Rates Scenario for April 18, 2024

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

Forecast Summary

(avg.)	Actual	Forecasts									
	2024	2024				2024		2025			
	Mar	Apr	May	Jun	Jul	Q3	Q4	Q1	Q2	Q3	Q4
BoC overnight[1]	5.00	5.00[2]	5.00	4.75	4.50	4.50	4.25	4.00	3.75	3.75	3.50
10-yr Canadas	3.44	3.65	3.60	3.55	3.50	3.45	3.25	3.20	3.20	3.20	3.20
Fed funds[1]	5.38	5.38	5.38	5.38	5.13	5.13	4.88	4.63	4.38	4.38	4.13
10-yr Treasuries	4.21	4.50	4.45	4.40	4.30	4.25	4.05	4.00	4.00	3.95	3.95
C$ per US$	1.35	1.37	1.37	1.36	1.36	1.35	1.34	1.33	1.32	1.31	1.30
US$/€	1.09	1.07	1.07	1.08	1.08	1.09	1.10	1.10	1.11	1.11	1.12
US$/£	1.27	1.25	1.25	1.26	1.26	1.27	1.28	1.28	1.29	1.29	1.30
¥/US$	150	153	153	152	152	151	150	148	147	146	145

[1] end of period; [2] actual value

Sources: BMO Economics, Haver Analytics

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Canada-U.S. Rates Outlook

Michael Gregory, CFA, Deputy Chief Economist

- **Our Federal Reserve and Bank of Canada calls have changed** since the last Rates Scenario (March 25). We still expect policy rate reductions to start around mid-year, but we now look for **slower rate cut cadences** that will **end at higher levels**. This 'higher-for-longer' profile for policy rates results in higher bond yields over the forecast horizon.

- ***Federal Reserve:*** The next FOMC confab is April 30-to-May 1, and we look for the **Fed to keep policy rates unchanged for the sixth consecutive meeting**, with the target range for the fed funds rate at **5.25%-to-5.50%.** Importantly, the forward guidance should be repeated, that the Fed will not cut rates until it has *"gained greater confidence that inflation is moving sustainably toward 2 percent."* In the presser, we suspect Chair Powell will reiterate what he said on April 16: *"The recent data have clearly not given us greater confidence and instead indicate that it's likely to take longer than expected to achieve that confidence."* And that *"it's appropriate to allow restrictive policy further time to work."* The market is already on that page.

- Currently, market expectations have a quarter-point rate cut for June pegged at 10% odds with less than two reductions priced in by December. Back in January, the market was pricing in more than three rate cuts by June, and six by year-end. Easing expectations were pared as economic indicators emphasized stubborn inflation and resilient growth. For example, over the three months ending December, payrolls averaged a 165k gain (at the time) with the core CPI increasing at a 3.3% annualized rate. Three months later, the average growth in payrolls was topping 275k and the core CPI was increasing at a 4.5% annualized rate. Chair Powell said this was going to be a *"bumpy ride"*, but 100k+ for job growth and 1.0 ppts+ for inflation are big bumps!

- Nevertheless, the data trends still have time to turn around by the FOMC's July 31 policy announcement. There are three employment and CPI reports ahead, along with four PCEPI readings, a full cycle of GDP data for Q1 and a first look at Q2. As such, we're sticking with our forecast for an **inaugural rate cut at July-end, but if May-released data fail to deliver, we'll be pushing this to September**. Importantly, we reckon the revealed bumpiness of this ride is now going to make the Fed even more cautious when it comes to the cadence of rate cuts. We now look for a prevalence of two-meeting gaps (3- to 4-month intervals) between policy actions.

