Interest Rate Forecast

central 1

Highlights

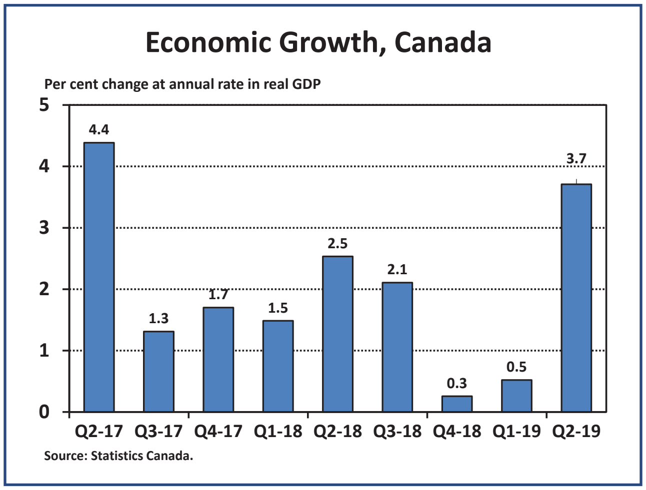
- Global economic slowdown continues
- Trade disputes escalate
- Bank of Canada and Fed on hold in near-term
- Additional insurance rate cuts expected later

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. Lower central bank rates are playing out in several economies. U.S.-China trade talks have made little progress and additional tariffs are likely. To compound matters, Japan and South Korea are now engaged in a high-tech trade dispute. On a positive note, a U.S.-Japan trade deal is near. Global economic growth will remain below-potential until the trade situation improves.

The U.S. Federal Reserve recently reduced its policy rate for the first time in ten years citing uncertainty about the trade situation and below-target inflation. The U.S. bond market priced in the Fed's rate cut and the inverted yield curve is pricing in more cuts.

An inverted yield curve often signals a pending economic recession. However, current economic and financial conditions are quite different from past instances of inversions and recessions. Current low bond yields are the result of weaker growth and inflation expectations stemming from trade issues and an increase in safe-haven flows into U.S. government bonds. Past yield curve inversions usually occurred when short term rates were rising faster than long bond yields during inflationary conditions.

Additional rate cuts by the Fed and other central banks will provide some support to consumer spending and economic growth. In some countries, fiscal stimulus can be used to boost the economy and avoid a recession. However, these stimulus measures take time to impact the real economy and a slower growth, low inflation, and low interest rate environment for 2020 is largely set, barring a shock event or an unexpected trade policy reversal.



The Fed's July 2019 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 latest federal budget deal adds some stimulus to the economy in the near term. Residential activity is seen increasing with lower mortgage rates, rising personal incomes, and ongoing job growth. The short-term outlook for the U.S. economy is still positive with growth around two per cent, notwithstanding manufacturing's weakness. An insurance rate policy stance does not call for consecutive meeting rate cuts, rather it is a wait-and-see, data-dependent approach.

The main economic risk stems from more tariffs and trade policy uncertainty. Another round of tariffs on China's exports to the U.S. are slated for October 1 and December 15, 2019. There is also the possibility that the U.S. will impose tariffs on auto imports. Should these tariffs proceed, China and other countries would retaliate with their own tariffs or restrictions. In this circumstance, the Fed would cut its policy rate by 50 basis points, and possibly more, in response the expectation that U.S. economic growth slows to less than two per cent in 2020 and beyond. Monetary policy cannot solve the U.S. trade imbalance.

There is no compelling case for an immediate insurance rate cut in Canada even with the weaker July 2019 jobs report, deteriorating external conditions, and rising policy uncertainty. Canada's economy posted a strong second quarter 2019 Gross Domestic Product (GDP) at 3.7 per cent annualized growth in real GDP. This topped the Bank of Canada's (Bank) 2.3 per cent growth forecast and will keep the Bank's policy rate on hold following its September 4, 2019 rate announcement

Canada: Key economic data releases

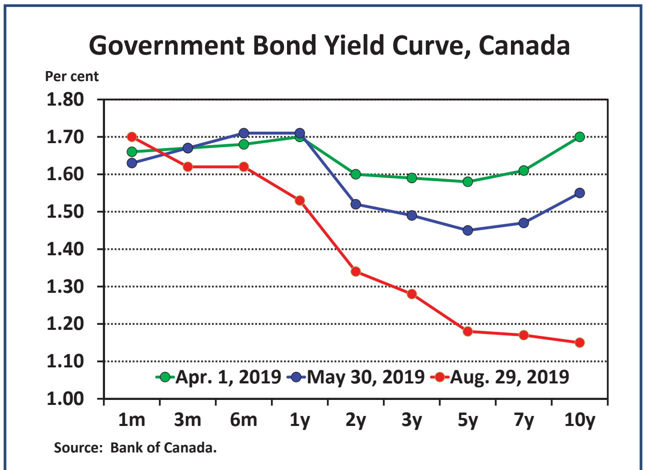
Indicator	Prior month	Latest month
Industry GDP, % change	0.3	0.2
Employment, % change	0.0	-0.1
Unemployment rate, %	5.5	5.7
Hours worked, % change	0.7	-0.6
Real international goods exports, % chg.	4.3	-2.2
Real international goods trade balance, $b	1.7	2.3
Real manufacturing sales, % change	1.7	-0.2
Real retail sales, % change	-0.6	0.5
Real wholesale sales, % change	-1.8	0.7
Non-residential building permits, % change	6.8	4.7
Housing starts, units, % change	24.7	-9.6
MLS residential sales, % change	0.6	3.5
Total CPI, % change y/y	2.0	2.0
Core CPI1., % change y/y	2.0	2.0

