Interest Rate Forecast

central 1

Highlights

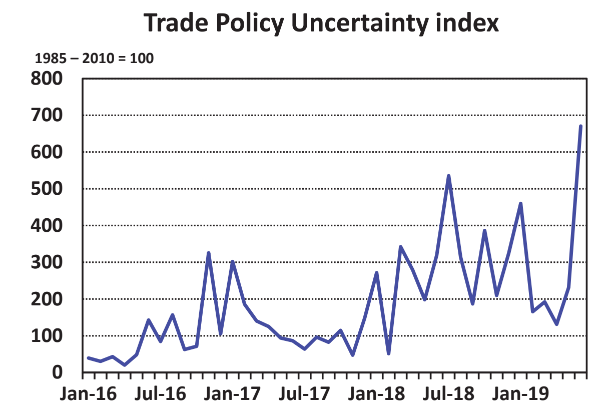
- Policy uncertainty heightens
- Global economic slowdown intensifies
- Canada’s economy temporarily bucks global trend
- Bank of Canada eases in 2020

Policy dependence has rarely been more crucial to an interest rate forecast. Imposed tariffs have depressed trade volumes, business confidence, and business spending. The imposition of more tariffs will exacerbate these conditions and put the economy on a growth recession path at a minimum, and possibly, lead to an outright recession. Trade policy uncertainty weighs on the economy causing central bankers to reevaluate their monetary stance.

The Trump-Xi meeting at the G-20 in Osaka eased some of these concerns with their agreement to restart trade negotiations and Trump’s concession to allow U.S. companies to sell equipment to Huawei. This trade truce does not mean the end of business uncertainty as the U.S. will likely keep up the pressure with the threat to impose tariffs on the remaining imports from China. Further, Trump has threatened tariffs on all auto imports later this year. Business confidence may receive a short-term boost from this trade truce but little else.

The latest manufacturing data paint a dismal picture. The Global Purchasing Managers’ Index (PMI) for June 2019 fell to its lowest level since October 2012 with production contracting and new orders slumping at their fastest pace in almost seven years. Business optimism fell to record low. The June Global Services PMI will likely post slower growth. The global economic slowdown continues and those economic green shoots that emerged earlier this year have withered.

Other political tensions will play out in the coming months. Brexit hangs over Europe and the U.S.-Iran situation continues to simmer with occasional boiling points. On the U.S. domestic front, the federal debt ceiling must be increased, or another government shutdown could play out with a divided Congress.



Source: Economic Policy Uncertainty. Latest: Jun-19 Note: Based on U.S. newspapers search of import tariffs, import duty, import barrier, government subsidies, government subsidy, wto, world trade organization, trade treaty, trade agreement, trade policy, trade act, doha round, uruguay round, gatt, dumping.

The U.S. federal deficit is on pace to be the largest since the financial crisis and a debt ceiling increase is necessary.

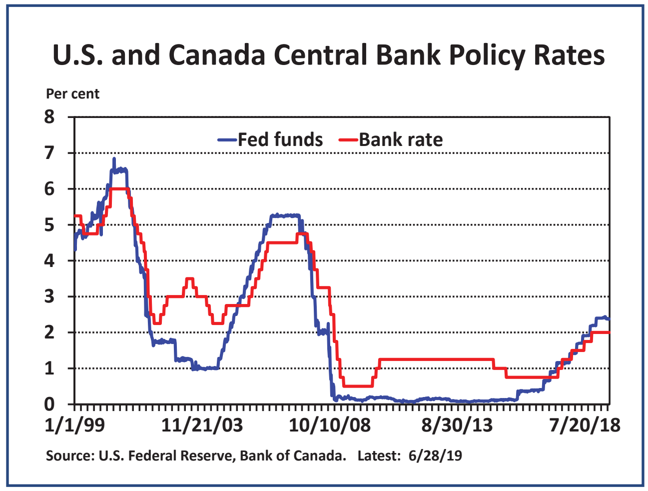
Futures markets are pricing in a substantial cut in the fed funds rate in the next 15 months. A full percentage point, or four quarter-point cuts, off the current rate is priced into the market with the first cut coming at the Fed’s July 31, 2019 meeting. The trade truce did little to change expectations. A similar market sentiment exists in Canada with Three-Month Canadian Bankers’ Acceptance Futures pricing in two quarter-point rate cuts over the same time period beginning in early 2020. The bond market also has a dismal view about the future economy with long bond yields falling to their lowest levels since late 2016 when the economy was coming out of its slump following the oil price collapse.

