NATIONAL BANK OF CANADA
FINANCIAL MARKETS

September 2024

Forecast Summary

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- Get going and/or keep going, as the case may be. That's the clear theme (and wholly appropriate stance) as it relates to interest rate relief in North America (and beyond really). Notably, the time has now come for the U.S. Federal Reserve to initiate a monetary easing cycle, FOMC members have clearly laid the groundwork for such a policy pivot in recent days and weeks (going back at least to the last interest rate decision in late July). Notwithstanding our long-standing and well-publicized anxieties surrounding U.S. growth prospects, there's now little to be gained from castigating the FOMC for having taken its time. What's done is done; importantly cuts are finally here. Perhaps the more vital aspect will be the speed and extent of looming policy rate relief.
- In some critical areas, including labour markets, the ground appears to be shifting under policymakers' feet. Accumulating weakness, which we fear will continue, argues for removing restrictiveness more quickly. We see little impediment on the inflation front, core pricing behaviour looking fairly encouraging/relatively becalmed of late. So while it seems likely that the FOMC will commence with a 'normal' (or less-alarmist) 25-bp cut on September 18th, we believe larger cuts will soon be warranted. That is reflected in our revised interest rate forecast, with 100 bps of FOMC easing forecast before the end of 2024. We've likewise dialed up the magnitude of policy rate relief in the first half of 2025, which implies a more-timely arrival at policy rate neutrality for a softening U.S. economy.
- One could seemingly credit the Bank of Canada for initiating rate cuts earlier than other major advanced economy central banks. Then again, Canada's highly levered and more interest rate-sensitive economy generally argues against leaving restrictive interest rate policy in place for too long. Despite delivering three successive quarter-point cuts, the Bank's policy rate (4.25% nominal) remains in legitimately restrictive territory (near 2% real). Judging from a rising unemployment rate, anemic housing market conditions, consumer apathy and overall poor GDP growth momentum, much more policy rate relief is needed.
- As in the U.S., the evolving inflation picture in Canada needn't delay monetary policy action, even if base effects may be less constructive this fall. Rather, we would mount an argument for *accelerating* rate cuts, a 50-basis point move an increasingly defensible proposition in our view (if not at the October decision than by December). While a larger cut would signify Governing Council's growing unease, this shouldn't be confused with monetary policy stimulus. Removing restrictiveness in a timely manner should be the overarching goal at this point. The BoC is right to focus on downside inflation risks in light of deepening labour market slack and a growing output gap. Unfortunately, the immediate pick-up in GDP and employment that they'd projected looks less and less likely to materialize. That means more slack will accumulate this year, which supports turning this cutting cycle up a notch. There are wild cards and uncertainties to be sure, the geopolitical backdrop unsettled (not just across the pond but closer to home as well). But volatility hardly looks accretive to global or domestic growth at this juncture. So yes, get on with it; there's really no time to waste.

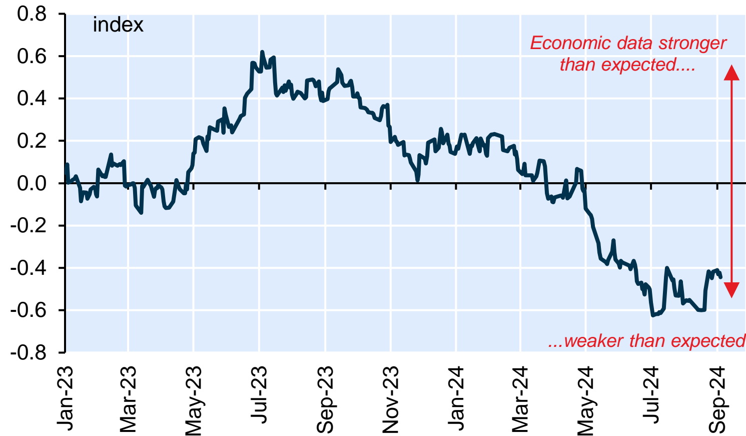
United States						
Quarter	Target	3M	2Y	5Y	10Y	30Y
9-Sep-24	**5.50**	**5.03**	**3.67**	**3.49**	**3.70**	**4.00**
Q3:2024	5.25	4.90	3.65	3.50	3.70	4.00
Q4:2024	4.50	4.10	3.50	3.40	3.60	3.90
Q1:2025	3.75	3.45	3.15	3.20	3.40	3.75
Q2:2025	3.50	3.25	2.90	3.05	3.25	3.60
Q3:2025	3.25	3.00	2.80	2.95	3.15	3.50
Q4:2025	3.25	3.05	2.90	3.05	3.25	3.55
Q1:2026	3.25	3.10	3.05	3.20	3.40	3.65
Q2:2026	3.25	3.10	3.20	3.35	3.55	3.75

