RETAIL RATE FORECASTS

The start of Donald Trump's mandate should set the tone for 2017

HIGHLIGHTS

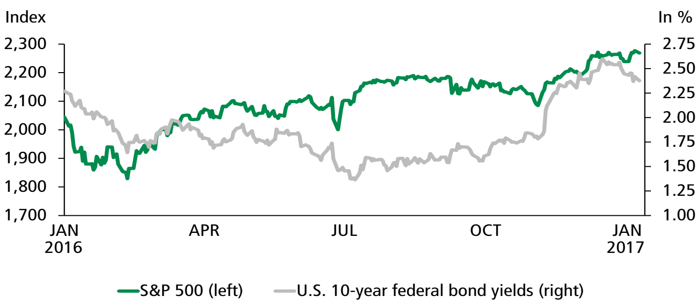
- Heading for slightly stronger economic growth in 2017.
- The Federal Reserve should continue to increase key rates gradually; in Canada, the status quo will last some time.
- The Canadian dollar has stood its ground fairly well against the U.S. dollar's ascent, but that may not last.
- The markets' optimism will have to be validated by concrete evidence.

- **Can the wave of optimism last?** The final months of 2016 were marked by the emergence of more positive sentiment following Donald Trump's win, which resulted in major advances by interest rates, the stock markets (graph 1), and the U.S. dollar. The agreement by oil exporting countries to curb crude output and better economic statistics in several nations were further factors in the renewed optimism. As markets seem a little more hesitant since the start of 2017, it will be important to keep a close eye on the new president's first announcements.

- **Promising signals from the U.S. economy.** The United States was already starting to show positive signs before the November 8 presidential election. Donald Trump's win does not seem to have hurt the trend, on the contrary. Consumer confidence indexes and the ISM indexes that reflect the situation for business have jumped in the last few months (graph 2). With activity having rebounded in the second half of 2016, the new year is looking fairly good in the United States. However, time will tell whether the first quarter will deliver another nasty surprise. The U.S. economy's performance will also reflect the measures the new administration implements. For now, we are expecting the economy to grow about 2.5% in 2017, after showing disappointing growth (estimated to be 1.6%) in 2016.

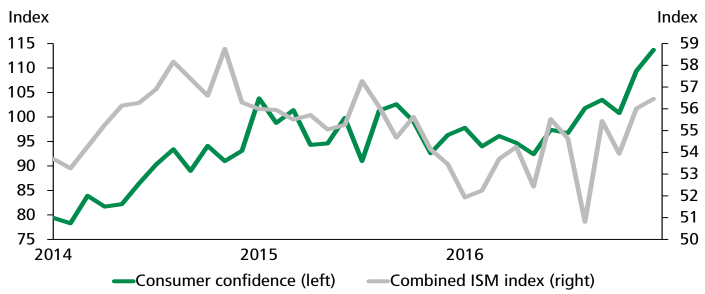
- **Canada should also do better in 2017.** The energy sector's stabilization and benefits of the federal government's stimulus plan should pave the way for slightly stronger economic growth. The Bank of Canada's (BoC) latest survey shows that

GRAPH 1
The stock markets and bond yields shot up after the U.S. election



Sources: Datastream and Desjardins, Economic Studies

GRAPH 2
U.S. business and consumer confidence swings up



Sources: Conference Board, Institute for Supply Management and Desjardins, Economic Studies

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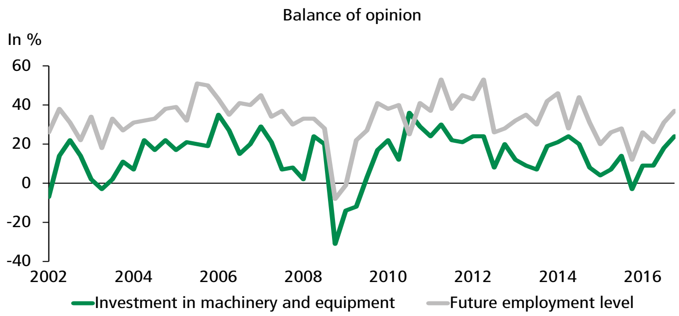
Canadian businesses are more confident and have raised their hiring and investment intentions (graph 3). Although 2016 was a tough year for economic growth, the labour market's solid performance is also encouraging. Some headwinds will continue to hamper Canada's economy, however, such as the housing market slowdown expected in several regions, and uncertainties over NAFTA's future.

