Focus

Feature Article

The Longer-Term Outlook for Long-Term Rates

Our Thoughts

- ChatGDP… and Jobs
- Can Cooler Wages Grease a Softer Landing?
- Goldilocks vs. the Bears
- ECB and BoE: The Same, but Very Different

Forecast Changes

- We added 25 bps to our terminal fed funds rate call (penciled in for May) after the blow-out jobs report and still-relatively hawkish-sounding Powell

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ChatGDP… and Jobs

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So, about that recession… Making a mockery of all the downbeat forecasts for 2023, the U.S. job market came flying out of the chute to start the year with a powerhouse 517,000 payroll advance in January. Adding to the mix, the companion household survey reported a towering 894,000 employment rise, which helped clip the jobless rate to a fresh 54-year low of 3.4%. The participation rate rose to match its pandemic-era high of 62.4%, and aggregate hours worked jumped 1.2% in the month—a strong gain. While the closely-watched average hourly earnings met expectations at up 0.3% m/m, revisions to earlier months left them a tad high at 4.4% y/y, offering no succor.

The surprisingly strong jobs report echoed earlier indications that **the labour market was holding up much better than almost anyone expected**. For example, initial jobless claims continue to grind down to unusually low levels, dipping to 183,000 last week. As well, job openings defied consensus with a pop higher in December to back above 11 million—with the latest dip in unemployment, there are again almost two openings for every person officially reported as jobless. If that wasn't enough, **auto sales** also chipped in with their best month in nearly two years in January, while the ISM services report snapped back to a solid 55.2.

The big caveat here is that, while no doubt an impressive set of figures, **January can be a very odd month** for economic data since it is so heavily influenced by the **weather**. And, generally speaking, it was an unusually mild month (aside from biblical rain in California), which likely gave a small bump to activity in general. And the bounce in auto sales and the services ISM followed a particularly weak December. Meantime, the factory ISM disappointed last month with a soft 47.4; which, while short of recession terrain, points to a contraction in manufacturing. Consumer confidence softened anew in January, home prices continue to fade, and layoff notices are soaring. Still, pulling all the diverse strands together suggests that **while underlying growth may be slowing, the economy is still pretty far from an outright downturn just yet**.

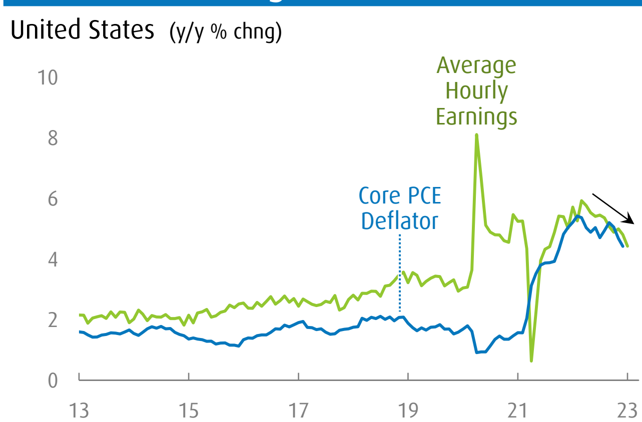
Where does this leave the Fed, after this week's by-the-book 25 bp rate hike to 4.50%-to-4.75%? Chair Powell's remarks to these ears weren't especially notable, but he chose not to forcefully push back at a rallying market and didn't directly address the possibility of a pause. And, thus, markets seized on some of his mildly dovish comments ("disinflation starting", and the "extent" of further hikes), and completely ignored his hawkish remarks. Our takeaway was a **very clear commitment to a *"couple"* more hikes**, and—combined with robust January economic results—have **prompted us to put back in a 25 bp hike at the May meeting**, after the universally assumed 25 bp hike at the next meeting in March. Thus, we are in sync with the Fed's view that the terminal rate will be 5.00%-to-5.25% and look for rates to stay there for the remainder of 2023.

The jobs shock prompted most markets to reverse course after a broad-based rally right up until Friday. The end result was a relatively small net move, with equities slightly higher on balance and yields only a touch higher as well. From a big picture lens, the 10-year Treasury yield is toggling around the 3.5% mark, just a touch shy of the 50-day moving average (closer to 3.6%) and now more than 100 bps south of the fed funds target. And, after spending much of the week on the defensive, the U.S. dollar bounced back after the blow-out jobs data and ended somewhat firmer.

The Canadian dollar ended slightly weaker, albeit still holding around its firmest level of the past four months at just under 75 cents (or $1.337). Even in the face of the Fed potentially hiking two more times and taking short-term U.S. rates more than 60 bps above the BoC's target, the loonie is absorbing the coming rate divergence with aplomb. And that's with oil prices sagging a bit further this week, and natural gas prices plunging to their lowest level in more than two years.

The fact is that all of the commodity currencies never really benefitted from the spike in resource prices last year, and are also not getting side-swiped by the pullback now. Instead, the U.S. dollar is driving the currency bus, and the big picture is that the greenback is gradually losing altitude. In part, that's because even with the resilient U.S. economy, **the end of Fed rate hikes are coming into view**.

Chart 1
A Welcome Calming



Sources: BMO Economics, Haver Analytics

Perhaps the best news of all this week is that even as jobs are still rolling, the job market strength is not translating into surging wages—arguably the opposite (*Chart 1*)—and underlying inflation is calming. While remaining alert to the risk that core services inflation will be persistent, even we must allow that wage and price trends have been surprisingly mild of late, notwithstanding a resilient economy. One really could not ask for a more favourable mix in recent months —and the theme was neatly captured in the payroll report: fading inflation trends amid a surprisingly sturdy growth backdrop. The pressing question looking ahead is whether this was a one-month fluke in a traditionally quirky month, or an accurate portrayal of a highly unusual economic cycle. While the reality is likely a little bit of both, it's almost certainly the case that **growth can't maintain January's hot pace and activity will lose considerable lustre in coming months**.

Can Cooler Wages Grease a Softer Landing?

