Rates Scenario for January 16, 2025

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

Forecast Summary

(avg.)	Actual 2024 Dec	Forecasts 2025 Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	2025 Q4
BoC overnight[1]	3.25	3.25	3.25	3.00	3.00	3.00	2.75	2.75	2.75	2.50	2.50
10-yr Canadas	3.16	3.40	3.40	3.40	3.35	3.30	3.30	3.25	3.20	3.20	3.10
Fed funds[1]	4.38	4.38	4.38	4.38	4.38	4.38	4.13	4.13	4.13	3.88	3.63
10-yr Treasuries	4.39	4.65	4.65	4.65	4.60	4.55	4.50	4.45	4.40	4.35	4.20
C$ per US$	1.42	1.44	1.43	1.43	1.43	1.42	1.42	1.41	1.41	1.40	1.39
US$/€	1.05	1.03	1.02	1.00	1.01	1.02	1.03	1.03	1.04	1.04	1.05
US$/£	1.26	1.22	1.20	1.20	1.21	1.21	1.22	1.22	1.23	1.23	1.24
¥/US$	154	156	155	154	154	153	152	152	151	151	150

[1] end of period

Sources: BMO Economics, Haver Analytics

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Canada-U.S. Rates Outlook

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A Rates Riddle Wrapped in A Policy Enigma

Given the profound policy uncertainty springing from the incoming Trump Administration, particularly about potential tariffs, **the confidence intervals around our base case forecasts for central bank policy rates, bond yields, and currencies have all widened considerably**. We await inauguration on January 20 for insight on whether the upside or downside risks to our forecasts will dominate.

We continue to expect the Federal Reserve and Bank of Canada to **curtail their rate cut cadences** this year. This follows the Fed's three consecutive actions worth 100 bps that began with a 50 bp cut, with the midpoint of the fed funds target range now at 4.375%. It also follows the Bank's five straight moves worth 175 bps that ended with back-to-back 50 bp cuts, with the target for the overnight rate now at 3.25%. The curtailing reflects two key factors.

First, both central banks are becoming **more cautious** as policy rates approach their neutral levels. In last month's post-meeting press conference, **BoC Governor Macklem** said: *"With inflation back to target, we have cut the policy rate by 50 basis points at each of the last two decisions because monetary policy no longer needs to be clearly in restrictive territory."* The Bank estimates a 2.25%-to-3.25% range for the neutral level with the policy rate now sitting at the top of the range. In turn, Macklem said: *"... with the policy rate now substantially lower, we anticipate a more gradual approach to monetary policy if the economy evolves broadly as expected."*

Fed Chair Powell, in last month's post-meeting presser, said that *"we're significantly closer to neutral"* and it's *"appropriate... now to proceed cautiously"*. But *"we believe policy is still meaningfully restrictive"*. Among policymakers' projections of the neutral level (in December's Summary of Economic Projections (SEP)), the range was 2.375%-to-3.875%, with a 2.75%-to-3.625% central tendency and a 3.00% median. The shift into a more cautious easing gear—while still shy of the FOMC's consensus view on the neutral level—partly reflects recent sticky inflation prints. Indeed, the SEP's median projection for the fed funds target showed 50 bps of total easing by end-2025, down from 100 bps before, reflecting *"both the higher inflation readings we've had this year and the expectation that inflation will be higher"*.

Second, both central banks are also becoming **more circumspect in response to the escalating risks** surrounding their outlooks for economic growth and inflation. The escalation is being driven by *"elevated uncertainty regarding specifics about the scope and timing of potential changes to trade, immigration, fiscal, and regulatory policies"* under the incoming Trump Administration (according to the latest FOMC Minutes).

For example, the mounting prospects for increased U.S. tariffs on Canada's and other countries' exports to the U.S., along with retaliatory tariffs by Canada and other countries on U.S. exports, are pumping both downside risks to growth and upside risks to inflation. Extra monetary policy caution is called for until it's clear whether one side of the risk scale is weighing heavier. Meantime, less immediate prospects for lower taxes (beyond the extension of expiring 2017 tax cuts) are weighing against meaningful spending cuts (which the GOP-led House has already begun considering).

Base case: From reducing policy rates every meeting by as much as 50 bps last year, we look for meetings to start being skipped this year and only 25 bp reduction steps. Our base case, as before, has both central banks easing a total of 75 bps this year, but with the Fed now starting in June. This is three months later than in the previous Rates Scenario (December 19) reflecting the anticipation of even more stubborn inflation (recall *"further progress on inflation"* is the prerequisite for more rate cuts). By year-end, the fed funds range midpoint will be touching the top of the FOMC's central tendency for the neutral level (3.625%). Then there's more easing in store for 2026 (50 bps worth) as the fed funds range settles at 3.00%-to-3.25% and PCE inflation finally settles at 2%.

