Dollars and Sense
Mission Accomplished By The Federal Reserve

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October 31, 2019

Highlights

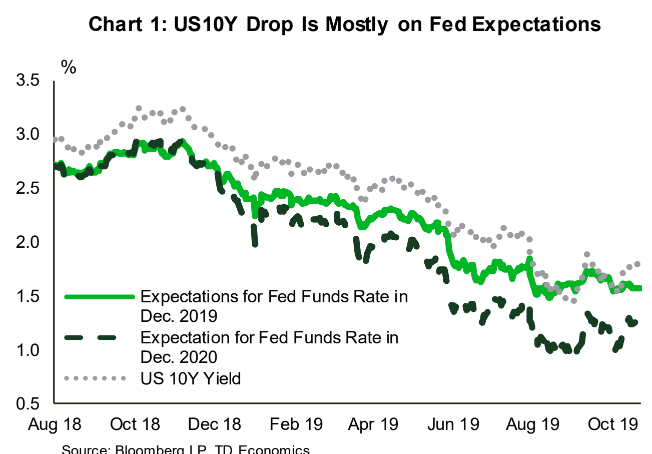
- After a dive lower in yields through September on escalating trade tensions, signs of détente sent yields up about 30 basis points.
- With the Fed cutting again on October 30th, this marks a fulfillment of our forecast. We have not pencilled in any further action, since we believe the Fed's success in anchoring down yields is allowing the household sector to offset weakness in business investment.
- The monetary transmission mechanism in the U.S. is working. The combination of the Federal Reserve's pivot to three insurance cuts and forward guidance to do more if necessary has resulted in lower government borrowing rates passing into mortgage rates. In turn, the evidence has materialized that this is boosting homes sales and residential activity.
- The Bank of Canada has resisted the urge to cut despite worsening global economic risks crashing onto the shores of this small, open economy. It will be difficult for Canada to remain on the sidelines should financial conditions tighten. Up until recently, Canada has benefited from 'importing' lower yields from Fed policy and global risk sentiment. But this pathway is now facing some friction.

Optimism started to creep back into financial markets with news of a U.S.-China "trade-lite" deal in October. In response, the 10-year Treasury yield has risen about 30 basis points to 1.7%, from a floor in September.

The details of the trade agreement still need to be fleshed out and published by the USTR. So far it seems to be narrowly focused on agriculture products, rather than addressing the more strategic areas of concern on intellectual security and the elimination of past retaliatory tariffs. In this way, it falls short on offering broader business transparency on market access, cost structures, and the general outlook. But, beggars can't be choosers. What had turned into a one-way risk, now has some balance.

From the Fed's perspective, relief on trade tensions was welcomed, but didn't deter another rate cut due to the persistence of uncertainty affecting business activity, particularly within manufacturing and broader capital spending. However, yesterday's decision to cut rates marks the last for us as the Fed steps back to evaluate.

Chart 1: US10Y Drop Is Mostly on Fed Expectations



Source: Bloomberg LP, TD Economics

With an economy growing by only 2% in a low yield environment, the natural question to ask is where's the proof that these insurance cuts are having an impact? First, we need to step back and note that the Fed's willingness to ease policy has aided financial conditions both domestically and globally through the sentiment channel. An easing in market volatility measures best captures this, alongside a return to a positively slopped U.S. yield curve.

Second, the insurance cuts have anchored yields at lower levels, where the transmission is becoming more noticeable on the household side. This is needed as businesses lean into the headwinds. It's important to remember the 'counterfactual' world of what may have come to pass had the Fed sat on their hands. A year ago, market participants were pricing a hiking cycle that would place the policy rate at around 3% by the end of 2019. Current market pricing has the fed funds rate at an expected level of 1.25% by the end of next year (Chart 1). This has translated into a material drop in the U.S. 10-year Treasury yield of about 1.80% over the past year, with nearly all that due to a reset in the expectations for the Fed.

