# RETAIL RATE FORECASTS

## Bond Yields on the Rise Once Again after a Pause

### HIGHLIGHTS

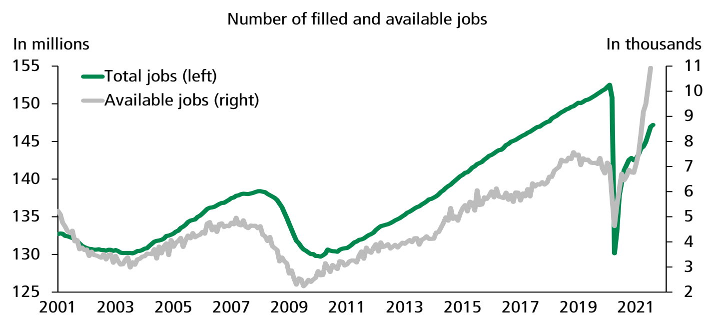
- The Federal Reserve is expected to dial back its quantitative easing as early as this fall.
- Canada's real GDP contracted in the second quarter, but inflation accelerated.
- The Canadian dollar is holding up better against the U.S. dollar than other currencies.
- Will investors face a difficult end of the year?

- **The economic recovery should withstand the Delta variant.** Despite the vaccination campaigns, the spread of COVID-19 once again picked up speed this summer. The now dominant Delta variant did not lead to a major increase in hospitalizations and deaths among people who are vaccinated, which helped avoid stringent lockdown measures. The economic recovery should remain on track in the United States and elsewhere, yet it is now production constraints and labour shortages that are becoming worrisome (graph 1) as our recent *Economic Viewpoint* on the U.S. labour market shows.

- **The Federal Reserve's (Fed) quantitative easing could quickly end.** At the September 22 meeting, the Fed indicated that an announcement about a reduction in its asset purchases could come as early as November if employment continues to recover. A complete reduction of net purchases could happen quickly in 2022, setting the scene for key rate hikes. The Fed's officials remain divided on this issue. Half of the committee members anticipate a first hike in 2022, while the other half sees it happening later. Even if the Fed remains focused on jobs, it can't ignore inflation. After four straight months around 5% and few signs of a break, action is required.

- **It was a tough spring for the Canadian economy.** Struck by the third wave of COVID-19, the Canadian economy grew weaker during the second quarter of 2021, with real GDP shrinking 1.1% at an annualized quarterly pace. The pullback continued in July according to GDP by industry. The Canadian economy does, however, remain well-positioned,

**GRAPH 1**
**Employment has been slow to bounce back in the United States, but it's not for a lack of need**




Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

and the drops in GDP are mostly due to temporary factors. Employment continued to recover during the summer, with the unemployment rate hitting 7.1% in August, its lowest level since the start of the pandemic.

- **The Bank of Canada (BoC) will stay the course despite the drop in GDP.** Contrary to the Fed, the BoC's mandate is not to ensure full employment. Also, the Fed's new framework allows a higher tolerance for inflation. These differences explain in part why the BoC reduced its asset purchases earlier. With an inflation rate that jumped to 4.1% in August, which is well outside the target range (graph 2 on page 2), it could end its quantitative easing as early as this fall. The first key rate hike is expected towards the end of 2022.

