NATIONAL BANK OF CANADA
FINANCIAL MARKETS

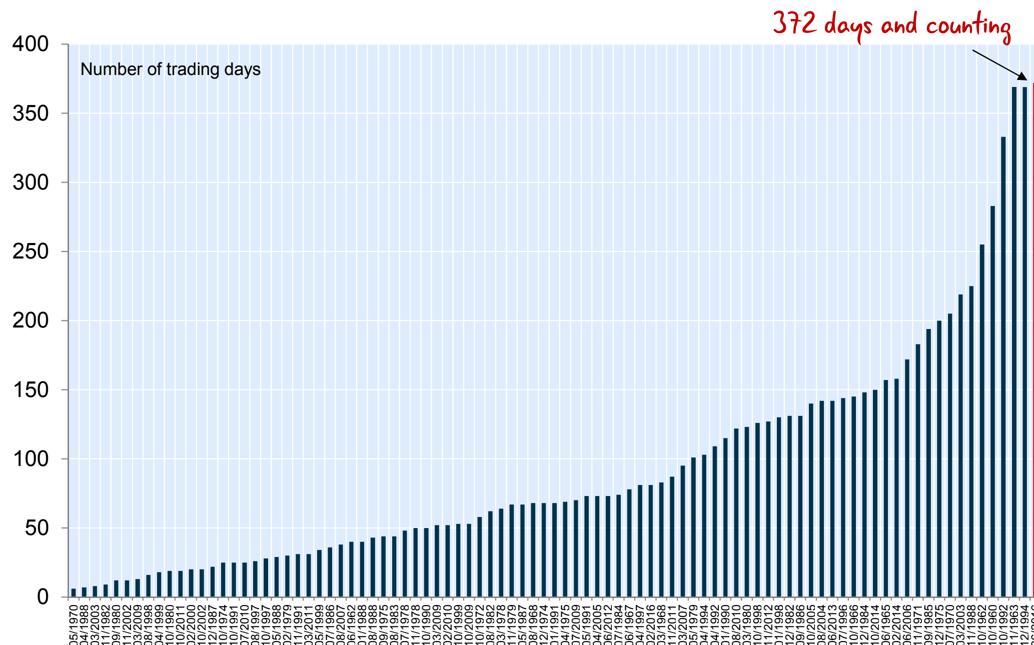
Morning Comment

Economics and Strategy

December 18, 2017

Best showing in 57 years for the S&P 500

The S&P 500 reached a landmark last week: 372 days and counting without a correction of 5% or more. As the chart below shows, this is the longest sequence since 1960. Previous longer rallies were those beginning in November 1963 (369 days) and December 1994 (369 days). With the S&P 500 now trading at 18.6 times forward earnings, the odds of a correction have certainly increased. Yet we do not foresee a severe or extended pullback because of the underlying strength of the economy. As explained in our latest *Monthly Equity Monitor*, the nonfinancial components of the leading indicator are growing at the fastest pace in eight years, earnings revisions are still positive, and the yield curve remains unusually steep at this point in the economic cycle (i.e. the matured phase).



NBF Economics and Strategy (data via Bloomberg as of Dec. 15, 2017)

The flattening of the yield curve became the focus of attention after the U.S. Federal Reserve hiked the upper bound of overnight rate to 1.5% last week. Chair Yellen argued that while the correlation between inverted yield curves and recessions has been high, correlation does not mean causality. The 10-year yield can be broken down between the expected average short rate over the term to maturity and the term premium. She noted that currently the term premium is quite low and this is contributing to the shape of the yield curve. So, even if monetary policy was to become marginally tight, the curve could become inverted although the policy stance would not be a source of concern for economic growth. Perhaps this is the case but we doubt that the Fed will want to test this assumption anytime soon. In other words, expect the yield curve to remain steeper for longer in this business cycle.

<u>Bottom-line</u>: The Fed's decision to raise interest rates just before the holidays was based on a strengthening economy and confidence that inflation will eventually pick up. The median FOMC participants projections still point to three rate hikes in 2018, which is one more than what we currently anticipate (see our *Fed Policy Monitor* for more details).

