Central 1™

Interest Rate Forecast

Economics March 2017

Highlights

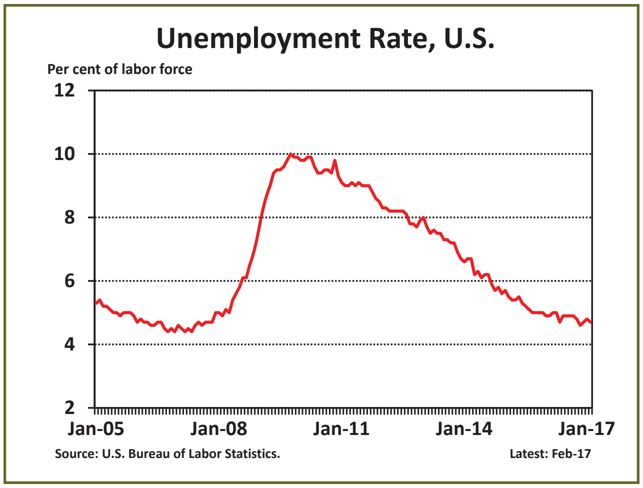
- Fed hike on March 15
- Global economic growth upturn
- Canada's economy to grow faster
- Bank of Canada on hold in 2017, follows Fed in late 2018

All signs point to a Fed rate increase on March 15, only the second since the Great Financial Crisis and in the weakest economic recovery in the post-war era, which is in its eighth year. Friday's U.S. employment report removed any doubt of a 25bp hike. The global economy continues to improve despite a slight cooling in February. Policy uncertainties hover over the most promising medium-term outlook since 2014.

U.S. nonfarm employment increased a robust 235,000 along with modest upward revisions to prior months. The unemployment rate declined to 4.7% and wages accelerated. The labour force participation rate reached a cycle high and further job and wage gains are expected to entice more workers into the labour force.

Other U.S. economic indicators were mostly positive in the past four weeks despite below trend GDP growth of 1.9% in the fourth quarter, down from the third quarter's 3.5%. U.S. manufacturing sector continued to expand at a robust pace in February some of which was due to inventory accumulation on higher sales expectations. The Conference Board Consumer Confidence Index rose in February to its highest reading since August 2001. Housing and auto sales moved higher. The warmer than usual winter weather probably boosted some indicators.

How will U.S. domestic and foreign policy unfold under the new administration? Lower tax rates, fewer regulations, and more spending on infrastructure and the military are widely expected and a reason behind the upward revisions to forecasts of U.S. economic growth in 2017 and 2018. U.S. economic growth would have been higher than 2016 in any case but will receive a lift if those policy measures are enacted. This assumes no major restrictions on trade will be imposed.



Global economic growth cooled a little in February but remained well in expansionary territory. The JPMorgan Global PMI fell for the first time in six months. Manufacturing activity grew at a fast pace while service sector growth slowed to a three-month low.

China's official manufacturing PMI reached a three-month high in February with a broad-based expansion. The Lunar New Year could have upwardly distorted the February data. The 2017 economic objectives announced at China's annual

National People's Congress is targeting 6.5% GDP growth. China has never missed an economic growth target, and should this goal appear in jeopardy, it would likely step up fiscal and monetary stimulus.

Politics dominate the European news flow with the general election in the Netherlands a barometer of populist sentiment. Polls suggest a close race between the mainstream party and the anti-EU party. In France, Le Pen remains the front-runner in the first-round election but not in the second round with the recent rise of the centrist candidate in the polls.

Europe's economy continues to improve with the Eurozone Manufacturing PMI hitting a 70-month high on growth momentum in Germany, the Netherlands and Italy during February. Business confidence rose on a strengthening global economy and very accommodative monetary policy. The unemployment rate was 9.6% in January, the lowest since May 2009. Headline inflation rose on energy but core inflation remained below 1%. While Brexit negotiations and general elections are a forecast risk, the economy looks to expand around 1.7% this year similar to last year.

Canada's economy finished 2016 on a positive note with fourth quarter real GDP expanding 2.6% annualized. However, the headline number hid less positive details such as a drop in business investment and weak exports. A sharp contraction in imports created a misleading strong trade surplus in the fourth quarter. Domestic demand posted a weak quarter due to lower business investment, which contributed to fewer imports.

