Retail Rate Forecasts

Desjardins Economic Studies
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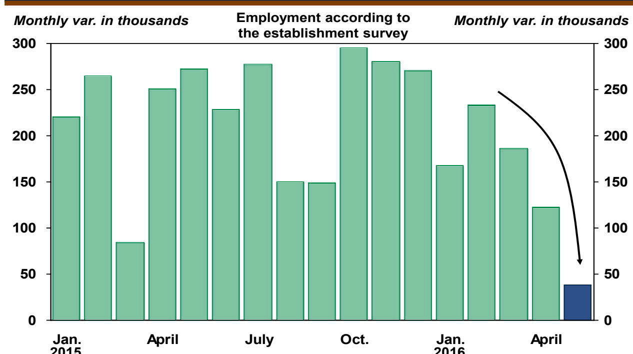
Weak job creation pushes U.S. key rate increases back

HIGHLIGHTS

- While U.S. economic growth seems to have rebounded, job creation has flagged.
- The Federal Reserve will wait a bit more before moving forward with monetary firming.
- Canada's economy will pull back in the second quarter.
- Oil prices are still rising.
- A U.S. interest rate increase could generate a lot of exchange rate movements.
- Volatility could rear its ugly head.

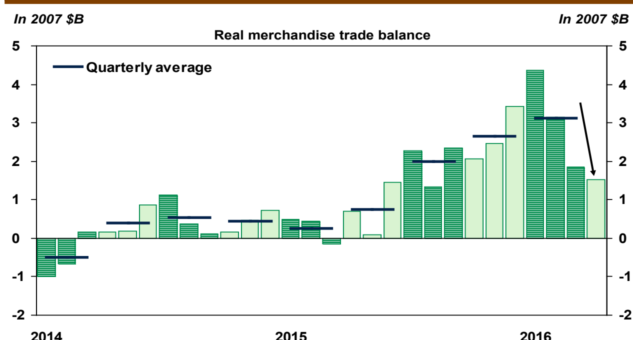
- **Contradictory signals about the U.S. economy.** U.S. GDP posted disappointing growth in the first quarter, but seems poised to record a solid advance in the spring. April's 0.6% surge in real consumption—the strongest monthly growth in more than two years—is especially encouraging. Against this backdrop, May's job statistics had all the impact of a cold shower. Not only did job creation plunge to just 38,000 jobs, but negative revisions to the results for prior months could signal a worrisome drop in job market momentum (graph 1).
- **The Federal Reserve (Fed) will wait a while before raising key rates.** The door seemed to be opening for a second U.S. key rate increase as of the June 15 meeting, but very disappointing data on employment will no doubt persuade the Fed to wait a little longer before going into action. However, in a context in which other job market data is more encouraging, and wages are starting to show signs of acceleration, Fed leaders will not want to wait too long. A key rate increase at the end of July is therefore quite possible.
- **A difficult second quarter for the Canadian economy.** In the end, Canada's real GDP went up 2.4% in the first quarter. The result is a little lower than anticipated, but still quite satisfactory. After giving growth substantial support at the start of the year, Canada's trade balance has eroded in the last few months (graph 2), which will impact growth this spring. The Fort McMurray fires—which brought about a third of Canada's crude production to a grinding halt—have also been a drag on economic activity in Canada, especially in May. In this context, Canada's real GDP should retreat about 1.5% in the second quarter, before rebounding in the third.

