Rates Scenario for December 19, 2024

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

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Forecast Summary

(avg.)	Actual 2024 Nov	Forecasts 2024 Dec	2025 Jan	Feb	Mar	Apr	May	Jun	Jul	2025 Q3	Q4
BoC overnight[1]	3.75	3.25[2]	3.25	3.25	3.00	3.00	3.00	2.75	2.75	2.50	2.50
10-yr Canadas	3.28	3.15	3.10	3.10	3.05	3.05	3.05	3.05	3.00	3.00	3.00
Fed funds[1]	4.63	4.38[2]	4.38	4.38	4.13	4.13	4.13	3.88	3.88	3.63	3.63
10-yr Treasuries	4.36	4.35	4.35	4.30	4.30	4.25	4.20	4.20	4.15	4.10	4.05
C$ per US$	1.40	1.42	1.43	1.43	1.43	1.43	1.42	1.42	1.41	1.41	1.39
US$/€	1.06	1.02	1.01	1.01	1.00	1.01	1.02	1.03	1.03	1.04	1.05
US$/£	1.27	1.25	1.25	1.25	1.26	1.26	1.26	1.26	1.26	1.26	1.27
¥/US$	154	154	154	153	153	153	152	152	152	151	150

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

Sources: BMO Economics, Haver Analytics

Canada-U.S. Rates Outlook

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Shifting Easing Gears

We look for both the Federal Reserve and Bank of Canada to rein in their rate-cut cadences in 2025 as monetary policies become more cautious. The caution is a reaction to the approach of policy rates to their neutral levels/ranges. But it's also a reaction to the heightening uncertainty surrounding the paths for U.S. fiscal and trade policies. Until there's some semblance of policy clarity, a slowing rate-cut tempo down to around the neutral realm seems to be the optimal forecast placeholder.

Federal Reserve: On December 18, the FOMC reduced the target range for the federal funds rate by 25 bps to 4.25%-to-4.50% and signalled that subsequent rate cuts would occur more carefully. For example, in the statement, the forward guidance was tweaked. It now says (emphasis ours): *"In considering <u>the extent and timing of</u> additional adjustments to the target range for the federal funds rate, the Committee will carefully assess incoming data, the evolving outlook, and the balance of risks."* The underlined part was new. Also, there was one dissent: Cleveland President Hammack voted in favour of no rate reduction. Another three non-voters were in her camp.

In the **Summary of Economic Projections** (SEP) and 'dot plot', the median projection for the fed funds rate showed 50 bps of easing for next year, down from 100 bps in September's SEP. There was 50 bps in 2026 (same as before) and 25 bps in 2027 (it was flat before). This leaves the policy rate at 3.125%, a net 25 bps higher, which is even above the now-raised projection for the longer run or neutral level. The latter was lifted 12.5 bps to 3.00%. The 'higher for longer' theme is indicative of extra policy caution.

Elsewhere in the SEP, for this year and next, real GDP growth was raised (to above 2.0%) and the unemployment rate was lowered. Total and core PCE inflation were lifted, with core by at least a couple of tenths. Indeed, core inflation now only returns to the 2.0% target in 2027, a year later than in the previous SEP. This revision pattern of stronger growth, lower joblessness and faster core inflation is also indicative of extra policy caution.

Finally, in the **press conference**, Chair Powell said that *"we're significantly closer to neutral"* but policy is *"still meaningfully restrictive"*. The former warrants the extra caution, but the latter still affords some room for further rate cuts. He added that *"for additional cuts we're going to be looking for further progress on inflation"* and *"as long as the economy and the labor market are solid we can be cautious"* in waiting for it.

We now look for the Fed to cut policy rates three times in 2025 (by 75 bps) as caution compels a further downshift from a quarterly cadence to a semi-annual one before year-end. The **easing endpoint** is **3.125%**, our estimate of the neutral level, during 2026 H2 (125 bps away). And for this year, the net risk lies on the upside should inflation prove even more stubborn.