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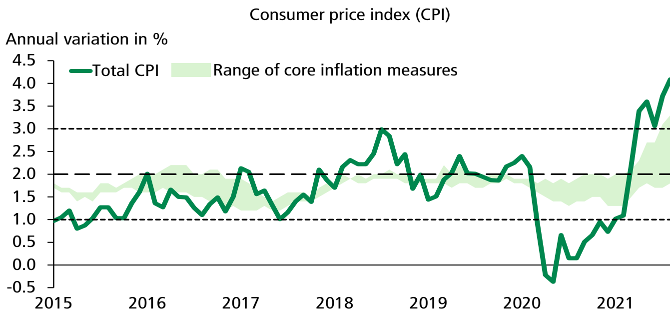
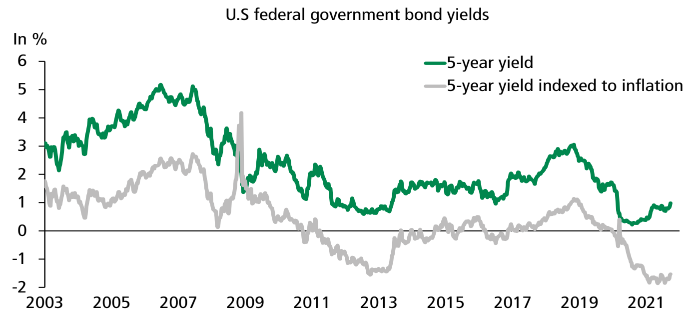
**GRAPH 2**
**Inflation in Canada has stayed above the target range for the last five months**




Sources: Statistics Canada, Bank of Canada and Desjardins, Economic Studies

**GRAPH 3**
**Real interest rates are at a historic low and will have to rise for monetary policy to have an impact**




Sources: Federal Reserve Board and Desjardins, Economic Studies

- **Bond yields are on the rise once again, and retail rates will follow.** It's difficult to explain this summer's drop in bond yields based on economic fundamentals. That is why the new rise in bond yields following the Fed's September meeting came as no surprise. To have an impact on the economy, the central bank will have to rein in real interest rates (after expected inflation) to bring them closer to their long-term average (graph 3) by reducing its demand for bonds. Therefore, unless lower inflation is expected, bond yields will have to continue to rise. Retail interest rates will follow this trend. Long-term fixed rates should keep on their upward trajectory, whereas short-term and variable rates will rise later in 2022.

## 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) | | | | | | | | |
| 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 2021 | 0.50 | 2.45 | 2.79 | 3.49 | 4.74 | 0.40 | 0.60 | 1.10 |
| July 2021 | 0.50 | 2.45 | 2.79 | 3.49 | 4.74 | 0.40 | 0.60 | 1.10 |
| August 2021 | 0.50 | 2.45 | 2.79 | 3.49 | 4.74 | 0.40 | 0.60 | 1.10 |
| September 2021 | 0.50 | 2.45 | 2.79 | 3.49 | 4.74 | 0.40 | 0.60 | 1.10 |
| October 6, 2021 | 0.50 | 2.45 | 2.79 | 3.49 | 4.74 | 0.40 | 0.60 | 1.10 |
| **Forecasts** | | | | | | | | |
| End of quarter | | | | | | | | |
| 2021: Q4 | 0,50 | 2,45 | 2.65–3.10 | 3.35–3.80 | 4.60–5.05 | 0.35–0.60 | 0.55–0.80 | 1.05–1.30 |
| 2022: Q1 | 0.50–0.75 | 2.45–2.70 | 2.50–3.20 | 3.20–3.90 | 4.45–5.15 | 0.20–0.70 | 0.40–0.90 | 0.90–1.40 |
| 2022: Q2 | 0.25–0.75 | 2.20–2.70 | 2.40–3.35 | 3.10–4.05 | 4.55–5.50 | 0.20–0.95 | 0.40–1.35 | 1.05–2.00 |
| 2022: Q3 | 0.25–1.00 | 2.20–2.95 | 2.25–3.45 | 2.95–4.15 | 4.55–5.75 | 0.20–1.05 | 0.45–1.65 | 0.90–2.10 |
| End of year | | | | | | | | |
| 2022 | 0.25–1.25 | 2.20–3.20 | 2.30–3.65 | 3.15–4.50 | 4.70–6.05 | 0.20–1.10 | 0.55–1.90 | 1.15–2.50 |
| 2023 | 0.75–2.25 | 2.70–4.20 | 2.65–4.55 | 3.35–5.25 | 4.70–6.60 | 0.25–2.10 | 0.80–2.70 | 1.00–2.90 |
| 2024 | 1.25–3.25 | 3.20–5.20 | 2.95–5.35 | 3.35–5.75 | 4.55–6.95 | 0.35–2.75 | 0.70–3.10 | 1.05–3.45 |

