Highlights
By Paul-André Pinsonnault / Jocelyn Paquet

- In light of the global slowdown in manufacturing, we think most FOMC members recognize a need for monetary policy to err on the side of accommodation. We see this view as consistent with one more rate cut in October. Our base case scenario is thus for the target fed funds range to end 2019 at 1.50%-1.75%. On the trade front, we assume negotiation will result in a lasting truce between the two largest economies, opening the door for the 10-year yield to move back up somewhat and close the year near 1.74%.

- All things considered – Canadian economy operating close to potential, core inflation on target at 2%, but global growth under pressure – we see the current Bank of Canada overnight rate of 1.75% as appropriate. With trade tension ebbing and some fiscal stimulus in the Eurozone, some normalization of the Canadian yield curve is likely to be possible over time. We see 10-year Canadas trading around 1.41% by year end.

Forecast dated October 4, 2019

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What a roller coaster

In our economic projections, U.S. quarterly growth is on a path of deceleration, from an quarterly annualized rate of 3.1% in Q1 to 1.8% in Q4. Under these conditions it is no surprise that market participants are reacting strongly to incoming news.

When the data suggest that the economy is slowing faster than the market expected, interest rates are dropping sharply, while good news, especially if related to US trade negotiations with China, have the opposite effect.

Uncertainty is fertile ground for volatility, as is illustrated by the pattern of intraday trading in 10-year Treasuries from September 3 through October 1 (chart).

The 10-year yield rose from a low of 1.43% September 3 to an intra-month peak of 1.90% September 13. Over the week of September 9, the 10-year yield posted its second-largest weekly advance (34 basis points) since June 2013 (40 bps). A better-than-expected U.S. non-manufacturing PMI the week before had set the stage for strong market responses. Fuelling a market risk-on mood was an ebbing of concern about U.S.-China trade talks on news that trade negotiators were preparing an October meeting of high-ranking officials, together with upside inflation surprises (12-month core CPI inflation 2.4% and consumers’ 1-year inflation expectation 2.8%).

After that week momentum reversed rapidly, on news including German surveys showing sentiment about the economy nosediving to a post-2010 low. That was more than enough to fuel fears that the malaise of the industrial sector might be spreading to services. The cancellation of a planned visit by Chinese trade negotiators to farms in Montana also contributed to daily volatility. The 10-year Treasury yield closed September 23 at 1.72%, down 18 bps from its September 13 high.

After trading sideways later in September, Treasuries began a roller coaster ride October 1. The 10-year yield fell from 1.75% in the early hours of that day to a low of 1.61% at lunchtime, closing the day at 1.64%. Moving the market that day were disappointing surveys of manufacturing purchasing managers both in the U.S. and abroad, stoking investor concern about the global economic outlook. The tone was set: yields felt further the next day despite a light calendar of economic news.

With the bond market trading as much on the fluctuating political posturing of the U.S. administration as on hard economic indicators, rate forecasts based on econometric models have a hard time keeping up.

In discussions of the economic outlook, optimists have focused on healthy hourly wage growth in the U.S. and record full-time employment, which have put real personal spending on track to expand at almost 3% in Q3. Not a picture consistent with a stumbling of the economy. Pessimists have noted that in the 2001 recession, personal consumption continued to add to...
GDP, but not enough to offset headwinds from business investment and exports. They worry that persistence of current trade tensions could bring a replay of 2001.

So the question is how much longer trade uncertainty can last before investment and trade headwinds kill the longest expansion in history.

The outcome of China–U.S. trade negotiations will be crucial to the global outlook for 2020. We still hope that a lasting truce between the two largest economies will give the current expansion more legs. This remains our base case scenario.

As if economic uncertainty were not enough, a spike of anxiety befell the fixed income market on September 17 when the secured overnight financing rate – a broad measure of the cost of overnight borrowing of cash collateralized by Treasuries – turned chaotic.¹

**Fed gets a wake-up call from chaotic overnight funding market**

Secured overnight funding rate (SOFR)

**Fed: Shifting target-rate probabilities for October 30 meeting**

As implied by fed funds futures market

In Canada

Bank of Canada deputy governor Lawrence Schembri, speaking to the Halifax Regional Chamber of Commerce September 5, noted that the trade war was the biggest risk to the Bank’s economic forecast. This certainly remains the case at this writing.

On the inflation front, the data available since then continue to show the average of the BoC’s three core measures in line with the midpoint of the Bank’s target range of 1% to 3%.

