Dollars and Sense: Patience and Pre-Conditions

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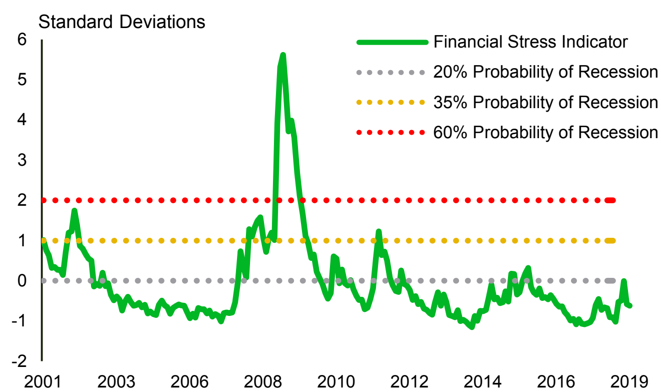
Highlights

- Both the Federal Reserve and the Bank of Canada have rightfully pressed the pause button on future rate hikes until the data confirm greater economic momentum.
- This leaves a higher burden of proof on the data, suggesting specific pre-conditions need to be met before a central bank steps back in with another upward policy rate adjustment. These include relatively stable financial conditions, a bounce-back in global growth, and stronger evidence of intensifying domestic inflationary pressures.
- It will take time for these factors to materialize, causing us to punt the timing for rate hikes into late 2019. However, it's important to emphasize that the data now needs to make a compelling case, since both central banks have moved into the lower bound of estimates of neutral interest rates. We have long argued that 2019 will be the peak in the interest rate cycle, and the case is probably more compelling today than it was in 2018.

On January 30th, financial markets let out a huge sigh of relief when the Federal Reserve signaled a shift in its monetary stance. It was only a short period prior (in October) when the Fed Chair stated "we're a long way from neutral" interest rates. In December, a formal FOMC communication reinforced the tightening cycle by noting "further gradual increases" were still warranted. But, just six weeks later, the January FOMC statement changed course by citing "the Committee will be patient" . In effect, a tightening bias quickly became redefined as a neutral stance. Were the earlier statements a miscalculation on the Fed's part? Not really. The sands shifted under their feet in that short period, and the Fed can be credited with demonstrating the flexibility required to be responsive and true to the data. To explain, we'll first need to take a small step back in time.

At the end of the summer in 2018, U.S. economic growth was pushing well above 3% and equity markets were hitting new highs. Then the world changed. Data started revealing that trade tensions and slowing growth in China and Europe were chipping away at sentiment, manufacturing and export activity. Corporations started reporting weaker earnings guidance and equities the world over fell precipitously. This is where recession talk began to heat up, and surveys began revealing higher odds being assigned by market participants. Then along came the New Year and with it, renewed optimism. This optimism was partly rooted in central bank speeches displaying candor in the need to reevaluate the risks to the economic outlook and the emphasis that monetary tightening was not on a preset course. That rhetoric has now been followed by action.

Chart 1: Financial Market Stress Easing



Source: TD Economics

The Fed has hit pause, but for how long?

The Fed's patient mood seems to be more rooted in the deterioration in the global outlook and the resulting fragility of financial market sentiment, rather than domestic conditions. An intensifying downdraft within China and Europe placed economic data surprises pretty much on one side: negative. Importantly, this started to reveal an increased risk of a synchronized global downturn. Although the U.S. data have not been out of step with our expectations in any meaningful way, an easing trend is unfolding against this global backdrop and amidst tighter financial conditions. Added to this is the reality that there has been little improvement in event risks related to trade tensions, Brexit, and other geopolitical tensions.

When combined with muted inflationary pressures, the Fed is under no pressing need to raise rates and, in fact, is showing some comfort at holding closer to the lower level of their neutral estimate (2.50-3.50%), at least until there's stronger data to suggest otherwise. As Powell has noted, "you can't directly observe the neutral rate … we have to put aside our own priors of what that rate might be and let the data speak to us". This leaves a higher burden of proof on the data, causing us to map out some possible pre-conditions that need to occur before the Fed would consider moving interest rates further into the estimated neutral range.

