Interest Rate Forecast

central 1

Highlights

- Trade tensions mount, fall-out minimal
- Oil prices climbing
- Higher U.S. rates
- Bank of Canada rate increase coming

Despite increasing trade tensions, U.S. and Canadian monetary policy will continue to normalize conditions in the near term. Those economies have not suffered any material setbacks from trade actions and are operating at levels requiring further removal of monetary stimulus. This stance will change when more trade tariffs are implemented, and the negative impacts of existing and new tariffs mount or other factors diminish growth.

Early signs of these negative impacts are materializing. The export orders index of the global manufacturing PMI has fallen to a two-year low since trade tensions intensified. Prices for intermediate and consumer goods hit by tariffs are up, and when additional tariffs are in place, inflation will bump up.

Central bankers usually look through transitory inflation impacts such as a spike in oil prices or a one-time tariff-driven price increase. But, when inflation induces wage increases, which in turn generates inflation pressure, central bankers respond with monetary tightening measures. With the economic and labour market environment in the U.S. already generating faster wage increases, the U.S. Fed will withdraw monetary stimulus for quite some time. In Canada, economic and inflationary conditions are not as urgent, and the Bank of Canada's more gradual approach looks to continue.

More tariffs have been implemented in the past month, the latest being U.S. duties on $200 billion imports from China and China's retaliation on $60 billion imports from the U.S. The U.S. duty rate begins at 10 per cent rising to 25 per cent by yearend, and the U.S. administration is threatening to impose duties on the remaining $267 billion of Chinese imports, if China does not relent.

Higher consumer prices are in the offing should those tariff measures proceed. Another inflation factor, at least in the near term, is higher oil prices due to U.S. sanctions on Iran. Most recently WTI is above $US 70 and Brent above $US 80. In 2019 should China's growth slow materially due to tariffs, its oil demand would subside along with other Asian EM economies, resulting in some downward pressure on oil prices. However, China is pursuing stimulative monetary and fiscal policies to counteract any growth slowdown.

Closer to home, the NAFTA dispute with the U.S. remains unresolved and Trump is threatening tariffs on autos and auto parts should a deal not favourable to the U.S. be made. The economic impact of no NAFTA on Canada's economy would be material, but not devastating, with real GDP loss estimates around 0.5 per cent over three to five years. The greater impact would come from auto tariffs with a loss in real GDP closer to one per cent over three to five years. Under these scenarios, the Bank of Canada would cut its policy rate and CAD would depreciate.

Turning to economic data, the U.S. is at or near full employment and growth is widely seen coming in around 3.0 per cent annualized in the third quarter, slower than the 4.2 per cent seen in the second quarter but above the economy's potential growth rate. With 2018 coming in around three per cent growth aided by fiscal stimulus, energy production and investment, income growth, and favourable interest rates.

Next year, growth looks to continue with leading economic indicators flashing green and no recession in sight. The economy looks to slow to around 2.5 per cent growth with the tax cut stimulus ebbing, higher inflation cutting into disposable income, and higher interest rates taking a larger bite. Business investment uncertainty will likely increase with tariff escalations and begin to affect non-energy investment spending. Positives will be faster wage and income growth, a higher USD offsetting higher priced imports, and further growth in energy.

The U.S. Federal Reserve's September rate hike will be followed up by another quarter-point increase in December and very likely three more increases in 2019. The market is pricing in only two rate increases in 2019. Unless the U.S. economy slows to below two

Canada: Key economic data releases		
Indicator	Prior month	Latest month
Industry GDP, % change	0.4	0.2
Employment, change, persons (000s)	54.1	-51.6
Unemployment rate, %	5.8	6.0
Real international goods exports, % chg.	2.4	-0.8
Real international goods trade balance, $b	699	1,006
Real manufacturing sales, % change	0.6	1.0
Real retail sales, % change	-0.2	0
Real wholesale sales, % change	-1.3	1.0
Non-residential building permits, % change	21.2	-5.3
Housing starts, units, % change	-16.1	-2.3
MLS residential sales, % change	3.0	0.9
Total CPI, % change y/y	3.0	2.8
Core CPI1. , % change y/y	2.0	2.1

