Retail Rate Forecasts

Desjardins Economic Studies
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May 9, 2016

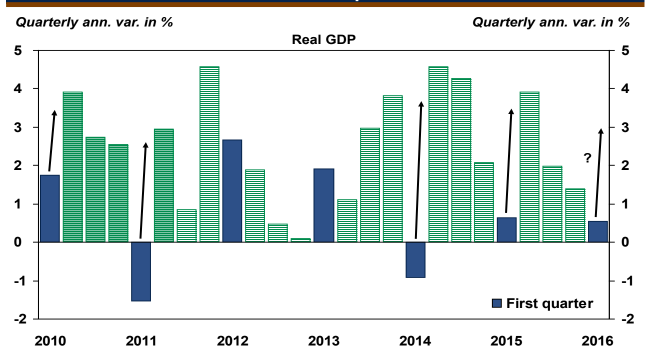
A start to the year that beats expectations in Canada

HIGHLIGHTS

- The U.S. economy had another disappointing first quarter.
- Surprisingly strong growth in Canada.
- Everything indicates that the status quo on Canadian key rates will continue.
- The loonie will have trouble getting above US$0.80 sustainably.
- We have raised our target for Canadian equities.

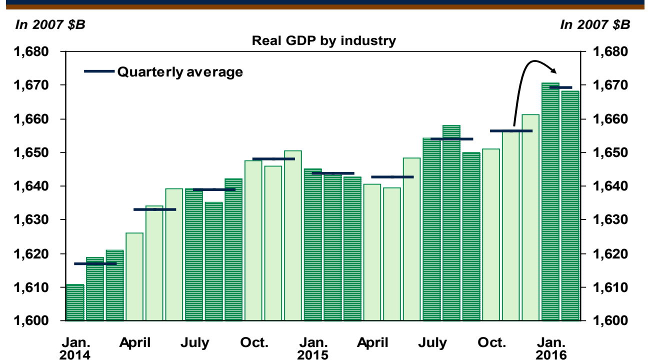
- **The U.S. economy only grew an annualized 0.5% in the first quarter of 2016.** Household consumption slowed and investment pulled back sharply, contributing to 2016's tough start. As has often happened in recent years, this surprising weakness should make way for stronger growth in the quarters to come (graph 1). The job market's solid performance and the fact that the ISM manufacturing index is now above 50 are encouraging.
- **When will U.S. key rates go up next?** Unsurprisingly, the Federal Reserve (Fed) did not change its monetary policy in April. Nor did it send a clear signal as to its plans for the June meeting, although Fed leaders seem a little less concerned about the international situation. If the U.S. economy picks up steam as expected and the looming British referendum on the European Union does not create too much upheaval, the next increase could be ordered as of June.
- **Growth seems to have been much stronger in Canada.** Canada's economic numbers have come in above expectations in recent months. Despite February's downtick, everything suggests real GDP growth will be around 3% (annualized) for the first quarter of 2016 (graph 2). More robust consumption and exports have play a role in this strong performance. This pace is not sustainable, however, as the Canadian economy is still adjusting to the drop in energy prices. Fort McMurray fires will also limit second quarter growth.
- **The Bank of Canada (BoC) is solidly on hold.** Despite the good Canadian data, the BoC only tweaked its growth outlooks when it released April's *Monetary Policy Report*. It stressed the Canadian dollar's rise and the less promising outlook for the world economy, as well as for investment in Canada's energy sector. However, the BoC was very

Graph 1 – The U.S. economy has often rebounded after a weak first quarter



Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

Graph 2 – Canadian growth could be around 3% for Q1 2016



Sources: Statistics Canada and Desjardins, Economic Studies

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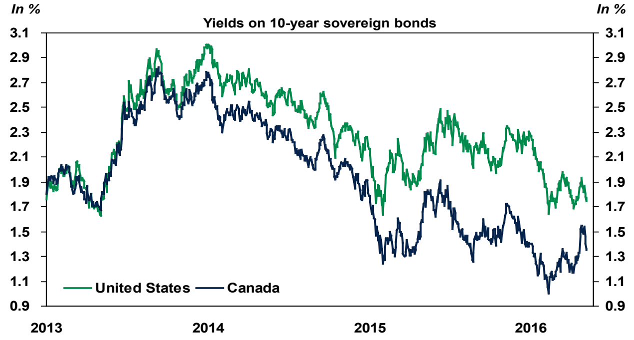
receptive to the stimulus measures in the last federal budget. Recent events bolster our outlook for an extended status quo on Canadian key rates. Governor Poloz even declared it would take a substantial shock for the BoC to contemplate further monetary easing.

