Economics

THE WEEK AHEAD

October 2 - 6, 2023

When the Fed says jump, we say, how high?

by **Avery Shenfeld** avery.shenfeld@cibc.com

My how things have changed. As recently as April, bond markets were pricing in rate cuts by the Fed and the Bank of Canada before this year was out. At the time, we argued that was much too premature, as we'll need to endure the economic pain of higher yields for several quarters to get all the way to a sustained 2% inflation rate. Since then, resilience in US economic growth justifiably started a rethink on when an easing might be expected, and that impacted Canadian yields given the strong linkage between the two bond markets.

Ten year treasuries are now roughly 130 basis point above where they stood four months ago, a huge move for a part of the curve that should garner some stability from the need to anchor long rates to where short rates will go over a full decade. While there are technical reasons behind some of that move, it seems like when the Fed said higher for longer, investors failed to ask, how high.

The Fed's FOMC forecast for overnight rates doesn't answer that, because for 2025, their individual projections are all over the map. Further out, one can't reasonably think about a year-by-year forecast for monetary policy stretching out over a decade. Instead, a more workable approach is typically to rely on a projection for monetary policy for the first year or two, and then ground the longer term view, or the "neutral rate," an estimate of what the economy can live with on average that is neither a headwind or tailwind to growth.

Although the prior cycle saw rates consistently below neutral, that was atypical. So there's no compelling reason to expect a long period of 1% or lower overnight rates ahead. Still, investors seem to have gone overboard in the other direction, with market-based proxies implying a nominal neutral rate of 4% stateside, and nearly that high in Canada. The FOMC, for its part, still put the long run nominal neutral rate at 2.5%, and a Fed research paper late last year argued that higher debt levels shouldn't have moved it up much from the last cycle.

We're skeptical about efforts to forecast where neutral might be several years ahead. So many variables are relevant (fiscal policy, technology change, global savings, demographics etc.) that you'd need a full playbook on what the world's economy will look like over the coming decade to use any of the theoretical models. Instead, the most credible approaches look at how the economy is behaving with yields at different levels to assess where neutral lies.

In Canada, today's lacklustre GDP data, even allowing for port strike distortions, added to ample evidence that 5% overnight rates are decidedly restrictive, even with trend inflation at 4%. If so, that suggests that a real interest rate of 1% is above neutral and is slowing growth. The upshot is that if we get inflation back to 2%, we'll need an overnight rate somewhere below 3% to keep the economy at full employment. If we get there by 2025, which doesn't seem far fetched, locking in today's 10-year rates looks reasonably attractive.

The Canadian bond market's real problem is the spillover from what is as yet a less convincing case that yields of over 5% are denting America's economy. We say "as yet", because with households able to draw down pandemic savings for a while, locked into cheap mortgages, and high rates only hitting new debt, the bite could simply be taking longer to show up. For now, growth remains healthy enough, although there are some cracks visible in moribund existing home sales, housing starts off earlier peaks, a gradual deceleration in hiring, and softer corporate profits that should cut into hiring decisions ahead.

So for those asking what will turn the tide for the bond market, the answer seems readily apparent. We'll need a longer list of signposts that today's yields are materially eating into American economic growth. If not delayed by a government shutdown, next week's payrolls report could provide an opportunity for markets to seriously ask "how high" when thinking about the path for rates ahead.

Week Ahead Calendar And Forecast—Canada

H, M, L = High, Medium or Low Priority

SAAR = Seasonally Adjusted Annual Rate

Consensus Source: Bloomberg

Date	Time	Economic Releases, Auctions and Speakers	Month	Priority	CIBC	Consensus	Prior
Monday, October 2	-	Bond Market Closed (National Day for Truth and Reconciliation)	-	-	-	-	-
Tuesday, October 3	8:00 AM	Speaker: Nicolas Vincent (Deputy gov.)	-	-	-	-	-
Wednesday, October 4	-	AUCTION: 2-YR CANADAS $5.5B	-	-	-	-	-
Thursday, October 5	8:30 AM	MERCHANDISE TRADE BALANCE	(Aug)	(H)	-$1.3B	-	-$1.0B
Thursday, October 5	10:00 AM	IVEY PMI	(Sep)	(L)	-	-	53.5
Friday, October 6	8:30 AM	EMPLOYMENT CHANGE	(Sep)	(H)	20.0K	-	39.9K
Friday, October 6	8:30 AM	UNEMPLOYMENT RATE	(Sep)	(H)	5.6%	-	5.5%

