

Retail Rate Forecasts

September 17, 2009

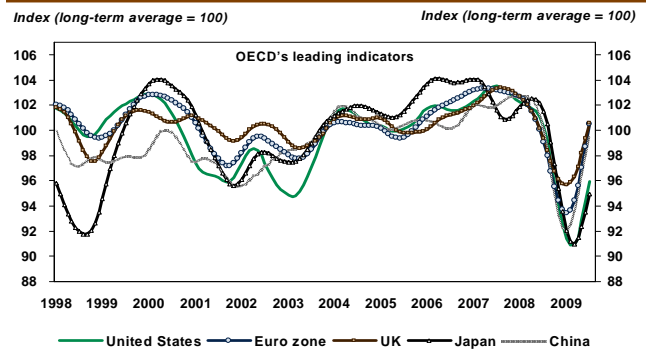
Surprise drop in mortgage rates

HIGHLIGHTS

- The recession is over or drawing to a close around the world, but the recovery could be lacklustre.
- The Bank of Canada shouldn't raise its key rate before the second half of 2010.
- The context continues to favour the loonie.
- Stock markets have thus far shrugged off concerns of a correction and should continue their current thrust into 2010.
- The recent drop in mortgage rates confirms that increases in retail rates, inevitable during an economic recovery, will begin mostly as of 2010.

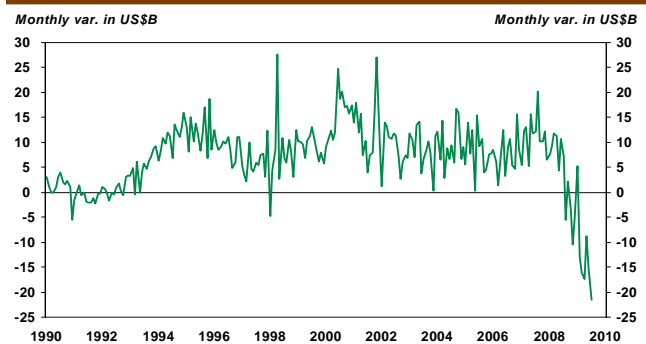
- **The economic recovery is starting to take root.** Encouraging economic statistics have been published around the world in the past few weeks. Consumer and business confidence indexes and leading indicators in particular have posted undeniable improvements (graph 1). Real GDP advanced in France, Germany and Japan in the second quarter, and it appears as though the recession is now over in the United States as well.
- **The recovery could be lacklustre.** Even though the economic and financial situation has obviously improved in the past few months, it would be foolish to think that every problem has been resolved. For example, the deterioration of balance sheets in households, international financial institutions and governments will require further painful adjustments in the quarters to come (graph 2). The return of economic growth relies heavily on unprecedented fiscal and monetary policies, and the private economy does not seem ready yet to fend for itself.
- **The recovery could be delayed in Canada.** Economic conditions are improving across the country. Consumption has started to grow again and the real estate market is looking better. Some adjustments, including the reduction of business inventories and deterioration of the foreign trade balance will continue however, reining in real GDP growth.
- **The Bank of Canada (BoC) is optimistic, but prudent.** For a third consecutive meeting, the BoC kept its key interest rate at 0.25% on September 10. It also reaffirmed its commitment to keeping it at that floor level until the end of June 2010, conditional to its inflation forecast.

Graph 1 – OECD's leading indicators continue to climb



Sources: Organisation for Economic Co-operation and Development and Desjardins, Economic Studies

Graph 2 – Outstanding consumer credit in the United States is contracting at an alarming pace



Sources: Federal Reserve Board and Desjardins, Economic Studies

François Dupuis
Vice-President and Chief Economist

Yves St-Maurice
Director and Deputy Chief Economist

Mathieu D'Anjou
Senior Economist

Martin Lefebvre
Senior Economist

Hendrix Vachon
Economist

514-281-2336 or 1 866 866-7000, ext. 2336
E-mail: desjardins.economics@desjardins.com

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

IMPORTANT: This document is based on public information, obtained from sources that are deemed to be reliable. Desjardins Group in no way guarantees that the information is complete or accurate. The document is provided solely for information purposes and does not constitute an offer or solicitation for purchase or sale. The document may under no circumstances be construed as a commitment by Desjardins Group, which takes no responsibility for the consequences of any decision made based on the information herein. The prices and rates shown are for information purposes only as they may change at any time based on market conditions. Past returns are no guarantee of future performance, and Desjardins Group does not hereby purport to provide any investment advice. The opinions and forecasts contained herein are, unless otherwise indicated, those of the document's authors and do not represent the official position of Desjardins Group. Copyright © 2009, Desjardins Group. All rights reserved.

