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Forecast Summary (averages)

	Actual	Forecasts				2019		2020			
	2019 Apr	2019 May	Jun	Jul	Aug	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	1.72	1.70	1.70	1.75	1.75	1.75	1.85	1.85	1.80	1.75	1.70
Fed funds	2.38	2.38 ¹	2.38	2.38	2.38	2.38	2.38	2.38	2.38	2.38	2.38
10-yr Treasuries	2.53	2.45	2.45	2.50	2.50	2.50	2.60	2.60	2.50	2.45	2.40
C\$ per US\$	1.338	1.345	1.342	1.339	1.336	1.336	1.328	1.321	1.315	1.308	1.302
US\$/€	1.12	1.12	1.12	1.12	1.12	1.12	1.12	1.12	1.13	1.13	1.14
US\$/£	1.30	1.30	1.30	1.31	1.31	1.31	1.31	1.31	1.31	1.32	1.32
MXN/US\$	18.96	19.15	19.25	19.30	19.40	19.40	19.65	19.55	19.25	18.90	18.60
¥/US\$	112	111	110	110	109	109	108	108	108	109	109

Policy rates are end of period; ¹ actual value for May 2019

Since the previous issue of Rates Scenario (on April 8th):

- We continue to look for no change in policy rates from either the Federal Reserve or the Bank of Canada this year and next, with the near-term risks surrounding the outlook skewed to the downside.
- In the press conference following the **FOMC's** policy announcement on May 1st, Chair Powell downplayed the recent deceleration in core inflation, often referring to it as being “*transitory*” or “*transient*”. Core PCE inflation was 1.6% y/y in March, down from December’s 2.0% bang-on-target reading. Powell’s choice of adjectives reflected the fact that the disinflation was related to last year’s decline in the stock market (that had fully recovered before retreating recently) and the turn-of-the-year caution in consumer and business spending (that, apart from the equity market scare, reflected the government shutdown and extreme weather). Spending was already beginning to rebound in March.
- While the Fed will be “*patient*” in waiting for core inflation to rebound, we judge that **the net risk of a rate cut is rising**, reflecting the chance that core PCE inflation does not rebound sufficiently. The April CPI report highlighted little forward momentum in its core measure. And, just as core inflation pressures faded last year after initially mounting owing to fiscal stimulus, the secular forces of disinflation (such as automation, aging workforce and digitalization) could offset some of the rebound. Meanwhile, “*global economic and financial developments*” are flaring again, as the U.S./China trade conflict escalates with another round of tit-for-tat tariffs and with potential U.S. automotive tariffs looming. While tariffs are inherently stagflationary (helps inflation, hurts growth), we suspect the Fed will pay more attention to the growth consequences given the failure so far to achieve the 2% inflation target in a symmetric fashion.
- The **Bank of Canada's** recent policy announcement (April 24th) dropped the prior reference to “*future rate increases*”. Not only was there no longer an indication of needing to get rates back to neutral (which was the mantra as recently as January), but the estimated neutral range was reduced by 25 bps to 2.25%-to-3.25%. The dovish policy tilt reflected the recent slowing of domestic and global economic activity, which the Bank expects will be “*temporary*”. And much like the Fed, we anticipate that the Bank will be patient in waiting for “*temporary*” to pan out, with a keen eye on “*household spending, oil markets, and global trade policy*”.

Governor Poloz later asserted that the risk of a global trade war was the “*greatest threat*” to the Canadian economy, and if anything, the global trade and economic backdrop has become more threatening. But, partly countering this was April’s super-strong job growth, which provided some evidence that the slowdown is indeed turning out to be temporary. On balance, the net policy risks remain weightier on the downside.

