RETAIL RATE FORECASTS

Financial Turbulence Could Signal an Important Turning Point for Markets

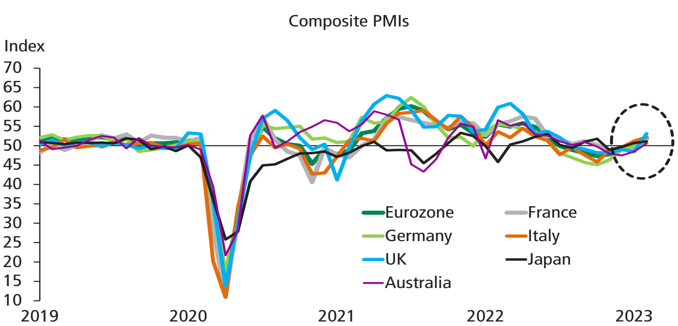
HIGHLIGHTS

- The global economy remains surprisingly resilient.
- The Bank of Canada is holding its key rate steady at 4.50%.
- Recent financial stress hasn't been benefiting the US dollar.
- Financial system risks could hurt stock market returns.

- **The global economy remains resilient, but financial stress could change that.** Economic data published so far this year isn't pointing to an imminent slowdown. On the contrary, rising PMIs in the eurozone and Asia indicate that we could see a rebound in growth for the early months of 2023 (graph 1). In the US, employment continued to grow in February, and consumer spending surprised to the upside in January. But all that has been eclipsed by the uncertainty now gripping the financial markets since Silicon Valley Bank (SVB) collapsed and other US and European banks started to show signs of trouble. The financial stress could lead to a decline in confidence and tighter credit conditions.

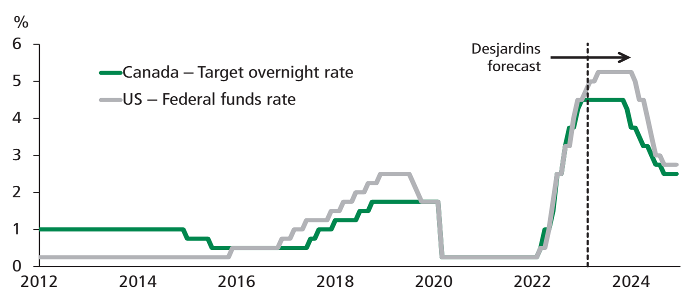
- **Despite the uncertainty, the Federal Reserve (Fed) raised the federal funds rate to 5.0%.** A more cautious-seeming Fed decided to raise its key rate by 25 basis points in March. The press release from the meeting noted the resilience of the US financial system, while also acknowledging that recent developments are likely to have impacts on the real economy. Compared to February's press release, which indicated that "ongoing increases in the target range will be appropriate," the Fed is now signalling that "some additional policy firming may be appropriate."

GRAPH 1
PMI Indexes Have Rebounded in Many Parts of the World



Sources: IHS/Markit, Datastream and Desjardins Economic Studies

GRAPH 2
Canada's Key Rate May Have Peaked



Sources: Datastream and Desjardins Economic Studies

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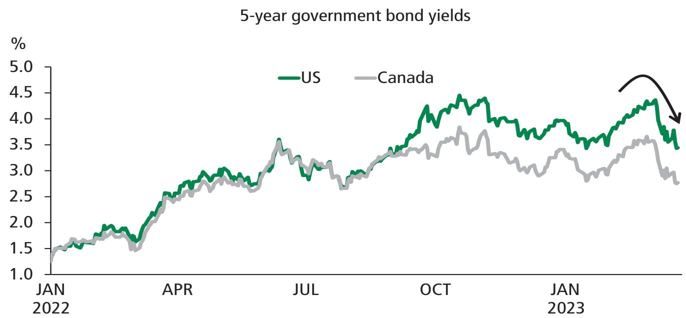
- **Risk aversion could have fallout for the Canadian economy.** Despite the stability of Canada's financial system, banking sector fears in other parts of the world could have consequences on this side of the border. We may see Canadian financial institutions start limiting access to credit, which could further curtail investment and consumer spending against a backdrop of already weakening domestic demand. As a result, Canada's real GDP may grow during the first quarter but turn negative thereafter.
- **The Bank of Canada (BoC) holds its key rate at 4.50%.** The BoC's most recent meeting was on March 8, before the SVB collapse and the ensuing climate of heightened uncertainty. The bank opted to hold its key rate steady, but signalled that future increases are still possible if inflation doesn't subside. For our part, we believe recent events are ample reason for the pause to continue. The Canadian economy is set to slide into a recession in the second half of the year, which would open the door to rate cuts around the turn of next year (graph 2 on page 1).
- **Retail rates are set to remain high a while longer yet.** Even though 5-year Canadian federal bond yields have lost more than 75 basis points in March, we haven't seen an equivalent decline in retail rates (graph 3). For one thing, financial institutions' cost of borrowing did not fall as much as government bond yields. And it now seems likely that some lenders will decide to keep rates higher to limit credit growth and ensure they hold on to their deposits.

