

Dollars and Sense: Searching for a Bottom

Beata Caranci, SVP & Chief Economist | 416-982-8067
 James Orlando, CFA, Senior Economist | 416-413-3180

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Highlights

- We knew that the first quarter would be a rough ride for global economic data, ultimately becoming the make-or-break period for momentum. Nearly four months in, and we are landing on the side of “make” amidst early signs of a bottom forming.
- Chinese stimulus and a united front by central banks on stating a dovish tone helped ease financial conditions and stabilizing measures of confidence.
- We do not expect the Federal Reserve to raise rates, but the markets may still be leaning a bit too dovish in their pricing of yields and the policy rate.

Since the closing months of 2018, we noted that the first quarter of 2019 would be make-or-break for the global economy. The slowdown that took root was a reflection of overlapping event risks colliding with mature business cycle dynamics. Financial market volatility set in play rampant talk of recession, which risked undermining business and household confidence. Fortunately, improved financial conditions are now being followed by early signs of stabilization in the economic data that are closing out the first quarter. Even though the data are not blowing our socks off, we’ll settle for a bottom forming in economic momentum.

Stable growth is enough to push risk assets higher

Overall sentiment towards risk assets has improved due to two main factors. The first was an easing in negative economic data surprises, and the second was the quick response by major central banks towards a dovish tilt (Table 1).

By the time March economic data began to roll in, a handful of key leading indicators, like manufacturing sentiment, offered some confidence in stabilization. At the same time, the service side of major advanced economies proved solid, as did labor markets. Importantly, there are two call-outs on this front. When the going gets tough, China gets going on fiscal stimulus. A large injection of stimulus has underpinned market confidence that it’s only a matter of months before real economic activity responds in kind. In turn, this will help shore up global trade flows. Across the pond, the U.S. economy was defiant in the face of negative market sentiment. The tracking for real GDP growth in the first quarter is coming in at around 2.5%.

	Tightening Bias		"Patience"
	6 months prior	3 months prior	Today
U.S. (Q4/Q4)	2.5	2.3	1.9
Canada	2.1	1.7	1.2
ECB/European Commission	1.8	1.7	1.1
Bank of England	1.8	1.7	1.2

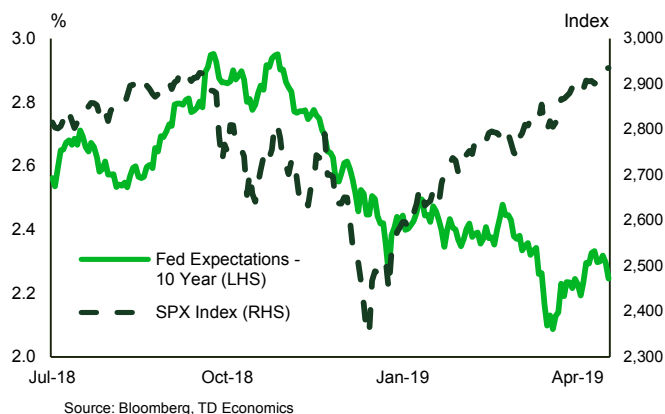
Source: Central Banks

This is more than double initial estimates, despite a number of negative temporary factors hitting the quarter, such as a lengthy government shutdown and weather disruptions. The consumer was not in fine form, but did make a late-quarter appearance that will help propel economic momentum again towards the 2% mark in the second quarter.

Market sentiment received a second boost from the decisive action of central banks, led by the Federal Reserve, to respond to deteriorating sentiment by putting future rate hikes on ice. This monetary support spurred risk taking, evidence by an S&P 500 Index that is now at a record high (Chart 1) and corporate credit spreads that have dropped below their average since 2010.

Not only did the Federal Reserve use forward guidance to remove any market pricing for higher interest rates, it also announced an earlier end to the normalization of its balance sheet. Several Fed members went further in also hinting an openness to cutting interest rates. The U.S. 10-year Treasury yield responded by dropping to 2.34% on March 28th, causing the yield curve to invert against the 3-month yield. This held for no more than a handful of days. Given the yield curve's strong track record of predicting recessions, its inversion captured significant market attention. However, a look back at history shows that inversions need staying power to have predictive power. In the U.S. and Canada, the yield curve has inverted for short periods (of less than a week) and not resulted in a recession on several occasions. The better recession signal occurs on yield inversions over the course of months.

