

Retail Rate Forecasts

February 6, 2013

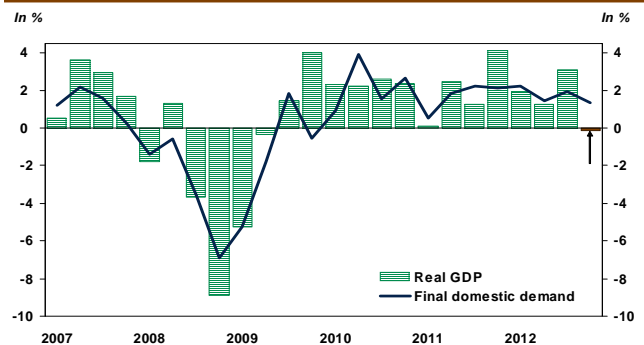
An encouraging start to the year, but not all has been settled

HIGHLIGHTS

- The agreement that helped avoid the full effect of the fiscal cliff diffused some major risks.
- Global economic growth remains modest.
- The Bank of Canada is sending stronger signals that it will not increase its key interest rate any time soon.
- Higher bond yields did not affect retail rates
- The Canadian dollar has weakened.
- Are investors too confident?

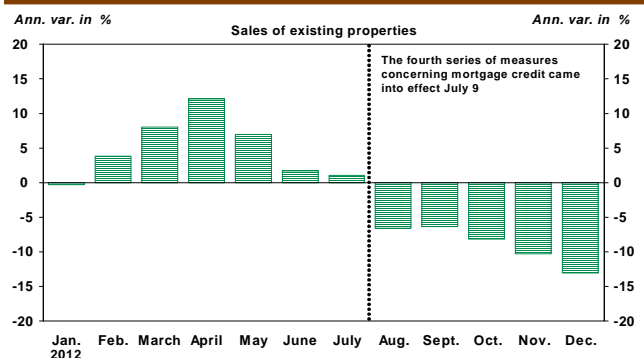
- **The political risks have been greatly reduced in the United States.** The agreement between Republicans and Democrats came about in the early hours of New Year's day, preventing the full effects of the fiscal cliff and, most likely, a recession in the United States. The budgetary and economic consequences of this agreement are much less severe than they would have been otherwise. Nevertheless, Americans are facing tax increases that will reduce incomes and hinder growth, and further negotiations will be necessary to resolve budget spending issues.
- **The end of 2012 proved a difficult time for the world economy.** Several major economies, including the United States (graph 1), Germany and the United Kingdom, declined over the last quarter of 2012. Despite showing some signs of stabilizing, all indications are that growth will remain weak in industrialized countries throughout the first half of 2013.
- **In Canada, economic troubles seem to be growing.** On one hand, international merchandise trade continues to suffer from soft global demand. On the other, the real estate market slowdown is materializing, with a drop by housing starts and pullback in sales of existing homes (graph 2). Instead of gradually rising as expected, the annual change of the total consumer price index stayed flat in December 2012, at 0.8%. This was the second straight month of inflation below the lower end of the Bank of Canada's (BoC) target range (graph 3 on page 2).

Graph 1 – First drop in U.S. real GDP since the recession



Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

Graph 2 – Sales of existing properties is slowing in Canada



Sources: Canadian Real Estate Association and Desjardins, Economic Studies

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- Canada's key interest rates will not rise any time soon.** The BoC lowered its estimates for economic growth and inflation. The BoC has also changed its tune regarding future key interest rate increases, hinting that they will take place later than previously foreseen. According to the monetary authorities: "While some modest withdrawal of monetary policy stimulus will likely be required over time, consistent with achieving the 2 per cent inflation target, the more muted inflation outlook and the beginnings of a more constructive evolution of imbalances in the household sector suggest that the timing of any such withdrawal is less imminent than previously anticipated."
- Higher bond yields did not affect retail rates.** The upturn in the U.S. political situation, the drop in financial strains in Europe as well as some encouraging economic statistics inflated investors' optimism. This situation negatively impacted the bond market, with North American 10-year yields recently crossing over 2.00% for the first time since last spring. In spite of this, Canadian retail rates have remained unchanged for a few months.
- Retail rates will likely remain very low.** The recent rise in bond yields could soon prompt Canadian financial institutions to adjust retail rates upwards slightly. However, any increases in retail rates should be limited by the fact that bond yields will likely remain very low, from a historical point of view, and because of strong competition leading into the most important time of year for the mortgage market (graph 4).

