Retail Rate Forecasts
Desjardins Economic Studies
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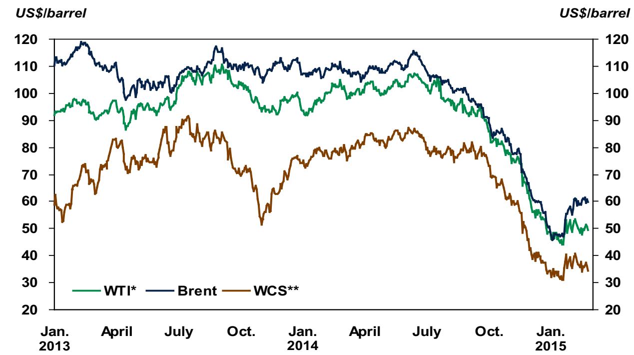
Markets remain volatile

HIGHLIGHTS

- Following January's dip, the stock markets and bond yields went up in February.
- The Bank of Canada now seems happy with where its key rates are.
- Retail rates should stay close to current levels.
- The Canadian dollar stabilizes in tandem with oil prices.
- The situation for the stock markets grows more complex, again!

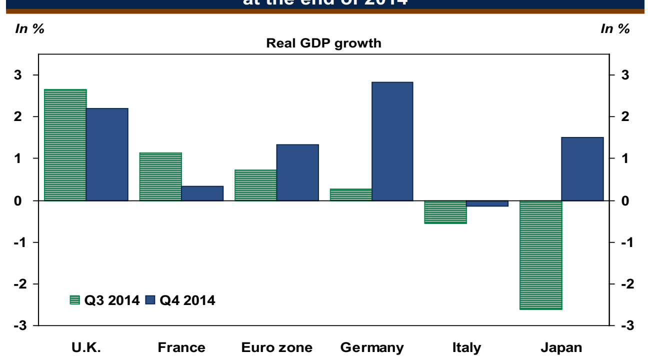
- **Investors seem a little more confident.** After a tough January, marked by another drop in oil prices, interest rates and the stock markets, the situation calmed down somewhat in February. Some stabilization in oil prices (graph 1) and an agreement to keep the new Greek government from defaulting helped boost investor optimism. Several stock indexes recently hit new historic peaks. However, the increased likelihood that the Federal Reserve will initiate monetary firming this summer created a lot of volatility in the markets in March.
- **Some hopes for Japan and the euro zone.** Some more encouraging economic news also helped soothe investors. Following the weakness in mid-2014, the Japanese and euro zone economies saw better growth in the fourth quarter (graph 2). The aggressive measures instituted by the Bank of Japan and European Central Bank, low yen and euro, and weak oil prices should allow the two economies to accelerate a bit in 2015.
- **Canada's economy had a good 2014, but 2015 is promising to be tougher.** Canada's real GDP advanced a quarterly annualized 2.4% in the fourth quarter of 2014. This, combined with an upgrade to the previous quarters, means Canada's economy expanded 2.5% in 2014, putting it in second place behind the United Kingdom among G7 nations. However, Q4's figures show the first signs of the adverse impact of the drop in oil prices, as non-residential investment retreated. These effects will intensify and will substantially curb growth in the coming quarters (graph 3 on page 2).

Graph 1 – After a spectacular plunge, oil prices have stabilized



* West Texas Intermediate; ** Western Canada Select.
Sources: Datastream, Bloomberg and Desjardins, Economic Studies

Graph 2 – Better economic growth in the euro zone and Japan at the end of 2014



Sources: Office for National Statistics, Bureau of Economic Analysis, Eurostat, Cabinet Office and Desjardins, Economic Studies

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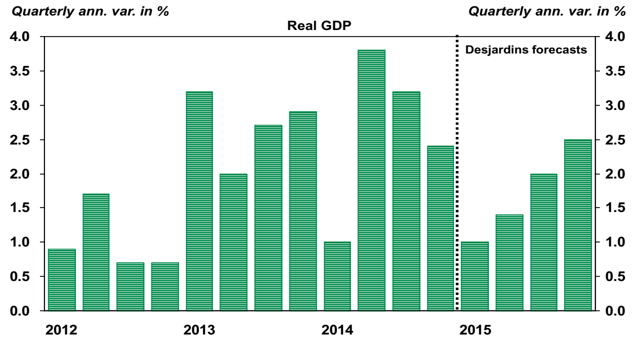
Note to readers: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

