# Dollars and Sense:
## Financial Markets do the Monster Mash

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### Highlights

- Financial markets have been coming to grips with a number of headline risks ranging from Chinese property bubbles to soaring energy prices. Though the risks may turn out to be little more than a short-term scare for risk assets, there is a fundamental move happening in the bond markets that is likely to endure.
- The Federal Reserve is preparing to taper its Quantitative Easing (QE) program and is signaling that it is going to hike rates at a swifter pace than many had been expecting. This outcome is finally starting to be priced into fixed income markets.

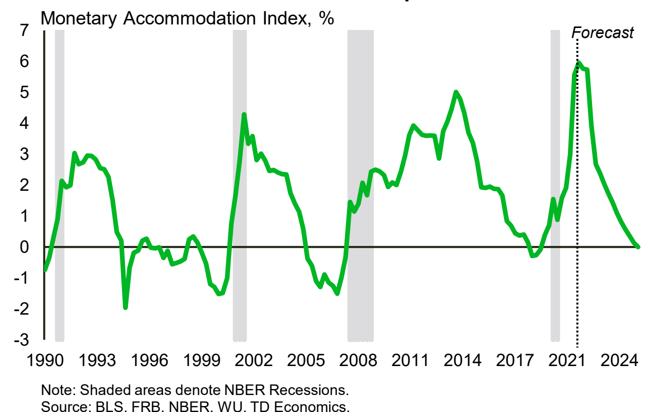
On every street, there's always that one house that kids flock to for Halloween. For me, it was the painted white clapboard house where the owner handed out full-sized bags of chips and chocolate bars packaged into a brown lunch bag for every child. The expectations within the neighborhood set in and more kids arrived every year. The owners kept up their efforts knowing they couldn't possibly reduce the treats they gave out.

Halloween is once again upon us, but this year central banks are getting ready to reduce the treats they will be handing out. All the while, government brinkmanship and global risks have come back to haunt financial markets. Equities have been volatile and soaring energy prices have brought back memories of the 1970s. Added to the list of events are woes from China's real estate giant, Evergrande, amongst others. And, not to be overshadowed, we have a U.S. government that can't seem to resolve an ongoing saga of debt ceiling limitations beyond temporary and short-term options. All of this has investors wondering, is this a trick or a treat? Buy the dip or pull back risk exposure? For fixed income investors, bond yields across major economies have started to rise. Although financial market volatility could prove to be as short-lived as a sugar high, we believe the rise in yields will endure.

### Central Banks Hand Out Less Candy

We have seen central banks become consistently more confident in the strength of the global economic recovery. For the Federal Reserve (Fed), members have pulled forward the start of the rate hiking cycle into 2022 (from a prior expectation of 2023 in June, and a consensus for 2024 back in the March DOT plot). Additionally, it is widely expected that the Fed will begin tapering its balance sheet in December and will end net-new Quantitative Easing (QE) by the middle of next year. Simply put, the Fed will be exerting less influence on bond yields.

**Chart 1: Monetary Accommodation Provided by the Fed is Still Ample**




Note: Shaded areas denote NBER Recessions.
Source: BLS, FRB, NBER, WU, TD Economics.

They are not alone in pulling back on monetary stimulus. We have already seen the Reserve Bank of New Zealand, the Bank of Korea and the Norges Bank lift policy rates off the floor. The overarching theme is that the 'normalizing economy' no longer warranted crisis management policy. As the economic rebound continues, rising inflation and asset price growth (housing) will be a thorn in the side of central bankers. This is why the Bank of England and Bank of Canada aren't too far behind. They are quickly preparing to end QE and may be in a position to hike policy rates in short order. Even the European Central Bank, which has provided an exorbitant amount of stimulus over the past decade, is prepping markets that the 'crisis phase' of the pandemic is over and the emergency programs are no longer needed.

## Don't Fear Less Loose Policy

The evolution of central bank policy has brought about lots of client questions. Many are worried that tighter policy will thwart the economic rebound. That it will reduce lending, profits, and even cause a stock market correction. To that point, we'd argue that less loose monetary policy doesn't mean tight monetary policy.

When a central bank says it is going to reduce the amount of bonds it is buying (or eliminate bond purchases altogether), it is merely easing its foot off the monetary accelerator. It is still stimulating the economy, just to a lesser degree. This is because bond purchases are supplemental to the main instrument, the policy rate. While the central bank can anchor short rates with its policy rate lever, it uses QE and forward guidance to weigh down the long end of the yield curve. As most people, businesses, and governments borrow at longer maturities, holding down long-term rates incentivizes more borrowing. Though this policy helped the economy bounce-back very quickly, central bankers run the risk of erring too much on the side of caution.

