RETAIL RATE FORECASTS

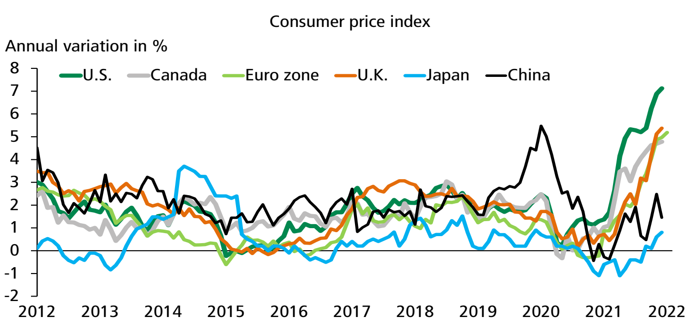
2022 Will Be the Year of Rate Hikes

HIGHLIGHTS

- The Omicron variant should have limited effects on the economy, but inflation could ramp up.
- The Bank of Canada's key rates could reach 1.25% by the end of the year.
- A very volatile beginning of the year for several exchange rates.
- Money tightening should rein in the stock markets, but not catastrophically.

- **The Omicron variant will do nothing to calm inflation.** The new Omicron variant took the world by storm at the beginning of winter, sparking new restrictions despite its reduced severity. The wave is likely to be short, however, with new cases and hospitalizations already down in several countries. Although the effects on economic growth appear to be limited, sporadic closings and high worker absenteeism could exacerbate the effects of the labour shortage and supply chain difficulties. That will continue to fuel the already very strong inflationary pressures. In 2021, inflation reached its highest level in years in many countries of the world (graph 1).

GRAPH 1
Inflationary pressures were felt around the globe in 2021



Sources: Datastream and Desjardins, Economic Studies

- **The Federal Reserve (Fed) is on a war footing to combat inflation**. At its January 26 meeting, the Fed signalled that a first increase of its federal funds rate was imminent and that several others would be needed throughout the year. Its asset purchasing program will end at the beginning of March, coinciding with a first rate hike. The Fed could then move quickly to start reducing its balance sheet by letting several of its securities mature. Such a brutal pivot by a central bank has rarely been seen. But, with real GDP growth at 5.7% in 2021 and an inflation rate above 7.0% in the United States, it was high time to act.
- **A good year end for the Canadian economy.** Although the Canadian economy hit a rough patch at the beginning of 2021, it made a strong recovery afterwards. Real GDP rebounded in the third quarter and posted strong monthly growth in October and November. The average monthly growth for 2021 should reach 4.9%. The job market was also pretty healthy before the Omicron variant hit, and even though more than 200,000 jobs were lost in january, it should recover quickly. But here, like elsewhere, inflation is the big worry. It was up to 4.8% in December.
- **The Bank of Canada (BoC) has no reason to outpace the Fed**. Although many were expecting the BoC to raise its overnight rate at its January 26 meeting, it decided to wait until March. It also signalled that further key rate increases as well as a reduction of its balance sheet should be expected. That puts the BoC squarely in line with the Fed's monetary

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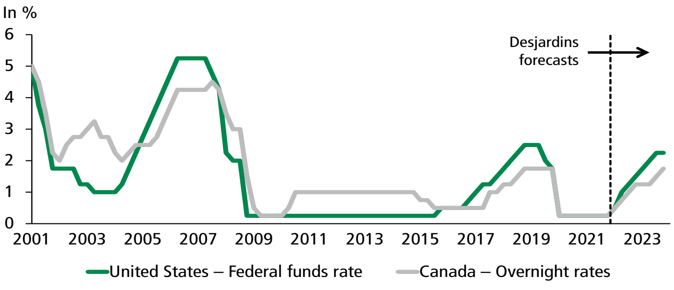
policy. However, it will have to take into account the increased vulnerability of the Canadian economy, including a housing market that is more sensitive to rate hikes, after two years of skyrocketing prices. We forecast that four 25 basis points rate hikes could take place in 2022, one less than in the United States (graph 2).

