The Yield Curve

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The difficult situation abroad will curb the U.S. yield rise

HIGHLIGHTS

- While the situation in the United States is becoming less positive for the bond market, the reverse is true in the euro zone. Beyond the tough economic context, there is room for concern about another surge in financial strains in Europe.
- A last-minute agreement should, in the end, allow Cyprus to stay in the euro zone, but the crisis could leave its mark, as the idea of a major banking union has retreated by several steps.
- The Federal Reserve is stating with increasing frequency that changes could be made to the securities purchase program. Securities purchases should continue at the same pace, i.e. US$85B per month, until fall. The level of monthly purchases should decrease thereafter, before stopping completely in spring 2014.
- Given the many economic difficulties, the Bank of Canada will likely have to wait until fall 2014 before raising key rates.

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Editorial

While relatively encouraging economic statistics have been released in the United States, including strong job growth and a dip of the jobless rate in February, North American bond yields pulled back in recent weeks. Increased concern about the euro zone explains the drop to around 1.90% by U.S. 10-year yields. In Canada, the pullback was magnified by additional disappointing economic statistics and further softening of the Bank of Canada's stance.

THE CLOUDS DISSIPATE IN THE UNITED STATES

Not long ago, the U.S. economy's recovery seemed to be facing a serious threat, with households having to cope with tax increases, gas poised to climb back to the critical level of US$4/gallon, and the political deadlock threatening to curb businesses' investment and hiring plans.

Since then, there have been several positive developments. Once the government automatic spending cuts were instituted on March first, there was a tangible decrease in the political acrimony between the Democrats and Republicans. Both parties quickly agreed to vote for additional budgetary appropriations, keeping the government from having to shut down at the end of March.

The drop in political risk in the United States since the start of 2013 seems to have helped bring about an improvement to business sentiment. The latest data on new orders and the ISM indexes point to strong business investment. The many hires recorded in the last few months also suggest that businesses are fairly confident about the future.

U.S. households also seem to be showing resilience. Consumer spending has risen in the last few months, despite the heavier tax burden on households. Note that the rise by home prices and stock markets in recent months has created a positive wealth effect for U.S. households (graph 1 on page 2). The drop in oil prices, which reined in surging gas

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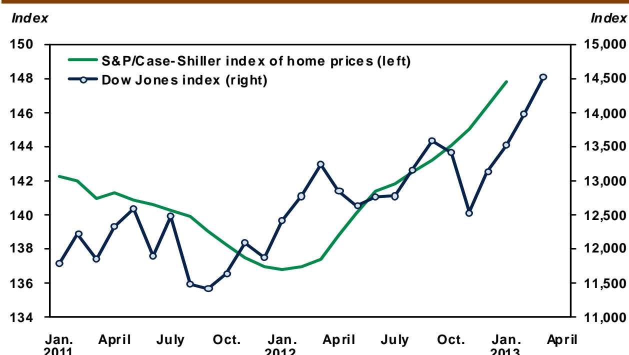
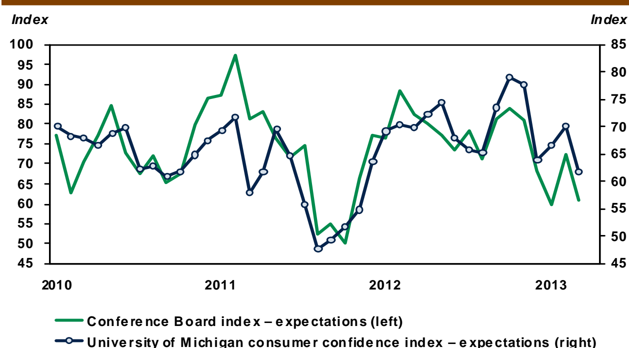
Graph 1 – Rising home prices and stock markets are benefiting U.S households



Sources: Datastream and Desjardins, Economic Studies

prices, also took some pressure off households. The confidence index plunged in March (graph 2), however, adding a dark spot to a fairly positive picture overall of U.S. consumption.

Graph 2 – U.S. consumer confidence dropped sharply in March



Sources: Conference Board, University of Michigan and Desjardins, Economic Studies

As for the financial situation, the Federal Reserve (Fed) clarified matters at its March meeting. It is still signalling that the third quantitative easing program will continue until the labour market outlook improves substantially. The Fed specified, however, that the pace of securities purchases could be adjusted according to how the economic outlook evolves. Accordingly, we now expect the Fed to slow the pace for QE3 as of the fall, winding the program up in the spring of 2014.

