Retail Rate Forecasts

Desjardins Economic Studies

www.desjardins.com/economics

June 20, 2013

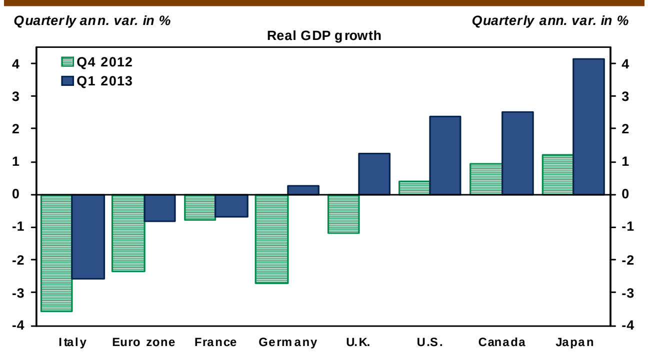
Interest rates should climb gradually

HIGHLIGHTS

- Economic data have provided both upside and downside surprises lately, but we can still expect global growth to pick up speed in the coming quarters.
- The Canadian and Quebec economies got the year off to a good start.
- Speculation about a potential decrease to the Federal Reserve's financial security purchases pushed bond yields up. Some Canadian retail rates have ticked up, but nothing points to a big rise.
- The Canadian dollar climbs to US$0.98.
- The U.S. stock rally hits the brakes.

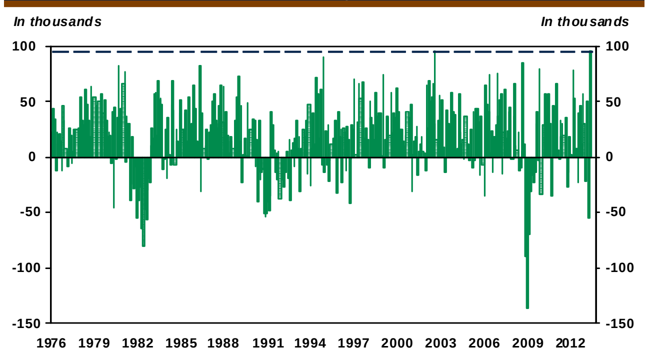
- **The global economy seems to be heading in the right direction.** The figures for Q1 of 2013 show that economic growth has accelerated in most industrialized economies after a tough year-end (graph 1). However, the euro zone is still in recession and its jobless rate rose at a new peak. The latest statistics from Europe are a little more encouraging, though, suggesting there is hope for renewed growth in the fall. The situation also seems to be improving in Japan and the United Kingdom.
- **The U.S. economy is sending conflicting signals.** Household consumption and the housing market continue to show encouraging signs, supported by stronger consumer confidence and fairly sustained job creation. Although growth seems increasingly well anchored in the United States, the drop of the ISM manufacturing index below the critical 50 mark, which signals expansion by the manufacturing sector, has raised some doubts about the strength of the U.S. economy.
- **Some positive surprises in Canada and Quebec.** Canada's real GDP increased by an annualized 2.5% in the first quarter of 2013, much faster growth than in the previous quarters. However, the results for domestic demand are much less stellar, rising by just 0.6%. After that, a near-record 95,000 jobs were created in May (graph 2), which was a real surprise. However, we must not let these volatile figures blind us. The growth forecast for 2013 as a whole remains 1.8%, as a number of factors should continue to rein in Canadian domestic demand. The first quarter's performance is also fairly good for Quebec's economy.

