RETAIL RATE FORECASTS

The Bank of Canada Surprises with Another Rate Hike

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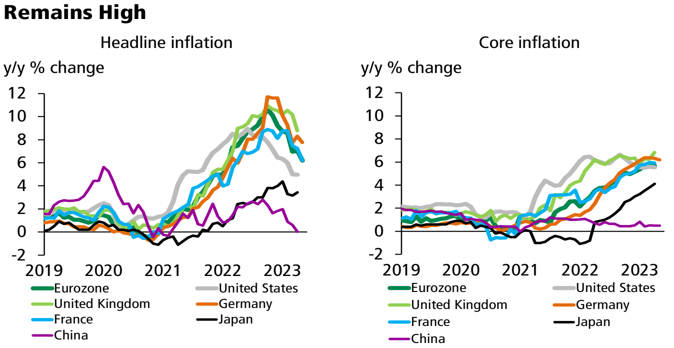
HIGHLIGHTS

- Interest rate hikes still haven't hobbled the global economy.
- Canada's overnight rate could soon hit 5.0%.
- The Canadian dollar got a boost from the Bank of Canada.
- Stocks are off to a strong start this year, but serious risks remain.

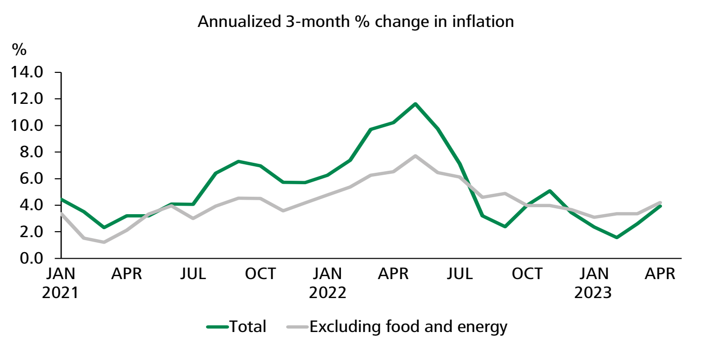
- **Interest rate hikes still haven't hobbled the global economy.** There are signs the global economy is slowing, but it hasn't tipped into a recession yet. More worryingly, inflation is still going up in several countries, especially core inflation, which strips out volatile components (graph 1). Yet real GDP growth slowed in the first quarter in the eurozone (-0.1%) and the United States (+1.1%), proof that higher interest rates are having an effect.
- **The Fed opted to pause rate hikes for now.** The Federal Reserve (Fed) held its key interest rate steady in June, deciding to wait for more data on the effect of past rate hikes. But it did raise its rate forecast for this year. Fed Chairman Jerome Powell also said he expects further rate hikes will be needed. We think the cumulative effects of rate increases will convince the Fed to hike just once more in July.
- **The Canadian economy posted steady growth in the first quarter.** Canada reported strong annualized real GDP growth of 3.1% in the first quarter. Household consumption remains robust, offsetting the decline in residential investment driven by higher interest rates. This economic strength was also seen in inflation, which was up again in April after falling for a few months (graph 2). But employment in Canada was down for the first time in May, signalling potential weakness ahead.

GRAPH 1
Headline Inflation Is Starting to Recede, but Core Inflation Remains High



Sources: Datastream and Desjardins Economic Studies

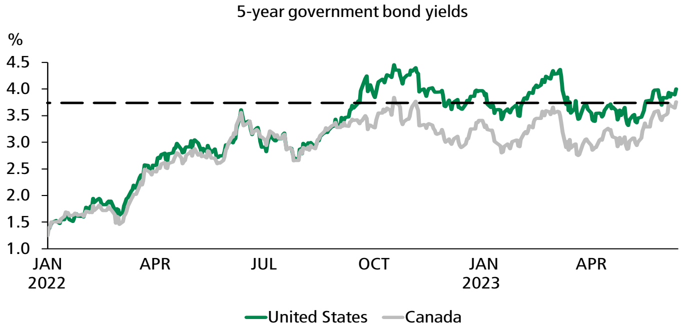
GRAPH 2
Inflation Seems to Be Trending Higher Again in Canada



