Retail Rate Forecasts

Desjardins Economic Studies
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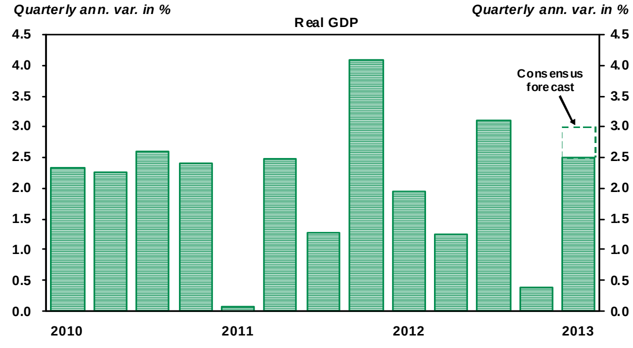
The changing of the guard at the Bank of Canada shouldn't affect interest rates much

HIGHLIGHTS

- The latest economic data out of Canada are a bit more encouraging.
- Despite the arrival of a new governor at the Bank of Canada, Canadian key interest rates should remain where they are for a long time.
- Turmoil in the global economy and aggressive action by the Bank of Japan have led to another drop in bond yields.
- The Canadian dollar could keep appreciating gradually.
- U.S. equity markets exhibit resilience.

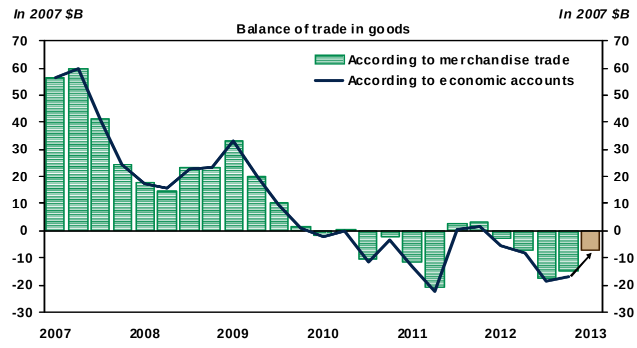
- **Economic weakness abroad pushes central banks into action.** The economic situation in the euro zone is still very worrisome. Economic data confirming that the recession is continuing, and another dip in inflation, have led the European Central Bank to lower its key interest rate to 0.50%, and it could take further action in an effort to stimulate growth. The Bank of Japan (BoJ) has been even more aggressive, announcing that it would purchase massive amounts of financial assets in an effort to bring inflation back to its target of 2.0%.
- **U.S. economic growth was a bit more sluggish than expected in the first quarter.** The release of a large number of encouraging economic statistics seemed to herald a strong rebound in the U.S. economy at the beginning of 2013. In the end, U.S. real GDP grew at an annualized rate of 2.5% in the first quarter, a little below expectations (graph 1). Several disappointing data in April raised concerns about a major spring slowdown in the United States, but the release of sound employment numbers at the beginning of May gave some reassurance to investors.
- **A better-than-expected start to the year in Canada.** After a few months of disappointing news, the latest Canadian data were surprisingly strong, and suggest that the economy grew at a good pace in the first quarter of 2013. This growth seems to have been mainly supported by foreign trade (graph 2), however, while the slowdown in domestic demand appears to be confirmed.
- **Despite the arrival of a new governor, the Bank of Canada (BoC) is unlikely to change its monetary policy.** In the end, it is Stephen Poloz who will replace Mark Carney at the helm of the BoC at the beginning of June. The appointment of an external candidate surprised analysts somewhat; they had foreseen that the governor's job would go to the current

Graph 1 – Despite a rally in the first quarter, U.S. real GDP growth was disappointing



