Interest Rate Forecast

Highlights

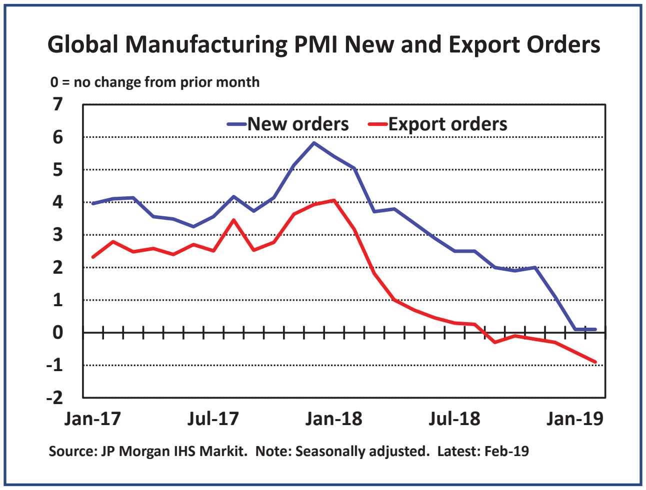
- Global economy weak, risks remain
- Canada's economy stumbles
- Rates on hold, flat yield curve

Economic conditions and prospects did not materially change during the past month and the same policy and geopolitical risks remain. Central bankers responded by either maintaining or easing monetary conditions, providing cautionary guidance and exhibiting patience. These conditions look to extend another three months or so before signs of firmer growth emerge.

There is a fair chance that growth and growth prospects in the second half of the year improve in response to policy stimulus and as temporary factors depressing recent growth pass in some economies. Tight labour market conditions and rising wages in the U.S. will prompt its central bank to resume its rate normalization process. No U.S. recession during 2019 is expected by most forecasters, nor signaled by leading indicators.

Trade policy risks cloud the outlook. Should the U.S. impose tariffs on imports of autos and parts, growth would slow in several key economies—including the U.S.—depressing global growth and its prospects. The U.S. Commerce Department recently filed a report on whether auto imports pose a threat to national security and the U.S. administration has 90 days to decide whether to impose tariffs. While Canada and Mexico are exempt from auto tariffs under the terms of a side letter under the Canada-United States-Mexico Agreement (CUSMA), tariffs would damage the auto sector in many countries, notably Japan, Germany, South Korea and the United Kingdom. In all likelihood, countries hit by U.S. auto tariffs would respond in kind, further damaging the economy.

The latest round of U.S.-China trade talks did not reach an agreement, but further meetings are planned, and a framework agreement is likely. As a result, the U.S. delayed raising the tariff rate to 25 per cent from the current 10 per rate on USD 200 billion of Chinese imports. However, the threat of expanding tariffs should no agreement materialize is always present.



Further talks on the substantive issues of intellectual property rights, technology transfer, state subsidies and verification could drag out for months casting a shadow over markets and sentiment.

The economic outlook beyond 2019 is more uncertain and with rising recession risks. However, economies are usually in a growth phase and spend little time in recession. For example, in the post-war era, the U.S. economy has been in recession only 15 per cent of the time and only 13 per cent for Canada. The U.S. economy has not had a recession since 2008-09 and its current expansion phase is approaching the duration record. After June 2019, it will break the record. Beyond 2019 recession odds increase but only a few forecasters are calling for one.

Recessions are difficult to accurately predict with respect to timing and severity. Recessions usually develop when significant imbalances exist, and a trigger event sends the economy into a contraction phase. A recession during this forecast horizon is possible but it is not the base scenario, which assumes the world and U.S. economies will grow at a slower pace through to 2021.

A slower U.S. growth phase—a trend growth below two per cent—will likely play out later in 2020 and into 2021. Fiscal tightening to deal with the large federal budget deficit will be one factor restraining growth as will higher interest rates and U.S. dollar.

U.S. real Gross Domestic Product (GDP) grew at a 2.6 per cent annual rate during the fourth quarter of 2018, down from 3.4 per cent in the prior quarter. For

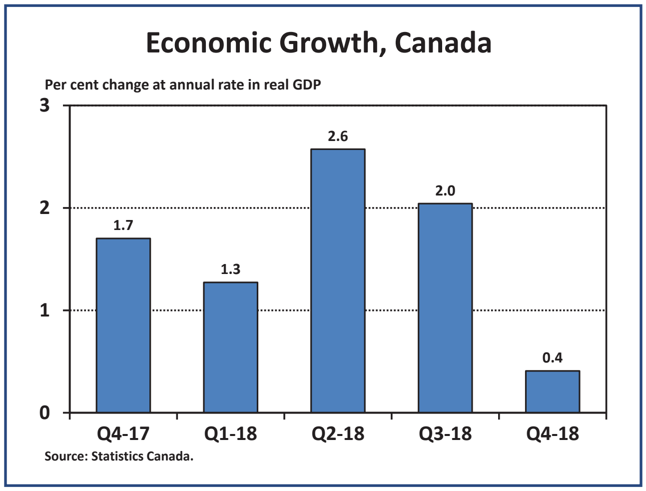
Canada: Key economic data releases

Indicator	Prior month	Latest month
Industry GDP, % change	-0.1	-0.1
Employment, change, persons (000s)	7.8	66.8
Unemployment rate, %	5.6	5.8
Hours worked, % change	0.0	-0.3
Real international goods exports, % chg.	-1.3	-1.5
Real international goods trade balance, $b	1.2	0.6
Real manufacturing sales, % change	-1.0	-1.2
Real retail sales, % change	-0.1	-0.4
Real wholesale sales, % change	0.5	-1.2
Non-residential building permits, % change	9.8	8.9
Housing starts, units, % change	-4.9	-2.6
MLS residential sales, % change	-2.0	3.6
Total CPI, % change y/y	2.0	1.4
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.

