The Yield Curve

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A respite for the bond market

HIGHLIGHTS

- The bond market has bounced back up over the last few weeks. The U.S. 10-year yield, which had reached 3.00% in early September, has therefore dropped back to around 2.50%.
- Under current circumstances, however, it is very difficult to believe the conditions will be in place for the Federal Reserve (Fed) to abandon the status quo by the end of 2013, especially after the disappointing figures on job creation recorded in September.
- The Fed should not announce any tapering to its purchases before March 2014. It should then wind down gradually until the securities purchase program ends in late 2014.
- Bond yields will end the year lower than we had previously anticipated, but they should rapidly start trending up again in the first quarter of 2014.
- The softening of the Bank of Canada stance and its inclination to further emphasize the many risks that still hinder Canada's economic outlook clearly indicate that Canadian key rates will remain stable for a rather long time to come.

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Editorial

The bond market has bounced back up over the last few weeks. After the Federal Reserve's (Fed) surprise decision on September 18 to maintain the pace of its third quantitative easing program (QE3), the U.S. political impasse was the main reason that investors returned to the bond market. The U.S. 10-year yield, which had reached 3.00% in early September, has therefore dropped back to around 2.50%.

WHAT CONSEQUENCES WILL THE SHUTDOWN HAVE?

Although it has been discussed extensively, the federal government's shutdown should not have enormous consequences for the U.S. economy. The 800,000 federal workers affected by the shutdown have now returned to work and will be paid for their days on furlough. However, it will not be possible to recoup some of the lost revenue, particularly for sub-contractors and companies that do business with the government. We estimate that this, combined with a resurgence of economic uncertainty, may lead to a 0.3% to 0.5% reduction (quarterly annualized) in real U.S. economic growth for the fourth quarter of 2013.

For the markets, the most serious consequence of the U.S. budget impasse is that it has made it more difficult to read the economic situation. Statistics for October and November will be difficult to interpret, as they may be strongly influenced by the U.S. government shutdown and return to operations. The uncertainty and weakened confidence resulting from the political impasse may also temporarily affect some economic statistics, especially since a lasting solution has not been found and the government may shut down again on January 15, 2014. In this context, it will be hard to identify the underlying trend for the U.S. economy over the coming months.

THE RETURN OF QE INFINITY?

The uncertainty surrounding the U.S. economy may have direct consequences for U.S. monetary policy. Note that Fed

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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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leaders explained their September decision to not slow their bond purchases on the basis of a need for more evidence that the U.S. economy recovery will be sustained. Some tapering of its purchases starting at the December or even October meeting was therefore quite possible if the political impasse had been resolved and encouraging economic figures had been released. Under current circumstances, however, it is very difficult to believe the conditions will be in place for the Fed to abandon the status quo by the end of 2013, especially after the disappointing figures on job creation recorded in September.

Recent events ant the fact that Janet Yellen, considered to be quite dovish, will take the helm at the Fed at the end of January 2014, could lead some to think the Fed is back in QE Infinity mode and will continue its securities purchases for several more quarters. However, many Fed leaders do not seem comfortable with the idea of QE Infinity, and we think they will want to start tapering their securities purchases at the first opportunity. The minutes of the September meeting showed that most participants still felt that it would be appropriate to begin tapering by the end of 2013, stopping purchases completely around mid-2014. The events of the last few weeks may have pushed back these deadlines somewhat, but they still indicate a desire to wind up the quantitative easing policy in a relatively short time frame.

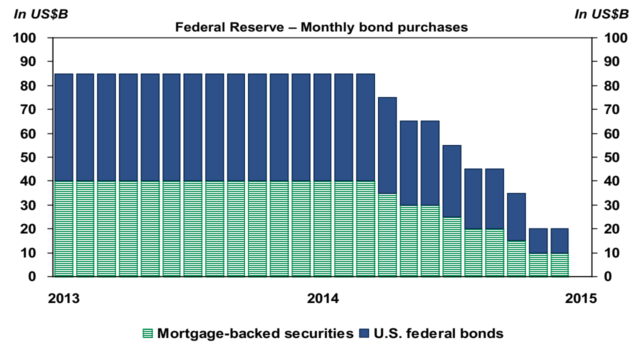
WHAT WILL SPUR THE FED INTO ACTION?

