Central 1™

Interest Rate Forecast

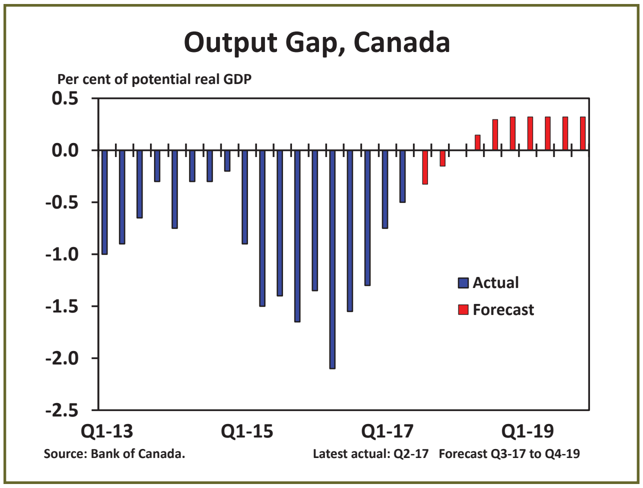
Economics   October 2017

Highlights

- Bank on hold in October
- Next rate increase soon thereafter

Now that the Bank of Canada has taken back the insurance rate cuts in response to the oil price collapse in 2015, what are the prospects for another rate increase this year? Another rate increase should occur if you go by the Bank's forecast of the economy. However, data released since their September meeting was mixed and it is likely the Bank will hold at its October meeting and raise at the December meeting.

Domestic economic indicators released since the Bank's September 6 meeting point to slower real GDP growth in the second quarter, though there was no expectation that it would surpass the 4.5 per cent annualized growth rate of the second quarter. Weaker exports, consumer spending, and building intentions contrasted with additional job growth, a bounce back in manufacturing sales, and housing gains. Core inflation was basically unchanged and remained below target.



Current expectations for third quarter real GDP growth between 2.0 and 2.5 per cent annualized. The Bank will release a forecast update on Wednesday, Oct. 25 and it will probably upgrade its third quarter forecast to 2.5 per cent from 2.0 per cent. In any case, the output gap (actual GDP minus potential GDP) will be nearer to zero, or the economy closer to full capacity. On this basis, the Bank should continue with rate normalization in October.

The Banks' autumn *Business Outlook Survey* revealed continued positive business sentiment across the country and prospects remained healthy, though moderated from the strong summer results.

Key Canada economic data releases since Sept. 6 Bank of Canada meeting

	Prior month	Latest month
Industry GDP	0.30%	0.00%
Employment	22.2k	10.0k
Unemployment rate	6.2	6.2
Real international goods exports	-1.80%	-1.50%
Real international goods trade balance	$723.9b	$9.3b
Real manufacturing sales	-1.40%	1.20%
Real retail sales	-0.20%	-0.70%
Real wholesale sales	2.1	0.40%
Building permits	-3.50%	-5.50%
Housing starts	225.9k	217.1k
MLS residential sales	40.2k	41.1k
Core CPI	+0.1 ppt.	no change

Source: Statistics Canada, CREA.

The external economic environment remains mostly positive with a modest pickup in global growth ahead. More key economies are growing at a faster pace in recent months and the large initial negative impact of the oil price collapse is over. Monetary conditions remain very accommodative most economies and fiscal stimulus measures are increasing.

Trade and geopolitical policies cloud the outlook and increase uncertainty. For Canada, NAFTA and the Softwood Lumber Agreement (SLA) are key influencers on important sectors and on the overall economy. The SLA preliminary duties will likely be unchanged and become final shortly. Their negative impact will be partially mitigated by higher lumber prices. NAFTA looms as a much larger negative economic impact. The U.S. may withdraw from it in 2018 causing substantial market disruptions, reducing trade flows, and raising U.S. import costs.

Geopolitical issues are becoming more contentious and have the potential to seriously disrupt financial markets and the economy. It is difficult to incorporate such risks into a forecast other than in a scenario situation. Should a crisis event occur, the USD would appreciate with safe-haven flows buying U.S. T-bonds, sending those yields lower. Lower U.S. yields and weaker economic conditions would pull down domestic bond yields and likely short-term rates engineered by the central bank.

The U.S. Federal Reserve is widely expected to raise rates in December, though the futures market for the 30-day fed funds rate assigns only an 80 per cent probability. Should data or policy events turn negative in the meantime, the Fed would hold off. Beyond the near-term, the futures market is pricing in three 25bps increases by the end of 2019. The consensus of economic forecasters has five increases with the most optimistic on the economy predicting seven increases and the most pessimistic no change.

Other factors influencing the Canadian economy and inflation are coming policy changes on mortgage credit and the minimum wage. The federal banking regulator announced a 'rate stress test' for uninsured mortgage borrowers effective Jan. 1, 2018 and the Ontario government has the minimum wage rising to $14.00 from $11.60 effective 2018. Other provinces have or will raise their minimum wage, though by a smaller increment.