the year, real GDP expanded 2.9 per cent. Prospects for first quarter 2019 growth are below two per cent annualized due to temporary factors, such as the government shutdown and bad weather. This will keep the Federal Reserve (Fed) on the sidelines until mid-year. The situation is expected to change when economic growth increases to more than two per cent annually in the remaining quarters of 2019, which prompts the Fed to resume rate normalization.

Economic conditions in China, Japan and Europe remained weak with their respective manufacturing indices declining in February and showing little upside potential for March, with new orders expanding at a slow pace. However, preliminary indices for the services sector in February were mostly positive. China's economic stimulus efforts will increase if growth disappoints and comes in below target. Europe's economic problems are many, of which some are temporary and others structural, with temporary factors such as car production issues last summer unwinding in the next couple of quarters. Nonetheless, European exports will benefit from improved Chinese consumption growth expected this year.



The major data development was the weak GDP report for Canada. At 0.4 per cent annualized growth, fourth quarter 2018 real GDP was the slowest growth pace in more than two years. Unlike the two weak GDP episodes in 2015 and 2016, it was not energy-related. Residential and business investment declined for the second consecutive quarter and exports were pulled down by refined petroleum and forest products in the latest quarter. The monthly industry GDP report for December was equally poor, recording its second consecutive monthly decline.

How to take these GDP reports? Do they mean a recession is underway or coming soon? How consistent are these readings with other economic indicators such as those on the labour market? Most importantly: how will the Bank of Canada react and what does this mean for rate settings?

A scan of current indicators reveals weakness in exports, manufacturing, retail sales and housing starts. One exception is the labour market, notably employment. During the fourth quarter of 2018, employment increased by more than 100,000 persons over the prior quarter, and in January 2019, by another 66,800 persons. Payroll employment from another survey, increased by 55,000 persons during the fourth quarter. These survey results tell a different story than the GDP data.

Considering these conflicting signals, the Bank will wait for additional and more conclusive data to obtain

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.

a better read on the economy and decide on rates. No rate change should be expected at the Bank's rate announcement on March 6, 2019.

However, markets do not wait, and they reacted quickly to the GDP news. Expectations of a rate cut rose causing the loonie to lose nearly one cent against the USD. The futures market for Three-month Bankers' Acceptances priced in a higher chance of a rate cut and short-term bond yields edged lower.

This forecast sees another weak quarter to begin 2019 owing to oil production cuts, poor weather and a weakening housing sector. Some of these factors will unwind in the second quarter and a moderate bounce-back led by exports is likely. The outlook for the rest of 2019 sees moderate above potential growth.

The stage appears set for one more rate increase by the Bank later this year. However, the risk is more to the downside and no rate change is the next likely alternative. The odds of a rate cut are greater than zero and could occur, if the U.S. imposes auto tariffs, or U.S.-China trade negotiations breakdown, or a global recession plays out.

Beyond 2019, the economic backdrop of slowing growth points to an end of rate normalization in Canada for this growth cycle. Canada's economy will not experience high unemployment during this next phase due to ongoing growth, and importantly, the increasing demographic drag on labour force growth. A rate cut under these conditions is possible, but not a given. Another consideration is how the government respond to slower economic growth. One scenario could see stepping up fiscal stimulus or changing regulations to spur housing, for example. Historically, Canada's economic growth performance is mostly influenced by external factors and this time is no different.

Following one more rate increase, the Bank is seen remaining on hold through 2020. The yield curve will remain fairly flat by historical standards but will steepen in the run up to the Bank's (and Fed's) rate increase later this year. Heading into 2021, the long end eases in response to slower growth concerns.

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)
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

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	1.65	1.65	1.65	1.80	1.85	1.85	1.85	1.80
3-mo. T-Bill	1.66	1.65	1.70	1.75	1.90	2.00	2.00	2.00	1.95
6-mo. T-Bill	1.85	1.75	1.80	1.90	2.05	2.15	2.15	2.20	2.15
1-year T-Bill	2.06	1.85	1.85	1.95	2.10	2.25	2.25	2.25	2.20
2-year GoC Bond	2.19	1.85	1.85	1.95	2.15	2.25	2.30	2.30	2.25
3-year GoC Bond	2.20	1.85	1.90	2.00	2.20	2.30	2.30	2.30	2.25
5-year GoC Bond	2.26	1.85	1.90	2.05	2.25	2.40	2.40	2.35	2.30
10-year GoC Bond	2.33	1.95	2.00	2.15	2.40	2.50	2.55	2.50	2.50

Source: Bank of Canada, Central 1 Credit Union. Note: Quarterly average based on daily data. a = actual, all others forecast.

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	4.30	4.30	4.30	4.30	4.45	4.45	4.45	4.45
5-year Mortgage	5.34	5.35	5.35	5.35	5.35	5.50	5.50	5.50	5.50

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.

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	2.40	2.40	2.40	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.