NATIONAL BANK OF CANADA
FINANCIAL MARKETS

Monthly Fixed Income Monitor

Economics and Strategy

June 2017

Highlights

- We continue to see 10-year Treasuries trading around 2.95% going into 2018 and the target range for the fed funds rate set at 1.25% to 1.50% at the December 12-13 FOMC meeting. In our view, rate hikes after Q1 2018 will depend on developments in international financial conditions as well as on incoming U.S. indicators.
- Currently our base case scenario is for the Bank of Canada to raise the overnight rate in Q12018. This said, we see more than 40% chance the BoC will decide before year end that the time has come to return the overnight rate to where it was before the oil shock (1.0%). Like the Bank, we will be watching the incoming data for indications of the appropriate timing and size of adjustments to the overnight rate. If employment growth remains firm and business investment picks up, an October hike may well become our base case scenario.

Paul-André Pinsonnault

Forecast dated May 26, 2017

United States

Quarters	Fed Fund	3 Mth Bill	2YR	5YR	10YR	30YR
05/26/17	1.00	0.93	1.30	1.79	2.25	2.91
Q2	1.25	1.08	1.35	1.84	2.32	2.97
Q3	1.50	1.30	1.70	2.24	2.80	3.41
Q4	1.50	1.33	1.85	2.43	2.95	3.53
Q1/18	1.75	1.55	2.10	2.65	3.09	3.65
Q2	1.75	1.72	2.24	2.73	3.15	3.67
Q3	2.00	1.97	2.45	2.87	3.24	3.73
Q4	2.25	2.08	2.60	2.96	3.30	3.76
Q1/19	2.50	2.30	2.70	3.02	3.34	3.78
Q2	2.50	2.30	2.77	3.08	3.37	3.79

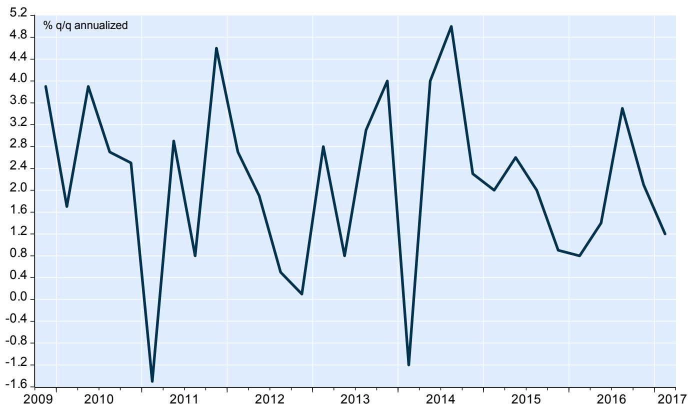
Canada

Quarters	Overnight	3 Mth Bill	2YR	5YR	10YR	30YR
05/26/17	0.50	0.53	0.72	0.97	1.45	2.08
Q2	0.50	0.51	0.74	1.05	1.57	2.21
Q3	0.50	0.50	0.97	1.47	2.10	2.70
Q4	0.50	0.63	1.09	1.56	2.18	2.75
Q1/18	0.75	0.74	1.20	1.64	2.25	2.78
Q2	1.00	0.96	1.48	1.87	2.43	2.91
Q3	1.00	1.13	1.67	2.03	2.52	2.97
Q4	1.25	1.37	1.98	2.32	2.68	3.09
Q1/19	1.50	1.45	2.09	2.37	2.72	3.09
Q2	1.50	1.45	2.19	2.41	2.75	3.11

The FOMC likely to maintain course

In the wake of the financial crisis of 2008-09 it was generally expected that the U.S. financial system and economy would take time to recover fully. Moreover, the road back to self-sustaining economic growth was booby-trapped. The Eurozone had its own existential crisis. To contain it, ECB president Mario Draghi had to pledge in the summer of 2012 that the central bank would do "whatever it takes" to preserve the euro. Peering into 2013, investors saw a U.S. fiscal cliff. In the summer of 2014 the price of oil went into free fall, from US$107.60 in late July to a low of $26.20 in February 2016. The oil shock hit investment spending hard and raised fears of substantial corporate financial defaults. And then, to the surprise of most pollsters, U.K. voters said yes to Brexit, generating another wave of uncertainty.

