Retail Rate Forecasts

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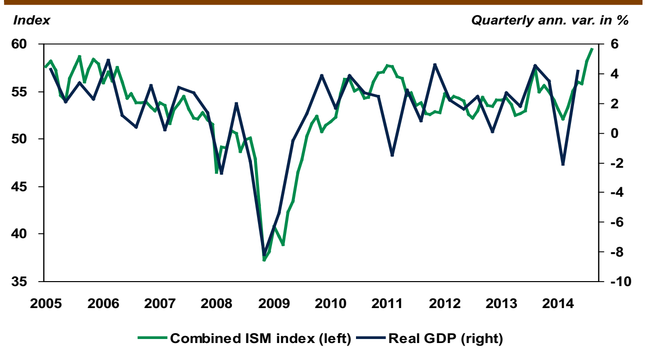
Accelerating economic growth points to interest rate increases

HIGHLIGHTS

- Several promising economic statistics in North America.
- The Federal Reserve could start firming up its monetary policy in mid-2015.
- Bond yields should continue their recent uptrend.
- The loonie's recent pullback primarily reflects the greenback's strength.
- Canada's stock market seems to be benefiting from the softer dollar.

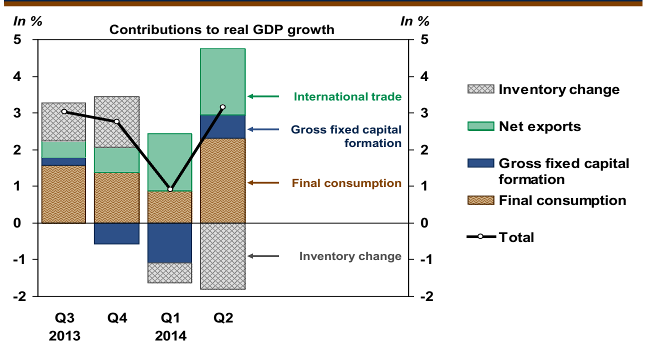
- **Promising signals from the U.S. economy.** After the harsh winter weather, the U.S. economy accelerated last spring. The coming quarters promise to be strong with, among other things, an acceleration in business investment suggested by a very solid performance of the ISM indexes (graph 1).
- **Canada's economy could post another strong performance in the third quarter.** In light of the latest indicators, we can be cautiously optimistic about Canada's economy. Real GDP bounced back in the second quarter with gains at a quarterly annualized 3.1%, after growing just 0.9% in the previous quarter (graph 2). Moreover, everything suggests that exports and consumption continued to advance quickly in the last few months, suggesting that the economy will record another robust gain of about 3% in Q3 2014. This projection, combined with last spring's higher-than-expected results, is prompting us to upgrade our forecast for 2014 from 2.2% to 2.4%.
- **The situation remains tougher for the rest of the world.** In the euro zone, Q2 growth was soft, with real GDP contracting in Germany, and there is nothing to suggest it will pick up substantial speed. April's consumption tax hike did more damage to Japan's economy than anticipated and the size of the bounceback promises to be moderate. The economic situation is still worrisome in some emerging nations, including China and Brazil.
- **The Federal Reserve (Fed) could start raising its key interest rates in mid-2015.** In its statement, the Fed is still signalling that its key rates will stay where they are for a considerable period. However, Fed leaders are also indicating that key rates could be increased by more

Graph 1 – The ISM indexes suggest that U.S. real GDP growth will remain lively



Sources: Institute for Supply Management, Bureau of Economic Analysis and Desjardins, Economic Studies

Graph 2 – Canadian growth accelerated in Q2 2014



Sources: Statistics Canada and Desjardins, Economic Studies

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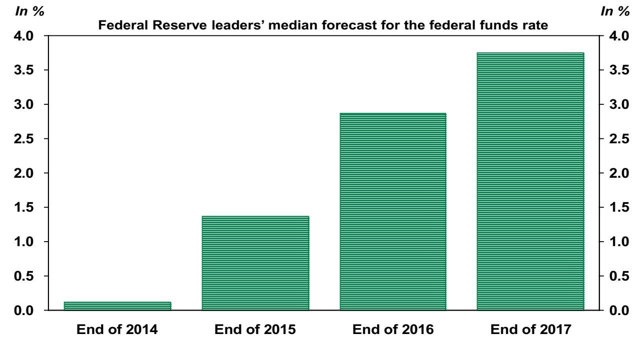
NOTE TO READERS: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

than 1% by the end of 2015 (graph 3). In this context, it is appropriate to look for monetary firming to start somewhere around mid-2015. Despite the encouraging developments for Canada's economy, the Bank of Canada could be more patient and keep its key rates where they are until October 2015.