U.S. Housing to Benefit from the Drop in Yields

For some time, we've shone a light on the U.S. housing market. It is the one area that has tremendous upside potential, but has consistently underperformed relative to its fundamentals:

- Low leverage of American households
- Low unemployment
- Rising wages

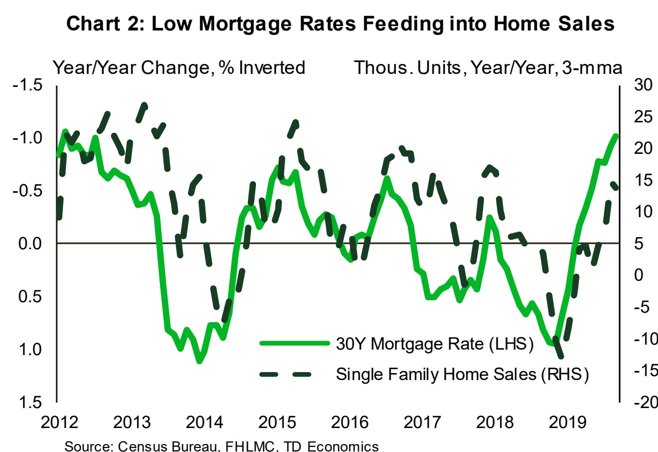
This is because the list of reasons supporting a lagging housing market performance is longer and includes:

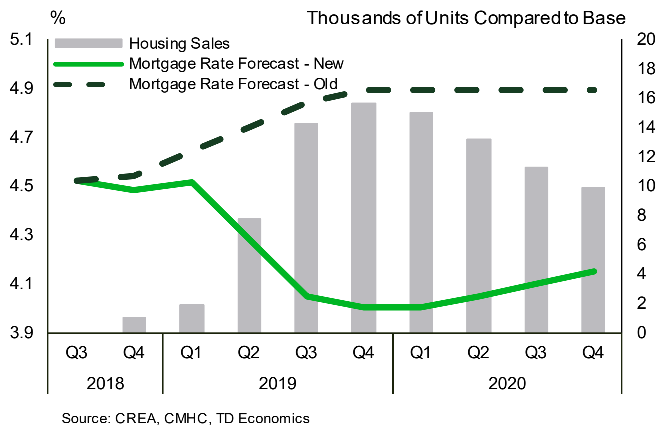
- Scarring from the financial crisis
- Less housing wealth transfer from the older homeowner generation
- High student debt that obstructs millennial ownership
- Supply constraints on the builder's side that leads to higher prices = an erosion of affordability for would-be buyers
- Persistent tight supply in the resale market
- A faster rise in mortgage rates relative to income growth in 2018

Some of these just needed more time for adjustment. But, when it comes to the last item, the Fed's pivot to lower rates has offered dividends in boosting housing demand. The conventional 30-year mortgage rate peaked in November 2018, and has since declined more than 100 basis points. Chart 2 shows the transmission from mortgage rates to sales is starting to occur. Should the low interest rate environment persist via Fed policy alongside the solid labor market, the outlook for housing should further improve over the next year. So, while the Fed remains on alert due to risks within trade, manufacturing, and the global outlook, the good news is that the monetary transmission mechanism is working on the household side to provide some counterbalance.

Bank of Canada on hold, for now

On the same day that the Fed implemented its third rate cut, the Bank of Canada refused to budge. The policy rate held firm at 1.75%, which is where it has sat for exactly a year. Though Governor Poloz, in his post-announcement Q&A, was far more downbeat in his assessment of the global economic risks, the Bank is still weighing the balance of risks, given that the housing market has come back to life in a number of markets across the country. It is this tension (or balancing act) that is keeping them from installing the insurance cuts that central banks around the world have already embraced. Where they go from here firmly lays in the hands of consumers. The building headwinds on the external front place even more dependence on the household sector to stay the course. We have maintained our position that the Bank's hand may end up being forced should financial conditions tighten, which was





already beginning to occur before they finally struck a more dovish tone at yesterday's policy meeting for the first time this year.

