

THE YIELD CURVE

The Good News Makes Things More Complicated

HIGHLIGHTS

- ▶ The news has been very good since mid-January, prompting a substantial upgrade to the [economic outlooks](#). Firstly, the second wave of the pandemic suddenly broke and the economies were more resilient than anticipated in facing this second wave. Moreover, vaccination programs have accelerated, and several studies confirm the vaccines' effectiveness, increasing the hope that we may start to get back to normal before the end of the year. Lastly, the new U.S. administration's very generous relief plans are improving the outlooks for growth in the United States.
- ▶ The improved economic outlooks only increased the bond market's difficulties. Fears about faster inflation are on the rise, as commodity prices continue to skyrocket. Some panic was even seen at the end of February, temporarily taking the U.S. 10-year bond yield over 1.50%. Initially, the upside pressures primarily affected long-term yields, essentially reflecting greater compensation for inflation. Recently, however, yields are rising more generally, particularly in the 5-year terms, and real yields are also rising; reflecting expectations of faster monetary policy tightening.
- ▶ So far, the Federal Reserve (Fed) has been maintaining a very prudent stance, emphasizing how far the job market has to go and minimizing the inflationary risks. If the second relief plan is approved and U.S. growth is as strong as we expect in the coming months, however, the Fed will have to gradually acknowledge that the situation no longer requires as much monetary stimulus. A gradual shift in its stance and onset of a progressive reduction to its asset purchases by the end of the year can, therefore, be anticipated. In the near term, however, the Fed may want to offer some support to the bond market; it seems fragile and is facing some technical obstacles, including the expiry of a measure allowing banks to hold more federal bonds. The Fed could therefore opt to further concentrate purchases in long-term bonds.
- ▶ The Canadian economy has been very resilient, showing annualized growth of 9.6% in the fourth quarter of 2020. Fears that the year would get off to a very difficult start because of the second wave have also ebbed substantially. With the housing market showing some signs of overheating, it seems increasingly obvious that it would be appropriate to reduce the surplus liquidity in Canada's financial system. The Bank of Canada's challenge will be to decrease its bond purchases without overly magnifying the upside pressures already being exerted on bond yields and the Canadian dollar. Yields on federal 5-year bonds have gone up about 50 basis points since the start of 2021, already suggesting that the country's mortgage rates will rise.

INTEREST RATE FORECASTS

- ▶ In the near term, uncertainty about the bond market is very high. The Fed's response to the current situation will probably be critical and the market reaction is hard to predict. Our scenarios assume that central banks will manage to gradually cut back on their intervention while avoiding a surge in bond yields.
- ▶ A long status quo can still be expected for North American key rates. A gradual decrease in asset purchases should be enough to keep inflation from surging. The central banks' determination to maintain favourable financial conditions for a long time does not suggest a rush to raise key rates.

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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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TABLE 1
Key interest rates

END OF PERIOD IN %	2020				2021				2022			
	Q1	Q2	Q3	Q4	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	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	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
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	0.00
United Kingdom												
Base 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
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
Fixed income market

END OF PERIOD IN %	2020				2021				2022			
	Q1	Q2	Q3	Q4	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
UNITED STATES												
Treasury bills												
3-month	0.11	0.16	0.10	0.09	0.05	0.05	0.10	0.15	0.15	0.15	0.15	0.20
Federal bonds												
2-year	0.25	0.17	0.13	0.13	0.15	0.15	0.20	0.30	0.40	0.50	0.60	0.75
5-year	0.36	0.28	0.27	0.35	0.70	0.75	0.70	0.80	0.85	0.95	1.05	1.20
10-year	0.67	0.65	0.68	0.91	1.45	1.50	1.45	1.55	1.60	1.70	1.80	1.90
30-year	1.32	1.41	1.45	1.64	2.25	2.30	2.25	2.35	2.40	2.45	2.50	2.55
Yield curve slopes												
5-year - 3-month	0.25	0.12	0.17	0.26	0.65	0.70	0.60	0.65	0.70	0.80	0.90	1.00
10-year - 2-year	0.41	0.49	0.55	0.79	1.30	1.35	1.25	1.25	1.20	1.20	1.20	1.15
30-year - 3-month	1.21	1.25	1.35	1.55	2.20	2.25	2.15	2.20	2.25	2.30	2.35	2.35
CANADA												
Treasury bills												
3-month	0.21	0.20	0.12	0.06	0.10	0.15	0.15	0.20	0.20	0.20	0.20	0.25
Federal bonds												
2-year	0.42	0.28	0.25	0.20	0.25	0.30	0.30	0.40	0.45	0.55	0.65	0.75
5-year	0.60	0.36	0.36	0.39	0.85	0.90	0.85	0.90	0.95	1.00	1.10	1.20
10-year	0.71	0.52	0.57	0.67	1.40	1.45	1.40	1.45	1.50	1.55	1.60	1.65
30-year	1.32	0.99	1.11	1.21	1.85	1.90	1.85	1.95	2.00	2.05	2.10	2.15
Yield curve slopes												
5-year - 3-month	0.39	0.16	0.24	0.33	0.75	0.75	0.70	0.70	0.75	0.80	0.90	0.95
10-year - 2-year	0.29	0.24	0.32	0.47	1.15	1.15	1.10	1.05	1.05	1.00	0.95	0.90
30-year - 3-month	1.11	0.79	0.99	1.15	1.75	1.75	1.70	1.75	1.80	1.85	1.90	1.90
Yield spreads (Canada—United States)												
3-month	0.10	0.04	0.02	-0.03	0.05	0.10	0.05	0.05	0.05	0.05	0.05	0.05
2-year	0.17	0.11	0.12	0.07	0.10	0.15	0.10	0.10	0.05	0.05	0.05	0.00
5-year	0.24	0.08	0.09	0.04	0.15	0.15	0.15	0.10	0.10	0.05	0.05	0.00
10-year	0.04	-0.13	-0.11	-0.24	-0.05	-0.05	-0.05	-0.10	-0.10	-0.15	-0.20	-0.25
30-year	0.00	-0.42	-0.34	-0.43	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40

