



February 2024

Forecast Summary

By Taylor Schleich & Warren Lovely

- Push back. That's been the name of the game since the late(r) stages of 2023, as once-rabid speculation over a near-term pivot to lower policy rates has faded... and faded badly. A host of economic releases and central bank communications have economists and markets pushing back the timing of interest rate cuts. Our own forecast revisions respond to these same cues.
- While we never endorsed a March FOMC rate cut, the ongoing resilience of the U.S. economy—combined with the most-recent setback on the road to price stability—suggests Powell & Co. could be in even less of a hurry to ease. True, the Fed is at least willing to discuss lower rates and most (all?) FOMC members believe less-restrictive policy will be appropriate before the year is out. But we now see July as a more likely timeframe for the first FOMC cut, the proverbial policy pivot pushed back one meeting vs. our prior forecast.
- In starting later, we view it likely that cumulative policy rate relief will be on the order of 100 bps in the second half of this year, surpassing the median amount of easing implied by December's 'dot plot' but less forceful than our prior thinking. Notwithstanding a non-trivial upgrade to our U.S. growth forecast, distinctly sub-potential growth and a rising incidence of joblessness would make an argument for additional easing into 2025.
- The Bank of Canada likewise seems in less of a rush to initiate monetary policy easing. In Canada's case, it's not so much because the economy has defied gravity. It hasn't. Beyond a somewhat firmer-than-expected profile for monthly GDP, cracks have formed in the Canadian economy. The labour market has softened, consumers are adopting a somewhat cautious stance and businesses remain understandably reluctant to invest.
- The noted difficulty or complication for the BoC, however, is stalled progress on the road to price stability. While the inflation picture remains fluid, recent CPI momentum indicators are not where the central bank would like them to be, with short-term inflation expectations still elevated and wage growth far too brisk (from a price stability perspective). This is not your mother's or even your grandmother's style of stagflation, but the combination of stagnant economic activity and sticky inflation makes for difficult policy making.
- As is increasingly apparent, one of the greatest risks to the Canadian inflation outlook is demography, and more specifically the intense shelter inflation being thrown off by truly exceptional population growth. Critically, Canada's population surge shows little signs of abating. At the risk of overplaying a single number/report, the underlying population figures attached to January's Labour Force Survey had us second guessing an assumed moderation in population growth for 2024. Population may well swell more than the BoC has assumed.
- As we noted recently, more heads (as in more population) could well mean fewer and slower rate cuts from the BoC... unless or until the central bank opts to look through sticky shelter inflation. All that to say, April now appears to be too premature for the first BoC rate cut. June may be a more viable timeframe, although even that delayed rate call hinges on receipt on some marginally dovish data. So it's push back in Canada too, even if our sub-consensus growth makes a case less restrictive policy settings. We now assume 125 bps of rate cuts from the BoC this year, the overnight target rate ending 2024 at 3.75%. The policy rate could approach 3% in the first half of 2025, but again we stress that the way forward for the BoC is uncertain, with the central bank's own assessment of potential needing to be clarified. (April's MPR will be important in that regard.)

United States

Quarter	Fed funds	3-month	2-year	5-year	10-year	30-year
15-Feb-24	5.50	5.39	4.55	4.21	4.22	4.40
Q1:2024	5.50	5.40	4.60	4.25	4.30	4.45
Q2:2024	5.50	5.30	4.45	4.15	4.20	4.35
Q3:2024	5.00	4.75	4.15	3.90	4.05	4.25
Q4:2024	4.50	4.20	3.80	3.60	3.85	4.05
Q1:2025	3.75	3.40	3.25	3.25	3.55	3.85
Q2:2025	3.25	3.05	3.10	3.15	3.50	3.85
Q3:2025	3.25	3.10	3.15	3.30	3.65	3.90
Q4:2025	3.25	3.15	3.25	3.40	3.75	4.00

Canada

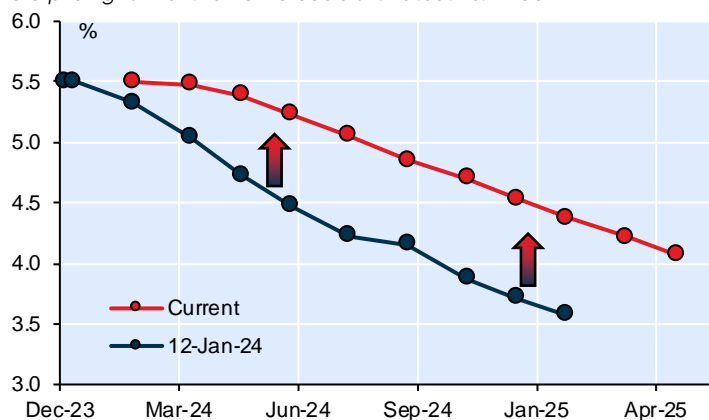
Quarter	Overnight	3-month	2-year	5-year	10-year	30-year
15-Feb-24	5.00	5.02	4.23	3.66	3.52	3.38
Q1:2024	5.00	5.00	4.20	3.65	3.55	3.40
Q2:2024	4.75	4.60	4.00	3.50	3.45	3.30
Q3:2024	4.25	4.05	3.65	3.25	3.25	3.20
Q4:2024	3.75	3.45	3.25	2.95	3.00	3.05
Q1:2025	3.00	2.85	2.70	2.60	2.75	2.85
Q2:2025	2.75	2.65	2.60	2.55	2.70	2.85
Q3:2025	2.75	2.70	2.70	2.75	2.90	2.95
Q4:2025	2.75	2.70	2.80	2.90	3.05	3.10

FOMC Update: Patience and prudence pays off

In the lead-up to the first Fed decision of the year, front-end rates markets were discounting more than 150 basis points of 2024 rate cuts, with easing expected to kick off in March. The late January meeting was therefore one of expectations management. Despite six months of “good” inflation news, Chair Powell stressed that more confidence was needed to begin the process of normalizing policy. As the Fed Chair plainly stated, it’s unlikely this confidence threshold will have been met by March. At the same time, an acknowledgement that the December SEP (which showed three 25 bp rate cuts) is still a good indicator of “where people are” would serve to push back on the total easing priced this year.