Graph 1 – G7 real GDP growth accelerated at the start of the year



Sources: Datastream and Desjardins, Economic Studies

Graph 2 – Canadian job creation nearly beat its all-time record in May



Sources: Statistics Canada and Desjardins, Economic Studies

François Dupuis
Vice-President and Chief Economist

Yves St-Maurice
Senior Director and Deputy Chief Economist

Mathieu D'Anjou
Senior Economist

Jimmy Jean
Senior Economist

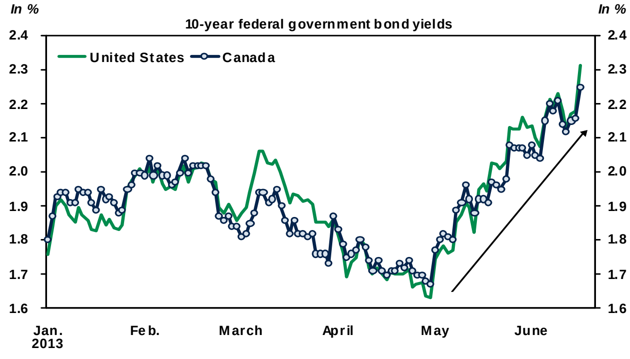
Hendrix Vachon
Senior Economist

514-281-2336 *or* 1 866 866-7000, ext. 2336
E-mail: desjardins.economics@desjardins.com

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

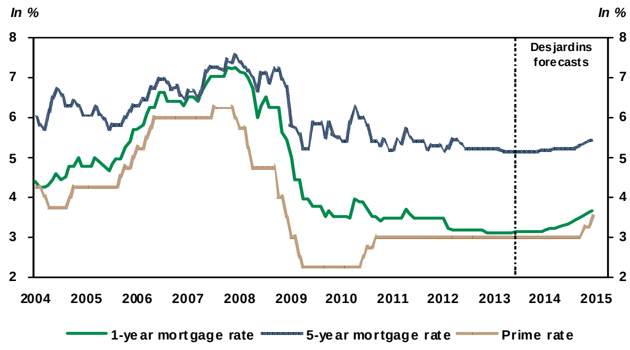
- **The Bank of Canada (BoC) should not change its stance.** The latest Canadian economic figures are relatively positive, with some signs that the housing market is rebounding; this should prompt the BoC to maintain its warning that the next change to monetary policy will be an increase to key rates. Inflation is weak, however, which should prompt the BoC to wait several quarters before it acts on its words.
- **The uncertainty about U.S. monetary policy pushes bond yields up.** The financial markets have been very volatile since early May, with investors attempting to guess when the Federal Reserve (Fed) will start to taper off its purchases of financial securities. U.S. 10-year yields have jumped over 60 basis points since the start of May (graph 3), bringing interest rates up around the world. The Fed tried to cool the situation at its June meeting, however, by precising its exit strategy and reiterating that U.S. monetary policy would remain highly expansive for a considerable time.
- **Retail rates should remain low for several more months.** The surge in bond yields prompted Canadian financial institutions to raise some retail rates slightly. Rates nevertheless remain close to their historic low (graph 4), and this situation should persist for several more months as central banks will do everything they can to keep financial conditions from tightening too quickly.

Graph 3 – Bond yields have rebounded in the last few weeks



Sources: Datastream and Desjardins, Economic Studies

Graph 4 – Canadian retail rates will remain 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								
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
February 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 2013	1.25	3.00	3.09	3.55	5.14	0.90	1.25	1.75
June 20, 2013	1.25	3.00	3.14	3.65	5.14	0.90	1.25	1.75
Forecasts								
End of quarter								
2013: Q2	1.25	3.00	3.10–3.25	3.55–3.75	5.10–5.25	0.80–1.00	1.15–1.35	1.65–1.90
2013: Q3	1.00–1.50	2.75–3.25	2.90–3.40	3.40–3.90	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	2.90–3.40	3.50–4.00	4.95–5.45	0.70–1.20	1.00–1.50	1.50–2.00
2014: Q1	1.00–1.50	2.75–3.25	3.00–3.50	3.75–4.25	5.00–5.50	0.70–1.20	1.05–1.55	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	5.65–6.45	6.25–7.05	1.60–2.60	2.60–3.40	3.00–3.80

