Retail Rate Forecasts

Desjardins Economic Studies

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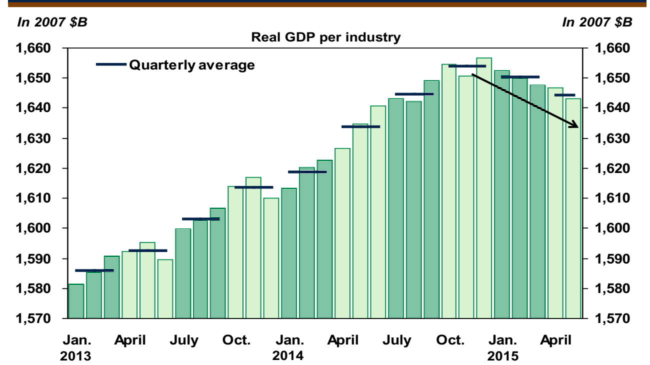
Recession concerns and a key rate cut in Canada

HIGHLIGHTS

- Canada appears to be in a technical recession.
- The Bank of Canada should opt to maintain the status quo after its key rate cut.
- The more favourable situation in the United States is limiting the decline in long-term rates.
- The Canadian dollar could continue to fall.
- Chinese stock market: What was bound to happen…

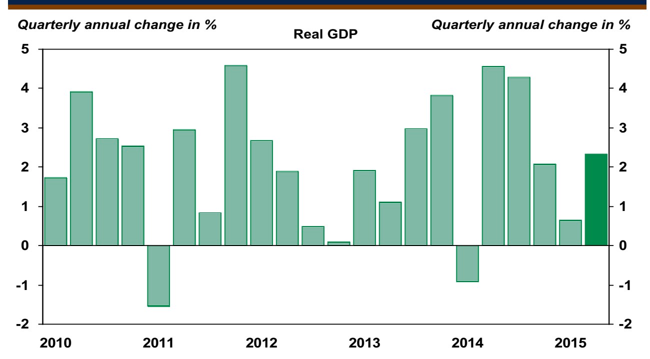
- **An unconventional recession in Canada.** With the monthly GDP declining for the fifth consecutive month in May (graph 1), everything suggests that Canada suffered a technical recession—or two back-to-back quarterly declines—in the first half of 2015. This contraction differs from the classic recessions seen in Canada, however. Firstly, with the third quarter expected to tilt back into positive territory, the scope of the decline in output will be much weaker than what is typically seen in a conventional recession. Secondly, the downturn in output is far from consistent across the country, with the energy sector and some regions standing out—namely, the oil-producing provinces.
- **New cut to Canada's key rates.** Like most analysts, the Bank of Canada (BoC) had to revise its 2015 growth forecasts for Canada's economy sharply downward. Since this adds to the downside risks weighing on inflation outlooks, the BoC cut its key rates by 0.25% at its July 15 meeting. After trimming its overnight rate to 0.75% in January, this rate is now 0.50%, or just a quarter of a percentage point above the historic low reached in 2009. The BoC is still fairly optimistic about the quarters ahead, however, hedging its bets on a rebound in Canadian exports. The BoC should therefore maintain the status quo in the months ahead, barring more bad news.
- **The U.S. economy rebounded this spring.** The U.S. real GDP expanded 2.3% (quarterly annualized) in Q2 2015 (graph 2), boosted by strong advances in household spending and residential investment. Business investment declined, however; the correction in oil prices continue to hurt the U.S. energy sector. The data on drilling activity in the U.S. suggest that this sector will stabilize somewhat in the third quarter. The door is open for the Federal Reserve

