Retail Rate Forecasts

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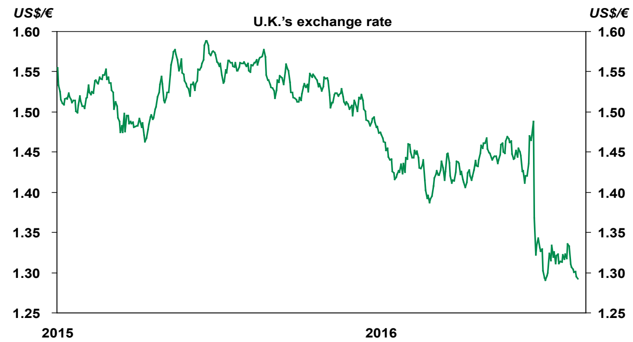
An eventful summer, but good for investors

HIGHLIGHTS

- British voters' decision to leave the European Union had limited impact on financial markets.
- The U.S. job market rebounded sharply.
- A very tough spring for Canada's economy.
- The Canadian dollar could still see some soft patches.
- Central bank action supports financial markets.

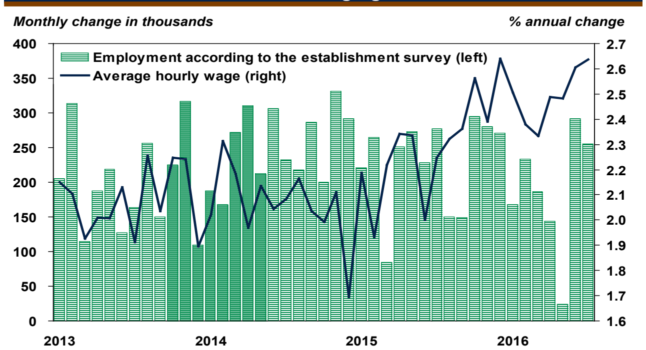
- **In the United Kingdom, *Brexit* posts a surprise win.** British voters' decision to leave the European Union (*Brexit*) surprised observers and prompted a surge of concern in the markets at the end of June. The pound quickly tumbled near US$1.30, a 30-year low (graph 1), and stock markets pulled back sharply around the world. However, the stock indexes bounced back in the ensuing weeks, as a political crisis was staved off in the United Kingdom, and a number of central banks signalled clearly that they were prepared to intervene if *Brexit* jeopardized the financial system's stability.
- **Subdued economic growth in the United States, but job creation has rebounded.** The hopes that the U.S. economy would accelerate strongly in the second quarter of 2016 in the end yielded to another disappointment, as U.S. real GDP only advanced an annualized 1.2%. However, the weak growth largely reflects surprise declines in business inventories and residential investment, which we should not see in the second half of the year. A second-quarter 4.2% jump in real consumption is reassuring, as is the strong job creation acceleration seen in June and July (graph 2).
- **Uncertainty over U.S. monetary policy.** Last spring's sudden job creation slowdown had worried Federal Reserve (Fed) leaders and had a big hand in their decision not to raise their key rates in June. The fears proved groundless, as hiring increased 292,000 in June and 255,000 in July. The financial markets' solid performance after *Brexit* also seems to have reassured Fed leaders, who are now in a tough spot. The job market's performance would justify a rate increase as of September; however, the international context, marked by monetary easing in several countries could encourage them to extend the status quo.

