

# Retail Rate Forecasts

February 6, 2012

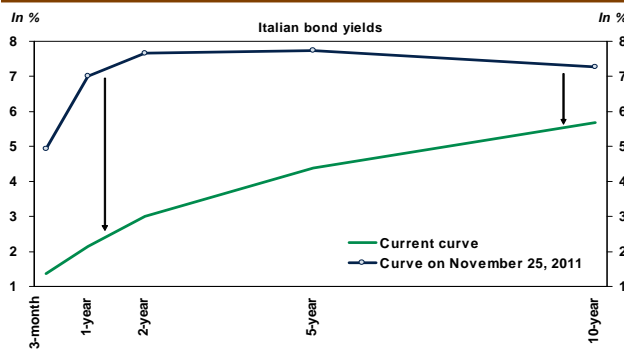
## The Federal Reserve's new commitment will favour persisting very low interest rates

### HIGHLIGHTS

- The actions of the European Central Bank have stabilized the European financial system.
- The Federal Reserve expects to keep its key interest rate at its floor until late 2014. This will delay monetary tightening in Canada.
- The weak bond yields pushed retail rates down.
- The loonie's return to parity against the U.S. dollar seems premature.
- The stock markets began 2012 on a high note, but volatility could return.

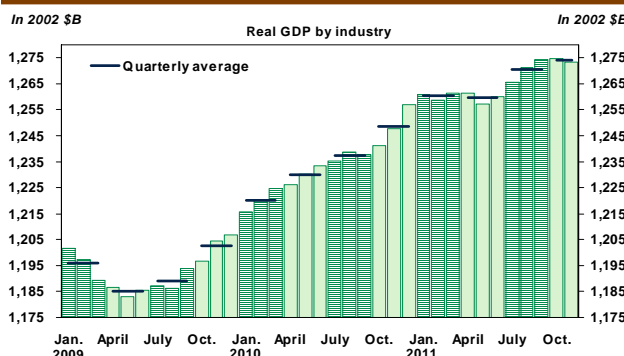
- **Tensions have dropped a notch in the euro zone.** The euro zone finally saw one encouraging development at the end of 2011. The decisive action taken by the European Central Bank (ECB), particularly a three-year financing operation for which demand totalled €489B (US\$636B), did away with a lot of the concern about the European banking sector.
- **The sovereign debt crisis is not over yet.** Far from having to sell off their sovereign bonds, European banks now have an incentive to increase their holdings, as these securities can be used as collateral with the ECB. The impact on the financing costs of several European countries, including Italy (graph 1) and Spain, is impressive, even though their credit rating was lowered. It is essential, however, that these countries pursue their efforts to get their public finances under control, thus winning back investors' confidence on a lasting basis.
- **In 2012, the Canadian and U.S. economies will post growth similar to 2011.** While several European economies seem to be heading for another recession, the situation is less worrisome in North America. In particular, U.S. economic statistics remain encouraging. Following the lively 3.5% rebound recorded in the third quarter of 2011, everything suggests that Canada's economy has slowed recently (graph 2). Canadian growth should still reach about 2% for 2012 as a whole.
- **The Federal Reserve (Fed) does not expect to raise its key rate before late 2014.** While this action is conditional on how the economic climate develops, this extensive commitment by the Fed, in spite of the improving economic statistics, surprised many. Once again, the Fed has demonstrated that it is prepared to do everything it can to support the job market while inflation seems to be under control.