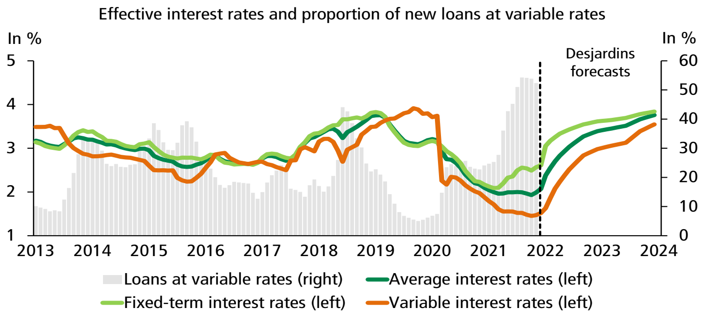
- **Key rate increases will be reflected in retail rates.** Despite the fact that bond yields have been rising for some months, several borrowers have managed to avoid paying higher mortgage rates by opting for variable rates (graph 3). With several key rate hikes now clearly signaled, variable rates are likely to follow suit, which will drag all retail rates up. Bond yields have soared since the beginning of the year, and are not likely to stop any time soon. Those increases will affect both rates on savings, which are already up nicely, and the rates offered to borrowers.

GRAPH 2
A new monetary tightening cycle is dawning in the United States and Canada



Sources: Datastream and Desjardins, Economic Studies

GRAPH 3
Borrowers have avoided the hikes by opting for variable rates



Sources: Bank of Canada and Desjardins, Economic Studies

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 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 2021	0.50	2.45	2.79	3.49	4.74	0.40	0.70	1.10
November 2021	0.50	2.45	2.79	3.49	4.74	0.40	0.70	1.10
December 2021	0.50	2.45	2.79	3.49	4.74	0.40	0.90	1.30
January 2022	0.50	2.45	2.79	3.49	4.74	0.40	1.15	1.50
February 8, 2022	0.50	2.45	2.84	3.49	4.79	0.40	1.15	1.50
Forecasts								
End of quarter								
2022: Q1	0.50–1.00	2.45–2.95	2.80–3.20	3.50–3.85	4.75–5.25	0.40–0.60	1.15–1.25	1.50–1.80
2022: Q2	0.75–1.25	2.70–3.20	2.80–3.50	3.70–4.40	4.90–5.60	0.40–1.00	1.10–1.70	1.60–2.20
2022: Q3	0.75–1.75	2.70–3.70	2.80–3.80	3.55–4.55	5.00–6.00	0.40–1.30	1.10–2.00	1.45–2.35
2022: Q4	1.00–2.00	2.95–3.95	2.85–4.15	3.55–4.85	4.85–6.15	0.20–1.50	0.90–2.20	1.25–2.55
End of year								
2023	1.25–2.75	3.20–4.70	2.85–4.75	3.40–5.30	4.75–6.65	0.30–2.20	0.85–2.75	1.10–3.00
2024	1.50–3.00	3.45–4.95	2.90–5.00	3.30–5.40	4.65–6.75	0.50–2.60	0.75–2.85	1.00–3.10
2025	1.25–3.25	3.20–5.20	2.90–5.30	3.30–5.70	4.50–6.90	0.35–2.75	0.60–3.00	0.85–3.25

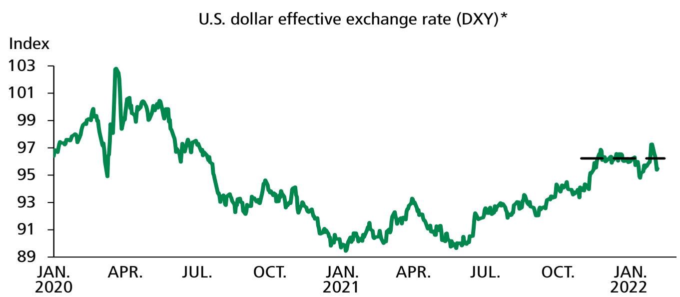
[1] Non-redeemable (annual); NOTE: Forecasts are represented using an asymmetric range reflecting the perceived probability of deviation from the base scenario. The mean of the range does not represent the forecast associated with the base scenario.
Source: Desjardins, Economic Studies

