Retail Rate Forecasts

Desjardins Economic Studies
www.desjardins.com/economics

**August 6, 2014**

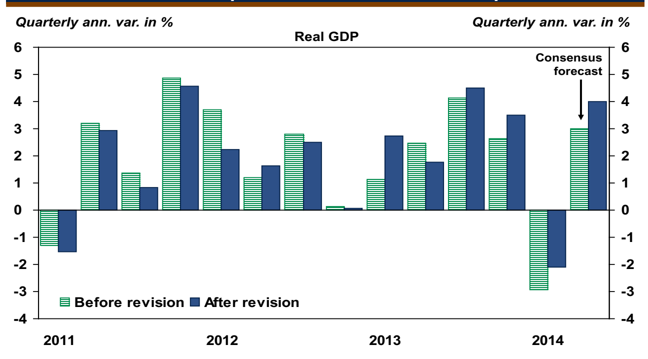
# The winds are starting to shift

## HIGHLIGHTS

- Activity in North America is ramping up.
- Central banks still have some wiggle room.
- Downtrend in interest rates should come to a halt.
- Canada's currency should stabilize.
- Volatility is back.

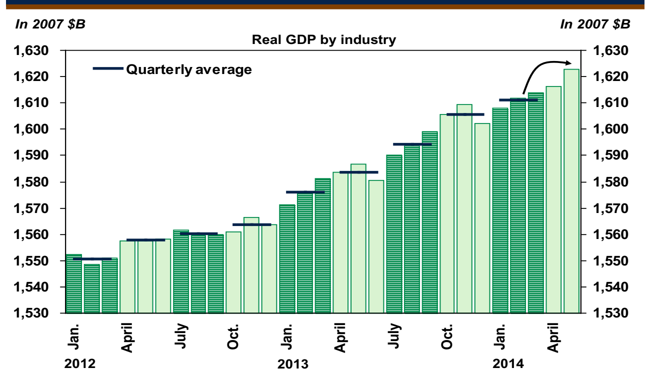
- **The U.S. economy beat expectations in the second quarter.** After a particularly harsh winter, U.S. real GDP surged by an annual 4% this spring, riding a wave of ramped-up consumption and investment, and capitalizing on a rebound in inventories. This result, which exceeded expectations, was also accompanied by an upward revision to most of the quarterly results in 2013 and the first quarter of 2014 (graph 1). This allows us to slightly raise our growth outlook for 2014 as a whole.
- **Canada's economy is also showing signs of acceleration.** After a fairly tough start to the year, real GDP by industry rose 0.4% in May (graph 2). Both the goods (+0.5%) and services (+0.4%) industries showed solid growth. This strong result was expected since most of Canada's economic indicators showed significant advances in May. Considering that June should end with another hike in real GDP by industry, Q2 could post growth in the area of 2.5%—a pace twice as fast as last winter's.
- **No changes in sight for Canada's monetary policy.** In its latest statement, the Bank of Canada (BoC) acknowledged that inflation had climbed more rapidly than expected. Even if the central bank stresses that temporary factors were behind the sharp spike in prices, the BoC removed from its statement the mention that downside risks to inflation were predominant. The general tone of the report confirms however that some time will have to pass before the BoC starts raising its rates, especially since it seems to be banking on a relatively weak loonie to drive exports, against the backdrop of a global economy that is turning in a disappointing performance.

**Graph 1 – The U.S. economy picked up and advances made in the last few quarters have been revised upwards**




Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

**Graph 2 – Growth in Q2 2014 is poised to accelerate in Canada**




Sources: Statistics Canada and Desjardins, Economic Studies

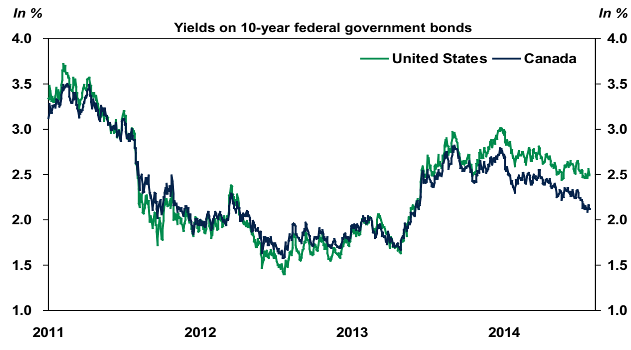
**François Dupuis**
Vice-President and Chief Economist