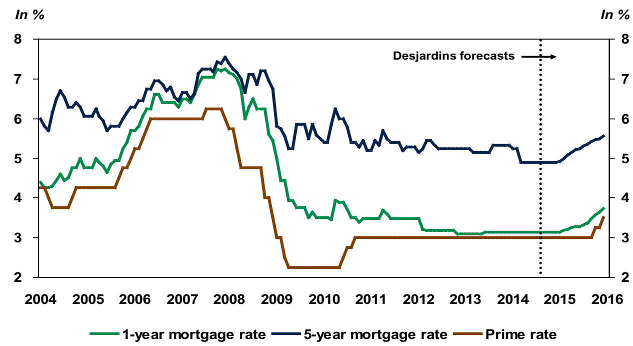
- **Bond yields edge up.** After falling since early 2014, North American bond yields have ticked up over the last few weeks, with investors apparently starting to prepare for a key rate hike next year. Long-term yields remain low, however, benefiting from the problems in economies overseas and major geopolitical tensions.
- **Retail rates should also start trending up within the next few quarters.** Retail rates have not budged in the last few months, remaining extremely low. The recent upswing in bond yields will not necessarily bring on an immediate upside adjustment to retail rates, as financial institutions' financing costs are still low. If the bond yield uptrend persists in the coming months as we expect, retail rates should, however, start to rise in the first half of 2015 (graph 4).

Graph 3 – Federal Reserve leaders signal that rates could go up substantially as of 2015



Sources: Federal Reserve and Desjardins, Economic Studies

Graph 4 – Retail rates should start to rise slowly in the first half of 2015



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								
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. 2014	1.25	3.00	3.14	3.75	4.89	0.90	1.25	1.75
Sep. 22, 2014	1.25	3.00	3.14	3.75	4.89	0.90	1.25	1.75
Forecasts								
End of quarter								
2014: Q3	1.25	3.00	3.00–3.30	3.60–3.90	4.75–5.05	0.80–1.05	1.10–1.40	1.60–1.90
2014: Q4	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
2015: Q1	1.00–1.50	2.75–3.25	2.95–3.45	3.75–4.25	4.80–5.30	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	0.80–1.20	1.15–1.65	1.75–2.25
End of year								
2015	1.50–2.00	3.25–3.75	3.50–4.00	4.45–4.95	5.30–5.80	1.10–1.60	1.55–2.05	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

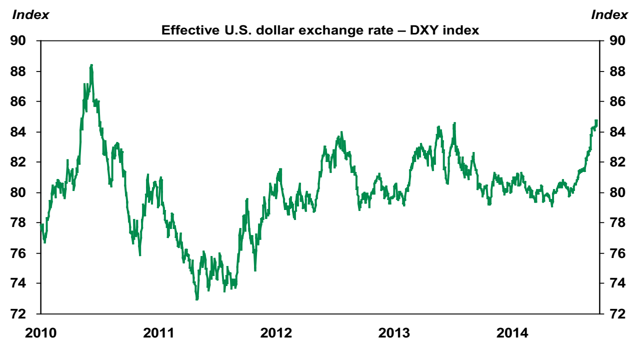
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

The loonie's recent pullback primarily reflects the greenback's strength

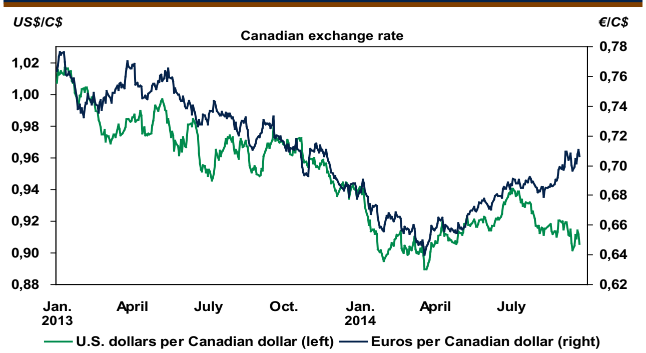
- The Canadian dollar has returned to around US$0.91 (C$1.10/US$) after temporarily reaching US$0.94 in early July. Thus, the Canadian dollar has not escaped the U.S. dollar's general strength (graph 5).
- Recent economic developments have been rather positive in Canada. The second-quarter rebound in exports stimulated economic growth, and the available data for the third quarter bodes quite well. That said, many uncertainties remain. It is still too soon to say that the improvement in exports is sustainable, and business investments have yet to accelerate. Household debt is also a concern, as is the disappointing economic data recently released in Europe and Asia. In the face of these uncertainties, the Bank of Canada (BoC) prefers to remain cautious and maintain its neutral bias.
- The loonie is still gaining against the euro (graph 6). Note that the latest economic statistics have been especially disappointing in the euro zone. Another erosion of the outlooks for economic growth and inflation convinced the European Central Bank (ECB) to announce another string of monetary easing measures at its meeting in early September. In addition to fostering growth of euro zone lending to businesses and consumers, the ECB wants to expand its balance sheet substantially, taking it closer to a true quantitative policy.
- **Forecasts:** The release of more good economic data for Canada, as well as fewer national and international uncertainties could breathe new life into the loonie over the coming months. The Canadian dollar should climb back to around US$0.93 (C$1.075/US$) by the end of the year. However, this improvement should not last very long in 2015, as we expect the Federal Reserve to begin monetary firming a few months before the BoC.