f: forecasts

Sources: Datastream and Desjardins, Economic Studies

Schedule 2021 of Central Bank Meetings

Date	Central banks	Decision	Rate
January			
14	Bank of Korea	s.q.	0.50
20	Bank of Brazil	s.q.	2.00
20	Bank of Canada*	s.q.	0.25
20	Bank of Japan	s.q.	-0.10
21	European Central Bank	s.q.	0.00
21	Bank of Norway	s.q.	0.00
27	Federal Reserve	s.q.	0.25
February			
1	Reserve Bank of Australia	s.q.	0.10
4	Bank of England	s.q.	0.10
10	Bank of Sweden	s.q.	0.00
11	Bank of Mexico	-25 b.p.	4.00
23	Reserve Bank of New Zealand	s.q.	0.25
24	Bank of Korea	s.q.	0.50
March			
1	Reserve Bank of Australia	s.q.	0.10
10	Bank of Canada		
11	European Central Bank		
17	Bank of Brazil		
17	Federal Reserve		
18	Bank of England		
18	Bank of Norway		
19	Bank of Japan		
25	Bank of Mexico		
25	Swiss National Bank		
April			
6	Reserve Bank of Australia		
13	Reserve Bank of New Zealand		
14	Bank of Korea		
21	Bank of Canada*		
22	European Central Bank		
27	Bank of Sweden		
27	Bank of Japan		
28	Federal Reserve		
May			
4	Reserve Bank of Australia		
5	Bank of Brazil		
6	Bank of England		
6	Bank of Norway		
13	Bank of Mexico		
25	Reserve Bank of New Zealand		
26	Bank of Korea		
June			
1	Reserve Bank of Australia		
9	Bank of Canada		
10	European Central Bank		
16	Bank of Brazil		
16	Federal Reserve		
17	Bank of Norway		
17	Swiss National Bank		
18	Bank of Japan		
24	Bank of England		
24	Bank of Mexico		

Date	Central banks	Decision	Rate
July			
1	Bank of Sweden		
6	Reserve Bank of Australia		
13	Reserve Bank of New Zealand		
15	Bank of Korea		
14	Bank of Canada*		
16	Bank of Japan		
22	European Central Bank		
28	Federal Reserve		
August			
3	Reserve Bank of Australia		
4	Bank of Brazil		
5	Bank of England		
12	Bank of Mexico		
17	Reserve Bank of New Zealand		
19	Bank of Norway		
26	Bank of Korea		
September			
7	Reserve Bank of Australia		
8	Bank of Canada		
9	European Central Bank		
22	Bank of Brazil		
22	Bank of Japan		
22	Federal Reserve		
23	Bank of England		
23	Bank of Norway		
23	Swiss National Bank		
30	Bank of Mexico		
**	Bank of Sweden		
October			
4	Reserve Bank of Australia		
5	Reserve Bank of New Zealand		
12	Bank of Korea		
27	Bank of Brazil		
27	Bank of Canada*		
28	European Central Bank		
28	Bank of Japan		
November			
1	Reserve Bank of Australia		
3	Federal Reserve		
4	Bank of England		
4	Bank of Norway		
11	Bank of Mexico		
29	Reserve Bank of New Zealand		
25	Bank of Korea		
**	Bank of Sweden		
December			
6	Reserve Bank of Australia		
8	Bank of Brazil		
8	Bank of Canada		
15	Federal Reserve		
16	European Central Bank		
16	Bank of England		
16	Bank of Norway		
16	Bank of Mexico		
16	Swiss National Bank		
17	Bank of Japan		

NOTE: Certain banks may decide to change rates in-between the scheduled meetings. The abbreviations s.q. and b.p. correspond to status quo and basis points respectively. * Monetary Policy Report published; ** To be determined.