Retail Rate Forecasts

Desjardins Economic Studies
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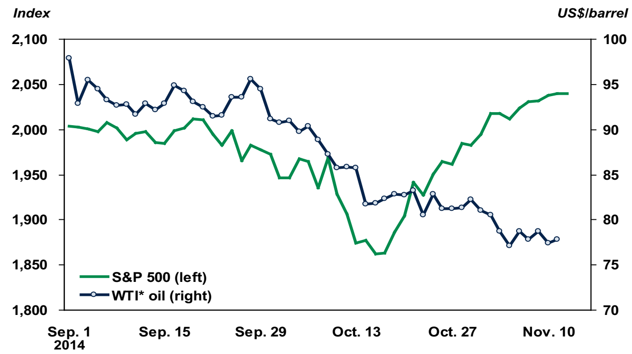
The period of stability for retail rates should continue

HIGHLIGHTS

- The financial markets have been quite volatile in recent weeks.
- Oil and gasoline prices are falling.
- Signals from the U.S. economy remain encouraging.
- The currency market is shaken by the U.S. dollar surge.
- A sad end to the year for the S&P/TSX.

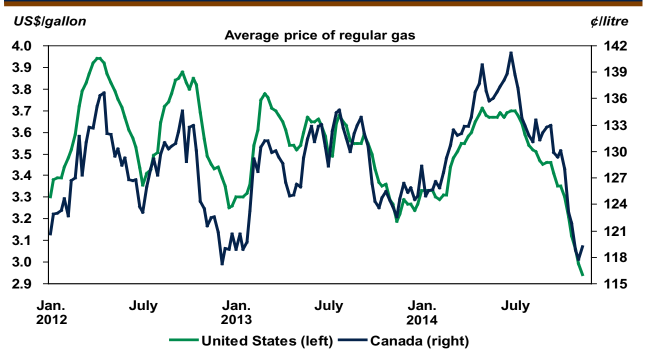
- **October was especially eventful.** Investor skittishness transformed into a true wave of panic on October 9, fuelled by fears of a third recession in the euro zone and Ebola cases in the United States. Stock markets, bond yields and oil prices all plummeted. However, investor confidence recovered almost as quickly as it had fallen, and the S&P 500 index bounced back to hit a new historic peak (graph 1).
- **Oil prices remain weak.** In contrast to the stock markets, oil prices have remained very low, around US$80 per barrel. This reflects soft global demand for crude oil, rapid growth of U.S. production and Saudi Arabia's refusal to act to curb the price drop. Oil prices could climb gradually over the coming months, but everything suggests that they will remain far lower than they have been in the last few years. Falling gasoline prices (graph 2) are excellent news for consumers and the U.S. economy.
- **Robust economic growth in the United States.** The U.S. economy maintained its good momentum in Q3 2014, with real GDP up 3.5%. This solid growth was accompanied by strong gains in the job market. Several factors point to continued good news for the U.S. economy. Despite fears tied to geopolitical issues, Ebola and the fluctuating financial markets, consumer confidence recently improved (graph 3 on page 2), thanks to falling gas prices, among other things.
- **Signals are more mixed in Canada.** After a lively spring in Canada, with real GDP by industry rising 0.5% in May and 0.3% in June, the first two months of the summer posted stagnating growth. International trade continued to improve in the third quarter, though, and signals from the labour market have been much more encouraging in recent months. In this context, the Bank of Canada shouldn't be too concerned with the summer's moderate economic growth.

Graph 1 – The U.S. stock market jumped back quickly, but oil prices remain depressed



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

Graph 2 – Gasoline prices have dropped steeply



Sources: Datastream, Natural Resources Canada and Desjardins, Economic Studies

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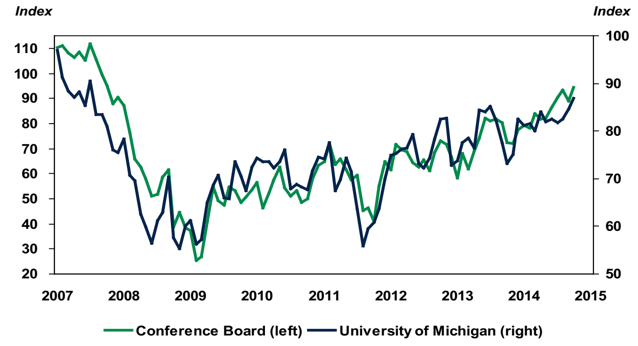
Note to readers: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

