The Yield Curve

Desjardins Economic Studies
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A confused Federal Reserve means a lot of volatility on the horizon

HIGHLIGHTS

- On September 18, the Federal Reserve (Fed) caused a surprise by opting for the status quo, wanting to wait for further confirmation that the job market was continuing to make gains before starting to taper their securities purchases.
- While the Fed's communications seem confused on a number of points, it is clear that this central bank is really dovish and will be hesitant for a long time to take any action that could rein in the economy.
- With no clear signal from the Fed, any good news could trigger new speculation about the tapering of purchases. We can therefore expect heavy volatility in the financial markets over the coming months.
- The other central banks will also be very hesitant to hike their key rates in a context in which a rise in long rates is already prompting tighter financial conditions worldwide. We therefore now expect the Bank of Canada to wait until spring 2015 before firming its monetary policy.

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Editorial

The upside pressure on bond yields continued over the last few weeks, with the U.S. 10-year yield even reaching 3% for the first time in over two years on September 6. With the economic data still mixed, the primary drag on the bond market seemed to be the rising expectations that the Federal Reserve (Fed) would announce a slight cut to its securities purchases. Investors did not seem too worried about the possibility, as the stock market began to trend up again.

To general surprise, on September 18, the Fed finally opted for the status quo. Fed leaders seemed fairly satisfied with the progress that had been made since the start of the third round of quantitative easing (QE3), but they wanted to wait for further confirmation that the job market was continuing to make gains before starting to taper their securities purchases. They seemed especially worried about rapid tightening of financial conditions from rising interest rates, as well of the risk of a political impasse in Washington that could, in the near future, make the federal government grind to a halt or even prompt a temporary default on its debt.

A STEP BACK

The Fed is understandably concerned about the outlook for the U.S. economy: some statistics on the U.S. housing market weakened after mortgage rates went up (graph 1 on page 2). The Fed might thus have been justified in opting for the status quo in September while clearly indicating that it still expected to taper its purchases very shortly, for example by reiterating that it still planned to start reducing its purchases by the end of 2013, as it did in June. Ideally, this message would have been signalled to the market prior to the meeting, to avoid pointless volatility. The most surprising thing about the September 18 meeting is that rather than using this strategy, which would have allowed them to save face, Fed leaders not only opted for the status quo, but they even decided to stop indicating the horizon over which they plan to wind up QE3. The following

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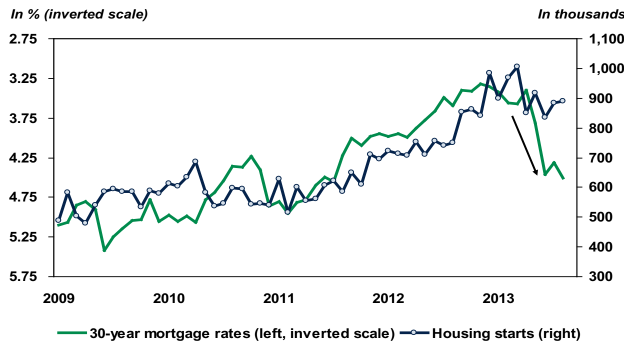
Graph 1 – Are rising mortgage rates threatening the U.S. housing sector's recovery?



Sources: Mortgage Bankers Association, U.S. Census Bureau and Desjardins, Economic Studies

remark made by Ben Bernanke at the press conference is illustrative: "we're dealing with tools that are less familiar, harder to quantify, and harder to communicate about than the traditional funds rate."

Remarks from Fed leaders since the meeting only increased the sense of confusion. While the Fed has been trying for months to convince the markets that slowing securities purchases did not constitute monetary firming, on September 20, the St. Louis Fed's James Bullard asserted that a change in the pace of purchases was equivalent to modifying key rates. The September 18 decision not to go forward with a slight cut to purchases, although investors had fully priced in that move, seems to indicate that this opinion is shared by many Fed leaders. It is also disconcerting to see a Fed leader arguing that the violent swings in the financial markets after the June and September meetings prove that quantitative monetary policy is a good monetary policy tool. We have always believed that the goal of monetary policy was to influence production and inflation over the medium term, not trigger sizable daily movements in the markets. Esther L. George (the only Fed leader to vote against the status quo) comments that the Fed was at risk of creating confusion and losing its credibility did not help reassure investors.

HOW SHOULD WE READ THIS?