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What if wage growth and inflation moderate despite tight labour markets? That goes against the grain of history, but it's not entirely outside the realm of possibility. This thought was likely in the back of Chair Powell's mind, perhaps explaining why he wasn't overtly hawkish on Wednesday, and perhaps why he said, "*We can now say for the first time that the disinflationary process has started*". He knows the last inflation card to fall is sticky core services prices (ex-housing), which is still underpinned by rising wages. But what if workers temper their wage demands now that inflation has fallen and job insecurity has risen? If so, the much-feared wage-price spiral might start spinning in reverse.

This week, **several key measures of U.S. labour compensation hinted that this virtuous cycle may have begun**. All showed tentative signs of easing even as the labour market remains exceedingly tight. The **employment cost index**, a Fed favourite, rose 4.0% annualized in Q4. While that's still above the two-year mean before the pandemic (2.8%), it's well below the cycle high (5.8%). Employment costs for private service-providing industries downshifted to a 3.9% rate. Similarly, **hourly compensation** in the nonfarm business sector grew 4.1% annualized in Q4. While it picked up from the prior quarter, so did productivity which jumped 3.0%. The difference between the two meant that **unit labour costs** grew just 1.1%, albeit after big jumps in the first half of the year. The timelier (though less reliable) **average hourly earnings** rose 3.7% annualized in January, the slowest in eleven months. Finally, the **ISM services survey's prices paid index**, which is a proxy for wages in the sector, eased further in January, falling to 67.8 compared with a record-high 84.5 in late 2021, though it's still above the long-run mean of 60.0.

Did I mention that **productivity picked up**? It's still far too soon to say we are on the cusp of a meaningful payoff from rapid investment in information technologies, robotics and AI, but some payoff is due. And, if it's occurring now, this would go some ways to explaining the recent easing in wage growth. Automation can't repeal the inverse relationship between unemployment and inflation (the Phillips curve), but it might lower the long-run rate of unemployment that sustains inflation (the NAIRU), which the FOMC pegs at around 4%.

For the moment, the **Fed is reluctant to bet the farm on a lower NAIRU and higher productivity**. After getting burned by the upswing in inflation, it doesn't want to repeat the policy mistake of the 1970s and prematurely ease policy. The labour market is still exceptionally tight, with the jobless rate at fresh 54-year lows, jobless claims historically low, and job openings returning to five-month highs. That said, layoff announcements spiked above 100,000 in January, about double the long-run norm and not just in the technology sector. In addition, anecdotal evidence suggests companies are pushing back against wage demands as customers push back against price hikes. Businesses are also less keen on filling job vacancies ahead of a possible recession. The **Fed would likely become more open to the idea of a lower NAIRU** if wage growth continues to moderate and services inflation ebbs despite low joblessness; that is, once it sees the whites of disinflation's eyes. But this Goldilocks scenario probably won't materialize until later this year, if at all, suggesting more rate pain is on the way.

Goldilocks vs. the Bears

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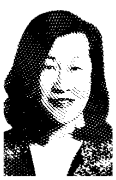
The **Federal Reserve raised rates by 25 bps this week**, as expected; it reiterated that *"ongoing increases in the target range will be appropriate"*; and Chair Powell tried to talk up further rate hikes and labour-market tightness in his press conference. But the market wasn't buying it (or rather, selling it), as risk assets and Treasuries both rallied strongly. The Nasdaq was up 5% on the week, with high-beta names in technology and communication services leading the charge. Ten-year Treasury yields fell just over 10 bps before the Friday payrolls report and even Bitcoin lurched higher post-Fed. Put it this way: If the Fed is concerned about easing financial conditions while their inflation fight is still underway, they took a step back this week.

It's a bit challenging to pinpoint exactly what set the market off during the FOMC proceedings. Perhaps it was as simple as the Fed just not acting or sounding any more hawkish than they have been. Chair Powell also gave some nods to **disinflation** and possibly even a **soft landing** narrative, which would certainly be read as bullish by the market. At one point, he said that *"it is gratifying to see the disinflationary process* *now getting underway, and we continue to get strong labour market data. So..."* at which point he cut himself off. Careful! Powell will have a chance to massage the Fed's message on Tuesday when he appears at the Economic Club of Washington.

More fundamentally, the Fed is now eying **core services inflation ex-housing** as the final crux in its inflation fight. On that front, annualized inflation over the past one- and three-month periods has a three handle, versus 4% y/y and above 5% y/y at the end of 2021. Perhaps the market figures it's just a matter of time before that breaks too. Indeed, we saw evidence of cooling wage inflation this week in the private service sector, as measured by the Employment Cost Index, but a blow-out payrolls report called it all back into question on Friday. Payrolls surged by 517k in January with hefty upward revisions, and the unemployment rate fell to 3.4%, the lowest level since 1969—not the stuff of a soft landing, but more the stuff of no landing.

That leaves **risk assets in an awkward position at a time when they need the temperature to be just right**. On the too-positive side, the payrolls report and a resurgent services ISM suggested that there was far more resilience in the economy early in Q1. On the too-negative side of the spectrum, a recession and meaningful markdown of earnings estimates caused by an even tighter Fed would add further pressure to equities which, to this point, have largely and reasonably seen valuations adjust to higher interest rates. A sturdy yet not overheating economy along with continued disinflation is the recipe, and that seems to be what the market grabbed onto this week.

ECB and BoE: The Same, but Very Different



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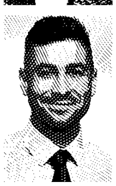

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This week, the BoE and the ECB raised rates 50 bps. The BoE hinted that it was almost done, while the ECB sounds as if it is just getting warmed up.

The **Bank of England's** hike to 4.0% was construed as dovish thanks primarily to the line: "*If there were to be evidence of more persistent pressures, then further tightening in monetary policy would be required*". That @if statement is far less committal than in December, when the Bank stated that persistent inflationary pressure "*justifies a further forceful monetary policy response*". But, oddly, Governor Bailey played up the uncertainty of the outlook to various media outlets yesterday, repeating the view that inflation risks are more skewed to the upside than any time in the MPC's history. So, some mixed comments but more dovish leaning.

