Interest Rate Forecast

central 1

Highlights

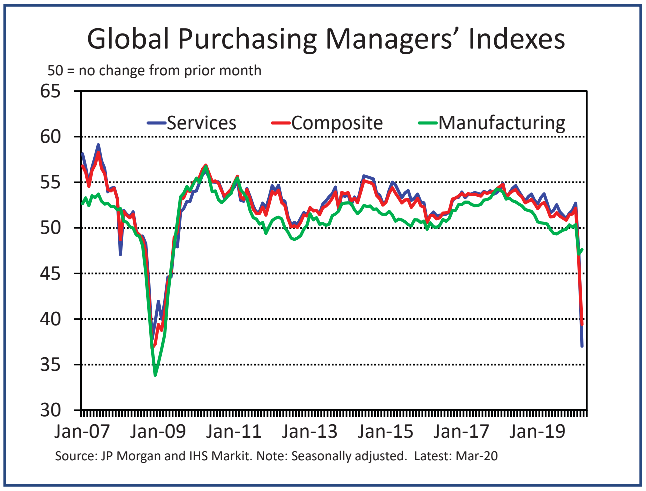
- Early signs of economic recession evident
- Unprecedented economic hit unfolding
- Pandemic measures to shape economy's path
- Ultra low Bank of Canada policy rate sticks through 2021

Reality is setting in on the unprecedented economic hit we will experience as a result of the coronavirus shock. A global recession is underway and the uncertain recovery path is dependent on how the virus spread, how itis contained, and ultimately, immunity from the virus. An untimely additional blow to Canada's economy is the oil price collapse. The Bank of Canada, along with many other central banks, has been aggressive in providing monetary stimulus to the economy and support to credit markets. In addition, governments are expanding income support to the economy.

The magnitude of the global economic disruption related to COVID-19 is coming into focus. The latest news validates the view that the global economy contracted sharply last quarter. The Global Composite Output Index fell to a 133-month low of 39.4 in March 2020. Furthermore, monthly drop in the index level (6.7 points) was the second-steepest on record. The global service sector saw business activity contract at the steepest rate in survey history.

The labour market is severely impacted by the stalling economy. For example, U.S. employment fell a remarkable 701,000 in March 2020 and 10 million initial jobless claims were filed after the March survey. The U.S. employment rate in April 2020 will shoot above 10 per cent.

Canada's labour market is in a similar situation. Claims filed for employment insurance are reportedly 2.5 million in the past three weeks. With the March 2020 Labour Force Survey (LFS) survey period ending in the week of March 14, the vast majority of these unemployed will not be captured in the LFS. The unemployment rate in Canada will exceed 10 per cent in April.



The pandemic's path has a direct impact on the length and depth of the recession and the subsequent economic recovery. In the near term, restrictive containment measures on movement and people gatherings will remain in place through April and in some form through June, and possibly beyond. The longer containment measures are in place, the longer the recession will be.

An optimistic scenario has containment measures beginning to ease around May with consumers and businesses resuming activities beyond the essentials needed for isolation and social distancing. This results in a short severe recession ending in the second quarter of 2020. A more likely scenario has this crisis persisting into the summer and the economic recession ending in the third quarter of 2020. A pessimistic scenario has the virus crisis and recession extending into 2021.

Recessions are usually followed by a strong rebound led by pent-up consumer demand for housing, autos and other durable goods. A quick V-shaped recovery is likely when workers and businesses resume activity and is aided by monetary stimulus and fiscal support. However, some containment measures restraining consumer spending are likely to remain in place.

The longer the recession lasts, the more likely the recovery is not V-shaped and becomes U-shaped or possibly a "Nike swoosh" shape, particularly in the pessimistic scenario. Another possibility is the virus resurges in the fall or winter months and containment measures are re-imposed, resulting in a W-shaped recession-recovery path.