Powell, then prices, push back on rate cut timing

OIS pricing for next 10 FOMC decision: Latest vs. 12-Jan

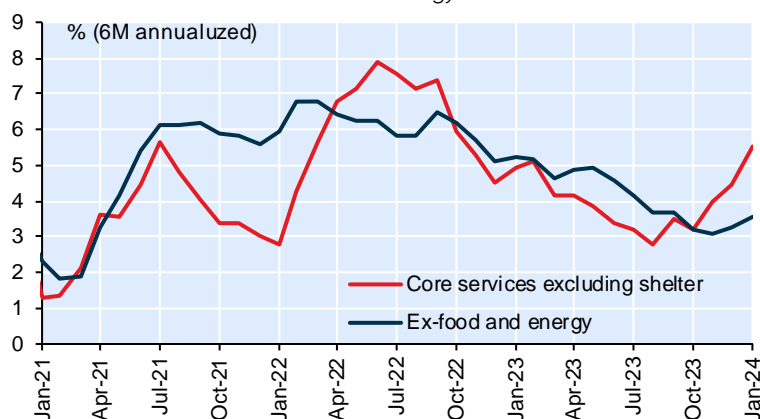


Source: NBF, Bloomberg | Note: Fed funds pricing adjusted for upper bound concept

Markets took notice and stripped out some of the easing that had been expected. Stronger-than-expected labour market data stripped out a bit more. However, with only consistent disinflation to go off, there’d been nothing to suggest that a strong economy *couldn’t* coexist with on-target prices pressures. Even if it wasn’t by March, inflation looked to give the green light to ease meaningfully later this year. That changed in February after an updated read on consumer prices. No matter how you slice it, the January CPI report was hot. Both the headline and core index surprised higher, with ex-food and energy prices advancing at the quickest pace since May. Even more discouraging was the jump in core services excluding shelter, a measure of underlying inflation that Powell has favoured.

Underlying inflation appears to be gaining momentum

6M annualized inflation: CPI ex-food & energy and core services excl. shelter



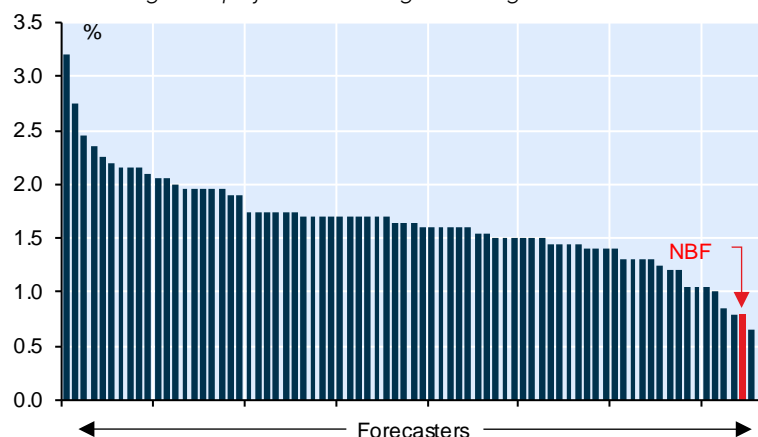
Source: NBF, Bloomberg, BLS

Yes, one month of inflation data does not make a trend. It’s possible January was a blip on the previously smooth path towards price stability. However, anyone looking at the economy through the lens of an output gap or Phillips curve should be skeptical that inflation can fall to 2% and stay there sustainably given the above-potential GDP growth and below-NAIRU unemployment. Jerome Powell may believe that the ‘last mile’ of inflation declines won’t be any more difficult than earlier declines but, as long as current economic conditions persist, we’d strongly disagree. Policymakers can’t have their cake and eat it too.

As our sister publication—[the Monthly Economic Monitor](#)—makes clear, we remain skeptical of the widespread view that a soft landing will be achieved. As a result, our U.S. growth outlook remains decidedly below-consensus. However, having underestimated the strength/momentum of the economy in Q4, the slowdown in our forecast has been delayed a few months. Naturally then, so too has our expected timing for the Fed’s initial rate cut. We now see July as the most likely time for the Fed to start the process of policy rate normalization, which is one meeting later than markets have been willing to discount.

We’re retaining our sub-consensus growth forecast

U.S. real GDP growth projections: Average annual growth 2024-25



Source: NBF, Bloomberg | Note: Forecasts via Bloomberg’s ECFC page as of 14-Feb.

In the second half of the year, when we see more material weakness taking hold, there will be scope for a relatively fast pace of rate cuts. So, despite a slightly later starting point, we see the Fed catching up to market expectations by year-end and easing even more aggressively in the first half of 2025. This outlook is consistent with 2-year yields trading water over the coming months and quickly declining thereafter. In a year’s time, we believe 3% will be in striking distance for the shorter end of the yield curve.

