NATIONAL BANK FINANCIAL MARKETS
A division of National Bank of Canada

MONTHLY FIXED INCOME MONITOR

June 2013

- If the economic outlook unfolds as we expect over the coming three to four months, the FOMC will gain the requisite confidence about the labour market outlook to cross the QE exit threshold latter this summer. The FOMC meeting scheduled for September 17-18, with its economic projections update and associated press conference by the Chairman, will provide the proper setting to announce a winding down of the current QE program.
- In light of the upward revision to February and March nonfarm payroll as well as our expectations that U.S. GDP growth will be somewhat stronger than what we initially projected for Q2 (1.2% currently, compared to 0.7% in our previous forecast), we are revising our interest rate projection. We now see 10-year Treasuries trading around 2.73% by year end, while the bond market will be adjusting to the winding down of QE3. Going into 2014, 10-year Canada should be trading around 2.65%, slightly below comparable Treasuries.

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Forecast dated May 29, 2013

United States

Quarters	Fed Fund	3 Mth Bill	2YR	5YR	10YR	30YR
05/28/13	0.250	0.035	0.288	1.017	2.165	3.322
Q2	0.250	0.075	0.258	0.937	2.064	3.232
Q3	0.250	0.085	0.353	1.221	2.429	3.535
Q4	0.250	0.085	0.434	1.459	2.732	3.810
Q1/14	0.250	0.107	0.522	1.572	2.846	3.866
Q2	0.250	0.107	0.798	1.764	2.962	3.942
Q3	0.250	0.107	0.913	1.886	3.073	4.003
Q4	0.250	0.107	1.217	2.088	3.185	4.064

Canada

Quarters	Overnight	3 Mth Bill	2YR	5YR	10YR	30YR
05/28/13	1.000	1.003	1.064	1.475	2.074	2.662
Q2	1.000	0.945	1.030	1.428	2.025	2.632
Q3	1.000	0.982	1.144	1.667	2.310	2.887
Q4	1.000	0.982	1.195	1.918	2.652	3.163
Q1/13	1.000	0.982	1.454	2.129	2.806	3.276
Q2	1.000	0.982	1.568	2.281	2.962	3.402
Q3	1.000	0.982	1.698	2.436	3.113	3.463
Q4	1.000	1.210	1.829	2.600	3.275	3.575

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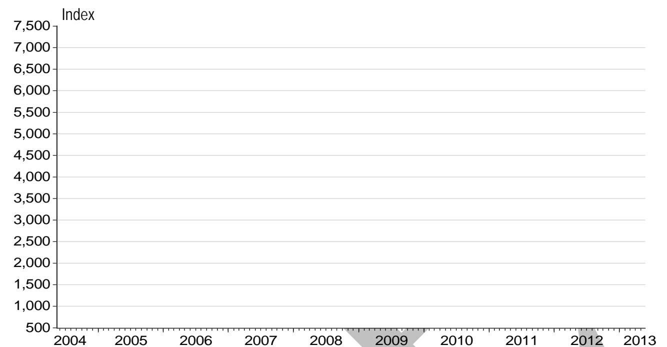
Unlocking the exit door

Early this year it was widely expected that U.S. economic growth would be slowed by fiscal drag. The indicators released so far in this quarter have supported this view. Moreover, with the euro zone turning in a sixth straight quarterly contraction in Q1, U.S. exports have had little support from global growth. Manufacturing output in April was down 0.4% from March, a second straight monthly contraction. In May the Empire State manufacturing index and the Philadelphia Fed index both dropped below zero, suggesting a third straight month of manufacturing weakness. These numbers have aroused concern about the outlook for the labour market. It has been improving lately, but the jobless rate remains quite high. Meanwhile, 12-month inflation excluding food and energy came in at 1.7% in April. Three-month headline inflation was running at a three-month low of 0.5% annualized and core inflation at a seven-month low of 1.3%. In other words, indicators of both employment and inflation suggest that the FOMC can wait a while before peeking through the exit door.

