Retail Rate Forecasts
Desjardins Economic Studies
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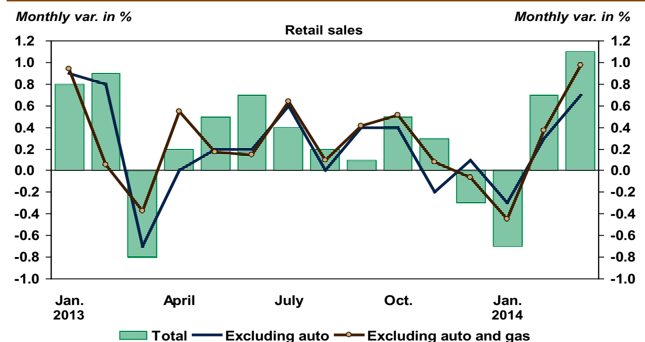
A spring rebound for the U.S. economy

HIGHLIGHTS

- After a very rough start to the year, the U.S. economy is showing promising signs.
- Canada's economy is doing fairly well, but the Bank of Canada is still concerned.
- Long-term bond yields and retail rates remain very low.
- Negative sentiment about the loonie is decreasing.
- Investors should beware of complacency.

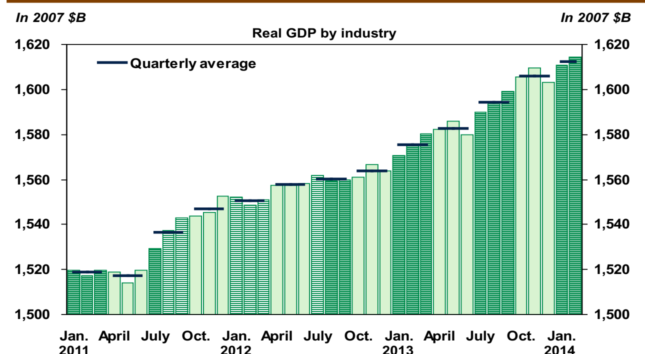
- **The U.S. economy is perking up after hibernating through the first quarter.** U.S. real GDP rose by just 0.1% (annualized) in Q1 of 2014. The harsh weather that affected the United States this winter is largely responsible for the near stagnation in activity. However, most economic figures have bounced back recently, pointing to a strong activity recovery this spring (graph 1).
- **Canada's economy seems to have advanced around 2% in the first quarter.** After plummeting in December, due to difficult weather, Canada's real GDP rebounded in January and February (graph 2). Assuming that March winds up with another small gain in real GDP by industry, the first quarter of 2014 as a whole should post growth of around 2%. This would be a net slowdown from the nearly 3% increase observed since mid-2013, but a much better result than in the United States.
- **Canada's period of very low inflation seems to be over.** Consumer price growth has accelerated considerably over the last few months, and the Bank of Canada (BoC) had to upgrade its inflation scenario when it released April's *Monetary Policy Report* (graph 3 on page 2). The BoC now expects the inflation rate to be close to the 2% target in the second half of 2014, around three quarters earlier than it anticipated in January. The cold winter, which caused energy prices to jump, and a weaker Canadian dollar both have a hand in this accelerating inflation.
- **The BoC remains worried.** Beyond the slower-than-forecast growth at the start of the year, the BoC notes promising developments for the Canadian economy, especially in terms of exports and business confidence. Despite this, its tone remains relatively concerned, calling attention to soft core inflation. Everything suggests that

Graph 1 – Weak U.S. sales at the start of the year were only temporary



Sources: U.S. Census Bureau and Desjardins, Economic Studies

Graph 2 – Canada's real GDP continues to climb after stumbling in December



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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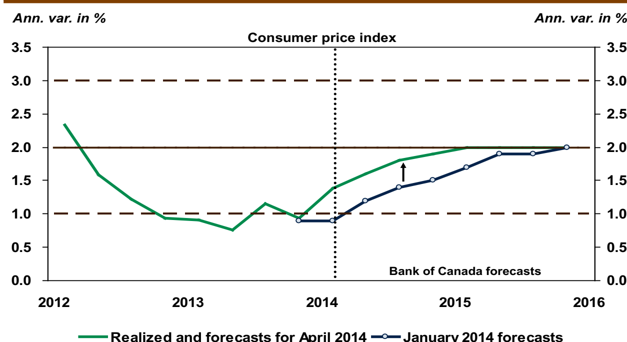
Canada's key rate will remain unchanged for several more quarters.

