RETAIL RATE FORECASTS

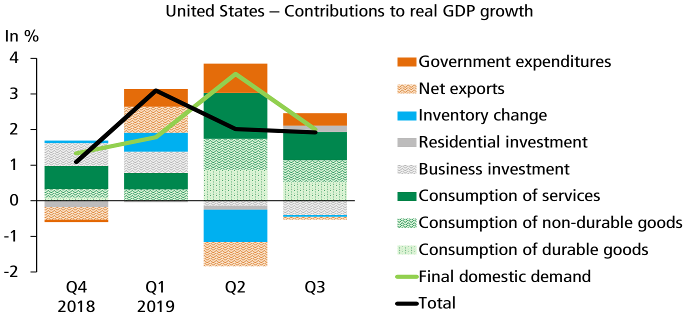
Will the Renewed Optimism Last?

HIGHLIGHTS

- Households are sustaining the U.S. economy despite the slowdown in manufacturing.
- The Federal Reserve is now in neutral after the third key rate cut.
- The Canadian dollar depreciated after October's monetary policy meeting.
- The returns on asset classes will be more limited in 2020.

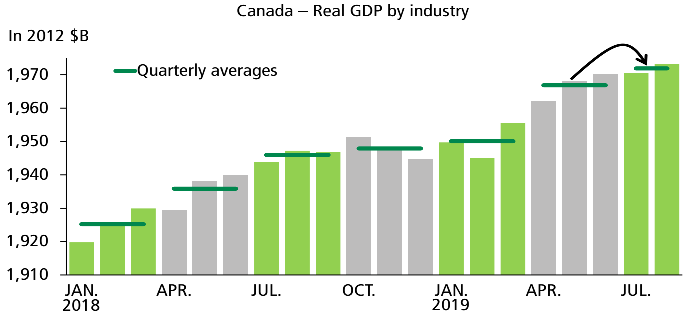
- **The U.S. economy is on track to grow despite a weak manufacturing sector.** Economic growth remained more or less stable at 1.9% annualized in the third quarter. A breakdown of the growth shows an economy operating at two speeds: weak business investment but sustained growth in consumer spending and residential investment (graph 1). The household sector's resilience is underpinned by a strong job market and lower interest rates. However, the outlook for the U.S. and global economies will depend on the developments associated with the trade dispute between China and the United States.
- **The Federal Reserve (Fed) is now in neutral after the third key rate cut.** The Fed introduced a new 25 basis-point cut in the target federal funds rate during the October 30 meeting while removing the mention that it will be ready to "act as appropriate to sustain the expansion" from its statement. The removing of this phrase was largely interpreted as a return to a more neutral position by the central bank.
- **The Canadian economy is expected to see lower growth as of the second semester of 2019.** After GDP jumped 3.7% annualized in the second quarter, the Canadian economy should slow in the third. At least, this is what the monthly figures for GDP by industry are suggesting, with two successive gains of 0.1% in July and August (graph 2). Growth should remain resilient despite everything, supported

GRAPH 1
The household sector is sustaining growth in the third quarter despite lower business investment



Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

GRAPH 2
Carryover of just 1.2% after two months for the third quarter



Sources: Statistics Canada and Desjardins, Economic Studies

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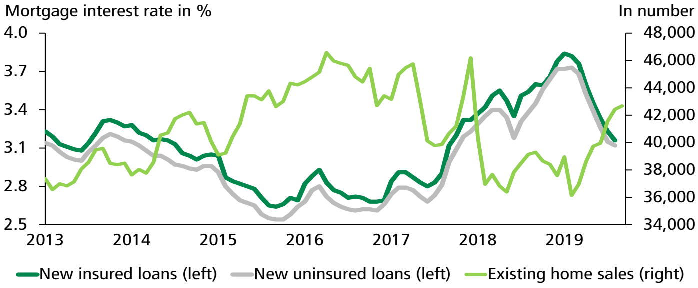
NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

GRAPH 3
The Canadian housing market recovery seems to be driven by rate cuts



Sources: Bank of Canada, Canadian Real Estate Association and Desjardins, Economic Studies

by a healthy household sector, a strong labour market, and a housing recovery following mortgage rate cuts (graph 3).

