

RETAIL RATE FORECASTS

Signs of Economic Slowdown Could Signal the End of Rate Hikes

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HIGHLIGHTS

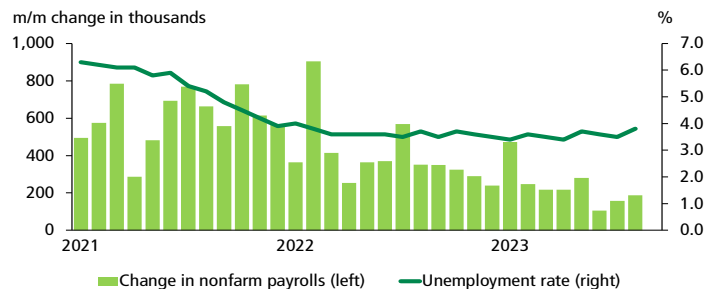
- ▶ The economy continues to expand in the US, but signs of weakness are showing up elsewhere.
- ▶ Another pause could mark the end of rate hikes in Canada.
- ▶ Uncertainty and higher bond yields are helping the US dollar.
- ▶ The stock market rally could start to lose steam.

- **The US economy has yet to buckle under the weight of rate hikes.** The target for the federal funds rate now stands at 5.5%, but most economic indicators still point to continued growth and labour market resilience in the US. Employers kept adding jobs in the third quarter (graph 1), and real GDP expanded 2.6% in Q2. But in recent months, there have been growing concerns about other economies, especially China, where the post-pandemic recovery is running out of steam. PMIs are also down in several European countries, indicating an economic slowdown.

- **The Fed held rates steady in September, but its next moves are unclear.** The Federal Reserve (Fed) kept interest rates unchanged in September as expected by market participants. The statement remained largely unchanged, but the Fed revised its forecasts for the Fed funds rate, bringing it 50 basis points higher for the end of 2024. The forecast for the end of 2023 leaves the door open for one last hike, but a lot of uncertainty remains.

- **The Canadian economy is showing increasing signs of weakness.** Canadian real GDP posted a slight 0.2% annualized contraction in the second quarter. Hiring has also slowed, with average monthly job gains of about 25,000 over the past 6 months. More worryingly, job creation is slowing as the working-age population is growing quickly, which has sent the unemployment rate higher over the summer (graph 2 on page 2). The housing market recovery that began early this

GRAPH 1
The US Job Market Remains Resilient

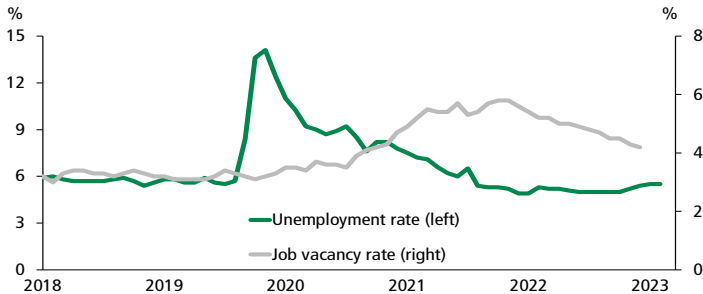


Sources: Bureau of Labor Statistics and Desjardins Economic Studies

year has been fading since the Bank of Canada's two most recent rate hikes eroded affordability further.

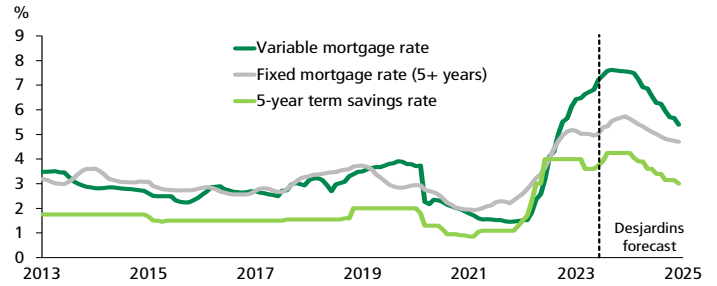
- **Another pause could mark the end of rate hikes in Canada.** The Bank of Canada (BoC) held rates steady early this month, citing lower Q2 real GDP as evidence that "excess demand in the economy is easing." But the Bank was careful to leave the door open to further interest rate hikes if necessary as, according to its statement, "Governing Council remains concerned about the persistence of underlying inflationary pressures." Although inflation is still a concern, the mounting risks to the Canadian economy could ramp up, prompting the Bank to start cutting rates in 2024.