Bank of Canada: On December 11, the Bank cut the policy rate by 50 bps to 3.25%. This was the second consecutive half-point action and the fifth straight move (for a total of 175 bps). And, the Bank signalled that it would be more cautious on further reductions. Governor Macklem's opening statement said (the emphases are ours): *"The Governing Council has reduced the policy rate substantially since June, and those cuts will be working their way through the economy. Going forward, <u>we will be evaluating the need for further reductions in the policy rate one decision at a time</u>. In other words, with the policy rate now substantially lower, <u>we anticipate a more gradual approach to monetary policy</u> if the economy evolves broadly as expected."*

With the latest cut, the policy rate hits the top of the neutral range, which the Bank estimates is 2.25%-to-3.25%. That alone could be an occasion for more policy caution, particularly when past easing efforts are already showing some signs of gaining traction (such as in home and vehicle sales). Meantime, there are developments unfolding or looming that could influence economic growth and/or inflation enough to impinge on monetary policy… again, arguing to tread carefully. These include changes to federal immigration policy, changes to federal and provincial fiscal policies (think tax rate holidays and rebate cheques) and the risk of U.S. tariffs.

As before, we expect the Bank's **easing endpoint** to be in the bottom half of the neutral range (**2.5%**, so 75 bps to go). But this could now be a 2025 H2 story with net risks resting on the upside.

Bond yields: Ten-year Treasury bond yields are on track to average above 4.35% in December, now having spent 15 of the past 17 months in 4%-plus territory (a profile not seen since 2007). The two months the average dipped below 4% were this August and September, as the market looked forward to the start of Fed easing and then got a surprise 50 bp cut. However, since September's low of 3.72%, the monthly trend has backed up about 60 bps, despite further easing. **The impact of Fed rate cuts is being countered by market concerns about bigger budget deficits.** For example, the extension of expiring 2017 tax cuts alone will add $4.0 trillion to the 10-year deficit according to the CBO, and there were lots more campaign promises. And it's also being countered by sticky inflation (perhaps to be made stickier by higher tariffs). Yearly core CPI and PCEPI inflation seem stuck in a range close to 3%, which is influencing the inflation expectations and risk premia embedded in bond yields, along with dampening prospects for further Fed easing.

Given the expected profile for Fed cuts and presuming some fiscal discipline emerges in Congress, we see yields modestly drifting down as 2025 unfolds, but staying at least above 4% (as a monthly average). Meanwhile, 10-year GoC bonds continue to outperform their U.S. counterparts. In November, Canada-U.S. yield spreads averaged -108 bps —the most negative ever—and December is on track for an even more negative amount (about -120 bps).

Three factors have partly been driving record negative spreads. First is the Bank of Canada's more aggressive easing tack. The Bank has cut rates 175 bps since starting in June with the last two actions at 50 bps. The Fed has cut 100 bps since starting in September with the last two moves at 25 bps. **Second** is Canada's better fiscal performance. The latest Canadian fiscal update showed the budget deficit running under 2% of GDP, even including the yet-to-be-accounted-for rebate cheques. This compares to the CBO's baseline for the U.S. budget deficit topping 6%. **Third** is Canada's better inflation performance. Canadian CPI inflation was 1.9% y/y in November (below the 2% target) with the main cores running around 2.6%-to-2.7%. U.S. headline and core CPI inflation was 2.7% and 3.3%, respectively. We reckon such extreme negative spreads will linger until these factors start ebbing (and it won't be the second one).

U.S. dollar: The market's old U.S. dollar narrative was that it would carve a weakening trend once the FOMC started cutting policy rates. And the Fed's trade-weighted index did depreciate during the July-to-September period (a cumulative 1.5% via monthly averages)—but, it has been appreciating since, despite additional Fed rate cuts (3.6% over October and November with December on track for a further 0.7%). The turnaround reflects the market's new narrative: that the incoming Administration's proclivity for tariffs will result in offsetting dollar strength and more inflation (which could prevent the Fed from easing further).

