CAPITAL MARKETS RESEARCH

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Special Update

New Canadian and U.S. Rates Forecasts

BoC On Hold Until 2012Q2, Fed On Hold Until 2012Q3

We have argued throughout this cycle that the neutral rate is lower than in past cycles, that the BoC should take a slow path toward a lower neutral rate, and that the tail risk was always more skewed toward later than the October 2011 hike that we have been forecasting since last Fall. We've now formally executed that fat tail risk into a print forecast that has the BoC on hold until 2012Q2 and we don't discount the risk that resumed rate hikes begin even later than that.

To this effect, those who are arguing that the BoC is behind the curve are treating monetary policy as being conducted in a vacuum in isolation of myriad other complicated influences upon the economy and markets. Rather, material tightening is being imposed on without any action by the BoC, via fiscal retrenchment, CAD strength, higher capital and liquidity requirements, commodity prices that are crowding out wage growth, tighter mortgage lending rules, rolling global fiscal shocks that create a back-drop of instability in financial markets, and risks facing fixed-term borrowing costs over 2012-13. Such forms of tightening are all forward looking and must be considered in a forecast for monetary policy as opposed to dwelling on the country's impressive accomplishments to date.

Add to this the enormous modeling uncertainty surrounding the impact of CAD appreciation on core inflation. The 95% confidence interval surrounding estimates of the impact of each 10% trade-weighted currency appreciation push as high as a 2% drop in core prices after two years. Current inflation readings are largely meaningless in the conduct of forward-looking monetary policy, such that the uncertainty over the impact of a stronger currency on pricing power justifies idled monetary policy for some time and catching up later if need be. It would likely be imprudent to hike before year-end without giving such effects enough time to be evaluated. What also leans in the direction of this argument is the uncertain medium-term outlook for commodity prices, but our base view is that their influences upon CPI inflation will ebb into next year when re-based to today's still relatively high commodity prices. That doesn't require further sustained declines in food and energy prices, but even a flattening out will have commodities drop out as influences upon headline inflation such that the BoC's guidance — and that of the Fed and BoE — to look through near-term inflation upsides is legitimate. If not, then materially higher commodities would likely spark renewed demand destruction and this would probably be disinflationary upon core CPI yet again.

Further, the BoC's output gap guidance remains that should the gap close by 2012Q2 (with the risk of being delayed a quarter after a very weak 2011Q2 and heavily inventory-distorted Q1 that left behind a weak domestic demand picture), then it merely rides flat thereafter if the BoC is correct in forecasting actual GDP growth to be in line with potential GDP growth into 2013. This is a key part of guidance from the BoC that was missed by many in the April rate statement and thereafter. It does not incorporate an embedded hawkish tightening rate profile as that would be at odds with all other forms of guidance from the BoC including Governor Carney's recent comments in a WSJ interview. Rather, we take such guidance to mean that when excess capacity is closed off, it will not do so in a manner that persistently pushes further and further into inflationary excess demand. Given structural headwinds facing the economy, this view on 2012-13 growth is reasonable. What the BoC is signaling here is that they believe their inflation target is unlikely to be sustainably breached into 2013 under current or only somewhat tighter monetary policy conditions later. While such guidance may or may not turn out to be correct over the long run, it is the guidance and reaction function being signaled to markets by the BoC and it does not support near-term rate hikes. Working backward from such guidance after incorporating lagged influences of monetary policy changes supports a hold view until next Spring or perhaps later.

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All of this must be placed within the context of less-than-spectacular fundamentals. The country has been unable to leverage up the US expansion and its commodity advantage as evidenced through a rising sea of red ink in its net trade deficits. High terms of trade (the ratio of export to import prices) are not filtering through the broader economy since real wage growth is flat despite decent trend job growth, and instead the terms of trade lift is being hoarded in operating profit margins and cash balances within the context of still-significant slack in labour markets. Further, the domestic household sector is operating at cycle peaks on volume, price and leverage measures that risk a sharp correction should rates rise significantly at the front end of the Canada curve in addition to our views on the belly of the curve. The question is not whether the BoC should hike to cool housing, consumption and debt growth amidst strong evidence of cooling pressures that are already underway. Instead, should the BoC impose appreciable rate shock on the Canadian economy, it risks being the catalyst to rolling over the household sector from all-time highs across so many variables that have reached their highs by pulling forward future demand.

