



# Interest Rate Forecast

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## Growth slowdown slowing

Unfolding economic evidence is suggesting a moderate growth path ahead with no major economic slowdown or recession likely. Inflation is on a positive track and not a near term problem. Nonetheless, mixed news keeps the bond market flip-flopping about the future causing volatility in its wake. No change to the two-year forecast rate profile in this month's forecast.

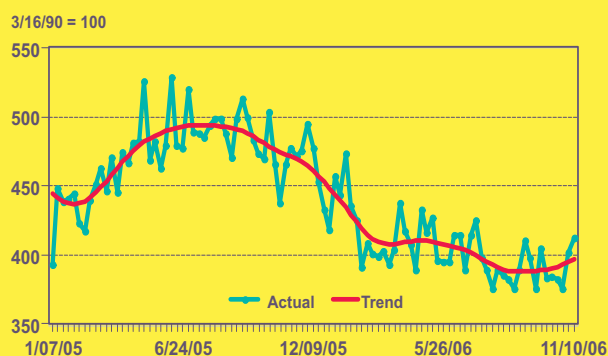
### Economy

There are increasing signs that the recent slowdown in the Canadian and U.S. economies is ending, at least temporarily. In Canada, gross domestic product (GDP) and employment posted back-to-back monthly gains after several months of little change. Monthly GDP grew 0.3% in August, after a 0.2% gain in July exceeding the cumulative gains in the previous four months. Employment gains in September and October more than made up losses in the prior three months.

Growth in the United States slowed to 0.4% in the third quarter, its smallest advance so far this year. Most of the easing originated in a sharp drop in housing, its fourth straight for a total loss of 8%. However, so far the contraction in housing has not noticeably affected other sectors of the economy. Consumer spending grew helped by a 0.9% gain in real disposable income. Consumer confidence in October hit its highest level in over a year, driven by lower gasoline prices.

The second consecutive monthly decline of 0.5% in headline U.S. consumer prices in October and the modest 0.1% increase in core prices indicates that inflation is moderating. The increase in core inflation was the smallest monthly gain in eight months though the year-over-year 2.7% rise in October is above the Fed's comfort zone. On a 3-month annualized basis, headline CPI is down 2.9%, and the core CPI is up only 2.3%.

Purchase Index, Weekly Mortgage Application Survey, U.S.



Source: Mortgage Bankers Association of America.

Canada's all-items consumer price index dropped massively in September, pushed down by a stunning drop (18.7% y/y and 17.4% m/m) of gasoline prices at the pumps. However, the core index rose as the price levels of other goods continued to rise and grew at 1.7% largely in line with earlier this year.

The Conference Board Leading Indicators rose 0.2% in October, following an upwardly-revised 0.4% gain in September. A more current reading comes from the Economic Cycle Research Institute's weekly leading indicator, which is at its highest level since mid-May 2006 and at its highest growth rate since June. Overall, leading indicators continue to point to an economy that is growing below potential (3%), but the likelihood of a recession is relatively modest.

That the U.S. housing slowdown is moderating is evident in the Purchase Index of the Weekly Mortgage Application Survey. Purchase applications were above 400 for a second consecutive week and purchase applications are nearly 7% above October's three-and-a-half year lows. Mortgage demand has picked up, as interest rates have retreated to the levels seen earlier in the year when housing demand was stronger.

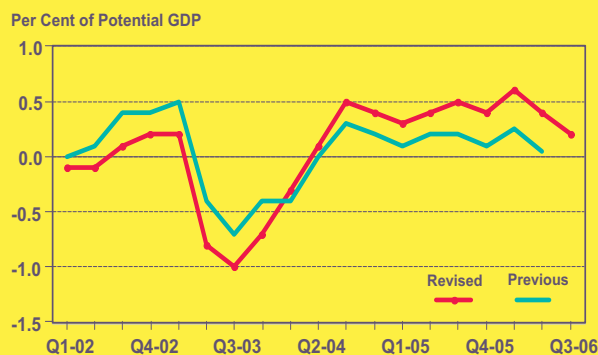
Canada's composite leading index rose 0.4% in September, following an upward-revision of 0.3% in August. This is in line with the trend over the past two years where the leading indicator has consistently risen by an average of 0.4% a month. Canada's economic growth rate is forecast at a 2.5% annual rate in the third quarter 2006 up slightly from the 2.0% rate of the second quarter and below the economy's potential.

The Bank of Canada's recent downward revision to the economy's potential growth rate raised its estimated positive output gap (inflation pressures) during the past two years. It has declined in the first two quarters on this year and if the Bank's Q3 GDP forecast of 2.0% materializes, it will fall to 0.2%. A higher Q3 growth rate will push up the gap and reduce the likelihood of a rate cut.

## Monetary Policy

In the U.S., the minutes from the Federal Reserve's October 24 meeting revealed that most committee members judged that the downside risks to economic activity slightly diminished. The October FOMC minutes noted that the labor market remained tight as all meeting participants expressed concern about the outlook for inflation. Recent changes in core prices had declined slightly from earlier in the year but nearly all participants viewed the current rates of core inflation as uncomfortably high and stressed the importance of further moderation. Inflation expectations could begin to drift upwards if core inflation remained elevated for a protracted period. All participants emphasized that the risks around the desired downward path to inflation remained to the upside.

