

Highlights

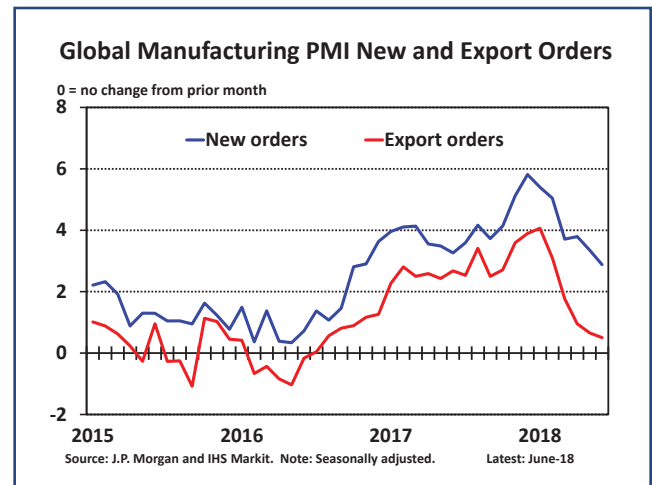
- Trade clouds hang over economy
- Bank of Canada to raise in July
- Mortgage rate cut likely

A deteriorating global trade situation makes the Bank of Canada's rate decision on July 11 the most difficult in several meetings. To what extent has, and will, escalating trade tensions derail growth and lift inflation is a question the Bank will wrestle with. Anticipating trade policy actions by this U.S. administration is not easy. With Canada's economy performing better in the second quarter and predicted to operate above its potential, the Bank is expected to raise its policy rate one more time this year and then wait for the trade issue and economic outlook to clarify.

The U.S. administration's trade track record and rhetoric have matched so far – tariffs on solar panels, washing machines, followed by steel and aluminum, and the \$50 billion tariffs on China. Canada, the EU, and China responded with retaliatory tariffs. However, the rhetoric is heating up with threats of U.S. tariffs on auto imports and on more imports from China.

Tariffs enacted thus far will not cause serious damage to those economies. However, each additional round of tariffs and retaliatory tariffs increases the economic loss and taken to the extreme, such as Trump's threat on auto and \$500 billion China imports, a global growth recession or outright recession would ensue. Will the U.S. administration follow through with its threats? The track record suggests yes, but the political reality may not allow for such an escalation. With respect to NAFTA, Trump stated that he would not sign a deal until after the U.S. midterm elections.

The global economy continued to expand in June with faster output growth led by the services sector. However, the manufacturing sector lost momentum partly due to the slowing pace in new export business,



which is a troublesome sign for future activity. Another contributor to the weaker June manufacturing PMI was declining business optimism, probably related to international trade concerns.

The U.S. economy generated better PMI results in June and other economic indicators support a three per cent plus annual GDP growth second quarter forecast. Some forecasts are close to four per cent. The Fed's rate increase in June and their dot plot projections are consistent with current trends and future expectations. Another two quarter-point rate increases this year and three or four more next year is the likely outcome. Next year's economic performance is more uncertain if trade tensions escalate.

Canada's economy will also post a faster GDP growth rate in the second quarter - 2.5 per cent versus 1.3 per cent in the first quarter. Economic indicators were mixed during the past month with the most positive tone coming from the labour market and consumer spending. Housing sales slipped lower in May, but the June sales report will likely be more positive with the adjustment to the B-20 guidelines largely digested.

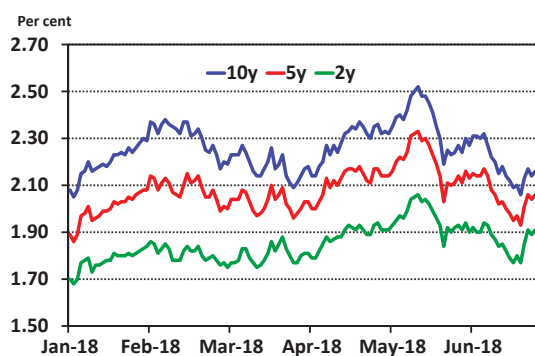
Excess capacity, or the output gap, in the Canadian economy effectively nil in the second quarter based on the Bank of Canada's potential output estimate and growth forecast. A positive output gap, actual GDP greater than potential GDP, is predicted going forward using the Bank's 2.0 per cent in 2018 and 2.1 per cent in 2019 forecasts. In this environment the Bank typically removes monetary stimulus, i.e., raises rates.

Canada: Key economic data releases

Indicator	Prior month	Latest month
Industry GDP, % change	0.3	0.1
Employment, change, persons (000s)	-7.5	31.8
Unemployment rate, %	5.8	6.0
Real international goods exports, % chg.	0.6	-1.0
Real international goods trade balance, \$b	182.0	-505.0
Real manufacturing sales, % change	0.6	-1.9
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	2.2	2.2
Core CPI1, % change	2.0	1.9

Source: Statistics Canada, CREA. Month-to-month changes except CPI year/year. 1. Average of three measures.