Graph 1 – U.S. job creation slowed sharply



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

Graph 2 – International trade got the year off to a good start, but will be a brake on the Canadian economy in the second quarter



Sources: Statistics Canada and Desjardins, Economic Studies

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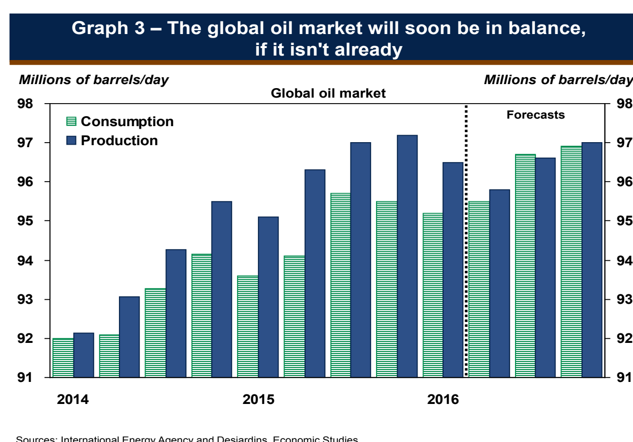
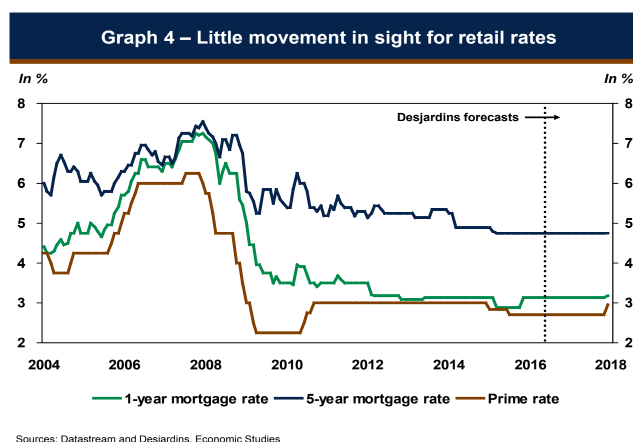
- **The rise in oil prices is encouraging.** WTI (West Texas Intermediate) recently went back over US$50 a barrel. Temporary production difficulties in several countries, including Canada, had a hand in the rebound, although it primarily reflects the sharp drop in U.S. production. The time of huge production surpluses in the global market, which had dragged oil prices down since mid-2014, seems to be poised to make way for a balanced market (graph 3). The increase in oil prices should convince the Bank of Canada to keep its monetary policy unchanged despite the economy's second-quarter problems.
- **The low interest rate environment seems here to stay.** The postponement of rate increases in the United States and highly expansive monetary policies around the world continue to support demand for bonds. North American bond yields remain very low and do not promise to go up much in the next few quarters, even if the Fed gradually raises its key rates. In the last few months, the drop in financial tensions has also been applying downside pressure on Canadian financial institutions' credit premiums and financing costs. In this context, everything suggests that retail rates will stay very low (graph 4).

Graph 3 – The global oil market will soon be in balance, if it isn't already



Sources: International Energy Agency and Desjardins, Economic Studies

Graph 4 – Little movement in sight for 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								
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 2016	0.75	2.70	3.14	3.39	4.74	0.85	1.15	1.50
June 13, 2016	0.75	2.70	3.14	3.39	4.74	0.85	1.15	1.50
Forecasts								
End of quarter								
2016: Q2	0.75	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	2.75–3.55	3.40–4.20	4.49–5.15	0.60–1.25	0.80–1.55	1.10–1.90
2018	1.25–2.25	3.20–4.20	3.40–4.20	3.90–4.70	4.60–5.40	0.60–1.40	0.85–1.65	1.30–2.10
2019	1.25–2.25	3.20–4.20	3.10–3.90	3.40–4.20	4.49–5.15	0.60–1.25	0.80–1.45	1.10–1.90

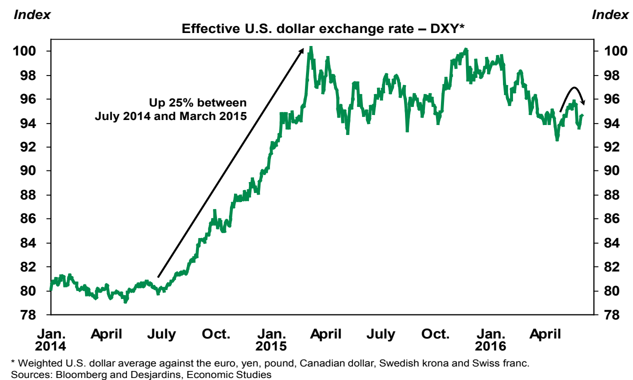
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

