Retail Rate Forecasts
Desjardins Economic Studies
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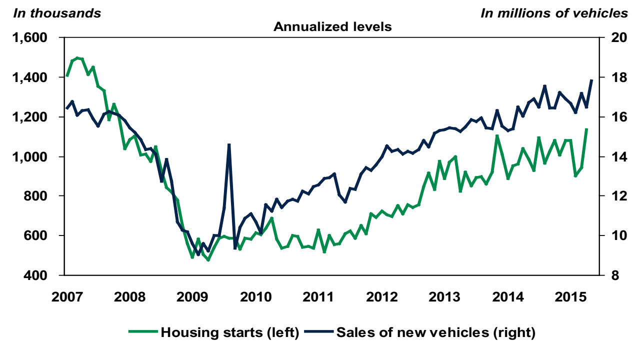
The start of the year was even more challenging than initially thought in North America

HIGHLIGHTS

- Finally, signs of a rebound in the U.S. economy.
- The contraction in Canadian GDP revives the possibility of a key interest rate cut.
- Higher long-term bond yields should not affect retail interest rates.
- The Canadian dollar resumes a downwards trend.
- Equities converge… lower.

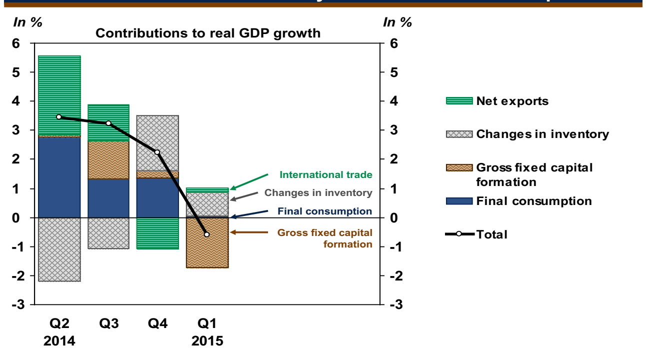
- **Finally, signs of a spring rebound in the United States.** The year got off to a disappointing start, with real GDP contracting by 0.7% in the first quarter. Fortunately, the latest statistics are much more encouraging, with housing starts and automobile sales soaring to peaks not seen in several years (graph 1), great improvement in the trade balance, and the creation of 280,000 new jobs in May. These data offer hope that the problems of last winter were just a temporary rough patch. The door is thus still open to a hike in U.S. key interest rates in September.
- **Surprise contraction of the Canadian economy in the first quarter.** Quasi-stagnation of economic activity was expected in the first quarter. In the end, Canadian real GDP contracted at an annualized rate of 0.6%, mainly due to a significant decline in business investment (graph 2). After three consecutive monthly drops in GDP, economic growth will struggle to surpass 1% in the second quarter. These disappointing data may indicate that the negative effects of the oil price correction are worse than anticipated. On the other hand, other economic statistics, including housing starts and job creation, are painting a rosier picture of the Canadian economy.
- **Will the Bank of Canada (BoC) lower its key interest rates again?** Indications are that the Canadian economy performed well below the BoC's expectations in the first half of this year. This will significantly increase the length of time during which the Canadian economy keeps operating below its full potential. Consequently, the BoC could decide to lower its key interest rates at its July 15 meeting, in an attempt to further stimulate economic activity. While that is a real possibility, recent signs of a rally in the United States and the turnaround in oil prices should, in the end, convince the BoC to keep its key interest rates where they stand.

Graph 1 – In the United States, housing starts and sales of motor vehicles have reached peaks not seen in many years



Sources: U.S. Census Bureau, Bureau of Economic Analysis and Desjardins, Economic Studies

Graph 2 – A drop in business investment caused the Canadian economy to contract in the first quarter



