Retail Rate Forecasts

Desjardins Economic Studies
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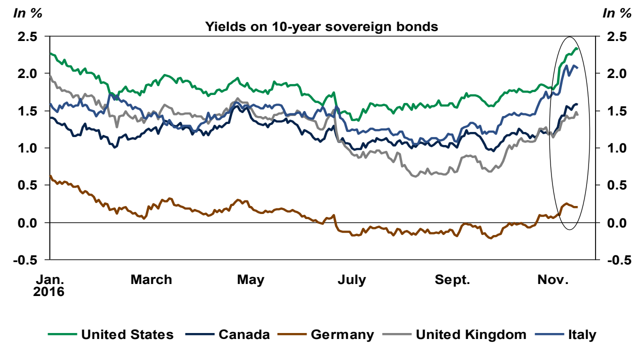
Higher interest rates after Donald Trump's election

HIGHLIGHTS

- Donald Trump's surprise win could support growth over the short run.
- The Federal Reserve should increase its key rates in December.
- Canada's economy rebounded in the third quarter, but many concerns persist.
- Mortgage rebates could decline.
- The U.S. dollar is rising against most currencies.
- North America's stock markets applaud Trump's election.

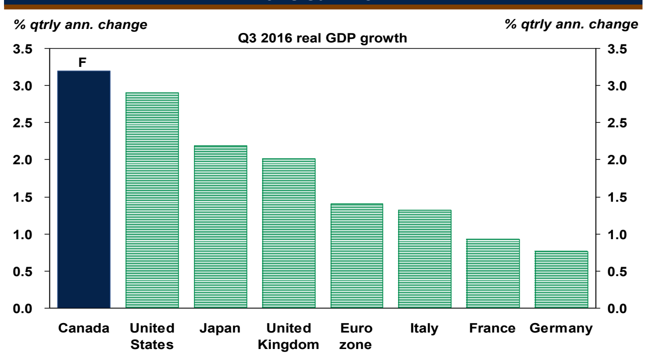
- **Voters generate another surprise.** Following the Brits' support of the Brexit option early last summer, U.S. voters took a turn at confounding the forecasters and chose Donald Trump as their next president. Instead of reacting negatively to the surprise, investors focused on the fact that the president-elect's promises could result in stronger growth and higher inflation in the United States. Stock markets in advanced countries did well, with the U.S. dollar and bond yields jumping (graph 1).
- **In many countries, economic growth was livelier in the third quarter.** After a relatively disappointing first half, especially in North America, several advanced countries saw their real GDPs post solid growth in the summer of 2016 (graph 2). The U.S. economy's 2.9% growth beat analysts' expectations slightly, while the Canadian economy may have done even better, according to our latest forecasts. The U.S. economy should accelerate next year, growing about 2.6% thanks, in part, to the major tax cuts pledged by Donald Trump. The president-elect's protectionist aims and the danger of a major deterioration in public finances constitute longer-term risks, however.
- **A December increase to U.S. key rates now seems almost guaranteed.** Even before the election, Federal Reserve leaders seemed determined to raise key rates before the end of the year. The possibility of higher inflation and more stimulating fiscal policy are two additional arguments for monetary firming. We therefore still expect U.S. key rates to go up 0.25% in December, with two further increases to come next year. Faster monetary firming is now even a possibility.

Graph 1 – Bond yields shot up after the U.S. election



Sources: Datastream and Desjardins, Economic Studies

Graph 2 – Economic growth was relatively strong in G7 nations this summer



F: Desjardins forecast
Sources: Datastream and Desjardins, Economic Studies

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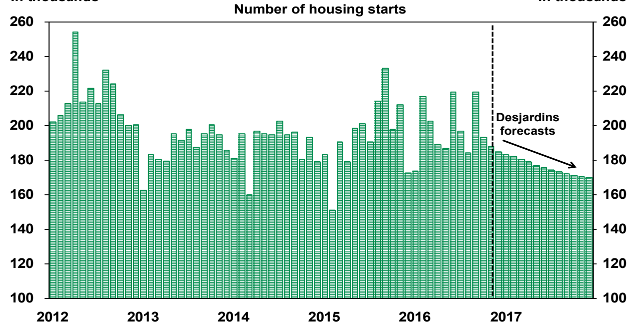
Note to readers: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

