

Retail Rate Forecasts

October 27, 2009

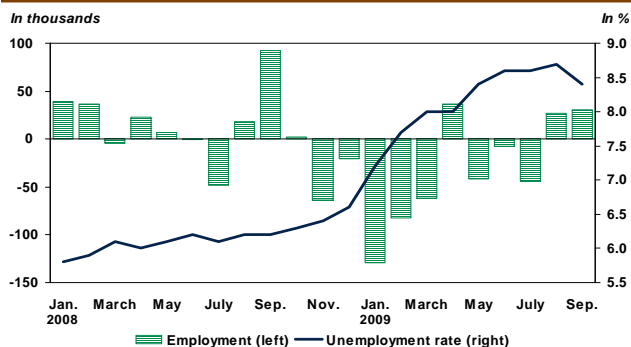
Mortgage rates continue to fluctuate up and down

HIGHLIGHTS

- The economic recovery is taking hold, but doubts remain about its scope and duration.
- The Bank of Canada reiterates its conditional commitment to keeping its key rate unchanged until mid-2010.
- The drop in mortgage rates in September was overturned in October. Rates remain very low, but a genuine ascent should begin next year.
- The loonie came just a hair away from parity.
- Stock markets continue to impress.

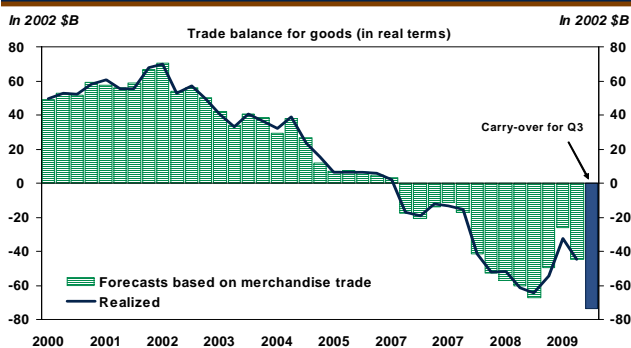
- **The economic recovery appears to be on track.** Several economic indicators continue to improve almost everywhere around the world and the recession seems to be over in most major economies. Improvements in economic conditions depend, however, on government action, especially in the United States. The many imbalances across the globe and the frailty of the financial sector still suggest that the global economic recovery will be relatively lacklustre.
- **Foreign trade's weakness is reining in Canada's economy.** Canada's domestic economy is showing encouraging signs, with a second straight month of strong job creation in September (graph 1) and the residential market rebounding sharply, almost wiping out the losses sustained during the recession. In contrast, the trade balance has suffered strong deterioration these past few months (graph 2) and a soaring loonie will keep exporters under pressure.
- **As forecast, the Bank of Canada (BoC) left its key interest rate at 0.25% in October.** The unbridled optimism shown by the monetary authorities these past few months has given way to greater caution. The Canadian dollar's strong ascent—flagged as a risk during September's meeting—is now slowing growth and inflation, to the point that the BoC believes it will more than offset the effects of positive developments seen since July.
- **The BoC reiterated its commitment to keeping its key rate unchanged until the end of Q2 2010.** Canada's economy should grow in the second half of 2009, but the recovery is still at a very early stage. With inflation (ex-energy) not much of a threat, the BoC has the leeway it needs to leave its key rate unchanged for several more months.

Graph 1 – Employment posts two consecutive increases in Canada



Sources: Statistics Canada and Desjardins, Economic Studies

Graph 2 – Will Canada's trade balance show another sharp deterioration in Q3?



Sources: Statistics Canada 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

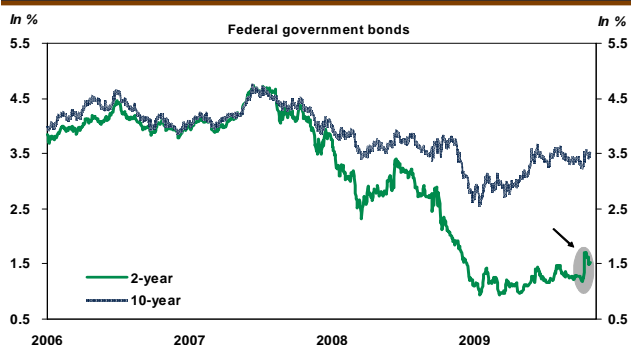
514-281-2336 or 1 866 866-7000, ext. 2336
E-mail: desjardins.economics@desjardins.com

