# US & Canadian Monetary Policy & Capital Markets

- **The Federal Reserve is forecast to cut twice more and then hold at 1.5%. Additional tools to address market liquidity are expected.**
- **The Bank of Canada is forecast to cut its policy rate twice and then hold at 1.25%.**
- **The US and Canadian yield curves are forecast to bear steepen over 2020–21 (charts 1, 2, table on page 5).**

## FEDERAL RESERVE—MORE TO COME

We have added one more forecast rate cut since the last round. The Federal Reserve is now expected to cut twice more and take its fed funds target rate down to 1.5% for a cumulative full percentage point of easing. With fed funds futures markets pricing the rate at 1% by the end of 2020, the balance of risks must still turn out more favourably than markets are assuming in order to avoid tightening financial conditions. October is expected to bring multiple forms of easing including a rate cut. Thereafter, we're split on the odds of an additional cut in December or the first quarter of next year and will assess as material risks are evaluated. Following these reductions, our forecast is for the Fed to remain sidelined over the duration of 2020 and throughout 2021. This forecast change is informed by explanations below in terms of rising risks to the global and domestic outlook, a heavy line-up of major event risks and challenges to funding markets.

## RISING GLOBAL DOWNSIDE RISKS

Risks to world growth have increased since our last forecast round. World trade volumes are shrinking with the pain being felt across Asia and Europe. Global industrial output has stalled. Global purchasing managers' indices foretell further weakening (chart 3). The effects of the US-led trade war—particularly, but not exclusively toward China—are causing rising spillover effects across many countries with significant dependence upon exports to China. Fixed investment in China has sharply diminished. Developments such as these reinforce the illustrations provided in Federal Reserve Vice Chair Clarida's speech in March

Chart 4

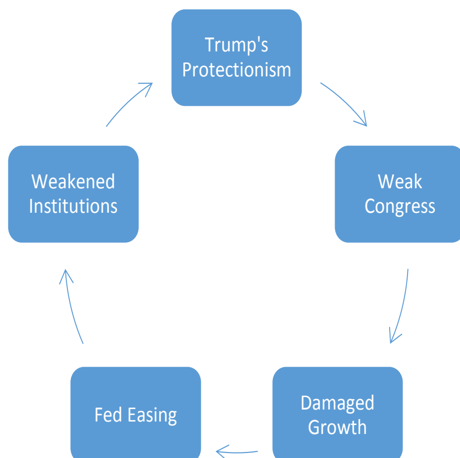


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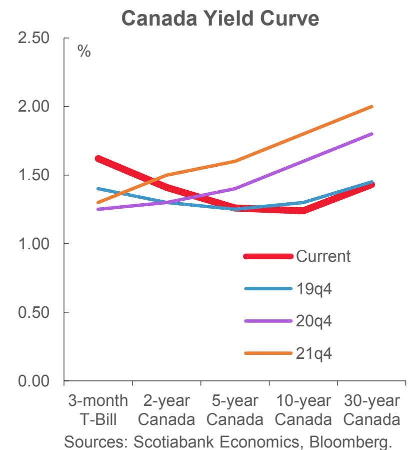
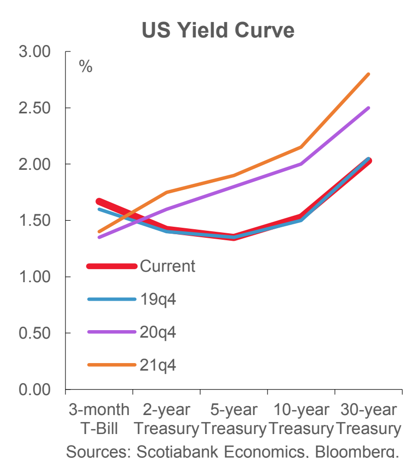
Chart 1



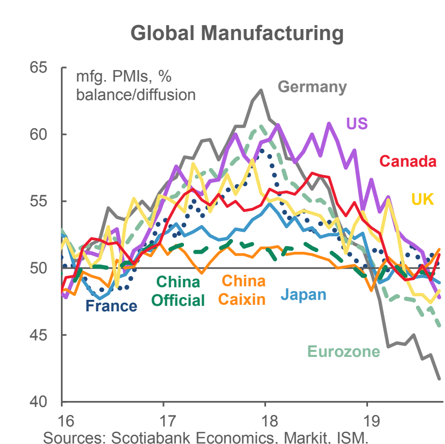

Sources: Scotiabank Economics, Bloomberg.

