The Yield Curve

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The Federal Reserve is in a delicate situation

HIGHLIGHTS

- After going from around 1.60% in early May to nearly 2.75% at the start of July, the U.S. 10-year yield stabilized at around 2.60% this summer. However, investor nervousness notched up in mid-August.
- For the Fed, the decision to cut back on the US$85B per month that goes to purchasing mortgage-backed securities and Treasuries seems hard to make. The U.S. economy is not sending any clear signals, making the Fed's decision more complex.
- Failing highly disappointing economic data in the coming weeks, we continue to think the Fed will choose to taper off its bond purchases this fall.
- We are raising our bond yield forecast to reflect investors' currently less favourable sentiment toward this asset class.

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Editorial

After going from around 1.60% in early May to nearly 2.75% at the start of July, the U.S. 10-year yield stabilized at around 2.60% this summer as Federal Reserve (Fed) leaders reiterated that their monetary policy would remain highly accommodative for an extended period, even if they were to decide to start tapering their bond purchases. The Fed's reassuring message helped take the U.S. stock market to a new peak.

However, investor nervousness notched up in mid-August, when encouraging global economic data prompted another rise in bond yields. With the U.S. 10-year yield at 2.90% and a cut to the Fed's securities purchases increasingly expected for the fall, major doubts emerged about the markets' ability to maintain momentum. After that, a few disappointing figures from the United States, fears of another political crisis there, and signs that a strike was imminent in Syria made investors even more nervous and took the 10-year yield back to around 2.75% (graph 1).

Graph 1 – Following July's lull, market worries have recently made a strong comeback

Sources: Datastream and Desjardins, Economic Studies

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Note to readers: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

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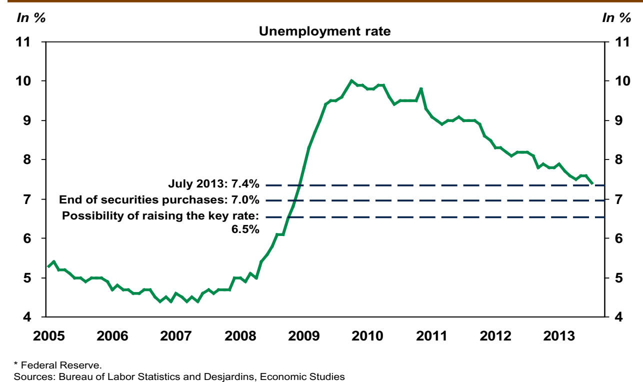
FED LEADERS KEEP THE SUSPENSE FOR THE SEPTEMBER MEETING

The U.S. economy is not sending any clear signals, making the Fed's decision regarding the opportunity to announce a cut to securities purchases as early as the September 18 meeting more complex. Some encouraging figures were released this summer, particularly July's surge of the ISM indexes; however, other statistics indicate that rising interest rates are starting to have negative impacts. The jobless rate continued to slide, closing in on the thresholds the Fed has previously cited for winding up security purchases and starting to contemplate key rate increases (graph 2). However, we have doubts about how useful the jobless rate is as a signal of changes to monetary policy[1].

Graph 2 – The U.S. jobless rate is still on the decline, which will make things more complex for the Fed's* communications



* Federal Reserve.
Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

THE FED HAS TWO OPTIONS

On September 18, Fed leaders could opt to maintain the current pace of security purchases for a few more months and wait to have a clearer picture of the outlook for the U.S. economy. The financial markets, particularly the stock markets, could initially be quite pleased with this decision. However, these gains could be short-lived, as uncertainty about future monetary policy would remain very elevated. Moreover, hawkish Fed leaders could oppose the decision, and it could become difficult for the Fed to credibly signal future monetary policy movement.

The Fed's other option would be to announce a cut to security purchases, while once again stressing that monetary policy will remain highly accommodative for several quarters. To limit the negative impact of this news on the markets, the Fed could use several strategies. It could announce a modest cut to its purchases, for example, going from US$85B of securities purchases a month to US$75B. It could also simultaneously announce it is lowering its jobless rate threshold for contemplating a key rate increase, to 6.0%, for example. It could also announce that purchases will only be tapered as of November or December, rather than in October.

MUCH ADO ABOUT NOTHING?

