Retail Rate Forecasts

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The difficult start to the year confirms that rates will remain very low

HIGHLIGHTS

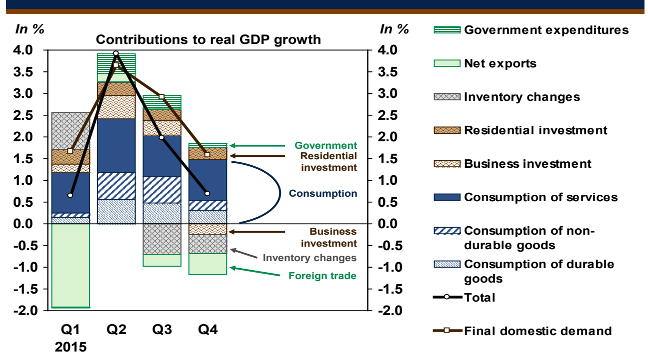
- Tough start to the year on financial markets.
- Monetary policies will remain highly expansionist.
- The drop in oil prices limits Canada's growth outlook.
- Too soon for the loonie to make a sustainable recovery.
- Oil rattles markets.

- **New wave of panic on the markets.** A new drop in oil prices and China's stock market fuelled investor concerns as 2016 unfolded. Stock markets around the world declined sharply in the first few weeks of January (graph 1). Actions by central banks helped stock markets recover somewhat, but market volatility remains very high.
- **Weak U.S. economic growth at the end of 2015.** U.S. real GDP rose only 0.7% (annualized) in Q4 2015 due to difficulties for foreign trade and declines in business investment, especially in the energy sector (graph 2). The U.S. economy still expanded by 2.4% in 2015 overall, thanks to a solid rise in consumer spending. Similar growth is expected for 2016.
- **Central banks will be very prudent.** The monetary authorities are not indifferent to the difficulties on the financial markets and the downgraded outlooks for oil prices and inflation. The Bank of Japan already implemented a negative rate policy and the European Central Bank has clearly signalled its intention to further ease its monetary policy in March. Federal Reserve leaders also appear concerned, and all signs suggest that increases to U.S. key rates will be even more gradual than previously expected.
- **A difficult year-end in Canada, but international trade developments are encouraging.** After rebounding last summer, Canada's economy appears to have stagnated in the fourth quarter of 2015. The new drop in oil prices point to ongoing difficulties in the energy sector. We have thus downgraded our 2016 growth outlook for Canada. However, the weak loonie and strong U.S. demand should continue to favour Canada's international trade (graph 3 on page 2).

Graph 1 – Stock markets suffer through a tough period, reminding us about the end of last summer

Sources: Datastream and Desjardins, Economic Studies

Graph 2 – U.S. economy slows at the end of 2015



Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

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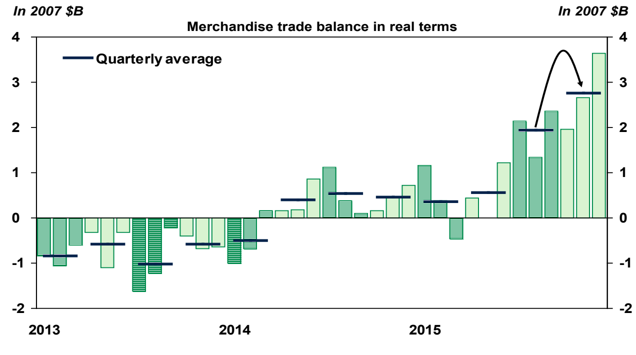
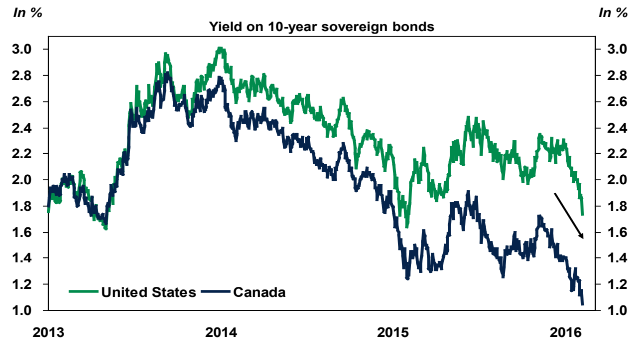
- **The Bank of Canada (BoC) seems more hesitant to act.** Despite tumbling oil prices, the BoC opted to maintain the status quo in December, betting on the weak loonie and budget measures to be announced in the next federal budget to offset the growing challenges for the energy sector. A very long status quo is the most likely scenario for Canada's monetary policy, but a rate cut could take place if the economic outlook deteriorates further.
- **Bond yields tumble while financing premiums rise.** The events of the last few weeks made bond yields plummet (graph 4). Rising concerns also fuelled a sharp rise in risk premiums, directly affecting the financing costs for Canada's financial institutions. This explains the steadiness of retail rates and why some promotional rates have even been slightly increased.
- **Little change in sight for retail rates.** The latest events confirm that bond yields will remain very low in the coming quarters. Evolving financial strains and competitive forces could bring about slight changes in retail rates but, all told, rates should remain close to current levels for a long while.