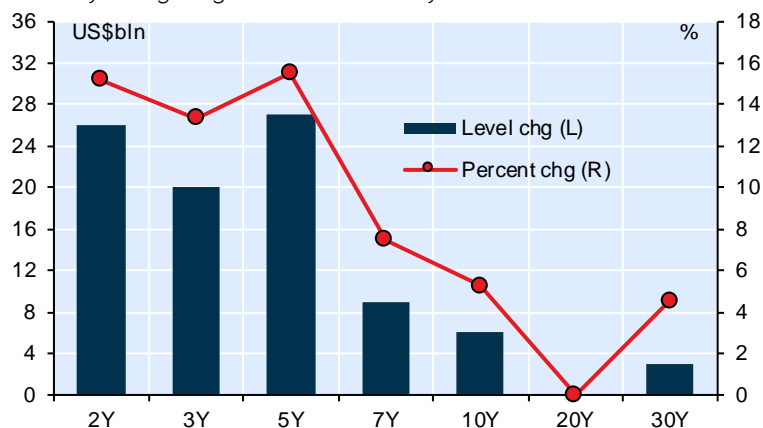
When it comes to the outlook for longer-term rates, the Treasury market was able to take a sigh of relief in the first quarter. A fresh Quarterly Refinancing Announcement revealed borrowing needs for the U.S. government were not as great as some had feared. In addition, increases in auction sizes were disproportionately steered to the shorter end of the curve, limiting the amount of duration investors will need to take down over the coming months. Moreover, the Treasury signaled that further increases (in the next QRA) may not be necessary.

No doubt, this is good news for a market that bemoaned increases in bond supply in the later summer of 2023 and sent yields spiking

higher. But keep in mind, higher-than-expected cash balances can be attributed to a heretofore resilient economy that's kept fiscal revenues healthy. To the extent this continues, there may be more relief in store for the longer end. However, we're more concerned about risks moving back the other way, particularly given our sluggish growth outlook in the years ahead.

New UST supply disproportionately steered to shorter end

Quarterly change in gross nominal Treasury issuance

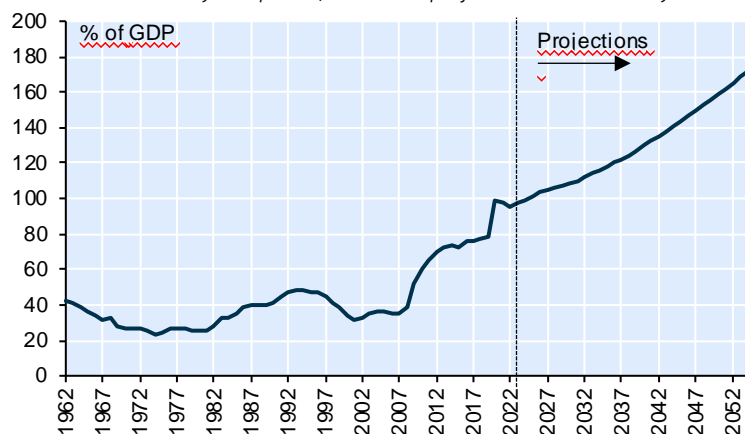


Source: NBF, U.S. Treasury

There's no clear plan to tackle the outsized U.S. deficit and there's a risk that it could balloon further following the federal election later this year. After all, it's not often you see a President enter office and immediately raise taxes and/or cut spending. It's possible then, that we could see bouts of indigestion if borrowing needs were to surprise higher. Our rates forecast doesn't necessarily reflect a deficit-driven temper tantrum from the market that would see the long end de-anchor. However, the rally out the curve might not be as forceful as one would expect given 200+ basis point in policy rate cuts. Looking beyond the coming easing cycle, we expect the 30-year treasury yield to stabilize around 4%. That's not all that far off from where the long bond is trading today.

Left unattended, the national debt will explode higher

Federal debt held by the public, with CBO projections for next 30 years



Source: NBF, CBO

BoC Update: Stagflation nation

It's too early to be talking about rate cuts. That was the overarching message from the Bank of Canada in the second half of 2023 and it remains their message so for this year. Unlike Powell and the FOMC,

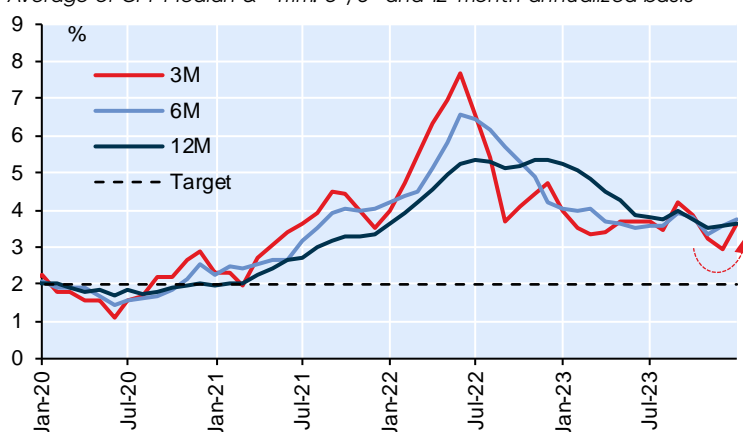
Macklem and company haven't even been willing to entertain rate cut discussions. This consistent push back has helped markets delay their expected timing for BoC easing from March/April at the start of the year to June/July today. We've been forced to adjust too.

Earlier expectations for a near-term policy pivot were not unwarranted. Just about every indicator of economic activity has slowed sharply over the past year as the economy moves from excess demand to excess supply. Even the Bank of Canada has acknowledged that a negative output gap is opening. In most circumstances, that would be consistent with rate cuts already being underway, particularly given the above-neutral starting point and the tendency to be forward-looking. Unfortunately, the indicator that matters most for the BoC—inflation—is just not cooperating.

For a moment last year, inflation momentum seemed to be cooling off. 3-month annualized CPI-Median and -Trim, the BoC's preferred measures of underlying price pressures, fell below 3% for the first time since early 2021. However, subsequent CPI data changed that assessment, these measures stubbornly returning to the 3-4% range.

