

Retail Rate Forecasts

April 24, 2009

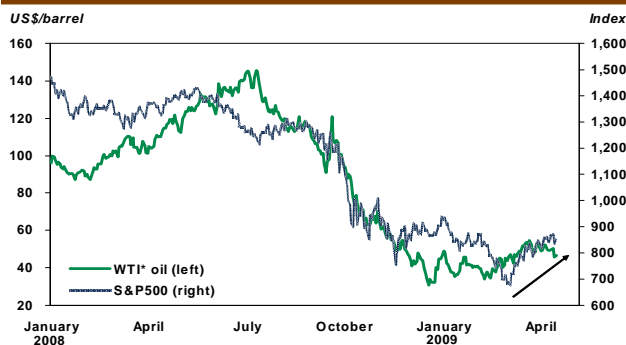
Finally some good news, but caution is in order

HIGHLIGHTS

- Hope of a stabilization of the global economy and financial system is bolstering investor optimism.
- The Bank of Canada commits to keeping its key interest rate at 0.25% until June 2010.
- The decline in retail rates is coming to an end, but no upturn is likely to occur before the end of the year.
- The possible adoption of a quantitative policy could rock the Canadian dollar temporarily.
- The stock markets' rebound is impressive, but the potential for any further increases is limited in the short term.

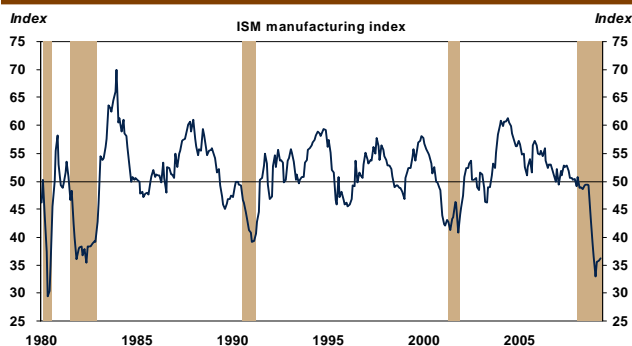
- **A wave of optimism rippled through the financial markets.** The overall gloom and doom and concerns of a worldwide depression that have held sway since the beginning of the year have since early March given way to hope for an economic recovery. Thus, investors developed an appetite for risk, resulting in a significant rebound in stock markets and commodity prices (graph 1).
- **Hope for the U.S. banking system.** The release of detailed information on the U.S. plan to solve the problem of toxic assets held by financial institutions and the return of several major banks to profitability in Q1 contributed largely to the markets' rebound. The impact of the recession on the quality of loans however, still represents a major risk to the financial system.
- **The global recession continues, but some less-negative signs are being seen.** The recent renewed optimism was also supported by better-than-expected economic results. However, the figures indicate that activity is still falling in the industrialized countries, and increases in some indicators only signal a less severe drop (graph 2). One exception is China where some signs of a recovery have been seen for a few weeks now.
- **The Bank of Canada (BoC) cut its key interest rate by yet another 0.25% in April (graph 3 on page 2).** In addition, the BoC has committed to maintaining its overnight target rate at its low point of 0.25% until mid-2010. In doing so, the BoC seeks to ensure that long-term rates will remain low, a condition required to kick-start the economy. Now that rate cuts are behind us, the door is open for more non-traditional measures to support the economy and make sure inflation does not fall below the 2% target for too long.

Graph 1 – Commodities and stock markets regained some lost lustre these past few weeks



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

Graph 2 – ISM index stabilizes in the U.S., but points to continued decline



Sources: Institute for Supply Management and Desjardins, Economic Studies

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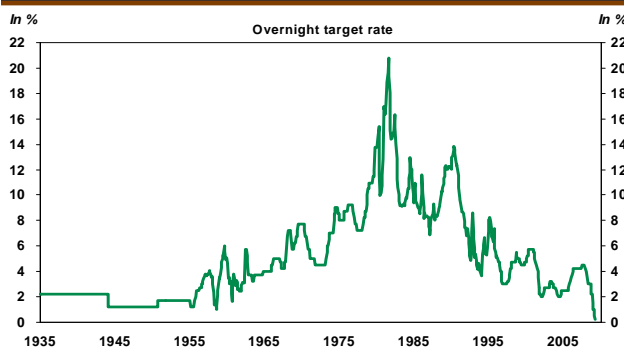
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NOTE TO READERS: The letters **K**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