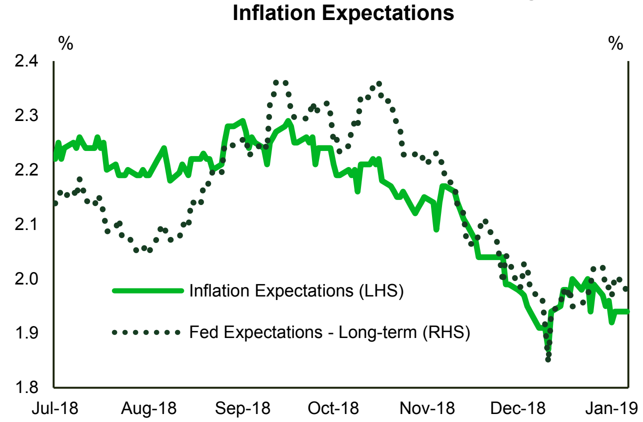
First, it almost goes without saying that financial markets need to be reasonably stable. We say "reasonably stable" because central banks guard against being responsive to the inherent volatility of risk-appetite. However, they generally take market volatility into consideration when outsized moves augment the impact-risks to the broader economy via wealth, confidence and spending behaviors. After a wild December, the appetite for risk-assets has bounced off the floor, allowing our Financial Stress Indicator (Chart 1) to return to levels consistent with an average degree of stress. This index now signals less than a 20% probability of recession in the next 12 months. With equities rallying, bond yields holding steady, and credit spreads narrowing, we don't need much more reassurance from financial markets that cooler heads prevail. However, sustainability is key on this front alongside what we believe to be a second precondition: stabilization in global conditions.

The Fed will want to see a period of stable-to-stronger global economic momentum, particularly given broadly weaker growth that set in towards the end of 2018. Most economists anticipated cloudy skies for the UK amidst Brexit limbo-land, but were caught off-guard by disappointments within mainland Europe, including France, Germany, and Italy. Although this deterioration partly reflects one-off factors, more worrisome is the prospect that underlying growth has weakened as a consequence of the slowdown in Chinese demand, and may also reflect the impact of elevated trade and global economic uncertainty. In addition, Europe has a much smaller growth-cushion to absorb negative shocks and is already at a low monetary setting.

Although global events historically do not move the Fed's hand due to the economy's low export dependency, revenues of many U.S. firms depend now more than ever on foreign demand. As such, the U.S. is no longer an island and financial market stability is increasingly intertwined with global developments. In addition, the Federal Reserve has previously shown patience in the face of global uncertainty, as recently as 2016, when the rate hike cycle was placed on a one-year hold while the Fed assessed the knock-on impact of China's slowing economy.

However, the most important precondition on the interest cycle is a return to above-trend domestic economic growth in Q2 and beyond. This would mark a proof-point that global conditions have not washed upon domestic shores. But, this alone may not be sufficient to satisfy the Federal Reserve. Ultimately, the burden of proof will fall to whether a persistence of economic growth is pushing up inflation-

Chart 2: Expectations for the Fed Declining with Inflation Expectations



Source: Bloomberg LP, Federal Reserve Board, TD Economics ary pressures and market expectations. The importance of this needs to be underscored. Chart 2 shows the pull-down forces that have been hitting U.S. Treasury yields in recent weeks. There has been an utter collapse in market expectations for both inflation (-40 bps) and the Fed policy path (-60 bps). We've been here before with expectations moving lower on the policy path, but the collapse in inflation is overdone relative to the state of the economy. This measure has a high correlation to oil price movements, but even absent that, it's clear that financial markets have shifted to an "I'll believe it when I see it" mind set. Strengthening in inflation and, importantly, inflation expectations will be a *necessary condition* for any further rate hikes. This may require the Fed to stretch its patience to allow for an inflation "overshoot" in order for the data to build the credibility needed to sustain higher market expectations.

All this to say that we find ourselves reinforcing the thesis presented at the start of the year that history may indeed characterize Q1 as the make-or-break quarter of this economic cycle. It will likely take a number of months before the ducks fall into line either supporting or refuting any further rate movements from the Fed. In this context, we have pushed out the timing of the next rate hike to the third quarter, but even this will have a low conviction if inflation does not deliver. At best we can argue that the balance of risks are between zero and one increase for 2019 as a whole.

The Bank of Canada to follow the Fed's lead

If these are the pre-conditions we expect for the Federal Reserve, than the bar is set even higher for the Bank of Canada. Added to their list of pre-conditions is a sustained acceleration in wages. The central bank has made no secret that it is looking for wage growth to reach 3% or more, with the recent decelerating trend being somewhat of a puzzle. Given Canada's more pronounced near-term growth challenges relative to our neighbors to the south, a patient Fed necessarily means an even more patient Bank of Canada. This is particularly true as the domestic housing market continues to underperform even modest expectations for stabilization. And, given historically high debt levels and consequently elevated interest-rate sensitivity, the Bank of Canada also needs reassurance that past interest rate increases do not weigh too heavily on households. The combination of events means that the risks around our prevailing Bank of Canada call have also shifted towards a longer delay into the fourth quarter.

