

## Interest Rate Forecast- March 2009

### Policy actions

This month, the US policymakers took dramatic steps to stimulate the economy and repair credit markets. The US Federal Reserve expanded their purchases of agency mortgage-backed securities and agency debt by up to \$850 billion and initiated the purchase of up to \$300 billion of longer-term Treasury securities. In addition, the Financial Stability Plan involving the Treasury, the Fed, the Federal Deposit Insurance Corporation, and other financial agencies, provides additional capital to commercial banks and a mechanism for taking distressed financial assets off private sector balance sheets under a Public-Private Investment Program.

These measures complement other Fed and Treasury programs previously announced such as the Commercial Paper Funding Facility, the Term Asset-Backed Securities Loan Facility, Troubled Assets Relief Program, and several others. When fiscal stimulus is included, US federal policymakers have pledged about \$12 trillion to fix the financial system and promote economic growth. Actual take-up thus far is considerably less but will increase with time.

Positive results from these policies take time to materialize and affect credit markets and the economy. Some early signs are lower mortgage rates, lower government bond yields, slightly lower corporate debt costs, and a slower rate of decline in recent economic indicators. This process needs several more months to work through the system but the direction is positive and the equity and commodity markets were encouraged by these developments.

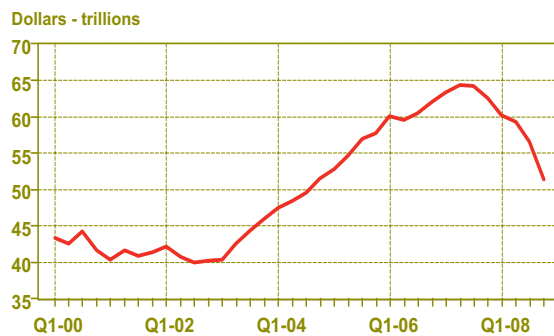
### Economy

Recent US data on home sales, housing starts, consumer spending and sentiment, and durable goods orders provide the very earliest signs of some easing in the recession. Real consumer spending is on pace to grow in the first quarter and pending tax cuts will provide a lift over the next several months. Mortgage refinance activity continues climbing

#### Highlights:

- *US policy actions move markets*
- *Tentative, early positive economic signs*
- *Recession continues for most of 2009, modest recovery in 2010*
- *April rate cut last by Bank of Canada, shift to credit easing*
- *Lower deposit and mortgage rates in 2009*
- *Rate-normalization process by central bank begins next year*

#### Net Worth of U.S. Households



Source: US Federal Reserve. Note: Includes nonprofit organizations. Latest: Q4-08

higher leaving borrowers with more money in their pockets as do lower energy prices.

While these are hopeful signs, it is too early to conclude the recession will soon end. One or two months do not make a trend. However, on a technical basis, the recent action of indicators is consistent with a shock event hitting



the economy -- a large sharp, swift fall in activity followed a slowing in the rate of descent and an eventual bottom.

US first quarter 2009 real GDP is contracting at a 5% annual rate led by a large inventory drop as businesses cut production to current demand, a further decline in non-residential investment, and another drop in exports. Residential investment declines as well but at a slower pace while government spending rises. The economy could contract at a faster pace than the 6.2% rate in the last quarter of 2008; it is too close to call.

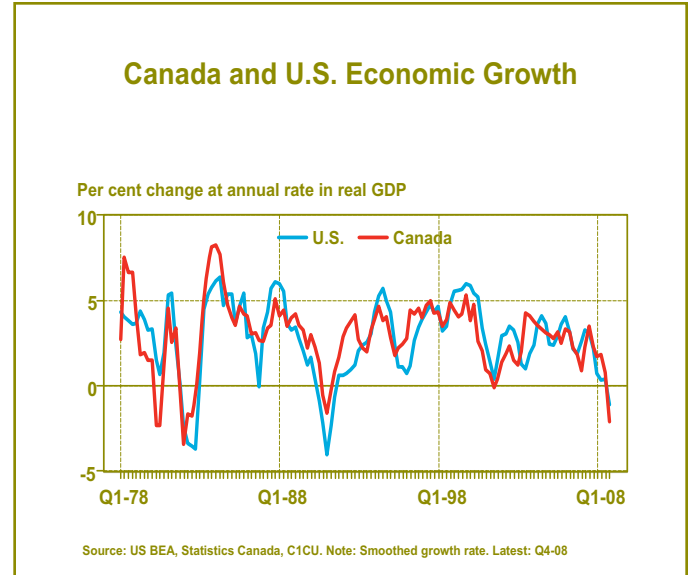
February's uptick in inflation is temporary and not of concern to policymakers. Rather, it is a welcome break from the deflation readings in prior months. Growing excess capacity in the economy keeps inflation at 1% or less for many more months. Some forecasters predict the unemployment rate to crest above 10%. It is currently 8.1%.

