

Highlights

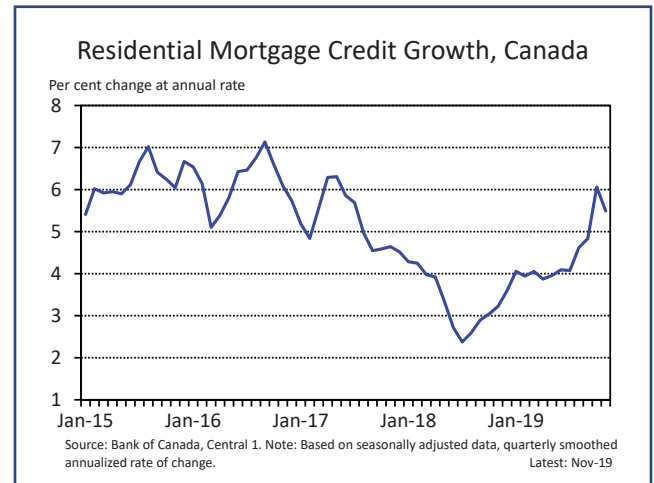
- Bank of Canada holds on rates
- Canada's economy in temporary weak growth period followed by rebound
- Global economy in early stages of stabilizing
- Significant coronavirus disruption possible in short-term

Some calm on the trade front emerged with markets reacting positively, but new geopolitical tensions and a viral outbreak unwound some of those gains. These new concerns could linger for a while and it is too early to estimate the magnitude of the outbreak. The global economy is stabilizing from the 2018-19 slowdown and looks to improve slightly, barring a flare-up in these new uncertainties or in trade disputes.

The Bank of Canada issued its rate announcement and an updated *Monetary Policy Report* on January 22, 2020. No change in its policy rates was expected and the Bank delivered. The Bank cited some concern about the Canadian economy's recent slowdown and left the door open to a rate cut if warranted by incoming data. The Bank's new economic forecast called for mild growth rebound in the first quarter of 2020 on the basis that the pipeline shutdown and strikes contributing to the slowdown were temporary.

The fading of these temporary factors and the improvement in market sentiment following the signing of the U.S.-China Phase One trade deal and the new North American trade agreement receiving legislative consent, sets the stage for better economic performance. Canada's annual economic growth was put at 1.6 per cent in 2020, the same as in 2019. Notably, the quarterly growth profile improves throughout 2020. The Bank's 2021 growth forecast is 2.0 per cent, an upgrade from 1.8 per cent previously.

The Bank also raised its estimate of Canada's potential growth rate reflecting higher trend labour productivity due to a larger capital stock, more investment, and higher population growth than previously seen. This new estimate combined with the forecast upgrades suggests a more optimistic Bank of Canada,



notwithstanding concerns around the financial vulnerabilities posed by high household debt.

Some commentators view the Bank's message more dovish than the last rate announcement and more likely to implement a rate cut with considerable attention given to the Bank's downgrade to fourth quarter 2019 growth. However, this is short-sighted because it is due to temporary factors and faster growth is expected. Last October, the Bank considered a rate cut in response to the slowing global economy and trade tensions but decided against it because that would increase financial vulnerabilities. Tensions have since eased while the risk of financial vulnerabilities has increased with the pickup in housing activity and mortgage lending. This suggests a more hawkish, not dovish, Bank of Canada stance. However, the economy would need to take a significant departure from the Bank's forecast to move rates in either direction in the near term.

The global economy is expected to show more signs of growth stabilization, building on recent trends. Preliminary, or flash, Purchasing Managers' Indexes (PMI) for January 2020 are beginning to trickle in. The IHS Markit Flash U.S. Composite PMI Output Index posted 53.1 in January, up from 52.7 in December, the quickest rise in output since last March. The Flash Eurozone PMI was unchanged from December 2019, though, France and Germany had positive starts to the year. A global growth inflection point is expected before mid-2020 assuming no further trade policy or geopolitical disruptions.

