NATIONAL BANK OF CANADA
FINANCIAL MARKETS

Monthly Fixed Income Monitor

Economics and Strategy

October 2018

Highlights

- We see U.S. GDP growth coming in at 3.6% annualized in Q3 and 2.3% annualized in Q4. With inflation on target, we think the economic backdrop will support a further rate hike in December. However, we see softer Q4/Q4 growth next year (2.0%) than the FOMC central tendency projects. In our view, this would argue for a somewhat less aggressive policy stance than is suggested by the median dot. We expect hikes in June and September, leaving the target fed funds range at 2.75% to 3.00% at year end 2019. In other words, we see one less rate hike in 2019 than is suggested by the latest FOMC Summary of Economic Projections. Over the rest of this year we see 10-year Treasuries trading in a range of 2.95% to 3.30%, ending the year around 3.14%.

- Since our forecast for the Bank of Canada policy rate already assumed a revamped trade deal with the U.S. and Mexico, it has not changed. We continue to see the BoC hiking in October and then staying on the sidelines until Q1. As for the longer portion of the yield curve, our base case scenario remains one of 10-year Canadas trading around 2.57% by year end and moving above 3% in the second half of 2019.

Paul-André Pinsonnault

Forecast dated September 28, 2018

United States						
Quarters	Fed Fund	3 Mth Bill	2YR	5YR	10YR	30YR
09/28/18	2.25	2.20	2.82	2.95	3.06	3.21
Q4	2.50	2.41	2.91	3.03	3.14	3.27
Q1/19	2.50	2.44	2.96	3.06	3.23	3.35
Q2	2.75	2.71	3.05	3.16	3.33	3.44
Q3	3.00	2.93	3.20	3.25	3.42	3.52
Q4	3.00	2.93	3.27	3.37	3.50	3.59
Q1/20	3.00	2.96	3.35	3.41	3.52	3.61
Q2	3.25	3.18	3.40	3.52	3.62	3.72
Q3	3.25	3.23	3.46	3.58	3.69	3.76
Q4	3.50	3.43	3.31	3.27	3.41	3.52

Canada						
Quarters	Overnight	3 Mth Bill	2YR	5YR	10YR	30YR
09/28/18	1.50	1.58	2.21	2.34	2.43	2.42
Q4	1.75	1.91	2.36	2.48	2.57	2.58
Q1/19	2.00	2.11	2.41	2.51	2.62	2.63
Q2	2.25	2.40	2.54	2.70	2.96	2.98
Q3	2.50	2.46	2.59	2.79	3.03	3.05
Q4	2.50	2.44	2.60	2.80	3.10	3.14
Q1/20	2.50	2.44	2.66	2.86	3.14	3.19
Q2	2.50	2.44	2.78	3.03	3.28	3.33
Q3	2.50	2.45	2.81	3.06	3.33	3.39
Q4	2.50	2.43	2.74	2.90	3.19	3.25

Whither the Fed? (Part 2)

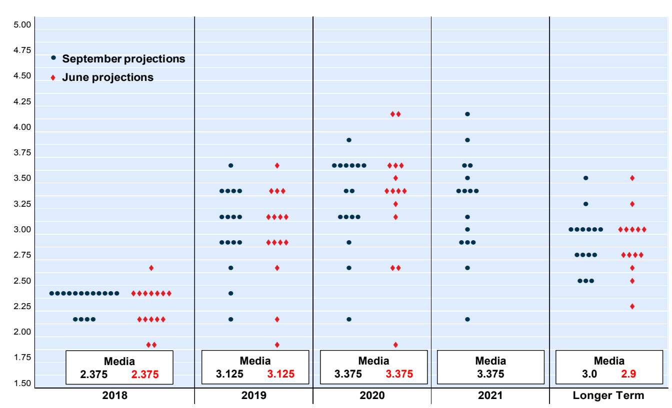
One notable change in the press release following the June FOMC meeting was the removal of previous forward guidance to the effect that the fed funds rate was "likely to remain, ***for some time***, below levels that are expected to prevail in the longer run" (emphasis ours). Given FOMC participants' economic projections for year end 2018 and subsequent year ends out to the forecast horizon, showing unemployment well below neutral and inflation on target, the FOMC had to adjust its message.

