

# Retail Rate Forecasts

October 23, 2008

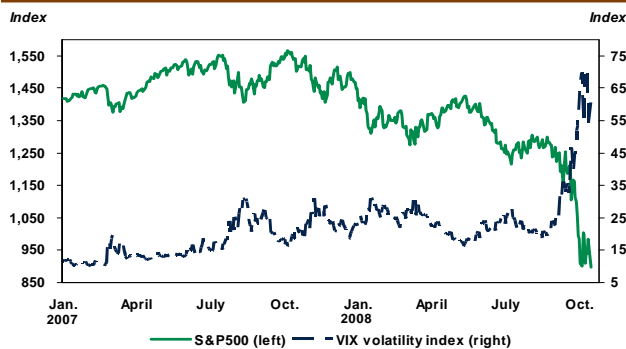
## The financial crisis affects retail rates

### HIGHLIGHTS

- The financial upheaval has intensified sharply in recent weeks, but things are starting to look better, particularly on the institutional money market.
- The Bank of Canada lowered its key rates by 75 basis points in October, with further cuts expected.
- The deepening financial crisis has driven some mortgage rates up.
- The loonie is free-falling.
- The crisis has hit the stock market indexes hard.

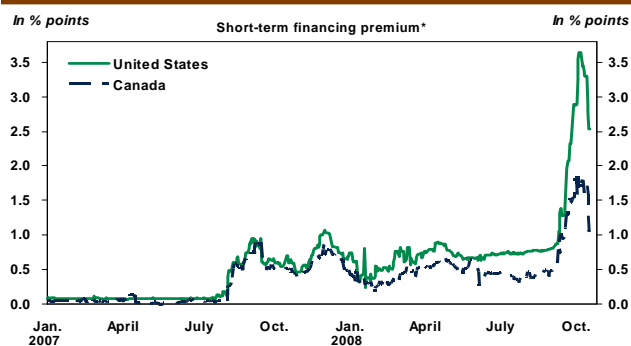
- **The financial crisis has taken a dramatic turn in the last few weeks.** The failure of Lehman Brothers, a major U.S. investment bank, and problems with many other financial giants have caused a real panic in the financial markets. Trust between the market's key players crumbled and the institutional money market ground almost to a halt, driving financing costs up sharply. The stock markets have not been spared: volatility has skyrocketed and the indexes have undergone a violent correction (graph 1).
- **Thankfully, the authorities have taken strong action in response.** Governments and central banks worldwide are doing everything in their power to limit the consequences of the financial crisis and rebuild investor confidence. It is too early to celebrate, but, in the last few days, their efforts finally seem to be bearing fruit, with the situation in the institutional money market beginning to calm down (graph 2).
- **The Bank of Canada (BoC) cut its key rates by 75 basis points in October.** The 50 basis point cut ordered on October 8 in conjunction with other major central banks was followed by a more modest 25 point cut on October 21, which took the bank rate to 2.5%. The darkening economic outlook and major strains in the financial markets justify the BoC's vigorous action, especially since the correction of commodities prices has taken a big bite out of inflation pressure. Against this backdrop, the BoC doesn't hide its intention of moving ahead with more key rate cuts.
- **The financial turbulence is having an impact on mortgage rates.** The increase in financial institutions' financing costs has made mortgage rates rise, regardless of low bond rates. The rate on a closed five-year mortgage thus went from 6.85% to 7.20% at the end of September. The premium over the prime rate demanded on new variable rate mortgages

Graph 1 – The financial crisis reached its apogee



Sources: Datastream and Desjardins, Economic Studies

Graph 2 – Financing spreads finally start to come down



\* Spread between the three-month Libor rate and overnight swap rates.  
Sources: Bloomberg and Desjardins, Economic Studies