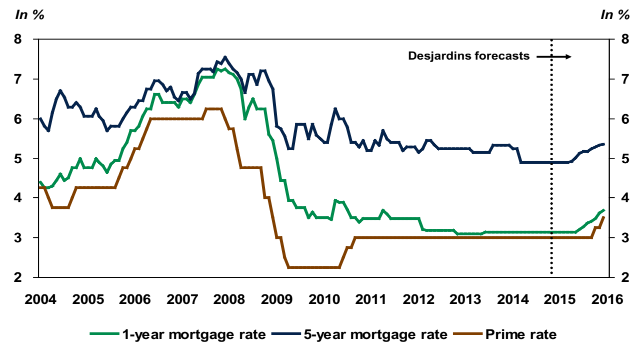
- **The Federal Reserve (Fed) ended its asset purchases.** In light of the solid performances from the U.S. economy and job market, Fed leaders don't seem overly worried about financial market volatility and the downside pressures on inflation resulting from lower gas prices. The Fed therefore ended its third quantitative easing program at its October 29 meeting, and the fairly optimistic tone of its statement still prompts us to call for a gradual increase in its key rates, starting in mid-2015.
- **Retail rates could remain stable for several more months.** October's concerns caused bond yields to drop substantially. They have since edged up, but everything indicates that financing costs of Canadian financial institutions will remain low for some time. We therefore still expect retail rates to remain unchanged until the end of next winter, followed by a gradual rise as North America draws closer to monetary firming (graph 4).

Graph 3 – U.S. consumer confidence improves



Sources: Conference Board, University of Michigan and Desjardins, Economic Studies

Graph 4 – The expected retail rate increase does not yet seem imminent



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								
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
Sept. 2014	1,25	3,00	3,14	3,75	4,89	0,90	1,25	1,75
Oct. 2014	1,25	3,00	3,14	3,75	4,89	0,90	1,25	1,75
Nov. 12, 2014	1,25	3,00	3,14	3,75	4,89	0,90	1,25	1,75
Forecasts								
End of quarter								
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	2.90–3.40	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	3.80–4.30	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	3.15–3.65	4.05–4.55	5.00–5.50	0.80–1.25	1.20–1.70	1.75–2.25
End of year								
2015	1.50–2.00	3.25–3.75	3.45–3.95	4.30–4.80	5.10–5.60	1.00–1.50	1.40–1.90	1.85–2.35
2016	1.75–2.75	3.50–4.50	3.95–4.95	4.80–5.60	5.45–6.25	1.25–2.05	1.75–2.55	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	2.35–3.15

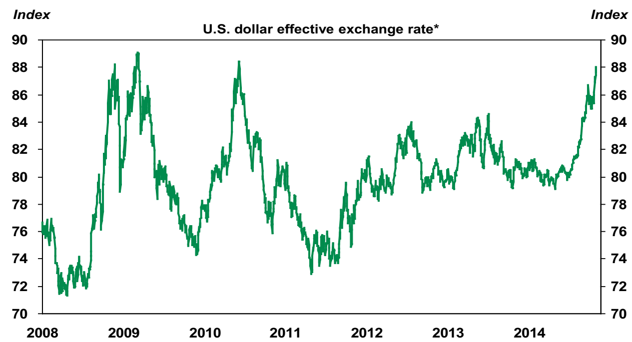
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

The currency market is shaken by the U.S. dollar surge

- The last four months have seen a dramatic comeback by the U.S. dollar (graph 5). The currency was supported by heightened geopolitical and economic tensions, among other things, though movement now seems to be dictated more by the opposite directions taken by major central banks for their monetary policy.
- Recent months have especially shown how influential monetary policy is on changes to the EUR/USD pair. Remember that the euro was worth around US$1.40 at the start of May, and that the downtrend began when the European Central Bank clearly stated its intention to relax its monetary policy in order to combat weak inflation. More recently, the yen suffered a similar fate after the Bank of Japan increased the pace of its asset purchases. During this time, the Federal Reserve ended its own purchases and monetary firming came into sight.
- The Canadian dollar is oscillating below US$0.90 and, on November 5, it hit its lowest point in more than five years, US$0.8724 (C$1.1463/US$). Some of the currency's new weakness is due to the greenback's appreciation, but another important factor has been the drop by oil prices, which largely appeared in early October (graph 6). The Bank of Canada's (BoC) cautious tone and diminished inflationary pressures are also currently unfavourable for the currency.
- **Forecasts:** The Canadian dollar should benefit from easing global uncertainty over the coming months. We remain especially confident about the U.S. economy, which should have ripple effects on the Canadian economy. Oil prices should also climb, helping the loonie return around US$0.90 (C$1.11/US$) in the next few months. The greenback's strength and the caution shown by the BoC will be the main factors limiting the Canadian dollar's gain. The euro should lose more ground, as differences in monetary policy increase over the coming quarters and economic growth remains weak in Europe.

