RETAIL RATE FORECASTS

The Global Economy Has Been Surprisingly Resilient

HIGHLIGHTS

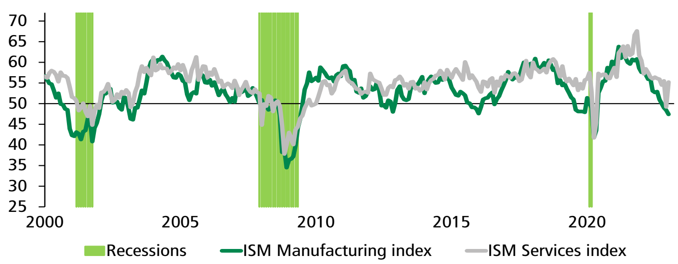
- The global economy is slowing, but not as fast as expected.
- The Bank of Canada has signalled it will pause interest rate hikes.
- Is the US dollar on the verge of a rebound?
- The outlook for returns is improving, but risks remain high.

- **The Global Economy Is Slowing, but Not as Fast as Expected.** We're seeing early signs of a recession, but economic growth appears to be holding up well in several countries. Despite previous concerns, eurozone real GDP grew by 0.1% in the fourth quarter of 2022. News has also been positive out of China, where relaxed COVID-19 restrictions could mean a rebound is around the corner. Q4 economic growth came in slightly higher than expected in the US, while nonfarm payroll employment increased by a stunning 517,000 jobs in January. Despite this strength, some indicators like the ISM Manufacturing index point to a decline in economic activity (graph 1).

- **Federal Reserve (Fed) Officials Think Further Rate Hikes Will Be Needed.** At the Fed's February 1 meeting, chairman Jerome Powell acknowledged that progress had been made in its ongoing fight against inflation. It also raised the federal funds rate by 25 basis points and signalled that further increases would likely be needed to finish the job. We still expect the federal funds rate to top out at 5.25% in April.

- **The Canadian Economy Slowed at the End of 2022.** Real GDP growth slowed to 0.1% in November, and the advance estimate shows a flat reading for December (graph 2). It was a tough year for housing, and the weakness in the Canadian economy now appears to be spreading to other sectors. That said, hiring surged by an unexpected 104,000 in December (revised to 69,000), sending the unemployment rate lower. But rising interest rates will continue to weigh on highly indebted businesses and households, and the economy is likely to contract during the first three quarters of this year.

GRAPH 1
The ISM Manufacturing Index Is Pointing to a Slowdown in US Activity, While the ISM Services Index Is Holding Steady



Sources: Institute for Supply Management, National Bureau of Economic Research and Desjardins Economic Studies

GRAPH 2
Canadian Real GDP Growth Slowed in Late 2022

* Statistics Canada advance estimate
Sources: Statistics Canada and Desjardins Economic Studies

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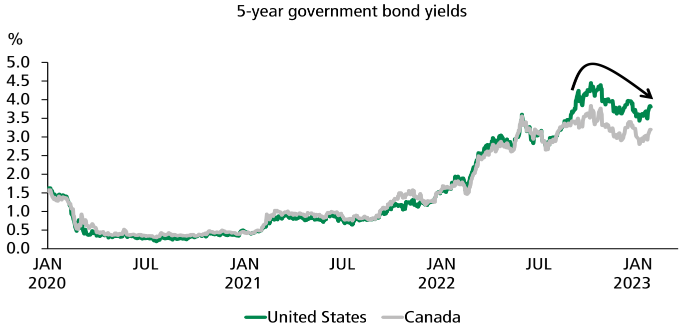
NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

- **The Bank of Canada (BoC) Raised Rates Again, but Signalled a Pause Ahead.** The Bank of Canada also raised its policy rate by 25 basis points in January, lifting it to 4.50%. But it made clear that it plans to hold rates steady going forward. We expect the overnight rate to stay where it is until fall despite deteriorating economic conditions. If inflation comes down closer to target later this year, the BoC could start cutting rates, ultimately lowering them to 2.25% later in 2024.

- **Retail Rates Are Stabilizing.** Although the Bank of Canada raised rates again in December and January, longer-term bond yields have been persistently trending lower in recent months (graph 3). As a result, rates offered to borrowers on longer-term loans have leveled off. But given a highly uncertain climate and deteriorating economic conditions, lower bond yields may not be immediately reflected in retail rates. Term savings rates could also remain high for some time as financial institutions try to attract deposits.

