Retail Rate Forecasts

Desjardins Economic Studies
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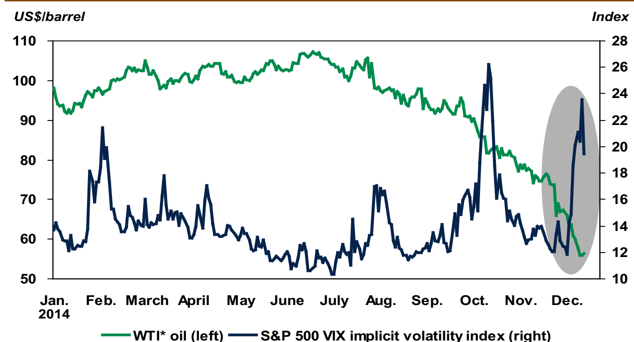
The year is ending on a better note for the economy than the financial markets

HIGHLIGHTS

- Oil and gasoline prices continue to drop.
- Economic growth in North America has been strong lately.
- Interest rates will remain relatively low in 2015.
- The drop in oil prices is hurting the Canadian dollar.
- The U.S. stock market could continue to perform well.

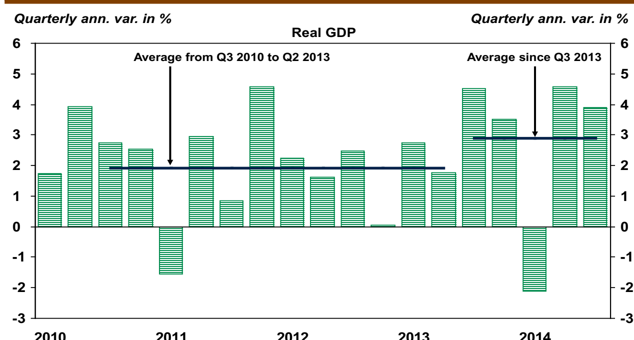
- **Oil prices continue to collapse.** The drop in oil prices accelerated in late November, after the Organization of the Petroleum Exporting Countries decided not to reduce its production quotas. Initially, this decrease largely hurt companies working in the energy sector, but it has recently begun to play against all risk assets, as investors seem increasingly worried about the correction's consequences for financial stability, especially in Russia (graph 1).
- **The U.S. economy is impressive.** Recent market volatility somewhat overshadowed the very positive signals coming from the U.S. economy, which finally seems to have returned to lively and lasting growth (graph 2). Employment figures also continue to beat expectations with, among other things, 321,000 jobs added in November. The uptrend in household confidence and the solid ISM indexes signal that these good economic results should continue, especially since lower oil and gas prices will give the U.S. economy another considerable boost.
- **Growth was also lively in Canada.** Real GDP growth substantially beat expectations in the third quarter, with a gain of 2.8% (graph 3 on page 2). Not only have exports continued to rise, but more positive signs were also seen in non-residential investment. What's more, household consumption spending remains lively, bolstered by rising auto sales, sustained growth in wages and employment, and fairly good confidence.
- **No rush to raise key rates in Canada.** With the upward revisions to economic growth for the last few years and the fairly rapid growth in recent quarters, everything suggests that Canada's surplus production capacity has been almost completely absorbed. Unemployment rate and industrial capacity utilization rate also indicates that Canada's

