Retail Rate Forecasts
Desjardins Economic Studies
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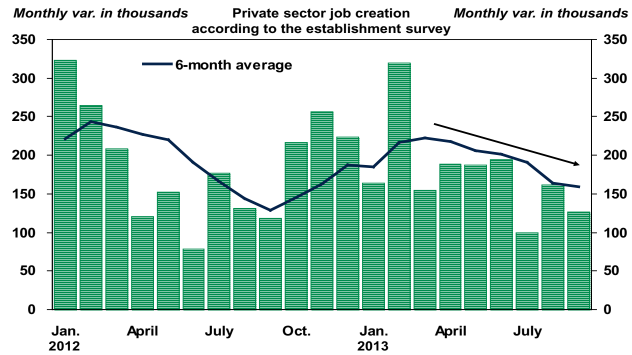
Less upside pressure on retail rates

HIGHLIGHTS

- The U.S. federal government's temporary shutdown and risks of another political impasse in early 2014 are generating a lot of economic uncertainty.
- Central banks have sent a clear signal: they will maintain highly accommodating monetary policy.
- Recent events have ended the surge by North American bond yields.
- Retail rates should not move much in the short term, but gradual increases are still expected in 2014.
- Worries persist for the Canadian dollar.
- The Federal Reserve has a huge influence on the markets.

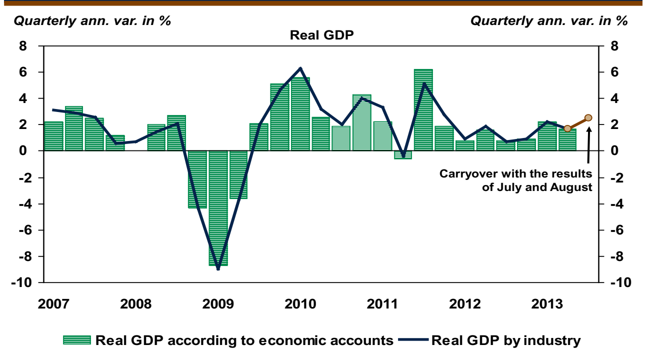
- **The federal government shutdown will have consequences for the U.S. economy.** In the end, the U.S. political impasse led to a partial halt of federal government activity which lasted 16 days. Some 800,000 government workers were affected, but they are now back at work and will be paid for their days on furlough. Some confidence indexes plummeted during the crisis, as a government default on some of its financial commitments even became conceivable at one point. These events may trim 0.3% to 0.5% from U.S. economic growth for the final quarter of 2013. What's more, another partial government shutdown could happen in January.
- **The Federal Reserve (Fed) continues its securities purchases.** Although most analysts expected the Fed to start tapering its securities purchases as of mid-September, the Fed instead opted for the status quo, preferring to wait for more evidence that the U.S. economy recovery will be sustained. The uncertainty surrounding the U.S. economic situation as a result of the political situation will certainly have validated the Fed's decision to wait before reducing its interventions. In our opinion, no slowing of purchases will be announced until March, especially since the most recent labour market statistics were disappointing (graph 1).
- **Canadian growth seems to have picked up this summer.** After a very difficult June (floods in Alberta, the construction strike in Quebec), Canada's economy bounced back in July and August (graph 2). The rebound is heavily reliant on oil production, however, a highly volatile sector. Canada's outlook for economic growth remains modest, as weak domestic demand seems to be confirmed and the anticipated upswing in exports has yet to materialize.

Graph 1 – Job creation in the United States has been disappointing these past few months



