Retail Rate Forecasts

Desjardins Economic Studies
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A winter that is more favourable to borrowers than to economic activity

HIGHLIGHTS

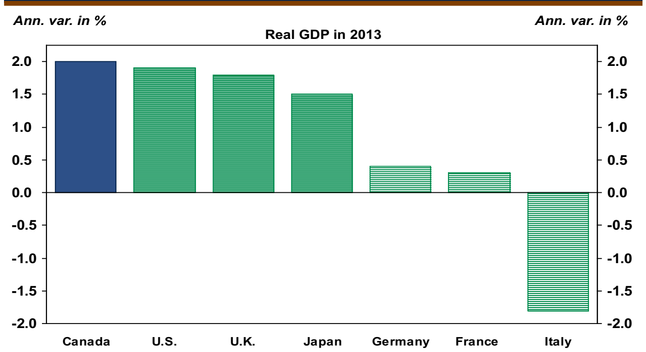
- Harsh weather conditions affect North American economic statistics.
- The economic environment should soon become more favourable.
- Canada's key interest rates will remain unchanged for a long while to come.
- Some posted mortgage rates have fallen to new lows.
- The loonie has stabilized at around US$0.90.
- Our target for the Canadian stock market is raised.

- **U.S. economic statistics are heavily impacted by the cold winter.** During the past three months, large snowfall accumulations on the American eastern seaboard and the glacial cold that took hold as far as the southern United States disrupted economic statistics. The pullback in many economic indicators (graph 1) heralds weak U.S. real GDP growth in the first quarter of 2014. We can hope, however, that the spring will bring a clear rebound of economic activity in the United States.
- **The Canadian economy exceeded expectations in 2013.** Not only did growth reach an annualized quarterly rate of 2.9% in the fourth quarter of 2013, but the data for the first and second quarters were revised upwards substantially. 2013 therefore wound up with a gain of 2.0%, putting Canada at the top of the G7 in terms of economic growth (graph 2). As in the United States, the latest data were affected by harsher-than-usual winter weather, however, which is likely to limit growth in the first quarter of 2014.
- **The situation in emerging countries is still worrisome.** At the end of January, concerns about a financial crisis arising from the emerging countries sent a jolt through the financial markets. Investor worries have abated since then, but the political situation is still very tense in many countries including Ukraine, Turkey and Venezuela. Concerns about the Chinese economy also intensified following the release of some disappointing economic statistics. We should keep in mind, though, that Chinese data are often very volatile at the start of the year.

Graph 1 – The U.S. economic data have been very disappointing in recent months

Sources: Bloomberg and Desjardins, Economic Studies

Graph 2 – Canada led the G7 for growth in 2013



Sources: Statistics Canada, U.S. Bureau of Economic Analysis, Eurostat, Datastream and Desjardins, Economic Studies

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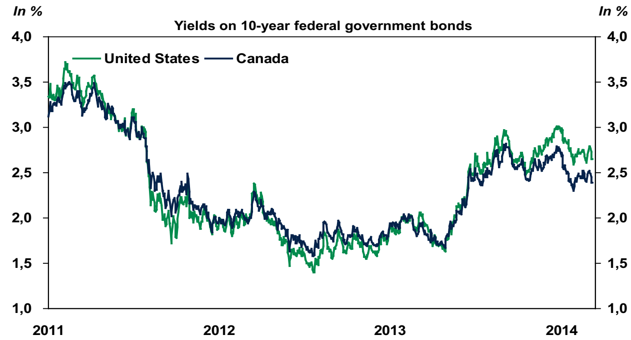
Note to readers: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

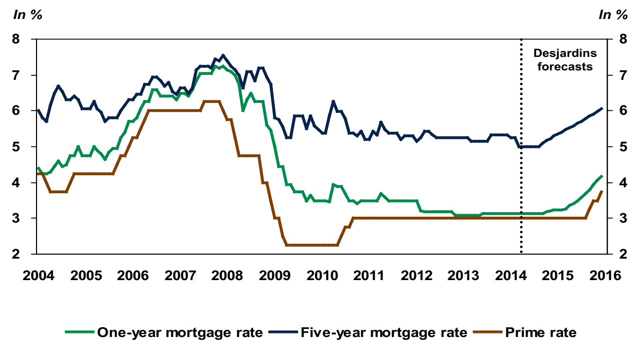
- **Nothing points towards any change in Canada's monetary policy.** The Bank of Canada (BoC) acknowledged in its most recent press release that the latest data on inflation and economic growth had slightly exceeded its expectations. Even though the BoC is still concerned about the weakness of inflation, it would take a substantial economic shock to convince it to lower its key interest rate. Keeping key interest rates at their current levels for several quarters is still clearly the most plausible scenario.
- **The bond market is waiting for a clearer signal from the U.S. economy.** After a sharp drop in January, U.S. and Canadian bond yields rallied a little in recent weeks. However, they are still significantly below the levels that were observed at the end of 2013 (graph 3), a situation that could persist for as long as it takes the data to confirm a spring rebound in the U.S. economy.
- **A new low for some mortgage rates.** The continuing relatively low cost of financing and some very fierce competition have prompted Canadian financial institutions to lower their mortgage rates once again. The posted five-year rate even fell to 4.99% recently; this is a new low. Retail rates could remain close to their current levels for a few months, but a confirmation of accelerating economic growth should send yields on a gradual ascent, starting at mid-year (graph 4).