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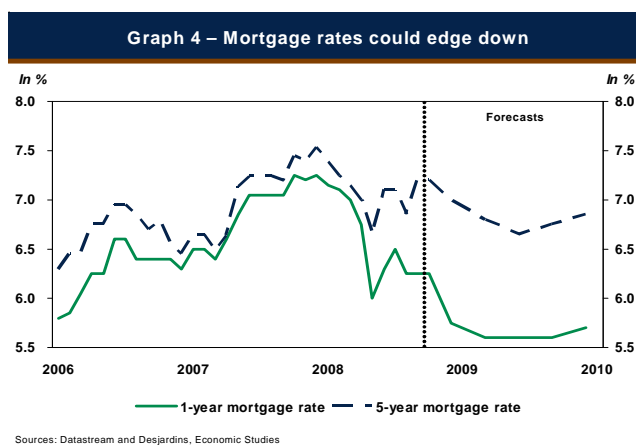
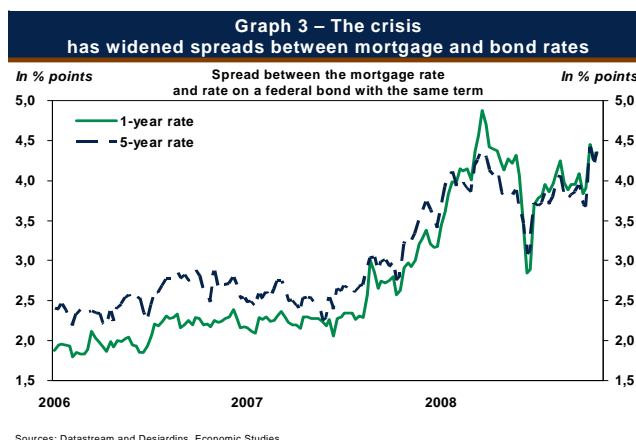
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has also shot up. However, the spread between the prime and discount rate has remained stable, allowing households with variable mortgages to benefit from the rate cuts ordered by the BoC.

- **Forecasts:** We continue to look for a moderate pullback in retail rates. The financial crisis will have lasting effects and the spreads between mortgage rates and rates on Canadian government bonds will remain fairly high for several quarters or even years. However, the current spreads (graph 3) reflect the extreme situation that has been with us in recent weeks and, as soon as the money market starts to roll again, financial institutions will have the leeway to bring their rates down slightly. The grim economic situation should keep bond rates very low over the next few quarters which, combined with further key rate cuts, will also put downward pressure on retail rates (graph 4).



**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>								
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. 2008	3.25	4.75	6.25	6.70	7.20	2.25	2.85	3.20
Oct. 22, 2008	2.50	4.00	6.25	6.70	7.20	2.25	2.85	3.20
<b>Forecasts – End of quarter</b>								
2008: Q4	2.00–2.50	3.50–4.00	5.50–6.00	6.10–6.60	6.75–7.25	1.65–2.15	2.25–2.75	2.65–3.15
2009: Q1	1.50–2.25	3.00–3.75	5.35–5.85	5.95–6.45	6.55–7.05	1.65–2.15	2.15–2.65	2.55–3.05
2009: Q2	1.50–2.25	3.00–3.75	5.35–5.85	5.90–6.40	6.40–6.90	1.65–2.15	2.10–2.60	2.45–3.05
2009: Q3	1.50–2.25	3.00–3.75	5.35–5.85	6.00–6.50	6.50–7.00	1.65–2.15	2.15–2.65	2.65–3.15
2009: Q4	2.00–2.50	3.50–4.00	5.45–5.95	6.20–6.70	6.60–7.30	1.80–2.30	2.45–3.05	2.85–3.35

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

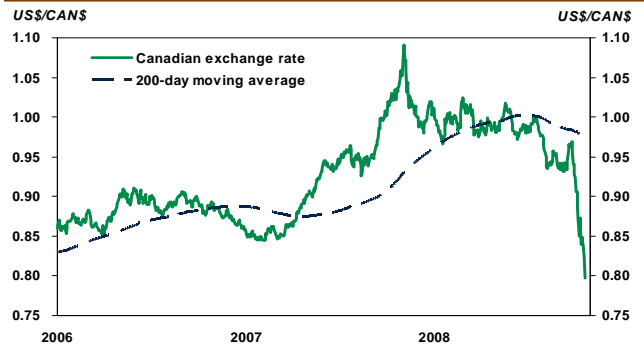
Source: Desjardins, Economic Studies

# CANADIAN DOLLAR

## The loonie was hard hit by the severe correction in commodity prices

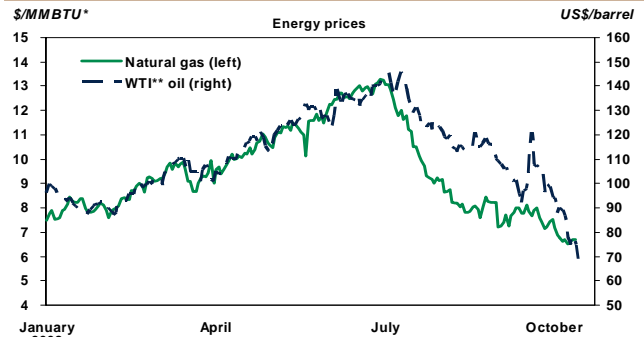
- **Our short-term position on the loonie has changed substantially in recent weeks.** After standing firm for a good portion of the crisis, the Canadian dollar collapsed starting in mid-September and drop below US\$0.80 on October 22 (graph 5).
- **The currency was hard hit by the severe correction in energy and non-energy raw materials prices (graph 6).** We feel that the retreat in oil prices has pretty much run its course, but unless the financial crisis is resolved soon, tensions in the credit market will continue to exacerbate risks of global recession, along with lower demand for commodities.
- **For the short term, the loonie is facing downside risks.** Darkening clouds over prospects of economic growth in Canada due to the exacerbation of financial tensions, risks of global recession and collapsing global demand for raw materials continue to work to the currency's disadvantage in the months to come. First of all, there is no sign of a rebound, or even of stabilization, in oil prices in the short term. Secondly, we now believe that the Bank of Canada will have to ease its monetary policy more than the markets are expecting, in order to limit the risk of recession in this country.
- **Forecasts:** The correction of the dollar seems advanced but the pressure is still on the downside, and the loonie could reach new cyclical low soon. In 2009, the context might be more favourable to the Canadian dollar as commodity prices should resume their upward trend.