- As such, we're projecting **50 bps in cumulative Fed rate cuts this year** (down from 75 bps before), with December next on the docket, and **75 bps next year** (down from 100 bps). This will push the rate cut campaign into early 2027, and we **lifted the terminal or neutral rate by 25 bps to a range of 3.00%-to-3.25%** (1%-to-1¼ % in real terms).
- Why the rise? Real policy rates are currently 2.6%, the highest level since the Great Recession, but the economy continues to emit signs of resilient growth—partly owing to sturdy productivity and population growth—along with stubborn inflation. This suggests the economy can not only manage higher real rates, but they're also warranted. Meanwhile, higher policy rates than before will probably be required to keep inflation at 2% over the long haul. The past secular disinflationary pressures caused by unbridled globalization are lessening as re-, near-, and friend-shoring expand. And new secular inflation forces are forming, owing to climate change and the pursuit of net zero.
- ***Bank of Canada:*** On April 10, the **Bank left the policy rate unchanged at 5.00% for the sixth consecutive meeting**. Although the statement asserted that *"inflation is still too high and risks remain"*, the overall tone was mildly more dovish. There was a nod to the rising unemployment rate, and it also said, *"CPI and core inflation have eased further in recent months"*. And, importantly, that *"the Council will be looking for evidence that this downward momentum is sustained."* At the time, there were two CPI reports looming before the next (June 5) policy announcement, and the first of them (on April 16) delivered more evidence. Among the array of core inflation measures (Trim, Median, CPIX, ex. food & energy), the average annualized gain so far this year was 1.3%.
- In the press conference, Governor Macklem said a *"June rate cut is within the realm of possibilities. We are encouraged by what we've seen since January."* (And this was before the March CPI data.) Speaking at an April 16 event and basking in the light of the March data, Macklem said: *"That does suggest that underlying inflationary pressures are continuing to ease, so we continue to be moving in the right direction."* And that direction is pointing to a **rate cut on June 5**, unless the April CPI (due May 21) or some other data upset the applecart.
- Given the Bank's tendency to move in couplets, we look for a **follow-up rate cut on July 24**, before the Fed's potential action (with mounting risk it could be postponed). With the paths for Canadian inflation and unemployment rates already diverging meaningfully from their U.S. counterparts, some divergence between monetary policies is justified. However, we reckon the **Bank will be increasingly cautious in testing the limits of policy divergence**, keeping an eye on the Canadian dollar (and the inflationary consequences of depreciation). Meanwhile, having wrestled inflation to the mat and wanting to make sure it doesn't get back up, particularly as housing activity heats up in the wake of rate cuts and amid easier financial conditions, we're now expecting a more cautiously tilted policy approach (two-meeting gaps between actions and a shift to single meeting moves after a couple of couplets). As such, we're projecting **75 bps in cumulative BoC rate cuts this year** (down from 100 bps before) and **75 bps next year** (down from 100 bps). This will push the rate cutting effort into mid-2026, and we also **lifted the neutral rate by 25 bps to 3.00%** (1% in real terms). The higher U.S. neutral rate had a hand here, as it did for the BoC (it lifted its range to 2¼% to 3¼%).
- ***Bond yields:*** Ten-year Treasury yields are averaging nearly 4.5% so far this month. Amid this nine-month run of 4%-plus averages (the most since 2007), October's 4.80% is the high with its peak daily close of 4.98%. This is when the market's 'higher-for-longer' fears were last running rampant. These fears were quelled by a three-month run of comforting data that resulted in December and January lows of 4.02% and 4.06%, respectively (both encouraged by the trough daily close of 3.79% on December 27). Yields later sold off as the data took a disturbing turn during the latest three months, rekindling 'higher-for-longer' concerns.

