US & Canadian Monetary Policy & Capital Markets

- **The Federal Reserve is forecast to cut three times this year and then hold at 1.75%.**
- **The Bank of Canada is forecast to hold its policy rate for now.**
- **The US Treasury yield curve is expected to bear steepen (chart 1) as markets scale back pricing for more cuts than we anticipate and price in more favourable circumstances for growth and inflation expectations.**
- **Canada's yield curve will remain inverted as markets may face greater uncertainty over the policy rate outlook later this year (chart 2).**

FEDERAL RESERVE—MANAGING DISAPPOINTMENT VS. EXUBERANCE

The Federal Reserve is forecast to cut its fed funds target rate by 75 basis points in three quarter point moves over the remaining four meetings this year and to then hold the rate constant at 1.75% over 2020. Our prior forecast round depicted this forecast in the market yields from 2s through 5s but this forecast round adds cuts to the administered rates given our higher conviction on timing. What changed to motivate cuts?; Why cutting more could risk greater damage than good; How stocks could manage less easing than priced; and How more easing than either forecast or priced may not benefit the risk trade are all discussed below.

WHAT CHANGED?

So what changed to add to conviction? Quite a lot actually. **The case for rate cuts has gone from a somewhat heretical tail bet on speculative foundations to one that is more informed.**

Starting in May, Fed funds futures contracts began pricing in earnest the prospect of rate cuts as soon as the July meeting. Prior to the May developments, the rate cut view was marginally priced and unconvincing as it appeared primarily rooted in fairly simple thinking toward the maturity of the US economic expansion and how a bust must follow a generally tepid but record-long expansion thereby requiring more accommodative policy. That a marginally positive real policy rate was overly restrictive following eight consecutive quarters of strong trend growth that pushed the US economy into excess aggregate demand conditions seemed illogical. Rate cuts prior to May were a tail bet and appeared to conflict with the nonconventional policy easing that the Fed announced at the March FOMC when it completely changed its balance sheet unwinding strategy.

THE FED'S REACTION FUNCTION SHIFTED

The Federal Reserve has altered its reaction function. It had spoken of a symmetrical inflation target for a long time, but never did much of anything about it as rate hikes were advanced during the period when years of FOMC forecasts for inflation simply expected it to rise to the 2% target and not overshoot.

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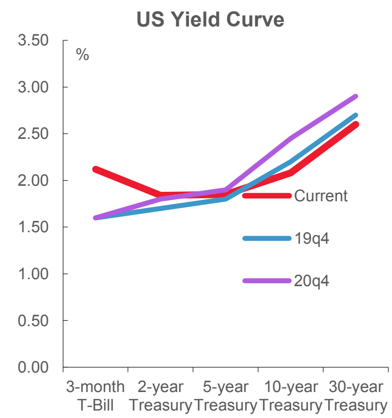
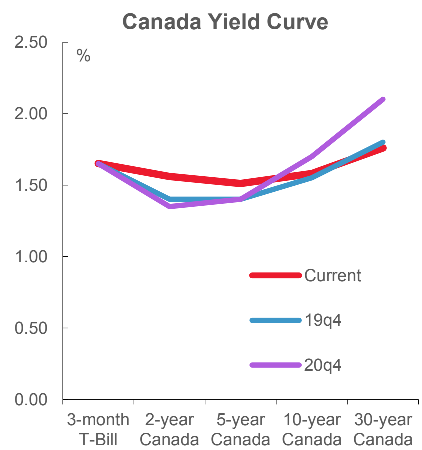
Chart 1



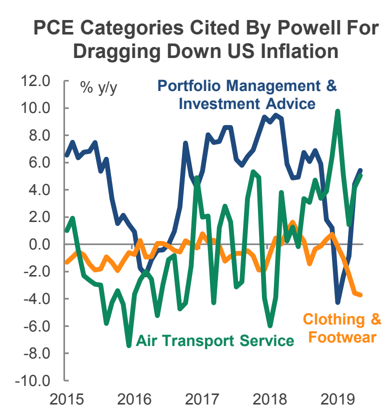
Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

Chart 3



Sources: Scotiabank Economics, BEA.

