RETAIL RATE FORECASTS

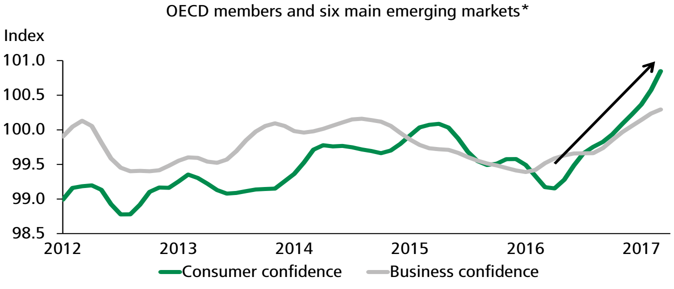
Investor Worries Keep Interest Rates Low

HIGHLIGHTS

- Economic indicators remain encouraging, but the geopolitical situation is causing concern.
- The Federal Reserve continued to firm up monetary policy and even the Bank of Canada adopted a more positive tone.
- Will the Canadian dollar benefit from higher expectations of monetary firming in the country?
- A darkening sky on the geopolitical front gives rise to caution.

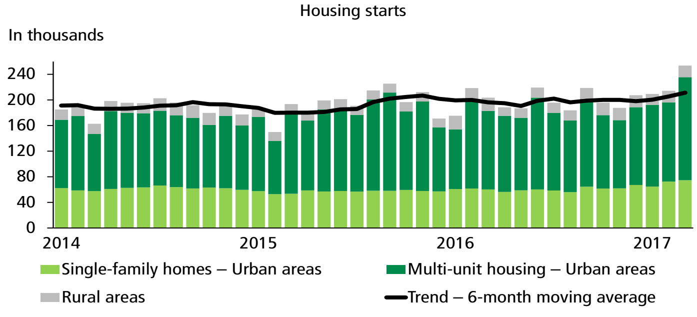
- **Confidence indicators continue to increase in most economies.** Clear improvement in business and consumer confidence (graph 1) appears to confirm that global economic growth in 2017 will be more vigorous than it was in 2016. However, all signs indicate that U.S. growth remained weak in the first quarter of 2017, but that partly reflects temporary factors. In contrast, the growth outlook has been revised upward for many economies, including Canada.
- **The Federal Reserve (Fed) picked up the pace.** Noting the strong performance of the job market and inflation returning to a near-target level, the Fed proceeded with a second consecutive quarterly key rate increase in mid-March. After having increased their key rates only 0.25% in 2015 and in 2016, U.S. monetary authorities now seem to be heading toward 0.75% annual increases in 2017 and in 2018.
- **The Bank of Canada (BoC) no longer plans to ease further its monetary policy.** A few months ago, the Canadian monetary authorities were still seriously considering to lower their key rates. This option is no longer on the table, since the Canadian economy's good performance combined with a downward revision of growth potential now suggest that the Canadian economy could reach its full potential in the first half of 2018. Nonetheless, the BoC remains cautious and considers that there is still no assurance that a solid foundation underpins growth. Canadian key rates should therefore remain unchanged for several more months. The intense activity in the

GRAPH 1
A generalized surge in confidence



OECD: Organisation for Economic Co-operation and Development; * Brazil, China, India, Indonesia, Russia and South Africa.
Sources: OECD and Desjardins, Economic Studies

GRAPH 2
Far from slowing, the Canadian housing market climbed to a new 10-year high in March



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

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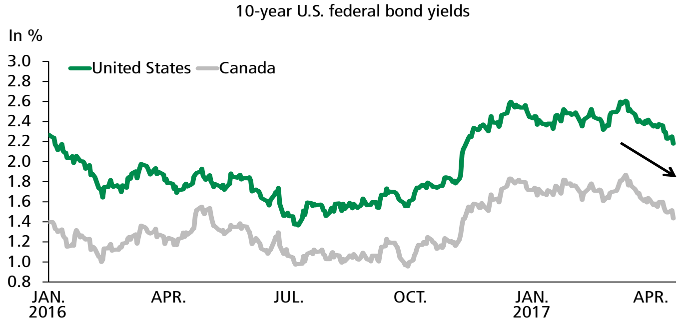
real estate sector (graph 2 on page 1) could however increase pressure on the BoC.

