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October 6, 2016

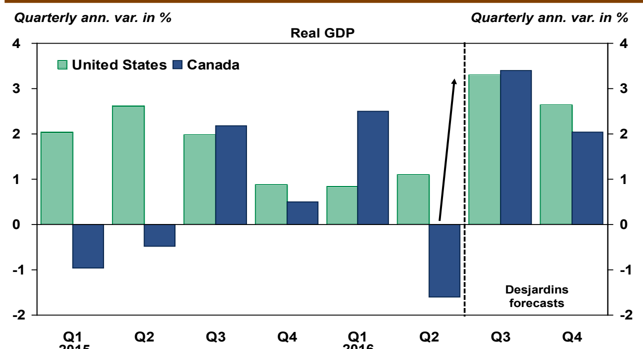
Bond yields should soon begin a slow ascent, but retail rates could remain stable

HIGHLIGHTS

- U.S. and Canadian economies seem to have rebounded in the third quarter.
- The Federal Reserve could raise its key rates soon, but the status quo will last for a while yet in Canada.
- The Canadian dollar dips.
- Resilient stock markets, despite the risks.

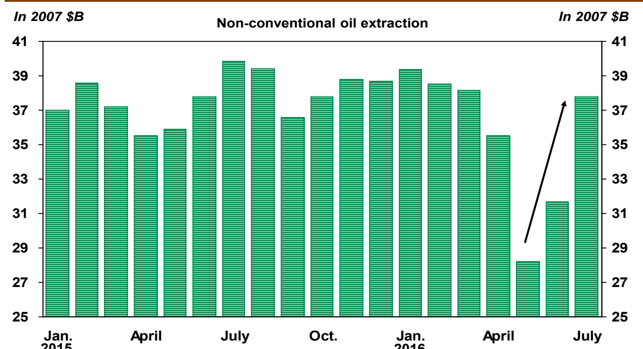
- **Toward accelerating economic growth in the United States.** In the first half of 2016, the U.S. economy posted its weakest growth since the end of 2012, despite a robust advance by household consumption. However, better growth is expected in the second half of the year, and in 2017 (graph 1). Consumption should remain relatively strong and business investment should start to pick up again now that the worst of the oil shock is past.
- **Rebounding oil output will boost Canadian growth in the third quarter.** Everything suggests that Canada's economy has rebounded following last spring's big pullback. The comeback by oil output (graph 2), as the effects of the Fort McMurray forest fires dissipated, resulted in robust monthly Canadian GDP growth, at 0.6% in June and 0.5% in July. The upswing in exports following a tough first half is also promising. Canada's real GDP may have grown just over 3% (annualized) in the third quarter.
- **Preliminary agreement to limit the oil supply.** After several months of fruitless efforts, the members of the Organization of the Petroleum Exporting Countries (OPEC) finally agreed to cut back their oil output somewhat. An agreement, if actually ratified, could make it possible to balance global oil demand with supply in 2017 and help oil prices oscillate closer to US$50 a barrel than US$40 (graph 3 on page 2).
- **The Federal Reserve (Fed) could increase its key rates in December.** Several Fed leaders recently signalled that they wanted to raise key rates soon. However, disappointing economic data released in the weeks prior to the meeting finally convinced the Fed to once again stick with the status quo in September, although three voters would have

Graph 1 – Economic growth expectations are high for the next few quarters in North America



Sources: Bureau of Economic Analysis, Statistics Canada and Desjardins, Economic Studies

Graph 2 – Canada's oil sector has now fully recovered



Sources: Statistics Canada 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.

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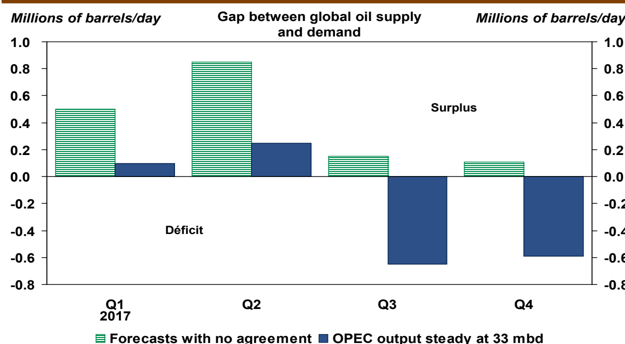
wanted to see immediate monetary firming. The door is now wide open for an increase in December, unless the U.S. election on November 8 or another event triggers a sharp deterioration in the economic outlook. In Canada, everything suggests the status quo will persist for quite some time.