It is somewhat disconcerting to consider that the Fed's September 18 decision could have a major short-term impact on financial markets worldwide. Logically, the fact that the Fed is buying a few billion dollars less in securities per month shouldn't change much. This amount is absolutely marginal for financial markets; previously, a much more abrupt winding up of other quantitative purchase programs did not send major shock waves into the financial markets. The Fed's own research shows that the quantitative purchasing programs have a limited total impact.[2] Over the mid- and long-term, bond market movements should primarily reflect the outlooks for growth and inflation as well as anticipated key rate movements.

NO CLEAR TREND FOR BOND YIELDS

Failing highly disappointing economic data in the coming weeks, we continue to think the Fed will choose to taper off its bond purchases this fall. The numerous risks (debt ceiling, conflict in the Middle East), ongoing doubt as to whether U.S. growth will accelerate, and a clear signal that, in advanced economies, key rates will stay at their floors for some time should limit the impact on the bond market, however. The U.S. 10-year yield should therefore oscillate in a range of 2.50% to 3.00% for a few quarters, but further highly volatile episodes can be expected.

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[1] Desjardins, Economic Studies, *Economic Viewpoint*, "Tying monetary policy to unemployment: Is the game worth the candle?", August 14, 2013, www.desjardins.com/en/a_propos/etudes_economiques/actualites/point_vue_economique/pv130814.pdf.

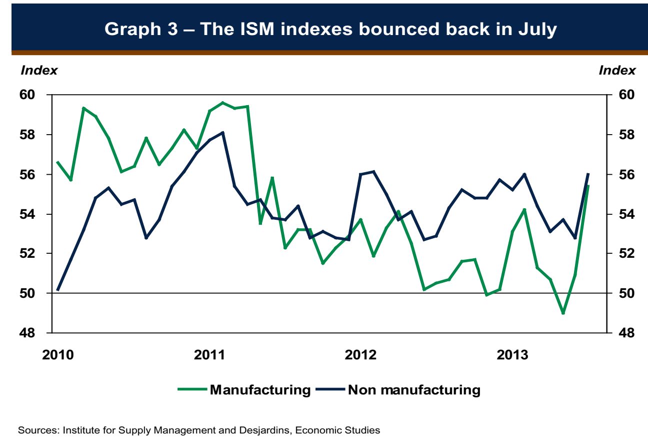
[2] FRBSF Economic Letter, *How Stimulatory Are Large-Scale Asset Purchases?*, August 12, 2013.

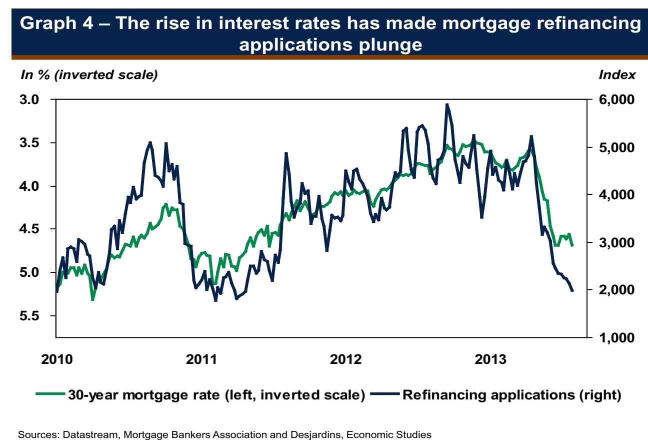
FEDERAL RESERVE

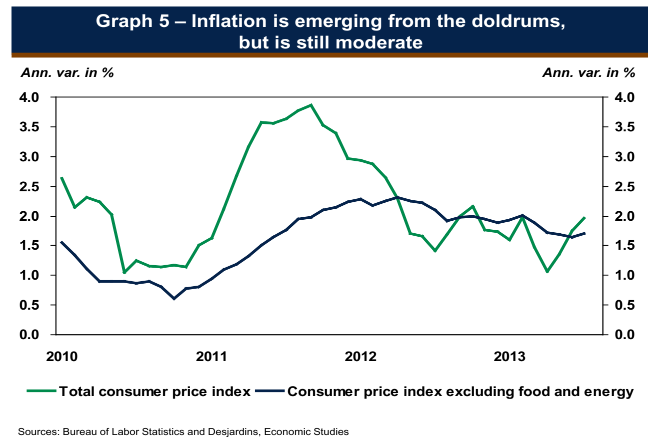
Tapering securities purchases: still vague