514-281-2336 *or* 1 866 866-7000, ext. 2336
E-mail: desjardins.economics@desjardins.com

**Mathieu D'Anjou** Senior Economist
**Jimmy Jean** Senior Economist
**Hendrix Vachon** Senior Economist

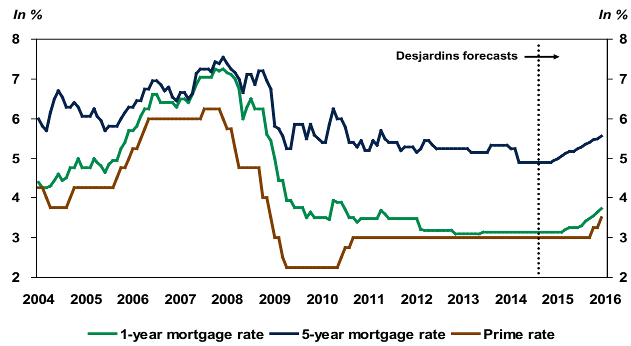
- **Bond yields remain very weak.** Encouraging economic data exerted some upward pressure on bond yields in recent weeks, especially on U.S. short-term yields. Long-term yields remain very low, particularly in Canada (graph 3), amid new concerns rippling through the markets and raising demand for safe-haven securities, including bonds.
- **Retail rates are climbing, gradually.** After dropping during the first few months of 2014, mortgage rates have been stable of late. The end of the busiest period for the housing market seems to have tempered the aggressiveness of some lenders. No noteworthy movement in retail rates is expected in the short term, but we continue to call for a gradual increase in the next few quarters (graph 4) while the economic environment continues to gain strength and monetary tightening starting to get closer in North America.

**Graph 3 – Bond yields are very low, especially in Canada**




Sources: Datastream and Desjardins, Economic Studies

**Graph 4 – After a period of stability, retail rates should climb gradually**




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** | | | | | | | | |
| 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 2014 | 1.25 | 3.00 | 3.14 | 3.75 | 4.89 | 0.90 | 1.25 | 1.75 |
| July 2014 | 1.25 | 3.00 | 3.14 | 3.75 | 4.89 | 0.90 | 1.25 | 1.75 |
| Aug. 6, 2014 | 1.25 | 3.00 | 3.14 | 3.75 | 4.89 | 0.90 | 1.25 | 1.75 |
| **Forecasts** | | | | | | | | |
| End of quarter | | | | | | | | |
| 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 | 3.55–4.05 | 4.70–5.20 | 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 | 3.75–4.25 | 4.85–5.35 | 0.80–1.15 | 1.00–1.50 | 1.55–2.05 |
| 2015: Q1 | 1.00–1.50 | 2.75–3.25 | 3.00–3.50 | 4.00–4.50 | 5.00–5.50 | 0.80–1.25 | 1.20–1.70 | 1.70–2.20 |
| End of year | | | | | | | | |
| 2015 | 1.50–2.00 | 3.25–3.75 | 3.50–4.00 | 4.45–4.95 | 5.30–5.80 | 1.15–1.65 | 1.60–2.10 | 2.00–2.50 |
| 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 |

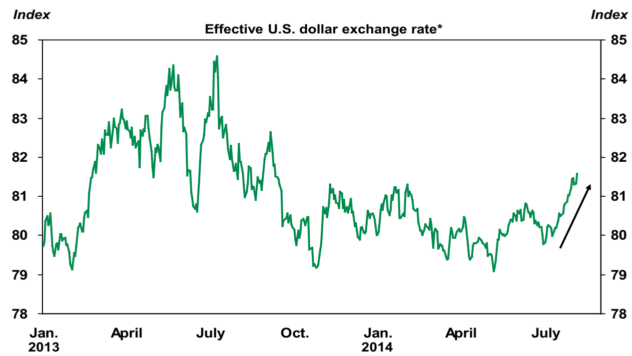
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