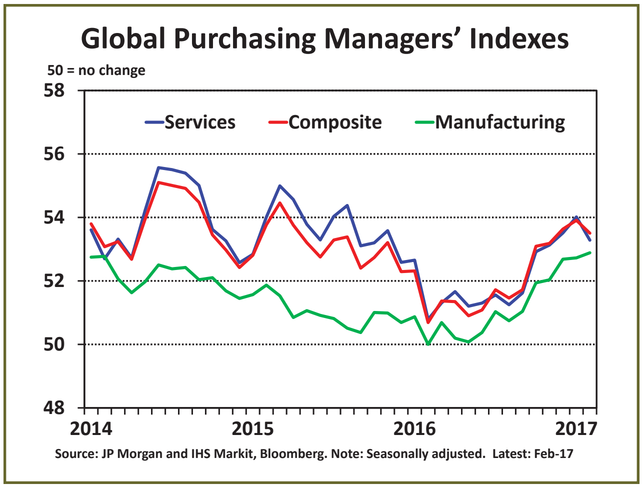
Monthly industry GDP grew at a respectable pace in December with most industries contributing. This report implied the economy had a good handoff into 2017 and is supported by recent labour market reports.

February's labour market generated another employment gain and a lower unemployment rate. Employment increased 15,300 with a huge 105,000 gain in full-time employment mostly offset by nearly equally large plunge in part-time employment. Survey volatility aside, trend employment growth is just under 1% or 13,000 per month. Since August, employment growth is well above trend at 35,000 per month. Given the ebb and flow in economic activity, a cooling and return to trend is likely in the near term.

The real international trade surplus narrowed slightly in January with real exports up on a significant gain in auto exports while real imports were lifted by motor vehicles and parts, energy products, and electronic and electrical equipment. A faster growing U.S. economy in 2017 and a low 'Lonnie should result in a trade surplus contributing to overall GDP growth.

Housing sales and prices for February will be released shortly and will show a still strong housing market in many parts of the country. A small decline in seasonally adjusted sales from January is likely from the impact of tighter federal mortgage insurance policy changes implemented last October. A small increase would not surprise, though. Housing prices will rise in any case because of market supply-demand imbalances. Another round of policy tightening measures this year to cool prices remains a strong possibility.

The federal budget is set for March 22 and the government's infrastructure spending



Plan will be a key item. In the 2016-2017 budget, the New Infrastructure Plan was a centrepiece to spend $182 billion of which $82.8 billion was new spending and $13.6 billion was to be spent in the first two years with the aim of providing economic stimulus. Only about one-third of the $13.6 billion has been allocated to specific projects, which is not surprising given the time lags between disbursement and shovel-ready projects. Going forward, a larger growth contribution from infrastructure spending is incorporated into the economic forecast.

Our forecast has growth increasing to 2.2% in 2017 and 2.3% in 2018. Stimulative monetary and fiscal policy, a low Canadian dollar, improving U.S. and global economies, and firming commodity prices are

Economic Forecast - Canada

	2016 Q3	2016 Q4	2017 Q1	2017 Q2	2015	2016	2017	2018
Real GDP, % a.r.	3.8	2.6	0.5	20	0.9	1.4	2.2	2.3
Unemployment Rate, %	7	6.9	6.8	6.7	6.9	7	6.8	6.5
Total CPI, % y/y	1.2	1.4	1.7	1.8	1.1	1.4	1.8	1.9

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

positive macroeconomic factors. Personal income growth is seen picking up to support consumption. There is no sign of an imminent economic recession in the U.S. or other main global economies that would pull Canada into recession. The external policy setting is the main forecast risk.

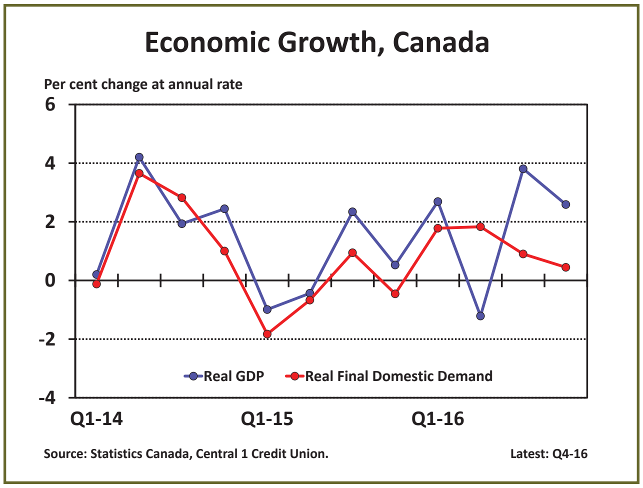
Bond markets backed up recently on the growing likelihood of more Fed rate hikes starting March 15. The U.S. 10-year government bond hit a two-year high at 2.61% while the Canadian government bond yield followed at 1.84%. Rate normalization by the Fed is a positive sign responding to better growth and rising inflation after a long, weak expansion phase restrained by debt, tight credit conditions, excess capacity, fiscal austerity, and negative exogenous shocks. Canada experienced a similar economic recovery from the financial crisis but with more volatility.

