Retail Rate Forecasts
Desjardins Economic Studies
www.desjardins.com/economics
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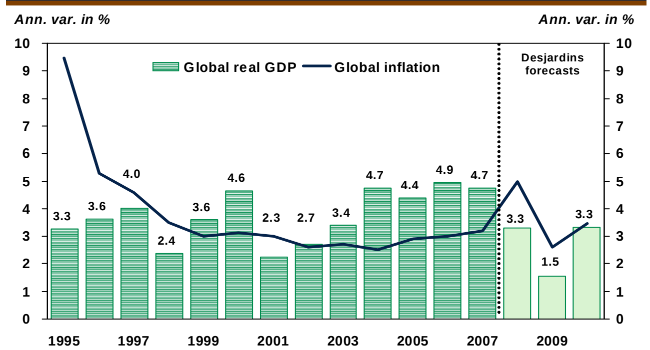
Further cuts to retail rates likely

Highlights

- The economic environment remains difficult, financial turmoil continues and the entire planet is slipping into recession.
- The Bank of Canada calls for a recession: key interest rates are cut by 75 basis points in December.
- In spite of financial tensions, declining bond rates are dragging down retail rates.
- The loonie is suffering from the worldwide economic slowdown, but the recent U.S. dollar weakness is limiting the downside.
- Stock markets haven't rebound yet.

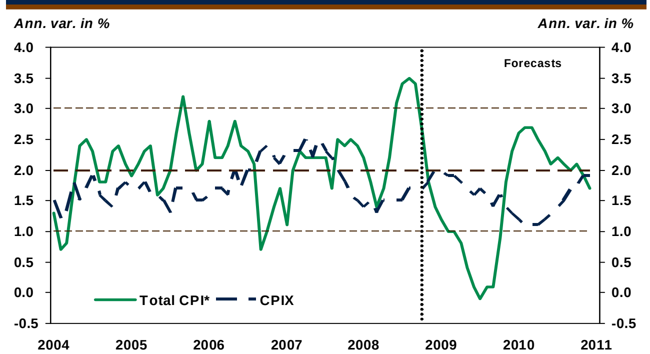
- **The effects of the financial crisis are still being felt.** The swift and decisive actions taken by monetary and government authorities saved several large international financial institutions from the brink of bankruptcy, but tensions remain high. And while the interbank market started to function more normally, credit conditions were severely tightened and financing premiums remain high.
- **The global economy will slip into recession.** This fall's deepening financial crisis worsened the economic slowdown. The third quarter results made it official: several developed countries are now in the grips of a recession. Concerns are now shifting to the emerging countries where signs of an economic slowdown are multiplying. Global growth could be limited to 1.5% next year, a level that clearly signals a global recession (graph 1).
- **The Bank of Canada (BoC) cut its key interest rates by 75 basis points in December.** Canada will not escape a recession. Our own forecasts call for real GDP growth to be in the red for a total of three quarters. This decline in economic activity, coupled with the brutal correction in oil prices, will exert significant downward pressure on prices. In our opinion, total annual inflation is likely to hold steady below the BoC's target range of 1% to 3% until the fall of 2009, with the possibility of total annual inflation falling below the 0% mark in mid-2009 (graph 2).
- **Monetary easing will continue.** To limit the recession's severity in Canada and keep core inflation in line with the mean target in the medium term, it now appears certain that more cuts will be made in the months to come. As such, the discount rate could reach a low of 1%.

Graph 1 – Global recession in 2009



Sources: International Monetary Fund, Consensus Forecasts and Desjardins, Economic Studies

Graph 2 – Canadian inflation is slowing sharply



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

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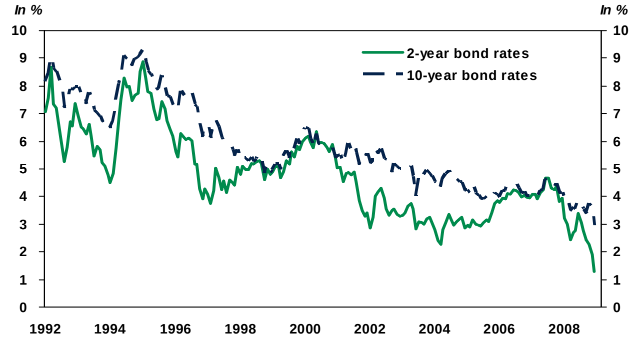
NOTE TO READERS: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