At its September meeting the FOMC moved one step further away from the extraordinary stimulus (zero fed funds rate, forward guidance, QE) that it had put in place in the aftermath of the financial crisis. It raised its target fed funds range a quarter-point to 2.00—2.25%, compared to the zero-to-0.25% range of three years ago. In October, as previously planned, the Fed will accelerate its balance sheet normalization. It will now roll over principal repayments exceeding $30 billion from its Treasury holdings maturing each month, and the threshold for reinvestment of agency debt and agency mortgage-backed securities will be increased to $20 billion.

While the rate increase was widely expected, the disappearance from the Committee's September press release of the statement that "the stance of monetary policy remains accommodative" drew much attention. Some saw it as an implicit Fed acknowledgment that the fed funds rate has moved into neutral territory.

United States: Federal Reserve dot plot

FOMC participants' assessments of appropriate monetary policy



NBF Economics and Strategy (Source: U.S. Federal Reserve)

We think that's a bit of a stretch. As Fed chair Jerome Powell noted in his post-rate-announcement press conference, even at 2.00—2.25%, the current range is below every participant's September projection for the longer-term neutral rate. In other words, the policy stance is still accommodative. We accept Mr. Powell's explanation to the effect that when the "remains accommodative" wording was introduced in 2015, the objective was to reinforce the notion that the Fed was not trying to slow the economy with its first rate hike and that monetary policy would continue to support growth. Three years later, in light of the Fed's current Summary Economic Projections and dot plot, keeping the "remains accommodative" statement in the press release would not provide useful information about FOMC intentions going forward. The time had come to drop it.

Given how much the U.S. economy has improved since the last recession and the expected path of the economic indicators bearing on its dual mandate, it is natural for the FOMC to move away from the use of forward guidance as a policy tool. Financial markets will soon have to operate in a "normal" monetary policy environment — no more hand-holding by the Fed. The FOMC will monitor incoming data from financial markets and the economy and will adjust its target rate as it sees fit.

We also note that Fed officials are taking their distance from debate around R* — the conceptual policy rate that would neither accelerate nor slow economic growth.

As New York Fed president John Williams, author of many working papers on R*, put it in a September 28 speech:

> "At times r-star has actually gotten too much attention in commentary about Fed policy. Back when interest rates were well below neutral, r-star appropriately acted as a pole star for navigation. But, as we have gotten closer to the range of estimates of neutral, what appeared to be a bright point of light is really a fuzzy blur, reflecting the inherent uncertainty in measuring r-star. More than that, r-star is just one factor affecting our decisions, alongside economic and labor market indicators, wage and price inflation, global developments, financial conditions, the risks to the outlook … I think you get the point."

Even the Fed chair tried, in an August speech, to downplay the role of R*, making a case that any estimate is at best imprecise and subject to revisions.

Fed governor Lael Brainard also suggested, in a September 12 speech, that market participants should be cautious about drawing conclusions from the dot plot. She put forward a distinction between the "shorter-run" neutral rate and the longer-run equilibrium rate reported in the FOMC dot plot. It is the shorter-run neutral rate, she said, that matters for the policy stance. In the current environment, with fiscal stimulus in the pipeline and financial conditions supporting growth, the shorter-run neutral rate is likely to rise further and may well exceed the longer-run equilibrium rate for a while. In other words, she was warning market participants that it may be misleading to compare the 3.4% median dot for 2020 and the 3.0% long-run median dot in judging whether or not monetary policy will be mildly restrictive in 2020.