Graph 1 – The spectacular fall in oil prices worries investors



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

Graph 2 – The U.S. economy is clearly improving



Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

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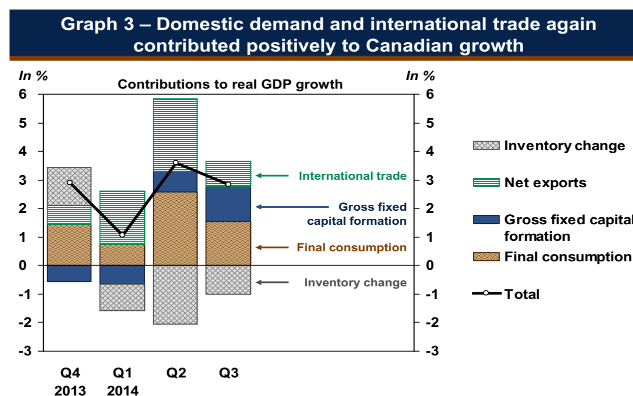
economy is operating close to full tilt. Usually, the Bank of Canada would soon be raising its key rates, especially since household debt remains a concern. However, the significant uncertainty surrounding the drop in oil prices will prompt it to wait for several more months before starting monetary tightening.

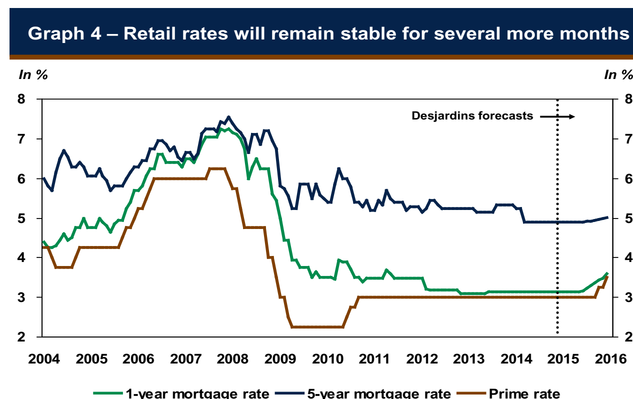
- **The oil correction is bringing bond yields down.** At first, the drop in oil and gas prices helped bonds by making investors downgrade their inflation expectations. Recently, yields have begun falling at a faster pace, as worried investors seek refuge in federal bonds.
- **Retail rates will remain very low in 2015.** Despite the slide in bond yields, retail rates have been steady over the last few months. This stability should continue for a good part of 2015 (graph 4), even though bond yields may climb gradually next year, as the Federal Reserve should begin to raise its key rates in mid-2015.

Graph 3 – Domestic demand and international trade again contributed positively to Canadian growth



Sources: Statistics Canada and Desjardins, Economic Studies

Graph 4 – Retail rates will remain stable for several more months



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								
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. 2014	1.25	3.00	3.14	3.75	4.89	0.90	1.25	1.75
Dec. 17, 2014	1.25	3.00	3.14	3.75	4.89	0.90	1.25	1.75
Forecasts								
End of quarter								
2014: Q4	1.25	3.00	3.04–3.24	3.60–3.90	4.74–5.04	0.80–1.10	1.15–1.35	1.65–1.85
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	2.90–3.40	3.65–4.15	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	3.15–3.65	3.85–4.35	4.70–5.20	0.80–1.25	1.00–1.50	1.50–2.00
End of year								
2015	1.50–2.00	3.25–3.75	3.35–3.85	4.00–4.50	4.75–5.25	0.90–1.40	1.10–1.60	1.55–2.05
2016	1.75–2.75	3.50–4.50	3.65–4.45	4.20–5.00	4.85–5.65	1.05–1.85	1.20–2.00	1.60–2.40
2017	2.50–3.50	4.25–5.25	4.55–5.35	5.05–5.85	5.50–6.30	1.40–2.20	2.00–2.80	2.20–3.00

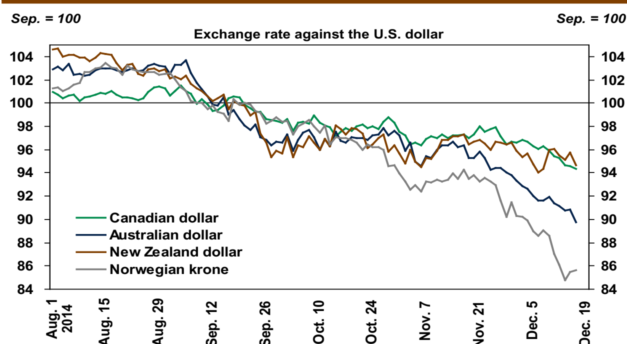
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