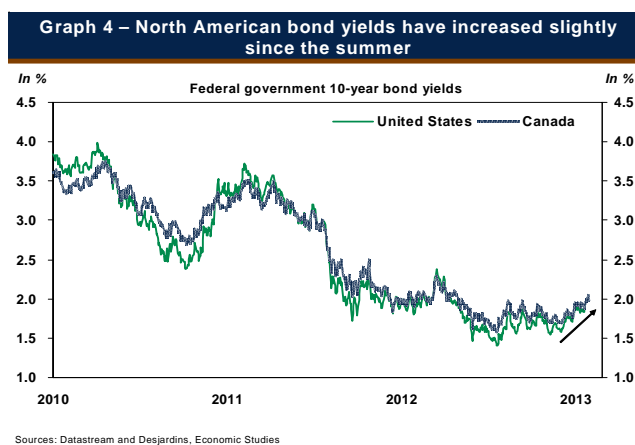
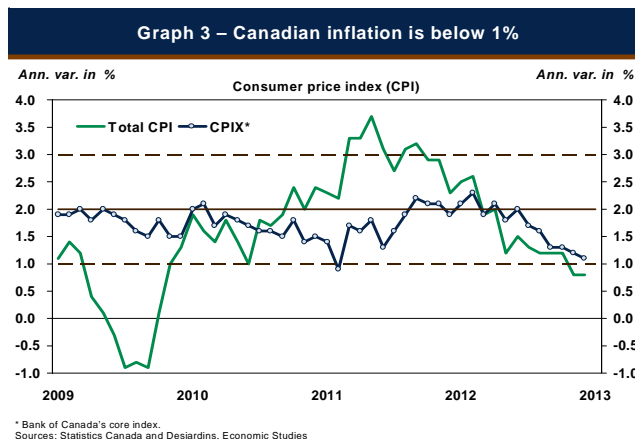


Table 1
Forecasts : Retail rate

	Discount rate (1)	Prime rate (1)	Mortgage rate (1)			Term savings (1) (2)		
			1 year	3 years	5 years	1 year	3 years	5 years
Realized – End of month								
August 2012	1.25	3.00	3.19	4.05	5.24	0.90	1.40	1.75
Sept. 2012	1.25	3.00	3.19	3.85	5.24	0.90	1.30	1.75
Oct. 2012	1.25	3.00	3.19	3.85	5.24	0.90	1.25	1.75
Nov. 2012	1.25	3.00	3.09	3.70	5.24	0.90	1.25	1.75
Dec. 2012	1.25	3.00	3.09	3.70	5.24	0.90	1.25	1.75
January 2013	1.25	3.00	3.09	3.70	5.24	0.90	1.25	1.75
Feb. 5, 2013	1.25	3.00	3.09	3.70	5.24	0.90	1.25	1.75
Forecasts								
End of quarter								
2013: Q1	1.00–1.50	2.75–3.25	3.00–3.30	3.60–3.90	5.10–5.40	0.80–1.10	1.15–1.45	1.65–1.90
2013: Q2	1.00–1.50	2.75–3.25	2.85–3.35	3.45–3.95	4.90–5.40	0.65–1.15	1.00–1.50	1.50–2.00
2013: Q3	1.00–1.50	2.75–3.25	2.85–3.35	3.60–4.10	4.90–5.40	0.65–1.15	1.05–1.55	1.50–2.00
2013: Q4	1.00–1.50	2.75–3.25	2.95–3.45	3.85–4.35	4.90–5.40	0.65–1.15	1.15–1.65	1.55–2.05
End of year								
2013	1.00–1.50	2.75–3.25	2.95–3.45	3.85–4.35	4.90–5.40	0.65–1.15	1.15–1.65	1.55–2.05
2014	1.50–2.00	3.25–3.75	3.45–3.95	4.40–4.90	5.30–5.80	1.05–1.55	1.70–2.20	2.15–2.65
2015	2.00–2.50	3.75–4.25	4.35–4.85	5.45–5.95	6.00–6.50	1.25–1.75	2.40–2.90	2.75–3.25

Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

The Canadian dollar has weakened

- After appreciating slightly at the beginning of the year, the Canadian dollar experienced some difficulty on the foreign exchange markets and recently dropped below US\$1.00 temporarily. Disappointing statistics on the Canadian economy, including a lower-than-expected inflation rate, have impacted yield spreads with the United States, thus affecting the exchange rate. The more dovish tone adopted by the Bank of Canada at its last monetary policy meeting further affected the loonie's trajectory.
- Rising oil prices no longer appear to be benefiting the Canadian dollar as much. Parity with the U.S. dollar is usually sustainable when the price of crude approaches US\$90 a barrel. However, the price of WTI (West Texas Intermediate) is currently over US\$95 a barrel, while Brent oil has surpassed US\$115 a barrel. Hindered by a lack of adequate infrastructure, the mounting difficulties in exporting western Canada oil are likely a key factor. The value of Canadian crude oil has not risen as sharply as elsewhere in the world. As a result, the terms of trade have not much improved and the currency is feeling the effects.
- The decline of the Canadian dollar is even more pronounced in relation to the euro. The common currency continues to benefit from easing tensions related to sovereign debt as well as from certain signals that suggest the zone's economy is improving. The euro has recently risen past US\$1.37, a 14-month high.
- Forecast:** Any dip of the Canadian dollar under parity should be temporary, and it should finish the year around US\$1.02. By the end of the year, the market should start, once again, to gradually anticipate a tighter Canadian monetary policy, which will support the loonie. Differences between Canadian and international oil prices should decrease over time. The Canadian dollar should also rise in relation to the euro. The recent strength of this currency seems exaggerated, considering that Europe still faces many challenges and financial strains could flare up at any time.

Graph 5 – Weak western oil prices are negatively impacting Canada's terms of trade



* West Texas Intermediate.
Sources: Bloomberg, Datastream and Desjardins, Economic Studies

Graph 6 – The Canadian dollar has further retreated against the euro recently



Sources: Datastream and Desjardins, Economic Studies

Determinants	Short-term	Long-term
Oil prices	↗	↗
Metals prices	→	↗
Interest rates spreads (Canada - United States)	↗	↗

Table 2
Forecasts: currency

End of period	2012		2013				2014			
	Q3	Q4	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US\$/CAN\$	1.0165	1.0079	1.0000	1.0100	1.0100	1.0200	1.0300	1.0300	1.0400	1.0500
CAN\$/US\$	0.9838	0.9922	1.0000	0.9901	0.9901	0.9804	0.9709	0.9709	0.9615	0.9524
CAN\$/€	1.2657	1.3081	1.3200	1.2871	1.2970	1.3039	1.3010	1.3107	1.2981	1.2952
US\$/€	1.2865	1.3184	1.3200	1.3000	1.3100	1.3300	1.3400	1.3500	1.3500	1.3600
US\$/£	1.6148	1.6255	1.6000	1.6100	1.6300	1.6600	1.6700	1.6800	1.6900	1.7000

Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies

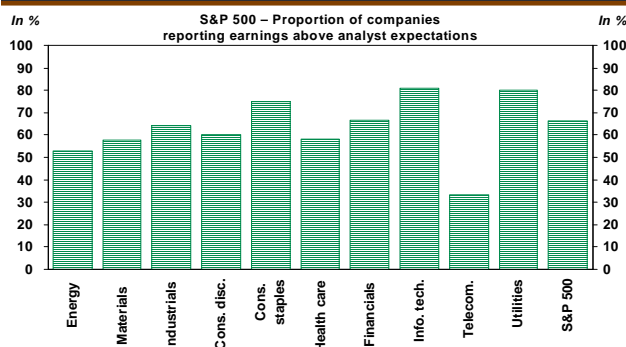
f: forecasts

ASSET CLASSES RETURN

Are investors too confident?

