Concerns Driving Down Bond Yields

After a disappointing start to the year, North American economies rebounded last spring. Real GDP in the United States posted a spectacular annualized advance of 4.1% in the second quarter, and Canada is also expected to record strong results. This pace of growth is not sustainable, but the high readings in the leading indicators on both sides of the border suggest that North American economies could keep humming slightly above their growth potential (estimated at just below 2.0% in both the United States and Canada). In this context, it’s no surprise that the Fed and the Bank of Canada (BoC) both ordered key rate increases at their last meetings. What’s more, both central banks have clearly signalled their intention to gradually keep normalizing their monetary policies.

Despite this, long-term bond yields have fallen significantly since mid-May, with the U.S. 10-year yield falling from over 3.10% to about 2.85% by mid-July, while the same yield on this side of the border declined from just over 2.50% to about 2.10% (graph 1). This decline is noteworthy, given the tightening of monetary policies in North America and the upside pressures this has on short-term yields. This caused a strong flattening of the yield curve in recent months (graph 2), which worries some observers since an inverted curve is often seen as a precursor to a recession.

The recent drop in long-term bond yields seems to mostly reflect heightened trade tensions after the United States levied tariffs on steel and aluminium imports from more countries and reciprocal customs tariffs were implemented by the United States and China. This surge in concerns drove investors to U.S. safe havens, pushing up the greenback and driving down long-term bond yields.

Concerns about a trade war recently drove down U.S. 10-year yields to about 2.85%. Market positioning expecting the Federal Reserve (Fed) to slow down its monetary tightening in the near term appears misplaced, however, especially given rising inflation risks. We expect the U.S. 10-year yield to end the year at about 3.30%, and a sharper increase seems more likely than a steep decline.
Will Trade Tensions Put an End to Rate Hikes?
Investors’ concerns about rising trade tensions are understandable. In a recent Economic Viewpoint on the topic, we estimated that the impacts of the tariffs announced thus far should be relatively contained, but that a genuine global trade war would have serious consequences on the global economy and the financial markets. The impact of a trade war on bond yields would be difficult to predict, since trade war could both lead to an economic slowdown and fuel inflationary pressures. We can, however, imagine an extreme scenario in which a trade war damaged the economic outlook to such an extent that the central banks would have no choice but to once again start easing their monetary policies, despite the temporary price hikes. If this were to occur, we would expect to see steep declines in federal bond yields, which would also greatly benefit from their safe-haven status.

Such an extreme scenario remains relatively unlikely, however, since most governments are continuing their efforts to prevent a rise in protectionism. Last week’s positive meeting between Donald Trump and Jean-Claude Juncker is an encouraging development. Up to now, the new trade barriers between the United States and other countries remained bilateral, which limits the negative impacts on the global economy. Developments in financial markets confirm that the markets are not positioned for a very negative growth scenario, with stock markets continuing to hum (graph 3) and credit spreads at very low levels. If investors really believed that a recession was imminent, we would expect them to be dumping risky assets by the boatload.

Expectations regarding U.S. key rates offer a better understanding of the market’s current positioning (graph 4). Futures on federal funds point to a key rate increase of about 40 basis points in the second half of 2018, followed by a similar increase for 2019 as a whole. While expectations for the rest of 2018 seem reasonable, they are highly conservative for 2019, as the Fed leaders’ median forecast suggests that key rates will climb 75 basis points next year. These conservative investor expectations regarding key rates in the medium term, combined with another drop in the term premium1 (graph 5), explain the recent pullback in long-term bond yields. In short, investors seem positioned for a scenario in which trade tensions would have few negative consequences on the economy but would convince central banks to taper their monetary tightening as of next year. This scenario does not appear very likely in our view.

Inflationary Risks Appear Underestimated
The main problem with the market’s current positioning is that it overlooks the upside inflation risks triggered by trade tensions. Some U.S. good prices are already showing the impact of trade tariffs (graph 6 on page 3). In a context where inflation is already above the targeted level and unemployment rates are at lows not seen in decades, central banks would have a tough time disregarding the inflation risks resulting from more tariffs. The BoC’s Governor was quite clear on this when he presented the Monetary Policy Report for July, stating: “Given the

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1 The term premium is the difference between a bond yield and the short-term rate expected for the bond’s term. It is usually positive to compensate investors for the increased risk of holding a long-term bond.
multiple channels through which protectionist measures affect economies, it should be clear that monetary policy is ill suited to counteract all of their effects. It may, of course, play a supporting role in conjunction with other policies. But, to put it bluntly, the economy would slow, inflation would rise, and the exchange rate would depreciate, adding further to near-term price pressures in the Canadian economy.”