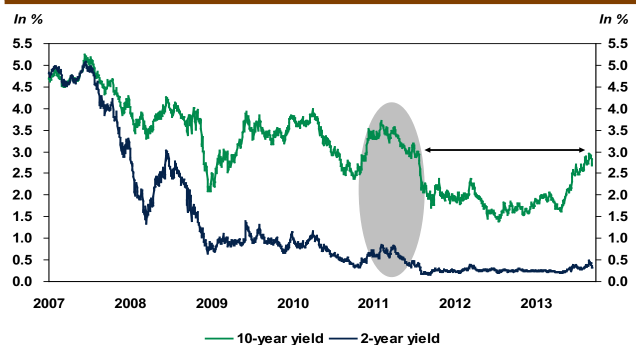
While the Fed's communications seem confused on a number of points, it is clear that the central bank is really dovish and will be hesitant for a long time to take any action that could rein in the economy. In this context, we are even more convinced that it will wait until at least the second half of 2015 before raising its key rate. Despite this, the Fed's statement stresses that it could opt to taper QE3 in the coming months. From the perspective that U.S. politicians will eventually reach an agreement in order to stave off the worst-case scenarios, the most likely option now seems to be tapering securities purchases as of January 2014 and continuing to wind down over the course of a year.

The other central banks will also be very hesitant to hike their key rates in a context in which a rise in long rates is already prompting tighter financial conditions worldwide. We therefore now expect the Bank of Canada to wait until spring 2015 before firming its monetary policy. Recent remarks from Stephen Poloz that Canada's economy could accelerate without generating inflationary pressure support our new forecast.

THE FED DOES NOT CONTROL LONG YIELDS, BUT IT CAN CREATE VOLATILITY

Despite a surprising and highly dovish decision from the Fed, the U.S. 10-year yield remained at around 2.65%, well above where it was last spring and even above the yields that were prevailing before QE3 was initiated. With no clear signal from the Fed, any good news could trigger new speculation about the tapering of purchases. We can therefore expect heavy volatility in the financial markets over the coming months, similar to what occurred at the end of last spring. Beyond the volatility, we are still anticipating modest bond yield increases in the coming quarters, as investor appetite for fixed-income securities has clearly waned. Persisting very low key rate limits the potential for increase, however, in a context in which the yield curve is already very steep (graph 2).

Graph 2 – The U.S. 10-year yield should not go much higher before shorter-term yields increase



Sources: Datastream and Desjardins, Economic Studies

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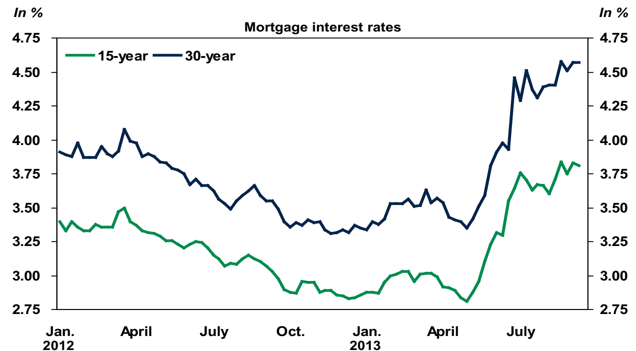
FEDERAL RESERVE

Tapering deferred

- The Federal Reserve (Fed) caused some uproar in the markets when it decided to opt for the status quo at the meeting that ended on September 18. Markets were largely betting on seeing a start to that notorious tapering—a gradual decrease in the Fed's bonds securities purchases. Instead, the Fed will leave more substantial monetary stimulus in place.
- Several factors prompted this caution. Firstly, the employment situation remains disappointing. August's creation of 169,000 jobs was not so bad, but it followed weaker figures, while the drop by the jobless rate to 7.3% stems more from a pullback by the labour force than acceleration by the job market. Secondly, market interest rates, on the rise since spring, are raising some concerns—they act as monetary firming—and long-term mortgage rates are up more than 100 basis points (graph 3). Thirdly, some housing market indicators suggest that the sector's recovery is struggling (graph 4). Fourthly, we are seeing some renewed political uncertainty surrounding the federal government's budget situation. If the political impasse is not resolved, household, business and investor confidence could be sorely undermined. Fifthly, inflation is showing few signs of strength, and the variations of the main price indexes remain well below Fed objectives.
- All of these factors also pushed Fed leaders to downgrade some of their economic forecasts. The Fed now expects real GDP to post annual growth of between 2.0% and 2.3% in the fourth quarter of 2013 (graph 5), which is less than the 2.3% to 2.6% range predicted in early June. The real GDP growth forecast for 2014 has also been trimmed.
- In June, Ben Bernanke stated that "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 horizon can still hold up, although the current lack of clarity about the economy should not have dissipated enough to expect a different announcement at the October meeting. For interest rates, the horizon for a first rate hike (estimated using the median forecast of Fed leaders) has not changed and points to three 0.25 rate increases in 2015.

