

## Interest Rate Forecast- April 2010

When the central bank makes a significant change, everyone takes notice and adjusts their views accordingly. At its last meeting, the Bank of Canada removed its conditional commitment to keep rates on hold until mid-2010 and raised its near term economic outlook thereby sending a clear signal to expect a rate hike at the June meeting. Markets reacted quickly with higher rates and yields, which spilled over to higher mortgage rates.

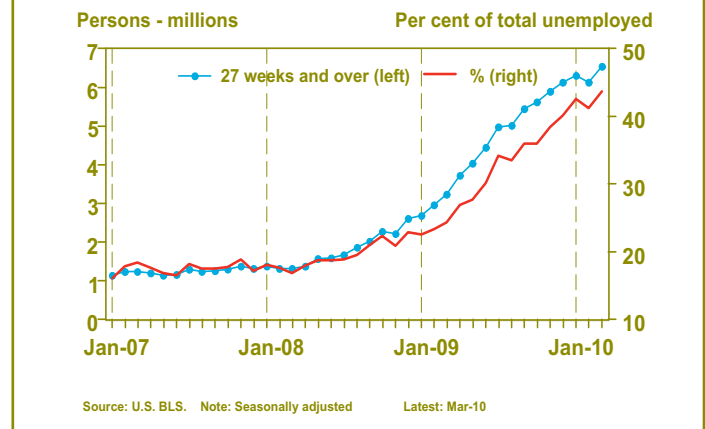
While the rate normalization phase will be underway in earnest during the second half of this year, its course thereafter is not as certain. Under the consensus forecast, economic conditions warrant a succession of rate increases during 2011 to bring rates into the lower end of the normal range. Clearly, the need for emergency low rates has past and higher interest rates are appropriate but an economic slowdown in the second half of 2010 causes the central bank to pause on its path to normal.

### Economy

Most recent data on U.S. spending and production indicates the economic recovery continues to unfold. However, the expansion needs to be sustained by increases in private demand since the boost from inventories is temporary and fiscal stimulus wanes later this year. Significant headwinds to the recovery exist, including weakness in residential and non-residential markets, poor consumer fundamentals, and the deteriorating fiscal position of state and local governments.

The U.S. housing market is slowly recovering from its deepest recession in decades but supply issues prevail. The homebuyers tax credit expiring in April is lifting existing-home sales at the expense of future sales and this sales boost does not look to be as large as last November's. Housing prices are bouncing along a bottom under a large inventory of unsold homes. The inventory of bank-foreclosed homes is estimated at above one million units and the shadow inventory at close to five million units. The shadow inventory

### U.S. Long-term Unemployment



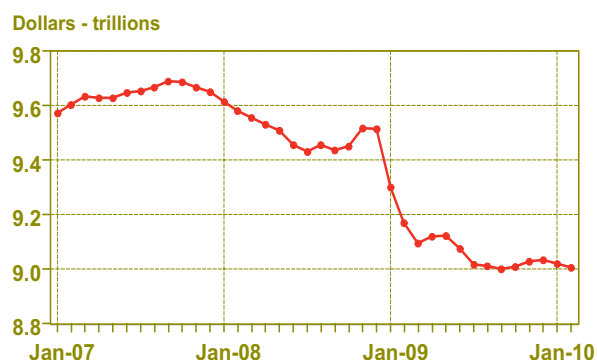
refers to mortgage holders in arrears more than 60 days or in the foreclosure process.

Mortgage rates could edge higher hindering affordability gains with the end of the Fed's purchases of mortgage-backed securities in March. When the tax credit inspired home sales end, the market will rely on private demand driven by fundamentals of job and income growth and security, financing costs, and population/household growth. In the near term, these consumer fundamentals suggest weak to moderate sales numbers and not the stuff of a strong housing led economic recovery.

While the labour market posted its first job gain significant gain in March, it remains weak with high unemployment and minimal income growth. Unemployment is almost 10% and long-term unemployment grows with each passing month. Those unemployed for 27 weeks and more have risen to almost seven million persons and to more than 40% of total unemployed. Inflation-adjusted personal income from private sources (non-government) is down to 2005-2006 levels and not yet growing.



