Interest Rate Forecast

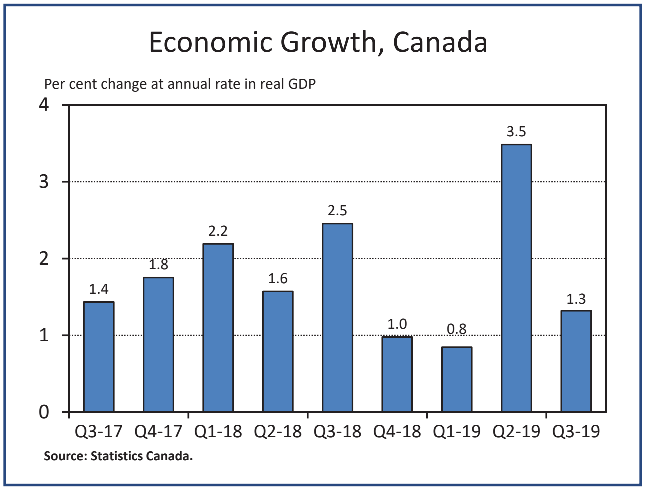
Highlights

- Market uncertainty falls with trade deals and Brexit outcome
- Early signs of better global economy ahead
- Bank of Canada on hold through 2020
- Canada's bond yield curve to turn positive

Significant political events affecting financial markets and the economy played out this past week. A phase one trade deal between the U.S. and China was announced and the Brexit question was decided in the U.K. election. These developments reduced, but did not eliminate, uncertainty hanging over markets and investors, and with recent signs of a growth inflection point ahead, economic prospects have improved.

The U.S. and China settled on a phase one trade deal. China will purchase more agricultural products, energy, and manufactured goods and made commitments on intellectual property protection and currency management. U.S. tariffs scheduled to go into effect December 15, 2019 on the remaining $160 billion of Chinese imports are suspended and China canceled its retaliatory tariffs due to take effect that same day. The tariff rate imposed on Sept 1, 2019 on $120 billion of Chinese imports will be cut in half to 7.5 per cent from 15 per cent. U.S. tariffs of 25 per cent on $250 billion worth of Chinese goods will remain unchanged. Final text of the deal will be released next month.

This phase one trade deal does not bring U.S.-China tariffs back to pre-2018 levels and the threat of new tariffs remains should either side become dissatisfied with the other's performance under the deal. A phase two deal will take much longer to complete because of the structural issues involved over China's state-owned enterprises, government subsidies, market access, among others. Phase one only dealt with 'low-hanging fruit'. It is very likely that phase two negotiations will go through an on-again-off-again pattern lasting well beyond 2020. At a minimum, the phase one deal brings a temporary truce after many disruptive and uncertain months.



The U.K. election returned a large Conservative majority, which ensures the U.K. leaves the E.U. at the end of January 2020. A transition period following the U.K.'s exit is slated by the end of 2020, but if the U.K. has not secured a trading agreement with the E.U. by that time, which is likely given that major trade deals take much longer to negotiate, considerable uncertainty for both exporters and importers would exist. However, the withdrawal agreement could have the option for the U.K. to request an extension of up to two years. Negotiations look to begin this March and there is still a chance of a no-deal Brexit.

Closer to home, the newly revised United States–Mexico–Canada Agreement (USMCA), or CUSMA in Canadian terms, modernizes trading rules, and strengthens enforcement of labor and environmental rights. However, the new content requirements for autos and steel will raise production costs, resulting in higher auto prices, and increase substitution of machines for workers. For Canada, it is likely a small net negative for the economy, though it does bring certainty to the trading relationship with the U.S. and in the long run that could offset the negatives.

Turning to the latest economic news, preliminary Purchasing Managers' Indexes (PMI) for December 2019 turned higher in the U.S. but stagnated for Japan and the Eurozone. This was a repeat performance of last month and suggests the global economy has not turned the growth corner. However, China's latest economic indicators point to growth stabilizing and the recent firming in global manufacturing PMIs is another positive sign.