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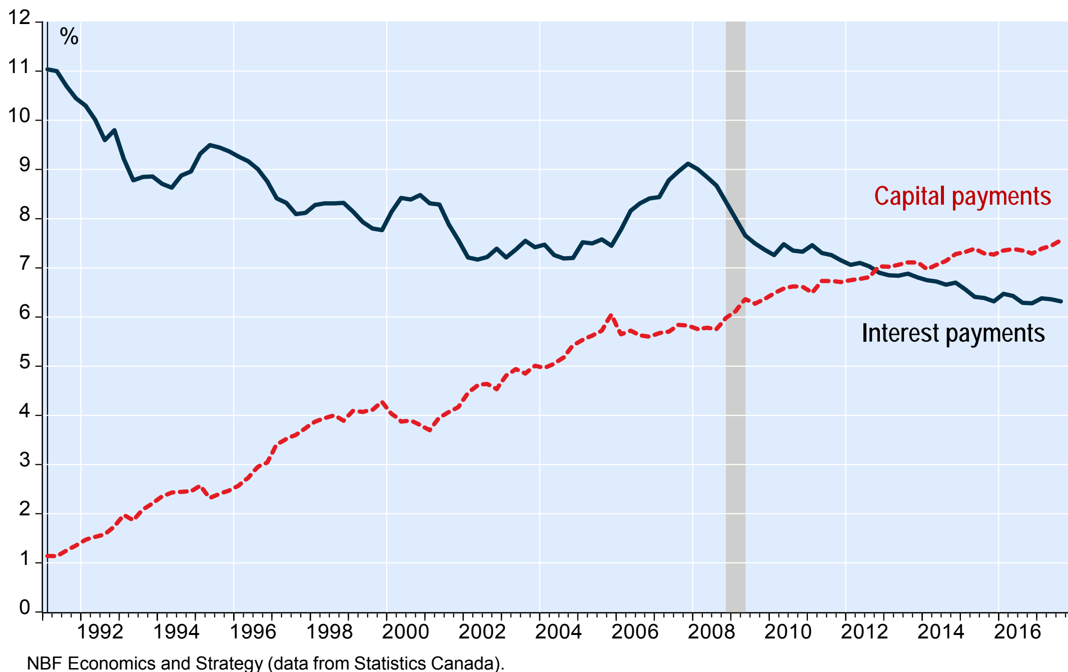
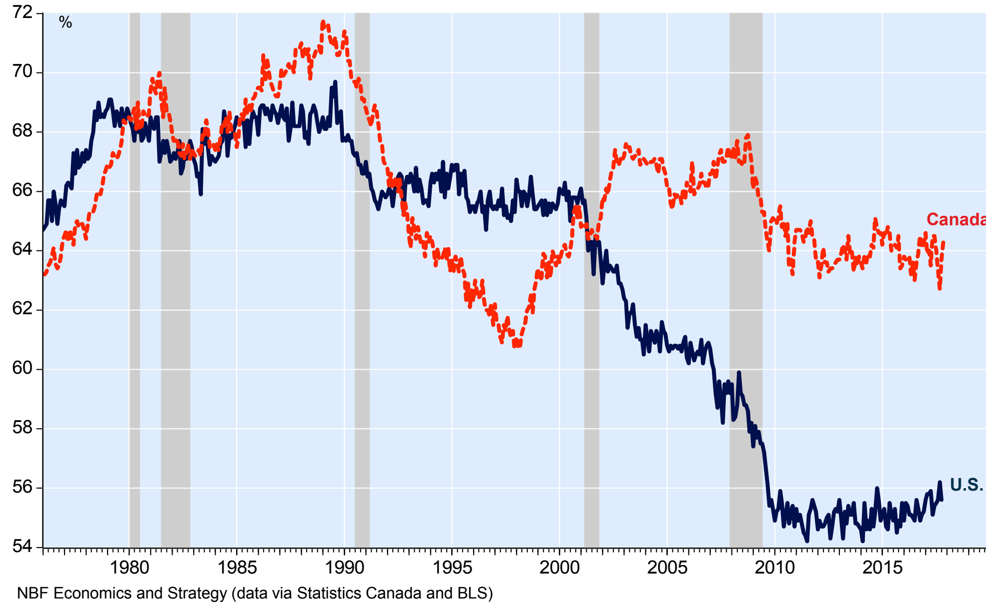
Poloz: Nightmares before Christmas

