The Yield Curve

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The Federal Reserve banks on transparency

HIGHLIGHTS

- Ben Bernanke indicated that if the U.S. economy continued to evolve as expected, it would be appropriate to start tapering off securities purchases later this year, winding them up around mid-2014. This conditional scenario is completely in line with our own forecasts.
- Given the recent developments in the real estate market, we must nonetheless expect the Bank of Canada to keep repeating its warnings about an eventual interest rate increase.
- Because of the ongoing recession in the euro zone and inflation that is apparently not poised for a rapid comeback, the European Central Bank has some leeway to take further action.
- We expect the U.S. 10-year yield to oscillate between 2.20% and 2.60% between now and the end of the year. We are raising our target for year's end to 2.45% in response to the faster-than-anticipated normalization of real rates.
- Long-term Canadian bonds will keep trading at yields lower than U.S. bonds but volatility could remain elevated (although probably less so than in June) until the Federal Reserve formally announces that it is tapering its purchases.

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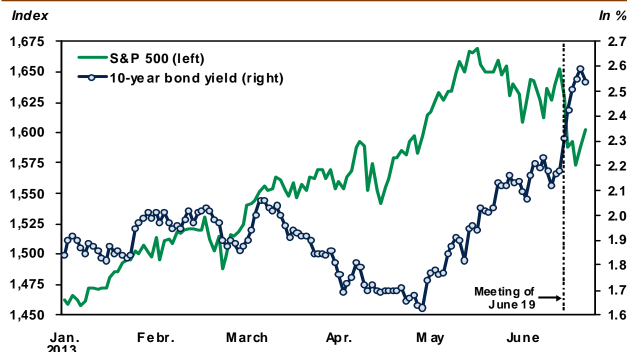
Editorial

The last few weeks have been especially tumultuous in the financial markets. Far from resolving, the volatility noted since early May intensified in June as speculation about the Federal Reserve's (Fed) next moves continued. In this context, all eyes were riveted on the June 19 Fed meeting. Ben Bernanke, aware of the need to better communicate the Fed's intentions, indicated that if the U.S. economy continued to evolve as expected, it would be appropriate to start tapering off securities purchases later this year, winding them up around mid-2014. The stock and bond markets plunged in response to these announcements (graph 1).

Graph 1 – Stocks and bonds continued to drop after the Federal Reserve meeting



Sources: Datastream and Desjardins, Economic Studies

WHAT IS THE FED SAYING?

In our opinion, we must remember a few key messages from the June 19 statement, new Fed forecasts and Ben Bernanke's long press conference.

The first is that the Fed will long maintain a monetary policy that supports the U.S. economy. Mr. Bernanke reiterated several times that moderating or even terminating QE3 does not imply the onset of monetary tightening. For the Fed, it is the accumulation of its purchases that determines how much

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monetary easing there is; everything suggests that this level will be maintained for a long while after QE3 ends. The Fed's Chair used an automobile analogy. Currently, the Fed's foot is on the accelerator; the onset of tapering only means the Fed will be gradually easing back on the gas. Only a fed funds' rate increase or sale of assets would be equivalent to putting on the brakes. On this topic, Fed leaders repeated that they expected the federal funds rate to stay at their current floor for a considerable time after QE3 ends. The 19 Fed officials' individual forecasts show that 15 do not expect rates to rise before 2015; the median forecast puts the overnight rate at just 1.00% at the end of 2015.

A second clear message is that the gradual withdrawal of QE3 is completely conditional on the economy evolving in line with the Fed's expectations. While some Fed leaders have slightly trimmed their growth forecasts for 2013 and 2014, overall, they seem a little more confident in the strength of the U.S. recovery. June's statement noted that the downside risks to the economy and job market had waned; Ben Bernanke added that the fundamentals seemed a little better. This means the Fed can continue banking on a moderately optimistic scenario which calls for economic growth to accelerate over the coming quarters and inflation to return to the 2% target. Ongoing gains in the job market would put the jobless rate at close to 7% around mid-2014. If the economic data contradicts this scenario, monetary policy will move in a direction other than the one tabled in June.

A third message is that a faster decline in the jobless rate would not be enough to justify faster monetary firming. Since last December, the Fed has been signalling that it will not raise its key rate until the jobless rate hits 6.5%. Initially, the 6.5% threshold was forecast to be reached toward mid-2015, a time at which most leaders expected to initiate monetary firming. A faster than forecast drop in the jobless rate, however, suggests that this threshold could be reached in early 2015. However, Mr. Bernanke stressed the fact that reaching this level did not signal a hike to the federal funds rate, but just a time when the Fed could start considering eventual monetary firming. If the situation is still deemed to be unsatisfactory, the Fed will not hesitate to wait a few more months before taking action, regardless of where the jobless rate is. The Fed even seems to be seriously considering lowering the threshold to 6.0% to make its message clearer.

