January 17, 2017

US & Canadian Monetary Policy & Capital Markets

The outlooks for monetary policy and broad market directions are so heavily interconnected that they require simultaneous consideration including risk scenarios.

FEDERAL RESERVE OUTLOOK—DEPENDS ON FISCAL MEASURES

The base case outlook for the Federal Reserve includes:

- three rate hikes this year followed by two hikes next year that would bring the fed funds target rate to 2% by the end of next year. At present, roughly 1½ hikes are priced into fed fund futures by the end of 2017.
- continued reinvestment of maturing Treasury, agency and MBS holdings that would preserve the level of the Fed's balance sheet at about $4½ trillion throughout 2017–18. We assume a gradual reduction in reinvestment of maturing holdings when rate normalization is "well underway" which we define to be around a fed funds target rate of 2% or higher.

Given the present composition of the FOMC, the risk to this base case is somewhat more heavily skewed toward fewer hikes (chart 1) and later phase-out of reinvestment. We may re-evaluate this risk should hawkish appointees fill two vacancies this year and replace Chair Yellen and Vice Chair Fischer in 2018H1.

Our base case Fed outlook assumes further improvement in the economy as discussed in the fundamentals outlook for the US economy on pp.10–13, and how that translates into the Fed's dual mandate to foster price stability and full employment. Wage growth at its fastest pace in over seven years presents cost-push inflation pressures contributing to our forecast for a sustained return to 2% inflation. More pricing power will also accompany the elimination of spare capacity as measured by the US output gap (chart 2). The strong USD mitigates some inflationary pressure that we estimate will shave a few tenths off of headline inflation if dollar strength sticks. Market-based inflation expectations have increased, including TIPS break-evens and inflation swaps, while survey-based measures are mixed with economists forecasting rising inflation as consumer confidence surveys signal slightly declining price pressures.

This forecast would continue extraordinarily easy monetary policy compared to a "Taylor Rule" or any other mechanistic approach to setting monetary policy. It would keep the inflation-adjusted 'neutral' policy rate near zero by the end of 2018 and thus a percentage point below the FOMC's long-run projection.

The risk of faster-than-forecast rate hikes is heavily dependent upon the exact nature and course of fiscal and regulatory stimulus net of trade policy. At this juncture, we judge this risk to be exceptionally difficult to evaluate. As Spring and Summer approach, we expect to have more information on broader policy risks.

International risks—such as global trade policy responses to potential US measures, European elections, OPEC's ability to enforce production cuts and influence firm or higher oil prices, China's economy, or potential geopolitical conflict—and risks to stretched asset valuations—discussed in a moment—**are why we shave the risks to the downside of our base case rate projection.**

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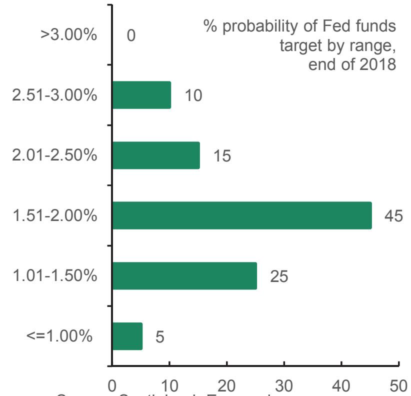
Chart 1

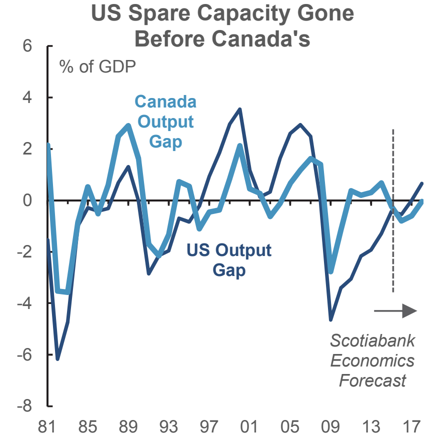
Probability Scenarios For Fed Policy



Source: Scotiabank Economics.

Chart 2

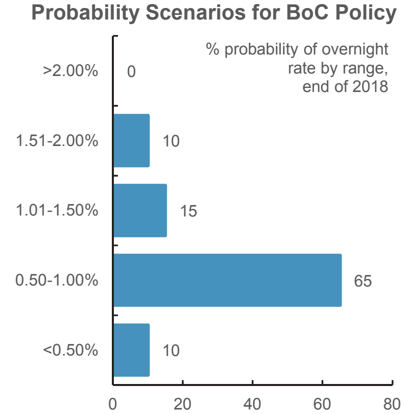
US Spare Capacity Gone Before Canada's



Sources: Scotiabank Economics, Bank of Canada, IMF, Congressional Budget Office.

Chart 3

Probability Scenarios for BoC Policy



Source: Scotiabank Economics.

BANK OF CANADA OUTLOOK—LAGGING THE FED

The base case for the Bank of Canada is for no rate changes this year, followed by two quarter-point hikes starting in mid-2018 that would raise the overnight rate to 1% by the end of next year. See chart 3 for probabilities surrounding this projection.