- For Ben Bernanke and his colleagues, the decision to cut back on the US$85B per month that goes to purchasing mortgage-backed securities and Treasuries seems hard to make. Some leaders are thoroughly entrenched in their positions. The minutes of recent meetings reveal the concerns the program is raising for the monetary policy committee's most hawkish members. Other leaders think the job market is still too weak and inflation too low to consider easing back on the current monetary accommodation. Most committee members appear to be somewhere in between and their stance depends on how the economic situation develops.
- Unfortunately, the indicators are not providing a very clear picture of the situation. The last few weeks have delivered some nice surprises, such as the rebound by the ISM indexes (graph 3) and stronger than anticipated surge by real GDP in the second quarter. There were also some disappointments: job creation is still relatively weak, new durable goods orders plunged in July, and consumer confidence is flat after improving for several months. The financial situation is also complicating matters. By taking retail interest rates along in their wake, the rise in bond yields is prompting a firming of monetary conditions, which could rein in the housing market's momentum. The rise in mortgage rates prompted a tumble by refinancing applications (graph 4) and seems to have triggered a pullback in new home sales. For now, the resale market is holding up.
- The inflation situation does not argue for major monetary policy changes. The annual changes in the consumer price index and consumption expenditure deflator are no longer as low as they were at the end of spring; however, they are not showing signs of accelerating, either (graph 5).
- Under the circumstances, should Federal Reserve (Fed) leaders stay on track with the unofficial schedule Ben Bernanke put out in June, or should they wait a little longer? The onset of new fiscal deadlines in Washington (expenditure budget at the end of September and debt ceiling in mid-October) is complicating the issue, not to mention the cloudiness around Ben Bernanke's successor at the Fed's helm.

Forecasts: Our core scenario still calls for the Fed to announce a cut to purchases at the meeting that ends on September 18. The drop could, however, be smaller than initially anticipated. There is also a strong chance that the Fed will wait for subsequent meetings (end of October or mid-December) to go into action. As for key rates, no increase is anticipated prior to mid-2015.







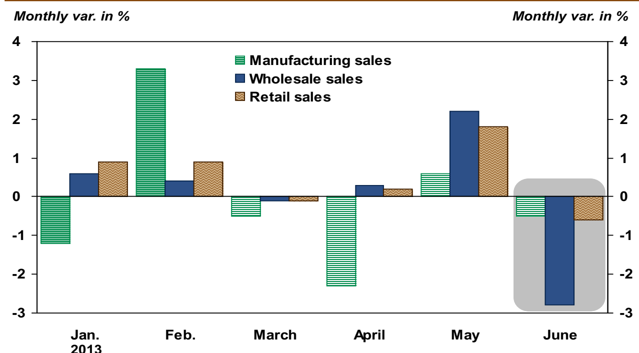
BANK OF CANADA

The outlook is the same, despite greater blips

- Canada's economy has undergone several blips in the last few weeks with flooding in Alberta and the strike by construction workers in Quebec. Ontario has also seen its share of problems due to disappointing performance by the auto industry. All in all, most economic indicators dropped sharply in June and, accordingly, economic growth slowed substantially in the second quarter (graph 6).
- With things slowly getting back to normal in Alberta and the strike ending in Quebec, Canada's economy should rebound in the second half of 2013. Despite greater volatility in the quarterly variations, our outlook for Canadian real GDP growth for 2013 as a whole remains the same. For 2014, the outlook is also unchanged and growth is forecast to accelerate. Among other things, Canada's international trade will increasingly get a boost from improving global demand, particularly from the United States.
- A bit of relief in July: home resales advanced by only 0.2% (graph 7). Note that resales had increased by an average of 2.6% per month since last March. Clearly, one month does not constitute a trend and it is much too early to declare a victory. This means that the worries about an overheating housing market are still very much with us, for now. The Bank of Canada (BoC) should keep a close eye on the situation, especially as the average price for existing properties has started to rise again.
- The output gap could close as of mid-2015, an outlook similar to the BoC's forecasts in July's *Monetary Policy Report*. Until then, price pressures will stay quite weak.
- The total annual inflation rate went from 1.2% in June to 1.3% in July. Clearly, the weak Canadian price growth we have been seeing since mid-2012 is persisting. Based on our latest projections, inflation might not start a stronger comeback before spring of 2014, returning to the mid-point target (2%) only in 2015 (graph 8).

