Interest Rate Forecast

central 1

Highlights

- Coronavirus spreads, markets tumble
- Domestic disruptions compound growth concerns
- Rate scenario dependent on pandemic outcome

With no immediate end in sight for the spread of COVID-19 - the coronavirus - financial markets are tumbling, and the global economy is hitting another stumbling block after showing some signs of a growth revival. Closer to home and to compound matters, protests and blockades have disrupted rail transportation and the Canadian economy. The base case scenario has COVID-19 subsiding in the second quarter of 2020 along with the associated economic disruptions followed by a backfilling growth rebound in the second half of the year.

Monetary policymakers have a balancing act to manage by not overreacting to these temporary economic disruptions while setting the conditions for stable on-target inflation, and full employment growth in some cases. The Bank of Canada has only one target – a stable two per cent inflation rate. With recent data showing success in meeting that target, there is little incentive to change monetary settings unless the outlook changes significantly.

Global economic prospects are downgraded for the first and second quarters of this year. Preliminary Purchasing Managers' Indexes (PMI) for February 2020 show a sharp drop in the Flash U.S. Composite PMI Output Index and the Flash Japan PMI has plummeted. However, the Eurozone PMI Composite Output Index hit a six-month high, off a low base. Common themes in these reports were weak new orders, supply chain disruptions, and a hit to travel and tourism services.

When the final PMI reports are released in February, the evidence will confirm the preliminary results and will likely paint an even more negative picture on first quarter 2020 economic growth. There will be COVID-19 disruption spillovers into the March PMI results as well.

China is reportedly beginning to reopen some businesses and factories as well as easing credit and liquidity conditions. Six provinces have reduced their declared emergency levels, allowing for a quicker resumption of production. These are positive signs, and more importantly, the growth in the number of confirmed COVID-19 cases continues to slow.

Unfortunately, the number of confirmed cases in the rest of the world is increasing at a faster pace. South Korea, Iran, and Italy, along with others, are seeing more cases though the numbers are low. The World Health Organization (WHO) has not declared COVID-19 a pandemic and assigns it a high-risk assessment. Should the virus not be contained and a wider contagion result, the economic consequences would be much more serious and probably cause a global growth recession. In the worst case scenario, an outright recession would play out.

Canada's economy was already taking a fourth quarter 2019 growth hit from strikes and a pipeline shutdown and now faces another round of disruptions in the first quarter of 2020. This will make two consecutive quarterly weak growth outcomes and increase the prospect of a rate cut by the Bank of Canada.

Markets have already priced in two quarter-point rate cuts this year with the first occurring at the next Bank of Canada rate announcement on March 4, 2020. Markets appear to be pricing in the worst-case scenario for COVID-19. There are good reasons to be pessimistic, but unless there is a global pandemic this market reaction is overdone.

For some positive news, rail transportation in Canada has begun to move again and there is a large backlog to clear before business as usual resumes. Another piece of good news is the housing market. Housing sales and prices are rising in several markets, which will hold up construction investment spending. In the non-residential construction space, market conditions are conducive for new investment to occur in some instances. The labour market is generating faster wage

Canada: Key economic data releases		
Indicator	Prior month	Latest month
Industry GDP, % change	-0.1	0.1
Employment, % change	0.1	0.2
Unemployment rate, %	5.6	5.5
Hours worked, % change	0.0	-0.1
Real international goods exports, % change	-1.1	1.8
Real international goods trade balance, $b	-0.6	-1.2
Real manufacturing sales, % change	-1.0	-0.4
Real retail sales, % change	0.9	0.0
Real wholesale sales, % change	-0.8	0.8
Non-residential building permits, % change	-1.6	8.3
Housing starts, units, % change	-4.5	8.8
MLS residential sales, % change	-0.4	-2.9
Total CPI, % change y/y	2.2	2.4
Core CPI1., % change y/y	2.1	2.0

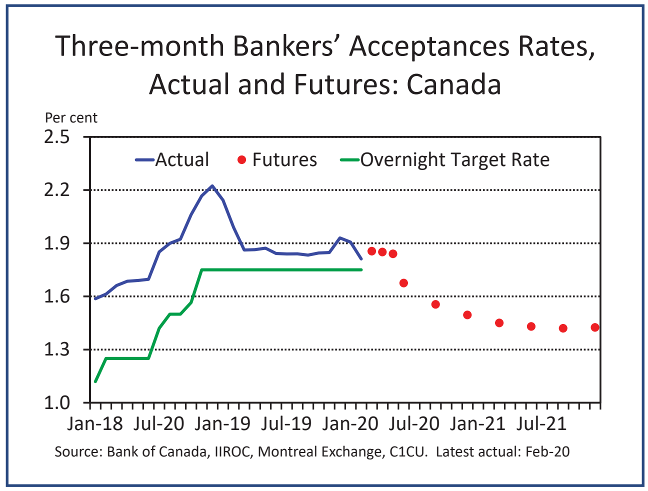
Source: Statistics Canada, CMHC, CREA. Month-to-month changes except CPI year/year. 1. Average of three measures.

and income growth, providing support to consumption spending.

