

Retail Rate Forecasts

September 11, 2008

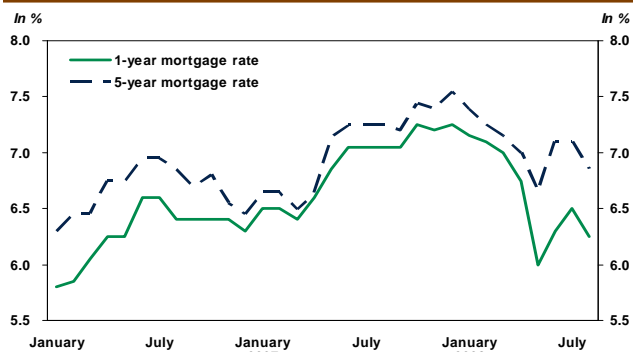
Retail rates may still fall a bit more

HIGHLIGHTS

- The decline in bond rates has brought mortgage rates back down.
- The Bank of Canada opted for the status quo for a third straight meeting, but the pressure seems to be increasingly tilted to the downside.
- Financial strains intensified this summer, but the U.S. government seems determined to avoid the worst.
- The loonie is short on support.
- Canada's stock market is hurt by the drop in commodity prices.

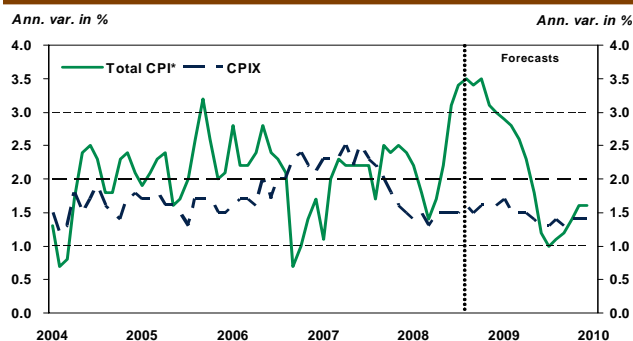
- **Mortgage rates retreated this summer.** As we had expected, June's increase in mortgage rates did not augur the start of a real up trend. Instead, financial institutions have brought their rates back down over the last few weeks, reflecting the movement in bond rates. The rates for one-year and five-year mortgages thus came down 25 basis points in August and are now at 6.25% and 6.85% respectively (graph 1). The rates paid on term savings remained much more stable.
- **Bank of Canada (BoC): prudence remains in order.** The BoC maintained its key rate at 3.0% in September. Canada's monetary authorities are signalling that their growth and inflation projections will be trimmed, and that the monetary bias is neutral.
- **Interest rates may drop by year-end.** Despite the correction in oil prices, total inflation will stay above 3.0% until 2009 (graph 2). This should incite the BoC to once again stay pat in October. However, Canada's weak economy (graph 3) should convince policymakers to resume monetary easing at its December meeting.
- **Financial strains intensified.** The hopes of seeing the effects of the financial crisis dissipate quickly evaporated early this summer. The problems facing major international financial institutions continued, bringing on another stock market correction. The loss of confidence in Fannie Mae and Freddie Mac, America's biggest mortgage lenders, even forced U.S. authorities to take action to keep the institutions above water; they guarantee almost half of a \$10,000B mortgage market. While this intervention from U.S. authorities was greeted favourably, investors remain nervous.

Graph 1 – Mortgage rates fall again



Sources: Datastream and Desjardins, Economic Studies

Graph 2 – Canadian inflation will remain above upper target until year-end



* Consumer price index.
Sources: Statistics Canada and Desjardins, Economic Studies

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- The economic slowdown brought bond rates back down.** The rapid and apparently exaggerated rise by bond rates as summer opened did not last and rates have pulled back substantially over the last few weeks (graph 4). The change in markets' expectations regarding Canadian monetary policy was a big contributor to the movement. The global economic slowdown, further financial strains and moderating commodity prices also boosted the bond market's appeal for investors. Given the tough economic and financial situation, bond rates should stay very low until mid-2009.
- Retail rates may dip slightly by year-end.** The decrease in the Canadian key rates may push mortgage rates down a bit in the months ahead, after which the retail rates are expected to remain stable until mid-2009 while the global economic and financial slump will keep bond rates very low. As such, we now do not expect retail rates to rise until the second half of 2009.

