Interest Rate Forecast

Highlights

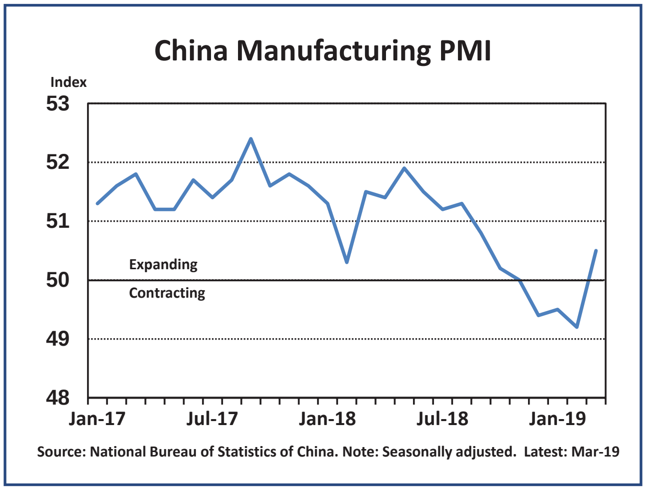
- Yield curve inverts, conflicting signals
- End to growth slowdown nearing
- Rates on hold for now

Financial markets are of two minds when it comes to the future of U.S. short-term rates, and consequently, the economic outlook. Equity markets have surged since the lows of last December, while bond markets sent yields to their lowest level in more than a year and partially inverted the yield curve – usually an ominous sign for the economy. Which view is correct? Are short-term rates headed lower because the economy is heading for a recession or is the recent growth slowdown temporary and better conditions lie ahead according to equities?

Global economic growth has yet to revive from its slowdown though there is a sprinkling of positive news amidst the gloom. Policy stimulus measures, the end of temporary factors, economic forces or animal spirits, and a reduction in uncertainty over trade tariffs will generate a pickup in the global economy's growth cycle. A steepening of the yield curve would follow, putting the equity and bond markets on the same page.

This scenario is expected to unfold with increasing signs of a growth revival materializing in the next three months or so. The latest promising sign is a pickup in China's manufacturing Purchasing Manager's Index (PMI) into expansion territory in March after falling for several months. While one month does not make a trend, the impact of past, and likely future, policy stimulus on the economy should provide more support. Trade talks between the U.S. and China are ongoing and will reach an agreement soon, further lifting China's economy and its regional trading partners.

Not all regions will contribute to this year's global growth revival. Europe's economy remains stuck in low gear with a slowdown in its major economies and a recession in Italy. The latest Eurozone manufacturing PMI attests to the ongoing challenges ahead and to a longer road to revival. Germany's manufacturing has



been on a downward trend since last August, due to the delayed introduction of new emission auto standards, weather issues, and fewer exports to China. However, the IFO index, Germany's leading indicator of the economy, increased in March suggesting a rebound. The negative sentiment and uncertainty around Brexit will continue to weigh on investment and economic performance. Europe will remain a growth laggard in 2019.

U.S. economic growth slowed into 2019 and in the first quarter, but this too, looks temporary. The tight labour market has generated wage growth approaching four per cent with more upward pressure coming. These personal income gains will pull consumer spending out of its recent soft patch along with the fall in mortgage rates. Housing activity stalled in 2018 but there are sufficient tailwinds to generate an upturn in 2019. Real Gross Domestic Product (GDP) growth in the middle quarters of 2019 is forecast to increase to around 2.5 per cent annualized. Expect the Federal Reserve to respond to this higher growth and inflation outcome by resuming its rate normalization process.

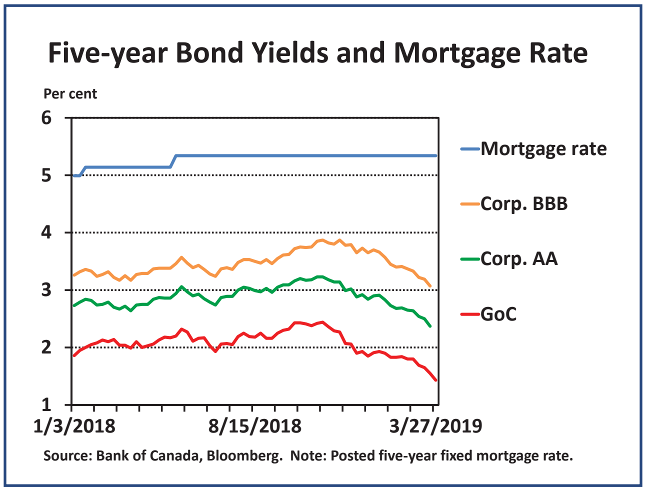
Canada's situation is different, but somewhat similar to the U.S. - a weak ending to 2018 and a weak beginning to 2019. Economic indicators paint a mixed picture though the most recent data points show more positives than negatives. In some cases, a rebound from prior declines often occurs without it resulting in a trend reversal. Nonetheless, it is too soon to conclude on the evidence that Canada's economy is reviving, however, that is the expectation.

