For every client we face who thinks the Fed is going to cut 100 basis points, we have one wondering why they are cutting at all. The second group would no doubt be puzzled that US central bankers are marching firmly towards lower rates at the end of a month in which the data showed more than a 200K climb in non-farm payrolls and a 0.3% monthly advance in core CPI prices. Just why is the Fed opting to buy insurance if there’s no visible economic flood?

The answer is largely one of risk vs. reward. If it turns out that lower rates were needed, the Fed would have made a costly error in standing pat and waiting for more evidence. With so little room to cut, the costs of delivering and later undoing a rate cut that the economy doesn’t end up needing don’t look as material (see pages 3-5).

The Fed isn’t really resting its decision on the idea that inflation is meaningfully too low today. Even its own Monetary Policy Report concluded that the recent dip in its targeted core PCE price index came from temporary factors. When the FOMC members fret about risks that inflation will remain below target, they’re really just worried that growth could tank, and that economic slack would bring less transient downward pressures on prices, and a miss against its other objective, full employment.

But the bond market is, of course, assuming that enough of a flood is coming that the central bankers will be building Noah’s ark, and is pricing in an extended run of Fed cuts into 2020. Our call is that this year’s rate relief, and perhaps some progress on trade talks in the first half of 2020, should obviate the need for additional Fed cuts next year. If so, equities will get some comfort from signs that the expansion has more room to run, but Treasuries investors will give back some of the past year’s winnings.
MARKET CALL

- A Fed rate cut later this month is a done deal, but there’s still plenty of debate over how far rates will have to fall to combat somewhat softer growth and inflation. We still suspect that, given the Fed is moving early relative to the slowdown in economic indicators, and with financial conditions already accommodative, 50bp of total cuts will be enough (see p3-5).

- The Bank of Canada sounded fairly cautious in its recent communications, and given the reliance on exports and business investment within its forecast, policymakers may not like what they’ve seen from the loonie recently either. However, with growth in the near-term still likely to beat the BoC’s conservative forecasts, we haven’t moved up the timing of our Bank cut. We still see our sole 25bp reduction in Q2 next year.

- The Federal Reserve cutting earlier than previously forecast, but our BoC forecast remaining un­changed, means that the Canadian dollar will likely be a little stronger (and for a little longer) than we previously anticipated.

### INTEREST & FOREIGN EXCHANGE RATES

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END OF PERIOD: 17-Jul Sep Dec Mar Jun Sep Dec
Fed Insurance: Why Now and at What Cost?
by Andrew Grantham and Katherine Judge

When it comes to Fed policy, the question is no longer when it will start, but rather by how much it will be cutting interest rates. Chairman Powell has given a strong indication that there will be a 25bp reduction in the funds rate by the end of the month, and we suspect that will be followed up by another quarter-point move before the end of the year.

That’s now a very consensus call that is well baked into financial markets. After that, however, things get more interesting, with bond yields and fed funds futures pricing in more rate cuts come 2020. But with only a handful of indicators suggesting that the US economy is heading towards something more worrisome than simply a period of slower growth, and with hope of trade tensions easing, we think that the two 25bp cuts this year will suffice. The question then turns to whether there will be a cost to pay for such insurance.

The Case For (Just) Insurance

To judge whether or not the economic data are yelling for interest rate cuts at this stage, we examined 16 key monthly indicators ranging from labour market trends (initial claims, payrolls, hours etc) to trade (exports, manufacturing production, ISM) and housing (construction spending, starts etc).

As discussed on the cover, a few key measures have been showing declines recently. However, with housing market activity and auto sales having stabilized on a three-month basis recently, only three have been showing a negative trend recently. That’s quite a low number compared to past instances of the Fed starting to cut interest rates (Chart 1, left), and is actually down slightly over the past couple of months (Chart 1, right).

Of course, not every indicator is created equal in their ability to foretell if the economy is heading for a recession. Some series are simply too volatile (even on the 3m/3m basis that we use) and/or represent too small a part of the economy. Part of the concern for those betting on more interest rate cuts could be that two of the indicators that are declining at present are in the top five most correlated with recessionary periods (Chart 2).

However, manufacturing is a much smaller share of the economy now than it was in 1990 (the starting point for this analysis). Moreover, given data availability, the analysis for hours worked was conducted using just production and non-supervisory employees. The full data series (available only since the mid-2000’s), is still showing an increase in hours albeit admittedly at the slowest pace in the current expansion.
And another one of the best indicators of economic health – the job count itself – shows not just that payrolls are still rising but also that they continue to outpace the trend in labour force growth (Chart 3). While payrolls have slowed a little more than they had before the insurance cuts of the mid and late-1990’s, the trend is still much more positive than when the first interest rate cuts were enacted in 2000 or 2007.