THE SKIES GROW DARKER OVER THE EURO ZONE

While the situation in the United States is becoming less positive for the bond market, the reverse is true in the euro zone. The latest economic figures, which include a pullback of the purchasing manager indexes, confirm an ongoing recession in that part of the world. The steadily worsening of France's economic situation is particularly worrying.

Beyond the tough economic context, there is room for concern about another surge in financial strains. The European Central Bank's pledge to do everything possible to save the euro has calmed the situation substantially since last summer. However, Italy's political deadlock and the difficult bailout of the Cypriot financial system confirm that the problems are not over in the euro zone and that Europe's financial crisis could resurface at any time. A last-minute agreement (Plan B) should, in the end, allow Cyprus to stay in the euro zone, but the crisis could leave its mark, as the idea of a major banking union has retreated by several steps. The principle that bank depositors can be treated like just any other creditors could also weaken the banking systems of peripheral nations. Moreover, the recent events in Italy and Cyprus confirm that there is a growing rift between Europe's leaders and their populations, a situation that does not bode well for the future.

BOND YIELDS WILL REMAIN LOW

While the situation in the United States is improving, the global economy continues to grapple with enormous problems. We could talk about decoupling business cycles, as the United States seems to be poised to begin stronger growth, while most of the other economies remain lacklustre. With the downturn in the real estate market increasingly evident, Canada also has poorer prospects than the United States. In the near term, this situation will keep demand for U.S. bonds strong and could even push bond yields down slightly. Yields are expected to gradually climb starting at the end of the summer, however, as the economies in several countries should accelerate and the Fed will begin to signal a decrease to its securities purchases.

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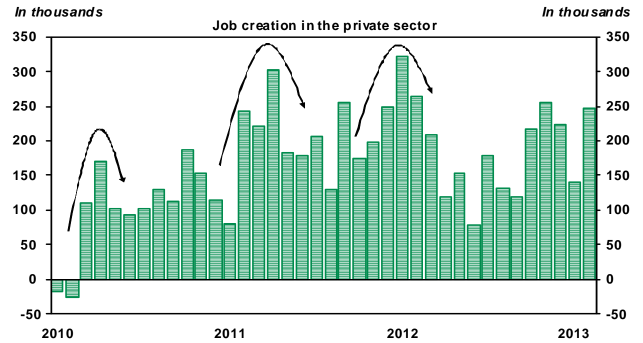
FEDERAL RESERVE

Heading for a pullback on securities purchases?

- The Federal Reserve (Fed) did not change any facet of its monetary policy during the meeting on March 19 and 20. Note that the economic situation still remains too vague to justify any real changes in tone by Ben Bernanke and his colleagues. The latest results for real GDP, for the fourth quarter, show that the U.S. economy has hardly advanced. Real income fell at the beginning of the year, a result of the direct and indirect effects of the tax hikes ordered at the start of the year. What's more, the federal government must now deal with the automatic spending cuts. As a result and for the first time, the Fed's statement mentioned the now restrictive nature of fiscal policy.
- There were some improvements, however, particularly in the labour market. The private sector created more than 200,000 jobs over four of the last five months, and the jobless rate dropped 0.2 points in February, falling to 7.7%, its lowest level since December 2008. At a press conference, however, the Fed's Chair mentioned the need for caution about these good performances; notable gains were observed in other winters, only to flag in the spring (graph 3). In addition to employment, residential and non-residential investments are also moving upwards.
- The Fed did not change its economic forecasts much; they remain fairly optimistic compared with our scenarios (graph 4). Expectations for the jobless rate were downgraded, however, reflecting the recent performance. Clearly, the members of the monetary policy committee are far from satisfied with the gains made by the economy and employment. They also feel that the benefits of the monetary policy currently in place outweigh the risks that it poses. As a result, only one member voted against pursuing the existing securities purchase policy, and 14 out of 19 participants do not see a need to raise rates before 2015 or 2016 (graph 5).
- This does not mean that these positions are carved in stone, though. On the contrary, the Fed is stating with increasing frequency that changes could be made to the securities purchase program. The statement that accompanied the most recent meeting suggests that the Fed will consider the amount of progress made towards economic goals in setting the pace and make-up of securities purchases. In other words, as Fed leaders become convinced that employment is approching desired levels without too many risks of a reversal, they could slow their securities purchases. Ben Bernanke reiterated this stance at the post-meeting press conference.