Graph 1 – Italy's financing costs have retreated



Sources: Bloomberg and Desjardins, Economic Studies

Graph 2 – The Canadian economy has slowed over the last few months



Sources: Statistics Canada and Desjardins, Economic Studies

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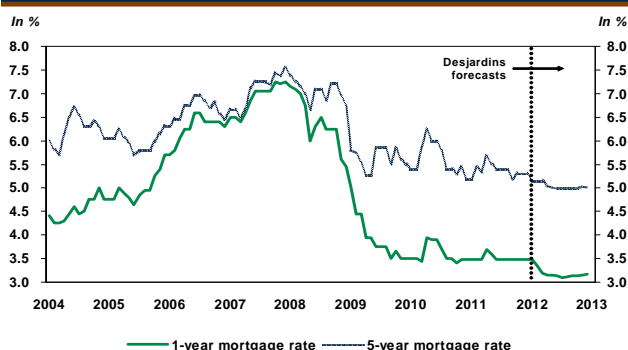
- **The Fed's announcement puts the Bank of Canada (BoC) in a tough position.** Concerned about triggering an overly violent rise of the Canadian dollar, the BoC will be hesitant to kick off monetary firming too much ahead of the Fed. The Canadian situation, however, is very different from the situation in the United States and, sooner or later, the BoC may run out of reasons for keeping its key rate at 1.00%. In our view, the BoC will start to firm up its monetary policy in spring 2014, about nine months later than we originally forecast.
- **North American bonds are highly sought after.** Despite the publication of more encouraging U.S. economic statistics and declining financial tensions in the euro zone, North American bond yields remain near historic lows (graph 3). With fewer and fewer euro zone nations considered to be high-quality issuers, investors must turn to bonds from other countries, including the United States and Canada.
- **Downside pressures on retail rates.** Ongoing incredibly low bond yields despite a less uncertain financial context caused Canadian financial institutions to lower their mortgage rates since 2012 began. Initially, institutions increased promotions and rate rebates, but recently posted rates have also been dropped. The rate posted for a five-year mortgage rate has dropped to 5.14%, a new low.
- **The situation will continue to favour borrowers in 2012.** Recent events, including the Fed's commitment to keep its key rate at its floor for a long time, confirm that all interest rates will remain very low for an extended period of time (graph 4).

**Graph 3 – U.S. yields remain exceptionally low, despite the encouraging statistics**



Sources: Datastream, Citigroup and Desjardins, Economic Studies

**Graph 4 – Retail rates will stay very low in 2012**



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>								
Aug. 2011	1.25	3.00	3.49	4.35	5.39	0.90	1.25	1.80
Sept. 2011	1.25	3.00	3.49	4.35	5.19	0.80	1.20	1.80
Oct. 2011	1.25	3.00	3.49	4.05	5.29	0.90	1.30	1.80
Nov. 2011	1.25	3.00	3.49	4.05	5.29	0.90	1.30	1.85
Dec. 2011	1.25	3.00	3.49	4.05	5.29	0.90	1.40	1.85
Jan. 2012	1.25	3.00	3.49	3.95	5.14	0.90	1.40	1.85
Feb. 6, 2012	1.25	3.00	3.49	3.95	5.14	0.90	1.40	1.85
<b>Forecasts – End of quarter</b>								
2012: Q1	1.00–1.25	2.75–3.00	2.95–3.45	3.70–4.20	4.90–5.40	0.65–1.15	1.00–1.50	1.50–2.00
2012: Q2	1.00–1.25	2.75–3.00	2.90–3.40	3.75–4.25	4.75–5.25	0.60–1.10	1.00–1.50	1.50–2.00
2012: Q3	1.00–1.50	2.75–3.25	2.90–3.40	3.80–4.30	4.75–5.25	0.65–1.15	1.05–1.55	1.50–2.00
2012: Q4	1.00–1.50	2.75–3.25	2.95–3.45	3.90–4.40	4.75–5.25	0.70–1.20	1.10–1.60	1.50–2.00

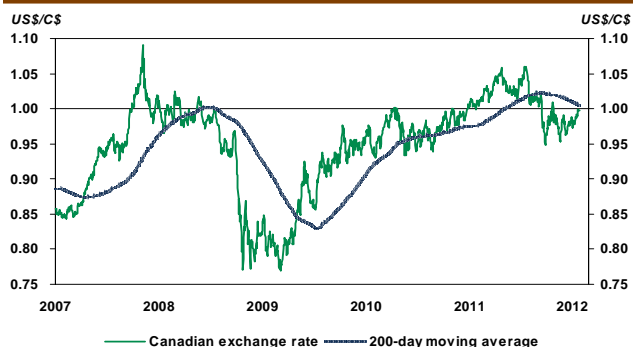
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).  
Source: Desjardins, Economic Studies

