Retail Rate Forecasts

Desjardins Economic Studies
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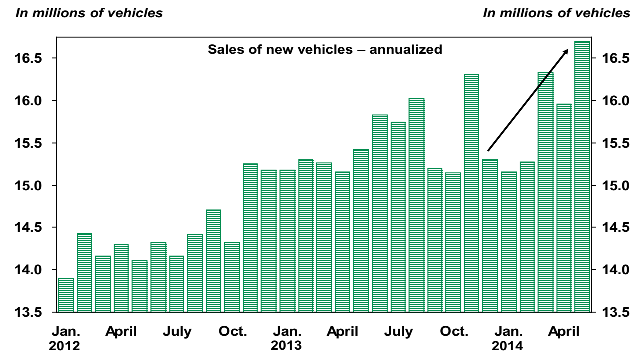
Interest rates will stay relatively low

HIGHLIGHTS

- After a winter to forget, the U.S. economy is sending out encouraging signals.
- Inflation is accelerating, but the Bank of Canada still has concerns.
- Interest rates will stay lower than in the past.
- Reappreciation of the Canadian dollar will remain limited.
- Smooth sailing is not guaranteed for the stock markets.

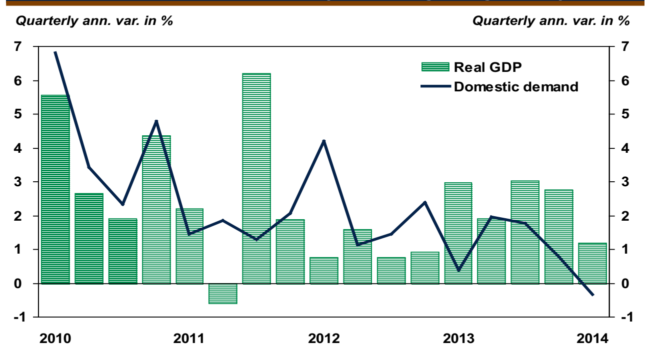
- **U.S. economic data are encouraging.** The year 2014 started off on a negative note for the U.S. economy, with particularly severe winter weather causing an annualized 1.0% contraction in real GDP for the first quarter. Fortunately, the latest statistics confirm that this rough patch was followed by a rally in economic activity in the spring (graph 1).
- **Growth in Canada also slowed at the start of the year.** Real GDP grew at an annualized rate of just 1.2% in the first quarter of 2014 (graph 2), a disappointing reading, especially since domestic demand declined by 0.3%. This is the first pullback in domestic demand since the 2008–2009 recession. Just as in the United States, the particularly harsh weather conditions observed last winter muddied the waters in the first quarter, and the economic data are suggesting a rebound in activity in the second quarter.
- **Despite accelerating inflation, the Bank of Canada (BoC) still has concerns.** At the beginning of June, the BoC acknowledged that inflation was continuing to accelerate faster than it had anticipated. The annual inflation rate had already returned to 2.0% in April (graph 3 on page 2) whereas a return to the median inflation target was not expected before 2015, according to the BoC's latest inflation report. While the news on the inflation front is good, the BoC is expressing greater concern about the economy. Among other things, it fears that the underlying momentum of the U.S. economy may be a bit weaker.
- **The BoC will raise its key interest rate after the Federal Reserve does so.** Until such time as a sustainable acceleration in foreign demand is confirmed, the BoC will remain concerned about the Canadian economy and will not even contemplate monetary firming, especially since it seems to be counting on a weak Canadian dollar. We now

Graph 1 – The surge in car sales is encouraging for the U.S. economy



Sources: Bureau of Economic Analysis, Bloomberg and Desjardins, Economic Studies

Graph 2 – The pullback in domestic demand curbed the Canadian economy at the beginning of the year



