Interest Rate Forecast

Highlights

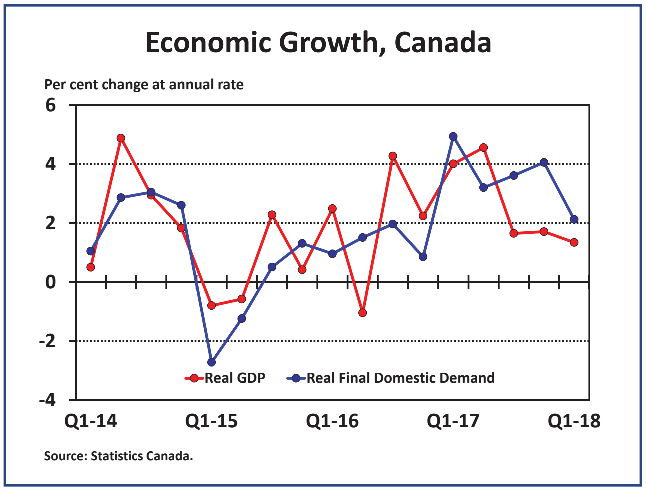
- Trump trade policy disruptive, uncertainty rises
- Slower global economy; U.S. bucks trend
- Fed rate increase coming in June
- Bank of Canada likely on tap in July
- Medium-term outlook policy-dependent

Trade tensions top the list of concerns and risks for economic prospects and monetary policy. The most recent trade action on steel and aluminum tariffs by the U.S. prompted retaliations, escalating tensions. Nonetheless, in the very near term, central banks in the U.S. and Canada will implement another round of rate increases, but the pace of normalization looks to slow in Canada.

It is early in this latest trade skirmish. The disruption to trade volumes and economic growth is small initially, however, the potential for more protectionist measures is considerable, especially with U.S.-China trade should those talks fail to reach a compromise. An escalation in trade retaliations is negative for world economy potentially resulting in a growth recession, and in the extreme, an outright recession.

This is playing out when the global economy is undergoing a growth slowdown mainly in Europe, China, Japan and other countries, except the U.S., according to May 2018 PMIs. This slowdown is off a 2017 resurgence and has been underway since early 2018. The main red flag is the weak performance in new export orders, which could be partly due to trade tensions.

U.S. economic growth was slower in the past quarter, but monthly indicators, such as the May 2018 jobs numbers and unemployment rate, point to faster growth in the second quarter. The full impact of the Tax Cuts and Jobs Act and new federal spending are still ahead, and growth looks to approach three per cent this year and above two per cent next year. With the economy at or near full employment and signs of faster wage growth and inflation beginning to percolate, the



Fed's upcoming June meeting should produce another quarter-point rate increase.

The market is not entirely convinced, though. The Fed Funds futures market is pricing in only a 75 per cent probability of a June increase, though a 100 per cent likelihood at the July meeting. The market's hesitation is likely based on the trade skirmishes initiated by the White House and on geopolitical problems ranging from Italy to Iran.

During the next two years, the fed funds rate should reach a 'normal' level of around three per cent barring a growth or outright recession. Whether these trade skirmishes evolve into something more serious is difficult to anticipate, but presumably at some point, saner policy will prevail. If not, the real economic impact would likely play out mostly in 2019 and beyond, which would see the central bank halt its normalization of monetary conditions.

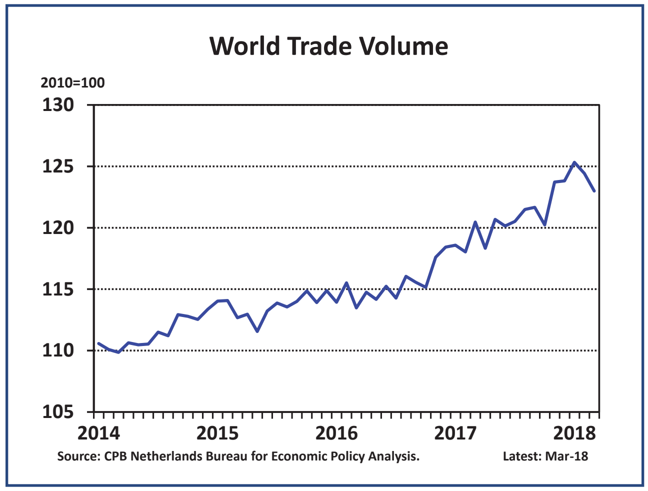
The Canadian economy is turning in a mixed, uneven performance. The first quarter GDP result of 1.3 per cent annualized growth was not as weak as it appears with final domestic demand expanding at 2.1 per cent. An import surge is the main reason for the weak headline GDP result aided by weaker housing-related expenditures. Indicators released in the past month were generally more positive.

