NATIONAL BANK OF CANADA
FINANCIAL MARKETS

Monthly Fixed Income Monitor

Economics and Strategy

July-August 2017

Highlights

- As widely expected, the FOMC raised its target fed funds range 25 basis points to 1.0–1.25% at its June meeting. For many market participants the question going into the meeting was the extent to which the recent weak inflation data would enter into the FOMC's deliberations. The Committee saw them as a temporary phenomenon and stood by its previous call, showing an intention to raise its rate once more in 2017 and to start reducing its balance sheet later this year "provided that the economy evolves broadly as anticipated."
- In a June 12 speech, Bank of Canada senior deputy governor Carolyn A. Wilkins laid the groundwork for a tightening of monetary policy sooner than markets were anticipating. Still, we think that before the Bank starts reducing monetary stimulus it would prefer to wait for a better view of the mid-term effect on the housing market of the macroprudential measures introduced in April by the Ontario government. In our view, with the Canadian economy projected to grow 2.4% in 2017, the Bank will be justified in reversing the 2015 rate cuts before year end. We expect it to start with a quarter-point hike in October. However, should the next employment report suggests above trend growth and oil prices stabilize a rate hike as soon as July 12 cannot be excluded.

Paul-André Pinsonnault

Forecast dated June 16, 2017

United States

Quarters	Fed Fund	3 Mth Bill	2YR	5YR	10YR	30YR
06/16/17	1.25	1.01	1.32	1.74	2.15	2.78
Q2	1.25	1.07	1.37	1.79	2.22	2.83
Q3	1.50	1.33	1.67	2.09	2.41	2.99
Q4	1.50	1.36	1.88	2.27	2.71	3.26
Q1/18	1.75	1.58	2.06	2.43	2.91	3.44
Q2	1.75	1.74	2.16	2.52	2.98	3.48
Q3	2.00	2.00	2.24	2.59	3.04	3.51
Q4	2.25	2.08	2.45	2.77	3.20	3.65
Q1/19	2.25	1.91	2.48	2.78	3.23	3.65
Q2	2.00	1.83	2.11	2.36	2.92	3.38

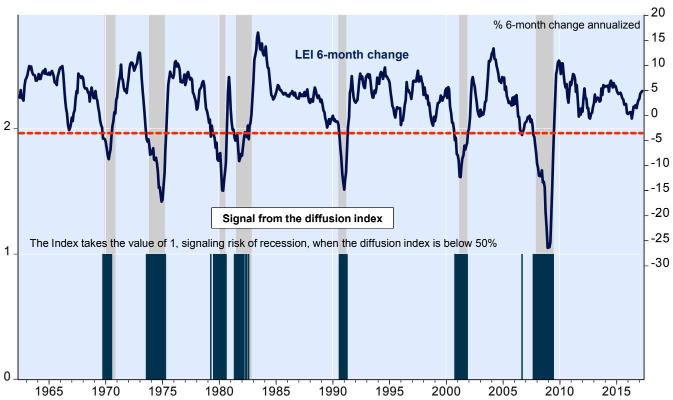
Canada

Quarters	Overnight	3 Mth Bill	2YR	5YR	10YR	30YR
06/16/17	0.50	0.55	0.89	1.14	1.52	2.03
Q2	0.50	0.52	0.93	1.17	1.56	2.08
Q3	0.50	0.72	1.13	1.38	1.80	2.30
Q4	1.00	1.13	1.32	1.71	2.26	2.72
Q1/18	1.25	1.38	1.61	1.94	2.46	2.89
Q2	1.50	1.46	1.73	2.09	2.55	2.96
Q3	1.50	1.46	1.84	2.26	2.65	3.04
Q4	1.50	1.63	1.98	2.32	2.69	3.09
Q1/19	1.75	1.72	2.11	2.38	2.74	3.13
Q2	1.75	1.72	2.05	2.32	2.71	3.11

The FOMC likely to maintain course

As widely expected, the FOMC raised its target fed funds range 25 basis points to 1.0–1.25% at its June meeting. Fed chair Janet Yellen described the decision as reflecting “the progress the economy has made, and is expected to make, toward maximum employment and price stability.” The FOMC rate-setting statement judged that “near-term risks to the economic outlook appear roughly balanced.”