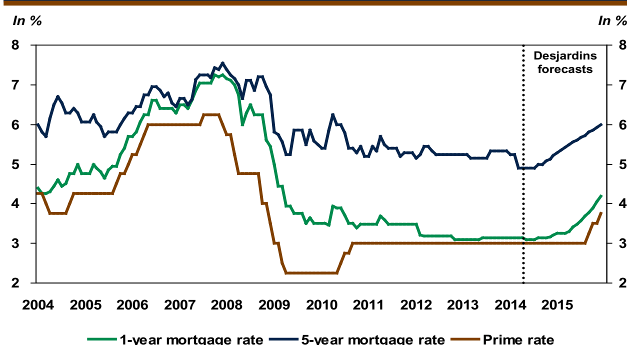
- **Long-term yields are immune to the positive economic data.** Although encouraging economic numbers were released in the United States and the Federal Reserve (Fed) is tapering its securities purchases, long-term bond yields remain well below where they were in late 2013. This allows Canadian financial institutions to continue offering very low mortgage rates. The rate posted (before rebates) for 5-year mortgages even dropped to a new low of 4.89%.
- **Retail rates should start climbing toward the end of summer.** Signs of acceleration from the U.S. economy will strengthen the Fed's determination to wrap up its securities purchases this fall and prepare the markets for a key rate hike in 2015. In this context, bond yields should start to trend up again in a few months, a situation that will have an impact on Canadian retail rates (graph 4).

Graph 3 – The period of very low inflation will be much shorter than the BoC expected in January



Sources: Statistics Canada, Bank of Canada and Desjardins, Economic Studies

Graph 4 – Toward a gradual rise of retail rates



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								
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
February 2014	1.25	3.00	3.14	3.85	5.24	0.90	1.25	1.75
March 2014	1.25	3.00	3.14	3.75	4.89	0.90	1.25	1.75
April 2014	1.25	3.00	3.14	3.75	4.89	0.90	1.25	1.75
May 7, 2014	1.25	3.00	3.14	3.75	4.89	0.90	1.25	1.75
Forecasts								
End of quarter								
2014: Q2	1.00–1.50	2.75–3.25	2.90–3.30	3.50–4.00	4.65–5.15	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	3.60–4.10	4.75–5.25	0.80–1.15	1.00–1.50	1.50–2.00
2014: Q4	1.00–1.50	2.75–3.25	2.95–3.45	3.85–4.35	4.95–5.45	0.80–1.20	1.20–1.70	1.65–2.15
2015: Q1	1.00–1.50	2.75–3.25	3.00–3.50	4.10–4.60	5.20–5.70	0.80–1.25	1.40–1.90	1.90–2.40
End of year								
2015	1.75–2.25	3.50–4.00	3.95–4.45	4.85–5.35	5.75–6.25	1.50–2.00	2.05–2.55	2.45–2.95
2016	2.25–3.25	4.00–5.00	4.35–5.35	5.25–6.05	5.95–6.75	1.60–2.40	2.30–3.10	2.70–3.50
2017	2.75–3.75	4.50–5.50	4.80–5.80	5.55–6.35	6.20–7.00	1.75–2.55	2.50–3.30	2.95–3.75

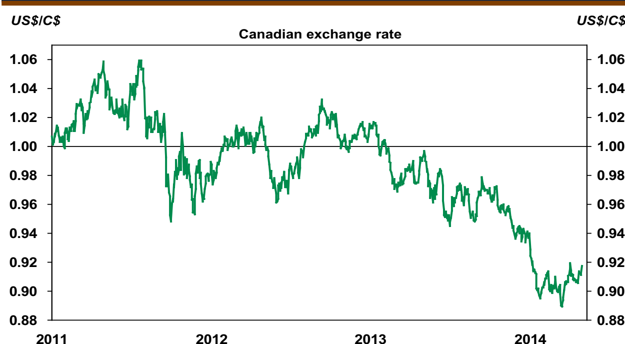
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