Bottom Line

If there is one main takeaway, it's that U.S. and Canada's central banks have shifted into a wait-and-see mode now that their policy rates are narrowing in on the lower bound estimates of the neutral range. This resets the bar for further rate hikes at a higher threshold, leaving less scope for higher rates in 2019 than in prior years. With global economic momentum disappointing, it is still uncertain whether a fulsome recovery will take hold to sustain financial market stability. Even once this occurs, the domestic data needs to find a stronger footing (which we think it will) and inflation expectations need to reflect that outcome. It could take a number of months before all these ducks fall into line to either support or refute any further rate movements from the Federal Reserve and the Bank of Canada. Until then, patience will be the catchword of 2019.

Interest Rate Outlook													
	Spot Rate	2018				2019				2020			
	Feb-05	Q1	Q2	Q3	Q4	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
CANADA													
Overnight Target Rate	1.75	1.25	1.25	1.50	1.75	1.75	1.75	1.75	2.00	2.25	2.25	2.25	2.25
3-mth T-Bill Rate	1.66	1.10	1.26	1.59	1.64	1.75	1.75	1.88	2.13	2.25	2.25	2.25	2.25
2-yr Govt. Bond Yield	1.83	1.77	1.91	2.21	1.86	1.85	2.00	2.15	2.25	2.35	2.35	2.35	2.35
5-yr Govt. Bond Yield	1.85	1.96	2.06	2.33	1.88	1.95	2.05	2.20	2.35	2.45	2.45	2.45	2.45
10-yr Govt. Bond Yield	1.94	2.09	2.17	2.42	1.96	2.05	2.20	2.35	2.45	2.60	2.60	2.60	2.60
30-yr Govt. Bond Yield	2.18	2.23	2.20	2.42	2.18	2.30	2.45	2.60	2.70	2.85	2.85	2.85	2.85
10-yr-2-yr Govt Spread	0.11	0.32	0.26	0.21	0.10	0.20	0.20	0.20	0.20	0.25	0.25	0.25	0.25
U.S.													
Fed Funds Target Rate	2.50	1.75	2.00	2.25	2.50	2.50	2.50	2.75	2.75	2.75	2.75	2.75	2.75
3-mth T-Bill Rate	2.36	1.70	1.89	2.15	2.40	2.40	2.53	2.65	2.65	2.65	2.65	2.65	2.65
2-yr Govt. Bond Yield	2.52	2.27	2.52	2.81	2.48	2.55	2.65	2.75	2.75	2.75	2.75	2.75	2.75
5-yr Govt. Bond Yield	2.51	2.56	2.73	2.94	2.51	2.65	2.75	2.85	2.85	2.85	2.85	2.85	2.85
10-yr Govt. Bond Yield	2.70	2.74	2.85	3.05	2.69	2.80	2.90	3.00	3.00	3.00	3.00	3.00	3.00
30-yr Govt. Bond Yield	3.03	2.97	2.98	3.19	3.02	3.05	3.15	3.25	3.25	3.25	3.25	3.25	3.25
10-yr-2-yr Govt Spread	0.18	0.47	0.33	0.24	0.21	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
CANADA - U.S SPREADS													
Can - U.S. T-Bill Spread	-0.70	-0.60	-0.63	-0.56	-0.76	-0.65	-0.78	-0.77	-0.52	-0.40	-0.40	-0.40	-0.40
Can - U.S. 10-Year Bond Spread	-0.76	-0.65	-0.68	-0.63	-0.73	-0.75	-0.70	-0.65	-0.55	-0.40	-0.40	-0.40	-0.40

F: Forecast by TD Economics, February 2019; Forecasts are end-of-period.
Source: Bloomberg, Bank of Canada, Federal Reserve.