GRAPH 2
Signs of a Labour Market Slowdown Are More Evident in Canada



Sources: Statistics Canada and Desjardins Economic Studies

GRAPH 3
Retail Rates Won't Come Down for Several More Months



Sources: Bank of Canada and Desjardins Economic Studies

- **Retail rates will remain high for several more months.** Although the rate hiking cycle may be coming to an end in Canada, retail rates could remain high for some time (graph 3). Upside inflation risks could keep long-term bond yields at high levels. And deteriorating economic conditions could keep borrowing costs higher for financial institutions, which should be reflected in the interest rates offered on savings and loans.

TABLE 1
Forecasts: Retail rates

%	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)								
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 2023	5.00	6.95	7.34	6.54	6.49	4.50	3.90	3.75
July 2023	5.25	7.20	7.49	6.54	6.49	5.00	4.05	3.90
August 2023	5.25	7.20	7.89	7.04	6.84	5.00	4.40	4.25
September 21, 2023	5.25	7.20	7.89	7.04	6.84	5.00	4.40	4.25
Forecast								
<u>End of quarter</u>								
2023: Q3	5.25	7.20	7.89	7.04	7.19	5.00	4.40	4.25
2023: Q4	5.25	7.20	7.69	7.04	7.49	5.00	4.40	4.25
2024: Q1	5.00	6.95	7.14	6.54	7.34	4.75	3.85	3.90
2024: Q2	4.50	6.45	6.44	6.29	7.14	4.00	3.60	3.60
<u>End of year</u>								
2024	3.50	5.45	5.54	5.64	6.64	3.05	2.95	3.00
2025	2.50	4.45	4.99	5.49	6.54	2.60	2.80	2.85
2026	2.50	4.45	4.99	5.49	6.54	2.60	2.80	2.85

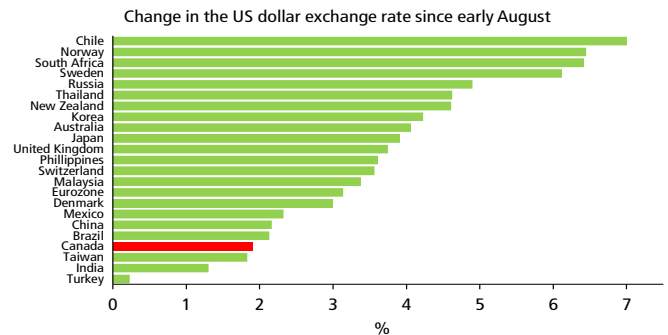
¹ Non-redeemable (annual); NOTE: Forecasts are represented using an asymmetric range reflecting the perceived probability of deviation from the base scenario. The mean of the range does not represent the forecast associated with the base scenario.
Source: Desjardins Economic Studies

Exchange Rate

Uncertainty and Higher Bond Yields Are Helping the US Dollar

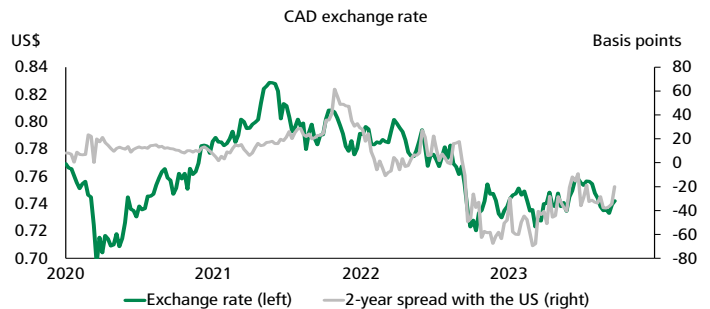
- Risk aversion grew in August, giving the US dollar a boost. And unlike many other countries, the United States continues to post solid economic numbers, further buoying the greenback. Higher interest rates in the US are helping, too.
- The Canadian dollar is holding up better than the currencies of most major advanced and emerging economies (graph 4). Since early August, the loonie has lost just about US\$0.01. It's currently trading above US\$0.74 (CAN\$1.34/US\$). High oil prices are supporting the Canadian dollar, offsetting lower prices for other commodities. The Canadian exchange rate is also getting help from bond yield spreads, especially for shorter maturities (graph 5). Although Canadian economic growth is slowing, recent inflation data have been higher than expected, pushing up yields.
- **Forecast:** Our forecast calls for Canada–US yield spreads to stabilize as spreads should start to narrow in both countries. That makes further appreciation of the loonie less likely. Moreover, we think oil prices are too high given the global economic slowdown on the horizon. Factor in increased risk aversion, and the Canadian dollar is more likely to depreciate slightly over the next few months before rebounding later next year.
- The euro and pound should benefit from moderating US bond yields. But decreased risk appetite and Europe's bigger economic challenges don't bode well for a meaningful rebound in these currencies.