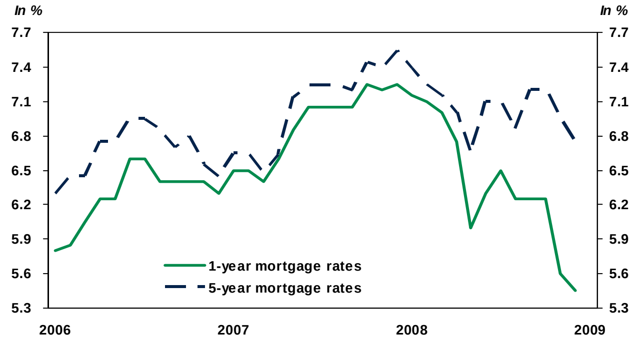
- **Bonds rates have fallen sharply.** Continuing financial tensions, the darkening outlook on global economy and the significant disinflation pressures due to the meltdown in prices for commodities continue to favour Canadian government bonds. Two-year bond rates have fallen to below 1.30% while ten-year rates are hovering at around 2,8%; two low levels not seen in several decades (graph 3).
- **Retail rates have also been cut.** Two contrasting trends have affected retail rates in Canada for the past few quarters now. On one hand, the BoC's monetary easing and the major drop in bond rates are putting downward pressures on retail rates. On the other hand, the financial turmoil and restricted access to liquidity argue in favour of higher rates. The first trend has been predominant recently, with mortgage and savings rates falling significantly since the beginning of November. The one-year mortgage rate has fallen sharply—from 6.25% to 5.45% (graph 4). It appears that the federal government's mortgage buyback program has succeeded in making it easier for Canada's financial institutions to access credit.
- **Other rate cuts in 2009.** Further monetary easing and weak bond rates should lead to other cuts to retail rates in Canada next year. While any return to normal seems far off, financial tensions could moderate gradually, allowing financial institutions to maintain low rates for several quarters moving forward.

Graph 3 – Canadian bond rates are dropping



Sources: Datastream and Desjardins, Economic Studies

Graph 4 – Mortgage rates are going down



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
Realized – End of month								
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. 2008	2.50	4.00	6.25	6.70	7.20	2.25	2.85	3.20
Nov. 2008	2.50	4.00	5.60	6.30	6.95	1.90	2.25	2.60
Dec. 17, 2008	1.75	3.50	5.45	6.20	6.75	1.50	2.25	2.60
Forecasts – End of quarter								
2008: Q4	1.75	3.50	5.25–5.45	6.00–6.20	6.50–6.75	1.20–1.50	2.00–2.25	2.35–2.60
2009: Q1	0.75–1.25	2.50–3.00	4.75–5.25	5.45–5.95	6.00–6.50	0.60–1.10	1.45–1.95	1.85–2.35
2009: Q2	0.75–1.25	2.50–3.00	4.75–5.25	5.45–5.95	6.00–6.50	0.55–1.05	1.45–1.95	1.75–2.25
2009: Q3	0.75–1.25	2.50–3.00	4.65–5.15	5.45–5.95	5.90–6.40	0.50–1.00	1.35–1.85	1.65–2.15
2009: Q4	0.75–1.25	2.50–3.00	4.60–5.10	5.45–5.95	5.85–6.35	0.50–1.00	1.35–1.85	1.65–2.15