HOW TO EXPLAIN THE MARKETS' REACTION?

Overall, the Fed's stance remains relatively dovish, as it stresses that monetary policy will remain quite stimulating for a long time even if the economic situation keeps improving. The QE3 tapering scenario presented does not constitute a policy change; rather, it spells out the existing policy. So how do we explain the markets' very negative reaction?

It can be interpreted in a few ways. If it reflects the fact that investors think the Fed is now a lot more hawkish and that the Federal funds rate could rise rapidly, the reaction seems out of proportion, and the bond market can be expected to rebound.

In our view, a more realistic interpretation is that, unlike the Fed, which thinks that what matters is the size of its balance sheet, many investors think it is the pace of the Fed's purchases that affects the bond market. Although not completely unexpected, a signal that QE3 will soon slow could be construed as the beginning of a long monetary firming process. This way of seeing things would justify much of the movement in bond yields in the last few weeks, as investors seem less prepared to keep buying bonds that are excessively rich, with real yields and term premiums in negative territory.

BOND YIELDS COULD SPEND SEVERAL QUARTERS IN A NEW RANGE

The markets' initial reaction is excessive, in our opinion. Volatility should now wane as the Fed's position is clearer. Barring major economic surprises that would substantially alter Fed leaders' forecasts, the U.S. 10-year yield should oscillate in a new band ranging from 2.20% to 2.60% until the end of the year. The main obstacle to a faster rise in yields is that, faced with this development, the Fed would rapidly adopt a more dovish stance to combat overly rapid firming in financial conditions

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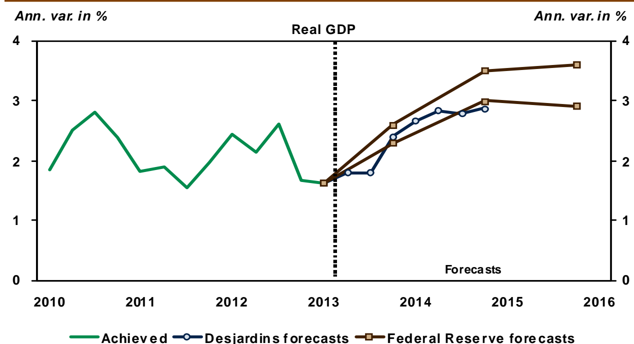
FEDERAL RESERVE

A cut to securities purchases is signalled

- The June Federal Reserve (Fed) monetary policy committee meeting was hotly awaited. While the official statement showed few changes, Fed Chair Ben Bernanke used his press conference to comment on what the institution has in store for us. He clearly opened the door to an eventual tapering off of securities purchases. “If the incoming data are broadly consistent with this forecast, the Committee currently anticipates that it would be appropriate to moderate the monthly pace of purchases later this year [...] we would continue to reduce the pace of purchases in measured steps through the first half of next year, ending purchases around midyear.” This conditional scenario is completely in line with our own forecasts.
- However, the U.S. economy would have to keep improving. The Fed’s new scenario calls for annual real GDP growth between 2.3% and 2.6% for the fourth quarter of 2013. Our own forecast is for 2.4% (graph 2). The job market would also have to maintain solid growth. Monthly hires have been rather tepid since spring began, especially compared with last winter’s livelier performance; nonetheless, we are anticipating further solid employment growth. The jobless rate should keep declining, although its slide could be slowed by a rise in the labour force. The Fed predicts the jobless rate will be between 7.2% or 7.3% on average in Q4. For these scenarios to materialize, other indicators would have to post clear-cut rises. On one hand, consumer confidence is on the right track, showing encouraging gains over the last few months. On the other, better performances from business will be needed: the ISM manufacturing index’s drop to 49.0 probably bothered some members of the monetary policy committee.
- Lastly, inflation will also have to pick up. Its recent weakness created some unusual, dovish dissent within the monetary policy committee. The annual change to the consumption expenditure deflator should gradually move up from May’s low of 0.7%, closing in on the Fed’s target, 2% (graph 3).