Graph 1 – Canada's economy has declined in recent months



Sources: Statistics Canada and Desjardins, Economic Studies

Graph 2 – U.S. growth ramped up during the spring thaw



Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

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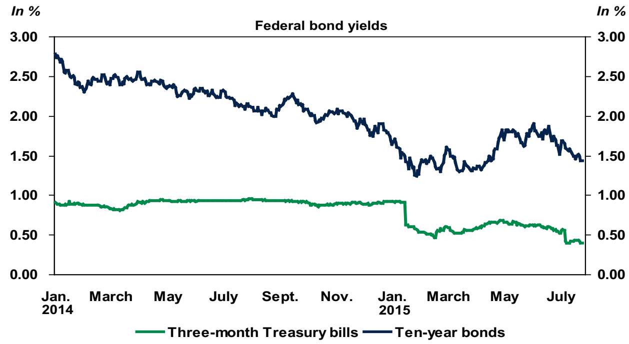
(Fed) to begin its gradual monetary tightening as of September, provided that the economic data continues to remain positive.

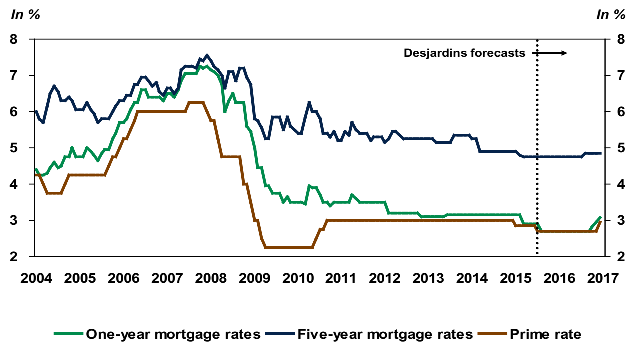
- **Short-term retail rates decline.** The BoC's recent rate cut was a boon to borrowers with variable rate loans, since most financial institutions in Canada cut their prime rates by 0.15%. The yields on term savings for some shorter maturities also declined in recent weeks. The retail rates for longer terms remain unchanged, however. International conditions, including the U.S. economic rebound and subsiding concerns about inflation, are keeping several bond yields above the levels reached last winter (graph 3).
- **The low interest rate environment will prevail for a few more quarters.** Some short-term retail rates could be adjusted slightly lower over the next few weeks. Retail rates should then settle for a long period of stability as key rates in Canada are unlikely to rise before late 2016 (graph 4).

Graph 3 – Some bond yields in Canada remain above the low point reached early in the year



Sources: Datastream and Desjardins, Economic Studies

Graph 4 – Retail rates will remain very weak



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								
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 2015	1.00	2.85	2.89	3.39	4.74	1.00	1.15	1.50
July 2015	0.75	2.70	2.89	3.39	4.74	0.85	1.05	1.50
August 4, 2015	0.75	2.70	2.89	3.39	4.74	0.85	1.05	1.50
Forecasts								
End of quarter								
2015: Q3	0.50–0.75	2.45–2.70	2.44–2.94	3.14–3.64	4.49–4.99	0.60–1.10	0.80–1.30	1.25–1.75
2015: Q4	0.50–0.75	2.45–2.70	2.44–2.94	3.14–3.64	4.49–4.99	0.60–1.10	0.80–1.30	1.25–1.75
2016: Q1	0.50–1.00	2.45–2.95	2.44–2.94	3.14–3.64	4.49–4.99	0.60–1.10	0.80–1.30	1.25–1.75
2016: Q2	0.50–1.00	2.45–2.95	2.44–2.94	3.14–3.64	4.49–4.99	0.60–1.10	0.80–1.30	1.25–1.75
End of year								
2016	0.75–1.25	2.70–3.20	2.85–3.35	3.60–4.10	4.60–5.10	0.70–1.20	1.00–1.50	1.35–1.85
2017	1.25–2.25	3.20–4.20	3.45–4.25	4.15–4.95	4.75–5.55	0.60–1.40	1.10–1.90	1.50–2.30
2018	2.00–3.00	3.95–4.95	3.95–4.75	4.50–5.30	5.10–5.90	0.75–1.55	1.45–2.25	1.80–2.60

