The Yield Curve

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The Bank of Japan will also support the bond market

HIGHLIGHTS

- The release of disappointing U.S. economic data has intensified the downwards trend of bond yields in recent weeks.
- While there were plenty of upside surprises in the first months of 2013, the U.S. situation now seems to be reversing course... somewhat reminiscent of the sluggishness that was recorded in the springtime in both 2011 and 2012.
- We expect that these signs of weakness will be temporary, but it will be enough to generate concern among the Federal Reserve officials.
- Through its massive purchases of Japanese government bonds, the Bank of Japan will force Japanese financial institutions to buy other types of financial assets. U.S. Treasury securities should be an especially attractive alternative for Japanese investors.
- The Bank of Canada outlook for Canada's real GDP growth in 2013 was reduced from 2.0% to 1.5% in the latest *Monetary Policy Report.* In our opinion, the risks surrounding next year's growth still seem to be on the downside.

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Editorial

The bond market got off to a strong start in the second quarter, with the U.S. 10-year yield falling to around 1.70%. Keep in mind that it had reached 2.08% at the beginning of March, before a resurgence of concerns about the euro zone gave some support to North American bonds.

ANOTHER SPRING SLUMP?

The release of disappointing U.S. economic data has intensified the downwards trend of bond yields in recent weeks. The disappointments started off on April 1, when the ISM manufacturing index dropped from 54,2 to 51.3. The U.S. job creation figure of a mere 88,000 jobs in March, compared with an average of 220,000 jobs in the previous four months, confirmed that the trend for U.S. data had changed course. These data are fuelling fears of a more significant deterioration of U.S. outlooks similar to those seen in the springs of 2011 and 2012.

In our opinion, such apprehensions are warranted to some extent, since the signs are that growth in the United States will decelerate sharply in the second quarter. But we are not overly concerned about this. Given the fiscal tightening, we have long expected that the U.S. economy would struggle in the first half of 2013. In fact, we were surprised by the vigour of the U.S. economy in the first quarter so it is natural that we should see some pullback in the second quarter.

We will need to keep an eye on the U.S. data, but for the time being they are not calling into question the fact that improvement in household balance sheets and the recovery of the real estate market are paving the way for more sustained growth from mid-2013 onwards. However, this spring slowdown should restrain certain Federal Reserve (Fed) officials who had suggested starting to wind down the third quantitative easing program (QE3) in the near future.

François Dupuis
Vice-President and Chief Economist

Yves St-Maurice
Senior Director and Deputy Chief Economist

514-281-2336 *or* 1 866 866-7000, ext. 2336
E-mail: desjardins.economics@desjardins.com

Mathieu D'Anjou Senior Economist
Benoit P. Durocher Senior Economist
Francis Généreux Senior Economist
Jimmy Jean Senior Economist
Hendrix Vachon Senior Economist

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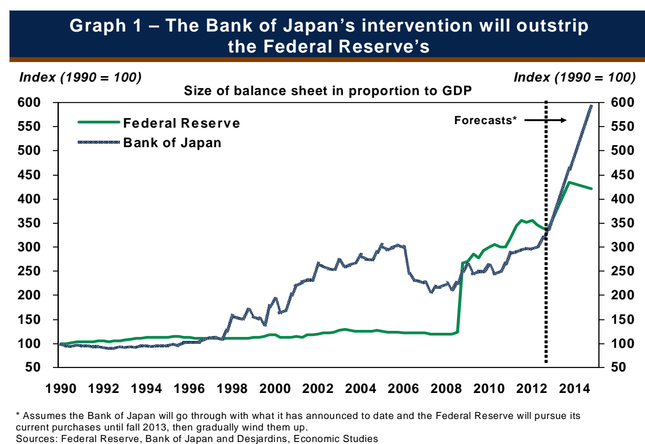
DO THE BANK OF JAPAN'S POLICIES REPRESENT AN INCREASE TO QE3?

