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What We Think...

A Changing Narrative For Monetary Policy

After years of following "non-conventional" policies that have not delivered as prescribed, central banks and central banking is under ever-increasing amounts of scrutiny - one might even argue that macroeconomics is under scrutiny, as central banking is largely an extension of macroeconomic models and the interplay of money and economics. Following the Credit Crisis it was widely assumed that non-traditional measures, invoked under Bernanke and later followed by Yellen, would eventually be reversed. In the US, the contexts for the non-traditional measures were the Volcker and Greenspan eras and the "normal" policy tools used during their reigns. However, as time passes, and the *normalising* of rates seems a far too distant goal, we detect a "Changing Narrative" surrounding monetary policy. There is now no normal and, if there once was, it was only within a context that, in fact, may have not been at all normal.

We see the changing narrative for monetary policy as potentially including changes to the assumptions for limits to QE, the floor for nominal rates, normal real rates, and unemployment and inflation targets. There are other more radical departures from the current policy framework that we will not consider here, but it is safe to assume that, so long as monetary policy remains the primary policy instrument (while fiscal policy remains largely restrained) and it continues to under-deliver and with growing adverse consequences, it will be challenged with increasing fervour.

The limits to QE and the floor for nominal rates have both already undergone radical changes in perception over the last few years. Although, in both cases, it has not been the Fed who has challenged the conventional understanding. When the Fed was active with QE policy, there was consistent reference to the eventual unwinding of its balance sheet and ways in which it might be achieved. Now we have both the ECB and the BoJ increasing or telegraphing purchases with little deference to eventual unwind. As a result, central bank goal posts have been moved, and not just for the ECB and the BoJ, but for others including the Fed. Similarly, the implementation of negative interest rate policy (NIRP) by a host of central bank has insidiously recalibrated the range of policy rates, with unintended consequences. Consider the number of banks, insurers and pension funds that are currently struggling with negative yields. Although the Fed has not indicated a desire to implement NIRP, it has not ruled it out either. Note, that in August, Fed Vice Chairman Stanley Fischer said, "We're in a world where [negative rates] seem to work."

RRB's & TIPS

In 1991, the Government of Canada issued its first Real Return Bonds with a 30-year maturity and coupon of 4.25% – then assumed to be the long-run real yield in Canada. In 1998, the US Treasury issued the first 30-year TIPS with a coupon of 3.625%; 4.25% 2026 RRB's were yielding 3.85% at the time. Issuance of TIPS with a much lower coupon than similar term RRB's brought down RRB yields, however a spread still existed reflecting the presumed difference in credit quality between Canada's and Treasuries. Today's yield spreads are reversed with 30-year RRB's and TIPS at 0.17% and 0.58% respectively.

Although liquidity plays an important role in inflation linked bond markets, it only explains a minor part of the decline in long-term real yields. We believe the majority of the decline relates to the growth expectations of respective economies and the supply of high quality inflation linked securities versus the demand from global investors.

A substantial amount of research effort is currently being directed towards identifying what the appropriate level of real rates should be for monetary policy purposes. Although, the natural rate of interest, which is defined as the interest rate that is compatible with a stable price level[i], would perhaps be more useful for implementing monetary policy than real rates, it is unobservable and hence of limited "real time" use. However, research conducted by Lubik and Matthes of the Richmond Fed[ii] suggest that the natural rate has undergone a secular decline from about 3.5% in the early 80's to 0.5% in 2015. Similarly, in a recent paper by

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Kevin Lansing of the San Francisco Fed[iii], the long run natural rate of interest is projected to be around 1%, with the current rate estimated to be around zero. In both cases, current real rates are below the natural rate, and both are well below assumed "normal" levels of real rates. We see the acceptance of very low real rates as already well underway and a thus an element of how the narrative for monetary policy has already changed.

Unemployment and inflation targets do not have particularly long histories at the Fed (many other central banks have had inflation targets for a long time – the Bank of Canada since 1991). In fact, it would be difficult to argue that the Fed's unemployment target has been anything but unstable and poorly defined. More importantly, the inflation target of 2% adopted by the Fed in 2012, to bring it more in-line with other major central banks appears to be up for discussion. In a recent Economic Letter, John Williams, president and CEO of the San Francisco Fed, made the case of higher inflation targeting consistent with raising natural rates of interest[iv].

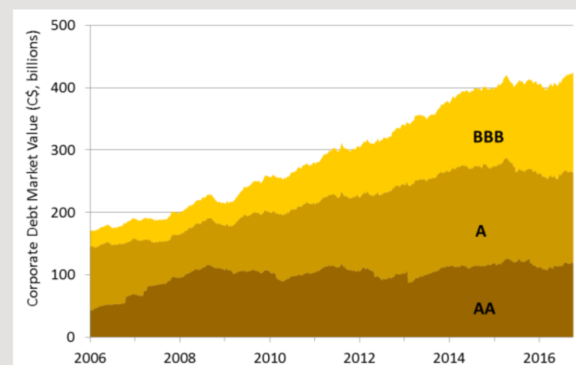
To us, the changing narrative of monetary policy is creating the rationale for an environment of lower policy rates (even negative), perpetual bloated central bank balance sheets, and low real yield curves. In some instances, the 80's and 90's are being described as anomalous periods with above-average GDP and consequently high real yields. While rate increases from the ECB and BoJ are a ways off, we expect the Fed to continue raising rates, but on a slow and shallow path.