How long could this recession last and what is the likely profile of the recovery? Since the main economic growth driver is government policy and the private sector is dependent on improved market and credit conditions, the recession lasts another two or possibly three quarters. Some forecasters have the recession extending into 2010.

The recovery is likely modest by historical standards since personal consumption of durable goods (mostly autos) and new housing construction are restrained by a large drop in net worth and little pent-up demand. Government spending and some inventory rebuilding account for most of the growth in the early recovery stages. The outlook for 2011 and 2012 is more promising with some additional growth from exports and the release of pent-up consumer demand.

Canada's economy produced similar results as in the US in the past month with another large drop in employment, higher unemployment, fewer exports, and a temporary pop in retail sales and consumer prices. The close linkage between their real and financial economies often means comparable performances, though in general, the US economy tends to lead Canada's business cycle.

In addition to the price-discounted jump in January retail sales, some optimism among Canadian businesses emerged in March surveys. Small- and mid-sized businesses were more optimistic (less pessimistic) in March, according to a survey by the Canadian Federation of Independent Business. In addition, manufacturers and exporters are more optimistic



about business conditions over the next three months than they have been since the beginning of 2009, according to the Canadian Manufacturers & Exporters' March Business Conditions Survey.

Leading economic indicators, however, still paint a poor short-term future, falling 1.1% in February and the sixth consecutive monthly decline. Nine out of ten sub-components experienced contraction, including an 8.0% decline in the housing component, a 7.5% fall in equities and a 4.8% pullback in new orders. The only sub-component of the index to improve was the money supply.

The recent equity market rebound helps the leading indicator in March as will the money supply but real economy components such as housing, manufacturing shipments, employment, and retail sales will not. Canada's recession continues at least as long as in the US.

Canada's fiscal stimulus begins to materialize in April when Budget 2009 takes effect and the spring building season appears. These spending impacts are concentrated in the construction industry and in projects with both short and long time horizons. Their economic impact is largely in 2010 and in any case Canada's recovery mostly depends on monetary stimulus and on the US economy.

A large contraction in first quarter 2009 real GDP is underway and likely exceeds the 6% annualized drop in fourth quarter 2008 US GDP. Investment, exports, and inventory decumulation lead the decline. This is probably the worst quarter for Canada during this recession but another sharp decline in the second quarter is possible. For

the year, real GDP contracts 2.8% followed by a below-average recovery in 2010 at 1.6%.

## Interest rates

Administered deposit and lending rates dropped in March, particularly at short and mid terms. The typical one-year nonredeemable GIC deposit rate fell to 0.38% from 0.88% at the end of February. Posted mortgage rates declined 50bps to 4.50% for a one-year term and to 4.65% for a three-year term. The five-year rate dropped 24bps to 5.65%.

Short-term rates for business credit also declined in the month helped by the Bank of Canada's 50bps cut in its target rate on March 3. Spreads remain higher than normal but well below the heights seen during the crisis months last year.

Following the Fed's announcement that it would purchase US Treasury bonds, government bond yields dropped about 20bps on the announcement but climbed back to prior levels by the end of the following week. The equity market rally may have attracted some bond investors along with renewed inflation concerns. Canadian bonds closely followed US bond yield performance.

