Retail Rate Forecasts

Desjardins Economic Studies
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September 22, 2015

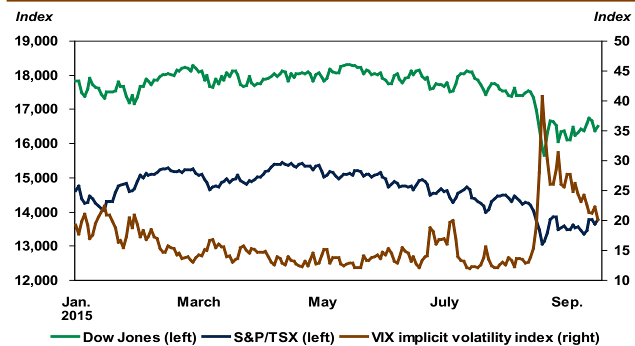
China puts investors on edge and causes the Federal Reserve to hesitate

HIGHLIGHTS

- A wave of panic washed over financial markets in the middle of August.
- The Bank of Canada and the Federal Reserve decide on the status quo.
- A rebound in exports is encouraging for the Canadian economy.
- Some respite for the Canadian dollar.
- The dust settles, but the markets are still watchful.

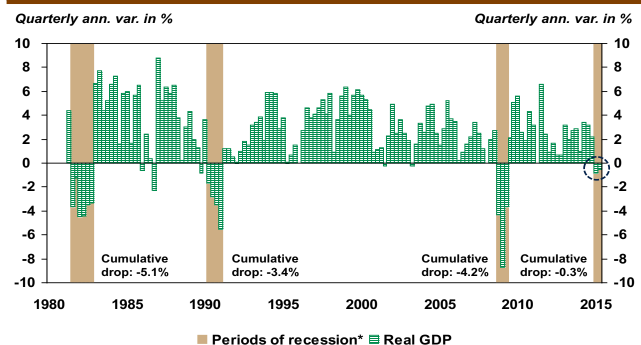
- **Brief panic on the markets in August.** Concerns about China intensified sharply starting in mid-August; the surprise devaluation of the yuan was perceived as a desperate measure on the part of Chinese authorities. A wave of panic then washed over the international financial markets, generating a correction in several stock markets. But the disarray in the financial markets was soon replaced with a rebound in bond yields and, to a lesser extent, in the stock market indexes (graph 1).
- **The Federal Reserve (Fed) is not yet ready to raise its key interest rates.** The spring rebound in the U.S. economy and signs of robust consumption paved the way for a hike in U.S. key interest rates in September. But concerns about the emerging countries and the volatility of financial markets persuaded the Fed to maintain the status quo once again. Yet, Chair Janet Yellen did say that the recovery is sufficiently advanced to justify an interest rate hike. Moreover, 13 of the 17 leaders foresee an initial hike between now and the end of 2015. Thus, a very gradual rise in U.S. key interest rates could begin this December.
- **Canada's recession has been confirmed... and may well already be over.** Real GDP shrank at an annualized quarterly rate of 0.5% in the second quarter of 2015, after a 0.8% decline in the first quarter. According to the commonly used definition of two consecutive quarters of contraction in real GDP, the Canadian economy was thus in recession in the first half of this year. But this recession differs from past episodes, in its limited scope (graph 2), and in the fact that the economic difficulties are concentrated in the provinces and sectors that depend on the oil industry. Furthermore, the significant rally in Canadian exports in June and July suggests that the Canadian economy will rebound in the

Graph 1 – After jumping in mid-August, investors' concerns have faded to some extent



Sources: Datastream and Desjardins, Economic Studies

Graph 2 – A limited scope recession in Canada



* According to the definition of at least two consecutive months of negative real GDP growth.
Sources: Statistics Canada 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.

