#1 MEILLEUR PRÉVISIONNISTE GLOBAL – CANADA
FOCUS ECONOMICS ANALYST FORECAST AWARDS 2022
#1 BEST OVERALL FORECASTER – CANADA

RETAIL RATE FORECASTS

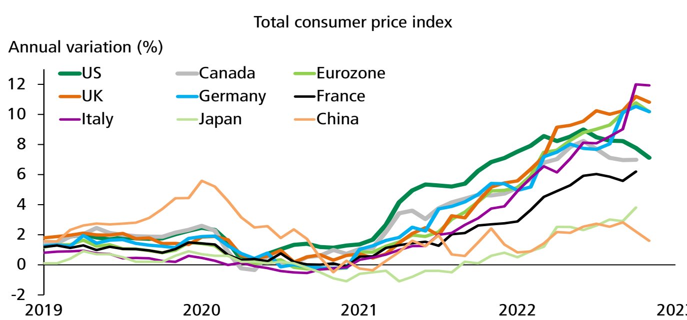
An End in Sight for Interest Rate Hikes in 2023

HIGHLIGHTS

- Inflation is inching lower in Canada and the US, but not everywhere else in the world.
- The Bank of Canada's key rate may have peaked at 4.25%.
- The loonie is losing speed.
- There's more turbulence ahead for financial markets in 2023.

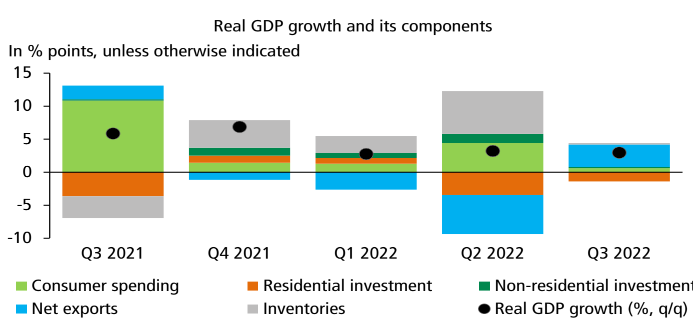
- **Inflation is inching lower in Canada and the US, but not everywhere.** Inflationary pressures are a truly global phenomenon, but European countries are being hit particularly hard due to rising energy costs (graph 1). Several of the world's central banks will face the difficult decision of choosing to sacrifice economic growth to rein in inflation. In the United States, inflation has been cooling for the past few months, even as the economy and labour market continue to grow. Still, the cumulative effect of rate hikes leads us to believe the US won't escape a recession in 2023.
- **The Federal Reserve (Fed) slows down the pace of rate hikes but shows no sign of stopping.** The Fed's press release following its December 14 meeting featured remarkably few changes compared to the previous version. The federal funds target rate was raised 50 bps to 4.5% and Fed officials now predict it will top 5.0% in 2023. During the press conference, Fed Chair Jerome Powell acknowledged a welcome reduction in inflation, but reiterated that some softening of the US labour market is needed to bring inflation down toward its target rate in a sustained way.
- **Real GDP continues to grow but domestic demand contracts in Canada.** The 2.9% growth in real GDP in the third quarter is almost exclusively due to net exports. In contrast, domestic demand fell 0.6% in Canada, dragged down by a decline in residential investment (graph 2). November's employment data was no more positive, with only 10,000 jobs added across the country. However, the labour market remains overheated, with the unemployment rate sitting at just 5.1%. But after a few months of a stagnant

GRAPH 1
Inflation is still rising in several economies



Sources: Datastream and Desjardins Economic Studies

GRAPH 2
Big Q3 increase in real GDP is concealing an underlying weakness



Sources: Statistics Canada, Desjardins Economic Studies

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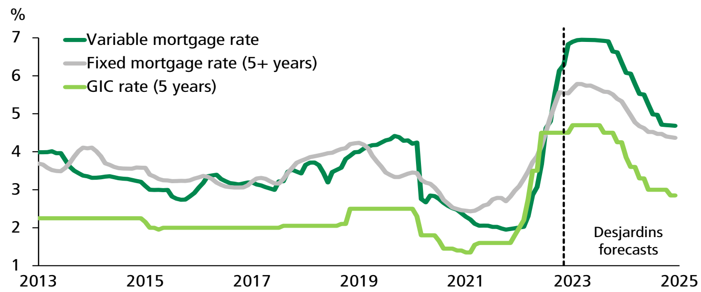
employment picture, we expect to see some retreat in total employment, signalling the start of the recession.

