Interest Rate Forecast

central 1

Highlights

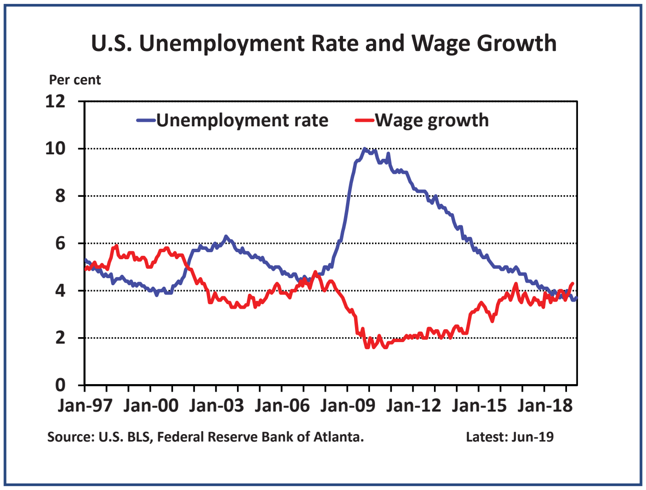
- Fed delivers an insurance cut
- Trade policy uncertainty remains high
- Canada's economy revives
- Bank of Canada on hold in the near term

The U.S. Federal Reserve did not disappoint market expectations for a rate cut by reducing its policy rate one-quarter percentage point at its July 31, 2019 meeting. To not cut rates after setting the stage with dovish talk would damage the Fed's credibility and increase market volatility. The data rationale for a rate cut was not strong and the insurance case was more about future economic prospects and erring on the side of caution.

In reaching its decision, the Fed cited weak and deteriorating external economic conditions, trade policy uncertainty, geopolitical tensions, and below target domestic inflation and low inflation expectations. Lower interest rates will stimulate the economy and inflation and extend the longest economic expansion, which is also the weakest in the post-war era. Initiating a rate cut this late in the cycle is not unprecedented but it is unique in that no shock event has occurred nor is the U.S. economy struggling.

The external economic environment and trade policy remain problematic. Early Purchasing Managers' Indexes (PMI) for the U.S., Eurozone, and Japan point to further manufacturing weakness though with growth in the service sector, it is basically a continuation of recent trends. Lower central bank rates are playing out in several economies. U.S.-China trade talks have resumed but little progress is expected in the near term. To compound matters, Japan and South Korea are now engaged in a high-tech trade dispute. Global economic growth will remain below-potential until the trade policy situation improves.

On the domestic front, the case for lower rates in the U.S. economy is not strong. The second quarter 2019 preliminary figure for real Gross Domestic Product (GDP) came in at a 2.1 per cent annualized



growth rate, slower than the 3.1 per cent pace in the first quarter of 2019 and from the 2.9 per cent pace for 2018. Growth in the latest quarter was driven by personal consumption and government spending while investment and trade contracted. The case for a rate cut diminishes with this GDP report, though the Fed can point to investment and trade as reasons to provide more monetary stimulus.

However, a lower Fed funds rate will not do much, if anything, to spur business investment and trade. Low rates will help the residential sector, while the trade issue must be addressed politically. Business investment uncertainty is influenced by trade, but the latest reading was not all negative. Investment in equipment and intellectual property was up while investment in structures declined. Investment in structures is a typically volatile component and the latest large decline is not necessarily indicative of a new trend. In addition, a rate cut in a low rate environment may not stimulate business investment.

Other data, notably the June 2019 jobs report, do not support a rate cut. The labour market is tight with the pace of wages increasing at a steadily faster pace. Personal income growth and consumption spending are buoyed by labour market conditions. While the Phillips Curve has flattened, it has not been repealed.

Core inflation, as measured by the Fed's benchmark, has remained well under its two per cent target since November 2018. However, the trimmed mean core inflation measure, a more accurate gauge of inflation,

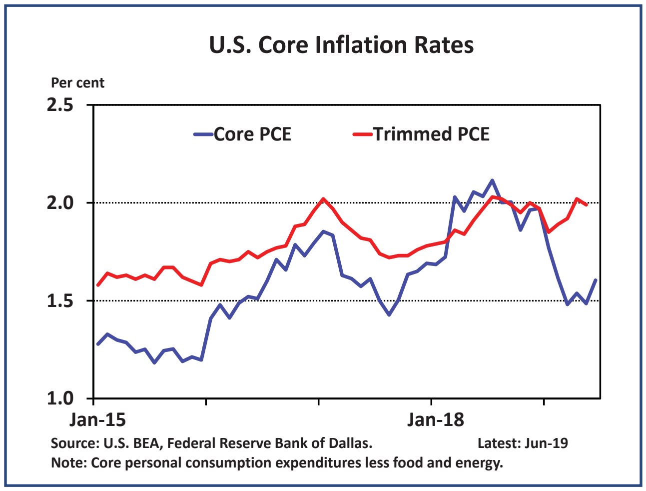
Canada: Key economic data releases		
Indicator	Prior month	Latest month
Industry GDP, % change	0.3	0.2
Employment, % change	0.2	0.0
Unemployment rate, %	5.4	5.5
Hours worked, % change	-0.3	0.7
Real international goods exports, % chg.	-1.8	1.3
Real international goods trade balance, $b	-0.5	-1.9
Real manufacturing sales, % change	-0.5	2.0
Real retail sales, % change	-0.1	-0.5
Real wholesale sales, % change	1.5	-1.9
Non-residential building permits, % change	1.2	7.3
Housing starts, units, % change	-14.7	24.8
MLS residential sales, % change	2.9	-0.2
Total CPI, % change y/y	2.4	2.0
Core CPI1., % change y/y	2.1	2.0

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

is at target and did not swoon in the first part of 2019. On this basis, a Fed rate cut is not justified.

