

## THE YIELD CURVE

# The Federal Reserve's Change in Tone Points to Higher Bond Yields

### HIGHLIGHTS

- ▶ After a surge in the first quarter, North American bond yields began a downward trend in early April that could be explained by fears related to the third wave of COVID-19 and the Federal Reserve's (Fed) refusal to consider a reduction to its asset purchases. However, news about the health crisis has been very encouraging recently as the effectiveness of vaccination programs offers hope for a sustainable reopening of the economies. The outlook for growth, thus, remains very robust and it is the issue of inflation that is gaining attention, with the latest figures showing annual inflation rates of 5.0% in the United States and 3.6% in Canada.
- ▶ In this context, it is difficult to explain why the decline in bond yields accelerated in early June, bringing the yield on U.S. 10-year federal bonds down to around 1.45%. Investors seemed to have accepted the argument that surging inflation was essentially a reflection of temporary factors. The recent decline in bond yields may also reflect distortions in financial markets, which appear to be having increasing difficulty absorbing the massive injections of liquidity by central banks. However, continued low interest rates, and even sharply negative real rates, represent a significant risk of a more sustained surge in inflation.
- ▶ After long holding to its position that it was too early to consider normalizing monetary policy, the Fed finally sent a first signal in that direction at its June meeting. Fed officials seem very encouraged by the drop in COVID-19 cases and are now signaling that a 50-point increase in policy rates may be appropriate in 2023. There is also a sense that the Fed felt it necessary to signal that its tolerance for inflation well above its target was not unlimited.
- ▶ After reducing the pace of its bond purchases in April, the Bank of Canada (BoC) unsurprisingly opted for the status quo at its June 9 meeting. The BoC does not seem overly concerned about rising inflation and the strong Canadian dollar, and notes that the favourable evolution of the health crisis suggests that the Canadian economy will rebound strongly over the summer. The BoC should therefore continue to gradually reduce its bond purchases and a further announcement to this effect is likely as early as the July meeting.
- ▶ Inflation rates are generally less worrisome in Europe. The European Central Bank remained cautious at its latest policy meeting and did not rush to announce a reduction to the pace of its purchases. The Bank of England, however, took this step as the British economy benefits from a faster vaccination campaign and inflationary pressures appear to be somewhat stronger in the United Kingdom.

### INTEREST RATE FORECASTS

- ▶ The coming quarters should be marked by a gradual normalization of monetary policies and an upward trend in bond yields. The Fed should begin to reduce its bond purchases next fall. In this context, the U.S. 10-year yield should end the year at around 2.00%.
- ▶ Nonetheless, a long status quo in North American key rates is still expected with a first Canadian increase in October 2022, followed by a first hike in the United States in December 2022.

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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	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
<b>United States</b>												
Federal funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50
<b>Canada</b>												
Overnight funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50
<b>Zone euro</b>												
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
<b>United Kingdom</b>												
Base rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.25
<b>Japan</b>												
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	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
<b>UNITED STATES</b>												
<b>Treasury bills</b>												
3-month	0.11	0.16	0.10	0.09	0.03	0.05	0.05	0.10	0.15	0.15	0.20	0.45
<b>Federal bonds</b>												
2-year	0.25	0.17	0.13	0.13	0.16	0.25	0.35	0.50	0.65	0.75	0.90	1.15
5-year	0.36	0.28	0.27	0.35	0.92	0.90	1.05	1.15	1.25	1.35	1.50	1.70
10-year	0.67	0.65	0.68	0.91	1.75	1.55	1.80	2.00	2.10	2.20	2.30	2.40
30-year	1.32	1.41	1.45	1.64	2.42	2.10	2.35	2.55	2.70	2.80	2.90	3.00
<b>Yield curve slopes</b>												
5-year - 3-month	0.25	0.12	0.17	0.26	0.89	0.85	1.00	1.05	1.10	1.20	1.30	1.25
10-year - 2-year	0.41	0.49	0.55	0.79	1.59	1.30	1.45	1.50	1.45	1.45	1.40	1.25
30-year - 3-month	1.21	1.25	1.35	1.55	2.39	2.05	2.30	2.45	2.55	2.65	2.70	2.55
<b>CANADA</b>												
<b>Treasury bills</b>												
3-month	0.21	0.20	0.12	0.06	0.09	0.10	0.15	0.20	0.20	0.25	0.35	0.60
<b>Federal bonds</b>												
2-year	0.42	0.28	0.25	0.20	0.22	0.45	0.55	0.65	0.80	0.90	1.05	1.30
5-year	0.60	0.36	0.36	0.39	0.99	0.95	1.10	1.25	1.40	1.50	1.65	1.85
10-year	0.71	0.52	0.57	0.67	1.55	1.45	1.65	1.85	2.00	2.10	2.20	2.30
30-year	1.32	0.99	1.11	1.21	1.97	1.90	2.10	2.25	2.40	2.50	2.60	2.70
<b>Yield curve slopes</b>												
5-year - 3-month	0.39	0.16	0.24	0.33	0.90	0.85	0.95	1.05	1.20	1.25	1.30	1.25
10-year - 2-year	0.29	0.24	0.32	0.47	1.33	1.00	1.10	1.20	1.20	1.20	1.15	1.00
30-year - 3-month	1.11	0.79	0.99	1.15	1.88	1.80	1.95	2.05	2.20	2.25	2.25	2.10
<b>Yield spreads (Canada—United States)</b>												
3-month	0.10	0.04	0.02	-0.03	0.06	0.05	0.10	0.10	0.05	0.10	0.15	0.15
2-year	0.17	0.11	0.12	0.07	0.06	0.20	0.20	0.15	0.15	0.15	0.15	0.15
5-year	0.24	0.08	0.09	0.04	0.07	0.05	0.05	0.10	0.15	0.15	0.15	0.15
10-year	0.04	-0.13	-0.11	-0.24	-0.20	-0.10	-0.15	-0.15	-0.10	-0.10	-0.10	-0.10
30-year	0.00	-0.42	-0.34	-0.43	-0.45	-0.20	-0.25	-0.30	-0.30	-0.30	-0.30	-0.30

