RETAIL RATE FORECASTS

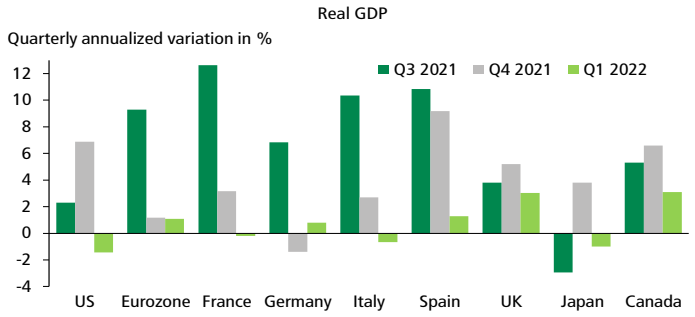
How High Will the Bank of Canada's Policy Rate Go?

HIGHLIGHTS

- The global economy is reaching a turning point.
- The Bank of Canada should raise its policy rate by 75 basis points in July.
- The stock markets will likely suffer further setbacks.
- The Loonie Is Expected to Depreciate Over the Next Few Quarters.

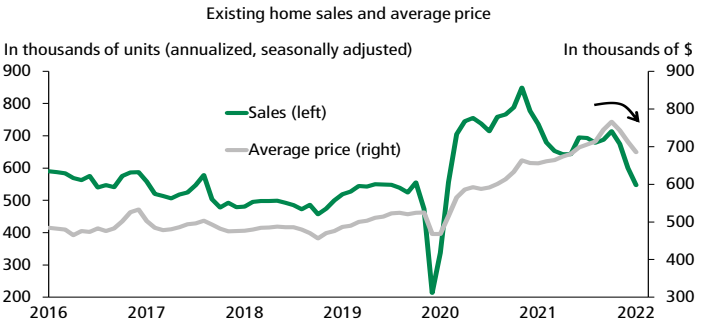
- **The global economy is reaching a turning point.** The exceptional economic recovery that we saw in 2021 now seems like a thing of the past. GDP growth moderated in many countries in the first quarter (graph 1), and this is probably just the beginning. In the United States, real GDP even declined 1.5% in the first quarter. However, with strong domestic demand, this is likely not the start of a recession. The job market is holding strong in many countries and inflation still has momentum, but it's increasingly clear that the wind is shifting as interest-rate-sensitive sectors are in decline.
- **The Federal Reserve (Fed) raised rates by 75 basis points in June**, the largest hike since 1994. The urgency at the Fed is palpable, and the biggest worry is inflation, which hit a new cyclical high of 8.6% in May. Fed officials now anticipate that the upper range of the federal funds rate target could hit 3.5% by the end of this year and go as high as 4.0% next year. However, we believe that the slowdown in the US economy could prevent further increases in 2023.
- **Canada's economy is holding its own, but the housing sector is slowing down.** Canada's real GDP grew by 3.1% in the first quarter, which was below expectations. As in the US, most of the weakness came from international trade, however. The job market continued to climb in May, with wages picking up and unemployment hitting a record low of 5.1%. But the housing market is the real thorn in the Canadian economy's side. Sales of existing homes declined over the last three months, and average property prices have now dropped 11% from their peak (graph 2).

GRAPH 1
The world economy is slowing down after its strong recovery



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

GRAPH 2
The Canadian housing market is declining



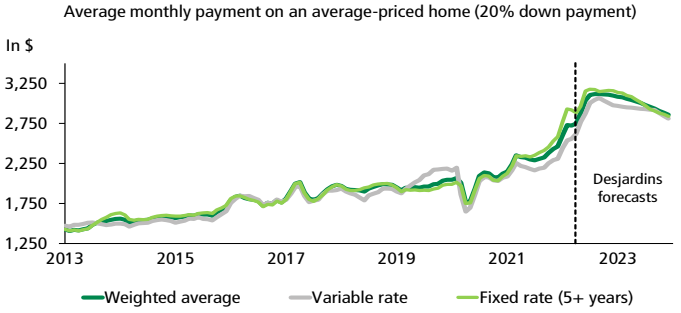
Sources: Canadian Real Estate Association and Desjardins Economic Studies

