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Rates Scenario

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Rates Scenario for November 2, 2023

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Forecast Summary

(avg.)	Actual	Forecasts									
	2023	2023		2024						2024	
	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Q3	Q4
BoC overnight[1]	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	4.75	4.50
10-yr Canadas	4.06	4.05	4.00	3.95	3.95	3.90	3.90	3.85	3.80	3.75	3.70
Fed funds[1]	5.38	5.38[2]	5.38	5.38	5.38	5.38	5.38	5.38	5.38	5.13	4.88
10-yr Treasuries	4.80	4.75	4.70	4.65	4.60	4.55	4.50	4.45	4.45	4.35	4.25
C$ per US$	1.37	1.36	1.35	1.34	1.34	1.33	1.33	1.32	1.31	1.30	1.28
US$/€	1.06	1.05	1.05	1.05	1.06	1.06	1.07	1.07	1.08	1.08	1.10
US$/£	1.22	1.21	1.20	1.20	1.21	1.21	1.21	1.21	1.22	1.22	1.23
¥/US$	150	150	150	149	148	148	147	146	145	143	141

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

Sources: BMO Economics, Haver Analytics

Canada-U.S. Rates Outlook

Michael Gregory, CFA, Deputy Chief Economist

causing monetary policies to still sport tightening biases, there is much more net risk of a year-ending (or year-beginning) action in the U.S. This is due to more resilient economic performance; U.S. real GDP expanded at a strong 4.9% annualized rate in Q3 compared to roughly no growth in Canada.

- And, as before, we look for rate cuts to commence on both sides of the border during the second half of next year once inflation appears on a clear 2% track. Both central banks aren't going to wait until the 2% target is attained before they start, although attainment or near-convergence is likely the prerequisite for more than a 25-bp quarterly easing cadence. Canada's relatively weaker economic momentum points to the BoC beginning rate cuts before the Fed (we've pencilled in July and September, respectively). And, after the easing pace picks up as 2025 unfolds, we expect policy rates to be at neutral levels (a 2.875% range midpoint for the Fed and 2.75% for the Bank) by the end of 2025.
- Recall, it was in our last Rates Scenario that we boosted neutral policy rates by 25 bps. We judged that the secular inflationary consequences of re-globalization, a chronically tight labour market (more a U.S. issue, as Canada has rapid population growth), along with climate change and net zero ambitions should cause higher policy rates over time. This boost has **lifted our forecast for longer-term bond yields**, along with the view that term premiums (the amounts by which bond yields are above the tenor-averages of short-term interest rates) are now also shifting persistently higher, reflecting demand-supply pressures in the Treasury market and rising risk premiums (see below). By the time we get to neutral policy rates, our forecasts for longer-term Treasury yields, for example, are now 50-to-60 bps above where we had them before.
- ***Bond yields:*** Ten-year Treasury yields averaged 4.80% in October, the highest since July 2007 with the daily closes flirting with 5% mid-month. The more-than-100 bp selloff over the past four months was mostly (>80%) driven by rising real yields (as seen via TIPS). This was prodded by three key factors.
- The **first** was the market's increasing expectations for Fed policy rates remaining 'higher for longer' because of the resilient economic data and sticky underlying inflation. These expectations were also pumped by the FOMC's latest Summary of Economic Projections (released September 20) and its median forecast for the fed funds target. It still had another rate hike by the end of this year, and it pared back the amount of easing next year from 100 bps to 50 bps. And even by the end of 2026, policy rates were still above their longer-run level (2.50%, according to the FOMC's median).
- The **second** factor is that higher yields are being required to equilibrate demand and supply in the Treasury market. On the supply side, Treasury's budget deficit more than doubled in the fiscal year ended September, to $2.0 trillion from $0.9 trillion in fiscal 2022 (after adjusting for the debacle over student loan cancellations). And the latest CBO projection showed the deficit averaging a large 5.7% of GDP over the coming decade even after incorporating the Fiscal Responsibility Act.
- Meanwhile, on the demand side, the Fed is reducing its holdings of Treasury securities by $60 billion per month, which has totalled $860 billion since quantitative tightening started in June 2022. Foreign investors have also been slowing their purchases of longer-term Treasury securities. In the three months ending August, they bought $75 billion, down from a record high topping $295 billion in the three months ended last October.
- The **third** factor is increasing risk premiums, such as a rising credit risk premium. Fitch downgraded the U.S. on August 1. It's interesting that Fitch's rating change was announced almost on the same day that S&P announced its downgrade 12 years earlier (on August 5, 2011). Indeed, what S&P concluded more than a decade ago is as relevant today as it was then. Meaningful fiscal consolidation *"is less likely than we previously assumed and will remain a contentious and fitful process"*. Moreover, *"the political brinksmanship of recent months highlights what we see as America's governance and policymaking becoming less stable, less effective, and less predictable than what we previously believed"*.
- More recently, in the leadup to the last-minute continuing resolution that avoided a government shutdown on October 1, Moody's said that a shutdown would be a credit-negative development that could eventually contribute to a rating downgrade, even though a shutdown would not interrupt Treasury's debt payments. Note that the continuing resolution expires on November 17.
- Meanwhile, 10-year **Government of Canada yields** averaged 4.06% in October, also the highest since 2007. However, Canada-U.S. yield spreads have been moving more negative: they averaged almost -75 bps in October, widening more than 30 bps over the past four months. The (bear market) outperformance reflects Canada's relatively stronger fiscal situation and relatively weaker economic performance. Although longer-term Canada yields should broadly follow Treasuries' lead, we expect some moderate spread narrowing (moving less negative) in the months ahead.
- ***Federal Reserve:*** The FOMC left policy rates unchanged on November 1, as was broadly expected. The target range for the fed funds rate remains at 5.25%-to-5.50%. In the statement, *"strong"* replaced *"solid"* in describing current economic activity, a meaningful upgrade, but this was countered by the mention of both *"tighter financial and credit conditions"* as weighing on future economic activity. Before, only tighter credit conditions were mentioned, in a new nod to higher bond yields. The Fed served few clues about potential policy actions on December 13 or January 31. In its *"meeting by meeting"* approach, the Committee will assess whether it has achieved sufficiently restrictive monetary policy. The Fed judges it's not there yet, but financial conditions are working to steer them in that direction. We'll see where this lands by mid-December, after a couple iterations of key data.

