

Interest Rate Forecast- April 2009

Economy

The sharp contraction in production since the September 2008 financial shock is largely over. Manufacturers in most countries rapidly adjusted their output to stop unwanted inventory build-up and more closely match production to sales. In the U.S. during the first quarter of 2009, the inventory drop contributed -2.8% of the -6.1% overall contraction in real GDP or nearly one-half of the total decline.

This shock phase caused sharp declines in monthly and quarterly GDP but the next phase should see lesser declines with some change in the composition of activity. A slower pace of decline in production, inventories, residential investment, and trade volumes than in the first quarter but private investment in machinery, equipment, and non-residential construction contracts at a faster pace. Two areas contributing to growth are government spending and personal consumption.

The OECD composite leading indicator fell to a record low in February suggesting no recovery in the near term. On the positive side, monthly declines are lessening. The U.S. leading indicator for March also confirms that the downturn is no longer intensifying. Once the index bottoms, economic growth resumes in about six months, on average, for recessions since 1960.

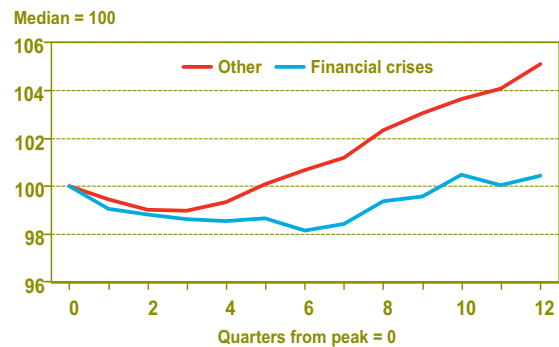
The global economic recession was caused by a financial crisis and it synchronized economic cycles in many countries. This combination causes a longer recession and a weaker recovery than if a financial crisis did not precede the recession or the recession is not synchronized, according to the latest IMF research. The average length of a recession in the advanced economies under those combined circumstances is 7.3 quarters and the loss in output is -4.8%. The recovery takes twice as long to reach the previous peak and growth after one year is 2.8% compared to 4.2% in a normal recession-recovery transition.

Using the U.S. economy as the marker against those IMF benchmarks, the recession is just past the halfway point in duration and amplitude or severity. The leading indicator benchmark points to recovery beginning in late 2009 or early 2010 while the IMF benchmark signals a recovery in

Highlights:

- *Economic recession shifts to next phase*
- *Weak growth during the initial economic recovery period*
- *Policy actions gain some traction*
- *Low interest rates for an extended period*

Output during recessions and recoveries associated with financial crises and other shocks



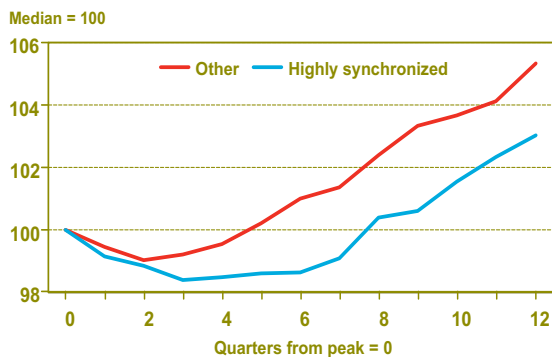
Source: IMF WEO April 2009.

the fourth quarter. Of course, these benchmarks are just that and the actual outcome will likely differ.

A recovery in the third quarter of 2009 is the consensus forecast for the U.S. economy, slightly sooner than the benchmarks. One major difference this recession that did not exist in recessions since 1960 is the aggressive policy responses in the U.S. and other countries. U.S. consumers get a lift from tax relief and income support payments in the second quarter and in the rest of the year. Stepped up infrastructure spending takes more time to implement but this too plays a larger role in the future.



Output during highly synchronized recessions



Source: IMF WEO April 2009.