True, most forecasters see GDP growth picking up in the second half. Our own forecast is for a second-half reacceleration to 2.4% annualized from 1.8% in the first half (2.4% Q1 and 1.2% in Q2). However, there is reason to believe it will take a few months more for the FOMC to become confident enough about the U.S. economic outlook to start dialling down its asset purchases.

Homebuilding has been contributing to growth, with starts over the last three months up 30.8% from the same period last year. Per-capita consumer spending has recovered fully from its abrupt decline during the recession. With both home prices and the equity market on the rise, consumers have shown some willingness to spend despite the modesty of recent income growth. It helps that low inflation makes a smaller dent in real disposable income. Money for discretionary spending is also being freed up by mortgage refinancing. The effective interest rate on the stock of outstanding mortgage debt keeps falling. In March it was 4.80%, down 163 basis points from 6.43% in 2007. The current effective 30-year mortgage rate of 3.79% is combining with home-price improvement to create an environment in which more homeowners are able to refinance their property at a lower rate.

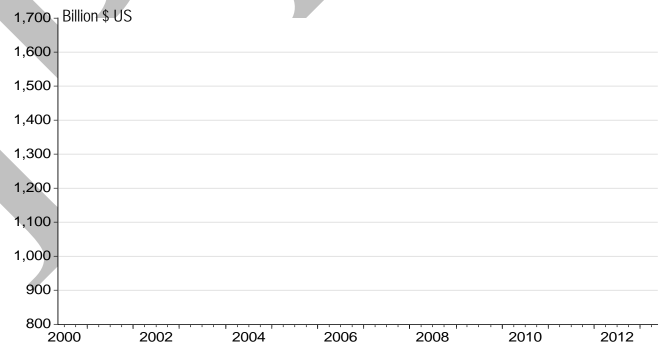
Mortgage Bankers Association refinancing index



NBF Economy & Strategy (data via Bloomberg) 2013-05-19

The sustained brisk pace of mortgage refinancing is a comfort to the FOMC. It indicates that monetary policy has some traction, a view reinforced by the growth of commercial and industrial loans.

U.S. commercial and industrial loans



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The FOMC strategy of expanding its balance sheet (buying assets) to lower risk premiums in financial markets, which supports wealth creation by nudging private investors into riskier assets, has certainly borne fruit. The S&P 500 has climbed 148% from its low of 2009, reaching new all-time highs. Meanwhile, the term premium on 10-year zero-coupon bonds has been crushed into negative territory.

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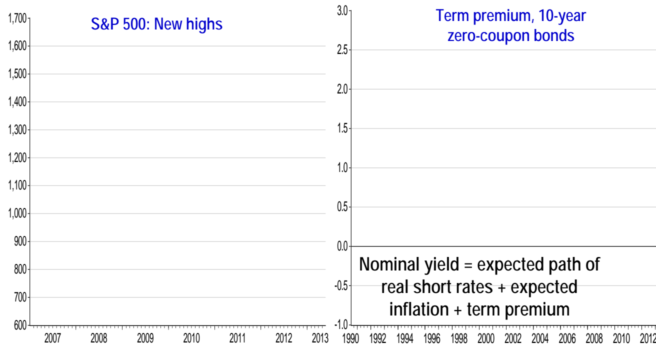
Financial markets: Driven by fundamentals or by QE?



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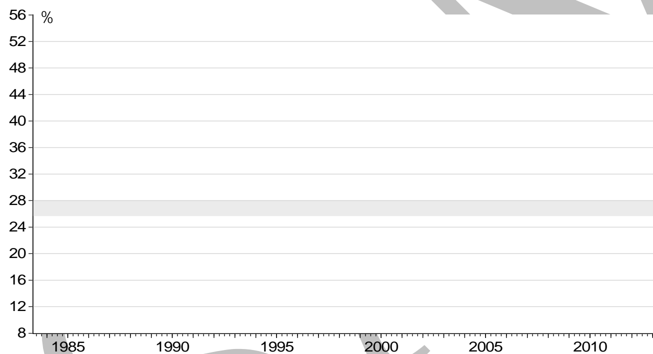
Investors have benefited from the market action, but many wonder whether the strength of equity prices could be a sign that FOMC quantitative easing and injections of liquidity by the world's central banks are entering a zone of too much of a good thing. Fed officials say they are aware of the risk that excessive easing poses to financial stability, but believe that this point has not been reached. As long as this is the case, it is the FOMC's confidence in the economic outlook and the improvement of the labour market that will drive its asset-purchase program.