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

Graph 2 – Economic growth should be around 2.5% in the third quarter



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.
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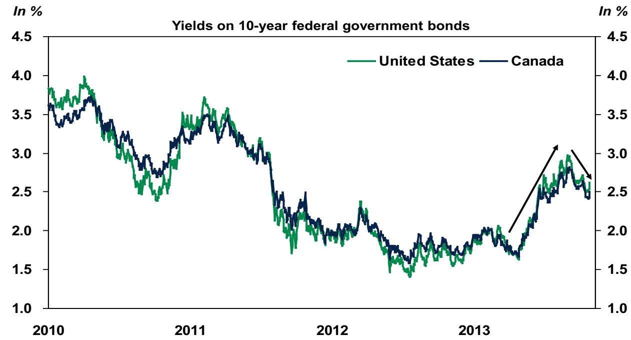
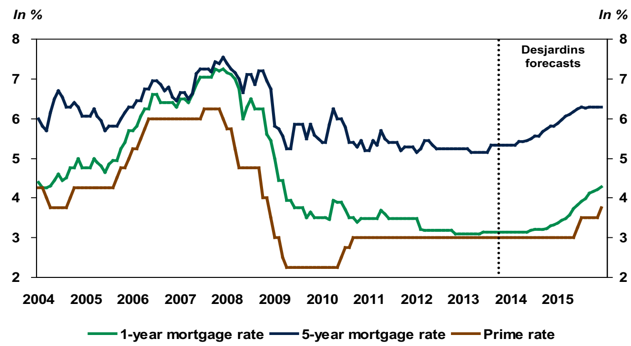
- **The Bank of Canada (BoC) is more concerned.** In October, the BoC dropped its remark on an eventual increase to Canadian key interest rates. Monetary authorities have therefore shifted into neutral after several months of signalling an increase. In its *Monetary Policy Report*, the BoC also downgraded its economic forecasts, largely due to weaker growth by exports and non-residential investments.
- **Bond yields have come back down.** Ongoing highly accommodative monetary policy and the economic uncertainty arising from the U.S. federal government shutdown have prompted many investors to return to fixed-income securities. The U.S. 10-year yield, which had reached 3.00% in early September, has slid back to around 2.50% (graph 3).
- **Less short-term pressure on retail rates.** The recent bond yield pullback has sharply reduced the risks of additional retail rate increases between now and the end of the year. If the U.S. economy accelerates next year, however, we must expect retail rates to eventually start trending up again in 2014 (graph 4). Retail rate increases should still be gradual, though, as central banks will want to avoid overly quick firming of financial conditions.

Graph 3 – After a sharp increase, North American bond yields recently pulled back



Sources: Datastream and Desjardins, Economic Studies

Graph 4 – Retail rates should stabilize for a few months before gradually climbing back up again



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								
May 2013	1.25	3.00	3.09	3.55	5.14	0.90	1.25	1.75
June 2013	1.25	3.00	3.14	3.65	5.14	0.90	1.25	1.75
July 2013	1.25	3.00	3.14	3.75	5.14	0.90	1.25	1.75
August 2013	1.25	3.00	3.14	3.95	5.34	0.90	1.25	1.75
Sept. 2013	1.25	3.00	3.14	3.95	5.34	0.90	1.25	1.75
Oct. 2013	1.25	3.00	3.14	3.95	5.34	0.90	1.25	1.75
Nov. 4, 2013	1.25	3.00	3.14	3.95	5.34	0.90	1.25	1.75
Forecasts								
End of quarter								
2013: Q2	1.25	3.00	2.90–3.40	3.70–4.20	5.10–5.60	0.80–1.15	1.10–1.40	1.50–2.00
2013: Q3	1.00–1.50	2.75–3.25	2.90–3.40	3.75–4.25	5.20–5.70	0.80–1.15	1.10–1.60	1.60–2.10
2013: Q4	1.00–1.50	2.75–3.25	2.95–3.45	3.90–4.40	5.25–5.75	0.80–1.30	1.25–1.75	1.75–2.25
2014: Q1	1.00–1.50	2.75–3.25	2.95–3.45	4.00–4.50	5.45–5.95	0.80–1.30	1.40–1.90	1.95–2.45
End of year								
2014	1.00–1.50	2.75–3.25	3.10–3.60	4.25–4.75	5.55–6.05	0.85–1.35	1.60–2.10	2.10–2.60
2015	1.75–2.25	3.50–4.00	4.00–4.50	5.15–5.65	6.05–6.55	1.45–1.85	2.25–2.75	2.70–3.20
2016	2.50–3.50	4.25–5.25	4.40–5.40	5.35–6.15	6.20–6.80	1.50–2.30	2.30–3.10	2.85–3.65