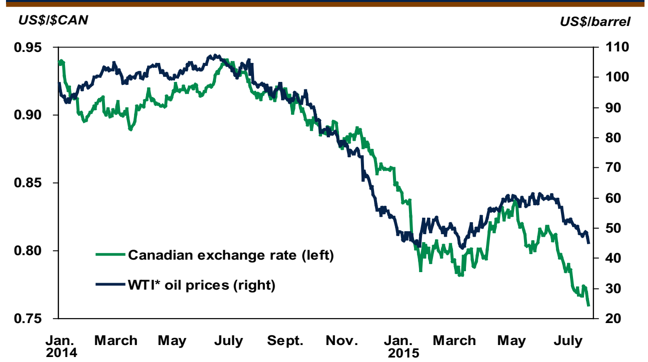
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

The fall could continue

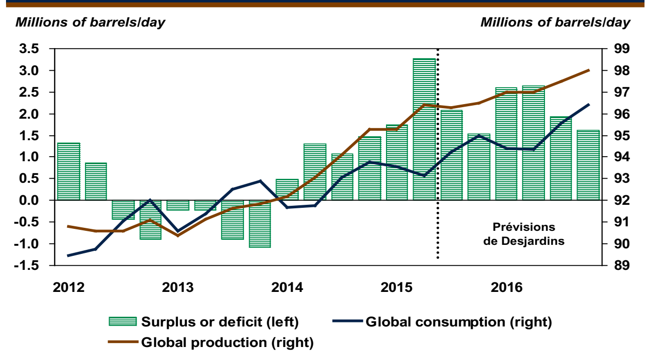
- The last few weeks have been particularly difficult for the loonie. Not only has it had to deal with disappointing data in Canada, which persuaded the BoC to order another round of monetary easing, but the sharp decline in commodity prices sideswiped Canada's currency. This new drop in resource prices reflects growing concerns about China's economy and unfavourable developments for oil prices. The value of the loonie slipped below US$0.76, a level not seen in more than 10 years (graph 5).
- The loonie is likely to remain under pressure in the next few months. Far from diminishing, the global oil glut has increased in recent months, with Iraq and Saudi Arabia both ramping up their production substantially. We should expect Iran's output to grow significantly in 2016 now that an agreement on Iran's nuclear program has been reached. We thus expect the global oil market to remain in a surplus situation for several more quarters (graph 6), which will keep oil prices at weak levels.
- We also have to expect most currencies to post declines vs. the greenback in the months ahead, as the Federal Reserve (Fed) should introduce monetary tightening fairly soon. The euro, which recently fell below US$1.10, could fall to US$1.05 in the next few months. The easing of tensions between Greece and its creditors in July failed to provide the euro with much of a boost while several analysts expect the Greek question to come back and haunt the euro zone in the short term or in a few quarters.
- **Forecasts:** Canada's currency could very well fall to about US$0.75 by the end of the quarter if the Fed decides to raise interest rates at its September meeting. The loonie could see a slight uptick once Canada's economy picks up steam by the end of 2015. However, ongoing weak oil prices will keep the loonie below US$0.80 for several more quarters.

Graph 5 – The BoC's decision and a new oil price drop weigh on the loonie



* West Texas Intermediate
Sources: Datastream and Desjardins, Economic Studies

Graph 6 – The global oil market could wrestle with a major surplus for some time



Sources: International Energy Agency 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	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0.8929	0.8605	0.7882	0.8004	0.7500	0.7700	0.7600	0.7700	0.7800	0.8000
CAN$/US$	1.1199	1.1621	1.2688	1.2493	1.3333	1.2987	1.3158	1.2987	1.2821	1.2500
CAN$/€	1.4147	1.4061	1.3626	1.3920	1.4000	1.3766	1.4079	1.4156	1.4231	1.4250
US$/€	1.2632	1.2101	1.0740	1.1142	1.0500	1.0600	1.0700	1.0900	1.1100	1.1400
US$/£	1.6212	1.5593	1.4845	1.5727	1.5200	1.5300	1.5400	1.5500	1.5600	1.5600

