RETAIL RATE FORECASTS

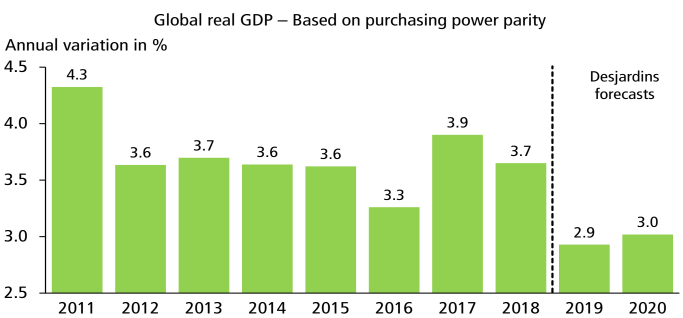
New Downside Pressures on Bond Yields

HIGHLIGHTS

- The coronavirus epidemic is feeding worries over the global economy.
- The Bank of Canada shows prudence regarding the recent slowdown in growth.
- The possibility of a key rate cut hurts the Canadian dollar.
- The coronavirus fans volatility in financial markets.

- **The coronavirus epidemic is feeding worries over the global economy.** Just when the outlook for the global economy had substantially improved with the signing of the first phase of the trade agreement between China and the United States, the worries seem to have come back strong with the appearance of a deadly, highly contagious form of the coronavirus in China. Draconian measures have been introduced to keep the disease from spreading, but these measures could have a substantial impact on China's economic growth. While the economic effects seem to be limited to continental China for now, more widespread contagion could cause problems worldwide, especially against the backdrop of a synchronized moderation in growth (graph 1).

GRAPH 1
Global economic growth slows



Sources: World Bank, Consensus Forecasts and Desjardins, Economic Studies

- **The message from the Federal Reserve (Fed) is essentially unchanged.** The Fed statement released for the January 29, 2020 meeting featured only minor tweaks from the previous document. Obviously, the Fed kept its key rate steady and, as expected, maintained the securities purchases intended to stabilize the money market. Even though the tone did not change, markets' expectations of rate cuts have increased in the last few days in tandem with the worries about the coronavirus. At the press conference, Fed Chair Jerome Powell noted that they were keeping a close eye on the situation, but stated that it was too early to know its effects.

- **Canada's economy posted soft growth in the fourth quarter, but the problems should be temporary.** Real GDP by industry ticked up 0.1% in Canada in November after dipping 0.1% in October, suggesting that growth for the fourth quarter of 2019 will be anemic. Some temporary factors, including strikes at Canadian National (CN) and at General Motors' (GM) U.S. plants, suggest that the weaker output growth is just a blip and that we can expect a rebound in early 2020 (graph 2 on page 2).

- **The Bank of Canada (BoC) shows prudence regarding the recent slowdown in growth.** The BoC maintained the status quo on its key rate at its January 22 meeting, releasing a statement that displayed concern over the Canadian economy's projected growth. While the BoC acknowledges the role of one-off factors in the slowing growth seen in recent months, it does not however rule out

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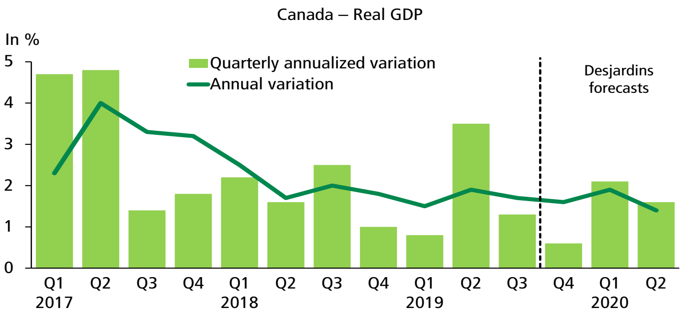
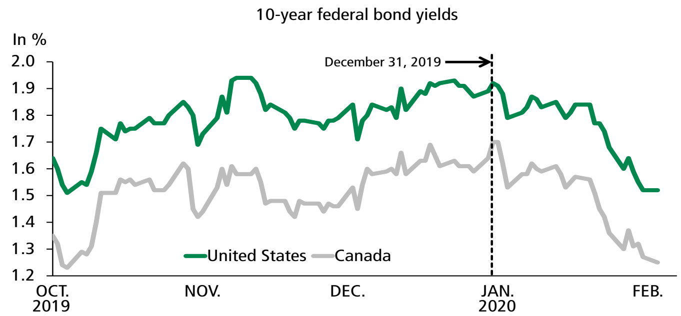
GRAPH 2
Canada's economy will slow temporarily in the fourth quarter



Sources: Statistics Canada and Desjardins, Economic Studies

GRAPH 3
Bond yields begin the year on a slide



Sources: Datastream and Desjardins, Economic Studies

the possibility that it may also be linked to a more global trend toward a moderating economic growth. The BoC's statement stresses that the key rate's trajectory will be highly dependent on the magnitude and persistence of the slowdown being observed.