Communications this year have gradually signalled a more serious focus upon emphasizing symmetry through allowing inflation to overshoot the 2% inflation target for a time. This view appears to be particularly championed by the likes of Vice Chair Clarida. The logic for doing so stems from the constraints of operating in a low rate environment with limited room to ease compared to past cycles. The easing constraint makes it more important to the Fed to step in front of falling inflation expectations the minute they register and err more on the side of overshooting its inflation target through deliberate action. That's especially true given the mixed inflation picture of late. Core PCE remains soft despite evidence that what were thought to be transitory downward influences have since been improving (chart 3), while trimmed mean inflation measures arguably trim out far too much.

TRADE POLICY AND GEOPOLITICS HAVE DISAPPOINTED EXPECTATIONS

Since at least May, however, the broader geopolitical framework has disappointed our house expectations and this has begun to have a more pronounced impact upon global growth. In terms of uncertainty about growth and markets, this is the dominant driver of the shift toward Fed rate cuts. A sound global economic expansion was placed in jeopardy by sequential policy missteps that impaired confidence in the outlook primarily through belligerently protectionist US trade policy and mismanagement of Brexit outcomes. In short, politics damaged the economics and it fell to central bankers to mop up the mess again. Moral hazard problems run deep as Fed easing could enable further protectionism.

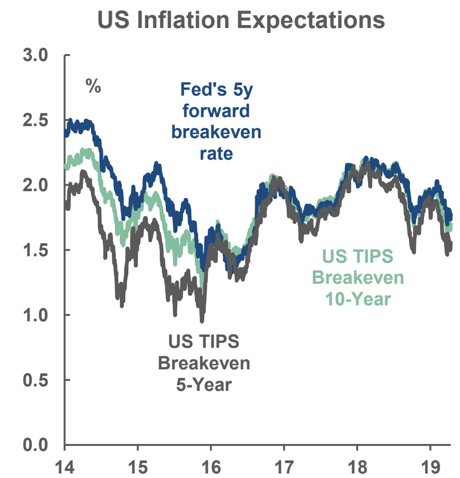
What specifically changed relative to our assumptions? Brexit has dragged on for longer and with much greater uncertainty than we had judged. A US-China trade deal that would achieve near-term trade peace appeared to be achievable until either China scuttled the agreement or walked away because the US was still insisting on tariffs after an agreement as it did with NAFTA. We also still do not have passage of the USMCA deal in Congress and did not anticipate Trump's Mexican stand-off in late May and early June that impaired c-suite confidence. Further, geopolitical tensions in the Middle East have risen and the threat of auto tariffs remains for longer than anticipated. Such concerns triggered greater evidence of a global slowdown in investment and trade. They also invoked automatic market stabilizers such as safe-haven seeking in Treasuries that sparked curve inversion aided by falling market-based measures of inflation expectations (chart 4). The drop in discount rates lifted risk assets including equities on the assumption that the Fed would have to respond.

LIMITED EASING

Notwithstanding these points, the information we have at present does not give us comfort toward forecasting more than three rate cuts. For one thing, **cumulative cut guidance from the Fed remains highly conditional** as illustrated by the most recent dot plot (chart 5) that shows no cuts this year and only one next year.

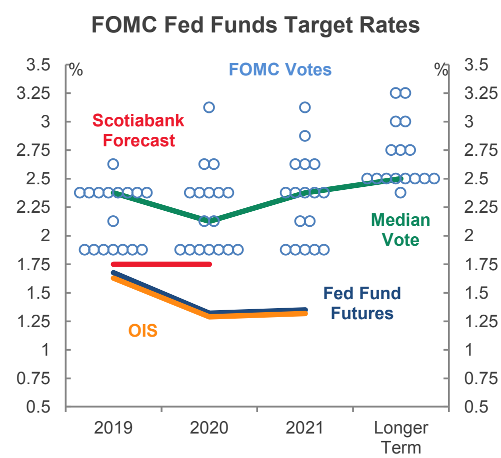
Further, we don't think easing to boost inflation would be met with much success. Work done by Scotia's René Lalonde and Nikita Perevalov with our proprietary macroeconometric models indicates limited chance of success to easing for the sake of boosting inflation expectations. Chart 6 depicts the results of four scenarios for no change and immediate full rate cuts of -50bps, -100bps and -150bps. All three cut scenarios are much more generous than markets have priced. Through an augmented Phillips curve model, the impact upon inflation over the medium- to longer-