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

ASSET CLASSES RETURN

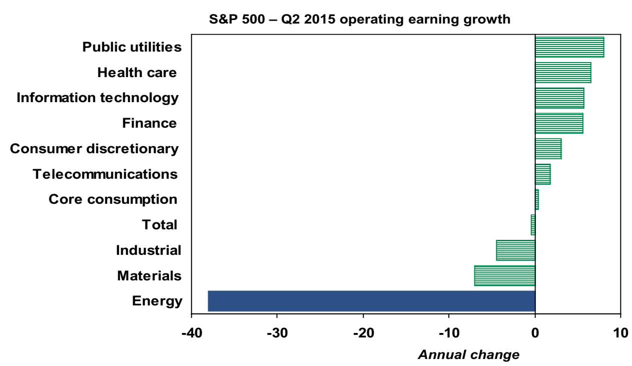
What was bound to happen…

- **Global stock markets' focus on China.** On June 8, the Shanghai index was up 153% (annualized), which has all the hallmarks of "irrational exuberance." The Chinese authorities have in recent years persuaded individuals to invest massively in the stock market while easing the restrictions on margin trading, which allows investors to apply leveraging extensively to multiply their gains (graph 7). With the economic slowdown in the background, the question was not whether the bubble was going to burst but when. The Shanghai index reached its peak on June 12 and has since shed 30%. The authorities' concerted attempts to limit the damage seemed to be working, but the 8.5% decline on July 27 was a stark reminder that the battle was not over.
- **The jolts in China continue to ripple through to other parts of Asia,** especially in Hong Kong and South Korea where the indexes started to fall in July. Europe's stock markets gained a little strength, relieved that the exasperating issue with Greece is now settled. The Euro Stoxx index gained 4% last month.
- **Concerns about Greece and China affected the U.S. stock markets at the end of June,** but the drop in risk aversion led to a slight upturn by mid-July. From a broader perspective, the U.S. stock market has been flat since April. According to Bloomberg, among the companies that published their results at July 30 (65% in total), about 74% posted profits that beat second quarter expectations. Aggregate profits continue to decline, however, primarily due to the heavy losses that continue to plague the energy industry (graph 8). The job market's strong performance since the start of the year and the GDP's run-up in growth in Q2 are encouraging signs. We stand by our forecast target of 8% for the S&P 500, with the same index turning in a similar performance—about 7.5%—in 2016.
- **Canada's stock market ranks among the most underperforming markets since the start of the year.** The energy sector seemed to stabilize in the spring, but signs that pointed to a previously underestimated over-abundance in the global oil supply have weighed on this component lately. At the same time, the price for base metals responded to the economic and financial difficulties in China, which dragged down the materials sector. The S&P/TSX is not out of the woods yet since the risk that Canada is in recession was enough to give some foreign investors the jitters, thus affecting the non-energy sectors. Financial sector stocks have had an especially tough time (graph 9). Far from considering the theoretically positive impact of rate cuts on real estate activity, investors appear more concerned with the risks to financial stability that the current situation implies.

Graph 7 – China's stock market surge in line with the ramped-up use of margin trading

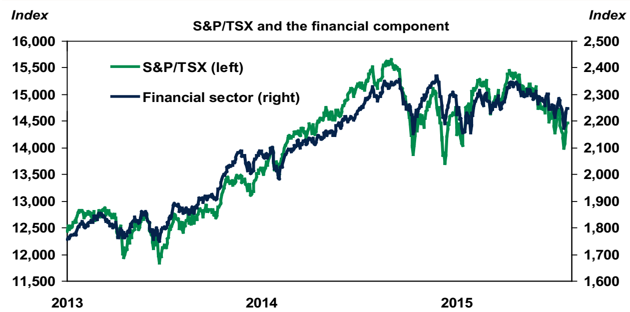
Sources: Bloomberg and Desjardins, Economic Studies

