RETAIL RATE FORECASTS

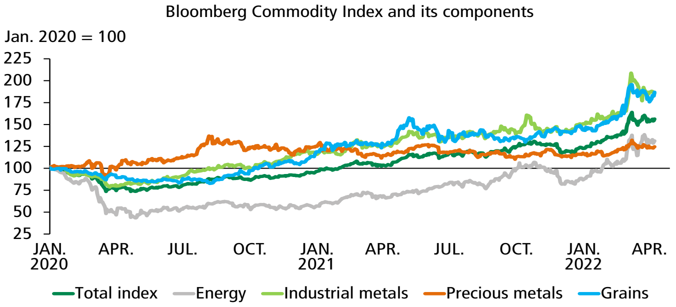
Picking Up the Pace of Interest Rate Hikes to Curb Inflation

HIGHLIGHTS

- The war in Ukraine is adding to inflationary pressures.
- The Federal Reserve and the Bank of Canada are taking action.
- The war and loose monetary policy have sent the euro lower.
- 2022 will be a tough year for riskier investments.

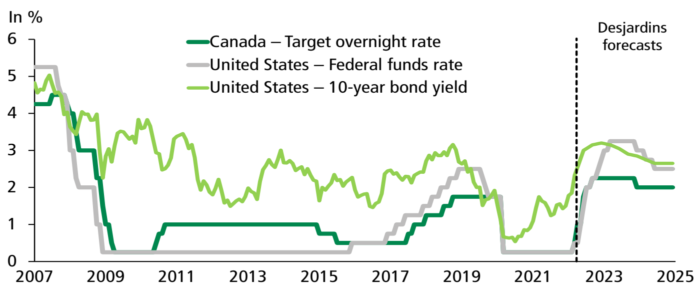
- **Inflation indicators are all flashing red.** Inflation was already a big concern at the start of the year. The war in Ukraine has only made it worse. Energy and other commodity prices are up sharply in response to the invasion and sanctions on Russia (graph 1). China continues to pursue a zero-COVID policy, and new lockdowns are raising fears for the already-strained global supply chains. In the United States, economic growth remains strong, with unemployment nearing its pre-pandemic low in March. This could increase upwards pressure on wages, which could mean an even more persistent inflation.
- **The US may be in for a rapid monetary tightening cycle.** The Federal Reserve (Fed) initiated monetary tightening on a cautious note in March, raising the target federal funds rate by 25 basis points. It will likely follow that up with several 50-point hikes in the coming months. It will also slash its enormous balance sheet by allowing up to US$95 billion in bonds and mortgage-backed securities to mature each month. By our estimate, the federal funds rate could top 3% by the end of next year (graph 2).
- **The Canadian economy is at risk of overheating.** Inflation jumped to 6.7% in March in Canada, the fastest pace since 1991 (graph 3 on page 2). But higher energy prices from the war in Ukraine are only partly to blame. More than 70% of the components in the CPI basket have seen prices rise over 3% in the past year. Economic growth didn't even slow in January despite the Omicron wave, and unemployment fell to 5.3% in March, the lowest level on record.

GRAPH 1
Many commodity prices spiked when war broke out in Ukraine



Sources: Datastream and Desjardins, Economic Studies

GRAPH 2
The terminal US federal funds rate should be higher than the Bank of Canada's terminal rate



Sources: Datastream and Desjardins, Economic Studies

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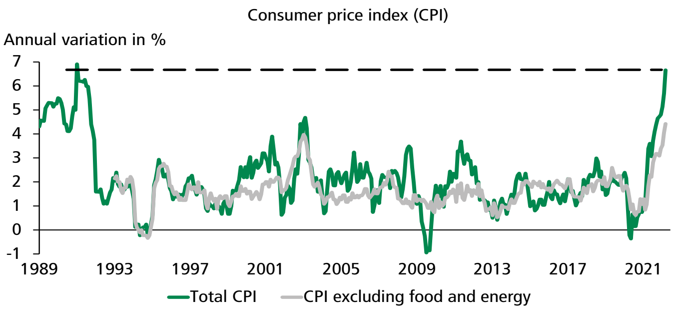
GRAPH 3
Inflation is spinning out of control in Canada



