Retail Rate Forecasts
Desjardins Economic Studies
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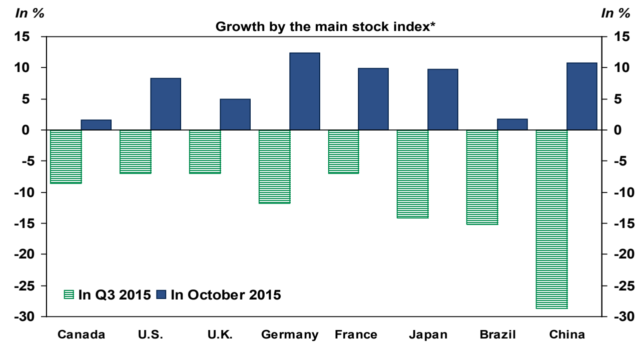
Renewed optimism despite looming U.S. monetary firming

HIGHLIGHTS

- Investor optimism improves after a tough third quarter.
- Canada's economy is doing much better than in the first half of the year.
- The job creation rebound opens the door to U.S. key rate increases.
- The greenback is on the rise again.
- The stock markets are relatively calm in the face of imminent monetary firming.

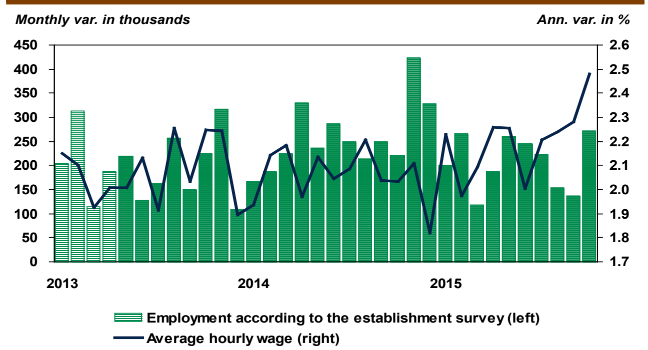
- **For investors, the fourth quarter got off to a good start.** Following the third-quarter plunge that took most stock indexes below where they ended 2014, the exchanges posted substantial rebounds in October (graph 1). The latest developments in China, including 6.9% real GDP growth (annualized third-quarter change) and further monetary policy easing, have eased fears of a collapse by emerging nations. The S&P 500 recently came back into positive territory and several European stock markets are once again showing better than 10% growth from the start of 2015.
- **The Canadian economy's rebound is confirmed.** There's no room for doubt: the technical recession that hit Canada's economy in the first half of 2015 is a thing of the past. Given real GDP growth by industry posted for June (+0.4%), July (+0.3%) and August (+0.1%), the carryover for the third quarter is very positive, at around 2.5%. The activity rebound primarily seems to be due to a substantial improvement in the trade balance. Data on employment and housing starts also beat expectations and nothing points to further Canadian monetary policy easing. However, the Bank of Canada will wait several more quarters before it contemplates a key rate increase.
- **Encouraging signs in the United States.** Real GDP rose by just 1.5% (annualized) in the third quarter of 2015, according to the advance estimate of the national accounts. The slowdown from the excellent 3.9% gain recorded last spring is, however, primarily due to a big slowdown in business inventories while U.S. domestic demand remained robust, posting growth of 2.9%. After two disappointing months, October's strong job creation and wage acceleration are further signs that the U.S. economy is solid (graph 2).

Graph 1 – The stock markets rebounded in October after a very tough Q3



* In national currencies.
Sources: Datastream and Desjardins, Economic Studies

Graph 2 – Employment rebounds in tandem with better wage growth



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

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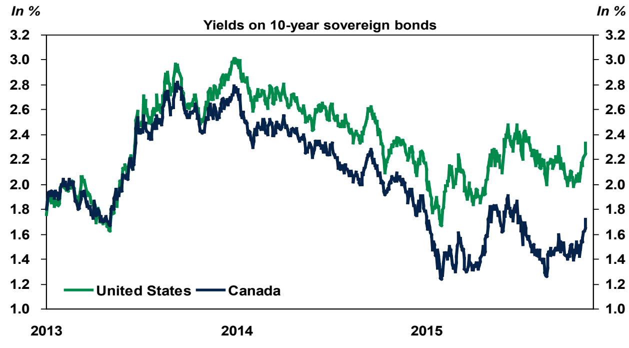
Note to readers: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