July’s flat GDP was weaker than expected, but considering the excellent handoff from June and a likely uptick in August, we see Canada on track to grow at about 1.5% annualized in Q3 – a more than decent performance considering the massive 3.7% print for Q2. So over the year to date the Canadian economy appears to have done better than the Bank of Canada was expecting.

1 See the appendix for more details on this subject.
As for foreign exchange, we note that the loonie, as measured by the weighted average of exchange rates with the currencies of Canada’s 17 main trading partners, has been volatile but trendless since the July MPR. And finally, commodity prices are softer than in July according to the BoC’s price index.

All things considered – economy operating close to potential, core inflation on target at 2%, but global growth under pressure – we see the current overnight rate of 1.75% as appropriate.

As noted above, the outcome of China-U.S. trade talks will be key to the global outlook for 2020 and thus for the appropriate degree of monetary policy stimulus.

Our base case scenario assumes a lasting truce between the two largest economies and modest fiscal stimulus in the Eurozone. Such an environment should allow some normalization of the Canadian yield curve over time.

The following charts show interest-rate forecasts for two scenarios. The bars in dark blue assume our base case scenario, those in red assume a mild recession.

For the time being we are maintaining a neutral duration stance, but stand ready to make significant adjustments to our portfolio. Indeed, if Beijing and Washington come up with a real trade truce, the North American economy should continue to expand in 2020 and higher long term rates should be expected.

Appendix

Repo market drama: What happened? Why? And how to fix it?

In late September, as we noted above, some sort of crisis took place in the secured overnight financing market. Although the general outline of the drama may be familiar to some of our readers, we suspect that the specifics remain unclear to many – and for good reason. Making sense of what happened requires a clear understanding of several complex topics ranging from the functioning of the Federal Reserve to the way financial institutions finance their day-to-day operations.

Why write about the September turmoil now that it seems to be over? Simply put, because what took place is likely to have broad effects, notably on the future actions of the Fed. More on that later.

Where to begin? Explaining what a repo is seems to be a good starting point (bear with us). A repo – repurchase agreement – is a way for a financial institution to borrow or lend cash with financial assets as collateral. In a typical repo transaction – a secured overnight financing operation – one party sells a security, like a Treasury bond, to another for cash and agrees to repurchase the security at a slight premium at a prescribed time, often the next day. The repo rate determines the size of the premium the borrower will pay to repurchase the security. Such transactions underpin much of the short-term borrowing and lending that financial institutions carry out to manage
their daily cash flow, and are thus vital to the proper functioning of the financial system. Trillions of dollars are exchanged every day in the U.S. repo market.

Most of the time the repo market operates without glitches. But in the week of September 16 it went berserk. The repo rate, which had been stable around 2%-2.5%, suddenly spiked to 10%, leaving those needing to borrow cash exposed. On the 17th, after some hesitation, the New York Fed offered $75 billion in alternative funding, effectively taking over from the private institutions that normally participate in that market. The intervention was repeated daily (and enhanced) in an effort to keep funding cheap and prevent contagion to other areas of finance. Repo rates eventually fell back to more normal levels, but a certain nervousness remained. After all, it was the first time the Fed had to intervene to stabilize the market since the crisis of 2008-09.

Why did it happen? The first explanations to come out in the media emphasized a surge in demand for cash in the week of September 16. Like much else in economics, repo rates are governed by supply and demand. When the volume of liquidities sought by would-be takers increases faster than supply, liquidity become dearer. There were indeed specific circumstances fuelling demand for cash in mid-September. First, companies in the U.S. had to pay tax instalments. At the risk of sounding a bit patronizing, let us explain how tax payments work from an accounting perspective. When a company writes a cheque to the government, the money moves from its bank account to the public treasury. Concretely, the disbursement reduces the bank’s reserves held at the Fed and increases the balance in the Treasury’s central bank account by the same amount. The disappearance of the tax-payment amount from the bank’s reserves leaves it with less cash on its books. All else equal, this will reduce this bank’s propensity to lend cash on the repo market. It may even look to borrow cash itself to restore its pre-disbursement liquidity ratios.

Compounding the effects of tax payments, the U.S. Treasury issued a large volume of debt in the days leading up to the repo market crisis, $77 billion of which settled on September 16. In a process similar to tax payments, when a dealer buys a debt auction, a transfer of reserves to the Treasury’s account occurs leaving less funds available to lend. With the U.S. budget deficit swelling at the moment, such large auctions are bound to become more frequent. This could increase the risk of disruption on the repo market.

Why now?

To summarize, repo rates spiked because of a surge in demand for cash. The latter was caused by an abnormal depletion of reserves, itself the combined effect of tax payments and large Treasury auctions.