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

meeting. Industry GDP expanded 0.2 per cent during June 2019 with broadly-based gains and a good hand-off to the third quarter. Housing will receive a modest boost when the federal government's program to help first-time buyers get in the homeownership market comes into effect in September.

With Canada's economy closely tied to the U.S. economy, weakness in China, Europe, and some Asian emerging economies is less impactful on Canada than on Australia's economy, for example. As the U.S. economy goes, so goes Canada's economy. The global slowdown does affect commodity prices and Canada's export profitability and investment related to those commodities. A further complication weighing on some trade-related business investment is an uncertain future tariff structure.

If not now, when will the Bank cut? Two more monthly indicator data sets will be released before the next rate announcement on October 30, 2019. A significant deterioration in labour, trade, and other data, in conjunction with a ramp up in tariffs, would clinch the



case for a rate cut. However, our Q3 2019 Canada real GDP forecast is 2.0 per cent annualized. If this comes to pass, there is no urgent need to cut rates this October and the Bank can 'save its ammo' for when conditions are weaker and prospects dimmer.

The Bank usually makes a rate change on their quarterly Monetary Policy Report (MPR) dates and this October's meeting is when the MPR and a new set of forecasts are released. Rate changes have occurred in between MPR meeting dates, but only under critical circumstances. This forecast is looking for the first rate cut to occur at the Bank's January 2020 MPR meeting, rather than this October as some forecasters are calling.

The Bank, as with the Fed, will not stop at one insurance rate cut. This assumes the trade policy situation worsens, or at least does not improve, and the real economy begins to show more negative impacts from the trade dispute. In Canada, this is seen occurring at the Bank's April 2020 MPR meeting.

The futures market is looking for at least two quarter-point cuts in the Bank Rate and another 100 basis points in the Fed Funds rate by the end of the third quarter 2020. These cuts in short-term rates will reduce the yield curve's inversion, and ultimately, result in a positively sloped yield curve.

ECONOMIC FORECAST - CANADA

	2019 Q1	2019 Q2	2019 Q3	2019 Q4	2018	2019	2020	2021
Real GDP, % annualized	0.4	3.0	2.0	1.5	1.8	1.5	1.5	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.

It is a precarious time for forecasters and markets given heightened trade policy uncertainty. Political science and psychology acumen are probably more relevant tools for prediction under this U.S. administration than economic foresight. It gives added meaning to the cliché that this time is different.

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Target Overnight Rate

Meeting Date	(Per cent)
Sep. 4, 2019	1.75 (a)
Oct. 30	1.75
Dec. 4	1.75
Jan. 2020	1.50
Mar.	1.50
Apr.	1.25
May	1.25
July	1.25
Sep.	1.25
Oct.	1.25
Dec.	1.25
Jan. 2021	1.25
Mar.	1.25
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	1.50	1.25	1.25	1.25	1.25	1.50
Prime Rate	3.95	3.95	3.95	3.70	3.45	3.45	3.45	3.45	3.70
1-mo. T-Bill	1.67	1.65	1.65	1.40	1.15	1.15	1.15	1.15	1.40
3-mo. T-Bill	1.67	1.65	1.65	1.45	1.25	1.25	1.25	1.25	1.50
6-mo. T-Bill	1.70	1.65	1.60	1.45	1.25	1.30	1.35	1.35	1.55
1-year T-Bill	1.70	1.65	1.50	1.40	1.25	1.30	1.35	1.45	1.65
2-year GoC Bond	1.53	1.40	1.35	1.25	1.25	1.30	1.35	1.50	1.65
3-year GoC Bond	1.51	1.35	1.25	1.25	1.25	1.30	1.35	1.55	1.70
5-year GoC Bond	1.49	1.30	1.20	1.20	1.25	1.35	1.40	1.60	1.75
10-year GoC Bond	1.62	1.30	1.20	1.20	1.30	1.40	1.50	1.70	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 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	3.50	3.35	3.35	3.35	3.35	3.45
3-year Mortgage	4.29	4.30	4.15	4.15	4.15	4.15	4.15	4.25	4.35
5-year Mortgage	5.34	5.20	5.05	4.90	4.90	4.90	4.90	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	1.10	1.00	1.00	1.00	1.00	1.10
3-year GIC	1.58	1.80	1.80	1.60	1.50	1.50	1.50	1.50	1.65
5-year GIC	2.15	2.00	2.00	2.00	1.80	1.80	1.80	1.80	1.95

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.