While the conditions in Europe and North America are unfolding pretty much as we had anticipated, we were hit by a surprise out of Japan.

The Liberal Democrats' return to power raised expectations about the Bank of Japan (BoJ). Those expectations were surpassed at the beginning of April, when the new governor, Haruhiko Kuroda, announced nothing short of a revolution. Monetary policy will no longer be set by means of the overnight interest rate, but by means of the monetary base[1] instead. In order to reach its 2% inflation target faster, the BoJ will double the monetary base by the end of 2014. To that end, it will purchase more government bonds and other types of assets. In addition, the average terms of the assets purchased will change to seven years, compared with three years as was formerly the case.

As the Fed is doing, the BoJ will thus inject massive amounts of liquidity in the upcoming quarters (graph 1). The term "massive" is no exaggeration. With an economy about one third the size of that of the United States, the BoJ will expand its balance sheet by approximately US$58B per month, including the purchase of US$42B worth of Japanese bonds. Bear in mind that the Fed is currently purchasing US$85B worth of assets per month, including US$45B of federal bonds. The first effect of these actions was to exacerbate the pullback of the yen and of Japanese bond yields.

Graph 1 – The Bank of Japan's intervention will outstrip the Federal Reserve's



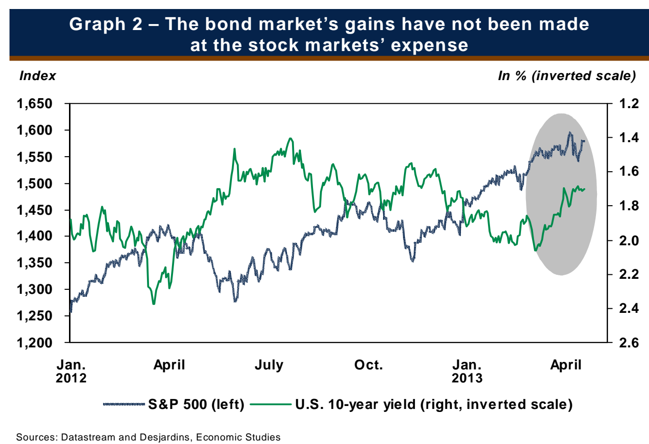
* Assumes the Bank of Japan will go through with what it has announced to date and the Federal Reserve will pursue its current purchases until fall 2013, then gradually wind them up.
Sources: Federal Reserve, Bank of Japan and Desjardins, Economic Studies

What impact will these BoJ purchases have on the North American markets? Of course, the direct effect is entirely different from QE3, since the BoJ will be buying only Japanese assets. However, central banks stress the importance of the portfolio effects of their quantitative measures. By purchasing bonds, they inflate demand not only for this type of asset, but for all assets that could be bought by the institutions that sell bonds to the central banks. This explains why the Fed's policies have led to a general decline in interest rates, even beyond the U.S. borders.

Through its massive purchases of Japanese government bonds, the BoJ will force Japanese financial institutions to buy other types of financial assets. Since Japanese alternatives are limited, we should expect that funds will exit Japan and head to other financial markets. U.S. Treasury securities should be an especially attractive alternative for Japanese investors. To prevent their currencies from appreciating too much against the yen, other Asian countries might also increase their purchases of American assets.

The BoJ's announcement may also have favoured the recent pullback in European bond yields and helped to limit the stock market pullback, despite certain worrisome developments (graph 2). U.S. bond yields could fall a little further in the short term, but we are still expecting them to climb back up in the second half of the year. In the longer term, however, we wonder whether these super-aggressive actions by the central banks might create other problems.

Graph 2 – The bond market's gains have not been made at the stock markets' expense



Sources: Datastream and Desjardins, Economic Studies

François Dupuis
Vice-President and Chief Economist

Mathieu D'Anjou, CFA
Senior Economist

[1] Coins, paper money and bank reserves at the central bank.