Tighter mortgage credit will reduce sales activity and cool prices at the margin. In the lead up to the new rule, sales activity will spike, pulling some sales forward, creating a dip in the first quarter of 2018. Thereafter, sales will stabilize at a lower level than in 2017 and grind higher. As long as the economy generates jobs, income growth, and consumer confidence, i.e., does not fall into recession, the housing market will hold up. Higher mortgage rates in 2018 and 2019 will cut into sales growth. Less housing activity from this new regulation will cut into economic growth.

The economic impact of higher minimum wages will play out in employment and inflation and depends on labour and product supply-demand conditions in sectors or industries. In general, most research finds a negative impact on employment of low-skill workers and little impact on inflation when the increase is small but a large increase has a noticeable inflation impact. Ontario's large increase will raise the province's CPI and the national CPI by a smaller amount.

With the national economy approaching full capacity and to inflation trend higher not only from the minimum wage effect but also from the ending of the food and oil price declines and the economy operating above its potential capacity. A central bank needs to react before inflation becomes a problem because interest rate changes affect the economy with a time lag estimated to around 18 months.

Economic Forecast – Canada

	2017 Q1	2017 Q2	2017 Q3	2017 Q4	2016	2017	2018	2019
Real GDP, % annualized	3.7	4.5	2.5	2.0	1.5	3.2	2.3	2.0
Unemployment Rate, %	6.7	6.5	6.2	6.1	7.0	6.4	6.0	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. Orange shaded values are forecasts.

The next major release on the economy is Dec. 1, when third quarter GDP data comes out, which is expected to record growth well above the economy's potential thereby further closing the output gap. While weakness in some recent indicators will keep the bank on hold in October, the third quarter GDP report should be enough evidence to raise the target rate another 25 bps. Of course, that GDP report may disappoint or negative developments may put off a December move.

The path of rate normalization looks to be more rapid in its initial stages before slowing to a more gradual pace with the central bank cautiously navigating towards normal – whether that is the new or old normal remains to be seen. Most see is it as a new normal with moderate economic growth and inflation, and hence, a new normal target rate around 2.5 per cent.

The futures market for three-month BAs is pricing a 70 per cent probability of a 25bps rate increase in December and a 100 per cent chance of two 25bps increases by Sept. 2018. Another 25bps increase by the end of 2019 is priced in for a total of three rate moves. This forecast sees four 25bps rate increases during the same period, which is at the low end of the consensus forecast range.

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Target Overnight Rate Forecast

Meeting Date	(Per cent)
Sep. 6 (a)	1.00
Oct. 25	1.00
Dec. 6	1.25
Jan. 2018	1.25
Mar.	1.25
Apr.	1.50
June	1.50
July	1.50
Sep.	1.50
Oct.	1.75
Dec.	1.75
Jan. 2019	1.75
Mar.	1.75
Apr.	1.75
June	1.75
Jul.	2.00
Sep.	2.00

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	1.05	1.25	1.50	1.50	1.75	1.75	1.75	2.00
Prime Rate	3.00	3.25	3.45	3.70	3.70	3.95	3.95	3.95	4.20
1-mo. T-Bill	0.73	1.00	1.20	1.45	1.45	1.70	1.70	1.75	1.95
3-mo. T-Bill	0.81	1.05	1.25	1.50	1.55	1.75	1.75	1.80	2.05
6-mo. T-Bill	0.98	1.15	1.35	1.60	1.65	1.85	1.85	1.90	2.15
1-year T-Bill	1.20	1.40	1.60	1.85	1.90	2.10	2.10	2.15	2.40
2-year GoC Bond	1.33	1.50	1.70	1.95	2.00	2.20	2.20	2.25	2.50
3-year GoC Bond	1.39	1.55	1.75	2.00	2.05	2.25	2.25	2.30	2.55
5-year GoC Bond	1.59	1.75	1.95	2.20	2.25	2.45	2.45	2.50	2.75
10-year GoC Bond	1.95	2.10	2.35	2.60	2.65	2.85	2.85	2.90	3.20

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	0.85	0.90	0.95	1.10	1.10	1.15	1.40
3-year GIC	1.27	1.20	1.30	1.45	1.45	1.55	1.55	1.55	1.70
5-year GIC	1.49	1.60	1.75	1.85	1.85	2.00	2.00	2.00	2.15

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	3.45	3.60	3.85	3.95	4.10	4.10	4.10	4.45
3-year Mortgage	3.42	3.75	3.95	4.20	4.20	4.35	4.40	4.45	4.75
5-year Mortgage	4.81	4.90	5.00	5.15	5.15	5.25	5.25	5.25	5.40

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.