Chart 2




Sources: Scotiabank Economics, Bloomberg.

Chart 3




Sources: Scotiabank Economics, Markit, ISM.

regarding past episodes of Fed easing in response to external risks (here). We have not lost sight of the conundrum faced by the Fed in that it is emboldening Trump in a vicious feedback loop between falling rates and more protectionism (chart 4).

## MAGNIFIED EVENT RISK

Since our last forecast round, the list of event risks over coming weeks has become even longer. We lack conviction to predict their outcomes but have tilted toward increased downside risks surrounding several of the examples illustrated below. Broad dollar strength that continues to point to ever-widening trade deficits may continue to translate into a persistently protectionist US administration (chart 5).

**1. October 10th:** US-China trade negotiators meeting in Washington.

**2. October 14th:** US-EU meeting on the Airbus-Boeing tariff dispute.

**3. October 15th:** US 5% tariff hike to 30% on US$250 billion of Chinese imports goes into effect.

**4. October 18th:** US tariffs on EU imports go into effect failing agreement.

**5. October 19th**: Benn Act Brexit deadline to request extension.

**6. October 31st:** possible UK withdrawal from the EU.

**7. November 17th:** US decision on auto tariffs is due.

**8. Late November:** The hoped-for timeline for passing the USMCA in Congress.

**9. December 15th:** US to impose 15% tariff on US$160 billion of Chinese imports.

## RISING US RISKS

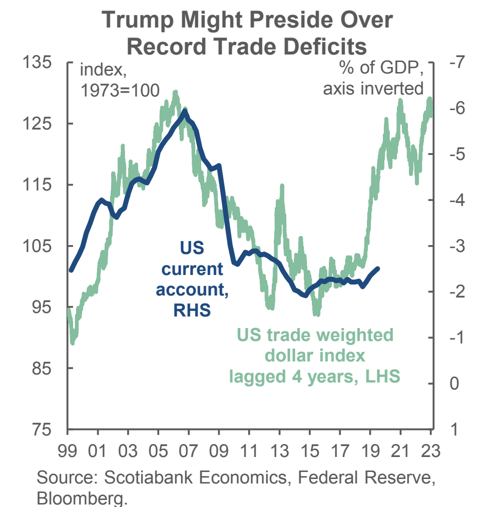
The argument that the trade wars impair prospects abroad but that the US economy will remain immune to the consequences has been clearly invalidated by a dispassionate reading of the macroeconomic and market signals. It is among the economic myths propagated by the US administration, along with the view that the tax cuts have paid for themselves. Bond markets are passing judgement with a roughly four-in-ten chance of recession being signalled which is on par with several other past downturns. ISM gauges have taken a turn for the worse and point to falling manufacturing output. The pace of hiring activity has noticeably slowed this year and wage growth may have crested and begun to moderate. Job growth may be further imperilled by production cuts to address relatively bloated inventories (chart 6). Fiscal policy is on the verge of transitioning toward being contractionary as the effects of the Tax Cuts and Jobs Act and the February 2018 spending bill drop out (chart 7).

At the same time that activity measures have soured somewhat, inflation has been gently on the mend (chart 8). This is unlikely to hold the Fed back from further easing because a) inflation remains below 2%, b) the prospect of overshooting 2% and proving symmetry to the Fed's goal is low, and c) Fed commentary has put emphasis upon using all available tools to keep the economy in a strong place and at full employment. In other words, just as one of the dual mandate variables—inflation—has begun to register some improvement, a bigger question mark has been placed upon activity measures.

## CHALLENGES TO FUNDING MARKETS

Despite the brave face the Fed presents regarding the matter, it's highly likely that the deterioration in short-term funding markets over September into October caught the

Chart 5

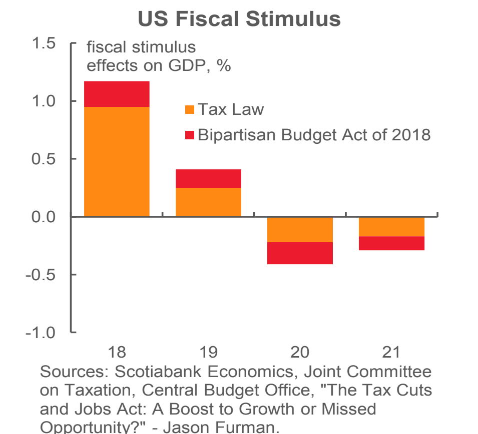



Source: Scotiabank Economics, Federal Reserve, Bloomberg.