We think the Bank of Canada will lag well behind the Federal Reserve in raising interest rates for several reasons. One is that Canada has a little more disinflationary economic slack that we expect to close only by 2018H2–19 (chart 2 again). Two is that headline inflation is expected to approach the 2% policy target, but core inflation that serves as more of an operational guide to inflation targeting is more uncertain and may not sustainably reach 2% until 2018 or later. The BoC has adopted three new measures of core inflation, including the preferred common component CPI metric, that will prove very difficult to forecast and may raise communication challenges. Further, wage inflation has decelerated to barely over 1% in Canada whereas it is about twice as fast in the US. In terms of fundamentals (see pp.4–7 for more), all-time highs in multiple measures of household activity combined with rising fixed borrowing costs and ongoing tightening of macroprudential rules suggest a cautious monetary policy approach. Export growth will be relied upon more heavily in a rebalancing of growth, but far more evidence of improvement on this count will be required for the BoC to have enough conviction to pull away the punchbowl especially given NAFTA risks and the prospect of a US border tax that can be likened to the Smooth-Hawley tariff of 1930.

Further, the outlook for Canadian monetary policy is heavily conditioned on the outlook for the Federal Reserve. There is indeed a limit to monetary policy divergence in the two economies in our view. We believe that the limit to undershooting the Fed's policy rate will be reached into 2018 when our forecast maximum spread of 100bps under Fed funds is reached (though it was much wider in the early 1990s).

Various forms of currency risk in the context of a very highly valued US dollar pose elevated uncertainty to our Bank of Canada outlook. BoC research (here) has indicated that every 10% trade-weighted depreciation in the Canadian dollar lifts headline CPI inflation by 0.6% and core inflation by 0.3% over the longer run, but that the effects are fairly transitory. A major trade policy shock, for instance, could prompt a swifter depreciation in CAD that could complicate BoC policy.

At this juncture and in the face of elevated uncertainty toward factors such as US policy, we judge the risk to this outlook to be fairly balanced.

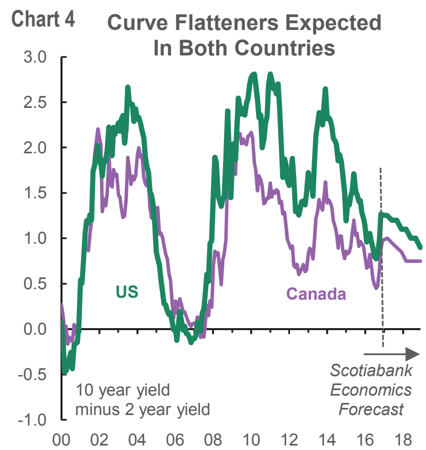
YIELD CURVES—BEAR FLATTENERS, CANADA TO OUT-PERFORM

Scotiabank Economics forecasts the US Treasury and Government of Canada yield curves to bear flatten over our forecast horizon by a 2yr10yr convention (chart 4). The faster rise in shorter-term yields than longer-term yields is conditioned on the belief that monetary policy will tighten over our forecast horizon, but that there are cyclical and structural limits to the extent to which longer-term bond yields can rise.

Much of this report focuses upon nearer-term cyclical influences such as improved growth and higher inflation, but in more limited fashion than at this stage of historical business cycles. Continued stimulus by foreign central banks (including ongoing bond purchases by the ECB and BoE plus a combination of purchases and a yield cap set by the Bank of Japan) maintains their significant involvement in their bond markets. That should continue to set a lower ceiling on rising foreign bond yields and, as a result, widened US Treasury spreads become more attractive to global fixed income portfolio managers. Fiscal stimulus can only go so far in possibly raising longer-run potential growth in the economy that faces headwinds such as an aging workforce.

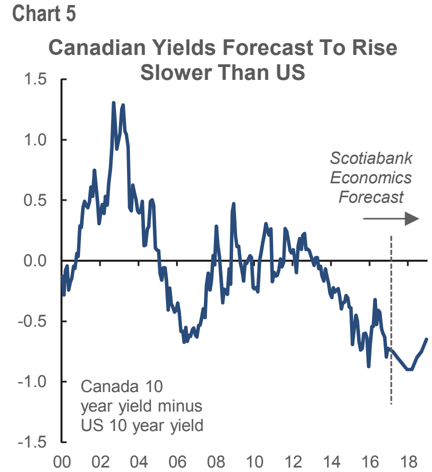
Indeed, upside risks to our longer-term yield forecasts include higher deficit-financing of fiscal stimulus in Canada and, most notably, the US. Studies by Hubbard et al (here) and Orszag and Gale (here) found that every one-percentage point rise in the US debt-to-gdp ratio raises the real interest rate by 2-7bps. Deficit repair and QE programs may have broken this relationship in the Global Financial Crisis era but the return toward full-employment, the end to QE at the Fed, and the risk of a blow-out in deficits may resurrect such a relationship with detrimental effects on global bond markets. This issue bears careful monitoring from the standpoint of many of our team's forecasts.

Chart 4



Sources: Scotiabank Economics, Bloomberg.

Chart 5



Sources: Scotiabank Economics, Bloomberg.