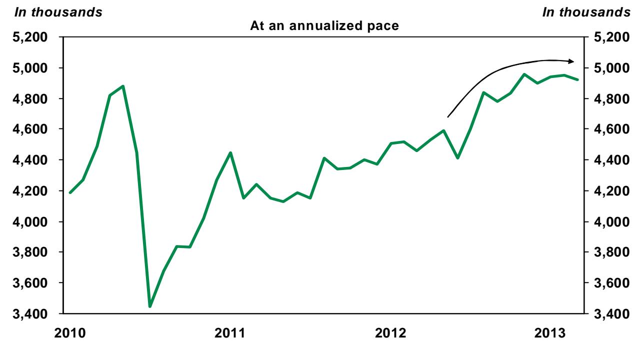
FEDERAL RESERVE

A spring setback that will worry the Federal Reserve

- The picture that is shown by the minutes of the Federal Reserve (Fed) meeting that concluded on March 20 is a little different from what emerged that day. Much of the meeting was devoted to discussions on the costs and benefits of the current quantitative policy. We note that differences of opinion do indeed exist, but the people who are the least comfortable with the Fed's recent decisions seem to be the regional presidents that currently do not have voting rights. It is conceivable, though, that a definite improvement in economic conditions would induce more and more Fed officials to lean towards the sceptics' point of view, paving the way for a near-term reassessment of the current pace of Treasury security or mortgage asset purchases.
- But this did not take into account the signs of renewed weakness in the U.S. economy. While, on one hand, the economic data released since the start of the year testify to healthy real GDP growth in the first quarter, they also point towards an economic slowdown in the spring. Only 88,000 new jobs were created in March, a definite deceleration. We also noted declines in the ISM indexes and in consumer confidence. Retail sales and manufacturing production also pulled back in March. Even the housing sector, which was finally showing more vigour, seems to be catching its breath: housing starts rose sharply, but fewer building permits were issued and resales are stagnating (graph 3). While there were plenty of upside surprises in the first months of 2013, the situation now seems to be reversing course... somewhat reminiscent of the sluggishness that was recorded in the springtime in both 2011 and 2012 (graph 4).
- The financial markets are also less optimistic as bond yields pullback in April. Most commodity prices also suffered significant setbacks. Inflation also slowed in March (graph 5).
- We expect that these signs of weakness will be temporary, but it will be enough to generate concern among the Fed officials. The most dovish members of the monetary policy committee will be glad that they were patient, while the most hawkish have lost an important foundation of their arguments. It will take several months of positive economic data before we are likely to see the Fed back off on its asset purchases.

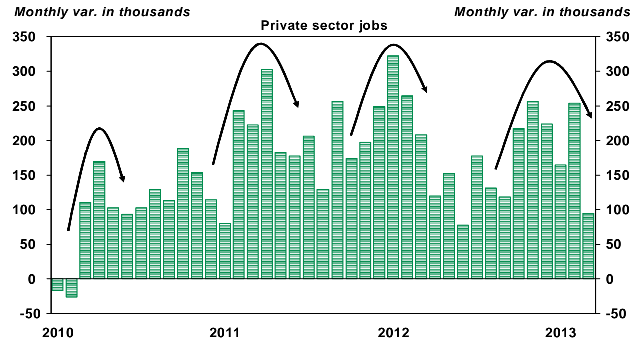
Forecasts: The quantitative policy should continue at the same pace, i.e. US$85B per month, until the fall. After that, the monthly purchases should taper off gradually until they stop entirely in the spring of 2014. As for the key interest rates, we do not expect any hike before mid-2015.