# CANADIAN DOLLAR

## The loonie is poised to stabilize

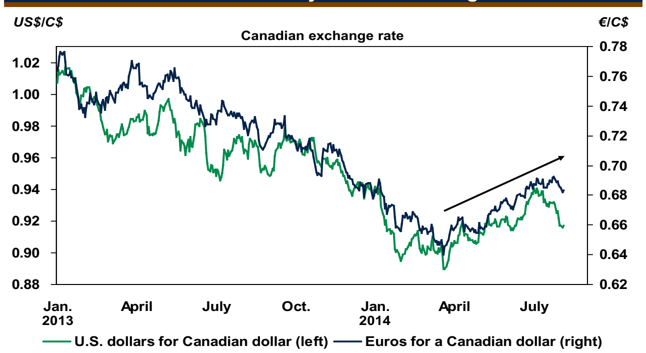
- The Canadian currency gained new momentum in the second half of June, settling temporarily around US$0.94 at the beginning of July. The release of disappointing employment figures on July 11 brought the loonie back around US$0.93. A broad increase in the greenback's value then pushed the loonie under US$0.92 (graph 5).
- That the greenback clipped the loonie's wings is not surprising. The main positive development in Canada's currency since last winter has been the continued and faster-than-expected increase in the inflation rate. At 2.4%, inflation now exceeds the Bank of Canada's (BoC) median target, removing the possibility of a rate cut. The BoC deems, however, that the run-up in inflation primarily reflects temporary factors—it seems far more concerned about the weak economy than by surging inflation. For the BoC, it is essential that exports and business investments strengthen. To facilitate this, the loonie cannot move up much higher for fear of hindering Canadian businesses already struggling with international competition. Thus, nothing suggests that monetary tightening in Canada is imminent.
- The Canadian dollar generally continued to gain value against the euro (graph 6). In addition to being held back by the monetary easing measures announced by the European Central Bank in June, the euro had to deal with the publication of several disappointing economic data amid new concerns about the strength of Europe's financial sector after the major difficulties experienced by Espirito Santo, a Portuguese bank.
- **Forecasts:** After achieving major gains in recent months, the Canadian dollar should primarily be in consolidation mode until the end of the year. A slight uptick in the loonie is still expected, while the global economic environment gradually takes a greater shine to commodity currencies. As such, we are maintaining our 2014 targets versus the greenback and euro at US$0.93 (CAN$1.075/US$) and at €0.70.

**Graph 5 – Are we finally on the brink of an uptrend for the greenback?**




* Trade-weighted U.S. dollar average against the euro, yen, pound, Canadian dollar, Swedish krona and Swiss franc.
Sources: Bloomberg and Desjardins, Economic Studies

**Graph 6 – The loonie advanced in recent months, but the last few days have been tougher**




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 | Q2 | Q3f | Q4f | Q1f | Q2f | Q3f | Q4f |
| US$/CAN$ | 0.9700 | 0.9414 | 0.9050 | 0.9372 | 0.9250 | 0.9300 | 0.9350 | 0.9400 | 0.9350 | 0.9300 |
| CAN$/US$ | 1.0310 | 1.0623 | 1.1050 | 1.0671 | 1.0811 | 1.0753 | 1.0695 | 1.0638 | 1.0695 | 1.0753 |
| CAN$/€ | 1.3955 | 1.4638 | 1.5229 | 1.4610 | 1.4486 | 1.4194 | 1.4011 | 1.3830 | 1.3797 | 1.3763 |
| US$/€ | 1.3536 | 1.3780 | 1.3782 | 1.3691 | 1.3400 | 1.3200 | 1.3100 | 1.3000 | 1.2900 | 1.2800 |
| US$/£ | 1.6194 | 1.6563 | 1.6672 | 1.7099 | 1.7000 | 1.7100 | 1.7200 | 1.7100 | 1.7000 | 1.6800 |

