Rates Scenario

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An outlook on key interest and foreign exchange rates March 7, 2019

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Forecast Summary (averages)

	Actual 2019 Feb	Forecasts 2019 Mar	Apr	May	2019 Q2	Q3	Q4	2020 Q1	Q2	Q3	Q4
BoC overnight	1.75	1.75[1]	1.75	1.75	1.75	1.75	2.00	2.00	2.00	2.00	2.00
10-yr Canadas	1.91	1.85	1.85	1.90	1.90	2.00	2.05	2.05	2.05	2.00	1.95
Fed funds	2.38	2.38	2.38	2.38	2.38	2.38	2.63	2.63	2.63	2.63	2.63
10-yr Treasuries	2.68	2.70	2.70	2.75	2.75	2.80	2.85	2.80	2.75	2.70	2.65
C$ per US$	1.321	1.340	1.338	1.337	1.337	1.332	1.327	1.321	1.315	1.308	1.302
US$/€	1.13	1.12	1.13	1.13	1.13	1.14	1.15	1.16	1.16	1.17	1.18
US$/£	1.30	1.30	1.31	1.32	1.32	1.32	1.31	1.31	1.32	1.33	1.35
MXN/US$	19.20	19.25	19.35	19.40	19.40	19.25	18.90	18.70	18.65	18.60	18.50
¥/US$	110	112	112	112	112	111	111	111	110	110	109

Policy rates are end of period; [1] actual value for March 2019

Since the previous issue of Rates Scenario (on February 7th):

- We continue to pencil in a rate hike by both the Federal Reserve and Bank of Canada by year-end. However, a few things have to happen first. Both economies have to pull out of their turn-of-the-year funk. Not only were there dismal year-end performances (Canada: -0.1% m/m real GDP growth in November and December; U.S.: -0.6% real PCE in December), but there were added dampeners to start 2019 (Alberta's mandatory oil production cuts, the partial U.S. government shutdown). The arithmetic impacts of these past/temporary factors will pull down Q1 GDP growth; in Canada, to 0.0% a.r. from 0.4% in Q4; and, in the U.S., to 1.2% from 2.6%. But, we are anticipating a return to at- or above-potential growth rates on both sides of the border for the remainder of this year.

- Next, for the **Federal Reserve**, presuming Chairman Powell's *"crosscurrents and conflicting signals about the outlook"* subside sufficiently, we judge inflation will need to pick up from its current pace—to a bit above 2%—before the Fed acts again. Powell said, *"I would want to see a need for further rate increases, and for me a big part of that would be inflation"*. The anticipated post-Q1 growth profile amid an already positive output gap should do the trick in prodding a bit more inflation pressure. We expect the unemployment rate to drop to 3.5% by year-end (matching half-century lows), with wages already mildly accelerating. Importantly, amid still-sturdy consumer demand, we anticipate businesses will be a touch better able to pass on some of their higher costs (e.g., wages, tariffs). In turn, we look for core PCE inflation to run in a slightly higher 2.0%-to-2.3% range as the year unfolds, up from the 1.8%-to-2.0% range currently; and, for the Fed to finally *"see a need"* for another rate hike.

- For the **Bank of Canada**, 2%-plus core inflation is not the prerequisite for a rate hike, although we reckon the BoC is going to get it. We project the three tracked metrics should average 2.2% by year-end, up from 1.9% currently. Instead, the prerequisite is that current substantial risks to the outlook have to retreat. In the March 6 policy announcement, the Bank said, *"with increased uncertainty about the timing of future rate increases, Governing Council will be watching closely developments in household spending, oil markets, and global trade policy"*; and, for the time being, *"the outlook continues to warrant a policy interest rate that is below its neutral* *range"*. There are also concerns about the adjustment in the housing sector to higher mortgage rates, with new mortgage guidelines and rules aimed specifically at the Greater Vancouver and Greater Toronto areas, along with lacklustre capex. While these risks and concerns suggest a higher BoC (than Fed) rate-hike hurdle, the Bank is still keeping *"future rate increases"* on the table since policy rates (currently 1.75%) are still well below the 2.5%-to-3.5% neutral range (the FOMC is currently at 2.375% with the same projected range for neutral); and, more importantly, still negative in real terms (using core inflation readings).