Sources: Statistics Canada and Desjardins, Economic Studies

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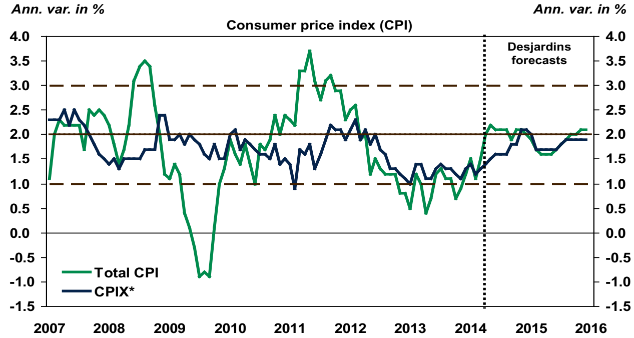
predict that Canada's key interest rate will not be raised before October 2015, that is slightly after the United States begins monetary firming.

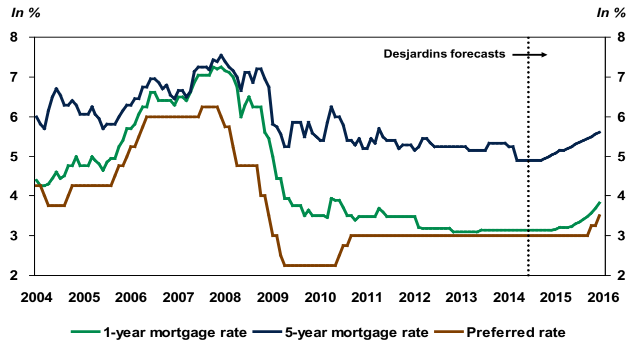
- **Key interest rate hikes will be gradual and restrained.** While all signs still point to the next monetary firming cycle beginning in the second half of 2015, it seems increasingly likely that, for the medium term, key interest rates will remain lower than what we have observed in recent decades. The less favourable demographic trends will reduce the potential for economic growth, pushing the equilibrium level of key interest rates down slightly in the long term. Moreover, certain headwinds, like government financial difficulties and high household debt, will be with us for a long time to come, thus encouraging central banks to limit their key rate hikes.
- **Retail rates will head up, but will remain relatively low.** Bond yields have risen slightly in recent weeks, but are still very low; this enables financial institutions to keep retail rates at floor level. Bond yields should continue rising in the second half of the year, as the economic environment becomes more favourable, generating a slight upturn in retail rates. These trends will continue in the years to come, but interest rates should remain at historically low levels (graph 4).

Graph 3 – Canadian inflation is moving towards the median target



* Bank of Canada core index.
Sources: Statistics Canada and Desjardins, Economic Studies

Graph 4 – Moving towards a gradual and limited increase in 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								
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 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 2014	1.25	3.00	3.14	3.75	4.89	0.90	1.25	1.75
June 12, 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	3.00–3.30	3.60–3.90	4.75–5.05	0.80–1.00	1.15–1.35	1.65–1.85
2014: Q3	1.00–1.50	2.75–3.25	2.90–3.40	3.50–4.00	4.65–5.15	0.80–1.15	1.00–1.50	1.50–2.00
2014: Q4	1.00–1.50	2.75–3.25	2.90–3.40	3.70–4.20	4.80–5.30	0.80–1.15	1.00–1.50	1.50–2.00
2015: Q1	1.00–1.50	2.75–3.25	2.95–3.45	3.90–4.40	4.90–5.40	0.80–1.20	1.10–1.60	1.60–2.10
End of year								
2015	1.50–2.00	3.25–3.75	3.60–4.10	4.50–5.00	5.35–5.85	1.20–1.70	1.60–2.10	2.05–2.55
2016	1.75–2.75	3.50–4.50	4.00–5.00	4.85–5.65	5.45–6.25	1.30–2.10	1.80–2.60	2.20–3.00
2017	2.50–3.50	4.25–5.25	4.50–5.50	5.15–5.95	5.65–6.45	1.45–2.25	2.10–2.90	2.40–3.20

