US & Canadian Monetary Policy & Capital Markets

BANK OF CANADA OUTLOOK — BET AGAINST RATE HIKES, FOR NOW

No change in policy rates is expected this year, with a first move expected in mid-2018. In our view, markets are prematurely pricing roughly one-in-four odds of a hike before the end of this year. Governor Poloz has made it clear that he is in no hurry to raise rates, and we believe he would be more comfortable with a temporary overshoot of the inflation target than an undershoot. If GDP growth continues at the recent pace then all else equal it may support a neutral-hawkish bias shift, but that's hardly clear and there are many other considerations.

Arguments in favour of a prolonged pause appear to carry the day at the Bank of Canada and fall into two broad categories.

Counter-arguments to hike logic

- While headline inflation is on target, gasoline price base effects are playing a major role and core inflation continues to trend lower (chart 1).
- Annualized job growth since July would roughly match the all-time record for job growth set in 1979 and is unlikely to be sustainable at this pace at the expense of labour productivity. Weakness in hours worked is an offset to job creation. Weak nominal wage growth at 1% y/y and falling real wages indicate appreciable labour market slack.
- Recent strength in retail sales may be driven by transitory factors such as elevated job growth and adjusting to higher child benefit payments.
- Q4 GDP growth was solid but masked weak investment and exports and was buoyed by import distortions. January GDP was solid but durability is unclear especially given that net exports are shaping up to be a big drag on Q1 GDP.
- Oil prices have stalled out and at best stabilize the energy cap-ex picture.
- Monetary policy is a blunt instrument not well designed to address housing markets in general, let alone regional housing markets. Toronto's pace of price gains may not be sustainable at the current pace.
- Sharp policy deviations between the US and Canada are not unprecedented (chart 2) and are presently supported by more disinflationary spare capacity in Canada than in the US (chart 3). The BoC sees inflation from currency weakness as transitory. A limit to this was tested as USDCAD hit 1.40–1.45.

Additional considerations

- The BoC has long hoped for a rotation of the sources of growth away from reliance upon a mature household sector toward investment and exports.
- Equipment investment plunged by over 10% in each of the past two quarters. Investment intentions are solid, but a hoped for recovery would also raise productive capacity in disinflationary fashion.

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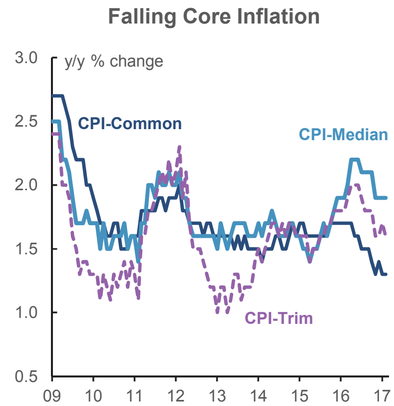
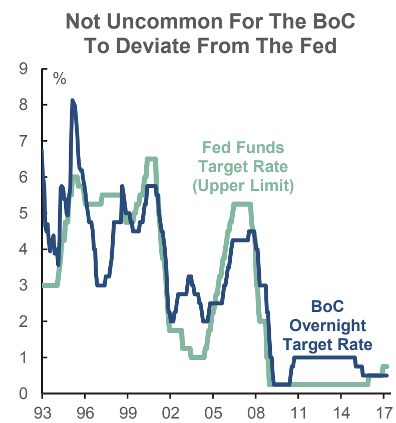
Chart 1



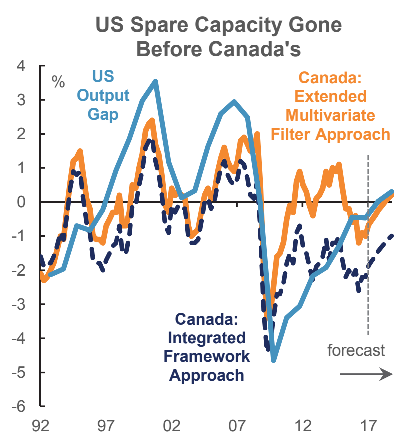
Sources: Scotiabank Economics, Statistics Canada.

Chart 2



Sources: Scotiabank Economics, Haver Analytics.

Chart 3



Sources: Scotiabank Economics, Bank of Canada, IMF.

- The trend in export volume growth remains weak.
- US trade policy risks include 'tweaks' to NAFTA, an across-the-board US border tax, or the indirect effects of a more narrowly applied border tax that exempts Canada. The BoC is likely to remain cautious for at least as long as this issue clouds the outlook.
- As a temporary growth support, fiscal stimulus offers only subtle effects.
- Canada has imported a bond shock that may be unsuited to local conditions.

