Retail Rate Forecasts

Desjardins Economic Studies
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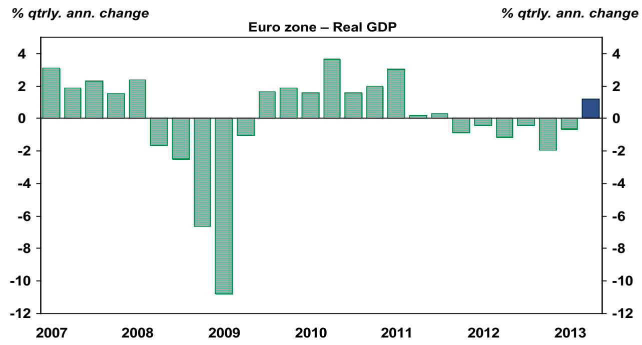
The rise in interest rates should pause soon

HIGHLIGHTS

- Economic outlooks continue to improve in the advanced economies.
- The faster-than-anticipated normalization of interest rates may prompt the Bank of Canada to wait until around mid-2015 before firming its monetary policy.
- Keeping the key rate very low should rein in rising bond yields and keep retail rates relatively low.
- The loonie will have a harder time reaching parity.
- The Canadian stock market is making up a little lost ground.

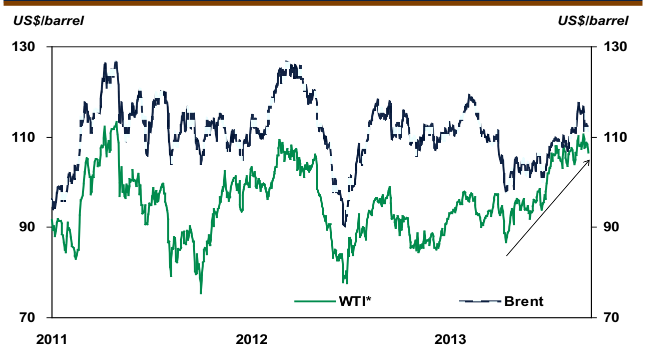
- **Encouraging news from the advanced economies.** The recession seems to have ended earlier than expected for the euro zone, where the real GDP rose in the spring (graph 1). If we add in the good economic results from the United Kingdom and Japan, the advanced economies are showing clear improvements. Furthermore, the leading indicators have shot up in the United States and elsewhere, suggesting economic growth will be accelerating in the coming quarters.
- **Some risks persist.** The news from emerging nations is more worrisome, as economic growth has slowed over the last few quarters. Several emerging currencies are also under substantial downside pressure. Syria bears watching as well, as the conflict could flare up and spread to bordering countries, amplifying the recent jump in oil prices (graph 2). There is also a real risk of a political impasse that would paralyze the U.S. government.
- **Consumption supported the Canadian economy in the second quarter.** As predicted, the floods in Alberta and the construction strike in Quebec curbed economic growth in the second quarter. Canada's real GDP therefore rose only a quarterly annualized 1.7%. If we put these blips aside, the Canadian economy is moving fairly in line with expectations. Domestic demand bounced back this spring, largely due to increased automobile sales.
- **Heading for a later key rate hike in Canada.** In its most recent statement, the Bank of Canada (BoC) acknowledged that the Canadian demand was taking longer than expected to rotate toward exports and investment. As long-term interest rates have already risen substantially and our forecasts for economic growth were revised slightly downwards, we now predict that the target overnight rate could stay at 1.00% until spring 2015.