- **Canada's December 50 bps rate hike could be its last.** The Bank of Canada (BoC) raised its overnight rate to 4.25% on December 7 and indicated for the first time that it "will be considering whether the policy interest rate needs to rise further." This addition signals that the door is now open for putting an end to its rate hike cycle. We think the key rate may very well have peaked and that economic indicators won't support another increase at the BoC's January meeting.
- **High retail interest rates are here to stay.** Borrowers will need to be patient as retail interest rates are likely to stay at historically high levels for a few more quarters. But the recent drop in long-term government bond yields suggests the rates offered to customers should at least hold steady (graph 3). It'll probably be well into 2023 before we see rates start to fall. With a recession hanging over the economy, we may also see financial institutions tighten their lending conditions.

GRAPH 3
Lower bond yields give hope for more stable retail rates



Sources: Bank of Canada and Desjardins Economic Studies

TABLE 1
Forecasts: Retail rate

IN %	DISCOUNT RATE	PRIME RATE	MORTGAGE RATE 1 year	MORTGAGE RATE 3 years	MORTGAGE RATE 5 years	TERM SAVINGS[1] 1 year	TERM SAVINGS[1] 3 years	TERM SAVINGS[1] 5 years
Realized (end of month)								
June 2022	1.75	3.70	4.74	5.39	6.04	1.50	2.75	4.00
July 2022	2.75	4.70	4.99	5.54	6.14	2.00	3.00	4.00
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 20, 2022	4.50	6.45	6.19	6.14	6.49	4.25	4.00	4.00
Forecasts								
End of quarter								
2022: Q4	4.50	6.45	6.19	6.19	6.49	4.25	4.00	4.00
2023: Q1	4.50	6.45	6.54	6.54	6.79	4.25	4.20	4.20
2023: Q2	4.50	6.45	6.54	6.54	6.79	4.25	4.20	4.20
2023: Q3	4.50	6.45	6.54	6.54	6.79	4.25	4.00	4.00
End of year								
2023	4.00	5.95	6.04	6.04	6.64	3.75	3.75	3.75
2024	2.50	4.45	4.84	4.99	6.09	2.30	2.35	2.35
2025	2.50	4.45	4.49	4.84	5.79	2.10	2.15	2.15

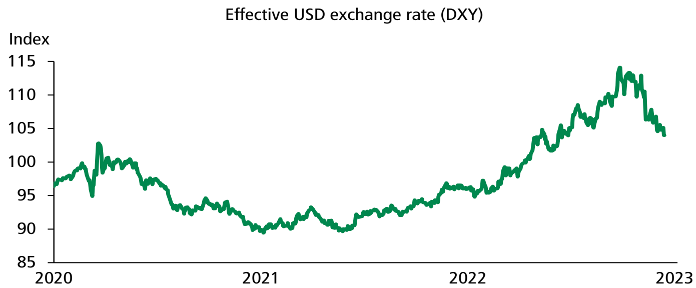
[1] Non-redeemable (annual); NOTE: Forecasts are represented using an asymmetric range reflecting the perceived probability of deviation from the base scenario. The mean of the range does not represent the forecast associated with the base scenario.
Source: Desjardins, Economic Studies

Exchange Rate

The loonie is losing speed

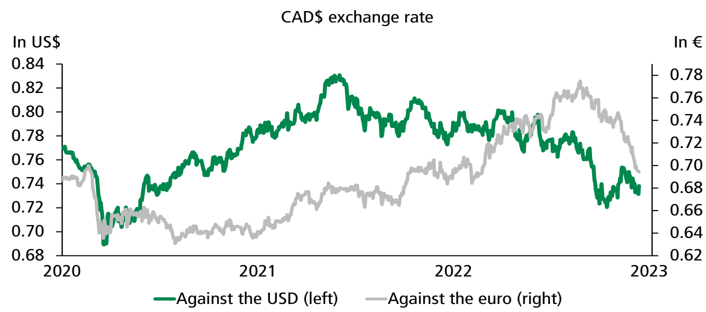
- Renewed optimism over the past two months has dented the appeal of the US dollar, causing it to depreciate against several currencies (graph 4). The DXY US Dollar Currency Index saw all its summer gains wiped out, and European currencies have seen an especially strong rebound. The pound sterling is currently trading at around US$1.23 compared to its September low of nearly US$1.04. The euro is hovering around US$1.06, a marked improvement considering that it was still trading below parity in November. Investor fears of a worsening energy crisis and a more severe recession appear to have abated somewhat.
- Inflation and interest rate changes remain top of mind in the markets, including foreign exchange markets. The loonie is affected by the pause in rate hikes signalled by the Bank of Canada, especially in contrast with the continued rises being signalled by other major central banks for 2023. The recent drop in oil prices also isn't helping. The Canadian dollar is currently trading at around US$0.73, and is down even more dramatically against other currencies, including the euro (graph 5).
- **Forecasts:** We'd been predicting that the recent bout of market optimism wouldn't last and that we might see the greenback rebound against other currencies. Several should depreciate in the first few months of 2023 as negative economic indicators pile up. We predict the Canadian dollar will bottom out at US$0.72 before rebounding later on in 2023.