GRAPH 4
We've Seen Broad Strength in the US Dollar, but the Canadian Dollar Has Been Holding Its Own



Sources: Datastream and Desjardins Economic Studies

GRAPH 5
The Loonie Continues to Track the Canada–US 2-Year Bond Spread Pretty Closely



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: Currencies

END OF PERIOD	2022		2023				2024			
	Q3	Q4	Q1	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US\$/CAN\$	1.3828	1.3551	1.3516	1.3238	1.3514	1.3699	1.3514	1.3158	1.2987	1.2987
CAN\$/US\$	0.7232	0.7380	0.7399	0.7554	0.7400	0.7300	0.7400	0.7600	0.7700	0.7700
CAN\$/€	1.3547	1.4462	1.4684	1.4443	1.4459	1.4658	1.4595	1.4605	1.4675	1.4805
US\$/€	0.9797	1.0673	1.0865	1.0910	1.0700	1.0700	1.0800	1.1100	1.1300	1.1400
US\$/£	1.1163	1.2029	1.2365	1.2714	1.2500	1.2500	1.2700	1.3100	1.3300	1.3400

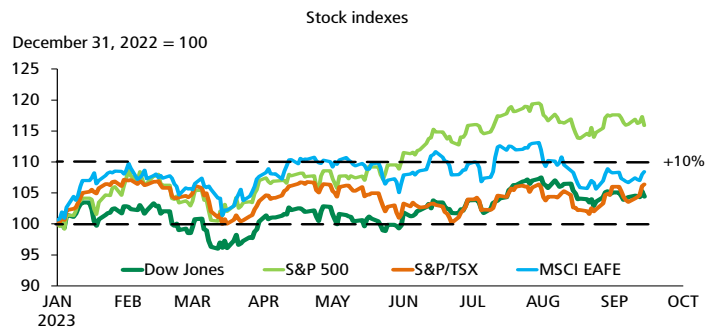
f: forecast
Sources: Datastream and Desjardins Economic Studies

Asset Class Returns

The Stock Market Rally Could Start to Lose Steam

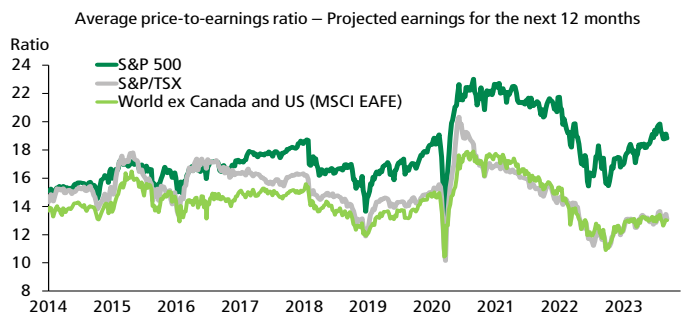
- Summer ended on a down note for stocks.** Global stock markets posted solid gains early in the summer, but stumbled in August and September. The S&P 500 in the US has been the centre of the rally, due to its high exposure to AI technologies (graph 6). But the rally was also fuelled by stronger-than-expected Q2 earnings and economic data, especially in the United States. Ironically, this upbeat economic news drove rate hike expectations and pushed up long-term bond yields, which explains much of the recent stock market decline.
- Despite stronger earnings, US stocks may still be overpriced.** US companies reported mostly positive earnings over the summer, but many stocks are still very highly priced (graph 7). In today's high interest rate environment, it would take sustained earnings growth to justify such valuations. While some companies leveraging AI might see this kind of earnings growth, it is unlikely to be widespread given the looming economic slowdown. But if growth does continue unabated, it could also have other significant implications for stock market valuations.
- Could bond yields stay higher for longer?** A period of sustained economic growth could be just as painful for stocks. While it could ensure long-term corporate earnings growth, it could also mean higher interest rates for longer. On one hand, if inflation is slow to moderate, central banks could be forced to keep raising rates. But if inflation cools and growth remains strong, there would be little reason to cut them. Such a scenario could lead to a yield curve disinversion, which would be especially painful for growth companies because they rely heavily on long-term debt. Recent market trends suggest this could be happening to some extent (graph 8).
- The S&P/TSX gets a bump from higher oil prices.** Canada's S&P/TSX index has been doing better in recent weeks mainly due to higher oil prices. The country's economic outlook worsened over the summer, and there's still a risk that the Bank of Canada will raise interest rates again—all bad news for returns. A recession is our most likely scenario for Canada. That means the recent S&P/TSX rally could be short-lived, especially since an economic slowdown would drive down the price of oil and several other commodities. Given the many vulnerabilities in the Canadian economy, other sectors could take a hit as well.