Canada						
Quarter	Target	3M	2Y	5Y	10Y	30Y
9-Sep-24	**4.25**	**4.09**	**3.03**	**2.77**	**2.94**	**3.08**
2024 Q3	4.25	3.95	2.95	2.75	2.95	3.10
2024 Q4	3.50	3.25	2.75	2.60	2.85	3.00
2025 Q1	3.00	2.85	2.55	2.45	2.70	2.90
2025 Q2	2.75	2.65	2.40	2.35	2.60	2.85
2025 Q3	2.75	2.65	2.45	2.40	2.70	2.90
2025 Q4	2.75	2.70	2.55	2.55	2.80	3.00
2026 Q1	2.75	2.70	2.65	2.70	2.90	3.05
2026 Q2	2.75	2.70	2.75	2.85	3.00	3.10

FOMC Update: The focus is on 50

It's safe to say the outlook for the U.S. economy, and thus monetary policy, has shifted. For a few months now, economic data has been surprising to the downside, but a very strong starting point (in the labour market) and still-solid headline GDP growth had limited the degree of concern. More recently, alarm bells have started to go off.

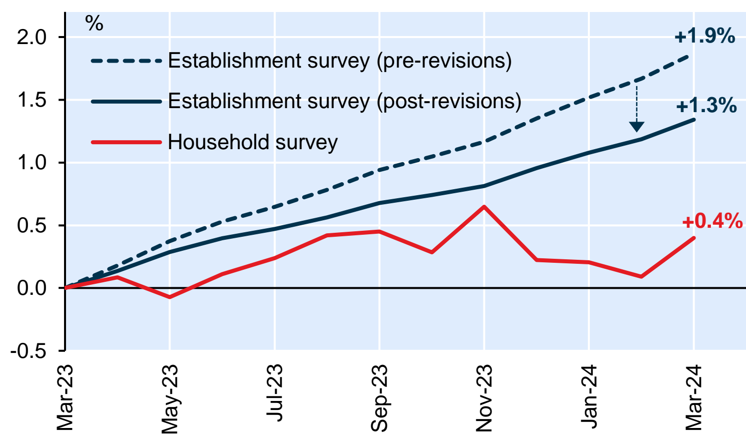
Economic data continues to disappoint
U.S. economic surprise index



Source: NBF, Bloomberg

Heightened anxiety really began with a disappointing July jobs report that showed both weaker hiring and a significant jump in the unemployment rate. Preliminary benchmark revisions to the establishment survey then revealed that earlier employment gains (from April 2023 to March 2024) were overstated by more than 800K jobs.

