Highlights

- Forecasting above-potential growth in 2019, we expect the FOMC to hike the target fed funds range 25 bps twice next year to a 2.75 to 3.0% range. That said, if the Fed reverts to macroprudential tools (e.g. countercyclical capital buffering) to balance support for economic expansion and control of financial vulnerabilities, it could deliver fewer rate hikes.

- As far as the longer end of the U.S. yield curve is concerned, we still think that the bond market will require some concession in pricing to digest the huge volume of expected net new supply. Net new borrowing requirements including the financing required as a result of Fed balance sheet redemptions could reach US$1.4 trillion next year. We continue to see 10-year Treasuries heading toward 3.50% in the second half of 2019.

- With the Bank of Canada still thinking it will need to raise its policy rate into a neutral range to achieve its inflation target, we see this rate at 2.50% by next December. The yield to maturity of 10-year Canadas is likely to drift up over the next 12 months in response to further policy normalization and higher long rates south of the border.

Paul-André Pinsonnault

Forecast dated December 5, 2018

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“What do you do when the lights go off? You slow down ... you feel your way”

From the economic surprise indexes, whether for major or for emerging economies, one gets the sense that the global economy is losing momentum. The softness of the surprise indexes comes not only from survey data like purchasing manager indexes but also from hard data. The GDPs of both Germany and Japan contracted in the third quarter. Chinese consumer spending is softer than at any time since May and Chinese bank lending fell in October. Further warning signals about global growth have come from commodity prices, which have been trending down since October. In the U.S., a volatile stock market closed the first week of December down 10% from its close of 46 trading days earlier. Analysts are revising down corporate earnings forecasts.

Against this backdrop, the slight curve inversion between 2- and 5-year Treasury rates has attracted much attention. Was it significant?

As is well-known, each of the last seven recessions (as defined by the NBER) have been preceded by yield curve inversions. But usually it is the difference between the 10-year yield and shorter rates such as those of 2-year or 90-day maturities that are used as leading indicators. These have not inverted yet. Moreover, although the rule of thumb is that an inverted curve heralds a recession in about a year, that lead time has varied from 8 to 23 months. So it might be early to head for the hills.

Looking for comfort, we would point to Engstrom and Sharpe’s study (FEDS Notes, June 28, 2018) showing near-term forward spreads statistically dominating the traditional 2-to-10-year slope as a leading indicator. Currently, the slope between the six-quarter forward rate and the 3-month bill is +45 bps, also still in positive territory.

Yet not all FOMC participants are comfortable with the current situation. Bloomberg reports Atlanta Fed president Raphael Bostic, a voting FOMC member, saying in November that ignoring weaker growth abroad was a “recipe for a policy mistake.” More recently, it was St. Louis Fed president James Bullard who said he was not interested in inverting the yield curve. He suggested that “the flat yield curve is a signal that the Fed has been more aggressive than necessary to keep inflation at target.” But among FOMC participants he is the most dovish. Not surprisingly, there are other voting members who appear likelier to support a December rate hike. Among them is governor Lael Brainard, who said December 7 that the gradual path of increases in the fed funds rate “remains appropriate in the near term [our italics], although the policy path increasingly will depend on how the outlook evolves.” In her view, “the most likely path for the economy is positive, although some tailwinds that have provided a boost are fading.”

At the December FOMC meeting some participants are likely to still argue for a quarter-point hike. After all, nonfarm payroll growth has averaged 170,000 over the last three months, still well above what is needed (110,000) to keep the unemployment rate unchanged at 3.7%. Personal income less transfer payments is steadily growing, which will support retail sales.
Moreover, the latest ISM manufacturing survey printed at 59.3. On that front we note that historically the FOMC has been inclined to raise the fed funds rate when the manufacturing index was above 52.5 and lower it when the index fell below that.

Turning to the inflation part of the FOMC dual mandate, we note that the most recent reading of the core Personal Consumption Expenditures deflator, that for October, was down one tick to 1.8%. Over the last six months, core PCE inflation has been running at 1.5% annualized. Is that the underlying trend? Assuming inflation remains in a range of 1.5% to 1.8% in coming months and assuming R* is currently 0.8% in real terms as the Fed’s model suggests, FOMC doves will argue that the fed funds rate need not be pushed much higher to reach the neutral range (2.30% to 2.60%).

