Rates Scenario

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An outlook on key interest and foreign exchange rates **June 15, 2018**

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Forecast Summary (averages)

	Actual 2018 May	Forecasts 2018 Jun	Jul	Aug	Sep	Oct	2018 Q4	2019 Q1	Q2	Q3	Q4
BoC overnight	1.25	1.25	1.50	1.50	1.50	1.75	1.75	2.00	2.25	2.50	2.50
10-yr Canadas	2.38	2.30	2.35	2.40	2.50	2.55	2.60	2.75	2.85	2.95	3.05
Fed funds	1.63	1.88[1]	1.88	1.88	2.13	2.13	2.38	2.63	2.88	2.88	2.88
10-yr Treasuries	2.98	2.95	3.00	3.05	3.10	3.15	3.20	3.30	3.40	3.45	3.50
C$ per US$	1.287	1.295	1.292	1.288	1.285	1.282	1.278	1.271	1.265	1.258	1.252
US$/€	1.18	1.17	1.18	1.19	1.20	1.20	1.21	1.23	1.23	1.24	1.25
US$/£	1.35	1.34	1.35	1.35	1.36	1.37	1.37	1.39	1.40	1.41	1.43
¥/US$	110	110	110	109	109	109	108	108	107	106	105

[1] actual value for June 2018

Since the last issue of Rates Scenario:

- Recent policy pronouncements on both sides of the Canada-U.S. border have increased our confidence in our current Bank of Canada and Federal Reserve forecasts. As such, we have made **no changes**.
- On May 30th, the **BoC** seemed to set the stage for a July rate hike. The policy statement omitted the phrase "*some monetary policy accommodation will still be needed to keep inflation on target*" and dropped the word "*cautious*" in reference to "*future policy adjustments*" (they are now going to be "*gradual*", which is what the Fed has been calling them). We're sticking with our call for a quarterly rate-hike cadence commencing next month and pausing when the Bank hits the bottom of its 2.50%-to-3.50% estimated neutral range (in July 2019). We judge there are net downside risks to our BoC call, with rate hikes becoming fewer and further apart, reflecting unfavourable "*incoming data*" and U.S. trade policy developments.
- Then, on June 13th, as expected, the **FOMC** lifted the target range for the federal funds rate by 25 bps to 1.75%-to-2.00%. That move marked an important milestone in the policy normalization process, with the new 1.875% midpoint now sitting above current core PCE inflation (1.8% y/y) for the first time since March 2008. The decade-long run of negative real policy rates has essentially come to an end, something we suspect the BoC is now also pining for. And, tearing a page out of the Bank's playbook, the Fed's policy statement dropped the phrase that has been in place since rate hikes started in December 2015, about rates "*likely to remain, for some time, below levels that are expected to prevail in the longer run*", while still calling for "*further gradual increases*". We look for the current quarterly rate-hike cadence to continue at least until the FOMC reaches its longer-term median projection of 2.75%-to-3.00% in June 2019. The Fed would then pause at this point, exhibiting some caution before potentially pushing rates into restrictive territory. We judge there are net upside risks to our Fed call, with rate hikes potentially continuing in 2019H2 should inflation trends warrant.
- The latest "***dot plot***" implied two more Fed rate hikes for this year (expected) and an additional three for next year (unexpected). It's tempting to use this as an occasion to lift our own forecast; but, note that the 2019 median is still only one participant away from moving back down to 2.875%. And, before calling for the start of restrictive policy, we would like to see the uncertainties clouding the outlook to clear up a bit. For example,

trade protectionism is becoming an increasing negative risk, and there's $50 bln in tariffs on Chinese goods, a Section 232 investigation into imported vehicles and parts, and NAFTA's fate ahead. The resurgence of "*global economic and financial developments*" is another (think Iran, Brexit, Italy, Turkey and Brazil).