- **The political situation worries markets.** The Trump administration's struggle to deliver on his campaign promises and a temporary drop in oil prices gave rise to some concerns in the market during March. In addition, U.S. intervention in Syria and the possibility of conflict with North Korea have intensified fears. The surge in popularity of a candidate from the extreme left in France also raised concerns about the political situation in Europe. In this context, investors have turned to safe-haven securities, which prompted downside pressure on North American bond yields (graph 3).
- **Retail rates should increase in the medium term.** The recent pullback in bond yields relieved upside pressure on financing costs for financial institutions. Stability in retail rates should therefore continue in the short term. Yet the favourable economic context and the gradual rise of U.S. key rates suggest an upward trend for bond yields and retail rates in the medium term.

GRAPH 3
Bond yields fell recently despite an increase in U.S. key rates in March



Sources: Datastream and Desjardins, Economic Studies

TABLE 1
Forecasts: Retail rate

IN %	DISCOUNT RATE	PRIME RATE	MORTGAGE RATE			TERM SAVINGS[1]		
			1 year	3 years	5 years	1 year	3 years	5 years
Realized (end of month)								
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
March 2017	0.75	2.70	3.14	3.39	4.74	0.85	1.15	1.50
April 18, 2017	0.75	2.70	3.14	3.39	4.74	0.85	1.15	1.50
Forecasts								
End of quarter								
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
2018: Q1	0.50–1.00	2.45–2.95	2.99–3.49	3.34–3.84	4.59–5.09	0.70–1.20	1.00–1.50	1.35–1.85
End of year								
2018	0.75–1.75	2.70–3.70	3.20–4.00	3.60–4.40	4.85–5.65	0.80–1.60	1.15–1.95	1.55–2.35
2019	0.75–1.75	2.70–3.70	2.85–3.65	3.20–4.00	4.65–5.45	0.60–1.40	0.90–1.70	1.30–2.10
2020	0.50–1.50	2.45–3.45	2.80–3.60	3.15–3.95	4.65–5.45	0.60–1.40	0.90–1.70	1.35–2.15

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

Exchange Rate

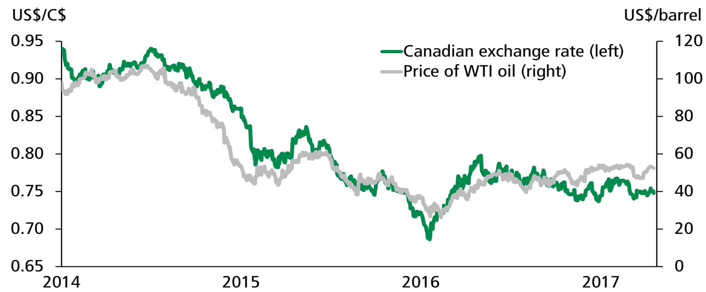
Will the Canadian dollar benefit from higher expectations of monetary firming?

- Several factors have become more favourable to the Canadian dollar. First, economic data continued to show robust growth in the country. Next, oil has climbed to close to US$54 per barrel. However, we note that the appreciation of the Canadian dollar remains tepid against recent advances in the price for crude oil (graph 4). One of the elements that still seems to limit the loonie's appreciation was the BoC maintaining a very cautious tone. The results could very well have changed after the monetary policy meeting in April. The BoC revised its economic scenario upward and finally seems to want to discard another decrease in its key rates. Investors could therefore be tempted to revise upward their expectations on monetary firming.

- The general evolution of the U.S. dollar continues to be a key part of currency forecasts. Once again, there was no sustainable benefit to the greenback from a new push, and it recently lost ground against most currencies (graph 5). Disappointment with economic data raised doubts on continued monetary firming in the United States. Donald Trump has shown himself to be more in favour of a weaker, rather than stronger, dollar, a fairly unusual stance for a U.S. president.

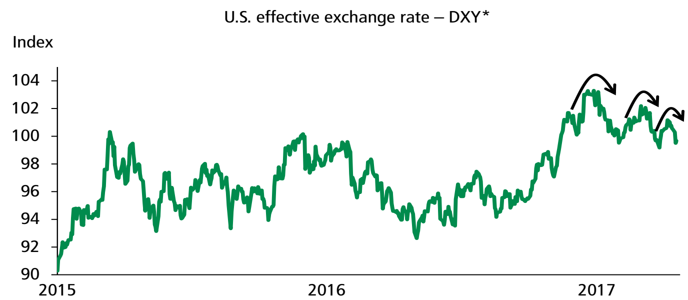
- **Forecasts:** The Canadian dollar could appreciate again in the very short term, especially if the U.S. dollar continues to retreat and if investors revise upward their expectations on monetary firming in Canada. That said, we still believe that the BoC will wait until spring 2018 before announcing a rate increase. Until then, monetary firming will advance even more in the United States, and the widening of the interest rate spreads should benefit the U.S. dollar compared with most currencies, including the Canadian dollar.