GRAPH 4
The US dollar is back down to its early summer level



Note: 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 has been underperforming in recent weeks



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	Q4f	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0.7232	0.7300	0.7200	0.7200	0.7300	0.7500	0.7700	0.7800	0.7900	0.7900
CAN$/US$	1.3828	1.3699	1.3889	1.3889	1.3699	1.3333	1.2987	1.2821	1.2658	1.2658
CAN$/€	1.3547	1.4247	1.3889	1.3889	1.4110	1.4000	1.3896	1.3974	1.4051	1.4304
US$/€	0.9797	1.0400	1.0000	1.0000	1.0300	1.0500	1.0700	1.0900	1.1100	1.1300
US$/£	1.1163	1.2000	1.1500	1.1500	1.1800	1.2100	1.2300	1.2500	1.2700	1.3000

f: forecasts
Sources: Datastream and Desjardins, Economic Studies

Asset Classes Return

There's turbulence ahead for financial markets in 2023

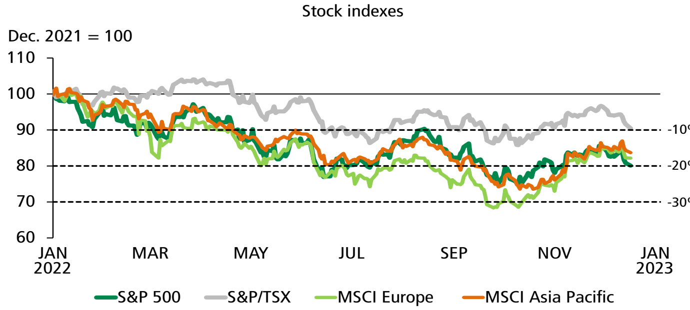
- **Although investors are encouraged by slowing inflation, nervousness remains present.** US inflation data for November confirmed recent investor optimism, but the message delivered by Jerome Powell coming out of the Fed's December meeting had the effect of a cold shower. It's true that seeing the inflation rate level off as the US economy continues to grow is a positive development, and it explains the recent drop in long-term bond yields. It also explains why the major global stock indexes have recouped a large part of their losses from earlier on in the year (graph 6). But as the Fed seems keen to (rightly) point out, you can't make an omelette without breaking eggs. By insisting on the fact that it is expecting a slowdown in the labour market, the Fed's message to investors is that they should also expect more pain for the economy and for returns.

- **Lower risk of bond yield surges.** With US inflation stabilizing, we're less likely to see a sudden shift in interest rate expectations. While we may still continue to see some volatility in the bond markets, we expect long-term yields to trend downward over the next year, paving the way for positive bond returns in 2023 (graph 7). Unless we see a new surge in inflation, stocks should also be less affected by bond market movements. With the rate hike cycle nearing its end, we expect the real economy to overtake inflation as the main concern for investors.

- **Earnings prospects are deteriorating.** Investors may be cheering the fact that the end of interest rate hikes is in sight, but it's still too soon for any kind of lasting optimism. While US and global stock indexes are set to kick off 2023 at relatively low valuations after a year of losses, listed corporate earnings appear to have peaked, and the outlook for 2023 is starting to lose its sheen (graph 8). There's a strong chance we'll continue to see net profits fall, and more steeply going forward. In addition to facing high borrowing costs, companies will have to contend with lower demand because of the recession. Expect 2023 to be another volatile year. While the outlook remains very uncertain, we're predicting low stock market returns in 2023.