Sources: Bureau of Economic Analysis, Bloomberg and Desjardins, Economic Studies

Graph 2 – Canada's balance of trade improved in the first quarter of 2013



Sources: Statistics Canada and Desjardins, Economic Studies

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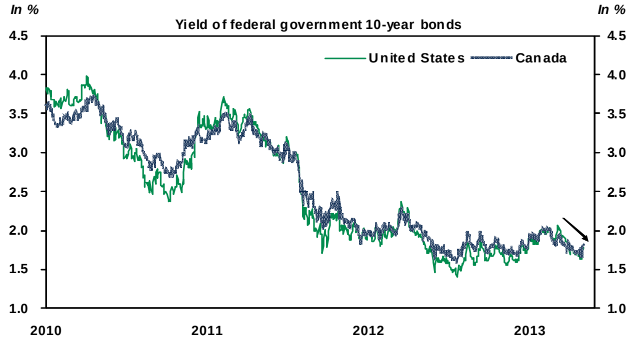
second-in-command at the BoC. While this appointment raises some questions about the independence of the BoC, there is no indication of any change to Canadian monetary policy in the months ahead. Canada's slightly stronger-than-expected economic growth in the first part of the year could convince the BoC to reiterate its comment about an eventual interest rate hike.

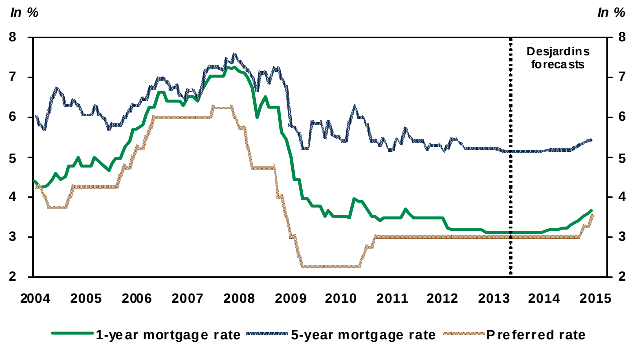
- **Bond yields lose ground again.** The combination of generally disappointing economic statistics and the announcement of major new asset purchases by the BoJ played in favour of North American bonds. The yields of both U.S. and Canadian 10-year bonds fell below 1.70% at the beginning of May before climbing back up to around 1.80% in reaction to good job statistics in the United States (graph 3).
- **No sign of rising retail interest rates.** The recent decline in bond yields has led Canadian financial institutions to slightly reduce certain interest rates paid on term savings. Mortgage rates are still at historic lows. This environment of very low interest rates should last for several months (graph 4).

Graph 3 – North American bond yields have retreated in recent weeks



Sources: Datastream and Desjardins, Economic Studies

Graph 4 – Canadian retail rates will stay 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								
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 2013	1.25	3.00	3.09	3.55	5.14	0.90	1.25	1.75
April 2013	1.25	3.00	3.09	3.55	5.14	0.90	1.25	1.75
May 8, 2013	1.25	3.00	3.09	3.55	5.14	0.90	1.25	1.75
Forecasts								
End of quarter								
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	0.95–1.45	1.40–1.90
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	0.95–1.45	1.40–1.90
2013: Q4	1.00–1.50	2.75–3.25	2.85–3.35	3.50–4.00	4.90–5.40	0.65–1.15	0.95–1.45	1.50–2.00
2014: Q1	1.00–1.50	2.75–3.25	2.95–3.45	3.75–4.25	4.95–5.45	0.65–1.15	1.00–1.50	1.60–2.10
End of year								
2014	1.50–2.00	3.25–3.75	3.40–3.90	4.25–4.75	5.20–5.70	1.10–1.60	1.50–2.00	2.05–2.55
2015	2.00–2.50	3.75–4.25	4.25–4.75	5.30–5.80	5.95–6.45	1.25–1.75	2.25–2.75	2.70–3.20
2016	2.75–3.75	4.50–5.50	4.80–5.80	5.60–6.40	6.20–7.00	1.60–2.60	2.60–3.40	3.00–3.80