Last year's jobs data don't look as strong after revisions
Chg. in US employment: Household, establishment survey (pre/post revisions)

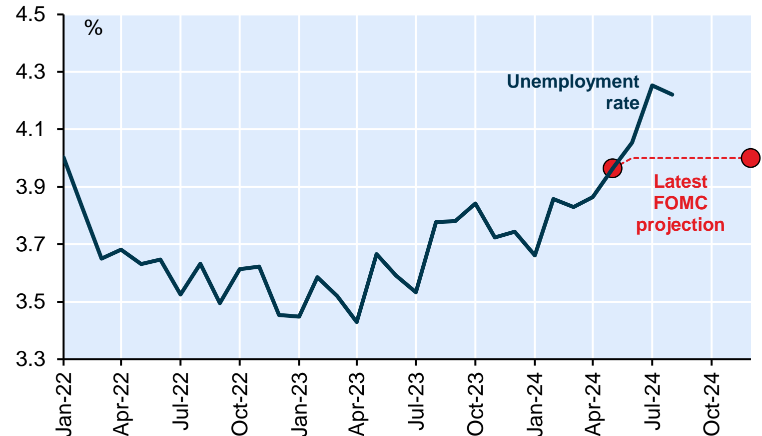


Source: NBC, BLS, Bloomberg | Note: Post-revision line assumes downward revision was evenly distributed across months. Futures releases will revise each monthly data point.

This all culminated in Fed Chair Powell's address at the Jackson Hole Economic Symposium where he drew a metaphorical line in the sand as it relates to the labour market. In addition to 'teeing up' a September interest rate cut (which was widely anticipated already), he stressed that they do not "*seek or welcome further cooling in labor market conditions*." He added that they will "do everything [they] can" to support a strong jobs market. Not surprisingly, investors added to bets that the Fed would be delivering at least one 50 bp cut this year.

Of course, there are other key datapoints on the Fed's radar, some we've yet to digest, the most important of which being CPI. There's a world in which a very soft inflation reading gives the Fed confidence to ease by 50 bps. However, it's the Fed's assessment of the labour market that should dictate the magnitude of the first move. Fortunately, the latest set of jobs data (for August) arrested the upward trend in the unemployment rate. And although headline job growth wasn't as strong as expected, the miss probably wasn't large enough to make a 50 bp rate cut the baseline move in September. We therefore believe cooler heads will prevail this month and the Fed will start 'small'.

Recent reprieve in the unemployment rate increase
U.S. unemployment rate and FOMC June projection

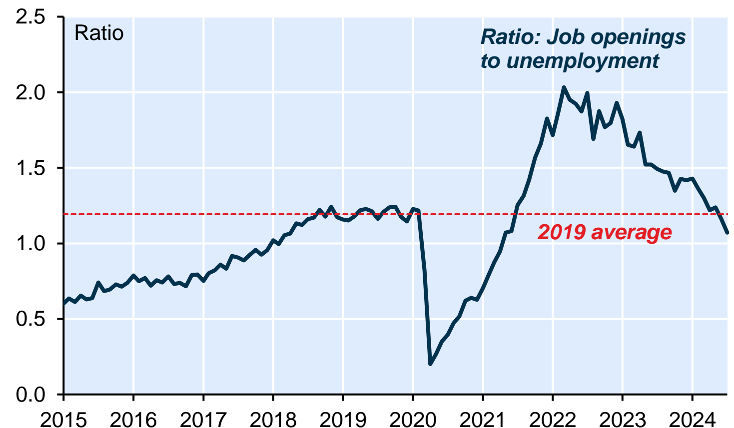


Source: NBC, Bloomberg, FRB

Even if the Fed 'only' delivers a 25 bp reduction this month and even if their updated dot plot were to 'only' imply three quarter point cuts this year, markets probably won't back down from pricing the risk of 50 bps in at least one of 2024's final meetings. And given the Fed's aversion to further job market cooling, they probably won't take it off the table either. Realistically, only improving data can totally remove that risk. Unfortunately, we don't see recent trends reversing soon.