reckon the headwinds from higher bond yields and the resumption of student loan payments should do the trick. Then there are the risks posed by a potential government shutdown (after November 17) and a potential spike in oil prices owing to geopolitical developments. Our base case is that the Fed is done.

- ***Bank of Canada:*** The Bank kept its policy rate unchanged at 5.00% on October 25, also for the second consecutive meeting. The statement acknowledged that there were *“clearer signs that monetary policy is moderating spending and relieving price pressures”*, which justified being *“patient”* and giving past rate hikes (including the actions in June and July) more time to work their way through the economy. However, the statement also asserted that *“progress towards price stability is slow and inflationary risks have increased”* and that the Bank was *“prepared to raise the policy rate further if needed”*.
- We suspect that still-strong wage growth and elevated core inflation trends will test the Bank’s patience in the months ahead amid a flat-at-best real GDP growth profile. However, it’s only at matter of time before this growth profile should muster enough disinflationary momentum to adequately address stubborn wage growth and sticky core inflation. We judge that the Bank will stick to its ‘hawkish hold’ in the interim, as long as growth doesn’t rebound or inflation doesn’t accelerate meaningfully. Our base case is that the BoC is also done.
- ***U.S. dollar:*** The Fed’s trade-weighted dollar index appreciated 1.5% in October (on average), which is exactly what it did in August and September. After hitting record highs in October 2022, the greenback depreciated a net 6.9% by July before rebounding. Initially, smaller incremental Fed rate hikes and an eventual skipped meeting seemed to weigh on the index, but as the ‘higher for longer’ narrative for Fed policy rates began gaining currency, the dollar rebounded with the FX market interpreting this to mean ‘stronger for longer’. Of course, part of the higher/stronger-for-longer story is prodded by U.S. economic resiliency, which is putting a further global shine on the greenback when compared with Chinese economic underperformance and ebbing European growth. Meanwhile, geopolitical risks have risen with events in the Middle East augmenting those in Eastern Europe. With our expectation that U.S. economic performance is poised to weaken meaningfully as the current quarter unfolds, we look for the big dollar to begin drifting mildly weaker with the pace picking up once the smell of Fed rate cuts is in the air. By the end of next year, we see the greenback down 4% from October’s average.
- ***Canadian dollar:*** The loonie depreciated 1.3% in October, averaging its weakest level (C$1.3717) since the immediate months after the onset of the pandemic and a few months amid 2015’s collapse in oil prices. In other words, the Canada dollar is in rough shape, mostly roughed up by a strong U.S. dollar. It’s also not helping that Canadian economic growth has already ground to a halt with the U.S. economy gushing resiliency, suggesting that the Bank of Canada, compared to the Fed, was less likely to hike rates again and more likely to cut them sooner. Nevertheless, as the greenback starts drifting down again, the loonie should start improving. By the end of next year, we see the loonie stronger by around 7%, compared to October’s average.