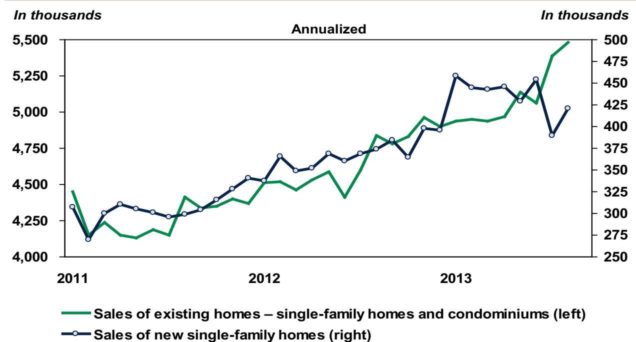
Forecasts: The Fed should announce some tapering of its purchases at its December meeting. The decrease should be timid, focusing on Treasuries securities instead of mortgage securities. The security purchasing program should wind up in late 2014. As for key rates, no increase is anticipated prior to September 2015.

Graph 3 – The Federal Reserve views the recent rates increases as a risk



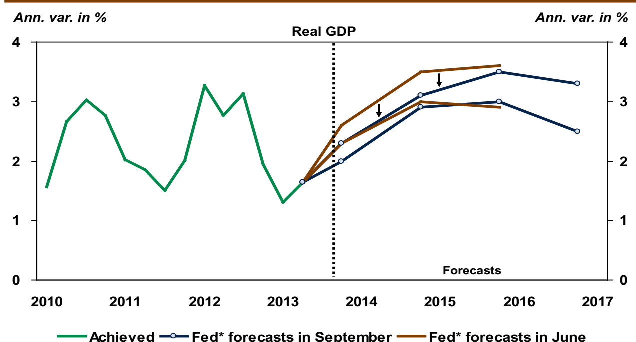
Sources: Mortgage Bankers Association and Desjardins, Economic Studies

Graph 4 – Progress by housing market indicators is rather mixed



Sources: National Association of Realtors, U.S. Census Bureau and Desjardins, Economic Studies