The **ECB** followed with its own 50 bp rate hike, but also expressed its intention of another 50 bp hike in March. This was truly hawkish as President Lagarde repeated on several occasions during the press conference that "*We have ground to cover. We know we are not done*". Plus, in all of their scenarios, "*significant rate increases will be needed*". A couple of hawkish Governing Council members on Friday morning—**Estonia's Madis Muller** and **Lithuania's Gediminas Simku**—both voiced their preference for 50 bps in March, with the former warning not to assume an economic slowdown would lower inflation, and the latter arguing that only something "*very big*" would prevent a March hike, and that it may not be the last move. It all comes down to inflation, and the record 5.2% core CPI pace is bothersome.

Unhelpfully, the Euro Area's flash estimate for CPI excluded Germany, since the region's largest economy was experiencing technical difficulties and delayed its release. But the German figures will be out on **February 9**, and they will be incorporated into the Euro Area's final CPI on **February 23**. Stay tuned.

Despite the varying degrees of dovishness and hawkishness, we look for one more rate hike by each central bank. For now.

Thoughts from Stephen Gallo: It's one month into 2023 and the reduced risk of an economic hard landing in Europe is providing better support to the EUR and the GBP. However, for sustained appreciation vs the USD, we think these currencies need a very sold risk appetite picture, and continued improvement in inflation. Progress in the Ukraine war, limited disappointment in energy prices, and smooth global trade ('Goldilocks') may also be prerequisites for substantial progress above 1.10 in EURUSD and 1.25 in GBPUSD.

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Indications of stronger growth and a move toward price stability are ***good news*** *for the economy.*

	Good News	Bad News
Canada ▪ Home sales remain very soft in January ▪ U.S. files new dairy dispute against Canada	**Auto Sales** +7.5% y/y (Jan.) **Conference Board Consumer Confidence Index** +0.9 pts to 65.9 (Dec.)	**Monthly Real GDP** +0.1% (Nov.)—and StatCan estimates unch for December **Building Permits** -7.3% (Jan.)
United States ▪ FOMC hikes 25 bps as expected; signals more to come ▪ No signs of a cooling job market with January trouncing expectations	**Nonfarm Payrolls** +517,000 (Jan.) **Jobless Rate** -0.1 ppts to 3.4% (Jan.)—54-yr low **Average Hourly Earnings** slowed to +0.3% (Jan.) **Job Openings** unexpectedly climbed to 11.0 mln (Dec.)—but puts pressure on the Fed **Initial Claims** -3k to 183k (Jan. 28 week) **Productivity** +3.0% a.r. (Q4 P)—and **Unit Labour Costs** slowed to +1.1% a.r. **Employment Cost Index** slowed to +1.0% q/q (Q4) **ISM Services PMI** +6.0 pts to 55.2 (Jan.) **S&P Case Shiller Home Prices** +6.8% y/y; **FHFA Home Prices** +8.2% y/y (Nov.)—easing **Auto Sales** jumped to 16.2 mln a.r. (Jan.) **Factory Orders** +1.8% (Dec.)	**ISM Manufacturing PMI** -1.0 pts to 47.4 (Jan.) **Conference Board Consumer Confidence Index** -1.9 pts to 107.1 (Jan.) **Construction Spending** -0.4% (Dec.)
China ▪ Economic activity ignites following reopenings	**Manufacturing PMI** +3.1 pts to 50.1; **Non-manufacturing PMI** +12.8 pts to 54.4 (Jan.) **Caixin Manufacturing PMI** +0.2 pts to 49.2; **Services PMI** +4.9 pts to 52.9 (Jan.)	
Japan ▪ BoJ Gov. Kuroda: appropriate to continue with easy monetary policy	**Jobless Rate** steady at 2.5% (Dec.) **Retail Sales** +1.1% (Dec.)	**Industrial Production** -0.1% (Dec. P)
Europe ▪ ECB hikes 50 bps as expected; signals another 50 bp hike in March ▪ BoE hikes 50 bps to 4.00%	**Euro Area—Real GDP** +0.1% q/q (Q4 A) **Euro Area—Consumer Prices** slowed to +8.5% y/y (Jan. P)—but **core** steady at +5.2% y/y **Euro Area—Economic Confidence** +2.8 pts to 99.9 (Jan.) **Euro Area—Jobless Rate** steady at 6.6% (Dec.) **Germany—Unemployment** -22,000 (Jan.)—and **Jobless Rate** steady at 5.5% **France—Real GDP** +0.1% q/q (Q4 P) **France—Industrial Production** +1.1% (Dec.) **Italy—Jobless Rate** steady at 7.8% (Dec.)	**Euro Area—Producer Prices** surprisingly jumped 1.1% (Dec.) **Germany—Real GDP** -0.2% q/q (Q4 P) **Germany—Retail Sales** -5.3% (Dec.) **Germany—Trade Surplus** narrowed to €10.0 bln (Dec.) **France—Consumer Spending** -1.3% (Dec.) **Italy—Real GDP** -0.1% q/q (Q4 P)
Other ▪ Brazil's central bank on hold ▪ OPEC+ sticks with output agreement	**Australia—Building Approvals** +18.5% (Dec.)	**Australia—Retail Sales** -3.9% (Dec.)

