Retail Rate Forecasts

Desjardins Economic Studies
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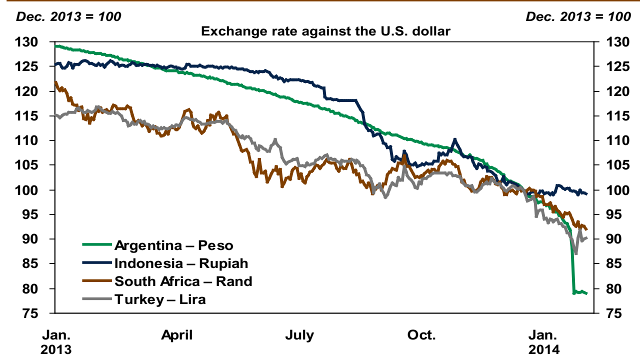
Another break for borrowers

HIGHLIGHTS

- New concerns over emerging nations.
- The growth outlook remains favourable.
- The Bank of Canada's comments impact Canadian financial markets, especially the loonie.
- Despite the recent pullback, a slight increase in retail rates should be expected for 2014.
- For now, the stock market retreat is not alarming.

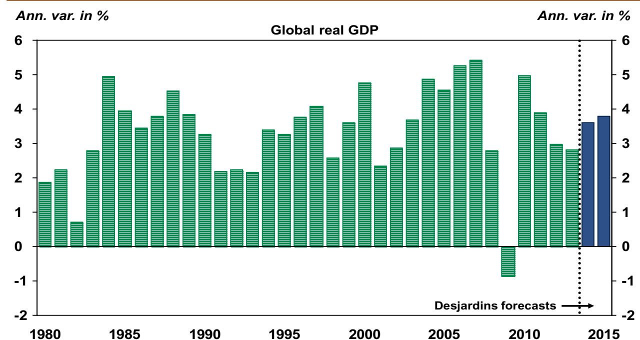
- **Investor skittishness has increased recently.** After a surge of optimism at the end of 2013, financial markets became a bit more nervous in January. These worries chiefly stem from emerging nations, as political instability in some countries and economic problems have caused several currencies to plummet (graph 1).
- **Global economic outlook is encouraging.** Overall, economic growth accelerated in the advanced economies in the second half of 2013, and everything suggests that this trend will continue. We therefore expect global real GDP to grow 3.6% in 2014 and 3.8% in 2015 (graph 2), despite the difficulties present in some emerging economies. Outlooks are especially favourable for the U.S. economy, which will foster increased Canadian exports.
- **The Federal Reserve (Fed) continues to reduce its interventions.** The Fed announced another US$10B cut to its monthly securities purchases at its January 29 meeting. If the economic situation unfolds as expected, the Fed will continue to wind down its intervention, with its asset purchasing program ending next fall.
- **The Bank of Canada (BoC) is more and more concerned about weak inflation.** Despite the Canadian economy's relatively robust performance in recent months and more favourable outlooks for the U.S. economy, the BoC deems that the downside risks to inflation have intensified. The BoC is therefore keeping the door open to a key rate cut, putting substantial downside pressure on the Canadian dollar and bond yields (graph 3 on page 2). A cut to Canadian key rates remains unlikely, but the BoC's position confirms that it will be very patient before beginning any monetary firming.

Graph 1 – Renewed worries in some emerging nations



Sources: Datastream and Desjardins, Economic Studies

Graph 2 – Global economic growth likely to be stronger in 2014 and 2015



Sources: World Bank and Desjardins, Economic Studies

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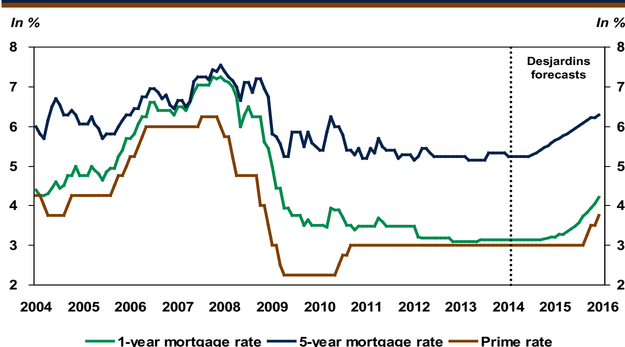
- **Bond market rebound at the start of the year.** 2013 saw bond yields rise considerably, with, for example, U.S. 10-year yields going from 1.75% to 3.00%. Although the Fed is tapering its purchases, the trend has reversed somewhat since the start of 2014, as some disappointing economic data, as well as problems in emerging economies, have convinced investors to take shelter in bonds. Canadian yields fell particularly sharply, given the concerns voiced by the BoC.
- **Reduction of some mortgage rates.** The recent drop in Canadian bond yields allowed Canadian financial institutions to lower some retail rates. The rate posted for five-year mortgages went from 5.34% to 5.24%. As spring approaches, an important time for the real estate market, we cannot rule out other small dips in mortgage rates.
- **Heading for even more gradual retail rate increases.** Retail rates should be fairly stable in the first half of the year, as the BoC's stance will keep the environment favourable to low rates. If the global economy accelerates as expected, bond yields should, however, return to their uptrend within the next few months, prompting a gradual rise in retail rates in the second half of the year (graph 4).