Sources: Datastream and Desjardins Economic Studies

- **The economy's resilience forced the Bank of Canada to pause the pause.** The Bank of Canada (BoC) unexpectedly resumed its rate hiking campaign at its June 7 meeting. In its statement, the BoC said "monetary policy was not sufficiently restrictive to bring supply and demand back into balance and return inflation sustainably to the 2% target." It didn't give much forward guidance about the future path of interest rates, saying only that it will continue to monitor incoming data. But we don't think the numbers will change enough by July to convince the Bank to hold, meaning the overnight rate will likely climb to 5.00%.
- **The Bank of Canada's latest increase should drive up retail rates.** The BoC's key rate isn't the only thing that's gone up in recent weeks. The strong economy has also sent long-term government bond yields sharply higher. 5-year bond yields are back near last year's 3.70% peak (graph 3). They're up across the curve, meaning they'll affect both fixed and variable mortgage rates. But bond yields should trend lower again in the coming months, helping to stabilize retail rates.

GRAPH 3
The 5-Year Canadian Bond Yield Is Back Near Its High



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)								
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 2023	4.75	6.70	6.19	6.14	6.49	4.25	4.00	4.00
March 2023	4.75	6.70	6.19	6.14	6.49	4.25	3.60	3.60
April 2023	4.75	6.70	6.19	6.14	6.49	4.25	3.60	3.60
May 2023	4.75	6.70	6.29	6.14	6.49	4.25	3.60	3.60
June 15, 2023	5.00	6.95	6.94	6.34	6.49	4.25	3.60	3.60
Forecasts								
End of quarter								
2023: Q2	5.00	6.95	6.94	6.34	6.79	4.75	3.80	4.05
2023: Q3	5.25	7.20	7.44	6.99	6.99	5.00	4.20	4.05
2023: Q4	5.25	7.20	7.44	6.79	6.99	5.00	4.20	4.05
2023: Q4	4.75	6.70	6.79	6.59	6.99	4.60	3.80	3.70
End of year								
2024	3.25	5.20	5.54	5.79	6.69	2.95	3.05	2.95
2025	2.50	4.45	4.94	5.34	6.44	2.50	2.60	2.75
2026	2.50	4.45	4.94	5.19	6.34	2.50	2.60	2.60

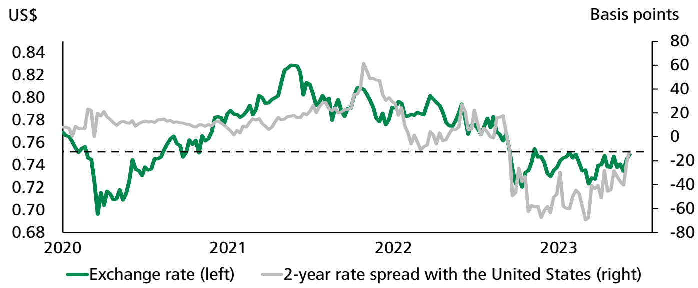
[1] Non-redeemable (annual); NOTE: Forecasts are represented using an asymmetric range reflecting the perceived probability of deviation from the base scenario. The mean of the range does not represent the forecast associated with the base scenario.
Source: Desjardins Economic Studies

Exchange Rate

The Canadian dollar got a boost from the Bank of Canada

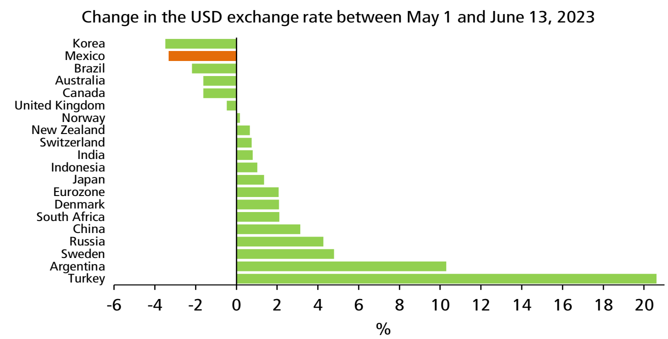
- With the Bank of Canada's surprise rate hike and the subsequent narrowing of interest rate spreads with the US, the loonie has settled in around US$0.75 (C$1.33/USD) (graph 4). The Canadian dollar could have moved even higher if oil prices had risen following OPEC's latest decision to cut production. Fears of weaker demand are weighing on the price of oil and other commodities that influence the value of the Canadian dollar.
- Several currencies have depreciated against the US dollar since May (graph 5). Even US debt ceiling uncertainty didn't hurt the greenback as the US dollar remains *the* safe haven for financial markets. Shifting US monetary policy expectations have also helped the greenback. In March, the market expected the Fed to cut rates early in response to regional bank troubles. Investors have since started to price in rate hikes again. Fed forecasts point to two additional hikes.
- **Forecast:** Renewed monetary tightening in Canada should have only a temporary effect on the Canadian dollar. We expect the loonie to fall back to US$0.73 (C$1.37/USD) by the end of the year. This is predicated on the Canadian and global economies slowing. Investor risk aversion would then kick in, sending the US dollar higher against several currencies. For now, the 2024 outlook for the Canadian dollar remains positive as the economy is expected to recover and risk appetite return.