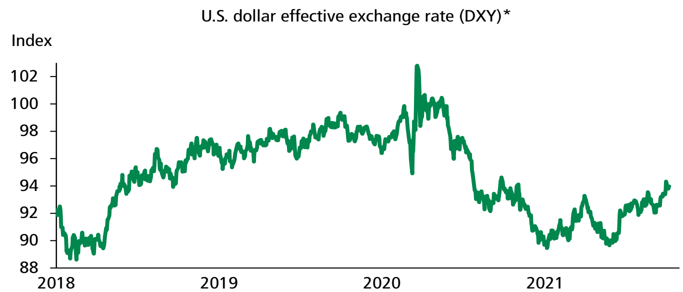
[1] Non-redeemable (annual); NOTE: Forecasts are represented using an asymmetric range reflecting the perceived probability of deviation from the base scenario. The mean of the range does not represent the forecast associated with the base scenario.
Source: Desjardins, Economic Studies

# Exchange Rate

## The Loonie Is Holding Up Better against the U.S. Dollar than Other Currencies

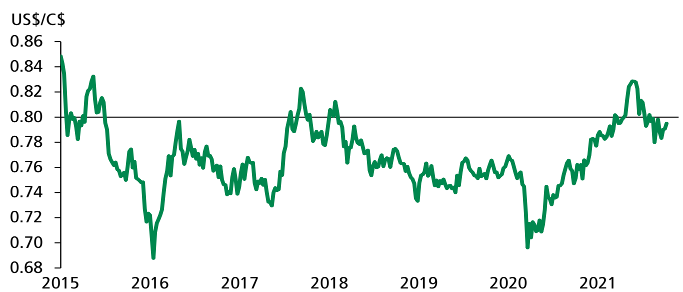
- The U.S. dollar gained in September. The DXY index, which measures the value of the U.S. dollar against the main currencies, has been at a peak since November 2020 (graph 4). The greenback is mostly benefiting from the Federal Reserve's change in tone and interest rate spreads that are more favourable for U.S. assets. Pandemic-induced residual concerns as well as new worries about China are also working in favour of the U.S. dollar.
- The Canadian dollar has held up better against the recent appreciation of the U.S. dollar. The loonie is currently trading at more than US$0.79, which is not far off the levels last seen a month ago (graph 5). The Bank of Canada (BoC) has already cut back its asset purchases significantly, and Canadian bond yields are rising in tandem with U.S. yields. So, yield spreads aren't penalizing the Canadian currency. In addition, the increase in the price of oil and other commodities is improving Canada's terms of trade.
- A month ago, the euro was trading at more than US$1.18; it's now back to trading around US$1.16. There are fewer expectations of monetary tightening in the euro zone compare to the United States. The struggle to form a coalition in Germany after the elections is also adding to the uncertainty in the region. Meanwhile, across the channel, the pound sterling also depreciated significantly. The United Kingdom is currently experiencing significant supply-chain problems, which seems to be a consequence of Brexit.
- **Forecasts:** We're counting on the Canadian dollar returning to US$0.80 by the end of 2021. Other small gains are forecast for next year as the BoC will begin to raise its key rate and the uncertainty associated with the pandemic will continue to subside.

**GRAPH 4**
**September was a good month for 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 Canadian dollar is still near US$0.80**




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 | Q2 | Q3 | Q4f | Q1f | Q2f | Q3f | Q4f |
| US$/CAN$ | 0.7507 | 0.7853 | 0.7962 | 0.8067 | 0.7886 | 0.8000 | 0.8000 | 0.8100 | 0.8200 | 0.8250 |
| CAN$/US$ | 1.3321 | 1.2734 | 1.2560 | 1.2396 | 1.2680 | 1.2500 | 1.2500 | 1.2346 | 1.2195 | 1.2121 |
| CAN$/€ | 1.5621 | 1.5580 | 1.4762 | 1.4700 | 1.4836 | 1.4750 | 1.4875 | 1.4691 | 1.4390 | 1.4182 |
| US$/€ | 1.1727 | 1.2236 | 1.1753 | 1.1859 | 1.1700 | 1.1800 | 1.1900 | 1.1900 | 1.1800 | 1.1700 |
| US$/£ | 1.2928 | 1.3670 | 1.3797 | 1.3815 | 1.3700 | 1.3800 | 1.3900 | 1.4000 | 1.4000 | 1.4100 |