Exchange Rate

A Very Volatile Beginning of the Year for Several Exchange Rates

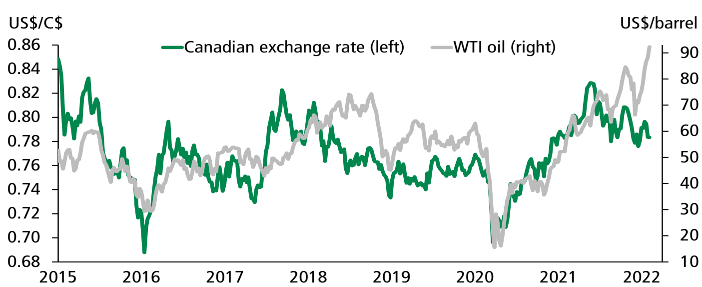
- As the appetite for risk declined on the financial markets, demand for safe havens increased, allowing the U.S. dollar to rebound during the second half of January (graph 4). It also got a boost from the Federal Reserve's (Fed) signals of further interest rate hikes. The greenback is having a hard time maintaining new gains, however; it depreciates as soon as investors start to feel less risk-averse, as they did at the beginning of February. Overall, the DXY effective U.S. dollar exchange rate index seems to have peaked since November, reinforcing the idea that its upward trend has ended.
- The loonie even went over the symbolic US$0.80 mark temporarily at the start of the year, although it fell back down again due to stronger volatility in the financial markets and the rising U.S. dollar. Higher gas and other commodity prices were not enough to maintain the loonie's gains (graph 5). When the Bank of Canada held the line at its January meeting it did not affect the currency much. The markets still expect several key rate increases.
- **Forecasts:** we do not anticipate a prolonged period of strong volatility on the financial markets, so the context should be less favourable to the U.S. dollar in the coming quarters. The Fed's coming decisions to raise interest rates may help the greenback, but only temporarily, as the thrust of the monetary tightening for 2022 seems to have already been taken into account. We will also have to see what decisions the other central banks make. As for the Canadian dollar, it could go over US$0.80 in the next few months. In the longer term, the predicted decline in commodity prices and more interest rate hikes in the United States compared to Canada could harm the loonie a bit.

GRAPH 4
The U.S. dollar peaked in November



* 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 has not kept pace with oil prices



WTI: West Texas Intermediate
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

	2021		2022				2023			
END OF PERIOD	Q3	Q4	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0.7886	0.7914	0.8050	0.8050	0.8000	0.7950	0.7900	0.7800	0.7900	0.7850
CAN$/US$	1.2680	1.2636	1.2422	1.2422	1.2500	1.2579	1.2658	1.2821	1.2658	1.2739
CAN$/€	1.4695	1.4370	1.4161	1.4286	1.4500	1.4717	1.4937	1.5128	1.5063	1.5287
US$/€	1.1590	1.1372	1.1400	1.1500	1.1600	1.1700	1.1800	1.1800	1.1900	1.2000
US$/£	1.3484	1.3545	1.3600	1.3700	1.3800	1.3900	1.4000	1.4000	1.4100	1.4100

f: forecasts
Sources: Datastream and Desjardins, Economic Studies

Asset Classes Return

Money Tightening Should Rein In the Stock Markets, but Not Catastrophically

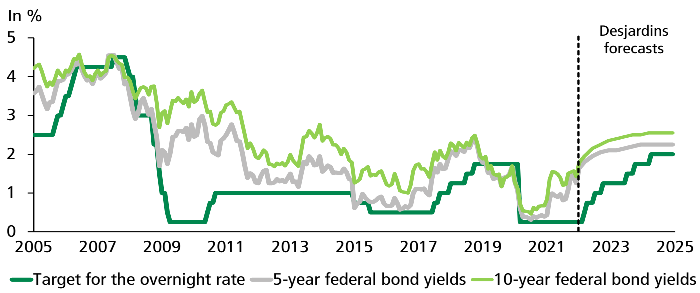
- Despite a decline in the bond market, the **stock markets' strong performance allowed a very good gain for an average portfolio in 2021**. That follows two other good years, but this pace should not last forever. Is the greater volatility on the financial markets since the beginning of the year a good harbinger of what we will see in the coming quarters? We have scaled down our earnings forecast, but we are still far from pessimistic scenarios.

- **The interest rate hikes are the main source of volatility.** The more the interest rates go up, the less attractive the stock markets become. Rising rates also bring concerns about whether the most heavily indebted companies can maintain profitability. We have recently added key rate hikes to our scenario and raised our year-end targets for several bond yields (graph 6). That is prompting us to revise our performance targets for the bond and stock markets downwards.

- It is interesting to make a **comparison with the last monetary tightening cycle of 2017 and 2018**. The markets were not too badly off at the beginning, but ended by slowing down (graph 7). 2018 ended with losses on most of the stock indexes. The money tightening had been very gradual, but the addition of interest rate hikes seemed to cool investors' ardour in the end. Other factors may have been in play in 2018. One such was the beginning of fears about U.S. protectionism. Recession fears were also beginning to grow.