Graph 3 – Bond yields are still quite low



Sources: Datastream and Desjardins, Economic Studies

Graph 4 – The posted five-year mortgage rate has never been so 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								
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
Jan. 2014	1.25	3.00	3.14	3.85	5.24	0.90	1.25	1.75
Feb. 2014	1.25	3.00	3.14	3.85	5.24	0.90	1.25	1.75
March 17, 2014	1.25	3.00	3.14	3.75	4.99	0.90	1.25	1.75
Forecasts								
End of quarter								
2014: Q1	1.25	3.00	3.00–3.30	3.60–3.90	4.85–5.15	0.80–1.10	1.10–1.40	1.60–1.90
2014: Q2	1.00–1.50	2.75–3.25	2.90–3.40	3.50–4.00	4.75–5.25	0.80–1.15	1.00–1.50	1.50–2.00
2014: Q3	1.00–1.50	2.75–3.25	2.90–3.40	3.65–4.15	4.85–5.35	0.80–1.15	1.05–1.55	1.50–2.00
2014: Q4	1.00–1.50	2.75–3.25	3.00–3.50	3.95–4.45	5.05–5.55	0.80–1.25	1.25–1.75	1.75–2.25
End of year								
2014	1.00–1.50	2.75–3.25	3.00–3.50	3.95–4.45	5.05–5.55	0.80–1.25	1.25–1.75	1.75–2.25
2015	1.75–2.25	3.50–4.00	3.95–4.45	4.90–5.40	5.80–6.30	1.45–1.95	2.10–2.60	2.50–3.00
2016	2.25–3.25	4.00–5.00	4.35–5.35	5.30–6.10	6.00–6.80	1.55–2.35	2.35–3.15	2.75–3.55

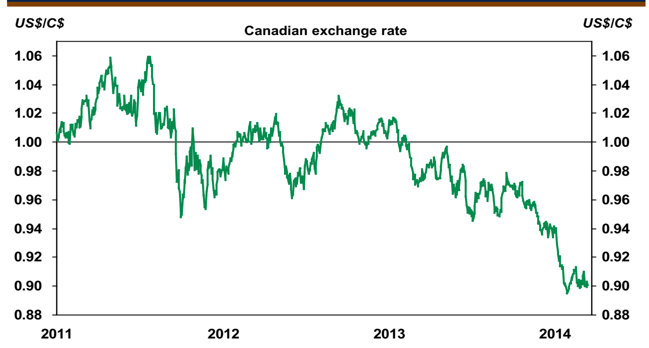
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