Jimmy Jean, Vice-President, Chief Economist and Strategist • Lorenzo Tessier-Moreau, Senior Economist • Hendrix Vachon, Senior Economist
Desjardins, Economic Studies: 514-281-2336 or 1 866-866-7000, ext. 5552336 • desjardins.economics@desjardins.com • desjardins.com/economics

- **The Bank of Canada (BoC) talks the talk, but will it walk the walk?** The BoC raised its key rate 50 basis points to 1.5% at its meeting on June 1 and suggested it could quickly hike past 3.0% to counter runaway inflation, which surged from 6.8% to 7.7% in May. However, we think that a policy rate that high could have a major impact on the Canadian economy. The rate increases seen so far this year have already made property much less affordable and placed many households in a precarious situation (graph 3). We're expecting a significant slowdown in the Canadian economy in the second half of the year, which could limit the policy rate to 2.5%.

- **Retail interest rates are now in prohibitive territory.** It's now increasingly difficult to find a five-year fixed interest rate on a mortgage at less than 5%, although a variable rate under 3.5% can still be found. That variable-rate advantage should narrow quickly, especially if the BoC mimics the Fed with a 75 basis-point increase in July as we expect. If such rates appear prohibitive for borrowers, that is precisely the Bank's aim. The BoC is hoping to turn consumers toward saving rather than borrowing, which might eventually help drive inflation down.

GRAPH 3
The average monthly payment for a new mortgage in Canada is rising sharply



Sources: Bank of Canada, Canadian Real Estate Association and Desjardins Economic Studies

TABLE 1
Forecasts: Retail rate

	DISCOUNT RATE	PRIME RATE	MORTGAGE RATE			TERM SAVINGS[1]		
IN %			1 year	3 years	5 years	1 year	3 years	5 years
Realized (end of month)								
January 2022	0.50	2.45	2.79	3.49	4.74	0.40	1.15	1.50
February 2022	0.50	2.45	2.89	3.49	4.79	0.50	1.30	1.70
March 2022	0.75	2.70	2.99	3.69	4.99	0.90	1.75	2.25
April 2022	1.25	3.20	3.29	4.09	4.99	1.25	2.25	3.00
May 2022	1.25	3.20	3.79	4.49	5.09	1.25	2.25	3.00
June 2022	1.75	3.70	4.74	5.39	6.04	1.50	2.75	4.00
July 6, 2022	1.75	3.70	4.74	5.39	6.04	1.50	2.75	4.00
Forecasts								
End of quarter								
2022: Q3	2.25–3.25	4.20–5.20	3.95–5.55	4.75–6.35	5.65–7.25	1.15–2.55	2.05–3.45	3.30–4.70
2022: Q4	2.00–3.25	3.95–5.20	3.85–5.65	4.80–6.60	5.85–7.65	1.25–2.85	2.15–3.75	2.80–4.40
2023: Q1	2.00–3.50	3.95–5.45	3.80–5.70	4.60–6.50	5.80–7.70	1.10–3.00	1.95–3.85	2.45–4.35
2023: Q2	2.00–3.50	3.95–5.45	3.80–5.70	4.40–6.30	5.45–7.35	1.10–3.00	1.75–3.65	1.90–3.80
End of year								
2023	1.75–3.25	3.70–5.20	3.30–5.20	3.90–5.80	4.95–6.85	0.90–2.80	1.35–3.25	1.45–3.35
2024	1.25–3.25	3.20–5.20	2.90–5.30	3.30–5.70	4.50–6.90	0.40–2.80	0.65–3.05	0.90–3.30
2025	1.25–3.25	3.20–5.20	2.90–5.30	3.30–5.70	4.40–6.80	0.40–2.80	0.55–2.95	0.75–3.15