The Canadian dollar is hurt by lower oil prices

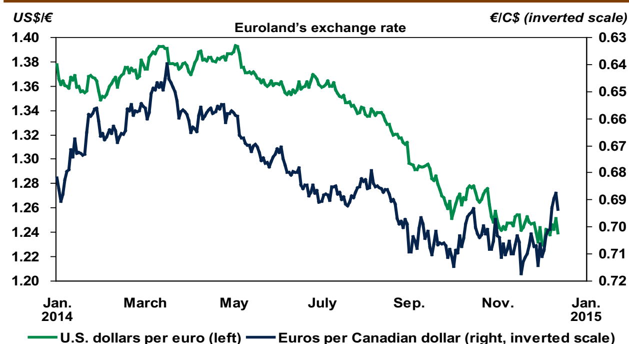
- The steep drop in oil prices has had its share of impact on currencies, including the Canadian dollar, which recently hit its lowest point in over five years, US$0.8568. However, the loonie is doing better than other commodity currencies (graph 5). The accumulation of encouraging statistics on Canada's economy seems to be giving the currency some support, limiting the depreciation caused by the drop in oil prices. Moreover, the Bank of Canada (BoC) has changed its tone, acknowledging the recent advances by the Canadian economy, which is likely also helping to curb the loonie's losses.
- The U.S. dollar's appreciation has slowed in November. One of the major supports to the greenback since this summer was the increased expectations of monetary tightening. However, these have been influenced by the lower oil prices, which decreased inflation expectations. That said, the good economic data coming from the United States continue to help the U.S. currency.
- The euro has benefited from the U.S. dollar's loss of momentum. The European currency, which went below US$1.23 in early December, temporarily reached US$1.25 more recently. The fact that the European Central Bank decided to once again postpone announcing more aggressive monetary easing measures is also weighing in the balance. The euro posted a more remarkable rebound against the Canadian dollar. It now takes about €0.69 to buy a Canadian dollar (graph 6).
- **Forecasts:** The Canadian dollar should benefit from easing global uncertainties in the coming quarters. We remain particularly confident about the U.S. economy, which should generate ripple effects for Canada. All the same, weak oil prices will keep the loonie below US$0.90 for several more quarters. The U.S. dollar should remain strong through 2015, but this should have less of an effect on the Canadian dollar, especially if the BoC follows in the Federal Reserve's footsteps for monetary tightening.

Graph 5 – The Canadian dollar is not down as much as other commodity currencies



Sources: Datastream and Desjardins, Economic Studies

Graph 6 – The Canadian dollar erased its gains against the euro from recent months



Sources: Datastream and Desjardins, Economic Studies

Determinants	Short-term	Long-term
Oil prices	↗	↗
Metals prices	↗	↗
Inflation and Bank of Canada	↘	↗

Table 2
Forecasts: currency

	2014		2015				2016			
End of period	Q3	Q4f	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0.8929	0.8650	0.8600	0.8700	0.8800	0.8900	0.9000	0.9050	0.9100	0.9050
CAN$/US$	1.1199	1.1561	1.1628	1.1494	1.1364	1.1236	1.1111	1.1050	1.0989	1.1050
CAN$/€	1.4147	1.4335	1.4186	1.3793	1.3523	1.3258	1.2889	1.2707	1.2418	1.2376
US$/€	1.2632	1.2400	1.2200	1.2000	1.1900	1.1800	1.1600	1.1500	1.1300	1.1200
US$/£	1.6212	1.5700	1.5800	1.5900	1.6000	1.6200	1.6300	1.6100	1.6000	1.6000