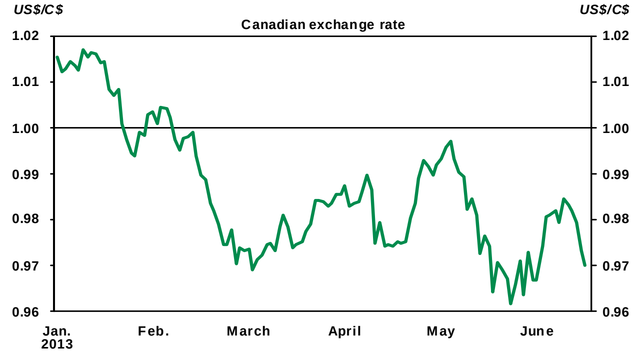
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

The Canadian dollar climbs to US$0.98

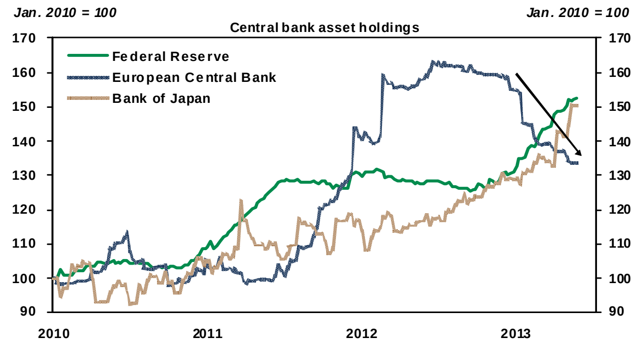
- The currency market has been highly volatile. The major surge by the U.S. dollar recorded in May quickly lost steam due to more temperate monetary policy expectations. Fears are still weighing on growth by emerging nations and demand for commodities. Despite all of this, the Canadian dollar managed to rise past the US$0.98 mark recently (graph 5).
- The loonie's upswing was mainly related to more encouraging statistics on Canada's economy for real GDP, employment and the real estate market. Investors thus have less of a reason to bet against the currency. Speculative positions had been particularly unfavourable for the loonie in the last few months, with little good news to turn the situation around.
- Given that most of the major currencies also rose against the greenback, the loonie's rebound was not widespread. In particular, the Canadian dollar moved downward against the euro, pound and yen. The euro benefited from weaker enthusiasm shown by the European Central Bank to use extraordinary measures like the Federal Reserve and Bank of Japan (graph 6). Some economic figures were also better than anticipated in Europe, giving the region's currencies an extra boost. As for the yen, the rise by Japan's bond yields raised doubts about how effective Japan's monetary policy was.
- **Forecasts:** The Canadian dollar should return to US$1.00 by year's end if the Canadian economy stays on track and global demand slowly improves, as forecast. In the nearer term, it could be hard for the loonie to rise again above US$0.98, as the next few statistics should not surprise as much on the upside. The loonie should still rise against the other currencies in the near term, including the euro. Keep an eye on the European Council meeting on June 27 and 28. Signs of dissent or a lack of progress on the banking union issue could renew financial strains and be a drag on the common currency.

Graph 5 – The loonie capitalizes on the good Canadian statistics in the beginning of June



Sources: Datastream and Desjardins, Economic Studies

Graph 6 – The European Central Bank stands alone in reducing its asset holdings, boosting the euro



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 Q3	2012 Q4	2013 Q1	2013 Q2f	2013 Q3f	2013 Q4f	2014 Q1f	2014 Q2f	2014 Q3f	2014 Q4f
US$/CAN$	1.0165	1.0079	0.9828	0.9800	0.9900	1.0000	1.0000	1.0100	1.0100	1.0200
CAN$/US$	0.9838	0.9922	1.0175	1.0204	1.0101	1.0000	1.0000	0.9901	0.9901	0.9804
CAN$/€	1.2657	1.3081	1.3065	1.3367	1.3131	1.3200	1.3300	1.3267	1.3366	1.3235
US$/€	1.2865	1.3184	1.2841	1.3100	1.3000	1.3200	1.3300	1.3400	1.3500	1.3500
US$/£	1.6148	1.6255	1.5185	1.5500	1.5700	1.5800	1.5900	1.6000	1.6100	1.6200