f: forecasts

Sources: Datastream and Desjardins, Economic Studies

# Schedule 2021 of Central Bank Meetings

Date	Central banks	Decision	Rate
<b>January</b>			
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
<b>February</b>			
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
<b>March</b>			
1	Reserve Bank of Australia	s.q.	0.10
10	Bank of Canada	s.q.	0.25
11	European Central Bank	s.q.	0.00
17	Bank of Brazil	+75 b.p.	2.75
17	Federal Reserve	s.q.	0.25
18	Bank of England	s.q.	0.10
18	Bank of Norway	s.q.	0.00
19	Bank of Japan	s.q.	-0.10
25	Bank of Mexico	s.q.	4.00
25	Swiss National Bank	s.q.	-0.75
<b>April</b>			
6	Reserve Bank of Australia	s.q.	0.10
13	Reserve Bank of New Zealand	s.q.	0.25
14	Bank of Korea	s.q.	0.50
21	Bank of Canada*	s.q.	0.25
22	European Central Bank	s.q.	0.00
27	Bank of Sweden	s.q.	0.00
27	Bank of Japan	s.q.	-0.10
28	Federal Reserve	s.q.	0.25
<b>May</b>			
4	Reserve Bank of Australia	s.q.	0.10
5	Bank of Brazil	+75 b.p.	3.50
6	Bank of England	s.q.	0.10
6	Bank of Norway	s.q.	0.00
13	Bank of Mexico	s.q.	4.00
25	Reserve Bank of New Zealand	s.q.	0.25
26	Bank of Korea	s.q.	0.50
<b>June</b>			
1	Reserve Bank of Australia	s.q.	0.10
9	Bank of Canada	s.q.	0.25
10	European Central Bank	s.q.	0.00
16	Bank of Brazil	+75 b.p.	4.25
16	Federal Reserve	s.q.	0.25
17	Bank of Norway	s.q.	0.00
17	Swiss National Bank	s.q.	-0.75
18	Bank of Japan	s.q.	-0.10
24	Bank of England		
24	Bank of Mexico		

Date	Central banks	Decision	Rate
<b>July</b>			
1	Bank of Sweden		
6	Reserve Bank of Australia		
13	Reserve Bank of New Zealand		
14	Bank of Korea		
14	Bank of Canada*		
16	Bank of Japan		
22	European Central Bank		
28	Federal Reserve		
<b>August</b>			
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		
25	Bank of Korea		
<b>September</b>			
7	Reserve Bank of Australia		
8	Bank of Canada		
9	European Central Bank		
21	Bank of Sweden		
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		
<b>October</b>			
4	Reserve Bank of Australia		
5	Reserve Bank of New Zealand		
11	Bank of Korea		
27	Bank of Brazil		
27	Bank of Canada*		
28	European Central Bank		
28	Bank of Japan		
<b>November</b>			
1	Reserve Bank of Australia		
3	Federal Reserve		
4	Bank of England		
4	Bank of Norway		
11	Bank of Mexico		
23	Reserve Bank of New Zealand		
24	Bank of Korea		
25	Bank of Sweden		
<b>December</b>			
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.