In our opinion, the Fed will begin gradually tapering its purchases as soon as a majority of voting members are confident that the U.S. economic recovery is continuing to strengthen, thus helping ensure that their objectives for the job market and inflation will be reached.

More specifically, they could wait until a political agreement is reached to avoid another federal government shutdown. They will also want to be sure that the real estate market continues to advance, as related data has been rather mixed since mortgage rates went up. Of course, they will also wait for more robust employment figures than have been seen in recent months.

In theory, all of these conditions could be in place by the Fed meeting in late January or even the December meeting. However, it seems more likely that these uncertainties will only have dissipated enough to convince the Fed to act by the March 2014 meeting. We are therefore expecting a decision in March and a gradual winding down of bond purchases between April and the end of 2014 (graph 1). The federal funds rate should remain at its floor until September 2015. In this context, bond yields will end the year lower than we had previously anticipated, but they should rapidly start

Graph 1 – The Federal Reserve should not begin to reduce its purchases until spring 2014



Source: Desjardins, Economic Studies

trending up again in the first quarter of 2014. Our medium-term targets for U.S. and Canadian bond yields are therefore unchanged.

Our scenario for the Fed assumes that the U.S. economy will accelerate substantially in 2014. If the U.S. economic recovery falters again for any reason, the Fed will either have to choose to continue its third quantitative easing program or find a new way to stimulate the economy. For now, though, we remain confident that the economy will accelerate next year, as the negative effects of government measures will be much smaller than in 2013. Furthermore, while some economic statistics have disappointed recently, other developments, including a pronounced drop by the U.S. dollar, the substantial pullback in gas prices and reductions to several interest rates after this summer's increase, will help give some momentum back to economic activity. The greenback's substantial retreat is problematic for the rest of the planet, however, and will prompt other central banks to maintain their highly stimulating monetary policies.

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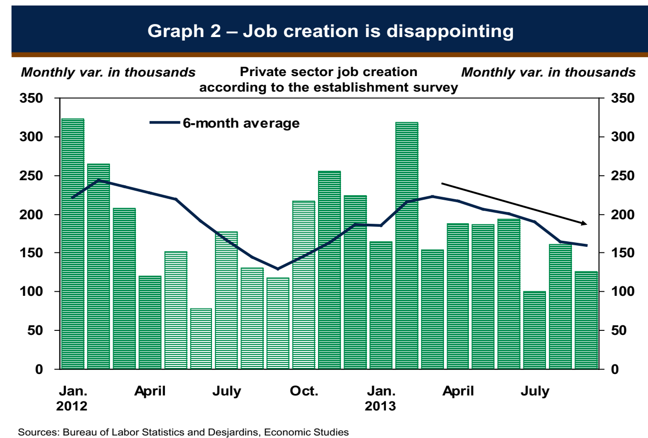
FEDERAL RESERVE

The budget impasse pushes tapering back to next year

- The Federal Reserve (Fed) caused some commotion when it decided not to change the pace of its securities purchases at its September meeting. However, the events that have occurred since have proved Fed leaders right: the situation is just not favourable to reducing monetary easing.
- The U.S. economy was already showing less convincing signs before the budget crisis. Consumer confidence crested over the summer and had dropped in September. August's retail sales came in below expectations. Even the housing market saw its recovery limited by rising interest rates. Only the ISM indexes' solid performance suggested that economic growth had improved.
- The shutdown considerably reduced the number of economic indicators published in the United States, and some figures that were originally expected in early October are now beginning to be released. This highly anticipated data includes September's employment report, whose results were disappointing. The private sector only created 126,000 jobs, whereas the average for the 12 previous months is 190,000 hires (graph 2). Excluding the improved jobless rate, the recent trend for employment is not moving in the right direction for the Fed. Note that the statement accompanying September's meeting mentioned that there would be no changes to monetary policy until "the outlook for the labor market has improved substantially". All of this is occurring in a context of weak inflation (graph 3).
- These disappointing figures should not show any notable improvements in October. On the contrary, the budget impasse probably had a harmful effect on growth. We can assume that annualized real GDP growth was trimmed by 0.3 to 0.5 percentage points in the fourth quarter. The effect on confidence may also be quite substantial. The daily index from Gallup shows an abrupt drop during the weeks of the shutdown (graph 4). It is unclear whether household and business sentiment will improve rapidly and the recent crisis will be quickly forgotten. The agreement, reached in extremis, only puts the problem off by a few months. The political debate may therefore be intense again at the start of next year, a situation that should prompt the Fed to wait for its March meeting before contemplating reducing its securities purchases.

