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MONTRÉAL EXCHANGE

October 2023

October Bank of Canada Decision

The decision that awaits the Bank of Canada on the 25th of October couldn't be more delicately poised given the global context, geo-political backdrop and the evolution of Canada's own domestic economy. Let's begin with discussing some of the topics that frame the global context currently. This will provide us with a good platform to then discuss the Canadian macro-economy and implications for domestic Fixed Income markets.

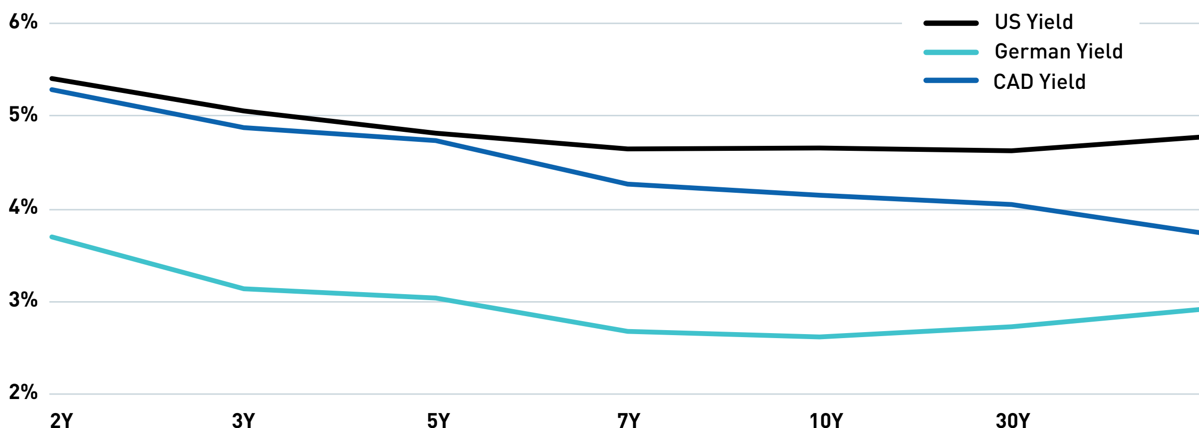
Global Macro Context

"Higher for longer"

Monetary policy globally has been tightened at a historic pace in an effort to bear down on inflationary pressures emerging from unprecedented stimulus during the COVID-19 shock, geopolitical considerations and supply chain logistics. The pace of increase and the outright level of overnight policy rates may now be deemed "**restrictive**" and central banks must tread carefully given nascent signs of slowing in interest-rate sensitive areas of the economy. Inflation remains stubborn however and well above mandated targets. This has led global central banks such as the Fed and the ECB to message a forward guidance modality to markets lest they price in an early reversal back to easier policy. Policy makers wish for markets to believe that monetary policy will remain sufficiently restrictive until inflation safely returns back to target. Market participants have understood the message creating a unique flattening of slope 1y out to 30y across the government yield spectrum as can be seen visually in the graph below.

FIGURE 1

Forward Guidance has flattened Yield Curves



Conclusions that could be drawn historically regarding the evolution of the macro-economy from the yield curve (i.e its shape and slope) are less clear under the current environment as the outright level of short term rates is being intentionally pushed out the curve as a form of monetary policy. This however has the side effect of diminishing the "information value" of yield curve analysis and makes the entire term structure particularly susceptible to incoming data.

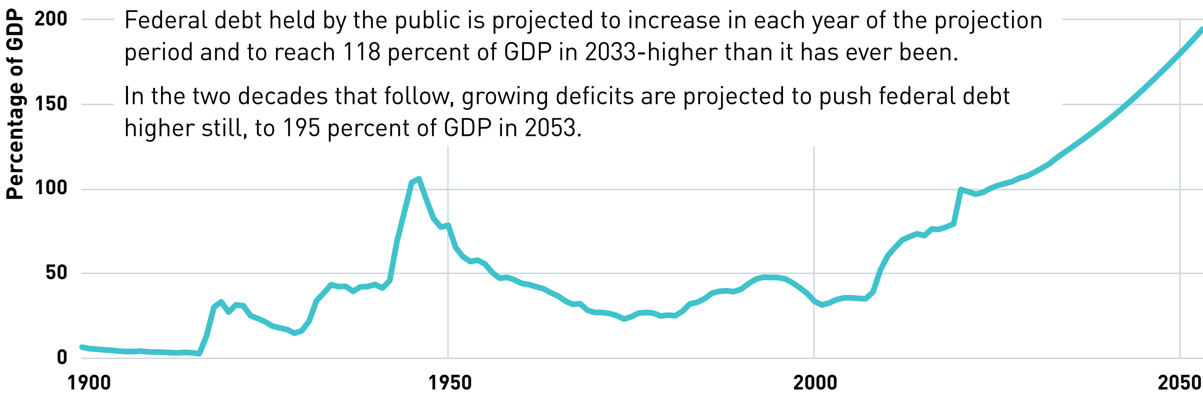
Increased market focus on Deficit Spending