As such, the interest rate reduction expected before the end of the month would be early relative to signs of slowing in the economy. Policymakers are responding to some growth and inflation (albeit, as we wrote last month, because of the use of PCE prices as the target), but also the threat of a worse outcome due to trade uncertainty.

And uncertainty is something that, at least according to recent academic work to measure such a phenomenon, is worse now than during other periods of interest rate reductions (Chart 4). Note though that uncertainty was elevated at the time of the late 1990’s insurance cuts, thanks to the Asian crisis, and when that didn’t end up having a big impact on the US economy the cuts were unwound only a year later.

The Cost of Insurance

So if these are simply insurance cuts to guard against potential threats, the question then turns to if there’s a cost of doing so. If there is, it probably won’t be a sudden surge in inflation. Even during the mid to late-1990’s, interest rate cuts did little to change the path of core PCE inflation.
inflation (Chart 5, left), although they did shore up inflation expectations a little (Chart 5, right). With inflation even stickier and better anchored around 2% currently than during that period, a sharp acceleration likely isn’t in the cards. Nor, for that matter, is it guaranteed that the reductions will get inflation back to the 2% target. However, we don’t think policymakers will lose as much sleep over that if growth picks back up and uncertainty falls.

There is the potential, however, for a cost related to unwanted exuberance in financial markets. After all, according to two widely watched measures of overall financial conditions, the Fed hasn’t cut interest rates with financial conditions already so loose (Chart 6). The closest such instance was the insurance cuts of the mid-1990’s.

But in the mid-1990’s there was room to run for the equity market. At the time of the first Fed cut in 1995, the S&P P/E ratio (based on next twelve months earnings expectations) was below its long-run average and remained below that mark a year later (Chart 7). Today, that isn’t the case, although the extent that the S&P appears already expensive isn’t as stark as it was at the time of 1998’s interest rate reductions.

One area of exuberance that occurred after the insurance cuts of the 1990’s that Federal Reserve officials won’t want to see repeated is the surge in corporate bond issuance by lower credit-quality corporates. This surged in the second half of the 1990’s (Chart 8, left), but is already even more elevated today as a share of the economy (Chart 8, right).

In a world of heightened uncertainty and slowing growth, the risks associated with taking out a couple of insurance cuts are not large. But they are also not zero. While it’s unlikely that inflation will run away, there are clearer concerns regarding adding further fuel to the equity market and BBB corporate bond issuance. As such, the economy will have to perform much worse than our only mediocre 2020 growth forecast to justify the extent of rate cuts currently priced into markets.
Let’s give credit where credit is due. During this long and winding global economic recovery, the Bank of Canada has been one of the most successful inflation-targeting central banks in the developed world (Chart 1). That’s no small feat given the persistent undershooting of inflation versus target in places like the US, Eurozone and Japan.

But the bond market isn’t showing much confidence in the ability of Canadian policymakers to continue that run. Real-return bonds are priced for inflation to average less than 1.4% over the next ten years. While those readings are certainly not unbiased indicators of actual expectations, that pricing represents a significant undershoot relative to the past decade.

Sure, the loonie played a major role in keeping inflation near target. By pushing up prices of imported goods and services through a depreciation, it worked as an automatic stabilizer when gas prices were barreling lower from late 2014 to 2016 (Chart 2). Subsequently, a strengthening loonie helped keep inflation from overshooting as gas prices were rebounding.

But, those currency swings didn’t come in isolation. Governor Poloz’s rate cuts in 2015, and the ensuing hikes, played a major role in directing the exchange rate. So the Bank of Canada deserves the credit for a job well done.

Moreover, the Bank of Canada’s strong track record both before and after the crisis has positive implications outside of just contemporaneous wins. It’s actually made it easier to be successful in the future. While difficult to empirically prove, theory suggests that if households and businesses see inflation around target more often than not, they will expect that to continue in the future, something that will feed back into actual inflation via, among other things, wage negotiations.

The de-anchoring of inflation expectations has been an important concern recently in those developed economies struggling to reach their inflation targets. However, despite inflation compensation in the bond market being below target, there’s little evidence in surveys (e.g. the BoC’s Business Outlook Survey) to suggest that actual expectations have moved materially lower. Keeping inflation running at 2% may sound boring, but with bonds priced for lower prints, it could make for some meaty returns for those who can (because of liquidity and other constraints) make that bet.

**Risks of Overheating?**

As with all good debates, though, there’s no clear consensus on the outlook for inflation. Some commentators are now worried that, with a historically low
unemployment rate and high prime-age employment-to-population ratio, Canada risks stoking undue inflationary pressures if the central bank ends up slashing rates. Indeed, the Bank of Canada’s three core inflation measures are now averaging a touch above the 2% target, and our own dispersion index shows that more of the CPI basket has seen increases of greater than 2% over the past year (Chart 3).