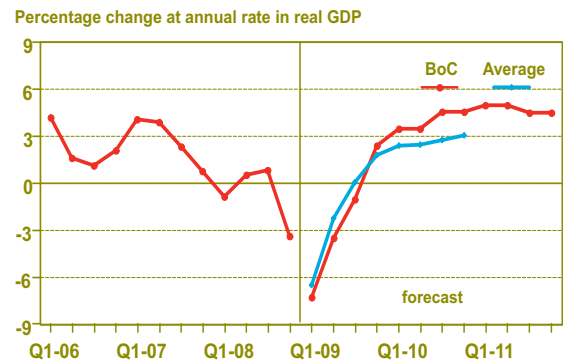
Aggressive monetary policy actions are gradually making a difference. Mortgage rates are lower, there is some life in housing sales, and stabilization in consumer spending is emerging. Credit conditions for businesses are easing though much more relief is needed to spur a stronger recovery.

The Conference Board index of consumer confidence recovered further in April, climbing to the highest level since November. Current conditions are considered bleak but consumers are becoming much more upbeat about the outlook. This is a positive sign for the economic outlook and provides hope that the recession ends later this year.

Turning to Canada's economy, a large contraction in first quarter 2009 GDP is widely expected. The general view is for the recovery to commence in the third quarter though some forecasters see it beginning in the fourth quarter. This forecast utilizes a U.S. recovery in late 2009 leading to Canada's recovery one to three months later and resulting in growth of 1.6% for all of 2010.

The Bank of Canada, however, takes a more optimistic view with a stronger recovery in 2010 than the average of forecasters and a much stronger rebound in 2011 with growth at 4.7%. The Bank needs this stronger growth profile to close the output gap and meet its 2% inflation target in 2011. The output gap is the difference between actual and potential economic growth. The Bank cut its potential growth rate estimate in half for 2009, along with large reductions for 2010 and 2011 in order to meet its inflation target. These reductions are quite arbitrary since potential output is the long term relationship between an economy's labour, capital, and technology and is not subject to cyclical swings.

Economic Forecasts, Canada



Source: Statistics Canada, C1CU Survey, Bank of Canada MPR April 2009.

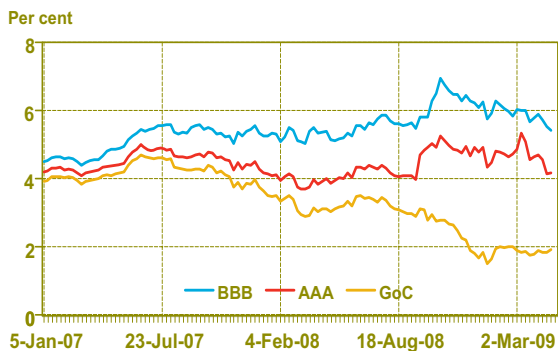
Monetary policy

The Bank of Canada executed its last rate cut for this cycle on April 21 with a 25 basis points cut in its Overnight Target Rate to 0.25%. The Bank also announced it would leave the overnight rate unchanged for more than a year depending on the inflation outlook.

The Bank released its "Framework for Conducting Monetary Policy at Low Interest Rates," contained in an appendix to the Monetary Policy Report. The Bank listed three unconventional instruments: conditional statements or transparent communications, quantitative easing, and credit easing. Quantitative easing refers to the purchase by a central bank of financial assets through creation of central bank reserves. Credit easing involves the purchase of assets in temporarily impaired markets and does not necessarily mean the creation of bank reserves. The Bank is already pursued a form of credit easing by accepting a wide range of collateral from impaired markets in its Purchase and Resale Agreements. The Bank will employ further credit easing and quantitative easing in particular with considerable caution.

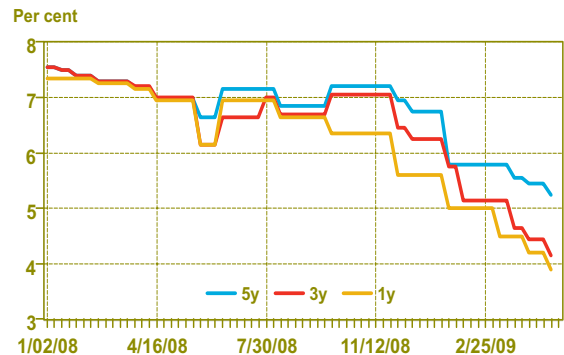
In the U.S., the Federal Open Market Committee stood pat since it has already cut rates to the bottom and its various credit and quantitative easing measures are underway. The FOMC saw some positive signs in recent economic data and described the economy as contracting at a "somewhat slower pace". The Fed recommitted to keeping borrowing costs low for an "extended period."