% of households saying jobs hard to get



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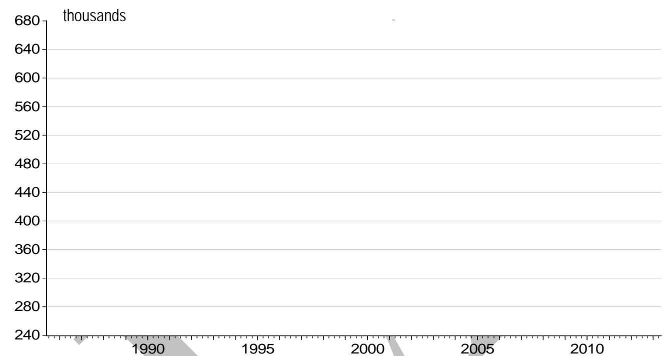
Household perception of job availability has improved considerably in the last year and a half. In September 2011, 49.4% of respondents to the Conference Board survey thought jobs were hard to get. In April 2013 the percentage was 37.1%. True, this is far from the range of the second half of 2004 (25.7% to 28%), when the Fed began normalizing its policy stance. But since we are talking about tapering QE rather than hiking rates, the line in the sand could be closer.

High-frequency employment indicators such as weekly initial jobless claims also suggest improvement in the labour market.

U.S. initial jobless claims



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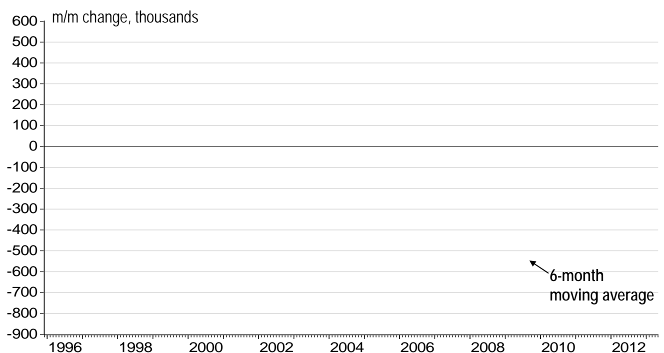
While the six-month average of monthly nonfarm payroll gains is a decent 208,000, that average includes a large gain of 332,000 in February. Moreover, the April report showed goods producers shedding jobs for the first time in seven months. With the full impact of the sequester still unknown and regional manufacturing surveys showing signs of weakness, we share FOMC vice-chairman William Dudley's view that another three or four months of data will probably be needed for the requisite confidence that the labour market will keep improving in the face of fiscal drag. If the economic outlook unfolds as expected, the Fed may cross the QE exit threshold at that point. At this stage we continue to expect that the Fed will announce a winding down of its QE program at its September meeting, which will coincide with the presentation of new economic projections.

U.S. nonfarm payrolls



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In the meantime, the U.S. bond market will likely be prone to bouts of nervousness as key economic indicators are released. The past month has certainly brought more than its share of market action. From a low of 1.63% at the May 1 close, the yield of 10-year Treasuries jumped 40 basis points to 2.04% on May 22. The change in market perception can be summarized in financial press headlines. On May 1 the Financial Times bannered: "Fed ready to increase QE3." Three weeks later it was "Bernanke poised to lift foot off QE pedal." Between the two takes, nonfarm payrolls had been revised up and the minutes of the April 30–May 1 FOMC meeting showed "a number" of participants thinking that the flow of purchases could be adjusted downward as early as June. And Mr. Bernanke acknowledged to the Joint Economic Committee of Congress that bond purchases could slow at the "next few" meetings, though he cautioned that premature tightening of monetary policy would "carry a substantial risk of slowing or ending the economic recovery and causing inflation to fall further."

