Focus

Feature Article

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It's a Small (Rate) World, After All

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This week saw a **global response to last week's aggressive 50 bp Fed rate cut**. The big step by the world's most important central bank, combined with another slide in crude oil prices, has taken the shackles off policymakers almost everywhere. **China got the ball really rolling with a series of long-awaited stimulus measures**, including 20-30 bp interest rate cuts and a drop in reserve requirements. **Sweden**, **Switzerland**, and **Mexico** cut rates by 25 bps, all three for the third time this cycle. Just a few short weeks ago, we crowed that the Bank of Canada was leading the world with 3 cuts of 25 bps—well, **the world just caught up**.

Chart 1
The Good, the Bad and the Okay

(Dec. 2019 = 100)
Equity Indexes

Sources: BMO Economics, Haver Analytics, SSE, TSX, S&P

Equities are thriving in a backdrop of fast-falling short-term rates and still-decent economic growth. The OECD nudged up its estimate of global growth by a tick to 3.2%, and sees the same for next year (matching our call for 2025). While 3.2% is a bit below the average growth rate of the past decade, it's close to what's seen as current potential global growth. That appears to be just the right pace to weigh on inflation while also supporting decent earnings growth. Juiced also by China's stimulus, stocks rose broadly this week, taking the World MSCI to a new high and up more than 10% from the early August lows. Even the previously laggard TSX is on a roll, closing above 24,000 for the first time, and now up 28% from last October's lows. There have been only two 11-month periods in the past 15 years that the Toronto market has managed to rise more than that: emerging from the deep 2008 plunge and rebounding from the 2020 plunge.

Amid all the excitement in equity markets, bonds played it cool, having long ago priced in relatively aggressive rate cuts. Treasury yields were almost unchanged on net this week, with 2s holding just below 3.6% and 10s close to 3.75%—thereby maintaining the mild upward sloping yield curve. Canada's curve was also broadly unchanged, albeit at much lower levels, with 2s staying close to 2.9% and 10s just a touch higher. Thus, the GoC curve is also now slightly upward sloping, a place it only returned to last week after more than two years of inversion.

The Treasury market was also responding to a mixed bag of economic data. Perhaps we can best capture the jumbled picture on the U.S. economy from this week's two major consumer sentiment surveys. First, the Conference Board reported that confidence took a large step back in September, suffering its biggest monthly setback since 2021. Yet, just days later, the University of Michigan reported that sentiment, in fact, rose nicely in September, as the one-year inflation expectation dipped to 2.7%. Making matters even murkier, the UofM's measure is still below the lows hit during the depths of the pandemic in 2020, which runs 180 degrees counter to the record highs for equities. Regional Fed metrics also muddied the picture, with many of the manufacturing surveys printing weak, but the Chicago Fed reporting that the broader national economy grew above trend last month.

Even the most important U.S. indicator of the week didn't really set a clear direction. **The core PCE deflator was milder than expected in August**, rising just 0.1% despite a 0.3% rise in core CPI for the same month. However, that was just firm enough to nudge up the annual rise in this key inflation gauge to 2.7%, and also pulled up the 3-month trend to just above 2%. Fed Governor Waller had specifically cited the drop in the latter to below 2% as a driving factor behind his newfound dovishness. And while real consumer spending came in a bit light last month at up 0.1%, it's still on track for Q3 growth of just above 3% annualized. At the same time, weekly jobless claims fell again to just 218,000, suggesting no significant strain in the job market.

Looking beyond the monthly and weekly noise, the bigger picture—which stocks appear to have their eye on—is that the U.S. economy remains amazingly resilient amid the battle to tame inflation. The big news in this week's GDP result was not that the U.S. economy did indeed grow at a stellar 3.0% pace in Q2, although that's impressive enough, but rather that prior years were revised markedly higher. Growth is now pegged at 2.9% for all of last year—the consensus call at the start of 2023 was for growth of just 0.5%, a massive misfire. Since the end of 2019, or just before the pandemic began, the U.S. is now estimated to have grown by a cumulative 10.7% (or about 2.3% annualized). While that may not sound particularly robust, it compares with just 5.5% growth in Canada over the same period, 3.9% in the Euro Area, 3.0% in Japan, and 2.3% in Britain. America's productivity growth will also now likely be revised higher, another area that the U.S. is separating itself from other major economies.

In contrast, Canada's economy has struggled to gain momentum after a respectable start to 2024. Monthly GDP did manage to rise 0.2% in July, but the early read on August points to a flat performance last month. This leaves the economy on course for growth of 1.3% in Q3 (our call), less than half the initial estimate of 2.8% by the BoC. It's a similar story for the year as a whole, with real GDP on track for little more than 1% growth, even as the U.S. economy is headed for a 2.6% full-year advance (or more).

The job market is also sending signals of further cooling, with the vacancy rate dropping to just 3.0% in July, and the ratio of unemployed to job openings jumping to 2.7—at its tightest in 2022, that ratio had dropped to 1.0, or essentially full employment. We're a long way from that happy place now. Meantime, **Canada's population keeps growing in leaps and bounds, driving further slack in the labour market**. While many read the latest quarterly population growth figures as "slowing", that's only compared with the super-heated pace of 2023. We would note that only 7 quarters in the past 50 years have seen the population grow by more than a quarter million people, and all 7 have been in the past three years alone, including the latest quarter. The bottom line is that the population has still grown by 3.0% in the past year or double the growth rate in the economy over the same period.

With the Bank now openly fretting about weak economic growth, confirmation that Q3 is coming in light of expectations **will simply fire up talk of a 50 bp cut at next month's decision**. We could thus soon be again pointing to the Bank of Canada as the global rate cut leader.

U.S. Growth Concerns Appear Overblown

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Ever since news broke that the U.S. jobless rate spiked to 4.3% in July, the market has been on recession-watch, looking for any signs the labour market and expansion could be cracking in a bigger way. Those fears ratcheted up after the Fed's outsized 50 bp rate cut as investors fretted about what the Fed knew that they did not. But new economic data since then show **very little evidence to suggest major trouble ahead**. Sure, consumer confidence plunged nearly 7 pts in September on the deteriorating view of current labour market conditions, but those views could have been shaded by the Fed's rate decision. Another potential driver of the decline was the large 0.2 ppts increase in the average consumer expectation of inflation over the next twelve months to 5.2%. In other words, it could be the unhappy combination of consumers seeing the best days of the labour market expansion as largely behind us and lingering concerns that future inflation may end up being stickier than we thought.