One lesson from the last recession was that low and stable inflation was not a sufficient condition for financial stability and sustained economic growth. Since then the Fed has reviewed its monitoring of financial stability, and in late November its board of governors published its first Financial Stability Report. On that occasion, Fed chair Jerome Powell reviewed its monitoring of financial stability, and in late November its board of governors published its first Financial Stability Report. On that occasion, Fed chair Jerome Powell shared his assessment of the current situation, concluding that overall financial stability vulnerabilities were moderate. Still, he acknowledged that risks were above normal in some areas, one of them being nonfinancial business borrowing.

The ratio of corporate debt to GDP is well above trend. But is that surprising after nearly a decade of economic expansion? The concern is that debt has been growing fastest at firms with higher leverage and interest burdens. Moreover, covenant-lite transactions now account for roughly 80% of the entire leverage lending market, compared to less than 30% a decade ago. For Fed governor Brainard, the econometric evidence shows that excess in corporate debt markets can amplify adverse shocks and contribute to job losses. Businesses facing financial strains would be expected not only to cut employment but to pull back on investment. She notes that with loan delinquencies and defaults on the rise, the willingness or ability of banks to lend would be reduced.

This would exacerbate corporate refinancing challenges. Her assessment of the current loan market leads her to believe it may be time for regulators to call for an increase in banks’ countercyclical capital buffer. In her view, that could be a way to lean against rising risks to financial stability at a time when “the degree of monetary tightening needed to achieve the same goal could be inconsistent with sustaining the expansion.”

So not that long ago, the FOMC narrative may have been quite straightforward, but times are changing. Until recently, the focus of policy discussions has been raising the fed funds rate toward R* at a gradual pace. At the December meeting, will macroprudential measures be discussed? Could they replace one or more rate hikes? We shall see. What can be said now is that recent domestic and global developments suggest much less visibility of the economic outlook and of how the FOMC should adjust its policy stance. To quote Mr. Powell, speaking in mid-November about how much further to raise rates and at what pace: “You’re walking through a room full of furniture and the lights go off. What do you do? You slow down. You stop, probably, and you feel your way. It’s not different with policy.” The debate among FOMC participants about the proper pace of policy normalization will likely be lively in months to come.

As for our own forecast, we continue to expect a GDP growth rate of 2.3% on average in 2019 with no runaway inflation. This environment, in our view, would support further policy normalization. However, in light of the current uncertainties, we would not be surprised if the decision about a rate hike in December were not unanimous.

Looking further down the road, our base case scenario for the target fed funds range at year end 2019 remains 2.75% to 3.0%. This is more aggressive than what the fed funds futures market is pricing in at this writing (graph, below).

In our September issue we referred to August CBO projections pointing to an acceleration of the economy’s potential growth rate between 2018 and 2022. Among the reasons given were boosts to investment from the 2017 tax reform. We argued at
the time that if the CBO projections were on the mark, the real neutral fed funds rate could be projected at around 1.4% in mid-2020. Even with inflation of only 1.8%, that would put the nominal neutral rate at 3.20%, compared to the range of 2.30% to 2.60% range we referred to earlier. However, the recent trend in business investment does not appear to support the CBO’s optimistic view. This is one factor in our downward revision of the appropriate fed funds range for the latter part of 2020.

We now expect the upper end of the target fed funds range to peak at 3%. Over time, with the fading of stimulus from the U.S. tax cuts and fiscal spending announced in late 2017 and early 2018, we expect further deceleration of economic growth, from 3.5% annualized in Q3 2018 to a much softer 1.4% in Q4 2020. That will set the stage for a rate cut by the FOMC, which will be doing what it can to sustain expansion without letting the inflation outlook deteriorate too much.

Expenses deflator growing at close to but slightly less than 2.0%, which will be consistent with headline CPI of 2.3%. Forecasting above-potential growth in 2019, we expect the FOMC to hike the target fed funds range 25 bps twice next year. That said, if the Fed reverts to macroprudential tools (e.g. countercyclical capital buffering) to balance support for economic expansion and control of financial vulnerabilities, it could deliver fewer rate hikes.