- **North American bond yields begin the year on a slide.** After rising until the end of 2019, yields on Canadian and U.S. government bonds started 2020 on a slide (graph 3), with economic data remaining mixed and the worries over the coronavirus's appearance starting to grow. In Canada, the BoC's cautious message also helped pull yields down on shorter maturities, signalling that markets are now expecting key rate cuts soon. For now, it is hard to say whether the tumble in bond yields will persist and pass through to the retail market, given that it is primarily associated with highly uncertain factors.

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)								
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 2019	2.00	3.95	3.69	4.34	5.19	1.40	1.60	2.00
December 2019	2.00	3.95	3.69	4.34	5.19	1.40	1.60	2.00
January 2020	2.00	3.95	3.69	4.34	5.19	1.40	1.60	2.00
February 5, 2020	2.00	3.95	3.69	4.34	5.19	1.40	1.60	2.00
Forecasts								
End of quarter								
2020: Q1	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: Q2	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: Q3	1.50–2.25	3.45–4.20	3.15–4.00	3.80–4.65	4.65–5.50	0.85–1.70	1.05–1.90	1.45–2.30
2020: Q4	1.50–2.50	3.45–4.45	3.10–4.20	3.75–4.85	4.60–5.70	0.80–1.90	1.00–2.10	1.40–2.50
End of year								
2021	0.75–2.25	2.70–4.20	2.95–4.45	3.20–4.70	4.25–5.75	0.50–2.00	0.80–2.30	0.95–2.45
2022	0.75–2.25	2.70–4.20	2.75–4.25	2.95–4.45	4.25–5.75	0.40–1.90	0.70–2.20	0.95–2.45
2023	1.00–2.50	2.95–4.45	2.95–4.45	3.20–4.70	4.45–5.95	0.40–1.90	0.85–2.35	1.05–2.55

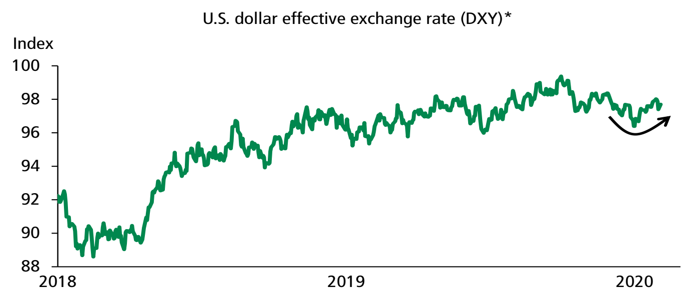
[1] Non-redeemable (annual); NOTE: Forecasts are represented using an asymmetric range reflecting the perceived probability of deviation from the base scenario. The mean of the range does not represent the forecast associated with the base scenario.
Source: Desjardins, Economic Studies

Exchange Rate

The Possibility of a Key Rate Cut Hurts the Canadian Dollar

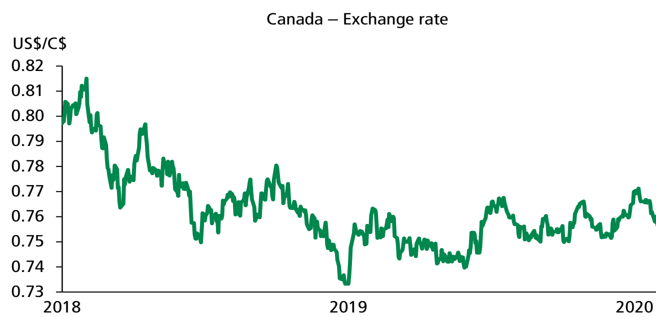
- The U.S. dollar strengthened a little in January, despite the reduction in trade tensions between China and the United States. New risks have emerged, buoying the U.S. dollar (graph 4). These include a potential trade war, this time involving Europe, and the possibility that the coronavirus will aggravate the global economy's slowdown.
- The upswing in the U.S. dollar's popularity is impacting the Canadian dollar's value; it is currently around US$0.75 (graph 5). For the loonie, this represents a monthly decline of about 2%, which may be due to the weakness in prices for several commodities and the Bank of Canada's (BoC) openness to a potential key rate cut in the coming months. Such a cut would, however, require the Canadian economy to do more poorly than anticipated in the near term. Here, the coronavirus and its potential adverse impacts increase the likelihood of that scenario and, in turn, Canadian dollar volatility.
- The uncertainty being generated by the coronavirus is having a greater impact on the Chinese yuan. The exchange rate against the U.S. dollar has gone back over 7.00 yuan/US$. In contrast, the Swiss franc is doing better because of its safe-haven role. The pound sterling benefited from avoiding a no-deal Brexit, although the uncertainty has not completely dissipated for the United Kingdom.
- **Forecasts:** For now, our baseline scenario does not include any significant negative impacts associated with the coronavirus. The uncertainty associated with the virus could decrease in the coming weeks, which would help several currencies against the U.S. dollar. Canada's economy should be robust enough to keep the BoC from lowering its key rates. We expect this to help the Canadian dollar climb back to around US$0.77 by the summer.