Graph 1 – Brexit's surprise victory took the pound down sharply



Sources: Datastream and Desjardins, Economic Studies

Graph 2 – The U.S. job market's recent performance is encouraging



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

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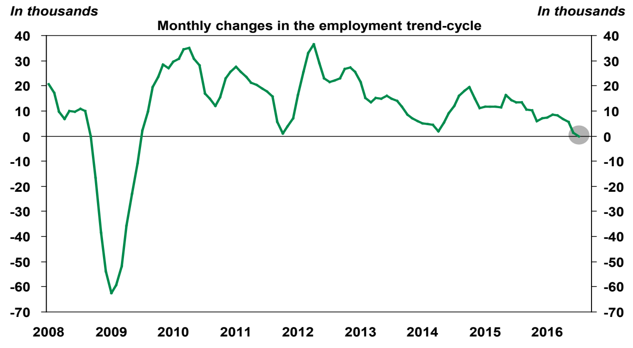
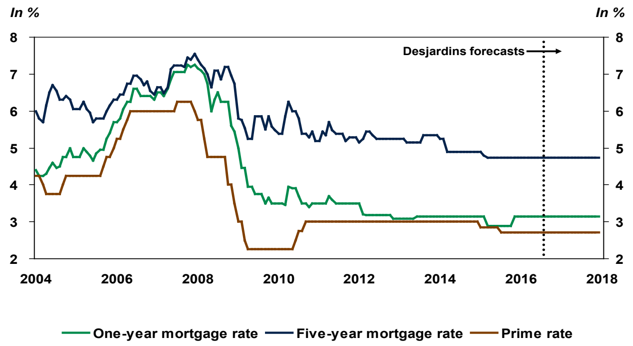
- **A tough spring for Canada's economy.** Unsurprisingly, the forest fires around Fort McMurray put the brakes on Canada's economy in May, making monthly GDP retreat by 0.6%. Although a rebound is anticipated for June, Canada's economy should retreat by about 1.4% for the second quarter as a whole. Beyond the temporary problems in Alberta's oil industry, Canada's economic growth is being curbed by the disappointing weakness in non-energy exports over the last few months. The Canadian labour market's recent performance is also weak: the trend-cycle metric compiled by Statistics Canada edged into negative territory in July (graph 3), for the first time since the 2008-2009 recession. Despite these worrisome developments, the Bank of Canada should keep its monetary policy where it is, as it expects the Canadian economy to rebound sharply in the third quarter.
- **Bond yields go down again.** By increasing the uncertainty over the global economy and prompting some central banks to announce further monetary easing, the *Brexit* win made bond yields go down further around the world. In Canada, the yields' slide was magnified by disappointing economic numbers. **Overall, retail rates have not moved much in recent months, with everything suggesting they will stay very low for some time to come (graph 4)**.

Graph 3 – The first retreat of the employment trend-cycle in Canada since the 2008-2009 recession



Sources: Statistics Canada and Desjardins, Economic Studies

Graph 4 – No changes in Canadian retail rates are expected until the end of 2017



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								
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 2016	0.75	2.70	3.14	3.39	4.74	0.85	1.15	1.50
July 2016	0.75	2.70	3.14	3.39	4.74	0.85	1.15	1.50
August 15, 2016	0.75	2.70	3.14	3.39	4.74	0.85	1.15	1.50
Forecasts								
End of quarter								
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
2017: 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	0.90–1.40	1.25–1.75
End of year								
2017	0.25–1.75	2.20–3.20	2.75–3.55	3.00–3.80	4.35–5.15	0.45–1.25	0.75–1.55	1.10–1.90
2018	0.75–1.75	2.70–3.70	2.95–3.75	3.40–4.20	4.40–5.20	0.60–1.40	0.85–1.65	1.25–2.05

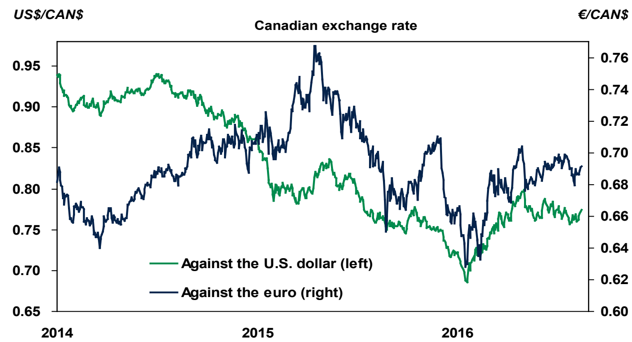
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