GRAPH 6
The Stock Market Rally Is Starting to Lose Steam



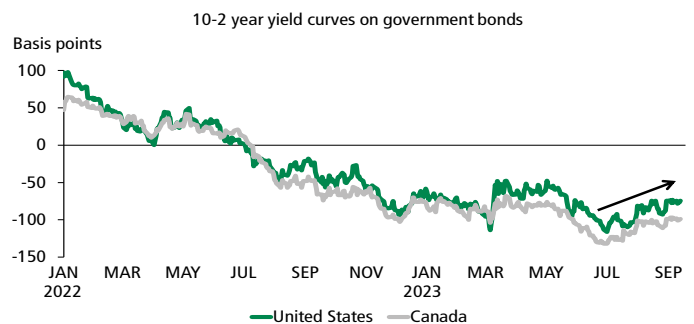
Sources: Datastream and Desjardins Economic Studies

GRAPH 7
The Average Price-to-Earnings Ratio Is Still Very High on the S&P 500



Sources: Datastream and Desjardins Economic Studies

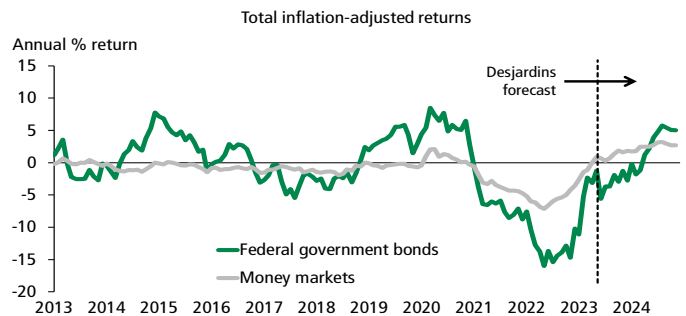
GRAPH 8
The Stock Market Decline Ushered In a Yield Curve Disinversion



Sources: Datastream and Desjardins Economic Studies

- Bad economic news is hurting global markets more.** There's also growing concern about some emerging economies, which are more sensitive to US interest rates and commodity prices. Bad economic news is also hurting European markets. Unless inflation doesn't ease as much as the European Central Bank would like over the coming months, the eurozone is probably heading for an interest rate pause. It's the same story in England. Among the major central banks, only the Bank of Japan still hasn't raised its policy rate. But keeping interest rates negative as inflation appears to be settling in above 2% is increasingly difficult to justify, and an unpleasant surprise on this front could send markets even lower.
- Returns are back, if you're discerning.** The good news for investors? Stocks had a great start to the year, and now safer asset classes are also offering positive real returns. Money markets are delivering positive inflation-adjusted returns for the first time since 2020, and bonds should follow suit over the coming months (graph 9). Stocks could keep rising if the economy surprises to the upside, but right now that seems less likely.

GRAPH 9
Positive Returns Are Available on Low-Risk Assets in Canada



Sources: Datastream and Desjardins Economic Studies

TABLE 3
Asset class returns (%)

END OF YEAR IN % (UNLESS OTHERWISE INDICATED)	CASH	BONDS	CANADIAN STOCKS	US STOCKS	INTERNATIONAL STOCKS	EXCHANGE RATE
	3-month T-bill	Bond index ¹	S&P/TSX index ²	S&P 500 index (US\$) ²	MSCI EAFE Index (US\$) ²	CS/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: 2.0	Target: -1.3	Target: 8.6	Target: 3.8	Target: 1.1 (US\$0.73)
Range	4.2 to 5.2	-1.0 to 5.0	-9.3 to 9.7	0.6 to 22.6	-4.2 to 14.8	-1.6 to 3.9
2024f	Target: 4.7	Target: 8.1	Target: 11.1	Target: 6.8	Target: 11.2	Target: -5.2 (US\$0.77)
Range	4 to 5.4	3.1 to 13.1	-3.4 to 21.6	-8.7 to 16.3	-3.3 to 21.7	-8.8 to -1.4

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

Sources: Datastream and Desjardins Economic Studies