Interest Rate Forecast

central 1

Highlights

- Economy rebounding to transition stage
- Pandemic uncertainty prevails
- Retail rate cuts in August not the last

The transition from the initial recovery rebound is in its very early stage and its future is quite uncertain. How will the virus play out with the reopening of schools, sporting events, and offices? Will a second wave occur in the fall and winter? Are more restrictions and lockdowns coming? The economy's performance is almost entirely dependent on the virus, and while easy monetary and supportive fiscal policies help to mitigate its negative impact, the economy is held back until the virus is brought under control.

The economy's strong rebound from this year's deep recession will fade later this year and into next year with ongoing service sector struggles in consumer-facing businesses and to some supply constraint issues. The large month-over-month percentage increases in sales and production are set to come down and remain at lower levels into 2021. Part of this is due to the 'base effect' of the deep contraction seen in March and April of this year but mostly to a slowdown in re-openings and re-engagements. Another resurgence in these activities will occur when the virus is under better control.

The base case economic scenario calls for Canada's economic annualized growth rate to slow to single-digits in the next three quarters following the 35 per cent annual rate in the third quarter of 2020. Statistics Canada will be releasing its first estimate of second quarter 2020 Gross Domestic Product (GDP) and this forecast expects a 40 per cent annualized, or a 12 per cent actual, contraction.

Most other economies are on a similar contraction and growth rebound in the second and third quarters of this year. Their growth profiles for the rest of this year and through 2021 are predicted to slow down as well. This pandemic recession and recovery will have similar impacts on most economies and is prompting policymakers to respond rapidly and substantively in most instances.
A growth resurgence in 2021 and 2022 is possible should a vaccine or therapeutic prove effective and safe and become widely available. However, another fallback into recession is possible if a second virus wave materializes and causes another round of movement restrictions and lockdowns.

No change in central bank policy rates in most countries are expected over the medium term. The Bank of Canada as well as the U.S. Federal Reserve are 'all in' for providing monetary stimulus to the economy by not only lowering their rates to the zero-lower-bound but also by engaging in substantial quantitative easing and providing forward guidance in some form. When combined with fiscal policymakers in a 'doing what it takes' mode to supporting the economy, the recovery is held down only by the pandemic.

The 5-year fixed posted mortgage rate offered by chartered banks declined 15 basis points to 4.79 per cent in mid-August, only the third cut since the beginning of the year and for a total of 40 basis points. Compared to rate cuts on other products, this does not reflect changes to market conditions. For example, the special offers rate for a five-year fixed mortgage has come down fairly steadily this year and sits at 2.24 per

Canada Economic Forecast

	2020 Q1 a	2020 Q2	2020 Q3	2020 Q4	2021 Q1	2021 Q2	2021 Q3	2021 Q4	2022 Q1	2019	2020	2021
Real GDP, % ar	-8.2	-40.0	35.0	5.0	2.5	7.5	10.0	5.0	7.5	1.6	-7.0	5.0
U. Rate, %	6.3	13.1	10.5	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	1.7	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 cent, compared to 3.12 per cent at the beginning of the year.

Target Overnight Rate Forecast	
Meeting Date	(Per cent)
July 15, 2020 a	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

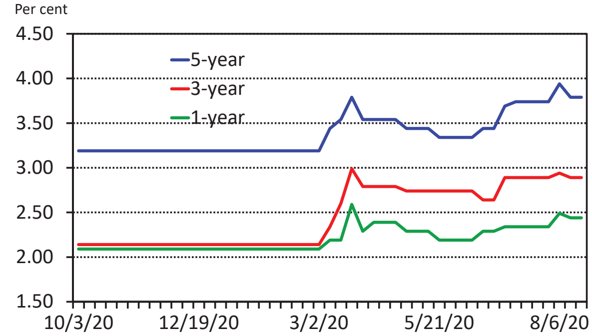
Source: Bank of Canada, Central 1. (a) actual

Banks are also quick to cut deposit rates. The posted five-year non-redeemable Guaranteed Investment Certificate (GIC) was cut to 1.00 per cent in early August from 1.20 per cent previously and now stands 100 basis points lower than at the beginning of the year. Consequently, the spread between the posted five-year mortgage and GIC rates widened to 3.79 per cent compared to 3.19 per cent earlier this year. A widening of spreads occurred at one-year and three-year

Further evidence of the impact of market conditions on mortgage rates is seen in the five-year fixed mortgage rate offered by mortgage brokers. It is currently at 1.99 per cent, down from 2.72 per cent in early January of this year.

The motivation to keep the five-year fixed mortgage rate at a higher level than supported by market conditions is unclear and may have to do with its use as the mortgage stress test rate required by bank regulators, though it is not obvious why banks would engage in a practice that reduces their lending activity and profitability. In any case, the posted rate practice is outdated and no longer the marketing angle it once was. As for the stress test, it would be sufficient to use

Spreads on Posted Mortgage and GIC Rates by Chartered Banks in Canada



Source: Central 1 Economics. Note: Non-redeemable GICs. Spreads based on median rates. Latest: 8/20/20

the two per cent rule only, rather than the higher of two per cent above the contract mortgage rate and the posted five-year rate.

There is more room for mortgage rates, particularly posted rates, to come down given the larger decline in the cost of funds and deposit rates during the past few months.

When the economic recovery becomes more sustainable and grows at a faster pace later in 2021, bond yields will begin to rise at a moderate pace commensurate with the large amount of economic slack. Canada's economy will probably not close the output gap until 2023, or possibly 2025, depending on how the pandemic plays out.

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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	0.15	0.15	0.15	0.20	0.20	0.20	0.20	0.25
3-mo. T-Bill	0.22	0.20	0.15	0.20	0.25	0.25	0.25	0.25	0.30
6-mo. T-Bill	0.28	0.20	0.15	0.20	0.25	0.30	0.35	0.45	0.45
1-year T-Bill	0.32	0.25	0.20	0.25	0.30	0.40	0.50	0.55	0.60
2-year GoC Bond	0.32	0.30	0.25	0.30	0.35	0.45	0.55	0.65	0.70
3-year GoC Bond	0.33	0.30	0.30	0.30	0.35	0.45	0.60	0.75	0.80
5-year GoC Bond	0.43	0.40	0.35	0.40	0.45	0.55	0.70	0.90	1.00
10-year GoC Bond	0.59	0.55	0.50	0.55	0.60	0.75	0.90	1.15	1.25

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	3.10	3.00	3.00	3.00	3.00	3.10	3.10	3.10
3-year Mortgage	3.94	3.80	3.65	3.50	3.45	3.50	3.50	3.60	3.65
5-year Mortgage	4.99	4.85	4.70	4.60	4.60	4.60	4.70	4.85	4.90

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	0.50	0.65	0.65	0.65	0.65	0.65	0.65	0.65
3-year GIC	1.12	0.75	0.85	0.85	0.85	0.85	0.85	0.90	0.95
5-year GIC	1.50	1.00	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.