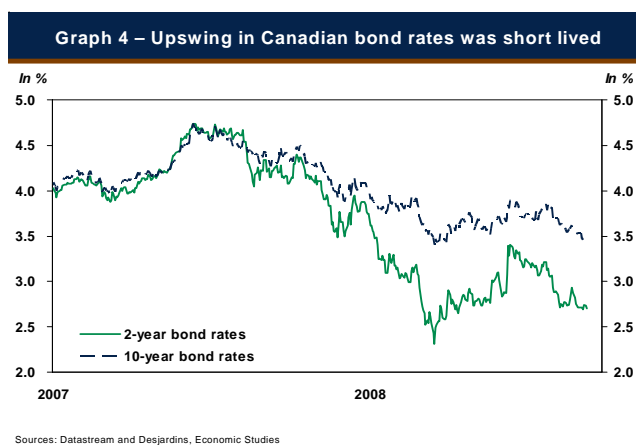
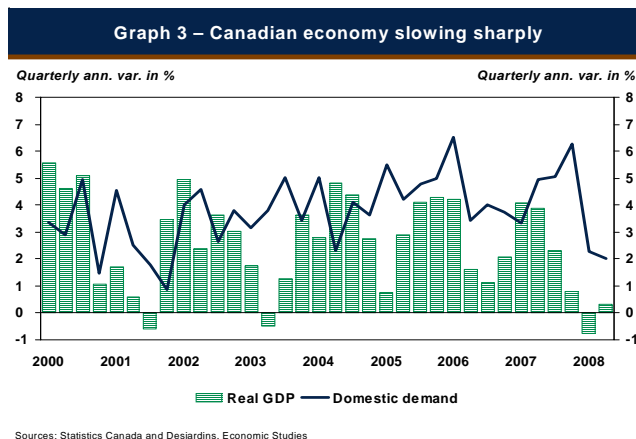


Table 1
Forecasts : Retail rate

	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
Realized – End of month								
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 2008	3.25	4.75	6.30	6.65	7.10	2.25	2.85	3.20
July 2008	3.25	4.75	6.50	7.00	7.10	2.25	2.85	3.20
August 2008	3.25	4.75	6.25	6.35	6.85	2.25	2.85	3.20
Sep. 10, 2008	3.25	4.75	6.25	6.35	6.85	2.25	2.85	3.20
Forecasts – End of quarter								
2008: Q3	3.25	4.75	6.00–6.50	6.10–6.60	6.60–7.10	2.00–2.50	2.60–3.10	2.95–3.45
2008: Q4	2.75–3.25	4.25–4.75	5.75–6.25	5.90–6.40	6.45–6.95	1.75–2.25	2.35–2.85	2.75–3.25
2009: Q1	2.50–3.00	4.25–4.75	5.55–6.05	5.75–6.25	6.35–6.85	1.55–2.05	2.15–2.65	2.75–3.25
2009: Q2	2.50–3.00	4.25–4.75	5.65–6.15	5.90–6.40	6.35–6.85	1.65–2.15	2.25–2.75	2.90–3.40
2009: Q3	2.50–3.00	4.25–4.75	5.85–6.35	6.15–6.65	6.55–7.05	1.85–2.35	2.45–2.95	3.05–3.55
2009: Q4	3.00–3.50	4.75–5.25	6.05–6.55	6.35–6.85	6.75–7.25	2.00–2.50	2.75–3.25	3.35–3.85

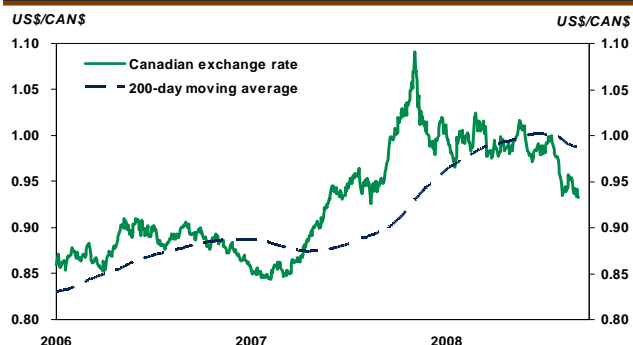
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