The housing market reaction to the latest mortgage rate stress test is mostly over. Sales are down, and pricing is softer but there are signs of emerging stability. Sales are expected to grind higher in the second half and

Canada: Key economic data releases		
Indicator	Prior month	Latest month
Industry GDP, % change	0.4	0.3
Employment, change, persons (000s)	32.3	-1.1
Unemployment rate, %	5.8	5.8
Real international goods exports, % chg.	0.3	3.0
Real international goods trade balance, $b	-640.0	-1298.0
Real manufacturing sales, % change	2.2	0.6
Real retail sales, % change	0.4	0.7
Real wholesale sales, % change	0.7	-0.9
Non-residential building permits, % change	-6.4	4.5
Housing starts, units, % change	-2.6	-4.9
MLS residential sales, % change	-0.2	-2.9
Total CPI, % change	2.3	2.2
Core CPI1. , % change	2.0	2.0

Source: Statistics Canada, CREA. 1. Average of three measures.

hold up in 2019 based on income, job, and population growth along with a strong desire homeownership. The key for the housing cycle is the macroeconomic backdrop and whether growth continues at a moderate pace, slows, or turns negative.



The missing impetus to Canada's growth is non-energy exports and non-residential investment. Without those drivers shifting into a higher gear, Canada's economy will languish at less than two percent growth. A trade war scenario would bring growth down to one per cent or less while bumping up inflation, which the central bank would overlook as transitory, and rate cuts. Economic growth expectations for 2020 were downgraded resulting in a more gradual rate profile into 2020.

Economic Forecast – Canada								
	2017 Q4	2018 Q1	2018 Q2	2018 Q3	2016	2017	2018	2019
Real GDP, % annualized	1.7	1.3	2.5	2.0	1.4	3.0	2.0	1.8
Unemployment Rate, %	6.0	5.8	5.7	5.6	7.0	6.3	5.6	5.3
Total CPI, % y/y	1.8	2.0	2.1	2.3	1.4	1.6	2.3	2.2

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

Second quarter growth is seen rebounding to 2.5 per cent but slowing again in the third quarter. Growth in 2018 is downgraded to 2.0 per cent. The 2019 and 2020 outlooks are quite uncertain due to trade and geopolitical issues and could turn out more negative than thought. This forecast, and the consensus view, presumes trade and geopolitical polices will not be overly disruptive.

Our forecast for the Bank of Canada target rate is for a quarter-point increase at its July meeting in what is likely the last hike this year. The Bank could delay the July increase if trade issues deteriorate further and quickly. The impact of the U.S. steel and aluminum tariffs could reduce overall growth by 0.1 to 0.2 per cent and obviously by much more in those industries. If trade issues subside, the Bank will be more aggressive than in the profile outlined in this forecast.

The medium-term outlook to 2020 is quite uncertain due to trade and geopolitical issues and dependent on policy responses. The U.S. administration's nationalist approach to trade and addressing bilateral trade deficits with bilateral deals is unorthodox in the current era and disruptive to trade flows and investment expectations. Invoking national security under section 232 by the administration, thereby avoiding Congressional consent to initiate trade actions, is symbolic of this approach. With targeted countries responding in kind to U.S. tariffs, prospects for slower economic growth are rising.

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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	1.75
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

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	1.70	1.75	1.75	1.90	2.00
Prime Rate	3.40	3.45	3.65	3.70	3.70	3.95	3.95	4.10	4.20
1-mo. T-Bill	1.07	1.15	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	1.70	1.75	1.75	1.90	2.00
6-mo. T-Bill	1.31	1.40	1.60	1.65	1.85	1.90	1.95	2.05	2.15
1-year T-Bill	1.59	1.70	1.90	1.95	2.15	2.20	2.25	2.35	2.40
2-year GoC Bond	1.80	1.90	2.15	2.20	2.40	2.45	2.55	2.65	2.70
3-year GoC Bond	1.90	2.00	2.25	2.30	2.50	2.55	2.65	2.75	2.80
5-year GoC Bond	2.04	2.15	2.35	2.40	2.65	2.70	2.85	2.95	3.00
10-year GoC Bond	2.24	2.40	2.60	2.65	2.90	2.95	3.10	3.20	3.25

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.