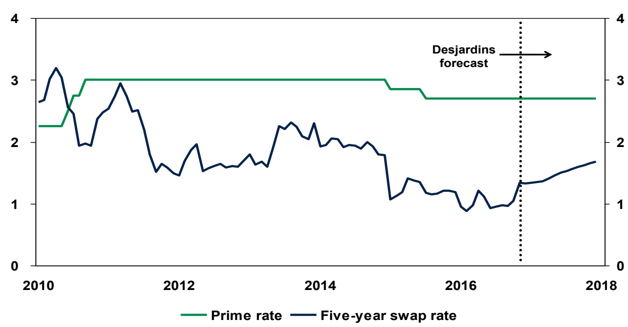
- **Canada's economy is facing headwinds and tailwinds.** The federal government's new restrictions on residential credit and the increase in some mortgage rates should slow activity in the housing sector (graph 3). The uncertainties associated with the surge in U.S. protectionism could also hurt Canadian business investment; the possibility of a repeal of NAFTA, although remote, is a major new risk. Conversely, Canada's economy will benefit from faster growth in U.S. demand, a weaker Canadian dollar, and the expansion to the federal government's stimulus plan. The Bank of Canada should keep its key rates where they are for several more quarters.
- **Upside pressure on some mortgage rates.** Posted retail rates remain very stable. In a context in which bond yields and swap rates have gone up substantially (graph 4), Canadian financial institutions' financing costs are on the rise, however, which has already prompted some banks to increase their promotional mortgage rates. As medium- and long-term financing costs should continue to rise gradually, the decline in rebates on mortgage rates could become general. The mortgage rates that borrowers actually pay could therefore go up somewhat in the coming quarters, although they will remain low, historically speaking. Variable rates and short-term retail rates should be more stable.

Graph 3 – Canadian homebuilding should slow next year



Sources: Canada Mortgage and Housing Corporation and Desjardins, Economic Studies

Graph 4 – Rising swap rates could keep a little upside pressure on some 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								
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. 2016	0.75	2.70	3.14	3.39	4.74	0.85	1.15	1.50
Oct. 2016	0.75	2.70	3.14	3.39	4.74	0.85	1.15	1.50
Nov. 23, 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	3.40–4.20	4.65–5.45	0.55–1.35	0.85–1.65	1.40–2.20
2019	0.25–1.25	2.20–3.20	2.60–3.40	2.90–3.70	4.40–5.20	0.45–1.25	0.80–1.60	1.20–2.00

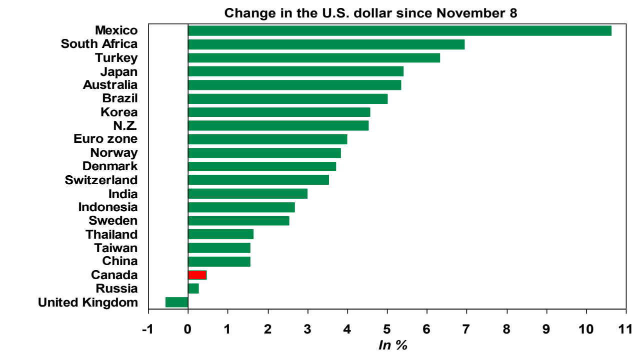
Note: Forecasts are expressed as ranges. (1) End of quarter forecasts; (2) Non-redeemable (annual).
Source: Desjardins, Economic Studies

