Retail Rate Forecasts

Desjardins Economic Studies
www.desjardins.com/economics

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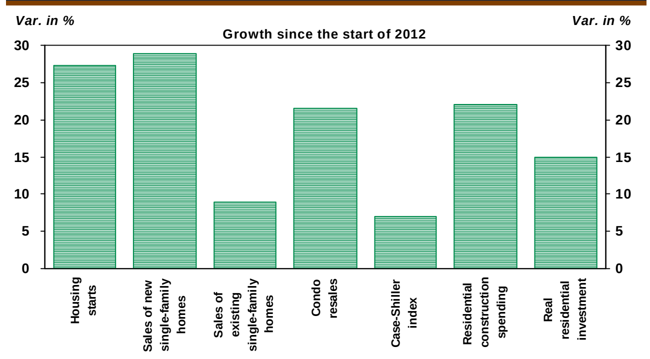
The difficulties of the Canadian economy confirm that interest rates will remain low

HIGHLIGHTS

- The economic situation remains difficult in several major economies, although the statistics are more encouraging for the United States.
- The Canadian economy is showing signs of weakness, especially in terms of domestic demand.
- The Bank of Canada should not raise its key rates before the last quarter of 2014.
- The Canadian dollar could climb back to parity with the greenback by late 2013.
- The stock market surge is fading.

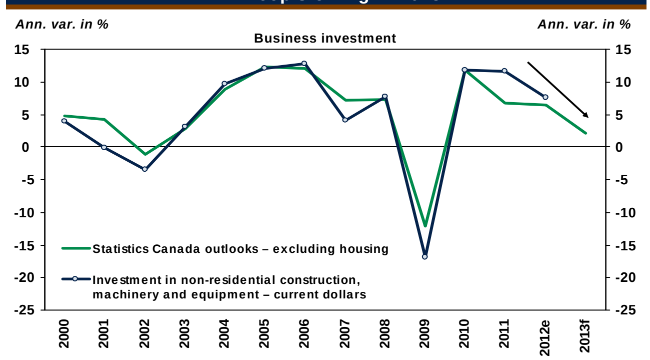
- **The global economy remains lacklustre.** Few signs suggest real improvement in the economic situation in the euro zone. The recession that has been ongoing since mid-2011 will therefore continue for several more months. The financial situation also seems very fragile in the euro zone given the inconclusive outcome to Italy's election and banking problems in Cyprus. Growth will also remain weak in the United Kingdom and Japan in 2013.
- **Encouraging news for the United States.** After getting through the fiscal cliff without too much damage, the U.S. economy seems to be showing continued resilience. Several U.S. economic indicators have beaten expectations since the beginning of the year. Retail sales' growth has remained positive, despite the expiration of the cut to the payroll tax. The investment outlook is encouraging, and the housing market is recovering slowly but surely (graph 1). Employment's solid performance, with 821,000 jobs created over the last four months, is also reassuring.
- **Canada's growth will be weak in 2013.** Canada's economy remained soft in the fourth quarter of 2012, as real GDP rose only a quarterly annualized 0.6%. The first half of 2013 also promises to be fairly difficult. The real estate market is cooling and governments are continuing to tighten their belts. What's more, the latest Statistics Canada survey on private and public investment intentions was disappointing, showing businesses were quite reluctant to invest (graph 2). An upturn is expected for early summer, however, as the accelerating U.S. economy should favour Canadian exports.

Graph 1 – The U.S. housing market recovery seems well underway



Sources: Datastream and Desjardins, Economic Studies

Graph 2 – Growth in Canadian non-residential investment will keep slowing in 2013



e: estimate; f: forecast
Sources: Statistics Canada and Desjardins, Economic Studies