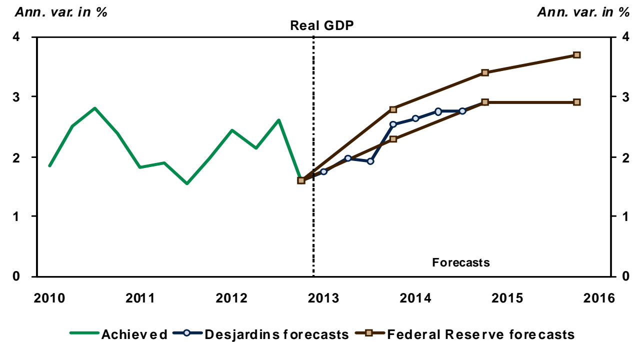
Forecasts: Securities purchases should continue at the same pace, i.e. US$85B per month, until fall. The level of monthly purchases should decrease thereafter, before stopping completely in spring 2014. As for key rates, we do not expect an increase before mid-2015.

Graph 3 – Past accelerations of labour market did not last



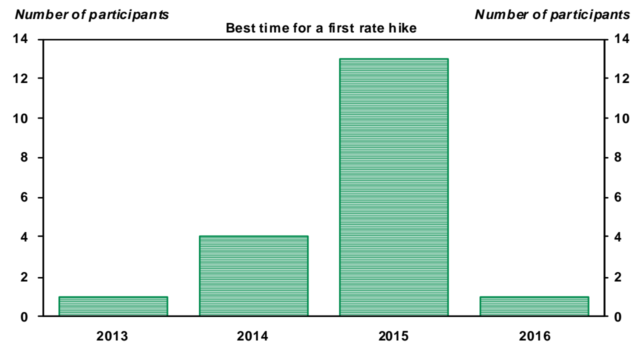
Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

Graph 4 – The Federal Reserve expects fairly strong real GDP growth



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

Graph 5 – The vast majority of Federal Reserve leaders do not foresee rate hikes before 2015



Sources: Federal Reserve Board and Desjardins, Economic Studies

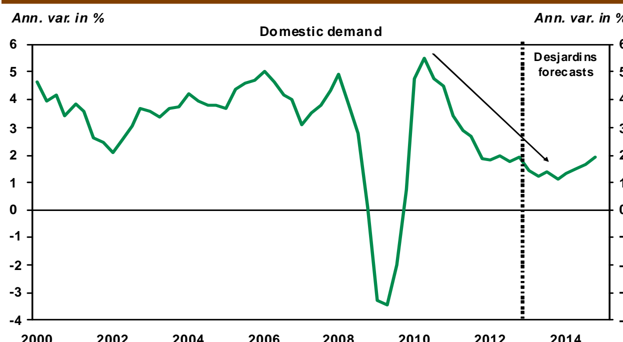
BANK OF CANADA

Rate hikes further away

- Canada's economic outlook is still riddled with uncertainties. Along with the persisting problems in global demand, Canada will also see domestic demand slow in 2013.
- The budget deficit fight will keep curbing current government expenditures as well as public investment. The real estate market's downtrend has now materialized. Consumer spending should continue to rise in the coming quarters, but a slowdown by credit and the effort to clean up household balance sheets will limit its growth potential. Until very recently, a great deal of hope was placed on non-residential investment to support Canada's economic growth. Statistics Canada's investment outlook for 2013 has made that picture gloomier.
- As of mid-2013, economic conditions south of the border should improve, and global demand is forecast to accelerate. Exports could therefore make a major contribution to Canada's economic growth.
- We recently lowered our 2013 growth outlook for Canada's real GDP from 1.8% to 1.5%. 2014 is expected to see growth of about 2.5%, however. Output could remain below potential for longer than anticipated, a situation that will delay the return to full capacity.
- Under these circumstances, inflation pressures will remain modest and it could take several months for the total annual inflation rate to close in on the Bank of Canada's (BoC) mid-point target (2%).
- The BoC softened its stance in early March, declaring that the "considerable monetary policy stimulus currently in place will likely remain appropriate for a period of time." Clearly, monetary authorities are continuing to push back the time frame for increasing the country's key interest rates.
- We can expect the BoC to downgrade its economic outlook when it publishes the next issue of the *Monetary Policy Report* on April 17. Among other things, in January, the BoC's forecast for Canadian real GDP growth in 2013 was 2.0%, which now seems overly optimistic as the latest forecast consensus calls for a gain of just 1.6%. The monetary authorities could also use the opportunity to further soften their stance, among other things, by removing their comment about eventual key rate increases.