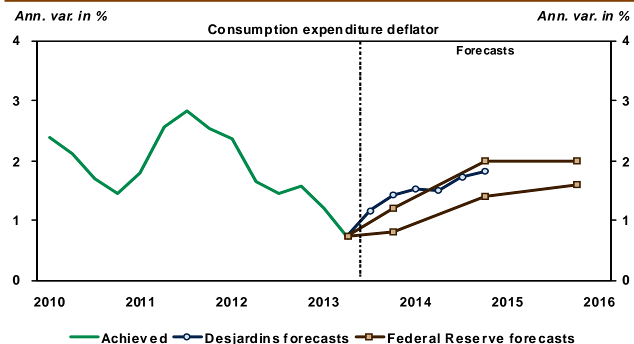
Forecasts: In September, the Fed should officially announce that the pace of securities purchases will slow. Initially, it should cut US$25B, taking monthly purchases to US$60B. Other decreases will be announced in December 2013 and April 2014 (graph 4), with the program expected to wind down in the summer of 2014, as set out in Ben Bernanke’s conditional scenario. As for key rates, we do not expect an increase before mid-2015.

Graph 2 – The Federal Reserve expects U.S. real GDP to grow at a solid pace



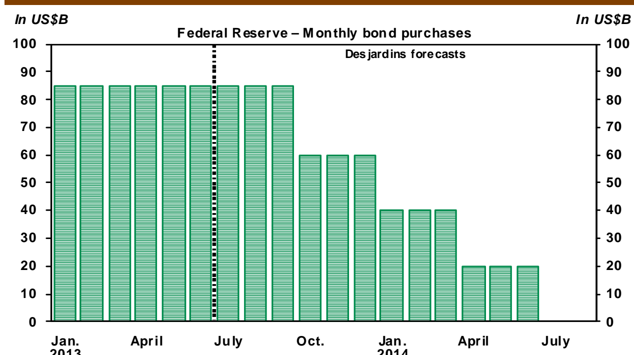
Sources: Bureau of Economic Analysis, Federal Reserve Board and Desjardins, Economic Studies

Graph 3 – Total inflation should come up gradually in the United States



Sources: Bureau of Economic Analysis, Federal Reserve Board and Desjardins, Economic Studies

Graph 4 – The Federal Reserve will taper off its securities purchases



Sources: Federal Reserve Board and Desjardins, Economic Studies

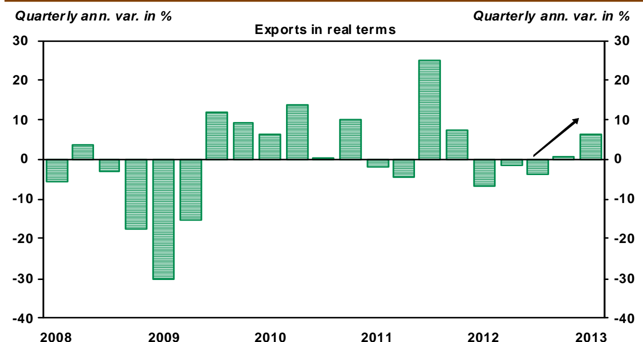
BANK OF CANADA

Monetary authorities will be keeping their eye on the real estate market

- Canada's real GDP increased by an annualized 2.5% in the first quarter of 2013, much faster growth than in the Bank of Canada's (BoC) latest forecast of 1.5%. Exports had a big hand in this gain, rising by 6.2% (graph 5).
- However, we may well wonder whether this kind of feat can be repeated in the coming quarters. Despite some signs of improvement, many roadblocks remain in the United States and Europe. Global demand for Canadian exports could therefore still run into some problems. It will likely be the fall before we see any lasting improvement in Canada, as real GDP growth could finally hold above production potential.
- The downtrend in the real estate market has showed some signs of stabilizing in the last few weeks. Home sales and prices have started to rise again (graph 6). Housing starts rebounded in May. The value of residential building permits has risen since the year began. In May, construction also posted the strongest job creation ever recorded. In other words, the positive signs proliferated recently and we cannot rule out the chances of another uptrend. Under these conditions, the concerns about an overly heavy imbalance in the real estate market and high household debt loads could resurface. Clearly, the BoC will keep a close eye on the situation.
- According to our estimates, Canada's economic output will return to full potential around mid-2015, a projection that is fairly consistent with the BoC's latest forecasts. Until then, price pressures will remain very weak.
- The total consumer price index (CPI) rose 0.2% in May, while its annual variation went from 0.4% to 0.7%. Slowly but surely, the total inflation rate is climbing toward the BoC's target range (1% to 3%). According to weekly surveys at the pump, gas prices are, to date, up by an average of 2% in June. This favours another slight monthly uptick in the total CPI, which should be enough to put its annual variation back above 1% as of June. Total and core inflation should therefore converge on similar levels shortly (graph 7).

