Forecast Summary

By Taylor Schleich, Warren Lovely & Ethan Currie

- So it's (economic) war then? Or is it? Predictably, the on-again, off-again, on-again, off-again nature of a U.S.-initiated and increasingly broad trade war has sown economic chaos and prompted a fundamental re-assessment of risk (across global bond markets and other asset classes). Suffice it to say, acute (unprecedented?) geopolitical uncertainty lends a highly contingent nature to our published interest rate forecast, with the U.S. administration having roundly shaken the confidence and conviction of economic decision makers, investors and forecasters alike.
- While hardly the only front in a U.S. trade war, developments at America's northern border have been galvanizing. Notwithstanding the arguably false pretext, announced U.S. tariffs on Canadian imports prompted swift retaliation by Canadian governments, the full extent and nature of Canada's countermeasures yet to be implemented. As we write this, the tariff situation is fluid, with mixed messaging as it relates to the precise coverage and timing of U.S. levies. Regardless, intense policy uncertainty risks short-circuiting what might have been a budding Canadian recovery. Indeed, recent Canadian data (GDP, jobs) had been encouraging, with underlying inflation also having surprised to the upside. But much could change quickly. The outlook for much-needed business investment has been imperiled by trade uncertainty, while domestic consumers are apt to delay purchases. Early reads show tariff-related noise is paralyzing key regional housing markets even as policy interest rates have moved lower.
- While an imperfect response to the economic destruction caused by a trade war, we see little choice but for the Bank of Canada to continue easing monetary policy. Beyond an expected 25 basis point rate cut on March 12th, our current working assumption/forecast envisions additional quarter-point cuts in April, June and July. That would bring the BoC's target rate to 2% by summer, amounting to 300 basis points of cumulative relief in a little more than one year's time. Our BoC call embeds one additional 25 basis point cut in 2025 compared to our previous forecast but don't let this relatively modest change in the projected terminal rate fool you. Absent tariff threats, impressively strong Canadian macroeconomic data would've had us revising *up* our earlier estimates. On net, call it an additional 50-75 basis points of interest relief relative to a non-tariffed world.
- When it comes to forecast risks, a more aggressive easing stance could be required/justified if trade war fallout is more significant than we expect. Conversely, a quick and genuine de-escalation could argue for a shallower glide path for BoC policy. We've much to control for then, including the evolving suite of fiscal measures and economic reforms that Canadian governments aim to implement. While still early, the first few provincial budgets confirmed marginal fiscal stimulus, with looser budgetary policy generally bending net borrowing needs higher. With sizeable public sector funding needs ahead and ~40% of the nation's debt securities now held externally, it will be increasingly vital to monitor investor attitudes towards Canada risk in all its forms. Just this month, the German bond market showed what large swings in the fiscal balance can mean for government borrowing costs. To be sure, our economic outlook is consistent with rates coming down across the curve. Nonetheless, our longer-term yield forecasts contain a larger-than-'normal' term premium. We'll also readily acknowledge the growing risk that yields get 'stuck' or move higher.
- For the U.S., a long-standing economic resilience narrative may need to be re-examined, as some signals of potential weakness have emerged of late. Complicating the path forward for the FOMC, however, is still-sticky observed inflation and an upward tilt to inflation expectations. U.S. tariffs are unlikely to soothe underlying inflation fears. If, as we expect, U.S. growth loses altitude and the pace of hiring slows, the FOMC could be in a position to re-start rate cuts by June. Consistent with our prior forecast, we assume 75 basis points of FOMC easing in calendar 2025, but would see the balance of risk as tilted to greater accommodation if geopolitical turbulence persists.

United States						
Quarter	Target	3M	2Y	5Y	10Y	30Y
10-Mar-25	**4.50**	**4.20**	**3.94**	**4.01**	**4.24**	**4.55**
Q1:2025	4.50	4.30	3.95	4.05	4.25	4.50
Q2:2025	4.25	4.05	3.80	3.90	4.15	4.40
Q3:2025	4.00	3.80	3.60	3.70	4.00	4.25
Q4:2025	3.75	3.55	3.45	3.55	3.85	4.15
Q1:2026	3.50	3.30	3.30	3.40	3.75	4.05
Q2:2026	3.25	3.10	3.35	3.45	3.85	4.10
Q3:2026	3.25	3.10	3.40	3.55	4.00	4.20
Q4:2026	3.25	3.20	3.50	3.70	4.10	4.30

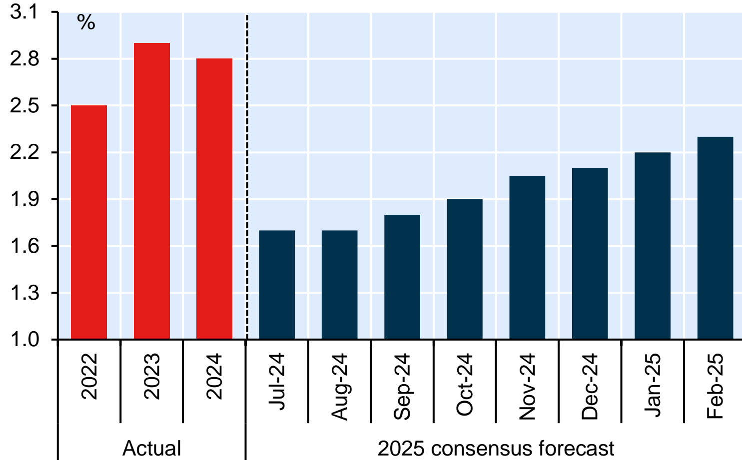
Canada						
Quarter	Target	3M	2Y	5Y	10Y	30Y
10-Mar-25	**3.00**	**2.71**	**2.54**	**2.63**	**2.98**	**3.22**
Q1:2025	2.75	2.50	2.50	2.60	2.90	3.15
Q2:2025	2.25	2.10	2.25	2.40	2.65	2.90
Q3:2025	2.00	1.95	2.10	2.25	2.60	2.85
Q4:2025	2.00	1.95	2.05	2.25	2.65	2.85
Q1:2026	2.00	2.00	2.15	2.35	2.70	2.90
Q2:2026	2.00	2.20	2.30	2.45	2.75	2.95
Q3:2026	2.25	2.45	2.50	2.65	2.85	3.00
Q4:2026	2.50	2.70	2.65	2.75	2.95	3.05

