

RETAIL RATE FORECASTS

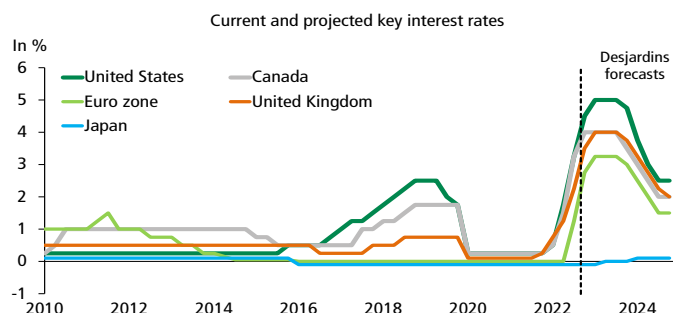
Early Signs That Rate Hikes Are Moderating, but the Fight against Inflation Isn't Over

HIGHLIGHTS

- ▶ High interest rates could drag the world economy into recession.
- ▶ The Bank of Canada indicated for the first time that it may moderate its rate hikes.
- ▶ It's too early for a lasting rebound in the Canadian dollar.
- ▶ Equity markets are recovering and back in the black—for now.

- **A worldwide recession seems likely in 2023.** Rising energy costs continue to fuel high inflation in Europe and will require aggressive interest rate hikes. China's economy is struggling and will have to contend with weaker global demand. Japan is an outlier and keeping its key interest rate at its lower bound (graph 1) as inflation is still under control. However, US economic growth rebounded in the third quarter and employment is still rising despite the major issues on the housing market. But this strength could be short-lived as the effects of interest rate hikes will take hold.

GRAPH 1
Interest rates are rising worldwide



Sources: Datastream and Desjardins, Economic Studies

- **The Federal Reserve (Fed) hasn't finished its monetary tightening cycle.** Investors were hoping that the Fed would change course at its meeting on November 2 but were left disappointed. While the meeting did leave open the possibility that the pace of tightening could slow, Fed Chair Jerome Powell was careful to specify at the press conference that it was premature to start thinking about pausing rate hikes. He also indicated that the required terminal key interest rate was higher than previously specified.
- **Canada's economy is holding up, despite the impact of rate hikes.** Even though the housing market is experiencing a sharp decline, economic growth held up in Canada in August according to GDP data by industry. As such, we're forecasting around 1.5% growth in the third quarter. The labour market recovered in September and October, after three months of declines. That said, the overall outlook remains negative, especially in Quebec where real GDP dropped for the fourth month in a row in July, indicating that the recession could already be underway (graph 2 on page 2).
- **Surprisingly, the Bank of Canada (BoC) only hiked by 50 basis points in October.** The BoC took the first step in moderating its monetary tightening, opting for a smaller 50 bps rate hike in October, whereas investors were broadly pricing in another 75 bps increase. Although the Bank continues to indicate that multiple further hikes will be needed, we believe that the deteriorating economic

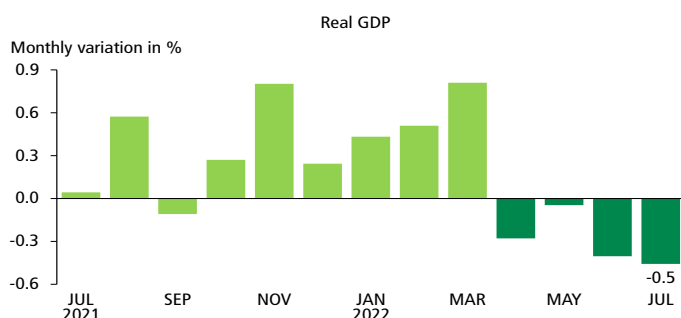
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NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

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GRAPH 2
Quebec's real GDP has declined for four successive months



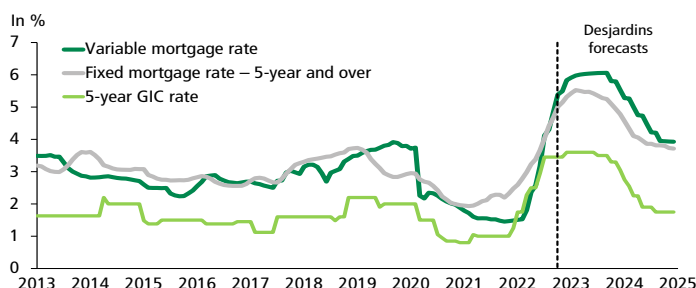
Sources: Institut de la statistique du Québec and Desjardins, Economic Studies

environment could warrant an end to the tightening cycle after one final 25 bps increase in December, which would limit the policy interest rate to 4.00%.

