Retail Rate Forecasts

Desjardins Economic Studies
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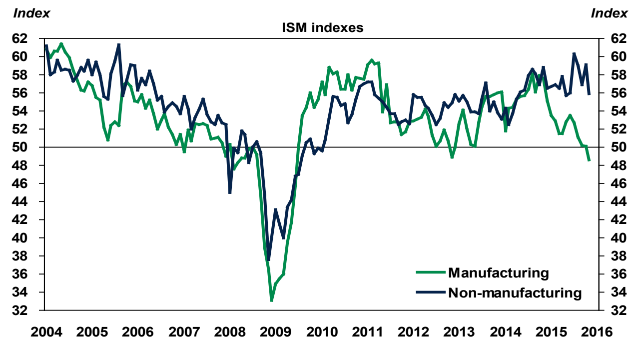
The Bank of Canada will not imitate the Federal Reserve anytime soon

HIGHLIGHTS

- The Federal Reserve raised its key rates for the first time in nearly 10 years.
- Weak oil prices confirm that the Bank of Canada will not consider raising its rates before 2017.
- The low interest rate environment should persist.
- The Canadian dollar is at a new cyclical low.
- Monetary firming will not hurt the stock markets in 2016.

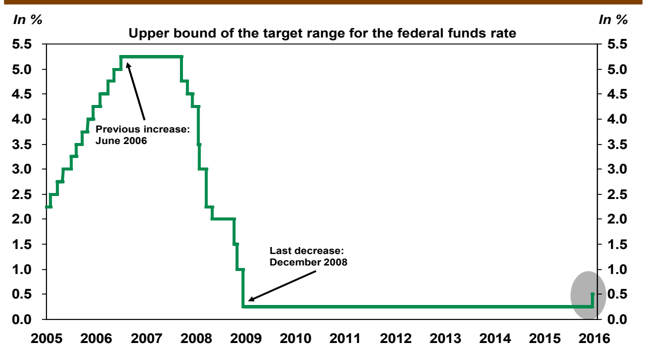
- **Modest growth by the U.S. economy in the second half of 2015.** After surging in the second quarter, the U.S. economy slowed last summer and limited growth is forecast for the fourth quarter. The problems in the manufacturing sector (graph 1), which is grappling with a slower energy sector and a skyrocketing U.S. dollar, are limiting U.S. economy's growth. The outlooks remain good for real estate and consumption, however, as a lively job market and tumbling gas prices are very good news for households.
- **First rate increase since June 2006 in the United States.** The U.S. job market's solid performance finally convinced Federal Reserve (Fed) leaders to launch monetary firming at their December 16 meeting (graph 2). The Fed clearly signalled, however, that U.S. key rate increases would be very gradual. The decision did not have much immediate impact on the financial markets, as it had been widely anticipated.
- **The problems of the Canadian economy are not over, but 2016 promises to be a little better.** After a very tough first half of the year, the Canadian economy posted a good rebound in Q3 of 2015 on a surge by exports. In the fourth quarter, however, growth promises to be disappointing (graph 3 on page 2), as oil prices weakened further and the recent evolution of international trade is less favourable. The problems in the energy sector should persist next year, but the Canadian economy could still accelerate somewhat as business investment should pull back less sharply and the federal government's infrastructure investment will increase.

Graph 1 – The manufacturing sector is facing some trouble but the rest of the U.S. economy is doing well



Sources: Institute for Supply Management and Desjardins, Economic Studies

Graph 2 – First Federal Reserve rate hike in nearly 10 years



Sources: Datastream and Desjardins, Economic Studies

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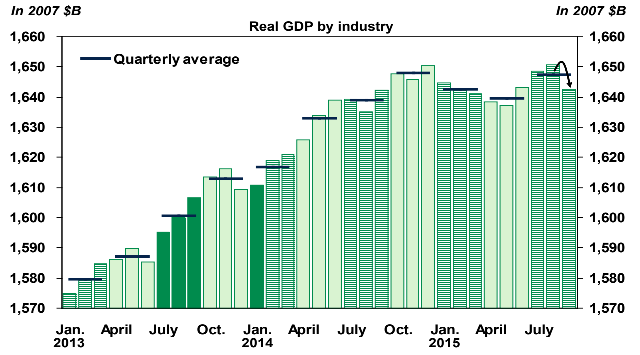
Note to readers: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

