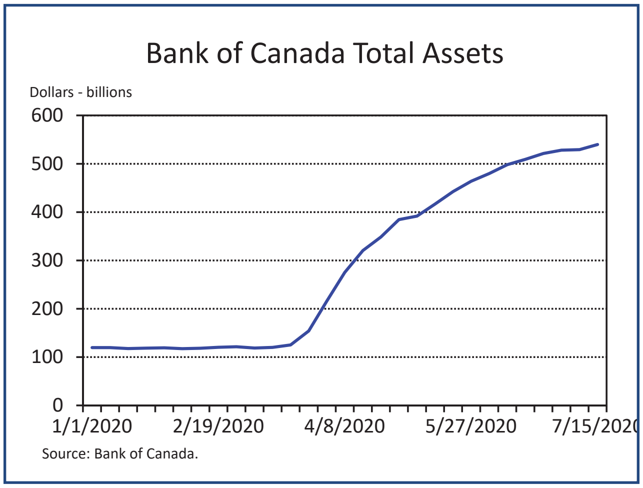
Interest Rate Forecast

central 1

Highlights

- Bank of Canada all in
- Initial economic rebound underway
- Pandemic to determine recovery path
- Ultra-low rates through 2021



The Bank of Canada's most recent rate announcement left no doubt where policy rates were heading and its willingness to 'do what it takes' to support the economic recovery and achieve its inflation objective. Rates will remain low until the economy has grown sufficiently to reduce excess capacity and the Bank's two per cent inflation target is in sight. Further monetary accommodation is possible and dependent on the COVID-19 pandemic's path, which is the great uncertainty and why the Bank has chosen scenario economic projections.

Canada's economic recession very likely ended in April 2020, after it began in March, making this the shortest (and deepest) recession on record. The recovery began in May 2020 and the economy continued to expand into July. However, a double-dip recession is possible should a second pandemic wave hit in the fall and winter months. Official dating of this business cycle will come later when complete data are available.

A high numerical recovery rebound is playing out for the third quarter of 2020 and is partly due to the low base effect of the second quarter as well as to the easing of containment measures allowing for more economic activity. This has the makings of a V-shaped recovery, but it will be truncated or incomplete, followed by an uneven and more gradual growth path. Containment measures may need to be tightened should flareups or worse occur potentially causing either slower growth or a downturn. Another issue is the timing of the end of government support programs and their impact on households and businesses, but it is likely that fiscal support will be extended if necessary.

In the July 2020 *Monetary Policy Report*, the Bank of Canada laid out a good assessment of the economic recovery. It will be led by personal consumption, housing and government with exports and business investment lagging. On the global scene, the Bank sees economic growth recovering in the third quarter of 2020 extending through 2022 with U.S. growth accelerating in that year. This will be beneficial for the rotation of Canada's growth into exports and less reliant on those early leading sectors.

Without going into the details or numbers, many economic indicators and most real-time activity measures show that a recovery rebound is underway in Canada and in many countries. The amount of economic slack, or excess capacity, is very large, and when economic growth forecasts are applied, it means

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	-40.0	25.0	5.0	5.0	10.0	7.5	5.0	7.5	1.6	-7.8	4.6
U. Rate, %	6.3	13.1	11.0	9.5	9.0	8.5	7.5	7.0	6.5	5.7	10.0	8.0
Core CPI, % y/y	1.9	1.6	1.5	1.4	1.5	1.5	1.6	1.8	1.9	1.7	1.6	1.6

Source: Statistics Canada, Central 1. a = actual, all others forecast. ar= annual rate that low inflation and above normal unemployment will prevail in the medium term. However, the trend is positive and economic growth over time will reduce excess capacity and generate higher inflation expectations.

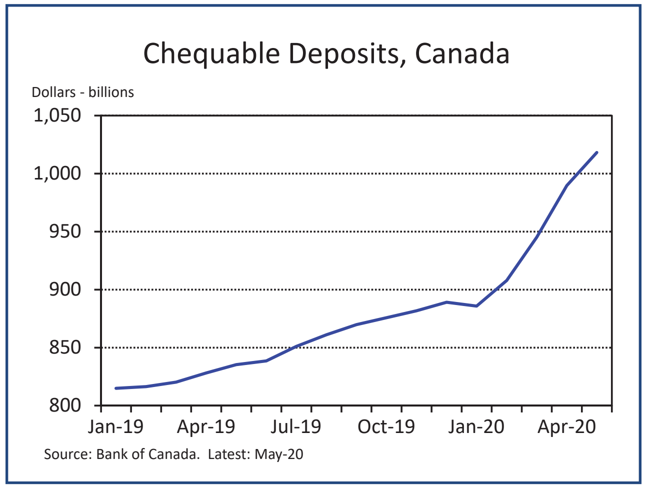
This economic forecast sees growth slowing after the third quarter rebound but gaining some momentum during 2021. In this scenario, no double-dip recession occurs, and should the second pandemic wave materialize, more fiscal and monetary measures would be implemented to mitigate some of the negative economic impacts.