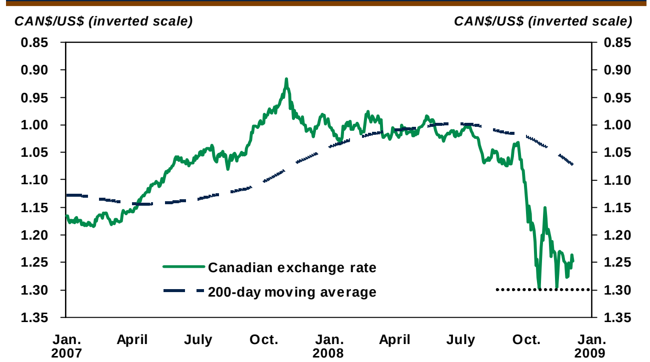
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

The Canadian dollar is suffering from the worldwide economic slowdown

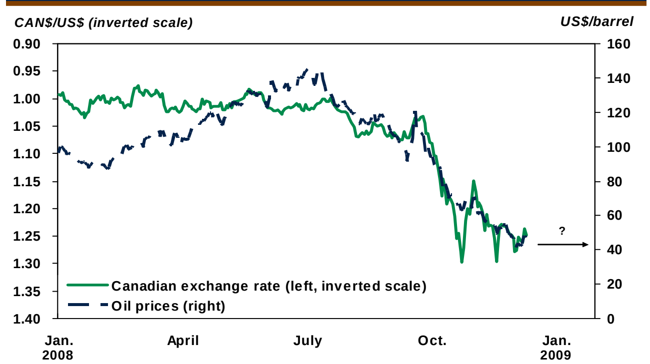
- While Canada's financial institutions are better capitalized, mortgage loans are of better quality and consumer credit conditions have not tightened as much as in the United States, Canada's currency is still feeling the effects of the global economic slowdown. At this time, the USD/CAD pair is at a resistance point at C$1.30, but the overall loonie trend is downward (graph 5).
- Note that the loonie is short on support. The global slowdown is translating into a sharp correction in energy and non-energy commodity prices. Despite a rebound in the first few days of November, the prices of almost all commodities are now down from where they were at this time last year. Oil prices hovered close to US$40 mark in early December, and, despite the U.S. dollar recent weakness, nothing is indicating any lasting rebound in crude prices (graph 6).
- Interest rate spreads will do nothing for the loonie. As the financial crisis and softening global demand for raw materials are having major repercussions for our economy, the Bank of Canada (BoC) slashed the overnight fund rate by 150 basis points in the last three months, taking it to 1.50% in December. The sharp pullback by oil prices means that inflation pressures have completely dissipated and the deepening of the gap with the Canadian economy's potential could prod the BoC to lower its key rate to a historic 0.75% in the first quarter of 2009.
- **Forecasts:** The loonie's recent correction seems quite advanced and, although it could go above C$1.3, the current situation is not conducive to extensive softness in early 2009. Over the longer range, once the financial turmoil has dissipated, investors could well be encouraged to take more risks. At this time, commodities will rebound from oversold levels, which will put the loonie back on track for growth.

Graph 5 – Canadian dollar has rebounded, but pressure is still downward



Sources: Datastream and Desjardins, Economic Studies

Graph 6 – Loonie still determined by low oil prices



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

	2008		2009				2010			
End of period	Q3	Q4f	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
CAN$/US$	0.9407	0.8200	0.7700	0.8000	0.8600	0.8800	0.9000	0.9200	0.9500	1.0000
US$/CAN$	1.0630	1.2195	1.2987	1.2500	1.1628	1.1364	1.1111	1.0870	1.0526	1.0000
CAN$/euro	1.4931	1.6707	1.6234	1.5250	1.4535	1.4773	1.4722	1.4761	1.4642	1.4240
US$/euro	1.4047	1.3700	1.2500	1.2200	1.2500	1.3000	1.3250	1.3580	1.3910	1.4240
US$/£	1.7825	1.5000	1.4500	1.5000	1.5500	1.6000	1.6500	1.7000	1.7500	1.8000

