Interest Rate Forecast

Highlights

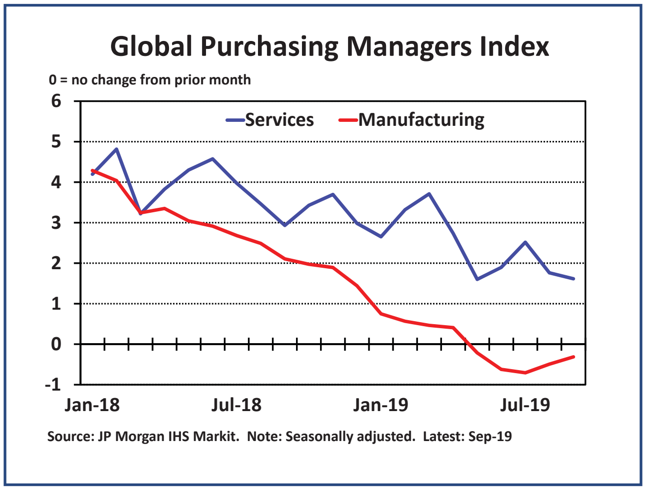
- Trade troubles slow economic growth
- More rate cuts coming

The growth slowdown from tariffs, Brexit, geopolitical tensions, and the resulting uncertainty on investment spending shows no let up, and to make matters worse, additional tariffs are threatened this year. Exports and manufacturing are worsening, and other economic sectors are increasingly caught up in their vortex. More countries are using monetary stimulus, and some are turning to fiscal stimulus, to boost growth and avoid a recession. The economy's growth recession phase will extend through next year, and likely beyond, causing even lower interest rates.

This scenario need not play out if the trade issue improves. A meaningful trade deal that reduces tariffs and expands trade between the U.S. and China would send financial markets higher, steepen the yield curve, and firm up economic growth. However, it remains to be seen whether and what kind of deal will be reached. The most that should be expected is a minor deal involving a truce on further tariffs against China.

President Trump delayed his tariff increase on $250 billion of Chinese imports from 25 to 30 per cent, originally set out on August 23, 2019, from October 1 to October 15. A minor deal would likely put these tariffs on hold. Nonetheless, auto tariffs are looming with a decision expected before yearend. If the U.S. imposes tariffs on auto imports, it would send markets and the economy down another step or two. These tariffs would be imposed in the interest of U.S. national security under the same legislation used in the steel and aluminum tariffs imposed earlier.

The accompanying graph shows the latest global indicators for the services and manufacturing sectors. Manufacturing is pulling down the services sector and the steady downward trajectory is very problematic. The global economy is in a synchronized slowdown



with manufacturing slowing the rest of the economy, China's slowdown impacting other economies, softer commodity prices, and uncertainty holding back investment spending.

U.S. interest rates are heading lower. The futures market is assigning it a near 100 per cent probability of a 25-basis point cut in the Fed funds rate at the end of this month and substantial odds of another cut before next January. It is difficult to argue with the market's assessment given the deteriorating external environment and the unsettled trade policy situation. The timing and magnitude of actual cuts may differ, but the outcome is clear under current and expected circumstances.

The monetary stance by the Bank of Canada is somewhat different than the U.S. Federal Reserve, but not markedly. Core inflation is on target, unlike in the U.S. which is below-target, and most key economic indicators, except manufacturing, are positive. Granted, third quarter 2019 real GDP growth will be much slower than the temporary surge seen in the prior quarter, but this is likely not enough to prompt the Bank to cut rates at the end of this month. Coincidentally, the Bank and the Fed announce their rate setting on the same day this month.

Housing activity in Canada is picking up. Sales and prices are rising, and housing starts remain at a high level. The decline in mortgage rates and pent-up demand is driving this year's uptrend. The federal government incentive for first-time buyers will extend this trend as will the expected decline in rates ahead.

Canada: Key economic data releases

Indicator	Prior	Latest month
Industry GDP, % change	0.2	0.2
Employment, % change	-0.1	0.4
Unemployment rate, %	5.7	5.7
Hours worked, % change	-0.6	0.7
Real international goods exports, % change	0.6	0.2
Real international goods trade balance, $b	1.1	0.9
Real manufacturing sales, % change	-0.4	-1.6
Real retail sales, % change	0.4	0
Real wholesale sales, % change	0.7	1.7
Non-residential building permits, % change	5.2	3.3
Housing starts, units, % change	2.2	-2.5
MLS residential sales, % change	4	1.4
Total CPI, % change y/y	2	1.9
Core CPI1., % change y/y	2	2

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

A Bank rate cut is coming; it is only a matter of when. The market is pricing in high odds of a rate cut at the end of this month. However, there is no urgent need to cut rates this October and the Bank can adopt a 'wait and see approach' without endangering the economy. Should external circumstances worsen before this meeting, a rate cut is more likely. While the GM auto strike will cut into GDP growth, the Bank does not react to temporary economic drags.