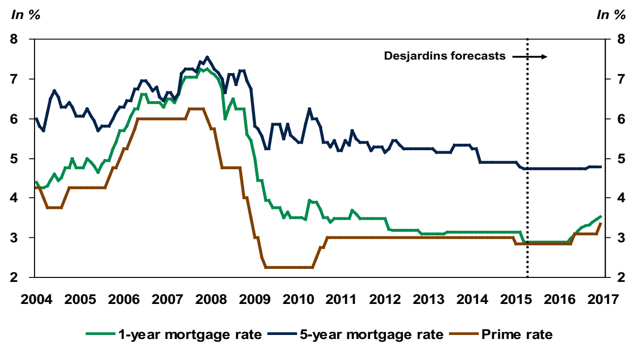
- **The Bank of Canada (BoC) seems to have wrapped up its monetary easing already.** The BoC opted for the status quo in March, deeming that financial conditions had eased enough as a result of January's surprise rate cut to help the Canadian economy through the problems associated with the collapse in oil prices. The most likely scenario now seems to be a target for the overnight rate of 0.75% for several quarters. However, we cannot rule out the possibility of another rate cut in the coming months if Canada's economy slows more than anticipated or oil prices start to slide again.
- **Bond yields rise.** The BoC's status quo and upswing in U.S. bond yields have taken Canadian bond yields higher in the last few weeks. Still, they remain very low historically speaking and the potential for a further rise in the near term seems limited.
- **Retail rates should be stable in the coming months.** Canada's financial institutions lowered their retail rates substantially after January's surprise key rate cut. Like Canadian key rates, the retail rates should stay close to where they are for several months, then start to rise slowly in 2016 (graph 4).

Graph 3 – The drop in oil prices will impact Canada's economic growth



Sources: Statistics Canada and Desjardins, Economic Studies

Graph 4 – Retail rates should not move much for several 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								
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. 2015	1.00	2.85	3.14	3.75	4.79	0.90	1.10	1.50
Mar. 12, 2015	1.00	2.85	2.89	3.39	4.74	0.85	1.10	1.50
Forecasts								
End of quarter								
2015: Q1	1.00	2.85	2.79–2.99	3.29–3.49	4.64–4.84	0.75–0.95	1.00–1.20	1.40–1.60
2015: Q2	0.75–1.00	2.60–2.85	2.64–3.14	3.14–3.64	4.49–4.99	0.60–1.10	0.85–1.35	1.25–1.75
2015: Q3	0.75–1.25	2.60–3.10	2.64–3.14	3.14–3.64	4.49–4.99	0.60–1.10	0.85–1.35	1.25–1.75
2015: Q4	0.75–1.25	2.60–3.10	2.64–3.14	3.14–3.64	4.49–4.99	0.60–1.10	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	4.40–5.20	0.60–1.30	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	0.75–1.55	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

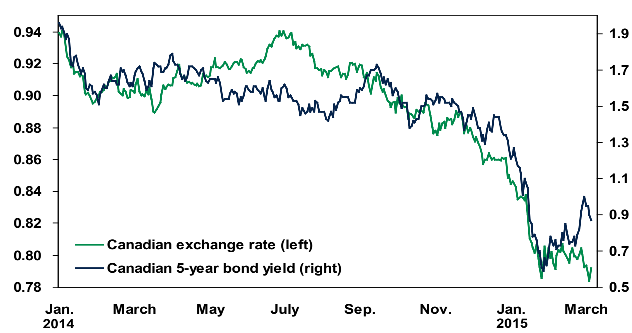
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

The Canadian dollar stabilizes

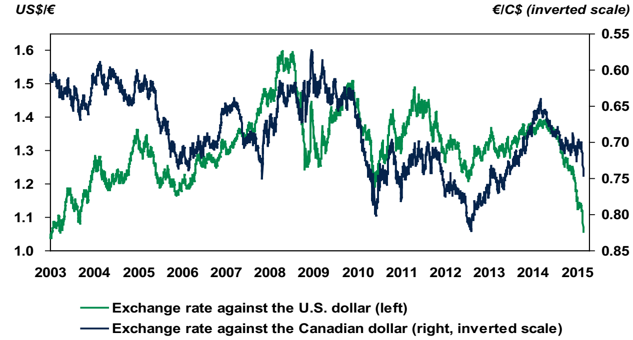
- The Canadian dollar is under less pressure since oil prices stabilized around US$50 a barrel. Astoundingly, the exchange rate did not go up in March when the Bank of Canada opted for the status quo and intimated that the easing cycle could already be finished. The loonie's stability contrasts with the upswing in Canadian bond yields (graph 5). Note that, in January, the Canadian dollar lost over US$0.04 in the wake of the country's surprise key rate cut.
- The U.S. dollar's general strength may be one reason for the lack of a Canadian dollar rebound. Recently, the U.S. dollar has been buoyed by more favourable comments on looming monetary firming from Federal Reserve members. The good U.S. employment data also gave the greenback a boost, as did the ongoing high level of uncertainty about the economies in some emerging nations.
- The euro got some attention in March, falling to a 12-year low at US$1.0494 (graph 6). The European Central Bank has started to purchase sovereign securities, generating a lot of movement on the euro. More fundamentally, Euroland's economy needs a weak currency in order to return to sustained growth; it is already having a big impact on the trade balance. Canadians travelling to Europe will be able to take advantage of the weak euro: a loonie is now worth near €0.75.
- **Forecasts:** Oil prices are forecast to rise gradually as of this summer, which should help the loonie to end the year above US$0.80. The U.S. dollar's strength will be the primary curb on a faster comeback by the loonie. The euro could rebound in the near term if the economic numbers improve in Europe, but the onset of monetary firming in the United States by fall will put downside pressure on Europe's currency.