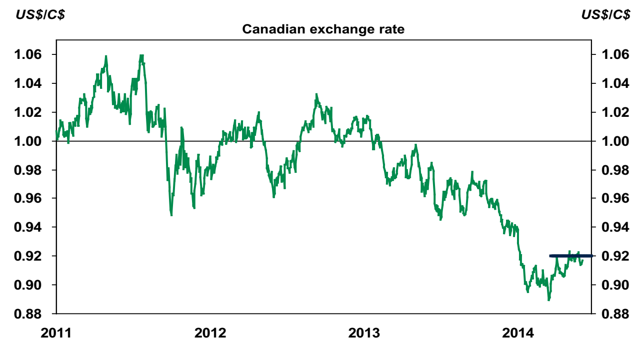
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

Reappreciation will remain limited

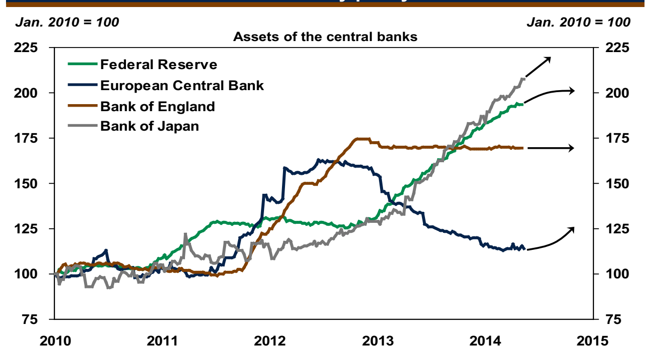
- After gaining a bit of altitude in April, the Canadian dollar stabilized close to the US$0.92 mark (graph 5). One factor in the Canadian dollar's favour is accelerated inflation, which reduces the likelihood of Canadian key interest rates being lowered. However, it is worth bearing in mind that the Canadian currency might appreciate more if the Bank of Canada (BoC) did not keep some ambiguity about the future direction of its monetary policy.
- Other factors are also holding back stronger reappreciation of the loonie, in particular flagging domestic demand, which means that economic growth is more dependent on a rally in exports. A greater contribution could also be hoped for from non-residential investment. The anticipated improvement in the U.S. and global economies should give a bit of a lift, but a Canadian dollar below parity is still preferable in order to confront the fierce international competition.
- The Canadian dollar is doing better against the euro, which is mainly suffering from the change of course by the European Central Bank (ECB). Until very recently, the ECB was the odd man out among the major central banks, in that it was holding off from interventions (graph 6). The picture has changed with the new easing measures introduced in the euro zone, especially since the interventions in the United States are coming to an end. Generally speaking, the U.S. dollar appears to have the advantage against many other currencies. However, the Canadian dollar should be able to hold its own against an appreciating greenback if this is accompanied by improvement in the U.S. economy and better outlooks for Canadian exporters.
- **Forecasts:** Considering the gains posted in the spring, the potential for further appreciation of the Canadian dollar against the U.S. dollar now appears to be small. The loonie could nevertheless close in on US$0.93 (C$1.075/US$) by the end of this year, in a context of waning concerns, especially those expressed by the BoC. The potential for appreciation against the euro appears stronger, since that currency will remain penalized by the more accommodative monetary policy of the ECB.

Graph 5 – The Canadian dollar holds steady at close to US$0.92



Sources: Datastream and Desjardins, Economic Studies

Graph 6 – The major currencies will be influenced by changes in monetary policy



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	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0.9700	0.9414	0.9050	0.9200	0.9250	0.9300	0.9350	0.9400	0.9350	0.9350
CAN$/US$	1.0310	1.0623	1.1050	1.0870	1.0811	1.0753	1.0695	1.0638	1.0695	1.0695
CAN$/€	1.3955	1.4638	1.5229	1.4674	1.4378	1.4194	1.4011	1.3830	1.3797	1.3690
US$/€	1.3536	1.3780	1.3782	1.3500	1.3300	1.3200	1.3100	1.3000	1.2900	1.2800
US$/£	1.6194	1.6563	1.6672	1.6800	1.6800	1.6900	1.7000	1.7000	1.6900	1.6800