GRAPH 4
The Canadian dollar indifferent to oil prices



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

GRAPH 5
Still no sustained appreciation in the U.S. dollar



* Weighted average of the U.S. dollar against the euro, pound, yen, Canadian dollar, Swiss franc and Swedish krona.
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	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0.7617	0.7445	0.7511	0.7450	0.7300	0.7300	0.7400	0.7500	0.7500	0.7600
CAN$/US$	1.3129	1.3433	1.3313	1.3423	1.3699	1.3699	1.3514	1.3333	1.3333	1.3158
CAN$/€	1.4754	1.4168	1.4239	1.4228	1.4247	1.3973	1.3784	1.3467	1.3600	1.3684
US$/€	1.1238	1.0547	1.0696	1.0600	1.0400	1.0200	1.0200	1.0100	1.0200	1.0400
US$/£	1.2990	1.2357	1.2505	1.2400	1.2100	1.1800	1.1600	1.1500	1.1500	1.1500

f: forecasts
Sources: Datastream and Desjardins, Economic Studies

Asset Classes Return

A darkening sky on the geopolitical front gives rise to caution

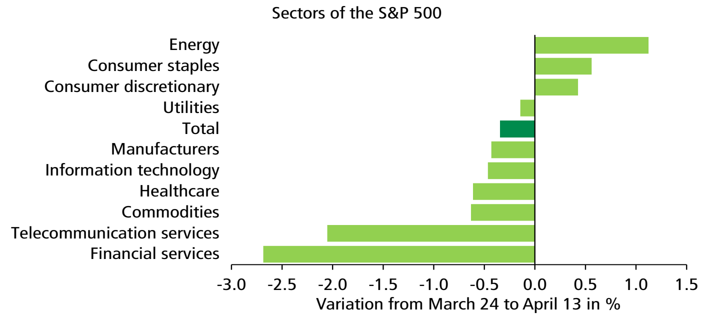
- **Following the prolonged excitement based on Donald Trump's economic promises, a sober mood seems to prevail.** The failure of Donald Trump's first big promise, to repeal Obamacare, greatly dampened expectations of an extensive tax. The S&P 500 posted a 0.6% decline between March 24—the date of the vote on Obamacare—and April 13 (graph 6). Financial stocks experienced the most difficulty, falling 2.8%. Telecommunications companies were also affected, recording a 2.2% decrease. The only real strong point in the U.S. stock market during this period was the energy sector, with a 1.3% gain that capitalized on the recovery in oil prices.

- **In addition to the doubts about Donald Trump's ambitions, there was a rapid escalation in geopolitical tensions.** The new U.S. president has demonstrated a willingness to assert himself on the world stage. The result: relations with Russia are strained and tensions are heating up between the United States and North Korea. This context has been favourable to oil. The U.S. strikes in Syria are not as much an issue as the risk of seeing the conflict escalate and end up creating logistical difficulties in the more sensitive areas of the Middle East. Meanwhile, gold is benefiting from general risk aversion, now nearing a 5-month high of close to US$1,300. In this kind of context, it is not surprising that stock markets are struggling to advance.

- **But, we have already seen much more brutal corrections in less worrying times.** For example, at the same time last year, the S&P 500 was down 6% year-to-date. Currently, it is still posting a 4% gain, despite the recent difficulties. Furthermore, the Federal Reserve seems much more resolved to normalize its monetary policy compared with the last two years. It surprised many in its latest meeting minutes, signalling that it would begin to decrease the size of its balance sheet at the end of the year. However, stock markets did not seem overly alarmed by this signal.

