NATIONAL BANK OF CANADA FINANCIAL MARKETS

Monthly Fixed Income Monitor

Economics and Strategy

July - August 2018

Highlights

- Assuming some limited further deterioration in trade talks between the U.S. and its major trading partners before year end, we expect the FOMC to be cautious taking the fed funds target range to 2.00%-2.25%. In the longer portion of the yield curve the market will face crosscurrents. International uncertainty will tend to limit rate increases while Fed balance sheet normalization, softer pension-fund demand and large borrowing requirements will tend to pull rates up. All things considered, we have revised our year-end forecast for the 10-year yield slightly downward, to 3.04% from 3.18%, but left it unchanged at 3.47% for year end 2019.

- While we see numerous yellow beeps on our radar screen, none are strong enough yet to turn outright bearish about the global outlook. In that context, our base case scenario (55% odds) is that the Bank will proceed with one more rate hike this year. Most likely in October when it will update its economic outlook. Looking at the longer end of the yield curve we see 10-year Canada trading around 2.57% by year end and around 3.09% in December 2019.

Paul-André Pinsonnault

Forecast dated July 11, 2018

United States						
Quarters	Fed Fund	3 Mth Bill	2YR	5YR	10YR	30YR
07/09/18	2.00	1.96	2.56	2.75	2.86	2.97
Q3	2.25	2.13	2.68	2.82	2.96	3.06
Q4	2.25	2.08	2.73	2.85	3.04	3.12
Q1/19	2.50	2.25	2.76	2.87	3.12	3.24
Q2	2.50	2.37	2.98	3.13	3.33	3.44
Q3	2.75	2.62	3.13	3.22	3.41	3.50
Q4	3.00	2.83	3.20	3.32	3.47	3.56

Canada						
Quarters	Overnight	3 Mth Bill	2YR	5YR	10YR	30YR
07/09/18	1.25	1.42	1.94	2.09	2.17	2.22
Q3	1.50	1.53	2.06	2.15	2.22	2.29
Q4	1.75	1.88	2.28	2.46	2.57	2.63
Q1/19	2.00	1.96	2.31	2.49	2.74	2.79
Q2	2.00	2.18	2.38	2.63	2.93	2.97
Q3	2.25	2.21	2.48	2.74	3.01	3.05
Q4	2.25	2.21	2.55	2.78	3.09	3.14

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FOMC: Trade policy uncertainty has intensified

On July 6 the U.S. and China, following through on previous announcements, each slapped tariffs on US$34 billion of its respective imports from the other. To put things into perspective, $34 billion is 0.17% of U.S. GDP. Even taken together with previously applied U.S. tariffs on steel and aluminum and European and Canadian responses to them, the numbers suggest that the combined effect of these measures could amount to a 0.1-point reduction of U.S. GDP growth over the next 12 months. At first sight, not a big worry.

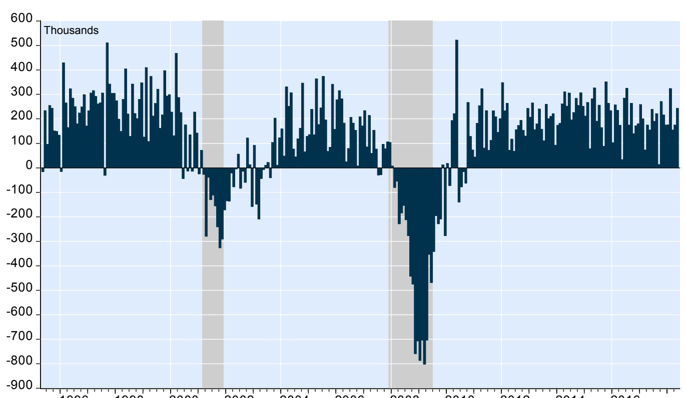
However, one of the main concerns about current trade tensions is that the associated risks and uncertainties could hurt investment spending and consumer confidence enough to significantly amplify the direct hit to growth. At the June FOMC meeting, most participants were already expressing these concerns, reporting comments from their business contacts that plans for capital spending had been scaled back or postponed. And with Beijing accusing President Trump of “trade bullying” that “seriously jeopardizes the global industrial chain,” who knows how far down the road of trade war the U.S.-China confrontation will drive the global economy?

Incoming economic indicators have so far shown no sign of a trade-fear effect on U.S. growth. Looking abroad, however, we see Chinese equities in a bear market and emerging-market currencies under pressure. In other words, international pressure points appear to be building. If the situation worsens and the U.S. economy shows a loss of momentum traceable to trade policy, FOMC participants will have to revise down their expectations for the pace of policy normalization.