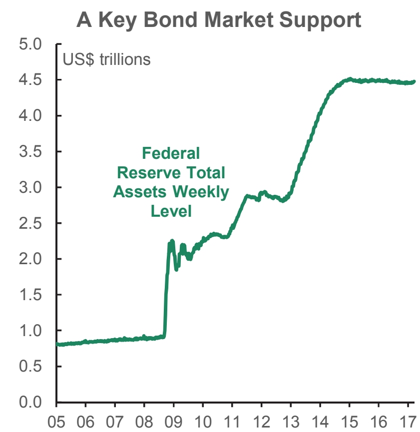
Arguments in favour of a rate cut would require a sharp shock to presently understood drivers of the framework. Recall Poloz's remark late last year when in response to a question about cut risk, he stated "It would require for us to have a significant departure in that outlook, such as we had in the case in the oil price shock." What we know about the base case outlook at this point downplays cut risk especially in the context of the risks to potentially courting negative rates.

FEDERAL RESERVE OUTLOOK — 2017 IS PRICED, FULLER CYCLE RISKS

Our base case outlook for the Federal Reserve continues to include:

- Three rate hikes in total this year which implies two more to come following the hike in March, likely in June and December as the pursuit of tax reforms is monitored over the summer. This is to be 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 further 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 as a bond market support throughout 2017–18 (chart 4). We assume a gradual reduction to 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 that is forecast to arrive into 2019.
- Our forecast for the terminal rate, or neutral rate is 3% in nominal terms, 1% in inflation-adjusted terms. This is the equilibrium rate that achieves stability in the Fed's dual mandate of full employment and price stability and is sometimes referred to as r-star.

Chart 4



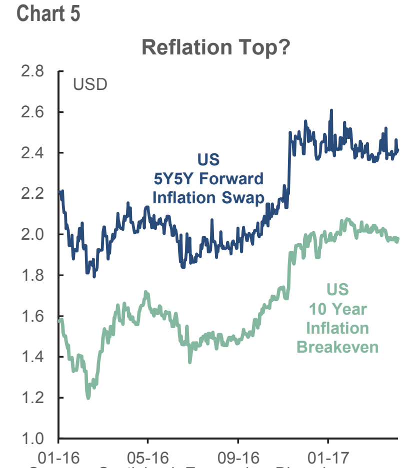
Sources: Scotiabank Economics, Federal Reserve.

The rationale for this base case forecast is rooted in sustained 2–2½% GDP growth throughout our forecast horizon that would slightly exceed the economy's estimated speed limit that the Fed puts at 1.8%. The result would be a closed output gap into 2018 and thus the complete removal of disinflationary slack. This is viewed as adequate to sustainably achieve the Fed's Congressionally mandated goals of price stability around a 2% inflation target and full employment around the Fed's estimate of a 4.7% unemployment rate. A degree of market stability is assumed that is highly contingent upon several risks.

Bi-directional sources of risk to this forecast include but are not limited to the following:

1. The Reflation trade: Markets and our forecasts assume that US inflation will persistently run at about 2% backed by commodities, wage growth and higher core inflation. A downside risk would be if core inflation pressures do not continue to fan out while energy-led base effects dissipate. An upside risk to inflation could come from stronger-than-forecast domestic and global growth that puts the US economy into excess demand conditions and raises inflation risk. A protectionist border tax could also accelerate inflation temporarily but likely drive disinflationary forces thereafter and how the Fed reads this will be important.

Chart 5



Sources: Scotiabank Economics, Bloomberg.

2. Other domestic policy risks: We remain sceptical of the potential benefits to growth from a possible shift in US fiscal, regulatory and trade policies as this first piece outlined. The benefits to the economy and markets relative to what is priced may very well remain exaggerated even if governance were to improve.

3. Geopolitical risks remain high including but not limited to European elections and foreign policy challenges in Asia.

4. Animal spirits: Will strong consumer confidence portend an acceleration in consumer spending with positive implications for top-line revenues that support present equity valuations? The evidence suggests the opposite risk in that consumer confidence usually peaks very late in the cycle after most gains have become exhausted (chart 6). Furthermore, there is no growth in consumption being tracked in Q1 this year.

5. The USD: Having fallen back to about where it was at the time of the US election, dollar strength poses slightly less downside risk to net exports and inflation but our house view sees further appreciation in the near-term.

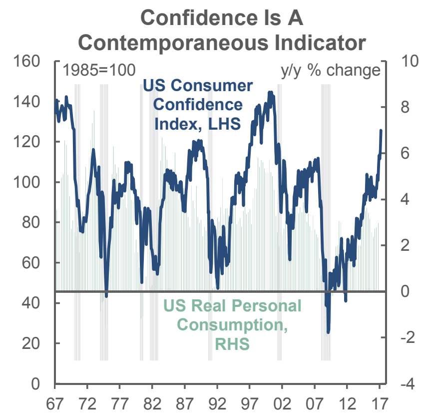
6. Vacancies remain a key source of uncertainty regarding the bias of the future composition of the Federal Open Market Committee and mainly next year. Since this piece surveyed the scope of potential vacancies, only one has been filled; retired Atlanta Fed President Dennis Lockhart has been succeeded by Raphael Bostic.