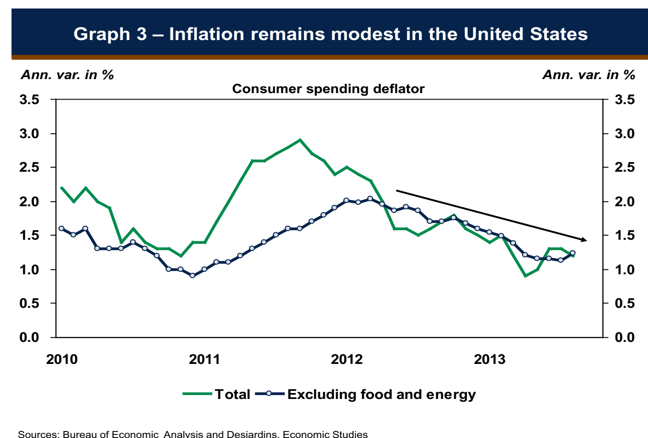
Forecasts: The Fed should not announce any tapering to its purchases before March 2014. It should then wind down gradually until the securities purchase program ends in late 2014. As for key rates, no increase is anticipated prior to September 2015.

Graph 2 – Job creation is disappointing



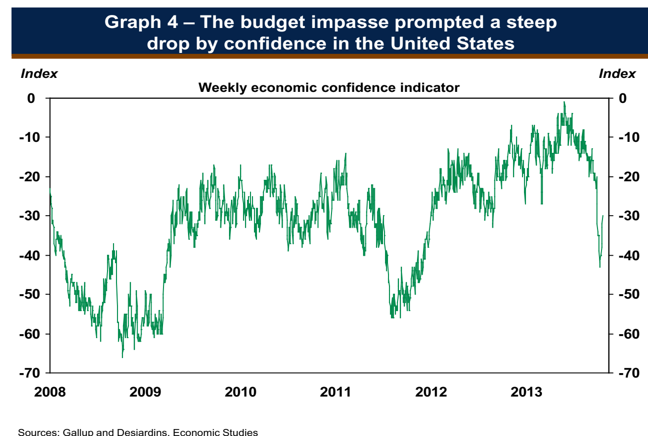
Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

Graph 3 – Inflation remains modest in the United States



Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

Graph 4 – The budget impasse prompted a steep drop by confidence in the United States



Sources: Gallup and Desjardins, Economic Studies

BANK OF CANADA

Monetary authorities are a little more worried

- The statement accompanying the Bank of Canada's (BoC) latest key rate decision, as well as its most recent *Monetary Policy Report* contain substantial softening of the monetary authorities' stance.
- Furthermore, the BoC dropped its remark on an eventual increase to Canadian key interest rates. Monetary authorities have therefore shifted into neutral, after several months of signalling an increase.
- In its *Monetary Policy Report*, the BoC also downgraded its economic forecasts, largely due to the weaker growth by exports and business non-residential investment. According to the monetary authorities, there is also a risk that the expected acceleration by these components will take even longer than forecast to materialize. The BoC is also worried about the uncertainties surrounding the real estate market, which has grown even stronger in some areas of the country, as well as by the movement by household spending. The BoC has therefore lowered its forecast for Canada's economic growth from 1.8% to 1.6% for 2013, and from 2.7% to 2.3% for 2014. This scenario is fairly close to the latest consensus forecast from the private sector (graph 5).
- Under these conditions, the BoC now expects the economy to gradually return to full capacity by the end of 2015, approximately. However, we feel that full capacity could be reached even later, around the start of 2016 (graph 6).
- Slack continues to rein in price growth in Canada. The BoC also cited increasing competitive pressures and sectoral factors (lower agricultural prices and decreased auto insurance premiums in Ontario) as elements that contributed to weaker price growth over recent months. Everything suggests that the total annual inflation rate will hold around the lower end of the range for several more quarters. A lasting return to the mid-point target is not expected before 2015, a prediction in line with the latest BoC forecast (graph 7).