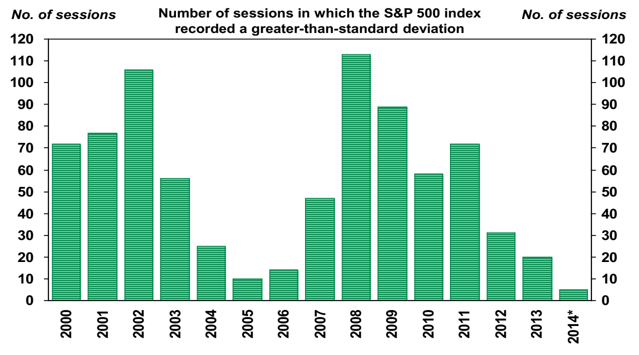
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies f: forecasts

ASSET CLASSES RETURN

Smooth sailing is not guaranteed for the stock markets

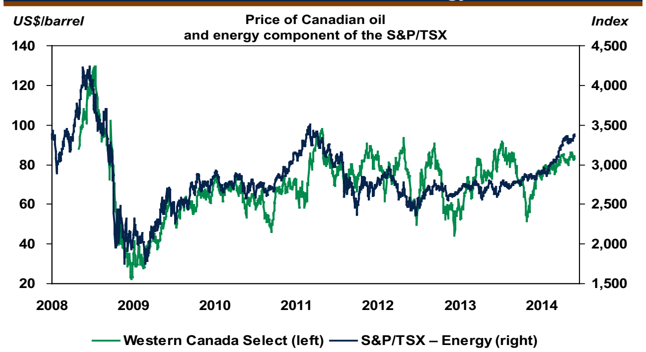
- **Now that the S&P 500 seems to be floating peacefully towards 2,000 points, we should not ignore the risk of a correction.** Not that the earnings reports were fundamentally bad in the first quarter; in fact, profit margins were more or less equivalent to the 9.75% record seen in the fourth quarter of 2013. In the context of U.S. growth being severely impeded by inclement weather during this period, this constitutes good news. And the spring improvement in economic statistics is a good omen for the future.
- **But we are still perplexed by the absence of volatility so far in 2014.** This is reminiscent of the complacency that reigned in the middle of the last decade, for which the ending story is well known (graph 7). It is practically impossible to determine precisely how long this state of affairs may last, or what events might blow a cold wind over the stock markets. Indeed, their resilience agiainst the turmoil in Ukraine and the economic uncertainty in China clearly show how robust the bullish sentiment currently is. However, we believe that a quick, upward adjustment in bond yields constitutes a downside risk scenario for the stock markets, which will bear watching in the short term.
- **Even though a possible consolidation is not completely out of the question in the short term, we still believe that the Canadian stock market will generate a greater return than the U.S. stock market in 2014.** The strong performance of Canadian oil prices has helped to push the energy component of the S&P/TSX up by 19% over the past six months; this is the fastest growth over six months that we have seen in three years (graph 8). The higher prices were accompanied by an 8.8% increase in volumes of energy product exports in the first quarter, ensuring solid profitability growth in the oil and gas extraction sector. In fact, the sector made the greatest contribution to Canadian business profit growth at the beginning of the year (graph 9). In this respect, the future still looks bright. The International Energy Agency has revised its forecast of growth in global demand for this year, upwards. We have also adjusted our target oil price upwards slightly. On another front, it is important to mention manufacturing, which also had a positive quarter: profits soared by 24%. Manufacturing nominal sales have risen for three consecutive quarters, supported in part by the depreciation of the currency. Strong new orders of late support of bullish outlook for manufacturing.
- **In view of the strong bond markets, we have revised our target yields for the end of the year.** We now think that the Canadian 10-year yield will wind up the year at 2.95%; this constitutes a downward revision of 25 basis points from our previous scenario. North American central banks have sent the word out, more insistently, that interest rates in the long term would remain below the levels commonly considered to represent a situation of equilibrium. Compared with last year, more Federal Reserve (Fed) leaders are now predicting a Fed funds rate converging to a level below 4.00% in the long term (graph 10 on page 5). Bank of

Graph 7 – The calm state of the stock markets in 2014 resembles that of the years preceding the financial crisis