Meanwhile, the June jobs report showed no such stresses. Employers added 213,000 jobs to their payrolls.

U.S.: Better-than-expected jobs creation in June

Not only 213,000 jobs added but a strong diffusion index (65.5%)



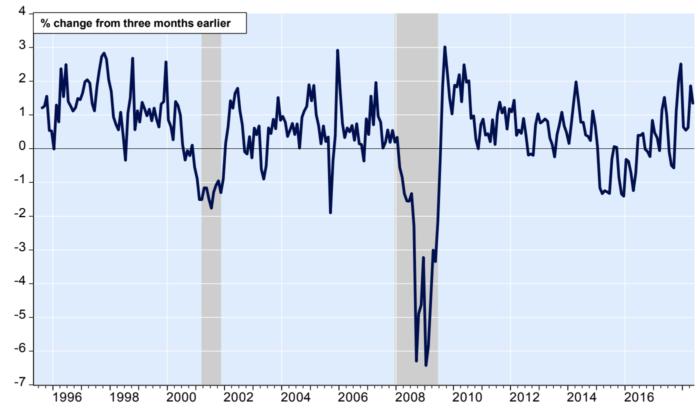
NBF Economics and Strategy (data via Bloomberg)

Moreover, the gains were broad-based across industries (diffusion index 65.5) and the growth of the previous two months was revised up by 37,000.

The trend of industrial production has remained robust and the ISM manufacturing index has risen to one of its strongest readings since January 2004.

U.S.: The trend of industrial production remains robust

May was depressed by a fire at a supplier of parts to truck assembly lines



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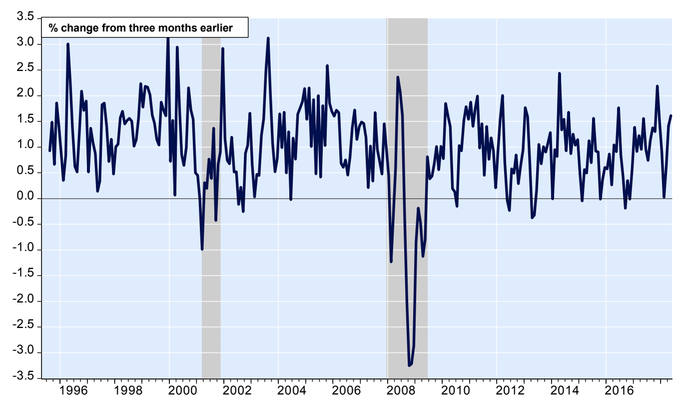
As for consumers, personal income less transfers keeps growing and the retail sales control group remains strong.

Retail sales less food, auto dealers, building materials and gas stations



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In other words, the U.S. economy appears to have enough momentum to breast the FOMC’s gradual normalization. We expect a quarter-point hike at the September meeting, to a fed funds target range of 2.00%-2.25% from the current 1.75%-2.00%.

After that, we continue to see the odds tilted slightly toward no change in Q4, since we expect some further deterioration in trade talks between the U.S. and its major trading partners before year end. By year end 2019, however, we see the target fed funds range at 2.75%-3.00%, just below the median 3.00%-3.25% projection of FOMC participants at the June meeting.

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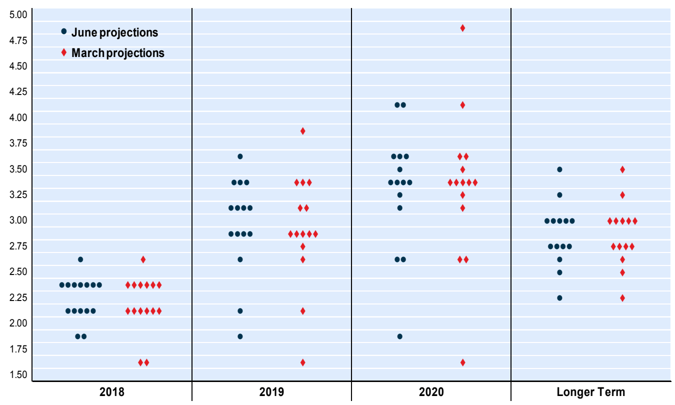
The median FOMC participant sees the fed funds rate above 3% in 2019
Projections of 15 participants for year ends and longer term



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Since early June the yield to maturity of 30-year Treasuries has declined 18 basis points, to 2.96% from 3.12%, and the yield of 10-year Treasuries has declined 12 bps. In the short portion of the curve, the yield of 2-years has drifted up 4 bps, from 2.52% to 2.56%. As for implied forward rates, on June 6 the market was pricing in a 5-bps rise out to the horizon for 2-years and marginal 1-bp increases for 10-years and 30-years. Price action at the short end has been basically consistent with expectations, while in the longer portion we note significant divergences.

