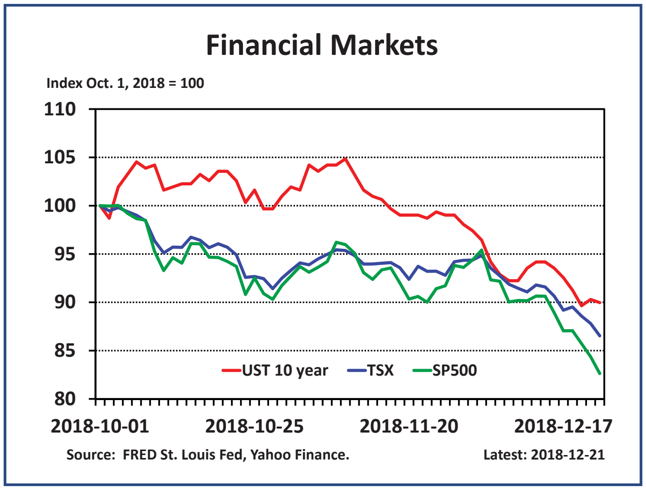
Interest Rate Forecast

Highlights

- Policy and market turmoil
- Central bankers more dovish
- Rate expectations pared back



Market turmoil over policy confusion was highlighted the past month. Equity markets fell and bond markets rallied in response to negative policy developments, interest rate concerns and slower global economic growth. Economic fundamentals do not support these drastic market moves, but sometimes markets overreact driven by sentiment and high-frequency trading.

A raft of political news and shifting policy announcements from the White House sent markets on a steep roller coaster decline. The U.S. equity market suffered its worst December since 1931 and treasury yields plunged causing a partial yield curve inversion. The U.S. President's criticism of the Federal Reserve (Fed) Chairman and call to not raise rates, added to the market's unease.

The Federal Open Market Committee (FOMC) increased the target range for the Fed's funds rate by 25 basis points from 2.25 per cent to 2.5 per cent on December 19 and struck a dovish tone in its statement. The FOMC economic and interest rate projections were pared back considering recent trade and global economic concerns. The median estimate was for two rate hikes next year and another in 2020, compared with three hikes previously.

Closer to home, the Bank of Canada kept its policy rate unchanged following its December meeting and took a more cautious tone about the economic outlook amid problems in the nation's oil sector. However, the Bank reiterated its desire to bring rates to a neutral level in the longer term, indicating this pause is temporary, and that raising rates is data and policy dependent.

Economic data released this month has been mixed and mostly softer. The flash U.S. Purchasing Managers' Index (PMI) for December showed the economy ending 2018 on a weaker note, with business activity expanding at the slowest pace in more than one year. New orders were the lowest since April of last year and expectations of future growth slipped to the lowest in two and a half years.

U.S. real Gross Domestic Product (GDP) growth is pegged around 2.5 per cent in the fourth quarter of 2018, down from 3.4 per cent in the third quarter and 4.2 per cent in the second quarter. Nonetheless, fourth quarter growth would remain above the economy's potential growth rate and generate inflation pressures, notwithstanding a temporary reprise from lower oil prices. Labour market tightness prevails with a sub-four per cent unemployment rate and faster wage growth. The Atlanta Fed's Wage Growth Tracker is recording four per cent increases, which is well above the inflation rate. On this basis, a rate increase by the Fed was entirely appropriate.

Another read on December economic activity is from the flash Eurozone PMI where the growth of business activity slowed to its weakest in four years. This slowing trend, which has been in effect since earlier this year, was exacerbated by protests in France. Forward-looking indicators such as new orders and future expectations remained subdued, adding downside risks to the outlook.

China's growth continues to slow with weakness in exports and domestic demand due in large part to the impact of U.S. tariffs. However, policies such as easing credit, tax cuts and infrastructure spending, will provide some offset next year. China's slowdown is spreading to other Asia-Pacific economies and some countries are expected to step up fiscal stimulus activities.

Canada: Key economic data releases		
Indicator	Prior month	Latest month
Industry GDP, % change	-0.1	0.3
Employment, change, persons (000s)	11.2	94.1
Unemployment rate, %	5.8	5.6
Hours worked, % change	0.0	0.9
Real international goods exports, % chg.	-1.2	-0.4
Real international goods trade balance, $b	1.4	1.4
Real manufacturing sales, % change	-0.1	0.2
Real retail sales, % change	0.3	0.0
Real wholesale sales, % change	-0.8	0.9
Non-residential building permits, % change	0.4	-7.0
Housing starts, units, % change	8.4	4.4
MLS residential sales, % change	-1.7	-2.3
Total CPI, % change y/y	2.4	1.7
Core CPI1., % change y/y	2.0	1.9

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

The U.S.-China trade war is in a 90-day truce with China agreeing to increase U.S. soybeans and energy imports in exchange for the U.S. not imposing higher tariffs on about one-half of Chinese exports from January 1, 2019. Negotiations are planned with a March 1, 2019 deadline. Should negotiations yield a positive outcome, markets will surge, while a breakdown would likely mean a market downturn, an escalation of the trade war and further slowing global economic growth.

