

The Yield Curve

December 17, 2015

First rate increase in the United States; uncertainties about what comes next

HIGHLIGHTS

- For the first time since June 2006, the Federal Reserve (Fed) increased its key rates at its December 16 meeting. The target range for federal funds rate has shifted from 0.00%–0.25% to 0.25%–0.50%.
- The decision made by U.S. monetary authorities in December was widely expected, given the U.S. job market's strong performance in October and November. At 5.0%, the U.S. unemployment rate has fallen by half since the peak reached during the financial crisis, and wages are finally showing signs of acceleration. Fed Chair Janet Yellen considers it more prudent to initiate gradual monetary firming rather than waiting for clearer signs of accelerating inflation and risking having to increase key rates abruptly.
- Fed leaders are clearly signaling that increases of 0.25% to U.S. key rates cannot be expected at each meeting. They forecast that the upper limit of the target range for federal funds could reach 1.50% by the end of 2016 and 2.50% by the end of 2017, while the markets are expecting rates to rise at about half that pace. Economic conditions will dictate the pace of monetary firming.
- Expectations of monetary firming in the United States pushed up short-term bond yields. The trend was not as clear for long-term maturities, as a surge of concerns boosted demand for safe-haven securities. Another steep drop in oil prices fuelled these concerns by weakening the junk bond sector.
- As it had signalled previously, the European Central Bank (ECB) announced new easing measures at the beginning of December. The ECB reduced its deposit rate to -0.30% and deferred the anticipated end of its securities purchase program to March 2017. Investors were deeply disappointed, however, by the absence of an increase in the pace of these purchases, thereby pushing the euro and bond yields up.
- The Bank of Canada (BoC) now believes that it can cut its key rate to about -0.50%, if necessary. In 2009, the BoC had estimated that a rate of 0.25% was the lower bound. However, a new, sizable shock would have to occur for the BoC to consider negative rates or other unconventional measures. Weak oil prices and some disappointing economic data have however recently revived the possibility of new key rate cuts in Canada.

INTEREST RATE FORECASTS

- Generally speaking, the Fed should increase its key rates by 0.25% per quarter. However, temporary downturns in the economic situation are likely to see the Fed take a few more pauses. We are therefore calling for U.S. key rates to increase 0.75% per year in 2016 and 2017. This monetary policy scenario and the international backdrop point to a gradual, but limited, increase in bond yields. Uncertainty about the Fed's next moves, especially at the March meeting, may keep volatility on financial markets at a high level.
- The BoC will wait until at least mid-2017 before it considers monetary firming. Another drop in oil prices and new economic disappointments could even open the door to another cut to Canadian key rates in the first half of 2016. Nonetheless, a long status quo is still the more likely scenario.

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Table 1
Key interest rates

End of period in %	2015				2016				2017			
	Q1	Q2	Q3	Q4f	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
United States												
Federal funds	0.25	0.25	0.25	0.50	0.75	0.75	1.00	1.25	1.25	1.50	1.75	2.00
Canada												
Overnight funds	0.75	0.75	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	1.00
Euro zone												
Refinancing rate	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.25
United Kingdom												
Base rate	0.50	0.50	0.50	0.50	0.50	0.50	0.75	1.00	1.00	1.25	1.25	1.50
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
October 2015			
6-7	Bank of Japan	---	---
8	Bank of England	s.q.	0.50
14	Bank of Korea	s.q.	1.50
21	Bank of Brazil	s.q.	14.25
21	Bank of Canada	s.q.	0.50
22	European Central Bank	s.q.	0.05
28	Reserve Bank of New Zealand	s.q.	2.75
28	Bank of Sweden	s.q.	-0.35
28	Federal Reserve	s.q.	0.00 / 0.25
29	Bank of Mexico	s.q.	3.00
30	Bank of Japan	---	---
November 2015			
2	Reserve Bank of Australia	s.q.	2.00
5	Bank of England	s.q.	0.50
5	Bank of Norway	s.q.	0.75
11	Bank of Korea	s.q.	1.50
18-19	Bank of Japan	---	---
25	Bank of Brazil	s.q.	14.25
30	Reserve Bank of Australia	s.q.	2.00
December 2015			
2	Bank of Canada	s.q.	0.50
3	European Central Bank	s.q.	0.05
9	Bank of Korea	s.q.	1.50
9	Reserve Bank of New Zealand	-25 b.p.	2.50
10	Bank of England	s.q.	0.50
10	Swiss National Bank	s.q.	-0.75
15	Bank of Sweden	s.q.	-0.35
16	Federal Reserve	+25 b.p.	0.25 / 0.50

