Central 1 — Interest Rate Forecast

Economics April 2017

Highlights

- Fed hike on March 15, moving to balance sheet policy
- BoC boosts growth outlook
- Geopolitical tensions rise

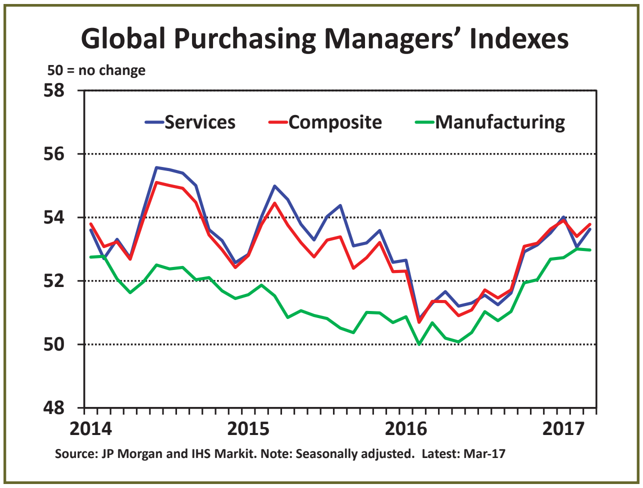
The global economy advanced during March maintaining the growth upshift of the past few months. In the near term, slower growth is likely when inventory restocking and consumer sentiment cools on higher energy prices and rising geopolitical tensions combining to slow manufacturing output. Uncertainty over U.S. trade and tax policies along with foreign policy is a growing concern for markets and economic agents and may dampen or disrupt improved growth widely expected in 2017 and 2018.

The J.P. Morgan global all-industry output PMI increased in March but showed signs of stabilizing following the yearend rally. March's gain was broadly based across the main economies led by Japan, the Euro area, and the UK. The US index slipped.

US economic growth in Q1-17 looks to be following a familiar pattern with GDP growth sagging to around 1.5% annualized from 2.1% in Q4-16. A bounce back to 2.8% in Q2-17 is foreseen. A residual seasonal adjustment problem is partly to blame for Q1 weakness in the past few years.

The US labor market remains in good shape despite a weaker employment number in March and downward revisions to January and February. The average employment gain in Q1-17 was 178,000, slightly higher than the 170,000 average In Q4-16. An East Coast snowstorm during the payroll reference week affected the March estimate. The ISM nonmanufacturing index decreased in March as did the manufacturing index.

Retail sales were weak in March falling 0.2% and February sales were revised to a 0.3% decline. Weaker auto sales accounted for all of the decline in March and for much of the downward revision to February. Core sales, excluding auto dealers and



gasoline stations, were essentially unchanged for the second straight month after the downward revision to February.

The US economic outlook is mostly positive, setting aside various policy risks. Economists are forecasting growth at 2.3% in 2017, 2.5% in 2018, and 2.1% in 2019 in a rising interest rate and low unemployment rate environment. The new US administration's proposed fiscal and deregulation plans have lifted growth expectations from pre-election times.

Risks to the outlook are considerable and policy uncertainty on the fiscal front looms large and could slow growth. Tax cuts and increased federal spending would be positive for consumers and businesses, but the amount and timing of these policies are highly uncertain. Higher deficits and debt are not a Republican policy platform nor is a border-adjustment tax endorsed by either party. If the failed health care reform bill is any indication, agreeing on a budget plan will be equally contentious and difficult.

Congress has an April 28 deadline to renew the expiring government spending authority and failure would result in a government shutdown. This would likely be temporary, as in 2013, which lasted two weeks and unsettled financial markets. A federal budget for fiscal 2018 that begins October 1 must be brought forward and passed. Further, the Treasury debt limit must be increased at roughly the same time. The president and Congress need to come to agreement on these weighty matters, which will require compromises on all sides.

China's GDP growth rose 6.9% on a year-ago basis in the first quarter, up from 6.7% in 2016. It was the fastest growth since the third quarter of 2015 was broadly based across most sectors with gains in construction, industrial production, investment, exports, and retail spending. The 2017 growth target of 6.5% looks achievable – not surprising because China has never missed a growth target.

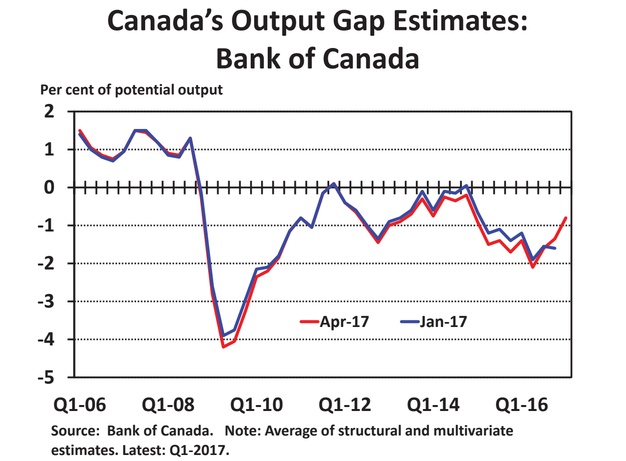
The Bank of Canada's latest *Monetary Policy Report* projected stronger growth in 2017 compared with last report and revised down its estimate of potential growth. This combination has the Bank anticipating that the output gap will close in the first half of 2018 rather than around mid-2018 in its prior two projections. The Bank was still cautious stating that it is too early to conclude that the economy is on a sustainable growth path. The projection to pull forward the closing of the output gap prompted forecasters to move up the first policy rate hike.