### Canada's Output Gap, Quarterly



Source: Bank of Canada. Note: Q3-06 is Bank's forecast.

While the market widely expects rate cuts, some Fed Governors are talking of further tightening. Voting Richmond Fed president Lacker dissented at the last three meetings for higher rates. The regional Dallas Fed submitted a request to raise the discount rate at the Sept meeting as the Philadelphia Fed bank did in August. Fed Vice-chairman Kohn noted that policy tightening depends on core inflation as Chicago president Moskow has noted the risk for further policy tightening. Clearly, rate cuts have to wait until core inflation turns decidedly lower or clear evidence of recession sets in.

## Interest Rates

Long bond yields seesawed in the last four weeks on news of declining energy prices, a strong employment report, and on benign inflation data. The inverted yield curve widened in the U.S. and in Canada. This disequilibrium market situation will ultimately resolve with a decline in short rates or an increase in long bond yields.

The futures market was pricing in no change in the Fed's target rate at the conclusion of the next policy meeting in December and at the January 2007 meeting. However, a combination of continued below potential growth and the expected decline in core inflation pressures have market participants assigning a 30% chance of rate cut in March. Thereafter, the market is fully pricing in at least one rate cut in the first half of next year.

In Canada, a 25 basis point cut by September is fully priced into the three-month futures rate, little changed from last month. Into 2008, the market sees a slight upward bias to rates.

## Interest Rate Forecast

No rate cut by either the U.S. or Canadian central bank during the next two quarters is a safe bet. Beyond this time horizon, forecasts diverge into two camps – the slow growth rate cut camp and the moderate growth little change camp. With short rates in the 'normal zone', central bankers are very reluctant to cut rates unless the evidence and the outlook are convincingly on the downside.

A straight-line forecast for short rates in Canada are best interpreted as the likely path with only minor variations. No doubt, the straight-line forecast is unlikely to play out exactly but the case for a substantial decline or increase in the overnight rate during the next two years is not strong in this opinion.

Even more uncertain is the short-term direction in long bond yields since they fluctuate with every positive or negative economic news report. Volatility is the byword here. Longer term (more than six months), bond yields should be gradually higher on a trend basis barring a slow growth rate cut outcome.

Target Overnight Rate Forecast BoC Meeting Date	
Sept. 6 (f)	4.25
Oct. 17	4.25
Dec. 5	4.25
Jan. 16, 2007	4.25
Mar. 6	4.25
April 24	4.25
May 29	4.25
July 10	4.25
Sept. 5	4.25
Oct. 16	4.25
Dec. 4	4.25
Jan. 2008	4.25
Mar.	4.25
April	4.25
June	4.25
July	4.25
Sept.	4.25

Long bond yields have fallen 13 of the past 16 years in December due in part to year-end asset-shifting activity. This mild seasonality in bond yields should keep the yield curve negative for a little longer before turning positive in 2007 and slightly more positive in 2008.

Interest Rate Forecast									
Item	2006 Q3a	2006 Q4f	2007 Q1	2007 Q2	2007 Q3	2007 Q4	2008 Q1	2008 Q2	2008 Q3
Target Overnight Rate	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25
Prime Rate	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00
1-mo. T-Bill	4.07	4.10	4.10	4.15	4.15	4.10	4.15	4.15	4.15
3-mo. T-Bill	4.16	4.15	4.20	4.25	4.25	4.25	4.25	4.25	4.25
6-mo. T-Bill	4.22	4.20	4.20	4.30	4.25	4.25	4.25	4.25	4.25
1-year T-Bill	4.27	4.15	4.20	4.30	4.30	4.30	4.30	4.30	4.30
2-year GoC Bond	4.09	4.20	4.15	4.20	4.25	4.25	4.30	4.30	4.35
3-year GoC Bond	4.11	4.05	4.15	4.25	4.30	4.30	4.35	4.35	4.40
5-year GoC Bond	4.14	4.05	4.20	4.30	4.35	4.35	4.40	4.45	4.50
10-year GoC Bond	4.25	4.10	4.25	4.40	4.50	4.55	4.60	4.65	4.70
Spread: 10y less 3m	0.09	-.05	0.05	0.15	0.25	0.30	0.35	0.40	0.45

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

Deposit Rate Forecast									
Item	2006 Q3 f	2006 Q4	2007 Q1	2007 Q2	2007 Q3	2007 Q4	2008 Q1	2008 Q2	2008 Q3
Prime Rate	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00
1-year GIC	3.02	2.90	2.95	3.05	3.10	3.10	3.10	3.10	3.10
3-year GIC	3.21	3.05	3.20	3.30	3.35	3.35	3.40	3.40	3.45
5-year GIC	3.34	3.15	3.30	3.45	3.60	3.65	3.70	3.75	3.80

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

Lending Rate Forecast									
Item	2006 Q3 f	2006 Q4	2007 Q1	2007 Q2	2007 Q3	2007 Q4	2008 Q1	2008 Q2	2008 Q3
Prime Rate	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00
1-year Mortgage	6.51	6.40	6.40	6.50	6.50	6.50	6.50	6.50	6.50
3-year Mortgage	6.65	6.50	6.60	6.70	6.75	6.75	6.80	6.80	6.85
5-year Mortgage	6.87	6.60	6.70	6.80	6.85	6.85	6.90	6.95	7.00

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