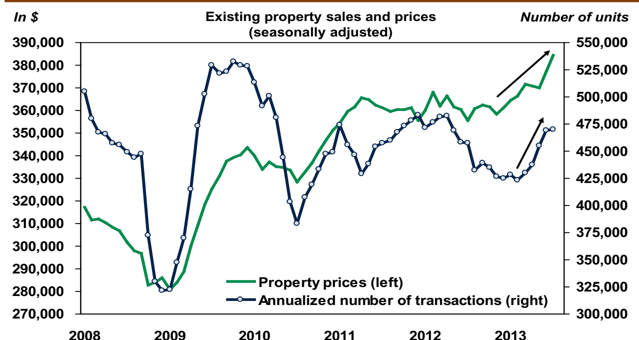
Forecasts: Weak inflation is giving the BoC a lot of leeway in conducting its monetary policy. Thus, our scenario is still the same: we will likely have to wait until fall 2014 before Canadian key interest rates go up. However, this will not keep monetary authorities from continuing to reiterate warnings about an eventual interest rate hike.

Graph 6 – Many Canadian economic indicators ran into trouble in June



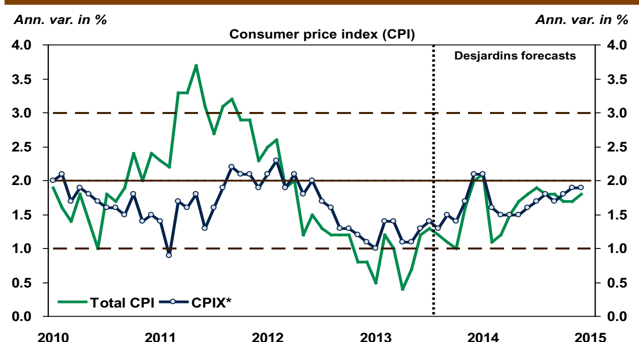
Sources: Statistics Canada and Desjardins, Economic Studies

Graph 7 – Although sales crested in July, the situation in Canada's real estate market remains a concern



Sources: Canadian Real Estate Association and Desjardins, Economic Studies

Graph 8 – Inflation will remain subdued for several more months in Canada



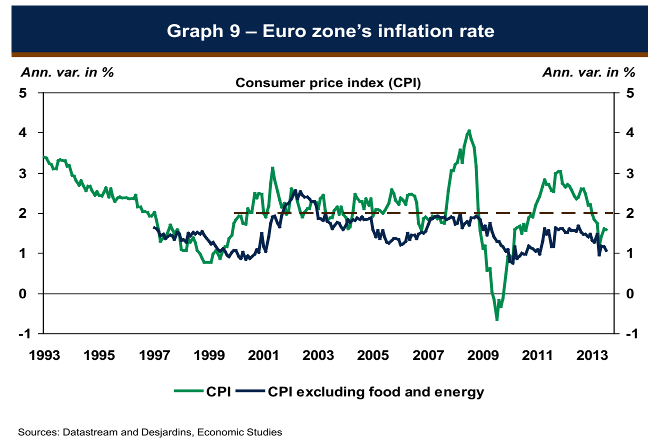
* Bank of Canada's core index.
Sources: Statistics Canada and Desjardins, Economic Studies

OVERSEAS CENTRAL BANK

The European situation improves

EUROPEAN CENTRAL BANK (ECB)

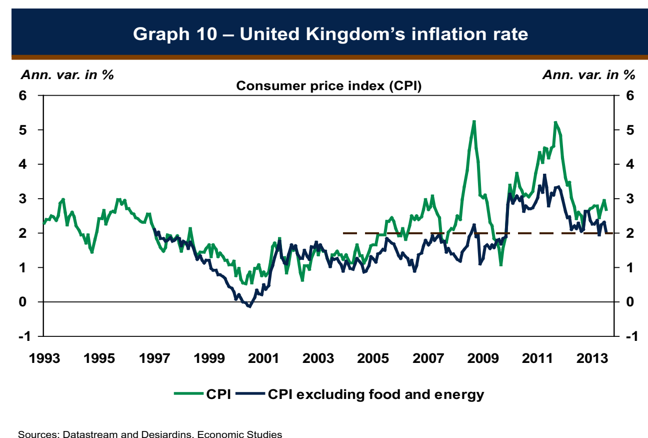
- The ECB made few changes to its monetary policy statement in early August. It pointed to some encouraging signs for the economy, while maintaining a cautious outlook for the future. The tone's statement could be a little brighter in September, given the publication of further encouraging data and the end of the euro zone recession. The ECB should nevertheless continue to see several downside risks to its scenario.
- The improved economic numbers make an upcoming key interest rate cut less likely. Already, since early August, ECB leaders no longer seem to be considering this possibility. They are primarily focused on their forward guidance that interest rates will remain at least at this level for a long time. The guidance is conditional on the inflation target being met over the medium term. Mario Draghi does not seem to want to tie the future path of interest rates to a particular economic variable, as other central banks have done.



