Central 1™

Interest Rate Forecast

Economics April 2018

Highlights

- Bank of Canada stays the course
- Mortgage rates hiked
- Housing holds up
- Central bank rate increase pending

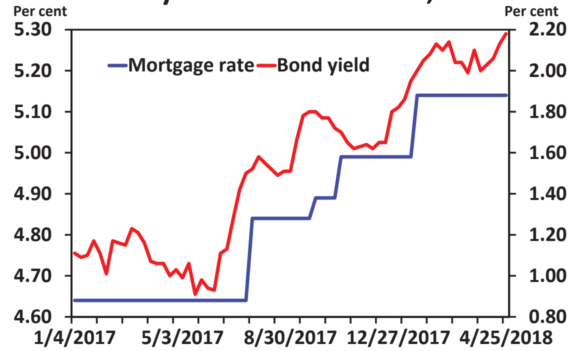
The Bank of Canada took center stage in April and delivered its standard performance. A largely neutral assessment of economic prospects with some emphasis on building inflation pressure and the strong likelihood of higher rates over time led by incoming data. No rate increase was announced, though none was expected. The Bank tinkered with its economic forecasts and potential growth estimates resulting in little change from its prior assessment.

Short-term rates and bond yields trended higher during April, though short-term rates fell back following the Bank's non-move. Higher bond yields toward month-end began to signal a looming increase in mortgage rates. One major bank pulled the trigger on Thursday, April 28 with a large 45bps jump in its five-year fixed mortgage rate to 5.59 per cent, raising many eyebrows. Another major bank also raised its five-year fixed mortgage rate, but by a lesser 20 bps to 5.34 per cent. The remaining banks will likely follow at the lesser rate increase.

The reason for the large variation in mortgage rate increases is not obvious, but it would appear the larger increase is due to company specific factors rather than entirely to a higher cost of funds motivation. As an aside, the 45bps increase in the five-year fixed mortgage rate was the largest since early 2010.

The Bank's posted five-year fixed term rate is used as one of the criteria in stress tests required by regulators. The Bank's method of calculating the posted reference rate is based on the mode of the rate distribution, i.e., the most frequent occurrence. If most banks opt for a 20bps

Posted 5-year Fixed Mortgage Rate and 5-year GoC Bond Yield,



Source: Bank of Canada.

increase in the five-year fixed mortgage rate, the Bank's published rate will be 5.34 per cent.

Consequently, qualifying income requirements for residential mortgages will be higher under the stress test criteria. More potential borrowers may postpone their home purchase to acquire the extra funds needed. Home sales will slow, at least temporarily, as a result.

Housing sales in April are expected to come in close to March's level and probably somewhat higher. This would signal that the market's adjustment to the latest stress test is close to, or at an end. Some further softness in prices, as measured by CREA's HPI, is likely but the overall reaction to the stress test was typical and relatively mild. Housing market activity is expected to hold in a range during the rest of the year.

The likely medium-term outlook for the housing market is a 'soft landing', playing out over the next two to four years. This entails an ongoing, gradual deterioration in first-time buyer affordability due to rising mortgage rates and home prices. Fewer entry-level buyers negatively impacts existing homeowner turnover, and unless new entrants to the market area offset, overall sales will trend lower. Housing supply, listings from the existing housing stock, will follow sales lower keeping prices from declining significantly, while new construction will likely overshoot. At this cycle's end, a mild price correction around five to ten per cent is conceivable.

A more serious home price correction, of 25 per cent or more, would require a trigger, such as an economic recession or geopolitical crisis event to disrupt the economy, financial markets, and consumer confidence. The odds of an economic recession in the near-term remain low, though looking beyond 2018, the ability of leading economic indicators and forecasters to accurately predict a recession is poor. That the current business cycle in North America is the second longest in the post-war era is not a sufficient condition to predict a recession.

The latest economic data are mostly positive and trending higher, abstracting from monthly noise due to weather, transportation, political, or holiday issues. Flash PMI reports indicated further expansion in the U.S., EU, and Japan economies, and in some instances at a faster pace than in March. The full suite of PMIs will come out in another week.

Real GDP in the U.S. economy expanded at a 2.3 per cent annual rate in the first quarter of 2018, slightly slower than in the fourth quarter of 2017, but in line with the 2.0 to 2.5 per cent trend growth observed. For the year, growth is forecast at close to three per cent, and potentially, the fastest pace since the last recession. The Tax Cuts and Job Act, along with the federal $300 billion spending plan, prompted upward revisions to 2018 and 2019 growth forecasts.

With a four per cent unemployment rate and building wage pressure along with rising commodity and energy prices, inflation concerns by the central bank are no doubt mounting. Hence, the Federal Reserve is turning more hawkish. The updated interest rate projections, or the dot plot, showed a more aggressive stance in 2019 and 2020 than previously. The Fed is likely to raise its policy rate at least two, probably three, more quarter-point increases in 2018 with another three rate increases next year.

The fed funds futures market is less positive about the economy and concerned about inflation with only two quarter-point increases this year, one in 2019, and none in 2020. The market is pricing in a seven per cent probability of a rate increase at the Fed's May 2 meeting and a 93 per cent chance at its June 13 meeting.

Turning to Canada, the data flow was more positive than in the prior month. Inflation edged higher and the labour market posted a significant jobs gain while manufacturing and retail sales reversed the prior month's losses. Industry GDP rebounded in February following production issues in oil and gas and auto manufacturing in January.

Our forecast for real GDP growth in the first quarter of 2018 is downgraded to 1.5 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 2.1 per cent in 2018 and around two per cent in 2019. The consensus view is 2.1 per cent in 2018 and 1.8 per cent in 2018.

