

RETAIL RATE FORECASTS

Economic Growth and Asset Class Returns Hurt by Rate Hikes

HIGHLIGHTS

- ▶ The effects of rate hikes are rippling through the global economy.
- ▶ A recession is now the most likely scenario in Canada.
- ▶ The Canadian dollar is back under US\$0.75.
- ▶ On the heels of rate hikes, the economic slowdown could dent returns.

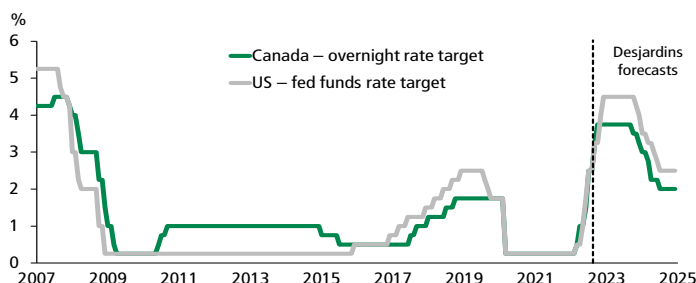
- **The global economy is weakened by inflation and interest rate hikes.** Several economic indicators are signalling that the eurozone and the United Kingdom are heading towards a recession against a backdrop of high inflation and interest rate hikes. China's economy is also struggling to recover from the successive lockdowns imposed under its zero-COVID policy. In the US, the outlook is somewhat more positive, despite two consecutive quarters of negative real GDP growth. Employment grew throughout the summer and economic growth is expected to return to positive territory in the third quarter. A US economic slowdown is forecasted for 2023 and a mild recession is now our base case scenario.
- **The Federal Reserve (Fed) continues its monetary tightening cycle.** The Fed announced another 75 basis point

(bps) rate hike at its September meeting, with little change to its statement. Officials' forecasts for the policy rate, however, signal that the monetary tightening could continue at a rapid pace, at least until the end of 2022. Another 75 bps hike seems likely in November, followed by a final increase in December, bringing the federal funds rate to 4.50% (graph 1).

- **A recession is now the most likely scenario in Canada.** Although the Canadian economy remained on a growth path in the first half of the year, it's increasingly clear that the recovery is at risk. Real GDP grew by 3.3% in the second quarter, but residential investment fell sharply due to housing market woes. Employment figures were also down for the third month in a row in August, and unemployment was up—stronger signs that a slowdown is underway (graph 2). And

GRAPH 1

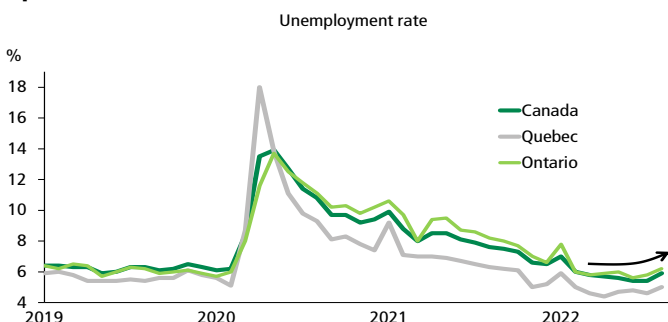
The US federal funds rate could hit 4.5%



Sources: Datastream and Desjardins, Economic Studies

GRAPH 2

Canada's unemployment rate remains low but is starting to tick up



Sources: Statistics Canada and Desjardins, Economic Studies

Jimmy Jean, Vice-President, Chief Economist and Strategist • Lorenzo Tessier-Moreau, Principal Economist • Hendrix Vachon, Principal Economist

Desjardins, Economic Studies: 514-281-2336 or 1 866-866-7000, ext. 5552336 • desjardins.economics@desjardins.com • desjardins.com/economics

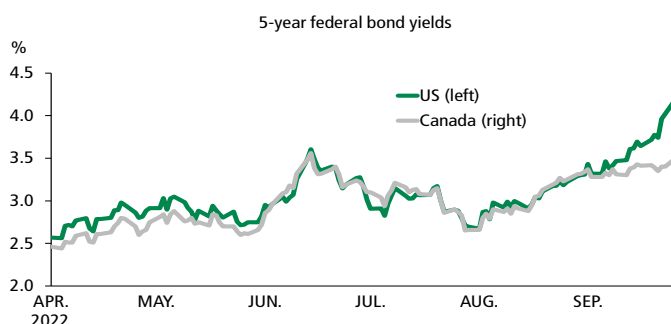
NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

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yet, the labour market remains tight overall. There's still some way to go before a recession, even if it's looking increasingly inevitable.