- **Bond yields plunge on US inflation data.** Following a few volatile weeks, the publication of the US CPI data for October induced a sharp drop in bond yields. US 10-year bond yields, which were previously hovering close to their recent highs, fell down close to 3.85 %. Canadian borrowers are relatively better off, as the equivalent yield north of the border stands at

about 3.15%, which is reflected in the rates offered to clients. Although there are still risks of renewed sharp rises in yields, we can expect a downward trend in 2023. However, it could take some time before this is reflected in the rates offered to borrowers (graph 3).

GRAPH 3
Retail rates aren't expected to stabilize until 2023



Sources: Bank of Canada and Desjardins, Economic Studies

TABLE 1
Forecasts: Retail rate

IN %	DISCOUNT RATE	PRIME RATE	MORTGAGE RATE			TERM SAVINGS ¹		
			1 year	3 years	5 years	1 year	3 years	5 years
Realized (end of month)								
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 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 15, 2022	4.00	5.95	6.19	6.14	6.34	3.00	3.75	4.00
Forecasts								
<u>End of quarter</u>								
2022: Q4	4.25	6.20	6.74	6.74	6.79	3.45	3.70	4.15
2023: Q1	4.25	6.20	6.74	6.74	7.04	4.05	4.15	4.15
2023: Q2	4.25	6.20	6.74	6.74	7.04	4.05	4.05	4.15
2023: Q3	4.25	6.20	6.54	6.54	7.04	4.05	4.05	4.05
<u>End of year</u>								
2023	3.75	5.70	6.09	6.09	6.69	3.60	3.60	3.60
2024	2.25	4.20	4.44	4.74	5.89	1.95	2.00	2.30
2025	2.25	4.20	4.29	4.54	5.74	1.75	1.95	2.10

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

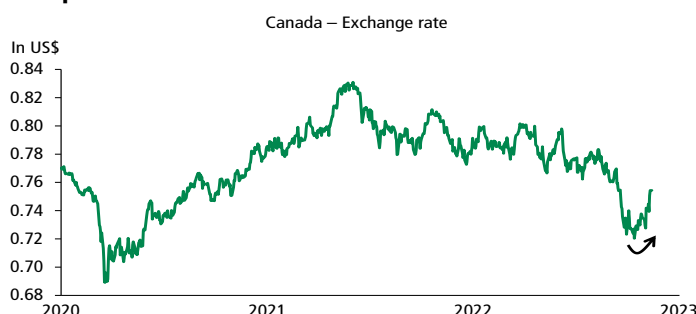
Exchange Rate

It's too early for a lasting rebound in the Canadian dollar

- Renewed investor risk appetite in October and early November coincided with several currencies appreciating against the US dollar once again. At the end of September, the Canadian dollar was trading around US\$0.72, but is now closer to US\$0.75 (graph 4). It rebounded despite the fact that interest rate spreads between the United States and Canada have tended to widen, particularly after the Bank of Canada's decision to opt for a smaller rate hike in October while signalling the approaching end of its monetary tightening. That said, Canada's solid employment figures released on November 4 and lower US inflation released the week after narrowed these interest rate spreads. Increases in prices of certain commodities, including oil, also boosted the loonie.
- Meanwhile, on the other side of the Atlantic, the pound sterling benefited from most of the government's September mini-budget—which had rocked the financial markets—being cancelled. The euro also rose back above the psychological barrier of US\$1.00. Warmer temperatures in Europe helped rebuild natural gas inventories and drove down prices (graph 5). This reduces the risk of a major energy crisis in the short term.
- Forecasts:** We expect further economic and financial turbulence in the months ahead, which should give the US dollar the upper hand against most currencies. We therefore believe the Canadian dollar will end the year around US\$0.72 before losing a bit more ground in early 2023. We think it will appreciate again later in 2023.

