Retail Rate Forecasts

Desjardins Economic Studies

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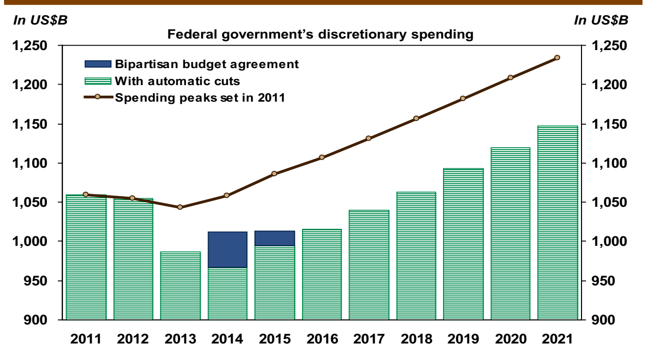
A better economic environment in 2014

HIGHLIGHTS

- The economic outlook seems more favourable after the budget agreement reached in the United States.
- North American central banks will keep their key rates unchanged for several more quarters.
- Long-term bond yields could continue to climb gradually, causing some retail rates to go up in 2014.
- The Canadian dollar is still trending down.
- Portfolio rebalancing will continue to favour the stock markets.

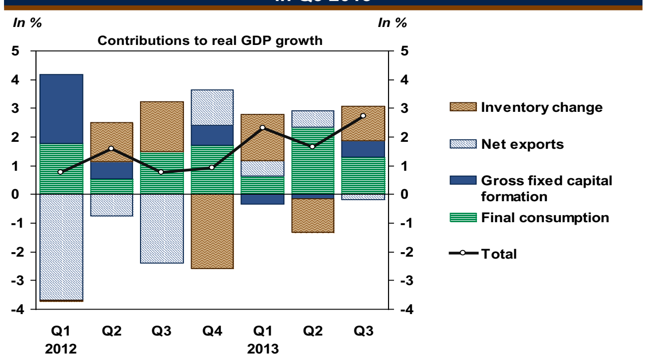
- **The sky seems to be clearing for the United States.** The latest U.S. economic statistics are encouraging and seem to indicate that the economy was less affected than expected by the federal government's temporary shutdown in October. Better still, U.S. politicians reached a compromise that will allow the government to be financed until September 2015 and avoid any further cuts to federal spending in 2014 (graph 1). This period of calm should boost business and consumer confidence and help the U.S. economy grow at a solid 2.9% in 2014.
- **The Federal Reserve (Fed) begins to reduce its interventions.** After months of speculation, the Fed has just announced it will start to reduce its monthly bond purchases, taking them from US$85B to US$75B as of January. If the situation evolves as forecast, purchases will continue to decline gradually over the following months. However, the Fed is still emphasizing that the key rate will remain at its floor for a long time, especially if inflation stays below the 2% target.
- **Canada's economy accelerated.** Canada's real GDP grew 2.7% in the third quarter of 2013, its best performance since summer 2011. The rebound, which followed a difficult second quarter marked by flooding in Alberta and the construction strike in Quebec, is largely driven by rising inventories (graph 2). What's more, exports haven't growth as expected recenly. More robust global demand in 2014 should help the Canadian economy to grow 2.3%, after a limited gain of 1.7% in 2013.
- **Canada's key rates will remain unchanged for a long time.** The Bank of Canada once again highlighted weak inflation in its December statement. However, the release of relatively strong Canadian data, another rise in household

Graph 1 – The budget deal in the United States prevents further automatic spending cuts in 2014



Sources: Congressional Research Service, House Budget Committee, Congressional Budget Office and Desjardins, Economic Studies