The Bank revised up its forecast for Q1-17 real GDP to 3.8% annualized from 2.5% previously. Much of this upgrade was attributed to a consumption boost from the Canada child benefit and strong housing activity. Q2-17 growth was projected at 2.5%. For all of 2017 growth was put at 2.6% compared to 2.1% in January. Real GDP growth is expected to slow in the second half of 2017 to less than 2%.

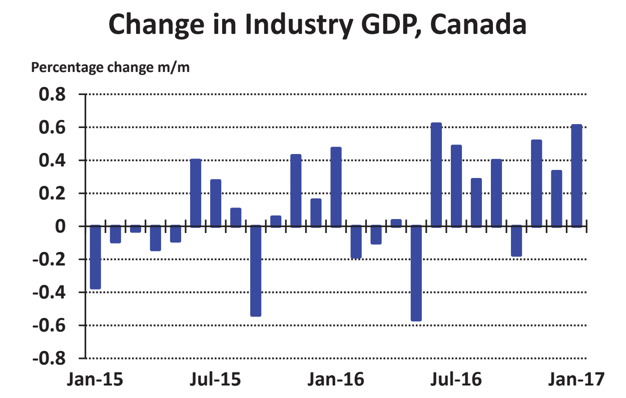
The Bank downgraded its 2018 growth forecast to 1.9% from 2.1% and posted its first 2019 projection put at 1.8% growth in real GDP. The Bank sees trade and business investment contributing more to growth with less lift coming from housing, government, and consumption. This has been a long-standing theme of the Bank's medium-term forecasts that has yet to pan out.

Canadian real GDP industry growth started the year on a strong note with total output advancing 0.6% in January. The gain was driven by manufacturing, energy production, residential construction, retail and wholesale trade. January's gain followed December's 0.3% advance. There is some skepticism whether the economy will maintain this pace.

More recent data are mixed. Canada's trade balance fell into deficit for the first time in four months. In real terms, exports decreased 2.5%, while real imports rose 0.3% and marked the first real trade balance deficit since September. Manufacturing sales slipped 0.2% in February after three consecutive months of gains though the volume of goods sold rose by 0.1%. Housing starts surged to their highest level since the recession.



Source: Bank of Canada. Note: Average of structural and multivariate estimates. Latest: Q1-2017.



Source: Statistics Canada, Central 1 Credit Union.

Total employment grew by 19,400 in March, slightly outpacing February's gain of 15,300. First quarter job growth now totals 83,000, a slight dip from the 91,000 jobs added in the fourth quarter of 2016.

A key element in the Bank's projection is the downgrade in potential output growth to 1.3% in 2017 from 1.5% previously. The Bank also downgraded 2018 to 1.4% from 1.5%. The rationale was "slower-than-anticipated trend labour productivity growth resulting from the unanticipated weakness in business investment." The Bank sees potential growth edging higher to 1.6% in 2020, which is consistent with their view on more business investment.

Potential output is a theoretical concept and not measurable. It is estimated using various statistical techniques and estimates are subject to revision and error, which is why the Bank presents their estimates in ranges and uses the mid-point as the base case. The 2017 mid-point is 1.3% in a range of 1.0% to 1.6%. The range expands over time, reflecting estimation uncertainty, to 1.1% to 1.9% in 2019. If potential output growth is higher than the mid-point, the output gap would close later than assumed and vice versa.

Economic Forecast - Canada

	2016 Q3	2016 Q4	2017 Q1	2017 Q2	2016	2017	2018	2019
Real GDP, % a.r.	3.8	2.6	3.0	2.0	1.4	2.5	2.3	2.1
Unemployment Rate, %	7.0	6.9	6.7	6.6	7.0	6.6	6.4	6.1
Total CPI, % y/y	1.2	1.4	1.7	1.8	1.4	1.8	1.9	2.1

Source: Statistics Canada, Central 1 Credit Union. Shaded values are forecasts.

The Bank looks at several measures of inflationary pressures in addition to the output gap and potential output. Capacity utilization rates, wages and costs, inflation expectations, real estate activity, foreign trade indicators, and various inflation measures are considered. There are occasions when the output gap closed without inflation climbing above 2%. The Bank reacts not only to current conditions but also to prospects for the economy and inflation.

