Interest Rate Forecast

Economics August 2017

Highlights

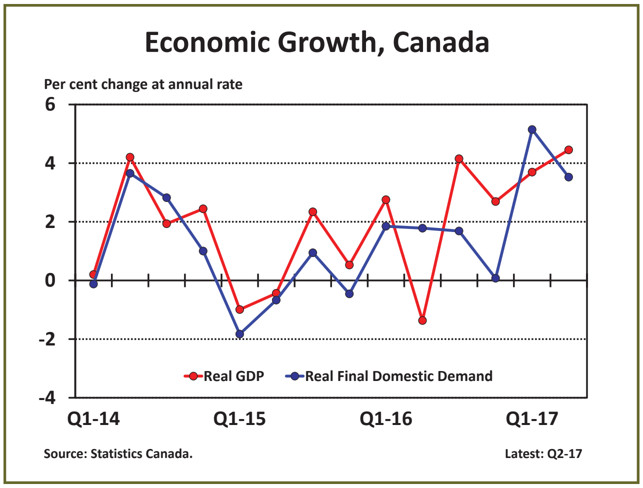
- Canada's economy blows past expectations
- September Bank rate move more likely
- Gradual rate normalization phase ahead

-The Bank of Canada faces a difficult decision at its upcoming rate setting meeting in early September. The Canadian economy posted another strong quarterly performance, more than triple the economy's potential growth rate, closing the output sooner than the Bank expected. However, below-target inflation, a recently elevated loonie, and an uncertain trade policy outcome weigh against a rate move. This forecast expects the Bank to move in September to stay ahead of the inflation curve and to give itself more buffer to cut rates when needed.

Canada's economy is on a roll and posted two consecutive quarters of real GDP above three per cent annualized and the strongest first half since 2002. Second quarter 2017 real GDP growth came in at 4.5 per cent annualized above the first quarter's 3.7 per cent rate. The Bank of Canada predicted second quarter growth at 3.0 per cent in its July 2017 *Monetary Policy Report*(MPR).

Various high frequency Canadian economic data points released since the first quarter GDP release pointed to a strong second quarter GDP result. Consumer spending, business investment, government spending, and exports were the main growth drivers in the second quarter. Residential investment contracted but growth was broadly based. The pickup in business investment and exports are two areas the Bank has often cited as necessary developments leading to a more sustained growth performance with less reliance on consumers and housing.

The monthly industry GDP for June was also a solid report with a 0.3 per cent expansion over May and broadly based across industries. Second quarter industry GDP expanded at a 4.7 per cent annual rate, close to the first quarter's 4.6 per cent pace.



More current data on the economy is from the Labour Force Survey (LFS), which recorded a modest 10.9k employment gain in July with the unemployment rate slipping to 6.3 per cent, the lowest in the post-recession era. In the prior six months, job growth average 31.0k per month. The labour market reflects recent economic gains with job growth at the fastest pace in a few years. Alberta and Saskatchewan economies are no longer in recession and are contributing to national labour market gains.

The economy is quickly closing in on potential output consistent with two per cent target inflation. Based on the Bank's forecasts of actual and potential output, the output gap is closed in the first quarter of 2018. However, new GDP data has the output gap closing sooner in the fourth quarter of 2017.

The Bank almost always responds in this situation by raising its policy rate well before the gap closes. In its July statement the Bank said, "Recognizing the lag between monetary policy actions and future inflation, Governing Council considers it appropriate to raise its overnight rate target at this time." Its July rate increase was the first since the oil price collapse and some argue the Bank should have moved earlier and is 'behind the curve'.

The futures market for three-month BAs is pricing a about a 75 per cent chance of a 25bps September move and 100 per cent odds in October. This forecast is going against the consensus and predicting a 25bps increase at the September 6 rate announcement.