Canada Economic Forecast											
	2019 Q4 a	2020 Q1	2020 Q2	2020 Q3	2020 Q4	2021 Q1	2021 Q2	2021 Q3	2021 Q4	2019 a	2020	2021

	2019 Q4 a	2020 Q1	2020 Q2	2020 Q3	2020 Q4	2021 Q1	2021 Q2	2021 Q3	2021 Q4	2019 a	2020	2021
Real GDP, % ar	0.3	-2.7	-27.2	-3.2	5.5	9.1	7.0	8.2	8.5	1.6	-5.4	4.0
U. Rate, %	5.7	5.9	9.9	9.4	7.8	6.9	6.5	6.3	5.9	5.7	8.2	6.4
Core CPI, % y/y	2.1	2.0	1.9	1.8	1.9	1.7	1.7	1.8	1.9	1.7	1.9	1.8

Source: Statistics Canada, Central 1. a = actual, all others forecast. ar= annual rate

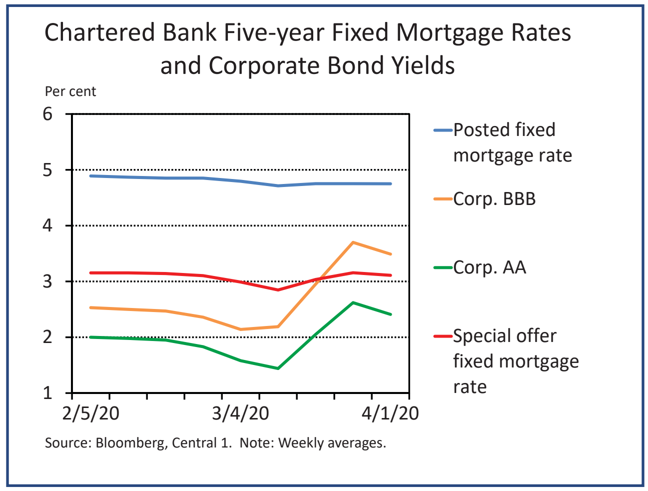
However, none of these scenarios would move the Bank of Canada's policy rate off 0.25 per cent. A negative policy rate requires a depression-like economy to emerge and quantitative easing measures to become ineffectual. The output gap, or excess capacity, in the economy resulting from the expected huge quarterly contraction in Gross Domestic Product (GDP) will take several quarters of growth to backfill. There is practically no chance of a Bank rate hike before 2022 under any scenario.

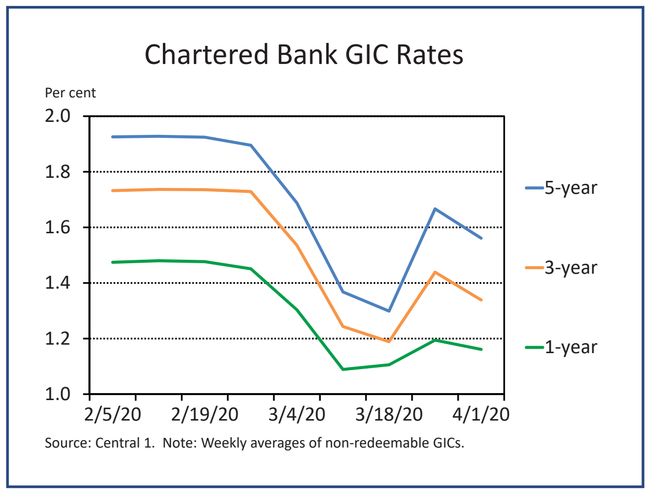
A more challenging forecast is bond yields and it depends largely on the shape and magnitude of the economic recession and recovery. Currently, bond yields are at record lows amid volatile markets with large daily swings on the news flow and sentiment shifts. Liquidity issues also affected the market and rate spreads causing a spike in government and corporate bond yields with the latter shooting up more than 100 basis points (bps) between March 9 and March 25, 2020. Yields have since come down, but corporate spreads remain very high reflecting uncertainty and recession risk.