Graph 5 – The U.S. dollar is rising rapidly



* 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 – A recovery by oil prices would be of great help to the Canadian dollar

* West Texas Intermediate.
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	Q3	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0,9700	0,9414	0,9050	0,9372	0,8929	0,8900	0,9100	0,8900	0,9000	0,9200
CAN$/US$	1,0310	1,0623	1,1050	1,0671	1,1199	1,1236	1,0989	1,1236	1,1111	1,0870
CAN$/€	1,3955	1,4638	1,5229	1,4610	1,4147	1,4157	1,3736	1,3820	1,3556	1,3261
US$/€	1,3536	1,3780	1,3782	1,3691	1,2632	1,2600	1,2500	1,2300	1,2200	1,2200
US$/£	1,6194	1,6563	1,6672	1,7099	1,6212	1,6000	1,6300	1,6600	1,6500	1,6500

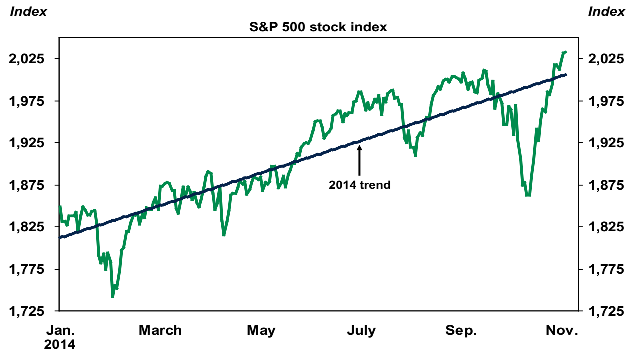
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies f: forecasts

ASSET CLASSES RETURN

A sad end to the year for the S&P/TSX

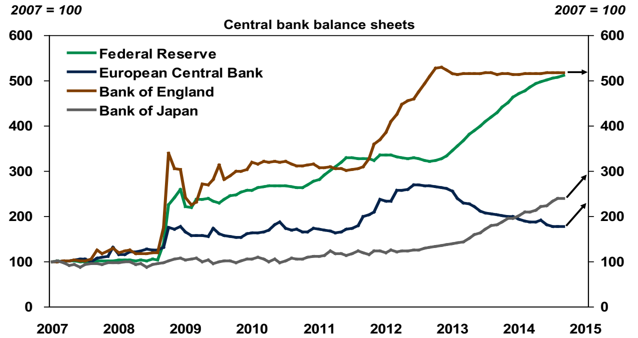
- **Volatility came roaring back in October.** For a long time, we have been saying that the complacency from early in the year could not last forever. In October, a host of events dragged world stock markets down, including disconcerting statistics in Europe, a warning signal from the International Monetary Fund about Europe's risks of entering into recession and the Ebola crisis. However, the climb back was equally dramatic. Not only did the S&P 500 make up the ground lost, but it also returned to its previous trend (graph 7). A good season of results in the United States and the many indicators pointing to a high degree of resiliency in the economy will therefore have allowed indexes to quickly recover from October's upheaval. Despite the scare of October, the spectacular turnaround allows us to continue to expect a return target of 10% for the S&P 500 this year.
- **However, if any message can be gleaned from this, it is that volatility will always resurface. What's more, there's no shortage of uncertainties.** We need look no further than the central banks. Though the Federal Reserve (Fed) has indicated that its extraordinary measures are coming to an end, the European Central Bank and Bank of Japan are both making every effort to stimulate their economies (graph 8). Financial markets have appeared to be more at ease with the idea of a less active Fed, but that might have been a false impression, since other central banks have stepped in with their own extraordinary stimulus measures. In time, when these banks will also come to reduce their degree of intervention, markets could react strongly.
- **In Canada, the year is ending on a rather sour note for the S&P/TSX, forcing us to downgrade our return targets for both 2014 and 2015.** We are now expecting returns of 10% for this year and the next, down from 15% and 12% respectively in our previous scenario. The dramatic slide in oil prices this fall brought the Canadian stock market index down considerably, owing its large energy sector. Added to this are the fears surrounding the global economy and the demand outlook for commodities, which had a significant impact on industrial materials (graph 9). Our macroeconomic scenario still calls for slight acceleration in world growth next year, though downside risks have intensified in the near term. Accordingly, even though we expect West Texas Intermediate (WTI) prices to climb back above US$90 per barrel, this may not happen until next year, when growth in some economies is more solidly grounded. There will likely be lingering concerns about investments and the profitability of Canada's tar sands, and it would not be inappropriate to somewhat moderate expectations for S&P/TSX returns.