Leading economic indicators: No recession warning
Annualized six-month change



NBF Economics and Strategy (data via Bloomberg) 2017-06-16

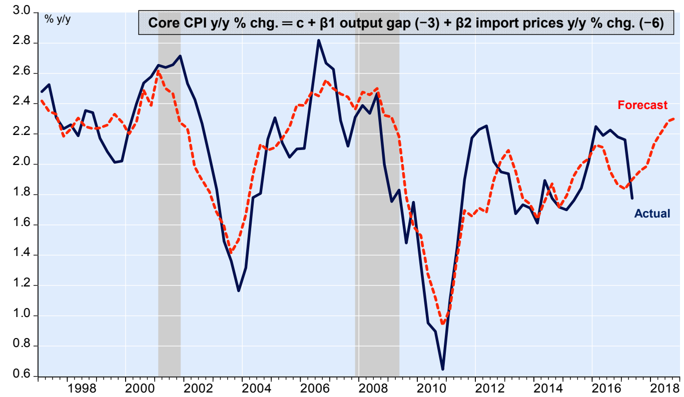
Indeed, judging by the current signal from the index of leading economic indicators, the economy appears to be on course for sustainable growth over the next 12 months. The index is rising at a decent pace and the diffusion index is well above the threshold of recession risk.

Historically, a six-month decline of more than 3.5% annualized in the leading index coupled with declines in more than half of its components has signalled a recession in store. In April the diffusion index was 80%, well above the 50% threshold.

For many market participants the question was not the sustainability of the current expansion but rather how the recent weak inflation data would enter into the FOMC’s decision. In May, core CPI inflation eased two ticks to 1.7%, the lowest in two years. Clearly Ms. Yellen had to address the question in her post-meeting press conference.

She attributed the recent lower readings of inflation to “one-off declines in certain categories of prices such as wireless telephone services and prescription drugs.” As she noted, the resulting base effect will restrain 12-month inflation figures until the low March reading drops out of the calculation. So although the underlying inflation trend is likely, as our macro model suggests (chart), to accelerate in coming months, this will take some time to show up in 12-month inflation. The Fed knows it and will focus on month-to-month inflation until then.

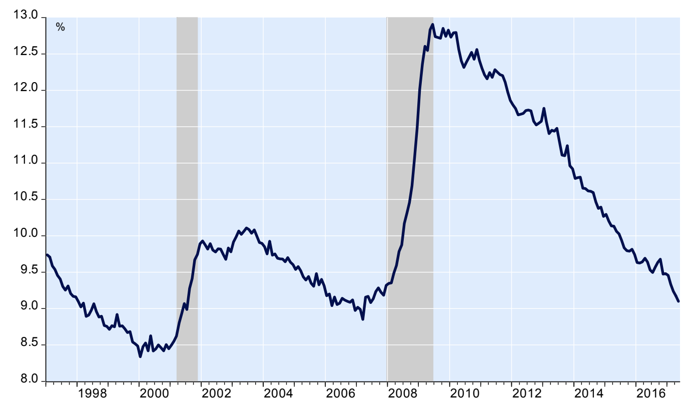
U.S.: Perspective on core inflation
12-month core CPI inflation, actual and model forecast, quarterly data



NBF Economics and Strategy (data via Datastream)

With a broad range of indicators signalling a tight labour market, the FOMC continues to expect wage growth to pick up even if “the so-called Phillips curve appears quite flat.”