GRAPH 4
As Interest Rate Spreads Have Narrowed, the Loonie Has Settled in around US$0.75 (C$1.33/USD)



Sources: Datastream and Desjardins Economic Studies

GRAPH 5
Only a Few Currencies Have Held Their Ground against the Greenback



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	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0.7232	0.7380	0.7399	0.7500	0.7400	0.7300	0.7500	0.7700	0.7800	0.7800
CAN$/US$	1.3828	1.3551	1.3516	1.3333	1.3514	1.3699	1.3333	1.2987	1.2821	1.2821
CAN$/€	1.3547	1.4462	1.4684	1.4400	1.4324	1.4521	1.4400	1.4286	1.4359	1.4487
US$/€	0.9797	1.0673	1.0865	1.0800	1.0600	1.0600	1.0800	1.1000	1.1200	1.1300
US$/£	1.1163	1.2029	1.2365	1.2600	1.2300	1.2200	1.2400	1.2700	1.2900	1.3000

f: forecasts
Sources: Datastream and Desjardins Economic Studies

Asset Class Returns

Stocks Are Off to a Strong Start This Year, but Risks Remain Tilted to the Downside

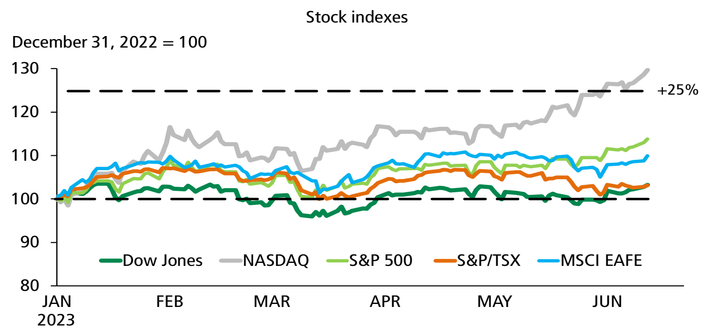
- **The tech sector is driving stock market gains.** North American and global stock markets have had a strong start to the year despite high interest rates, recession fears and banking turmoil. The S&P 500 and global markets are up about 10% this year, and the S&P/TSX has added about 3%. In the US, gains have been heavily concentrated in the tech sector, with the NASDAQ soaring almost 30% since the start of the year (graph 6). This is partly due to the recent AI hype, but more stable long-term bond yields are also improving the outlook for this debt-heavy sector.

- **A new tech bubble?** The tech sector is especially prone to speculative bubbles, and the latest price rally has raised eyebrows. Also, recent stock gains haven't come with a commensurate increase in earnings estimates, pushing price-to-earnings ratios back near record highs (graph 7). And while tech stock prices are usually inversely related to bond yields, the recent rally has coincided with a rise in bond yields. Against the backdrop of a slowing economy, the advertised technological advances would need to generate significant productivity gains to justify present stock valuations.

- **High interest rates are driving investors into money markets.** Now that short-term interest rates are in the 5% range, money markets are drawing the attention of investors looking for risk-free returns (graph 8). And with today's inverted yield curve, money market funds offer better returns than risk-free long-term bonds. The attractiveness of money market funds will continue to put pressure on other asset classes, limiting capital flows to risk assets as well as their potential gains.