**Graph 5 – The Canadian dollar correction accelerates**



Sources: Datastream and Desjardins, Economic Studies

**Graph 6 – The dollar has been hard hit by plummeting energy prices**



\* Million British Thermal Units; \*\* 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	0.9407	0.8000	0.8200	0.8800	0.9400	1.0000
US\$/CAN\$	0.8669	0.9389	0.9944	0.9979	1.0259	1.0309	1.0630	1.2500	1.2195	1.1364	1.0638	1.0000
CAN\$/euro	1.5354	1.4389	1.4143	1.4589	1.6256	1.6243	1.4931	1.6500	1.5610	1.4205	1.2979	1.2200
US\$/euro	1.3311	1.3506	1.4222	1.4620	1.5846	1.5755	1.4047	1.3200	1.2800	1.2500	1.2200	1.2200
US\$/£	1.9673	2.0080	2.0471	1.9865	1.9833	1.9936	1.7825	1.6800	1.6500	1.6200	1.6000	1.6000

Source: Desjardins, Economic Studies

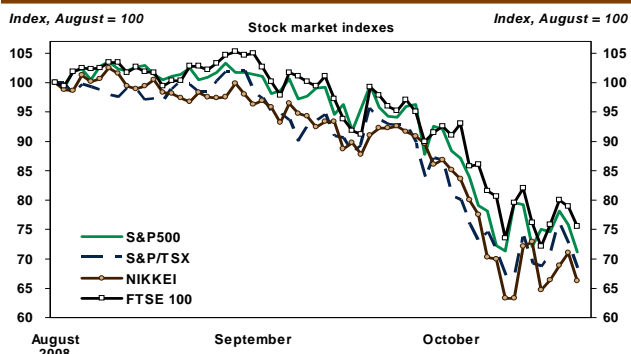
f: forecasts

# ASSET CLASSES RETURN

## The stock market pullback has turned into a rout

- The various asset classes evolved in step with the crisis.** Deepening strain generated a real wave of panic in the markets. Volatility reached record levels and stock market indexes collapsed worldwide (graph 7). The simultaneous drive by many investors to leave the stock market magnified the correction. In just a week in early October, the S&P500 lost almost 20%, when panic seemed to be reaching an apex. Sturdy government intervention finally appears to be starting to have an impact on the money market, but growing fears of a global recession are still putting downside pressure on the exchanges.
- The crisis amplified the commodity price correction.** Extreme risk aversion, a lack of liquidity and the strong U.S. dollar are prodding many investors to reduce their investments in the resource sector. Moreover, the financial collapse confirms that the global economic recession will last several more quarters, sapping demand for commodities. As a result, the generalized correction of raw materials prices continued, with oil even closing one session under US\$70/barrel for the first time since August of 2007 (graph 8).
- The Canadian stock market continues to struggle.** Unsurprisingly, the combination of a generalized drop in the stock markets and resource prices is really hurting Canada's market. The S&P/TSX is therefore off by about 30% since early September. Even a major fertilizer producer such as PotashCorp was hard hit by the pullback in commodity prices. The Canadian market's relative under-performance in comparison with the U.S. markets in the last few months is particularly remarkable if we consider our currency's depreciation (graph 9).
- The bond market has not benefited from surging strains.** The deepening of the crisis only helped short-term federal securities, which did a good job in fulfilling their role as safe-haven securities. Investors turned their backs on all securities that presented the slightest risk, especially corporate bonds. Even rates on long-term federal bonds have not fallen, as investors seem to be worried that the energetic action being taken by government authorities to combat the financial crisis, especially in the United States, will bring on too much of an increase in the supply of federal securities.
- The BoC will lower its key rates further.** The combined effects of the credit crisis, American recession and sagging global demand for natural resources will continue to play against Canada's economy in the coming quarters. As inflation risks are now obviously tilted to the downside, the BoC has clearly indicated that it intends to cut its key rates further in the next few months. We are expecting at least two more 25 basis point rate cuts, at the December and January meetings (graph 10). This, combined with the tough economic situation, will keep Canada's bond rates very low over the months to come.

