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## Forecast Summary (averages)

	Actual	Forecasts							2019		2020
	2018 Nov	2018 Dec	2019 Jan	Feb	Mar	Apr	May	Jun	Q3	Q4	Q1
BoC overnight	1.75	1.75 <sup>1</sup>	1.75	1.75	1.75	2.00	2.00	2.00	2.00	2.25	2.25
10-yr Canadas	2.41	2.15	2.15	2.20	2.25	2.30	2.30	2.35	2.45	2.55	2.65
Fed funds	2.13	2.38	2.38	2.38	2.38	2.38	2.63	2.63	2.88	2.88	3.13
10-yr Treasuries	3.12	2.90	2.95	2.95	3.00	3.05	3.05	3.10	3.15	3.25	3.35
C\$ per US\$	1.321	1.330	1.337	1.343	1.350	1.349	1.347	1.346	1.343	1.339	1.334
US\$/€	1.14	1.14	1.14	1.14	1.14	1.13	1.13	1.13	1.14	1.16	1.16
US\$/£	1.29	1.26	1.25	1.24	1.23	1.23	1.23	1.24	1.26	1.29	1.31
MXN/US\$	20.25	20.00	20.35	20.65	21.00	20.75	20.50	20.25	19.75	19.00	18.70
¥/US\$	113	113	113	113	112	112	112	112	111	110	110

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

## Since the previous issue of Rates Scenario (on November 12<sup>th</sup>):

- **We have changed our forecasts for the Federal Reserve and the Bank of Canada.** We now call for fewer rate hikes next year (two instead of three) and spaced further apart (beyond three months). However, the reasons for these changes are different.
- For the **Fed**, we were forecasting that the current quarterly rate-hike cadence would continue until the target range first enveloped the FOMC's median projection of the neutral fed funds rate (3.00%), and that the tightening tempo would subsequently slow as the Fed began taking its first policy steps into net restrictive territory. We now judge that this caution will kick in earlier, once the target range first touches the bottom of the FOMC's range of projections (2.50%-to-3.50%), and we'll likely be there December 19<sup>th</sup> when the range is raised 25 bps to 2.25%-to-2.50%. In consequence, we look for the Fed to modify its forward-looking language by dropping the reference to "gradual" actions, which has become synonymous with quarterly moves (the Bank of Canada also did this recently).
- It's not clear whether Fed Chair Powell's recent comments were intended to rein in rate-hike expectations. On November 28<sup>th</sup>, Powell said policy rates "remain just below the broad range of estimates of the level that would be neutral for the economy", which the market interpreted as being decidedly more dovish than his October 3<sup>rd</sup> comments ("We may go past neutral. But we're a long way from neutral at this point, probably"). We judge both remarks are perfectly consistent with the Summary of Economic Projections, admittedly emphasizing different aspects. The catalyst for our forecast change was that recent economic data point to two unexpected developments—a much weaker housing sector and ebbing core PCE inflation. After December 19<sup>th</sup>, variable intervals between moves will become easier with pressers after each FOMC confab. We see rate hikes in May and September (we had a March-June-December configuration before), with one hike in 2020 (same as before). This implies a peak of 3.125% vs. 3.375% before.
- The **Bank of Canada** has its sights set on neutral, too, and a similar 2.5%-to-3.5% range. The Bank's drive-to-neutral conviction is prodded by an economy operating close to capacity, a jobless rate probing multi-decade lows and core inflation rates averaging the 2.0% target—particularly now that (nearly all) NAFTA uncertainty

has been lifted. The conviction appeared pretty strong at the October policy announcement (rates “*will need to rise to a neutral stance to achieve the inflation target*”), but... when the facts change...