The Longer-Term Outlook for Long-Term Rates

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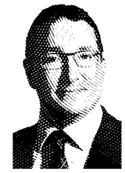

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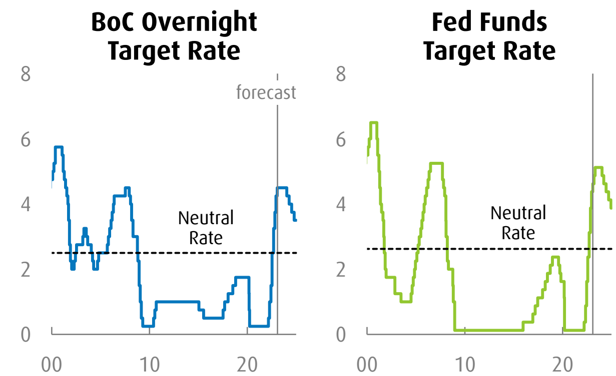
With the Bank of Canada clearly signalling that rate hikes may be drawing to a close, and the Fed edging in that direction as well, market focus is turning to when rate cuts may commence. For the record, we believe rate reductions will be a story for 2024, primarily due to stubborn core inflation trends and a resilient job market. But the more interesting issue may instead be: *Where do rates ultimately settle when we are beyond this inflation episode?* That is still very much open for debate, and is probably much more important than precisely when central banks begin to reverse course. **In a nutshell, we expect that the landing spot for rates will be notably higher than in the decade prior to the pandemic, with Canadian rates in the 2.5%-to-3.0% zone, and the U.S. a bit higher than that.** We lay out the factors behind that conclusion below, as well as some key implications for fiscal policy, housing, and financial markets.

The building blocks for long-term interest rates start with the overnight rate set by central banks. The past year has seen a dramatic surge in policy rates to combat inflation, leaving them well above where the so-called "neutral" rate was perceived to be for the past decade. The neutral rate is where policy is neither stimulative nor restrictive, or the sweet spot. The theoretical level combines expected inflation and real interest rates. The Bank of Canada believes neutral is in the 2%-to-3% range—its estimate fell consistently in the lead-up to the pandemic amid low inflation and sluggish growth—while the Federal Reserve's assumed neutral range is a touch higher at 2.25%-to-3.25%. The tumultuous events of the past three years, and a potentially altered post-pandemic landscape, suggest that the neutral rate could take a trip higher. For now, our thinking is in line with the BoC at 2.5% for Canada, with the U.S. modestly higher at 2.50%-to-2.75% (*Chart 1*).

Chart 1
Finding Neutral

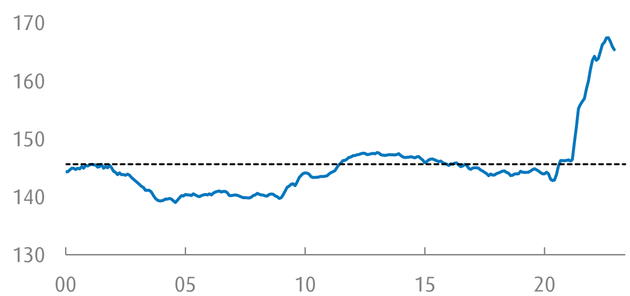
(% : as of February 3, 2023)



Sources: BMO Economics, Haver Analytics

Chart 2
Peak Globalization?

United States (1982-84 = 100 : s.a.)
Core Goods Prices[1]



[1] CPI commodities less food & energy
Sources: BMO Economics, Haver Analytics

The two decades heading into the pandemic were characterized by globalization and the integration of China and other emerging markets into the global economy. The resulting increase in the global labour force and productive capacity acted as a positive supply shock and a persistent headwind on goods inflation. For example, U.S. core goods inflation was exactly zero from 2000 to 2020 (*Chart 2*). **That highly favourable backdrop for low inflation is gone**, with the world unlikely to find another massive increase in labour supply, as well as rising geopolitical tensions, and the trend toward friendshoring. Layer on the cost of decarbonization, and it's easy to see why inflation could trend at least modestly higher than pre-pandemic norms, especially for goods.

The pandemic and policy reactions drove a rapid acceleration in inflation, with ongoing uncertainty around how quickly it will return to target. Part of the price surge was the result of the massive fiscal stimulus, which was accompanied by ballooning government debts. Higher debt burdens and the clear appetite of governments to spend aggressively in a crisis, combined with the inflation spike, suggest bond yields will have a somewhat higher term premium embedded than over the past decade.

The **path for real interest rates** has many drivers, most of which are difficult to quantify. The outlook for economic growth is an input, as central banks want to ensure real rates are calibrated to ensure supply and demand are balanced to keep inflation in check. In Canada's case, ramped-up immigration targets point to firmer economic growth and could necessitate a higher real rate. However, other factors, including **global savings/investment dynamics**, could continue to put downward pressure on interest rates, primarily further out the curve. And, the **quantitative easing** that central banks have engaged in for most of the past decade has put clear downward pressure on rates, with most now headed in reverse.

Where does that leave interest rates over the medium term? Moderately higher trend inflation and a larger risk premium point to higher rates than over the past decade. However, those factors will be somewhat offset by the global savings glut and the lingering spectre of more QE. Looking at longer-term rates, **Canada 10-year yields are expected to be around 2.75%**, keeping the yield curve positively sloped, with **the U.S. 10-year somewhat higher near 3%** (*Chart 3*). Those assumptions are both nearly 100 bps higher than the average yield of the past ten years.

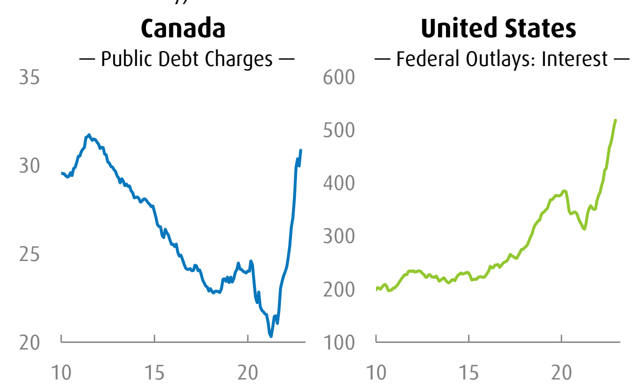
Chart 3
The Wheel Turns for Tens

Canada (percent)
10-year Benchmark Bond Yield

Shading marks U.S. recessions
Sources: BMO Economics, Haver Analytics

Chart 4
Rising Interest

(blns in local currency)



Sources: BMO Economics, Haver Analytics

What are the implications of this higher landing zone for interest rates, after the dust settles on the current inflation episode? We consider three broad areas:

