Talking Points

BMO Capital Markets®
We're here to help.™

The latest view on the economy May 18, 2018

Light my Bond-Fire of the Vanities

Douglas Porter, CFA, Chief Economist • douglas.porter@bmo.com • 416-359-4887

You know that it would be untrue, you know that I would be a liar, if I was to say to you, yields they couldn't get much higher. We often remind that the punchline of Aesop's fable *"The Boy Who Cried Wolf"* is that the wolf actually does show up one day (and eats said boy, after polishing off the local sheep). And, after forecasters seemingly cried wolf for years about the threat of rising interest rates, the wolf has finally shown up… and it's hangry.

This week saw yet another upward lurch in long-term North American yields, with the 10-year Treasury at one point reaching the highest level since 2011 at above 3.10%. That also just happened to be our year-end target, prompting a reset in the forecast, with the new call 3.25% (but next year's steady at 3.50%). Not to be outdone, Canadian 10-year yields also continued their long march higher, pushing above 2.50%, also close to our previous end-18 target (now 2.7%). While yields on both sides of the border took a small step back on Friday, the technical damage has been done, and both are still up a meaty 10 bps from a week ago.

Given that economic growth, inflation and wage gains haven't done anything particularly surprising this year, **the X-factor behind the yield surge has been the powerful rise in oil prices**. Brent pushed above US$80 at one point this week, WTI touched $72, and even the previously lacklustre WCS popped above $55. Put in perspective, these are all upwards of $15 above the Bank of Canada's assumptions employed in the latest MPR, which was released precisely one month ago. That is a very big change in a fundamental variable in a very short period of time.

As we discussed in greater detail in last week's Focus Feature, there are normally at least three economic and financial light switches that get thrown by such a pronounced move in oil prices: 1) the Canadian dollar, 2) the TSX, and 3) relative Canadian GDP growth. So far, those switches look like they are moving through cold molasses.

The loonie has actually weakened this year and even over the past month against the rapidly rising U.S. dollar amid no resolution on the NAFTA file (the May 17 "deadline" came and went with nary a whimper). The loonie has in fact made a strong run against other currencies, and is actually one of the firmer units in the past two months. But, the key point is that it is still down against the big dollar even with the remarkable recovery in Canadian oil prices. It even softened further on Friday to 77.5 cents despite reasonably firm March retail sales (+0.6%) and another small upward grind in core inflation (to just above 2.0% in April).

There was much fanfare over the 10-day winning streak by the TSX (which looked in small danger on Friday), as it received a nice lift from the comeback in energy. Over the past three months, the beleaguered index has managed to rise 4.5%, handily outperforming the S&P 500 (down 0.6% over that time frame), largely thanks to an 11.4% pop in the energy component. Yes, outperforming. But, alas, the index is still slightly underwater so far in 2018 after a tough start to the year, and the

fact that much of the energy surge represents a rebound from the extremely depressed conditions during the winter. Still, the sustained strength in oil prices provides very real hope that the long-standing relative underperformance of the TSX may finally be coming to an end.

However, the combination of the upswing in oil, the better tone to the TSX, and the still-competitive level of the loonie **has not moved the needle much on the relative Canadian economic growth outlook**. The latest consensus forecast, compiled just this week, shows a tiny uptick in this year's call to 2.1% GDP growth, but no change to 2019 at 1.9% (both are one tick above our call, while the BoC is at 2.0% and 2.1%, respectively). That still leaves Canada trailing far behind the expected U.S. average growth rate of 2.8% this year and 2.5% in 2019, even with the big added assist from rapidly rising oil prices. We would be remiss to not point out the helpful and huge move in lumber—a one-time stalwart of Canadian exports. Softwood prices have essentially doubled over the past year, soaring well above US$600 this week, easily smashing prior records.

For the Bank of Canada, this coincidence of events likely leaves it on the sidelines at the May 30 decision. While the strength in oil is a positive for the growth and inflation outlook, it seems highly unlikely to deliver the capital spending lift that would normally flow from such a move in crude. The latest pipeline headlines just served to remind all of the constraints on that front. Meantime, we have no clarity on NAFTA, and the housing sector may be living down to fears about the sensitivity of the economy to higher rates—April home sales fell almost 14% y/y and MLS prices are now barely positive on a yearly basis. Arguably, the rapid back-up in bond yields—and the pressure that could put on mortgage rates—will make the Bank even more cautious on further moves, given their well-advertised concerns about households' sensitivity to rising rates.

The title of this piece is a painfully obvious ode to American writer Tom Wolfe, who passed away this week. His *"The Bonfire of the Vanities"* was a seminal 1980s work, and it seems somehow very appropriate to focus on that novel this week (rather than, say, *"The Right Stuff"*). After all, recall that key player, Sherman McCoy, was a Wall Street bond trader. It's really too bad that Mr. Wolfe never had a chance to follow up with how Sherman fared during the 2007-09 financial crisis.

