

# Retail Rate Forecasts

June 25, 2008

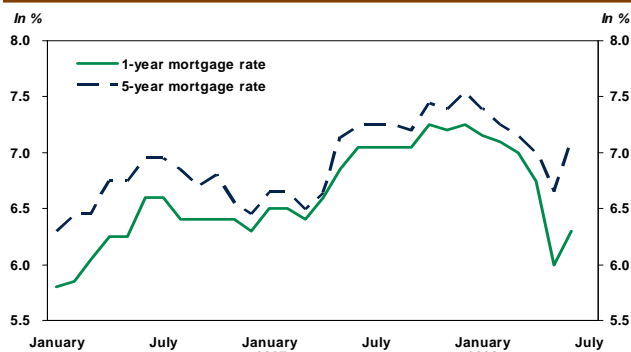
## Mortgage rates are not expected to rise quickly

### HIGHLIGHTS

- Inflation pressures push interest rates higher.
- The Bank of Canada ends its monetary easing abruptly.
- The loonie continues to face headwinds.
- Canadian stock markets appear vulnerable to declining oil prices.

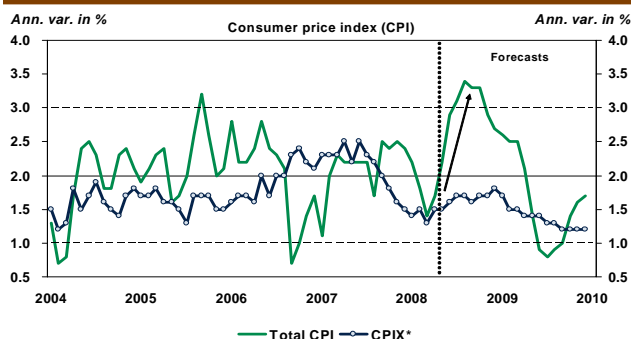
- **Retail rates have fluctuated wildly.** Financial institutions lowered their mortgage rates significantly at the end of May. The rate for a 1-year mortgage was lowered by 75 basis points while the 5-year rate was cut by 35 points. Rising bond rates and the faster-than-expected end to key rate cuts in Canada however convinced lenders to back pedal and increase mortgage rates in mid-June. The 1-year rate is now at 6.3% compared to 7.10% for a 5-year term. In both cases, the level remains significantly less than that at the beginning of the year (graph 1). The rates paid on term savings—stable since March—were also up slightly in June.
- **Monetary easing comes to an early halt in Canada.** In a widely unexpected move, after two straight 50 basis point cuts in March and April, the Bank of Canada (BoC) kept its key rate at 3.0% at its June meeting.
- **The latest inflation twist probably prodded the BoC to be prudent.** Persistent high prices for oil and some foods will have repercussions on total inflation. It is therefore likely that the BoC's target ceiling (3.0%) will be breached over the next few months (graph 2). This situation is likely to be temporary, with stabilization or, even better, a correction in energy prices taking total inflation back down quickly.
- **Bond rates up sharply.** Growing inflation pressures and changes to the stance adopted by central banks made government bond rates jump around the world. Canada is no exception to this trend and the 2-year rate rose by more than 50 basis points since the end of April (graph 3). In our opinion, the markets' reaction was a tad excessive and rates could fall again slightly by the end of the year.

Graph 1 – Mortgage rates' trough is behind us



Sources: Datastream and Desjardins, Economic Studies

Graph 2 – Underlying inflation is contained, but the BoC is concerned about high oil prices



\* Index that excludes the eight most volatile components and the effect of changes to indirect taxes.  
Sources: Statistics Canada and Desjardins, Economic Studies