- The Bank of Canada (BoC) will need to ease off its hawkish stance.** August marked a second consecutive fall in Canada's inflation rate—an encouraging development, but at 7.0% it's still well outside the inflation-control target range. That means further action will be required from the Bank of Canada. It could follow its September's 75 bps rate hike with a further 50 bps increase in October, bringing the key rate to 3.75%. Clearer signs of a recession could however convince the Bank to hold still in December, provided inflation calms down. We believe a weak Canadian economy will bring about rate cuts in 2023, once inflation is back within target range.
- Retail interest rates aren't done climbing yet.** Government bond yields have resumed a strong uptrend after falling in July (graph 3). This increase has partially made its way to fixed-term rates on loans and savings products. At the same time, policy rate increases keep pushing variable rates higher, a trend that may continue even if long-term bond yields stabilize. Faced with higher costs of borrowing, financial institutions are gradually adjusting the rates on their products.

GRAPH 3
Bond yields are trending up again



Sources: Datastream and Desjardins, Economic Studies

We could see retail rates start to come back down again in 2023.

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)								
March 2022	0.75	2.70	2.99	3.69	4.99	0.90	1.75	2.25
April 2022	1.25	3.20	3.29	4.09	4.99	1.25	2.25	3.00
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 27, 2022	3.50	5.45	5.69	5.89	6.14	2.00	3.00	4.00
Forecasts								
<u>End of quarter</u>								
2022: Q3	3.50	5.45	5.40–5.80	5.95–6.35	6.75–7.15	2.20–2.60	3.10–3.50	4.00–4.40
2022: Q4	3.25–4.75	5.20–6.70	5.15–6.70	6.00–7.55	6.80–8.35	2.65–4.00	3.35–4.70	3.60–4.95
2023: Q1	3.25–5.00	5.20–6.95	4.80–7.25	5.65–8.10	6.45–8.90	2.25–4.60	2.95–5.30	3.20–5.55
2023: Q2	3.00–5.50	4.95–7.45	4.60–7.50	5.25–8.15	6.05–8.95	2.00–4.90	2.45–5.35	2.55–5.45
<u>End of year</u>								
2023	2.25–5.00	4.20–6.95	3.85–7.00	4.25–7.40	5.15–8.30	1.40–4.55	1.55–4.70	1.65–4.80
2024	1.00–3.75	2.95–5.70	2.80–5.65	3.20–6.05	4.40–7.25	0.35–3.20	0.50–3.35	0.70–3.55
2025	1.25–3.25	3.20–5.20	2.95–5.35	3.35–5.75	4.45–6.85	0.50–2.90	0.65–3.05	0.75–3.15

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.