A U.S. interest rate increase could generate a lot of movement

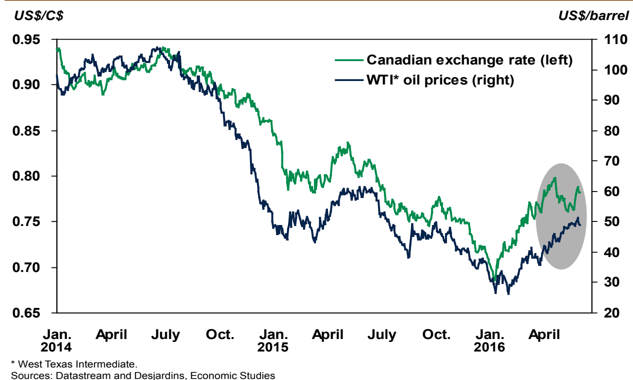
- The U.S. dollar shot up between July 2014 and March 2015 as the market started to price in U.S. monetary firming. Now that interest rate increases seem to be lagging, the greenback is rather flat. In early May, the feeling that the Federal Reserve (Fed) could finally go into action in June gave the U.S. dollar a push, but that did not last (graph 5).
- The greenback rebound in early May impacted the Canadian exchange rate, which fell after having closed in on US$0.80. The loonie was also penalized by more disappointing economic numbers in Canada. The ongoing rise in oil prices was not enough to stave off depreciation (graph 6). The forest fires in Alberta seem to have limited the upside impact of higher crude prices, in addition to adding to the uncertainty about Canada's economy.
- Like the Canadian dollar, most other currencies were penalized by the greenback's short-lived rebound. The euro, for example, fell about four cents in May, hitting US$1.11. The pound stood out, mainly fluctuating in step with surveys about the results of the upcoming referendum on the United Kingdom's exit from the European Union.
- **Forecasts:** If the Fed moves ahead with monetary firming as anticipated, ordering two interest rate increases by year's end, that would re-energize the greenback. Most currencies would then come down against the U.S. dollar in the coming quarters. For the Canadian dollar, the risks of depreciation seem higher in the near term, as the rise in oil prices could pause for several months following the big gains made since February. Also, more mixed Canadian economic data could temporarily add to the loonie's weakness. Our target for the end of the year is US$0.77 (C$1.30/US$).

Graph 5 – The U.S. dollar is struggling to strengthen



* Weighted U.S. dollar average against the euro, yen, pound, Canadian dollar, Swedish krona and Swiss franc.
Sources: Bloomberg and Desjardins, Economic Studies

Graph 6 – The Canadian dollar has not tracked movement in oil prices as closely recently



* West Texas Intermediate.
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	0.7750	0.7500	0.7700	0.7600	0.7800	0.7900	0.8100
CAN$/US$	1.3315	1.3841	1.3006	1.2903	1.3333	1.2987	1.3158	1.2821	1.2658	1.2346
CAN$/€	1.4863	1.5035	1.4820	1.4452	1.4400	1.3896	1.4079	1.3974	1.3924	1.3704
US$/€	1.1162	1.0863	1.1395	1.1200	1.0800	1.0700	1.0700	1.0900	1.1000	1.1100
US$/£	1.5148	1.4739	1.4373	1.4700	1.4500	1.4700	1.4900	1.5200	1.5300	1.5500

