

US & Canadian Monetary Policy & Capital Markets

- The Bank of Canada's overnight rate is forecast to double by early 2020;
- The Federal Reserve's policy rate is forecast to rise 100bps by 2019Q3;
- Yield curves to flatten further as cycle maturity limits term premia.

BANK OF CANADA—FROM GLACIAL TO GRADUAL

The Bank of Canada is forecast to raise its policy rate by 150bps by the first quarter of 2020 and to then shift to the sidelines. This should further narrow the Canada-US policy rate differential to -25bps in support of the C\$. The Canadian yield curve is expected to shift upward and flatten particularly across the shorter yield spreads (chart 1). This is a continuation of our forecast stance dating back to the summer of 2017 when we intensified warnings of pending inflationary pressures that would motivate 100bps of rate hikes to date—and counting. We have now tweaked this successful thematic view to reflect greater conviction in the story, lessened NAFTA risks and a more positive outlook for business investment including progress on pipelines and LNG into 2020–21.

The core belief that is backing this forecast is that monetary policy is overly lax in Canada and that it continues to inappropriately cling to crisis levels of stimulus. The Bank of Canada has largely raised its policy rate at a pace that has been commensurate with increased inflation. This has left the inflation-adjusted (real) policy rate little changed, in negative territory howsoever defined (chart 2 for one example) and comparable to the most liberal monetary policy conditions abroad (chart 3). Alternative measures of the real policy rate—using average core CPI (2.1%), the 5yr inflation breakeven (1.8%), the Bloomberg inflation consensus for 2019 (2.1%), or the BoC's Business Outlook Survey's inflation expectations — all show that it presently lies between about -25bps and -50bps or possibly lower. As a consequence, the currency remains artificially weak, provincial and mortgage credit spreads are tight as are investment-grade and high-yield corporate spreads. Financial conditions are arguably overly stimulative.

Keeping company with other negative real rate economies is a curiosity when Canada's core inflation rate is double—or more—the rate in the Eurozone and Japan. Canada's core inflation rate is on par with the UK and both countries' central banks are durably achieving their 2% inflation targets. A major difference is that the UK continues to grapple with high Brexit uncertainty. Canada also faced high uncertainty over NAFTA negotiations, but has now reached agreement on a USMCA deal pending passage in all three countries' legislative assemblies which we think is likely but not until well into 2019. This development merits reducing negative risk judgement applied to our growth forecasts. Canada is therefore now alone among major economies in terms of possessing a negative real policy rate and easy financial conditions absent very low inflation, high risk to its principal trade regime and/or close proximity to a market with deeper negative real rates.

Policy needs to return to more normal conditions that are suited to an economy that is beginning to slip into excess aggregate demand amid high capacity constraints and rising labour shortages. It risks overheating with overly accommodative

CONTACTS

Derek Holt, VP & Head of Capital Markets Economics
416.863.7707
Scotiabank Economics
derek.holt@scotiabank.com