Canada: Key economic data releases		
Indicator	Prior month	Latest month
Industry GDP, % change	-0.1	0.3
Employment, change, persons (000s)	66.8	55.9
Unemployment rate, %	5.8	5.8
Hours worked, % change	-0.3	-0.7
Real international goods exports, % chg.	-1.2	1.0
Real international goods trade balance, $b	0.8	0.3
Real manufacturing sales, % change	-1.0	1.4
Real retail sales, % change	-0.1	0.0
Real wholesale sales, % change	0.1	0.8
Non-residential building permits, % change	10.5	-15.8
Housing starts, units, % change	-2.8	-16.3
MLS residential sales, % change	3.6	-9.1
Total CPI, % change y/y	1.4	1.5
Core CPI1., % change y/y	1.9	1.8

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

Housing will continue as a source of economic weakness, or a drag on growth, in the near-term. Mortgage rates have come down marginally, despite the larger decline in bond yields, and the structural restraint from the B-20 regulations. The federal government's *Budget 2019* included two housing stimulus programs intended to spur first-time homebuyer activity and should result in more housing sales and construction, though probably less than the government expects. The First-Time Homebuyer Incentive program does not come into effect until September.

The near-term 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, which will be updated by the Bank of Canada in its next *Monetary Policy Report* released in late April. A downward revision to Canada's potential growth rate is expected.



Beyond this year, the slowing U.S. economy will play an important role in Canada's performance in 2020 and 2021. Further, the long-standing under-performance issue in business investment and exports does not have a quick fix. This slower growth phase in Canada suggests the Bank's rate normalization phase is at or near an end.

The futures money market is pricing in a rate cut by the Fed and the Bank of Canada. However, the money market is over-reacting to recent negative economic news and under estimating the economy's near-term revival potential. Granted, the trade policy environment is problematic and weighs on market sentiment. A decision on U.S. auto import tariffs will be made before May 15 and current thinking is that no tariffs will be imposed.

Another rate increase by the Fed with the Bank following is seen later in 2019. Thereafter, the Fed will probably remain on hold as will the Bank. A rate cut in 2020 or 2021 is possible. The yield curve will remain flat but will steepen in the run up to the rate increase later this year. Heading into 2021, the long end eases in response to slower growth concerns.

The yield curve's partial inversion is different this time and does not portend a recession. In the past, restrictive monetary conditions have caused yield curve inversions, but this is not the case today. Rather, the yield curve is signaling a rate cut this time based

Economic Forecast – Canada								
	2018 Q3	2018 Q4	2019 Q1	2019 Q2	2017	2018	2019	2020
Real GDP, % annualized	2.0	0.4	1.0	2.5	3.0	1.8	1.6	1.7
Unemployment Rate, %	5.9	5.6	5.8	5.7	6.3	5.8	5.6	5.5
Total CPI, % y/y	2.7	2.0	1.5	1.8	1.6	2.3	1.9	1.9

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

on an overly pessimistic assessment of the economy and its near-term prospects.

The forecast of retail lending and deposit rates calls for some slippage at longer terms in the near future. Some mortgage rates have come down recently, except the posted fixed rates monitored by the Bank. The slowdown in housing sales and mortgage loan demand, along with the drop in bond yields and the cost of funds, should have brought about lower mortgage rates sooner and by a larger margin.

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)
Mar. 6, 2019	1.75 (a)
Apr. 24	1.75
May 29	1.75
Jul. 10	1.75
Sep. 4	1.75
Oct. 30	1.75
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	1.85	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	1.75	1.85	1.85	1.85	1.80
3-mo. T-Bill	1.66	1.65	1.65	1.70	1.85	2.00	2.00	2.00	1.95
6-mo. T-Bill	1.85	1.70	1.70	1.75	1.90	2.10	2.15	2.20	2.15
1-year T-Bill	2.06	1.80	1.70	1.75	2.00	2.20	2.25	2.25	2.20
2-year GoC Bond	2.19	1.75	1.65	1.80	2.05	2.25	2.30	2.30	2.25
3-year GoC Bond	2.20	1.75	1.65	1.80	2.10	2.30	2.30	2.30	2.25
5-year GoC Bond	2.26	1.75	1.65	1.85	2.15	2.40	2.40	2.35	2.30
10-year GoC Bond	2.33	1.85	1.70	1.95	2.25	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	3.75	3.85	3.85	3.85
3-year Mortgage	4.29	4.30	4.20	4.20	4.20	4.25	4.25	4.25	4.25
5-year Mortgage	5.34	5.35	5.15	5.15	5.15	5.25	5.35	5.35	5.35

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	1.40	1.40	1.50	1.60	1.60	1.60	1.60
5-year GIC	1.92	2.20	2.00	2.00	2.20	2.20	2.20	2.20	2.20

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.