Graph 3 – The balance of trade in goods improves again in Q4 2015



Sources: Statistics Canada and Desjardins, Economic Studies

Graph 4 – Bonds yields retreated sharply



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								
August 2015	0.75	2.70	2.89	3.39	4.74	0.85	1.05	1.50
Sept. 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. 2015	0.75	2.70	3.14	3.39	4.74	0.85	1.05	1.50
January 2016	0.75	2.70	3.14	3.39	4.74	0.85	1.05	1.50
Feb. 8, 2016	0.75	2.70	3.14	3.39	4.74	0.85	1.05	1.50
Forecasts								
End of quarter								
2016: Q1	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: Q2	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: Q3	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: Q4	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								
2017	0.50–1.50	2.45–3.45	2.85–3.65	3.50–4.30	4.49–5.15	0.60–1.30	0.80–1.50	1.25–1.95
2018	1.50–2.50	3.45–4.45	3.45–4.25	4.00–4.80	4.65–5.45	0.60–1.40	0.95–1.75	1.35–2.15
2019	1.25–2.25	3.20–4.20	3.15–3.95	3.60–4.40	4.49–5.15	0.60–1.25	0.80–1.50	1.25–1.95

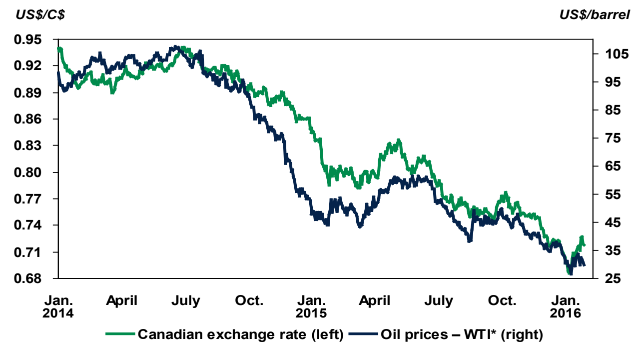
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

Too soon for the loonie to make a sustainable recovery

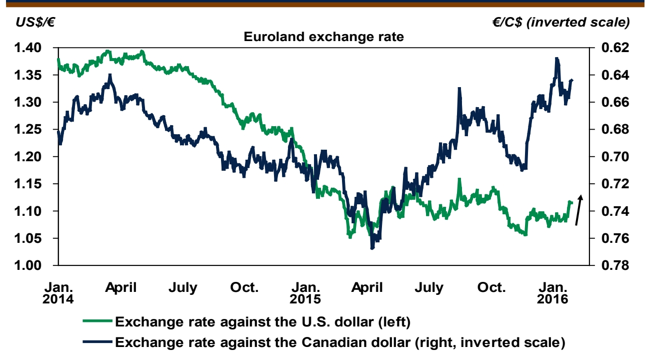
- The first weeks of the year were difficult for the loonie, which reached a 13-year low of US$0.6808 on January 20. The drop in oil prices and expectations regarding monetary easing in Canada are the main driving forces behind this weakness. More favourable tailwinds lifted the loonie in recent weeks, including a comeback by oil prices (graph 5). The reassuring tone adopted by the Bank of Canada at its meeting on January 21 was another upshot that forced the markets to revisit their expectations on key interest rates. The Canadian dollar would have likely kept dropping had another rate cut been ordered.
- As for the other currencies, the U.S. dollar struggled in recent weeks due to the weakness of some indicators released in the United States and the sentiment that the Federal Reserve will not be able to increase key rates as expected. For more than a year, the greenback's strength was largely attributed to the expected divergence between U.S. monetary policy and that of other major central banks. If less divergence translates into a weaker U.S. dollar, stronger demand for safe-haven securities limit any bearish movement, however. This new reality makes other currencies look better by comparison, including the loonie. The euro recently reached US$1.12 (graph 6), despite the fact that the European Central Bank should announce further monetary easing measures in March. The euro depreciated slightly against the loonie in recent weeks.
- **Forecasts:** The Canadian dollar especially runs the risk of depreciating in the short term. We believe it is too early to call for a sustainable recovery in oil prices. Moreover, the pessimism about the U.S. economy seems exaggerated, and suggests the greenback is poised to stage a comeback in the next few months. Later on this year, the loonie should capitalize on a new uptrend—sustainable this time—in oil prices, pushing the exchange rate to about US$0.73. The loonie should also gain ground against the euro.