Graph 8 – Heavy losses for the energy sector



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

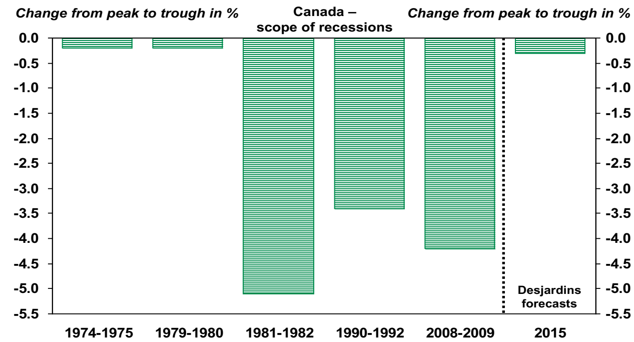
Graph 9 – Financial sector concerns dragged down the S&P/TSX



Sources: Datastream and Desjardins, Economic Studies

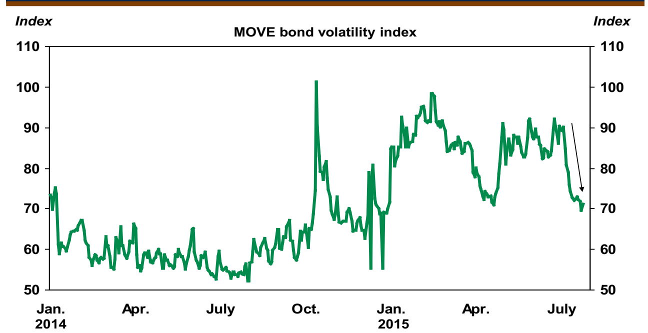
- **The contraction in Canada's GDP in the first two quarters of the year will be small compared to other episodes (graph 10).** The GDP should rebound in the third quarter, with growth accelerating by the end of the year. This should calm the markets and get bargain hunters on the move. That said, the commodities-related sectors will not see that shaft of light at the end of the tunnel anytime soon. We revised our scenario for oil prices downward, expecting WTI to close the year at only US$52. The recovery of the U.S. dollar, concerns about China and the emerging countries' poor performance also limit the upside potential for metals. As such, we are revising our performance target for the S&P/TSX to 2.0% for 2015.
- **The bond market has shown resilience in 2015, much like in 2014.** The upward swings in bond yields last spring gave way to a recent lull in the bond market (graph 11), but not before yields were slashed at the height of the tensions about Greece. During this period, the Bank of Canada had to rescue the economy by instituting a second rate cut this year. In the United States, the Fed is mulling the opposite as it edges closer to gradually increasing its key rates. This should trigger a slight uptick in longer term bond yields in Canada. As it stands, this asset class is poised to reach a 4.0% return in 2015 vs. our previous target of 2.0%. We are calling for a negative 3.0% return in 2016.

Graph 10 – Heading toward a very mild recession



Sources: Statistics Canada and Desjardins, Economic Studies

Graph 11 – Calm sets in on bond markets



Sources: Bank of America Merrill Lynch 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: 0.55	target: 4.0	target: 2.0	target: 8.0	target: 9.0	target: 11.8 (US$0.77)
range	0.45 to 0.65	1.0 to 7.0	-4.0 to 6.0	4.0 to 14.0	2.0 to 14.0	7.6 to 17.9
2016f	target: 0.45	target: -3.0	target: 7.5	target: 7.5	target: 7.0	target: -3.8 (US$0.80)
range	0.20 to 0.70	-6.0 to 1.0	2.0 to 13.0	3.0 to 12.0	1.0 to 13.0	-7.2 to 2.7