Retail Rate Forecasts

Desjardins Economic Studies
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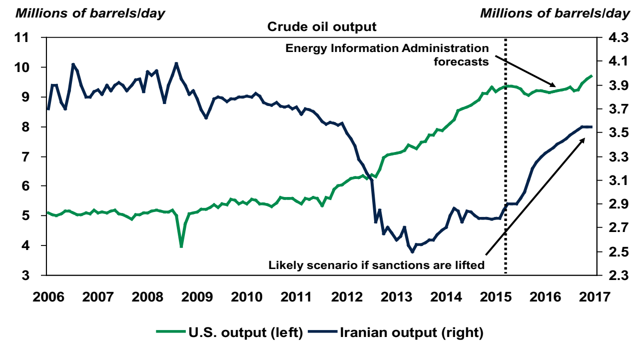
The oil price outlook remains uncertain

HIGHLIGHTS

- Higher oil prices benefit Canadian assets, but the outlook is uncertain.
- After a very weak first quarter, North American economies should rebound.
- Nothing points towards imminent movement in Canadian key interest rates.
- The Canadian dollar climbs to US$0.82.
- Are rallies in Europe and the emerging countries sustainable?

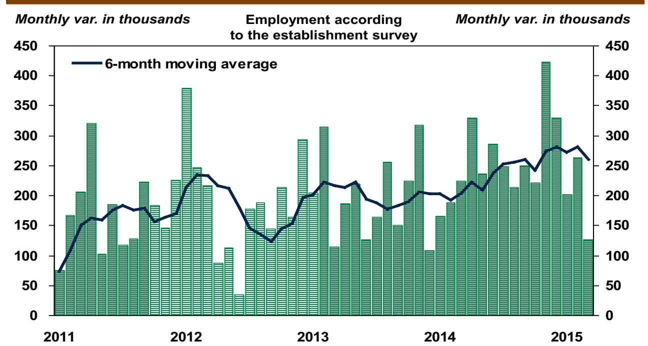
- **Oil prices have climbed back up, but the potential for further increases in the short term appears limited.** The price of West Texas Intermediate (WTI) oil escalated from US$44 per barrel in mid-March to a little over US$55 recently. This reflects indications that the surge in U.S. oil output will soon come to an end (graph 1). Higher oil prices benefited the loonie and the Canadian stock market. However, the preliminary agreement of April 2 between Iran and the major powers increases the probability of an upswing in Iranian oil exports in the second half of 2015. That would keep the global oil market in a surplus position for several quarters, and could extend the period of low crude prices.
- **Many U.S. statistics are disappointing.** Even hiring slowed in March, adding just 126,000 jobs compared with an average of 281,000 over the six previous months (graph 2). Real GDP growth is likely to be below 1% in the first quarter. This tough start to the year has led Federal Reserve leaders to review downwards their outlook for economic growth and key interest rates. However, with better weather and the end of the labour dispute at West Coast ports, some encouraging signs are starting to materialize. A rebound is expected this spring.
- **The Canadian economy also started off the year with a struggle.** The data released in Canada suggest that the economy practically stagnated in the first quarter of 2015, with business investment taking a hard hit from low oil prices. The temporary setbacks that the U.S. economy suffered in the winter also seem to be delaying the upturn in non-commodity exports and manufacturing sales.

Graph 1 – The surge in U.S. oil output is winding up, but Iran could temporarily take up the slack



Sources: Bloomberg, Energy Information Administration and Desjardins, Economic Studies

Graph 2 – After a run of strong growth, U.S. employment was disappointing in March