GRAPH 3
Government Bond Yields Fell in March



Sources: Datastream and Desjardins Economic Studies

TABLE 1
Forecasts: Retail rate

%	DISCOUNT RATE	PRIME RATE	MORTGAGE RATE 1-year	MORTGAGE RATE 3-year	MORTGAGE RATE 5-year	TERM SAVINGS[1] 1-year	TERM SAVINGS[1] 3-year	TERM SAVINGS[1] 5-year
Realized (end of month)								
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 2023	4.75	6.70	6.19	6.14	6.49	4.25	4.00	4.00
March 31, 2023	4.75	6.70	6.19	6.14	6.49	4.25	3.75	3.75
Forecasts								
End of quarter								
2023: Q1	4.75	6.70	6.19	6.14	6.49	4.25	3.75	3.75
2023: Q2	4.75	6.70	6.19	6.14	6.49	4.25	4.00	3.95
2023: Q3	4.75	6.70	6.19	6.14	6.49	4.25	4.00	3.95
2023: Q4	4.50	6.45	6.19	6.14	6.49	3.85	3.85	3.80
End of year								
2024	2.75	4.70	4.79	5.19	6.14	2.35	2.50	2.50
2025	2.50	4.45	4.64	4.79	5.89	2.15	2.20	2.15
2026	2.50	4.45	4.44	4.79	5.89	2.15	2.20	2.15

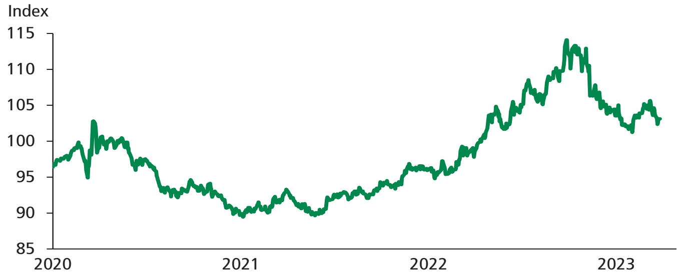
[1] Non-redeemable (annual); NOTE: Forecasts are represented using an asymmetric range reflecting the perceived probability of deviation from the base scenario. The mean of the range does not represent the forecast associated with the base scenario.
Source: Desjardins Economic Studies

