US Rates Outlook 2020–21

- **The Federal Reserve may not be done cutting as the balance sheet expands.**
- **US inflation risks are tilted lower.**
- **Treasury curve forecast to mildly steepen.**

FEDERAL RESERVE—EASY, BUT JUST DON'T CALL THEM THAT!

The Federal Reserve is likely on an extended pause with greater risk of further rate cuts than hikes later in the year. We've retained one rate cut in our forecast to signal our concerns about risks to the inflation outlook and growth prospects plus broader policy risks, but if the Fed were to resume easing then it is likely they would go beyond this forecast marker. Rate cuts are not expected to be withdrawn over our 2020–21 forecast horizon. To prevent the real policy rate from rising and imposing tightened conditions upon the US economy, inflation risks may require nominal rate cuts. Chart 1 shows our yield curve forecasts.

A. SO LONG, QUANTITATIVE TIGHTENING

As risks to the outlook and future potential rate cuts are evaluated, the more significant nearer-term development is the likelihood that within just a few months, the Federal Reserve will probably have fully unwound the shrinkage of its balance sheet that began in 2018. At present, the US$4.17 trillion in assets has already reversed about 60% of the decline in the size of the balance sheet that had been induced by ending reinvestment. By Spring, it's likely that the balance sheet will be pushing back toward US$4.5 trillion again. The Fed's prior plans to shrink the balance sheet are partially in tatters.

The balance sheet has been increased by the Fed in two primary ways that are expected to continue. One has been through the System Open Market Account (SOMA) portfolio that has climbed by over US$160 billion since October. This has been achieved through Treasury bill purchases as the Federal Reserve addressed liquidity risks overhanging markets. The New York Federal Reserve has pledged to continue these purchases "at least into the second quarter" of 2020. The second way has involved a large expansion of the overnight and term reverse repurchase agreements that were also designed to address funding pressures (chart 2).

To this point, we cannot refer to these balance sheet developments as restarting quantitative easing that involved the Fed engaging in non-sterilized purchases of Treasuries, agencies, mortgage backed securities and TIPS. All of the Fed's actions of late have involved expanding holdings of shorter-term instruments in order to address funding risks, including by raising depleted excess reserves (chart 3).

Those funding risks were being driven by insufficient liquidity in the financial system that had arisen through multiple complex drivers as opposed to President Trump's accusation that the Fed simply mismanaged its balance sheet. In the context of those drivers, the Fed—in retrospect—had engaged in an overly rapid pace of balance sheet unwinding. Why? For one, the Liquidity Coverage Ratio had not been materially tested by fresh market developments and it arguably

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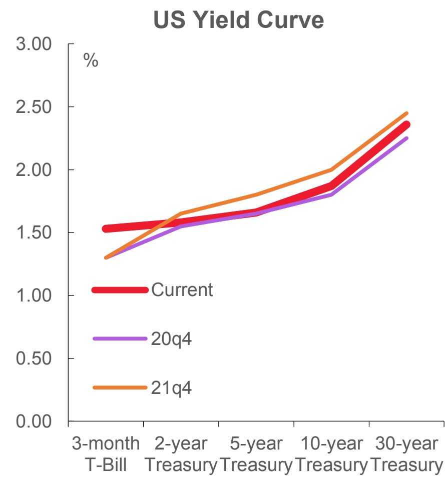
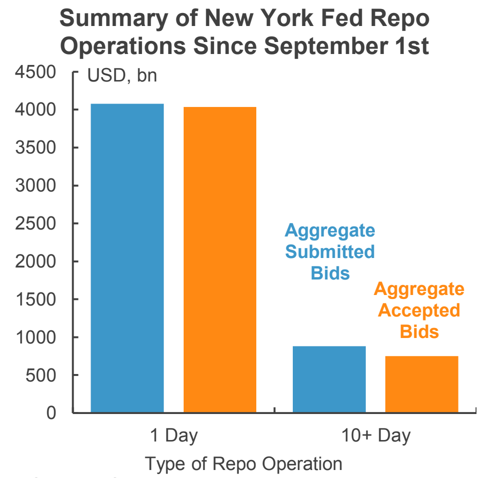
Chart 1



Sources: Scotiabank Economics, Bloomberg.