The latest economic indicators do not reflect the negative impact of the rail disruptions but will in the next month or two. Consequently, economic growth in the first quarter of 2020 is revised down and the second quarter is revised up to recognize the rebound effect following the rail and coronavirus virus disruptions. Canada's 2020 economic growth is nudged lower to 1.4 per cent and 2021 is unchanged at 1.9 per cent.

Forecasting during shock events requires scenarios given the prevailing high uncertainty. The base scenario in the forecast has the virus scare subsiding by mid-year and the economy growing at a faster pace in the second half. Under this scenario, there is no urgency for central banks in Canada and the U.S. to cut rates in response to a temporary slowdown when improving growth prospects are approaching.

The alternative scenario involves a more dire virus situation and economic outcome, which would require



the central bank to cut rates. The Three-Month Canadian Bankers' Acceptance Futures market pricing of two quarter-point rate cuts is a reasonable forecast under this scenario. Hopefully, this will not come to pass.

Bond yields have plummeted and would continue to fall in the alternative scenario. As of this writing, Government of Canada five-year and ten-year bond yields have dropped to 1.20 per cent from around 1.60 per cent in early January 2020. Current levels are almost as low as last August when global economic growth and prospects were poorest during the height of the U.S.-China trade dispute. Prior to that occasion, bond yields fell even lower when the oil price collapse of 2014-2015 caused a national growth recession and an outright recession in oil-dependent provincial economies.

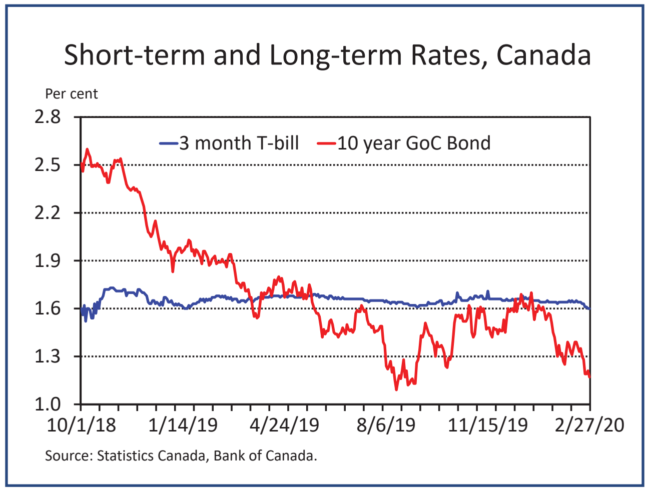
Some mortgage rates have followed bond yields lower and more downside to market sensitive mortgage rates is likely. However, the mortgage rate used for the stress test has not changed since last July and remains at 5.19 per cent. This is changing as of April 6, 2020 when a modification to this benchmark rate takes place making it responsive to market conditions. The stress test will then be based on the greater of the borrower's contract rate or the weekly median five-year fixed insured mortgage rate from mortgage insurance applications, plus two percentage points. The difference to a borrower is small but positive.

Economic Forecast - Canada								
	2019 Q3	2019 Q4	2020 Q1	2020 Q2	2018	2019	2020	2021
Real GDP, % annualized	1.3	0.5	1.0	2.0	1.9	1.6	1.4	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. Shaded areas are forecasts.

This new benchmark mortgage rate will be made available by the Bank of Canada. The last data observation available is for November 2019 when this rate was 2.83 per cent. The recent decline in bond yields and the cost of funds looks to bring the rate down by 20 to 30 basis points or more.

Canada's yield curve in more inverted as a result of the fall in long bond yields. This condition is seen extending for another couple of months or so until the virus scare subsides and improving growth prospects push up bond yields. In the medium term under the base scenario, the yield curve turns positive later this year and in early 2021 and remains relatively flat through 2021.



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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.	1.75
Sep.	1.75
Oct.	1.75
Dec.	1.75

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	1.75	1.75
Prime Rate	3.95	3.95	3.95	3.95	3.95	3.95	3.95	3.95	3.95
1-mo. T-Bill	1.67	1.65	1.65	1.65	1.65	1.70	1.70	1.70	1.70
3-mo. T-Bill	1.66	1.65	1.65	1.65	1.70	1.75	1.75	1.75	1.80
6-mo. T-Bill	1.69	1.60	1.60	1.65	1.70	1.75	1.80	1.80	1.85
1-year T-Bill	1.71	1.55	1.50	1.60	1.70	1.75	1.85	1.90	1.95
2-year GoC Bond	1.60	1.45	1.40	1.50	1.65	1.75	1.90	1.95	2.00
3-year GoC Bond	1.58	1.40	1.35	1.50	1.65	1.75	1.90	2.00	2.05
5-year GoC Bond	1.53	1.35	1.30	1.45	1.65	1.80	1.95	2.00	2.10
10-year GoC Bond	1.52	1.35	1.30	1.45	1.65	1.80	2.00	2.10	2.15

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	3.65	3.65	3.65
3-year Mortgage	3.94	3.95	3.95	3.95	3.95	3.95	3.95	4.00	4.05
5-year Mortgage	5.19	5.20	5.20	5.20	5.20	5.20	5.25	5.30	5.40

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	1.35	1.35	1.35
3-year GIC	1.80	1.80	1.80	1.80	1.80	1.80	1.80	1.90	1.95
5-year GIC	2.00	2.00	2.00	2.00	2.00	2.00	2.05	2.10	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.