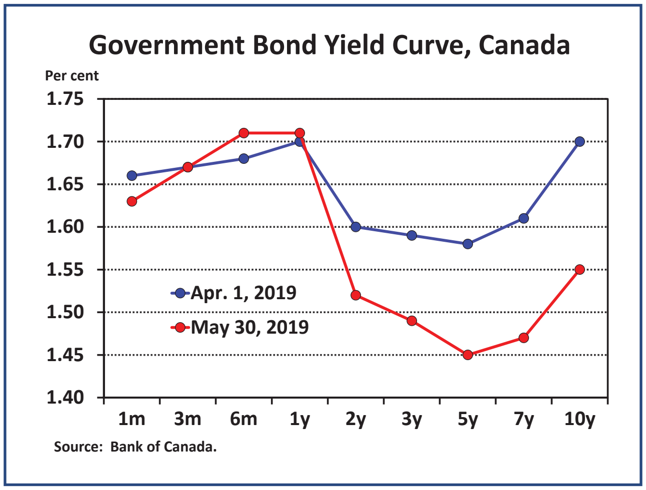
Interest Rate Forecast

central 1

Highlights

- Trade policy is front and centre
- Global growth revival sputters
- Policy rates on hold for now, low bond yields



"Tariff Man" – President Donald Trump - is at it again. This time threatening to impose tariffs on all goods imported from Mexico if it does not deal with the migration issue to his satisfaction. Trump has threatened tariffs on auto and auto parts coming into the U.S., and while he postponed their imposition for six months, it weighs on financial markets. Tariffs are increasingly being used not only as trade negotiation tactics, but also to achieve political goals.

Financial markets were gaining going into May but turned sharply downward on a Trump tweet that the 10 per cent tariff on $200 billion of imports from China will increase to 25 per cent on May 10, 2019. He also indicated that a 25 per cent tariff on the rest of U.S. imports from China will be imposed "shortly". Not surprisingly, China retaliated with its own tariff increases as well as threatening to stop rare earth exports to the U.S. among other non-tariff measures.

The new tariff threat to Mexico casts doubt on the ratification of the United States-Mexico-Canada Agreement, or USMCA. Removal of the steel and aluminum tariffs on Canada and Mexico had lifted hopes of its ratification, though Congress's approval was still needed and was not a certainty. This latest action against Mexico makes ratification unlikely under these circumstances.

Markets are worried not only about trade and tariffs, but also about recent softness in some economic data. The latest Purchasing Manager's Indexes (PMI) pulled back from gains made in recent months raising doubts about the global economy's growth revival. The impact of tariffs, threats of tariffs, and other restrictions on trade and the economy are negative on output, business sentiment, and investment.

A global economic growth recession – a sustained period of below potential growth – will ensue if all tariff threats materialize. Some offset would come from fiscal and monetary policy stimulus implemented in many countries to counter weakening economic conditions. Whether there is a further escalation in trade wars remains to be seen but given Tariff Man's track record more rather than less disruption is likely along with slower growth.

The bond market is ahead of Tariff Man by pricing in a low growth and inflation economy. The government bond yield curve is mostly, but not entirely, inverted signaling a possible recession. The "this time is different" cites a false positive due to factors pushing down the long end that were not present in prior inversions preceding recessions. At a minimum, the bond market's main message is that short rates need to come down.

The Fed Funds futures market agrees. It is pricing in two quarter-point rate cuts before the end of the year and another cut in 2020. This is a major shift from only six weeks ago when the futures markets expected no rate change in 2019 and less than a 50 per cent chance of a rate cut in 2020. Tariff Man's trade politics can change market expectations quickly.

The U.S. Federal Reserve is not ready to cut rates and does not see a rate cut for the foreseeable future but that would change if incoming data shows weaker growth along with deteriorating growth prospects. The U.S. labour market is at record low unemployment with hourly wage increases approaching four per cent.