Graph 2 – Inventories contributed heavily to Canadian growth in Q3 2013



Sources: Statistics Canada and Desjardins, Economic Studies

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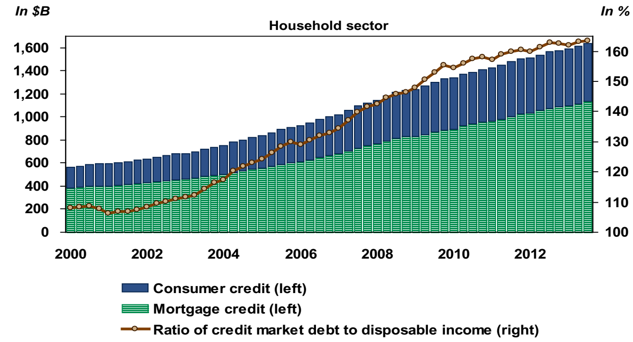
debt (graph 3) and Governor Poloz's remarks stressing the connections between financial and economic stability all confirm that a key rate cut is still unlikely.

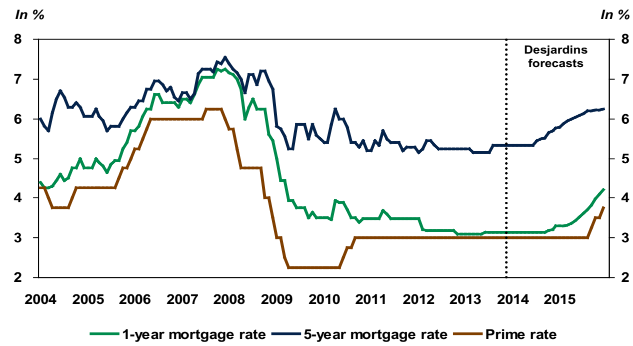
- **Bond yields edge up.** The publication of generally positive economic data and the fact that the Federal Reserve will soon begin to taper its bond purchases have pushed North American bond yields back to around where they were at the end of the summer. Short-term yields, however, remain quite low, and nothing suggests that key rates will go up soon.
- **Heading for gradual retail rate increases.** Despite the fluctuations on the bond market, the main retail rates have been steady since late summer. Short-term yields should not fluctuate much in the coming months, as key rates are expected to remain stable. All the same, the more favourable economic environment may lead to upside pressure on longer-term retail rates (graph 4).

Graph 3 – The debt ratio for Canadian households reached a new peak in Q3 2013



Sources: Statistics Canada and Desjardins, Economic Studies

Graph 4 – Retail rates will climb gradually over the coming years



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								
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. 2013	1.25	3.00	3.14	3.95	5.34	0.90	1.25	1.75
Dec. 18, 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	3.00–3.30	3.80–4.10	5.20–5.50	0.80–1.05	1.10–1.40	1.60–1.90
2013: Q3	1.00–1.50	2.75–3.25	2.90–3.40	3.70–4.20	5.10–5.60	0.80–1.15	1.00–1.50	1.50–2.00
2013: Q4	1.00–1.50	2.75–3.25	2.90–3.40	3.75–4.25	5.10–5.60	0.80–1.15	1.10–1.60	1.60–2.10
2014: Q1	1.00–1.50	2.75–3.25	2.90–3.40	3.95–4.45	5.25–5.75	0.80–1.15	1.25–1.75	1.80–2.30
End of year								
2014	1.00–1.50	2.75–3.25	3.05–3.55	4.15–4.65	5.50–6.00	0.80–1.25	1.45–1.95	2.00–2.50
2015	1.75–2.25	3.50–4.00	3.95–4.45	5.00–5.50	6.00–6.50	1.40–1.90	2.10–2.60	2.65–3.15
2016	2.25–3.25	4.00–5.00	4.35–5.35	5.35–6.15	6.10–6.90	1.50–2.30	2.30–3.10	2.85–3.65