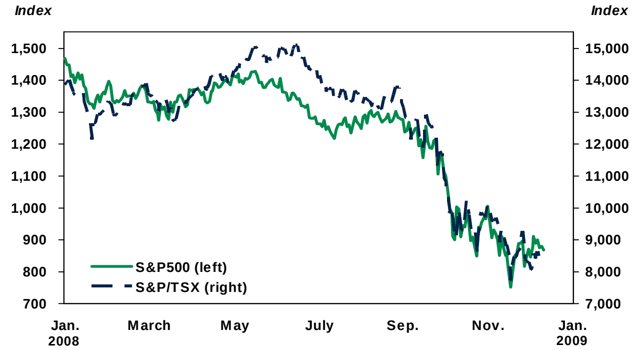
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies f: forecasts

ASSET CLASSES RETURN

Stock markets may not see a real rebound until the second half of the year

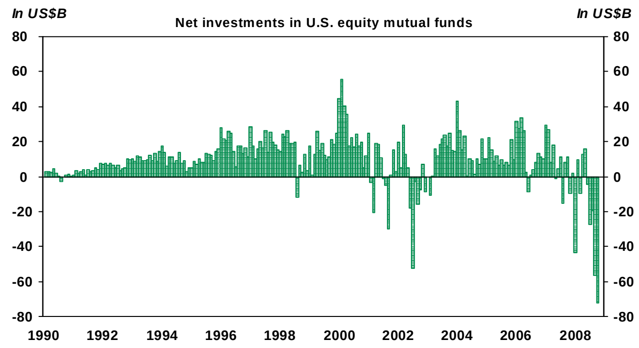
- **The recent trends continued.** Stubborn financial tensions and the darkening outlook on the global economy continued to fuel investors' fears. As a result, safe haven assets, especially federal bonds, appreciated further. In contrast, the environment remained unfavourable for all risky assets.
- **Stock markets remain distressed.** Highly volatile shifts saw the stock markets fall to new lows on November 20. While stock indexes have shot up by more than 10% since then, it is still far too early to say that the worst is behind us. Investor confidence is still very fragile and stock markets are fluctuating wildly. Despite their recent rise, the S&P500 in the U.S. and Canada's S&P/TSX are still down nearly 40% from their 2007 closing levels (graph 7).
- **Fund withdrawals worsen the decline.** Investor confidence was badly shaken in the last few quarters and many investors decided to liquidate their market holdings. The Investment Company Institute reported that U.S. investors withdrew $56B from their stock mutual funds in September and $72B in October (graph 8). At the same time, many hedge funds have had to liquidate their positions to cover their losses and reimburse some investors. The massive outflow of capital from stock markets is applying downward pressure on stock indexes, explaining perhaps why stock indexes fell below the levels justified by fundamentals.
- **Commodity prices continue to melt.** The prices for most commodities have fallen by more then 50% compared with their cyclical peaks (graph 9). This sharp and unprecedented correction was mostly caused by the swift deterioration of the economic environment that is impacting demand for raw materials. Financial factors, including the greenback's strength and the departure of several speculators, are intensifying the price declines. This correction in raw materials prices is especially damaging for Canada's stock market, whose relative performance is also affected by the loonie's drop in value.
- **Canadian key rates will be cut further.** The Bank of Canada will cut their rates again in the months ahead to help limit the scope of the recession (graph 10). At first glance, central banks already seem to be running low on ammunition now that rates are already hovering near the zero mark. Luckily, the monetary authorities have another weapon in their arsenal: liquidity injections. As it stands, the Fed has already started to buy several financial securities to help ease the markets. We expect the monetary authorities to continue to inject massive sums into the economy in the months ahead to stop any potential deflation.
- **Bond rates could decline further.** Inflation's spectacular slowdown and concerns about deflation could drag federal bond rates down even lower in the first half of 2009. Rates should then remain very low for several quarters since our forecast calls for a very lukewarm economic rebound.