Chart 4



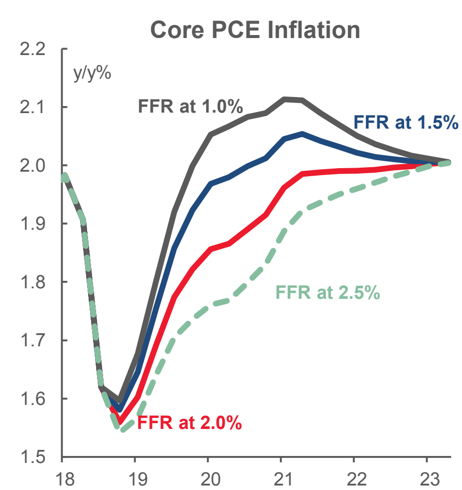
Source: Scotiabank Economics, Bloomberg.

Chart 5



Sources: Scotiabank Economics, Federal Reserve System.

Chart 6



Sources: Scotiabank Economics.

run is limited to something between barely achieving 2% core PCE inflation to a slight transitory overshoot of one or two tenths of a percentage point. Given that these rate scenarios are more extreme than anything being conveyed by the Fed or priced by markets, the probability of achieving such inflation outcomes is even more remote.

If massive easing doesn't boost inflation, then why bother with any easing? For one, the 90s10s slope that is a predictor of recession risk would likely swing from being negative (hence inverted) to slightly positive as the bills yield falls with fed funds. For another, a steeper curve could be reinforced by raising market inflation expectations somewhat and with that the nominal 10 year Treasury yield. The combined effects could restore a term premium and lessen bond market signals of recession risk. **A steeper yield curve is thus a key part of our forecasts.**

Going with deeper cuts could tilt the Fed's risk-reward calculus more aggressively toward courting greater financial stability worries. Hello, 1%, you were so kind to the financial system in 2003–04 and thereafter! I'll return to this issue in the next section.

Our projected three rate cuts would still put monetary policy below estimates of the neutral rate (around 2.5%) into expansionary territory with the US economy operating with excess demand through a positive output gap, the lowest unemployment rate since December 1969 and inflation not far from target. The assumption that the Trump administration will seek to achieve moderate improvement in trade policies by getting the USMCA deal passed in Congress and striking some accord with China continues to be fairly reasonable into a Presidential election year. So does the forecast assumption that core PCE inflation will come under marginally greater upward pressure over 2019H2 into 2020 and CPI recently supported this view (here). In other words, fifty might do just fine for insurance purposes but be careful toward other motives for greater easing.

MANAGING DISAPPOINTMENT

This forecast nevertheless implies that the rates complex will ultimately be disappointed with three instead of four cuts. **While bad for bonds, such disappointment need not be quite as disconcerting to risk assets as one might think but it requires President Trump to meet the Fed halfway after having caused many of the present challenges.**

In the most reduced form, stocks are driven by three things. One concerns discount rate assumptions that the Fed can influence, but not dictate, with the BAA corporate bond yield being a reasonable discount rate proxy over time. That discount rate is also influenced by other considerations such as term premia, carry and hedging arguments relative to other global markets, and spread determinants that are partly a function of the risk cycle. The second is risk appetite as measured by multiples attached to a projected earnings stream and informed by other proxy measures such as the VIX measure of equity market volatility. Third is earnings growth. With this understanding, **one scenario is that modest but below-market monetary policy accommodation could combine with our forecast for stabilizing world growth that could benefit earnings per share and also improved risk appetite conveyed through earnings multiples if trade policy settles down in order to leave stock market levels unchanged or even higher.**

MANAGING EXUBERANCE

Further, on its own, giving the bond market what it wants or possibly more with at least four rate cuts may not even support risk assets as much as one thinks or at all. It's conceivable that the Fed would grow more concerned about financial stability issues as was the case when they cut down to 1% in 2003–04 and unleashed a torrent of speculative behaviour. The Fed may not be overly fussed by speculative pressure now, but it knows the risks of that episode repeating. It misjudged transmission mechanisms into risky behaviour and by the time it caught on it over-reacted by raising the policy rate by more than four percentage points and thus played a heavy role in driving the Global Financial Crisis.