CURRENCY MARKETS

The U.S. dollar is rising against most currencies

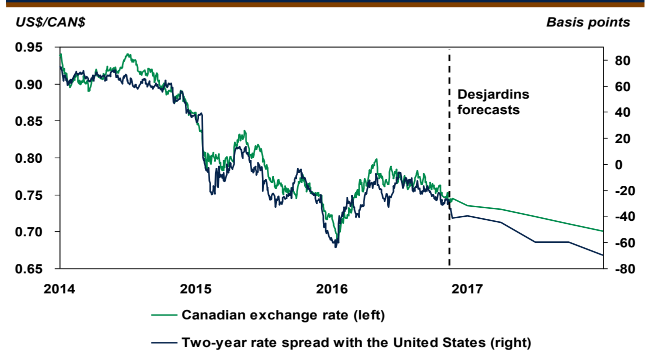
- The U.S. dollar had tended to depreciate when Donald Trump gained points in the polls before the U.S. presidential election. It is therefore somewhat surprising that the greenback has surged in the last two weeks. In fact, it is in line with the markets' global reaction. The optimism finally fanned by certain measures Trump promised, such as tax cuts, is supporting the greenback, particularly as anticipations of U.S. monetary firming have intensified.
- The greenback is appreciating against almost all currencies, hitting the Mexican peso the hardest (graph 5). Donald Trump's arrival in the White House could be especially disruptive for Mexico, as it appears that the North American Free Trade Agreement (NAFTA) will be renegotiated, and a wall could be built on the Mexican border. Several other emerging nation currencies have posted big declines against the U.S. dollar. As happened in 2013, the rebound by bond yields is reducing these currencies' appeal, as global capital flows could shift.
- The Canadian dollar was less affected by the greenback's appreciation. Note that the loonie had lost more ground in previous weeks due to a drop in oil prices and pessimistic signals from the Bank of Canada (BoC). The recent upswing in oil prices has offset the widening of interest rate spreads with the United States. That being said, a look at our interest rate forecasts quickly reveals that the Canadian dollar's future trend could remain downwards (graph 6).
- **Forecasts:** We have downgraded our forecasts for the Canadian dollar. Canada's exchange rate should end 2016 at around US$0.73 (CAN$1.37/US$), and 2017 at close to US$0.70 (CAN$1.43/US$). These forecasts include the impact of greater widening by rate spreads with the United States, but also a less optimistic scenario for oil prices. However, the loonie is expected to edge up against other major currencies.

Graph 5 – The U.S. dollar is advancing against all of the major currencies



Sources: Datastream and Desjardins, Economic Studies

Graph 6 – Interest rate spreads should continue to penalize the Canadian dollar



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	0.7300	0.7300	0.7200	0.7100	0.7000
CAN$/US$	1.3315	1.3841	1.3006	1.2925	1.3129	1.3699	1.3699	1.3889	1.4085	1.4286
CAN$/€	1.4863	1.5035	1.4820	1.4359	1.4754	1.4521	1.4521	1.4444	1.4507	1.4571
US$/€	1.1162	1.0863	1.1395	1.1110	1.1238	1.0600	1.0600	1.0400	1.0300	1.0200
US$/£	1.5148	1.4739	1.4373	1.3368	1.2990	1.2300	1.2100	1.1700	1.1500	1.1300

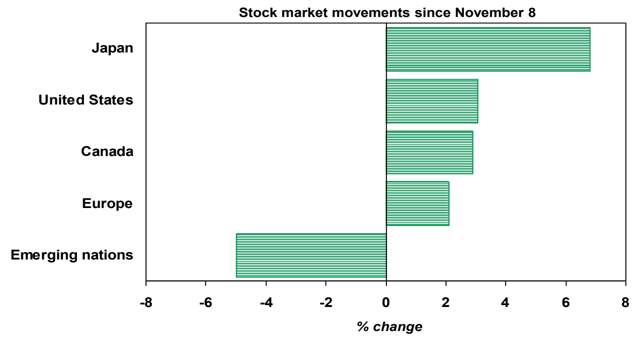
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies f: forecasts