The Canadian dollar is short on support

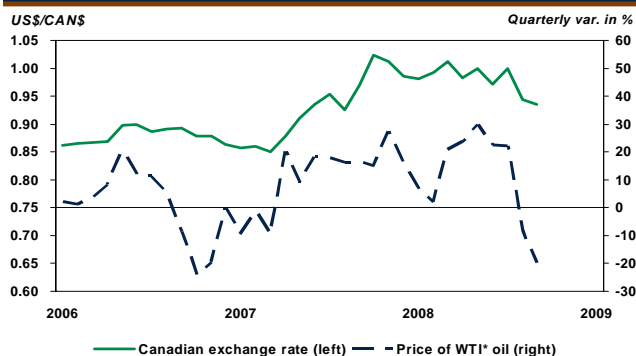
- **The correction of the Canadian dollar continues.** The loonie has been hard hit by the greenback's broadbased appreciation against the major currencies, as well as by the drop in commodity prices and the darkening outlook for the Canadian economy. After flirting with parity in the first half of the year, the downward pressure on the currency accelerated, gradually driving the loonie to a low of US\$0.9279 on September 3 (graph 5).
- **In the short term, the pressure seems downward on the Canadian dollar.** First, metal prices continue to drop, and our scenario of US\$100 for a barrel of crude by the end of the year is on its way to becoming a reality. Second, we have revised our projection for real GDP growth downward for the coming quarters, for a total of just 0.6% for 2008. With less inflationary pressure from energy prices, there is a general consensus that the Bank of Canada will resume monetary easing at the end of the year or in early 2009.
- **However, we are more optimistic over the longer range.** In our opinion, the drop in energy and non-energy commodity prices is merely a correction within an upward trend, and the structural changes resulting from Asia's rapid industrialization will continue to push up prices since supply is limited. While the nearly 30% correction in oil prices partly explains the loonie's recent direction (graph 6), crude prices, which are now more in line with their equilibrium level, could conceivably re-establish their historical connection with the Canadian dollar.
- **Forecasts:** In the short term, the pressure on the loonie is to the downside. The loonie's movement will remain dependent on the U.S. slowdown's impact on Canada's economy, on demand for commodities, interest rate expectations, and the markets' perception about a lasting rebound by the greenback.

Graph 5 – Loonie continues its correction



Sources: Datastream and Desjardins, Economic Studies

Graph 6 – Drop in oil prices partly explain loonie's fall

* 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	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
CAN\$/US\$	1.1535	1.0654	1.0056	1.0021	0.9748	0.9700	0.9200	0.8800	0.9000	0.9400	0.9700	1.0000
US\$/CAN\$	0.8669	0.9389	0.9944	0.9979	1.0259	1.0309	1.0870	1.1364	1.1111	1.0638	1.0309	1.0000
CAN\$/euro	1.5354	1.4389	1.4143	1.4589	1.6256	1.6243	1.5761	1.6364	1.5556	1.4468	1.3608	1.3200
US\$/euro	1.3311	1.3506	1.4222	1.4620	1.5846	1.5755	1.4500	1.4400	1.4000	1.3600	1.3200	1.3200
US\$/£	1.9673	2.0080	2.0471	1.9865	1.9833	1.9936	1.7900	1.7300	1.6700	1.7000	1.7000	1.7400

Source: Desjardins, Economic Studies

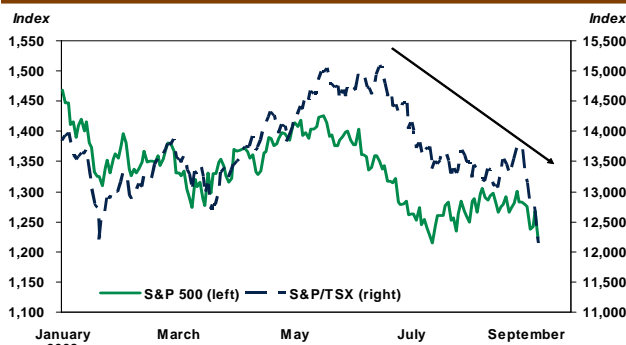
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ASSET CLASSES RETURN

After a very tough 2008, stocks should do better in 2009

- **The markets are still volatile.** Investor confidence was once again shaken by the problems facing financial institutions and the clear signs of a worldwide economic slowdown. Stock market indexes everywhere came down sharply as investors opted to once again head for safe-haven securities (graph 7).
- **Commodity prices recorded a correction.** After an impressive surge in the first half of 2008, prices for most commodities have come down in the last few weeks. In particular, oil's price per barrel went from a peak of US\$147 to close to US\$100 (graph 8). The impact of the world economic slowdown on demand for commodities and the rising U.S. dollar could continue to put downward pressure on commodity prices for the next few months.
- **Canada's stock market performance took a heavy hit.** In June, we had recommended opting for U.S. equity over the Canadian stock market, given the latter's extensive vulnerability to a correction by commodity prices. This recommendation proved to be sound, as the Canadian stock market has pulled back more sharply than the market south of the border since the end of June. The Canadian stock market's underperformance was also magnified by the loonie's pullback against the greenback.
- **Markets overseas will record a substantial loss for 2008 as a whole.** The economic and financial problems are also hitting markets overseas, where the pullback by the main stock market indexes since the year opened is now often over 20% (graph 9). Even emerging exchanges have been hard hit, as with the collapse by Chinese securities.
- **Investor pessimism has benefited the bond market.** Financial fears and the drop in inflationary pressure following the correction of oil prices have increased demand for government bonds. The drop in Canadian bond rates has thus pushed the bond market's return up to 4% since the year opened. At this point, however, there does not seem to be much potential for further declines in Canadian rates.
- **Canadian key rates should drop by year-end.** The recent moderation in commodity prices and more pronounced than expected economic slowdown are paving the way for further monetary easing in Canada. However, Canada's inflation is well over the Bank of Canada's (BoC) target and price evolution over the next few months is very uncertain. Under the circumstances, we think the BoC will once again opt for the status quo in October but will trim rates slightly in December (graph 10).