- **No FX intervention.** Given the recent improvement in economic and financial conditions, the idea of resorting to further unconventional stimuli is now wishful thinking. Using them to intervene on the exchange rate would be even more unwise, especially since the BoC's optimism seems once again to be on the upswing; despite the loonie being stronger than it was when the BoC issued its last assessment in July, the Bank now anticipates that recent developments may herald faster growth than expected in the second half of this year.
- **Bond rates remain very weak.** Despite the good news regarding economic statistics and sharp stock market advances, investors continue to show caution. Demand for government bonds is very high, allowing governments to finance their significant deficits at low prices. The absence of inflation pressures is also contributing to maintaining low bond rates (graph 3).
- **Good news for borrowers.** Very low bond rates and easing financial tensions allowed Canada's financial institutions to announce mortgage rates cuts at the start of September (graph 4). The fixed mortgage rate for five-year terms therefore fell from 5.85% to 5.50%, while the one-year rate fell by 25 points to 3.50%. Most of the term savings rates remained stable, but the five-year rate climbed 10 basis points in August.
- **Few increases in retail rates before 2010.** The recent drop in mortgage rates confirms that increases in retail rates, inevitable during an economic recovery, will begin mostly as of 2010. We can expect rates to stay very close to current levels until the end of 2009.

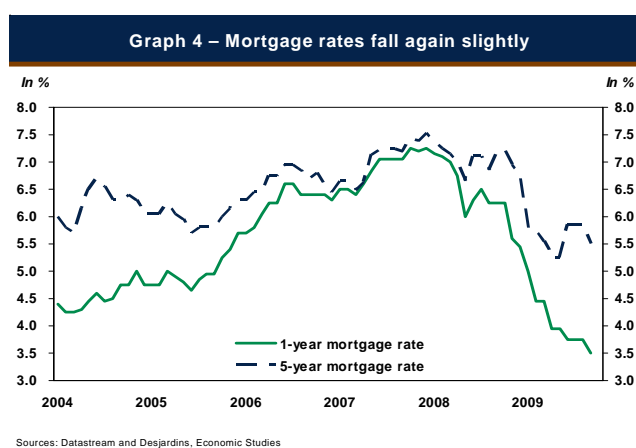
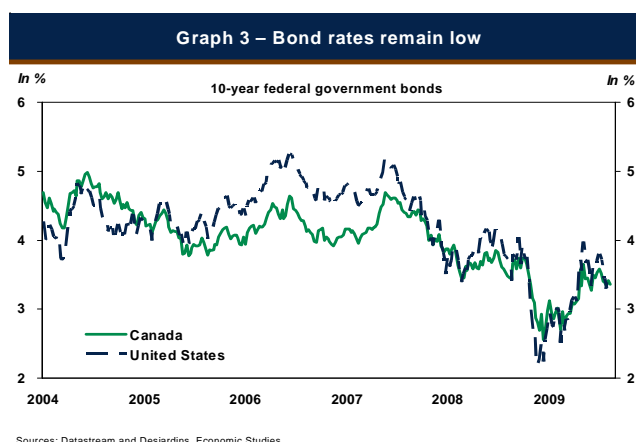


