Central 1™

Interest Rate Forecast

Economics February 2018

Highlights

- Global economy generates inflation concerns
- Trade war prospect takes centre stage
- U.S. rate increase imminent
- Canada's economy shows cracks but sound
- Bank of Canada poised to normalize again

Underlying economic conditions indicate central banks will continue on their path to normal monetary conditions in 2008 and 2019. Some disruptions and delays will likely occur along the journey, but the road ahead is clearly laid out. Prospects for a trade war emerged unsettling markets and potentially the global economy.

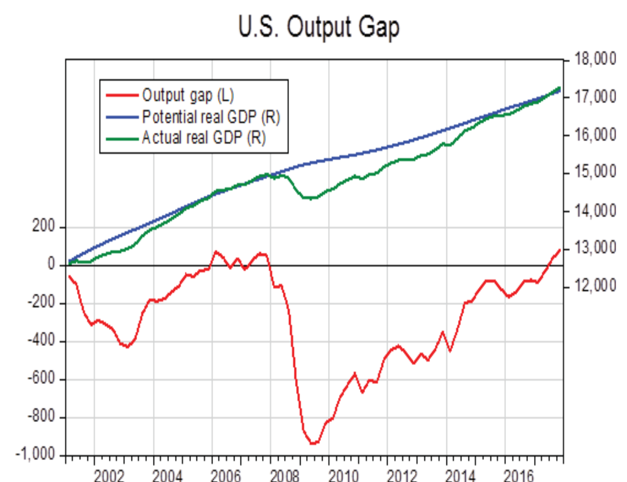
The global economic scene remains positive with February manufacturing PMIs for the major economies – U.S., China, Euro area, and Japan – expanding or holding relative to January and prior months. The main theme was some slowing in output growth, a pickup in new orders, and more signs of inflation, relative to January. PMIs for the service sector are released later.

Some slowing in manufacturing growth following a strong rebound in 2017 is not worrisome. PMI levels remain elevated and supportive conditions prevail. What is worrisome, is building inflation pressures, and while not problematic at this point, the stage is being set for reflation and a change in monetary settings during the year and beyond.

There is no shortage of downside risks to the reflation scenario. The main risk is a trade disruption caused by a U.S.-China duties retaliation spat or a U.S. NAFTA withdrawl or a U.S. exit from the WTO. Perhaps, the hardline U.S. posturing and rhetoric is a bargaining tactic and not reflective of actual intentions. However, the U.S. has recently imposed duties on solar panels, washing machines, softwood lumber, and is set to do so on steel and aluminum. Geopolitical risks abound from North Korea to Iran to the Middle East to the South China Sea and beyond.

The U.S. administration is proposing duties on steel and aluminum imports, which could come into effect shortly. The main consequence is not the negative impact on economies exports those products to the U.S. and to U.S. producers relying on those imports, which will arrive at a higher cost but rather the likely retaliation by countries affected buy those duties. The ensuing trade war would be damaging to the global economy. Financial markets have reacted swiftly and negatively to the proposed tariffs announced by the U.S. administration and the possible expansion of a tariff war.

The U.S. economy is at or near full employment and full capacity based on its four per cent unemployment rate and a positive output gap – actual real GDP greater than potential real GDP. With real GDP growth projected at 2.8 per cent in 2018 and 2.4 per cent in 2019 – above the economy's non-inflationary growth limit – the excess positive output gap will increase generating inflation pressures. Faster wage growth emerged more than one year ago from a low level and a stagnant pace.



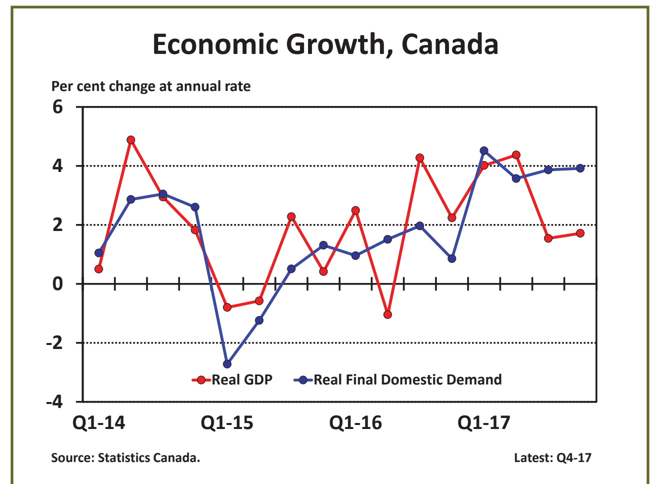
Source: U.S. Bureau of Economic Analysis, U.S. Congressional Budget Office. Latest: Q4-2017

The Fed responded to these emerging conditions more than three years ago with its first rate increase and has gradually raised its policy rate four more times. However, the pace of removing monetary stimulus, or normalizing monetary conditions, is accelerating, not only by adjusting its policy rate but also by shrinking its balance sheet, or selling its bond and MBS holdings, at a faster pace.