Non-employment index, including part-time for economic reasons
Broad measure of labour market resource utilization is back to pre-recession levels



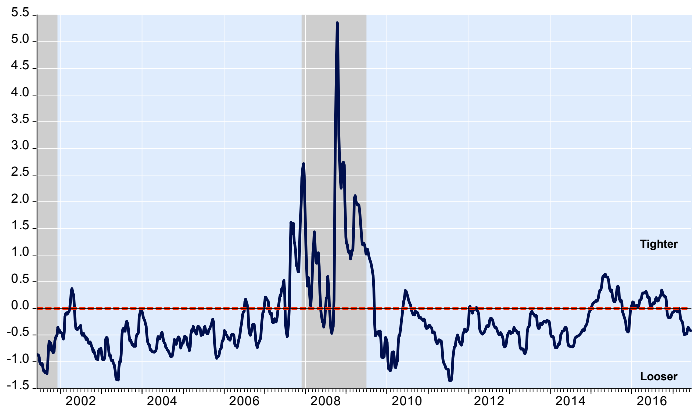
NBF Economics and Strategy (data via Federal Reserve Bank of Richmond)

This to a large extent explains why FOMC participants continue to see one more rate hike this year though inflation continues to undershoot their target.

That said, if weakness persists in month-over-month inflation, calling into question their view of the underlying inflation trend, FOMC members will reassess their expectation for the path of the fed funds rate. As Ms. Yellen says, policy is not on a pre-set course and the FOMC is monitoring inflation developments closely.

It has been clear for some time that most FOMC participants have been looking for opportunities to take further steps along the path of normalization in order to create “policy space.” They want room to manoeuvre in the event the economy stumbles down the road. So despite disappointing retail sales and flat industrial production in May, the FOMC did not hesitate to take advantage of looser financial conditions, thanks to the stock market and a softer U.S. dollar, to tighten at the June meeting.

Financial conditions index adjusted for economic conditions
The Chicago Fed ANFCI indicated easier financial conditions heading into the June FOMC meeting



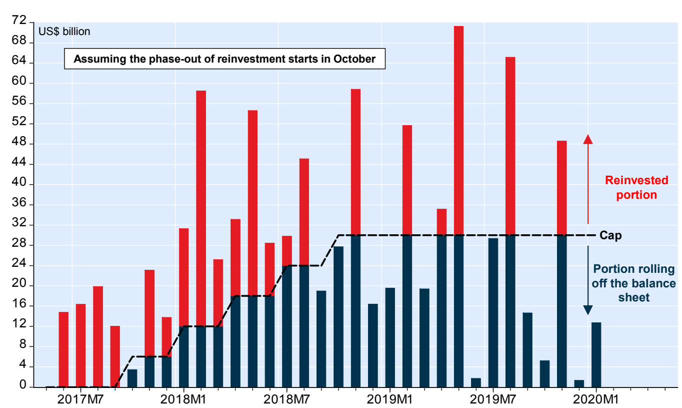
NBF Economics and Strategy (data via Federal Reserve Bank of Chicago) 2017-06-09

The FOMC also provided details of its plan for normalization of its balance sheet, which is set to begin this year "provided that the economy evolves broadly as anticipated."

As of June 7, 2017, the portfolio of the System Open Market Account consisted of $2.5 trillion in Treasuries, $1.8 trillion in agency MBS and $9 billion in agency debt securities, with about 60% of the Treasuries maturing within five years.

Under the plan, the Fed will reinvest only the portion of principal payments that exceeds gradually rising caps. For Treasuries, the FOMC expects to set the cap at $6 billion per month initially, rising $6 billion monthly every three months until it reaches $30 billion monthly. For agency debt and MBS the initial cap will be $4 billion monthly rising $4 billion every three months until it reaches $20 billion monthly.

SOMA: Treasury maturities and run-off caps
Maturity schedule of notes, bonds, floating-rate notes and TIPS

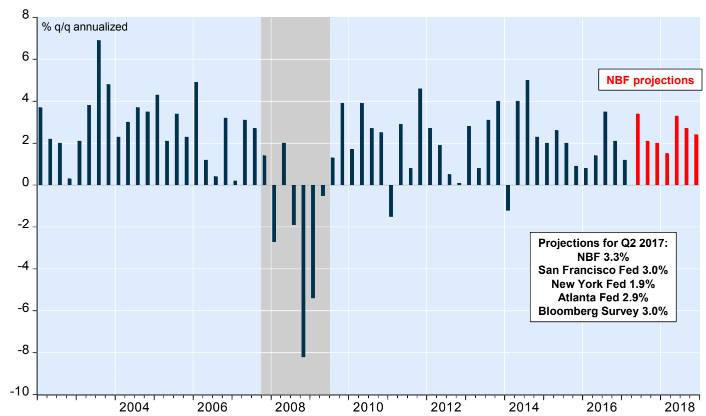


NBF Economics and Strategy (data via Federal Reserve Bank of New York)