Other central banks are making similar comments. In Box 6 of its August 2018 Inflation report, the Bank of England decomposes the equilibrium real interest rate into a longer-run or "trend" component and a shorter-term component.

$$\underbrace{r^*}_{\text{Equilibrium real rate}} = \underbrace{R^*}_{\text{Trend real rate}} + \underbrace{s^*}_{\text{Shorter-term component}}$$

In this framework the trend real rate, R*, is determined by slow-moving structural factors. The BoE noted that in the near term the equilibrium real rate r* can fluctuate around its trend level as a result of shorter-term influences on the economy (s*).

So what can be said about the likely path of monetary policy as the FOMC aims for a policy stance that will support maximum employment and stable prices?

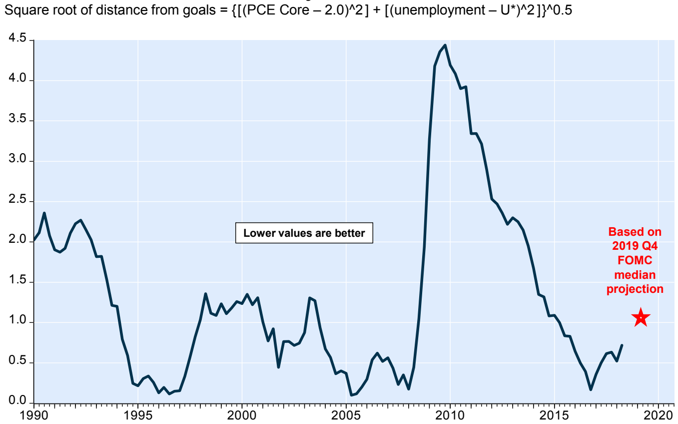
The September FOMC press release was quite upbeat about the economy, noting “that the labor market has continued to strengthen and that economic activity has been rising at a strong rate.” Our own forecast is that GDP growth will come in at 3.6% annualized in Q3 and 2.3% annualized in Q4. With inflation on target, we see the economic backdrop supporting a further rate hike in December.

And for 2019?

We see more rate hikes in store. The latest FOMC Summary of Economic Projections (SEP) suggests that unemployment will drift farther below its natural rate. Though the projections suggest little inflation, when these economic indicators are combined into a single measure, it shows a drift away from the Fed’s goals of full employment and 2% inflation, suggesting that some policy action will be warranted.

Deviation from dual-mandate objectives

Square root of distance from goals = {[(PCE Core – 2.0)^2] + [(unemployment – U*)^2]}^0.5



NBF Economics and Strategy (data via Bloomberg)

However, we see softer Q4/Q4 growth next year (2.0%) than the FOMC central tendency projects.

Softer-than-projected growth would argue for a somewhat less aggressive policy stance than is suggested by the median dot. We expect hikes in June and September, leaving the target fed funds range at 2.75% to 3.00% at year end 2019. In other words, we see one less rate hike in 2019 than is suggested by the SEP.

Economic Projections

	FOMC Central tendency	NBF
Change in Real GDP (%)		
2018	3.0 - 3.2	3.1
2019	2.4 - 2.7	2.0
2020	1.8 - 2.1	2.0
2021	1.6 - 2.0	---
Long Run	1.8 -2.0	---
Unemployment Rate (%)		
2018	3.7	3.8
2019	3.4 - 3.6	3.6
2020	3.4 - 3.8	3.5
2021	3.5 - 4.0	---
Long Run	4.3 - 4.6	---

