Monthly Fixed Income Monitor

Economics and Strategy

NATIONAL BANK OF CANADA FINANCIAL MARKETS

February 2019

Highlights

By Paul-André Pinsonnault

- In late January Fed chair Jerome Powell basically acknowledged that unresolved government policy issues, ranging from ongoing trade negotiations and uncertainty about how long the government will avoid another shutdown, meant that he could not have strong conviction about the U.S. economic outlook. Neither can we. Much will depend on how politicians play their cards in coming weeks and months. We are optimistic as we wait for time to tell. In the meantime, we are leaving our interest-rate forecasts unchanged from last month. We continue to see one Fed rate hike in September and the 10-year Treasury yield ending the year around 3.34%. If U.S. economic growth turns out softer – say closer to 1.5% than to our base case scenario of 2.3% – then 10-year Treasuries could easily end the year closer to 2.25% or lower.

- Like the Bank of Canada, we project an acceleration of the Canadian economy after a weak first quarter. Assuming that the spot price of West Texas Intermediate crude ends the year at about US$63 and that trade tensions ease, we continue to see GDP growth of 1.8% in 2019 and headline inflation averaging 1.7% but returning to 2% by late 2019. We accordingly keep our interest-rate forecast unchanged: two BoC hikes and 10-year Canadas trading at 2.67% by year end. As with our U.S. forecast, our conviction about that outlook is less than strong.

Forecast dated January 31, 2019

United States						
Quarters	Fed Fund	3 Mth Bill	2YR	5YR	10YR	30YR
01/31/19	2.50	2.40	2.46	2.44	2.63	3.00
Q1/19	2.50	2.43	2.58	2.54	2.72	3.05
Q2	2.50	2.46	2.64	2.65	2.78	3.12
Q3	2.75	2.68	2.87	3.04	3.19	3.52
Q4	2.75	2.71	2.95	3.11	3.34	3.66
Q1/20	3.00	2.94	3.19	3.33	3.46	3.77
Q2	3.00	2.94	3.25	3.36	3.49	3.80
Q3	3.00	2.88	2.93	3.07	3.23	3.52
Q4	2.75	2.52	2.45	2.49	2.71	2.98
Q1/21	2.50	2.26	2.35	2.45	2.69	2.95
Q2	2.25	2.18	2.34	2.48	2.75	3.01

Canada						
Quarters	Overnight	3 Mth Bill	2YR	5YR	10YR	30YR
01/31/19	1.75	1.66	1.78	1.79	1.88	2.14
Q1/19	1.75	1.71	1.90	1.91	1.99	2.17
Q2	1.75	1.93	2.03	2.05	2.14	2.32
Q3	2.00	2.13	2.22	2.26	2.34	2.50
Q4	2.25	2.21	2.40	2.52	2.67	2.83
Q1/20	2.25	2.21	2.56	2.70	2.89	3.04
Q2	2.25	2.21	2.68	2.87	3.10	3.24
Q3	2.25	2.14	2.67	2.88	3.15	3.29
Q4	2.00	1.79	2.27	2.48	2.65	2.78
Q1/21	1.75	1.71	1.84	1.95	2.42	2.54
Q2	1.75	1.71	1.83	1.97	2.44	2.55

Faced with weakening of global growth, central bankers talk patience

The rhetoric of central bankers has taken a dovish turn. In the U.S., with inflation pressures still mild, Fed officials have made clear they think they can afford to be patient in their normalizing of monetary policy. In Japan, the latest BoJ quarterly outlook shows a 2-tick downward revision of inflation forecasts for both 2019 and 2020. The Bank of Canada adjusted its narrative in early January, revising its growth forecast for 2019 down substantially from 2.1% to 1.7%. In Europe, the ECB assesses risks to the Eurozone economy as skewed to the downside.