Stabilization at around US$0.90

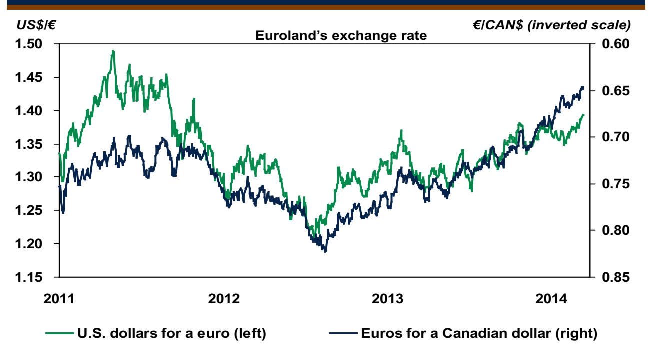
- Since the beginning of February, the Canadian dollar has halted its downward trend and is now tending to stabilize near US$0.90 (graph 5). Weakness in the U.S. dollar temporarily helped the loonie to appreciate to over US$0.91 in mid-February, but a series of disappointing economic data in Canada soon brought that movement to an end. The loonie fell back below US$0.90, but the unexpected rise in Canada's inflation rate limited the damage.
- We need to remember that the main factor behind the strong depreciation of the loonie since the end of October is the change of tone by the Bank of Canada (BoC), which is expressing concern about disinflationary pressures. However, that concern seems to be stabilizing, which was rather positive for the Canadian currency after the monetary policy meeting in early March. But disappointing job creation numbers rained on the parade and cut short a second attempt at a rally by the Canadian dollar.
- Many other currencies have fared better than the Canadian dollar lately, especially the European ones. The pound sterling is benefiting from the fact that the British economy is doing well, and from expectations of early monetary tightening. As for the euro, it is still benefiting from the European Central Bank being in no hurry to announce new monetary easing measures and, more recently, from a safe-haven effect stemming from the tensions between Ukraine and Russia. Canadians now receive less than 0.65 euro for each loonie they sell (graph 6).
- **Forecast:** In the months to come, the Canadian dollar will continue to be very sensitive to changing trends in economic data, particularly inflation, and to statements from the BoC. Inflation will probably fall back below 1% temporarily in the short term, which could be enough to push the loonie below US$0.90. As for the euro, its strength does not reflect the fragility of the euro zone economy, and we still believe that a downward trend will soon take hold.

Graph 5 – The Canadian dollar stabilizes near US$0.90



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	→	↗
Inflation and Bank of Canada	↘	↗

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$/€	1.3955	1.4638	1.5393	1.5000	1.4615	1.4348	1.4086	1.3978	1.3723	1.3474
US$/€	1.3536	1.3780	1.3700	1.3500	1.3300	1.3200	1.3100	1.3000	1.2900	1.2800
US$/£	1.6194	1.6563	1.6600	1.6500	1.6600	1.6700	1.6800	1.7000	1.7000	1.6800

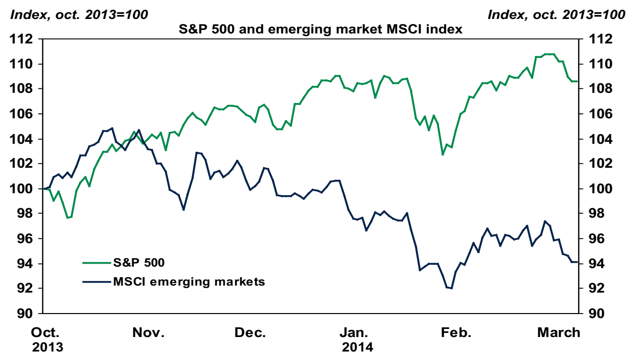
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies f: forecasts

ASSET CLASSES RETURN

Target raised for the Canadian stock market

- **The start of the year was painful for stock markets but, as expected, investors managed to get beyond the turbulence in emerging countries.** Since the beginning of February, the S&P 500 has headed up by more than 7%, while the Canadian stock market index has continued its good performance with a gain of 6.1%. Even the emerging countries' indexes, which had been adversely affected by concerns about their economies, managed to stabilize in February (graph 7). The stock markets were reasonably resilient when confronted by mounting geopolitical tensions in Ukraine at the end of February. They were also stoic about U.S. economic statistics that were clouded by weather effects. It should be pointed out that corporate earnings in the United States have allayed some apprehensions that existed at the beginning of the year, especially after a remarkable performance from the United States in 2013.
- **The Canadian stock market is continuing to do well after a strong start.** This is all the more remarkable, given that concerns about growth in the emerging countries posed a considerable threat to the rally in the materials sector. Despite a difficult global environment for mining companies, the sector has managed to hold onto the gains recorded since the end of 2013 (graph 8). Admittedly, the two previous years were difficult for this sector, so some improvement was built into our scenario. As for the energy component, it had a bit more trouble, staying flat since the beginning of the year. We should point out that unconventional oil production has been booming in the United States, limiting the potential for price increases. The latest data indicate that crude oil production rose by nearly one million barrels per day in the United States in 2013, beating the historic record of 2012, and all signs point towards a similar increase this year. However, the fact that U.S. imports of oil from Canada have kept climbing, contrary to imports from other countries (graph 9), probably helped prevent a worse outcome for the energy component. Meanwhile, strong Canadian bank earnings reports in the fourth quarter gave back some composure to the financial component of the Canadian index, but after a 14.6% gain in 2013, and in light of less favourable conditions for the mortgage market than have been seen in recent years, tougher times could lie ahead. Financial stocks have been seesawing for the past six months (graph 10 on page 5) and a similar trend is expected for the short term.

