

# RETAIL RATE FORECASTS

## Heading for another U.S. key rate hike

### HIGHLIGHTS

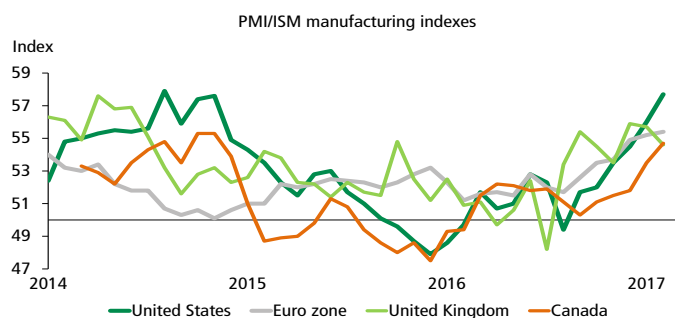
- ▶ Leading indicators continue to send encouraging signals and inflation has picked up in advanced economies.
- ▶ The Federal Reserve should raise its key rates again in March, but the Bank of Canada seems to be in no rush to follow suit.
- ▶ The U.S. dollar starts heading up again after a tougher start to the year.
- ▶ The U.S. stock markets are still giving Trump the benefit of the doubt.

- **Leading indicators continue to send encouraging signals.** Far from reversing, the surge in confidence that began last fall persists. In both Europe and North America, business activity indexes and confidence indexes have shot up in recent months, in many cases hitting peaks that date back several years (graph 1). Several countries also recorded solid economic growth at the end of 2016. The U.S. economy only grew 1.9% in the last quarter, however, and it could remain weak in early 2017, due to the weather, among other factors.
- **Inflation is rebounding.** Around the world, inflation rates have rebounded sharply in recent months, in many cases going back over most central banks' 2% target (graph 2). This is a big change from the situation in recent years, when central

banks were very worried about weak inflation. The upswing in inflation largely reflects the rebound of gasoline prices, as oil prices have nearly doubled in the last year. Inflation should thus not be much of a worry for the central banks. The likelihood that they will announce further monetary easing is, however, now almost zero.

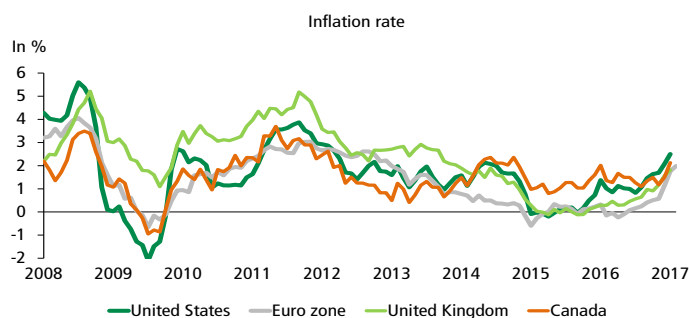
- **The Federal Reserve (Fed) seems ready to raise its key rates again.** While GDP growth seems disappointing at the beginning of 2017, other economic statistics paint a promising picture of the U.S. economy. This, combined with the fact that financial markets are doing well and inflation has picked up, should convince the Fed to move ahead with another key rate hike at its March 15 meeting.

**GRAPH 1**  
Business is sending encouraging signals



Sources: Bloomberg and Desjardins, Economic Studies

**GRAPH 2**  
Inflation has come up in recent months



Sources: Datastream and Desjardins, Economic Studies

François Dupuis, Vice-President and Chief Economist

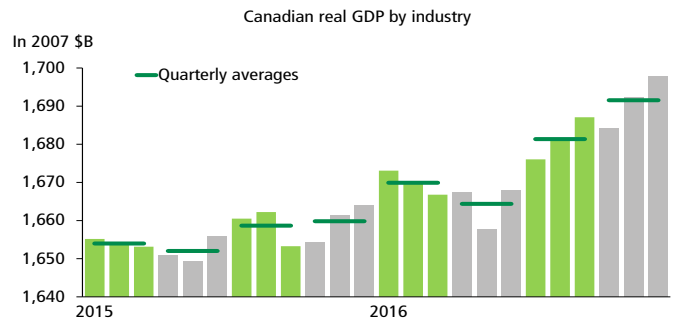
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NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