Core inflation continues to hover between 3% and 4%

Average of CPI-Median & -Trim: 3-, 6- and 12-month annualized basis

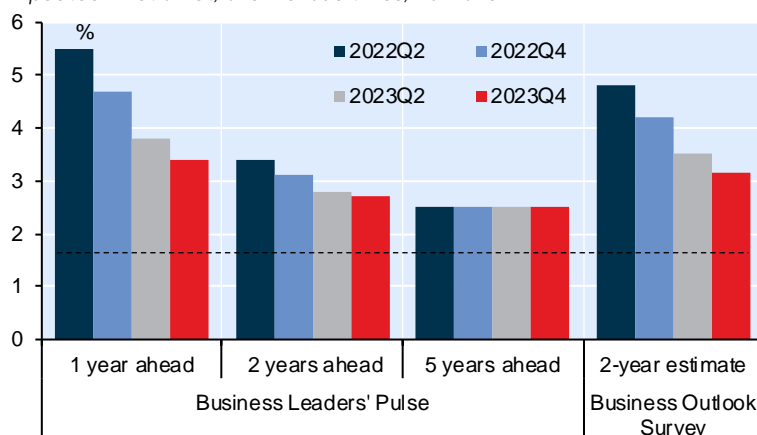


Source: NBF, StatCan

The BoC's other focus items remain somewhat problematic but are largely moving in the right direction. Near-term inflation expectations are a bit higher than policymakers would prefer but are consistently moderating. So too is corporate pricing behaviour.

Inflation expectations somewhat high but clearly moderating

Expected inflation at/over various times/horizons

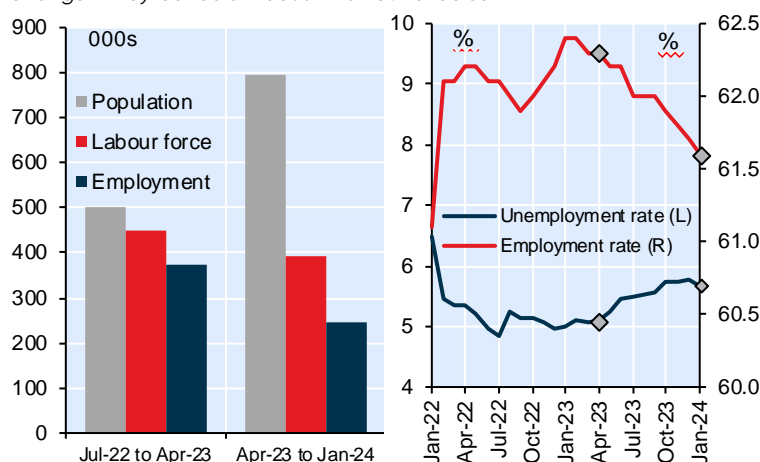


Source: NBF, Bank of Canada

Wage growth hasn't yet come back down to earth, but to us, it's just a matter of time before we see relief there given the ongoing loosening in the labour market. On this front, a surface level look at the latest jobs data might suggest that labour market conditions are tightening based on 'healthy' net hiring and a decline in the unemployment rate. But interpreting it as such would be a mistake. A steep drop in the participation rate kept the jobless rate artificially low. The employment rate, or the share of the working age population with a job, has deteriorated consistently over the past year. Moreover, the private-public sector split, and the full time-part time composition of recent job growth has been underwhelming. All that to say, we expect the impulse from businesses to pay 4-5% annual wage increases to subside this year.

Population is surging, hiring is not

Change in key Canadian labour market variables

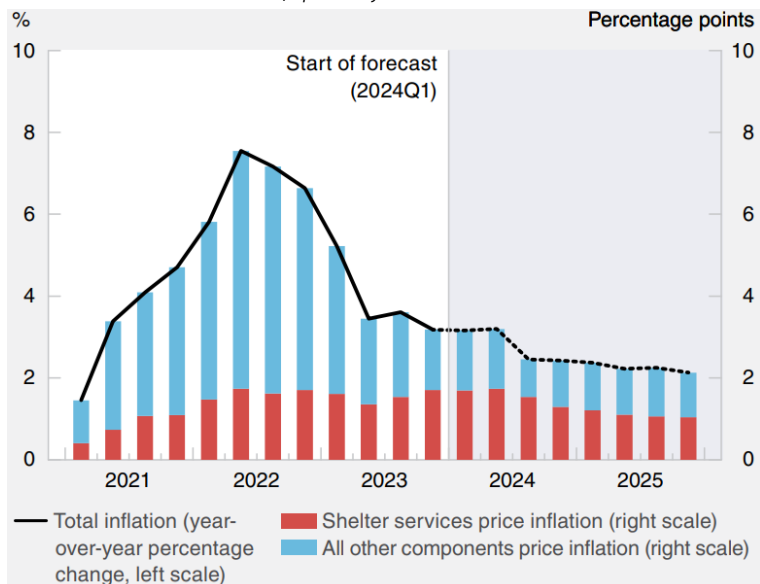


Source: NBF, StatCan

Really, what it comes down to for the BoC and the outlook for interest rates, is what happens to shelter inflation. The central bank admitted as much in their last MPR when they forecast that this single component would make up at least half of overall inflation over the next two years, despite it comprising just 28% of the CPI basket.