**Graph 7 – Stock markets have posted major declines**



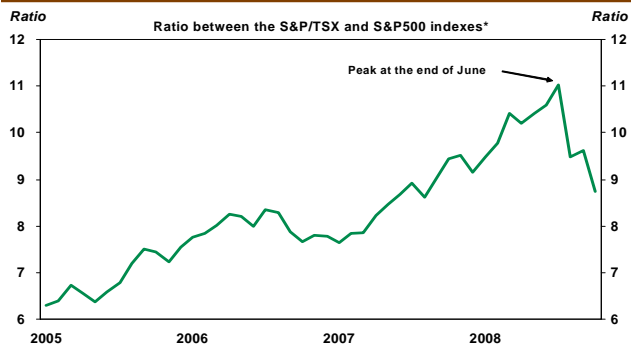
Sources: Datastream and Desjardins, Economic Studies

**Graph 8 – Oil prices undergo a spectacular correction!**



Sources: Datastream and Desjardins, Economic Studies

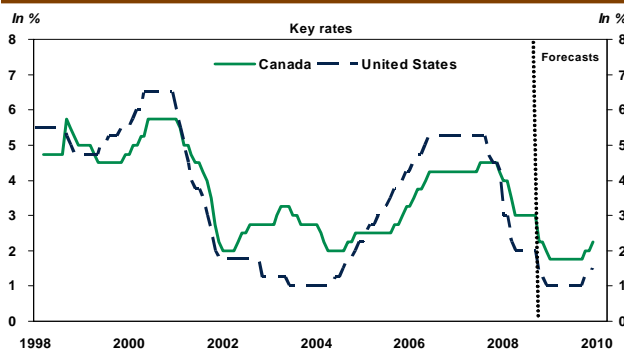
**Graph 9 – The Canadian stock market's over-performance comes to an abrupt halt**



\* In Canadian dollars.  
Sources: Datastream and Desjardins, Economic Studies

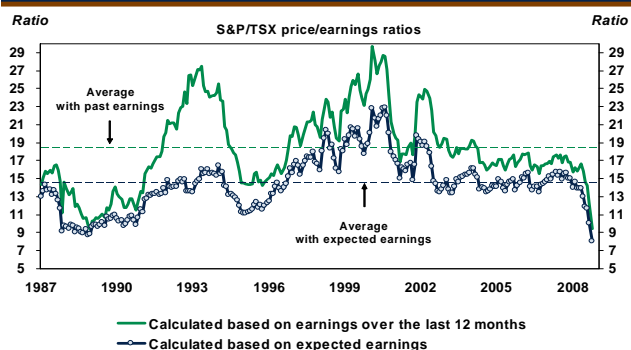
- Forecasts:** The stock markets could erase some of their losses by year's end and in 2009. It is hard to be optimistic under the circumstances, but we must not forget that stock market corrections have usually been followed by a strong comeback of the indexes. Although extreme volatility could be with us for a while, which argues in favour of investors' taking a prudent approach, the stock market now looks attractive, historically speaking, especially in Canada (graph 11). Fears of a recession and its impacts on corporate earnings will keep downward pressure on the stock markets, but one could think that the current level already reflects a very pessimistic economic scenario. After a sharp loss in 2008, stock market returns should therefore close in on 10% next year, in our opinion. In the current situation, however, we should stress that these forecasts are surrounded with greater uncertainty. Further declines in stock indices could occur before the real rebound.

Graph 10 – Further key rate cuts can be expected



Sources: Datastream and Desjardins, Economic Studies

Graph 11 – The Canadian stock market has rarely been this cheap



Sources: Institutional Brokers Estimate System 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: 2.40 2.3 to 2.5	target: 3.00 1.5 to 4.0	target: -15.00 -30.0 to -10.0	target: -20.00 -35.0 to -15.0	target: -30.00 -45.0 to -20.0	target: 25.3 (US\$0.80) 17.9 to 33.6 (US\$0.75 to US\$0.85)
2009f range	target: 2.00 1.5 to 2.5	target: 2.50 1.0 to 4.0	target: 10.00 0.0 to 20.0	target: 9.00 2.0 to 18.0	target: 12.00 5.0 to 20.0	target: -20.0 (US\$1.00) -11.1 to -23.8 (US\$0.90 to US\$1.05)

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

Sources: Datastream and Desjardins, Economic Studies