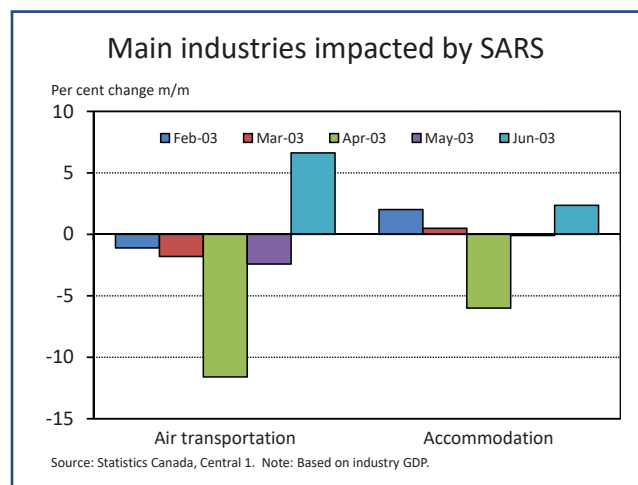
Canada: Key economic data releases

Indicator	Prior month	Latest month
Industry GDP, % change	0.0	-0.1
Employment, % change	-0.4	0.2
Unemployment rate, %	5.9	5.6
Hours worked, % change	-0.2	0.0
Real international goods exports, % change	-0.5	-1.9
Real international goods trade balance, \$b	0.2	0.0
Real manufacturing sales, % change	0.1	-0.8
Real retail sales, % change	-1.2	0.7
Real wholesale sales, % change	-1.4	-0.9
Non-residential building permits, % change	-6.7	22.2
Housing starts, units, % change	-9.3	0.3
MLS residential sales, % change	0.9	-0.9
Total CPI, % change y/y	2.2	2.2
Core CPI1., % change y/y	2.1	2.1

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

The new coronavirus (2019-nCoV) situation could be a disruptor, or external shock, to the economy. Markets have reacted negatively to this news sending equities, bond yields, and oil prices lower. The number of confirmed cases continues to rise as does the number of countries with confirmed cases. In China, eight cities are on lock down as of this writing. In prior instances of a pandemic, the economic impact was substantial on travel, tourism and related industries. How long or widely this pandemic will spread and last remains to be seen. It presents a significant downside risk to near-term economic forecasts.

A look at the impact of Severe Acute Respiratory Syndrome (SARS) in Canada during the early months of 2003 reveals an overall contraction in industry GDP for two months (March and April). The air transportation industry was hardest hit, contracting four consecutive months, for a total drop of 16.2 per cent through to May, followed by a large 6.6 per cent rebound in June 2003. Accommodation industry GDP plunged 6.0 per cent in April 2003. Other sectors impacted to a lesser



degree were performing arts, spectator sports and related industries and food services and drinking places. The coronavirus situation is still unfolding, and should it become more extensive, the economic impacts will be similar in kind, though not necessarily in magnitude, to SARS.

How did the Bank of Canada react during SARS? Typically, the Bank does not react to, and looks through, temporary economic disruptions. In 2003, SARS was but one shock event – others were the war in Iraq, the isolated case of bovine spongiform encephalopathy (BSE) in Canada, and the sharp fall in the U.S. dollar. In light of these events, the Bank cut rates in July and September 2003. Three more quarter-point cuts followed later in 2003 and into 2004. It took more than SARS for the Bank to change rates.

Canada's economy is undergoing a transition from temporary disruptions to a backfilling rebound followed by a return to moderate trend growth. The latest economic indicators reflect the impact of the GM and CN strikes and the Keystone pipeline closure. A return to operations is underway which will show up in these statistics in the next month or two.