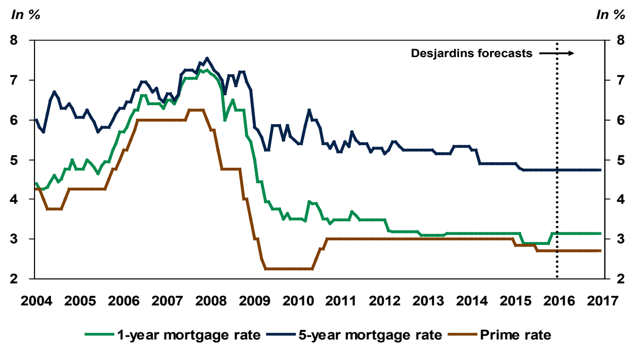
- **No Canadian key rate increase before 2017.** The outlook for Canada's economy is not as good as it is for the U.S. economy, particularly in terms of domestic demand. The Bank of Canada (BoC) will therefore have no reason to raise its key rates in 2016. Additional disappointment from the economy and another decline by oil prices could even open the door to further monetary easing in Canada in the first half of the year. An extended status quo remains the most likely scenario.
- **Negative rates are possible but unlikely in Canada.** In light of the European experience, the BoC now thinks it can, if necessary, lower the target for the overnight rate to around -0.50%. It would take another big shock however for the BoC to consider negative rates or other unconventional measures, especially against the backdrop of rising U.S. rates.
- **Retail rates will stay close to where they are.** North American bond yields remain very low and the slow rise of U.S. key rates suggests only a limited increase in the coming months. In this context, Canadian financial institutions should keep retail rates close to where they are through 2016 (graph 4).

Graph 3 – Canada's economic growth is shaping up to be weak in Q4



Sources: Statistics Canada and Desjardins, Economic Studies

Graph 4 – Retail rates should stay close to where they are throughout 2016



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								
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. 2015	0.75	2.70	3.14	3.39	4.74	0.85	1.05	1.50
Dec. 21, 2015	0.75	2.70	3.14	3.39	4.74	0.85	1.05	1.50
Forecasts								
End of quarter								
2015: Q4	0.75	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	0.75–1.75	2.70–3.70	3.00–3.80	3.70–4.50	4.50–5.20	0.60–1.30	0.80–1.50	1.25–2.00
2018	1.75–2.75	3.70–4.70	3.70–4.50	4.10–5.00	4.90–5.70	0.75–1.55	1.15–1.95	1.55–2.35

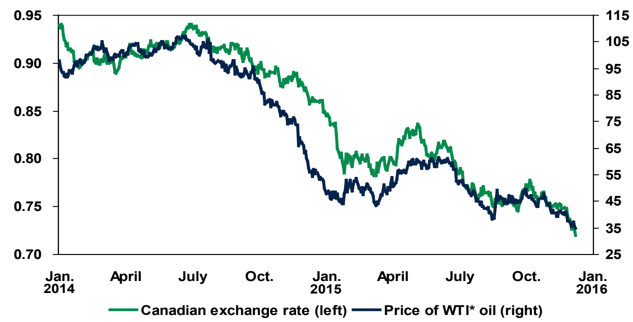
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