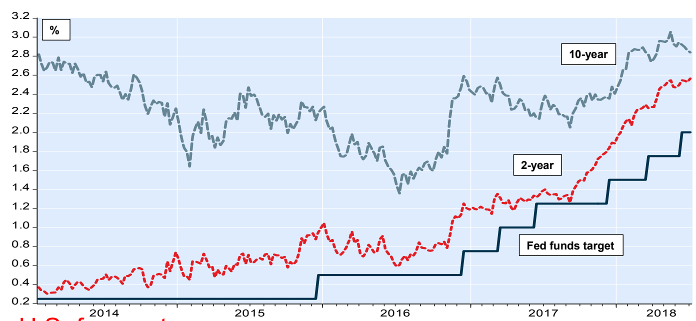
By way of explanation, many point to pension funds and changes in taxation law. Companies' contributions to their pension plans through mid-September can be deducted from income on their prior-year tax return. Since last year's tax reform cut the corporate tax rate to 21% from 35%, companies have great incentive to make the deduction this summer, before the current $65 after-tax cost of a $100 contribution rises to $79. Ignoring interest income, the $14 difference means that for a company to break even in postponing the investment, the yield to maturity on a 30-year bond holding would have to jump from the current 2.97% to 4.00%. For a bond of shorter duration the required yield jump would be even larger. The Wall Street Journal has reported (June 21 and July 5) announcements of billions of dollars in corporate contributions before the cutoff date.

In other words, for an explanation of the low term premium in long bonds one should look not only at quantitative easing but also at tax changes. When some safe haven flows related to international uncertainty are added to the picture, much of the change in the 10-year term premium since mid-May (from −36 bps to −53 bps) can be accounted for.

It can accordingly be asked whether demand for Treasuries will be softer in Q4 as a result of pension funds making bond purchases earlier in the year.

Bottom line: Assuming some limited further deterioration in trade talks between the U.S. and its major trading partners before year end, we expect the FOMC to be cautious and limit its rate hikes to a total of three in 2018, taking the fed funds rate to target range of 2.00%-2.25%. In the longer portion of the yield curve the market will face crosscurrents. International uncertainty will tend to limit rate increases while Fed balance sheet normalization, softer pension-fund demand and large borrowing requirements will tend to pull rates up. All things considered, we have revised our year-end forecast for the 10-year yield slightly downward, to 3.04% from 3.18%, but left it unchanged at 3.47% for year end 2019.

U.S. Treasuries



U.S. forecast

	07/09/18 actual	2018Q3 forecast	2018Q4 forecast	2019Q1 forecast	2019Q2 forecast	2019Q3 forecast	2019Q4 forecast
Fed funds target rate, upper bound	2.00	2.25	2.25	2.50	2.50	2.75	3.00
10-year Treasury yield (quarter end)	2.86	2.96	3.04	3.12	3.33	3.41	3.47

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... and in Canada

On July 11 the Bank of Canada raised its overnight rate a quarter-point to 1.50% and updated its economic projections, leaving its growth outlook unchanged for 2018.

BoC: Summary of Economic Projections

	Latest	April projection
Change in real GDP (%)		
2018	**2.0**	2.0
2019	**2.2**	2.1
2020	**1.9**	1.8
CPI inflation (%)		
2018	**2.4**	2.3
2019	**2.2**	2.1
2020	**2.1**	2.1

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In his post-rate-announcement press conference, BoC governor Poloz acknowledged that the downside risks associated with trade negotiations and tariff threats were serious, but added that much of those dangers could evaporate if NAFTA were settled this fall. So there was little certitude in trade matters and, he argued, monetary policy must be based on what is known rather than on hypotheticals. And the knowns, the incoming data, have been encouraging. The Bank was happy to see that “housing markets are beginning to stabilize following a weak start to 2018” and that “business investment is growing in response to solid demand growth and capacity pressures.” Although the Bank’s models project that the reciprocal import tariffs put in place so far by the U.S. and Canada will subtract about 2/3 of 1% from GDP by the end of 2020, they nevertheless show an economy growing above potential out to the projection horizon. In that light, and given the current state of the Canadian economy, the Bank judged appropriate to raise the overnight rate in July in the expectation that higher interest rates will be warranted to keep inflation near target.