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- The Canadian economy problems seem to be over.**  
 The commodity price correction did a lot of damage to Canada's economy in 2015 and first half of 2016. The situation has recovered since then, and Canada's real GDP ended 2016 on a good note, recording annualized growth of 2.6% (graph 3). Although the outlook for private investment remains weak, the federal government's stimulus plan should buoy Canada's economy in the coming quarters. However, the Bank of Canada (BoC) is still concerned about the many risks looming over the situation in Canada, and is stressing the fact that the country still has substantial excess capacity.
- Heading for new upside pressure on some retail rates.**  
 Faster monetary firming in the United States suggests higher bond yields in Canada and additional upside pressure on financial institutions' financing costs. The retail rates actually offered for medium- and long-term could therefore go up slightly in the next few months. Posted retail rates are very stable, and this could persist, however. The BoC's long status quo also suggests there will be little change for short term rates.

**GRAPH 3**
**Canada's economic growth accelerated sharply in the second half of 2016**


Sources: Statistics Canada and Desjardins, Economic Studies

**TABLE 1**
**Forecasts: Retail rate**

IN %	DISCOUNT RATE	PRIME RATE	MORTGAGE RATE			TERM SAVINGS <sup>1</sup>		
			1 year	3 years	5 years	1 year	3 years	5 years
<b>Realized</b> (end of month)								
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
January 2017	0.75	2.70	3.14	3.39	4.74	0.85	1.15	1.50
February 2017	0.75	2.70	3.14	3.39	4.74	0.85	1.15	1.50
Mar. 6, 2017	0.75	2.70	3.14	3.39	4.74	0.85	1.15	1.50
<b>Forecasts</b>								
<u>End of quarter</u>								
2017: Q1	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
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
<u>End of year</u>								
2018	0.50–1.50	2.45–3.45	3.00–3.80	3.45–4.25	4.80–5.60	0.65–1.45	1.05–1.85	1.50–2.30
2019	0.25–1.25	2.20–3.20	2.60–3.40	2.95–3.75	4.50–5.30	0.35–1.15	0.80–1.60	1.30–2.10
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

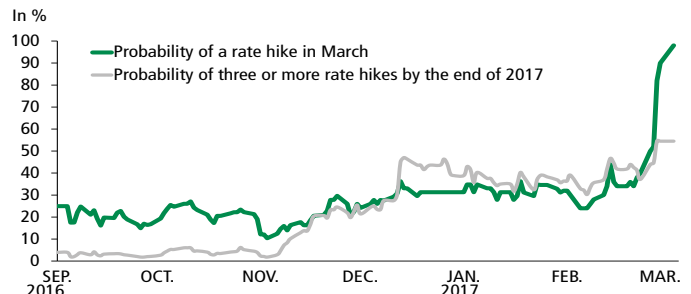
<sup>1</sup> Non-redeemable (annual); NOTE: Forecasts are expressed as ranges.  
 Source: Desjardins, Economic Studies

# Exchange rate

## The U.S. dollar starts heading up again after a tougher start to the year

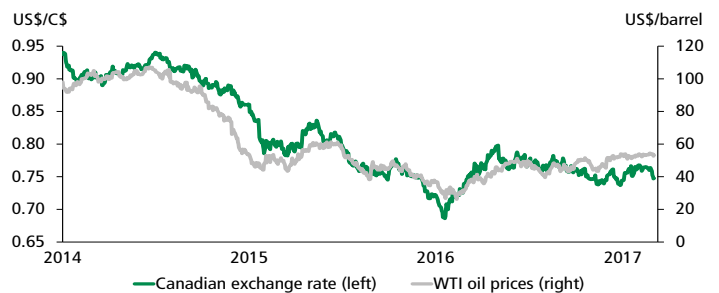
- The U.S. dollar fell against several currencies in January, but it has reversed its heading in the last few weeks. The change is essentially due to the growing feeling that the Federal Reserve (Fed) will move ahead with monetary firming, ordering a rate increase in March and perhaps two more after that, before year's end (graph 4). The greenback was especially responsive to hawkish remarks from various Fed leaders at the end of February.
- In the wake of the greenback's rise, Canada's exchange rate dropped back below US\$0.75. The slow rise by oil prices, which are now around US\$55 a barrel, is not enough to keep the loonie from depreciating (graph 5). That being said, if crude prices had not improved, the Canadian dollar would have had a much harder time in the last few months. Since November, the loonie has also advanced against other currencies, including the euro. The good economic numbers released in Canada were one more favourable point, fuelling the sense that the Bank of Canada (BoC) will eventually have to raise its rates. That being said, the BoC seems to be in no rush to act, and some of the Canadian dollar's recent slide can be chalked up to the still cautious tone the BoC took in its latest monetary policy statement.
- **Forecasts:** The Canadian exchange rate should end 2017 at close to US\$0.72 (C\$1.39/US\$). This scenario includes greater widening by interest rate spreads with the United States, and small gains by oil prices. We also think the BoC will maintain a cautious tone. Most of the other currencies should also slide against the U.S. dollar.