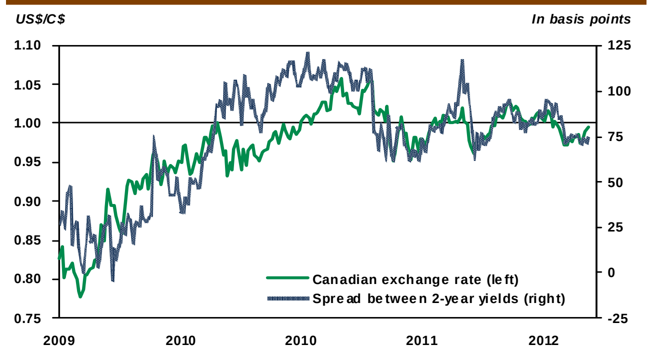
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

A slight appreciation in the offing

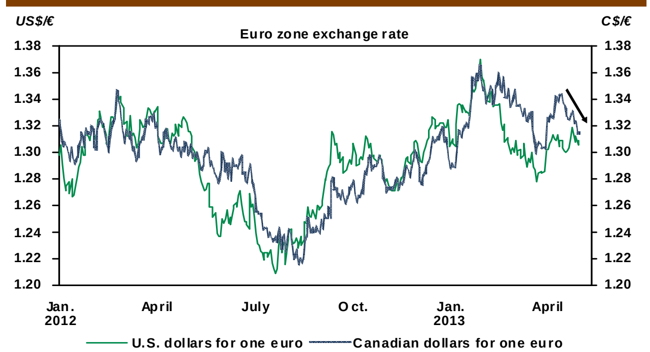
- Good news for Canadians who were thinking about buying U.S. dollars or euros: the loonie gained a bit of altitude recently. The Canadian currency had a fairly tough winter, against a backdrop of disappointing economic data. This drove the loonie to a cyclical low of US$0.9669 before the winds shifted direction in the spring.
- The Canadian dollar is still very sensitive to fluctuations in yield spreads between Canada and the United States (graph 5). Those spreads have been a bit more favourable in recent weeks. This trend has been influenced to some degree by the improvement in Canadian economic data and by the Bank of Canada leaving its comment about a future interest rate hike in its press release. External factors are also supporting the currency. Several commodity prices have risen, and quantitative monetary policies in the United States and Japan are encouraging investors to seek other investment options, such as Canadian securities.
- On the other side of the Atlantic, the economy is still looking quite gloomy, which is hurting the euro. The European Central Bank not only cut its key interest rates at the beginning of May, but left the door open to further interventions. This isn't enough to push the euro below the US$1.30 mark; as the Federal Reserve (Fed) is maintaining a very interventionist policy. We do note a slight depreciation of the euro against the Canadian dollar, however (graph 6).
- **Forecasts:** The Canadian dollar should appreciate slightly in the upcoming quarters, in tandem with the expected improvement in economic statistics and commodity prices. That appreciation is likely to be held in check by the strength of the U.S. dollar once the Fed shows signs of cutting back on its interventions. However, the underlying trend for the greenback should be downwards if its safe haven status gradually fades, as expected. In the short term, the euro will continue to be afflicted by the recession in the euro zone and by the risk of a resurgence of financial tensions. A more lasting appreciation of the euro should begin around the autumn.

Graph 5 – The Canadian dollar is still very sensitive to interest rate spreads with the United States



Sources: Datastream and Desjardins, Economic Studies

Graph 6 – The euro has lost a few cents against the Canadian dollar since mid-April



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	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	1.0165	1.0079	0.9828	0.9800	0.9900	1.0000	1.0100	1.0200	1.0300	1.0400
CAN$/US$	0.9838	0.9922	1.0175	1.0204	1.0101	1.0000	0.9901	0.9804	0.9709	0.9615
CAN$/€	1.2657	1.3081	1.3065	1.3265	1.3232	1.3300	1.3267	1.3235	1.3107	1.3077
US$/€	1.2865	1.3184	1.2841	1.3000	1.3100	1.3300	1.3400	1.3500	1.3500	1.3600
US$/£	1.6148	1.6255	1.5185	1.5400	1.5600	1.5800	1.6000	1.6100	1.6200	1.6300