Negative sentiment about the currency is down

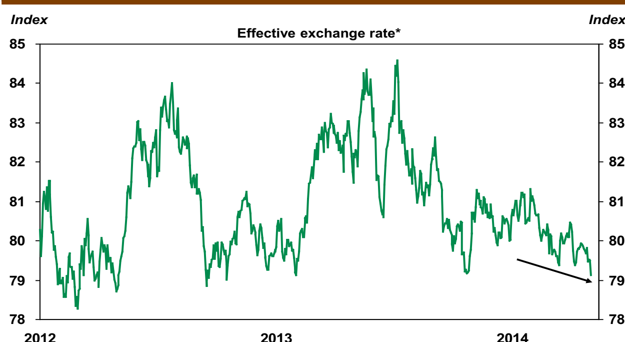
- The Canadian dollar is rising slowly, nearing US$0.92 (C$1.087/US$) (graph 5). Inflation and the Bank of Canada's (BoC) fearful tone were the most punishing determinants for the loonie between October and January. Now that inflation is climbing faster than expected, the chances of an interest rate cut in Canada have waned, and the Canadian dollar is not being penalized as much by this outlook. We can assume that the loonie would be rising more steeply if the BoC were to stop trying to maintain doubt about its future monetary policy direction.
- The Canadian economy also needs to rebalance toward exports and non-residential investment, another factor that is reining in the loonie's comeback. The global economy's expected improvement should help bring this transition about but, unless they make sufficient productivity gains, Canadian businesses will continue to need help from the currency to deal with fierce international competition.
- With regard to other currencies, the U.S. dollar is slow to trend upwards, despite an encouraging outlook for the U.S. economy and tapered Federal Reserve securities purchases (graph 6). On the other hand, the euro is profiting from the European Central Bank's (ECB) reluctance to announce further easing measures. The common currency is also benefiting from renewed enthusiasm for euro zone peripheral nations, as investors are reaching for yield.
- **Forecasts:** The Canadian dollar is nearing our year-end target, US$0.925 (C$1.081/US$). This will be a difficult mark to maintain in the short term. The expected rebound by the U.S. dollar, as well as the BoC's ambiguous remarks will help rein in the loonie's appreciation for a few more months. Stronger gains are expected against the euro, whose value is not a good reflection of the euro zone's slow economic growth and heightened chances of ECB intervention.

Graph 5 – The Canadian dollar climbs slowly



Sources: Datastream and Desjardins, Economic Studies

Graph 6 – The U.S. dollar is still weak



* Trade-weighted U.S. dollar average against the euro, yen, pound, Canadian dollar, Swedish krona and Swiss franc.
Sources: Bloomberg 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	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0.9700	0.9414	0.9050	0.9100	0.9200	0.9250	0.9300	0.9300	0.9400	0.9500
CAN$/US$	1.0310	1.0623	1.1050	1.0989	1.0870	1.0811	1.0753	1.0753	1.0638	1.0526
CAN$/€	1.3955	1.4638	1.5229	1.4945	1.4565	1.4378	1.4086	1.3978	1.3723	1.3474
US$/€	1.3536	1.3780	1.3782	1.3600	1.3400	1.3300	1.3100	1.3000	1.2900	1.2800
US$/£	1.6194	1.6563	1.6672	1.6800	1.6700	1.6800	1.6900	1.7000	1.7000	1.6800

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

ASSET CLASSES RETURN

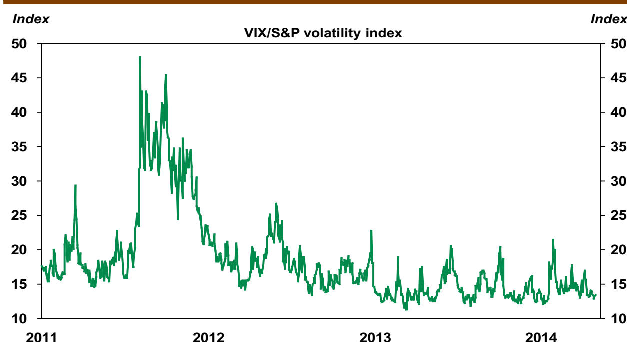
Beware of complacency

- **We maintained a favourable bias toward the Canadian stock market early this year, and so far we have not been disappointed.** Canada's stock market is one of the best performers this year, primarily boosted by solid energy prices, which were in turn driven up by the geopolitical tensions in Ukraine. Growth in the S&P/TSX energy component is therefore ahead, at nearly 15% since the start of the year. We must also highlight the impact of the loonie's depreciation, which has favoured the profit outlook of some sectors, including those most sensitive to the U.S. economy.
- **Besides energy, industrial materials have posted lively growth of nearly 10% in 2014.** The industrial sector was more timid at the start of the year, but came back strong in April and is up 4.5% from the beginning of the year. In this context of fairly widespread component strength, the Canadian stock market continues to rank among the best performers this year. With economic growth poised to strengthen in the United States this spring and improvements on the horizon for Canadian exports, these gains could be maintained, especially since in some cases, such as industrial materials, there is still a lot of room for catch up after three gloomy years (graph 7).
- **As for the United States, fears of a collapse after 2013's spectacular performance have been dispelled.** After rebounding 4.3% in February, the S&P 500 managed to post increases that, while modest, helped to approach the 1,900-point mark. This is all the more remarkable since the high tensions in Ukraine and economic troubles in the United States during the first quarter would have been grounds for a longer stock market correction than what was observed in January. Of course, business results were reassuring, but the decreased volatility recently has us a bit perplexed (graph 8). Even the fears of overvalued tech stocks in March were rapidly followed by bargain-hunting. At the very least, the punishment was hardly severe; NASDAQ is down just 1.0% from the start of the year.
- **All the same, we see some negative risks on the horizon for the stock markets, especially with regard to the situation in the bond market.** Yields, especially those for longer maturities, now seem disconnected from the macroeconomic context, and there could be a rude awakening. A sharp increase in yields, as observed in 2013, could be an obstacle for the stock markets. Since December, the Federal Reserve (Fed) has lifted two major sources of uncertainty that prevailed in 2013: the timing of the start of tapering and changes to its forward guidance for rates. One thing the Fed has never done, however, is to signal that it would put off tightening its monetary policy, although it was careful to repeat that when the time came to raise rates, it would be done very gradually (graph 9). For now, heavy demand for securities offering higher returns is favouring long-term bonds but, in our opinion, the markets seem poorly positioned for the onset of monetary firming, which we expect to see just over a year from now.