Chart 6

Source: Scotiabank Economics, U.S. Census Bureau.

Chart 7




Sources: Scotiabank Economics, Joint Committee on Taxation, Central Budget Office, "The Tax Cuts and Jobs Act: A Boost to Growth or Missed Opportunity?" - Jason Furman.

central bank flat-footed. Inadequate market liquidity struggled to deal with demand for cash in order to meet corporate tax payments and large Treasury auction settlements, given rising deficits and Treasury issuance after the debt ceiling was lifted following a half-year binding freeze on net issuance. The result was that the Fed was losing control over rising short-term market rates that were rippling through other markets and impacting confidence.

At the heart of the matter is whether Fed policy underestimated the amount of reserves required in the system to be held at the Fed. Since reserves peaked in 2014, they have fallen by about US$1.5 trillion and nearly $1 trillion of that amount has occurred since the start of 2018 (chart 9). This is not a question of Fed competence. It has always been highly uncertain what amount of reserves may be required in the context of changing regulations such as requiring banks to hold more liquidity and higher quality liquid assets.

To make up for this decline in market liquidity, the New York Federal Reserve has embraced aggressive use of repo operations that are scheduled to continue through the October 30th FOMC meeting. The Fed enters into agreements to purchase Treasuries in exchange for a cash loan that can be redeployed in the interim period of the short-term agreement. To date, the volumes being taken down in recent one day repos and 10 day term repos have been very substantial (chart 10). Clearly there is demand for liquidity, but more permanent solutions are expected to be unveiled.

**Thus, at the October 29th–30th FOMC meeting, we expect an announcement about a permanent Standing Fixed-Rate Repo Facility that was last broached in the minutes to the June FOMC meeting. The facility would offer funds slightly above the interest rate on excess reserves.** Such a facility could improve market transparency and improve certainty regarding the adequacy and timeliness of liquidity backstops compared to traditional open-market operations by the New York Fed. **Chair Powell has also indicated that the Fed will restart purchases of Treasury bills to inflate reserves and it is likely that the Fed will return to the pre-crisis era of growing Treasury security holdings in keeping with GDP.** It may well be that the Fed needs to target between US$1½–1¾ trillion of reserves (from US$1.34 trillion now) and thus inject US$250 billion or more. This will involve experimentation to discover the optimal level of excess reserves in the system.

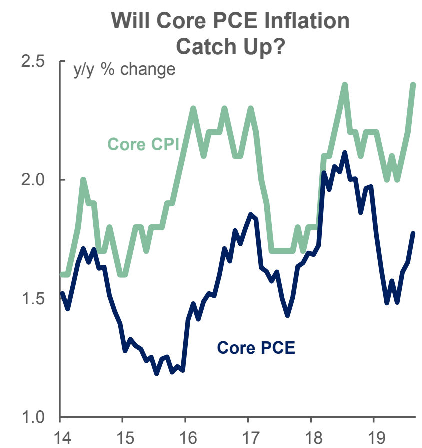
Simultaneous to such actions, a further potential option is to simultaneously reduce the fed funds target rate and IOER rate by another quarter percentage point and maybe slightly widen the IOER-Fed funds spread again.

**Thus, addressing market dysfunction as well as managing risks to the fundamentals-based drivers of monetary policy are complementary reasons for easing policy somewhat more than previously forecast.** At the heart of the matter, however, Trump's trade wars are directly responsible for forecast changes and by corollary support a bias toward more easing than forecast rather than less.

## BANK OF CANADA—MORE POTENTIAL THAN THE FED TO SHOCK MARKETS

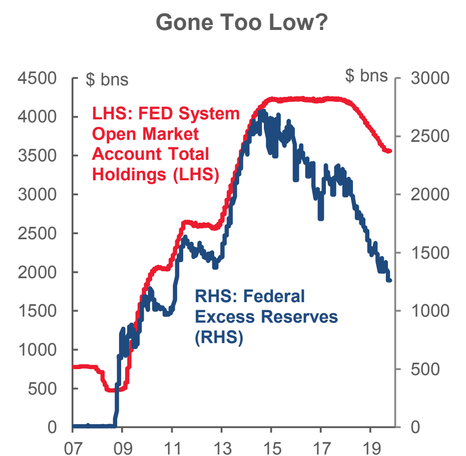
Our forecast at this point continues to be for the Bank of Canada to cut its overnight lending rate twice starting in each of 2019Q4 and 2020Q1 with even odds that a first reduction is delivered either in October or December. The next Business Outlook Survey, additional domestic data and key trade-related deadlines over coming weeks as highlighted on the previous page are among the considerations we will be monitoring closely. Thereafter, we expect the rate to remain on hold over the duration of 2020–21. In contrast to our Fed view, our forecast for the BoC is somewhat more aggressive than a) consensus and b) market pricing in OIS contracts.