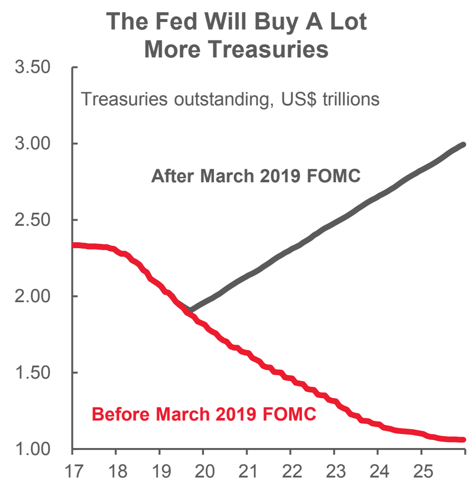
To counter such transmission mechanisms into parts of the economy and markets where it doesn't want stimulus to land, this time the Fed could employ a whole new suite of tools it did not have back then. One such tool would be to raise the CCyB. At this moment the risks may be the other way, but cutting aggressively could change that. The last time the Fed reaffirmed its commitment to the counter cyclical capital buffer of 0% was in December 2017. Go here for a global overview of the CCyB by country. Today's Basel III framework provides regulators with a new suite of tools to mitigate speculative froth in a low rate environment. While overall evidence of financial stability risks is mixed but generally not alarming now, it is also not absent. Each of consumer credit outstanding and commercial and industrial loans have grown by 12% since the November 2016 election, or 2–3 times inflation, with mortgage debt up by 8–9%. Pursuing as many rate cuts as markets have priced if not more could well tilt this balance toward greater stability concerns and systemic risks to the financial system and the economy. **Would stocks rally if the CCyB was hiked as rates were cut four or more times?** The net effects upon banks and credit dependent channels of the economy are unclear.

LEAVE THE BALANCE SHEET ALONE

Our forecast also assumes that balance sheet policy is unlikely to materially change. After September, the SOMA holdings of Treasuries, MBS and agencies, FRNs and TIPS will flat-line instead of shrink, and the Treasury portfolio will rise sharply instead of continuing along the pre-March plan toward shrinking (chart 7). There is a risk that the Fed slightly expedites its plan to cease unwinding its balance sheet from the end of September 2019 to when it cuts the policy rate. The de minimis gain to markets that have already priced in the plans that were introduced at the March meeting and that began to be implemented in May by rolling over MBS flows into Treasuries argues against changing anything. Then again, the risks associated with expediting plans are also de minimis so one could argue the opposite. **On balance, we feel that the Federal Reserve is content with decisions it has made on balance sheet management, wary of creating the impression that it will fiddle with the balance sheet in erratic fashion, and will rely upon its policy rate to incrementally adjust to circumstances.** One remaining possibility is nevertheless to introduce a **standing repo facility** with a rate set marginally above the fed funds rate as a market backstop to funding pressures. This would add to the steps taken to widen the spread between Interest on Excess Reserves (IOER) and fed funds with IOER as an anchor-point to weigh down market rates through arbitrage on reserves. It would also add to the powers of the NY Fed's market desk to engage in open market operations to control short-term rates given ongoing pressure.

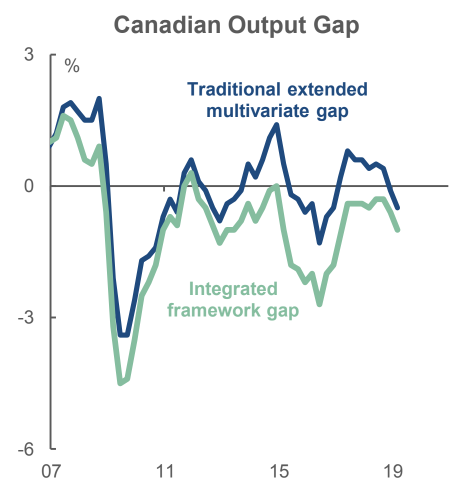
For a further summary cheat sheet of the pros and cons to policy easing see the appendix.

