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Quick Hit – Lower yes, but steeper? Not really

By Warren Lovely / Taylor Schleich

At least prior to this week's repo madness, firmer data and a perceived easing of some geopolitical concerns had the US Treasury curve re-steepen substantially. The US 2s-10s curve moved back into positive territory at the beginning of the month, moving as steep as 9 bps last Friday. And after digesting yesterday's second FOMC rate cut, the curve currently resides at 3 bps. Now, it might be premature to declare an end to the US curve inversion, since the typical "inversion cycle" has lasted over 14 months and the time spent inverted in August amounts to just 8 days. And while Fed Chair Powell was somewhat dismissive of overnight repo pressures, some are tempted to view money market dysfunction as the proverbial canary in the coal mine.

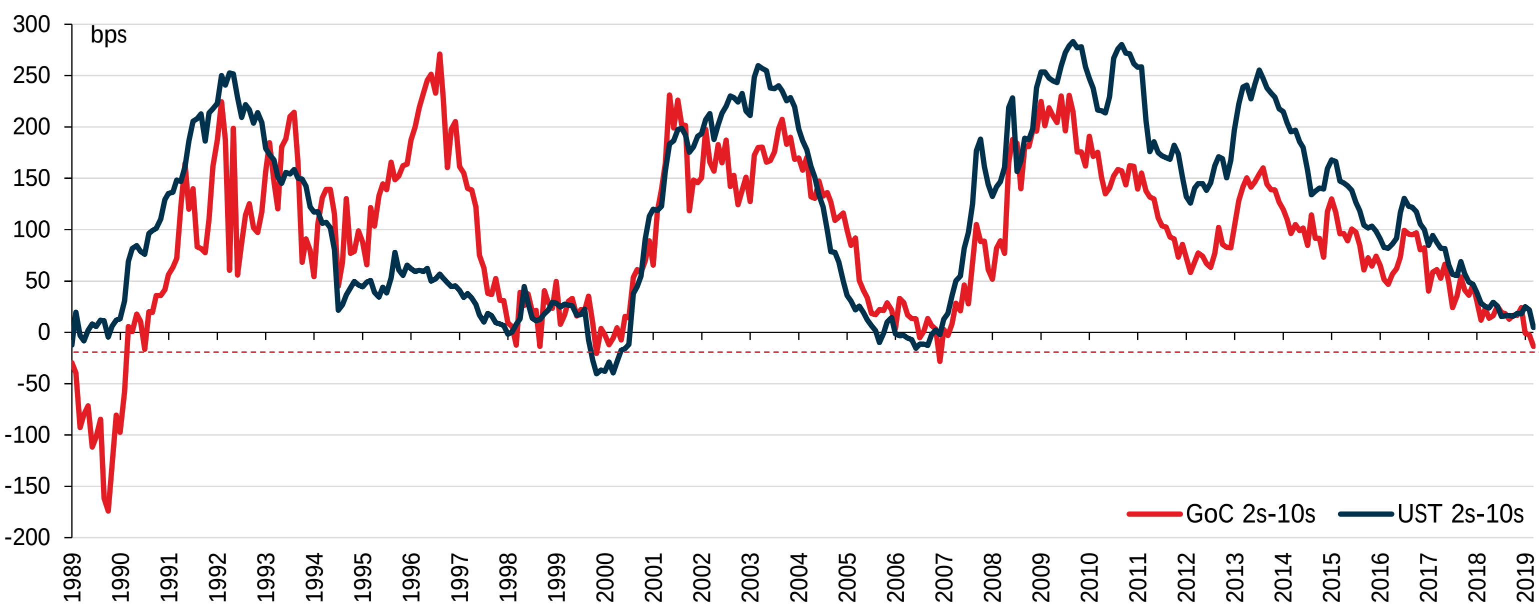
Closer to home (at least for us), Canadian rates have sold off on our own set of firmer data. Ten-year Canadas have backed up 33 bps versus an August low of 1.09%, but our yield curve remains stubbornly inverted. As we write this, Canada 2s-10s is inverted by more than 18 bps, which, despite the recent sell-off, is only than 3 bps removed from the most inverted levels of the year. That means we continue to flirt with the flattest (i.e. most inverted) levels in nearly 30 years (Chart 1). Further, this is about the most inverted curve you'll find anywhere in the developed world's fixed income markets (Chart 2). (Technically, Hong Kong's is more inverted, although in terms of size, Hong Kong's stock of outstanding sovereign bonds pales in comparison to Canada's.)

