Interest Rate Forecast

Highlights

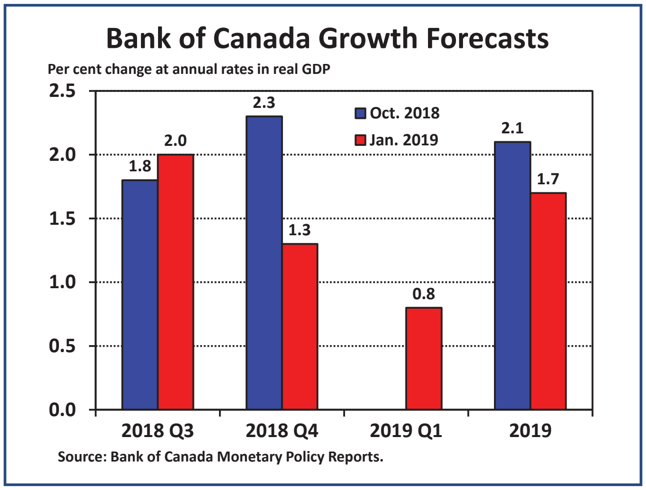
- Economic conditions weaken
- The Fed talks patience
- Trade policy risks prevail

The Bank of Canada's decision to hold rates at its last meeting was justified by incoming data showing further weakness in the global economy, as well as in Canada, since. In addition, trade policy uncertainty extended into the new year, casting a cloud over the global economy and its prospects. In the short term, these conditions will persist leaving central bankers in no hurry to tighten monetary conditions.

How long central bankers remain on hold will depend on how the economy performs and its prospects, in other words, data dependent—we could add policy dependent. The U.S.-China trade dispute has substantial ramifications for the global economy, and if negotiations falter, financial markets will swoon and may prompt the U.S. administration to raise and expand tariffs on Chinese imports. However, if negotiations are productive, markets and the economic outlook will lift. China is implementing fiscal and monetary policy stimulus to offset several months of economic slowdown due to restrictive policies and tariffs imposed last year. These measures will take time to have an effect with positive signs likely emerging in the next three to six months. China's latest readings on the economy showed another contraction in manufacturing.

The U.S. economy is facing some headwinds resulting in slower growth. Real economic growth in the fourth quarter of 2018 will slow to below three per cent annualized and to less than two per cent in the first quarter of 2019. Near-term policy risks include another partial government shutdown, U.S.-China trade negotiations, the debt ceiling issue and policy gridlock in general.

It was no surprise when the Federal Reserve (Fed) Chairman, Jerome Powell, cited the U.S. slowdown and weaker performances in China and Europe as the reasons for not increasing its policy rate at its January meeting. The Fed's statement and Chairman Powell's



comments were taken as dovish and signaling patience as to when the next rate change may occur. In other words,—how and when the Fed responds to economic conditions and prospects is data dependent.

Some have read into the Fed's position that no further rate increases are likely. The Fed funds futures market is not pricing in an increase in 2019 or 2020, rather it is assigning a material probability of a rate cut in 2020 or 2021. This view is consistent with a substantial slowdown or outright recession playing out in those years.

Economic growth in the U.S. is seen picking up in the second and third quarters of 2019 when some of the policy overhang dissipates, housing activity increases with lower mortgage rates, business investment perks up and labour income gains spur consumer spending. The global economy will pick up after the first quarter when stimulus measures in China, Japan and other countries kick in and Europe's economy bounces back from the temporary factors that slowed its recent performance. Under these conditions, the Fed is likely to resume the rate normalization process and raise its policy rate at least once, and possibly twice, before yearend.

Canada's economic performance worsened in the fourth quarter based on poor data released for November and December in 2018. The table of key economic indicators shows more minus signs than in the prior month's releases. The Bank of Canada rightly downgraded its latest economic forecast for the fourth quarter of 2018 and 2019.

Canada: Key economic data releases

Indicator	Prior month	Latest month
Industry GDP, % change	0.3	-0.1
Employment, change, persons (000s)	94.1	9.3
Unemployment rate, %	5.6	5.6
Hours worked, % change	0.9	0.0
Real international goods exports, % chg.	-1.3	-1.5
Real international goods trade balance, $b	1.2	0.6
Real manufacturing sales, % change	0.3	-0.9
Real retail sales, % change	-0.1	-0.3
Real wholesale sales, % change	0.5	-1.1
Non-residential building permits, % change	13.0	-5.0
Housing starts, units, % change	5.6	-4.9
MLS residential sales, % change	-2.2	-2.5
Total CPI, % change y/y	1.7	2.0
Core CPI1., % change y/y	1.9	1.9

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

This forecast also sees a substantial slowdown in the first quarter of 2019, mainly due to Alberta's oil production cutbacks and less residential investment spending. A modest growth rebound is expected in the second quarter as oil production returns to more normal levels. However, range-bound growth below two per cent is seen extending through 2020.