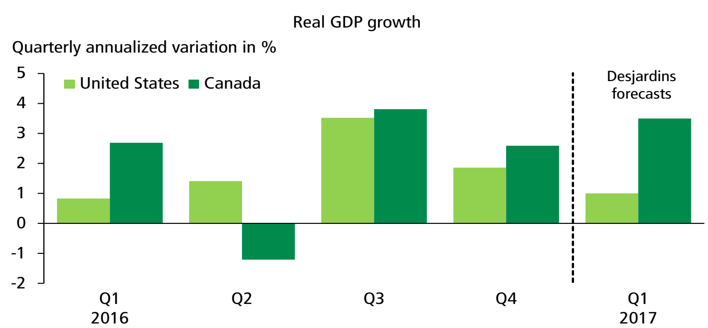
- **It could indicate that there is still some optimism regarding the Trump effect.** Even if other failures to push through policies strongly diminish the direct impact his election will have on the economy, the famous animal spirits could well have been stirred in a relatively sustainable manner. We anticipate a rebound of around 3% in growth in the second quarter, which should reassure markets. Our 10% return target for the S&P 500 allowed for more difficult phases, like the one the stock market is going through. We maintain this target, while noting that the orientation of risks has moved a little to the downside.

GRAPH 6
Financial and telecommunications securities were heavily penalized by the U.S. stock exchange



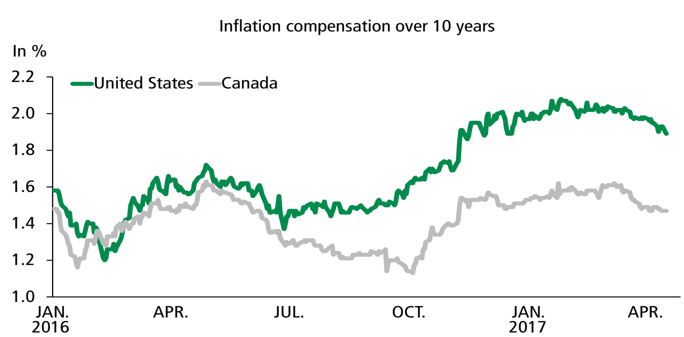
Sources: Bloomberg and Desjardins, Economic Studies

GRAPH 7
Recent Canadian growth was stronger than recent U.S. growth



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

GRAPH 8
Inflation expectations weakened in North America



Sources: Bloomberg and Desjardins, Economic Studies

- **While not quite a renaissance, the Canadian stock market has shown itself to be relatively resilient in the last month.** Since the failure of the Obamacare repeal, it is showing a modest 0.6% gain. In risk-averse conditions, this could have been worse. Energy and materials, two heavyweights in the S&P/TSX, have posted respective increases of 1.9% and 2.9% since March 24. This helps compensate for the difficulties in Canadian financial stocks, which have since fallen 1.8%, in tandem with the decrease recorded south of the border. The Canadian stock market therefore has enjoyed some level of protection against disillusionment with Donald Trump, in that it has benefited from a recovery in commodities. From a fundamental point of view, economic accounts for the first quarter will likely reveal that Canada outpaced the United States in terms of growth in four of the last five quarters (graph 7 on page 4). Job creation was particularly vigorous, as was the housing market, which even prompted the recently rather pessimist Bank of Canada (BoC) to significantly revise upward its 2017 growth forecast for the economy. In this context, we are holding our return target for the S&P/TSX at 6.5%.

- **Government bonds are among the winners in the risk-averse climate.** The U.S. 10-year yield peaked at 2.63% on December 15. Currently, it is almost 50 basis points below that level. The observation is similar for the Canadian 10-year yield, which was brought back to 1.43%. We note a persistent decrease in inflation expectations. In the wake of Donald Trump's election, inflation compensation over 10 years in the United States jumped to 2.08% in January, a peak since 2014. Currently, the compensation is 1.80%. Diminished expectations concerning the U.S. budget stimulus program are behind this, but the latest inflation data also surprised by their weakness in the United States. A downward trend in inflation expectations was also observed in Canada. Inflation compensation over 10 years, which was already very low, fell below 1.50% recently (graph 8 on page 4). This contrasts with the BoC's message, which signalled that the economy would return to full capacity as of early next year. A few upside surprises in inflation is all it would take to get investors to revise their inflation expectations upward in Canada. In such context, bonds may struggle to maintain their recent gains. We keep our return target of 0.5% for the bond asset class.

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: 0.5	target: 6.5	target: 10.0	target: 7.0	target: 2.0 (US$0.73)
range	0.3 to 0.7	-2.0 to 3.0	2.0 to 10.0	5.0 to 13.0	2.0 to 11.0	-2.0 to 6.4

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