

# Retail Rate Forecasts

February 3, 2010

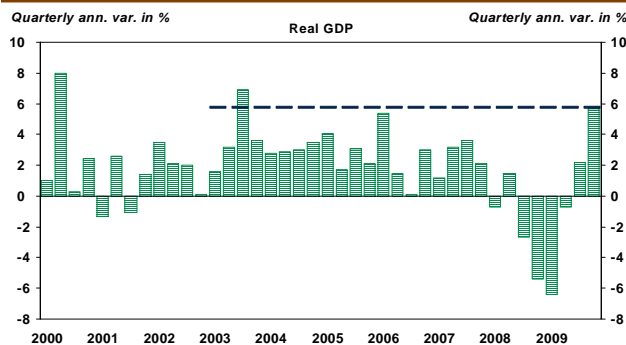
## New concerns pull down the stock market and interest rates

### HIGHLIGHTS

- The global economy continues to expand, but new concerns have emerged, particularly as regards China and Greece.
- The Bank of Canada still intends to keep its key rate unchanged until at least mid-2010.
- Low bond rates have prompted another slight pullback in mortgage rates.
- The loonie's dip should be temporary.
- Rising financial strains hurt the stock market.

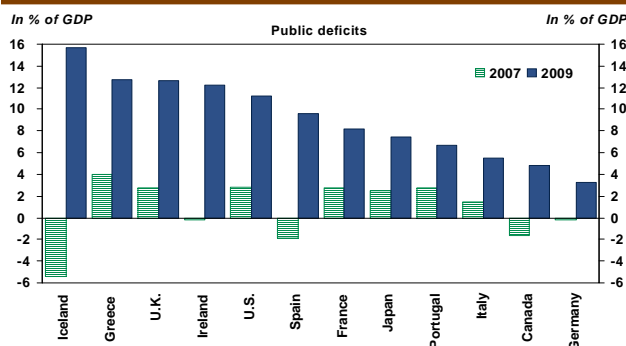
- **The worldwide economic recovery is increasingly apparent.** The U.S. economy advanced by an impressive 5.7% (annualized) in the final quarter of 2009 (graph 1). Although this figure was inflated by the change in business inventories, some factors, including strong export growth and the rebound of investment in software and equipment, point to a real improvement in the situation in the United States. The latest statistics also suggest that Canada was undergoing robust economic growth at year's end. However, activity should not advance as briskly on either side of the border in the coming quarters.
- **Upswing in concern on the financial markets.** The problems with Greece's sovereign debt, the start of a monetary firming cycle in China, and the Obama administration's political difficulties, including the loss of its absolute majority (a filibuster proof 60/40) and concerns about more stringent banking regulation, have weighed down investor sentiment in the last few weeks. Around the globe, governments' budget problems constitute a major risk to the economy's recovery (graph 2).
- **As forecast, the Bank of Canada (BoC) kept its key rate steady in January.** The statement's tone seems a little more upbeat, but we should not see this as signalling any upcoming change in monetary policy, in that the recent improvement in the global and Canadian economies remains, to date, largely dependent on recovery efforts made by the planet's governments and monetary authorities. The BoC also reiterated its conditional commitment to keeping its key rate at a 0.25% low until June 2010.

Graph 1 – The stronger U.S. growth since the third quarter of 2003



Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

Graph 2 – The financial crisis and recession made public deficits balloon



Sources: Organisation for Economic Co-operation and Development 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

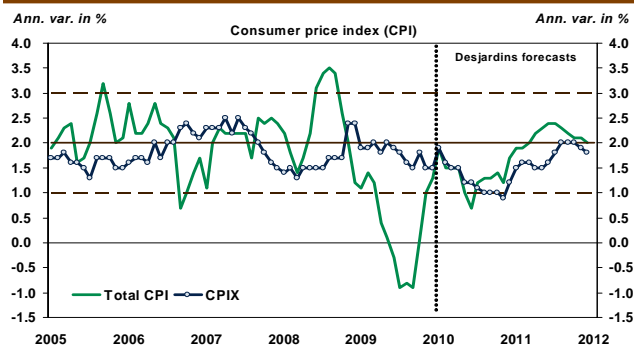
514-281-2336 or 1 866 866-7000, ext. 2336  
E-mail: [desjardins.economics@desjardins.com](mailto:desjardins.economics@desjardins.com)