Graph 3 – Sales of existing homes are advancing more slowly in the United States



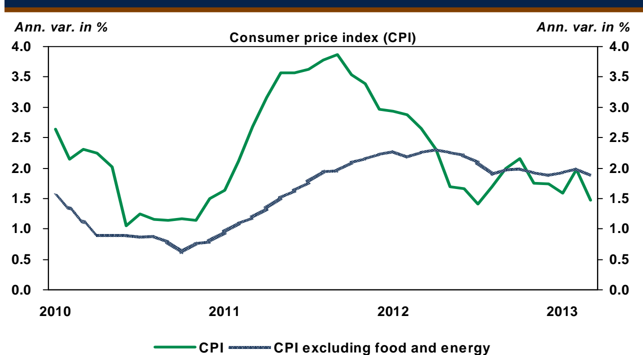
Sources: National Association of Realtors and Desjardins, Economic Studies

Graph 4 – The U.S. job market is slowing, just as in previous springs



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

Graph 5 – Inflation in the United States remains modest



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

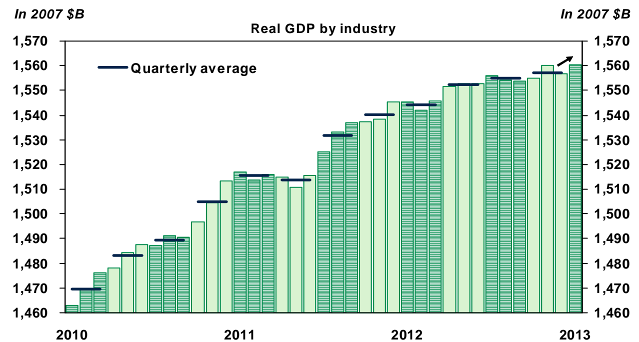
BANK OF CANADA

Monetary authorities lower their forecasts

- The weakness that has been observed in the Canadian economy since mid-2012 is continuing at the start of 2013. Real GDP by industry did edge up by 0.2% in January, but the carry-over for the first quarter of 2013 is still fairly limited (graph 6).
- The domestic demand components are still having trouble. Among other things, the real estate market is continuing its downwards trend (graph 7) and consumer spending is still being curbed by households showing greater caution about debt.
- The recent economic indicators left no doubt that the Bank of Canada (BoC) would have to revise its economic scenario downwards. Accordingly, the BoC's outlook for Canada's real GDP growth in 2013 was reduced from 2.0% to 1.5% in the latest *Monetary Policy Report*; this prediction is identical to our most recent projections. For 2014, the BoC now expects a gain of 2.8%.
- In our opinion, the risks surrounding next year's growth still seem to be on the downside. According to the most recent forecasters' consensus, Canada's real GDP growth could come in at just 2.4% in 2014. The monetary authorities may therefore be forced to revise their economic scenario further downwards in the coming quarters.
- In such conditions, it may take longer than the BoC is currently predicting (mid-2015) for Canada to achieve its full production potential. In fact, our most recent forecasts suggest that the return to full potential may not happen until around mid-2016 (graph 8).
- The total annual inflation rate fell to the BoC's lower target (1%) in March, while core inflation remained stable at a very low level. Thus inflationary pressures are still under control and very weak in this country, which leaves plenty of leeway for managing monetary policies.

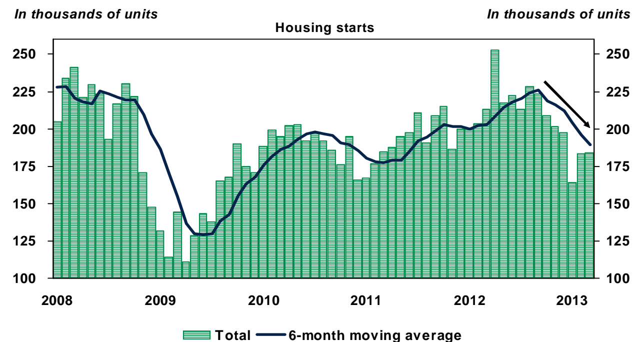
Forecasts: The BoC will most likely have to wait until the end of 2014 before modestly reducing its monetary easing, as it keeps repeating. But is it really necessary to go on warning Canadians so far in advance? Certainly, the fact that concerns about the real estate market have not completely evaporated hangs in the balance. Besides, the BoC probably wants to leave plenty of scope for action to the next governor, whose appointment is expected soon.