- **Heading for smaller bond yield increases.** Bond yields surged at the end of 2016 and now seem ripe for some consolidation over the next few months. The Federal Reserve raised its key rates a second time in December, and is expected to slowly tighten its monetary policy in the quarters to come. Despite a few encouraging signals from Canada's economy, the many risks should persuade the BoC to wait until late 2018 before starting to firm up its monetary policy.
- **Toward a slow rise in retail rates.** Posted retail rates have been quite stable in recent months, a phenomenon that could well persist throughout 2017. However, the rise by bond yields has a substantial impact on Canadian financial institutions' financing costs, with many raising their promotional mortgage rates in the last few months. The slow uptrend for the mortgage rates actually offered in Canada could continue. Variable retail and very short-term rates should be less affected in 2017, benefiting from the Canadian monetary policy status quo.

GRAPH 3
Investment and hiring intentions are up in Canada



Sources: Bank of Canada and Desjardins, Economic Studies

TABLE 1
Forecasts: Retail rate

IN %	DISCOUNT RATE	PRIME RATE	MORTGAGE RATE 1 year	MORTGAGE RATE 3 years	MORTGAGE RATE 5 years	TERM SAVINGS[1] 1 year	TERM SAVINGS[1] 3 years	TERM SAVINGS[1] 5 years
Realized (end of month)								
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. 2016	0.75	2.70	3.14	3.39	4.74	0.85	1.15	1.50
Dec. 2016	0.75	2.70	3.14	3.39	4.74	0.85	1.15	1.50
Jan. 11, 2017	0.75	2.70	3.14	3.39	4.74	0.85	1.15	1.50
Forecasts								
End of quarter								
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
2017: 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
End of year								
2018	0.50–1.50	2.45–3.45	2.95–3.75	3.40–4.20	4.70–5.50	0.60–1.40	1.00–1.80	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	0.35–1.15	0.75–1.55	1.20–2.00
2020	0.25–1.25	2.20–3.20	2.60–3.40	3.00–3.80	4.50–5.30	0.35–1.15	0.80–1.60	1.25–2.05

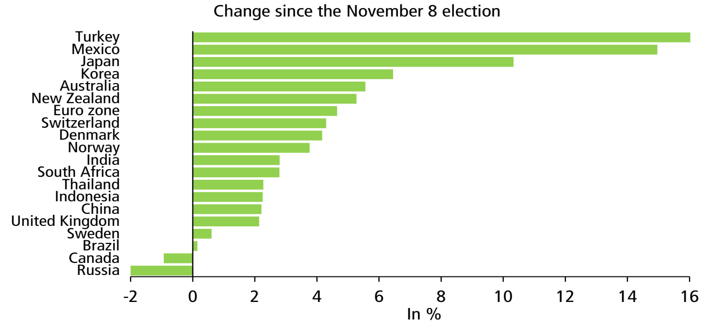
[1] Non-redeemable (annual); NOTE: Forecasts are expressed as ranges.
Source: Desjardins, Economic Studies

Exchange rate

The loonie has stood its ground fairly well against the U.S. dollar's ascent

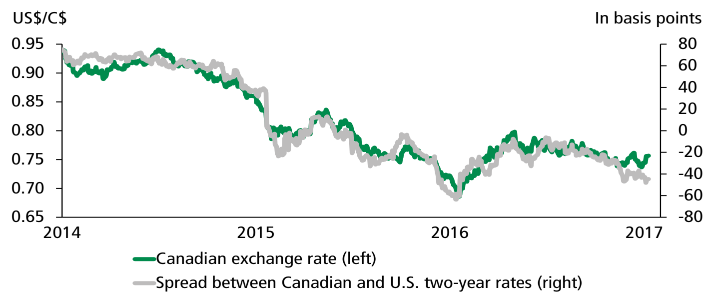
- The Canadian dollar was oscillating around US$0.74 (C$1.35/US$) before the end of 2016. It has gone up since then, and is currently around US$0.76 (C$1.32/US$), about 1% higher than it was before the U.S. election on November 8. The Canadian dollar's performance against the greenback contrasts with that of the other currencies. Although the U.S. dollar edged back recently, the fact remains that it has continued to rise against most other currencies since last November (graph 4).
- The main factor helping the greenback is expectations for U.S. monetary policy firming. This is being reflected in interest rate spreads, among other things, which often correlate well with exchange rates. The Canadian dollar's value has tracked the spread between Canadian and U.S. 2-year rates especially well in the last few years (graph 5). More recently, however, Canada's currency has clearly not fallen as much as dictated by interest rate movements. In fact, other positive factors compensated, allowing the loonie to do well. Firstly, oil prices have risen since mid-November. Also, Canadian economic statistics have generally been better than anticipated, even suggesting to some that the Bank of Canada (BoC) could take a more optimistic tone.
- **Forecasts:** We still pessimistic about the loonie. Our forecasts include greater widening of rate spreads with the United States, and small gains by oil prices. We also think the BoC will maintain a fairly cautious tone, given the numerous risks that continue to loom over the economy. The Canadian exchange rate should end 2017 at close to US$0.71 (C$1.41/US$).