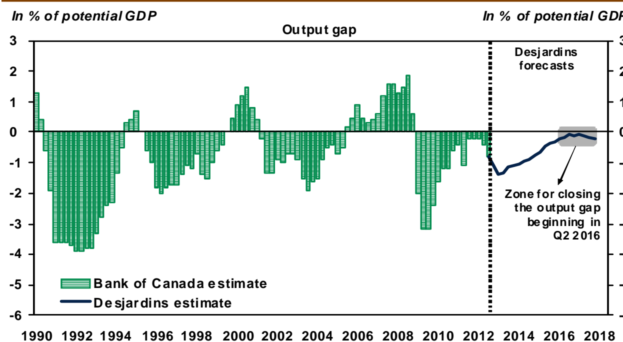
Forecasts: Given the many economic difficulties, the BoC will likely have to wait until fall 2014 before raising key rates.

Graph 6 – Canada's domestic demand strength is eroding



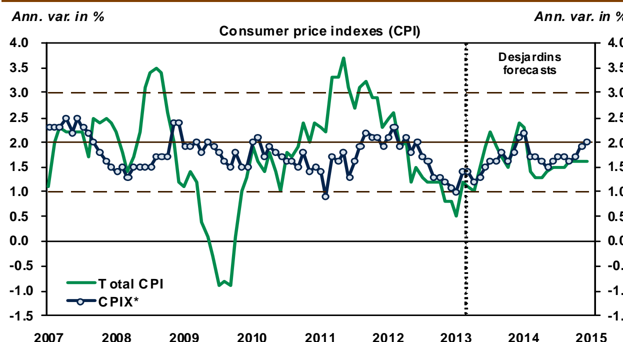
Sources: Statistics Canada and Desjardins, Economic Studies

Graph 7 – It could take longer to get back to full capacity



Sources: Bank of Canada, Statistics Canada and Desjardins, Economic Studies

Graph 8 – Inflation will stay several months below the mid-point target



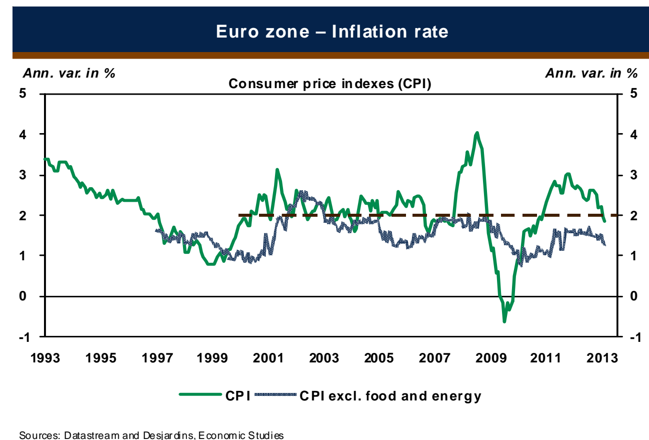
* Bank of Canada's core index.
Sources: Statistics Canada and Desjardins, Economic Studies

OVERSEAS CENTRAL BANK

Changing of the guard at the Bank of Japan

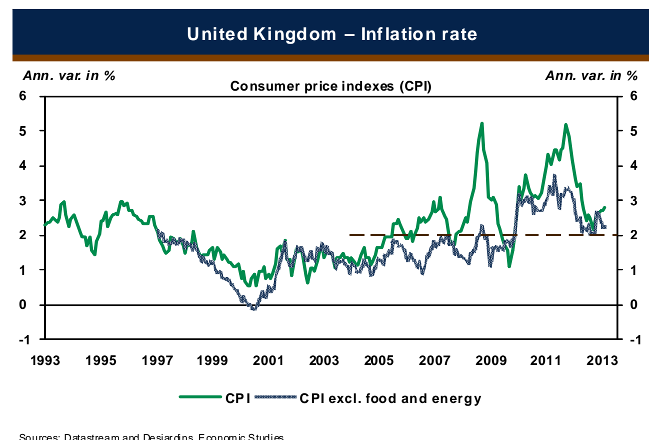
EUROPEAN CENTRAL BANK (ECB)

- The ECB has slightly downgraded its economic scenario, calling for real GDP to contract between 0.1% and 0.9% in 2013. The revision essentially stems from weaker-than-forecast figures at the end of 2012, which lowered the carryover for the start of this year to -0.5%. Given that the GDP should pull back again shortly, we think that the contraction is more likely to be in the neighbourhood of 0.9%. What's more, there are still many downside risks to the economy. While Germany is showing some encouraging signs, other countries, such as France, are seeing more worrisome trends. The ECB will likely have to lower its key rates one more time, an option that was discussed in March. Inflation has dropped below the 2% target, arguing for additional action, particularly as the ECB does not anticipate strong price acceleration for 2013 and 2014. Renewed financial tensions could also force the ECB to act.