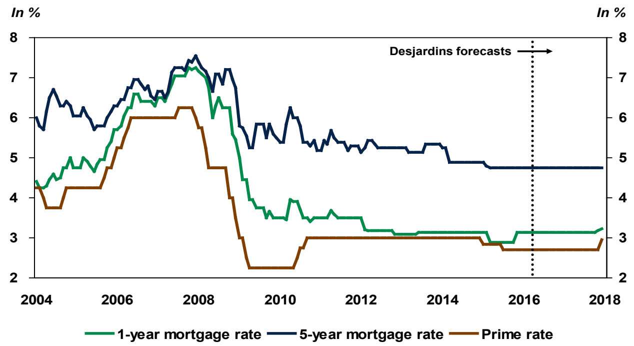
- **Canadian bond yields rise substantially.** Renewed calm in the financial markets and rising in oil prices have put some upside pressure on bond yields. The rise was especially steep in Canada (graph 3), as the promising economic numbers wiped out the chances of another key rate cut. The upswing in market optimism is, however, also leading to a decline in credit spreads, limiting the increase of Canadian financial institutions' financing costs.
- **Little change in sight for retail rates.** Retail rates have moved very little in the last few months and everything suggests this trend will persist (graph 4). Retail rates should only really start to rise late in 2017; and the rise promises to be slow and limited.

Graph 3 – Canadian bond yields have risen in recent months



Sources: Datastream and Desjardins, Economic Studies

Graph 4 – Retail rates should continue to remain stable



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								
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
February 2016	0.75	2.70	3.14	3.39	4.74	0.85	1.05	1.50
March 2016	0.75	2.70	3.14	3.39	4.74	0.85	1.15	1.50
April 2016	0.75	2.70	3.14	3.39	4.74	0.85	1.15	1.50
May 9, 2016	0.75	2.70	3.14	3.39	4.74	0.85	1.15	1.50
Forecasts								
End of quarter								
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	0.90–1.40	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	0.90–1.40	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	0.90–1.40	1.25–1.75
2017: 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	0.90–1.40	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	0.80–1.55	1.25–1.95
2018	1.25–2.25	3.20–4.20	3.45–4.25	3.95–4.75	4.60–5.40	0.60–1.40	0.90–1.70	1.30–2.10
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	1.25–1.90

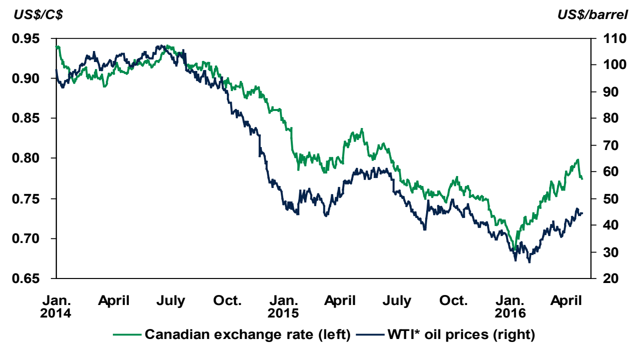
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

The loonie will have trouble getting above US$0.80 sustainably

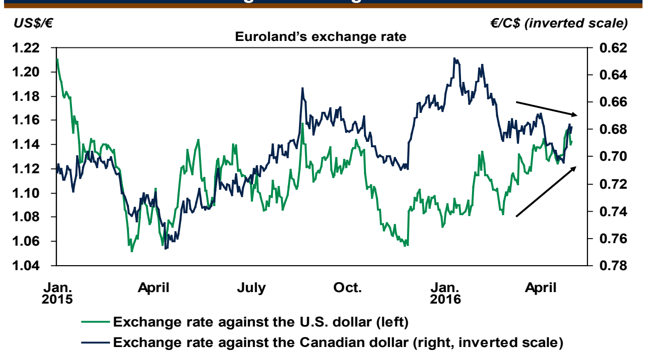
- The Canadian dollar has been trending up in the last few months. It reached US$0.80 recently before edging back to around US$0.78. Several factors have had a hand in the loonie's momentum to date. The rise in oil prices is, of course, one of them. Oil prices are up by more than US$15 a barrel since mid-February (graph 5). Also, economic statistics have generally been good in Canada and the likelihood of another Canadian key interest rate cut is much lower now than it was at the start of the year. Lastly, the Canadian dollar's strength also reflects a U.S. dollar that is being sapped by mixed economic numbers in the United States and a lack of clarity about ongoing U.S. monetary firming.
- Like the Canadian dollar, the euro is benefiting form the greenback's weakness, recently going above US$1.15 (graph 6). The monetary easing measures the European Central Bank announced in mid-March did not reverse the euro's uptrend. Its exchange rate against the Canadian dollar has been a little more stable, but the loonie is still edging up against the euro.
- The British pound is one of the few currencies to have been under pressure in recent months. The main cause is the upcoming referendum on the United Kingdom leaving the European Union, which is generating a lot of uncertainty and pushing back the country's monetary policy firming scenarios.
- **Forecasts:** Given that we do not expect oil prices to make further substantial gains in the near term, it also seems hard to believe that the Canadian dollar will keep going up. The loonie could also be hurt by an eventual greenback rebound if U.S. economic numbers improve and the Federal Reserve moves ahead with further monetary firming. We think the Canadian dollar could depreciate to around US$0.76 (C$1.32/US$) by the end of June. The trend could then primarily be stabilization for several quarters.