Graph 9 – Euro zone's inflation rate

BANK OF ENGLAND (BoE)

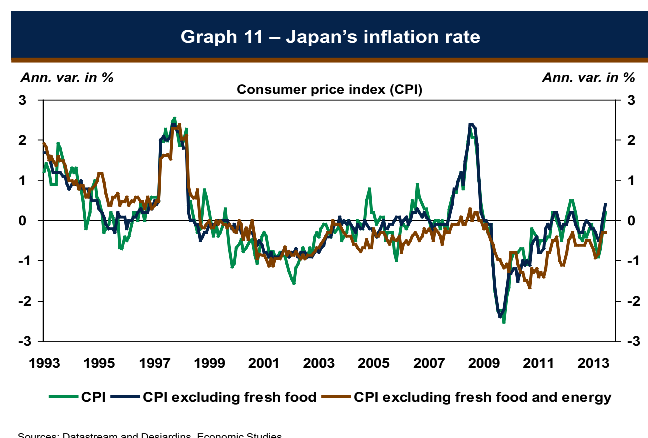
- The BoE had opened the door to using forward guidance last July, and made it official on August 7. The BoE has therefore pledged not to increase its primary key rate until the jobless rate has dropped below the 7% mark. This commitment is, however, conditional on forecasted inflation, which must not exceed 2.5% over a two-year horizon. In a context in which inflation has been above its target for several years now and the economy is looking up, the BoE's options are increasingly limited. The likelihood that it will once again resort to its securities purchasing policy seems even more remote. As for the future, keep an eye on what the jobless rate and inflation outlook do.



Graph 10 – United Kingdom's inflation rate

BANK OF JAPAN (BoJ)

- The BoJ is maintaining asset purchases at a pace of ¥60 000B - ¥70 000B per year (US$600B to US$700B) to get inflation up to 2%. Total inflation recently came back into positive territory but, except for movement by fresh food and energy, the variation in prices remains negative. A lot remains to be done to reach the target. Moreover, economic growth was weaker than forecast in the second quarter, raising some doubts about how effective BoJ policy is, as well as about yen depreciation. It will take one or two quarters before we can draw up a fuller picture of the progress made and assess whether it would be useful for the BoJ to expand its interventions.



Graph 11 – Japan's inflation rate

BOND MARKET

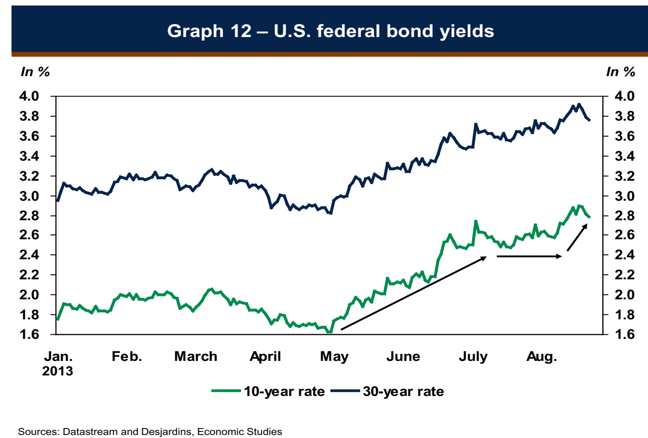
Upcoming changes at the Federal Reserve will keep bondholders nervous

