Interest Rate Forecast

central 1

Highlights

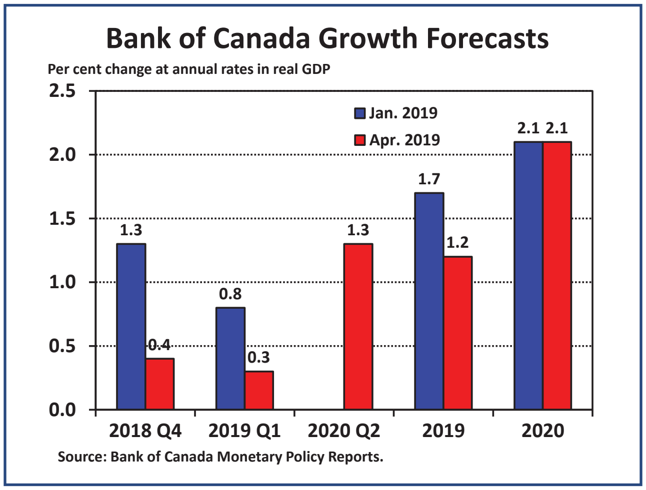
- An optimistic Bank of Canada expects higher rates
- Global growth revival begins
- Canada's economic outlook to keep rates on hold

May you live in interesting times is an oft-cited curse and these times are certainly that for a forecaster. There are many moving parts and a disruptive policymaker at the helm of the world's largest economy threatening more tariffs on an increasingly beleaguered world trade system. If not for those trade tensions, economic fundamentals would have bond markets, central bankers, and rate forecasters on a more positive and confident footing.

The Bank of Canada has fewer qualms about the future course of interest rates than do markets and most forecasters. In its latest *Monetary Policy Report*, the Bank acknowledged trade risks along with other risk factors but presented an economic forecast implying higher rates. The Bank has a long-standing practice of presenting a forecast that closes the output gap at the end of the projection horizon, and when excess capacity is the starting point, implying higher rates are warranted.

The Bank is projecting Canada's economy to grow two per cent in both 2020 and 2021, which is considerably higher than its 1.2 per cent growth forecast for 2019. Near-zero growth in the first quarter of 2019 is to be followed by a rebound to 1.3 per cent growth in the second quarter and to more than two per cent in the second half of the year. All forecasters are predicting a growth rebound following a lethargic first quarter of 2019, but the Bank stands alone in its 2020 and 2021 forecasts.

Another important element in the report was the Bank's new estimate of the neutral intertest rate and potential output for Canada. Both were revised lower, the former by one-quarter percentage point and the latter by 0.1 and 0.2 percentage points, depending on the year. The main takeaways are that rates need not rise as much as before to achieve a neutral setting and that there is less slack in the economy implying the need for higher rates.



The Bank's economic growth forecast, and new potential output estimate, strongly implies that no rate increase is necessary in 2019, and not until the second half of 2020. This could change quickly, though, as all forecasters are data dependent, and in these uncertain times, policy dependent as well.

Another trade policy announcement is coming this May 18 when the U.S. administration issues a decision on whether U.S. auto imports are a threat to national security. This needs to be taken in the context of bilateral trade negotiations with China, Japan, and the European Union (EU). If the threat of auto tariffs is to influence those negotiations, then the administration will very likely prolong the process and extend this uncertainty. It would be another cloud over the economy and business investment decisions. In addition, the U.S. administration is considering levying anti-dumping duties on fabricated structural steel imports from Canada, China, and Mexico.

The anticipated global economic growth pickup is materializing. U.S. growth came in above three per cent annualized in the first quarter of 2019, China's first quarter Gross Domestic Product (GDP) held up, and the eurozone's GDP accelerated in the first quarter. Central banks have adopted a more dovish stance, some governments initiated fiscal measures to boost growth, and the fading of some temporary growth depressing factors are in play.

Canada: Key economic data releases		
Indicator	Prior month	Latest month
Industry GDP, % change	0.3	-0.1
Employment, change, persons (000s)	55.9	-7.2
Unemployment rate, %	5.8	5.8
Hours worked, % change	-0.7	1
Real international goods exports, % chg.	0.9	-3.8
Real international goods trade balance, $b	0.1	-1.4
Real manufacturing sales, % change	1.4	-0.5
Real retail sales, % change	0	-0.4
Real wholesale sales, % change	0.5	0.3
Non-residential building permits, % change	-17.2	-0.5
Housing starts, units, % change	-18.1	15.8
MLS residential sales, % change	-7.2	0.9
Total CPI, % change y/y	1.5	1.9
Core CPI1., % change y/y	1.9	2

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

It is still early in the global growth cycle's revival and there is some doubt as to how durable it is. For example, China's official manufacturing PMI weakened in April, after rebounding to a six-month high in March. However, it was above the expansion/contraction threshold. Conversely, the capex environment remains under the cloud of trade tensions and higher oil prices are a net drag on the global economy.