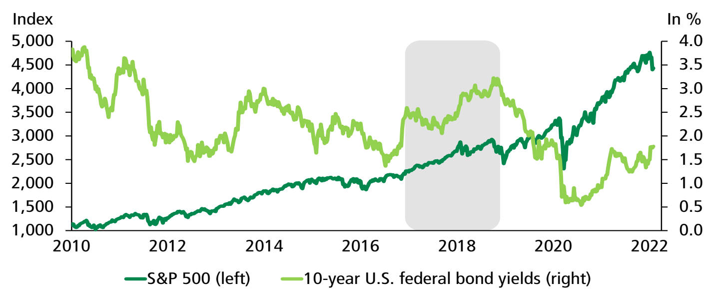
- **The expected growth of profits remains strong** and is one of the main props for the stock markets (graph 8). The various production hurdles do not seem to be affecting business profitability right now, but the situation may vary from one sector to another. That said, we expect a good year on the economic front as the pandemic wanes and production problems work themselves out. Business profitability will probably get a boost. Inflation may also have only a limited effect, especially among businesses that manage to transfer higher costs to their customers. Wage increases may affect profitability in the long run, but productivity gains should help mitigate the impact.

GRAPH 6
More bond yield increases are expected



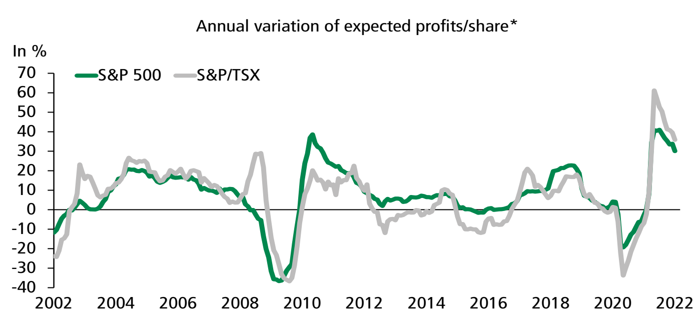
Sources: Datastream and Desjardins, Economic Studies

GRAPH 7
The markets slowed down during the 2017–2018 monetary tightening



Sources: Datastream and Desjardins, Economic Studies

GRAPH 8
Profit outlooks remain very high

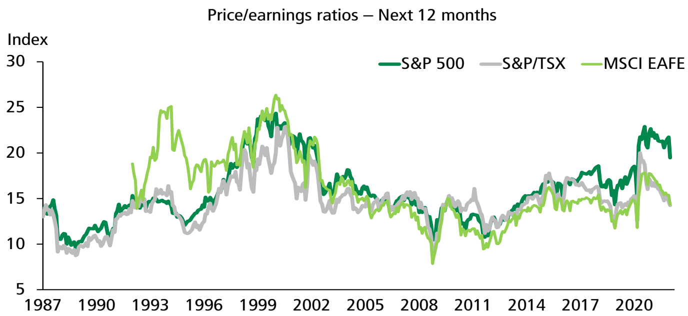


* Anticipated profits for the next 12 months.
Sources: Datastream and Desjardins, Economic Studies

- **The U.S. stock markets seem at greater risk of underperforming.** Judging by price/earnings ratios, U.S. stocks are more costly than in Canada and other advanced countries (graph 9). January's declines in the NASDAQ and S&P 500 were more significant than those in the S&P/TSX and other indexes.

- **Commodities help the Canadian markets** in January, but that may not last as we expect lower prices for oil and other resources in 2022. That said, profits should remain high in Canada and, since the Canadian stock market is not overvalued, we believe this asset class will record a gain in 2022. Higher dividends also continue to help several Canadian stocks. Overall, the other advanced country stock markets have also more attractive valuations, which gives us grounds for optimism. Moreover, the potential for interest rate hikes appears lower in Europe and Japan, which will be less restrictive for stock markets in these regions. So far, inflationary pressures have remained weaker in the euro zone and in Japan. Not to mention the several years struggling to get inflation on target even with negative interest rates.

GRAPH 9
The U.S. stock markets are still more costly than others



Sources: I/B/E/S, 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]
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
2021	0.2	-2.5	25.1	28.7	11.8	-0.8
2022f	target: 0.4	target: -3.6	target: 7.0	target: -1.0	target: 8.0	target: -0.5 (US$0.795)
range	0.25 to 0.55	-6.6 to -0.6	2.0 to 12.0	-7.0 to 6.0	2.0 to 14.0	-3.5 to 2.8

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