The Bank will release a new set of economic forecasts at this October's meeting. Their quarterly Monetary Policy Report will likely contain a slight upgrade to their 2019 Canada GDP growth forecast followed by a slight downgrade to its 2020 forecast. The Bank has a long-standing practice of forecasting the economy to grow close to its potential in the last forecast year, in this case 2021, and to have inflation at its two per cent target. These last year (2021) forecasts are discounted as organization set; the Bank does forecast its failure to deliver on-target inflation. At the same time, the Bank does not reveal its interest rate or exchange rate forecasts that result in achieving on-target inflation.

This forecast has the Bank holding rates until next January when the negative external environment forces its hand to cut a quarter point. This expectation rests on a trade policy situation that worsens, or at least does not materially improve, and the economy remains stuck at a below two per cent growth rate. A somewhat more robust housing market and consumer in 2020 will not be enough to offset the weakness in exports, manufacturing, and business investment to have the Bank forgo a rate cut.

Chances are that more than one quarter point rate cut will be needed because this global growth stagnation extends into 2021. The most likely next rate cut looks to be at the Bank's April 2020 meeting, though a hold until July 2020 is conceivable. This would bring the Bank's policy rates down by 50 basis points from current levels.

The futures market is looking for at least two quarter-point cuts in the Bank Rate and another 75 basis points in the Fed Funds rate by the end of the third quarter 2020.

Cuts in short-term rates will reduce the yield curve's inversion and result in a positive-sloped yield curve at that time. Another scenario resulting in a positive yield curve is an improvement in actual and future economic growth pulling up the long end. Unfortunately, this latter scenario looks more than two years away.

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ECONOMIC FORECAST - CANADA

	2019 Q1	2019 Q2	2019 Q3	2019 Q4	2018	2019	2020	2021
Real GDP, % annualized	0.5	3.7	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.

Target Overnight Rate Forecast	
Meeting Date	(Per cent)
Sep. 4, 2019	1.75 (a)
Oct. 30	1.75
Dec. 4	1.75
Jan. 22, 2020	1.50
Mar. 4	1.50
Apr. 15	1.25
June 3	1.25
July 15	1.25
Sep. 9	1.25
Oct. 28	1.25
Dec. 9	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 Q3 a	2019 Q4	2020 Q1	2020 Q2	2020 Q3	2020 Q4	2021 Q1	2021 Q2	2021 Q3
Target Overnight Rate	1.75	1.75	1.50	1.25	1.25	1.25	1.25	1.50	1.50
Prime Rate	3.95	3.95	3.70	3.45	3.45	3.45	3.45	3.70	3.70
1-mo. T-Bill	1.65	1.65	1.40	1.15	1.15	1.15	1.15	1.40	1.40
3-mo. T-Bill	1.64	1.65	1.45	1.25	1.25	1.25	1.25	1.50	1.50
6-mo. T-Bill	1.66	1.60	1.45	1.25	1.30	1.35	1.35	1.55	1.55
1-year T-Bill	1.65	1.50	1.40	1.25	1.30	1.35	1.45	1.65	1.65
2-year GoC Bond	1.48	1.35	1.25	1.25	1.30	1.35	1.50	1.65	1.65
3-year GoC Bond	1.43	1.30	1.25	1.25	1.30	1.35	1.55	1.70	1.70
5-year GoC Bond	1.36	1.25	1.20	1.25	1.30	1.40	1.60	1.75	1.75
10-year GoC Bond	1.36	1.25	1.20	1.25	1.35	1.50	1.70	1.85	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 Q3 a	2019 Q4	2020 Q1	2020 Q2	2020 Q3	2020 Q4	2021 Q1	2021 Q2	2021 Q3
1-year Mortgage	3.64	3.65	3.50	3.35	3.35	3.35	3.35	3.45	3.45
3-year Mortgage	4.16	4.15	4.00	3.85	3.85	3.85	4.00	4.00	4.15
5-year Mortgage	5.21	5.05	4.90	4.90	4.90	4.90	5.05	5.05	5.20

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 Q3 a	2019 Q4	2020 Q1	2020 Q2	2020 Q3	2020 Q4	2021 Q1	2021 Q2	2021 Q3
1-year GIC	1.35	1.30	1.10	1.00	1.00	1.00	1.00	1.10	1.10
3-year GIC	1.80	1.80	1.60	1.50	1.50	1.50	1.50	1.65	1.65
5-year GIC	1.97	2.00	2.00	1.80	1.80	1.80	1.80	1.95	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.