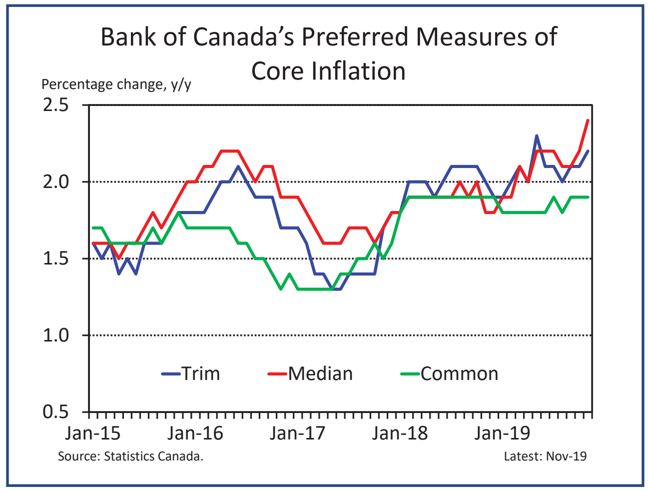
Canada: Key economic data releases		
Indicator	Prior month	Latest month
Industry GDP, % change	0.2	0.2
Employment, % change	0.0	-0.4
Unemployment rate, %	5.5	5.9
Hours worked, % change	0.1	-0.2
Real international goods exports, % change	-1.8	0.7
Real international goods trade balance, $b	0.7	0.8
Real manufacturing sales, % change	-0.5	-0.4
Real retail sales, % change	0.3	-0.1
Real wholesale sales, % change	0.7	1.7
Non-residential building permits, % change	-6.7	22.2
Housing starts, units, % change	-9.3	0.3
MLS residential sales, % change	1.3	0.0
Total CPI, % change y/y	1.9	2.2
Core CPI1., % change y/y	2.1	2.2

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

A global growth inflection point occurring before mid-2020 is expected if there are no further trade policy or geopolitical disruptions. Economic agents are adjusting to the new tariff realities, adapting their supply chain as needed, and responding to monetary stimulus. Market expectations usually precede or anticipate changes in economic prospects and judging by the recent performance in equities and bonds, economic performance looks to improve.

Canada's economic prospects remain subdued in the near term. Latest economic releases were more negative than positive though the employment report looks to be a one-off survey result and not the beginning of a trend. The problems in manufacturing, particularly in autos and forestry, are mostly structural and longer term, not cyclical. Consumer spending is holding, and housing is gaining, which will drive most of the economy's overall growth.

Fourth quarter 2019 real GDP growth is forecast at 1.5 per cent annualized and 2019 will come in at 1.7 per cent, which will be one of the slowest growth performances since the last recession. No economic recession is on the immediate horizon given the ease in trade tensions, improved global growth prospects, and stimulative monetary conditions will maintain growth and avoid a slump. The 2020 growth outlook is slightly better as is the expectation for 2021. Economic prospects are heading in the right direction but could be interrupted by another bout of trade disputes and protectionism or a geopolitical shock event.



Inflation in Canada is well behaved and near the Bank of Canada's inflation target. The Consumer Price Index (CPI) reading for November 2019 saw a small bounce to 2.2 per cent year-over-year, but that was mainly due to the base effect when global oil prices fell sharply in November 2018. Core CPI edged higher and the main concerns here are faster wage increases and rising housing costs.

Market expectations for a rate cut in Canada have changed in tandem with the ease in trade tensions and reduced uncertainty. Current pricing in the Three-month Canadian Bankers' Acceptance futures market calls for no rate cut through to December 2022. This is a substantial change from last month and it shows how quickly expectations can shift.