Chart 1

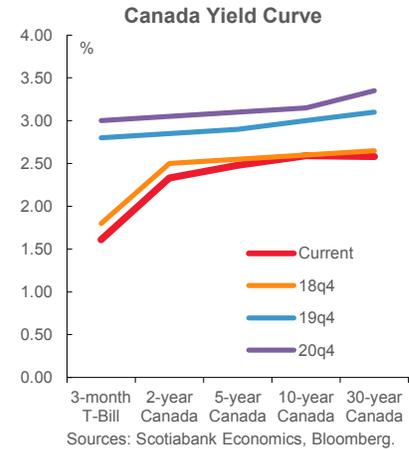


Chart 2

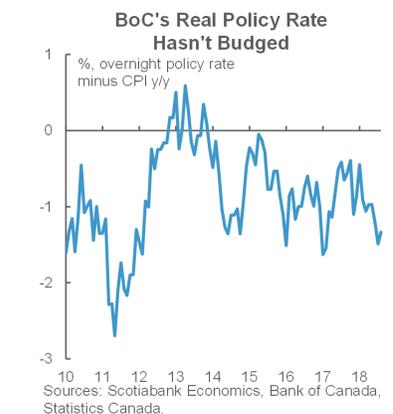
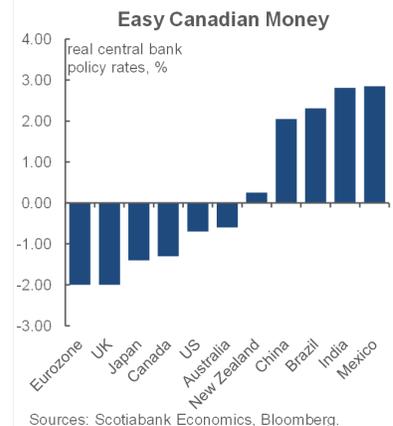


Chart 3



monetary policy and possibly expanded fiscal stimulus into an election year. The BoC should transition toward actually raising its policy rate at a gradual pace. It has not done so this year, other than applying two rate hikes at a glacial speed. A hike per quarter is how the Federal Reserve has defined 'gradual' in practice and we think the BoC should adopt this path. Indeed, there is now a case for a more expedited pace of rate hikes in order to achieve a zero or slightly positive real rate more quickly in what could amount to at least a temporary abandonment of the 'gradual' mantra. As business investment and trade face fewer trade policy risks and more pressure to invest as capacity constraints become binding, interest sensitive sectors like housing need to sustainably cool in order to keep broad economy-wide capacity pressures in check.

FEDERAL RESERVE—LITTLE IN ITS WAY

The Federal Reserve is forecast to raise the Fed funds target range by one more percentage point by the third quarter of next year. At that point, the policy rate is forecast to crest at a slight overshoot of the estimated neutral rate. Similar to the FOMC consensus, we anticipate the inflation-adjusted policy rate to rise at a somewhat quicker pace than the real neutral policy rate in a cyclical overshoot aimed at incrementally tightening monetary policy conditions. Markets are underpricing both the FOMC's 'dot plot' and Scotia's house rate forecasts (chart 4).

