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## Forecast Summary (averages)

	Actual	Forecasts					2019	2020	Q2	Q3	Q4
	2019	2019									
	May	Jun	Jul	Aug	Sep	Oct	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	1.66	1.45	1.45	1.45	1.45	1.45	1.40	1.45	1.45	1.45	1.50
Fed funds	2.38	2.38	2.13	2.13	2.13	1.88	1.88	1.88	1.88	1.88	1.88
10-yr Treasuries	2.40	2.10	2.10	2.05	2.05	2.05	2.00	2.00	2.05	2.10	2.10
C\$ per US\$	1.346	1.342	1.339	1.335	1.331	1.327	1.324	1.317	1.312	1.307	1.302
US\$/€	1.12	1.13	1.13	1.13	1.13	1.12	1.12	1.12	1.13	1.13	1.14
US\$/£	1.28	1.27	1.25	1.23	1.24	1.24	1.25	1.26	1.27	1.28	1.30
MXN/US\$	19.11	19.40	19.45	19.45	19.50	19.55	19.55	19.40	19.15	18.85	18.60
¥/US\$	110	107	107	107	108	108	108	108	108	109	109

Policy rates are end of period

## Since the previous issue of Rates Scenario (on May 13<sup>th</sup>):

- **We have cut our Fed forecast, and now look for two rate reductions in 2019H2, but continue to expect no change in Bank of Canada policy this year and next.** The near-term risks surrounding the growth outlook are still skewed to the downside.
- Last month's escalation of the U.S./China trade war was a tipping point for the U.S. economic outlook, shifting our growth forecast from a slightly above-potential track to a slightly below-potential profile. It also tilted the risks surrounding the outlook to the downside, by lifting the odds of additional tit-for-tat actions with China and a broadening of America's trade war to cover non-North American automotive imports (probably eliciting retaliation from the likes of the EU and Japan). The escalation also appears to have emboldened the Administration to employ tariffs as a tool for something other than trade policy, in the case of illegal migration and the now "*indefinitely suspended*" tariffs on Mexico.
- In addition to the combination of trade-war dampened economic performance and trade-risk dimmed growth prospects, inflation was also a reason for our Fed forecast downgrade. Core PCE inflation was 1.6% y/y in April, with the shorter-term trends suggesting little upward pressure ahead. This demonstrates that the secular forces of disinflation driven by technology-enabled disruption and demographics continue to completely check the cyclical inflation pressures prodded by full employment and a positive output gap. It now seems that core inflation will be hard-pressed to top 2% anytime soon, even with the added impetus of tariffs. For a "symmetric" target, core PCE inflation has not printed above 2.1% in nearly 11 years.
- After setting the stage at next week's meeting, **we judge the FOMC will lower rates 25 bps at the July meeting**, with a **follow-up** move in **October**. The latter action 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 rapid deterioration in the U.S. economy (a key risk but not our base case), **we doubt the Bank will match the Fed**. The BoC's core inflation measures are much closer to the 2% target (averaging 1.9% y/y in April) and the 1.75% policy rate is currently negative in real terms (the Fed's is

positive). Also, having achieved a semblance of stability in the housing market with a mix of multi-jurisdictional macro-prudential policy and central bank rate hikes, we suspect the Bank will be careful about risking some of this stability with rate cuts. One wrinkle will be the **Canadian dollar**, if it appreciates too much or too quickly amid unmatched Fed moves. This could prompt the Bank to act.

- As the Fed cuts rates a couple times and the market still bets on more, we look for Treasury yields to continue declining this year, with the curve (2s10s) sporting a steepening bias. We reckon 10-year yields will remain around 2% on average (in a range of 1.85%-to-2.15%), with 2-year yields eventually running well below the fed funds target. Next year, with 10-year yields drifting up only modestly (to the top of the range) on dashed Fed rate-cut hopes, we expect the curve (2s10s) to flatten like a pancake and for the front-end inversion to disappear. The Canada curve should follow a similar theme. Although shorter-term Canada-U.S. spreads are likely to become much less negative as the Fed cuts rates, longer-term spreads should remain resilient, and close to current levels. The persistent large 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.
- Fed rate cuts should normally be negative for the U.S. dollar. But, since they are occurring amid a worsening global trade war (note that the greenback has been trending higher since January 2018 when tariffs were used as a U.S. trade policy tool for the first time in many years), along with dimming global economic prospects, they should result in only a mild downturn in the big dollar. And, in consequence, a mild upturn in the **Canadian dollar** (averaging around \$1.32 by the end of this year and \$1.30 by the end of next year). We still judge that competitiveness issues are a longer-term drag for the loonie, acting to augment shorter-term headwinds and diminish shorter-term tailwinds.
- In Europe, there is a case of two central banks with differing views of monetary policy. The **ECB** has become increasingly dovish, as the usual three factors—geopolitics, the rising threat of protectionism and vulnerabilities of emerging markets—remain firmly behind the Governing Council's view that risks to the outlook remain tilted to the downside. Although employment growth is strong, wages are rising and financing conditions are favourable, "*an ample degree of monetary accommodation is necessary*". The ECB pushed back its rate guidance in June, and now sees interest rates staying at record lows "*at least through the first half of 2020*" instead of the end of 2019. And, President Draghi opened the door to more stimulus, revealing that policymakers were engaged in a long discussion on options such as more rate cuts, restarting the asset purchase program, and a further extension of the forward guidance. The rising possibility of another cut to the deposit rate (while leaving the refi rate unchanged), along with a potential clash between Italy and Brussels, will keep a lid on the EUR, leaving it unable to break firmly above \$1.13 through year-end. Meantime, despite the new October 31<sup>st</sup> Brexit date, political uncertainty over not just Brexit but who will take over for Theresa May, and the economy's very weak start to Q2 (April GDP fell 0.4%), the **BoE** continues to warn that rate hikes could be coming sooner rather than later. Nonetheless, with slower domestic and global economic growth, it would be difficult to justify why a rate increase would be necessary. We look for the GBP to remain weak, slipping towards \$1.25 by year-end.
- The **BoJ** has not changed its monetary policy program one iota. But, it is becoming more likely that Governor Kuroda will be forced to increase monetary stimulus (or for PM Abe to increase fiscal stimulus). Yes, the economy defied expectations in Q1, but consumer spending remains weak, raising doubts over the government's commitment to go through with October's sales tax hike.