This forecast has also shifted in response to changes on the trade front. It was always a challenge to anticipate how the U.S.-China trade issue would evolve and to

ECONOMIC FORECAST - CANADA								
	2019 Q1	2019 Q2	2019 Q3	2019 Q4	2018.0	2019.0	2020.0	2021.0
Real GDP, % annualized	0.9	3.5	1.3	1.5	1.9	1.7	1.8	1.9
Unemployment Rate, %	5.8	5.5	5.5	5.6	5.8	5.6	5.5	5.3
Core CPI, % y/y	1.9	1.9	2.0	2.0	1.9	2.0	1.9	2.1

Source: Statistics Canada, Central 1 Credit Union.

some extent Brexit as well. The uncertainty generated by these issues have a large impact on markets and investors. Now that there is more clarity, markets are reacting positively. In addition to financial markets, commodity markets are turning up in anticipation of better industrial demand. A word of caution is in order. The tentative U.S.-China phase one deal may yet fall apart and cause markets to retreat. The unpredictability of this U.S. administration has not changed.

Another factor was the upward revision to prior GDP quarters suggesting that amount of economic slack was less than previously estimated. With a smaller output gap and on-target inflation, the Bank of Canada is more likely to remain on hold and would cut only if external conditions deteriorated causing a weaker domestic economy.

The current forecast sees the Bank of Canada on hold into 2021 and restarting the rate normalization phase later that year, which assumes no setback on the trade issue and no significant economic slowdown or recession in the U.S. or other main economic power. Of course, markets and the economy do not operate in a consistent, steady direction indefinitely; something usually occurs to change sentiment and actual performance.

Canada is one of the last G-7 countries to have an inverted bond yield curve, mainly because the Bank of Canada did not cut rates in the past year or so. This is about to change with the increase in long bond yields. In this forecast the yield curve turns positive in the first quarter of 2020, likely by February. And, barring any negative policy or economic developments will become increasingly positively-sloped through the forecast.

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Target Overnight Rate Forecast

Meeting Date	(Per cent)
Dec. 4, 2019	1.75 (a)
Jan. 22, 2020	1.75
Mar. 4	1.75
Apr. 15	1.75
June 3	1.75
July 15	1.75
Sep. 9	1.75
Oct. 28	1.75
Dec. 9	1.75
Jan. 2021	1.75
Mar.	1.75
Apr.	1.75
Jun.	2.00
Jul.	2.00
Sep.	2.00

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	1.75	1.75	1.75	1.75	1.75	1.90	2.00
Prime Rate	3.95	3.95	3.95	3.95	3.95	3.95	3.95	4.10	4.20
1-mo. T-Bill	1.65	1.65	1.65	1.65	1.65	1.65	1.70	1.80	1.90
3-mo. T-Bill	1.64	1.65	1.70	1.70	1.70	1.75	1.80	1.90	2.00
6-mo. T-Bill	1.66	1.70	1.70	1.75	1.75	1.80	1.85	1.95	2.05
1-year T-Bill	1.65	1.70	1.75	1.75	1.75	1.85	1.95	2.00	2.10
2-year GoC Bond	1.48	1.60	1.75	1.75	1.75	1.85	1.95	2.05	2.20
3-year GoC Bond	1.43	1.55	1.75	1.75	1.80	1.90	2.00	2.10	2.20
5-year GoC Bond	1.36	1.50	1.80	1.85	1.80	1.95	2.05	2.20	2.30
10-year GoC Bond	1.36	1.50	1.80	1.85	1.80	2.00	2.10	2.30	2.45

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

Mortgage Rate Forecast

	2019 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	3.65	3.65	3.65	3.75	3.75	3.85	3.85
3-year Mortgage	4.16	3.95	3.95	4.00	4.05	4.05	4.15	4.15	4.25
5-year Mortgage	5.21	5.20	5.35	5.45	5.45	5.50	5.55	5.60	5.65

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	1.35	1.35	1.35	1.35	1.35	1.40	1.45	1.50
3-year GIC	1.80	1.80	1.95	1.95	1.95	2.00	2.05	2.10	2.15
5-year GIC	1.97	2.00	2.10	2.10	2.10	2.20	2.25	2.30	2.35

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.