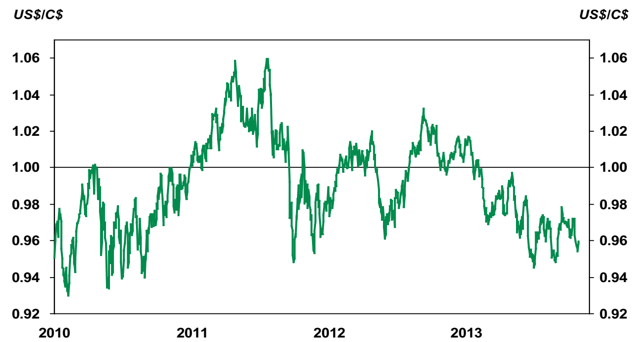
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

Concerns persist

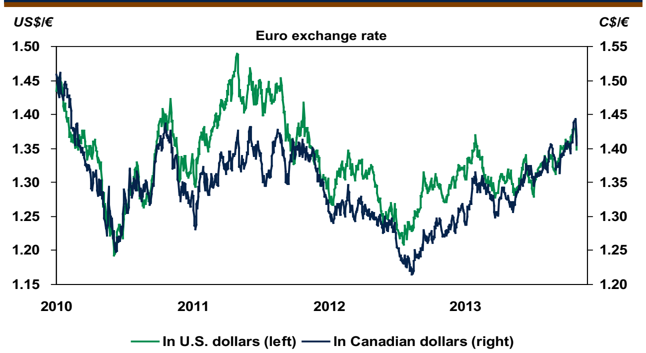
- Several currencies have made gains against the U.S. dollar over the last two months, due to expectations that the Federal Reserve would wait several more months before reducing its quantitative easing. However, the Canadian dollar did not benefit, recently falling below US$0.96 (graph 5).
- The loonie continues to be penalized by fears about the Canadian economy. Weaker job creation and high debt loads for Canadians are reducing potential increases in consumption and residential investment. The acceleration of economic growth is therefore primarily based on international merchandise trade, but the large number of global uncertainties and competition problems for Canadian exports are muddying the picture. Canada's currency also remains quite vulnerable to changing statistics in the United States, Canada's main trade partner.
- The euro has benefited more from the greenback's weakness. For the first time in two years, the common currency reached US$1.38 (graph 6). This chiefly reflects the fact that there are few major currencies and that they cannot all depreciate at once. Appreciation was a bit more pronounced against the Canadian dollar. The euro reached a 3-year peak at C$1.44. However, the euro zone is still grappling with serious problems, which are limiting the currency's potential for appreciation. Recent economic statistics have been rather mixed, and everything suggests that Euroland's economic growth will remain modest in the coming quarters.
- **Forecasts:** Modest growth in Canadian domestic demand is not compatible with a fast return to parity by Canada's dollar. The currency could even depreciate a bit more in the short term on these uncertainties. Next year, the loonie should gradually rise, assuming that the economic context improves and concerns die down. The euro should trend down, hurt by Euroland's soft economy and the numerous challenges that the region must still face.

Graph 5 – The Canadian dollar's soft patch continues



Sources: Datastream and Desjardins, Economic Studies

Graph 6 – The euro has done well in recent months



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	Q2	Q3	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	1.0165	1.0079	0.9828	0.9506	0.9700	0.9500	0.9600	0.9700	0.9800	0.9900
CAN$/US$	0.9838	0.9922	1.0175	1.0520	1.0310	1.0526	1.0417	1.0309	1.0204	1.0101
CAN$/€	1.2657	1.3081	1.3065	1.3674	1.3955	1.4000	1.3646	1.3608	1.3673	1.3434
US$/€	1.2865	1.3184	1.2841	1.2999	1.3536	1.3300	1.3100	1.3200	1.3400	1.3300
US$/£	1.6148	1.6255	1.5185	1.5167	1.6194	1.6000	1.5800	1.5900	1.6100	1.6000

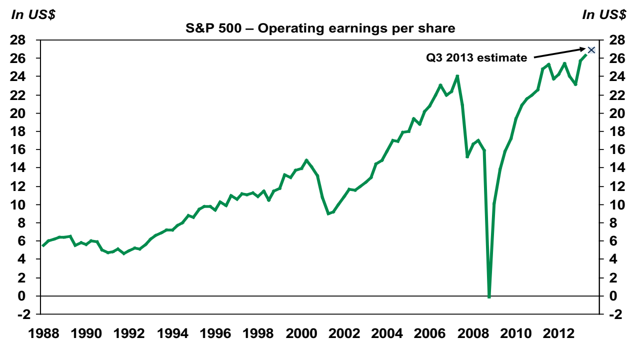
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies
f: forecasts

