RETAIL RATE FORECASTS

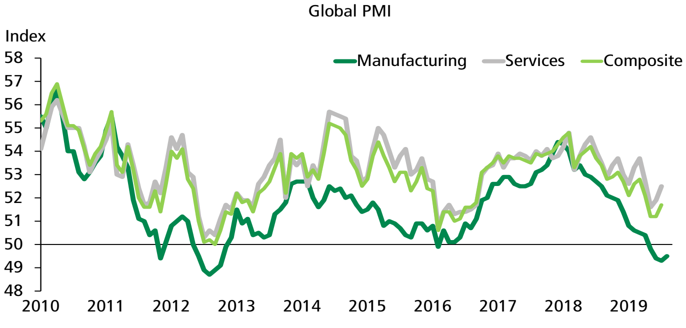
International Uncertainty Pushed Interest Rates Even Lower

HIGHLIGHTS

- The trade war between the United States and China is sapping global growth.
- Major central banks worldwide are in easing mode, while the Bank of Canada is staying put.
- Currencies remain highly sensitive to changes in the risks to the economy.
- Investors are benefiting from the drop in interest rates.

- **Trade disputes are sapping global growth.** The concrete consequences of the trade disputes could very well be materializing. Countries exporting goods seem to be the most affected, with China, Germany and several emerging countries leading the way. On a global scale, the manufacturing sector has been hit the hardest as shown by the plunge in the manufacturing PMI (graph 1). This is also true in the United States, where the manufacturing ISM fell below the key 50 mark in August. With new tariffs due to come into effect in October and December, it is becoming increasingly difficult to envision a rebound in the short term.

GRAPH 1
The drop in the global PMI remains confined to the manufacturing sector



Sources: Datastream and Desjardins, Economic Studies

- **Major central banks are ready to ease their monetary policies.** After the Federal Reserve (Fed) reduced its key rate 25 basis points in July, followed by a second cut in September, the European Central Bank (ECB) followed suit and lowered the deposit interest rate by 10 basis points on September 12, taking this rate to -50 basis points. The ECB also announced it would be relaunching its asset-buying program at a pace of €20B per month. Not only the ECB and the Fed, but other central banks worldwide are willing to support the economy through additional rate cuts.
- **The Canadian economy is holding up and low rates could revive the housing sector.** Economic growth in the second quarter was strong at 3.7% (quarterly annualized), as exports rebounded considerably (graph 2 on page 2). However, domestic demand slipped back into negative territory. After two quarters of weak growth (0.3% and 0.5% respectively), the most recent figure could be interpreted as an appreciable rebound. The problems plaguing the oil and gas extraction industry now seem to be behind us and the housing sector is once again trending up with residential investment on the rise (+5.5 %).
- **The Bank of Canada (BoC) is staying put for now.** The BoC kept its key rate unchanged at its meeting on September 4 despite the rate cuts by other central banks around the world. However, the BoC has not closed the door on possible rate reductions, citing, in particular, the developments on the international scene as a risk to the

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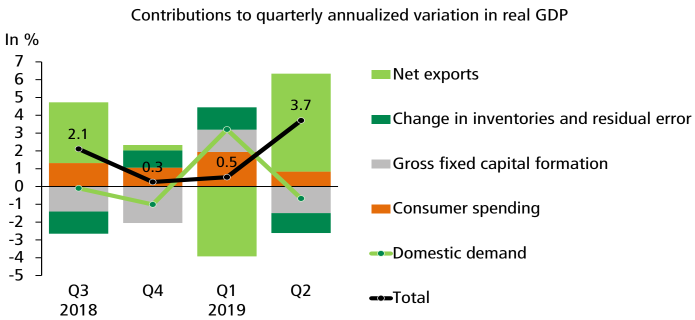
GRAPH 2
The rebound in growth is due, in large part, to exports



Sources: Statistics Canada and Desjardins, Economic Studies

Canadian outlook. If the BoC refuses to follow the easing trend, it is because the outlook for Canada remains positive, with a strong labour market and wages rising once again. The BoC is also concerned about the level of debt, which could be driven higher by the rebound in the real estate market.

- **Global bond yields bounce back from the doldrums.** The deteriorating economic outlook, the changing tone of the central banks, and the trade dispute between China and the United States have caused bond yields to plummet around the world. The rates on long-term bonds in many European countries plunged into negative territory to the extent that some banks have even started to offer negative mortgage rates to consumers. Yet rates rebounded in the first half of September, especially in Canada, where expectations of a drop in key rates is lower. Canadian financial institutions, which have not had the time to fully adjust their posted retail rates in light of the major reductions in bond yield, could do so in the coming months.