Graph 5 – The Fed's* growth forecasts were downgraded



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

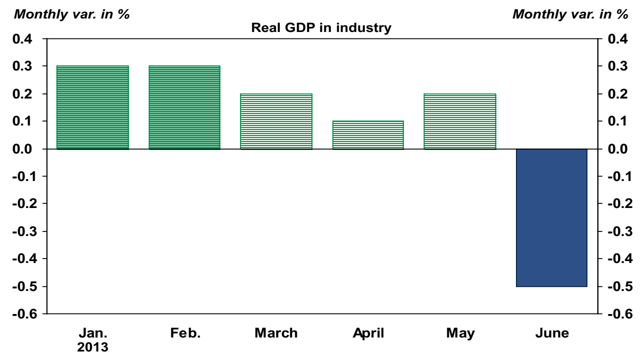
BANK OF CANADA

Key rate increases will be slower to come

- As forecast, the negative effects of Alberta's floods last spring and the Quebec construction workers' strike hurt the economy. Real GDP therefore grew by just 1.7% (quarterly annualized) in the second quarter of 2013 (graph 6).
- However, the recent advance by economic indicators confirms that production bounced back in July, with most activities getting back to normal. Among other things, manufacturing sales rose 1.7% that month, while wholesale sales increased 1.5% and building permits jumped 20.7%.
- Growth is therefore forecast to accelerate in the third quarter. However, factoring in the downside revision to the results for Q1, we have trimmed our forecast for Canadian real GDP growth 2013 as a whole to 1.7% from 1.8%. The growth forecast for 2014 has also been lowered, from 2.5% to 2.4%.
- These changes mean it will take slightly longer for Canada to reach full capacity. As a result, the output gap may only close in 2016 rather than mid-2015, as previously forecast (graph 7). Bank of Canada (BoC) Governor Stephen Poloz also stated in a recent speech that "as global demand improves and investment growth strengthens, we should see higher potential output growth." If the Canadian economy's growth potential eventually accelerates, as the BoC seems to think it will, it could take longer to achieve full capacity as the path there would be longer.
- Inflation is still very low in Canada. The total consumer price index (CPI) barely budged in August, with the annual variation going from 1.3% to 1.1% (graph 8). Three provinces are even showing inflation that is below the bottom of the BoC's target range: New Brunswick (0.9%), Quebec (0.8%) and British Columbia (-0.1%). The core index's (CPIX) annual variation also edged down to 1.3% from July's 1.4%. As the output gap will persist for several more quarters, inflationary pressures will likely remain very low in Canada.

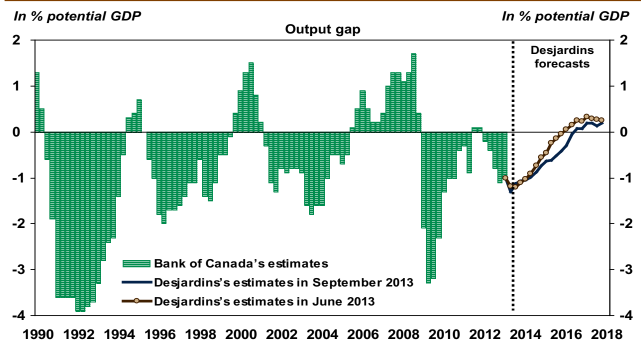
Forecasts: The later return to full capacity, combined with very weak pressures on inflation, calls for an adjustment to the forecast for Canada's key interest rate increases. While the first increase was initially forecast for the end of 2014, the target for the overnight rate could remain at 1.00% until the spring of 2015.

Graph 6 – Canadian output experienced some difficulties in June



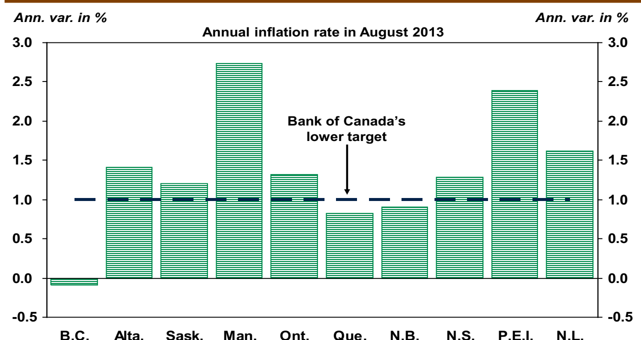
Sources: Statistics Canada and Desjardins, Economic Studies

Graph 7 – Canada's economy could reach its full capacity later



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

Graph 8 – Inflation remains very low in Canada



Sources: Statistics Canada and Desjardins, Economic Studies

OVERSEAS CENTRAL BANK

Will these good economic figures continue?

EUROPEAN CENTRAL BANK (ECB)

- The faster-than-expected improvement by Euroland's economy has reduced the chances that the ECB will lower its key rates again. However, we must not assume that all of the euro zone's problems have been solved. Several countries' public finances remain in worrying situations. Among other things, Greece may need a third bailout plan. European financial institutions also remain fragile, and it is taking a long time to concretize the banking union. The re-election of Angela Merkel, a pro-euro leader, was good news, but it remains to be seen if that will really accelerate progress in the major European issues. In the meantime, the ECB remains cautious, indicating that its key rates will remain at or below current levels for an extended period of time.

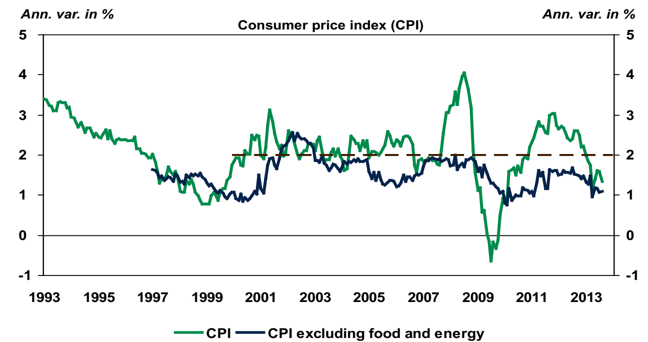
BANK OF ENGLAND (BoE)

