Retail Rate Forecasts

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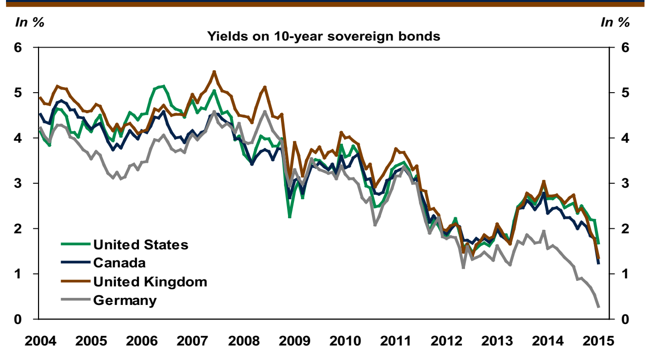
The surprise key rate cut takes retail rates down

HIGHLIGHTS

- A fairly negative climate shrouded the beginning of 2015, fostering additional interest rate decreases.
- U.S. consumers benefit from dropping gas prices.
- Canadian key rates have been lowered.
- Central banks generated a lot of currency volatility.
- The greenback’s rise worries the U.S. stock markets.

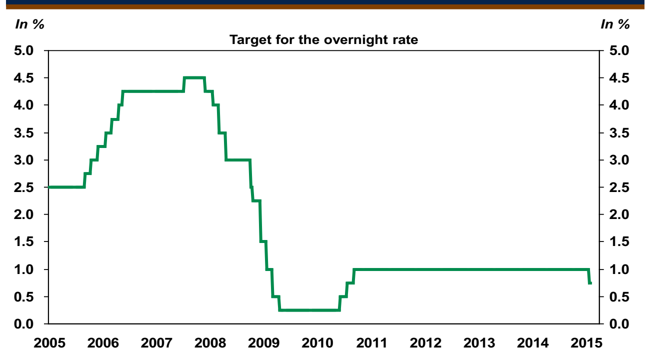
- **Numerous concerns at the start of 2015.** The markets got the year off to a poor start. Rather than seeing the additional slide in oil prices as a good thing, investors read this development as a sign of weakness in the global economy. Another political crisis in Greece, which led to an anti-austerity government being elected, also fuelled negative sentiment in the markets.
- **The European Central Bank (ECB) will buy sovereign bonds.** With collapsing oil prices taking Euroland’s inflation rate into negative territory, in January, the ECB announced a massive sovereign security purchasing program. This intensified the downside pressure on bond yields around the world (graph 1).
- **Surprise cut to Canada’s key rates.** Deeming that an immediate response to the spectacular plunge in oil prices was needed, the Bank of Canada (BoC) lowered its key rates by 0.25% on January 21 (graph 2). The BoC’s official economic outlooks remain relatively positive, but the action was presented as insurance for preventing further erosion in the Canadian situation. Unless oil prices come back quickly, another 0.25% cut is very likely in early March.
- **The U.S. economy still stands out.** While concern is in order in most countries and several central banks are finding it necessary to ease their monetary policies, the situation in the United States is very different. After two spectacular quarters, U.S. real GDP growth slowed in Q4 2014, but household consumption posted its best growth since 2006 (graph 3). Consumer confidence has spiked in response to the tumble in gas prices and the job market’s solid performance, which augurs well for the coming quarters.