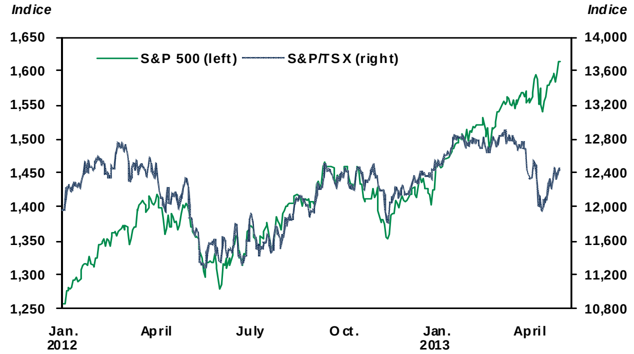
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies f: forecasts

ASSET CLASSES RETURN

U.S. equity markets exhibit resilience

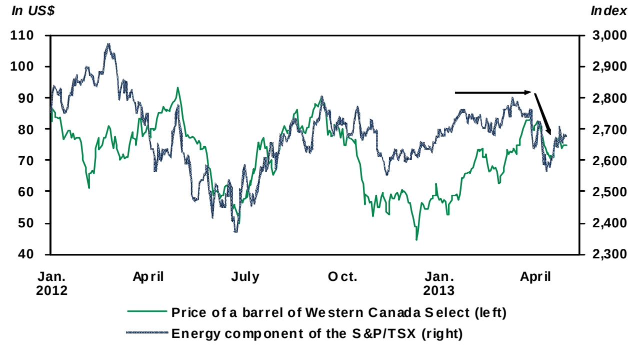
- **The U.S. stock market continues to impress, despite a global economy that is still very fragile.** In early May, the S&P 500 soared past the 1,600 point mark; this constitutes a robust gain of more than 13% since the beginning of 2013. While not shiny, earnings reported by U.S. companies in the first quarter were within the norms. Monetary easing measures in Japan and Europe offset disappointing economic indicators, enabling the U.S. stock market to quickly recover from recent episodes of turbulence.
- **Once again, the performance of the Canadian stock market leaves to be desired.** The unexpected deceleration in Chinese GDP growth in the first quarter threw cold water on commodity prices. This dynamic drove the S&P/TSX down sharply at the beginning of the spring, after already lagging behind U.S. equity markets (graph 7). Even though Canadian crude oil prices have strengthened since the beginning of the year, the energy sub-sector of the S&P/TSX has remained weak (graph 8). Meanwhile, weaker prices in non-energy commodities, especially gold, weighed down the materials sub-sector of the S&P/TSX: it has suffered a colossal 23% slump since the start of the year. Due to the issues affecting its largest sectors, the Canadian stock market has shown barely any growth since January 1. This overshadows the fact that some of the smaller sectors, such as technology, healthcare and discretionary consumption, have been performing well this year (graph 9).
- **The S&P/TSX will probably continue to struggle in the short term, as it will take some time for commodity prices to recover.** Gold price trends in particular could constitute a drag, since the precious metal no longer seems to enjoy investors' favour (graph 10 on page 5). Whereas past episodes of quantitative easing by central banks generated strong gains in value for precious metals, their prices have been impervious to these influences in 2013.
- **In the short term, bond yields will remain within their current range, but a gradual move upwards is expected from the summer onwards.** In this regard, our point of view has not changed: we expect the weakness of the global economy and certain disinflationary pressures (graph 11 on page 5) to limit the scope of any upward movement in yields. While the Federal Reserve will probably reduce the pace of its monthly bond purchases starting in the fall, it has highlighted that it could consider increasing them in the event of unfavourable developments in employment and inflation. This warning should at least provide some support for bonds, especially in the short term, until the recovery proves more sustained.