The long end of the US fixed income market has been forced to think about "right pricing" these assets given recently published outlooks of US government spending (see chart below), trend dynamics in foreign ownership of US government bonds & QT by the Federal Reserve. Demand remains strong however for short term US debt, in part due to the outright risk free yield they deliver.

Volatility in bond markets for the most part has remained manageable and a repricing may even be seen as a "healthy re-rating" given supply/demand conditions. If, however, markets sought to price in a higher risk premia for these assets too quickly, it could have important implications for monetary policy and risk assets in general.

FIGURE 2

Federal US Debt held By the Public , Historical & Projected



USD Strength

The USD has remained incredibly resilient across a broad basket of currencies given its relative "real yield" advantage. While a "strong dollar" is beneficial for the US both in terms of fighting inflation and keeping demand for US assets steady, it has important implications for other central banks when weighing their respective policy options and inflation fighting efforts. A policy prescription which generates an undesired weakening in the domestic currency vs the USD can make the job of returning inflation safely back within target even more difficult than it is currently proving to be.

FIGURE 3

The Dollar has been in a Bull Market as of late

Energy price volatility

Price fluctuations in energy markets have become more volatile since the summer after a period of relative stability. Prices have risen on geo-political considerations and may be a source of continued volatility in the weeks and months ahead given the recent rise in Mideast tensions. Predicting the "**net impact**" on headline inflation and consumer demand will be problematic to gauge at this juncture as will the hit to global risk sentiment. It will be prudent for policy makers to buy time before reacting too quickly to what could potentially end up being a temporary stagflationary shock.

FIGURE 4

Crude Oil Prices Have Been Volatile

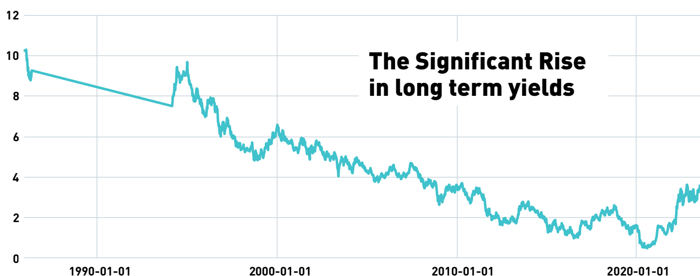
Canada Macro Landscape

Domestic data

Domestic data has exhibited some signs of slowing as a result of lagged effects from a more restrictive monetary policy. Housing activity and prices continue to level off while job creation in cyclical sectors of the economy such as finance and real estate construction exhibit early signs of exhaustion (Sep 23 Jobs report). Retail sales however are proving resilient and headline consumer price growth is still well above target.

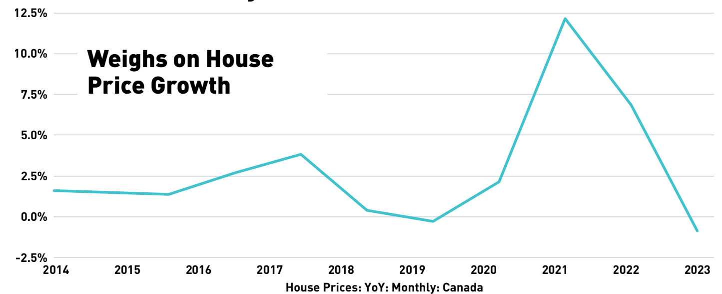
FIGURE 5

Canada Government Bond 10Y



Source: Koyfin

Canada Monthly House Prices YoY



Source: ceicdata.com | CEIC Data

Domestic Risk Assets

Bank equity has continued to languish in response to concerns around the health of the real estate sector and the consequent rise of PCL's and its effect on earnings growth. Housing related REITS have been under significant pressure both due to higher funding costs and slowing in housing related activity. The energy sector has outperformed partially in response to higher global energy prices.