Consumer confidence is also likely being influenced to at least some extent by the impending national election and the negative campaign ads flooding the airwaves on the state of the economy and inflation. We have found that consumers' views of the economy have become much more polarized around political affiliation than they were in the past. For these reasons, **we don't take a lot of signal from the September consumer confidence hit** and continue to see the economy and labour market holding up well enough in the third quarter.

The final estimate of Q2 real GDP, released this week, remained at a buoyant 3.0% annualized, built on a broad and solid base of robust consumer, business, and government spending growth. But the most important revelation on Q2 was the **sharp upward revision in Gross Domestic Income (GDI) growth** from 1.3% to a sizzling 3.4% annualized. This elevated the GDP/GDI average growth rate to a very healthy 3.2% from the anemic 2.1% prior reported pace. Bears have been pointing out for more than a year now that lagging GDI growth could be a harbinger of a major downward revision in real GDP growth. Instead, the annual revisions, which went back to 2019, revealed significant upward revisions in both GDP and GDI growth. Turns out, income growth has actually been tracking along nicely with the solid real GDP growth trend this year, giving us more confidence in our forecast that consumer spending will continue to drive this expansion into 2025 and beyond.

Beyond GDP, this week's initial jobless claims data continued to surprise on the lowest end of analyst estimates at a nothing-to-see here level of 218k, continuing a downtrend in the 4-week moving average that is now in its seventh consecutive week. That brings me to **our above-consensus forecast for September nonfarm payroll growth of 150k jobs**, which is a noticeable improvement from July's 89k gain that sent the jobless rate to 4.3%. Even so, it will likely be a mixed jobs report overall with the unemployment rate popping back to 4.3%. The slowdown in job growth from Q1's hectic pace will still be quite visible in the three-month moving average. In short, the general theme from the latest economic tea leaves doesn't scream out for the need to aggressively scale-back monetary restriction. The U.S. economy and labour market appear to be doing just fine. We made no major changes to our forecasts for Q3 and Q4 GDP this week, and **still see Q3 GDP growth slowing to around 2.2% a.r., and Q4 GDP growth at 1.7%**, not far from the long-term potential growth rate.

U.S. Profits: The Epitome of Resilience

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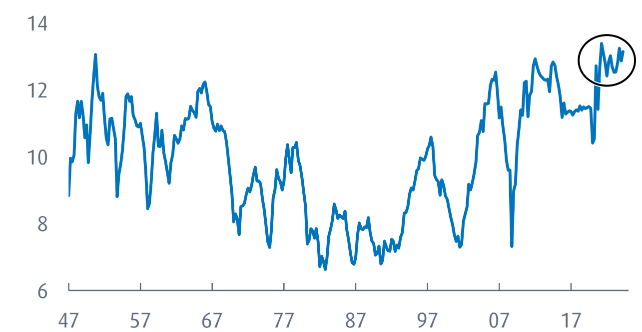
We learned this week that two underpinnings of U.S. consumer spending—income and savings—were ratcheted higher in the BEA's annual revisions. But a key pillar of business investment (and equity markets) also drew a swift upgrade. **Corporate profits (before taxes) rose 10.8% y/y in Q2**, nearly three percentage points faster than previously estimated. That's roughly twice as strong as the two-decade median (5.3%) as well as nominal GDP growth in the quarter (5.7% y/y). Profits as a percentage of GDP, a rough proxy for margins, have remained consistently high in recent years and even widened to 13.2% in Q2, just two tenths shy of the all-time peak (*Chart 1*). That's despite one of the most aggressive courses of monetary tightening in decades.

For domestic nonfinancial industries, profits jumped 12.5% y/y in Q2, extending a lengthy run of double-digit gains, with little sign of ebbing. **Leading the earnings parade are three industries:** machinery (35.8% y/y), information (30.6%), and retail (13.5%) amid strength in real nonresidential fixed investment (3.3%) and consumer spending (2.7%).

Chart 1
A Wide Margin of Profit
United States (s.a.a.r. : % of nominal GDP)
Corporate Profits[1]



Sources: BMO Economics, Haver Analytics, BEA *[1] before tax*

Supporting profit growth are two underlying drivers. The first is an economy that's still expanding at a healthy 3.0% y/y clip. The second is unit labour costs which are barely rising (0.3%) thanks to a pickup in labour productivity (2.7%) that has almost fully neutralized wage increases from impacting the bottom line.

Corporate earnings should remain healthy in 2025 as interest rates fall, even as some moderation is likely with nominal GDP growth expected to downshift to around 4%. With labour markets loosening, unit labour costs should stay in check even as productivity growth fades somewhat.

Profits are the well-spring of new jobs and investment. So long as earnings growth holds up reasonably well, hiring and spending should remain healthy, **keeping the soft landing on track**. Meantime, credit spreads could remain tight and the equity rally could have legs.

Canadian Economy: Fifty-Fifty on 50

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The Canadian economy continues to grind out sub-potential growth and, with inflation back at the 2% target, talk of more aggressive easing continues. Real GDP grew 0.2% in July, firmer than the flat initial reading from StatCan. Retail, wholesale and manufacturing were all up in the month, partly offset by small declines in mining and construction. That leaves year-over-year growth at a below-potential 1.5%, while the economy is also running with sub-2% annualized growth over the past three- and six-month periods. Importantly, the initial look at August shows that the economy was flat, which will leave **Q3 growth on track to meet our sluggish 1.3% call**.

Chart 1
Finding Neutral
Canada (percent)
Bank of Canada Real Policy Rate[1]

[1] *policy rate minus CPI inflation*
Sources: BMO Economics, Bank of Canada, Statistics Canada

For the Bank of Canada, this is shaping up to be a significant undershoot. Recall that the Bank had penciled in a hefty 2.8% jump for Q3 in the July MPR, so we're now even more confidently tracking well below that mark. That leaves us with inflation bang on the 2% target, growth running persistently below-potential and a job market that looks looser by the month—not a combination that would leave one wanting restrictive policy. At some point, debate about the landing level for rates will take over, but for now 4.25% (or 2.25% in real terms, which hasn't fallen yet because of the melt in inflation) is simply too high against a presumed 2.25%-to-3.25% neutral rate (Bank of Canada's view). **The near-term path for rates is decidedly lower**, and this run of data will keep a 50 bp rate-cut in play for October.

