

THE YIELD CURVE

Federal Reserve still seems hesitant

HIGHLIGHTS

- ▶ Bond rates shot up in the final months of 2016, but have been oscillating without a clear trend since the beginning of 2017. The U.S. 10-year yield brushed 2.60% in mid-December; it is now generally fluctuating in a band of 2.30% to 2.50%. The lack of a clear signal that the Federal Reserve (Fed) will keep going with monetary firming in March is limiting the upside pressure on bond yields.
- ▶ The economic environment remains generally favourable, with confidence and purchasing manager indexes hitting very encouraging levels in several advanced economies. However, the actual U.S. numbers are not as convincing, as economic growth weakened in the fourth quarter of 2016, and there is no reason to dismiss fears of another slowdown in Q1 2017, as has happened frequently in the last few years. In the United States, employment growth jumped in January, but wage pressure weakened a bit.
- ▶ In this context, the market is only pricing in a 25% probability of a U.S. key rate increase in March. The statement of the February's meeting did not send any clear signals, although some Fed leaders seem to want to keep the door open for firming. The Fed could be patient, given that this year's FOMC is made up of leaders who seem more dovish, replacing the members who were in more of a hurry to raise key rates. Moreover, the new U.S. administration has not made a clear announcement on tax cuts yet.
- ▶ In Europe, the higher inflation and satisfying economic results suggest that European monetary policies will not be relaxed further. The Bank of Japan is in a similar situation, but it may have to act to review or defend its target for the 10-year bond yield. The Bank of England may even have to raise its policy rates faster than is currently anticipated if the surge in inflation continues and economic growth remains robust.
- ▶ Canadian bond yields have tracked the movement of U.S. yields very closely in the last few months. The release of encouraging economic statistics in Canada seemed to make some investors believe that the Bank of Canada (BoC) could follow the Fed's lead and raise its key rates within a few quarters. However, when January's *Monetary Policy Report* was published, Governor Poloz clearly indicated that the situation in Canada was very different from the United States', and the presence of numerous risks, tied to such things as U.S. policies, was keeping the option of another key rate cut on the table.

INTEREST RATE FORECASTS

- ▶ Recent bond market movements are fairly consistent with our scenarios, which called for yields to consolidate in the early months of 2017. However, we must keep a very close eye on the Fed, as a key rate increase at the March meeting could trigger another surge in yields. For now, our 2017 scenario, which calls for two 0.25% U.S. key rate increases, in June and December, and a slight rise in bond yields, remains more likely.
- ▶ In Canada, the BoC's latest statements are consistent with our forecast for a monetary policy status quo until late 2018. Contrasting movements by North American monetary policies should result in widening spreads between Canadian and U.S. yields, particularly in the shorter maturities.

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TABLE 1
Key interest rates

END OF PERIOD IN %	2016				2017				2018			
	Q1	Q2	Q3	Q4	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
United States												
Federal funds	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25	1.50	1.75	2.00
Canada												
Overnight funds	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75
Zone euro												
Refinancing rate	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.05
United Kingdom												
Base rate	0.50	0.50	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Japan												
Main key rate	-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 banks	Decision	Rate
October			
31	Bank of Japan	s.q.	-0.10
November			
2	Federal Reserve	s.q.	0.50
3	Bank of England	s.q.	0.25
9	Reserve Bank of New Zealand	-25 b.p.	1.75
10	Bank of Korea	s.q.	1.25
17	Bank of Mexico	+50 b.p.	5.25
30	Bank of Brazil	-25 b.p.	13.75
December			
5	Reserve Bank of Australia	s.q.	1.50
7	Bank of Canada	s.q.	0.50
8	European Central Bank	s.q.	0.00
14	Bank of Korea	s.q.	1.25
14	Federal Reserve	+25 b.p.	0.75
15	Bank of England	s.q.	0.25
15	Bank of Norway	s.q.	0.50
15	Bank of Mexico	+50 b.p.	5.75
15	Swiss National Bank	s.q.	-0.75
19	Bank of Japan	s.q.	-0.10
21	Bank of Sweden	s.q.	-0.50
January			
11	Bank of Brazil	-75 b.p.	13.00
12	Bank of Korea	s.q.	1.25
18	Bank of Canada	s.q.	0.50
19	European Central Bank	s.q.	0.00
30	Bank of Japan	s.q.	-0.10
February			
1	Federal Reserve	s.q.	0.75
2	Bank of England	s.q.	0.25
6	Reserve Bank of Australia	s.q.	1.50
8	Reserve Bank of New Zealand	s.q.	1.75