Graph 7 – The S&P 500 has recovered and emerging market equities have managed to stabilize since February

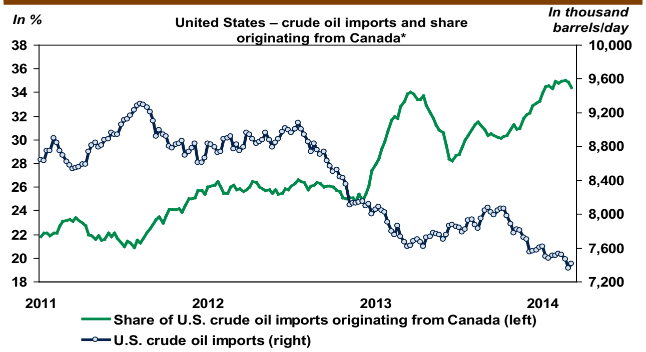


Sources: Bloomberg, MSCI and Desjardins, Economic Studies

Graph 8 – The materials' component of the Canadian stock market has maintained its gains despite an uncertain context

Sources: Bloomberg and Desjardins, Economic Studies

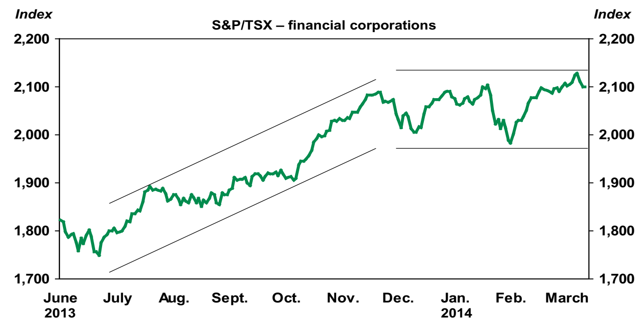
Graph 9 – Canada has not been penalized by the decline in U.S. imports of crude oil



*8-week moving average.
Sources: Department of Energy and Desjardins, Economic Studies

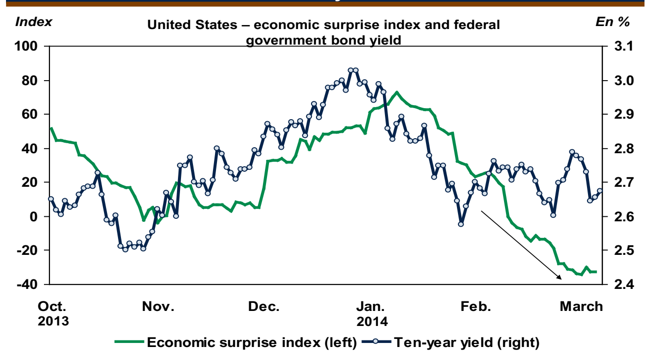
- **The fun and games may be over for the bond market.** After benefiting from revived risk aversion at the beginning of the year, and worries about the U.S. economy, bonds are already having a tougher time. The U.S. 10-year yield approached 2.80% recently, but did not manage to surpass that point. Still, it has stayed at a reasonable distance from the trough of 2.57% that was reached at the beginning of February. The latest job creation statistics support hopes that the U.S. economy will rebound fairly quickly from the brake on activities imposed by the harsh winter (graph 11). With the Federal Reserve staying on course towards a complete halt to its purchases of securities by the fall, or thereabouts, the markets will start speculating again about a future interest rate hike, which we are still forecasting for September 2015. In these conditions, our general viewpoint on bonds remains unchanged.
- **Return forecasts:** The resilience of the Canadian materials sector and the strong performance by the S&P/TSX lead us to raise our year-end target slightly. Accordingly, we now predict a return of 13.0%, instead of 11.0%. This implies that the Canadian stock market should outperform the U.S. stock market to a greater extent than previously assumed. We are keeping our return target for the S&P 500 unchanged, at 8.0%. We are still calling for a negative return of 1.0% for bonds, with 10-year yields expected to break through the 3.0% threshold once again in the coming quarters.

Graph 10 – Despite the recent rebound, financial equities are trading sideways since last fall



Sources: Bloomberg and Desjardins, Economic Studies

Graph 11 – The weather's impact on economic data partly explains the low level of yields in 2014



Sources: Bloomberg, Citigroup 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: 0.95	target: -1.0	target: 13.0	target: 8.0	target: 6.0	target: 2.3 (US$0.92)
range	0.85 to 1.00	-3.0 to 2.0	5.0 to 20.0	2.0 to 14.0	0.0 to 12.0	-0.9 to 8.2

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