Graph 1 – Euroland's economy is starting to grow again



Sources: Eurostat and Desjardins, Economic Studies

Graph 2 – Oil prices have shot up in recent months



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

François Dupuis
Vice-President and Chief Economist

Yves St-Maurice
Senior Director and Deputy Chief Economist

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

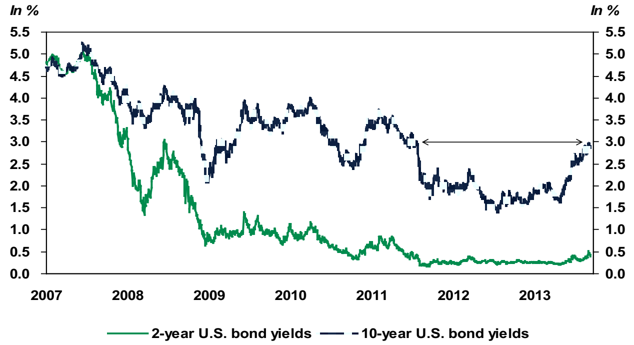
Mathieu D'Anjou
Senior Economist

Jimmy Jean
Senior Economist

Hendrix Vachon
Senior Economist

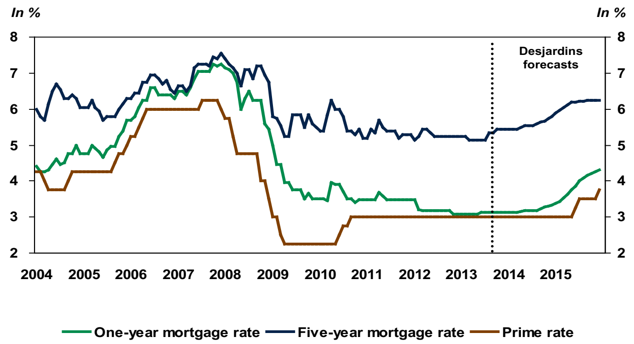
- **Bond yields continue to rise.** The U.S. 10-year yield recently hit 3.00% for the first time in over two years (graph 3). It will be hard for long-term yields to get much higher without moving up expectations of monetary policy firming. The Federal Reserve (Fed) meeting on September 18 could elicit a strong reaction from the financial markets.
- **Increased financing costs are putting upside pressure on retail rates.** The rise by long-term interest rates in recent months has had a direct impact on financing costs at Canadian financial institutions. After dropping their rate rebates substantially this summer, financial institutions have raised some posted mortgage rates in recent weeks. Other moderate increases in retail rates may occur in the short term. Rates should then stabilize for several quarters (graph 4), while ongoing very low key rates should cause bond yields to plateau.

Graph 3 – Normalization of 10-year U.S. bond yield is well advanced



Sources: Datastream and Desjardins, Economic Studies

Graph 4 – Persisting very low key rates will limit the rise in retail rates



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								
March 2013	1.25	3.00	3.09	3.55	5.14	0.90	1.25	1.75
April 2013	1.25	3.00	3.09	3.55	5.14	0.90	1.25	1.75
May 2013	1.25	3.00	3.09	3.55	5.14	0.90	1.25	1.75
June 2013	1.25	3.00	3.14	3.65	5.14	0.90	1.25	1.75
July 2013	1.25	3.00	3.14	3.75	5.14	0.90	1.25	1.75
Aug. 2013	1.25	3.00	3.14	3.95	5.34	0.90	1.25	1.75
Sept. 17, 2013	1.25	3.00	3.14	3.95	5.34	0.90	1.25	1.75
Forecasts								
End of quarter								
2013: Q3	1.25	3.00	3.14–3.30	3.95–4.15	5.34–5.54	0.90–1.10	1.25–1.45	1.75–1.95
2013: Q4	1.25	3.00	3.00–3.40	3.75–4.25	5.25–5.65	0.80–1.20	1.15–1.55	1.65–2.05
2014: Q1	1.00–1.50	2.75–3.25	3.00–3.50	3.75–4.25	5.20–5.70	0.80–1.30	1.15–1.65	1.75–2.25
2014: Q2	1.00–1.50	2.75–3.25	3.00–3.50	3.85–4.35	5.30–5.80	0.80–1.30	1.30–1.80	1.85–2.35
End of year								
2014	1.25–1.75	3.00–3.50	3.10–3.60	4.25–4.75	5.55–6.05	0.80–1.30	1.60–2.10	2.10–2.60
2015	1.75–2.25	3.50–4.00	4.05–4.55	5.25–5.75	6.00–6.50	1.40–1.90	2.25–2.75	2.70–3.20
2016	2.50–3.50	4.25–5.75	4.65–5.65	5.60–6.40	6.25–7.05	1.60–2.60	2.55–3.35	3.00–3.80