It thus seems that even in Canada—a small, open economy that is heavily dependent on trade with the United States—we can’t count on the monetary policy to combat the ill effects of trade tensions. It should then be crystal clear that potential tariff barriers are unlikely to see the Fed deviate from its intentions to keep normalizing key rates gradually. Tariffs would spur inflation rather than slow U.S. economic growth, at least in the short term. The latest ISM indexes show that U.S. businesses are still on a very positive tear, but inflation pressures are increasingly being felt (graph 7). We also have to keep in mind that the Fed is a central bank that responds primarily to what affect the U.S. economy. Growth prospects in the United States would have to take a big hit before any trade conflict pushed the Fed to taper its monetary tightening.

In our opinion, the biggest risk of this trade conflict for the U.S. economy is that it could fuel the inflation uptrend to a worrisome level. This could lead to more significant hikes in key rates and bond yields than we currently anticipate and deal the stock markets a major blow. These unfavourable developments in financial markets could slash household and business confidence, and thereby curb economic activity. It is striking, however, that recent developments in the financial markets—rising stock markets and falling bond yields—are in the opposite direction and could stimulate the U.S. economy instead.

**Bond Yields Likely Retreat Only to Bounce Back Higher**

The recent decline in U.S. bond yields is thus difficult to justify. We can, of course, conjure up catastrophic scenarios that could drive bond yields even lower, but investors fearing such scenarios would be better off betting on a stock market correction or an increase in credit spreads. The economic environment is far more likely to remain relatively favourable in spite of U.S. protectionist measures, however. The pace of gradual monetary tightening as signalled by Fed leaders in June seems reasonable in our view, and all signs point to additional U.S. key rate increases to be announced at the meetings in September and December. Key rate developments in 2019 are not as clear, but with underlying inflationary pressures2 mounting (graph 8), there is little reason to believe that Fed leaders will soon decide to signal that fewer rate increases should be expected. The U.S. 2-year yield should therefore end the year at about 2.90%. The recent drop in long-term yields is thus unlikely to continue; instead, we expect a slight steepening of the yield curve to push the 10-year yield up to about 3.30% by the end of 2018. Long-term bond yields could easily post a sharper increase if inflationary pressures continue to rise or if the term premium quickly tilts back into positive territory.

**GRAPH 8**

Higher underlying inflationary pressures should prompt the Federal Reserve to continue its monetary tightening

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2 Underlying Inflation Gauge: An indicator that captures sustained movements in inflation from information contained in a broad set of price, real activity, and financial data.
If bond yields resume their upward trend soon, as they seem to be doing in the last few days, this will be the third time in as many years that the U.S. bond market made a temporary wrong call by underestimating the Fed’s intention to normalize its monetary policy (graph 9). In the summer of 2016, weaker U.S. data and the vote in favour of Brexit saw many bond yields plunge to historic lows, while the Fed seemed reluctant to continue its monetary tightening. However, encouraging economic data soon reassured the Fed, and Donald Trump’s election drove up bond yields strongly at the end of 2016. This happened again in late summer 2017, when many were convinced that weak inflation would move the Fed to slow down its tightening, bringing the 10-year yield back to about 2%. Nevertheless, the Fed stayed the course and, supported by tax breaks, the 10-year yield exceeded the 3% mark in early 2018. Weak inflation now appears to be firmly behind us as the U.S. economy is near full capacity, and trade tensions are likely to increase upward pressure on prices in the short term. Therefore, we have even fewer reasons to think that the Fed will deviate from the path it has set for the next few quarters. Long-term bond yields should thus reach a new cyclical peak in no time.

**GRAPH 9**

Downturns since mid-2016 did not prevent bond yields from posting an uptrend

U.S. federal 10-year bond yields

Sources: Datastream and Desjardins, Economic Studies

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