RETAIL RATE FORECASTS

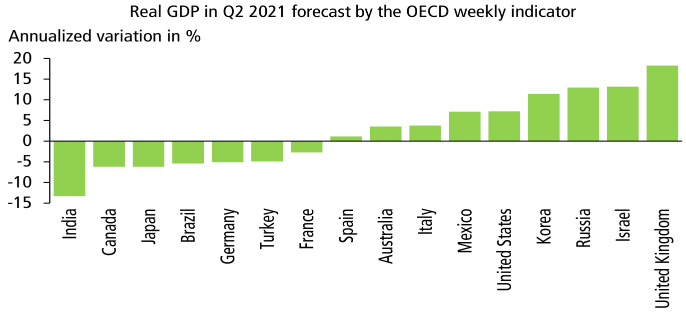
Strong Inflation Should Lead to Higher Interest Rates

HIGHLIGHTS

- U.S. inflation has reached 5%, its highest level since 2008.
- A first increase in Canadian key rates could occur in 2022.
- No overvaluation of the Canadian dollar at US$0.83.
- Impressive stock markets and earnings performance.

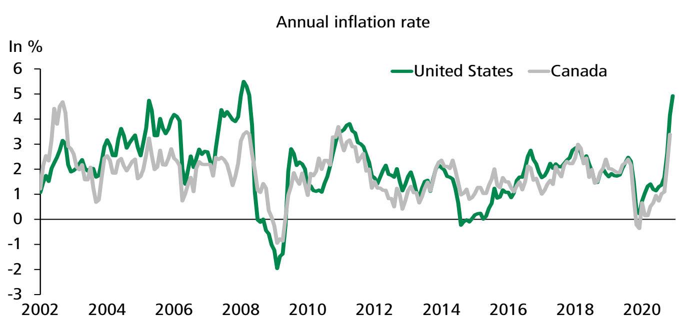
- **Inflation is back as the global economy begins to emerge from the pandemic.** The health situation remained difficult this spring in several countries affected by the third wave of the pandemic. However, vaccination campaigns have since accelerated, particularly in advanced countries, raising hopes for a fuller reopening from the third quarter onwards and a sustained rebound in economic growth. The United States, less affected by the third wave, has a head start that should boost its growth in the second quarter (graph 1). U.S. inflation reached 5% in May, a sign that demand is being strongly stimulated.
- **The Federal Reserve (Fed) appears to be starting to consider reducing its asset purchases.** Although Fed Chair Jerome Powell remains cautious, there is some discussions among the members of the Federal Open Market Committee about the eventual announcement of a reduction in the quantitative easing program. A strong recovery in U.S. employment is still being awaited, which justifies stimulative policy for the time being. Inflation is nevertheless a growing concern (graph 2), which may soon force a change in tone, especially if price pressures turn out to be less temporary than what central banks anticipate.
- **The Canadian economy could be propelled by the effectiveness of the country's vaccination campaign.** Canada leads advanced countries in the distribution of a first dose of vaccine, and the campaign continues. The spring wave of the coronavirus hit the Canadian economy hard, but new infections are now declining rapidly. As a result, weaker growth is expected in the second quarter, followed by a strong

GRAPH 1
Unaffected by the spring wave, the United States could see strong growth in the second quarter



OECD: Organisation for Economic Co-operation and Development
Sources: OECD and Desjardins, Economic Studies

GRAPH 2
Inflationary pressures are growing in North America

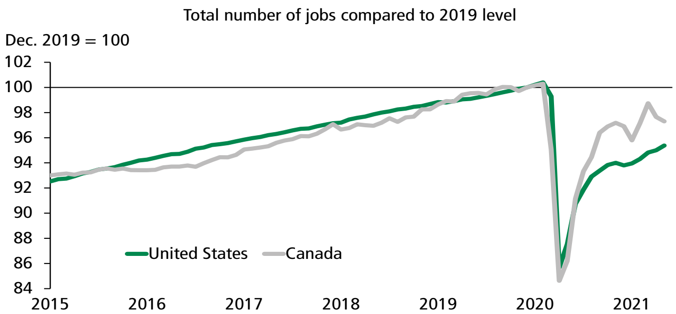


Sources: Datastream and Desjardins, Economic Studies

Jimmy Jean, Vice-President, Chief Economist and Strategist • Mathieu D'Anjou, Deputy Chief Economist
Lorenzo Tessier-Moreau, Senior Economist • Hendrix Vachon, Senior Economist
Desjardins, Economic Studies: 514-281-2336 or 1 866-866-7000, ext. 5552336 • desjardins.economics@desjardins.com • desjardins.com/economics

rebound. Indeed, real GDP could return to pre-pandemic levels as early as this summer. Like the United States, Canada is facing strong household demand and inflationary pressures are being felt. However, the Canadian labour market is in better shape (graph 3).

