FINANCIAL MARKETS MONTHLY UPDATE

January 23, 2015

Canadian interest rate forecast update

Bank of Canada's unexpected rate cut sets stage for lower rates in 2015

The Bank of Canada unexpectedly cut the overnight rate by 25 bps to 0.75% on January 21, 2015. It was the first change in the policy rate since September 2010. The Bank characterized the decision to lower the overnight rate as being aimed at providing a measure of insurance against the risks associated with the sharp drop in oil prices on the inflation outlook and financial stability. Underpinning the rate cut were downward revisions to the Bank's forecast for economic growth and headline inflation in 2015 and an assumption that WTI oil prices will hold around $55.00.

The Bank's forecast update showed a sharp slowing in growth in the first half of 2015 with real GDP expected to grow at a 1.5% rate in both the first and second quarters of the year. The positive effects of lower oil prices on growth in the US combined with the weakening in the Canadian dollar and "the Bank's monetary policy response" will result in an acceleration in economic activity in Canada in the second half of the year. This pattern will result in real GDP growth of 2.1% in 2015, slower than the Bank's October forecast of 2.4% and the upwardly revised growth forecast in 2014 (also 2.4%). The strengthening in momentum in the second half of 2015 will continue in 2016 with real GDP forecast to increase by 2.4%, slightly firmer than the previous projection of 2.3%.

The main change in the Bank's forecast was weaker investment activity by oil and gas companies which the Bank estimates will fall by about 30% in 2015. Much of this decline will be offset by a pickup in business investment outside of energy however on net, the Bank projects investment will trim the economy's growth rate by 0.1 ppt in 2015. This is a significant change from the October projection which anticipated investment would add 0.4 ppt. Energy exports are also forecast to slow with the Bank forecasting growth of just 1% in 2015 compared to 6% in 2014. Offsetting this slowing is an anticipated pickup in exports of non-energy products. The Bank links this strengthening to firmer US demand and the weaker Canadian dollar. Net exports are forecast to contribute 0.7ppts to real GDP growth in 2015, more than the 0.5 ppts expected in October. Estimates of the contribution from consumption and government spending were unchanged from the previous forecast with the Bank continuing to expect a soft landing in the housing sector. The Bank expects household spending to slow in 2015. Gross domestic income is forecast to rise by just 0.6%, well below the 2.0% pace of previous years reflecting the deterioration in Canada's terms of trade.

The updated economic forecast implies that the output gap will be eliminated by the end of 2016, six months later than the Bank assumed in October. The updated inflation forecast profile shows the headline inflation rate revised lower due to the sharp drop in energy prices with the rate averaging 0.6% this year. Conversely, the forecast for the core measure was upgraded slightly to average 1.9% in 2015 from 1.8%. The core inflation forecast for 2016 was unchanged at 1.9%. The Bank of Canada's forecast assumes oil prices (Brent) will average $60.00 in 2015 and 2016. The Bank pointed to pass-through from the depreciation in the Canadian dollar and some sector specific issues as offsetting "disinflationary pressures from the slack in the economy and competition in the retail sector" resulting in little movement in the core measure. At the same time, the decline in energy prices will weigh on the headline rate.

On balance, the changes to the economic and inflation forecasts were modest meaning that the Bank's decision to implement an "insurance" rate cut was driven by the Governor's thesis that "monetary policy formulation these days is more a process of risk management than one of precision engineering."(1). RBC's forecast incorporates less downside from the oil price shock on the economy in 2015 with lower investment by the energy sector expected to largely be offset by stronger consumer spending and solid business investment by companies outside the oil and gas industry. Net exports are also expected to benefit from growing US demand and the weaker Canadian dollar. This stronger growth profile implies the economy will reach full capacity much sooner than the Bank of Canada projects and underpins our view that core inflation will remain at or above 2% throughout the forecast horizon.

Financial markets will remain on guard against another rate cut should energy prices continue to slide in the months ahead. The Bank suggested that if oil prices were even $10 below their expectation this would result in a greater delay in the closing of the output gap.