The upward revision to 2018 real GDP growth to 2.8 per cent, some forecasters have it above three per cent, is largely due to the Tax Cut and Jobs Act and the new two-year budget deal that increased federal spending by $300 billion. To implement fiscal stimulus at this stage of the business cycle is more likely to lead to higher prices than to higher output. Fiscal stimulus can be helpful when unemployment is high and economic output is less than its potential. Research finds a smaller fiscal multiplier at or near full employment than when excess capacity exists.

Spending increases and tax cuts lead to greater deficits, expected to surge past 5% of GDP, and to an increase in the national debt, which needs to be financed by issuing bonds. More bonds coming to the market, not only to finance the deficit but also from the Fed's balance sheet normalization, will cause Treasury yields to rise. The current yield on the 10-year T-Bond is around 2.85 per cent and yields will easily break through three per cent and approach four per cent in 2020, if not sooner.

The Fed is poised to make its sixth quarter-percentage point increase in March and very likely followed by three more before year end. The futures market is less sanguine, pricing in only three quarter-percentage point increases for the year. In 2019, the futures market expects only one more increase, bringing the fed funds rate to around 2.5 per cent by the end of 2019. It could be those market participants view that rate as the new normal where the Fed stops.



The Fed would stop at 2.5 per cent if the economy slowed to below potential growth rate, estimated between 2.0 and 2.5 per cent. The current consensus 2019 forecast at 2.4 per cent implies no relief to the economy's capacity shortfall or positive output gap and ongoing inflation pressure. Barring substantial slowdown or trade war or economic recession or geopolitical crisis, the U.S. economy will need more rate increases to the point where monetary tightening is in effect – the next phase after normalization.

Turning to Canada, the latest batch of monthly data was decidedly negative. Employment plunged following two very strong reports, exports fell as did manufacturing, retail, and wholesale sales. January housing sales dropped on the heels of the latest mortgage stress test, and expectations are for another sales drop in February. Housing sales will begin to stabilize in March or April.

The latest GDP report, fourth quarter 2017, came in below expectations at 1.7 per cent annualized growth versus the 2.5 per cent forecast by the Bank of Canada and the consensus at 2.2 per cent. Growth edged up from the third quarter's 1.5 per cent annual pace. For the year, real GDP growth came in at 3.0 per cent, up from 1.4 per cent in 2016.

Economic Forecast – Canada

	2017 Q3	2017 Q4	2018 Q1	2018 Q2	2016	2017	2018	2019
Real GDP, % annualized	1.5	1.7	2.5	2.1	1.4	3.0	2.2	2.0
Unemployment Rate, %	6.2	6.0	5.8	5.7	7.0	6.3	5.6	5.2
Total CPI, % y/y	1.4	1.8	1.8	1.9	1.4	1.6	2.2	2.1

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

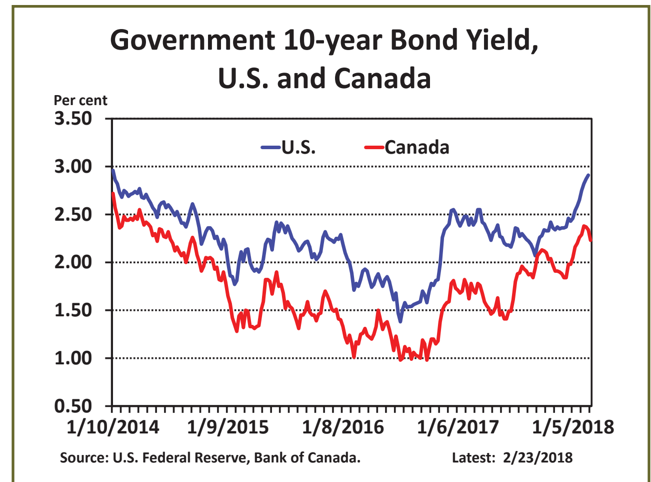
Canada: Key economic data releases		
Indicator	Prior month	Latest month
Industry GDP	0.00%	0.40%
Employment	64.8k	-88.0k
Unemployment rate	5.8	5.9
Real international goods exports	0.50%	-0.20%
Real international goods trade balance		
Real manufacturing sales	3.00%	-0.10%
Real retail sales	0.20%	-0.90%
Real wholesale sales	0.50%	-0.90%
Building permits	-7.30%	4.80%
Housing starts	216.3k	216.2k
MLS residential sales	46.4k	39.6k
Total CPI	1.90%	1.70%
Core CPI1.	1.80%	1.80%

Source: Statistics Canada, CREA. 1. Average of three measures.

Fourth quarter GDP growth was pulled down by a weak trade performance, imports grew faster than exports, and an inventory drawdown similar to the third quarter. Those sectors aside, the domestic economy performed very well. Final domestic demand grew at a 3.9 per cent annual pace in the fourth quarter, identical to the third quarter. Business and residential investment and government capital spending were particularly robust in the fourth quarter with personal consumption spending advancing at a moderate (1.6 per cent annual) pace.