The Canadian Corporate Market

After the explosive growth of the Canadian public corporate bond market in the 1990's, in both absolute and relative (to overall public debt) terms, we have seen continued absolute growth but a levelling off in relative terms. In the most recent decade, we have seen deteriorating overall credit quality as more issuers have fallen into the lowest investment grade category and Canadian investors have become more receptive to lower-rated credit in their search for yield. From an industry perspective, financials continue to dominate the corporate market, a situation that has persisted since the late nineties, while the balance of the industry mix has remained relatively consistent. Recently, the most noticeable rise has come from the real estate sector, which has sought more investment outside financial institutions over the last few years.

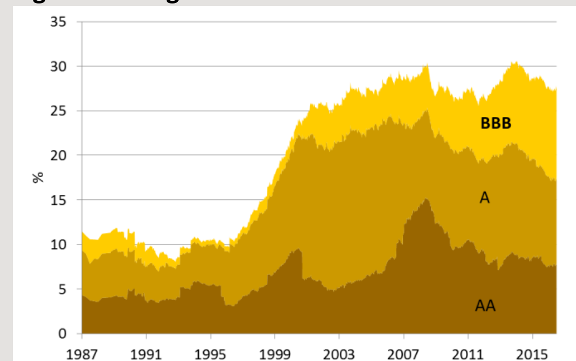
Figures 1-3 show the growth in public corporate investment grade debt in Canada according to the FTSE TMX Universe indices. Over the last ten years, the corporate weight as a percentage of overall public issues has been relatively constant, hovering between 25-30%. Over the same period, overall corporate, like government, debt growth

Figures 1-3: Canadian Investment Grade Corporates
Figure 1: Debt Outstanding



Source: FTSE TMX Debt Capital Markets, Statistics Canada & Lorica Investment Counsel Inc.; September 2016

Figure 2: Weight in Universe Index



Source: FTSE TMX Debt Capital Market & Lorica Investment Counsel Inc.; September 2016

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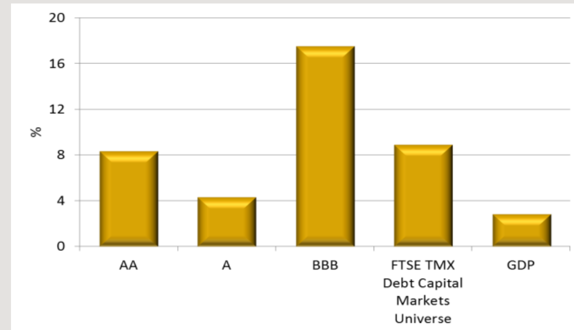
has greatly surpassed GDP growth – 3.1 times greater on average per year. This exorbitant debt growth has been particularly true for lower-rated categories such as BBB's (and below investment grade debt) where debt growth has been 6.2 times greater per year.

The rise in corporate debt in the 90's can be traced back to the disintermediation of financial institutions (mainly banks) from the financing of large borrowers, which led to a massive increase in public corporate debt. The cause of the rise in the 2000's is less specific to corporate bonds as there was a commensurate rise in government debt. There is little doubt that the deterioration in government finances has led to a significant rise in government debt to GDP at both the provincial and federal level, although low financing costs have also been a catalyst. In the corporate sector however, it has been low rates that have encouraged borrowers to take on more leverage, although not necessarily for the reasons intended from low rate policies. Capital investment and employment gains have been relatively poor through most of this low rate period – see Figure 4. Instead, we have seen a lot more balance sheet consolidation and M&A activity.

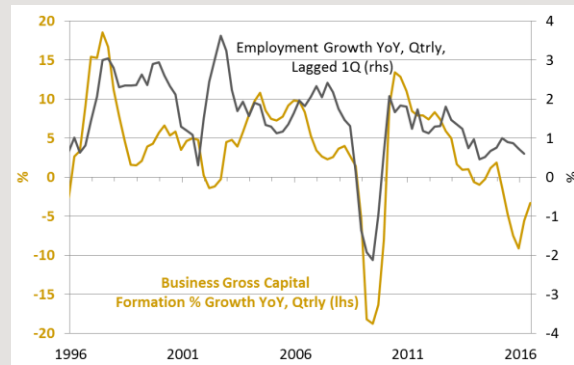
While low rate policies have had an impact on both issuer and investor behaviour, the results have not always been desirable. To offset fallen government yields across the yield curve, Canadian investors have been willing to take on more credit and yield spread risk. Canadian borrowers have also responded by repatriating lower-rated issuance from the US and generally making greater use of public markets. There has also been a deterioration in credit quality as businesses have taken on more leverage – see Figure 5.