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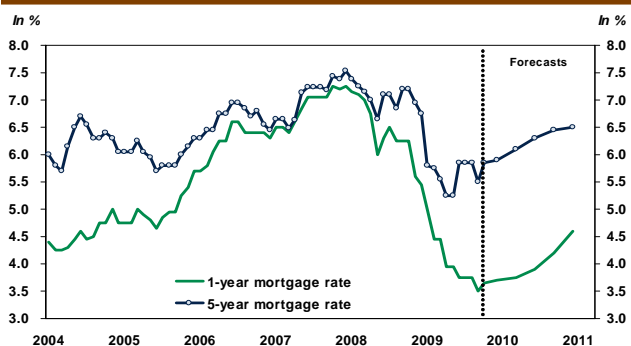
- Canadian bond rates surge in early October.** Strong job creation across the country and Australia's decision to increase its key rate had several investors convinced that Canada's monetary policy was about to be tightened. This made bond rates in Canada jump by dozens of basis points at the beginning of the month (graph 3). The BoC, however, eased expectations on monetary tightening during its meeting in October, thus allowing Canadian bond rates to retreat somewhat.
- Mortgage rates are back up.** After falling surprisingly in September, mortgage rates shifted in the opposite direction in early October. The jump in Canada's bond rates was reflected in higher financing costs for financial institutions, which in turn decided to increase their mortgage rates. The one-year rate rose from 3.50% to 3.65% while the five-year rate rose by 35 points to back to 5.85%, the rate in effect at the beginning of September. The drop in bond rates following comments made by the BoC led to a slight drop in mortgage rates at some institutions, however.
- Getting ready for a more significant increase in retail rates in 2010.** Looking past the seesaw pattern of the past few months, we have to conclude that retail rates are still very low right now. This situation is unlikely to change in the very short term since there is little announcing an increase in key rates or bond rates. However, a clear, upward trend is expected to start in spring 2010, which could see rates for a five-year term rise to about 6.50% by the end of the year (graph 4).

Graph 3 – Bond rates in Canada have been more volatile lately



Sources: Datastream and Desjardins, Economic Studies

Graph 4 – Mortgage rate increases set to accelerate next year



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								
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. 2009	0.50	2.25	3.50	4.35	5.50	0.40	1.60	2.10
Oct. 26, 2009	0.50	2.25	3.65	4.65	5.85	0.40	1.60	2.10
Forecasts – End of quarter								
2009: Q4	0.50	2.25	3.40–3.90	4.45–4.95	5.60–6.10	0.20–0.70	1.45–1.95	1.90–2.40
2010: Q1	0.50–0.75	2.25–2.50	3.55–4.05	4.65–5.05	5.80–6.30	0.40–0.90	1.65–2.05	2.15–2.65
2010: Q2	0.50–1.00	2.25–2.75	3.75–4.25	5.00–5.50	6.10–6.60	0.60–1.10	2.00–2.50	2.55–3.05
2010: Q3	0.50–1.00	2.25–2.75	4.05–4.55	5.30–5.80	6.25–6.75	0.85–1.35	2.35–2.85	2.80–3.30
2010: Q4	1.00–1.50	2.75–3.25	4.45–4.95	5.55–6.05	6.30–6.80	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).

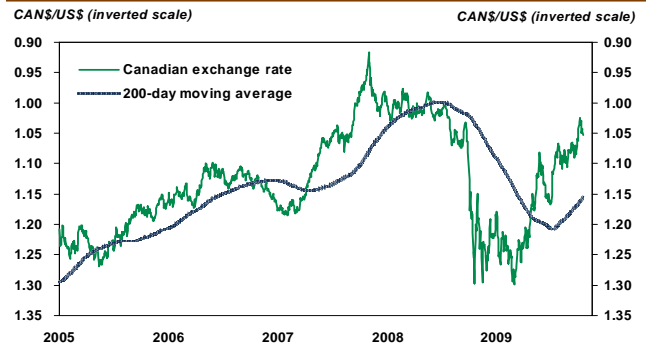
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