In addition to the most closely followed labour market measures, 'secondary' data (some of which are more forward-looking) don't paint a particularly optimistic picture either (and haven't been for some time). Job vacancies, for example, have been steadily declining for more than two years. Despite starting from an extremely elevated level, the vacancy rate is effectively back to where it was on the eve of the pandemic. The ratio of job vacancies to unemployed workers, a measure once emphasized by the Fed, is now *below* where it was in 2019. And as we've noted for months, the details of recent jobs reports aren't encouraging whether we look at temporary employment, the industrial breadth of job gains or the full-time/part-time split, just to name a few.

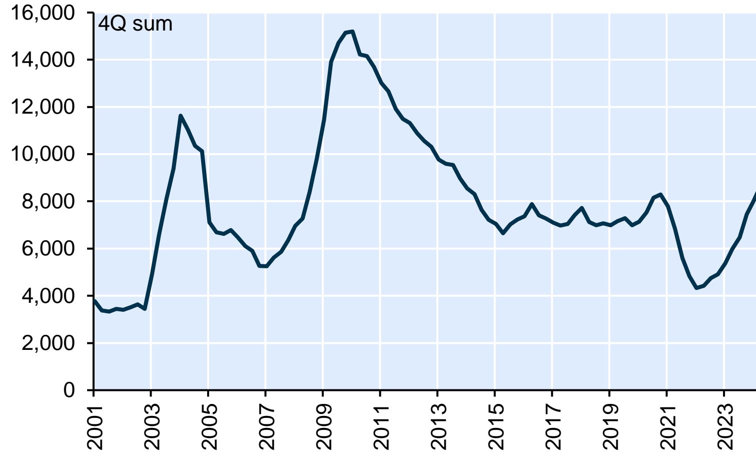
The balance between labour demand and supply is shifting
Ratio of job vacancies to unemployed workers



Source: NBC, BLS, Bloomberg

As our colleagues have astutely noted, the 800K downward revisions to jobs data through March 2024 is only the tip of the iceberg. Data released since then has also been overstating job gains and will undergo a similar, if not more significant, revision in the future. With bankruptcies piling up, the BLS's 'birth-death' model, which estimates business formation based on historical trends, is significantly overestimating *net* company creation. As a result, hiring is being overestimated too. The Fed is aware of this as was noted in the latest minutes: "*many participants noted that reported payroll gains might be overstated*". It means each report is being taken with and should be taken with a large pinch of salt.

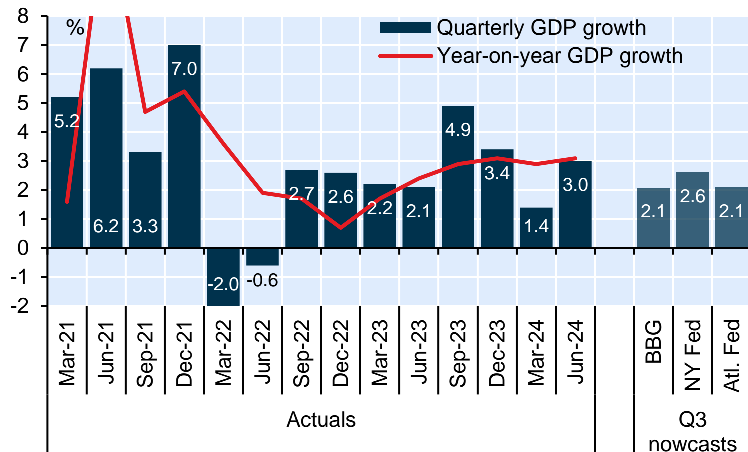
Rising bankruptcies indirectly impact jobs data
U.S. Chapter 11 business bankruptcy filings: 4 quarter moving sum



Source: NBC, BLS, Bloomberg

We'll concede that not *all* data has been disappointing. GDP somehow continues to defy gravity. While slowing from the unsustainable pace in the second half of 2023, growth remains around potential and preliminary gauges of Q3 suggest that hasn't changed. However, we still believe it will be extremely difficult for that to continue going forward given the path that the labour market is on. We expect growth to slow drastically at the end of 2024 and into 2025 which will make future decisions to ease even easier for policymakers.