- **The key rate in Canada remains unchanged, but the Bank of Canada (BoC) will keep a very careful watch.** While the Fed opted for a 25-basis-point drop on October 30, the BoC chose instead to leave its key rate unchanged at 1.75%. This move brought back equality between the upper limit of the fed funds rate and the Canadian policy interest rate. However, the BoC adopted a gloomier outlook in its last *Monetary Policy Report*, so much so that it expects growth to be below potential for the second half of 2019. Given this situation, and facing moderate inflationary pressures, the BoC will closely monitor just how much the global slowdown spreads beyond manufacturing and investment, and will cut the key rate if needed.
- **Bond yields regain lost ground thanks to some good news.** Bond yields have fluctuated wildly since early September, reflecting market concerns about the trade dispute between China and the United States, the global economy, and the possibility of a no-deal Brexit. Yields started to move back up in October as rumours began to surface of a possible agreement between China and the United States. Good U.S. economic figures, especially employment and GDP growth, also helped reassure the markets, as did the postponement of the deadline for the United Kingdom to leave the European Union to January 31, 2020. This should help sustain bond and retail yields near their current levels in the coming months.

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)								
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
September 2019	2.00	3.95	3.69	4.34	5.19	1.40	1.60	2.00
October 2019	2.00	3.95	3.69	4.34	5.19	1.40	1.60	2.00
November 6, 2019	2.00	3.95	3.69	4.34	5.19	1.40	1.60	2.00
Forecasts								
End of quarter								
2019: Q4	1.75–2.00	3.70–3.95	3.45–3.85	4.10–4.50	4.95–5.35	1.15–1.55	1.35–1.75	1.75–2.25
2020: Q1	1.50–2.25	3.45–4.20	3.35–3.95	4.00–4.60	4.85–5.45	1.05–1.65	1.25–1.85	1.65–2.25
2020: Q2	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	1.45–2.30
2020: Q3	1.50–2.25	3.45–4.20	3.10–4.05	3.60–4.55	4.55–5.50	0.80–1.75	1.00–1.95	1.40–2.35
End of year								
2020	1.25–2.50	3.20–4.45	2.95–4.20	3.45–4.70	4.40–5.65	0.65–1.90	0.85–2.10	1.25–2.50
2021	0.75–2.25	2.70–4.20	2.85–4.35	3.10–4.60	4.25–5.75	0.50–2.00	0.75–2.25	1.05–2.55
2022	0.75–2.25	2.70–4.20	2.70–4.20	2.95–4.45	4.15–5.65	0.35–1.85	0.70–2.20	0.95–2.45

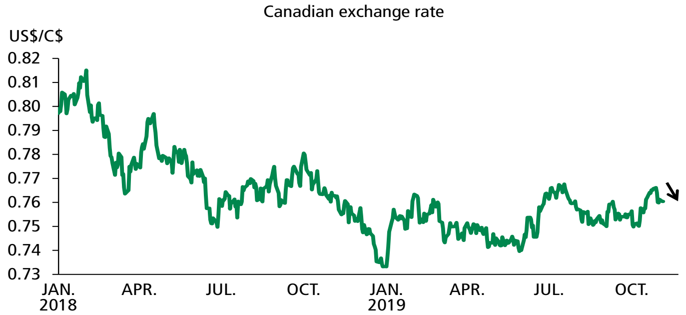
[1] Non-redeemable (annual); NOTE: Forecasts are expressed as ranges.
Source: Desjardins, Economic Studies

Exchange Rate

The Loonie Depreciated after October's Monetary Policy Meeting

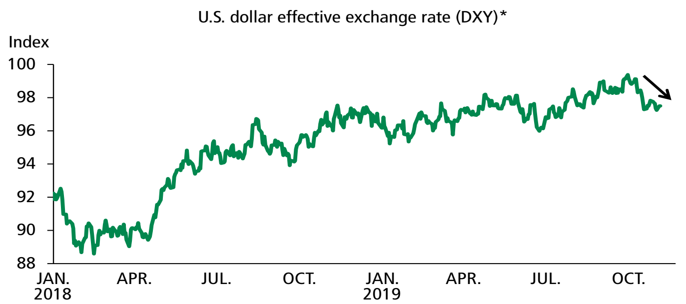
- The Canadian dollar was performing rather well in the weeks leading up to the Bank of Canada's monetary policy meeting at the end of October. It neared the US$0.77 mark. It is currently trading around US$0.76 as investors now consider the possibility of monetary easing in Canada more likely (graph 4). The depreciation of the Canadian dollar was nonetheless held in check by the more optimistic mood on the markets, primarily as a result of the ongoing trade negotiations between China and the United States.
- Optimism's return to the markets worked in favour of several currencies against the U.S. dollar. One sign that the demand for safe-haven has fallen is the net decrease the U.S. dollar effective exchange rate index (DXY) posted in relation to the beginning of October (graph 5). As a result, the euro climbed to around US$1.11. After opting for even lower negative rates in September, the European Central Bank did not hint that it would order other easing measures in the coming months. Furthermore, there appears to be far less leeway available to ease monetary policy in the euro zone compared to the situation in the United States.
- **Forecasts:** A renewed wave of concern, especially regarding the trade tensions between China and the United States, could hurt several currencies in the short term. It seems best to tread cautiously when it comes to this issue. Despite several new developments and encouraging signals during the year, tariffs has been escalating. Under these circumstances, the loonie could drop to almost US$0.75 by the end of the year. That would be similar to the level seen in August and September, when widespread concern had grown on the markets.