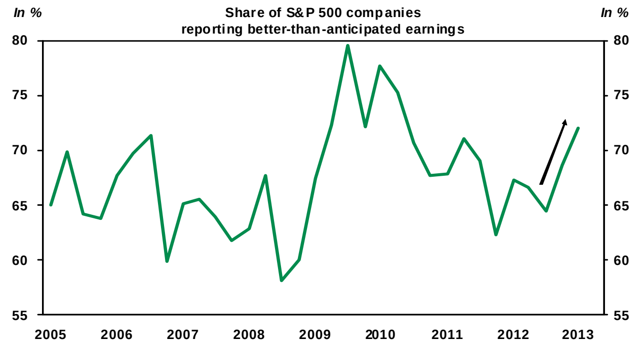
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies f: forecasts

ASSET CLASSES RETURN

The U.S. stock rally hits the brakes

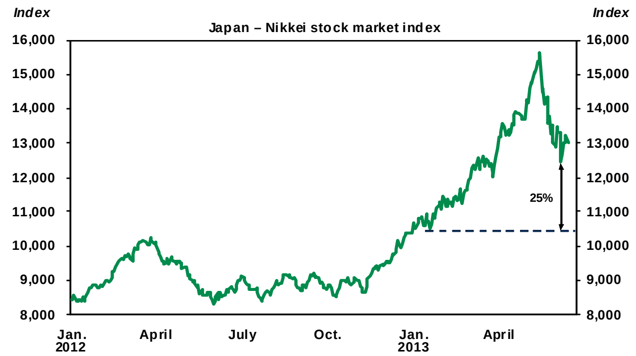
- **Almost infallible since the start of the year, U.S. stock markets ran into trouble in May.** Primarily, the renewed volatility in global markets hurt the riskiest assets. The volatility was triggered by uncertainty about the withdrawal of easing measures in the United States. The economic outlook has not changed fundamentally since spring began, and U.S. earnings in the first quarter have been acceptable, overall (graph 7). The prospect of an eventual Federal Reserve (Fed) withdrawal of monetary stimulus measures put the brakes on stock markets, attesting to some doubt about business's capacity to generate returns without major support from monetary authorities.
- **Although U.S. stock markets have been a bit choppy lately, the S&P 500 is still showing very healthy growth of about 15% from the start of the year.** And the recent downtrend seems slight compared with the upheaval in the Japanese stock market, which is off by more than 20% from its peak of 15,943 points hit on May 23 (graph 8). Note that the Nikkei had gotten ahead of itself somewhat after the Bank of Japan's aggressive actions, and a correction was to be expected. Despite this, the Japanese index is still up by over 25% from the start of 2013! Overall, the recent difficulties faced by stock markets that have done the best since the year began are not anomalous. The indexes could be somewhat flat this summer given the uncertainty about the actions and communications of the major central banks. Despite the turbulence that can be expected, the fundamental economic picture is gradually improving, particularly with respect to consumption and the housing market in the United States, which should keep the U.S. stock market from free falling.
- **The problems in the energy and materials sector are still obscuring the solid performances delivered by other segments of the S&P/TSX.** Many of these sectors are showing very strong growth, such as health (35%), technology (27%) and discretionary consumption (15%). Depressed metal prices continue to hurt the Canadian stock market's materials sector. Among other things, the situation in China is instrumental for industrial metal prices. The latest news from China is not very encouraging: metal imports are down sharply compared with last year and recent economic indicators are disappointing.
- **The S&P/TSX energy sector has been nearly flat since the year began, despite a strong rebound in profitability within the oil and natural gas extraction industry during the first quarter (graph 9).** Contributing to the rebound in profits is the acceleration in rail transport of oil, which helps get around the problems pipeline gluts that had put downward pressure on Canadian oil prices at the end of 2012. Despite the improvement on this front, North American oil output and refinery capacity is showing vigorous growth, keeping inventories very elevated. With a supply and demand dynamic that does not favour price increases, the energy