By March 2025, we see the trade-weighted unit hitting a new record high, surpassing the prior peak from October 2022. But, when the Fed is still seen easing in March and (presuming) the market's worst tariff fears aren't being realized, we reckon the old narrative should gain some currency again. Amid these dueling forces, by the end of 2025, we see the dollar depreciating 2.7% from March's probable peak and a net 0.4% from last month's level. However, the net risk is that the greenback could be stronger than this.

Canadian dollar: The Canadian dollar closed below US$0.70 on December 17 for the first time since March 2020 and the days following the declaration of the pandemic. And this time, the currency could average below that mark, which it didn't do in 2020; it's currently on track for US$0.702 (C$1.424) assuming no further changes. This already sneaks past the monthly low recorded in January 2016, when oil prices were plummeting. **Two factors are driving this two-decade-extreme bout of loonie weakness**, apart from the latest flare-up of domestic political uncertainty. **First**, there's the Bank of Canada's more aggressive easing tack than the Fed's. Although both central banks are now following a more cautious course, with BoC policy rates much closer to neutral, once the Fed resumes rate cuts in March we suspect this loonie-negative factor will have already started to fade.

Second, the risk of U.S. tariffs, generally, and ones on Canada, specifically, have increased. On November 25, President-elect Trump posted that, once in office, he would immediately apply a 25% tariff on all imports from Canada and Mexico (and another 10% on those from China) until the countries took actions to address the flow of illegal migrants and drugs into the U.S. from their jurisdictions. Interestingly, Canada recently announced plans to do just that, potentially paring these specific risks. However, the general threat of tariffs (Mr. Trump's modus operandi) and uncertainty surrounding the mid-2026 revisiting of the USMCA look to be more perennial factors negatively affecting the loonie. On balance, we see the Canadian dollar remaining weak through next March, eventually averaging a bit below US$0.70 (hitting C$1.43), before rebounding to almost US$0.72 (or C$1.39) by the end of next year. But the net risks lie on the side of a weaker loonie.

Overseas

Jennifer Lee, Senior Economist

Every look ahead to the coming year is a challenge, but 2025 seems particularly rife with uncertainty. Much of this has to do with a looming trade war with the U.S. given the incoming Administration's strong protectionist views. How monetary policy plays out will depend on the evolving political stage and the data, with possibly deeper rate cuts across the Euro region and the U.K. As such, the greenback will retain its resilient status.

The **ECB** eased four times in 2024 (100 bps total). It started in June, paused in July, then swiftly cut three times in a row, ending in December, bringing the deposit rate to 3.00%. Given the parade of Governing Council members that emerged after the December meeting, and the media reports, well, we can take a hint. For example, Reuters reported that five Governing Council members had pushed for a 50 bp rate cut initially (not just Greece!). Then, Latvia's Martins Kazaks warned that yes, a gradual step-by-step approach was the right way to go, but a larger rate cut could be warranted depending on how the economy fares. France's Francois Villeroy de Galhau says he is "*rather comfortable*" with the market's thinking of more than 100 bps of cuts in 2025. Estonia's Madis Muller feels that current rates are "*still more likely to be high*", and Spain's Jose Luis Escriva said to expect rate cuts "*in the next meetings*"—using the plural of "cut". Austria's Robert Holzmann is no longer an uber-hawk, as he openly agreed with President Lagarde's remark that rates are headed lower and that neutral was around 2%. Even Isabel Schnabel gave the green light for more easing, but just added that the ECB should "*proceed with caution*". With political chaos in Germany and France in the background, the **ECB is likely unwilling to wait until March before easing again**. All in, we look for 100 bps of cuts in 2025.

