

THE YIELD CURVE

Investors Are Starting to Believe That Monetary Tightening Will Continue



HIGHLIGHTS

- ▶ The U.S. 10-year yield, which fell to about 2.80% in mid-August, recently climbed back close to its cyclical peak of 3.11% reached last May. Initially, this increase in long-term bond yields seemed to mostly reflect a moderation of concerns about emerging countries. The upswing in bond yields accelerated in early September, on job data that signalled an acceleration in wage growth in the United States. The end of a tax benefit that appeared to have inflated demand for bonds by U.S. pension funds may also have helped push long-term yields higher.
- ▶ Stronger wage growth seems to have convinced investors to give more weight to the Federal Reserve's (Fed) intention to keep tightening its monetary policy in the coming years. No one doubted that a key rate hike would be ordered at the end of September. Many investors had doubts that monetary tightening would then continue, however. By mid-August, Fed funds futures suggested that the Fed would stop its monetary tightening when the top of the target range for federal funds reached 2.75%—only 50 basis points higher than the current level. The same futures today point to an additional increase of 25 points. However, the latest forecasts by Fed officials signal that federal funds could rise to about 3.50% in 2020 and 2021.
- ▶ The Bank of Canada (BoC) opted to maintain the status quo in September. Noting that recent data reinforce the assessment that higher interest rates will be warranted, the BoC clearly signalled its intention to continue its monetary tightening in October. Economic growth in Canada was solid last spring and some data suggest that the slowdown in the third quarter may be less steep than what the BoC anticipated in its July *Monetary Policy Report*. The annual inflation rate should gradually return closer to its 2% target, while the impact of higher gas prices and air transportation fades. Core inflation should be watched closely, however, as the BoC's three core inflation measures were up in August, rising slightly above 2% on average.
- ▶ Unlike the Fed and the BoC, the European Central Bank (ECB), the Bank of England and the Bank of Japan are not signalling any imminent change to their key rates. The ECB still expects to end its securities purchases in December.

INTEREST RATE FORECASTS

- ▶ The latest comments from Fed leaders and the acceleration in wages support our scenario that calls for a 0.25% quarterly increase in U.S. key rates until fall 2019. As such, the recent rise in long-term yields seems highly appropriate to us and further increases should be expected in the months ahead.
- ▶ The BoC should not hesitate to increase its key rates on October 24, barring a major shock, such as the levying of tariffs on automobile exports. After October, we are still comfortable with our scenario of a key rate increase in Canada every six months. That said, another increase in January is not out of the question if the economic data exceed expectations or if trade tensions ease.

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NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

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TABLE 1
Key interest rates

END OF PERIOD IN %	2017				2018				2019			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
United States												
Federal funds	1.00	1.25	1.25	1.50	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.25
Canada												
Overnight funds	0.50	0.50	1.00	1.00	1.25	1.25	1.50	1.75	1.75	2.00	2.00	2.25
Zone euro												
Refinancing rate	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.05	0.25
United Kingdom												
Base rate	0.25	0.25	0.25	0.50	0.50	0.50	0.75	0.75	0.75	0.75	1.00	1.00
Japan												
Main key rate	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10