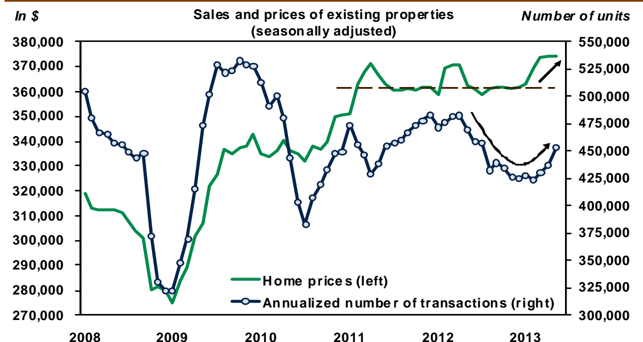
Forecasts: Our scenario for the BoC is once again unchanged. The monetary authorities will likely have to wait until the fall of 2014 before starting to raise key interest rates. Given the recent developments in the real estate market, we must nonetheless expect the BoC to keep repeating its warnings about an eventual interest rate increase.

Graph 5 – Exports rebounded in Canada in early 2013



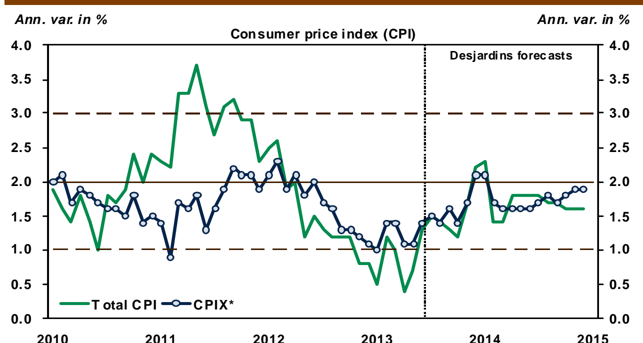
Sources: Statistics Canada and Desjardins, Economic Studies

Graph 6 – The market for existing homes seems to be gaining strength in Canada



Sources: Canadian Real Estate Association and Desjardins, Economic Studies

Graph 7 – Canadian inflation will remain in the bottom of the target range



* Bank of Canada core index.
Sources: Statistics Canada and Desjardins, Economic Studies

OVERSEAS CENTRAL BANK

Mark Carney arrives at the Bank of England

EUROPEAN CENTRAL BANK (ECB)

- The ECB did not announce any new measures in June, but it trimmed its 2013 economic growth forecast to -0.6%, as real GDP pulled back more than expected in the first quarter. The inflation outlook was also revised downwards to 1.4% for 2013 and left at 1.3% for 2014. Because of the ongoing recession in the euro zone and inflation that is apparently not poised for a rapid comeback, the ECB has some leeway to take further action.
- In May, the door had been opened to an asset-backed securities purchase program, but this project seems to have been nipped in the bud. At the press conference, Mario Draghi stressed that this program could not be implemented quickly and that the market for these securities was too small. The most likely option in the near term remains another key interest rates cut. However, it is uncertain that the ECB will risk taking its deposit rate below 0%.

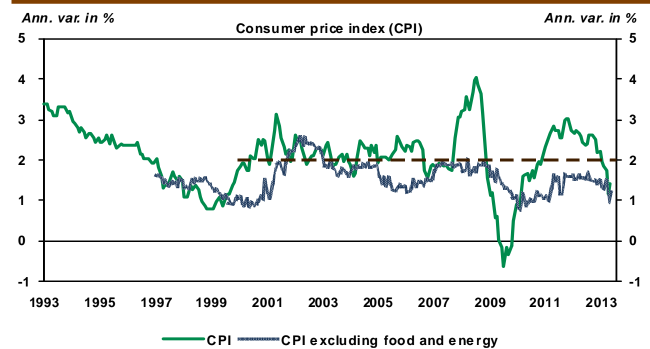
BANK OF ENGLAND (BoE)

- Mark Carney takes the helm at the BoE on July 1, but this should not bring many changes to Britain's monetary policy. The situation is hardly conducive to new asset purchases. Inflation is well above the 2% target, which continues to worry some BoE leaders, and the British economy continues to recover. Moreover, the number of loans approved for the purchase of a home is up, suggesting that the Funding for Lending Scheme is starting to generate concrete results. Mark Carney could still make some changes to the BoE's communications. For example, statements accompanying monetary policy decisions could be more explicit and could contain forward guidance.