- It's noteworthy that the midpoint of this run's extremes is around 4.40% (for both the monthlies and dailies), not far from the month-to-date tally. This suggests the bond market is balancing between a move to October-type levels should the disturbing data theme continue, and a break back to December-type levels should the data take another comforting turn. Underpinning our slightly better-than-even odds of a July rate cut is the assumption of such a turn. We see **4% forming a floor for 10-year yield averages over the reminder of the year** (with a 3.75% floor for the daily closes), higher than we had before owing to less aggressive Fed easing and higher neutral rates. Next year, we see average yields drifting down very modestly, approaching the longer-run level of 3.9% [1].
- Ten-year GoC yields are averaging 3.64% month-to-date, 82 bps below comparable Treasuries (the latest close was 3.69% and -90 bps). In the prior six months, the spread ran in a range from -70 bps to -80 bps, and we look for it to move back up to the bottom of this range by year-end, before gradually drifting up to the top over the forecast horizon. Supporting these historically extreme (negative) spreads (note: the median since 1990 is -6 bps), is Canada's relatively stronger fiscal situation and relatively weaker economic performance. These themes are expected to continue over the forecast period complemented by the Bank of Canada's earlier start to rate cuts.
- Finally, on both sides of the border, **quantitative tightening** (QT) is expected to continue past the start of rate cuts and past the end of the year, applying some offsetting upward pressure on bond yields [2].
- ***U.S. dollar:*** The Fed's trade-weighted dollar index is on track to average about 1.7% stronger in April, to its highest level since October (there's that month again), owing to dimming prospects for policy rate cuts. Despite ongoing geopolitical and global economic concerns, we suspect market expectations for, and realized, Fed rate cuts will continue to be the dollar's dominant driver, even amid other major central banks jumping on the rate cut bandwagon. We see the greenback down 2½% by the end of this year (compared to April's tracking) with roughly similar depreciation next year.
- ***Canadian dollar:*** The loonie is on track to average around US$0.729 in April (C$1.371), 1.2% weaker than in March, mirroring strength in the greenback (and despite firmer oil prices). Amid relatively softer economic readings, Canada's stellar relative inflation performance is reinforcing expectations that not only will the Bank of Canada start cutting rates before the Fed, but overnight interest rate spreads could trend more negative in the months ahead. Although this could weigh on the loonie even as the Fed begins to cut rates, we still judge that a broadly weaker big dollar will dominate. We see the loonie 2½% stronger by year-end (compared to April's tracking), averaging US $0.749 (C$1.335), with comparable appreciation next year.

[1] The longer-run level reflects the combination of neutral policy rates in the 3.00%-to-3.25% range and more normal-looking term premiums. Since the FOMC began targeting the fed funds rate in the 1980s, the spread between 10-year yields and effective fed funds rates has generated a median around 150 bps. Our working assumption is for an eventual spread around 75 bps, resulting in a 3.75%-to-4.00% longer-run range. Pushing levels closer to the upper bound is the economy's likely larger inherent inflation risk (see above) and Treasuries' higher inherent credit risk (according to the three major rating agencies). Meanwhile, the government is sporting large budget deficits and borrowing requirements as far as the eye can see.

[2] In last month's post-meeting presser, Chair Powell said the Fed was looking to taper QT "fairly soon". Our working assumption is that the current $60 billion monthly amount for Treasuries will be cut in half, while the non-binding $35 billion for MBS could get a token clip. The announcement could come as early as May 1. Reserves are currently above their pre-QT level at $3.6 trillion, as the overnight reverse repo (ON RRP) facility has absorbed the impact of QT. However, ON RRPs are quickly converging on minimum levels which means that reserves will soon begin regularly absorbing the impact. Powell said, "right now we would characterize them as abundant, and what we're aiming for is ample... which is a little bit less than abundant". But given the uncertainty over where "ample" lives, and wanting to avoid the money market dislocations that occurred in 2019 during the last QT episode, the Fed wants to be extra cautious as reserves begin absorbing QT. We reckon the Fed will end QT when reserves get down to $3.0 trillion, sometime in early 2025. Meantime, in a March 21 speech, BoC Deputy Government Gravelle said QT would continue until settlement balances (reserves) were in the $20 billion to $60 billion range (confirming the range first revealed a year earlier). They are currently topping $125 billion, meaning there is at least $65 billion of QT to go, and that QT could last until "sometime in 2025". However, the ultimate end date will be influenced by the vagaries of Government of Canada deposits.