Fourth quarter 2019 real Gross domestic Product (GDP) looks to come in well below one per cent annualized growth. A subsequent rebound in the first quarter 2020 should play out with the fading and backfilling of those

Economic Forecast - Canada

	2019 Q3	2019 Q4	2020 Q1	2020 Q2	2018	2019	2020	2021
Real GDP, % annualized	1.3	0.5	2.0	1.5	1.9	1.6	1.7	1.9
Unemployment Rate, %	5.5	5.7	5.6	5.5	5.8	5.7	5.5	5.3
Core CPI, % y/y	2.0	2.1	2.0	1.9	1.9	2.0	1.9	2.1

Source: Statistics Canada, Central 1 Credit Union.

temporary factors depressing growth in the prior quarter. Disruptions aside, Canada's underlying growth trend remains in the 1.5 per cent to 2.0 per cent range. The Bank of Canada's recent upward reassessment of trend labour productivity and economy-wide potential growth is encouraging for future performance. A sustained plus 2.0 per cent trend growth rate will require productivity gains, labour force growth, and investment to improve physical and human capital. A stronger export sector is an essential driver of investment spending, higher valued-added jobs, and hence, productivity.

Current pricing in the Three-month Canadian Bankers' Acceptance futures market reflects the coronavirus concerns. With the Bank of Canada's rate announcement, this market was pricing in one quarter-point rate cut by the end of 2020. Two days later, the coronavirus increased the expectation of a lower rate to 38 basis points by the end of 2020. Events and expectations are moving rapidly and there is no sense of stabilization at this time.

Forecasting interest rates during shock events is more difficult than usual. There is an increasing risk of a rate cut should the coronavirus situation spread more widely and deeply and combine with other shocks such as the U.S. imposing auto tariffs as part of the trade negotiations with the European Union or a geopolitical event.

The base case assumes no significant disruption by the coronavirus other than depressing bond yields in the very short-term. The Bank of Canada is presumed to remain on hold into 2021 and restart the rate normalization phase later that year when economic growth is above the economy's potential. The yield curve looks to steepen, but only modestly and remain below normal.

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Target Overnight Rate Forecast	
Meeting Date	(Per cent)
Jan. 22, 2020	1.75 (a)
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.	1.75
Jul.	2.00
Sep.	2.00
Oct.	2.00
Dec.	2.00

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

Interest Rate Forecast									
	2019 Q4 a	2020 Q1	2020 Q2	2020 Q3	2020 Q4	2021 Q1	2021 Q2	2021 Q3	2021 Q4
Target Overnight Rate	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.95	2.00
Prime Rate	3.95	3.95	3.95	3.95	3.95	3.95	3.95	4.15	4.20
1-mo. T-Bill	1.67	1.65	1.65	1.65	1.65	1.70	1.70	1.90	1.90
3-mo. T-Bill	1.66	1.70	1.70	1.70	1.75	1.75	1.80	1.95	2.00
6-mo. T-Bill	1.69	1.70	1.70	1.75	1.75	1.80	1.85	2.00	2.05
1-year T-Bill	1.71	1.55	1.65	1.75	1.80	1.85	1.90	2.05	2.10
2-year GoC Bond	1.60	1.50	1.60	1.70	1.80	1.90	1.90	2.05	2.15
3-year GoC Bond	1.58	1.50	1.60	1.70	1.80	1.90	1.95	2.10	2.15
5-year GoC Bond	1.53	1.50	1.60	1.70	1.80	1.90	1.95	2.10	2.20
10-year GoC Bond	1.52	1.50	1.60	1.75	1.85	1.95	2.00	2.15	2.30

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

Mortgage Rate Forecast									
	2019 Q4 a	2020 Q1	2020 Q2	2020 Q3	2020 Q4	2021 Q1	2021 Q2	2021 Q3	2021 Q4
1-year Mortgage	3.64	3.65	3.65	3.65	3.65	3.65	3.75	3.85	3.90
3-year Mortgage	3.94	3.95	3.95	3.95	3.95	4.05	4.05	4.10	4.15
5-year Mortgage	5.19	5.20	5.20	5.20	5.20	5.35	5.35	5.40	5.45

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 Q4 a	2020 Q1	2020 Q2	2020 Q3	2020 Q4	2021 Q1	2021 Q2	2021 Q3	2021 Q4
1-year GIC	1.35	1.35	1.35	1.35	1.35	1.35	1.40	1.45	1.55
3-year GIC	1.80	1.80	1.80	1.80	1.80	1.80	1.95	2.00	2.05
5-year GIC	2.00	2.00	2.00	2.00	2.00	2.00	2.15	2.15	2.20

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.