



# Interest Rate Forecast

October 2006 . ISSUE 10

## A balancing act

The Bank's views on the economy just released in its October *Monetary Policy Report* sends a somewhat mixed message. Growth this year and next is revised down about 0.4% in 2006 and 0.5% in 2007 from its July assessment and growth in 2008 is left unchanged. While an outlook downgrade by the Bank normally raises the odds of monetary easing, the Bank took the extra step of also downgrading the economy's potential growth rate thereby lowering the odds of monetary easing. The Bank is able to maintain its current rate stance while acknowledging slower growth in 2006 and 2007 – a masterful balancing act.

Essentially, the Bank is on hold until the weight of evidence or a more convincing outlook prompts it to change. It is probably reluctant to ease monetary conditions after a long uphill fight to put short rates into the neutral zone. This forecast sees no rate change for at least two more quarters and probably well beyond.

### Economy

Most recent US housing data shows that housing starts rebounded by nearly 6%, to 1.772 million units SAAR in September. In addition, there was a modest rebound in October's NAHB housing activity index and the weekly MBA Purchase Index stabilized in September. However, this does not mean the end of the housing correction. More declines in home construction, sales, and prices are expected.

Construction has the most significant impact on real GDP and it will clearly subtract from overall growth in the Q3 and Q4 2006 figures as it did in Q2. When housing starts might stabilize and turn higher is the subject of considerable debate. This forecast takes the view that since rates are not high and personal income growth is well above inflation, housing demand will not plummet. Buyer affordability is the main demand negative, which will improve as prices decline during this correction. Should rate cuts occur, it

Target Overnight Rate Forecast BoC Meeting Date	Rate
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

will re-stimulate housing demand. In the first half of 2007, most, if not all, of the housing contraction should be history.

Speculative demand is more unpredictable, and if there is a housing bubble, then speculators might rush to the exits and prompt a more severe price contraction. A wait and see approach is taken but judging by the doomsayers, it is almost a foregone conclusion.

The first estimate of US GDP for Q3 2006 to be released before month end has the market expecting 2.1% (annual rate) versus 2.6% in Q2 2006. This is below the economy's potential growth rate and opens up more slack in the economy. Unlike Canada, excess capacity prevails (negative output gap) making a stronger case for a US rate cut.

While short-term growth is important, the 2007 forecast carries more weight in the decision-making of the Fed. Here, the consensus has growth around 2.6%, which if it materializes very likely means a rate cut in 2007. The Fed is expecting growth to accelerate from the current softness, though when is not exactly known.

Below potential growth alleviates inflation concerns. The declines in energy prices, some softer indicators of economic activity, and slightly lower readings on core inflation point to a satisfactory inflation outlook.

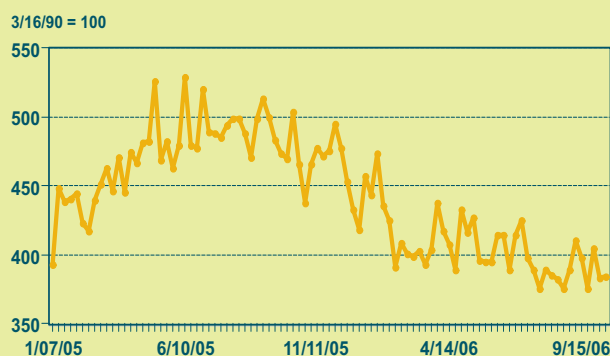
Canada's economy is predicted to grow 2.5% in Q3 2006, up slightly from 2.0% in the previous quarter. While below the economy's potential, the presence of a small positive output gap means the Bank is under no pressure to alter rates anytime soon. In fact, the Bank is forecasting only 2.0% growth in Q3 2006 and is showing no concern.

Core CPI is up to 2.3% in September, slightly above the Bank's 2% target and is the highest rate in three years. However, this is not a huge concern since the Bank is expecting a slight increase in Q4 2006 and into the first half of 2007 to 2.2%. It would become a concern if core CPI consistently exceeds the Bank's forecast in which case further monetary tightening would occur.

## Interest Rates

Markets executed a minor reversal in the rate outlook less convinced of the severity of the US economic and housing slowdown. Ten-year US government bond yields backed up about 20 basis points and reversed the entire decline of the prior three weeks. Short-term rates moved much less since the Fed anchors them. However, the Fed fund futures rate moved up and the market cutback on Fed rate easing. Data on retail sales, manufacturing, and the labour market have pointed to slightly better growth momentum going into the fourth quarter.

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



Source: Mortgage Bankers Association.

Latest: 10/13/06

Financial markets are very 'data-dependent' as is the Bank of Canada and the Fed. Volatility will remain above normal during these uncertain times and until the outlook is much clearer one way or the other. Futures markets are currently factoring in about a 50:50 probability of a rate cut by the Bank the end of 2007 – a considerable difference from last month when 100% odds of a 25 bps cut by September 2007 prevailed.

While the futures market sees a chance of a rate cut by end of 2007, the consensus view among economic forecasters calls for two 25 bps cuts before next October. This is a considerable divergence and most probably, the consensus will catch up with the market in the next poll.

The partially inverted yield curve is an unstable condition and it could last for another quarter or two. Ultimately, one end of the curve has to give with this forecast seeing long bond yields rising rather than short rates coming down.

The next Fed meeting on Oct. 24/25 likely results in a 'stay the course' outcome. Pressure for a rate cut builds in the ensuing months with the shift to ease probably beginning in the spring or summer of 2007.

The overnight rate forecast is a straight-line, trend projection best interpreted as the likely path with minor variations occurring above or below the projected level. The straight-line forecast is unlikely to play out exactly as that but there is no strong case for a substantial (more than 50 bps) decline or increase in the overnight rate during the next two years. It is difficult to predict accurately minor moves in rates.

<b>Interest Rate Forecast</b>									
<b>Item</b>	<b>2006 Q3a</b>	<b>2006 Q4f</b>	<b>2007 Q1</b>	<b>2007 Q2</b>	<b>2007 Q3</b>	<b>2007 Q4</b>	<b>2008 Q1</b>	<b>2008 Q2</b>	<b>2008 Q3</b>
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	4.05	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	4.10	4.20	4.30	4.35	4.35	4.40	4.45	4.50
10-year GoC Bond	4.25	4.20	4.30	4.45	4.50	4.55	4.60	4.65	4.70
Spread: 10y less 3m	0.09	0.05	0.10	0.20	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 Q3f	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.