Interest Rate Forecast

central 1

Highlights

- Bank of Canada raises rates
- Exports and housing key to Bank of Canada's forecasts
- Policy momentum to raise rates in 2019
- Slower growth in 2020 stalls rate normalization

Rate announcement as expected

The Bank of Canada's (Bank) rate increase on October 24 did not surprise markets. The removal of the word 'gradual' in the announcement was interpreted by many as a hawkish sign, implying faster rate increases ahead. The Bank has long maintained that it desires to have its policy rate at a neutral level and the announcement restated this goal. How quickly the Bank arrives at neutral will depend on incoming data, trade policy developments, and prospects for inflation.

The word gradual appeared in the last three announcements, and previously, the Bank used 'cautious' to describe its approach to future rate settings. In the Bank's Opening Statement, the reason for the deletion of 'gradual' was "…to avoid the impression that we are following a preordained, mechanical policy path"[1]. The Bank believes this is the market's impression. Interestingly, the timing of rate increases since July 2017 have not been on a regular timetable.

The Bank has previously stated that interest rates rising to a neutral level will be required over time. The Bank estimates the neutral policy rate to be between 2.5 per cent to 3.5 per cent, to be associated with an economy growing at its potential rate and output with inflation at two per cent. At the neutral rate, monetary policy is neither accommodative nor restrictive. The neutral rate varies based on economic factors and is one reason for the estimated range.

[1] https://www.bankofcanada.ca/2018/10/opening-statement-241018/

Minor forecast revisions

The Bank's latest assessment and forecast does not reveal a notable upgrade from recent Monetary Policy Reports (MPR). The Bank made very minor adjustments to headline Gross Domestic Product (GDP) growth in 2018 and 2019, compared to the prior two MPRs, and no change in its assessment that the economy is operating at close to its potential. The forecast itself does not signal a shift towards a more hawkish monetary stance.

Exports and housing key to Bank's forecast

Two aspects of the Bank's rather optimistic economic forecast stand out. The first is its export forecast. A substantial boost from exports to GDP growth is expected in 2018 amounting to 0.9 percentage points, up from 0.5 percentage points in the July 2018 MPR. However, this year through to Q2 2018, exports have contributed 0.55 percentage points to GDP growth on highly variable quarterly results due to temporary factors. Based on monthly results in the third quarter (see key releases table), exports will make little or no contribution to third quarter GDP growth. A fourth quarter surge is needed to reach the Bank's 2018 export forecast. Further, the Bank sees exports making significant contributions to 2019 and 2020 growth as well. The United States-Mexico-Canada Agreement (USMCA) has reduced some uncertainty, and as a result, the Bank revised its export forecast higher relative to the July 2018 MPR. The Bank's forecast calls for exports to account for about 40 per cent of overall GDP growth. With global and U.S. growth expected to slow, recent weakness in non-energy commodity prices, and Canada's export competitiveness restrained by several factors, the Bank's export forecast appears optimistic. A recent Bank research report concluded, "… broad-based competitiveness losses and structural supply factors to continue to restrain the growth of non-energy exports over the projection horizon, which extends until 2020."[2]

Housing is the second questionable aspect of the Bank's forecast. The Bank has housing, or more specifically residential investment, holding up through

[2] https://www.bankofcanada.ca/2018/08/staff-analytical-note-2018-25/ What Is Restraining Non-Energy Export Growth?

Canada: Key economic data releases		
Indicator	Prior month	Latest month
Industry GDP, % change	0.4	0.2
Employment, change, persons (000s)	-51.6	63.3
Unemployment rate, %	6	5.9
Real international goods exports, % chg.	-0.4	-1.1
Real international goods trade balance, $b	1.2	1.6
Real manufacturing sales, % change	1.2	-0.3
Real retail sales, % change	-0.2	-0.3
Real wholesale sales, % change	-1.3	1
Non-residential building permits, % change	21.2	-5.3
Housing starts, units, % change	-1.5	-5.1
MLS residential sales, % change	1	-0.4
Total CPI, % change y/y	2.8	2.2
Core CPI1. , % change y/y	2.1	2