As before, we expect the Bank of Canada to next move in March, but we can't rule out a January action. By September, with the policy rate at 2.50% and having fallen into the bottom half of the estimated neutral range, we expect the Bank to pause indefinitely.

However, for both the Fed and BoC, cumulative rate cuts this year could easily be larger if it's the realized downside growth risks that dominate. And they could be smaller, with eventual rate hikes not ruled out (particularly in the U.S.), if it's the realized upside inflation risks that rule. In the wake of the January 20 inauguration, we should begin getting a better sense of where the balance of risks is tipping.

Bond yields: Ten-year Treasury bond yields are on track to average 4.67% this month, up 28 bps from December's mean. This will mark the second-highest level in more than 17 years, with October 2023's 4.80% print taking top prize. Among the past 18 months, yields have averaged below 4% in only two of them. These were last August and September as the market was bracing for the start of Fed rate cuts and then got a surprise 50 bp action. However, since September's low of 3.72%, the monthly trend has backed up 95 bps, despite further easing. The impact of Fed cuts has been countered by market concerns about faster inflation and bigger budget deficits, along with corresponding dimming prospects for further Fed easing.

Since September, 10-year real yields (TIPS) are up 64 bps with implied inflation expectations up 31 bps. The latter have been prodded by stubborn inflation results and concerns over a policy-induced pickup owing mostly to tariffs. Meanwhile, the extension of expiring 2017 tax cuts alone will add $4.0 trillion to the 10-year deficit (according to the CBO) with most years already recording budget shortfalls above 6.0% of GDP. While House Republicans have already started looking at cuts to mandatory spending, there are also plans to lower taxes further on the incoming Administration's agenda. However, as Fed rate cuts are resumed and presuming some fiscal discipline emerges in Congress, we look for the bond yield trend to turn back down, but with yields remaining above 4%.

Meanwhile, 10-year Government of Canada bond yields continue to outperform their U.S. counterparts. This month, they are on track to average 3.38% and a record 129 bps below comparable Treasuries. Apart from technical pressures, there are four fundamental factors driving record negative Canada-U.S. yield spreads. First is the Bank of

Canada's more aggressive easing tack so far, at 175 bps compared to the Fed's 100 bps. And the Bank is expected to cut again sooner. Second is Canada's better fiscal performance. The federal budget deficit is running under 2% of GDP compared to the 6%-plus outcomes south of the border. 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 (in December) was 2.9% and 3.3%, respectively. Finally, the prospects for U.S. tariffs on Canadian exports poses more downside risk to Canadian growth and more upside risk to U.S. inflation, which is constructive for Canada-U.S. yield spreads.

We reckon such extreme negative yield spreads will linger for a while longer before moving slightly less negative as 2025 unfolds. But they should remain in the triple-digit range, holding the -100 bp line. Finally, we judge the net risk to both our bond yield forecasts rests on the upside.

U.S. dollar: The Fed's broad trade-weighted dollar index is on track to average a record high for the second consecutive month in January, appreciating 1.3%. Last summer, the greenback was drifting weaker in anticipation of Fed rate cuts. But after bottoming in September (when they started), the currency has been on an appreciating trend. It has gained 6.0% through January. Driving the dollar has been market speculation about increased tariffs which would result is offsetting dollar strength. It would also result is more inflation which would make the Fed less willing to ease as much, or at all. This, too, would be dollar friendly.

We see the greenback appreciating through March, gaining a further 0.7% from January's average. Our working assumption (which could change soon after January 20) is that once tariff plans are revealed, they will likely fall short of the market's worst fears. In a case of classic 'buy on rumour, sell on fact' along with renewed speculation (and eventual realization) of resumed Fed rate cuts, we look for the dollar to trend weaker through the rest of the year (-2.9%). Overall, we judge the net risk is still that the greenback could be stronger than this.

Canadian dollar: The loonie is on track to average US$0.696 (C$1.436) this month, marking the weakest level in more than two decades (since April 2003). The potential for U.S. tariffs on Canadian exports is weighing heavy for two reasons. First, there's outright U.S. dollar strength and, second, there's the risk of more aggressive easing by the Bank of Canada to mitigate the economic hit. Meantime, political uncertainty is not helping the situation. A new Liberal Party leader (and Prime Minister) will be chosen on March 9. Parliament is prorogued until March 24 and, when it's reconvened, a likely successful non-confidence vote will set the stage for a federal election sometime in May.