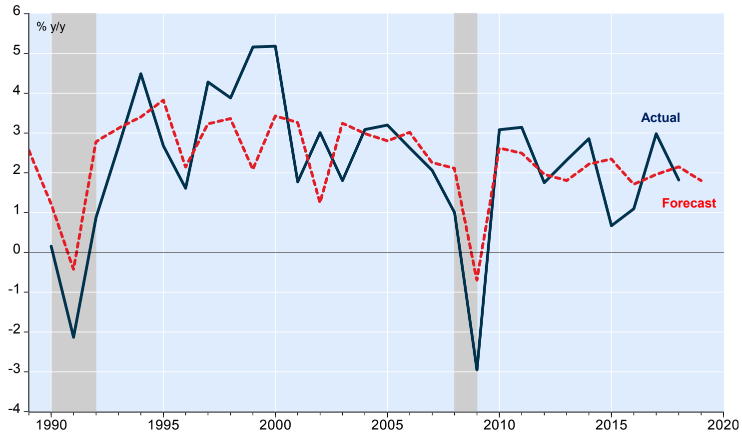
In recognition that economic momentum is likely to be weaker in the near term than first expected, discussion among forecasters is focusing on the factors in the current softening of the outlook and how persistent they might prove.

Time will tell. High on everyone's list of key risks to the global economy are the outcome of trade negotiations and the evolution of financial conditions in coming quarters. Most forecasts assume that trade divergences/tensions will be more or less ironed out. The consensus sees 2019 global growth averaging 3.5%, compared to the 3.7% estimated by the IMF for 2018.

The BoC projects acceleration of the Canadian economy after a weak first quarter. In the view of BoC governor Stephen Poloz, its soft patch is temporary and insufficient to affect inflation materially in the medium term. But the Bank recognizes significant uncertainties in its projections. How will U.S.-China trade relations evolve? Will Congressional ratification of the USMCA be delayed? How long will oil prices stay soft? How will investment, terms of trade and national income be affected? And finally, the Canadian housing market has been softer than the BoC expected. It is unclear how much of this is due to various municipal or provincial measures as well as federal macroprudential initiatives. Higher mortgage rates have obviously taken a toll. Any of these items on the Bank of Canada watch list could influence its monetary policy decisions.

Since GDP forecasts necessarily make assumptions about exogenous economic variables and the behaviour of politicians, discrepancies between what is forecast on the eve of a new year and the actual growth over that year are hardly surprising.

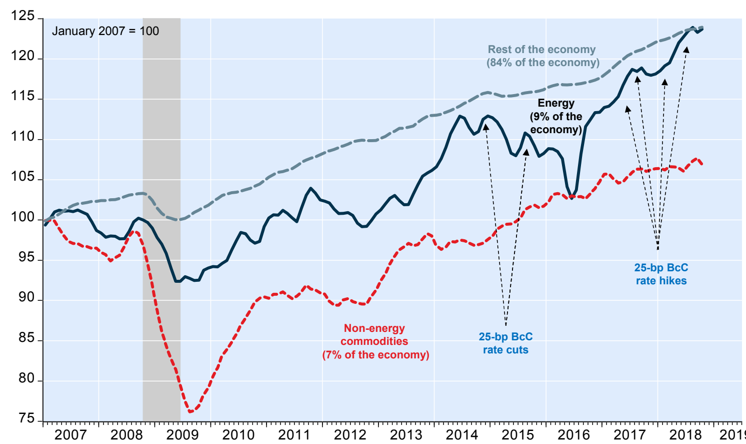
Canada: Actual GDP growth vs. beginning-of-year consensus forecast
Median absolute forecast error since the last recession: 0.6 percentage points



NBF Economics and Strategy (data via Refinitiv)

The median absolute error of consensus forecasts since the last recession is significant. Forecast error was particularly eye-catching in the 2015-2017 period, one main factor being the unexpected oil shock and the extent of the energy sector rebound in 2017.