Sources: Statistics Canada and Desjardins, Economic Studies

- **The Bank of Canada (BoC) is caught between a rock and a hard place.** After an initial 25-point rate increase in March and a 50-point hike in April, the BoC's key rate is already at 1%. The bank also began quantitative tightening, allowing maturing bonds to roll off its balance sheet. The BoC is ahead of the Fed, but that doesn't mean it should tighten monetary policy more aggressively. On the contrary, it should be more cautious given how sensitive the Canadian housing sector is to interest rate increases. Look for the BoC to rapidly raise the key rate in the coming year but keep it below 2.5%.
- **Consumers are already feeling the effects of interest rate hikes.** Bond yields are up sharply since the start of the year, and fixed mortgage rates have risen almost in lock step. At the end of 2021, the average rate on fixed mortgages with terms of 5-year or more was 2.5%. Today, we estimate it's over 4%. Variable rates are also creeping up and will continue to rise as the BoC's policy rate increases. But there's good news for those looking for safer investments: returns on term deposits are looking a lot better now.

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)								
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 2022	0.50	2.45	2.89	3.49	4.79	0.50	1.30	1.70
March 2022	0.75	2.70	2.99	3.69	4.99	0.90	1.75	2.25
April 27, 2022	1.25	3.20	3.24	3.89	4.99	1.25	2.25	3.00
Forecasts								
End of quarter								
2022: Q2	1.50–2.00	3.45–3.95	3.05–4.15	3.90–5.00	5.20–6.30	0.90–1.80	1.70–2.60	2.10–3.00
2022: Q3	1.75–2.75	3.70–4.70	3.40–4.80	4.15–5.55	5.35–6.75	1.05–2.25	1.75–2.95	2.00–3.20
2022: Q4	1.75–3.00	3.70–4.95	3.50–5.20	4.25–5.95	5.30–7.00	1.10–2.80	1.60–3.30	1.85–3.55
2023: Q1	1.75–3.25	3.70–5.20	3.50–5.35	4.25–6.10	5.30–7.15	1.10–2.95	1.60–3.45	1.85–3.70
End of year								
2023	1.50–3.00	3.45–4.95	3.35–5.25	3.75–5.65	4.85–6.75	0.90–2.80	1.05–2.95	1.20–3.10
2024	1.25–3.25	3.20–5.20	2.95–5.35	3.35–5.75	4.45–6.85	0.45–2.85	0.60–3.00	0.75–3.15
2025	1.25–3.25	3.20–5.20	2.95–5.35	3.35–5.75	4.45–6.85	0.45–2.85	0.60–3.00	0.75–3.15

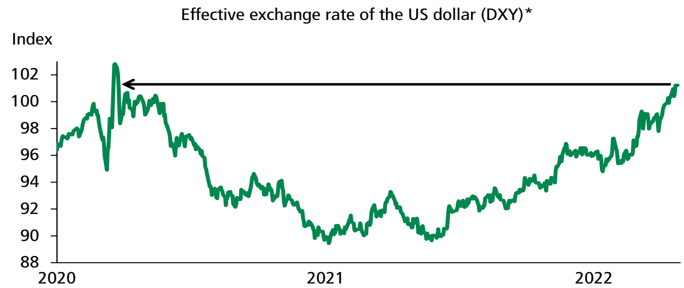
[1] Non-redeemable (annual); NOTE: Forecasts are represented using an asymmetric range reflecting the perceived probability of deviation from the base scenario. The mean of the range does not represent the forecast associated with the base scenario.
Source: Desjardins, Economic Studies

Exchange Rate

The War and Loose Monetary Policy Have Sent the Euro Lower

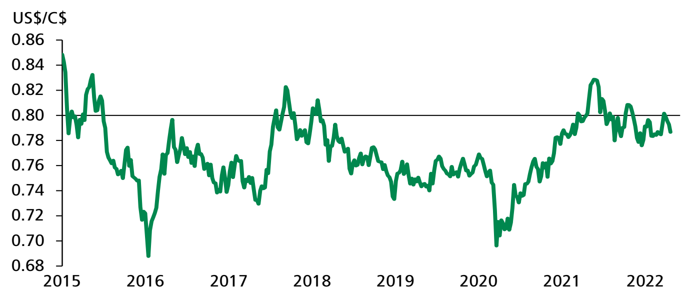
- The US dollar had a good April. The DXY index of the US dollar's effective exchange rate is at a two-year high (graph 4). The euro and the yen are just two of the major currencies struggling against the greenback. Loose monetary policy is hurting both. The Bank of Japan continues to make massive asset purchases to keep the 10-year bond yield at 0.00%. Given the current climate, that's an increasingly difficult policy to maintain. The yen is down about 5% this month after a similar decline in March. The European Central Bank also continues to buy up assets. Given the recent surge in inflation, however, we could soon see the beginning of a monetary policy tightening, which could help the euro.
- Commodity prices were a bit more subdued in April, slowing the Canadian dollar's rise. The loonie even traded below US$0.80 for much of April (graph 5). The biggest drag on the Canadian dollar is the widening US–Canada yield spread. But spreads have closed recently, strengthening temporarily the Canadian dollar somewhat—especially after Canada's higher-than-expected inflation numbers last week.
- **Forecasts:** If commodity prices fall, most commodity currencies could have a rougher go of it over the coming quarters. The Canadian dollar would also struggle if the Federal Reserve raised key rates higher than Canada's. European currencies have a better long-term outlook provided the war in Ukraine ends.

