

Rates Scenario for November 5, 2019

A Publication of BMO Capital Markets Economic Research · Douglas Porter, CFA, Chief Economist, BMO Financial Group

Forecast Summary

	Actual	Forecasts							2020		
	2019 Oct	2019 Nov	2019 Dec	2020 Jan	2020 Feb	2020 Mar	2020 Apr	2020 May	2020 Q2	2020 Q3	2020 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	1.45	1.55	1.55	1.55	1.55	1.55	1.60	1.60	1.60	1.65	1.65
Fed funds	1.63	1.63	1.63	1.63	1.63	1.63	1.63	1.63	1.63	1.63	1.63
10-yr Treasuries	1.71	1.80	1.80	1.80	1.80	1.85	1.85	1.90	1.90	1.95	2.00
C\$ per US\$	1.319	1.320	1.330	1.328	1.325	1.323	1.320	1.318	1.318	1.310	1.303
US\$/€	1.11	1.10	1.09	1.09	1.09	1.10	1.10	1.10	1.10	1.10	1.11
US\$/£	1.27	1.28	1.30	1.29	1.29	1.28	1.28	1.27	1.27	1.26	1.25
MXN/US\$	19.32	19.20	19.30	19.25	19.20	19.15	19.10	19.05	19.05	18.95	18.80
¥/US\$	108	109	109	109	108	108	108	107	107	106	105

(policy rates are end of period; averages otherwise)

Sources: BMO Economics, Haver Analytics

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Since the previous issue of Rates Scenario (on September 20):

- Our base case remains no change in either Federal Reserve or Bank of Canada policy rates from November levels (1.625% midpoint of fed funds target range, 1.75% BoC overnight target) through at least the end of next year. Compared to our previous projection (Sept. 20), the BoC profile is 25 bps higher as we had pulled our prior rate-cut call early in the interim period. However, **the net risk for both central banks is for lower policy rates.**
- The **FOMC** cut rates by 25 bps for a third consecutive meeting on October 30. The policy statement's language was changed to suggest that a December 11 cut or a move in subsequent months was less likely. The key passage was that the Fed would "continue to monitor the implications of incoming information for the economic outlook as it assesses the appropriate path of the target range for the federal funds rate." Gone was the "act as appropriate" phrase which was used in the policy statements for the meetings that came immediately before each of the past three cuts. Chair Powell said there would have to be a "material reassessment of the outlook" for the Fed to cut rates again.
- Some called this a "hawkish cut". However, markets were still buoyed by the fact that the prospects for an eventual rate hike were also dimmed. The latter concern has lingered ever since Chair Powell referred to current rate cuts as a 1990's-style "mid-cycle adjustment" in which rate reductions were eventually reversed. However, Powell also said the Fed "would need to see a really significant move up in inflation that's persistent before we even consider raising rates." The words "really significant" and "persistent" are key, since the cycle peak for core PCE inflation is only 2.1%. And, we've touched it just six times (Dec. 2011-Mar. 2012, May & July 2018) and never gone above it. Indeed, 82% of the time since the end of the recession, it's run under 1.9%. This, combined with the fact that core inflation actually fell a tenth to 1.7% in September, argues that rate hikes are a very low probability scenario for the next year or two.

