US & Canadian Monetary Policy & Capital Markets

Scotiabank Economics has not materially altered its forecasts for the Federal Reserve, Bank of Canada and broader yield curves. One more hike from each central bank this year is still expected to be followed by two more hikes from each next year in such fashion as to continue bear flattening the 2s10s slopes of each country's yield curve as a neutral influence upon CAD (charts 1, 2). We forecast a constant overnight rate spread of -25bps over our forecast horizon with policy rates coming close to if not converging upon neutral rate assumptions in 2019.

BANK OF CANADA — PAUSE, THEN GRADUAL

The BoC is expected to hike by 25bps in December and twice more in 2018 around April and October timelines. In timing the next hike, the risk is skewed toward later than December rather than sooner. By 2019, a neutral policy rate range of 2–2.5% is forecast for this cycle.

Governor Poloz's recent speech and press conference continue to leave the door open to further rate hikes while also indicating some patience and data dependence (here). In reference to how tightening involves more than just reversing the two cuts in 2015, Poloz stated that "At a minimum, that additional stimulus is no longer needed." Briefly summarized, a pause was signalled by a) stating that the BoC will "feel our way cautiously", b) indicating nothing "mechanical in our approach to monetary policy" which leans against a straight line of uninterrupted policy moves in anticipation of model-based developments, c) flagging still-soft wage data, d) indicating uncertainty over the investment cycle and its influences upon spare capacity and hence inflation pressures, and d) indicating uncertainty toward the "cause, size and persistence" of currency movements and associated effects.

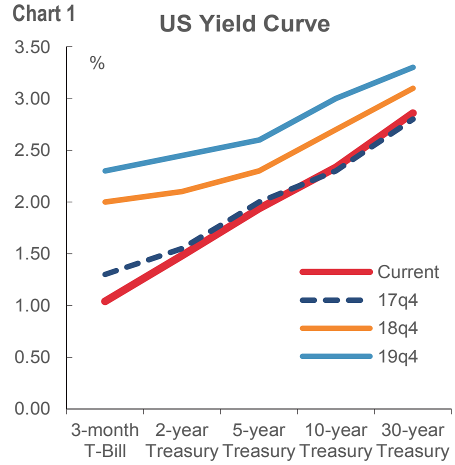
The reasons for a tightening bias continue to include:

- The lifting of domestic idiosyncratic inflation drivers as prices for gasoline, autos and electricity turn from being disinflationary toward reflationary;
- The general output gap framework as spare capacity has largely closed on the back of strong growth while we anticipate that a slower-growing economy will slip marginally into excess aggregate demand going forward. With the customary lag, a mild rise in inflationary pressure is anticipated (chart 3).
- Event risk has subsided. It appears unlikely a) that the US will impose border taxes, b) that NAFTA will be a major macro-event as opposed to a sector-specific consideration, and c) that Canada will import a major bond market shock from the US on the application of fiscal and regulatory stimulus late in the cycle while the term premium rises as the Federal Reserve's balance sheet shrinks (more on this below).
- Financial stability risks. The corrections in Vancouver's and Toronto's housing markets will likely prove to be temporary and motivate further comfort toward tightening at a gradual pace. Indeed, household credit growth has accelerated over the summer.

CONTACTS

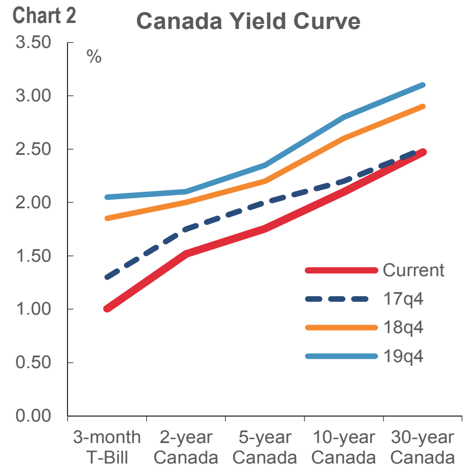
Derek Holt, VP & Head of Capital Markets Economics
416.863.7707
Scotiabank Economics
derek.holt@scotiabank.com