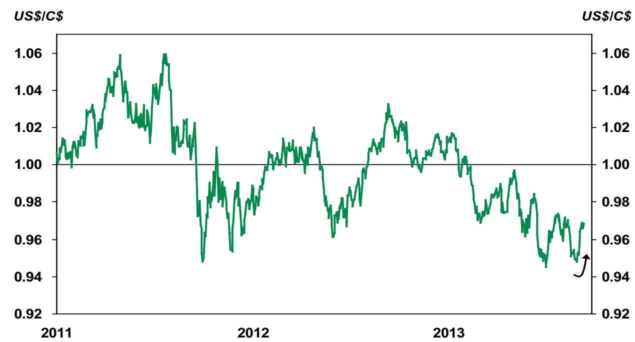
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

The loonie will have a harder time reaching parity

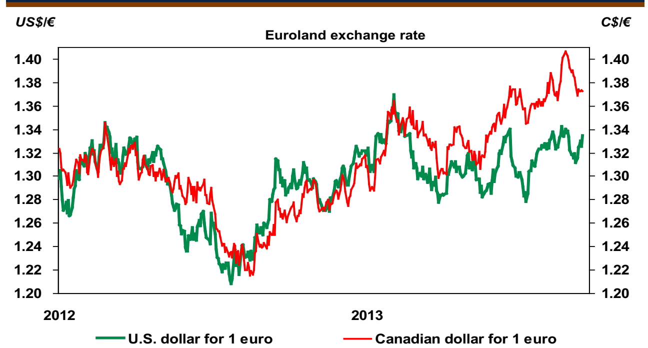
- The Canadian dollar dropped back below US$0.95 in August and began September at a similar level. Once again, this decrease was caused by a stronger U.S. dollar in anticipation of less accommodating monetary policy in the United States. Concerns about several emerging nations and the collateral damage they could do to global demand also harmed the loonie. Investors are showing signs of worry about the outlook for Canada's economy, especially as demand for commodities could be weaker.
- However, the Canadian dollar started to regain some altitude on September 6, after fairly positive employment figures were released in Canada and the United States posted disappointing results. More encouraging statistics from some emerging nations have also recently helped the Canadian dollar recover. The loonie is once again fluctuating around US$0.97 (graph 5).
- The euro showed greater stability against the greenback until upside revisions to U.S. real GDP were released at the end of August. The worry expressed by the European Central Bank about Euroland's economy also weighed on the common currency. The euro's loss of steam was only temporary, however, and the currency is now trading at around US$1.33. The exchange rate against the Canadian dollar is currently oscillating around C$1.37/euro. It had reached C$1.41 in August (graph 6).
- **Forecast:** The postponement of the next key rate hike in Canada to mid-2015 means we have downgraded our forecast for the Canadian dollar. Return to parity now seems much more difficult for 2014. What's more, fears about global demand for commodities may linger for several more quarters, and more disappointing data could be released for Canada's economy in the short term. The loonie could therefore finish the year at close to US$0.95 before beginning a gradual climb. It should also depreciate slightly against the euro before the end of the year, appreciating next year.

Graph 5 – The Canadian dollar rebounds again



Sources: Datastream and Desjardins, Economic Studies

Graph 6 – The euro has been more stable against the U.S. dollar



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

	2012		2013				2014			
End of period	Q3	Q4	Q1	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	1.0165	1.0079	0.9828	0.9506	0.9600	0.9500	0.9600	0.9700	0.9800	0.9900
CAN$/US$	0.9838	0.9922	1.0175	1.0520	1.0417	1.0526	1.0417	1.0309	1.0204	1.0101
CAN$/€	1.2657	1.3081	1.3065	1.3674	1.3750	1.3789	1.3750	1.3711	1.3673	1.3535
US$/€	1.2865	1.3184	1.2841	1.2999	1.3200	1.3100	1.3200	1.3300	1.3400	1.3400
US$/£	1.6148	1.6255	1.5185	1.5167	1.5600	1.5700	1.5800	1.5900	1.6000	1.6000