GRAPH 4
New sources of concern buoy the U.S. dollar



* 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
The loonie fell back to around US$0.75



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

	2019		2020				2021			
END OF PERIOD	Q3	Q4	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0.7552	0.7699	0.7600	0.7700	0.7700	0.7600	0.7500	0.7500	0.7550	0.7600
CAN$/US$	1.3241	1.2988	1.3158	1.2987	1.2987	1.3158	1.3333	1.3333	1.3245	1.3158
CAN$/€	1.4435	1.4579	1.4605	1.4545	1.4416	1.4474	1.4400	1.4533	1.4570	1.4605
US$/€	1.0902	1.1225	1.1100	1.1200	1.1100	1.1000	1.0800	1.0900	1.1000	1.1100
US$/£	1.2323	1.3248	1.3000	1.3000	1.2900	1.2800	1.2500	1.2600	1.2800	1.3000

f: forecasts
Sources: Datastream and Desjardins, Economic Studies

Asset Classes Return

The Coronavirus Brings Back Concern and Volatility

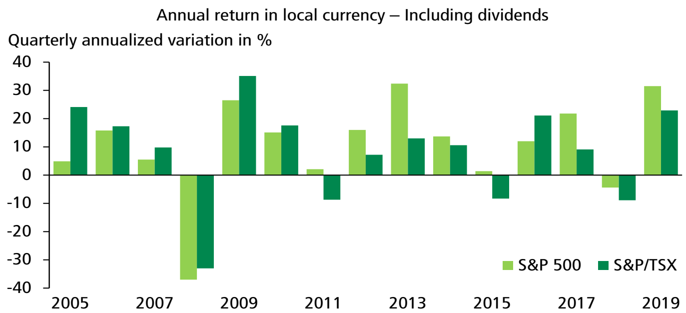
- **The stock market surge continued at the end of 2019 and in early 2020.** The hopes for a trade truce, which gave stock exchanges a boost last fall, materialized when China and the United States concluded the first phase of a trade agreement in December. The election of a Conservative majority in the United Kingdom, finally allowing Brexit to occur with a transition period at the end of January, also reassured investors, as did the rapid progress on ratifying the new trade agreement between Canada, the United States and Mexico (CUSMA). The stock markets therefore maintained their momentum to end 2019 with remarkable gains (graph 6). Despite the spike in tensions between the Iran and the United States, stock exchanges continued to advance strongly in the early weeks of 2020.

- **Uncertainties have recently come back strong.** Concerns over the new coronavirus in China fanned worries and volatility in financial markets at the end of January (graph 7), completely wiping out the big gains posted by the U.S. indexes in previous weeks. For now, it is very hard to assess the epidemic's consequences for the economy, but it clearly represents a new risk for major corporations that are exposed to Asian markets. Also, stock markets were ripe for profit-taking after the surge seen in recent months.

- **Oil had a tumultuous start to the year.** The surge in strains in the Middle East drove oil prices up at the start of January (graph 8). Given that Iran and the United States seemed to want to avoid a true military confrontation, oil prices then quickly moderated, as the global oil supply remains abundant. The pullback accelerated recently, as the coronavirus could substantially reduce China's strong demand for oil in the near term. The Organization of the Petroleum Exporting Countries (OPEC) is even contemplating further output cuts to keep the slide in oil prices from continuing. Despite the recent difficulties in commodity prices, the Canadian stock market has done a little better than the major U.S. indexes since the new year began.