Sources: Statistics Canada and Desjardins, Economic Studies

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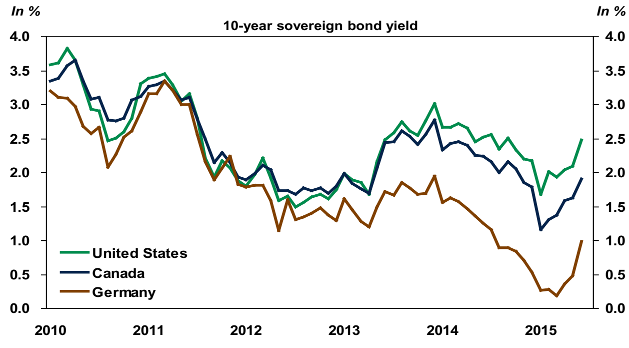
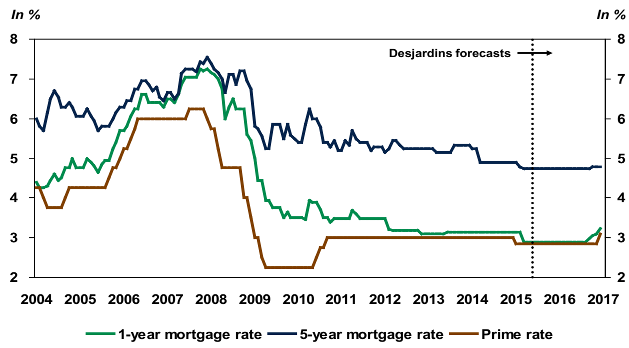
- **Generalized upward movement in long-term bond yields.** After dropping sharply at the beginning of 2015, long-term bond yields have moved back up to a significant degree since the middle of March, both in Europe and in North America (graph 3). Higher oil prices, which reduce the risk of deflation, are partly responsible for this change of trend. The higher yields also seem to reflect the fact of some investors becoming uncomfortable with the extreme weakness of bond yields, especially in Europe. Despite their recent ascent, bond yields are still very low from a historical perspective. Just as for oil prices, the potential for a further increase in bond yields between now and the end of 2015 appears limited.
- **We are still predicting great stability in retail interest rates.** The increase in long-term bond yields should not have any impact on retail interest rates for maturities of five years or less. Indications are that they will remain close to their current levels for many quarters to come (graph 4), especially since Canadian key interest rates are unlikely to start heading back up until the very end of 2016. Short-term retail interest rates might even fall further, should the BoC surprise us again by lowering its key interest rates.

Graph 3 – After falling very low at the beginning of the year, bond yields have recently rallied



Sources: Datastream and Desjardins, Economic Studies

Graph 4 – Little movement foreseen for retail interest rates



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								
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 2015	1.00	2.85	2.89	3.39	4.74	0.85	1.05	1.45
May 2015	1.00	2.85	2.89	3.39	4.74	1.00	1.15	1.50
June 11, 2015	1.00	2.85	2.89	3.39	4.74	1.00	1.15	1.50
Forecasts								
End of quarter								
2015: Q2	1.00	2.85	2.79–2.99	3.29–3.49	4.64–4.84	0.90–1.10	1.05–1.25	1.40–1.60
2015: Q3	0.75–1.25	2.60–3.10	2.64–3.14	3.14–3.64	4.49–4.99	0.75–1.25	0.80–1.40	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	0.75–1.25	0.80–1.40	1.25–1.75
2016: Q1	0.75–1.25	2.60–3.10	2.64–3.14	3.14–3.64	4.49–4.99	0.75–1.25	0.80–1.40	1.25–1.75
End of year								
2016	0.75–1.75	2.60–3.60	2.85–3.65	3.60–4.40	4.40–5.20	0.75–1.50	0.85–1.65	1.25–2.00
2017	1.25–2.25	3.10–4.10	3.35–4.15	4.15–4.95	4.75–5.55	0.90–1.70	1.20–2.00	1.50–2.30
2018	2.00–3.00	3.85–4.85	3.95–4.75	4.50–5.30	5.10–5.90	1.10–1.90	1.45–2.25	1.80–2.60