TABLE 1
Forecasts: Retail rate

	DISCOUNT RATE	PRIME RATE	MORTGAGE RATE			TERM SAVINGS[1]		
IN %			1 year	3 years	5 years	1 year	3 years	5 years
Realized (end of month)								
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 2019	2.00	3.95	3.79	4.34	5.19	1.40	1.60	2.00
July 2019	2.00	3.95	3.79	4.34	5.19	1.40	1.60	2.00
August 2019	2.00	3.95	3.69	4.34	5.19	1.40	1.60	2.00
Sept. 18, 2019	2.00	3.95	3.69	4.34	5.19	1.40	1.60	2.00
Forecasts								
End of quarter								
2019: Q3	2,00	3,95	3.50–3.80	4.15–4.45	5.00–5.30	1.20–1.50	1.40–1.70	1.80–2.20
2019: Q4	1.75–2.25	3.70–4.20	3.45–3.95	4.00–4.55	4.90–5.40	1.15–1.65	1.35–1.85	1.75–2.25
2020: Q1	1.50–2.25	3.45–4.20	3.15–4.00	3.65–4.50	4.60–5.45	0.85–1.70	1.05–1.90	1.40–2.25
2020: Q2	1.50–2.25	3.45–4.20	3.10–4.05	3.55–4.50	4.55–5.50	0.80–1.75	1.00–1.95	1.35–2.30
End of year								
2020	1.25–2.50	3.20–4.45	2.95–4.20	3.35–4.60	4.35–5.60	0.65–1.90	0.85–2.10	1.15–2.40
2021	0.75–2.25	2.70–4.20	2.65–4.15	3.05–4.55	4.10–5.60	0.30–1.80	0.60–2.10	0.80–2.30
2022	0.75–2.25	2.70–4.20	2.60–4.10	2.80–4.30	4.05–5.55	0.25–1.75	0.55–2.05	0.75–2.25

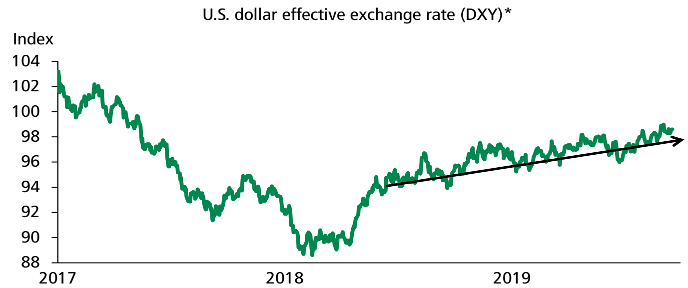
[1] Non-redeemable (annual); NOTE: Forecasts are expressed as ranges.
Source: Desjardins, Economic Studies

Exchange Rate

Currencies Remain Highly Sensitive to Changes in Risks to the Economy

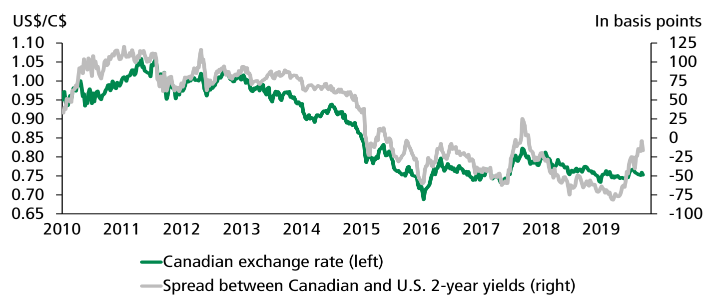
- The U.S. dollar depreciated somewhat since the end of August, but it's still following the upward trend that began last year (graph 3). The cut to key rates in the United States doesn't seem to have seriously hurt the greenback as other central banks have also introduced easing measures or are thinking of doing so. Additionally, the U.S. dollar tends to be preferred in times of economic uncertainty like now. Lastly, the appreciation of the greenback is consistent with the escalation in protectionist measures as predicted according to economic theory.
- All the same, the Canadian dollar is holding its own fairly well against the strength of the U.S. currency. The exchange rate recently rose to nearly US$0.76. However, the loonie could be worth a lot more right now based on its historical relationship with the spread in interest rates between Canada and the United States (graph 4). Therefore, the loonie has benefited little from the lowered expectations of a drop in Canadian key rates. Its relationship with commodity prices also suggests that it could be a little higher. The uncertainty surrounding the global economy seems, therefore, to be severely penalizing the Canadian currency by preventing it from appreciating more. Still, it has risen against weaker currencies, such as the euro.
- **Forecasts:** Our scenario is based on a certain amount of uncertainty continuing until the end of the year and possibly into the beginning of next year. This should continue to help the U.S. dollar against most other currencies. We forecast a slight depreciation in the loonie within the same period, which would bring it back down to near US$0.75. This presumes limited improvement in interest rate spreads and that commodity prices will increase little. More mixed data on the Canadian economy could clip the loonie's wings somewhat in the short term.