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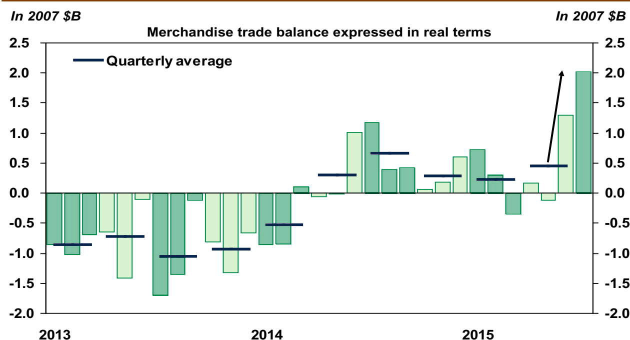
third quarter, thanks to a substantial positive contribution from international trade (graph 3).

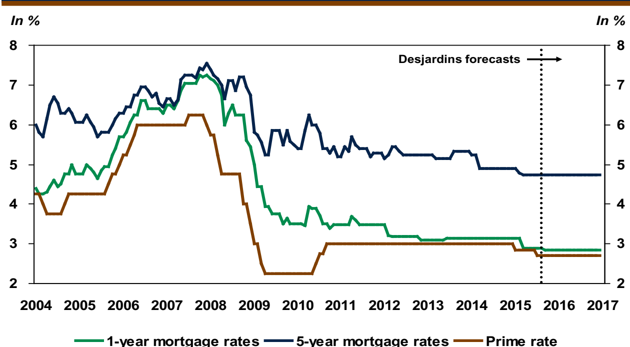
- **Key interest rate cuts may have come to an end in Canada.** After lowering its key interest rates last July, the Bank of Canada (BoC) returned to the status quo in September. Noting encouraging signs for the Canadian economy, the BoC left the target for the overnight rate at 0.50%. But by emphasizing that the adjustments to low oil prices will take considerable time, and that fluctuations in the dollar facilitate those adjustments, the BoC is telling us that it will wait a long while before considering any hike in its key interest rates.
- **Little change in interest rates.** After tumbling in mid-August, bond yields quickly climbed back up to levels that had been observed at the end of July. Thus, Canadian retail rates have remained stable in recent weeks. We would also point out that tensions in the financial markets have led to an increase in the financing premiums of financial institutions.
- **Another sign that the low interest rate environment will not be disappearing any time soon.** The Fed's hesitation to start monetary firming reinforces the idea that North American bond yields will stay low. Thus, we continue to predict that retail rates will remain close to their current levels for several more quarters (graph 4).

Graph 3 – The third quarter is starting off on a very positive note for Canada's international trade sector



Sources: Statistics Canada and Desjardins, Economic Studies

Graph 4 – Nothing points towards a substantial increase in retail 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								
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
Aug. 2015	0.75	2.70	2.89	3.39	4.74	0.85	1.05	1.50
Sep. 22, 2015	0.75	2.70	2.89	3.39	4.74	0.85	1.05	1.50
Forecasts								
End of quarter								
2015: Q3	0.75	2.70	2.79–2.99	3.29–3.49	4.64–4.84	0.75–0.95	0.95–1.15	1.40–1.50
2015: Q4	0.50–0.75	2.45–2.70	2.59–3.09	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	2.59–3.09	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	2.59–3.09	3.14–3.64	4.49–4.99	0.60–1.10	0.80–1.30	1.25–1.75
End of year								
2016	0.50–1.00	2.45–2.95	2.59–3.09	3.25–3.75	4.49–4.99	0.60–1.10	0.80–1.30	1.25–1.75
2017	1.00–2.00	2.95–3.95	3.25–4.05	4.10–4.90	4.60–5.40	0.60–1.30	0.90–1.70	1.35–2.15
2018	2.00–3.00	3.95–4.95	4.00–4.80	4.50–5.30	5.10–5.90	0.75–1.55	1.45–2.25	1.80–2.60