f: forecasts

Sources: Datastream and Desjardins, Economic Studies

TABLE 2
Fixed income market

END OF PERIOD IN %	2017				2018				2019			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
UNITED STATES												
Treasury bills												
3-month	0.76	1.03	1.06	1.39	1.73	1.93	2.20	2.45	2.70	2.95	3.10	3.20
Federal bonds												
2-year	1.24	1.37	1.49	1.88	2.27	2.53	2.85	3.00	3.15	3.25	3.30	3.40
5-year	1.92	1.88	1.92	2.19	2.55	2.73	2.95	3.15	3.30	3.40	3.50	3.55
10-year	2.40	2.30	2.33	2.41	2.75	2.86	3.05	3.30	3.45	3.55	3.60	3.65
30-year	3.02	2.84	2.86	2.74	2.97	2.99	3.20	3.40	3.55	3.65	3.70	3.75
Yield curve slopes												
5-year - 3-month	1.16	0.85	0.86	0.80	0.82	0.80	0.75	0.70	0.60	0.45	0.40	0.35
10-year - 2-year	1.16	0.93	0.84	0.53	0.47	0.33	0.20	0.30	0.30	0.30	0.30	0.25
30-year - 3-month	2.26	1.81	1.80	1.35	1.24	1.06	1.00	0.95	0.85	0.70	0.60	0.55
CANADA												
Treasury bills												
3-month	0.52	0.71	1.00	1.06	1.10	1.26	1.55	1.70	1.80	1.95	2.05	2.20
Federal bonds												
2-year	0.75	1.09	1.52	1.68	1.77	1.91	2.20	2.30	2.35	2.45	2.50	2.60
5-year	1.12	1.38	1.75	1.86	1.96	2.06	2.30	2.45	2.55	2.65	2.75	2.80
10-year	1.63	1.75	2.10	2.04	2.09	2.17	2.40	2.60	2.75	2.85	2.90	2.95
30-year	2.31	2.13	2.47	2.26	2.23	2.20	2.40	2.65	2.80	2.90	2.95	3.05
Yield curve slopes												
5-year - 3-month	0.60	0.67	0.75	0.80	0.86	0.80	0.75	0.75	0.75	0.70	0.70	0.60
10-year - 2-year	0.88	0.66	0.58	0.36	0.32	0.26	0.20	0.30	0.40	0.40	0.40	0.35
30-year - 3-month	1.79	1.42	1.47	1.20	1.13	0.94	0.85	0.95	1.00	0.95	0.90	0.85
Yield spreads (Canada—United States)												
3-month	-0.24	-0.32	-0.06	-0.33	-0.63	-0.67	-0.65	-0.75	-0.90	-1.00	-1.05	-1.00
2-year	-0.49	-0.28	0.03	-0.20	-0.50	-0.62	-0.65	-0.70	-0.80	-0.80	-0.80	-0.80
5-year	-0.80	-0.50	-0.17	-0.33	-0.59	-0.67	-0.65	-0.70	-0.75	-0.75	-0.75	-0.75
10-year	-0.77	-0.55	-0.23	-0.37	-0.66	-0.69	-0.65	-0.70	-0.70	-0.70	-0.70	-0.70
30-year	-0.71	-0.71	-0.39	-0.48	-0.74	-0.79	-0.80	-0.75	-0.75	-0.75	-0.75	-0.70

f: forecasts

Sources: Datastream and Desjardins, Economic Studies

Schedule 2018 of Central Bank Meetings

Date	Central banks	Decision	Rate
January			
17	Bank of Korea	s.q.	1.50
17	Bank of Canada*	+25 b.p.	1.25
22	Bank of Japan	s.q.	-0.10
25	European Central Bank	s.q.	0.00
25	Bank of Norway	s.q.	0.50
31	Federal Reserve	s.q.	1.50
February			
5	Reserve Bank of Australia	s.q.	1.50
7	Reserve Bank of New Zealand	s.q.	1.75
7	Bank of Brazil	-25 b.p.	6.75
8	Bank of England	s.q.	0.50
8	Bank of Mexico	+25 b.p.	7.50
14	Bank of Sweden	s.q.	-0.50
26	Bank of Korea	s.q.	1.50
March			
5	Reserve Bank of Australia	s.q.	1.50
7	Bank of Canada	s.q.	1.25
8	European Central Bank	s.q.	0.00
8	Bank of Japan	s.q.	-0.10
15	Bank of Norway	s.q.	0.50
15	Swiss National Bank	s.q.	-0.75
21	Reserve Bank of New Zealand	s.q.	1.75
21	Bank of Brazil	-25 b.p.	6.50
21	Federal Reserve	+25 b.p.	1.75
22	Bank of England	s.q.	0.50
April			
3	Reserve Bank of Australia	s.q.	1.50
11	Bank of Korea	s.q.	1.50
12	Bank of Mexico	s.q.	7.50
18	Bank of Canada*	s.q.	1.25
26	European Central Bank	s.q.	0.00
26	Bank of Sweden	s.q.	-0.50
26	Bank of Japan	s.q.	-0.10
May			
1	Reserve Bank of Australia	s.q.	1.50
2	Federal Reserve	s.q.	1.75
3	Bank of Norway	s.q.	0.50
9	Reserve Bank of New Zealand	s.q.	1.75
10	Bank of England	s.q.	0.50
16	Bank of Brazil	s.q.	6.50
17	Bank of Mexico	s.q.	7.50
23	Bank of Korea	s.q.	1.50
30	Bank of Canada	s.q.	1.25
June			
5	Reserve Bank of Australia	s.q.	1.50
13	Federal Reserve	+25 b.p.	2.00
14	European Central Bank	s.q.	0.00
14	Bank of Japan	s.q.	-0.10
20	Bank of Brazil	s.q.	6.50
21	Bank of England	s.q.	0.50
21	Bank of Norway	s.q.	0.50
21	Bank of Mexico	+25 b.p.	7.75
21	Swiss National Bank	s.q.	-0.75
27	Reserve Bank of New Zealand	s.q.	1.75