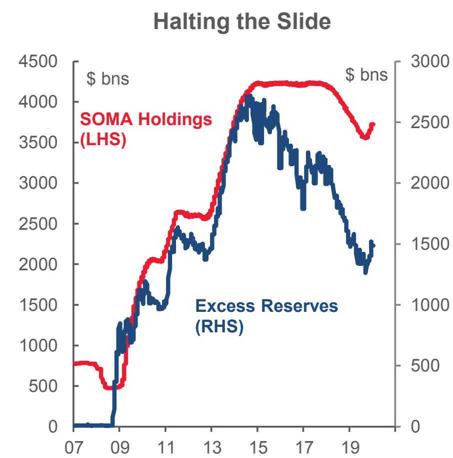
Chart 2



Sources: Scotiabank Economics, New York Federal Reserve.

wound up tying up a higher proportion of assets held in liquid instruments than markets could handle during funding swings. For another, the US fiscal deficit has increased by about US$1.7 trillion since the 2016 election with about three-quarters of that rise occurring since the February 2018 spending bill and the January 2018 Tax Cuts and Jobs Act. So much for tax cuts paying for themselves! Pressure to fund quarterly corporate tax installments also grew relative to these other developments.

Chart 3



Sources: Scotiabank Economics, Bloomberg.

B. INFLATION DOWNSIDES

Part of our relatively dovish caution is rooted in the concern that renewed downside risk to inflation may surface. There are four reasons for this.

The US economy is operating under excess aggregate demand conditions with a positive output gap. Our growth forecast (1.7% 2020, 1.8% 2021) assumes that GDP expands at a slower pace than the FOMC's estimated potential rate of growth (1.9%). This should drive lower excess demand conditions and at least cap inflation risk to the extent to which today's flatter Phillips curve operates upon inflation risk.

Second, housing is the dominant driver of inflation at the moment but this is likely to change. Chart 4 shows the weighted contributions to CPI inflation derived from various components and the dominant role played by shelter costs. 'Rent of shelter' is a category that includes rental payments of tenant-occupied housing but more importantly imputed rental of owner-occupied housing. This latter owners' equivalent rent component is climbing by 3.3% y/y and accounts for about one-quarter of the CPI basket. As chart 5 shows, cooling house price inflation should carry lagged downward influences upon owners' equivalent rent in CPI and with that a material source of downward pressure on overall inflation.

Chart 4

Source: Scotiabank Economics, BLS.

Third, whereas wage growth has accelerated over time to the present 3.1% y/y rate, it has slightly cooled from the pace being set earlier last year. More important is that to translate into classic cost-push types of wage pressures, there would need to be more evidence that real wage growth (presently less than 1%) is exceeding soft productivity growth but this is not evident (chart 6).

Last is the impact of the USD (chart 7). We believe that the estimates of dollar pass-through into inflation that were provided in this speech remain valid. Each sustained 10% appreciation/depreciation in the broad US$ subtracts/adds about 0.5% to US inflation within six months and dissipates to about 0.25% within one year. Despite its slight depreciation since September, the broad dollar remains slightly firmer than at the start of 2019 and still over 10% stronger since early 2018. There isn't enough depreciation in place yet to drive an inflationary reversal of currency influences but this will require continued monitoring.

C. GROWTH RISKS

Scotiabank Economics forecasts US GDP growth to occur at a rate somewhat below Bloomberg consensus. We think the economy will expand by 1.7% this year and 1.8% next year. Chart 8 shows how we compare to consensus for 2020 growth. Chart 9 breaks down drivers.

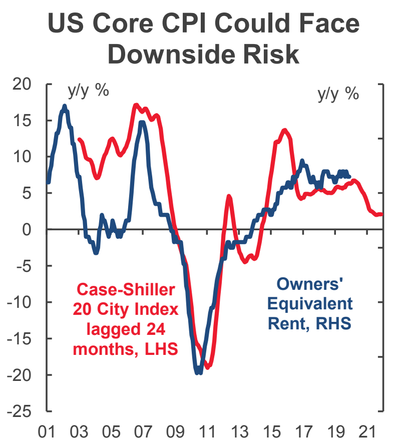
One reason we are below consensus is that we anticipate significant import leakage of activity driven in part by lagging effects of broad dollar strength.