GRAPH 4

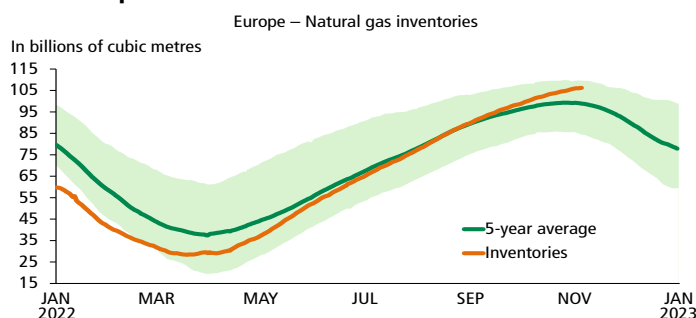
The Canadian dollar recovered a little following its sharp decline in September



Sources: Datastream and Desjardins, Economic Studies

GRAPH 5

European natural gas inventories are benefiting from unusually warm temperatures



Sources: European gas infrastructure, U.S. Energy Information Administration and Desjardins, Economic Studies

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

TABLE 2

Forecasts: Currency

END OF PERIOD	2021		2022				2023			
	Q3	Q4	Q1	Q2	Q3	Q4f	Q1f	Q2f	Q3f	Q4f
US\$/CAN\$	0.7886	0.7914	0.7999	0.7768	0.7232	0.7200	0.7100	0.7200	0.7300	0.7500
CAN\$/US\$	1.2680	1.2636	1.2501	1.2873	1.3828	1.3889	1.4085	1.3889	1.3699	1.3333
CAN\$/€	1.4695	1.4370	1.3909	1.3458	1.3547	1.3611	1.3662	1.3750	1.3836	1.3733
US\$/€	1.1590	1.1372	1.1127	1.0455	0.9797	0.9800	0.9700	0.9900	1.0100	1.0300
US\$/£	1.3484	1.3545	1.3167	1.2145	1.1163	1.1200	1.1100	1.1200	1.1400	1.1700

f: forecasts

Sources: Datastream and Desjardins, Economic Studies

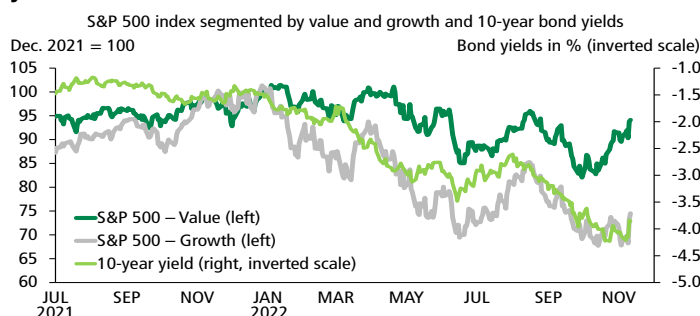
Asset Classes Return

Positive returns were back in October, but don't get too excited

- The Dow Jones had its best month since 1976.** Investors saw positive equity market returns once again in recent weeks. Although the economic environment remains uncertain, optimism seems to be winning out thanks to various good news. Corporate earnings have remained solid despite moderating demand and higher input and borrowing costs. The first few signs that the Federal Reserve (Fed) could moderate the pace of its future interest rate hikes, but also the slowing down of US inflation in October were well perceived by investors.
- Rising bond yields seems to be having less impact on equity markets.** Although equity markets declines have largely been the reflection of the uptick in bond yields so far this year, the recent rebound has been the exception. Bond yields continued to rise in October and early November, particularly in the wake of the Federal Reserve meeting, but this didn't trigger an equivalent drop in the S&P 500. However, the impact of rising bond yields was more acute for growth companies, which generally have higher debt levels (graph 6). The relationship between stock market returns and bond yields did however make a strong comeback after the release of inflation data with indexes rebounding strongly as yields plummeted.
- Downside risks still dominate.** Even with the current low valuation levels of most stock market indexes, many downside risks remain (graph 7). First, a backdrop of high interest rates justifies lower valuations of listed securities. Corporate profitability requirements increase as money market and bond yields become more attractive. As such, we shouldn't expect a substantial equity market rebound until earnings rise materially too. We believe that the opposite will happen. The economic slowdown combined with moderating inflation is likely to lead to a fall in earnings (graph 8).
- The energy sector is responsible for an increasing share of S&P/TSX earnings.** The Canadian S&P/TSX index rebounded in October, rising 5.3%, as Canadian stocks benefited from the movement toward value securities. The energy sector also contributed to the rise as oil prices remained high. The S&P/TSX's composition and earnings have shifted significantly in the last year. Between October 2021 and October 2022, the weight of the energy sector in the index increased from 14% to 19%, while its share of earnings rose from 15% to 26% (graph 9 on page 5). Oil companies' large surpluses are underpinning the index's value, but are also increasing its volatility as these prices are fluctuating. The outlook is much less positive for the other sectors of the Canadian economy.