Real GDP growth in the first quarter of 2018 will likely increase, notwithstanding the negative January labour and housing sales reports. A rebound in inventories, faster personal consumption growth, and further investment gains are expected. For the year, growth will come in at 2.2 per cent in 2018 and around two per cent in 2019. The consensus view is 2.1 per cent in 2018 and 1.8 per cent in 2018.

Statistics Canada revised GDP higher in each of the first three quarters of 2017. As a result, the output gap as of the third quarter was smaller. But with the fourth quarter coming below the Bank's forecast, the output gap as of the fourth quarter was slightly wider than previously – i.e., operating at less over capacity.



The Bank's first quarter 2018 forecast is 2.5 per cent annualized followed by growth below two per cent very quarter through 2019. The important consideration is those forecasts remain above the economy's estimated potential growth, resulting in an increasing positive output gap. This outcome may change when the Bank issues its revised estimates of potential output in the next Monetary Policy Report due at its April 18 rate announcement.

The Bank increased its estimate of potential output on an interim basis in its MPR released in January. This was due to upward revisions to business investment and the capital stock, increasing the level of potential output. A similar upward revision is possible given recent gains in business investment, which would mean the economy will be operating with less inflationary pressure.

The futures market is pricing a quarter-percentage point move before June and another before December. Thereafter, the expectation for the next increase is June 2019, remaining on hold until late 2020.

This forecast places the next Bank of Canada move in April, calling for a quarter percentage point increase followed by a similar move in October. In 2019, another two quarter percentage point moves are expected. The forecast consensus view is similar.

The Bank's March statement will likely have a cautious theme but still refer to removal of monetary stimulus with the economy at capacity and core inflation trending higher.

There is rising downside risk to the timing of the next move should the trade situation deteriorate noticeably, which would negatively hit investor confidence and expectations. Economic growth forecasts would be revised lower, as would interest rate prospects and predictions for CAD.

Administered rates bumped up in January with the Bank's last move and have remained unchanged since. Rising policy rates and bond yields will evolve during the next two years, which will cause higher GIC and mortgage rates. The pace of increase will remain gradual, allowing for adjustments to higher rates evolve without significant disruption to the economy.

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Target Overnight Rate	
Meeting Date	**(Per cent)**
Jan. 17, 2018	1.25 (a)
Mar. 7	1.25
Apr. 18	1.50
May 30	1.50
July 11	1.50
Sep. 5	1.50
Oct. 24	1.75
Dec. 5	1.75
Jan. 2019	1.75
Mar.	2.00
Apr.	2.00
June	2.00
Jul.	2.25
Sep.	2.25
Oct.	2.25
Dec.	2.25

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

Interest Rate Forecast									
	2017 Q4a	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1	2019 Q2	2019 Q3	2019 Q4
Target Overnight Rate	1.00	1.25	1.45	1.50	1.70	1.80	2.00	2.25	2.25
Prime Rate	3.20	3.45	3.65	3.70	3.90	4.00	4.20	4.45	4.45
1-mo. T-Bill	0.85	1.15	1.35	1.40	1.65	1.75	1.95	2.15	2.20
3-mo. T-Bill	0.92	1.20	1.45	1.50	1.75	1.80	2.00	2.25	2.30
6-mo. T-Bill	1.10	1.35	1.60	1.65	1.90	2.00	2.20	2.45	2.50
1-year T-Bill	1.37	1.60	1.85	1.90	2.20	2.30	2.55	2.75	2.80
2-year GoC Bond	1.50	1.80	2.05	2.10	2.40	2.50	2.60	2.80	2.85
3-year GoC Bond	1.55	1.95	2.20	2.30	2.60	2.65	2.70	2.90	2.90
5-year GoC Bond	1.70	2.10	2.35	2.45	2.75	2.80	2.80	3.00	3.00
10-year GoC Bond	1.96	2.30	2.55	2.65	2.95	3.00	3.00	3.20	3.20

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

Deposit Rate Forecast									
	2017 Q4a	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1	2019 Q2	2019 Q3	2019 Q4
1-year GIC	0.72	0.75	0.85	0.85	1.00	1.00	1.15	1.25	1.25
3-year GIC	1.35	1.35	1.45	1.45	1.60	1.65	1.65	1.80	1.80
5-year GIC	1.60	1.60	1.75	1.85	1.95	2.00	2.00	2.10	2.10

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 Q4a	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1	2019 Q2	2019 Q3	2019 Q4
1-year Mortgage	3.24	3.35	3.50	3.50	3.70	3.75	3.95	4.15	4.25
3-year Mortgage	3.71	4.15	4.30	4.30	4.50	4.55	4.55	4.80	4.80
5-year Mortgage	4.97	5.15	5.30	5.30	5.50	5.50	5.50	5.65	5.65

Source: Bank of Canada, Central 1 Credit Union.te: 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.