

THE YIELD CURVE

Toward Gradual Monetary Policy Normalization

HIGHLIGHTS

- ▶ After pulling back sharply in June and July, bond yields have edged up since the start of August. Investors seem quite hesitant, however, as the Delta variant and major supply constraints, especially in the auto industry, have dampened growth outlooks somewhat. Central banks are ill equipped to deal with supply shortages that could intensify the already very palpable inflationary pressures. There is thus an increasing consensus among central banks that the extraordinary measures introduced during the pandemic are no longer appropriate and that it is time to start normalizing monetary policies. Some central banks in emerging countries and the Bank of Korea have already begun raising their key rates.
- ▶ While monthly U.S. price increases slowed in July and August, inflation is still over 5%, with many signs of inflationary pressures persisting in production prices and elsewhere. The major question is whether last spring's heavy, temporary pressure on prices will make way for more lasting, widespread pressure. Given this real risk, most Federal Reserve (Fed) leaders think that it will be appropriate to start reducing asset purchases before the end of the year. We could see an announcement about this at the September 22 meeting. The immediate impact of such an announcement on bond yields and financial markets should, however, be fairly subdued.
- ▶ In Canada, second-quarter economic growth was well below expectations, with real GDP retreating an annualized 1.1%. This disappointing result does not reflect soft demand, however, but rather the effects of the pandemic's third wave and substantial supply constraints. Already high, inflation delivered an upside surprise in July and August, hitting a nearly 20-year peak. Even the Bank of Canada (BoC) core indexes are trending up more and more away from the 2% target. As a result, there is every indication that the BoC will continue to taper its bond purchases and could, even as soon as its October meeting, elect to stabilize its bond holdings, replacing only bonds that are maturing on its balance sheet. The BoC's governor recently indicated that a hike in key rates would take place before this reinvestment period ends.
- ▶ Inflation has also risen in Europe and the Bank of England (BoE) and European Central Bank (ECB) both announced cuts to their asset purchases. The BoE could complete its purchases by the end of the year. Meanwhile, the ECB's special pandemic purchase program is slated to end no earlier than March 2022. Simultaneously, the ECB is signalling that will hold its regular purchase program at a pace of €20B per month until the eve of an increase in key rates.

INTEREST RATE FORECASTS

- ▶ Our scenarios are mostly unchanged. Despite some concerns over economic growth, inflation risks continue to suggest gradual monetary policy normalization. We still expect bond yields to rise over the next few quarters. This will allow the major central banks to keep their key rates at their lower bounds for several more months. In North America, the first key rate increases are still expected in the fourth quarter of 2022.

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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 %	2020				2021				2022			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
United States												
Federal funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50
Canada												
Overnight funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50
Zone euro												
Refinancing rate	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
United Kingdom												
Base rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.25
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 %	2020				2021				2022			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
UNITED STATES												
Treasury bills												
3-month	0.11	0.16	0.10	0.09	0.03	0.05	0.05	0.10	0.15	0.15	0.20	0.45
Federal bonds												
2-year	0.25	0.17	0.13	0.13	0.16	0.24	0.25	0.40	0.60	0.75	0.90	1.15
5-year	0.36	0.28	0.27	0.35	0.92	0.86	0.85	1.00	1.20	1.35	1.50	1.70
10-year	0.67	0.65	0.68	0.91	1.75	1.44	1.35	1.60	1.85	2.05	2.25	2.40
30-year	1.32	1.41	1.45	1.64	2.42	2.07	1.90	2.15	2.35	2.55	2.70	2.85
Yield curve slopes												
5-year - 3-month	0.25	0.12	0.17	0.26	0.89	0.81	0.80	0.90	1.05	1.20	1.30	1.25
10-year - 2-year	0.41	0.49	0.55	0.79	1.59	1.20	1.10	1.20	1.25	1.30	1.35	1.25
30-year - 3-month	1.21	1.25	1.35	1.55	2.39	2.02	1.85	2.05	2.20	2.40	2.50	2.40
CANADA												
Treasury bills												
3-month	0.21	0.20	0.12	0.06	0.09	0.15	0.15	0.20	0.20	0.25	0.35	0.60
Federal bonds												
2-year	0.42	0.28	0.25	0.20	0.22	0.45	0.45	0.60	0.75	0.90	1.05	1.30
5-year	0.60	0.36	0.36	0.39	0.99	0.97	0.85	1.05	1.30	1.50	1.65	1.85
10-year	0.71	0.52	0.57	0.67	1.55	1.39	1.25	1.50	1.75	1.95	2.15	2.30
30-year	1.32	0.99	1.11	1.21	1.97	1.84	1.80	2.00	2.15	2.30	2.40	2.55
Yield curve slopes												
5-year - 3-month	0.39	0.16	0.24	0.33	0.90	0.82	0.70	0.85	1.10	1.25	1.30	1.25
10-year - 2-year	0.29	0.24	0.32	0.47	1.33	0.94	0.80	0.90	1.00	1.05	1.10	1.00
30-year - 3-month	1.11	0.79	0.99	1.15	1.88	1.69	1.65	1.80	1.95	2.05	2.05	1.95
Yield spreads (Canada—United States)												
3-month	0.10	0.04	0.02	-0.03	0.06	0.10	0.10	0.10	0.05	0.10	0.15	0.15
2-year	0.17	0.11	0.12	0.07	0.06	0.21	0.20	0.20	0.15	0.15	0.15	0.15
5-year	0.24	0.08	0.09	0.04	0.07	0.11	0.00	0.05	0.10	0.15	0.15	0.15
10-year	0.04	-0.13	-0.11	-0.24	-0.20	-0.05	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
30-year	0.00	-0.42	-0.34	-0.43	-0.45	-0.23	-0.10	-0.15	-0.20	-0.25	-0.30	-0.30