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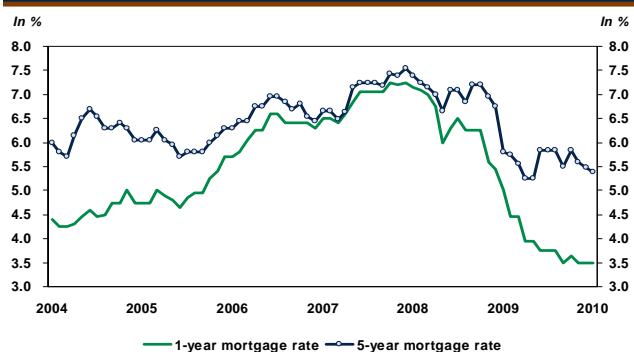
- **Inflation's upswing is not a concern.** Canada's inflation rate returned to positive territory in the fourth quarter. Core inflation proved to be a little stronger than expected. However, this is mainly due to unfavourable base effects, and, given the substantial ongoing surplus supply here and around the world, Canadian inflation pressures will remain largely subdued (graph 3).
- **Investor concerns benefit federal bonds.** After a substantial rise at the end of 2009, bond rates have retreated sharply in the last few weeks, as investors turned to the most secure assets. Demand for Canadian securities was also pumped by Canada's strong relative position in terms of public finances, among other things, which is attracting foreign investors seeking an alternative to U.S. assets. The Canadian 10-year rate went from over 3.60% at the start of the year to about 3.35%.
- **Mortgage rates pull back a little further.** Despite major movements in bond rates, retail rates have not changed much since the end of November. The recent pullback by bond rates, however, allowed financial institutions to announce a 10 basis point cut to mortgage rates for the 3-, 4- and 5-year terms. At 5.39%, the five-year mortgage rate has now descended very close to its historic low of 5.25% (graph 4).
- **We are maintaining our forecasts for retail rates.** The recent resurgence of market pessimism confirms that the context still is not conducive to a rapid rise in interest rates. Retail rates should thus continue to fluctuate close to current levels until at least mid-2010. A real rise should not start until the second half of the year.

**Graph 3 – The rise by the year-over-year total CPI change is ending in Canada**



Sources: Statistics Canada and Desjardins, Economic Studies

**Graph 4 – Mortgage rates are at, or near, historic lows**



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
<b>Realized – End of month</b>								
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. 2009	0.50	2.25	3.65	4.65	5.85	0.40	1.60	2.10
Nov. 2009	0.50	2.25	3.50	4.25	5.59	0.40	1.45	2.00
Dec. 2009	0.50	2.25	3.50	4.25	5.49	0.40	1.45	2.00
Jan. 2010	0.50	2.25	3.50	4.15	5.39	0.40	1.45	2.00
Feb. 2, 2010	0.50	2.25	3.50	4.15	5.39	0.40	1.45	2.00
<b>Forecasts – End of quarter</b>								
2010: Q1	0.50	2.25	3.25–3.75	3.90–4.40	5.15–5.65	0.20–0.65	1.20–1.70	1.75–2.25
2010: Q2	0.50–0.75	2.25–2.50	3.30–3.80	4.00–4.50	5.35–5.85	0.20–0.70	1.25–1.75	1.80–2.30
2010: Q3	0.50–1.00	2.25–2.75	3.55–4.05	4.45–4.95	5.55–6.05	0.40–0.90	1.55–2.05	2.05–2.55
2010: Q4	0.75–1.25	2.50–3.00	3.90–4.40	4.65–5.15	5.80–6.30	0.75–1.25	1.75–2.25	2.35–2.85