Graph 1 – New substantial, generalized decline in bond yields



Sources: Datastream and Desjardins, Economic Studies

Graph 2 – First change to key interest rates in more than four years



Sources: Bank of 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

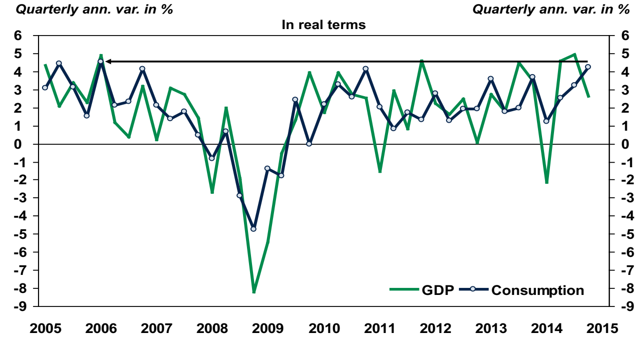
Mathieu D’Anjou
Senior Economist

Jimmy Jean
Senior Economist

Hendrix Vachon
Senior Economist

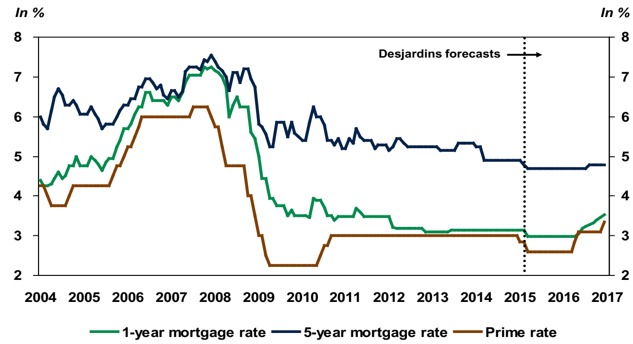
- **The drop in oil prices will impact Canada's provinces unevenly.** In the oil-producing provinces, the fallout is already becoming visible. The big question is whether the positive effects in the rest of the country of lower energy costs, a lower loonie, and a stronger U.S. economy will be enough to offset the hit. Canada's real GDP should go up about 2.0% this year overall. However, there is a sizable risk that the slowdown will be sharper, which is why the BoC acted so promptly.
- **Retail rates are down.** After several months of stability, Canadian retail rates fell subsequent to the BoC move. Several posted rates are now at historic lows. However, prospective borrowers must be aware that rates this low are partially due to a weaker economic environment.
- **The very low interest rate environment could persist.** Retail rates could retreat somewhat in the next few months, especially if the BoC lowers its key rates again. After that, retail rates should be stable for several quarters (graph 4).

Graph 3 – Real GDP slowed in the United States, but consumption growth is strongest since 2006



Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

Graph 4 – All signs point to retail rates remaining very low for several quarters



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								
Aug. 2014	1.25	3.00	3.14	3.75	4.89	0.90	1.25	1.75
Sep. 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. 2014	1.25	3.00	3.14	3.75	4.89	0.90	1.25	1.75
Jan. 2015	1.00	2.85	3.14	3.75	4.89	1.00	1.25	1.65
Feb. 4, 2015	1.00	2.85	3.14	3.75	4.79	1.00	1.10	1.50
Forecasts								
End of quarter								
2015: Q1	0.75–1.00	2.60–2.85	2.74–3.14	3.30–3.75	4.45–4.79	0.55–1.05	0.85–1.20	1.25–1.60
2015: Q2	0.50–1.00	2.35–2.85	2.74–3.24	3.30–3.80	4.45–5.10	0.55–1.05	0.85–1.35	1.25–1.75
2015: Q3	0.50–1.00	2.35–2.85	2.74–3.24	3.30–3.80	4.45–5.10	0.55–1.05	0.85–1.35	1.25–1.75
2015: Q4	0.50–1.00	2.35–2.85	2.74–3.24	3.30–3.80	4.45–5.10	0.55–1.05	0.85–1.35	1.25–1.75
End of year								
2016	1.00–2.00	2.85–3.85	3.10–3.90	3.65–4.45	4.45–5.20	0.55–1.20	0.85–1.50	1.25–1.90
2017	1.75–2.75	3.60–4.60	3.80–4.60	4.35–5.15	4.90–5.70	0.75–1.65	1.30–2.10	1.65–2.45
2018	2.50–3.50	4.35–5.35	4.40–5.20	4.80–5.60	5.25–6.05	1.20–2.00	1.75–2.55	1.95–2.75