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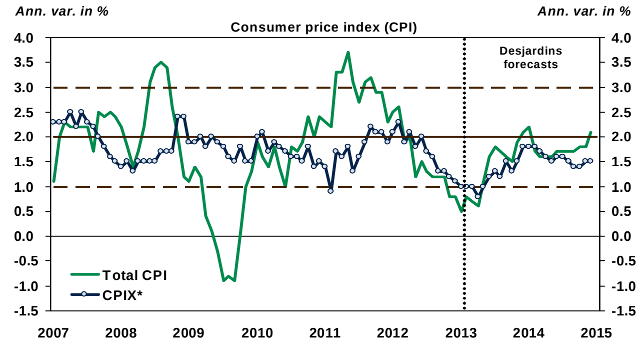
NOTE TO READERS: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

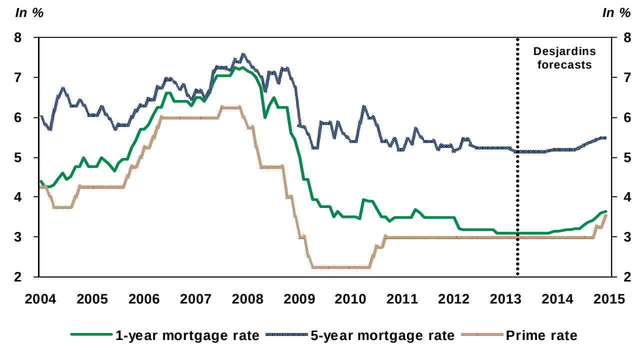
- **Canada's key rates will remain where they are for a long time.** The many problems of the Canadian economy and very weak inflation (graph 3) are giving the Bank of Canada a lot of leeway. The BoC once again softened its stance in March, stressing that the considerable monetary stimulus currently in place will likely remain appropriate for some time. A cut to key rates is unlikely, as that would only fuel concerns about household debt. The next move should therefore be a hike, but only in the last quarter of 2014.
- **Bond yields pulled back somewhat.** Some renewed concerns in the euro zone have brought North American bond yields down somewhat since the end of January. Disappointing Canadian figures and the postponement of expectations for key rate hikes amplified the drop of Canadian yields.
- **Slight dip in mortgage rates.** The decrease in bond yields and strong competition in this crucial time for the real estate market have prompted financial institutions to lower some mortgage rates by 10 to 15 basis points. Some institutions have also introduced very aggressive promotional rates, which the Canadian government sees as a worrying development. We are still forecasting very low retail rates over the coming quarters (graph 4).

Graph 3 – Canadian inflation will be soft for several months



* Bank of Canada core index.
Sources: Statistics Canada and Desjardins, Economic Studies

Graph 4 – Canadian retail rates will stay very low



Sources: Datastream and Desjardins, Economic Studies

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								
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
Jan. 2013	1.25	3.00	3.09	3.70	5.24	0.90	1.25	1.75
Feb. 2013	1.25	3.00	3.09	3.70	5.24	0.90	1.25	1.75
March 25, 2013	1.25	3.00	3.09	3.55	5.14	0.90	1.25	1.75
Forecasts								
End of quarter								
2013: Q1	1.25	3.00	3.00–3.20	3.45–3.65	5.05–5.25	0.80–1.00	1.15–1.35	1.65–1.85
2013: Q2	1.00–1.50	2.75–3.25	2.85–3.35	3.30–3.80	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	3.35–3.85	4.90–5.40	0.65–1.15	1.00–1.50	1.50–2.00
2013: Q4	1.00–1.50	2.75–3.25	2.90–3.50	3.45–3.95	4.90–5.40	0.65–1.15	1.00–1.50	1.55–2.05
End of year								
2013	1.00–1.50	2.75–3.25	2.90–3.50	3.45–3.95	4.90–5.40	0.65–1.15	1.00–1.50	1.55–2.05
2014	1.50–2.00	3.25–3.75	3.40–3.90	4.35–4.85	5.25–5.75	1.00–1.50	1.60–2.10	2.15–2.65
2015	2.00–2.50	3.75–4.25	4.25–4.75	5.35–5.85	6.00–6.50	1.10–1.60	2.30–2.80	2.75–3.25