## U.S. Real Personal Private Income



Source: U.S. Federal Reserve, C1CU. Note: Seasonally adjusted Latest: Feb-10

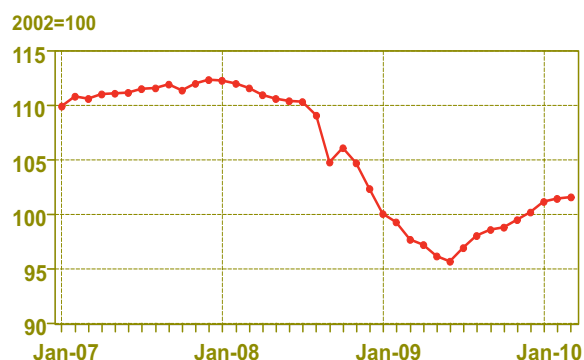
The labour market and incomes are one of the last areas to exhibit growth coming out of a recession. The past recession left more unemployed than at any time since the 1930s along with the largest income decline on record. Growth from these depths hinges on exports, technical change and innovation, looser credit conditions, enabling policies including low interest rates, and more attractive consumer fundamentals. The government sector has done about as much as it can to initiate and spur economic growth and from here on it is up to the private sector.

Industrial production, while hardly growing in March, is set to expand further as businesses need to grow inventory and output more closely matching sales. The boost to output that comes from this restocking phase will drive industrial production gains for much of the year.

U.S. economic growth is forecast to slow in the second half of 2010 to the 2 to 3% range from 3 to 4% in the first half. Q2-2010 real GDP growth could well be the high water mark for this year. Private sector growth should begin to build momentum in 2011 when some of the excesses, restrictions, and market imbalances are worked off or remedied.

Real GDP growth in 2011 is in the 3 to 3.5% range with stronger growth in the second half than in the first half. Since the consumer will come to the fore late in this recovery, the outlook for 2012 is more positive with growth in the 3.5 to 4% range. That higher growth in the U.S. economy is forthcoming is not in doubt; it is just a matter of timing.

## U.S. Industrial Production



Source: U.S. Federal Reserve. Note: Seasonally adjusted Latest: Mar-10

Much of Canada's growth profile depends on the U.S. despite the recent reliance on domestic demand during this recovery. Personal consumption, residential investment, and government spending propelled the economy out of recession largely due to various policy stimulus measures but some of these have ended or are about to end. Canada's 5% annualized growth rate in the last quarter of 2009 coupled with a similar figure in the first quarter of 2010 highlights this growth source.

Business investment is a lagging particularly in non-residential construction though gains in machinery and equipment purchases are forthcoming thanks to the high Canadian dollar. Another growing source of business investment is inventories, which will make a larger contribution to growth in 2010, albeit temporary.

Residential investment is set to expand at a double digit pace in the first half and possibly into the third quarter on the strength of new home construction. Home renovations activity probably peaked in the first quarter when the federal tax credit expired. Housing starts are up 10% in the first quarter following a 14% jump in the previous quarter and some activity is due to the pending HST in B.C. and Ontario in addition to the broad-based improvement in housing markets.

This source of growth wanes in the second half of the year with the end of the HST-induced spurt and to worsening affordability brought about by higher mortgage rates, tighter credit rules, and higher housing prices. Recently, housing sales have topped out and show signs of weakening.

A fair portion of personal spending is related to the health of the housing market and a slowdown in housing starts affects spending on furniture, furnishings, and household equipment.

A second half growth slowdown is almost certain with the ending of various temporary growth sources driving the recovery and the expected U.S. slowdown. The fourth quarter of 2010 is the weakest in the forecast at growth less than 2%.

Government spending is set to decline in 2011 with the completion of many infrastructure projects and government's attempts to reduce deficits and control rising debt by limiting the growth of spending of goods and services. Public sector employment, excluding the health sector, undergoes downsizing during this period.

Growth in 2011 and beyond must come from the private sector, which includes exports. The problem of the high Canadian dollar diminishes when export prices are high or rising. The commodity price outlook is generally positive but export volumes will be constrained by below normal consumption levels of autos, new housing, and energy in the U.S. into 2012. Canada's primary exports need robust markets to make a significant contribution to economic growth and to offset rising imports.

Annual economic growth is forecast at 3.5% this year slowing to 2.6% next year and picking up to 3 to 3.5% in 2012. The

The Bank of Canada's latest economic outlook concludes that Canada's economic recovery will slow with a fading housing surge and government stimulus. The Bank uses the term "front-loaded" growth because of record low interest rates and fiscal stimulus. The Bank upgraded its 2010 growth forecast to 3.7% from 2.9% in January and reflects stronger than expected growth of 5% annualized in the fourth quarter of 2009 and an estimated 5.8% in the first quarter of 2010. Economic growth diminishes in each successive quarter to mid-2011.