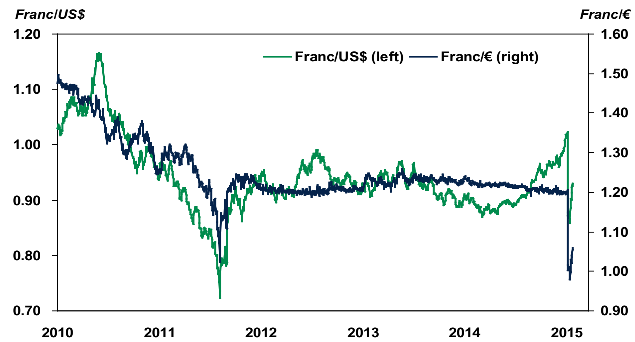
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

The central banks generated a lot of currency volatility

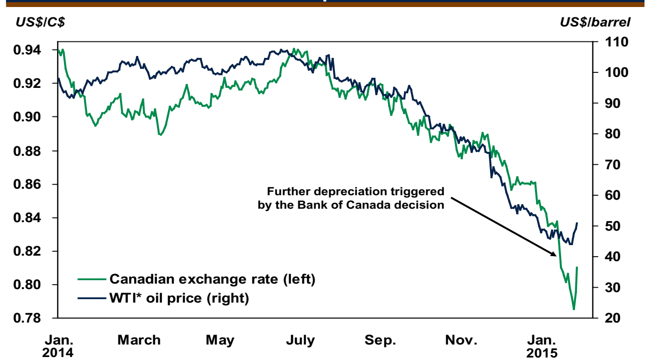
- January was packed with upheaval pertaining to the central banks, which contributed its share of volatility to several currencies. The Swiss National Bank started things off with a surprise move to abandon its 1.20 franc/€ floor, which made the Swiss franc shoot up (graph 5). The next surprise came from the Bank of Canada, with its key rate cut. The loonie lost a little more than ¢2 on the announcement, and continued to trend down in the following days. The European Central Bank (ECB) also contributed to the volatility by increasing its monetary stimulus through the purchase of sovereign bonds. Although the ECB decision had been partially priced in, it still pushed the euro down to nearly US$1.10, a low that dates back more than ten years. The trough also coincided with the election of an anti-austerity government in Greece.
- Given the many weak currencies, the U.S. dollar continued to look good in January, but has been reversing since the start of February. Fundamentally, the U.S. dollar still has an edge due to expectations regarding future U.S. monetary firming, but some disappointments with U.S. data moderated those expectations. On the other side, the euro recently got a boost from slightly more encouraging indicators and the feeling that an agreement could be reached with Greece's new government. The Canadian dollar has been busy, too. Oil prices recently rose above US$50/barrel, taking the loonie above US$0.80 (graph 6).
- **Forecasts:** The Canadian dollar could lose some ground in the near term, on expectations of additional Canadian interest rate cuts, as well as potential backsliding by oil. Over the longer term, however, the loonie should rise in tandem with a more lasting upswing in crude prices and an improved Canadian economy. The euro will have a harder time going up given the ECB's highly expansive monetary policy and the many ongoing challenges in Europe.

Graph 5 – The Swiss franc shoots up after the 1.20 franc/€ floor rate is abandoned



Sources: Datastream and Desjardins, Economic Studies

Graph 6 – The Canadian dollar will be sensitive to any upswing in oil prices



* 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

	2014		2015				2016			
End of period	Q3	Q4	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0.8929	0.8605	0.7900	0.8000	0.8000	0.8200	0.8300	0.8500	0.8600	0.8800
CAN$/US$	1.1199	1.1621	1.2658	1.2500	1.2500	1.2195	1.2048	1.1765	1.1628	1.1364
CAN$/€	1.4147	1.4061	1.4304	1.4375	1.4000	1.3415	1.3494	1.3647	1.3140	1.2727
US$/€	1.2632	1.2101	1.1300	1.1500	1.1200	1.1000	1.1200	1.1600	1.1300	1.1200
US$/£	1.6212	1.5593	1.5200	1.5400	1.5400	1.5600	1.5800	1.6000	1.5800	1.5700