Housing boosted by lower 'imported' yields

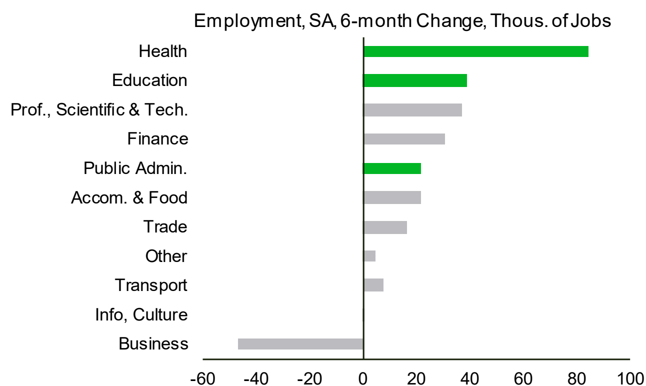
We have often said that Canada is a 'price taker' as a small, open economy. This runs true for government of Canada bond yields, which strongly mirror developments and risk-appetite flowing from the U.S. Treasury market. In other words, lower U.S. yields have translated into lower Canadian yields. Even with the BoC not budging on policy rates, the 10-year government bond yield has dropped 1.1% from its peak in October 2018. This is a key reason why the Canadian yield curve shows persistent inversion, while the U.S. yield curve no longer does so. The policy setting of the Bank of Canada is perceived as high, relative to what markets embed on the growth and risk outlooks.

In terms of the end-game and transmission of lower rates into the economy, Canada's housing market is capturing similar responsiveness to those described south of the border. The posted conventional 5-year Canadian mortgage rate has fallen 50 basis points (with transactional rates dropping even more). This unexpected downdraft in borrowing costs has been a key component to the housing market rebound after a long hiatus that stemmed from the combination of tighter regulatory measures and a rising interest rate environment in 2018.

So, this begs the question: what has been the impact of lower imported yields on the housing market? Our counterfactual analysis shows that Canadian mortgage rates would have likely been set about 1% higher than today's levels. If that played out, our models tell us that home sales would have been about 14 to 16 thousand units less than they are today (Chart 3). Given that higher homes sales lead to higher consumer spending, we would be seeing Canadian GDP about 0.1 to 0.3 ppts lower. Of course, this embeds the classic economics assumption of ceterus paribus (all else equal). In this world, without the drop in yields (which capture global risk and Fed action), the Canadian housing market and related economic data may not have proven as resilient.

This brings us to a final point. Prior to Wednesday's BoC policy meeting, the 10-year GoC yield had retraced some of its steps, rising 40 basis points and returning to July levels. This occurred because of the de-escalation of U.S.-China trade tensions, but not its resolution. The Bank of Canada was losing its advantage from importing lower yields. If this continues to occur amidst a persistence of slow global growth maintaining pressure on trade and business investment, an already leveraged consumer suddenly becomes the only go-to strategy to shore up economic activity. This risk (tightening global financial conditions) was in fact at the top of the list in the latest Monetary Policy Report. The balance of risks in that scenario require action, while trusting in macroprudential policy to manage household vulnerability. On this note, past policies seem to be effective, as evidenced by a reduced share of high-risk mortgage lending (i.e. loan-to-income ratio greater than 450%), alongside other positive behaviors such as a shift towards greater payment stability via fixed rate mortgages upon renewals and prepayments. However, had a higher Canadian yield curve occurred that was in alignment to the Bank of Canada's policy setting, households would have absorbed more 'payment shock' relative to the current environment on renewals. Should this occur in the absence of stronger drivers within other areas of the economy, it would deteriorate an already very thin cushion of growth.