# CANADIAN DOLLAR

## Return to parity against the U.S. dollar seems premature

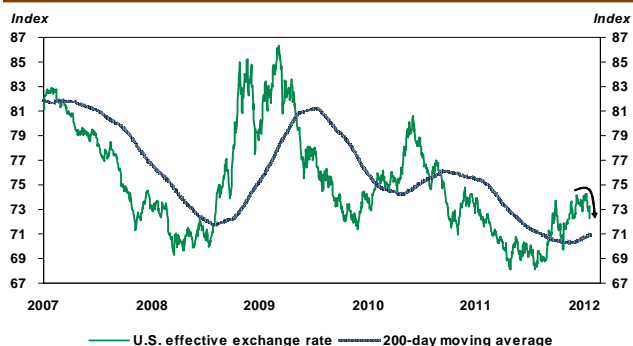
- On the rise since the beginning of the year, the Canadian dollar has returned to parity against the greenback (graph 5). It seems too early, however, to say the trend has changed for good. From a technical standpoint, the loonie has not yet gained enough momentum, and its 200-day moving average remains on a downward slope. The Canadian dollar's recent appreciation seems nothing more than a reflection of the U.S. dollar's retreat. The decline in tensions about sovereign debt in Europe in the last several weeks, and the publication of some better-than-expected statistics about the global economy have limited the U.S. dollar's safe-haven role. Optimism may rapidly die down, as Europe's financial and economic problems are still far from over and a global economic slowdown is still expected. As a result, the U.S. dollar should reappreciate and weigh negatively on the Canadian exchange rate in the coming months.
- From a more fundamental standpoint, the loonie is also short on support. Domestic demand shows signs of weakness in Canada, with consumer and government spending on the decline. Job creation is more modest, and the unemployment rate has risen to 7.6%. The global economy's expected weakness should also be reflected in Canadian exports and commodity prices.
- One element that should continue to favour the Canadian dollar, however, is the Federal Reserve's decision to keep its key interest rate unchanged until late 2014. This decision, announced on January 25, has had a big hand in the U.S. dollar's depreciation (graph 6). The greenback decline associated with the decision should not be recouped unless other central banks also decide to announce to keep their rates unchanged for a long time, which would be surprising.
- Forecasts:** The Canadian dollar will depreciate in the short term. A return to parity with the U.S. dollar will be more sustainable in the second half of the year, in conjunction with the expected drop in financial tensions and economic uncertainty.

Graph 5 – The Canadian dollar returns to parity



Sources: Datastream and Desjardins, Economic Studies

Graph 6 – The greenback falls after the Fed\* announces plans to postpone its first key rate increase to late 2014



\* Federal Reserve.  
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	2011		2012				2013			
	Q3	Q4	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US\$/CAN\$	0.9523	0.9807	0.9800	0.9700	1.0000	1.0000	1.0100	1.0200	1.0200	1.0300
CAN\$/US\$	1.0501	1.0197	1.0204	1.0309	1.0000	1.0000	0.9901	0.9804	0.9804	0.9709
CAN\$/€	1.4089	1.3237	1.2449	1.2371	1.2200	1.2500	1.2574	1.2745	1.2941	1.3010
US\$/€	1.3417	1.2981	1.2200	1.2000	1.2200	1.2500	1.2700	1.3000	1.3200	1.3400
US\$/£	1.5578	1.5541	1.5000	1.5000	1.5200	1.5500	1.5600	1.5800	1.6000	1.6200

