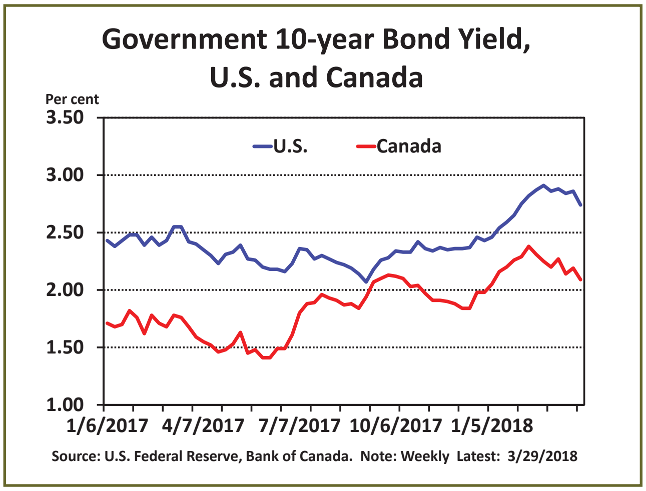
Central 1™

Interest Rate Forecast

Economics March 2018

Highlights

- Trade concerns dominate
- Global growth deceleration amid rising costs
- Fed on normalization track
- Bank of Canada on hold in April



Escalating trade tensions are deflating financial markets and expectations, despite positive signals coming from many economic indicators. Recent trade tariffs imposed by the U.S., and China's retaliation, do not bode well for future trade prospects with another round of U.S. tariffs and China retaliation in the offing. An all-out tit-for-tat trade war between the two largest economies, or between the U.S. and other countries, will slow growth, increase costs, and disrupt markets.

Inflation pressures are beginning to materialize and any additional cost increases from trade restrictions will exacerbate the situation. Central bankers will look through a temporary inflation boost if it does not raise inflation expectations and become entrenched in wage settlements. This depends on the extent and severity of trade duties or restrictions, which at this juncture appear minor in the big picture. Ultimately, the U.S. administration must come to realize the increasing collateral damage from escalating trade disruptions and seek alternative means to deal with trade issues.

On NAFTA, the U.S. is pushing for a deal in broad terms before the Summit of the Americas on April 13, with technical details and legal text hammered out thereafter. The political calendar is dictating this timeline because if a deal is not reached soon, it could not be ratified before the Mexican election in July and the U.S. mid-terms in November. Failing a deal, the political landscape could change, altering bargaining positions. Trade deals normally take years, not months, to conclude.

The U.S. will continue to generate trade deficits, regardless of new trade deals, as long as economic fundamentals remain the same. The U.S. economy consumes more than the income it generates, resulting in a saving-investment imbalance, which requires policy changes to these fundamentals rather than to trade policies. Ironically, or more accurately, ill-advisedly, the just enacted Tax Cuts and Jobs Act will increase this imbalance and result in a larger trade deficit.

If trade tensions were not enough, geopolitical risks are rising as well, and the uncertainty surrounding tensions with North Korea, Iran, the Middle East, islands in the South China Sea, and U.S.-Russia saber-rattling is an additional negative factor affecting markets. Safe-haven capital flows have increased in recent weeks not only due to geopolitical uncertainty but also from trade tensions and equity market declines.

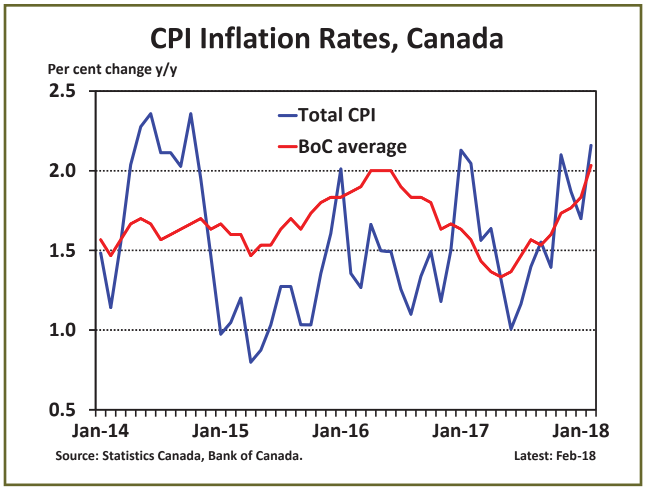
Recent economic reports are mostly positive, indicating ongoing global economic growth in its main regional economies. The first readings for March, from the manufacturing PMIs, were in the growth zone with some common themes emerging. The growth acceleration of the past several months is beginning to slow, stockpiling of goods is increasing, input costs are rising, and output prices are climbing. These are signs the economic cycle is maturing, albeit in varying degrees among the regional economies, requiring further removal of monetary stimulus.