The BoC sees persistent shelter inflation over coming years

Contribution to CPI inflation, quarterly data



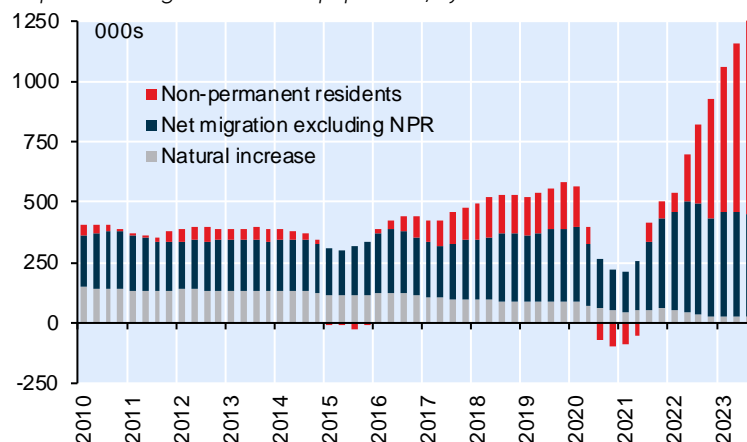
Source: Bank of Canada January 2024 Monetary Policy Report

Unfortunately, there's not much the BoC can do here. Some might suggest that the central bank should simply 'look through' red-hot rent inflation, particularly given that higher rates appear to be holding back residential construction and exacerbating the housing supply crunch. That might be a more tenable approach if we weren't coming off three years of above-target inflation. Instead, the remedy is more softness in all other CPI components, driven by more weakness in the overall economy. Fortunately, the recent jump in interest rates will help keep conditions restrictive, which is particularly important as we enter the springtime homebuying season. Policymakers surely want to avoid a repeat of last year where housing activity and prices spiked, ultimately leading to more rate hikes.

While the near-term may not offer the central bank much relief on shelter prices, we could see a deceleration later this year. Indeed, as popular support for the reigning Liberal party has crashed over the past year, the federal government is starting to heed Canadians' discontent with rabid population growth and its cost-of-living impacts. In recent weeks, there was a cap placed on the number of student visas that will be issued. Now, it seems immigration minister Marc Miller has his sights set on temporary foreign workers. These two groups accounted for most of the explosive increase in the population in 2023. Dialing this back in 2024 still leaves Canada with an above-average population growth rate, but the deceleration may be enough to take some pressure off shelter demand, allowing the BoC to dial back its monetary policy restrictiveness. That's certainly the hope for an otherwise sluggish economy.

NPRs have driven explosive population growth

4-quarter change in Canadian population, by source

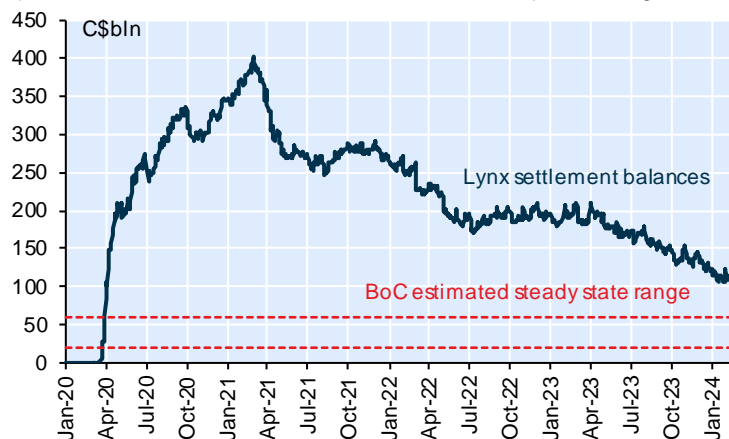


Source: NBF, StatCan

While the evolution of inflation will continue to demand most of the focus going forward, there's another aspect of monetary policy that's worth monitoring: Quantitative Tightening. As we've discussed at length before, ongoing balance sheet normalization has been draining liquidity from the banking/financial system. Settlement balances, akin to excess reserves, have dropped from \$400 billion to just above \$100 billion today. In a speech nearly a year ago, Deputy Governor Toni Gravelle noted that the evolution of these settlement balances would dictate how long QT could continue. In his view, \$20-60 billion was the likely steady state level for this variable. That means QT could continue until the end of 2024, or even into early 2025. The problem is, it's hard to have much confidence in this estimate, when we consider that this is the Bank's first foray into balance sheet policy. Even in the U.S. where QT has been done before, estimating the appropriate level of reserves is a difficult (impossible?) task.

Settlement balances approaching steady state range

Lynx settlement balance and BoC's estimated steady state range

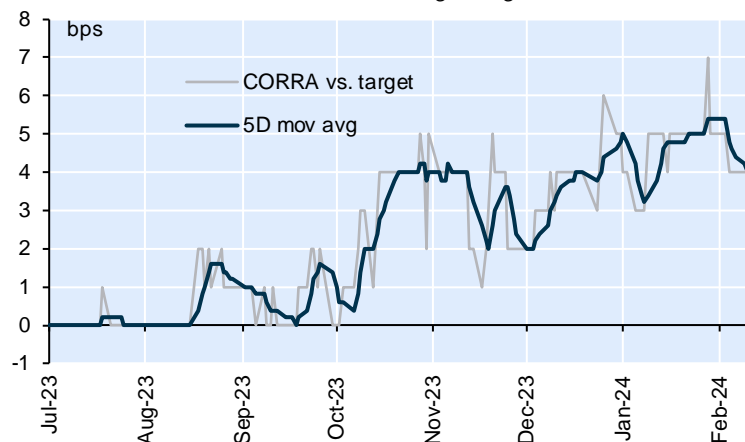


Source: NBF, Bloomberg, BoC

The BoC has highlighted key variables that help in determining when the banking system has reached a sufficiently low level of settlement balances. The predominant one is overnight repo rates and here, there's been some tension lately. CORRA, the Bank's effective policy rate, has been setting above the overnight target for 88 straight sessions and counting. Modestly higher at first, pressures intensified into year-end and have continued in 2024. CORRA is now regularly setting 4-5 basis points above target, sometimes requiring intervention via overnight liquidity injections.