Canadian dollar at a new cyclical low

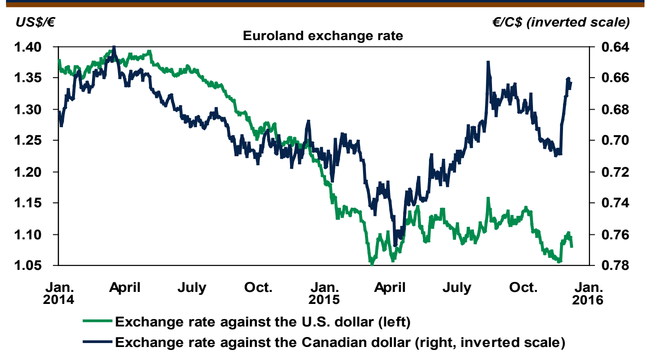
- The loonie recently hit US$0.7146, its lowest point since May 2004. Over the last year and a half, the loonie has primarily been affected by tumbling oil prices (graph 5). The impact on the exchange rate is making itself felt through a drop in export revenue, and therefore a drop in demand for Canadian dollars. Moreover, by sapping the Canadian economic outlook, low oil prices are increasing interest rate spreads with other countries, putting additional downside pressure on the currency.
- The fact that the Federal Reserve (Fed) has launched monetary firming while the Bank of Canada seems to be nowhere near doing so is widening interest rate spreads. Monetary firming favours the U.S. dollar over the loonie, as well as against most other currencies. That being said, the Fed is able to raise its interest rates now because the U.S. economy is doing well. A rise of the U.S. demand is generally good for Canada's economy, which can limit the loonie's depreciation. However, the positive effect on the economy must be confirmed by an upswing in Canadian exports, which was not the case with the most recent data.
- After several months of weakness, the euro rebounded against a number of currencies in early December. The easing measures announced by the European Central Bank (ECB) disappointed the markets. Among other things, they were hoping that the ECB would pick up the pace on securities purchases. The Canadian dollar is now worth less than €0.67 (graph 6).
- **Forecasts:** The Canadian dollar should benefit from the expected upswing by oil prices, something we should mainly see in the second half of 2016. The unfavourable movement by interest rate spreads resulting from ongoing monetary firming in the United States will, however, limit the loonie's gains, and it should end 2016 at around US$0.75. It promises to rise more steeply against the euro, which will continue to be penalized by the fragility of the economic recovery and the level of ECB intervention.

Graph 5 – Oil takes the loonie down with it



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

Graph 6 – The euro rebounds at the start of December



Sources: Datastream and Desjardins, Economic Studies

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

Table 2
Forecasts: currency

	2015		2016				2017			
End of period	Q3	Q4f	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0.7510	0.7200	0.7200	0.7400	0.7500	0.7500	0.7600	0.7700	0.7900	0.8100
CAN$/US$	1.3315	1.3889	1.3889	1.3514	1.3333	1.3333	1.3158	1.2987	1.2658	1.2346
CAN$/€	1.4863	1.5000	1.4583	1.3919	1.3600	1.3467	1.3553	1.3506	1.3291	1.3333
US$/€	1.1162	1.0800	1.0500	1.0300	1.0200	1.0100	1.0300	1.0400	1.0500	1.0800
US$/£	1.5148	1.5000	1.4900	1.4800	1.4900	1.5000	1.5100	1.5200	1.5300	1.5500

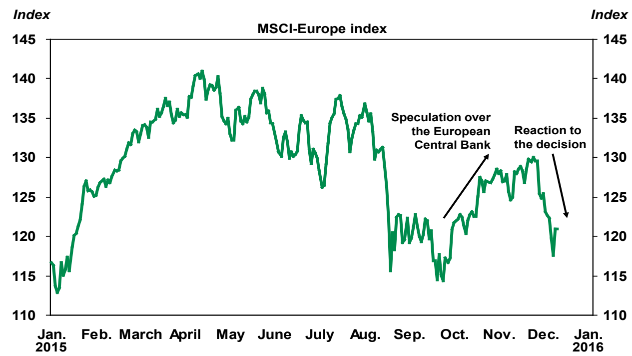
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies f: forecasts