GRAPH 4
The loonie has returned to around US$0.76 after October's monetary policy meeting



Sources: Datastream and Desjardins, Economic Studies

GRAPH 5
The greenback depreciated as optimism returned to the markets



* 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

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	Q3	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0.7748	0.7333	0.7493	0.7638	0.7552	0.7500	0.7500	0.7600	0.7700	0.7600
CAN$/US$	1.2906	1.3638	1.3346	1.3092	1.3241	1.3333	1.3333	1.3158	1.2987	1.3158
CAN$/€	1.4990	1.5590	1.4986	1.4909	1.4435	1.4533	1.4400	1.4342	1.4286	1.4342
US$/€	1.1615	1.1431	1.1228	1.1388	1.0902	1.0900	1.0800	1.0900	1.1000	1.0900
US$/£	1.3041	1.2736	1.3031	1.2727	1.2323	1.2600	1.2400	1.2500	1.2700	1.2500

f: forecasts
Sources: Datastream and Desjardins, Economic Studies

Asset Classes Return

After a Remarkable Year, Returns Will Be More Limited in 2020

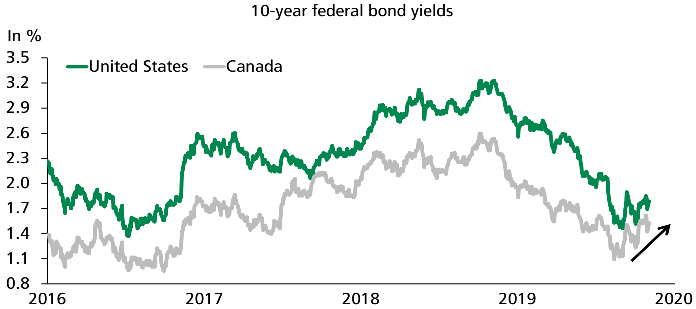
- **There is renewed optimism on the markets as uncertainty recedes.** After a late summer marked by a burst of uncertainty in response to new trade hostilities between China and the United States, a more positive sentiment has taken hold of the stock markets in recent months. Monetary easing by several central banks and another postponement of the Brexit deadline, to January 31, 2020, have helped reassure investors. Still, the most important factor behind the renewed optimism is the resumption of trade negotiations between the two superpowers. At the time of writing, China and the United States appear to be on the verge of concluding the first phase of an agreement that could help avoid a new hike in trade tariffs. Even if the recent progress is encouraging, uncertainty threatens to return as more difficult issues remain to be resolved concerning Brexit and China-U.S. trade relations.

- **Bond yields edge up.** Less uncertainty internationally has resulted in bond yields rising, including in North America (graph 6). The Federal Reserve (Fed) has made a 25-basis-point cut of its key rates three times in a row since July in addition to increasing the size of its balance sheet to ensure the smooth operation of the money market.[1] The Fed now believes the monetary policy is appropriate and that other changes won't be necessary unless the economic outlook deteriorates significantly. This more neutral position is also helping drive bond yields up, as many investors were still, until recently, positioned for a long period of monetary easing. The Canadian economy's resilience, especially the labour market's remarkable performance (graph 7), also caused expectations about possible monetary easing in Canada to fall dramatically. Even if everything points to it maintaining the status quo, the Bank of Canada recently noted, however, that the Canadian economy's resilience in the face of a deteriorating international situation had its limits.