So here we are—we know how these cycles work: Policy is too loose; inflation breaks out; central banks scramble to tighten; inflation cracks; and, central banks respond with rate cuts, hopefully before the economy breaks too. The real question becomes, **are rate cuts coming early and fast enough to avoid the typical oversteering into a textbook recession?** We believe that will be the case in Canada as still-sluggish near-term growth drifts back up toward potential through 2025. The Bank of Canada's early start to the easing cycle, and the Federal Reserve's enthusiastic entry, will help.

Beyond the traditional playbook, torrid **population growth is a unique feature shaping this cycle**. There's fear out there that an abrupt slowdown in population growth will actually tip Canada into recession, but we'd urge otherwise. For one, incorrectly-calibrated inflows have immediately driven demand well in excess of our ability to match it with supply—think housing, transportation and services infrastructure. The impact was immediate inflation pressure that pushed interest rates higher than they otherwise would have been, for longer than they otherwise would have been. The flip side is that outsized inflows eventually drag on per-capita output, add slack to the job market, dampen wages and weigh on productivity. We might not be through that progression yet (see wage growth), but a 1.8 ppt increase in the unemployment rate (6.5 ppts for youth), has come entirely from the supply side.

All told, the market is about 50/50 right now on a 50 bp rate cut by the Bank of Canada in October. That detail will be ironed out soon, but the bigger picture is that we're on a quick path back to rates that are closer to, if not slightly below, neutral.

Take This… You'll Feel Better in the Morning

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Another week, another round of rate cuts.

Policy rates were being cut in **Switzerland**, **Sweden**, **Mexico** and **China** (well, China did a heck of a lot more… read Art Woo's insightful views) this week. The tone was widely dovish: the **Riksbank** (cut rates 25 bps to 3.25%) said that rates "*may also be cut*" at the two last meetings of the year, and one of those could be a 50 bp'er; the **SNB** (cut rates 25 bps to 1.00%) also gave clear forward guidance: "*further cuts… may become necessary… to ensure price stability*"; and, **Banxico** (cut rates 25 bps to 10.50%) expects the supply shocks that pressured noncore food prices will "*continue to dissipate in coming quarters*" and its "*evolution*" will allow for more rate cuts.

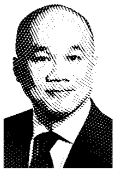
Then there's the **ECB**. It may be regretting its firm message made earlier this month that an October 17 rate cut is unlikely given that it won't have a lot of new information by then. This week, Germany was hit by quite a few negative indicators (such as rising joblessness, a 7-month low composite PMI, and problems gathering data), pointing to weaker growth. And, the group formerly known as the Five Wise Men now expects Germany's economy to shrink this year. In other words, that October meeting should be considered live at this point.

The dovishness is not shared by all policymakers. The **RBA** held its ground, keeping not just the cash rate at a 12-year high of 4.35%, but its hawkish tones. Underlying inflation "*remains too high*" and it will take "*some time*" before it returns sustainably to the target. But Governor Bullock seemed to want to play down the possibility of a rate hike, stating that the Board "*didn't explicitly consider an interest rate rise*" but their view hasn't changed from the last meeting. It's a bit confusing, but it left this observer with the impression that the hawkishness was being toned down.

All of this should be supportive for growth. Aside from notable areas such as Germany, most economies are still growing, albeit at a slower pace. In fact, the **OECD** just raised its 2024 global growth forecast to 3.2% (was 3.1% in May), and held to its 3.2% call for next year, on the back of easier monetary policy, slower inflation and the subsequent boost to incomes.

Bottom Line: The soft landing narrative is still in place.

China Steps Up Stimulus



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Following numerous calls for bolder policy support, China's authorities stepped up to the plate this week. But rather than rely on its old playbook of drip-feeding the economy with small and sporadic fiscal or stimulus measures, **Beijing brought out the big bats all at once in a coordinated effort to jolt confidence**. Although we doubt the latest array of measures will be enough to revitalize growth, it's clearly a step in the right direction.

The **three most surprising measures** were **direct central bank support for the stock market**, the **injection of capital into the big six state-owned banks**, and **cash handouts** (i.e., consumption vouchers) given out ahead of the Golden Week (7-day national holiday from October 1-7). Note that the latter has been a hotly debated topic since the pandemic began and suggests Beijing is keen to support consumer spending. Although official details on the total fiscal costs have yet to be unveiled, the announced measures are unlikely to bust the budget. Otherwise, the spate of monetary and macroprudential measures (cutting benchmark policy and mortgage rates and lowering the downpayment ratio to 15% from 25% on secondary home purchases) are squarely aimed at trying to stabilize the housing market.

The decision to ramp up stimulus was likely driven by four key developments: (1) housing prices continue to fall, (2) the job market is struggling, (3) corporate profits are under pressure, and (4) growing concerns that the trade war with the West could escalate. It's become more evident that the downturn in the housing market will not be easy to arrest, which is highlighted by the more rapid decline in existing housing prices of late, with the 70-city average declining 9.0% y/y in August. Although the urban unemployment rate, at 5.3% in August, does not appear overly concerning, it likely overstates the 'true' health of the labour market. More tellingly, the youth unemployment rate is hovering at 18.8%. Meanwhile, industrial profits, which were revealed just after all the measures were rolled out, plunged 17.8% y/y in August. And with the U.S. presidential election only weeks away, Beijing recognized that it needed to shore up the economy against the risk of higher tariffs being imposed on its exports, especially if former president Donald Trump is victorious.

Although the measures are encouraging news, **we remain concerned about the underlying health of the economy**. Growth has essentially been supported by the manufacturing/export sector, but this may not last for much longer as some of the recent strength could be related to importers trying to get ahead of impending tariff increases. More problematic is that turning around the housing market remains a big challenge, as the overhang of new housing stock will likely take at least a few more years to digest. We could not help but notice that recent estimates of presold-uncompleted housing units have risen immensely. Of note, the IMF stated in August that "*unfinished presold housing as of end-2023 amounted to eight times the 2023 annual completion rate*", equivalent to roughly 60 million units, according to our calculations.