Our baseline forecast assumes that oil prices will recover somewhat this year, Canada's economy will grow by 2.7% in 2015 with the core rate averaging 2.1% and the unemployment rate edging down to 6.3%. These factors underpin our assessment that the Bank of

Canada will not need to cut interest rates further and arguably could have maintained the policy rate at 1.0%. The sharp depreciation in the Canadian dollar in the aftermath of the January 21 rate cut presents some upside risk to our forecast for export growth and core inflation. Until markets are convinced that no more rate cuts are in the pipeline and that oil prices have bottomed, the Canadian dollar is likely to remain under downward pressure against the US dollar and we are revising our forecast for the currency to account for recent events. Against this backdrop, we expect the Bank to stand on the sidelines throughout 2015 maintaining the 25 bps insurance cut with the overnight rate holding at 0.75% as policymakers wait for the economy to clear the obstacles created by the oil price shock. The Bank's cautious approach to managing the risks to the economy and inflation suggests that it will take several quarters of above-potential growth before the Bank will begin to raise the policy rate and we expect the Bank to initiate a series of rate increases in the first quarter of 2016. Our forecast calls for the overnight rate to end 2016 at 2.0%.

Consistent with this view and our assumption that the Federal Reserve will begin to raise the fed funds target in June 2015, we forecast Canadian government bond yields to slowly grind higher this year from today's exceptionally low levels. The risks that the Bank will add more "insurance" via interest rate cuts in the months ahead will limit the move up in short-term yields in the near term. As the data clearly signals that the oil price decline will not result in a further widening in the output gap and concerns about a feed-through to core inflation ease, two and five-year yields will rise more aggressively although this is only likely to begin late in 2015 with faster increases likely in 2016.

Longer-term yields will also likely be lower than we projected earlier with markets watching to ensure that the sharp decline in the headline inflation rate does not translate into downward pressure being exerted on the core measure or weigh on inflation expectations. The Business Outlook Survey showed the majority of participants expect inflation in the 1% to 2% range over the next two years and only 2% forecast a rate below 1%. In the Monetary Policy Report, the Bank acknowledged "a small upward drift" in measures of underlying inflation which we expect will persist going forward pegging the core rate around the 2% mark. With core inflation expected to remain at or above 2% and US Treasury yields forecast to rise on the back of strong economic growth and upcoming Fed rate hikes, longer-term yields in Canada will move higher with the 10-year rate forecast to end 2015 at 2.55% and 2016 at 3.45% from less than 1.5% today.

(1)Monetary Policy an Exercise in Risk Management, Bank of Canada Governor Stephen S. Poloz, Montreal Quebec, December 2013

Interest rate forecasts, end of period, %

	Actuals				*Forecast*							
	14Q1	14Q2	14Q3	14Q4	15Q1	15Q2	15Q3	15Q4	16Q1	16Q2	16Q3	16Q4
Canada												
Overnight	1.00	1.00	1.00	1.00	0.75	0.75	0.75	0.75	1.00	1.25	1.50	2.00
Three-month	0.90	0.94	0.92	0.91	0.75	0.75	0.75	0.85	1.15	1.40	1.65	2.15
Two-year	1.07	1.10	1.13	1.01	0.70	0.80	0.85	1.05	1.50	1.75	2.00	2.30
Five-year	1.71	1.53	1.63	1.34	1.15	1.45	1.60	1.80	2.15	2.35	2.60	2.80
10-year	2.46	2.24	2.15	1.79	1.70	2.10	2.35	2.55	2.90	3.10	3.30	3.45
30-year	2.96	2.78	2.67	2.34	2.25	2.60	2.85	3.00	3.30	3.45	3.60	3.75
United States												
Fed funds	0.25	0.25	0.25	0.25	0.25	0.50	0.75	1.00	1.50	2.00	2.50	3.00
Three-month	0.05	0.04	0.02	0.04	0.10	0.40	0.65	0.90	1.40	1.90	2.40	2.80
Two-year	0.45	0.47	0.58	0.67	0.75	1.10	1.60	2.00	2.25	2.50	2.80	3.20
Five-year	1.74	1.62	1.78	1.65	1.65	1.95	2.20	2.50	3.00	3.15	3.30	3.50
10-year	2.73	2.53	2.52	2.17	2.25	2.65	2.90	3.10	3.55	3.70	3.85	4.00
30-year	3.55	3.34	3.21	2.75	2.85	3.25	3.50	3.75	4.10	4.25	4.35	4.50