Another consideration is the Bank of Canada's communication relative to it's counterpart south of the border. Since the U.S. remains more committed to lowering rates as a precautionary economic support, the differing central bank paths can cause the rate differential to push the loonie higher relative to the greenback. In other words, tighter financial conditions could set in through multiple paths.



Note: Green bars indicate public facing sectors. Source: Statistics Canada, TD Economics

Fortunately, Canada has a strong job market in its back pocket to offer sturdy fundamentals. But caution is always warranted. Private sector employment accounts for roughly two-thirds of the entire job market, but in the last six months, it has accounted for less than 40% of employment growth. And, new job demand has increasingly resided within sectors that are somewhat more acyclical, including education, health, and public administration (Chart 4), relative to broad business activity.

Putting the pieces together, we have maintained two rate cuts as a precautionary setting for the BoC, and we have placed them in the first half of 2020. We have yet to see what will come from Canada's new Federal government, and any significant fiscal stimulus on this front could take the pressure off the Bank of Canada to do the heavy lifting. However, early analysis suggests that not much of a growth lift is likely (report). The big picture remains that when you strip out the impact of low imported interest rates, the rebound in economic growth over the last few months is much less encouraging. Consumer spending and investment are weak and further deterioration in global growth could worsen these sectors, as well as housing. Over the past decade, strength of the Canadian economy has been centered in the consumer and housing market. This 'golden goose' (or golden 'loon') has been the focus of risk management policy to avoid financial instability. Both remain the most important areas to watch for the health of the Canadian economy going forward and its influence on the Bank of Canada's decision.

Bottom Line

The Federal Reserve has been actively trying to support the U.S. economy in the face of persistent trade risks that are negatively impacting manufacturing and investment spending. Though interest rate cuts are not the cure to offset the supply side shock from trade tariffs, they are having an impact on other areas of the economy. By shifting from a hiking bias to cutting rates, financial conditions have eased significantly. Lower government borrowing costs have been passed on to lower mortgage rates, and this has directly benefited housing demand in both the U.S. and Canada.

In the case of Canada, this reacceleration of housing activity is occurring even as the Bank of Canada is firmly on hold. The BoC is in the enviable position where it can import lower global yields, while it waits to see how the economic data evolve. However, this may become a more challenging position to hold if the data continue to show ongoing pressures on the global front, while domestic competitiveness is challenged via a stronger loonie on international policy differentials. Already the Canadian dollar has strengthened relative to its trading partners, including the greenback more recently.

For the Fed, the improvement in housing is a welcomed sign given its lackluster performance since the financial crisis. With 75 basis points in cuts now in their backpocket, the members of the FOMC can afford to pause given the transmission into the household sector has been successfully triggered. As the Fed noted in its communication on October 30th, it will take a material re-assessment of the outlook to justify more rate cuts from here. And should that occur, we have no doubt that they stand ready to act.