Graph 6 – Despite January's upturn, Canada's first-quarter growth is likely to be weak in 2013



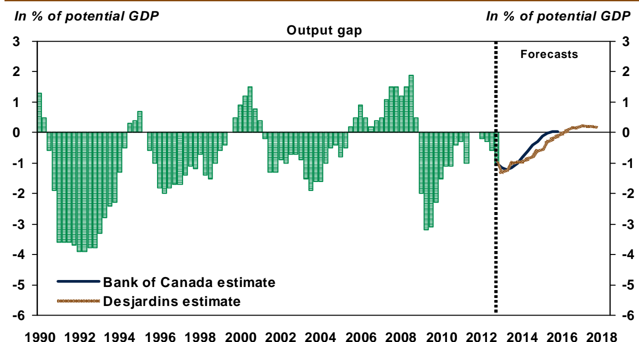
Sources: Statistics Canada and Desjardins, Economic Studies

Graph 7 – The Canadian housing start trend is still downwards despite upticks in February and March



Sources: Canada Mortgage and Housing Corporation and Desjardins, Economic Studies

Graph 8 – The return to full potential could take more time in Canada



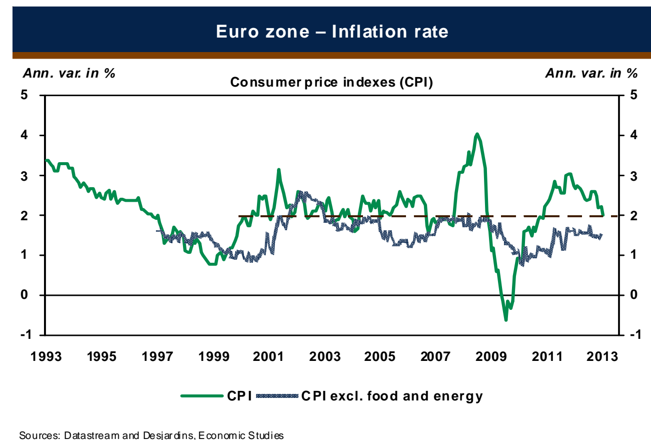
Sources: Bank of Canada, Statistics Canada and Desjardins, Economic Studies

OVERSEAS CENTRAL BANK

The Bank of Japan moves into high gear

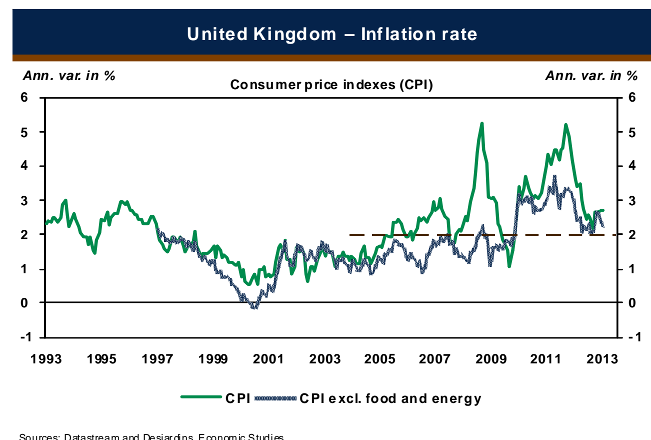
EUROPEAN CENTRAL BANK (ECB)

- The ECB seems to have a slightly more negative outlook on the economy. The weakness seen at the end of 2012 continued into the beginning of 2013, and many downside risks are still threatening the recovery. Inflation has taken root below its 2% target, and the ECB does not anticipate any sharp price acceleration in 2013 or 2014. At a press conference in early April, Mario Draghi mentioned that a key interest rate cut had again been discussed. Deliberations also focused on measures that might reduce the segmentation of financial markets and improve the lending conditions applied to small- and medium-sized businesses. However, it is by no means clear that the ECB has the tools needed to address this issue. Unless the ECB manages to quickly come up with a new solution, an interest rate cut appears increasingly likely.