With the economy running at capacity and inflation pressures on the rise, keeping the inflation-adjusted overnight rate in negative territory much longer would obviously be hard to justify on domestic economic grounds. An October rate hike is possible if the BoC’s growth forecasts pan out. That said, the central bank made clear that it is data-dependent and nothing is cast in stone.

Not only would a broadening of U.S. tariffs on auto imports — the U.S. commerce department is to hold public hearings in the second half of July — hurt the Canadian economy directly, but the Bank’s projections are based on continuing solid foreign demand and accommodative global financial conditions, all of which could be shaken by further escalation of trade tensions.

Internationally, economic and political vulnerabilities in emerging economies have led to notable depreciation of many currencies against the U.S. dollar. Emerging-market central banks, struggling to contain depreciation of their currencies, have been drawing heavily on their foreign reserves. This development should go on the watch list for warnings of a potential risk-off environment, especially considering the downward trend of commodity prices since early June.

China’s benchmark Shanghai stock index has entered bear territory, a 22% drop since January 24, and the USD has risen 6.6% against the Chinese renminbi since mid-April. While China’s foreign-exchange reserves rose US$1.5 billion in June, to US$3.112 trillion, this came after decreases of US$14.23 billion in May and US$17.97 billion in April.

China: Shanghai composite stock index has entered bear territory

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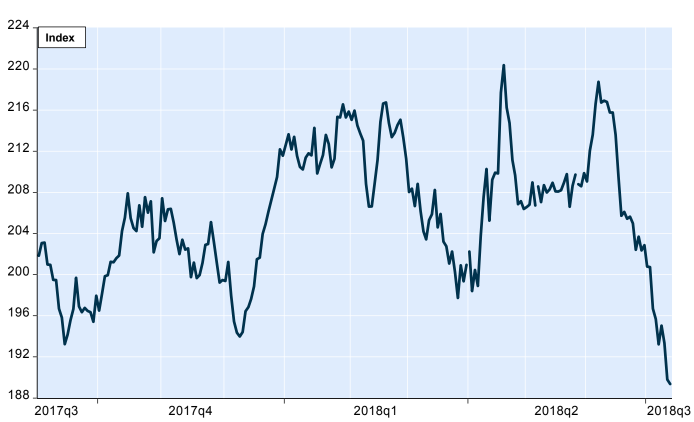
If these global trends accelerate, both the Fed and the BoC may have to revise their plans for policy normalization.

Bottom line: While we see many yellow lights on our global-outlook radar, none of them are flashing red yet. In these conditions, our base case scenario (55% odds) projects one more BoC rate hike this year, most likely in October when the Bank updates its economic outlook.

In the longer portion of the yield curve, we see 10-year Canadas trading around 2.57% by year end and around 3.09% in December 2019.

Base metal spot price index down 13% since early June
Bloomberg index



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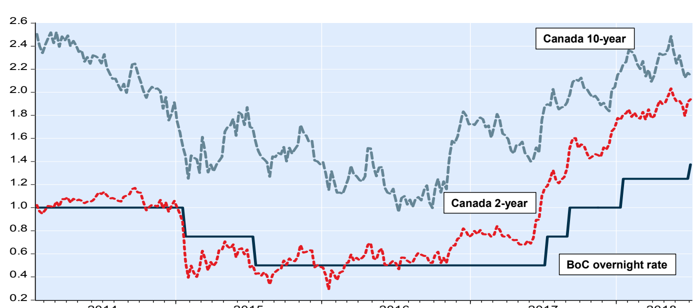
Yield of 2-year Canadas



Canadian forecast

	07/09/18 actual	2018Q3 forecast	2018Q4 forecast	2019Q1 forecast	2019Q2 forecast	2019Q3 forecast	2019Q4 forecast
BoC overnight rate	1.25	1.50	1.75	2.00	2.00	2.25	2.25
Canada 10-year yield (quarter end)	2.17	2.22	2.57	2.74	2.93	3.01	3.09