Table 3
Coming soon

Date	Central Bank
December 2015	
17	Bank of Norway
17	Bank of Mexico
17-18	Bank of Japan
January 2016	
14	Bank of England
20	Bank of Brazil
20	Bank of Canada
21	European Central Bank
27	Federal Reserve
28	Reserve Bank of New Zealand
28-29	Bank of Japan
February 2016	
2	Reserve Bank of Australia
4	Bank of England
10-11	Bank of Sweden
March 2016	
1	Reserve Bank of Australia
2	Bank of Brazil
9	Bank of Canada
10	European Central Bank
10	Reserve Bank of New Zealand
14-15	Bank of Japan
16	Federal Reserve
17	Bank of England
17	Bank of Norway
17	Swiss National Bank
20-21	Bank of Sweden

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

Source: Desjardins, Economic Studies

Table 4
United States: fixed income market

End of period in %	2015				2016				2017			
	Q1	Q2	Q3	Q4f	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Key rate												
Federal funds	0.25	0.25	0.25	0.50	0.75	0.75	1.00	1.25	1.25	1.50	1.75	2.00
Treasury bills												
3-month	0.03	0.01	0.00	0.30	0.55	0.60	0.85	1.05	1.10	1.35	1.60	1.80
Federal bonds												
2-year	0.54	0.58	0.60	1.00	1.10	1.15	1.40	1.55	1.65	1.85	2.05	2.20
5-year	1.37	1.62	1.35	1.70	1.95	2.00	2.15	2.25	2.30	2.45	2.55	2.65
10-year	1.93	2.33	2.06	2.30	2.45	2.50	2.65	2.75	2.80	2.90	2.95	3.00
30-year	2.54	3.10	2.88	3.00	3.10	3.15	3.20	3.25	3.25	3.30	3.35	3.40
Yield curve												
5-year - 3-month	1.34	1.61	1.35	1.40	1.40	1.40	1.30	1.20	1.20	1.10	0.95	0.85
10-year - 2-year	1.39	1.75	1.46	1.30	1.35	1.35	1.25	1.20	1.15	1.05	0.90	0.80
30-year - 3-month	2.51	3.09	2.88	2.70	2.55	2.55	2.35	2.20	2.15	1.95	1.75	1.60

f: forecasts

Sources: Datastream and Desjardins, Economic Studies

Table 5
Canada: fixed income market

End of period in %	2015				2016				2017			
	Q1	Q2	Q3	Q4f	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Key rate												
Federal funds	0.75	0.75	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	1.00
Treasury bills												
3-month	0.56	0.58	0.44	0.50	0.50	0.50	0.50	0.50	0.50	0.65	0.90	1.15
Federal bonds												
2-year	0.50	0.48	0.52	0.55	0.65	0.70	0.80	0.90	1.00	1.20	1.40	1.60
5-year	0.76	0.82	0.80	0.80	1.05	1.15	1.30	1.40	1.50	1.65	1.80	1.95
10-year	1.36	1.69	1.43	1.50	1.65	1.70	1.85	1.95	2.05	2.15	2.25	2.35
30-year	1.98	2.31	2.20	2.25	2.35	2.40	2.45	2.50	2.55	2.60	2.70	2.80
Yield curve												
5-year - 3-month	0.20	0.24	0.36	0.30	0.55	0.65	0.80	0.90	1.00	1.00	0.90	0.80
10-year - 2-year	0.86	1.21	0.91	0.95	1.00	1.00	1.05	1.05	1.05	0.95	0.85	0.75
30-year - 3-month	1.42	1.73	1.76	1.75	1.85	1.90	1.95	2.00	2.05	1.95	1.80	1.65
Spreads (Canada - U.S.)												
3-month	0.53	0.57	0.44	0.20	-0.05	-0.10	-0.35	-0.55	-0.60	-0.70	-0.70	-0.65
2-year	-0.04	-0.10	-0.08	-0.45	-0.45	-0.45	-0.60	-0.65	-0.65	-0.65	-0.65	-0.60
5-year	-0.61	-0.80	-0.55	-0.90	-0.90	-0.85	-0.85	-0.85	-0.80	-0.80	-0.75	-0.70
10-year	-0.57	-0.64	-0.63	-0.80	-0.80	-0.80	-0.80	-0.80	-0.75	-0.75	-0.70	-0.65
30-year	-0.56	-0.79	-0.68	-0.75	-0.75	-0.75	-0.75	-0.75	-0.70	-0.70	-0.65	-0.60

f: forecasts

Sources: Datastream and Desjardins, Economic Studies