- **U.S. stock markets go from high to high.** Worrisome economic data caused the markets to pull back between late September and early October. Nonetheless, more reassuring statistics and less uncertainty internationally allowed stock markets to rebound strongly in recent weeks. As U.S. corporate earnings released to date for the third quarter are generally positive, U.S. stock markets performed particularly well, and the S&P 500, Dow Jones and NASDAQ all set new records recently. The Canadian stock market saw a more marked drop at the end of September, followed by a

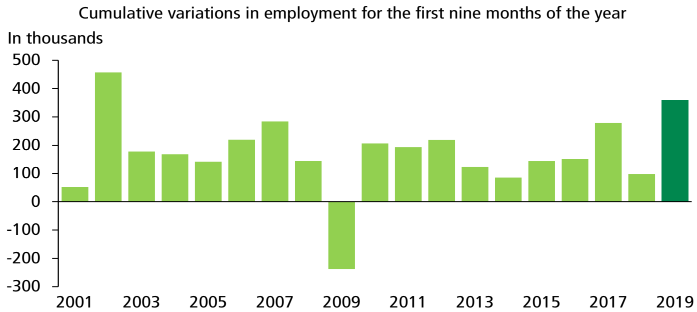
[1] *Is the Federal Reserve's Balance Sheet Increase Quantitative Easing?*, Desjardins, Economic Studies, Economic Viewpoint, October 23, 2019, 3 p.

GRAPH 6
Bond yields edge up a little



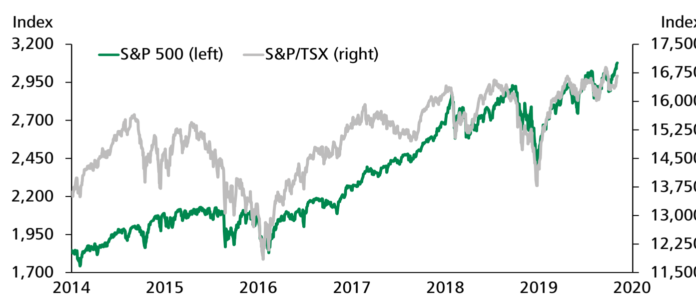
Sources: Datastream and Desjardins, Economic Studies

GRAPH 7
The Canadian labour market has been very strong since the beginning of 2019



Sources: Statistics Canada and Desjardins, Economic Studies

GRAPH 8
North American stock market trends remain favourable



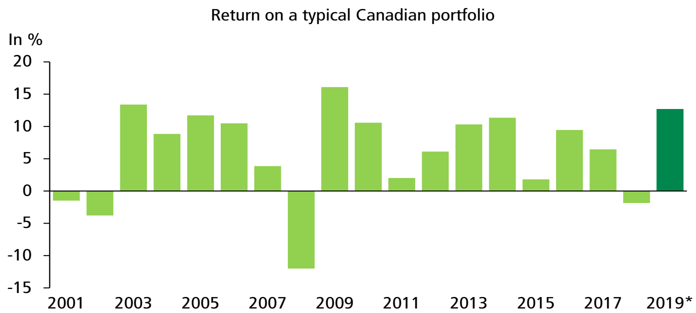
Sources: Datastream and Desjardins, Economic Studies

less dramatic rebound, yet the S&P/TSX has posted a gain of over 15% since the beginning of 2019 (graph 8 on page 4).

- **Asset classes performed remarkably in 2019.** Unless the end of the year proves to be extremely difficult, everything points to 2019 being a stellar year for Canadian investors. After ten months, a typical portfolio (35% Canadian equities, 15% U.S. equities, 45% Canadian bonds and 5% 3-month Treasury bills) was posting returns of nearly 13%, which would make 2019 the best year since 2009 (graph 9). The sharp drop in bond yields and the stock market rebound, on the heels of a major decline in the last few months of 2018, explain this outstanding performance.

- **More limited returns are expected next year.** The fact that the North American stock market indexes should end 2019 near historic highs limits their potential gain. The climate of low interest rates and sustained high profits could still help them record some gains. Still, index volatility threatens to remain high, as recession fears or a trade war could move to the forefront once again. The process of impeaching President Donald Trump and, most notably, the presidential elections in November 2020, also threaten to cause markets to fluctuate. The return on fixed-income securities should also be much more limited, with our scenarios counting on bond yields to rise slightly.

GRAPH 9
So far, 2019 has been highly profitable for investors



* Cumulative for the first ten months of the year.
Sources: Statistics Canada 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: 18.0	target: 22.5	target: 16.5	target: -2.2 (US$0.75)
range	1.60 to 1.70	6.0 to 10.0	12.0 to 26.0	15.0 to 30.0	10.0 to 24.0	-4.8 to -0.9
2020f	target: 1.65	target: 1.5	target: 7.5	target: 7.0	target: 7.5	target: -1.3 (US$0.76)
range	1.30 to 1.80	-1.0 to 5.0	2.0 to 16.0	2.0 to 15.0	2.0 to 14.0	-5.1 to 2.7

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