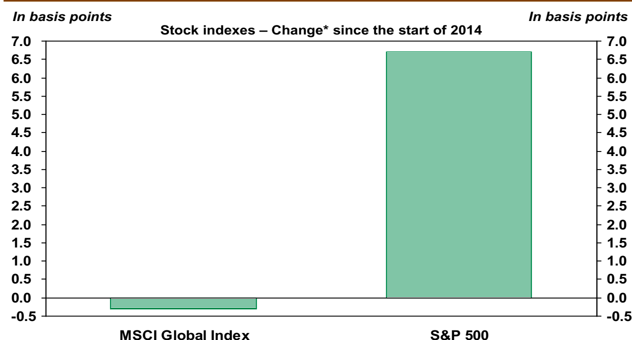
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies f: forecasts

ASSET CLASSES RETURN

The "Great Decoupling" should continue in 2015

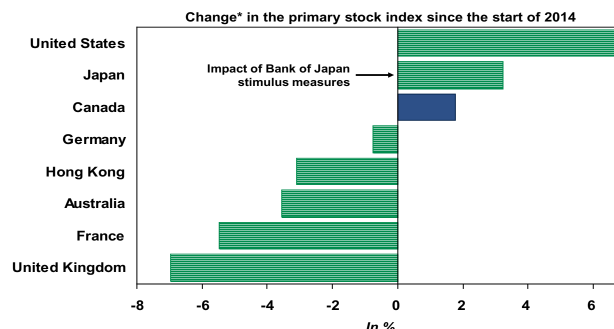
- **The U.S. market is looking more and more like a lone wolf.** The S&P 500 is en route to end the year with returns of 10%, in line with our target. However, from a global standpoint, this is the exception, rather than the norm. As of December 17, the MSCI global index was down 0.3% on the year (graph 7). Considering that U.S. equity accounts for 58% of this index, we have a good idea of the situation prevailing on the other stock markets. The main stock indexes of the United Kingdom, France, Germany, Italy, Hong Kong and Australia are all poised to post contractions for the year. The S&P/TSX index has seen its year-to-date gain melt to less than 2% (graph 8).
- **The spectacular divergence in 2014 could continue to influence the markets in 2015.** Europe is flirting with deflation, and falling oil prices are only worsening the de-anchoring of inflation expectations, central banks' *bête noire*. In Japan, the return to recession for the fourth time since 2008 illustrates the difficulties that will continue to plague Japan's authorities in dealing with structural headwinds. After 2014, a year with zero returns on international equities, we expect gains of just 8% next year. Early 2015 should still be a struggle. The possible start of a bond purchasing program in the euro zone could steer European investors into the stock markets, as happened in the United States, but such a movement would need a green light from the macro environment, which could be some time in coming. In time, the soft euro and yen (graph 9) could positively impact profitability for exporters in the euro zone and Japan, and provide considerable support for a stock market recovery in these regions.
- **We continue to expect the U.S. stock market to return 10% (including dividends) next year.** Besides the volatility currently affecting the stock markets, U.S. economic fundamentals remain quite solid. Lower energy input costs should foster profitability in the manufacturing sector, while the stimulus provided by lower gas prices to U.S. consumption should boost the consumer staples and discretionary spending sectors. As for the S&P/TSX, we cannot overlook the weakness in the energy sector, which accounts for 20% of the Canadian stock index (graph 10 on page 5). All the same, as in the United States, several sectors will profit from lower oil prices. This will combine with the benefits the weaker dollar offers to export sectors. Overall, the economic impact of recent trends is uncertain, given how important oil extraction activity is to some provincial economies. The Canadian stock market should therefore lag behind the U.S. stock market, with returns of 7.5% (including dividends). Improvements to international economic conditions in the second half of 2015 could allow the S&P/TSX to gain a bit of momentum in that timeframe.