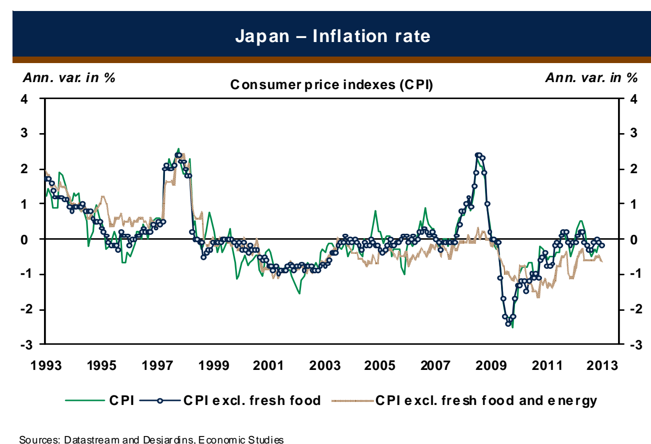
BANK OF ENGLAND (BoE)

- Three of the nine members of the monetary policy committee (including the Governor, Mervyn King) are still in favour of new asset purchases. So the tug of war is continuing at the BoE. On the one hand, it is felt that the weakness of the economy justifies doing more; on the other, there are worries about inflation which is staying above the BoE's target. In fact, rising inflation expectations could complicate the return to the target in the medium term. It will probably take deterioration in economic conditions to induce the BoE to resume its asset purchases. Still, the Funding for Lending program has been enhanced by focusing more on credit to small- and medium-sized businesses.



BANK OF JAPAN (BoJ)

- The arrival of a new governor at the helm of the BoJ has clearly changed the rules of the game. The monetary base has officially become the operating target of monetary policy, instead of the overnight interest rate. It will be nearly doubled to ¥270,000B (US$2,700B) between now and the end of 2014, in an effort to bring inflation down to 2.0%. Proportionally speaking, the BoJ will be expanding its balance sheet faster than the Federal Reserve. The difference will be even more obvious in 2014, when the Americans halt their asset purchases. It remains to be seen whether these steps will be sufficient. There is a long way to go, since the Japanese inflation rate currently stands at -0.6%. The depreciation of the yen will help push consumer prices up faster through the prices of imports, but more importantly, the BoJ will have to convince the economic players to revise their inflation expectations, upwards. Other actions will be required if it becomes clear that the objective cannot be reached.



BOND MARKET

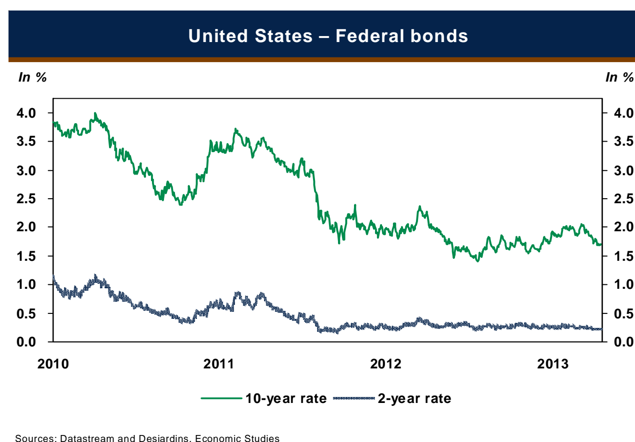
Will inflation expectations drop further?