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

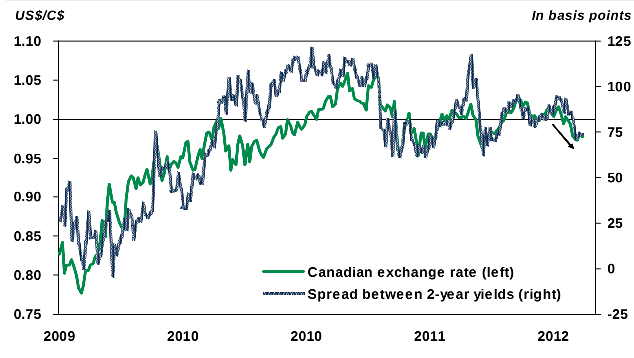
Desjardins Economic Studies

CANADIAN DOLLAR

A return to parity feasible by the end of the year

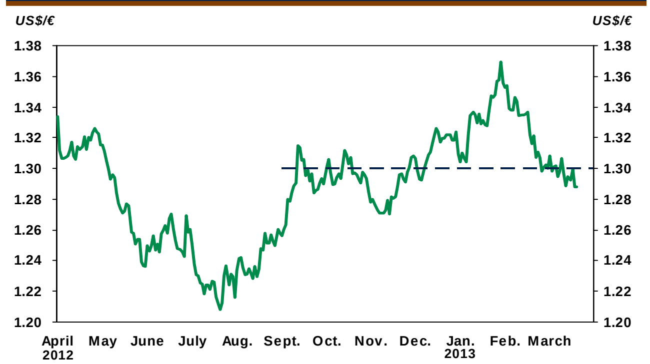
- The Canadian dollar has weakened since mid-January. A series of disappointing economic statistics and a softer stance from the Bank of Canada (BoC) have carried more weight than the upswing in commodity prices. After falling below US$0.97 several times in early March, the loonie now seems to be stabilizing close to US$0.98.
- Canada's weak economy in recent quarters has widened the output gap, which should push the first key rate increase back to late 2014. Interest rate spreads should not be as favourable for the loonie as they were before (graph 5).
- The worst of the slowdown seems to be behind us, however. Consumption and business investment seem to be holding firm. A greater contribution by exports will still be needed to increase economic growth and confidence in the Canadian dollar. Because of this, the rebound in U.S. demand is fairly encouraging.
- The euro has also pulled back against the U.S. dollar. Its gains at the beginning of the year were completely erased after hitting a cyclical peak of US$1.37 (graph 6). European leaders and the European Central Bank initially showed concern about the euro's appreciation. Subsequently, Italy's inconclusive election, disappointing economic statistics and worries about the bailout plan for Cyprus' banking system steepened the euro's decline, bringing it below US$1.30.
- **Forecasts:** The Canadian dollar could weaken again if the BoC softens its stance further in April. Some investors could position themselves for an interest rate cut. Nevertheless, these expectations seem exaggerated, especially since economic statistics should be less disappointing, given the expected rebound in Canadian exports. In this context, the loonie could return to parity by the end of the year. The euro is also expected to appreciate.

Graph 5 – The Canadian dollar pulled back in tandem with interest rate spreads



Sources: Datastream and Desjardins, Economic Studies

Graph 6 – The euro erased the gains made at the start of the year



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

	2012		2013				2014			
End of period	Q3	Q4	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	1.0165	1.0079	0.9800	0.9800	0.9900	1.0000	1.0100	1.0200	1.0300	1.0400
CAN$/US$	0.9838	0.9922	1.0204	1.0204	1.0101	1.0000	0.9901	0.9804	0.9709	0.9615
CAN$/€	1.2657	1.3081	1.3265	1.3265	1.3232	1.3300	1.3267	1.3235	1.3107	1.3077
US$/€	1.2865	1.3184	1.3000	1.3000	1.3100	1.3300	1.3400	1.3500	1.3500	1.3600
US$/£	1.6148	1.6255	1.5200	1.5300	1.5500	1.5800	1.6000	1.6100	1.6200	1.6300