s.q.: statu quo; b.p.: basis points

Source: Desjardins, Economic Studies

TABLE 3
Next meetings

Date	Central banks
February	
9	Bank of Mexico
14	Bank of Sweden
21-22	Bank of Brazil
22	Bank of Korea
March	
1	Bank of Canada
7	Reserve Bank of Australia
9	European Central Bank
15	Bank of Japan
15	Federal Reserve
16	Bank of England
16	Bank of Norway
16	Swiss National Bank
22	Reserve Bank of New Zealand
30	Bank of Mexico
April	
4	Reserve Bank of Australia
11-12	Bank of Brazil
12	Bank of Korea
12	Bank of Canada
26	Bank of Sweden
26	Bank of Japan
27	European Central Bank
May	
2	Reserve Bank of Australia
3	Federal Reserve
4	Bank of Norway
10	Reserve Bank of New Zealand
11	Bank of England
18	Bank of Mexico
24	Bank of Korea

Source: Desjardins, Economic Studies

TABLE 4
United States: Fixed income market

END OF PERIOD IN %	2016				2017				2018			
	Q1	Q2	Q3	Q4	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Key interest rate												
Federal funds	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25	1.50	1.75	2.00
Treasury bills												
3-month	0.21	0.26	0.29	0.51	0.60	0.80	0.85	1.05	1.10	1.35	1.60	1.85
Federal bonds												
2-year	0.75	0.58	0.76	1.17	1.20	1.40	1.45	1.60	1.60	1.90	2.15	2.30
5-year	1.21	1.00	1.15	1.92	1.90	2.10	2.15	2.30	2.30	2.55	2.85	2.90
10-year	1.78	1.49	1.61	2.45	2.45	2.60	2.65	2.80	2.75	2.95	3.25	3.25
30-year	2.62	2.31	2.33	3.06	3.05	3.15	3.20	3.30	3.30	3.40	3.55	3.55
Yield curve slopes												
5-year - 3-month	1.00	0.74	0.86	1.41	1.30	1.30	1.30	1.25	1.20	1.20	1.25	1.05
10-year - 2-year	1.03	0.91	0.85	1.27	1.25	1.20	1.20	1.20	1.15	1.05	1.10	0.95
30-year - 3-month	2.41	2.05	2.04	2.55	2.45	2.35	2.35	2.25	2.20	2.05	1.95	1.70

f: forecasts

Sources: Datastream and Desjardins, Economic Studies

TABLE 5
Canada: Fixed income market

END OF PERIOD IN %	2016				2017				2018			
	Q1	Q2	Q3	Q4	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Key interest rate												
Overnight funds	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75
Treasury bills												
3-month	0.44	0.49	0.53	0.46	0.50	0.55	0.55	0.55	0.55	0.60	0.65	0.85
Federal bonds												
2-year	0.54	0.52	0.52	0.75	0.75	0.80	0.80	0.85	0.85	1.10	1.25	1.40
5-year	0.67	0.57	0.62	1.12	1.05	1.25	1.30	1.40	1.40	1.65	1.90	2.00
10-year	1.23	1.06	1.00	1.72	1.70	1.85	1.85	1.95	1.90	2.10	2.35	2.40
30-year	2.00	1.71	1.66	2.31	2.35	2.45	2.45	2.50	2.50	2.55	2.65	2.70
Yield curve slopes												
5-year - 3-month	0.23	0.08	0.09	0.66	0.55	0.70	0.75	0.85	0.85	1.05	1.25	1.15
10-year - 2-year	0.69	0.54	0.47	0.97	0.95	1.05	1.05	1.10	1.05	1.00	1.10	1.00
30-year - 3-month	1.56	1.22	1.13	1.85	1.85	1.90	1.90	1.95	1.95	1.95	2.00	1.85
Yield spreads (Canada—United States)												
3-month	0.23	0.23	0.24	-0.05	-0.10	-0.25	-0.30	-0.50	-0.55	-0.75	-0.95	-1.00
2-year	-0.22	-0.06	-0.24	-0.43	-0.45	-0.60	-0.65	-0.75	-0.75	-0.80	-0.90	-0.90
5-year	-0.54	-0.43	-0.53	-0.80	-0.85	-0.85	-0.85	-0.90	-0.90	-0.90	-0.95	-0.90
10-year	-0.56	-0.43	-0.61	-0.73	-0.75	-0.75	-0.80	-0.85	-0.85	-0.85	-0.90	-0.85
30-year	-0.62	-0.59	-0.67	-0.75	-0.70	-0.70	-0.75	-0.80	-0.80	-0.85	-0.90	-0.85

f: forecasts

Sources: Datastream and Desjardins, Economic Studies