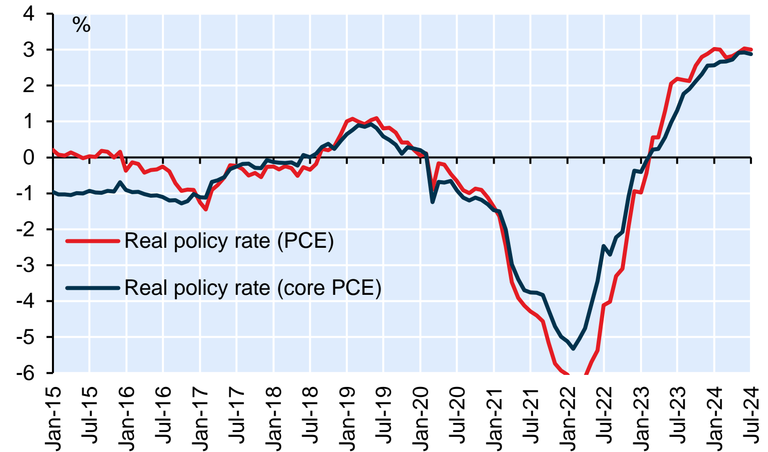
GDP continues to defy gravity
Q/Q and Y/Y U.S. GDP growth with 'nowcasts' of Q3 growth



Source: NBC, BLS, Bloomberg, FRB

As noted earlier, there's another side to the Fed's dual mandate. However, inflation has clearly taken a back seat of late. With the significant progress already made, it's unlikely these data will be able to derail a steady dose of rate cuts over the coming months. Thinking about policy from a real rate perspective, the Fed grows more restrictive with each month inflation eases even if they're not actively tightening policy. The real policy rate is still well, *well* above most estimates of neutrality, so the first ~150 bps of easing should be relatively easy. Assuming status quo price pressures from here, inflation probably won't be a major factor in Fed decision making until well into 2025.

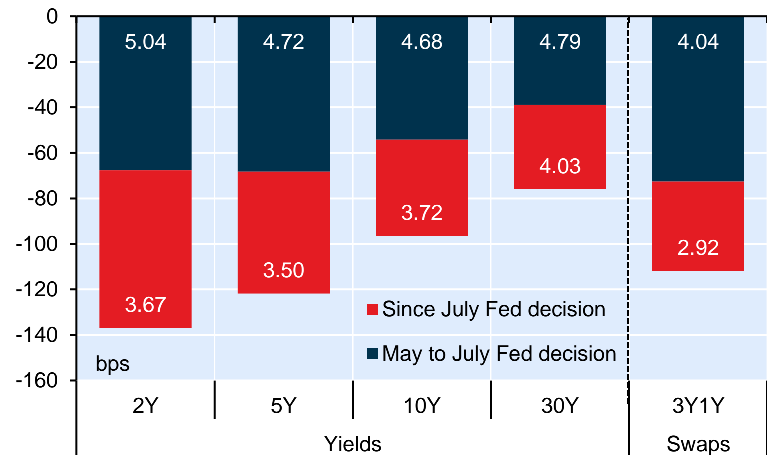
The Fed isn't hiking but policy tightens as inflation eases
Fed funds target (upper bound) less Y/Y PCE and core PCE deflator



Source: NBC, BLS, Bloomberg

While we believe the Fed is more likely than not to deliver a 50 basis point cut before the year is out, it must be pointed out that markets have discounted this and *then some*. Moreover, market-based estimates of the Fed's neutral rate (as proxied by the 3Y1Y OIS swap, among others) have come crashing down over 100 basis points since the spring. While there is scope for rates to decline with the policy rate in coming months, *material* downside may be limited. It follows that the aggressiveness of the curve steepening move is also likely to moderate.