In the Fed's current operations, maturing Treasuries are rolled over into Treasuries, other than T-bills, issued on the maturity date. Currently the shortest term for a Treasury coupon security is 2 years, so at this stage the normalization process can be projected to July 2019 (chart, above).

As for when balance sheet normalization will begin, Ms. Yellen said that was a question of the FOMC's confidence in the economic outlook and in its projections of the future path of the target fed funds rate. In late May, Fed governor Lael Brainard suggested that the change in balance sheet policy could start when the fed funds rate has reached "a level at which it can be cut if needed to buffer adverse shocks." In our view, a 1.50% fed funds rate would meet that definition.

U.S. GDP growth expected to bounce back in Q2



NBF Economics and Strategy (data via Bloomberg and various Federal Reserve Banks)

We expect the U.S. economy to grow 2.3% over the coming four quarters, faster than the growth of its potential (1.50% to 1.75%). 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 assume the Fed will hike its target rate once more in September and start balance sheet normalization in October.

Will the 10-year Treasury yield break 2.10%?
Fading market expectations of meaningful fiscal stimulus deflate the 10-year yield

NBF Economics and Strategy (data via Bloomberg) 2017-06-16

Bottom line: Despite our growth forecast, we anticipate that uncertainties about the inflation outlook will weigh on the 10-year yield in the short run. We have lowered our year end forecast to 2.71%, but continue to see 10-year Treasuries trading just above 3% by mid-year 2018.

Monthly Fixed Income Monitor

Our base case scenario is for three Fed rate hikes in 2018, but that will depend very much on how international financial conditions evolve over the next 16 months. We are keeping an eye on the ECB.

…and in Canada

In a June 12 speech, Bank of Canada senior deputy governor Carolyn A. Wilkins laid the groundwork for a tightening of monetary policy sooner than markets were anticipating. Ms. Wilkins described Q1 growth — 3.7% annualized — as "pretty impressive." In explaining the performance, she emphasized the contribution of growing business investment and was also keen on reminding her audience that Canada's good showing was "not being driven by just a few key industries." Although she acknowledged that exports had come in weak in Q1 and that "higher-than-expected spending, if funded by credit, could add to the vulnerabilities in the household sector," she saw encouraging signs that "sources of growth are broadening across sectors and regions" and said the "adjustment to lower oil prices is now largely behind us." Under such conditions, Ms. Wilkins declared, the "Governing Council will be assessing whether all of the considerable monetary policy stimulus presently in place is still required." Even if inflation were to remain below the central bank's target, she seemed inclined to a more hawkish approach, suggesting that policymakers had not only to focus on current economic conditions but to "anticipate the road ahead."

In early 2015, Bank of Canada governor Stephen Poloz said it was appropriate to take out some insurance, in the form of a lower policy rate, to cushion the impact of the drop in oil prices and facilitate the economy's sectoral adjustment to the new circumstances. Two and a half years later, the time is at hand to remove this 50-basis-point insurance policy and return the overnight rate to 1%.