Graph 7 – The last earnings season went reasonably well in the United States



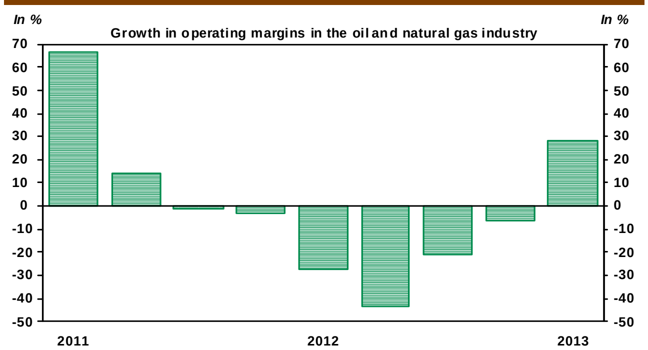
Sources: Blooomberg and Desjardins, Economic Studies

Graph 8 – Despite the recent correction, Japan's stock market is still showing strong gains from the start of the year



Sources: Datastream and Desjardins, Economic Studies

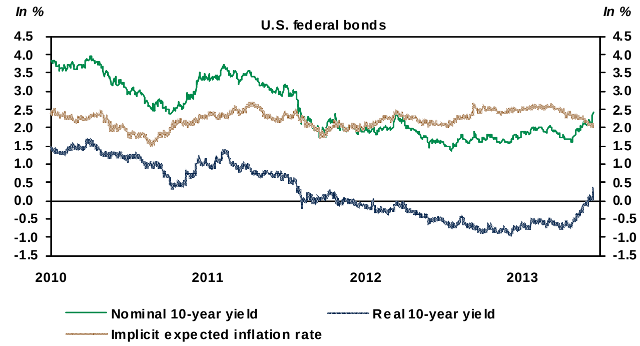
Graph 9 – Oil and natural gas industry profits rebounded in Canada



Sources: Statistics Canada and Desjardins, Economic Studies sector could continue to be a drag on the Canadian stock market's advance.

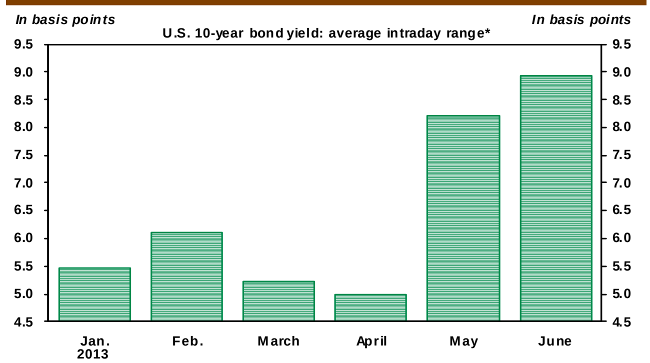
- **The bond market was hurt by the lack of clarity from Fed leaders.** May's 45 basis point rise in the 10-year bond yield was the largest rise since December 2012. The surge was primarily caused by an increase in real yields, as inflation expectations weakened (graph 10). The expectancy of a reduction in the pace of monthly purchases of securities was the trigger, but the slightly fuzzy message the Fed sent in May had also prompted significant volatility (graph 11) until the June 19 decision. Although tapering speculation occurred earlier than anticipated, it was part of our scenario, and remains broadly consistent with the very low target we have been maintaining for the fixed-income asset class for some time.
- **Return forecasts.** We have made few changes to our yield targets. Despite the increased volatility, recent movements have, overall, been consistent with our expectations. We are nonetheless shifting our range for bonds to the downside, in order to factor in a slight risk of a faster rise in yields in the event of prolonged uncertainty about the withdrawal of monetary stimulus measures in the United States.

Graph 10 – The real 10-year yield is back in positive territory, while inflation expectations weakened



Sources: Bloomberg and Desjardins, Economic Studies

Graph 11 – Bond markets remain highly volatile



* Spread between the highest and lowest yields within a single session.
Sources: Bloomberg 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 0.90 to 1.05	target: 1.0 -3.0 to 3.0	target: 6.0 1.0 to 10.0	target: 14.0 8.0 to 20.0	target: 8.0 0.0 to 12.0	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