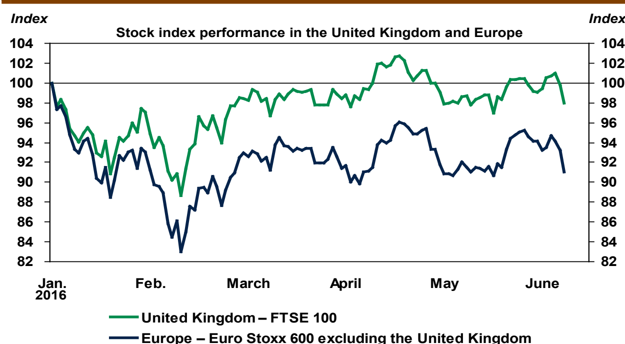
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies f: forecasts

ASSET CLASSES RETURN

Volatility could rear its ugly head

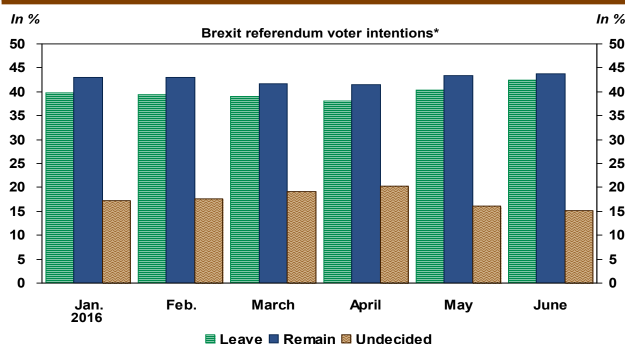
- **After pausing in the middle of spring, stock markets have been heading up nicely between mid-May and mid-June.** In the United States, the S&P 500 recently crossed the 2,100 mark again. Markets in emerging nations also participated in this rally, with the MSCI index for those countries up more than 5% since May 19. We cannot say the same for European markets, which have been fairly hesitant since the start of spring. Although the euro zone's economic growth has been stronger than anticipated since the start of the year, fears persist in the banking sector. The Euro Stoxx index's banking component is down 28% from the start of the year. Added to that are the fears about a United Kingdom exit from the European Union (Brexit). Note, however, that the British stock market is performing better than the euro zone's (graph 7): the FTSE 100 index is off 3% since January, while the Euro Stoxx index is down 12%.
- **Although they were looking like they are a thing of the past, the volatile swings seen at the start of the year could resurface.** The Brexit referendum is to be held June 23. The proportion of undecided voters has declined in the latest surveys. Initially, this seemed to favour the anti-Brexit camp, but the opposing camp has strengthened, and voting intentions suggest a heated contest (graph 8). A vote in favour of leaving the European Union could generate substantial losses in stock markets in the United Kingdom and Europe, given the surge in uncertainty. Bookmakers show a probability of just 25% that a Brexit scenario will materialize. All therefore suggests that a meaningful surprise effect could hit stock markets in the regions involved.
- **The outcome of November's U.S. election is another major event, but the markets do not seem overly concerned.** Although Republican candidate Donald Trump has confounded the sceptics so far, it will be hard for him to reach a large part of the electorate, antagonized by his rhetoric. Even in the unlikely eventuality he gets elected, he would have to get Congress's approval to implement his policies. Trump will therefore keep making headlines, but the stock markets could remain as unmoved as they have been so far.
- **In this context, and assuming that the anti-Brexit side wins the June 23 referendum, the trend for the U.S. stock market should be determined by fundamentals such as growth and profit outlooks.** Earnings of the S&P 500 contracted for a sixth straight quarter on a year-over-year basis in Q1 2016 (graph 9). The good news is that oil prices are recovering and the U.S. energy sector's consolidation is relatively advanced. Also, the greenback is weaker than it was this time last year (graph 10 on page 5). Recall that the strong U.S. dollar has put significant downside pressure on multinationals' profit growth recently. Better days are therefore ahead in earnings, which should help the U.S. stock market advance again. We are therefore raising our return target to 9%.