FIGURE 6
TSX Returns have Stagnated

The Canadian Dollar

The CAD/USD exchange rate has remained at relatively weak levels in recent months due to general dollar strength (as discussed earlier). The US's lower household Debt/Gdp ratios as compared to Canada will be particularly important for currency market sentiment as we enter into later stages of the tightening cycle. This can be problematic from the BoC's perspective as a weakening Canadian dollar at this stage will further complicate the task of returning inflation safely back within its 2% target.

FIGURE 7
Canadian Dollar has been relatively weak

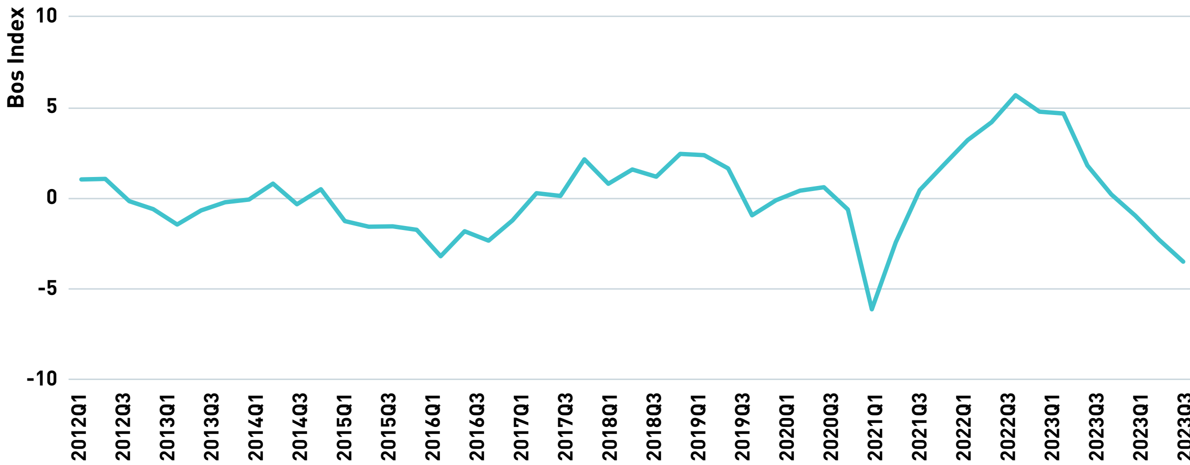
The BoC Decision

The Bank of Canada is likely to keep the overnight rate unchanged on the 25th of October, continuing with its policy of reducing the balance sheet and signaling to markets that it stands ready to raise rates further should conditions warrant. While headline inflation has remained sticky, core prices show a clear softening trend. The Bank will be pleased.

Softening on the activity front is apparent as well, evidenced in the latest release of the Bank's Business outlook Survey which showed a further deterioration in the third quarter. Businesses continue to expect sales volumes to decline, labor shortages to ease and for the impact of tightening credit conditions to weigh on their respective businesses. Global trends in fixed income have also pushed up yields at the long end of the curve which will tighten domestic credit conditions further. Given this context, the Bank can continue to let the already restrictive level of interest rates do the work of gently bearing down on demand and inflation.