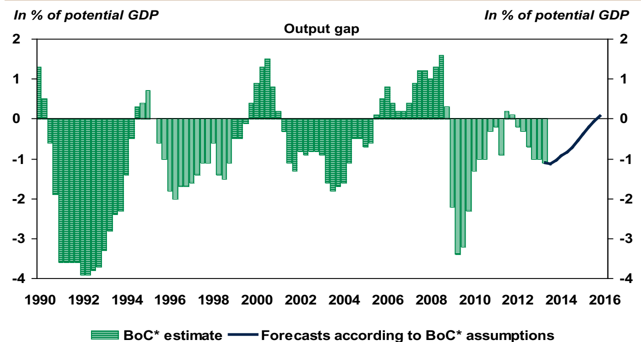
Forecasts: The softening of the monetary authorities' stance and their inclination to further emphasize the many risks that still hinder Canada's economic outlook clearly indicate that key rates will remain stable for a rather long time to come. According to our projections, conditions favourable to a first increase to Canada's key rates will not be in place until mid-2015.

Graph 5 – Contributions to average annual GDP growth according to the Bank of Canada's scenario

	2012	2013f	2014f	2015f
Consumption	1.1%	1.3%	1.3%	1.4%
Housing	0.4%	-0.1%	0.0%	0.0%
Public administration	0.3%	0.3%	0.1%	0.1%
Business investment	0.6%	0.1%	0.4%	0.8%
Exports	0.4%	0.3%	1.0%	1.5%
Imports	-1.0%	-0.4%	-0.7%	-1.2%
Inventory change	0.0%	0.1%	0.2%	0.0%
Real GDP	1.7%	1.6%	2.3%	2.6%

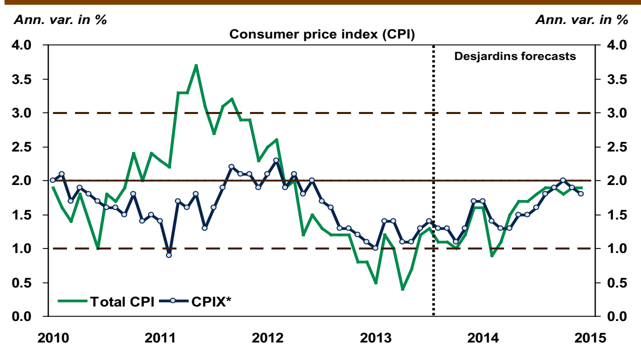
f: forecasts
Sources: Bank of Canada and Desjardins, Economic Studies

Graph 6 – Canada's economy could reach full capacity later



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

Graph 7 – Canadian inflation will remain subdued for several more months



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

OVERSEAS CENTRAL BANK

The euro's appreciation could seriously worry the European Central Bank

EUROPEAN CENTRAL BANK (ECB)

- According to the ECB, the euro zone's economic recovery remains fragile, with the balance of risks tilted to the downside. With inflation oscillating well below the 2% mark, this suggests that interest rate cuts, or other easing measures, could be necessary. The ECB is not ruling out further intervention but, for now, it is confident it will reach its inflation target in the medium term. The euro's appreciation could shake that confidence. Earlier this year, the ECB had indicated that overly steep currency appreciation could lower its inflation forecasts and prompt it to intervene. However, the ECB would probably only have to threaten action for the euro to depreciate, thereby eliminating this downside risk to inflation.
- The ECB's role as banks' single supervisor is materializing. It will soon begin its analysis of the European banking sector, which will include stress tests. The calendar has not been established, but everything should be finished for November 2014. This process will put additional pressure on already-struggling European banks, increasing the likelihood that the ECB will announce new measures in the coming quarters, including some to boost bank liquidities.