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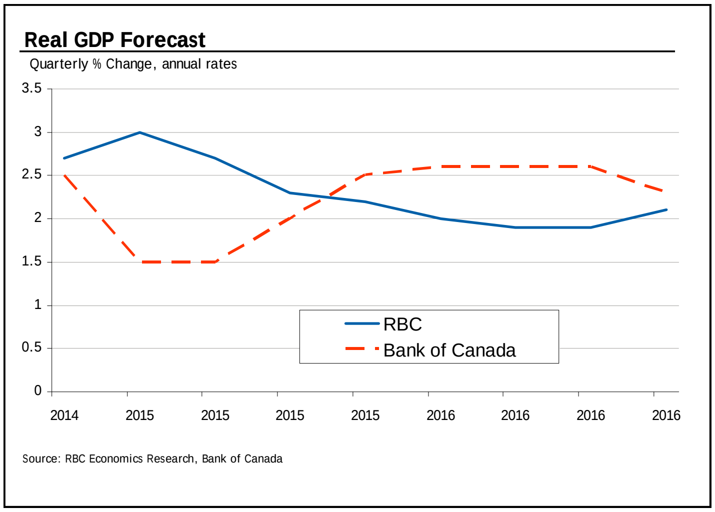
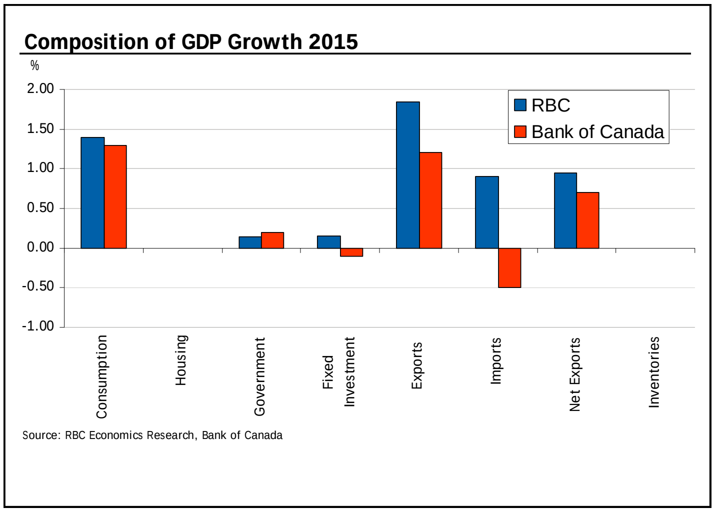
Bank of Canada only like to implement one “insurance” rate cut in 2015

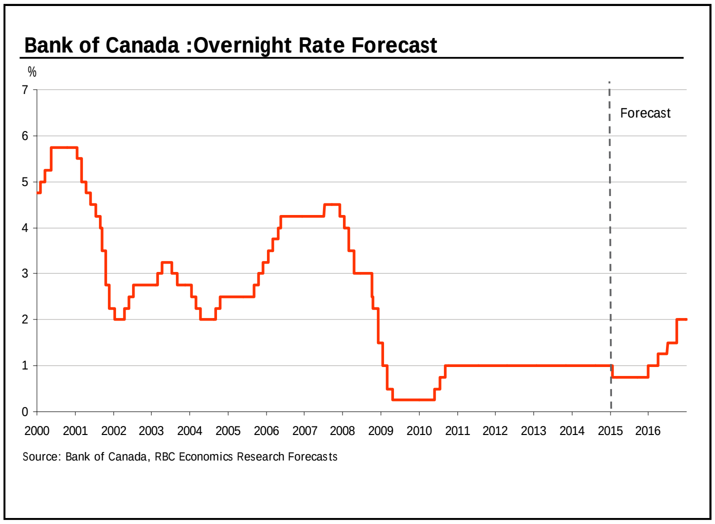
The Bank of Canada expects the economy's growth rate to slow in the first half of 2015 as the impact of sharply lower oil prices plays out. We expect the economy to maintain an above-potential growth rate throughout 2015.



In large part the discrepancy between the forecasts comes down to impact on investment and the degree of support coming from lower energy costs for consumers. We see a stronger flow-through to exports as well



Against this backdrop, the Bank is unlikely to reduce the policy rate further although will continue to be cautious and maintain the 0.75% overnight rate throughout 2015.



In the near term, government bond yields will remain low however as evidence that the economy is coping with the oil price shock materializes, rates will begin to move up more aggressively.