Forecasting the short-end of the yield curve is straightforward under these economic conditions and forecasts combined with the central bank's monetary policy stance. No policy rate change is foreseen for the next two years. A second wave recession scenario would prompt more quantitative easing rather than a negative policy rate setting. Higher policy rates are possible if the pandemic threat is minimized either by a vaccine or a therapeutic, allowing for a widespread release of consumer activity nationally and globally.

Target Overnight Rate Forecast	
Meeting Date	(Per cent)
June 3, 2020 a	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
Apr.	0.25
Jun.	0.25

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

The yield curve begins to steepen modestly during this economic recovery but less than in a typical recovery phase reflecting a large amount of excess economic capacity and low inflationary expectations. One aspect of this unique recession is the destruction



of productive capacity and its impact on growth and inflation. With some businesses forced to close and others to restructure, the economy's potential output diminishes, which reduces economic capacity. This will become more evident over time, and when demand increases at a sustainable faster pace, inflation and long bond yields will also rise.

Posted mortgage rates are slow to decline in this near-zero rate environment. The five-year fixed mortgage rate posted by chartered banks, that is used in the mortgage stress test, is currently at 4.94 per cent, compared to 5.19 per cent before the recession. The prime lending rate is down 150 basis points compared 25 basis points for that posted rate. Market-sensitive mortgage rates have fallen more than posted rates. The 'special offers' five-year fixed mortgage rate by chartered banks is down to around 2.50 per cent from 3.15 per cent before the recession.

The cost of funds for mortgage financing has come down mortgage rates. The five-year non-redeemable GIC rate is down nearly 100 basis points among the chartered banks during the same period and the corporate five-year bond yield is down by a similar amount. Consequently, a much lower posted five-year fixed mortgage rate is feasible, though not likely given its past history. Market-sensitive rates have room to decline as well with another 30 basis points appropriate given market conditions.

Excess deposits are materializing with the large drop in household spending. Chequable deposits in Canada are up 12.2 per cent between February and May 2020. Previously, chequable deposits were increasing at less than one per cent per month. Consumers spending fell sharply when stay-at-home and physical distancing measures were implemented. Between mid-March and April, retail sales in Canada fell by one-third. Income flows to household have not fallen as much during this period in part due to government support measures. Retail sales have since rebounded and will slow the increase in chequable deposits, but lenders will remain flush with funds for some time. Low, and possibly lower, deposit rates are likely.

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Interest Rate Forecast

	2020 Q2 a	2020 Q3	2020 Q4	2021 Q1	2021 Q2	2021 Q3	2021 Q4	2022 Q1	2022 Q2
Target Overnight Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Prime Rate	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.45
1-mo. T-Bill	0.17	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.25
3-mo. T-Bill	0.22	0.20	0.20	0.25	0.25	0.25	0.25	0.25	0.30
6-mo. T-Bill	0.28	0.25	0.25	0.30	0.30	0.35	0.40	0.45	0.45
1-year T-Bill	0.32	0.30	0.30	0.35	0.35	0.45	0.50	0.55	0.60
2-year GoC Bond	0.32	0.30	0.30	0.35	0.40	0.50	0.60	0.65	0.70
3-year GoC Bond	0.33	0.30	0.35	0.40	0.45	0.55	0.65	0.75	0.80
5-year GoC Bond	0.43	0.40	0.45	0.50	0.55	0.65	0.80	0.95	1.05
10-year GoC Bond	0.59	0.55	0.60	0.65	0.75	0.90	1.10	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 Q2 a	2020 Q3	2020 Q4	2021 Q1	2021 Q2	2021 Q3	2021 Q4	2022 Q1	2022 Q2
1-year Mortgage	3.24	3.00	3.00	3.00	3.00	3.00	3.10	3.10	3.10
3-year Mortgage	3.94	3.70	3.60	3.50	3.45	3.50	3.50	3.60	3.65
5-year Mortgage	4.99	4.60	4.60	4.60	4.65	4.75	4.75	4.85	4.95

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 Q2 a	2020 Q3	2020 Q4	2021 Q1	2021 Q2	2021 Q3	2021 Q4	2022 Q1	2022 Q2
1-year GIC	0.81	0.65	0.65	0.65	0.65	0.65	0.65	0.65	0.65
3-year GIC	1.12	0.85	0.85	0.85	0.85	0.85	0.85	0.90	0.95
5-year GIC	1.50	1.15	1.15	1.15	1.15	1.25	1.25	1.35	1.35

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.