- Ahead of the December 5<sup>th</sup> meeting, risks surrounding the outlook had mounted. On the upside was the signing of the USMCA, new federal government tax measures (accelerated depreciation allowances), and a temporary truce in the U.S.-China trade war. On the downside were plummeting oil prices, weak-in-the-details Q3 GDP, slower November vehicle sales which hinted at heightened household sensitivity to higher interest rates, and the Democrats winning control of the U.S. House of Representatives which cast doubt about a smooth USMCA ratification. The downside risks tipped the scale in the Bank’s eyes. The policy announcement (and Governor Poloz’s speech the next day) said the path to policy neutrality would now depend on “*the effect of higher interest rates on consumption and housing... global trade policy developments... the persistence of the oil price shock, the evolution of business investment, and the Bank’s assessment of the economy’s capacity.*” The oil and investment references were new. The downside risks tipped the scale in our eyes as well. We now look for the BoC to hike rates in April and October (we had a January-April-July configuration before), with one hike in 2020 to a peak of 2.50%. We judge the Bank’s “*decidedly data dependent*” path to neutrality will now be a longer one.
- The Canadian dollar is expected to struggle into the early portion of 2019. The Bank’s move to the sidelines for now is expected to keep the currency on the defensive, though much of that shift is already priced in. We have the C\$ little-changed through 2019, staying in a C\$1.30-to-C\$1.35 range, as the BoC matches the Fed’s moves and amid a decelerating U.S. growth backdrop. An expected recovery in world oil prices should provide some support as we head toward mid-year, but that will rely on Canadian oil discounts remaining well behaved.
- As the Fed raises rates, we expect longer-term Treasury yields to retrace their recent rally. Several pressures are poised to help prod yields higher, including an anticipated modest re-acceleration of inflation expectations (thank you cycle-high core PCE inflation readings and firming crude oil prices), continued Fed balance sheet reduction (alleviating some of the compression pressure on term premiums), and a surging supply of Treasuries (with budget deficits looking to top \$1 trln). However, offsetting these pressures are yield-starved investors (particularly as yields hit new multi-year highs), what seems to be regular bouts of flight-to-liquidity, and the fact that longer-run nominal GDP growth is destined to stay tucked under 4%. On balance, we look for 10-year Treasury yields to close next year around 3.25%, in line with their early-November trading high. Meanwhile, we look for the yield curve (2s10s) to continue flattening to low single-digits and skirt persistent inversion, and for the more complete curve (from 3 months out to 10 years) to stay persistently positive.
- With the Bank of Canada keeping pace with Fed rate hikes during 2019 and early 2020, but with the net risk that the Fed does more than the Bank, we expect Canada-US 10-year yield spreads will stick to their current range of -70 bps to -80 bps, with the most negative readings reserved for the longest tenors. This reflects America’s much worse fiscal dynamics as well as Canada’s poorer economic competitiveness (that should result in a perennial more-cautious-than-Fed monetary policy stance).
- Outside of North America, a great deal of uncertainty lies ahead. The trials and tribulations around Brexit (is it on or off?) will keep markets on edge ahead of the mid-January U.K. parliamentary vote. It will keep a lid on the British pound and the **BoE** on alert. The Bank could fine-tune its comments on future rate hikes at its December 20<sup>th</sup> meeting, and may soften its long-held view that “*ongoing tightening over the forecast period*” was still necessary. Meantime, we are taking Governor Carney’s words at face value, which is to estimate one rate hike per year. We judge that 2019’s move will be later in the summer (August), at the earliest.

- The **ECB** finally announced the end of QE as of December 2018. The press conference was dovish, even though the rates guidance was unchanged. The ECB still expects rates to stay where they are “*at least through the summer of 2019*”, but we anticipate that this phrase will change in coming months, pushing out expectations toward the fall or winter of 2019.
- The **BoJ** will have an eventful year as it deals with soft growth ahead of the October sales tax hike (projected to rise 2 ppts to 10% unless PM Abe delays it for the third time). Although most central banks have started to tighten or move away from easing, Governor Kuroda continues to deploy massive monetary stimulus, although lifting the 0% ceiling on the 10-year JGB should be considered. Meantime, the central bank’s official word remains: no end to stimulus until inflation reaches the 2% target.
- The **RBA** cites a domestic economy that is “*performing well*”, despite sluggish household consumption. That is a “*continuing source of uncertainty*” due to high debt levels and weak income growth. The RBA is in no rush to lift rates; the cash rate is expected to remain at 1.5% for the third consecutive year, with the next move not in the cards until early 2020.

