

Interest Rate Forecast- June 2010

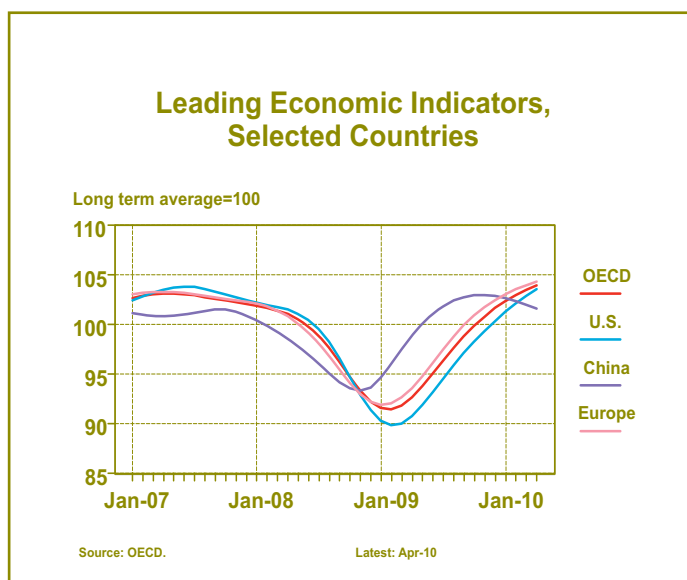
The future of economy has not been this doubtful since the worst of the financial crisis in late 2008 and early 2009. The sovereign debt crisis in Europe combined with some exhaustion of fiscal stimulus and the fading of recession/recovery inventory dynamics cast a large cloud over the economic outlook. Markets are quick to factor in surprises and to change their expectations, in this case from an ongoing recovery scenario to, at the extreme, a double-dip recession and another financial crisis.

With Canada's economy no longer in recession and after several months of gains in output and employment, the Bank of Canada is in the process of unwinding its emergency monetary settings. This process will continue through the summer months and into the fall before conditions prompt the Bank to remain on hold until the economic outlook is more certain and positive. The Bank will resume its rate normalization process around mid-2011.

Economy

Leading economic indicators are flashing slowdown ahead and the odds of a fallback into recession are rising but remain well below 50:50. The Euro debt crisis has weakened the financial and monetary components of leading indicators while the real economy components are holding for now. China's leading index has already rolled over while the indices for most industrialized economies are decelerating. Chinese authorities began withdrawing and winding down various stimulus measures in recent weeks.

The likely scenario is a growth slowdown rather than an outright recession. A fallback into recession requires the Euro debt crisis to intensify and cause serious problems in Europe's interbank funding and credit markets along with a banking crisis. The collateral damage to global financial markets would hurt the real economy along with reduced trade volumes and shattered consumer and business confidence. However, policymakers were aggressive with their mitigating measures during the September-October 2008 financial crisis and they will react accordingly should the need arise.



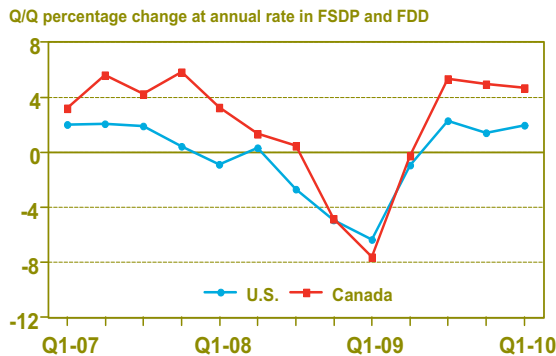
Some observers make the point that policymakers have little ammunition left after their all-out efforts to combat the Great Recession. Government debt levels are much higher now and will climb for the next few years. At the just-completed G-20 meeting, a consensus was reached to reduce deficits and stabilize total debt. Nonetheless, another recession would constitute an emergency and policymakers in those affected economies would have little choice but to re-stimulate. Clearly, there are some exceptions such as Greece.