We look for the loonie to fly around current weak levels for the next several weeks. Our working assumption is that U.S. tariffs will be less than worst feared, which could start flipping the currency's fortunes around. The latter would be augmented by ebbing domestic political uncertainty and, later, by the end of Bank of Canada easing. This should lift the loonie to average around US$0.719 (C$1.390) by year-end. Again, the confidence interval around our C$ forecast (and all our currency forecasts) has widened considerably.

Overseas

Jennifer Lee, Senior Economist

Yes, it was obvious that there would be plenty of uncertainty as 2025 began, but that is an understatement. The **threat of U.S. tariffs** is a big issue for the world, and there is no clarity around the W5... the who, what, where, when and why. Not to mention 'how'. Specifically, the size of the tariffs themselves, what and who the targets are, when they will take effect, and for how long. The European Union, several months ago, declared that it is not interested in a trade war with the U.S. and will increase its imports of U.S. LNG. That will hopefully eliminate the need for tariffs and help Europe reduce its reliance on Russian energy. The U.K. has, so far, avoided being named in the same breath as the word tariffs, but its exports to the U.S. (pharmaceuticals and cars are the two largest products) would be subject to the same blanket 10% or 20% tax as other imports. All of this uncertainty puts central banks in a tough spot, but **the direction is clear: rates continue to move lower.**

We continue to expect the **BoE** to lower its Bank Rate another 25 bps in February to 4.50%. This would be only the third cut so far this cycle, or 75 bps in total. The Bank has been slower to cut given stickier inflation and wage growth. And, there is, or was, a very clear split amongst those on the MPC, with a couple of ardent doves and the rest sporting varying shades of dovishness. But, the latest **inflation** report was much better than expected and should bring more doves into the open. Most notable was the slowdown in services CPI to a 33-month low of 4.4% (although it was driven by volatile airfares and hotel prices). The economy also stagnated in the second half of 2024: Q3 **real GDP** growth was flat, and looks to be the same in Q4 so far. Plus, financial markets are questioning the government's resolve to rein in the fiscal deficit by sending, at one point, 30-year Gilt yields to their highest levels since 1998, and the GBP to a 14-month low of $1.2111. BMO already has three 25 bp rate cuts pencilled into this year (February, May and August) but this volatility introduces the possibility of more, or larger, reductions.

The **ECB** cut the deposit rate 100 bps in 2024 and another 100 bps are expected in 2025, starting in January. The central bank is leaning more dovish: at the previous meeting, the phrase about keeping rates "*restrictive for as long as necessary*" was dropped, and a handful of the 26 Governing Council members initially pushed for a 50 bp rate cut. Government spending will be under pressure as the incoming U.S. Administration has introduced the idea for higher defense spending: from 2% to 5% of GDP. But the ECB views fragmentation and trade protectionism as the biggest risk. In Germany, the economy shrank in both 2023 and 2024, the first back-to-back contraction in over two decades. Political uncertainty there (election on February 23), and in France (4th PM in one year), will prevent significant economic reform from passing in the near-term. It is not all downbeat: Italy is growing and PM Meloni has led the country with a firm hand; and, Spain had the strongest growth (3%) among the major economies in 2024. The ECB still looks for rate cuts this year but the speed is debatable, with some calling for caution, while Chief Economist Philip Lane recently warned that if rates stay "*too high for too long*", then "*inflation could materially fall below target*".

The **RBA** was one of the few central banks (along with Norges Bank) that stuck to the sidelines in 2024, as the Board wanted "*more confidence*" that inflation was headed at a sustained pace for the 2%-to-3% target. It should have enough evidence now, with the latest trimmed mean CPI falling from 3.5% to close-to-3-year lows of 3.2% in November. We look for a 25 bp cut in February, but it is not a slam dunk. Governor Bullock made it a point to say that the RBA focuses on the quarterly CPI, and less so the monthlies. And the latest report was for November alone.

Only one major central bank stands out in the crowd (aside from Brazil). The **BoJ** has been very cautiously tightening: it ended negative rates in March 2024, then lifted them 20 bps to "*around 0.25%*" in July. The Bank took a pass in December, although one voter dissented in favour of a 25 bp hike. With inflation still above target, and likely to stay that way (Tokyo inflation accelerated in the latest month), more firms raising wages, and the JPY not far from 38-year lows, the Bank is poised to tighten again, perhaps as soon as next week. However, the BoJ may stay cautious, given the timing (may want clarity on U.S. tariffs), and hold off until March.