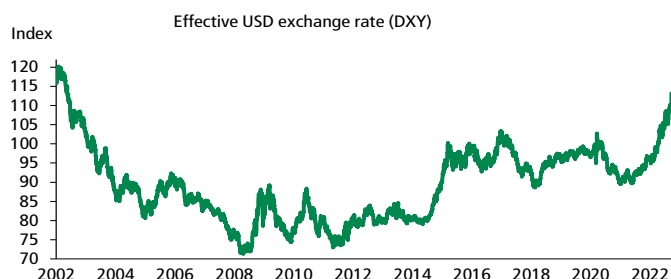
Source: Desjardins, Economic Studies

Exchange Rate

The Canadian dollar is back under US\$0.75

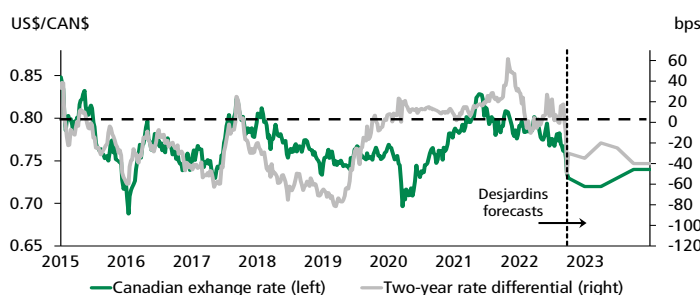
- Generally speaking, the US dollar remains strong against most currencies. The DXY US Dollar Currency Index has hit its highest peak since 2002 (graph 4). Recession fears and financial market volatility have dampened risk appetite, which is continuing to bolster demand for the greenback. It's also getting support from the Fed's aggressive course of monetary tightening, which is widening interest rate spreads with other major economies.
- Until recently, the Canadian dollar had managed to withstand the strength of its US counterpart, supported by Canadian rate hikes and high commodity prices. However, the most recent economic data has been more negative for Canada, showing the labour market starting to turn. The markets are also starting to believe the BoC will pause its rate hikes earlier than the Fed. Interest spreads are now less favourable for the Canadian dollar, and this trend is expected to continue (graph 5).
- It's been a rough summer for European currencies. The euro slipped below parity with the US dollar, and the pound sterling isn't doing so well either, trading below US\$1.10. The markets have reacted very badly to the recent economic stimulus measures announced by the British government. Inflation could persist longer in the UK and require more interest rate hikes.
- **Main factors to watch:** Investor risk appetite is likely to remain soft over the coming quarters, continuing to support a strong US dollar. The Canadian dollar should end the year at around US\$0.72, with risk of a larger depreciation if the economy deteriorates more than expected.

GRAPH 4
US dollar hits its highest peak since 2002



* 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
Canadian dollar weakened by economic uncertainty and less favourable interest rate spreads



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

END OF PERIOD	2021		2022				2023			
	Q3	Q4	Q1	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US\$/CAN\$	0.7886	0.7914	0.7999	0.7768	0.7300	0.7200	0.7200	0.7300	0.7400	0.7400
CAN\$/US\$	1.2680	1.2636	1.2501	1.2873	1.3699	1.3889	1.3889	1.3699	1.3514	1.3514
CAN\$/€	1.4695	1.4370	1.3909	1.3458	1.3151	1.3194	1.3333	1.3562	1.3649	1.3919
US\$/€	1.1590	1.1372	1.1127	1.0455	0.9600	0.9500	0.9600	0.9900	1.0100	1.0300
US\$/£	1.3484	1.3545	1.3167	1.2145	1.0700	1.0500	1.0500	1.0800	1.1200	1.1500

f: forecasts

Sources: Datastream and Desjardins, Economic Studies

Asset Class Returns

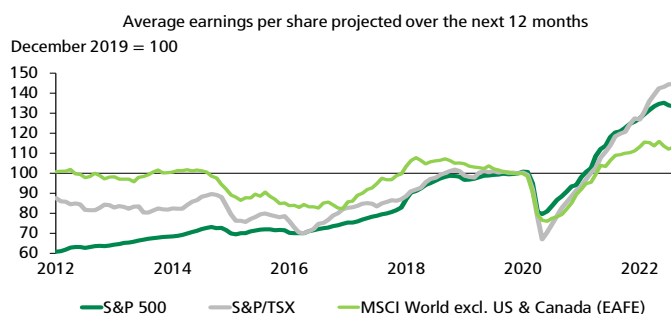
After rate hikes, the economic slowdown could hurt returns

- Interest rate hikes continue to spook stock markets.** After a strong rebound in mid-July, global stock indexes fell again in August and September. It seems fairly clear that the stock market turmoil has initially been linked to policy rate expectations and rising bond yields (graph 6). The rebound coincided with a more moderate message coming out of the Fed's July meeting, and the decline picked up speed after Jerome Powell took on a more hawkish tone in his speech at the annual Jackson Hole symposium. Things however took a turn for the worse at the end of September and it looks like markets are now bracing for economic impact.
- US stock markets don't seem to be pricing in a recession just yet.** The recent stock market drop saw the S&P 500 fall back down more than 20% from its peak. This decline in stock values, combined with strong corporate earnings growth, caused some stock valuations to fall substantially. But overall, 2023 projected earnings supporting those valuations remain high (graph 7). That could change quickly if we see clearer signs of a recession. In the last 4 recessions identified by the National Bureau of Economic Research (NBER), S&P 500 earnings dropped an average of 23%. Fears of a similar fate could be enough to drag the index well below its current level.
- The yield curve could remain inverted for some time.** The yield curve inversion trend continued for both Canadian and US bonds (graph 8). Such movement is generally considered as a harbinger of a recession. With inflation at around 8.0% in the United States, higher interest rates are simply a short-term inevitability and could very well drop back down as inflation comes under control. The fact that the yield curve inversion is steeper in Canada than the US, says something. Given the similarities between the two countries in terms of inflation and policy rates right now, investors seem to be foreseeing a more pronounced economic slowdown in Canada.
- Earnings growth isn't driving Canadian stock market gains.** Although Canadian stock losses haven't been as severe as those seen on the US and global indexes (graph 9 on page 5), the average price-to-earnings ratio for the S&P/TSX Index remains relatively low. The reason is simple: the earnings surge seen in recent months has not produced an equivalent rise in stock prices. Earnings growth has largely come from the energy and commodities sectors, which explains why investors remain cautious. Although these sectors are currently benefiting from high commodity prices, the medium-term outlook is much less rosy. We expect a moderate decline in oil prices to limit gains, while other sectors could be hurt by