A European Union recession is quite possible or at least for some of its members. Countries with substantial trade ties to the EU would see exports decline. A sizable portion of China's exports are destined for the EU, compared to less than 10% of U.S. and Canadian exports, which will pull down China's 10% plus growth rate. Collateral damage to the North American economy will be mainly through the financial and confidence channels.

A growth slowdown, or in the economics jargon a 'growth recession' in general terms, is the working scenario underlying this rate forecast. Growth slowdowns occur frequently and



Demand Growth, U.S. and Canada



Source: U.S. Bureau of Economic Analysis, Statistics Canada.

usually last 6 to 12 months. The unemployment rate tends to stay up or occasionally increase during this growth cycle phase.

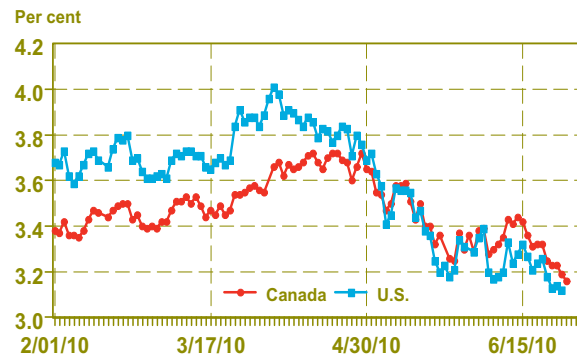
The U.S. economic forecast entails real GDP growth of 2 to 3% in 2Q-10 and 3Q-10 with a chance of less than 2% quarterly growth in one quarter before the year ends. The 2011 outlook is slightly better with a rising growth profile as the year progresses. Consumer spending fundamentals in the U.S. are poor and remain weak into 2011 though on an improving trend. The U.S. housing market is still under duress with supply excesses extending well into next year.

Canada's economy is stronger than the U.S. economy as seen in the performance of domestic demand and this prompted the Bank's action earlier this month. While the financial crisis pulled most economies down into recession, the recoveries have not been as synchronized resulting in varying fiscal and monetary policy settings across countries. Real GDP growth in Canada also slows to the end of this year before picking up in 2011.

Inflation

No inflation pressure from the real economy either in Canada or in the U.S. since excess capacity exists. Cost-push inflation pressures in Canada are not likely until 2013 or 2014 and even later in the U.S. Commodity price inflation is a more likely inflation source but it largely depends on energy prices. Monetary sources of inflation are not likely either and ultimately depend on credit demand conditions.

10-year Government Bond Yields, U.S. and Canada



Source: U.S. Bureau of Economic Analysis, Statistics Canada.

Monetary policy

No change from last month's report since the next meeting is not until July 20. The Bank is keen to normalize rates but it too reacts to changing conditions and expectations. To the extent that the Bank did not anticipate and incorporate their outlook, a downgrade to their economic forecast will occur in the MPR on July 22. However, this downgrade is unlikely to forestall a rate increase in July 20.

Interest rates

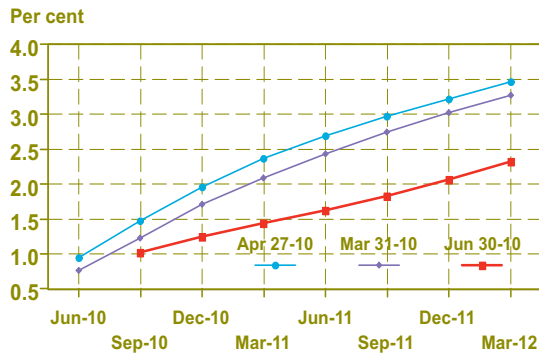
The current crisis has caused a flight to safety and to less risky assets such as government bonds. Yields are down across the term structure in the past two months and the U.S. 2-year government bond yield hit a record low 0.625%. Canadian government bond yields have followed U.S. yields lower.