Chart 7



Sources: Scotiabank Economics, FRB New York.

Chart 8



Sources: Scotiabank Economics, Bank of Canada.

BANK OF CANADA—MORE POTENTIAL TO SHOCK MARKETS

Our forecast at this point is for the Bank of Canada to remain on hold over 2019–20, but we're less certain of the underlying narrative in light of material global developments since our last Global Outlook. Developments since then have led us to swing risks to our base case outlook more toward the risk of easing.

The Bank of Canada's problem is the opposite of the Fed's which is also arguably what makes it more interesting to explore. It is opposite to the Fed's because, by contrast, it is a truism to remark that when little is expected of the BoC, it's harder for it to disappoint markets and easier for a policy shift to be impactful.

THE CASE FOR STANDING PAT

Markets have only priced in about a one in three chance for a single quarter-point rate cut by year-end. A full cut is priced in bonds over the longer term through a mildly inverted yield curve including the spread between the overnight rate and the two year GoC yield. Conventional wisdom posits that the BoC doesn't need to ease for the following reasons:

- The BoC is **starting at a more relaxed policy stance than the Fed** with slightly negative real rates and below its neutral rate. This gives the BoC more of a policy buffer against downside risks;
- **Core inflation is on- if not a smidge above-target** at 2.1% y/y while the Fed's preferred gauge is well below 2% at 1.6%.

- **Canadian dollar weakness is the flip side to the implications of US dollar strength.** The CAD rally of about a nickel since early June has been backed by firmer commodity prices. Further CAD appreciation may be limited if the Fed cuts because US monetary policy easing is already significantly priced in;

- **Canada's economy is on the rebound** in Q2 whereas the US is decelerating;

- **Domestic trade policy risks are less negative for Canada** now given the CUSMA deal that is pending passage in the US and Canada (but passed in Mexico) and the reversal of steel and aluminum tariffs and reciprocal actions;

- **Housing markets are stabilizing** in Canada, driven by job growth, lower mortgage rates and distance from B20;

- **Canada's job market has remained very strong this year** including the details behind the most recent jobs tally such as explosive hours worked, stronger wage growth and gains in payroll employment (here);

- Canada has imported bond market easing driven by Fed rate expectations and **can ride along the Fed's coat tails.**

These are all valid points, but they don't make the call a slam dunk by any means. They may just suggest a Canadian version of patience that has yet to be exhausted as apparently is the case with the Fed. The BoC 'cut' thesis is worth exploring relative to a consensus that sounds convinced it is implausible.

1. Slack

Canada has excess capacity in the economy that the BoC expects to persist, whereas the US is in a state of excess aggregate demand (chart 8). This makes a stronger case for easing in Canada and to give a nudge to the closure of slack.

2. Dead Cat Bounce?

Canada's Q2 economic rebound from a temporary soft patch in Q4/Q1 could well prove as transitory as the soft patch itself. Present tracking suggests Q2 growth around 2.5% after no growth over Q4/Q1. One indication of potentially renewed growth disappointment in Q2 came through recent trade figures (recap here).

3. Bloated inventories

Amidst evidence of slack there is disconcerting evidence of over-production. Inventory levels remain very high at manufacturers, wholesalers and economy-wide (chart 9). Was a tepid Q2 GDP rebound only due to over-production that has gone straight to inventories and by hiring excess workers? We've seen this movie!

4. Confidence in the outlook

The BoC's confidence in the outlook was steadily deteriorating this year and it cannot have increased since the last statement given geopolitical, trade, and global macro data.