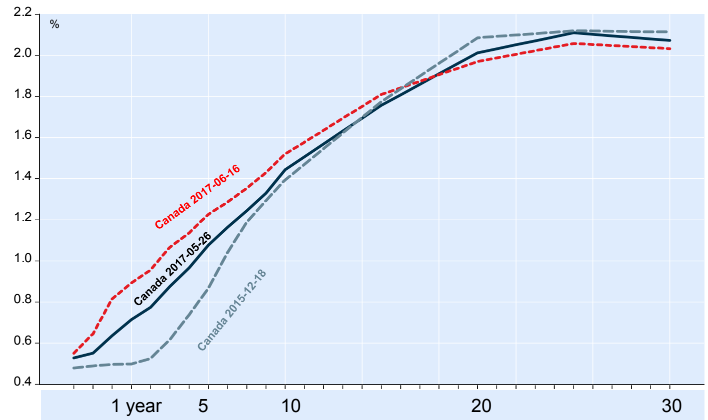
In light of Ms. Wilkins's speech, an early move by the Bank of Canada cannot be excluded. However, with Toronto home sales diving 25% in May, the Bank will probably want to wait for a better view of the mid-term effect on the housing market of the macroprudential measures introduced in April by the Ontario government before it starts reducing monetary stimulus. In our view, with the Canadian economy projected to grow 2.4% in 2017, the Bank will be justified in reversing the 2015 rate cuts before year end. We expect a quarter-point hike of the policy rate in October.

But at what pace will policy normalization proceed after that? After all, the Bank expects the output gap to close in the first half of 2018, and in April it estimated the neutral policy rate in Canada at 3% (a range of 2.5% to 3.5%). Unfortunately, the vulnerabilities associated with high household indebtedness may squeeze the Bank's options for adjustment of its policy.

In our analysis, a 1-point increase in 5-year mortgage rates would bring about a 7% decline in home prices countrywide. The resulting negative wealth effect would shave consumer spending growth to 1.3%, compared to 2.2% if home prices were to rise 2%. Anything more than that would severely hurt Canada's economic performance. In other words, the Bank of Canada will need to be cautious in normalizing its policy stance. We accordingly expect a BoC overnight rate of 1.50% by year end 2018, still well below the lower bound of the 2.5%-to-3.0% range estimated by the BoC for the neutral rate.

Total returns

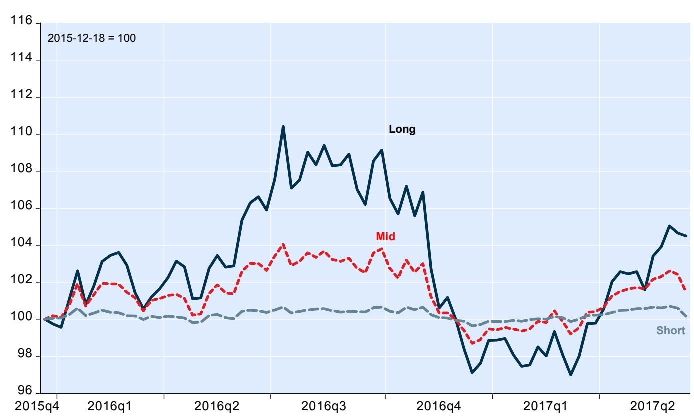
Canada: Yield curves
Yield to maturity



NBF Economics and Strategy (data via Bloomberg) 2017-06-16

The slope of the yield curve, as measured by the difference between 2-year and 30-year Canada yields, has flattened by 22 basis points since our last issue. At this writing, Canada 2-years are trading at 0.89%, up 18 bps from May 26. At the long end of the curve, the yield of Canada 30-years has fallen 4 bps to 2.03% over the same period and Canadas maturing in 1 to 5 years have generated a negative return (−0.44%). Mid terms did worse, −0.76%, while maturities longer than 10 years have, as a group, returned a positive 0.55%.

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



NBF Economics and Strategy (data via Datastream) 2017-06-16

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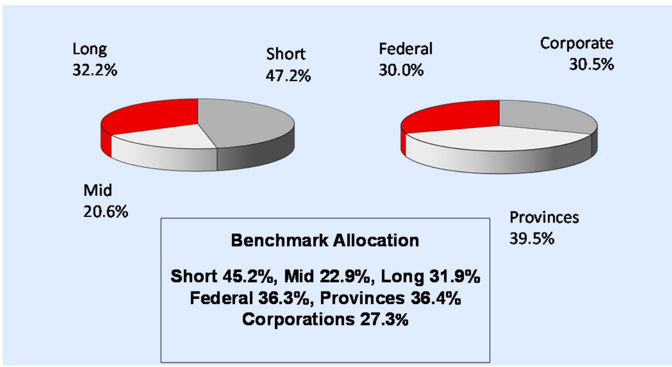
Recommended bond allocation