The Bank's new forecasts in the Monetary Policy Report were extended to 2020 with real GDP growth in 2018 revised lower and 2019 revised higher, compared to the previous quarterly report. The weak first quarter in 2018, revised down to 1.3 per cent annualized growth from 2.5 per cent, was the main reason behind 2018's downgrade. The upgrade to 2019 is based on the trade sector - more exports and fewer imports – making a large contribution to growth. Final domestic demand is expected to slow to 1.8 percentage points in 2019 from 2.5 in 2018.

Potential economic growth was raised 0.4 and 0.3 percentage points in 2018 and 2019, respectively, due to improved business investment historically and for future prospects. This means the economy has more room to grow without causing inflation.

Economic Forecast – Canada

	2017 Q3	2017 Q4	2018 Q1	2018 Q2	2016	2017	2018	2019
Real GDP, % annualized	1.5	1.7	1.5	2.5	1.4	3	2.1	2
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	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, % change	-0.1	0.4
Employment, change, persons (000s)	15.4	32.3
Unemployment rate, %	5.8	5.8
Real international goods exports, % chg.	-2.3	0.2
Real international goods trade balance	-$313.4b	-$847.0b
Real manufacturing sales, % change	-1.2	2
Real retail sales, % change	-0.1	0.3
Real wholesale sales, % change	0.7	-0.9
Non-residential building permits, % change	4.5	-6.6
Housing starts, units, % change	6.7	-2.5
MLS residential sales, % change	-6.3	1.3
Total CPI, % change	2.2	2.3
Core CPI[1], % change	2	2

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

In the end, the net impact on the Bank's output gap (actual minus potential GDP) estimate was little changed with the economy considered to be operating at, or very near, full capacity. By the end of 2020, the economy will be operating at a larger positive output gap, though at only 2.1 per cent CPI inflation. The Bank incorporates an interest rate assumption into their forecasts.

In the Bank's ideal world, economic growth settles in at the potential growth rate with inflation at two per cent. The neutral Bank target rate in these circumstances will be between 2.5 and 3.5 per cent. This implies another 125bps to 225 bps, or five to nine quarter-point, increases are likely into 2020 with actual timing determined by the data flow.

The data flow could be disrupted by a deterioration in trade issues, either a NAFTA cessation, U.S.-China escalation, or U.S. vs others. A geopolitical crisis event is another possibility, with no shortage of possible candidates, but all involving the U.S. An economic recession due to these, or other developments, is also possible. The Bank would cut rates in these circumstances.

The recent run-up in bond yields since mid-April has eased to levels comparable to late January and early February of this year. The rationale for the latest increase in fixed mortgage rates is on shaky ground, particularly the 45bps increase in the five-year fixed rate. Other banks usually follow the leader but likely with a lesser increase.

Our forecast calls for another Bank quarter-point increase at their July meeting, which assumes no economic disruption plays out. The pace of rate normalization will be gradual, and we see it evolving at a slower pace than the Bank projects.

Target Overnight Rate Forecast	
Meeting Date	**(Per cent)**
Apr. 18, 2018	1.25 (a)
May 30	1.25
July 11	1.50
Sep. 5	1.50
Oct. 24	1.50
Dec. 5	1.50
Jan. 2019	1.50
Mar.	1.75
Apr.	1.75
June	1.75
Jul.	1.75
Sep.	1.75
Oct.	2.00
Dec.	2.00
Jan. 2020	2.00
Mar.	2.00

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

The futures market is pricing a quarter-point move in July and another in December. Thereafter, the next increase is around June 2019 and another around September 2020.

Administered rates will be trending higher with larger mortgage rate increases than deposit rate increases. In addition to a higher cost of funds pushing up mortgage rates, a factor working in the opposite direction will be slowing mortgage loan demand. Competition among lenders should become more intense over a shrinking new loan origination market with the effect of restraining rate increases. However, Canada's oligopolistic market structure in residential mortgages is not conducive to competitive actions.

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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	1.25	1.45	1.50	1.55	1.75	1.75	1.90	2.00
Prime Rate	3.40	3.45	3.65	3.70	3.75	3.95	3.95	4.10	4.20
1-mo. T-Bill	1.07	1.20	1.40	1.45	1.50	1.70	1.70	1.85	1.95
3-mo. T-Bill	1.14	1.25	1.45	1.50	1.55	1.75	1.75	1.90	2.00
6-mo. T-Bill	1.31	1.40	1.60	1.65	1.70	1.90	1.90	2.05	2.15
1-year T-Bill	1.59	1.70	1.90	1.95	2.00	2.15	2.20	2.35	2.45
2-year GoC Bond	1.80	1.95	2.15	2.20	2.25	2.40	2.45	2.60	2.70
3-year GoC Bond	1.90	2.05	2.25	2.30	2.35	2.50	2.55	2.70	2.80
5-year GoC Bond	2.04	2.20	2.40	2.50	2.55	2.75	2.80	2.95	3.05
10-year GoC Bond	2.24	2.45	2.60	2.65	2.85	2.95	3.10	3.15	3.30

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	0.85	0.85	0.95	0.95	1.05	1.10
3-year GIC	1.35	1.35	1.45	1.45	1.45	1.55	1.55	1.65	1.70
5-year GIC	1.60	1.60	1.70	1.75	1.75	1.85	1.75	1.90	2.00

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	3.40	3.50	3.50	3.50	3.60	3.60	3.75	3.85
3-year Mortgage	4.08	4.20	4.30	4.30	4.30	4.45	4.50	4.65	4.75
5-year Mortgage	5.12	5.25	5.40	5.40	5.40	5.55	5.55	5.70	5.75

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.