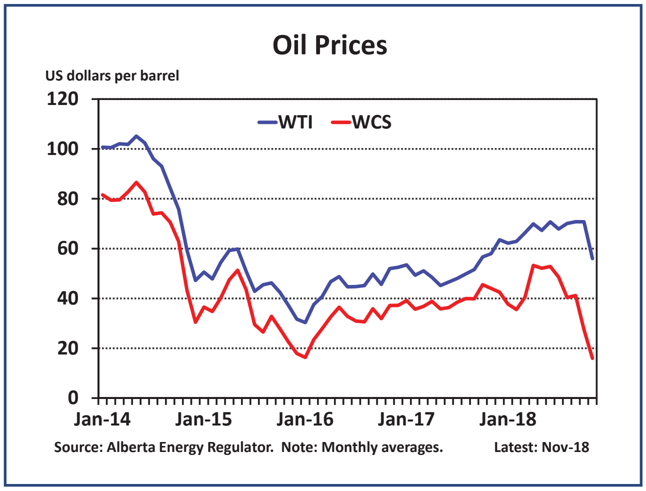
Interest Rate Forecast

Highlights

- December bank rate hike off the table
- Bank of Canada to be more cautious with rate hikes
- Oil price plunge poses problem for Canada's economy
- Weak Canadian economic data



Slowing economy and oil troubles

More signs emerged that the Bank of Canada's rates will remain on hold in December and into 2019. The sharp plunge in oil prices, lacklustre global growth, slowing domestic consumer and housing activity, and risks associated with the U.S.-China trade conflict require a cautious approach to further removal of monetary stimulus in Canada. The announcement by General Motors to close its Oshawa plant is another sign. However, further rate increases are expected when conditions and prospects improve.

The latest readings on the global economy were consistent with a growth slowdown, which began several months ago. Flash Purchasing Managers Indexes (PMI) for November registered slower output growth in the U.S., Eurozone, and Japan. Weaker manufacturing was notable in those reports and services-sector activity also slowed. Another feature was higher input price inflation.

The plunge in oil prices will deliver some positives—it lowers inflation and stimulates consumer spending by increasing their disposable income. Lower prices are beneficial to the global economy, on balance, though not beneficial to oil producers and oil-related capital investments. A key question is: is the price downshift temporary or long-lasting?

Forecasts have oil prices stabilizing around current levels and rising gradually thereafter. The West Texas Intermediate (WTI)-Western Canada Select (WCS) price difference is expected to narrow in future market pricing. There is considerable risk in these forecasts and more price declines are possible in the near term. However, the best antidote for low prices is low prices.

The production decline in a low-price environment sets the stage for firmer prices. The oil supply response to demand is more rapid with shale. With extensive shale resources and a slower demand growth future, the long-term price outlook is muted.

The issue for the Bank of Canada is the impact of low oil prices on the Canadian economy. The Bank's last *Monetary Policy Report* (MPR) assumed WTI and WCS prices would remain around $70 and $35 per barrel in US dollars, respectively. Current prices are closer to $50 and $20 with weak price prospects. Canada's economic growth will be pulled down by a likely decline in oil production and capital spending, and the growth recession heading for Alberta's economy. A forecast downgrade by the Bank is expected in its January 2019 MPR.

Weak incoming data on Canadian economy

Gross Domestic Product (GDP) expenditure accounts were released and painted a weak picture of the third quarter of 2018. Real GDP growth came in at a respectable 2.0 per cent annual rate, but it hid poor details. The gain was mostly the result of a 7.8 per cent annualized decline in imports. Final domestic demand fell 0.1 per cent at an annualized rate, led by a 5.0 per cent annualized drop in business investment with both residential and non-residential investment spending down. Growth in household consumption expenditures decelerated from 2.4 per cent to 1.2 per cent annualized. Real exports edged up 0.9 per cent annualized.

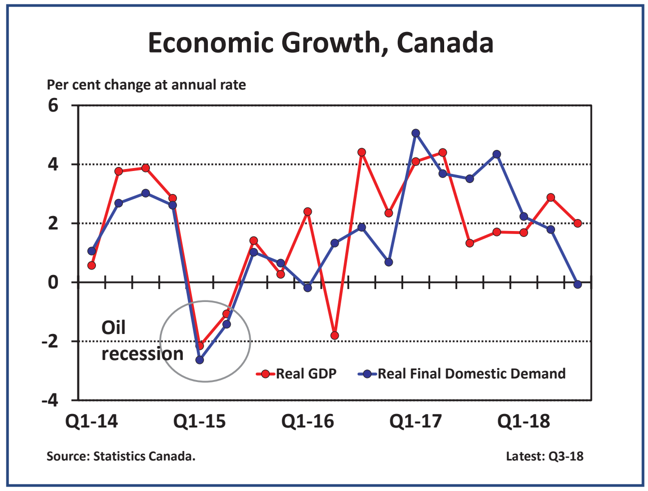
Canada: Key economic data releases		
Indicator	Prior month	Latest month
Industry GDP, % change	0.1	-0.1
Employment, change, persons (000s)	63.3	11.2
Unemployment rate, %	5.9	5.8
Hours worked, % change	-0.4	0.0
Real international goods exports, % chg.	-1.5	-1.0
Real international goods trade balance, $b	0.5	0.6
Real manufacturing sales, % change	-0.4	-0.1
Real retail sales, % change	-0.2	0.5
Real wholesale sales, % change	0.2	-0.7
Non-residential building permits, % change	6.0	0.6
Housing starts, units, % change	-4.1	8.5
MLS residential sales, % change	-0.2	-1.6
Total CPI, % change y/y	2.2	2.4
Core CPI1. , % change y/y	1.9	2.0

