



Interest Rate Forecast

December 2006

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Another conundrum?

The growth slowdown continues to play out with incoming data. Counterbalancing this are more positive signs for the U.S. housing market though further downward adjustments in housing starts is expected. Central bankers concern over above target inflation will keep them on hold in the near term. Considerable divergence in the future course of interest rates exists among forecasters.

The recent plunge in bond yields has deepened the yield curve inversion and raised the spectre of another bond conundrum. One positive fallout is the demand stimulation in the economy and in housing in particular.

Short rates are seen little changed during the forecast period while long bond yields gradually trend higher, restoring a positive yield curve.

Economy

U.S. third quarter growth slowed to 2.2% annualized from the 2.6% pace of the second quarter. Positives for growth in the third quarter were stronger business investment in equipment and software, greater consumer spending on durable goods, and federal government spending. The housing market remains a drag on the economy. Over the past two quarters, investment in residential structures has declined an annualized 15%, the biggest contraction since 1990.

However, some positive news on U.S. housing came out since the last forecast. The purchase applications index rose 4.9% in the latest period and has risen 13.6% over the past six weeks to leave the index at a six-month high. Further, housing affordability is improving as NAR's index is up 7.5% thanks to lower housing prices and mortgage rates. Existing housing sales edged up for the first time since March.

Of course, lower housing prices are bad news for builders as housing starts dived in October, registering its largest decline of the current down cycle. Housing starts have declined in seven of the past nine months, and are 34% below their peak in January 2006 and 27% below year-ago levels. More subtraction from GDP growth is expected but the much anticipated and feared widespread negative-wealth effect on consumer spending remains a forecast.

Data on the core inflation rate (excludes energy and food) improved modestly, but core CPI inflation over the most recent twelve months was 2.7%, up from 2.1% over the previous twelve months. The Fed's favorite core inflation measure, the price index for personal consumption expenditures excluding food and energy, was up 2.4% over the past year, compared with a 2.1% rise in the preceding twelve months.

The economy is likely to expand at a moderate pace going forward below 3% in the near term but that by the second half of 2007, it will return to over 3%. Consumer spending supported by rising incomes will continue to grow fairly well and the drag from the motor vehicle and housing sectors will gradually diminish. The negative impact of the housing correction on the economy is likely to persist into next year but the rate of decline in home construction should slow as the supply adjustment plays out.

Core inflation is expected to moderate gradually over the next year or so. Some of the factors that pushed up core inflation in the recent past--in particular, energy prices and shelter costs--appear likely to be more neutral in the coming year, and inflation expectations remain contained. Further, the economy's below potential growth performance should ease pressures on resource utilization.

Turning to Canada, real GDP advanced 1.7% annualized in the third quarter. The growth drivers included a modest improvement in exports, a pickup in business non-residential investment, and personal expenditure. Offsetting growth in these was a drop in investment in residential construction and weaker government current expenditures.

Despite some weakness in third quarter GDP numbers, the stronger labor market in the two months of the fourth quarter bode well for a snap back in real economic activity. Employment is up 73,000 persons since September.

The main downside risk is the slower U.S. economy impact on Canadian exports. In the fourth quarter, the Canadian dollar declined providing a little relief for exporters but probably not enough to make a substantial difference to fourth quarter real GDP growth. The consensus forecast calls for 2.5% real GDP growth in Q4, though a lower figure will probably pan out.

Headline CPI fell 0.2% from September and posted a modest increase of 0.9% from last October, however core CPI rose 2.3% from a year ago. In October, gasoline prices were down 14.3% from last October and the natural gas index fell 16.4%. The sharp moderation in gasoline prices has been an important factor in driving headline prices lower.

Monetary Policy

Fed officials are still talking tough on inflation despite the growth slowdown. It could be that given the weakness in the dollar and plunge in bond yields the Fed is wary of accommodating a further easing of financial conditions amid uncomfortably elevated inflation. At the December 12 meeting, no change



in the policy rate is expected and the greater focus will be on the language and message in the FOMC statement. It will keep a slight tightening bias and possibly shift to neutral at the January meeting.

The Bank of Canada's decision to leave its policy rate unchanged came as no surprise and the announcement gave no clue as to the Bank's next move. Since the Bank's forecast of core inflation is 2.2% for the first half of 2007 (1.4% for headline CPI) is above its 2% target, there is little chance of a rate cut in the near term if there are no surprises.

In general, the Bank considers its policy rate to be in the neutral range and appropriate for the economy's future growth rate. It will take below trend economic growth in Q4-06 and Q1-07 to force the Bank to cut rates.

Interest Rates

Bond yields plunged to their lowest levels since January or February in early December after a run of gloomy data. A slight retrenchment emerged in the run-up to the all-important employment report on Dec. 8. The yield curve inversion deepened since short rates are well-anchored.

