Rates Scenario

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An outlook on key interest and foreign exchange rates

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Forecast Summary (averages)

	Actual	Forecasts									
	2019	2019				2019		2020			
	Mar	Apr	May	Jun	Jul	Q3	Q4	Q1	Q2	Q3	Q4
BoC overnight	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
10-yr Canadas	1.71	1.70	1.70	1.75	1.75	1.80	1.85	1.85	1.80	1.75	1.70
Fed funds	2.38	2.38	2.38	2.38	2.38	2.38	2.38	2.38	2.38	2.38	2.38
10-yr Treasuries	2.57	2.50	2.50	2.55	2.55	2.55	2.60	2.60	2.50	2.45	2.40
C$ per US$	1.337	1.336	1.334	1.333	1.332	1.330	1.326	1.321	1.315	1.308	1.302
US$/€	1.13	1.13	1.13	1.13	1.13	1.14	1.14	1.15	1.16	1.16	1.17
US$/£	1.32	1.31	1.31	1.31	1.31	1.31	1.30	1.31	1.32	1.33	1.34
MXN/US$	19.24	19.20	19.35	19.50	19.40	19.25	18.90	18.70	18.65	18.60	18.50
¥/US$	111	111	111	111	111	111	110	110	110	109	109

Policy rates are end of period

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

- Our **Federal Reserve** and **Bank of Canada** calls have changed. The one rate hike we were projecting at year-end on both sides of the border has been pulled. Policy rates now remain at current levels indefinitely, with the fed funds target range at 2.25%-to-2.50% (2.375% midpoint) and the BoC's overnight target at 1.75%.

- The **FOMC's** policy pivot in January (becoming *"patient"*) and subsequent pared rate-hike expectations (March's Summary of Economic Projections sported a median forecast for no rate hikes in 2019, down from two in December) reflected the reaction to *"global economic and financial developments"* and *"muted inflation pressures"*. We now judge that neither of these two factors will evolve in a manner that will compel the Fed to raise rates.

- Although U.S. and global financial conditions have improved meaningfully since late last year (e.g., the S&P 500 is up about 23% from its Christmas Eve low), the key risks to the global economic outlook have not subsided commensurately. Recall, these risks, along with signs of slowing global growth on the ground, were catalysts for the equity market sell-off in the first place. Although U.S./China trade talks seem to be making some progress (thus, the hike in U.S. tariffs to 25% from 10% has been postponed indefinitely), a deal could still be months away. And, a cloud of uncertainty is gathering over forthcoming formal U.S./EU trade talks given the tangible threat of U.S. automotive tariffs (a decision is expected by May 18). If global developments sour to the potential detriment of the U.S. economy and financial markets, the Fed wouldn't hesitate to ease; it has done it before.

- Core PCE inflation was 1.8% y/y in January, back at the bottom of the 1.8%-to-2.0% range it has tracked for the past 11 months. The Fed's formal target is 2.0%, but officials have indicated that they want to see inflation running slightly above 2% for a while as evidence that the target can be sustained. We are still expecting core inflation to drift up to a 2.0%-to-2.2% range, with the top hit for a few months early next year. However, we now judge that the Fed will interpret this as insufficient evidence. Indeed, if inflation fails to accelerate to at least 2.0% in the months ahead, we would not be surprised to see the Fed cut rates. It will likely take a core inflation run of at least 2.4% (which would begin pushing real policy rates negative) to get the Fed thinking about rate hikes again.

- Although the **Bank of Canada** still sports a directional bias in its forward-looking language, referring to "*future rate increases*" in the March announcement, this likely reflects the fact that policy rates are still negative in real terms. However, this doesn't preclude a Fed-comparable desire to stand pat given the substantial risks posed by higher interest rates (given a record-high household debt-to-income ratio), along with global economic headwinds and trade uncertainties. And, average core inflation has yet to stabilize at the 2.0% target. Importantly, the reasons why the Fed would cut rates would only compound these factors, and we reckon the Bank would follow the Fed in short order. Although it's not our base case, it's not unreasonable for the bond markets on both sides of the border to be betting a bit on policy rate cuts.

- Eventually, for 10-year Treasury yields, an anticipated modest re-acceleration of inflation expectations—owing to up-drifting core PCE inflation readings and firmer oil prices—along with a post-Q1 return to above-potential real GDP growth, should exert some modest net upward pressure on yields. But, not enough to push them past 2¾%, with some offsetting support coming from the Fed's end of balance sheet reduction (September) and start of net purchases of Treasuries to replace redeeming MBS. We judge Canada/US longer-term yield spreads are likely to become a little less negative as the year unfolds, but stay well shy of the current overnight spread (-62½ bps). This reflects America's much worse fiscal dynamics as well as Canada's poorer economic competiveness (that should result in market expectations of a perennially more-cautious-than-Fed monetary policy stance).