Administered rates did not change during the past month except for some erratic upward movement in the 1-year redeemable GIC deposit rate and a slight drop in the 5-year posted mortgage rate to 5.89%. Another small decline in this posted mortgage rate is likely since new mortgage demand is slowing in tandem with the housing market.

Interest rate forecast

Another 0.25% increase in the target rate by the Bank of Canada on July 20 is a virtual certainty. For the doubters, consider that Canada's economy is no longer in recession and monetary conditions remain highly stimulative with a

Three-Month Canadian Bankers' Acceptance Futures



Source: Montreal Exchange, C1CU.

0.50% target rate. This forecast sees another rate increase in September and October but not one in December. This is a change from the last forecast and is due to the crisis in Europe and the weaker economic outlook. The pause period commences after the October increase and extends until next June when stronger growth materializes and the rate normalization process resumes.

Economic forecasters are not the only ones to change their minds. Have a look at the graph on three-month Bankers Acceptance futures – instead of a 3.5% rate in March 2012 expected only two months ago, the futures market is now pricing a 2.32% rate. A wholesale downshift in rate expectations by these market experts highlights the rapid change resulting from unexpected events.

Target Overnight Rate Forecast

Meeting Date	Rate (%)
June 1, 2010	0.50
July 20 (f)	0.75
Sept. 8	1.00
Oct. 19	1.25
Dec. 7	1.25
Jan. 2011	1.25
Mar.	1.25
Apr.	1.25
June	1.50
July	1.75
Sept.	2.00
Oct.	2.25
Dec.	2.50
Jan 2012	2.75
Mar.	2.75

Interest Rate Forecast

Item	2010 Q1a	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2012 Q1
Target Overnight Rate	0.25	0.35	0.75	1.25	1.25	1.35	1.75	2.25	2.75
Prime Rate	2.25	2.35	2.75	3.25	3.25	3.35	3.75	4.25	4.75
1-mo. T-Bill	0.15	0.20	0.60	1.15	1.15	1.25	1.65	2.15	2.60
3-mo. T-Bill	0.20	0.40	0.85	1.30	1.25	1.40	1.85	2.35	2.75
6-mo. T-Bill	0.30	0.70	1.15	1.55	1.55	1.70	2.00	2.60	3.15
1-year T-Bill	0.65	1.15	1.65	1.95	1.90	1.90	2.40	2.95	3.45
2-year GoC Bond	1.40	1.80	2.15	2.40	2.30	2.35	2.75	3.25	3.60
3-year GoC Bond	1.75	2.25	2.55	2.70	2.65	2.65	2.95	3.50	3.80
5-year GoC Bond	2.60	2.85	2.95	3.15	3.10	3.15	3.50	3.75	4.05
10-year GoC Bond	3.45	3.45	3.35	3.50	3.60	3.75	4.00	4.35	4.60
Spread: 10y less 3m	3.25	3.05	2.50	2.20	2.35	2.35	2.15	2.00	2.00

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

Deposit Rate Forecast

Item	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2012 Q1
Prime Rate	2.25	2.35	2.75	3.25	3.25	3.35	3.75	4.25	4.75
1-year GIC	0.28	0.65	1.25	1.45	1.45	1.40	1.80	2.10	2.40
3-year GIC	1.33	1.40	1.60	1.60	1.60	1.60	1.90	2.30	2.70
5-year GIC	1.88	1.95	1.90	1.90	1.95	2.00	2.20	2.55	2.90

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

Lending Rate Forecast

Item	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2012 Q1
Prime Rate	2.25	2.35	2.75	3.25	3.25	3.35	3.75	4.25	4.75
1-year Mortgage	3.60	3.70	3.90	4.20	4.20	4.35	4.80	5.25	5.65
3-year Mortgage	4.20	4.60	4.70	4.65	4.70	4.85	5.15	5.55	5.90
5-year Mortgage	5.43	6.05	5.90	6.00	6.10	6.20	6.35	6.60	6.95

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