Graph 7 – The U.S. stock market did not deviate from its trend for very long



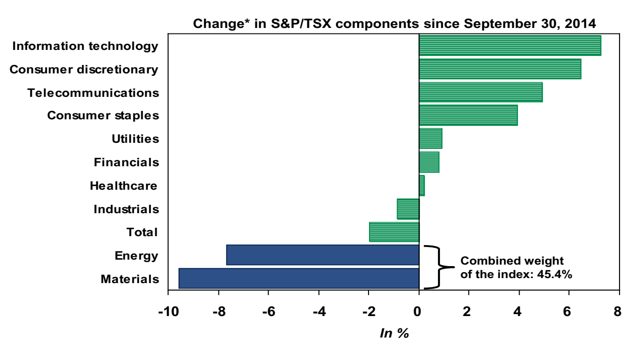
Sources: Bloomberg and Desjardins, Economic Studies

Graph 8 – The central banks with less inflated balance sheets will step in



Sources: Bloomberg and Desjardins, Economic Studies

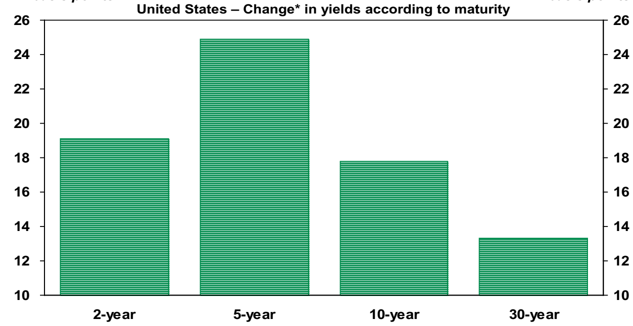
Graph 9 – The S&P/TSX index is being dragged down by commodity heavyweights



* On November 7, 2014.
Sources: Bloomberg and Desjardins, Economic Studies

- **Bond markets thumbed their noses at the Fed's reduced monthly asset purchases in 2014, but we do not expect a repeat of these antics next year.** FOMC leaders seem increasingly confident in the job market's recovery with every meeting, while continuing to imply that financial markets are incorrectly calibrating the trajectory of policy rates. It must be noted that U.S. short-term yields are gradually beginning to adapt to this reality, but this has yet to translate properly to longer maturities (graph 10). Recently, the sharp drop in inflation expectations has added additional negative pressure to yields. For now, falling energy prices and anaemic wage growth are helping to keep inflation expectations at their lowest point since 2011 (graph 11). However, if the jobless rate continues to fall and hiring intentions remain strong, thus resulting in more concrete signs of wage inflation, yields could turn around more suddenly. We continue to expect a negative return for the fixed income asset class.

Graph 10 – A slower rise in long-term yields



* Since October 15, 2014.
Sources: Bloomberg and Desjardins, Economic Studies

Graph 11 – Inflation expectations are now where they were following the 2011 U.S. downgrade

* Determined using futures on Treasury inflation-indexed securities.
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: 0.90	target: 5.0	target: 10.0	target: 10.0	target: 0.0	target: 5.8 (US$0.89)
range	0.85 to 0.95	3.0 to 7.0	5.0 to 15.0	6.0 to 15.0	-6.0 to 4.0	2.3 to 10.7
2015f	target: 1.15	target: -3.0	target: 10.0	target: 7.0	target: 8.0	target: -3.3 (US$0.92)
range	0.95 to 1.35	-6.0 to 0.0	5.0 to 15.0	2.0 to 12.0	1.0 to 15.0	-5.3 to 1.1

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