Graph 5 – The U.S. dollar is at its highest since summer 2010



Sources: Bloomberg and Desjardins, Economic Studies

Graph 6 – The loony keeps rising against the euro



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	0.9200	0.9300	0.9350	0.9200	0.9100	0.9200
CAN$/US$	1.0310	1.0623	1.1050	1.0671	1.0870	1.0753	1.0695	1.0870	1.0989	1.0870
CAN$/€	1.3955	1.4638	1.5229	1.4610	1.4022	1.3763	1.3690	1.3696	1.3846	1.3587
US$/€	1.3536	1.3780	1.3782	1.3691	1.2900	1.2800	1.2800	1.2600	1.2600	1.2500
US$/£	1.6194	1.6563	1.6672	1.7099	1.6400	1.6800	1.7000	1.6900	1.6800	1.6800

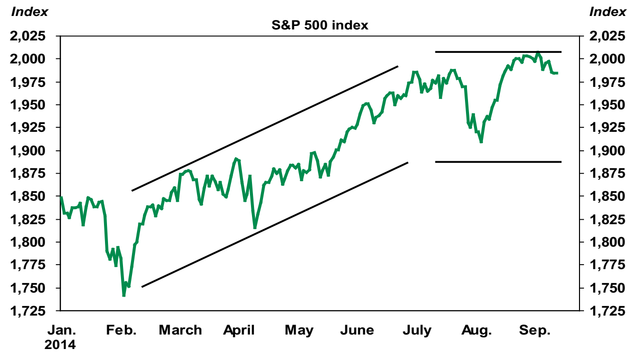
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies f: forecasts

ASSET CLASSES RETURN

Canada's stock market will benefit from the softer dollar

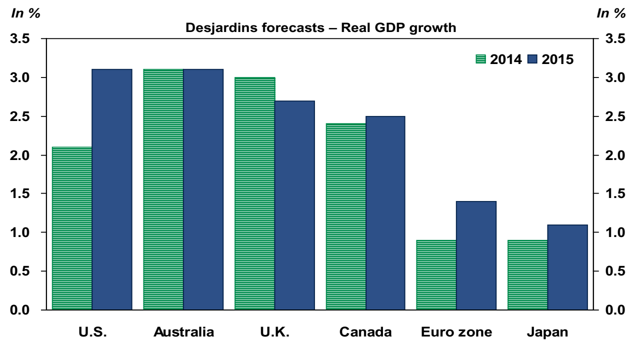
- **Recess seems to be over for North America's stock markets.** The stock indexes' laborious advance since last summer contrasts with the nearly irresistible surge seen in the first half of the year (graph 7). Although the medium-term outlook is generally still favourable for the stock markets, we think a short, near-term correction is possible. First, bond yields seem to want to get back on their long upward pilgrimage after 2013's false start. Higher yields will hurt stock valuations a little. Second, the Federal Reserve (Fed) seems to be a few quarters away from normalizing its monetary policy. Insofar as the central bank's ultra-accommodative policy has stimulated the appetite for risk assets in the last few years, the return to a conventional approach will do away with this stock market support. Thirdly, growth in many parts of the globe is worrisome and lacklustre economies could hurt the profits of some U.S. multinationals. The U.S. economy should still be among the top performers next year, a situation that should help cushion the impact (graph 8).
- **The Canadian stock market could well continue to play catch-up in 2015.** The surge by commodity prices helped the S&P/TSX during the stock market cycle that preceded the crisis (graph 9). However, between the stock market trough in 2009 and the end of 2013, Canadian stocks lagged behind U.S. stocks, primarily because of the supply problems that hurt profitability in the energy sector. Last year's emergence of oil transportation by train continued to help this important component of the S&P/TSX in 2014. Indeed, railway equities themselves are having another great year (graph 10 on page 5), contributing to the industrial sector's solid performance.
- **A weaker dollar and lively U.S. economy since last spring also seem to be boosting major export sectors.** This year's profit acceleration in auto manufacturing has had positive repercussions, particularly for part manufacturer stocks (graph 11 on page 5). We expect the Canadian dollar to fluctuate within a band of US$0.90 to US$0.95 in 2015; this should help exporters continue capitalizing on accelerating economic growth south of the border.