Forecast real GDP growth slows to 1.9% from mid-2011 to the end of 2012. The Bank's rationale for this rather anemic growth performance is poor productivity performance and demographically constrained labour force growth. This is the Bank's estimate of the economy's potential growth rate. Another factor, though not publically

stated, is uncertainty – it is a default position and not to be taken too seriously as a medium term forecast.

Based on the Bank's forecasts of actual and potential growth, the economy is expected to reach full capacity in the second quarter of 2011, one quarter sooner than previously estimated. As usual, the Bank has inflation returning to its 2% target later in the forecast.

The Bank identified several forecast risks among them sovereign debt issues, the high Canadian dollar, global economic growth, commodity prices, fiscal consolidation, and macroeconomic global imbalances. Some of the risks are both on the upside and downside. Since this financial crisis-induced recession is not your garden-variety recession, credit constraints result in a below average recovery growth while aggressive policy stimulus leads to front-loaded growth followed by a slowdown.

## **Inflation**

Inflation is not a problem nor expected to be a problem during the forecast period. The HST in BC and Ontario temporarily lifts headline CPI but it is a one-time upshift in the CPI. The Bank's core CPI inflation measure excludes the impact of the HST and is a better assessment of underlying inflation than the headline CPI.

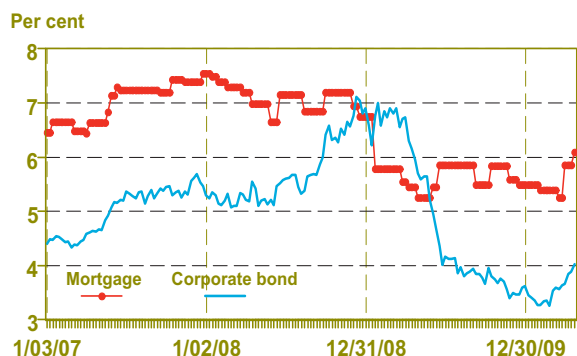
Most recently, the Bank of Canada's core CPI index advanced 1.7% in the 12 months ending March, following a 2.1% rise in February. On a monthly basis, the seasonally adjusted monthly core index fell 0.3% in March, following a 0.4% increase in February.

## **Monetary policy**

The Bank of Canada held the overnight rate target at 0.25% but removed its conditional commitment. The removal of the conditional commitment to hold its target rate at 0.25% was most significant and cleared the path for an interest rate increase on June 1<sup>st</sup>. For a central banker, this is as unambiguous as it gets and markets immediately priced in that expected increase. The main question facing market participants is whether June's increase is 25 bps or 50 bps.

In the U.S., the Fed's significant change in language comes when it removes the "extended period" phrase. Removing the extended period language signals a first rate hike though

### 5-yr. Fixed Term Posted Mortgage Rate and AA Corporate Bond Yield, Weekly, Canada



Source: Bank of Canada, BMOCM, C1CU.

Latest: 21/04/10

not necessarily at the next meeting as in Canada. The likely scenario has the Fed altering its statement in 2011 since the amount of slack or excess capacity in the economy is very large.

### Interest rates

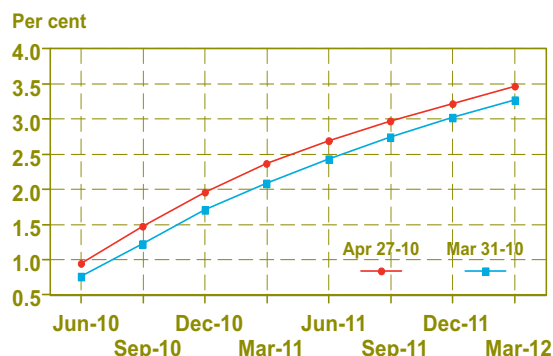
Upward pressure on interest rates continued into April pushing up bond yields and some administered rates. A sharp upturn occurred immediately after the Bank of Canada's removal of its conditional commitment on April 20. Fixed term posted mortgage rate jumped 25 bps followed by another 15 bps a few days later. Discounted mortgage rates moved up by similar amounts. Mortgage rates moved up due to a higher cost of funds in the market and are up more than a full percentage point in about six weeks.

GIC deposit rates barely moved during this period but are poised to increase since yields on competing savings instruments such as government bonds are up about 50 to 60 bps depending on term. The current spread between the 5-year government bond yield and the 5-year redeemable GIC rate is among the largest on record.