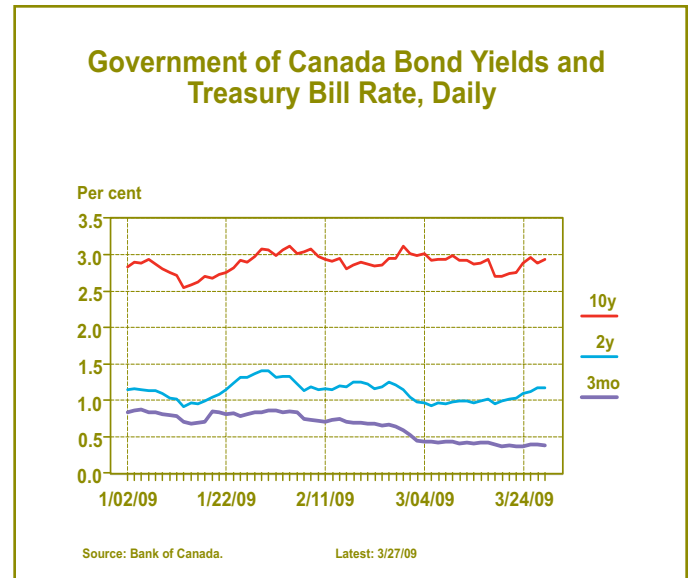
## Monetary policy

The Bank of Canada is shifting to credit and quantitative easing to provide monetary stimulus since its target rate is approaching zero. In its April *Monetary Policy Report*, the Bank will outline a framework for the possible use of such measures. In addition, the Bank will lower its sights on economic growth for 2009 and 2010 in particular, which at 3.8% is an optimistic outlier.

The Bank of Canada continues to engage in term purchase and resale agreements to provide additional liquidity to financial markets. The Bank remained active in March with \$23 billion of assets purchased from primary dealers and all participants in the LVTs.

## Interest rate forecast

A 25bps cut in its target rate to 0.25% by the Bank of Canada on April 21 is expected. This is the Bank's last rate cut and in the future relies exclusively on its balance sheet operations to provide liquidity to the financial system. The target rate remains at 0.25% into 2010, but when economic growth resumes and prospects are positive, the Bank



embarks on a rate-normalization phase. The first increase is penciled in for July 2010 with the target rate rising to 1.25% by the end of 2010.

Deposit rates decline another 30 to 60 bps depending on the term and then track government rates higher in 2010. Posted mortgage rates decline another 50bps depending on term reflecting a lower cost of funds and federal government purchases of mortgage-backed securities.

Target Overnight Rate Forecast	
BoC Meeting Date	Rate
Jan. 20, 2009	0.50
Mar. 3 (f)	0.25
Apr. 21	0.25
June 4	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

## Interest Rate Forecast

Item	2008 Q4a	2009 Q1f	2009 Q2	2009 Q3	2009 Q4	2010 Q1	2010 Q2	2010 Q3	2010 Q4
Target Overnight Rate	2.15	0.95	0.25	0.25	0.25	0.25	0.25	0.60	1.25
Prime Rate	3.98	2.95	2.25	2.25	2.25	2.25	2.25	2.60	3.25
1-mo. T-Bill	1.32	0.55	0.25	0.20	0.20	0.25	0.25	0.55	1.15
3-mo. T-Bill	1.46	0.65	0.35	0.25	0.25	0.30	0.35	0.70	1.30
6-mo. T-Bill	1.57	0.70	0.45	0.35	0.30	0.40	0.45	0.85	1.45
1-year T-Bill	1.64	0.75	0.60	0.55	0.50	0.55	0.65	1.05	1.75
2-year GoC Bond	1.82	1.15	0.90	0.80	0.80	0.85	1.00	1.35	2.05
3-year GoC Bond	2.10	1.45	1.25	1.15	1.10	1.15	1.40	1.75	2.35
5-year GoC Bond	2.51	1.90	1.65	1.55	1.50	1.55	1.75	2.10	2.65
10-year GoC Bond	3.39	2.90	2.80	2.70	2.65	2.65	2.70	3.05	3.60
Spread: 10y less 3m	1.93	2.25	2.45	2.35	2.40	2.35	2.35	2.35	2.30

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

## Deposit Rate Forecast

Item	2008 Q4f	2009 Q1	2009 Q2	2009 Q3	2009 Q4	2010 Q1	2010 Q2	2010 Q3	2010 Q4
Prime Rate	4.00	2.95	2.25	2.25	2.25	2.25	2.25	2.60	3.25
1-year GIC	1.69	0.85	0.35	0.30	0.30	0.30	0.35	0.70	1.30
3-year GIC	2.56	1.85	1.35	1.00	1.00	1.00	1.20	1.35	1.70
5-year GIC	2.91	2.15	1.75	1.40	1.40	1.40	1.65	1.80	2.15

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

## Lending Rate Forecast

Item	2008 Q4f	2009 Q1	2009 Q2	2009 Q3	2009 Q4	2010 Q1	2010 Q2	2010 Q3	2010 Q4
Prime Rate	4.00	2.95	2.25	2.25	2.25	2.25	2.25	2.60	3.25
1-year Mortgage	6.08	4.95	4.30	4.25	4.10	4.15	4.20	4.15	4.25
3-year Mortgage	6.79	5.40	4.50	4.40	4.35	4.40	4.40	4.40	4.45
5-year Mortgage	7.07	5.90	5.40	5.30	5.20	5.05	4.95	4.95	5.10

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