ASSET CLASSES RETURN

Monetary firming will not hurt the stock markets in 2016

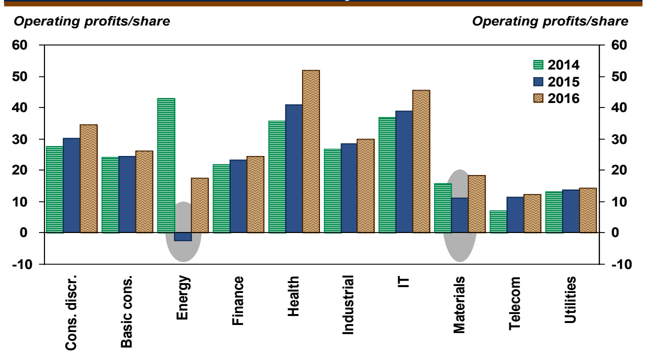
- **The year 2015 concludes with renewed volatility in stock markets.** The VIX/S&P index has made a few incursions above 20 points in December. Strains in the lower-quality corporate bond markets had an adverse impact on investor sentiment. Central banks have added to the nervousness. In Europe, stock markets were buoyed in November when persisting rumours led many to expect spectacular announcements from the European Central Bank (ECB) at its December 3 meeting. The ECB did announce another cut to its deposit rate and an extension to its securities purchasing program, but these moves left many investors wanting. The stock market lost much of its gains following the decision (graph 7). Ironically, European stock markets later saluted the Federal Reserve's (Fed) announcement of a first rate increase in over nine years. In general, the world's stock markets welcomed the decision, given that the Fed reassured by indicating it did not intend to aggressively tighten its monetary policy.
- **In the United States, the S&P 500 is holding between 2,000 and 2,100 points.** This is down slightly from where it was in early November. Stock market is poised to end the year with a flat return. Things could have been worse, given the problems in the energy sector and the impact of a stronger dollar on the value of income generated abroad. However, a look at operating profits per share shows that the profitability problems are confined to the commodity sectors (graph 8). Estimated profits for 2015 are otherwise up in most sectors, with the trend forecast to continue in 2016, in conjunction with renewed profitability in commodities.
- **This should help the S&P 500 beat this year's fairly mediocre performance in 2016.** The Fed's gradual monetary policy firming should not compromise the U.S. stock market's performance. In the last cycle, from 2004 to 2006, the S&P 500 posted annualized growth of 7.1% (graph 9). With dividends included, we anticipate a return of 7.5% in 2016. Canadian investors looking to increase exposure to the U.S. market will still have to keep an eye on currency fluctuations. The expected appreciation of the loonie in the second half of the year could eat into returns generated in the United States once it is repatriated.
- **Although it has stabilized somewhat since November, 2015 will nonetheless be a year to forget for the S&P/TSX.** The problems plaguing the commodity sectors are well known but since last summer, the Canadian stock market slump has spread to several other components. Valeant's struggles have taken the health sector down. Industrials are being hurt by the problems Bombardier is experiencing. We expect a better performance for next year, especially in energy, in line with our scenario for a rise in oil prices. WTI (West Texas Intermediate) should end the year at US$55/barrel. Already, receding U.S. oil output points to a global oil surplus that will come to diminish (graph 10 on page 5). Meanwhile, the global economy is forecast

Graph 7 – Lack of speculation makes the European stock markets slump again



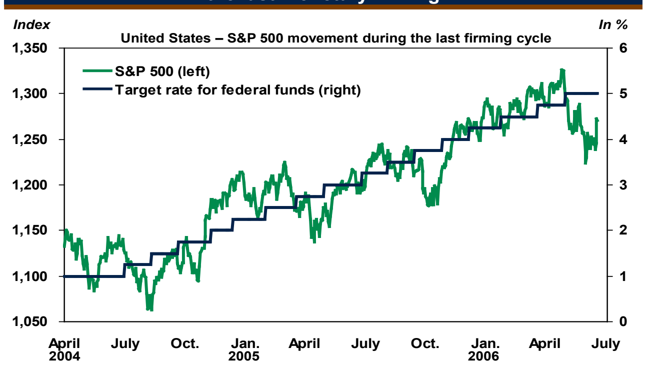
Sources: Bloomberg and Desjardins, Economic Studies