Graph 7 – For materials, the recent improvement seems quite modest after the contraction observed in recent years

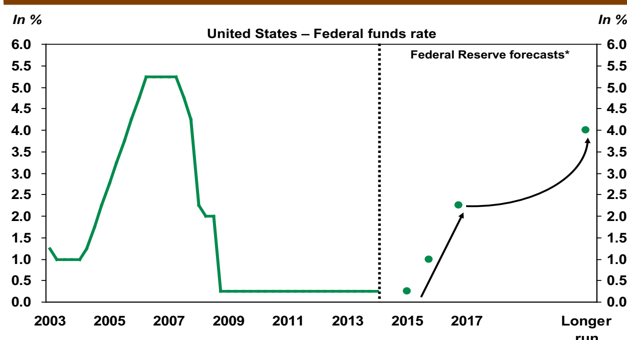
Sources: Bloomberg and Desjardins, Economic Studies

Graph 8 – Low volatility could be a symptom of complacency



Sources: Chicago Board of Trade and Desjardins, Economic Studies

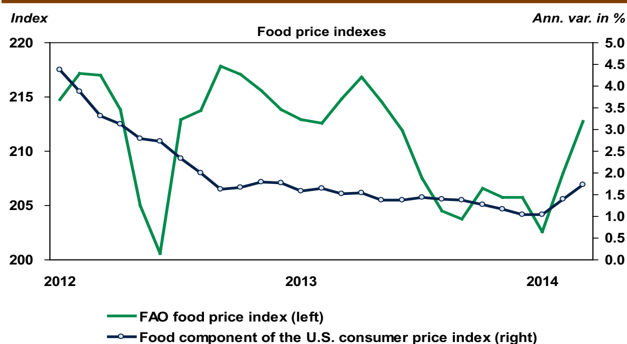
Graph 9 – The Federal Reserve maintains that rates will take time to return to normal



* Median of the 16 individual FOMC-member forecasts.
Sources: Federal Reserve and Desjardins, Economic Studies

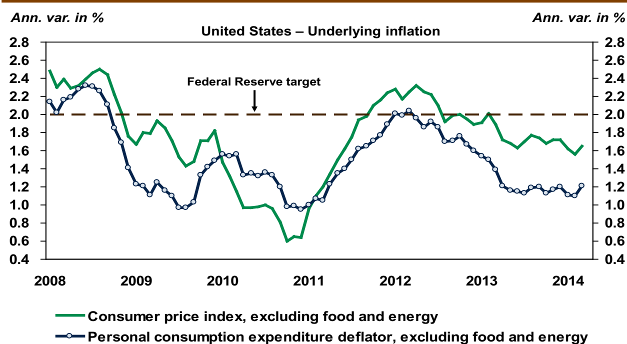
- **Inflation is one of the elements most likely to trigger a trend reversal in fixed income markets, in our view.** The recent rise in food prices (graph 10) could, of course, put some pressure on the total inflation indexes, but the Fed would rather dismiss it as a temporary factor. Instead, core inflation will have the most impact on the Fed's tone, and, consequently, the bond markets. However, we must admit that, for now, there are few signs of pressure in core inflation (graph 11) and it could take longer for rates to begin to trend up.
- **Return forecasts.** We remain comfortable with our 13% target for the Canadian stock market, a target we recently revised upwards. In our opinion, the Canadian stock market is still showing more potential than the U.S. stock market, for which we maintain a target of 8%. For bonds, we are keeping our negative return target of 1%, but have adjusted the top of the band to 3% to factor in the possibility that the rise in bond yields is delayed considerably.

Graph 10 – The rise in food prices is beginning to show in inflation



Sources: Food and Agriculture Organization of the United Nations, Bureau of Labor Statistics and Desjardins, Economic Studies

Graph 11 – Underlying inflation remains stubbornly below the Federal Reserve's target



Sources: Bureau of Labor Statistics, 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 %)**
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: 1.8 (US$0.95)
range	0.85 to 1.00	-3.0 to 3.0	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