- As such, **we look for a long policy pause ahead**, laced with net downside risks, including U.S./China trade talks faltering (again), the global trade war escalating (again), or weakness in manufacturing caused by a deterioration in the capex-exports complex spreading to other parts of the economy—particularly jobs and consumer spending.
- The **Bank of Canada** left its policy rate unchanged for the eighth straight meeting on October 30, which was mostly expected, but there was a sense that it was closer to a rate cut than it had been previously. Against the background of ongoing trade policy uncertainty (arguably less intense than the last meeting), the statement said: *“In considering the appropriate path for monetary policy, the Bank will be monitoring the extent to which the global slowdown spreads beyond manufacturing and investment.”* But, this wasn’t flagging an imminent rate reduction, as the Bank will also *“pay close attention to the sources of resilience in the Canadian economy – notably consumer spending and housing activity – as well as to fiscal policy developments.”* On the latter point, post-election federal fiscal policy appears poised to become more stimulative.
- So, we have a battle between opposite economic risks, and the side that gets the edge will dictate the next policy step (acknowledging the bar to cut rates is meaningfully lower than the one to hike them). Governor Poloz said the Bank *“considered whether the downside risks to the Canadian economy were sufficient at this time to warrant a more accommodative monetary policy as a form of insurance against those risks, and we concluded that they were not.”* We judge the mere consideration of an insurance move suggests the Bank was/is closer to cutting rates than before. Looking ahead, while we expect the Bank to remain on hold indefinitely, if the downside risks mount or the Fed cuts rates for a fourth time, it will likely reduce rates as well.
- We still look for a mildly rising bond yield trend, with both the Fed and BoC not expected to move through 2020. And, on both sides of the border, there will be bigger federal budget deficits to finance. Meanwhile, inflation should drift slightly higher. For the most part, we judge Canada-U.S. bond yield spreads should stay relatively stable, having already moved much less negative.
- With Bank of Canada and Fed policies now more in sync, we look for the **Canadian dollar** to trade around current levels, in the \$1.32-to-\$1.33 range. Competitiveness issues remain a longer-term drag for the currency.
- It is a new era in **Europe**, with Christine Lagarde at the helm of the ECB. She inherited a weaker Euro Area economy, weighed down by the uncertainties caused by the global trade war and, now, the prospect of U.S. tariffs on European car imports. To deal with this headache, Mario Draghi's parting gift was a large package of easing measures including the return of asset purchases (€20 bln each month starting now), a lower deposit rate, and forward guidance that is not calendar dependent. President Lagarde is not expected to stray from that path, but she has already called out countries with *“chronic fiscal surpluses like the Netherlands and Germany”* to step up and help with the current imbalances. That likely did not go over well; and, there is already unrest within the Governing Council over Mr. Draghi's easing moves. But if Germany has, indeed, lapsed into a technical recession, the Bundestag may have no choice but to be more flexible with its balanced budget rule.
- The **Bank of England** has some breathing room with Brexit now delayed until January 31, 2020. Everything is on hold until the December 12 election and anything can happen on that front. Although PM Johnson could win a majority if the current polls are correct, there is a lot of behind-the-scenes deal-making going on, including a rumoured pact between a few pro-EU parties and a big fight from Nigel Farage's Brexit Party unless the British leader ditches his current deal with the EU. The uncertainty will drag on but the declining possibility of a hard Brexit has given the GBP a needed near-term boost.
- The **Bank of Japan** continues to cry wolf, warning that it will ease *“without hesitation”* if it finds itself straying too far from the 2% inflation target. However, the massive easing program has done little for inflation and only time will tell if the sales-tax hike had a lasting impact.