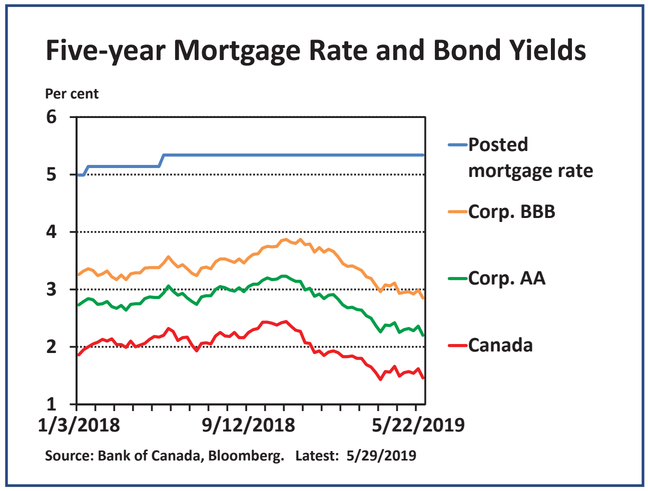
Canada: Key economic data releases		
Indicator	Prior month	Latest month
Industry GDP, % change	-0.2	0.5
Employment, change, persons (000s)	-7.2	106.5
Unemployment rate, %	5.8	5.7
Hours worked, % change	1.0	0.4
Real international goods exports, % chg.	-4.6	2.8
Real international goods trade balance, $b	-1.5	-0.9
Real manufacturing sales, % change	-0.3	1.6
Real retail sales, % change	0.4	0.3
Real wholesale sales, % change	0.3	1.0
Non-residential building permits, % change	1.2	7.9
Housing starts, units, % change	14.8	22.6
MLS residential sales, % change	2.3	3.6
Total CPI, % change y/y	1.9	2.0
Core CPI1., % change y/y	2.0	1.9

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

Under these conditions, core inflation should firm and receive a push from tariffs, though some offset would come from slower growth and some cooling in the labour market.

A growth slowdown in the global economy coinciding with a slowdown in the U.S. economy is negative for Canada's economic outlook. Canada's recent economic sluggishness is mainly due to internal factors, namely a housing slowdown and energy transportation issues, which look to continue. Adding weaker U.S. and global economies and trade tensions to the mix will result in a below-average outcome.

Canada's first quarter real Gross Domestic product (GDP) growth came in at an anemic 0.4 per cent annualized. However, the hand-off to the second quarter was substantial with most key indicators posting much stronger performances in the latest month. Notable were the 0.5 per cent growth in industry GDP, an employment increase of more than 100,000 persons, a positive reversal in exports, and another large jump in housing starts. Second quarter 2019 real GDP growth is put at 2.0 per cent.



During 2019, a firmer quarterly growth profile is foreseen before slowing into 2020. The annual average in 2020 is higher than in 2019, but it is only a statistical result and the quarterly pattern is more relevant for the rate forecast.

The Bank of Canada's economic forecast of 2.0 per cent annualized growth each quarter from the second half of 2019 to the end of 2021 would require it to raise rates should the forecast materialize. However, that forecast is too optimistic and is driven by the Bank's desire to achieve a neutral rate setting during the projection period.

This forecast sees the Bank's policy rate on hold through 2020 and the yield curve remaining partially inverted and very flat. Downside risks are increasing with each passing month and move by Tariff Man. A ceasefire in trade wars is possible and would shift rate risk to the upside but that is expecting a turnaround from what has been irrational policymaking. Perhaps the upcoming election cycle and the need to have a strong economy will trump – pen intended – tariff policy?

The Three-Month Canadian Bankers' Acceptance Futures market is pricing a quarter-point rate cut before December 2019 and another by September 2020. In mid-April 2019, this futures market was assigning two-thirds probability of one rate cut by the end of 2020.
Mortgage rates should be lower given the decline in

Economic Forecast – Canada								
	2018 Q4	2019 Q1	2019 Q2	2019 Q3	2017	2018	2019	2020
Real GDP, % annualized	0.3	0.4	2.0	2.0	3.0	1.8	1.3	1.8
Unemployment Rate, %	5.6	5.8	5.7	5.6	6.3	5.8	5.6	5.5
Core CPI, % y/y	1.9	1.9	1.9	1.9	1.5	1.9	1.9	1.9

Source: Statistics Canada, Central 1 Credit Union.

bond yields. Also, mortgage loan demand has slowed, which usually prompts more competition among lenders. However, no rate cut has occurred other than minor moves by a couple of lenders and major lenders are surprisingly holding, though it only takes one to break from the pack, and the rest usually follow.

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Target Overnight Rate Forecast

Meeting Date	(Per cent)
May 29, 2019	1.75 (a)
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	1.70	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	1.75	1.70	1.75	1.75	1.70
1-year T-Bill	1.79	1.70	1.70	1.75	1.75	1.70	1.75	1.75	1.70
2-year GoC Bond	1.76	1.60	1.60	1.65	1.70	1.70	1.70	1.75	1.70
3-year GoC Bond	1.76	1.60	1.60	1.65	1.70	1.75	1.75	1.75	1.70
5-year GoC Bond	1.76	1.60	1.60	1.70	1.75	1.75	1.80	1.80	1.75
10-year GoC Bond	1.86	1.70	1.70	1.80	1.85	1.80	1.85	1.90	1.85

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.