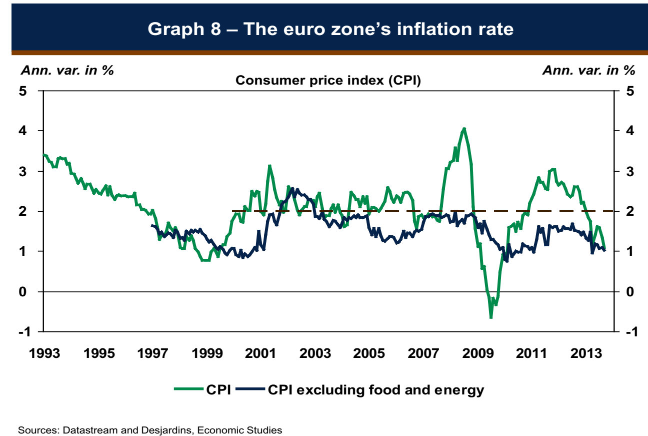
BANK OF ENGLAND (BoE)

- Economic data continues to be encouraging in the United Kingdom. The BoE does not really see any reason for further easing measures. Market attention is increasingly shifting to some eventual monetary firming, but it looks like this is still quite distant, as the unemployment rate is going down more slowly. Inflation was a little higher than expected, but what matters to the BoE is that inflation returns to its medium-term target. It will be interesting to see how the BoE's forecasts have changed in its next *Inflation Report*, to be released on November 13.

BANK OF JAPAN (BoJ)

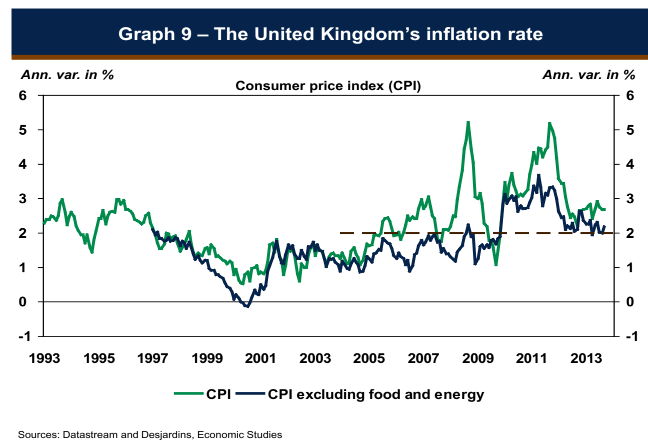
- Japan's inflation rate has been rising since last spring, and is now at 1.1%. However, a lot of ground needs to be covered before reaching the BoJ's 2.0% target in a lasting fashion. Inflation pressures will have to come from more components. Excluding the change in energy and fresh food prices, the inflation rate is at just 0.0%. Sustained economic growth would help inflation reach its target, but after a very encouraging first half of the year, signals are once again mixed in Japan. The BoJ could have to expand or extend its assets purchases.

Graph 8 – The euro zone's inflation rate



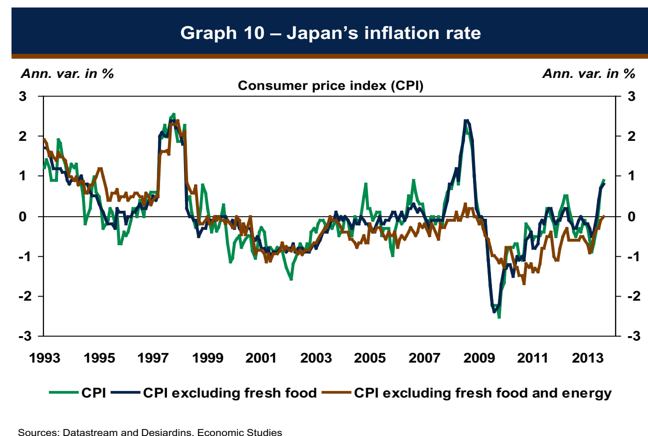
Sources: Datastream and Desjardins, Economic Studies

Graph 9 – The United Kingdom's inflation rate



Sources: Datastream and Desjardins, Economic Studies

Graph 10 – Japan's inflation rate



Sources: Datastream and Desjardins, Economic Studies

BOND MARKET

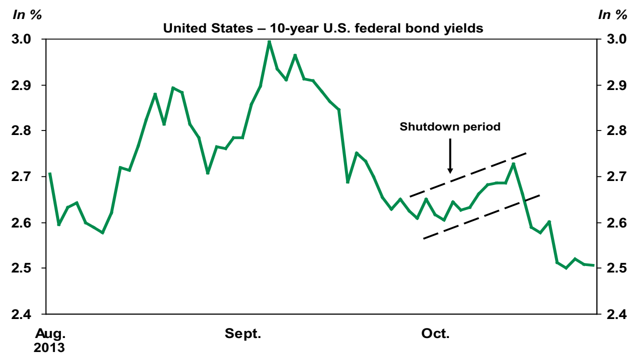
The U.S. budget situation is still unclear and will limit upward movement in yields

