RETAIL RATE FORECASTS

Interest Rates Are Expected to Stay Very Low

HIGHLIGHTS

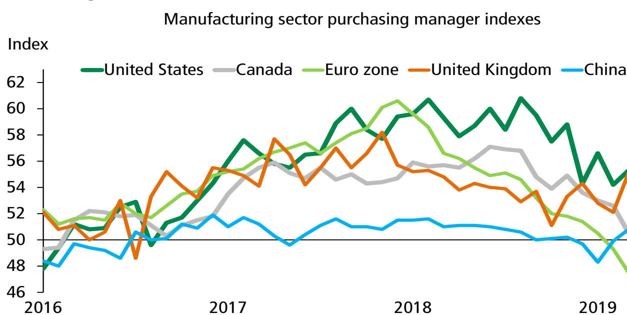
- There are renewed concerns over trade tensions.
- Domestic demand in Canada has rebounded.
- Has the rise in the U.S. dollar come to an end?
- Bonds are benefiting from the uncertainty.

- **Hope for a Sino-U.S. trade agreement has evaporated.** Judging that the Chinese government was backpedaling in the negotiations, President Donald Trump suddenly announced that new tariffs would be slapped on Chinese imports in May. This caused volatility to return to financial markets and magnified concerns about the global economy. Although economic growth in Q1 2019 did exceed expectations in a number of countries, the manufacturing sector is showing signs of a fairly widespread slowdown (graph 1). The additional threat of tariffs on Mexican goods, however, was narrowly avoided in early June, reassuring investors somewhat.

- **The Federal Reserve (Fed) is watching the situation closely.** At the beginning of May, the latest economic figures and the positive trend in financial markets seemed to reassure the Fed. Still, the renewed financial tensions are casting a shadow over the economic outlook, with investors betting on a series of key-rate decreases between now and the end of 2019. In a recent statement, the Fed Chair confirmed that he was closely monitoring the situation and would be taking appropriate action to sustain the expansion of the U.S. economy.

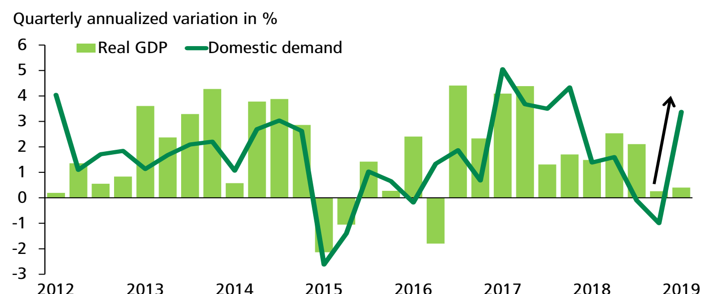
- **The period of weakness in the Canadian economy should be over.** The Canadian economy saw low growth in early 2019 for the second quarter in a row. Nonetheless, the 3.4% jump in domestic demand after two consecutive quarters of contraction is very encouraging for the future (graph 2), as is the excellent performance of the labour market. The solid 0.5% hike in monthly GDP in March and

GRAPH 1
The manufacturing sector appears to have been slowing in recent quarters



Sources: Bloomberg and Desjardins, Economic Studies

GRAPH 2
Canadian domestic demand rebounded despite weak real GDP growth



Sources: Statistics Canada and Desjardins, Economic Studies

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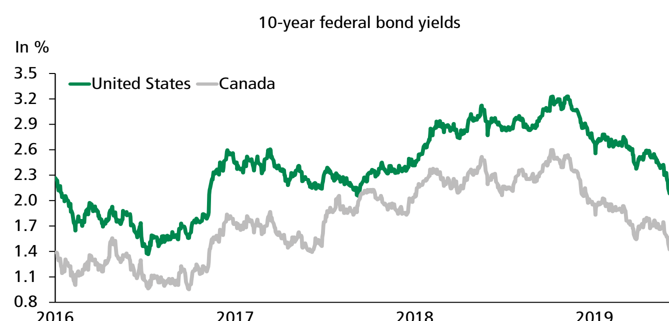
improvement in the export sector also suggest more robust growth as early as Q2. Whereas the scenario of a temporary slowdown in the Canadian economy followed by a rebound seems to be coming true even as international threats are on the rise, all indications are that the Bank of Canada will be keeping key rates where they are for a long time.

