Central 1™

Interest Rate Forecast

Economics May 2017

Highlights

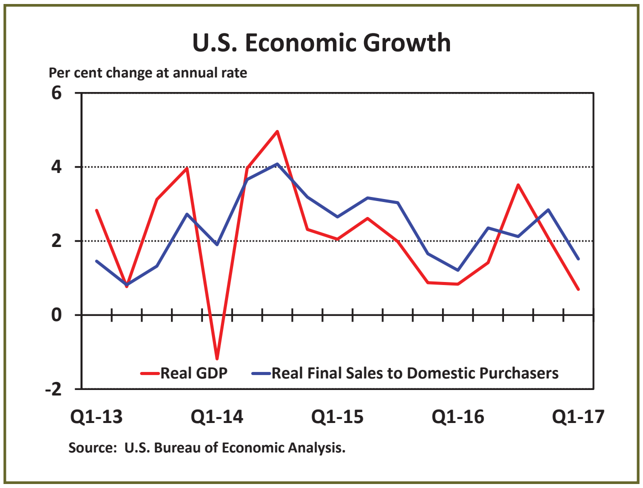
- Economy churns ahead despite policy issues
- Fed to hike in June
- No Bank rate increase this year

A key political risk was lessened with the election of French President Emmanuel Macron while others persist. North Korea, German elections, U.S.-China relations, Middle East tensions, and U.S. trade protectionism are problematic and remain potential market and economy disruptors. Recent economic news and developments were mixed but generally positive supporting the gradual reflation and growth resynchronization theme underway since late 2016. Interest rate movements mirrored these and geopolitical

The global economy continued to generate growth momentum in April according to PMI data various national surveys. The Composite Global PMI was unchanged in April from March and comparable with the first quarter average, which was the highest since early 2015. In April, Europe posted its best growth in two years while emerging economies, led by China, slowed.

First quarter 2017 U.S. GDP growth started on a weak note with real GDP expanding only 0.7% annualized, down from the fourth quarter's 2.1%. Consumer spending was nearly flat due to a large drop in auto sales and partially to poor weather in March. Fixed investment in energy and residential structures were significant growth drivers while trade made a small contribution and inventories were a large drag. Technically, measurement issues around residual seasonality possibly played a role as in prior first quarter GDP estimates. The recent pattern has been a weak first quarter offset by stronger gains in the second and third quarters.

A more accurate portrayal of the U.S. economy in the first quarter is real final sales to domestic purchasers, which expanded 1.5% annualized,



down from 2.8% in the prior quarter. This measure excludes net exports and inventories and has outperformed real GDP since late 2014 when USD began to appreciate.

More recent data such as the ISM surveys for April show a pullback in manufacturing from March but a rise in nonmanufacturing. U.S. job growth rebounded in April with a 211,000 gain and the unemployment rate fell to 4.4% from 4.5%, the lowest since 2006 sparking labour supply and wage-push inflation concerns. Wage growth will continue to accelerate and, ideally, entice more workers back into the labour force. Should this not transpire, a lack of workers would constrain job growth.

The U.S. economy is eight years into its recovery from the financial crisis and recession making this expansion the third longest in the post-war era. It has the potential to be the longest and extend for many more quarters because of considerable pent-up demand in housing and related consumer spending, faster personal income growth, historically low interest rates, and likely stepped up infrastructure and government spending.

GDP growth is widely seen rebounding in the second quarter to above 3% partially to a reversal of temporary factors pulling down the first quarter. Third quarter growth looks to ease back to around 2.5%. No U.S. recession is on the horizon based on these growth forecasts nor when examining leading economic indicators.