GRAPH 3
The U.S. dollar is still trending up



* 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 4
The recent narrowing of interest rate spreads could have helped the Canadian dollar more



Sources: Datastream and Desjardins, Economic Studies

Impacts on the Canadian dollar	Short-term	Long-term
Risk aversion	→	↗
Commodity prices	→	↘
Interest rate spreads	↗	→

TABLE 2
Forecasts: Currency

	2018		2019				2020			
END OF PERIOD	Q3	Q4	Q1	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0.7748	0.7333	0.7493	0.7638	0.7550	0.7500	0.7500	0.7600	0.7700	0.7600
CAN$/US$	1.2906	1.3638	1.3346	1.3092	1.3245	1.3333	1.3333	1.3158	1.2987	1.3158
CAN$/€	1.4990	1.5590	1.4986	1.4909	1.4570	1.4533	1.4400	1.4342	1.4286	1.4342
US$/€	1.1615	1.1431	1.1228	1.1388	1.1000	1.0900	1.0800	1.0900	1.1000	1.0900
US$/£	1.3041	1.2736	1.3031	1.2727	1.2500	1.2400	1.2300	1.2400	1.2600	1.2500

f: forecasts
Sources: Datastream and Desjardins, Economic Studies

Asset Classes Return

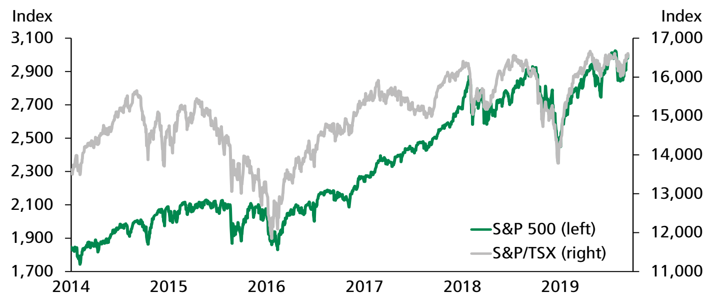
Investors Are Benefiting from the Drop in Interest Rates

- **A volatile summer on financial markets.** After a spring marked by increased trade tensions between China and the United States, a certain optimism returned to the financial markets in July as the trade negotiations restarted between the two superpowers. This helped North American stock markets set new highs (graph 5). All the same, the Federal Reserve (Fed) lowered its key rates on July 31 for the first time in ten years. President Donald Trump's announcement of new tariffs on Chinese exports caused significant volatility to return to the markets in early August. New fears of a global recession then caused long-term bond yields to plummet (graph 6) to the point that 10-year U.S. bond yields temporarily dipped below the 2-year yield for the first time since the crisis of 2008. Still, new signs of easing in the tensions between China and the United States saw a more positive sentiment return to the markets recently.

- **Investment portfolio performance remains extremely positive.** The bond markets benefited hugely from the drop in bond yields in recent months. As a result, at the end of August, the FTSE Canada Universe Bond index was posting a spectacular gain of almost 9% since the beginning of 2019. Despite the uncertainties, the North American stock markets have consolidated their major gains from the start of the year and are hovering near their historical highs. Only overseas stock markets performed less well recently, undermined by the economic challenges that are more evident elsewhere in the world and by the strength of the U.S. dollar. Still, the MSCI EAFE index is posting a return of more than 10% compared with the end of last year. In spite of the uncertainties and recession fears, 2019 has thus been highly profitable until now for Canadian investors.

