Interest Rate Forecast

Highlights

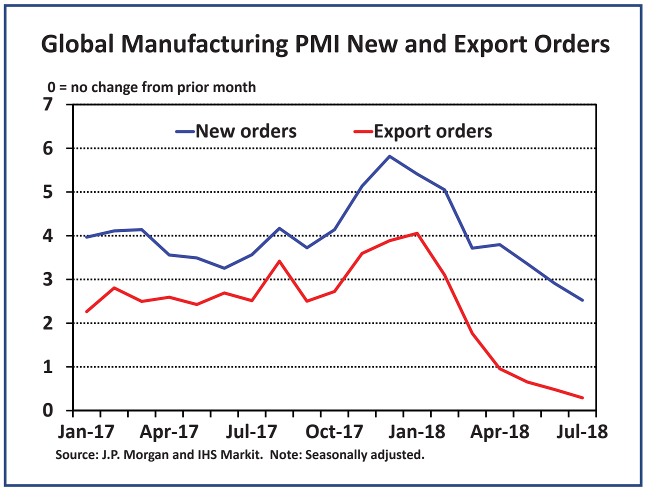
- Trade tensions escalate
- Increasing signs of trade damage
- Canada's economy operating above potential
- Bank of Canada moves in October

The economic impact of trade tensions and tariffs are minimal thus far but are becoming more evident and will be more impactful over time. The U.S.-China trade skirmish is turning into a trade war and U.S. trade actions against other trading partners are escalating. Adding to trade concerns, deteriorating financial conditions in Turkey are raising fears of a crisis requiring an IMF bailout and involving European bank losses.

Nonetheless, financial markets are buoyed by mostly positive economic data, especially coming out of the U.S. Offsetting this optimism are signs of slower growth and increasing vulnerabilities in emerging economies as the U.S. dollar and interest rates rise. Capital flows into safe haven assets such as U.S. government bonds has increased recently.

A slowdown in the global economy is apparent in the latest PMI data, particularly in manufacturing. The overall PMI expanded at a slower rate in July with manufacturing slowing for the seventh straight month due to weakening export orders. Most of this slowdown is centred in Asia.

The trade war between the U.S. and China continues to escalate. China will impose tariffs on $60 billion U.S. goods imports with tariff rates ranging from 5% to 25% in response to the U.S.'s planned tariffs on $200 billion in Chinese goods imports, which the Trump administration is considering raising to 25% from the original 10%. These measures are in addition to the 25% tariffs on $34 billion in goods in July and a further $16 billion to be implemented shortly. Trump has threatened to impose tariffs on all Chinese imports ($500 billion in 2017).



Imposing and raising tariffs will increasingly negatively impact the U.S. economy. The U.S. manufacturing sector is showing early signs of future weakness with the ISM manufacturing index down in July on weaker new orders and export orders among other components. Tariffs will ultimately result in higher costs, disruptions to the global supply chain, and lower output.

The U.S. economy posted a 4.1% annualized real GDP growth rate in the second quarter.
Growth was widespread, including fixed investment, consumer spending and exports, while inventories and imports were a drag. The economy is on pace for 3% growth this year with considerable momentum going into 2019 due to large fiscal stimulus, job and faster wage growth, and below-normal interest rates.

The Fed is poised to raise its policy rate at the upcoming September meeting and very likely once more before yearend. Three quarter-point increases in 2019 are likely, assuming no significant disruptions from trade tensions or a financial crisis in Turkey or other emerging economies.

Canada's economy will also post faster GDP growth rate in the second quarter following a slow first quarter and boosted by some temporary factors such as a return to more normal weather and more oil sands production after maintenance and construction shutdowns. Predictions for the second quarter are for three per cent annualized growth, with the Bank of Canada at 2.8% and some forecasters seeing more than three per cent.

Canada: Key economic data releases		
Indicator	Prior month	Latest month
Industry GDP, % change	0.1	0.5
Employment, change, persons (000s)	31.8	54.1
Unemployment rate, %	6.0	5.8
Real international goods exports, % chg.	-1.6	2.2
Real international goods trade balance, $b	-505	856
Real manufacturing sales, % change	0.9	0.7
Real retail sales, % change	-1.1	2.0
Real wholesale sales, % change	-0.1	1.3
Non-residential building permits, % change	-6	-0.7
Housing starts, units, % change	-2.6	-4.9
MLS residential sales, % change	3.4	1.9
Total CPI, % change y/y	2.5	3.0
Core CPI1. , % change y/y	2.0	2.0

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

Economic Forecast – Canada								
	2017 Q4	2018 Q1	2018 Q2	2018 Q3	2016	2017	2018	2019
Real GDP, % annualized	1.7	1.3	3.0	2.0	1.4	3.0	2.1	1.8
Unemployment Rate, %	6.0	5.8	5.8	5.7	7.0	6.3	5.7	5.3
Total CPI, % y/y	1.8	2.0	2.3	2.5	1.4	1.6	2.4	2.2

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

Most of the key economic indicators in the table reflect activity in May and June and support a second quarter GDP rebound. Third quarter real GDP growth is widely expected to slow to around two per cent annualized. The strong headline job growth in July suggests a higher number but it was diminished by more part-time and fewer full-time jobs. Nor will June's export and trade balance rebound hold up.