Chart 8



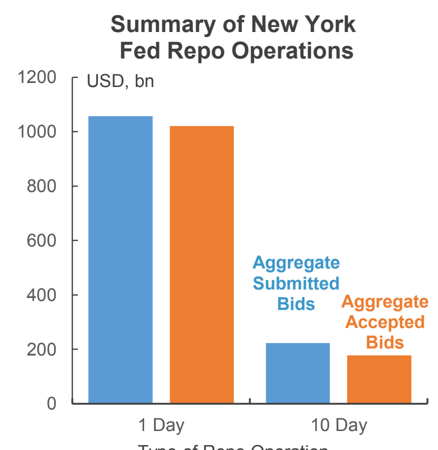
Sources: Scotiabank Economics, Bloomberg.

Chart 9



Sources: Scotiabank Economics, Bloomberg.

Chart 10



Sources: Scotiabank Economics, New York Federal Reserve.

The international arguments—including those that apply to the US—won't be repeated here, but they compound the uncertainties facing the Canadian economy and the Bank of Canada. If downside risks to the global and US outlook continue to build, then Canada has never been fully immune to such developments in the past.

Several of the more domestic arguments in favour of policy easing have strengthened or at least been maintained since our last forecast round.

**1. Narrowing BoC-Fed Rate Differential**

When the Fed eases materially, the BoC almost always follows suit (chart 11). When it has materially parted company with the Fed, like into the early 2000s after previously following the Fed in the late 1990s, the BoC has had to quickly change course thereafter. This makes perfect sense for a modestly sized open economy with open capital markets that are highly integrated with the US economy and financial system.

The point of joining the Fed is drawing nearer. The BoC has lost most of its relative rate advantage to the Federal Reserve such that the policy rate spread now sits at just -0.25% and may disappear entirely at the end of October and go positive soon thereafter if the BoC sits out Fed easing. While the C$ has not performed in sync with tightening Canada-US rate differentials, this may say more about persistent US dollar strength against a variety of currencies since the Fed began easing, and partly due to safe-haven demand. CAD, however, may be more vulnerable the longer the policy rate narrows and the more it narrows if the BoC were to do nothing. We don't find it plausible that the BoC would tolerate material C$ appreciation that would further erode export competitiveness amidst global trade tensions.

**2. Increased market risk of recession**

The risk of recession derived from bond markets has increased (chart 12). It is not as useful a measure as in US and both are distorted, but, like the Fed, there is little for the BoC to gain by challenging thousands of agents clearing information in markets each day.

**3. Weak trend growth**

The second quarter was strong with Canadian GDP growth of 3.7%. That, however, is an anomaly by comparison to no growth over the prior two quarters and a material slowdown in the third quarter that is still being monitored. If, by later this year, the Bank of Canada can look back and see only one stand-out quarter for growth in the past four quarters while the rest average out to well below potential growth, then even backward-looking data independent of forward-looking risks might suggest the economy is in need of some stimulus. Just as there were transitory drivers of prior softness, there were transitory drivers of Q2 strength and the trend remains soft.

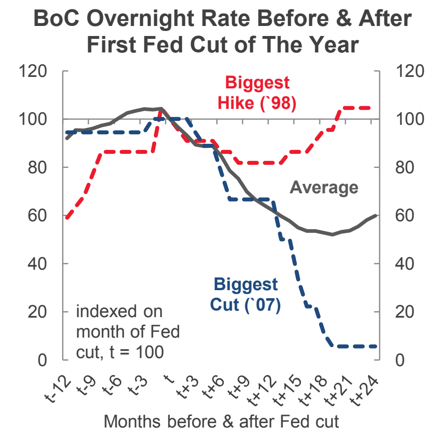
**4. Slack**

There continues to be excess capacity in the Canadian economy (chart 13). The BoC's two gap measures roughly ranged from -½% to -1% at the end of Q2. This lies in contrast to the US where the output gap is materially in excess demand territory. The persistence of slack and risks to growth don't guarantee that the BoC stays on its 2% inflation target and it may opt to take out insurance via easing. In any event, it is a target range of 1–3% that connotes some flexibility to address uncertainties. Further, while they are not the greatest measures, market-based inflation expectations are very low (chart 14).