FOMC: Growth affair to growth beware

Going into 2025, economists were growing more optimistic on the U.S. outlook. Even after three years of above potential GDP growth, it was generally accepted that this streak would extend to four. While firming conditions first emerged at the tail end of the Biden administration, Trump's election victory and promises on de-regulation, tax cuts and pro-business policy boosted sentiment and growth expectations too.

High (and growing) expectations for 2025 US real growth

US real GDP growth: Actual and 2025 consensus forecast over time

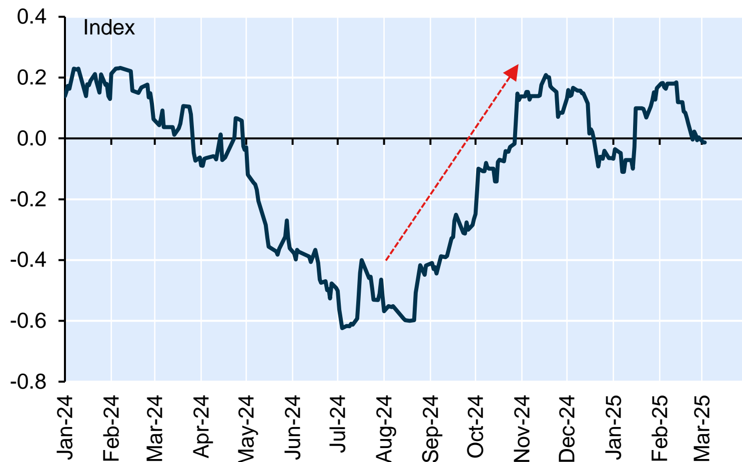


Source: NBC, BBG

To be sure, this wasn't blind optimism. In addition to the policies touted on the campaign trail, economic data was improving after the growth 'scare' that took root last summer.

U.S. growth optimism was not unjustified

Bloomberg US economic surprise index

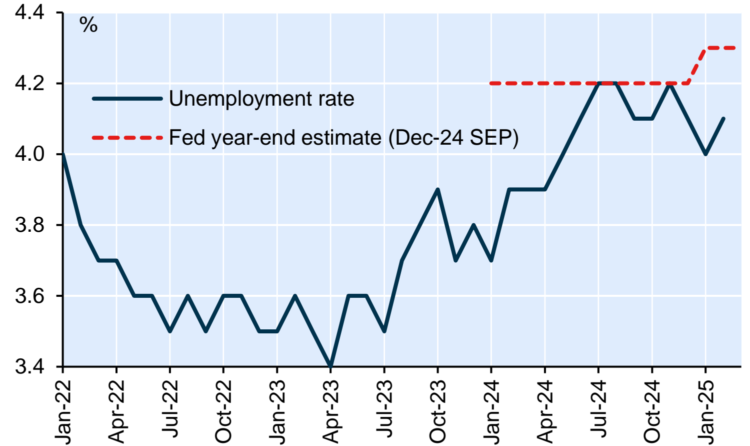


Source: NBC, BBG

The labour market had perhaps been the primary source of mid-2024 anxieties but these worries were steadily quelled in the fall and winter. Recent data on hiring has been solid, jobless claims have remained remarkably low, and the closely watched unemployment rate has found support around 4%. True there's been no shortage of concern over *public sector* employment in light of DOGE 'fat-trimming' efforts and February data *did* usher in a one-tick increase in the jobless rate. However, this is insufficient to derail the Fed's assessment that the labour market is in good shape, as Powell reaffirmed this month. Certainly, the labour market today is stronger than the FOMC was expecting just months ago.

The jobless rate stabilized below prior FOMC expectations

US unemployment rate (actual) vs year -end Fed estimate (2024, 2025)