Interest Rate & Foreign Exchange Rate Outlook		Spot Rate	2019				2020				2021			
		Oct-30	Q1	Q2	Q3	Q4F	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Interest Rates														
Fed Funds Target Rate		1.75	2.50	2.50	2.00	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
3-mth T-Bill Rate		1.55	2.35	2.08	1.84	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.68
2-yr Govt. Bond Yield		1.60	2.27	1.75	1.63	1.60	1.60	1.60	1.65	1.75	1.85	1.95	2.05	2.15
5-yr Govt. Bond Yield		1.61	2.23	1.76	1.55	1.60	1.60	1.60	1.70	1.80	1.90	2.00	2.10	2.20
10-yr Govt. Bond Yield		1.78	2.41	2.00	1.68	1.75	1.75	1.75	1.85	1.95	2.05	2.15	2.25	2.35
30-yr Govt. Bond Yield		2.26	2.81	2.52	2.12	2.25	2.25	2.25	2.35	2.45	2.55	2.65	2.70	2.75
10-yr-2-yr Govt Spread		0.18	0.14	0.25	0.05	0.15	0.15	0.15	0.20	0.20	0.20	0.20	0.20	0.20
Exchange rate to U.S. dollar														
Chinese Yuan	CNY per USD	7.06	6.71	6.87	7.15	7.15	7.15	7.15	7.15	7.15	7.15	7.15	7.15	7.15
Japanese yen	JPY per USD	109	111	108	108	108	107	106	106	105	105	104	104	103
Euro	USD per EUR	1.11	1.12	1.14	1.09	1.09	1.09	1.09	1.10	1.11	1.12	1.13	1.14	1.15
U.K. pound	USD per GBP	1.29	1.30	1.27	1.23	1.27	1.25	1.25	1.26	1.27	1.28	1.29	1.30	1.31
Swiss franc	CHF per USD	0.99	1.00	0.98	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Canadian dollar	CAD per USD	1.32	1.34	1.31	1.32	1.31	1.32	1.31	1.30	1.30	1.30	1.30	1.30	1.30
Australian dollar	USD per AUD	0.69	0.71	0.70	0.68	0.68	0.69	0.70	0.70	0.70	0.70	0.70	0.70	0.70
NZ dollar	USD per NZD	0.64	0.68	0.67	0.63	0.64	0.65	0.67	0.68	0.69	0.69	0.69	0.69	0.69
Exchange rate to Euro														
U.S. dollar	USD per EUR	1.11	1.12	1.14	1.09	1.09	1.09	1.09	1.10	1.11	1.12	1.13	1.14	1.15
Japanese yen	JPY per EUR	121	124	123	118	118	117	116	116	117	117	118	118	119
U.K. pound	GBP per EUR	0.86	0.86	0.90	0.89	0.86	0.87	0.87	0.87	0.87	0.88	0.88	0.88	0.88
Swiss franc	CHF per EUR	1.10	1.12	1.11	1.09	1.09	1.09	1.09	1.10	1.11	1.12	1.13	1.14	1.15
Canadian dollar	CAD per EUR	1.47	1.50	1.49	1.44	1.43	1.44	1.43	1.43	1.44	1.46	1.47	1.48	1.50
Australian dollar	AUD per EUR	1.62	1.58	1.62	1.62	1.60	1.58	1.56	1.57	1.59	1.60	1.61	1.63	1.64
NZ dollar	NZD per EUR	1.75	1.65	1.70	1.74	1.70	1.68	1.63	1.62	1.61	1.62	1.64	1.65	1.67
Exchange rate to Japanese yen														
U.S. dollar	JPY per USD	109	111	108	108	108	107	106	106	105	105	104	104	103
Euro	JPY per EUR	121	124	123	118	118	117	116	116	117	117	118	118	119
U.K. pound	JPY per GBP	140	144	137	133	137	134	133	133	133	134	134	135	135
Swiss franc	JPY per CHF	110.0	111.1	110.5	108.3	108.2	107.2	106.2	105.7	105.2	104.7	104.2	103.7	103.5
Canadian dollar	JPY per CAD	82.7	82.8	82.4	81.6	82.4	81.1	80.9	81.2	80.8	80.4	80.0	79.6	79.4
Australian dollar	JPY per AUD	75.1	78.6	75.6	72.9	73.4	73.8	74.2	73.9	73.5	73.2	72.8	72.5	72.3
NZ dollar	JPY per NZD	69.5	75.5	72.4	67.7	69.1	69.6	71.0	71.7	72.5	72.1	71.8	71.4	71.2