Graph 8 – The retreat by S&P 500 profits is limited to the commodity sectors



Sources: S&P Dow Jones Indices and Desjardins, Economic Studies

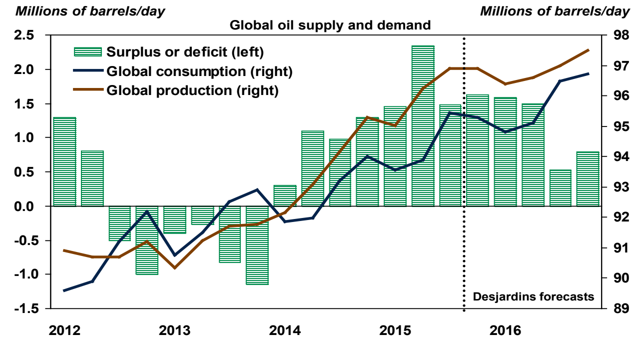
Graph 9 – The U.S. stock market's trend was positive during the last monetary firming



Sources: Bloomberg and Desjardins, Economic Studies to accelerate slightly, which should support demand. We expect a return of 6.5% from the S&P/TSX.

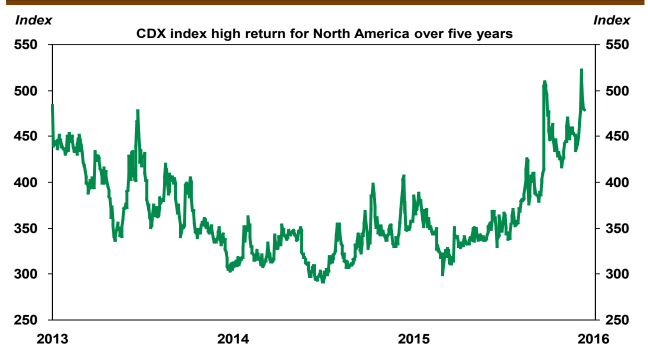
- **For fixed-income securities, 2015 was essentially in line with expectations.** While yields for some maturities rose in the United States following the Fed's announcement, the situation is quite different in Canada, as the Bank of Canada ordered two key rate cuts in addition to opening the door to negative rates at the end of the year. This helped the Canadian bond index generate a positive return. The less cautious investors were hurt at year-end, particularly in the U.S. junk bond market. With the policy rate increase and profitability problems in the energy sector, the perception of risk has intensified, as demonstrated by the higher prices for credit default swaps (graph 11). Insofar as monetary policy previously caused investors to underappreciate these risks, the adjustment can be construed as a positive development.

Graph 10 – The surplus supply should start being absorbed as of mid-2016



Sources: International Energy Agency and Desjardins, Economic Studies

Graph 11 – Investors anticipate more payment defaults by higher risk borrowers



Sources: Bloomberg 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 range	target: 0.55 0.50 to 0.60	target: 3.5 2.5 to 4.5	target: -8.0 -11.0 to -5.0	target: 0.0 -3.0 to 3.0	target: -2.0 -5.0 to 1.0	target: 19.5 (US$0.72) 17.9 to 21.2
2016f range	target: 0.50 0.25 to 0.65	target: 0.0 -4.0 to 3.0	target: 6.5 1.0 to 11.0	target: 7.5 3.0 to 12.0	target: 8.0 1.0 to 13.0	target: -4.0 (US$0.75) -8.9 to 4.3

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