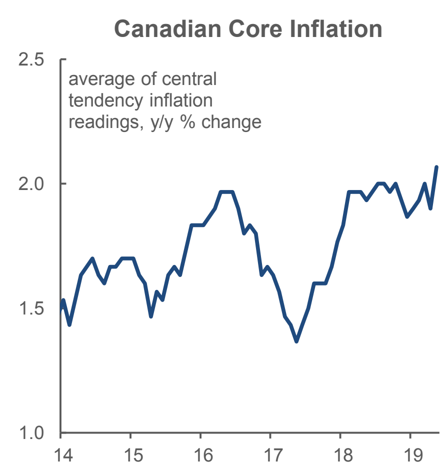
Chart 9

Sources: Scotiabank Economics, Statistics Canada.

Chart 10

Sources: Scotiabank Economics, Bloomberg.

Chart 11



Sources: Scotiabank Economics, Statistics Canada.

5. Insurance

Piece together points so far and Canada has a decent case for an insurance cut.

6. Inflation

Much like elsewhere, market-derived measures of inflation expectations have plummeted in Canada (chart 10). We think inflation will remain near target, but the BoC has not durably hit 2% for years (see chart 11). If 2% is a symmetrical target in Canada, then the case for overshooting is at least as strong as in the US.

7. Bond market signals

Canada's rates curve is inverted and, while it is distorted and serves as a poorer signal of recession risk than in the US, it nevertheless fits a picture of concern. The 90s10s slope is inverted by over 30bps and the 2s10s curve is very flat. There remains a reward for term extension on the corporate lending book (chart 12).

8. Commodities and the terms of trade

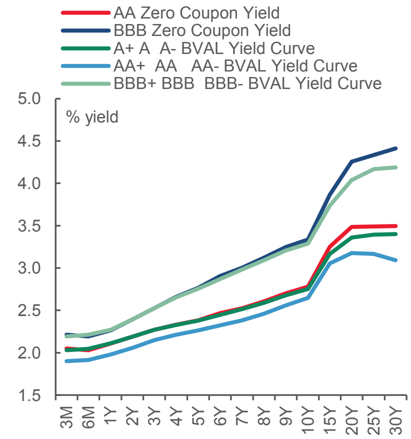
As chart 13 demonstrates, Canada's terms of trade remains healthier than it was toward the end of last year. Nevertheless, risk to this through the commodities picture remains elevated through US-China trade policy developments.

9. Relative Central Banks

The BoC does not need to bend to foreign central banks' policy goals, but the odds of coordinated easing clearly rise as more central banks participate.

In fact, several of the arguments presented above sound an awful lot like they did a decade ago when Canada spent some time in denial that external risks would take Canada's prospects down with them. At that time, Ottawa was in denial that global risks would come home to roost and the Bank of Canada was still raising its overnight rate under Governor Dodge in late 2007.

Chart 12



Sources: Scotiabank Economics, Bloomberg.

Chart 13

Sources: Scotiabank Economics, Statistics Canada.

Table 1

Scotiabank Economics' Canada-US Yield Curve Forecast

	2018	2019				2020			
	(end of quarter, %)								
Canada	**Q4**	**Q1**	**Q2**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
BoC Overnight Target Rate	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
Prime Rate	3.95	3.95	3.95	3.95	3.95	3.95	3.95	3.95	3.95
3-month T-bill	1.65	1.67	1.65	1.65	1.65	1.65	1.65	1.65	1.65
2-year Canada	1.86	1.55	1.47	1.50	1.40	1.35	1.35	1.35	1.35
5-year Canada	1.89	1.52	1.39	1.45	1.40	1.40	1.40	1.40	1.40
10-year Canada	1.97	1.62	1.46	1.50	1.55	1.60	1.65	1.65	1.70
30-year Canada	2.18	1.89	1.68	1.70	1.80	1.90	2.00	2.05	2.10
United States	**Q4**	**Q1**	**Q2**	**Q3f**	**Q4f**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
Fed Funds Target Rate	2.50	2.50	2.50	2.00	1.75	1.75	1.75	1.75	1.75
Prime Rate	5.50	5.50	5.50	5.00	4.75	4.75	4.75	4.75	4.75
3-month T-bill	2.36	2.39	2.09	1.85	1.60	1.60	1.60	1.60	1.60
2-year Treasury	2.49	2.26	1.76	1.70	1.70	1.80	1.80	1.80	1.80
5-year Treasury	2.51	2.23	1.77	1.75	1.80	1.90	1.90	1.90	1.90
10-year Treasury	2.68	2.41	2.00	2.10	2.20	2.35	2.40	2.45	2.45
30-year Treasury	3.01	2.82	2.53	2.65	2.70	2.85	2.85	2.90	2.90

Sources: Scotiabank Economics, Bloomberg.