Graph 7 – European equities still lags behind British equities



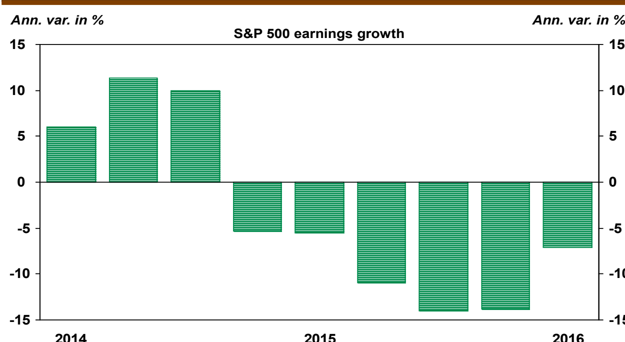
Sources: Bloomberg and Desjardins, Economic Studies

Graph 8 – Dead heat between the Leave and the Remain camps



* Average of surveys done during the month.
Sources: Bloomberg and Desjardins, Economic Studies

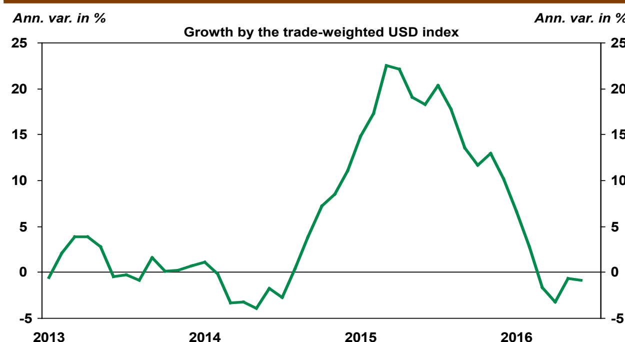
Graph 9 – Six quarters of annual contraction in earnings



Sources: Standard & Poor's and Desjardins, Economic Studies

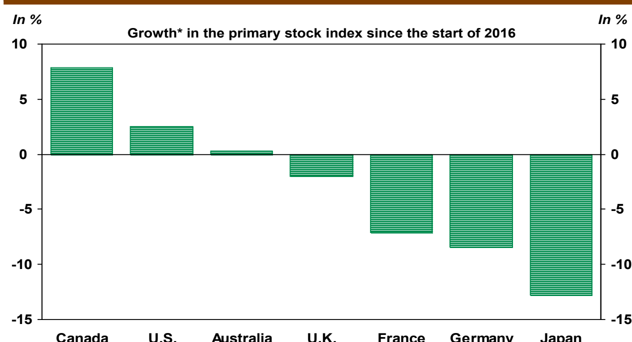
- **For its part, the S&P/TSX is hanging onto its gains.** The index continues to lead among the developed nations (graph 11). Naturally, the surge in commodity prices has been the key enabler of this performance. Even the major disruption to oil output caused by the Alberta forest fires did not shake investor confidence. We have raised our year-end target for oil prices to US$55. In this context, the Canadian stock market should post a somewhat larger gain than anticipated earlier. Our target is 12%.
- **We are also increasing the target for bonds slightly; they should generate a yield of 1.5%.** Two of the four most influential central banks will maintain biases toward more stimulus measures. Germany is may well follow Japan's lead in terms of 10-year bond yields below zero. Although we still expect the Federal Reserve to raise rates twice this year, the context in other parts of the world should maintain strong demand for higher-yielding North American bonds. We have lowered our year-end targets for bond yields, which implies slightly better performance for bonds compared with our previous scenario.

Graph 10 – The U.S. dollar is hurting profit growth less



Sources: Bloomberg and Desjardins, Economic Studies

Graph 11 – The Canadian stock market is still going strong



* As of June 10, 2016.
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: 1.5	target: 12.0	target: 9.0	target: 3.0	target: -6.2 (US$0.77)
range	0.30 to 0.65	-1.0 to 4.5	6.0 to 18.0	2.0 to 14.0	-8.0 to 10.0	-10.8 to -1.0

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