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

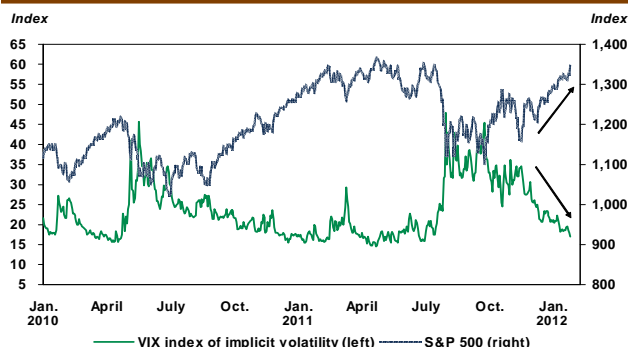
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# ASSET CLASSES RETURN

The stock markets began 2012 on a high note, but there is still a lot of volatility

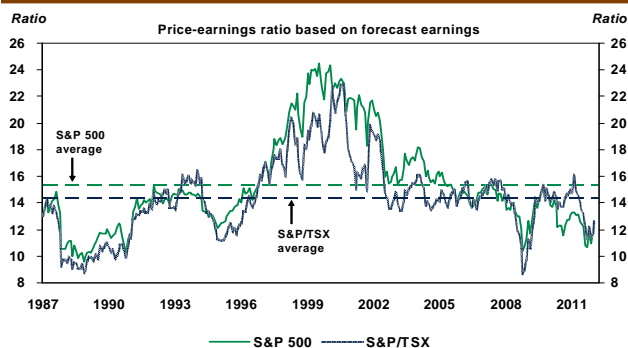
- 2011 was clearly a year for safe-haven securities.** North America's bond markets once again confounded the sceptics by posting a remarkable performance in 2011. The Canadian DEX Bond Universe Index returned a yield of nearly 10% last year, an even more impressive result when we consider that most of the other major asset classes, such as the stock markets and commodities, delivered small or negative returns.
- The wind shifted in early 2012.** After 2011, a very disappointing year for the stock markets, especially in Canada, the S&P 500 jumped 4.4% in January (graph 7), its best start in 15 years. The gain is due to an upswing in investor confidence on the drop by financial strains in the euro zone and more encouraging U.S. economic statistics. The financial sector, which had been a heavy drag on the indexes' gains last year, was especially strong early this year.
- The stock market rebound is fully justified by profits.** Despite the relatively tough economic context, corporate profits have posted strong advances in recent years, hitting new peaks. Price-earnings ratios were well below their historic averages at the end of 2011 (graph 8). This opens the door to good stock market performance in the coming years, even if earnings growth is now expected to slow.
- Volatility could make a quick comeback.** While stocks are currently the asset class offering the best return potential, not every month in 2012 will be as good as January. The recent upswing by investor confidence seems shaky, especially in an economic and financial environment that is marked by many major risks. Although the worst should be avoided, the euro zone is still facing sizable challenges and the first half of the year's major refinancing needs (graph 9) could drive financial strains up, in a context in which the economic data could confirm another recession.
- Commodity prices are facing headwinds.** The last few months of 2011 were tough for commodity prices, as the worsening global economic outlook and strong U.S. dollar prompting a widespread drop in prices. Capitalizing on the increasing tension between Iran and Western nations, oil prices held at around US\$100/barrel, however. Recently, the Federal Reserve's (Fed) aggressive action has reintroduced some doubt about the U.S. dollar's solidity, a positive development for commodity prices, especially gold (graph 10 on page 5).

**Graph 7 – The drop in financial strains in early 2012 gave the stock markets a boost**



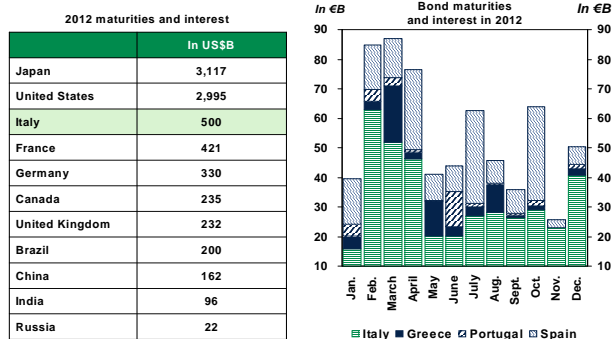
Sources: Datastream and Desjardins, Economic Studies