CORRA has crept steadily higher in 2024

Difference between CORRA and the overnight target

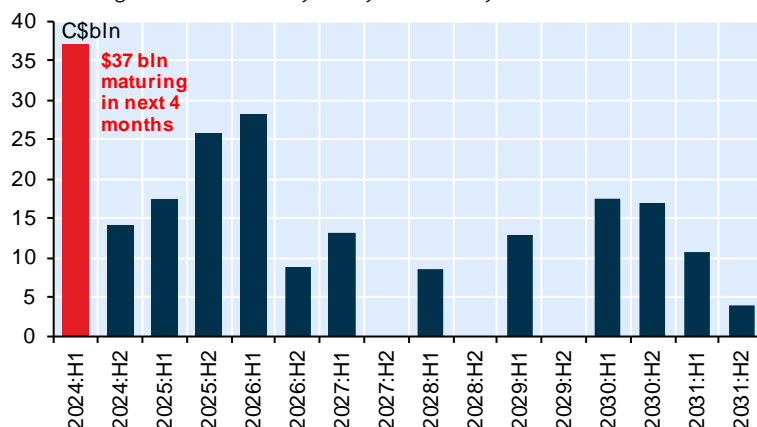


Source: NBF, BoC

Is this a sign that QT needs to end soon? Perhaps not, based on the BoC's lack of urgency/discussion in the recent policy decision. The reintroduction of receiver general cash auctions starting in late February are a sign that they want to exhaust all options to get CORRA down before ceasing balance sheet run-off. It remains to be seen if this will help moderate pressure in funding markets but if it doesn't, there's a risk upward pressure could intensify. Indeed, over the next four months, just over \$37 billion will mature from the BoC's balance sheet, which will bring settlement balances near the top of Toni Gravelle's estimated steady state range. In other words, there's a chance that a QT adjustment could come before earlier guidance. On that front, circle your calendar for March 21st. Toni Gravelle is slated to discuss QT for the first time since March 2023.

Significant run-off in coming months

BoC holdings of GoC bonds by half-year maturity bucket



Source: NBF, BoC | Note: 2024:H1 does not include February bond maturity

Monthly Fixed Income Monitor

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Interest Rates, spreads & foreign exchange: Current levels vs. those prevailing 3, 6, 9 and 12 months ago

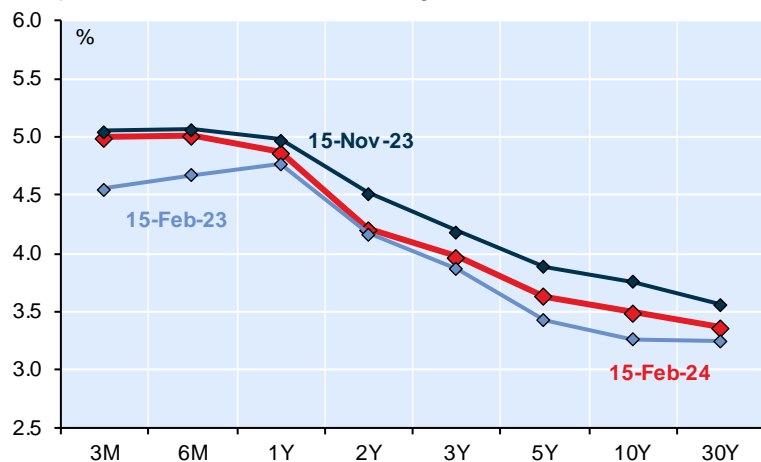
Canada						
Closing:	Current	3M	6M	9M	12M	5Y avg
Interest Rates (%)						
3M	5.00	5.03	5.13	4.48	4.54	1.94
1Y	4.87	4.96	5.30	4.67	4.75	2.14
2Y	4.21	4.52	4.80	4.05	4.17	2.01
3Y	3.97	4.19	4.55	3.87	3.87	1.97
5Y	3.63	3.88	4.13	3.30	3.42	1.93
10Y	3.50	3.75	3.77	3.10	3.26	2.01
30Y	3.37	3.56	3.61	3.11	3.24	2.22
Spreads (bps)						
3M-10Y	-150	-128	-136	-138	-128	7
2Y-10Y	-71	-76	-103	-95	-91	0
5Y-10Y	-13	-13	-35	-19	-16	8
10Y-30Y	-13	-19	-16	0	-2	21
Currencies						
USD/CAD	1.35	1.37	1.35	1.35	1.34	1.31
EUR/CAD	1.46	1.48	1.47	1.46	1.43	1.46

United States						
Closing:	Current	3M	6M	9M	12M	5Y avg
Interest Rates (%)						
3M	5.38	5.42	5.45	5.23	4.77	2.03
1Y	4.92	5.27	5.36	4.90	4.96	2.14
2Y	4.53	4.91	4.97	4.16	4.63	2.09
3Y	4.33	4.67	4.67	3.82	4.35	2.08
5Y	4.19	4.52	4.41	3.59	4.04	2.12
10Y	4.21	4.53	4.25	3.57	3.81	2.31
30Y	4.39	4.70	4.35	3.86	3.84	2.71
Spreads (bps)						
3M-10Y	-117	-89	-120	-166	-96	28
2Y-10Y	-32	-38	-72	-59	-83	22
5Y-10Y	2	1	-15	-2	-23	19
10Y-30Y	19	17	10	29	4	40
Currencies						
CAD/USD	0.74	0.73	0.74	0.74	0.75	0.76
EUR/USD	1.08	1.08	1.09	1.08	1.07	1.11

Source: NBF, Bloomberg | Note: values quoted in 3-month intervals from present day to the nearest trading date 3M, 6M, 9M, and 12M prior