Exchange Rate

The Recent Financial Stress Hasn't Been Benefiting the US Dollar

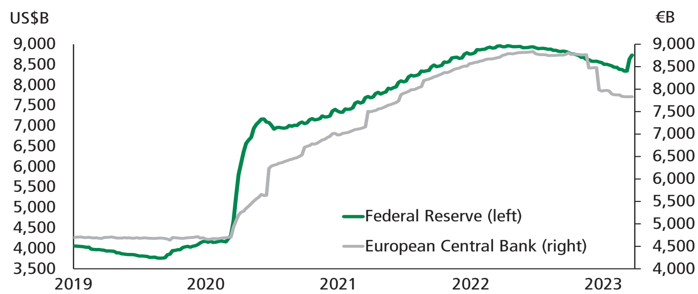
- The US dollar tends to appreciate when investors start to worry and markets turn volatile. But despite banking system concerns and increased market volatility, the last few weeks have actually seen the greenback slip (graph 4). The fact that fears seem to have been mostly contained to US banks, without any real contagion to the wider international financial system, might explain why the US dollar is struggling. The currency is also taking a hit from lowered US interest rate expectations and the Fed's re-expanding balance sheet after it stepped in to shore up the country's banking system (graph 5).
- The Canadian dollar failed to benefit from the weakness of its US counterpart in March. A decline in interest rate spreads with the US should have also worked in the loonie's favour, but it ended up losing ground due to concerns of slowing global demand for commodities, with the US benchmark price for oil temporarily dipping below US$70, among other indicators. The Canadian dollar also ended up depreciating against most European currencies and the yen.
- **Forecast:** Over the next few months, we could see the Canadian dollar fall back to around US$0.72, or even slightly lower. This forecast assumes the markets will remain nervous, particularly about global economic growth and demand for commodities. The Bank of Canada's decision to hit pause on its rate hikes could still do more damage to the loonie, with other central banks not yet finished with their monetary tightening cycles.

GRAPH 4
Despite New Financial Stress, the US Dollar Hasn't Benefited from Safe-Haven Demand



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 Federal Reserve's Balance Sheet Has Started to Expand Again



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

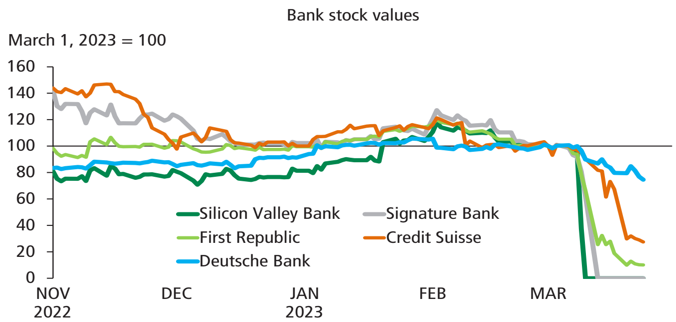
f: forecasts
Sources: Datastream and Desjardins Economic Studies

Asset Class Returns

Returns Are Entering a Zone of Turbulence

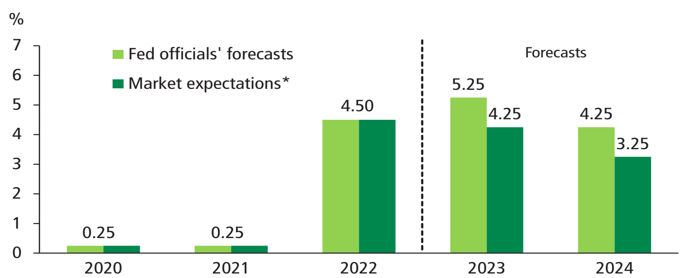
- **As a recession nears, financial volatility is to be expected.** While a specific event like the SVB collapse is hard to predict, a financial market shock of this kind comes as no surprise. For some time now, our baseline forecast scenario has included a recession caused by rapid rate hikes, an environment that tends to include heightened volatility and a rise in numerous risks. For that reason, we're keeping our targets for returns on riskier asset classes low over the coming months.
- **What's happening with the financial system?** The recent turmoil began with the collapse and sudden bankruptcy of SVB on March 10. The problem originated with poor management practices at the bank, which mainly catered to tech companies. When concerns emerged about its ability to honour deposits, customers began pulling out their money, leading to a liquidity crisis. But the panic also spread to other institutions, leading Signature Bank to the same fate and creating widespread fears about regional US banks (graph 6). Regulators quickly stepped in by announcing targeted support programs, both expanding deposit insurance protections and providing liquidity to banks that needed it. But investors' fears about the viability of some banks made their way to Europe, causing Credit Suisse's stock price to plummet before the bank was taken over by its competitor UBS.
- **Risk aversion is driving bond yields Lower.** Government bond yields have fallen in response to recent events. The sharp drop in long-term yields seems to be less a reflection of future interest rate expectations and more a result of strong investor demand for less risky assets. The bond markets are now contradicting the Fed's projections, which still put the federal funds rate above 5.0% at the end of the year (graph 7). Bond yields usually fare well in times of financial volatility, since bonds are considered to be lower risk. But given how much yields have fallen recently, the risk of a bond market correction remains high—and it will stay that way until it's clear inflation has been contained.
- **The S&P/TSX is down despite greater resilience of Canada's financial system.** The problems afflicting US and European banks seem less likely to make their way to Canada. The Canadian banking system is highly consolidated, and its financial institutions are well capitalized and regulated. Yet recent fears still managed to rattle the S&P/TSX Composite Index, although financial sector stocks took less of a hit in Canada than in other regions (graph 8). It comes down to basic math: since the financial sector makes up 30% of the Canadian index, a banking shock is bound to have a disproportionate impact on returns. Falling oil prices also