Key Takeaway: China's beleaguered economy has received a much-needed shot in the arm. However, we do not believe Beijing's coordinated policy response will provide the economy much of a lift. Thus, we are sticking with our real GDP growth forecasts of 4.8% in 2024 and 4.5% in 2025.

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*Indications of stronger growth and a move toward price stability are **good news** for the economy.*

	Good News	Bad News
Canada ▪ BoC Governor Macklem sounds dovish ▪ Liberals survive non-confidence vote, but Bloc sets Oct. 29 deadline for demands	**Monthly Real GDP** +0.2% (July)—but StatCan estimates that August was flat **New Home Prices** unch y/y (Aug.)—good for shelter component of CPI	**Manufacturing Sales** -1.5% (Aug. A) **Wholesale Trade** -1.1% (Aug. A) **Job Vacancy Rate** falls to 3.0% (July) **Population Growth** +3.0% y/y (Q3)—slowing but still elevated **Ottawa** posted a budget deficit of $7.3 bln (Apr.-to-July)—vs. $1.2 bln deficit last year
United States ▪ Big upward U.S. GDP revisions in recent years ▪ Stocks hit record highs amid boosted hopes of continued GDP growth ▪ Government shutdown averted for now	**Real Personal Spending** +0.1% (Aug.)—and **Wages and Salaries** +0.5% **Core PCE Price Index** +0.1% (Aug.) **Real GDP** confirmed at +3.0% a.r. (Q2) **Core Durable Goods Orders** +0.2% (Aug.) **Chicago Fed National Activity Index** 0.12 (Aug.) **S&P Case-Shiller Home Prices** +5.9% y/y; **FHFA Home Prices** +4.5% y/y (July) **Pending Home Sales** +0.6% (Aug.) **Initial Claims** -4k to 218k (Sep. 21 week) **U of M Consumer Sentiment** edged up to 70.1 (Sep.) **Goods Trade Deficit** shrank to $94.3 bln (Aug. A)	**Conference Board Consumer Confidence Index** -6.9 pts to 98.7 (Sep.) **New Home Sales** -4.7% to 716,000 a.r. (Aug.)
China ▪ Beijing unveils a slew of stimulus measures		**Industrial Profits** -17.8% y/y (Aug.)—and up just 0.5% YTD
Japan ▪ Yen surges after LDP ruling party picks Shingeru Ishiba as next PM	**Services PMI** +0.2 pts to 53.9 (Sep. P)	**Manufacturing PMI** -0.2 pts to 49.6 (Sep. P)
Europe ▪ Inflation rates fall below 2% in France and Spain, adding pressure for an earlier ECB move ▪ SNB cuts 25 bps, and signals more to come ▪ Riksbank cuts 25 bps, does not rule out a 50 bp move next	**Euro Area—Adjusted Private Sector Credit** +1.6% y/y (Aug.) **Euro Area—Economic Confidence** -0.3 pts to 96.2 (Sep.) **Germany—Retail Sales** +1.8% y/y (July) **Germany—GfK Consumer Confidence** +0.7 pts to -21.2 (Oct.) **France—Consumer Spending** +0.2% (Aug.) **France—Consumer Confidence** +2 pts to 95 (Sep.) **France—Consumer Prices** slowed to 1.5% y/y (Sep. P) **Italy—Consumer Confidence** +2.2 pts to 98.3 (Sep.) **Spain—Consumer Prices** cooled to 1.7% y/y (Sep. P)	**Euro Area—Manufacturing PMI** -1.0 pts to 44.8; **Services PMI** -2.4 pts to 50.5 (Sep. P) **Germany—ifo Business Climate** -1.2 pts to 85.4 (Sep.) **Germany—Unemployment** +17,000 (Sep.) **U.K.—Manufacturing PMI** -1.0 pts to 51.5; **Services PMI** -0.9 pts to 52.8 (Sep. P)
Other ▪ OECD bumps up 2024 growth estimate to 3.2% (was 3.1%) ▪ A still-hawkish RBA stays on the sidelines ▪ Banxico eases policy 25 bps to 10.50%		**Australia—Consumer Prices** slowed to +2.7% y/y (Aug.)—but still too high

The Yield Curve… Again

The yield curve inversion garnered plenty of headlines and warnings of a U.S. recession. Now, it looks like a false positive as the economy steers a soft landing.

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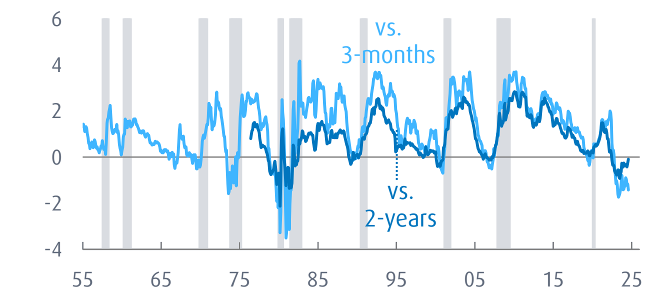
In recent weeks, two-year Treasury yields have been closing consistently below 10-year yields with September poised to average a positive spread (10y-2y) for the first time since flipping negative, or inverting, in July 2022. This un-inversion or 'reversion' of the yield curve is said to have recession-signalling ability akin to the curve's initial inversion 26 months ago. Below, we assess how well the yield curve has done in predicting economic downturns, via both inversions and reversions (*Chart 1*).

Chart 1
Inversions and Reversions

United States (ppts : monthly avg.)
10-year Treasury Yield Spreads



Shading marks U.S. recessions
Sources: BMO Economics, Haver Analytics, U.S. Treasury

Inversions revisited

Persistent yield curve inversions (i.e. 10y-2y averaging a negative value for at least one month) have occurred before the first month of the past five pre-pandemic recessions. The signal ranged from 11 to 23 months ahead, for an average of around 17 months (*Table 1*). So, **once the curve inverted in July 2022, the prediction was for a recession starting December 2023 and no later than June 2024**.

