Interest Rate Forecast

central 1

Highlights

- Deep economic recession is widespread
- Economic recovery pandemic dependent
- Early recovery signs in China
- Disinflationary and low rate environment in Canada's medium term

Pandemic-related restrictions are beginning to ease in varying degrees around the world signaling better economic times ahead, or perhaps another infection surge. Considerable uncertainty about the future exists, though the stock market's recent large gain suggests otherwise. Re-opening the economy will be gradual and measured in most instances with some governments taking a more aggressive approach. While recovery from the sharpest and most severe recession since the Great Depression is coming, its shape and path are far from certain.

An economic recovery from recession is defined by various benchmarks, including two or more consecutive quarters of increasing real Gross Domestic Product (GDP) and when the economy reaches its prior level before the recession hit. These and more technical criteria are used by business cycle dating committees to gauge when a recovery has occurred.

The main issue now is not the ability of the economy to grow or the amount of government support to mitigate the recession's effect and assist the recovery, but rather how the pandemic will unfold. Uncertainty around whether a second wave occurs in the fall/winter and if a vaccine or treatment becomes available. Several scenarios are possible, and none are predictable without a high degree of certainty.

A number of possible recovery shapes are put forward and include a V, U, W, L, and the Nike swoosh. Each one would be driven mainly by a pandemic path. Under normal conditions following a shock-induced recession, the economy recovers quickly with the release of pent-up consumer demand usually led by housing and consumer durable goods spending. This time is probably different with activity restrained by the gradual lifting of pandemic restrictions. Further, consumers need to feel safe before resuming usual spending patterns and providing that early lift to the recovery. Consequently, a strong V-shaped recovery is not expected.

Latest economic data show the extent of this recession. Its suddenness, severity, and breadth is unprecedented in the modern era and perhaps surpassed only by the two recessions in the Great Depression decade. When restrictions were first imposed around mid-March 2020, the economy began to free-fall through April and into May. All industries were negatively affected with travel, accommodation, retail, restaurants, and businesses dependent on people gatherings hurt the most.

The second quarter of 2020 will very likely mark the low point of this recession barring a second pandemic wave. Canada's real GDP is forecast to plunge 50 per cent annualized, or roughly 12.5 per cent in actual terms, from the first quarter of 2020. Statistics Canada estimated that real GDP dropped 8.2 per cent annualized in the prior quarter. Consumer spending, trade, and inventory drawdown accounted for most of the decline.

Similar large second quarter 2020 economic contractions are expected in a majority of countries and will rank as the worst quarterly performance in decades. Expectations for the U.S. economy are for a 35 per cent annualized contraction in the quarter with some nowcasting models predicting a 52 per cent

Canada Economic Forecast

	2020 Q1 a	2020 Q2	2020 Q3	2020 Q4	2021 Q1	2021 Q2	2021 Q3	2021 Q4	2022 Q1	2019 a	2020	2021
Real GDP, % ar	-8.2	-50.0	30.0	10.0	5.0	10.0	7.5	5.0	3.5	1.6	-7.1	6.6
U. Rate, %	6.3	14.5	11.5	9.5	9.0	8.5	7.5	7.0	6.5	5.7	10.5	8.0
Core CPI, % y/y	1.9	1.7	1.6	1.5	1.5	1.6	1.6	1.8	1.9	1.7	1.7	1.6

Source: Statistics Canada, Central 1. a = actual, all others forecast. ar= annual rate annualized fall. Germany's economy is seen dropping 45 per cent annualized, Japan at 32 per cent, and the U.K. at 57 per cent.

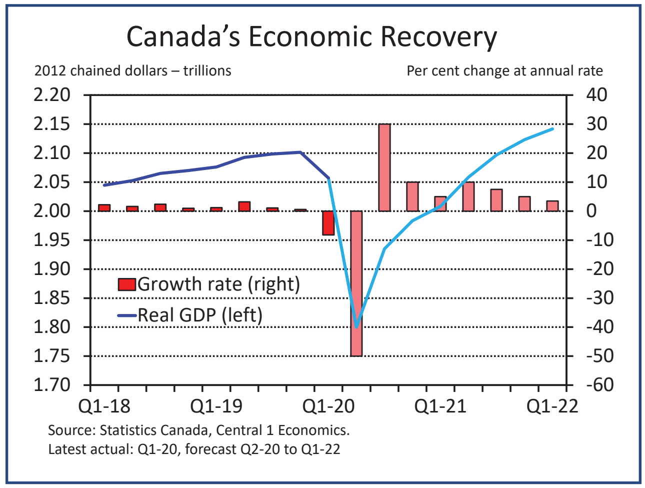
One major economy bucking this trend is China. The latest economic data shows an economy in the early stages of recovery following a sharp contraction in the first quarter of 2020 when COVID-19 prompted a lockdown and movement restrictions. With reported new cases down more than 95 per cent from their highs, restrictions have eased and economic activity is increasing. Second quarter 2020 real GDP is forecast to rebound about 40 per cent annualized.