GRAPH 4
The US dollar is back to its pre-pandemic peak



* Based on a basket of currencies including the Canadian dollar, the euro, the pound, the yen, the Swiss franc and the Swedish krona.
Sources: Datastream and Desjardins, Economic Studies

GRAPH 5
The Canadian dollar struggles to sustainably cross 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

	2021		2022				2023			
END OF PERIOD	Q3	Q4	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
US$/CAN$	0.7886	0.7914	0.7999	0.8000	0.8000	0.7900	0.7800	0.7700	0.7600	0.7500
CAN$/US$	1.2680	1.2636	1.2501	1.2500	1.2500	1.2658	1.2821	1.2987	1.3158	1.3333
CAN$/€	1.4695	1.4370	1.3909	1.3750	1.4000	1.4557	1.5000	1.5325	1.5526	1.5733
US$/€	1.1590	1.1372	1.1127	1.1000	1.1200	1.1500	1.1700	1.1800	1.1800	1.1800
US$/£	1.3484	1.3545	1.3167	1.3000	1.3200	1.3500	1.3700	1.3800	1.3900	1.3900

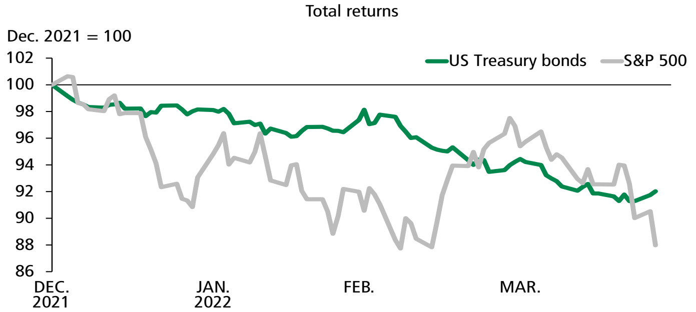
f: forecasts
Sources: Datastream and Desjardins, Economic Studies

Asset Classes Return

2022 Will Be a Tough Year for Riskier Investments

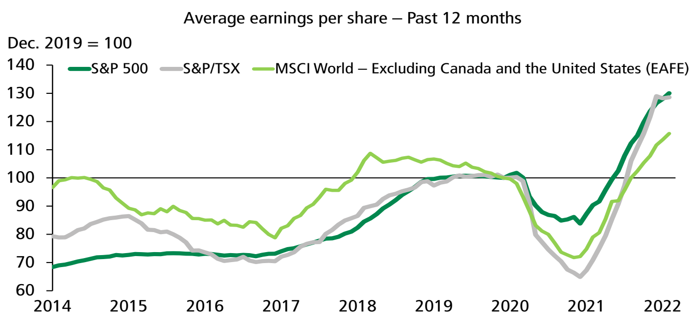
- **The year is off to a bad start for a number of asset classes.** Even before the war in Ukraine, North American stock markets were seeing more volatility. First, they fell on rapidly rising bond yields and rate hike expectations. Then the decline picked up speed in the run-up to the war in Ukraine. Investors tend to turn to bonds in times of uncertainty. There was a short lull in the bond market before prices fell again as interest rates continued to rise (graph 6).
- **Stock market gains remain fragile despite a March rebound.** The volatility caused by the war in Ukraine momentarily dropped in March. The Russian offensive has largely stalled, forcing the Kremlin to limit its military objectives. But the war in Ukraine is having very tangible economic effects, especially on inflation. Central banks in Europe, Canada and the United States have also taken a tougher tone since the invasion started as they seek to keep inflation in check.
- **Monetary tightening is the number one focus.** With inflation showing little sign of easing, investors are still skittish about bonds. The final level of interest rate required to bring inflation back to target remains hard to predict. The effects of the reduction of central banks' balance sheets should be more clear cut. As central banks retreat from bond markets, private investors will have to pick up the slack. The improving returns on bond markets should gradually incentivize investors to reallocate a larger share of their portfolio to this asset class.
- **Earnings growth is likely to slow.** The average earnings of publicly traded companies are up dramatically over the past year (graph 7). However, the extraordinary economic growth we've seen during the post-pandemic recovery will give way to more moderate growth in 2022. Inflation will remain high, continuing to fuel corporate revenue growth, but price increases may be harder to pass on to consumers as real wages shrink. Higher interest rates will also increase the cost of borrowing for businesses. Even if we see another year of strong profit growth, high stock valuations could make the markets a risky bet, especially in the United States (graph 8).
- **The Canadian stock market could fare better.** Unlike US markets, Canadian stock markets have performed relatively well since the start of the year (graph 9 on page 5). Furthermore, stock valuations on the S&P/TSX are starting at much more reasonable levels, making them less vulnerable to rising interest rates. However, the index is up mostly on higher commodity prices, and the commodity sector is expected to post smaller gains the rest of the year. We'll also be keeping an eye on the financial sector, which accounts for nearly 30%

