Rates Scenario for July 5, 2021

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

Forecast Summary

(avg.)	Actual 2021 Jun	Forecasts 2021 Jul	Aug	Sep	Oct	Nov	Dec	2022 Q1	Q2	Q3	Q4
BoC overnight[1]	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
10-yr Canadas	1.43	1.40	1.45	1.50	1.55	1.60	1.65	1.70	1.75	1.80	1.85
Fed funds[1]	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13
10-yr Treasuries	1.52	1.45	1.55	1.60	1.65	1.70	1.75	1.80	1.85	1.90	2.00
C$ per US$	1.22	1.22	1.22	1.21	1.21	1.20	1.20	1.20	1.19	1.18	1.18
US$/€	1.21	1.21	1.21	1.21	1.21	1.21	1.21	1.21	1.21	1.22	1.22
US$/£	1.41	1.40	1.41	1.41	1.41	1.41	1.41	1.41	1.41	1.42	1.42
MXN/US$	20.06	19.95	19.90	19.80	19.75	19.65	19.60	19.55	19.50	19.40	19.35
¥/US$	110	110	110	110	110	110	110	110	110	109	109

[1] end of period

Sources: BMO Economics, Haver Analytics

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Canada-U.S. Rates Outlook

Michael Gregory, CFA, Deputy Chief Economist

We have made no major changes to our interest and exchange rate forecasts since the last Rates Scenario (June 3). However, the risks of Fed and BoC policy rate liftoff before 2023Q1 have risen.

- **Federal Reserve:** Amid raised dots and taper talk, the Fed took a hawkish turn on June 16. In the Summary of Economic Projections (SEP), the 2023 median forecast for the fed funds rate was raised to now reflect two 25 bp rate hikes by the end of the year, from none in the March SEP. Among the 18 policymakers, 13 penciled in at least one rate rise, up from seven in March. And, although the 2022 median remained unchanged, there were now seven individual forecasts of rate hikes, up from four before. It will now take just two participants changing their call to a rate hike to raise the median for 2022 as well. In the press conference, Chair Powell indicated that the FOMC had started to talk about tapering. We suspect the staff was charged with briefing the Committee on tapering options and consequences for the July meeting, putting us on 'announcement watch' for as early as the September meeting.
- Meanwhile, real GDP should have completely recovered from the recession in Q2 (data to be released July 29). We look for payroll employment to do the same by the end of next summer, with the unemployment rate returning to its pre-pandemic range (well below the 4.1% natural rate) before the end of next year. By early 2023, labour market performance should convince the Fed that the policy tightening prerequisite of maximum employment, defined in a broad-based and inclusive fashion, is solidly on track to soon be achieved. This should be enough for policy rate liftoff with the Fed's other tightening prerequisite, inflation running moderately above 2% for some time, likely considered satisfied. We look for core PCE inflation to settle in the 2¼%-to-2½% range after spiking to nearly 4% this year owing to the mix of exuberant demand and constrained supply (both mostly temporary). Our base case calls for a March 2023 rate hike, with follow-up moves every half year.

- Our tapering call is based on three factors. First, the Fed will likely ensure a reasonable amount of time elapses between the end of quantitative easing (QE)—the end of adding accommodation—and March 2023—the start of removing accommodation (say, some three to six months). Second, following 2013-14's playbook, the FOMC's purchases will probably be pared gradually. Our working assumption is by $10 billion and $5 billion, respectively, for Treasuries and MBS each meeting cycle, which results in a year-long tapering process. Third, from a risk management perspective, the FOMC may want to be able to raise rates by the end of next year if necessary (and seven participants already project it will). These factors point to a September announcement, with tapering starting in October.

- **Bank of Canada:** Despite the pandemic-related restrictions across the country during Q2, the Canadian economy still likely managed to expand. This reflects the strong handoff from Q1 (March alone was +1.3% m/m), a smaller-than-expected drag from the restrictions (April was -0.3% vs. the -0.8% flash), and the likely resumption of growth in June as restrictions started being relaxed. Meanwhile, amid a first-dose vaccination rate that has become one of the best in the world, the economy is finding support from further fiscal stimulus, a strengthening U.S. economy and robust commodity markets. Real GDP should have completely recovered from the recession in Q3 (a quarter behind the U.S.). By the end of this year, jobs should have done the same (outpacing the U.S.), with the unemployment rate returning to its pre-pandemic range (5.6%-to-5.7%) by next autumn and the core inflation metrics also averaging in the 2¼%-to-2½% range.