Table 1
Recessions and Inversions

	10-year less 2-year		10-year less 3-month	
Cycle peak	Inversion?[1]	Months to recession	Inversion?[1]	Months to recession
08/1957			No	—
04/1960			No	—
12/1969			Yes	13
11/1973			Yes	6
01/1980	Yes	17	Yes	15
07/1981	Yes	11	Yes	10
07/1990	Yes	19	Yes	14
03/2001	Yes	14	Yes	9
12/2007	Yes	23	Yes	17
02/2020 (pandemic)	No	—	Yes	9
Mean[2]		16.8		12.0
Median[2]		17.0		13.0
High[2]		23		17
Low[2]		11		6

[1] for at least one month on average; [2] pre-pandemic measures only
Sources: BMO Economics, Haver Analytics

We're still waiting for the downturn. Not only did real GDP grow at a 3.0% annualized rate in Q2 (and 3.0% y/y), but most of the six key monthly indicators employed by the NBER to date business cycles are still at their cyclical peaks. That includes nonfarm payrolls, real personal income less transfers, real PCE and real business sales. Admittedly, household employment peaked in November 2023 and is down a net 0.3% over the past nine months, while industrial production peaked in September 2022 and has slipped a net 0.4% over the past 23 months. On balance, **the economy appears to be far from an overall recession, arguing the recent inversion's signal was a false positive**, i.e., a curve inversion not followed by a downturn.

Historically, there has been only one other false positive signal. In June 1998, there was the briefest and near-smallest possible inversion, just one month averaging -2 bps followed by zero in July. Meanwhile, there have been no false negatives for the 10y-2y metric, i.e. a recession that was *not* signalled by an inversion. Although listed in the tables, we do not include the 2020 pandemic-driven recession in our assessments of the yield curve's downturn-signalling ability.

All told, yield curve inversions (10y-2y) sport a 71% success rate in predicting recessions since 1980, including the latest episode. However, 2-year notes started being issued only in 1976. For a longer and/or corroborating assessment of the yield curve's effectiveness in signalling contractions, **we look at the spread between 10-year yields and 3-month T-bill rates** (on a coupon-equivalent basis). Currently, the yield curve defined by these nodes (10y-3m) is still inverted at -82 bps.

Interestingly, the NY Fed's recession probability model is based on this metric, with last month's average inversion (-132 bps) implying 62% odds of a recession in the year ahead. Of course, this will be marked down owing to the Fed's rate cut. The key takeaway from the model… the greater the degree of inversion, the higher the risk of recession.

So, looking at the 10y-3m spread, an inverted curve has occurred before the first month of all seven pre-pandemic recessions since 1969 (*Chart 1 again*). The signal ranged from six to 17 months ahead, for an average of 12 months (*Table 1 again*). In the current episode, this metric inverted in November 2022, later than the 10y-2y metric because three-month tenors are more influenced by contemporaneous policy rates. **The consequent prediction was a recession starting November 2023 and no later than April 2024.** These dates were only a month or two away from what was heralded by the 10y-2y spread. But, like it, **this too was a false positive signal** (inversion but no recession).

Historically, there has been another false positive in 1966 along with two false negative signals (no inversion but recession) in 1957 and 1960. Unlike the 10y-2y metric, it didn't invert during 1998 (on a monthly average basis) but it did invert during 2019, which we are not counting owing to the pandemic. As such, the 10y-3m spread has a 64% success rate in predicting recessions since 1957 including the latest episode, with a 71% success ratio since 1980 (in line with 10y-2y).

Reversions introduced

Returning attention to the 10y-2y spread, persistent yield curve reversions, in which this metric averages a positive value for at least one month after an inversion, have occurred before only three of the last five pre-pandemic recessions. On those three occasions, the signal ranged from three to 10 months ahead for an average around seven months (*Table 2*). Interestingly, in the other two episodes in the early 1980s, reversion occurred within three months *after* the start of the downturn.

Reversion has also had one false positive signal, when the yield curve returned to a positive slope after an inversion's false positive signal in 1998. This results in a success rate of just 50% (not including the latest episode) as a leading recession indicator. Of course, the success ratio doubles focussing on the three most recent downturns, but this is a **rather small sample**. For the record, with reversion unfolding in September, this predicts a recession starting next April and by July 2025 at the latest. We'll jot it down in our calendar just in case.

Table 2

Recessions and Reversions

Cycle peak	10-year less 2-year: Reversion?[1]	10-year less 2-year: Months to recession	10-year less 3-month: Reversion?[1]	10-year less 3-month: Months to recession
08/1957			No	—
04/1960			No	—
12/1969			No[2]	—
11/1973			No[2]	—
01/1980	No[2]	—	No[2]	—
07/1981	No[2]	—	No[2]	—
07/1990	Yes	10	Yes	7
03/2001	Yes	3	Yes	2
12/2007	Yes	7	Yes	7
02/2020 (pandemic)	No	—	Yes	5
Mean[3]		6.7		5.3
Median[3]		7.0		7.0
High[3]		10		7
Low[3]		3		2

[1] for at least one month on average; [2] reversion eventually occurred, nearly all within three months after the recession's start; [3] pre-pandemic measures only

Sources: BMO Economics, Haver Analytics

For the 10y-3m yield curve spread, reversions have occurred before only three of the past nine pre-pandemic recessions. On those three occasions, the signal ranged from two to seven months ahead with an average of five months (*Table 2 again*). Also, in the four preceding episodes, reversions eventually occurred, nearly all within three months after the start of recession.

Meanwhile, there was one false positive signal in early 1967 after an inversion's false positive in late 1966. It did revert during 2019 after inverting but, again, we're not counting that one owing to the pandemic. In total, reversion of the 10y-3m spread has a 30% success rate predicting recessions but, like the 10y-2y metric, it's 3-for-3 in the small sample of the last three downturns.

This time is different

In the pre-pandemic period, the yield curve's power to predict recessions was strong since 1980 for inversions and since 1990 for reversions (forgiving the latter's dismal pre-1990 performance). However, 2022's curve inversions pointed to recession by 2024Q2, at the latest, which hasn't happened yet. We reckon the now-unfolding curve reversions (10y-2y this month, 10y-3m likely by early next year) face a similar 'false positive' fate. This is not completely surprising. Since the last 'true positive' signal during 2006-2007, a series of developments have **inherently flattened the yield curve, making it more prone to inversions and false positive signals**.