GRAPH 6
Assets classes had a rough start to the year



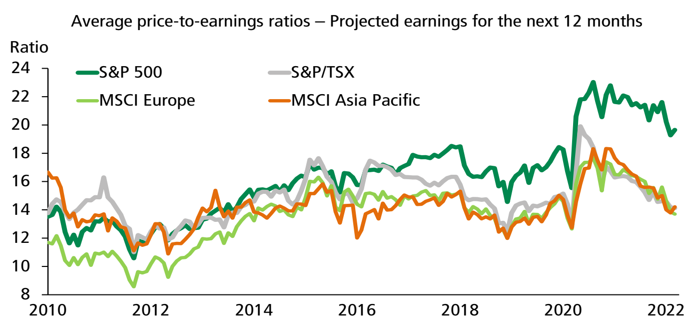
Sources: Datastream and Desjardins, Economic Studies

GRAPH 7
Corporate earnings are well above pre-pandemic levels



Sources: Datastream and Desjardins, Economic Studies

GRAPH 8
Price-to-earnings ratios are at an unsustainable level in the United States

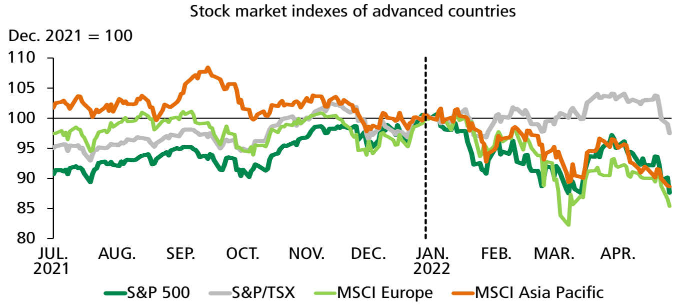


Sources: Datastream and Desjardins, Economic Studies

of the index. A high interest rate environment is usually good for banking sector profits as long as rates don't reach a level which could increase the risk of borrower defaults.

- **Global markets will also offer limited returns.** The European Central Bank (ECB) hasn't started raising rates yet, but its messaging has shifted as inflation continues to surprise. The war in Ukraine is expected to slow the economy in Europe more so than elsewhere. We'll therefore likely see smaller interest rate hikes from the ECB and other central banks on the continent. Europe's economic struggles will probably also mean weaker stock market performance. Returns could be a bit better elsewhere, but it's doubtful we'll see positive overall returns on overseas markets this year. The evolution of the Chinese economy will also have to be closely monitored as it could lead to an additional downside risk on various stock indexes in the coming quarters.

GRAPH 9
Canada's S&P/TSX index has performed relatively well since the start of the year



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]
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: 1.3	target: -7.0	target: 3.3	target: -6.7	target: -5.0	target: 0.2 (US$0.79)
range	1.1 to 1.5	-10.0 to -4.0	-11.7 to 8.3	-16.7 to 3.3	-15.0 to 5.0	-2.3 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