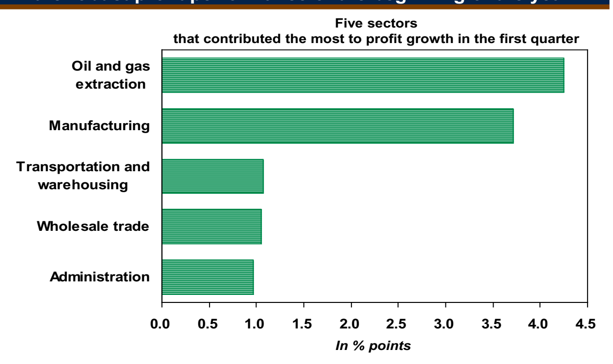
* Up until June 9.
Sources: Bloomberg and Desjardins, Economic Studies

Graph 8 – Stronger prices contributed to the boost in the Canadian stock market's energy sector



Sources: Bloomberg and Desjardins, Economic Studies

Graph 9 – Energy and manufacturing played a decisive role in the robust profit performance of the beginning of the year

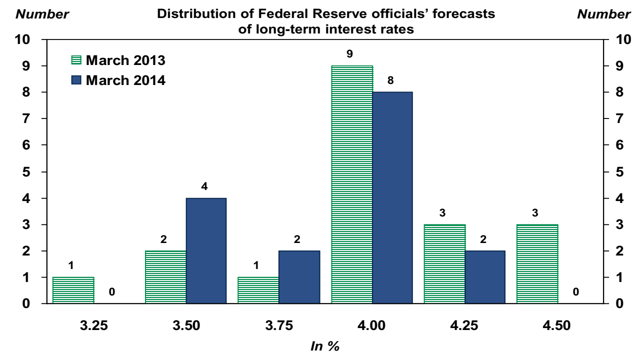


Sources: Statistics Canada and Desjardins, Economic Studies

Canada (BoC) Governor, Stephen Poloz, made comments along those lines in recent speeches. There are also many grounds for believing that continuing high excess capacity around the globe, combined with other headwinds, will keep the central banks on a cautious path in the years ahead. Consequently, we believe that the BoC's key interest rate and bond yields will converge towards lower levels than had previously been anticipated (graph 11).

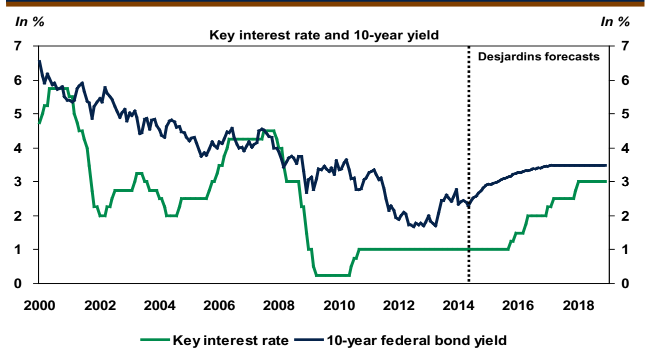
- **Forecasts:** We are adjusting our target for bonds upwards, now calling for a positive return of 1.0%. While we still anticipate yields drifting higher in the second half of 2014, according to our base scenario, they will rise gradually, ending the year only slightly above their levels of December 2013. We must not overlook the risk of broader movement in yields, in the short term, should the Fed attempt to convince the markets that the complacency-driven low degree of volatility is an unwelcome situation. This could put a damper on the stock markets. We are including that possibility in our decision to keep our year-end targets unchanged, despite the fact that the returns recorded so far are getting close to those numbers.

Graph 10 – Slightly more officials than in 2013 now expect an equilibrium interest rate below 4%



Sources: Federal Reserve and Desjardins, Economic Studies

Graph 11 – Interest rates and bond yields will rise very gradually in Canada



Sources: Datastream 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: 1.2 (US$0.93)
range	0.85 to 1.00	-2.0 to 4.0	6.0 to 20.0	2.0 to 14.0	0.0 to 12.0	-1.9 to 8.2

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