The Bank of Canada will be releasing its revised estimates of potential output in April and these estimates will very likely be reduced. Lower potential output will shrink the output gap, the difference between actual and potential output, meaning there is less slack in the economy than previously thought. This is more than of technical importance because it is one benchmark used by the Bank to set monetary conditions. Less slack implies a greater chance of a rate increase.

Risks to this rate forecast are more to the downside than upside. While one more quarter-point increase is penciled in for late October, no rate increase remains a fair possibility. With policy errors taking the global centre stage, it is difficult to accurately anticipate outcomes. One could paint a scenario leading to a rate cut later in 2020 as easily as a scenario with the opposite result. As an aside, some forecasters have two—and even three—quarter-point increases in their sights for Canada.

The BAX (Canadian Bankers' Acceptance) futures market is not pricing in a quarter-point rate cut through 2021. Rather, this market is pricing a growing probability of a rate increase. Market sentiment and expectations can turn quickly when the unexpected happens.

A few major banks announced a cut of 15 basis points in their five-year fixed mortgage rate around mid-January, but it has not shown up in the data. The Bank of Canada posted their five-year fixed rate remains unchanged at 5.34 per cent and our Interest Rate Survey also shows no change in that fixed rate. However, our survey did capture reductions in some special offer mortgage rates. Conditions remain ripe for lower mortgage rates with the housing slowdown ongoing in conjunction with lower bond yields.

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Economic Forecast – Canada

	2018 Q3	2018 Q4	2019 Q1	2019 Q2	2017	2018	2019	2020
Real GDP, % annualized	2.0	1.5	1.0	2.0	3.0	2.1	1.7	1.7
Unemployment Rate, %	5.9	5.6	5.7	5.5	6.3	5.8	5.6	5.5
Total CPI, % y/y	2.7	2.0	1.4	1.8	1.6	2.3	1.8	1.9

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

Target Overnight Rate Forecast	
Meeting Date	(Per cent)
Jan. 9, 2019	1.75 (a)
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
Oct.	2.00
Dec.	2.00

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

Interest Rate Forecast									
	2018 Q4 a	2019 Q1	2019 Q2	2019 Q3	2019 Q4	2020 Q1	2020 Q2	2020 Q3	2020 Q4
Target Overnight Rate	1.70	1.75	1.75	1.75	1.90	2.00	2.00	2.00	2.00
Prime Rate	3.95	3.95	3.95	3.95	4.10	4.20	4.20	4.20	4.20
1-mo. T-Bill	1.56	1.60	1.65	1.65	1.80	1.85	1.85	1.85	1.85
3-mo. T-Bill	1.66	1.65	1.70	1.75	1.90	2.00	2.00	2.00	2.00
6-mo. T-Bill	1.85	1.80	1.85	1.95	2.10	2.20	2.15	2.20	2.20
1-year T-Bill	2.06	1.90	1.95	2.05	2.25	2.45	2.40	2.45	2.45
2-year GoC Bond	2.19	2.00	2.05	2.15	2.35	2.55	2.55	2.60	2.60
3-year GoC Bond	2.20	2.00	2.05	2.20	2.40	2.60	2.60	2.65	2.65
5-year GoC Bond	2.26	2.00	2.10	2.25	2.50	2.70	2.70	2.75	2.75
10-year GoC Bond	2.33	2.05	2.15	2.30	2.60	2.85	2.80	2.90	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 Q4 a	2019 Q1	2019 Q2	2019 Q3	2019 Q4	2020 Q1	2020 Q2	2020 Q3	2020 Q4
1-year GIC	1.16	1.30	1.30	1.30	1.35	1.35	1.45	1.45	1.45
3-year GIC	1.47	1.50	1.50	1.50	1.60	1.70	1.70	1.70	1.70
5-year GIC	1.92	2.20	2.20	2.20	2.30	2.45	2.45	2.45	2.45

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 Q4 a	2019 Q1	2019 Q2	2019 Q3	2019 Q4	2020 Q1	2020 Q2	2020 Q3	2020 Q4
1-year Mortgage	3.62	3.65	3.65	3.65	3.65	3.85	3.95	3.95	3.95
3-year Mortgage	4.29	4.20	4.20	4.20	4.30	4.50	4.50	4.55	4.55
5-year Mortgage	5.34	5.35	5.35	5.35	5.35	5.50	5.55	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.