Date	Central banks	Decision	Rate
July			
3	Reserve Bank of Australia	s.q.	1.50
3	Bank of Sweden	s.q.	-0.50
11	Bank of Korea	s.q.	1.50
11	Bank of Canada*	+25 b.p.	1.50
26	European Central Bank	s.q.	0.00
31	Bank of Japan	s.q.	-0.10
August			
1	Bank of Brazil	s.q.	6.50
1	Federal Reserve	s.q.	2.00
2	Bank of England	+25 b.p.	0.75
2	Bank of Mexico	s.q.	7.75
7	Reserve Bank of Australia	s.q.	1.50
8	Reserve Bank of New Zealand	s.q.	1.75
16	Bank of Norway	s.q.	0.50
30	Bank of Korea	s.q.	1.50
September			
4	Reserve Bank of Australia	s.q.	1.50
5	Bank of Canada	s.q.	1.50
6	Bank of Sweden	s.q.	-0.50
13	European Central Bank	s.q.	0.00
13	Bank of England	s.q.	0.75
18	Bank of Japan	s.q.	-0.10
19	Bank of Brazil	s.q.	6.50
20	Bank of Norway	+25 b.p.	0.75
20	Swiss National Bank	s.q.	-0.75
26	Reserve Bank of New Zealand	s.q.	1.75
26	Federal Reserve	+25 b.p.	2.25
October			
2	Reserve Bank of Australia	s.q.	1.50
4	Bank of Mexico	s.q.	7.75
17	Bank of Korea	s.q.	1.50
24	Bank of Sweden	s.q.	-0.50
24	Bank of Canada*	s.q.	1.25
25	European Central Bank	s.q.	0.00
25	Bank of Norway	s.q.	0.50
30-31	Bank of Japan	s.q.	-0.10
31	Bank of Brazil	s.q.	6.50
November			
1	Bank of England	s.q.	0.50
5	Reserve Bank of Australia	s.q.	1.50
7	Reserve Bank of New Zealand	s.q.	1.75
8	Federal Reserve	s.q.	1.75
15	Bank of Mexico	s.q.	7.75
29	Bank of Korea	s.q.	1.50
December			
3	Reserve Bank of Australia	s.q.	1.50
5	Bank of Canada	s.q.	1.25
12	Bank of Brazil	s.q.	6.50
13	European Central Bank	s.q.	0.00
13	Bank of Norway	s.q.	0.50
13	Swiss National Bank	s.q.	-0.75
19	Federal Reserve	s.q.	1.75
19-20	Bank of Japan	s.q.	-0.10
20	Bank of England	s.q.	0.50
20	Bank of Sweden	s.q.	-0.50
20	Bank of Mexico	s.q.	7.75

NOTE: Certain banks may decide to change rates in-between the scheduled meetings. The abbreviations s.q. and b.p. correspond to status quo and basis points respectively. * Monetary Policy Report published.