GRAPH 6
Several Banks Faced Existential Challenges in March



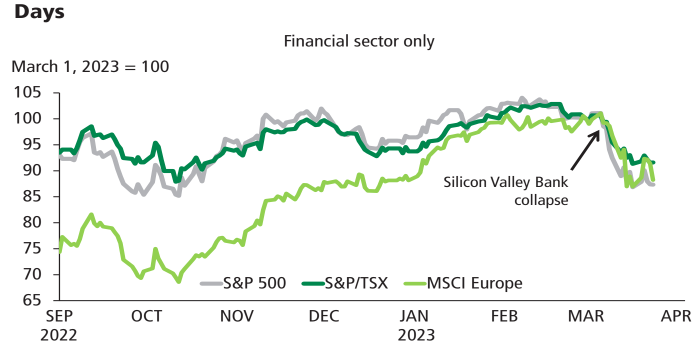
Sources: Datastream and Desjardins Economic Studies

GRAPH 7
Investors' Rate Expectations Are More Dovish than Fed Projections



* At March 30, 2023.
Sources: Bloomberg, US Federal Reserve and Desjardins Economic Studies

GRAPH 8
Financial Sector Stock Valuations Have Plummeted in Recent Days

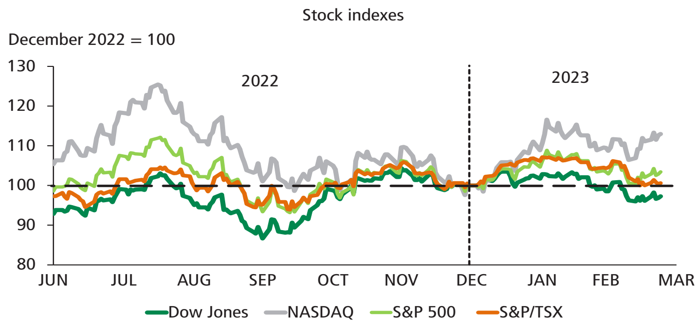


Sources: Datastream and Desjardins Economic Studies

pulled the index down, given the weight of the energy sector in Canada's economy.

- **Vulnerabilities may soon re-emerge in Europe.** Although Europe has so far dodged a recession and stocks have been performing well since the start of the year, the continent should start feeling the delayed impacts of interest rate hikes over the coming quarters. And the monetary tightening cycle isn't over yet, with inflation still high and several European central banks signalling that more rate hikes are to come. Recent concerns about some European banks also indicate that a number of vulnerabilities remain.
- **A new period of volatility could be on the way.** Stock indexes have only moderately declined despite fears about the financial system (graph 9). For now, the stock markets seem to be benefiting from the sharp drop in long-term bond yields and have regained much of their lost ground. This is not sustainable in our opinion. Investors' interest rate expectations aren't realistic, outside of a big recession, in which case a major stock market correction is to be expected. We're forecasting something more middle of the road involving a moderate recession and further stock market declines.

GRAPH 9
Stock Indexes Are Down but Only Moderately



Sources: 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: 4.5	target: 1.3	target: -3.1	target: 2.5	target: 1.1 (US$0.73)
range	4.1 to 5.1	1.5 to 8.5	-7.7 to 7.3	-12.1 to 2.9	-6.5 to 8.5	-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