Treasuries: From 1.63% to 2.04% in 14 trading days

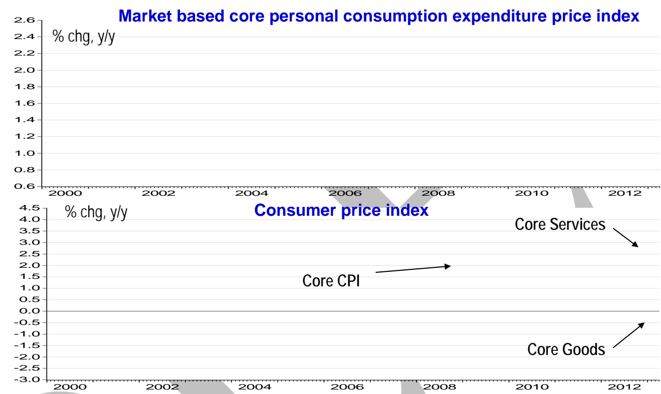
Event	10-year Treasuries
05/01/2013 Financial Times headline: "Fed Ready to Increase QE3"	1.63%
05/03/2013 Nonfarm payrolls: April 165K > E 140K March revised from 88K to 138K February revised from 268K to 332K	1.74%
05/09/2013 Jobless claims 323K, lowest since Jan 2008	1.81%
05/13/2013 Retail sales +0.1% vs. E −0.3% Retail sales "control group" +0.5%	1.92%
05/15/2013 Industrial production: April −0.5%	1.92%
05/22/2013 FOMC minutes Bernanke testimony to Joint Economic Committee	2.04%

NBF Economy & Strategy (data via Bloomberg) 2013-05-19

With bond investors on high alert, Fed watchers will be peering into the tea leaves of Fed governors' and presidents' speeches in the context of incoming economic information. Besides domestic indicators (employment, industrial production, retail sales, ISM survey, GDP, housing, inflation – i.e. the usual candidates), they will scrutinize developments in Europe for their potential effect on U.S. growth and thus on Fed thinking. The foreign exchange market will also be on the watch list as Japan's own monetary policy experiment unfolds.

Meanwhile, as market participants focused on the labour market to make educated guesses about the timing of QE3 dial-down, U.S. inflation measures were falling. It may be only a matter of time before the bond market starts to pay closer attention.

U.S. inflation slowing down



NBF Economy & Strategy (data via Bloomberg) 2013-05-22

Back in 2010, the Fed launched a round of quantitative easing as both core goods inflation and core PCE, which is based on market-observable prices, fell below one percent. The Fed acted vigorously to head off the risk that deflation could become entrenched in the U.S. economy. Though we do not see deflation as a threat at this juncture, we think a stronger U.S. dollar, soft commodity prices and falling import prices will further abate inflation pressures that are already tame. At the end of the day, the U.S. economy may find itself with inflation sticky around 1.5% for some time. Under such conditions, long-term inflation expectations could drift somewhat lower, making long-term nominal bonds more attractive. Absent a threat of outright deflation, subdued inflation will not be enough to push the Fed off its track toward ending QE. In our view, however, it will be enough to temper the upward drift of long-bond yields that is expected to result from the end of the FOMC's purchase program. Consequently, the 40-basis-point rise of the 10-year yield over the last 14 trading days has already pushed long rates significantly along the way towards our revised year end projection. In light of the upward revision to February and March nonfarm payroll as well as our expectations that U.S. GDP growth will be somewhat stronger than what we initially projected for Q2 (1.2% currently, compared to 0.7% in our April forecast), we have revised our interest rate forecast. We now see 10-year Treasuries trading around 2.73% and Canada around 2.65% by year end