GRAPH 3
Employment recovery is more advanced in Canada than in the United States, despite the third wave



Sources: Datastream and Desjardins, Economic Studies

- **The Bank of Canada (BoC) is on the path to monetary tightening.** After announcing a reduction in the pace of its asset purchases on April 21, the BoC stayed the course at its June 9 meeting. It acknowledged that the third wave of the pandemic will probably weigh more heavily than expected on the Canadian economy. Nonetheless, a further adjustment of its asset purchases is to be expected at the next meeting. However, the BoC does not expect to raise its policy rate until the economy's excess capacity is filled, which should happen sometimes in the second half of 2022.
- **After a pause, the rise in retail rates is expected to continue.** Although government bond yields have stabilised following their sudden rise at the beginning of the year, further upward movements seem inevitable. Bond purchases by central banks are putting downward pressure on yields, but also on risk premia. These trends should reverse when the Fed's quantitative easing program is scaled back. Retail interest rates, particularly those on fixed-rate mortgages, are likely to be driven up again. A rise in variable interest rates is likely to come later, with the first policy rate hikes from the BoC.

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)								
December 2020	0.50	2.45	2.89	3.54	4.74	0.45	0.65	0.90
January 2021	0.50	2.45	2.89	3.54	4.74	0.40	0.60	0.85
February 2021	0.50	2.45	2.79	3.49	4.74	0.40	0.60	0.85
March 2021	0.50	2.45	2.79	3.49	4.74	0.40	0.60	1.05
April 2021	0.50	2.45	2.79	3.49	4.74	0.40	0.60	1.10
May 2021	0.50	2.45	2.79	3.49	4.74	0.40	0.60	1.10
June 14, 2021	0.50	2.45	2.79	3.49	4.74	0.40	0.60	1.10
Forecasts								
End of quarter								
2021: Q2	0,50	2,45	2.70–2.95	3.40–3.65	4.65–4.90	0.35–0.50	0.55–0.70	1.05–1.20
2021: Q3	0.50–0.75	2.45–2.70	2.60–3.10	3.30–3.80	4.55–5.05	0.30–0.60	0.50–0.80	1.00–1.30
2021: Q4	0.25–0.75	2.20–2.70	2.45–3.30	3.15–4.00	4.40–5.25	0.10–0.85	0.30–1.05	0.80–1.55
2022: Q1	0.25–1.00	2.20–2.95	2.35–3.40	3.05–4.10	4.40–5.45	0.00–1.00	0.15–1.20	0.80–1.85
End of year								
2022	0.25–1.50	2.20–3.45	2.05–3.65	3.10–4.70	4.60–6.20	0.00–1.25	0.35–1.95	1.00–2.60
2023	0.75–2.25	2.70–4.20	2.60–4.50	3.40–5.30	4.70–6.60	0.20–2.10	0.75–2.65	1.00–2.90
2024	1.25–3.25	3.20–5.20	2.90–5.30	3.30–5.70	4.55–6.95	0.45–2.85	0.75–3.15	1.05–3.45

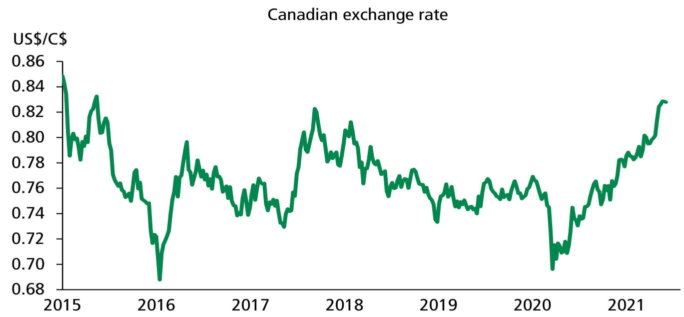
[1] Non-redeemable (annual); NOTE: Forecasts are represented using an asymmetric range reflecting the perceived probability of deviation from the base scenario. The mean of the range does not represent the forecast associated with the base scenario.
Source: Desjardins, Economic Studies