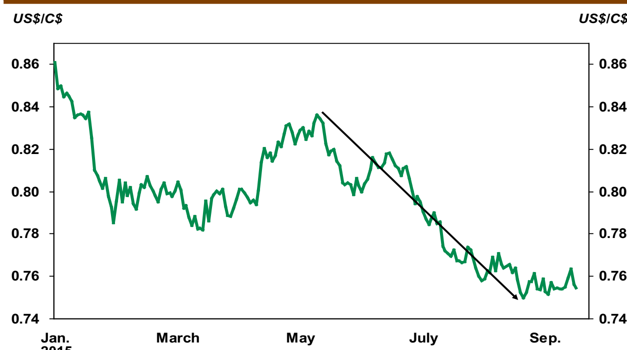
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

Some respite for the Canadian dollar

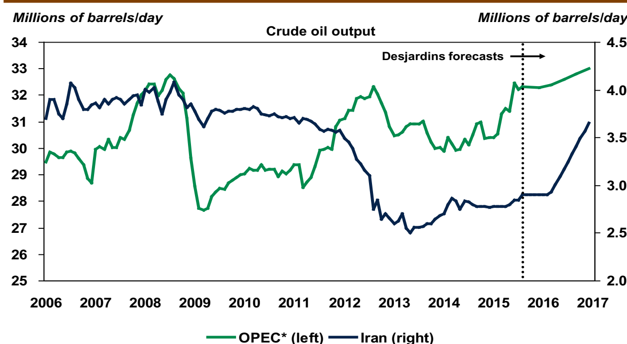
- After the significant depreciation of recent months (graph 5), the Canadian dollar is enjoying a period of greater stability and even made a brief incursion close to US$0.77 (CAN$1.30/US$) recently. However, this temporary rebound was not supported by any improvement in fundamental variables; rather, it was mainly caused by the depreciation of the U.S. dollar that occurred when the Federal Reserve (Fed) decided to postpone the start of its monetary firming.
- The other major currencies, such as the euro, pound sterling and yen, also reacted to the greenback's weakness. The euro climbed to over US$1.14 and the pound to over US$1.56, while the Japanese exchange rate reached ¥119/US$. Those currencies generally enjoyed a stronger and more lasting advance than the Canadian dollar did. The euro and the pound are benefiting from an improved economic climate in Europe. The pound is also capitalizing in on expectations of monetary firming in the United Kingdom. As for the yen, it is considered to be a regional safe haven, and is benefiting from the current concerns surrounding many emerging countries, including China.
- Oil price fluctuations are still a key variable underlying the trend of the Canadian dollar, and setbacks multiplied for crude prices during the summer. The factor with the most serious impact is the sharp increase in production by the Organization of the Petroleum Exporting Countries (OPEC), which increase is likely to continue in the coming quarters, when Iranian oil is expected to make its return to the market (graph 6). The low oil prices also generate a considerable degree of uncertainty about the Canadian economy, and foster the possibility of further action by the Bank of Canada.
- **Forecasts:** The current respite for the Canadian dollar is expected to be temporary. The U.S. dollar should pick up steam in the coming months once the Fed finally goes ahead with monetary firming. The Canadian dollar will likely fall back below US$0.75 (above CAN$1.33/US$). Over the longer term, the anticipated lasting weakness of oil prices does not herald any strong rebound for the loonie.

Graph 5 – The Canadian dollar lost 10% of its value between May and August



Sources: Datastream and Desjardins, Economic Studies

Graph 6 – With the lifting of sanctions against Iran, OPEC* output will keep increasing



* Organization of the Petroleum Exporting Countries.
Sources: Bloomberg 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	0.7600	0.7400	0.7400	0.7500	0.7600	0.7700
CAN$/US$	1.1199	1.1621	1.2688	1.2493	1.3158	1.3514	1.3514	1.3333	1.3158	1.2987
CAN$/€	1.4147	1.4061	1.3626	1.3920	1.4737	1.4459	1.4324	1.4400	1.4211	1.4286
US$/€	1.2632	1.2101	1.0740	1.1142	1.1200	1.0700	1.0600	1.0800	1.0800	1.1000
US$/£	1.6212	1.5593	1.4845	1.5727	1.5500	1.5200	1.5400	1.5600	1.5500	1.5700