Canada: Perspective on Canadian economy since 2007
Real gross domestic product, constant 2007 dollars



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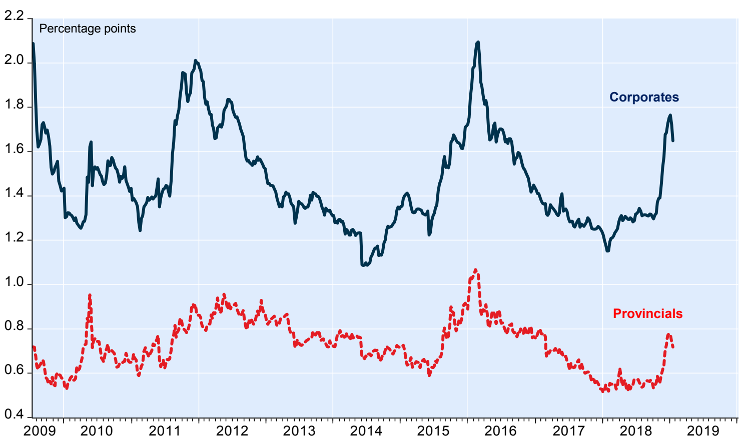
However numerous the potential sources of forecasting error may be, they do not dispense us from providing point estimates for the overnight rate and the shape of the yield curve. First, some of the assumptions in our base case scenario: The spot price of West Texas Intermediate crude will end the year at about US$63 compared to the current US$53.17. The CAD will trade around 1.28 to the USD by year end compared to 1.3277 at this writing. On the political front, we join the consensus view that trade tensions are likely to ease. On these assumptions, we continue to see the Canadian economy growing 1.8% in 2019 and headline inflation averaging 1.7% but returning to 2% by late 2019.

In other words, our base case scenario has not changed. We accordingly keep our interest-rate forecast unchanged: two BoC hikes and 10-year Canadas trading at 2.67% by year end.

As for financial markets, we expect volatility over the next few months, but with the global expansion still having legs we expect a significant reversal of the credit-spread widening of Q4 2018.

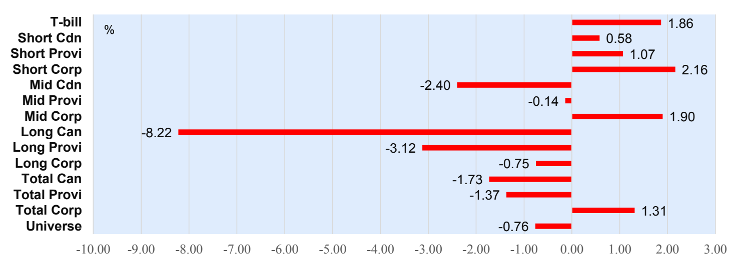
Canada: Spreads of mid term corporates and provincials to Canadas
5- to 10-year maturities



NBF Economics and Strategy (data via Datastream)

In this scenario, the total return of the Canadian bond market will be a negative 0.76%.

Canada: Projected total returns, 2018-12-31 to 2019-12-31
Based on rate and yield-spread forecasts, fixed sector weights



Canada: Spreads	12/31/18	Forecast
Corporate		
Long All	196	167
Mid All	175	137
Short All	115	92
Provincial		
Long	103	79
Mid	78	55
Short	42	31

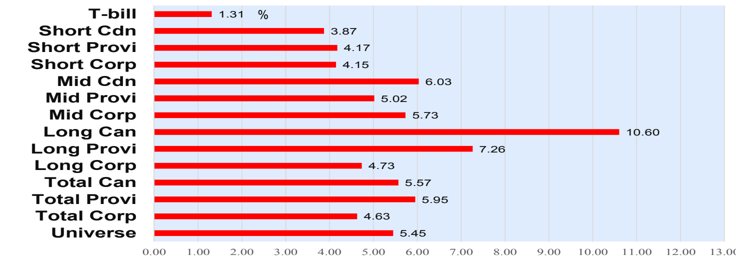
Canada						
Quarters	Overnight	3 Mth Bill	2YR	5YR	10YR	30YR
12/31/18	1.75	1.65	1.86	1.89	1.97	2.18
Q1/19	1.75	1.71	1.90	1.91	1.99	2.17
Q2	1.75	1.93	2.03	2.05	2.14	2.32
Q3	2.00	2.13	2.22	2.26	2.34	2.50
Q4	2.25	2.21	2.40	2.52	2.67	2.83