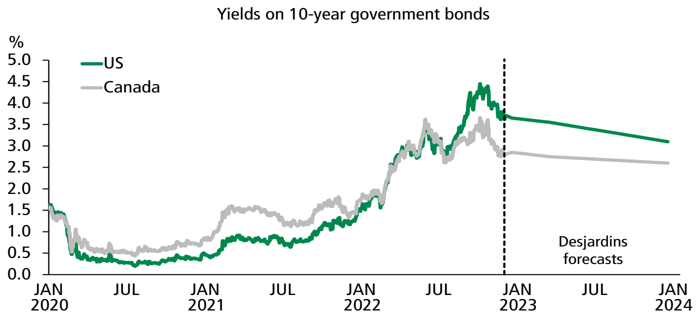
- **Rates may not rise as high in Canada, but the recession could be more painful.** Canadian bond yields are now much lower than their US counterparts, and the Bank of Canada's terminal rate is likely to be below the Fed's. But the Canadian S&P/TSX stock index could still post meager returns in 2023. While the value of the index is being supported by strong corporate earnings, we predict that a more severe recession in Canada could quickly cut those profits down and cause

GRAPH 6
Global stock indexes have recouped much of their value since October



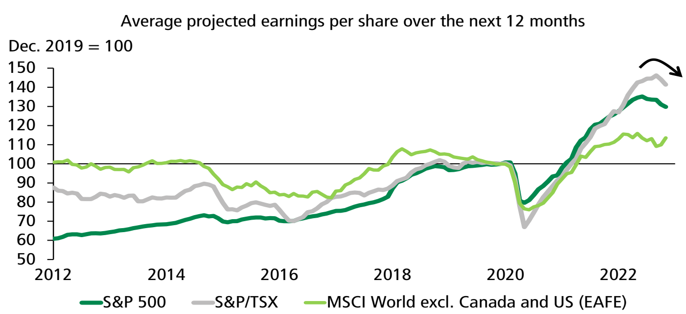
Sources: Datastream and Desjardins Economic Studies

GRAPH 7
Bond yields are set to trend downward



Sources: Datastream and Desjardins Economic Studies

GRAPH 8
Projected earnings are starting to slip

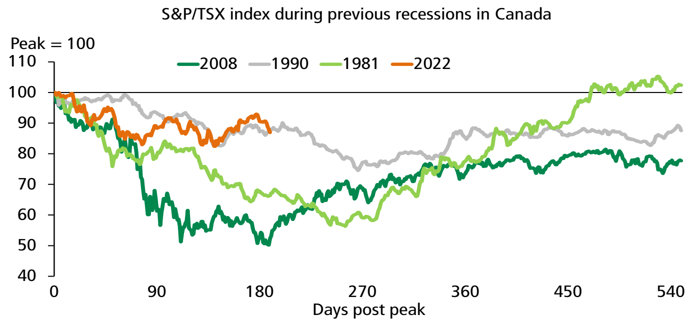


Sources: Datastream and Desjardins Economic Studies the index to plummet again (graph 9). That said, high energy prices mean we shouldn't see the index drop as low as it did during previous recessions.

- **Global markets will bear the brunt of anti-inflation efforts.** Several central banks are expected to follow in the Fed's footsteps and announce further rate hikes in early 2023. The European Central Bank also said it would start reducing the size of its balance sheet in March 2023, which will reduce liquidity in European financial markets. Eyes are also on the Bank of Japan (BoJ). While less of a problem than elsewhere, inflation has been gradually rising in Japan and is now above target. We may see the BoJ further relax its yield curve control and lift its key interest rate into positive territory. That would help the yen regain some value, but it could also deal a blow to some Japanese companies in terms of competitiveness and profitability.

- **Another difficult year for returns?** Big risks remain for market returns in 2023, both in Canada and elsewhere, which will continue to fuel volatility. However, with a moderate recession followed by a 2024 recovery, we could see stock markets rebound and avoid another year of losses. Assuming rates have indeed peaked, we can also expect to see positive returns in the bond and money markets.

GRAPH 9
The S&P/TSX index wasn't spared during previous recessions



Sources: Datastream and Desjardins Economic Studies

TABLE 3
Asset classes percentage return

	CASH	BONDS	CANADIAN STOCKS	US 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: 1.8	target: -9.6	target: -8.4	target: -20.4	target: -16.2	target: 8.4 (US$0.73)
range	1.7 to 1.9	-11.6 to -7.6	-11.9 to -2.9	-23.9 to -16.9	-19.7 to -10.7	6.9 to 9.9
2023f	target: 4.4	target: 4.3	target: 5.9	target: 3.4	target: 6.2	target: -2.7 (US$0.75)
range	3.7 to 5.1	-0.7 to 9.3	-8.6 to 16.4	-12.1 to 12.9	-8.3 to 16.7	-6.4 to 1.4

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