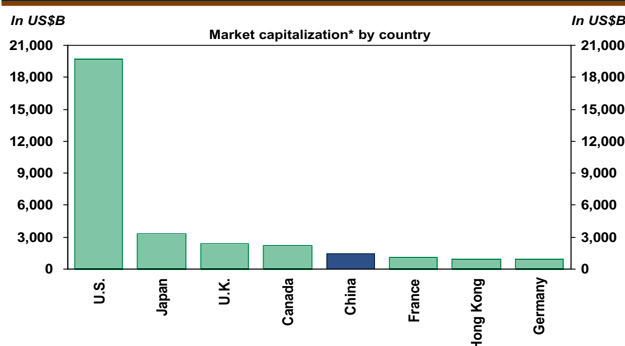
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies | f: forecasts

ASSET CLASSES RETURN

Dust settles but markets are still on the edge

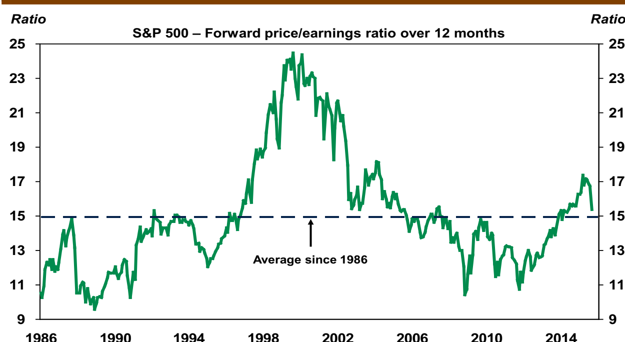
- **In overseas stock markets, stabilization is the order of the day.** August's sudden plunge—due to a series of events in China—has left its mark. For example, in Europe, German and French stock markets are still languishing more than 10% lower than where they stood on July 31. Those declines are only slightly less than that of the Shanghai stock market, even though it was the epicentre of the summer tensions. Although we note that despite the bad press emerging markets have been subject to, the MSCI index of those countries has recovered half of the losses sustained between July 31 and the trough of August 24. In reality, the global reaction to the tensions in China was out of proportion, especially when we consider the relatively small size of the Chinese market (graph 7), in addition to the limited foreign exposure to it. If we also take into account the fact that the turmoil occurred during a period of low liquidity in global stock markets, the return to a more normal situation in September appears even more logical.
- **In the United States, the S&P 500 is heading, albeit unsteadily, towards 2,000 points.** The index suffered a correction on August 25, setting a low at 1,867 points. The tensions of August was reflected in the VIX/S&P volatility index, which shot up to the level of 41 (its highest point since 2011) on August 24. It subsequently subsided, although no lower than 20 points, mirroring the rather erratic progress of the S&P 500. This rally nonetheless challenges the arguments of those who attributed the August meltdown to a sudden realization on the part of investors that the market was overvalued. Certainly, the forward price/earnings ratio is above its long-term average (graph 8), but not to a dramatic degree. These conditions are partly a reflection of extremely accommodative monetary policies, but even if the Federal Reserve (Fed) starts normalizing interest rates soon, the process will be characterized by a deliberately slow pace (graph 9). The Fed will strive to avoid the sort of destabilization that some observers are apprehending, although we acknowledge that until it makes that decision, the investment climate will remain tense. We have downgraded our target return for the S&P 500 to 3.5%. A rebound of 7.5% is expected next year.
- **The Canadian stock market, also battered during the August upheaval, is now faring slightly better.** But its uptick of 4.7% since its trough of August 24 is slightly less than the S&P 500's recovery during the period; oil prices in particular are continuing to tarnish its performance. Indeed, Canadian oil prices underwent powerful downward pressures over the summer, even tumbling to US$22.57 on August 17 (graph 10), jeopardizing the profitability of oil sand operations. The slight rebound above US$30 in September does not offer much in the way of reassurance. Meanwhile, concerns about China have triggered a new correction in base metal prices. It is therefore not surprising that energy and materials are the sectors that have struggled the most since the beginning of the third quarter.