BANK OF JAPAN (BoJ)

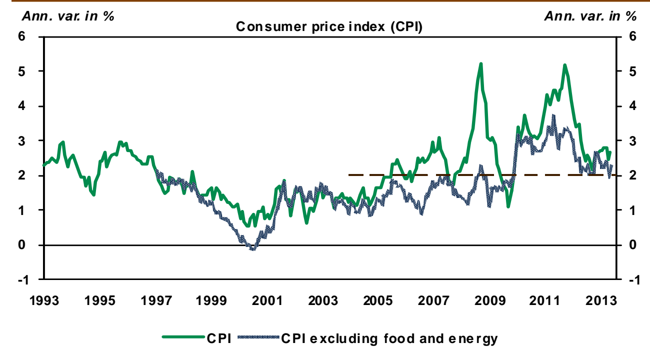
- The BoJ disappointed in June when it did not announce anything to rein in bond market volatility. Despite the BoJ's massive securities purchases, Japanese bond yields have gone up recently; before that, however, they had plunged. The BoJ prefers to stay focused on its inflation target and its upcoming decisions will be steered by progress on inflation. For now, inflation remains in negative territory, but it is still too soon to see the effects of Japan's monetary policy. The fact remains that inflation expectations have recently declined; hitting the 2% target by the end of 2014 is still ambitious.

Graph 8 – Euro zone's inflation rate



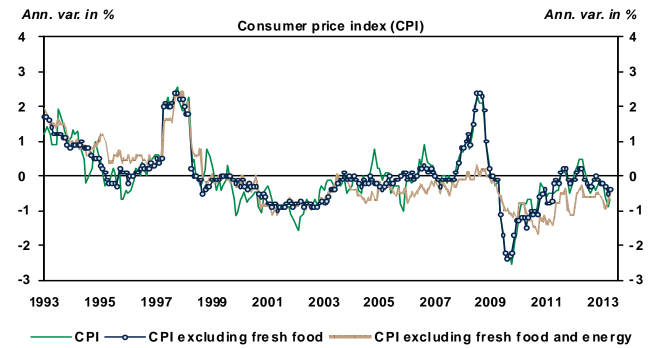
Sources: Datastream and Desjardins, Economic Studies

Graph 9 – United Kingdom's inflation rate



Sources: Datastream and Desjardins, Economic Studies

Graph 10 – Japan's inflation rate



Sources: Datastream and Desjardins, Economic Studies

BOND MARKET

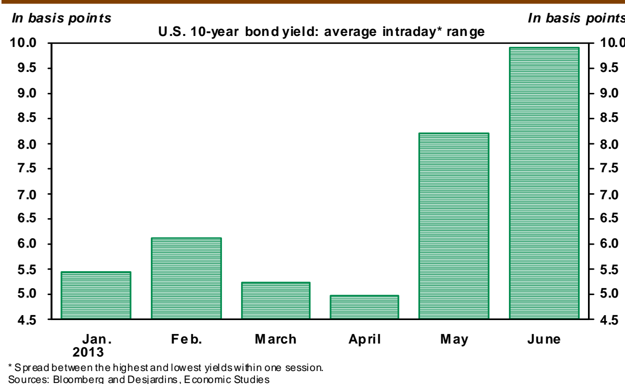
The Great yield backup: one first stage completed

U.S. FEDERAL BONDS

- Though it has long been assumed that bond resilience would eventually end when the Federal Reserve (Fed) begins to prepare the markets for an eventual exit, it must be said that recent movements in yields have been surprisingly large (graph 11).
- The markets had been used to constant support from the Fed; the mere confirmation that the end was approaching was enough to provoke a knee-jerk reaction by investors. Note that, since the Great Recession, the Fed has almost never been in a position to communicate a less accommodating policy. On the contrary, communications have almost exclusively been designed to provide more assurance that monetary policy would remain expansionary for a long time. Recall that in the spring of 2012, markets dared to expect a more hawkish Fed, but in the end they were scared away from such view by Bernanke's dovish remarks (graph 12). Keeping that in mind, it could be that, despite the signal that already had been sent in May, some investors were still somewhat incredulous in the run-up to the June 19 statement, expecting the Fed to be more focused on defending its price stability mandate.
- Even though Ben Bernanke was very clear that tapering represents nothing more than easing back on the gas pedal, the reiteration of May's signal led markets to rethink the Fed's reaction function, after years of a very dovish stance. Furthermore, the normalization of the term premium (compensation required by investors for long-term risk exposure) reflects the perception of a market that will now be more volatile as the Fed has less of a presence. All the same, it can be seen as a healthy process, after years of quasi-anaesthesia on the bond markets (graph 13).