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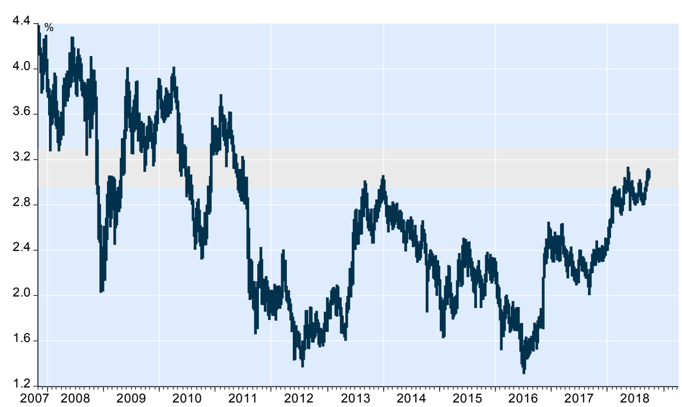
Although year end 2020 is a long way down the road, we think a growth slowdown sufficient to prompt the Fed to ease somewhat will be more of a 2021 story. This is reflected in the slope from the 3-month T-Bill yield to the 10-year Treasury yield in our forecast for late 2020.

Over the rest of this year we see 10-year Treasuries trading in a range of 2.95% to 3.30%, ending the year around 3.14%.

U.S. 10-year Treasury yield likely to be range-bound in Q4



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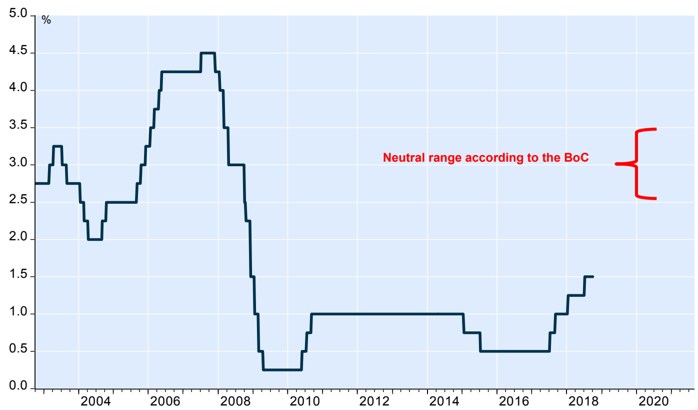
… and in Canada

Bank of Canada governor Stephen Poloz took the opportunity of a September 27 speech to remind financial markets that his game plan is to move the overnight rate toward a more neutral level over time, not mechanically but gradually while remaining dependent on incoming data and other information to guide the Bank’s decisions.

Since that speech, a cloud of uncertainty over the outlook for the Canadian business cycle has lifted with the announcement of a trilateral trade deal among Canada, the U.S. and Mexico. Although the USMCA still requires ratification by Congress, the skies over the Canadian auto industry in particular appear to be clearing, significantly reducing risks to the Canadian economy.

Bank of Canada overnight rate



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Mr. Poloz reports the economy running at capacity and inflation close to target. Add the USMCA to the mix and the BoC governor will be hard-pressed to justify leaving the Bank's target policy rate unchanged October 24. Especially considering that the bond market is priced for a rate hike.

Looking past the October rate announcement, we expect that federal finance minister Bill Morneau will take advantage of the government's fall fiscal update to encourage investment in the domestic economy by corporate Canada. And with an election a year away, more support for the so-called middle class could be coming in 2019. Depending on the heft of these fiscal stimuli and assuming the BoC is on the mark with its July inflation forecast of 2.1% in both 2019 and 2020, we see the overnight rate at 2.50% (the low end of the BoC's estimated neutral-rate range) by July of next year.

Bottom line: Since our forecast for the Bank of Canada policy rate already assumed a revamped trade deal with the U.S. and Mexico, it has not changed. We continue to see the BoC hiking in October and three times more in 2019.

As usual, there are upside and downside risks to this base case scenario. For one, inflation may prove stronger than the BoC expects, forcing Mr. Poloz to take a more aggressive stance in 2019. After all, unemployment is low and we are projecting above-potential growth through next year in the wake of fiscal stimulus expected from Ottawa. On the international front, the ECB policy stance is shifting and U.S. borrowing requirements are a source of concern, a mix that could boost term premiums in the bond market. The resulting tightening of global financial conditions could even stall the Bank of Canada's march toward neutral if it sees a need to limit the debt-service burden of Canadian households.