Graph 7 – Still waiting for a real stock market rally



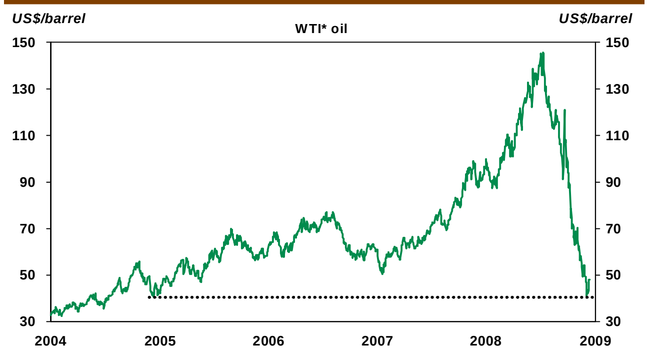
Sources: Datastream and Desjardins, Economic Studies

Graph 8 – Many investors have liquidated their equity investments



Sources: Investment Company Institute and Desjardins, Economic Studies

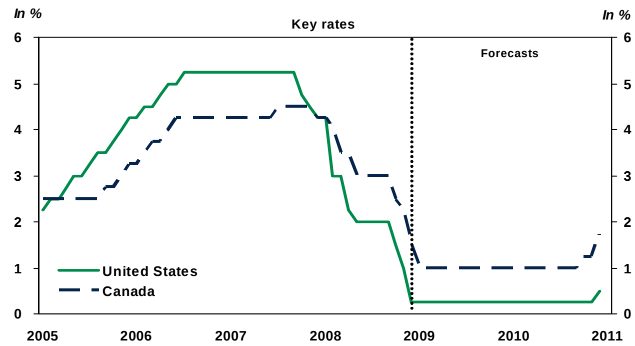
Graph 9 – Oil price is back to 2004 level



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

- **Stock markets should rebound in 2009.** The very difficult economic and financial environment as well as further investment liquidations make any swift rebound in the markets somewhat unlikely. We believe that stock markets will continue to be highly volatile–with significant movements up and down, at near current levels–until approximately mid-2009. Experience has shown, however, that investors could then see major gains (graph 11). In our opinion, the main North American indexes could end 2009 up by more than 10% vs. year-end 2008. Shifts in currency trends and commodity prices could again bode well for Canada's stock markets in the second half of 2009. The bond market should benefit from low federal rates and the gradual pullback in the premiums required for corporate and provincial securities.

Graph 10 – Key interest rates to remain low until late 2010



Sources: Federal Reserve, Bank of Canada and Desjardins, Economic Studies

Graph 11 – Stock market corrections are usually followed by sharp rebounds

S&P500 index and U.S. real GDP

Recessions (NBER*)	Market's loss (in %)	Gain after the bottom (in %)			GDP loss (in %)	GDP gain (in %)
		1-month	3-month	1-year	During the recession	One year after the recession
December 69 to November 70	-26.0	6.0	17.2	43.7	-0.6	4.5
November 73 to March 75	-48.4	17.3	13.5	38.0	-3.1	6.1
January 80 to July 80	-17.1	7.6	18.1	37.1	-2.2	4.4
July 81 to November 82	-25.0	19.4	36.2	58.3	-2.6	7.7
July 90 to March 91	-19.9	8.1	5.8	29.1	-1.3	2.7
March 2001 to November 2001	-49.2	12.8	19.4	33.7	-0.4	2.2
Other correction:						
1987 crash	-33.5	14.3	19.4	21.4		
Averages	-31.3	12.2	18.5	37.3	-1.7	4.6

➢ **The next market rally could be less spectacular because of the slower economic recovery.**

* National Bureau of Economic Research.
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&P500 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	target: 2.40	target: 4.15	target: -34.00	target: -36.00	target: -45.00	target: 6.5 (US$0.93)
range	2.3 to 2.5	4.0 to 4.3	-38.0 to -30.0	-40.0 to -32.0	-50.0 to -40.0	5.0 to 8.0
2009f	target: 0.75	target: 5.00	target: 14.00	target: 17.00	target: 20.00	target: 14.0 (US$0.83)
range	0.5 to 1.0	3.5 to 6.5	0.0 to 20.0	5.0 to 25.0	0.0 to 30.0	10.0 to 20.0

f: forecasts; * Dividends included; ** Negative = appreciation and positive = depreciation.
Sources: Datastream and Desjardins, Economic Studies