BOND MARKETS — BEAR FLATTENERS, BUT DON'T ABANDON ALL BONDS

Our base case forecast for rising bond yields is somewhat more focused upon shorter-term maturities than longer-dated securities. Please see the accompanying table below for forecasts and chart 7 for a depiction of the bear flatteners that we continue to stand by.

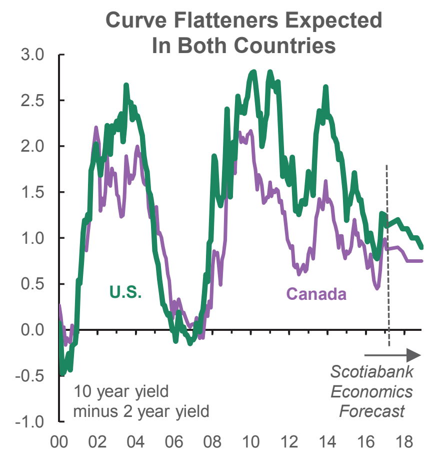
One reason for forecasting faster increases in shorter-term rates than longer-term yields is keyed off of US monetary policy expectations. A considerable part of our base line forecast for the Federal Reserve is priced into shorter-dated Treasuries. At present, fed

Chart 6



Sources: Scotiabank Economics, US Conference Board, US BEA, US NBER.

Chart 7



Source: Scotiabank Economics, Bloomberg.

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

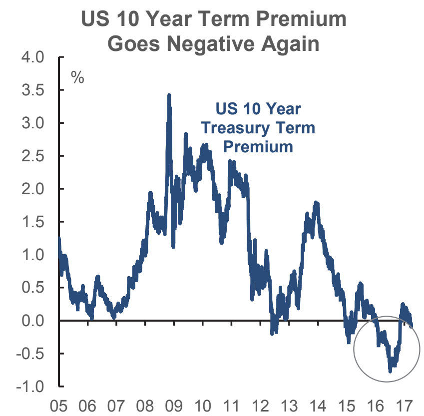
	2016				2017 (end of quarter, %)				2018			
Canada	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
BoC Overnight Target Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	0.75	1.00
Prime Rate	2.70	2.70	2.70	2.70	2.70	2.70	2.70	2.70	2.70	2.95	2.95	3.20
3-month T-bill	0.45	0.49	0.53	0.46	0.55	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	1.12	1.25	1.35	1.40	1.50	1.65	1.80	1.90
10-year Canada	1.23	1.06	1.00	1.72	1.63	1.75	1.85	1.90	1.95	2.10	2.20	2.35
30-year Canada	2.00	1.72	1.66	2.31	2.30	2.35	2.45	2.50	2.55	2.65	2.75	2.80
United States	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
Fed Funds Target Rate	0.50	0.50	0.50	0.75	1.00	1.25	1.25	1.50	1.50	1.75	1.75	2.00
Prime Rate	3.50	3.50	3.50	3.75	4.00	4.25	4.25	4.50	4.50	4.75	4.75	5.00
3-month T-bill	0.20	0.26	0.27	0.50	0.75	1.00	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	1.92	2.05	2.20	2.30	2.40	2.50	2.55	2.60
10-year Treasury	1.77	1.47	1.59	2.44	2.39	2.55	2.70	2.80	2.85	2.90	2.95	3.00
30-year Treasury	2.61	2.28	2.31	3.07	3.01	3.05	3.20	3.30	3.35	3.40	3.45	3.50

fund futures are pricing about three of our forecast five hikes by the end of 2018. This implies some further room for upward pressure on shorter-dated securities.

A second reason is our view on the term premium in Treasuries (chart 8). Recall this measure compares 10 year zero-coupon Treasury yields to a series of short-term maturity bonds. It had been rising in the wake of the election and a little before that when global turmoil over 2016H1 began to subside. Investors began to build in rising inflation expectations and demanded more of a premium to lock in a nominal bond for a finite longer term. More recently, this term premium is hovering around zero as reflation enthusiasm has peaked. For our forecast purposes, we assume that an average term premium around zero will be maintained as a compromise between not returning to last year's distortions and restraining enthusiasm for the so-called reflation and Trump trades.

Foreign 'carry' trades into US Treasuries will also likely continue to cap Treasury yields. The nominal yield spread between, say, US 10 year yields and 10 year bunds sits at over 200bps and versus 10 year JGBs it is over 230bps. Such a yield pick-up makes Treasuries relatively attractive to global fixed income portfolios and maintains demand.

Chart 8



Sources: Scotiabank Economics, Federal Reserve Bank of New York.

Overall, sovereign bonds will likely remain over-valued throughout our forecast horizon relative to a classic rule of thumb that relates 10 year nominal Treasury yields to longer-run expectations for nominal GDP growth that could be reasonably portrayed around 4% including 2% longer-run inflation. A major reason continues to be the relative scarcity of tradable fixed income product brought on by quantitative easing programs at major global central banks. This scarcity continues to worsen as bond buying programs continue at the ECB and Bank of Japan while the Fed continues to reinvest maturing Treasuries. The greater upside risk concerns supply pressures pending developments in US fiscal policy.