As for the longer part of the yield curve, our base case scenario remains one of 10-year Canadas trading around 2.57% by year end and moving above 3% in the second half of 2019.

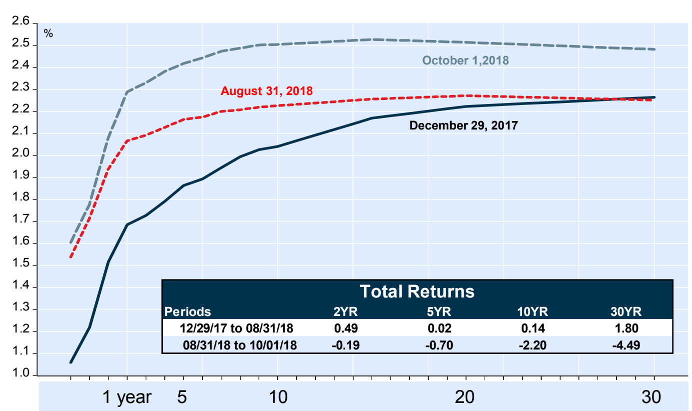
Canada 10-year yield projected to move above 3% in 2019

NBF Economics and Strategy (data via Bloomberg)

Yield curve

The Canadian yield curve has shifted significantly over the year to date. Over the first eight months, the 30-year yield traded basically sideways while the 2-year yield rose 38 bps. Long Canadas generated a total return of 1.80% over that period, outperforming mid terms by a wide margin. Since the end of August, the 2-year and 30-year yields have moved up almost in parallel, with a slightly greater rise in the middle section of the curve.

Canadian yield curve



NBF Economics and Strategy (data via Bloomberg) 2018-10-01

In 2019 we expect the yield curve to shift up further, with a bear steepening bias. We see 2-year bonds trading at 2.60% (+24 bps Q4/Q4) and 10-years around 3.10% (+53bps).

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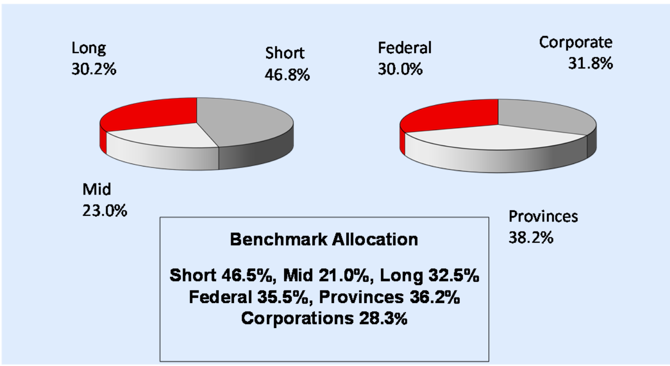
Recommended bond allocation
Recommended duration 7.11 vs the September projected benchmark 7.39
Maintain overweight in provincial and corporate bonds



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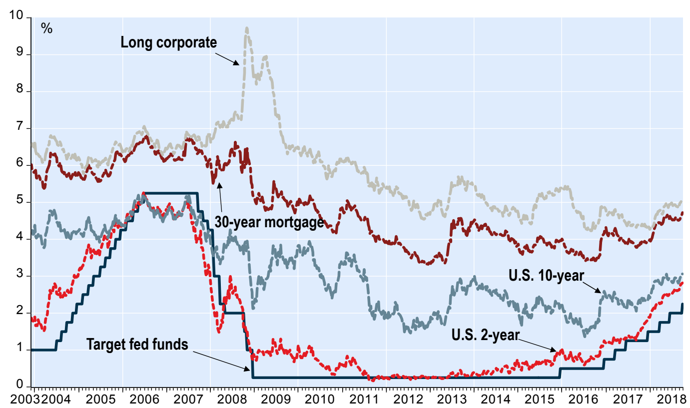
Canadian bond market – total returns