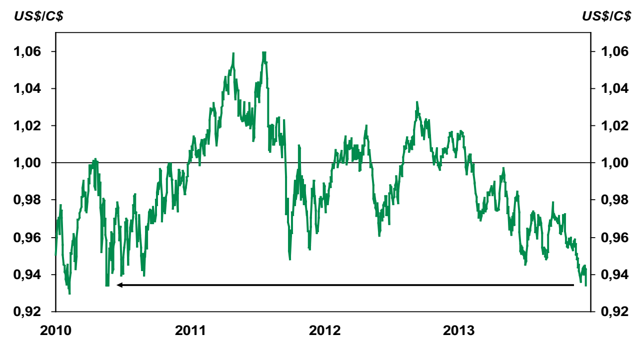
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

The downtrend continues

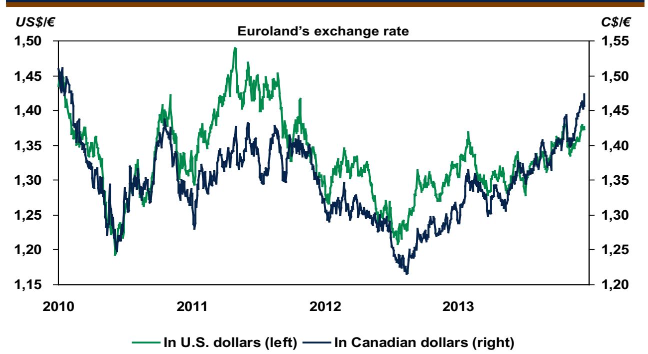
- The Canadian dollar is short on support. The currency recently hit its lowest point in three and a half years, US$0.9322 (graph 5). For several quarters now, investors have been increasingly concerned by the Canadian economy, a situation that has affected exchange rates. Among other things, it seems that economic growth will have to be more reliant on international trade and, given the country's competitiveness problems, the loonie's drop is entirely appropriate.
- The Bank of Canada's (BoC) meeting on October 23 also impacted the currency's recent movement. By striking the mention of an eventual key rate hike from its official remarks, the BoC helped to modify monetary policy expectations. There is a growing perception that the (BoC) will not move ahead of the Federal Reserve (Fed) in raising its key rates, thus invalidating a major argument justifying the loonie's appreciation.
- The situation would be even worse for the Canadian currency if the U.S. dollar were to benefit further from the forthcoming cuts to the Fed's securities purchases. As for the euro, the depreciation that began in late October did not last long, and the currency is once again moving around US$1.37. The EUR/CAD pair went above C$1.46 (graph 6). The lack of financial strain and sense that the economy is on the right track seem to be masking the risks that continue to linger in Europe.
- **Forecasts:** There is not much to justify rapid appreciation by the loonie, which may even pull back in the short term, especially if the U.S. dollar strengthens. All the same, the Canadian dollar could end 2014 on a more positive note if fears over Canada's economy subside. The loonie's outlook against the euro should be better, as the euro is expected to depreciate. The fragile economic recovery in the euro zone, deflation concerns and the fact that monetary policy will probably have to be put to use again are also elements that could harm the common currency.

Graph 5 – The Canadian dollar reached its lowest point against the greenback in three and a half years



Sources: Datastream and Desjardins, Economic Studies

Graph 6 – The euro continues to appreciate



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

	2013		2014				2014			
End of period	Q3	Q4f	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0.9700	0.9350	0.9300	0.9350	0.9400	0.9500	0.9500	0.9600	0.9700	0.9800
CAN$/US$	1.0310	1.0695	1.0753	1.0695	1.0638	1.0526	1.0526	1.0417	1.0309	1.0204
CAN$/€	1.3955	1.4332	1.4086	1.4118	1.4149	1.3895	1.3789	1.3542	1.3196	1.3061
US$/€	1.3536	1.3400	1.3100	1.3200	1.3300	1.3200	1.3100	1.3000	1.2800	1.2800
US$/£	1.6194	1.6200	1.6000	1.6200	1.6300	1.6300	1.6400	1.6500	1.6600	1.6800