U.S. FEDERAL BONDS

- After the U.S. 10-year bond yield climbed about 115 basis points following Federal Reserve (Fed) Chair Ben Bernanke's first tapering signal in May, the yield settled into a more stable range of 2.50% to 2.75% between early July and mid-August. However, the last few weeks have attested to further upward momentum, with the yield reaching to as much as 2.93% on August 22 before beating a slight retreat thereafter (graph 12).
- While the first upswing episode was largely justified by the normalization of real rates from the perspective of a decrease in the U.S. central bank's support for the bond asset class, motivations behind the second episode are less clear. The minutes of the Fed meeting that ended August 1 did show that nearly all monetary policy committee members agreed to contemplating the onset of tapering by year's end, but this element of information was not much of a surprise. Neither can it be said that economic indicators provide arguments in favour of a much more hawkish stance by the Fed (graph 13). Among other things, mortgage applications dropped, raising fears that the rise by mortgage rates would hurt the real estate market (graph 14). Not surprising that the mid-August's rise in yields was partially reversed after soft housing indicators surfaced.
- That being said, some of the upside adjustment to the term premium seen this summer seems to reflect greater uncertainty about how the easing measures will be withdrawn. This is particularly true as the face of the monetary policy committee will change substantially in January 2014, with a new chair highly likely and some of the more hawkish committee members obtaining the right to a vote. In a context in which the Fed has had some trouble communicating effectively this year, these changes could keep bondholders anxious, which would maintain upside pressure on the term premium. Hence, taking a broader perspective, yields should keep moving up.

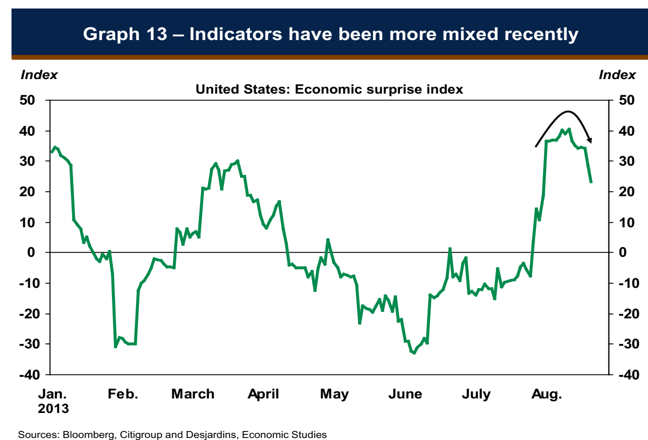
Forecasts: We are raising our bond yield forecast to reflect investors' currently less favourable sentiment toward this asset class. While disappointing economic numbers or stronger fiscal strains could prompt short downside movements in yields, the Fed will likely stay the course on tapering its purchases (even if very incrementally), a factor that should play against bonds. The 10-year yield should end the year at 2.85%.

Graph 12 – U.S. federal bond yields



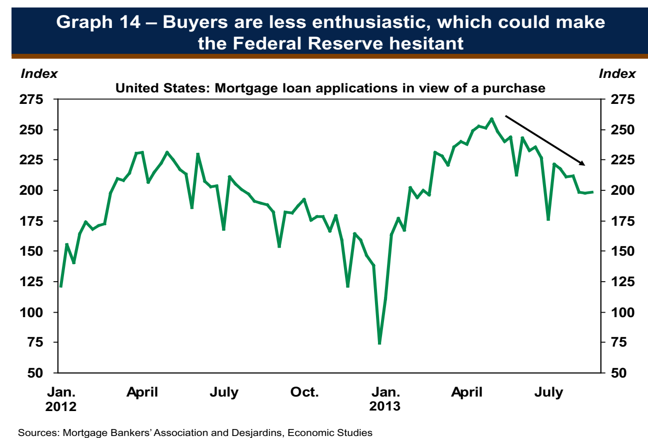
Sources: Datastream and Desjardins, Economic Studies

Graph 13 – Indicators have been more mixed recently



Sources: Bloomberg, Citigroup and Desjardins, Economic Studies

Graph 14 – Buyers are less enthusiastic, which could make the Federal Reserve hesitant



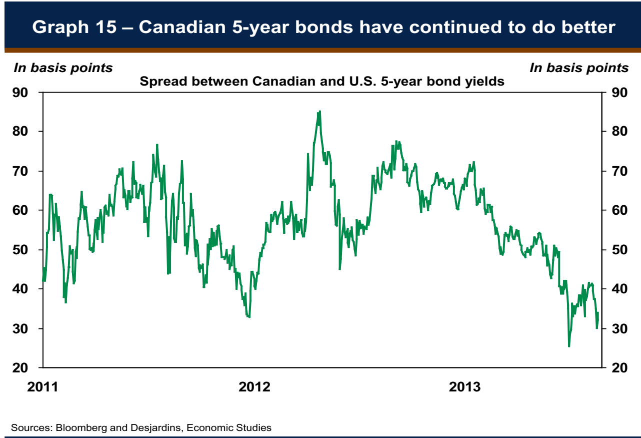
Sources: Mortgage Bankers' Association and Desjardins, Economic Studies