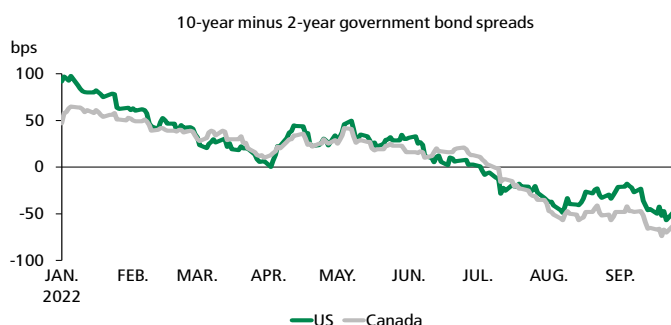
GRAPH 6
Bond yield movements largely account for stock market fluctuations



GRAPH 7
Projected earnings remain high for now

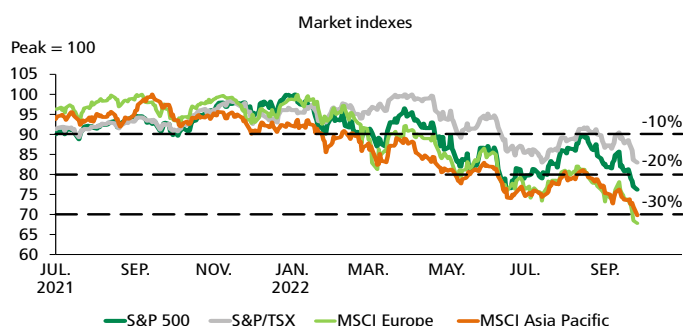


GRAPH 8
A more pronounced yield curve inversion in Canada than the US



the recession. We'll be keeping an eye on the financial sector, which accounts for more than 30% of the S&P/TSX's market capitalization. A rise in borrower defaults could drag down earnings.

- European markets are also feeling the pain of inflation and rate hikes.** The European Central Bank (ECB) and Bank of England (BoE) have both picked up the pace of monetary tightening. Their interest rate hikes come amid a more fragile economic environment in Europe than in North America, however. Already facing a severe energy crisis, the continent now also has to contend with an economic slowdown brought on by higher interest rates. The next few quarters are shaping up to be difficult for European stock markets. That said, periods of euphoria have been few and far between in recent years, and European stocks have already dropped significantly. This could limit downside potential.
- Asset class returns under pressure.** Investors and savers will probably be happy to see the back of 2022. Among the asset classes we forecast, only money markets and the US dollar should provide positive returns (table 3). Home values, which represent a major source of savings for many households, are also expected to continue falling (see [Spotlight on Housing](#)). Worse yet, once inflation, which is expected to come in at 6.4% for the year, is factored in, asset returns are even lower. After two years of strong growth in asset values, that's the price to pay to rein in inflation. 2023 could bring a rebound in returns, but only if a severe recession is avoided.

GRAPH 9
Canadian stock losses less pronounced than other markets


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: 1.7	target: -10.5	target: -16.0	target: -24.6	target: -29.1	target: 5.5 (US\$0.72)
range	1.5 to 1.9	-12.5 to -8.5	-26.5 to -8.5	-34.1 to -17.1	-34.6 to -21.6	5.5 to 14.7
2023f	target: 3.7	target: 5.5	target: 7.0	target: 3.6	target: 9.8	target: -3.0 (US\$0.74)
range	3.0 to 4.4	0.5 to 10.5	-8.5 to 16.5	-11.9 to 13.1	-5.7 to 19.3	-6.5 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