Five-year Corporate and Government Bond Yields, Weekly



Source: BMOCM, Bank of Canada. Latest: 27-Apr-09

Posted Mortgage Rates by Term, Weekly



Source: Bank of Canada. Latest: 4/29/09

Interest rates

Administered deposit and lending rates declined in April. The typical one-year GIC deposit rate fell to a record low 0.28% from 0.38% at the end of March while the three-year rate dropped to 1.48% from 1.68% and the five-year rate declined 30bps to 1.78%. Posted mortgage rates declined 60bps to 3.90% for a one-year term and 50 bps to 4.15% for a three-year term. The five-year rate dropped 30bps to 5.25%.

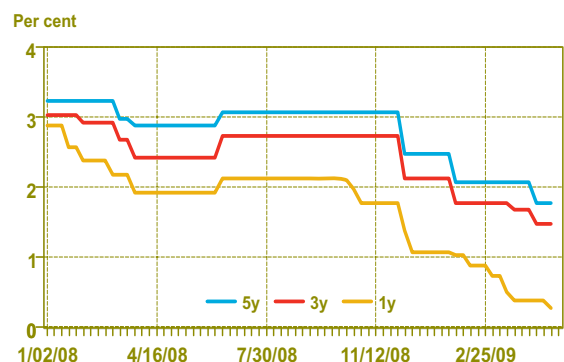
Rates for short-term business credit followed the target rate lower in April, which indicates the successful impact of monetary easing. The three-month commercial paper rate declined about 30bps and the three-month bankers' acceptance rate dropped about 25bps. While spreads remain higher than normal, these reductions are positive signs of some easing in the financial crisis.

One segment of business credit that remains constrained is longer term funding sources. For example, the cost of raising funds in the bond market for an AAA rated company is more than 4% and for a BBB rated company it is about 5.5%. These rates are down from the September crisis period but are still high and are not following the Bank rate lower. This is goes to the core of the credit crisis and presents the greatest challenge for policymakers and the greatest risk to the economic outlook.

This situation is more constrained in the U.S. than in Canada and presents problems for Canadian companies who raise funds in the U.S. it is estimated that about 25% of Canadian company financing is, or was, sourced from U.S. markets.

The government bond yield curve steepened during April with lower Treasury bill rates and higher longer term yields.

GIC Deposit Rates by Term, Weekly



Source: Bank of Canada. Latest: 4/29/09

The ten-year bond yield rose between 10 to 20bps while the three-month t-bill rate declined about 20bps.

Interest rate forecast

The Bank's target rate remains at 0.25% well into 2010 and turns up when economic growth resumes and the outlook is positive. The first increase is around mid-2010 but the main risk is for a later increase if the recession last longer than expected. During the recovery phase and the initial rate-normalization phase, the Bank is likely move to the target rate up rather quickly and in 50bps increments at times.

Some further declines in mid to long term deposit and mortgage rates is likely in the next quarter or two. Administered rates are approaching the bottom for this cycle, likely this year.

Target Overnight Rate Forecast

| BoC Meeting Date | Rate |
|------------------|------|
| Apr. 21 a | 0.25 |
| June 4 (f) | 0.25 |
| July 21 | 0.25 |
| Sept. 10 | 0.25 |
| Oct. 20 | 0.25 |
| Dec. 8 | 0.25 |
| Jan. 2010 | 0.25 |
| Mar. | 0.25 |
| Apr. | 0.25 |
| June | 0.25 |
| July | 0.50 |
| Sept. | 0.75 |
| Oct. | 1.25 |
| Dec. | 1.25 |
| Jan. 2011 | 1.50 |
| Mar. | 1.75 |