Graph 7 – The Chinese market is far from large enough to destabilize the rest of the world



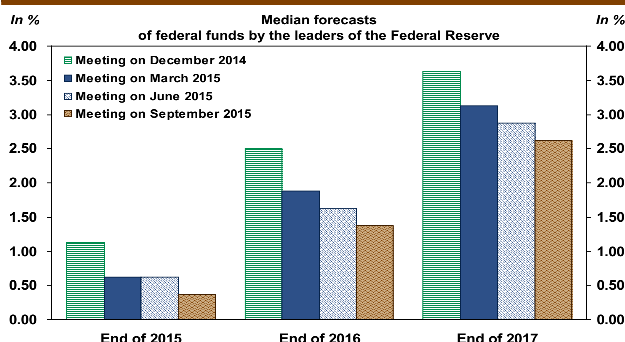
* In September 2015.
Sources: Bloomberg and Desjardins, Economic Studies

Graph 8 – The U.S. stock market was not inordinately overvalued



Sources: Institutional Brokers' Estimate System, Datastream and Desjardins, Economic Studies

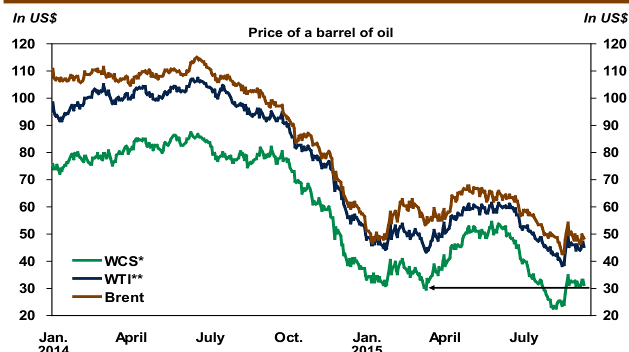
Graph 9 – The Federal Reserve still signals a gradual key interest rate increase



Sources: Federal Reserve and Desjardins, Economic Studies

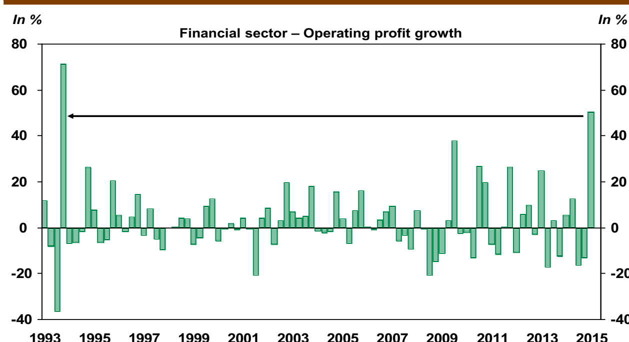
- **The financial sector, which also carries a significant weight in the Canadian stock market index, paid the price as foreign investors reduced their exposure to Canada earlier this year, but the sector has managed to stabilize in recent weeks.** Both announced results and official data have testified to surprisingly strong profitability in Canada's financial industry (graph 11). Now that the negative halo effect of the technical recession is dissipating, financial stocks should be able to keep winning more ground. All things considered, we are now forecasting a negative return of 1.0% for the Canadian stock market this year. Assuming that commodity prices stabilize, the outlook is somewhat more constructive for 2016, but not spectacular. We are setting our target at 6.5% for next year.

Graph 10 – The price of a barrel of Canadian oil merely managed to climb back to its previous low



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

Graph 11 – Best profit growth in more than two decades in Canada's financial industry



Sources: Statistics Canada 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: -1.0	target: 3.5	target: 4.0	target: 16.3 (US$0.74)
range	0.45 to 0.65	1.0 to 7.0	-8.0 to 3.0	-6.0 to 8.0	-7.0 to 11.0	11.8 to 21.2
2016f	target: 0.45	target: -3.0	target: 6.5	target: 7.5	target: 8.0	target: -3.9 (US$0.77)
range	0.20 to 0.70	-6.0 to 1.0	1.0 to 11.0	3.0 to 12.0	1.0 to 13.0	-8.6 to 4.2

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