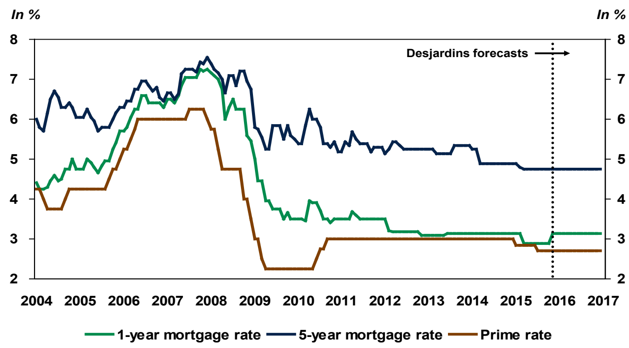
- **The Federal Reserve (Fed) should kick off monetary firming in December.** The factors that had prompted the Fed to stick with the status quo in September—the problems in the financial markets and emerging nations—no longer seem to be an obstacle to a key rate increase. If the economic and financial situation remains fairly solid, the conditions should finally be in place for a first U.S. key rate increase at the December 16 meeting. The Fed will, however, be sure to reiterate that interest rates will only come up very gradually.
- **Retail rates should stay quite stable.** The growing expectations of a looming key rate increase pushed North American bond yields up in recent weeks (graph 3). However, yields are still very low and increases should be limited in the coming quarters, as the Fed will be cautious and Canadian key rates will not change. Some Canadian mortgage rates went slightly up recently. In general, however, retail rates should stay close to current levels for several more quarters (graph 4).

Graph 3 – Despite the recent increase, bond yields remain relatively low



Sources: Datastream and Desjardins, Economic Studies

Graph 4 – Stability in sight for most 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								
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. 2015	0.75	2.70	2.89	3.39	4.74	0.85	1.05	1.50
Oct. 2015	0.75	2.70	2.89	3.39	4.74	0.85	1.05	1.50
Nov. 12, 2015	0.75	2.70	3.14	3.39	4.74	0.85	1.05	1.50
Forecasts								
End of quarter								
2015: Q4	0.50–0.75	2.45–2.70	2.89–3.39	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	2.89–3.39	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	2.89–3.39	3.14–3.64	4.49–4.99	0.60–1.10	0.80–1.30	1.25–1.75
2016: Q3	0.50–1.00	2.45–2.95	2.89–3.39	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	2.89–3.39	3.14–3.64	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	3.85–4.65	4.50–5.30	0.60–1.30	0.80–1.60	1.25–2.05
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	1.75–2.55

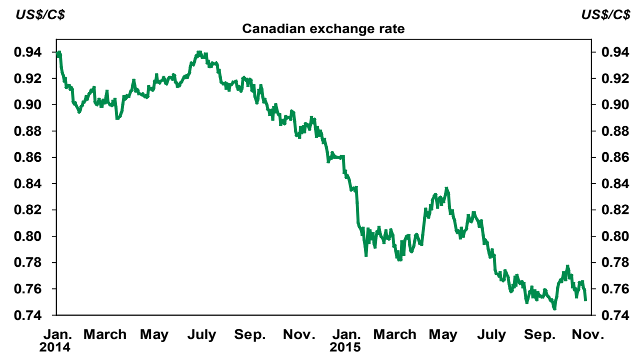
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

The greenback is on the rise again

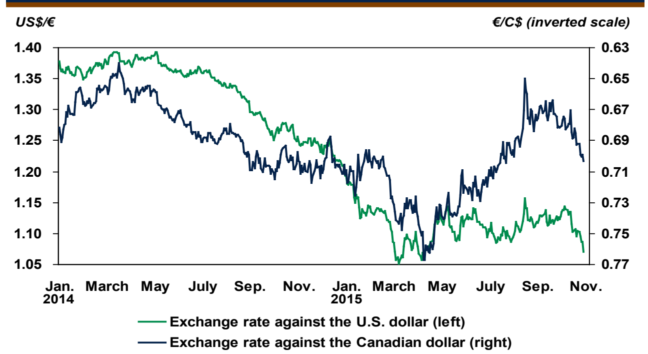
- The U.S. dollar is capitalizing on the recent improvement to U.S. economic figures and higher expectations of monetary firming in December. In exchange, this is hurting most of the other currencies, including the Canadian dollar, which slid back to around US$0.75 (graph 5). The loonie had risen to almost US$0.78 a few weeks before.
- Aside from greenback movements, the loonie remains very sensitive to the value of oil. WTI (West Texas Intermediate) fell back below the US$45/barrel mark, putting additional pressure on the currency. A more positive factor for the loonie is the drop in expectations of a Canadian key interest rate cut, as the economy is showing clear signs of rebounding following the technical recession in the first half of the year. That said, the impact on the loonie is being offset by interest rate movement in the United States. Moreover, given that Canada's economic rebound is highly dependent on how exports do, the exchange rate must stay low not to rein in this driver.
- Among the major currencies, the euro slid further in the last few weeks (graph 6). Like the Canadian dollar, the euro is being affected by the strong U.S. dollar, but expectations for euro zone monetary policy are steepening the movement. In October, the European Central Bank clearly opened the door to further monetary easing, which could be ordered in December.
- **Forecast:** The greenback should remain strong over the coming months unless U.S. key interest rate increases are postponed. In this context, the Canadian dollar should drop below US$0.75, especially as oil prices are not expected to go up much in the near term. The euro should test the US$1.05 mark and remain relatively stable against the loonie.