- **Bond yields plunge.** Already extremely low, U.S. and Canadian bond yields have declined significantly in recent weeks (graph 3). The resurgence in trade tensions made bonds more attractive and motivated investors to count increasingly on monetary policy easing, especially in the United States.
- **Retail rates will remain very low in the coming quarters.** The plunge in bond yields since last fall had an impact on the cost of funds for Canadian financial institutions, and some posted retail rates were lowered. The drop in negotiated mortgage rates was even more pronounced. Without a decrease in Canadian key rates, it would be surprising to see retail rates continue to follow a downward trend. However, there is every indication that rates will remain very low for a long time to come.

GRAPH 3
Bond yields plunged to their lowest level in almost two years



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)								
Dec. 2018	2.00	3.95	3.79	4.34	5.54	1.40	1.60	2.00
January 2019	2.00	3.95	3.79	4.34	5.54	1.40	1.60	2.00
February 2019	2.00	3.95	3.79	4.34	5.54	1.40	1.60	2.00
March 2019	2.00	3.95	3.79	4.34	5.34	1.40	1.60	2.00
April 2019	2.00	3.95	3.79	4.34	5.34	1.40	1.60	2.00
May 2019	2.00	3.95	3.79	4.34	5.34	1.40	1.60	2.00
June 17, 2019	2.00	3.95	3.79	4.34	5.34	1.40	1.60	2.00
Forecasts								
End of quarter								
2019: Q2	2.00	3.95	3.55–3.85	4.05–4.45	5.05–5.45	1.15–1.45	1.35–1.65	1.70–2.10
2019: Q3	1.75–2.25	3.70–4.20	3.50–4.00	3.85–4.40	4.90–5.40	1.05–1.55	1.30–1.80	1.50–2.00
2019: Q4	1.75–2.25	3.70–4.20	3.40–4.00	3.75–4.35	4.80–5.40	1.00–1.60	1.25–1.85	1.40–2.00
2020: Q1	1.75–2.25	3.70–4.20	3.35–4.05	3.70–4.40	4.75–5.45	0.95–1.65	1.20–1.90	1.35–2.05
End of year								
2020	1.50–2.50	3.45–4.45	3.20–4.20	3.55–4.55	4.60–5.60	0.80–1.80	1.05–2.05	1.20–2.20
2021	1.00–2.00	2.95–3.95	3.10–4.10	3.40–4.40	4.60–5.60	0.65–1.65	1.05–2.05	1.20–2.20
2022	1.00–2.00	2.95–3.95	2.95–3.95	3.20–4.20	4.50–5.50	0.50–1.50	0.90–1.90	1.15–2.15

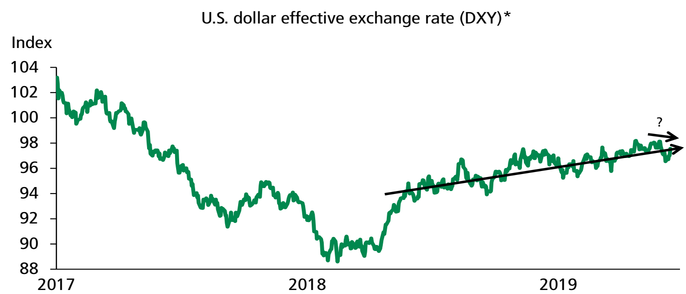
[1] Non-redeemable (annual); NOTE: Forecasts are expressed as ranges.
Source: Desjardins, Economic Studies

Exchange Rate

Has the Rise in the U.S. Dollar Come to an End?

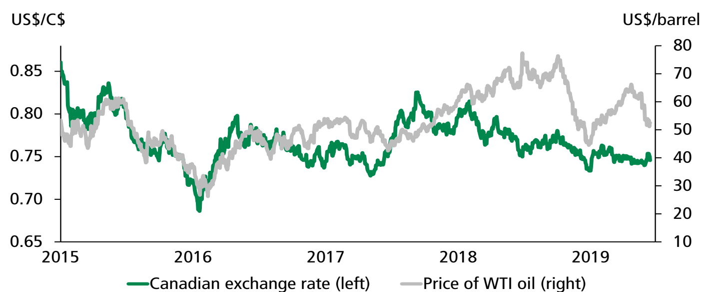
- The U.S. dollar trended up for a little more than a year against most of the major currencies. However, it took a new tack in June against the backdrop of anticipated lower interest rates in the United States and an increased appetite for risk on the financial markets (graph 4). The Mexican peso is one of the currencies that appreciated the most against the greenback recently as the threat of new tariffs was avoided.
- The Canadian dollar moved closer to US$0.75. Major swings in oil prices had little impact on the Canadian exchange rate (graph 5). It mostly benefited from a weaker U.S. dollar and more favourable interest rate spreads.
- The euro climbed to more than US$1.13 in June. Even though the euro zone economy still seems fragile, the common currency benefited from the depreciation of the U.S. dollar. The possibility of lower interest rates also seems greater in the United States as European monetary policy is already very accommodating. Across the Channel, the pound sterling is tending to stabilize after a major correction recorded in May due to the increasing uncertainty concerning Brexit.
- **Forecasts:** Potential interest rate cuts in the United States could add downward pressure on the U.S. dollar, especially if the degree of risk aversion tends to decrease with rate cuts. The Canadian dollar could appreciate slightly, predominantly if the economic figures remain encouraging in Canada and the central bank refrains from accompanying the Federal Reserve with its interest rate cuts.