Are the money and bond markets too pessimistic about the economy? The stock market is more optimistic and does not see the U.S. economy not falling into recession soon. That a growth slowdown is underway is supported by the evidence. Final sales to domestic purchasers decelerated to 1.6 per cent in the first quarter of 2019 and industrial production, led by manufacturing, remains below its December 2018 high. However, a growth slowdown is not a recession, which requires an outright contraction of the economy.

There are worrying signs of possible recession down the road and the bond yield curve’s inversion is one of them. Dr. Copper has sent a mild negative signal with prices below the 2018 high but above the slump

Canada: Key economic data releases		
Indicator	Prior month	Latest month
Industry GDP, % change	0.5	0.3
Employment, change, persons (000s)		27.7
Unemployment rate, %	5.7	5.4
Hours worked, % change	0.4	-0.3
Real international goods exports, % chg.	3.1	1.1
Real international goods trade balance, $b	-0.6	0.8
Real manufacturing sales, % change	2.1	-0.8
Real retail sales, % change	0.5	-0.2
Real wholesale sales, % change	1	1.6
Non-residential building permits, % change	51.5	0.1
Housing starts, units, % change	21.3	-13.3
MLS residential sales, % change	3.6	1.9
Total CPI, % change y/y	2	2.4
Core CPI1., % change y/y	1.9	2.1

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



of 2015-16. More important for economists is that available leading economic indicators are not flashing recession. However, a recession may be beyond the time frame usually signaled by these indicators.

This U.S. business cycle is the most unusual in the post-war era and probably ever. In July 2019, it will become the longest in the post-war era. It is also the weakest expansion in the post-war era because of the 2008 financial crisis. Household balance sheets were hit hard and investment struggled despite record low interest rates but in tight credit conditions. Housing starts fell to record lows and have not responded to low mortgage rates as in the past. After the initial recovery, fiscal austerity was applied and slowed growth. It was not until 2014 that growth was mostly above two per cent. The Fed began raising its policy rate in late 2015 and adjusted its monetary setting at a gradual pace until 2017 when it became more confident of the economic outlook and was moved by its desire to normalize rates.

The tight labour market is an increasing area of concern and remains a key focus for the Fed. Wages are rising at a pace well above inflation and job openings outnumber those looking for work by a wide and growing margin. However, core inflation is below the Fed's two per cent target suggesting an economy not operating at full capacity and leaving room for more monetary stimulus. While core inflation is running at 1.6 per cent, another and a superior measure of core inflation, the trimmed mean PCE inflation rate, is higher at two per cent. Under these conditions, a rate cut is inappropriate.

The Fed's latest statement struck a dovish tone citing worries over trade tensions and a possible escalation in tariffs along with a decelerating global economy. The statement was accompanied by a new set of forecasts. The 'dot plot' showed a minority shift to a lower policy rate. Eight of the seventeen Fed policymakers who made projections saw a rate cut, with seven of them showing 50 bps in cuts by year end. The median forecast for the fed funds rate at the end of 2020 was 2.125% versus the prior estimate of 2.625%. The Fed's statement removed the word 'patient', implying more immediacy than before and downgraded its view on economic growth to moderate from solid.

For the Fed to cut rates now at this point in the business cycle and without a clear sign of economic weakness on the horizon and given existing uncertainties would be yielding to market, and possibly political, pressure. A July rate cut is not a given, notwithstanding market expectations. Should the July payroll report hugely

ECONOMIC FORECAST - CANADA								
	2018 Q4	2019 Q1	2019 Q2	2019 Q3	2018	2019	2020	2021
Real GDP, % annualized	0.3	0.4	2.5	2	1.8	1.4	1.7	1.3
Unemployment Rate, %	5.6	5.8	5.7	5.6	5.8	5.6	5.5	5.8
Core CPI, % y/y	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.8

Source: Statistics Canada, Central 1 Credit Union.

disappoint, and subsequent data support the slowdown scenario, then a July rate cut would be more likely.

