

## Interest Rate Forecast- May 2010

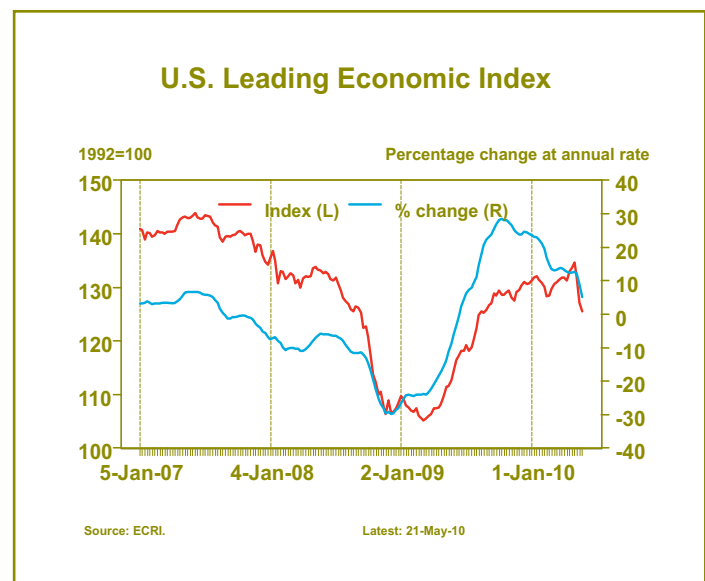
While the Euro debt crisis roils markets and heightens uncertainty, the economic recovery faces additional challenges from several sources. The initial cyclical lift from the inventory cycle and pent-up demand accumulated during the recession is ebbing along with some policy stimulus measures. A growth slowdown is in the offing.

The Bank of Canada's continues to remove monetary stimulus this year until the growth slowdown prompts a pause for a few months. The economic recovery is well entrenched in Canada under a moderate growth outlook. The main concerns are on the external front and with Canada's weakening trade sector.

### Economy

The Euro debt crisis will probably not cause a global recession. The amount of debt involved in those European countries is small compared to the trillions involved in the US mortgage market and the exposures and risks are more transparent and better understood than in the sub-prime crisis. Also, the global economy is stronger and monetary policy is very accommodative compared to the financial crisis of 2008. Perhaps most importantly, European authorities and the IMF have provided a strong package of support, about \$1 trillion US, involving access to funding for troubled European countries and the European Central Bank buying public and private securities in the euro-zone. This support buys time for those high-debt countries to make some progress in cutting their deficits. In the Euro area, economic growth will be weaker due to the debt crisis and fiscal contraction though a much lower currency provides some export offset.

This does not mean that future events will unfold smoothly and there will be no further market disruptions. The weakened financial system in Europe makes it vulnerable since many of its banks are the holders of problem debt and a banking crisis is possible. Debt restructuring, should it occur, often results in repayment below face value. The likely scenario is that it will unfold more like the Asian crisis



in 1997-98 rather than the financial crisis of 2008. The Asian crisis saw sharp regional economic and equity market slumps but global growth continued.

The U.S. economic recovery appears robust with GDP growth rates of 2.2%, 5.6%, and 3.0% in the last three quarters ending March 2010. However, the economy is weaker than those headline numbers. Demand or final sales



to domestic purchasers, a less reported metric, is growing 2.3%, 1.4%, and 2.0% in the same quarters and gives a more accurate picture of the economy's condition. The difference between these figures is inventories, a temporary source of growth. Inventory adjustments by manufacturers, wholesalers, and retailers have played a large role in the initial phase of this recovery.

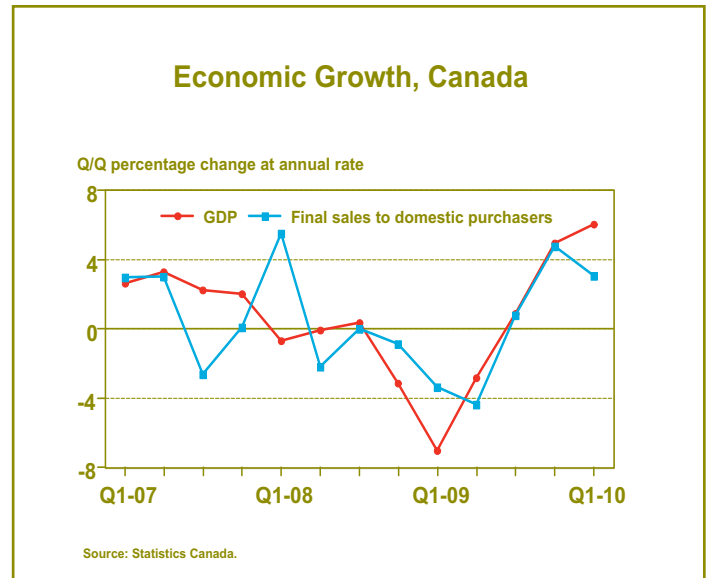
Private sector demand growth in the U.S. while improving remains muted due to high unemployment and household debt levels. Wage income growth is occurring but it is not robust with unemployment near 10%. Household wealth remains well below its peak and some limitations to credit access remain. Housing prices are not expected to post any significant gains this year or likely next year. On the plus side, consumers have cut their debts and debt payments and perhaps most importantly, job growth has materialized.