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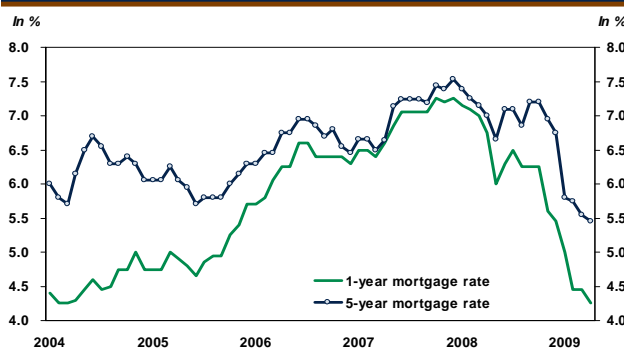
- **Bond rates are stagnating.** After falling to levels not seen in decades at the end of 2008—and rebounding in January—federal bond rates on both sides of the border have stabilized over the past few months. Rates for 10-year bonds have hovered between 2.50% and 3.00% in the U.S. and Canada since the end of January and could remain at these levels for quite some time.
- **Retail rates fell slightly in April.** At 4.25% for a one-year term and 5.45% for a five-year term, mortgage rates have recently fallen to historic lows (graph 4). The total decline since the beginning of the year reached 1.20% for the one-year rate and 1.30% for the five-year rate. The rates paid on term savings continued to decline as well.
- **Rate cuts are almost history.** The recent cut to Canada's key interest rate could lead to a new drop in retail rates, especially in the short term. After that, a long period of stability in key interest rates and bond rates should keep retail rates close to their lowest levels until the end of 2009. We should, however, see rates climb back up gradually sometime in 2010, as the economic context improves.

Graph 3 – BoC cuts its key interest rate to a historic low



Sources: Bank of Canada and Desjardins, Economic Studies

Graph 4 – Drop in mortgage rates appears very advanced



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								
October 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. 2008	1.75	3.50	5.45	6.20	6.75	1.20	2.25	2.60
January 2009	1.25	3.00	5.00	5.75	5.80	1.15	1.90	2.20
Feb. 2009	1.25	3.00	4.45	5.50	5.75	1.00	1.90	2.20
March 2009	0.75	2.50	4.45	4.95	5.55	0.50	1.80	2.20
April 23, 2009	0.50	2.25	4.25	4.75	5.45	0.40	1.60	2.00
Forecasts – End of quarter								
2009: Q2	0.50	2.25	3.95–4.25	4.45–4.75	5.15–5.45	0.15–0.40	1.25–1.60	1.65–2.00
2009: Q3	0.50	2.25	3.85–4.35	4.35–4.85	5.15–5.65	0.15–0.65	1.25–1.75	1.65–2.15
2009: Q4	0.50	2.25	3.85–4.35	4.35–4.85	5.15–5.65	0.15–0.65	1.25–1.75	1.65–2.15
2010: Q1	0.50	2.25	3.95–4.45	4.40–4.90	5.30–5.80	0.20–0.70	1.40–1.90	1.75–2.25
2010: Q2	0.50	2.25	4.10–4.60	4.60–5.10	5.50–6.00	0.30–0.80	1.50–2.00	1.80–2.30
2010: Q3	0.50–0.75	2.25–2.50	4.10–4.60	4.70–5.20	5.55–6.05	0.40–0.90	1.60–2.10	1.85–2.35
2010: Q4	0.50–1.00	2.25–2.75	4.20–4.70	4.90–5.40	5.75–6.25	0.45–0.95	1.70–2.20	2.05–2.55