## Foreign Exchange Forecasts

Local Currency per U.S. Dollar (averages)

	Actual	Forecasts					2019	2020	2020	2020	2020
	2019	2019	2019	2019	2019	2019					
	May	Jun	Jul	Aug	Sep	Oct	Q4	Q1	Q2	Q3	Q4
<b>Canadian Dollar</b>											
C\$ per US\$	1.346	1.342	1.339	1.335	1.331	1.327	1.324	1.317	1.312	1.307	1.302
US\$ per C\$	0.743	0.745	0.747	0.749	0.751	0.753	0.755	0.759	0.762	0.765	0.768
Trade-weighted	93.7	93.9	94.2	94.5	94.8	95.1	95.4	95.9	96.1	96.4	96.6
<b>U.S. Dollar</b>											
Trade-weighted <sup>1</sup>	128.7	128.6	128.9	129.2	129.4	129.6	129.9	129.7	129.0	128.4	127.8
<b>European Currencies</b>											
Euro <sup>2</sup>	1.12	1.13	1.13	1.13	1.13	1.12	1.12	1.12	1.13	1.13	1.14
Danish Krone	6.67	6.65	6.65	6.65	6.65	6.65	6.65	6.65	6.60	6.55	6.55
Norwegian Krone	8.74	8.65	8.65	8.70	8.70	8.70	8.75	8.70	8.65	8.60	8.55
Swedish Krone	9.59	9.45	9.50	9.55	9.55	9.60	9.65	9.65	9.55	9.45	9.35
Swiss Franc	1.010	1.000	0.998	0.997	0.995	0.993	0.992	0.992	0.994	0.997	0.999
U.K. Pound <sup>2</sup>	1.28	1.27	1.25	1.23	1.24	1.24	1.25	1.26	1.27	1.28	1.30
<b>Asian Currencies</b>											
Chinese Yuan	6.85	6.90	6.92	6.93	6.95	6.97	6.98	6.98	6.96	6.93	6.91
Japanese Yen	110	107	107	107	108	108	108	108	108	109	109
Korean Won	1,183	1,185	1,185	1,190	1,190	1,195	1,195	1,195	1,185	1,180	1,175
Indian Rupee	69.8	69.5	70.1	70.6	71.2	71.7	72.3	72.5	71.9	71.4	70.9
Singapore Dollar	1.37	1.37	1.38	1.38	1.39	1.39	1.40	1.40	1.40	1.40	1.39
Malaysian Ringgit	4.17	4.20	4.20	4.20	4.20	4.20	4.25	4.20	4.10	4.05	3.95
Thai Baht	31.8	31.4	31.5	31.6	31.8	31.9	32.1	32.2	32.3	32.4	32.4
Philippine Peso	52.2	51.9	52.1	52.4	52.7	53.0	53.3	53.3	52.8	52.4	51.9
Taiwan Dollar	31.2	31.4	31.5	31.6	31.6	31.7	31.8	31.8	31.8	31.8	31.7
Indonesian Rupiah	14,374	14,270	14,335	14,400	14,470	14,535	14,600	14,615	14,535	14,455	14,380
<b>Other Currencies</b>											
Australian Dollar <sup>2</sup>	0.694	0.695	0.693	0.690	0.688	0.685	0.683	0.683	0.688	0.693	0.698
New Zealand Dollar <sup>2</sup>	0.656	0.660	0.657	0.653	0.650	0.647	0.643	0.643	0.648	0.653	0.658
Mexican Peso	19.11	19.40	19.45	19.45	19.50	19.55	19.55	19.40	19.15	18.85	18.60
Brazilian Real	3.99	3.85	3.90	3.90	3.95	4.00	4.00	4.05	4.05	4.00	4.00
Russian Ruble	64.9	65.0	65.3	65.7	66.0	66.3	66.6	66.8	66.5	66.2	65.9
South African Rand	14.4	14.8	14.7	14.6	14.5	14.4	14.3	14.2	14.1	14.1	14.0
<b>Cross Rates</b>											
<b>Versus Canadian Dollar</b>											
Euro (C\$/€)	1.51	1.52	1.51	1.50	1.50	1.49	1.48	1.48	1.48	1.48	1.48
U.K. Pound (C\$/£)	1.73	1.70	1.67	1.64	1.64	1.65	1.65	1.66	1.67	1.68	1.69
Japanese Yen (¥/C\$)	82	80	80	80	81	81	81	82	83	83	84
Australian Dollar (C\$/A\$)	0.93	0.93	0.93	0.92	0.92	0.91	0.90	0.90	0.90	0.91	0.91
<b>Versus Euro</b>											
U.K. Pound (£/€)	0.87	0.89	0.90	0.92	0.91	0.91	0.90	0.89	0.89	0.88	0.88
Japanese Yen (¥/€)	123	121	121	121	121	121	121	122	122	123	124