A self-sustaining recovery depends critically on job growth. Employment was up rather sharply in March and April aided in part by temporary hiring for the 2010 Census as will the May report. Nonetheless, the labour market is improving and more hiring than layoffs are occurring. The number of hours worked per week is also inching up. These are positive signs for the economy and consumer spending but the outlook remains problematic.

A reliable indicator of the economy's short-term performance is flashing slowdown ahead. This weekly index is a 39-week low and clearly points to slower growth in the next two quarters. In addition to this technical measure, fundamental considerations are the approaching end of the inventory adjustment, a winding down of fiscal stimulus such as the end of the housing tax credit in April, the upcoming Census layoffs, and some negative fallout on confidence from the Euro debt crisis along with the higher USD cutting into exports. Looking further ahead, fiscal contraction is a larger force in 2011, which likely begins with the end of the Bush tax cuts.

There are positive forces that will keep the economy growing but at a moderate rate. Oil prices are temporarily lower saving consumers and businesses money, which can be re-directed to other purposes. Interest rates remain very low and access to credit is improving though still a restraint. The 30-year mortgage rate fell well below 5.00% in the past month.

Forecasts for real GDP growth through to 2012 are in the



3% range. A weaker performance is expected in the second half of 2010 and into 2011. By the second half of 2011, above 3% growth is likely when the approaching slowdown has run its course. The lingering impact of the financial crisis on the debt reduction process by households and businesses keeps growth in the moderate range but after more progress on deleveraging a higher growth phase is likely.

Canada's growth performance has been stronger than in the U.S. but here too the inventory cycle is overstating underlying demand growth. Real GDP grew 0.9%, 4.9%, and 6.1% in the latest three quarters, however, stripping out inventories leaves final sales growing at 0.8%, 4.8%, and 3.1%, respectively. The 1Q 2010 difference is most stark with the inventory buildup accounting for 40% of the quarter's growth.

Canada's trade sector remains its weak link and the Euro crisis results in mixed signals. The CAD is lower, which positive for trade, but lower commodity prices are not. On balance, the drop in commodity prices is larger than the drop in the CAD leaving the trade sector weaker than before the crisis.

Fiscal stimulus in Canada will be winding down leaving the private sector to generate growth. The Canadian government has already begun to remove some of its stimulus measures such as the Home Renovation Tax Credit which ended in January. In addition, the government announced that its infrastructure program would end in March 2011 as scheduled.

A housing slowdown is already underway in Canada with housing sales on a declining trend since late 2009 and housing prices following behind. The initial strong recovery phase in the housing market is changing to a moderate market adjustment phase that will likely extend to mid-2010 and perhaps beyond before settling into a more narrow activity range. However, in 2011, a market revival is expected when affordability conditions have improved and confidence levels are higher.

The Harmonized Sales Tax (HST) coming to B.C. and Ontario on July 1, 2010 will influence the monthly profile of housing activity. Some housing sales and housing starts will be pulled forward prior to its implementation at the expense of future activity. Other consumer spending could follow the same pattern but thereafter consumer spending will likely be lower under the HST than with no HST. There is a one-time increase in the headline Consumer Price Index because of the HST. The main benefits of the HST are lower business costs, a lower cost of investment, a more transparent tax, and lower tax collection costs.

The out-sized job gain in April is unlikely to be repeated any time soon and to some extent overstates the performance of the economy. The trend growth rate since the recovery began is around 30,000 per month, which is where the consensus expectation normally lies. A contraction in May is quite possible since the sample can generate large swings and a very large monthly gain is often followed by a loss. The Labour Force Survey sample is too small.

Canada's economy enjoys moderate growth in 2010 but with some easing later in the year and into 2011 before another growth pickup materializes. The initial cyclical lift extends into the second quarter of 2010 before easing due to a smaller inventory adjustment, less residential construction, and fewer exports to the U.S. For the 2010 as a whole, inflation-adjusted growth in the 3.0 to 3.5% range is likely followed by a slightly weaker performance of 2.5 to 3.0% in 2011.

## Inflation

Consumer Price Index headline inflation in Canada rose by 1.8% in April from a year ago, following a 1.4% increase in March. Similar to recent months, the 12-month change in energy prices, primarily gasoline, was the main driver of inflation. The Bank of Canada's core index,

which excludes energy and other volatile items, advanced 1.9% over the 12 months to April, following a 1.7% rise in March. April's increase was due primarily to a rise in prices for the purchase of passenger vehicles, passenger vehicle insurance premiums, property taxes, and food purchased from restaurants.

Inflation pressures in Canada and the U.S. are not an issue currently or in 2011. Excess capacity in the real economy drives the medium term inflation outlook and until the output gap closes, inflation pressures will be moderate.