Rates moved aggressively recently (incl. neutral rate outlook)
Change in yields and swap rates since May 2024



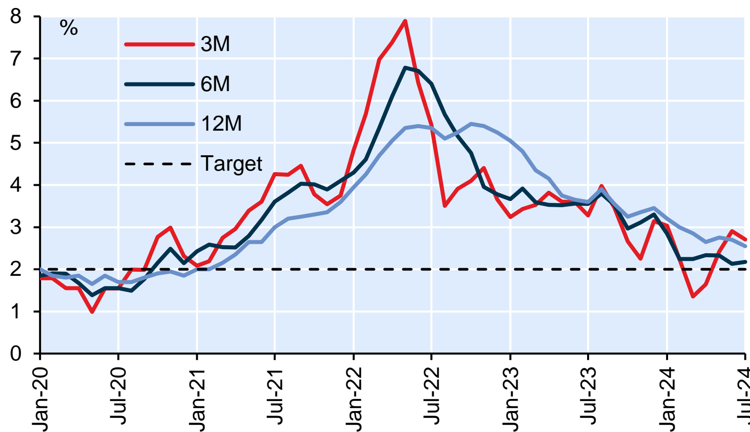
Source: NBC, Bloomberg | Note: Labels refers to levels as of 30-Apr and 9-Sep

BoC Update: The focus *should* be on 50

With slack already well-established in the Canadian economy, it didn't much matter what other economic data did between the July and September meetings. The decision to cut or not was always going to come down to the July CPI report. To us, the BoC's playbook essentially boiled down to: Soft inflation = cut, hot inflation = consider pausing. Fortunately, the BoC received a 'good' report, making the decision to ease an easy one.

Even with a couple of warm readings in May and June, core inflation is still running below 3% on a 3-month basis (and on a 6- and 12-month basis too). Headline pressures, now at just 2.5%, have an outside chance to hit 2% in August thanks to some favourable base-year effects. Less favourable base effects thereafter suggest inflation will run slightly above 2% for the rest of 2024 but that shouldn't get in the way of further easing as real rates remain definitively restrictive.

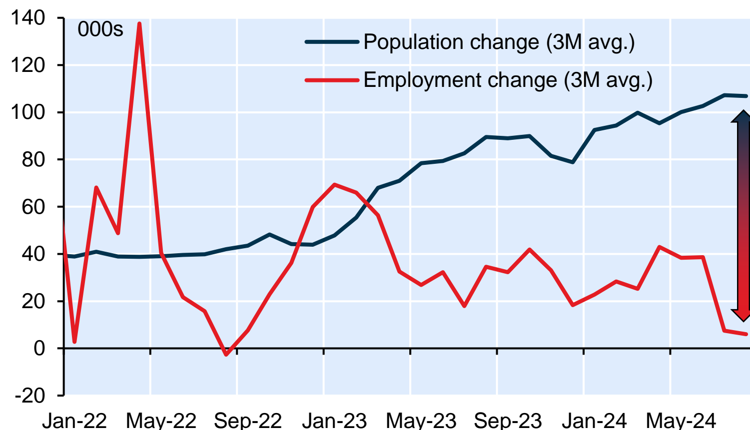
No matter the horizon, inflation is in the 1-3% control band
Average of CPI-median and -trim: 3M, 6M, and 12M annualized inflation



Source: NBC, StatCan

Assuming inflation doesn't resurface in a meaningful way (which we don't believe it will), it's going to be the labour market that dictates the rate path from here. Recent data on this front has not been promising. Hiring over the last three months barely has registered a pulse while the population (and the labour force) is still expanding at a heady clip. This story is nothing new of course and it's helped drive the jobless rate steadily higher over the past two years. That trend continued in August as unemployment climbed another two ticks to 6.6%, the highest since May 2017.