- We increased our 2018-end forecast for **10-year Treasury yields** to 3.25% (keeping 2019 at 3.50%), as a rising but ratcheting pattern continues to unfold. The ratchets (or rallies) regularly occur as new multi-year highs beacon yield-starved investors, or rashes of weaker economic indicators cast doubt on Fed expectations, or something completely different comes from out of the blue (often from the "*global economic and financial developments"* front). And, the ratchets can sometimes be fast and furious. Last month, after yields topped 3.10% on May 17th —the highest in more than 6½ years and the catalyst for our changed call—Italian political developments and subsequent global flight-to-liquidity flows rallied yields below 2.80%. But, they've been creeping back. We continue to judge that the combination of Fed policy normalization (on the policy rate and balance sheet fronts), strengthening nominal economic growth (on the real growth and inflation fronts), and surging Treasury supply to finance trillion dollar budget deficits will, eventually, trump the ratcheting forces.
- We still do not expect the yield curve (2s10s) to persistently invert, unless the Fed feels compelled to push policy rates above longer-run neutral in 2019H2. As for longer-term Canadas, with the Bank of Canada poised to push policy rates up next month and begin regularly leap-frogging Fed moves, we look for current Canada-U.S. yield spreads to grind less negative. By 2018-end, we expect **10-year Canadas** to average around 2.65%, and 3.05% by the end of next year.
- The **Canadian dollar** should also find some lift from Bank of Canada prospects and sturdy, if not firming, oil prices. But, it remains vulnerable to the vagaries of U.S. trade policy, and not just remedies aimed at Canada. Persistent, hefty trade deficits and portfolio investment net inflows fading from recent record highs are also not helping the loonie's case. The currency has been trading in a C$1.28-C$1.30 range since late April, and recently breached the higher end. From a longer-term perspective, we continue to look for a strengthening trend on the back of a weakening greenback prodded by America's unsavoury duo of deteriorating budget and current account deficits. However, trade policy developments (and the BoC's potential response) stand to trump these forces for the time being, and also set the mark from where the loonie should start flying higher. By 2018-end, we look for the loonie to average around C$1.275, and C$1.25 by the end of next year.
- The **ECB** has also taken a big step to normalization. At the June 14th policy meeting, President Draghi announced forthcoming changes to its QE program. Monthly bond purchases of €30 bln would continue until the end of September; then, they will be reduced to €15 bln from October to the end of the year. At that point, the QE program would end. Although this decision was fully in line with our call, the announcement was made sooner than expected. The euro's rally was brief, however, held back by the guidance on interest rates ("*rates would stay at present levels at least through the summer of 2019*"). Again, this lines up nicely with our call for a rate hike in September 2019. Although this was a unanimous decision, there were reports that some of the dovish rate-setters wanted to use looser language around the bond buying, while some of the hawks wanted to say "*middle of the year*", implying a June hike. As per usual, there are plenty of risks (Italy's populist government will table its budget in September, and there is a trade row with the U.S.), but this is a positive step for the Euro Area, which is currently on track for its fifth consecutive year of economic growth. We see the euro rallying in this environment, to $1.22 by the end of this year and $1.25 by the end of 2019.
- The **BoE** is still looking to raise rates again; but, given that the domestic economy barely grew in the first quarter (real GDP rose 0.1% q/q, not annualized), it wants to be assured that the weakness was transitory. In the

Bank's words, the "*costs to waiting…were likely to be modest*". Indeed, the U.K. economy was held back by a number of special factors in Q1, particularly bad weather ("Beast from the East") and some of the surveys are pointing to a bounce back. However, the Bank had looked for an upward revision to the weak Q1 GDP reading, and it didn't happen. And, consumer price inflation rose at its slowest pace in 13 months. These two factors are likely significant enough for policymakers to take more time to assess the environment. The 'no rush' theme allowed us to move our BoE rate-hike call from August to November. Brexit uncertainty will continue to weigh, but any progress will provide support for the currency. We see the GBP finishing off 2018 at $1.38, then $1.43 the following year.

- The **BoJ** will have a smaller share of real estate in this report than the rest of the G7 members. The central bank stayed on hold June 15th, to the surprise of no one, but lowered its assessment of inflation, putting it in a range of 0.5%-to-1.0%. Back in April, the BoJ saw inflation moving around 1%. In the words of Governor Kuroda, "*it's most appropriate to patiently maintain our powerful monetary easing*". It will be some time before the dovish BoJ tweaks monetary policy, keeping the JPY in the vicinity of ¥110.
- The **RBA** also remained on the sidelines on June 5th. And, and while it is still concerned about high household debt levels and slow-growing incomes, broader economic growth is expected to average over 3% over the next couple of years. A rate hike, the first since 2010, is possible in the second half of 2019.