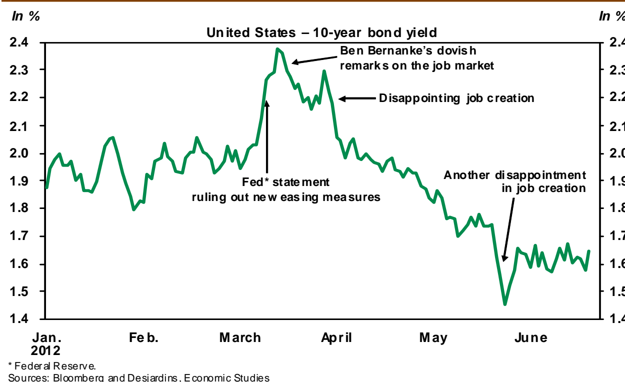
Forecasts: The markets are still trying to establish a fluctuation band, and the next big economic statistics (ISM, employment, annual revision to GDP, etc.) should allow them to set some parameters. Barring any major disappointments and/or the materialization of downside risks, we can think of the 2.0% level as an element of the past. On the other hand, upward movement will probably be reined in by weak inflation expectations. We expect the 10-year yield to oscillate between 2.20% and 2.60% between now and the end of the year. We are raising our target for year's end to 2.45% in response to the faster-than-anticipated normalization of real rates. Shorter yields are nevertheless likely to reverse, as the Fed is definitely not ready to consider raising rates earlier.

Graph 11 – Bond market volatility recently notched up



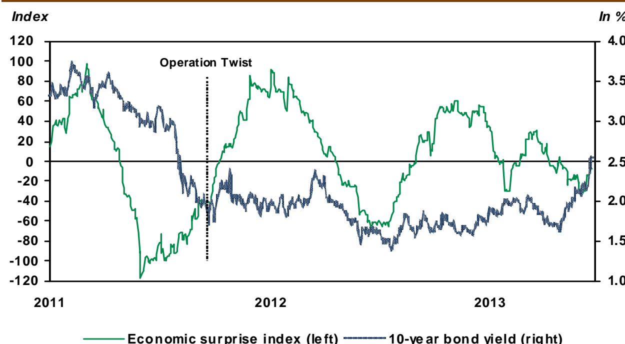
* Spread between the highest and lowest yields within one session.
Sources: Bloomberg and Desjardins, Economic Studies

Graph 12 – In 2012, the idea of a more hawkish Fed* was quickly stamped out by Ben Bernanke and a string of poor figures



* Federal Reserve.
Sources: Bloomberg and Desjardins, Economic Studies

Graph 13 – Since Operation Twist, yields had been relatively uninfluenced by economic data



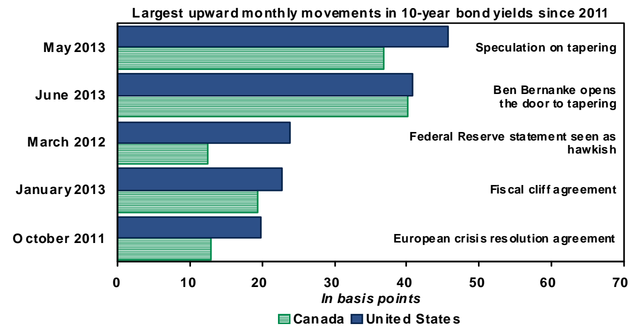
Sources: Bloomberg, Citigroup and Desjardins, Economic Studies

CANADIAN FEDERAL BONDS

- Canadian bonds have outperformed the U.S. bonds since the beginning of May, although this is no anomaly as Canadian yields generally tend to rise a bit more slowly than their U.S. counterparts in major selloffs (graph 14). Notwithstanding, the rise in Canadian yields was sharp, especially in the 5- and 10-year sectors (graph 15). The 2/5 and 2/10 curves steepened sharply, while yields for the shorter terms were not under as much upside pressure. Longer-term bonds did especially well compared with the belly of the curve, and the 10/30 slope flattened by around 15 basis points since the beginning of May, reaching its 2011 low point.
- Although largely dictated by the turbulence created by the Fed, the steepening observed for most sectors of the Canadian curve also tends to reflect some anchoring of monetary policy expectations. Investors are expecting the first increase in overnight rates for the spring of 2014, which is roughly two quarters before our own projection and significantly ahead of where expectations were three months ago. In previous contexts of bond sell-offs, the markets on several occasions brought their expectations for Canadian policy rate increases to a one- or two-meeting horizon. For now, they seem reluctant to subscribe to such an aggressive view, and with good reason.
- The underlying variables behind the Bank of Canada's (BoC) reaction function are not sending any signals conducive to a much more hawkish stance. In the second quarter, total inflation remained below the BoC's operating band, and slightly below its April projection. According to our forecasts, a negative output gap for another two years will ensure a very gradual return to the 2.0% target. In terms of financial stability, households continue to clean up their balance sheets, and the ratio of debt to disposable income has dropped for the second quarter in a row. This outcome is in line with BoC assumptions, and there does not seem to be any necessity to tighten the screw further on this end, even if we expect the bank to maintain its forward guidance within the statement. Arguments in favour of a more dovish stance are not more convincing, with likely further decent GDP growth in the second quarter, a healthy job market and a currency that has recently depreciated (graph 16).