Yes, there are some technical considerations that have contributed to a flatter curve in Canada. Not least of which is a relative dearth of longer-dated Canada supply—a theme expected to be reinforced with today's *Quarterly Bond Schedule*. But this lack of 10-year (and 30-year) supply is hardly a novel feature of Canada's sovereign bond market. We've been dealing with this for much of the post-crisis period… nor did this short-dated supply tactic prevent Canada 2s-10s from matching a 10-country average for extended periods of the post-crisis trading range. But in recent times we've deviated, and the Canada curve has moved relatively flatter than other nations' sovereign curves. Even in more recent sessions, the effect of the improvement in global risk sentiment has been much more evident in the Treasury curve (Chart 3). Certainly, this can't all be explained by technical supply factors as investors have clearly discounted some longer-term growth concerns into the GoC bond market.

Now, we don't aim to be unnecessarily alarmist. To be clear, recessionary conditions aren't the foundation for our base case outlook. In fact, NBF Economics' own official forecast has the Canada curve re-steepening *without* the Bank of Canada adjusting the overnight rate. But that projection is predicated on a sustained easing of geopolitical headwinds that have clouded the outlook for well over a year, extending back to NAFTA/USMCA negotiations last year. If the recent progress on trade talks ends up disintegrating (as it did back in May when the nations were, according to Mnuchin, "90% of the way there"), it'd be tough to expect any organic steepening in the yield curve. Indeed, should global risks remain elevated/reinvigorate and/or the longer-term growth concerns priced into the Canada curve begin to manifest into hard economic data, the only solution may be an outright reduction in the Bank of Canada overnight rate. Although the historical sample size is admittedly small, both of Canada's most recent experiences with curve inversions required/resulted in BoC easing to bring about sharp steepenings of the yield curve. Ultimately, this iteration may be no different. But with less than a single cut priced over the next twelve months, BoC easing is a possibility that, to us, appears underappreciated.

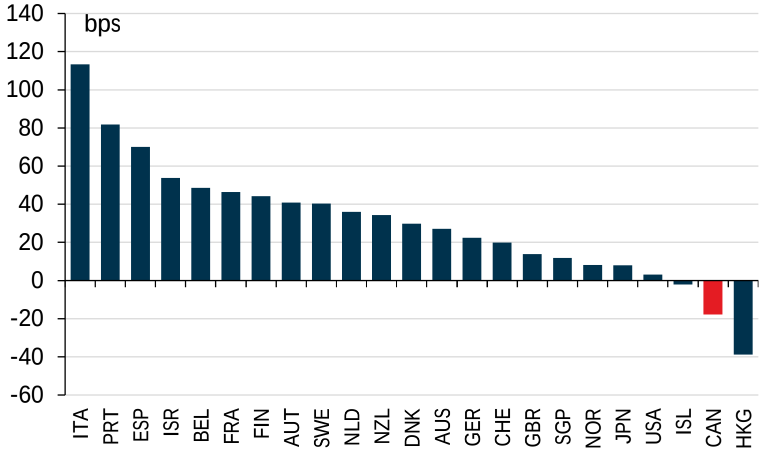
Chart 1: Flirting with the flattest levels in nearly 30 years

2s-10s GoC and Treasury curve over the last 30 years (monthly average yield)



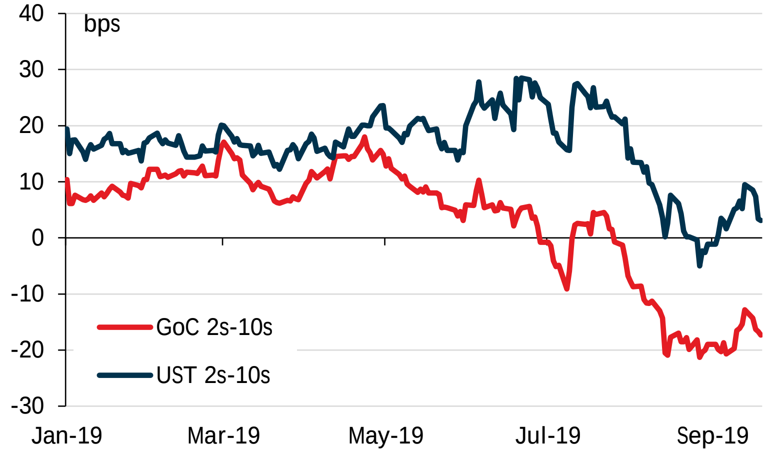
Source: NBF, Bloomberg

Chart 2: Canada curve stands out among peers
2s-10s curve across developed nations



Source: NBF, Bloomberg

Chart 3: Recent perspective on Canada-US 2s-10s
2s-10s GoC and Treasury curve in 2019



Source: NBF, Bloomberg

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