First, the long-run neutral policy rate, or 'r-star', has fallen meaningfully over time. For example, when the FOMC first began publishing its projection of the longer-run neutral rate in 2012 the median was 4.25%, which was in line with historic norms. The latest median published last week was 2.875%. Although up 50 bps from its low in 2022, it remains well below what it was at least a dozen years ago. To the extent the neutral policy rate guides market expectations of the profile for short-term interest rates over the coming decade, this major component of 10-year yields will be commensurately lower.

Second, the Fed's adoption of a formal inflation target in January 2012 helped shrink the 'all-in' inflation expectations that are embedded in long-term bond yields, both the expected level (now better anchored at 2%) and the perceived risk surrounding it.

Third, the Fed's quantitative easing (QE) efforts that began in the wake of the Global Financial Crisis started including Treasuries in March 2009. These large-scale asset purchases were skewed to longer-term maturities with the intent to pare the term premium and thus reduce longer-term yields relative to shorter-term rates. Although quantitative tightening (QT) efforts reduced the Fed's portfolio of Treasuries, it remained vastly larger than it was pre-QE (mirroring the shift from a scarce reserves system to an abundant reserves regime). Moreover, QT was conducted via not reinvesting the proceeds from maturing securities, not by outright sales, keeping a longer-term skew to the Fed's portfolio from fading too quickly. All told, this has likely exerted some persistent flattening pressure on the yield curve.

Bottom Line: The yield curve may no longer be as dependable a recession indicator as it used to be. But it's still worth watching.

Economic Forecast Summary for September 27, 2024

		2024				2025				Annual		
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2023	2024	2025
CANADA												
Real GDP	(q/q % chng : a.r.)	1.8	2.1	1.3	2.0	1.7	2.0	2.0	1.9	1.2	1.1	1.8
Consumer Price Index	(y/y % chng)	2.8	2.7	2.1	2.0	2.0	1.8	1.8	1.8	3.9	2.4	1.8
Unemployment Rate	(percent)	5.9	6.3	6.6	6.9	7.1	7.0	6.9	6.9	5.4	6.4	7.0
Housing Starts	(000s : a.r.)	245	250	252	252	255	260	263	260	242	250	260
Current Account Balance	($blns : a.r.)	-21.5	-33.9	-33.7	-35.0	-36.8	-39.2	-41.2	-42.8	-21.0	-31.0	-40.0
Interest Rates		(average for the quarter : %)										
Overnight Rate		5.00	4.92	4.42	3.92	3.42	2.92	2.50	2.50	4.77	4.56	2.83
3-month Treasury Bill		4.94	4.81	4.25	3.80	3.35	2.85	2.50	2.45	4.74	4.45	2.80
10-year Bond		3.43	3.58	3.15	2.90	2.85	2.80	2.75	2.70	3.36	3.25	2.75
Canada-U.S. Interest Rate Spreads		(average for the quarter : bps)										
90-day		-52	-66	-96	-81	-73	-91	-101	-82	-53	-73	-87
10-year		-73	-87	-80	-77	-75	-74	-72	-71	-60	-79	-73
UNITED STATES												
Real GDP	(q/q % chng : a.r.)	1.6	3.0	2.2	1.7	1.5	1.7	1.9	2.0	2.9	2.6	1.8
Consumer Price Index	(y/y % chng)	3.2	3.2	2.6	2.4	2.1	1.9	2.2	2.2	4.1	2.9	2.1 ↓
Unemployment Rate	(percent)	3.8	4.0	4.3	4.5	4.8	4.8	4.7	4.6	3.6	4.1	4.7
Housing Starts	(mlns : a.r.)	1.41	1.34	1.31	1.36	1.40	1.42	1.43	1.44	1.42	1.35	1.42
Current Account Balance	($trlns : a.r.)	-0.96	-1.07	-1.12 ↓	-1.13 ↓	-1.14 ↓	-1.15 ↓	-1.16 ↓	-1.17 ↓	-0.91	-1.07 ↓	-1.16 ↓
Interest Rates		(average for the quarter : %)										
Fed Funds Target Rate		5.38	5.38	5.21	4.63	4.04	3.79	3.54	3.29	5.10	5.15	3.67
3-month Treasury Bill		5.45	5.47	5.25	4.60	4.10	3.80	3.55	3.25	5.28	5.20	3.65
10-year Note		4.16	4.44	3.95	3.65	3.60	3.55	3.45	3.40	3.96	4.05	3.50
EXCHANGE RATES		(average for the quarter)										
US¢/C$		74.2	73.1	73.3	72.6	72.3	72.8	73.3	73.9	74.1	73.3	73.1
C$/US$		1.35	1.37	1.36	1.38	1.38	1.37	1.36	1.35	1.35	1.36	1.37
¥/US$		149	156	149	141	140	139	139	138	140	149 ↑	139
US$/Euro		1.09	1.08	1.10	1.11	1.11	1.12	1.12	1.13	1.08	1.09	1.12
US$/£		1.27	1.26	1.30 ↑	1.33 ↑	1.34 ↑	1.34 ↑	1.35 ↑	1.35 ↑	1.24	1.29 ↑	1.35 ↑

Blocked areas mark BMO Capital Markets forecasts; up and down arrows (↑↓) indicate forecast changes; spreads may differ due to rounding

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ISM Manufacturing PMI

Tuesday, 10:00 am

Sep. (e)	**47.0**
Consensus	*47.7*
Aug.	47.2

The **ISM manufacturing PMI** is expected to slip 0.2 points to 47.0 in September. New orders likely fell again after dropping to the lowest level in over a year in August. Meantime, production looks to dig deeper into contraction terrain and reach the lowest level since the onset of the pandemic. These two sub-indexes, along with gauges for new export orders and the backlog of orders, should suggest that demand is slowing. The employment index will likely underscore softening labour market conditions. Although the Fed kicked off its easing cycle with a 50-bp move, the manufacturing sector will likely stay subdued until rates come down meaningfully. — P.T.

ISM Services PMI

Thursday, 10:00 am

Sep. (e)	**51.6**
Consensus	*51.5*
Aug.	51.5

The ISM Services PMI is expected to tick up to 51.6 in September amid a slight improvement in new orders and business activity. Still, the rest of the details will likely remain lacklustre with order backlogs and supplier delivery times at low levels. The employment gauge, which is already teetering around the 50-mark, could slip into contraction terrain. While the services sector is still expanding, the PMI gauge suggests that the pace has slowed notably from the 2021 peak of 67.1 and remains below pre-pandemic trends. — P.T.