Overseas

Jennifer Lee, Senior Economist

well-deserved break.

- And one of those banks include the **ECB**, which finally paused in October for the first time since last July. After raising rates at every meeting, for a combined 450 bps, bringing the refi rate to 4.50%, inflation has finally reached the same time zone as the official target. This has come at a cost, as the Euro Area economy contracted in Q3 and a further decline cannot be ruled out. Indeed, a number of hawks have been sounding less hawkish of late, acknowledging what the press release stated. Specifically, if rates remain at current levels for a "*sufficiently long duration*", they will make a "*substantial contribution to this goal*" of 2% inflation. Most recently, one of the biggest hawks, the Netherlands' Klaas Knot, said that rates have now reached a "*good cruising altitude*". The ECB's decision was made when the central bank only had the September CPI on hand, and it was noted that inflation had "*dropped markedly*" during that month and that "*most measures of underlying inflation have continued to ease*". On cue, the following week, the Euro Area inflation rate fell to 2.9% in October, the first time it gripped the 2-handle in over two years and the slowest pace since June 2021. Core CPI hit a 1½-year low of 4.2%, also supporting the ECB's stance. There are still lots of risks, which President Lagarde pointed out at the press conference, such as the effects on energy prices stemming from the ongoing war in Ukraine and the conflict in the Middle East, and the effects on food prices caused by climate change. She warned that "*the fact that we are holding doesn't mean to say that we will never hike again*". Perhaps; but at this point, a cut might be more likely than a hike. We look for the ECB to stay on the sidelines until the first half of 2024 before sluggish growth prompts a cut.

- The **BoE** has stayed on the sidelines for two consecutive meetings, with the first by the narrowest of margins (5-to-4 in favour of holding), and the second by a wider one (6-to-3). In November, the decision to stay the course, and leave its Bank Rate at 5.25%, was clearly a difference in opinion. **The majority** cited weaker growth, a loosening labour market, and the expectation for inflation to "*decline significantly*" in coming quarters. And, they noted that the record increase in wages was not reflected in other measures. But, most of that group (very likely excluding the dovish Swati Dhingra) felt that rates should stay at these restrictive levels for "*an extended period of time*" to lower inflation. **The trio** that pushed for a rate hike pointed to higher real household incomes, positive economic activity, a still-tight job market, high wage growth and services CPI, and persistent inflationary pressures. We don't expect any more hikes from Governor Bailey and the MPC. Rate cuts should begin around mid-2024.

- The **BoJ** is heading in the opposite direction. While the others were tightening aggressively, the Bank patiently maintained its own aggressive easing stance, keeping short-term rates at -0.1% and the target on 10-year JGBs at 0%. It has, however, taken baby steps towards tightening up. In July, it announced it would allow more flexibility around 10-years. It kept the +/-0.5 percentage points range, but stated its intention to buy 10-years daily at 1.0%, meaning that the 10-year JGB can trade +/-1.0%. In October, the BoJ dropped the range, and said that the upper limit of 1% will be a "*reference*". With core inflation above target for 18 consecutive months, the BoJ raised its forecasts for FY23 (to 2.8% from 2.5% back in July), and particularly so for FY24 (to 2.8% from 1.9%). At some point, perhaps after the spring wage negotiations, the BoJ can finally leave YCC behind.

- The **RBA** is different. It raised rates 400 bps in a span of 14 months but paused in July, keeping the cash rate at 4.10%, citing the need for more time to "*assess the impact*" of rates. That reason was cited at the following meetings as well, including Governor Bullock's first in October. However, the new Governor has sounded a bit more hawkish than her predecessor. She recently warned that the RBA "*will not hesitate*" to raise rates further if there was a "*material upward revision to the outlook for inflation*". Meantime, inflation has been moving higher for two months in a row, with the latest reading for September at 5.6%, a five-month high. Retail sales tripled expectations in September, and private sector credit growth accelerated. The jobless rate ticked down to 3.6%, not far from record lows of 3.4%. Governor Bullock seemed to walk back that comment, complicating matters by stating the latest CPI figure was in line with what the Bank expected. In any event, given the direction of the data and the difference in tone, we would not be surprised to see the new head make her mark by lifting the cash rate one more time, by 15 bps to 4.25%, allowing further moves (up or down) to be made in quarter-point increments.