Graph 5 – The surge in oil prices explains much of the Canadian dollar's rise in recent months



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

Graph 6 – The euro is advancing against the greenback and has edged down against the loonie



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	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0.7510	0.7225	0.7689	0.7600	0.7700	0.7600	0.7700	0.7800	0.7900	0.8100
CAN$/US$	1.3315	1.3841	1.3006	1.3158	1.2987	1.3158	1.2987	1.2821	1.2658	1.2346
CAN$/€	1.4863	1.5035	1.4820	1.4474	1.4026	1.3947	1.3766	1.3974	1.3924	1.3704
US$/€	1.1162	1.0863	1.1395	1.1000	1.0800	1.0600	1.0600	1.0900	1.1000	1.1100
US$/£	1.5148	1.4739	1.4373	1.4300	1.4400	1.4600	1.4900	1.5300	1.5300	1.5500

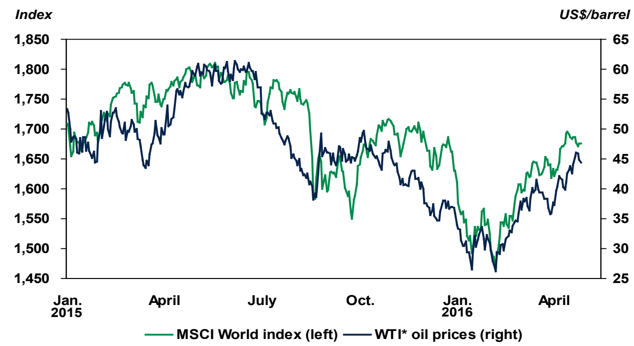
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies f: forecasts

ASSET CLASSES RETURN

Lifting our target for Canadian equities

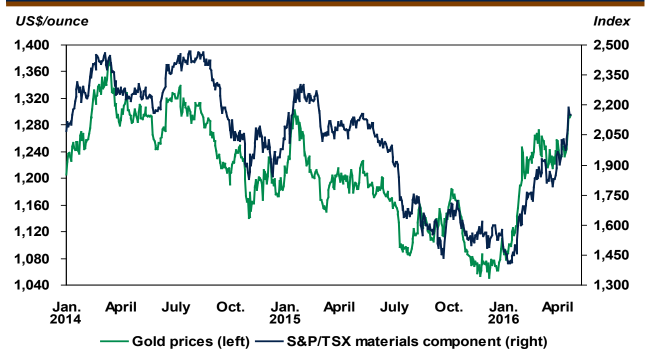
- **World stock markets have done well since the start of spring, to the point that the MSCI World index has recouped all of the losses recorded at the start of the year.** Among other things, fears about China and the European banking sector have eased. Also note that stock trends continue to closely match oil price trends (graph 7); oil prices have swung up since January. The presence of a causal link between oil prices and the stock markets remains nebulous; rather, the two asset classes seem to be governed by overall market sentiment. In the last few weeks, investors have realized that the fears of a world recession were unfounded. Among other things, the release of promising data on Chinese trade and industrial output was well received. The environment of policy rates (and bond yields) below zero in a number of countries was another source of concern early in the year, but some signs of caution exhibited by the European Central Bank, and more recently by the Bank of Japan, suggested that rates might have limited additional downside within the negative realm.
- **Canada's stock market continues to perform well, and we are raising our target return for the year to 8.0%.** The notion that oil prices constituted the catalyst behind the rally remains questionable for global equities but the hypothesis is easier to validate for the Canadian stock market. The Canadian stock market is up nearly 7% from the start of the year, as its energy component has gained almost 13%. More dramatically still, the industrial materials component is posting an increase of more than 40%. With the U.S. dollar continuing to move downwards, prices for metals, especially gold, have soared, favouring the materials component (graph 8).
- **The next few months could nonetheless be more arduous, especially if the Federal Reserve (Fed) decides to raise its policy rates in June, in line with our baseline scenario.** An upswing in the greenback would then reverse some of the recent gains made by metal prices. For now, markets are sceptical with respect to June tightening, instead expecting the Fed to wait until the end of the year (graph 9). If our scenario for U.S. monetary policy proves true, the resulting surprise effect could undermine some of the Canadian equity sectors that have outperformed so far this year. But beyond the near-term horizon, the expected acceleration in growth in the United States should support market confidence, allowing the Canadian stock market to hang onto much of its gains.