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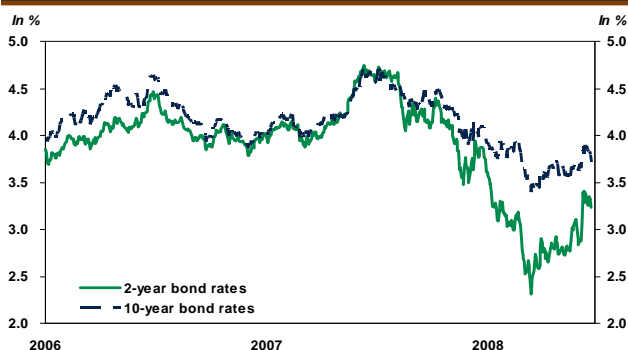
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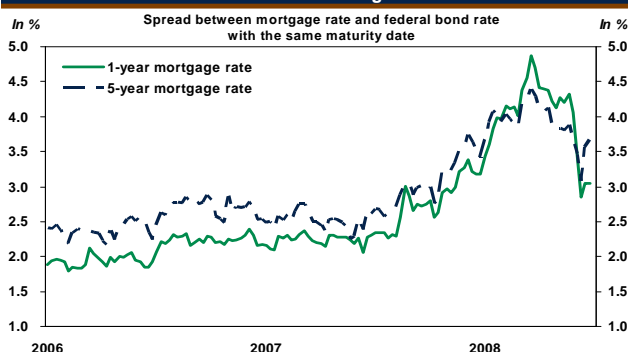
- **Credit and liquidity problems persist.** The credit crisis reached its peak in mid-March when it appeared the U.S. financial system was headed for a genuine meltdown. Financial tensions have eased since then, but it would be foolhardy to think that everything is back to normal. The real estate market in the U.S. is still undergoing a correction and financial institutions continue to post significant losses. In this context, financing costs remain high, meaning that the spread between mortgage rates and bond rates could stay at relatively high levels for several months (graph 4).
- **Mortgage rates should remain relatively stable.** Now that retail rates seem to have hit their cyclical trough, should we be worrying about major increases? In our opinion, the answer is no. Despite the inflation risks brought on by high oil prices, the difficult economic and financial situation in North America makes it highly unlikely that interest rates and bond rates will rise sharply any time soon. After posting a slight increase in June, retail rates should remain relatively stable for several months and could even fall again slightly by the end of 2008, before shifting to an upward trend next year. In 2009, increases in mortgage rates are expected to be limited by the gradual contraction in the variance between mortgage and bond rates.

**Graph 3 – Bond rates in Canada continue to climb**



Sources: Datastream and Desjardins, Economic Studies

**Graph 4 – Spreads between mortgage and bond rates are closing, but remain high**



Sources: Datastream and Desjardins, Economic Studies

**Table 1**  
**Forecasts : Retail rate**

	Discount rate (1)	Prime rate (1)	Mortgage rate (1)			Term savings (1) (2)		
			1 year	3 years	5 years	1 year	3 years	5 years
<b>Realized – End of month</b>								
Dec. 2007	4.50	6.00	7.25	7.55	7.55	3.00	3.15	3.35
Jan. 2008	4.25	5.75	7.15	7.40	7.40	2.70	3.10	3.30
Feb. 2008	4.25	5.75	7.10	7.30	7.25	2.40	3.05	3.35
March 2008	3.75	5.25	7.00	7.20	7.15	2.10	2.60	3.15
April 2008	3.25	4.75	6.75	7.00	7.00	2.10	2.60	3.15
May 2008	3.25	4.75	6.00	6.15	6.65	2.10	2.60	3.15
June 25, 2008	3.25	4.75	6.30	6.65	7.10	2.25	2.85	3.20
<b>Forecasts – End of quarter</b>								
2008: Q2	3.25	4.75	6.20–6.50	6.55–6.85	7.00–7.30	2.15–2.40	2.75–3.05	3.10–3.40
2008: Q3	3.00–3.50	4.50–5.00	6.00–6.50	6.35–6.85	6.80–7.30	1.95–2.45	2.55–3.05	2.95–3.45
2008: Q4	3.00–3.50	4.50–5.00	5.85–6.35	6.15–6.65	6.55–7.05	1.85–2.35	2.35–2.85	2.75–3.25
2009: Q1	3.00–3.50	4.50–5.00	6.00–6.50	6.30–6.80	6.75–7.25	2.00–2.50	2.55–3.05	3.05–3.55
2009: Q2	3.25–3.75	4.75–5.25	6.20–6.70	6.55–7.05	6.85–7.35	2.35–2.85	2.85–3.35	3.25–3.75
2009: Q3	3.50–4.00	5.00–5.50	6.25–6.75	6.70–7.20	6.95–7.45	2.55–3.05	3.15–3.65	3.55–4.05
2009: Q4	4.00–4.50	5.50–6.00	6.35–6.85	6.80–7.30	7.00–7.50	2.85–3.35	3.40–3.90	3.80–4.30

Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).