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... and in Canada

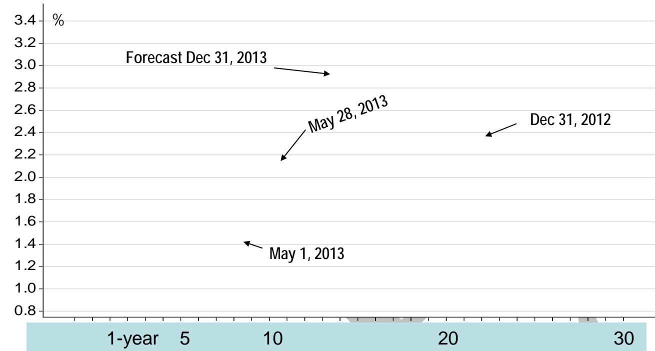
With market participants revising their expectations for U.S. monetary policy, bond yields on both sides of the border have moved up significantly since May 1. Not surprisingly, the movement was sharper south of the border. Ten-year Treasuries closed May 28 at 2.17%, up 54 basis points, compared to 2.076% for Canadas, up 40 basis points. The yield of 30-year Treasuries has risen 49 basis points, versus 31 basis points in Canada (from 2.35% to 2.66%). Since we expect economic growth in both countries to pick up in the second half of the year, we see recent market action as the underlying trend of the quarters to come.

Long-provincial spreads have been stuck in a wide trading range over the last 12 months. Long Ontarios, for example, have traded as tight as 93.4 basis points and as wide as 110.1 basis points over Canadas. On May 24 they closed at 3.54%, 97.6 basis points above Canadas. In most provinces housing starts have been below their 12-month moving average over the last three months (the two exceptions being Alberta and Manitoba), and Canada as a whole has lost jobs over the year to date. Under these conditions there is a risk that midyear provincial financial updates will disappoint, at least in central Canada. We accordingly think it will be difficult for provincial spreads to break out of their trading range on the downside this summer. However, economic growth should accelerate later this year and in 2014.

Over the last 52 weeks ending May 24, A-rated corporate bonds have generated not only positive total returns (short 3.72%, mid 5.33%, long 3.80%) but significant excess returns relative to Canadas (short 305 bps, mid 530 bps, long 641 bps). On a week-by-week basis, mid corporates did particularly well, adding more value than Canadas in 41 weeks out of 52. Long corporates did so in 34 of 52 weeks. With the North American economy expected to achieve escape velocity by the end of this year and then accelerate in 2014, there is room for corporate spreads to narrow further. We see 2014 economic growth of 3.1% in the U.S. and 2.3% in Canada. That said, the economic soft patch of the second quarter will crimp earnings, which could create some volatility.

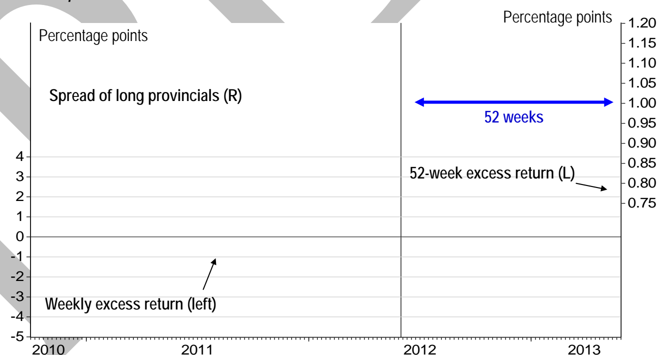
Recommendation: Duration shorter than benchmark, spread products overweight.