Nonfarm Payrolls

Friday, 8:30 am

Sep. (e)	**+150,000**
Consensus	*+130,000*
Aug.	+142,000

Unemployment Rate

Sep. (e)	**4.3%**
Consensus	*4.2%*
Aug.	4.2%

Average Hourly Earnings

Sep. (e)	**+0.3%**	**+3.8% y/y**
Consensus	*+0.3%*	*+3.8% y/y*
Aug.	+0.4%	+3.8% y/y

Nonfarm payrolls are forecast to increase by a moderate 150k jobs in September, a modest improvement from the August pace of 142k, which was an improvement on July's anemic 89K gain—the weakest of the year. The 3-month average pace should improve to around 127k jobs a month from 116k in August but remain well below the first quarter average of 267k. So far, job growth has cooled, but not cratered as catch-up hiring in health care and leisure & hospitality sectors wanes and businesses become more cautious in hiring due in part to election uncertainty. Bolstering our forecast for job growth is an improvement in initial jobless claims, which have been trending lower on a four-week moving average basis over the past seven weeks. The rebound in job growth should be a shallow one, however, as September consumer confidence sank by the most in three years, with consumers' views of the labour market dimming and inflation expectations rising. The September S&P Global PMI employment indexes were mixed with the manufacturing measure showing a worsening contraction, though the services metric did firm up. The **unemployment rate** may tick back up to 4.3% as it would only take three-hundredths of an increase from the August level to get there. Average hours worked are expected to hold steady at 34.3 hours. **Average hourly earnings** growth is forecast to increase 0.3% with the year-on-year pace holding at 3.8%. The report will help set market expectations around the November FOMC rate cut and whether it will be another outsized half-percentage-point move, or a more measured quarter-point cut. — S.A.

Financial Markets Update for September 27, 2024

		Sep 27 [1]	Sep 20	Week Ago	4 Weeks Ago	Dec 31, 2023
					(basis point change)	
Canadian	Call Money	4.25	4.25	0	-25	-75
Money Market	Prime Rate	6.45	6.45	0	-25	-75
U.S. Money	Fed Funds (effective)	5.00	5.00	0	-50	-50
Market	Prime Rate	8.00	8.00	0	-50	-50
3-Month Rates	Canada	4.00	4.03	-3	-15	-104
	United States	4.60	4.65	-5	-51	-73
	Japan	0.06	0.05	1	-4	27
	Australia	4.44	4.42	2	5	9
2-Year Bonds	Canada	2.93	2.93	0	-40	-96
	United States	3.63	3.59	3	-29	-62
10-Year Bonds	Canada	2.98	2.95	3	-18	-13
	United States	3.77	3.74	3	-13	-11
	Japan	0.84	0.84	1	-4	24
	Germany	2.14	2.21	-7	-16	12
	United Kingdom	3.99	3.90	9	-3	46
	Australia	3.96	3.92	4	-1	0
Risk Indicators	VIX	15.4	16.2	-0.8 pts	0.4 pts	2.9 pts
	Inv. Grade CDS Spread [2]	52	52	0	3	-4
	High Yield CDS Spread [2]	308	308	0	-17	-48
					(percent change)	
Currencies	US¢/C$	74.17	73.70	0.6	0.1	-1.8
	C$/US$	1.348	1.357	—	—	—
	¥/US$	142.84	143.85	-0.7	-2.3	1.3
	US$/€	1.1178	1.1162	0.1	1.2	1.3
	US$/£	1.341	1.332	0.7	2.1	5.3
	US¢/A$	69.31	68.07	1.8	2.5	1.7
Commodities	CRB Futures Index	284.63	282.39	0.8	2.7	7.9
	Oil (generic contract)	67.93	71.00	-4.3	-7.6	-5.2
	Natural Gas (generic contract)	2.86	2.72	5.3	34.6	13.9
	Gold (spot price)	2,651.83	2,621.88	1.1	5.9	28.5
Equities	S&P/TSX Composite	24,064	23,867	0.8	3.1	14.8
	S&P 500	5,758	5,703	1.0	1.9	20.7
	Nasdaq	18,185	17,948	1.3	2.7	21.1
	Dow Jones Industrial	42,519	42,063	1.1	2.3	12.8
	Nikkei	39,830	37,724	5.6	3.1	19.0
	Frankfurt DAX	19,461	18,720	4.0	2.9	16.2
	London FT100	8,325	8,230	1.1	-0.6	7.6
	France CAC40	7,795	7,500	3.9	2.2	3.3
	S&P ASX 200	8,212	8,209	0.0	1.5	8.2