Graph 5 – The loonie still closely tied to changes in oil prices



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

Graph 6 – Euro rebounds slightly as the greenback weakens



Sources: Datastream and Desjardins, Economic Studies

Determinants	Short-term	Long-term
Oil prices	→	↗
Metals prices	→	↗
Interest rate spreads	↘	→

Table 2
Forecasts: currency

	2015		2016				2017			
End of period	Q3	Q4	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0.7510	0.7225	0.6900	0.7100	0.7200	0.7300	0.7300	0.7400	0.7500	0.7700
CAN$/US$	1.3315	1.3841	1.4493	1.4085	1.3889	1.3699	1.3699	1.3514	1.3333	1.2987
CAN$/€	1.4863	1.5035	1.5652	1.4930	1.4583	1.4110	1.4247	1.4189	1.4267	1.4156
US$/€	1.1162	1.0863	1.0800	1.0600	1.0500	1.0300	1.0400	1.0500	1.0700	1.0900
US$/£	1.5148	1.4739	1.4400	1.4600	1.4800	1.4900	1.5100	1.5200	1.5300	1.5500

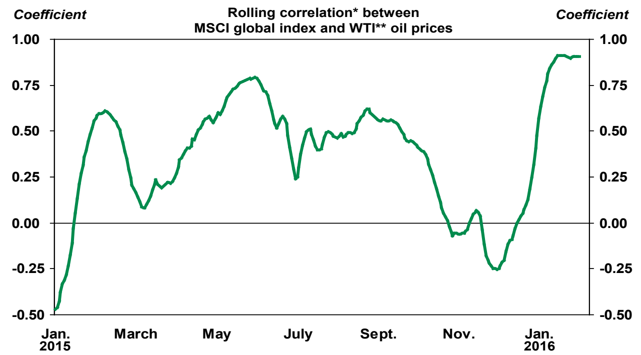
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies f: forecasts

ASSET CLASSES RETURN

Oil rattles stock markets

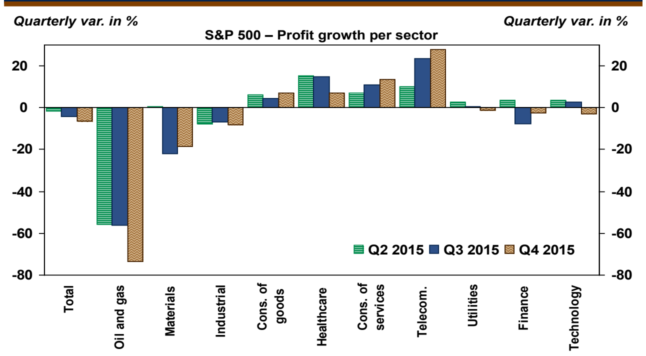
- **An eventful January for stock markets.** The MSCI global index declined 4.6% in January, but this outcome reflects the spectacular jump in global equities after the Bank of Japan's surprise announcement on January 29. The day before, the MSCI index was rather on track to post the worst record for the month of January since the financial crisis. The turmoil has not been confined to equity markets. Many currencies in the foreign exchange market suffered sharp declines in January after an already turbulent 2015. Credit securities, like corporate bonds and even provincial bonds, were not spared.
- **January's equity market shakeout began in China but quickly rippled through other stock markets, especially in Europe.** Only the signals sent by central banks managed to calm market jitters. Case in point, the European MSCI index recorded two of its best gains on January 22, after Mario Draghi clearly left the door open to new stimulus measures, and on January 29, when the Bank of Japan stepped into the negative rate universe. A similar phenomenon took place in the United States, where plummeting oil prices were the common vector behind this concerted shift—the intraday level of US$26.19 reached on January 20 marked a low dating back to 2003. As an indication of how oil prices are tied to investor sentiment, the correlation between crude oil prices and the MSCI global index closed in on 1 for the month (graph 7).
- **What has made the 2016 stock market meltdown unique is that it went against economic fundamentals, or at least those in most advanced nations.** The high frequency indicators in Europe continue to point to positive, albeit sluggish growth. The industrial sector in the United States is facing headwinds due to the strong dollar and major adjustments in the oil extraction sector. However, the economy continues to create jobs at a satisfactory pace and wage growth is accelerating.
- **S&P 500 earnings constitute a meaningful blemish to this picture, as they are poised to post a third consecutive contraction in Q4.** Equities tied to commodities continue to suffer material profit losses, and even some sectors that had resisted the trend thus far, e.g. finance and technology, are starting to post lower returns (graph 8). For some observers, this weak profit environment points to an economic recession in the United States. This stems from the fact that retreating profits have at times set the stage for a recession. However, there have also been several instances of contracting profits without an ensuing recession (graph 9). Downturns almost invariably take place following overheating episodes and major monetary tightening; the current situation does not present such characteristics. Our return target for the U.S. stock market is at 7.0%.