Graph 7 – The U.S. stock market stood out in 2014



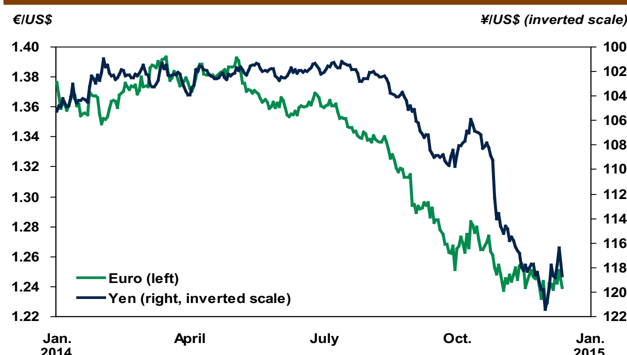
* At December 17, 2014.
Sources: Bloomberg and Desjardins, Economic Studies

Graph 8 – Stock markets with strong gains were few and far between



* At December 17, 2014.
Sources: Bloomberg and Desjardins, Economic Studies

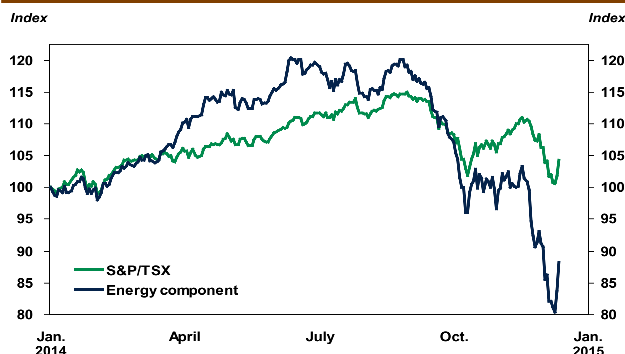
Graph 9 – Depreciated currencies will provide considerable support for exports



Sources: Bloomberg and Desjardins, Economic Studies

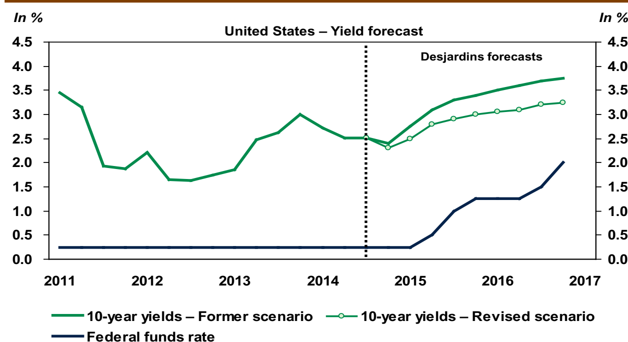
- **Bonds are still expected to post negative returns.** The -1.2% return for the bond index in 2013 seemed to be the prelude to negative returns for this expensive asset class. Instead, the index is on its way to posting a baffling return of 7.5% for 2014. With the collapse in oil prices, this is beyond the shadow of a doubt the biggest surprise of the year. We are still maintaining our target at -3.0% for 2015. In other words, 2014's better-than-expected performance is not synonymous with a sharper reversal in 2015 in our baseline scenario. We recently downgraded our targets for bond yields in 2015 (graph 11), as long-term bonds could very well react atypically to the start of monetary tightening in the United States in 2015. The Bank of Japan, and quite possibly the European Central Bank, will take over for the Federal Reserve in terms of quantitative easing policy, which could increase the relative appeal of North American bonds and slow the climb in yields accordingly.

Graph 10 – Energy has spoiled the fun for Canada's stock market since this summer



Sources: Bloomberg and Desjardins, Economic Studies

Graph 11 – The climb in long-term yields will probably be slow, despite monetary tightening



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: 7.5	target: 7.5	target: 12.5	target: -4.0	target: 8.8 (US$0.865)
range	0.85 to 0.95	5.0 to 10.0	2.5 to 11.0	8.0 to 15.0	-10.0 to 0.0	7.0 to 10.7
2015f	target: 1.10	target: -3.0	target: 7.5	target: 10.0	target: 8.0	target: -2.8 (US$0.890)
range	0.90 to 1.30	-6.0 to 0.0	2.0 to 13.0	5.0 to 14.0	1.0 to 15.0	-4.9 to 3.0

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