Chart 1



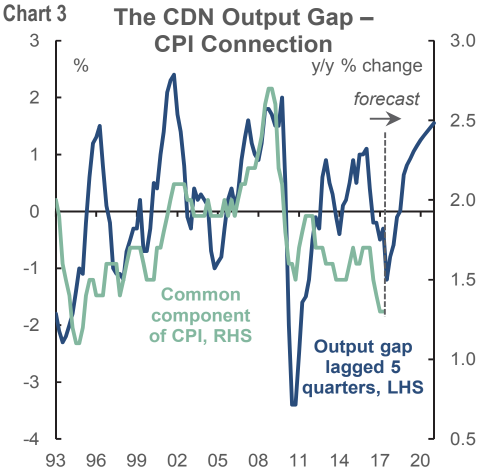
Sources: Scotiabank Economics, Bloomberg.

Chart 2



Source: Scotiabank Economics.

Chart 3



Sources: Scotiabank Economics, Bank of Canada.

- To sterilize a fiscal policy overshoot. The combined application of monetary and fiscal policy stimulus led to stronger-than-expected GDP growth averaging nearly 4% over the past four quarters in inflation-adjusted terms.

FEDERAL RESERVE — CONVENTIONAL TIGHTENING

A rate hike in December is expected to be followed by two more hikes in 2018 around June and December timelines and hence one less than the Fed's 'dot plot' guidance. We then anticipate that a neutral policy target range of 2.25–2.5% will be realized into 2019 as the rate hike cycle comes to a close.

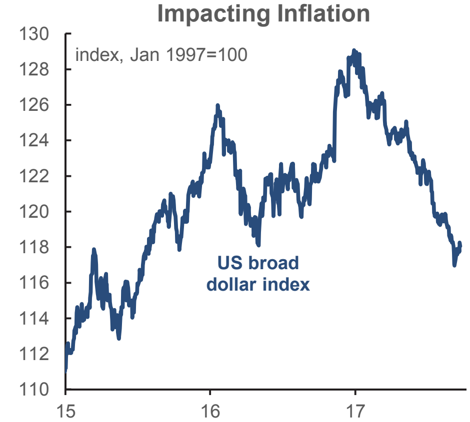
There are at least three main considerations that are guiding our forecast beyond the underlying growth and spare capacity fundamentals that we think support further hikes.

1. Inflation And The Dollar

Inflation is probably undergoing transitory headwinds related to past USD strength. As the USD has weakened since spring, **a higher inflation profile is anticipated and this should support a return to policy tightening**. While the connection between the dollar and inflation is hardly air-tight, large, abrupt swings in the dollar tend to be more correlated with large, abrupt swings in import prices (chart 4) and modest pass-through to CPI. The broad dollar index is now at its lowest since April 2016 and has reversed all of the pre- and post-election rally and then some. A more muted correction in the dollar in early 2016 was followed by a rise in core PCE inflation from about 1.2% y/y to 1.9% y/y with several drivers, the USD among them.

Chart 4

USD's Rise and Fall Impacting Inflation



Sources: Scotiabank Economics, US Federal Reserve.

It is important to recall the literature and to note that the Federal Reserve views the currency's role in this way. Indeed this speech about two years ago by retiring Vice Chairman Stanley Fischer was specifically on the very topic of exchange rate effects on growth and inflation. Fischer stated that Fed models indicate that for every 10% trade-weighted appreciation in the dollar, core PCE inflation is reduced by 0.5% in the two quarters following the dollar's move and the four-quarter effect is to reduce core PCE inflation by about 0.3%. Note that the broad dollar index appreciated by about 9% from the spring of 2016 until early 2017 and has since depreciated by a similar amount.

It is therefore conceivable that much of the deceleration in core PCE inflation from 1.9% at the start of this year to 1.4% as of August was due to the dollar's prior appreciation. **By corollary, dollar depreciation since earlier this year may well have the Fed much closer to its inflation target as soon as 2018H1.**

2. Rely On Conventional Tightening

As explained in the yield curve forecasts below, it's unlikely that the Fed will be able to singlehandedly cheapen the Treasury curve through raising the term premium via reduced reinvestment. Thus, **unconventional policy tightening is no clear substitute for conventional policy tightening**. It therefore remains unclear that the Fed should count upon unconventional tightening in lieu of conventional rate hikes as some FOMC officials appeared to suggest or implied comfort toward over the summer.