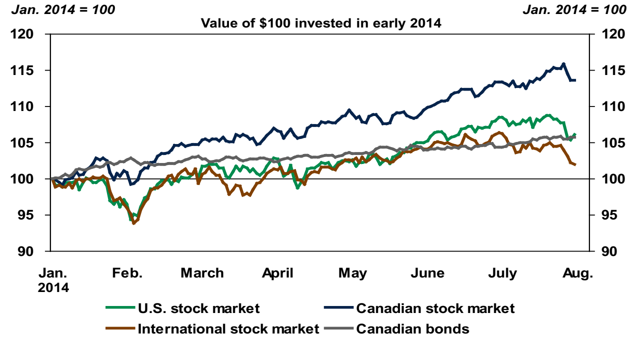
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies f: forecasts

# ASSET CLASSES RETURN

## Volatility is back

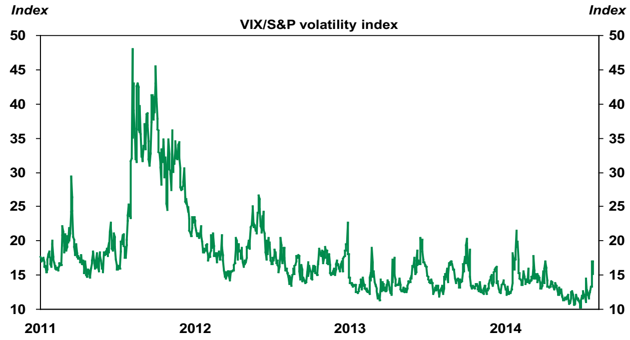
- **A milestone first half of 2014 for Canadian investors.** All major asset classes have turned in positive performances since the start of the year and the solid results posted by North American equities and bonds beat our expectations. A $100 investment in Canada's stock market at the start of 2014 reached almost $115 in value by mid-July, compared to $109 for a U.S. investment or $105 invested in Canada's bond market (graph 7).
- **Is the complacency over?** The major gains in asset classes were achieved in an environment of very low volatility, despite the many international risks: the conflict in Ukraine, major tensions in the Middle East, etc. In July, problems at Espirito Santo, a Portuguese bank, turned the spotlight on the fragile state of Europe's financial system. Until very recently, investors seemed to be ignoring these worrisome developments, as the weak reading of the VIX index, which measures the implied volatility of the S&P 500 index, suggests. That said, the VIX index has recovered some lost ground in the past few days as several stock indexes have relapsed (graph 8).
- **A delicate balance.** Ironically, a good economic surprise—the U.S. economy's stronger-than-expected performance in the second quarter—seems to have triggered the recent turmoil in the stock market. One of the explanations for the solid showing in many asset classes these past few months is the theory of the "reach for yield". This explanation suggests that maintaining bond yields at very low levels for a prolonged period forces investors to turn to other, riskier, financial products. The end result is a balance where the value of other asset classes rises in step with declining bond yields, something that closely resembles what has been observed since the start of 2014. The problem is as follows: as soon as bond yields begin to rise, all asset classes risk being negatively affected, at least temporarily.
- **On to a more eventful second half.** If most stock indexes are no longer very affordable from a fundamental standpoint, they do not appear to be highly overvalued in our opinion, especially when compared to the bond market (graph 9). The stock market thus remains an attractive option for investors with a medium- to long-term view. However, the next few months could bring far more volatility and a temporary correction cannot be ruled out. Besides future developments in international tensions, the winding down of the Federal Reserve's (Fed) third monetary easing program this fall and the possibility of a noteworthy increase in bond yields could create major fluctuations on stock markets.
- **Strengthening demand for commodities could bode well for Canada's stock market.** The main commodity price indexes declined significantly in recent weeks. These declines do not signal a widespread drop in resource prices, but a correction in prices for natural gas and grains amid recent developments confirming that concerns of a shortage that swirled at the beginning of the year are no

