Retail Rate Forecasts

Desjardins Economic Studies

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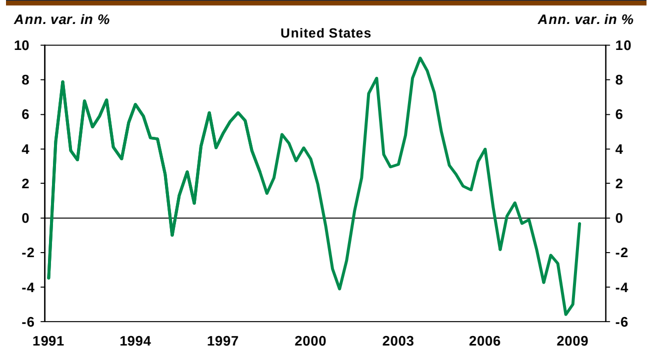
Mortgage rates should not rise too much

Highlights

- Market sentiment continues to improve with proliferating signs that the recession will be over soon.
- The economic recovery should be a modest one, however, which will prompt banks to keep their key rates close to zero.
- Bond rates have shot up, leading to an increase in long-term mortgage rates.
- The overall context remains favourable to an appreciation of the loonie.
- The stock markets' up trend is well underway, but a temporary correction is likely in the near term.

- **Optimism has kept rising.** The release of a number of economic statistics that beat expectations bolstered hopes that the worst of the global recession is now behind us. The recession continues for the moment, but economic activity could return to growth this fall (graph 1).
- **The financial environment is still improving.** Authorities have finally managed to calm the widespread fears many international financial institutions would go bankrupt or be nationalized. The financing premiums demanded to the major banks have thus come back close to where they were before the Lehman Brothers bankruptcy. Another clear sign that the financial environment is getting better is the fact that the VIX index has improved. This index calculates the U.S. stock market's implicit volatility (graph 2).
- **The economy's recovery could be modest.** While the global recession should soon be over, this does not mean that North America's economies are set to blast off for strong economic growth. Instead, we anticipate modest growth for several quarters, especially in the United States, where consumption will remain very low.
- **The Bank of Canada kept its key rate at 0.25%.** The recent improvement in economic and financial conditions has, to date, persuaded the Bank not to use additional non-traditional measures like the ones the Federal Reserve (Fed) has instituted. However, Canada's economy is still in poor shape and will continue to need a solid dose of monetary stimulus, since inflation could move well below the 2% target in the coming months.

Graph 1 – The leading indicator signals the end to the economy's deterioration



Sources: Conference Board and Desjardins, Economic Studies

Graph 2 – Financial strains are resolving

Sources: Datastream and Desjardins, Economic Studies

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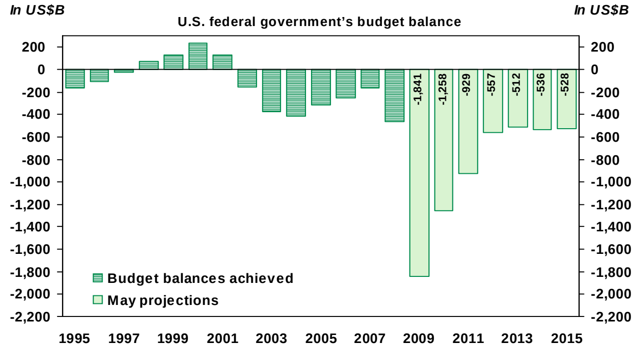
Note to readers: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

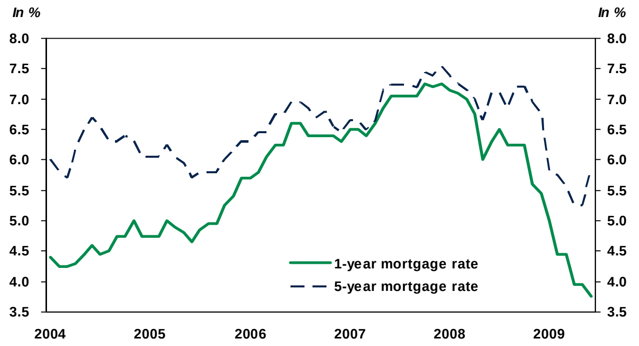
- **Bond rates have climbed substantially.** Investors' renewed risk appetite and the deterioration in governments' fiscal situations have pummelled the bond market in the last few months. U.S. bond rates have shot up, especially in the long portion of the curve, as the government must make repeated emissions to finance its deficit (graph 3). Canadian rates followed the same trend, with a less spectacular surge. On both sides of the border, bond rates are still very low, however, historically speaking.
- **First rise of mortgage rates since the fall of 2008.** Although financial strains have waned and credit spreads have narrowed, the recent increase in bond rates has prompted financial institutions to raise long-term mortgage rates. The five-year rate has thus gone from a historic low of 5.25% to 5.85% in early June, while the one-year rate has been reduced 20 basis poins (graph 4). The rate paid on savings for a five-year term has also come up slightly.
- **Retail rates will remain low.** Although the worst of the recession is over, the economic situation is still very difficult and inflation pressures will remain weak for several quarters. The climate does not favour another increase in long-term bond rates; a pullback is even likely if the Fed decides to ease monetary conditions further. Mortgage rates should therefore stay close to where they are now for several months, although further slight increases cannot be ruled out.