Overseas

Jennifer Lee, Senior Economist

- The opportunity for cutting rates is approaching for many central banks, broadly speaking. Although growth hasn't slowed markedly, inflation has been making its way towards the target, and it looks like it can be sustained. But, the sudden shock of three sticky U.S. inflation reports in a row caused a recalibration of Fed easing plans, and threw a wrench into other central bank plans. "*Now what?*" was likely a question uttered by policymakers after seeing the March U.S. CPI results. With the market rethinking the Fed's moves, there are obvious reverberations felt around the world, particularly in the FX market. The **G7 finance ministers** recognized this, and issued a statement which included a reference to exchange rates: "*The key commitment is the recognition that excessive volatility and disorderly movements in exchange rates can have adverse implications for economic and financial stability*."
- Meantime, it looks like central bankers are maintaining the "Keep calm and get ready to cut" mentality. **The ECB remains set to lower rates in June**. It stressed that there will be plenty of new information come June, including two new CPI reports. Plus, the latest Press Release (April) contained a new line that gave a blindingly obvious hint: "*If the Governing Council's updated assessment of the inflation outlook… were to further increase its confidence that inflation is converging to the target in a sustained manner, it would be appropriate to reduce the current level of monetary policy restriction.*" In other words, unless something comes out of left field and knocks all the encouraging data seen of late off its feet, expect a rate cut on June 6. At the IMF/World Bank meetings in D.C., the ECB head admitted that a rate cut should come in "*reasonably short order*", a view shared by nearly every Council member. But what the Fed does will influence their thought process. As President Lagarde put it, although the ECB's policy is not Fed-dependent, "*it matters to us and… all of that finds its way into our projections*".
- The **BoE meets in May and in June** and it, too, is preparing to ease monetary policy, likely at the mid-year mark. Governor Bailey pointed out that "*there's more demand-led inflation in the U.S. than we're seeing*" in the U.K., setting up for a divergence between European rates and U.S. policy rates. In Britain, inflation has been trending down and wages grew at their slowest pace in 1½ years in the three months to February. The labour market is cooling, with total employment down 156k in the latest month, and the jobless rate at a 6-month high. However, the economy is starting the year with better momentum (real GDP grew in January and February), which suggests last year's recession was short-lived, and gives the BoE some time to observe activity. But there needs to be a lot more convincing data to allow for a majority to push through a cut. There may be fewer hawks voting for rate hikes these days, but the other hawks are still hawks. For example, Megan Greene warned that rate cuts "*should still be a way off*" given the persistence of inflation pressures. BMO continues to look for a June cut, but we reserve the right to be data-dependent as there are still two CPI and job reports to sift through ahead of that decision.
- Meantime, the **BoJ** is in a tight spot, particularly with the JPY cracking through a new 34-year low of ¥154. Mixed messages from Governor Ueda were unhelpful: he suggested that he will not change policy because of the currency; but, is open to less easing. On top of that, the Bank is reportedly going to raise its CPI forecast at the next meeting on April 26. That will likely be the only major change it will make. However, we do not believe the BoJ is finished adjusting policy this year. And it is likely only a matter of time before the MoF steps in to defend the currency.