Some analysts offer up the possibility of a pending recession based on the inverted yields curve. The reasons for the inversion are more important than the inversion itself. In the past, substantial monetary tightening in an inflationary environment caused the inversion and ultimately an economic recession. This time it is vastly different. Long term bond yields are declining because of actual and perceived economic weakness and lower inflation. If further economic weakness plays out, central banks will cut short rates and the yield curve will turn positive. The inverted yield curve heralds slower economic growth but not a recession.

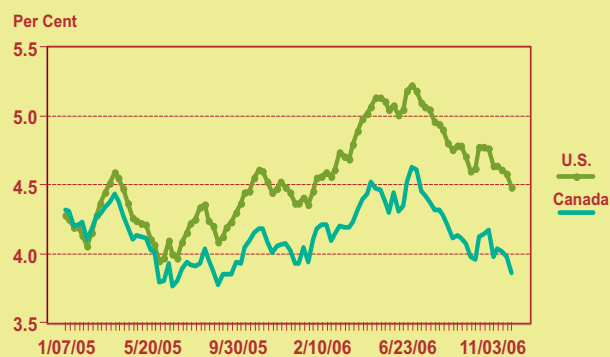
The Fed funds futures market is factoring in one 25 basis point cut by June 2007 and two more 25 bps cuts by December 2007. The market continues to anticipate no movement in the Fed's target following the December 12th meeting. The focus of this meeting is any change to the tightening bias in their statement. A shift to a neutral bias would be interpreted that rate cuts are on the horizon.

In Canada, a 25 basis point cut by May is now priced into the three-month futures rate compared to a similar by September less than four weeks ago. The change in sentiment is due to the weaker than expected economic reports. The market sees a slight upward bias to 2008 rates.

Interest Rate Forecast

No change in Canadian short rates is foreseen. The Bank of Canada is on hold for at least the next two quarters. Thereafter, the consensus view calls for one and likely two 25 bps rate cuts based on further below-potential growth in the next three quarters. This forecast has growth improving throughout 2007 from Q3-06's low 1.7% growth rate and the current slowdown is not sufficient to prompt a rate cut in light of improving growth in 2007.

Government 10-Year Bond Yields, Weekly



Source: US Federal Reserve, Bank of Canada. Latest: 12/01/06

Most forecasters predicting rate cuts have short rates returning to current levels by the end of 2007 and early 2008 and staying there to the end of 2008. Such fine-tuning by the Bank is possible but not common in its history. The Bank is more inclined to keep a stable policy setting and not adjust rates for temporary slowdowns.

The future path of long bond yields is more difficult to predict accurately. Their current low setting is at a disequilibrium level and those yields are buffeted up and down by just released economic news and future expectations of the economy and inflation. For example, Friday's U.S. employment report could move yields 10 bps in either direction depending on its strength or weakness. The consensus view calls for a 110,000 increase.

Long bond yields should be higher given the current inflation rate, short rates, and forecast economic growth for 2007. Ten-year bond yields below 4% should be associated with an inflation rate of 1% and economic growth of a similar magnitude and not with an inflation rate of slightly over 2% and 2007 growth projected at 2.5% to 3%.

This is a conundrum to use a term coined by former Fed chairman Greenspan, though in that instance, low bond yields prevailed during a monetary tightening phase, not like this time. The global saving glut is the preferred explanation along with other factors lowering the term risk premium. However, combination of the low level of bond yields and negative economic news move yields even lower causing the inversion.

It will take a spate of positive economic news to push bond yields higher and keep them there. This forecast has a gradual trend increase in bond yields during the next two years due to improving economic growth in the second half of 2007 and 2008. A gradual return to a positive yield curve under steady short rates is forecast.

Target Overnight Rate Forecast	
BoC Meeting Date	Rate
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
Oct.	4.25

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	4.15	4.20	4.25	4.25	4.25	4.25	4.25
6-mo. T-Bill	4.22	4.15	4.15	4.20	4.25	4.25	4.25	4.25	4.25
1-year T-Bill	4.27	4.10	4.10	4.15	4.25	4.30	4.30	4.30	4.30
2-year GoC Bond	4.09	3.95	4.00	4.10	4.25	4.25	4.30	4.30	4.35
3-year Goc Bond	4.11	3.90	4.00	4.10	4.25	4.30	4.35	4.35	4.40
5-year GoC Bond	4.14	3.90	4.00	4.15	4.30	4.35	4.40	4.45	4.50
10-year GoC Bond	4.25	4.00	4.05	4.15	4.30	4.40	4.45	4.50	4.60
Spread: 10y less 3m	0.09	-.15	-.10	0.00	0.05	0.15	0.20	0.25	0.35

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	2.80	2.80	2.85	2.95	3.00	3.00	3.00	3.00
3-year GIC	3.21	3.00	3.00	3.10	3.25	3.30	3.35	3.35	3.40
5-year GIC	3.34	3.10	3.10	3.25	3.40	3.45	3.50	3.55	3.60

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	6.45	6.50	6.55	6.55	6.60	6.60
3-year Mortgage	6.65	6.50	6.60	6.70	6.80	6.85	6.90	6.90	6.90
5-year Mortgage	6.87	6.60	6.65	6.75	6.85	6.95	6.95	7.00	7.05

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