Foreign Exchange Forecasts

Local Currency per U.S. Dollar (averages)

	Actual 2018 May	Forecasts 2018 Jun	Jul	Aug	Sep	Oct	2018 Q4	2019 Q1	Q2	Q3	Q4
Canadian Dollar											
C$ per US$	1.287	1.295	1.292	1.288	1.285	1.282	1.278	1.271	1.265	1.258	1.252
US$ per C$	0.777	0.772	0.774	0.776	0.778	0.780	0.782	0.787	0.791	0.795	0.799
Trade-weighted	97.3	96.9	97.0	97.2	97.3	97.5	97.6	98.0	98.3	98.6	98.9
U.S. Dollar											
Trade-weighted[1]	121.5	122.7	122.4	122.1	121.9	121.6	121.4	120.8	120.2	119.6	119.1
European Currencies											
Euro[2]	1.18	1.17	1.18	1.19	1.20	1.20	1.21	1.23	1.23	1.24	1.25
Danish Krone	6.30	6.35	6.30	6.25	6.25	6.20	6.15	6.10	6.05	6.00	5.95
Norwegian Krone	8.10	8.10	8.05	8.00	7.95	7.90	7.85	7.75	7.70	7.65	7.60
Swedish Krone	8.76	8.70	8.70	8.65	8.65	8.65	8.60	8.55	8.50	8.40	8.35
Swiss Franc	0.997	0.986	0.986	0.985	0.985	0.984	0.984	0.986	0.990	0.995	0.999
U.K. Pound[2]	1.35	1.34	1.35	1.35	1.36	1.37	1.37	1.39	1.40	1.41	1.43
Asian Currencies											
Chinese Yuan	6.37	6.40	6.40	6.39	6.39	6.39	6.38	6.37	6.36	6.34	6.33
Japanese Yen	110	110	110	109	109	109	108	108	107	106	105
Korean Won	1,077	1,075	1,075	1,075	1,075	1,075	1,070	1,070	1,070	1,065	1,065
Indian Rupee	67.5	67.3	67.4	67.5	67.6	67.7	67.8	68.1	68.4	68.6	68.9
Singapore Dollar	1.34	1.34	1.34	1.35	1.35	1.35	1.35	1.36	1.36	1.37	1.37
Malaysian Ringgit	3.96	4.00	4.00	4.05	4.05	4.10	4.10	4.15	4.20	4.20	4.25
Thai Baht	32.0	32.0	32.2	32.4	32.6	32.8	33.0	33.2	33.2	33.2	33.2
Philippine Peso	52.3	52.8	53.0	53.2	53.5	53.7	54.0	54.3	54.4	54.6	54.7
Taiwan Dollar	29.9	29.8	29.9	30.0	30.1	30.1	30.2	30.3	30.3	30.3	30.4
Indonesian Rupiah	14,038	13,900	13,975	14,050	14,130	14,205	14,280	14,385	14,435	14,485	14,530
Other Currencies											
Australian Dollar[2]	0.753	0.760	0.764	0.768	0.773	0.777	0.781	0.788	0.791	0.795	0.799
New Zealand Dollar[2]	0.695	0.700	0.705	0.710	0.715	0.720	0.725	0.733	0.738	0.743	0.748
Mexican Peso	19.55	20.40	20.25	20.15	20.00	19.95	19.85	19.60	19.25	18.95	18.60
Brazilian Real	3.64	3.80	3.80	3.85	3.85	3.85	3.90	3.90	3.90	3.95	3.95
Russian Ruble	62.4	62.4	62.5	62.6	62.7	62.8	63.0	63.1	63.2	63.2	63.2
South African Rand	12.5	13.0	13.0	13.0	13.0	13.0	13.0	13.0	13.1	13.2	13.2
Cross Rates											
Versus Canadian Dollar											
Euro (C$/€)	1.52	1.52	1.52	1.53	1.54	1.54	1.55	1.56	1.56	1.56	1.56
U.K. Pound (C$/£)	1.73	1.74	1.74	1.74	1.75	1.75	1.76	1.76	1.77	1.78	1.79
Japanese Yen (¥/C$)	85	85	85	85	85	85	85	85	84	84	84
Australian Dollar (C$/A$)	0.97	0.98	0.99	0.99	0.99	1.00	1.00	1.00	1.00	1.00	1.00
Versus Euro											
U.K. Pound (£/€)	0.88	0.87	0.87	0.88	0.88	0.88	0.88	0.88	0.88	0.88	0.87
Japanese Yen (¥/€)	130	129	129	130	130	131	131	132	132	131	131

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

Interest Rate Forecasts

Percent (averages)