- The **Canadian dollar** has traded in a tight range so far this year as a more dovish Bank of Canada has countered a hearty rebound in oil prices. Indeed, the trade backdrop (record deficit, USMCA and broader trade uncertainty), soft underlying growth, and tempered growth expectations are all consistent with a softer loonie, and explain the lack of movement despite oil prices pushing above $60. Historically, the US$ has been the biggest driver of the C$; and, given our subdued outlook for the greenback, it's difficult to weaken the Canuck buck outside of the recent range despite all of the headwinds noted above. We're looking for more of the same for the loonie until the big dollar shows some momentum either way.

- The 'patient' stance taken by the Fed and the BoC has also been adopted in various forms elsewhere. The **BoE**, at its March 21 meeting, stuck to the view that, if the economy were to develop "*broadly in line*" with their projections, then it will tighten gradually but to a "*limited extent*". However, **Brexit** is the big wild card, and the central bank stated that uncertainties have "*intensified*" and that the "*cumulative effect*" on investment has risen. Since that meeting, these uncertainties have grown and intensified further. Indeed, Brexit Day is a moving target, with the original March 29 date moved to April 12, possibly May 22; and now, maybe June 30, if PM May's request is granted. The new discussions between PM May and the Labour Party have stoked talk of a customs union, but there is no guarantee that Labour will support the current government and that Brussels will even accept a customs union. Even if the opposition supports the government, introducing a customs union into the deal will require more negotiations and time, which means a longer extension, and forces the U.K. to participate in the European Parliamentary elections in May. How Brexit ultimately plays out will determine the BoE's next step. But, for now, Governor Carney will stay on the sidelines and could very well pass the decision on monetary policy to his successor, as his term ends in January 2020.

- The **ECB** is likely wishing that it could turn back time. In the weeks just before ending asset purchases last December, the Euro Area economy began to slow at a faster pace and there has been little let-up since. The central bank introduced a new round of cheap financing (TLTRO-III) last month, and will likely revise its forward rates guidance in June, and drop the calendar-based reference. Meantime, policymakers are concerned about the high degree of uncertainty facing the region, due to trade tensions between the U.S. and China, along with the U.S. and the EU. Brexit is another big source of uncertainty, as well as the Euro Area's economic slowdown. The next monetary policy meeting will be held on April 10, the same day as the EU emergency summit and just before the G20 meeting of central bankers and finance ministers. No changes are expected, but President Draghi's tone and responses to some tough questions during the press conference will be scrutinized. Like Mark Carney, the next ECB move will quite likely be under a different president, as Mario Draghi's term ends in October.

Foreign Exchange Forecasts

Local Currency per U.S. Dollar (averages)

	Actual 2019 Mar	Forecasts 2019 Apr	May	Jun	Jul	2019 Q3	Q4	2020 Q1	Q2	Q3	Q4
Canadian Dollar											
C$ per US$	1.337	1.336	1.334	1.333	1.332	1.330	1.326	1.321	1.315	1.308	1.302
US$ per C$	0.748	0.749	0.749	0.750	0.751	0.752	0.754	0.757	0.761	0.764	0.768
Trade-weighted	94.2	94.3	94.4	94.5	94.6	94.6	94.8	95.0	95.4	95.8	96.1
U.S. Dollar											
Trade-weighted[1]	127.2	127.3	127.2	127.2	127.0	126.7	125.9	125.4	125.1	124.7	124.4
European Currencies											
Euro[2]	1.13	1.13	1.13	1.13	1.13	1.14	1.14	1.15	1.16	1.16	1.17
Danish Krone	6.61	6.65	6.65	6.60	6.60	6.60	6.50	6.50	6.45	6.40	6.40
Norwegian Krone	8.61	8.60	8.60	8.60	8.55	8.55	8.55	8.50	8.45	8.40	8.35
Swedish Krone	9.29	9.30	9.25	9.25	9.25	9.20	9.20	9.15	9.10	9.05	9.00
Swiss Franc	1.001	0.999	1.000	1.000	1.001	1.002	1.004	1.008	1.013	1.019	1.024
U.K. Pound[2]	1.32	1.31	1.31	1.31	1.31	1.31	1.30	1.31	1.32	1.33	1.34
Asian Currencies											
Chinese Yuan	6.71	6.70	6.69	6.67	6.66	6.65	6.61	6.59	6.58	6.57	6.55
Japanese Yen	111	111	111	111	111	111	110	110	110	109	109
Korean Won	1,132	1,135	1,130	1,125	1,120	1,115	1,095	1,090	1,090	1,090	1,095
Indian Rupee	69.5	69.5	69.7	69.8	70.0	70.1	70.6	70.6	70.4	70.3	70.1
Singapore Dollar	1.35	1.35	1.35	1.34	1.34	1.34	1.32	1.32	1.33	1.33	1.34
Malaysian Ringgit	4.08	4.10	4.10	4.10	4.05	4.05	4.00	3.95	3.90	3.85	3.75
Thai Baht	31.7	31.8	31.9	31.9	32.0	32.1	32.3	32.4	32.4	32.4	32.4
Philippine Peso	52.5	52.4	52.3	52.2	52.1	51.9	51.6	51.4	51.2	51.0	50.8
Taiwan Dollar	30.9	30.8	30.7	30.6	30.5	30.4	30.1	30.0	30.1	30.1	30.1
Indonesian Rupiah	14,197	14,185	14,145	14,105	14,065	14,025	13,900	13,840	13,815	13,790	13,765
Other Currencies											
Australian Dollar[2]	0.708	0.711	0.713	0.715	0.718	0.720	0.728	0.733	0.738	0.743	0.748
New Zealand Dollar[2]	0.684	0.676	0.679	0.682	0.685	0.688	0.697	0.703	0.708	0.713	0.718
Mexican Peso	19.24	19.20	19.35	19.50	19.40	19.25	18.90	18.70	18.65	18.60	18.50
Brazilian Real	3.84	3.85	3.85	3.85	3.85	3.85	3.85	3.85	3.90	3.90	3.95
Russian Ruble	65.2	65.2	65.2	65.3	65.3	65.3	65.5	65.3	64.9	64.6	64.2
South African Rand	14.4	14.2	14.2	14.2	14.3	14.3	14.5	14.6	14.7	14.8	15.0
Cross Rates											
Versus Canadian Dollar											
Euro (C$/€)	1.51	1.50	1.50	1.51	1.51	1.51	1.52	1.52	1.52	1.52	1.52
U.K. Pound (C$/£)	1.76	1.76	1.75	1.75	1.74	1.74	1.73	1.73	1.73	1.74	1.74
Japanese Yen (¥/C$)	83	83	83	83	83	83	83	83	83	84	84
Australian Dollar (C$/A$)	0.95	0.95	0.95	0.95	0.96	0.96	0.97	0.97	0.97	0.97	0.97
Versus Euro											
U.K. Pound (£/€)	0.86	0.86	0.86	0.86	0.87	0.87	0.88	0.88	0.88	0.88	0.87
Japanese Yen (¥/€)	126	125	125	125	125	125	126	126	127	127	127