NBF Economics and Strategy (author's calculation) 2019-01-30

Since the downside risks to the baseline economic forecast are significant in the current environment, it may be instructive to consider what total return could be expected from fixed income securities in two alternative scenarios, bearish and bullish.

In our bearish scenario, Canadian GDP growth slows to 1.1% on average with no quarter-to-quarter contractions, the output gap widens more than 1 percentage point, inflation falls short of 2% at year end and the BoC cuts its overnight rate to 0.75%. Credit spreads to Canadas widen to levels comparable to those of early 2016.

Canada bearish economic scenario: Projected total returns
Based on rates and yield spreads of bearish scenario, fixed sector weights



Canada: Spreads	12/31/18	Forecast
Corporate		
Long All	196	244
Mid All	175	208
Short All	115	159
Provincial		
Long	103	128
Mid	78	106
Short	42	57

Canada						
Quarters	Overnight	3 Mth Bill	2YR	5YR	10YR	30YR
12/31/18	1.75	1.65	1.86	1.88	1.97	2.18
Q1/19	1.75	1.53	1.90	1.91	1.99	2.21
Q2	1.50	1.17	1.57	1.63	1.73	1.97
Q3	1.00	0.89	1.12	1.26	1.50	1.78
Q4	0.75	0.71	0.86	1.07	1.40	1.70

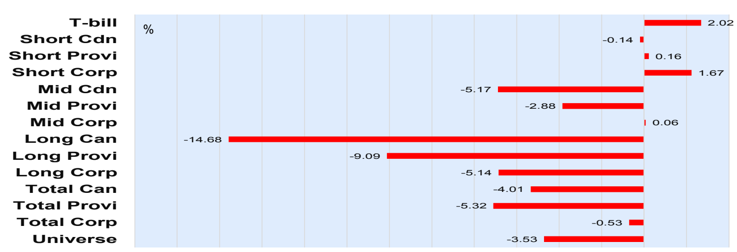
NBF Economics and Strategy (author's calculation) 2019-01-30

In that scenario, the Canadian bond market would generate a total return of 5.45%, but mid and long provincial and corporate bonds would underperform comparable Canadas.

In the bullish scenario, Canadian GDP growth accelerates to 2.1%. The output gap, estimated by the BoC at between −1% and zero in Q4 2018, is erased. With demand exceeding supply, inflation rises toward 2% somewhat faster than in the base case scenario. In this environment, the BoC raises its overnight rate five times in the next 18 months.

In that scenario, the total return of the Canadian bond market is a negative 3.53%.

Canada bullish economic scenario: Projected total returns
Based on rates and yield spreads of bullish scenario, fixed sector weights



Canada: Spreads	12/31/18	Forecast
Corporate		
Long All	196	157
Mid All	175	125
Short All	115	79
Provincial		
Long	103	77
Mid	78	55
Short	42	32

Canada						
Quarters	Overnight	3 Mth Bill	2YR	5YR	10YR	30YR
12/31/18	1.75	1.65	1.86	1.88	1.97	2.18
Q1/19	1.75	1.89	1.90	1.91	1.99	2.17
Q2	2.00	2.10	2.40	2.52	2.67	2.85
Q3	2.25	2.38	2.56	2.70	2.89	3.03
Q4	2.50	2.46	2.75	2.92	3.19	3.29

NBF Economics and Strategy (author's calculation) 2019-01-30

If the odds of these scenarios materializing are respectively 60%, 25% and 15%, the weighted expected return is 0.38%.

… and in the U.S.