	Actual 2018 May	Forecasts 2018 Jun	Jul	Aug	Sep	Oct	2018 Q4	2019 Q1	Q2	Q3	Q4
Cdn. Yield Curve											
Overnight	1.25	1.25	1.50	1.50	1.50	1.75	1.75	2.00	2.25	2.50	2.50
3 month	1.24	1.35	1.45	1.45	1.60	1.70	1.70	1.95	2.15	2.35	2.35
6 month	1.41	1.50	1.60	1.60	1.70	1.80	1.85	2.05	2.25	2.40	2.40
1 year	1.71	1.75	1.80	1.85	1.90	2.00	2.05	2.20	2.40	2.55	2.55
2 year	1.96	1.95	2.00	2.05	2.10	2.15	2.20	2.35	2.50	2.65	2.65
3 year	2.06	2.00	2.05	2.10	2.20	2.25	2.30	2.45	2.60	2.70	2.75
5 year	2.20	2.15	2.20	2.25	2.35	2.40	2.45	2.60	2.70	2.85	2.90
7 year	2.28	2.20	2.25	2.30	2.40	2.45	2.50	2.65	2.80	2.85	2.95
10 year	2.38	2.30	2.35	2.40	2.50	2.55	2.60	2.75	2.85	2.95	3.05
30 year	2.41	2.35	2.35	2.40	2.50	2.60	2.65	2.80	2.95	3.05	3.15
1m BA	1.64	1.65	1.75	1.75	1.85	1.95	1.95	2.15	2.35	2.55	2.55
3m BA	1.74	1.85	1.95	1.95	2.05	2.15	2.20	2.40	2.60	2.75	2.75
6m BA	1.93	1.95	2.00	2.00	2.10	2.20	2.25	2.40	2.60	2.75	2.75
12m BA	2.15	2.15	2.20	2.25	2.30	2.35	2.40	2.55	2.70	2.85	2.85
Prime Rate	3.45	3.45	3.70	3.70	3.70	3.95	3.95	4.20	4.45	4.70	4.70
U.S. Yield Curve											
Fed funds	1.63	1.88[1]	1.88	1.88	2.13	2.13	2.38	2.63	2.88	2.88	2.88
3 month	1.90	1.95	1.95	2.05	2.15	2.15	2.25	2.45	2.65	2.75	2.75
6 month	2.07	2.10	2.10	2.20	2.25	2.25	2.35	2.50	2.70	2.80	2.80
1 year	2.27	2.35	2.35	2.40	2.50	2.50	2.55	2.70	2.85	2.90	2.90
2 year	2.51	2.55	2.60	2.65	2.70	2.75	2.75	2.90	3.00	3.05	3.05
3 year	2.66	2.70	2.70	2.75	2.80	2.85	2.90	3.00	3.15	3.15	3.20
5 year	2.82	2.80	2.85	2.90	2.95	3.00	3.05	3.15	3.25	3.30	3.35
7 year	2.93	2.95	2.95	3.00	3.05	3.10	3.15	3.25	3.35	3.40	3.45
10 year	2.98	2.95	3.00	3.05	3.10	3.15	3.20	3.30	3.40	3.45	3.50
30 year	3.13	3.10	3.10	3.15	3.25	3.30	3.35	3.45	3.50	3.55	3.60
1m LIBOR	1.95	2.05	2.05	2.20	2.30	2.30	2.40	2.65	2.90	3.05	3.05
3m LIBOR	2.34	2.35	2.35	2.45	2.55	2.55	2.65	2.85	3.05	3.15	3.15
6m LIBOR	2.50	2.50	2.50	2.60	2.70	2.70	2.85	3.05	3.30	3.40	3.40
12m LIBOR	2.75	2.75	2.80	2.90	2.95	3.00	3.10	3.30	3.50	3.55	3.55
Prime Rate	4.75	5.00	5.00	5.00	5.25	5.25	5.35	5.60	5.85	6.00	6.00
Other G7 Yields											
ECB Refi	0.00	0.00[1]	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.25	0.25
10yr Bund	0.51	0.60	0.70	0.80	0.90	0.95	1.05	1.20	1.30	1.40	1.45
BoE Repo	0.50	0.50	0.50	0.50	0.50	0.50	0.75	0.75	0.75	1.00	1.00
10yr Gilt	1.42	1.50	1.60	1.65	1.75	1.85	1.90	2.10	2.20	2.35	2.45
BoJ O/N	-0.07	-0.05[1]	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	-0.05	0.00
10yr JGB	0.04	0.05	0.06	0.07	0.08	0.08	0.09	0.10	0.11	0.12	0.12

[1] actual value for June 2018