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

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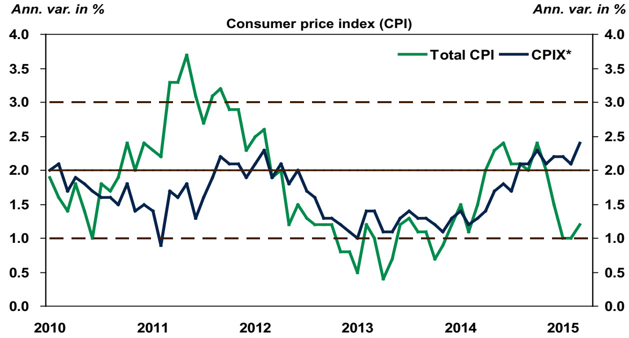
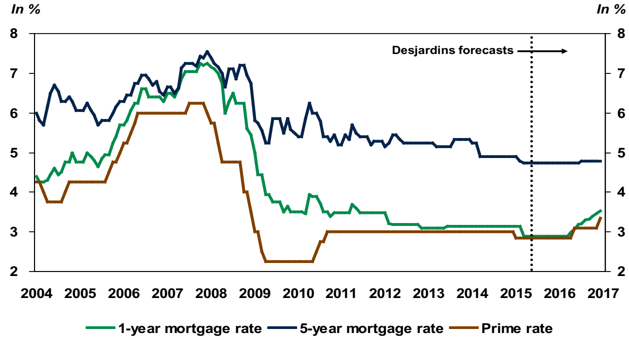
- **The Bank of Canada (BoC) appears to be confident about the future.** Besides choosing once again to maintain the status quo in April, the BoC adopted a slightly more optimistic tone. It seems confident that the firming up of exports will trigger a rebound of the Canadian economy in the second half of 2015. With core inflation reaching 2.4% in March (graph 3), its highest level since 2008, the probability of further easing of Canadian monetary policy appears relatively slim.
- **Interest rates remain low.** The BoC's optimistic tone gave a little boost to Canadian money market rates and to short-term bond yields. The yields of longer-term Canadian bonds are still very low, however, since the international situation remains very favourable for government bonds. Low bond yields and the particularly competitive environment at this time of year have led financial institutions to lower certain posted retail rates and to offer mortgage rate promotions that are very appealing to borrowers.
- **Heading for a long period of stability in retail rates.** Since Canadian key interest rates should hold steady over the coming quarters, and it looks like any increases in bond yields will be limited, the environment of very low retail rates is likely to last several more quarters (graph 4). A real rebound is unlikely to start until late in 2016.

Graph 3 – Core inflation reaches a level not seen since the end of 2008



* Bank of Canada core index.
Sources: Statistics Canada and Desjardins, Economic Studies

Graph 4 – Retail rates will remain low



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								
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
March 2015	1.00	2.85	2.89	3.39	4.74	0.85	1.05	1.50
April 23, 2015	1.00	2.85	2.89	3.39	4.74	0.85	1.05	1.45
Forecasts								
End of quarter								
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	0.80–1.30	1.20–1.70
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	0.80–1.30	1.20–1.70
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	0.80–1.30	1.20–1.70
2016: Q1	0.75–1.25	2.60–3.10	2.64–3.14	3.14–3.64	4.49–4.99	0.60–1.10	0.80–1.30	1.20–1.70
End of year								
2016	1.00–2.00	2.85–3.85	3.10–3.90	3.65–4.45	4.40–5.20	0.60–1.25	0.80–1.45	1.20–1.85
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

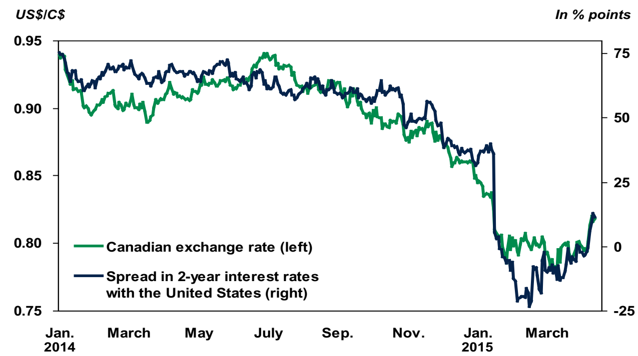
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

The Canadian dollar climbs back to US$0.82.