## Foreign Exchange Forecasts

Local Currency per U.S. Dollar (averages)

	Actual	Forecasts							2019 Q3	2019 Q4	2020 Q1
	2018 Nov	2018 Dec	2019 Jan	Feb	Mar	Apr	May	Jun			
<b>Canadian Dollar</b>											
C\$ per US\$	1.321	1.330	1.337	1.343	1.350	1.349	1.347	1.346	1.343	1.339	1.334
US\$ per C\$	0.757	0.752	0.748	0.744	0.741	0.742	0.742	0.743	0.745	0.747	0.749
Trade-weighted	95.8	95.0	94.7	94.3	93.9	94.0	94.1	94.1	94.1	94.0	94.1
<b>U.S. Dollar</b>											
Trade-weighted <sup>1</sup>	128.3	128.0	128.6	129.2	129.8	129.8	129.8	129.7	128.8	127.4	126.7
<b>European Currencies</b>											
Euro <sup>2</sup>	1.14	1.14	1.14	1.14	1.14	1.13	1.13	1.13	1.14	1.16	1.16
Danish Krone	6.57	6.55	6.55	6.50	6.50	6.50	6.50	6.50	6.45	6.45	6.40
Norwegian Krone	8.48	8.55	8.55	8.55	8.55	8.55	8.60	8.60	8.60	8.60	8.65
Swedish Krone	9.07	9.00	9.00	9.00	9.00	9.00	9.00	9.05	9.05	9.05	9.00
Swiss Franc	1.001	1.000	0.998	0.995	0.993	0.990	0.988	0.985	0.980	0.973	0.985
U.K. Pound <sup>2</sup>	1.29	1.26	1.25	1.24	1.23	1.23	1.23	1.24	1.26	1.29	1.31
<b>Asian Currencies</b>											
Chinese Yuan	6.94	6.90	6.93	6.97	7.00	7.03	7.07	7.10	7.03	6.93	6.88
Japanese Yen	113	113	113	113	112	112	112	112	111	110	110
Korean Won	1,126	1,120	1,120	1,125	1,125	1,125	1,130	1,130	1,130	1,135	1,140
Indian Rupee	71.7	71.1	71.2	71.3	71.4	71.5	71.6	71.8	72.0	72.3	72.0
Singapore Dollar	1.38	1.37	1.37	1.37	1.37	1.37	1.37	1.38	1.38	1.38	1.38
Malaysian Ringgit	4.18	4.15	4.15	4.15	4.15	4.15	4.15	4.15	4.15	4.20	4.15
Thai Baht	33.0	32.8	32.9	33.0	33.1	33.1	33.2	33.3	33.5	33.7	33.8
Philippine Peso	52.8	52.8	52.9	53.0	53.1	53.2	53.3	53.5	53.7	54.0	54.0
Taiwan Dollar	30.8	30.9	30.9	30.9	31.0	31.0	31.1	31.1	31.2	31.3	31.4
Indonesian Rupiah	14,658	14,475	14,520	14,570	14,615	14,665	14,710	14,760	14,855	14,995	14,915
<b>Other Currencies</b>											
Australian Dollar <sup>2</sup>	0.724	0.725	0.727	0.729	0.731	0.733	0.735	0.738	0.742	0.748	0.752
New Zealand Dollar <sup>2</sup>	0.678	0.690	0.688	0.685	0.683	0.680	0.678	0.675	0.670	0.663	0.667
Mexican Peso	20.25	20.00	20.35	20.65	21.00	20.75	20.50	20.25	19.75	19.00	18.70
Brazilian Real	3.79	3.85	3.85	3.90	3.90	3.90	3.90	3.95	3.95	4.00	4.05
Russian Ruble	66.5	66.6	67.2	67.7	68.3	68.8	69.4	69.9	71.1	72.7	73.1
South African Rand	14.1	14.1	14.1	14.2	14.3	14.4	14.4	14.5	14.7	14.9	15.1
<b>Cross Rates</b>											
<b>Versus Canadian Dollar</b>											
Euro (C\$/€)	1.50	1.52	1.52	1.53	1.53	1.53	1.52	1.52	1.53	1.55	1.55
U.K. Pound (C\$/£)	1.70	1.68	1.67	1.67	1.66	1.66	1.66	1.67	1.69	1.73	1.75
Japanese Yen (¥/C\$)	86	85	84	84	83	83	83	83	83	82	82
Australian Dollar (C\$/A\$)	0.96	0.96	0.97	0.98	0.99	0.99	0.99	0.99	1.00	1.00	1.00
<b>Versus Euro</b>											
U.K. Pound (£/€)	0.88	0.90	0.91	0.92	0.92	0.92	0.92	0.91	0.90	0.90	0.89
Japanese Yen (¥/€)	129	129	128	128	127	127	126	126	127	127	128

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

## Interest Rate Forecasts

Percent (averages)

