

THE YIELD CURVE

U.S. Monetary Tightening Should Continue in June

HIGHLIGHTS

- ▶ Benefiting from investor concerns, North American bond yields quickly started to trend down following U.S. key rate hikes in mid-March. Falling oil prices also exerted downside pressure on inflation expectations. Yields on U.S. 10-year bonds dropped to 2.16% in mid-April, the lowest level observed since November 10, 2016.
- ▶ Yet, bond yields started to rise in recent weeks, bringing the U.S. 10-year yield to around 2.40%. Favourable results for the French presidential election seemed to trigger the return of optimism. The release of encouraging corporate results and the ongoing high confidence index level in most economies also contributed to reassuring investors.
- ▶ The recent increase in bond yields also reflects expectations of a new rise in U.S. key rates in June. The Federal Reserve (Fed) meeting on May 3 did not hold many surprises, but the Fed clearly indicated that it was not worried about U.S. economic weakness at the beginning of the year. The falling jobless rate also argue in favour of continued monetary firming. The Fed could also use its June meeting to specify how it will proceed with starting to reduce the size of its balance sheet.
- ▶ If investors are banking on a U.S. key rate hike in June, they expect very little monetary firming afterwards. This explains why bond yields are staying very low. Futures suggest that between now and the end of 2018 there will only be two additional 0.25% increases after June's hike. This position is difficult to explain when Fed leaders were already signalling in March faster tightening and the jobless rate had fallen below the level they were anticipating for the end of 2018.
- ▶ The Bank of Canada (BoC) adopted a more positive tone when presenting its *Monetary Policy Report* for April. Contrary to the U.S. economy, the Canadian economy had a strong start to 2017, with GDP seeming to have advanced a bit over 4%, annualized, in the first quarter. The BoC is therefore not looking to further soften its monetary policy, and expects that the Canadian economy will run at full capacity as of the first half of 2018. However, several risks remain for the Canadian economy, particularly the possibility of a spike in U.S. protectionism.

INTEREST RATE FORECASTS

- ▶ We still expect two additional key rate hikes in the United States by the end of 2017. They should occur faster, however, in June and in September. Three additional increases of 0.25% are still expected for next year. Market expectations could soon adjust to reflect such a scenario. That should lead to upside pressure on the complete yield curve and push the U.S. 10-year yield to around 2.90% at the end of 2017.
- ▶ The improved Canadian economic outlook and the BoC's change in tone have prompted us to expect a first key rate increase in April rather than in July 2018. Other major central banks will only begin increasing their rates in late 2018, or in 2019. Partially following the U.S. trend, Canadian bond yields should gradually increase in the coming quarters.

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TABLE 1
Key interest rates

END OF PERIOD IN %	2016				2017				2018			
	Q1	Q2	Q3	Q4	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
United States												
Federal funds	0.50	0.50	0.50	0.75	1.00	1.25	1.50	1.50	1.75	1.75	2.00	2.25
Canada												
Overnight funds	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	0.75	1.00
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
February			
6	Reserve Bank of Australia	s.q.	1.50
8	Reserve Bank of New Zealand	s.q.	1.75
9	Bank of Mexico	+50 b.p.	6.25
15	Bank of Sweden	s.q.	-0.50
22	Bank of Korea	s.q.	1.25
22	Bank of Brazil	-75 b.p.	12.25
March			
1	Bank of Canada	s.q.	0.50
6	Reserve Bank of Australia	s.q.	1.50
9	European Central Bank	s.q.	0.00
15	Federal Reserve	s.q.	0.75
15	Bank of Japan	s.q.	-0.10
16	Bank of England	s.q.	0.25
16	Bank of Norway	s.q.	0.50
16	Swiss National Bank	s.q.	-0.75
22	Reserve Bank of New Zealand	s.q.	1.75
30	Bank of Mexico	+25 b.p.	6.50
April			
4	Reserve Bank of Australia	s.q.	1.50
12	Bank of Korea	s.q.	1.25
12	Bank of Brazil	-100 b.p.	11.25
12	Bank of Canada	s.q.	0.50
27	Bank of Japan	s.q.	-0.10
27	European Central Bank	s.q.	0.00
27	Bank of Sweden	s.q.	-0.50
May			
2	Reserve Bank of Australia	s.q.	1.50
3	Federal Reserve	s.q.	0.75
4	Bank of Norway	s.q.	0.50
10	Reserve Bank of New Zealand	s.q.	1.75
11	Bank of England	s.q.	0.25