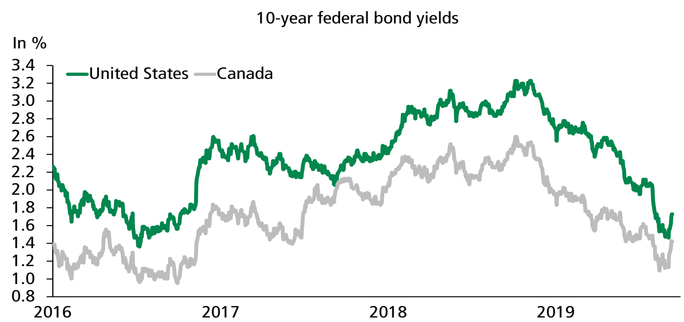
- **Corporate profit growth seems to be slowing.** The solid performance of the North American stock markets in recent years was based on the strong earnings growth of the companies listed on them. After the spectacular surge last year, helped along by U.S. tax reform, earnings of the companies that make up the S&P 500 are heading for a gain of about 10% in 2019. Nonetheless, the feeling is that the trade tensions and moderating global economic growth are starting to weigh on the outlook. Several companies have warned that their operations could be negatively impacted by the tariffs, and analyst expectations regarding future profits now seem to have plateaued (graph 7). However, in a world of extremely low interest rates, where corporate dividends surpass a number of bond yields, the stock markets could still attract investors, even when faced with modest earnings growth.

GRAPH 5
Despite the uncertainty, North American stock markets consolidate their gains



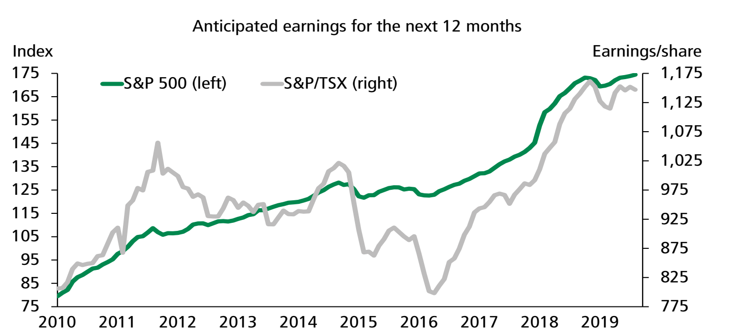
Sources: Datastream and Desjardins, Economic Studies

GRAPH 6
The drop in bond yields continued until just recently



Sources: Datastream and Desjardins, Economic Studies

GRAPH 7
Earnings expectations now seem to be plateauing

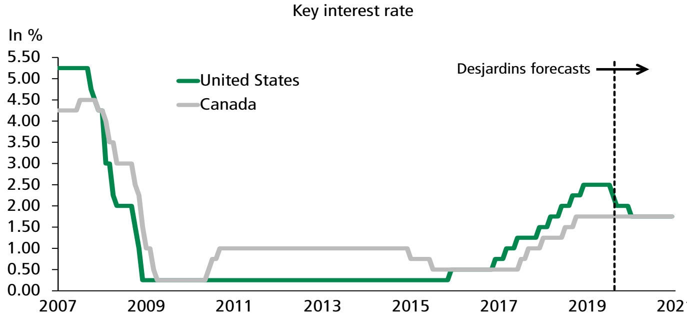


Sources: S&P Dow Jones Indices, Datastream and Desjardins, Economic Studies

- **The bond market is not risk-free.** Many are wondering if the recent drop in long-term bond yields isn't excessive in light of the latest economic growth and inflation figures, which remain relatively solid in North America. A significant upswing in bond yields has already happened since the start of September, especially in Canada, where the Bank of Canada doesn't appear to be heading toward monetary easing (graph 8). While interest income on bonds purchased today will be limited, the bond market's performance will depend largely on changes in the economic situation and the impact on interest rates. The negative interest rate environment that seems likely to last for a while in Europe and Japan is, nonetheless, limiting the risk of a sharp increase in North American bond yields.

- **The next few quarters should see more modest returns.** As our economic scenarios don't anticipate that bond yields will continue to fall, the bond market performance should be much more limited. Nevertheless, this asset class offers some protection against another major deterioration of the economic situation. In a world of extremely low interest rates, the stock markets could potentially record more significant gains if the return of optimism to the financial markets were to last. However, it seems more prudent to count on indexes advancing only slightly in the coming quarters as the level of international uncertainty threatens to remain relatively high and global growth could continue to moderate.

GRAPH 8
Canadian key rates are expected to remain unchanged for some time to come



Sources: Datastream and Desjardins, Economic Studies

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: 8.0	target: 20.0	target: 21.5	target: 14.0	target: -2.2 (US$0.75)
range	1.55 to 1.70	5.0 to 10.0	10.0 to 26.0	11.0 to 28.0	5.0 to 23.0	-4.8 to 0.4

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