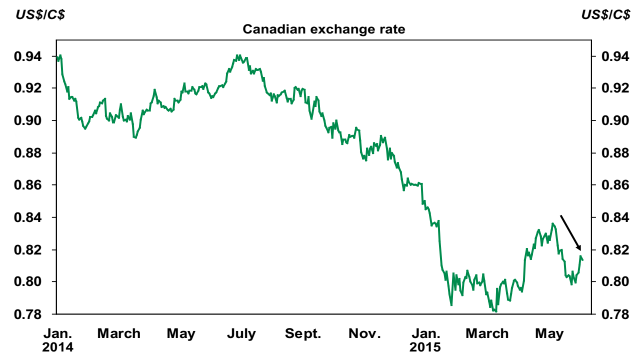
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

The Canadian dollar loses its recent gains

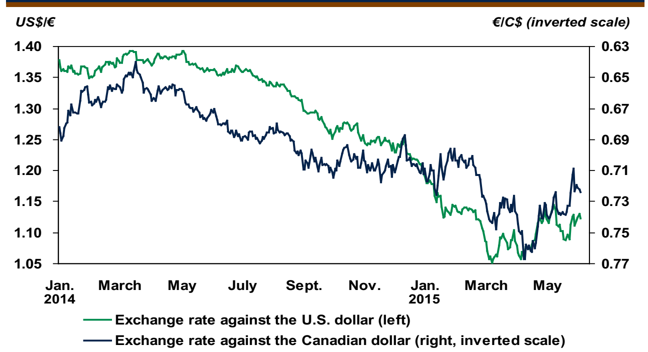
- The appreciation of the Canadian dollar that started last April is proving to be short-lived. Despite the fact that oil prices have stabilized at close to US$60 per barrel, the Canadian currency recently depreciated, back to around US$0.80 (C$1.25/US$) (graph 5). The main factors behind this movement in the Canadian exchange rate are the release of disappointing economic data in Canada, and a recovery by the U.S. dollar.
- Oil is still an important determinant of the ups and downs of the Canadian dollar. In this regard, the upturn in crude prices since March appears fragile, since global production has not been sufficiently adjusted to balance the market. New downside risks for prices have recently emerged due to expanding production by the members of the Organization of the Petroleum Exporting Countries (OPEC) and the possibility of Iranian oil making a return to Western markets.
- Diverging monetary policies are still a major theme for currencies. Expectations of monetary tightening in the United States have contributed strongly to the appreciation of the U.S. dollar since last summer. That movement has been amplified by the easing measures announced by many central banks. The deterioration in U.S. economic data during the winter temporarily cast doubt on the possibility of the Federal Reserve raising its interest rates. The euro benefited from that situation (graph 6), especially since in many cases the European data surpassed expectations. But the winds are starting to blow in the greenback's favour once again, especially when we look at the healthy job numbers in the United States.
- **Forecasts:** It is too early for any sustainable appreciation of the Canadian dollar, which will probably stay below US$0.80 in the months to come. The factors that undermined it last year are still in effect. Oil prices are likely to fall back down, the U.S. dollar is likely to appreciate, and the Bank of Canada could change course once again. Many other currencies, including the euro, should also depreciate against the U.S. dollar.

Graph 5 – The re-appreciation of the Canadian dollar has proven to be temporary



Sources: Datastream and Desjardins, Economic Studies

Graph 6 – The euro is appreciating after several months of weakness



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	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0.8929	0.8605	0.7882	0.8000	0.7800	0.7900	0.8000	0.8100	0.8200	0.8400
CAN$/US$	1.1199	1.1621	1.2688	1.2500	1.2821	1.2658	1.2500	1.2346	1.2195	1.1905
CAN$/€	1.4147	1.4061	1.3626	1.3750	1.3333	1.3291	1.3250	1.3457	1.3537	1.3571
US$/€	1.2632	1.2101	1.0740	1.1000	1.0400	1.0500	1.0600	1.0900	1.1100	1.1400
US$/£	1.6212	1.5593	1.4845	1.5200	1.4700	1.4800	1.5100	1.5500	1.5600	1.5600