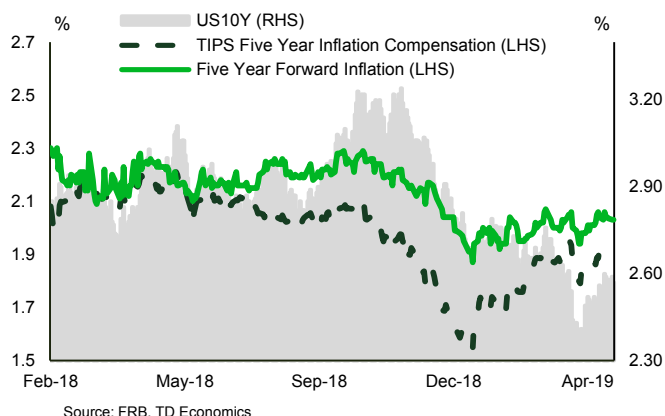
Chart 1: Equities Jumping with Dovish Monetary Policy



The direction of bond yields

Nonetheless, the Federal Reserve's dovish tilt has prompted market participants to believe that the next move in the policy rate will be a cut. We view this as premature. In our view, the current level of the policy rate is right around the neutral level. If economic growth continues to stabilize as our tracking implies, then the Federal Reserve has got it right on rates just as they are. On the inflation front, market based measures have clearly bottomed (Chart 2) and with wages increasing above 3% on average, we forecast that core measure of inflation will begin to improve in the next couple of months. As the data begin to confirm this trend, market pricing for the policy path and inflation should unwind the pricing for a cut and offer some slight upside for Treasury yields. We maintain our year-end target of roughly 2.85% for the 10-year Treasury yield.

Chart 2: Market Pricing for U.S. Inflation Stabilizing



A sustained break above this mark would likely need a few conditions to materialize. Importantly, inflationary pressures would have to become significantly more threatening. By extension, economic momentum would have to heat up much more than we are currently expecting. Likewise, global risks would need to recede. Europe is front and center in our minds. With Italian bank weakness, populist disruptions in France, and Germany's dependence on trade flows, growth in Europe is trading water. It would not take much of a data miss to undermine confidence once again in the region's prospects. And, it may get worse for them yet. As progress occurs with U.S./China trade talks, the U.S. Administration is now lining Europe and Japan

within its sights as the next target. China had the luxury of high growth during the tit-for-tat tariff inflictions, which is not afforded to the economies of either Europe or Japan. Lingering economic threats will ultimately cap the upside for yields globally.

Bottom Line

The global economy is starting to show signs of improvement. This is good news, but it's premature to get excited given its early days and now the test will be on evidence that momentum can indeed strengthen into the second half of this year. Despite firming economic momentum, the multitude of significant global risks will likely continue to limit the degree to which bond yields can make any significant headway.

