

The Yield Also Rises

A Publication of BMO Capital Markets Economic Research · Douglas Porter, CFA, Chief Economist, BMO Financial Group

After a seemingly non-stop, one-way trip south in the first eight months of the year, global bond yields have suddenly popped back up so far this month. In a broad risk-asset rally, yields posted their biggest weekly jump in years, with Treasuries rising 26-34 bps across the curve in a steepening fashion. German long-term yields, which appeared to have no limit on the far side of zero, became less negative this week by nearly 20 bps, even amid a meaty easing package from the ECB. Staying in character, Canadian yields posted a somewhat less aggressive back-up, but also were in step with the leaders, rising 15-23 bps on the week.

While the move is no doubt impressive, most yields are simply back to around early August levels, or at the time the latest trade war chapter opened. And, naturally, since it was the trade tiff that sent yields spinning lower again in August, it was a modest stand-down on that front that spurred rates to march back up this week. Both China and the U.S. extended some minor goodwill gestures on tariffs, ahead of low-level talks next week, and then more serious negotiations early next month. Moreover, rumours are swirling around the possibility of a limited deal to tide things over through 2020, before tougher topics are addressed. The rumour was officially denied by the U.S. (making it that much more credible), but such an arrangement could make some sense for both parties. Make no mistake, we remain highly sceptical that bilateral relations are headed in a good direction, but some easing of tensions could continue.

The less-negative tone around the trade war has helped dampen recession chatter, which reached full pitch in August. There are at least three other factors that have quieted the doom and gloom crowd a bit:

1. The **back-up in long-term yields** has somewhat renormalized the Treasury curve—that is, it's **no longer inverted** between 10s and 2s.
2. **Equity markets** are flirting with all-time highs, with the TSX reaching that mark on Friday. Stocks aren't always the best economic leading indicator, but they're rarely *that* wrong.
3. The **economic data** just aren't playing along with any recession script. While slowing, job gains remain healthy. The U.S. consumer is holding up very well, as shown by August retail sales—core sales were up 0.3% m/m and 5.3% y/y. And, consumer sentiment has snapped back after a spill last month, according to the University of Michigan.

Despite this sunnier backdrop, the Fed is still widely expected to trim rates again at next week's meeting by 25 bps to a range of 1.75%-to-2.00%. However, the market no longer views a third rate cut this year as a *fait accompli*. Beyond the factors listed above, there's the small matter that inflation is suddenly showing some flickers. Even as the Fed's measure of core inflation remains low at 1.6% y/y, the more timely core

ECONOMIC RESEARCH

1-800-613-0205

economics.bmo.com

Douglas Porter, CFA, Chief Economist

+1 (416) 359-4887

douglas.porter@bmo.com

CPI nudged up to a 2.4% y/y clip in August—its fastest annual pace in 11 years. We don't view this as a particularly worrisome development, but it chips away at the "inflation is too low" reasoning for further rate cuts.

But, of course, **the Fed also faces external pressure** to keep cutting. Not content to let policymakers deal with market expectations of meaty rate cuts, the President weighed in heavily with his own, unique views on monetary policy. Apparently envious of the ECB's negative rates, he called on the Fed to cut rates to zero or negative forthwith, allowing the U.S. to then "*refinance*" its debt. It's tough to know where to begin with this one, even looking past the gratuitous and far-from-civil "*boneheads*" shot. We'll simply note that the Fed can only directly control the very short end of the curve, and that longer-term rates are set by what lenders are willing to accept. In the extremely unlikely event that the Fed were to suddenly chop rates aggressively to pre-emptively spur an economy already at full employment, there is zero guarantee bond yields would fall in lockstep—and the very real possibility they could even rise.

Having said all that, there is a small kernel of an idea in the President's latest broadside on the 'refinancing' front. At least prior to this week's snap-back in yields, the massive rally in long-term bonds had left them below inflation almost everywhere, presenting debt managers with a **huge opportunity to lock-in borrowing costs for a very long time at very reasonable levels**. And, on cue, Treasury Secretary Mnuchin indicated that the possibility of a **50-year** (and even century) **bond** was being studied. But, why complicate matters? Why not just tilt current borrowings a bit further out the curve? With 30-year yields now just above 2.3%, that already looks very inviting, unless one believes that nominal GDP growth will average less than 2.3% over a 30-year period. Treasury is normally highly reluctant to make tactical changes to its borrowing plan, but it could be argued that these **extreme low long-term yields** seem to be more of a **new fixture** rather than a quirk, so twisting borrowings would be more of a strategic measure, aimed at satisfying enormous demand for safe, positive-yielding, long-term paper.

Turning to Canada, the BoC of course is highly unlikely to face any political pressure to ease, even amid the federal election campaign that officially got under way this week. The much better tone in markets—notably including the record high for the TSX—as well as decent domestic economic data, on-target inflation, a stable loonie, and a revival in housing have almost taken BoC rate cuts out of the picture for now. Today's Q2 results showed another dip in the debt/income ratio for the third quarter in a row. But, a rebound in housing has perked up mortgage borrowing again; it has climbed to 3.8% y/y (from a low of 3.3% earlier this year). The comeback in Canadian housing markets make it that much tougher to justify BoC rate relief. Of course, the overall picture could change on a dime (or a tweet), since the Bank's next rate decision is still nearly seven weeks away (October 30, same day as the FOMC) and is nine days after the election (October 21).