Table 1
Forecasts : Retail rate

	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 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 2009	0.50	2.25	3.75	4.65	5.85	0.40	1.60	2.00
July 2009	0.50	2.25	3.75	4.65	5.85	0.40	1.60	2.00
August 2009	0.50	2.25	3.75	4.65	5.85	0.40	1.60	2.10
Sep. 17, 2009	0.50	2.25	3.50	4.35	5.50	0.40	1.60	2.10
Forecasts – End of quarter								
2009: Q3	0.50	2.25	3.25–3.75	4.10–4.60	5.25–5.75	0.15–0.65	1.35–1.85	1.85–2.35
2009: Q4	0.50	2.25	3.25–3.75	4.15–4.65	5.30–5.80	0.15–0.65	1.35–1.85	1.90–2.40
2010: Q1	0.50–0.75	2.25–2.50	3.30–3.80	4.30–4.80	5.55–6.05	0.25–0.75	1.45–1.95	2.15–2.65
2010: Q2	0.50–1.00	2.25–2.75	3.55–4.05	4.75–5.25	6.00–6.50	0.55–1.05	1.90–2.40	2.60–3.10
2010: Q3	0.50–1.00	2.25–2.75	3.90–4.40	5.20–5.70	6.20–6.70	0.85–1.35	2.35–2.85	2.80–3.30
2010: Q4	1.00–1.50	2.75–3.25	4.30–4.80	5.45–5.95	6.25–6.75	1.15–1.65	2.60–3.10	2.90–3.40

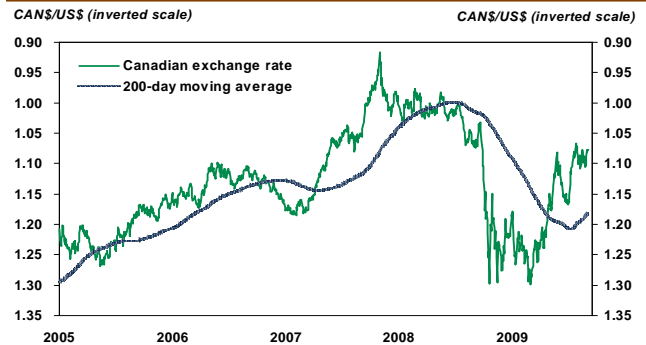
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

Environment bodes well for loonie to rise modestly

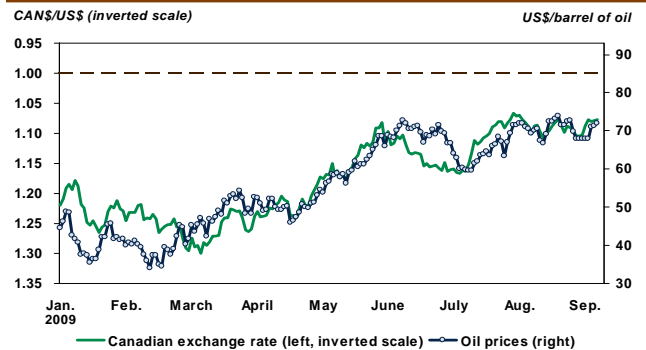
- Following a strong surge by the loonie associated with the greenback's tumble and resulting rise in commodity prices, the USD/CAD pair was stuck in a tight channel between C\$1.07 and C\$1.12, in August (graph 5). This is, in part, a reflection of the lull in the stock markets and concerns about the strength of the economic recovery. However, the Canadian dollar's rise against the greenback has continued to underperform that of the Australian dollar—another currency that is tied to commodity price movements—due to rumours regarding a Bank of Canada (BoC) intervention in the exchanges.
- If signs of recovery become concrete and the stock market keeps rallying, the loonie will continue to benefit from the renewed appetite for risk. However, we will not see lasting parity any time soon. Oil prices are struggling to climb above US\$75/barrel and, although the chances of a hurricane are allowing crude prices to go up further, the balance between supply and demand is playing against a sustained rise. Parity between the loonie and the greenback will only last once oil prices have reached approximately US\$90 a barrel over a long period (graph 6).
- Given the currency's slight appreciation, which reflects the improvement in fundamentals, the BoC is unlikely to intervene in the foreign currency markets. However, no doubt it won't try to change its message in the next few months.
- Forecasts:** The loonie should continue on a gradual upward path, with a slight chance of reaching parity with the U.S. dollar as soon as the first half of next year, although on a sustainable basis only in the second half. The euro's vitality against the greenback in the next few months will have repercussions on the EUR/CAD cross rate. However, it is expected that the loonie will recover lost grounds somewhere in the first quarter of 2010.