GRAPH 4
An upward trend had been detected since April 2018



* Based on a basket of currencies that includes the Canadian dollar, euro, pound, yen, Swiss franc and Swedish krona.
Sources: Datastream and Desjardins, Economic Studies

GRAPH 5
At around US$0.75, the loonie now has little to do with the price of oil



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

Determinants	Short-term	Long-term
Risk aversion	↘	↗
Commodity prices	→	↗
Interest rate spreads	↗	→

TABLE 2
Forecasts: Currency

	2018		2019				2020			
END OF PERIOD	Q3	Q4	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0.7748	0.7333	0.7493	0.7550	0.7650	0.7600	0.7650	0.7600	0.7600	0.7550
CAN$/US$	1.2906	1.3638	1.3346	1.3245	1.3072	1.3158	1.3072	1.3158	1.3158	1.3245
CAN$/€	1.4990	1.5590	1.4986	1.4967	1.4902	1.5000	1.5033	1.5263	1.5395	1.5497
US$/€	1.1615	1.1431	1.1228	1.1300	1.1400	1.1400	1.1500	1.1600	1.1700	1.1700
US$/£	1.3041	1.2736	1.3031	1.2700	1.2800	1.3000	1.3300	1.3400	1.3600	1.3700

f: forecasts
Sources: Datastream and Desjardins, Economic Studies

Asset Classes Return

Fears of a Trade War Spur Bonds

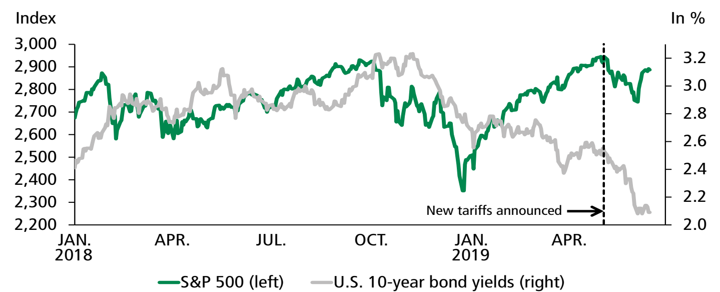
- **Trade tensions are back in full force.** The abrupt end to the trade truce in early May has revived concerns about the global economy and brought back significant volatility on the financial markets. After a remarkable rebound, stock markets slumped while the drop in bond yields accelerated (graph 6). Investor concerns peaked in early June when President Donald Trump threatened to impose tariffs on all imports from Mexico. However, a last-minute deal between the Mexican and U.S. leaders to improve border security helped avoid opening a new front in the trade wars.

- **Investors are counting on significant help from the Federal Reserve (Fed).** Thus far the stock market decline since the return of substantial trade tensions has been fairly contained, especially in North America. This seems to mostly reflect the fact that investors are betting more and more on central banks stepping in to offset the negative impact of the trade tensions. It is worth remembering that a major change in the Fed's tone at the beginning of the year boosted the stock market rebound after a difficult 2018. Now, the market is positioned for a number of drops in U.S. key rates between now and the end of 2019 (graph 7).

- **The bond market is benefiting from the situation.** The increased demand for safe-haven assets and the expectation of an imminent decrease in key rates have caused bond yields to plummet in North America. The spread between the 10-year and 3-month rates is once again firmly negative on both sides of the border (graph 8). Still, this does not seem to reflect real expectations of a recession, since the reaction of credit spreads, like the one of stock market indexes, has been restrained. Under these circumstances, Canadian bond indexes have done very well, and an attractive 5% gain is now foreseeable for all of 2019.