The loonie came just a hair away from reaching parity

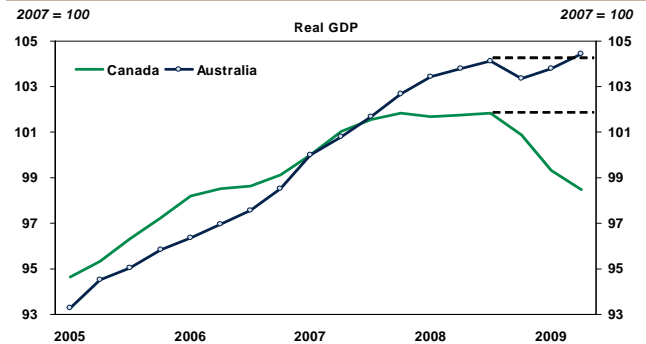
- The renewing appetite for risk that can be construed from the spectacular comeback by the main stock exchanges and commodity prices is continuing to benefit the loonie. The USD/CAD pair has continued to slide, going from about C\$1.10 in August to a low of C\$1.0207 on October 15, before recouping some of its losses in the following days (graph 5).
- Fundamentally, the latest statistics continue to point to improving economic activity. However, the Canadian economy still has some weak points. These include foreign trade, which could make a very negative contribution to real GDP growth in Q3. Moreover, the benefits to the Canadian auto industry of the U.S. Cash for Clunkers program will reverse in Q4.
- The Bank of Canada (BoC) should remain cautious. With inflation low and subdued, it will maintain the leeway it needs to keep its key rate at a lower bound of 0.25% until June 2010. In our opinion, the risks to growth and inflation are already tilted to the downside; bringing interest rates up too early would only exacerbate things.
- In mid-October, the loonie's strength partially reflected market expectations. Several analysts believed that the BoC could follow in the footsteps of the Bank of Australia and start tightening its monetary policy in the near term (graph 6). The BoC, however, reined in market expectations at its meeting on October 20 by reiterating its intention to keep its key rate unchanged until mid-2010. This led to a sharp drop in Canada's currency.
- **Forecasts:** Conditions are still favourable to the Canadian dollar. Negative greenback sentiment combined with oil prices that have finally crossed US\$75 a barrel should keep upward pressure on the loonie. At the pace set in the last few weeks, we could see parity well before year's end. However, we are maintaining our position: energy prices must go higher before the loonie settles into lasting parity against the greenback.

Graph 5 – Canadian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

Graph 6 – The economic climate in Australia cannot be compared to Canada's



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	Q3	Q4f	Q1f	Q2f	Q3f	Q4f
US\$/CAN\$	0.9407	0.8204	0.7918	0.8600	0.9353	0.9600	0.9600	0.9800	1.0000	1.0000
CAN\$/US\$	1.0630	1.2189	1.2630	1.1628	1.0692	1.0417	1.0417	1.0204	1.0000	1.0000
CAN\$/€	1.4931	1.6943	1.6769	1.6309	1.5628	1.5833	1.6146	1.5102	1.4200	1.3800
US\$/€	1.4047	1.3901	1.3277	1.4027	1.4617	1.5200	1.5500	1.4800	1.4200	1.3800
US\$/£	1.7825	1.4378	1.4334	1.6469	1.5994	1.6500	1.6500	1.6500	1.7000	1.7000

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

f: forecasts

ASSET CLASSES RETURN

The stock market's rebound shows impressive resilience

- Stock markets continue to impress.** After a year that saw the worst market correction ever in 2008, it looks like 2009 will go down in history as the year of a spectacular market rebound. Major North American markets started to trend upward again these past few weeks after some hesitation at the end of September and in early October. The Dow Jones even broke through the psychological barrier of 10,000. As regards the low point reached last March, the S&P 500 is up by about 60% compared with a little more than 50% for the S&P/TSX. Despite a somewhat less spectacular performance since reaching the trough, the gains in Canada's stock market, which tumbled less steeply at the beginning of the year, should overtake U.S. markets by about 7% for 2009 (graph 7).
- Corporate earnings continue to exceed expectations.** To date, about 75% of S&P 500 companies that published their third-quarter results surpassed analyst expectations. Most companies have reported welcome surprises for three consecutive quarters now. There is one major drawback, however: profitability is back mostly due to cost cutting while revenues are still weak. Companies are going to have to generate much higher revenues in the near term to support the market rebound.
- The risk of a temporary correction is still high.** Even though we remain optimistic about the stock market's performance in the medium term, we have to conclude that the current upsurge seems increasingly extended. When stock markets recover, upward trends are often interrupted by temporary corrections that can easily reach 10%. These types of corrections appeared imminent in early September and October, but reports of good news quickly dispelled investors' doubts. The fact that the VIX index recently fell close to the 20 mark (graph 8), which represents an almost normal market, can also be seen as a sign that investors have become complacent about risk.
- The weak U.S. dollar is good for commodities.** After surging last spring and early last summer, prices for commodities seemed poised to enter a consolidation phase. The price of crude oil shifted around US\$70 a barrel after failing to break the US\$75 a barrel barrier on a few occasions. The marked weakness of the U.S. dollar at the beginning of October, however, boosted crude oil prices to around US\$80 a barrel and pushed gold prices to a historical high of US\$1,071 an ounce (graph 9).
- Key interest rates should remain the same at least until mid-2010 (graph 10 on page 5).** Economic statistics are quite encouraging overall and the recovery seems to have started. However, the recovery is largely dependent on the support of fiscal and monetary policies. The central banks are very well aware that any sharp increase in interest rates could stifle the recovery.