The risk of lower yields than forecast comes partly from geopolitical developments such as European elections and sundry potential disturbances that could drive safe-haven demand A debt ceiling conflict that mitigates or jeopardizes net fiscal stimulus plans and the risk of retaliatory trade measures could also put downward pressure upon yields as could an abrupt correction in risk assets.

Longer-run Canadian rates are expected to rise less rapidly than US yields (chart 5). This is because of less potential upward pressure upon deficits and a AAA Government of Canada rating, somewhat greater economic slack, less full-cycle inflation risk in the face of a mature household cycle, and potential risk from US protectionism. Total exports are one-third of Canadian GDP.

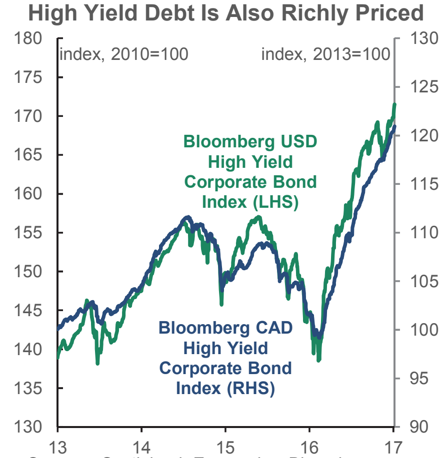
MULTIPLE ASSET CLASSES ARE RICHLY PRICED

Among the market risks to the monetary policy and macroeconomic outlook is how rich multiple measures of asset valuations have become. Potential gains resulting from 'Trumponomics' have arguably been largely priced, leaving scope for disappointment if execution fails. Monetary policy is not immune to the risks posed to financial stability and feedback effects on growth stemming either from excessive froth—such as in the lead-up to the Global Financial Crisis—or abrupt corrections. Forecasting peaks and troughs across valuations and timing them is extraordinarily difficult, but **one would be remiss not to end this note with a caution about high valuations.**

- US equity values are at their richest since the dot-com era. This is true in terms of multiple measures like trailing price-to-earnings, forward P/Es, Shiller's cycle smoothed P/E, Tobin's Q (price to replacement cost), and a 2% S&P500 dividend yield. Equity valuations reflect a 'Trump effect' and if policy execution is imperfect then valuations may be disappointed;
- The broad-dollar index is at its highest since the dot-com era and suggests a sharp widening of the US current account deficit that may further intensify protectionist sentiment in Washington;
- US high yield debt has risen by about 70% since the end of 2009 and energy-dominated Canadian high yield debt has risen to higher prices than existed when WTI oil was trading around $90 per barrel (chart 6);
- BAA rated US corporate bond spreads over 10 year Treasuries are nearing the post-crisis low set in 2014 before oil prices fell;
- US home prices are now just above where they were on average at the pre-crisis peak in 2006 according to the S&P Corelogic Case-Shiller home price index. Canadian home prices are lofty by multiple yardsticks.

Chart 6

High Yield Debt Is Also Richly Priced



Sources: Scotiabank Economics, Bloomberg.

Table 1 — Scotiabank Economics' Canada-US Yield Curve Forecast

	2016				2017 (end of quarter, %)				2018			
Canada	**Q1**	**Q2**	**Q3**	**Q4**	**Q1f**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
BoC Overnight Target Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	0.75	1.00
Prime Rate	2.70	2.70	2.70	2.70	2.70	2.70	2.70	2.70	2.70	2.95	2.95	3.20
3-month T-bill	0.45	0.49	0.53	0.46	0.50	0.50	0.50	0.50	0.60	0.80	0.90	1.10
2-year Canada	0.54	0.52	0.52	0.75	0.75	0.85	0.95	1.05	1.20	1.35	1.45	1.60
5-year Canada	0.68	0.57	0.62	1.11	1.15	1.25	1.30	1.40	1.50	1.65	1.80	1.90
10-year Canada	1.23	1.06	1.00	1.72	1.75	1.80	1.85	1.90	1.95	2.10	2.20	2.35
30-year Canada	2.00	1.72	1.66	2.31	2.35	2.30	2.35	2.45	2.55	2.65	2.75	2.80
United States	**Q1**	**Q2**	**Q3**	**Q4**	**Q1f**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
Fed Funds Target Rate	0.50	0.50	0.50	0.75	0.75	1.00	1.25	1.50	1.50	1.75	1.75	2.00
Prime Rate	3.50	3.50	3.50	3.75	3.75	4.00	4.25	4.50	4.50	4.75	4.75	5.00
3-month T-bill	0.20	0.26	0.27	0.50	0.55	0.80	1.05	1.25	1.30	1.55	1.60	1.80
2-year Treasury	0.72	0.58	0.76	1.19	1.25	1.40	1.50	1.70	1.75	1.90	1.95	2.10
5-year Treasury	1.20	1.00	1.15	1.93	2.00	2.10	2.20	2.30	2.40	2.50	2.55	2.60
10-year Treasury	1.77	1.47	1.59	2.44	2.50	2.60	2.70	2.80	2.85	2.90	2.95	3.00
30-year Treasury	2.61	2.28	2.31	3.07	3.05	3.15	3.20	3.30	3.35	3.40	3.45	3.50