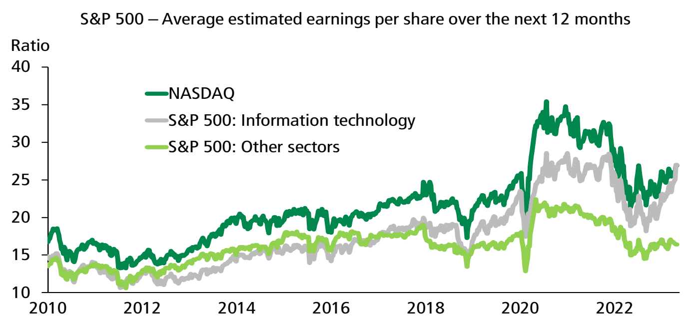
- **The recent rally didn't help the Canadian stock market.** The S&P/TSX hasn't benefited from the recent tech craze. Although the tech sector is also performing well in Canada, it doesn't make up much of the index. Unlike in the US and elsewhere, earnings estimates for listed companies weren't revised upward during the latest earnings season (graph 9 on page 5). The big news in Canada was disappointing bank earnings and lower commodity and energy prices. The resumption of rate hikes in early June also sent the index lower.

GRAPH 6
The NASDAQ Is Up almost 30% since the Start of the Year



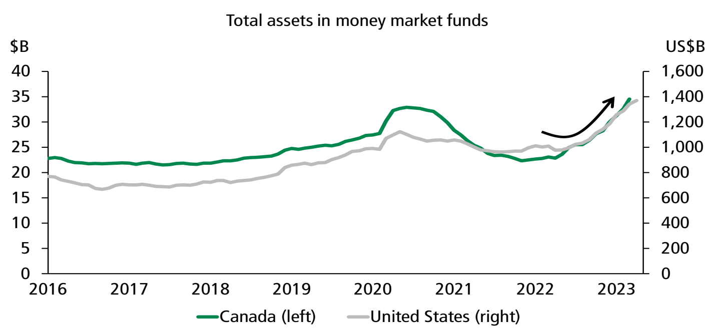
Sources: Datastream and Desjardins Economic Studies

GRAPH 7
Tech Stocks Valuations Are Flying High Again



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

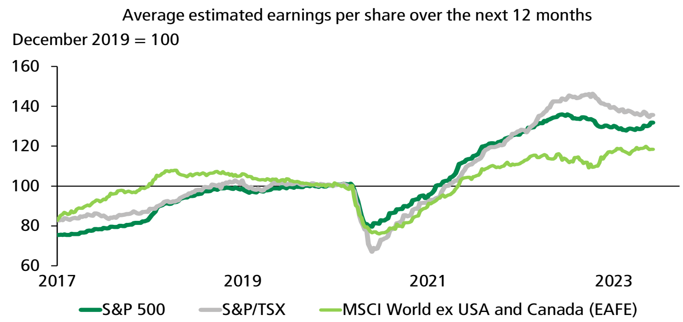
GRAPH 8
Money Market Funds Are Gaining in Popularity



Sources: Bank of Canada, Federal Reserve and Desjardins Economic Studies

- **Global markets are also at risk.** Most European stock markets have performed well so far this year, but the outlook remains bleak, with more monetary tightening to come in Europe. Inflation is so high in the United Kingdom that the Bank of England may have to resume its 50-point hikes. The European Central Bank may raise rates another 25 points before pausing. Germany is already officially in a recession, and other countries will likely join them as interest rate hikes work their way through the economy. In Asia, we'll have to see if the rebound in Chinese demand continues. Ongoing uncertainty on this front could hold back Asian stocks.
- **A market correction is still likely before the year is out.** Although the stock market outlook is improving, returns will continue to be at risk the rest of the year. Tech stocks are high again, increasing the likelihood of another drop, especially given today's elevated interest rates and slowing economy. Notably, the Bank of Canada's latest interest rate hikes are making money markets more attractive than other asset classes.

GRAPH 9
Earnings Estimates Inched Higher in the US, but Not in Canada



Sources: Datastream and Desjardins Economic Studies

TABLE 3
Asset class returns (%)

	CASH	BONDS	CANADIAN STOCKS	US STOCKS	INTERNATIONAL STOCKS	EXCHANGE RATE
END OF YEAR IN % (UNLESS OTHERWISE 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$/US$ (% 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: 4.7	Target: 4.6	Target: -1.3	Target: 2.1	Target: 3.8	Target: 1.1 (US$0.73)
Range	4.2 to 5.2	1.6 to 7.6	-9.3 to 8.7	-5.9 to 16.1	-4.2 to 14.8	-3.0 to 5.5

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