ASSET CLASSES RETURN

The Federal Reserve has an enormous influence over the markets

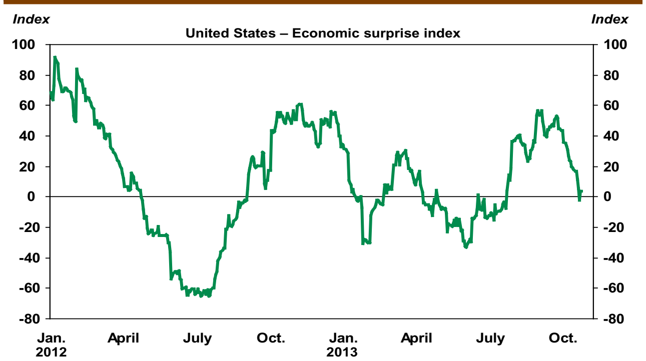
- **Nobody would have believed that the S&P 500 would rise nearly 25% in a year featuring a bond market sell-off and a U.S. government shutdown.** This is, however, what happened since the beginning of 2013. Throughout the budget impasse, U.S. stock market posted gains, ignoring potential repercussions on economic growth and the uncertainty that businesses would face. Third-quarter results for businesses were mixed, as only 67% of the first 245 businesses publishing their earnings managed to beat analyst's expectations. Although profitability was not as good as expected, it remained solid. The S&P 500 is headed for gains of 2.2% on earnings per share for the third quarter, which would send the level of earnings to a new record (graph 7). This was primarily caused by expanding operating profit margins, which are poised to post an average of 9.6% for the third quarter, highest level in seven years. Sales growth remains moderate, however, and it could become harder for businesses to raise their profits if the economy does not accelerate.
- **Aside from profits, stock markets seem to have been influenced by anything that could have even a remote impact on the trajectory of U.S. monetary policy.** Since the shutdown materialized in early October, stock markets have gone on a steep upward trend, in line with the notion that the Federal Reserve (Fed) will remain accommodating for a longer time than previously expected. Stock market investors do not seem to have been the least bit affected by the concerns about a default on payment. After the budget agreement was reached in mid-October, stock markets have grown even more, with the S&P 500 hitting a new record of 1,775 points at the end of the month, despite the fact that several U.S. economic indicators had been disappointing (graph 8).
- **Unlike the situation at the start of the year, Canada's stock market now manages to benefit from optimistic U.S. markets.** In October, nearly all major sectors of Canada's stock market posted gains (graph 9). Although growth was a bit slower in the still-hampered materials sector, it was especially solid in the industrial and financial sectors. The rebound in Canada's stock market is all the more interesting because it occurred as energy prices fell. Nearing US$108 in the first half of September against the backdrop of geopolitical tensions, WTI (West Texas Intermediate) oil prices fell to around US$96 at the end of October. The price per barrel for Western Canada Select has dropped more than US$30 since mid-July, and the gap with WTI prices has reached the levels that had caused some concern a year ago (graph 10 on page 5). It is therefore remarkable that the oil and natural gas sector managed to post gains in this context.

Graph 7 – Profits could set a new record



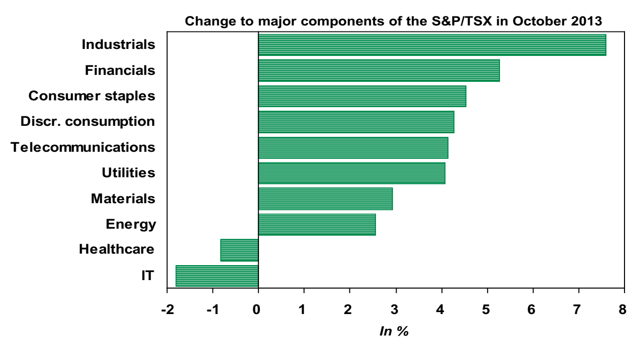
Sources: Standard & Poor's and Desjardins, Economic Studies