The U.S. is at the forefront to normalize monetary conditions with its economy operating at or near full capacity. The FOMC raised its policy rate one quarter percentage point in March and for the sixth time this cycle beginning in Dec. 2015. The fed funds rate remains well below what is considered normal – between 2.5 and 3.5 per cent.

The FOMC was more hawkish given the strength of the economy and the coming boost from fiscal stimulus. Its new economic and interest rate projections revised up GDP growth forecast, lowered the unemployment rate, and edged up the inflation rate. The Fed expects three quarter point rate hikes in 2018, three in 2019, and two in 2020.

The fed funds futures market is less positive about the economy resulting in expectations of two more increases this year, one more in 2019, and none in 2020. Who will be closer to the mark - the Fed or the futures market? Barring a trade war or geopolitical crisis, this money is on the Fed.

Canada's economic news flow in March was less negative than in the prior month. Employment stabilized following a steep plunge in February as did retail and wholesale sales. Housing starts increased along with non-residential building permits. Not surprisingly, housing sales declined in response to the latest mortgage stress test. The main negative items were a small contraction in industry GDP, weaker exports, and a drop in manufacturing sales. Industry GDP declined 0.1 per cent in January mainly on a drop in oil sands production attributed to unscheduled maintenance. A bounce-back in February is likely.



Inflation picked up in February led by energy, durable goods, and services. Headline CPI rose 2.2 per cent year-over-year, up from 1.7 per cent in January while the Bank of Canada's core CPI measures increased to 2.0 per cent from 1.8 per cent. The Bank of Canada's CPI inflation forecast for Q1-2018 is 1.7 per cent, compared to 1.9 per cent currently, which will generate some concern.

Fourth quarter 2017 real GDP growth at 1.7 per cent annualized was pulled down imports and an inventory drawdown. The domestic economy performed very well advancing at a near four per cent pace. Business and residential investment and government capital spending were robust in the fourth quarter with personal consumption spending advancing at a moderate pace.

Housing sales during March will decline at a slower pace than in February, signaling the adjustment to the latest stress test is nearing an end. House price increases will slow further but not likely decline because listings will remain low.

Real GDP growth in the first quarter of 2018 is downgraded to 2.0 per cent given the weak start to the quarter. Second quarter growth was correspondingly raised to 2.5 per cent. Growth in 2018 is forecast at 2.2 per cent in 2018 and around two per cent in 2019. The consensus

Economic Forecast – Canada

	2017 Q3	2017 Q4	2018 Q1	2018 Q2	2016	2017	2018	2019
Real GDP, % annualized	1.5	1.7	2.0	2.5	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	2.0	2.1	1.4	1.6	2.3	2.2

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

Canada: Key economic data releases		
Indicator	Prior month	Latest month
Industry GDP	0.20%	-0.10%
Employment	-88.0k	15.4k
Unemployment rate	5.9	5.8
Real international goods exports	0.40%	-4.00%
Real international goods trade balance	-$1,124b	-$1,090b
Real manufacturing sales	-0.10%	-1.10%
Real retail sales	-0.70%	0.10%
Real wholesale sales	-0.50%	0.50%
Non-residential building permits	0.30%	5.00%
Housing starts	215.3k	229.7k
MLS residential sales	39.9k	37.3k
Total CPI	1.70%	2.20%
Core CPI1.	1.80%	2.00%

Source: Statistics Canada, CREA. 1. Average of three measures. Note: Per cent change except where indicated.

view is 2.1 per cent in 2018 and 1.8 per cent in 2018.