- The Bank already took a hawkish turn on April 21, and it stayed in that direction on June 9. While still committing to hold the policy rate at the effective lower bound "*until economic slack is absorbed so that the 2 percent inflation target is sustainably achieved*", this now happens "*sometime in the second half of 2022*" (it was "*into 2023*" before April). Our base case calls for a January 2023 rate hike, with follow-up moves every half year. At the April meeting, the Bank also reduced its QE bond buying to $3 billion per week from $4 billion. We're expecting another QE pullback either this month or in October (to $2 billion), and the program to have ended by early next year.

- **Bond yields:** Ten-year Treasury yields (constant maturity) slipped below 1.45% to start July, after spending most of June in the 1.45%-to-1.55% range, which was, in turn, down from the 1.55%-to-1.70% range that had been in place since April. The bond market is interpreting the Fed's hawkish turn in a bullish light, scaling back inflation expectations and risks, amid increased growth concerns (owing to the Delta variant) and continued supportive capital inflows (1.45% is still globally attractive, particularly with a more stable U.S. dollar). Despite the recent slide, we look for yields to move modestly higher by year-end, to around 1.75% (which they already flirted with in March). This reflects more persistent inflation and a Q4 start to tapering (both of which are not fully priced in). In 2022, policy rate tightening speculation should augment the moderate upward pressure on yields, ending around 2.00%. Ten-year Canadas began July trading near the bottom of the 1.35%-to-1.45% range in place since early June, with Canada-U.S. spreads running in a 3-bp range on either side of -10 bps, which is where we judge they'll run for the remainder of this year. While a relatively earlier end to QE could contribute to Canadas underperforming, this should be offset by a strengthening Canadian dollar.

- **U.S. dollar:** The Fed's hawkish turn helped turn the broad U.S. dollar index around. The index had been drifting weaker since late March (a total 3.2%), reflecting improving investor-perceived global economic prospects and ebbing risks. And, as record-sized budget and trade deficits were likely starting to take a toll. The greenback is currently 1.8% above its pandemic low hit at the beginning of June. However, we judge the greenback will ultimately weaken again reflecting the same factors. From current levels, we see the unit averaging 1½% lower by the end of this year, before starting to stabilize next year.

- **Canadian dollar:** The loonie was the best-performing major currency through the first half of the year, reflecting rising commodity prices (Canada's non-energy prices averaged record highs in May), an improving balance of payments (Q1 showed the first current account surplus since 2008), and the Bank of Canada's hawkish turn. We look for the Canadian dollar's strengthening momentum to continue, averaging C$1.20 (above US$0.833) by the end of this year and C$1.175 (above US$0.851) by the end of 2022.

Overseas

Jennifer Lee, Senior Economist

- One would've imagined more enthusiasm as the second half of 2021 began, especially as vaccinations continue and economies reopen (some fully). But the spread of the Delta variant (among others) is cause for concern, particularly in Asia but also in parts of Europe, such as the U.K. and Portugal. Then there are the difficulties in gauging the rise in inflation… is it temporary or does it have staying power? The surge in demand for goods and services after being locked down for a year is natural and some of it will cool off (how many haircuts does one need?). However, higher prices from supply shortages and disruptions, and lengthy delivery times, are being passed on to consumers. On top of that, labour shortages have caused an increase in wages and overall compensation. In other words, it is not a slam dunk that either side is correct and more time will be needed before changes, if any, to monetary policy will be made. We've lowered the year-end points for some of the major currencies.
- For the **ECB**, although some hawks have found their voices again and are speaking up for either an earlier end to the Pandemic Emergency Purchase Programme (PEPP), or a tapering of the purchases, the majority of the Governing Council remains very hesitant to do anything just yet. Indeed, President Lagarde recently acknowledged that the recovery "*is now beginning to get underway*", but that it is still "*fragile*". And, Vice-President Luis de Guindos went as far as to say that any talk about moving from the PEPP to the Public Sector Purchase Program was "*a little premature*". All in, the July 22 decision will be a non-event, while there is some expectation of a move away from the PEPP by the September 9 meeting. And by then, the EU's Recovery and Resilience Facility will have already begun to disburse funds to Member States. It will be a good opportunity for the ECB to take a step back and let the fiscal side do some work.
- The **BoE** has become more uniformly dovish after the lone hawk on the MPC (Andrew Haldane) left the building. This is indeed the case, even with the stronger economic recovery and inflation heating up. The U.K. just had its biggest back-to-back monthly increase in consumer prices in a decade, with May's CPI rising above the BoE's 2% target for the first time in two years. Yet, Governor Bailey is particularly cautious and sees this as temporary. The rebound in growth "*will revert to the lower average underlying growth rates*" which will "*bring its own challenges.*"
- Just last month, the **Bank of Japan** extended its COVID relief program by six months. Then, during the press conference, Governor Kuroda declared that the country will need continued stimulus, even after the pandemic is over. It is a good thing he cleared that up, because the pandemic has legs. With just a few weeks to go before the start of the Summer Olympics, new infections are climbing; so, Tokyo may be forced to extend its state of emergency beyond July 11. Australia is also facing a worrying number of new infections and locked down four of its largest cities, or half of the country's population. That sort of news is keeping the **RBA** on alert with tightening not an option right now, even as the economy reached pre-pandemic levels way back in Q1. The official target for tightening remains 2024, "*at the earliest*".