Quarterly U.S. GDP growth has been volatile
While quarterly growth has averaged 2.1% annualized since Q4 2009, it has ranged from −1.5% to +5.0%



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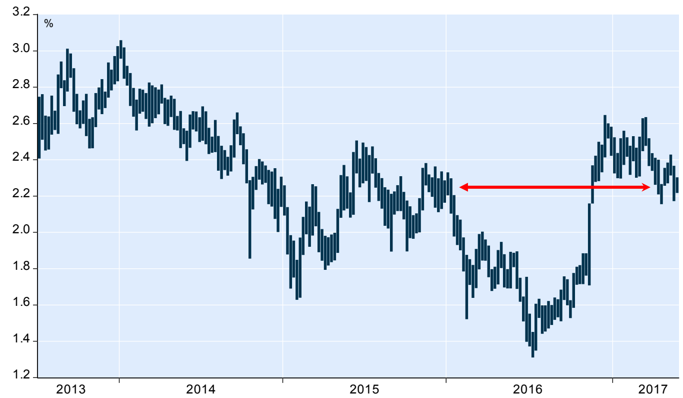
Quarter-to-quarter U.S. growth rates have been volatile in the years since the Great Recession. Financial markets feared at times that the economy would stall and slump anew. In the event, quarterly growth from Q4 2009 to Q1 2017 averaged 2.1% annualized. Central bankers could say their monetary policy countered cyclical headwinds and helped the economy through air pockets. But monetary policy could do little about the tectonic plates in movement belowground. Between 2014, when Larry Summers started to talk about it, and the fall of 2016, the idea that the U.S. economy was falling into secular stagnation went mainstream. The economic skies were clouded by population aging; growth was expected to be modest and inflation low for years to come. By 2016 the debate seemed less about "whether" than about "how much" and "for how long." Last summer the 10-year Treasury yield traded as low as 1.32%.

The election in November of a pro-business U.S. administration promising to spend heavily on infrastructure was a potential game-changer. Risk of recession suddenly disappeared from the horizon. Mr. Trump's economic platform boosted hope of measures to boost productivity that would offset some of the headwinds of secular stagnation.

10-year Treasury yield: Back where it was in December 2015
Fading market expectations of meaningful fiscal stimulus deflate the 10-year yield



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President Trump's election was followed not only by an impressive 14.9% jump of the S&P 500 between November and February but by a 130-basis-point rise of the 10-year Treasury yield, from its low to a high of 2.62% in March.

At this writing, four months into the Trump administration, the markets are lowering their expectations about the timing and extent of fiscal reform, and infrastructure is seen more as a story for 2019, if then. Financial markets, disappointed by the apparent inability of the political process to deliver, are taking some comfort from the increasing synchronization of the global economy. Sentiment indicators in the Eurozone are quite strong. In Germany business sentiment is the most optimistic since reunification. The ECB's economic assessment is encouraging. ECB Executive Board member Peter Praet noted in a May 24 speech that the upswing of the Eurozone economy "is becoming increasingly solid and continues to broaden across sectors and countries." In the U.S., the staff economic review as reported in the minutes of the May FOMC meeting also sounded more upbeat about international developments. Q1 real GDP growth was seen as "solid" in the Eurozone and Japan and as having picked up in China, in some other Asian economies and in parts of South America. As for the U.S., FOMC participants saw the softness of Q1 indicators as "transitory" and judged that "if economic information came about in line with their expectations, it would soon be appropriate for the Committee to take another step in removing some policy accommodation."

The market read the May FOMC minutes as signalling a rate hike at the June 14 meeting. The 10-year Treasury yield is down from its March high as the "Trump trade" fizzles, but given the improvement of the global economy is not expected to break below 2.10% even on temporary U.S. soft data, unless geopolitical turmoil hits the domestic scene. At this writing it is 2.24%, where it was in December 2015.