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

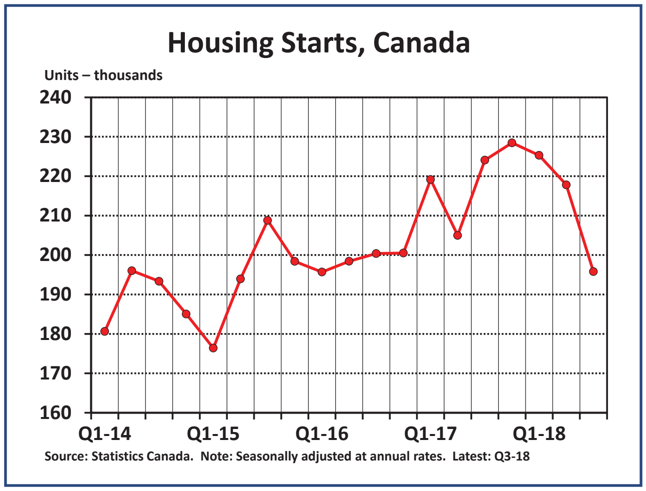
2020. But housing starts and sales, leading indicators of residential investment, have downshifted this year. The Bank recognized this in its latest forecast and reduced housing's growth contribution forecast by 0.2 percentage points from the previous MPR. While in the right direction, we see residential investment declining in 2019 and 2020, not holding up.

The Bank's real GDP forecast is 2.1 and 1.9 per cent in 2019 and 2020, respectively. With potential and actual real GDP growth at 1.9 per cent and inflation at 2.0 per cent, its forecast likely incorporates a neutral policy interest rate in 2020, and possibly earlier. How quickly the policy rate enters the neutral range depends on several factors including incoming data.

Canadian data flow mixed

Recent Canadian economic indicators are mixed. Consumer and housing are weaker. The large September employment gain will likely be unwound in the volatile October Labour Force Survey sample. Manufacturing came off in the latest month and exports were lower for the second consecutive month.

The two B20 mortgage guideline changes effectively act as large mortgage rate increases, and with further rate increases coming, housing activity will slow unless there is an offset from higher wages and faster population growth. Lower prices will inhibit new construction investment if construction costs do not fall faster to benefit profit margins.



U.S. growth holds for now; slowdowns in Europe, Asia-Pacific unfolding

U.S. GDP growth remains above trend at a 3.5 per cent annualized rate in the third quarter, only slightly slower than the 4.2 per cent estimated for the second quarter. Real final sales to domestic purchasers, or GDP less net exports and inventories, rose 3.1 per cent, down from 4.0 per cent in the second. One negative detail was the large inventory buildup, which implies an unwinding in the fourth quarter and slower GDP growth.

With the U.S. economy operating at full capacity, a tight labour market, and upward cost pressures, the Federal Reserve Board (Fed) will continue to remove monetary stimulus. The Fed wants to avoid being 'behind the inflation curve' and having to sharply raise rates after the fact, which usually causes a recession. Growth prospects are sufficiently favourable for the Fed to raise its policy rate this December and about three times in 2019, even with an expected growth slowdown to around 2.5 per cent.

These rate increases will bring the policy rate into the neutral zone, and if growth remains above the economy's potential in 2020, further rate increases will be required and will result in restrictive monetary conditions. However, growth prospects in 2020 are uncertain due to possible further trade restrictive policy actions, the impact of tariffs, slower global growth, and domestic and geopolitical political developments. A U.S. recession in 2020 is not likely unless policy mistakes occur, but slower growth is expected due to the unwinding of fiscal stimulus, looming fiscal restraint, higher interest rates, and slower global growth.

The global economy continues to desynchronize. Growth is slowing in Europe. The flash PMI (Purchasing Managers Index) for October 2018 put the

Economic Forecast – Canada								
	2018 Q2	2018 Q3	2018 Q4	2019 Q1	2017	2018	2019	2020
Real GDP, % annualized	2.9	1.5	2	1.5	3	2	1.8	1.7
Unemployment Rate, %	5.8	5.9	5.7	5.7	6.3	5.8	5.6	5.5
Total CPI, % y/y	2.3	2.7	2.3	2.3	1.6	2.4	2.1	1.9

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

Eurozone Composite Output Index at a 25-month low with manufacturing leading the slowdown. New orders eased and new export orders decreased, with many survey respondents referring to trade wars and tariffs as a cause. The Eurozone area will post slower growth in 2018 than last year and 2019 forecasts call for slower growth.

Growth prospects in China and Asia-Pacific emerging market economies are also dimmer. Manufacturing is slowing due to the escalating trade war with the U.S. and Chinese authorities are pursuing stimulative monetary and fiscal policies to counteract the slowdown. Expectations are for China's growth to slow to 6.3 per cent in 2019, down from 6.6 per cent in 2018. A top concern is China's growing debt burden, which authorities may put on the backburner while dealing with the slowdown.