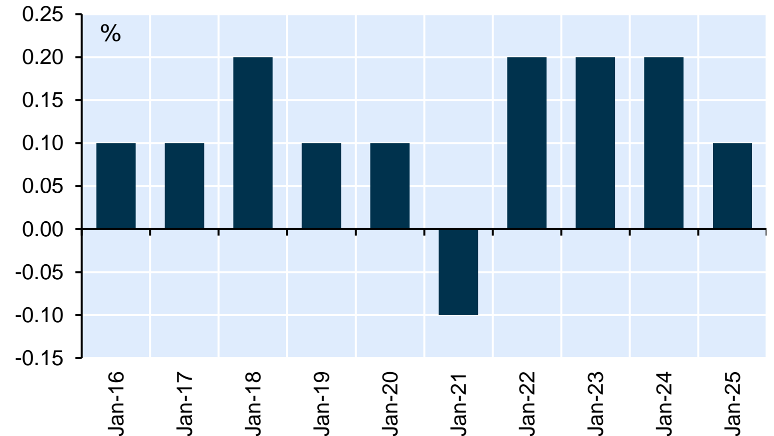


Source: NBC, BBG, FRB | Note: Based on December 2024 SEP

On the inflation side of the Fed's dual mandate, the progress policymakers are seeking has stalled. January's CPI report was not particularly encouraging, inflation increasing (on a monthly basis) at the fastest pace since January 2023. Underlying inflation, proxied by core services excluding shelter, advanced at a 9.5% annualized clip, the fastest since last January. There's an argument to be made that January data is mired by 'residual seasonality'. After all, CPI in the first month of the year has surprised to the upside in 9 of the past 10 years. February's report will thus be a good test on whether or not this was a false signal (that seems to be how the market is viewing it for now).

January CPI prints (almost) always surprise to the upside

Monthly CPI change versus Bloomberg median estimate, last 10 Januarys

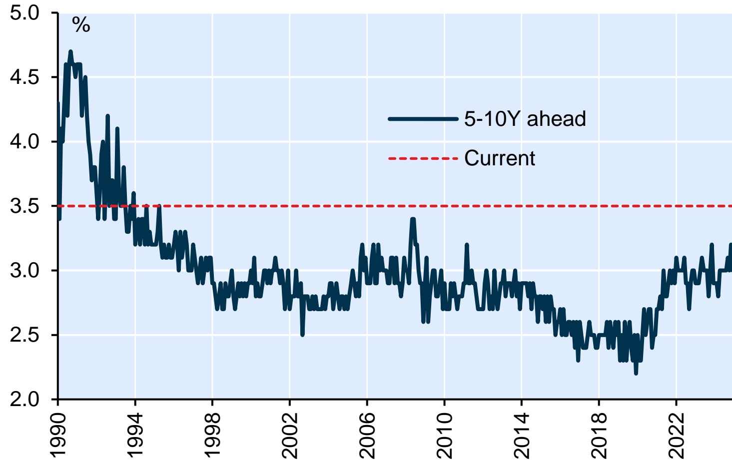


Source: NBC, BBG

Encouragingly, PCE inflation (the figure that matters most to the Fed's) wasn't *as* hot and is "only" running at 2.5% year-on-year. But beyond an only-slightly-above-target rate, it's hard to be optimistic that near-term inflation relief is in the pipeline. For one, soft data is increasingly pointing towards greater cost pressures. The prices paid sub-index of the ISM services and manufacturing reports have risen markedly of late. This is echoed in S&P Global's PMIs. Likewise, the Beige Book hints at increasing cost pressures for US companies across several districts. The key question is whether these cost pressures will be passed onto consumers or absorbed in profit margins. Stay tuned.

An analogous trend can be observed on the inflation expectations front, both in survey- and market-based measures. For now, Fed Chair Powell is retaining the view that these are well-anchored. This stance could be tested if recent trends persist.

U.S. inflation expectations continue to ascend
University of Michigan 5-10 year inflation expectations

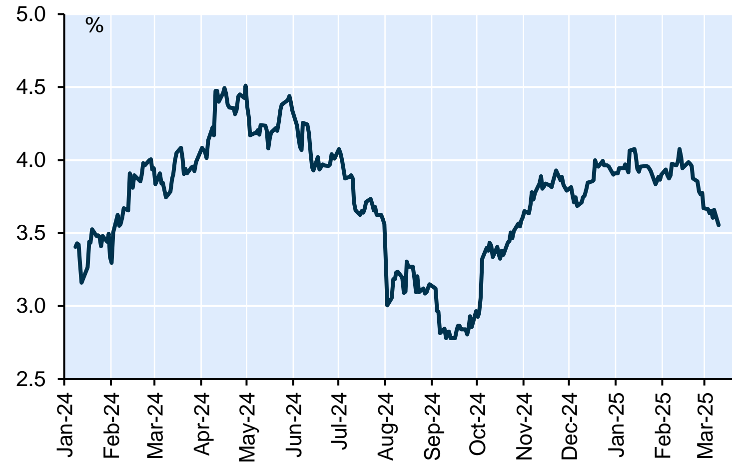


Source: NBC, BBG

The President's tariff threats were undoubtedly a contributor to this uptick. Meantime, the magnitude of promised April 2nd "reciprocal" tariffs remains to be seen but government officials have promised this will be the "big one". This shouldn't help rein in expectations either. And now that some duties are in place (for Canadian, Mexican and Chinese goods), we may begin to see direct price impacts, although the timing and magnitude of tariff pass-through is difficult to predict.

Between the heretofore improving growth picture, still-strong jobs data and sticky inflation (and its expectations), implied Fed easing in 2025 was being steadily walked back. For a while, markets worried the latest dot plot was too *dovish*, traders in February bracing for just a single cut this year.