Graph 5 – The Canadian dollar is back at US$0.75



Sources: Datastream and Desjardins, Economic Studies

Graph 6 – The euro has dropped more steeply



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	Q2	Q3	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0.8929	0.8605	0.7882	0.8004	0.7510	0.7500	0.7400	0.7500	0.7600	0.7700
CAN$/US$	1.1199	1.1621	1.2688	1.2493	1.3315	1.3333	1.3514	1.3333	1.3158	1.2987
CAN$/€	1.4147	1.4061	1.3626	1.3920	1.4863	1.4267	1.4189	1.4133	1.4211	1.4286
US$/€	1.2632	1.2101	1.0740	1.1142	1.1162	1.0700	1.0500	1.0600	1.0800	1.1000
US$/£	1.6212	1.5593	1.4845	1.5727	1.5148	1.5100	1.5100	1.5300	1.5600	1.5700

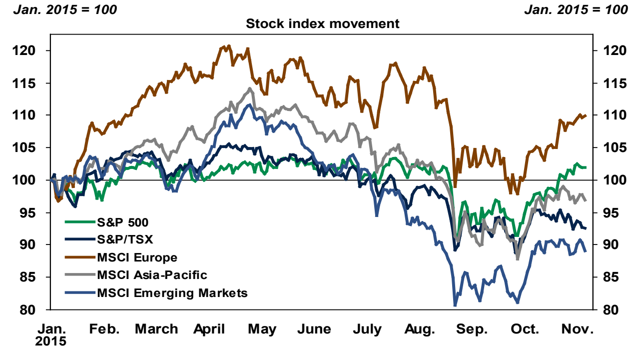
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies f: forecasts

ASSET CLASSES RETURN

The stock markets are relatively calm in the face of imminent monetary firming

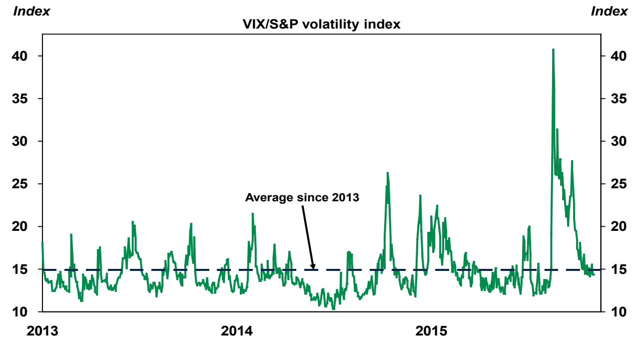
- **Following a stabilization phase at the end of the third quarter, the stock markets are poised to wrap up the year on a good note.** Major stock market gains were recorded in October in most regions (graph 7). The German and French indexes posted respective gains of 12.3% and 9.9%. In Asia, the Japanese stock market did well, rising 9.7%; even the Shanghai index, which tumbled for much of the summer, recouped 10.8%. The Federal Reserve's (Fed) decision to push back its rate increases provided some relief, especially in emerging countries. These countries' currencies have been much more stable in comparison to the third quarter's widespread depreciation. The stabilization of the stock markets and currencies goes hand in hand with abating capital outflows, particularly in China. Hence, even though the Fed recently warned that a first rate increase could come in December, emerging markets seem a little better prepared.
- **In the United States, the S&P 500 is in the neighbourhood of 2,100 points after October's 8.8% jump.** The index has recouped a good portion of last summer's losses. Our year-end target for the S&P 500 index is now at 2,150 points, for a return of 6.0%. Volatility cooled more definitively in October, with the VIX/S&P index tumbling to around 15 points (graph 8), the average that preceded August's events. On the earnings' front, as of November 5, two thirds of businesses had unveiled their third-quarter results. Just over 70% reported earnings that beat expectations, although some industries struggled. In the materials sector, operating profits per share dropped 66% over a year. In the energy sector, despite some recovery in the third quarter, earnings were 85% below where they were in the third quarter of 2014. On the other hand, solid consumption is stimulating profitability in the consumer discretionary sector and profits were up 14% year-over-year.
- **It will be interesting to watch how the sectors adjust to the monetary tightening environment.** For example, in the first months following the start of the last three hiking episodes, finance, capital goods and technologies were among sectors that tended to outperform the total index. By opposition, consumer durables, materials and pharmaceuticals had more difficulty. It is not unreasonable to expect higher rates to favour the profitability of banks and insurance companies, while reining in consumption somewhat. We must nonetheless keep in mind that the looming hiking cycle will be a very gradual one. Sectors could therefore react differently than they have previously, especially as tightening will occur in a more fragile global economic environment compared with some prior episodes (graph 9).