CANADIAN FEDERAL BONDS

- After hitting -19 basis points in early June, the spread between the Canadian 10-year bond yield and its U.S. counterpart narrowed somewhat, without returning to where it was prior to the Fed's first signal of tapering. The strong performance of Canadian bonds is especially striking in the five-year term (graph 15). After hitting a low that dates back more than three years in early July, the Canada–United States spread widened briefly in mid-August, only to tumble after that. Note that the U.S. 5-year yield has been subject to heavy upside pressure, as the real component for this term closed in on positive territory. The idea that the policy rate normalization process, once begun, will likely be more aggressive in the United States than Canada (graph 16), also seems to be helping keep some downside pressure on the spread.
- Aside from these trends, which largely stem from movements in U.S. markets (and in turn from the play of expectations about Fed policy), the Canadian bond market seems rather stable. Since new Governor Stephen Poloz took the stage, the domestic macroeconomic backdrop has highlighted some vulnerable points (particularly due to one-off factors that arose at the end of the second quarter), along with persistently weak inflation, although housing market dynamics continue to argue in favour of vigilance from the central bank. These factors continue to play in favour of the status quo and, as a result, the overall situation has not changed decisively enough since last spring to prompt investors to modify their views of how Canadian monetary policy will evolve.
- At the provincial level, one of the major themes recently was Quebec bonds' outperformance compared to Ontario bonds (graph 17). While the economies of Canada's two largest provinces are currently experiencing difficulties of their own, the underperformance of Ontario bonds reflects persisting concern about the province's public finances. While Quebec's government expects to eliminate the deficit this fiscal year, Ontario's government is still grappling with one of the country's biggest deficits, relatively speaking, and it will be a long while before it is wiped out. Ontario is also one of the provinces that is the least advanced in terms of financing the deficit for this fiscal year, with completed borrowing representing less than half of estimated needs at August 26. A year end busy with Ontario bond issues could continue to hurt this province's bonds compared with that of others.

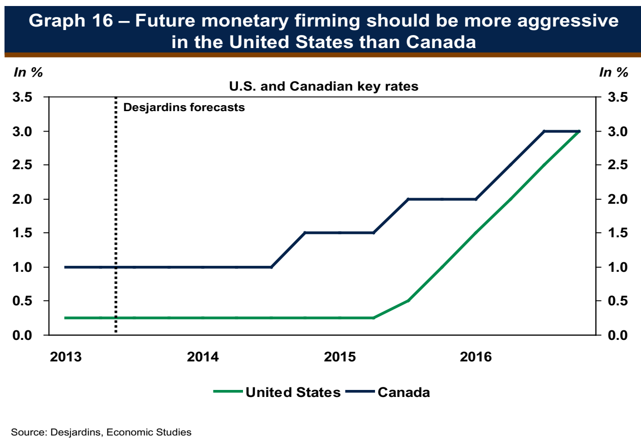
Forecasts: While Canadian long-term bonds could continue to do well against U.S. bonds, our yield forecast is still being adjusted upward to reflect the uptrend. The 10-year yield should reach 2.70% at the end of 2013.

Graph 15 – Canadian 5-year bonds have continued to do better



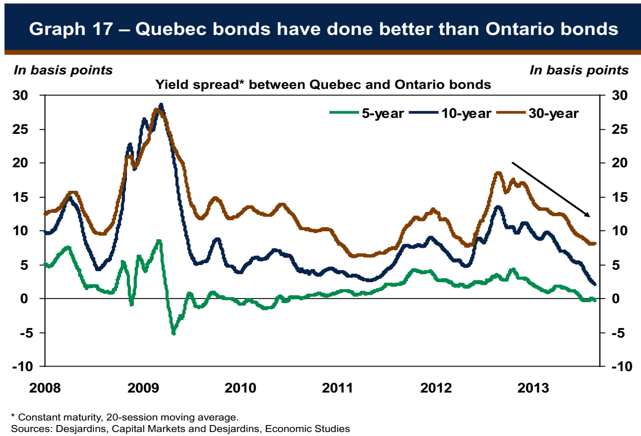
Sources: Bloomberg and Desjardins, Economic Studies

Graph 16 – Future monetary firming should be more aggressive in the United States than Canada