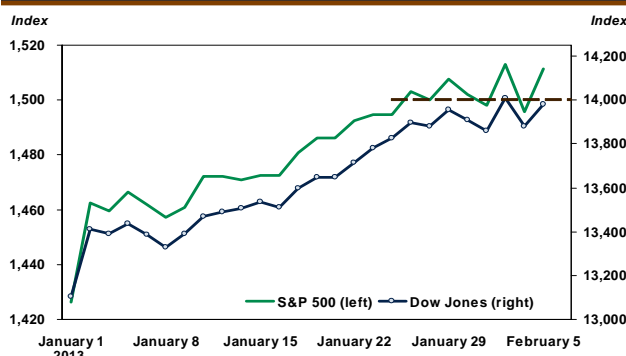
- Having performed very well in 2012, U.S. stock markets also started 2013 on a tear.** At the beginning of February, the S&P 500 is already showing a 6% gain over last year, higher than our target for the entire year. The lifting of uncertainties surrounding the U.S. budget crisis was certainly beneficial. However, relatively positive fourth-quarter results were what helped boost investor optimism the most. As of February 4, more than two-thirds of companies making up the S&P 500 index had announced results exceeding expectations (graph 7). The reaching of certain psychological thresholds also helped reinforce confidence: in only a few days, the S&P 500 index crossed the 1,500-point mark, while the Dow Jones index surpassed 14,000 points (graph 8).
- However, from a macroeconomic perspective, the situation seems less positive.** In the fourth quarter, the U.S. economy experienced its first contraction since the recession. Consumer confidence seems to have been shaken by the increase in payroll deductions, which came into effect under the fiscal cliff provisions. Job creation was also somewhat weakened last fall. It remains to be seen how the reduction in disposable income will impact consumer activity in January.
- The handling of the budget crisis played a role.** Although economic signals were rather mixed (graph 9), the attractiveness of stocks in the face of an overpriced bond market left no doubt. Investors were waiting to determine the appropriate time to re-balance their portfolios, and it seems that the avoidance of a recession brought on by Washington was a satisfactory catalyst. However, several rounds of play remain, and an escalation of political tensions is still possible.
- Despite our relatively favourable view of the stock market, investors seem overly optimistic.** This can be seen in the operating earning prospects of the S&P 500: analysts are anticipating an increase of 14% in 2013, and expectations have been continuously revised upwards in recent weeks. Growth in operating earnings was not as strong in 2012, as earnings levels have already reached record highs. The beginning of 2013 should be a difficult time for U.S. consumption, as the European recession continues. The market thus seems vulnerable to any negative surprises in the short term.

Graph 7 – Fourth quarter earnings results were generally good relative to expectations



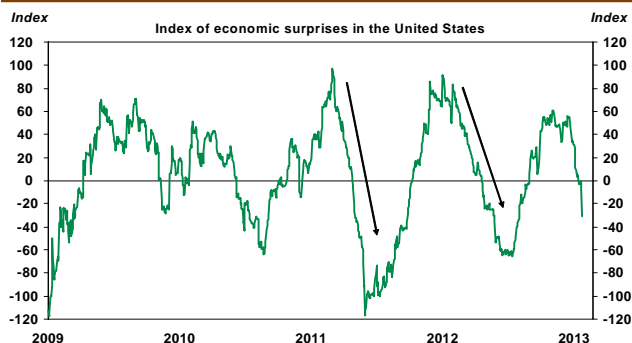
Sources: Standard & Poor's and Desjardins, Economic Studies

Graph 8 – Stocks have reached important psychological thresholds



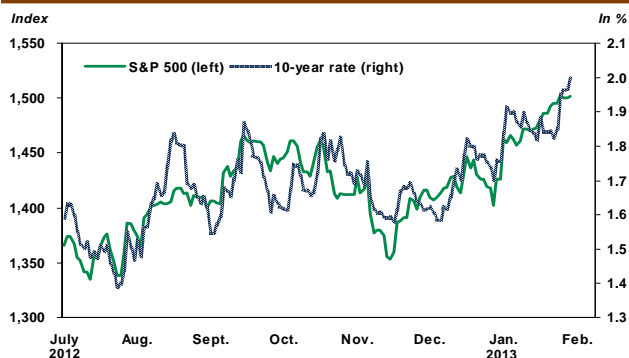
Sources: Datastream and Desjardins, Economic Studies