Chart 4

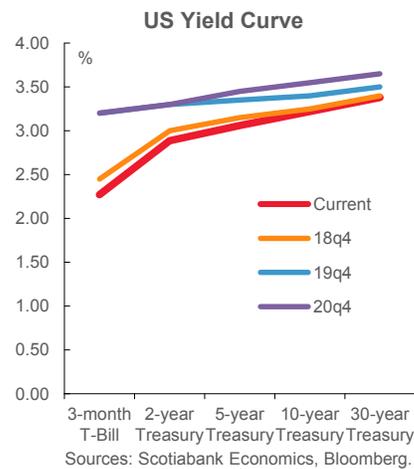


Chart 5

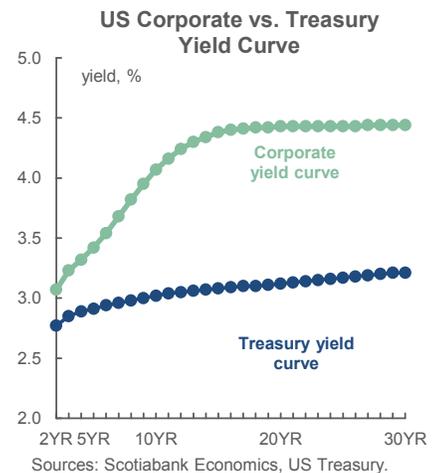


Chart 6

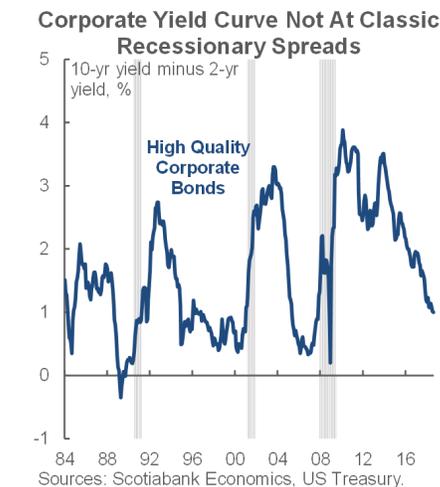
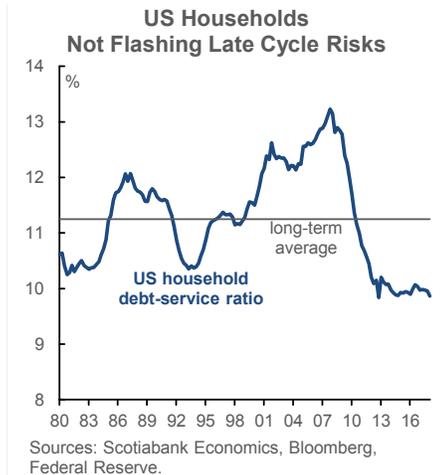


Chart 7



The profile of rate hikes is informed by three main arguments. One is that the Fed's signalled reaction function has defined 'gradual' hikes to mean a steady pace of one hike per calendar quarter in a straight line unless something big and possibly transitory—like 3 hurricanes in 2017—interrupts such plans. The Fed seems to want to gradually get toward a modest cyclical overshoot of its roughly 3% nominal neutral policy rate with pretty steady, unwavering determination. Fed Chair Powell's recent communications have leaned in favour of setting a high bar to being interrupted on such a path.

Second is that from a fundamentals standpoint, the case for continued Fed policy tightening is compelling. The US economy's output gap has shut and moved into material excess aggregate demand with more to come. Core PCE inflation is in-line with the Fed's 2% inflation target. Fiscal stimulus is a contributing factor to overshooting growth that I've long felt would necessitate sterilization efforts through a stronger US dollar and rising bond yields alongside Fed rate hikes. This view goes back to my initial assessment of Trumponomics back in a piece written in November 2016; the chickens may well be coming home to roost on the full cycle effects of Trumponomics that over-stimulated an economy that didn't need stimulus and that is left with high debt issuance and the worst performing US Treasury bond market of any prior President to a comparable stage of the Presidency.

Third, however, is that we are not in the camp that warns of limits to rate hikes derived from late-cycle risks and the slope of the yield curve. We don't expect the US Treasury curve to invert and its slope is a distorted signal for the economy versus in the past. Longer-run Treasury yields are expected to rise, albeit not at the sustained pace of late (see next section). Issuance and term premia effects of Fed balance sheet unwind could be drivers. In any event, the reward to taking term lending risk exists in the

corporate market much more so than in the more policy-distorted sovereign market (chart 5). The corporate yield curve remains a fair distance away from inverting or becoming very flat as it has tended to do in the lead-up to past recessions (chart 6).

Drivers of such past recessions have typically involved greater evidence of balance sheet disrepair across households and businesses than we observe (chart 7).

BONDS—HOW REGS BLEW A HOLE IN A NICE THEORY

We're disinclined to extrapolate the recent rise in bond yields. The drivers of the large jump in yields may be relatively temporary through year-end before then reversing into the new calendar year. The more sustainable drivers of rising bond yields are likely to evolve more gradually over time.

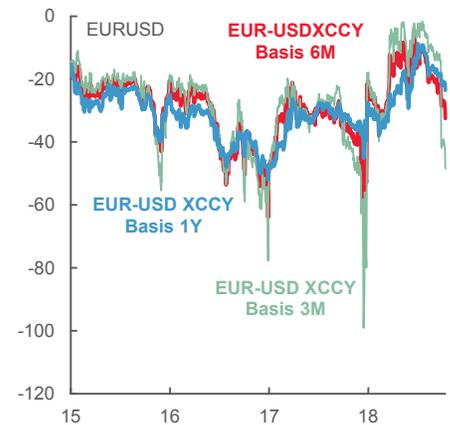
In addition to uncertainty facing risk tolerance, the foundation to the explanation of this reservation that follows is a model called covered interest parity. Theory posits that the difference between identically defined rates in two markets should equate to the spread between the forward and spot exchange rates between those same markets. If it doesn't, then that means one of two things. Either market participants will spring into action to seek out arbitrage opportunities in order to bring the relationship back into line. Alternatively, when the relationship persistently fails to hold, then a residual term is given a name: the cross currency basis. In theory, the cross currency basis should not exist. Theory, however, assumes away sundry market imperfections and liquidity shortfalls that may restrain full deployment of balance sheets that would be necessary to pursue arbitrage profit opportunities. Those balance sheets have historically been the large, well-capitalized and relatively sophisticated traditional financial institutions.