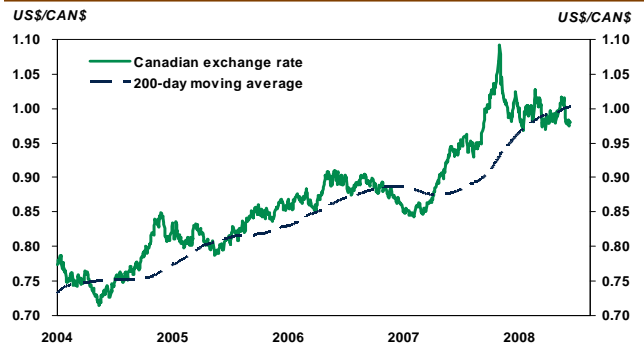
Source: Desjardins, Economic Studies

# CANADIAN DOLLAR

## The Canadian dollar is being buffeted by headwinds

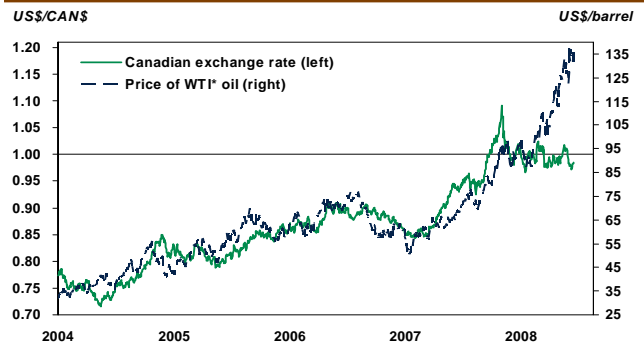
- The loonie maintains itself slightly below parity (graph 5).** On one hand, the currency is being hit because of the U.S. slowdown's potential impact on foreign trade. On the other, in a situation in which all central banks are putting more focus on inflation risks, the relative interest rate expectations are not good for the loonie.
- The rapid rise of oil prices is a source of concern.** The Bank of Canada, however, has more leeway to manage interest rates and can sustain a status quo longer. Because of this, Canada's monetary policy will not provide the currency with much support in the near future. Therefore, although oil prices are setting new records on an almost daily basis, they are having less of an impact on the currency (graph 6).
- We do not expect a rebound in the near term.** We continue to expect the Canadian dollar to reach a trough just below parity in the early months of summer. An improvement in the economic situation could quickly put the loonie back on a rising trend, however. Our scenarios are for oil prices to correct but even if they go back toward US\$100/barrel, this would still be compatible with a loonie that is above parity with the greenback. High prices for oil and non-energy commodities will continue to lead to gains in the terms of trade and foster sustained growth in Canada's aggregated demand.
- Forecasts:** The downward pressure on the loonie will not last long. The currency should continue to trade in the US\$0.95 to US\$1.00 band this summer. In the longer term, however, the rising trend in prices for energy and non-energy commodities will drive the currency up again.

**Graph 5 – The loonie remains at a level slightly below parity**



Sources: Datastream and Desjardins, Economic Studies

**Graph 6 – Rising oil prices partly offset the effect of U.S. slowdown on the loonie**



\* West Texas Intermediate.  
Sources: Datastream and Desjardins, Economic Studies

Determinants	Short-term	Long-term
Oil prices	↑	↗
Metals prices	↘	↗
Interest rates spreads (Canada - United States)	↓	↑

**Table 2**  
**Forecasts: Currency**

	2007				2008				2009			
	Q1	Q2	Q3	Q4	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
CAN\$/US\$	1.1535	1.0654	1.0056	1.0021	0.9748	0.9700	1.0000	1.0250	1.0000	0.9800	1.0200	1.0500
US\$/CAN\$	0.8669	0.9389	0.9944	0.9979	1.0259	1.0309	1.0000	0.9756	1.0000	1.0204	0.9804	0.9524
CAN\$/euro	1.5354	1.4389	1.4143	1.4589	1.6256	1.5979	1.5500	1.4439	1.4200	1.4082	1.3333	1.2571
US\$/euro	1.3311	1.3506	1.4222	1.4620	1.5846	1.5500	1.5500	1.4800	1.4200	1.3800	1.3600	1.3200
US\$/£	1.9673	2.0080	2.0471	1.9865	1.9833	1.9700	1.9500	1.9300	1.9050	1.9000	1.8800	1.8500