ASSET CLASSES RETURN

North America's stock markets applaud Trump's election

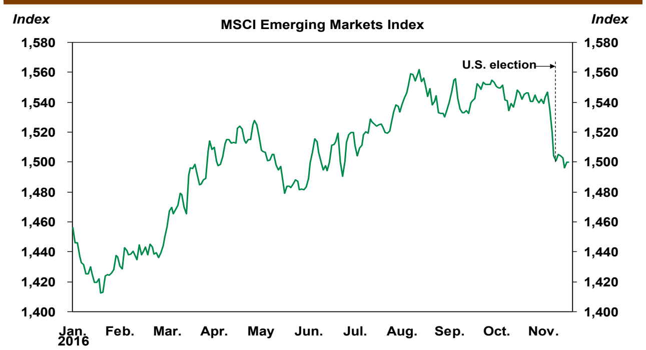
- **Most observers were expecting a Trump win to trigger a surge in anxiety that would hurt the markets.** Nonetheless, stock markets received the outcome enthusiastically. At the time of writing, the main U.S. indexes were in record territory. Bank securities sounded the charge. The S&P 500's financial component is up 12.0% since the election, galvanized by the prospects of deregulation. The industrial (7.0%) and energy (5.0%) sectors follow suit, banking on infrastructure projects and Trump's desire to make the United States even more energy-independent. The euphoria is not limited to the United States. The Japanese stock market is up 6.8%. The S&P/TSX has gained 2.9%, and the Euro Stoxx 600 is up 2.1% since the election. This contrasts sharply with the situation in the emerging markets (graph 7). The MSCI index for these countries is down 5.0% since November 8. The U.S. dollar advance that accompanied the election put substantial pressure on the currencies of many emerging nations (graph 8), fostering a flight of capital.
- **The robustness of stock markets in developed nations is remarkable, particularly against the backdrop of a spike in bond yields that eclipsed the early days of the 2013 taper tantrum.** Could the rejuvenated optimism about the profit outlook under Trump be supplanting the rate effect? If so, next year could see somewhat of a return to reality, when the U.S. government's direction becomes clear. Already, Trump's hostile stance on free trade could give some U.S. businesses headaches. Imposing tariffs could increase input costs (graph 9) and decrease profitability, particularly for goods-producing activity. The crackdown on illegal immigration could decrease the pool of available labour just when the economy seems to be closing in on full employment. This means higher labour costs for some businesses. On the other hand, a less restrictive regulatory context and the end of the Congress showdowns that marked the Obama era are more positive factors. All in all, keep in mind that the markets could be very volatile in the coming months. For now, our targets have not changed. Following this year's 9.5% gain, the S&P 500 could show more modest growth of around 8.5% next year.
- **For the Canadian stock market, we are raising our return target to 16.0% for this year, as the index continues to post surprises.** Yet, Canada's economic situation remains highly uncertain. The U.S. president-elect seems to have a strong aversion to the North American Free Trade Agreement (NAFTA) and, if renegotiating the agreement does not work out, the President can terminate it without going through Congress. Although his election campaign recriminations were primarily aimed at Mexico, Trump is unlikely to give Canada a free ride. During the campaign, he mentioned the "big-league" trade deficit with Canada. His transition team is threatening to restore the country-of-origin labelling rules, which could affect beef exporters. The desire to bring lumber into the NAFTA renegotiations could also be

Graph 7 – Emerging markets did not participate in the post-election equity rally



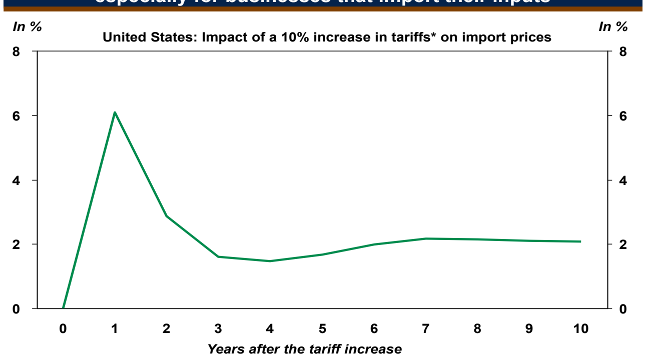
Sources: Bloomberg and Desjardins, Economic Studies