Unfortunately, ever since at least 2007, the strictly defined covered interest parity model has not worked terribly well and deviations from it may be worsening. There has been a fairly persistent and highly seasonal residual term (aka the basis). Indeed, a major driver of the recent rise in bond yields that we think will persist into year-end is the strong rise in year-end demand for US dollars and its effect on foreign currency hedging costs for investors looking to buy more attractive Treasury yields relative to European and Japanese government bonds. At the heart of the issue is the blow-out in the so-called cross currency basis when swapping out of Euros and yen into the USD (charts 8, 9). After taking account of the rising cost of hedging FX risk, the yield pick-up on Treasuries vapourizes or at least turns less advantageous than keeping money in local currency EGBs and JGBs. That, in turn, has potentially destroyed foreign demand for Treasuries which had served to restrain the upward pressure upon their yields against the backdrop of strong US fundamentals and heavy US debt issuance. In short, arbitrage isn't occurring to take advantage of the much higher yield spread offered by Treasuries because the currency market is getting in the way. By extension, this has spilled over into rising Canadian bond yields, though less significantly. Obviously this is not a factor for investors not hedging currency risk, but many major types of nonfinancial and financial accounts do hedge.

An entirely plausible explanation for the persistence of the cross currency basis relies upon two arguments. One is that there is heavy year-end seasonality to funding pressures as demand for USD soars from both nonfinancial firms and banks. Two is that an unintended consequence to a plethora of regulatory changes over the post-GFC era has been to restrain the effective deployment of balance sheets in order to drive arbitrage activities during such episodes. Whether Basel, or Dodd-Frank or the Volcker Rule, there is a serious risk that the good intentions of making the system 'safer' have perhaps achieved somewhat the opposite effect by allowing market dislocation effects to persist and pose risks to the economy and financial system. This can be particularly true during vulnerable stress points in global markets (e.g. trade wars, Italy's risks to the Eurozone, a potential US 'fiscal cliff', etc.).

Chart 8

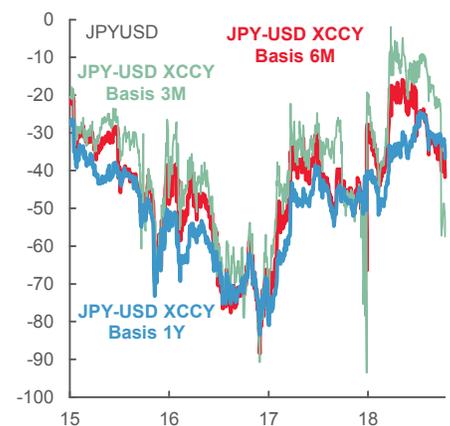
The EUR-USD Cross Currency Basis



Sources: Scotiabank Economics, Bloomberg.

Chart 9

The JPY-USD Cross Currency Basis

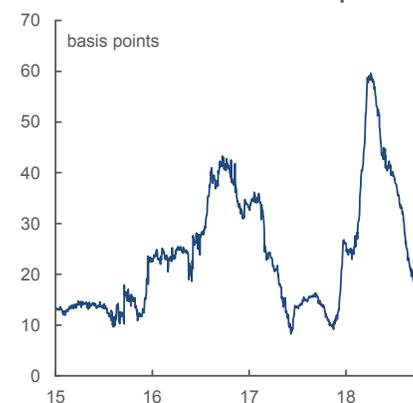


Sources: Scotiabank Economics, Bloomberg.