Why not wait until the October meeting rather than go in September? After all, inflation remains well below target, the September meeting is not accompanied by new forecasts, the Bank has not telegraphed such a move, and some downside risks exist. Finally, waiting seven weeks should not matter much in any case. However, the room to move narrowed considerably and quickly with the latest economic accounts release.

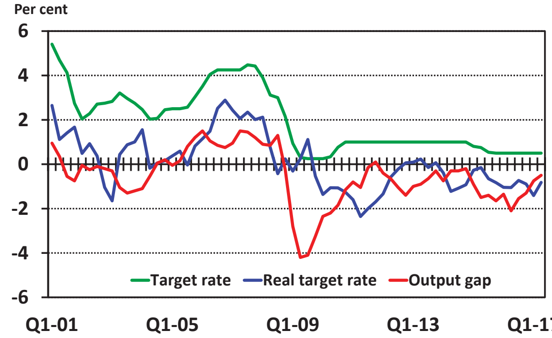
Below-target inflation would not hold back the Bank from moving in September. Inflation was as low at their July rate increase and the Bank considers this to be temporary on account of "… food price competition, electricity rebates in Ontario, and changes in automobile pricing."

The September meeting will not be accompanied by a new set of economic and inflation forecasts in the Bank's MPR. The MPR is released quarterly with the next coming at their October 25 rate announcement. Historically most rate moves have occurred in conjunction with the MPR release, but not all. Under certain conditions, the Bank has moved on a non-MPR announcement date when events have overtaken their expectations.

That the Bank has not telegraphed a September move during the summer vacation period is not a strong argument. No speeches or hearings testimony by the Governor or Deputy Governors were slated in any case and it would be unusual for a key member to offer comments on monetary policy apart from that avenue.

Before the July increase, the Bank's May statement was rather dovish – a wait and see approach with the expectation of moderation in the second quarter. That all changed with the release of first quarter GDP and June LFS data prompting the Bank to raise 25bps in response to, "Recent data have bolstered the Bank's confidence in its outlook for above-potential growth and the absorption of excess capacity in the economy." The same situation now exists.

Canada's Output Gap and Bank of Canada Target Rate



Source: Bank of Canada, Central 1 Credit Union. Note: Output gap is per cent of potential output. Real target rate excludes CPI inflation. Latest: Q2-2017.

The Bank regularly mentions downside risks of high household debt and overheated housing markets as well as weak exports and business investment. The first two risks are interrelated and highly problematic only when an economic recession occurs. The latter two risks are also related to external conditions as well as to the evolution of Canada's economy in response to technological change, transportation improvements, and trade policies. Nothing has here changed sufficiently since their July meeting to cause the Bank to hold off a rate increase in either September or October.

Perhaps the Bank will hold off until the Fed raises rates for concern over the CAD's appreciation on a unilateral move. The Fed is widely expected to refrain from a rate increase in September and focus on balance sheet reduction. Their end-of-October meeting is not likely to deliver a rate increase given the economic disruptions caused by Hurricane Harvey. The Bank will be faced with the same predicament in October as now.

External economic conditions remain on a positive trajectory. Recent and latest data show a resynchronization of growth cycles across the large key economies except for China, which is growing at a slower, but still high rate. Flash PMI numbers for August

Economic Forecast – Canada

	2017 Q1	2017 Q2	2017 Q3	2017 Q4	2016	2017	2018	2019
Real GDP, % annualized	3.7	4.5	2.5	2.0	1.5	3.2	2.3	2.0
Unemployment Rate, %	6.7	6.5	6.4	6.3	7.0	6.5	6.3	6.1
Total CPI, % y/y	1.9	1.3	1.5	1.7	1.4	1.6	1.9	2.1

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

were positive for the U.S., Eurozone, and Japan. U.S. second quarter real GDP was revised up to 3.0 per cent from 2.6 per cent annualized. Leading economic indicators are flashing positive; no recession in the near term barring a shock event.