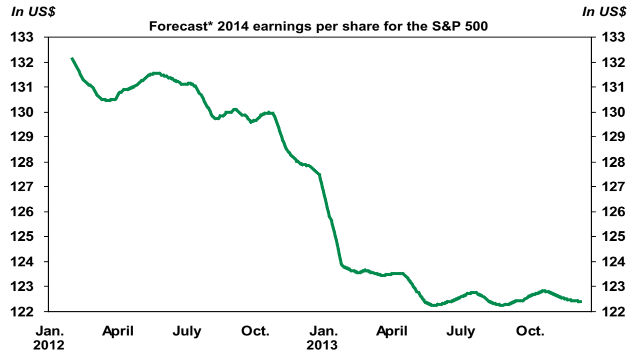
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies
f: forecasts

ASSET CLASSES RETURN

Portfolio rotation will continue to favour stock markets

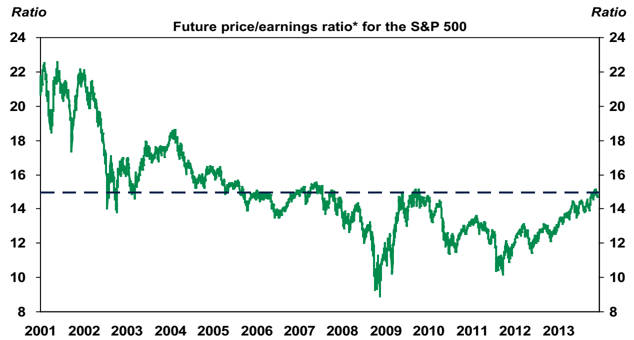
- **Stock markets could have been expected to retreat somewhat**, as of November, in a context where better-than-expected U.S. statistics increasingly suggested that Federal Reserve (Fed) tapering could occur sooner than previously anticipated. After all, U.S. stock markets had a banner year in 2013, partly due to the Fed's highly accommodative policy. This was not the case, however. The S&P 500 continued to ascend, even hitting the 1,800-point mark on several occasions in December. We could justify this situation by arguing that the fact that monetary policy will become slightly less accommodating is offset by a more robust economy and stronger profits. Note, however, that operating profit expectations for 2014 have been moving down since last spring (graph 7), as it could become harder for businesses to boost their profit margins, which are already at record highs. In fact, it is primarily the rising price/earnings ratio that is bringing the index up.
- **Despite these conditions the price/earnings ratio is holding close to the historic average (graph 8).** Stock markets still have the advantage, as rising bond yields will lead to negative returns for this asset class in the coming years. The appeal of stocks is also perceptible in mutual funds, as we are seeing their weight increase in portfolios (graph 9). Ongoing portfolio rebalancing should continue to favour the stock markets, but we will have to expect much smaller returns than in 2013.
- **The Canadian stock market's upswing of early fall is still holding up**, even though the last few weeks have been a little more lacklustre. The S&P/TSX has remained practically flat since the end of October. The weak energy and material sectors were offset by the solid performance by industrial and financial securities. Company results in the third quarter were unremarkable, a fact corroborated by the quarterly financial statistics for enterprises released by Statistics Canada, which noted that profits barely grew during this period (graph 10). However, we still expect the Canadian stock market to do well in 2014. Easing fears about growth in emerging nations should help to solidify commodity securities. The recent climb of Canadian oil prices is also one of the first encouraging signs. This could largely make up for the difficulties likely to be encountered in the financial sector, as higher interest rates should slow demand for credit.
- **The Fed seems to have a better control of the long end of the yield curve.** Although the statistics are more solid than they were last summer during the selloff, bond yields have only risen gradually this time around. With Janet Yellen at the helm, the Fed may continue to move cautiously to avoid a repetition of this episode. Nonetheless, we continue to think that returns will be negative, as in 2013, in a context in which the U.S. economy should accelerate (graph 11) and inflation should recover. Our scenario has not changed in this regard.