- In the wake of the U.S./China trade conflict’s escalation and its reverberation through global equity markets, fixed income markets have moved to fully price in a Fed rate cut this year (Canadian markets are pricing in less than 50% odds). Treasury yields now sit below the midpoint of the fed funds target range (2.38%) beyond the 7-year tenor, and 10s are just a few basis points away, as the 3-month/10-year curve flirts with inversion again. It’s important to restate that, as a recession signal, this is not as reliable as it used to be because the curve is now inherently flatter than before (owing to lower terminal policy rates, less inflation volatility and QE’s legacy).
- While there’s heightened risk of the market’s Fed call becoming a self-fulfilling prophecy, it’s still not our base case. As such, when it becomes evident that the Fed is not easing—against a background of rebounding core PCE inflation that hits a new cycle high above 2.1% (but not high or persistent enough to change the Fed’s tune), sturdy WTI oil prices in the \$60+ range, and continued at-least-potential real GDP growth—Treasury yields should face some modest upward pressure. But, we reckon 10-year yields, for example, should stay south of 2.70%. There is also 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/U.S. 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 persistent large negative spread 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).
- Competitiveness issues are also a longer-term drag for the **Canadian dollar**, acting to augment shorter-term headwinds and diminish shorter-term tailwinds. The loonie has been trending closer to the top of the \$1.31-to-\$1.35 range in place since early January, reflecting the Bank of Canada’s dovish tilt away from its January 9th ardent call to get rates back to neutral, along with a host of trade issues—CUSMA not passed, a deteriorating real non-energy trade balance, U.S. and global trade policy uncertainty, and, now, tariff hikes that tend to boost the greenback. Sturdy oil prices and potentially calmer trade policy waters should help turn the loonie around, but it still looks to remain range bound.
- The **Brexit** can was kicked down the road and October 31st is the new official date for when the U.K. will leave the European Union. However, the timing can be sooner if Parliament can ratify the current Withdrawal Agreement, but this looks increasingly unlikely as talks between PM May and the Labour Party are not progressing smoothly. And, by the looks of it, Britain will be participating in the European Parliamentary elections that begin on May 23rd. Recent polls point to a big win by Nigel Farage’s Brexit Party; and, if they are accurate, PM May will be under tremendous pressure to resign, which means more turmoil in the British government. We should also be prepared for another Brexit delay as the new government will surely want to renegotiate the Withdrawal Agreement, which Brussels is very much against. In this environment, it is difficult to see how the BoE continues to lean toward the view that rate hikes may still be appropriate. Yes, the U.K. economy started the year off on a stronger footing, but much of that had to do with stockpiling ahead of the then-departure date of March 29th. With Brexit becoming increasingly uncertain and a global trade war looming, we remain of the view that the **BoE** will stay on the sidelines, with risks tilted toward easing if necessary. The **GBP** will be little changed in the near-term, and may receive some support from a new government that could command a majority around Brexit plans.

- No changes in the outlook for the **ECB**. We await details on its TLTRO-III plans, which are scheduled to begin in September. Meantime, the central bank will watch to see if the recent improvement in economic activity has staying power. Worries that the U.S. will impose tariffs on European car imports will weigh on the region's confidence levels and economic activity. We continue to see the ECB on hold, and the currency to stay flattish at current levels of \$1.12.
- The **BoJ** has stuck to its highly accommodative policies and that looks like it was a good decision. The economy continues to soften, and the drop in the latest coincident indicator for March has brought up the possibility of yet another delay in Japan's sales tax (currently scheduled to rise from 8% to 10% in October). And yet, the **JPY** will likely strengthen, as it rallies on the back of this rising risk environment.

Foreign Exchange Forecasts

Local Currency per U.S. Dollar (averages)

	Actual	Forecasts					2019		2020			
	2019 Apr	2019 May	Jun	Jul	Aug	Q3	Q4	Q1	Q2	Q3	Q4	
Canadian Dollar												
C\$ per US\$	1.338	1.345	1.342	1.339	1.336	1.336	1.328	1.321	1.315	1.308	1.302	
US\$ per C\$	0.747	0.743	0.745	0.747	0.748	0.748	0.753	0.757	0.761	0.764	0.768	
Trade-weighted	94.2	93.8	94.0	94.2	94.4	94.4	95.0	95.5	95.8	96.2	96.6	
U.S. Dollar												
Trade-weighted ¹	127.4	128.5	128.7	128.9	129.1	129.1	129.8	129.5	128.9	128.3	127.6	
European Currencies												
Euro ²	1.12	1.12	1.12	1.12	1.12	1.12	1.12	1.12	1.13	1.13	1.14	
Danish Krone	6.65	6.65	6.65	6.65	6.65	6.65	6.65	6.65	6.60	6.55	6.55	
Norwegian Krone	8.56	8.75	8.75	8.75	8.75	8.75	8.75	8.70	8.65	8.60	8.55	
Swedish Krone	9.33	9.60	9.60	9.65	9.65	9.65	9.70	9.65	9.55	9.45	9.35	
Swiss Franc	1.008	1.016	1.012	1.009	1.005	1.005	0.994	0.992	0.994	0.997	0.999	
U.K. Pound ²	1.30	1.30	1.30	1.31	1.31	1.31	1.31	1.31	1.31	1.32	1.32	
Asian Currencies												
Chinese Yuan	6.72	6.85	6.87	6.89	6.91	6.91	6.98	6.98	6.96	6.93	6.91	
Japanese Yen	112	111	110	110	109	109	108	108	108	109	109	
Korean Won	1,142	1,175	1,180	1,180	1,185	1,185	1,195	1,195	1,185	1,180	1,175	
Indian Rupee	69.4	69.8	70.2	70.6	71.1	71.1	72.4	72.5	71.9	71.4	70.9	
Singapore Dollar	1.36	1.36	1.37	1.37	1.38	1.38	1.39	1.40	1.40	1.40	1.39	
Malaysian Ringgit	4.11	4.15	4.15	4.15	4.20	4.20	4.25	4.20	4.10	4.05	3.95	
Thai Baht	31.8	32.0	32.0	32.1	32.1	32.1	32.2	32.2	32.3	32.4	32.4	
Philippine Peso	52.0	52.1	52.3	52.5	52.7	52.7	53.3	53.3	52.8	52.4	51.9	
Taiwan Dollar	30.8	31.0	31.1	31.2	31.3	31.3	31.7	31.8	31.8	31.8	31.7	
Indonesian Rupiah	14,141	14,300	14,350	14,405	14,455	14,455	14,615	14,615	14,535	14,455	14,380	
Other Currencies												
Australian Dollar ²	0.711	0.700	0.697	0.694	0.691	0.691	0.683	0.683	0.688	0.693	0.698	
New Zealand Dollar ²	0.671	0.661	0.658	0.655	0.652	0.652	0.643	0.643	0.648	0.653	0.658	
Mexican Peso	18.96	19.15	19.25	19.30	19.40	19.40	19.65	19.55	19.25	18.90	18.60	
Brazilian Real	3.90	3.95	3.95	4.00	4.00	4.00	4.05	4.05	4.05	4.00	4.00	
Russian Ruble	64.6	65.0	65.3	65.6	65.8	65.8	66.7	66.8	66.5	66.2	65.9	
South African Rand	14.1	14.4	14.4	14.3	14.3	14.3	14.2	14.2	14.1	14.1	14.0	
Cross Rates												
Versus Canadian Dollar												
Euro (C\$/€)	1.50	1.51	1.50	1.50	1.50	1.50	1.49	1.48	1.48	1.48	1.48	
U.K. Pound (C\$/£)	1.74	1.75	1.75	1.75	1.75	1.75	1.74	1.73	1.73	1.72	1.72	
Japanese Yen (¥/C\$)	83	82	82	82	82	82	82	82	82	83	84	
Australian Dollar (C\$/A\$)	0.95	0.94	0.94	0.93	0.92	0.92	0.91	0.90	0.90	0.91	0.91	
Versus Euro												
U.K. Pound (£/€)	0.86	0.86	0.86	0.86	0.86	0.86	0.86	0.86	0.86	0.86	0.86	
Japanese Yen (¥/€)	125	124	123	123	123	123	121	122	122	123	124	