**5. Rising Inventory Imbalances**

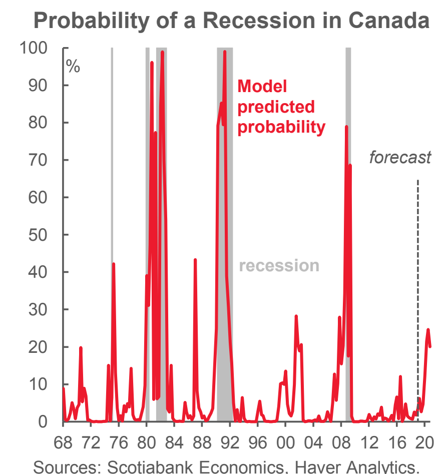
Whether output and hiring are sustainable may lie in doubt in the face of evidence regarding high inventory imbalances (chart 15). Costly to finance and store, the imbalance across manufacturers and wholesalers is at its worst since 2009.

Chart 11



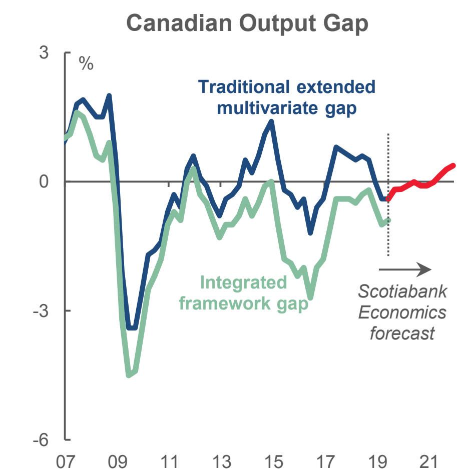

Sources: Scotiabank Economics, Federal Reserve, Bank of Canada.

Chart 12




Sources: Scotiabank Economics, Haver Analytics.

Chart 13




Sources: Scotiabank Economics, Bank of Canada.

### 6. Strained households

While housing markets are generally stabilizing in the wake of adjustments to B20 mortgage guidelines introduced at the start of 2018, cyclical pressures upon household finances are evident. Job gains and lower fixed rate borrowing costs have helped, but debt payments are taking about a percentage point more out of incomes than they were 2–3 years ago. Further, saving off disposable income has been running around just over 1% since mid-2018 and in stark contrast to the much higher US rate of saving.

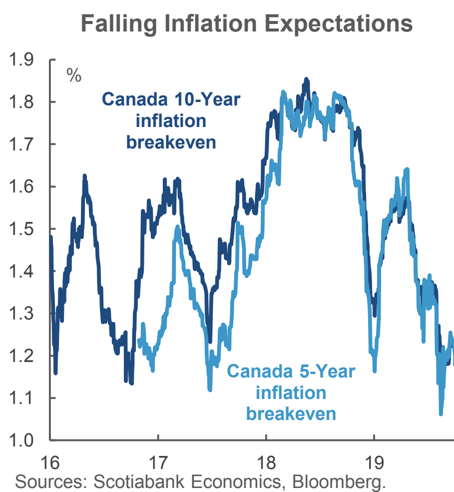
### 7. Investment is not Reacting to Stimulus

Tax incentives to invest that were introduced in the October 2018 mini-budget are thus far not having the intended effect of boosting trend investment. This is largely a global phenomenon in the age of trade wars. Maybe investment would be weaker without the incentives, but its weakness calls into question future complementary job gains and export growth.

### 8. Don't Count on Fiscal Policy

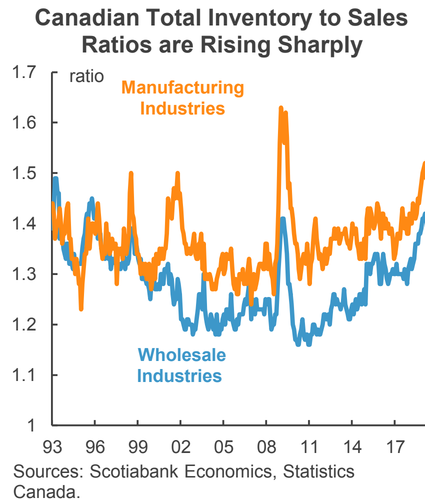
Can the BoC count upon post-election fiscal policy easing? That's doubtful. By the time the election is over and some probably fractured parliament sits, a budget would then have to be presented and passed. Implementation and impact lags would likely push out small fiscal stimulus to next summer as a transitory one-off to growth (chart 16).