- The BoE affirmed that it will not consider raising its key rate before the unemployment rate reaches 7%. This commitment remains conditional on inflation below 2.5% over an 18- to 24-month horizon, along with well-anchored inflation expectations and long-term financial stability. Changes to the economic data are very important for future monetary policy decisions, due to the effect they may have on inflation. However, even though Britain's economy is improving a bit faster than expected, the BoE mentioned that several risks are reducing the probability of overly high inflation. Among other things, the pound's appreciation will reduce inflationary pressures in the medium term, provided it lasts. The most likely scenario for the BoE remains a long status quo, for now.

BANK OF JAPAN (BoJ)

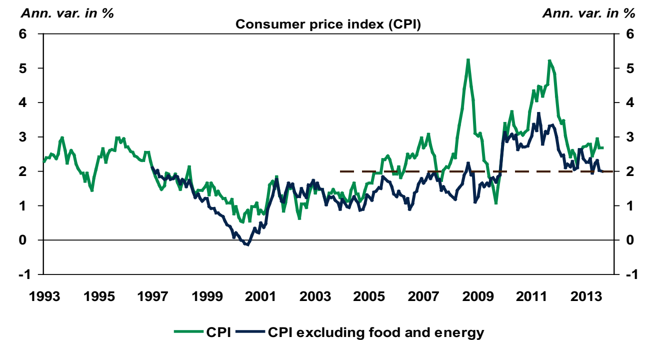
- The BoJ is maintaining its pace for assets purchases between an annual ¥60,000B and ¥70,000B. It seems to want to continue on this path until the 2% inflation target is reached. Inflation recently moved into positive territory, but progress remains slow, and the target should not be reached before the end of 2014, as initially expected. Excluding fresh food and energy, inflation is still slightly negative. Japan's economy has done well recently, but it remains vulnerable to risks from abroad that may impact exports. On the domestic level, consumption could be affected in 2014 and 2015 by a sales tax increase. These obstacles could force the BoJ to revise its monetary policy next year. Among other things, the BoJ might have to speed up its assets purchases or prolong them.

Graph 9 – The euro zone's inflation rate



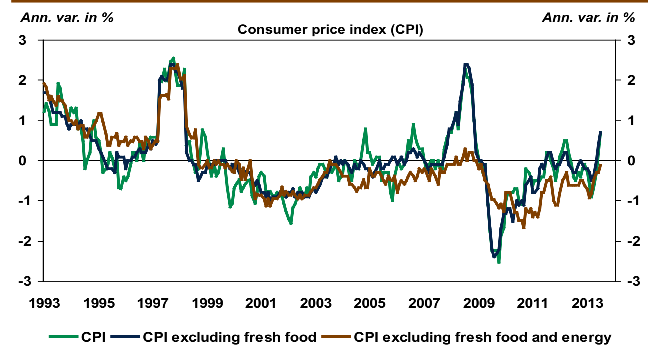
Sources: Datastream and Desjardins, Economic Studies