As for as the longer portion of the yield curve, we still think the bond market will require some concession in pricing to digest a huge volume of expected net new supply. Net new borrowing requirements including the financing required as a result of Fed balance sheet redemptions could reach US$1.4 trillion next year. We continue to see 10-year Treasuries heading toward 3.50% in the second half of 2019.

Bottom line: Although we recognize that the list of downside risks to the economy is long, we continue to forecast U.S. GDP growth averaging 2.3% in 2019. As for the inflation part of the FOMC dual mandate, we see the Personal Consumption...
troubling. He noted that if the situation persisted, revenue for Canada could be significantly depressed. He said the Bank planned to talk to contacts in the oil industry to determine the extent to which investment, spending and hiring plans were being revised. This information would supplement what the terms-of-trade economic model (ToTEM) told the Bank about the economic outlook.

Alberta premier Rachel Notley subsequently announced production cuts to take effect in January. Her announcement was followed by a significant rally of Canadian oil prices, whose discounts narrowed to US$13 for WCS and US$1.25 for SYNC. While producers welcome the most recent news, suggesting that it may prevent layoffs, it remains to be seen how much capital spending plans for 2019 had already been shaved in light of this fall’s soft prices.

The January MPR can be expected to delve into the subject at greater length. The winter edition of the Business Outlook Survey (December 21) may also provide clues.

Adding to the complexity of monetary policy implementation are Statistics Canada downward revisions to GDP going back to 2015. But what was the growth rate of potential GDP over that period? Governor Poloz said the Bank will review its estimate of the output gap in time for the January MPR.

All in all, Mr. Poloz’s speech, in conjunction with the rate-announcement press release the day before, suggests that the Bank will revise down its growth projection for 2019. The extent of the revision is not yet clear, but we think Canadian monetary policy normalization will be put on hold, probably until April or May.

The underlying tone of the corporate bond market, taking its lead from the stock market, has deteriorated significantly in Q4. Spreads to Canada have widened materially for all types of issuers.

Despite what is shaping up to be a soft first quarter (GDP growth 0.9% annualized), we continue to see the Canadian economy growing at an average 1.8% annualized in 2019. That is 3 ticks slower than was projected in the October MPR. We forecast average headline inflation of 2.1% next year. This environment will support further rate hikes later in the year. With the Bank still thinking it will need to raise its policy rate into a neutral range to achieve its inflation target, we see that rate at 2.50% by next December.

The yield to maturity of 10-year Canadas is likely to drift up over the next 12 months in response to further policy normalization and higher long rates south of the border.

The spreads of 10-year A-rated corporates are now quoted 27 bps wider than in late September. Provincial bonds have also been under pressure but to a lesser extent. For example a 10-year Ontario now trades at a spread 15 bps wider.

Since Federal Reserve officials have been communicating that their goal is to keep the economic expansion alive, we expect a dovish tone at the next FOMC rate announcement. That could go a long way to comfort the stock market and thus the corporate bond market. We accordingly leave our sector allocation unchanged this month.
Monthly Fixed Income Monitor

Recommended bond allocation
Recommended duration 7.33 vs the September projected benchmark 7.48
Maintain overweight in provincial and corporate bonds

U.S. interest rates
Last observation December 7, 2018

Canadian bond market – total returns

Canadian interest rates
Weekly, last observation December 7, 2018

Bond Market - Canada

Interest Rates
90-day (B/A’s) 2.254 2.210 1.983 1.753 1.430
2 years 2.001 2.336 2.110 1.927 1.552
5 years 2.009 2.434 2.215 2.165 1.670
10 years 2.072 2.505 2.288 2.320 1.860
30 years 2.234 2.527 2.299 2.364 2.167

Spreads
90 d - 2 years -25.3 12.6 12.8 17.5 12.2
2 - 5 years 0.8 9.8 10.5 23.8 11.8
2 - 10 years 7.1 16.9 17.8 39.3 30.8
10 - 30 years 16.2 2.2 1.1 4.4 30.7

Currencies
CAD / USD 1.3322 1.3210 1.3161 1.2926 1.2849
EUR / CAD 0.6598 0.6678 0.6574 0.6573 0.6610

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

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Monthly Fixed Income Monitor

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