Foreign Exchange Forecasts

(local currency per US$: avg.)	Actual 2024 Mar	Forecasts 2024 Apr	May	Jun	Jul	2024 Q3	Q4	2025 Q1	Q2	Q3	Q4
Canadian Dollar											
C$ per US$	1.35	1.37	1.37	1.36	1.36	1.35	1.34	1.33	1.32	1.31	1.30
US$ per C$[1]	0.739	0.730	0.732	0.735	0.737	0.739	0.747	0.752	0.757	0.762	0.768
Trade-weighted	117.0	116.3	116.5	116.8	117.0	117.2	117.9	118.4	118.9	119.3	119.8
U.S. Dollar											
Trade-weighted[2]	121.0	122.5	122.2	121.9	121.6	121.3	120.4	119.6	119.0	118.3	117.7
European Currencies											
Euro[1]	1.09	1.07	1.07	1.08	1.08	1.09	1.10	1.10	1.11	1.11	1.12
Danish Krone	6.86	6.95	6.95	6.90	6.90	6.85	6.80	6.75	6.70	6.70	6.65
Norwegian Krone	10.61	10.90	10.85	10.85	10.80	10.80	10.70	10.65	10.60	10.55	10.50
Swedish Krone	10.41	10.85	10.80	10.75	10.75	10.70	10.65	10.55	10.55	10.50	10.45
Swiss Franc	0.89	0.90	0.90	0.89	0.89	0.89	0.87	0.87	0.86	0.86	0.85
U.K. Pound[1]	1.27	1.25	1.25	1.26	1.26	1.27	1.28	1.28	1.29	1.29	1.30
Asian Currencies											
Chinese Yuan	7.20	7.23	7.21	7.20	7.18	7.17	7.12	7.07	7.02	6.97	6.92
Japanese Yen	150	153	153	152	152	151	150	148	147	146	145
Korean Won	1,332	1,370	1,370	1,365	1,365	1,360	1,355	1,345	1,335	1,330	1,320
Indian Rupee	83.0	83.5	83.3	83.1	82.9	82.7	82.1	81.5	81.0	80.4	79.8
Singapore Dollar	1.34	1.35	1.35	1.35	1.34	1.34	1.34	1.33	1.32	1.31	1.30
Malaysian Ringgit	4.71	4.75	4.75	4.75	4.75	4.70	4.70	4.65	4.65	4.60	4.55
Thai Baht	36.0	36.7	36.6	36.5	36.5	36.4	36.1	35.9	35.6	35.4	35.1
Philippine Peso	55.9	56.9	56.8	56.7	56.6	56.5	56.2	55.9	55.5	55.1	54.7
Taiwan Dollar	31.7	32.3	32.2	32.2	32.1	32.1	31.9	31.7	31.5	31.3	31.0
Indonesian Rupiah	15,707	16,075	16,050	16,020	15,995	15,970	15,885	15,785	15,675	15,565	15,450
Other Currencies											
Australian Dollar[1]	0.656	0.648	0.650	0.651	0.653	0.654	0.659	0.663	0.666	0.670	0.674
New Zealand Dollar[1]	0.608	0.595	0.596	0.598	0.599	0.600	0.604	0.608	0.611	0.615	0.619
Mexican Peso	16.77	16.80	16.80	16.80	16.80	16.80	16.75	16.70	16.65	16.60	16.50
Brazilian Real	4.98	5.15	5.15	5.10	5.10	5.05	5.00	4.95	4.90	4.90	4.85
South African Rand	18.8	19.0	18.9	18.9	18.9	18.8	18.7	18.7	18.6	18.6	18.5
Cross Rates											
Versus Canadian Dollar											
Euro (C$/€)	1.47	1.47	1.47	1.47	1.47	1.47	1.47	1.47	1.46	1.46	1.46
U.K. Pound (C$/£)	1.72	1.71	1.71	1.71	1.71	1.71	1.71	1.71	1.70	1.70	1.69
Japanese Yen (¥/C$)	111	112	112	112	112	112	112	112	112	112	112
Australian Dollar (C$/A$)	0.89	0.89	0.89	0.89	0.89	0.88	0.88	0.88	0.88	0.88	0.88
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 (¥/€)	163	164	164	164	164	164	164	164	163	163	163

[1] (US$ per local currency); [2] Federal Reserve Broad Index
Sources: BMO Economics, Haver Analytics