### Interest rate forecast

The forecast incorporates the central bank's conditional removal and its revised economic outlook. The first Bank of Canada move comes on June 1 with a 25 bps increase in its target rate followed by a series of similar hikes at each meeting for the rest of the year. The market has anticipated this change and begun tightening monetary conditions by

### Three-Month Canadian Bankers' Acceptance Futures



Source: Montreal Exchange, C1CU.

raising various lending rates and bond yields.

While the rate path for the next few months is fairly certain, how rates play out after 2010 is open to debate. The futures market for three-month Bankers Acceptances is pricing in rate increases at every meeting until June 2011 followed by intermittent increases through to March 2012. In total, the market expects short rates to increase of more than 275 bps. The Bank's target rate would be at least 3.00% with the prime lending rate at 5.00% in March 2012.

The market's expectation is based on an economic forecast that does not include a notable slowdown period unlike this interest rate forecast which incorporates a second half 2010 economic slowdown in the U.S. and Canada. Given the reporting lags in economic data, this slowdown will not be materially evident until late 2010. For example, Canada's third quarter 2010 real GDP estimate will be released on Nov. 30, 2010.

Economic forecasters are evenly split between higher and lower growth in 2011 than in 2010 but a shift towards lower growth in 2011 is occurring. A similar shift towards weaker 2011 growth has taken place among U.S. economic forecasters. Central bankers react to economic developments and regularly adjust their forecasts and the futures market is no different.

### Target Overnight Rate Forecast

Meeting Date	Rate (%)
Mar. 2, 2010	0.25
Apr. 20	0.25
June 1	0.50
July 20	0.75
Sept. 8	1.00
Oct. 19	1.25
Dec. 7	1.50
Jan. 2011	1.50
Mar.	1.50
Apr.	1.50
June	1.50
July	1.75
Sept.	2.00
Oct.	2.25
Dec.	2.50
Jan 2012	2.75
Mar.	3.00

### Interest Rate Forecast

Item	2010 Q1a	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2012 Q1
Target Overnight Rate	0.25	0.35	0.75	1.25	1.50	1.50	1.75	2.25	2.75
Prime Rate	2.25	2.35	2.75	3.25	3.50	3.50	3.75	4.25	4.75
1-mo. T-Bill	0.15	0.30	0.75	1.15	1.35	1.40	1.70	2.25	2.75
3-mo. T-Bill	0.20	0.45	0.85	1.30	1.50	1.50	1.85	2.35	2.85
6-mo. T-Bill	0.30	0.75	1.10	1.55	1.65	1.60	2.00	2.60	3.15
1-year T-Bill	0.65	1.30	1.60	1.95	2.00	1.90	2.40	3.00	3.50
2-year GoC Bond	1.40	2.15	2.35	2.60	2.50	2.35	2.75	3.30	3.70
3-year GoC Bond	1.75	2.60	2.65	2.75	2.70	2.75	2.95	3.40	3.75
5-year GoC Bond	2.60	3.25	3.35	3.40	3.30	3.35	3.45	3.80	4.05
10-year GoC Bond	3.45	3.80	3.85	3.85	3.80	3.85	4.05	4.35	4.55
Spread: 10y less 3m	3.25	3.35	3.00	2.55	2.30	2.35	2.20	2.00	1.70

Note: Quarterly average based on daily data. a = actual, all others forecast.

### Deposit Rate Forecast

Item	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2012 Q1
Prime Rate	2.25	2.35	2.75	3.25	3.50	3.50	3.75	4.25	4.75
1-year GIC	0.28	0.35	0.45	0.70	0.75	0.70	1.05	1.50	1.95
3-year GIC	1.33	1.50	1.65	1.70	1.75	1.70	1.90	2.15	2.50
5-year GIC	1.88	2.10	2.20	2.25	2.20	2.25	2.35	2.70	2.90

Note: Quarterly average based on weekly data. a = actual, all others forecast. Redeemable rates.

### Lending Rate Forecast

Item	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2012 Q1
Prime Rate	2.25	2.35	2.75	3.25	3.50	3.50	3.75	4.25	4.75
1-year Mortgage	3.60	3.85	3.95	4.35	4.40	4.40	4.70	4.95	5.25
3-year Mortgage	4.20	4.95	4.95	5.00	5.10	5.15	5.25	5.55	5.75
5-year Mortgage	5.43	6.15	6.25	6.15	6.10	6.10	6.25	6.55	6.85

Note: Quarterly average based on weekly data. a = actual, all others forecast. Posted fixed term rates.

### Central 1 Credit Union Economics

Helmut Pastrick, Chief Economist . David Hobden, Economist . Bryan Yu, Economist. Judy Wozencroft, Economics Coordinator