Graph 7 – Stock markets have fallen sharply in the last few months



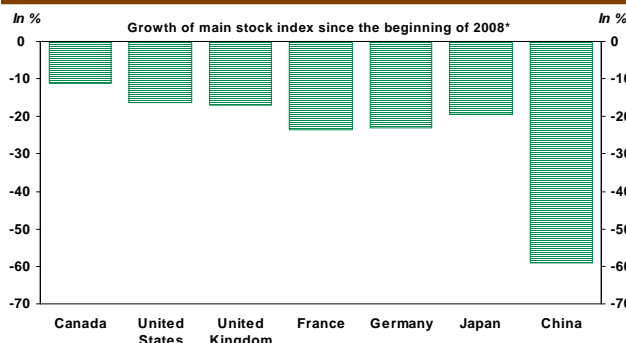
Sources: Datastream and Desjardins, Economic Studies

Graph 8 – Oil prices tumble near US\$100 per barrel



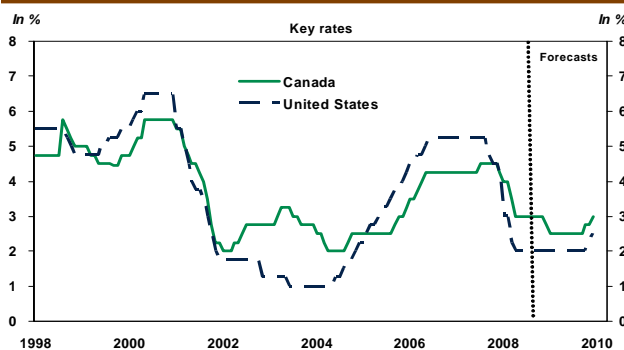
Sources: Datastream and Desjardins, Economic Studies

Graph 9 – 2008 is a tough year for stock markets

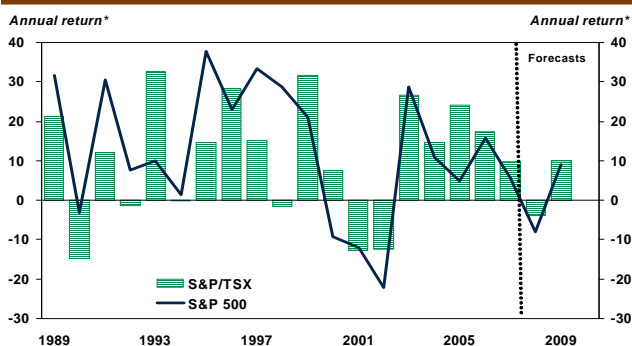


* In national currencies.
Sources: Bloomberg and Desjardins, Economic Studies

- **2008 will be a year to forget for investors.** The stock markets' highly disappointing performance in the last few months means we have to substantially downgrade our return outlook for this asset class. Despite the slight comeback expected in the next few months, markets overseas will not be able to stave off a substantial yearly pullback for 2008 as a whole. The Canadian stock market should also end the year with a negative return. Lastly, the bond market should finish 2008 with a gain of about 4%.
- **Stock market returns should improve next year.** The effects of the financial crisis, which has been sapping stock market performance for over a year now, should progressively dwindle over the coming quarters. This should make it possible for the market indexes to record almost normal performance in 2009 (graph 11), especially since the market usually tends to rebound several months before the trough in the economic cycle. The expected comeback by interest rates in the second half of 2009 could, however, limit the bond market return to around 2.5%.

Graph 10 – The Bank of Canada should lower its key rates at the end of the year


Sources: Datastream and Desjardins, Economic Studies

Graph 11 – The return on North American stock markets often exceeds 10%
* Including dividends.
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: 4.00 3.0 to 5.0	target: -4.00 -14.0 to 4.0	target: -8.00 -16.0 to -2.0	target: -15.00 -25.0 to -10.0	target: 13.9 (US\$0.88) 5.5 to 17.9 (US\$0.85 to US\$0.95)
2009f range	target: 2.80 2.5 to 3.0	target: 2.50 1.0 to 4.0	target: 10.00 5.0 to 15.0	target: 9.00 4.0 to 14.0	target: 8.00 0.0 to 16.0	target: -12.0 (US\$1.00) -7.4 to -16.2