In a speech in Toronto last week, Bank of Canada Governor Stephen Poloz offered a rather mixed interpretation of the economic situation in the country. On the one hand, he acknowledged that **"the [Canadian] economy has made tremendous progress over the past year, and it is close to reaching its full potential"**. This was encouraging news for the BoC which is now **"increasingly confident that the economy will need less monetary stimulus over time"**. Taken on its own, that's statement would have pointed in the direction of a rate hike in early 2018, **but the Governor blurred thing up by adding that "while a mechanical approach to policy would suggest that monetary policy should already be less stimulant, the Bank still see signs of ongoing, albeit diminishing, slack in the labour market"**, a reality which posed a downside risk to the BoC's inflation anticipations. Counterbalancing that risk was "the fact that the economy is operating near its capacity, and that growth is forecast to continue to run above potential", two factors that could end up lifting inflation more quickly than the Bank currently expects. Those conflicting risks, Poloz said, were being monitored "in real time", in line with the "data dependent" approach to monetary policy now being favored by the central bank. **Mr. Poloz is certainly more upbeat than he was a few months ago, but not too much. Incoming data will could have a big impact on his future mood.**

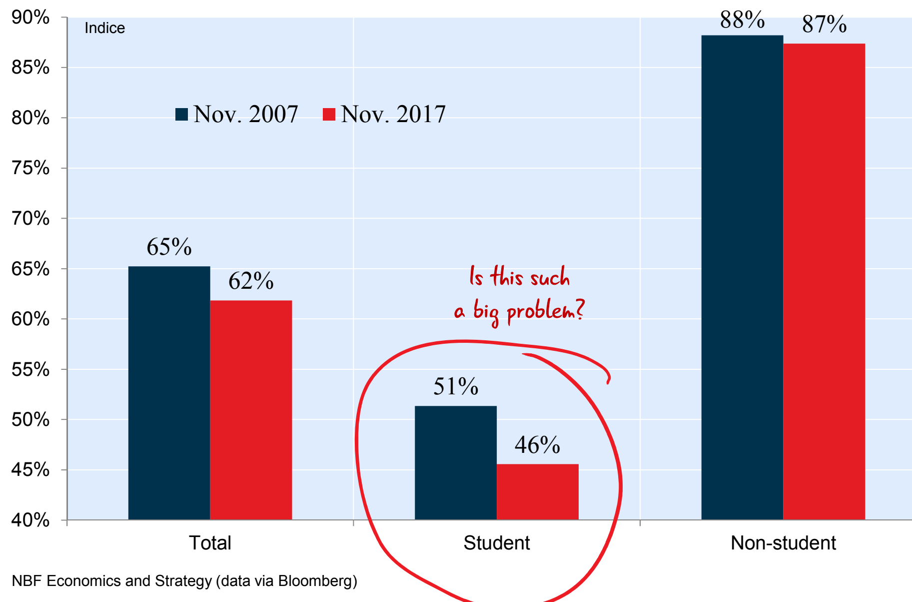
The BoC governor is a special kind of guy. After his assessment of the cyclical backdrop, Mr. Poloz shared with the audience three slow-moving nagging issues that keep him awake at night: **1- Cyber threats**; **2- high house prices and household debt**; **3- Youth underemployment.** With respect to nightmare number one (cyber threats) we agree with the Governor that this is something that could potentially destabilize our financial system and that it is vital for financial institutions to have contingency plans should an attack occur. Having said this, we don't think cyber is an issue likely to impact the stance of monetary policy in the coming months. **Turning to nightmare number two** (high house prices and household debt), Mr. Poloz continues to ponder on the extent to which high levels of debt will make the economy as a whole more sensitive to higher interest rates than in the past. That's fine, but we would argue that by keeping the overnight rate below inflation despite surging full-time job creation, Mr. Poloz is actually feeding the same "debt beast" that wakes him up during the night. At this juncture, we think the Canadian economy remains in good shape to absorb higher interest rates since the debt-service ratio of Canadian households in Q3 2017 remains dominated by capital repayments, not interest payment (chart).