The Fed's rate cut is probably a 'one and done' for the time being. Economic data and economic prospects need to worsen before another rate cut can be seriously considered. The U.S. economy is widely seen slowing in 2020 to around two per cent growth from more than two per cent in 2019. The latest federal budget deal removes some fiscal drag on the economy in the near term. Residential activity is seen increasing with lower mortgage rates, rising personal incomes, and ongoing job growth. The main economic risk stems from more tariffs and trade policy uncertainty.

While U.S. GDP growth slowed in the second quarter, Canada's economy picked up. Second quarter 2019 real GDP growth is forecast to increase to 2.5 per cent annualized from the weak start to 2019 and closing quarters of 2018. 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.



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 is seen slowing on a trend basis through 2020. The higher annual growth 2020 forecast is driven by a base effect and not underlying growth. The growth outlook for 2021 looks to remain at the lower end of the economy's potential due to external factors and domestic economic issues.

The Bank of Canada's *Monetary Policy Report*, released earlier this month, had a more optimistic economic outlook for Canada in 2020 and 2021 than this forecast. As in its previous forecasts, the Bank is relying on more business investment and exports to achieve its two per cent annual growth forecast.

At the Bank of Canada's next rate announcement, it will not follow the Fed's rate cut and remain on hold. How long it remains on hold depends on U.S. trade policy. Tariffs by the U.S. could expand to include autos and other goods dragging down the European and Asian economies, commodity prices, and Canada's economy. Based on past performance the chance of this occurring is high.

A holding pattern in the Bank's policy rates is expected through this year and into 2020 before easing with one quarter-point rate cut in April 2020 in response to Canada's slowing growth and growth prospects. The U.S., China, and European Union economies will slow further from the impact of more tariffs disrupting supply

ECONOMIC FORECAST - CANADA								
	2019 Q1	2019 Q2	2019 Q3	2019 Q4	2018	2019	2020	2021
Real GDP, % annualized	0.4	2.5	2.0	1.5	1.8	1.4	1.6	1.7
Unemployment Rate, %	5.8	5.5	5.5	5.6	5.8	5.6	5.5	5.6
Core CPI, % y/y	1.9	1.9	2.0	1.9	1.9	1.9	1.9	1.8

Source: Statistics Canada, Central 1 Credit Union.

chains and causing weaker capex spending. Commodity prices soften under these conditions. Looser monetary conditions will keep those economies from falling into an outright recession.

The flat, mostly inverted yield curve remains in effect until the central bank lowers its policy rate. Long bond yields are seen rising later in the forecast and pulls up the yield curve to a positive slope.

Lending and deposit rates follow the central bank rate and bond yields. The Bank of Canada's posted five-year fixed mortgage rate was lowered to 5.19 per cent with some delay despite the drop in bond yields and slippage in contract mortgage rates. This rate sets the bar for the federal mortgage stress test.

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Target Overnight Rate Forecast	
Meeting Date	**(Per cent)**
Jul. 10, 2019	1.75 (a)
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	1.50
Sep.	1.50
Oct.	1.50
Dec.	1.50
Jan. 2021	1.50
Mar.	1.50
Apr.	1.50
May	1.50

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

Interest Rate Forecast

	2019 Q2 a	2019 Q3	2019 Q4	2020 Q1	2020 Q2	2020 Q3	2020 Q4	2021 Q1	2021 Q2
Target Overnight Rate	1.75	1.75	1.75	1.75	1.50	1.50	1.50	1.50	1.50
Prime Rate	3.95	3.95	3.95	3.95	3.70	3.70	3.70	3.70	3.70
1-mo. T-Bill	1.67	1.65	1.65	1.60	1.40	1.40	1.40	1.45	1.45
3-mo. T-Bill	1.67	1.65	1.65	1.60	1.45	1.45	1.45	1.50	1.50
6-mo. T-Bill	1.70	1.65	1.65	1.60	1.45	1.45	1.45	1.50	1.55
1-year T-Bill	1.70	1.65	1.65	1.60	1.45	1.45	1.50	1.55	1.60
2-year GoC Bond	1.53	1.45	1.45	1.40	1.45	1.45	1.50	1.55	1.60
3-year GoC Bond	1.51	1.40	1.40	1.35	1.45	1.45	1.50	1.55	1.60
5-year GoC Bond	1.49	1.40	1.45	1.40	1.45	1.50	1.50	1.60	1.65
10-year GoC Bond	1.62	1.45	1.45	1.40	1.45	1.55	1.60	1.65	1.75

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

Mortgage Rate Forecast

	2019 Q2 a	2019 Q3	2019 Q4	2020 Q1	2020 Q2	2020 Q3	2020 Q4	2021 Q1	2021 Q2
1-year Mortgage	3.64	3.65	3.65	3.65	3.45	3.45	3.45	3.45	3.45
3-year Mortgage	4.29	4.30	4.30	4.20	4.20	4.20	4.20	4.20	4.20
5-year Mortgage	5.34	5.20	5.20	5.05	5.05	5.05	5.05	5.05	5.05

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 Q2 a	2019 Q3	2019 Q4	2020 Q1	2020 Q2	2020 Q3	2020 Q4	2021 Q1	2021 Q2
1-year GIC	1.35	1.30	1.30	1.30	1.05	1.05	1.05	1.05	1.05
3-year GIC	1.58	1.40	1.40	1.40	1.15	1.15	1.15	1.15	1.15
5-year GIC	2.15	2.00	2.00	2.00	1.75	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.