Our forecast has 2017 growth at roughly the same pace as the Bank but we have slightly higher growth rates for 2018 and 2019 and we think potential output growth is higher than the Bank's mid-point estimate. Consequently, we see the output gap closing in the second half of 2018 rather than in the first half as the Bank does.

The economic forecast directly impacts the timing of rate changes. We moved up the first bank rate increase to July 2018 from September because potential output growth was lowered. If the Bank's projection were followed, the first increase would likely occur in late 2017. The Bank always moves ahead of the output gap closing, assuming prospects are favourable. The futures market for 3-month BAs is pricing a 25bps rate increase in May 2018.

The bond market has unwound recent yield gains with yields down around 20 to 25bps in the past month, depending on term. Markets reacted to geopolitical events, doubts about Trump's ability to implement tax policy changes, and some softer US economic data in March. The US 10-year Treasury yield is below 2.20%, its lowest since the election. Canada's bond yields followed US yields lower.

A notable development occurred in the FOMC March minutes suggesting that it would be appropriate to start its balance sheet normalization process later this year. This would take the form of either ceasing or phasing out reinvestments of both Treasuries and MBS. As to timing, normalization will likely begin later this year. This balance sheet policy can be considered a policy-induced tightening of financial conditions and it will be done gradually over a long period of time.

More importantly, the Fed raised its policy rate by 25bps. Markets are pricing in another Fed rate hike in October and one more Sept. 2018. This is a more subdued rate profile than in the FOMC minutes and in the consensus forecasts, which sees two more increases this year and another two increases next year.

Uncertainty is running quite high as is the way forward. Conceptually, the economy should advance at a reasonable pace and interest rates normalize within the next two to four years. However, policy missteps could setback normalization and this is main uncertainty with the new US administration along with other geopolitical actors.

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Target Overnight Rate Forecast

Meeting Date	(Per cent)
Apr. 12, 2017	0.50 (a)
May 24	0.50
July 12	0.50
Sep. 6	0.50
Oct. 25	0.50
Dec. 6	0.50
Jan. 2018	0.50
Mar.	0.50
Apr.	0.50
June	0.50
July	0.75
Sep.	0.75
Oct.	0.75
Dec.	0.75
Jan. 2019	1.00
Mar.	1.00

Source: Bank of Canada, Central 1 Credit Union.
(a) actual

Interest Rate Forecast									
	2017 Q1a	2017 Q2	2017 Q3	2017 Q4	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1
Target Overnight Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.75	0.75	1.00
Prime Rate	2.70	2.70	2.70	2.70	2.70	2.70	2.95	2.95	3.20
1-mo. T-Bill	0.43	0.45	0.45	0.45	0.45	0.45	0.70	0.70	0.95
3-mo. T-Bill	0.47	0.50	0.50	0.50	0.50	0.50	0.75	0.75	1.00
6-mo. T-Bill	0.52	0.55	0.55	0.55	0.55	0.55	0.80	0.80	1.05
1-year T-Bill	0.61	0.60	0.60	0.65	0.65	0.65	0.95	0.95	1.20
2-year GoC Bond	0.77	0.80	0.85	0.90	0.95	1.00	1.30	1.35	1.60
3-year GoC Bond	0.90	0.90	0.95	1.00	1.10	1.20	1.50	1.60	1.90
5-year GoC Bond	1.14	1.10	1.20	1.35	1.45	1.55	1.85	1.95	2.30
10-year GoC Bond	1.71	1.65	1.80	2.00	2.15	2.25	2.55	2.65	3.00

Source: Bank of Canada, Central 1 Credit Union. Note: Quarterly average based on daily data. a = actual, all others forecast.

Deposit Rate Forecast									
	2017 Q1a	2017 Q2	2017 Q3	2017 Q4	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1
1-year GIC	0.73	0.75	0.75	0.75	0.75	0.75	0.75	0.85	0.95
3-year GIC	1.08	1.00	1.00	1.00	1.00	1.00	1.20	1.30	1.45
5-year GIC	1.30	1.15	1.15	1.15	1.15	1.25	1.35	1.40	1.60

Source: Bank of Canada, Central 1 Credit Union. Note: Quarterly average based on weekly data. a = actual, all others forecast. Non-redeemable semi-annual rates from Bank of Canada based on typical rate (mode) at six major banks.

Mortgage Rate Forecast									
	2017 Q1a	2017 Q2	2017 Q3	2017 Q4	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1
1-year Mortgage	3.14	3.15	3.15	3.15	3.15	3.15	3.15	3.30	3.50
3-year Mortgage	3.39	3.40	3.40	3.40	3.40	3.45	3.50	3.65	3.85
5-year Mortgage	4.64	4.65	4.65	4.65	4.65	4.75	4.90	5.05	5.25

Source: Bank of Canada, Central 1 Credit Union. Note: Quarterly average based on weekly data. a = actual, all others forecast. Posted fixed term rates from Bank of Canada rates based on typical rate (mode) at six major banks.