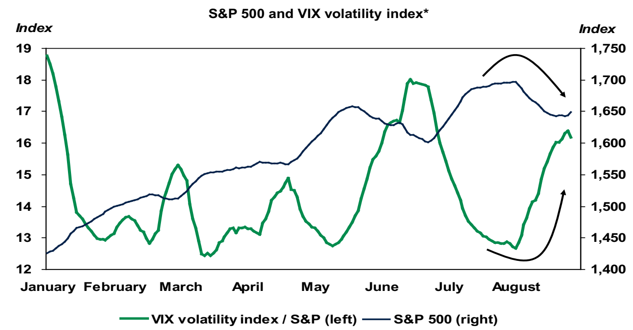
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies f: forecasts

ASSET CLASSES RETURN

The Canadian stock market makes up a little lost ground

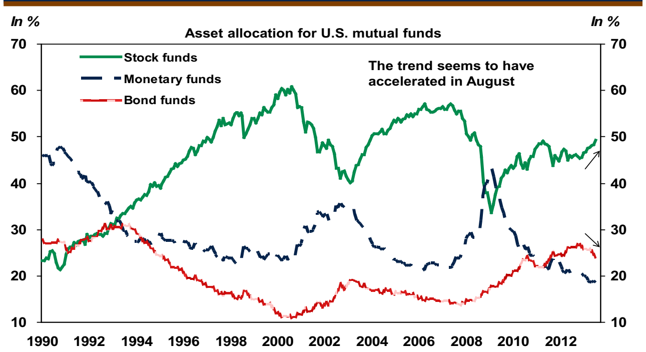
- **After successfully overcoming the obstacles of early summer when bond yields skyrocketed, U.S. stock markets are once again facing tougher times.** The S&P 500 has barely made any progress since early August, as bond yields continue to feel upside pressure and, above all, the recent rise in geopolitical tensions in the Middle East (graph 7). Note that expectations for 2013 operating profits were high at the beginning of the year, and despite the acceptable results achieved recently, analysts have constantly had to temper their outlooks. The moderation observed in recent months seems justified in this context. All the same, the U.S. stock market is still headed for returns of 18% according to our forecasts. Among other things, lower investor interest in bonds will continue to favour stock markets until year's end, as well as next year (graph 8). Yet, we expect less stellar returns in 2014, as price/earnings ratios suggest that stocks are not as much of a bargain as they have been in recent years. Relatively moderate growth in book earnings should also lead to slightly weaker returns. Our target stands at 6.5% for 2014 (graph 9).
- **In contrast, we expect the S&P/TSX to continue the catch-up process begun in recent months.** The Canadian stock index has jumped more than 9% since hitting its low point very early this summer, and is posting slight growth of around 3% since the start of the year. This is generally in line with our 6% target for total returns this year. We expect better for 2014, and are predicting returns of 8.0%. The S&P/TSX's recent surge got a lot of help from financial shares' solid performance, after satisfactory earnings for the third quarter were posted by the major banks and some dividend increases were announced. The consumer discretionary sector maintained the strong performance posted to date in 2013; consumer staples made up some of the ground lost this summer. In other good news, the energy sector, which had done some tangible damage to the Canadian stock market in the first half of the year, has regained its composure (graph 10 page 5), largely due to the resolution of supply problems and the increase in oil prices since the start of the summer. Nonetheless, for the Canadian stock market, keep an eye on emerging markets, which are currently experiencing economic and financial difficulties (graph 11 page 5); these could once again hurt the industrial materials sector that has been a drag on the S&P/TSX over the last two years.
- **In terms of international equities, Europe currently offers some hope, thanks to an economy that is emerging from recession earlier than expected, as well as a lull in financial tensions.** While it is highly likely that economic growth will remain anaemic, the global appeal of the stock markets could make investors hunt for deals in the Old World. Nevertheless, keep in mind that new periods of tension are not only possible, but probable. In all, we expect moderate returns of 6.0% in 2014.

Graph 7– Geopolitical tensions hurt U.S. stock markets



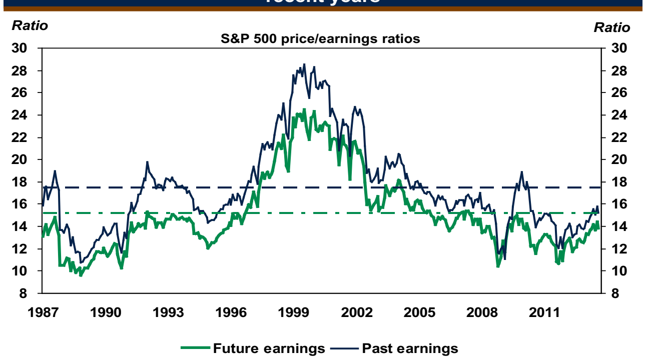
*10-session moving averages
Sources: Bloomberg and Desjardins, Economic Studies

Graph 8 – Heading for a shift to the stock market?