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

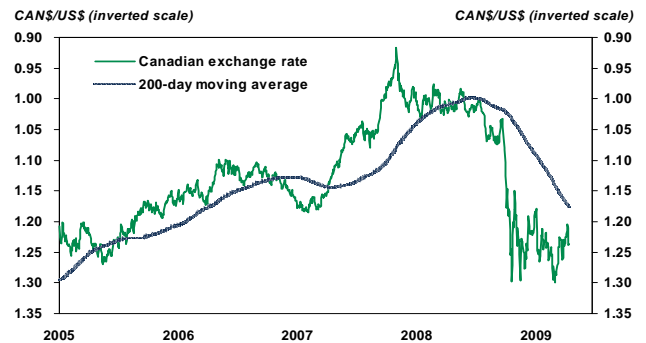
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

The possible adoption of a quantitative policy could rock the Canadian dollar temporarily

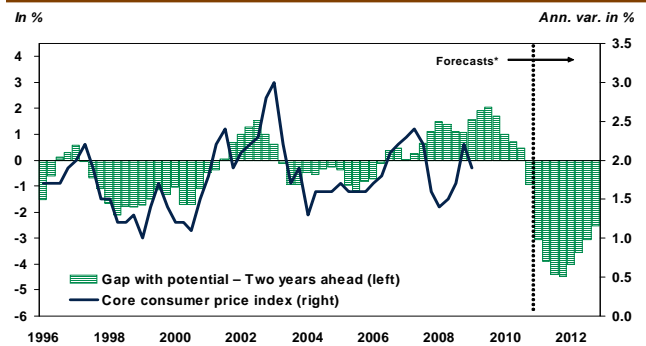
- The Canadian dollar has delivered an exemplary performance in the last few weeks. The USD/CAD pair went from a peak of C\$1.3065 on March 9 to almost C\$1.20 recently, the loonie gaining 8.5% in just over a month (graph 5). This partially reflects the greenback's spontaneous correction in mid-March and, in particular, the gradual rise in oil prices from a recent low at US\$33.55 a barrel on February 12 to over US\$50 lately.
- Overall, the economy's fundamentals are unfavourable to the loonie. Manufacturing shipments are freefalling; the merchandise trade balance is now in a deficit position for the first time since 1976; and the labour market has deteriorated at an average of 71,000 jobs a month from its October 2008 peak.
- Due to the rapid deterioration in the global and Canadian economic context, and with no inflation pressure, the Bank of Canada (BoC) cut its key interest rate by 25 basis points to a historic low of only 0.25% on April 21, 2009. At the same time, the BoC announced that the rates would remain at this level until mid-2010.
- Our estimates for Canada's economic growth indicate that the BoC works is not done. The substantial increase in the output gap may be difficult to close in the coming years. The surplus supply will keep downside pressure on prices and, although we are not anticipating any ex-energy deflation, there is a risk that the inflation target (2%) may not be met over the medium range. Under the circumstances, our monetary indicators show that the BoC will have to adopt a quantitative policy as soon as possible.
- **Forecasts:** In the short term, the Canadian dollar is at risk. Adopting a quantitative policy could temporarily make the USD/CAD pair approach C\$1.30. Consolidating commodity prices should allow it to avoid the worst but, due to the widespread economic downturn, we must remain cautious.

Graph 5 – Canadian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

Graph 6 – Downward pressures on inflation to grow in Canada



* As of Q4 2010.
Sources: Statistics Canada and Desjardins, Economic Studies

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

Table 2
Forecasts: currency

End of period	2008		2009				2010			
	Q3	Q4	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US\$/CAN\$	0.9407	0.8204	0.7918	0.8000	0.8600	0.8800	0.9000	0.9200	0.9500	1.0000
CAN\$/US\$	1.0630	1.2189	1.2630	1.2500	1.1628	1.1364	1.1111	1.0870	1.0526	1.0000
CAN\$/€	1.4931	1.6943	1.6769	1.5750	1.4884	1.4773	1.4722	1.4761	1.4642	1.4240
US\$/€	1.4047	1.3901	1.3277	1.2600	1.2800	1.3000	1.3250	1.3580	1.3910	1.4240
US\$/£	1.7825	1.4378	1.4334	1.4500	1.5500	1.6000	1.6500	1.7000	1.7500	1.8000