For the Fed, tapering and ending QE should be viewed as the first step in allowing the economy to stand on its own two feet. With U.S. policy rates at the floor, there is a ton of monetary support still in the system. In Chart 1, our Monetary Accommodation Index shows the amount of room for the Fed to cut policy support before its actions become restrictive. By this estimate, the Fed will still be providing monetary stimulus to the economy through 2024.

## Watch the Bond Market Reaction

Since the Fed began pivoting its communication towards less monetary support in March 2021, the U.S. 10-year yield declined from a peak of 1.74%, to a low of 1.19% in August. This move ran counter to the Fed's rhetoric because market participants were focused on the temporary slowdown in economic momentum related to the Delta variant. Now that case counts are on the decline and the economy is showing resilience, the market mindset has started to change. Yields have risen decisively over the last month, with the 10-year pushing above 1.6%.

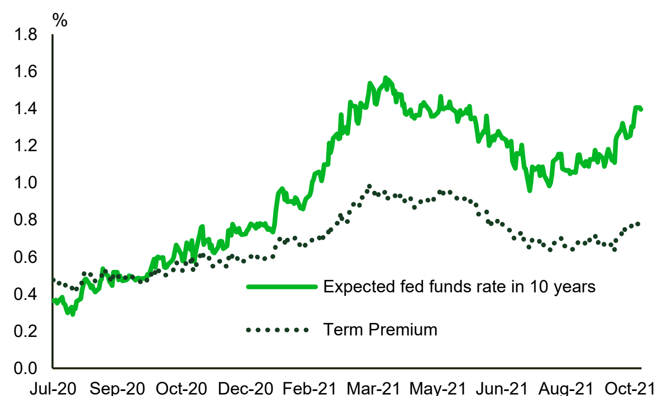
Adding to the direction has been the persistence of high inflation and its implication for the future path of Fed policy. As we have been warning, supply-chain issues can last for a lot longer than people think. And even when it gets resolved, the demand push from the underlying strength of the economy will keep inflation higher than the pre-crisis period for years to come. This adds to the motivation that central bankers should ensure that policy reflects the balance of risks.

Breaking down the yield curve into expectations for the path of Fed policy and the term premium, we find that the former was twice as impactful relative to the latter in forcing yields higher over the last two months (Chart 2). This implies that markets are starting to believe the forward guidance of the Fed. It also implies that the recent move higher in yields should have staying power.

## Bottom Line

The month of October is notoriously scary. It is not just the Halloween costumes, thriller movies, or the threat

**Chart 2: Fed Expectations Driving Long-term Yields Higher**




Source: Bloomberg, TD Economics. Last observation: October 12, 2021.

of a visit to the dentist after eating too much candy. It is also the month that's credited with some of the most terrifying market crashes. There was the Bank Panic of 1907, the 1929 Stock Market Crash, and the more recent Black Monday Crash of 1987. Reading the news headlines over the last few weeks may have sent shivers down your spine. However, markets have largely kept their cool, despite the occasional bad day.

Central bankers have also shown nerves of steel by looking past the risks and focusing on the strength of the rebound. Many major central banks are removing emergency monetary policy. Whether it be ending QE or, in some instances, hiking rates, the trend is underway and starting to solidify in yields. Just like the Monster Mash, it's caught on in a flash. The party has just begun.