Graph 7 – Stock markets and oil remain closely linked



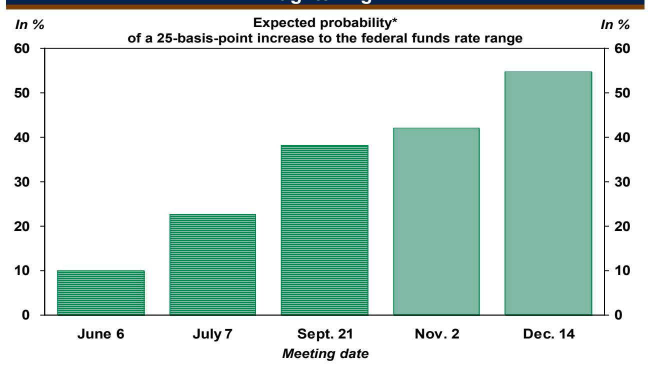
* West Texas Intermediate.
Sources: Bloomberg and Desjardins, Economic Studies

Graph 8 – Gold has not buckled yet and materials have kept momentum



Sources: Bloomberg and Desjardins, Economic Studies

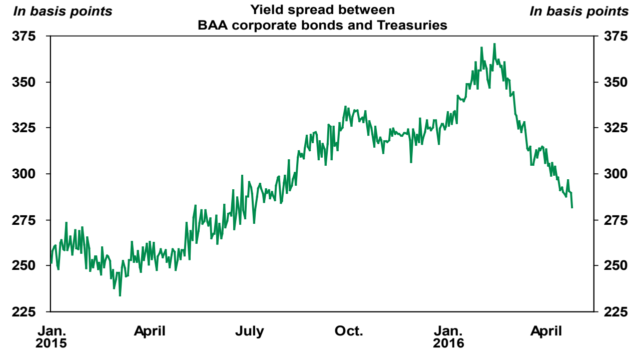
Graph 9 – Markets are positioned for delayed Federal Reserve tightening



* According to federal funds futures.
Sources: Bloomberg and Desjardins, Economic Studies

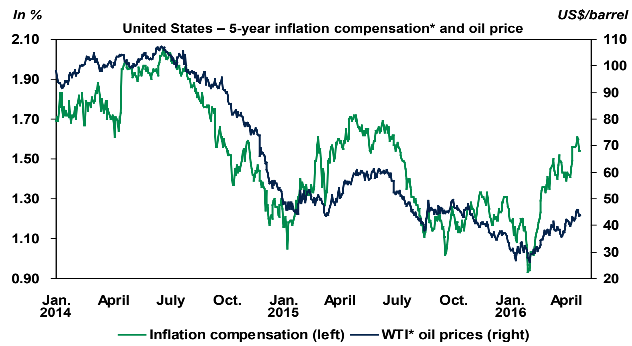
- **We now expect the U.S. stock market to advance slightly less than the Canadian stock market.** According to the Standard & Poor's compilation, earnings per share in the U.S. stock market were down for a third straight quarter for Q1 2016. Unlike previous quarters, the weakness was not isolated to energy and materials. On the contrary, these sectors benefited from the rebound in commodity prices. Rather, the consumer and information technology sectors were among the ones that saw difficulties. The greenback's descent does not yet seem to be having a positive impact on the value of profits generated abroad, particularly as the use of foreign exchange hedging contracts delays the impact of exchange rate movements on profits. If growth improves in the second quarter, as per the trend in recent years, the U.S. stock market could still post some moderate gains. We are keeping our return target at 7%.
- **The outperformance in government bonds at the onset of the year has given way to a few difficulties this spring.** The surge in optimism decreased the appeal of safe-haven securities until the end of April. The result, however, was some relief in corporate yield spreads (graph 10). Overall, the stars are not in alignment for the fixed income asset class. Already, the rise in oil prices has promoted a rebound in inflation compensation measures (graph 11). Expected Fed hikes in June and December should continue to keep some pressure on bonds.

Graph 10 – Corporate bond markets decompress



Sources: Bloomberg and Desjardins, Economic Studies

Graph 11 – The end of the oil price rout has coincided with the rebound in inflation expectations



* Spread between nominal and inflation-protected 5-year yields; ** West Texas Intermediate.
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: 8.0	target: 7.0	target: 3.0	target: -4.9 (US$0.76)
range	0.30 to 0.65	-2.0 to 4.0	0.0 to 14.0	2.0 to 12.0	-8.0 to 10.0	-10.8 to 0.3

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