Graph 7 – The Canadian stock market is very vulnerable compared with the U.S. stock market



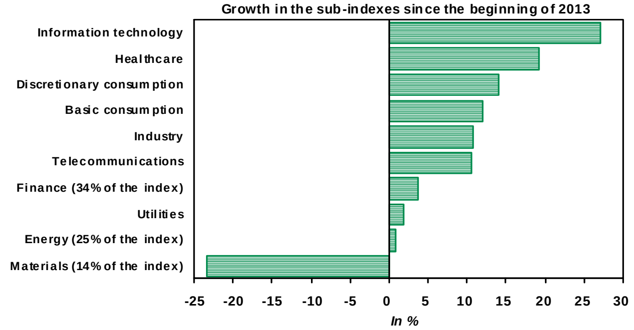
Sources: Datastream and Desjardins, Economic Studies

Graph 8 – Energy stocks on the Canadian stock market have been more sensitive to downwards trends in oil prices



Sources: Datastream and Desjardins, Economic Studies

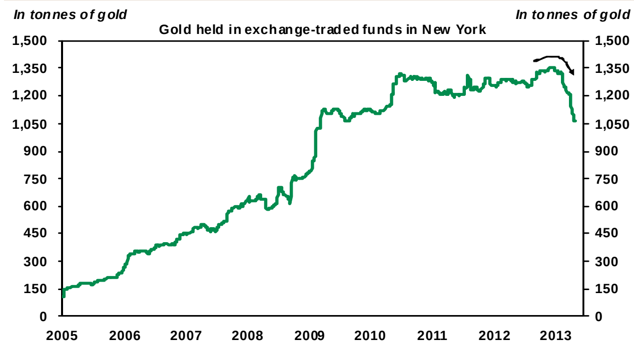
Graph 9 – Difficulties experienced by S&P/TSX heavyweights overshadow healthy performances in other sectors



Sources: Bloomberg and Desjardins, Economic Studies

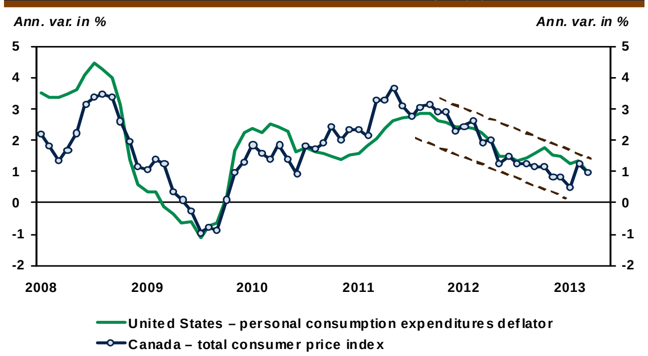
- **The Bank of Canada, also faced with weak inflation and a slowdown in several components of domestic demand, is likely to keep signalling that no rate hike is around the corner.** Broadly speaking, given the uncertainty surrounding the magnitude of the impact that automatic spending cuts in the United States could have on growth, it will take a few more months before bond yields emerge from their current range. However, as far as returns are concerned, bonds have lost the upper hand quite some time ago and we keep our return target at 1.0%.
- **Return forecasts.** The main changes to our scenario pertain to the Canadian and U.S. stock markets. Given the moribund state of the Canadian stock market so far this year and the difficulties that will persist in the commodity sector, we are lowering our target slightly; we now estimate that the S&P/TSX will generate a return of 6%. On the other hand, the performance by the U.S. stock markets indicates greater resilience than expected; we are now looking for a return of 14% for the S&P 500. Having said that, some volatility probably lies ahead in the coming months: U.S. economic data could reveal more bad surprises due to budget cuts, and the analysts' profit predictions still strike us as rather optimistic. The economic improvement expected in the second half of the year should still provide medium term support.

Graph 10 – Investor demand for gold has dropped sharply



Sources: Exchange Traded Gold and Desjardins, Economic Studies

Graph 11 – The disinflationary trend in Canada and the United States is keeping yields low



Sources: Bureau of Economic Analysis, 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	target: 0.95	target: 1.0	target: 6.0	target: 14.0	target: 8.0	target: 0.8 (US$1.00)
range	0.85 to 1.05	-2.0 to 4.0	1.0 to 10.0	7.0 to 20.0	0.0 to 16.0	-1.2 to 5.0

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