The minutes of the May FOMC meeting lifted a corner of the veil over the Committee's intentions for its balance sheet. Nearly all policymakers said they thought it would likely be appropriate to begin reducing the Fed's securities holdings this year if the economy behaves as expected. They expressed a favourable view of an approach under which the FOMC would announce a set of limits on the dollar amounts of Treasuries and agency securities that would be allowed to run off each month. Only any principal repayments exceeding these limits would be reinvested. The limits would be set low at first and then raised every three months to a fully phased-in amount that would be maintained until the balance sheet returned to normal size. According to the minutes, policymakers agreed that additional details of the operational plan should be available “soon.” (June 14?)

We expect the pace of balance-sheet normalization to be very gradual, allowing the target range of the fed funds rate to play the primary role in adjustment of the monetary policy stance.

We expect the U.S. economy to grow 2.3% over the coming four quarters. We anticipate some productivity gain over the period as well as further recovery of the participation rate of prime-age workers. In this scenario, the unemployment rate will be 4.4% in Q1 2018. These conditions will in our view support further monetary policy normalization. We see two more rate hikes in 2017 (June and September). For 2018 our base case scenario remains three rate hikes. That said, we recognize that how much the Fed will deliver may depend on what the ECB does in 2018 and its effect on international financial conditions. Other uncertainties are the U.S. fiscal stance in 2018 and whether the phasing out of the Fed’s reinvestment policy proceeds smoothly.

Bottom line: We continue to see 10-year Treasuries trading around 2.95% going into 2018 and the target range for the fed funds rate set at 1.25% to 1.50% at the December 12-13 FOMC meeting. In our view, rate hikes after Q1 2018 will depend on developments in international financial conditions as well as on incoming U.S. indicators.

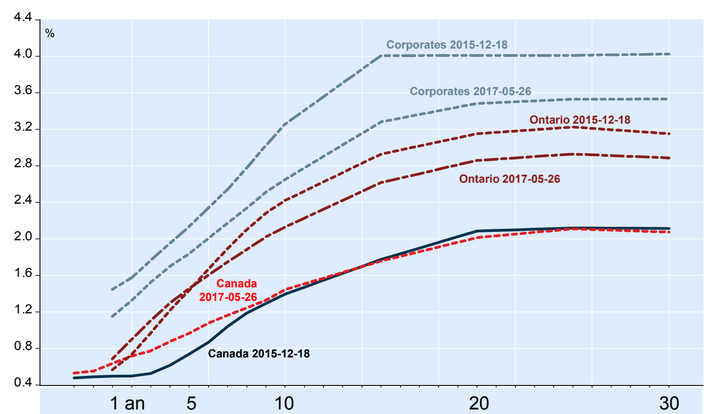
…and in Canada

As widely expected, the Bank of Canada kept its overnight rate unchanged at 0.50% in May. What was surprising was the tone of the press release, much less dovish than anticipated. The Bank chose to emphasize that the global economy is improving and that Canada’s adjustment to the oil shock is largely complete. The “material” excess capacity in the economy noted in previous rate-setting announcements became “ongoing” excess capacity — enough to justify standing pat for now, but setting the stage for a move from a neutral stance to a tightening bias before year end. The Bank’s acknowledgment that “macroprudential and other policy measures … have yet to have a substantial cooling effect on housing markets” was very interesting. It suggests that if the resale market does not soften, the central bank may decide to complement macroprudential measures with rate hikes in an attempt to restrain home-price inflation. All in all, the May 24 statement is consistent with our view that there is a more than 40% chance the BoC will decide before year end that the time has come to gradually return the overnight rate to where it was before the oil shock (1.0%). Like the Bank, we will be watching the incoming data for indications of the appropriate timing and size of adjustments to the overnight rate. If employment growth remains firm and business investment picks up, an October hike may well become our base case scenario.

Total returns

Not only is the 10-year Treasury yield back to where it was trading in December 2015, but the yield curve of Government of Canada maturities of 9 years and more is also little changed from that time.

Canada: Yield curves
Yield to maturity



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A buy-and-hold strategy for long Canadas, with reinvestment of coupon payments, would have taken a $100 investment in December 2015 to a value of $103.92 at this writing.

As the chart shows, however, the yield curve for Canadas may have changed little but those for provincials and corporates have moved. Spreads to Canadas have narrowed substantially — about 27 bps for Ontarios longer than 10 years and 54 bps for A-rated corporates.