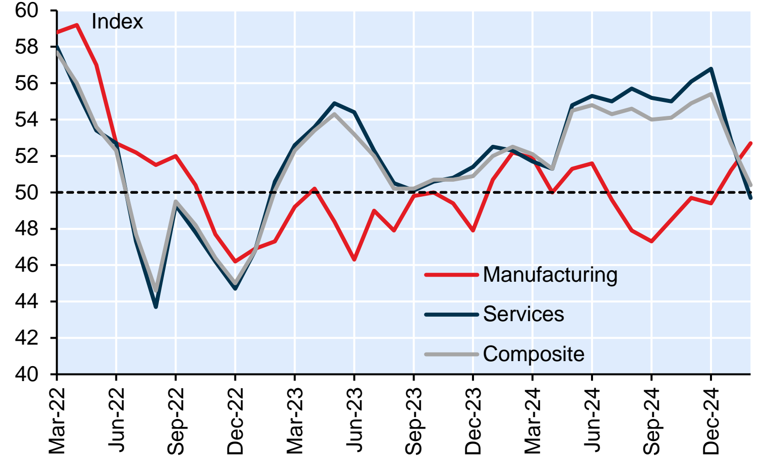
Expectations of a more hawkish Fed *were* building
Implied December 2025 fed funds rate based on fed funds futures



Source: NBC, BBG

But now the shine of Trump's pro-growth policies are wearing off and the growth-negative impacts of elevated uncertainty are taking front and centre. Indeed, "soft data" for February indicated in a sharp decline in activity, particularly in the services sector. "This paints a worryingly weak picture of [business] conditions compared to the buoyancy recorded late last year", according to S&P Global. While readings on the manufacturing sector were surprisingly healthy, this was attributable to front-loading trade activity ahead of anticipated tariff implementation. In other words, "the health of the manufacturing sector [may] only be skin deep".

Growth worries have begun to show up in 'soft' data
S&P Global United States PMIs since 2022

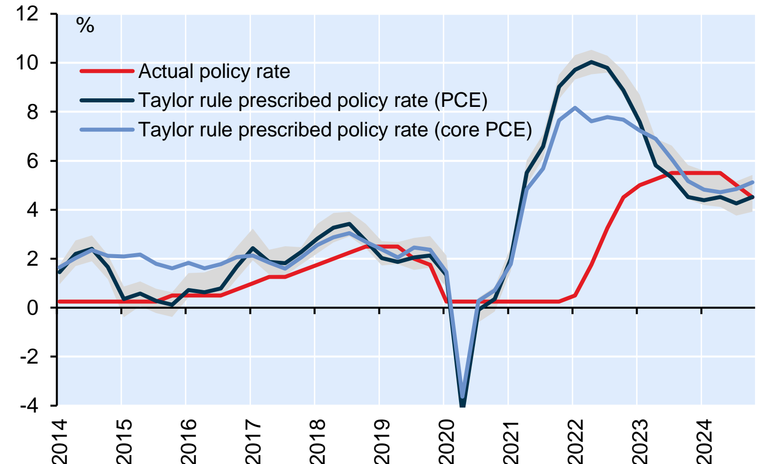


Source: NBC, BBG, S&P Global

Nowcasts of Q1 GDP growth suggest a steep decline in economic activity to start the year. While that's largely a function of imports surging ahead of tariffs (arithmetically puling down growth) and adverse weather impacting consumer spending in January, there's likely to be *some* signs of a legitimate pullback in the data. More generally, there's a growing risk that underlying activity could slow sharply in 2025. This anxiety is clearly reflected in the U.S. bond market, as the growth scare is (for now) trumping inflation concerns.

This leaves the Fed in a tricky spot. Hard economic data and inflation suggests monetary policy is appropriately calibrated. However, a forward-looking central bank may want to take heed of emerging downside risks. The problem is that inflation may not allow policymakers to do so, especially since the cause of the growth concern brings upside inflation risks with it.

Taylor rule suggests Fed policy is spot-on
Taylor rule-prescribed FOMC policy using PCE measures



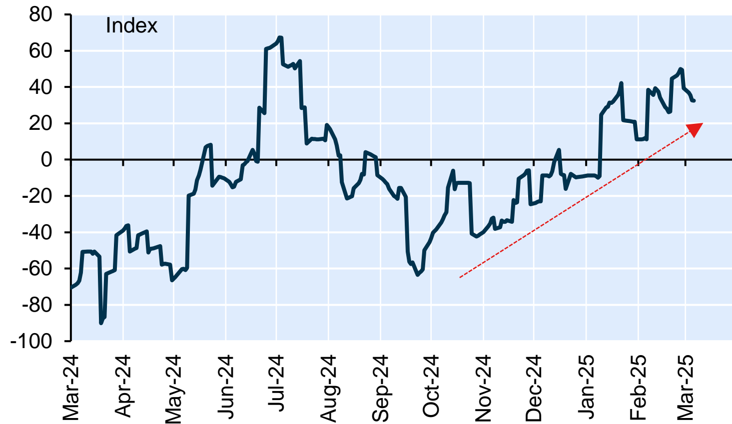
Source: NBC, BBG, FOMC | Note: grey range denotes long-run Fed dot range

Cutting through the noise, we expect the Fed to remain sidelined in March and May, resuming rate cuts in June. That forecast is unchanged from our prior monitor, but the risks around that call may now be skewed to earlier (i.e., May) if economic weakness and softer labour market conditions crystalize quicker. Similarly, we retain our call for two more cuts in the second half of the year. Here again, rapidly shifting growth risks could mean the Fed delivers *more* cuts than our baseline forecast, not less.