f: forecasts
Sources: Datastream and Desjardins, Economic Studies

# Asset Classes Return

## Will Investors Face a Difficult End of the Year?

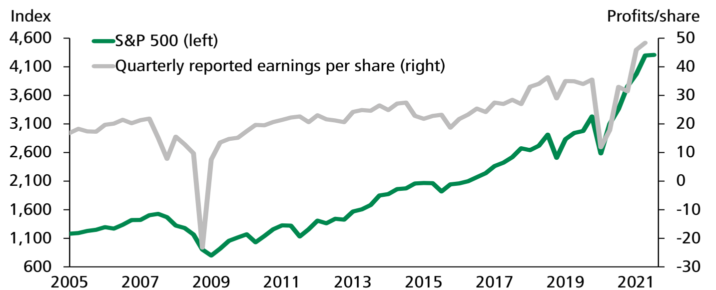
- **Investors had it easy until the end of August.** Despite the new wave of the pandemic relating to the Delta variant and the increased fears surrounding inflation, stock markets overall continued to advance in July and August. As a result, both the S&P 500 and the S&P/TSX climbed to historic highs in early September and, remarkably, had soared by about 20% since the beginning of 2021. This great performance was based on the spectacular rebound in corporate profitability in recent quarters and on the positive outlook for growth (graph 6). The stock markets also benefited from extremely low bond yields, which had been trending lower since the end of the winter. This, in turn, helped the Canadian bond market reduce the loss that it had posted at the beginning of the year.

- **It's been a rough September.** Volatility returned to the financial markets in September with a vengeance, and the S&P 500 pulled back nearly 5%, its worst result since March 2020 (graph 7). The financial difficulties facing Chinese giant Evergrande Real Estate Group and some edginess in the run up to September's Federal Reserve (Fed) meeting drove many investors to take profits at the beginning of the month. Recently, it's the sharp increase in bond yields and the political uncertainty in the United States, as the negotiations to approve new investment plans and raise the debt ceiling drag on, that seem to be worrying investors.

- **Inflation is increasingly worrisome.** Fears of a longer-lasting surge in inflation have grown in recent months, as output constraints and labour shortages are limiting the ability of producers to respond to strong consumer demand. As a result, inflation recently hit a multi-year high in many countries (graph 8), and a new jump in energy prices suggests that there won't be a break any time soon. There is an increasing consensus among central banks that it's time to start normalizing monetary policies. Some central banks have already begun raising their key rates.

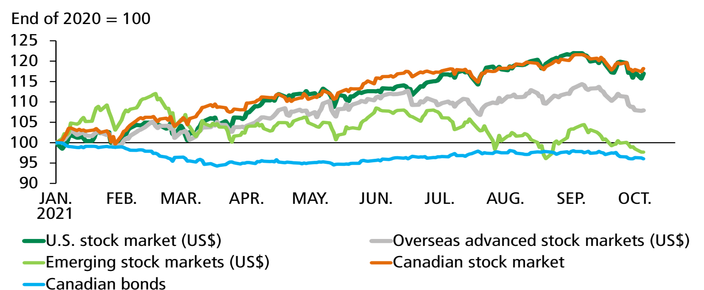
- **Bond yields should keep going up.** In September, the Fed again opted for the status quo. However, its statement stresses that it may soon be necessary to slow the pace of asset purchases. Moreover, the Fed's officials are signalling more key rate hikes in the medium term, which caused a jump in bond yields. The Bank of Canada, for its part, is contemplating stabilizing its bond holdings soon. Assuming an agreement is reached soon in Washington, this gradual monetary policy normalization and the major upside inflation risks point to further increases in bond yields in the coming quarters (graph 9 on page 5).