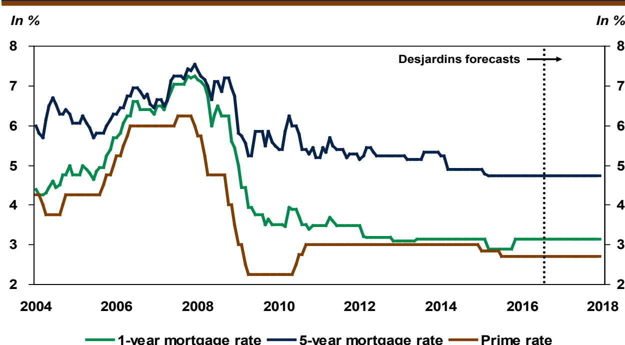
- **Toward a slight rise in bond yields.** Some central banks seem less at ease with the extremely low or even negative interest rates seen in advanced countries. As inflation should come up in the next few months, and the Fed should start—very slowly—to raise its key rates again, bond yields should also start a slight uptrend shortly.
- **Few impacts on retail rates expected.** As the posted retail rates did not really react to the latest drops by bond yields, they will likely also ignore the slight rise in bond yields we are expecting in the coming quarters. The lack of monetary firming in Canada and the fact that bond yields will stay very low prompt us to continue to expect Canadian retail rates to remain very stable (graph 4).

Graph 3 – An OPEC production freeze could turn the slight oil surplus forecast for 2017 into a slight deficit



OPEC: Organization of the Petroleum Exporting Countries; mbd: millions of barrels per day
Sources: Agence internationale de l'énergie and Desjardins, Economic Studies

Graph 4 – Retail rates should 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								
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 2016	0.75	2.70	3.14	3.39	4.74	0.85	1.15	1.50
Sept. 2015	0.75	2.70	3.14	3.39	4.74	0.85	1.15	1.50
August 31, 2016	0.75	2.70	3.14	3.39	4.74	0.85	1.15	1.50
Forecasts								
End of quarter								
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
2017: 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	0.90–1.40	1.25–1.75
End of year								
2017	0.25–1.25	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	0.50–1.50	2.45–3.45	2.85–3.65	3.30–4.10	4.40–5.20	0.50–1.30	0.80–1.60	1.15–1.95
2019	0.25–1.25	2.20–3.20	2.60–3.40	2.95–3.75	4.35–5.15	0.55–1.25	0.75–1.55	1.10–1.90

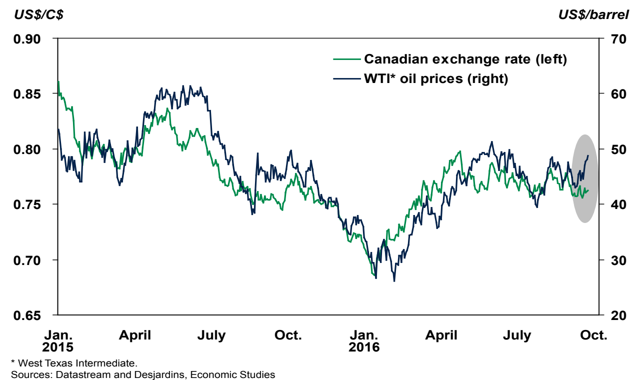
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CANADIAN DOLLAR

The Canadian dollar dips slightly

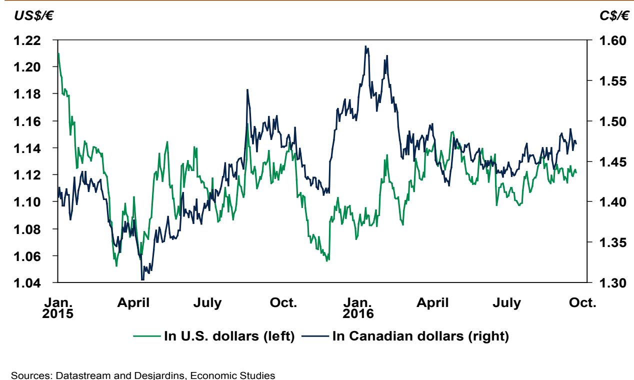
- The Canadian dollar has stayed below the US$0.77 (CAN$1.30/US$) mark in recent weeks. The slight dip from previous weeks is mainly due to an upswing in concern over Canada's economy and the likelihood of another key rate cut. This was fuelled by the release of some disappointing data, and the Bank of Canada's more cautious stance. Oil's comeback to close to US$50/barrel was therefore not enough to give the loonie some new momentum (graph 5). That being said, if crude prices had not gone up recently, the loonie would no doubt have depreciated further.
- The fact that the Federal Reserve once again opted for the status quo in September and reviewed the outlook for its future monetary policy trajectory limited the U.S. dollar's rise. The currency also had trouble finding lasting support in the U.S. economic numbers, which often sent mixed signals.
- The euro seems to have found a new comfort zone around US$1.12 (graph 6). The European Central Bank did not announce further measures in September, instead saying it was going to analyze its ability to complete the existing measures. In other words, there is nothing to justify a drop by the euro. The latest economic figures are consistent with continued moderate growth in the euro zone.
- Forecasts: With the interest rate increase forecast in the United States for December, the U.S. dollar should see the year out with a roar. This momentum should persist for a few quarters if further rate increases are ordered in 2017. The Canadian dollar could lose a little more ground by the end of the year. Next year, a rise by oil to around US$60 a barrel and improved Canadian economic data should allow the loonie to return to the US$0.78 (CAN$1.28/US$) mark.