BoC: Uncertainty Trumps all

It's a tale of two economic outlooks in Canada. One is pleasant, lower interest rates helping drive a recovery and absorb accumulated economic slack. There's greater evidence that this is version of the world we *were* residing in late 2024, as economic surprises (mostly reflecting Q4 or January data) have generally been positive.

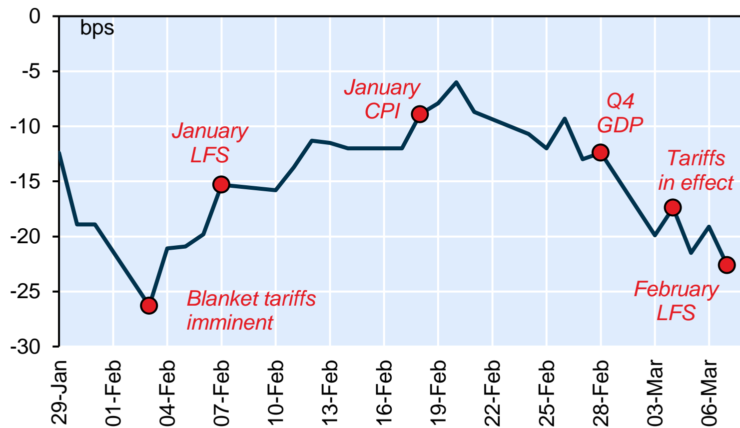
Economic data surprising higher in recent months
Citi Canada economic surprise index



Source: NBC, BBG

The other outlook is far less pleasant as tariff threats/implementation and acute uncertainty paralyze economic activity. Several indicators suggest this is playing out *right now*. For the Bank of Canada, it's an uncomfortable position to be in. Which is the better signal? Backward-looking data reflecting an improving economy or heightened uncertainty that *could* stop the recovery in its tracks. The evolution of market expectations for the March decision reflects this conundrum.

March rate cut odds on inter-meeting roller coaster ride
OIS-implied BoC policy rate change on 12-Mar decision date

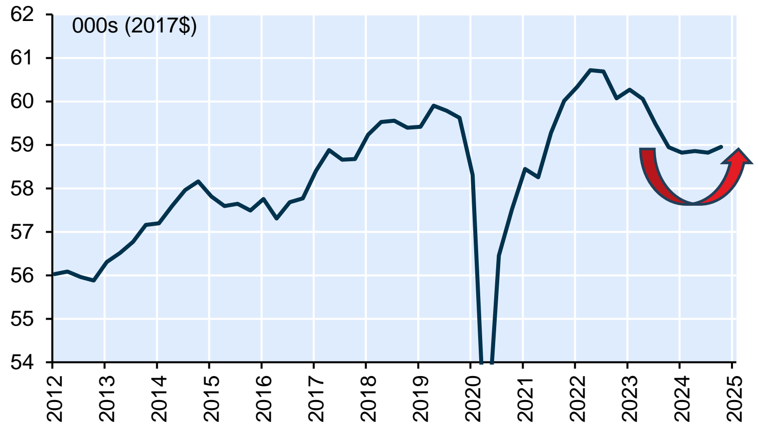


Source: NBC, BBG

At this point, we feel a March rate cut is all but assured, as do markets based on where trading has settled ahead of the decision. When it comes to the rest of the year though, the policy rate path is highly uncertain, dependent largely on geopolitical developments. It is perhaps useful to examine the two extreme scenarios to set the boundaries of where we can expect rates to set over the coming year.

Consider the status quo, or at least the one that existed before Trump tariff threats really ratcheted up earlier this year. With substantial policy rate relief, GDP growth was picking up even as the pace of population increase moderated dramatically. Per capita GDP, previously consistent with recessionary conditions, was healing.

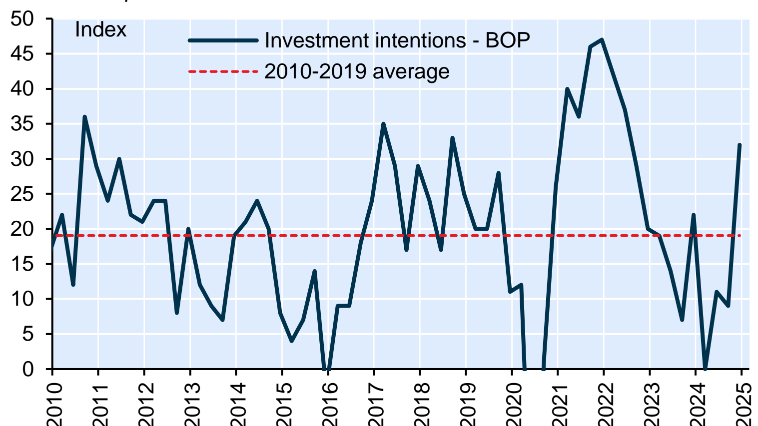
The end of the GDP per capita recession?
Canadian real GDP per capita



Source: NBC, BBG

Housing activity was steadily rebounding, sales edging up each successive month. Even investment, which had been a major headwind to Canadian growth was looking up, per the Bank of Canada's latest Business Outlook Survey.