APPENDIX

Federal Reserve Cheat Sheet

Arguments *For* Easing	Arguments *Against* Easing
GDP growth will weaken to a one-handled pace that just isn't good enough	The US economy is strong with low unemployment and continued growth that doesn't need help
There are downside risks to mild projected GDP growth that require accommodation even if no recession lurks	There are also upside risks to growth, such as if trade disputes are settled
Bond markets are signalling recession probabilities in line with actual past recessions	Bond markets are distorted and markets often over react such that policymakers should craft policy independently
Don't disappoint market pricing for cuts that would tighten financial conditions	Markets have gone too far and easing could inflame bubbles
Trade policy risks have been worse than anticipated for longer and will remain elevated. The damage has already been done to trade and investment	Trump will settle down into an election year
Look through potential tariff effects on inflation as transitory and in favour of growth drivers of the dual mandate, or view tariffs as ultimately deflationary like the 1930s. Bernanke vowed to never repeat the Fed's mistake back then.	Tariff effects could be inflationary if presented as a persistent supply shock such that easing would inflame inflation risk
The Fed's 2% inflation goal is symmetrical, meaning that ten years of failed model-based forecasts for higher inflation will now position the Fed to risk an overshoot of 2% as an average goal and not a ceiling to prove it is serious about its target	2% is still the target, trying to overshoot may not work or it could be problematic with unintended consequences to the bond market.
Inflation expectations are falling as a threat to Fed goals	Falling inflation expectations depend upon the measure and they are at best imperfect guides.
Fed-speak sounds more open to easing and don't fight the Fed	Powell hasn't said much of late and wait for the more open June FOMC debate
The Fed will give into Trump's pressure tactics	The Fed is independent, will pursue its Congressional dual mandate and might even exert its independence by defying Trump
The Fed may want to act faster and more pre-emptively in the face of increased risks this time	The Fed remains slow moving and will take its time and monitor further developments like the G20, OPEC meeting etc.
USD strength has many drivers and it has tightened financial conditions while putting downside pressure on inflation pass-through that requires Fed counter-action.	USD strength may be transitory if it is driven by trade policies that could settle down.
Other central banks like the PBOC, ECB, BoJ and BoE are shoving dollar strength onto the Fed which requires relative central bank adjustments	Currency markets face many varied drivers with monetary policy just one of them and duelling central banks yield subpar outcomes compared to global coordination
The Fed has to respect its Congressional dual mandate and do whatever it thinks is necessary.	Easing would bow to Trump and by bailing him out it could embolden him in such fashion as to worsen the outlook for trade policy
Weak payrolls in May were a warning shot as hiring confidence has been drained and don't risk waiting to find out	Volatile jobs could bounce higher next time so wait for a trend
The unemployment rate can go lower without stoking materially faster wage and price pressures that have eluded the Fed to date. Estimates for the natural rate of unemployment keep pushing lower so let's test it further.	Where the natural rate of unemployment rests is uncertain and this may be a dangerous pursuit
The US economic expansion is long in the tooth and the risk of accidents is naturally higher, requiring pre-emptive action	Expansions don't die of old age
The Fed is central banker to the world and easing could benefit multiple regions to the indirect benefit of the US economy and global financial stability	Monetary policy must be conducted strictly in terms of what is necessary for the US while letting the rest of the world adjust and adapt
Monetary policy can still ignite aggregate demand	Monetary policy would be like pushing on a string in the face of confidence-sapping trade wars that push us into a liquidity trap
The Fed has plenty of ammunition in the tank through varied tools in order to counter future risks even if it gives away a few rate cut bullets now	Don't prematurely give away precious room for conventional easing and QE policies are less and less effective over time