# Interest Rate Forecast

## Highlights

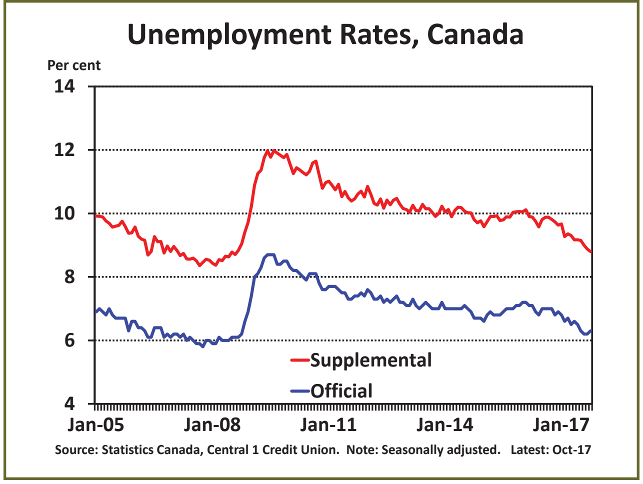
- Central bank on hold in December
- Uncertainty highlighted
- Economic growth downshifts in third quarter
- Gradual rate normalization ahead

The Bank of Canada will remain on hold in December, and likely until mid-2018, despite Its output gap estimates showing the economy approaching full capacity. In this circumstance, the Bank would usually remove monetary stimulus but not on this occasion based on the significant uncertainties it cites for the outlook and the recent data flow. In the medium term, the path of rate normalization will remain gradual, in line with moderate economic growth and those uncertainties.

In recent speeches, and in the Bank's last *Monetary Policy Report*, uncertainties related to inflation, labour market slack, soft wage growth, and elevated household debt are highlighted. How the first three will evolve is incorporated in the Bank's forecast but with a fairly wide range of possibilities. The fourth and last uncertainty is how sensitive the economy is to higher interest rates given elevated household debt.

The Bank offered possible explanations for low inflation rates, not only in Canada but globally, and these included globalization, the digital economy, and some temporary factors more recently, such as drop in food prices and the Ontario government's reduction in electricity prices.

Labour market slack as captured by the official unemployment rate is incomplete because it omits workers who have dropped out of the labour force, involuntary part-time workers, and those marginally attached to the labour force. Canada's official unemployment rate was 6.3 per cent in October while the all-in supplementary unemployment rate was 8.8 per cent, indicating



Source: Statistics Canada, Central 1 Credit Union. Note: Seasonally adjusted. Latest: Oct-17

substantial slack. Both measures have trended lower since the recession. The Bank's Labour Market Indicator shows excess capacity or more labour supply. A contrary indicator is the Bank's Intensity of Labour Shortages measure, which is at a post-recession high.

In addition to those measures of labour market slack, a relevant market indicator is the price of labour or wages. The slow pace of wage increases seen in Canada is directly, but not completely, driven by labour market slack. Other factors such as demographic and labour force compositional shifts to relatively more younger workers, globalization, and automation also come into play. The time lag between changes in labour market conditions and wage increases could account for some of the slow wage growth as well.

The Bank is concerned about elevated household debt and its impact on the economy during rising interest rates. Their research concluded the economy is more sensitive to higher interest rates than in the past. Regulatory changes on mortgage credit since the recession and the upcoming stress test on uninsured mortgages have increased credit quality, which should mitigate some of the negative impacts of higher rates.