Graph 5 – The Canadian dollar did not follow the rebound in bond yields



Sources: Datastream and Desjardins, Economic Studies

Graph 6 – The euro is at a low against the greenback that dates back to 2003



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	0.7900	0.8000	0.8100	0.8200	0.8400	0.8400	0.8500
CAN$/US$	1.1199	1.1621	1.2658	1.2658	1.2500	1.2346	1.2195	1.1905	1.1905	1.1765
CAN$/€	1.4147	1.4061	1.3418	1.3797	1.3125	1.2593	1.2805	1.3095	1.2857	1.2941
US$/€	1.2632	1.2101	1.0600	1.0900	1.0500	1.0200	1.0500	1.1000	1.0800	1.1000
US$/£	1.6212	1.5593	1.5100	1.5400	1.5200	1.5000	1.5400	1.5800	1.5600	1.5700

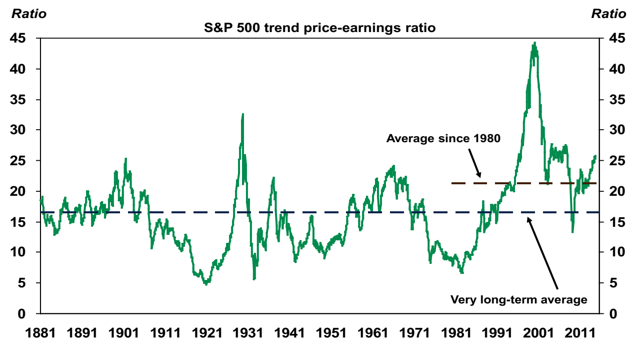
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies f: forecasts

ASSET CLASSES RETURN

Stock markets: it gets complicated again!

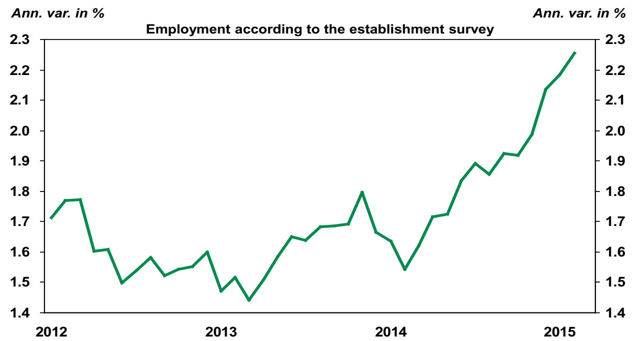
- **Following the very volatile start to the year, a more positive tone had started to settle in in February.** The MSCI global index posted a gain of 4.6% over the month. European stock markets, which were already doing better than the rest at the start of the year thanks to the announcement of bond purchasing programs in Europe, maintained their momentum. Meanwhile, U.S. stock markets recouped some lost ground; the S&P 500 jumped 5.2% in February. Even the Canadian market managed to overlook concerns about the energy sector; the S&P/TSX advanced 3.9% last month.
- **However, the situation has worsened since the start of March, with most stock indexes once again heading down.** In the United States, the stock market has not been a bargain in some time: the trend price-earnings ratio is currently above the averages, both long term and very long term (graph 7). Increases in indices will largely be dependent on growth in earnings but this is increasingly difficult to achieve by cutting costs, in an environment in which companies are engaged in frenzied hiring (graph 8). The constructive economic outlook in the United States justifies expanding payrolls, but much of the revenue of S&P 500 companies comes from abroad, where the outlooks are more modest. Additional obstacles include a soaring U.S. dollar and the coming interest rate increases. It is not surprising to see some investors wisely take their profits at this point. The fact remains that global growth, which should continue to improve in 2015, will prevent any freefall. Despite occasional blips, we still expect moderate gains in the United States.
- **The Canadian stock market did not escape March's downtrend.** However, the simple fact that the S&P/TSX has outperformed the S&P 500 since the start of the year could be an achievement in and of itself. We should not entertain illusions, however, because the Canadian stock market's relatively good recent performance is largely due to the fact that stock in Valeant, a pharmaceutical firm, has been skyrocketing since it was acquired by Salix Pharmaceuticals in February. Valeant accounts for more than 85% of the Canadian index's health care component, a component that is up 44% since the start of the year (graph 9). Without being disastrous, the picture is less stellar in the other sectors. Even if for energy stocks, the worst seems to be behind, they are mostly trading sideways, as are oil prices, which are oscillating around US$50 for West Texas Intermediate (WTI) and barely US$35 for Western Canada Select (WCS) (graph 10 on page 5). Meanwhile, financials have to deal with an environment of slower property sales and low rates. In this context, we continue to expect a moderate return from the Canadian stock index, in the order of 6.0% for 2015.