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

Interest Rate Forecasts

Percent (averages)

	Actual 2019 Apr	Forecasts 2019				2019 Q3	2019 Q4	2020 Q1	2020 Q2	2020 Q3	2020 Q4
		May	Jun	Jul	Aug						
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	1.68	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70
6 month	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70
1 year	1.72	1.70	1.70	1.70	1.70	1.70	1.75	1.75	1.75	1.75	1.75
2 year	1.59	1.60	1.60	1.60	1.60	1.60	1.65	1.65	1.65	1.70	1.70
3 year	1.59	1.55	1.55	1.55	1.60	1.60	1.60	1.65	1.65	1.65	1.70
5 year	1.58	1.55	1.55	1.55	1.55	1.55	1.55	1.60	1.65	1.65	1.70
7 year	1.63	1.60	1.60	1.60	1.60	1.60	1.65	1.65	1.65	1.70	1.70
10 year	1.72	1.70	1.70	1.75	1.75	1.75	1.85	1.85	1.80	1.75	1.70
30 year	2.01	1.90	1.95	2.00	2.00	2.00	2.15	2.15	2.10	2.05	2.00
1m BA	1.97	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.05	2.05	2.05
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	2.09	2.10	2.10	2.10	2.10	2.10	2.10	2.10	2.10	2.10	2.10
12m BA	2.24	2.20	2.20	2.20	2.25	2.25	2.25	2.25	2.25	2.25	2.25
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 ¹	2.38	2.38	2.38	2.38	2.38	2.38	2.38	2.38	2.38
3 month	2.43	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40
6 month	2.46	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.40	2.40	2.40
1 year	2.42	2.35	2.35	2.40	2.40	2.40	2.45	2.45	2.45	2.40	2.40
2 year	2.34	2.20	2.25	2.30	2.35	2.35	2.45	2.50	2.45	2.40	2.40
3 year	2.31	2.20	2.25	2.30	2.35	2.35	2.50	2.50	2.45	2.45	2.40
5 year	2.33	2.20	2.25	2.30	2.35	2.35	2.50	2.55	2.50	2.45	2.40
7 year	2.43	2.30	2.35	2.40	2.45	2.45	2.55	2.55	2.50	2.45	2.40
10 year	2.53	2.45	2.45	2.50	2.50	2.50	2.60	2.60	2.50	2.45	2.40
30 year	2.94	2.85	2.90	2.90	2.95	2.95	3.00	3.00	2.95	2.90	2.80
1m LIBOR	2.48	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.50	2.50	2.50
3m LIBOR	2.59	2.50	2.50	2.50	2.50	2.50	2.50	2.55	2.55	2.55	2.60
6m LIBOR	2.63	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.65
12m LIBOR	2.74	2.70	2.70	2.70	2.75	2.75	2.80	2.80	2.80	2.80	2.85
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	0.01	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 ¹	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
10yr Gilt	1.15	1.15	1.15	1.10	1.10	1.10	1.10	1.10	1.10	1.10	1.10
Boj O/N	-0.07	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05
10yr JGB	-0.04	-0.04	-0.03	-0.03	-0.02	-0.02	-0.01	0.00	0.00	0.00	0.00

Policy rates are end of period; ¹ actual value for May 2019

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