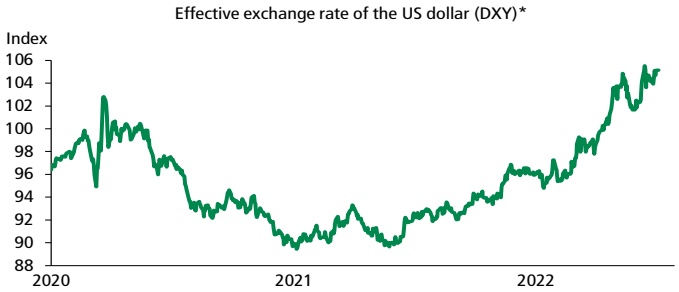
[1] Non-redeemable (annual); NOTE: Forecasts are represented using an asymmetric range reflecting the perceived probability of deviation from the base scenario. The mean of the range does not represent the forecast associated with the base scenario.
Source: Desjardins, Economic Studies

Exchange Rate

The Loonie Is Expected to Depreciate Over the Next Few Quarters

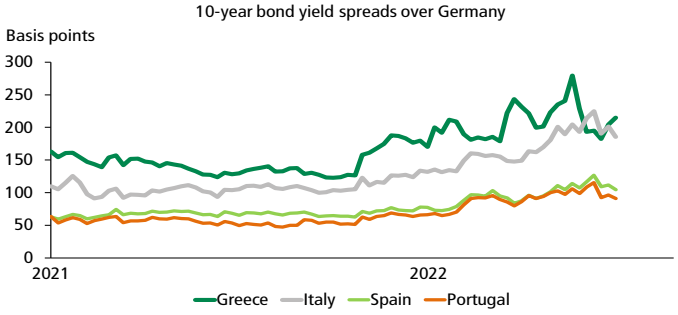
- There's still a lot of action on the financial markets. Risk appetite remains generally low, despite occasional bursts of optimism. As such, the US dollar continues to profit from its safe-haven role and remains on an upward trend (graph 4). Monetary tightening in the US is also underpinning the greenback.
- Many other central banks have also adopted a more hawkish monetary policy. The European Central Bank (ECB) joined the ranks in June, signalling possible hikes of up to 50 basis points during the summer. However, this hasn't done much for the euro, as the European economy could slow further and trigger another sovereign debt crisis (graph 5).
- Fears of a global recession are hampering the Canadian dollar. It's not the most highly sought-after currency in uncertain periods, and many commodity prices have recently dropped. Interest rate expectations remain high in Canada, but not high enough to lift up the Canadian dollar. What's more, higher interest rates are exacerbating the problem of high household debt in Canada and increasing the risk of a major housing market correction.
- **Key factors to watch:** Investors' risk appetite is likely to remain low over the coming quarters, keeping the US dollar stronger for longer. Against this backdrop, the Canadian dollar could bottom out at US$0.73 by mid-2023. The loonie will also be hobbled by falling commodity prices, in addition to the slowdown in the Canadian economy and a nearly 15% correction in housing prices.

GRAPH 4
The US dollar continues to appreciate



* Based on a basket of currencies including the Canadian dollar, the euro, the pound, the yen, the Swiss franc and the Swedish krona.
Sources: Datastream and Desjardins Economic Studies

GRAPH 5
Credit spreads are widening for certain European countries



Sources: Datastream and Desjardins Economic Studies

Impacts on the Canadian dollar	Short-term	Long-term
Risk aversion	↘	↗
Commodity prices	↘	→
Interest rate spreads	↘	→

TABLE 2
Forecasts: Currency

	2021		2022				2023			
END OF PERIOD	Q3	Q4	Q1	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0.7886	0.7914	0.7999	0.7768	0.7700	0.7500	0.7400	0.7300	0.7300	0.7400
CAN$/US$	1.2680	1.2636	1.2501	1.2873	1.2987	1.3333	1.3514	1.3699	1.3699	1.3514
CAN$/€	1.4695	1.4370	1.3909	1.3458	1.3506	1.3733	1.3784	1.4110	1.4247	1.4324
US$/€	1.1590	1.1372	1.1127	1.0455	1.0400	1.0300	1.0200	1.0300	1.0400	1.0600
US$/£	1.3484	1.3545	1.3167	1.2145	1.2100	1.1900	1.1900	1.2000	1.2100	1.2300