A Fed rate cut usually presages a Bank of Canada rate cut because the Canadian economy is intertwined with the U.S. economy. The statistical relationship between the fed funds rate and the bank rate is high and strong. However, there are occasions when the two central banks have diverged in their rate setting. The last time the Fed cut rates and the Bank of Canada did not follow was in 2003 when the Fed cut 50 bps in late 2002 and the Bank raised 50 bps four months later. In fact, the Bank began raising rates in April 2002 while the Fed was on hold following 9/11. These and other occasions of rate divergence drives home the point that domestic considerations are the ultimate decider for a central bank.

Canada's economy is reviving from its growth slump of the prior two quarters. The opening months of the second quarter were positive across most key indicators and built on the strong handoff from the last month of the first quarter. Second quarter 2019 real GDP growth is put at 2.5 per cent annualized, up from 0.4 per cent in the prior quarter.

Despite the projected growth pickup in the middle quarters of 2019, economic growth for the year will come in at less than 1.5 per cent. The quarterly growth profile slows on a trend basis through 2020, notwithstanding its higher annual growth forecast, which is driven by a base effect and not underlying growth. The growth outlook for 2021 looks to remain on the slowdown track due to external factors, notably a slower U.S. economy and lower oil prices.

The Bank of Canada's upcoming *Monetary Policy Report* will incorporate the latest data and revise up its second quarter 2019 real GDP forecast. Its annual forecast of 2.1 per cent growth this year and 2.0 per cent is unlikely to increase and may be revised down a notch due to rising uncertainty around trade and tariffs.

The Bank of Canada is expected to remain on hold through this year before easing with two quarter-point rate cuts in 2020 beginning in April in response to Canada's slowing growth and growth prospects. The U.S., China, and EU economies will slow further from the impact of tariffs, disruption to supply chains, and weaker capex spending. Commodity prices soften under these conditions. The U.S. budget/deficit situation is another likely drag on U.S. growth going forward. Easing monetary conditions will keep the economies from falling into an outright recession by stimulating consumption and housing.

The flat, mostly inverted yield curve remains in effect until the central bank lowers its policy rate. There is little chance of long bond yields rising to the pull the yield curve to a positive slope in an economic slowdown. An economic growth resurgence is possible, but not in the forecast.

Lending and deposit rates will ultimately follow the central bank rate and bond yields lower. The Bank of Canada's posted GIC and mortgage rates have not changed little despite the drop in bond yields. Other data sources show some slippage in mortgage rates, which is consistent with the bond market and slower housing sales.

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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.	1.50
May	1.50
July	1.25
Sep.	1.25
Oct.	1.25
Dec.	1.25
Jan. 2021	1.25
Mar.	1.25

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	1.50	1.25	1.25	1.25
Prime Rate	3.95	3.95	3.95	3.95	3.95	3.70	3.45	3.45	3.45
1-mo. T-Bill	1.63	1.65	1.65	1.65	1.60	1.40	1.20	1.20	1.20
3-mo. T-Bill	1.65	1.70	1.65	1.65	1.60	1.45	1.25	1.25	1.25
6-mo. T-Bill	1.72	1.70	1.65	1.65	1.60	1.45	1.25	1.25	1.25
1-year T-Bill	1.79	1.70	1.65	1.65	1.60	1.45	1.25	1.20	1.25
2-year GoC Bond	1.76	1.55	1.45	1.45	1.40	1.35	1.20	1.20	1.25
3-year GoC Bond	1.76	1.50	1.40	1.40	1.35	1.35	1.20	1.20	1.25
5-year GoC Bond	1.76	1.50	1.40	1.45	1.40	1.35	1.25	1.30	1.30
10-year GoC Bond	1.86	1.60	1.50	1.45	1.40	1.40	1.35	1.40	1.45

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	3.25	3.25	3.25	3.25
3-year Mortgage	4.29	4.30	4.30	4.30	4.20	3.90	3.90	3.90	3.90
5-year Mortgage	5.34	5.34	5.34	5.34	5.14	4.94	4.94	4.94	4.94

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	1.05	1.05	1.05	1.05
3-year GIC	1.50	1.40	1.40	1.40	1.40	1.15	1.15	1.15	1.15
5-year GIC	2.20	2.00	2.00	2.00	2.00	1.75	1.75	1.75	1.75

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.