Thus a $100 investment in long corporates, including those rated from AA to BBB, would have grown to $114.02 by now and the same investment in provincials to $109.16 (charts on next page).

Bottom line: Our base case scenario is for the Canadian economy to grow 2.4% in 2017 and 2.0% next year. This would be an environment still supportive of credit products but also of an upward trend in the Canadas yield curve. Consequently, our portfolio duration is shorter than its benchmark and we are maintain an overweight in provincial (+3.0%) and corporate (+3.3%) bonds.

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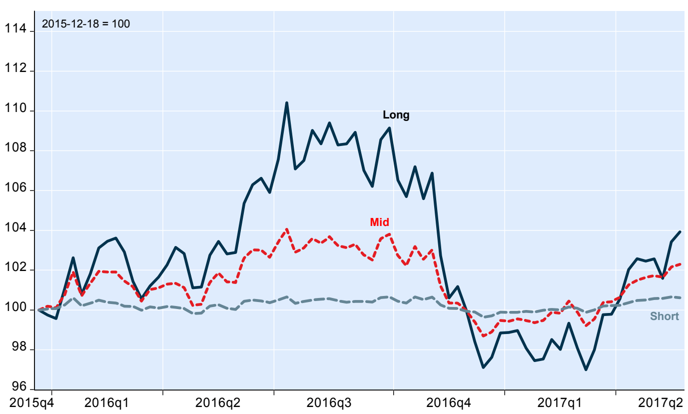
Canadas: Total return
Value of a $100 investment made in December 2015



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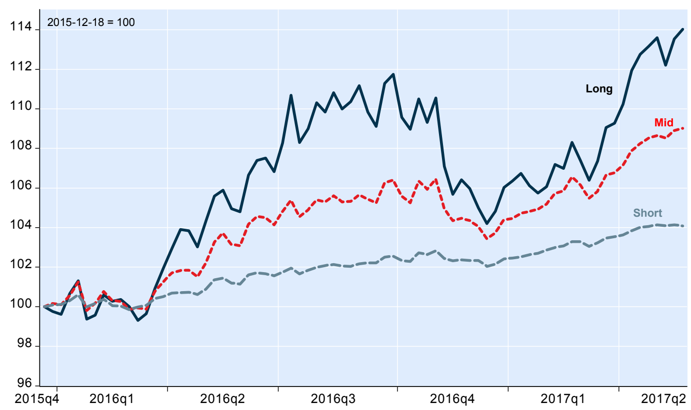
Corporates: Total return
Value of a $100 investment made in December 2015



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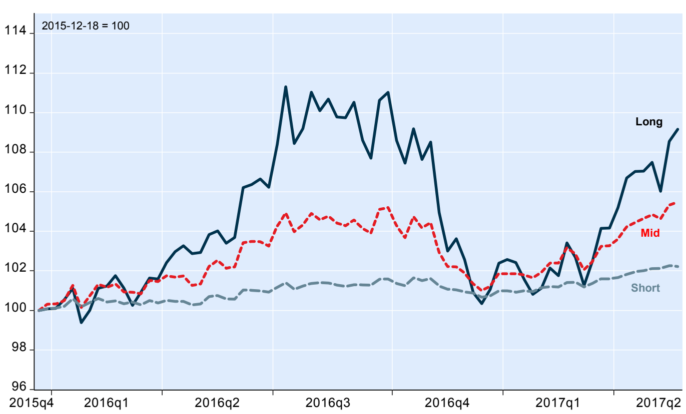
Provincials: Total return
Value of a $100 investment made in December 2015



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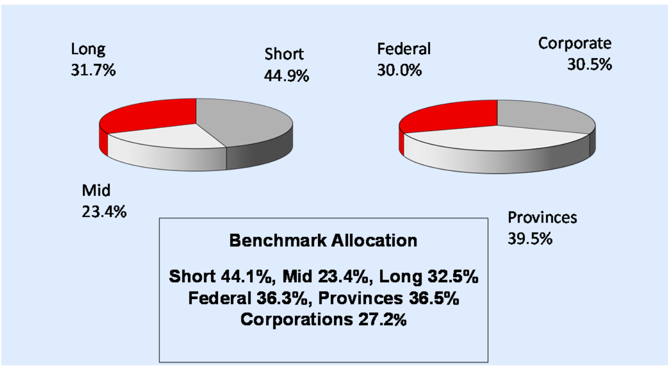
Recommended bond allocation