Chart 14



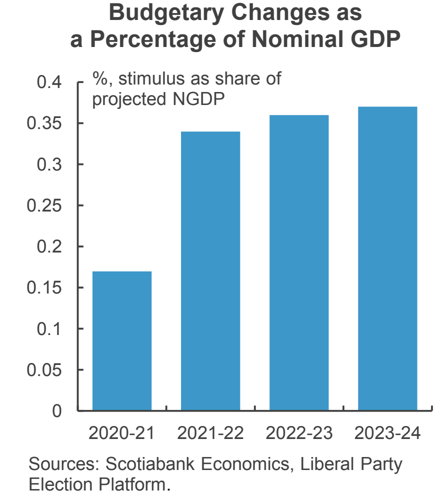

Sources: Scotiabank Economics, Bloomberg.

Chart 15




Sources: Scotiabank Economics, Statistics Canada.

Chart 16




Sources: Scotiabank Economics, Liberal Party Election Platform.

**Table 1**

**Scotiabank Economics' Canada-US Yield Curve Forecast**

| | 2019 | | 2020 | | | | 2021 | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | (end of quarter, %) | | | | | | | | | |
| **Canada** | Q3 | Q4f | Q1f | Q2f | Q3f | Q4f | Q1f | Q2f | Q3f | Q4f |
| BoC Overnight Target Rate | 1.75 | 1.50 | 1.25 | 1.25 | 1.25 | 1.25 | 1.25 | 1.25 | 1.25 | 1.25 |
| Prime Rate | 3.95 | 3.70 | 3.45 | 3.45 | 3.45 | 3.45 | 3.45 | 3.45 | 3.45 | 3.45 |
| 3-month T-bill | 1.65 | 1.40 | 1.20 | 1.20 | 1.25 | 1.25 | 1.25 | 1.25 | 1.25 | 1.30 |
| 2-year Canada | 1.58 | 1.30 | 1.20 | 1.25 | 1.30 | 1.30 | 1.35 | 1.40 | 1.45 | 1.50 |
| 5-year Canada | 1.40 | 1.25 | 1.25 | 1.30 | 1.35 | 1.40 | 1.45 | 1.50 | 1.55 | 1.60 |
| 10-year Canada | 1.36 | 1.30 | 1.40 | 1.50 | 1.55 | 1.60 | 1.65 | 1.70 | 1.75 | 1.80 |
| 30-year Canada | 1.53 | 1.45 | 1.55 | 1.65 | 1.75 | 1.80 | 1.85 | 1.90 | 1.95 | 2.00 |
| **United States** | Q3f | Q4f | Q1f | Q2f | Q3f | Q4f | Q1f | Q2f | Q3f | Q4f |
| Fed Funds Target Rate | 2.00 | 1.75 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 |
| Prime Rate | 5.00 | 4.75 | 4.50 | 4.50 | 4.50 | 4.50 | 4.50 | 4.50 | 4.50 | 4.50 |
| 3-month T-bill | 1.85 | 1.60 | 1.35 | 1.35 | 1.35 | 1.35 | 1.35 | 1.35 | 1.35 | 1.40 |
| 2-year Treasury | 1.62 | 1.40 | 1.45 | 1.50 | 1.50 | 1.60 | 1.65 | 1.70 | 1.70 | 1.75 |
| 5-year Treasury | 1.55 | 1.35 | 1.45 | 1.60 | 1.70 | 1.80 | 1.80 | 1.85 | 1.85 | 1.90 |
| 10-year Treasury | 1.67 | 1.50 | 1.60 | 1.70 | 1.85 | 2.00 | 2.05 | 2.10 | 2.10 | 2.15 |
| 30-year Treasury | 2.11 | 2.05 | 2.10 | 2.20 | 2.35 | 2.50 | 2.60 | 2.70 | 2.75 | 2.80 |

Sources: Scotiabank Economics, Bloomberg.

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