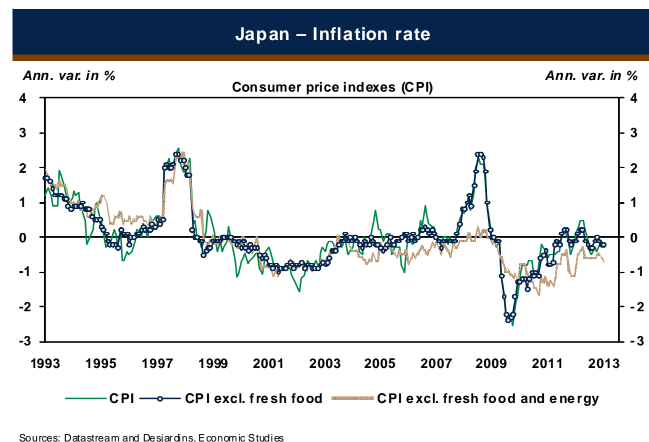
BANK OF ENGLAND (BoE)

- The chances of an increase in the BoE's asset holdings seemed elevated in March, after three out of nine monetary policy committee members showed they were in favour of this in February. Governor Mervyn King was one of them. However, in the end, the status quo was maintained and the three dissenters reaffirmed their positions. A tug-of-war seems to be underway within the BoE, with one side believing that the soft economy justifies doing more, while the other is increasingly worried about inflation. The increase in inflation expectations could complicate a return to the target over the medium range. Moreover, the pound's depreciation is adding further inflation pressure; there is concern that this might partly be the result of well-known flexibility about the inflation target. In this context, the BoE could instead opt to expand its Funding for Lending program, particularly as it seems to be achieving satisfactory results.



BANK OF JAPAN (BoJ)

- No announcements were made following the monetary policy meetings in February and March, but that could change in April, when Haruhiko Kuroda steps in as governor. Kuroda has made a number of statements to the effect that the Bank of Japan should be more interventionist, a scenario in keeping with Prime Minister Abe's preferred strategy. Expectations regarding monetary easing are very high; in fact, they played a major role in weakening the yen. Getting monetary policy to pass through to the real economy will essentially require a rise in Japanese exports. The currency's depreciation will also raise import prices, thus helping get inflation back to the 2% target. There is a lot of ground to cover, however. In Japan, the annual change in prices is still less than 0%.



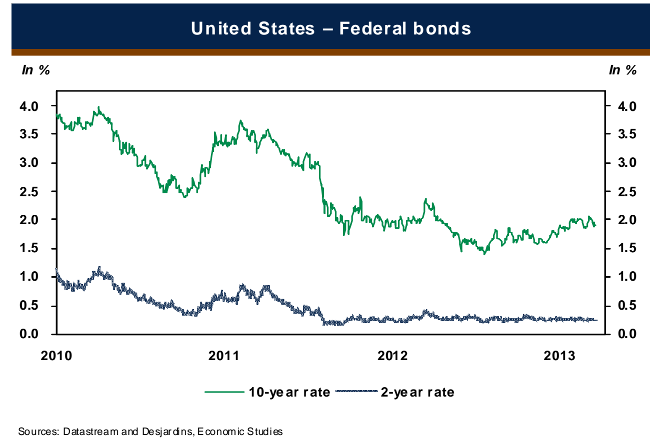
BOND MARKET

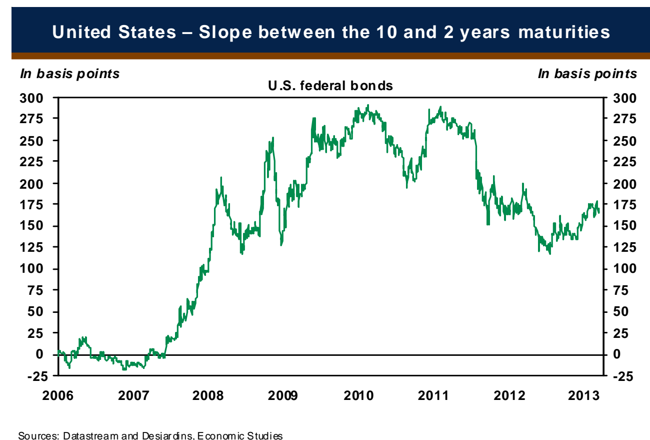
Dovish shift in the Bank of Canada's tone could keep spreads wide in the long end