In the context of what has been said thus far, advice in favour of the BoC hiking earlier than expected on the heels of the latest inflation report is off-base. To do so would be a policy distortion of monumental proportions when even backward-looking core inflation remains well behaved at 1.8% y/y. Distortions that fed the month-over-month rise included seasonal pricing (whereas seasonally adjusted inflation was up only 0.2% m/m on headline and core), temporarily higher gas prices that have already reversed and that are outside of the BoC's control, and narrowly based inflation in the clothing and footwear category that largely just reversed the prior month's drop. Evidence of a fanning out in inflationary pressures remains weak.

Lastly, we're left with geopolitical concerns. Today's 'yes' vote in Greece alters nothing by way of the still large and looming funding challenges that stretch across the peripheral economies. The next hurdle is tomorrow's vote in the Greek parliament that is oriented toward passing legislation needed to enact the austerity measures. Following that, Sunday's meeting of euro-area finance ministers will determine whether to release the next tranche of funding required to bridge over Greece's short-term needs. That's likely to be agreed upon, but then the fun begins. What happens from that point forward is still marked by enormous uncertainty. How to address Greece's longer-run funding requirements within the confines of an economy that stands no hope of doing it on its own through economic and revenue growth, and how to do so without triggering a default stamp is proving to be enormously complex. Ratings agencies have been fairly clear for some time now that any restructuring that alters the original indenture terms for the worse, and/or that is deemed necessary in order to avoid an outright default, will be classified as a default on Greece's obligations. That then leaves open the next round of uncertainty with respect to whether this is deemed a credit event by ISDA, and thus whether CDS coverage can be triggered or not. In all, whether Greece or elsewhere, the future will continue to be marked by rolling fiscal shocks that jeopardize market stability and cause ongoing consternation in global central bank circles.

Our broader yield curve views (see below) incorporate more of a classic bear flattener in Canada than in the U.S., albeit mildly. In the US, Scotia Economics continues to forecast that the classic historical tendency to exhibit relief in the belly and the back end of the yield curve once monetary policy tightening commences does not transpire this time. Long-run exit concerns regarding unconventional monetary policy are one factor. Another is the prospect of further fiscal stimulus extension into a Presidential election year despite rating agency warnings that a credible fiscal exit plan must be in place by 2013; this is expected to contribute toward deepening concerns over the US fiscal position as expressed by bond markets and rating agencies. A globally correlated bond sell-off weighted more toward the US with less of an impact on Canada is expected to add spread opportunities. Our forecast that the US Fed is on hold until 2012Q3 may face later risk given disappointment in the Fed's full employment mandate and the intertwined political and fiscal risks. Either way, the Fed is a constraint on when the BoC can recommence hiking given the impact on CADUSD and the ensuing flow-through effects into growth and inflation.

Scotia Economics' Canada-U.S. yield curve forecast

end of quarter, %

June 29th 2011

Canada	**10q1f**	**10q2f**	**10q3f**	**10q4f**	**11q1f**	**11q2f**	**11q3f**	**11q4f**	**12q1f**	**12q2f**	**12q3f**	**12q4f**
BoC Overnight Target Rate	0.25	0.50	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.50	2.00	2.25
Prime Rate	2.25	2.50	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.50	4.00	4.25
3-month T-Bill	0.30	0.61	1.01	1.05	0.96	0.88	0.90	0.95	1.15	1.70	2.25	2.30
2-year Canada	1.74	1.39	1.38	1.68	1.83	1.55	1.45	1.55	1.80	2.15	2.30	2.50
5-year Canada	2.90	2.33	2.03	2.42	2.78	2.25	2.15	2.25	2.50	2.80	2.95	3.10
10-year Canada	3.57	3.08	2.76	3.12	3.35	3.05	3.00	3.20	3.30	3.45	3.65	3.85
30-year Canada	4.07	3.65	3.36	3.53	3.76	3.50	3.50	3.60	3.80	3.95	4.20	4.35
United States	**10q1f**	**10q2f**	**10q3f**	**10q4f**	**11q1f**	**11q2f**	**11q3f**	**11q4f**	**12q1f**	**12q2f**	**12q3f**	**12q4f**
Fed Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.75	1.25
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.75	4.25
3-month T-Bill	0.15	0.17	0.15	0.12	0.09	0.02	0.05	0.15	0.20	0.40	1.00	1.40
2-year Treasury	1.02	0.60	0.42	0.59	0.82	0.50	0.50	0.55	0.85	1.10	1.40	1.80
5-year Treasury	2.54	1.77	1.26	2.00	2.28	1.70	1.65	1.80	2.00	2.45	2.75	3.10
10-year Treasury	3.83	2.93	2.51	3.29	3.47	3.10	3.00	3.20	3.50	3.80	4.10	4.50
30-year Treasury	4.71	3.89	3.68	4.33	4.51	4.35	4.30	4.40	4.55	4.70	4.95	5.20