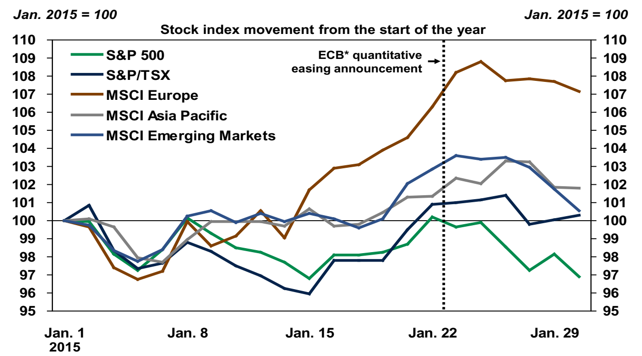
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies f: forecasts

ASSET CLASSES RETURN

The greenback's rise worries U.S. stock markets

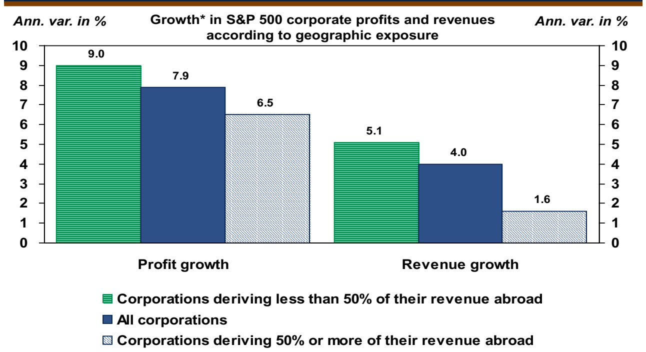
- **Events have unfolded very quickly at the start of 2015.** The spectacular plunge in oil prices is taking global inflation indexes down sharply, while fragile growth in many countries prompts central banks to react: in January, central banks in a dozen countries took monetary stimulus action. However, rates have to come down further to inject some life into the markets. Only the European Central Bank's quantitative easing seems to have managed to get a substantial positive response (graph 7). As was the case in the United States, euro zone sovereign bond purchases are steering private investors toward risk assets. The weak euro and first promising signs for manufacturing activity and exports are nonetheless giving some fundamental support as well to European stock markets.
- **The Federal Reserve does not intend to stray from its plan to start normalizing its monetary policy this year.** As a result, the Great Divergence continues, leading the U.S. dollar to appreciate. The trade-weighted U.S. dollar index hit its highest level in nearly 12 years; its annual change is the largest recorded since 2009. This situation is introducing its share of concern about the profits of S&P 500 multinationals. In Q3 of 2014, companies that derived the bulk of their revenue abroad underperformed in terms of both revenue and profits (graph 8). The Q4 reporting season indicates that the trend continued: multinationals like Pfizer, Procter & Gamble, Microsoft and Apple stressed that the dollar's appreciation had substantially curbed revenue growth. Analysts downgraded their expectations for S&P 500 earnings per share, especially for 2015 (graph 9), partially to factor in the impact of a stronger dollar.
- **We have trimmed 2015's target return for the S&P 500 to 8%.** The dollar's appreciation and eventual policy rate increases in the United States are factors that could hurt profits and valuations. The fact remains that the U.S. economy is seeing its best days since the last recession. The low jobless rate and sustained hiring should result in a rise in wages, while we estimate that lower gas prices will liberate nearly US$900 per household in 2015, much of which will be spent.

Graph 7 – European stock markets welcome the ECB's* aggressive moves



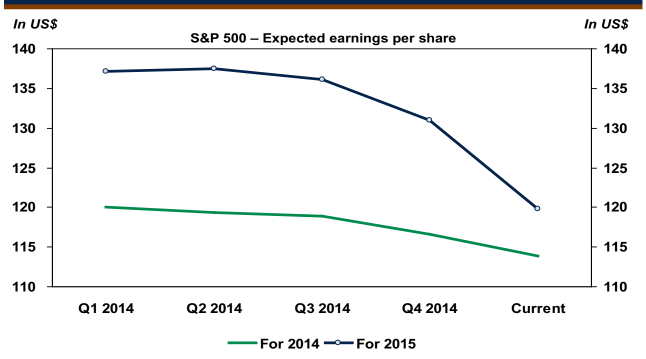
* European Central Bank .
Sources: Bloomberg and Desjardins, Economic Studies