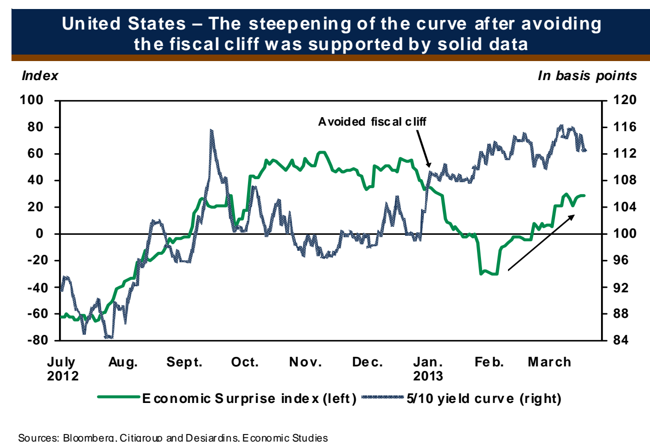
U.S. FEDERAL BONDS

- U.S. bond yields moved upwards overall in the first two months of the year, but then showed extensive volatility in March. Following Italy's inconclusive vote, the 10-year yield dropped 30 basis points from the 2.07% peak reached in February. Market sentiment quickly recovered from this episode, however, boosted by job creation that was well above expectations in the United States. After climbing to the middle of the 2.00% to 2.10% range, the 10-year yield immediately dipped in response to the crisis in Cyprus, hitting a low of around 1.90%, then trending upwards again when a solution was announced.
- This roller coaster ride is a good characterization of the two major forces that are butting heads at this time. On one hand, the U.S. economy continues to surprise, and the payroll tax increases at the start of the year are still not being reflected in the inflow of economic statistics. This good performance affects bonds, insofar as it prompts investors to reassess when exactly the Federal Reserve's (Fed) bond purchase program will end. On the other hand, risk aversion in Europe is still a very powerful factor, fostering periods of bond market rallies.
- This dynamic is quite consistent with our expectations. We must admit that the economy is showing better resilience than anticipated. This is the dominant factor, responsible for the steepening of the curve in the first quarter; however, it also spotlights the risks. For one thing, the effect of the automatic cuts will begin to show at some point. Although political tensions have eased in Washington, this does not mean that all is well. The debt ceiling will have to be raised in May and negotiations on this matter could be contentious. As the outlook of a very slight increase to the debt ceiling (postponing the problem for a few months) seems possible, keep an eye on the response from credit rating agencies. Also key to watch is if the U.S. economy undergoes another spring slump, as seems to have become the norm since the crisis. The impact of the automatic cuts will become increasingly apparent over the coming months, for both growth and employment. Adding to that the European environment, which is likely to remain in flux, we believe the negative risks will be dominant in the second quarter, a situation that will favour bonds.

Forecasts: The next few months could be tense and we are expecting yields to remain low in the second quarter. However, we expect that prospects for a slow reduction in the pace of bond purchases as of next fall will put upside pressure on yields as of this summer. Our year-end target of 2.30% for the 10-year yield is slightly higher than in our last scenario, to account for this dynamic, which differs slightly from what we initially anticipated.