Graph 7 – The U.S. stock market has been treading water since mid-year



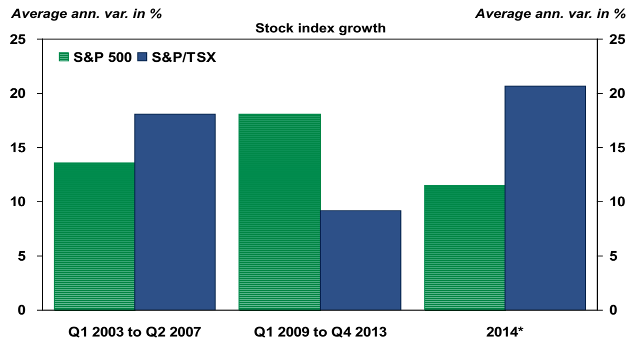
Sources: Bloomberg and Desjardins, Economic Studies

Graph 8 – U.S. growth should be one of the highest among advanced nations in 2015



Sources: Datastream and Desjardins, Economic Studies

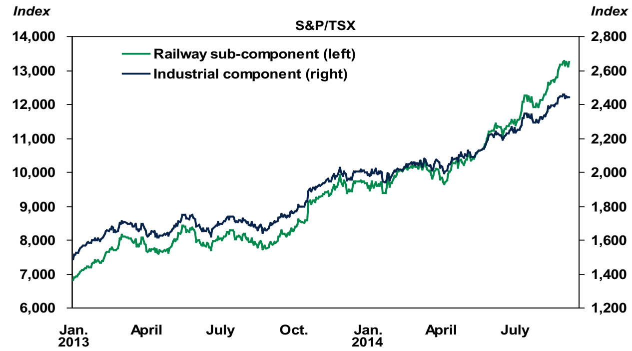
Graph 9 – Canada's stock market catching up after some tough years



* Annualized change from January to mid-September 2014.
Sources: Bloomberg and Desjardins, Economic Studies

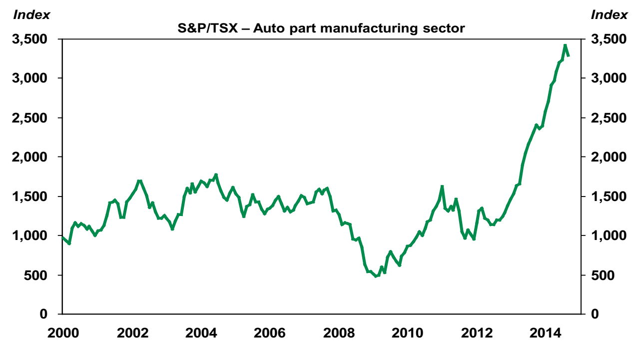
- **The retreat seems to have sounded in the bond market.** 2014's impressive strength is due to a convergence of factors that we're for the most part hard to predict. These include the geopolitical strains that have persisted for much of the year, the emergence of a threat of deflation in the euro zone, and some regulatory constraints that stimulated demand for risk-free assets by financial institutions. Still, some of these factors are temporary. Moreover, Fed leaders are signalling that monetary firming could start around the end of spring 2015. The decision-makers' median projection points to a cumulative policy rate increase of 125 basis points next year. Everything therefore suggests that rates will start a slow but steady rise in the next few months. We thus expect a slightly negative return by the fixed-income class next year.

Graph 10 – The strong advance in railway stocks galvanizes the Canadian equity market's industrial component



Sources: Bloomberg and Desjardins, Economic Studies

Graph 11 – Part manufacturer equities have rarely experienced such rally



Sources: Bloomberg 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: 3.0	target: 1.2 (US$0.93)
range	0.85 to 1.00	1.0 to 6.0	9.0 to 22.0	5.5 to 16.0	-4.0 to 7.0	-1.9 to 8.2
2015f	target: 1.15	target: -2.0	target: 12.0	target: 7.0	target: 8.0	target: 1.1 (US$0.92)
range	0.95 to 1.35	-4.0 to 2.0	6.0 to 18.0	2.0 to 12.0	1.0 to 15.0	-3.1 to 6.9