Recommended duration 7.51 vs the benchmark 7.63
Maintain overweight in provincial and corporate bonds



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Canadian bond market – total returns

Total Returns	6/16/17			
	Since 5/19/17	Since 3/17/17	Since 12/16/16	Since 6/17/16
Cash	0.03	0.13	0.24	0.49
Canada				
Short	-0.47	0.22	0.67	-0.03
Mid	-0.66	1.98	2.98	-0.86
Long	0.99	6.56	7.59	-1.88
Universe	-0.21	1.86	2.54	-0.62
Provincial	0.30	4.16	5.84	2.01
Municipal	0.23	3.80	5.72	2.81
Corporate				
AA	-0.35	0.74	1.87	1.36
A	0.27	3.67	5.84	4.10
BBB	-0.07	2.62	4.94	4.60
Universe	0.02	2.55	4.47	3.62
Total	0.03	2.86	4.25	1.49
S&P/TSX	-1.49	-1.21	1.02	12.41

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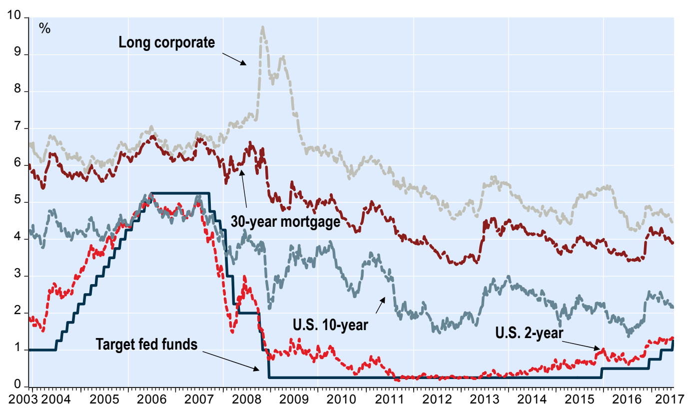
U.S. interest rates

Last observation June 16, 2017



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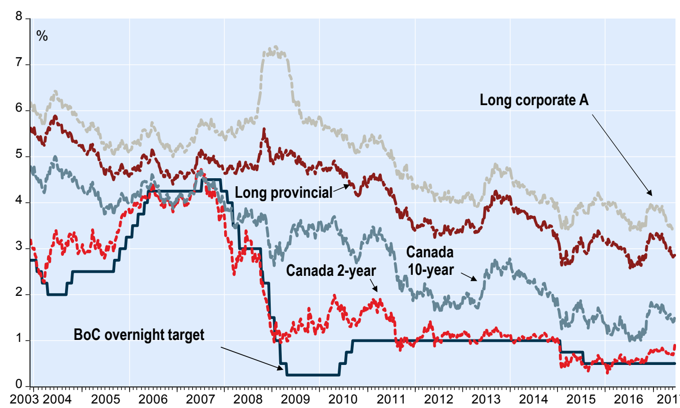
Canadian interest rates

Weekly, last observation June 16, 2017



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Bond Market - Canada

	Close-on 6/16/17	5/19/17	3/17/17	12/16/16	6/17/16
Interest Rates					
90-day (B/A's)	0.91	0.89	0.93	0.92	0.89
2 years	0.90	0.68	0.81	0.82	0.54
5 years	1.14	0.95	1.21	1.22	0.59
10 years	1.52	1.48	1.76	1.83	1.12
30 years	2.04	2.11	2.41	2.43	1.77
Spreads					
90 d - 2 years	-2	-21	-12	-10	-35
2 - 5 years	24	27	40	39	4
2 - 10 years	63	80	96	101	58
10 - 30 years	51	63	65	59	65
Currencies					
CAD / USD	1.3213	1.3513	1.3351	1.3336	1.2894
EUR / CAD	0.6758	0.6604	0.6975	0.7177	0.6880

Source: NBF Economy and Strategy (data via Bloomberg)

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