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

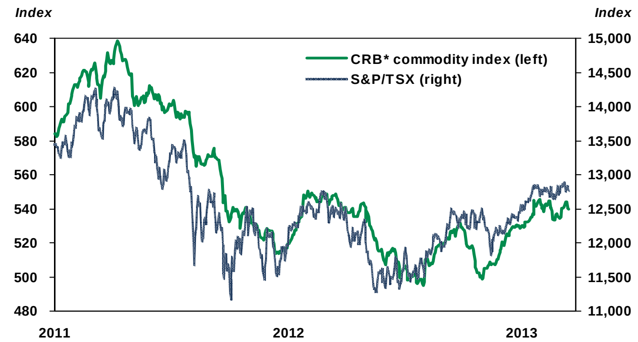
Note: For more details, see our *FX Forecasts* at www.desjardins.com/en/a_propos/etudes_economiques/previsions/devises/dev1303.pdf.

ASSET CLASSES RETURN

The stock market is losing momentum

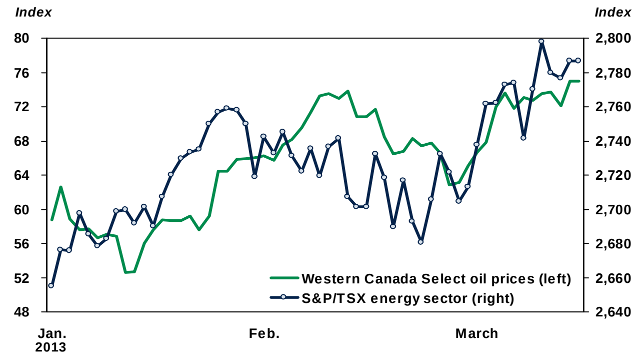
- **Europe sabotages the rally once again.** After two months of euphoria, which took the Dow Jones index to a new record, stock markets have run into some difficulties in March. The European crisis, which had apparently fallen off the radar at the start of the year, has come back full force, first with inconclusive elections in Italy, and then with the controversy in Cyprus, raising fears of a bank run in other countries with vulnerable financial systems. Expectations of the Federal Reserve's next moves also harmed U.S. stock markets, though a bit more subtly. With the recent improvements in economic statistics, investors have for some time been fearful of an early stop to the bond purchase program and its stimulating impact on stock markets. However, there was hardly any reaction when automatic spending cuts came into effect in the United States, and it could be that investors still do not fully grasp their potential impact (we are expecting a 0.6 percentage point bite out of growth in 2013).
- **Meanwhile, the Canadian stock market continues to bear the brunt of stumbling commodity prices.** The materials sector continues to be a drag, falling nearly 10% since the beginning of the year. Weak global commodity prices clearly play a major role (graph 7) and the situation could persist, in line with our forecast of another year of weak global growth (3.1%). The energy sector nonetheless posted a good recovery in February, as Canadian oil prices moved upwards, narrowing the gap with WTI (West Texas Intermediate) oil prices by almost half from the level of the beginning of the year (graph 8). One hopes that prices remain sustained, as profitability in the oil and natural gas extraction industry has dropped to its lowest level in 14 years (graph 9).
- **Despite everything, profits were healthy overall.** The results for Canadian businesses were solid for the fourth quarter, with 58% of businesses posting returns that beat analysts' expectations, a historically high level. Most of the major banks were part of this group, despite low interest rates and the slowdown observed in Canada's real estate market since last summer. Some of them even increased their dividends over the quarter. In this context, the Canadian stock market seems to deserve better than its current ranking among global stock markets (graph 10), and we expect some improvement later in the year.