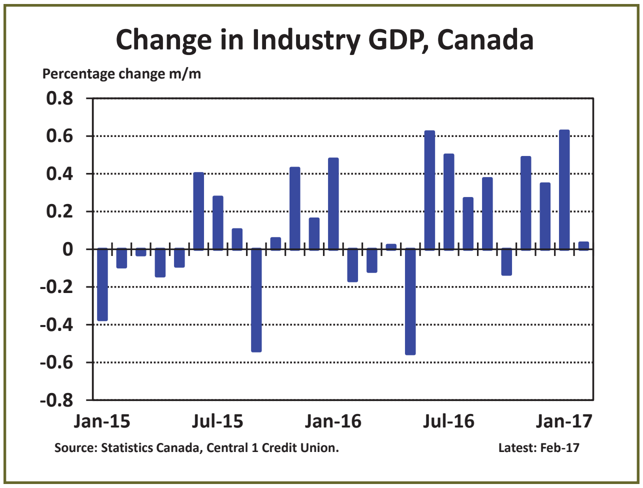
The ECRI weekly leading index rose in the week ended April 28 and the Conference Board's leading index posted another gain in March. The OECD's March leading index for the U.S. was not as robust showing only modest growth ahead. Leading indicators typically signal changes in economic activity six to nine months ahead. More importantly, imbalances and excesses that appear near the onset of a recession are not present. However, U.S. policy uncertainty is a wild card. Uncertainty related to trade, foreign relations, and domestic policies is high with the potential to cause cyclical, structural, and shock problems negatively impacting markets and the economy.

U.S. growth forecasts for 2017 through 2019 call for 2.0% to 2.5% annual performances under the current policy environment. Inflation is seen staying above 2% but restrained by higher interest rates as the Fed moves forward with rate normalization.

China's PMIs slowed in April posting a loss of momentum across both the manufacturing and service sectors. Policymakers efforts to cool debt-driven activity may have played a role and it could also be due to a payback for stronger activity in prior months. China's economy grew 6.9% in the first quarter, faster than in the prior quarter and the government's 2017 target. Growth is expected to slow with government implementing more measures to cool the property sector and to contain financial risks.

Turning to home, Canada's industry GDP growth was unchanged in February, following strong gains in seven of the previous eight months. The trade balance recorded a deficit in March as in February though in real terms a trade surplus emerged, which is important for real GDP while the nominal deficit is important for capital flows and the currency. CPI inflation cooled with a 0.2% decline in March on a seasonally adjusted basis, comparable to the 0.3% decline in February. The year-over-year change in consumer prices slowed to 1.6% from 2.0%. Declines were led by transportation, notably gasoline, and unwound some of the large increases seen recently. The Bank of Canada's preferred measures of core inflation slowed to around 1.5%.

April's Labour Force Survey (LFS) measured a statistically insignificant change in total employment, a 3,200 increase over March. The unemployment rate fell to 6.5% due to a decline in the labour force, mainly among 15-24 year olds. Sample variability likely played a role in April's weak reading and such outcomes occur occasionally and are meaningless. One month does not a trend make. Trend employment growth is around 15,000 monthly.



A fair amount of attention was placed on the slowest wage growth, 0.7% y/y in April, in many years recorded by the LFS. This measure of average hourly wages is overly influenced by geographic, industry, and full-time/part-time shifts. A more reliable measure from Survey of Employment, Payrolls and Hours is the fixed weighted index of average hourly earnings, which showed an increase of 2.4% y/y in February and is consistent with evolving labour market conditions.

Despite flat industry GDP in February, first quarter real GDP is expected to grow at a faster pace than in the prior quarter. Some forecasters see 3.5% or more annualized growth in the first quarter. We are less optimistic at 3.0% but the trade sector and inventories are usually the more volatile components and could send GDP higher than expected. However, one high quarter does not necessarily mean a permanent upshift has occurred. Most likely, a strong first quarter will be followed by a slower second quarter.

Beyond the short-term, Canada's economy looks to growth in the 2.0% to 2.5% range through 2019, assuming no major setbacks in trade policy. A slowdown from 2017 is expected but that has more to do with the base effect of a weaker 2016 than with a change in the real economy. As long as there is no global or U.S. economic recession or geopolitical event, Canada's economy will grow at a moderate pace. Specific industry developments, such as the oil price collapse, can have a large impact of Canada's overall growth performance and with major regional implications.