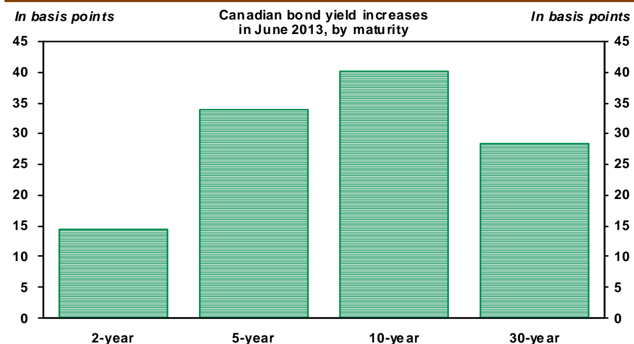
Forecasts: In line with the revisions to our U.S. targets, we are raising our year-end forecasts for Canadian yields. Our target for the 10-year yield is now at 2.35%, after ending the third quarter at 2.40%. Long-term Canadian bonds will keep trading at yields lower than U.S. bonds but volatility could remain elevated (although probably less so than in June) until the Fed formally announces that it is tapering its purchases; in our view, this will happen in September.

Graph 14 – Canadian yields have tended to climb more slowly than U.S. yields during major bond selloffs



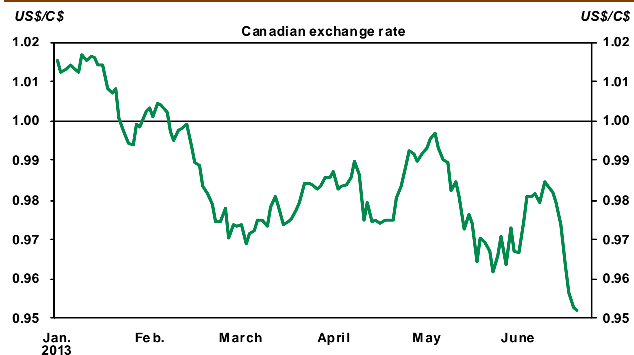
Sources: Bloomberg and Desjardins, Economic Studies

Graph 15 – Yields in the belly of the Canadian curve were the most subject to upside pressure



Sources: Bloomberg and Desjardins, Economic Studies

Graph 16 – The depreciating loonie weakens the case for a more dovish Bank of Canada stance



Sources: Datastream and Desjardins, Economic Studies

Table 1
Key interest rates

End of period in %	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2f	2013 Q3f	2013 Q4f	2014 Q1f	2014 Q2f	2014 Q3f	2014 Q4f
United States												
Federal funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Canada												
Overnight funds	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.50
Euro zone												
Refinancing rate	1.00	1.00	0.75	0.75	0.75	0.50	0.25	0.25	0.25	0.25	0.25	0.25
United Kingdom												
Base rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Japan												
Overnight funds	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10

f: forecasts
Sources: Datastream and Desjardins, Economic Studies

Table 2
Schedule and key rates

Date	Central Bank	Decision	Rate
April 2013			
4	European Central Bank	s.q.	0.75
4	Bank of England	s.q.	0.50
4	Bank of Japan	s.q.	0.10
17	Bank of Sweden	s.q.	1.00
17	Bank of Brazil	+25 b.p.	7.50
17	Bank of Canada	s.q.	1.00
23	Reserve Bank of New Zealand	s.q.	2.50
26	Bank of Japan	s.q.	0.10
26	Bank of Mexico	s.q.	4.00
May 2013			
1	Federal Reserve	s.q.	0.00 / 0.25
2	European Central Bank	-25 b.p.	0.50
7	Reserve Bank of Australia	-25 b.p.	2.75
8	Bank of Norway	s.q.	1.50
9	Bank of England	s.q.	0.50
22	Bank of Japan	s.q.	0.10
29	Bank of Brazil	+50 b.p.	8.00
29	Bank of Canada	s.q.	1.00
June 2013			
4	Reserve Bank of Australia	s.q.	2.75
6	European Central Bank	s.q.	0.50
6	Bank of England	s.q.	0.50
7	Bank of Mexico	s.q.	4.00
11	Bank of Japan	s.q.	0.10
12	Reserve Bank of New Zealand	s.q.	2.50
19	Federal Reserve	s.q.	0.00 / 0.25
20	Bank of Norway	s.q.	1.50
20	Swiss National Bank	s.q.	0.00