## Interest Rates & Foreign Exchange Rates

| Interest & Exchange Rates | | Spot Rate Oct-13 | 2021 Q1 | 2021 Q2 | 2021 Q3 | 2021 Q4F | 2022 Q1F | 2022 Q2F | 2022 Q3F | 2022 Q4F | 2023 Q1F | 2023 Q2F | 2023 Q3F | 2023 Q4F |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Interest Rates** | | | | | | | | | | | | | | |
| Fed Funds Target Rate | | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.50 | 0.75 | 1.00 | 1.25 | 1.50 |
| 3-mth T-Bill Rate | | 0.05 | 0.03 | 0.05 | 0.04 | 0.10 | 0.13 | 0.15 | 0.30 | 0.55 | 0.80 | 1.05 | 1.30 | 1.55 |
| 2-yr Govt. Bond Yield | | 0.36 | 0.16 | 0.25 | 0.28 | 0.50 | 0.80 | 1.00 | 1.20 | 1.40 | 1.55 | 1.70 | 1.80 | 1.90 |
| 5-yr Govt. Bond Yield | | 1.07 | 0.92 | 0.87 | 0.98 | 1.10 | 1.35 | 1.55 | 1.70 | 1.80 | 1.90 | 1.95 | 2.00 | 2.05 |
| 10-yr Govt. Bond Yield | | 1.54 | 1.74 | 1.45 | 1.52 | 1.85 | 2.00 | 2.10 | 2.20 | 2.30 | 2.35 | 2.35 | 2.30 | 2.25 |
| 30-yr Govt. Bond Yield | | 2.03 | 2.41 | 2.06 | 2.08 | 2.15 | 2.30 | 2.40 | 2.50 | 2.60 | 2.65 | 2.65 | 2.60 | 2.55 |
| 10-yr-2-yr Govt Spread | | 1.18 | 1.58 | 1.20 | 1.24 | 1.35 | 1.20 | 1.10 | 1.00 | 0.90 | 0.80 | 0.65 | 0.50 | 0.35 |
| **Exchange rate to U.S. dollar** | | | | | | | | | | | | | | |
| Chinese Yuan | CNY per USD | 6.43 | 6.55 | 6.46 | 6.44 | 6.49 | 6.54 | 6.59 | 6.64 | 6.69 | 6.74 | 6.80 | 6.80 | 6.80 |
| Japanese yen | JPY per USD | 113 | 111 | 111 | 112 | 112 | 110 | 108 | 106 | 104 | 102 | 100 | 99 | 99 |
| Euro | USD per EUR | 1.16 | 1.17 | 1.19 | 1.16 | 1.17 | 1.16 | 1.17 | 1.18 | 1.19 | 1.20 | 1.21 | 1.22 | 1.23 |
| U.K. pound | USD per GBP | 1.37 | 1.38 | 1.38 | 1.35 | 1.37 | 1.38 | 1.39 | 1.40 | 1.41 | 1.42 | 1.42 | 1.42 | 1.42 |
| Swiss franc | CHF per USD | 0.92 | 0.94 | 0.93 | 0.93 | 0.94 | 0.95 | 0.96 | 0.97 | 0.98 | 0.99 | 1.00 | 1.00 | 1.00 |
| Canadian dollar | CAD per USD | 1.24 | 1.26 | 1.24 | 1.27 | 1.26 | 1.27 | 1.28 | 1.27 | 1.27 | 1.27 | 1.27 | 1.27 | 1.27 |
| Australian dollar | USD per AUD | 0.74 | 0.76 | 0.75 | 0.72 | 0.73 | 0.73 | 0.73 | 0.73 | 0.73 | 0.73 | 0.73 | 0.73 | 0.73 |
| NZ dollar | USD per NZD | 0.70 | 0.70 | 0.70 | 0.69 | 0.70 | 0.70 | 0.70 | 0.69 | 0.69 | 0.69 | 0.69 | 0.69 | 0.69 |
| **Exchange rate to Euro** | | | | | | | | | | | | | | |
| U.S. dollar | USD per EUR | 1.16 | 1.17 | 1.19 | 1.16 | 1.17 | 1.16 | 1.17 | 1.18 | 1.19 | 1.20 | 1.21 | 1.22 | 1.23 |
| Japanese yen | JPY per EUR | 131 | 130 | 132 | 129 | 131 | 128 | 126 | 125 | 124 | 122 | 121 | 121 | 122 |
| U.K. pound | GBP per EUR | 0.85 | 0.85 | 0.86 | 0.86 | 0.85 | 0.84 | 0.84 | 0.84 | 0.85 | 0.85 | 0.85 | 0.86 | 0.87 |
| Swiss franc | CHF per EUR | 1.07 | 1.11 | 1.10 | 1.08 | 1.10 | 1.10 | 1.12 | 1.14 | 1.17 | 1.19 | 1.21 | 1.22 | 1.23 |
| Canadian dollar | CAD per EUR | 1.44 | 1.48 | 1.47 | 1.47 | 1.47 | 1.47 | 1.50 | 1.50 | 1.51 | 1.52 | 1.54 | 1.55 | 1.56 |
| Australian dollar | AUD per EUR | 1.57 | 1.54 | 1.58 | 1.60 | 1.60 | 1.59 | 1.61 | 1.62 | 1.64 | 1.65 | 1.67 | 1.68 | 1.69 |
| NZ dollar | NZD per EUR | 1.66 | 1.68 | 1.70 | 1.68 | 1.68 | 1.67 | 1.68 | 1.70 | 1.71 | 1.73 | 1.74 | 1.76 | 1.78 |
| **Exchange rate to Japanese yen** | | | | | | | | | | | | | | |
| U.S. dollar | JPY per USD | 113 | 111 | 111 | 112 | 112 | 110 | 108 | 106 | 104 | 102 | 100 | 99 | 99 |
| Euro | JPY per EUR | 131 | 130 | 132 | 129 | 131 | 128 | 126 | 125 | 124 | 122 | 121 | 121 | 122 |
| U.K. pound | JPY per GBP | 155 | 153 | 153 | 150 | 153 | 152 | 150 | 148 | 146 | 144 | 142 | 141 | 140 |
| Swiss franc | JPY per CHF | 122.7 | 117.4 | 120.0 | 119.4 | 119.1 | 115.8 | 112.6 | 109.4 | 106.3 | 103.2 | 100.0 | 99.4 | 98.9 |
| Canadian dollar | JPY per CAD | 91.1 | 88.0 | 89.5 | 88.0 | 88.9 | 86.6 | 84.4 | 83.5 | 81.9 | 80.3 | 78.7 | 78.3 | 77.8 |
| Australian dollar | JPY per AUD | 83.6 | 84.2 | 83.2 | 80.6 | 81.8 | 80.3 | 78.7 | 77.1 | 75.7 | 74.2 | 72.7 | 72.2 | 71.8 |
| NZ dollar | JPY per NZD | 78.9 | 77.3 | 77.5 | 76.9 | 78.0 | 76.6 | 75.1 | 73.6 | 72.2 | 70.8 | 69.4 | 68.9 | 68.5 |