Graph 3 – The precariousness of the U.S. public finances is hurting the bond market



Sources: Office of Management and Budget and Desjardins, Economic Studies

Graph 4 – Long-term mortgage rates did not stay at their low for long



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								
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 2009	0.50	2.25	3.95	4.15	5.25	0.40	1.60	2.00
May 2009	0.50	2.25	3.95	4.15	5.25	0.40	1.60	1.90
June 15, 2009	0.50	2.25	3.75	4.65	5.85	0.40	1.60	2.00
Forecasts – End of quarter								
2009: Q2	0.50	2.25	3.60–3.90	4.50–4.80	5.70–6.00	0.20–0.60	1.45–1.75	1.85–2.15
2009: Q3	0.50	2.25	3.50–4.00	4.35–4.85	5.55–6.05	0.15–0.65	1.30–1.80	1.70–2.20
2009: Q4	0.50	2.25	3.50–4.00	4.30–4.80	5.55–6.05	0.15–0.65	1.35–1.85	1.75–2.25
2010: Q1	0.50	2.25	3.55–4.05	4.40–4.90	5.85–6.35	0.20–0.70	1.40–1.90	2.10–2.60
2010: Q2	0.50–0.75	2.25–2.50	3.70–4.20	4.80–5.30	6.15–6.65	0.35–0.85	1.75–2.25	2.45–2.95
2010: Q3	0.50–1.00	2.25–2.75	4.00–4.50	5.05–5.55	6.40–6.90	0.65–1.15	1.95–2.45	2.70–3.20
2010: Q4	1.00–1.50	2.75–3.25	4.40–4.90	5.40–5.90	6.55–7.05	1.05–1.55	2.25–2.75	2.85–3.35

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

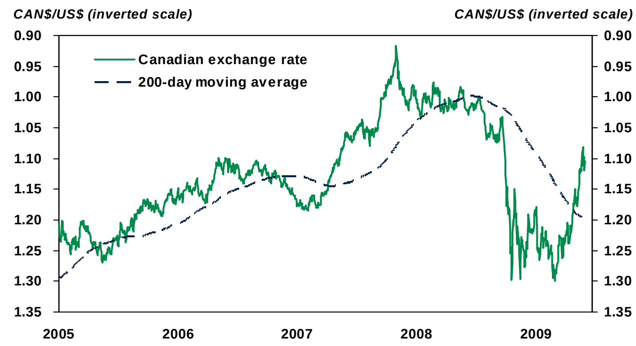
Desjardins Economic Studies

CANADIAN DOLLAR

Canadian dollar parity is not sustainable before 2010

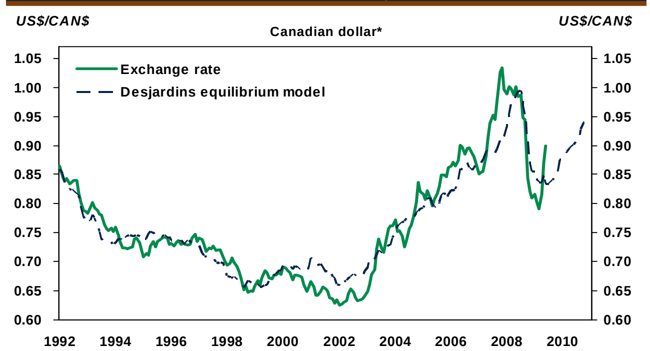
- Among the currencies, those whose movements are tied to commodity prices have benefited the most from the renewed appetite for risk. The Canadian dollar is no exception. With the big surge in metal and oil prices, the loonie appreciated by almost 20%, driving the USD/CAD pair from C$1.3065 in early March to a low of C$1.0784 in June (graph 5).
- If the recent rise of commodity prices continues, there is nothing to keep currency traders from pushing the loonie toward parity. However, the Canadian dollar's recent appreciation is not in line with fundamentals, and parity will not last unless oil is over US$90 for a long time. For now, hopes of an economic recovery have prompted markets to drive prices upward, but the current crude oil prices do not reflect the balance between supply and demand.
- Moreover, with the deterioration in the trade balance and public finances, the edge Canada once had is visibly crumbling. The worst of the recession does appear to be behind us, but the economic recovery promises to be modest at best and the skyrocketing loonie could offset the benefits of the increase in natural resource prices for Canada's economy.
- Under these circumstances, monetary policy will not be a major support for the currency in the next few months. The Bank of Canada (BoC), which has demonstrated its concern about how quickly the loonie is appreciating, repeated that it was committed to keeping interest rates at 0.25% until June 2010, as long as its inflation scenario materializes. However, the loonie's recent surge is one more risk that the BoC will have to downgrade its projection.
- **Forecasts:** The dollar could appreciate further in the very near term, but the realization that the economic recovery will be modest should soon put an end to its surge. Lasting parity with the greenback should not be achieved until 2010 (graph 6).