3. Sterilizing Other Policy Stimulus

Will potential fiscal and regulatory policy easing be achieved in such fashion as to offer meaningful macroeconomic benefits? This is a hugely loaded question that present space is not suited to addressing in full, but our assumption is that there will be very little macroeconomic benefit to potential policy reforms. If we're wrong then markets and Federal Reserve policy may sterilize the outcomes which means **the Fed's response to fiscal policy initiatives ranges between being relatively benign to incrementally hawkish relative to our base case scenario.**

One argument not on this list of key considerations is that FOMC officials desire policy tightening in order to build future policy flexibility away from the lower bound on rates should downside risks to the economy and the Fed's dual mandate resurface. There may be some who believe this, but the embedded circular logic is that the Fed wishes to court recession risks through policy tightening that is otherwise unsuitable so that it has the flexibility to counter the next recession.

YIELD CURVES — ASYMMETRIC TERM PREMIUM RESPONSE?

A key issue governing the outlook for the yield curves (see table) is whether the Treasury term premium rises as the Fed reduces its balance sheet holdings of Treasuries and MBS and at what pace. I think the term premium will rise more slowly as the balance sheet shrinks than it fell as QE expanded the balance sheet over the post-crisis period. That doesn't mean Treasuries can't cheapen further from here over the next year, with our forecast being that US 10 year yields end 2018 at about 2¾%, but added pressures from a big rise in the term premium are unlikely in my view.

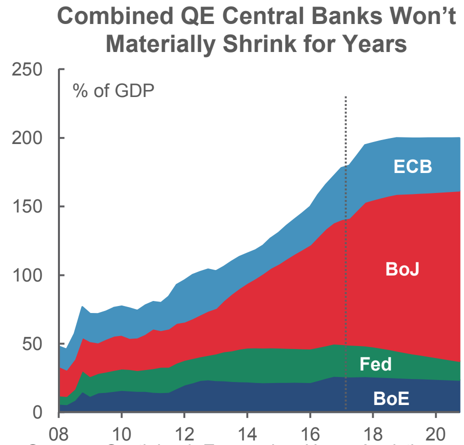
Research (here) suggests US 10 year Treasury yields are about 1% lower than where they would be otherwise in the absence of the Fed's balance sheet expansion and controlling for other influences. The view that the Treasury term premium will rise less materially than it fell (i.e., a shallow 'U' versus a 'V') is based upon many other considerations affecting the Treasury market than just the Fed's balance sheet that have markets understanding the reduction plan but in the context of other considerations. They include:

- Late cycle concerns that could slow, halt or reverse balance sheet reduction plans at some point along the multi-year plan. There is practically zero science around timing a business cycle but the risks of disappointment somewhere along the way are more material when one is dealing with the third longest expansion on record that will soon become the second longest than they would be if the expansion were at a more embryonic stage;

- The actions of other major QE central banks whose balance sheets will not be shrinking for years (BoE) or will continue to expand even if at a slower pace in future (ECB, BoJ). Please see chart 5. This is unlike the taper tantrum in May 2013 in that other central banks were nowhere nearly as active including the ECB whose balance sheet was shrinking at the time. The estimate of the term premium's reduction via the Fed's QE program was also skewed toward a period when QE1 and QE2 were rolled out before much more aggressive foreign central bank actions on conventional (negative policy rates) and unconventional (QE, guidance, term lending programs, etc.) policies. The ability of the Fed to cheapen the Treasury market on its own is limited in a world of connected carry trades adjusted for FX hedging risks if other foreign central banks are still hesitant to allow their own yields to rise materially.