However, a cautious approach should be taken in ascribing too much weight to the current, or potential future, run of above-target inflation readings. Looking beneath the surface, there are moving parts blurring the lines between sustainable price growth and idiosyncratic moves.

The Housing Market Giveth and Taketh Away

The basket of items tied to shelter represents roughly one-quarter of the total index. Price movements in that major category climbed up to the Bank of Canada’s 2% inflation target in mid-2018 and have continued to rise above it ever since. But the acceleration has been more of a grind recently, and could be on the verge of reversing course.

The component of shelter costs that account for those associated with the depreciation of a dwelling, in which year-over-year home price movements can be used as a reasonable proxy (Chart 4), had been running hot in 2017 and 2018. However, amidst new housing and mortgage rules, not to mention higher rates from the Bank of Canada, those price increases have virtually vanished. There has been an easing in some financial conditions recently, but home price growth is not expected to accelerate anywhere close to those prior highs.

Just as one housing-related component decelerated, though, others picked up. Rent inflation skyrocketed earlier this year. That, however, also appears transitory, largely due to the distorting effects of a methodology change (Chart 5). According to Statistics Canada, after a period of volatility in the first year of the new calculations, the year-over-year inflation rate, should settle back down.

Mortgage interest costs have also been rising, on the back of what had been higher interest rates, particularly yields on 5-year Government of Canada bonds, to which many mortgages are tied (Chart 6). But the drop in yields more recently and the likelihood that they’re set to remain low
for some time, should also translate into a deceleration in the pace of growth for mortgage interest costs.

Nevertheless, despite the projected slowdowns in the large chunk of the index related to housing, our forecast sees headline inflation hanging around the 2% target in the near-term, and actually accelerating into year-end, reaching a pace of more than 2½% in Q1 2020.

But that's not a result of any sustainable inflationary pressures. Rather it's due to a fall in gas prices from a year earlier (Chart 7). Indeed, the average quarterly annualized pace for Q4 ’19 and Q1 ’20 is expected to clock-in closer to 1 ¾%. So, after those base effects have fallen out of the annual calculation, the headline inflation rate should settle down in a range much closer to the 2% target.

**Chart 7**
**Soft Gasoline Prices Early in 2019 Likely to Have Inflation Above Target in Q1 2020**

![Chart 7](chart7.png)

Source: Statistics Canada, CIBC

What’s A Central Bank Governor To Do?

Inflation is, of course, a lagging indicator. Waiting for economic weakness or strength to show up in inflationary pressures means reacting to changing conditions with a significant delay. The most reliable way to judge underlying inflationary pressures has been to use the output gap, the shortfall or overshoot of economic activity relative to usual capacity constraints.

Indeed, there have been only two periods since 1997 that the Bank of Canada’s core common component indicator of inflation has been above the 2% target for more than a cup of coffee (Chart 8). Each of those periods coincided with an economy that had been operating above its potential for a prolonged period of time. Even the major deviations from trend to the downside required a substantial and sustained undershoot of activity relative to potential. For now, an output gap exists and if, as we expect, growth disappoints in the second half of the year, the Bank of Canada will clearly have room to cut rates without stoking sustainably above-target inflation.

Part of the stickiness of inflation around 2% has to do with anchored inflation expectations (or past successes), while another part is probably attributable to the countercyclical moves often seen in the Canadian dollar. Either way, when you add it all up, your best bet for forecasting inflation over the medium term is to pick a number close to 2%. That sounds mundane, but for those worrying about runaway inflation and bond markets pricing in material downside misses, another long run of 2% inflation will come as a surprise.
The disconnect between the Canadian jobs market and the economy in general, and income growth in particular is, in many ways, defining the current cycle. The labour market continues to create jobs at an impressive pace, with the unemployment rate at its lowest since the 1970s. At the same time, real GDP growth, while expected to improve during the year, is not remotely close to where it should be given the headline employment numbers. The long-term correlation between job creation and income growth in Canada is on a downward trajectory (Chart 1).

Clearly, it appears those new jobs do not add much to the nation’s overall productive capacity. This disconnect can be explained, at least in part, by the continued weakness of employment quality in Canada. Our index of employment quality fell by 1.4% during the year ending May 2019—building on the downward trajectory seen since the 1990s (Chart 2).

This reality of a lower level of quality also plays a role in explaining the disappointing pace of income growth in Canada. Note, that in the late 1980s, when our measure of employment quality was 15% higher, a one percent increase in employment generated on average, a 4.4% increase in real labour income. Today, it generates less than a 3% increase in real labour income.