Graph 5 – Canadian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

Graph 6 – Our model calls for the loonie to climb slowly over the next two years



* Monthly average.
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	Q4	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0.9407	0.8204	0.7918	0.8800	0.9000	0.9300	0.9300	0.9500	1.0000	1.0000
CAN$/US$	1.0630	1.2189	1.2630	1.1364	1.1111	1.0753	1.0753	1.0526	1.0000	1.0000
CAN$/€	1.4931	1.6943	1.6769	1.5909	1.6000	1.5269	1.5054	1.4737	1.3800	1.3600
US$/€	1.4047	1.3901	1.3277	1.4000	1.4400	1.4200	1.4000	1.4000	1.3800	1.3600
US$/£	1.7825	1.4378	1.4334	1.6000	1.6500	1.6500	1.6500	1.6500	1.7000	1.7500

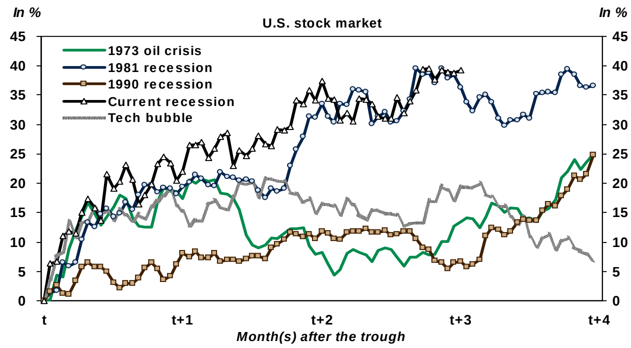
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies f: forecasts

ASSET CLASSES RETURN

Can the stock markets consolidate their gains?

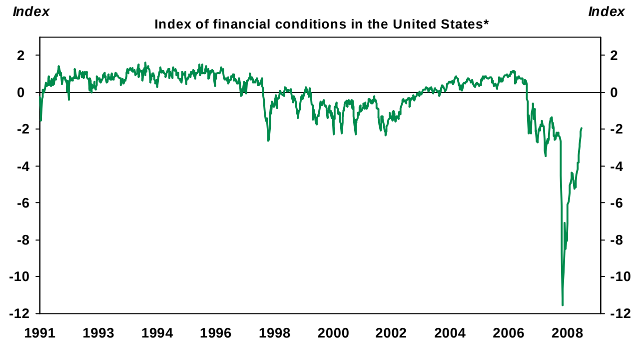
- **The stock markets have made a spectacular comeback since early March.** North American indexes continued to rise in the last few weeks, with optimism still blowing through the markets. From its low on March 6, the U.S. S&P500 index has jumped over 35%, swinging back to about 5% below where it was at the end of 2008. A similar movement of the Canadian stock market put it more than 15% over where it started the year. The size of the indexes' rebound is impressive and compares well with the spectacular recovery that followed the recession of the early 80s (graph 7).
- **The comeback of the indexes is mainly due to easing financial strains.** A shift from extreme risk aversion to moderate optimism in the markets is benefiting all risky financial assets and justifies the indexes' quick surge (graph 8). The radical swing in investors' mood was especially good for emerging markets. For example, China's stock market has advanced by more than 50% since the year started.
- **The profit outlook is still fairly weak.** After posting a first loss at the end of 2008, the firms that make up the S&P 500 recorded positive though weak profits in Q1 of 2009. The modest recovery in economic activity and deep structural changes that have struck the financial industry could limit the increase in earnings for several more quarters.
- **Commodities are also capitalizing on the improvement in the economic and financial context.** Hopes of economic recovery, especially in China, and the weak U.S. dollar have allowed raw material prices to keep rising. Oil prices thus bounced just over US$70 a barrel in the last few days. Global oil demand is still very low (graph 9), however, which, combined with large inventories, limits the potential for further appreciation in the short run.
- **A temporary correction is likely in the near term.** Investors seem to be increasingly expecting a V-shaped recovery. Hopes of a lively recovery could be dashed, however, which would lead to a temporary correction by the stock indexes and prices for commodities. Their values should still remain well above their cyclical lows, however, as another surge in financial tension is not expected.
- **Interest rates will stay low for several more months.** Although the markets appear to be starting to worry about a potential surge in inflation, for monetary authorities, deflation will remain the biggest risk, given the substantial economic potential that is not being used (graph 10). The Federal Reserve and Bank of Canada could gradually change their stances, but they should not initiate monetary firming until mid-2010 (graph 11). These factors should also keep rates on federal bonds relatively low.