As widely expected, the Federal Reserve left the fed funds rate unchanged at 2.25-2.50% in January. The FOMC changed its communication significantly by removing from its press release the sentence about further gradual increases in the fed funds rate. The Fed now says "the Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate" to support "sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective." At the post-rate-announcement press conference, Fed chair Jerome Powell said the FOMC sees the outlook as generally favourable but noted that indicators such as business confidence surveys are sending warning signals. The FOMC intends to let the data clarify what adjustments to the policy stance will be required over time, but has no strong a priori view on rates at this stage, Mr. Powell said.

In other words, the data will determine how long the Fed will be patient. We note that the FOMC press release expressed sensitivity to "muted inflation pressures" and downside risks to the global economy. All in all, the Fed's statement of January 30 does not change our view that there will be no more than one interest rate hike this year.

A fair portion of Mr. Powell's post-rate-announcement press conference was devoted to the FOMC's plans for normalization of its balance sheet. The Committee is still evaluating the right size for the Fed's balance sheet and expects to complete its evaluation over coming meetings. However, it has formally decided that it will "continue to implement monetary policy in a regime in which an ample supply of reserves ensures" that the fed funds rate will be controlled primarily through the setting of administered rates.

Bottom line

At that January 30 press conference, Mr. Powell basically acknowledged that unresolved government policy issues, ranging from ongoing trade negotiations and uncertainty about how long the government will avoid another shutdown, meant that he could not have strong conviction about the U.S. economic outlook. Moreover, growth has slowed in some major foreign economies at a time when the risk of a hard Brexit is on the rise.

For the same reasons, our own conviction about our baseline scenario is no stronger (60% odds). Much will depend on how politicians play their cards in coming weeks and months. We are optimistic as we wait for time to tell. Meanwhile, with inflation muted and the fed funds target range above core PCE inflation, the Fed has the luxury of waiting and seeing.

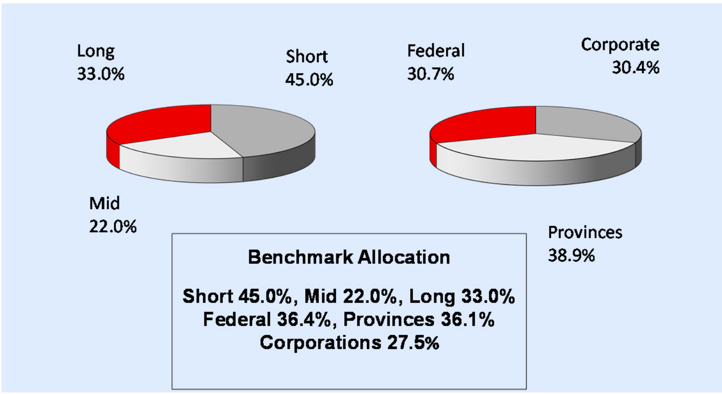
So we leave our interest-rate forecasts unchanged from last month. We continue to see one Fed rate hike in September and the 10-year Treasury yield ending the year around 3.34%. If economic growth turns out softer – say closer to 1.5% than to our base case scenario of 2.3% – then 10-year Treasuries could easily end the year closer to 2.25%.

10-year Treasury yield at year end: 3.375% or 2.125%?
The Fed lacked economic visibility to hazard a balance-of-risks assessment in its press release

NBF Economics and Strategy (data via Bloomberg) 2019-01-31

Recommended bond allocation

Recommended duration 7.46 vs the benchmark 7.46
Maintain overweight in provincial and corporate bonds