Headline CPI jumped to 3.0% year-over-year in July and may raise some alarm and expectation of a rate hike in September. Energy was the main driver of the acceleration, and while oil and gasoline prices are higher this year, gasoline prices were declining last summer resulting in a base effect boosting the year-over-year change. Core CPI, the Bank of Canada's preferred inflation guide, held steady at 2.0%.

Looking further ahead, Canada's economy is seen growing at less than two per cent in 2019 and likely in 2020 as well. Growth above two per cent will require a more robust export performance to offset a slower domestic economy. Downside risks from trade tensions and NAFTA aside, non-energy goods exports look to continue to lack significant impetus. A lower CAD is a positive but likely insufficient to spark an upshift or offset slower global growth. Less residential construction and slower increases in consumer, government, and business investment spending is anticipated.

In the near term, the Bank of Canada is expected to raise its policy rate one more time this year to account for the economy's strong second quarter performance and for the positive output gap (actual GDP greater than potential). Fundamentally, the increase is a continuation of the Bank's rate normalization process.

As to timing, while one forecaster has the quarter-point increase at September, the market and this forecast expects it at the Bank's October meeting. Little new economic information for July will be available for the Bank at its September meeting, while waiting another seven weeks for key economic data on the third quarter would prudent. In addition, there is no urgency to follow up July's increase with a consecutive meeting increase.

There is more downside than upside risk to the economy and core inflation in the medium term. Accordingly, this forecast has only one quarter point increase in 2019 followed by another in 2020. Should trade tensions dissipate and NAFTA 2.0 materialize, economic prospects improve, and rate normalization would advance at a quicker pace. Conversely, a negative a trade outcome would halt rate normalization, and under dire circumstances, require monetary stimulus. Other downside risks such as Turkey's financial difficulties exist, but trade policymakers hold the key.

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Target Overnight Rate Forecast	
Meeting Date	**(Per cent)**
July 11, 2018	1.50 (a)
Sep. 5	1.50
Oct. 24	1.75
Dec. 5	1.75
Jan. 9, 2019	1.75
Mar. 6	1.75
Apr. 24	1.75
May 29	1.75
Jul. 10	2.00
Sep. 4	2.00
Oct. 30	2.00
Dec. 4	2.00
Jan. 2020	2.00
Mar.	2.00
Apr.	2.25
May	2.25

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

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	1.70	1.75	1.75	1.95	2.00	2.00	2.25
Prime Rate	3.45	3.65	3.90	3.95	3.95	4.15	4.20	4.20	4.25
1-mo. T-Bill	1.11	1.35	1.60	1.65	1.65	1.85	1.90	1.90	2.20
3-mo. T-Bill	1.21	1.45	1.70	1.75	1.75	1.95	2.00	2.00	2.25
6-mo. T-Bill	1.40	1.60	1.90	1.95	1.95	2.15	2.20	2.20	2.45
1-year T-Bill	1.68	1.85	2.10	2.15	2.15	2.35	2.40	2.40	2.65
2-year GoC Bond	1.90	2.05	2.20	2.25	2.30	2.45	2.50	2.55	2.75
3-year GoC Bond	2.00	2.10	2.25	2.30	2.40	2.55	2.55	2.60	2.80
5-year GoC Bond	2.12	2.20	2.30	2.35	2.45	2.60	2.60	2.65	2.85
10-year GoC Bond	2.28	2.30	2.40	2.45	2.55	2.70	2.70	2.80	3.00

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	0.73	0.75	1.00	1.00	1.00	1.15	1.15	1.20	1.35
3-year GIC	1.18	1.10	1.25	1.25	1.30	1.45	1.45	1.50	1.70
5-year GIC	1.60	1.60	1.60	1.70	1.70	1.75	1.75	1.85	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	3.44	3.50	3.70	3.70	3.70	3.85	3.85	3.85	4.05
3-year Mortgage	4.25	4.30	4.40	4.40	4.45	4.55	4.60	4.65	4.85
5-year Mortgage	5.26	5.35	5.40	5.45	5.45	5.55	5.55	5.55	5.65

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.