f: forecasts
Sources: Datastream and Desjardins, Economic Studies

Asset Classes Return

The Stock Markets Will Likely Suffer Further Setbacks

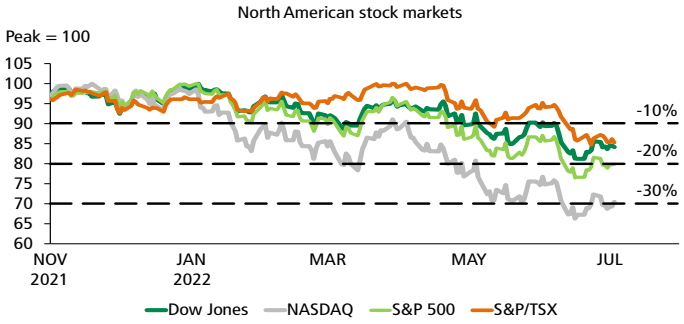
- **The S&P 500 and NASDAQ are in a bear market.** Times are tough for investors on the stock markets, which have had little respite this year. After rebounding briefly at the end of May, the US and Canadian stock markets dropped lower still in June. The S&P 500 is down more than 20% from its peak, while the NASDAQ has plunged by more than 30% (graph 6). The Canadian S&P/TSX index, which had held up better since the beginning of the year thanks to high commodity prices, has now fallen more than 10% from its peak.

- **Stock market downturns mirror rising interest rates.** Rising bond yields continue to be an important catalyst for the decline in stock market indexes (graph 7). The stock market's plunge in June matched the sharp jump in bond yields ahead of the Federal Reserve meeting on June 15. And with good reason. The Fed announced a 75 basis-point increase and revised its assessment of future rates—both major risks for investors. Typically, high interest rates are especially hurtful to businesses in growth sectors, given that they generally carry more debt and pay less in dividends. But the rapid pace of current monetary tightening is sowing fear of greater consequences for the wider economy. Now all companies are seeing their profitability threatened by the increasing risks of a recession, not just the growth industries.

- **Stock market valuations have improved but remain high.** The recent drop in the stock markets has somewhat restored balance to the valuations of listed securities. The average price-to-earnings ratio of S&P 500 securities fell back down to around 16, close to its five-year average before the pandemic. The average P/E ratio for the S&P/TSX is now in a trough at just above 11. Calculating a price-to-earnings ratio for Canadian stocks that are not in the energy and commodities sectors, however, takes off a bit of that shine. A ratio of about 13.5 for those sectors is still higher than the historical average (graph 8). However, those ratios are based on projected earnings for the coming year, and we know they could be revised downward when listed companies publish their quarterly earnings. With economic growth expected to slow and rising borrowing costs, we are forecasting a weak earnings growth for the rest of this year, and it could turn negative in 2023.

- **Tighter monetary policies are making an impact around the world.** On top of the economic headwinds from China's economy and the war in Ukraine, the global markets will also be greatly influenced by interest rate and monetary policy developments. The Bank of Japan has decided to stay the course with its 0% target for Japanese 10-year government bonds. The yield spread with the US is very high, severely

GRAPH 6
North American stock markets are in bear market territory

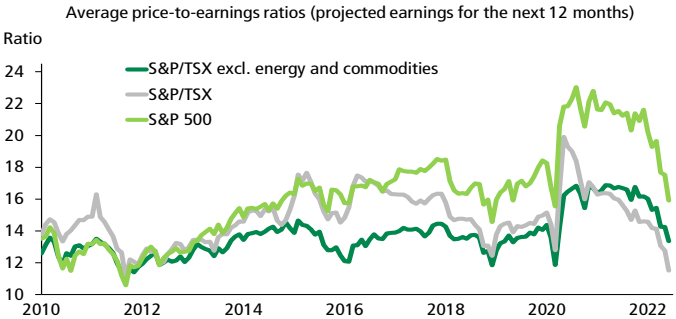


Sources: Datastream and Desjardins Economic Studies

GRAPH 7
Bond yield trends have been responsible for much of the stock market fluctuations