- For 10-year Treasury yields, with one Fed rate hike looming (but not currently priced in), an anticipated modest re-acceleration of inflation expectations (given coming-soon cycle-high core PCE inflation readings and firmer oil prices), and a surging supply of Treasuries (to fund budget deficits soon topping $1 trillion), we expect them to drift up, on average, as the year unfolds, but remain under 3%. Ensuring yields don't stray much higher, there is buying from yield-starved investors, what seems to be regular bouts of flight-to-liquidity, and the fact that longer-run nominal GDP growth (the ultimate bond yield anchor over the long haul) is expected to stay tucked under 4%.

- With the Bank keeping pace with Fed rate hikes, we judge Canada/US longer-term yield spreads are likely to become a little less negative as the year unfolds (e.g., 10-year spreads around -75 bps by year-end), which are still more negative than the overnight spread (-62½ bps). This reflects America's much worse fiscal dynamics as well as Canada's poorer economic competiveness (that should result in a perennially more-cautious-than-Fed monetary policy stance).

- With a more dovish BoC, the **Canadian dollar** will be under pressure over the next few months. We expect the loonie to remain weak in the face of global and domestic uncertainty. The currency will likely stay in the $1.30-to-$1.35 range through the course of 2019.

- There has been no progress on **Brexit**, due to take place at month-end, which might be contributing to rising expectations that it will be delayed (pending EU approval, of course). A number of other factors are also supporting this view. U.K. business confidence plunged to an 11-year low; consumer spending on the essentials rose (stockpiling?), at the expense of non-essentials; a dozen lawmakers resigned from Labour and the Tories to join a newly formed party due to the "*disastrous handling of Brexit*'; and, Jacob Rees-Mogg, head of the ERG, has eased up on his demands for Brexit. But a delay is clearly not a sure thing. There are some key dates to watch this month. Parliament will vote on PM May's deal (March 12). If it is a "no" (very likely), next will be a vote on leaving without a deal (March 13). If that is voted down, then there will be a vote on asking Brussels for more time (March 14). But, the EU would demand specifics on how that extra time would be used. Time is running out; or, it already has. The **BoE** does not meet until March 21st and it will be interesting to see if, given the heightened uncertainty, it still believes it is "*appropriate*" to have "*ongoing tightening over the forecast period*". One of the hawks on the MPC, Michael Saunders, has already downplayed it. We no longer believe a rate hike is warranted and now see the Bank on hold over the next two years.

- In the **Euro Area**, the economic slowdown has intensified markedly, enough to justify the **ECB's** move to slash its near-term GDP and CPI forecasts at the March 7th monetary policy meeting. President Draghi pointed to mainly external factors but domestic growth has also disappointed. Then there is the growing possibility of a trade war between the U.S. and the EU which will weigh on growth prospects, particularly in Germany, with an economy highly exposed to exports. Agriculture and autos are two of the main areas of contention. President Trump warned that "*if we don't make a deal, we'll do the tariffs*"; the EU response was that the European Commission would react in a "*swift and adequate manner*." There has been a better tone in the data recently

(Euro Area PMI rose to a 3-month high in February, retail sales recovered in January), and the Yellow Vest protests have eased a little, but it hasn't been significant enough to calm the ECB's concerns. Hence, the ECB revised its rates guidance, and is no longer looking for rates to stay at current levels "*through the summer of 2019*". Instead, rates will remain where they are "*through the end of 2019*". And, a new round of cheap financing was introduced, called TLTRO-III. Much like the BoE, we no longer believe that the ECB will raise rates in 2020. We look for the central bank to keep rates on hold over the next two years.

- The **BoJ** has been perched on the sidelines for a long time, hesitant to raise rates in the face of still-disappointing growth and a clear lack of inflationary pressure. Governor Kuroda continues to hint about exiting, but is extremely cautious. He borrowed from the Federal Reserve's word wall recently, saying that the BoJ will be "*patient*" as it maintains its massive stimulus programme to keep inflation heading in the right direction.

