9	67.4	66.9	66.5	66.1	66.1	64.7	63.4	62.0	
South African Rand	14.1	15.5	15.8	16.2	16.5	16.5	16.6	16.6	16.7	16.8	17.0	
<b>Cross Rates</b>												
<b>Versus Canadian Dollar</b>												
Euro (C\$/€)	1.51	1.51	1.51	1.51	1.50	1.50	1.50	1.50	1.52	1.54	1.56	
U.K. Pound (C\$/£)	1.68	1.67	1.66	1.64	1.63	1.61	1.59	1.60	1.64	1.69	1.73	
Japanese Yen (¥/C\$)	85	85	86	86	86	86	86	86	86	86	86	
Australian Dollar (C\$/A\$)	0.96	0.93	0.92	0.91	0.89	0.89	0.90	0.90	0.90	0.91	0.91	
<b>Versus Euro</b>												
U.K. Pound (£/€)	0.90	0.90	0.91	0.92	0.92	0.93	0.94	0.94	0.93	0.91	0.90	
Japanese Yen (¥/€)	128	129	129	129	130	130	129	130	131	133	134	

<sup>1</sup> Federal Reserve Broad Index    <sup>2</sup> (US\$ per local currency)

## Interest Rate Forecasts

Percent (averages)

	Actual 2018 Aug	Forecasts 2018						2019			
		Sep	Oct	Nov	Dec	Jan	Feb	Q1	Q2	Q3	Q4
<b>Cdn. Yield Curve</b>											
Overnight	1.50	1.50 <sup>1</sup>	1.75	1.75	1.75	1.75	1.75	1.75	2.00	2.25	2.25
3 month	1.49	1.60	1.70	1.70	1.70	1.70	1.70	1.75	1.95	2.15	2.15
6 month	1.66	1.75	1.85	1.85	1.85	1.85	1.85	1.90	2.05	2.20	2.20
1 year	1.94	2.00	2.05	2.05	2.10	2.10	2.10	2.15	2.25	2.40	2.40
2 year	2.11	2.15	2.15	2.20	2.20	2.25	2.25	2.25	2.35	2.45	2.50
3 year	2.13	2.15	2.20	2.25	2.25	2.30	2.30	2.30	2.40	2.50	2.55
5 year	2.22	2.25	2.30	2.35	2.40	2.45	2.45	2.45	2.55	2.60	2.70
7 year	2.25	2.30	2.35	2.40	2.45	2.50	2.55	2.55	2.60	2.70	2.75
10 year	2.30	2.35	2.45	2.50	2.55	2.60	2.60	2.60	2.70	2.75	2.80
30 year	2.31	2.40	2.45	2.50	2.60	2.65	2.65	2.65	2.75	2.85	2.95
1m BA	1.83	1.90	2.05	2.05	2.05	2.05	2.05	2.05	2.25	2.45	2.45
3m BA	1.96	2.05	2.15	2.15	2.15	2.15	2.15	2.20	2.40	2.55	2.55
6m BA	2.11	2.20	2.30	2.30	2.30	2.30	2.30	2.30	2.45	2.60	2.60
12m BA	2.33	2.40	2.45	2.45	2.45	2.50	2.50	2.50	2.60	2.70	2.75
Prime Rate	3.70	3.70	3.95	3.95	3.95	3.95	3.95	3.95	4.20	4.45	4.45
<b>U.S. Yield Curve</b>											
Fed funds	1.88	2.13	2.13	2.13	2.38	2.38	2.38	2.63	2.88	2.88	2.88
3 month	2.07	2.20	2.20	2.25	2.35	2.35	2.45	2.45	2.65	2.75	2.75
6 month	2.24	2.30	2.30	2.40	2.45	2.45	2.55	2.55	2.70	2.80	2.80
1 year	2.45	2.50	2.55	2.60	2.65	2.65	2.70	2.70	2.85	2.90	2.90
2 year	2.64	2.70	2.70	2.75	2.80	2.85	2.90	2.90	3.00	3.05	3.05
3 year	2.71	2.75	2.80	2.85	2.90	2.95	2.95	2.95	3.05	3.10	3.10
5 year	2.77	2.80	2.85	2.90	2.95	3.00	3.00	3.00	3.10	3.15	3.15
7 year	2.84	2.90	2.95	3.00	3.05	3.05	3.10	3.10	3.15	3.20	3.20
10 year	2.89	2.95	3.00	3.05	3.10	3.10	3.15	3.15	3.20	3.20	3.25
30 year	3.04	3.10	3.15	3.20	3.25	3.25	3.30	3.30	3.35	3.35	3.40
1m LIBOR	2.07	2.30	2.30	2.45	2.55	2.55	2.65	2.65	2.90	3.05	3.05
3m LIBOR	2.32	2.55	2.55	2.65	2.75	2.75	2.85	2.85	3.05	3.15	3.15
6m LIBOR	2.52	2.75	2.75	2.85	3.00	3.00	3.10	3.10	3.35	3.45	3.45
12m LIBOR	2.82	3.05	3.05	3.15	3.25	3.30	3.35	3.35	3.60	3.70	3.70
Prime Rate	5.00	5.25	5.25	5.25	5.50	5.50	5.50	5.60	5.85	6.00	6.00
<b>Other G7 Yields</b>											
ECB Refi	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.25	0.25
10yr Bund	0.36	0.50	0.70	0.85	1.00	1.00	1.05	1.05	1.10	1.15	1.25
BoE Repo	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00
10yr Gilt	1.31	1.45	1.60	1.70	1.85	1.85	1.90	1.90	1.90	1.95	2.00
Boj O/N	-0.06	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	0.00
10yr JGB	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.11	0.12	0.12

<sup>1</sup> actual value for September 2018

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