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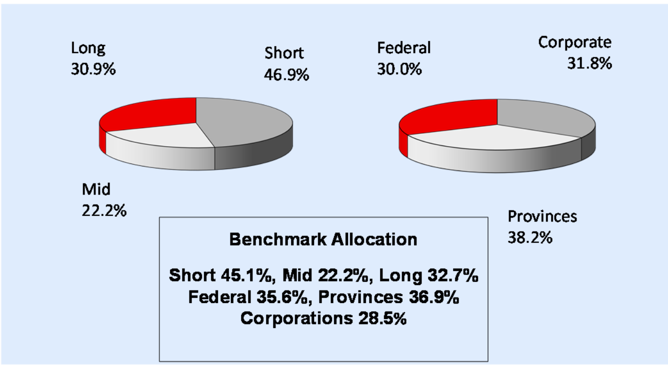
Recommended bond allocation

Recommended duration 7.22 vs the benchmark 7.56
Maintain overweight in provincial and corporate bonds



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Canadian bond market – total returns

Total Returns		07/06/2018		
	Since 06/08/2018	*Since 04/06/2018*	*Since 01/05/2018*	*Since 07/07/2017*
Cash	0.11	0.30	0.62	0.98
Canada				
Short	0.30	0.38	0.78	0.31
Mid	1.27	0.72	1.11	-0.03
Long	3.19	2.43	3.60	2.95
Universe	1.02	0.85	1.42	0.79
Provincial	1.76	2.11	1.71	2.58
Municipal	1.58	1.83	1.68	2.71
Corporate				
AA	0.52	0.45	0.82	0.80
A	1.23	1.23	1.53	2.21
BBB	1.11	1.21	1.69	2.70
Universe	1.07	1.09	1.47	2.16
Total	1.30	1.36	1.54	1.80
S&P/TSX	1.31	8.46	1.65	12.13

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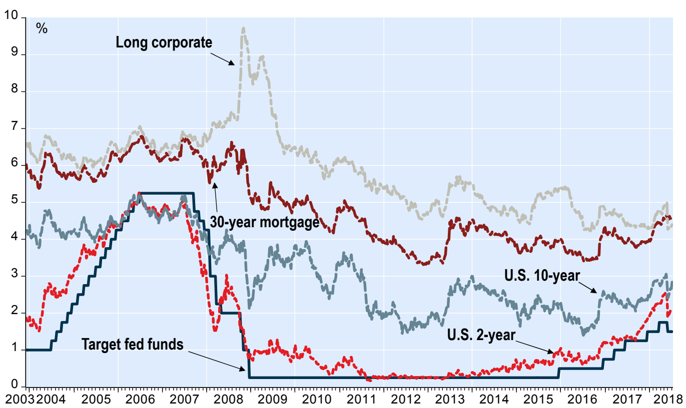
U.S. interest rates

Last observation July 6, 2018



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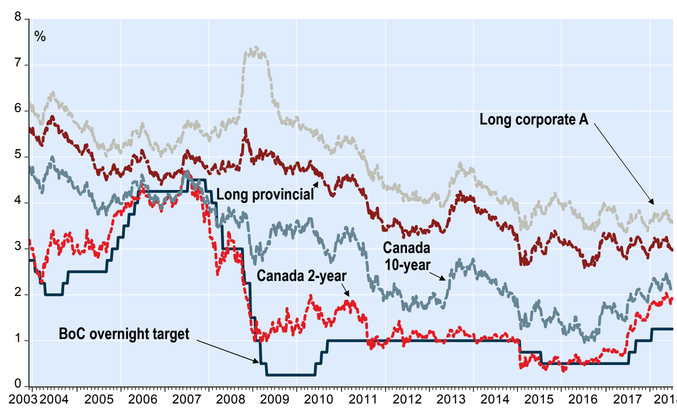
Canadian interest rates

Weekly, last observation July 6, 2018



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Bond Market - Canada

	Close-on 7/06/18	*6/08/18*	*4/06/18*	*1/05/18*	*7/07/17*
Interest Rates					
90-day (B/A's)	1.843	1.753	1.735	1.606	1.156
2 years	1.913	1.927	1.792	1.776	1.189
5 years	2.051	2.165	1.999	1.970	1.470
10 years	2.130	2.320	2.142	2.154	1.880
30 years	2.168	2.364	2.307	2.359	2.258
Spreads					
90 d - 2 years	7.1	17.5	5.7	17.0	3.3
2 - 5 years	13.8	23.8	20.7	19.4	28.1
2 - 10 years	21.7	39.3	35.0	37.8	69.1
10 - 30 years	3.8	4.4	16.5	20.5	37.8
Currencies					
CAD / USD	1.3072	1.2926	1.2785	1.2411	1.2875
EUR / CAD	0.6506	0.6573	0.6371	0.6699	0.6810

Source: NBF Economics and Strategy (data via Bloomberg)

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