Graph 10 – The United Kingdom's inflation rate



Sources: Datastream and Desjardins, Economic Studies

Graph 11 – Japan's inflation rate



Sources: Datastream and Desjardins, Economic Studies

BOND MARKET

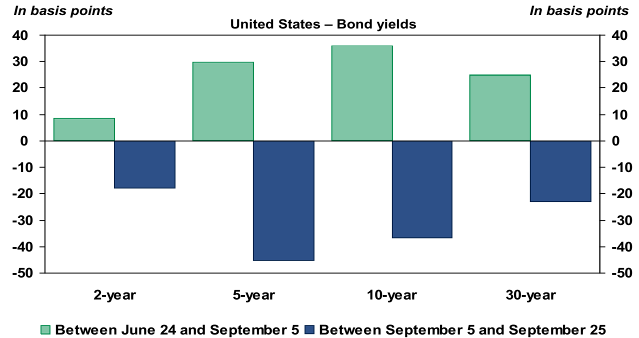
The Federal Reserve chokes the selloff

U.S. FEDERAL BONDS

- Bond yields picked up between mid-August and early September, primarily in the shorter maturities. Among others, the two-year yield, which had stayed at around 0.25% since summer 2011, began an astonishing recovery, hitting a peak of 0.52% in early September. The recent 1.85% level established by the five-year yield is a peak dating back to May 2011. Also, the 10-year yield hit 3.00% for the first time in two years. The rapidity of the selloff (the 10-year yield had been at 1.60% just four months earlier) obviously underscored the risks of a reversal as soon as an occasion presented itself.
- There was no shortage of such occasions, with disappointing job creation figures, Lawrence Summer's withdrawal from the race for Federal Reserve Chair, and lastly, the Fed's decision to leave the pace of its monthly securities purchases unchanged, to the surprise of many. Following these events, yields at the shorter end of the curve were those that fell back the most (graph 12). The two-year yield also returned to around 0.32%, close to its average held from May to July, while the Fed's dovish message showed that expectations of a first rate hike had been too premature. The readjustment of expectations following the Fed's decision (graph 13) also went in tandem with the drop in short yields.
- Two main lessons can be learned from recent events. First, over a short-term horizon, bond yields will have a much harder time going up than they did this summer, as it can be assumed the Fed will act to counter any ramp up that it deems unjustified. Second, the immediate environment will be subject to renewed volatility. The Fed clearly relies on economic indicators, but these can be revised or give out false signals, as we saw recently when jobless claims dropped substantially but the rise by employment came in below expectations (graph 14). Moreover, tensions surrounding the budgetary situation in the United States are likely to keep uncertainty elevated in October.

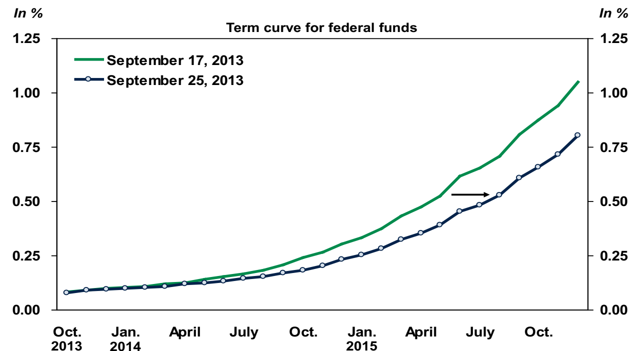
Forecasts: We expect the 10-year yield to remain in a range of 2.50% to 2.75% in upcoming weeks. With the first tapering likely to be announced at December's meeting, we still expect yields to reach 3.00% at the beginning of 2014.

Graph 12 – September's decreases were larger in the short part of the curve than the increases posted earlier this summer



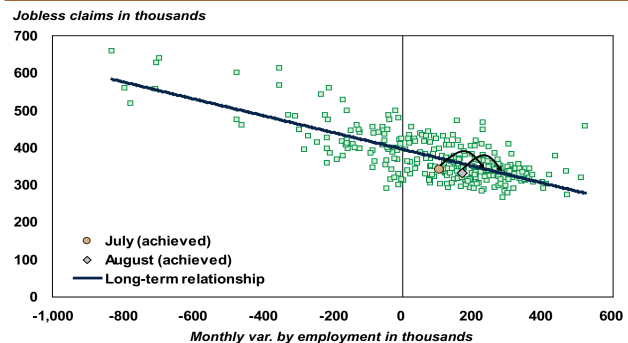
Sources: Bloomberg and Desjardins, Economic Studies

Graph 13 – Investors moderated their expectations after the Federal Reserve's decision



Sources: Bloomberg and Desjardins, Economic Studies

Graph 14 – The level of jobless claims falsely suggested higher growth by employment



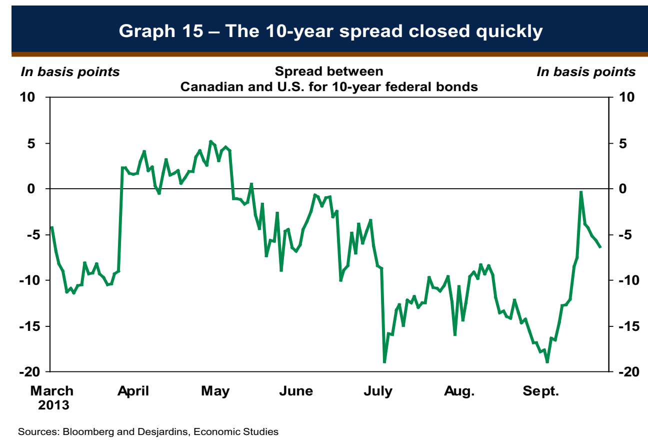
Sources: Bureau of Labor Statistics, United States Department of Labor and Desjardins, Economic Studies

