Central 1™

Interest Rate Forecast

Economics January 2018

Highlights

- Economic conditions and prospects remain positive
- Inflation drivers mounting
- Rate increase looming

With the Canadian economy expected to perform above the Bank of Canada's estimate of potential growth and with inflation ticking higher, another rate increase is likely to occur sooner rather than later. Improved global economic conditions and higher commodity prices are a supportive backdrop. However, trade policy uncertainty and recent changes to mortgage guidelines generate considerable concerns and argue for delaying the next rate increase until more clarity arises.

Canada's economic growth momentum from the oil recession remains largely intact, notwithstanding volatility in some key monthly indicators. The Bank of Canada's growth forecast of 2.5 per cent annualized growth in Q4 2017 and Q1 2018 is reasonable, though slightly higher than consensus. For all of 2018, the Bank is predicting 2.2 per cent growth. The key takeaway is that the Bank expects growth to be above the economy's potential resulting in a positive output gap, or above non-inflationary full capacity.

Under these expected conditions, and the economy currently operating near or at full capacity, the Bank needs to stay ahead of the inflation curve by reducing monetary stimulus. Headline and core Inflation are firming, and faster wage growth is emerging with declining labour market slack and notwithstanding recent minimum wage increases. The runup in commodity prices, notably oil, will feed through to higher goods and services prices in 2018 and likely into 2019.

Rising commodity prices are mainly the result of the recent improvement in the global economy aided by sector specific supply conditions. The latest flash PMI numbers confirm that the main economies are growing at the faster pace seen last year. In some cases, growth in 2018 is expected to be faster than in 2017, and the main example here is the U.S., with real GDP expected to rise from 2.3 per cent in 2017 to 2.7 per cent in 2018.

Canada: Key economic data releases

Indicator	Prior month	Latest month
Industry GDP	0.00%	0.40%
Employment	79.5k	78.6k
Unemployment rate	5.9	5.7
Real international goods exports	0.60%	1.20%
Real international goods trade balance	$1,018.0b	-$342.4b
Real manufacturing sales	-1.90%	2.50%
Real retail sales	1.40%	0.40%
Real wholesale sales	1.30%	-0.50%
Building permits	4.40%	-7.70%
Housing starts	251.7k	217.0k
MLS residential sales	44.0k	46.0k
Total CPI	2.10%	1.90%
Core CPI1.	1.70%	1.80%

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

Economic Forecast – Canada								
	2017 Q2	2017 Q3	2017 Q4	2018 Q1	2016	2017	2018	2019
Real GDP, % annualized	4.3	1.7	2.5	2	1.5	3.0	2.3	2.0
Unemployment Rate, %	6.5	6.2	6	5.7	7	6.3	5.5	5.2
Total CPI, % y/y	1.3	1.4	1.8	1.9	1.4	1.6	2.2	2.1

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

U.S. inflation is also on the upswing, not in a sharp fashion, but enough to move the federal Reserve to withdraw monetary stimulus at a speedy pace. Wages are rising at a faster pace and this will intensify with the U.S. unemployment rate heading to the mid-threes later this year and in 2019. Producer prices will also pick up on recent USD weakness, higher oil prices, and higher tariffs on some imported goods, with more tariffs likely.

Conditions will form prompting the Federal Reserve to raise rates faster than most expect. The Federal Reserve's "dot plot" points to three rate hikes in 2018 while the fed funds futures market is pricing in two hikes in 2018. Stronger economic growth, accelerating wages and inflation will force the Fed to raise rates four times in 2018.

Not only will short-term interest rates be rising but also long-term rates. Higher inflation and inflation expectations combined with reductions in the Fed's balance sheet, and larger federal deficits will put upward pressure on long-term bond yields. The 10-Year Treasury bond yield reached its highest level in three years and looks to easily breach 3.00 per cent by yearend.

This growth scenario could be disrupted by trade policy mistakes leading to trade retaliations between the U.S. and China or other countries. A geopolitical crisis is another possible disruptor of the economy and financial markets. Given the close and numerous linkages between Canada and the U.S., any disruption to U.S. growth would spill over into this country.

The Bank of Canada considers issues such as NAFTA and other uncertainties into their rate deliberations, and at their upcoming March rate announcement, the Governing Council will be faced with the same circumstances as at their January meeting which saw the policy rate increased 25bps. In some respects, economic conditions are more compelling for a rate increase now than in January.

Barring a large negative development before the March meeting, the Bank is expected to raise its overnight target rate 25bps to 1.50 per cent. Another increase is seen in July followed by two more hikes in 2019. A central bank does not want to fall behind the inflation curve, and if it does err on the side of too restrictive, it can take back a rate hike, albeit at the expense of some credibility.

The futures market for 3-month BAs is pricing in a 25bps increase at the Bank's April meeting followed by another in September. Thereafter, the market is expecting a 25bps increase around mid-2019 and a high probability of another by yearend.

Canada's yield curve will gradually flatten during the next two years and not come close to inversion – a condition that occurs later in the monetary tightening cycle. Technically, the Bank is in the rate normalization phase of the cycle.

Higher rates and bond yields will translate into higher lending and deposit rates with the former outpacing the latter.

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Target Overnight Rate Forecast	
Meeting Date	**(Per cent)**
Jan. 17, 2018	1.25 (a)
Mar. 7	1.50
Apr. 18	1.50
May 30	1.50
July 11	1.75
Sep. 5	1.75
Oct. 24	1.75
Dec. 5	1.75
Jan. 2019	2.00
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	1.50	1.75	1.75	2.00	2.00	2.25	2.25
Prime Rate	3.20	3.45	3.70	3.95	3.95	4.20	4.20	4.45	4.45
1-mo. T-Bill	0.85	1.15	1.40	1.65	1.65	1.90	1.95	2.15	2.20
3-mo. T-Bill	0.92	1.25	1.50	1.75	1.75	2.00	2.05	2.25	2.30
6-mo. T-Bill	1.10	1.45	1.85	2.10	2.10	2.35	2.40	2.55	2.60
1-year T-Bill	1.37	1.70	1.95	2.20	2.25	2.45	2.55	2.60	2.65
2-year GoC Bond	1.50	1.90	2.15	2.40	2.45	2.55	2.60	2.70	2.75
3-year GoC Bond	1.55	2.00	2.25	2.45	2.50	2.65	2.70	2.80	2.85
5-year GoC Bond	1.70	2.15	2.35	2.55	2.60	2.75	2.80	2.90	2.95
10-year GoC Bond	1.96	2.35	2.55	2.75	2.80	2.95	3.00	3.10	3.15

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	0.85	0.95	1.15	1.20	1.35	1.45	1.50	1.55
3-year GIC	1.35	1.35	1.35	1.45	1.45	1.55	1.65	1.75	1.75
5-year GIC	1.60	1.60	1.75	1.85	1.85	2.00	2.00	2.05	2.05

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	3.25	3.50	3.75	3.80	4.00	4.10	4.25	4.25
3-year Mortgage	3.71	3.95	4.20	4.45	4.55	4.75	4.75	4.90	5.00
5-year Mortgage	4.97	5.00	5.15	5.20	5.25	5.35	5.35	5.45	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.