f: forecasts

Sources: Datastream and Desjardins, Economic Studies

Schedule 2021 of Central Bank Meetings

Date	Central banks	Decision	Rate
January			
14	Bank of Korea	s.q.	0.50
20	Bank of Brazil	s.q.	2.00
20	Bank of Canada*	s.q.	0.25
20	Bank of Japan	s.q.	-0.10
21	European Central Bank	s.q.	0.00
21	Bank of Norway	s.q.	0.00
27	Federal Reserve	s.q.	0.25
February			
1	Reserve Bank of Australia	s.q.	0.10
4	Bank of England	s.q.	0.10
10	Bank of Sweden	s.q.	0.00
11	Bank of Mexico	-25 b.p.	4.00
23	Reserve Bank of New Zealand	s.q.	0.25
24	Bank of Korea	s.q.	0.50
March			
1	Reserve Bank of Australia	s.q.	0.10
10	Bank of Canada	s.q.	0.25
11	European Central Bank	s.q.	0.00
17	Bank of Brazil	+75 b.p.	2.75
17	Federal Reserve	s.q.	0.25
18	Bank of England	s.q.	0.10
18	Bank of Norway	s.q.	0.00
19	Bank of Japan	s.q.	-0.10
25	Bank of Mexico	s.q.	4.00
25	Swiss National Bank	s.q.	-0.75
April			
6	Reserve Bank of Australia	s.q.	0.10
13	Reserve Bank of New Zealand	s.q.	0.25
14	Bank of Korea	s.q.	0.50
21	Bank of Canada*	s.q.	0.25
22	European Central Bank	s.q.	0.00
27	Bank of Sweden	s.q.	0.00
27	Bank of Japan	s.q.	-0.10
28	Federal Reserve	s.q.	0.25
May			
4	Reserve Bank of Australia	s.q.	0.10
5	Bank of Brazil	+75 b.p.	3.50
6	Bank of England	s.q.	0.10
6	Bank of Norway	s.q.	0.00
13	Bank of Mexico	s.q.	4.00
25	Reserve Bank of New Zealand	s.q.	0.25
26	Bank of Korea	s.q.	0.50
June			
1	Reserve Bank of Australia	s.q.	0.10
9	Bank of Canada	s.q.	0.25
10	European Central Bank	s.q.	0.00
16	Bank of Brazil	+75 b.p.	4.25
16	Federal Reserve	s.q.	0.25
17	Bank of Norway	s.q.	0.00
17	Swiss National Bank	s.q.	-0.75
18	Bank of Japan	s.q.	-0.10
24	Bank of England	s.q.	0.10
24	Bank of Mexico	+25 b.p.	4.25

Date	Central banks	Decision	Rate
July			
1	Bank of Sweden	s.q.	0.00
6	Reserve Bank of Australia	s.q.	0.10
13	Reserve Bank of New Zealand	s.q.	0.25
14	Bank of Canada*	s.q.	0.25
14	Bank of Korea	s.q.	0.50
16	Bank of Japan	s.q.	-0.10
22	European Central Bank	s.q.	0.00
28	Federal Reserve	s.q.	0.25
August			
3	Reserve Bank of Australia	s.q.	0.10
4	Bank of Brazil	+100 b.p.	5.25
5	Bank of England	s.q.	0.10
12	Bank of Mexico	+25 b.p.	4.50
17	Reserve Bank of New Zealand	s.q.	0.25
19	Bank of Norway	s.q.	0.00
25	Bank of Korea	+25 b.p.	0.75
September			
7	Reserve Bank of Australia	s.q.	0.10
8	Bank of Canada	s.q.	0.25
9	European Central Bank	s.q.	0.00
21	Bank of Sweden		
22	Bank of Brazil		
22	Bank of Japan		
22	Federal Reserve		
23	Bank of England		
23	Bank of Norway		
23	Swiss National Bank		
30	Bank of Mexico		
October			
4	Reserve Bank of Australia		
5	Reserve Bank of New Zealand		
11	Bank of Korea		
27	Bank of Brazil		
27	Bank of Canada*		
28	European Central Bank		
28	Bank of Japan		
November			
1	Reserve Bank of Australia		
3	Federal Reserve		
4	Bank of England		
4	Bank of Norway		
11	Bank of Mexico		
23	Reserve Bank of New Zealand		
24	Bank of Korea		
25	Bank of Sweden		
December			
6	Reserve Bank of Australia		
8	Bank of Brazil		
8	Bank of Canada		
15	Federal Reserve		
16	European Central Bank		
16	Bank of England		
16	Bank of Norway		
16	Bank of Mexico		
16	Swiss National Bank		
17	Bank of Japan		

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.