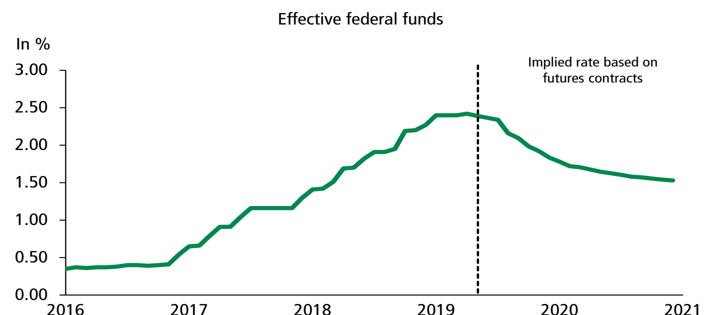
- **Commodities hit by the uncertainty.** Commodity prices declined significantly in recent weeks, and the price of WTI (West Texas Intermediate) oil approached US$50 per barrel (graph 9 on page 5). This seems to primarily reflect growing concerns about the Chinese economy, from which the demand is still key for industrial commodities. A rise in oil inventories in the United States also contributed to the drop in the price of crude.

GRAPH 6
Trade tensions caused stock markets and bond yields to fall



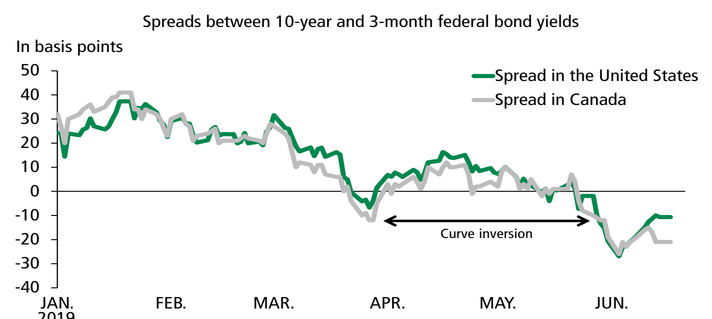
Sources: Datastream and Desjardins, Economic Studies

GRAPH 7
The markets are anticipating a rapid, substantial drop in U.S. key rates



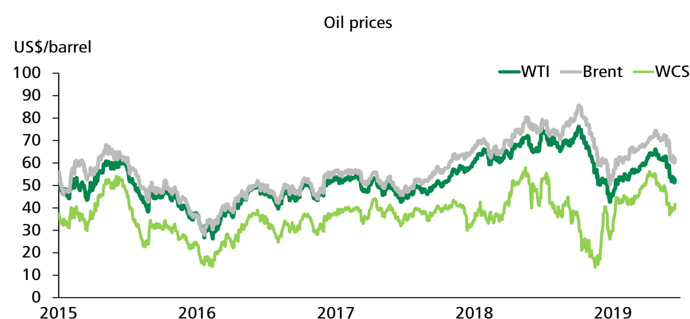
Sources: Datastream, Bloomberg and Desjardins, Economic Studies

GRAPH 8
The yield curve inverted once again



Sources: Datastream and Desjardins, Economic Studies

GRAPH 9
Oil prices move lower again



WTI: West Texas Intermediate; WCS: Western Canadian Select
Sources: Datastream, Bloomberg and Desjardins, Economic Studies

- **Market volatility could prevail in the coming months.** North American stock markets are continuing to perform remarkably well, with returns of approximately 15% since the beginning of 2019. Still, two major risks require close monitoring. First, President Donald Trump is threatening to announce a new round of tariffs against China if the G20 meeting at the end of June is deemed to be unsatisfactory. Second, investors counting on multiple drops in key rates could be disappointed. Some U.S. key rate cuts is now the most likely scenario, but it remains to be seen whether this will satisfy investors. As a result, the next few months could prove to be rough ones for stock markets. Nonetheless, the stock markets could then trend upwards again, taking advantage of decent economic growth and an environment of very low interest rates.
- **Our targets remain mostly unchanged.** Recent events increased the risks for the global economy somewhat, but the additional drop in interest rates will help support growth in the coming quarters. Under these circumstances, we continue to believe that North American stock markets could still advance a little by the end of the year. Everything points to bond yields remaining very low, and we have revised our target for Canadian bonds up slightly.

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]
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
2017	0.7	2.5	9.1	21.8	25.6	-6.4
2018	1.4	1.4	-8.9	-4.4	-13.4	8.4
2019f	target: 1.65	target: 5.0	target: 19.0	target: 21.5	target: 16.0	target: -3.5 (US$0.76)
range	1.55 to 1.75	3.0 to 7.0	8.0 to 26.0	10.0 to 28.0	5.0 to 23.0	-7.1 to 1.8

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