Sources: Datastream and Desjardins, Economic Studies

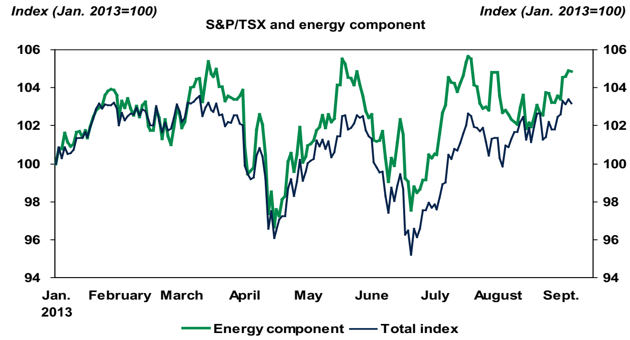
Graph 9 – Stock markets are still appealing, but less so than in recent years



Sources: Institutional Brokers Estimate System and Desjardins, Economic Studies

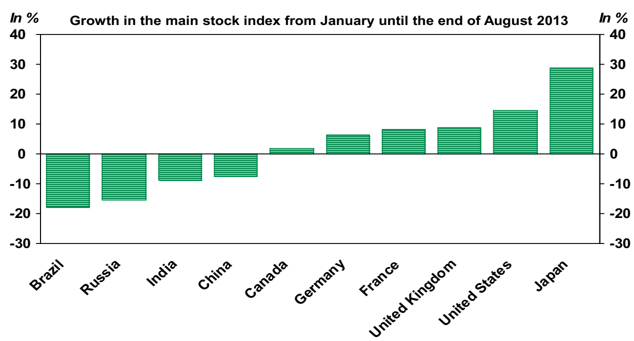
- **The underlying trend remains staunchly negative for bond yields, a situation that should continue through the next year.** Our scenario for bond yields now has U.S. 10-years ending 2013 at 3.00% and 2014 at 3.40%. Canadian bonds will not be immune to this trend. While some risks on the horizon (further upheaval around the U.S. budget situation, weak inflation and employment in the United States) could limit rate increases, it would take a relatively major shock to sustain a downtrend. In terms of asset allocation, this class should not be favoured.
- **Yield forecasts.** We are revising our bond yield target to -2.0% for 2013, as there is no longer much doubt that the major bond rally of the last two decades has come to an end. For equities, we are maintaining our return forecasts for North America, but slightly raising our target for international stocks, given the better-than-expected performance of recent months. For 2014, we expect the Canadian stock market to recover and more moderate returns from the U.S. stock market. Bonds will likely see another difficult year of negative returns in 2014.

Graph 10 – The Canadian stock market owes much of its recovery to the energy sector



Sources: Bloomberg and Desjardins, Economic Studies

Graph 11 – Weak stock markets in emerging nations reflect the difficulties they are experiencing



Sources: Bloomberg and Desjardins, Economic Studies

Table 3
Asset classes percentage return

	Cash	*Bonds*	*Canadian stocks*	*U.S. stocks*	*International stocks*	*Exchange rate*
End of year	**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
2012	0.95	3.6	7.2	16.0	17.9	-2.7
2013f	target: 1.00	target: -2.0	target: 6.0	target: 18.0	target: 11.0	target: 6.1 (US$0.95)
range	0.95 to 1.05	-4.0 to 0.0	1.0 to 9.0	12.0 to 24.0	5.0 to 17.0	2.8 to 8.4
2014f	target: 1.00	target: 0.0	target: 11.0	target: 7.5	target: 6.0	target: -4.0 (US$0.99)
range	0.95 to 1.10	-3.0 to 3.0	4.0 to 18.0	2.0 to 15.0	0.0 to 12.0	-6.9 to -1.0