Foreign Exchange Forecasts

Local Currency per U.S. Dollar (averages)

	Actual 2019 Feb	Forecasts 2019 Mar	Apr	May	2019 Q2	Q3	Q4	2020 Q1	Q2	Q3	Q4
Canadian Dollar											
C$ per US$	1.321	1.340	1.338	1.337	1.337	1.332	1.327	1.321	1.315	1.308	1.302
US$ per C$	0.757	0.746	0.747	0.748	0.748	0.751	0.754	0.757	0.761	0.764	0.768
Trade-weighted	95.3	94.2	94.2	94.3	94.3	94.5	94.7	95.0	95.4	95.7	96.0
U.S. Dollar											
Trade-weighted[1]	126.8	127.5	127.3	127.1	127.1	126.5	125.9	125.4	125.0	124.5	124.1
European Currencies											
Euro[2]	1.13	1.12	1.13	1.13	1.13	1.14	1.15	1.16	1.16	1.17	1.18
Danish Krone	6.58	6.55	6.55	6.55	6.55	6.50	6.50	6.45	6.40	6.35	6.35
Norwegian Krone	8.59	8.55	8.55	8.55	8.55	8.50	8.50	8.45	8.40	8.35	8.30
Swedish Krone	9.25	9.25	9.20	9.20	9.20	9.20	9.15	9.10	9.05	9.00	8.90
Swiss Franc	1.002	1.001	1.001	1.001	1.001	1.001	1.000	1.003	1.007	1.011	1.016
U.K. Pound[2]	1.30	1.30	1.31	1.32	1.32	1.32	1.31	1.31	1.32	1.33	1.35
Asian Currencies											
Chinese Yuan	6.74	6.72	6.71	6.70	6.70	6.65	6.61	6.59	6.58	6.57	6.55
Japanese Yen	110	112	112	112	112	111	111	111	110	110	109
Korean Won	1,122	1,120	1,115	1,110	1,110	1,100	1,090	1,090	1,090	1,090	1,095
Indian Rupee	71.2	71.1	71.1	71.0	71.0	70.9	70.8	70.6	70.4	70.3	70.1
Singapore Dollar	1.35	1.35	1.35	1.34	1.34	1.33	1.32	1.32	1.33	1.33	1.34
Malaysian Ringgit	4.08	4.05	4.05	4.05	4.05	4.05	4.00	3.95	3.90	3.85	3.75
Thai Baht	31.3	31.4	31.5	31.6	31.6	31.9	32.2	32.4	32.4	32.4	32.4
Philippine Peso	52.2	52.1	52.0	52.0	52.0	51.8	51.5	51.4	51.2	51.0	50.8
Taiwan Dollar	30.8	30.7	30.6	30.6	30.6	30.3	30.1	30.0	30.1	30.1	30.1
Indonesian Rupiah	14,028	14,010	13,995	13,980	13,980	13,925	13,875	13,840	13,815	13,790	13,765
Other Currencies											
Australian Dollar[2]	0.714	0.703	0.706	0.709	0.709	0.718	0.727	0.733	0.738	0.743	0.748
New Zealand Dollar[2]	0.683	0.685	0.686	0.688	0.688	0.693	0.698	0.703	0.708	0.713	0.718
Mexican Peso	19.20	19.25	19.35	19.40	19.40	19.25	18.90	18.70	18.65	18.60	18.50
Brazilian Real	3.73	3.80	3.80	3.80	3.80	3.85	3.85	3.85	3.90	3.90	3.95
Russian Ruble	65.8	65.8	65.7	65.6	65.6	65.5	65.3	64.9	64.5	64.1	63.7
South African Rand	13.8	13.9	14.0	14.0	14.0	14.2	14.4	14.6	14.7	14.8	15.0
Cross Rates											
Versus Canadian Dollar											
Euro (C$/€)	1.50	1.50	1.51	1.51	1.51	1.52	1.52	1.53	1.53	1.53	1.53
U.K. Pound (C$/£)	1.72	1.74	1.75	1.76	1.76	1.76	1.73	1.73	1.74	1.74	1.75
Japanese Yen (¥/C$)	84	84	84	84	84	84	84	84	84	84	84
Australian Dollar (C$/A$)	0.94	0.94	0.94	0.95	0.95	0.96	0.96	0.97	0.97	0.97	0.97
Versus Euro											
U.K. Pound (£/€)	0.87	0.86	0.86	0.86	0.86	0.87	0.88	0.88	0.88	0.88	0.87
Japanese Yen (¥/€)	125	125	126	127	127	127	128	128	128	128	129

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

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Interest Rate Forecasts

Percent (averages)