Interest Rate & Foreign Exchange Rate Outlook														
		Spot Rate	2018				2019				2020			
		Apr-24	Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Interest Rates														
Fed Funds Target Rate		2.50	1.75	2.00	2.25	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50
3-mth T-Bill Rate		2.37	1.70	1.89	2.15	2.40	2.35	2.40	2.40	2.40	2.40	2.40	2.40	2.40
2-yr Govt. Bond Yield		2.32	2.27	2.52	2.81	2.48	2.27	2.45	2.50	2.50	2.50	2.50	2.50	2.50
5-yr Govt. Bond Yield		2.31	2.56	2.73	2.94	2.51	2.23	2.50	2.60	2.60	2.60	2.60	2.60	2.60
10-yr Govt. Bond Yield		2.52	2.74	2.85	3.05	2.69	2.41	2.70	2.75	2.85	2.85	2.85	2.85	2.85
30-yr Govt. Bond Yield		2.94	2.97	2.98	3.19	3.02	2.81	2.95	3.00	3.10	3.10	3.10	3.10	3.10
10-yr-2-yr Govt Spread		0.20	0.47	0.33	0.24	0.21	0.14	0.25	0.25	0.35	0.35	0.35	0.35	0.35
Exchange rate to U.S. dollar														
Chinese Yuan	CNY per USD	6.72	6.27	6.62	6.87	6.88	6.71	6.80	6.80	6.80	6.80	6.80	6.80	6.80
Japanese yen	JPY per USD	112	106	111	113	110	111	109	108	107	106	105	105	104
Euro	USD per EUR	1.12	1.23	1.17	1.16	1.15	1.12	1.14	1.14	1.15	1.16	1.17	1.18	1.19
U.K. pound	USD per GBP	1.29	1.40	1.32	1.31	1.28	1.30	1.31	1.32	1.33	1.34	1.35	1.36	1.37
Swiss franc	CHF per USD	1.02	0.95	0.99	0.98	0.98	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Canadian dollar	CAD per USD	1.35	1.29	1.31	1.29	1.36	1.34	1.33	1.33	1.33	1.33	1.32	1.32	1.31
Australian dollar	USD per AUD	0.70	0.77	0.74	0.72	0.71	0.71	0.71	0.71	0.72	0.73	0.73	0.73	0.73
NZ dollar	USD per NZD	0.66	0.72	0.68	0.66	0.67	0.68	0.68	0.69	0.70	0.71	0.71	0.71	0.71
Exchange rate to Euro														
U.S. dollar	USD per EUR	1.12	1.23	1.17	1.16	1.15	1.12	1.14	1.14	1.15	1.16	1.17	1.18	1.19
Japanese yen	JPY per EUR	125	131	129	132	126	124	124	123	123	123	123	123	124
U.K. pound	GBP per EUR	0.86	0.88	0.89	0.89	0.90	0.86	0.87	0.86	0.87	0.87	0.87	0.87	0.87
Swiss franc	CHF per EUR	1.14	1.17	1.16	1.13	1.13	1.12	1.14	1.14	1.15	1.16	1.17	1.18	1.19
Canadian dollar	CAD per EUR	1.50	1.59	1.53	1.50	1.56	1.50	1.52	1.52	1.53	1.54	1.54	1.55	1.56
Australian dollar	AUD per EUR	1.59	1.60	1.58	1.61	1.63	1.58	1.61	1.61	1.60	1.59	1.60	1.62	1.63
NZ dollar	NZD per EUR	1.69	1.70	1.72	1.75	1.71	1.65	1.68	1.65	1.64	1.63	1.65	1.66	1.68
Exchange rate to Japanese yen														
U.S. dollar	JPY per USD	112	106	111	113	110	111	109	108	107	106	105	105	104
Euro	JPY per EUR	125	131	129	132	126	124	124	123	123	123	123	123	124
U.K. pound	JPY per GBP	145	149	146	148	140	144	143	143	142	142	142	142	142
Swiss franc	JPY per CHF	110.0	111.4	111.6	116.3	111.6	111.1	109.4	108.4	107.4	106.4	105.4	104.9	104.4
Canadian dollar	JPY per CAD	83.2	82.4	84.3	87.8	80.4	82.8	82.0	81.2	80.5	80.0	79.5	79.5	79.4
Australian dollar	JPY per AUD	78.7	81.7	81.9	82.1	77.3	78.6	77.4	76.7	77.0	77.4	76.7	76.3	75.9
NZ dollar	JPY per NZD	74.0	76.9	75.0	75.3	73.6	75.5	74.1	74.5	74.9	75.3	74.6	74.2	73.8

F: Forecast by TD Economics, April 2019; Forecasts are end-of-period.

Source: Federal Reserve, Bloomberg.