It’s Not a Full-Time/Part-Time Story

The index combines information on the distribution of part-time vs. full-time jobs; self-employment vs. paid employment; and the compensation ranking of full-time paid employment jobs in more than 100 industry groups. Our index measures not only the quality of new jobs, but more importantly, the changing dynamics and quality of existing jobs.

Note, that the recent softening in the index was not due to strong performance in part-time or self-employment jobs. The opposite is the case. Over the past year, full-time employment rose much faster than part-time, accounting for 81% of all jobs created. Ditto for paid-employment which rose by no less than 2.5% over the past year—notably faster than the pace seen in self-employment (Chart 3).

This means that the decline in employment quality over the past year is due to the composition of job creation by industry. Looking at the distribution of job creation by compensation over the year ending May 2019 reveals that the number of low-paying, full-time jobs rose very strongly relative to mid-paying jobs, with the weakest performance seen among high-paying industries (Chart 2).
4). The worsening composition of the compensation sub-index reflects strong growth rates in relatively low-paying sectors such as food services, accommodation, personal services, administration and personal care as well as non-store retailing.

Job Growth by Income Bracket—Consistent with Lower Quality Trajectory

The three measures used above are basically proxies for compensation-based job quality. But they are far from perfect. A proxy is a proxy. Regardless of how we fine-tune the data, we might have a situation in which growth in self-employment can come from the higher-end of the pay-scale of that category. In that case, we underestimate the overall quality of employment. Alternatively, growth in full-time paid-employment can come from low-paying jobs in high-paying sectors—biasing our measure upward.

In addition, given that our focus is on the long-term trajectory of quality, those measures cannot capture some important demographic forces that might influence aggregate quality measures. For example, the declining share of young Canadians in the labour force might work to increase the overall quality since young workers, on average, earn less. That is obviously a short-coming of such a measure.

To overcome those difficulties, we used a direct measure of compensation by utilizing special unpublished Statistics Canada tabulations aimed at measuring employment growth by income brackets.

We then calculated the share of jobs that earn below the average wage in a given year. By using the average of each year as the base, we avoid inflationary biases due to workers migrating from one wage bracket to another. As illustrated in Chart 5, the share of workers who are paid below the average wage has risen over the years to just under 61% in 2018. That trend is consistent with a widening wage gap symptomatic of deteriorating labour market quality.

Chart 6 goes even further and examines job growth by different income categories. Interestingly, we find that the most significant increase in the below average-paying jobs segment occurred in the second wage range of between 50% and 100% of average wage in any given year. That trend has been consistent over time. It’s as true now as it was over the past few decades. That group currently accounts for no less than 51% of total employment.

Is it Good or Bad?

The recent softening in the quality index might suggest that, when it comes to job quality, the labour market might be a victim of its own success. Given the
high labour market participation rate and the low unemployment rate, it is possible that the new entrants into the labour market represent a group of people who, in the past, would have probably stayed out of the labour market. In that context, one might claim that the decline in the quality of employment is not such a bad news story. Another possibility is that Canadian workers simply do not have the necessary skills needed by firms. To the extent that Canadian companies cannot find the right people and have to compromise on less qualified workers, the overall quality of employment suffers.

The inability of the labour market to close the quality gap is also due to a slow increase in the number of high-paying jobs. And it seems that the supply of high-paying jobs is not rising fast enough to meet growing demand, as reflected in the relatively fast pace of wage gains in high-paying sectors (Chart 7). During the year ending May 2019, wages in high-paying industries rose by more than double the rate seen in mid-paying industries (wage growth in low-paying industries was impacted by minimum wage increase and therefore cannot be compared here).

Regardless of how you measure it, by occupation, by industry and more directly by income, the overall quality of employment in Canada is on a decline. Simply put, all other things being equal, lower employment quality means that the labour market must run faster to stay in the same place since we need relatively more workers to generate the same increase in income.
Canadian data have been on a roll lately, but the economy has yet to prove that the current acceleration is anything more than a rebound to more normal levels of activity from virtual stagnation in the fourth quarter of last year and the first quarter of 2019. It’s likely that after the current period of adjustment, growth returns to a more modest pace, as household spending and housing market growth slows down, while exports and business investment don’t enough to pick up the slack. Inflation should, therefore, hover around target, rising later this year only because of base-effects from previous weakness in gas prices.

UNITED STATES

The US economy’s outperformance in Q1 was driven in large part by an inventory buildup and strong exports, two things that appear to have reversed in Q2. That will leave consumers as the main drivers of growth, as business investment cooled substantially amidst heightened trade tensions. A 1.6% pace of growth in Q2, along with the damage to sentiment that trade uncertainty has caused, has made a July rate cut a near certainty at this point.