GRAPH 3
Bond Yields Are Trending Lower



Sources: Datastream and Desjardins Economic Studies

TABLE 1
Forecasts: Retail rate

%	DISCOUNT RATE	PRIME RATE	MORTGAGE RATE			TERM SAVINGS[1]		
			1-year	3-year	5-year	1-year	3-year	5-year
Realized (end of month)								
August 2022	2.75	4.70	5.39	5.79	6.14	2.00	3.00	4.00
September 2022	3.50	5.45	5.79	5.89	6.14	2.00	3.00	4.00
October 2022	4.00	5.95	6.19	6.14	6.34	2.00	3.00	4.00
November 2022	4.00	5.95	6.19	6.14	6.49	3.00	3.75	4.00
December 2022	4.50	6.45	6.19	6.14	6.49	4.25	4.00	4.00
January 2023	4.75	6.70	6.19	6.14	6.49	4.25	4.00	4.00
February 9, 2023	4.75	6.70	6.19	6.14	6.49	4.25	4.00	4.00
Forecasts								
End of quarter								
2023: Q1	4.75	6.70	6.19	6.14	6.49	4.25	4.00	4.00
2023: Q2	4.75	6.70	6.19	6.14	6.49	4.25	4.00	4.00
2023: Q3	4.75	6.70	6.19	6.14	6.49	4.25	4.00	3.85
2023: Q4	4.25	6.20	6.19	6.14	6.49	3.85	3.50	3.55
End of year								
2024	2.50	4.45	4.74	4.94	5.99	2.20	2.25	2.35
2025	2.50	4.45	4.59	4.74	5.84	2.05	2.05	2.15
2026	2.50	4.45	4.39	4.74	5.69	2.05	2.05	2.15

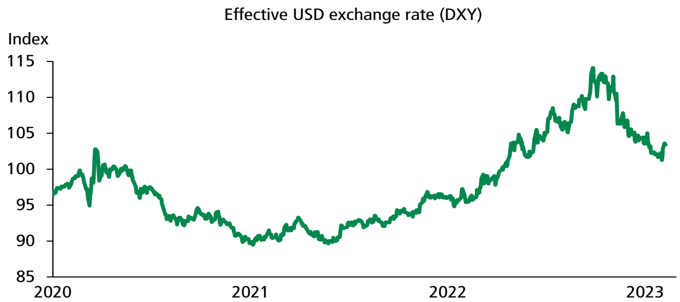
[1] Non-redeemable (annual); NOTE: Forecasts are represented using an asymmetric range reflecting the perceived probability of deviation from the base scenario. The mean of the range does not represent the forecast associated with the base scenario.
Source: Desjardins Economic Studies

Exchange Rate

Is the US Dollar on the Verge of a Rebound?

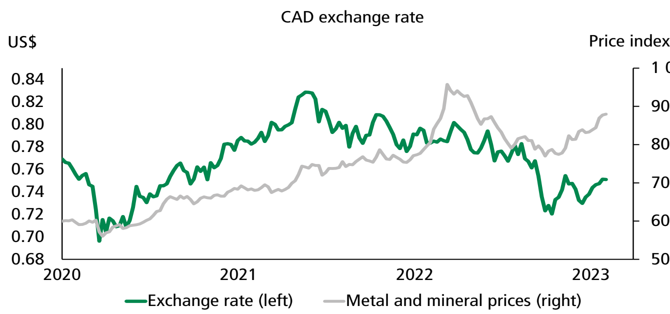
- Market optimism tends to reduce investor appetite for safe havens, penalizing the US dollar (graph 4). But the greenback has been holding up lately, benefitting from the strong January jobs report and rebounding ISM Services index among other things. Interest rate spreads continue to drive currency markets, and any news that could send a country's interest rates higher also tends to do the same to its currency.
- That's why the euro rose on clear signals from the European Central Bank that it would continue to raise interest rates. Positive economic news didn't hurt, either. The eurozone still hasn't recorded a single quarter of decline, and so far it has dodged the energy crisis many had feared. Conversely, the Canadian dollar's gains have been limited by the rate hike pause announced by the Bank of Canada. But the loonie is being helped by general market optimism, briefly hitting US$0.75 in early February (graph 5). The rise in some commodity prices is also providing some support.
- **Forecasts:** As long as investors remain upbeat on the economy, the US dollar will struggle to rebound significantly. However, the greenback could benefit if expectations continue to rise for further interest rate hikes in the US, especially if the economy remains strong in the near term. We still believe the economy will eventually deteriorate, at which point several currencies could lose substantially more ground, including the Canadian dollar. The loonie should also be penalized by weaker commodity prices, helping to bring it back to around US$0.72 this spring.