Foreign Exchange Forecasts

(local currency per US$: avg.)	Actual 2024 Dec	Forecasts 2025 Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	2025 Q4
Canadian Dollar											
C$ per US$	1.42	1.44	1.43	1.43	1.43	1.42	1.42	1.41	1.41	1.40	1.39
US$ per C$[1]	0.702	0.695	0.697	0.699	0.701	0.704	0.706	0.708	0.710	0.713	0.717
Trade-weighted	114.4	114.1	114.8	115.2	115.3	115.4	115.5	115.6	115.8	116.0	116.4
U.S. Dollar											
Trade-weighted[2]	127.8	129.4	130.1	130.3	129.7	129.2	128.6	128.3	127.9	127.5	126.8
European Currencies											
Euro[1]	1.05	1.03	1.02	1.00	1.01	1.02	1.03	1.03	1.04	1.04	1.05
Danish Krone	7.12	7.25	7.25	7.20	7.20	7.20	7.20	7.15	7.15	7.15	7.10
Norwegian Krone	11.22	11.35	11.35	11.35	11.30	11.30	11.25	11.25	11.25	11.20	11.15
Swedish Krone	10.99	11.15	11.10	11.10	11.10	11.05	11.05	11.05	11.00	11.00	10.95
Swiss Franc	0.89	0.91	0.91	0.90	0.90	0.90	0.89	0.89	0.89	0.88	0.87
U.K. Pound[1]	1.26	1.22	1.20	1.20	1.21	1.21	1.22	1.22	1.23	1.23	1.24
Asian Currencies											
Chinese Yuan	7.28	7.31	7.32	7.32	7.31	7.30	7.30	7.29	7.28	7.27	7.26
Japanese Yen	154	156	155	154	154	153	152	152	151	151	150
Korean Won	1,440	1,460	1,460	1,455	1,455	1,450	1,450	1,450	1,445	1,445	1,440
Indian Rupee	85.0	86.3	86.5	86.4	86.3	86.2	86.1	86.1	86.0	85.9	85.7
Singapore Dollar	1.35	1.37	1.37	1.37	1.36	1.36	1.36	1.36	1.36	1.36	1.35
Malaysian Ringgit	4.46	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.45	4.45	4.45
Thai Baht	34.1	34.5	34.5	34.5	34.4	34.4	34.4	34.3	34.3	34.2	34.2
Philippine Peso	58.4	58.5	58.4	58.4	58.3	58.3	58.2	58.2	58.1	58.1	58.0
Taiwan Dollar	32.6	32.9	32.9	32.8	32.8	32.8	32.7	32.7	32.7	32.6	32.6
Indonesian Rupiah	16,066	16,310	16,295	16,285	16,270	16,260	16,245	16,235	16,220	16,210	16,185
Other Currencies											
Australian Dollar[1]	0.633	0.621	0.623	0.625	0.628	0.630	0.632	0.634	0.636	0.638	0.643
New Zealand Dollar[1]	0.575	0.560	0.562	0.565	0.567	0.569	0.571	0.574	0.576	0.578	0.583
Mexican Peso	20.26	20.65	21.00	20.90	20.80	20.70	20.60	20.50	20.40	20.30	20.10
Brazilian Real	6.10	6.05	6.00	5.95	5.90	5.85	5.80	5.75	5.70	5.65	5.55
South African Rand	18.2	18.8	18.7	18.7	18.6	18.5	18.4	18.4	18.3	18.2	18.1
Cross Rates											
Versus Canadian Dollar											
Euro (C$/€)	1.49	1.48	1.46	1.43	1.44	1.45	1.46	1.46	1.46	1.46	1.46
U.K. Pound (C$/£)	1.80	1.75	1.72	1.72	1.72	1.72	1.72	1.73	1.73	1.73	1.74
Japanese Yen (¥/C$)	108	108	108	108	108	108	107	107	107	108	108
Australian Dollar (C$/A$)	0.90	0.89	0.89	0.89	0.89	0.89	0.90	0.90	0.90	0.90	0.90
Versus Euro											
U.K. Pound (£/€)	0.83	0.85	0.85	0.83	0.84	0.84	0.85	0.85	0.84	0.84	0.84
Japanese Yen (¥/€)	161	161	158	154	155	156	157	157	157	157	157