Sources: Datastream and Desjardins Economic Studies

GRAPH 8
Price-to-earnings ratios have plummeted recently, but remain high amid rising interest rates

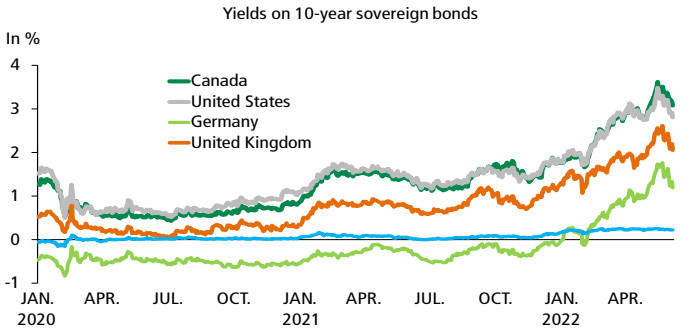


* Last data point as of June 30.
Sources: Datastream and Desjardins Economic Studies

penalizing the yen, but inflationary pressures in Japan remain low (graph 9). The change in course is much more dramatic in Europe. The European Central Bank finally abandoned its cautious approach and is now pointing to several interest rate hikes by the end of the year. Negative interest rates are expected to quickly become a thing of the past in Europe. However, we must keep a close eye on credit spreads between European countries over the next few quarters. The ECB is planning measures to limit financial tensions during its monetary tightening, but they might not be enough. Fears of renewed sovereign debt problems in Europe could have a major impact on the markets.

- **Volatility will remain as long as inflation hasn't peaked.** In the current climate, it'll remain difficult for the stock markets to stabilise. Bond yields seem to have plateaued and fell back down in late June, but they're still at risk of soaring again unless inflation shows more signs of moderation. The Fed began reducing its balance sheet in June and will pick up the pace in the coming months, putting additional pressure on the stock and bond markets. Paradoxically, a slowdown in the world economy, which would signal a moderating inflation, lower bond yields, and easier monetary policy, could be what is needed to shore up the stock markets. Our scenario suggests that such a signal could appear near the end of the year. Meanwhile, brace yourselves for continuing volatility.

GRAPH 9
Bond yields are rising globally, but remain much lower in Japan



Sources: Datastream and Desjardins, Economic Studies

TABLE 3
Asset classes percentage return

	CASH	BONDS	CANADIAN STOCKS	U.S. STOCKS	INTERNATIONAL STOCKS	EXCHANGE RATE
END OF YEAR IN % (EXCEPT IF INDICATED)	3-month T-Bill	Bond index[1]	S&P/TSX index[2]	S&P 500 index (US$)[2]	MSCI EAFE index (US$)[2]	C$/US$ (variation in %)[3]
2011	1.0	9.7	-8.7	2.1	-11.7	2.3
2012	1.0	3.6	7.2	16.0	17.9	-2.7
2013	1.0	-1.2	13.0	32.4	23.3	7.1
2014	0.9	8.8	10.6	13.7	-4.5	9.4
2015	0.6	3.5	-8.3	1.4	-0.4	19.1
2016	0.5	1.7	21.1	12.0	1.5	-2.9
2017	0.6	2.5	9.1	21.8	25.6	-6.4
2018	1.4	1.4	-8.9	-4.4	-13.4	8.4
2019	1.6	6.9	22.9	31.5	22.7	-4.8
2020	0.9	8.7	5.6	18.4	8.3	-2.0
2021	0.2	-2.5	25.1	28.7	11.8	-0.8
2022f	target: 1.4	target: -9.2	target: -9.8	target: -20.4	target: -15.7	target: 5.5 (US$0.75)
range	1.2 to 1.6	-12.2 to -6.2	-27.3 to -2.3	-32.9 to 7.9	-28.2 to -3.2	2.1 to 9.9

f: forecasts; [1] FTSE Canada Universe Bond index; [2] Dividends included; [3] Negative = appreciation, positive = depreciation.
Sources: Datastream and Desjardins, Economic Studies