Uncertainty around trade policy looms large in the outlook. The Bank cites some evidence this uncertainty is negatively impacting business investment, which is incorporated into their

| Key Canada economic data releases in past month | | |
|---|---|---|
| | Prior month | Latest month |
| Industry GDP | 0.00% | -0.10% |
| Employment | 10.0k | 35.3k |
| Unemployment rate | 6.2 | 6.3 |
| Real international goods exports | -1.40% | -0.20% |
| Real international goods trade balance | $24.1b | -$401.0b |
| Real manufacturing sales | 1.00% | 0.70% |
| Real retail sales | -0.50% | -0.60% |
| Real wholesale sales | 0.4 | -1.10% |
| Building permits | -5.10% | 3.80% |
| Housing starts | 219.3k | 222.8k |
| MLS residential sales | 41.2k | 41.6k |
| Core CPI | 1.60% | 1.60% |

Source: Statistics Canada, CREA.

forecast. Economic model simulations on the impact of a North American Free Trade Agreement (NAFTA) breakup show a mild negative impact on Canada with Mexico most impacted and the U.S. slightly impacted. In a full-blown trade war scenario, impacts deepen across the board.

The recent data flow tended to more negative than last month. Weakness emerged in international goods trade and there was further slippage in retail sales. However, housing held up posting small gains and the labour market had a solid job performance. Third quarter real GDP was never expected to match the high growth rates of the first half, but with key indicators available to September, a slower than expected rate of 1.5 per cent seem likely. The Bank of Canada is predicting 1.8 per cent.

The scenario behind this rate forecast is further moderate economic growth. The improving global economic environment is seen extending into 2018 and likely into 2019 with no economic recession on the horizon. Canada's export performance will still struggle notwithstanding supportive external markets and a relatively low loonie because of its limited product and market composition.

With trade not a significant growth driver, economic growth will depend on domestic demand. Personal consumption has more room to grow as long as income and job growth continue and interest rates are not punishing. Housing-related spending and residential investment will face tighter credit conditions and some slowing during the forecast period. A necessary driver for a growth upshift is business investment, and despite some gains in the first half, performance has been lacklustre. Government spending looks to make a larger contribution to growth though the results will remain spotty on fixed capital or infrastructure.

An alternative scenario is weaker economic growth, due perhaps to NAFTA becoming unraveled or to a policy mistake or to a geopolitical crisis, and the amount of slack in the economy increases. Rates would remain low, and possibly cut, because real GDP would decline, CAD depreciate, and CPI inflation rise temporarily.

Ultimately, the wage-inflation nexus is the main driver of short-term interest rates. In the base scenario, market forces gradually put more upward pressure on wages. It may well be that the wage-inflation tradeoff has changed significantly and wage increases will remain muted in this 'new normal' world of global competition, technological innovation, and improved communication channels. The new normal for the neutral target rate is around thee per cent compared to four per cent in prior decades.

The futures market for three-month Bankers Acceptances is pricing in a 25bps rate increase in

| Economic Forecast – Canada | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2017 Q1 | 2017 Q2 | 2017 Q3 | 2017 Q4 | 2016 | 2017 | 2018 | 2019 |
| Real GDP, % annualized | 3.7 | 4.5 | 1.5 | 2.5 | 1.5 | 3.1 | 2 | 2 |
| Unemployment Rate, % | 6.7 | 6.5 | 6.2 | 6.1 | 7 | 6.4 | 6 | 5.7 |
| Total CPI, % y/y | 1.9 | 1.3 | 1.4 | 1.6 | 1.4 | 1.6 | 1.9 | 2.1 |

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

April 2018 and almost 75 bps by Sept. 2019. The consensus forecast sees the target rate about 120bps higher.

In the base scenario, a steepening of the yield curve is expected before flattening later in the cycle. Administered rates will drift higher as the yield curve upshifts with a higher central bank rate and bond yields.

At this time, the balance of risks appears tilted to the negative mainly due to uncertain trade policy and to the geopolitical situation. These concerns may ease with the give and take in negotiations and in the ebb and flow of economic activity.