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

Sources: BMO Economics, Haver Analytics

Interest Rate Forecasts

(% : avg.)	Actual 2024 Dec	Forecasts 2025 Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	2025 Q4
Canada											
Overnight target (period end)	3.25	3.25	3.25	3.00	3.00	3.00	2.75	2.75	2.75	2.50	2.50
Overnight target	3.43	3.25	3.25	3.10	3.00	3.00	2.79	2.75	2.75	2.65	2.50
CORRA[2]	3.51	3.30	3.30	3.13	3.03	3.03	2.80	2.77	2.77	2.66	2.50
3-month bills	3.19	3.10	3.10	2.95	2.90	2.90	2.70	2.65	2.65	2.55	2.45
6-month	3.15	3.05	3.10	2.95	2.90	2.90	2.75	2.70	2.70	2.65	2.55
1-year	3.11	3.05	3.05	2.95	2.90	2.90	2.75	2.75	2.70	2.65	2.55
2-year bonds	3.00	3.00	2.95	2.90	2.85	2.85	2.80	2.75	2.70	2.65	2.55
3-year	2.95	2.95	2.90	2.90	2.85	2.85	2.80	2.80	2.75	2.75	2.65
5-year	2.96	3.10	3.10	3.05	3.00	3.00	2.95	2.95	2.90	2.85	2.80
7-year	3.05	3.25	3.20	3.20	3.15	3.10	3.10	3.05	3.05	3.00	2.95
10-year	3.16	3.40	3.40	3.40	3.35	3.30	3.30	3.25	3.20	3.20	3.10
30-year	3.25	3.50	3.50	3.50	3.45	3.40	3.40	3.35	3.30	3.30	3.20
Prime rate	5.63	5.45	5.45	5.30	5.20	5.20	4.99	4.95	4.95	4.85	4.70
United States											
Fed funds target (period end)	4.38	4.38	4.38	4.38	4.38	4.38	4.13	4.13	4.13	3.88	3.63
Fed funds target	4.52	4.38	4.38	4.38	4.38	4.38	4.28	4.13	4.13	4.02	3.82
EFFR[3]	4.48	4.33	4.33	4.33	4.33	4.33	4.24	4.09	4.09	3.99	3.80
SOFR[4]	4.53	4.30	4.28	4.28	4.28	4.28	4.19	4.05	4.05	3.95	3.76
3-month bills	4.39	4.35	4.35	4.35	4.35	4.35	4.25	4.10	4.10	4.00	3.80
6-month	4.32	4.25	4.25	4.25	4.25	4.25	4.15	4.05	4.05	3.95	3.75
1-year	4.23	4.20	4.20	4.20	4.15	4.15	4.05	3.95	3.95	3.85	3.70
2-year notes	4.23	4.30	4.30	4.30	4.20	4.15	4.10	4.05	3.95	3.90	3.75
3-year	4.22	4.35	4.35	4.35	4.30	4.25	4.20	4.10	4.05	4.00	3.90
5-year	4.25	4.45	4.45	4.45	4.40	4.35	4.30	4.25	4.20	4.15	4.05
7-year	4.32	4.55	4.55	4.55	4.50	4.50	4.45	4.40	4.35	4.30	4.20
10-year	4.39	4.65	4.65	4.65	4.60	4.55	4.50	4.45	4.40	4.35	4.20
30-year bonds	4.58	4.90	4.90	4.90	4.85	4.75	4.70	4.65	4.60	4.55	4.45
Prime rate	7.65	7.50	7.50	7.50	7.50	7.50	7.40	7.25	7.25	7.15	6.95
Other G7											
ECB Deposit Rate[1]	3.00	2.75	2.75	2.50	2.50	2.50	2.25	2.25	2.25	2.00	2.00
10yr Bund	2.23	2.50	2.45	2.45	2.40	2.40	2.35	2.35	2.30	2.30	2.20
BoE Repo[1]	4.75	4.75	4.50	4.50	4.50	4.25	4.25	4.25	4.00	4.00	4.00
SONIA[5]	4.70	4.70	4.49	4.45	4.45	4.26	4.20	4.20	4.00	3.95	3.95
10yr Gilt	4.43	4.70	4.65	4.65	4.60	4.55	4.50	4.50	4.45	4.40	4.35
BoJ O/N[1]	0.25	0.25	0.25	0.50	0.50	0.75	0.75	1.00	1.00	1.00	1.25
10yr JGB	1.07	1.08	1.08	1.09	1.10	1.10	1.11	1.12	1.12	1.13	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

Sources: BMO Economics, Haver Analytics

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