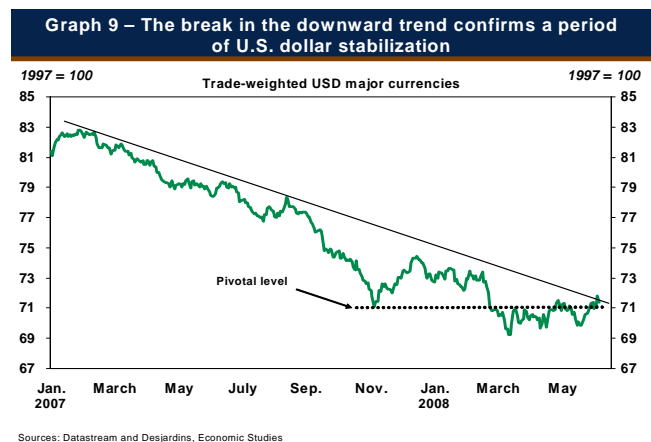
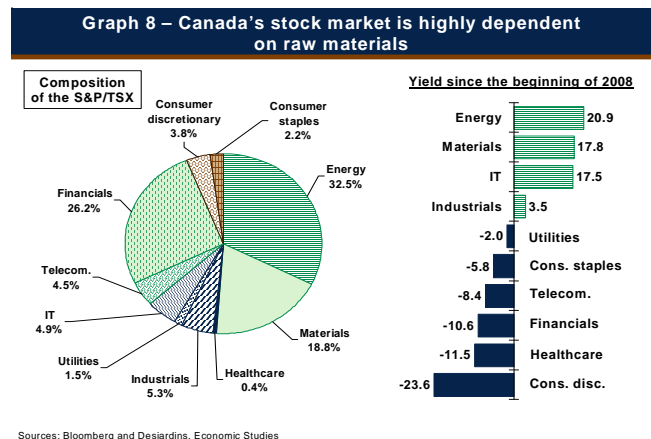
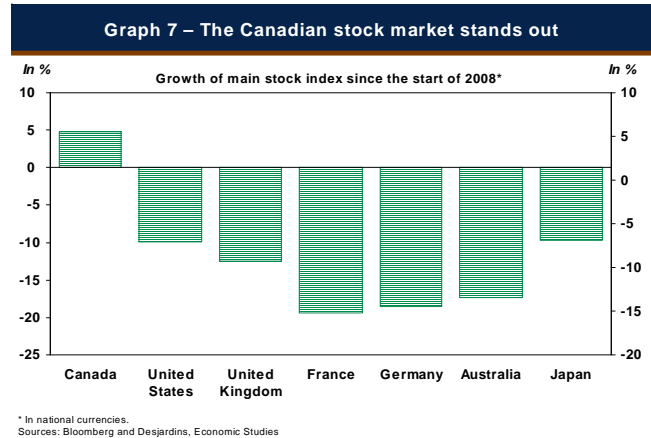
Source: Desjardins, Economic Studies