Graph 9 – The disappointing data recently released in the United States are reminiscent of the disappointments of early 2011 and 2012

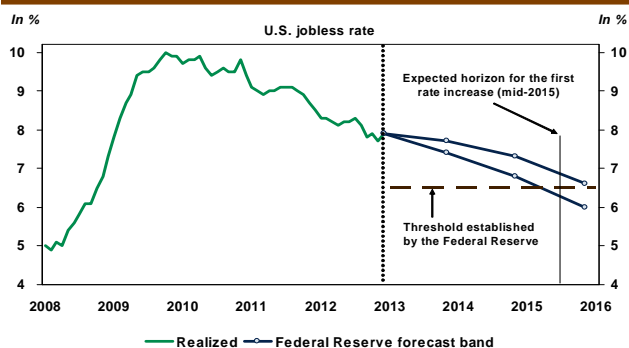


Sources: Datastream, Citigroup and Desjardins, Economic Studies

- **The bond market has not yet had its last word.** The strength of the stock market and the rebalancing of portfolios certainly tested the resiliency of bond markets at the beginning of the year (graph 10). Nevertheless, the 10-year U.S. yield is struggling to stay above 2%, indicating a certain level of caution. The 7.9% unemployment rate is still far beyond the threshold of 6.5% set by the Federal Reserve (graph 11), and the latter should continue with bond purchases throughout the rest of the year. In this climate of uncertainty, both from a political and growth perspective, the moment of truth has perhaps not yet arrived for bond markets. However, as in 2012, bonds will generate a very mediocre yield compared to riskier asset classes.
- **Return forecasts.** Our scenario is based on solid stock performances, although 2012's profits will be harder to beat than what analysts are currently expecting. Fixed-income securities remain overvalued and will not provide an attractive return. In an alternative, optimistic scenario, where political progress is made in the United States, we may even expect negative returns. Canadian stocks should see a better year than 2012, while a global recovery should boost the prices of commodities. However, we need to wait until the second half of the year for this scenario to take shape. Although 2013 should prove better than the last two years with regard to the performance of the S&P/TSX index, we do not expect a repeat of the spectacular gains that marked the first two years of the recovery.

Graph 10 – Stock market strength has had a negative influence on U.S. bonds


Sources : Bloomberg and Desjardins, Economic Studies

Graph 11 – The Federal Reserve's unemployment rate threshold remains far


Sources : U.S. Bureau of Labor Statistics, Federal Reserve Board and Desjardins, Economic Studies

**Table 3
Asset classes percentage return**

End of year	Cash	Bonds	Canadian stocks	U.S. stocks	International stocks	Exchange rate
	3-month T-Bill	Dex Universe Bond Index	S&P/TSX Index*	S&P 500 Index (US\$)*	MSCI EAFE Index (US\$)*	C\$/US\$ (var. in %)**
2000	5.45	10.2	7.4	-9.1	-14.0	3.8
2001	3.88	8.1	-12.6	-11.9	-21.2	6.5
2002	2.52	8.7	-12.4	-22.1	-15.7	-1.5
2003	2.87	6.7	26.7	28.7	39.2	-17.7
2004	2.23	7.1	14.5	10.9	20.7	-7.1
2005	2.70	6.5	24.1	4.9	14.0	-3.3
2006	4.01	4.1	17.3	15.8	26.9	0.2
2007	4.14	3.7	9.8	5.5	11.6	-14.4
2008	2.35	6.4	-33.0	-37.0	-43.1	22.1
2009	0.34	5.4	35.1	26.5	32.5	-13.7
2010	0.57	6.7	17.6	15.1	8.2	-5.2
2011	0.92	9.7	-8.7	2.1	-11.7	2.3
2012	0.95	3.6	7.2	16.0	17.9	-2.7
2013f	target: 0.95	target: 1.0	target: 9.5	target: 7.5	target: 6.0	target: -1.2 (US\$1.02)
range	0.70 to 1.20	-2.0 to 4.0	1.5 to 17.5	0.0 to 15.0	-2.0 to 14.0	-4.0 to 1.8

f: forecasts; * Dividends included; ** Negative = appreciation and positive = depreciation.

Sources: Datastream and Desjardins, Economic Studies