U.S. FEDERAL BONDS

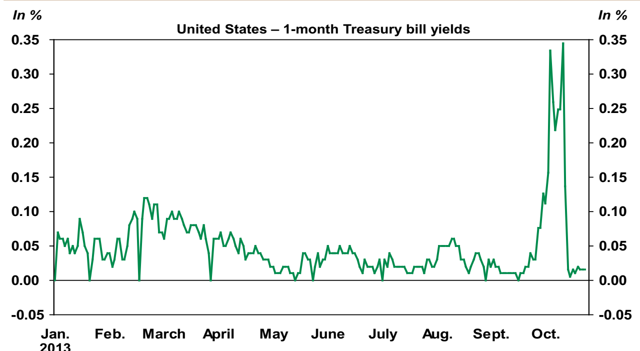
- The Federal Reserve's (Fed) surprising decision in September to maintain its monthly purchases caused 10-year yields to pull back 22 basis points in the week following the meeting. However, it is important to note that during the political impasse that occurred in the first weeks of October, the yield recovered by around 13 basis points (graph 11). A default on payment by the United States, believed to be completely impossible several weeks earlier, had gradually begun to cause alarm. One-month Treasury bills, among the first maturities that would have been affected by a default, bore the weight of these fears, with their yields reaching 0.34% on October 15, before falling back to their average prior to the tensions once an agreement was reached (graph 12). The 22 basis point drop in 10-year yields after the end of the shutdown could also have been partly caused by the easing of the risk premium that had begun to form.
- It must also be said that investors revised their expectations about the Fed's first tapering move, a logical response to the greater uncertainty about the impact that the political standstill could have had on growth in the fourth quarter, as well as the disruption to the collection and release of economic statistics, an essential input to the Fed's monetary policy. President Obama's choice of Janet Yellen as Ben Bernanke's successor could also have contributed to the recent descent by yields, given her inclination towards aggressive monetary policy.
- Markets could also be reluctant to initiate another massive sell-off like the one seen this summer. The budget agreement remains very temporary and if an agreement is not reached, the government will shut down once more on January 15. Meanwhile, the law on the debt ceiling will be suspended until February 7, and after the exhaustion of extraordinary measures, a payment default in early spring could once more become a possibility. Of course, this does not mean that the Republicans will adopt the same all-or-nothing strategy, especially as this proved to be a resounding failure in terms of the party's image with electors (graph 13).

Forecasts: At this point, we believe that tapering will begin in March, and that 10-year yields will end the year at 2.75%, slightly up from what was previously forecast, largely due to the probable effect of a resurgence by political tension. We continue to think that they will reach 3.0% in the first quarter of 2014, as yields will gradually climb as tapering measures become foreseeable once more. The Fed should manage to guide the markets better, and a sell-off like last summer's would seem to be less likely.

Graph 11 – Yields moved up during the U.S. government shutdown



Graph 12– One-month Treasury bills were hit hard by fears of a payment default

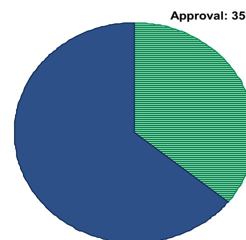


Graph 13 – The electorate passes a scathing verdict on Republicans

Opinion of registered* voters on the management of budget negotiations in October 2013