f: forecasts

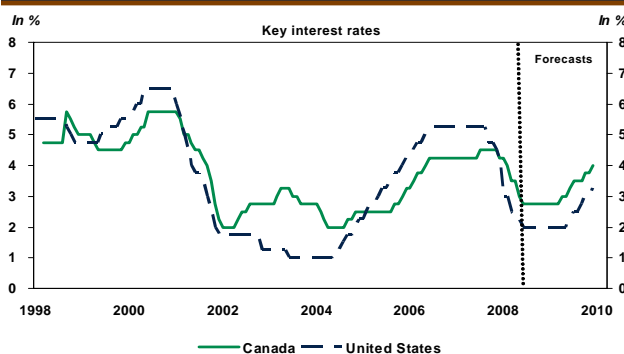
# ASSET CLASSES RETURN

## The Canadian stock market will have trouble keeping this pace

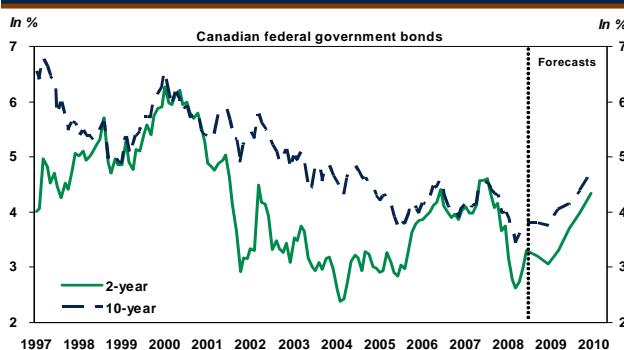
- The performance of most asset classes remains weak.** The first half of 2008 was not very profitable for investors. After a rocky start of the year for stock markets, the bond market is now suffering from growing inflation pressures. Canada's stock market was an exception, however, as it reached even new heights. The question is: Will this continue through the second half of the year?
- The U.S. stock market is still in trouble.** While some gains have been made since hitting its low point in mid-March, the U.S. stock market still posts a loss of approximately 10% since the start of the year. Investors' confidence is fragile and new worries for financial institutions made the S&P500 fall in the past few weeks. While volatility will likely remain high, financial tensions should continue to ease in the second half of the year. This would allow U.S. stock market to continue to post modest increases to end 2008 up slightly from 2007.
- The Canadian stock market's excellent performance is a reflection of oil prices.** Canada's S&P/TSX index rebounded in a much more spectacular fashion, hitting a new historic high. Canada's stock market has gained about 5% since the start of the year—a performance that is the envy of the rest of the world—as the major stock markets in Europe and Asia posted even greater losses than in the United States (graph 7). However, the growing number of companies in the raw materials sector exposes the Canadian market to much greater volatility (graph 8).
- We now recommend overweighting U.S. shares.** We believe the current level of oil prices is unsustainable given that it does not reflect the reality of supply vs. world demand. The most likely scenario is a gradual return to a level of about US\$100 per barrel by the end of the year, which should see Canada's stock market underperform. The potential for appreciation seems better south of the border. In addition, the stable greenback makes the U.S. stock market more attractive now than it has been in the past few years (graph 9).
- Key rate hikes expected by the market seem premature.** Inflation fears led the Federal Reserve and the Bank of Canada (BoC) to put an end to their monetary easing and adopt a much firmer stance on the need to maintain price stability. Several analysts are now expecting key interest rates to rise the coming months. However, the significant economic slowdown on both sides of the border should be more than enough to make sure inflation slows down especially if, as we believe, oil prices moderate in the coming quarters. Faced with a real risk of recession and their wish to ensure price stability, the monetary authorities will be cautious, in our opinion, opting for a long status quo, at least until the end of 2008 (graph 10).



- **Bond rates should come down again slightly.** Interest rate increases over the past few months have made the Canadian bond market more attractive for investors, especially the short end of the curve. In addition to offering a slightly better yield, bond values should benefit from a drop in interest rates in the coming months as the markets realize that the BoC will be unable to tighten its monetary policy quickly (graph 11).
- **Overall, our return forecasts for 2008 still stand.** Recent shifts in the past few weeks have not had a major impact on our forecasts for 2008. For stock markets, we expect the U.S. markets to rally in the second half of the year while Canada's stock market should be relatively flat, still ending 2008 with a gain of approximately 8%, however. The bond market should continue to gain modestly in the second semester and finish the year with a return of 2.5%. We recommend counting on a steepening of the yield curve, given that declines in short-term rates should be more significant.
- **Inflation risks remain a concern.** The persistence of high oil prices is taking on worrisome proportions. In our opinion, crude prices are overvalued and we anticipate a correction in the short term. However, should oil prices be maintained or reach even new heights, inflation pressures could prompt a quick tightening of key rates, which could have a negative impact on the performance of both stock and bond markets.

**Graph 10 – The most likely option is the status quo for an extended period**


Sources: Datastream and Desjardins, Economic Studies

**Graph 11 – Bond rates could fall slightly by the end of the year**


Sources: Datastream and Desjardins, Economic Studies

**Table 3  
Asset classes return**

	Cash	Bonds	Canadian stocks	U.S. stocks	International stocks	Exchange rate
	3-month T-Bill	Scotia Capital Bond Index	S&P/TSX Index*	S&P 500 Index (US\$)*	MSCI EAFE Index (US\$)*	CAN\$/US\$ (var. in %)**
2000	5.50	10.20	7.40	-9.10	-14.00	3.80
2001	3.90	8.10	-12.60	-11.90	-21.20	6.50
2002	2.50	8.70	-12.40	-22.10	-15.70	-1.50
2003	2.90	6.70	26.70	28.70	39.20	-17.70
2004	2.20	7.10	14.50	10.90	20.70	-7.10
2005	2.70	6.50	24.10	4.90	14.00	-3.30
2006	4.00	4.10	17.30	15.80	26.90	0.20
2007	4.10	3.70	9.80	5.50	11.60	-14.40
2008f range	target: 2.75 2.5 to 3.0	target: 2.50 1.0 to 5.0	target: 8.00 -4.0 to 12.0	target: 3.00 -6.0 to 7.0	target: 4.00 -7.0 to 8.0	target: -1.80 (US\$1.02) -4.6 to 5.5 (US\$0.95 to US\$1.05)

f: forecasts; \* Dividends included; \*\* Negative = appreciation and positive = depreciation.

Sources: Datastream and Desjardins, Economic Studies