GRAPH 4
The U.S. dollar has gained against nearly almost all currencies since November 8



Sources: Datastream and Desjardins, Economic Studies

GRAPH 5
The widening of interest rate spreads with the United States hurts 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

	2016		2017				2018			
END OF PERIOD	Q3	Q4	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0.7617	0.7445	0.7400	0.7300	0.7200	0.7100	0.7100	0.7000	0.7100	0.7200
CAN$/US$	1.3129	1.3433	1.3514	1.3699	1.3889	1.4085	1.4085	1.4286	1.4085	1.3889
CAN$/€	1.4754	1.4168	1.4189	1.4247	1.4306	1.4366	1.4225	1.4429	1.4085	1.4028
US$/€	1.1238	1.0547	1.0500	1.0400	1.0300	1.0200	1.0100	1.0100	1.0000	1.0100
US$/£	1.2990	1.2357	1.2400	1.2000	1.1700	1.1500	1.1400	1.1200	1.1000	1.1000

f: forecasts
Sources: Datastream and Desjardins, Economic Studies

Asset classes return

Market optimism will have to be validated by concrete evidence in 2017

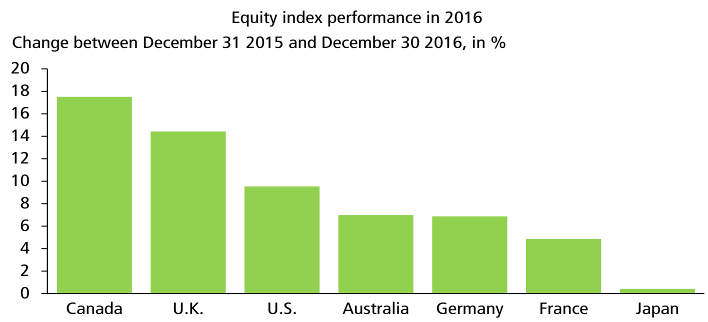
- **The theme for 2016 was the stock markets' defiance.** It first showed following the referendum in the United Kingdom. Stock markets stumbled for a few days, then shot up spectacularly. Donald Trump's surprise win in November also triggered a stock market shakeout, lasting a grand total of three hours! In just a few weeks, the indexes set new records. Nothing shook the markets in December, however. The Federal Reserve (Fed) announced a rate hike, as anticipated, and a wide array of U.S. confidence indexes soared, corroborating the stock market enthusiasm. It was in this rosy environment that the stock markets ended the year, delivering generous returns. The S&P 500 posted a total return of 12.0%. The Canadian stock market avenged its 8.3% loss of 2015 by yielding a spectacular 21.1% in 2016, dominating the stock markets of several developed nations (graph 6). Equity had a tougher year in developed nations abroad, with the MSCI EAFE index returning 5.9% (1.5% in U.S. dollars). Given Brexit, however, we could have expected worse.

- **Will the stock markets repeat this performance in 2017?** Since 2014, the S&P 500 forward price/earnings ratio has oscillated between 15.0 and 17.5. It is now at the top of this range. This valuation may seem slightly high, historically, but is a little more justified given the extremely low interest rate environment and the fact that the bond market is even more expensive. Despite that, incursions above 18.0 have rarely ended well. The indexes should therefore be guided by the prospects of higher profits. This could be difficult given already lofty expectations (graph 7).

- **Investors seem to be banking heavily on the new U.S. administration, but there are a lot of question marks about how profits will respond under the policies that will be announced.** For example, the pledged tax cuts for business could help somewhat, but the increase in input costs due to new tariff barriers and the U.S. dollar's rise are some of the factors that could work in the other direction. Beyond that, the new U.S. administration's foreign policy directions could destabilize the geopolitical climate and end up sapping market confidence. Many questions remain unanswered and, in our view, the risks of a market tailspin are not negligible, especially given that stock market optimism seems to have reached a climax. In this spirit, the S&P 500 should post a smaller return of around 9.0% this year, factoring in the possibility of one or two tougher quarters.

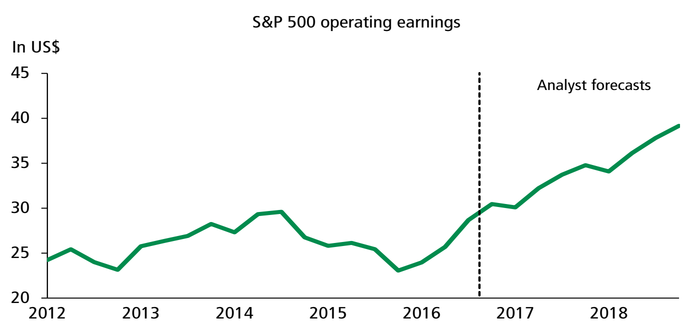
- **In Canada, one can hardly hope for a return better than 2016's.** The total return of 21.1% is the biggest recorded since 2009. This S&P/TSX performance occurred