But tax payments and Treasury auctions have happened before. Why did the wheels came off this time? Because reserves are less abundant than in the past.

Explaining why requires delving a little more deeply into central bank accounting. The Fed’s assets (mostly Treasuries and mortgage-backed securities) must, like those of any other bank, be equal to its liabilities (currency in circulation and reserves, among other items). In response to the crisis of 2008-09, the Fed boosted the size of its balance sheet from about $870 billion to roughly $4.5 trillion. Most of the increase came from aggressive bond-buying by the central bank, known as quantitative easing or QE. As the Fed bought bonds in the secondary market, it paid for them by creating reserves that it deposited to the account of the selling bank. As a result of QE, the amount of outstanding reserves surged from virtually nothing to a peak of $2.7 trillion in 2014.

Then, as the Fed began to reduce the size of its balance sheet, the process reversed and reserves started shrinking. Bank deposits were affected more than suggested by the size of the balance sheet, as other liabilities – mainly currency in circulation – continued to expand. Since 2014, reserves have shrunk roughly 50% to $1.3 trillion, whereas the Fed’s balance sheet is down just 15%. (Let us be clear here: the reserves held at the Fed are still abundant.)

U.S. financial institutions are required to keep prescribed minimum reserves at the Fed (currently less than $200 billion) to cover deposit liabilities. These are called “required” reserves. Total reserves at present exceed that amount by more than $1 trillion. Clearly, recent tax payments and Treasury issuance did not threaten to reduce reserves below the required minimum. So if financial institutions did not risk crossing the regulatory threshold, why were they reluctant to lend their reserve cash through the repo market? The answer to that question is closely linked to new post-crisis regulations and changing bank preferences.
Since the recession, regulators have demanded that systematically important financial institutions hold minimum levels of high-quality liquid assets (HQLA) to prevent the kind of acute liquidity shortages observed in 2007-08. Such assets include deposits at the Fed, Treasury bonds, mortgage-backed securities and others. Though reserves and Treasury bonds are treated equally in the overall liquidity ratio, banks have shown an increased preference for the former. There are many reasons for this inclination.

First, apart from liquidity coverage ratios, regulators track what is called “intraday liquidity” – cash that can be immediately accessed by financial institutions. That Treasuries cannot be included in intraday liquidity – Treasury transactions settle on day T+1 – effectively puts a premium on reserves.

Second, since the crisis, reserves have become more attractive relative to other liquid assets. Before 2007-08, reserves held at the Fed earned zero interest, putting them at a significant disadvantage to, say, Treasuries. As a result, most financial institutions opted to keep their average reserves as close as possible to the minimum regulatory requirement. Today, the Fed pays interest on reserves (Interest Rate on Excess Reserves or IOER), greatly reducing the opportunity cost of holding them.

The final reason banks now want to hold more reserves has to do with liquidity risk, as was clearly explained in April by New York Fed vice-president Lorie K. Logan2:

“There are new factors driving reserve demand, and that demand is, and will likely continue to be, much higher than it was before the crisis. To start, the crisis appropriately changed attitudes toward risk and increased focus on managing liquidity risk. The subsequent creation of a liquidity regulatory framework for larger banks reinforced the benefits of holding unencumbered liquid assets for both domestic and foreign banks. While these liquidity regulations do not themselves impose any specific requirements to hold central bank reserves, many banks now use internal models that also estimate the very short-term liquidity they need to hold in order to be prepared for a stress scenario. These models make assumptions about a bank’s reduced access to funding and ability to sell securities during earlier stages of a stressed period. The bank may therefore decide to hold a portion of its liquidity buffer as reserves on an ongoing basis as a precautionary measure.”

In other words, since Treasuries carry an interest-rate risk in the internal stress-test scenarios of financial institutions, they are not treated on a par with reserves held at the Fed.

All of these factors mean that financial institutions now want to hold a lot more reserves than they did in the past. But exactly how much is not clear. In an effort to determine the lowest comfortable level that would be adequate in the system, the Federal Reserve ran surveys of financial institutions. The latest one found that participants would be comfortable with a level of reserves ranging from $800 to $900 billion. These results left the Fed confident that current reserves were unlikely to trigger the kind of crunch that occurred in the repo market. But the Fed was wrong. Surveys are estimates that can change over time for reasons specific to each institution or because of change in market environment (Logan 2019). For instance, it is possible that all the recent talk of the possibility of recession increased the level of reserves that banks wanted to have.