Foreign Exchange Forecasts

(local currency per US$: avg.)	Actual 2021 Jun	Forecast 2021 Jul	Aug	Sep	Oct	Nov	Dec	2022 Q1	Q2	Q3	Q4
Canadian Dollar											
C$ per US$	1.22	1.22	1.22	1.21	1.21	1.20	1.20	1.20	1.19	1.18	1.18
US$ per C$[1]	0.820	0.821	0.823	0.826	0.828	0.831	0.833	0.836	0.841	0.845	0.850
Trade-weighted	124.4	124.7	125.0	125.3	125.6	125.9	126.3	126.6	127.1	127.6	128.1
U.S. Dollar											
Trade-weighted[2]	111.7	111.7	111.6	111.4	111.3	111.1	111.0	110.8	110.5	110.2	109.9
European Currencies											
Euro[1]	1.21	1.21	1.21	1.21	1.21	1.21	1.21	1.21	1.21	1.22	1.22
Danish Krone	6.16	6.15	6.15	6.15	6.15	6.15	6.15	6.15	6.15	6.10	6.10
Norwegian Krone	8.40	8.40	8.35	8.35	8.30	8.30	8.25	8.25	8.25	8.20	8.20
Swedish Krone	8.38	8.40	8.40	8.40	8.40	8.40	8.45	8.40	8.40	8.40	8.35
Swiss Franc	0.91	0.91	0.91	0.90	0.90	0.90	0.90	0.90	0.89	0.88	0.87
U.K. Pound[1]	1.41	1.40	1.41	1.41	1.41	1.41	1.41	1.41	1.41	1.42	1.42
Asian Currencies											
Chinese Yuan	6.42	6.43	6.43	6.44	6.44	6.45	6.45	6.45	6.44	6.44	6.43
Japanese Yen	110	110	110	110	110	110	110	110	110	109	109
Korean Won	1,121	1,120	1,115	1,110	1,105	1,100	1,095	1,090	1,080	1,075	1,065
Indian Rupee	73.5	73.6	73.6	73.6	73.5	73.5	73.5	73.4	73.3	73.2	73.0
Singapore Dollar	1.33	1.33	1.32	1.31	1.30	1.30	1.29	1.29	1.29	1.29	1.29
Malaysian Ringgit	4.13	4.10	4.10	4.10	4.10	4.10	4.10	4.10	4.10	4.05	4.05
Thai Baht	31.4	31.3	31.2	31.0	30.9	30.8	30.6	30.6	30.6	30.6	30.6
Philippine Peso	48.2	48.1	48.0	48.0	47.9	47.8	47.7	47.7	47.7	47.6	47.6
Taiwan Dollar	27.8	27.8	27.8	27.8	27.8	27.7	27.7	27.7	27.7	27.7	27.7
Indonesian Rupiah	14,332	14,315	14,295	14,275	14,260	14,240	14,220	14,215	14,205	14,195	14,180
Other Currencies											
Australian Dollar[1]	0.766	0.765	0.766	0.767	0.768	0.769	0.770	0.773	0.778	0.783	0.788
New Zealand Dollar[1]	0.712	0.711	0.712	0.713	0.714	0.714	0.715	0.717	0.719	0.722	0.724
Mexican Peso	20.06	19.95	19.90	19.80	19.75	19.65	19.60	19.55	19.50	19.40	19.35
Brazilian Real	5.04	5.00	5.00	5.00	5.00	4.95	4.95	4.95	4.95	4.90	4.90
Russian Ruble	72.6	72.5	72.4	72.3	72.1	72.0	71.9	71.8	71.7	71.5	71.4
South African Rand	13.9	13.8	13.8	13.7	13.6	13.6	13.5	13.6	13.7	13.8	14.0
Cross Rates											
Versus Canadian Dollar											
Euro (C$/€)	1.47	1.47	1.47	1.46	1.46	1.46	1.45	1.45	1.44	1.44	1.44
U.K. Pound (C$/£)	1.71	1.71	1.71	1.70	1.70	1.70	1.69	1.69	1.68	1.68	1.67
Japanese Yen (¥/C$)	90	90	91	91	91	91	92	92	92	92	93
Australian Dollar (C$/A$)	0.93	0.93	0.93	0.93	0.93	0.93	0.92	0.92	0.93	0.93	0.93
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 (¥/€)	133	133	133	133	133	133	133	133	133	133	133