GRAPH 4
The US Dollar Has Continued to Slide in the New Year



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
The Canadian Dollar Strengthened to US$0.75 and Continues to Be Supported by High Commodity Prices



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

	2022		2023				2024			
END OF PERIOD	Q3	Q4	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0.7232	0.7380	0.7300	0.7200	0.7300	0.7400	0.7600	0.7800	0.7900	0.7900
CAN$/US$	1.3828	1.3551	1.3699	1.3889	1.3699	1.3514	1.3158	1.2821	1.2658	1.2658
CAN$/€	1.3547	1.4462	1.4384	1.4583	1.4658	1.4730	1.4605	1.4487	1.4430	1.4557
US$/€	0.9797	1.0673	1.0500	1.0500	1.0700	1.0900	1.1100	1.1300	1.1400	1.1500
US$/£	1.1163	1.2029	1.1900	1.1800	1.2000	1.2300	1.2500	1.2800	1.3000	1.3200

f: forecasts
Sources: Datastream and Desjardins Economic Studies

Asset Class Returns

The Outlook for Asset Returns Is Improving, but Risks Remain High

- **Investor Risk Appetite Returned Early This Year.** Stock markets started the year on a strong note, as investors focused on lower long-term bond yields and encouraging signs on inflation. Growth stocks like many Nasdaq-listed tech companies rebounded strongly on expectations that rate hikes will be ending soon (graph 6). This renewed risk appetite seems to be trumping concerns about a possible recession. Markets appear to be pricing in a soft landing for the US economy, but not necessarily a more painful alternative.

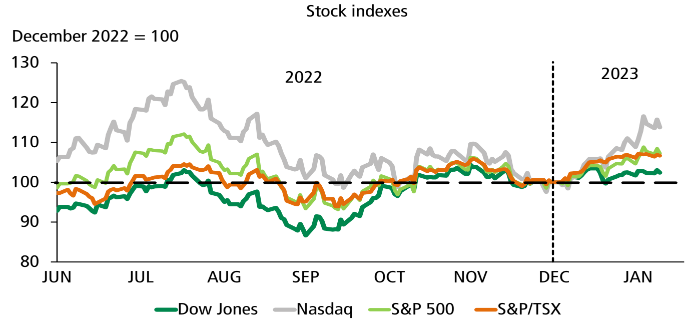
- **The Yield Curve Is Becoming More Inverted.** The recent decline in long-term bond yields has inverted the yield curve further. The difference between the yields on 2- and 10-year US government bonds is now smaller than it has been since the 1980s as investors expect a sharp decline in inflation over the coming months. But an inverted yield curve has very often preceded recessions in the United States (graph 7). While lower bond yields are generally good for returns on risky assets, lower yields resulting in a steeply inverted yield curve can have the opposite effect.

- **A new correction appears likely on North American stock markets.** The current risk-on sentiment is puzzling, especially as the corporate earnings outlook continues to deteriorate. Analysts have lowered their forecasts by about 5.5% for the S&P 500 and 6% for the S&P/TSX. And the downward revisions in earnings affect almost every sector of the economy (graph 8). Such widespread downward revisions of earnings were last seen during the 2020 pandemic shock and the 2008–2009 recession.

- **The S&P/TSX Has also Started the Year Strong.** Canada's S&P/TSX Composite Index has also risen on renewed investor risk appetite. It's up nearly 7.0% since the beginning of the year. The Bank of Canada further boosted investor confidence by signalling a rate hike pause. But the Canadian economy is also more at risk due to high household debt and greater interest rate sensitivity. The S&P/TSX hasn't corrected as much as US and global indexes over the past year. It continues to be buoyed largely by strength in the energy sector, making it more vulnerable to major price swings.