The Canadian dollar could still see some soft patches

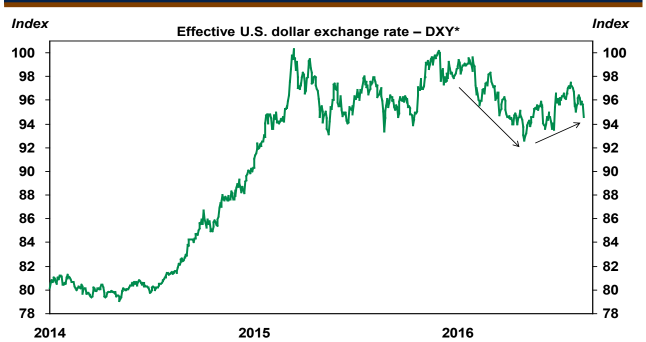
- The Canadian dollar is considerably less volatile since the spring; it is oscillating close to US$0.77 (graph 5). Against the euro, the Canadian exchange rate is also fairly stable, at between €0.68 and €0.70/CAN$. However, the loonie is not safe from further upheaval in the Canadian and global economies, or negative developments in the financial markets. It recently ran into a soft patch due to disappointing statistics on Canadian exports and employment. The negative impact was magnified by an appreciation of the greenback in response to stronger-than-anticipated U.S. job creation. Earlier in the summer, the spike in risk aversion seen after the referendum in the United Kingdom also resulted in a Canadian dollar downturn against the U.S. dollar.
- Overall, the U.S. dollar's trend has been tilted slightly to the upside for the last few months (graph 6). Aside from heightened demand for safe-haven securities and economic figures that are often better in the United States, monetary policy expectations play a key role in this trend. Although expectations for interest rate increases in the United States are low compared with what they have been in the past, this is increasingly being offset by expectations of monetary easing elsewhere in the world. Recently, the Bank of England softened its monetary policy and left the door open for further action. The European Central Bank could do the same this fall if the economic situation deteriorates.
- **Forecasts:** Even if the Federal Reserve does not raise its rates in the near term, the U.S. dollar could maintain some appeal against several currencies. The Canadian dollar could lose a little ground in the near term, especially if other economic numbers disappoint. Still, the forecast increase in oil prices in the coming quarters would be a positive point for the loonie, and make up for other, less favourable factors. Our target for the end of the year is US$0.77. We could see a return to the neighbourhood of US$0.80 in 2017.

Graph 5 – The Canadian dollar has been much less volatile in the last few months



Sources: Datastream and Desjardins, Economic Studies

Graph 6 – The U.S. dollar has started to rise again, though timidly



*Trade-weighted U.S. dollar average against the euro, yen, pound, Canadian dollar, Swedish krona and Swiss franc.
Sources: Bloomberg 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	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0.7510	0.7225	0.7689	0.7737	0.7600	0.7700	0.7600	0.7750	0.7900	0.8000
CAN$/US$	1.3315	1.3841	1.3006	1.2925	1.3158	1.2987	1.3158	1.2903	1.2658	1.2500
CAN$/€	1.4863	1.5035	1.4820	1.4359	1.4474	1.4026	1.4079	1.4065	1.4177	1.4000
US$/€	1.1162	1.0863	1.1395	1.1110	1.1000	1.0800	1.0700	1.0900	1.1200	1.1200
US$/£	1.5148	1.4739	1.4373	1.3368	1.3000	1.3000	1.3300	1.3700	1.4200	1.4200