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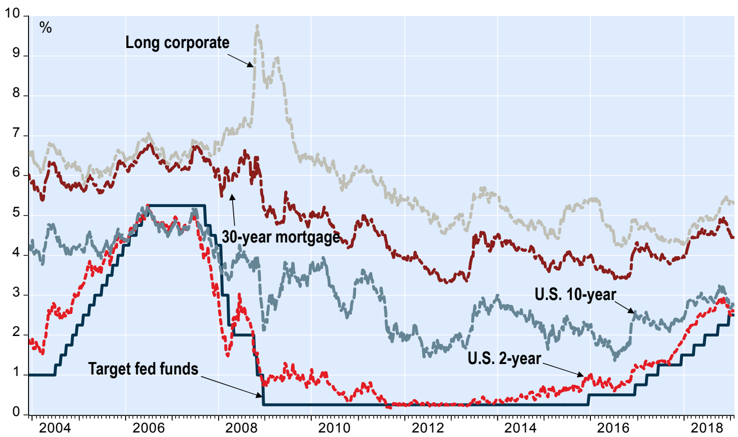
Canadian bond market – total returns

	Total Returns	*01/31/2019*		
	Since 01/04/2019	***Since 11/02/2018***	***Since 08/03/2018***	***Since 02/02/2018***
Cash	0.12	0.45	0.81	1.43
Canada				
Short	0.38	2.13	2.15	2.78
Mid	0.70	4.90	4.31	5.28
Long	0.24	7.78	5.36	7.33
Universe	0.42	3.77	3.22	4.22
Provincial	1.12	4.59	3.23	4.36
Municipal	0.97	4.05	2.95	4.06
Corporate				
AA	0.92	2.62	2.72	3.30
A	1.50	4.09	2.77	3.24
BBB	1.74	3.37	2.61	3.52
Universe	1.43	3.40	2.70	3.45
Total	0.95	3.95	3.07	4.05
S&P/TSX	7.95	3.65	-3.84	2.70

NBF Economics and Strategy (data via Datastream)

U.S. interest rates

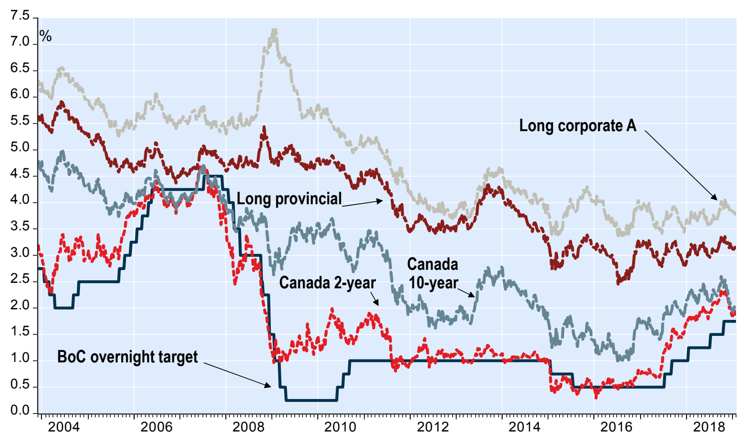
Last observation January 25, 2019



NBF Economics and Strategy (data via Bloomberg)

Canadian interest rates

Weekly, last observation January 25, 2019



NBF Economics and Strategy (data via Bloomberg)

Bond Market - Canada

	Close-on 1/31/19	*1/04/19*	*11/02/18*	*8/03/18*	*2/02/18*
Interest Rates					
90-day (B/A's)	2.178	2.318	2.210	1.944	1.678
2 years	1.775	1.854	2.349	2.098	1.787
5 years	1.786	1.853	2.447	2.255	2.137
10 years	1.879	1.930	2.534	2.353	2.363
30 years	2.136	2.136	2.571	2.365	2.438
Spreads					
90 d - 2 years	-40.3	-46.4	13.9	15.4	11.0
2 - 5 years	1.1	-0.1	9.8	15.7	35.0
2 - 10 years	10.4	7.6	18.5	25.5	57.6
10 - 30 years	25.7	20.6	3.7	1.2	7.5
Currencies					
CAD / USD	1.3125	1.3372	1.3111	1.2992	1.2431
EUR / CAD	0.6655	0.6561	0.6703	0.6654	0.6457

Source: NBF Economics and Strategy (data via Bloomberg)

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