The **BoE** kept its Bank Rate at 4.75% in December, which was no surprise. The focus was on the vote and, as expected, the gap was not as wide as it once was. At the prior meeting, it was 8-to-1 to cut, with one member (Catherine Mann) voting to hold. This time, it was 6-to-3 to hold, with three members voting for a cut. Yes, Swati Dhingra now has more company in the dovish camp. The increase in the number of turtle doves was reflected in the economic forecasts with no growth expected in Q4. They also see sluggish demand and a weaker job market. For the rest of the MPC, the job market is "*broadly in balance*" but inflation pressures are only being resolved "*more slowly*". That's another way of saying sticky. Governor Bailey again used the word "*gradual*", a word he used at the November meeting (and just a couple of weeks before that, he mused about being more aggressive) to describe the Bank's approach to rates. Like all central banks out there, there is "*heightened uncertainty*". So, understandably, Governor Bailey said that he "*can't commit to when or by how much to cut in '25*". The MPC is becoming increasingly dovish, which will weigh on the GBP for the first part of 2025. As far as rates go, **we're comfortable with our view that the next cut will come in February**, followed by two more during the year (total 75 bps).

The **BoJ** is being careful and cautious. Subtle hints were dropped that it would keep its powder dry in December, and that is exactly what it did, although one dissenter argued for a rate hike to around 0.5%, citing upside risks to prices, instead of leaving it at "*around 0.25%*". But to say that the Bank is dovish might be a stretch, as it mentioned the need to "*pay due attention*" to the FX market and its impact on the economy and inflation. It also noted "*firms' behavior shifting more toward raising wages and prices recently*" and, combined with the currency moves, are "*more likely to affect prices*". Governor Ueda, during the press conference, alluded to more rate hikes in 2025 but will gauge how U.S. trade policies play out, and the spring wage talks, and how they filter through to prices. But against the backdrop of a less dovish Fed and a more cautious BoJ, the JPY is headed for more near-term weakness. It is notable that it hit a 6-month low of ¥157 even after the expected on-hold announcement. Indeed, **a January rate hike might be too soon for the BoJ**. **March is the earliest**, but let's see how the data, global trade and the wage negotiations play out. For now, we look for 100 bps of hikes in 2025.

The **RBA** has been glued to the sidelines throughout 2024 (so has the Norges Bank!), patiently waiting for evidence of inflation returning to the 2%-to-3% target. At the December meeting, Governor Bullock finally sounded more dovish, saying that the Board is “*gaining some confidence*” that inflation is headed to the midpoint of the target. There is one job and one quarterly CPI report before the first meeting of 2025 (in **February**). By then, **the Board should have enough confidence to lower the cash rate** (or a total of 75 bps in 2025).