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

Economic Forecast – Canada								
	2018 Q2	2018 Q3	2018 Q4	2019 Q1	2017	2018	2019	2020
Real GDP, % annualized	2.9	1.5	2,0	2,0	3.0	2.0	1.9	1.7
Unemployment Rate, %	5.8	5.8	5.7	5.6	6.3	5.8	5.5	5.3
Total CPI, % y/y	2.3	2.7	2.6	2.4	1.6	2.4	2.2	2.1

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

per cent growth and with similar prospects, the Fed will not curtail its rate normalization effort.

In Canada, incoming economic data are mixed but mostly positive. The Labour Force Survey continues to deliver large monthly swings, which cannot be taken seriously. Housing is showing more signs of adjusting to the B-20 mortgage regulations implemented on Jan. 1, 2018 with sales up in the last four months. Core CPI crept above two per cent in August giving the Bank of Canada a little more support for an October rate increase. The July industry GDP print showed the economy is growing, though third quarter real GDP is expected to slow.

Overall growth is seen at a forecasted 1.5 per cent annual pace in the third quarter following 2.9 per cent growth in the second quarter. Most of the expected slowdown will be in the trade sector. A moderate pickup is expected in the fourth quarter, and beyond this, growth is seen in the 1.5 to 2.0 per cent range through to 2020 – a lacklustre performance.

The Bank of Canada sees it somewhat differently and is banking on a turnaround in trade to generate 2.2 per cent growth in 2019. While desirable, and a long hoped for outcome by the Bank and others, it has not materialized and probably will not in the near term. Consequently, there is downside risk to the Bank's forecast unless other sectors grow faster.

The rate outlook remains one of gradual rate normalization by the Bank of Canada, which includes a quarter-point increase at its Oct. 24 meeting. The economy is operating at or near its full potential with core inflation at the mid-point of the target range. Another rate increase is consistent with its approach to stay ahead of the inflation curve. Following this increase, a longer pause is foreseen with only one additional quarter-point increase in 2019 and another single move in 2020.

The futures market for three-month Bankers' Acceptances is more optimistic by pricing in two quarter-point moves in 2019 – the first in March and the second around November. No rate increase in 2020 is currently priced in.

The prime rate lending rate will increase one quarter-point following the Bank's Oct. 24 move. Variable and shorter-term mortgage rates will follow though not necessarily longer-term mortgage rates. The five-year mortgage rate is more likely to increase when the cost of funds rises sufficiently or when bond yields rise and often due to higher U.S. bond yields. The recent downshift in Canadian home sales due to B-20 regulations along with affordability issues has slowed mortgage loan demand growth and increased competition among lenders putting downward pressure on rates.

A trade-related scenario could see the rate profile move either way. A NAFTA deal enhances economic growth and advances rate normalization, while no NAFTA and imposed auto tariffs degrades growth and unwinds rates. With today's politics at play it is not easy to correctly anticipate the outcome, but eventually a NAFTA deal with Canada is likely.

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Target Overnight Rate Forecast	
Meeting Date	**(Per cent)**
Sep. 5, 2018	1.50 (a)
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	1.30	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	1.65	1.90	1.95	1.95	2.15	2.20	2.20	2.45
1-year T-Bill	1.68	1.90	2.10	2.15	2.15	2.35	2.40	2.40	2.60
2-year GoC Bond	1.90	2.10	2.25	2.25	2.30	2.45	2.50	2.55	2.70
3-year GoC Bond	2.00	2.15	2.30	2.30	2.35	2.50	2.55	2.60	2.75
5-year GoC Bond	2.12	2.20	2.35	2.35	2.45	2.60	2.60	2.65	2.80
10-year GoC Bond	2.28	2.30	2.40	2.45	2.55	2.70	2.70	2.75	2.90

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.