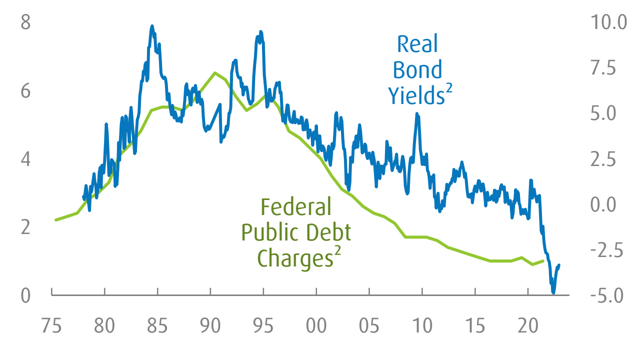
Fiscal Policy: While our assumed landing zone for long-term yields is generally a little below today's levels, the impact of the 2022 blast-off in rates has yet to fully weigh in on government finances. That's because the lion's share of public debt is long-term in nature and rolls over only gradually. Even so, the rapid run-up in interest rates in the past year has already begun to affect government finances in a taste of what's to come. In Canada, public debt costs have risen markedly, with Ottawa's interest outlays climbing above $30 billion in the past 12 months from little more than $20 billion in 2020 and 2021 (*Chart 4*). Similarly, Washington's net interest costs rose more than

40% last year, taking the 12-month tally to above US$517 billion by December. This rising interest burden leaves less manoeuvering room for policymakers (less space for discretionary spending), and is thus at least an indirect force behind the coming showdown over the U.S. debt ceiling.

Still, interest charges remain sedate from a long-term perspective, at least for Ottawa. For example, Canada's federal debt charges in the past year are still only slightly above 1% of GDP, up from the modern-day low of 0.9% in 2020, but far from the record highs of more than 6% of GDP in the early 1990s. The big difference with the bad old days of three decades ago is that real interest rates have shriveled. Our call would leave nominal rates barely above the medium-term outlook for inflation, whereas 10-year bond yields were on average a full 5 percentage points above inflation in the 1990s, creating an incredibly challenging debt dynamic (*Chart 5*). We don't foresee a return to that set of circumstances. Still, the net interest burden for Washington has risen to 2% of GDP, up from little more than 1% in 2015, and not far from the highs of just above 3% in the early 1990s.

Chart 5
Far From the Madding Years

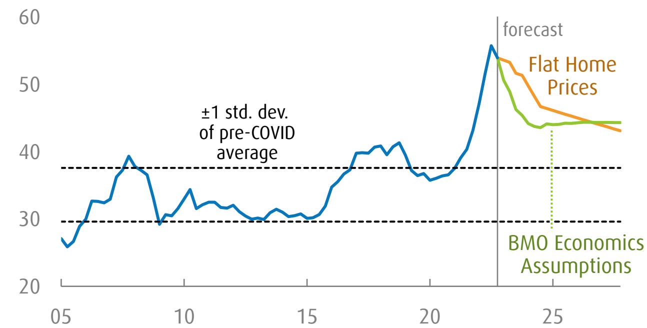
Canada (percent)



¹ (lhs : % of GDP); ² 10+ year bond yield less headline CPI inflation (rhs)
Sources: BMO Economics, Haver Analytics

Chart 6
Canadian Housing Affordability: A Long Descent

Housing Valuation¹ — Canada (percent)



¹ mortgage payment as % of household income, with 10% down; assumes 3.5% a.r. income growth, 1% a.r. labour force growth, 4% mortgage rates by 2024Q3
Sources: BMO Economics, Haver Analytics

Housing: The steep back-up in interest rates has hit the reset button on a wide variety of asset price valuations, including housing. No doubt, some of the big home price move in the past year in North America was exaggerated by the boom/bust in activity amid the unique backdrop of the pandemic. Our view is that the housing market in both economies is still digesting the steep rate rise, and the price correction has yet to fully run its course. Looking further ahead, the expected retreat in short-term rates—presumably by 2024—should put a floor under the market, with Canada supported also by robust population growth. Still, with yields expected to settle in at a higher level than pre-pandemic trends (let alone the extreme lows during the depths of 2020), **we don't expect much headroom for home prices over the medium term**.

Chart 6 looks at a typical monthly mortgage payment as a share of disposable income in Canada over many years—a rising line denotes a deterioration in affordability. The pandemic housing boom unsurprisingly crushed affordability, and matters have barely improved since as the retreat in home prices in the past year has been offset by higher interest rates. In this projection, even flat home prices over a five-year period will only bring affordability to somewhat less unaffordable levels. U.S. housing affordability was also walloped in the past few years, dropping even below the lows in 2006, albeit in line with the early 1990s. As in Canada, there will be limited potential for significant U.S. home price appreciation in our interest rate scenario, given the weak starting point for affordability.

Financial markets: In some respects, it's a similar story to housing for many financial markets, as almost all asset prices are readjusting to the new rate reality. Of course, in contrast to housing, financial market pricing can adjust almost instantaneously to new information, and our long-term view on yields is not markedly different from what's already largely built into the yield curve, with perhaps a modest upside bias. Still, most markets have precious little risk premium built in at the moment, and are potentially vulnerable to any negative surprises, whether it's on the inflation/rate front or on the growth outlook (perhaps due to a geopolitical shock).

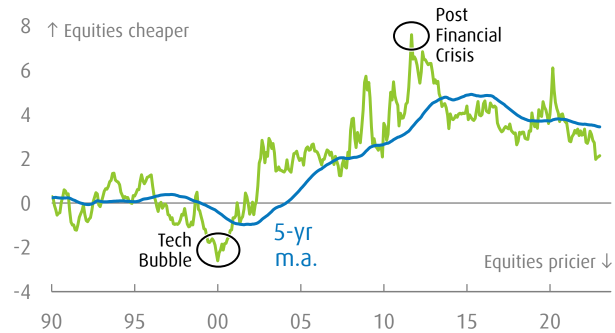
One way to consider that reality is to look at the S&P 500's forward earnings yield (the inverse of the P/E ratio) versus the 10-year Treasury yield (*Chart 7*). A large positive gap would suggest that the equity market is cheap relative to bonds (such as in the post-Financial Crisis era around 2010/11), while a deeply negative gap points to equity overvaluation (with the 1999 tech bubble the prime example). Note that the twin bear markets of 2022 in both stocks and bonds actually left equity market valuations the worse for wear, with the back-up in bond yields dominating. Looking ahead, it's a fair debate—and a topic of a future piece—whether these relative valuations ultimately return to the "norms" of the early-to-mid 1990s (i.e., a more positive outcome for equity markets) or the pre-pandemic "norms" (i.e., pointing to further softness for equities). But the key conclusion is that even with last year's market damage, the new rate backdrop does not leave relative equity valuations as particularly cheap.