F: Forecast by TD Economics, October 2021; Forecasts are end-of-period.
Source: Federal Reserve, Bloomberg.

## Commodity Price Outlook

| Commodity | Price Oct-13 | 52-Week High | 52-Week Low | 2021 Q1 | 2021 Q2 | 2021 Q3 | 2021 Q4F | 2022 Q1F | 2022 Q2 | 2022 Q3F | 2022 Q4F | 2023 Q1F | 2023 Q2F | 2023 Q3F | 2023 Q4F |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Crude Oil (WTI, $US/bbl) | 80 | 81 | 36 | 58 | 66 | 71 | 79 | 77 | 73 | 72 | 71 | 70 | 70 | 69 | 69 |
| Natural Gas ($US/MMBtu) | 5.35 | 15.83 | 2.04 | 3.56 | 2.94 | 4.36 | 5.75 | 5.50 | 3.90 | 3.80 | 4.00 | 4.10 | 3.50 | 3.40 | 3.75 |
| Gold ($US/troy oz.) | 1793 | 1951 | 1684 | 1795 | 1814 | 1790 | 1750 | 1675 | 1650 | 1625 | 1600 | 1585 | 1570 | 1565 | 1550 |
| Silver (US$/troy oz.) | 23.06 | 29.05 | 21.54 | 26.25 | 26.71 | 24.36 | 22.50 | 21.75 | 21.50 | 21.25 | 21.00 | 20.75 | 20.50 | 20.25 | 20.00 |
| Copper (cents/lb) | 432 | 474 | 303 | 386 | 440 | 426 | 428 | 415 | 401 | 390 | 374 | 370 | 365 | 360 | 355 |
| Nickel (US$/lb) | 8.61 | 9.25 | 6.82 | 7.97 | 7.88 | 8.67 | 8.28 | 7.82 | 8.19 | 8.05 | 7.94 | 7.70 | 7.50 | 7.30 | 7.10 |
| Aluminum (Cents/lb) | 139 | 139 | 82 | 95 | 109 | 120 | 126 | 119 | 115 | 107 | 102 | 100 | 98 | 96 | 94 |
| Wheat ($US/bu) | 10.80 | 10.77 | 6.51 | 7.41 | 8.53 | 10.28 | 10.75 | 9.75 | 9.50 | 9.25 | 9.00 | 8.75 | 8.50 | 8.25 | 8.00 |

F: Forecast by TD Economics, October 2021; Forecast are period averages; E: Estimate.
Source: Bloomberg, USDA (Haver).