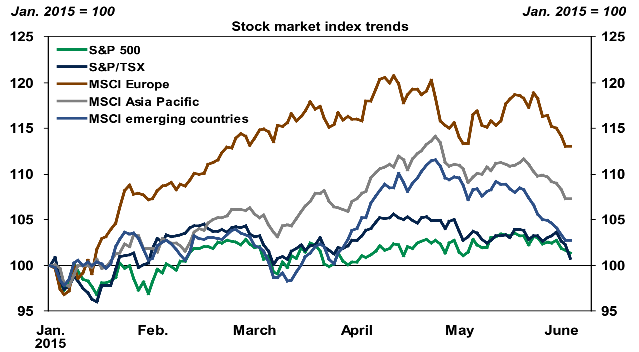
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies f: forecasts

ASSET CLASSES RETURN

Equities converge… lower

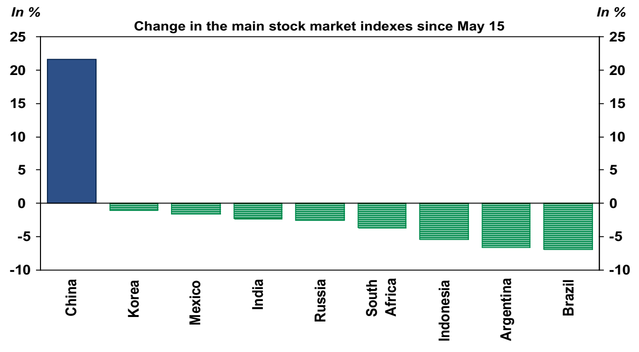
- **A convergence of the world's stock markets appears to be taking shape, but unfortunately in a downwards direction.** After charging ahead at full throttle in the first three months of the year, the European stock markets started to run out of gas in April (graph 7). After a sluggish month of May, the European MSCI index has been heading decisively downwards since the beginning of June, against a backdrop of increased risk of default by the Greek government. In the emerging countries, we see a similar situation: the MSCI index has fallen by nearly 8% since the end of April. In fact, emerging countries have not performed much better than North American stock markets since the beginning of the year. Markets in Korea, India and Latin American countries in particular, have suffered significant reversals since mid-May (graph 8). Meanwhile, the Shanghai index (which at this point is still excluded from the MSCI index) remains at stratospheric levels, boasting a spectacular rise of nearly 60% since January. Yet the fundamentals in China are in no better shape than those of other emerging countries, and the Chinese stock market is showing many symptoms of a speculative bubble.
- **Meanwhile things are fairly quiet for the S&P 500 and the S&P/TSX, which have posted meagre gains of 1% since January.** North American markets also stand apart with low levels of volatility, in net contrast to the resurgence of volatility that has been observed in the global bond markets in recent months (graph 9). The scope of bond yield movements in recent weeks could have wrought havoc on stock markets, but we must take into account the fact that the S&P 500 and the S&P/TSX were considerably less vulnerable to a correction, than equities in Europe and emerging countries, which were quick to react to the movement in bond yields.
- **Stocks could still be in for tough times in the coming months.** Among other things, the fundamentals in Canada are still rather shaky. The economy suffered an unexpected contraction in the first quarter. The scope of the contraction in GDP is rather preoccupying, especially since other signals also give cause for concern. For example, non-energy exports, on which so many hopes are pinned, have proven unable to take full advantage of the cumulative depreciation of the Canadian dollar. The downturn in capital goods investments, recorded both in Canada and in the United States, seems to be exacting a heavy toll on Canadian non-energy exports, to the point that they have grown less, in terms of volume, than exports of energy products during the past year.

Graph 7 – A call to order for equities in Europe and emerging countries



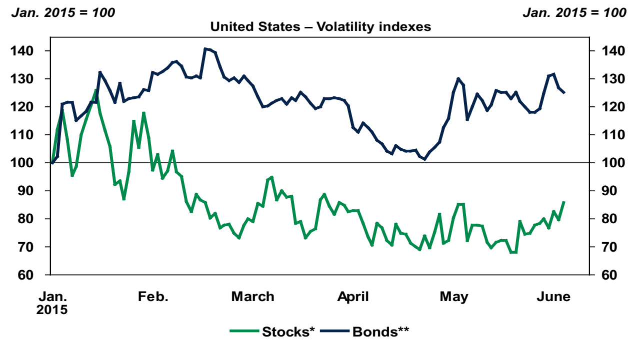
Sources: Bloomberg and Desjardins, Economic Studies