Chart 7

Equity Valuations: Middle Ground

United States (ppts)

S&P 500 Earnings Yield less 10-year Treasuries



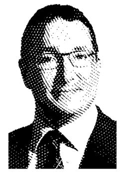
Sources: BMO Economics, Haver Analytics

Economic Forecast Summary for February 3, 2023

	2022 Q1	2022 Q2	2022 Q3	2022 Q4	2023 Q1	2023 Q2	2023 Q3	2023 Q4	Annual 2021	Annual 2022	Annual 2023
CANADA											
Real GDP (q/q % chng : a.r.)	2.8	3.2	2.9	1.5	-1.0	-1.2	0.0	1.5	5.0	3.6	0.5
Consumer Price Index (y/y % chng)	5.8	7.5	7.2	6.7	5.7	3.7	3.4	3.0	3.4	6.8	4.0
Unemployment Rate (percent)	5.7	5.1	5.1	5.1	5.4	5.9	6.2	6.4	7.5	5.3	6.0
Housing Starts (000s : a.r.)	243	270	281	259	245	235	223	218	274	263	230
Current Account Balance ($blns : a.r.)	3.7	10.6	-44.4	-49.7	-45.3	-44.5	-44.6	-45.7	-6.7	-20.0	-45.0
Interest Rates (average for the quarter : %)											
Overnight Rate	0.33	1.17	2.75	3.92	4.50	4.50	4.50	4.50	0.25	2.04	4.50
3-month Treasury Bill	0.39	1.43	2.91	3.96	4.35 ↓	4.40 ↓	4.40 ↓	4.40 ↓	0.11	2.17	4.40
10-year Bond	1.92	2.98	3.01	3.16	2.95 ↓	3.15 ↓	3.10	3.05	1.36	2.77	3.05 ↓
Canada-U.S. Interest Rate Spreads (average for the quarter : bps)											
90-day	9	33	16	-22	-34	-57 ↓	-67 ↓	-67 ↓	7	9	-56 ↓
10-year	-2	5	-10	-67	-59	-56	-53	-51	-8	-18	-55
UNITED STATES											
Real GDP (q/q % chng : a.r.)	-1.6	-0.6	3.2	2.9	-1.0	-1.0	0.0	0.5	5.9	2.1	0.5
Consumer Price Index (y/y % chng)	8.0	8.6	8.3	7.1	5.5	3.9	3.3	3.2	4.7	8.0	4.0
Unemployment Rate (percent)	3.8	3.6	3.5	3.6	3.6 ↓	4.2 ↓	4.7 ↓	5.0	5.4	3.6	4.4
Housing Starts (mlns : a.r.)	1.72	1.65	1.45	1.40	1.36	1.33	1.34	1.37	1.61	1.56	1.35
Current Account Balance ($trlns : a.r.)	-1.13	-0.95	-0.87	-0.87	-0.83	-0.85	-0.85	-0.85	-0.85	-0.96	-0.85
Interest Rates (average for the quarter : %)											
Fed Funds Target Rate	0.21	0.96	2.63	3.79	4.63	5.04 ↑	5.13 ↑	5.13 ↑	0.13	1.90	4.98 ↑
3-month Treasury Bill	0.30	1.10	2.75	4.18	4.70 ↓	4.95 ↑	5.05 ↑	5.05 ↑	0.05	2.08	4.95 ↑
10-year Note	1.94	2.93	3.10	3.83	3.55 ↓	3.70 ↓	3.65	3.55	1.44	2.95	3.60 ↓
EXCHANGE RATES (average for the quarter)											
US¢/C$	79.0	78.4	76.6	73.7	74.7	75.4	76.0	76.7	79.8	76.9	75.7
C$/US$	1.27	1.28	1.31	1.36	1.34	1.33	1.32	1.30	1.25	1.30	1.32
¥/US$	116	130	138	141	130	130	129	128	110	131	129
US$/Euro	1.12	1.06	1.01	1.02	1.08	1.09	1.10	1.11	1.18	1.05	1.09
US$/£	1.34	1.26	1.18	1.17	1.23	1.24	1.25	1.26 ↓	1.38	1.24	1.24 ↓

Blocked areas mark BMO Capital Markets forecasts; up and down arrows (↑↓) indicate forecast changes; spreads may differ due to rounding

Canada



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Merchandise Trade Balance

Tuesday, 8:30 am

Dec. (e)	**-$100 mln**
Nov.	-$41 mln

Canada's **merchandise trade** balance likely edged further into modest deficit territory in December. We look for a $100 mln shortfall, slightly deeper than the $41 mln deficit reported in the previous month. Lower oil prices likely weighed on energy exports, with a small offset from higher prices for natural gas. Meantime, a negative manufacturing flash points to weakness in imports and non-energy exports. Despite our call for a second consecutive monthly deficit, the merchandise trade account likely recorded a surplus in nine of the 12 months in 2022, matching 2021 for the most since 2008.