Evolution of the Canadian yield curve

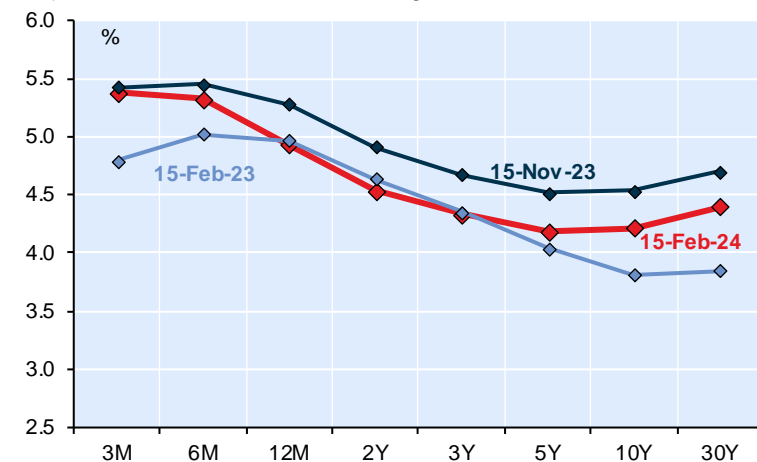
GoC yield curve: Current, 3 & 12 months ago



Source: NBF, Bloomberg

Evolution of the U.S. yield curve

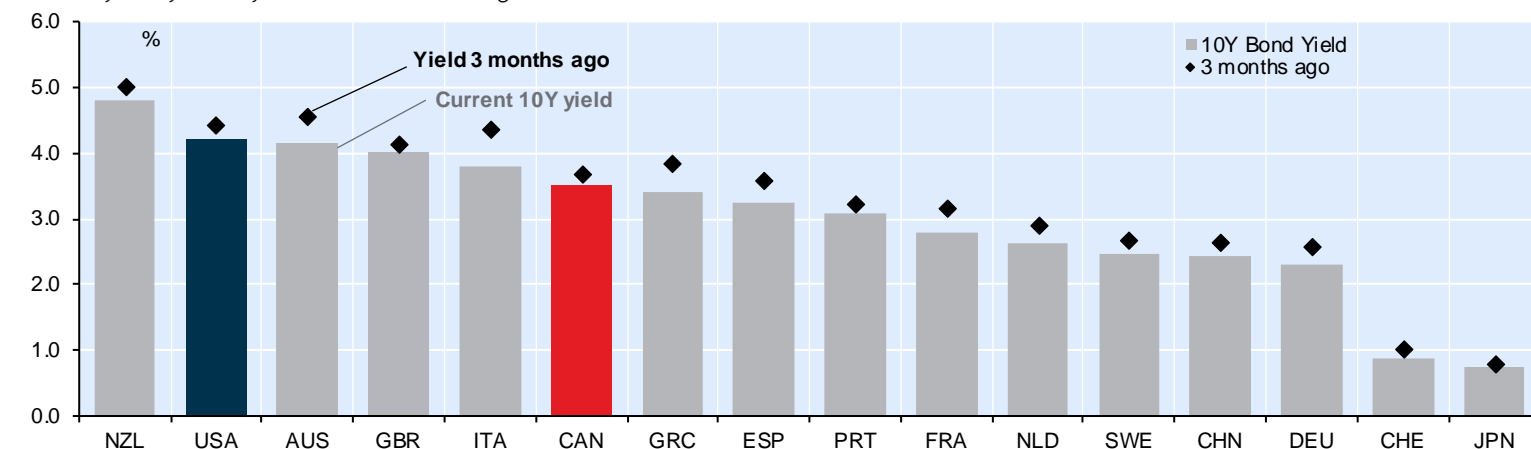
U.S. yield curve: Current, 3 & 12 months ago



Source: NBF, Bloomberg

World bond market snapshot

10Y bond yield by country: Current vs. 3 months ago



Source: NBF, Bloomberg

Monthly Fixed Income Monitor

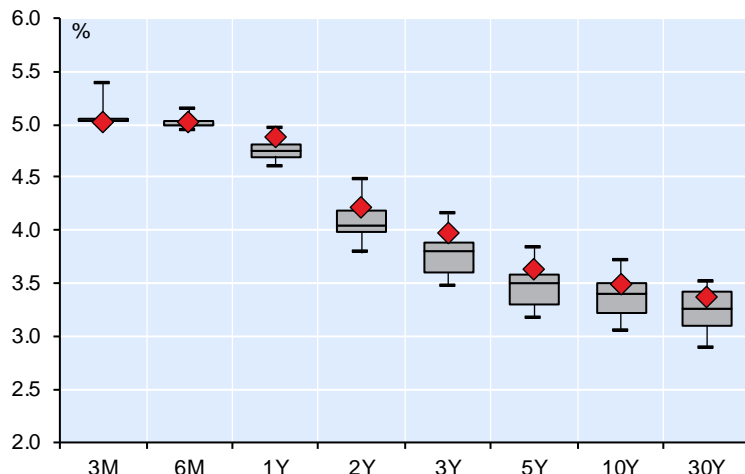
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Canadian benchmark interest rates

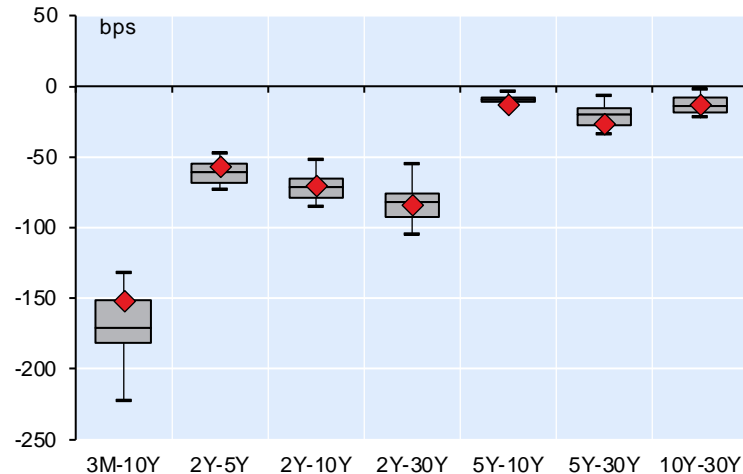
GoC benchmark bond yields: Current & 3-month trading range