Canadian yield curve



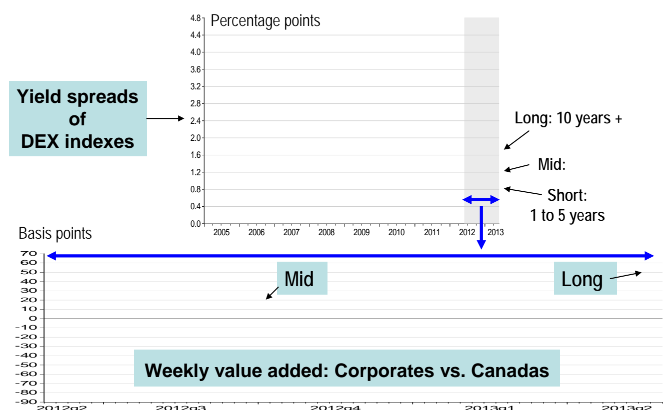
NBF Economy & Strategy 2013-05-29

Provincials: 52-week added value
Yield spread to Canadas and total excess return



NBF Economy & Strategy (data via Datastream), 2013-05-24

Single-A corporate bonds: Still room to outperform



NBF Economy & Strategy (data via Datastream) 2013-05-24

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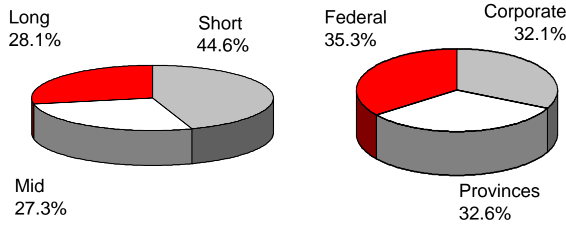
Recommended bond allocation

Recommended duration 6.70 (vs. 6.85 for the benchmark as of May 24,2013).
Defensive duration but overweight provincial and corporate bonds



Benchmark Allocation

Short 44.5%, Mid 25.5%, Long 30.0%
Federal 40.5%, Provinces 31.2%
Corporations 28.3%

Canadian Bond Market – Total Returns

	Total Returns	05/24/2013		
	Since 04/26/2013	Since 02/22/2013	Since 11/23/2012	Since 05/25/2012
Cash	0.07	0.23	0.50	1.02
Canada				
Short	-0.19	0.41	0.82	1.45
Mid	-1.30	0.98	0.81	1.81
Long	-2.57	1.27	-1.17	-0.18
Universe	-0.95	0.69	0.43	1.24
Provincial	-0.88	1.61	1.31	2.66
Municipal	-0.72	1.58	1.89	3.65
Corporate				
AA	-0.29	0.88	1.73	3.83
A	-0.70	1.60	2.29	5.08
BBB	-0.51	2.24	3.52	6.51
Universe	-0.53	1.60	2.49	5.14
Total	-0.81	1.23	1.28	2.76
S&P/TSX	3.81	0.54	5.35	12.86

NBF Economy & Strategy (data via Datastream)

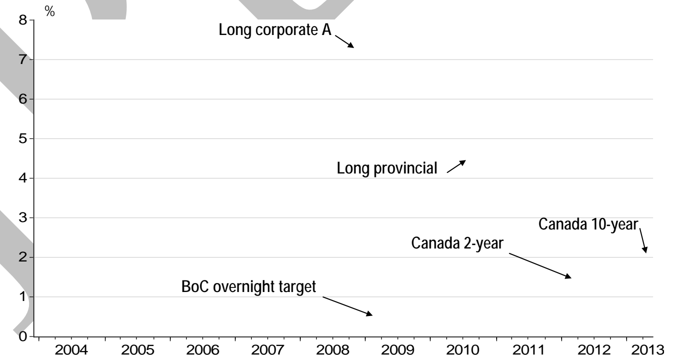
U.S. interest rates

Last observation May 24, 2013

NBF Economy & Strategy (data via Bloomberg)

Canadian interest rates

Weekly, last observation May 24, 2013



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Bond Market - Canada

	Close-on 05/24/2013	*04/26/2013*	*02/22/2013*	*11/23/2012*	*05/25/2012*
Interest Rates					
90-day (B/A's)	1.27	1.28	1.29	1.30	1.32
2 years	1.03	0.94	1.07	1.12	1.09
5 years	1.37	1.18	1.40	1.37	1.32
10 years	1.95	1.71	1.94	1.79	1.81
30 years	2.57	2.38	2.59	2.36	2.36
Spreads					
90 d - 2 years	-24	-34	-22	-17	-23
2 - 5 years	34	24	34	24	24
2 - 10 years	92	77	88	67	73
10 - 30 years	62	67	64	57	54
Currencies					
CAD / USD	1.0318	1.0167	1.0215	0.9929	1.0294
EUR / CAD	0.7492	0.7549	0.7422	0.7763	0.7761

Source: NBF Economy and Strategy (data via Bloomberg)

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