Graph 7 – Analysts have trimmed their earnings forecasts for next year



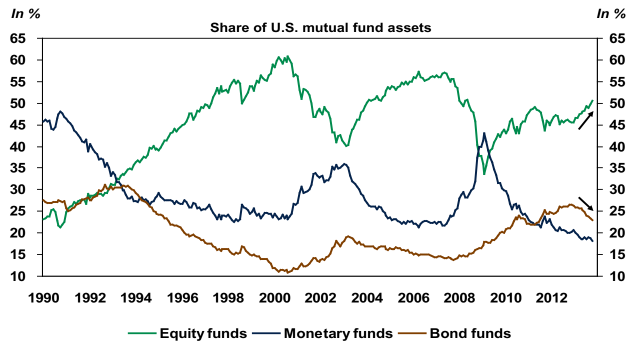
* Consensus forecast of analysts surveyed by Bloomberg.
Sources: Bloomberg and Desjardins, Economic Studies

Graph 8 – The price/earnings ratio remains close to its average



* Next 12 months.
Sources: Institutional Brokers Estimate System and Desjardins, Economic Studies

Graph 9 – The great rotation seems to be underway



Sources: Datastream and Desjardins, Economic Studies

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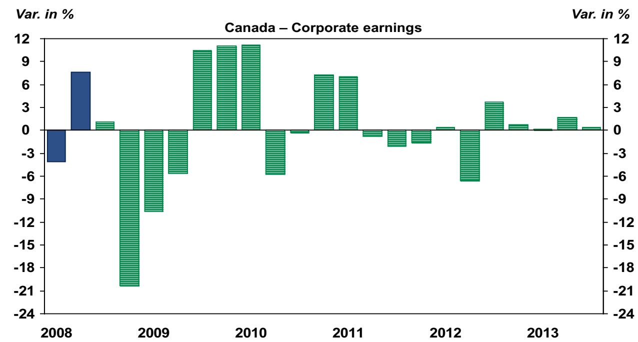
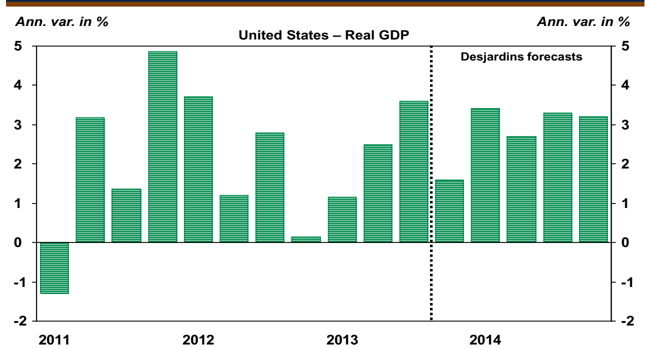
- **Return forecasts.** The target for the end of 2013 has risen to 27.0% for the U.S. stock market, taking into account the surprising performance recorded this fall. On the other hand, the outlook for 2014 has not changed, with returns assessed at 8.0%, much closer to the growth we anticipate over the long-term horizon. The Canadian stock market is heading for a better year-end than initially anticipated, and the target stands at 9.0%; there again, however, our projections for 2014 are intact, with returns of around 11.0%. The onset of reduced monetary support in the United States will push yields up slowly, and we can expect a year of negative returns for bonds.

Graph 10 – Official statistics show that profit growth has been fairly modest in Canada recently



Sources: Statistics Canada and Desjardins, Economic Studies

Graph 11 – The U.S. economy should set a solid pace in 2014



Sources: Bureau of Economic Analysis 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 -2.5 to 0.5	target: 9.0 5.0 to 12.0	target: 27.0 23.0 to 30.0	target: 16.0 10.0 to 22.0	target: 7.8 (US$0.935) 6.1 to 10.8
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: 8.0 2.0 to 14.0	target: 6.0 0.0 to 12.0	target: -1.6 (US$0.950) -5.5 to 2.7

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