GRAPH 6

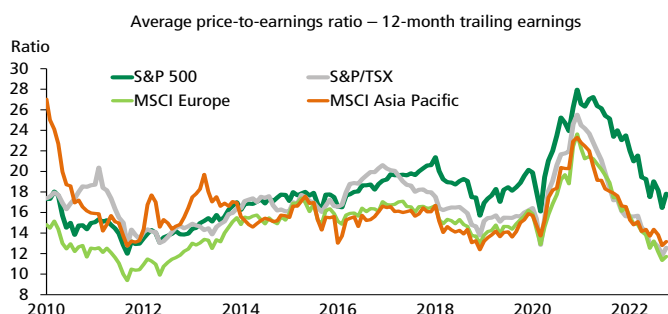
Growth companies are suffering the impacts of rising bond yields



Sources: Datastream and Desjardins, Economic Studies

GRAPH 7

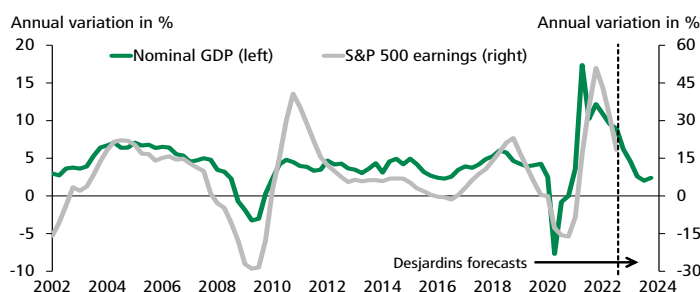
Price-to-earnings ratios have fallen back to more attractive levels



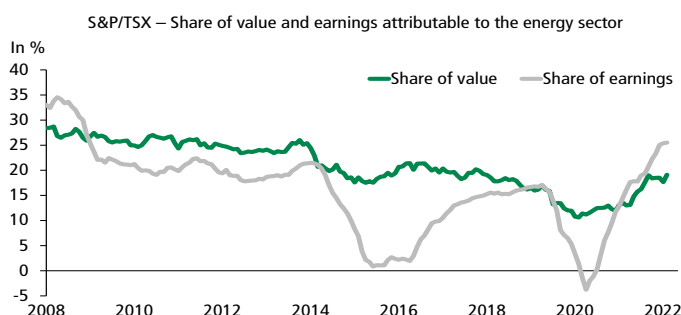
Sources: Datastream and Desjardins, Economic Studies

GRAPH 8

S&P 500 earnings tend to track growth in nominal GDP



Sources: Datastream and Desjardins, Economic Studies

GRAPH 9
Oil is becoming an increasingly important S&P/TSX sector


Sources: Datastream and Desjardins, Economic Studies

- **Global markets remain volatile, but are also rebounding.** The European Central Bank and the Bank of England both hiked rates by 75 basis points at their last meetings and indicated that they would continue their monetary tightening. However, that didn't stop the European equity markets from rising in October as they benefited from record low valuations. On the other hand, the Reserve Bank of Australia quickly returned to a more normal hiking pace of 25 basis points per meeting. Meanwhile, the Bank of Japan is maintaining its ultra-accommodative monetary policy. This is hobbling the yen and exacerbating inflationary pressures, even though they remain lower than

elsewhere. These factors keep a high level of uncertainty around equity returns on global markets. We'll also have to keep a close eye on developments in China.

- **Have we reached a turning point for the bond markets?** All evidence suggests that it'll be difficult to avoid a global recession, and the US economy will be no exception. As such, we expect further movements toward safe haven securities. As clearer signs that inflation is moderating appear, the bond markets will become a more attractive option for investors. The equity markets could end up paying the price for this reallocation, at the same time as corporate earnings suffer the impact of declining demand.

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: 1.7	target: -12.7	target: -8.4	target: -20.4	target: -21.6	target: 9.9 (US\$0.72)
range	1.5 to 1.9	-14.7 to -10.7	-16.4 to -3.4	-27.4 to -15.4	-24.6 to -16.6	5.5 to 13.1
2023f	target: 4.1	target: 5.6	target: 5.9	target: 3.6	target: 6.4	target: -4.0 (US\$0.75)
range	3.4 to 4.8	0.6 to 10.6	-9.6 to 15.4	-11.9 to 13.1	-9.1 to 15.9	-6.5 to 0.0

f: forecasts; ¹ FTSE Canada Universe Bond index; ² Dividends included; ³ Negative = appreciation, positive = depreciation.

Sources: Datastream and Desjardins, Economic Studies