General Disclosure

"BMO Capital Markets" is a trade name used by the BMO Financial Group for the wholesale banking businesses of Bank of Montreal and its subsidiaries BMO Nesbitt Burns Inc., BMO Capital Markets Limited in the U.K. and BMO Capital Markets Corp. in the U.S. BMO Nesbitt Burns Inc., BMO Capital Markets Limited and BMO Capital Markets Corp are affiliates. This document is issued and distributed in Hong Kong by Bank of Montreal ("BMO"). BMO is an authorized institution under the Banking Ordinance (Chapter 155 of the Laws of Hong Kong) and a registered institution with the Securities and Futures Commission (CE No. AAK809) under the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong). BMO does not represent that this document may be lawfully distributed, or that any financial products may be lawfully offered or dealt with, in compliance with any regulatory requirements in other jurisdictions, or pursuant to an exemption available thereunder. This document is directed only at entities or persons in jurisdictions or countries where access to and use of the information is not contrary to local laws or regulations. Their contents have not been reviewed by any regulatory authority. Bank of Montreal or its subsidiaries ("BMO Financial Group") has lending arrangements with, or provide other remunerated services to, many issuers covered by BMO Capital Markets. The opinions, estimates and projections contained in this report are those of BMO Capital Markets as of the date of this report and are subject to change without notice. BMO Capital Markets endeavours to ensure that the contents have been compiled or derived from sources that we believe are reliable and contain information and opinions that are accurate and complete. However, BMO Capital Markets makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors and omissions contained herein and accepts no liability whatsoever for any loss arising from any use of, or reliance on, this report or its contents. Information may be available to BMO Capital Markets or its affiliates that is not reflected in this report. The information in this report is not intended to be used as the primary basis of investment decisions, and because of individual client objectives, should not be construed as advice designed to meet the particular investment needs of any investor. This document is not to be construed as an offer to sell, a solicitation for or an offer to buy, any products or services referenced herein (including, without limitation, any commodities, securities or other financial instruments), nor shall such Information be considered as investment advice or as a recommendation to enter into any transaction. Each investor should consider obtaining independent advice before making any financial decisions. This document is provided for general information only and does not take into account any investor's particular needs, financial status or investment objectives. BMO Capital Markets or its affiliates will buy from or sell to customers the securities of issuers mentioned in this report on a principal basis. BMO Capital Markets or its affiliates, officers, directors or employees have a long or short position in many of the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. The reader should assume that BMO Capital Markets or its affiliates may have a conflict of interest and should not rely solely on this report in evaluating whether or not to buy or sell securities of issuers discussed herein.

Dissemination of Research

Our publications are disseminated via email and may also be available via our web site http://economics.bmocapitalmarkets.com. Please contact your BMO Financial Group Representative for more information.

Conflict Statement

A general description of how BMO Financial Group identifies and manages conflicts of interest is contained in our public facing policy for managing conflicts of interest in connection with investment research which is available at http://researchglobal.bmocapitalmarkets.com/Public/Conflict_Statement_Public.aspx.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST

BMO Financial Group (NYSE, TSX: BMO) is an integrated financial services provider offering a range of retail banking, wealth management, and investment and corporate banking products. BMO serves Canadian retail clients through BMO Bank of Montreal and BMO Nesbitt Burns. In the United States, personal and commercial banking clients are served by BMO Harris Bank N.A., Member FDIC. Investment and corporate banking services are provided in Canada and the US through BMO Capital Markets. BMO Capital Markets is a trade name used by BMO Financial Group for the wholesale banking businesses of Bank of Montreal, BMO Harris Bank N.A, BMO Ireland Plc, and Bank of Montreal (China) Co. Ltd. and the institutional broker dealer businesses of BMO Capital Markets Corp. (Member SIPC), BMO Nesbitt Burns Securities Limited (Member SIPC) in the U.S., BMO Nesbitt Burns Inc. (Member Canadian Investor Protection Fund) in Canada, Europe and Asia, BMO Capital Markets Limited in Europe, Asia and Australia and BMO Advisors Private Limited in India.

"Nesbitt Burns" is a registered trademark of BMO Nesbitt Burns Inc., used under license. "BMO Capital Markets" is a trademark of Bank of Montreal, used under license. "BMO (M-Bar roundel symbol)" is a registered trademark of Bank of Montreal, used under license.

® Registered trademark of Bank of Montreal in the United States, Canada and elsewhere.

™ Trademark Bank of Montreal in the United States and Canada.

© COPYRIGHT 2018 BMO CAPITAL MARKETS CORP.

A member of BMO Financial Group