A positively-sloped yield curve has emerged with large rate cuts at the front end while the long end declined at a slower pace on recession concerns. The government bond yield curve will steepen gradually during 2020 and slightly more briskly in 2021 when better economic growth prospects are more certain.

Mortgage rates moved higher in the second half of March 2020 in tandem with higher yields on government and corporate bonds. The chartered bank average five-year fixed special offer rate rose to 3.16 per cent at month end from 2.85 per cent in mid-March while the banks' posted five-year fixed term rate was little changed during this period. The special offer rate average is beginning to edge lower as of the latest week.

The sudden weak demand for mortgage credit and a declining cost of funds should combine to bring mortgage rates lower. Housing sales look to drop by more than 50 per cent in April over March 2020 and the outlook for May is equally dismal due to movement restrictions. Beyond this COVID-19 induced housing drop, sales and starts should pick up as pent-up demand is released and supportive fundamentals re-emerge. Mortgage rate are seen edging higher in 2021.





Guaranteed Investment Certificate (GIC) rates were also impacted by the market disruption in second-half of March. Non-redeemable GIC rates posted by the chartered banks rose between 10 bps and 40 bps depending on the term. In the latest week, these rates have come down about 10 bps with the average five-year rate at 1.56 per cent. Further declines are foreseen in the near term.

During this recession and except for the late-March period, GIC rates have declined by more than mortgage rates. The spread between the chartered bank average five-year fixed mortgage rate and the five-year GIC rate has widened to 1.55 per cent as of April 2, 2020 compared to 1.21 per cent on March 2, 2020. Some further spread widening is expected in the next quarter or two.

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Interest Rate Forecast

	2020 Q1 a	2020 Q2	2020 Q3	2020 Q4	2021 Q1	2021 Q2	2021 Q3	2021 Q4	2022 Q1
Target Overnight Rate	1.48	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Prime Rate	3.70	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.45
1-mo. T-Bill	1.29	0.15	0.20	0.20	0.20	0.20	0.20	0.25	0.25
3-mo. T-Bill	1.27	0.20	0.25	0.25	0.25	0.25	0.25	0.30	0.30
6-mo. T-Bill	1.27	0.30	0.30	0.35	0.35	0.35	0.35	0.40	0.45
1-year T-Bill	1.26	0.40	0.40	0.40	0.45	0.50	0.45	0.45	0.50
2-year GoC Bond	1.20	0.40	0.45	0.45	0.50	0.55	0.60	0.65	0.70
3-year GoC Bond	1.20	0.50	0.55	0.55	0.60	0.65	0.70	0.70	0.80
5-year GoC Bond	1.17	0.60	0.65	0.75	0.90	0.95	1.00	1.00	1.10
10-year GoC Bond	1.20	0.70	0.80	0.95	1.05	1.15	1.15	1.25	1.35

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

Mortgage Rate Forecast

	2020 Q1 a	2020 Q2	2020 Q3	2020 Q4	2021 Q1	2021 Q2	2021 Q3	2021 Q4	2022 Q1
1-year Mortgage	3.57	3.15	3.00	3.00	3.00	3.00	3.00	3.10	3.10
3-year Mortgage	3.94	3.60	3.40	3.40	3.40	3.45	3.45	3.45	3.50
5-year Mortgage	5.17	4.80	4.65	4.65	4.65	4.70	4.75	4.75	4.85

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.

GIC rates are declining faster than mortgage rates

Deposit Rate Forecast

	2020 Q1 a	2020 Q2	2020 Q3	2020 Q4	2021 Q1	2021 Q2	2021 Q3	2021 Q4	2022 Q1
1-year GIC	1.28	0.85	0.75	0.75	0.75	0.75	0.75	0.75	0.75
3-year GIC	1.61	1.00	0.90	0.90	0.90	0.95	0.95	0.95	0.95
5-year GIC	1.84	1.40	1.20	1.20	1.20	1.25	1.25	1.25	1.25

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.