Commodity Price Outlook															
	Price Apr-24	52-Week High	52-Week Low	2018				2019				2020			
				Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Crude Oil (WTI, \$US/bbl)	66	76	42	63	68	70	59	55	62	60	62	64	65	65	66
Natural Gas (\$US/MMBtu)	2.53	4.80	2.53	3.08	2.86	2.93	3.80	2.92	2.70	2.70	2.60	2.50	2.51	2.53	2.54
Gold (\$US/troy oz.)	1275	1341	1174	1329	1306	1213	1229	1303	1325	1350	1375	1375	1375	1425	1425
Silver (US\$/troy oz.)	14.94	17.17	14.00	16.74	16.56	15.02	14.58	15.58	17.00	17.25	17.50	18.00	18.00	18.75	18.75
Copper (cents/lb)	290	333	259	316	312	277	280	282	284	293	293	302	302	311	311
Nickel (US\$/lb)	5.62	7.14	4.85	6.01	6.56	6.02	5.21	5.60	6.01	6.06	6.10	6.12	6.35	6.58	6.58
Aluminum (Cents/lb)	85	107	82	98	102	93	89	84	90	93	93	95	100	99	99
Wheat (\$US/bu)	6.19	7.98	6.03	7.42	7.46	6.70	6.85	7.08	6.50	6.83	7.03	7.06	7.08	7.11	7.14

F: Forecast by TD Economics, April 2019; Forecast are period averages; E: Estimate.

Source: Bloomberg, USDA (Haver).

International Interest Rates Outlook													
	Spot Rate Apr-24	2018				2019				2020			
		Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Germany													
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.25	-0.25	-0.25
3-mth T-Bill Rate	-0.52	-0.79	-0.65	-0.58	-0.84	-0.55	-0.50	-0.50	-0.50	-0.43	-0.35	-0.35	-0.23
2-yr Govt. Bond Yield	-0.59	-0.62	-0.67	-0.53	-0.62	-0.61	-0.57	-0.50	-0.42	-0.33	-0.12	0.07	0.23
5-yr Govt. Bond Yield	-0.43	-0.11	-0.30	-0.09	-0.32	-0.46	-0.13	0.00	0.24	0.44	0.64	0.84	1.02
10-yr Govt. Bond Yield	-0.01	0.49	0.30	0.47	0.24	-0.07	0.30	0.50	0.90	1.20	1.40	1.60	1.80
30-yr Govt. Bond Yield	0.63	1.15	1.02	1.08	0.87	0.57	1.05	1.35	1.55	1.75	1.95	2.15	2.35
10-yr-2-yr Govt Spread	0.58	1.11	0.97	1.00	0.86	0.54	0.87	1.00	1.32	1.53	1.52	1.53	1.57
United Kingdom													
Bank Rate	0.75	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.25	1.25
3-mth T-Bill Rate	0.77	0.51	0.59	0.75	0.70	0.75	0.75	0.75	0.88	1.00	1.13	1.25	1.38
2-yr Govt. Bond Yield	0.76	0.81	0.71	0.82	0.73	0.64	0.88	1.10	1.26	1.42	1.57	1.73	1.88
5-yr Govt. Bond Yield	0.90	1.11	1.03	1.17	0.90	0.69	1.26	1.48	1.65	1.83	2.01	2.19	2.37
10-yr Govt. Bond Yield	1.18	1.35	1.28	1.44	1.14	0.99	1.65	1.85	2.05	2.25	2.45	2.65	2.85
30-yr Govt. Bond Yield	1.71	1.71	1.74	1.91	1.82	1.55	2.00	2.20	2.40	2.60	2.80	3.00	3.00
10-yr-2-yr Govt Spread	0.42	0.54	0.57	0.62	0.41	0.35	0.77	0.75	0.79	0.83	0.88	0.92	0.97

F: Forecast by TD Economics, April 2019; Forecasts are end-of-period.
Source: Bloomberg.

Global Stock Markets					
	Price Apr-24	30-Day % Chg.	YTD % Chg.	52-Week High	52-Week Low
S&P 500	2,927	4.5	16.8	2,934	2,351
DAX	12,313	8.4	16.6	13,170	10,382
FTSE 100	7,472	3.7	11.1	7,877	6,585
Nikkei	22,200	2.6	10.9	24,271	19,156
MSCI AC World Index*	525	3.7	15.1	528	436

*Weighted equity index including both developing and emerging markets.
Source: Bloomberg, TD Economics.

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