Foreign Exchange Forecasts

	Actual	Forecasts							2020		
	2019 Oct	2019 Nov	Dec	2020 Jan	Feb	Mar	Apr	May	Q2	Q3	Q4
Canadian Dollar											
C\$ per US\$	1.319	1.320	1.330	1.328	1.325	1.323	1.320	1.318	1.318	1.310	1.303
US\$ per C\$	0.758	0.758	0.752	0.753	0.755	0.756	0.758	0.759	0.759	0.763	0.768
Trade-weighted	95.9	95.8	95.1	95.3	95.5	95.7	95.8	96.0	96.0	96.4	96.8
U.S. Dollar											
Trade-weighted ¹	130.2	129.9	130.1	130.3	130.4	130.6	130.5	130.4	130.4	130.1	129.6
European Currencies											
Euro ²	1.11	1.10	1.09	1.09	1.09	1.10	1.10	1.10	1.10	1.10	1.11
Danish Krone	6.76	6.70	6.85	6.80	6.80	6.80	6.80	6.80	6.80	6.75	6.70
Norwegian Krone	9.15	9.15	9.05	9.00	9.00	8.95	8.95	8.95	8.95	8.85	8.80
Swedish Krone	9.77	9.65	9.80	9.80	9.80	9.75	9.75	9.70	9.70	9.65	9.60
Swiss Franc	0.993	0.987	0.980	0.982	0.983	0.985	0.987	0.988	0.988	0.993	0.998
U.K. Pound ²	1.27	1.28	1.30	1.29	1.29	1.28	1.28	1.27	1.27	1.26	1.25
Asian Currencies											
Chinese Yuan	7.09	7.07	7.05	7.10	7.15	7.20	7.20	7.20	7.20	7.17	7.08
Japanese Yen	108	109	109	109	108	108	108	107	107	106	105
Korean Won	1,184	1,155	1,165	1,165	1,170	1,175	1,175	1,180	1,180	1,190	1,200
Indian Rupee	71.0	70.9	70.8	70.9	71.0	71.1	71.2	71.3	71.3	71.6	71.9
Singapore Dollar	1.37	1.35	1.37	1.37	1.38	1.38	1.39	1.39	1.39	1.41	1.42
Malaysian Ringgit	4.19	4.15	4.15	4.15	4.15	4.15	4.15	4.15	4.15	4.15	4.15
Thai Baht	30.3	30.3	30.3	30.4	30.6	30.7	30.8	30.9	30.9	31.3	31.6
Philippine Peso	51.4	50.5	50.8	50.8	50.9	50.9	51.0	51.1	51.1	51.2	51.4
Taiwan Dollar	30.7	30.5	30.7	30.8	31.0	31.1	31.3	31.4	31.4	31.8	32.3
Indonesian Rupiah	14,112	14,000	14,030	14,035	14,040	14,045	14,055	14,060	14,060	14,075	14,095
Other Currencies											
Australian Dollar ²	0.680	0.685	0.690	0.693	0.695	0.698	0.700	0.703	0.703	0.710	0.718
New Zealand Dollar ²	0.634	0.640	0.640	0.641	0.642	0.643	0.643	0.644	0.644	0.647	0.649
Mexican Peso	19.32	19.20	19.30	19.25	19.20	19.15	19.10	19.05	19.05	18.95	18.80
Brazilian Real	4.08	4.00	3.95	3.95	3.95	3.95	3.95	3.95	3.95	4.00	4.00
Russian Ruble	64.3	64.0	64.2	64.5	64.8	65.1	65.3	65.6	65.6	66.5	67.3
South African Rand	14.9	14.9	14.5	14.5	14.5	14.5	14.5	14.5	14.5	14.5	14.5
Cross Rates											
Versus Canadian Dollar											
Euro (C\$/€)	1.46	1.45	1.45	1.45	1.45	1.45	1.45	1.45	1.45	1.45	1.44
U.K. Pound (C\$/£)	1.67	1.69	1.73	1.72	1.70	1.69	1.69	1.68	1.68	1.65	1.63
Japanese Yen (¥/C\$)	82	82	82	82	82	82	82	81	81	81	81
Australian Dollar (C\$/A\$)	0.90	0.90	0.92	0.92	0.92	0.92	0.92	0.93	0.93	0.93	0.93
Versus Euro											
U.K. Pound (£/€)	0.87	0.86	0.84	0.84	0.85	0.86	0.86	0.86	0.86	0.87	0.88
Japanese Yen (¥/€)	120	119	119	119	118	118	118	118	118	117	117

Local currency per U.S. Dollar (averages); ¹ Federal Reserve Broad Index; ² (US\$ per local currency)