**GRAPH 4**  
The markets are now pricing in a Federal Reserve interest rate hike in March



Sources: Bloomberg and Desjardins, Economic Studies

**GRAPH 5**  
The Canadian dollar did not track the rise by oil prices



WTI: 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

END OF PERIOD	2016		2017				2018			
	Q3	Q4	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US\$/CAN\$	0.7617	0.7445	0.7450	0.7400	0.7300	0.7200	0.7200	0.7100	0.7100	0.7200
CAN\$/US\$	1.3129	1.3433	1.3423	1.3514	1.3699	1.3889	1.3889	1.4085	1.4085	1.3889
CAN\$/€	1.4754	1.4168	1.4161	1.4189	1.4110	1.4167	1.4167	1.4225	1.4085	1.4028
US\$/€	1.1238	1.0547	1.0550	1.0500	1.0300	1.0200	1.0200	1.0100	1.0000	1.0100
US\$/£	1.2990	1.2357	1.2200	1.2100	1.1700	1.1500	1.1400	1.1200	1.1000	1.1000

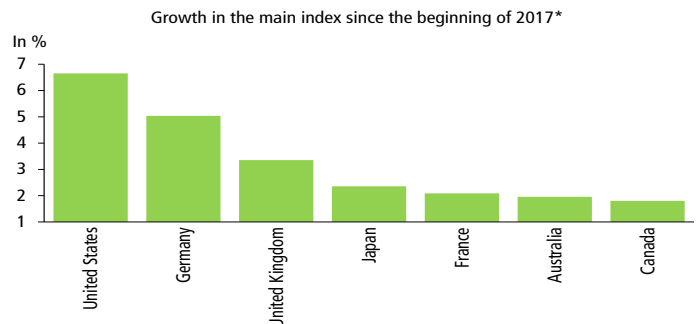
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Sources: Datastream and Desjardins, Economic Studies

## Asset classes return

### U.S. stock markets are still giving Trump the benefit of the doubt

- The stock market surge that followed Donald Trump's win was accompanied by fears about how long the movement would last.** It was guided by hopes for new economic policy that would be highly beneficial to U.S. businesses, although many questions are still pending. Nearly 45 days after Donald Trump's inauguration, most of these parameters are still not known, although investors have not lost patience. The U.S. stock market has been leading the developed nations since the start of the year, posting a gain of about 7.0% in the case of the S&P 500 (graph 6). This is in addition to the 6.3% climb posted between the November 8 election and the end of 2016.
- While the indexes in most other developed nations are also up, the gains are somewhat smaller, in the area of 3% to 4% for the German and British stock markets, and less than 2% for the stock markets in France, Japan and Australia.** In Europe, investors remain on the lookout against a backdrop of political uncertainty, especially in France, where far right candidate Marine Le Pen is leading in the polls for the first round of the presidential election next spring.
- In contrast, emerging nation stock markets have been booming since the start of the year, with investors attracted by these markets' affordable valuations (graph 7).** The economic outlook is improving in countries that were in recession in recent years, especially commodity-producing countries (Brazil, Russia). This has prompted analysts to increase their return expectations. The MSCI Emerging Market Index is up 8.9% since January 1, with double-digit gains in Latin American stock markets. This performance is all the more impressive considering that some countries, like Mexico, are directly threatened by the new U.S. administration's policies.
- The big question is what the outcome will be for the U.S. stock market.** Several valuation metrics are signalling that the market is too rich. For example, the dividend yield of the S&P 500 has dropped below the yield on a risk-free 10-year government bond (graph 8). Investors need a catalyst to take their profits, however. Look elsewhere than earnings; they improved strongly in the fourth quarter, year over year. Most sectors are posting much better earnings, with the energy sector leading the way. Corporate executives also seem to be optimistic. During their quarterly teleconferences with analysts, many reported being enthusiastic about the Trump administration's ambitions for infrastructure, deregulation, and changes to the tax system. The fact remains that Trump has pledged annual economic growth of 4%, a tall