Graph 8 – Emerging market currencies plunge



Sources: Bloomberg and Desjardins, Economic Studies

Graph 9 – Imposing tariffs would increase businesses' costs, especially for businesses that import their inputs

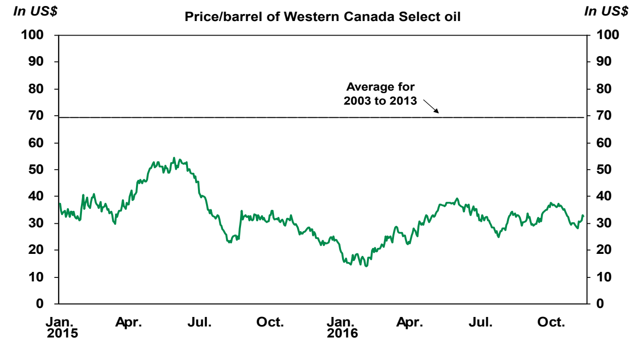


* On imports of all origins
Sources: International Monetary Fund and Desjardins, Economic Studies

a complication for the forestry industry. Where Trump's win has a more positive impact is with the Keystone XL pipeline project, which he favours under certain conditions. But even with the project, prices will have to come up enough to make Canadian oil corporations profitable again (graph 10). Given the many uncertainties, we are slightly trimming our return target for Canada's stock market to 8.5% for next year.

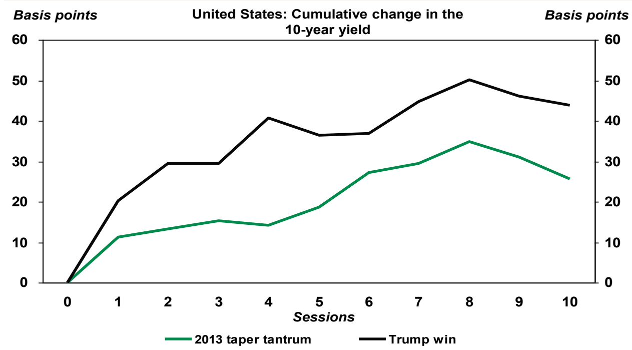
- **In bond markets, the secular downtrend in yields seems to have ended.** The U.S. 10-year yield has gained nearly 50 basis points since the Trump win (graph 11). Fiscal support and the protectionist approach are factors that could make inflation accelerate. We expect U.S. inflation to be at 2.0% in 2017 and 2.8% in 2018. These conditions will prompt the Federal Reserve to order two rate hikes next year and three in 2018. We will also have to keep an eye on how the credit rating agencies react to Trump's budget plan. Fitch has signalled that applying Trump's promises as is would adversely affect the United States' solvency. A U.S. downgrade could generate heavy volatility. We maintain a flat return target for Canadian bonds in 2017.

Graph 10 – A Keystone XL approval would not necessarily make Canadian oil extraction more profitable



Sources: Bloomberg and Desjardins, Economic Studies

Graph 11 – In the first 10 sessions since the election, the rise by yields eclipses the rise during the taper tantrum



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: 2.0	target: 16.0	target: 9.5	target: -1.0	target: -1.0 (US$0.73)
range	0.45 to 0.55	0.0 to 4.0	13.0 to 20.0	5.0 to 13.0	-5.0 to 2.0	-4.9 to -0.3
2017f	target: 0.50	target: 0.0	target: 8.5	target: 8.5	target: 4.0	target: 4.3 (US$0.70)
range	0.30 to 0.70	-3.0 to 3.0	1.0 to 16.0	2.0 to 15.0	-5.0 to 13.0	-1.4 to 9.0