s.q.: status quo; b.p. : basis points
Source: Desjardins, Economic Studies

Table 3
Coming soon

Date	Central Bank
July 2013	
2	Reserve Bank of Australia
3	Bank of Sweden
4	European Central Bank
4	Bank of England
10	Bank of Brazil
11	Bank of Japan
12	Bank of Mexico
17	Bank of Canada
24	Reserve Bank of New Zealand
31	Federal Reserve
August 2013	
1	European Central Bank
1	Bank of England
6	Reserve Bank of Australia
8	Bank of Japan
28	Bank of Brazil
September 2013	
3	Reserve Bank of Australia
4	Bank of Canada
5	European Central Bank
5	Bank of England
5	Bank of Sweden
5	Bank of Japan
6	Bank of Mexico
11	Reserve Bank of New Zealand
18	Federal Reserve
19	Bank of Norway
19	Swiss National Bank

Source: Desjardins, Economic Studies

Table 4
United States: fixed income market

End of period in %	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2f	2013 Q3f	2013 Q4f	2014 Q1f	2014 Q2f	2014 Q3f	2014 Q4f
Key rate												
Federal funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Treasury bills												
3-month	0.07	0.09	0.10	0.05	0.07	0.05	0.10	0.15	0.15	0.20	0.20	0.25
Federal bonds												
2-year	0.35	0.32	0.24	0.24	0.25	0.35	0.35	0.35	0.40	0.45	0.45	0.50
5-year	1.03	0.72	0.61	0.70	0.74	1.40	1.35	1.30	1.30	1.35	1.40	1.60
10-year	2.22	1.66	1.64	1.75	1.85	2.50	2.50	2.45	2.45	2.50	2.55	2.70
30-year	3.35	2.77	2.83	2.94	3.11	3.55	3.55	3.50	3.50	3.55	3.65	3.80
Yield curve												
5-year - 3-month	0.96	0.63	0.51	0.65	0.67	1.35	1.25	1.15	1.15	1.15	1.20	1.35
10-year - 2-year	1.87	1.34	1.40	1.51	1.60	2.15	2.15	2.10	2.05	2.05	2.10	2.20
30-year - 3-month	3.28	2.68	2.73	2.89	3.04	3.50	3.45	3.35	3.35	3.35	3.45	3.55

f: forecasts
Sources: Datastream and Desjardins, Economic Studies

Table 5
Canada: fixed income market

End of period in %	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2f	2013 Q3f	2013 Q4f	2014 Q1f	2014 Q2f	2014 Q3f	2014 Q4f
Key rate												
Overnight funds	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.50
Treasury bills												
3-month	0.92	0.88	0.97	0.92	0.97	1.00	1.00	1.00	1.00	1.05	1.20	1.50
Federal bonds												
2-year	1.20	1.03	1.07	1.14	1.00	1.15	1.20	1.20	1.25	1.40	1.60	1.75
5-year	1.57	1.25	1.27	1.36	1.30	1.80	1.75	1.75	1.85	2.00	2.15	2.30
10-year	2.11	1.74	1.73	1.80	1.76	2.40	2.40	2.35	2.35	2.45	2.55	2.70
30-year	2.66	2.33	2.32	2.37	2.51	2.90	2.95	2.95	3.00	3.10	3.20	3.35
Yield curve												
5-year - 3-month	0.65	0.37	0.30	0.44	0.33	0.80	0.75	0.75	0.85	0.95	0.95	0.80
10-year - 2-year	0.91	0.71	0.66	0.66	0.76	1.25	1.20	1.15	1.10	1.05	0.95	0.95
30-year - 3-month	1.74	1.45	1.35	1.45	1.54	1.90	1.95	1.95	2.00	2.05	2.00	1.85
Spreads (Canada - U.S.)												
3-month	0.85	0.79	0.87	0.87	0.90	0.95	0.90	0.85	0.85	0.85	1.00	1.25
2-year	0.85	0.72	0.83	0.90	0.75	0.80	0.85	0.85	0.85	0.95	1.15	1.25
5-year	0.54	0.53	0.66	0.66	0.56	0.40	0.40	0.45	0.55	0.65	0.75	0.70
10-year	-0.11	0.08	0.09	0.05	-0.09	-0.10	-0.10	-0.10	-0.10	-0.05	0.00	0.00
30-year	-0.69	-0.44	-0.51	-0.57	-0.60	-0.65	-0.60	-0.55	-0.50	-0.45	-0.45	-0.45

f: forecasts
Sources: Datastream and Desjardins, Economic Studies