Graph 7 – The stumbling of some commodities hurts the Canadian stock market



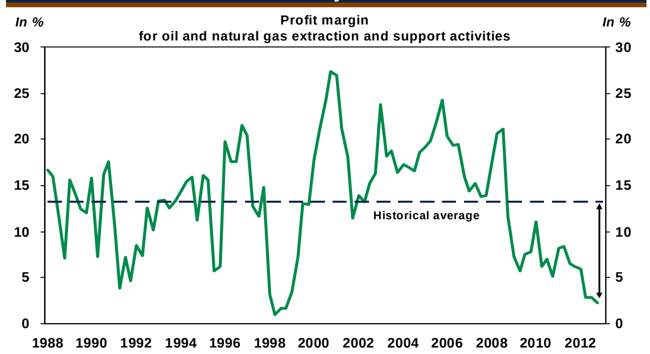
* Commodity Research Bureau.
Sources: Datastream and Desjardins, Economic Studies

Graph 8 – The energy sector has benefited from the rise of Canadian crude oil prices



Sources: Datastream and Desjardins, Economic Studies

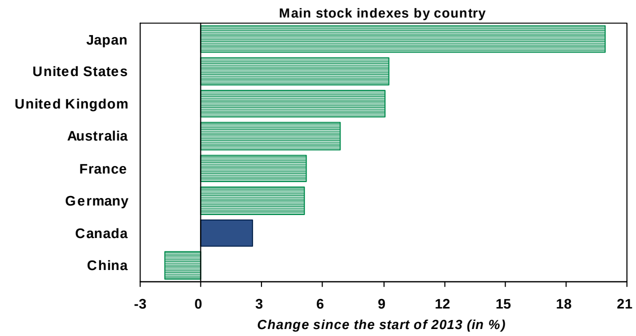
Graph 9 – In oil and natural gas extraction, profit margins are very low



Sources: Statistics Canada and Desjardins, Economic Studies

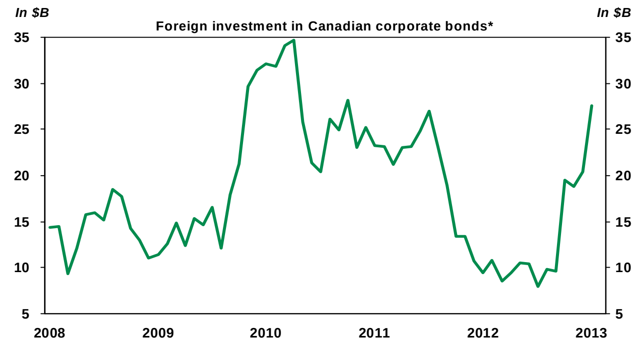
- **Bonds will continue to be supported in the coming months.** The recent rise of tensions in Europe is in line with the scenario we have been calling on since the beginning of the year, and we expect federal bonds to remain attractive in the short term. In Canada, while the provincial budgets released since the beginning of the year underscore the challenge of eliminating deficits in a context of weak revenue growth, provincial bonds will likely remain sought after, as has been the case in recent months. Continued quest for returns and the relative quality of provincial issuers will keep interest firm, especially from foreign investors, who have also been strongly attracted to Canadian corporate bonds (graph 11).
- **Return forecasts.** We must admit that the Canadian stock market has been disappointing early in the year. Our scenario still calls for some improvement in the second half of the year, but we slightly lower at 7.5% our target for Canadian stock market performance. The U.S. stock market is already performing close to our year-end target, and we expect the coming months to be a bit more difficult. Bonds will benefit from increased uncertainty in the short term, but the underlying trend will remain solidly negative.

Graph 10 – The Canadian stock market trails



Sources: Bloomberg and Desjardins, Economic Studies

Graph 11 – Heavy demand for corporate bonds



* Total over 12 months.
Sources: Statistics Canada and Desjardins, Economic Studies

Table 3
Asset classes percentage return

	Cash	*Bonds*	*Canadian stocks*	*U.S. stocks*	*International stocks*	*Exchange rate*
End of year	**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 range	target: 0.95 0.80 to 1.10	target: 1.0 -2.0 to 4.0	target: 7.5 1.0 to 13.0	target: 10.0 3.0 to 17.0	target: 8.0 -1.0 to 16.0	target: 0.8 (US$1.00) -1.2 to 5.0

f: forecasts; * Dividends included; ** Negative = appreciation and positive = depreciation.
Sources: Datastream and Desjardins, Economic Studies