Interest Rate Forecasts

(% : avg.)	Actual 2024 Mar	Forecasts 2024 Apr	May	Jun	Jul	2024 Q3	Q4	2025 Q1	Q2	Q3	Q4
Canada											
Overnight target (period end)	5.00	5.00[6]	5.00	4.75	4.50	4.50	4.25	4.00	3.75	3.75	3.50
Overnight target	5.00	5.00[6]	5.00	4.79	4.70	4.57	4.45	4.06	3.93	3.75	3.58
CORRA[2]	5.02	5.02	5.02	4.81	4.72	4.59	4.47	4.08	3.95	3.77	3.60
3-month bills	4.91	4.90	4.90	4.70	4.60	4.45	4.35	3.95	3.85	3.65	3.50
6-month	4.88	4.85	4.85	4.65	4.60	4.45	4.35	4.00	3.90	3.70	3.55
1-year	4.69	4.70	4.65	4.45	4.40	4.30	4.20	3.95	3.80	3.65	3.50
2-year bonds	4.13	4.20	4.05	3.90	3.85	3.85	3.75	3.65	3.55	3.40	3.30
3-year	3.88	4.05	3.95	3.80	3.80	3.75	3.60	3.50	3.45	3.35	3.30
5-year	3.51	3.70	3.70	3.75	3.70	3.65	3.50	3.40	3.35	3.30	3.25
7-year	3.43	3.65	3.65	3.65	3.60	3.55	3.40	3.30	3.30	3.25	3.20
10-year	3.44	3.65	3.60	3.55	3.50	3.45	3.25	3.20	3.20	3.20	3.20
30-year	3.35	3.55	3.50	3.45	3.40	3.35	3.20	3.15	3.20	3.20	3.20
1m BA	5.32	5.30	5.30	5.05	4.95	4.85	4.70	4.30	4.15	4.00	3.80
3m BA	5.32	5.25	5.25	5.05	4.95	4.80	4.70	4.30	4.20	4.00	3.85
Prime rate	7.20	7.20[6]	7.20	6.99	6.90	6.77	6.65	6.26	6.13	5.95	5.78
United States											
Fed funds target (period end)	5.38	5.38	5.38	5.38	5.13	5.13	4.88	4.63	4.38	4.38	4.13
Fed funds target	5.38	5.38	5.38	5.38	5.38	5.21	5.09	4.84	4.57	4.38	4.22
EFFR[3]	5.33	5.33	5.33	5.33	5.33	5.17	5.05	4.81	4.54	4.35	4.20
SOFR[4]	5.31	5.32	5.31	5.31	5.31	5.15	5.03	4.79	4.53	4.33	4.18
3-month bills	5.47	5.45	5.45	5.45	5.45	5.25	5.15	4.90	4.60	4.40	4.25
6-month	5.36	5.35	5.40	5.40	5.40	5.20	5.10	4.85	4.60	4.40	4.25
1-year	4.99	5.10	5.05	5.00	4.95	4.85	4.75	4.55	4.35	4.20	4.10
2-year notes	4.59	4.85	4.75	4.60	4.50	4.45	4.35	4.25	4.15	4.05	3.95
3-year	4.38	4.70	4.60	4.55	4.45	4.40	4.30	4.20	4.10	4.05	3.95
5-year	4.20	4.55	4.50	4.45	4.40	4.35	4.20	4.10	4.05	4.00	3.95
7-year	4.21	4.55	4.50	4.40	4.35	4.30	4.15	4.05	4.00	4.00	3.95
10-year	4.21	4.50	4.45	4.40	4.30	4.25	4.05	4.00	4.00	3.95	3.95
30-year bonds	4.36	4.65	4.55	4.50	4.45	4.40	4.20	4.10	4.10	4.10	4.10
Prime rate	8.50	8.50	8.50	8.50	8.50	8.33	8.22	7.97	7.70	7.50	7.35
Other G7											
ECB Refi[1]	4.50	4.50[6]	4.50	4.25	4.25	4.00	4.00	3.75	3.50	3.25	3.00
10yr Bund	2.36	2.35	2.35	2.35	2.35	2.35	2.30	2.25	2.25	2.20	2.15
BoE Repo[1]	5.25	5.25	5.25	5.00	5.00	4.75	4.75	4.50	4.25	4.00	3.75
SONIA[5]	5.19	5.20	5.20	5.11	4.95	4.78	4.70	4.54	4.30	4.05	3.79
10yr Gilt	4.01	4.00	3.95	3.90	3.90	3.85	3.80	3.70	3.65	3.60	3.55
BoJ O/N[1]	-0.10	0.07	0.08	0.10	0.11	0.13	0.15	0.15	0.15	0.15	0.15
10yr JGB	0.74	0.77	0.80	0.83	0.85	0.88	0.97	0.98	0.96	0.93	0.91

[1] end of period; [2] Canadian Overnight Repo Rate Average; [3] Effective Fed Funds Rate; [4] Secured Overnight Financing Rate;
[5] Sterling Overnight Index Average; [6] actual value

Sources: BMO Economics, Haver Analytics

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