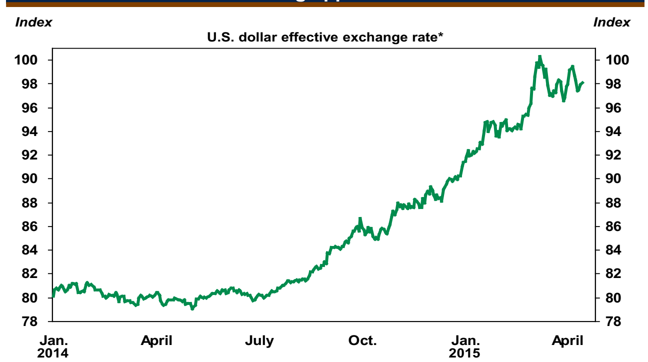
- After many months of weakness, the Canadian dollar is doing better, reaching US$0.82 in April. Crude prices returning to over US$55 per barrel certainly has something to do with the loonie's ascent. That said, these higher crude prices appear to be not very sustainable in the short term, especially if we consider the possibility of Iranian oil returning to international markets, starting this summer.
- The turnaround in oil prices allows the Bank of Canada (BoC) to show more patience, giving an extra boost to the Canadian dollar. In January, the surprise cut in key interest rates ordered by the BoC sent a major shock wave over the currency. The markets are now adjusting their positions; this may be seen by the relationship between the exchange rate and the two-year interest rate spread with the United States (graph 5).
- The Canadian dollar is not the only currency that has appreciated against the U.S. dollar lately. Generally speaking, the U.S. currency's upward trend has been running out of steam since mid-March (graph 6). One of the key factors behind exchange rate trends over the past three quarters is the fact that investors are anticipating a sharp divergence between U.S. monetary policy and that of many other economies, including the euro zone and Japan. However, the rather disappointing economic data out of the United States is encouraging investors to revise their expectations about divergent monetary policies. That said, the economic slowdown in the United States is likely to be temporary, as it seems to have been mainly caused by inclement weather.
- **Forecasts:** The Canadian dollar should remain below US$0.80 for most of the rest of this year. The currency's recent appreciation does not appear to be readily sustainable, given the high risk that oil prices will fall again, due to the lack of sufficient adjustment in global production. Lastly, the loonie will likely also be impacted by an imminent reinvigoration of the U.S. dollar, which will be supported by a probable return of positive economic data in the United States.

Graph 5 – The lower probability of the Bank of Canada cutting its rates is helping the Canadian dollar to re-appreciate



Sources: Datastream and Desjardins, Economic Studies

Graph 6 – The U.S. dollar takes a break after several months of strong appreciation



* Trade-weighted U.S. dollar average against the euro, yen, pound, Canadian dollar, Swedish krona and Swiss franc.
Sources: Bloomberg and Desjardins, Economic Studies

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

Table 2
Forecasts: currency

End of period	2014 Q3	2014 Q4	2015 Q1	2015 Q2f	2015 Q3f	2015 Q4f	2016 Q1f	2016 Q2f	2016 Q3f	2016 Q4f
US$/CAN$	0.8929	0.8605	0.7882	0.7800	0.7700	0.7900	0.8000	0.8200	0.8300	0.8400
CAN$/US$	1.1199	1.1621	1.2688	1.2821	1.2987	1.2658	1.2500	1.2195	1.2048	1.1905
CAN$/€	1.4147	1.4061	1.3626	1.3846	1.3506	1.3291	1.3250	1.3293	1.3253	1.3333
US$/€	1.2632	1.2101	1.0740	1.0800	1.0400	1.0500	1.0600	1.0900	1.1000	1.1200
US$/£	1.6212	1.5593	1.4845	1.5000	1.4700	1.4800	1.5100	1.5500	1.5600	1.5500

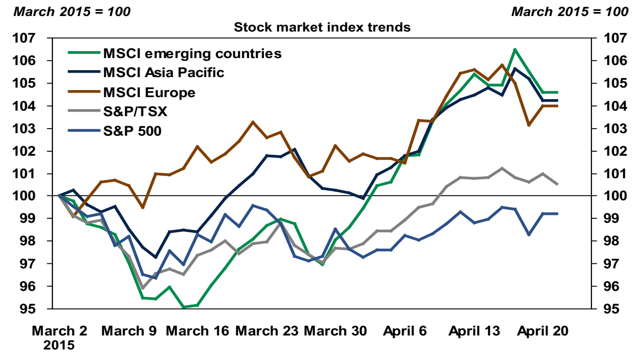
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies f: forecasts

ASSET CLASSES RETURN

Are rallies in Europe and the emerging countries sustainable?