Economic Forecast - Canada								
	2016 Q3	2016 Q4	2017 Q1	2017 Q2	2016	2017	2018	2019
Real GDP, % a.r.	3.8	2.6	3	2	1.4	2.5	2.3	2.1
Unemployment Rate, %	7	6.9	6.7	6.6	7	6.6	6.4	6.1
Total CPI, % y/y	1.2	1.4	1.7	1.8	1.4	1.8	1.9	2.1

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

The U.S. Federal Reserve did not change its interest rate or balance sheet policies at its May meeting. A policy rate increase in June is very much in play. The FOMC noted that the labour market is strengthening and first quarter GDP weakness looks temporary. Fed funds futures are pricing in a high probability (83%) of a 25bps increase on June 14. The next increase is not fully priced in until March 2018.

Long-term bond yields declined through mid-April on reports of low inflation and geopolitical instability driving safe-haven demand but have risen into May reaching pre-April levels. No significant changes occurred in Canadian administered lending or deposit rates in the past four weeks

No change in the target overnight rate is expected at the Bank of Canada's May 24 rate announcement. The futures market for 3-months BAs is pricing in a near-zero probability. Looking further out, the futures market is looking to the third quarter of 2018 for a 25bps increase. Coincidentally, this is also the same time frame seen in this forecast. A gradual rate normalization process by the Bank will play out in Canada.

A steeper yield curve in Canada is foreseen developing over the next two years partly from U.S. spillover effects and from ongoing economic growth generating higher underlying inflation and inflation expectations. Higher commodity prices and faster wage growth are key drivers in this scenario. When the Bank has achieved rate normalization, the next phase will be monetary tightening and a flatter yield curve.

Target Overnight Rate Forecast	
Meeting Date	**(Per cent)**
Apr. 12, 2017	0.50 (a)
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	0.75
Sep.	0.75
Oct.	0.75
Dec.	0.75
Jan. 2019	1.00
Mar.	1.00

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

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Interest Rate Forecast									
	2017 Q1a	2017 Q2	2017 Q3	2017 Q4	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1
Target Overnight Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.75	0.75	1.00
Prime Rate	2.70	2.70	2.70	2.70	2.70	2.70	2.95	2.95	3.20
1-mo. T-Bill	0.43	0.45	0.45	0.45	0.45	0.45	0.70	0.70	0.95
3-mo. T-Bill	0.47	0.50	0.50	0.50	0.50	0.50	0.75	0.75	1.00
6-mo. T-Bill	0.52	0.55	0.55	0.55	0.55	0.55	0.80	0.80	1.05
1-year T-Bill	0.61	0.60	0.60	0.65	0.70	0.70	0.95	1.00	1.25
2-year GoC Bond	0.77	0.75	0.80	0.85	0.90	1.00	1.25	1.35	1.55
3-year GoC Bond	0.90	0.85	0.90	0.95	1.05	1.15	1.40	1.50	1.70
5-year GoC Bond	1.14	1.05	1.15	1.25	1.40	1.55	1.80	1.95	2.15
10-year GoC Bond	1.71	1.65	1.75	1.85	2.00	2.15	2.40	2.60	2.80

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

Deposit Rate Forecast									
	2017 Q1a	2017 Q2	2017 Q3	2017 Q4	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1
1-year GIC	0.73	0.75	0.75	0.75	0.75	0.75	0.75	0.85	0.95
3-year GIC	1.08	1.05	1.00	1.00	1.00	1.00	1.20	1.30	1.45
5-year GIC	1.30	1.15	1.15	1.15	1.15	1.25	1.35	1.40	1.60

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 Q1a	2017 Q2	2017 Q3	2017 Q4	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1
1-year Mortgage	3.14	3.15	3.15	3.15	3.15	3.15	3.25	3.30	3.45
3-year Mortgage	3.39	3.40	3.40	3.40	3.40	3.45	3.55	3.60	3.75
5-year Mortgage	4.64	4.65	4.65	4.65	4.65	4.70	4.85	4.95	5.10

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.