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

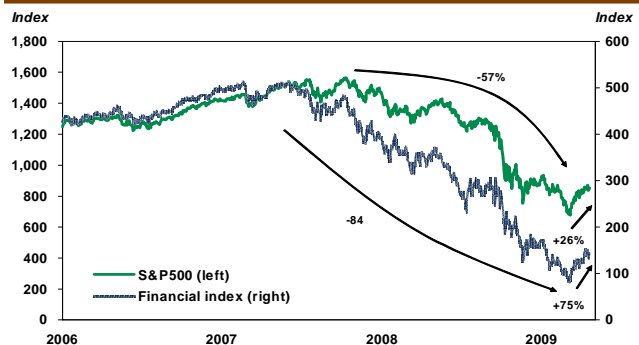
f: forecasts

ASSET CLASSES RETURN

Will stock markets be able to consolidate their gains?

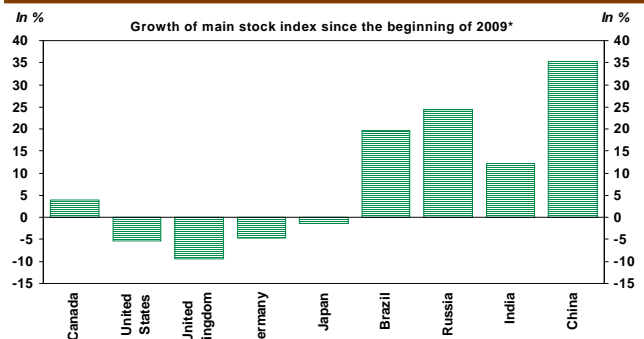
- Stock markets continued to recover.** After hitting a low point not seen for several years at the beginning of March, stock markets posted an impressive recovery. A levelling-off of some concerns regarding the health of the finance sector contributed greatly to this rebound (graph 7) while several U.S. banks returned to profitability in Q1. Most North American stock markets posted increases of more than 25% since early March, which saw Canada's stock market top its start of the year level.
- Corporate profits are still under pressure.** Several corporations announced Q1 results that were slightly above analysts' forecasts. It must be said however that the market had extremely weak expectations and that certain temporary factors, like significant gains from the rescue of AIG, pumped up the results of some companies. The economic environment remains very difficult and we are almost assured that North American companies will post significant profit declines in 2009.
- Stock markets in emerging countries are on fire.** After the spectacular meltdown in the second half of 2008, the emerging exchanges profited handsomely from the recent drop and investors' aversion to risk, especially China, where the exchange has soared by 35% since the beginning of the year (graph 8). China is profiting from signs that the plan to kick-start that country's economy is starting to work.
- Prices for industrial commodities are up sharply.** The newfound optimism among investors and hope for stabilization in the global economy—or even a recovery in China—also gave a boost to commodities. Oil prices rose temporarily to close to US\$55, a peak since November 2008 (graph 9), while several base metals saw their prices rise by more than 20%. In contrast, this did not bode well for gold prices, as investors stayed away from safe haven assets.
- Bond rates could remain relatively stable for several months (graph 10 on page 5).** On one hand, the weak economy, low inflationary pressures and the efforts of central banks will limit any rate hikes. On the other hand, massive new bond issues to finance public deficits will continue to weigh on investors' minds, making any return to the low point reached at the end of 2008 unlikely.
- The gradual tightening of rate spreads could bode well for the bond market.** The low interest rates paid by federal bonds and the limited rate reductions expected this year are not signalling high returns for Canada's bond market. Provincial and corporate bonds could however benefit from a gradual softening of financial tensions in the coming quarters.