U.S. FEDERAL BONDS

- Those who believed, at the start of the year, that the partial resolution of the fiscal cliff would put the nail in the bond market's coffin are probably experiencing frustrating moments. Due to the negative turn in macro trends over the past few weeks (disappointing job numbers, weakening ISM index, flagging consumer confidence, etc.), the 10-year bond yield has plunged, even falling below 1.70% several times in April.
- On top of the U.S. economic weakness, three major developments in Asia have given support to bonds. First, the Bank of Japan confounded sceptics with a program to expand the monetary base by an unparalleled degree, creating a "threat" of massive flows out of Japan and towards foreign bond markets. Next, China's GDP negatively surprised in the first quarter, recording growth of only 7.7% on a year-over-year basis, well below expectations and one of the weakest performances since the recession. Lastly, the possibility of armed conflict between North Korea and the United States presented an additional risk factor. Given that many of these uncertainties are unlikely to disappear any time soon and that certain other issues (e.g. debt ceiling, Italian governance) could return to the fore, bonds do not look very vulnerable in the short term.
- We also note that inflation expectations have fallen significantly lately. This could be a sign of the perceived risk that the Federal Reserve (Fed) might cease providing its support before any convincing recovery has materialized. It is still too early to completely subscribe to this hypothesis, however. If the economy deteriorates, the Fed will maintain or increase the pace of its purchases. In fact, some officials have mentioned that the Fed had the option to increase its purchases if necessary. This possibility should, in principle, prevent inflation expectations from plunging too heavily. It must also be noted that the 10-year breakeven yield is currently around the level it was at in September 2012, just prior to the Fed's announcement of the current quantitative easing program. Markets are therefore far from anticipating deflation. While we expect slightly weaker growth in the second quarter, any further sharp reductions in inflation expectations do not strike us as being warranted either from a fundamental point of view, or from a monetary policy point of view.

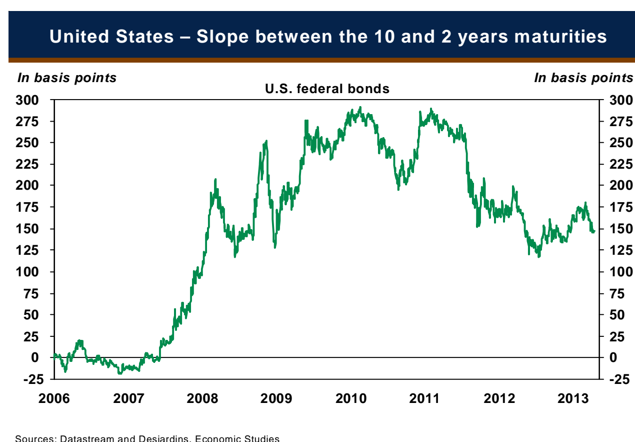
Forecasts: We are leaving our scenario unchanged. Other areas of turbulence lie ahead in the second quarter, and yields will stay within their current range for a few months before ending off the quarter at 1.80%, in the case of the 10-year Treasury note. Looking beyond, prospects of a gradual slowing of the pace of bond purchases starting next fall should begin putting upwards pressure on yields.

United States – Federal bonds



Sources: Datastream and Desjardins, Economic Studies

United States – Slope between the 10 and 2 years maturities



Sources: Datastream and Desjardins, Economic Studies

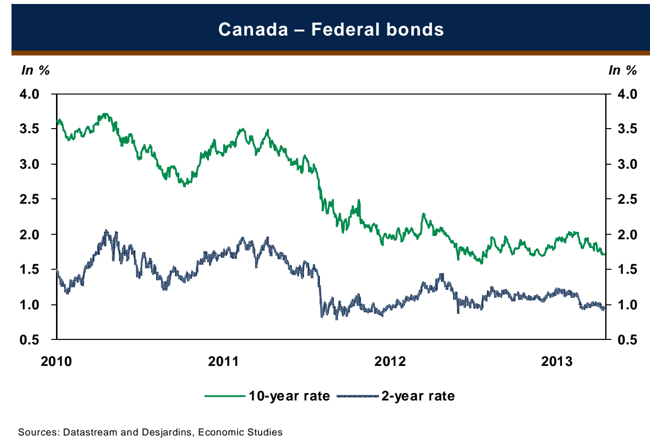
United States – Inflation expectations

* Based on the yield spreads between nominal return bonds and real return bonds.
Sources: Bloomberg and Desjardins, Economic Studies