Employment

Friday, 8:30 am

Jan. (e)	**+0.1% (+20,000)**
Dec.	+0.3% (+69,200)

Unemployment Rate

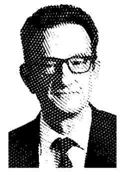
Jan. (e)	**5.1%**
Dec.	5.0%

Average Hourly Wages

Jan. (e)	**+5.0% y/y**
Dec.	+4.8% y/y

The labour market ended 2022 in fine form, with near-70k employment gains in two of the final three months of the year (down from 100k each thanks to the magic of revisions). This winter has been particularly mild, and January was no different which could boost some sectors. Indeed, construction was a big contributor to the strong headline increases in Q4, and we could see something similar this month. One sector that's been under consistent pressure is retail/wholesale trade, recording job losses in seven consecutive months; while hotels/restaurants have risen seven months in a row. That fits with the shift in consumer spending from goods to services. This report will be among the first data points for the new year, and will give us an idea of whether economic momentum held up into 2023. Our call for a 20,000 increase in **employment** is expected to lift the **unemployment rate** a tick to 5.1%. We judge there may be some upside risk for job growth given mild weather and the blowout U.S. jobs report. Watch **wage growth** after it slowed a full percentage point in December (after revisions)—but at 4.8% y/y, was still far too high for the BoC's comfort. Lastly, hours worked rose a mere 0.6% annualized in 2022H2, taking some of the lustre off the 1.8% employment gain over the same period. However, that's been the trend for the past decade (though less extreme), and we'll see if it continued.

United States



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Global Supply Chain Pressure Index

Monday, 10:00 am
Jan.
Dec. 1.18

The NY Fed's **Global Supply Chain Pressure Index** hit a record (24-year) high in December 2021 amid the pandemic's peak imbalance between strong demand and constrained supply, and as the Omicron variant was surging. As net supply began catching up, the GSCPI steadily declined through most of last year apart from a back-up during February-March owing to Russia's invasion of Ukraine. It quickly resumed declining only to bounce up and stabilize during the final three months of the year, partly reflecting the impact of China's COVID restrictions. These have since been dropped and we look for the GSCPI to do the same in January. Note that America's contribution to the index—the ISM measures on manufacturers' supplier delivery delays, order backlogs and inventories—all ebbed in the month.

State of the Union Address

Tuesday, 9:00 pm

The **president's annual speech to Congress** will lay out the administration's key priorities for the year ahead. A speech long on new spending initiatives could conflict with the Fed's aim of restoring price stability, while meeting resistance from House-led Republicans and setting the stage for a fight to raise the debt ceiling. By contrast, efforts to find common ground on long-term initiatives such as competitiveness and health care may find some bipartisan support. The scope of the administration's support for the war in Ukraine could also be outlined.

Financial Markets Update for February 3, 2023

		Feb 3 [1]	Jan 27	Week Ago	4 Weeks Ago	Dec 31, 2022
					(basis point change)	
Canadian Money Market	Call Money	4.50	4.50	0	25	25
	Prime Rate	6.70	6.70	0	25	25
U.S. Money Market	Fed Funds (effective)	4.75	4.50	25	25	25
	Prime Rate	7.75	7.50	25	25	25
3-Month Rates	Canada	4.36	4.35	1	16	13
	United States	4.64	4.66	-2	6	30
	Japan	-0.17	-0.18	1	-5	1
	United Kingdom	4.04	4.10	-6	11	17
	Australia	3.33	3.38	-5	1	7
2-Year Bonds	Canada	3.78	3.68	11	-19	-27
	United States	4.26	4.20	6	1	-17
10-Year Bonds	Canada	2.94	2.89	5	-15	-36
	United States	3.53	3.51	2	-3	-35
	Japan	0.48	0.48	0	-2	7
	Germany	2.19	2.24	-4	-1	-37
	United Kingdom	3.06	3.32	-26	-41	-61
	Australia	3.38	3.56	-18	-44	-67
Risk Indicators	VIX	18.5	18.5	-0.1 pts	-2.7 pts	-3.2 pts
	Inv. Grade CDS Spread [2]	66	71	-5	-10	-16
	High Yield CDS Spread [2]	404	430	-26	-54	-80
					(percent change)	
Currencies	US¢/C$	74.82	75.13	-0.4	0.6	1.4
	C$/US$	1.337	1.331	—	—	—
	¥/US$	130.99	129.88	0.9	-0.8	-0.1
	US$/€	1.0856	1.0868	-0.1	2.0	1.4
	US$/£	1.211	1.238	-2.2	0.1	0.2
	US¢/A$	69.77	71.00	-1.7	1.5	2.4
Commodities	CRB Futures Index	271.63	277.66	-2.2	2.6	-2.2
	Oil (generic contract)	77.29	79.68	-3.0	4.8	-3.7
	Natural Gas (generic contract)	2.37	2.85	-17.0	-36.3	-47.2
	Gold (spot price)	1,873.65	1,928.04	-2.8	0.4	2.7
Equities	S&P/TSX Composite	20,823	20,714	0.5	5.1	7.4
	S&P 500	4,178	4,071	2.6	7.3	8.8
	Nasdaq	12,185	11,622	4.8	15.3	16.4
	Dow Jones Industrial	34,110	33,978	0.4	1.4	2.9
	Nikkei	27,509	27,383	0.5	5.9	5.4
	Frankfurt DAX	15,476	15,150	2.2	5.9	11.1
	London FT100	7,904	7,765	1.8	2.7	6.1
	France CAC40	7,228	7,097	1.8	5.3	11.6
	S&P ASX 200	7,558	7,494	0.9	6.3	7.4