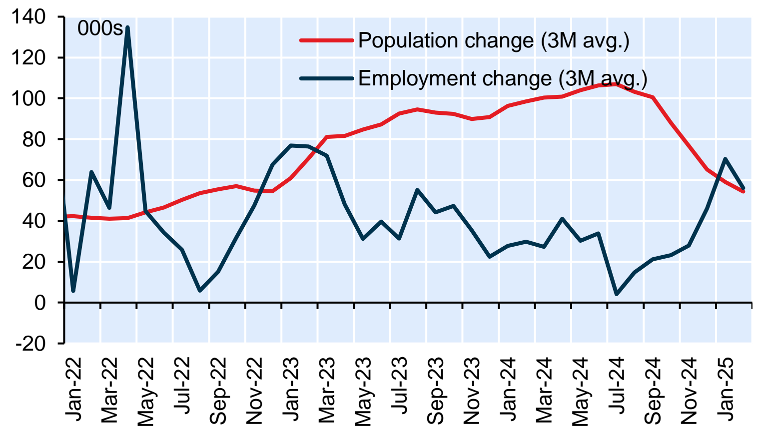
Canadian investment intentions rebounded in Q4
Balance of opinion on investment intentions in the next 12 months



Source: NBC, BoC Business Outlook Survey (January 2025)

The labour market which—along with GDP per capita—was the poster child for earlier Canadian struggles, was showing some signs of improvement. The LFS suggested hiring was accelerating and the closely watched unemployment rate was starting to move lower.

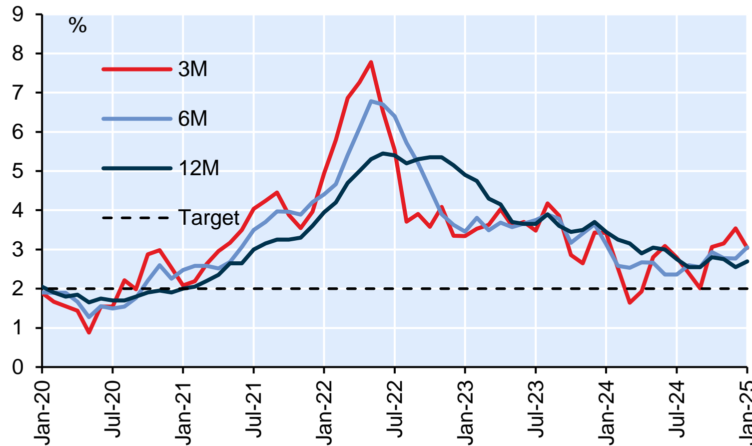
Hiring had picked up around the turn of the year
Canada working age population and employment change (3M MA)



Source: NBC, BBG

And while the most important data point for the BoC—CPI inflation—has been hovering at/or below 2% for six straight months, there were some signs that underlying pressures could be rebuilding.

Some core inflation measures are rebounding
Average of CPI-median and-trim: Last 3, 6, and 12M

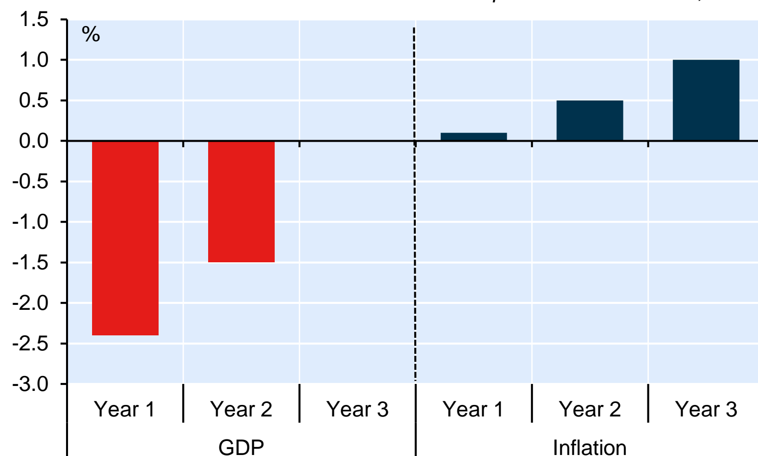


Source: NBC, BBG

Based solely on these data, the Bank could easily justify holding policy steady at neutral (2.75%, after a now all-but-assured March cut), allowing the output gap to close over the coming year. Hypothetically, the removal of all tariffs and associated uncertainty (highly unlikely) might be consistent with that. Consider this the upper bound on the policy rate outlook.

At the other extreme, sustained U.S. tariffs on Canadian goods and Canadian retaliation, is consistent with material economic damage. The Bank of Canada, in January, estimated what a prolonged trade war could look like from an economic perspective and its unsurprisingly not great. GDP growth is effectively wiped out this year and even after growth recovers way out in 2027, the economy is left ~4% smaller than would be the case absent a trade war. The Bank predicts that inflation impacts would be modest at first, but as increased costs are passed onto consumers, inflation may get a 1%-pt boost.

GDP damage would outweigh inflation spike in trade war
BoC 'benchmark calibration' simulated trade war impact on baseline GDP, CPI



Source: NBC, BoC Jan-25 MPR

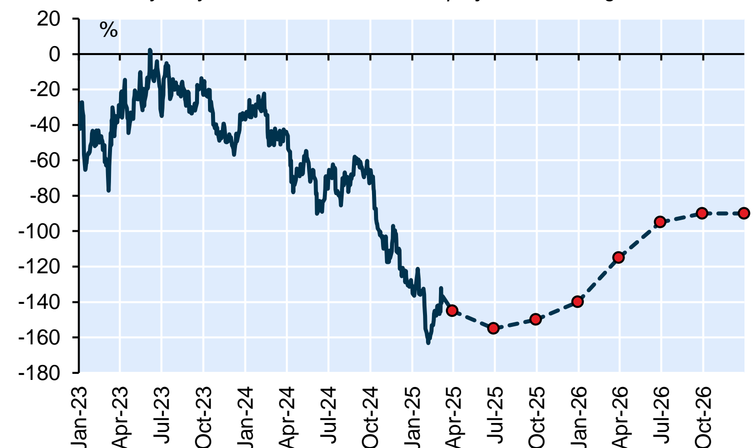
To us, this scenario would involve material BoC easing. Inflation pressures could limit the extent of policy rate relief, but we could still be looking at perhaps up to 200 bps of additional rate relief in 2025 and into 2026. Consider this the lower bound on BoC policy.