Graph 7 – The U.S. stock market is a little rich, historically speaking



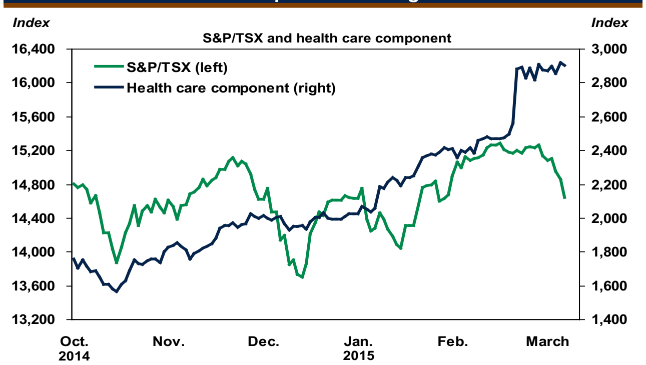
Sources: Robert J. Shiller, Yale University and Desjardins, Economic Studies

Graph 8 – Hiring is accelerating in the United States



Sources: Bureau of Labor Statistics, Desjardins, Études économiques

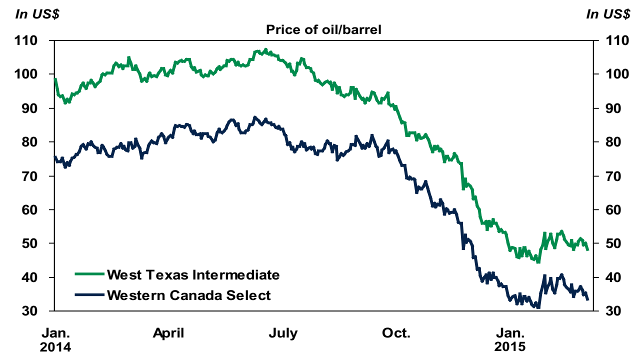
Graph 9 – The Canadian stock market would not have performed as well without the spectacular surge in health care



Sources: Bloomberg and Desjardins, Economic Studies

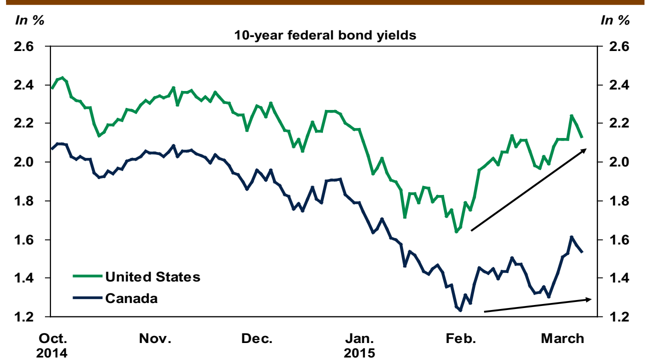
- **Unlike what usually happens, bonds are not benefiting from the problems in the stock markets.** On the contrary, yields have posted substantial increases in recent weeks. The U.S. 10-year yield gained about 50 basis points from its January 30 low. The rebound was slighter in Canada, where uncertainty persists about the future direction of monetary policy, but the 10-year yield is still up about 30 basis points since the start of February (graph 11). The Bank of Canada (BoC) recently intimated that it was comfortable with an overnight rate of 0.75%. However, the risks are significant: if growth is more resilient than expected to the oil price shock, the BoC could decide the Canadian economy does not need the support provided by January's rate cut. The converse is also true, and gloomier data than expected could prompt the BoC to order further monetary easing. Our main scenario is based on an overnight rate of 0.75% until 2016, which should result in a slightly positive return for the bond asset class in 2015. However, the great uncertainty over Canada's monetary policy is being reflected in a fairly wide return range.

Graph 10 – For now, weak oil prices will keep energy securities from rebounding



Sources: Bloomberg and Desjardins, Economic Studies

Graph 11 – Yields will rise much more slowly in Canada



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: 0.60	target: 2.0	target: 6.0	target: 8.0	target: 9.0	target: 6.2 (US$0.81)
range	0.35 to 0.75	-1.0 to 5.0	0.0 to 12.0	4.0 to 14.0	2.0 to 16.0	2.4 to 14.7

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