CANADIAN FEDERAL BONDS

- After once again nearing -19 basis points while U.S. 10-year yields were approaching 3.00%, the spread between Canada and the United States for 10-year yields narrowed to around -5 basis points (graph 15). Investors seem to have recognized the richness of Canadian bonds compared with U.S. bonds after August's employment figures were released. While the creation of 169,000 jobs was met with disappointment in the United States, the creation of 59,200 jobs in Canada nearly tripled the consensus forecast, causing the usual spread widening in the short end of the curve (graph 16). It must also be noted that the Fed's decision to leave the pace of its monthly purchases unchanged also gave new momentum to U.S. bonds; this did not benefit Canadian bonds as much, which have generally exhibited less volatility over the summer (graph 17).
- Despite the fact that since the Fed's meeting, investors have somewhat reassessed their expectations about the next policy rate hike in Canada, anticipations for tightening around mid-2014 still seem too optimistic to us. Our most recent scenario calls for a slower narrowing of the output gap. The Bank of Canada (BoC) could also hold this opinion now, after having estimated that the gap would close in mid-2015. On one hand, in its September 4 statement, it mentioned that the gap would not start to narrow before 2014. On the other hand, in his remarks on September 18, Governor Stephen Poloz indicated that if business investment accelerated as expected, stronger growth in potential output could lead to a slower closing of the output gap and limit inflationary pressures.
- Clearly, there is no intimation of a rush to raise rates. We therefore expect the BoC to leave its monetary policy unchanged until spring 2015. Assuming that the BoC reinforces this message in its October 23 *Monetary Policy Report* the Canadian curve could gain some support. On the other hand, given that the Fed issued a serious warning that it would fight any excess tightening of financial conditions, we cannot expect longer-term Canadian bonds to perform as well (against U.S. bonds) as they did this summer.

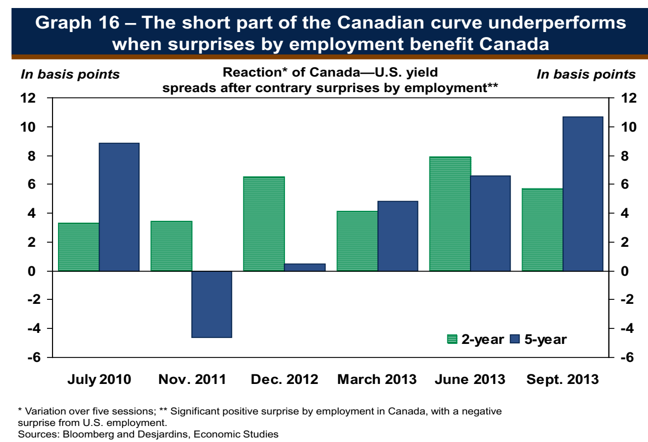
Forecasts: The Canadian 10-year yield should move around 2.55% over the coming weeks, as uncertainties about U.S. budgetary policy and the Fed's hesitation will stifle any upward momentum for some time. However, the movement should pick up around the end of the year, under the assumption of a tapering announcement.

Graph 15 – The 10-year spread closed quickly



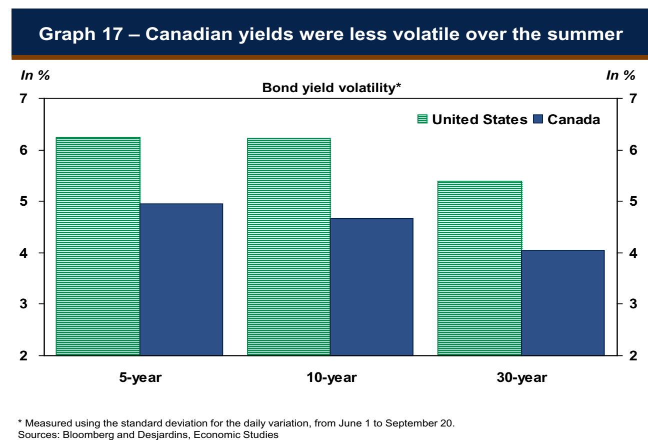
Sources: Bloomberg and Desjardins, Economic Studies