**Graph 8 – Fundamentally, the stock markets remain appealing**



Sources: Institutional Brokers Estimate System and Desjardins, Economic Studies

**Graph 9 – European debt financing will remain a drag in 2012**

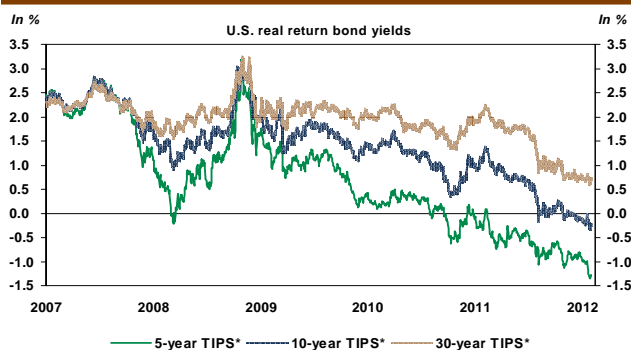


Sources: Bloomberg and Desjardins, Economic Studies

- **The Fed is not giving short-term yields much of a chance to rise.** Although it was almost certain that the major central banks would not initiate monetary firming in 2012, it now seems that they will be keeping their key rates at their floor until 2014 or even 2015. In this context, we can expect yields on bonds with terms of five years or less to remain extremely low in the coming quarters.
- **Long-term bond yields could edge up in the second half of the year.** The impact on long-term bond yields of later key rate normalization is not as clear, especially if it leads to increased inflation expectations. Currently, note that U.S. and Canadian 10-year bonds are barely paying enough to offset inflation (graph 11), a sign that demand for these safe-haven securities is extremely strong. If the central banks' efforts manage to reassure investors, long-term North American bond yields should sooner or later rise to better reflect the economic situation.
- **The stock markets should offer the best returns in 2012.** Even though financial strains could rise a few times in the coming quarters, the stock indexes seem to be in good position to post attractive returns this year. Conversely, the extremely low interest rates are a heavy curb on the potential returns of fixed-income securities.

**Graph 10 – The greenback's recent pullback pushed gold prices up**

Sources: Bloomberg, Datastream and Desjardins, Economic Studies

**Graph 11 – Real bond yields hit new lows**\* Treasury Inflation Protected Securities.  
Sources: Bloomberg and Desjardins, Economic Studies
**Table 3**  
**Asset classes percentage return**

End of year	Cash	Bonds	Canadian stocks	U.S. stocks	International stocks	Exchange rate
	3-month T-Bill	Dex Universe Bond Index	S&P/TSX Index*	S&P 500 Index (US\$)*	MSCI EAFE Index (US\$)*	C\$/US\$ (var. in %)**
2000	5.45	10.2	7.4	-9.1	-14.0	3.8
2001	3.88	8.1	-12.6	-11.9	-21.2	6.5
2002	2.52	8.7	-12.4	-22.1	-15.7	-1.5
2003	2.87	6.7	26.7	28.7	39.2	-17.7
2004	2.23	7.1	14.5	10.9	20.7	-7.1
2005	2.70	6.5	24.1	4.9	14.0	-3.3
2006	4.01	4.1	17.3	15.8	26.9	0.2
2007	4.14	3.7	9.8	5.5	11.6	-14.4
2008	2.35	6.4	-33.0	-37.0	-43.1	22.1
2009	0.34	5.4	35.1	26.5	32.5	-13.7
2010	0.57	6.7	17.6	15.1	8.2	-5.2
2011	0.92	9.7	-8.7	2.1	-11.7	2.3
2012f range	target: 0.90 0.65 to 1.15	target: 2.5 -1.0 to 6.0	target: 10.5 2.5 to 19.0	target: 9.0 1.5 to 17.0	target: 10.0 0.0 to 20.0	target: -1.9 (US\$1.00) -3.9 to 3.2

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