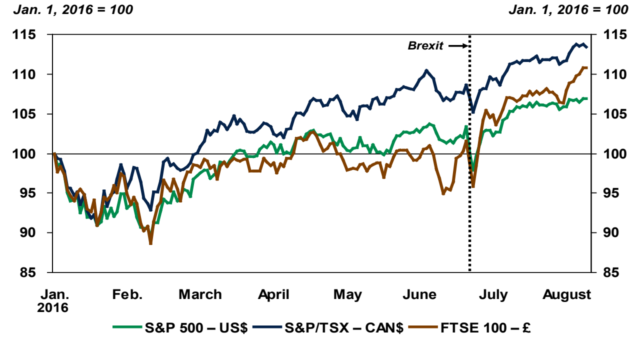
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies f: forecasts

ASSET CLASSES RETURN

Central bank action supports financial markets

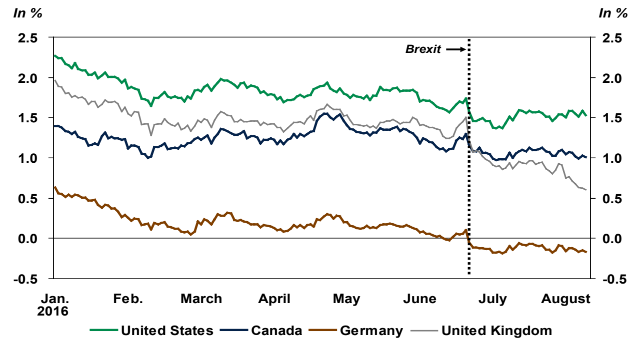
- **Stock markets quickly took off again after the *Brexit* vote.** Concerned in early June about the possibility that the Brits would opt to leave the European Union, investors were finally convinced that they would choose to stay. It was a brutal wakeup call, therefore, and the pound and global stock markets plunged after the June 23 referendum. The pound remains very low, but the stock indexes rebounded quickly in the following weeks. The uptrend persisted in July despite other worrisome events, including a surge in concern over the Italian banks, another attack in France and an attempted coup d'etat in Turkey. The S&P 500 thus recently set a new historic high, and even the U.K.'s stock market has shot up (graph 7).
- **The bond markets are getting a big boost from central banks' actions.** A quick political transition in the United Kingdom helped soothe investors. Central banks' determination to do anything to keep the *Brexit* vote from destabilizing the financial markets also had a big hand in that resilience. Unsurprisingly, the Bank of England was especially active, taking its key rate to a new low, starting to buy bonds again, and instituting a big program to provide British banks with liquidity. In addition to reassuring investors, these central bank actions are inflating demand for bonds. They have taken bond yields even lower in several countries (graph 8), and everything suggests the low interest rate environment will persist for a long time.
- **Low interest rates are also helping the stock markets.** With a growing proportion of advanced nations' government bonds posting negative yields, and some companies even managing to get financing at negative rates, it is not surprising to see investors in search of returns quickly move back to the stock markets as soon as the worst of the worries dissipate. Despite its solid performance in recent years, the U.S. stock market is still relatively affordable for investors compared with the bond market (graph 9).
- **The risks of another oil price collapse seem limited.** Oil prices came up strongly in the first half of 2016, but they have come down recently, closing in on US$40/barrel. This situation may be reminiscent of what happened last year, when an unjustified spring upswing gave way to another spectacular tumble by oil and commodity prices. Such a relapse would be especially bad for the Canadian stock market, whose excellent performance since the start of 2016 was helped by the commodity price upswing. The situation is quite different this year, however, with crude price gains based on a true rebalancing of the global oil market (graph 10). The outlook therefore remains fairly good for commodity prices and the Canadian stock market (graph 11).
- **The stock markets could do well again next year.** Ongoing very low interest rates and the gradual rebound of commodity prices and corporate earnings should allow North American stock markets to post further good growth next year. Foreign stock markets could once again see a