Opinions on the Democratic Party

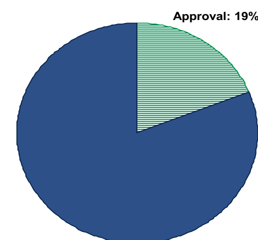
Approval: 35%



Disapproval: 65%

Opinions on the Republican Party

Approval: 19%



Disapproval: 81%

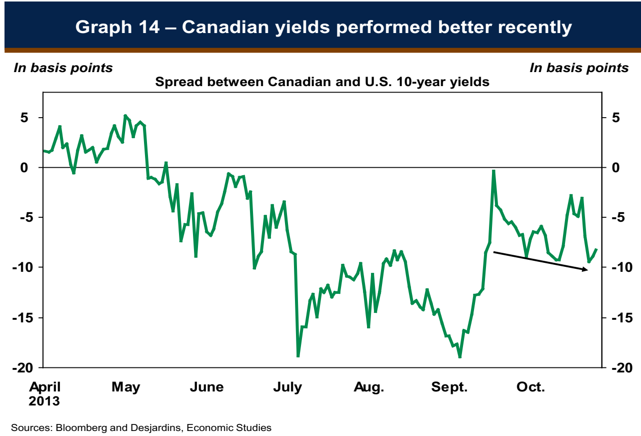
* Survey conducted from October 17 to 20 inclusively.
Sources: Washington Post, ABC News and Desjardins, Economic Studies

CANADIAN FEDERAL BONDS

- Canadian bonds have performed very well since the Fed's September 18 meeting. After the spread between Canadian and U.S. 10-year yields neared positive territory on that day, the spread once again widened in the wake of the budget upheaval in the United States, reaching -9 basis points on October 14, before closing somewhat (graph 14). The same favourable trend for Canadian bonds was noted in 2- and 5-year bonds, but the most pronounced movement was recorded by 3-month Treasury bills.
- The 3-month yield has fallen 12 basis points since mid-September, hitting 0.91% on October 14, their lowest point since January, and the spread between Canadian and U.S. yields for this maturity hit an 8-month low (graph 15). While the upside pressure on yields for 3-month U.S. Treasury bills mostly died out after the budget agreement was reached, the spread for 3-month yields has not returned to where it was before this tension; this suggests that lingering uncertainties over the U.S. political situation continue to benefit Canada. The U.S. crisis seems to have increased the appeal of Canadian securities among a large number of foreign investors, looking for attractive alternatives to U.S. money market securities. With its AAA credit rating undisputed, Canada is one of the winners. Similar trends have been seen for Treasury bills from several other developed nations (graph 16).
- Meanwhile, Canada's economy continues to show modest growth, and the Bank of Canada (BoC) adopted a more dovish tone in October. We think that the next BoC rate hike will not occur until the second quarter of 2015, one quarter before the Fed's first increase. There should therefore be little reason for the Canadian curve to markedly under-perform against the U.S. curve. The spread in 10-year yields should instead head back toward -10 basis points. If another tense episode in Washington again highlights the appeal of Canadian bonds, this spread could break even further into negative territory.

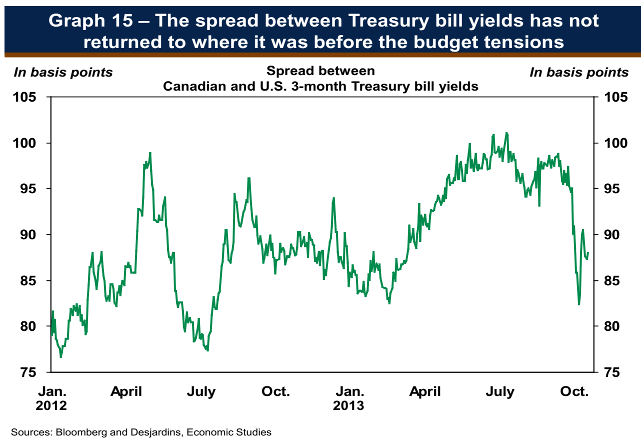
Forecasts: We are revising our end-of-year target for Canadian 10-year yields to 2.65%, implying that the spread against U.S. yields should remain close to current levels for some time. The BoC's dovish stance and the trend for Canadian bonds to perform better in sell-off situations should be an advantage when the Fed gets close to announcing a start to tapering.