	Actual	Forecasts							2019 Q3	2019 Q4	2020 Q1
	2018 Nov	2018 Dec	2019 Jan	Feb	Mar	Apr	May	Jun			
<b>Cdn. Yield Curve</b>											
Overnight	1.75	1.75 <sup>1</sup>	1.75	1.75	1.75	2.00	2.00	2.00	2.00	2.25	2.25
3 month	1.71	1.65	1.65	1.75	1.80	1.90	1.90	1.90	2.00	2.15	2.25
6 month	1.90	1.80	1.90	1.95	2.00	2.10	2.10	2.10	2.20	2.35	2.45
1 year	2.13	2.00	2.05	2.10	2.15	2.20	2.20	2.25	2.30	2.40	2.50
2 year	2.27	2.05	2.10	2.15	2.15	2.20	2.25	2.30	2.35	2.45	2.55
3 year	2.28	2.05	2.10	2.15	2.15	2.20	2.25	2.30	2.35	2.45	2.55
5 year	2.34	2.05	2.10	2.15	2.20	2.20	2.25	2.30	2.35	2.45	2.60
7 year	2.36	2.10	2.15	2.15	2.20	2.25	2.25	2.30	2.40	2.50	2.60
10 year	2.41	2.15	2.15	2.20	2.25	2.30	2.30	2.35	2.45	2.55	2.65
30 year	2.46	2.30	2.35	2.35	2.40	2.45	2.50	2.50	2.60	2.70	2.80
1m BA	2.10	2.20	2.20	2.25	2.35	2.40	2.40	2.40	2.45	2.60	2.65
3m BA	2.22	2.25	2.25	2.35	2.40	2.50	2.50	2.50	2.55	2.70	2.75
6m BA	2.34	2.35	2.45	2.45	2.50	2.55	2.55	2.55	2.70	2.80	2.90
12m BA	2.56	2.55	2.60	2.65	2.70	2.70	2.75	2.75	2.80	2.85	3.00
Prime Rate	3.95	3.95	3.95	3.95	3.95	4.20	4.20	4.20	4.20	4.45	4.45
<b>U.S. Yield Curve</b>											
Fed funds	2.13	2.38	2.38	2.38	2.38	2.38	2.63	2.63	2.88	2.88	3.13
3 month	2.37	2.40	2.40	2.40	2.50	2.60	2.70	2.70	2.90	3.05	3.20
6 month	2.52	2.55	2.55	2.60	2.70	2.75	2.80	2.85	2.95	3.15	3.25
1 year	2.70	2.70	2.70	2.75	2.80	2.85	2.90	2.95	3.05	3.15	3.30
2 year	2.86	2.75	2.80	2.85	2.85	2.90	2.95	3.00	3.05	3.20	3.30
3 year	2.91	2.75	2.80	2.85	2.85	2.90	2.95	3.00	3.10	3.20	3.30
5 year	2.95	2.80	2.80	2.85	2.90	2.90	2.95	3.00	3.10	3.20	3.30
7 year	3.04	2.85	2.85	2.90	2.90	2.95	3.00	3.05	3.10	3.20	3.30
10 year	3.12	2.90	2.95	2.95	3.00	3.05	3.05	3.10	3.15	3.25	3.35
30 year	3.36	3.15	3.20	3.20	3.25	3.30	3.30	3.35	3.40	3.50	3.60
1m LIBOR	2.32	2.45	2.45	2.45	2.55	2.60	2.70	2.70	2.90	3.10	3.25
3m LIBOR	2.65	2.80	2.80	2.80	2.85	2.95	3.00	3.00	3.15	3.30	3.50
6m LIBOR	2.86	2.90	2.90	2.85	2.95	3.05	3.15	3.10	3.35	3.45	3.65
12m LIBOR	3.12	3.10	3.15	3.05	3.15	3.25	3.35	3.30	3.50	3.55	3.75
Prime Rate	5.25	5.50	5.50	5.50	5.50	5.50	5.75	5.75	5.85	6.00	6.25
<b>Other G7 Yields</b>											
ECB Refi	0.00	0.00 <sup>1</sup>	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.10	0.10
10yr Bund	0.38	0.25	0.30	0.35	0.35	0.40	0.45	0.50	0.55	0.70	0.70
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	1.44	1.35	1.40	1.40	1.45	1.45	1.50	1.50	1.55	1.65	1.65
Boj O/N	-0.06	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	0.00	0.00
10yr JGB	0.10	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.16

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

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