GRAPH 6
The Canadian stock market stood out in 2016



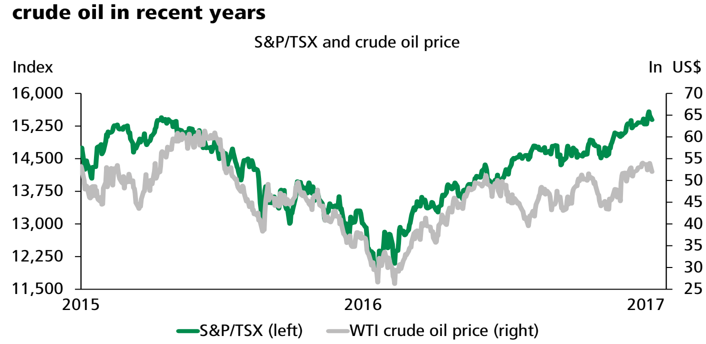
Sources: Bloomberg and Desjardins, Economic Studies

GRAPH 7
Analysts have high expectations for profits



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

GRAPH 8
Canada's stock market performance has been closely tied to crude oil in recent years



WTI : West Texas Intermediate
Sources: Bloomberg and Desjardins, Economic Studies

even though Canada's economic growth did not accelerate much. The case remains that the Canadian market is more sensitive to commodity price movements than local economic conditions (graph 8 on page 4). Oil prices rose 19% in 2016. Even though Canadian oil extraction is still having a hard time generating profits with oil prices just above US$50, the outlook is slowly improving, as the output cut announced by the members of the Organization of the Petroleum Exporting Countries (OPEC) should help the oil market get back to equilibrium within the next few months. The advent of a U.S. administration favourable to the Keystone XL pipeline project also augurs well. Our target for oil prices is US$58 at year's end; this should allow the energy sector to hang onto its gains. We expect the overall Canadian stock market to return 8.5%. Keep in mind that the uncertainties mentioned earlier for the U.S. stock market could also generate volatility for the Canadian stock market.

- **Canadian bonds delivered positive returns in 2016 for a third straight year.** However, the yield was somewhat smaller than in 2014 and 2015. Bonds had clear sailing until the fall, helped by the turmoil early in the year, and Brexit. In the wake of those events, inflation expectations fell to levels that were increasingly hard to justify, something investors started to acknowledge around September. Donald Trump's surprise win sped up the normalization of expectations. Fed officials also signalled slightly faster monetary tightening in 2017 than previously expected, helping uplift real rates. Canadian yields rose less than their U.S. counterparts, but still trended up. The time has now come for concrete proof, however. South of the border, inflation data will have to validate the rapid rise in expectations, something that is not entirely certain in the context of U.S. dollar appreciation. In Canada, the Bank of Canada will likely frown at an overly rapid rise in rates, in a context where homeownership standards have already been toughened, and U.S. protectionism is a worry. In the short term, we expect bond yields to edge down, until some of the uncertain parameters clarify. We expect to see a very slow rise starting next spring. Bonds should generate a total return of just 1.0%.

TABLE 3
Asset classes percentage return

	CASH	BONDS	CANADIAN STOCKS	U.S. STOCKS	INTERNATIONAL STOCKS	EXCHANGE RATE
END OF YEAR IN % (EXCEPT IF INDICATED)	3-month T-Bill	Bond index[1]	S&P/TSX index[2]	S&P 500 index (US$)[2]	MSCI EAFE index (US$)[2]	C$/US$ (variation in %)[3]
2006	4.0	4.1	17.3	15.8	26.9	0.2
2007	4.1	3.7	9.8	5.5	11.6	-14.4
2008	2.4	6.4	-33.0	-37.0	-43.1	22.1
2009	0.3	5.4	35.1	26.5	32.5	-13.7
2010	0.6	6.7	17.6	15.1	8.2	-5.2
2011	0.9	9.7	-8.7	2.1	-11.7	2.3
2012	1.0	3.6	7.2	16.0	17.9	-2.7
2013	1.0	-1.2	13.0	32.4	23.3	7.1
2014	0.9	8.8	10.6	13.7	-4.5	9.4
2015	0.5	3.5	-8.3	1.4	-0.4	19.1
2016	0.5	1.7	21.1	12.0	1.5	-2.9
2017f	target: 0.5	target: 1.0	target: 8.5	target: 9.0	target: 5.0	target: 4.9 (US$0.71)
range	0.3 to 0.7	-2.0 to 3.0	3.0 to 11.0	4.0 to 12.0	0.0 to 9.0	-2.0 to 7.9

[1] FTSE TMX Canada Bond Universe; [2] Dividends included; [3] Negative = appreciation, positive = depreciation; f: forecasts
Sources: Datastream and Desjardins, Economic Studies