Foreign Exchange Outlook														
Currency	Exchange	Spot Price	2018				2019				2020			
	rate	Feb-05	Q1	Q2	Q3	Q4	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Exchange rate to U.S. dollar														
Chinese Yuan	CNY per USD	6.74	6.27	6.62	6.87	6.88	6.80	6.80	6.80	6.80	6.80	6.80	6.80	6.80
Japanese yen	JPY per USD	110	106	111	113	110	109	107	106	105	104	103	103	102
Euro	USD per EUR	1.14	1.23	1.17	1.16	1.15	1.15	1.17	1.18	1.20	1.21	1.22	1.23	1.24
U.K. pound	USD per GBP	1.30	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	1.00	0.95	0.99	0.98	0.98	0.98	0.98	0.98	0.98	0.98	0.98	0.98	0.98
Canadian dollar	CAD per USD	1.31	1.29	1.31	1.29	1.36	1.31	1.31	1.30	1.30	1.29	1.29	1.28	1.28
Australian dollar	USD per AUD	0.72	0.77	0.74	0.72	0.71	0.73	0.73	0.74	0.75	0.76	0.76	0.76	0.76
NZ dollar	USD per NZD	0.69	0.72	0.68	0.66	0.67	0.68	0.69	0.70	0.71	0.72	0.72	0.72	0.72
Exchange rate to Euro														
U.S. dollar	USD per EUR	1.14	1.23	1.17	1.16	1.15	1.15	1.17	1.18	1.20	1.21	1.22	1.23	1.24
Japanese yen	JPY per EUR	125	131	129	132	126	125	125	125	126	126	126	126	126
U.K. pound	GBP per EUR	0.88	0.88	0.89	0.89	0.90	0.89	0.89	0.89	0.90	0.90	0.90	0.90	0.91
Swiss franc	CHF per EUR	1.14	1.17	1.16	1.13	1.13	1.13	1.15	1.16	1.18	1.19	1.20	1.21	1.22
Canadian dollar	CAD per EUR	1.50	1.59	1.53	1.50	1.56	1.51	1.53	1.53	1.56	1.56	1.57	1.58	1.58
Australian dollar	AUD per EUR	1.58	1.60	1.58	1.61	1.63	1.58	1.60	1.60	1.60	1.59	1.61	1.62	1.63
NZ dollar	NZD per EUR	1.65	1.70	1.72	1.75	1.71	1.69	1.69	1.68	1.69	1.68	1.69	1.71	1.72
Exchange rate to Japanese yen														
U.S. dollar	JPY per USD	110	106	111	113	110	109	107	106	105	104	103	103	102
Euro	JPY per EUR	125	131	129	132	126	125	125	125	126	126	126	126	126
U.K. pound	JPY per GBP	142	149	146	148	140	142	140	140	140	139	139	139	140
Swiss franc	JPY per CHF	110.0	111.4	111.6	116.3	111.6	110.9	108.8	107.8	106.8	105.8	104.8	104.3	103.7
Canadian dollar	JPY per CAD	83.7	82.4	84.3	87.8	80.4	83.2	81.7	81.5	80.8	80.6	80.2	80.0	79.9
Australian dollar	JPY per AUD	79.6	81.7	81.9	82.1	77.3	79.6	78.1	78.4	78.8	79.0	78.3	77.9	77.5
NZ dollar	JPY per NZD	75.8	76.9	75.0	75.3	73.6	74.2	73.9	74.3	74.7	75.0	74.3	73.9	73.6
Exchange rate to Canadian dollar														
U.S. dollar	USD per CAD	0.76	0.78	0.76	0.77	0.73	0.76	0.76	0.77	0.77	0.78	0.78	0.78	0.78
Japanese yen	JPY per CAD	83.7	82.4	84.3	87.8	80.4	83.2	81.7	81.5	80.8	80.6	80.2	80.0	79.9
Euro	CAD per EUR	1.50	1.59	1.53	1.50	1.56	1.51	1.53	1.53	1.56	1.56	1.57	1.58	1.58
U.K. pound	CAD per GBP	1.70	1.81	1.73	1.69	1.74	1.70	1.72	1.72	1.73	1.73	1.74	1.74	1.75
Swiss franc	CHF per CAD	0.76	0.74	0.76	0.76	0.72	0.75	0.75	0.76	0.76	0.76	0.77	0.77	0.77
Australian dollar	AUD per CAD	1.05	1.01	1.03	1.07	1.04	1.05	1.05	1.04	1.03	1.02	1.02	1.03	1.03
NZ dollar	NZD per CAD	1.10	1.07	1.12	1.17	1.09	1.12	1.10	1.10	1.08	1.08	1.08	1.08	1.09