To be clear, this lower bound is a relatively low probability outcome too. As we write this, carve-outs have been announced for the auto sector (at least for the next month). "USMCA-compliant" trade is also off the hook for the time being. It remains to be seen what 'steady state' tariffs will be, but the breadth of trade levies (and perhaps the rate) is likely to be less than the indiscriminate approach initially advertised. That means less economic damage and with it less interest rate relief.

For now, this 'middle ground' scenario is our base case outlook. These more narrowly scoped but still material tariffs would lead to slower GDP and job growth, halting the recent progress made on the output gap. The BoC, uncertain about how long tariffs will remain in place, is likely to forgo larger 50 basis point cuts and instead opt for a steady dose of 25s. Assuming the trade war extends into the summer, we see the easing cycle terminating at 2% in Q3, a modestly accommodative monetary policy stance.

This steady pace of cuts occurring at a time when the Fed is still sidelined, should produce a renewed bid to GoCs relative to treasuries. However, with trade policy uncertainty, an immigration crackdown and a gutting of the public sector likely to weigh on US growth, we continue to look for UST outperformance in the second half of the year.

GoC performance gives way to UST performance in H2
Canada-US 2-year yield differential with NBC projections through 2026



Source: NBC, BBG | Note: Dots refer to quarter end forecast

For both nations, fiscal policy remains a key wildcard. Trump and the GOP have been clear that tax cuts are a priority and, while they've promised tariff revenue and DOGE cost savings will be able to fund these, we're not convinced. That should keep the U.S. debt curve pointed higher. In Canada, governments of all levels are prepared to offer support to a tariff-burdened economy (and some already are). Fortunately, there's more fiscal room in Canada to play with but the willingness of investors (especially those abroad) to fund evermore debt is unclear. Just this month, the German bond market showed what large swings in the fiscal balance can mean for sovereign borrowing costs. So, while our economic outlook is consistent with yields coming down *across the curve*, we'll readily acknowledge the growing risk that longer-term yields get 'stuck' or move higher.

Subscribe to our publications: NBC.EconomicsStrategy@nbc.ca – To contact us: 514-879-2529

General

This Report was prepared by National Bank Financial, Inc. (NBF), (a Canadian investment dealer, member of CIRO), an indirect wholly owned subsidiary of National Bank of Canada. National Bank of Canada is a public company listed on the Toronto Stock Exchange.

The particulars contained herein were obtained from sources which we believe to be reliable but are not guaranteed by us and may be incomplete and may be subject to change without notice. The information is current as of the date of this document. Neither the author nor NBF assumes any obligation to update the information or advise on further developments relating to the topics or securities discussed. The opinions expressed are based upon the author(s) analysis and interpretation of these particulars and are not to be construed as a solicitation or offer to buy or sell the securities mentioned herein, and nothing in this Report constitutes a representation that any investment strategy or recommendation contained herein is suitable or appropriate to a recipient's individual circumstances. In all cases, investors should conduct their own investigation and analysis of such information before taking or omitting to take any action in relation to securities or markets that are analyzed in this Report. The Report alone is not intended to form the basis for an investment decision, or to replace any due diligence or analytical work required by you in making an investment decision.

This Report is for distribution only under such circumstances as may be permitted by applicable law. This Report is not directed at you if NBF or any affiliate distributing this Report is prohibited or restricted by any legislation or regulation in any jurisdiction from making it available to you. You should satisfy yourself before reading it that NBF is permitted to provide this Report to you under relevant legislation and regulations.

National Bank of Canada Financial Markets is a trade name used by National Bank Financial and National Bank of Canada Financial Inc.

Canadian Residents

NBF or its affiliates may engage in any trading strategies described herein for their own account or on a discretionary basis on behalf of certain clients and as market conditions change, may amend or change investment strategy including full and complete divestment. The trading interests of NBF and its affiliates may also be contrary to any opinions expressed in this Report.

NBF or its affiliates often act as financial advisor, agent or underwriter for certain issuers mentioned herein and may receive remuneration for its services. As well NBF and its affiliates and/or their officers, directors, representatives, associates, may have a position in the securities mentioned herein and may make purchases and/or sales of these securities from time to time in the open market or otherwise. NBF and its affiliates may make a market in securities mentioned in this Report. This Report may not be independent of the proprietary interests of NBF and its affiliates.

This Report is not considered a research product under Canadian law and regulation, and consequently is not governed by Canadian rules applicable to the publication and distribution of research Reports, including relevant restrictions or disclosures required to be included in research Reports.