Another reason is that fiscal stimulus is turning toward fiscal drag. Chart 10 shows a respected fiscal economist's estimates of the impact of the US$300 billion spending bill in February 2018 and the prior month's tax cuts upon growth in GDP over 2018–21. Stimulus is dropping out of the equation this year. Tax Cuts 2.0 in this Congress—in arguably the most divided election year in recent memory—is highly unlikely to be delivered. Fiscal hawks within Congress that supported earlier stimulus are likely more agitated by the predictable failure of self-funding promises. In spite of his propensity to spend, partisan policy precludes any further fiscal stimulus in an election year (outside of a war act).

Chart 11 demonstrates that even if relative peace has been achieved for trade policy risks, the second round effects of trade wars are likely to be a weight on GDP growth. The disruption across supply chains has driven upward pressure upon inventories relative to sales with the ratio back toward cycle peaks and that bodes poorly for production and employment. A portion but not all of this is traceable to Boeing's 737Max challenges that we estimate will subtract a meaningful amount from GDP growth at least at the start of 2020.

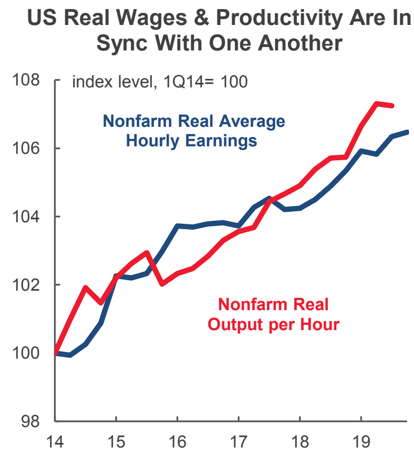
We conclude this article with charts 12–14 because no discussion on risks to markets and Fed policy can leave behind trade policy.

Chart 5



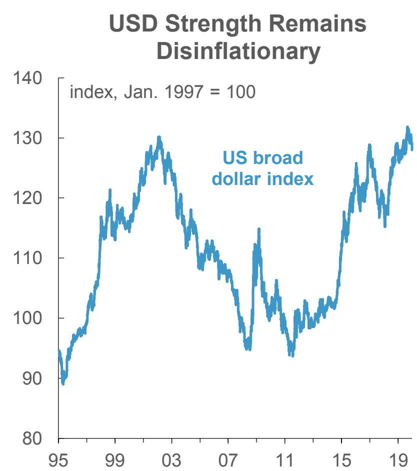
Sources: Scotiabank Economics, BLS, Bloomberg.

Chart 6



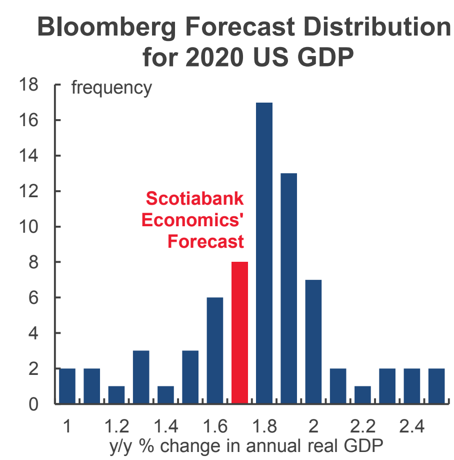
Sources: Scotiabank Economics, BLS.

Chart 7



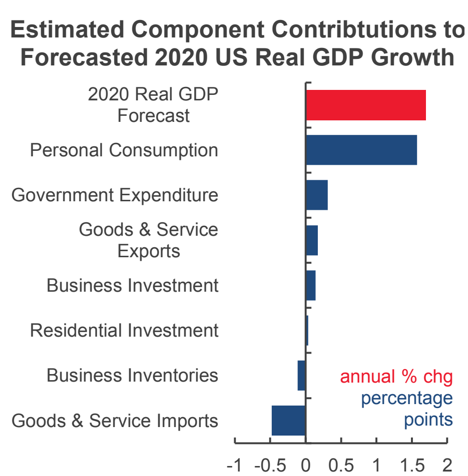
Sources: Scotiabank Economics, US Federal Reserve.

Chart 8



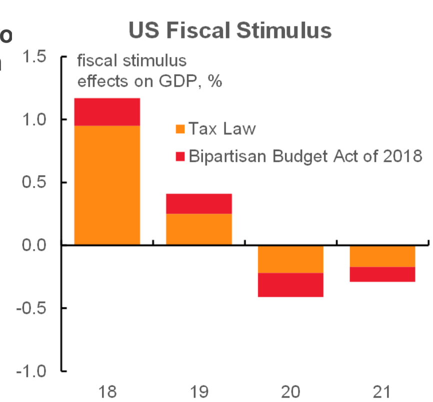
Note: Forecasts as of January 10th, 2020.
Sources: Scotiabank Economics, Bloomberg.