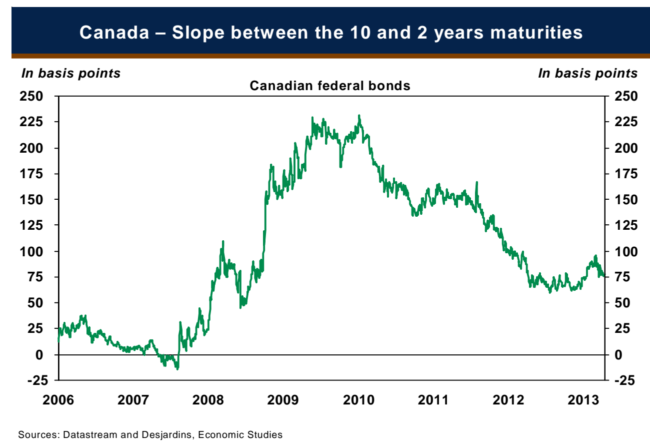
CANADIAN FEDERAL BONDS

- In the current context of intensifying financial tensions around the globe, and due to the attractive characteristics they still offer to foreign investors, Canadian federal bonds continue to be sought after. The 10-year bond yield headed downwards for most of the month of April. One sign of the attraction of Canadian bonds is the fact that global risk aversion did not have the usual effect of widening yield spreads against U.S. bonds. The 10-year yield spread stayed pretty much within a fairly narrow range of between -0.5 and 4.0 basis points. As for Canadian 5-year bonds, they performed better than their U.S. counterparts; the spread diminished from 52.6 basis points at the beginning of the month to 49 basis points as of April 19.
- We should also point out that expectations over the timing of the first monetary tightening move in Canada have evolved considerably. While investors hesitate to price in rate cuts aggressively for the near future, the futures curve on bankers' acceptances shows that markets are not expecting the first rate hike until 2015. The Bank of Canada's (BoC) *Monetary Policy Report* of April supported these expectations, as the BoC now believes that the economy will not reach its full potential before mid-2015. This is one year later than the scenario that was presented in January.
- Changing expectations regarding monetary policy has gone hand in hand with the decline in inflation expectations that has also been observed in Canadian markets. The decline was nonetheless far more modest than what has been observed in the United States. With year-over-year growth rates of 1.0% and 1.5% respectively, the Canadian and U.S. consumer price indexes are on the soft side and this could be influencing market expectations. However the recent slump in commodity prices, largely tied to apprehensions of flagging demand from China, seems to be the dominant driver. In any event, inasmuch as no economic contraction is anticipated in North America, we believe that inflation expectations should stabilize soon.

Forecasts: We are not making any major change to our targets for Canada this month. Bond yields should fluctuate within their current range, consistent with a relatively tense global financial backdrop, combined with soft growth dynamics domestically. We continue to assess that Canadian bonds will perform slightly better than U.S. bonds in the second half of the year, as the Fed starts tapering its asset purchase program.



Sources: Datastream and Desjardins, Economic Studies



Sources: Datastream and Desjardins, Economic Studies

* Based on the yield spreads between nominal return bonds and real return bonds.
Sources: Bloomberg 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	0.50	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
January 2013			
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
April 2013			
1	Reserve Bank of Australia	s.q.	3.00
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

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

Table 3
Coming soon

Date	Central Bank
April 2013	
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
July 2013	
2	Reserve Bank of Australia
3	Bank of Sweden
4	European Central Bank
4	Bank of England
10	Bank of Brazil
10	Bank of Japan
12	Bank of Mexico

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	0.10	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	0.74	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	3.11	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	0.67	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	3.04	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 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	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	1.76	1.75	1.95	2.20	2.35	2.45	2.55	2.70
30-year	2.66	2.33	2.32	2.37	2.51	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	0.33	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	0.76	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	1.54	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	0.90	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	0.56	0.55	0.50	0.50	0.55	0.65	0.75	0.70
10-year	-0.11	0.08	0.09	0.05	-0.09	-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