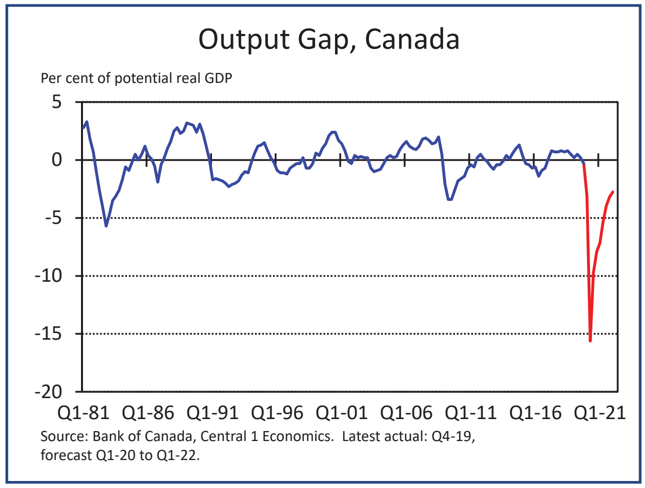
Canada's economic recovery depends not only on how the pandemic plays out in this country but also in other countries. Trade linkages and commodity prices determine a significant portion of GDP directly and more indirectly through investment spending. With the world economy in recession, export-driven growth will not occur in the near term and the initial recovery rebound depends on domestic consumer spending.

Assuming movement restrictions in Canada and elsewhere, notably in the U.S., are eased further and a second wave does not happen in the fall or winter months, a V-like economic recovery is expected. It would not be a full V-recovery because some restrictions will remain in place beyond the third quarter of 2020 and consumers remain wary of virus infection. A lifting of all restrictions at once would generate a complete V-shaped recovery.

Canada's third quarter 2020 growth rate is forecast at 30 per cent annualized, which is boosted by the base effect from the large drop in the prior quarter. Some forecasters have third quarter growth well north of 40 per cent annualized. High growth rates typically occur in the early stages of recovery and diminish thereafter. This third quarter rebound will set a modern record high in Canada and other countries.

Despite the high growth rates in the expected in the first few quarters of recovery, considerable excess capacity in the economy persists. The output gap, or the difference between actual and potential GDP, is very large and at a record low in the second quarter. Based on this GDP forecast, the output gap shrinks steadily but does not close at the end of the next two years. It will likely not close until sometime in 2023 at the earliest, assuming no setback on the pandemic front or to an economic disruption.This amount of excess capacity brings economy-wide disinflation and





outright deflation in some sectors. Inflation rates have eased and will continue to face downward pressure in the medium term.

This low interest rate environment prevails into the foreseeable future. The Bank of Canada's rate cuts are done and its quantitative easing (QE) measures are underway. QE will be needed through this year and possibly into 2022 depending on the economy's performance. There are some who view negative interest rates as the next move by this central bank. However, this require a quite negative longer-term economic outcome beginning with a stalled economic recovery. In any case, the Bank would engage in yield curve control before embarking on the negative rate path.

The yield curve begins to steepen with the economic recovery while the short end is anchored by the Bank's zero-lower-bound position through this forecast period. The increase in long bond yields looks to be relatively modest by typical recovery standards and reflects a disinflationary environment. This time is different in many respects.

Administered rates have room to decline. Some downward movement has already occurred. but mortgage and deposit rates are still high relative to the cost of funds and demand conditions. The Bank's actions to deal with the liquidity squeeze in mid-March worked to lower the cost of finds and now market conditions will come to bear. Excess deposits are materializing with the large drop in household spending. Mortgage loan originations are at low levels and look to remain at below-normal levels for several more months.

Helmut Pastrick
Chief Economist, Central 1 Credit Union
hpastrick@central1.com
www.central1.com 604.737.5026

Target Overnight Rate Forecast

Meeting Date	(Per cent)
Apr. 15 a	0.25
June 3	0.25
July 15	0.25
Sep. 9	0.25
Oct. 28	0.25
Dec. 9	0.25
Jan. 2021	0.25
Mar.	0.25
Apr.	0.25
Jun.	0.25
Jul.	0.25
Sep.	0.25
Oct.	0.25
Dec.	0.25
Jan, 2022	0.25
Mar.	0.25

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

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	0.20	0.20	0.20	0.20	0.20	0.20	0.25	0.25
3-mo. T-Bill	1.27	0.25	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	0.35	0.40	0.40	0.45	0.45	0.45	0.50	0.55
2-year GoC Bond	1.20	0.35	0.40	0.45	0.50	0.55	0.60	0.65	0.70
3-year GoC Bond	1.20	0.40	0.45	0.50	0.60	0.65	0.70	0.70	0.80
5-year GoC Bond	1.17	0.45	0.50	0.60	0.70	0.80	0.90	0.95	1.10
10-year GoC Bond	1.20	0.60	0.65	0.75	0.90	1.05	1.15	1.20	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	3.20	3.10	3.00	3.00	3.00	3.00	3.10	3.10
3-year Mortgage	3.94	3.90	3.70	3.40	3.40	3.45	3.45	3.45	3.50
5-year Mortgage	5.17	4.95	4.75	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.

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	0.80	0.75	0.75	0.75	0.75	0.75	0.75	0.75
3-year GIC	1.61	1.10	0.90	0.90	0.90	0.95	0.95	0.95	0.95
5-year GIC	1.84	1.45	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.