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

Commodity Price Outlook	Price	52-Week	52-Week	2019				2020				2021			
	Oct-30	High	Low	Q1	Q2	Q3	Q4F	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Crude Oil (WTI, $US/bbl)	55	66	42	55	60	56	57	57	58	58	59	59	60	60	60
Natural Gas ($US/MMBtu)	2.72	4.80	2.02	2.92	2.56	2.38	2.40	2.40	2.40	2.45	2.50	2.51	2.53	2.54	2.55
Gold ($US/troy oz.)	1495	1552	1200	1303	1307	1473	1500	1525	1550	1550	1550	1550	1550	1550	1550
Silver (US$/troy oz.)	17.85	19.60	14.00	15.58	14.91	17.02	17.90	18.25	18.50	18.50	18.50	18.50	18.50	18.50	18.50
Copper (cents/lb)	268	297	253	282	278	263	263	263	270	276	281	283	284	285	287
Nickel (US$/lb)	7.63	8.19	4.85	5.60	5.56	7.05	7.71	7.60	7.48	7.26	7.26	7.30	7.33	7.37	7.41
Aluminum (Cents/lb)	80	90	77	84	81	80	79	81	84	88	93	93	94	94	95
Wheat ($US/bu)	6.91	7.55	5.62	7.08	6.36	6.14	6.65	6.78	6.85	7.00	7.18	7.21	7.25	7.28	7.32

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

International Interest Rates Outlook													
	Spot Rate	2019				2020				2021			
	Oct-30	Q1	Q2	Q3	Q4F	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Germany													
ECB Deposit Rate	-0.50	-0.40	-0.40	-0.50	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.40	-0.40
3-mth T-Bill Rate	-0.61	-0.55	-0.60	-0.61	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.55	-0.45	-0.38
2-yr Govt. Bond Yield	-0.63	-0.61	-0.76	-0.78	-0.61	-0.58	-0.53	-0.48	-0.40	-0.31	-0.20	-0.09	0.02
5-yr Govt. Bond Yield	-0.58	-0.46	-0.67	-0.78	-0.57	-0.53	-0.48	-0.43	-0.36	-0.29	-0.21	-0.08	0.05
10-yr Govt. Bond Yield	-0.35	-0.07	-0.33	-0.58	-0.34	-0.28	-0.23	-0.18	-0.13	-0.07	-0.02	0.03	0.08
30-yr Govt. Bond Yield	0.18	0.57	0.26	-0.10	0.02	0.08	0.13	0.18	0.23	0.27	0.32	0.36	0.39
10-yr-2-yr Govt Spread	0.28	0.54	0.43	0.20	0.28	0.29	0.30	0.30	0.27	0.24	0.18	0.12	0.06
United Kingdom													
Bank Rate	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
3-mth T-Bill Rate	0.79	0.75	0.75	0.77	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
2-yr Govt. Bond Yield	0.52	0.64	0.68	0.36	0.45	0.35	0.45	0.55	0.65	0.67	0.80	0.89	0.96
5-yr Govt. Bond Yield	0.48	0.69	0.61	0.28	0.55	0.48	0.58	0.70	0.83	0.88	1.00	1.10	1.18
10-yr Govt. Bond Yield	0.69	0.99	0.83	0.40	0.65	0.60	0.70	0.85	1.00	1.10	1.20	1.30	1.40
30-yr Govt. Bond Yield	1.21	1.55	1.47	0.98	1.10	1.10	1.25	1.35	1.45	1.55	1.65	1.75	1.85
10-yr-2-yr Govt Spread	0.17	0.36	0.15	0.05	0.20	0.25	0.25	0.30	0.35	0.43	0.40	0.41	0.44

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

Global Stock Markets					
	Price Oct-30	30-Day % Chg.	YTD % Chg.	52-Week High	52-Week Low
S&P 500	3,047	2.9	21.5	3,047	2,351
S&P/TSX Composite	16,501	-1.2	15.2	16,900	13,780
DAX	12,910	4.3	22.3	12,942	10,382
FTSE 100	7,331	-1.3	9.0	7,687	6,585
Nikkei	22,843	4.4	14.1	22,974	19,156
MSCI AC World Index*	534	2.8	17.3	534	436

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

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