FIGURE 8

Bos indicator deteriorates further



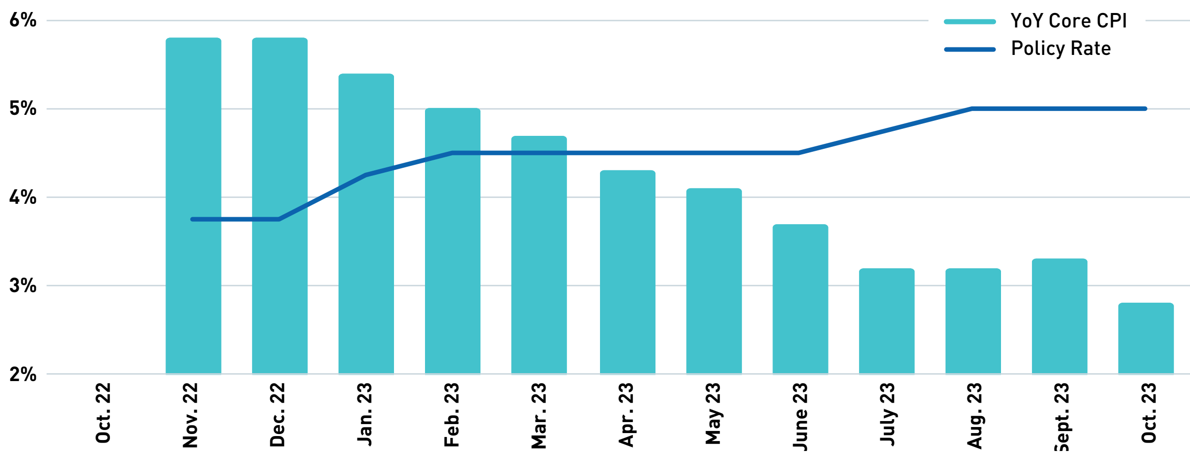
Implications for CORRA & CGB™ Futures Curve

The Bank of Canada is committed to bringing down inflation safely back within target and current monetary policy has been set restrictive enough to continue to weigh down both on cyclical sectors of the economy and inflation. Therefore, from an outright value perspective, the front end of the Canadian curve (**either via the front 4 strip of Corra futures or TwoYear Government of Canada Bond Futures (CGB**) is attractive. With core prices now at 2.8%, the roughly 5% yield offered by the front end of Canada looks appealing from a real yield perspective (see chart below). Should current BoC policy indeed achieve its goals, a shift to easier policy would also make owning the front end, on an outright basis, logical sense.

Front end looks attractive from a real yield perspective

FIGURE 9

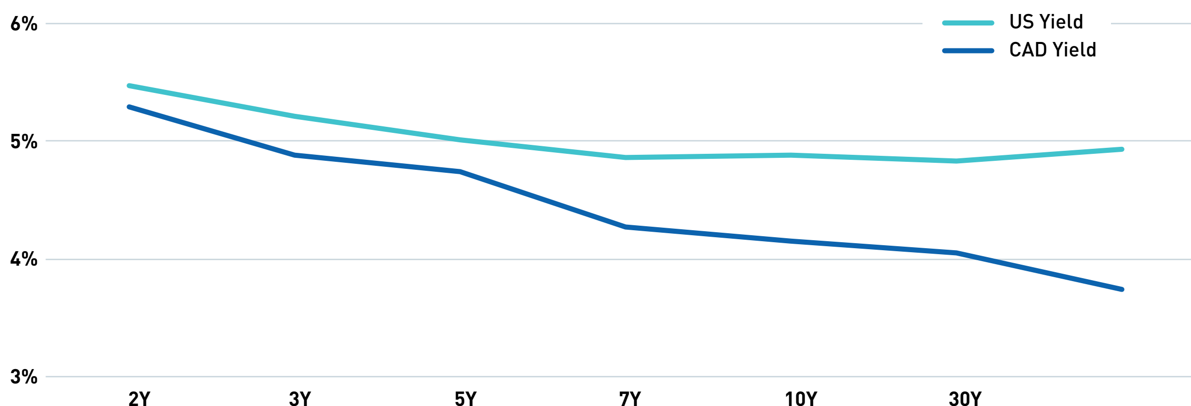
Core inflation less o.n rate yields real rate of 3.2%



The long-end however seems a tougher sell. Global concerns regarding government deficits and volatility of energy prices could continue to push up risk premiums further out the curve while forward guidance pushes up bond yields arithmetically the longer overnight policy remains restrictive. As the market prices in these factors and the domestic Canadian economy naturally slows down we expect the 2s vs 10s portion of the Canadian curve, currently trading at -80 bps, to continue to steepen towards more normal levels from a historical perspective.

Long end looks rich relatively to the US

FIGURE 10
Canadian Lond end rich end rich relativity



Combining a value analysis on the front end with macro-economic considerations on the **long end, one might consider a strategy involving long 2yr CGZ futures** and short 10yr CGB futures, with an eye on the possibility of a yield curve adjustment towards parity.

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