Graph 5 – Canadian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

Graph 6 – Oil prices have to increase further for the loonie to reach parity



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

End of period	2008		2009				2010			
	Q3	Q4	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US\$/CAN\$	0.9407	0.8204	0.7918	0.8600	0.9100	0.9400	0.9300	0.9600	1.0000	1.0000
CAN\$/US\$	1.0630	1.2189	1.2630	1.1628	1.0989	1.0638	1.0753	1.0417	1.0000	1.0000
CAN\$/€	1.4931	1.6943	1.6769	1.6309	1.5824	1.5638	1.6129	1.5000	1.4000	1.3800
US\$/€	1.4047	1.3901	1.3277	1.4027	1.4400	1.4700	1.5000	1.4400	1.4000	1.3800
US\$/£	1.7825	1.4378	1.4334	1.6469	1.6500	1.6500	1.6500	1.6500	1.7000	1.7500

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

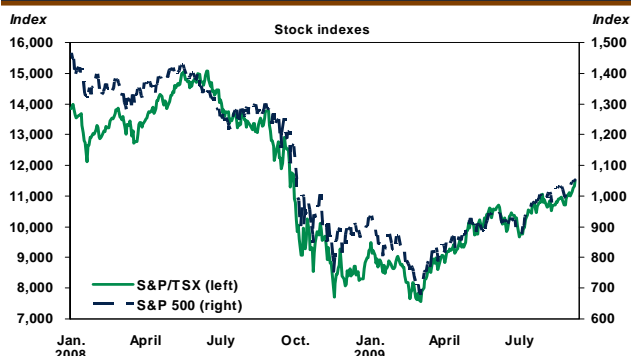
f: forecasts

ASSET CLASSES RETURN

The stock market rebound will continue in 2010

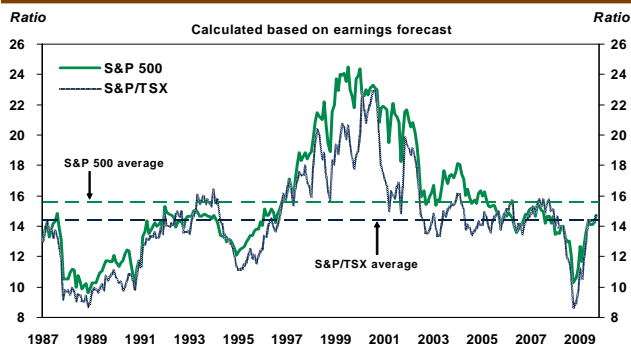
- Stock indexes continued to climb.** The S&P 500 index thus crossed back over the 1,000-point mark and is now up by about 15% from the beginning of the year and by over 50% from its low. In Canada, the S&P/TSX, which benefits from the comeback by commodity prices, is up by about 25% from the beginning of 2009 and by almost 50% since the beginning of March (graph 7).
- The upward trend should continue in the medium term.** Our stock market valuation model, which is based on profits, financial strains and interest rates, shows that, although it may seem spectacular, the markets' rise from their March low is not exaggerated. The other valuation criteria, including price/earnings ratios, send a similar message: the market is no longer strongly undervalued, but it is not showing any signs of overvaluation either (graph 8). Given an economic and financial context that should continue to slowly improve; we can therefore expect the indexes to stay on an up trend for the next few years.
- Some worrisome signs appeared in early September.** The relapse of Shanghai's Stock Market (graph 9) and concerns about a correction after the summer vacation period spiked financial tensions temporarily. After hesitating somewhat, North American stock markets continued their ascent, however.
- A number of threats are still looming over the economy and financial system.** In the United States, the number of bank failures is up sharply and this trend could worsen as the problems with commercial loans rise. This should do something to temper investor enthusiasm. Other short correction periods like the one seen at the beginning of the summer can thus be expected.
- Prices for raw materials continued to climb.** The upcoming global economic recovery and investors' renewed appetite for risk were a huge boon to raw materials. Oil prices have hovered around the US\$70 a barrel mark for a few weeks now, a more than 100% gain vs. the cyclical low of US\$31. Some industrial metals, including copper, did even better. The price of gold, which has been quite stable these past few months, jumped above US\$1,000 at the beginning of September, benefiting from some investor concerns and another drop by the greenback (graph 10). The most likely scenario calls for a consolidation in prices for raw materials, followed by gradual appreciation.
- It would be premature to expect any imminent tightening of monetary policy.** Conditional to its inflation forecast, the Bank of Canada is already committed to keeping its key interest rates at their current levels until the mid-2010 (graph 11). The employment situation and ongoing disinflation in non-energy prices should encourage the Federal Reserve to do the same.