Graph 3 – The Bank of Canada's stance is affecting Canadian financial markets

Sources: Datastream and Desjardins, Economic Studies

Graph 4 – Retail rates will stay very low for some time to come



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								
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. 2013	1.25	3.00	3.14	3.95	5.34	0.90	1.25	1.75
January 2014	1.25	3.00	3.14	3.85	5.24	0.90	1.25	1.75
Feb. 3, 2014	1.25	3.00	3.14	3.85	5.24	0.90	1.25	1.75
Forecasts								
End of quarter								
2014: Q1	1.00–1.50	2.75–3.25	2.90–3.40	3.60–4.10	5.00–5.50	0.80–1.15	1.00–1.50	1.50–2.00
2014: Q2	1.00–1.50	2.75–3.25	2.90–3.40	3.65–4.15	5.00–5.50	0.80–1.15	1.00–1.50	1.60–2.10
2014: Q3	1.00–1.50	2.75–3.25	2.90–3.40	3.80–4.30	5.15–5.65	0.80–1.15	1.10–1.60	1.80–2.30
2014: Q4	1.00–1.50	2.75–3.25	2.95–3.45	4.00–4.50	5.35–5.85	0.80–1.20	1.30–1.80	2.00–2.50
End of year								
2014	1.00–1.50	2.75–3.25	2.95–3.45	4.00–4.50	5.35–5.85	0.80–1.20	1.30–1.80	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	1.50–2.00	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	2.35–3.15	2.85–3.65

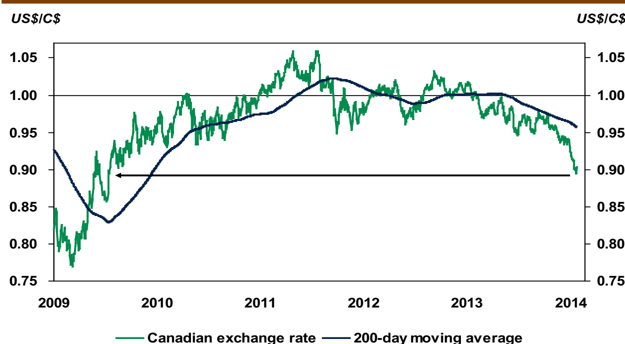
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

Depreciation primarily caused by the Bank of Canada

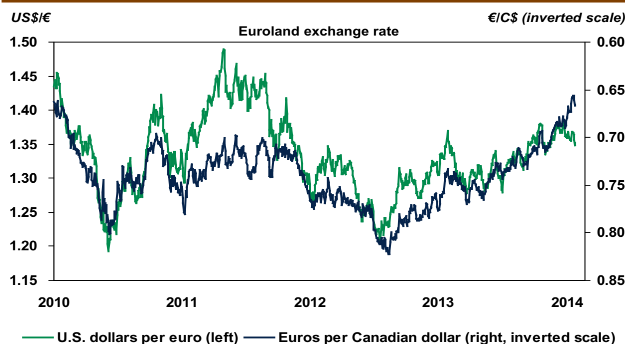
- The Canadian dollar lost a little over US$0.04 in January, hitting its lowest point since July 2009, US$0.8941 (graph 5). The loonie did not only slide against the U.S. dollar; it also fell against most of the other major currencies.
- The Bank of Canada (BoC) had a big hand in this depreciation by voicing many concerns over the country's soft inflation. While the BoC has not cut its key rates recently, the possibility that it will do so, or that it will stick with the status quo for a long time yet, was enough to bring the currency down. Fears about Canada's economic growth are magnifying the movement. Canadian exporters are having trouble capitalizing on the global economic recovery, suggesting competition problems and, in turn, a need for the loonie to adjust. Add to that the fears about global demand for commodities, which is dependent on growth in emerging nations.
- The euro is still high, despite the difficulties in Europe (graph 6). Economic growth remains weak, and unemployment is slow to drop. The banking sector also remains at risk, and credit continues to be lacklustre. A weak euro would boost economic growth through exports. Finally, it seems likely that the European Central Bank (ECB) will step up its intervention shortly, while the Federal Reserve continues to move in the opposite direction.
- **Forecasts:** The loonie is unlikely to rise rapidly in the short term. It could even lose a few more cents if the likelihood of monetary easing were to increase in Canada. However, our scenario does not include a key rate cut, which should help stabilize the currency this year and even take it back to around US$0.92. The Canadian dollar should also appreciate against the euro. Weak growth in the euro zone and a more interventionist ECB will be the main elements dragging down Europe's currency. Currently oscillating around €0.66, the Canadian dollar should end the year at around €0.70.