Week Ahead Calendar And Forecast—United States

H, M, L = High, Medium or Low Priority

SAAR = Seasonally Adjusted Annual Rate

Consensus Source: Bloomberg

Date	Time	Economic Releases, Auctions and Speakers	Month	Priority	CIBC	Consensus	Prior
Monday, October 2	9:45 AM	S&P GLOBAL US MANUFACTURING PMI	(Sep)	(L)	-	48.9	48.9
Monday, October 2	10:00 AM	ISM - MANUFACTURING	(Sep)	(H)	47.6	47.8	47.6
Monday, October 2	10:00 AM	CONSTRUCTION SPENDING M/M	(Aug)	(M)	-	0.6%	0.7%
Monday, October 2	1:30 PM	Speaker: Jerome H Powell (Chairman) (Voter) & Patrick Harker (Philadelphia) (Voter)	-	-	-	-	-
Monday, October 2	1:30 PM	Speaker: John C. Williams (Vice Chairman, New York) (Voter)	-	-	-	-	-
Monday, October 2	7:30 PM	Speaker: Loretta Mester (Cleveland) (Non-Voter)	-	-	-	-	-
Tuesday, October 3	-	AUCTION: 1-YR TREASURIES $44B	-	-	-	-	-
Tuesday, October 3	10:00 AM	JOLTS Job Openings	(Aug)	-	8500K	8900K	8827K
Tuesday, October 3	10:00 AM	Speaker: Raphael W. Bostic (Atlanta) (Non-Voter)	-	-	-	-	-
Wednesday, October 4	7:00 AM	MBA-APPLICATIONS	(Sep 29)	(L)	-	-	-1.3%
Wednesday, October 4	8:15 AM	ADP EMPLOYMENT CHANGE	(Sep)	(M)	-	150K	177K
Wednesday, October 4	9:45 AM	S&P GLOBAL US SERVICES PMI	(Sep)	(L)	-	50.2	50.2
Wednesday, October 4	9:45 AM	S&P GLOBAL US COMPOSITE PMI	(Sep)	(L)	-	-	50.1
Wednesday, October 4	10:00 AM	FACTORY ORDERS M/M	(Aug)	(M)	-	0.2%	-2.1%
Wednesday, October 4	10:00 AM	DURABLE GOODS ORDERS M/M	(Aug)	(H)	-	-	0.2%
Wednesday, October 4	10:00 AM	DURABLE GOODS ORDERS EX-TRANS M/M	(Aug)	(H)	-	-	0.4%
Wednesday, October 4	10:00 AM	ISM - SERVICES	(Sep)	(M)	52.0	53.5	54.5
Wednesday, October 4	10:25 AM	Speaker: Michelle W Bowman (Governor) (Voter)	-	-	-	-	-
Wednesday, October 4	10:30 AM	Speaker: Austan D. Goolsbee, Chicago (Voter)	-	-	-	-	-
Thursday, October 5	8:30 AM	INITIAL CLAIMS	(Sep 30)	(M)	-	-	204K
Thursday, October 5	8:30 AM	CONTINUING CLAIMS	(Sep 23)	(L)	-	-	1670K
Thursday, October 5	8:30 AM	GOODS & SERVICES TRADE BALANCE	(Aug)	(H)	-$66.0B	-$65.2B	-$65.0B
Thursday, October 5	9:00 AM	Speaker: Loretta Mester (Cleveland) (Non-Voter)	-	-	-	-	-
Thursday, October 5	12:00 PM	Speaker: Mary C. Daly (San Francisco) (Non-Voter)	-	-	-	-	-
Friday, October 6	8:30 AM	NON-FARM PAYROLLS	(Sep)	(H)	165K	170K	187K
Friday, October 6	8:30 AM	UNEMPLOYMENT RATE	(Sep)	(H)	3.8%	3.7%	3.8%
Friday, October 6	8:30 AM	AVERAGE HOURLY EARNINGS ALL EMPLOYEES M/M	(Sep)	(H)	0.3%	0.3%	0.2%
Friday, October 6	8:30 AM	AVERAGE WEEKLY HOURS ALL EMPLOYEES	(Sep)	(H)	-	34.4	34.4
Friday, October 6	8:30 AM	MANUFACTURING PAYROLLS	(Sep)	(H)	-	10K	16K
Friday, October 6	3:00 PM	CONSUMER CREDIT	(Aug)	(L)	-	$11.3B	$10.4B

Week Ahead's market call

by Avery Shenfeld

In the **US**, we might get some important readings on late summer activity, or not much, depending on whether last ditch efforts to avoid a government shutdown hit their mark. We're close in line with consensus on the payrolls count, but look for the jobless rate to hold at 3.8%. If official data are held back, other sources like the ISM will garner more attention. A tepid ISM reading for manufacturing won't surprise markets, but we're a bit below consensus on the services ISM headline. "Prices paid" measures in both will be impacted by higher energy costs.

In **Canada**, employment data from the always volatile household (LFS) survey will get top billing. While any one month's forecast is a challenge given the statistical noise in this survey, the softness in GDP suggests that we'll see more months ahead in which moderate job gains trail the brisk immigration-driven growth in the workforce, nudging the jobless rate higher in the process.