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

Interest Rate Forecasts

Percent (averages)

	Actual 2019 Mar	Forecasts 2019 Apr	May	Jun	Jul	2019 Q3	Q4	2020 Q1	Q2	Q3	Q4
Cdn. Yield Curve											
Overnight	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
3 month	1.65	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	1.68	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.75	1.75	1.75
2 year	1.62	1.60	1.60	1.60	1.60	1.60	1.65	1.65	1.65	1.70	1.70
3 year	1.62	1.60	1.60	1.60	1.60	1.60	1.65	1.65	1.65	1.70	1.70
5 year	1.60	1.55	1.60	1.60	1.60	1.60	1.65	1.65	1.65	1.70	1.70
7 year	1.64	1.60	1.60	1.60	1.65	1.65	1.65	1.70	1.70	1.70	1.70
10 year	1.71	1.70	1.70	1.75	1.75	1.80	1.85	1.85	1.80	1.75	1.70
30 year	2.01	1.95	2.00	2.00	2.05	2.05	2.15	2.10	2.10	2.05	2.00
1m BA	1.98	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00
3m BA	2.04	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00
6m BA	2.12	2.10	2.10	2.10	2.10	2.10	2.10	2.10	2.10	2.10	2.10
12m BA	2.28	2.25	2.25	2.25	2.25	2.25	2.25	2.30	2.30	2.30	2.30
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	2.38	2.38	2.38	2.38	2.38	2.38	2.38	2.38	2.38	2.38
3 month	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.40	2.40	2.40
6 month	2.51	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.40	2.40	2.40
1 year	2.49	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.40	2.40
2 year	2.41	2.35	2.35	2.40	2.40	2.40	2.50	2.50	2.45	2.40	2.40
3 year	2.37	2.30	2.35	2.35	2.40	2.40	2.50	2.50	2.45	2.45	2.40
5 year	2.37	2.30	2.35	2.35	2.40	2.45	2.55	2.55	2.50	2.45	2.40
7 year	2.47	2.40	2.40	2.45	2.45	2.50	2.55	2.55	2.50	2.45	2.40
10 year	2.57	2.50	2.50	2.55	2.55	2.55	2.60	2.60	2.50	2.45	2.40
30 year	2.98	2.90	2.90	2.95	2.95	2.95	3.00	3.00	2.95	2.85	2.80
1m LIBOR	2.49	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.45
3m LIBOR	2.61	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60
6m LIBOR	2.67	2.65	2.65	2.65	2.65	2.65	2.65	2.65	2.65	2.65	2.65
12m LIBOR	2.82	2.75	2.75	2.75	2.75	2.80	2.80	2.80	2.80	2.80	2.80
Prime Rate	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.50
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	0.05	0.00	0.00	0.00	0.00	0.00	0.00	0.00	-0.05	-0.10	-0.10
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	1.14	1.10	1.10	1.10	1.10	1.10	1.10	1.10	1.10	1.10	1.10
BoJ O/N	-0.06	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05
10yr JGB	-0.04	-0.07	-0.06	-0.04	-0.03	-0.01	0.04	0.05	0.05	0.05	0.05

Policy rates are end of period