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

Source: Desjardins, Economic Studies

TABLE 3
Next meetings

Date	Central banks
May	
18	Bank of Mexico
24	Bank of Korea
24	Bank of Canada
31	Bank of Brazil
June	
6	Reserve Bank of Australia
8	European Central Bank
14	Federal Reserve
15	Bank of England
15	Swiss National Bank
16	Bank of Japan
21	Reserve Bank of New Zealand
22	Bank of Norway
22	Bank of Mexico
July	
4	Reserve Bank of Australia
4	Bank of Sweden
12	Bank of Korea
12	Bank of Canada
20	Bank of Japan
20	European Central Bank
26	Bank of Brazil
26	Federal Reserve
August	
1	Reserve Bank of Australia
3	Bank of England
9	Reserve Bank of New Zealand
10	Bank of Mexico
30	Bank of Korea
September	
5	Reserve Bank of Australia

Source: Desjardins, Economic Studies

TABLE 4
United States: Fixed income market

END OF PERIOD IN %	2016				2017				2018			
	Q1	Q2	Q3	Q4	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Key interest rate												
Federal funds	0.50	0.50	0.50	0.75	1.00	1.25	1.50	1.50	1.75	1.75	2.00	2.25
Treasury bills												
3-month	0.21	0.26	0.29	0.51	0.76	1.05	1.30	1.35	1.55	1.60	1.80	2.05
Federal bonds												
2-year	0.75	0.58	0.76	1.17	1.24	1.50	1.75	1.80	2.00	2.05	2.25	2.45
5-year	1.21	1.00	1.15	1.92	1.92	2.10	2.35	2.45	2.65	2.75	2.95	3.05
10-year	1.78	1.49	1.61	2.45	2.40	2.50	2.80	2.90	3.10	3.15	3.30	3.40
30-year	2.62	2.31	2.33	3.06	3.02	3.10	3.25	3.30	3.40	3.45	3.55	3.65
Yield curve slopes												
5-year - 3-month	1.00	0.74	0.86	1.41	1.16	1.05	1.05	1.10	1.10	1.15	1.15	1.00
10-year - 2-year	1.03	0.91	0.85	1.27	1.16	1.00	1.05	1.10	1.10	1.10	1.05	0.95
30-year - 3-month	2.41	2.05	2.04	2.55	2.26	2.05	1.95	1.95	1.85	1.85	1.75	1.60

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	Q1	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	0.75	0.75	1.00
Treasury bills												
3-month	0.44	0.49	0.53	0.46	0.52	0.55	0.55	0.60	0.70	0.90	0.95	1.20
Federal bonds												
2-year	0.54	0.52	0.52	0.75	0.75	0.80	0.95	1.00	1.15	1.30	1.45	1.65
5-year	0.67	0.57	0.62	1.12	1.12	1.20	1.40	1.50	1.65	1.85	2.05	2.15
10-year	1.23	1.06	1.00	1.72	1.62	1.65	1.90	2.00	2.15	2.30	2.45	2.55
30-year	2.00	1.71	1.66	2.31	2.30	2.30	2.45	2.50	2.55	2.65	2.75	2.85
Yield curve slopes												
5-year - 3-month	0.23	0.08	0.09	0.66	0.60	0.65	0.85	0.90	0.95	0.95	1.10	0.95
10-year - 2-year	0.69	0.54	0.47	0.97	0.88	0.85	0.95	1.00	1.00	1.00	1.00	0.90
30-year - 3-month	1.56	1.22	1.13	1.85	1.78	1.75	1.90	1.90	1.85	1.75	1.80	1.65
Yield spreads (Canada—United States)												
3-month	0.23	0.23	0.24	-0.05	-0.24	-0.50	-0.75	-0.75	-0.85	-0.70	-0.85	-0.85
2-year	-0.22	-0.06	-0.24	-0.43	-0.49	-0.70	-0.80	-0.80	-0.85	-0.75	-0.80	-0.80
5-year	-0.54	-0.43	-0.53	-0.80	-0.80	-0.90	-0.95	-0.95	-1.00	-0.90	-0.90	-0.90
10-year	-0.56	-0.43	-0.61	-0.73	-0.77	-0.85	-0.90	-0.90	-0.95	-0.85	-0.85	-0.85
30-year	-0.62	-0.59	-0.67	-0.75	-0.71	-0.80	-0.80	-0.80	-0.85	-0.80	-0.80	-0.80

f: forecasts

Sources: Datastream and Desjardins, Economic Studies