Chart 9



Sources: Scotiabank Economics, BEA.

Chart 10



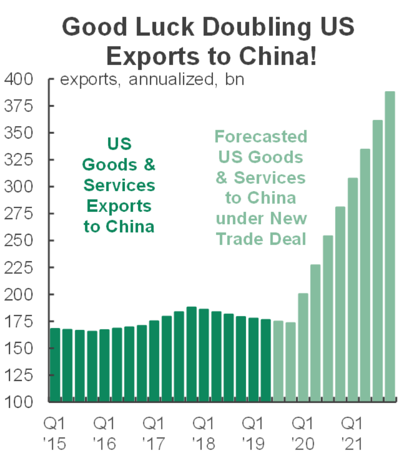
Sources: Scotiabank Economics, Joint Committee on Taxation, Central Budget Office, "The Tax Cuts and Jobs Act: A Boost to Growth or Missed Opportunity?" - Jason Furman.

Over 2019, we underestimated the magnitude of the risks to trade policy and their growth-dampening influences upon the world economy. It's still prudent to err on the side of prolonged trade tensions despite a current pause in the action. The US-China 'phase 1' trade agreement has set unachievable targets for China to purchase overall US goods and services. Ditto for just the agricultural products portion. It's unclear if China agreed to this to achieve partial tariff relief and had one over on Trump in the process, or if Trump has set up China to fail and take another end-run at protectionist measures when enforcement efforts may fail. The lagged influences of dollar strength on the current account deficit add to skepticism that the US trade deficit will durably dwindle as it has of late. If not, the politics of trade deficits could well resurface and probably after the election this November.

Chart 11

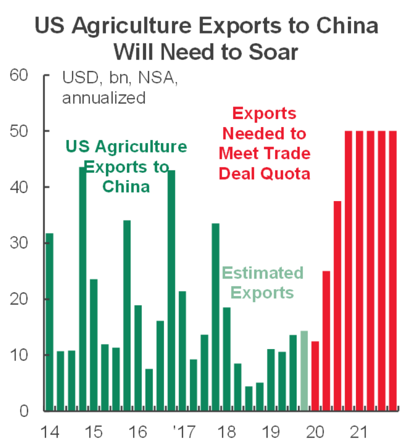
Source: Scotiabank Economics, U.S. Census Bureau.

Chart 12



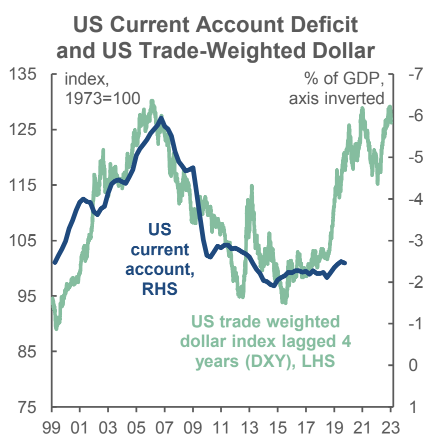
Sources: Scotiabank Economics, US Congressional Research Service.

Chart 13



Sources: Scotiabank Economics, US Census Bureau Trade Data.

Chart 14



Source: Scotiabank Economics, Federal Reserve, Bloomberg.

Table 1

Scotiabank Economics' US Yield Curve Forecast

	2019	2020				2021			
		(end of quarter, %)							
United States	Q4	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Fed Funds Target Rate	1.75	1.75	1.75	1.50	1.50	1.50	1.50	1.50	1.50
Prime Rate	4.75	4.75	4.75	4.50	4.50	4.50	4.50	4.50	4.50
3-month T-bill	1.51	1.55	1.55	1.30	1.30	1.30	1.30	1.30	1.30
2-year Treasury	1.57	1.60	1.55	1.50	1.55	1.60	1.65	1.65	1.65
5-year Treasury	1.69	1.65	1.60	1.60	1.65	1.70	1.75	1.80	1.80
10-year Treasury	1.92	1.80	1.75	1.75	1.80	1.85	1.90	1.95	2.00
30-year Treasury	2.39	2.25	2.15	2.20	2.25	2.30	2.35	2.40	2.45

Sources: Scotiabank Economics, Bloomberg.