[1] = as of 11:05 am *[2] = One day delay*

Global Calendar — February 6–February 10

	Monday February 6	Tuesday February 7	Wednesday February 8	Thursday February 9	Friday February 10
China	**Foreign Reserves** [D] **Jan. (e)** **$3.2 trln** Dec. $3.1 trln		**Aggregate Yuan Financing** [D] **Jan. (e)** **5.4 trln** Dec. 1.3 trln **New Yuan Loans** [D] **Jan. (e)** **4.0 trln** Dec. 1.4 trln **M2 Money Supply** [D] **Jan. (e)** **+11.7% y/y** Dec. +11.8% y/y		**CPI** / **PPI** **Jan. (e)** **+2.2% y/y** **-0.5% y/y** Dec. +1.8% y/y -0.7% y/y
Japan		**Household Spending** **Dec. (e)** **-0.4% y/y** Nov. -1.2% y/y	**Bank Lending (incl. trusts)** **Jan.** Dec. +2.7% y/y	**Machine Tool Orders** **Jan. P** Dec. +0.9% y/y	
Europe	**EURO AREA** **Retail Sales** **Dec. (e)** **-2.5%** **-2.7% y/y** Nov. +0.8% -2.8% y/y **GERMANY** **Factory Orders** **Dec. (e)** **+2.0%** **-11.6% y/y** Nov. -5.3% -11.0% y/y **UNITED KINGDOM** **Construction PMI** **Jan. (e)** **48.5** Dec. 48.8	**GERMANY** **Industrial Production** **Dec. (e)** **-0.8%** **-1.7% y/y** Nov. +0.2% -0.4% y/y **FRANCE** **Trade Deficit** **Dec.** Nov. €13.8 bln	**ITALY** **Retail Sales** **Dec.** Nov. +0.8% +4.4% y/y	**GERMANY** **Consumer Price Index** **Jan. P (e)** **+1.4%** **+10.0% y/y** Dec. -1.2% +9.6% y/y **UNITED KINGDOM** **4:45 am ET BoE Governor Bailey testifies to Parliament**	**ITALY** **Industrial Production** **Dec. (e)** **+0.1%** **-1.7% y/y** Nov. -0.3% -3.7% y/y **UNITED KINGDOM** **Real GDP** **Q4 (e)** **unch** **+0.4% y/y** Q3 -0.3% +1.9% y/y **Monthly Real GDP** **3m/3m** **Dec. (e)** **-0.3%** **n.a.** Nov. +0.1% -0.3% **Services Index** **3m/3m** **Dec. (e)** **-0.4%** **+0.1%** Nov. +0.2% -0.1% **Industrial Production** **Dec. (e)** **-0.2%** **-5.3% y/y** Nov. -0.2% -5.1% y/y **Manufacturing Production** **Dec. (e)** **-0.2%** **-6.1% y/y** Nov. -0.5% -5.9% y/y **Trade Deficit** **Dec. (e)** **£17.3 bln** Nov. £15.6 bln
Other		**AUSTRALIA** **Trade Surplus** **Dec. (e)** **A$12.4 bln** Nov. A$13.2 bln **RBA Monetary Policy Meeting**	**INDIA** **RBI Monetary Policy Meeting**	**MEXICO** **Bank of Mexico Monetary Policy Meeting**	**AUSTRALIA** **RBA Statement on Monetary Policy**

[D] = date approximate

Upcoming Policy Meetings | Bank of England: Mar. 23, May 11, June 22 | European Central Bank: Mar. 16, May 4, June 15

North American Calendar — February 6–February 10

	Monday February 6	Tuesday February 7	Wednesday February 8	Thursday February 9	Friday February 10
Canada	**10:00 am** **Ivey PMI (s.a.)** **Jan.** Dec. 33.4	**8:30 am** **Merchandise Trade Balance** **Dec. (e)** **-$100 mln** Nov. -$41 mln **12:30 pm** **BoC Governor Macklem speaks to CFA Society Quebec in Quebec City on "How Monetary Policy Works"; press conference at 2:00 pm** 11:15 am Cash management bond buybacks $0.5 bln	**1:30 pm** **BoC Summary of Deliberations for the Jan. 25 decision** Noon 2-year bond auction $3.5 bln	3-year bond auction announcement	**8:30 am** **Employment** **Jan. (e)** **+0.1% (+20,000)** Dec. +0.3% (+69,200) **8:30 am** **Unemployment Rate** **Jan. (e)** **5.1%** Dec. 5.0% **8:30 am** **Average Hourly Wages** **Jan. (e)** **+5.0% y/y** Dec. +4.8% y/y **10:30 am** **BoC Senior Loan Officer Survey (Q4)**
United States	**10:00 am** **Global Supply Chain Pressure Index** **Jan.** Dec. 1.18 11:30 am 13- & 26-week bill auctions $108 bln **Saturday February 4** Fed Speaker: St. Louis' Bullard (12:15 pm)	**8:30 am** **Goods & Services Trade Deficit** **Dec. (e)** **$68.5 bln** *Consensus* *$68.5 bln* Nov. $61.5 bln **3:00 pm** **Consumer Credit** **Dec. (e)** **+$25.0 bln** [c] Nov. +$28.0 bln **Noon** **Fed Chair Powell interview at the Economic Club of Washington** **9:00 pm** **President Biden delivers State of the Union Address** Fed Speaker: Governor Barr (2:00 pm) 11:00 am 4-, 8- & 17-week bill auction announcements 1:00 pm 3-year note auction $40 bln	**7:00 am** **MBA Mortgage Apps** **Feb. 3** Jan. 27 -9.0% **10:00 am** **Wholesale Inventories** **Dec. F (e)** **+0.1%** [c] Nov. +0.9% Fed Speakers: New York's Williams (9:15 am); Governor Cook (9:30 am); Governor Barr, Atlanta's Bostic (10:00 am); Minneapolis' Kashkari (12:30 pm); Governor Waller (1:45 pm) 11:30 am 17-week bill auction 1:00 pm 10-year note auction $35 bln	**8:30 am** **Initial Claims** **Feb. 4 (e)** **195k (+12k)** [c] Jan. 28 183k (-3k) **8:30 am** **Continuing Claims** **Jan. 28** Jan. 21 1,655k (-11k) 11:00 am 13- & 26-week bill, 20-year bond, 30-year TIPS auction announcements 11:30 am 4- & 8-week bill auctions 1:00 pm 30-year bond auction $21 bln	**8:30 am** **Consumer Price Index Revisions** **10:00 am** **University of Michigan Consumer Sentiment** **Feb. P (e)** **65.0** [c] Jan. 64.9 **2:00 pm** **Budget Balance** **Jan. '23** Jan. '22 +$118.7 bln Fed Speakers: Gov. Waller (12:30 pm); Philadelphia's Harker (4:00 pm)

[c] = consensus [D] = date approximate [R] = reopening

Upcoming Policy Meetings | Bank of Canada: Mar. 8, Apr. 12, June 7 | FOMC: Mar. 21-22, May 2-3, June 13-14

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