Source: Desjardins, Economic Studies

Graph 17 – Quebec bonds have done better than Ontario bonds



* Constant maturity, 20-session moving average.
Sources: Desjardins, Capital Markets and Desjardins, Economic Studies

Table 1
Key interest rates

End of period in %	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2	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*
May 2013			
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
July 2013			
2	Reserve Bank of Australia	s.q.	2.75
3	Bank of Sweden	s.q.	1.00
4	European Central Bank	s.q.	0.50
4	Bank of England	s.q.	0.50
10	Bank of Brazil	+50 b.p.	8.50
11	Bank of Japan	s.q.	0.10
12	Bank of Mexico	s.q.	4.00
17	Bank of Canada	s.q.	1.00
24	Reserve Bank of New Zealand	s.q.	2.50
31	Federal Reserve	s.q.	0,00 / 0,25
August 2013			
1	European Central Bank	s.q.	0.50
1	Bank of England	s.q.	0.50
6	Reserve Bank of Australia	-25 b.p.	2.50
8	Bank of Japan	s.q.	0.10
28	Bank of Brazil	+50 b.p.	9.00

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

Table 3
Coming soon

Date	*Central Bank*
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
October 2013	
1	Reserve Bank of Australia
2	European Central Bank
4	Bank of Japan
9	Bank of Brazil
10	Bank of England
23	Bank of Canada
24	Bank of Norway
24	Bank of Sweden
25	Bank of Mexico
30	Reserve Bank of New Zealand
30	Federal Reserve
31	Bank of Japan
November 2013	
4	Reserve Bank of Australia
7	European Central Bank
7	Bank of England
21	Bank of Japan

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 Q2	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	0.04	0.05	0.10	0.15	0.20	0.20	0.25
Federal bonds												
2-year	0.35	0.32	0.24	0.24	0.25	0.34	0.35	0.40	0.40	0.40	0.45	0.55
5-year	1.03	0.72	0.61	0.70	0.74	1.36	1.60	1.65	1.60	1.70	1.80	1.95
10-year	2.22	1.66	1.64	1.75	1.85	2.48	2.80	2.85	2.80	3.00	3.10	3.25
30-year	3.35	2.77	2.83	2.94	3.11	3.50	3.75	3.80	3.75	3.90	4.00	4.10
Yield curve												
5-year - 3-month	0.96	0.63	0.51	0.65	0.67	1.32	1.55	1.55	1.45	1.50	1.60	1.70
10-year - 2-year	1.87	1.34	1.40	1.51	1.60	2.14	2.45	2.45	2.40	2.60	2.65	2.70
30-year - 3-month	3.28	2.68	2.73	2.89	3.04	3.46	3.70	3.70	3.60	3.70	3.80	3.85

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 Q2	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	1.02	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	1.22	1.20	1.25	1.30	1.40	1.65	1.90
5-year	1.57	1.25	1.27	1.36	1.30	1.80	1.95	2.00	2.05	2.25	2.40	2.60
10-year	2.11	1.74	1.73	1.80	1.76	2.44	2.65	2.70	2.70	2.90	3.05	3.20
30-year	2.66	2.33	2.32	2.37	2.51	2.90	3.10	3.15	3.20	3.35	3.50	3.65
Yield curve												
5-year - 3-month	0.65	0.37	0.30	0.44	0.33	0.78	0.95	1.00	1.05	1.20	1.20	1.10
10-year - 2-year	0.91	0.71	0.66	0.66	0.76	1.22	1.45	1.45	1.40	1.50	1.40	1.30
30-year - 3-month	1.74	1.45	1.35	1.45	1.54	1.88	2.10	2.15	2.20	2.30	2.30	2.15
Spreads (Canada - U.S.)												
3-month	0.85	0.79	0.87	0.87	0.90	0.98	0.95	0.90	0.85	0.85	1.00	1.25
2-year	0.85	0.72	0.83	0.90	0.75	0.88	0.85	0.85	0.90	1.00	1.20	1.35
5-year	0.54	0.53	0.66	0.66	0.56	0.44	0.35	0.35	0.45	0.55	0.60	0.65
10-year	-0.11	0.08	0.09	0.05	-0.09	-0.04	-0.15	-0.15	-0.10	-0.10	-0.05	-0.05
30-year	-0.69	-0.44	-0.51	-0.57	-0.60	-0.60	-0.65	-0.65	-0.55	-0.55	-0.50	-0.45

f: forecasts
Sources: Datastream and Desjardins, Economic Studies