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

Sources: BMO Economics, Haver Analytics

Interest Rate Forecasts

(% : avg.)	Actual 2021 Jun	Forecasts 2021 Jul	Aug	Sep	Oct	Nov	Dec	2022 Q1	Q2	Q3	Q4
Cdn. Yield Curve											
Overnight[1]	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3 month	0.12	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15
6 month	0.16	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15
1 year	0.21	0.20	0.20	0.25	0.25	0.25	0.25	0.25	0.30	0.30	0.35
2 year	0.37	0.45	0.45	0.45	0.45	0.45	0.50	0.50	0.55	0.65	0.75
3 year	0.56	0.65	0.65	0.65	0.70	0.70	0.75	0.80	0.85	0.95	1.05
5 year	0.92	0.95	1.00	1.05	1.05	1.10	1.10	1.15	1.20	1.25	1.30
7 year	1.15	1.15	1.20	1.25	1.25	1.30	1.35	1.40	1.45	1.50	1.55
10 year	1.43	1.40	1.45	1.50	1.55	1.60	1.65	1.70	1.75	1.80	1.85
30 year	1.92	1.85	1.90	1.95	2.00	2.05	2.10	2.10	2.15	2.15	2.20
1m BA	0.41	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40
3m BA	0.43	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.45
6m BA	0.54	0.55	0.55	0.55	0.55	0.55	0.55	0.55	0.55	0.55	0.55
12m BA	0.58	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.65	0.70	0.75
Prime Rate[1]	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.45
U.S. Yield Curve											
Fed funds[1]	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13
3 month	0.04	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
6 month	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
1 year	0.07	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.15	0.20	0.25
2 year	0.20	0.25	0.25	0.25	0.25	0.30	0.30	0.35	0.40	0.50	0.60
3 year	0.39	0.45	0.50	0.50	0.50	0.55	0.55	0.65	0.75	0.85	0.95
5 year	0.84	0.90	0.90	0.95	0.95	1.00	1.05	1.10	1.15	1.25	1.30
7 year	1.23	1.25	1.25	1.30	1.35	1.40	1.45	1.50	1.55	1.60	1.65
10 year	1.52	1.45	1.55	1.60	1.65	1.70	1.75	1.80	1.85	1.90	2.00
30 year	2.16	2.10	2.15	2.20	2.25	2.30	2.35	2.35	2.40	2.45	2.50
1m LIBOR[2]	0.09	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3m LIBOR[2]	0.13	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15
6m LIBOR[2]	0.16	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15
12m LIBOR[2]	0.24	0.25	0.25	0.25	0.25	0.25	0.25	0.30	0.30	0.35	0.45
Prime Rate[1]	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25
Other G7 Yields											
ECB Refi[1]	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
10yr Bund	-0.21	-0.20	-0.20	-0.20	-0.15	-0.15	-0.15	-0.10	-0.05	0.00	0.10
BoE Repo[1]	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
10yr Gilt	0.77	0.80	0.85	0.85	0.90	0.90	0.95	1.00	1.10	1.20	1.30
BoJ O/N[1]	-0.05	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
10yr JGB	0.06	0.07	0.07	0.08	0.09	0.09	0.10	0.10	0.10	0.10	0.10

[1] end of period; [2] Most LIBOR rates will cease being published by the provider as of December 31, 2021. However, some USD tenors will continue being published until June 30, 2023 including overnight along with 1, 3, 6 and 12 months.

Sources: BMO Economics, Haver Analytics

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