Source: NBF, Bloomberg | Note: Grey box denotes 25th to 75th percentile trading range

Canadian interest rate curves

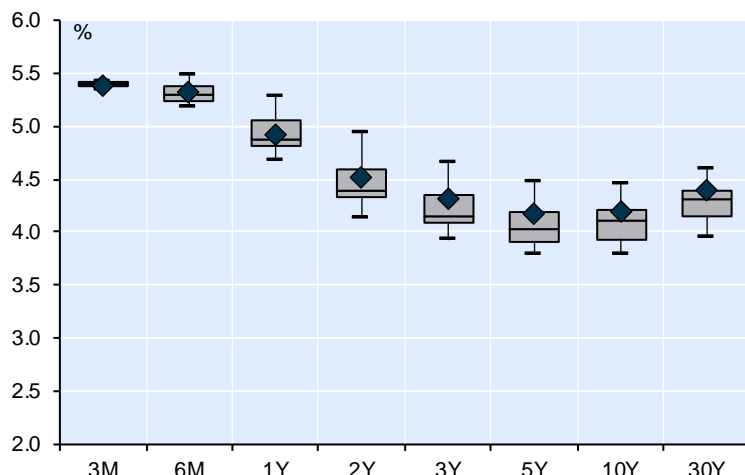
GoC benchmark bond yield curves: Current & 3-month trading range



Source: NBF, Bloomberg | Note: Grey box denotes 25th to 75th percentile trading range

U.S. benchmark interest rates

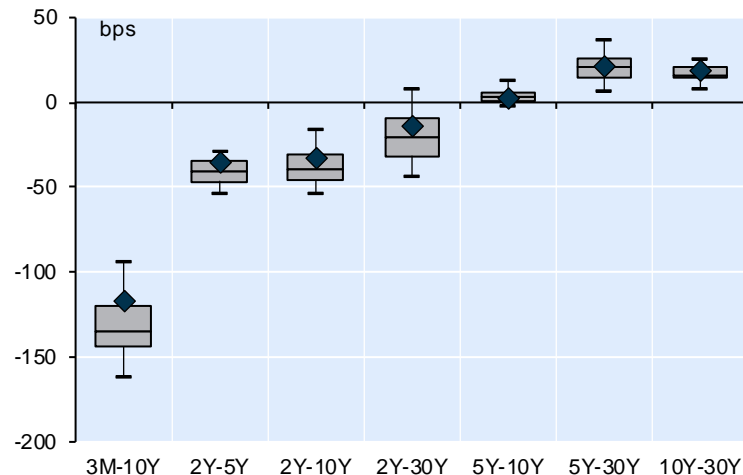
UST benchmark bond yields: Current & 3-month trading range



Source: NBF, Bloomberg | Note: Grey box denotes 25th to 75th percentile trading range

U.S. interest rate curves

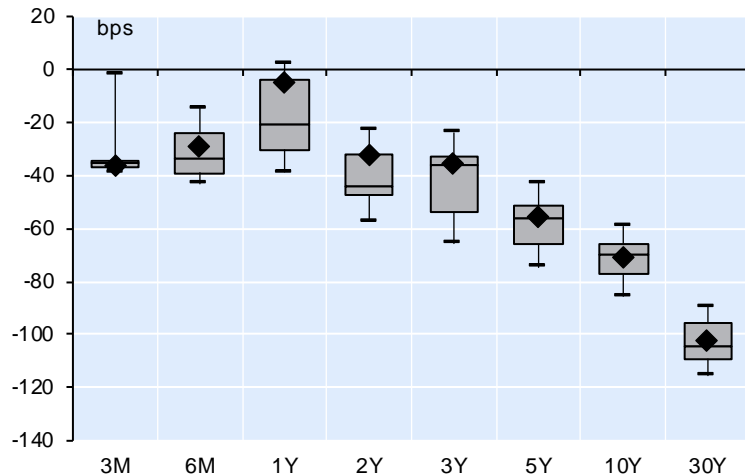
UST benchmark bond yield curves: Current & 3-month trading range



Source: NBF, Bloomberg | Note: Grey box denotes 25th to 75th percentile trading range

Canada-U.S. interest rate differentials

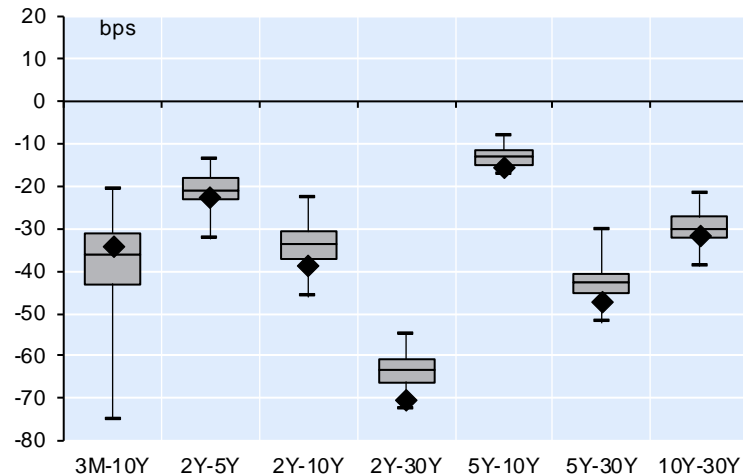
GoC-UST benchmark bond yields: Current & 3-month trading range



Source: NBF, Bloomberg | Note: Grey box denotes 25th to 75th percentile trading range

Canada-U.S. interest rate boxes

GoC-UST yield curves: Current & 3-month trading range



Source: NBF, Bloomberg | Note: Grey box denotes 25th to 75th percentile trading range



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General

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