Graph 7 – Since the start of 2009, the increase in Canada's stock market has exceeded that of the S&P 500



Sources: Datastream and Desjardins, Economic Studies

Graph 8 – Has the situation improved enough to justify such a sharp drop in financial strains?



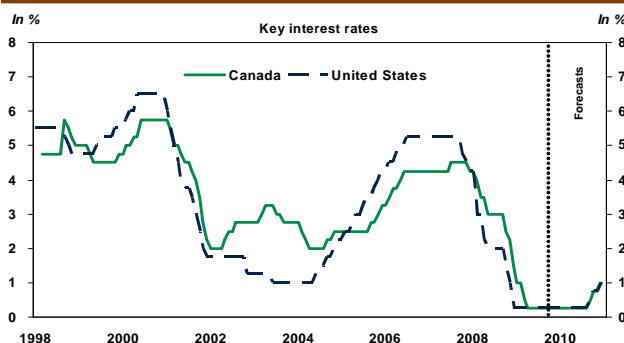
Sources: Datastream and Desjardins, Economic Studies

Graph 9 – The weak U.S. dollar boosts oil and gold

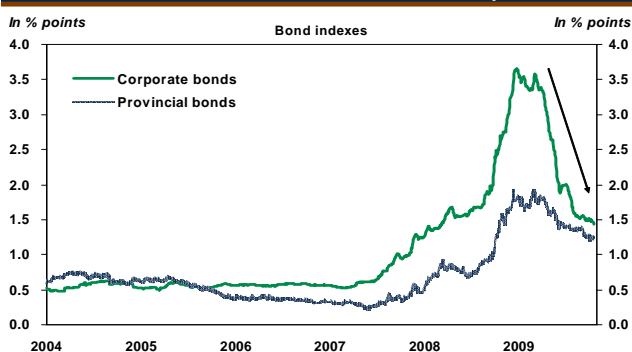


Sources: Datastream and Desjardins, Economic Studies

- **The bond market is faring well.** The major gains made by risky assets did not come at the expense of bonds. Demand for federal securities is still strong, which keeps bond rates low since inflation pressures are non-existent. Provincial and corporate bonds, for their part, are benefiting from the sharp contraction in premiums paid on riskier securities (graph 11). Canada's bond market should end the year up by about 5%.
- **It looks as though 2010 could be more difficult for the bond market.** It will grapple with sharper increases in interest rates, reflecting a tightened monetary policy that is sure to follow.
- **Our targets for stock markets are revised slightly upwards.** Temporary corrections in stock markets of varying magnitudes can occur at any time, however, given the markets' performance since last spring. Stock indexes could close 2009 somewhat below current levels before posting nice gains in 2010, while corporate results should continue to improve.

Graph 10 – Key rates expected to rise in the second half of 2010 only


Sources: Datastream and Desjardins, Economic Studies

Graph 11 – Spread between Canadian bond rates and federal securities have narrowed considerably


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	target: 0.30	target: 5.0	target: 25	target: 18	target: 30	target: -14.5 (US\$0.96)
range	0.25 to 0.40	3.5 to 6.5	18 to 35	10 to 30	20 to 40	-19.6 to -10.8
2010f	target: 0.75	target: 2.0	target: 14	target: 16	target: 18	target: -4.0 (US\$1.00)
range	0.50 to 1.00	0.0 to 4.0	5 to 25	7 to 27	5 to 30	-7.7 to 0.0

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

Sources: Datastream and Desjardins, Economic Studies