(local currency per US$: avg.)	Actual 2023 Oct	Forecasts 2023 Nov	Dec	2024 Jan	Feb	Mar	Apr	May	Jun	2024 Q3	Q4
Canadian Dollar											
C$ per US$	1.37	1.36	1.35	1.34	1.34	1.33	1.33	1.32	1.31	1.30	1.28
US$ per C$[1]	0.730	0.735	0.741	0.744	0.748	0.751	0.755	0.758	0.762	0.769	0.781
Trade-weighted	117.2	118.1	119.0	119.3	119.7	120.1	120.5	120.9	121.2	122.0	123.2
U.S. Dollar											
Trade-weighted[2]	123.9	123.6	123.4	123.0	122.6	122.3	121.9	121.5	121.2	120.4	119.3
European Currencies											
Euro[1]	1.06	1.05	1.05	1.05	1.06	1.06	1.07	1.07	1.08	1.08	1.10
Danish Krone	7.06	7.10	7.10	7.10	7.05	7.00	7.00	6.95	6.95	6.90	6.80
Norwegian Krone	11.01	11.15	11.30	11.30	11.25	11.20	11.15	11.10	11.05	11.00	10.85
Swedish Krone	11.01	11.15	11.25	11.20	11.15	11.10	11.05	11.05	11.00	10.90	10.75
Swiss Franc	0.90	0.89	0.87	0.87	0.87	0.87	0.86	0.86	0.86	0.86	0.85
U.K. Pound[1]	1.22	1.21	1.20	1.20	1.21	1.21	1.21	1.21	1.22	1.22	1.23
Asian Currencies											
Chinese Yuan	7.31	7.30	7.30	7.27	7.24	7.21	7.18	7.15	7.13	7.07	6.98
Japanese Yen	150	150	150	149	148	148	147	146	145	143	141
Korean Won	1,352	1,340	1,325	1,320	1,315	1,310	1,305	1,300	1,295	1,285	1,270
Indian Rupee	83.2	83.1	83.0	82.7	82.3	82.0	81.7	81.3	81.0	80.3	79.4
Singapore Dollar	1.37	1.37	1.36	1.36	1.35	1.35	1.34	1.33	1.33	1.32	1.30
Malaysian Ringgit	4.74	4.75	4.75	4.70	4.70	4.70	4.65	4.65	4.65	4.60	4.55
Thai Baht	36.5	36.1	35.8	35.7	35.5	35.4	35.2	35.1	35.0	34.7	34.2
Philippine Peso	56.8	56.7	56.6	56.4	56.2	56.0	55.7	55.5	55.3	54.8	54.2
Taiwan Dollar	32.3	32.3	32.2	32.1	32.0	31.9	31.7	31.6	31.5	31.2	30.8
Indonesian Rupiah	15,760	15,785	15,810	15,750	15,685	15,620	15,560	15,495	15,435	15,305	15,115
Other Currencies											
Australian Dollar[1]	0.635	0.642	0.650	0.652	0.653	0.655	0.657	0.658	0.660	0.663	0.668
New Zealand Dollar[1]	0.590	0.595	0.600	0.602	0.603	0.605	0.607	0.608	0.610	0.613	0.618
Mexican Peso	18.06	18.05	18.00	18.05	18.10	18.15	18.15	18.20	18.25	18.35	18.45
Brazilian Real	5.06	5.00	4.90	4.90	4.90	4.90	4.85	4.85	4.85	4.85	4.80
South African Rand	19.0	18.8	18.5	18.5	18.5	18.6	18.6	18.6	18.6	18.7	18.7
Cross Rates											
Versus Canadian Dollar											
Euro (C$/€)	1.45	1.43	1.42	1.42	1.42	1.41	1.41	1.41	1.41	1.41	1.40
U.K. Pound (C$/£)	1.67	1.64	1.62	1.62	1.61	1.61	1.60	1.60	1.59	1.59	1.57
Japanese Yen (¥/C$)	109	110	111	111	111	111	111	111	110	110	110
Australian Dollar (C$/A$)	0.87	0.87	0.88	0.88	0.87	0.87	0.87	0.87	0.87	0.86	0.86
Versus Euro											
U.K. Pound (£/€)	0.87	0.87	0.88	0.88	0.88	0.88	0.88	0.88	0.88	0.89	0.89
Japanese Yen (¥/€)	158	158	158	157	157	157	156	156	156	155	154