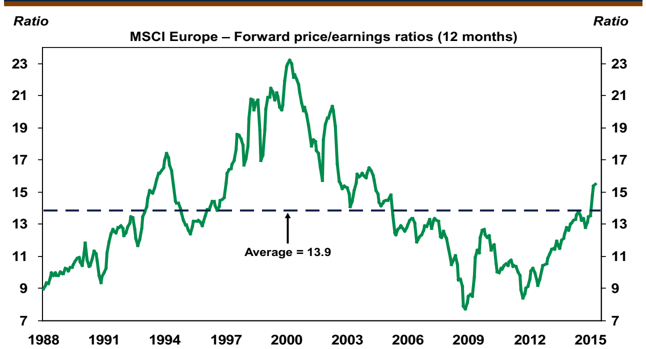
- **The theme of global divergence is intact.** Stock markets in Europe and emerging countries continue to top the growth charts, as evidenced by gains of 3.9% and 4.6% in their respective MSCI indexes since the beginning of March (graph 7). In Europe, the more constructive path adopted by economic growth, in conjunction with the crowding-out effect of the European Central Bank's quantitative easing policy on bond markets, is giving the stock markets a boost. Notwithstanding the fact that the price/earnings ratio of the MSCI Europe index now exceeds its average of the past 27 years (graph 8), the maintaining of an expansionist monetary policy should keep providing some support to European equities, particularly given the dearth of substitutes for returns.
- **In emerging markets, Chinese equities are having an even more impressive bull run; the Shanghai index is up by 30% since January.** Such a spectacular performance in the context of an economic downshift raises questions about a possible bubble (graph 9). The current state of affairs does not sit well with China's regulatory authorities, who felt compelled to intervene in April by tightening margin lending requirements.
- **Meanwhile, U.S. businesses are still grappling with the repercussions of the strong U.S. dollar.** The S&P 500 displays a very slim advance of 2% since the beginning of the year. The first quarter's earnings season is focused on the impact of the appreciating U.S. dollar on revenues. Earnings per share did fall back in the fourth quarter of 2014, although largely owing to the energy sector (graph 10 on page 5). The risk is that the strength of the dollar damaged multinationals' profitability further in the first quarter. The U.S. economy's disappointing performance early on this year offers no hint of a material positive compensation from sectors for which revenues are domestically concentrated. We nevertheless continue to believe that U.S. growth will pick up starting in the second quarter, providing sturdier support for earnings. Our target for the overall return of the S&P 500 is set at 8%, which would make it the most subdued in the past four years.
- **After getting an unsuspecting shot in the arm from mergers and acquisitions, the Canadian stock market is now benefiting from rising oil prices.** Nearly left for dead after a sharp selloff in late 2014, the energy sector has rallied 6% since the beginning of the year. Fundamentally speaking, this strikes as rather surprising, since the price/earnings ratio in the energy sector actually points to extreme overvaluation (graph 11 on page 5). Either the ebullience on energy stocks rests on shaky foundations, either analysts were overly alarmist as they shaved their earnings' forecasts. Ultimately, the uncertainty surrounding the impact of lower oil prices on profits demands caution when interpreting the multiple. That said, it would be premature to believe that oil prices are no longer immune to further slumps. Meanwhile, the industrial sector, which is supposed to benefit from the

Graph 7 – The markets in Europe and Asia are still booming; those in North America are lagging behind