Recommended duration 7.40 vs the benchmark 7.56
Maintain overweight in provincial and corporate bonds



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Canadian bond market – total returns

	Total Returns	*05/26/2017*		
	Since 04/28/2017	*Since 02/24/2017*	*Since 11/25/2016*	*Since 05/27/2016*
Cash	0.04	0.12	0.26	0.51
Canada				
Short	0.12	0.54	0.69	0.83
Mid	0.63	1.96	2.23	1.38
Long	1.45	4.65	2.80	1.12
Universe	0.51	1.66	1.45	1.04
Provincial	1.24	3.53	3.81	3.90
Municipal	1.10	3.36	4.05	4.41
Corporate				
AA	0.03	0.88	1.58	2.35
A	0.33	3.06	4.41	5.62
BBB	0.31	2.35	4.26	6.20
Universe	0.31	2.25	3.62	4.98
Total	0.72	2.49	2.89	3.15
S&P/TSX	-0.96	-0.06	3.72	12.40

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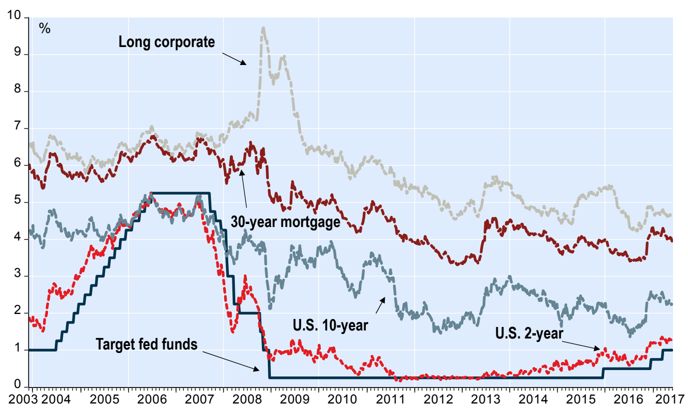
U.S. interest rates

Last observation May 26, 2017



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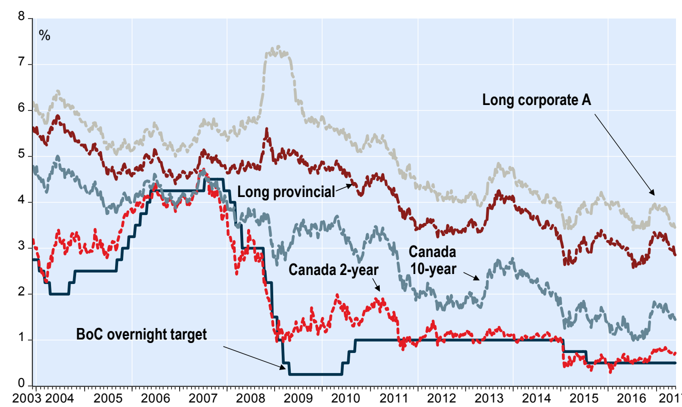
Canadian interest rates

Weekly, last observation May 26, 2017



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Bond Market - Canada

	Close-on 5/26/17	*4/28/17*	*2/24/17*	*11/25/16*	*5/27/16*
Interest Rates					
90-day (B/A's)	0.89	0.92	0.95	0.89	0.91
2 years	0.72	0.72	0.75	0.67	0.51
5 years	0.97	1.01	1.09	0.99	0.78
10 years	1.45	1.55	1.61	1.56	1.35
30 years	2.08	2.16	2.33	2.15	1.99
Spreads					
90 d - 2 years	-18	-20	-21	-22	-40
2 - 5 years	25	29	34	32	27
2 - 10 years	73	83	86	89	85
10 - 30 years	63	62	72	59	63
Currencies					
CAD / USD	1.3447	1.3654	1.3091	1.3521	1.3021
EUR / CAD	0.6648	0.6720	0.7232	0.6978	0.6908

Source: NBF Economy and Strategy (data via Bloomberg)

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