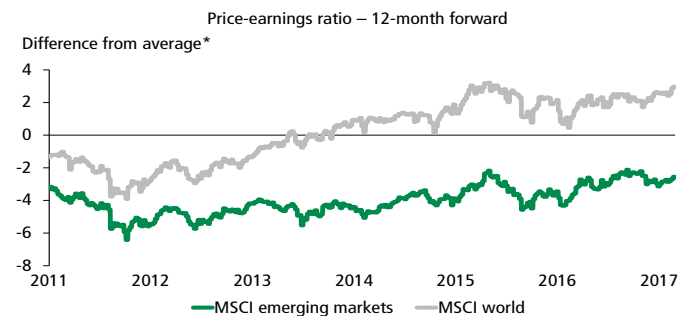
**GRAPH 6**  
U.S. stocks lead the way



\*As of March 2, 2017.

Sources : Bloomberg and Desjardins, Economic Studies

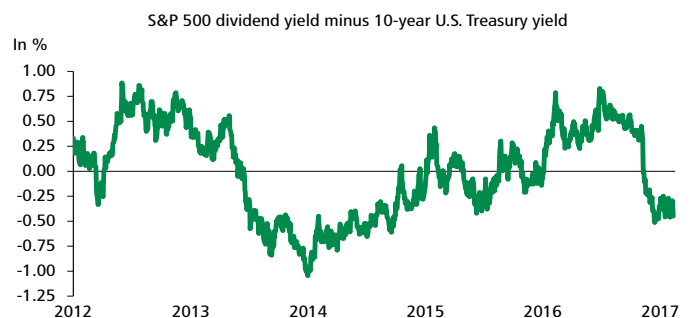
**GRAPH 7**  
More attractive valuations in emerging markets



\* Since 1987.

Sources : I/B/E/S, Datastream and Desjardins, Economic Studies

**GRAPH 8**  
The S&P now looks expensive relative to Treasury bonds



Sources : Datastream and Desjardins, Economic Studies

order in this demographic and productivity climate, especially given how little control public policy may have over these variables in the very short term. All in all, we are expecting a total return of 10.0% for the U.S. stock market, slightly higher than our previous scenario, given the stronger than expected resilience at the start of the year. However, we continue to think that volatility, essentially absent in 2017, could resurface in the near future, especially if the markets become disenchanted with Trump.

- Until recently, the Canadian market has been participating fully in the optimism.** On February 21, its year-to-date performance was even better than the S&P 500's. Then things started to fall apart. The S&P/TSX fell 3.3% between February 21 and 28, wiping out nearly all of its gains. Commodities cannot be blamed; the Bank of Canada's commodity price index is up slightly since January 1. Nor is it Canadian corporate results. As of March 2, two-thirds of companies had released their results, and 59% of them had beaten analysts' expectations, up slightly from the previous quarter. The Canadian stock market's recent struggles could therefore be relatively short-lived. Note that the stock market delivered by far the best performance among developed nations last year, taking its price-earnings ratio above its long-term average. It has thus become harder to justify persistent outperformance. In this context, we have trimmed our target for the S&P/TSX slightly.

- The U.S. stock market's ascent over the last three months has not hurt long-term government bonds too much.** The Federal Reserve (Fed) still raised rates in December, and we expect it to do so again on March 15. We think the Fed will proceed with three rate hikes this year, instead of the two we were expecting previously. This should allow bond yields to end the year at slightly higher levels in the United States, and to a lesser degree, in Canada. We are therefore trimming our return target slightly for bonds.

**TABLE 3**  
**Asset classes percentage return**

END OF YEAR IN % (EXCEPT IF INDICATED)	CASH	BONDS	CANADIAN STOCKS	U.S. STOCKS	INTERNATIONAL STOCKS	EXCHANGE RATE
	3-month T-Bill	Bond index <sup>1</sup>	S&P/TSX index <sup>2</sup>	S&P 500 index (US\$) <sup>2</sup>	MSCI EAFE index (US\$) <sup>2</sup>	C\$/US\$ (variation in %) <sup>3</sup>
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 range	target: 0.5 0.3 to 0.7	target: 0.5 -2.0 to 3.0	target: 6.5 2.0 to 10.0	target: 10.0 5.0 to 13.0	target: 7.0 2.0 to 11.0	target: 3.4 (US\$0.72) -2.0 to 7.9

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