Graph 8 – The latest economic figures were disappointing



Sources: Bloomberg, Citigroup and Desjardins, Economic Studies

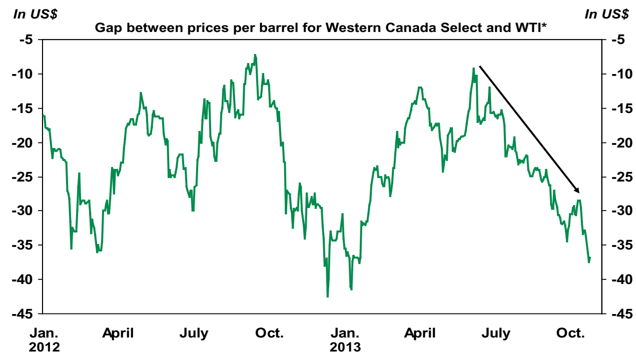
Graph 9 – The Canadian stock market did well overall in October



Sources: Bloomberg and Desjardins, Economic Studies

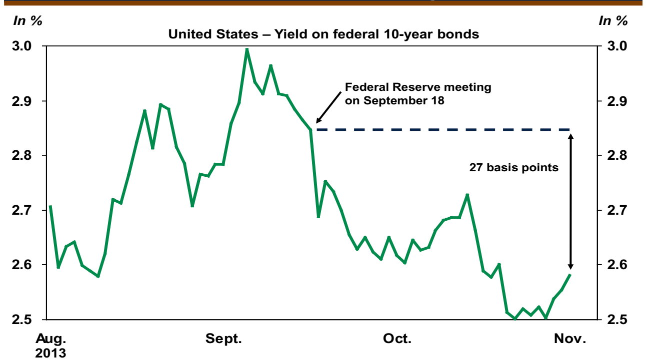
- **The Fed's about-face in September and political impasse in October lent solid support to bonds.** Since the Fed's meeting on September 18, U.S. 10-year bond yields have dropped nearly 30 basis points (graph 11), and given the relatively uncertain economic and political situation that will reign until the end of the year, we cannot expect yields to climb as much as they have this summer. With the appointment of Janet Yellen, the fact that there is now a bit more clarity about Chair Ben Bernanke's successor should also help to calm the bond market in the short term.
- **Return forecasts.** The remarkable performance by U.S. stock markets in early fall has prompted an increase to our target for 2013, now at 21%. However, this combines with a slightly less optimistic outlook for 2014, as we expect more modest returns of 7.5%. As well, some of the recent gains could be wiped out when the Fed's tapering becomes more imminent. The S&P/TSX momentum should help Canada's stock markets generate returns of 6% for this year and 11% next year, when the materials sector should recover. Recent events gave the bond markets a bit of a break, and we are revising our yield target up a little for 2013, which should still end with a 1% loss. However, we expect yields to resume their uptrend in 2014, meaning another year of negative returns for bonds.

Graph 10 – The narrowing of the oil price gap didn't last long



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

Graph 11 – Bonds have had strong support since the September Federal Reserve meeting



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 %)****
2002	2.23	7.1	14.5	10.9	20.7	-7.1
2003	2.70	6.5	24.1	4.9	14.0	-3.3
2004	4.01	4.1	17.3	15.8	26.9	0.2
2005	4.14	3.7	9.8	5.5	11.6	-14.4
2006	2.35	6.4	-33.0	-37.0	-43.1	22.1
2007	0.34	5.4	35.1	26.5	32.5	-13.7
2008	0.57	6.7	17.6	15.1	8.2	-5.2
2009	0.92	9.7	-8.7	2.1	-11.7	2.3
2010	0.95	3.6	7.2	16.0	17.9	-2.7
2011	0.00	0.0	0.0	0.0	0.0	0.0
2012	0.00	0.0	0.0	0.0	0.0	0.0
2013f range	target: 0.95 0.90 to 1.00	target: -1.0 -3.0 to 1.0	target: 6.0 1.0 to 11.0	target: 21.0 15.0 to 27.0	target: 16.0 10.0 to 22.0	target: 6.1 (US$0.95) 2.8 to 8.4
2014f range	target: 1.00 0.95 to 1.10	target: -1.0 -3.0 to 1.0	target: 11.0 4.0 to 18.0	target: 7.5 2.0 to 15.0	target: 6.0 0.0 to 12.0	target: -4.0 (US$0.99) -6.9 to -1.0

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