**GRAPH 6**
**The S&P 500 and corporate profits record a spectacular post-pandemic rebound**



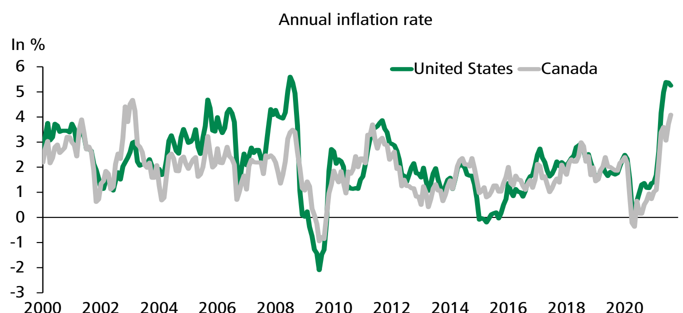

Sources: S&P Dow Jones Indices, Datastream and Desjardins, Economic Studies

**GRAPH 7**
**After a period of robust growth, stock markets stumbled in September**



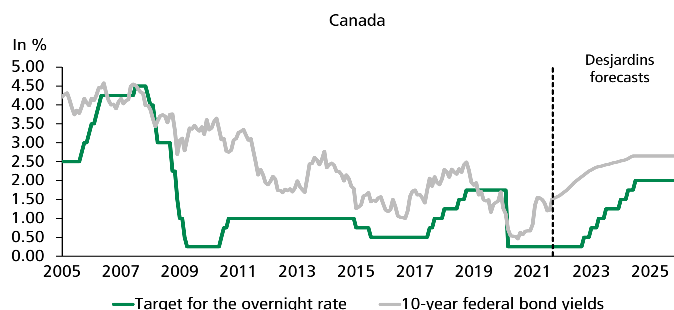

Sources: Datastream and Desjardins, Economic Studies

**GRAPH 8**
**Inflation hit multi-year highs**




Sources: Datastream and Desjardins, Economic Studies

**GRAPH 9**
**More bond yield increases are expected**




Sources: Datastream and Desjardins, Economic Studies

- **The stock markets may continue to advance next year.** The forecast increase in bond yields suggests more small losses for the bond market by the end of this year and next. The stock markets could remain volatile in the short term, especially if the political situation in the United States continues to be a major source of uncertainty. After the spectacular gains in recent quarters, a period of consolidation or profit taking is completely normal, especially for U.S. technology stocks, at a time when faster interest rate increases are expected. Still, once this period is over, the stock markets should embark on their upward trajectory again, a reflection of high corporate profitability and the positive economic outlook. In relative terms, the stock market remains much more attractive than the bond market in an environment marked by inflationary risks and a gradual normalization of monetary policies.

- **We'll have to relearn how to deal with more volatility.** Even if we're still relatively optimistic about the stock market's outlook, it's likely that we'll have to get used to more periods of volatility. When the pandemic began, the central banks did everything they could to maintain favourable financial conditions. This is still one objective for them, but it must now be balanced with the risks surrounding inflation and financial stability. As a result, investors must be aware that they can no longer count on the central banks' unconditional support.

## 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: 0.12 | target: -4.5 | target: 23.0 | target: 21.0 | target: 13.0 | target: -1.8 (US$0.800) |
| range | 0.10 to 0.15 | -6.0 to -1.5 | 14.0 to 27.0 | 12.0 to 26.0 | 5.0 to 18.0 | -4.2 to 2.0 |
| 2022f | target: 0.30 | target: -3.0 | target: 10.0 | target: 8.0 | target: 12.0 | target: -3.0 (US$0.825) |
| range | 0.15 to 0.45 | -6.0 to 0.0 | 4.0 to 16.0 | 2.0 to 14.0 | 3.0 to 19.0 | -5.9 to 1.3 |

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