	Actual 2019 Feb	Forecasts 2019 Mar	Apr	May	2019 Q2	Q3	Q4	2020 Q1	Q2	Q3	Q4
Cdn. Yield Curve											
Overnight	1.75	1.75[1]	1.75	1.75	1.75	1.75	2.00	2.00	2.00	2.00	2.00
3 month	1.67	1.65	1.65	1.65	1.65	1.65	1.85	1.95	1.95	1.95	1.95
6 month	1.74	1.70	1.70	1.70	1.70	1.75	1.95	2.00	2.00	2.00	2.00
1 year	1.81	1.75	1.75	1.75	1.75	1.85	1.95	2.00	2.00	2.00	2.00
2 year	1.79	1.70	1.75	1.75	1.75	1.90	2.00	2.05	2.00	2.00	1.95
3 year	1.80	1.70	1.75	1.75	1.75	1.90	2.00	2.05	2.00	2.00	1.95
5 year	1.81	1.70	1.75	1.80	1.80	1.90	2.00	2.05	2.00	2.00	1.95
7 year	1.85	1.75	1.80	1.80	1.80	1.90	2.05	2.05	2.00	2.00	1.95
10 year	1.91	1.85	1.85	1.90	1.90	2.00	2.05	2.05	2.05	2.00	1.95
30 year	2.16	2.10	2.15	2.20	2.20	2.25	2.35	2.35	2.30	2.25	2.25
1m BA	2.09	2.00	2.00	2.00	2.00	2.00	2.20	2.30	2.30	2.30	2.30
3m BA	2.14	2.05	2.05	2.05	2.05	2.05	2.25	2.35	2.35	2.35	2.35
6m BA	2.25	2.15	2.15	2.15	2.15	2.20	2.40	2.45	2.45	2.45	2.45
12m BA	2.43	2.35	2.35	2.40	2.40	2.45	2.60	2.65	2.65	2.65	2.60
Prime Rate	3.95	3.95	3.95	3.95	3.95	3.95	4.05	4.20	4.20	4.20	4.20
U.S. Yield Curve											
Fed funds	2.38	2.38	2.38	2.38	2.38	2.38	2.63	2.63	2.63	2.63	2.63
3 month	2.44	2.45	2.45	2.45	2.45	2.45	2.65	2.70	2.70	2.65	2.65
6 month	2.50	2.55	2.55	2.55	2.55	2.55	2.70	2.75	2.70	2.70	2.65
1 year	2.55	2.55	2.55	2.55	2.55	2.65	2.75	2.75	2.75	2.70	2.65
2 year	2.50	2.50	2.55	2.60	2.60	2.70	2.80	2.80	2.75	2.70	2.65
3 year	2.48	2.50	2.55	2.55	2.55	2.65	2.75	2.80	2.75	2.70	2.65
5 year	2.49	2.50	2.55	2.55	2.55	2.65	2.75	2.80	2.75	2.70	2.65
7 year	2.57	2.60	2.60	2.65	2.65	2.75	2.80	2.80	2.75	2.70	2.65
10 year	2.68	2.70	2.70	2.75	2.75	2.80	2.85	2.80	2.75	2.70	2.65
30 year	3.02	3.05	3.10	3.10	3.10	3.15	3.20	3.20	3.15	3.05	3.00
1m LIBOR	2.49	2.50	2.50	2.50	2.50	2.50	2.70	2.80	2.80	2.80	2.80
3m LIBOR	2.68	2.60	2.60	2.60	2.60	2.60	2.80	2.90	2.90	2.90	2.90
6m LIBOR	2.74	2.70	2.70	2.70	2.70	2.70	2.90	3.00	3.00	3.00	3.00
12m LIBOR	2.91	2.90	2.90	2.90	2.90	2.95	3.10	3.20	3.20	3.20	3.20
Prime Rate	5.50	5.50	5.50	5.50	5.50	5.50	5.60	5.75	5.75	5.75	5.75
Other G7 Yields											
ECB Refi	0.00	0.00[1]	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
10yr Bund	0.13	0.15	0.15	0.15	0.15	0.15	0.20	0.25	0.20	0.15	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	1.20	1.20	1.20	1.20	1.20	1.20	1.25	1.30	1.30	1.30	1.30
BoJ O/N	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05
10yr JGB	-0.03	-0.02	-0.02	-0.01	-0.01	0.00	0.02	0.05	0.05	0.05	0.05

Policy rates are end of period; [1] actual value for March 2019