Government of Canada Bond Yields



Source: Bank of Canada.

Latest: Jul. 5, 2018

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	5.8	5.6	7.0	6.3	5.7	5.3
Total CPI, % y/y	1.8	2.0	2.2	2.3	1.4	1.6	2.3	2.2

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

The Bank will be updating its economic forecast at the July meeting when it releases the *Monetary Policy Report*. Little change to its GDP and CPI forecasts is expected.

The U.S. steel and aluminum tariffs and Canada's retaliation will negatively impact Canada's economic performance by a small amount and not enough to bring actual GDP below potential GDP. An escalation of the trade dispute to cover more goods and industries, notably autos, under tariffs would result in a substantial bite into growth and prompt a forecast downgrade.

This forecast has the Bank raising its policy rate a quarter-point at the July 11 meeting. The futures market is also pricing in the increase though some forecasters think the uncertainty over trade should keep the Bank on the sideline. This is a legitimate concern the Bank will address in its report and statement but with the economy at full potential, inflation around target, and the labour market generating faster wage increases, the Bank will likely take out some insurance. Should future economic conditions deteriorate, the Bank would reduce rates.

The pace of rate normalization is seen more gradual than in earlier forecasts and assumes that no

Target Overnight Rate Forecast

Meeting Date	(Per cent)
May 30, 2018	1.25 (a)
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.	1.75
Dec.	2.00
Jan. 2020	2.00
Mar.	2.00
Apr.	2.00
May	2.00

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

recession emerges. No additional rate increase in 2018 is foreseen and two quarter point increases in 2019 with a long interval between raises. The Bank's policy rate reaches 2.00 per cent in late 2019 but with considerable uncertainty around timing.

Bond yields have fallen about 20 to 40 bps, depending on term, from their mid-May 2018 highs. Mortgage rates were raised around mid-May but now look to be reduced. Bond yields have fallen due to safe-haven flows into U.S. bonds taking Canadian and other country bond yields with them. This is one consequence of trade disputes and the uncertainty created.

Mortgage rates will also face downward pressure from the downshift in residential loan demand. Lenders competing in a smaller market will react with price and nonprice competition.

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Interest Rate Forecast									
	2018 Q2 a	2018 Q3	2018 Q4	2019 Q1	2019 Q2	2019 Q3	2019 Q4	2020 Q1	2020 Q2
Target Overnight Rate	1.25	1.45	1.50	1.70	1.75	1.75	1.80	2.00	2.00
Prime Rate	3.45	3.65	3.70	3.90	3.95	3.95	4.00	4.20	4.20
1-mo. T-Bill	1.11	1.40	1.45	1.65	1.70	1.70	1.75	1.95	1.95
3-mo. T-Bill	1.21	1.45	1.50	1.70	1.75	1.75	1.80	2.00	2.00
6-mo. T-Bill	1.40	1.60	1.65	1.85	1.90	1.90	1.95	2.15	2.15
1-year T-Bill	1.68	1.80	1.90	2.10	2.15	2.20	2.25	2.40	2.40
2-year GoC Bond	1.90	2.00	2.10	2.30	2.35	2.40	2.50	2.65	2.70
3-year GoC Bond	2.00	2.10	2.20	2.35	2.40	2.45	2.55	2.70	2.75
5-year GoC Bond	2.12	2.20	2.30	2.45	2.50	2.55	2.65	2.80	2.85
10-year GoC Bond	2.28	2.35	2.50	2.65	2.70	2.75	2.85	3.00	3.05

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

Deposit Rate Forecast									
	2018 Q2 a	2018 Q3	2018 Q4	2019 Q1	2019 Q2	2019 Q3	2019 Q4	2020 Q1	2020 Q2
1-year GIC	0.75	0.85	1.00	1.00	1.15	1.15	1.15	1.30	1.30
3-year GIC	1.35	1.35	1.35	1.45	1.45	1.45	1.45	1.70	1.70
5-year GIC	1.60	1.60	1.60	1.70	1.70	1.70	1.70	2.00	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 Q2 a	2018 Q3	2018 Q4	2019 Q1	2019 Q2	2019 Q3	2019 Q4	2020 Q1	2020 Q2
1-year Mortgage	3.40	3.50	3.50	3.50	3.60	3.60	3.60	3.75	3.75
3-year Mortgage	4.20	4.20	4.30	4.30	4.30	4.30	4.30	4.45	4.45
5-year Mortgage	5.25	5.25	5.35	5.35	5.35	5.35	5.45	5.60	5.60

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.