Foreign Exchange Forecasts

(local currency per US$: avg.)	Actual 2024 Nov	Forecasts 2024 Dec	2025 Jan	Feb	Mar	Apr	May	Jun	Jul	2025 Q3	Q4
Canadian Dollar											
C$ per US$	1.40	1.42	1.43	1.43	1.43	1.43	1.42	1.42	1.41	1.41	1.39
US$ per C$[1]	0.716	0.703	0.702	0.700	0.699	0.701	0.704	0.706	0.708	0.710	0.717
Trade-weighted	115.9	114.9	114.9	115.0	114.8	114.9	115.0	115.1	115.3	115.5	116.1
U.S. Dollar											
Trade-weighted[2]	126.5	128.6	129.0	129.5	129.6	129.1	128.6	128.1	127.7	127.4	126.4
European Currencies											
Euro[1]	1.06	1.02	1.01	1.01	1.00	1.01	1.02	1.03	1.03	1.04	1.05
Danish Krone	7.02	7.15	7.15	7.15	7.15	7.15	7.15	7.10	7.10	7.10	7.10
Norwegian Krone	11.05	11.25	11.25	11.25	11.25	11.25	11.25	11.25	11.30	11.30	11.30
Swedish Krone	10.91	11.00	11.00	10.95	10.95	10.95	10.95	10.95	10.95	10.95	10.90
Swiss Franc	0.88	0.89	0.89	0.89	0.89	0.88	0.88	0.88	0.88	0.88	0.87
U.K. Pound[1]	1.27	1.25	1.25	1.25	1.26	1.26	1.26	1.26	1.26	1.26	1.27
Asian Currencies											
Chinese Yuan	7.21	7.28	7.30	7.30	7.30	7.29	7.27	7.26	7.25	7.23	7.19
Japanese Yen	154	154	154	153	153	153	152	152	152	151	150
Korean Won	1,395	1,435	1,435	1,435	1,435	1,430	1,430	1,430	1,430	1,425	1,425
Indian Rupee	84.3	84.9	85.3	85.5	85.3	85.1	85.0	84.8	84.6	84.4	83.9
Singapore Dollar	1.34	1.35	1.35	1.35	1.35	1.35	1.35	1.35	1.34	1.34	1.34
Malaysian Ringgit	4.43	4.45	4.45	4.45	4.45	4.45	4.45	4.45	4.45	4.45	4.45
Thai Baht	34.4	34.3	34.3	34.2	34.2	34.2	34.2	34.1	34.1	34.1	34.0
Philippine Peso	58.7	58.7	58.6	58.6	58.5	58.5	58.5	58.4	58.4	58.3	58.2
Taiwan Dollar	32.4	32.6	32.5	32.5	32.4	32.4	32.4	32.3	32.3	32.3	32.1
Indonesian Rupiah	15,828	16,090	16,085	16,080	16,075	16,070	16,065	16,055	16,050	16,045	16,030
Other Currencies											
Australian Dollar[1]	0.653	0.630	0.631	0.633	0.634	0.635	0.636	0.638	0.639	0.640	0.644
New Zealand Dollar[1]	0.591	0.570	0.571	0.573	0.574	0.575	0.576	0.578	0.579	0.580	0.584
Mexican Peso	20.34	20.35	20.50	21.00	20.90	20.80	20.70	20.60	20.50	20.40	20.10
Brazilian Real	5.80	6.10	6.05	6.00	5.95	5.90	5.85	5.80	5.75	5.70	5.55
South African Rand	17.9	18.2	18.3	18.2	18.1	18.0	18.0	17.9	17.8	17.8	17.6
Cross Rates											
Versus Canadian Dollar											
Euro (C$/€)	1.48	1.45	1.44	1.44	1.43	1.44	1.45	1.46	1.46	1.46	1.46
U.K. Pound (C$/£)	1.78	1.78	1.78	1.79	1.79	1.79	1.79	1.79	1.78	1.78	1.77
Japanese Yen (¥/C$)	110	108	108	107	107	107	107	107	107	107	108
Australian Dollar (C$/A$)	0.91	0.90	0.90	0.90	0.91	0.91	0.90	0.90	0.90	0.90	0.90
Versus Euro											
U.K. Pound (£/€)	0.83	0.82	0.81	0.80	0.80	0.80	0.81	0.82	0.82	0.82	0.83
Japanese Yen (¥/€)	163	157	156	154	153	154	155	157	157	157	157