Growth expectations for the U.S. economy in 2018 and 2019 are in the 2.0 to 2.5 per cent range. Rate normalization by the Fed unfolds at a gradual pace with a combination of rate increases and balance sheet reductions. Fiscal and trade policies changes are expected but their nature and extent are uncertain with positive and negative impacts possible.

Canada's 2017 growth forecast is raised to 3.2 per cent from 2.9 per cent as a result of the latest GDP release. Quarterly growth is expected to slow from the 4.5 per cent pace due to an inventory drawdown in the third quarter, slower energy exports, and fewer housing transactions. Beyond 2017, trend growth in the 2.0 to 2.5 per cent range is likely.

The Bank of Canada will increase its estimate of potential output growth at its annual revision cycle in early 2018. This will recognize recent strength and accommodate higher growth without an excessive overshoot on the output gap.

In the event the Bank does not move in September, an October rate increase is almost certain, and in any case, the Bank will be on a gradual rate normalization phase lasting three to four years. A four to six month pause to give the Bank time to assess the impact of the next rate increase is likely. Two 25 bps rate increases are expected in 2018 and 2019. A normal target rate is around 3.00 per cent, and when achieved, subsequent rate increases will be considered as rate tightening.

Target rate increases will set in motion higher rates across the yield curve, which is seen steepening during normalization and narrowing during the tightening phase. Administered deposit and lending rates generally track changes in the target rate and yield curve.

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Target Overnight Rate Forecast

Meeting Date	(Per cent)
July 12 (a)	0.75
Sep. 6	1.00
Oct. 25	1.00
Dec. 6	1.00
Jan. 2018	1.00
Mar.	1.00
Apr.	1.25
June	1.25
July	1.25
Sep.	1.50
Oct.	1.50
Dec.	1.50
Jan. 2019	1.50
Mar.	1.50
Apr.	1.75
June	1.75

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

Interest Rate Forecast									
	2017 Q2a	2017 Q3	2017 Q4	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1	2019 Q2
Target Overnight Rate	0.50	0.80	1.00	1.00	1.25	1.25	1.50	1.50	1.75
Prime Rate	2.70	3.00	3.20	3.20	3.45	3.45	3.70	3.70	3.95
1-mo. T-Bill	0.48	0.75	0.95	0.95	1.20	1.20	1.45	1.50	1.70
3-mo. T-Bill	0.54	0.85	1.00	1.00	1.25	1.25	1.50	1.55	1.75
6-mo. T-Bill	0.59	0.95	1.10	1.10	1.35	1.35	1.60	1.65	1.85
1-year T-Bill	0.68	1.15	1.35	1.35	1.60	1.60	1.85	1.85	2.10
2-year GoC Bond	0.77	1.30	1.45	1.45	1.70	1.70	1.95	1.95	2.20
3-year GoC Bond	0.84	1.35	1.50	1.50	1.75	1.75	2.05	2.05	2.30
5-year GoC Bond	1.04	1.55	1.70	1.75	1.95	2.00	2.30	2.35	2.60
10-year GoC Bond	1.51	1.95	2.10	2.15	2.35	2.40	2.75	2.75	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 Q2a	2017 Q3	2017 Q4	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1	2019 Q2
1-year GIC	0.73	0.75	0.85	0.90	0.95	1.10	1.20	1.25	1.40
3-year GIC	1.02	1.20	1.25	1.25	1.30	1.45	1.55	1.55	1.70
5-year GIC	1.12	1.35	1.45	1.45	1.55	1.55	1.70	1.75	1.90

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 Q2a	2017 Q3	2017 Q4	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1	2019 Q2
1-year Mortgage	3.14	3.25	3.40	3.45	3.70	3.70	3.95	4.00	4.25
3-year Mortgage	3.39	3.45	3.60	3.65	3.85	3.85	4.10	4.15	4.40
5-year Mortgage	4.64	4.80	4.90	4.90	4.90	5.00	5.20	5.20	5.45

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.