The Bank of Canada is seen remaining on hold through 2017 and beginning to normalize rates later in 2018. The first policy rate increase is put at their Sept. 2018 meeting. Normalization will be gradual and measured, as in the U.S., but will lag the Fed by a considerable margin. Around five Fed 25bp hikes by the end of 2018 are factored in by the market whereas the market is expecting two hikes in Canada commencing mid-2018. This forecast has only one 25bp increase by the end of 2018 because negative surprises are bound to occur.

An upgrade to Canada's economic growth is the main reason behind the move to advance the first Bank of Canada rate hike in this forecast. The consensus forecast has the first increase in Q2-2018 with a handful of forecasters seeing a move in Q1-2018. A smaller number have a 25bp cut as the next move.

The widening interest rate differential with the U.S. will place downward pressure on CAD relative to the USD. A decline to 72 cents US is foreseen by yearend. Higher oil prices could upset this forecast.

Helmut Pastrick
Chief Economist, Central 1 Credit Union
hpastrick@central1.com
www.central1.com
604.737.5026



Target Overnight Rate Forecast	
Meeting Date	**(Per cent)**
Mar. 1 2017	0.50 (a)
Apr. 12	0.50
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	0.50
Sep.	0.75
Oct.	0.75
Dec.	0.75

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

Interest Rate Forecast									
	2016 Q4a	2017 Q1	2017 Q2	2017 Q3	2017 Q4	2018 Q1	2018 Q2	2018 Q3	2018 Q4
Target Overnight Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.60	0.75
Prime Rate	2.70	2.70	2.70	2.70	2.70	2.70	2.70	2.80	2.95
1-mo. T-Bill	0.45	0.45	0.45	0.45	0.45	0.45	0.45	0.55	0.70
3-mo. T-Bill	0.48	0.50	0.50	0.50	0.50	0.50	0.50	0.60	0.75
6-mo. T-Bill	0.53	0.55	0.55	0.55	0.55	0.55	0.55	0.65	0.80
1-year T-Bill	0.58	0.60	0.60	0.60	0.65	0.65	0.65	0.75	0.95
2-year GoC Bond	0.66	0.80	0.85	0.90	0.95	0.95	1.00	1.15	1.30
3-year GoC Bond	0.70	0.85	0.95	1.00	1.05	1.15	1.25	1.45	1.60
5-year GoC Bond	0.90	1.15	1.25	1.35	1.45	1.55	1.60	1.80	2.00
10-year GoC Bond	1.25	1.75	1.85	2.00	2.05	2.15	2.25	2.40	2.60

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

Deposit Rate Forecast									
	2016 Q4a	2017 Q1	2017 Q2	2017 Q3	2017 Q4	2018 Q1	2018 Q2	2018 Q3	2018 Q4
1-year GIC	0.74	0.75	0.85	0.85	0.85	0.85	0.85	0.85	0.95
3-year GIC	1.15	1.15	1.15	1.15	1.15	1.15	1.15	1.20	1.30
5-year GIC	1.45	1.45	1.45	1.45	1.45	1.45	1.50	1.50	1.65

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									
	2016 Q4a	2017 Q1	2017 Q2	2017 Q3	2017 Q4	2018 Q1	2018 Q2	2018 Q3	2018 Q4
1-year Mortgage	3.14	3.15	3.15	3.15	3.15	3.15	3.15	3.15	3.35
3-year Mortgage	3.39	3.40	3.40	3.40	3.45	3.45	3.55	3.60	3.75
5-year Mortgage	4.64	4.65	4.65	4.65	4.75	4.80	4.95	5.00	5.20

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 (the mode) at six major banks.