Figure 3: 10-Year Average Annual Growth Rates



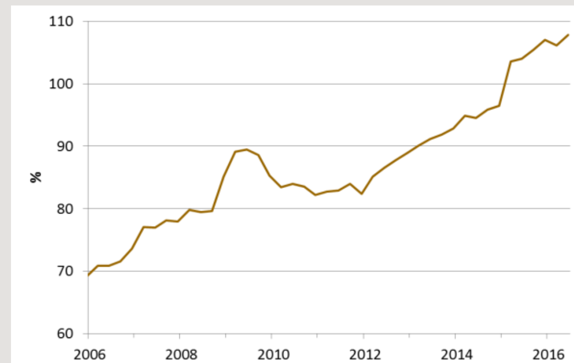
Notes: Uses geometric averaging
Source: FTSE TMX Debt Capital Market & Lorica Investment Counsel Inc.; September 2016

Figure 4: Canadian Business Investment vs Employment



Source: Bloomberg, Statistics Canada & Lorica Investment Counsel Inc.; September 2016

Figure 5: Canadian Non-Financial Corporate Debt as % GDP



Notes: Includes Non-Financial corporate debt and loans
Source: Statistics Canada & Lorica Investment Counsel Inc.; September 2016

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What's Next For the Bank of Canada?

Although the Canadian economy is still in recovery, it is fair to assume that Bank of Canada is still on the sidelines. We expect "for how long?" to become a more important question, as the government's fiscal policy plays out and the Fed finally implements another rate increase. The Canadian economy is still struggling to adapt to energy prices that have fallen 47% over the last two years, in an environment where US growth is still uneven and global trade no longer favours Canada, despite a 17% depreciation of the Canadian dollar over the same period.

Current Canadian GDP is running at 1.3% YoY, but a very disappointing -1.6% QoQ on an annualized basis as at Q2. The growth data has been impacted by the devastating fire and flooding in Fort McMurray, which should see a rebound when Q3 data is released. Other, timelier data, such as exports and manufacturing are showing modest, albeit inconsistent, improvement, although the overall trends for both are still somewhat unconvincing. Recent employment data has been spectacular, but Canadian employment data is notoriously volatile and therefore cannot be entirely trusted. While new jobs have averaged a healthy 11.6k a month for the last year, just under ⅔'s of those gains have come from part-time employment and about ¼ have come from the public sector or through self-employment – not necessarily the most productive job gains.

The Bank's low rate policy has been extended across the yield curve by the decline in developed country sovereign yields, which has flattened out the Canadian yield curve. The overnight to 30-year yield curve is now at 132, which is relatively flat after such a long period of policy stimulus. However, we believe the more tangible objective of lower rates and forward guidance has been the depreciation of the Canadian dollar with its expected stimulus to exports, manufacturing, and capital spending. While there has been some progress, there remains much room for improvement. We suggest disappointing and erratic growth in the US, the disappearance of both manufacturing industries and capacity over the last decade, and barriers to business investment as some of the main factors causing this weakened response.

Perhaps the most obvious impact of low rates has been on selected parts of the Canadian real estate sector – specifically housing in Vancouver and Toronto, with the corresponding inflation of prices and risky purchasing behaviour. However, given the Federal and provincial government interventions, with policies designed to reduce the level of purchaser risk, increase domestic affordability while allowing the BoC to maintain its low rate policies, it would not be unreasonable to expect some slowing in the sector going forward.

While many developed country central banks are trying to goad governments into stimulative fiscal policy, the Bank of Canada has been applauding the government for taking the lead with infrastructure and other spending in its inaugural budget. Although, the timeliness and effectiveness of the stimulus is a work in progress, Governor Poloz has been content to sit on the sidelines while policies (including those on housing) play out. However, should a substantive level of growth not emerge soon, the end of the honeymoon period for the Bank and the Budget will not be far off. Ultimately, we see the Bank of Canada remaining on hold as the likeliest scenario. Growth will be modest, but not weak enough to force the Bank into action, particularly while the US implements a gradual path to higher rates. Although short term yields in Canada should remain relatively stable, longer term yields are likely to follow the lead of US yields.

[i] See Knut Wicksell, *Interest and Prices: A Study of the Causes Regulating the Value of Money, 1898*, English translation, London: Macmillan and Company, 1936, p. 102.
[ii] See Thomas A. Lubik and Christian Matthes, Calculating the Natural Rate of Interest: A Comparison of Two Alternative Approaches, EB15-10 – Federal Reserve Bank of Richmond, October 2015.
[iii] See Kevin J. Lansing, *Projecting the Long-Run Natural Rate of Interest*, FRBSF Economic Letter, 2106-25, August 29, 2016.
[iv] John C. Williams, *Monetary Policy in a Low R-Star World*, FRBSF Economic Letter, 2106-23, August 15, 2016.