Canada's economy needs a durable global growth revival to grow at a faster pace and to meet the Bank's export growth forecast. A modest growth pickup in the first quarter of 2019 is expected following the very poor end to 2018. Recent economic indicators are mixed but when viewed over the first quarter, the evidence points to one per cent real GDP growth.

During 2019, a firming quarterly growth profile is foreseen before slowing into 2020. Annual averages contradict the quarterly pattern, but it is only a statistical result and 2019 and 2020 are not significantly different. The quarterly pattern is more relevant for the rate forecast.

This rate forecast has shifted to a no change scenario through the next two years. The global growth revival is expected to ebb once again in 2020 when the U.S. economy slows further. Three-month Bankers' Acceptance futures are assigning a 100 per cent probability of a quarter-point rate cut by June 2020. A similar outcome is priced in the U.S. federal funds futures market. These market expectations anticipate an underperforming economy with no inflation pressures and the need for the central bank to stimulate growth.

It may play out that way in Canada, but the U.S. labour market is at full employment and wages are rising faster than inflation. Higher oil and gasoline prices could spill over into core inflation over time. Another rate increase by the Fed is not off the table, notwithstanding the recent communications shift by the Fed and U.S. administration urgings. In fact, this observer expects to see a rate increase before the year concludes.

The bond yield curve will remain shallow and inverted in the middle terms during the next quarter or so. A mild steepening during 2019 is expected in response to the global growth revival, above-potential U.S. growth, and increases in headline inflation. An underlying force behind higher long bond yields is the rising federal deficit, which needs to be funded. Another debt ceiling issue is before Congress with a debt deal needed before October, otherwise automatic spending cuts kick in.

Retail mortgage rates should be lower given the decline in bond yields. Some mortgage rates have come down recently, but not the posted fixed rates the Bank publishes. Housing sales and mortgage loan demand have slowed and will continue to remain sluggish, which usually prompts more competitive pricing among lenders.

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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	1.8
Unemployment Rate, %	6.0	5.6	6.2	5.7	6.3	5.8	5.6	5.5
Core CPI, % y/y	2.0	1.9	1.9	1.8	1.5	1.9	1.9	1.9

Source: Statistics Canada, Central 1 Credit Union.

Target Overnight Rate Forecast	
Meeting Date	(Per cent)
Apr. 24, 2019	1.75 (a)
May 29	1.75
Jul. 10	1.75
Sep. 4	1.75
Oct. 30	1.75
Dec. 4	1.75
Jan. 2020	1.75
Mar.	1.75
Apr.	1.75
May	1.75
July	1.75
Sep.	1.75
Oct.	1.75
Dec.	1.75
Jan. 2021	1.75
Mar.	1.75

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

Interest Rate Forecast									
	2019 Q1 a	2019 Q2	2019 Q3	2019 Q4	2020 Q1	2020 Q2	2020 Q3	2020 Q4	2021 Q1
Target Overnight Rate	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
Prime Rate	3.95	3.95	3.95	3.95	3.95	3.95	3.95	3.95	3.95
1-mo. T-Bill	1.63	1.65	1.65	1.65	1.65	1.65	1.70	1.65	1.70
3-mo. T-Bill	1.65	1.65	1.70	1.70	1.75	1.70	1.75	1.70	1.75
6-mo. T-Bill	1.72	1.70	1.70	1.75	1.80	1.75	1.75	1.75	1.80
1-year T-Bill	1.79	1.70	1.70	1.75	1.80	1.80	1.75	1.80	1.80
2-year GoC Bond	1.76	1.65	1.75	1.75	1.85	1.80	1.80	1.80	1.85
3-year GoC Bond	1.76	1.65	1.75	1.80	1.90	1.85	1.85	1.85	1.85
5-year GoC Bond	1.76	1.70	1.80	1.90	2.05	1.95	1.85	1.90	1.95
10-year GoC Bond	1.86	1.80	1.90	2.00	2.15	2.05	1.95	2.00	2.05

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

Mortgage Rate Forecast	2019 Q1 a	2019 Q2	2019 Q3	2019 Q4	2020 Q1	2020 Q2	2020 Q3	2020 Q4	2021 Q1
1-year Mortgage	3.64	3.65	3.65	3.65	3.65	3.65	3.65	3.65	3.65
3-year Mortgage	4.29	4.30	4.30	4.30	4.30	4.30	4.30	4.30	4.30
5-year Mortgage	5.34	5.34	5.34	5.34	5.34	5.34	5.34	5.34	5.34

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	2019 Q1 a	2019 Q2	2019 Q3	2019 Q4	2020 Q1	2020 Q2	2020 Q3	2020 Q4	2021 Q1
1-year GIC	1.30	1.30	1.30	1.30	1.30	1.30	1.30	1.30	1.30
3-year GIC	1.50	1.40	1.40	1.40	1.40	1.40	1.40	1.40	1.40
5-year GIC	2.20	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00

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.