| International Interest Rates Outlook | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Interest Rates | Spot Rate Oct-13 | 2021 | | | | 2022 | | | | 2023 | | | |
| | | Q1 | Q2 | Q3 | Q4F | Q1F | Q2F | Q3F | Q4F | Q1F | Q2F | Q3F | Q4F |
| **Germany** | | | | | | | | | | | | | |
| ECB Deposit Rate | -0.50 | -0.50 | -0.50 | -0.50 | -0.50 | -0.50 | -0.50 | -0.50 | -0.50 | -0.50 | -0.50 | -0.50 | -0.50 |
| 3-mth T-Bill Rate | -0.74 | -0.66 | -0.66 | -0.67 | -0.60 | -0.60 | -0.60 | -0.60 | -0.60 | -0.60 | -0.60 | -0.50 | -0.38 |
| 2-yr Govt. Bond Yield | -0.67 | -0.69 | -0.67 | -0.69 | -0.54 | -0.46 | -0.42 | -0.36 | -0.28 | -0.19 | -0.08 | 0.04 | 0.16 |
| 5-yr Govt. Bond Yield | -0.48 | -0.63 | -0.59 | -0.56 | -0.49 | -0.41 | -0.37 | -0.31 | -0.23 | -0.14 | 0.02 | 0.14 | 0.26 |
| 10-yr Govt. Bond Yield | -0.13 | -0.29 | -0.21 | -0.20 | -0.14 | 0.01 | 0.16 | 0.32 | 0.47 | 0.62 | 0.77 | 0.93 | 1.08 |
| 30-yr Govt. Bond Yield | 0.30 | 0.26 | 0.29 | 0.27 | 0.46 | 0.61 | 0.77 | 0.92 | 1.07 | 1.22 | 1.38 | 1.53 | 1.67 |
| 10-yr-2-yr Govt Spread | 0.54 | 0.40 | 0.46 | 0.49 | 0.40 | 0.47 | 0.58 | 0.67 | 0.75 | 0.81 | 0.86 | 0.89 | 0.91 |
| **United Kingdom** | | | | | | | | | | | | | |
| Bank Rate | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.25 | 0.50 | 0.75 | 1.00 | 1.25 |
| 3-mth T-Bill Rate | 0.09 | 0.01 | 0.02 | 0.03 | 0.02 | 0.05 | 0.05 | 0.15 | 0.35 | 0.60 | 0.85 | 1.10 | 1.35 |
| 2-yr Govt. Bond Yield | 0.58 | 0.10 | 0.05 | 0.23 | 0.50 | 0.65 | 0.85 | 1.05 | 1.25 | 1.45 | 1.55 | 1.65 | 1.75 |
| 5-yr Govt. Bond Yield | 0.76 | 0.28 | 0.33 | 0.55 | 0.86 | 1.04 | 1.22 | 1.41 | 1.58 | 1.75 | 1.81 | 1.85 | 1.88 |
| 10-yr Govt. Bond Yield | 1.09 | 0.84 | 0.72 | 0.93 | 1.08 | 1.22 | 1.36 | 1.50 | 1.64 | 1.78 | 1.90 | 2.02 | 2.04 |
| 30-yr Govt. Bond Yield | 1.34 | 1.39 | 1.23 | 1.37 | 1.58 | 1.72 | 1.86 | 2.00 | 2.14 | 2.28 | 2.40 | 2.52 | 2.54 |
| 10-yr-2-yr Govt Spread | 0.51 | 0.75 | 0.66 | 0.70 | 0.58 | 0.57 | 0.51 | 0.45 | 0.39 | 0.33 | 0.35 | 0.37 | 0.29 |

F: Forecast by TD Economics, October 2021; Forecasts are end-of-period.
Source: Bloomberg.

| Global Stock Markets | | | | | |
|---|---|---|---|---|---|
| Major Market Indexes | Price Oct-13 | 30-Day % Chg. | YTD % Chg. | 52-Week High | 52-Week Low |
| S&P 500 | 4,364 | -2.1 | 16.2 | 4,537 | 3,270 |
| DAX | 15,249 | -2.3 | 11.2 | 15,977 | 11,556 |
| FTSE 100 | 7,142 | 1.6 | 10.5 | 7,220 | 5,577 |
| Nikkei | 28,140 | -7.4 | 2.5 | 30,670 | 22,977 |
| MSCI AC World Index* | 713 | -3.3 | 10.4 | 748 | 551 |

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