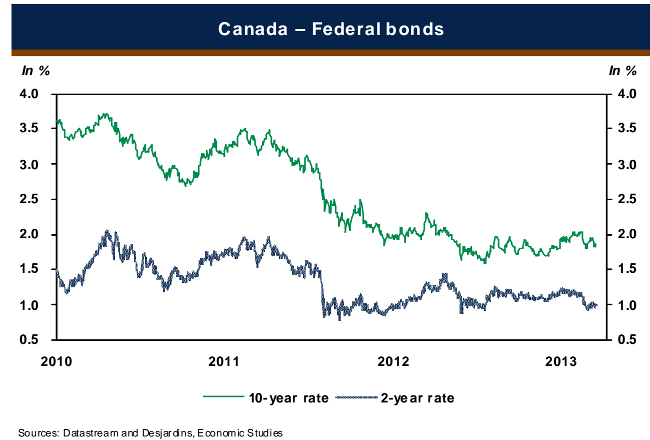


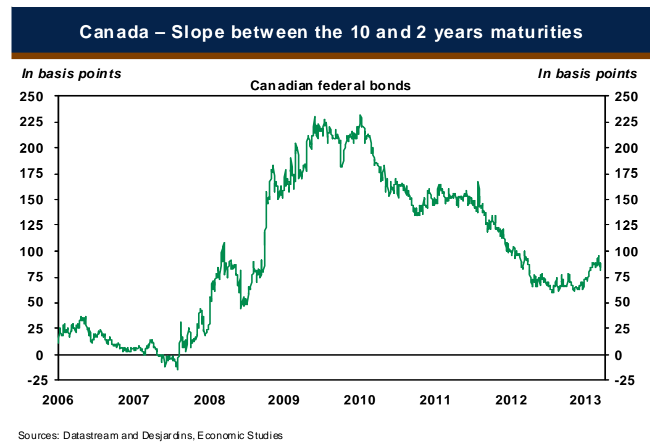


CANADIAN FEDERAL BONDS

- Following the fourth quarter's disappointing growth, some factors suggested that the economy would rebound as of January. January's GDP confirmed this expectation, but the upswing was modest when taken in the context of a tough month of December for the Canadian economy. Canada's bond markets were especially volatile at the start of the month, which featured a change in monetary policy expectations. After not having reacted much to a string of poor economic figures during February, expectations of a potential key rate cut were bolstered following the election in Italy. In its statement at the start of March, the Bank of Canada (BoC) had to adjust its stance, specifying that the monetary stimulus "will likely remain appropriate for some time, after which some modest withdrawal will likely be required." The incorporation of the part of the sentence was construed as a shift to a more dovish stance, which fuelled speculation about a potential rate cut. February's positive surprise in employment, and later, the spike in inflation, invalidated this view.
- The Canadian benchmark 10-year yield has recently been lower than its U.S. counterpart. After hitting -12 basis points at the start of March, the spread stabilized around -9 points. Note that this spread compares the two countries' benchmark 10-year bonds. Until March 27, the Canadian 10-year benchmark bond was the one scheduled to mature in June 2022, making it in fact a 9-year, 3-month bond. Following the March 27 auction, the bond maturing in June 2023 (closer to a real 10-year bond) replaced the bond maturing in June 2022 as the 10-year benchmark bond. As a result, the yield spread on 10-year benchmark bonds returned to above zero. Technicalities aside, the fact remains that the Canada–U.S. spread has narrowed substantially, a situation that is not typical in a risk-off environment in which U.S. bonds generally tend to do better.
- This situation should persist, however. While the U.S. monetary policy is essentially the same as it was at the start of the year, the BoC continues to moderate its stance, with the Canadian economy's weak points particularly salient and inflation still weak. Risk-aversion phases could revive rate cut expectations, but it is unlikely they will be very strong. Instead, market participants could stick with the "low-for-long" perspective, to the point of questioning the extent of the horizon that separates a first BoC rate hike from the Fed's first rate hike. Canada–U.S. spreads could have a hard time perking upwards in this context.

Forecasts: Adjustments to our scenario focus primarily on the short part of the Canadian curve. Our forecast now includes a first rate hike at the very end of 2014, one quarter later. In line with this change, we believe the 2-year yield will end the year lower, at around 1.10% compared with 1.25% in our previous forecast. The forecast for the remainder of the curve has not changed much. However, our adjustments to the U.S. outlook mean that our (negative) yield spread year-end targets for the 10- and 30-year horizons are slightly higher than they were in our February outlook.