Total Returns	09/28/2018			
	Since 08/31/2018	*Since 06/29/2018*	*Since 03/30/2018*	*Since 09/29/2017*
Cash	0.11	0.31	0.62	1.15
Canada				
Short	-0.24	-0.13	0.14	0.49
Mid	-1.08	-1.08	-0.93	-0.26
Long	-2.40	-2.77	-2.14	2.20
Universe	-0.83	-0.82	-0.48	0.71
Provincial	-1.25	-1.49	-0.74	2.33
Municipal	-1.15	-1.28	-0.68	2.28
Corporate				
AA	-0.26	0.08	0.28	1.00
A	-1.24	-1.06	-0.65	1.77
BBB	-0.78	-0.37	0.16	2.60
Universe	-0.79	-0.46	-0.04	2.10
Total	-0.97	-0.96	-0.45	1.66
S&P/TSX	-0.89	-0.57	6.16	5.87

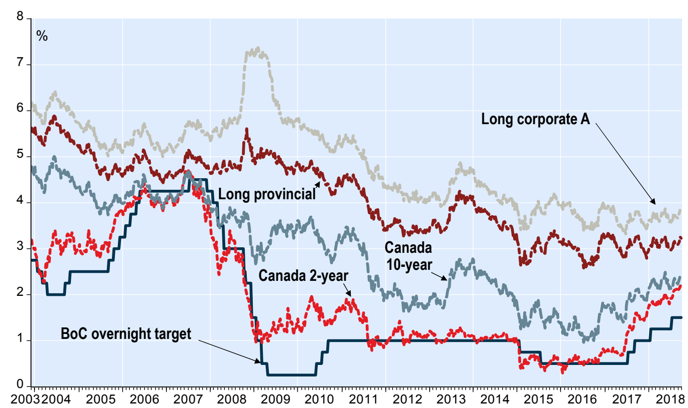
NBF Economics and Strategy (data via Datastream)

U.S. interest rates
Last observation September 28, 2018



NBF Economics and Strategy (data via Bloomberg)

Canadian interest rates
Weekly, last observation September 28, 2018



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Bond Market - Canada

	Close-on 9/28/18	*8/31/18*	*6/29/18*	*3/30/18*	*9/29/17*
Interest Rates					
90-day (B/A's)	2.015	1.980	1.774	1.734	1.415
2 years	2.214	2.070	1.914	1.775	1.548
5 years	2.341	2.168	2.068	1.969	1.753
10 years	2.427	2.228	2.168	2.091	2.099
30 years	2.422	2.252	2.205	2.228	2.472
Spreads					
90 d - 2 years	19.9	9.0	14.0	4.1	13.3
2 - 5 years	12.7	9.8	15.4	19.4	20.5
2 - 10 years	21.3	15.8	25.4	31.6	55.1
10 - 30 years	-0.5	2.4	3.7	13.7	37.3
Currencies					
CAD / USD	1.2909	1.3040	1.3134	1.2900	1.2471
EUR / CAD	0.6674	0.6606	0.6516	0.6290	0.6788

Source: NBF Economics and Strategy (data via Bloomberg)

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Montreal Office
514-879-2529

Stéfane Marion
Chief Economist and Strategist
stefane.marion@nbc.ca

Matthieu Arseneau
Deputy Chief Economist
matthieu.arseneau@nbc.ca

Krishen Rangasamy
Senior Economist
krishen.rangasamy@nbc.ca

Paul-André Pinsonnault
Senior Fixed Income Economist
paulandre.pinsonnault@nbc.ca

Marc Pinsonneault
Senior Economist
marc.pinsonneault@nbc.ca

Kyle Dahms
Economist
kyle.dahms@nbc.ca

Jocelyn Paquet
Economist
jocelyn.paquet@nbc.ca

Angelo Katsoras
Geopolitical Analyst
angelo.katsoras@nbc.ca

Toronto Office
416-869-8598

Warren Lovely
MD & Head of Public Sector Strategy
warren.lovely@nbc.ca

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