Canada has its own economic issues, with the oil sector the most prominent and immediate concern. The Bank of Canada's December 5 rate announcement recognized that low prices and production cutbacks would weaken growth. Another factor mentioned was that the downward historical revisions to output implied more excess capacity and additional room for noninflationary growth than previously thought. With headline inflation seen declining and core inflation contained, the Bank's hold decision reflected these concerns.

Recent economic data shed a positive light on the Canadian economy compared to last month but some of this is likely temporary. The near-term growth outlook is subdued due to oil production cutbacks, a slowing housing market and weak business investment. This forecast has the Canadian economy growing below potential in the near and medium term.

The Bank's rate normalization process will continue at a slow pace with more excess capacity emerging in the near-term due to weakness in the oil sector. The next Bank rate move is expected to be a quarter-point increase in late October 2019 on the expectation that oil prices have stabilized at a higher level, U.S.-China trade tensions have eased and global growth has stabilized. Not surprisingly, forecast risk is on the downside and a scenario of no rate increase in 2019 is quite possible should those factors not improve. A worse-case scenario—where U.S.-China tensions escalate or U.S. policies cause more disruptions and its political situation worsens—would bring a rate cut scenario into play.

The BAX (Canadian Bankers' Acceptance) futures market is not pricing in a quarter-point increase into 2021. This is a large shift in expectations from last month when this market was pricing in quarter-point increases in March and December 2019. The consensus rate forecast among economists changed as well, but only marginally, pushing back a quarter-point increase to April from March 2019. This consensus has three quarter-point increases by the end of 2020, which seems reasonable under normal circumstances, but these are not normal times.

In a similar large sentiment shift, the U.S. Fed funds futures market is also not pricing in a rate increase through 2020. Previously, it saw two quarter-point increases.

Conditions for a mortgage rate cut are forming. Bond yields have declined and the demand for mortgage credit has slowed. A lower cost of funds in combination with slowing demand usually results in a mortgage rate cut. It is likely too early for a rate cut with lenders deciding whether recent bond market moves are

Economic Forecast – Canada								
	2018 Q2	2018 Q3	2018 Q4	2019 Q1	2017	2018	2019	2020
Real GDP, % annualized	2.9	2.0	1.5	1.0	3.0	2.1	1.7	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	2.0	1.9

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

temporary or not. However, the slowdown in housing sales and mortgage credit demand is a trend extending until the next easing interest rate cycle and may prompt some lenders to offer more competitive rates or conditions.

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

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	1.75	1.75	1.75	1.90	2.00	2.00	2.00
Prime Rate	3.68	3.95	3.95	3.95	3.95	4.10	4.20	4.20	4.20
1-mo. T-Bill	1.31	1.55	1.60	1.60	1.65	1.80	1.85	1.85	1.85
3-mo. T-Bill	1.46	1.65	1.65	1.70	1.75	1.90	2.00	2.00	2.00
6-mo. T-Bill	1.64	1.85	1.85	1.90	1.95	2.10	2.20	2.15	2.20
1-year T-Bill	1.90	2.10	2.00	2.05	2.10	2.35	2.45	2.40	2.45
2-year GoC Bond	2.07	2.20	2.05	2.10	2.20	2.45	2.55	2.55	2.60
3-year GoC Bond	2.10	2.25	2.10	2.15	2.25	2.50	2.60	2.60	2.70
5-year GoC Bond	2.19	2.30	2.10	2.20	2.30	2.60	2.70	2.70	2.75
10-year GoC Bond	2.28	2.35	2.15	2.30	2.40	2.70	2.85	2.80	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 Q3a	2018 Q4	2019 Q1	2019 Q2	2019 Q3	2019 Q4	2020 Q1	2020 Q2	2020 Q3
1-year GIC	0.93	1.15	1.30	1.30	1.30	1.35	1.35	1.45	1.45
3-year GIC	1.21	1.45	1.50	1.50	1.50	1.60	1.70	1.70	1.70
5-year GIC	1.55	1.90	2.20	2.20	2.20	2.30	2.35	2.35	2.40

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	3.60	3.65	3.65	3.65	3.65	3.85	3.95	3.95
3-year Mortgage	4.30	4.30	4.30	4.30	4.30	4.30	4.50	4.50	4.55
5-year Mortgage	5.34	5.35	5.35	5.35	5.35	5.35	5.50	5.55	5.55

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.