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| Target Overnight Rate Forecast | |
|---|---|
| **Meeting Date** | **(Per cent)** |
| Oct. 25 (a) | 1.00 |
| Dec. 6 | 1.00 |
| Jan. 2018 | 1.00 |
| Mar. | 1.00 |
| Apr. | 1.00 |
| June | 1.00 |
| July | 1.25 |
| Sep. | 1.25 |
| Oct. | 1.25 |
| Dec. | 1.50 |
| Jan. 2019 | 1.50 |
| Mar. | 1.50 |
| Apr. | 1.75 |
| June | 1.75 |
| Jul. | 1.75 |
| Sep. | 1.75 |

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

| Interest Rate Forecast | 2017 Q3a | 2017 Q4 | 2018 Q1 | 2018 Q2 | 2018 Q3 | 2018 Q4 | 2019 Q1 | 2019 Q2 | 2019 Q3 |
|---|---|---|---|---|---|---|---|---|---|
| Target Overnight Rate | 0.79 | 1.00 | 1.00 | 1.00 | 1.20 | 1.35 | 1.50 | 1.70 | 1.75 |
| Prime Rate | 3.00 | 3.20 | 3.20 | 3.20 | 3.40 | 3.55 | 3.70 | 3.90 | 3.95 |
| 1-mo. T-Bill | 0.73 | 0.85 | 0.90 | 0.95 | 1.15 | 1.30 | 1.45 | 1.65 | 1.70 |
| 3-mo. T-Bill | 0.81 | 0.95 | 1.00 | 1.05 | 1.20 | 1.35 | 1.50 | 1.70 | 1.75 |
| 6-mo. T-Bill | 0.98 | 1.05 | 1.10 | 1.15 | 1.30 | 1.45 | 1.60 | 1.80 | 1.85 |
| 1-year T-Bill | 1.20 | 1.30 | 1.40 | 1.45 | 1.55 | 1.70 | 1.80 | 2.00 | 2.10 |
| 2-year GoC Bond | 1.33 | 1.50 | 1.60 | 1.65 | 1.75 | 1.90 | 2.05 | 2.20 | 2.35 |
| 3-year GoC Bond | 1.39 | 1.55 | 1.65 | 1.70 | 1.85 | 1.95 | 2.10 | 2.25 | 2.40 |
| 5-year GoC Bond | 1.59 | 1.70 | 1.80 | 1.90 | 2.05 | 2.15 | 2.35 | 2.45 | 2.60 |
| 10-year GoC Bond | 1.95 | 2.00 | 2.10 | 2.20 | 2.35 | 2.45 | 2.70 | 2.75 | 2.95 |

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

| Deposit Rate Forecast | 2017 Q3a | 2017 Q4 | 2018 Q1 | 2018 Q2 | 2018 Q3 | 2018 Q4 | 2019 Q1 | 2019 Q2 | 2019 Q3 |
|---|---|---|---|---|---|---|---|---|---|
| 1-year GIC | 0.72 | 0.75 | 0.75 | 0.85 | 0.85 | 0.95 | 1.05 | 1.10 | 1.10 |
| 3-year GIC | 1.27 | 1.35 | 1.35 | 1.45 | 1.45 | 1.55 | 1.65 | 1.65 | 1.75 |
| 5-year GIC | 1.49 | 1.60 | 1.60 | 1.75 | 1.75 | 1.85 | 2.00 | 2.00 | 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 Q3a | 2017 Q4 | 2018 Q1 | 2018 Q2 | 2018 Q3 | 2018 Q4 | 2019 Q1 | 2019 Q2 | 2019 Q3 |
|---|---|---|---|---|---|---|---|---|---|
| 1-year Mortgage | 3.14 | 3.25 | 3.25 | 3.50 | 3.50 | 3.80 | 4.00 | 4.10 | 4.25 |
| 3-year Mortgage | 3.42 | 3.75 | 3.75 | 4.00 | 4.00 | 4.25 | 4.40 | 4.45 | 4.50 |
| 5-year Mortgage | 4.81 | 4.95 | 5.00 | 5.15 | 5.15 | 5.25 | 5.35 | 5.35 | 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.