Slowdown ahead for Canada

Our Canadian economic forecast has a similar quarterly profile as the Bank for the rest of 2018, at around two per cent growth. However, we see a weaker outcome for 2019 and 2020 than the Bank, based on weaker export and housing expectations. Our forecast has excess capacity developing in 2020 when growth falls below potential. This implies slower inflation in 2020 and no need for rate increases.

Bank to raise rates twice in 2019

Slower third quarter growth of 1.8 per cent will prompt the Bank to hold rates steady at its December meeting. As for the January 2019 meeting, which will be accompanied by a forecast update, we expect another hold as well because the global and U.S. economic data flow will become more negative. At that time, U.S. tariffs on $200 billion of China imports will be at 25 per cent, in addition to the original $50 billion. The impacts from these and previously imposed tariffs will take an increasing toll on China and its Asia-Pacific trading partners. The U.S. administration is threatening to impose tariffs on the remaining $250 billion of Chinese imports, and should this occur, it would be another negative for the global economy. Should the U.S and China reach a trade deal, growth prospects would markedly improve, and accelerate rate normalization in the U.S. and Canada.

As for the USMCA, the U.S. ratification process will occur in 2019 under a House of Representatives, and if controlled by the Democrats, rather than Republicans, its fate may be in doubt. If not ratified, the Bank would reinstate its more negative assessment on investment and exports, thereby reducing GDP and potential growth. Another issue with the USMCA ratification is removal of U.S. steel and aluminum tariffs on Canada and Mexico. Both parties have implied or stated the USMCA will not be signed unless the U.S. removes those tariffs. The U.S. is proposing a quota system to remove the duties, but that is not being well-received by the other parties.

Rate forecasts

With the economy operating at close to full capacity, unemployment at a 40-year low, and inflation on target, prospects remain favourable for further rate increases. The BAX (Canadian Bankers' Acceptance) Futures market is pricing in a quarter-point increase in January 2019, followed by another in July and about 50:50 odds of another in 2020. This forecast sees the next Bank rate increase at their March 2019 meeting, followed by another quarter-point increase in July. Prospects of below-potential growth in 2020 will prompt the Bank to remain on hold until circumstances warrant a change.

Some forecasts have the Bank's overnight rate reaching 3.00 per cent before stabilizing, and some see four consecutive quarter-point increases at each MPR in 2019. For these forecasts to play out, the economy will need to perform at above-potential growth rates in the context of no major trade or geopolitical disruptions.

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

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

Interest Rate Forecast	2018 Q3a	2018 Q4	2019 Q1	2019 Q2	2019 Q3	2019 Q4	2020 Q1	2020 Q2	2020 Q3
Target Overnight Rate	1.47	1.70	1.85	2.00	2.25	2.25	2.25	2.25	2.25
Prime Rate	3.68	3.90	4.05	4.20	4.45	4.45	4.45	4.45	4.45
1-mo. T-Bill	1.31	1.60	1.75	1.90	2.15	2.15	2.15	2.15	2.15
3-mo. T-Bill	1.46	1.70	1.85	2.00	2.25	2.25	2.25	2.25	2.25
6-mo. T-Bill	1.64	1.90	2.05	2.20	2.45	2.45	2.45	2.40	2.45
1-year T-Bill	1.90	2.15	2.25	2.40	2.65	2.65	2.65	2.60	2.60
2-year GoC Bond	2.07	2.35	2.45	2.60	2.80	2.80	2.80	2.75	2.80
3-year GoC Bond	2.10	2.35	2.50	2.65	2.85	2.85	2.85	2.80	2.85
5-year GoC Bond	2.19	2.45	2.55	2.75	2.95	2.95	2.95	2.90	2.95
10-year GoC Bond	2.28	2.50	2.60	2.80	3.00	3.00	3.05	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 Q3a	2018 Q4	2019 Q1	2019 Q2	2019 Q3	2019 Q4	2020 Q1	2020 Q2	2020 Q3
1-year GIC	0.93	1.10	1.15	1.25	1.45	1.45	1.45	1.45	1.45
3-year GIC	1.21	1.45	1.45	1.60	1.80	1.80	1.80	1.80	1.80
5-year GIC	1.55	1.60	1.70	1.80	1.95	1.95	1.95	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 Q3a	2018 Q4	2019 Q1	2019 Q2	2019 Q3	2019 Q4	2020 Q1	2020 Q2	2020 Q3
1-year Mortgage	3.49	3.65	3.70	3.80	3.95	3.95	3.95	3.95	3.95
3-year Mortgage	4.30	4.40	4.50	4.65	4.85	4.85	4.85	4.85	4.85
5-year Mortgage	5.34	5.35	5.45	5.55	5.65	5.65	5.65	5.65	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.