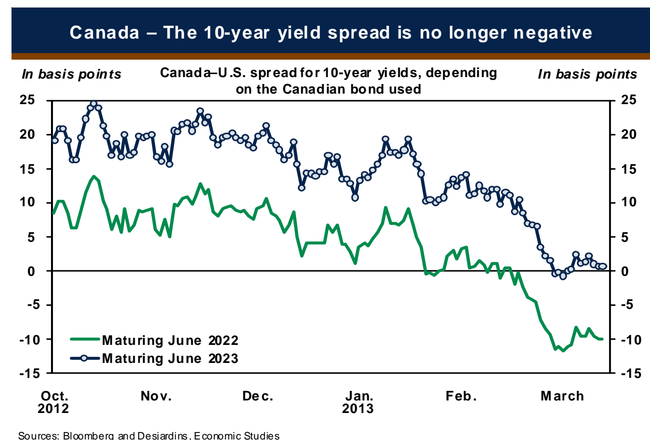


Table 1
Key interest rates

End of period in %	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1f	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	0.50	0.50	0.50	0.50	0.50	0.50
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
December 2012			
19	Bank of Japan	s.q.	0.10
January 2013			
10	European Central Bank	s.q.	0.75
10	Bank of England	s.q.	0.50
16	Bank of Brazil	s.q.	7.25
18	Bank of Mexico	s.q.	4.50
21	Bank of Japan	s.q.	0.10
23	Bank of Canada	s.q.	1.00
30	Reserve Bank of New Zealand	s.q.	2.50
30	Federal Reserve	s.q.	0.00 / 0.25
February 2013			
4	Reserve Bank of Australia	s.q.	3.00
7	European Central Bank	s.q.	0.75
7	Bank of England	s.q.	0.50
13	Bank of Sweden	s.q.	1.00
13	Bank of Japan	s.q.	0.10
March 2013			
4	Reserve Bank of Australia	s.q.	3.00
6	Bank of Brazil	s.q.	7.25
6	Bank of Canada	s.q.	1.00
6	Bank of Japan	s.q.	0.10
7	European Central Bank	s.q.	0.75
7	Bank of England	s.q.	0.50
8	Bank of Mexico	-50 b.p.	4.00
13	Reserve Bank of New Zealand	s.q.	2.50
14	Bank of Norway	s.q.	1.50
14	Swiss National Bank	s.q.	0.00
20	Federal Reserve	s.q.	0.00 / 0.25

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

Table 3
Coming soon

Date	Central Bank
April 2013	
1	Reserve Bank of Australia
3	Bank of Japan
4	European Central Bank
4	Bank of England
17	Bank of Sweden
17	Bank of Brazil
17	Bank of Canada
23	Reserve Bank of New Zealand
26	Bank of Japan
26	Bank of Mexico
May 2013	
1	Federal Reserve
2	European Central Bank
7	Reserve Bank of Australia
8	Bank of Norway
9	Bank of England
21	Bank of Japan
29	Bank of Brazil
29	Bank of Canada
June 2013	
4	Reserve Bank of Australia
6	European Central Bank
6	Bank of England
7	Bank of Mexico
10	Bank of Japan
12	Reserve Bank of New Zealand
19	Federal Reserve
20	Bank of Norway
20	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 Q1f	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	0.10	0.10	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	0.25	0.30	0.35	0.40	0.45	0.45	0.50
5-year	1.03	0.72	0.61	0.70	0.75	0.75	0.95	1.20	1.30	1.35	1.40	1.60
10-year	2.22	1.66	1.64	1.75	1.85	1.80	2.05	2.30	2.45	2.50	2.55	2.70
30-year	3.35	2.77	2.83	2.94	3.10	3.00	3.20	3.40	3.50	3.55	3.65	3.80
Yield curve												
5-year - 3-month	0.96	0.63	0.51	0.65	0.65	0.65	0.85	1.05	1.15	1.15	1.20	1.35
10-year - 2-year	1.87	1.34	1.40	1.51	1.60	1.55	1.75	1.95	2.05	2.05	2.10	2.20
30-year - 3-month	3.28	2.68	2.73	2.89	3.00	2.90	3.10	3.25	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 Q1f	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	0.95	0.95	1.00	1.00	1.00	1.00	1.20	1.50
Federal bonds												
2-year	1.20	1.03	1.07	1.14	1.00	0.95	1.05	1.10	1.20	1.40	1.60	1.75
5-year	1.57	1.25	1.27	1.36	1.30	1.30	1.45	1.70	1.85	2.00	2.15	2.30
10-year	2.11	1.74	1.73	1.80	1.85	1.75	1.95	2.20	2.35	2.45	2.55	2.70
30-year	2.66	2.33	2.32	2.37	2.50	2.45	2.70	2.90	3.00	3.10	3.20	3.35
Yield curve												
5-year - 3-month	0.65	0.37	0.30	0.44	0.35	0.35	0.45	0.70	0.85	1.00	0.95	0.80
10-year - 2-year	0.91	0.71	0.66	0.66	0.85	0.80	0.90	1.10	1.15	1.05	0.95	0.95
30-year - 3-month	1.74	1.45	1.35	1.45	1.55	1.50	1.70	1.90	2.00	2.10	2.00	1.85
Spreads (Canada - U.S.)												
3-month	0.85	0.79	0.87	0.87	0.85	0.85	0.90	0.85	0.85	0.80	1.00	1.25
2-year	0.85	0.72	0.83	0.90	0.75	0.70	0.75	0.75	0.80	0.95	1.15	1.25
5-year	0.54	0.53	0.66	0.66	0.55	0.55	0.50	0.50	0.55	0.65	0.75	0.70
10-year	-0.11	0.08	0.09	0.05	0.00	-0.05	-0.10	-0.10	-0.10	-0.05	0.00	0.00
30-year	-0.69	-0.44	-0.51	-0.57	-0.60	-0.55	-0.50	-0.50	-0.50	-0.45	-0.45	-0.45

f: forecasts
Sources: Datastream and Desjardins, Economic Studies