Exchange Rate

No Overvaluation of the Canadian Dollar at US$0.83

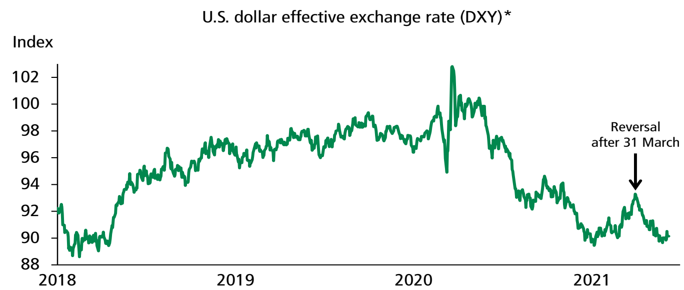
- The Canadian dollar recently rose above US$0.83. This was the highest level since May 2015 (graph 4). The value of the loonie does not seem exaggerated based on the evolution of its main determinants. First, oil and several commodity prices are very high, which improves Canada's terms of trade. Second, the economic situation is rather encouraging. Canada has come through the second and third waves of the pandemic without too much damage. The next few months look even better with the vaccination campaign well underway and reopening plans announced in several provinces. The loonie is also benefiting from the fact that the Bank of Canada has already begun to normalize its monetary policy.
- Several other currencies have also made gains against the U.S. dollar recently. Since April, the trend in the U.S. effective exchange rate has been downward (graph 5). This is consistent with reduced uncertainty in several countries and weaker demand for safe-haven U.S. assets. Rising inflation in the United States does not help either. Added to this is the fact that the Federal Reserve (Fed) maintains a very dovish bias to its monetary policy.
- **Forecasts:** It will be interesting to follow the Fed's next communications. If it opens the door to a reduction in asset purchases, it will help stabilize the greenback against several currencies. If the greenback does better, the Canadian dollar may have a harder time making further gains in the coming quarters. It would also be surprising if commodity prices all remain at such high levels. We expect the Canadian dollar to be around US$0.82 by the end of the year.

GRAPH 4
Canadian dollar at its highest level since 2015



Sources: Datastream and Desjardins, Economic Studies

GRAPH 5
After a temporary rebound in March, the greenback returned to near previous lows



* Based on a basket of currencies including 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

	2020		2021				2022			
END OF PERIOD	Q3	Q4	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0.7507	0.7853	0.7962	0.8350	0.8300	0.8200	0.8200	0.8250	0.8300	0.8350
CAN$/US$	1.3321	1.2734	1.2560	1.1976	1.2048	1.2195	1.2195	1.2121	1.2048	1.1976
CAN$/€	1.5621	1.5580	1.4762	1.4611	1.4699	1.4756	1.4756	1.4667	1.4458	1.4251
US$/€	1.1727	1.2236	1.1753	1.2200	1.2200	1.2100	1.2100	1.2100	1.2000	1.1900
US$/£	1.2928	1.3670	1.3797	1.4200	1.4200	1.4300	1.4300	1.4300	1.4400	1.4500

f: forecasts
Sources: Datastream and Desjardins, Economic Studies

Asset Classes Return

Impressive Stock Markets and Earnings Performance

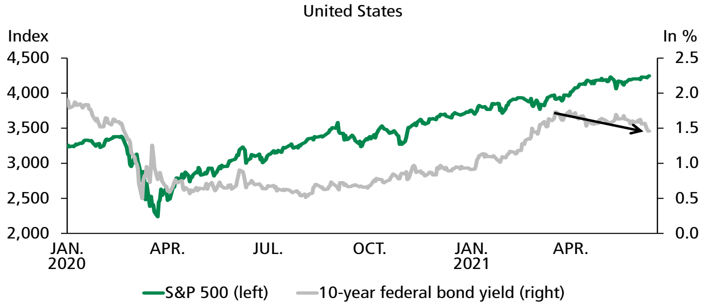
- **A respite for bonds as stock markets continue to perform well.** The first quarter of 2021 saw a surge in stock markets and bond yields as the rapid progress of vaccination programs led to a significant upward revision of the outlook for economic growth and inflation in advanced countries. Financial markets were more hesitant in April and May and bond yields even declined somewhat (graph 6) as the Federal Reserve (Fed) seemed determined to continue its ultra-stimulative monetary policy for some time to come. Despite some hesitation, stock markets generally continued to do well. In early June, the S&P 500 and S&P/TSX indices were up nearly 12% and 15% respectively since the start of 2021.

- **Dramatic rebound in corporate profits.** There is no doubt that the unprecedented support of central banks, which lowered their key interest rates to the floor and injected massive amounts of liquidity, played a key role in helping stock markets to continue to rise last year despite the pandemic. It is questionable whether this support is still needed today when the business situation looks much better. With more than 97% of S&P 500 companies having reported, earnings have surged to a new high in the first quarter of 2021. Better still, the improvement is widespread, with almost all sectors reporting higher earnings than before the pandemic (graph 7). This strong performance reflects a rapid rebound in sales by large U.S. companies and record profit margins. Corporate results are also very encouraging in Canada, notably for banks, and analysts' earnings outlooks have also jumped to a new high for the S&P/TSX (graph 8).