Graph 7 – Stock markets continue their ascent



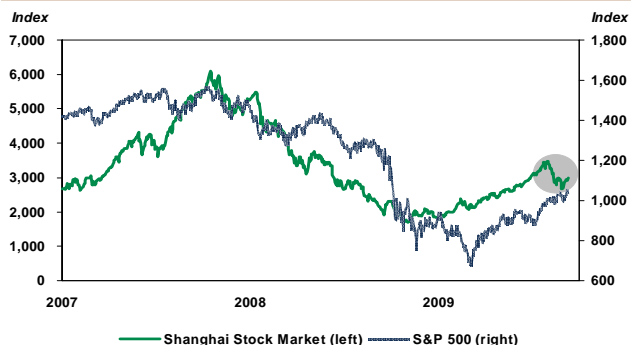
Sources: Datastream and Desjardins, Economic Studies

Graph 8 – Price/earnings ratios do not show overvaluation in North America



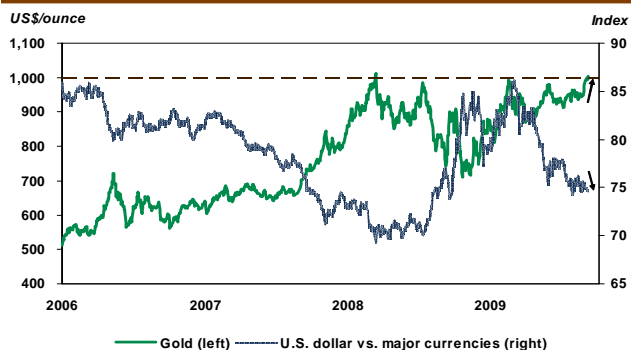
Sources: Institutional Brokers Estimate System and Desjardins, Economic Studies

Graph 9 – Relapse of Shanghai's stock market a precursor for other indexes?

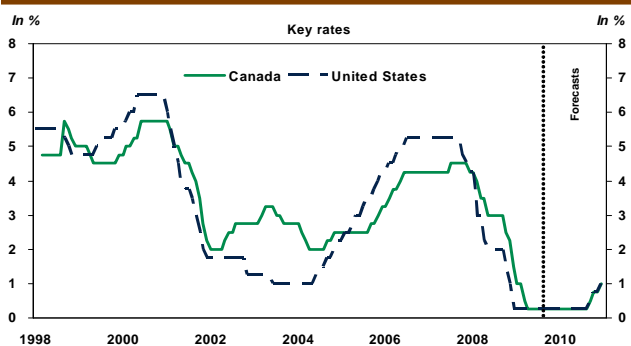


Sources: Datastream and Desjardins, Economic Studies

- **The bond market's performance is improving.** Strong demand for federal bonds, coupled with declining credit spreads for riskier bonds, means better bond performance. We now expect 2009 to close with gains of about 5% in this asset class. 2010 will be more difficult due to rising interest rates.
- **In the near term, stock market movement is surrounded by uncertainties.** A temporary correction or at least a period of consolidation seems to be the likeliest scenario for the next few months. This would make the indexes end 2009 just below where they are now. Including dividends, the S&P 500 would thus be up by an annual 12% for 2009 compared with 23% for the S&P/TSX. However, the fundamentals continue to favour stock market growth over the medium range; respective increases of 16% and 13% are forecast for the U.S. and Canadian markets in 2010. These targets may even be a bit conservative.

Graph 10 – Weak U.S. dollar helped push gold prices closer to \$1,000 per ounce


Sources: Datastream and Desjardins, Economic Studies

Graph 11 – No imminent increases in key interest rates


Sources: Datastream 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: 0.35 0.20 to 0.50	target: 5.0 3.0 to 6.0	target: 23.0 17.0 to 35.0	target: 12.0 7.0 to 27.0	target: 25.0 15.0 to 35.0	target: -12.7 (US\$0.94) -18.0 to -8.8
2010f range	target: 0.75 0.5 to 1.0	target: 2.0 0.0 to 4.0	target: 13.0 5.0 to 25.0	target: 16.0 7.0 to 27.0	target: 18.0 5.0 to 30.0	target: -6.0 (US\$1.00) -9.6 to -2.0

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

Sources: Datastream and Desjardins, Economic Studies