Labour demand can't keep pace with labour supply
Change in Canadian employment and working age population

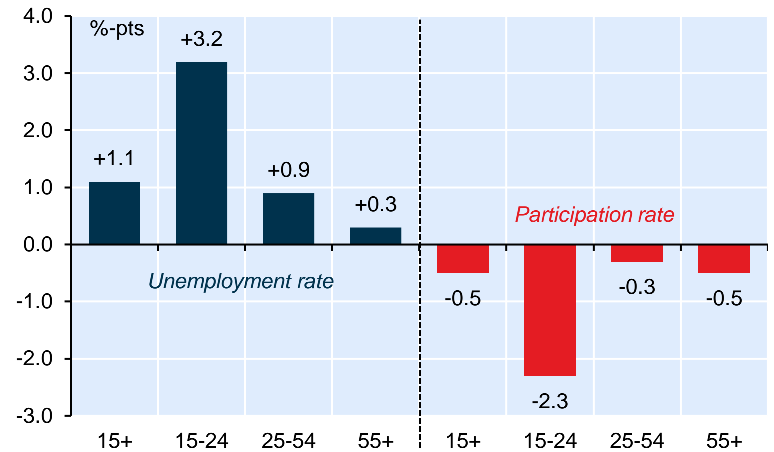


Source: NBC, StatCan

Some may argue that Canada's unemployment rate woes are a youth story, driven by the surge in students and temporary workers. While there's some truth to that—the youth jobless rate is up ~5%-pts since the low registered two years ago—core-aged Canadians are not immune either. The unemployment rate for this cohort has climbed 1.5%-pts since then and is up 0.9%-pts over the past 12 months.

Moreover, we'd argue that the unemployment rate today is understating labour market weakness. Consider labour force participation. After a quick recovery during the pandemic, the size of the labour force hasn't kept pace with recent population increases, leading to a shrinking participation rate. That's not the sign of a particularly buoyant labour market. And once again, the influx of young people has contributed to this but is not the sole driver. Time will tell where participation heads but if it were to normalize, there is not sufficient labour demand to absorb marginal workers. It means that risks to the jobless rate remain skewed decisively to the upside.

No age cohort is immune from weaker jobs market
1-year change in unemployment and participation rates (Aug-23 to Aug-24)



Source: NBC, StatCan

What does this mean for the policy outlook? 50 bp rate cut debates have ratcheted up in the U.S. over the past month but it's probably time we have these discussions north of the border. Even though there was nothing said at the September meeting that indicated policymakers had seriously contemplated a 50 bp cut, consider the context going forward:

1) The BoC "*needs*" GDP growth and job creation to pick up, lest they risk inflation *under*shooting over the projection horizon.

2) The BoC *expects* GDP growth and job creation to pick up immediately. The July MPR presented a rosy 2.8% Q3 GDP forecast, with growth seen running at/above 2% thereafter. We can only guess their unemployment projection but with above potential growth, they presumably see the jobless rate stabilizing quickly too.

3) The BoC thinks about the economy and inflation from an output gap perspective which means growth below potential puts downward pressure on inflation.

We've since learned that job creation has not picked up (at least not in a material way). GDP growth, meanwhile, is tracking well below the BoC's earlier estimate. So, if the Bank was guiding towards a steady pace of rate cuts *with* above potential growth then surely, they'd be open to cutting faster when growth continues to run below potential.

As per our sister publication, ***the Monthly Economic Monitor***, the Canadian economy is unlikely to accelerate meaningfully in the second half of the year. As a result, we believe the risks are now skewed towards a 50 bp cut in the fourth quarter, potentially as soon as October. This shouldn't be difficult for the Bank to 'sell'. Recall that policymakers view a neutral policy stance as being between 2.25% and 3.25%. Further 2024 rate cuts (however large) simply represent the normalization of monetary policy and *not* the introduction of stimulus. However, the Canadian market is not priced for larger rate decreases which leaves us biased to outperformance of GoC over USTs in coming months. In 2025, however, Canada bonds are likely to lag the rally of their US counterparts.

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