Graph 7 – The stock markets have recovered somewhat since the start of Q4



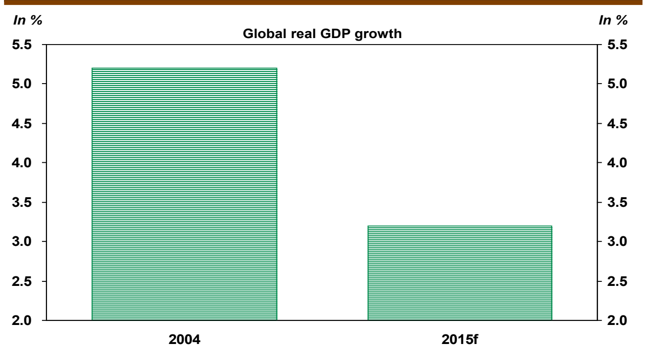
Sources: Bloomberg and Desjardins, Economic Studies

Graph 8 – Stock market volatility has receded



Sources: Chicago Board of Trade and Desjardins, Economic Studies

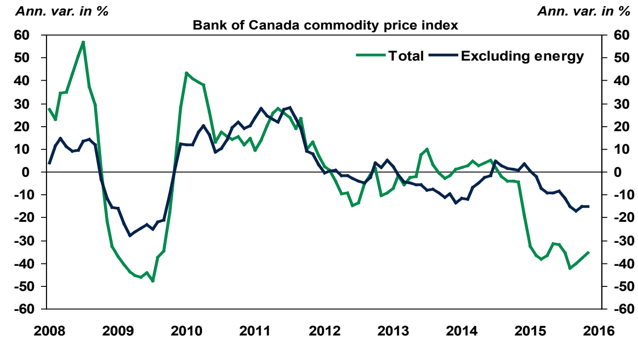
Graph 9 – Global growth is somewhat weaker than in 2004, when the Federal Reserve started firming



f: Desjardins forecasts.
Sources: International Monetary Fund and Desjardins, Economic Studies

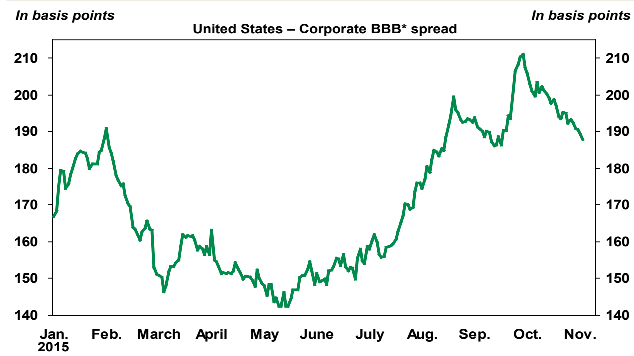
- **Unsurprisingly, the Canadian stock market is lagging and poised to post a 2.0% loss for 2015.** Company results of major oil producers continue to attest to intense pressure on profits, with Canadian oil struggling to stay above US$30 a barrel. The weakness in non-energy commodity prices (graph 10) is also affecting the materials sector. Added to this are the struggles faced by major names in the pharmaceutical and aviation industries. On the other hand, as we expected, the financial sector has turned around in the last few weeks. Given the problems that continue to afflict the outlook for commodity prices and the Canadian currency, it would be surprising for foreign investors to rush back to Canada.
- **Bonds finally started to beat a retreat in recent weeks.** The looming U.S. key rate increase necessarily implies that this asset class will be disadvantaged. However, risk assets showed good tolerance given the imminence of this scenario, resulting in a narrowing of corporate and provincial credit spreads this fall following the upswing at the end of the summer (graph 11). In general, we expect the Fed's very gradual approach to stave off any carnage for bonds. Following a return of 2.0%, bonds should generate a flat return next year.

Graph 10 – Non-energy commodity prices are also down



Sources: Bank of Canada and Desjardins, Economic Studies

Graph 11 – Credit spreads have been consolidating in the last few weeks



* Compared with U.S. 10-year federal bonds.
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: 0.55	target: 2.0	target: -2.0	target: 6.0	target: 4.0	target: 14.7 (US$0.75)
range	0.50 to 0.60	0.0 to 4.0	-8.0 to 2.0	-2.0 to 9.0	-5.0 to 7.0	11.8 to 17.9
2016f	target: 0.45	target: 0.0	target: 6.5	target: 7.5	target: 8.0	target: -2.6 (US$0.77)
range	0.25 to 0.65	-4.0 to 3.0	1.0 to 11.0	3.0 to 12.0	1.0 to 13.0	-7.4 to 4.2

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