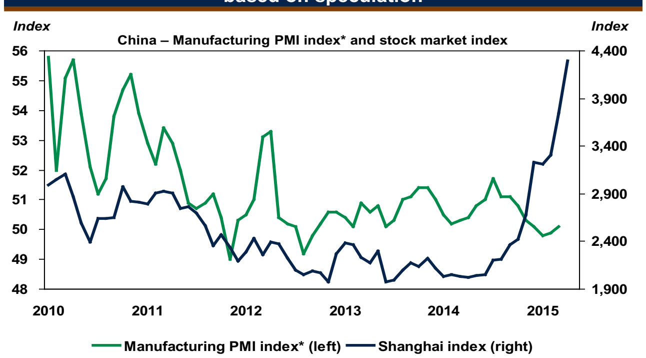
Sources: Bloomberg and Desjardins, Economic Studies

Graph 8 – The European stock markets are no longer under-valued



Sources: Datastream and Desjardins, Economic Studies

Graph 9 – China's stock market performance appears to be based on speculation

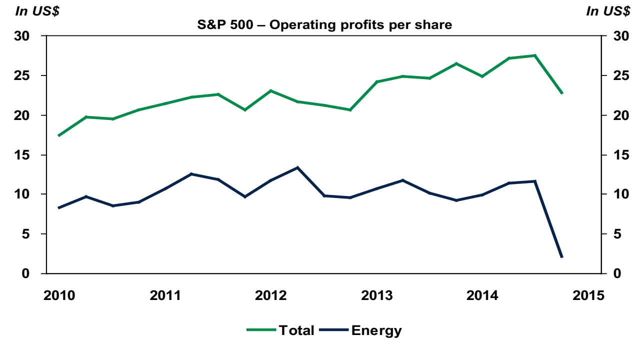


* Official data.
Sources: Bloomberg and Desjardins, Economic Studies

depreciation of the currency, has shown no growth since the beginning of the year. Deep cuts in energy-sector capital expenditures inflict considerable damage to earnings of manufacturers supplying the industry. Thus far, this seems to mitigate the benefits of the depreciated currency on revenues of exporting manufacturers. All told, it should come as no surprise if the S&P/TSX were to give back some of its recent gains in the near term. Later this year, once the oil price shock has definitely dissipated, and once the U.S. economy reengages into the sort of solid growth trajectory that defined 2014, Canadian equities may enjoy a more credible run-up. At 7.5%, our targeted return for the S&P/TSX is close to that of the S&P 500.

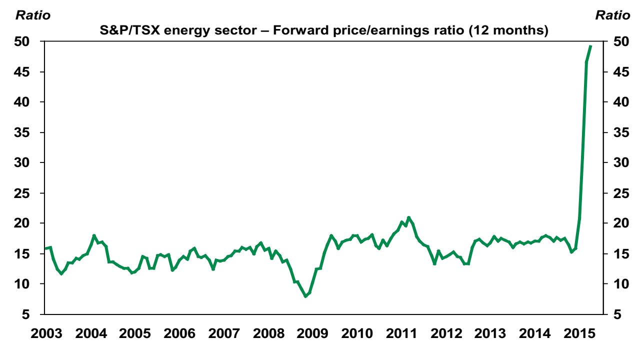
- **The Bank of Canada's (BoC) lack of appetite for further rate cuts reinforces our scenario of stable policy rates for about a year.** Central banks' expectations pertaining to North American growth from here on out have been upgraded, that being said. Should upcoming indicators bring major disappointments, both the BoC and the Federal Reserve would be more amenable to keeping monetary conditions accommodative for longer than currently anticipated. However, nothing compels us to alter our scenarios for very gradual bond yield increases at this stage, and our return target for the bond asset class remains unchanged.

Graph 10 – The oil price slump impacted S&P 500 profits at the end of 2014



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

Graph 11 – Explosion of the price/earnings ratio in the energy sector of the Canadian stock market



Sources: Datastream 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: 0.65	target: 2.0	target: 7.5	target: 8.0	target: 9.0	target: 8.9 (US$0.79)
range	0.50 to 0.80	-1.0 to 5.0	1.0 to 14.0	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