Graph 14 – Canadian yields performed better recently



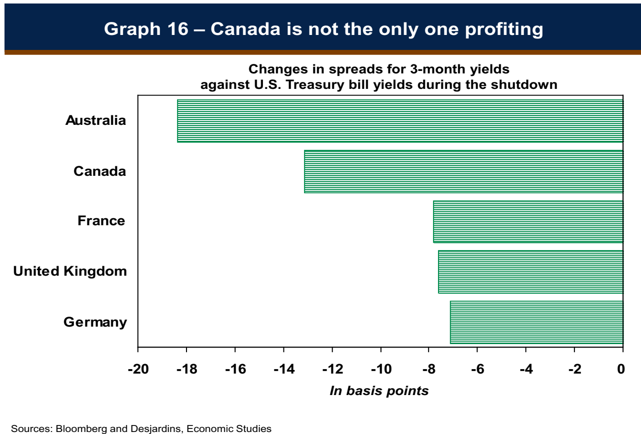
Sources: Bloomberg and Desjardins, Economic Studies

Graph 15 – The spread between Treasury bill yields has not returned to where it was before the budget tensions



Sources: Bloomberg and Desjardins, Economic Studies

Graph 16 – Canada is not the only one profiting



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 Q3	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
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
Septembre 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
Octobre 2013			
1	Reserve Bank of Australia	s.q.	2.50
2	European Central Bank	s.q.	0.50
4	Bank of Japan	s.q.	0.10
9	Bank of Brazil	+50 b.p.	9.50
10	Bank of England	s.q.	0.50
23	Bank of Canada	s.q.	1.00
24	Bank of Norway	s.q.	1.50
24	Bank of Sweden	s.q.	1.00
25	Bank of Mexico	-25 b.p.	3.50

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

Table 3
Coming soon

Date	Central Bank
October 2013	
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
20	Bank of Japan
January 2014	
9	European Central Bank
9	Bank of England
15	Bank of Brazil
22	Bank of Canada
22	Bank of Japan
29	Federal Reserve
30	Reserve Bank of New Zealand

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 Q3	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	0.02	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	0.32	0.35	0.45	0.60	0.80	1.00
5-year	1.03	0.72	0.61	0.70	0.74	1.36	1.36	1.50	1.80	1.90	2.05	2.25
10-year	2.22	1.66	1.64	1.75	1.85	2.48	2.62	2.75	3.00	3.10	3.20	3.40
30-year	3.35	2.77	2.83	2.94	3.11	3.50	3.69	3.75	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	1.34	1.45	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	2.40	2.55	2.50	2.40	2.40
30-year - 3-month	3.28	2.68	2.73	2.89	3.04	3.46	3.67	3.70	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 Q3	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	0.98	0.95	1.00	1.00	1.00	1.00
Federal bonds												
2-year	1.20	1.03	1.07	1.14	1.00	1.22	1.19	1.20	1.30	1.40	1.55	1.75
5-year	1.57	1.25	1.27	1.36	1.30	1.80	1.86	1.95	2.20	2.30	2.45	2.65
10-year	2.11	1.74	1.73	1.80	1.76	2.44	2.54	2.65	2.90	3.00	3.10	3.30
30-year	2.66	2.33	2.32	2.37	2.51	2.90	3.07	3.20	3.30	3.35	3.50	3.65
Yield curve												
5-year - 3-month	0.65	0.37	0.30	0.44	0.33	0.78	0.88	1.00	1.20	1.30	1.45	1.65
10-year - 2-year	0.91	0.71	0.66	0.66	0.76	1.22	1.35	1.45	1.60	1.60	1.55	1.55
30-year - 3-month	1.74	1.45	1.35	1.45	1.54	1.88	2.09	2.25	2.30	2.35	2.50	2.65
Spreads (Canada - U.S.)												
3-month	0.85	0.79	0.87	0.87	0.90	0.98	0.96	0.90	0.90	0.85	0.80	0.75
2-year	0.85	0.72	0.83	0.90	0.75	0.88	0.87	0.85	0.85	0.80	0.75	0.75
5-year	0.54	0.53	0.66	0.66	0.56	0.44	0.50	0.45	0.40	0.40	0.40	0.40
10-year	-0.11	0.08	0.09	0.05	-0.09	-0.04	-0.08	-0.10	-0.10	-0.10	-0.10	-0.10
30-year	-0.69	-0.44	-0.51	-0.57	-0.60	-0.60	-0.62	-0.55	-0.55	-0.55	-0.50	-0.50

f: forecasts
Sources: Datastream and Desjardins, Economic Studies