Graph 8 – Among the emerging countries, the Chinese stock market stands apart from the rest



Sources: Bloomberg and Desjardins, Economic Studies

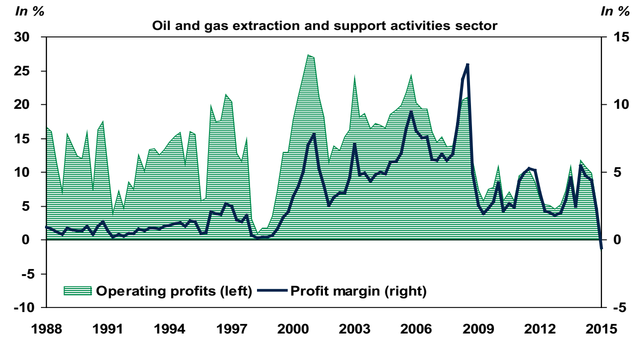
Graph 9 – So far this year, stock markets have been more stable than bonds



* VIX index; ** MOVE index.
Sources: Bank of America Merrill Lynch, Chicago Board Options Exchange and Desjardins, Economic Studies

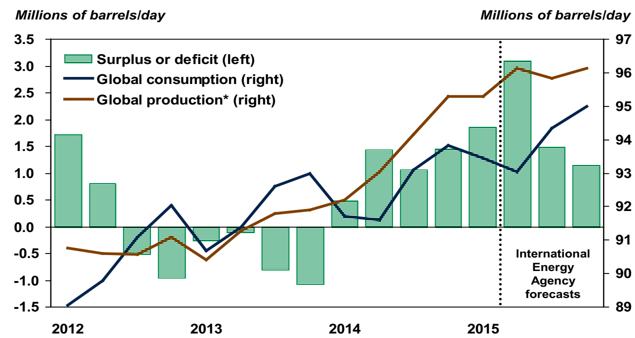
- **In the energy sector, despite the resilience of export volumes, profits moved into negative territory in the first quarter.** This is the first time losses have occurred in the history of official data series (graph 10). This clearly demonstrates the severity of the shock, and justifies the downwards adjustment that the Canadian stock market suffered at the time of the price collapse. In the short term, the fate of the S&P/TSX will continue to be influenced by the ups and downs of oil prices. Unfortunately, the outlook for prices is not constructive. The spectacular surge in production by the members of the Organization of the Petroleum Exporting Countries (OPEC) and their determination to keep producing in sustained fashion suggest that the global oil surplus could last for a good while longer (graph 11). In fact, we predict a slight decline in oil prices during the summer. In this context, even though we think the Canadian stock market will manage to eke out a total return of 7.5% this year, we should not be surprised if the next quarter proves tedious.
- **From a fundamental perspective, it is difficult to believe that long-term bond yields will keep climbing sharply.** Since January, we have revised our forecasts of global GDP growth in 2015 downwards. The stabilization of oil prices has promoted a resurgence of inflation expectations, but they are unlikely to continue to rise rapidly, now that a good portion of the catching up to "normal" levels has been accomplished. Meanwhile, the Federal Reserve has always indicated that monetary policy would be tightened in very small increments, such as not to destabilize growth. Assuming that volatility will abate to some degree, bond yields could dip slightly in the short term. We are therefore staying on course for a 2% return of the bond index in 2015.

Graph 10 – The troubles of the energy sector are confirmed by official profitability data



Sources: Statistics Canada and Desjardins, Economic Studies

Graph 11 – A significant surplus is likely to persist in the global oil market



* Assuming that production by the Organization of Petroleum Exporting Countries (OPEC) remains stable at 31.5 million barrels per day.
Sources: International Energy Agency 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 0.75	-1.0 to 5.0	1.0 to 14.0	4.0 to 14.0	2.0 to 16.0	3.7 to 16.3

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