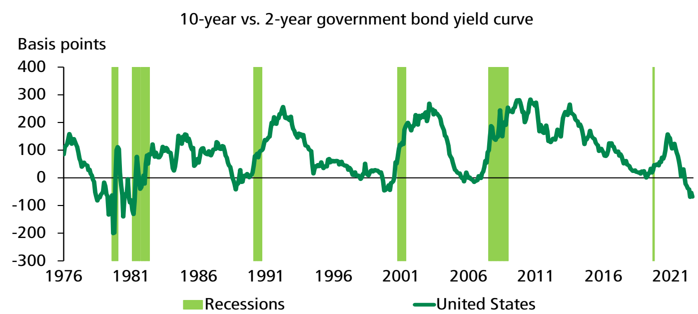
- **Global Markets Are Better Cause for Optimism.** Unlike North American markets, global stock markets have gained on renewed risk appetite and a much improved outlook. In Europe, the energy crisis many analysts feared hasn't materialized, and economic growth remained positive at the end of last year. Meanwhile corporate earnings have bounced

GRAPH 6
North American Stock Indexes Bounced Back Strong to Start the Year



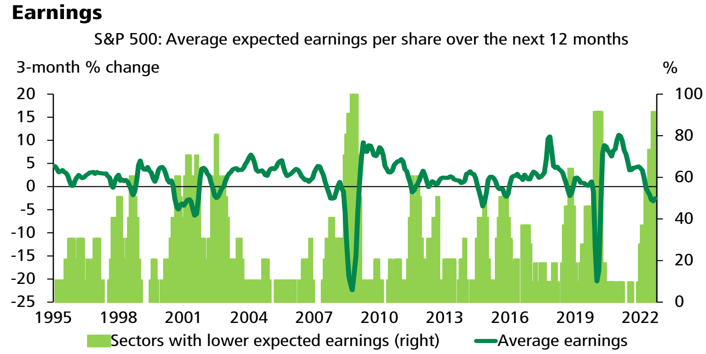
Sources: Datastream and Desjardins Economic Studies

GRAPH 7
An Inverted Yield Curve Has Preceded Previous US Recessions



Sources: Datastream and Desjardins Economic Studies

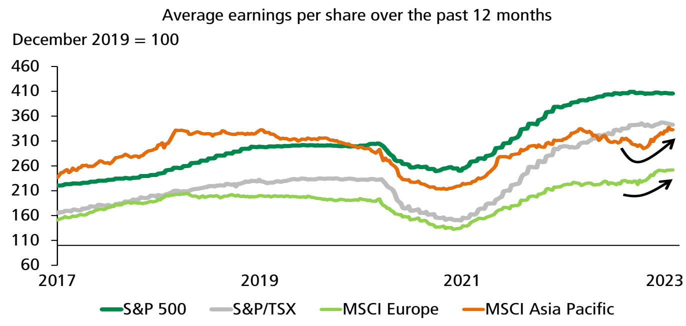
GRAPH 8
Virtually Every S&P 500 Sector Is Expected to Report Lower Earnings



Sources: I/B/E/S, Datastream and Desjardins Economic Studies back strong in recent months as companies have capitalized on the inflationary environment. The same is true for Asian stocks, which have been supported by rebounding profits and the improved outlook for China now that the country has dropped its zero-COVID policy. The European Central Bank remains hawkish on interest rate hikes, clearly telegraphing more increases ahead. This could continue to hurt returns on risk assets. However, European and Asian stocks should fare better given their lower valuations.

- **The Outlook for Returns Is Improving, but Risks Remain high.** We expect most asset classes to deliver positive returns in 2023 despite a challenging economic environment (see table 3 below). We're seeing encouraging trends in key economic indicators, and inflation appears to be coming under control in North America. This should keep pushing bond yields lower. The recent stock rally was fuelled by the improved outlook, but we don't think it accurately reflects the risks facing the global economy.

GRAPH 9
Corporate Earnings Have Rebounded in Europe and Asia



Sources: I/B/E/S, Datastream and Desjardins Economic Studies

TABLE 3
Asset class returns (%)

END OF YEAR IN % (UNLESS OTHERWISE INDICATED)	CASH 3-month T-bill	BONDS Bond index[1]	CANADIAN STOCKS S&P/TSX index[2]	US STOCKS S&P 500 index (US$)[2]	INTERNATIONAL STOCKS MSCI EAFE Index (US$)[2]	EXCHANGE RATE C$/US$ (% change)[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
2022	1.8	-11.7	-5.8	-18.1	-14.0	7.2
2023f	target: 4.6	target: 6.8	target: 2.8	target: -0.3	target: 6.4	target: -0.3 (US$0.74)
range	4.1 to 5.1	3.8 to 10.8	-5.2 to 8.8	-8.3 to 5.7	-1.6 to 12.4	-3.0 to 4.0

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