The Bank of Canada will release its new economic projections at the upcoming April rate announcement. Little change is expected to its 2018 2.2 per cent growth forecast, though the 2019 forecast of 1.6 per cent is likely to be revised higher. Of particular interest will be the Bank's new potential output estimates, which were temporarily raised in January, and look to be raised on a more official basis. This will increase the output gap and give the Bank more leeway to slow the pace of rate normalization.

Nonetheless, higher rates are coming unless the trade file implodes, or a geopolitical crisis explodes. This forecast sees the Bank on hold in April but raising in May followed by another quarter point raise in October. Two additional raises are expected in 2019 bringing the target rate closer to its neutral rate and likely at neutral in 2020 or early 2021.

Target Overnight Rate Forecast	
Meeting Date	(Per cent)
Mar. 7, 2018	1.25 (a)
Apr. 18	1.25
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
Jan. 2020	2.50
Mar.	2.50

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

The futures market is pricing a quarter-percentage point move in May and another before December. Thereafter, the expectation for the next increase is September 2019, remaining on hold until late 2020. Similar to the Fed funds futures market, market expectations in Canada are pessimistic about the economy in the medium term.

A preliminary NAFTA deal in April will boost markets and growth expectations. Bond yields will rise and retrace most, if not all, the decline of the past two months. CAD will appreciate to 79 US cents, possibly higher. How likely a deal will be reached is difficult to know, but if the US is willing to compromise on key chapters, such as dispute settlement, auto content, a sunset clause, etc., a deal is more likely.

Reports have it that the U.S. wants a preliminary deal by April 13, which is before the Bank of Canada's rate announcement. Should this transpire, the Bank may be more willing to move in April, though a preliminary deal still leaves the possibility of no deal. The Bank will not speculate whether the preliminary deal is a done deal and not be moved to move in April on this basis.

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Interest Rate Forecast

	2018 Q1a	2018 Q2	2018 Q3	2018 Q4	2019 Q1	2019 Q2	2019 Q3	2019 Q4	2020 Q1
Target Overnight Rate	1.20	1.35	1.50	1.70	1.80	2.00	2.25	2.25	2.50
Prime Rate	3.40	3.55	3.70	3.90	4.00	4.20	4.45	4.45	4.70
1-mo. T-Bill	1.07	1.20	1.40	1.60	1.70	1.90	2.15	2.20	2.40
3-mo. T-Bill	1.14	1.30	1.50	1.70	1.80	2.00	2.25	2.30	2.50
6-mo. T-Bill	1.31	1.45	1.65	1.85	1.95	2.15	2.40	2.45	2.65
1-year T-Bill	1.59	1.75	1.90	2.10	2.20	2.45	2.70	2.75	2.90
2-year GoC Bond	1.80	1.95	2.10	2.35	2.45	2.70	2.95	2.95	3.10
3-year GoC Bond	1.90	2.05	2.25	2.50	2.60	2.85	3.15	3.15	3.35
5-year GoC Bond	2.04	2.15	2.35	2.60	2.70	2.95	3.25	3.25	3.45
10-year GoC Bond	2.24	2.30	2.50	2.75	2.85	3.10	3.40	3.40	3.55

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

Deposit Rate Forecast

	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1	2019 Q2	2019 Q3	2019 Q4	2020 Q1
1-year GIC	0.73	0.75	0.85	0.95	1.05	1.15	1.25	1.25	1.35
3-year GIC	1.35	1.35	1.45	1.60	1.70	1.85	1.95	1.95	2.05
5-year GIC	1.60	1.60	1.70	1.95	2.00	2.15	2.25	2.25	2.30

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									
	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1	2019 Q2	2019 Q3	2019 Q4	2020 Q1
1-year Mortgage	3.32	3.35	3.50	3.70	3.75	3.95	4.15	4.15	4.35
3-year Mortgage	4.08	4.15	4.30	4.50	4.55	4.75	4.95	4.95	5.20
5-year Mortgage	5.12	5.20	5.35	5.50	5.50	5.65	5.80	5.80	5.90

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.