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

The decline in final domestic demand is the most troublesome feature of third quarter GDP. It's the first decline since the first quarter of 2016 when the economy was impacted by the 'oil recession'. The housing slowdown played a role, with sales declines in consumer durable goods and residential investment spending. While the housing slowdown is likely seen as desirable by policymakers, the poor performance in business investment is not. The federal government's recently announced investment incentives will help, but factors such as the demand for their goods and services, technological change, profitability, and others determine business investment spending. The decline in oil prices does not augur well for capital investment in energy.

The slowing monthly pattern during the third quarter was another troublesome feature in the GDP releases. Industry GDP—or value-added GDP—declined 0.1 per cent in September mainly due to a fall in oil and gas extraction and residential construction. Expenditure and industry GDP data signaled a weak hand-off to the fourth quarter.

Employment growth was minimal and statistically insignificant in October while housing sales declined. Housing starts shot up on more multi-units but during a downtrend that has been in place since last year. Housing starts are a lagging indicator in the housing market and the housing sales downshift this year suggests further weakness in housing starts, residential construction, and residential investment.



Headline inflation remains a little elevated, though core inflation was on target in October. The oil price decline will contribute to lower headline inflation in 2019. Core inflation matters more to monetary policy, and with the economy operating at or near full capacity in the Bank's estimation, underlying inflation pressures could increase. However, this will depend on the economy's future performance.

Slowdown ahead for Canada

Our forecast for the economy remains essentially the same as last month, though we downgraded fourth quarter 2018 GDP growth to 1.5 per cent annualized from 2.0 per cent. Our forecast assumes weaker exports and housing outcomes, and more spare capacity during 2019 and 2020 compared to the Bank's forecast. Consequently, our forecast implies that the removal of monetary stimulus is not urgent and will require only two more quarter-point increases through 2020.

A more positive economic scenario could play out if U.S.-China tensions cool, global growth firms and Canada's economy responds to business investment incentives.

Rate forecasts

The Bank's rate normalization process will continue but at a slower pace than previously expected. Some excess capacity due weakness in the oil sector will emerge in the near term prompting the Bank to hold off on a rate increase until the second quarter of 2019. There is a fair chance the Bank could hold off until the third quarter.

The BAX (Canadian Bankers' Acceptance) futures market is no longer pricing in a quarter-point increase in January 2019, as it did in July and October 2018. Weak

Economic Forecast – Canada								
	2018 Q2	2018 Q3	2018 Q4	2019 Q1	2017.0	2018.0	2019.0	2020.0
Real GDP, % annualized	2.9	2.0	1.5	1.5	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.

GDP; Canadian and international concerns surrounding data and U.S-China trade; and, slowing global growth were likely factors weighing on market participants. This market is pricing in a March 2019 quarter-point increase followed by another in December 2019 and no change in 2020.

The next Bank rate increase is forecast at their April 2019 meeting followed by a long hold into 2020 before administering another quarter-point increase. There is downside risk to the forecast in that the next rate increase may not occur until oil prices have firmed and there are signs of rising business investment.

Helmut Pastrick
Chief Economist, Central 1 Credit Union
hpastrick@central1.com
www.central1.com 604.737.5026

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	1.75
Apr. 24	2.00
May 29	2.00
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
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	1.75	1.75	1.90	2.00	2.00	2.00	2.20	2.25
Prime Rate	3.68	3.95	3.95	4.10	4.20	4.20	4.20	4.40	4.45
1-mo. T-Bill	1.31	1.55	1.60	1.75	1.90	1.90	1.95	2.15	2.15
3-mo. T-Bill	1.46	1.70	1.75	1.90	2.00	2.00	2.05	2.20	2.25
6-mo. T-Bill	1.64	1.90	1.95	2.10	2.15	2.15	2.20	2.40	2.45
1-year T-Bill	1.90	2.10	2.15	2.30	2.35	2.35	2.40	2.60	2.60
2-year GoC Bond	2.07	2.30	2.30	2.35	2.40	2.45	2.50	2.70	2.80
3-year GoC Bond	2.10	2.30	2.35	2.45	2.50	2.55	2.60	2.80	2.85
5-year GoC Bond	2.19	2.35	2.40	2.50	2.60	2.65	2.70	2.90	2.95
10-year GoC Bond	2.28	2.55	2.50	2.55	2.65	2.70	2.80	3.00	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 Q3a	2018 Q4	2019 Q1	2019 Q2	2019 Q3	2019 Q4	2020 Q1	2020 Q2	2020 Q3
1-year GIC	0.93	1.10	1.10	1.25	1.25	1.25	1.35	1.45	1.45
3-year GIC	1.21	1.45	1.50	1.55	1.60	1.60	1.70	1.75	1.75
5-year GIC	1.55	1.80	2.20	2.20	2.20	2.20	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	3.80	3.85	3.85	3.85	3.95	4.00
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.