UK Residents

This Report is a marketing document. This Report has not been prepared in accordance with EU legal requirements designed to promote the independence of investment research and it is not subject to any prohibition on dealing ahead of the dissemination of investment research. In respect of the distribution of this Report to UK residents, NBF has approved the contents (including, where necessary, for the purposes of Section 21(1) of the Financial Services and Markets Act 2000). This Report is for information purposes only and does not constitute a personal recommendation, or investment, legal or tax advice. NBF and/or its parent and/or any companies within or affiliates of the National Bank of Canada group and/or any of their directors, officers and employees may have or may have had interests or long or short positions in, and may at any time make purchases and/or sales as principal or agent, or may act or may have acted as market maker in the relevant investments or related investments discussed in this Report, or may act or have acted as investment and/or commercial banker with respect hereto. The value of investments, and the income derived from them, can go down as well as up and you may not get back the amount invested. Past performance is not a guide to future performance. If an investment is denominated in a foreign currency, rates of exchange may have an adverse effect on the value of the investment. Investments which are illiquid may be difficult to sell or realise; it may also be difficult to obtain reliable information about their value or the extent of the risks to which they are exposed. Certain transactions, including those involving futures, swaps, and other derivatives, give rise to substantial risk and are not suitable for all investors. The investments contained in this Report are not available to retail customers and this Report is not for distribution to retail clients (within the meaning of the rules of the Financial Conduct Authority). Persons who are retail clients should not act or rely upon the information in this Report. This Report does not constitute or form part of any offer for sale or subscription of or solicitation of any offer to buy or subscribe for the securities described herein nor shall it or any part of it form the basis of or be relied on in connection with any contract or commitment whatsoever.

This information is only for distribution to Eligible Counterparties and Professional Clients in the United Kingdom within the meaning of the rules of the Financial Conduct Authority. NBF is authorised and regulated by the Financial Conduct Authority and has its registered office at 70 St. Mary Axe, London, EC3A 8BE.

NBF is not authorised by the Prudential Regulation Authority and the Financial Conduct Authority to accept deposits in the United Kingdom.

EU Residents

With respect to the distribution of this report in the member states of the European Union ("EU") and the European Economic Area ("EEA") by NBC Paris, the contents of this report are for information purposes only and do not constitute investment advice, investment research, financial analysis or other forms of general recommendation relating to transactions in financial instruments within the meaning of Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 ("MiFID 2"). This report is intended only for professional investors and eligible counterparties within the meaning of MiFID 2 and its contents have not been reviewed or approved by any EU/EEA authority. NBC Paris is an investment firm authorised by the French Prudential Control and Resolution Authority ("ACPR") to provide investment services in France and has passported its investment services throughout the EU/EEA under the freedom to provide services and has its registered office at 8 avenue Percier, 75008 Paris, France. "NBC Financial Markets, a subsidiary of National Bank of Canada" is a trade name used by NBC Paris S.A.

NBF is not authorised to provide investment services in the EU/EEA.

U.S. Residents

With respect to the distribution of this report in the United States of America, National Bank of Canada Financial Inc. ("NBCFI") which is regulated by the Financial Industry Regulatory Authority (FINRA) and a member of the Securities Investor Protection Corporation (SIPC), an affiliate of NBF, accepts responsibility for its contents, subject to any terms set out above. To make further inquiry related to this report, or to effect any transaction, United States residents should contact their NBCFI registered representative.

This report is not a research report and is intended for Major U.S. Institutional Investors only. This report is not subject to U.S. independence and disclosure standards applicable to research reports.

HK Residents

With respect to the distribution of this report in Hong Kong by NBC Financial Markets Asia Limited ("NBCFMA") which is licensed by the Securities and Futures Commission ("SFC") to conduct Type 1 (dealing in securities) and Type 3 (leveraged foreign exchange trading) regulated activities, the contents of this report are solely for informational purposes. It has not been approved by, reviewed by, verified by or filed with any regulator in Hong Kong. Nothing herein is a recommendation, advice, offer or solicitation to buy or sell a product or service, nor an official confirmation of any transaction. None of the products issuers, NBCFMA or its affiliates or other persons or entities named herein are obliged to notify you of changes to any information and none of the foregoing assume any loss suffered by you in reliance of such information.

The content of this report may contain information about investment products which are not authorized by SFC for offering to the public in Hong Kong and such information will only be available to, those persons who are Professional Investors (as defined in the Securities and Futures Ordinance of Hong Kong ("SFO")). If you are in any doubt as to your status you should consult a financial adviser or contact us. This material is not meant to be marketing materials and is not intended for public distribution. Please note that neither this material nor the product referred to is authorized for sale by SFC. Please refer to product prospectus for full details.

There may be conflicts of interest relating to NBCFMA or its affiliates' businesses. These activities and interests include potential multiple advisory, transactional and financial and other interests in securities and instruments that may be purchased or sold by NBCFMA or its affiliates, or in other investment vehicles which are managed by NBCFMA or its affiliates that may purchase or sell such securities and instruments.

No other entity within the National Bank of Canada group, including National Bank of Canada and National Bank Financial Inc, is licensed or registered with the SFC. Accordingly, such entities and their employees are not permitted and do not intend to: (i) carry on a business in any regulated activity in Hong Kong; (ii) hold themselves out as carrying on a business in any regulated activity in Hong Kong; or (iii) actively market their services to the Hong Kong public.

Copyright

This Report may not be reproduced in whole or in part, or further distributed or published or referred to in any manner whatsoever, nor may the information, opinions or conclusions contained in it be referred to without in each case the prior express written consent of NBF.