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

	2023	2023		2024						2024	
	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Q3	Q4
Canada											
Overnight target (period end)	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	4.75	4.50
Overnight target	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	4.82	4.56
CORRA[2]	5.03	5.04	5.02	5.01	5.00	5.00	5.00	5.00	5.00	4.82	4.56
3-month bills	5.08	5.05	5.05	5.05	5.05	5.05	5.05	5.05	5.05	4.85	4.55
6-month	5.13	5.05	5.05	5.00	5.00	5.00	5.00	5.00	5.00	4.80	4.55
1-year	5.17	5.05	4.95	4.90	4.85	4.75	4.70	4.65	4.60	4.45	4.20
2-year bonds	4.78	4.65	4.50	4.40	4.25	4.10	4.00	3.85	3.80	3.70	3.60
3-year	4.64	4.55	4.40	4.30	4.20	4.05	3.95	3.85	3.80	3.75	3.60
5-year	4.23	4.20	4.10	4.05	4.00	3.95	3.90	3.85	3.80	3.75	3.65
7-year	4.13	4.10	4.05	4.00	3.95	3.95	3.90	3.85	3.80	3.75	3.70
10-year	4.06	4.05	4.00	3.95	3.95	3.90	3.90	3.85	3.80	3.75	3.70
30-year	3.81	3.80	3.80	3.75	3.75	3.75	3.70	3.70	3.70	3.65	3.65
1m BA	5.40	5.40	5.40	5.40	5.40	5.40	5.40	5.40	5.40	5.20	4.90
3m BA	5.55	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.30	5.00
Prime rate	7.20	7.20	7.20	7.20	7.20	7.20	7.20	7.20	7.20	7.02	6.76
United States											
Fed funds target (period end)	5.38	5.38[6]	5.38	5.38	5.38	5.38	5.38	5.38	5.38	5.13	4.88
Fed funds target	5.38	5.38[6]	5.38	5.38	5.38	5.38	5.38	5.38	5.38	5.34	5.09
EFFR[3]	5.33	5.33	5.33	5.33	5.33	5.33	5.33	5.33	5.33	5.30	5.05
SOFR[4]	5.31	5.32	5.32	5.32	5.32	5.32	5.32	5.32	5.32	5.29	5.04
3-month bills	5.60	5.55	5.55	5.55	5.55	5.55	5.55	5.55	5.55	5.55	5.25
6-month	5.57	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.50	5.20
1-year	5.42	5.35	5.25	5.20	5.15	5.10	5.00	4.95	4.90	4.75	4.55
2-year notes	5.07	4.95	4.80	4.70	4.55	4.45	4.30	4.20	4.05	3.85	3.70
3-year	4.89	4.80	4.70	4.60	4.50	4.40	4.30	4.20	4.15	3.95	3.85
5-year	4.77	4.70	4.65	4.55	4.50	4.40	4.35	4.30	4.20	4.10	3.95
7-year	4.82	4.75	4.70	4.65	4.55	4.50	4.45	4.40	4.35	4.20	4.10
10-year	4.80	4.75	4.70	4.65	4.60	4.55	4.50	4.45	4.45	4.35	4.25
30-year bonds	4.95	4.90	4.85	4.80	4.75	4.70	4.65	4.60	4.60	4.50	4.40
Prime rate	8.50	8.50[6]	8.50	8.50	8.50	8.50	8.50	8.50	8.50	8.47	8.22
Other G7											
ECB Refi[1]	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.25	4.00	3.75
10yr Bund	2.85	2.90	2.90	2.90	2.90	2.90	2.85	2.85	2.85	2.85	2.80
BoE Repo[1]	5.25	5.25[6]	5.25	5.25	5.25	5.25	5.25	5.00	5.00	4.75	4.50
SONIA[5]	5.19	5.19	5.19	5.19	5.19	5.19	5.19	4.95	4.94	4.77	4.54
10yr Gilt	4.54	4.60	4.70	4.65	4.60	4.60	4.55	4.50	4.45	4.40	4.25
BoJ O/N[1]	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
10yr JGB	0.82	0.88	0.95	0.95	0.96	0.96	0.97	0.97	0.98	0.98	1.00

[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

Disclosures

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