Some observers point to monetary indicators such as the central bank's larger balance sheet as a potential source of future inflation but this is a non-issue since the central bank has the means to shrink its balance sheet in an orderly manner. Others point to the large and increasing government debt, particularly in the U.S., as a potential inflation source. This is also somewhat misplaced and rather the main concern should be about financing that debt and the potential for 'crowding out' private sector demand leading to higher bond yields.

## Monetary policy

The Bank of Canada followed through on its signal in the April rate announcement removing its conditional commitment to keep rates unchanged until mid-2010. The Bank began raising rates at its June 1 meeting and re-established the normal operating band of 50 basis points for the overnight rate. Obviously, the Bank sees the recent improvements in Canadian economy as strong indications that the emergency conditions that forced near-zero rates are past.

In its carefully worded statement, the Bank mentioned the downside risks to its outlook because of the problems in Europe. It concluded that the spillover has been limited to a modest fall in commodity prices and some tightening of financial conditions. The Bank also stated that there is considerable monetary stimulus in the economy after the 0.25% increase in the policy rate to 0.50%. Reading between the lines, should the Europe situation not cause further collateral damage to Canada and the economy performs to their expectations, expect further monetary tightening.

## Interest rates

There was considerable movement in interest rates during May beginning with a modest cut to posted fixed term mortgage rates followed by lower government bond yields by mid-month in a reaction to lower U.S. bond yields and the Euro debt crisis. Short-term t-bill rates moved up in anticipation of the Bank's June 1<sup>st</sup> increase.

## Interest rate forecast

The Bank of Canada will raise rates by 0.25% at its July meeting and again in September. This forecast sees rate increases until December followed by a pause period in response to the coming economic slowdown. After a few months, the rate normalization process continues at a measured and moderate pace.

Some forecasters see a more aggressive rate normalization process with the policy rate at 3.50% by the end of 2011 compared to 2.50% in this forecast. The main difference is a stronger expected economic performance than used here. A normal policy rate for Canada is in the 3.50 to 4.00% range and it is just a question of when normal returns.

The futures market for three-month Bankers Acceptances has pared down its expectations from last month and is expecting this rate up 200 to 225 basis points by the end of 2011. This compared to about 250 bps one month earlier and no doubt, the Euro debt crisis is influencing these expectations.

In uncertain times, it is useful to look at an alternative scenario. Should the Europe debt crisis devolve into a banking crisis, which spills over into U.S. banks, and indirectly into Canada downgrading the economic outlook, the Bank would hold off on rate hikes and possibly cut rates. All other rates and yields would come down as well. This, however, would set the stage for another economic revival later.

| Target Overnight Rate Forecast |          |
|--------------------------------|----------|
| Meeting Date                   | Rate (%) |
| June 1, 2010                   | 0.50     |
| July 20 (f)                    | 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     | 0.25    | 0.60    | 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    | 1.05    | 1.55    | 1.65    | 1.70    | 2.00    | 2.50    | 3.05    |
| 1-year T-Bill         | 0.65     | 1.25    | 1.50    | 1.90    | 2.00    | 1.90    | 2.40    | 2.95    | 3.45    |
| 2-year GoC Bond       | 1.40     | 1.95    | 2.15    | 2.45    | 2.50    | 2.35    | 2.75    | 3.25    | 3.60    |
| 3-year GoC Bond       | 1.75     | 2.30    | 2.45    | 2.65    | 2.70    | 2.65    | 2.95    | 3.30    | 3.70    |
| 5-year GoC Bond       | 2.60     | 3.00    | 3.15    | 3.30    | 3.30    | 3.35    | 3.50    | 3.70    | 4.00    |
| 10-year GoC Bond      | 3.45     | 3.55    | 3.65    | 3.75    | 3.80    | 3.85    | 4.00    | 4.25    | 4.50    |
| Spread: 10y less 3m   | 3.25     | 3.10    | 2.80    | 2.45    | 2.30    | 2.35    | 2.15    | 1.90    | 1.65    |

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    | 0.55    | 0.75    | 0.90    | 0.95    | 0.90    | 1.25    | 1.55    | 1.95    |
| 3-year GIC | 1.33    | 1.40    | 1.45    | 1.55    | 1.65    | 1.60    | 1.80    | 2.05    | 2.45    |
| 5-year GIC | 1.88    | 1.95    | 2.05    | 2.15    | 2.15    | 2.15    | 2.25    | 2.50    | 2.75    |

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    | 3.70    | 3.95    | 4.35    | 4.40    | 4.40    | 4.80    | 5.25    | 5.65    |
| 3-year Mortgage | 4.20    | 4.60    | 4.65    | 4.85    | 4.90    | 4.90    | 5.25    | 5.55    | 5.95    |
| 5-year Mortgage | 5.43    | 6.05    | 6.00    | 6.15    | 6.10    | 6.10    | 6.25    | 6.50    | 6.75    |

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