Week Ahead's key Canadian number: Employment—September

(Friday, 8:30 am)

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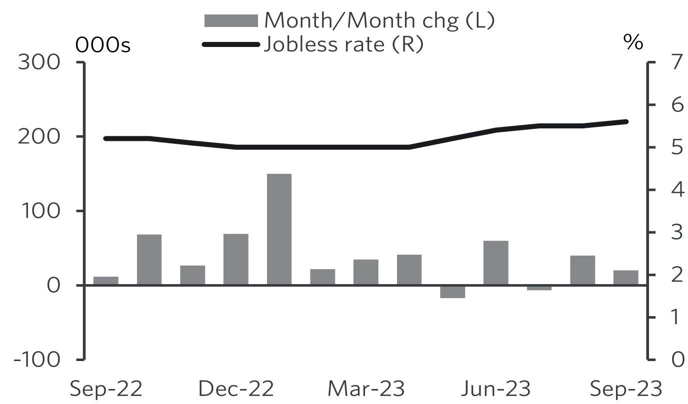
Variable	CIBC	Mkt	Prior
Employment change	20.0K	-	39.9K
Unemployment rate	5.6%	-	5.5%

Chart: Canadian employment



Source: Statistics Canada, Haver Analytics, CIBC

The Bank of Canada will need to see a higher unemployment rate to instill confidence that Canada's labour market is loosening sufficiently to bring inflation towards target in the future. The September employment data could have delivered that, as we expect to see a moderate 20K jobs created, half of the pace seen in August, and more in line with weaker domestic demand signals seen in the GDP and retail sales data lately. Brisk population growth has raised the bar for the magnitude of hiring that's required to prevent a climb in the unemployment rate, with September's job gain likely not meeting that threshold, causing the jobless rate to tick up to 5.6%. Annual average hourly wage growth will likely also cool, helped by a strong year-ago increase dropping out of the annual calculation.

Forecast implications — A continued climb in the unemployment rate will likely leave the Bank of Canada on hold as it portends weaker domestic demand, which will compound the negative impact of mortgage renewals on consumption ahead.

Other Canadian releases: Merchandise trade—August

(Thursday, 8:30 am)

Two-way trade will have benefitted from the end of the port strike on Canada's west coast in August, with a bounce back in imports likely only partly mitigated by higher crude exports to the US, resulting in a widening of the trade deficit to $1.3bn. Still, exports started the quarter on solid footing and that will likely make net trade a growth contributor in the third quarter. Looking through the volatility caused by the strike and floods, a weaker global growth backdrop will put a cap on export growth ahead, while weaker domestic demand will limit import growth.

Week Ahead's key US number: Employment situation—September

(Friday, 8:30 am)

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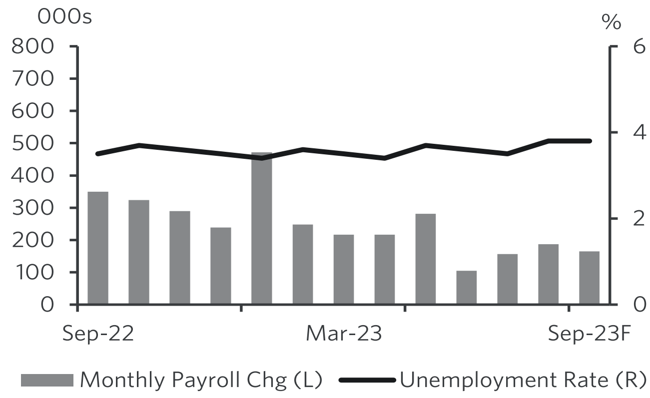
Variable	CIBC	Mkt	Prior
Employment (m/m)	165K	170K	187K
Unemployment rate	3.8%	3.7%	3.8%
Avg hourly earnings (m/m)	0.3%	0.3%	0.2%

Chart: US payroll employment



Source: BLS, Haver Analytics, CIBC

If the government does not shutdown, headlining next week's US data will be Friday's September labour report. We expect more of what we've seen over past six months: a gradual weakening of job growth and further evidence of a slow but steady rebalancing of the labour market. The unemployment rate and the participation rate should hold at 3.8% and 62.8% respectively.

Forecast implications — Another soft labour report will keep intact the slowdown in labour incomes, which eventually will feed into weaker consumption. That combined with the triple header of the student loan repayments, UAW strike and impending government shutdown should result in a weak patch for GDP growth in Q4.

Market impact — We are slightly below consensus this week on payrolls. A moderate upside surprise to consensus may not mean much for the Fed at this point. In arguing why the committee left in another rate hike in 2023, Powell noted that "we need more than three good months" in a clear reference to inflation and that near-term readings will determine the course of Fed policy.

Other US Releases: ISM Manufacturing—September

(Monday, 10:00 am)

The ISM manufacturing index should stay unchanged in September given mixed readings from regional PMIs in the month, leaving it in contractionary territory as cyclical areas of the economy remain under pressure from higher interest rates.

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