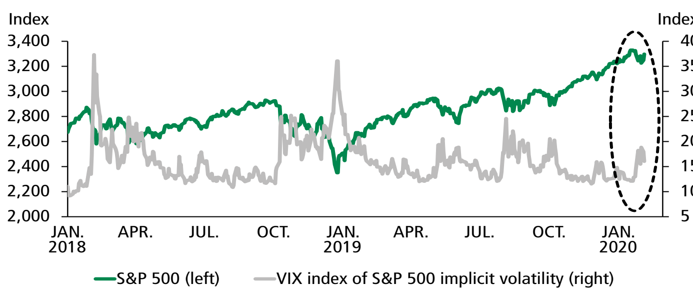
- **The bond market is benefiting from the situation.** Renewed optimism at the end of 2019 and the major central banks' adoption of a much more neutral tone did not augur anything very positive for the bond market in 2020. After shooting up last fall, North American bond yields were nonetheless edging back at the start of 2020. After that, the coronavirus triggered a sharp drop in yields (graph 3 on page 2), as investors fled to safe-haven securities and even started to bet on monetary easing in North America. This is especially true in Canada, where signs of softness in the economy in the last quarter of 2019 had already prompted

GRAPH 6
2019 was a remarkable year for North American stock markets



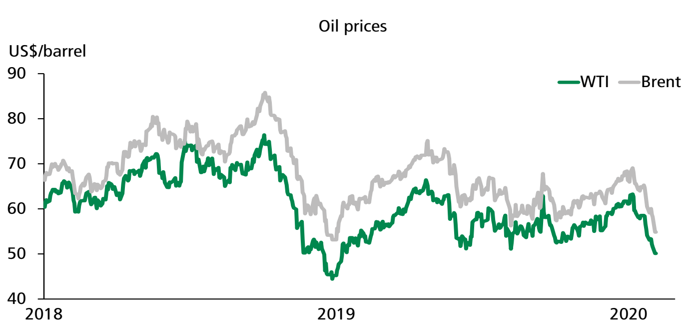
Sources: Datastream and Desjardins, Economic Studies

GRAPH 7
The coronavirus returned some anxiety to financial markets



Sources: Datastream and Desjardins, Economic Studies

GRAPH 8
Oil prices have dropped in recent days

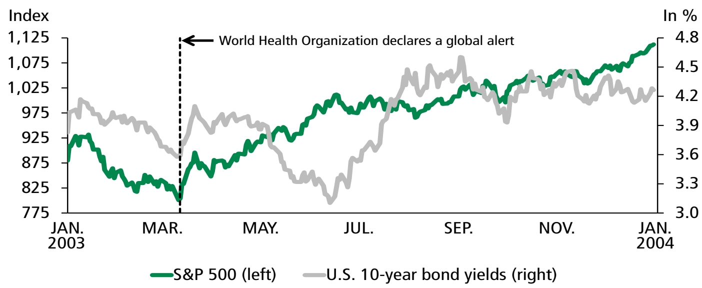


WTI: West Texas Intermediate
Sources: Datastream and Desjardins, Economic Studies

the Bank of Canada to open the door to monetary easing. A close eye must be kept on the situation but, for now, stable Canadian and U.S. key rates throughout 2020 remains the most likely scenario, in our opinion.

- **We are generally maintaining our forecasts for asset classes.** Concerns surrounding the coronavirus could remain present in the near term, and we could well see stock exchanges and bond yields go down further in the next few weeks. However, the experience in past crises, such as the SARS epidemic that contributed to a decline in stock markets in early 2003, shows that the impact of this type of event on the asset classes often does not last long (graph 9). Once the crisis is contained, the stock markets and bond yields are therefore likely to start ascending gradually, which would, by the end of 2020, take them close to the levels we were previously targeting. We are therefore still expecting relatively normal returns from the major stock exchanges this year, while the outlook remains subdued for the bond market.

GRAPH 9
The 2003 SARS epidemic had no lasting impact on financial markets



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]
2009	0.6	5.4	35.1	26.5	32.5	-13.7
2010	0.5	6.7	17.6	15.1	8.2	-5.2
2011	1.0	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	0.6	3.5	-8.3	1.4	-0.4	19.1
2016	0.5	1.7	21.1	12.0	1.5	-2.9
2017	0.6	2.5	9.1	21.8	25.6	-6.4
2018	1.4	1.4	-8.9	-4.4	-13.4	8.4
2019	1.6	6.9	22.9	31.5	22.7	-4.8
2020f	target: 1.65	target: 2.0	target: 8.0	target: 7.0	target: 5.0	target: 1.3 (US$0.76)
range	1.30 to 1.80	-1.0 to 6.0	2.0 to 16.0	1.0 to 15.0	0.0 to 10.0	-2.5 to 5.5

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