Graph 5 – The Canadian dollar did not follow the recent rise by oil prices



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

Graph 6 – The euro is less volatile



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	Q2	Q3	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0.7510	0.7225	0.7689	0.7737	0.7617	0.7550	0.7550	0.7600	0.7700	0.7800
CAN$/US$	1.3315	1.3841	1.3006	1.2925	1.3129	1.3245	1.3245	1.3158	1.2987	1.2821
CAN$/€	1.4863	1.5035	1.4820	1.4359	1.4754	1.4437	1.4437	1.4211	1.4156	1.4103
US$/€	1.1162	1.0863	1.1395	1.1110	1.1238	1.0900	1.0900	1.0800	1.0900	1.1000
US$/£	1.5148	1.4739	1.4373	1.3368	1.2990	1.2800	1.2800	1.2800	1.3100	1.3300

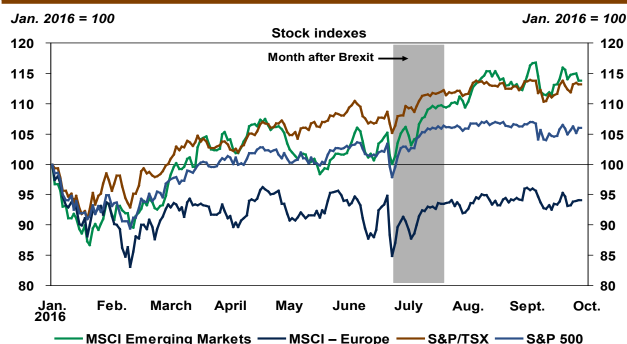
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies f: forecasts

ASSET CLASSES RETURN

Resilient stock markets, despite the risks

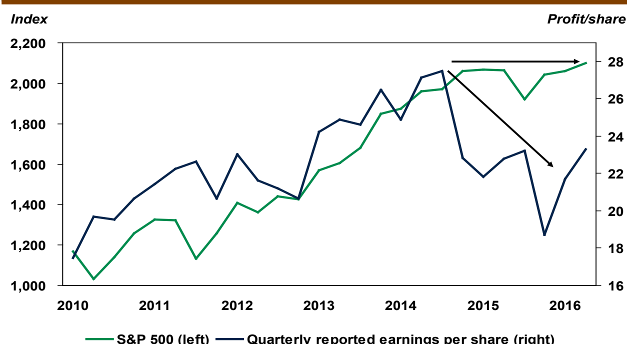
- **Stock markets have exhibited such degree of resilience in the face of shocks, that they have given the impression of an uneventful recent period** (graph 7). Most of the stock indexes were flat following the summer's post-Brexit rebound. Yet, there was no shortage of events likely to trigger volatility. Federal Reserve (Fed) officials have notched up their tone on the imminence of tightening, which is normally something stock markets don't receive well. The European Central Bank (ECB) and Bank of Japan (BoJ) were not as aggressive as anticipated in their latest announcements, at least leading to some speculation that they might have exhausted their resources. The prospect of a slightly lower degree of stimulus than in the last few years could have scared stock market investors. Even the fears of a new financial crisis inspired by the recent Deutsche Bank problems did not have a lasting impact on stock markets, any more than Donald Trump's rise in the polls up until the first presidential debate.
- **Nonetheless, this resilience was somewhat artificial.** In the United States, equities have deviated from the trend dictated by profits (graph 8), and the S&P 500's good performance has been essentially due to its price-earnings ratio rising to ever higher levels. Once again, the impact of highly stimulating monetary policies worldwide, which maintain the appeal of risk assets, is clear. We should also note that low oil prices have penalized profits heavily recently, hurting shares in this sector. The current gradual rise in oil prices, and the efficiency gains of U.S. oil producers, nonetheless suggest that the large drops in the sector's profits are behind us. We also expect the bond curve to stop flattening, which should bring in some relief for bank profits in 2017. All in all, we think the U.S. stock market will see better days for profits. This should help it post another gain next year, in the order of 8.5% after this year's forecast 9.5% return.
- **Canadian stock market remains poised to end the year with a very solid performance.** Our target for 2016 is 15.0%, followed by 9.5% next year. The two heavyweights of the S&P/TSX did most of the lifting this year. The energy component is up 24% from January 1, while the materials segment has jumped 45% (graph 9). This is a complete reversal from 2015, when the two sectors were primarily responsible for the index's 8.3% decline in return. The expected slow rise in oil prices will provide support to Canada's stock market in the coming months, but we cannot expect as buoyant returns as we have seen so far this year. Canada's economy remains fragile. Businesses seem to be opting to pay dividends instead of investing (graph 10); this could hurt their competitiveness and their ability to generate profits. Although the Canadian dollar should stay low in the near term, exporters will not benefit from the strong depreciation current they enjoyed in 2014 and 2015. On the other hand, monetary and, in particular, fiscal policies will