Graph 16 – The short part of the Canadian curve underperforms when surprises by employment benefit Canada



* Variation over five sessions; ** Significant positive surprise by employment in Canada, with a negative surprise from U.S. employment.
Sources: Bloomberg and Desjardins, Economic Studies

Graph 17 – Canadian yields were less volatile over the summer



* Measured using the standard deviation for the daily variation, from June 1 to September 20.
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 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	1.00
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
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
September 2013			
3	Reserve Bank of Australia	s.q.	2.50
4	Bank of Canada	s.q.	1.00
5	European Central Bank	s.q.	0.50
5	Bank of England	s.q.	0.50
5	Bank of Sweden	s.q.	1.00
5	Bank of Japan	s.q.	0.10
6	Bank of Mexico	-25 b.p.	3.75
11	Reserve Bank of New Zealand	s.q.	2.50
18	Federal Reserve	s.q.	0.00 / 0.25
19	Bank of Norway	s.q.	1.50
19	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
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
27	Bank of Brazil
December 2013	
2	Reserve Bank of Australia
4	Bank of Canada
5	European Central Bank
5	Bank of England
5	Bank of Norway
6	Bank of Mexico
11	Reserve Bank of New Zealand
12	Swiss National Bank
17	Bank of Sweden
18	Federal Reserve

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	0.05	0.10	0.15	0.20	0.25
Federal bonds												
2-year	0.35	0.32	0.24	0.24	0.25	0.34	0.35	0.40	0.45	0.60	0.80	1.00
5-year	1.03	0.72	0.61	0.70	0.74	1.36	1.45	1.60	1.80	1.90	2.05	2.25
10-year	2.22	1.66	1.64	1.75	1.85	2.48	2.65	2.90	3.00	3.10	3.20	3.40
30-year	3.35	2.77	2.83	2.94	3.11	3.50	3.70	3.80	3.85	3.90	4.00	4.15
Yield curve												
5-year - 3-month	0.96	0.63	0.51	0.65	0.67	1.32	1.40	1.55	1.70	1.75	1.85	2.00
10-year - 2-year	1.87	1.34	1.40	1.51	1.60	2.14	2.30	2.50	2.55	2.50	2.40	2.40
30-year - 3-month	3.28	2.68	2.73	2.89	3.04	3.46	3.65	3.75	3.75	3.75	3.80	3.90

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	1.00
Treasury bills												
3-month	0.92	0.88	0.97	0.92	0.97	1.02	1.00	1.00	1.00	1.00	1.00	1.00
Federal bonds												
2-year	1.20	1.03	1.07	1.14	1.00	1.22	1.20	1.25	1.30	1.40	1.55	1.75
5-year	1.57	1.25	1.27	1.36	1.30	1.80	1.90	2.05	2.20	2.30	2.45	2.65
10-year	2.11	1.74	1.73	1.80	1.76	2.44	2.60	2.80	2.90	3.00	3.10	3.30
30-year	2.66	2.33	2.32	2.37	2.51	2.90	3.10	3.20	3.25	3.35	3.50	3.65
Yield curve												
5-year - 3-month	0.65	0.37	0.30	0.44	0.33	0.78	0.90	1.05	1.20	1.30	1.45	1.65
10-year - 2-year	0.91	0.71	0.66	0.66	0.76	1.22	1.40	1.55	1.60	1.60	1.55	1.55
30-year - 3-month	1.74	1.45	1.35	1.45	1.54	1.88	2.10	2.20	2.25	2.35	2.50	2.65
Spreads (Canada - U.S.)												
3-month	0.85	0.79	0.87	0.87	0.90	0.98	0.95	0.95	0.90	0.85	0.80	0.75
2-year	0.85	0.72	0.83	0.90	0.75	0.88	0.85	0.85	0.85	0.80	0.75	0.75
5-year	0.54	0.53	0.66	0.66	0.56	0.44	0.45	0.45	0.40	0.40	0.40	0.40
10-year	-0.11	0.08	0.09	0.05	-0.09	-0.04	-0.05	-0.10	-0.10	-0.10	-0.10	-0.10
30-year	-0.69	-0.44	-0.51	-0.57	-0.60	-0.60	-0.60	-0.60	-0.60	-0.55	-0.50	-0.50

f: forecasts
Sources: Datastream and Desjardins, Economic Studies