It could also be that total demand for reserves is higher than the sum of each bank’s requirements in an environment where reserves are not distributed efficiently. Each institution determines what mix of HQLA is right for its need, and some may want to hold a lot of reserves – much more than they are required to – and still be unwilling to lend on the repo market.

The upshot is that nobody is quite sure what would be an appropriate level of reserves in the system, i.e. a level that would prevent the kind of chaotic movements that took place on the repo market in September. So how does the Fed make sure that recent events don’t recur periodically?

**What are the fixes?**

In the near term, the Fed is likely to continue providing ad hoc short-term funding to keep overnight rates under control, but a longer-term fix is needed. At the moment two possibilities are being discussed. The first is for the Fed to resume expansion of its balance sheet. As previously noted, reserves grow when the Fed purchases assets, so buying Treasuries sounds like the obvious way to make reserves swell. What amount are we talking about here? Well, since demand for money in circulation is expected to keep growing, the Fed will need to expand its balance sheet by approximately $75-100 billion a year just to keep up with that demand (“organic” growth). But in light of recent market action, it appears that the current supply of reserves is insufficient. The Fed will thus need to be more aggressive in its asset purchases. Recent estimates suggest that an additional $200-$500 billion in total would be needed to build a sufficient reserves buffer.

An announcement on that topic could come as early as the Fed’s next meeting, October 29-30. In our view, the Fed might err on the side of prudence here, trying to keep its bond purchases to a minimum (about $250 billion) to avoid giving the

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impression that it is restarting QE by another name. We also have in mind that the central bank has stated many times that it wished to operate with a balance sheet “no larger than necessary for efficient and effective policy implementation.”

Since demand for reserves varies through time for different reasons, the buffer provided by this $250 billion might occasionally prove insufficient. This is why we think the Fed should also introduce a standing repo facility that would permit banks and dealers to obtain secured overnight financing against Treasuries on demand at a pre-determined rate. This rate would have to be low enough to act as a true backstop but high enough not to crowd out the private repo market. Whenever repo rates start rising above a certain threshold, market participants would start using the Fed’s facility instead of private lenders. That would lead to automatic injection of liquidity by the central bank via purchase of Treasuries and a corollary increase in reserves.

To sum up, we see the Fed buying approximately $250 billion of Treasuries in an effort to build a reserves buffer sufficient to prevent further chaotic episodes in the repo market. After that the Fed will probably keep building its balance sheet at a rate sufficient to meet bank demand for reserves. We also expect the Fed to introduce a standing-repo facility that would prevent wild fluctuations in repo rates.
**Monthly Fixed Income Monitor**

**Economics and Strategy**

**Recommended bond allocation**

Recommended duration 8.21 vs the benchmark 8.21

Stand ready to reduce duration on positive developments on the trade front.

![Pie chart showing bond allocation](image)

**Benchmark Allocation**

Short 42.9%, Mid 22.4%, Long 34.7% Federal 34.5%, Provinces 37.9% Corporations 27.5%

**Canadian bond market – total returns**

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**U.S. interest rates**

Last observation October 4, 2019

![Graph showing interest rates](image)

**Interest Rates**

- **90-day (B/A's)**
  - 1.970
  - 1.963
  - 1.975
  - 2.019
  - 2.070

- **2 years**
  - 1.413
  - 1.490
  - 1.621
  - 1.592
  - 2.271

- **5 years**
  - 1.249
  - 1.322
  - 1.533
  - 1.570
  - 2.485

- **10 years**
  - 1.234
  - 1.283
  - 1.572
  - 1.699
  - 2.600

- **30 years**
  - 1.422
  - 1.499
  - 1.741
  - 1.971
  - 2.585

**Spreads**

- **90 d - 2 years**
  - -55.7
  - -47.3
  - -35.4
  - -42.7
  - 20.1

- **2 - 5 years**
  - -16.4
  - -16.8
  - -8.8
  - -2.2
  - 21.4

- **2 - 10 years**
  - -17.9
  - -20.7
  - -4.9
  - 10.7
  - 32.9

- **10 - 30 years**
  - 18.8
  - 21.6
  - 16.9
  - 27.2
  - -1.5

**Currencies**

- **CAD / USD**
  - 1.3315
  - 1.3173
  - 1.3081
  - 1.3384
  - 1.2938

- **EUR / CAD**
  - 0.6842
  - 0.6884
  - 0.6813
  - 0.6659
  - 0.6707

**Source:** NBF Economics and Strategy (data via Bloomberg)
Monthly Fixed Income Monitor
Economics and Strategy

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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