Sources: BMO Economics, Haver Analytics

Interest Rate Forecasts

	Actual	Forecasts							2020		
	2019 Oct	2019 Nov	Dec	2020 Jan	Feb	Mar	Apr	May	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	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70
6 month	1.68	1.70	1.70	1.70	1.70	1.70	1.70	1.75	1.75	1.75	1.80
1 year	1.70	1.70	1.70	1.70	1.70	1.70	1.75	1.75	1.75	1.75	1.80
2 year	1.58	1.60	1.60	1.65	1.65	1.65	1.65	1.65	1.65	1.70	1.70
3 year	1.54	1.60	1.60	1.65	1.65	1.65	1.65	1.65	1.65	1.70	1.70
5 year	1.46	1.55	1.55	1.60	1.60	1.60	1.60	1.60	1.60	1.65	1.70
7 year	1.45	1.55	1.55	1.60	1.60	1.60	1.60	1.60	1.60	1.65	1.70
10 year	1.45	1.55	1.55	1.55	1.55	1.55	1.60	1.60	1.60	1.65	1.65
30 year	1.59	1.70	1.70	1.70	1.70	1.75	1.75	1.75	1.75	1.85	1.90
1m BA	1.95	1.95	1.95	1.95	1.95	1.95	1.95	1.95	1.95	1.90	1.95
3m BA	1.98	1.95	1.95	1.95	1.95	1.95	1.95	1.95	1.95	2.00	2.00
6m BA	2.01	2.00	2.00	2.00	2.00	2.05	2.05	2.05	2.05	2.10	2.15
12m BA	2.11	2.10	2.10	2.10	2.10	2.10	2.15	2.15	2.15	2.15	2.20
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	1.63	1.63	1.63	1.63	1.63	1.63	1.63	1.63	1.63	1.63	1.63
3 month	1.68	1.55	1.55	1.55	1.55	1.55	1.60	1.60	1.60	1.65	1.65
6 month	1.67	1.55	1.55	1.60	1.60	1.60	1.60	1.65	1.65	1.65	1.70
1 year	1.61	1.55	1.55	1.55	1.60	1.60	1.60	1.65	1.65	1.70	1.70
2 year	1.55	1.60	1.60	1.60	1.60	1.65	1.65	1.65	1.65	1.70	1.75
3 year	1.53	1.60	1.60	1.60	1.60	1.65	1.65	1.70	1.70	1.75	1.80
5 year	1.53	1.60	1.60	1.60	1.65	1.65	1.70	1.70	1.70	1.80	1.85
7 year	1.62	1.70	1.70	1.70	1.75	1.75	1.75	1.80	1.80	1.85	1.90
10 year	1.71	1.80	1.80	1.80	1.80	1.85	1.85	1.90	1.90	1.95	2.00
30 year	2.19	2.25	2.25	2.30	2.30	2.30	2.35	2.35	2.35	2.40	2.45
1m LIBOR	1.88	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
3m LIBOR	1.98	1.90	1.90	1.90	1.95	1.95	1.95	1.95	1.95	2.00	2.05
6m LIBOR	1.96	1.90	1.90	1.95	1.95	1.95	2.00	2.00	2.00	2.05	2.05
12m LIBOR	1.95	1.95	1.95	1.95	2.00	2.00	2.00	2.05	2.05	2.10	2.20
Prime Rate	4.75	4.75	4.75	4.75	4.75	4.75	4.75	4.75	4.75	4.75	4.75
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	-0.45	-0.45	-0.60	-0.60	-0.60	-0.60	-0.65	-0.65	-0.65	-0.65	-0.65
BoE Repo	0.75	0.75	0.75	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
10yr Gilt	0.62	0.65	0.55	0.45	0.40	0.40	0.40	0.45	0.45	0.45	0.50
BoJ O/N	-0.03	-0.05	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
10yr JGB	-0.16	-0.13	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10

Percent (policy and prime rates are end of period; averages otherwise)

Sources: BMO Economics, Haver Analytics

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