Graph 7 – Impressive stock market performance despite *Brexit*



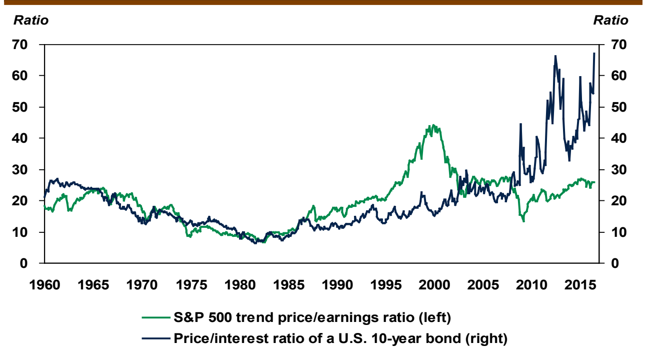
Sources: Datastream and Desjardins, Economic Studies

Graph 8 – Bond yields have come down again in several countries



Sources: Datastream and Desjardins, Economic Studies

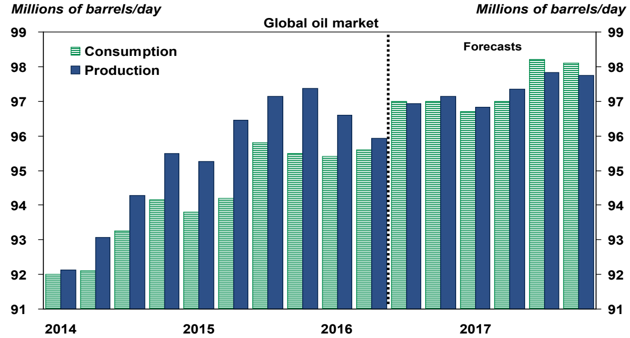
Graph 9 – The U.S. stock market's valuation does not seem as high when compared with the bond market's



Sources: Global Financial Data, Robert Shiller, Datastream and Desjardins, Economic Studies slightly weaker performance, especially once expressed in U.S. dollars. Further interest rate reductions have benefited fixed-income securities, and 2016 should end with the Canadian bond market posting an nice gain of about 4%. However, extremely low rates will limit the bond market's performance starting now, and suggest zero returns next year for this asset class.

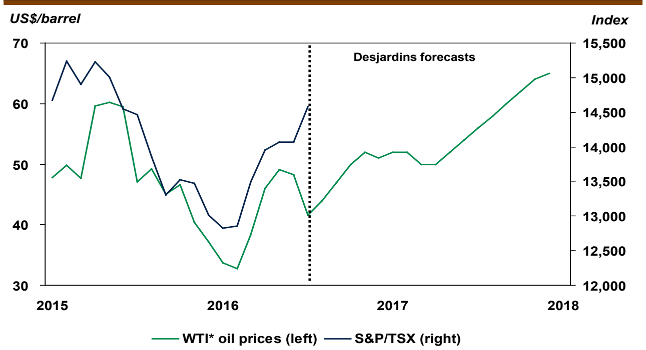
- **Watch out for complacency.** The major support provided to financial markets by monetary policies could raise some concerns for the future. Among other things, we could be concerned about the markets' reaction if accelerating inflation were to force central banks to normalize monetary policy more quickly. The impression that the central banks will always be there to support the markets could also prompt the formation of financial bubbles. Investors must therefore remain vigilant, especially with riskier assets or sectors.

Graph 10 – The major oil surplus period seems to be over



Sources: International Energy Agency and Desjardins, Economic Studies

Graph 11 – The gradual rise by oil prices should keep helping the Canadian stock market



* West Texas Intermediate.
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 %)***
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: 4.0	target: 15.0	target: 9.5	target: 3.0	target: -6.2 (US$0.77)
range	0.30 to 0.65	2.0 to 6.0	8.0 to 22.0	4.0 to 14.0	-5.0 to 10.0	-9.7 to -2.4
2017f	target: 0.50	target: 0.0	target: 9.5	target: 8.5	target: 6.0	target: -3.8 (US$0.80)
range	0.30 to 0.70	-3.0 to 3.0	3.0 to 16.0	2.0 to 15.0	-5.0 to 15.0	-7.2 to 4.1

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