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

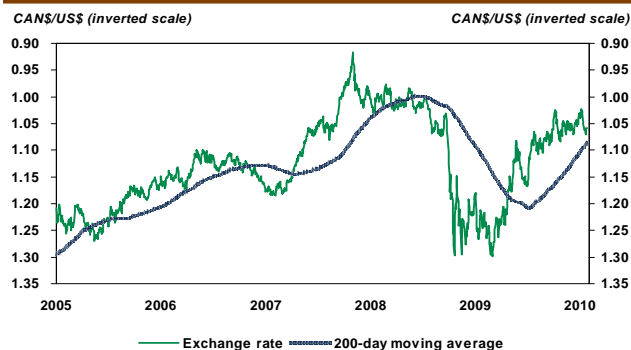
Source: Desjardins, Economic Studies

# CANADIAN DOLLAR

## The loonie's dip should be temporary

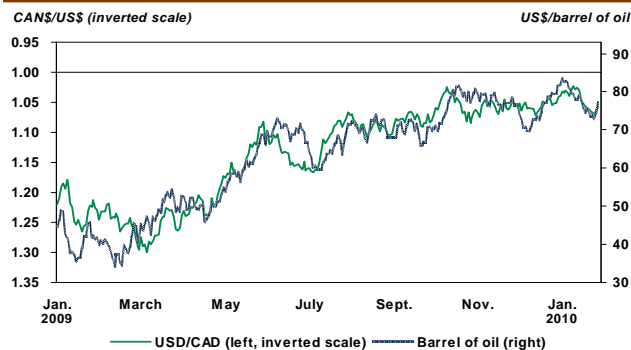
- In December, the loonie managed to successfully limit the effects of a widespread increase in the U.S. dollar vs. other main currencies and the drop in commodity prices. The gradual recovery of risk positions allowed the USD/CAD, after edging up slightly above C\$1.07 in December, to settle around the C\$1.02 level in January, its weakest showing since October 2009. The last few days have seen an upswing in financial strain, which took the pair to around C\$1.07 (graph 5).
- Fundamentally, the economic and financial situation is still favourable to the loonie's rise. Canada's economy flirted with modest growth in the third quarter, and there are signs that activity further improved at the end of 2009. Domestic demand in particular will remain strong, boosted by the real estate market's rebound, improvements in the terms of trade, the turnaround in household confidence (compared with the low point reached during the crisis) and weak interest rates. The gains made in October and November should even see the external sector contribute to real GDP growth in the fourth quarter.
- We believe that the Bank of Canada (BoC) will stick to its conditional commitment to leave its key rate unchanged for the first half of 2010. In fact, the lack of pressures on inflation, the tepid recovery in the United States and the risks a lively loonie has on growth and inflation in Canada should prompt the BoC to postpone any rate increases until the fourth quarter of 2010.
- **Forecasts:** Right now, the loonie is bearing the brunt of the uncertainty caused by the problems in Greece and monetary tightening in China. The current infatuation for the greenback and weak commodity prices do not augur well for Canada's currency, but its upward trend is holding firm. If the rumours about portfolio diversification continue and foreigners keep snapping up Canadian securities, the loonie could once again reach parity sometime next summer (graph 6).

Graph 5 – Canadian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

Graph 6 – An upsurge in energy prices would easily push the loonie towards 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	2009		2010				2011			
	Q3	Q4	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US\$/CAN\$	0.9353	0.9506	0.9600	0.9800	1.0000	0.9800	1.0000	1.0200	1.0300	1.0400
CAN\$/US\$	1.0692	1.0520	1.0417	1.0204	1.0000	1.0204	1.0000	0.9804	0.9709	0.9615
CAN\$/€	1.5628	1.5094	1.5625	1.5102	1.4200	1.4082	1.3600	1.3137	1.2816	1.2500
US\$/€	1.4617	1.4348	1.5000	1.4800	1.4200	1.3800	1.3600	1.3400	1.3200	1.3000
US\$/£	1.5994	1.6149	1.6500	1.6500	1.6000	1.5500	1.5000	1.4500	1.4000	1.3500

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

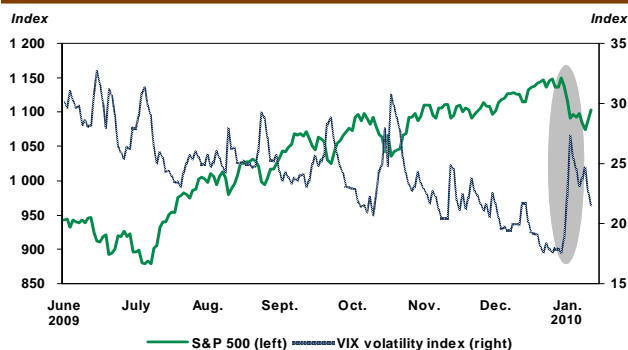
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# ASSET CLASSES RETURN

## Financial strain edges up

- Renewed pessimism affects the stock markets.** Investors' concerns about monetary firming in China and a potential default by the Greek government prompted somewhat of a flight to quality in the financial markets. This played heavily against the stock markets, which retreated by more than 4% in just a few days, dropping back below the levels reached at the end of 2009 (graph 7).
- Corporate results have not helped to dissipate concerns.** Contrary to previous quarters, the release of corporate earnings for the last quarter of 2009 did not give the stock markets another push. Yet the results were generally good, as earnings continued to rise and most companies beat expectations. However, investors seem to be concerned about future growth outlooks.
- These kinds of stock market pull-backs are normal.** Before the recent dip, the advance the stock indexes made since their March 2009 low beat all of the rebounds recorded in recent decades (graph 8). Since the economic situation is still relatively tough, the VIX volatility index's drop below 20 was surprising and, according to some, pointed to a little recklessness in the markets. This is why, despite our relatively optimistic targets for the stock market, we were anticipating some temporary corrections in 2010.
- Commodity prices also pull back sharply.** After climbing above US\$80 a barrel at the start of the year, when a cold wave hit several parts of the globe, oil prices retreated to around US\$70 a barrel, when investors turned away from risky assets (graph 9). Fears that Chinese authorities would curb their economy too sharply also drove base metal prices down. Large inventories of several base products should limit commodity price growth in the months to come.
- Investors took shelter in government bonds.** After a fairly difficult 2009 year-end, the bond market got a big boost from the recent upsurge in market anxiety (graph 10 on page 5). The solid performance by federal bonds allows Canada's bond market to post a gain of almost 2% since the start of 2010.
- No key rate increase in the first half of 2010.** It is too early to expect any change in the country's monetary policy. The Bank of Canada (BoC) has all the leeway it needs to maintain its conditional commitment to keeping the key rate at 0.25% until at least June 2010. With the Federal Reserve seemingly in no rush to firm up its monetary policy, the BoC could well have to postpone its rate hikes until the final quarter of 2010 (graph 11 on page 5).