Interest Rate Forecast

| Item | 2009 Q1a | 2009 Q2f | 2009 Q3 | 2009 Q4 | 2010 Q1 | 2010 Q2 | 2010 Q3 | 2010 Q4 | 2011 Q1 |
|-----------------------|----------|----------|---------|---------|---------|---------|---------|---------|---------|
| Target Overnight Rate | 0.95 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.60 | 1.25 | 1.50 |
| Prime Rate | 2.95 | 2.25 | 2.25 | 2.25 | 2.25 | 2.25 | 2.60 | 3.25 | 3.50 |
| 1-mo. T-Bill | 0.53 | 0.20 | 0.20 | 0.20 | 0.25 | 0.25 | 0.55 | 1.15 | 1.40 |
| 3-mo. T-Bill | 0.64 | 0.25 | 0.25 | 0.25 | 0.30 | 0.35 | 0.70 | 1.30 | 1.65 |
| 6-mo. T-Bill | 0.69 | 0.30 | 0.30 | 0.30 | 0.40 | 0.45 | 0.85 | 1.45 | 1.75 |
| 1-year T-Bill | 0.77 | 0.45 | 0.45 | 0.45 | 0.55 | 0.65 | 1.05 | 1.75 | 2.10 |
| 2-year GoC Bond | 1.12 | 0.90 | 0.85 | 0.85 | 0.85 | 1.00 | 1.35 | 2.05 | 2.40 |
| 3-year GoC Bond | 1.47 | 1.25 | 1.20 | 1.25 | 1.30 | 1.40 | 1.75 | 2.35 | 2.70 |
| 5-year GoC Bond | 1.89 | 1.75 | 1.70 | 1.75 | 1.80 | 1.85 | 2.10 | 2.65 | 3.00 |
| 10-year GoC Bond | 2.88 | 2.90 | 2.80 | 2.85 | 2.95 | 3.00 | 3.15 | 3.65 | 4.05 |
| Spread: 10y less 3m | 2.21 | 2.65 | 2.55 | 2.60 | 2.65 | 2.65 | 2.45 | 2.35 | 2.40 |

Note: Quarterly average based on daily or weekly data. a = actual, all others forecast.

Deposit Rate Forecast

| Item | 2009 Q1a | 2009 Q2 | 2009 Q3 | 2009 Q4 | 2010 Q1 | 2010 Q2 | 2010 Q3 | 2010 Q4 | 2011 Q1 |
|------------|----------|---------|---------|---------|---------|---------|---------|---------|---------|
| Prime Rate | 2.95 | 2.25 | 2.25 | 2.25 | 2.25 | 2.25 | 2.60 | 3.25 | 3.50 |
| 1-year GIC | 0.86 | 0.30 | 0.30 | 0.30 | 0.30 | 0.40 | 0.80 | 1.40 | 1.75 |
| 3-year GIC | 1.86 | 1.40 | 1.10 | 1.00 | 1.05 | 1.20 | 1.35 | 1.70 | 2.00 |
| 5-year GIC | 2.18 | 1.70 | 1.45 | 1.40 | 1.40 | 1.65 | 1.80 | 2.15 | 2.40 |

Note: Quarterly average based on weekly data. a = actual, all others forecast. Redeemable rates.

Lending Rate Forecast

| Item | 2009 Q1a | 2009 Q2 | 2009 Q3 | 2009 Q4 | 2010 Q1 | 2010 Q2 | 2010 Q3 | 2010 Q4 | 2011 Q1 |
|-----------------|----------|---------|---------|---------|---------|---------|---------|---------|---------|
| Prime Rate | 2.95 | 2.25 | 2.25 | 2.25 | 2.25 | 2.25 | 2.60 | 3.25 | 3.50 |
| 1-year Mortgage | 4.98 | 4.00 | 3.85 | 3.80 | 3.95 | 4.10 | 4.25 | 4.45 | 4.65 |
| 3-year Mortgage | 5.39 | 4.15 | 4.10 | 4.10 | 4.20 | 4.45 | 4.50 | 4.70 | 5.10 |
| 5-year Mortgage | 5.93 | 5.25 | 5.20 | 5.20 | 5.25 | 5.25 | 5.25 | 5.35 | 5.55 |

Note: Quarterly average based on daily or weekly data. a = actual, all others forecast. Fixed term posted mortgage rates.