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

Interest Rate Forecasts

(% : avg.)	Actual	Forecasts									
	2024	2024	2025							2025	
	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Q3	Q4
Canada											
Overnight target (period end)	3.75	3.25[6]	3.25	3.25	3.00	3.00	3.00	2.75	2.75	2.50	2.50
Overnight target	3.75	3.43[6]	3.25	3.25	3.10	3.00	3.00	2.79	2.75	2.72	2.50
CORRA[2]	3.79	3.49	3.33	3.33	3.16	3.05	3.05	2.82	2.78	2.74	2.50
3-month bills	3.48	3.20	3.15	3.15	3.00	2.90	2.90	2.70	2.65	2.65	2.45
6-month	3.39	3.15	3.10	3.10	3.00	2.90	2.90	2.75	2.75	2.70	2.55
1-year	3.29	3.10	3.05	3.05	2.95	2.90	2.90	2.75	2.75	2.70	2.55
2-year bonds	3.18	3.00	2.95	2.95	2.90	2.85	2.80	2.75	2.70	2.65	2.55
3-year	3.14	2.95	2.95	2.90	2.90	2.85	2.80	2.80	2.75	2.75	2.65
5-year	3.11	2.95	2.95	2.95	2.90	2.90	2.85	2.85	2.85	2.80	2.75
7-year	3.21	3.05	3.05	3.00	3.00	3.00	2.95	2.95	2.95	2.90	2.85
10-year	3.28	3.15	3.10	3.10	3.05	3.05	3.05	3.05	3.00	3.00	3.00
30-year	3.31	3.20	3.20	3.15	3.10	3.10	3.10	3.10	3.10	3.10	3.05
Prime rate	5.95	5.63[6]	5.45	5.45	5.30	5.20	5.20	4.99	4.95	4.92	4.70
United States											
Fed funds target (period end)	4.63	4.38[6]	4.38	4.38	4.13	4.13	4.13	3.88	3.88	3.63	3.63
Fed funds target	4.68	4.52[6]	4.38	4.38	4.28	4.13	4.13	4.03	3.88	3.84	3.63
EFFR[3]	4.64	4.48	4.34	4.34	4.25	4.10	4.10	4.00	3.85	3.82	3.61
SOFR[4]	4.64	4.49	4.34	4.34	4.25	4.10	4.10	4.00	3.85	3.82	3.61
3-month bills	4.62	4.35	4.20	4.20	4.10	3.95	3.95	3.90	3.75	3.70	3.50
6-month	4.43	4.25	4.15	4.15	4.05	3.95	3.95	3.85	3.75	3.70	3.55
1-year	4.33	4.25	4.15	4.15	4.10	4.00	3.95	3.90	3.80	3.75	3.60
2-year notes	4.26	4.25	4.20	4.15	4.10	4.05	4.00	3.95	3.90	3.85	3.70
3-year	4.21	4.25	4.20	4.15	4.10	4.05	4.00	3.95	3.95	3.90	3.75
5-year	4.23	4.25	4.20	4.20	4.15	4.10	4.05	4.05	4.00	3.95	3.85
7-year	4.29	4.30	4.30	4.25	4.20	4.20	4.15	4.10	4.10	4.05	3.95
10-year	4.36	4.35	4.35	4.30	4.30	4.25	4.20	4.20	4.15	4.10	4.05
30-year bonds	4.54	4.55	4.50	4.50	4.45	4.40	4.40	4.35	4.35	4.30	4.20
Prime rate	7.81	7.65[6]	7.50	7.50	7.40	7.25	7.25	7.15	7.00	6.97	6.75
Other G7											
ECB Deposit Rate[1]	3.25	3.00[6]	2.75	2.75	2.50	2.50	2.50	2.25	2.25	2.00	2.00
10yr Bund	2.32	2.35	2.35	2.35	2.35	2.35	2.30	2.30	2.30	2.30	2.30
BoE Repo[1]	4.75	4.75[6]	4.75	4.50	4.50	4.50	4.25	4.25	4.25	4.00	4.00
SONIA[5]	4.75	4.70	4.70	4.49	4.45	4.45	4.26	4.20	4.20	4.05	3.95
10yr Gilt	4.43	4.45	4.45	4.45	4.40	4.40	4.40	4.40	4.40	4.35	4.35
BoJ O/N[1]	0.25	0.25[6]	0.25	0.25	0.50	0.50	0.75	0.75	1.00	1.00	1.25
10yr JGB	1.03	1.05	1.06	1.07	1.08	1.08	1.09	1.10	1.11	1.12	1.14

[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

General Disclosures

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