Graph 7 – Global stock market shifts in sync with recent oil price movements



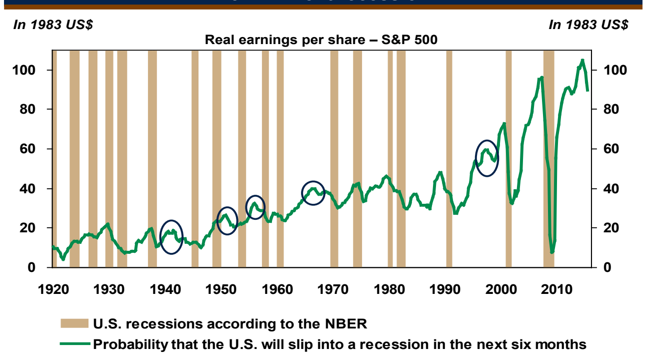
* Over three months; ** West Texas Intermediate.
Sources: Bloomberg and Desjardins, Economic Studies

Graph 8 – Several sectors post shrinking profits



Sources: Bloomberg and Desjardins, Economic Studies

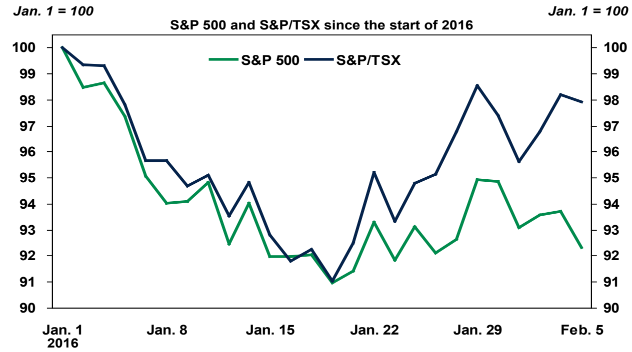
Graph 9 – There have been several profit downturns with no imminent recession



Sources: Robert J. Shiller, National Bureau of Economic Research and Desjardins, Economic Studies

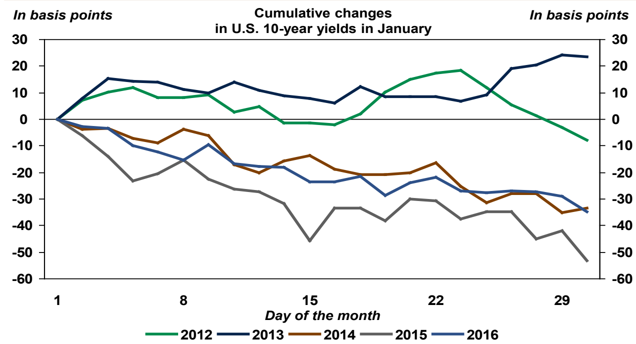
- **Canada's stock market has remarkably outperformed its U.S. counterpart since the start of the year** (graph 10). The weight of commodity stocks has fallen significantly given the severe cheapening of these securities in the past 18 months or so. While these sectors are still clearly depressed, signs of resilience are seen in consumer staples and utilities. The federal government is poised to introduce a potentially generous economic stimulus program and boost its annual infrastructure expenditures. This could provide an impetus to a number of sectors, such as materials, especially if the program includes greater support for transportation infrastructure than that outlined in the Liberal Party's election platform.
- **Despite the Federal Reserve's (Fed) initial decision to raise key rates in December, the climate of risk aversion that reigned throughout January was profitable for bonds.** This is not new for January. In 2014 and 2015, the U.S. 10-year yield had plunged by similar levels (graph 11). The yields should recover, however, as the Fed pursues monetary tightening by ordering two rate increases this year. This should limit the fixed income market's return to 1.0%.

Graph 10 – S&P/TSX faring better than the S&P 500 since the start of the year



Sources: Bloomberg and Desjardins, Economic Studies

Graph 11 – Yields tumble in January for the third straight year



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 %)***
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
2015	0.53	3.5	-8.3	1.4	-0.4	19.1
2016f	target: 0.50	target: 1.0	target: 3.0	target: 7.0	target: 4.0	target: -1.0 (US$0.73)
range	0.20 to 0.65	-2.0 to 4.0	-5.0 to 8.0	2.0 to 12.0	-8.0 to 10.0	-6.2 to 6.3

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