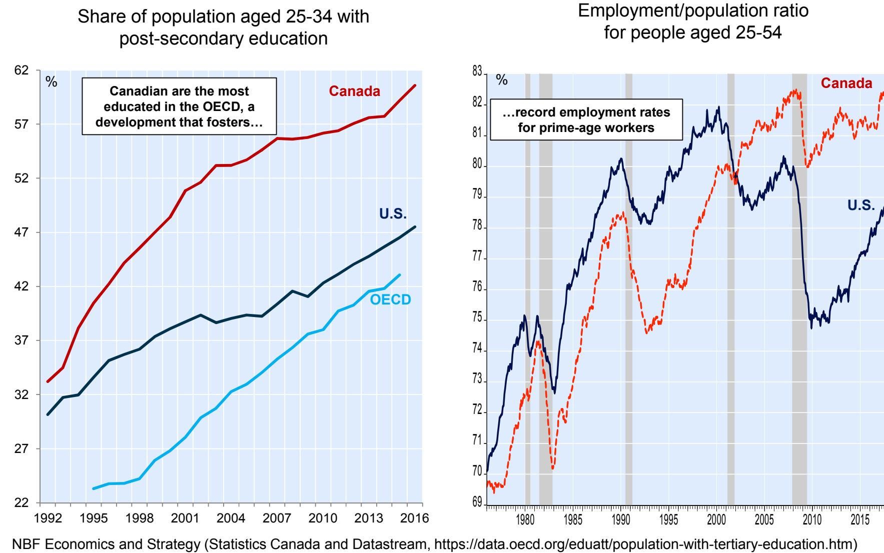
What about nightmare number three, youth underemployment? Is this a good enough reason to keep interest rates below inflation in Canada? Mr. Poloz is apparently losing sleep over the fact that the youth participation rate is at 64%, the lowest in almost 20 years. That's one nightmare we cannot interpret: **If Mr. Poloz is indeed losing sleep over youth underemployment, than he probably considers Mrs. Yellen to be reckless for raising interest rates at a time when the U.S. youth participation rate is a whopping 8 percentage points below Canada's (chart). Yet, Mr. Poloz continues to claim that that there is more labour market slack in Canada than in the U.S.!**



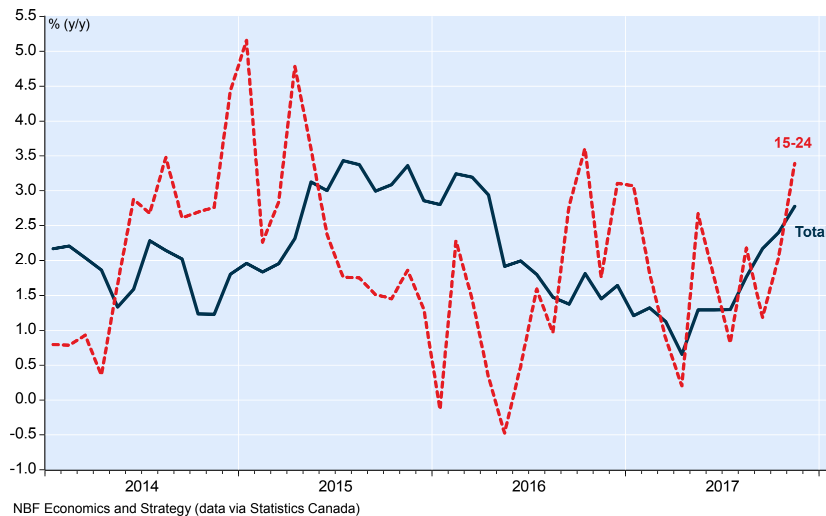
So why has the participation rate for people aged 15-24 declined in Canada since 2007? Our analysis reveals that the decline is exclusively driven by students (mostly those aged 15-19). For non-students, the participation rate has remained unchanged at around 87% (chart).



So the question begs to be asked: what's wrong with having a bigger proportion of our youth attend school? Two decades ago, only 32% of Canadians aged 25-34 had post-secondary education. The proportion now stands at almost 62%, about 15 percentage points above that in the U.S. The more educated the population is, the more likely they are to remain employed in their prime age. As the chart below shows, that's exactly what is happening in Canada.



In our opinion, the fact that the participation rate of "non-student" youth is currently just as high as it was in 2007 depicts a favourable cyclical backdrop for youth employment. Case in point, average hourly wage inflation for youth stood at 3.4% in November, well above the national average of 2.8% (chart)



Nightmares notwithstanding, eventually reality will catch up with you. There are no compelling arguments for keeping real interest rates negative in Canada at this time. Incoming data (GDP, CPI inflation, Employment/wages and the BoC business outlook survey) may still convince the Bank of Canada to hike on January 17, 2018.

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Morning Comment

Economics and Strategy

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