Graph 5 – The Canadian dollar is at its lowest since July 2009



Sources: Datastream and Desjardins, Economic Studies

Graph 6 – The euro remains strong



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				2015			
End of period	Q3	Q4	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0.9700	0.9414	0.8900	0.9000	0.9100	0.9200	0.9300	0.9300	0.9400	0.9500
CAN$/US$	1.0310	1.0623	1.1236	1.1111	1.0989	1.0870	1.0753	1.0753	1.0638	1.0526
CAN$/€	1.3955	1.4638	1.5056	1.4778	1.4505	1.4348	1.4086	1.3978	1.3723	1.3474
US$/€	1.3536	1.3780	1.3400	1.3300	1.3200	1.3200	1.3100	1.3000	1.2900	1.2800
US$/£	1.6194	1.6563	1.6400	1.6300	1.6400	1.6500	1.6500	1.6600	1.6700	1.6900

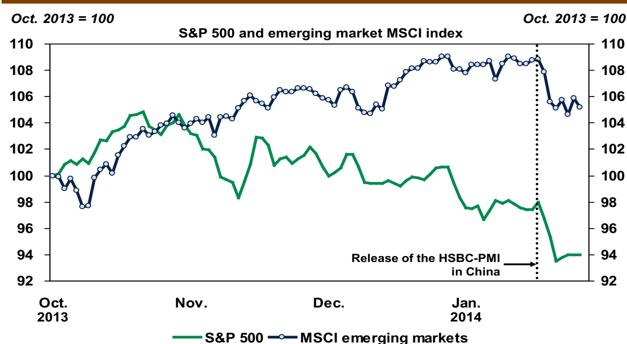
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies f: forecasts

ASSET CLASSES RETURN

The stock market's pullback is not alarming just yet

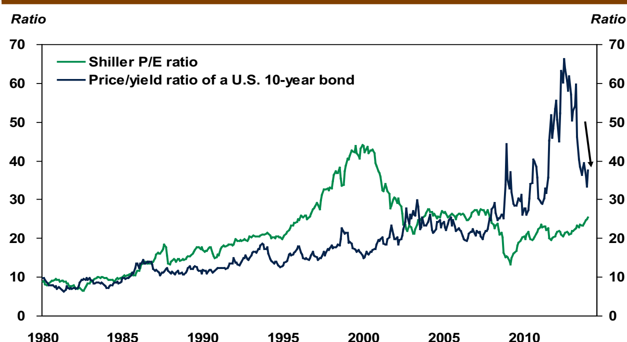
- **After defying gravity in 2013, stock markets are now having a harder time.** The S&P 500 fell by more than 4% in January, erasing all the gains made after the decision of the Federal Reserve (Fed) to reduce its monthly purchases of securities in December. Markets have been particularly influenced by the turmoil in the currency market, most especially currencies of emerging markets. Stocks indeed traded about flat until January 22, and the nosedive really only began after a surprisingly weak Chinese manufacturing estimate triggered a wave of risk aversion that sent many emerging nations' stock markets significantly down (graph 7) and dragged U.S. stocks along with them. Part of the weakness in U.S. equities was also due to the unwinding of some of the excesses that might have been encouraged by ultra-accommodative monetary policy in the United States.
- **Hence, the current adjustment is not a huge surprise: it is consistent with our scenario, which calls for less generous returns than in 2013.** Note that the S&P 500's 32.4% return was the largest since 1997. The stock market performance in 2013 was primarily the result of expansion in price-to-earnings ratios, rather than any real thrust in profits. For 2014, the consensus forecast for earnings has maintained a downward trajectory since early last year. While the U.S. economy and consumer spending are progressing respectably, a sizable portion of the index's business revenue comes from abroad. With anaemic growth in Europe and heightened risks of a sharp slowdown in emerging nations, there could be some disappointments in this area. In addition, the fact that stocks now look much less compelling against bonds than in recent years (graph 8) could remove one important tailwind.
- **The S&P/TSX has delivered a few surprises early this year.** Given the pessimism that seems to have taken hold about emerging nations and the scenario for commodity prices, it is interesting to note that the Canadian stock market is among the frontrunners since the start of the year (graph 9). The recovery that we were anticipating in the materials subsector has shown signs of materializing: it is one of the top performers since October (graph 10 on page 5). There has been interesting movement in several other subsectors, including health and technology. Although the turbulence in emerging nations has not had a big negative impact on the S&P/TSX to date, there is still a risk that aggressive central bank intervention with the aim of protecting weakened currencies will considerably limit growth and depress commodity prices. For now, our core scenario calls for strains to ease; we are thus maintaining our year-end target for the Canadian stock market.