Graph 7 – The stock market rebound is similar to the rebound of the 1981 recession



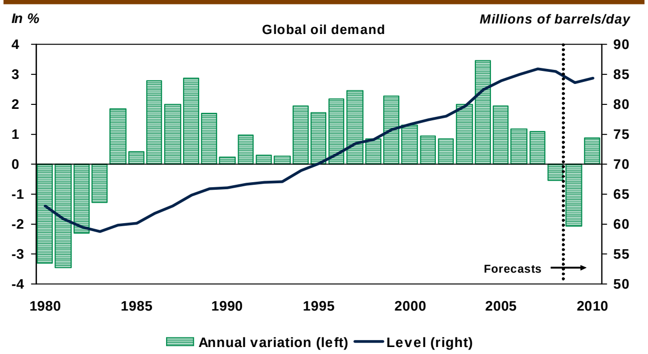
Sources: Datastream and Desjardins, Economic Studies

Graph 8 – Financial conditions are still improving substantially



* Based on interest rate spreads, the money market, the stock market, normalized to 0.
Sources: Bloomberg and Desjardins, Economic Studies

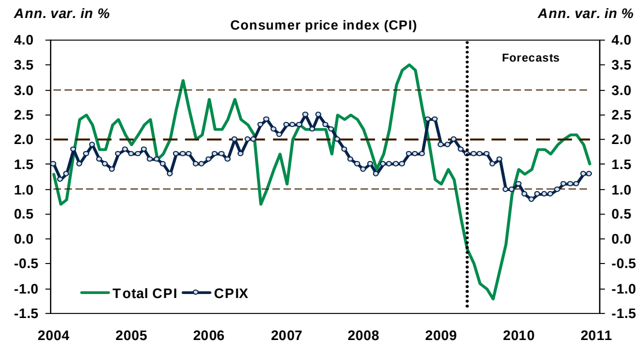
Graph 9 – The drop in oil demand should curb the price's rise



Sources: Datastream, Energy Information Administration and Desjardins, Economic Studies

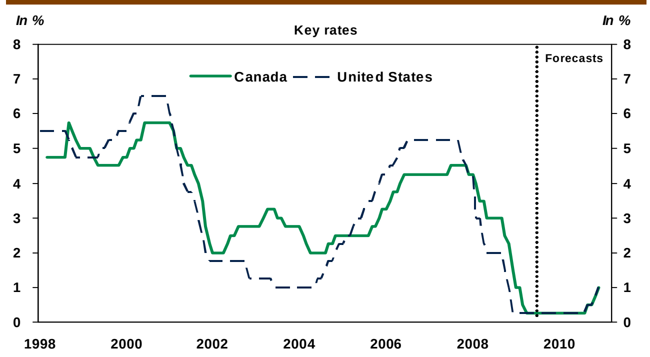
- **A number of crosswinds are affecting the Canadian bond market.** Despite the difficulties of federal bonds, the Canadian bond market has been up slightly since the year began. The rapidly narrowing credit spreads have really benefited corporate bonds and provincial securities. These trends could continue for a while; we thus expect a modest return of about 3% in 2009 and 2010.
- **A very good year for the Canadian stock market.** The fact that the conditions for a true bull market have been achieved a little more quickly than expected, and given the indexes' spectacular rebound in the last few weeks, we are raising our stock market targets for 2009. Although a slight downswing is likely in the very near term, the medium-range up trend seems to be in place and the Canadian stock market should end the year up, including dividends, about 22%, compared with 10% for the U.S. market.

Graph 10 – Temporary deflation is expected in Canada



Sources: Statistics Canada and Desjardins, Economic Studies

Graph 11 – Key rates will stay at this floor for a long time



Sources: Datastream and Desjardins, Economic Studies

Table 3
Asset classes return

	Cash	*Bonds*	*Canadian stocks*	*U.S. stocks*	*International stocks*	*Exchange rate*
End of year	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: 0.3 0.2 to 0.5	target: 3.0 1.0 to 5.0	target: 22.0 10.0 to 30.0	target: 10.0 -5.0 to 20.0	target: 15.0 5.0 to 25.0	target: -11.8 (US$0.93) -13.6 to 2.6
2010f range	target: 0.5 0.3 to 0.8	target: 3.0 1.0 to 5.0	target: 13.0 5.0 to 20.0	target: 16.0 5.0 to 25.0	target: 18.0 5.0 to 25.0	target: -7.0 (US$1.00) -15.4 to 3.3

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