Why I think these effects will subside leans heavily upon observing their seasonality. Going back to chart 8, note that the 3-month tenor has seen the biggest blow out in the cross currency basis relative to the six-month and one-year tenors. That supports a year-end funding challenge that is usually transitory. If FX hedging costs return to normal into the new year, then relative demand for US (and Canadian et al) rates product might improve and thereby put renewed downward pressure upon bond yields. This view would suggest that central banks should look through year-end market distortions but closely monitor them. To repeat, such possible effects are compounded upon uncertainty regarding risk tolerance into year-end.

What is nevertheless encouraging is that a measure of funding strains in short-term lending markets is not showing classic crisis widening (chart 10). Indeed, the three-month LIBOR-OIS spread is quite well behaved and has been falling since the US lifted the debt ceiling and passed a spending and appropriations bill in February. That indicates the absence of systemic risk considerations and leans further toward the possibility that reduced demand for Treasuries and the associated rise of FX hedging costs is a transitory year-end event.

Nevertheless, pressures upon the US and global bond markets are likely to contribute toward a rocky road for equity markets into year-end. For income-oriented investors, the rise in Treasury yields has become tempting over the dividend yield on the S&P500 (chart 11). In fact, the unadjusted spread between the two measures sits at its widest since 2011; adjustments for risk, taxes and other factors are then necessary but the relative comparison has clearly changed. The rise in bond yields depresses the present value of expected future dividend streams and drives a reassessment of equity valuations. To the extent to which bond and currency market funding pressures may be proven to be temporary through year-end, so may emerge opportunities for equity investors on dips. Of course, how this plays out will also be informed by relative valuations across equity markets. Right now, the US markets remain among the world's most expensive even with recent declines. Equities will remain vulnerable to H2 earnings, currency and bond market developments, uncertainty into the US mid-terms, US-China tensions and Italy-Eurozone tensions.

Chart 10
3-Month US Libor-OIS Spread


Sources: Scotiabank Economics, Bloomberg.

Chart 11
Shine Off Equities?


Sources: Scotiabank Economics, Bloomberg.

Table 1
Scotiabank Economics' Canada-US Yield Curve Forecast

	2018		2019				2020			
	Q3	Q4f	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
	(end of quarter, %)									
Canada										
BoC Overnight Target Rate	1.50	1.75	2.00	2.25	2.50	2.75	3.00	3.00	3.00	3.00
Prime Rate	3.70	3.95	4.20	4.45	4.70	4.95	5.20	5.20	5.20	5.20
3-month T-bill	1.58	1.80	2.05	2.30	2.55	2.80	3.00	3.00	3.00	3.00
2-year Canada	2.21	2.50	2.40	2.55	2.70	2.85	3.05	3.05	3.05	3.05
5-year Canada	2.34	2.55	2.50	2.60	2.75	2.90	3.10	3.10	3.10	3.10
10-year Canada	2.43	2.60	2.60	2.70	2.85	3.00	3.15	3.15	3.15	3.15
30-year Canada	2.42	2.65	2.65	2.75	2.90	3.10	3.30	3.35	3.35	3.35
United States										
Fed Funds Target Rate	2.25	2.50	2.75	3.00	3.25	3.25	3.25	3.25	3.25	3.25
Prime Rate	5.25	5.50	5.75	6.00	6.25	6.25	6.25	6.25	6.25	6.25
3-month T-bill	2.20	2.45	2.70	2.95	3.20	3.20	3.20	3.20	3.20	3.20
2-year Treasury	2.82	3.00	3.00	3.10	3.30	3.30	3.30	3.30	3.30	3.30
5-year Treasury	2.95	3.15	3.05	3.15	3.35	3.35	3.40	3.40	3.45	3.45
10-year Treasury	3.06	3.25	3.15	3.20	3.40	3.40	3.50	3.50	3.55	3.55
30-year Treasury	3.21	3.40	3.30	3.30	3.50	3.50	3.60	3.60	3.65	3.65

Sources: Scotiabank Economics, Bloomberg.