Graph 7 – Concerns in emerging countries spread to U.S. equities after the release of the PMI in China



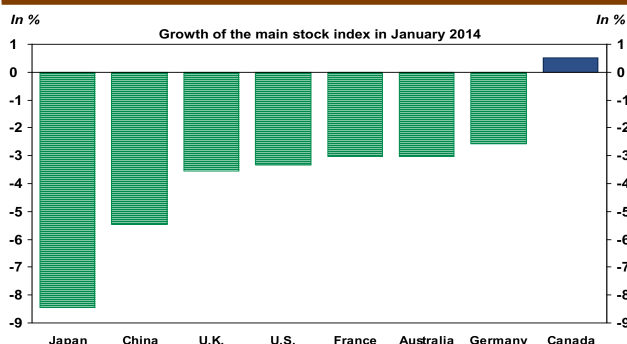
Sources: Bloomberg, MSCI and Desjardins, Economic Studies

Graph 8 – Stocks still look cheap against bonds, but much less than in recent years



Sources: Global Financial Data, Robert Schiller, Datastream and Desjardins, Economic Studies

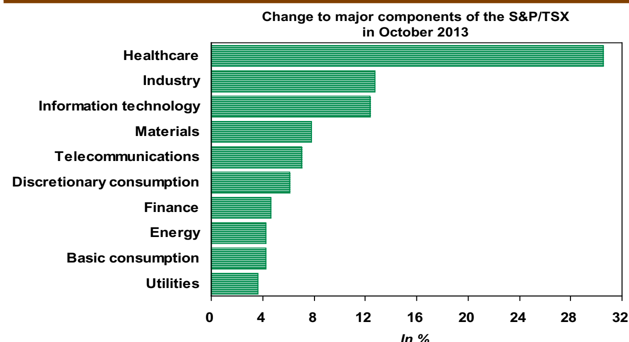
Graph 9 – Canada's stock market stands out



Sources: Bloomberg and Desjardins, Economic Studies

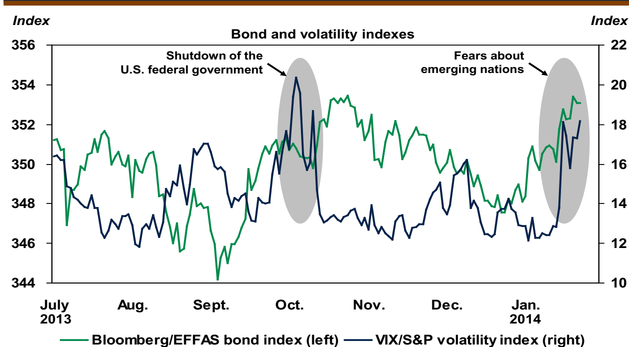
- **Bonds have benefited from renewed risk aversion (graph 11).** However, we still think that bond yields will once again begin a slow climb, in line with our scenario for U.S. economic growth, which we have raised for 2014. The Fed should continue to gradually taper its monthly securities purchases until next fall; the fact that the unemployment rate will probably reach the 6.5% threshold this year does not mean an automatic policy rate increase, but the event will mark another step toward conventional monetary policy. Finally, with an inflation rate that will close in on the 2% target throughout the year, inflation expectations (which edged down in January) should begin to move up again. Our return target therefore remains slightly negative for bonds.
- **Return forecasts.** The downward shift in stock indexes since the start of the year must be seen as a brief purge, rather than a lasting trend. Although weakness could continue on in the near term, we still expect some recovery, which will help generate U.S. stock market returns of 8% in 2014. The Canadian stock market should outperform its U.S. counterpart this year, with returns of 11%, but our range factors in a risk that commodities will be harder hit by the upheaval in emerging nations, if it continues. Like the U.S. stock markets, stock markets of other advanced economies should yield more sober returns of 6%, after coming in over 23% last year. Lastly, with the Canadian dollar's depreciation since the fall, our year-end target for the exchange rate has been reduced to US$0.92.

Graph 10 – Canada's stock market strength since October was widespread



Sources: Bloomberg and Desjardins, Economic Studies

Graph 11 – The safe-haven status of bonds has been demonstrated a few times in recent months



Sources: Bloomberg, Chicago Board of Trade 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 %)**
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
2013	0.97	-1.2	13.0	32.4	23.3	7.1
2014f	target: 1.00	target: -1.0	target: 11.0	target: 8.0	target: 6.0	target: 2.3 (US$0.92)
range	0.95 to 1.10	-3.0 to 1.0	4.0 to 18.0	2.0 to 14.0	0.0 to 12.0	-1.9 to 7.0

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