Graph 8 – Businesses that generate much of their revenue abroad did not do as well



* In Q3 2014.
Sources: FactSet and Desjardins, Economic Studies

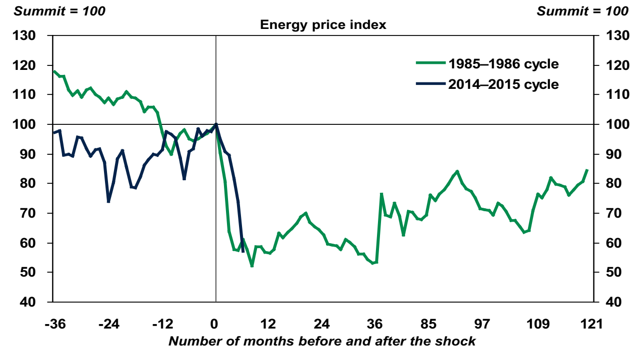
Graph 9 – Analysts are still trimming their earnings forecasts



Sources: Standard & Poor's and Desjardins, Economic Studies

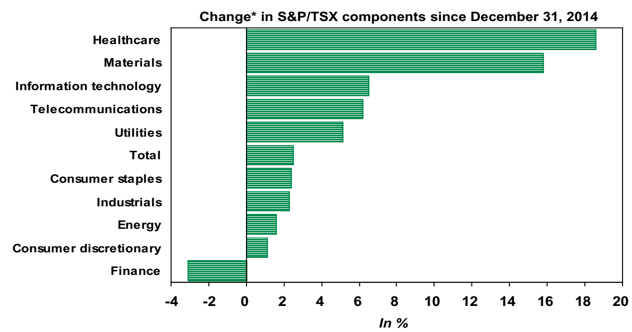
- **Our return target for Canada's stock market stays at 6%.** The wind of negativity surrounding Canada's economy is particularly strong at the moment. In this context, the fact that the S&P/TSX is not experiencing a catastrophe can be seen as good news. The energy price shock is reminiscent of the 1985–1986 shock (graph 10), which, among other things, had put Alberta into recession. At this point, it seems that the bad news has largely been priced in. After dropping 7.8% in 2014, the energy component is up slightly since the start of the year. For now, major gains in health care and materials are helping the Canadian stock market keep its head above the water (graph 11). We expect oil prices to start to move up more convincingly as of mid-year, which could give energy stocks a boost. Weaker energy expenditures than in recent years, a dollar that is down sharply and firm U.S. growth will all be positive factors for profitability in the export-oriented sectors.
- **We now think that bonds will post positive returns in 2015.** The Bank of Canada's (BoC) surprise rate cut provoked a stir in the Canadian bond market. January's 73 basis point drop in the 5-year yield is unmatched aside from the 75 point drop recorded in December 2008, at the heart of the financial crisis. In our opinion, the BoC will lower its key rates again in March, to try to mitigate, for better or worse, the macroeconomic impact of the swift decline in oil prices. The overnight rate should stay at 0.50% until the second quarter of 2016. U.S. monetary firming, which is to kick off at the end of next summer, should take longer-term bond yields up slightly. Nonetheless, the year will end with a return of 2.0% for the Canada Universe Bond Index.

Graph 10 – In Canada, the energy price shock is similar to the shock of 1985–1986



Sources: Bank of Canada and Desjardins, Economic Studies

Graph 11 – Large gains in a range of sectors are compensating for the problems in finance



* As of February 5, 2015.
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 %)***
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
2014	0.91	8.8	10.6	13.7	-4.5	9.4
2015f	target: 0.45	target: 2.0	target: 6.0	target: 8.0	target: 7.0	target: 4.9 (US$0.82)
range	0.30 to 0.65	-1.0 to 6.0	0.0 to 12.0	4.0 to 14.0	1.0 to 15.0	2.4 to 10.3

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