[1] = as of 11:00 am *[2] = One day delay*

Global Calendar — September 30–October 4

	Monday September 30	Tuesday October 1	Wednesday October 2	Thursday October 3	Friday October 4
China	**Manufacturing PMI** / **Nonmfg** **Sep. (e) 49.4 50.4** Aug. 49.1 50.3 **Caixin Mfg PMI** / **Services** **Sep. (e) 50.5 51.6** Aug. 50.4 51.6 **Current Account Surplus** [D] **Q2 F (e) $54.9 bln** Q1 $39.2 bln	**Markets closed**	**Markets closed**	**Markets closed**	**Markets closed**
Japan	**Industrial Production** **Aug. P (e) -0.5% -1.5% y/y** July +3.1% +2.9% y/y **Retail Sales** **Aug. P (e) +0.5% +2.6% y/y** July +0.2% +2.6% y/y	**Jobless Rate** **Aug. (e) 2.6%** July 2.7% **Tankan Large Mfg Outlook** **Q3 (e) 12** Q2 14 **Manufacturing PMI** **Sep. F (e) 49.6** Aug. 49.8		**Services PMI** / **Composite** **Sep. F (e) 53.9 52.5** Aug. 53.7 52.9 **Consumer Confidence** **Sep. (e) 37.0** Aug. 36.7	
Europe	**GERMANY** **Consumer Price Index** **Sep. P (e) unch +1.8% y/y** Aug. -0.2% +2.0% y/y **ITALY** **Consumer Price Index** **Sep. P (e) +1.3% +0.9% y/y** Aug. -0.2% +1.2% y/y **UNITED KINGDOM** **Real GDP** **Q2 F (e) +0.6% +0.9% y/y** Q1 +0.7% +0.3% y/y	**EURO AREA** **Consumer Price Index** **Sep. P (e) unch +1.9% y/y** Aug. +0.1% +2.2% y/y **Core CPI** / **Services** **Sep. P (e) +2.7% y/y n.a.** Aug. +2.8% y/y +4.1% y/y **Manufacturing PMI** **Sep. F (e) 44.8** Aug. 45.8 **UNITED KINGDOM** **Manufacturing PMI** **Sep. F (e) 51.5** Aug. 52.5	**EURO AREA** **Jobless Rate** **Aug. (e) 6.4%** July 6.4% **ITALY** **Jobless Rate** **Aug. (e) 6.6%** July 6.5%	**EURO AREA** **Services PMI** / **Composite** **Sep. F (e) 50.5 48.9** Aug. 52.9 51.0 **UNITED KINGDOM** **Services PMI** / **Composite** **Sep. F (e) 52.8 52.9** Aug. 53.7 53.8 **DMP 1-Year CPI Expectations** **Sep. (e) +2.7% y/y** Aug. +2.6% y/y	**FRANCE** **Industrial Production** **Aug. (e) +0.4% -1.9% y/y** July -0.5% -2.2% y/y **Manufacturing Production** **Aug.** July -0.9% -3.0% y/y **ITALY** **Retail Sales** **Aug.** July +0.5% +1.0% y/y
Other	**AUSTRALIA** **Private Sector Credit** **Aug. (e) +0.5%** July +0.5%	**AUSTRALIA** **Retail Sales** **Aug. (e) +0.4%** July unch	**OPEC JMMC Meeting**	**AUSTRALIA** **Trade Surplus** **Aug. (e) A$5.4 bln** July A$6.0 bln	**AUSTRALIA** **Household Spending** **Aug. (e) +0.5% +2.7% y/y** July +0.8% +2.9% y/y

[D] = date approximate

Upcoming Policy Meetings | Bank of England: Nov. 7, Dec. 19, Feb. 6 | European Central Bank: Oct. 17, Dec. 12, Jan. 30

North American Calendar — September 30–October 4

	Monday September 30	Tuesday October 1	Wednesday October 2	Thursday October 3	Friday October 4
Canada	**National Day for Truth and Reconciliation (stock markets open; bond markets closed)**	**9:30 am S&P Global Manufacturing PMI** **Sep.** Aug. 49.5 **Auto Sales[D]** **Sep.** Aug. +5.6% y/y 11:15 am Cash management bond buybacks $0.5 bln	Noon 5-year bond auction $5.0 bln	**9:30 am S&P Global Services PMI** **Sep.** Aug. 47.8 2-year bond auction announcement	**10:00 am Ivey PMI (s.a.)** **Sep.** Aug. 48.2
United States	**9:45 am Chicago PMI** **Sep. (e) 45.4** *Consensus 46.4* Aug. 46.1 **10:30 am Dallas Fed Mfg. Activity** **Sep. (e) -14.0** Aug. -9.7 **1:55 pm Fed Chair Powell gives luncheon address at NABE conference** Fed Speaker: Governor Bowman (8:50 am) 11:30 am 13- & 26-week bill auctions $151 bln	**9:45 am S&P Global Manufacturing PMI (Sep. F)** **10:00 am ISM Manufacturing PMI** **Sep. (e) 47.0** *Consensus 47.7* Aug. 47.2 **10:00 am Construction Spending** **Aug. (e) -0.1%** *Consensus +0.1%* July -0.3% **10:00 am Job Openings & Labor Turnover Survey** **Aug. (e) 7,600k (-73k)** July 7,673k (-237k) **Autodata Total Vehicle Sales[D]** **Sep. (e) 15.5 mln a.r.** *Consensus 15.7 mln a.r.* Aug. 15.1 mln a.r. **9:00 pm Vice Presidential Election Debate** Fed Speakers: Atlanta's Bostic (11:00 am); Governor Cook (11:10 am); Atlanta's Bostic, Richmond's Barkin, Boston's Collins (6:15 pm) 11:00 am 4-, 8- & 17-week bill auction announcements 11:30 am 42-day cash management bill auction $70 bln 11:30 am 52-week bill auction $48 bln	**7:00 am MBA 30-year FRM** **Sep. 27** Sep. 20 6.13% **8:15 am ADP National Employment Report** **Sep. (e) +130,000** Aug. +99,000 **OPEC JMMC Meeting** Fed Speakers: Cleveland's Hammack (9:00 am); St. Louis' Musalem (10:05 am); Governor Bowman (11:00 am); Richmond's Barkin (12:15 pm) 11:30 am 17-week bill auction	**7:30 am Challenger Layoff Report** **Sep.** Aug. +1.0% y/y **8:30 am Initial Claims** **Sep. 28 (e) 220k (+2k)** Sep. 21 218k (-4k) **8:30 am Continuing Claims** **Sep. 21** Sep. 14 1,834k (+13k) **9:45 am S&P Global Services/ Composite PMI (Sep. F)** **10:00 am ISM Services PMI** **Sep. (e) 51.6** *Consensus 51.5* Aug. 51.5 **10:00 am Factory Orders** **Aug. (e) +0.5%** *Consensus +0.1%* July +5.0% Fed Speakers: Atlanta's Bostic, Minneapolis' Kashkari (10:40 am) 11:00 am 13- & 26-week bill, 3-, 10[R]-year note, 30[R]-year bond auction announcements 11:30 am 4- & 8-week bill auctions	**8:30 am Nonfarm Payrolls** **Sep. (e) +150,000** *Consensus +130,000* Aug. +142,000 **8:30 am Unemployment Rate** **Sep. (e) 4.3%** *Consensus 4.2%* Aug. 4.2% **8:30 am Average Hourly Earnings** **Sep. (e) +0.3% +3.8% y/y** *Consensus +0.3% +3.8% y/y* Aug. +0.4% +3.8% y/y **10:00 am Global Supply Chain Pressure Index** **Sep.** Aug. +0.20 Fed Speaker: New York's Williams (9:00 am)

[C] = consensus; [D] = date approximate; [R] = reopening

Upcoming Policy Meetings | Bank of Canada: Oct. 23, Dec. 11, Jan. 29 | FOMC: Nov. 6-7, Dec. 17-18, Jan. 31-Feb. 1

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