Graph 7 – The stock markets have been oscillating in tight ranges since the blips over Brexit



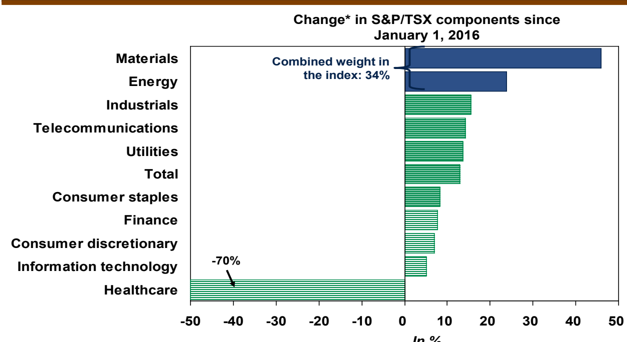
Sources: Bloomberg and Desjardins, Economic Studies

Graph 8 – The S&P 500 and profits have diverged sharply recently



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

Graph 9 – Commodity heavyweights are taking the S&P/TSX index up

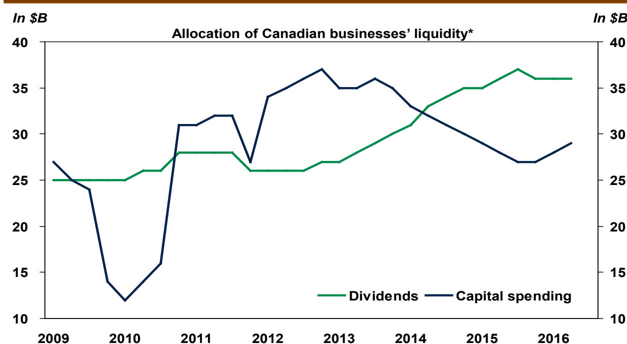


* As at October 4, 2016.
Sources: Bloomberg and Desjardins, Economic Studies

provide some support. All in all, we expect a return that will be more closely aligned to the U.S. market in 2017.

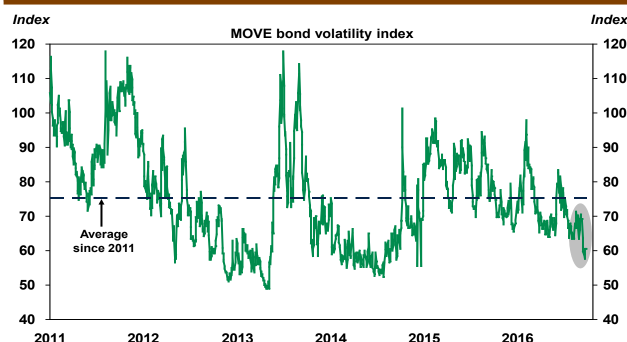
- **Like equity markets, bond markets are stimulated by sustained central bank asset purchases.** We note that volatility has dropped to extreme low levels (graph 11), pointing to a certain amount of complacency. The BoJ is signalling a transition to a more targeted quantitative easing approach, as it might run short of bonds to acquire. Even though the ECB is less constrained than the BoJ right now, maintaining its purchasing program at a pace of €80B a month could down the line lead to a similar situation. We cannot completely rule out the hypothesis that a reduction in market intervention by two major central banks could cause an effect similar to the 2013 taper tantrum. We are keeping our bond return target at zero for 2017, following a forecast return of 4.0% this year. However, the risk of a strong upward yield adjustment should not be taken lightly in the near term.

Graph 10 – Canadian businesses have put less cash into investment and more into dividends



* Excluding oil and gas.
Sources: Statistics Canada and Desjardins, Economic Studies

Graph 11 – Weak bond market volatility is the sign of some complacency



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: 4.0	target: 15.0	target: 9.5	target: 3.0	target: -4.3 (US$0.755)
range	0.30 to 0.65	3.0 to 6.5	8.0 to 22.0	4.0 to 14.0	-5.0 to 10.0	-8.5 to -1.0
2017f	target: 0.50	target: 0.0	target: 9.5	target: 8.5	target: 6.0	target: -3.2 (US$0.78)
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	-7.9 to 2.0

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