Finally, one of the first economic proposals from the ruling party on Canada's campaign trail was a 1% annual speculation tax on vacant homes held by non-residents. We would simply note that after years of denial from almost all corners of Ottawa policymakers, there seems to be a grudging official recognition that this form of

speculation was indeed a major factor behind the steep run-up in home prices (and thus household debt), especially in 2016/17.

Lucky 13: It's only appropriate that some equity markets reached their all-time high today, on Friday the 13th. I, for one, welcome the date. Why? Well, being one of the 3.29% of Earth's population who came into this world on the 13th day of a month (as did my wife), I find it rather preposterous that anyone should consider 13 to be unlucky in any way, shape, or form.

Speaking of birthdays, here's a fun factoid, totally unrelated to anything. Newly crowned U.S. Open champ Bianca Andreescu, who will almost certainly be this year's Canadian athlete of the year, was born precisely three days after Penny Oleksiak, the 2016 winner of the prize—both born in the GTA, within three days of each other in June 2000. Oh, and the latter young lady was born on the 13th.

General Disclosures

"BMO Capital Markets" is a trade name used by the BMO Financial Group for the wholesale banking businesses of Bank of Montreal and its subsidiaries BMO Nesbitt Burns Inc., BMO Capital Markets Limited in the U.K. and BMO Capital Markets Corp. in the U.S. BMO Nesbitt Burns Inc., BMO Capital Markets Limited and BMO Capital Markets Corp are affiliates. This document is issued and distributed in Hong Kong by Bank of Montreal ("BMO"). BMO is an authorized institution under the Banking Ordinance (Chapter 155 of the Laws of Hong Kong) and a registered institution with the Securities and Futures Commission (CE No. AAK809) under the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong). BMO does not represent that this document may be lawfully distributed, or that any financial products may be lawfully offered or dealt with, in compliance with any regulatory requirements in other jurisdictions, or pursuant to an exemption available thereunder. This document is directed only at entities or persons in jurisdictions or countries where access to and use of the information is not contrary to local laws or regulations. Their contents have not been reviewed by any regulatory authority. Bank of Montreal or its subsidiaries ("BMO Financial Group") has lending arrangements with, or provide other remunerated services to, many issuers covered by BMO Capital Markets. The opinions, estimates and projections contained in this report are those of BMO Capital Markets as of the date of this report and are subject to change without notice. BMO Capital Markets endeavours to ensure that the contents have been compiled or derived from sources that we believe are reliable and contain information and opinions that are accurate and complete. However, BMO Capital Markets makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors and omissions contained herein and accepts no liability whatsoever for any loss arising from any use of, or reliance on, this report or its contents. Information may be available to BMO Capital Markets or its affiliates that is not reflected in this report. The information in this report is not intended to be used as the primary basis of investment decisions, and because of individual client objectives, should not be construed as advice designed to meet the particular investment needs of any investor. This document is not to be construed as an offer to sell, a solicitation for or an offer to buy, any products or services referenced herein (including, without limitation, any commodities, securities or other financial instruments), nor shall such Information be considered as investment advice or as a recommendation to enter into any transaction. Each investor should consider obtaining independent advice before making any financial decisions. This document is provided for general information only and does not take into account any investor's particular needs, financial status or investment objectives. BMO Capital Markets or its affiliates will buy from or sell to customers the securities of issuers mentioned in this report on a principal basis. BMO Capital Markets or its affiliates, officers, directors or employees have a long or short position in many of the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. The reader should assume that BMO Capital Markets or its affiliates may have a conflict of interest and should not rely solely on this report in evaluating whether or not to buy or sell securities of issuers discussed herein.

Dissemination of Research

Our publications are disseminated via email and may also be available via our web site <https://economics.bmo.com>. Please contact your BMO Financial Group Representative for more information.

Conflict Statement

A general description of how BMO Financial Group identifies and manages conflicts of interest is contained in our public facing policy for managing conflicts of interest in connection with investment research which is available at http://researchglobal.bmocapitalmarkets.com/Public/Conflict_Statement_Public.aspx.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST

BMO Financial Group (NYSE, TSX: BMO) is an integrated financial services provider offering a range of retail banking, wealth management, and investment and corporate banking products. BMO serves Canadian retail clients through BMO Bank of Montreal and BMO Nesbitt Burns. In the United States, personal and commercial banking clients are served by BMO Harris Bank N.A., Member FDIC. Investment and corporate banking services are provided in Canada and the US through BMO Capital Markets. BMO Capital Markets is a trade name used by BMO Financial Group for the wholesale banking businesses of Bank of Montreal, BMO Harris Bank N.A., BMO Ireland Plc, and Bank of Montreal (China) Co. Ltd. and the institutional broker dealer businesses of BMO Capital Markets Corp. (Member SIPC), BMO Nesbitt Burns Securities Limited (Member SIPC) in the U.S., BMO Nesbitt Burns Inc. (Member Canadian Investor Protection Fund) in Canada, Europe and Asia, BMO Capital Markets Limited in Europe, Asia and Australia and BMO Advisors Private Limited in India. "Nesbitt Burns" is a registered trademark of BMO Nesbitt Burns Inc., used under license. "BMO Capital Markets" is a trademark of Bank of Montreal, used under license. "BMO (M-Bar roundel symbol)" is a registered trademark of Bank of Montreal, used under license.

© Registered trademark of Bank of Montreal in the United States, Canada and elsewhere.

™ Trademark Bank of Montreal in the United States and Canada.

© COPYRIGHT 2019 BMO CAPITAL MARKETS CORP.

A member of BMO Financial Group