**Graph 7 – Gains across the board since the beginning of 2014**



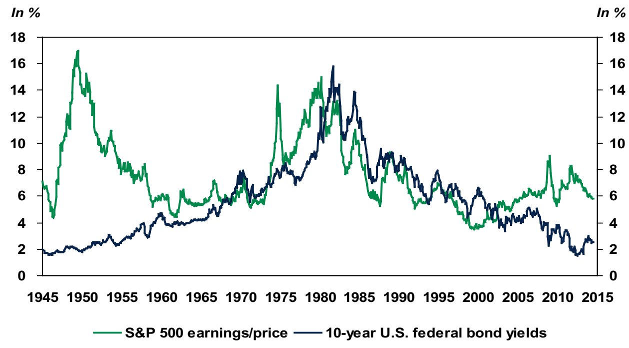

Sources: Datastream and Desjardins, Economic Studies

**Graph 8 – The stock market's implicit volatility rose suddenly to a more normal level**




Sources: Chicago Board of Trade and Desjardins, Economic Studies

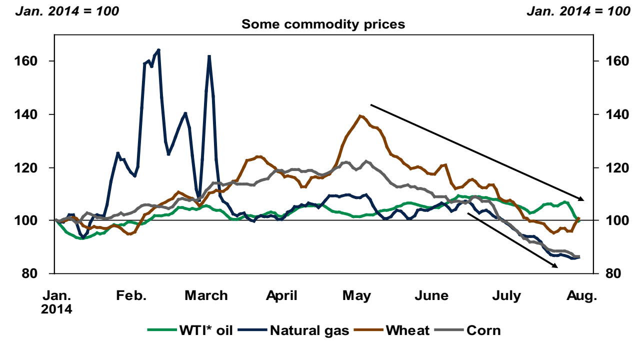
**Graph 9 – The S&P 500 continues to offer significantly higher returns than federal bonds**




Sources: Global Financial Data, Datastream, Institutional Brokers Estimate System and Desjardins, Economic Studies longer justified (graph 10). On the positive side, the recent uptrend in metal prices continued. The signs of ramped-up activity in China and the U.S. point to stronger demand for industrial resources, a situation that should support commodities as well as Canada's stock market.

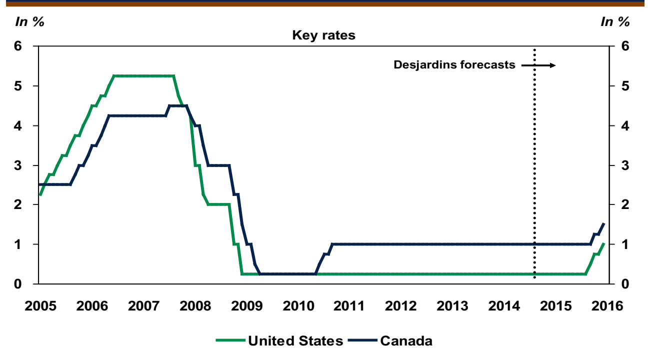
- **On to a tougher second half of the year for the bond market.** While no imminent increase in key rates is on the horizon (graph 11), bond yields should soon start to rise, to better reflect the economic and financial environment. Stormy Fed debates could magnify the recovery in bond yields.
- **Stock markets could do well again in 2015.** The anticipated recovery in bond yields over the next few quarters should see the bond market suffer a slight pullback after the unforeseen gains made in the first half of the 2014. We expect stock markets to seesaw in the coming months, ending the year close to the peaks seen recently. In 2015, stock markets should continue to offer attractive returns, especially in Canada where resource-linked sectors will ride the wave of an accelerating global economy.

**Graph 10 – After a surge, some commodity prices are experiencing a correction**




* West Texas Intermediate
Sources: Datastream and Desjardins, Economic Studies

**Graph 11 – Monetary tightening should only begin in late 2015**




Sources: Federal Reserve, Bank of Canada 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** | **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: 3.0 | target: 15.0 | target: 10.0 | target: 6.0 | target: 1.2 (US$0.93) |
| range | 0.85 to 1.00 | 0.0 to 6.0 | 8.0 to 22.0 | 4.0 to 16.0 | 0.0 to 12.0 | -1.9 to 8.2 |
| 2015f | target: 1.15 | target: -1.0 | target: 12.0 | target: 8.0 | target: 8.0 | target: 0.0 (US$0.93) |
| range | 0.95 to 1.35 | -4.0 to 3.0 | 6.0 to 18.0 | 2.0 to 14.0 | 1.0 to 15.0 | -4.1 to 4.5 |

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