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

## Interest Rate Forecasts

Percent (averages)

	Actual	Forecasts					2019	2020	Q2	Q3	Q4
	2019 May	2019 Jun	Jul	Aug	Sep	Oct					
<b>Cdn. Yield Curve</b>											
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	1.68	1.65	1.65	1.65	1.65	1.65	1.65	1.65	1.65	1.65	1.65
6 month	1.71	1.65	1.65	1.65	1.65	1.65	1.65	1.65	1.65	1.65	1.65
1 year	1.72	1.65	1.65	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.65
2 year	1.58	1.40	1.35	1.35	1.30	1.30	1.25	1.30	1.40	1.50	1.60
3 year	1.57	1.35	1.35	1.35	1.30	1.30	1.30	1.35	1.40	1.50	1.60
5 year	1.54	1.35	1.35	1.35	1.35	1.35	1.35	1.35	1.40	1.50	1.55
7 year	1.58	1.35	1.35	1.35	1.35	1.35	1.35	1.40	1.45	1.50	1.50
10 year	1.66	1.45	1.45	1.45	1.45	1.45	1.40	1.45	1.45	1.45	1.50
30 year	1.91	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.75	1.80	1.85
1m BA	1.98	1.95	1.95	1.95	1.95	1.95	1.95	2.00	2.00	2.00	2.00
3m BA	2.01	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00
6m BA	2.08	2.00	2.00	2.00	2.00	2.00	2.00	2.05	2.05	2.05	2.05
12m BA	2.22	2.10	2.10	2.10	2.10	2.05	2.05	2.05	2.10	2.10	2.10
Prime Rate	3.95	3.95	3.95	3.95	3.95	3.95	3.95	3.95	3.95	3.95	3.95
<b>U.S. Yield Curve</b>											
Fed funds	2.38	2.38	2.13	2.13	2.13	1.88	1.88	1.88	1.88	1.88	1.88
3 month	2.40	2.30	2.20	2.10	2.05	1.95	1.85	1.80	1.85	1.90	1.90
6 month	2.42	2.15	2.10	2.05	1.95	1.90	1.85	1.80	1.85	1.90	1.95
1 year	2.34	2.00	1.95	1.90	1.85	1.80	1.75	1.80	1.85	1.95	2.05
2 year	2.21	1.85	1.80	1.80	1.75	1.70	1.65	1.70	1.85	1.95	2.10
3 year	2.16	1.80	1.80	1.80	1.75	1.75	1.75	1.80	1.90	2.00	2.10
5 year	2.19	1.85	1.85	1.85	1.85	1.85	1.80	1.85	1.95	2.00	2.10
7 year	2.29	1.95	1.95	1.95	1.95	1.95	1.90	1.95	2.00	2.05	2.10
10 year	2.40	2.10	2.10	2.05	2.05	2.05	2.00	2.00	2.05	2.10	2.10
30 year	2.82	2.60	2.55	2.55	2.55	2.50	2.50	2.50	2.55	2.55	2.60
1m LIBOR	2.44	2.40	2.15	2.15	2.15	1.90	1.90	1.95	1.95	2.00	2.00
3m LIBOR	2.53	2.45	2.35	2.30	2.20	2.10	2.05	2.00	2.05	2.10	2.15
6m LIBOR	2.57	2.40	2.30	2.25	2.15	2.10	2.05	2.00	2.10	2.20	2.25
12m LIBOR	2.65	2.35	2.30	2.25	2.20	2.15	2.15	2.15	2.30	2.40	2.50
Prime Rate	5.50	5.50	5.25	5.25	5.25	5.00	5.00	5.00	5.00	5.00	5.00
<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	0.00	0.00
10yr Bund	-0.08	-0.15	-0.25	-0.30	-0.40	-0.45	-0.55	-0.55	-0.45	-0.35	-0.25
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	1.06	0.95	0.90	0.80	0.70	0.60	0.55	0.50	0.60	0.70	0.80
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	-0.06	-0.05	-0.05	-0.04	-0.04	-0.03	-0.02	0.00	0.00	0.00	0.00

Policy rates are end of period; <sup>1</sup> actual value for June 2019

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