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

International Interest Rates Outlook

	Spot Rate Feb-05	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1F	2019 Q2F	2019 Q3F	2019 Q4F	2020 Q1F	2020 Q2F	2020 Q3F	2020 Q4F
Germany													
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.25	-0.25	0.00	0.00	0.25
3-mth T-Bill Rate	-0.52	-0.79	-0.65	-0.58	-0.84	-0.50	-0.50	-0.43	-0.35	-0.23	-0.10	0.03	0.15
2-yr Govt. Bond Yield	-0.57	-0.62	-0.67	-0.53	-0.62	-0.44	-0.34	-0.22	-0.07	0.11	0.39	0.67	0.90
5-yr Govt. Bond Yield	-0.30	-0.11	-0.30	-0.09	-0.32	-0.07	0.08	0.24	0.42	0.65	0.90	1.13	1.35
10-yr Govt. Bond Yield	0.17	0.49	0.30	0.47	0.24	0.30	0.50	0.70	0.90	1.20	1.40	1.60	1.80
30-yr Govt. Bond Yield	0.78	1.15	1.02	1.08	0.87	0.85	1.05	1.35	1.55	1.75	1.95	2.15	2.35
10-yr-2-yr Govt Spread	0.74	1.11	0.97	1.00	0.86	0.74	0.84	0.92	0.97	1.09	1.01	0.93	0.90
United Kingdom													
Bank Rate	0.75	0.50	0.50	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.25	1.25	1.25
3-mth T-Bill Rate	0.78	0.51	0.59	0.75	0.70	0.75	0.75	0.88	1.00	1.13	1.25	1.25	1.38
2-yr Govt. Bond Yield	0.75	0.81	0.71	0.82	0.73	0.75	0.94	1.17	1.31	1.45	1.59	1.73	1.88
5-yr Govt. Bond Yield	0.87	1.11	1.03	1.17	0.90	1.10	1.30	1.51	1.68	1.85	2.02	2.19	2.37
10-yr Govt. Bond Yield	1.23	1.35	1.28	1.44	1.14	1.45	1.65	1.85	2.05	2.25	2.45	2.65	2.85
30-yr Govt. Bond Yield	1.74	1.71	1.74	1.91	1.82	1.80	2.00	2.20	2.40	2.60	2.80	3.00	3.00
10-yr-2-yr Govt Spread	0.48	0.54	0.56	0.62	0.42	0.70	0.71	0.68	0.74	0.80	0.86	0.92	0.97

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

Global Stock Markets

	Price Feb-05	30-Day % Chg.	YTD % Chg.	52-Week High	52-Week Low
S&P 500	2,738	8.1	9.2	2,931	2,351
S&P/TSX Composite	15,703	8.8	9.6	16,567	13,780
DAX	11,368	5.6	7.7	13,170	10,382
FTSE 100	7,177	5.0	6.7	7,877	6,585
Nikkei	20,844	6.6	4.1	24,271	19,156
MSCI AC World Index*	493	7.2	8.2	528	436

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

Commodity Price Outlook

	Price Feb-05	52-Week High	52-Week Low	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1F	2019 Q2F	2019 Q3F	2019 Q4F	2020 Q1F	2020 Q2F	2020 Q3F	2020 Q4F
Crude Oil (WTI, $US/bbl)	54	76	42	63	68	70	59	54	58	62	65	65	66	66	66
Natural Gas ($US/MMBtu)	2.57	4.80	2.52	3.10	2.82	2.90	3.78	3.23	3.10	3.05	3.08	3.04	2.98	2.99	3.01
Gold ($US/troy oz.)	1315	1354	1174	1329	1306	1213	1229	1275	1290	1300	1325	1330	1350	1355	1365
Silver (US$/troy oz.)	15.85	17.25	14.00	16.74	16.56	15.02	14.58	15.50	16.00	16.50	17.00	17.25	17.50	17.70	17.70
Copper (cents/lb)	279	333	259	316	312	277	280	268	279	293	293	302	303	305	306
Nickel (US$/lb)	6.02	7.14	4.85	6.01	6.56	6.02	5.21	4.99	5.22	5.67	5.90	6.12	6.35	6.38	6.41
Aluminum (Cents/lb)	87	115	82	98	102	93	89	85	87	93	93	95	98	99	99
Wheat ($US/bu)	7.00	8.08	6.15	7.42	7.46	6.70	6.85	6.80	6.94	7.00	7.02	7.05	7.07	7.10	7.13

F: Forecast by TD Economics, February 2019; Forecasts are period averages; E: Estimate.
Source: Bloomberg, USDA (Haver).

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