- **Inflationary pressures are mounting.** As vaccination and the reopening of economies accelerate and household purchasing power is boosted by savings accumulated during the pandemic, there is every reason to believe that companies will continue to benefit from very robust demand for their products. The challenge is likely to be more on the production and cost side as more and more surveys report major difficulties in hiring and sourcing inputs. While commodity prices continue to rise, the latest inflation figures have been very strong, particularly in the United States, where annual inflation reached 5% in May (graph 2 on page 1).

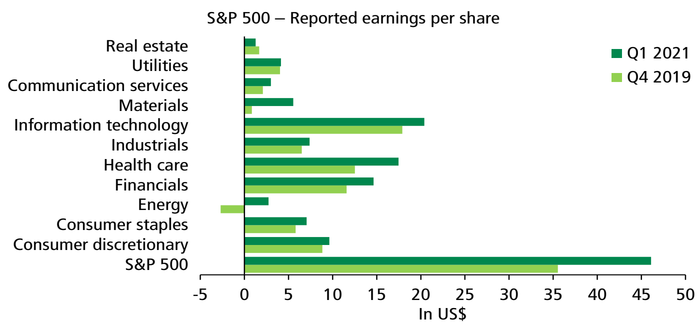
- **The bond market looks vulnerable.** The resilience of the bond market since the beginning of the second quarter has been a nice surprise for Canadian investors. However, this respite is likely to be short-lived. The latest inflation figures are not compatible with bond yields staying as low as they are now, and there will be strong pressure for the Fed to reduce its bond purchases before the end of the year. Therefore, we expect U.S. and Canadian bond yields to return to an uptrend

GRAPH 6
Bond yields have been falling slightly in recent months, while the upward trend in the stock markets continues



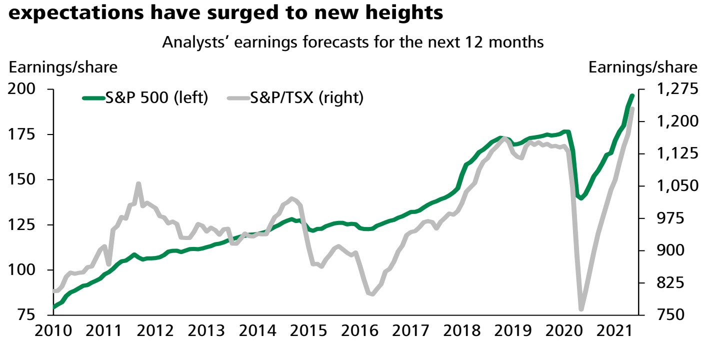
Sources: Datastream and Desjardins, Economic Studies

GRAPH 7
Almost all sectors show higher profits than before the pandemic



Sources: Standard & Poor's and Desjardins, Economic Studies

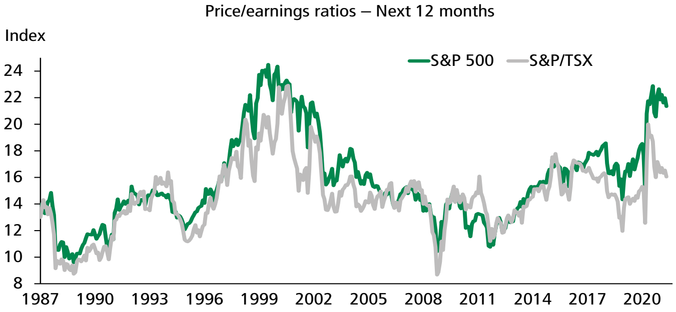
GRAPH 8
After a sharp drop at the beginning of the pandemic, earnings expectations have surged to new heights



Sources: I/B/E/S and Desjardins, Economic Studies soon and we have even slightly increased the expected loss for the bond market this year.

- **The environment should generally remain favourable for stock markets.** Our robust growth and inflation scenarios should continue to favour riskier investments in the coming quarters and the commitment of central banks to maintain favourable financial conditions limits the risk of a major and sustained stock market correction. As a result, we have revised our stock market targets upwards. However, we expect fairly limited gains between now and the end of the year, as a period of consolidation, particularly for the U.S. stock market, seems likely after the spectacular gains of recent quarters. The expected evolution of the Fed's speech over the next few months could create some volatility and lead investors to take profits. From a relative standpoint, the Canadian stock market seems to be in a good position with less stretched valuation measures than in the United States (graph 9).

GRAPH 9
The level of the Canadian stock market doesn't seem to reflect all the good news



Sources: I/B/E/S 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]
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
2020	0.9	8.7	5.6	18.4	8.3	-2.0
2021f	target: 0.10	target: -6.5	target: 20.0	target: 15.0	target: 14.0	target: -4.2 (US$0.82)
range	0.00 to 0.20	-9.0 to -3.0	9.0 to 26.0	7.0 to 22.0	5.0 to 25.0	-6.5 to -0.6

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