**Graph 7 – Investors' anxiety is impacting the stock markets**



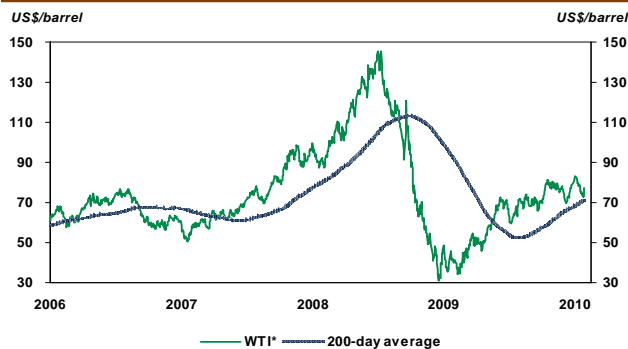
Sources: Datastream and Desjardins, Economic Studies

**Graph 8 – The current rebound is still one of the strongest**



Sources: Datastream and Desjardins, Economic Studies

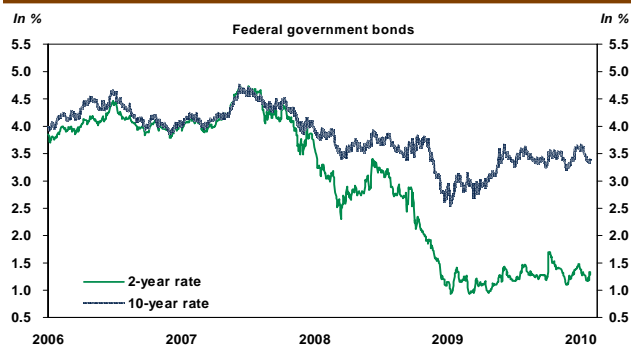
**Graph 9 – Oil prices are back near US\$70 per barrel**



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

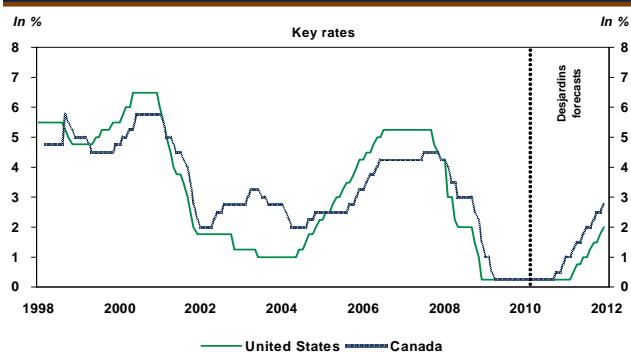
- Canadian bonds are in good position.** First, the inflation risks are more subdued, the relative good performance of Canada's economy during the crisis allowed the BoC to avoid having to resort to aggressive quantitative policies. While the government's budget situation has certainly deteriorated, all things considered, the financing needs in Canada are much weaker than they are in the United States. In fact, our local markets still have hearty appetites for government securities, and, judging by the rumours regarding the diversification of central banks, the appeal of Canadian securities is not about to fade.
- We are still optimistic about the stock market.** The indexes' recent retreat is not surprising; further temporary dips could occur in the months to come. However, it would take a much bigger tumble to call the bull market into question. In the context of economic recovery and gradually rising corporate earnings, North American stock markets still have solid growth potential, especially as nothing suggests that the markets are currently overvalued. The S&P 500 could thus yield a return of about 15% in 2010. Commodity prices' limited rise could prompt a slightly smaller gain by Canada's stock market this year.

Graph 10 – Canadian bond rates remain low



Sources: Datastream and Desjardins, Economic Studies

Graph 11 – Canada's key rate will only start to come up in the fall of 2010



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
2009	0.30	5.40	35.10	26.50	32.50	-13.70
2010f range	target: 0.45 0.30 to 0.70	target: 3.0 1.0 to 5.0	target: 13 5 to 22	target: 15 7 to 25	target: 18 5 to 30	target: -3.0 (US\$0.98) -6.8 to 1.1

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

Sources: Datastream and Desjardins, Economic Studies