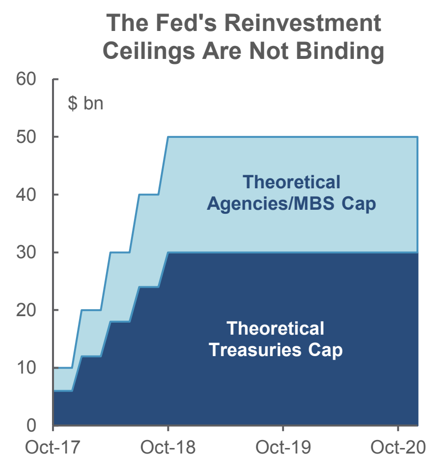
- Elevated stock markets may merit a safe-haven bid that preserves demand for Treasuries.

Chart 5



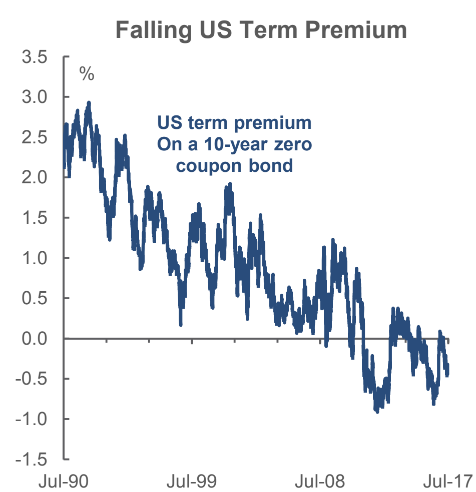
Sources: Scotiabank Economics, Haver Analytics, IMF.

Chart 6



Sources: Scotiabank Economics, US Federal Reserve Board.

Chart 7



Sources: Scotiabank Economics, Federal Reserve.

- The reinvestment caps (chart 6) are theoretical and not binding. The actual amounts allowed to roll off the balance sheet each month depend upon the flow of maturing securities and, in the case of MBS, prepayments risk. Starting about a year from now, there will be several months each year in which the actual amount of Treasuries maturing and rolling off the balance sheet will be materially lower than the theoretical investment caps.

- Neutral rate estimates continue to move lower and are the ultimate anchor for the curve's pricing of potential future Fed rate policy actions.

- There are various other influences upon the term premium that has been dropping for decades and well before QE, like estimates of long-run inflation risk (chart 7). On that note, the 5y5y inflation swap is pricing longer-run inflation of 2.3% at the moment which seems fairly reasonable at this point.

Table 1

Scotiabank Economics' Canada-US Yield Curve Forecast

	2017		2018				2019			
	(end of quarter, %)									
Canada	**Q3**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
BoC Overnight Target Rate	1.00	1.25	1.50	1.50	1.75	1.75	2.00	2.00	2.00	2.00
Prime Rate	3.20	3.45	3.70	3.70	3.95	3.95	4.20	4.20	4.20	4.20
3-month T-bill	1.00	1.30	1.55	1.60	1.80	1.85	2.05	2.05	2.05	2.05
2-year Canada	1.52	1.75	1.85	1.90	1.95	2.00	2.05	2.05	2.10	2.10
5-year Canada	1.75	2.00	2.05	2.10	2.15	2.20	2.25	2.25	2.30	2.35
10-year Canada	2.10	2.20	2.25	2.35	2.45	2.60	2.70	2.75	2.80	2.80
30-year Canada	2.48	2.50	2.55	2.60	2.75	2.90	2.95	3.00	3.05	3.10
United States	**Q3**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
Fed Funds Target Rate	1.25	1.50	1.50	1.75	1.75	2.00	2.00	2.00	2.25	2.25
Prime Rate	4.25	4.50	4.50	4.75	4.75	5.00	5.00	5.00	5.25	5.25
3-month T-bill	1.04	1.30	1.40	1.60	1.70	2.00	2.05	2.05	2.30	2.30
2-year Treasury	1.48	1.55	1.75	1.85	1.95	2.10	2.20	2.30	2.35	2.45
5-year Treasury	1.93	2.00	2.10	2.15	2.20	2.30	2.40	2.50	2.55	2.60
10-year Treasury	2.34	2.30	2.35	2.45	2.60	2.70	2.75	2.80	2.90	3.00
30-year Treasury	2.86	2.80	2.80	2.85	3.00	3.10	3.10	3.15	3.20	3.30

Sources: Scotiabank Economics, Bloomberg.