Graph 7 – Stock market rebound depends on the financial sector



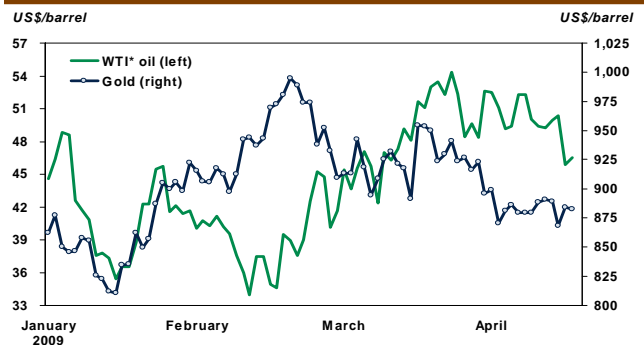
Sources: Datastream and Desjardins, Economic Studies

Graph 8 – Emerging exchanges stand apart



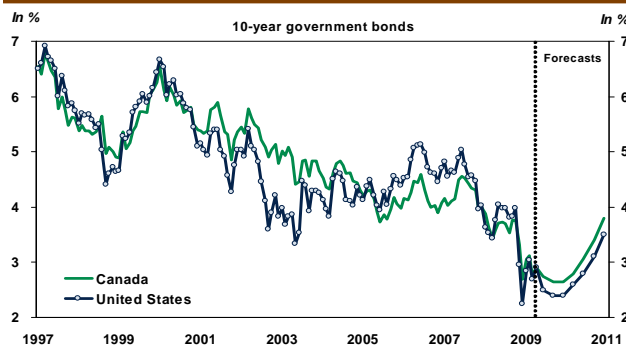
* In national currencies.
Sources: Bloomberg and Desjardins, Economic Studies

Graph 9 – Oil prices rose while gold prices deflated

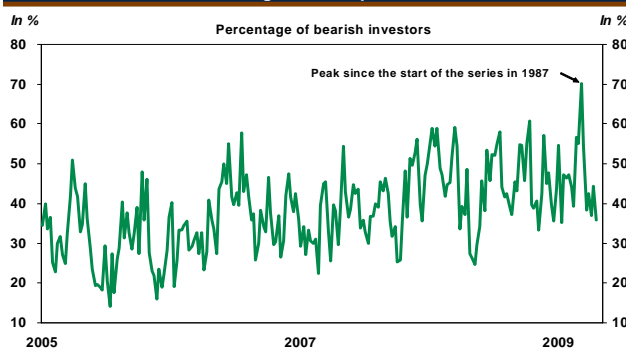


* West Texas Intermediate.
Sources: Datastream and Desjardins, Economic Studies

- **Investor optimism will surely be tested.** The quick rebound of stock markets and commodity prices now seems somewhat stretched. It would be very surprising if other large increases were posted in the very short term since we are still facing very serious economic difficulties, despite a few encouraging signs. Investors must therefore be ready for more bad news. Nonetheless, we can hope the markets are entering a consolidation phase that will succeed in keeping them above their cyclical lows. In fact, the stock market levels at the beginning of March reflected extreme investor pessimism, which we hope will not be repeated in the short term (graph 11).
- **We are generally maintaining our return forecasts.** The recent rebound in stock markets has not led us to revise our return outlooks for 2009 in any meaningful way. Market indexes will fluctuate at close to current levels over the next few months and could start to trend upward by the end of the year as signs of an economic recovery, however moderate, will become more obvious. Our target for stock market gains—5% in the U.S. and 10% in Canada, since we expect prices for raw materials to strengthen somewhat—seems realistic. In the current context, sharp movements could continue to affect financial markets over the next few quarters, which increases the uncertainty of our forecasts.

Graph 10 – Bond rates should remain close to current levels for several quarters


Sources: Datastream and Desjardins, Economic Studies

Graph 11 – Stock markets hit lowest levels in early March, reflecting extreme pessimism


Sources: American Association of Individual Investors and Desjardins, Economic Studies

**Table 3
Asset classes return**

End of year	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
2008	2.30	6.40	-33.00	-37.00	-43.10	22.10
2009f range	target: 0.4 0.2 to 0.6	target: 4.5 2.5 to 6.5	target: 10.0 -5.0 to 15.0	target: 5.0 -10.0 to 10.0	target: 2.0 -12.0 to 12.0	target: -6.8 (US\$0.88) -13.6 to 2.6

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

Sources: Datastream and Desjardins, Economic Studies